ENVESTNET

BlackRock®

Portfolios under pressure:

Help clients earn more with alternatives

Sharing Perspectives

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Introduction

In this issue of *Sharing Perspectives*, we offer insights on alternative assets. With interest in alternatives surging, we highlight Envestnet and BlackRock's shared perspectives on how you can best navigate the challenges presented by a low-yield environment and lower expected investment returns moving forward. We believe advisors must think about diversifying beyond traditional equity and fixed-income portfolios to other return drivers so they can help clients stay on track toward achieving their long-term investment goals.

Alternatives can be a valuable component of today's portfolio construction process. When you can explore alternative strategies based on what you are trying to help your clients achieve, you can better determine where they fit in an overall investment portfolio. While we acknowledge that alternatives are not suitable for every investor, we believe there are underserved investors for whom alternatives can complement traditional portfolio strategies. With greater access to innovative alternative strategies and better data to understand how the different options can affect a portfolio, advisors have more opportunities to serve their clients' unique needs.

This whitepaper defines three growing trends we see taking shape across the alternatives landscape, and we provide advisors with new perspectives and solutions to help. Our goal is to deliver an outcome-oriented framework to help you think about what roles alternatives can play in client portfolios.

Defining alternative assets

While alternatives can mean different things to different people, we define them as investments that offer non-traditional exposure. Broadly speaking, alternatives can provide one of two things: Access to alternative asset classes, for example, commodities and real estate, or access to alternative asset strategies that might include existing asset classes like long/short strategies. This paper highlights a subset of the most widely available alternative strategies and those of most interest to advisors. However, we believe the trends identified here resonate across the full spectrum of solutions.

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Advisors and their clients face challenges in a new market regime

While the investment landscape is ever-changing, we believe we are entering a new market regime. Volatility is up, bond yields are down, and interest rates and inflation are rising. We believe advisors are under increased pressure to help clients navigate today's markets.

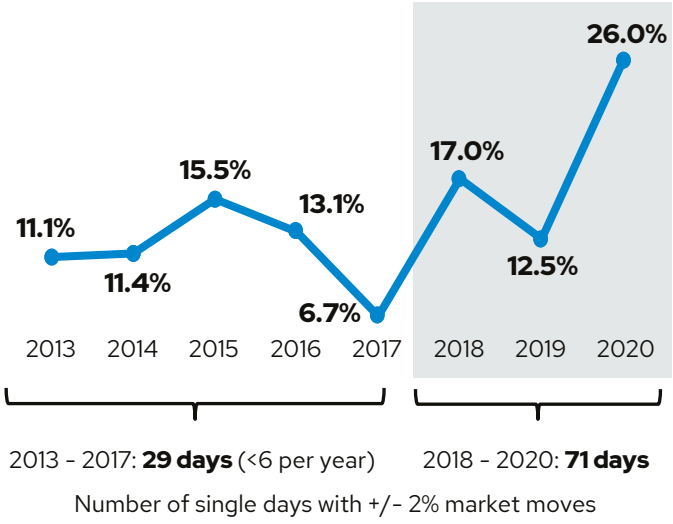
In this shifting investment landscape, investors require truly differentiated sources of portfolios returns. The traditional 60% stock and 40% bond portfolio is strained from both a capital markets assumption perspective and the fact that investors demand more strategies from which to choose. This pressure is forcing a change in portfolio construction to a new way of thinking, an allocation that could look more like 50% stocks, 30% bonds and 20% alternatives, as an example.

Return expectations for 60/40 portfolios are under pressure[1]

New sources of return and broader diversification are needed in today's challenging markets.

"The 60": Stock volatility is increasing

Annual volatility of the S&P 500



"The 40": Bond yields are at sustained lows

10-yr Treasury yield

1 Equity market data – Source: Morningstar, as of 9/30/21. Stock market represented by the S&P 500 Index. Annual volatility of the S&P 500 Index from 2013-2020. Average annual volatility based on standard deviation. Index performance is for illustrative purposes only. It is not possible to invest in an unmanaged index. Rates data – Source: U.S. Dept. of the Treasury as of 9/30/21. Data is since 7/25/12 when the 10-year Treasury hit a 30-year low point. Past performance is no guarantee of future results.

