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CIBC ASSET MANAGEMENT

Investing in private market alternatives

Part III – Asset class deep dive

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Summary

In this third installment in our private market alternatives research paper series, we provide a deep-dive into five main private market alternatives: private credit; real estate; infrastructure; private equity; and hedge funds (or Absolute Return).[1] For simplicity and ease of explanation, we treat these alternatives as distinct from one another. In reality, there are growing areas of overlap; for instance, between private credit and infrastructure debt, and between private equity and hedge funds.

Other alternatives, including structured products, farmland and timberland, and intangible collectibles are increasingly important components of private markets. However, we consider the five alternatives we focus on below to be of most relevance to a majority of high net worth (HNW) investors.

Private credit spans an eclectic array of investment opportunities

Key asset class features:

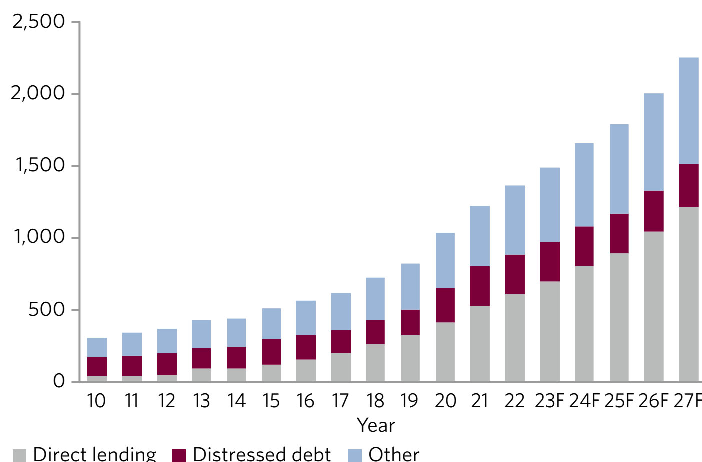
- AUM size as at Q4 2022: $1.4 trillion
- An alternative to traditional public fixed income investments
- Offers attractive yields and risk-adjusted expected returns even in the new higher interest rate environment, as well as opportunities for portfolio diversification and capital preservation
- Floating rates often associated with private credit can provide investors with an ability to hedge against inflation risk

Private credit, (or debt) refers to loans typically originated by private lenders without the use of a bank or other financial intermediary. This asset class spans an eclectic array of investment opportunities across corporate, real estate, structured, and infrastructure debt.

The 2008 global financial crisis was a catalyst for vigorous growth in the private credit market (Chart 1). Regulatory limitations on bank middle-market lending capabilities introduced in response to this crisis provided an opportunity for alternative, private lenders, including institutional asset managers, to meet demand for capital from middle market corporate borrowers.[2] These borrowers are unwilling to cede ownership control to private equity investors, and yet they are often unable to obtain financing for growth and working capital from banks or through public debt issuance. Private equity funds have also taken advantage of private financing to fund corporate buyouts. And a concurrent search for yield and a willingness to forego liquidity has meant private credit solutions were positively received by investors.

As the private credit market has grown, transactions previously only possible in the public syndicated loan market with many lenders can now be executed by individual direct lenders or small groups—termed "clubs"—of lending firms. These clubs often include fewer than five firms. Associated loans have a typical maturity of five to seven years, and are rarely traded. This illiquidity is one source of the enhanced expected yields, return, and diversification offered by private credit compared with public market fixed income. Other sources include smaller issuer size, lack of issuer credit rating, and in many cases the use of higher leverage.

Chart 1 – Global private credit assets under management and projected ($bn)



