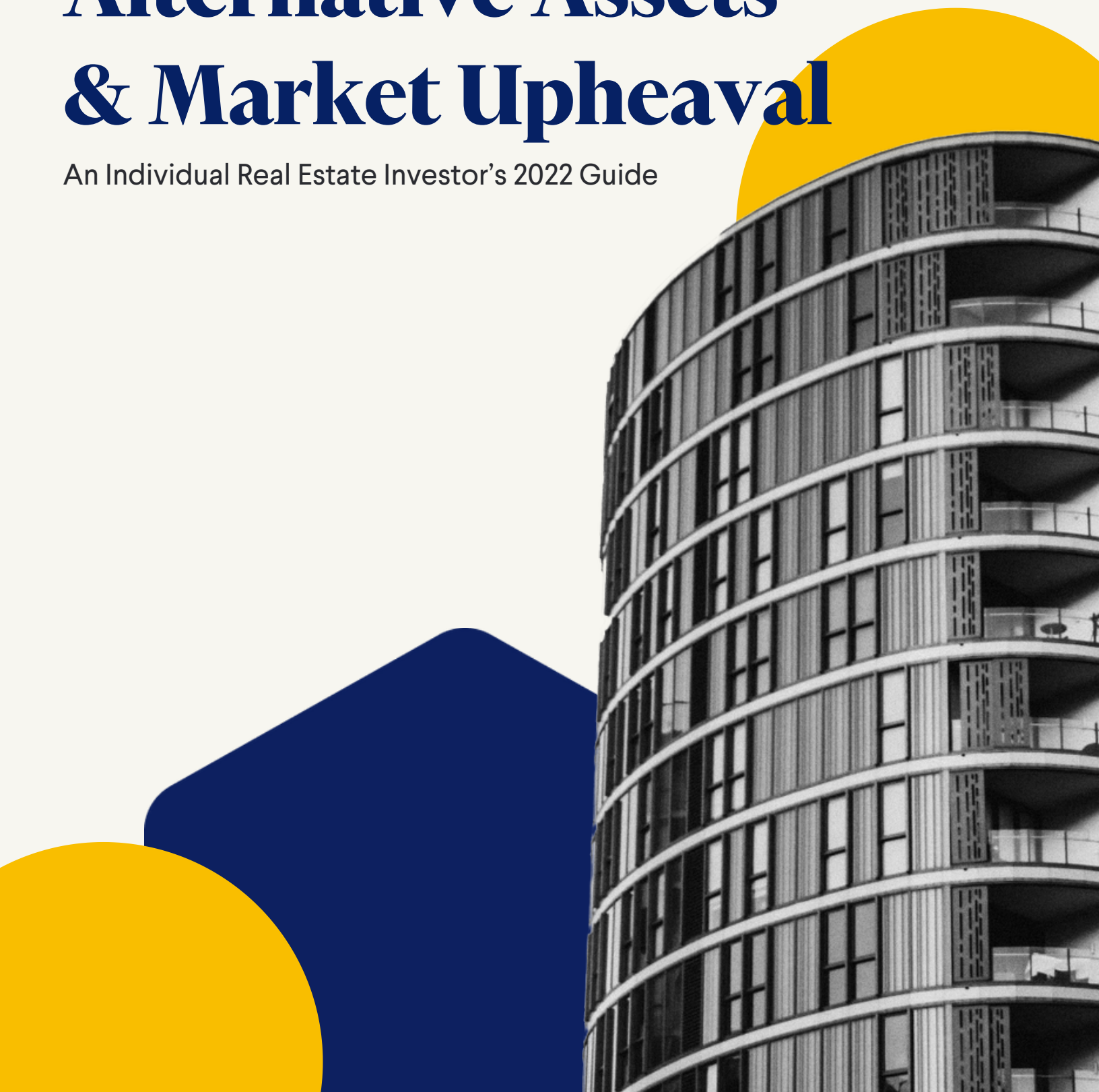


WHITEPAPER

# Alternative Assets & Market Upheaval

An Individual Real Estate Investor's 2022 Guide