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Alternative portfolio construction:
Three emerging trends to watch

1 The democratization of alternatives and advances in technology are increasing access

We see an acceleration in the adoption of alternative strategies in client portfolios, with no signs of slowing down. In fact, according to Cerulli, advisors report alternative allocations taking up 10.5% of their portfolios and expect this to increase to 11.8% in two years.[2] Moreover, when looking at BlackRock data as of September 30, 2021, we see an even more significant increase: 37% of advisor model portfolios held at least one alternative investment product, up from 24% at the end of 2020 — a 13-percentage-point increase in just nine months.[3]

Because of innovation and access, interest in alternatives has never been higher for advisors and investors. Advisors are interested in offering their clients new opportunities, and many investors are ready to embrace new options. But more work is needed to help educate investors on what is available and how to access it.

For instance, registered funds for private equity and alternatives within pre-packaged models are now widely available. Interval funds that provide access to private market investments but with quarterly liquidity and simplified tax reporting have also made alternatives more investor friendly. We also see a changing landscape around lower minimums for private investments, traditionally accessible only to qualified purchasers or accredited investors. Add to that document digitization, the availability of electronic due diligence data rooms, and more significant scale, and we see a broader adoption of private investments than ever before.

With sophisticated technology to help assess so many different options, today's advisors have a greater ability to offer their clients the right solutions at scale. Additionally, the number and sophistication of choices have increased, with platforms such as iCapital offering intuitive, scalable digital solutions that have transformed how private market and hedge fund investments are bought and sold.

At the end of 2020,

24%

of advisor model portfolios held exposure to alternative investments.[3]

By October 2021,

37%

of advisor model portfolios held exposure to alternative investments.[3]

2 Source: Cerulli Associates: Advisor Use of Alternative Investments in 2021. 3 Source: BlackRock. Based on an analysis of 21,322 model portfolios that advisors shared with BlackRock over the 12-month period ended 9/30/2021.

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2 Private markets are creating more opportunities: Private equity and private credit

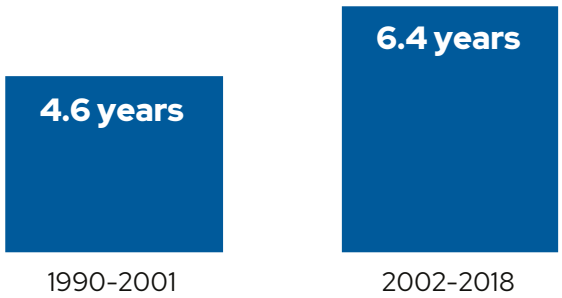
Today, we see most of a company's growth taking place in the private markets before a company has an initial public offering (IPO). The number of private companies with more than 100 employees has grown almost 40% over the last 30 years, while the number of public companies has declined by a comparable but slightly smaller amount. This reflects a shift in preference for private financing among business owners. Similarly, many private credit strategies offer the opportunity to produce high, consistent returns across a broad range, from opportunistic and distressed debt to middle-market investing and specialty finance.

Private market funding networks have become more developed as a result of significant advances in data and technology. It is also much less cumbersome for owners, founders, management and investors to transact in private markets today.

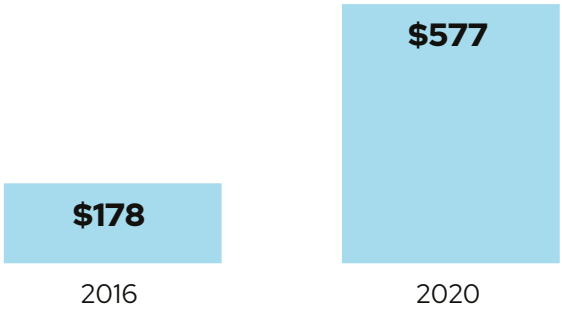
Here is a closer look at the shift of wealth creation toward private equity.

Private equity: America's wealth creator

Companies are taking longer to IPO[4]...
Average age to IPO



...and are coming to market at higher valuations[5]
Median company valuation before IPO in the U.S. over the last 5 years (M)

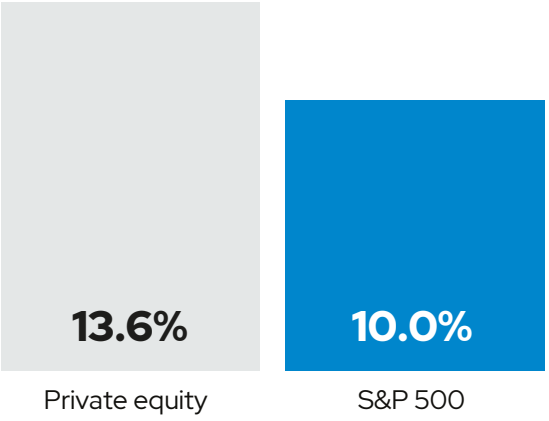


4 Source: National Venture Capital Association. Data as of 12/31/19. 5 Source: Data derived on 9/15/2021 from article "Median firm valuation before initial public offering (IPO) in the United States from 2000 to 2020."

