REFRAMING THE ROLE OF ALTERNATIVES

Focus on investing for outcomes

IN RESEARCH

FS INVESTMENTS®

FOREWORD

Investing today looks nothing like it did four years ago in the heart of a bull market, let alone what it looked like forty years ago for our grandparents and parents. In today's market, investors are considering how to maintain the level of returns they have enjoyed over the past decade and how, in these uncertain times, they can achieve their goals.

Looking ahead, the need for greater diversification, higher income, lower volatility and less correlated returns is leading many investors to seek new investment strategies and alternative sources of income and growth. The challenge, however, is that there are countless investment strategies, structures and managers, and no easy way for investors to get their heads around it all. The marketplace is moving beyond the days of picking individual securities, mutual funds and ETFs to construct a traditional 60/40 portfolio.

Now more than ever, advisors and investors are looking to the growing category of strategies and investments known as "alternatives" to achieve their goals. This survey, produced in partnership with *InvestmentNews* Research, aims to identify trends and thought patterns regarding alternative investments. As you read the pages that follow, you'll see a common thread emerge: there's a pressing need for education on why and how alternatives should become an integral part of investors' portfolios.

Here is what we learned:

- While investors appear to be clear on their objectives, they remain unaware of how alternatives can help as complements to their more traditional portfolio investments.
- Investors are open to using alternatives to achieve their financial goals: more than half expressed interest in hearing how nontraditional investments could help them.
- Despite their interest in alternatives, fewer than half of investors have ever discussed alternatives with their financial advisors.
- This communication gap may stem from a lack of quality educational resources available to advisors, as fewer than a quarter expressed feeling "very knowledgeable and informed" when discussing alternatives with their clients.

At FS Investments, we're doing our part to help educate financial advisors and their clients on the fundamentals of alternative strategies, structures and innovations through resources tailored to different levels of sophistication. We hope this research report proves helpful and invite you to explore and share our materials and welcome your engagement. While no one can predict what the world of investing will look like forty – or even four – years from now, staying informed can help advisors and their clients improve their conversations and build better portfolios.

MICHAEL FORMAN
Chairman and CEO
FS Investments

Introduction

A historic equity bull market. Persistently low interest rates. More frequent spikes in volatility. These are just some of the challenges investors face today in finding reasonable long-term returns and sources of predictable, stable income. Advisors and their clients are eagerly searching for ways to navigate these uncertain times, especially as many investors are planning for, approaching or in retirement in the coming years.

Alternative investments may help investors achieve their financial goals, yet there remain impediments to broader advisor and client adoption. As this white paper will discuss, some of these hurdles are well understood and may be addressed through enhanced education, while others are likely due to misperceptions and false assumptions that both advisors and clients have about one another's views on alternatives.

This white paper draws on a study conducted in partnership by FS Investments and *InvestmentNews* Research. Building upon the findings of an advisor-focused survey by *InvestmentNews* in 2016, this study compiles the perspective of both advisors and investors. The twin surveys examine advisor and investor goals, their attitudes toward alternatives, the perceived benefits and drawbacks of alternatives, and insights on ways to enhance advisor-client conversations around using alternatives to construct diversified portfolios that meet their financial goals.

Key takeaways:

- Investors have clear goals for their portfolios related to loss prevention and risk mitigation. Advisors know that these needs can be met using alternatives, but conversations between advisors and clients about the portfolio application of alternatives are not taking place.

- Investors are open to new and unfamiliar asset classes such as alternatives despite potential concerns around fees and liquidity, especially when framed in the context of their financial objectives. Conversations between advisors and investors should focus on "why alternatives" and proper portfolio applications.

- The largest impediment to more productive client conversations about alternatives is likely a knowledge gap. Advisors themselves need more education on alternatives and believe their clients do as well.

- Advisors seeking education on alternatives should turn to broker-dealers, home offices, custodians and, perhaps most importantly, the creators and managers of alternative investments themselves.

