HIGH YIELD LIQUID ALTERNATIVE INVESTMENTS

The merits of managed portfolios of high yield liquid alternatives for higher levels of consistent income over increasingly long life spans.

DEFINING ALTERNATIVE INVESTMENTS

As fellow CFA charter-holder, Michael Manning, remarked in a recent CFA Institute podcast entitled, *New Horizons in Asset Allocation: Combining Liquid Alternatives in Portfolios*, “there is no easy definition of alternatives.”

The alternative label is too often used as a catch all for investments that fail to fit neatly into the traditional categories of stocks, bonds and cash. This ambiguity may result in the neglect of this important investment tool by many investors who might otherwise benefit.

In this paper, we will focus on the use of liquid alternatives, as opposed to traditional stocks, bonds and cash, as well as compared to using illiquid, or non-traded alternatives, to generate high levels of portfolio income not possible with traditional investments.

HIGH-YIELD LIQUID ALTERNATIVES

Investing higher yielding, alternative asset types can provide higher levels of current income than traditional stocks and bonds, especially in today's very low interest rate environment. Reaching for this extra yield is not without its risks and should not be assumed to be a low volatility approach as is often associated with some alternative asset strategies.

As alluded to in the above paragraph, a good way to think about and categorize alternative investments is to identify each as either an *alternative* ***asset class*** or an *alternative* ***strategy***. The table below details a list of each.

ALTERNATIVE ASSET CLASSES

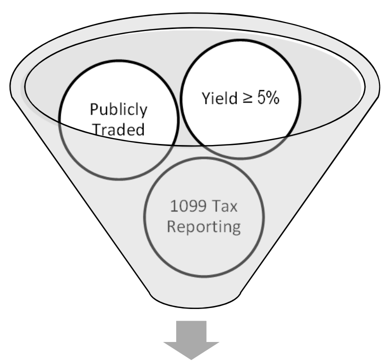
Alternative income asset classes include a wide variety of investment types that provide exposure to real or financial asset types.

- Real Estate Investment Trusts
- Business Development Companies
- Master Limited Partnerships
- Listed Private Equity
- Floating Rate & High Yield Credit

ALTERNATIVE STRATEGIES

Alternative strategies tend to use approaches like leverage, options writing or long-short to achieve the desired result.

- Covered Call ETFs/Funds
- Put Write ETFs/Funds
- ETFs/Funds of CEFs
- Long/Short Tactical-Credit ETFs/Funds



Addressable Investment Universe

There is debate in the investment industry as to whether alternative investments truly provide the diversification benefits they promise investors. There is a wide disparity between the correlation of alternative investments to the broad stock and bond markets during bull markets versus times of market distress. Often, correlations are low or negative in up markets (when you do not need it) and increase during significant market pullbacks when low correlations are desired. During periods of rising stock prices, alternatives may become a drag on performance, but continue to provide current income without the need to liquidate assets.

The intent of this whitepaper is to demonstrate the ability of a managed mix of various alternative investments to enhance the income to investors with reasonable price stability over investment time horizons greater than 15 years. As the Baby Boom Generation (born between 1946 and 1964) enters retirement, sources of income become increasingly important, especially in today's very low interest rate environment.

UNIVERSE CRITERIA

Liquid

Liquid, in this case, simply means the investment is traded on a public exchange and is able to be converted to cash on a daily basis. Liquid alternatives can be purchased and sold without the requirement to complete subscription agreements and liquidation request forms, which are common when investing in illiquid alternatives such as non-traded real estate investment trusts (REITs) or business development companies (BDCs). Also, liquid in contrast to direct investments in alternatives such as real estate and private equity/debt.

If you stop to consider the underlying investments in a REIT or private loan fund such as a BDC, the liquidity issue makes sense. You are investing in a structure that purchases real estate or issues loans to private companies. Once the funds have been deployed, the assets held in the REIT or BDC are generally not able to be sold on a daily basis. Until loans mature or properties are sold, investor capital is locked into these various investments with the possibility of partial periodic redemptions, but rarely access to retrieve your full investment back for a long period of time.

In the real everyday world, unforeseen events and circumstances occur during the life of individual investors that may require access to funds previously invested. Liquidity can be an important consideration for many investors and the ability to collect income and maintain liquidity is attractive.

High Yielding

In thinking about high yield investments versus high growth investments, the mechanics of each help to explain what investors should expect from high yield alternative investments.

