Conversations with Commerce Trust Podcast

May Episode: A Look at Alternative Investments — May 1, 2024

David Hagee: Hello and welcome to *Conversations with Commerce Trust*, our show about the markets, investment themes, and economic insights that matter to you. I'm your host, David Hagee, Chief Investment Officer with Commerce Trust. Today, we're discussing alternatives and the opportunities available inside the asset class with Cindy Rapponotti, our Director of Alternative Investments. Welcome to the podcast, Cindy.

Cindy Rapponotti: Thank you, David. How are you?

David: Doing well, doing well. This is a topic that we wanted to talk about for quite some time on the podcast. Just get a good handle on what alternatives are. So, let's start at the very beginning and foundational sort of work here. What are we talking about when we're talking about alternatives here?

Cindy: Alternatives are investments that do not fall into the conventional category of stocks, bonds, and cash. They would include real estate, commodities, precious metals, hedge funds, private investments, both private equity and private credit, art, antiques, and collectibles. Historically, alternatives were suitable for only large institutional investors or very high net-worth individuals, and that's due to their high minimums, investment minimums, and illiquid structures. But today, many alternatives are available in liquid strategies through mutual funds and exchange-traded funds. But remember, the private investments do not have the liquidity of the public markets. Commerce views alternatives in the context of every client's objective, risk tolerance and overall financial situation. So, alternatives are not for everyone and what strategies we employ are very tailored to each client.

David: Well, thanks for that, Cindy. That's a great overview of exactly what the asset class, or how we're defining the asset class, is. Maybe walk us through who's using these inside their portfolios and what are some of the unique characteristics surrounding alternatives, and especially private equity and private credit at this point?

Cindy: Well, I'll talk about unique characteristics in general. They are more complex, harder to understand and have a higher fee structure and less liquidity. So, time horizons are going to be very long. Manager risk is also higher, especially when you're looking at private investments. So, due diligence is important. But many clients are using it. Our institutions, our pension funds, foundations, endowments. And then on the individual side, many clients, small clients are going to be using the liquid strategies, the mutual funds and our larger high net worth family offices are using the privates, both equity and private credit.

David: Cindy, you mentioned manager selection is remarkably important inside this category. In terms of the research and due diligence that you mentioned, what's the approach that Commerce Trust Company takes?

Cindy: Well, working with outside managers and evaluating them is very important. We've got a long-term time horizon. We want to make sure that we're representing our clients. We want to make sure that their interests are aligned with these outside managers. In summary, we're trying to figure out, are they the right people? Do we understand their philosophy? Do we understand their process? So, what they've been doing in the past, is that likely to be repeated in the future? So, we need to kick the tires and understand all those dimensions when we're choosing an outside manager.

David: So, given all these unique characteristics surrounding the asset class, why are people investing inside the alternative space at this point?

Cindy: Well, there's lots of reasons. Really when we think of alternatives, it's a different way of investing relative to a traditional stock/bond portfolio. Think of it as another set of tools in the toolbox. They may provide diversification. If you use strategies that behave differently than your stock/bond portfolio, things that have low correlation to the traditional markets. It's also important to look at, are these worthwhile? Are they improving the risk-reward profile of the portfolio?

David: So, as we're currently assessing things inside the private placement space, maybe you could talk a little bit about what private equity is and what private credit is.

Cindy: So private equity, it is a big space, and it is also a spectrum of investments, but the commonality, it's equity investment in non-public companies. These may be growth companies, young companies, or relatively mature companies. Think of venture capital, Silicon Valley, that's early-stage equity investing to startup companies and small businesses that are believed to have long-term growth potential. This is an area that has much higher risk-return profile than other areas of private equities.

Then we have buyouts. Buyouts occur when a buyer acquires more than 50% of a company leading to a change in control. Secondary fund investments is interesting as these funds provide liquidity to private equity investors by purchasing their limited partnership interests or their equity stake. You know, your private equity investment is going to have, as I said, a long-term time horizon and a typical fund may be in place for 12 to 15 years. So, you could have that investment going on for that long.

Now all your money is not invested at the beginning. It may take five or six years till you're invested, but you need to have available cash. Private investments are not for people that need a lot of cash flow or liquidity because that money is tied up.

On the private credit side, that's simply lending the companies, something that banks have been doing for some time. So, you're seeing these private credit funds really getting into the space that has traditionally been banks. So, there's some sectors there, too. There's distress that companies that aren't doing well, they're troubled maybe in bankruptcy, that need to access capital markets, might be easier for them to do it within the private space versus traditional banks. Then there's also direct lending. Any company, they may choose to diversify, and they may borrow from banks, but they also may borrow from the private markets. So again, that's, generally, those direct loans are going to be senior to the capital structure, meaning senior to say what their say public debt is.

David: As we think about alternatives in the portfolio sense, what should investors and what should our clients be thinking about here?

Cindy: Well, if we look at private investments, those are going to be generally at the more aggressive end of a client's portfolio. So, that's going to be typically a subset of equity, probably your small cap equity space. So, that's why some of these large hurdles, you really want to have enough assets to commit to it so that you're meeting the minimums from the investment standpoint, from the fund standpoint, and not over-allocating or having a concentration in your own portfolio. So, you kind of have to size that up. We work very closely with clients that, maybe they're starting out on that space to help them assess their overall portfolio, and then how should we size the private equity or private credit allocation, and then how should that be committed on a year-to-year basis. So, it's really a journey with those clients. It's not something that you can get done in one year.

David: I do think that is a very meaningful part of this, is to have a robust conversation with the portfolio manager around this to be able to frame up exactly what this could be for a portfolio. And again, as you mentioned earlier, that these investments should be viewed in the context of a portfolio, both a portfolio of private placements as well as the broader context of aggregate level portfolio.

Thanks for the interesting discussion, Cindy. For more information on today's topic, please visit our website www.commercetrustcompany.com and download our latest commentary. Also, if you've enjoyed what you've heard, you can subscribe to our show on Apple Podcasts, Spotify, Amazon Music, or wherever you get your podcasts from. Thank you for joining us on *Conversations with Commerce Trust*. I'm David Hagee. We'll talk again soon.

May 1, 2024
Commerce Trust is a division of Commerce Bank.