V A N   L I E W   T R U S T   C O M P A N Y

as we see it

Spring 2024

THOUGHTS FROM OUR CHAIRMAN

Whether it is the weather, human development or the market, change is inevitable. Financial institutions and their means to an end are no exception. Capital is identified and increasingly committed in different ways.

Guided by individual account investment objectives and guidelines at Van Liew, we have identified, analyzed and ultimately approved the use of some alternative investments. Additional diversification helps with minimizing volatility. There are now publicly traded options for investors.

In this issue of As We See It, our associate, James Powell, goes into more detail.

Alfred B. Van Liew

Alternative Investments

James Powell, CFA, CAIA, CFP®

There has been a lot of press recently about the rise of alternative investments, so we thought it might be helpful to start a conversation that perhaps we can continue in a later call or meeting. Let us begin with what alternative investments are before we delve into why they are becoming so much more common. Our hope is that by the end of this essay we can stop calling certain investments alternative with the realization that many are quickly becoming traditional investments.

An alternative investment is any investment that is not a traditional stock, bond or cash that we believe may improve our risk and return profile.

When we say "stocks and bonds," we really mean Common Equity and Unsecured Debt in the capital structure, yet they are not the only options a business might have to raise money. We can use alternative investments to invest in other segments of the capital structure.

Asset-Based Loans
Senior Secured Debt
SENIOR UNSECURED DEBT
Subordinated Debt
Preferred Equity
COMMON EQUITY

Why do we hear so much about alternative investments now?

Our financial landscape has evolved significantly. Banks have long been the institutions that provided capital to mid-sized businesses that do not (or cannot) issue public debt, yet largely due to regulatory reasons, bank financing has decreased from about 70% of the bank (leveraged) loan market in the mid-1990s to less than 10% in recent years, whereas non-bank financing now comprises more than 90% of leveraged loans.[1]

Our market structures have adapted. Individual investors used to buy and hold corporate bonds (and clip a physical coupon!); now institutions (i.e., mutual funds) purchase the vast majority of debt securities. The individual investor benefited by achieving a diversified fixed income portfolio with limited capital at very low cost.

Another issue is the declining number of public equities, an offshoot of the surge in passive investing. In 2008, the S&P 500 comprised 72% of total US equities, with 15% of that concentrated in five companies. In 2022, that number increased to 80%, with 25% of that concentrated in the largest five companies (think about the Magnificent Seven). Do you remember the Wilshire 5000 Index? As of March 31, 2024, it comprised just 3,381 stocks![2]

Chances are, you may have already invested in alternative investments but did not realize it. Many have become traditional investments over time. Just a decade ago, the Chartered Alternative Investment Analyst (CAIA) Association® considered commodities an alternative investment. Today we broadly acknowledge the different ways investors can gain exposure to many commodities through traditional investments. Other areas we think are ripe to become traditional investments include private credit, digital assets, and real estate.

Private credit. Private credit has been the domain of institutions for decades: large pension plans, endowments, foundations, and ultra-high net worth investors. As funding needs have increased and pension assets have decreased, the private credit market became democratized. Many individual investors who don't need immediate liquidity can now invest in different parts of the capital structure, such as Asset-Based Loans and Senior Secured Debt, and actually improve the risk and return profile that was formerly available to them through traditional investments only.

Digital assets. The relatively new field of digital assets is fraught with volatility, but those who can accept a high level of risk may benefit from the potential broad use of these new technologies. If the use case for digital assets proves successful, we may consider them traditional investments sooner than we expect.

Real Estate. Investors have long considered real estate an alternative investment because it has a risk and return profile different from public equity and debt. Today, you can invest in public Real Estate Investment Trusts (REITs) or private REITs, depending on how soon you need to access your capital and your individual risk tolerance.

This brings us to thorny questions about risk, the other side of the coin from return. While some alternative investments are broadly helpful to most investors, all alternative investments are certainly not for everyone. There are no passive indexes for alternative investments and they do come at a cost. By law, you have to work with a financial advisor to gain access to most (but not all) of these investments, who must verify eligibility and suitability.

As I have written in these pages before, our goal is to help our customers achieve an optimal risk-adjusted return. Alternative investments will help us do that. Let us continue the discussion in person.

1. Congressional Research Service, Leveraged Lending and Collateralized Loan Obligations: FAQs, 12/4/2019
2. FT Wilshire 5000 Index Series fact sheet, 3/31/2024

We would be delighted to meet with you to share comments about this article, or to review your portfolio in detail.

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Ask for Joe Healy or Ted Staples

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NEWPORT
Ask for James Powell or Lydia Owen