In general, companies that pay regular dividends to shareholders are distributing profits not needed to fund future growth opportunities for the company, either because the company has plenty of cash on hand, access to outside capital, or because company management just cannot identify any attractive opportunities in which to invest.

In the case of liquid alternative investments, such as REITs and BDCs, both are required to distribute at least 90% of their annual net income to shareholders. It is this dynamic, along with the nature of the cash flow generating investments in the REIT or BDC, that result in higher yields than can be achieved through investment in traditional stocks and bonds.

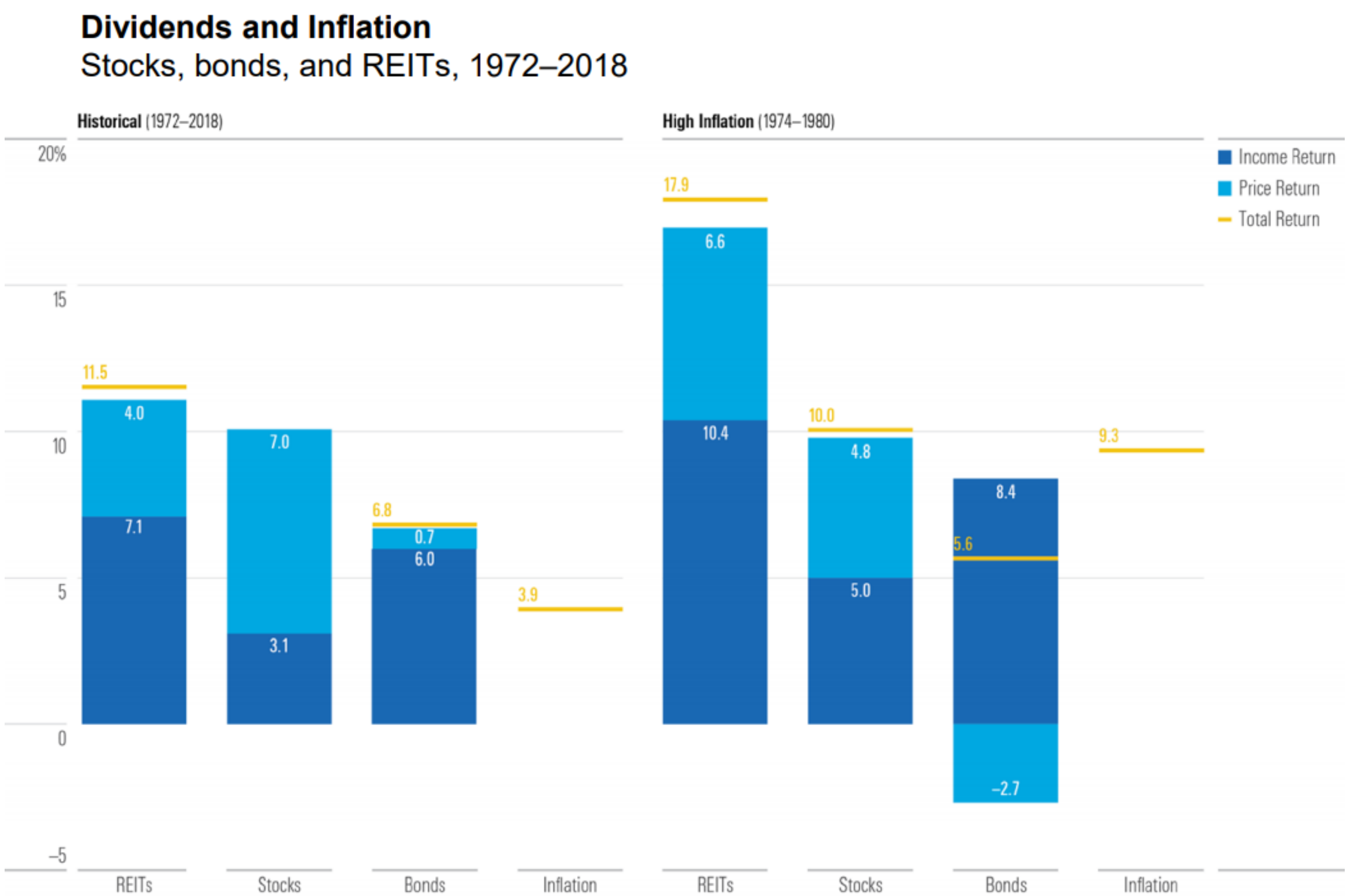
However, there is a give and take between potential price appreciation and yield. It is difficult, if not impossible, to achieve high levels of both. High yielding alternative investments may provide some capital appreciation over time, but the largest portion of the total return from these is expected to come from income distributions. It should be noted that a high distribution yield affords the investor the opportunity to be patient while long-term appreciation is sought.

