

Alternatives 2022 Outlook

February 2022

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Introduction

Economic fundamentals matter. Whether investing in credit or equities, currencies or commodities, real estate or infrastructure, the macroeconomic context will ultimately influence performance. Understanding how markets affect our Alternatives strategies is a central tenet of our investment philosophy, and for nearly a decade, Wilshire Advisors (“Wilshire”) has developed annual investment themes based on macro trends. As always, macro views can never take the place of rigorous bottom-up research. However, it can serve as a guide when allocating scarce resources to find and evaluate the most compelling investment strategies. We hope that you find this work a helpful guide to private investment opportunities in 2022.

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Global Overview

Wilshire's Alternatives research practice follows a thesis-driven investment process, incorporating a top-down macroeconomic view that informs its portfolio decisions and supports the proactive development of investment themes as the basis for directed manager sourcing and research. A distinct investment strategy is then deployed for each Alternatives sector included in a portfolio. Market information such as capital flows, valuation levels, and pricing power is analyzed to identify where the best value and most inefficient markets exist within each sector. An integrated global process that leverages local team expertise and relationships seeks to optimize return and risk for our global clients.

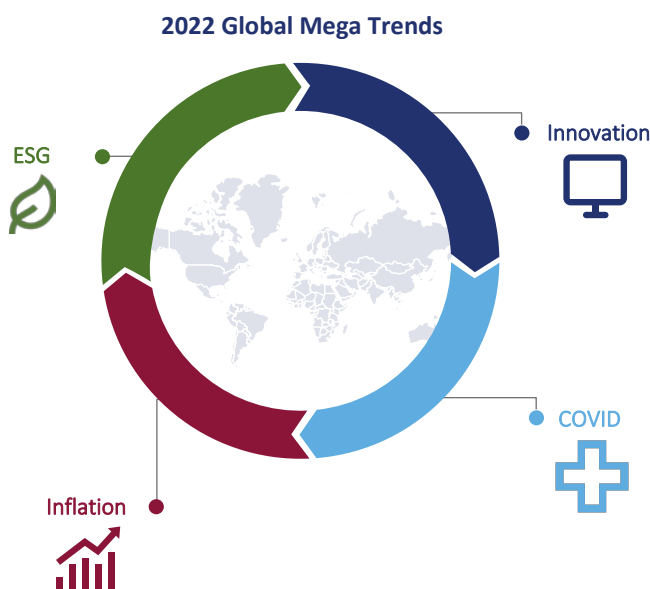
We believe that having a top-down economic perspective better informs portfolio construction and focuses our research efforts on the most compelling segments of the market. To be clear, top-down perspectives do not replace extensive, local bottom-up manager research but they may clarify and inform the ultimate investment decision. These forces will influence both risks and opportunities for Alternatives managers in the coming year.

As the world adapts to COVID we emerge into a market landscape dominated by slowing, albeit still above-trend, global growth, higher inflation, and supply chain havoc. The recent COVID case spikes globally and emergence of the Omicron variant remind us that the pandemic persists, and the virus will likely be with us for a long time if not indefinitely. Despite this it is also clear that we have learned to live with the virus – people are getting back to normal and the economic effects of COVID are diminishing with each successive wave. As global economies normalize aggregate demand remains strong, the problem has become getting supply to market.

With COVID risk coming into clearer focus investors must now deal with its consequences. Certain spending that otherwise would have gone to services is being diverted to goods. Strong demand is being met with low inventories and supply chain challenges which is leading to higher prices. These together with higher wages – necessary to lure people back into the labor market – has driven inflation to multi-decade highs. While most of the current inflation is expected to be transitory, it's reasonable to assume that some of these higher prices will be longer lasting. Higher wages and higher rents, as two examples, are difficult to reverse once increased, and may suggest a world of sustainably higher input costs for consumers and corporations alike. Governments, who provided unprecedented stimulus during the recovery, are beginning to withdraw support and rates, once again historically low, will start increasing in 2022 it's just a matter of when and how fast.

