



# Using Alternative Investments to construct a diversified, robust and self-funding investment portfolio

## In this whitepaper we cover:

1. How an allocation to private equity and other alternative investments can be used to target higher potential returns and lower volatility than a traditional 60:40 equity/bond portfolio.
2. Why alternative investments can increase the diversification of an investment portfolio.
3. How a portfolio could become 'self-funding' through exit proceeds and investment realisations.

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# Using Alternative Investments to construct a diversified, robust and self-funding investment portfolio

Against a backdrop of low economic growth, high inflation and geopolitical tensions, now more than ever investors need to be thinking strategically about asset allocation and how they construct their investment portfolio to achieve their investment goals.

At Connection Capital we believe alternative investments have a prominent part to play. Asset classes such as private equity and private debt are capable of improving the diversification of an investment portfolio and can target higher potential returns, with lower volatility, than traditional public market equivalents. The problem for individual investors has historically been – how to access these asset classes?



Hopefully, as you're reading this, you've gathered that we can help. We set up our business in 2010 to help investors access alternative investment strategies from low minimum investment levels (all of our investment opportunities are available to investors in multiples of £25,000).

Since then we've established an incredibly strong network of industry relationships which has enabled us to offer our clients a wide range of alternative investment opportunities, from direct investments in established, profitable private companies to private equity funds operated by some of the world's best performing specialist private equity managers.

In this whitepaper, "**Using Alternative Investments to construct a diversified, robust and self-funding investment portfolio**", we explain more about how an allocation to alternative investments can improve returns and reduce volatility when compared to a traditional 60:40 equity/bond portfolio.

We also look at why alternative investments improve the diversification of an investment portfolio and how an investment portfolio with an allocation to alternative investments such as private equity could become 'self-funding' through exit proceeds and investment realisations over time.

I hope you enjoy the read. If you have any questions at all, please do get in touch with us.



Claire Madden  
Founder and Managing Partner

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# 1. The impact of alternatives on a traditional investment portfolio

Based on the Modern Portfolio Theory research of Nobel prize winner Harry Markowitz, the 60% public market equity, 40% public market bond allocation was designed so that “**risk-averse investors can construct portfolios to optimize or maximize expected return based on a given level of market risk**”. This principle of seeking optimal returns for a given level of risk is known as ‘risk-adjusted’ returns.

The 60% exposure to equities intends to target capital growth and the 40% allocation to fixed income (government debt, corporate bonds and cash deposits) targets income and risk mitigation, whilst being uncorrelated with the performance of equities.

The 60:40 ratio was established in 1952 and since then has been used as the bedrock of portfolio construction for wealth managers and institutional and private investors the world over, with the ratios flexed to provide different portfolio risk categories. But is it still fit for purpose?

In 2022, in particular, the role of fixed income in mitigating risk broke down, with a 60:40 portfolio down 17% (source: BlackRock<sup>1</sup>), and – as both public equities and fixed income fell – failing to demonstrate how the supposedly uncorrelated asset classes would offset losses from each other.

## 60:40 portfolio performance since 2000



Source: Refinitiv Datastream, chart by BlackRock Investment Institute as at 3 January 2023. Based on MSCI AC World and Bloomberg Barclays Global Aggregate.

As a result, questions are being asked about whether the reliance on fixed income in mitigating risk is still appropriate (we don't think so). And, when it comes to constructing a 'risk-adjusted' portfolio, what are investors supposed to do?

<sup>1</sup><https://www.trustnet.com/news/13355518/portfolios-need-to-be-built-differently-blackrock-calls-time-on-the-6040-portfolio>

## Using Alternative Assets to improve diversification

The investment universe is now unrecognisable compared to 1952. The growth of private (and public) markets, the variety of underlying alternative asset classes, and the complexity of investment strategies and structures available mean that, with access, investors have far greater choice and exposure to different sources of risk and return with which to construct a diverse investment portfolio.

