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MONEY MANAGER INTERVIEW

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Using Alternative Investments to Reduce Portfolio Volatility

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SECTOR — GENERAL INVESTING

(AHW505) TWST: Why don't we start with an overview of the company?

Mr. Kennedy: My partner and I built the practice back at Morgan Stanley. We were both alternative investment directors at Morgan Stanley and managed money for high net worth, ultra high net worth families along with institutions. Back in 2020, we launched the firm with a simple premise that we could do the same thing we were doing for institutions for high net worth retail investors. So we like to say we help individuals invest like institutions.

TWST: And why now might be people looking at alternative investments based on what's going on with the market and the economy?

Mr. Kennedy: That's a great question. First of all, alternatives are designed to work in any environment. Private credit, private real estate, private equity. We feel those are allocations that should be in all portfolios. But specifically, when markets aren't doing well or are doing poorly, alternatives serve as a bit of a buoy within the portfolio that can hold the rest of the portfolio up during a storm.

So if you look at a year like 2022, although the stock market did very poorly, most hedge funds were up, most private credit was up, private real estate took a big hit, private equity took a big hit. But the portfolios that had alternative exposure tended to fare a bit better than your typical 60/40 portfolio, 60% stocks, 40% bonds.

TWST: There's concern by a lot of people in the public markets about volatility. There are so many events going on geopolitically. It's an election year. The Federal Reserve could be changing rates. So might all of those factors together lead to people looking at private investments?

Mr. Kennedy: Yes. Our clients are people that have made it. Many of them are qualified purchasers; someone with $5 million in assets or more. And they get access to, really, the gamut of the private investments out there. That type of client does not want to be 100% reliant on the stock market going up to be successful from a portfolio management standpoint.

What we try and do is build out portfolios that aren't 100% reliant on the market doing well in order for that portfolio to do well. Again, we'll use things within the alternative universe that don't have a high correlation to stocks and bonds.

Your typical adviser will look at risk just through a market risk lens. They'll say, if this person wants to be conservative, I'm not going to give them a lot of exposure to stocks, and I'll put the rest in bonds. We think that while that's an OK way to manage money, if you can get into alternative investments, if you have the net worth that meets the requirements for most of them, there's just a better way to do it. Lower market risk doesn't necessarily mean lower return.

So, when you can add tools such as hedge funds, private credit, private real estate, private equity, you can avoid the market risk within the portfolio. In other words, not be as susceptible to market drawdowns while keeping the return somewhat attractive. So the alternative, again, is if you don't want to take market risk, most advisers will put you in bonds, and that usually equates to a lower return over time.

TWST: Could you explain what private credit is?

Mr. Kennedy: Absolutely. So, private credit is simply like the private version of a bond. If a public company wants to raise money, they have a lot of different ways to do that. They can go out to the public equity markets and issue equity. They can go out and issue bonds. Private credit is simply debt taken by a privately owned company that doesn't have access to the public markets. This is done by the private company going out to a fund, a private credit manager, and taking a loan out.

We like first lien debt right now within the private credit realm, which basically means it's an asset-backed loan and you have first bite at the apple should anything happen to that company. Typically, it's backed by some sort of hard asset, whether it be inventory or real estate or something that the company owns — sometimes it's intellectual property or patents, things like that.

We look for 50% loan-to-value or less, meaning the asset backing the loan is worth 2X the loan value or more.

Because rates are higher right now and most of these loans are floating rate, you can get really attractive returns within the private credit realm that we feel will keep up with the equity market with much less volatility.

For instance, look at the Cliffwater Direct Lending Index, which is like the S&P 500 to private credit. Going back to 2005, the return has actually kept up with the U.S. stock market with much less volatility; a ~3.5% standard deviation versus ~16.5% standard deviation for U.S. stocks.

“When you’re in a long-only strategy, totally exposed to stocks, when there is a market pullback, you’re going to deal with some volatility. These multi-strategy hedge funds are designed to outperform, really, in all environments.”

TWST: And I understand private real estate is another sector that you look at. Could you explain how that works?

Mr. Kennedy: Yes. So, private real estate was nothing short of a bloodbath throughout 2022 and 2023 when rates went from 0% to 5%. Across the board, real estate valuations were impacted in a big way.

We feel that that created a lot of opportunity out there and that there will be somewhat of a recovery in certain sectors of private real estate. Not all. We would still avoid office, simply because we feel like there’s some structural issues that have changed office altogether as an asset class, like the work-from-home movement, the regional banking crisis, that sort of thing.

Areas we like within real estate right now, we really like logistics. So, the logistics sector is basically real estate that is supply chain oriented. We prefer last mile logistics, which makes it possible for one- and two-day shipping for most companies.

