



Alternative assets

Enhancing portfolio resilience and diversification

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When managing money in a world full of uncertainty, diversification is more important than ever. Alternative assets (also known as alternatives) provide investors access to superior portfolio diversification and lower levels of volatility, which typically increases the likelihood of achieving an investor's objectives over the long-term.

Alternatives offer investors the opportunity to minimise portfolio volatility and correlations with traditional asset classes such as shares and bonds. This helps protect long-term capital and lower the downside risk during unforeseen market crises such as the Global Financial Crisis (GFC) and COVID-19. Alternatives can also help investors navigate market volatility and uncertainties caused by geopolitical risks, such as the recent US tariff announcements and current global conflicts.

However, alternatives come with their own risks and are generally more illiquid and complex compared to traditional assets. It is essential that investors understand the different type of alternatives and their risk-reward profiles before incorporating them into portfolios.

This paper discusses the role alternatives play in portfolios, and explores the different types of alternatives available to investors. It also provides an overview of how alternatives are used in portfolio construction with regard to risk management, and what effective investment criteria look like when selecting the right alternative managers.

Definition and applications of alternatives

Alternatives are financial assets that do not fall into the category of traditional asset classes such as shares and bonds. Alternatives include a broad range of investments including hedge funds, private equity, venture capital and other non-traditional assets. Real assets, such as infrastructure and commercial property, are also classified as alternatives because they fall outside the category of traditional assets.

Alternatives are generally uncorrelated with traditional assets, meaning that the price movements of alternatives do not follow the same direction as those of traditional assets like shares and bonds. According to modern portfolio theory (MPT), a diversified portfolio with exposures to different uncorrelated asset classes tends to have lower volatility and can generate more consistent returns over the long term.

The lower volatility may seem illusory. However, reducing the fluctuation in a portfolio's value can provide comfort to investors who may have otherwise reacted irrationally to frequent portfolio movements such as those occasionally experienced in listed markets. The lower volatility smoothens portfolio returns, and the compounded rate of return is uninterrupted by significant price movements.

When used appropriately, alternatives can enhance the overall risk-return profile of portfolios and help investors stay the course during turbulent market conditions. In a world full of uncertainty, it is important to remember the words of renowned investor Howard Marks: "You can't predict. You can prepare."

The role of alternatives in portfolios

Empirical research has shown that asset allocation accounts for more than 90% of portfolio outcomes. In their influential paper of 1986, 'Determinants of portfolio performance', Gary Brinson, Randolph Hood and Gilbert Beebower have shown that superior diversification improved long-term returns by analysing portfolio performance data from 91 large US pension funds from 1974 to 1983.

These findings complemented Nobel Prize-winning US economist Harry Markowitz's earlier 'Portfolio selection' paper of 1952, which set the groundwork for MPT. Markowitz showed that risk-adjusted returns can be maximised by diversifying across various asset classes. Therefore, alternatives that are uncorrelated to traditional assets can reduce the overall volatility of portfolios and provide genuine diversification for investors.

Diversified portfolios with exposure to alternatives can better withstand market corrections and minimise the risk of portfolio drawdowns, which are the peak-to-trough declines during specific periods for a portfolio. This helps preserve the invested capital invested over the long term.

The MPT investment philosophy was widely adopted by university endowment funds (one of the oldest classes of institutional investing, endowments are dedicated sources of funding established by non-profit organisations), including at Yale. The late David Swensen, as Yale's chief investment officer, managed its endowment fund from 1985 to 2021, and during this time diversified the fund away from public markets to alternatives.

Yale's endowment achieved an annualised return of 10.3% p.a. over the past 20 years (as of 30 June 2024), outperforming the median 20-year return for university endowments by approximately 3.0% p.a.

More recently, US university endowments including Yale and Harvard have been reducing exposure to private equity, in an effort to increase liquidity and free up cash to help manage proposed future taxes on university income as well as changes to federal funding for US universities.