### Traditional and Alternative investments in 2023

Traditional		Alternatives		
Equity	Fixed Income	Equity	Fixed Income	Other Assets
Large Cap	Government Bonds	Private Equity	Direct Lending	Real Estate
Mid-Cap	Corporates	Venture Capital	Structured Debt	Real Assets
Small-Cap	Investment Grade	Long/Short	Long/Short	Infrastructure
Growth	High Yield	Market Neutral	Distressed	Commodities
Value	Fixed/Floating Rate	Short Bias	Credit Arbitrage	Currencies
Domestic	Global Emerging Markets	Convertible	Structured Credit	Systematic Strategies
International		Arbitrage	Relative Value	Niche Assets
Emerging Markets		Merger Arbitrage	Global Macro	
		Event Driven		

Source: Connection Capital.

### Given the vast range, where is an investor to start?

In the world of investment portfolio management and alternative investments, one name is held up as a guiding light, David Swensen.

Swensen was the Chief Investment Officer at Yale University (USA) from 1985 to May 2021. Over this period, he oversaw the Yale Endowment growing from \$1.3 billion to \$42.3 billion – an annualised gain of 13.7% per annum<sup>1</sup>.

One of the fundamental drivers of these returns was his transformation of the portfolio construction away from traditional assets to alternative investments strategies such as private equity, which are able to provide greater diversification and target higher potential returns than public market equivalents.

According to Yale:

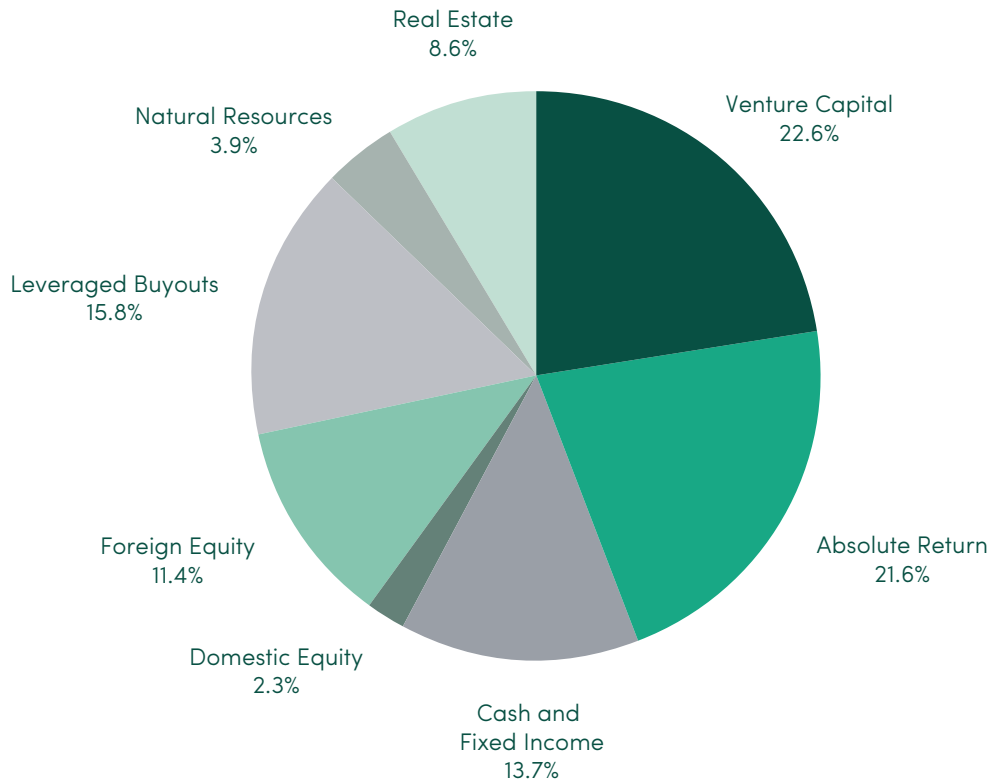
**“In 1989, nearly three quarters of the Yale Endowment was committed to U.S. stocks, bonds, and cash. Today, domestic marketable securities account for less than one-tenth of the portfolio, while foreign equity, private equity, absolute return strategies, and real assets represent over nine-tenths of the Endowment.**

**The heavy allocation to non-traditional asset classes stems from their return potential and diversifying power.<sup>2</sup>”**

<sup>1</sup><https://news.yale.edu/2021/10/22/david-swensens-coda>

<sup>2</sup><https://investments.yale.edu/about-the-yio>

## The Yale Endowment Asset Allocation Model



Source: Yale news, as at June 2020.

