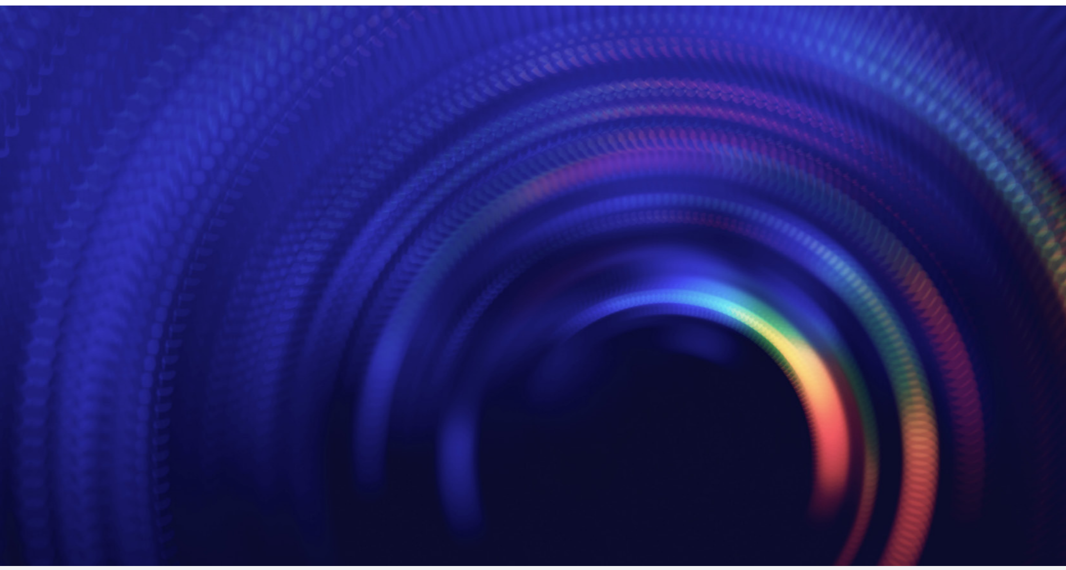
Morgan Stanley

INVESTMENT MANAGEMENT

Portfolio Construction with Alternative Investments



ALTERNATIVE INVESTMENTS | 2025

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In recent years, investors and advisors have started to rethink portfolio construction. This has been driven by an era of low interest rates, dissatisfaction with the diversification of publicly traded portfolios, and the substantial growth of alternative investments, including private equity, private credit, hedge funds and real assets. Investors who remain exclusively invested in public equity and fixed income securities are vulnerable to various risks, some of which can be mitigated by diversifying into alternative investments.

Key Takeaways

- Alternative investments are becoming mainstream, with 92% of surveyed advisors holding allocations in client portfolios. Typical allocations range between 6% and 25%.
- Alternative investments can overcome the shortcomings of the 60/40 portfolio, increasing income, reducing downside risk, enhancing diversification and hedging against inflation.
- While each investor has unique circumstances, most investors don't require liquidity in 100% of their portfolio. Evergreen funds, including tender offer funds, provide access to alternative investments with potentially greater liquidity than drawdown funds. Evergreen funds allow for the democratization of alternatives, as they are available to a wider audience than drawdown funds.

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The 60/40 Portfolio

Many investors still exclusively allocate to publicly traded assets. The most famous portfolio is the 60/40 portfolio, which allocates 60% to publicly traded equities and 40% to publicly traded fixed income.

This portfolio was once derived from the global market portfolio, which is the mix of the market capitalization of all global asset classes. In recent years, this market portfolio has evolved and is now invested 43.8% in global equities, 42.6% in fixed income (about half in government bonds and half in credit), and 13.6% in other assets, primarily private equity and real estate.[1] Its popularity may be related to Bengen's rule, which simulated the safe portfolio withdrawal rate that provides income to retirees with a low probability of the investor outliving their assets.[2] The safe withdrawal rate was initially set at 4% of assets and was expected to increase annually in line with inflation. Bengen's research was published in 1994, when Treasury interest rates exceeded 5%, making it easier for retirees to live off the income from their portfolio. It is challenging to meet this spending requirement in times of lower rates.