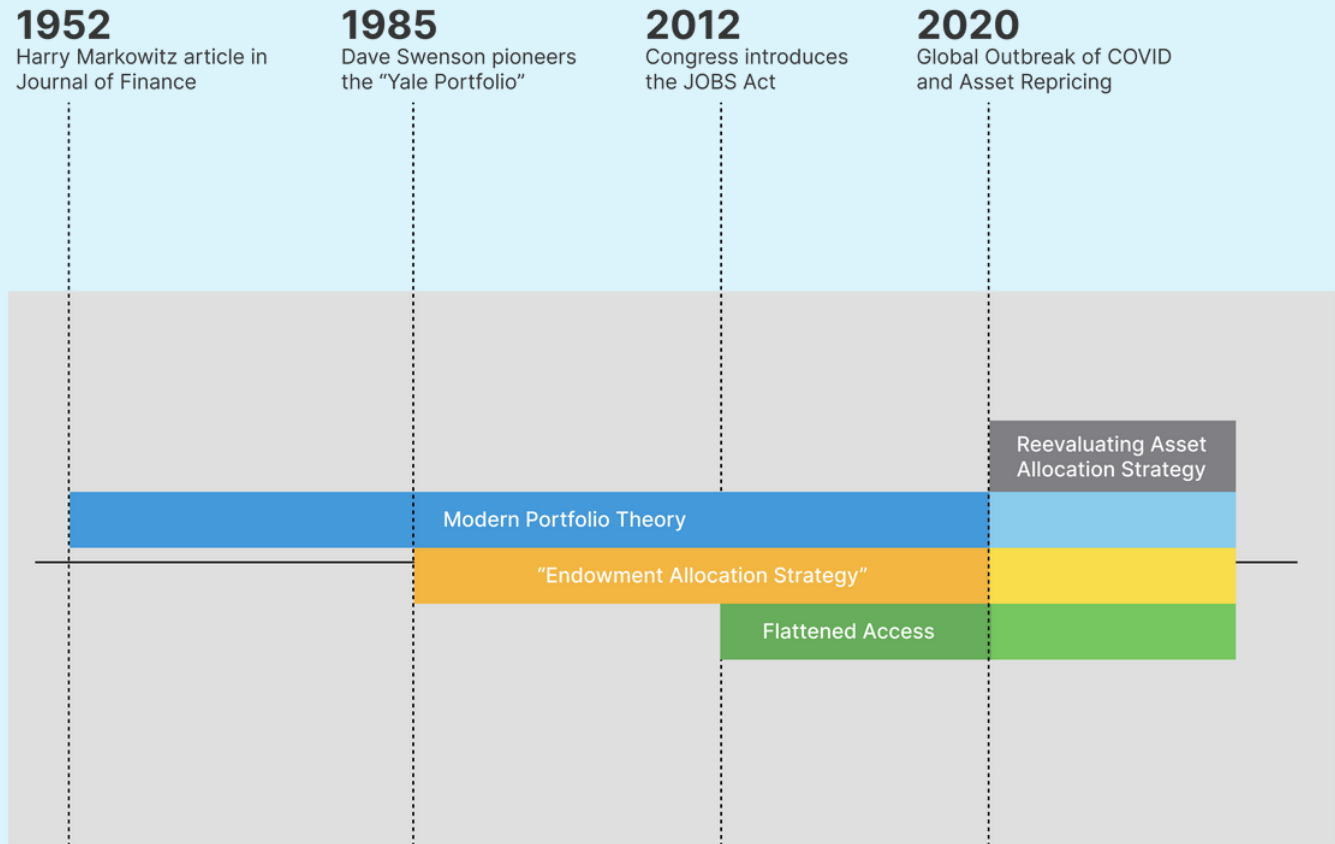


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# Intro: a Brief History of Alternative Asset Theory