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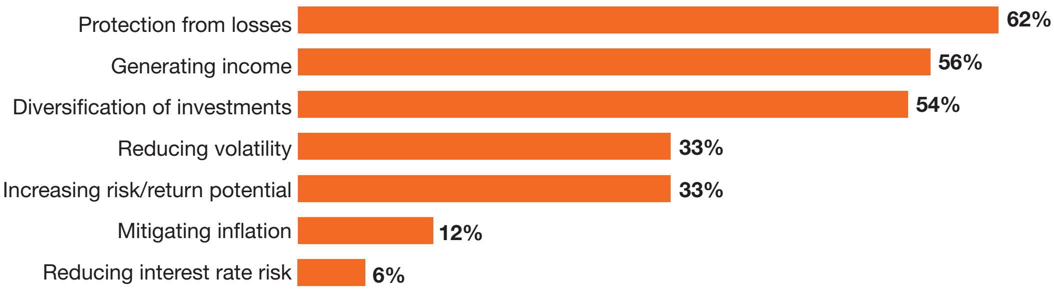
Investors clear on objectives, but unaware of how alternatives can help

If fear and profit are the classic drivers of investor behavior, it seems that the pendulum has swung toward the former. When asked what their advisors should focus on over the next five years, investors often chose issues relating to loss prevention and risk mitigation such as "protection from losses," "reducing volatility" and "diversification".

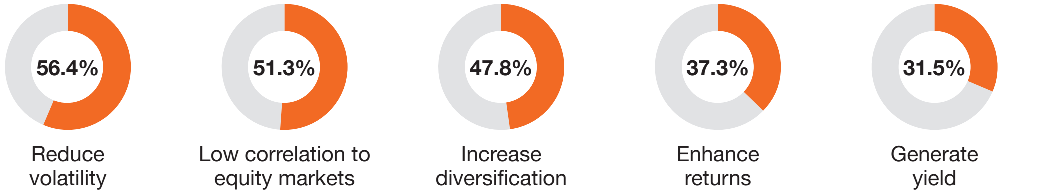
No doubt these conservative goals reflect investors' concerns about the future. Is the equity bull market running out of steam? Where can I turn for stable and reliable levels of income? These are questions advisors likely hear from their clients on a daily basis. While investors speak in terms of real-world goals – saving for college, planning for retirement or purchasing a home – advisors play a critical role in connecting personal goals to financial goals for their clients.

Investor survey: Over the next five years, what are the top three areas that your advisor should focus on to help you achieve your goals?

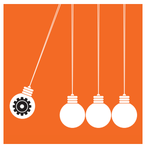


The survey results show that advisors are well aware that alternative investments – in the broad sense – can help accomplish many of these investor needs and desired outcomes. In fact, when asked what outcome would motivate an increase in their target allocation to alternatives, advisors put volatility reduction at the top of the list, followed by low correlation to equity markets, greater diversification, enhanced returns and generating yield. Despite this understanding, only 44% of investors report that their advisors have discussed alternatives with them.

Advisor survey: Which of the following investment objectives would most likely motivate an increase in your target allocation to alternatives?



So, if advisors understand how alternatives can help connect clients' personal goals with their financial goals, why are advisors not engaging in more meaningful conversations about alternatives with their clients?



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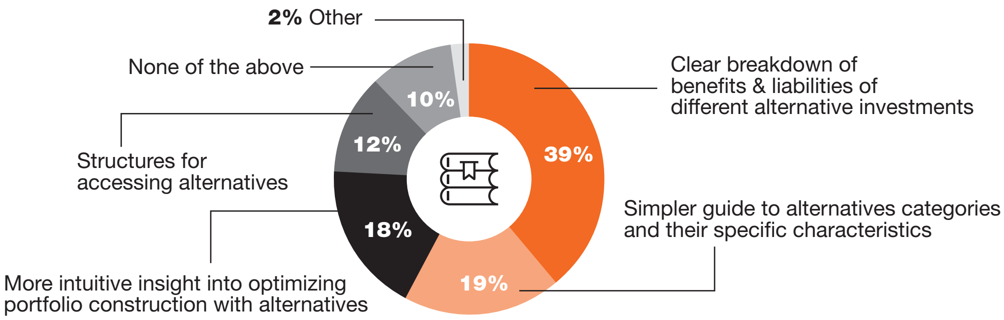
The knowledge gap

Considering that 8 in 10 advisors believe their clients are interested in alternatives, the fact that more than half of advisors have not spoken to clients about alternatives is puzzling. Especially when 91% of investors cited at least some interest in alternatives. Are advisors worried the conversations will be dominated by investors expressing misgivings — such as higher fees, lower liquidity and apprehension about investing in new, unfamiliar asset classes? Or do advisors feel they need a better understanding of how to use alternatives in a portfolio to adequately explain the benefits to clients?