Unfortunately, stock and bond returns have become more highly correlated since 2022, as the higher interest rate environment has simultaneously weakened stock and bond returns. That is, investment-grade bonds have recently been unable to play the role of portfolio protection they have historically played. One of the key vulnerabilities of the 60/40 portfolio is that both stocks and bonds earn below-average, and even negative, returns during times of rising interest rates and rising inflation.

DISPLAY 1

The Vulnerabilities of the 60/40 Portfolio

The 60/40 portfolio has at least six different vulnerabilities:

Lower-than-desired returns	Lower-than-desired income	Declining diversification over time
Incomplete access to investment opportunities	Higher-than-desired maximum drawdowns	Vulnerability to rising inflation and interest rates

DISPLAY 2

Correlation of Returns to Inflation

60/40 PORTFOLIO	S&P 500 INDEX	BLOOMBERG AGGREGATE BOND INDEX
-0.22	-0.15	-0.42

Correlation of returns to U.S. CPI inflation: 2002-2024

[1] Dec. 2021 update of Doeswijk, R., Lam, T., and Winkels, L., 2014, "The Global Multi-Asset Market Portfolio, 1959-2012", Financial Analysts Journal 70 (2), pp. 26-41.

[2] Bengen, William P. (October 1994). "Determining Withdrawal Rates Using Historical Data". Journal of Financial Planning: 14–24.

ADDRESSING THE VULNERABILITIES OF THE 60/40 PORTFOLIO WITH ALTERNATIVE INVESTMENTS

The vulnerabilities of the 60/40 portfolio can be directly addressed through allocations to alternative investments. Private equity investments seek to offer higher returns than public equity indices. Private credit investments can increase the income potential relative to public fixed-income securities.

While stocks and bonds have negative exposure to inflation, real asset strategies such as real estate and infrastructure tend to have a positive exposure to inflation. Downside risk may be mitigated when portfolios include hedge funds, managed futures, structured products or option overlay strategies.

DISPLAY 3

Rolling Correlation of Stock and Bond Quarterly Returns, 2002-2024

Rolling two-year correlation between quarterly total returns of the S&P 500 and Bloomberg Aggregate Bond Indices, 2002-2024.

DISPLAY 4

Desired Portfolio Outcomes Sought by Each Type of Alternative Investment

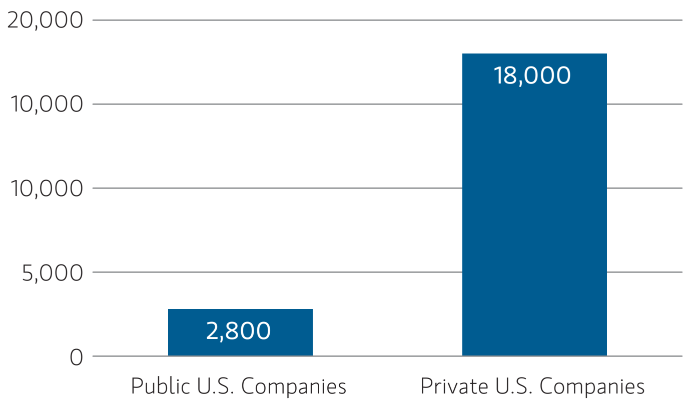
RETURN ENHANCEMENT	DIVERSIFICATION AND DOWNSIDE RISK PROTECTION	INCOME ENHANCEMENT	INFLATION PROTECTION
▪ Private Equity and Venture Capital ▪ Cryptocurrencies and Digital Assets	▪ Hedge Funds and Managed Futures ▪ Structured Products and Options Overlays	▪ Private Credit ▪ Royalties and Alternative Income	▪ Real Estate ▪ Infrastructure ▪ Commodities and Natural Resources

Private Equity

Morgan Stanley research[3] shows that 2,800 publicly traded companies are listed in the U.S. equity market with annual revenues exceeding $100 million, but there are 18,000 private companies with similar revenue.

DISPLAY 5

Publicly Traded vs. Privately Held U.S. Companies with Revenues Over $100 Million



Source: Morgan Stanley Private Markets

Companies are also staying private longer, with the average age of companies floating IPOs rising from 4.5 years in 1999 to 12 years today. Since 2000, the number of companies traded on U.S.-listed stock markets has declined from approximately 7,800 to 4,800. Because companies are staying private longer, the assets committed to and invested in private equity continue to grow faster than public market AUM, rising from $2.05 trillion in 2014 to over $5.7 trillion in 2024. This indicates that investors who exclusively allocate to public equity do not have exposure to the full universe of investments in U.S. companies.