The concept of Modern Portfolio Theory was introduced by Harry Markowitz, in earnest, in a 1952 issue of the *Journal of Finance*. In 1985, David Swenson took over a Yale Endowment portfolio that was nearly 75% stocks, bonds, and cash and, over three decades, shifted to a majority alternative asset strategy - thereby ushering in the new school of "endowment allocation strategy." Between the mid-eighties and 2012, and through three recessions (or 3.5, depending on who you ask), institutional investors shifted more and more capital to alternative assets for reasons we will get to shortly. Not least of which: institutional investors gradually allocated more to alternative assets, in aggregate, because they could. Alternate assets are by definition found in opaque, private markets, and have historically required extensive capital and/or connections to access. This all changed in 2012, with the signing of the JOBS Act, which effectively allowed individual accredited investors to access private-market alternatives. The JOBS Act paved the way for a broad new set of alternative asset options for individual investors. Paired with the rapid ascent of web platform technology, a new era of access was born, ushering in both opportunity and risks for individual investors.

# Timeline: the Evolution of Alternative Assets



## Recap: Why Alternatives?

Financial and capital markets are fundamentally either private or public. This binary refers to the mechanisms by which buyers and sellers are connected

- The level of access inherent in the market;
- The level of visibility of the market’s activity; and
- The liquidity the market affords (i.e how easy it is for buyers and sellers to transact and, by extension, how easy it is for investors to sell down a position and reclaim capital). These three fundamental attributes of financial markets are interrelated.

## Other Examples of Alternative Assets

Real estate is one of the most prominent and tangible forms of alternative assets, but the term may encompass any security or asset that is not traded publicly, such as...

- Private shares of pre-IPO startups
- Fine Art
- Rare Wines
- Rare Sports Cards
- Private Debt

Because public markets more readily offer access, breadth, and liquidity, public-market assets are often referred to interchangeably as “traditional” assets. Many individual investors will be familiar with the “traditional portfolio of stocks and bonds” paradigm – typically a 60/40 ratio, and entirely composed of publicly traded assets. Conversely, private-market investments are often referred to synonymously as “alternative assets” or “alts”: less liquid and historically more difficult to access. The mechanisms of private vs. public markets also directly influence the risk/return profile, typical hold periods, and cross-asset correlations of constituent asset classes. In short, private-market alternatives offer a higher “alpha”: return potential and risk factors that are idiosyncratic to the asset itself, to skill of management, and to microeconomic factors. To take an example, the acquisition and rehabilitation of a 4 story, 18-unit apartment building would be considered a private-market investment. Whether the investment group is a single individual or firm, a small group of investors bound by a collective legal agreement, or a syndication through a platform like EquityMultiple, the investment is transacted via slow-moving private markets and cannot be easily liquidated. Hence, returns and risks may be a function of the following factors:

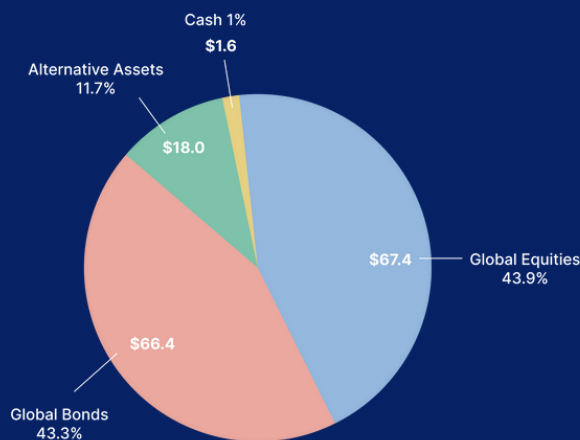
- **Skill of Investment Management:** for this real estate investment to succeed and yield favorable ROI, the lead investor must accurately assess opportunity, acquire the asset at a favorable basis, and efficiently, skillfully handle many facets of asset management – such as lease-up, day-to-day operations, and successful, timely sale.
- **Market & Submarket:** microeconomic factors related to a metro area or neighborhood – even the performance of a single employer or cluster of businesses – can influence performance of a real estate asset.
- **Asset-Specific Dynamics:** such as geopolitical movements that impact foreign trade, and hence industrial markets where import/export is critical; or macro shifts that impact travel, and hence hospitality assets.