Although, private equity has helped endowments like Yale achieve strong risk-adjusted returns over the long term, managing liquidity is essential for the prudent management of capital. Therefore, investors with strict liquidity requirements can consider adding exposure to more liquid alternatives relative to private equity and other illiquid assets.

Types of alternative investments

With such a broad range of alternative investments available, it is important for investors to know the key differences between alternative strategies and the respective risk-reward profiles associated with each one. This section explains the different types of alternatives such as hedge funds, private equity and venture capital and real assets.

1. Hedge funds

A hedge fund is a pool of investments that is actively managed using non-traditional strategies, such as lever-

age, derivatives, and long and short positions. Hedge funds are typically uncorrelated to traditional asset classes because they can take both long and short positions in different types of assets.

In other words, hedge funds can benefit from both rising market prices (through long positions) as well as during market downturns (through short positions). Having a market-neutral strategy using long and short positions can reduce a portfolio's overall volatility and market price sensitivities from indices like the S&P/ASX200 or S&P500.

Careful research and due diligence must be done before investing in hedge funds because some funds have been known to lock up capital due to illiquidity events, and some large hedge funds have even collapsed. When evaluating a hedge fund, investors should assess the fund's long-term track-record (net of fees), its investment selection process and ability to generate consistent returns above relevant benchmarks.

Investors should also consider a hedge fund's fee structure, given that fees can be expensive especially compared with traditional managed funds. Higher fees can be justified when performance objectives are met or exceeded, but it is still important to know how fee structures impact net returns.

2. Private equity and venture capital

As the name suggests, private equity (PE) funds generally invest in private companies that are not listed on public exchanges. Private equity has become a sought-after asset class as investors seek higher returns than those provided by cash and bonds, with lower volatility than listed shares. According to McKinsey, in 2019 the total assets under management (AUM) of private equity funds grew 12.2% to USD \$3.9 trillion.

PE funds raise capital from investors which is then invested into private companies to accelerate their growth, improve operational efficiencies and achieve higher company valuations. PE funds then exit these companies by either floating them on public exchanges or selling them to other companies in order to generate returns for their investors.

The competition between private equity funds has intensified in recent years, and the number of private equity firms has more than doubled over the past decade. Private equity firms are competing fiercely to access the best sources of deal-flow and research to generate attractive returns for their investors.

Due to the vast number of private equity funds and limited supply of high-quality deal-flow, the net returns of private equity funds have become widely dispersed, which is why private equity manager selection plays such a critical role in achieving superior portfolio returns.

Venture capital (VC) is a subset of private equity and involves investing in early-stage companies. These early-stage companies are expected to grow exponentially and are typically from industries such as information technology and life sciences. VC investing usually occurs af-



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The quote

Outside of infrastructure and property, natural resources such as renewables and water entitlements provide investors with diversification and economic benefits.

ter a company's initial seed funding round, when founders raise capital from family, friends and angel investors.

Specialist skills are required when assessing whether to back a particular early-stage company, as well as the ability to negotiate favourable terms such as liquidation preferences. Investing with an experienced VC fund gives investors access to such skills and offers exposure to a diversified portfolio of carefully selected companies.

When selecting VC funds, investors should assess the long-term track record of successful exits, experience of the VC fund's team, access to talented founders and ability to add value to early-stage companies such as offering strategic advice and valuable contacts from the fund manager's network.

3. Real assets

Real assets refer to physical assets that have their intrinsic worth based on the substance and utility of the underlying asset. For example, real assets include infrastructure, property and agriculture.

Real assets such as direct commercial property and infrastructure have previously provided investors with steady, predictable income streams as well as capital appreciation from growing populations. However, as an outcome of COVID-19, commercial property faces structural challenges because employees are opting for a hybrid model that involves working from home and the office. In the short term, this has led to higher office vacancies and reduced rental income. It is uncertain at this stage as to how this will play out in the long term.

For diversification benefits, investors can consider investing in unlisted property trusts rather than purchasing physical commercial property directly. This eliminates the concentration risk of being overly exposed to a single illiquid asset, and an unlisted fund can offer exposure to several properties in different regions.