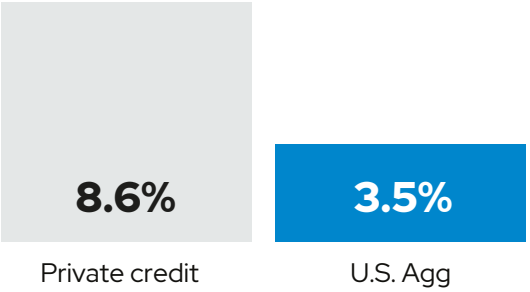
At the same time, alternatives give access to private markets, such as private equity, private credit, infrastructure and private real estate. And a closer look at both private equity and private credit shows historical outperformance over time.

The case for private markets[6]

Private equity
Annualized return of private equity vs. U.S. equities



Private credit
Annualized return of private credit vs. U.S. bonds



3 A focus on alternative investment outcomes is taking center stage

Because many types of alternatives encompass exposure to a wide range of strategies, knowing "what" you are buying and "why" is increasingly crucial as you think about the role within a client's portfolio. Whatever alternative allocation you recommend, be sure it is the most effective strategy to accomplish the right goal.

With new technology available today, you can offer your clients more transparency around the return and outcome expectations for the alternative strategies you recommend. Technology and data can help you better understand significant differences across and within alternative categories, helping you match the intended outcome to the appropriate solution.

6 Index comparison is used to demonstrate private market performance compared to public market performance during comparable time periods. There are material differences in individual index methodologies (both public and private) and differences in the way public and private market performance is calculated; the comparisons shown may not fully reflect these differences. In general, public market indexes are unmanaged, represent a group of constituent securities which may change over time, reflect the reinvestment of dividends but do not reflect the deduction of any fees or expenses. Private market indexes often rely on self-reporting by managers. Therefore, there may be survivorship bias given that fund managers have discretion to report, or to discontinue reporting for various reasons (e.g., due to liquidation), and therefore private market indexes may reflect a bias towards funds with track records of success. Private Equity represented by the Burgiss Private Equity Index (Buyouts) for the 15-year period 3/31/06 to 3/31/21 (latest data available) (index inception date was 2001; the 15 year-period captures the longest and most recent standardized time period over that timeframe). Private Credit represented by the Cliffwater Direct Lending Index. Private credit reflects rolling quarterly returns and most recent return from 9/30/15 (index inception) to 6/30/21 (latest available data). **Past performance does not guarantee or indicate future results.** Index performance is shown for illustrative purposes only. It is not possible to invest directly in an unmanaged index. **The Cliffwater Direct Lending Index (CDLI)** is an index that assists investors to better understand private credit as an asset class. The CDLI seeks to measure the unlevered, gross of fees performance of U.S. middle market corporate loans, as represented by the underlying assets of Business Development Companies ("BDCs"), including both exchange-traded and unlisted BDCs, subject to certain eligibility criteria. The CDLI is an asset-weighted index that is calculated on a quarterly basis using financial statements and other information contained in the U.S. Securities and Exchange Commission ("SEC") filings of all eligible BDCs. Eligibility is set as all assets held by BDCs that (1) are regulated by the SEC as a BDC under the Investment Company Act of 1940; (2) have a substantial majority (approximately 75%) of reported total assets represented by direct loans made to corporate borrowers, as categorized by each BDC and subject to Cliffwater's discretion, and (3) file SEC form 10-Q (or (10-K, as applicable) within 75 (or 90) calendar days following the current Valuation Date. If a BDC meets the eligibility criteria, but has not filed its report on Form 10-K or 10-Q with the SEC at the time the index is reconstituted, asset information from its report will be included in the index at the time of the next reconstitution. This information is derived from sources that are considered reliable, but BlackRock does not guarantee the veracity, currency, completeness or accuracy of this information.