All this amounts to highly specific, highly self determined outcomes - which can contribute to generating outsized alpha. Conversely, public assets, which are publicly traded, are often discussed in terms of their beta. Given the increased transparency, liquidity, frequency of trading, and lack of arbitrage opportunities, there is little opportunity for true alpha in public markets; therefore Beta and idiosyncratic risk are larger factors. Broad-Market Index ETFs typically have a beta very close to 1, meaning that their performance closely mirrors performance of the market as a whole, and closely tracks to indices such as the S&P 500.

Beta investments like broad-market index ETFs are often referred to as “buying the economy,” and while individual public assets may exhibit volatility that accompanies public sentiment (encompassing shocks like political headlines, earning reports and, indeed, a global viral outbreak), economies tend to grow over the long term, alongside public market indices such as the S&P 500. Alternative assets, by contrast, offer the potential for higher alpha in addition to several other benefits on a portfolio-wide basis, including lower correlation to public markets, and decreased volatility. The bottom line is that alternative investments that offer a potentially higher alpha tend to bear a lower correlation to public assets than public asset classes do to one another. This thesis, foundational to modern portfolio theory, was embraced as “endowment allocation,” came into vogue, and has driven the persistent growth in global allocation to alternative assets.

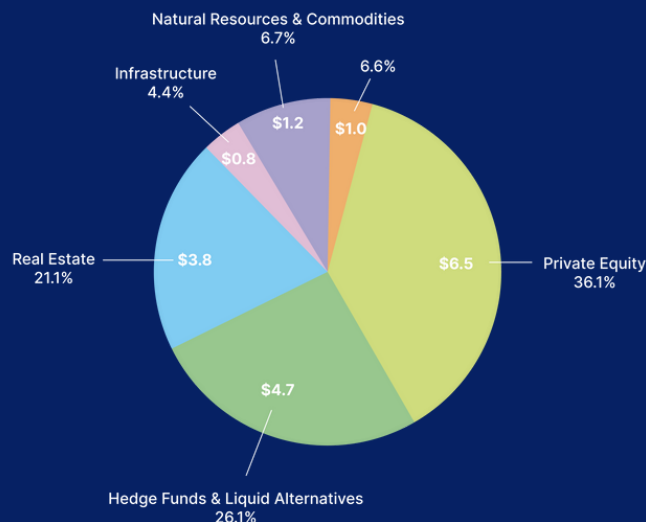
## Global Investable Market (\$Trillion) As of December 31, 2020

GLOBAL ASSETS



Total \$153.40

ALTERNATIVE ASSETS



Total \$18.0

# Traditional vs Alternative Assets

	Private Market (Alternative) Assets	Public Market (Traditional) Assets	What it Means
Liquidity		✓	Investors should consider their need for capital on-hand in formulating asset allocation between liquid assets and illiquid "alts"
De-Correlation Potential	✓		The next step for investors looking to diversify beyond a traditional portfolio of stocks and bonds
Historic Volatility	Generally Lower	Generally Higher	While both traditional and alternative assets may offer attractive return potential, publicly traded assets tend to fluctuate more widely as a function of systematic risk