Direct infrastructure such as road networks, airports, rail and ports can offer investors attractive yields and capital appreciation. When considering direct infrastructure, investors should consider investments that offer predictable cash-flows through economic cycles. For example, some infrastructure funds invest in broadcast towers, cable and wireless networks and data centres which benefit from the increase in demand for online services.

Recent interest rate cuts by central banks can present tailwinds and potential valuation upside for real assets such as direct property and infrastructure. This is because the lowering of interest rates reduces 'discount rates', which generally leads to higher net present values when using 'discounted cash flow' analysis, a methodology commonly used to calculate valuations of real assets.

In increasing numbers, investors are also seeking impact investments that are designed to deliver financial returns as well as social and environmental benefits. These impact investments are in (but not limited to) social infrastructure, sustainable agriculture and clean energy storage.

Outside of infrastructure and property, natural re-

sources such as gold, water entitlements, and select agricultural assets can provide investors with diversification and economic benefits. For example, over the past few years gold has proven to be a strong performing commodity and safe haven during times of geopolitical risk and uncertainty.

This paper does not cover other alternative assets such as art, collectables, and digital assets such as cryptocurrencies. These other alternatives have the potential to provide attractive returns and diversification benefits. However, they each bring their own set of risks and should be clearly understood before investing in them. For these reasons, investors should consider engaging specialist advisers to help research, understand and explain different alternative strategies and their risks and benefits.

Constructing portfolios with alternatives

One of the main challenges investors face when evaluating alternative investments is determining which alternatives to include in portfolios and in what proportions. This section discusses how alternatives can be used in portfolio construction with regard to risk management and what effective investment criteria look like for selecting the right alternative managers.

1. Managing key risks

Investors with different risk tolerances, investment timeframes and liquidity requirements should hold different allocations of alternative investments according to these preferences. Considering key risks such as market risk, sequencing risk and concentration risk will help investors determine which alternative investments are suitable for them and in what proportions.

Markowitz's MPT framework includes mean-variance analysis, which is a quantitative framework for constructing a portfolio, such that the expected return is maximised for a given level of risk, measured by the portfolio's standard deviation. The standard deviation is used to quantify risk and measures the variance or volatility of a portfolio's value movement.

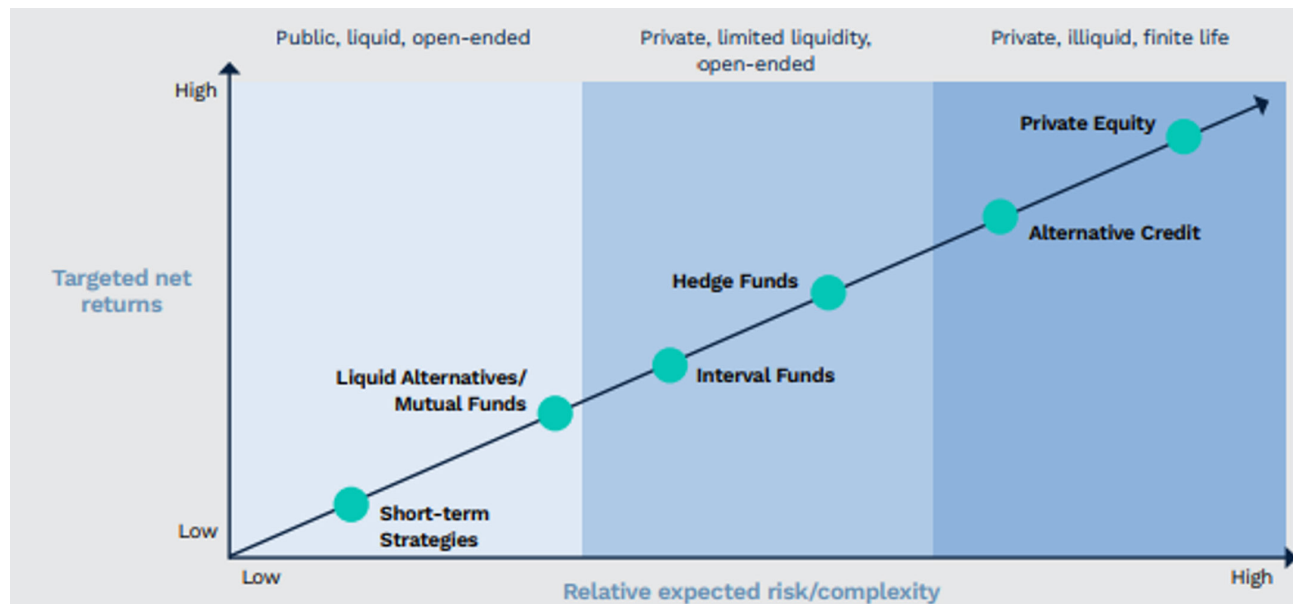
Through a process known as risk budgeting, investors can manage market risk by determining a suitable range of standard deviation that portfolios can tolerate. Investors can also identify the risk versus return profiles of different types of alternatives and select which types match their risk profile. For example, Figure 1 shows the risk versus return profiles of different types of alternatives investors can consider for portfolios.