Survey results show that investors are open to conversations about alternatives, even given some of the potential objections listed above, if the perceived "drawback" is tied to a potential benefit (e.g., investors may need to give up some liquidity, but the investment offers a higher relative degree of income). If commonly reported impediments such as fees and liquidity can be overcome when paired with the benefit, it appears, then, that the largest impediment to more productive client conversations on alternatives is due to a knowledge gap. In fact, more than one-quarter of advisors (27%) stated that their clients' lack of understanding about alternatives is a significant hurdle. Approximately 33% of advisors themselves expressed a need for more education on alternatives.

Advisor survey: Which of the following educational topics is most relevant for you to become more familiar with alternatives?



The volume and depth of education on alternatives published over the last decade has come a long way. What we have found, however, is there is a good deal of literature focused on the "what"– what the underlying strategies are, the size of the markets, industry players, etc. Education on the "what" – is indeed helpful, as 33% of advisors said that they would welcome education generally on alternatives. But from an advisor-client conversation perspective, more time needs to be spent addressing the "why" and the "how." As in, why should investors incorporate alternatives in their portfolios and how can they thoughtfully build portfolios with alternatives to complement existing exposures?

In fact, 57% of advisors said they would like a clearer understanding of how to build portfolios with alternatives, including an understanding of the benefits and key risks. Between advisors' desire to educate themselves and their clients' perceptions of alternatives, there is a need for clear and approachable messaging on the "why" — why alternatives, why the time is right for increased adoption, and why they should be an integral part of investors' portfolios. Shifting the focus to the value of alternative investments for the overall portfolio can help reframe investors' perceptions of alternatives.

57%

of advisors are looking for education that focuses on portfolio construction, including a clear breakdown of the benefits and liabilities of alternatives and insight into constructing a portfolio with alternatives.

Start with the benefits to the portfolio

Since the last *InvestmentNews* Research study was conducted in 2016, advisor priorities regarding their expectations for alternative investments have remained the same. At that time, the primary drivers of alternatives usage were desires for increased diversification (expressed by 66% of advisors in the 2016 survey) and reduced volatility (63%). Additional benefits advisors were seeking included enhanced returns (45%), greater yields (34%), reduced interest rate risk (20%) and inflation protection (10%).

These portfolio applications should dominate the advisor-client conversations. When considering an allocation to traditional investments, advisors align both individual investments and overall portfolio construction to investor objectives. Advisors can apply the same approach to alternatives by taking inventory of investor goals and mapping them to the appropriate alternative asset class and structure.

This deficiency in portfolio application knowledge may explain the large divide between awareness of alternative asset classes and investment in alternatives. For instance, many investors have heard of private equity and private debt (57% and 30%, respectively), but only a small percentage have invested in each – just 14% in private equity and 7% in private debt. Today, more and more firms are bringing products to market that give individuals access to these once institutional-only assets. As discussed above and explored further below, increased adoption comes down to the need for quality education and better conversations about the role of alternatives in a portfolio.