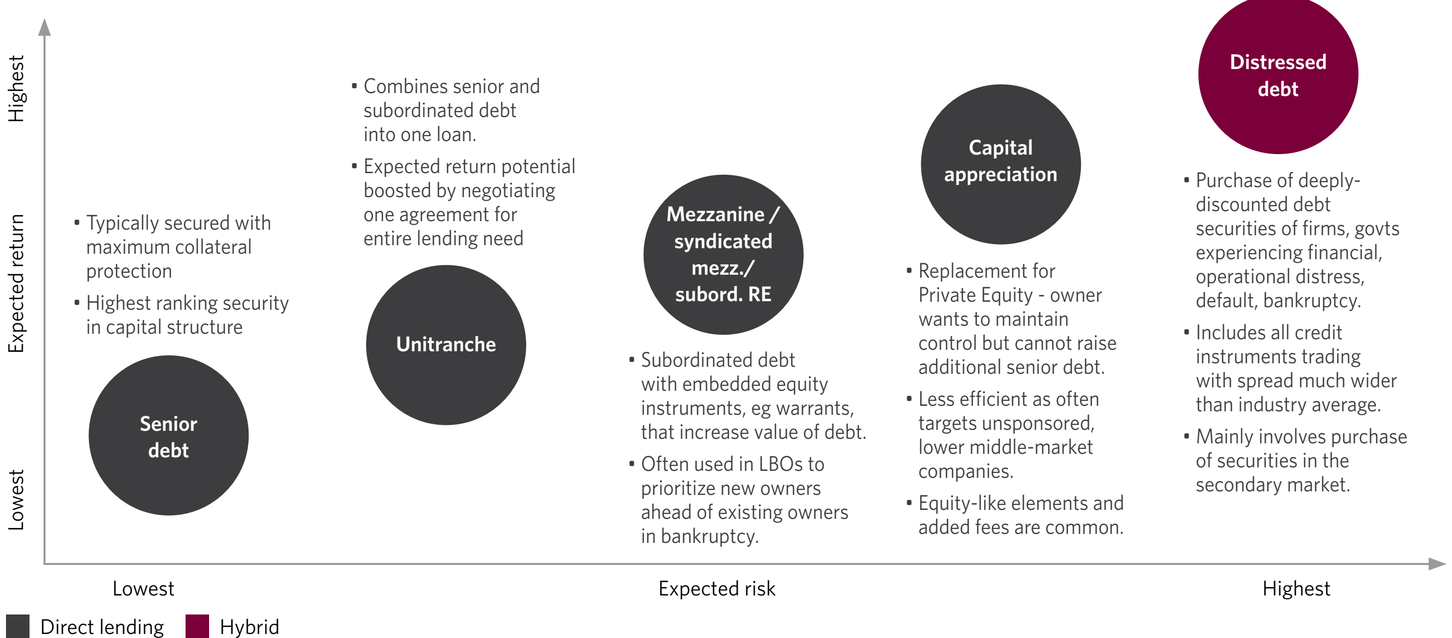
The information was prepared by CIBC Asset Management Inc. using the following third-party data: Preqin (2022), Private debt Global Report 2023.

As interest rate volatility has risen, institutions continue to consider ways to augment allocations to traditional core fixed income. This suggests an opportunity for further significant growth in conservative middle-market lending. Lenders with a history of consistently delivering solutions across good and bad economic conditions appear particularly well-positioned to see consistent and quality deal flow. This includes prudent junior capital strategies focused on downside risk mitigation, which are expected to generate returns in the low teens. And direct lending can offer complementary mid-single digit expected annualized returns from high-quality senior secured loans. As non-bank loan default rates are at historic lows, investors would need to accept considerable risk to generate comparable yields and income from traditional fixed income investments.

A majority of private loans are structured with floating rates. The resulting relatively low duration helps insulate investors against inflation in a rising interest rate environment. By contrast, traditional public market fixed income allocations have relatively high duration. In addition, as private loans are typically not traded, the volatility of private credit as an asset class tends to be lower than public fixed income. For this reason, private credit also offers a predictable, relatively smooth stream of interest and principal payments. This facet is particularly welcome during periods of public market drawdown, and in the context of generally higher public market volatility. Lower historical default and loss rates compared with public high-yield bonds are also appealing characteristics. These reflect strong covenants, management oversight, and other safeguards.[3]

There are many different private credit strategies (Chart 2). Each has a different return/risk profile. As all of them are less liquid than traditional fixed income, investors have been rewarded for a willingness to accept this feature by relatively higher offered returns (Chart 3).

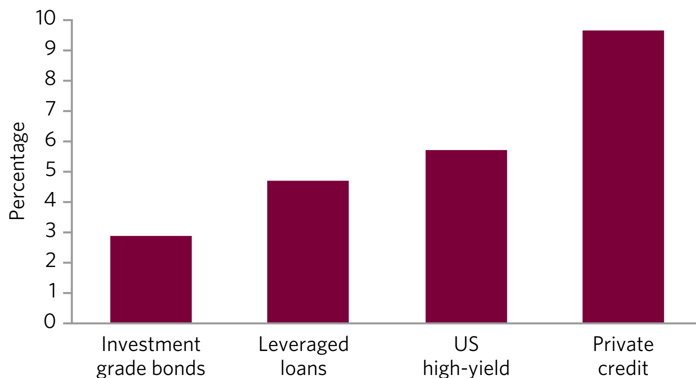
Chart 2 – Private strategies collectively form a diverse investment opportunity set



The information was prepared by CIBC Asset Management Inc.. This chart is for illustrative and general information purposes only.

Private senior debt is the most conservative strategy. Nonetheless, it still has associated risks. These include leverage associated with many senior loans, and the permanency of accompanying leverage lines. Investors should also identify the true risk of the underlying loans. For example, some senior lenders refer to second-lien loans as senior because they enjoy priority over all but first-lien lenders. Similarly, a split-lien loan secured only by a priority pledge of intellectual property may be a second lien in disguise if another lender to the same borrower has secured working capital, fixed assets, and machinery and equipment. And the advent of unitranche loans enables lenders to remain the senior lender of record while retaining only a last-out tranche of the original instrument after selling a first-out piece to another lender.

