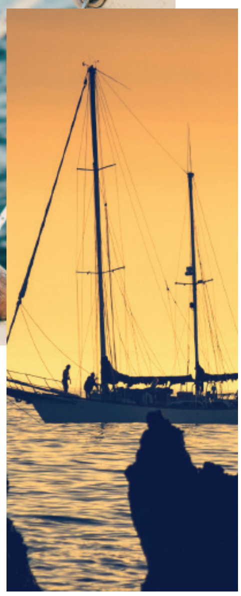
BREAKWATER
1031

Why Alternative Investments are Growing

It's common procedure for people to set up a retirement account with their employer, and then turn over control of that account to the plan's custodian to allocate funds as it deems best given an individual's age, income and retirement objectives. After the initial account set up, many people take a hands-off approach and let the custodian manage investments as they see fit. The problem with this approach, though, is that most custodians will defer to investing in traditional assets, such as stocks, bonds and mutual funds. This makes an individual's portfolio highly susceptible to the ebbs and flows of the stock market, and may prevent them from earning potentially higher returns if they were to invest elsewhere.

Elsewhere, in this case, refers to alternative investments. Alternative investments, once deemed "too risky" for individual investors to participate, are becoming more mainstream. Today, individual investors are following the lead of institutional and high-net-worth investors who have invested in alternatives for decades. Individual investors are finding that alternatives provide the potential for tremendous value - from diversification to greater stability, growth potential and more.



What Are Alternative Investments?

Most people are taught to invest, for retirement or otherwise, in some combination of stocks, bonds and mutual funds. These publicly-traded equities are considered "traditional" investment and are the most common investment choices. Typically, when someone talks about "diversifying" their portfolio, they are referring to diversifying into various types of these equities, ranging from "riskier" stock options to historically "safer" bonds or mutual funds. Some might invest in specific sectors (e.g., tech) whereas others might invest in up-and-coming sectors (e.g., a "sustainable leaders" fund) as a way of further diversifying.

In any event, these traditional investments are all relatively liquid and closely correlated with the general movement within the stock market. This means the value of traditional investments can ebb and flow, sometimes dramatically, even on a daily basis.

Alternative investments are often much different than traditional investments. Alternative investments run the gamut and can include tangible assets such as precious metals, collectibles like art or antiques, crops and other commodities. They can also be investments in financial assets such as private equity, venture capital, distressed securities, carbon credits, cryptocurrencies, and

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Key Features of Alternative Investments

Most Alternative investments have a few key properties that help to distinguish them from traditional investments. These features include:

Low historical correlation with the stock market.

Whereas traditional stocks, bonds and securities generally respond to overall stock market fluctuations, alternative investments typically operate more independently. This is partially due to the illiquid nature of alternative investments (more on this below). Simply put, most alternative investments can not be easily purchased or sold with the click of a button the way other publicly-traded securities are. There is a longer lead time to purchasing or selling alternative assets, often including a robust due diligence period, which has historically made alternative investments less prone to market volatility.

Investors experienced this first-hand during the COVID-19 pandemic. At one point, during the height of the pandemic, the Dow plummeted 10,000 points in one day. It has since bounced back, but during this time, many alternative assets including many of those invested in real estate continued to hold their value (with a few notable exceptions, like hospitality which took a hit due to widespread pandemic-related restrictions on travel).

Can be difficult to determine underlying value.

One of the challenges associated with investing in alternative investments, and one of the reasons why these investments have historically been reserved only for institutional and high-net-worth investors, is that the underlying value of these assets can be difficult to ascertain. Unlike investing in stocks or bonds, where most data is publicly available, those interested in alternative investments will find that they are operating in a world of imperfect knowledge and marketing information.

The value of some assets, for example, can be entirely subjective - someone may be willing to pay more for a specific property, for example, if they have a personal attraction to that investment. Properties in vacation markets are a great example of this phenomenon: someone may be willing to pay double what someone else is willing to pay for a property located in Cape Cod if their family has a long-standing history of vacationing in that area. In this case, the value the investor is willing to pay is not necessarily rationale.

Other factors, such as a person's willingness to put debt on a property (and at what terms), may also overly influence what the "market" deems the asset's value to be. With alternative assets, the market value is simply what someone (even just one person) is willing to pay for that asset.come along with withdrawal penalties of some kind.

Provide less liquidity than traditional investments.

Compared to traditional investments, alternative investments are generally illiquid. The illiquidity can be explained by the absence of centralized markets and the low demand for some of these assets relative to traditional investments (e.g., fine art).

Many alternative investments also require the investor to remain in the deal for a specified period of time, or else they might face penalties from an early exit. For example, someone might invest in a real estate fund that has a minimum five-year hold. Investors in this fund may be able to exit early, but doing so could likely

Even in a scenario in which someone is free to purchase or sell at any time, alternative investments generally require substantial due diligence and/or processing time for a transaction to complete. For example, someone looking to sell an office building will still need to hire a broker, procure a buyer, and then usually have at least 30 days of paperwork, processing, financing, etc. that is necessary prior to the deal closing. This contributes to the illiquid nature of alternative assets.