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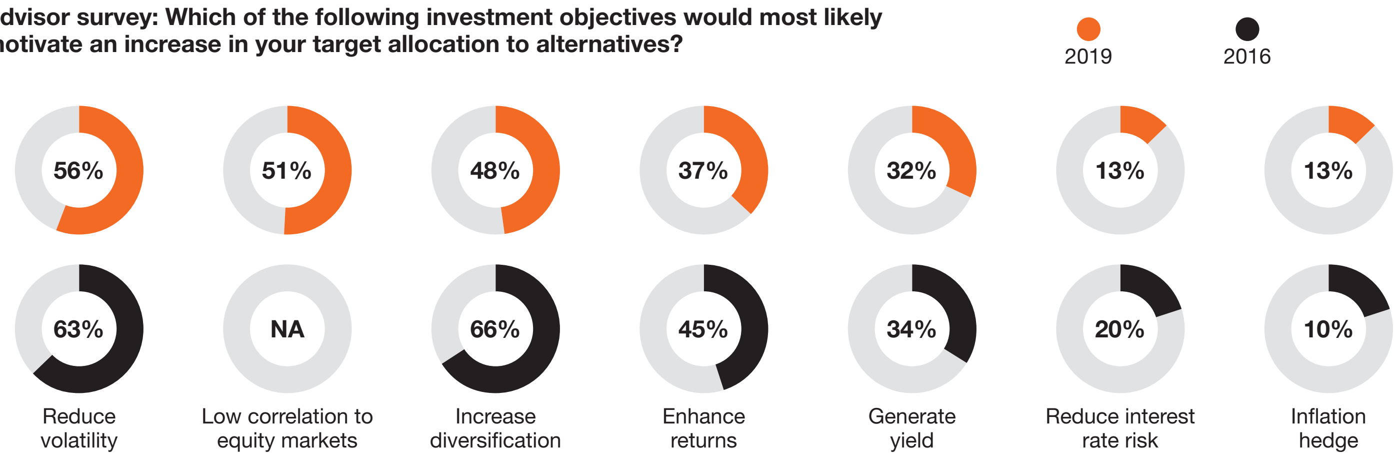
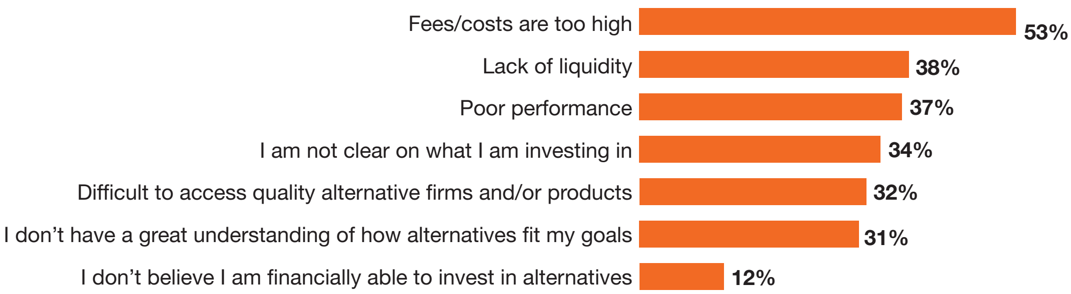


Advisor survey: Top characteristics of a "true" alternative investment

Reframing advisor-client conversations

Alternative assets and strategies are inherently different than traditional investments – which enables them to produce results that align particularly well with investor objectives of low correlation, income, growth potential and stability. In fact, many investors acknowledged that the benefits alternatives can provide to a portfolio outweigh some of their main concerns.

Investor survey: Which of the following concerns might prevent you from investing in alternatives?



Putting fees in context

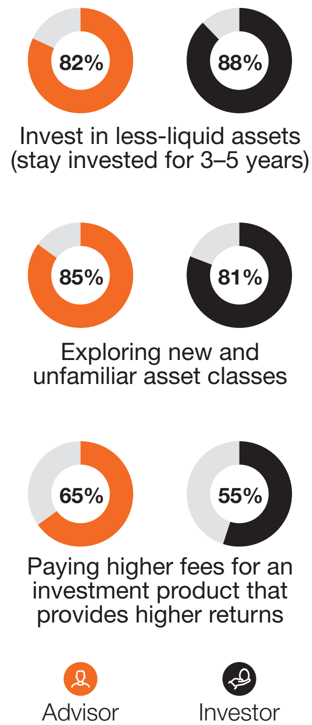
Almost 45% of advisors say the expense/return tradeoff is a top consideration when they evaluate an alternative investment for clients. For investors, higher fees were the number one concern when considering allocating more to alternative investments. However, over half of surveyed investors (55%) said they would be at least somewhat likely to pay higher fees in order to grow assets consistently and avoid volatility. Fees may be a big mental barrier for many investors to cross, but the issue is not insurmountable.

Just as in client conversations surrounding the role of alternatives in portfolios, educating investors about the fees associated with these investments may help dispel concerns. There is a cost associated with the expertise needed to access these strategies and asset classes. Yes, some of the expense goes to manager incentives, but that also means investors have benefited from strong performance as well. Other fees, such as those for asset acquisition and storage, underwriting, valuation and banking, all factor into the higher costs.

Additionally, it is important to educate investors on the various fee structures within the alternative investment asset class. When asked which investments they personally considered to be alternatives, the leading response among advisors was private equity, mentioned by 56% of advisors, followed by non-traded REITs (52%), venture capital (52%), private debt (49%) and hedge fund strategies (49%) — investments typically associated with higher fees than most traditional assets.

It is important for investors to understand that fees have a spectrum — some liquid alternatives cost no more than traditional mutual funds. Bringing these factors to light may go a long way in building client comfort with the fees associated with these strategies.

In order for your investments to grow consistently and avoid volatility, would you be likely to consider any of the following?