Against this backdrop the role of Alternatives in diversified portfolios has shifted from “nice to have” to “need to have.” Historically high valuations, rising rates and elevated inflation coupled with high volatility and low yields support the utility of Alternatives as an offset to each. Examples include real assets, where inflation-linked contracts hedge inflation risk, private credit, where floating rate structures hedge interest rate risk, uncorrelated strategies, where orthogonal risk offsets market volatility, and private equity, where operationally focused strategies trade valuation risk for execution risk. Indeed, Alternatives are being recognized not only as a source of higher absolute return but also an important tool for risk management.

In the following sections we will review how COVID, innovation, inflation and ESG (together the 2022 “Global Mega Trends”) translate into a regional context for North America, Europe and Asia-Pacific, and how the resulting regional investment themes will guide the construction of our global portfolios in 2022.



North America

Regional Context

We expect the U.S. economy in 2022 to be characterized by strong consumer demand, labor market tightness, inflation with varying degrees of transitory and persistence, and waning fiscal and monetary stimulus which combine into strong growth but reversion towards trend levels. With this view we have distilled the 2022 Global Mega Trends into Regional Context and Local Opportunities in the U.S. across the asset classes that we cover.

	Regional Context	Local Opportunities
Innovation	<ul style="list-style-type: none"> Digital Economy Financial Products Life Science 	<ul style="list-style-type: none"> E-Commerce Acceleration Democratization of Alternatives Pharmaceuticals
ESG	<ul style="list-style-type: none"> Environmental Initiatives Diversity and Inclusion Wealth Redistribution 	<ul style="list-style-type: none"> Sustainable Products Energy Transition Education & Housing
COVID	<ul style="list-style-type: none"> Economic Recovery Supply Chain Challenges Deglobalization 	<ul style="list-style-type: none"> Pent-up Consumer Demand Healthcare re-focus Distance X
Inflation	<ul style="list-style-type: none"> Interest Rates Monetary & Fiscal Policy Financial Risk 	<ul style="list-style-type: none"> Real Assets Special Situations Alt Yield

Strong consumer demand is driving robust consumer spending, which accounts for more than two-thirds of U.S. economic activity. Despite this demand, supply remains constrained as COVID catalyzed an abrupt, although likely temporary, shift in the U.S. from consumption of services towards consumption of goods resulting in bottlenecks and disruptions throughout many supply chains. Meanwhile the number of Americans quitting their jobs is at a multi-decade high resulting in a labor market where the number of job openings now exceeds the number of unemployed.

2022 is a midterm election year in the U.S. and historical precedence suggests that Democrats are likely to lose control of the House or Senate or both. The resulting split government should mute the possibility of significant legislation through 2024, and the overall trend towards fiscal and monetary withdrawal is expected to continue absent unforeseen shocks. As rates adjust upward, assets with the highest valuations and highly levered balance sheets will likely be the most vulnerable.

In the public markets, directional marketable alternatives have naturally benefited more than their diversifying counterparts from rising prices of risk assets coming off the 2020 pandemic-induced trough. As public markets wrestle with pervasive uncertainty regarding inflation, novel COVID variants, record valuations and leverage, and central bank tapering, directionality should take a backseat to both diversification and idiosyncratic risk opportunities, which stand to profit irrespective of

North America Alternatives

Private Equity	
Buyout	●
Growth	●
Venture	●
Special Situations	●
Private Real Assets	
Real Estate	●
Natural Resources	●
Infrastructure	●
Private Credit	
Direct Lending	●
Distressed Debt	●
Opportunistic	●
Alternative Yield	●
Marketable Alternatives	
Macro/CTA	●
Equity Hedge	●
Credit	●
Event Driven	●
Relative Value	●

- Highly Favorable
- Favorable
- Neutral
- Cautious
- Unfavorable

market directionality. Nonetheless, while our expectations for marketable alternatives in 2022 are mixed, our views are predicated on the belief that uncertainty will persist in the near to medium term, resulting in material alpha potential and sustained levels of elevated price volatility.

Overall, 2022 will begin with key risks that echo the end of 2019 – namely, high valuations and historically high levels of debt across asset classes. Regional context becomes critical to understanding which areas of the market provide the strongest cyclical and secular tailwinds and which sectors require caution.

