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5 Things to Know About Alternatives

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The Global Macro, Balance Sheet & Risk team recently published *An Alternative Perspective: Past, Present, and Future* detailing where we continue to see compelling investment opportunities across the global private markets landscape. From its modest beginnings as an investment strategy, the broad Alternatives industry is now expected to grow to more than $24 trillion in assets in 2028 from $15 trillion in 2022, while still representing less than 2.4% of total global financial assets. Importantly, Alternatives comprise multiple asset classes, each with unique characteristics in terms of expected return, risk, yield, liquidity, and capital requirements. As we discussed in the *Global Wealth Investment Playbook*, some asset classes may serve more of a growth and capital appreciation purpose, while others may protect portfolios against inflation and/or provide stable income. Some may offer a combination. Today, in addition to pensions and endowments, more individuals are able to access these private market investment opportunities via innovative fund structures as well as traditional drawdown funds. We offer some key takeaways for wealth managers and individual investors below.

1

The need for private capital to support economic growth is outsized. Government budgets are stretched thin by rising debt, aging populations, and pressing priorities such as defense, leaving a vast funding gap for critical, long-term needs. For example, $3.7 trillion in annual infrastructure investment will be required to support global GDP growth demands through 2035, which is far beyond the public capacity of most countries (*Exhibit 1*). As a result, private capital increasingly must be mobilized across multiple industries to provide both financial and operating resources to complete these high-impact projects.

Exhibit 1: $3.7 Trillion Per Year of Investment in Economic Infrastructure Is Needed Through 2035 to Keep Pace With Expected GDP Growth

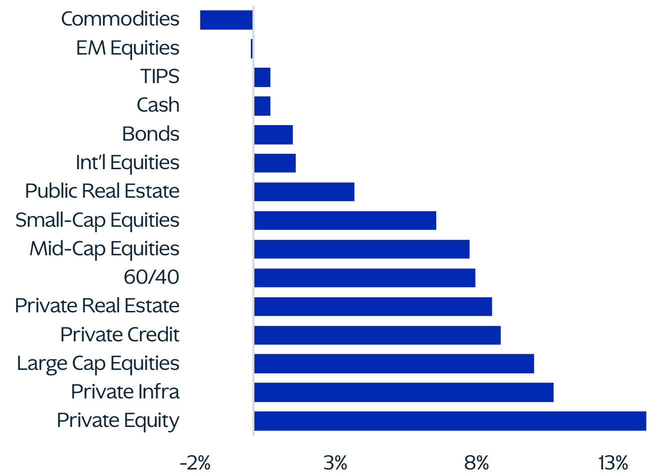
Global Average Infrastructure Need, % of GDP and US$ Trillions		
	% of Global GDP per Annum	US$ Trillions Spend in Aggregate, 2017-2035
Roads	1.0%	18.0
Rail	0.4%	7.9
Ports	0.1%	1.6
Airports	0.1%	2.1
Power	1.3%	20.2
Water	0.5%	9.1
Telecom	0.6%	10.4
Total	4.1%	69.4

Data as at December 31, 2017. Source: IHS Global Insight, ITF, GWI, National Statistics, McKinsey Global Institute analysis.

Long-term savers may increasingly rely on the private market illiquidity premium amid growing retirement insecurity.

Exhibit 2: Strong Performance From Both Public and Especially Private Asset Classes Will Be Needed to Narrow the Growing Savings Gap