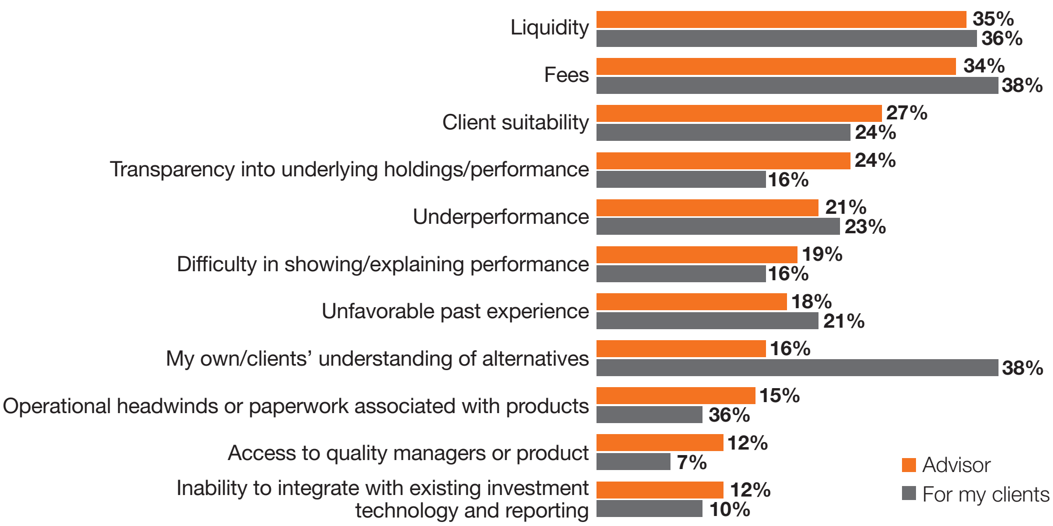


Accounting for liquidity

As with perceptions around fees, advisors may view their clients' reservations around limited liquidity as a barrier to alternatives adoption. However, 88% of surveyed investors said that they would be willing to invest in less-liquid asset classes to grow assets consistently and avoid volatility. The paradox is that while 35% of advisors and 36% of their clients say lack of liquidity impedes their investing in alternatives, illiquidity often permits the compelling return profiles that many alternatives can offer.

What is important to remember is that this question is not always one of full liquidity versus full illiquidity. As products have evolved to meet investor needs, liquidity profiles have evolved as well. Many alternative investment products lie on a spectrum somewhere between fully liquid and fully illiquid. These investments are more liquid, more accessible and often carry the added benefit of lower fees.

What are the key impediments to advisors allocating more to alternatives?



Key to further investor adoption of alternatives is an advisor's ability to better explain how liquidity affects the performance characteristics of alternative investments, especially those with low correlation to equities, and how liquidity needs should shape portfolio construction.

Advisors and investors alike should be mindful that in portfolios earmarked for retirement and other purposes with longer time frames, forgoing some measure of liquidity may be a worthwhile tradeoff for attractive levels of income and growth in a designated portion of a portfolio. Greater understanding of the role of liquidity in investing and learning to view portfolio diversification through a liquidity lens would go a long way toward encouraging greater use of alternatives as well as contributing to greater investor satisfaction with alternative investments and the advisors who recommend them.

Advisors and investors alike should be mindful that in portfolios earmarked for retirement and other purposes with longer time frames, forgoing some measure of short-term liquidity may be a worthwhile trade-off for attractive levels of income and growth in a designated portion of a portfolio.

Where to turn for information

The time is right to reframe the role alternatives can play in individual investor portfolios. Advisors are looking to increase their clients' allocations to alternatives from 5% to 10% over the next three years and the number of products used from four to six. But how can they ensure they are sifting through all the information and helping their investors make informed decisions?

More education is part of the solution. The typical advisor sees multiple benefits from learning more about alternatives, including the ability to offer clients a broader menu of products (60%) and a greater opportunity to meet client goals (53%). But fewer than one-fourth of advisors (22%) feel very knowledgeable and informed when discussing alternatives with clients.

When asked what factors would help them better utilize alternatives in client portfolios, the number one response by advisors was the availability of investment research data on products. Specifically, they requested a clear breakdown of the benefits and liabilities of different alternative investments, a simpler guide to alternatives categories and their specific characteristics, and more intuitive insight into optimizing portfolio construction with alternatives.

To help provide the information, solutions and guidance that advisors need to help their clients with alternatives, support must come from broker-dealers, home offices, custodians and, perhaps most importantly, the creators and managers of alternative investments themselves. The responsibility of alternatives providers extends far beyond product creation and management. Only by continuously educating advisors and investors alike will these alternative managers fully deliver on these products.