Europe

Regional Context

The European economic recovery continues but the momentum has weakened. While vaccinations have generally been effective at mitigating negative effects of COVID-19 and aggregate consumer spending largely rebounded, concerns around new variants of the virus, a tight labor market, and rising inflation, create uncertainty about the sustainability of the continent's growth prospects going into 2022. With this in mind we have distilled the 2022 Global Mega Trends into Regional Context and Local Opportunities in Europe across the asset classes that we cover.

	Regional Context	Local Opportunities
Innovation	<ul style="list-style-type: none"> Digital Disruption Ubiquitous Connectivity Maturing Tech Ecosystem 	<ul style="list-style-type: none"> E-Commerce & FinTech HealthTech Cybersecurity & Big Data
ESG	<ul style="list-style-type: none"> Climate Change Energy Transition Circular Economy 	<ul style="list-style-type: none"> Decarbonization AgriTech & Housing Pollution & Waste Control
COVID	<ul style="list-style-type: none"> COVID-19 Uncertainty Demographic Shifts Market Dislocations 	<ul style="list-style-type: none"> Healthcare & Life Sciences Value-Based Products Special Situations
Inflation	<ul style="list-style-type: none"> Monetary & Fiscal Support Interest Rates Demand Outstrips Supply 	<ul style="list-style-type: none"> Alt Yield Real Assets

Against the backdrop of the ongoing pandemic, Europe reported an economic growth rate of circa 5% in 2021. In a markable break from Europe's lower inflation levels in recent decades, this strong increase in economic activity has been accompanied by a rise in inflationary pressures, and Eurostat estimates 5% inflation in the Euro Area in 2021. European labor markets are recovering from a significant hit in 2020, with the unemployment rate close to its pre-pandemic level (6.5% as of December 2021 vs 6.3% as of March 2020). Where do we go from here?

While growth is anticipated to be supported by a further improving labor market, still high consumer savings, and accommodative financing conditions, new headwinds to the European outlook are mounting. Central banks across the globe have been clear that they are not willing to take any risks with the economic recovery and the consensus view is that European rates remain low throughout (the majority of) the new year. While supply chains are expected to increasingly normalize later in 2022, higher inflation could endure, amongst others driven by labor demand (translating in higher salaries), monetary support, and surging energy prices. The political environment creates another layer of localized uncertainty to the outlook. For instance, there will be (presidential) elections in Italy and France in 2022. Further escalation of tensions between Ukraine and Russia could potentially hamper Europe's growth prospects as well.

European Private Markets

Private Equity	
Buyout	●
Growth	●
Venture	●
Special Situations	●
Private Real Assets	
Real Estate	●
Natural Resources	●
Infrastructure	●
Private Credit	
Direct Lending	●
Distressed Debt	●
Opportunistic	●
Alternative Yield	●

- Highly Favorable
- Favorable
- Neutral
- Cautious
- Unfavorable

Against this macro-economic context, we continue to favor more defensive business models, underpinned by demand regardless of the state of the European economy, as well as recurring revenues. Whether inflation is temporary or indeed more structural, private assets will be affected, for instance by impacting EBITDA margins. In our view, therefore, inflation is a key theme in our private markets allocations in 2022.

Across our European portfolios, technology remains one of the strong secular opportunities, only accelerated by COVID-19. Technology disruption is taking place in an increasing number of sectors, with technology touching healthcare, financials, education, retail, agriculture, and many other industries today. While valuations have increased, particularly in technology, we believe transformational trends such as universal connectivity are irreversible and hence digital transformation continues to present vast growth potential across private markets. While rising technology penetration results in an increase in the spread of cyberattacks, this spurs innovation and the emergence of cybersecurity-focused venture capital firms.

Lastly, going into 2022, increasingly more European governments, consumers and investors alike are embracing growth with purpose, which was further fueled by the global climate conference COP26 in 2021. There is a rising climate change focus, with implications for the energy transition and the circular economy. Fiscal stimulus packages will be supporting infrastructure spend, including in renewables. We anticipate this will create attractive “planet positive” European investment opportunities in our 2022 pipeline.