Last 10 Years Net Return by Asset Class, Thru 3Q23, %



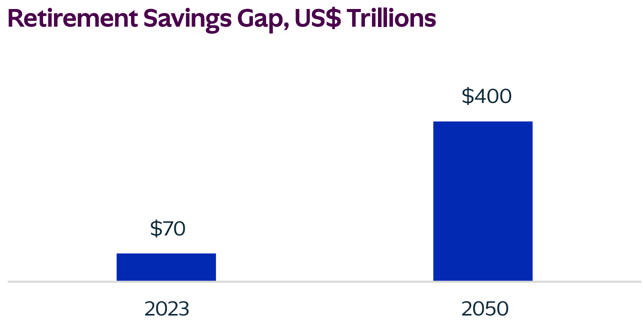
Note: Analysis using EEM, VNQ, MDY, SPSM, SPY, EFA, TIP, AGG, DJP, BIL, SPW, CDLI, Cambridge Associates Private Equity, Real Estate, and Infrastructure. Private Equity, Private Real Estate, and Private Infrastructure are Net Returns to LPs. Private Credit is a gross unlevered return. 60 /40 represented by 60% SPY and 40% AGG. Data as at 3Q23. Source: Cambridge Associates, Bloomberg.

2

Long-term savers may increasingly rely on the private market illiquidity premium amid growing retirement insecurity. Thoughtful asset selection, operational improvement, and timing of entry and exit has resulted in a premium return for private market investments versus public market indices (*Exhibit 2*). As many countries are reporting savings shortages for their retirees, we believe the need for the excess return that the illiquidity premium can provide will likely go up, not down. Moreover, low birth rates, stagnant working-age populations, and increasing life expectancies have put pressure on global pensions and personal savings, a backdrop that increases fears about retirement insecurity for many savers. Consistent with this view, a recent World Economic Forum analysis suggests that the current global retirement savings gap is US$70 trillion; more importantly, it is expected to increase to

US$400 trillion by 2050 *(Exhibit 3)*. The U.S. represents fully 40% of the total gap, implying a $28 trillion savings shortfall.

Exhibit 3: The Global Retirement Savings Gap Is Expected to Reach $400 Trillion by 2050

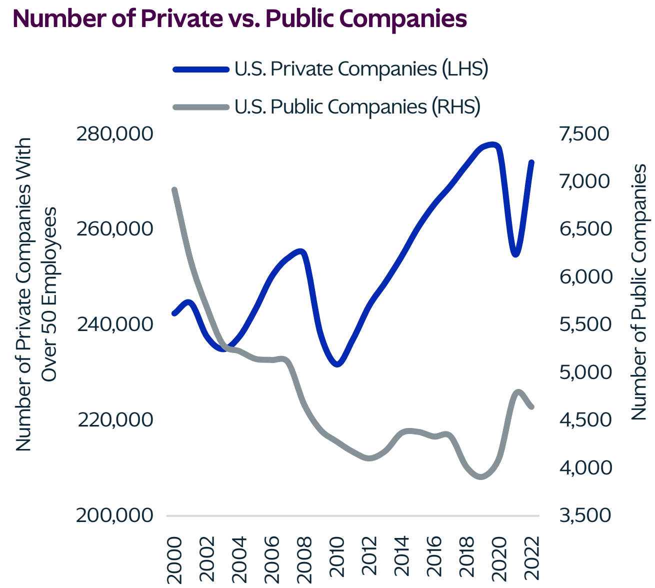


Data as at December 31, 2023. Source: The World Economic Forum.

3

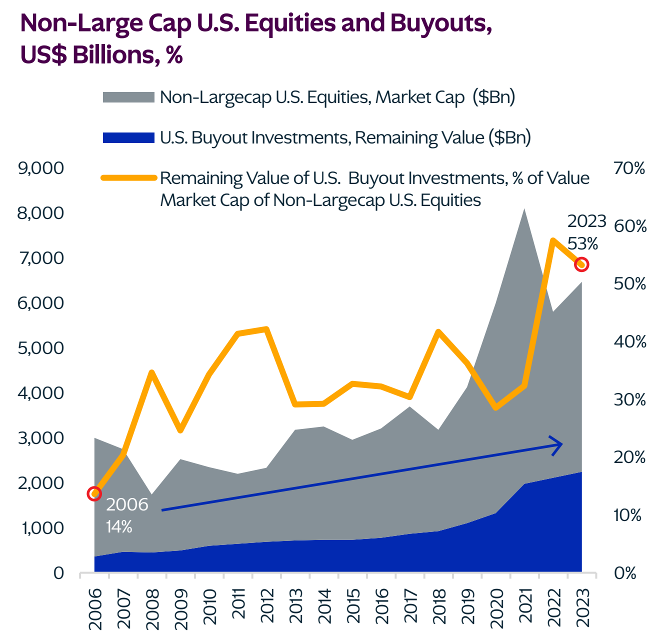
The opportunity set in Private Alternatives is much larger and growing, while the public investment universe is shrinking. The number of firms listed on public exchanges has shrunk by about 30% over the past 40 years. When the dot.com bubble burst in 2000, it coincided with the peak in companies wanting to go public. We estimate that over 95% of the companies in the U.S. are held privately. Indeed, there are nearly 270,000 private companies with over 50 employees vs. less than 5,000 public counterparts *(Exhibit 4)*. Importantly, though, only a few PE investments are sourced on a public-to-private basis each year. In fact, we calculate that just 13% of Buyout dollars invested in 2023 were actually take-private transactions, with most investments sourced from private ownership.