The 'Yale Model' has long been adopted by other endowments and institutional investors which operate long-term investment horizons. And the principles apply to other investors who can accept the longer hold periods which can be inherent with many alternative investment types.

“ The heavy allocation to non-traditional asset classes stems from their return potential and diversifying power. ”

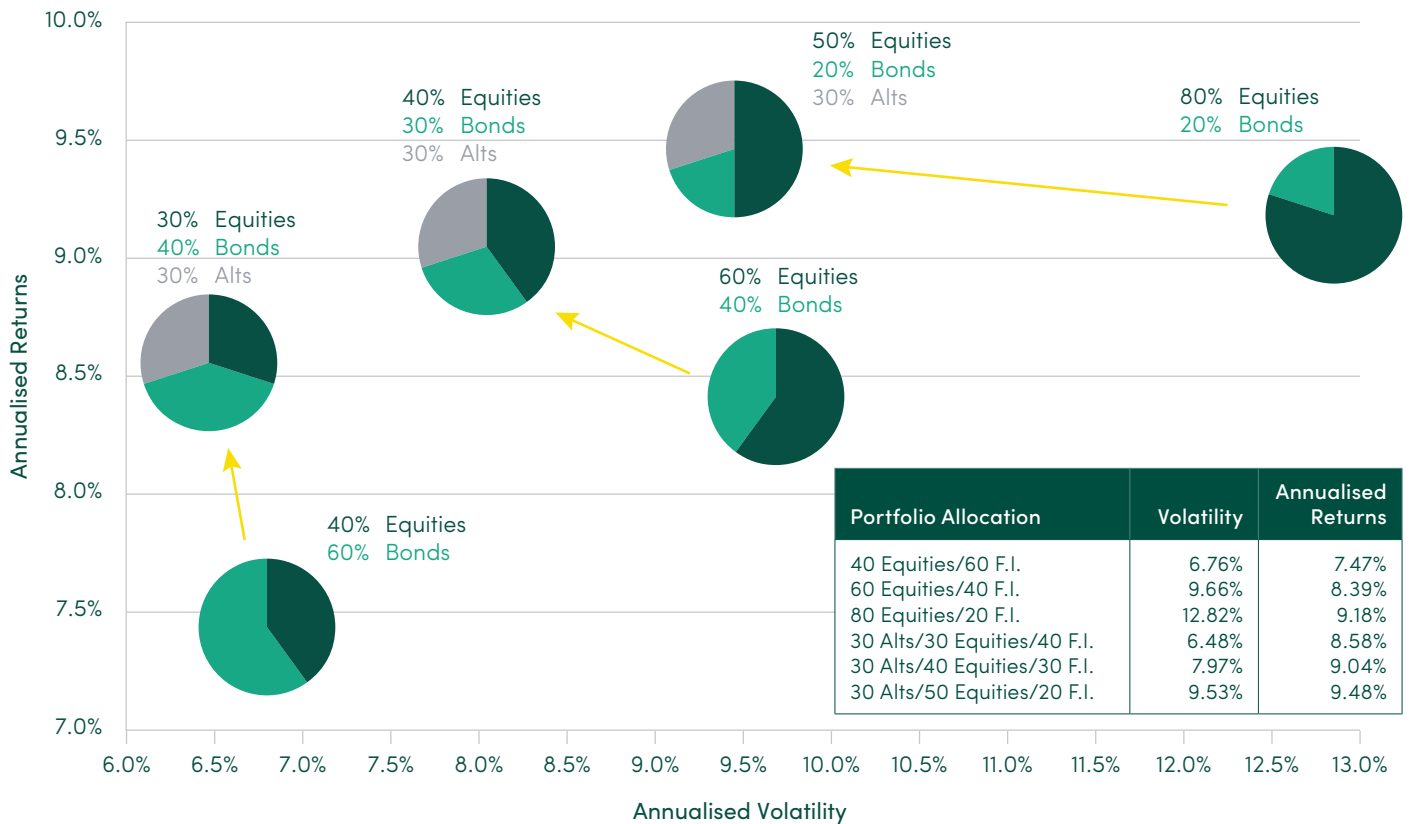
## What's the right level of alternative of investments in an investment portfolio?