Chart 3 – Annualized historical returns for bonds and private credit



The information was prepared by CIBC Asset Management Inc. using the following third party sources: Bloomberg. Sample: 2007-2022. Investment Grade Bonds: Bloomberg U.S. Aggregate Total Return Index. Leveraged Loans: Markit iBoxx Leveraged Loans Total Return Index. High-Yield: Bloomberg U.S. Corporate High-Yield Total Return Index. Private Credit: Cliffwater Direct Lending Total Return Index. All returns in Canadian dollars. Data as at March 2023.

Expected returns increase as investors are willing to move down the credit structure and accept exposure to incrementally more risk, including credit risk, in other private credit strategies. These include more opportunistic strategies such as mezzanine or subordinated debt often used by private equity investors to finance leveraged buyout transactions or acquisitions. Unlike much of the private credit universe, mezzanine debt often has an associated fixed interest rate, meaning it has more interest rate risk than higher quality direct loans.

Private credit managers can also invest in quasi-equity strategies with higher expected returns. These distressed debt opportunities include mid- to large-capitalization companies undergoing transformation, and those unable to access sponsor financing. It also includes credit instruments trading at a significant discount and with a spread substantially wider than the industry average. Many investors in this market segment expect to hold the credit while the company restructures and then sell after its value appreciates. Another group of investors—termed "distressed-for-influence"—are more activist, and seek to generate value by negotiation with borrowing firms in the context of the relevant bankruptcy code.

Real estate can offer portfolio diversification and potentially an attractive source of expected return

Key asset class features:

- Private real estate AUM as at Q4 2022: $1.1 trillion
- Attractive source of expected income, derived from stable assets offering capital preservation and regular pay-outs
- Attractive source of expected return from opportunistic strategies, derived from redevelopment and repositioning of assets
- Portfolio diversification, due to relatively low average correlation with other asset classes, as well as a wide range of available strategies, property types, and geographies
- An attractive inflation hedge, reflecting tenancy rental increases contractually linked to inflation

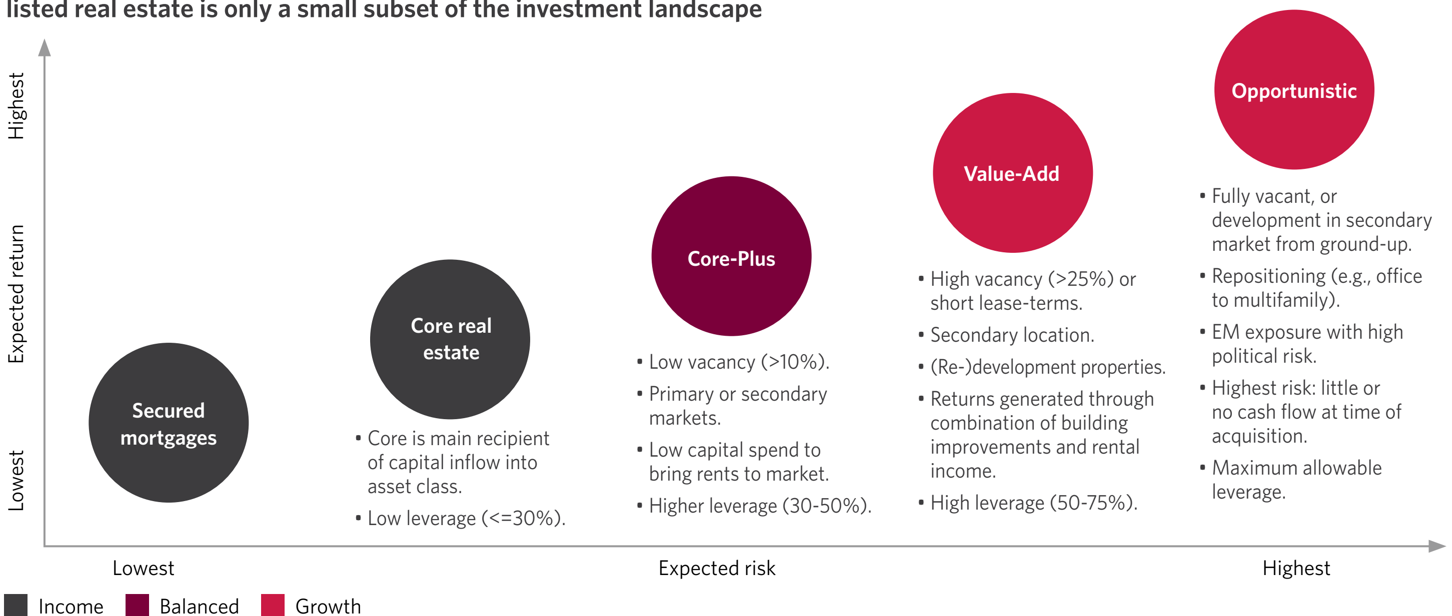
Real estate investing involves investment of capital in residential, commercial and industrial property, either individually or through a real estate venture fund or investment trust. These are long-lived assets with an income stream that generally adjusts to inflation. For this reason, they can act as an effective hedge against this risk. However, the speed of adjustment to inflation, and therefore the quality of the hedge, differs between sectors, with rents in residential and niche sectors such as student housing much quicker to re-set than office.

