ALTERNATIVES RESEARCH

Alternative Income Strategies: One Possible Antidote to the Investor's Challenge

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Introduction: "So you're saying there's a chance!"[1]

As we have described in recent Wilshire research,[2] today's economic and market environment present significant challenges and a strong headwind for investors. The "investor's challenge," as we have labeled it, is generally defined by muted long-term expected returns across asset classes with a dramatic loss in the overall portfolio utility of nominal bonds at its core. As the primary risk anchor within most institutional portfolios, investors are in a desperate search for supplements to this important fixed income portfolio allocation. In this introductory note, we review *Alternative Income* strategies, which, while not a direct replacement for traditional fixed income, have the potential to provide several key investment characteristics that might improve investors' chances of prudently supplementing the "40" in the proverbial "60/40" portfolio. As we will describe, while *Alternative Income* financing grew in response to address borrowers' needs following the Global Financial Crisis, their economic rationale should endure long term and provide institutions with viable investment options well into the future, even after the current investor's challenge has subsided.

Defining *Alternative Income* and its Origin

Since no single, simple definition currently exists, we begin by attempting to generally describe the *Alternative Income* universe. There are various characteristics that may separate this strategy group from traditional fixed income investments, including vehicle type and underlying investment liquidity; however, in Wilshire's view, there is one common set of attributes that distinguish this diverse universe of investment strategies from both traditional fixed income and other alternative investments: a consistent expected return stream that is derived from some yield or income source and is independent from the typical market mechanisms or events within risk assets. This broader opportunity set can be considered an expansion beyond more commonly known income-based strategies, such as direct lending, into more complex and esoteric areas, such as specialty finance and risk transfer strategies.

The *Alternative Income* strategy universe has expanded and evolved over time due to multiple regulatory and structural changes to the financial markets, as well as growing demand for investment products that have the potential to generate higher yields as return expectations within traditional fixed income sectors have softened. This progression was primarily sparked by impactful regulatory changes in both the U.S. and Europe following the Global Financial Crisis ("GFC") in 2008, which reduced the financing capabilities and activities of large global banks. While demand for specialty finance solutions (i.e. direct, custom lending solutions to consumers and mid/small-sized businesses to replace the role previously held by larger public entities) continued to rise in conjunction with global economic growth, there was a widening gap in the supply/demand function, which led to the emergence of private investment solutions to fill this void.

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[1] "Dumb and Dumber" (1994), Lloyd Christmas (Jim Carrey) to Mary Swanson (Lauren Holly)

[2] Wilshire Associates Incorporated (2020), The Investor's Challenge: "Runnin' Against the Wind," Foresti
Wilshire Associates Incorporated (2020), The Investor's Challenge: Nominal Bonds: "Running on Empty," Foresti

Fundamental Credit Backdrop

SUPPLY CATALYST

Financial regulation & accounting changes

Mass exodus of banks from credit markets created significant void in staffing and activity.

DEMAND CATALYST

Rise of SMEs across the globe

Accelerating demand for creative capital solutions within traditional commercial- and asset-based credit sub-sectors.

As interest rates remain near record-low levels and credit spreads within both high yield and loan markets have narrowed considerably since blowing out in March, the *Alternative Income* universe is propelled by growing investor demand for other sources of yield. There are two primary mechanisms that have solidified the market inefficiency addressed by *Alternative Income* strategies and should enable it to persist over time. The first is the broad set of structural catalysts within the credit industry. Aside from the aforementioned financial regulations following the GFC, there has been growing consolidation within the asset management industry, increased demand for customized finance solutions vs. generic product offerings, the growing need for asset/sector specialization as financial markets become increasingly complex, and capacity constraints within relatively smaller specialty finance platforms. These supply/demand drivers continue to stifle the traditional barriers to entry that were erected by massive global banks prior to the GFC and continue to drive the growth of unique, specialized private solutions.

The emergence and entrenchment of the *Alternative Income* universe is also driven by the rigid structure of the typical asset allocation framework. Many investment policies use specific buckets for traditional fixed income, marketable alternatives, and private assets, each of which has particular targets related to risk, return, and liquidity; however, as noted in Wilshire's aforementioned research, today's challenges begin with 0% yields on cash and cash equivalents within fixed income markets, while the potential yield within private assets is accompanied by a significant illiquidity premium. This asset allocation dilemma is potentially mitigated by the integration of *Alternative Income* strategies that offer higher yield potential than traditional credit-oriented fixed income securities and, given their more flexible and/or liquid vehicle structures, are also complementary to private market alternatives.