If you're reading this, it's likely that your portfolio already includes investments outside equities and bonds. You may have property investments or have made direct investments in unquoted companies or even invested in private equity funds. But what level of alternative investment exposure is optimal?

Using analysis undertaken by JPMorgan on the impact of a 30% allocation to alternatives (private equity, hedge funds, real estate) on an equity/bond portfolio, we can see that returns are enhanced and volatility reduced across a variety of portfolios of differing equity/bond weightings.

### Alternatives and portfolio risk/return

Annualised volatility and returns, 1989–2022



Source: Bloomberg, Burgiss, HRFI, NCREIF, Standard & Poor's, FactSet, J.P. Morgan Asset Management. Alts include hedge funds, real estate and private equity, with each receiving an equal weight. Portfolios are rebalanced at the start of the year.

Data is based on availability as of 30 November 2022.

The 30% allocation to alternatives used in JPMorgan's portfolio performance analysis is, according to Alternatives data provider Preqin, roughly in line with the portfolios of public pension funds. Preqin has been tracking these funds and notes steadily increasing allocations to alternatives over the past decade, with the median allocation rising from 18.1% in 2010 to 30.3% in 2020<sup>1</sup>.

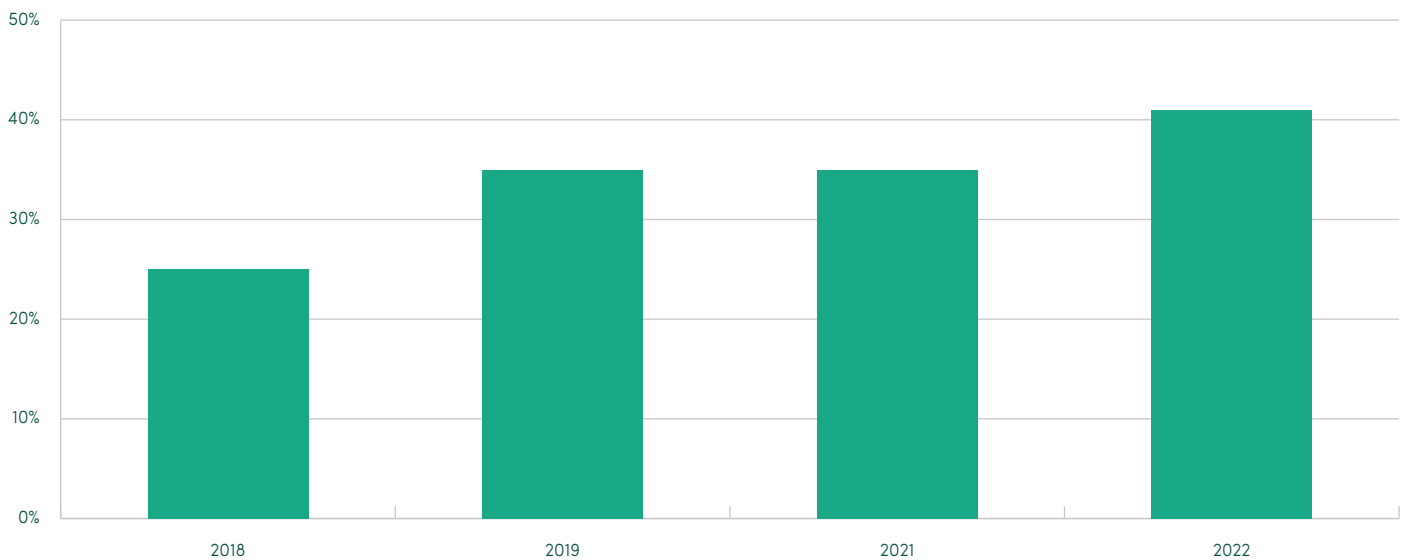
<sup>1</sup>PreQin: Future of Alternatives 2025 Report <https://www.preqin.com/insights/research/blogs/future-of-alternatives-2025-investors-inexorable-push-to-alternatives>

## What have Connection Capital clients told us about how they approach portfolio construction?

Connection Capital's professional client base is made up of HNW/UHNW private investors from a range of backgrounds and with a range of roles. This includes, for example, entrepreneurs, company founders, C-suite execs at listed companies, angel investors, fund managers, partners at private equity firms, banks, corporate finance advisers, law firms etc and family offices.

