By Tyler Wilton

Balancing liquid and illiquid alternatives

Understanding each strategy's benefits and drawbacks, and getting the mix right

Alternative asset classes, such as real estate and infrastructure, have historically featured specific attributes relative to traditional stocks and bonds, such as uncorrelated returns and diversification. However, investing in alternatives can present challenges in certain market environments depending on the degree of liquidity. For example, right now the investment community is combatting the impact of the COVID-19 global pandemic, which has raised concerns for investors with exposure to both illiquid and liquid alternatives. The unprecedented economic, social and political toll felt from COVID-19 has resulted in dramatic volatility for publicly traded liquid investments while at the same time restricting access to capital locked up in illiquid investments. As such, investors need to understand and prepare for events such as this.

Within the financial adviser community, "illiquidity" can be a sensitive topic, primarily based on the fear of telling clients they cannot immediately access illiquid investments. Investors who attempt to "time the market" with regards to balancing liquid and illiquid exposures may not be able to implement decisions in a timely manner. As such, a thorough investment plan should be put in place before investing in alternatives, while accounting for individual client objectives, goals and constraints.

Alternative investments typically require additional layers of due diligence in comparison to traditional stocks and bonds. It is important to understand the rationale of investing in liquid and illiquid alternatives. First off, the alternatives realm is not clearly defined, so for simplicity sake, we will focus on "real asset classes," which generally consists of real estate and infrastructure. Broadly speaking, the value proposition of real asset classes is primarily based on investing in tangible essential economic assets.

A SIMPLIED VIEW

For simplicity, the following research and opinions are in context of investing in the real estate market, as it is generally a well understood and mature alternative asset class with both liquid and illiquid investment options. Importantly, the views expressed are meant to apply across the alter-

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natives realm, and not solely real estate. We will specifically look at how investors access the real estate market and what are key considerations when seeking a balance between liquid and illiquid exposure.

Investing in the United States real estate market is generally achieved through two avenues — private markets ("illiquid") and public markets ("liquid"). An investor who chooses to gain exposure through private markets (invest directly in physical real estate assets) comes with illiquidity and are likely to have their capital tied up or restricted for a number of years until the investment plays out. The other option is to invest in public markets via listed real estate stocks, commonly referred to as REITs (real estate investment trusts). Publicly traded real estate stocks are typically more liquid as one can trade these on a daily basis. The listed market is comprised of publicly traded equities that own and operate income-producing commercial real estate.

For several decades, real estate investments have been a common and important component of institutional and retail high-net-worth portfolios, providing unique exposure to an essential asset class that has displayed defensive characteristics. However, the type of real estate exposure can vary drastically when accessed through liquid or illiquid channels. Like any investment, there are positive and negative traits to consider.

Direct (illiquid) real estate has clear benefits and potential drawbacks.

- Direct investments may require significant resources, time and expertise to properly reap the full benefits of a long-term allocation to physical real estate assets.
- While unique cases exist, the investable universe of the private market is somewhat limited in scope, which is where the public market can play an integral role in enhancing an overall portfolio.

Similarly, listed (liquid) real estate has positive and negative aspects.

- Public REITs may serve as a liquid complement or possible substitute for private real estate.
- In addition, REITs offer investors access to a broader array of specialty property, which may provide additional tactical opportunities over the course of a market cycle.
- However, public markets have exhibited greater volatility due to general stock market gyrations and interest rate sensitivity.
- Return dispersion is evident at a sector and individual stock level, providing diversification and opportunity for active managers. We believe there is greater potential for active managers to gain an information advantage when dealing with specialty assets classes, such as real estate.
- Importantly, listed real estate has historically behaved similar to direct real estate over the long term. This is based on the premise that both public and private markets derive underlying cash flows from commercial real estate.

These characteristics, along with a range of opportunities and strong historical returns, warrants consideration for a real estate allocation in a well-diversified portfolio. Investors might benefit from a combination of public and private real estate investments. For investors with an existing strategic investment in private real estate, it could make sense to consider adding exposure to listed REITs.

HOW THE MARKET CAN IMPACT YOUR EXPOSURE

Real estate may potentially offer investors many benefits, including diversification beyond traditional equities and fixed income, attractive growth prospects, and a strong income profile. However, returns only tell one side of the story. When considering volatility, risk-adjusted returns for illiquid markets might appear more stable compared with liquid markets largely due to lower historical volatility in private markets. In the case of direct real estate, properties are appraised to determine values. For public markets, REIT valuations may at times be more influenced by the broader stock market and economic environment. Appraisal-based valuation typically lags the public market, leading to "smoother" valuations and less volatility. Direct real estate valuations tend to respond slower during recessionary periods due to the appraisal nature compared to listed real estate.

