JOHNSON FINANCIAL GROUP®

Alternatives Outlook

2024 Year Forecast

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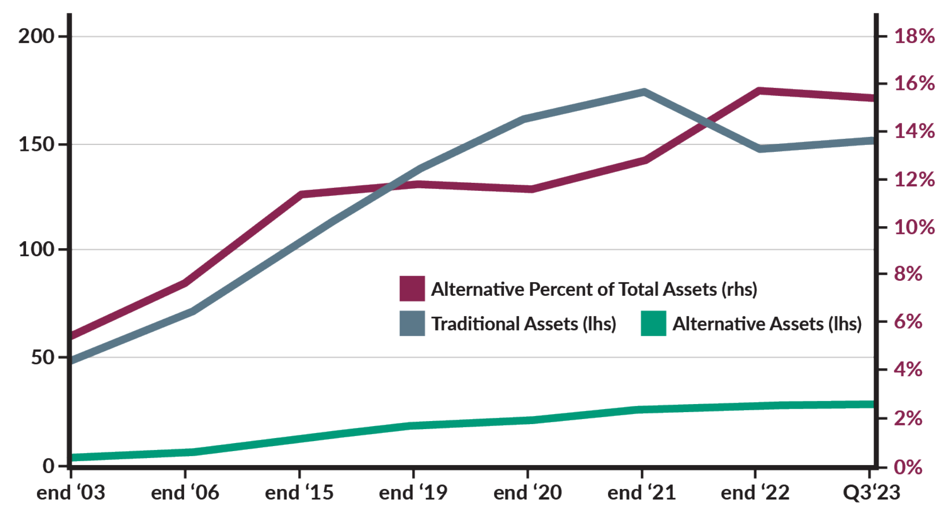
Over the past few weeks, we have shared our quarterly Economic & Market Outlook, followed by the individual outlooks for stocks and bonds. This commentary represents the final installment, where we'll provide our views on the highly diverse alternative investment landscape.

We generally consider alternative investments as anything other than publicly traded stocks and bonds or investment vehicles that invest only in those securities, such as mutual funds and ETFs. Alternative investments range from commonly understood investments, such as multi-family real estate (i.e., apartment buildings), to less conventional investments such as venture capital.

Although new to some investors, alternative asset classes are a large and rapidly growing part of the total investment landscape, as shown in the accompanying chart. Since 2003, alternative assets' total share of global asset capitalization has grown from 5.5% to 15.4%, and ordinary investors have more access than ever due to increasingly accepted semi-liquid investment structures. *[Figure 1]*

Figure 1

Global Asset Capitalization



Source: EIKON, Bloomberg Finance L.P. Barclays, Pregin, MSCI, HFR, J.P. Morgan

Why Alternatives?

At Johnson Financial Group, we believe alternative investments can have important contributions to portfolios when appropriate for client investment objectives and risk tolerance. Perhaps the most critical reason to consider the addition of alternative investments is the need to further diversify a stock and bond portfolio during a period of elevated correlations between the two traditional asset classes. *Figure 2* shows that correlation has recently been near 50-year highs.

Therefore, the essential message of this outlook is to encourage investors not currently allocating to alternatives to discuss the opportunity set with their investment team.

Diversity of Outlooks

Alternatives encompass a broad and diverse collection of investments, each with its own merits. Not surprisingly, some are more favorable than others. Here are three areas we find attractive: private debt, secondary markets for private funds, and—with respect to potentially attractive entry points—commercial real estate.