Since 2018 we have surveyed our clients, annually, to seek their thoughts on alternative investments and portfolio construction. The results of the survey show the same increasing allocation to alternatives that institutional investors such as pension funds have embraced in recent years. In 2022, 41% of respondents said they were allocating more than 20% of their portfolio to alternative investments. The proportion of clients allocating this much of their portfolio to alternatives has risen every year we've undertaken the survey. We believe that the trend will continue as investors seek greater diversification from public markets.

### % of clients allocating >20% of investment portfolio to alternatives<sup>1</sup>



Source: Connection Capital.

<sup>1</sup>Survey respondents only; no survey undertaken in 2020.

## 2. How alternative investments help to diversify an investment portfolio

We've seen how adding alternatives into a portfolio of equities has the potential to reduce volatility and enhance returns, but what are the features and characteristics which deliver this improved diversification?

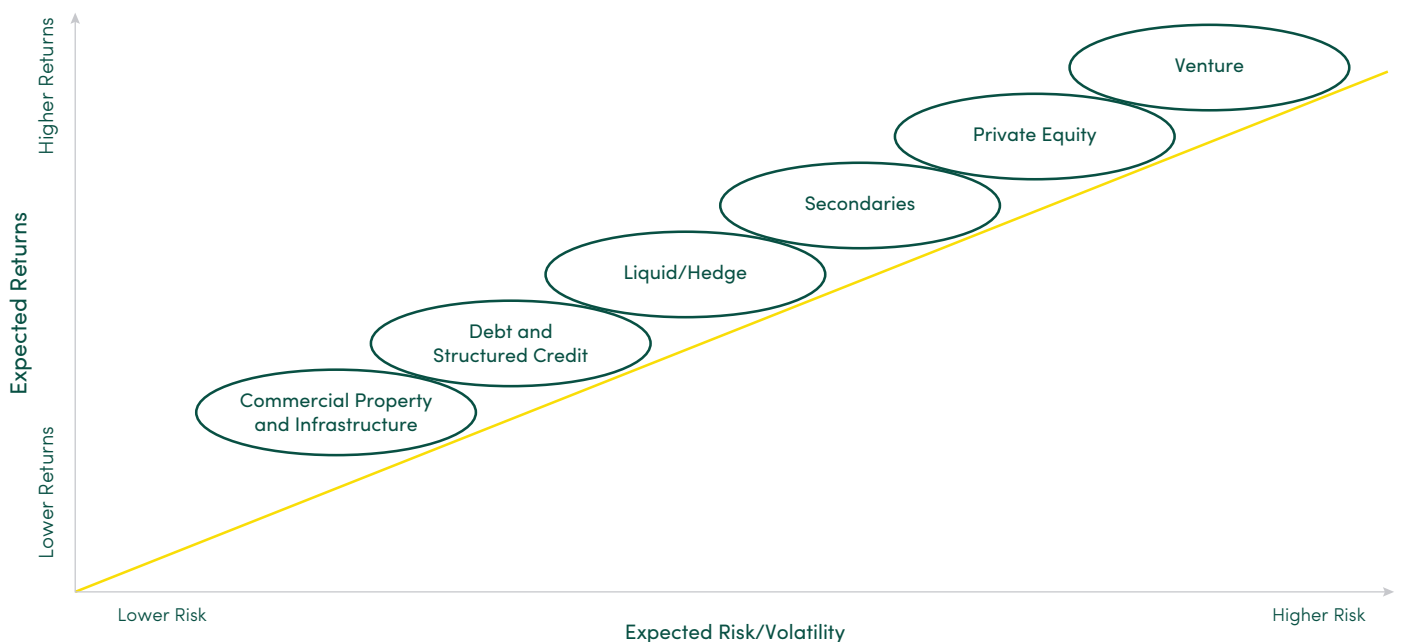
To answer that, we need to be aware of the vast range of alternative investment asset classes, investment strategies and structures that exist and are available to private investors, assuming they have access.