## Why Alternative Exposure has Grown Over Time

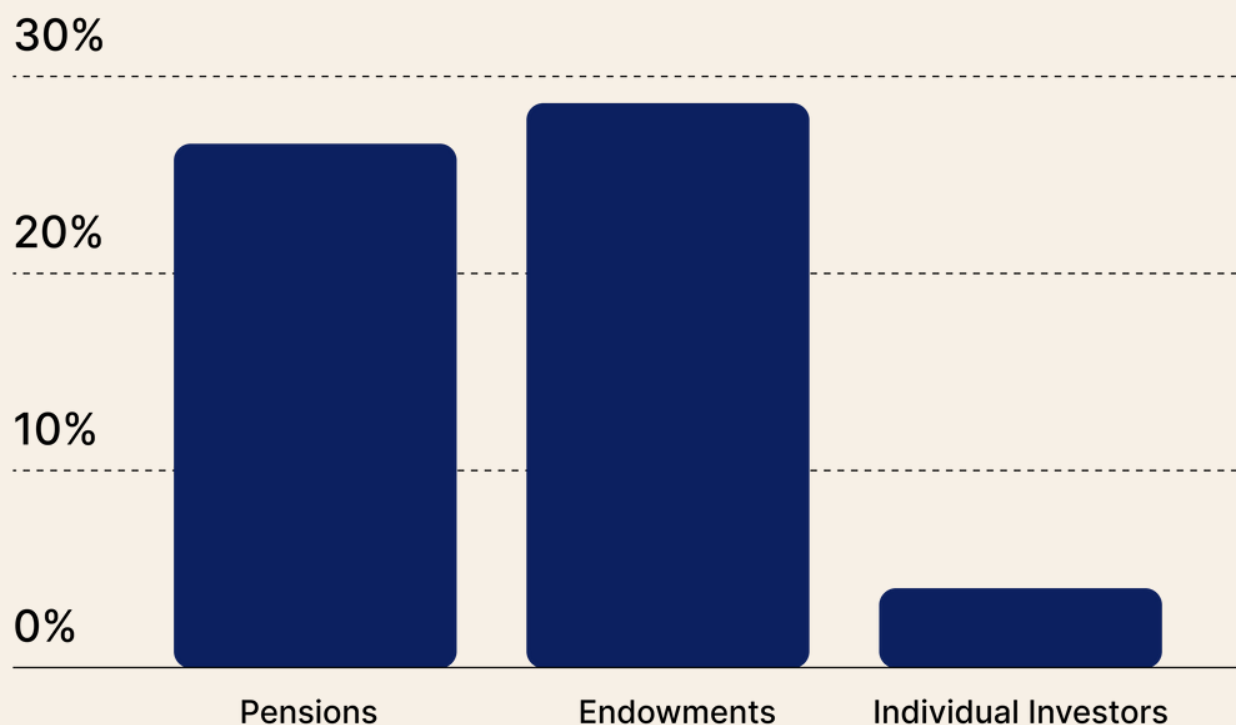
While the “Yale Model” reflected a growing appetite for alternative assets among institutional investors in the mid ‘80s, allocation to alternatives has accelerated more than ever during the first two decades of the new millennium. Some particular contours of this trend:

- Pensions in the US more than tripled allocation across all alternative asset classes between 2001 and 2019 – from 8.7% to 27%.<sup>2</sup>
- Holdings of private debt more than tripled between 2008 and 2019.<sup>2</sup>
- While alternative assets accounted for just 6% of assets under management worldwide in 2003, alts are projected to account for 18-24% by 2025.<sup>2</sup>

Numerous factors have contributed to this seachange in asset allocation. These are some of the biggest drivers of the shift toward alternatives:

## Institutions vs. Individual Allocations

Alternatives Exposure





## Empirical Evidence of Better Portfolio Risk-Adjusted Returns

Recent Blackstone research has shown that portfolios with at least 20% allocation to illiquid alternative assets have produced better risk-adjusted returns over time, i.e. reflected a more favorable efficient frontier over time than a portfolio of only traditional liquid assets.<sup>3</sup>

## A Widening Volatility Gap

Professional investors have long understood that alternatives have historically exhibited lower volatility across market cycles than publicly traded assets (for reference, see Yale's asset allocation strategy).<sup>4</sup> This is practically an identity: alts exhibit lower volatility precisely because they are illiquid and/or correlated to a much lesser degree with public market investments/sentiment. While this has borne out empirically for several decades, the gap has become more pronounced in recent decades due to:

- The rise of algorithmic, high-frequency trading, driven by machine learning and taking hundreds of inputs, including those driven by ever-greater velocity of information.
- An increasingly global world, and the corresponding backlash to globalization. Supply chains and capital flows are increasingly interconnected across the globe, and populist movements and trade disputes are more and more common in recent years in reaction to these forces. This fundamental tension has created an environment where daily swings of 2% in public market indices have become commonplace, even before the global outbreak of COVID-19 further roiled markets.

As such, sophisticated investors have found the relatively safe harbor of non-traded alternatives appealing.