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Understanding outcomes: A new framework

We believe alternatives can be bucketed into four categories to describe what they do in a portfolio: hedge, diversify, modify and amplify (HDMA). The BlackRock HDMA framework can help you understand the different roles that alternatives can play in client portfolios. It illustrates BlackRock's thinking about the outcomes associated with alternatives and the purpose they serve in a portfolio.

While four outcomes are available, alternative strategies that seek to diversify and amplify deserve your focus in today's new market regime. A 20% allocation to alternatives, for instance, can help diversify or seek higher returns. Modify and hedge both have a tactical dimension that makes them more difficult to use. Moreover, the high correlation of modify strategies can often lead to downside in market sell offs that may be inconsistent with an investor's intended outcome.

Four outcomes for alternatives

Know the outcome(s) you are seeking with alternatives and match intent with execution.

1 Hedge Designed to help increase in value when core exposures are falling	**3** **Diversify** **Seek low/moderate correlation to core equities with different return drivers**
2 Modify Seek less volatility than core equities with similar return drivers	**4** **Amplify** **Seek higher returns than core equities in less liquid markets**

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The many dimensions of alternatives

As you prepare to introduce clients to alternative strategies, we recommend you first understand the potential outcomes. Using the BlackRock HDMA framework as a guide, here is a look at the alternative strategies available to consider. When it comes to representative strategies, we advise that you review minimum investment and suitability requirements to determine which approach makes the most sense. For example, liquid alternatives are generally accessible to all, while other types of alternatives are only available to accredited or qualified purchasers.

The alternatives framework: What you need to know about potential outcomes

Outcome	Use case & key features	Equity correlation	Volatility level relative to equities	Representative strategies	Sourcing
Hedge	Tactical; downside protection	Negative	Low to high	Short bias funds, managed futures	Most effective risk reduction from equity; core bond replacement
Diversify	Core holding; idiosyncratic risk	Moderate to low	Low to equal	Market neutral, event-driven, select multi-strategies	Either; fixed income often in the current environment
Modify	Tactical within long equity; constrained equity risk	High	Moderate to equal	Equity long/short (high equity risk), options-based liquid alternatives	Never from fixed income; equity and other liquid alternatives/ hedge funds
Amplify	Core holding; illiquidity premium and idiosyncratic risk	Moderate to high	High	Private equity (venture & buyout), private credit, private real estate, private infrastructure	Public to private, e.g., private equity from public equity; private real estate proportionately from equity and debt

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Lean into the alternatives conversation to change perceptions and address concerns

When was the last time you talked with your clients about non-traditional investment strategies for their portfolios? It's time to engage clients in new thinking to help them solve unique challenges with a broader solution set. We believe top advisors are increasingly leaning into innovative alternative strategies for diversification, downside protection and enhanced returns.

While alternatives are not suitable for all investors, once you have a greater sense of their role in a client portfolio, you'll know better who they are suitable for and how to use them. Think about the investment's true purpose: What is it attempting to achieve in a client's portfolio?

Sometimes, starting the alternatives conversation with clients can be challenging. In our discussions with advisors, here are some areas to focus on and fresh ideas to help you shift the conversation:

Understand liquidity needs.

According to Cerulli, 54% of advisors surveyed said their number one challenge to investing in illiquid alternative investments was that the lack of liquidity was not suitable for their clients.[7] Explore your client's unique situation to understand when these assets are needed and consider the required spending rate and the portfolio's risk allocation. The actual need for liquidity, the potentially limited ability to access money for a specified period, should be discussed with your client as part of a broader financial planning conversation.

When considering client needs, advisors should be mindful of liquidity considerations even though many investors with a long-term investing perspective typically hold an investment for a full market cycle. Given this, we believe some investors overestimate the liquidity they need in their portfolios.

For others, a genuine concern might exist about the limited liquidity of some alternative vehicles. You need to explore an approach that fits the specific cash needs of these clients. Also, we advise giving careful thought to the positioning of alternatives in the broader context of portfolio rebalancing.

Dispel the belief that only traditional portfolio diversification is needed.

Diversification is a crucial part of a healthy portfolio. Alternatives can play a pivotal role, offering a different source of return. Help clients think beyond traditional investments to achieve the portfolio diversification needed to attain their goals.

While core bonds diversify equity risk, they may deliver lower than expected yields. Stocks and bonds alone are simply not enough to solve investor needs. Help your clients see that low correlation alternative strategies can offer another way to diversify a traditional stock and bond portfolio and seek attractive returns, an approach that is critical in today's new regime.