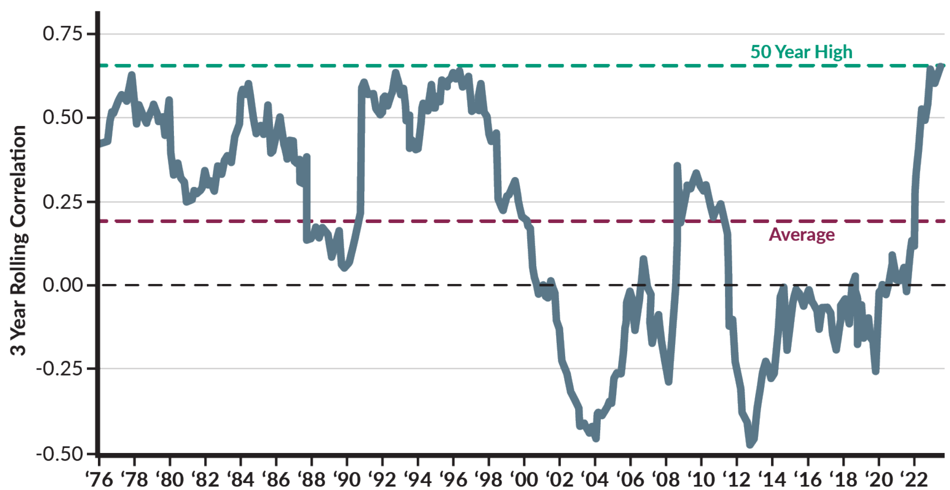
Return to Lender

Following a sustained period of low and near-zero interest rates, the Fed rate hiking cycle has dramatically shifted the landscape for lenders. Higher rates and multiple regional bank failures have produced a significantly tighter credit environment, which has imposed higher interest rates on borrowers. *[Figure 3]* That shift has been perhaps most evident in private debt.

Private debt, already a rapidly growing asset class, has filled the void as traditional lenders retreat. Private lenders have grabbed market share, earning higher yields through a combination of rising base rates (driven by Fed hikes) and widening spreads (due to the lessened competition with traditional lenders). In this environment,

Figure 2

Correlation of Returns Between U.S. Stocks and Bonds

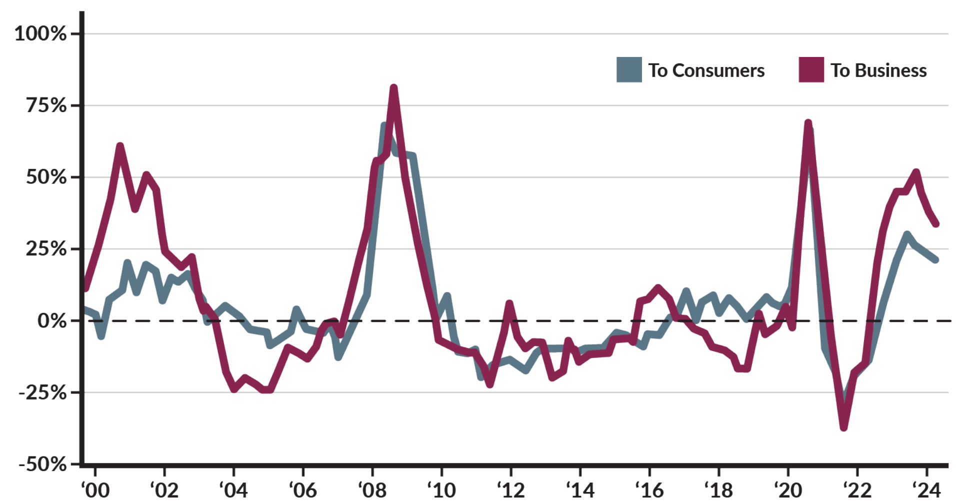


Source: Bloomberg, CoreCommodity; 1973 - Sep 2023.

Note: Stocks represents the S&P 500 Index. Bonds represent the Bloomberg U.S. Aggregate Gov/Credit Index through Feb 1976 and the Bloomberg U.S. Aggregate Bond Index thereafter. Commodities represents the Bloomberg Commodity Index Total Return.