Private equity investors may wish to focus on investing in lower-middle-market companies. The large number of companies in this sector presents opportunities to potentially acquire companies at lower levels of valuation, while also offering greater opportunities to add value through operational improvements. The smaller size of these companies may enhance exit opportunities, as the lower price can attract a larger number of potential buyers.

ACCESS THROUGH DRAWDOWN FUNDS: Historically, private equity has been accessed through drawdown funds, which were available primarily to institutional investors and qualified purchasers. Drawdown funds typically require large minimum investments and holding periods as long as ten to twelve years. Investors will need to continually allocate to newly offered private equity funds to achieve vintage year diversification and to stay invested over long time periods. In compensation for this liquidity risk, private equity investors in drawdown funds, also known as limited partners (LPs), have substantially outperformed public equity investors over long periods. This outperformance has been termed an illiquidity premium, where investments in illiquid assets have historically outperformed those in liquid assets.

Since 2002, the S&P 500 has generated a total return of 9.4%, while private equity buyouts have earned average annual returns of 14.3% (PitchBook).

SECONDARIES AND CO-INVESTMENTS: Investors may be able to further enhance returns through co-investments, while secondary private equity transactions typically have a shorter time to exit and lower volatility compared to primary funds. Co-investments allow investors to make direct investments in portfolio companies outside of the private equity fund structure. Co-investments offered to LPs by GPs typically charge lower fees, as the GP seeks to attract investors to reduce the size of the investment held in the fund.

Limited partners may choose to sell their interests in a private equity fund without waiting for the GP to distribute the proceeds of exited portfolio company investments. By offering their interests in the secondary market, LPs can seek liquidity but may need to sell at a discount to net asset value to access it. Investors may be able to purchase secondaries at a discount to NAV and avoid the fees paid while the original investor held the fund. This mitigates the J-curve, where returns tend to be lower early in the private equity fund's life as capital calls are made, then accelerate exponentially.

ACCESS THROUGH EVERGREEN FUNDS: Today, accredited investors have access to alternative investments through evergreen funds, including tender offer funds for private equity. These funds are available to purchase on a regular basis without requiring the GP to launch a new drawdown fund. Tender offer funds can offer vintage year diversification and potentially greater liquidity than drawdown funds, as the GP may offer regular or irregular redemption opportunities for investors via share repurchasing. Investors seeking liquidity can participate in the tender offer, while those wishing to remain invested can continue to hold for longer periods.

[3] https://advisor.morganstanley.com/scott.altemose/documents/field/s/sc/scott-a--altemose/MS-PM-2024.pdf

Private Credit

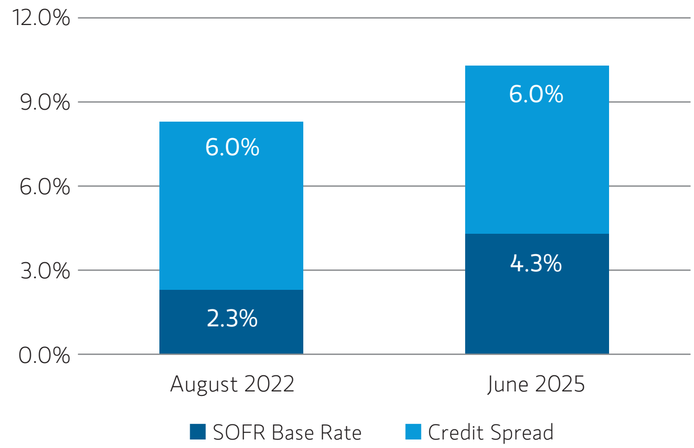
PitchBook data shows that private credit investments reached over $1.8 trillion by the end of 2024, more than double the level of 2016, demonstrating the tremendous demand for private credit from both borrowers and investors. Banks have reduced corporate lending as a result of regulations enacted after the global financial crisis. Private credit can provide capital to small and medium-sized companies that no longer have access to bank credit.