Traditionally high barriers to entry.

Alternative assets have historically had high barriers to entry. This is particularly true as it pertains to high-cost alternative assets, such as "trophy" real estate. The sheer size and value of deals like these meant that only institutional investors and high-net-worth individuals had access. With changes to SEC regulations in 2014, the ability to engage in "general solicitation" made crowdfunding for alternative assets easier which, in turn, has opened the door for individuals looking to invest smaller denominations in alternative assets for the first time.

Alternative Investments Provide True Diversification

Alternative investments are a way for investors to truly diversify their investment portfolios. As a general rule of thumb, most advisors will suggest moving anywhere from 15 to 20 percent of your holdings into alternative assets of some kind. Institutional investors exceed this threshold, with pension funds sometimes investing 30 percent of their assets in alternatives and endowments investing more than 50 percent in the same. Today, individual investors average only 5 percent in alternatives, a number most advisors suggest increasing by three- or four-fold.

Diversification has several benefits. For one, diversification provides a greater potential for stability and may make a portfolio less susceptible to swings in the market. Two, by investing in alternatives, people can potentially boost returns above what they may earn by investing in low-returning asset classes like government bonds.

Alternative Investments Often Target Higher Returns Than Traditional Investments

Many alternative investments offer the potential for a higher rate of return than traditional investments. This is particularly true when looking at risk-adjusted returns over a decade or more. For example, farmland, timberland and real estate all outperformed the S&P 500 over a 20-year period. Absolute returns were often even more impressive. For example, between 1992 and 2018, farmland averaged 10 percent total returns, including income and price appreciation.

Often, the performance of alternative investments during period of market volatility has also historically been impressive. According to an EY study published in November, alternative investments outperformed during the early days of the pandemic, which helped to mitigate an otherwise big crash among stocks and bonds.* Portfolios that had diversified and included alternative investments were spared from what could have otherwise been devastating losses.

“Alternative managers outperformed their performance expectations during Covid-19, especially in private equity, where a ratio of 4:1 felt their managers outperformed expectations. Hedge fund performance varied by strategy, but on average, almost all significantly exceeded major benchmarks. When major indices were down 15-20 percent in early 2020, many hedge funds were only down low single digits. Funds demonstrated their value in preserving capital in the downturn while opportunistically stepping in to capitalize on market dislocations.”

One of the reasons alternative investments are performing so well today has to do with the fact that we are operating in a historically low interest rate environment. The rate on 10-Year U.S. Treasury bonds hovers around 1.6 percent, which is less than the rate of inflation, which is closer to 2 percent. Investors seeking greater yield have no choice but to look further out on the risk spectrum, which often leads them to alternative investments like real estate.

How to Invest in Alternative Assets

Historically, investing in alternative assets has been a time consuming, complicated and expensive process that left individual investors confused and frustrated. Today, given changes to SEC rules and regulations, it is easier than ever to invest in alternative assets.

There are a few ways to get started. One way would be to liquidate stocks or bonds and/or invest cash directly into an alternative asset class. This could be done, for example, by investing directly with a real estate sponsor or fund manager specializing in alternative assets. Private equity funds, such as Delaware Statutory Trusts (DSTs), allow individuals to fractionally invest in alternative assets like real estate.

Another option is to roll your traditional or Roth IRA into a self-directed IRA (SDIRA) with an alternative asset custodian. Through the SDIRA, you can then make investments into alternative investments of all kinds - including but not limited to real estate, DSTs or otherwise. The SDIRA will facilitate the transaction and then hold title to the assets on your behalf.

Conclusion

Alternative assets, once thought of as too risky for individual investors to pursue, are now becoming more mainstream. Investors looking to diversify their portfolios will certainly want to consider their options, including real estate. Investing with a real estate sponsor or fund that has a long track record of performance is a great way to seek to mitigate the risk otherwise associated with alternative investing. Traditionally high barriers to entry.

GENERAL DISCLOSURE

Not an offer to buy, nor a solicitation to sell securities. Information herein is provided for information purposes only, and should not be relied upon to make an investment decision.

All investing involves risk of loss of some or all principal invested. Past performance is not indicative of future results. Speak to your finance and/or tax professional prior to investing.

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1031 RISK DISCLOSURE

- There is no guarantee that any strategy will be successful or achieve investment objectives;
- Potential for property value loss – All real estate investments have the potential to lose value during the life of the investments;
- Change of tax status – The income stream and depreciation schedule for any investment property may affect the property owner's income bracket and/or tax status. An unfavorable tax ruling may cancel deferral of capital gains and result in immediate tax liabilities;
- Potential for foreclosure – All financed real estate investments have potential for foreclosure;
- Illiquidity – Because 1031 exchanges are commonly offered through private placement offerings and are illiquid securities. There is no secondary market for these investments.
- Reduction or Elimination of Monthly Cash Flow Distributions – Like any investment in real estate, if a property unexpectedly loses tenants or sustains substantial damage, there is potential for suspension of cash flow distributions; Impact of fees/expenses
- Costs associated with the transaction may impact investors' returns and may outweigh the tax benefits