We believe that higher yielding liquid alternative investments can be blended together in a portfolio to achieve current cash flow income, with attractive total return over longer periods of time, generally with lower volatility than the stock market.

INCOME CONTRIBUTION TO TOTAL RETURN

As mentioned above, a liquid alternatives high yield strategy seeks to achieve total return (price return + income return) with a primary focus on return from income. As the chart below of the total return breakdown among stocks, bonds and REITs demonstrates during a long period of more moderate inflation from 1972 to 2018 was 11.5% for REITs and 10.1% for stocks. However, the income return component of REIT total return was 7.1% or approximately 60% of total return for the period. During a period of high inflation from 1974 – 1980, not only did REITs outperform stocks and bonds on a total return basis once again, but the return from income for REITs was again approximately 60% of total return.

Since REITs encompass a large portion of the liquid alternatives universe, we will use REITs as a proxy for high yield alternatives for purposes of this paper. The important take away is that for longer investment time horizons, the income component of total return may provide an edge over stocks and certainly over bonds. This is particularly important for todays' retirees as the number of years the portfolio of assets must effectively serve to not only maintain the current standard of living, but also at least match the pace of inflation as prices continue to rise over time.

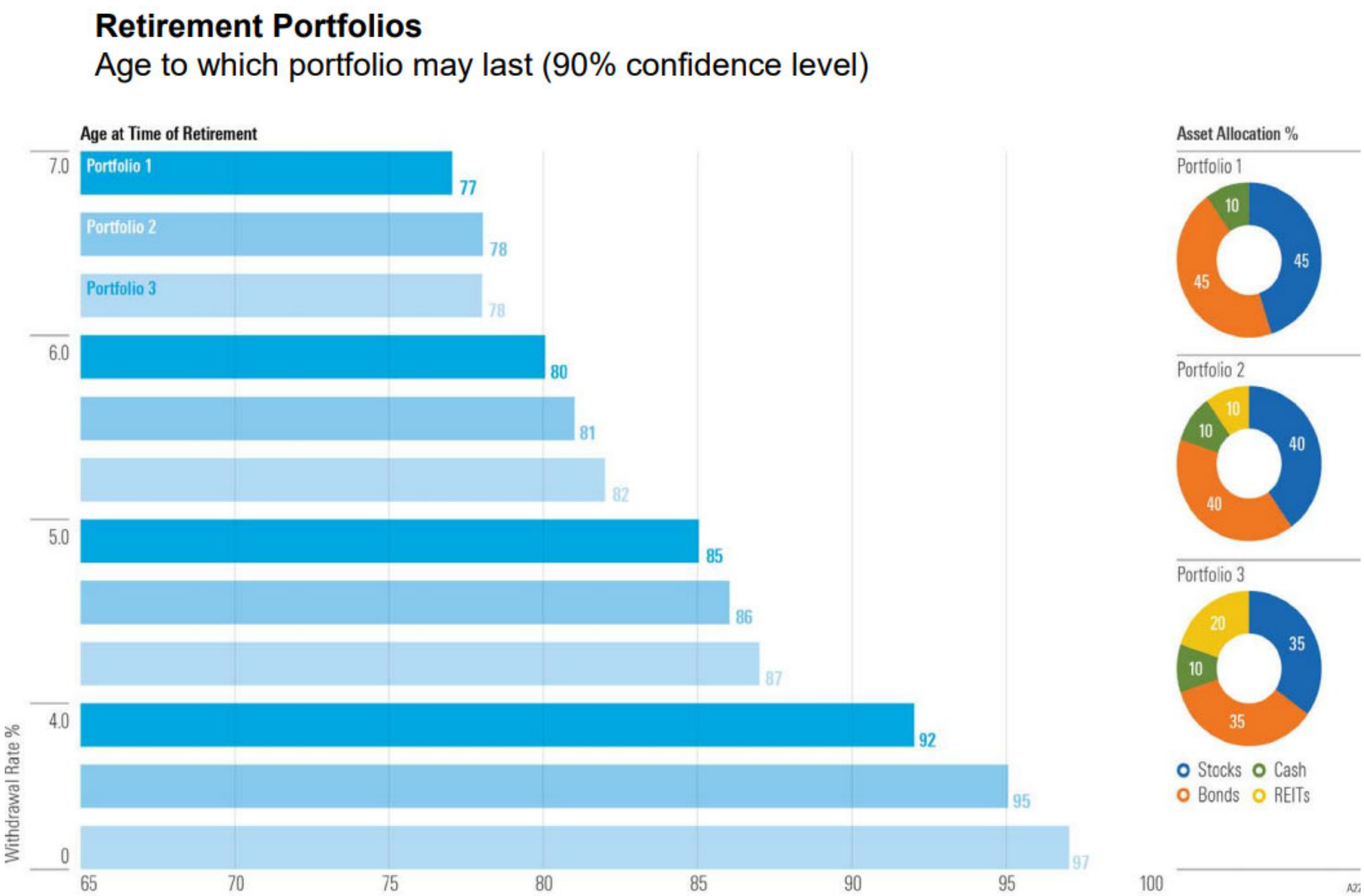


Source: Morningstar Direct™

HIGH YIELD LIQUID ALTERNATIVES IN RETIREMENT PORTFOLIOS

Investors who can view their allocation to liquid alternative high yielding investments as long-term total return positions may enjoy higher levels of current income and price stability of their investment portfolio through the lens of total return. Higher levels of income reduce the need to sell assets and distribute principal when expenses exceed other income sources. This benefit is of particular value during periods where growth investments have declined in value.

The ability to avoid sequencing risk, the risk of drawing down portfolio principal in a down market permanently reducing a retiree's investment base, as current income needs are met through greater portfolio cash flows leads to greater financial success in the distribution phase. As the chart below illustrates, the greater the allocation to REITs within the three hypothetical portfolios, the greater the chance of success at nearly every initial retirement age and withdrawal rate.



Source: Morningstar Direct™

SUMMARY

Many yield-seeking investors have used various non-traded investment vehicles to gain exposure to alternative investments such as income producing real estate and other similar assets. The Great Recession in 2008 – 2009 resulted in an unprecedented period of low interest rates across the spectrum of fixed income assets. Retirees have suffered the most from this dynamic, forced to reach for yield in non-traditional and unfamiliar places.