Investors can realize an allocation to real estate via public REITS or private market solutions. Public REITS are listed entities that typically own majority real estate holdings in their portfolio. These vehicles also distribute more than 90% of annual earnings as dividends in a tax-efficient structure that allows investors to avoid double taxation on dividend income. There are two major types of public REITS: equity REITs (the most common) buy and own physical properties and collect rent from tenants; mortgage REITs own mortgages instead of physical real estate.

Private unlisted real estate funds pool investor capital to acquire, own, and sell real estate assets and offer investors the ability to gain targeted exposure to this asset class, in terms of geography, property type or investment strategy.

From an investment perspective, real estate can be classified according to its expected return and risk profile (Chart 4). At the low end of the spectrum, core and core-plus real estate strategies are typically diversified across markets, property sectors, tenants, and economic factors. Core funds tend to invest in stable assets, such as office properties with high-credit quality tenants located in prime areas in major urban areas of developed market economies. These funds focus primarily on generating a stable income stream. With periodic re-settings of contractual rent payments, an allocation to core real estate is expected to provide at least a partial hedge against inflation. Core open-end real estate funds are generally the most liquid vehicles in this asset class, and typically offer quarterly liquidity. That said, as the underlying investment is illiquid, investors typically do not have the opportunity to realize major capital outflows from funds due to pre-defined and communicated limits on overall liquidity available.

Chart 4 – The real estate opportunity set is diverse, ranging from income to growth; listed real estate is only a small subset of the investment landscape



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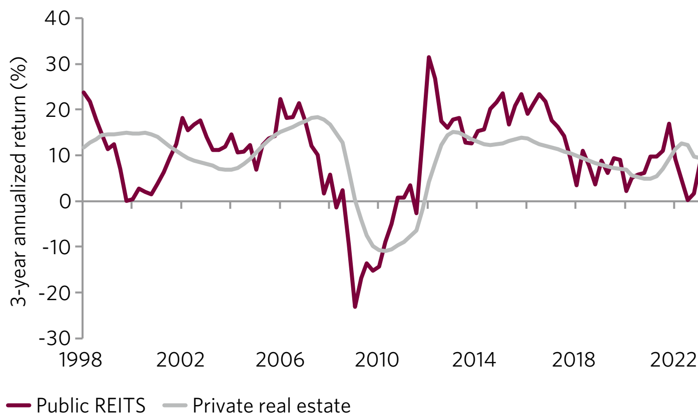
At the other end of the investment spectrum, opportunistic real estate funds use more leverage and take on higher-risk opportunities with a focus on capital appreciation. Opportunistic and other non-core real estate investments are generally offered as closed-end funds with no liquidity provisions. Investors are expected to remain invested for the life of the fund, which is typically eight to ten years. A secondary market for non-core real estate funds has existed for several years, but activity is modest and buyers typically seek deep discounts.

In recent years, investors in private real estate have gradually shifted down the risk curve and have shown increasing interest in core and core-plus strategies. This shift has likely been driven by investors increasingly identifying their allocations to private real estate as higher yield fixed-income substitutes, with the potential for greater tax efficiency and other benefits such as diversification.

We can also think about real estate from the perspective of sector specific investing. The most popular sectors include: residential (both single and multi-family), industrials, health-related and life science facilities, and student housing. Fund managers must understand how each of these sectors performs across market cycles in order to manage operational risk and capital allocation decisions. Diversifying into these property sectors may also require a joint venture, hiring a management team from a specialized firm, or finding competent operators for the properties.

Returns to listed and unlisted real estate have been similar over the past two decades; there has been no observed illiquidity premium (Chart 5).

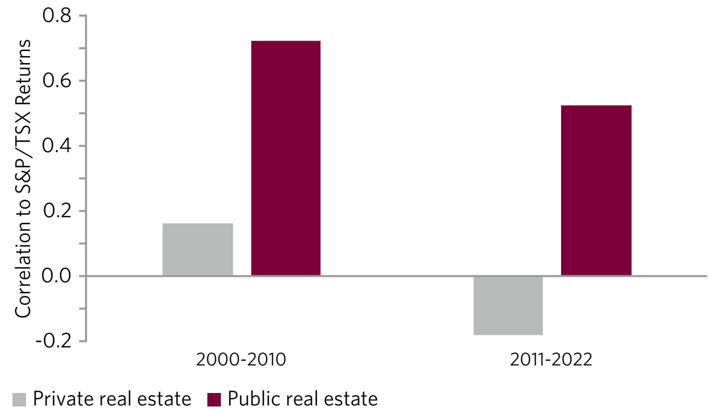
Chart 5 – Returns to listed and unlisted real estate



The information was prepared by CIBC Asset Management Inc. using the following third party sources: Bloomberg. Public REITs: FTSE Nareit All Equity REITs TR USD, Private real estate: NCREIF Fund ODCE. Sample: January 1996 - December 2022. Based on data available at March 2023. All returns in Canadian dollars.