We should also remember that true diversification is achieved when a portfolio has a mix of investments and is not concentrated in one area. This mix of investments should be uncorrelated (or not directly correlated with each other) and have differing sources of risk and return.

Let's remind ourselves of some of the main differences between traditional investments and alternative investments.

Traditional investment	Alternative investments
<p>Primarily focused on public market equities and bonds. Features include:</p> <ul style="list-style-type: none"> <li>• High liquidity</li> <li>• Assets are in public market</li> <li>• High correlation to markets</li> <li>• Passive shareholders</li> </ul>	<p>Look to exploit market inefficiencies by focus on non-traditional assets and strategies. Features include:</p> <ul style="list-style-type: none"> <li>• Potential for lower liquidity</li> <li>• Assets and strategies in both public <b>and</b> private markets</li> <li>• Lower correlation to markets</li> <li>• Active shareholders</li> <li>• Exposure to nascent markets</li> </ul>

As we saw on page 3, alternatives extend the investment universe, allowing investors access to a greater variety of asset types and investment strategies, enhancing diversification. These investment strategies cater to different investment objectives and have differing risk and return profiles.



Source: Connection Capital.

What's more, investors can diversify their portfolio not just by strategy but by entry route and structure i.e. through a fund, direct or co-investments.

### **Fund investments**

Alternative investment funds allow investors to improve diversification through different managers, different asset classes, different strategies within each asset class and different ranges of underlying holdings.

Fund commitments can also help investors enhance the temporal diversity of their portfolio – that is the diversification achieved through investing across different time periods, which can help to mitigate the impact of market downturns. This feature occurs naturally in fund investing as fund managers will construct a portfolio by making investments into underlying companies over an 'investment period', which could be anything between one and four years.

### **Direct investments and co-investments: single-asset transactions**

Investors may also wish to gain access to alternative asset classes like private equity through direct investments (investment in a single asset e.g. providing growth capital to a private company or investing in the equity of a management buy-out); or through a co-investment where the investment is a single asset or transaction alongside a private equity fund.

These investments can offer attractive target returns from backing private businesses supported by professional investors.

### **Ensuring diversity across your alternatives allocation**

Concentration risk exists in traditional investments and alternative investments. The same is true of risk and return correlation across the underlying asset classes within in each group. Investors need to remember that a thoroughly diversified portfolio is the best way to reduce risk and smooth volatility. Clearly, we want all our investments to succeed and deliver outperformance, but we must be realistic. Unexpected things happen. If we look back even a short while to global events that have occurred since 2020, it is not difficult to pinpoint a few!

So, while venture and single asset private equity transactions with the potential for the highest returns may attract many investors, it is wise to construct a portfolio that includes a mix of different alternative investments, with different uncorrelated exposures and different time horizons, which is capable of delivering robust performance even when individual assets and strategies suffer periods of stress.



### 3. How diversification supports the construction of a self-funding portfolio

By constructing a diverse portfolio, investors can target not only uncorrelated returns, smoothing volatility in times of stress, but also a portfolio that is capable of funding commitments to new investments, with the returns generated from previous investments.

Once this is achieved i.e. annual proceeds generated from the portfolio equal or exceed any new annual commitments, theoretically, no 'new' capital is required to be placed at risk – as the proceeds from historic, maturing investments fuel the commitments to new investments. Let's take a look at how this might be possible.

#### The J-curve

Different investments have different return profiles which will affect investors' cashflows differently, including the time period over which the capital committed to the investment is drawn from the client and then returned plus the target gains.

For example, a direct investment in a management buyout transaction of a UK SME or the provision of growth capital to a high growth venture company is likely to require investor's full capital commitment once the deal completes.