Figure 3

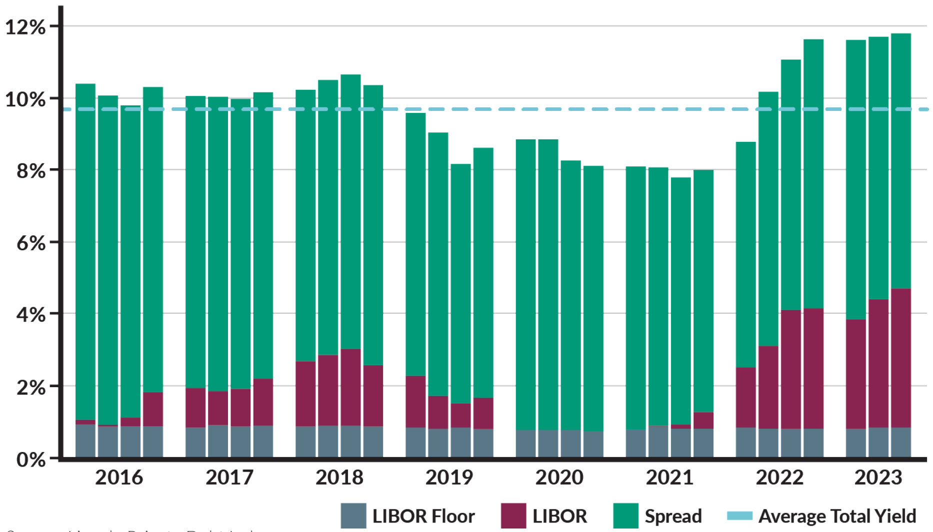
Percentage of Banks Tightening Credit



Source: Federal Reserve Economic Database (FRED), 2000-2003, as of 1.25.24

Figure 4

Decomposing Yield - All Loans

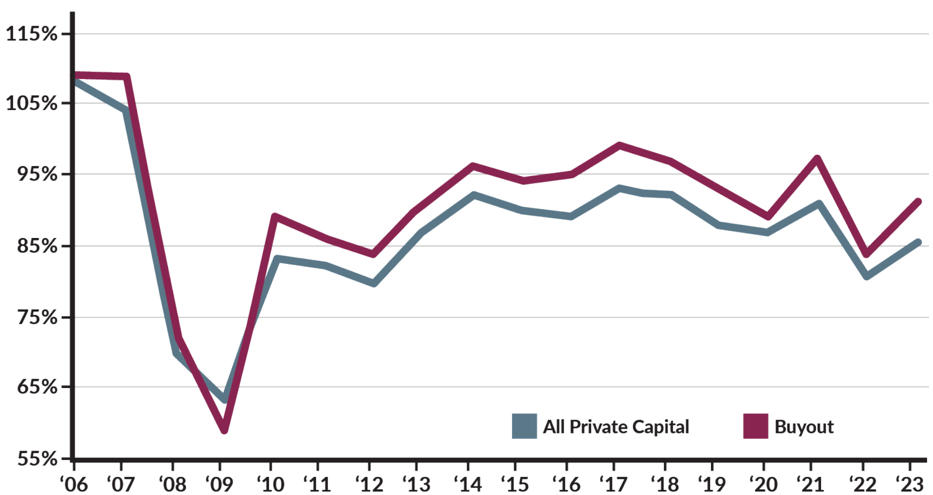


Source: Lincoln Private Debt Index

Note: LIBOR Floor reflects fair value weighted average for each peroid while LIBOR above reflects the extent to which LIBOR is above the floor.

Figure 5

Secondary Transaction Pricing



Source: Greenhill, Jeffries

private lenders can issue new loans with all-in yields of nearly 12%, which are further supported by more meaningful contributions from equity shareholders. *[Figure 4]* This is an attractive entry point, with equity-like return expectations and the added protection of being first-lien lenders that provides superior protection in the event of financial difficulties.

An economic downturn that results in widespread financial difficulty for corporate borrowers represents the most significant risk to our positive outlook in this area. While higher yields benefit the lender, borrowers already contending with higher interest and input costs may be unable to endure the further stress of an economic downturn. We're closely watching default rates, which, though rising, remain slightly below the long-term average.

Secondary Elevation

The secondary market for private funds is also well-positioned in the current market environment. Secondaries, where an investor buys an interest in a limited partnership fund from an existing investor, are an increasingly accepted way for private market allocators to obtain liquidity or reposition portfolios. The benefit to the new investor is that by acquiring the fund mid-life, they have increased visibility into the companies the fund holds and can expect to receive distributions much earlier. Furthermore, buyers typically purchase at a discount to the estimated value of the position.