However, return-smoothing associated with private market valuation methodologies has meant unlisted real estate has realized stronger risk-adjusted returns than public real estate and a lower average correlation to public equity (Chart 6).

Chart 6 – Private real estate investment solutions have provided more diversification than public REITS



The information was prepared by CIBC Asset Management Inc. using the following third party data: Bloomberg. Based on data available at March 2023.

Infrastructure can offer diversification and potentially play a defensive role in portfolios

Key asset class features:

- Private Infrastructure AUM as at Q4 2022: approximately $1 trillion
- Attractive expected return due to high barriers to entry, which in turn reflect the cost and complexity of developing infrastructure assets and their longevity
- Portfolio diversification, due to a low average correlation with other asset classes
- Stable and predictable long-term cash flows determined by long-term contracts
- Hedge against inflation risk through regulation, concession agreements or contracts with rates set to rise in line with, or above, inflation rates
- During a disinflationary environment, this asset class plays a defensive role in portfolios, offering higher-yielding assets
- Long-term liability matching

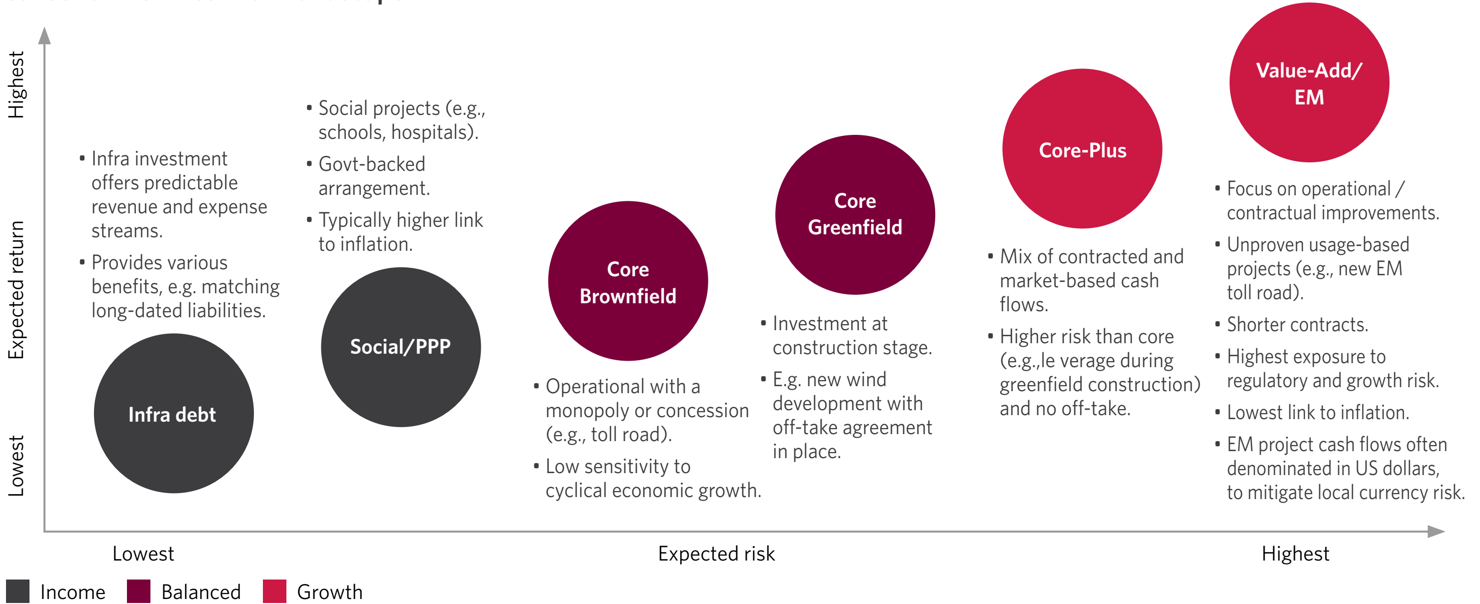
The growth in privatization has helped infrastructure mature as an asset class, resulting in increased interest from institutional and retail investors.

Infrastructure encompasses a wide range of investment opportunities spanning numerous industries and sectors. It is defined as the facilities, services, and installations essential to the functioning of a society, and is categorized as either economic or social. Economic infrastructure includes energy, telecommunications, natural resources, transportation,

renewable resources, power utilities, clean technology, water utilities, logistics, and waste management. Social infrastructure includes defense, education, government, the judicial sector, and healthcare. Over time, the asset class has evolved to encompass an ever more diverse range of assets, including data centers, highway service stations, and facilities management companies.

From an investment perspective, infrastructure projects can be classified according to their expected return and risk profile (Chart 7). Infrastructure debt offers the lowest expected return, albeit a premium over global investment-grade debt. Alpha generation in these debt transactions typically derives from structuring expertise and an understanding of asset-specific risks.