Align on the importance of the alternatives opportunity.

Increase your clients' understanding of the different roles alternatives can play and what they can help achieve in a portfolio. Offer your clients a fundamental understanding of the alternative landscape through a series of educational sessions, as an example.

When you do so, you will be differentiating your practice from the competition with innovative investments to help diversify client portfolios. And you will help your clients get more comfortable with the types of alternative investments that might help them achieve their financial goals.

Help clients embrace new investment ideas.

Despite the dramatic interest in alternatives, some investors may simply be hesitant to embrace innovative investment ideas. Focus on your clients' needs to amplify return potential and diversify risk.

Concentrate on what you can control and not some experience from the past with an alternative investment that was not clearly understood for what it was designed to deliver. Technology gives you the ability to provide greater transparency to help clients understand the risks and attributes of the solutions they are considering today.

7 Cerulli Associates: Advisor Use of Alternative Investments in 2021.

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Getting started:
Resources to help you better meet client goals

Whether you are already talking to clients about incorporating alternatives into their portfolios or looking to gain more knowledge to help your clients think about the opportunity and find the right entry point, we are committed to helping you uncover the right opportunities. Envestnet and BlackRock offer a variety of investment vehicles and technology solutions to help.

Here are some resources to help you take the next steps on the alternatives journey.

Alternative pre-packaged strategies

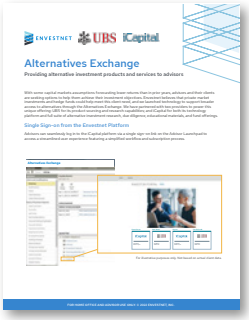
Through the **Alternatives Exchange**, offered by Envestnet and powered by iCapital and UBS, you have access to private market investment opportunities, including more than 35 funds from managers across geographies and strategies. This offering includes access to iCapital's enhanced technology and processing capabilities.

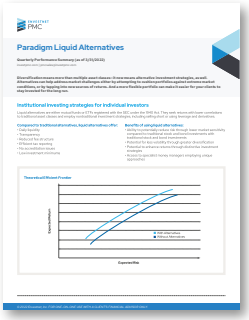
Envestnet | PMC Paradigm Liquid Alternatives portfolios enable advisors to effectively and efficiently construct portfolios that benefit from exposure to liquid alternatives. There are three strategies from which to choose: a fixed income complement, equity complement or diversifier.

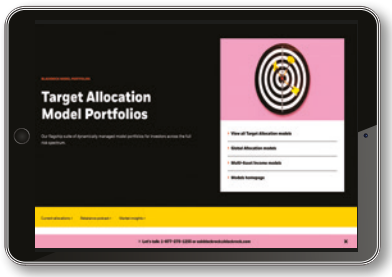
Alternative investment solutions across the full spectrum of options are available at BlackRock, including BlackRock Target Allocation model portfolios with alternatives, private credit interval funds and private equity portfolios.

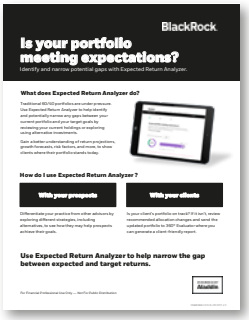
Technology to analyze portfolios

BlackRock's **Expected Return Analyzer** lets you test your current portfolio against forward-looking projections and may help you identify how a portfolio stacks up against a targeted return and highlights potential gaps. You can also explore how exposures to alternatives can help narrow the gap to achieve better outcomes or analyze your existing alternative allocations.









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Summary:

Engage in new conversations to expand access to non-traditional assets

With traditional portfolio construction strategies under pressure, we are committed to helping advisors identify alternative sources of return for their clients. Non-traditional assets can help investors navigate fast-changing markets and stay the course in pursuit of their long-term financial goals.

We believe alternative solutions can help enhance client investment portfolios. Through the intersection of technology and access, you can focus on redesigning portfolios to connect your clients with the differentiated sources of investment returns they want and need.

Contact us today to learn more about the array of alternative solutions and tools at your disposal. We can assist as you think about what it means to add alternatives to your overall portfolio construction process.

We look forward to introducing more *Sharing Perspectives* over the year. For our *Sharing Perspectives* on sustainable investing and tax management, link here.

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