





2023 OUTLOOK FOR ALTERNATIVE ASSETS

2022 was a challenging year for stocks, bonds, US treasuries and most other asset classes. The S&P 500 entered bear market territory and stayed there throughout the year, and the correlation of stock and bond returns turned significantly positive. With a backdrop of high inflation and rising interest rates, bonds' lost their efficacy as a hedge for stocks in investment portfolios. Both asset classes posted negative returns for the year.



As we enter 2023, inflation remains elevated and the Federal Reserve's campaign to temper suggests 'higher for longer' rates. As such, volatility in the stock and bond markets appears likely to continue, giving alternative investments—which provide low to negatively correlated returns and diversification away from traditional assets—a key role client portfolios again in 2023. In this commentary, we share our outlook on specific alternative asset classes, the risks associated with certain illiquid assets, and our playbook for asset allocation in this space.

ILLIQUID ASSETS OUTLOOK

Equity	 POTENTIAL TAILWIND	 POTENTIAL RISKS
BUYOUT	<ul style="list-style-type: none"> • Corporate restructurings/asset stripping could boost cash positions and generate deal flow • Stressed companies could be ripe for an operationally-focused manager to deliver value • M&A tends to be cycle resilient 	<ul style="list-style-type: none"> • Rising interest rates create higher cost of debt, potentially reducing returns • Recession could negatively impact corporate earnings
GROWTH	<ul style="list-style-type: none"> • Significant valuation re-rating, particularly in growth and technology, could provide attractive entry points 	<ul style="list-style-type: none"> • Private valuations lag public markets by 2-3 quarters, exposing growth assets to additional valuation pressure under recession scenario • Tight capital markets could delay exit opportunities
VENTURE	<ul style="list-style-type: none"> • Earlier stage ventures less exposed to public market volatility • Innovation needed for productivity gains to offset labor shortages, demographics • Tech advancements to drive further discovery (ex. Machine learning) 	<ul style="list-style-type: none"> • Low interest rates and excess investor capital drove higher performance for most VC's recently, making manager and asset selection key going forward • Tight capital markets will make exiting more challenging; investors should prepare for longer duration

Credit	 POTENTIAL TAILWIND	 POTENTIAL RISKS
DIRECT LENDING	<ul style="list-style-type: none"> ● Bank lending and general credit extension tightening, allowing private credit to lead with preferred terms and higher coupons 	<ul style="list-style-type: none"> ● Floating rate and higher coupon has an inflection point where “good credit” becomes bad ● Interest coverage is currently healthy, but if corporate earnings slow it could strain ability to service debt
ASSET-BACKED LENDING	<ul style="list-style-type: none"> ● General tightening of credit increases ability to lead with higher rates and better terms ● Exposure to asset as opposed to general corporate credit adds diversification benefit ● Tends to be shorter duration and amortizing, reducing credit risk ● Can have structural enhancements for seniority 	<ul style="list-style-type: none"> ● In a default scenario, selling asset could be challenging if macro outlook deteriorates ● With acuteness of rate increase, assets could become stressed or lose value quickly
SPECIAL SITUATIONS/DISTRESSED	<ul style="list-style-type: none"> ● Tightening credit markets and potential for economic slowdown should increase opportunities 	<ul style="list-style-type: none"> ● Monetary policy could loosen later in 2023, leading to broader asset support and reducing duration of opportunities ● Stressed companies could become distressed



Real Assets	 POTENTIAL TAILWIND	 POTENTIAL RISKS
REAL ESTATE	<ul style="list-style-type: none"> ● Undersupply in multifamily ● Onshoring, reconfiguring supply chains ● Correlation with inflation 	<ul style="list-style-type: none"> ● Higher cost of debt ● Mean reversion in pricing due to rapid increase in asset values
AGRICULTURE	<ul style="list-style-type: none"> ● Elevated inflation ● Diminishing arable farmland reduces food supply ● Climate change reduces crop output, increasing prices ● Increasing cost of debt could cause distress for over-levered properties, creating opportunities ● Sustainable economy = less commodity-intensive 	<ul style="list-style-type: none"> ● Cost of debt could reduce returns ● Climate change could impact crop yields (hedging and insurance as mitigate)
INFRASTRUCTURE	<ul style="list-style-type: none"> ● Energy transition funding ● Contractual offtake producing stable yield 	<ul style="list-style-type: none"> ● Political risks ● Tech obsolescence ● High capex ● Crowded
OTHER REAL ASSETS	<ul style="list-style-type: none"> ● Hard asset-backed deals reduce downside risk ● Stabilized yield reduces capital at risk and portfolio volatility ● Tend to be correlated with inflation 	<ul style="list-style-type: none"> ● Unforeseen idiosyncratic risks

Hedge Funds



POTENTIAL TAILWIND



POTENTIAL RISKS

LONG/SHORT EQUITY

- Increased dispersion leaves room for manager alpha
- Short equity strategies should help mitigate downside volatility; higher rates provide short rebate

- Frequent swings in equities can challenge long/short strategies
- Investors may have to accept “losing less” in bear markets and focus on the relative value the strategy provides

CREDIT

- Interest rate volatility can lead to fund flows, allowing managers to actively trade
- Credit spread volatility lends well to security selection and arbitrage fund flows

- Credit spreads could widen further, generating mark-to-market losses
- Stressed companies could become distressed and illiquid

GLOBAL MACRO

- Interest rate, commodity, credit and equity volatility produce attractive environment for macro. These conditions are expected to persist.
- Volatile, sideways-trending markets

- Opportunity window could narrow with a quicker Fed pivot

EVENT-DRIVEN

- Corporate actions, M&A, divestitures, tight capital markets etc. generate activity, leading to broader opportunity set

- Soft landing occurs or Fed pivot could narrow window of opportunities
- Credit quality deterioration could generate mark-to-market losses

WE FAMILY OFFICE PLAYBOOK

In consideration of the potential tailwinds and risks described above, we are approaching alternative asset allocation with the following factors in mind.