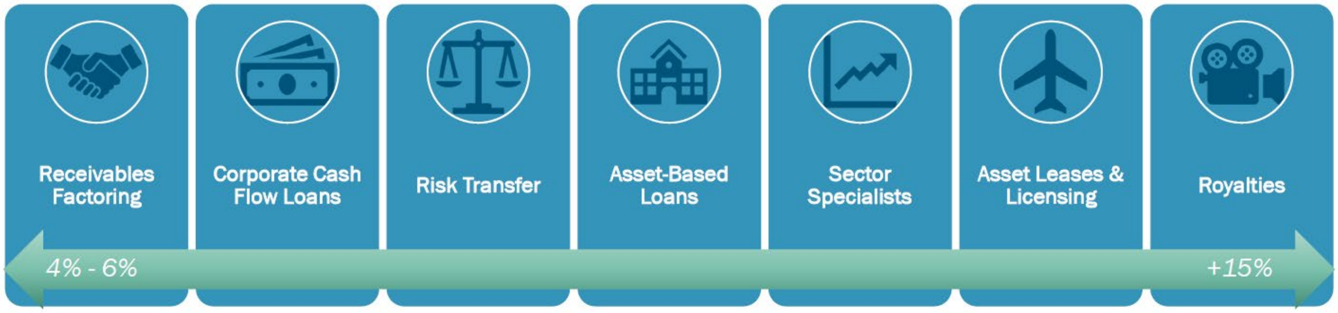
Alternative Yield Stratification

While the *Alternative Income* universe continues to evolve, Wilshire has developed a basic stratification framework to distinguish specific groups within the broader strategy set and support the ongoing asset allocation discussion. The *Alternative Income* universe can be divided into four primary groups:

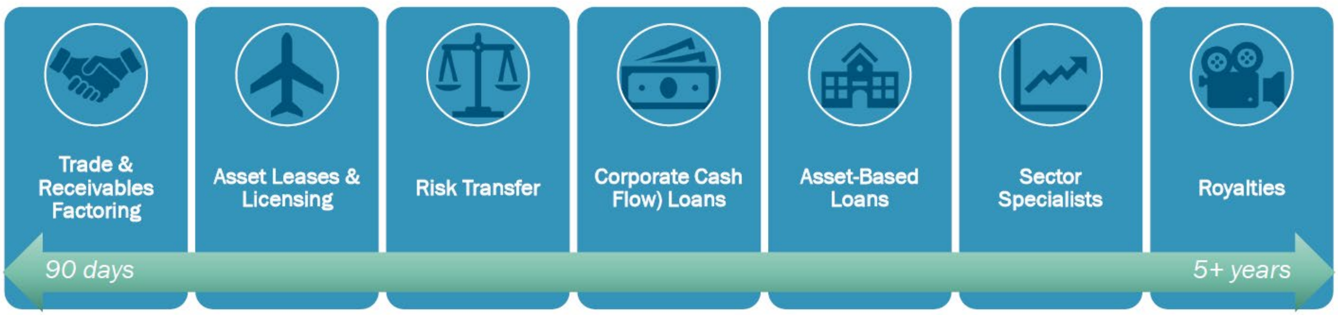
1. Opportunistic Direct Lending (i.e. providing direct loans to middle market companies)
2. Asset-Based Lending (i.e. providing direct loans to middle market companies with a fungible asset as the loan collateral)
3. Specialty Finance (i.e. providing short-duration bridge loans to an existing transaction, such as trade finance)
4. Risk Transfer (i.e. providing immediate liquidity by purchasing securities that have an expected future cash flow, such as lottery receivables)

Alternative Income strategies are offered in open and closed-end structures with revolving liquidity or natural, self-liquidating portfolio elements. Within each primary group, there are various subsets of the universe that have the potential to deliver very different risk, return, and liquidity characteristics based upon a specific policy's investment objectives and constraints. The related yield/liquidity spectrum is depicted below.

Yield Spectrum



Liquidity Spectrum



Alternative Yield and Risk Management

In its most simplistic form, fixed income investments are structured by providing capital upfront in exchange for a future stream of principal and income over a specific time period and in a pre-determined cadence. Fixed income investments are typically governed by agreed-upon terms that come in the form of a legal document, such as a loan, mortgage, lease, royalty or other agreement. Therefore, risks include any challenge to the timing or execution of those cash flows as determined by the legal document governing the transaction. Irrespective of underlying exposures, *Alternative Income* opportunities face many of the same risk factors as their traditional fixed income counterparts. These may include counterparty risk, duration, economic sensitivity, valuations, leverage, capital structure, structural protections, industry sensitivity, interest rates, and political/regulatory considerations. These risks should be carefully assessed and measured throughout the due diligence process, and Wilshire emphasizes that investment risk management is a crucial component to the process, regardless of the universe in which the strategy falls.