Ten years ago, one- and two-day shipping was a competitive edge for some companies. We feel like today it’s not a competitive edge. It’s something that you need as part of doing business. There’s still a ton of infrastructure that needs to be built out around last mile logistics.

On top of that, supply chain onshoring is taking place. There’s entire supply chains that need to be built out, since things are coming back onshore, which creates a lot of demand for logistics. When real estate was beat up, logistics was also beaten up. And again, we look at it as a baby that was thrown out with the bathwater.

TWST: So, some of these properties might be at or near airports, or they could be near metropolitan areas, so that they’re closer to the point of where things need to be delivered?

Mr. Kennedy: Correct. That’s why they’re called last mile.

TWST: And in the future we might get more organizations wanting same-day delivery to really give them a competitive edge over other companies in their sector.

Mr. Kennedy: Yes. Again, we feel that that’s a need that’s not going to be going away anytime soon. And the delivery time is getting shorter and shorter. It used to be two-day shipping for Amazon. Now it’s one-day shipping. And to your point, I think it’s going more and more to same-day shipping. So there needs to be an infrastructure that supports that.

We like that infrastructure a lot. One, because it’s necessary for a company to do business, to have that real estate in place. It’s a necessary piece of their business that’s not going anywhere. The rent is stable because of that. Two, the property appreciates over time.

Now, you do have some corrections within that asset class, simply because it is a real estate asset. And when interest rates go up, you’re going to feel it across the board. But that would be the opportunity that we pounce on when real estate gets hit, because rates have gone up.

TWST: I understand you also look at multi-strategy funds, and there are a few of them. Maybe you could explain the different ones you use?

Mr. Kennedy: A multi-strategy fund is a type of hedge fund. There’s lots of different types of hedge funds out there. Long/short hedge funds, where they’ll bet on stocks going up, they’ll bet on stocks going down. There’s quantitative hedge funds; they use algorithmic trading. There’s statistical arbitrage that will take advantage of inefficiencies. A multi-strategy hedge fund has all of the above under one roof.

They’ll typically have between 100 to 200 trading teams within one organization. So it’s more like a small corporation designed to suck money out of the markets rather than just a fund. They’re usually market-neutral, meaning they’re not reliant on the market to go in any one direction to make money. Yet most of them have an investment guideline that they want to keep up with the S&P 500, usually with about a third of the volatility.

So, the goal is to give you stock market-like returns with less volatility over time, which our investors tend to like because they don’t have to deal with the large drawdowns.

When you’re in a long-only strategy, totally exposed to stocks, when there is a market pullback, you’re going to deal with some volatility. These multi-strategy hedge funds are designed to outperform, really, in all environments. So it’s what we call an all-weather approach, meaning they’re supposed to perform in any market environment.

TWST: And I understand the hedge funds that you’re using also trade stocks and bonds.

Mr. Kennedy: Yes. Again, most of these multi-strats will have a long/short component to them, and all that means is they’ll go long on certain stocks or bet certain stocks are going to appreciate over time, and they’ll short other companies, betting certain stocks are going to go down over time. And by having that bi-directional toolkit that allows them to outperform in more environments than your typical long-only manager.

We also keep a close tab on what these funds are doing to give us some insight into the overall markets. We’ll look at net exposure. So how exposed are these funds at any given moment to the market? That gives us a good idea of what the institutional dollars are doing at any one point. And it helps us size positions within the long-only portion of our portfolio, the stock portion of our portfolio.

TWST: And the private equity funds that you are involved with, they rely on the IPO markets?

Mr. Kennedy: They do. Private equity is simply an asset class in which investors own privately held companies. Private equity managers go out and buy a stake within a privately held company. What they'll try and do is have that company appreciate in value to sell it down the road.

"But when you look at some of the regional banks, we still think office has yet to really play its way through the system. Some of these commercial real estate loans could end up hitting regional banks. Now, whether or not that's systemic or not, I think, is anybody's guess."

So much like a stock manager will go out and buy a basket of stocks and hope they appreciate over time, a private equity manager will go out and buy a basket of privately held companies, and not just hope they'll appreciate over time, but actually execute within the company to try and add value, whether that be changing management or merging the company with another privately held company.

Typically, there's much more of a hands-on approach with these private equity managers than there is with some of your long-only stock managers. When you're a long-only stock manager and you're buying stocks, there's only so much you can do to influence that company's value. You're really buying it just based on your research.

When you're a private equity manager, you can have a direct impact on the company that you're buying, simply because you usually have greater control of that company in the private markets. You can go out and again do things like change the management, merge with another company, add a product line, change supply chain, decrease expenses, etc. There's a lot you can do to add value over time.