Exhibit 4: Market Share of Small Companies Has Increasingly Migrated Out of Public Markets



Data as at December 31, 2022. Source: U.S Bureau of Labor Statistics, World Bank, Haver Analytics.

Exhibit 5: Private Equity's Share of the Total Addressable Universe Has Steadily Increased



Non-Large cap = Total U.S. market cap ex Russell 1000. Data as at December 31, 2023. Source: Bloomberg, Federal Reserve, Pitchbook.

4

A disciplined approach to portfolio construction is critical to building robust, diversified portfolios. Given the growing interest in Alternatives, our discussions with clients increasingly revolve around how to blend private and public strategies under the same framework. To this end, we believe that understanding the benefits offered by each asset class – both quantitatively and qualitatively – will lead to a more refined portfolio construction approach. Most strategies do have sensitivities to multiple factors. *Exhibit 6* shows a qualitative assessment informed by quantitative measurements of private sub-asset classes' ability to deliver return, income, inflation hedge, volatility dampening and diversification benefits. Our analysis suggests that Asset-Based Finance strategies are some of the best diversifiers relative to traditional asset classes. Meanwhile, strategies such as Infrastructure, Real Estate and Asset-Based Finance provide a reasonable hedge against inflation. For investors who want to add more exposure to long-term growth to their portfolios, strategies with the ability to compound capital via higher cash flow generation/growth should be prioritized, including Private Equity. Finally, Infrastructure is an example of an asset class that can deliver growth, yield, and/or diversification in many instances.

Exhibit 6: We Believe That Attribute Analysis Is Key to Having a Holistic View of a Diversified Portfolio

Contribution Analysis

	Generic Asset Class Attributes				
	Return	Income Yield	Inflation Hedge	Reduced Volatility	Diversification vs. 60 /40
Public Equity					
Public Fixed Income (2/3 Govt Bonds)					
Private Equity					
Direct Lending					
Asset-Based Finance					
Diversified Infrastructure					
Diversified Real Estate					