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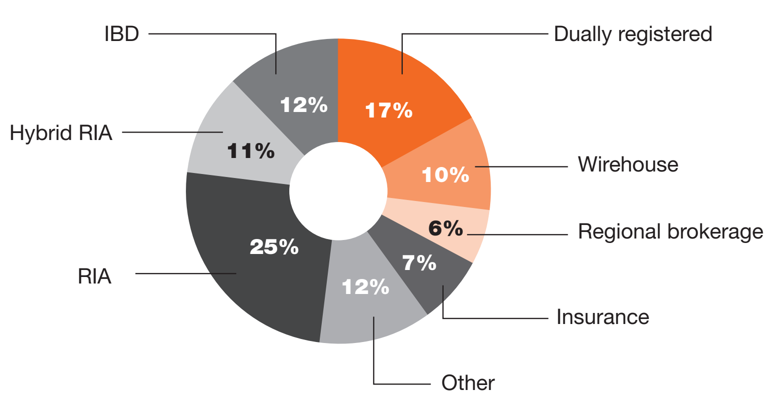
About the survey

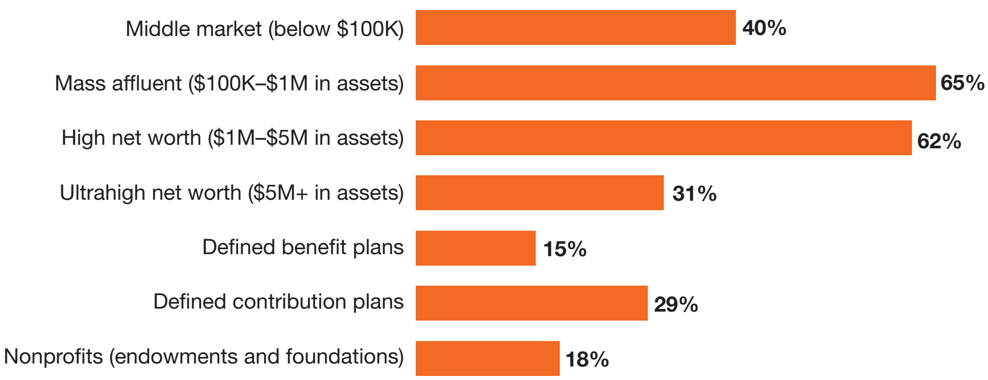
Underpinning this research, *InvestmentNews* conducted a survey of investors from Aug. 14, 2019–Sept. 6, 2019; a survey of advisors was conducted from Aug. 22, 2019–Sept. 9, 2019. The online surveys were distributed via Qualtrics to a 100,000+ advisor contact list and a 300,000+ investor contact list. For their participation, advisors were offered a complimentary copy of the study and investors were eligible to enter a drawing for a chance to win one of five $50 Amazon gift cards.

The resulting data was collected, checked and analyzed by the *InvestmentNews* Research team. In total, 864 individual investors and 342 advisors participated in the survey. Reflecting the *InvestmentNews* audience, independent advisors comprise a majority of the sample. The findings of this survey may be accepted as accurate at a 95% confidence level, within a sampling tolerance of approximately ±4.9%.

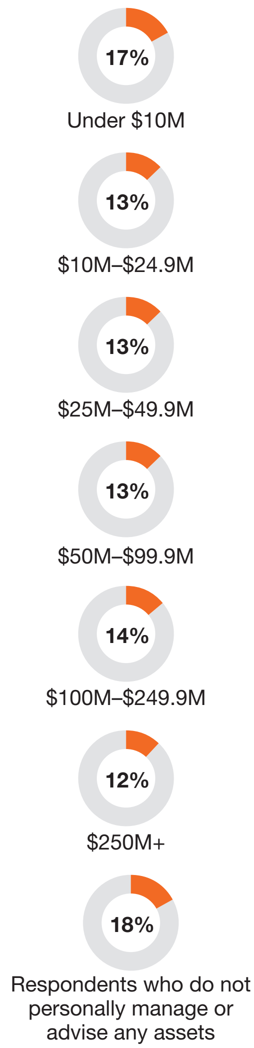
Channel:



Clients served:



Personal AUM:



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Today we manage a growing suite of funds designed for financial advisors, individuals and institutions to achieve a variety of financial goals.

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