Sequencing risk

Sequencing risk is the danger that the timing of withdrawals from a portfolio will damage the investor's overall return. For example, withdrawing capital during a market correction will be detrimental to investors if they are forced to sell-down assets at significantly lower prices.

If investors require immediate access to capital, they

Figure 1. Risk versus return profiles of alternative assets



Source: PIMCO Market Intelligence, 'What are alternative investments?', 2019

Table 1. Historic correlation matrix (5 years)

	Aus Equities (ASX300)	Aus. Listed Property	Int. Equities (DM)	Int. Equities (EM)	Infrastructure	Agriculture	Gold	Private Equity	Private Debt	Int. Bonds	Aus. Bonds	Cash
Aus Equities (ASX300)	1.00	0.75	0.60	0.68	0.49	0.28	-0.31	0.38	-0.04	-0.11	-0.17	-0.10
Aus. Listed Property	0.75	1.00	0.53	0.44	0.45	0.20	-0.22	0.32	0.12	0.14	0.10	-0.11
Int. Equities (DM)	0.60	0.53	1.00	0.63	0.32	0.07	-0.18	0.60	0.24	0.18	0.05	-0.19
Int. Equities (EM)	0.68	0.44	0.63	1.00	0.39	0.31	-0.12	0.42	0.05	-0.15	-0.16	-0.04
Infrastructure	0.49	0.45	0.32	0.39	1.00	0.14	-0.24	0.21	-0.05	-0.01	-0.09	-0.10
Agriculture	0.28	0.20	0.07	0.31	0.14	1.00	-0.12	0.06	0.10	0.02	-0.10	0.38
Gold	-0.31	-0.22	-0.18	-0.12	-0.24	-0.12	1.00	-0.11	0.16	0.32	0.41	0.11
Private Equity	0.38	0.32	0.60	0.42	0.21	0.06	-0.11	1.00	0.14	-0.11	-0.04	-0.11
Private Debt	-0.04	0.12	0.24	0.05	-0.05	0.10	0.16	0.14	1.00	0.28	0.43	0.08
Int. Bonds	-0.11	0.14	-0.18	-0.15	-0.01	0.02	0.32	-0.11	0.28	1.00	0.82	0.34
Aus. Bonds	-0.17	0.10	-0.05	-0.16	-0.09	-0.10	0.41	-0.04	0.43	0.82	1.00	0.30
Cash	-0.10	-0.11	-0.19	-0.04	-0.10	0.38	0.11	-0.11	0.08	0.34	0.30	1.00

Source: Koda Investment Strategy Group Research, June 2025

should have lower allocations to illiquid alternatives or maintain sufficient liquidity in other parts of their portfolio. Investors should select alternatives that match their liquidity requirements by examining the redemption windows (that is, how frequently can they take out money from the fund) and the specific terms in relation to lockup and suspension policies of alternatives before adding them to portfolios.