Asia-Pacific

Regional Context

While COVID-19 and its new variants continue to affect the world, Asia-Pacific, in general, continues to be resilient in terms of economic performance. Recovery is trending positively, primarily due to robust government containment measures and strict compliance from the general public. Among the major economies, China continues to lead economic recovery efforts, while other major developed economies have shown positive recovery signs since the second half of 2021. According to the World Economic Outlook, the GDP forecasts of major Asian economies are as follows: (2021/2022) – China (8.0%/5.6%); Japan (2.4%/3.2%); Korea (4.3%/3.3%), ASEAN-5 (2.9%/5.8%).¹

	Regional Context	Local Opportunities
Innovation	<ul style="list-style-type: none"> Continuous Tech Advancement Maturing Venture Ecosystem Accelerated Digital Adaptation 	<ul style="list-style-type: none"> B2B Services & Supply Chain Transformation Healthcare Tech New Consumer
ESG	<ul style="list-style-type: none"> Social equality Anti-Trust and Fairness Demographic Shifts Pollution 	<ul style="list-style-type: none"> Consumer Staple and Upgrade Healthcare Elderly Related Services Environmental
COVID	<ul style="list-style-type: none"> Economic Recovery Supply Chain Challenges 	<ul style="list-style-type: none"> Broader Consumer Foreign Supply Replacement Supply Chain Transformation
Inflation	<ul style="list-style-type: none"> Rising Asset Prices Reduction of Government Stimulus Package in Post-COVID Recovery 	<ul style="list-style-type: none"> Early-Stage VC Special Situations Real Assets

Economic activities are trending towards pre-COVID levels in the major economies in Asia-Pacific, while consumer confidence regains traction, and unemployment remains at manageable levels. Together with the demographic shifts, including an aging population and rising middle class, it is expected that the broader consumer sectors will continue to benefit from tailwinds. Meanwhile, given the travel restrictions and other COVID-19 related measures, global supply chain management has become increasingly challenging. With Asia-Pacific playing an important role as both a key supplier and consumer in the global supply chain, it has catalyzed the supply chain transformation with new business models and the adoption of new technology to enhance efficiency. In the case of China, which also faces the risks of geopolitical tensions with Western countries, it has put a strong emphasis on the theme of foreign supply replacement and encourages the businesses to shift the development of key components and technology along its core supply chain to domestic markets.

Asia-Pacific Private Markets

Private Equity	
Buyout	●
Growth	●
Venture	●
Special Situations	●
Private Real Assets	
Real Estate	●
Natural Resources	●
Infrastructure	●
Private Credit	
Direct Lending	●
Distressed Debt	●
Opportunistic	●
Alternative Yield	N/A

- Highly Favorable
- Favorable
- Neutral
- Cautious
- Unfavorable

¹ Refers to Indonesia, Malaysia, Thailand, the Philippines and Singapore

Technology and innovation are widespread in Asia-Pacific. Notably, the mature venture capital ecosystem in China equips with ample supply of talents, the strong government support on technological innovations, as well as the integration of the full investment cycle from early-stage investing to the build-up of local unicorns, and subsequently multiple exit channels. Southeast Asia is also catching up with a strong adoption of technology and an increased penetration of mobile-internet, which together with favorable macro factors, accelerate the process of digital transformation. Overall, Wilshire expects a wave of opportunities to arise from digital consumption, tech-enabled B2B services, and healthcare tech sectors.

Meanwhile, ESG has become an increasingly important subject. In China, the recent regulatory changes around TMT sectors have a strong focus on promoting social equality and the well-being of citizens. 2022 will mark an important year for the implementation of these regulatory changes, which are expected to have a positive long-term effect to the overall investment environment in China. Meanwhile, an aging population, rising middle class, and environmental issues will remain as the key socio-economic themes in Asia-Pacific. Wilshire expects more funds to incorporate ESG considerations as part of their investment process and philosophy, and this will naturally lead to new opportunities surrounding environmental and recycling, healthcare and elderly-related services.

While inflation concerns are generally less spoken of in key Asian economies, there is an expected spillover effect from Western countries that will likely drive up asset prices in Asia. Wilshire believes that more opportunities and investor appetite will trend towards real assets in the backdrop of an inflationary environment. More so, this reinforces Wilshire's high conviction towards an overweight of early-stage venture capital. At the same time, Wilshire observes that some governments in this region have started planning to reduce stimulus or subsidiary packages in the post-COVID recovery era, which may in turn create opportunities for special situations investments.

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