Private credit investments are very different from those of the Treasury, agency, and investment-grade corporate debt tracked by the Bloomberg Aggregate Bond Index. While the Index tracks fixed-rate investment-grade bonds, private credit loans are typically floating-rate and non-investment-grade.

Floating-rate private credit loans have low duration and interest rate risk, as coupons are reset on a quarterly or semi-annual basis. During times of rising rates, private credit is likely to outperform the Bloomberg Aggregate Bond Index, which has a duration of 5.8 years. For example, the Index lost 15% of its value from the first to third quarters of 2022, a time when private credit earned positive returns. Investors prefer to have exposure to longer-duration portfolios during times of declining interest rates and to shorter-duration and floating-rate credit during times of rising interest rates. While fixed-rate bonds decline in value as interest rates rise, the rates on floating-rate loans are reset to the market rate on a regular basis.

DISPLAY 6

Example of Floating-Rate Loan Coupon



Due to the differences between private debt and the Bloomberg Aggregate Bond Index, private debt allocations are not recommended to be sourced exclusively from investment-grade credit allocations. Investors moving assets to private debt should consider funding the allocation from high-yield corporate bonds or balancing funding between equities and investment-grade fixed income.

While private debt has historically earned higher returns than high-yield bonds, a case can be made that private debt is less risky than high-yield bonds. Many private loans are floating-rate, collateralized, and come with strong covenants. High-yield bonds tend to be fixed-rate and uncollateralized, which can result in both higher credit risk and interest rate risk compared to many private credit loans.

Accredited investors can access private credit through drawdown funds, while evergreen funds provide potential quarterly liquidity.

Real Estate and Infrastructure

Stocks and bonds tend to underperform during periods of high and rising inflation, with the S&P 500 Index's returns showing a correlation to inflation of -0.15 and the returns to the Bloomberg Aggregate Bond Index showing a correlation to inflation of -0.42. Real assets, such as real estate, infrastructure, commodities, or oil and gas, tend to exhibit positive exposure to inflation. Adding real assets to a portfolio tends to mitigate the negative impact of inflation on stocks and fixed-income holdings.

Historically, stocks and bonds earned their highest returns when inflation was in the lowest quartile of CPI observations. Conversely, real assets earned strong returns when inflation was in the highest quartile of CPI observations. Because real assets have an opposite exposure to inflation than stocks and bonds, adding real assets to a portfolio adds substantial diversification, likely reducing portfolio volatility and drawdowns, especially during times of rising inflation and rising rates, such as 2022. There is little cost to this diversification strategy, as the long-term returns to real estate, infrastructure and private debt are similar to the S&P 500 Index.

Real asset investments can be accessed in both public and private markets. Investors can purchase REITs or infrastructure stocks. Infrastructure and real estate can also be accessed through private equity-style drawdown funds and evergreen vehicles. These funds can vary in their risk exposure, ranging from the lowest risk core funds to medium-risk core-plus funds and higher-risk value-added and opportunistic funds.

Advisors are encouraged to understand the total financial picture of each of their clients. Many high-net-worth clients hold one or more income-earning real estate properties. Before adding real asset exposure through either public or private markets, each client's existing investment properties should be considered as part of the asset allocation.

DISPLAY 7

Asset Returns and Inflation

QUARTERLY RETURNS	12 MO. CHANGE IN CPI	BLOOMBERG AGGREGATE BOND INDEX	S&P 500 INDEX	REAL ESTATE	OIL & GAS	COMMODITIES	INFRASTRUCTURE
Low Inflation	0.6%	1.4%	4.3%	0.2%	-0.8%	0.4%	2.6%
Medium Inflation	2.3%	0.8%	3.7%	3.2%	4.8%	-0.3%	3.9%
High Inflation	5.2%	0.2%	-0.6%	3.9%	6.0%	1.3%	3.3%
All time periods (Q4 2003-Q4 2023)	2.6%	0.8%	2.7%	2.4%	3.7%	0.3%	3.4%

Exposure of asset classes to the 12-month change in CPI inflation. Q4 2003-Q4 2023. Bloomberg Aggregate Bond Index, S&P 500, Bloomberg Commodity Index, PitchBook indices of private real estate, oil and gas, and infrastructure funds. The low and high inflation scenarios each include 25% of all calendar quarters of sorted inflation, while the medium inflation scenario includes 50% of all calendar quarters.