Assuming the investment performs to plan and is exited in e.g. year 5, the investor will then receive their investment returns (original capital committed plus investment proceeds). In the intervening period there may be investment returns via loan interest, depending on the way the private equity transaction was structured. But the majority of the returns are to be expected upon the exit/sale of the company.

If we plot these cashflows on a chart (net cashflow vs time), we can see the return profile is 'J'-shaped. This is known as the J-curve. The J-curve for a single asset investment i.e. a direct investment or a co-investment is likely to be very steep. The full commitment is taken at the beginning of the investment and the majority of the returns coming at the point of exit, in our example below at year 5.

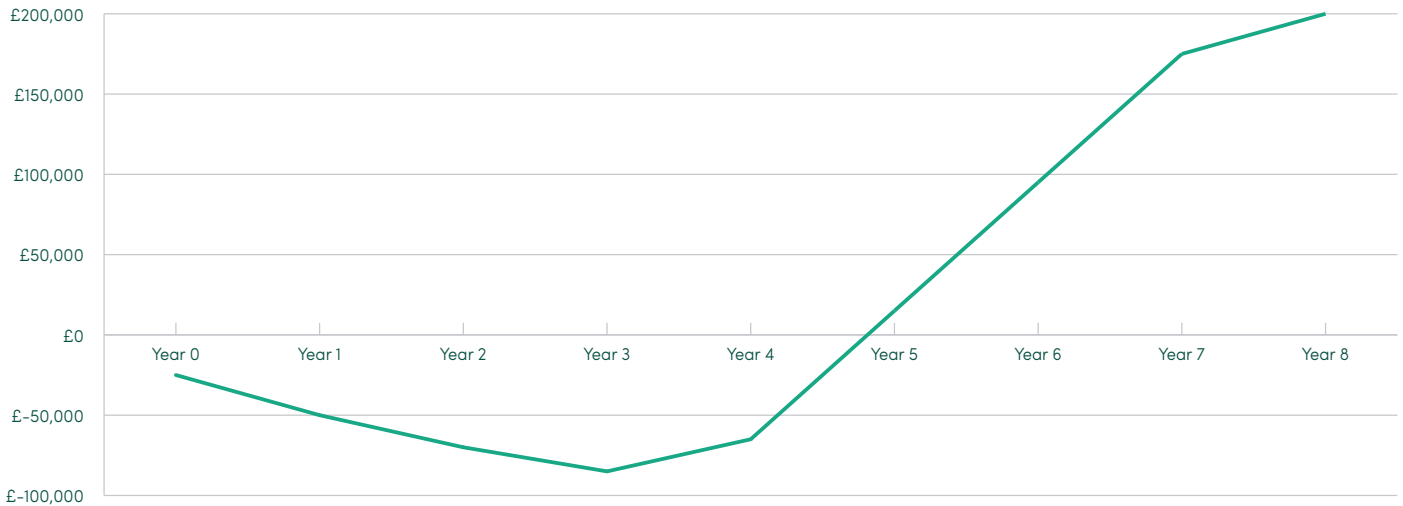
#### Investor net cashflows for Direct Investment – Example



Source: Connection Capital.

In contrast, investments made in funds (where there are multiple underlying individual investments) will have a much shallower J-curve than direct investments. For example, private equity funds tend not to require the investors' full commitment on day one (typically just 25%, with the balance often drawn over subsequent years as the fund manager makes investments and constructs a portfolio). And, as funds invest in a number of independent underlying holdings, the cashflows to investors (via distributions and realisations) will be staggered until all holdings have been exited. This accounts for the more shallow J-curve when compared to a single asset investment.

