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Top 5 Trends in ALTERNATIVE INVESTMENT 2023

Over the last five years, the growth in private markets has been exponential, with alternative investments providing sophisticated investors access to a variety of direct assets and diversified funds. The lack of correlation to listed equity markets allows investors to increase their returns and diversify their portfolios.

Alternatives are becoming more frequently acknowledged as an integral component of an investor portfolio. According to Preqin, increasing wealth in APAC also underpins the demand for alternative assets in the region. Alternatives are logical additions to the portfolios of investors that are looking to diversify, spread risk, and increase their earnings. To assist wholesale investors to understand the current environment, here are five trends we feel will be relevant to investors interested in investing in alternatives in 2023.

1. Increased demand for private market investments linked to changing portfolio weightings.

Whilst 2022 saw a consistent increase in the number of investors in alternatives, we see 2023 as a year where existing investors increase weightings. Alternatives are becoming more frequently acknowledged as an integral component of an investor portfolio.

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Changing investor portfolio weightings has implications for several areas. Investors have been reconsidering their compositions of holdings in fixed-income allocations, with private credit taking a core weighting within defined fixed-income buckets. With more companies opting to stay private for longer, investor choice has widened.

Whilst private equity is getting viewed as a longer-term weighting within equity allocations, whereby a breakdown of types of equity assets is made based on their varied time frames and risk factors.

2. Differentiated return drivers of greater importance in the higher inflationary environment where consumer spending will slow.

Having ridden a year of high volatility across traditional assets in equities and fixed income, opportunities in alternatives will be assessed by investors based on their unique drivers of the return being differentiated to other portfolio exposures.

Whilst the consumer has shown strong resilience in spending despite the rate rises throughout 2022, this is likely to change in the first half of 2023. The additional risks of mortgages rolling off lower fixed rate terms will be contributing to this slowdown. Understanding that alternatives can provide real asset exposures that are differentiated is nothing new and has already been recognised for some time as a potential strength. However, a greater understanding of those return drivers across a suite of investments and particularly their resilience towards a slowing consumer will be increasingly important.

3. Capital structure seniority is a priority when businesses are carrying higher costs of funding.

Assessment of private businesses' abilities to withstand higher funding costs that come with a higher rates environment is an integral part of due diligence in private markets. Whilst higher returns are advantageous for an investor that's contributing to a private credit facility that provides higher coupon returns, the additional cost of carrying can provide headwinds to the ongoing viability of the private business. Companies that have the ability to pass on their higher funding costs through their consumer products will be much better positioned to maintain margins.

Prioritising credit opportunities that provide exposures at more senior levels of the capital structure and/or those where there is the security of having full recourse to a specific asset pool, will provide a viable risk mitigation strategy.

4. Stronger entry points in real estate equity opportunities, whilst refinancing emerging across real estate debt.

The re-pricing of real estate equity valuations through 2022, largely removing gains made in the prior two years, is setting up an opportunity to increase weightings towards real estate at more opportune pricing.

Similarly on the debt funding side, which had seen significant yield compression through prior years as more competitors emerged across non-bank lenders in real estate, made the risk-reward of many opportunities quite questionable.

The opportunity to take debt position funding via refinancings is emerging where existing lenders may look to reduce exposures as a risk mitigation process or where supply chain disruptions had extended their approved timeline of funding a project. The investor opportunity to take exposure to projects that have been partially de-risked by some construction progress will provide new opportunities to be considered.

5. Opportunities to lock in higher fixed rate returns in private credit before yield expectations shift.

In light of the higher base of interest rates and the yield curve, investors have an opportunity in 2023 to lock in private credit opportunities at stronger yields.

Whilst the second half of 2022 has seen an increasing array of opportunities in floating rate private credit deals where investors benefit from rising rates, there will be an opportune point in time somewhere in 2023 where switching back to specific fixed opportunities could be advantageous for investors.

With this time juncture difficult to predict, monitoring yield curve shape is going to be important to make the most of multi-year fixed-rate opportunities. This juncture can be taken advantage of by investors, just prior to the markets taking a widespread view that inflation may have peaked and the yield curve locally likely moves to an inverted shape with expectations rate rises are near completed.

www.ipartners.com.au
sales@ipartners.com.au
Phone: +61 2 8029 0561