Concentration risk

Concentration risk refers to the possibility of being overly exposed in a single investment or asset class. If a concentrated investment or asset class drops significantly in value, it will cause meaningful damage to a portfolio's overall value. To manage concentration risk, investors should determine the investment parameters of being exposed to a single holding or asset class and also be aware of the correlations between different investments and asset classes.

The role of correlation

Correlation refers to the degree of dependency between two variables (such as two investment strategies) and is measured by the correlation coefficient, which has a range of -1.00 to +1.00. A correlation coefficient greater than zero indicates a positive relationship between two variables, a value of less than zero indicates a negative relationship, and a value of zero indicates no relationship.

Having negative or low correlations between different investments and asset classes is the key to achieving good portfolio diversification. The correlation matrix in Table 1 shows the correlations between 11 different asset classes. It indicates that the correlations between alternatives and the other asset classes are relatively low. Therefore, having exposure to alternatives provides less volatility across a given portfolio.

2. Alternative manager selection

The decision to diversify into alternative assets will not in itself necessarily improve results, but it can increase the probability of achieving an investor's return objective. The underlying alternative investment manager still has to have the skill required to find mispricing and other attractive investment opportunities, and the investors and their advisers should have the means to pick superior managers.

Some of the factors considered for selecting alternative managers are outlined in the following discussion.

Investment process

Assessing the alternative manager's quality of research, idea generation, portfolio management and implementation are essential. Managers should be required to demonstrate conviction that their ideas can be applied with consistent discipline throughout the investment cycle.

Risk management

Managing risk is at the core of the investment process, and an expectation regarding investment manager selection. It is important to assess a manager's risk management systems and controls in relation to operational, governance and market risks using quantitative and qualitative methods.

Performance

It is crucial to differentiate luck from skill and select managers that consistently outperform their benchmarks net of fees. Performance attribution needs to be reviewed regularly to determine if past success was based on skill or simply being in the right place at the right time.

Fee structure

Fees charged by alternative managers can sometimes be high relative to other investments due to a manager's specialist skills. Active fund managers should be incentivised to perform above their benchmarks, however, investors should not have to pay excessive fees for average or underperformance.

Capacity constraint

It is preferable to invest with managers with limited capacity in their funds. This helps ensure that managers remain focused and disciplined when managing invested capital, in order to capture mispricings and market inefficiencies and ultimately to generate alpha. High-performing alternative strategies are often capacity constrained and available to institutional investors only. At Koda, we have built long-term relationships with institutional-grade managers, and provide access to these specialist alternative strategies for our clients.

Alignment of interests

Portfolio managers should have a meaningful portion of their personal wealth invested in their own funds which demonstrates conviction in their own ideas and processes. Having 'skin in the game' helps align the interests of managers with those of clients.

There are other important factors for consideration in the due diligence process that are not covered in this paper. For example, impact investing and environmental, social and governance (ESG) factors can be applied portfolio construction, according to different client preferences.

Conclusion

Alternatives offer investors the opportunity to minimise portfolio volatility and correlations with traditional asset classes. This helps protect the invested capital and lower downside risk during unforeseen market events.

When used appropriately, alternatives enhance the overall risk-return profile of portfolios and help investors stay the course during turbulent market conditions. As a result, diversified portfolios with exposure to alternatives can better withstand market corrections and minimise the risk of significant drawdowns. Further, this approach allows clients to remain substantially invested throughout market cycles while increasing the ability to generate strong risk-adjusted returns that support their objectives.

Managing key risks, such as those mentioned in this paper, is essential for protecting long-term capital. Diversifying into alternative assets will not in itself improve results, which is why it is important for investors and their advisers to have research capability and

access to select alternative managers that have demonstrated strong track-records over the long term and consistently delivered superior returns relative to their peers and benchmarks.

Engaging specialist advisers can help determine the suitability of incorporating alternatives into existing portfolios, as each investor's objectives and risk profiles are unique. **FS**

Notes

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