Can Alternative Assets Reduce Retirement Income Worry?

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Whether tried and true (REITs) or hot and new (Opportunity Zones), advisors are looking to alternative investments to address market volatility

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Major financial media outlets recently reported a break in the inverse relationship between stocks and bonds, something that contributed to fourth-quarter pain in 2018 according to the Wall Street Journal. What rises together potentially falls together, rendering traditionally safe havens ineffective in times of market turmoil, and more advisors and investors are taking notice.

With traditional assets classes moving in tandem, the need for new strategies that act independently of stocks and bonds is increasingly critical.

The level of investor risk is compounded by the sequence of returns, something with which advisors are acutely aware. The dangers of retiring into a down market are well-documented, and damage done to retirement income from lower investment returns is further aggravated by the withdrawal of assets for everyday living expenses—thus making it harder to fully recover losses from the eventual rebound.

Morningstar and many others warn of low expected returns in the near future, and the proverbial perfect storm now exists for advisors to introduce alternative investments as a possible solution.

These non-correlated investments, whether tried and true (Real Estate Investment Trusts—REITs— hedge funds, private equity) or hot and new (Opportunity Zones) can potentially offer better risk-adjusted returns over time—something that fits with investors' longer-term retirement income objectives.

Certain liquidity issues aside, there's increasing interest in the benefits they provide, yet there's also confusion about what alternative investments are and how they work.

While more than half of advisors (65%) are comfortable with alternative investments, nearly as many (55%) cite this investor confusion as the reason for a lack of alternative uptake, according to Cerulli Associates.

Yet Cerulli also notes significant adoption, which presents an opportunity for advisors to differentiate themselves, especially for those that take time to understand, explain and incorporate alternative investments in their product and service offerings.

Non-traded REITs, in particular, have proven adept at delivering alternative sources of retirement income, as have hedge funds and private equity.

But due diligence in the form of a comprehensive and transparent "look under the hood," as well as a greater advisor awareness of new products and trends, is essential to achieving optimal client outcomes.

Here's why.

Retirement Income from Real Estate

The potential to produce income, along with typically lower correlations with the broader stock market, are just two advantages REITs offer. As an asset class, they've outperformed gold, oil, the S&P 500, bonds and the EAFE index on an annualized basis for the 20 years ending December 31, 2018, as cited by Financialadvisoriq.com in August.

A non-traded REIT typically has lower volatility and correlation due to its absence from an exchange, and new entrants to the REIT space are offering more institutionally priced products to advisors. Additionally, investors no longer need $1 million or even $100,000 to get in, which is a product evolution for managers, and now a matter of building awareness with advisors.

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Advisors with a retirement income focus are currently looking for yield and a somewhat stable net asset value (NAV). As a result, they're closely watching the REIT's "life cycle," where a non-traded REIT performs well enough, and gathers enough assets, to warrant a listed version. At that point, many advisors will sell and reinvest in another non-traded REIT to ensure consistent yield, and the life cycle repeats itself, a trend that is expected to continue.

One area of advisor concern with alternative investments in general, is their lack of transparency, traditionally an Achilles heel to greater utilization. It's something that product innovation, and many managers themselves, are addressing, specifically related to fees.

Research firms dedicated to transparency and education are helping advisors lift the hood by analyzing most non-traded REIT's strategy, product type, where they reside in the life cycle, the type of real estate in which they're invested (residential property versus commercial property), how are they categorized and more.

Outsized Opportunity

Recent real estate innovation related to REITs is the advent of Opportunity Zones, economically distressed communities that encourage new investment through favorable tax incentives (such as the reduction or even elimination of capital gains tax).

Created by the Tax Cuts and Jobs Act in late 2017, both the community and investment must meet certain qualifications; for example, investor capital must be committed for five, seven and 10 years to receive full or partial tax benefits.

In the vein of win-win, assets can be pooled in Opportunity Zone funds, an alternative investment getting attention. Investors with a financial windfall or recent liquidity event can reinvest the proceeds within 180 days to mitigate federal taxes, while encouraging job creation and economic growth in the communities in which they invest.

One criticism, however, is their complexity, specifically related to Internal Revenue Service (IRS) and the limited guidance provided so far. A second set of proposed regulations—meant to assist in defining terms and clarification of certain operational procedures within the zones themselves—was released in May, with advisors, accountants and tax specialists still digesting its intent.

But with more than $2 trillion in gains yet to be realized, according to Washington, D.C.-based think tank Economic Innovation Group, interest in their potential impact and ability to attract assets is rapidly increasing (from CNBC.com, May 6, 2019).

Hedge Fund Help

Once open only to institutions, hedge funds (and hedging strategies) are now more accessible to the investing public.

One reason is that—-like other areas of the advisor industry—they're increasingly subject to fee compression, and the 2% and 20% management/performance fee structure is no longer the norm.

Creativity in how they charge is also increasingly seen, with some instituting lower management fees but higher performance fees if the manager high-water marks are exceeded.

Traditionally offered in a limited partnership format, hedging strategies are now available as managed accounts, customized portfolio solutions and liquid alternatives to offer investors different options in how they're accessed. Regardless of how advisors are looking to invest in alternative investments there are platforms that exist to help customize the experience with reporting and manager due diligence tools while providing access across a suite of different products. CAIS and iCapital are just two firms that work with advisors in this way.

Hedge funds' role in retirement income, specifically, is dependent on several factors, including capital preservation through increased diversification and reduced volatility, as well as periodic payments, which serve as an alternative source of current income and tax efficiency.

Private Equity's Public Appeal

A major trend in private equity is more opportunity, simply because more companies are now private. According to Bloomberg.com, there were 50 percent fewer public companies listed on U.S. stock exchanges in 2017 than 1997.

And while private equity is getting a lot of attention—both positive and negative—it's hard to argue with performance.

J.P. Morgan Asset Management found that in the 15 years through the end of 2017, private equity generated a 14.4% net annual return versus 8.8% for the MSCI World equity index, reported by Forbes.com.

Like other alternative asset classes, it can be an effective diversifier that can generate solid relative returns.

Indeed, recent research from Georgetown University's Angela Antonelli found that including even a conservative private equity allocation in retirement strategies can increase median retirement income by 6% (or higher) for certain investors. Importantly, improvements in downside protection were also reported.

Traditionally opaque about its inner workings, private equity is also now more transparent, driven by asset managers' desire to reach mass-affluent investors. Advisors that are looking to allocate more funds to private equity also face fewer operational barriers to entry than in previous years.

Ultimately, the current market environment presents an opportunity for advisors to revisit the benefits of including alternative investments in a properly diversified portfolio, potentially leading to lower volatility, higher risk-adjusted returns and, consequently, more retirement income for the investors with whom they work.

Advisors that are considering the use of alternatives should ask themselves who might benefit from a particular solution, and a thorough look at the underlying investments—what they are and how they work—is central to the due diligence process.

It's critically important to explain the recommended asset class, potential risks and rewards, the tax structure and fees, and to clearly set expectations to avoid unwanted outcomes.

Between the investment manager and other third parties that specialize in alternative investments, there is a wealth of resources available to help.

To learn more about Pershing's Alternative Investment Solutions, visit pershing.com or Resources within NetX360®.

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