The end goal for any private equity firm is to eventually take that company public or sell the company to another private equity firm or company. If you can take the company public, usually that's a large payday. It's a liquidity event that allows the private equity manager to exit the position and get a payoff. That or sell to another private equity firm down the line. But the IPO markets are a great exit strategy for most of these private equity players.

During 2022 and 2023, the IPO markets were largely turned off, simply because rates were so high and valuations got hit hard. Private equity firms were impacted by rates moving so high. They're reliant on debt. They go out, they borrow money to buy some of these privately held companies. So, when rates go up and the cost of debt goes up, they feel it, which means they're not going to jump at the IPO markets at a bad valuation.

TWST: And typically your clients will hold not only these alternative investments, but also publicly traded equities?

Mr. Kennedy: Correct. So, we'll typically have anywhere between 20% to 50% in long-only stocks. Where we differ from other advisers is the allocation that typically goes to bonds we will allocate to alternative investments. So we absolutely still have stock exposure in the portfolio.

We believe in the U.S. economy, we think the stock market is a great asset class over time. We just don't think it's the only tool you should have within your portfolio. We absolutely still have exposure to stocks.

We tend to use separately managed accounts versus mutual funds. So, separately managed accounts, you go out and you own the individual stock. When the manager picks the portfolio for you, your cost basis is at the individual stock level rather than owning an overall mutual fund.

The reason why we like it is it's very tax efficient. When you own individual stocks, you can tax-loss harvest at the end of the year, sell your losers against your winners. When you own a mutual fund, you can't do that at the end of the year. You either sell shares of your mutual fund or you don't.

So it's more effective, in our opinion, to have separately managed accounts within taxable accounts where you can tax-loss harvest. You can also monitor the portfolio a bit better since you can see the names at any given day on what that manager is going to own, whereas within the mutual fund, you just see XYZ mutual fund within that account.

TWST: You said that your clients' portfolios are $5 million and above. What's on their minds now with the economy and with the different risks that are out there?

Mr. Kennedy: A lot of our clients are cautious right now. Again, most of them have worked very hard to make their money over time. The last thing they want to do is take on a lot of risk, particularly in the stock market, to grow their wealth. They need to keep their wealth and grow it.

Most of them are pretty cautious with everything going on in the world right now. When you look at the geopolitical landscape, I think we've had, or we're currently in, probably the highest stress environment since the Cold War era.

When you look at China, there's major problems with their economy structurally. I think Xi Jinping just came out and he's thinking about making it a matter of national security to talk badly about the economy. It kind of tells you what's going on underneath the surface.

And then here at home, even though we've avoided recession up to this point, we still believe that there's a few legs that have not fallen yet within the U.S. economy.

Currently, the markets are strong. The job market has been very resilient. But when you look at some of the regional banks, we still think office has yet to really play its way through the system. Some of these commercial real estate loans could end up hitting regional banks. Now, whether or not that's systemic or not, I think, is anybody's guess.

And on top of that, usually when you have these rate tightening cycles where rates go as tight as they did over the last two years, from zero up to 5.25, that takes a while to work its way through the system. The typical rate hike is, what, 12 to 18 months to when you fully see it baked into the economy. So I think that we haven't really seen the full effect of those rate hikes hit the economy yet.

Most of them are cautious because of everything going on, everything that I just went through.

TWST: As your clients age, they need money in their retirement years. People are living longer, and some of their wealth might be inherited by their heirs or be passed on to some kind of a charitable organization. Do you think their heirs are ready to take the responsibility of handling this kind of wealth?

Mr. Kennedy: It's funny you ask about that because we spend a lot of time working with the children of our clients, simply because when you inherit a lot of wealth, it can be a curse. It really can.

"We tend to use private credit as our number one income strategy for retirees. And then what we'll do on top of that for market exposure is use the market-neutral hedge funds that we talked about earlier. Those are designed to give market-like returns with less volatility."

When you inherit a certain amount of money and there's no real expectations for you going forward after that, it can really rob you of things in life. When you have to go out and earn a living and work towards something, that really creates a person, in my opinion. So when that's taken away from you because you inherit a bunch of money and you don't have to go do those things, it can be difficult.

So we spend a lot of time with our clients' children, kind of teaching them about markets, teaching them about the portfolio and that sort of thing. But then, more importantly, having them work with a trust and estate adviser to make sure everything's set on that end. Sometimes, we'll have them work with a career coach to make sure that they're going out and being a productive person within society, even though they're going to inherit a lot of wealth at some point.

So there's different avenues that we'll take to connect with the kids of our clients. But yes, that's definitely a focus for us to work with the children of our clients and make sure that they're ready to inherit this sort of wealth at some point.

TWST: And people are living longer, and they do need to prepare for those later years if they're not working.

