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INCOME INVESTING

Alternatives Can Produce the Yield Fixed Income Can't

By Amey Stone

Investors who think of alternatives as synonymous with hedge funds, risk, and volatility had best think again—especially if generating income is a primary goal. The truth, mainly known to high-net-worth individuals and their financial advisors, is that alternatives can fit well as part of a fixed-income allocation. In fact, one of the best reasons to turn to "alts" in the past year was for income.

Private credit—the most popular alternative-asset class for this purpose—private real estate, and infrastructure funds have delivered yields in the 5% to 8% range in 2021, often with less risk and volatility than their publicly traded counterparts. "It depends on the strategy, but each of those three asset classes is able to produce income in that range," says Cliff Corso, chief investment officer of Advisors Asset Management. "It is the liquidity you're giving up and the illiquidity that you're getting paid extra for."

In practice, that means many alternative funds that hold illiquid private debt allow only quarterly withdrawals, and even those may be limited if a lot of investors try to cash out at the same time. Interval funds, a structure commonly used for illiquid asset classes, allow 5% of assets to be withdrawn each quarter, and if requests exceed that amount, investors get their share prorated. That protects existing investors from the negative effect of a rush for the exits, which could require the fund managers to raise cash far faster than they can unload private holdings.

Losing some liquidity is a reasonable price to pay for the attractive yields and other benefits these asset classes offer, including welcome diversification away from traditional stocks (with high valuations) and bonds (with paltry yields and worrisome interest-rate risk), says Michael Harris, director of the family office practice at Verdence Capital Advisors. One major positive: Private debt is generally floating rate, so yields should reset higher if prevailing interest rates climb as expected. Rising rates generally lead to lower prices for bonds issued with a fixed rate.

"In the traditional bond market right now, even high yield is not high yield," says Harris. Junk bonds yield in the 4% to 5% range. "It is high risk, but you're not getting a whole lot of return," he adds. "That's why we had clients in private credit in 2021, and going into 2022, we're actively looking for more private credit managers that can bolster returns in portfolios."

Private credit tends to yield more than publicly traded debt mainly because lenders bypass public mar-

Funds That Invest in Private Securities Can Offer Higher Yields

Fund / Ticker*	Holdings	Distribution Rate	Liquidity
BlackRock Credit Strategies / CREDX	Private and public debt	6.4%	Quarterly
Blackstone Private Credit / N/A	Private credit	8.1	Quarterly
Blackstone Secured Lending / BXSL	Private credit	6.7	Daily
KKR Real Estate Select Trust / KRSTX	Private and public real estate	5.4	Quarterly
Pimco Flexible Municipal Income / PMFLX	Public and private munis	4.0**	Quarterly

* Some funds may only be available through certain financial advisors and have other restrictions. **Taxable equivalent distribution rate Source: company reports

kets and the bank lending process, says Brad Marshall, co-head of Blackstone Credit's performing credit platform and CEO of the Blackstone Private Credit fund, a private business development company, or BDC. That fund has attracted $12.6 billion in equity and returned 11% since launching at the start of the year. "By issuing a direct loan to the company, lenders end up holding on to more of the return and more yield is passed on to investors," he explains.

In its survey of capital market assumptions held by pension fund managers, Horizon Actuarial Services found that they expect asset classes such as real estate, private debt, and infrastructure to have a total-return outlook that is similar to or better than large-cap stocks over the next 10 years.

These investments benefit from the economic recovery and their status as a "solid inflation hedge," says Corso.

John Bowman, executive vice president of alts industry association CAIA, says the massive global infrastructure gap makes infrastructure investments, sometimes done as partnerships with municipalities, "the best-kept secret in the alternatives buffet table."

That doesn't mean they aren't without risk or complexity. While income-oriented alts performed well in the past 18 months, "in a risk-off environment, net asset values can decline over a short period of time," says Michael Sheldon, chief investment officer at RDM Financial Group. "We often limit a client's alts position to about 5% of total assets." He also tends to favor offerings of some of the largest firms with the biggest brand names, including Blackstone (ticker: BX), Carlyle Group (CG), and Starwood Property Trust (STWD).