Although the continued increase in value of the portfolio companies is a major return driver for secondaries, acquiring at more dramatic discounts is always an attractive proposition. Pricing for secondaries has historically varied depending on the supply of capital and seller demand, and the balance now favors buyers. *[Figure 5]* This dynamic is a result of:

- Growing private market allocations from large institutions, such as pensions and insurance companies.
- Strong performance, which, combined with the increasing allocations, has resulted in overallocations to alternative investments.
- Reduced return of cash from private equity investments due to a drought in the M&A environment. The seized-up M&A market has diminished the ability of private equity firms to sell portfolio companies and return cash to investors.
- Continued desire from large allocators to commit to new funds while overweight and lacking available cash, as noted above.

The result of these factors is a substantial pool of potential and motivated sellers. In comparing the total amount of deals closed to the amount of available capital, the supply barely exceeds the demand. That means there are ample opportunities for secondary buyers to consider, and it reduces the impulse for buyers to sacrifice pricing or quality to put cash to work. *[Figure 6]*

Commercial Real Estate Downturn

Without a doubt, the most disappointing space for alternative investors last year was in commercial real estate, as it was among the most hard-hit areas due to the significant levels of debt commonly associated with property ownership. The clear loser is the office sector, where valuations have declined every quarter since Q2 2022 and have now fallen more than 20%. The bad news for existing investors is that current trends don't suggest the end is in sight, and some estimates suggest that an additional 20% decline may be in store in some areas. Because buyers and sellers have been unable to agree on pricing, there's a limited sample set for comparison, but buyers will likely need to move in the direction of sellers to close deals.

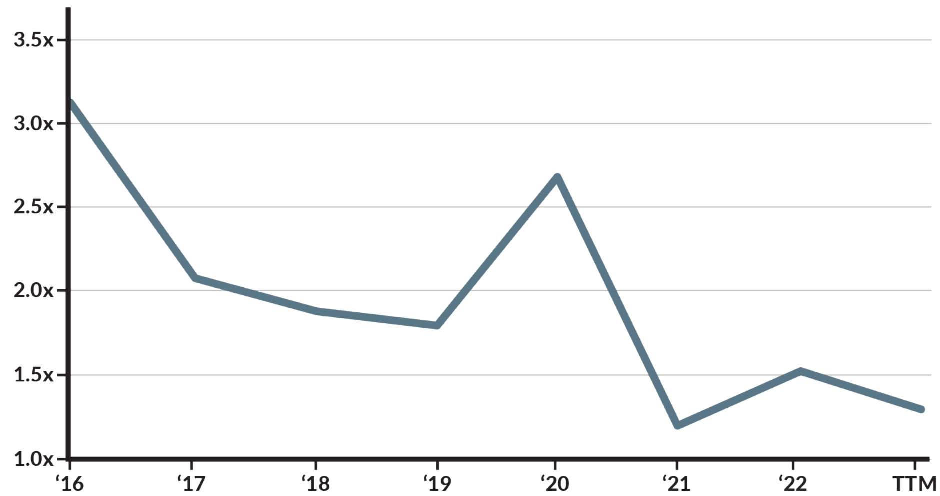
It's critical to look through the headlines, however, and recognize that meaningful differences exist within the sub-types of real estate. For example, modern logistics facilities that support last-mile delivery for e-commerce operations continue to have high occupancy rates and attractive cap rates, and multi-family housing has significant long-term trends supporting the sector.

Diversification — Not Swinging for the Fences

If there's a lesson to be learned from the past several years, it's that it's difficult to predict what will be the next source of market drama or how the market will respond. We encourage investors to consider educating themselves on alternative investments and the diversifying role they may play in portfolios, and we are eager to partner with our clients in those conversations to build portfolios more resilient to the unknown market environments to come.

Figure 6

Secondary Market Annual Capital Overhang



Source: Hamilton Lane Database (July 2023), Evercore Secondary Market Review (July 2023)

Let's Start a Conversation

Your Johnson Financial Group team is here to help you understand this complex and ever-changing economic landscape. Over the coming weeks, we'll share more specific outlooks for stocks, bonds and alternative investments. We aim to position your portfolio with the flexibility to navigate this volatility while also meeting your financial goals. **Thank you for your partnership and trust in Johnson Financial Group.**

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