Mr. Kennedy: I think you're referring to financial planning. And yes, we do have a financial planning component of the practice. While most of our clients have more than enough money to handle retirement and health care, we look at some insurance solutions more from tax planning than protecting against health care expenses and that sort of thing.

We'll look at the cost of health care, obviously. You know the cost of health care has gone up dramatically on top of inflation, and we'll factor that into the income models that we put together for retirement.

But that's really as far as we take it within the financial planning tool, factoring in the cost, making sure that our clients can pay for it accordingly. And more than often, the answer is yes when you're dealing with this type of wealth.

TWST: So people might retire when they're 65 or 70, but they can easily live another 30 years now. And to keep the same lifestyle, it might mean that they have to have investments that are well thought out and rewarding.

Mr. Kennedy: Yes, absolutely. And again, that goes back to the way we design portfolios. So when you're living off your portfolio in retirement, even if you're a high-net-worth person— let's say you have a $5 million portfolio and you have a quarter million dollar a year need for living expenses — well, that portfolio needs to generate that.

And if it's within the stock market, the stock market is going to go through periods where it's flat for a long period of time. A lot of people think about the last 10 years and the bull market run that we've been on, and that's great. But many forget that the market can be flat for decades at a time.

Look at the late '60s into the early '80s, the last time inflation reared its ugly head. Look at 2000 to 2013. If you invested $100 in the S&P 500 in 2000, you didn't get back to even until 2013 and you had two 50% corrections along the way.

So what we try and do for that particular client, again, is not just diversify within the stock market, but diversify with the tools that we just talked about, because they need the money to last them the next 30 years and they don't want to deal with the volatility of markets.

Private credit, going back to what we were discussing earlier, is a great solution for income. So if you're getting market-like returns within private credit with monthly or quarterly distributions, to us, we view that as a very powerful income generator within a portfolio.

And then when you look at the risk aspect of it, the first lien debt, which we tend to home in on, you get first bite at the apple should anything happen to these companies, meaning that if the private credit fund does have a default, does have a company go under, and they need to go claim the asset, they get first bite at that asset.

When you look at the Cliffwater Direct Lending Index, the default rates are less than 1%. And the recapture rate on that 1% is usually 75% or higher. So, what I mean by that is, OK, well, if you give 100 loans out and you have a 1% default rate, one goes belly up. And then of that 1%, 75% of that value is recaptured when you go and sell the asset that backs that loan. So, for us, the risk/return is just really attractive.

We tend to use private credit as our number one income strategy for retirees. And then what we'll do on top of that for market exposure is use the market-neutral hedge funds that we talked about earlier. Those are designed to give market-like returns with less volatility. So we feel like that's a good one-two punch within a retirement portfolio.

Now, managers will come and go. So it's our job to make sure that we keep close tabs on these managers and know what changes are happening within any particular fund at any given time. And if a material change happens that goes against our investment thesis with that fund, we need to make changes within the portfolio. So that's one of the few downsides of investing in alternatives.

Over the long run, changes will have to be made within any given strategy since they are actively managed. So you need someone that's going to keep a close tab on these managers and hold their feet to the fire and make sure that if they aren't delivering, that you're switching them out of the portfolio.

TWST: Anything else that we haven't talked about that you care to bring up?

Mr. Kennedy: I know we talked a little bit about private equity. I think there's a lot of great opportunities in private equity right now. Going back 35 years, the Cambridge Associates U.S. Private Equity Index has given you a ~14% annual return compared to the S&P 500 with a ~9% annual return during the same period.

With the IPO markets being largely frozen in 2022 and 2023, you didn't see many deals getting done. So if I'm a private equity firm and I know that, OK, right now, the public markets are not rewarding small companies, if you don't have a way to exit that company at the end of the day, it makes it very difficult to make an investment not knowing what the exit strategy is.

Now that the IPO markets are starting to open up, as the perception is that rates are going down, we think that private equity companies have a great opportunity to go after some of these beaten down companies and pick them up at great valuations.

There was a big reset in valuations throughout 2022 and 2023 in the private equity landscape because, one, they're working with small companies, and two, private equity in general is reliant on the cost of debt. Where if you're a private equity firm now with fresh dollars coming in, you could really take advantage of that reset and pick up some attractive companies.

We think that the landscape is going to change going forward. Beforehand, when rates were at zero, much like the public stock market, the private equity market, any company would work as long as it had a growth story behind it. If it had loose fundamentals, but a 20-year growth story in front of it, it could still work for investors. Investors would still go after it because it was growth at all costs when rates were at zero.

Now that rates have gone to 5%, we think those days are done. The story companies are behind us. We feel like it's much more about quality going forward. Fundamentals matter in a big way. And just like the public markets, private equity companies can now focus on those quality companies, and those sorts of strategies should do well going forward, in our opinion.

TWST: Thank you. (ES)

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