Hedge Funds and Managed Futures

By their nature, hedge funds are not designed to outperform an equity market index during a bull market. That is, hedge funds tend to underperform stocks in a bull market, while outperforming stocks in a bear market. The goal of investing in hedge funds is to achieve a return higher than that of bonds over a full market cycle, experience less volatility than equities over the same period, and remain defensive during times of equity market declines.

There are four primary hedge fund strategies: long-short equity, relative value, event-driven, and macro/managed futures. While most hedge funds primarily invest in just one of these strategies, funds of funds and multi-strategy funds diversify across all four strategies.

Macro and managed futures funds typically focus on broad market sectors, including equity indices, sovereign debt, currency markets, and commodities such as energy, metals and agricultural products. Macro funds tend to be more concentrated and more discretionary, while managed futures funds are trend followers that tactically allocate in the direction of market trends. Over time, macro and managed futures funds tend to alternate between long and short positions, exhibiting little to no bias in favor of either long or short positions in any market over the long run.

While the CISDM CTA index of managed futures funds outperformed the Bloomberg Aggregate Bond Index from 2003 to the second quarter of 2024, the pattern of returns was very different.

DISPLAY 8

Calendar Year Returns

	MANAGED FUTURES	S&P 500 INDEX
2008	+11.6%	-37.0%
2022	+21.7%	-18.1%

Calendar year returns for 2008 and 2022 for the CISDM CTA Equal Weighted Index and the S&P 500 Index

Long-short equity is the most popular hedge fund strategy, whether measured by AUM or the number of funds. These managers need to have skills in buying undervalued stocks and selling short overvalued stocks. On average, long-short equity funds may have 150% of capital exposed to stock selection and only 50% exposed to directional market moves. This leaves an equity beta of approximately 0.5 and a high correlation with equity market returns.

Relative value strategies earn profits from convergence in valuations between related securities. Strategies include convertible bond arbitrage, fixed income arbitrage, and mortgage-backed fund arbitrage.

While relative value strategies are predominantly implemented in fixed income, event-driven strategies typically hold mostly equity securities. Event-driven strategies focus on changes in a company's capital structure. Event-driven strategies include merger arbitrage, distressed securities, spin-offs, and emerging from bankruptcy. These funds ideally profit when the anticipated events take place at the predicted timing, but can incur losses when the event doesn't happen as anticipated.

Portfolio Construction With Alternative Investments

Before building a portfolio allocation for any investor, it is essential to understand their personal goals, assets, income, age, family situation and risk tolerance. Liquidity needs must be evaluated when allocating to alternative investments.

Taxes are a key consideration for assets held in non-retirement accounts. Many alternative investment strategies now report taxes via Form 1099. In addition to earning equity-like returns and hedging against inflation, taxable investors may also benefit substantially from certain real asset investments that can offer tax deductions and tax deferral opportunities. These can include triple net lease real estate, 1031 exchange programs, and oil and gas investments.

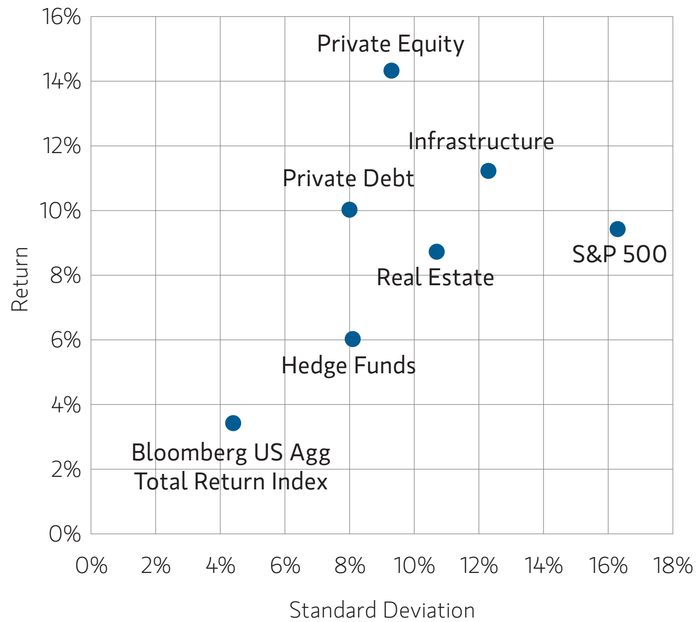
An inspection of asset class and strategy returns over the last 23 years shows that investors can increase returns by moving from public equity to private equity and from public credit to private credit. A portfolio of real assets, private debt and hedge funds offers returns competitive to public equity with lower downside risk and the potential to offer portfolio diversification and an improved experience during times of high inflation. An investor with a long-term horizon and limited liquidity needs may wish to allocate 50% each to public and private assets.