## A Flattening of Access

The JOBS Act was signed into law in 2012, following the financial collapse and ensuing credit crunch, opening investment into “private placements” to individual accredited investors. In other words, alternative assets became broadly available to individual investors. While the platform-based economy for alternative assets is still relatively young, and the allocation gap between individuals and institutional investors remains substantial, the space is growing rapidly year-over-year. Platform-based asset purveyors grew more specialized between 2015 and 2020 – platforms like EquityMultiple offer specific kinds of private real estate investments, while other platforms offer a spectrum of alternative assets, from private equity to farmland to hard assets. As awareness of new opportunities has increased, so too has exposure to alternative assets among individual investors. In a recent survey of investors, EquityMultiple found that 53% plan on increasing their allocation to alternative assets. This survey was conducted following the outbreak of COVID-19 and mandatory “shelter in place” orders.

# A New Normal Emerging: the Future of Alternative Asset Investing

Economic expansions, like anything else, end. The specifics and timing of economic downturns are impossible to predict with any certainty, which is part and parcel of the case for alternative assets, and for a well-diversified portfolio bearing low cross-asset correlation. We entered 2019 with two-thirds of surveyed economists expecting some form of correction by the end of 2020. No one, though, could have predicted the severity and suddenness of the global economic downturn caused by the outbreak of COVID-19. Or our subsequent path to recovery, which has now given way to headlines around rising interest rates and persistent inflation.

While the full scope of economic ramifications are still evolving as of this writing, we do know that the shakeup of asset pricing will create opportunity for investors. At a high level, we have already seen an acceleration of trends that have persisted throughout the past several decades:

- **Public Market Volatility:** Public markets have, as expected, reacted very negatively to the evolving crisis – after several decades of historically steady/low volatility, the stock market spasmed and lurched (generally downward) with greater frequency during the weeks following the virtual shutdown of the global economy. Two-plus years later, as of August 2022, the S&P is now down roughly 16%, albeit for different reasons (mainly, uncertainty around the potential impact of the Fed's current efforts to reduce inflation). We can expect that macro-driven swings will continue to provide (increasing) periods of volatility shocks, which impact public investments more aggressively than private investments.
- **A Focus on Diversification:** The current outbreak (and economic fallout) is a reminder of just how unpredictable and sudden economic swings can be. Macroeconomic shocks can impact sectors, asset classes, and local markets in infinite ways. As this crisis has played out over the past two years, many investors have started to wonder how they can be better positioned for the next one. The precise answer is unattainable, but the general thesis is clear: greater diversification.

## 2022 Commercial Real Estate Outlook

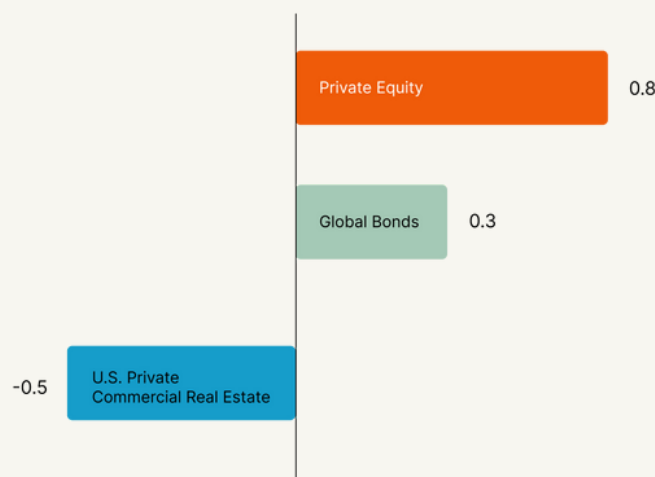
Here are just a few of the trends we expect to characterize private real estate markets in coming years:

- **Ecommerce Market Share Capture Accelerates:** In just the first month of mandated social distancing, online retail skyrocketed – from 15% of overall retail transactions in 2019 to nearly 25% of overall U.S. retail transaction volume by the end of April, 2020. The ascent of ecommerce was already upending the retail asset class, forcing retail operators and investors to modernize their approach or suffer the consequences. As of this writing, we believe ecommerce-ready industrial and neighborhood retail (including grocery) still stand to benefit, as consumers continue to follow similar purchasing habits.
- **Creative Readaptation & Hybrid Property Types:** As “work-from-home” becomes preferred by more knowledge workers and more employers, hybrid multifamily/office/creative space development may emerge to meet new demand. “Flex” office space is expected to increase to 13% of all office square footage by 2030, from 2% today.
- **Reevaluating Re-Urbanization:** Over the past twenty years, younger professionals (and an increasing volume of retirement-age baby boomers) flocked to urban centers, seeking cultural amenities and prizing social engagement. Employers and retailers followed suit as the preferences of millennials came to dominate real estate investment focus across asset classes. In recent years, some gateway markets became overheated, exhibiting rampant housing affordability issues, and prompting net in-migration to secondary and tertiary markets with more palatable cost-of-living and average rents.

As the Danish philosopher Kierkegaard once remarked, “life can only be understood backwards, but it must be lived forwards.”

It is tempting to take lessons from past recessions and recoveries, but of course, past performance does not guarantee future results. Many investors – institutional and individual – are newly focused on longer-dated opportunities for this very reason; keeping capital occupied across market cycles is a way of mitigating the risk of buying at a temporarily inflated value. Real estate investors are turning increased attention to funds (including debt funds), where capital is invested over time rather than at a single moment, and managed by experts.

### Correlation to Global Public Equities 2009-2019



Sources: IPD Global Property Fund Index, MSCI, Bloomberg, Barclays, Cambridge Associates Global Private Equity Index

# Commercial Real Estate Investing Today

We believe real estate has been consistently one of the most favorable long-term investments for individual investors in recent years. In the last several quarters, we observed a greater appetite for shorter target hold periods and more senior positions in the capital stack, likely due to a perception that the market was at or near its peak. Now, with a precipitous drop in asset values and heightened public market volatility, private commercial real estate has come into greater focus, with preference changing rapidly with respect to investment structure and property type.

Alternatives are characterized by low cross-asset correlation with public markets, U.S. core private real estate has exhibited a particularly low degree of correlation with public markets over the years 2009-2019: -0.3 to global bonds, and -0.5 to global equities. For the decade ending in 2019, U.S. commercial real estate was the least correlated to global (publicly traded) equities of any major index-tracked alternative asset class. The pandemic and its economic fallout have impacted sectors of the real estate market in non-uniform ways, however. In our surveying of accredited investors, we found shifting preference toward different property types, and a renewed focus on appreciation.

# Conclusion: the Path Ahead for Individual Investors

Individual investors have become more aware of alternative asset strategies over the past decade. At the same time, access to alternative assets has flattened considerably, with platforms like EquityMultiple making private market, illiquid assets accessible to individuals at relatively low minimums. Still, individuals remain under-allocated as compared to their institutional counterparts. This is a moment for individuals to examine their exposure to alternative assets, and move further toward mirroring the allocation strategies of institutional investors in order to attain broad exposure to opportunity. For institutional and individual investors alike, the moment calls for the following actions:

- Further diversify and maintain asset allocations that may insulate portfolios against systemic risk, including precipitous market declines from future pandemics and other global shocks.
- Capitalize on new opportunities, such as hybrid property types, as well as more established assets, like multifamily and industrial properties.

**Awareness, quality management, and access are all necessary in order for individual investors to continue closing the alternative asset allocation gap. EquityMultiple aims to provide all three. We are hopeful that the “real estate crowdfunding” industry as a whole, and other facets of the platform-based investing space, will provide transparency and quality as investors seek to insulate their portfolios from risk.**

## Sources:

<sup>1</sup><https://caia.org/portfolio-for-the-future>

<sup>2</sup><https://pws.blackstone.com/wp-content/uploads/sites/5/2020/09/seeking-an-alternative-paper-insights.pdf>

<sup>3</sup><https://caia.org/next-decade>

<sup>4</sup><https://investments.yale.edu/about-the-yio>

<sup>5</sup><https://www.kkr.com/global-perspectives/publications/rethinking-asset-allocation>

<sup>6</sup>Internal data

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