An Alternate View on Alternative Investments
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Introduction

Over the past fifty years, so-called alternative investments have become an important category in the portfolios of institutional investors. Led by forward thinkers such as David Swenson at Yale, institutions have gradually moved away from portfolios consisting primarily of common stocks and investment grade bonds, to portfolios which include significant holdings of private equity, hedge funds, private credit and other more exotic investments.

In more recent years, alternative investments have played an increasing role in the construction of individual investors' portfolios. There are at least four reasons for this trend. First, improved technology has led to the creation of platforms which allow alternatives to be marketed to individuals by brokerage firms and investment advisors while still meeting the SEC's requirements for non-registered offerings. Second, the SEC has taken a more accommodative stance on allowing such investments to be sold to individual investors. Third, a significant effort by managers of alternative investments to access the enormous pool of assets held by individual and retirement accounts is showing results. Fourth, a demand for liquidity by institutions on their existing investments has created a sense of urgency for alternative managers to find a new pool of investors.

The term alternative investment is admittedly a catchall which includes many investment categories. Some of these act more like equities (such as private equity) and others act more like fixed income (private credit, some hedge fund strategies.) The characteristics which alternative investments generally share are (1) they offer exposure to a type of investment not generally available to investors who only invest in stocks and bonds, (2) they are generally less liquid than traditional investments, (3) they often require a longer time frame than traditional investments, and (4) the fees are almost always (much) higher.

The Difference Between Institutions and Individuals

One of the selling points used to convince individual investors to invest in alternatives is that they are being given access to a type of investment which was previously only available to sophisticated institutional investors. While this may be true, on closer examination the logic isn't as compelling as it sounds. Institutional investors such as endowments and pension fund are different in many ways from individuals. Institutions invest over effectively infinite time horizons, are not subject to personal liquidity needs, and often have teams of professionals conducting due diligence, negotiating fees, and managing liquidity.

Individual investors, by contrast, live finite lives. They face real-world demands—retirement spending, healthcare expenses, tuition, and other cash needs—that make liquidity and flexibility essential. Committing capital to a private fund with a seven- to ten-year lockup may seem manageable at the outset but can become highly restrictive when life circumstances or market conditions change.

During periods of financial stress, the mismatch between an investor's personal liquidity needs and the illiquid nature of private investments can be a serious problem. Institutions can ride out market cycles. Individuals may be forced to redeem at unfavorable prices—or find that redemptions are not permitted at all in a reasonable time frame. The "illiquidity premium" that is meant to compensate for this risk may be of little use when an investor needs their funds for an emergency or wishes to reallocate for other reasons.

Performance and the Impact of Fees

Advocates of alternative investments frequently cite their attractive long-term returns. But when measured against public markets and adjusted for fees, the picture is less compelling than might be expected. From 2014 to 2024, the S&P 500—including dividends—returned 13.4% annually. Over the same period, U.S. private equity funds returned 14-15% (net of fees), while hedge funds averaged around 8-9% (net of fees). We would argue that for most individuals, the returns on alternative investments, while competitive, don't necessarily make up for the lack of liquidity, additional paperwork, monitoring costs and additional tax preparation costs which go with many private investments.

One explanation for the mediocre performance by private funds is the higher fees generally charged on private investments. It is not uncommon for a private equity fund to charge 1-2% management fees plus 10-20% of profits. The compounding effect of those fees is dramatic. A $100,000 investment earning 10% per year grows to roughly $673,000 after 20 years before fees. With 2.5% in annual fees, the same investment ends at about $429,000—a 36% shortfall. While there are fees on publicly traded investments, they are generally much lower.

Behavioral and Structural Risks

Proponents of alternatives sometimes argue that illiquidity helps protect investors from themselves by preventing panic selling. While there may be truth to that, illiquidity also introduces new risks. Because valuations are reported infrequently, portfolios appear smoother than they really are. This can create a false sense of stability.

More importantly, liquidity is a strategic asset. It gives investors the ability to respond to changing conditions--an ability that isn't available on the portion of a portfolio tied up in illiquid investments. Public-market investors enjoy the advantage of being able to reallocate quickly when dislocations create opportunity. The 2008 crisis, while painful for most investors, produced extraordinary opportunities for those with the liquidity to act. Investors who were "gated" in existing illiquid funds, and unable to move capital, missed those opportunities. Furthermore, many private investments require capital calls at undetermined points in the future, which can require liquidating public market investments at inopportune times.

Conclusion

Alternative investments can play a useful role for institutions with perpetual time horizons, substantial resources, and access to the best managers. But for individual investors, the combination of illiquidity, opacity, high fees, and uncertain access often turns potential advantages into disadvantages.

In an era when complexity is often confused with sophistication, simplicity is often a better alternative. The approach of Western Pacific is simple, and time tested. We seek to preserve and grow our clients' capital through investment in outstanding companies, usually for the long term. We do this by investing with proven fund managers who have the track record, incentives and organization to maximize their likelihood of success. Our clients are long-term investors, an approach which- while there are no guarantees- over time has been a proven way to build and preserve wealth.

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