While private market or non-traded assets do not exhibit mark-to-market volatility in a similar manner to their traditional fixed income security counterparts, the ultimate measurement of risk can be considered as the potential for permanent impairment of principal (i.e. default risk). Risk, and therefore risk management, can be boiled down to how effectively an investor can control both price and structure as a means to compensate for the probability of default, as well as what structural protections are in place to ensure that there is no permanent impairment of capital. From a risk management perspective, *Alternative Income* opportunities confer numerous advantages and disadvantages relative to the traditional fixed income universe, which typically involve trading some degree of simplicity and “vehicle liquidity” in exchange for complexity risk and better potential control over price and structure.

In many cases, the level of competition in a given market drives liquidity, but that generally comes at the expense of controlling price and/or structure. That is to say that the more competition exists for a specific deal, transaction or asset class, the more choices exist from which counterparties can choose, which in turn leads to erosion of price and/or structural terms that are most favorable to the borrower rather than the investor.

Traditional fixed income investments are inherently more competed over for a variety of reasons, most notably the standardization of transparency measures, security structure, governing documents, and pricing necessary for facilitating institutional capital investment. *Alternative Income* opportunities on the other hand, are generally customized solutions that may take the form of debt or structured equity, meeting the unique needs and desires of counterparties that are not readily available in liquid traditional fixed income markets. The aforementioned idea of a customized financing solution takes more time and effort for all parties involved, which in turn leads to not only a stickier counterparty who is more likely to repay, but also a counterparty willing to pay more and/or concede more rigorous structural protections to the investor.

Tradeoffs: Alternative Income versus Traditional Fixed Income

In this section, we further elaborate on several key areas of differentiation between *Alternative Income* and traditional fixed income.

Informational Advantages: Many *Alternative Income* opportunities confer potential advantages associated with better transparency into underlying individual business operations and company data not afforded to publicly traded fixed income securities due to the unique solutions offered by many private entities. That is, better access to management, better visibility into collateral backing the transaction, and fewer distinct entities participating in deals. Ultimately, the ability for an investor to have a better understanding of the various risks within a specific lending arrangement, should lead to more appropriate pricing of that risk.

Structural Seniority: *Alternative Income* managers generally seek out structural seniority or priority in the repayment waterfall ahead of other parties. When providing a "solution" rather than "dollars," a borrower or counterparty is willing to concede such prioritization to the investor.

Collateral: In addition to structural seniority, *Alternative Income* investments are generally "secured" or managers have control over assets that will be used to generate cash flows for repayment purposes. While bank loans may have such security in the event of default, banks are generally not in a position to seize and monetize asset collateral. Furthermore, bonds are generally unsecured obligations and may not be afforded the same protections.

Covenants: Agreements between investors and borrowers that have specific limitations/guidelines regarding what a borrower can, and sometimes more importantly, cannot do, are called covenants. Covenants in *Alternative Income* are typically customized or tailored by the investor authoring the governing documents. *Alternative Income* opportunities typically feature full covenant packages that include:

i. Affirmative covenants, whereby the language stipulates what a borrower must do. For example, pay certain fees, provide financial statements, etc.

ii. Negative Covenants, whereby the language stipulates what borrowers can or cannot do. For example, limiting activities such as M&A, incremental debt issuance, etc.

iii. Financial maintenance covenants, whereby the borrower must meet certain pre-specified financial standards at regular intervals during the life of the transaction such as maximum leverage ratio or minimum fixed charge coverage ratios. If these financial metrics are not met, the lender has the right to take action.

iv. Financial incurrence covenants, whereby the borrower must receive approval from the investor to take specific action such as taking on additional debt, selling assets to pay down debt, and/or making acquisitions among other actions.

Amortization: *Alternative Income* opportunities typically have amortization characteristics not often seen in their traditional fixed income counterparts. *Alternative Income* investments, such as private asset-backed loans, are often paid down in routine, scheduled segments throughout the life of the deal, which effectively repay principal and interest simultaneously versus interest-only and a bullet repayment at maturity (often seen within traditional fixed-income securities). These features can improve the overall risk profile of the strategy given they naturally reduce duration and credit/default risk as the principal value gradually decreases over the term of the loan.