Chart 7 – The infrastructure opportunity set is diverse, ranging from income to growth; listed infrastructure is only a small subset of the investment landscape



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Public private partnership (PPP) infrastructure projects have proven popular amongst investors. These projects are co-funded by sovereign or local governments or international funding organizations alongside private investors. They typically represent an attractive hedge against inflation risk, given contractual features included to protect ownership rights, to provide price escalation consistent with current rates of inflation, as well as to rebate and cap related expenses on the associated asset base. Incremental capital expenditure on maintenance is generally relatively limited in PPP projects. This feature contributes to higher project margins and the ability of infrastructure companies to pass along more cash flows to investors.

Moving further along the risk curve, core infrastructure projects offer predictable cashflow with limited downside risk. Within this category, brownfield funds (defined in Chart 7 above) target mature assets, and greenfield funds focus on new projects exploiting proven strategies with limited technology risk. Greenfield projects (also defined in Chart 7) are typically protected by off-take agreements that contractually bind a purchaser to the project, in turn making its initial funding more assured. At the higher end of the risk spectrum, value-add opportunities typically involve substantial change in current business models and may also have exposure to emerging markets. These projects tend to have the lowest ability to hedge inflation risk, since contract length tends to be short. They also expose investors to significant project, economic, and regulatory risk.

We can also differentiate between infrastructure debt and equity. Investing in infrastructure debt involves obtaining secured loans to finance the construction of new infrastructure or the maintenance of existing assets. This debt can include senior loans, mezzanine debt or preferred equity. Senior debt is the most common, reflecting simple capital structures and relatively low risk exposures.

Infrastructure debt has consistently provided investors with a higher yield than developed market government bonds and investment-grade infrastructure corporate bonds, as a reward for a willingness to forego liquidity.

Investors gain access to infrastructure equity through listed infrastructure equities—a subset of the global equity market—or unlisted (private) equity investments in infrastructure projects via funds and external managers. They can also allocate to unlisted projects via direct or co-investment in specific infrastructure projects or companies.

Unlisted infrastructure has provided a higher historical return than listed infrastructure, consistent with the liquidity give-up associated with unlisted structures. Over the sample period March 2002 to September 2022, private infrastructure—as measured by the EDHEC Infra300 Index—realized a 13% annualized return compared to 4% for the S&P Global Listed Infrastructure Index.

Private equity offers diversification and enhanced expected return potential

Key asset class features:

- AUM as at Q4 2022: approximately $4 trillion
- Long-term performance drivers similar to public equity (corporate earnings)
- Access to ownership of innovative private businesses across the risk spectrum
- Enhanced expected returns through value-added investments that take advantage of market dislocations and unique business opportunities
- Diversification due to a low reported correlation to public markets that results from infrequent marking-to-market of fund NAVs

Private equity refers to capital investments in companies not publicly traded or listed on a public stock exchange. These investments can range from financing of start-up entities, to infusing growth equity into an expanding private company. Private equity funds also often purchase—or buy out—public companies subsequently delisted from public exchanges and taken private using debt financing. Private equity fund managers actively seek to improve the expected profitability of acquired companies by implementing various forms of corporate restructuring, including the replacement of existing management teams and boards of directors, cost cutting, adding products and services, or divesting parts of the company in a spinoff to raise additional funds.

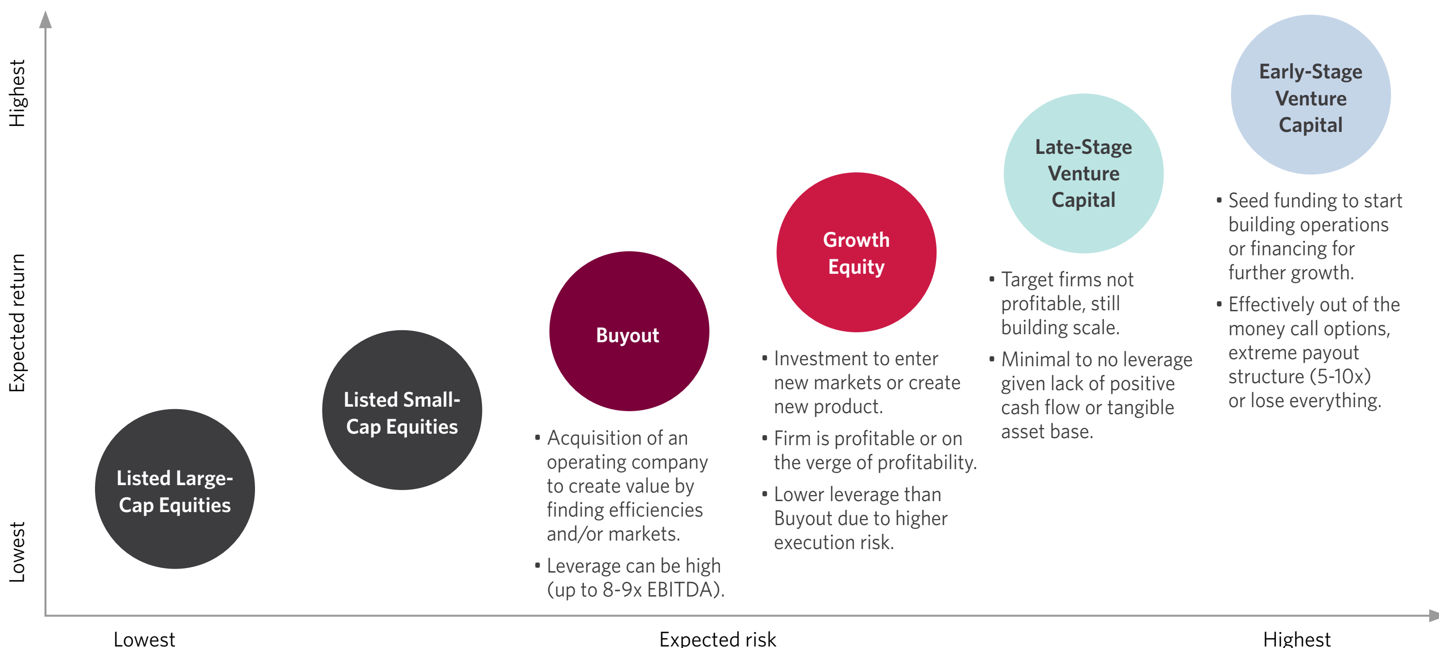
Private equity funds make either direct investments in companies or investments in other funds to achieve portfolio diversification. A typical private equity fund will invest in five to twenty individual companies throughout its lifecycle. The ultimate aim is to monetize the value they add to companies, via initial public offering (IPO), restructuring (reorganization or divestment of various parts of the entity), or sale to another private equity fund (known as a secondary buyout). One of these paths typically happens after three to five years.