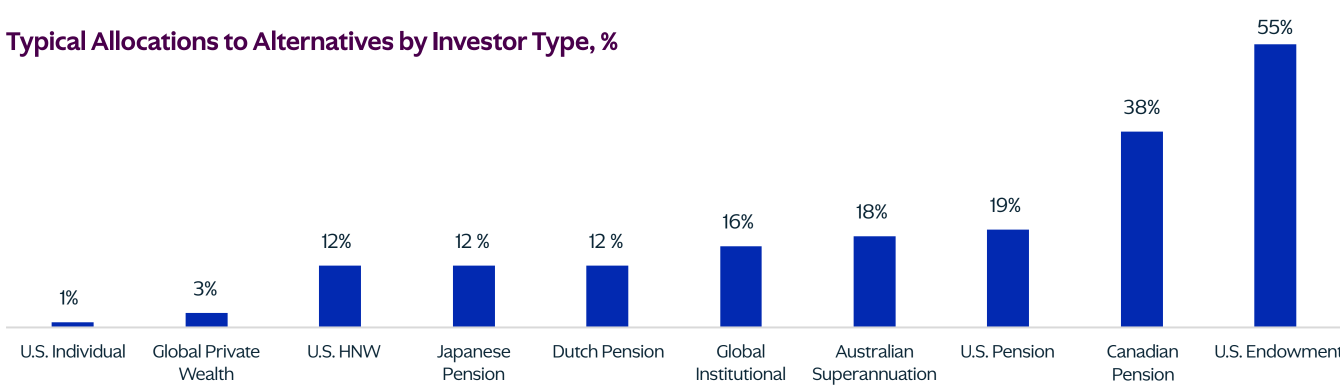
Note: Darker green signifies more attractive attribute. Return refers to historical returns. Income Yield refers to the long run expected cash yield. Asset inflation hedge characteristic is based on exposure to inflation surprise, calculated as the sum of the coefficients in a multi-linear regression with GDP surprise and inflation surprise up to two quarterly lags. Inflation surprise defined as difference between true value and prediction made a year before. Analysis using data as at September 30, 2024, based on quarterly YoY return data after desmoothing from the following: Buyout: Cambridge U.S. Buyout from 1986Q2 to 2023Q3 - Growth: Cambridge U.S. Growth from 1988Q2 to 2023Q3 - Infra: Burgiss U.S. Infra from 2000Q3 to 2023Q3 - Real Estate: Cambridge U.S. RE from 1986Q4 to 2023Q3 - Venture Capital : Cambridge VC from 1986Q2 to 2023Q3 - Credit: Cambridge U.S. Senior Debt from 1996Q1 to 2023Q3 : Real Estate Credit: Giliberto-Levy 1 from 1991Q3 to 2023Q3. Factor data from Bloomberg. Desmoothing model based on Geltner D. (1993a) Estimating market values from appraised values without assuming an efficient market. Reduced Volatility refers to the volatility of the returns, which have been desmoothed based on Geltner D. (1993a). Diversification vs 60 / 40 refers to the correlation with a 60% public equity and 40% Global Agg portfolio. Return and Volatility figures calculated using annual data from 2005-2023. Correlations are calculated using quarterly data from 2020 to 3Q 2024, or until available. Public Equity refers to the S&P 500, Public Fixed Income refers to the Bloomberg Global Agg, Private Equity refers to the Cambridge Index, Direct Lending refers to the Cliffwater Direct Lending Index (except for Inflation Hedge which refers to the Cambridge Index), Asset Based Finance is based on KKR's experience investing in and analyzing the asset class, Diversified Infrastructure refers to a 50% weighting of the Cambridge Core & Core Plus Infrastructure Index and a 50% weighting to the Cambridge Value Added Infrastructure Index, Diversified Real Estate refers to a 50% weighting to the Cambridge Real Estate Index and a 50% weighting to the Giliberto Levy Commercial Mortgage Index. Color shading based on KKR's current and expected assessment of underlying quantitative figures. Source: Bloomberg, Cambridge, Cliffwater, Giliberto-Levy, KKR GBR analysis.

5

Our 'New Regime' calls for enhancing portfolio diversification via different sources of return and risk. We believe we are in a new macroeconomic regime defined by elevated inflation volatility and higher rates, which are upheld by long-term secular shifts including a greater fiscal impulse, increased geopolitical tensions, a messy energy transition, aging demographics, and massive investment in AI. Higher inflation as well as increased inflation volatility often propel increased correlations between stocks and bonds, which has significant implications for most traditional portfolios. In particular, the historical belief that government bonds can act as `shock absorbers' when Equities, or other risk assets, go down in value is being challenged in today's changing macroeconomic environment. As a result, we believe that a more holistic and 'distributed' approach to diversification, including the use of more Alternatives in certain situations, may be warranted. Institutional investors have historically leaned into Private Alternatives to reap the benefits of diversification and the illiquidity premium. With the invention of evergreen vehicles, we expect the individual investors to increase their allocation to Alternatives as such products have become more accessible via lower minimums, more transparency, and increased liquidity.