Richard Daskin, head of RSD Advisors, recommends getting into these funds after a market downturn. "The time to take on an illiquid investment is when there isn't a lot of liquidity," he says. "That way you're being paid rent for your liquidity."

The funds may have very high minimums and are often available only to wealthy people who qualify as "accredited" or "qualified" investors through a financial advisor. Investors interested in these asset classes can start by asking their financial advisors what relationships they have in place. Some use leverage and may include extra tax complexity. Some private funds can be included on a 1099 tax form, but others may require the extra work of filing a K-1. "Investors have to do their homework and understand the details of what they are buying," says Sheldon.

Publicly traded mutual funds, closed-end funds, or BDCs that invest in private credit, real estate, and infrastructure are available, but they may not be pure plays, or they may trade on equity exchanges, adding volatility.

For example, the Blackstone Secured Lending fund (BXSL) is a publicly traded BDC that holds securities similar to those of Blackstone Private Credit. "Some investors like BXSL for daily liquidity, but it is subject to volatility in equity markets" and may trade at a net asset value that is above or below its book value, says Joan Solotar, Blackstone's global head of private wealth solutions. "Others prefer the private option, where you don't have to worry about a premium or discount."

Still, investors who don't have access to higher-yielding private funds might find the publicly traded options in some income-producing asset classes worth considering, says Verdence's Harris: "They add diversification to portfolios at a time when stocks are at all-time highs and you're not getting much yield from fixed income. There's really no better time to have diversified strategies in your portfolio."

Important Disclosure Information and Risk Factors

Summary of Risk Factors

Blackstone Private Credit Fund ("BCRED") is a non-exchange traded business development company ("BDC") that expects to invest at least 80% of its total assets (net assets plus borrowings for investment purposes) in private credit investments (loans, bonds and other credit instruments that are issued in private offerings or issued by private companies). This investment involves a high degree of risk. You should purchase these securities only if you can afford the complete loss of your investment. You should read the prospectus carefully for a description of the risks associated with an investment in BCRED. These risks include, but are not limited to, the following:

- We have limited prior operating history and there is no assurance that we will achieve our investment objectives.
- This is a "blind pool" offering and thus you will not have the opportunity to evaluate our investments before we make them. You should not expect to be able to sell your shares regardless of how we perform.
- You should consider that you may not have access to the money you invest for an extended period of time.
- We do not intend to list our shares on any securities exchange, and we do not expect a secondary market in our shares to develop prior to any listing.
- Because you may be unable to sell your shares, you will be unable to reduce your exposure in any market downturn.
- We have implemented a share repurchase program, but only a limited number of shares will be eligible for repurchase and repurchases will be subject to available liquidity and other significant restrictions.
- An investment in our Common Shares is not in the best interest of or suitable for you if you need access to the money you invest. See "Suitability Standards" and "Share Repurchase Program" in the prospectus.
- You will bear substantial fees and expenses in connection with your investment. See "Fees and Expenses" in the prospectus.
- We cannot guarantee that we will make distributions, and if we do we may fund such distributions from sources other than cash flow from operations, including the sale of assets, borrowings, return of capital or offering proceeds, and although we generally expect to fund distributions from cash flow from operations, we have not established limits on the amounts we may pay from such sources.
- Distributions may also be funded in significant part, directly or indirectly, from temporary waivers or expense reimbursements borne by Blackstone Credit BDC Advisors LLC (the "Adviser") or its affiliates, that may be subject to reimbursement to the Adviser or its affiliates. The repayment of any amounts owed to our affiliates will reduce future distributions to which you would otherwise be entitled.
- We use and continue to expect to use leverage, which will magnify the potential for loss on amounts invested in us.
- We intend to invest in securities that are rated below investment grade by rating agencies or that would be rated below investment grade if they were rated. Below investment grade securities, which are often referred to as "junk," have predominantly speculative characteristics with respect to the issuer's capacity to pay interest and repay principal. They may also be illiquid and difficult to value.
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