Investors allocating to alternative investments must complete a comprehensive due diligence process. The portfolios presented here utilize the returns of private markets indices, which combine dozens or hundreds of managers into a single return observation each quarter. When building alternative investment portfolios, investors cannot purchase index funds, but must allocate to each fund individually. The return dispersion in alternative investments is much larger than in traditional investments. While the difference in returns between public equity funds with strong and weak performance may differ by 5% annually within a style group, the difference between the performance of strong and weak private equity and venture capital managers may be 10% to 15% annually or more.

Annualized quarterly returns, 2002 to 2024. S&P 500 Index, Bloomberg Aggregate Bond Index, CISDM Equal-weighted Hedge Fund Index, PitchBook returns for Private Equity, Private Debt, Real Estate and Infrastructure.

DISPLAY 9

Alternative Investments Risk and Return, 2002-2024



Annualized quarterly returns, 2002 to 2024. S&P 500 Index, Bloomberg Aggregate Bond Index, CISDM Equal-weighted Hedge Fund Index, PitchBook returns for Private Equity, Private Debt, Real Estate and Infrastructure.

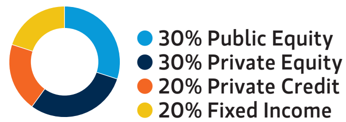
A simple illustration shows that a portfolio could split the 60% equity allocation into 30% public equity and 30% in private equity and split the 40% allocation into 20% aggregate bonds and 20% private credit. By moving half the portfolio into private equity and private debt, the average annual return increases from 7.4% to 10.0%, with slight improvements in portfolio standard deviation, drawdown, and the correlation of returns to stocks, bonds and inflation. The increase in return will be less if investors move from high yield to private credit rather than funding the allocation from aggregate bonds.

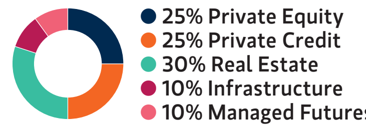
A portfolio 100% invested in alternative assets might be allocated 25% to private equity, 25% to private debt, 30% to real estate, 10% to infrastructure and 10% to managed futures funds. This portfolio offers improved risk-return tradeoffs relative to a portfolio 50% invested in public markets, with returns rising to 10.7%, standard deviation declining to 7.1%, and the correlation to inflation moving to a positive 0.10, while the correlation to aggregate bonds declines to -0.08. While investors will typically not invest 100% in alternatives, there are benefits of adding allocations of 10% to 40% to private markets.

DISPLAY 10

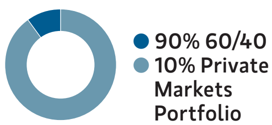
Historical Returns of Example Portfolio Allocations

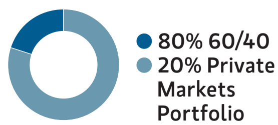
2002-2024

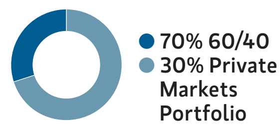


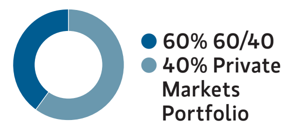


Return	7.4%	10.0%	10.7%
Std Dev	9.9%	8.4%	7.1%
Drawdown	-27.3%	-27.2%	-26.2%
Corr (CPI)	-0.22	-0.15	0.10
Corr (S&P 500)	0.98	0.94	0.58
Corr (Agg)	0.17	0.08	-0.08









