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Enhancing Portfolio Performance with Alternative Investments – Part 2

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Retirement portfolios traditionally focus on publicly traded assets like stocks and bonds. As discussed in part 1 of this series, incorporating alternative investments can enhance diversification, decrease volatility, and potentially increase returns. This article explores how private investments, including private equity replication funds and actual private investments funds, can fit into a retirement portfolio. Additionally, it discusses the differences between globally listed infrastructure funds (Common_Investment_Mistakes.pdf) and global unlisted Infrastructure funds.

Private Equity Replication Funds

Aimed to mimic the performance of private equity investments but with the liquidity of public market assets. This is to-date what I have used with clients who still want full liquidity on a daily basis, no different than any other equity ETF or mutual fund.

These funds offer several benefits:

- **Liquidity**: Investors can easily buy and sell shares daily without the long-term commitment required by traditional private equity.
- **Accessibility**: Lower minimum investment requirements make these funds more accessible to individual investors.
- **Transparency**: Regular reporting and market pricing provide clarity on fund performance.

However, replication funds may not fully capture the illiquidity premium investment returns associated with traditional private equity investments.

Risks of Private Equity Replication Funds

These funds come with several risks:

- **Volatility**: While replication strategies may reduce volatility compared to direct private equity, they can still be more volatile than traditional private equity funds due

to their reliance on public market instruments. This is because actual private equity funds have much less frequent valuation of shares than private equity replication fund that is valued daily in the stock market.

- **Lack of Control**: Replication funds cannot replicate the operational improvements and company selection that private equity firms achieve through real direct ownership and management.
- **Fees and Costs**: While replication funds often have lower fees than traditional private equity, they still incur costs associated with managing the replicating strategy.

Actual Private Equity Investments Funds

Provide direct access to private equity opportunities. These investments offer:

- **Diversification**: Exposure to a range of private equity strategies, including buyouts, growth, and core investments. This creates lower correlation with your traditional retirement assets.
- **Illiquidity Premium**: Potentially higher returns longer-term than the public stock markets due to the illiquidity of these investments.
- **Expertise**: Access should be with a leading global private equity firm with extensive experience and history in these assets.

Risks of Actual Private Equity

Actual private equity investments involve several risks:

- **Leverage**: Many private equity deals are highly leveraged to be able to offer the potential higher returns, increasing the risk of default and financial distress.
- **Illiquidity**: Private equity investments are typically illiquid, meaning investors may face challenges when trying to exit their positions quickly or at moment notice. The redemption options will depend on the structure of the fund and could be periodical every few months.
- **Company-Specific Risks**: Private equity firms may potentially acquire companies with significant operational challenges, which can impact returns if not managed effectively and well understood.

These funds typically require an offering memorandum, a certain liquid net worth to be a qualified investor, a minimum starting amount to invest (as low as $ 25,000 to start with), and because it involves much less liquidity redemption options, it makes them more

suitable for long-term investors or investors with considerable liquid assets who can redeem other assets quickly, should immediate funds be needed.

Global Listed Infrastructure

- **Liquidity**: Listed infrastructure investments, such as REITs or infrastructure ETFs / mutual funds, offer easy access to cash when needed as they are redeemed in the stock markets.
- **Transparency**: Publicly traded infrastructure companies provide regular financial reporting and market pricing.
- **Volatility**: Listed infrastructure can be more volatile due to market fluctuations.
- **Inflation Protection**: Typically pass on costs of business to customers.
- **Yield**: Majority of public infrastructure ETFs and mutual funds have higher than average dividend income.

Risks of Global Listed Infrastructure Investments

1. Interest Rate Risks

- **Impact on Valuations**: Rising interest rates, which impact most publicly traded stocks negatively, can negatively affect the valuations of listed infrastructure companies more than other market sectors, as higher rates increase the cost of borrowing and can reduce the present value of future cash flows.
- **Sector Sensitivity**: Infrastructure sectors with high levels of debt are particularly sensitive to interest rate changes, which can impact their financial health and stock performance.

2. Market Volatility

- **Equity Market Fluctuations**: While listed infrastructure tends to be less volatile than broader stock market equities, it is still exposed to market fluctuations. During downturns, infrastructure stocks may decline, though they often capture less of the market's downside action.
- **Sector-Specific Risks**: Certain infrastructure sectors, such as those heavily reliant on commodity prices (e.g., energy infrastructure), can experience significant volatility due to external factors like commodity price fluctuations and political events.

3. Regulatory Risks

- **Policy Changes**: Infrastructure companies are often subject to regulatory environments that can change, impacting cash flows and profitability. For example, changes in energy policy due to politics.

Global Unlisted Infrastructure

- **Stability**: Unlisted infrastructure investments often provide more stable returns due to their insulation from public daily stock market volatility.
- **Illiquidity Premium**: Similar to actual private equity funds, investors may receive higher returns due to the illiquidity of these investments.
- **Complexity**: Accessing unlisted infrastructure typically requires more expertise and financial resources, hence a company that has a reputable history of managing these types of investments should be used.
- **Inflation Protection**: Typically pass on costs of business to customers.
- **Yield**: May provide dividend income if it has established steady cash flow, depending on maturity of the business.

Risks of Global Unlisted Infrastructure Funds

Unlisted infrastructure investments also carry risks:

- **Valuation Challenges**: Unlisted infrastructure assets can be sometimes difficult to value accurately due to the potential lack of regular market pricing.
- **Regulatory Risks**: Infrastructure projects are often subject to regulatory changes, which can impact cash flows and returns.
- **Operational Risks**: Managing infrastructure assets requires significant operational expertise to maintain profitability and manage risks.

The purchase of global unlisted infrastructure funds has similar considerations to purchase of actual global private equity funds with direct exposure, as well as the qualifications to be an investor and less liquid redemption options.

Ultimately, both Infrastructure investment types can potentially provide stable inflation-adjusted investment income.

Conclusion

Incorporating private equity investments into a retirement portfolio can enhance diversification and potentially increase long-term returns. While private equity replication funds offer liquidity and accessibility, actual private investments funds provide access to unique asset classes with potential for higher returns. Understanding the differences between listed and unlisted infrastructure investments is also crucial for making informed decisions. Ultimately, a balanced approach that considers both traditional and private investments can help create a resilient retirement portfolio.

By carefully evaluating these factors and incorporating a mix of traditional and private investments, investors can build robust retirement portfolios tailored to their needs.

If you want to explore post-retirement goals aimed at creating healthy and balanced financial strategies, please contact me at wwoo@researchcapital.com.

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