### Investor net cashflows for Fund Investment – Example

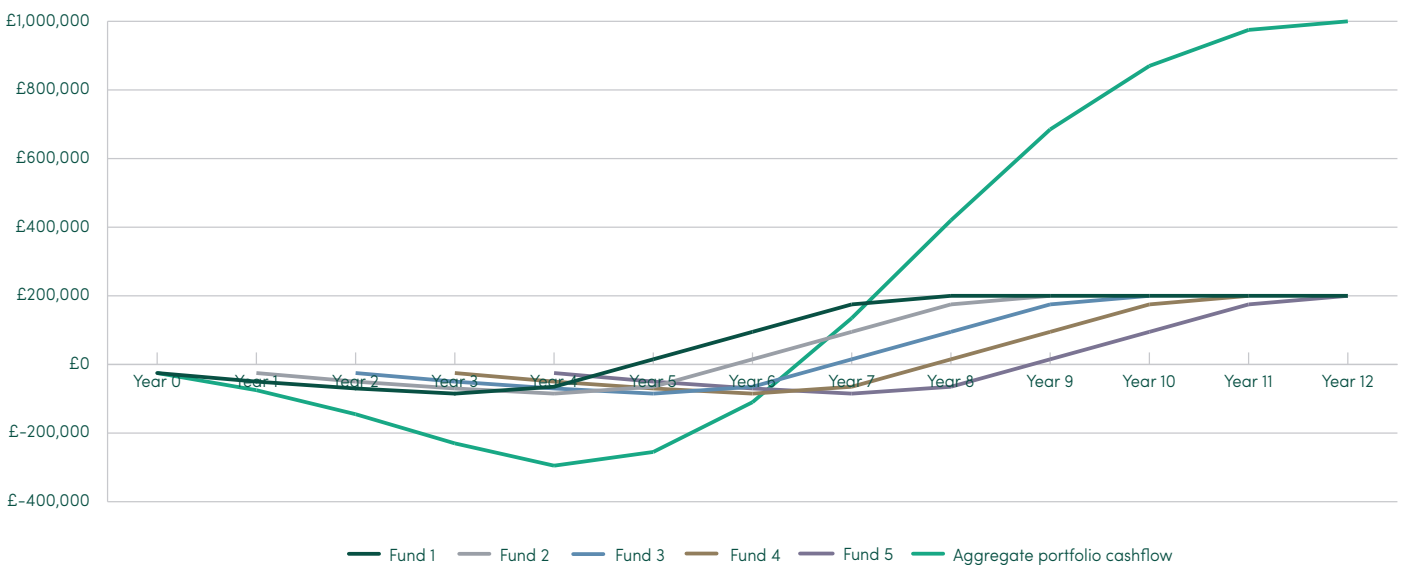


Source: Connection Capital.

In this way, investments in private equity funds could be used to soften the J-curve of portfolio which includes single asset private equity investments.

And, by investing in a range of alternative investment funds over a number of years, investors can aim to use the cashflows from maturing investments to fund capital commitments to new investments.

### Investor net cashflows – Portfolio of Funds – Example



Source: Connection Capital.

In the hypothetical example shown in the chart above, the investor commits £100,000 to a different fund each year for five years (a total commitment of £500,000).

Each fund draws £25,000 of the investor's commitment at completion (shown as 'Year 0') and then each fund draws £25,000 a year for the next three years. As the earlier funds mature and start to distribute investment proceeds by returning capital to investors, the total net capital at risk for the investors' overall portfolio of five funds only reaches -£295,000 rather than £500,000.

This example shows how fund cashflows and the smoother J-curve of these investments could support an investor to fund future capital calls, or even new investments, from the distributions of earlier investments.

It also suggests how introducing fund investments could smooth the volatility of returns (at a portfolio level) and 'flatten the J-curve' of a portfolio of direct investments.

By constructing a portfolio of alternatives where the underlying investments all have different J-curves it is possible to eventually target an entirely self-funding portfolio and one that is increasingly valuable.

N.B. Investors should note that many funds never fully draw the capital committed so may wish to increase their allocation to ensure they reach the exposure to the fund/strategy that they believe is appropriate for their portfolio.

### **Taking a strategic approach to asset allocation**

Taking a strategic approach to asset allocation means appraising your investment portfolio and its true diversification and aligning its exposures with your investment objectives. That is often easier said than done. We encourage our clients to think long-term and about what level of exposure to each asset class is suitable for them and allocate accordingly.

If you would like to talk to us about this whitepaper, your portfolio or any of our live or upcoming investments strategies, please call us on **020 3696 4010**.



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