That said, there is no one size fits all approach to Private Markets investing, as goals vary by age, sources of income, and life circumstances. To this end, we developed proprietary models integrating 30% of a traditional 60/40 portfolio into Private Alternatives to achieve three primary investor objectives: to boost return, preserve capital, and/or generate income (*Exhibit 8*). The KKR Wealth `Boost Return' portfolio is designed for investors with the goal of achieving the maximum risk-adjusted return. This is where Private Equity really plays its role. The `Preserve Capital' model emphasizes asset classes that tend to exhibit low volatility, shallow drawdowns, and reliable inflation hedging like Private Infrastructure and Private Credit. The `Generate Income' investor reallocates from the Public Equity tranche to more yield-oriented Alternative asset classes. Importantly, all three model portfolios outperform the 60/40 across different macro regimes (*Exhibit 9*).

Exhibit 7: Private Alternatives Tend to Represent Between 16-55% of Institutional-Type Client Allocations, But High Net Worth Investors Are Catching Up



Data as at December 31, 2023. Source: KKR GBR analysis.

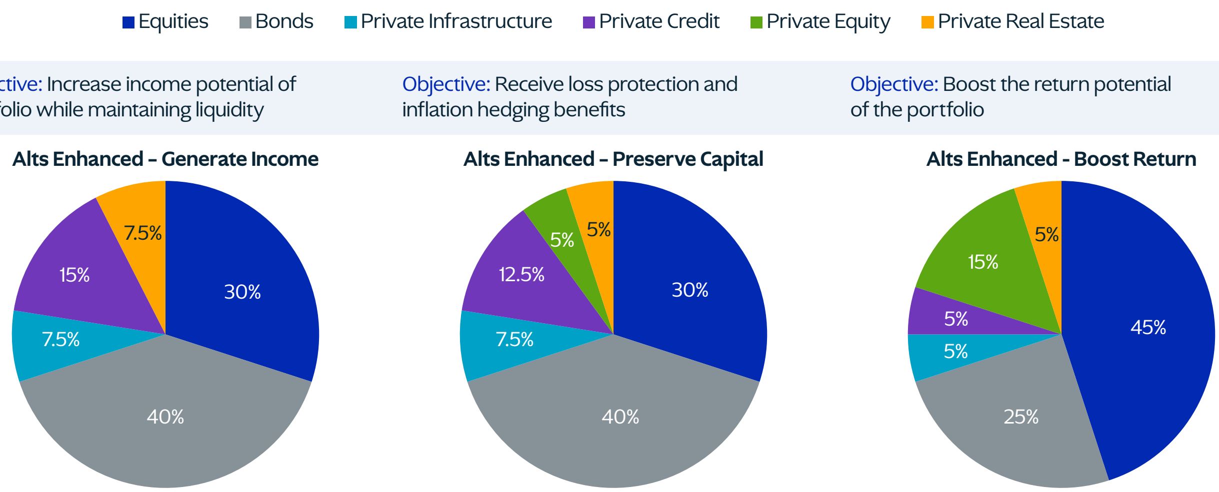
Exhibit 8: Alternative Asset Classes Have Historically Helped Investors Generate Income, Preserve Capital, and/or Boost Returns in Many Instances

KKR Alts Enhanced Framework For Wealth

Objective: Increase income potential of portfolio while maintaining liquidity

Objective: Receive loss protection and inflation hedging benefits

Objective: Boost the return potential of the portfolio



Historical Performance vs 60 / 40:

· Income +1.6% · Liquidity ▼

· Volatility -2.4% · Liquidity ▼

· Return +1.1% · Liquidity ▼

Data as at September 30. 2024. Source: Cambridge, Bloomberg, KKR GBR analysis. No specific KKR products referenced. See important notes at end on methodology.