Lower volatility within the private market compared to public markets has influenced historical returns. Despite direct real estate generally showing favorable risk-adjusted returns, specifically in periods of market stress, listed real estate may offer benefits. Some of the primary benefits include its liquid nature, no time lag for deploying capital, and being able to gain exposure to sub-sectors that are usually hard to access in private markets. In addition, investors may see publicly traded real estate stocks trading below the net asset value of comparable assets in the private space, thus presenting a potential attractive arbitrage opportunity.

Private real estate generally provides exposure to the four "traditional" property types — apartments, office, retail and industrial. In addition to these traditional sectors, public real estate provides potential exposure to less traditional "niche" sectors, thus increasing diversification across a larger number of property types and individual assets that are managed by dedicated and experienced real estate professionals. Niche REIT sectors now account for a sizable portion of the public real estate universe, a notable shift from 10 years ago. Among these niche sectors are manufactured homes, student housing, single-family rentals, healthcare, hotels, data centers, self-storage, cellular towers, net lease, prisons and gaming.

Broadly speaking, traditional sectors have historically generated returns through contracted rental income and potential capital appreciation. While niche and traditional sectors share similarities, these niche property types can introduce unique, uncorrelated risk and return drivers. Lastly, access to niche sectors provide additional tools for actively managed strategies depending on the economic environment.

Within the real estate market, cyclicality factors can impact performance to varying degrees based on property type, location and quality. Historically, there are notable differences in how property types respond to macroeconomic conditions. By incorporating niche sectors, public markets can display traits that may help offset disruptions within more traditional sectors.

In certain time periods, niche sectors have exhibited a lower correlation to GDP compared to traditional sectors. Thus, one could make the case that nontraditional sectors could produce lower returns in a rising GDP environment, but present some downside protection in a declining GDP environment relative to traditional sectors. For example, hotels are most sensitive to economic growth given the sector's reliance on the health of the overall economy, while self-storage has strong secular tailwinds and is a shorter lease-duration sector, which allows cash flows to adjust more rapidly to a changing environment.

While we focused on real estate in this article, the same overall point can be applied across other alternative investments, such as infrastructure. In general, for investors with significant illiquid exposure, there may be liquid complements to improve liquidity. If private markets are not a feasible option, there are listed real estate and infrastructure funds available to strategically add to an alternatives sleeve.

Alternative investments are inherently complex and inefficient, at times, requiring a deep understanding of what ultimately drives returns from both a fundamental perspective and a broader top-down macroeconomic perspective. Liquid alternatives may offer all types of investors an opportunity to gain exposure to unique markets, and can provide a suitable complement to illiquid alternatives. A balance between illiquid and liquid alternative asset classes may provide long-term investment opportunities over the course of a full market cycle.

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A HOLISTIC SOLUTION TO LIQUID ALTERNATIVES

Liquid real assets are becoming increasingly popular for both retail and institutional portfolios, which encompasses global real estate, global infrastructure, commodities and natural resource equities. We have also seen a trend for holistic and dynamic liquid real asset solutions, which may act as the standalone liquid alternatives sleeve or a complement to existing illiquid real assets.

From an asset allocation perspective, it can be difficult for investors to understand how to construct an alternatives allocation given the complexities and the need to understand how various asset classes work together. A dynamic and holistic liquid real assets allocation may provide a one-stop solution for a resilient alternatives portfolio that takes into consideration various risk and return drivers across the real asset market.

As advisers and investors look to reduce the number of complex investment options, liquid real assets can offer exposure to multiple asset classes. Liquid alternative investments may appeal to plan sponsors and investors who are bearing larger expenses, such as administrative and advisory fees. Also, with an ever-increasing focus on compliance, a single holistically managed liquid real assets solution may be an attractive opportunity to reduce both the cost and complexity of compliance and client reviews. A liquid real asset solution can assist investors in gaining exposure to real assets, while also managing the potential of capital calls and distributions associated with illiquid markets. As such, liquid real assets should warrant consideration. ■

Tyler Wilton is vice president and liquid real assets specialist **DWS Group.**

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