There are pros and cons to investment selection in the non-traded space. In the case of non-traded Real Estate Investment Trusts, investors collect distributions from the net rental income of the underlying assets after layers of management fees and other costs. The value of their investments are based on periodic appraisals of the underlying assets, which result in a net asset value or NAV. Problems often arise when the REIT eventually lists on an exchange subjecting it to the forces of market supply and demand of shares rather than the nebulous values derived from real estate appraisals. The now-public REIT competes with other liquid investments of similar characteristics for investor capital, a very different dynamic compared to the REIT's non-traded days. At this point, the daily value of REIT shares often decline as the repricing process ensues. In some cases, the distribution yield may also decline. Investors may be caught off guard by these events, causing heartburn for the investor and advisors alike.

Other issues include the illiquid nature of non-traded investments such as REITs and BDCs. Investors frequently shift their preferences over market cycles as other investments become more attractive in their eyes. Frustration occurs when the REIT or BDC denies redemptions, even though the potential illiquid nature of the investment was disclosed at the time of the initial purchase.

Liquid alternatives to the non-traded versions described above abound in today's investment universe. In many cases, the illiquidity premium that should be associated with a non-traded investment is less than appropriate compared to higher yields available in traded investments with daily liquidity. Our work has revealed that higher levels of income yield are readily available in the liquid alternative securities universe. While liquid alternatives may offer high yields, the fact that they are liquid each day makes them susceptible to periodic volatility, which investors should be prepared for while pursuing the income benefits and long-term appreciation potential.

Liquid alternatives with higher yielding income streams provide income seeking investors an attractive option to complement other investments and income sources. Alternatives may provide additional diversification benefits with historically lower correlations to traditional stock and bond markets. The ability to offer a total return that includes a significant portion of return from income may also serve as a defensive buffer in times of financial market stress. Because of the inflation protection potentially gained by investing in certain alternatives that own real estate and floating rate credit instrument, liquid alternatives with high yields have tended to perform well historically through higher inflationary periods.

We believe that a managed portfolio of diversified liquid alternative assets and strategies can provide an attractive income stream, capital appreciation over time periods of 15 years and beyond and diversification benefits.

DISCLOSURES

About Integra Capital Management

Integra Capital Management is a fee-only registered investment advisor founded in 1992. We manage the Liquid Alternatives High Yield Portfolio strategy and a rising dividend stock strategy known as the Elite Dividend Portfolio. To learn more about these strategies call us at 941-778-1900, or visit our website at **www.integrcapitalmanagement.com**

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