Exhibit 9: Reducing Liquid Allocations to 70% and Adding 30% to Alternatives Outperforms the 60/40 Model In All Macroeconomic Environments

All Periods by Portfolio	Return	Volatility	Return per Unit of Risk	△ vs. 60/40	% Liquid Asset	Cash Yield
Alts Enhanced - Generate Income	8.7%	10.8%	0.81	0.14	70%	5.7%
Alts Enhanced - Preserve Capital	9.0%	11.1%	0.81	0.14	70%	5.4%
Alts Enhanced - Boost Return	10.2%	14.0%	0.73	0.06	70%	3.9%
60 / 40	9.1%	13.5%	0.67		100%	4.1%
High Inflation						
Alts Enhanced - Generate Income	9.7%	10.8%	0.90	0.19	70%	6.4%
Alts Enhanced - Preserve Capital	10.2%	11.1%	0.92	0.20	70%	6.0%
Alts Enhanced - Boost Return	11.9%	13.6%	0.87	0.15	70%	4.4%
60 / 40	9.5%	13.2%	0.72		100%	4.9%
Low Inflation						
Alts Enhanced - Generate Income	7.7%	10.4%	0.75	0.16	70%	4.5%
Alts Enhanced - Preserve Capital	7.9%	10.7%	0.74	0.15	70%	4.1%
Alts Enhanced - Boost Return	8.8%	14.7%	0.60	0.01	70%	3.0%
60 / 40	8.2%	14.0%	0.59		100%	2.6%

Data as at September 30, 2024. Source: Cambridge Associates, Green Street, Bloomberg, NCREIF, KKR GBR analysis. See important notes at end on methodology.

Notes

Important notes for *Exhibit 8* on methodology: Optimization and historical analysis performed using the S&P 500 for Public Equities, the Bloomberg Global Aggregate for Fixed Income, the Cambridge Associates Benchmark for Private Equity, the Cliffwater Direct Lending Index for Private Credit, the Cambridge Associate Global Infrastructure Benchmark for Private Infrastructure, and the Cambridge Associates Real Estate Index for Private Real Estate. Income modeled for Public Equity using S&P 500 12M gross dividend yield, Private Equity proxied using S&P Small Cap 12M gross dividend yield, Private Infrastructure proxied using S&P Infrastructure 12M gross dividend yield from 2006 onwards and 1990-2006 back filled using S&P Utilities, Public Fixed income based on Bloomberg US Agg yield to worst, Private Credit using Cliffwater Direct Lending Index Income Return, Private Real Estate based on Green Street All-sector Equal-weighted cap rate.

Important notes for *Exhibit 9* on methodology. Note: High Inflation is defined as annual CPI > 2.5% and Low Inflation is defined as annual CPI < 2.5%. Portfolio returns and volatility modeled using annual total returns from 1971 to 2022 for the S&P 500, from 1997 to 2022 for Private Real Estate, from 2004 to 2022 for Private Infrastructure, from 1974 to 2022 for Bonds, from 1997 to 2022 for Private Equity, and from 2005 to 2022 for Private Credit. Assumes continuous rebalancing of the portfolios. U.S. Equities modeled using the S&P 500 Index. Bonds modeled using the Bloomberg US Agg. Private Real Estate modeled using the Cambridge Associates Real Estate Index. Private Infrastructure modeled using the Cambridge Associates Infrastructure Index. Private Equity modeled using the Cambridge Associates Private Equity Index. Private Credit modeled using the Cliffwater Direct Lending Index. Cash yields modeled using annual data from 1970 to 2022 for Public Equity, from 1976 to 2022 for Bonds, 2000 to 2022 for Private Real Estate, 1990 to 2022 for Private Infrastructure, 1994 to 2022 for Private Equities, and 2005 to 2022 for Private Credit. Public Equities using S&P 500 12M gross dividend yield, Private Equity proxied using S&P Small Cap 12M gross dividend yield, Private Infrastructure proxied using S&P Infrastructure 12M gross dividend yield from 2006 onwards and 1990-2006 back filled using S&P Utilities, Public Fixed income based on Bloomberg US Agg yield to worst, Private Credit using Cliffwater Direct Lending Index Income Return, Private Real Estate based on Green Street All-sector Equal-weighted cap rate.

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