Return	7.7%	8.1%	8.4%	8.8%
Std Dev	9.4%	8.8%	8.3%	7.9%
Drawdown	-26.9%	-26.6%	-26.6%	-26.5%
Corr (CPI)	-0.20	-0.18	-0.16	-0.13
Corr (S&P 500)	0.98	0.98	0.97	0.95
Corr (Agg)	0.16	0.14	0.12	0.10

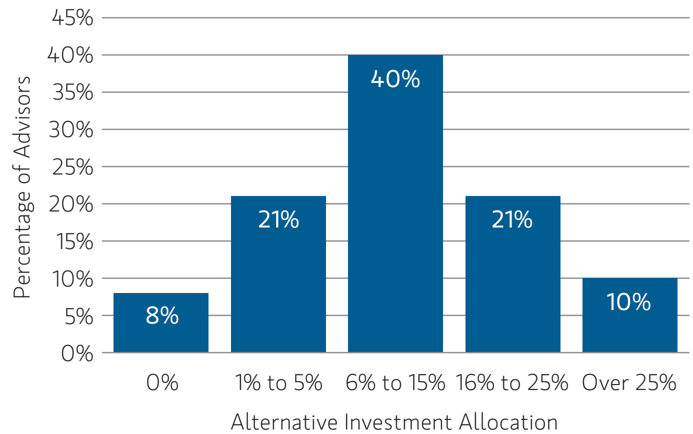
Quarterly Returns 2002-2024. 60/40 portfolio is 60% S&P 500 and 40% Barclays Aggregate Bond Index. Indices include Equities = S&P 500, Fixed Income = Barclays Aggregate Bond Index, Managed Futures = CISDM CTA Equal Weighted, PitchBook Private Equity, Private Debt, Infrastructure and Real Estate.

Alternative Investments in Advisory Practices

Financial advisors are already investing in alternatives, with 92% of advisors currently allocating in client portfolios.[4] Of advisors allocating to alternative investments, 43% recommend client allocations between 6% and 15%, while 23% recommend allocations of 16% to 25%, and 11% recommend allocations above 25%.[5] Of the surveyed advisors who allocate to alternative investments, at least 85% invest in private debt, private equity and/or real estate. Approximately half of the advisors allocate to hedge funds, infrastructure and/or structured notes.[6]

DISPLAY 12

Allocation to Alternative Investments Across Surveyed Advisors



Source: 2025 Report. The State of Alternative Investments in Wealth Management. CAIS.

Conclusion

While the label "alternative investments" remains widely used, these investments have become mainstream for financial advisors and their clients who are accredited investors or qualified purchasers. The adoption of alternative investments in the private wealth channel accelerated after the Fed raised interest rates in 2022, when inflation and rising rates decimated the stock and bond markets.

Each alternative investment is designed to meet an investment goal and to offset at least one of the shortcomings of the 60/40 portfolio. Investors seeking higher returns can allocate to private equity, while private credit is used to increase income. Investors concerned about inflation allocate to real assets, such as real estate, infrastructure, commodities and natural resources. Investors who wish to reduce the downside risk of their portfolio seek out hedge funds, managed futures and options overlays to meet their goals. Advisors who do not allocate to alternative investments forfeit their potential for return enhancement and inflation hedging.

While many investors still consider a 60/40 portfolio to be diversified, sophisticated advisors and their high-net-worth clients are increasingly shifting toward a 50/30/20 portfolio, which is composed of 50% public equity, 30% public fixed income and 20% alternative investments. The diversity of alternative investments enables the creation of customized portfolios that cater to the goals of investors ranging from the most aggressive to the most conservative. Allocations to alternative investments need to consider each investor's unique risk tolerance and liquidity preferences. Alternative investments come in a wide array of vehicles and liquidity structures, ranging from the least liquid drawdown funds to semi-liquid tender offer and evergreen funds, to fully liquid, publicly traded alternative assets.

Investors who allocate only to publicly traded equity and fixed income are only investing in a small portion of the available investment opportunities. Continuing to focus exclusively on public markets forfeits the opportunity to enhance diversification, reduce portfolio cyclicality relative to inflation and interest rates, and hedge downside risks.

[4] https://www.caisgroup.com/articles/the-state-of-alternative-investments-in-wealth-management-2025-report-article

[5] Ibid

[6] Ibid

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