Given the expected continued volatility and wide range of potential outcomes, the following are strategies one could consider to navigate the uncertainty:



Yield-oriented strategies providing income can mitigate expected equity and fixed income volatility.

Forward capital market assumptions creates relatively unattractive risk/return outlook for equities. We therefore believe that locking-in attractive yields reduces capital at risk and should add stability during volatile markets.

High yield bonds, although producing attractive yields, could be impacted in a recessionary environment due to credit risk and market beta.

- Diversifying yield strategies can help mitigate against uncertainty, allow diversification away from corporate credit risk, and reduce portfolio volatility.
- We recommend being flexible in fixed income and credit beyond ordinary investment grade and high-yield corporate bonds, looking also to loans, securitized credit, emerging markets debt, mortgages, corporate hybrid securities, semi-liquid credit markets, etc.



Real asset overweight can provide stabilized yield, serve as an inflation hedge, and capture structural tailwinds.

Here are a few areas of focus:

COMMODITIES: De-globalization appears likely to drive raw material hoarding, and the energy transition to renewables will also require significant raw materials to generate. 2022 made it clear that the transition will take time and cannot be executed without keeping fossil fuels as integral part of transition. Climate change and geopolitical risks could add volatility to food-based commodities.

INFRASTRUCTURE: Midstream projects and development needed to transport fossil fuels, and clean energy infrastructure is in nascent stage. Investments in these areas can provide long-term stable yields.

REAL ESTATE: Real estate tends to outperform post interest rate increases while allowing for diversification amongst macro factors. There may also be sources of inflation-linked rental adjustments. However, given the rapid increase in real estate values over the past couple years and subsequent acute rise in interest rates, it's important to be diversified by macro exposures. The following table illustrates some property types and their potential macro factor exposure:

PROPERTY TYPE	MACRO FACTOR
Multifamily	Employment, Household Formations
Retail	Employment, Consumer Spending, Consumer Credit, Consumer Confidence
Hotel	Employment, Consumer Spending, Consumer Credit, Consumer Confidence
Office	Business Cycle, Business Formations, Employment
Industrial	Business Cycle, Changing Supply Chain Routes
Self Storage	Demographic Trends, Employment

OTHER REAL ASSETS: Additional diversification to real asset portfolio and unique return streams, from maritime, aircraft, and mineral royalties for example.



Overweight global macro and long/short credit. With volatility expected to continue for the foreseeable future, hedge funds can cushion against drawdowns, take advantage of passive fund flows, and capture unique return streams while adding to portfolio diversification.

GLOBAL MACRO: Macro tends to outperform during periods of elevated equity, credit spread, currency, interest rate, and commodity volatility. With expected volatility and sideways trending markets, macro should continue to outperform.

LONG/SHORT (LS) CREDIT: LS credit offers a low volatility approach to holding bonds and loans, offering a hedge to eroding credit quality, arbitraging passive fund flows, and credit selection.



Investing in innovation. Demographics and aging population produce need for innovation across many sectors, including manufacturing, healthcare and tech.

- Aging demographic with low immigration will require greater levels of efficiency and productivity.
- Covid-19 also spurred a wave of onshoring and rethinking of global supply chains, shifting focus from "just in time" to "just in case".
 - Both will require technological innovations in manufacturing.
- Aging demographic and advances in machine learning continue to produce new opportunities in biotech.

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Selective focus on assets/strategies with tailwinds. As always, manager selection is key, as is the need to target strategies seeking capitalize on longer term trends.

- Manager selection. Over the previous few years, many managers enjoyed markets in which returns were fairly easy to come by. As we enter a higher rate, lower growth, less liquid environment with higher asset price dispersion, investors will discover how good managers actually are.
- Focus on strategies that have tailwinds seeking to capitalize on longer- term themes and trends. Healthcare, for instance, made up 18.3% of GDP in 2021, and is projected to be near 20% in 2028¹ with an aging population. Meeting the rising demand will require innovation, onshoring and adjustments to supply chains. The energy transition and onshoring of manufacturing and supply chains will also require new investment.

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Opportunistic credit can provide a countercyclical balance to portfolio. With a hawkish Fed and sticky inflation, a prolonged higher rate environment should produce a longer window of opportunities both domestically and abroad.

- While credit dislocation funds performed fairly well in the early days of Covid, the opportunity set was a narrow window due to monetary policy and significant investor dry powder.
- Tightening of credit in capital markets and traditional lenders create opportunities for stricter terms, higher coupons, OID and fees.
- Diversify from traditional US corporate credit, casting a broad net across US and Europe, corporate credit, asset-based credit, structured credit and others.

¹ Source: <https://www.cms.gov/research-statistics-data-and-systems/statistics-trends-and-reportsnationalhealthexpenddata/nhe-fact-sheet>

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