Based on historical results, private equity has outperformed public equity on average and offers unique opportunities not available to investors in traditional public market investment solutions. For instance, the venture capital sector offers investors the opportunity to access companies on the cutting edge of the technology, healthcare or energy sectors. And buyout transactions offer investors opportunities to participate in the transformation of out-of-favour companies or corporate divisions within existing companies that have the potential to increase in value when nurtured with substantial financial and strategic effort. These opportunities are less common for public companies under constant pressure to meet quarterly financial targets that may conflict with longer-term business priorities.

Private equity investment vehicles are illiquid. This means investors are typically unable to actively rebalance exposures in the same way they can traditional public asset classes. And aside from exploring the secondaries market, private equity investors really only control the size of commitments they make to private equity funds and their selection of which managers to invest in Mercer, 2022. They do not control the pace of capital deployment. From an investors perspective, private equity portfolio construction is often a multi-year process. Starting from scratch, a custom portfolio typically takes six or more years of consistent construction before reaching its target allocation. The best institutional investors also size commitments flexibly rather than allowing short-term constraints to influence long-term investment decisions. For instance, investors have no control over when target managers will launch and close new fund offerings. When subject to rigid commitment budget constraints, an investor may miss out on attractive opportunities. Potentially even worse, an investor may allocate to a lower-quality manager simply to deploy their full annual budget (Mercer, 2022).

Private equity funds provide access to investment opportunities across the risk spectrum (Chart 8). Buyouts occur when a mature, typically public company is taken private and purchased by either a private equity firm or its existing management team. This type of investment makes up the largest portion of funds in the private equity space. Growth equity funds also invest in relatively mature companies. In this case, the target companies are seeking capital for expansion, to enter new markets, for M&A to improve margins, or to generate synergies with existing business lines. Venture capital funds provide financing for highest-risk opportunities. These involve relatively new private firms with little or no track record unable to access public equity markets or secure traditional debt financing. The probability of success is relatively low, but the expected return is commensurately higher than either buyout or growth equity. Venture capital investments may begin with a seed round involving initial start-up capital (these deals are termed early-stage). Investors seek to acquire relatively large ownership interests in target companies in order to maximize the proceeds they receive at exit.

Chart 8 – The private equity opportunity set is diverse, ranging from largescale buyouts to early-stage venture capital



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Hedge funds offer diversifying return potential across a variety of market conditions

Key asset class features:

- AUM as at Q4 2022: approximately $4.8 trillion
- A wide variety of strategies and styles offers scope for combinations of hedge funds to generate diversifying returns across a variety of market conditions
- Diversification to traditional asset classes, and relatively low volatility
- Ability to mitigate equity drawdown risk
- Many hedge fund strategies can be replicated using liquid alternative mutual fund vehicles. Liquid alternatives have daily liquidity, lower fees, and similar net-of-fee expected performance as their illiquid hedge fund equivalents

Hedge funds are pooled vehicles that invest in a wide variety of markets, assets, and securities. They rely on complex investment techniques to identify and extract value. By providing expected downside protection in periods of equity drawdowns and upside participation in bull markets, hedge funds often represent a valuable addition to a well-diversified portfolio.