Other Controls: In addition to covenants and amortization, *Alternative Income* managers can customize solutions for counterparties that include features such as bankruptcy remoteness, lock box accounts, LIBOR floors, etc. Bankruptcy remoteness effectively ring fences the cash flow generating assets of a corporate entity into the legal control of the investor such that in the event of default, an investor can monetize these assets by finding a new operator or servicer, as well as selling the assets as a means to recoup principal and interest. Lock box accounts are legal features that direct disbursement and repayment to and from an account that is controlled by the investor so that a counterparty cannot misuse investor capital. Finally, *Alternative Income* opportunities are generally floating rate agreements, reducing interest rate risk to the upside as well as to the downside in the form of a LIBOR floor (i.e. minimum amount of interest should LIBOR fall below a certain threshold).

Risk Factors: Very broadly, *Alternative Income* investors are trading broad market and economic risk factors in exchange for non-market execution risk, which essentially becomes idiosyncratic default risk. For example, a traditional fixed income security exposed to the energy sector bears significant risk to the boom and bust cycle of energy. In the event of default, a creditor may be one of hundreds of other creditors seeking repayment through a long and drawn out Chapter 11 process. On the other hand, a private credit investor who has lent money to an energy company may benefit from better control over the collateral via bankruptcy remote special purpose vehicles (SPVs), lock box accounts and other features that ultimately lead to monetization in excess of the underwritten amount. While that is the primary risk to consider, *Alternative Income* strategies also carry similar risks to those found within related investment strategies, including valuation, liquidity, and organizational risks.

Diversification Characteristics: *Alternative Income* strategies offer unique diversification benefits that separate this universe from traditional fixed income investments within an asset allocation framework. One of the most attractive features of *Alternative Income* strategies, as we've discussed, is the group's generally expected uncorrelated nature given the underlying portfolio return drivers are typically entirely idiosyncratic and, therefore, independent from the typical market mechanisms or events within risk assets; however, it is important to distinguish between zero correlation and negative correlation to risk assets, which is a common beneficial feature of traditional fixed income. *Alternative Income* strategies do not provide the typical "safe haven" role occupied by traditional fixed income and should not be expected to provide those portfolio benefits in "risk off" scenarios. In other words, traditional fixed income generally carries more duration risk, which can be a positive or negative element relative to *Alternative Income*, depending on the investment objectives of the allocation. As always, the investment objectives and constraints of a given portfolio should be considered first, and the balance between traditional fixed income and *Alternative Income* is dependent upon individual investor considerations.

Fees: Due to their highly customized, specialty nature and the complexity involved throughout the investment process, *Alternative Income* strategies demand higher investment management and advisory fees than do traditional core fixed income mandates; however, due to the less liquid nature of these strategies, they generally offer lower management/incentive fees than the average Marketable Alternatives strategy. *Alternative Income* management fees tend to fall into the range of 50-100 bp base fees with 10-15% performance participation. Wilshire's alternative research team has conducted extensive investment due diligence within this universe in recent years and currently maintains a diverse list of managers that we are actively monitoring. As part of our Marketable Alternatives/Hedge Fund advisory service, Wilshire is prepared to engage with clients to source Alternative Income managers and collaborate on customizing portfolio structures.

Concluding Thoughts

Alternative Income is, perhaps, the fastest growing strategy subset within the Marketable Alternatives landscape, and the emergence of this universe creates unique investment advantages, as well as distinct risks and considerations. Wilshire does not view the current evolution of the industry as a temporary trend. Instead, *Alternative Income* strategies serve a critical role within financial markets today by providing custom financing solutions and transactional liquidity to smaller independent entities, which was a market previously dominated by larger global banks prior to the Global Financial Crisis. In general, the primary expected benefit of *Alternative Income* strategies is a consistent return stream that is derived from some yield or income source and is independent from the typical market mechanisms or events within risk assets. The tradeoffs to harness these benefits are usually cost, complexity, and liquidity given the private nature of the underlying investments. *Alternative Income*, while often offering a higher potential yield, is not a direct substitute for traditional fixed income, and overall portfolio objectives/constraints should always be considered before investing; however, due to the diminished utility of traditional nominal bonds that we have discussed in recent research (i.e. resulting from their lower expected returns and reduced diversification potential), *Alternative Income* strategies are worthy of investor consideration and may play a key role in managing portfolios through the challenges of the current environment.

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