There is a wide and eclectic array of hedge fund strategies (Chart 9). Investment processes used to implement strategies can be highly quantitative, completely qualitative, or somewhere in-between. And investment horizons can range from seconds to years, depending upon the source of the investment opportunity. A typical institutional investor will allocate to a set of complementary hedge fund strategies, to maximize diversification within this portfolio sleeve, as well as across their total portfolio. The most common hedge fund strategies include:

- **Global macro:** profit from a top-down assessment of global and idiosyncratic macroeconomic and geopolitical conditions. Utilize a broad investment universe encompassing a wide range of asset classes and strategies.
- **Multi-strategy:** combine a variety of complementary investment strategies managed by different portfolio management teams, typically from within the same organization, with the goal of delivering a relatively smooth return stream to investors. Manager concentration risk is high.
- **Hedge fund of funds:** invest as a limited partner into a range of other (general partner) hedge fund strategies to build a diversified hedge fund portfolio. Advantages include economies of scale, diversification, ability to negotiate fee discounts, and access to funds otherwise closed to new investors. Different from multi-strategy in that invested hedge funds span a range of managers, and are not sourced from the same organization.

- **Equity hedge funds:** include long/short, market neutral, and short sellers. The latter specialize in capitalizing on opportunities where asset values are significantly overpriced, or by uncovering catalysts for price declines such as accounting fraud or management malfeasance.
- **Event-driven:** exhibit a return profile similar to insurance sellers. Expect to consistently earn relatively small risk premiums for providing protection against large losses associated with unfavourable events. Strategies also include merger arbitrage, which seeks to take advantage of the difference between an announced purchase price and the current market price before a merger closes.
- **Relative value:** long/short strategies in related securities, including equities, bonds, and volatility. Strategies assume little market risk and benefit from price convergence during normal market conditions. Category also includes convertible bond arbitrage.
- **Activist:** seek to identify corporations not maximizing shareholder wealth, and invest in positions that benefit from a change in corporate governance. Strategies include distressed debt and capital structure arbitrage.
- **Managed futures:** trend-based strategies offered by commodity trading advisors (CTAs). Managed futures seek to provide low-cost tail hedging during episodic equity drawdowns, when trend strategies identify and benefit from negative market trends. These strategies offer less attractive performance during rangebound markets, when trend strategies risk being whipsawed.
- **Liquid alternatives:** regulated mutual funds that replicate various hedge fund strategies, including: macro; multi-strategy; equity long/short, market neutral and short-bias; and managed futures. Compared with their hedge fund equivalents, liquid alternatives have higher daily liquidity, lower fees, and similar net-of-fee performance expectations.

Chart 9 – Relatively low hedge fund correlations allow investors to allocate to a complementary set of strategies expected to diversify other portfolio holdings

Asset Class	Macro	Multi-strategy	Hedge FoF	Equity long/short	Market neutral	Event driven	Relative value	Convertible Arb	Activist	Managed futures	Public equity	Public fixed income
Macro	1.00											
Multi-strategy	0.33	1.00										
Hedge Fund of Funds	0.52	0.82	1.00									
Equity long/short	0.41	0.78	0.93	1.00								
Equity market neutral	0.39	0.45	0.59	0.54	1.00							
Equity event driven	0.35	0.85	0.89	0.92	0.50	1.00						
Relative value	0.24	0.92	0.83	0.80	0.51	0.87	1.00					
Convertible Arb	0.18	0.86	0.71	0.69	0.40	0.73	0.88	1.00				
Activist	0.18	0.79	0.84	0.90	0.56	0.91	0.83	0.73	1.00			
Managed futures	0.75	0.05	0.19	0.02	0.26	-0.01	0.01	-0.03	-0.09	1.00		
Public equity	0.34	0.70	0.77	0.86	0.40	0.81	0.72	0.60	0.85	-0.01	1.00	
Public fixed income	-0.03	0.06	0.09	0.08	-0.10	0.04	0.09	0.10	0.12	0.04	0.16	1.00

Blue Cells Indicate opportunities for greatest average diversification benefit. **Red Cells** Indicate highest pairwise correlations.
Numbers below 0.49 indicate opportunities for the greatest diversification benefit. Numbers above 0.50 indicate the highest pairwise correlations.

The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: Bloomberg Finance L.P.. Maximum sample is January 2000 to March 2023.

Continued growth

Capital continues to flow into private market alternatives as investors seek more efficient ways to improve the breadth and diversification of portfolios, and to enhance expected long-term performance. Our deep dive analysis has sought to provide the reader with a better understanding of the various facets of private market alternatives to assist with allocation decisions. We hope it has been informative.

To learn more about private market alternative investment solutions, please contact your CIBC advisor.

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We provide our clients with our research insights and expertise on industry issues and themes that matter most to them.

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For more insights, connect with us on LinkedIn and Twitter.

[1] Many hedge fund strategies can be replicated using liquid alternative strategies that invest in public markets.
[2] Middle market companies can be defined as having around $50 million in EBITDA. Lower middle-market firms have $5 million to $25 million in EBITDA. As defined by PGIM (2022), New Frontiers.
[3] Usually, lower default and higher recovery rates would be consistent with a lower yield. But the illiquidity premium ensures expected private credit yields and returns remain relatively high.

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