2022 Alternative Investments Outlook

OPPENHEIMER ASSET MANAGEMENT

Manager Skill, Diversification to Drive Alpha

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When looking outside the style box for broader portfolio diversification, we believe it pays to set your sights on lower correlation. Asset classes and skilled managers that don't move in lockstep with stocks and bonds should continue to deliver alpha in 2022, as heightened volatility and a series of macro risks pose stiff challenges for traditional 60/40 portfolios—60% stocks and 40% bonds. Amid a backdrop of wider dispersion between winners and losers—due to rising inflation, Fed tightening and lingering Covid-19 concerns—security selection should play an even larger role in generating strong risk-adjusted returns for investors this year. Specifically, long/short managers with a blend of factors are well-positioned to take advantage of dispersion and alpha-generating opportunities those market conditions present.

At the start of 2021, vaccination programs were in full swing, fiscal and monetary stimulus continued to flood global financial systems and reopening plans allowed consumers to resume normal activities. The year was soon focused on short squeezes, speculative Reddit stocks, new Covid-19 variants and supply-chain shocks that ultimately led to a disparity between value and growth stocks. Managers with outsized factor exposure had to navigate new challenges on both the long and short side, resulting in continued uncertainty heading into 2022. Still, the S&P 500 (up 29%) and Nasdaq (up 22%) posted double-digit returns in 2021.

However, in this robust rally, the top 10 stocks disproportionately drove performance, indicating that the historical safety and diversification benefits associated with passive index performance continues to be skewed. Indeed, the top 10 stocks in the Morningstar US Large-Mid TR Index, predominantly FAANG and other mega-cap companies, contributed 20% of overall returns through November 2021.

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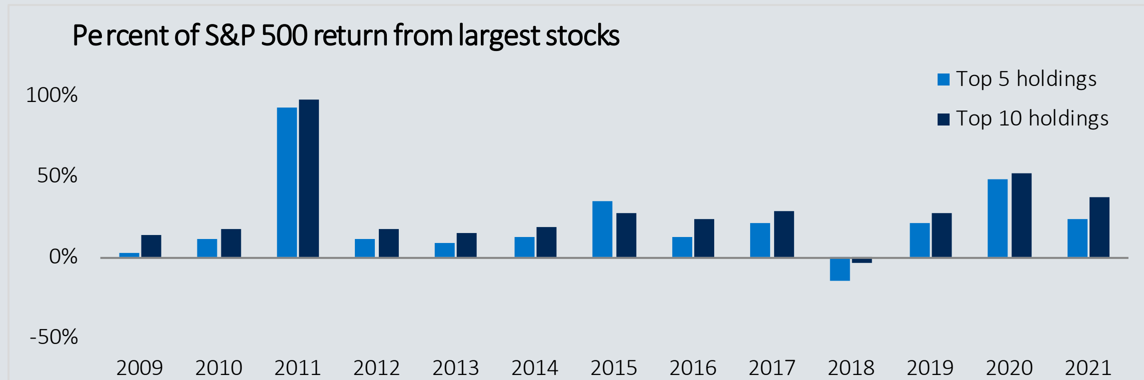
Top Heavy

The top 10 large-cap stocks, predominantly the FAANG companies—Facebook, Amazon, Apple, Netflix and Google—contributed 20% of overall returns in 2021.



Source: Bloomberg. Morningstar Direct. Data is based on S&P 500 Total Return Index. Data as of Dec. 31, 2021.

Although economists predict slower growth in 2022, citing supply-chain disruption, Fed tapering, new Covid variants and a more hawkish central bank, we anticipate that fundamentals for high-quality companies will remain intact. And active management will be critical in producing stable performance in the event of another correction.

> *"Stock selection will likely be key during this period of dispersion between high- and low-quality stocks…"*

Looking ahead, risks have evolved since early 2021 but the case for portfolio diversification and active management has only grown stronger. Our objective remains the same: Invest with balanced, differentiated managers that are able to protect capital on the downside as we brace for moderate volatility, while locating long-term winners that can drive performance. Stock selection will likely be key during this period of dispersion between high- and low-quality stocks, whereby the winners and losers in a post-Covid economy will exhibit considerable room for alpha generation in 2022.

Poised to Outperform

In 2021, uncorrelated strategies came out on top as the best-performing strategies in the face of market volatility. We believe this trend will continue in 2022, with event-driven, multi-manager and private strategies remaining highly attractive. Additionally, we believe that the role of long/short equity strategies in a portfolio remains intact—providing diversification and downside

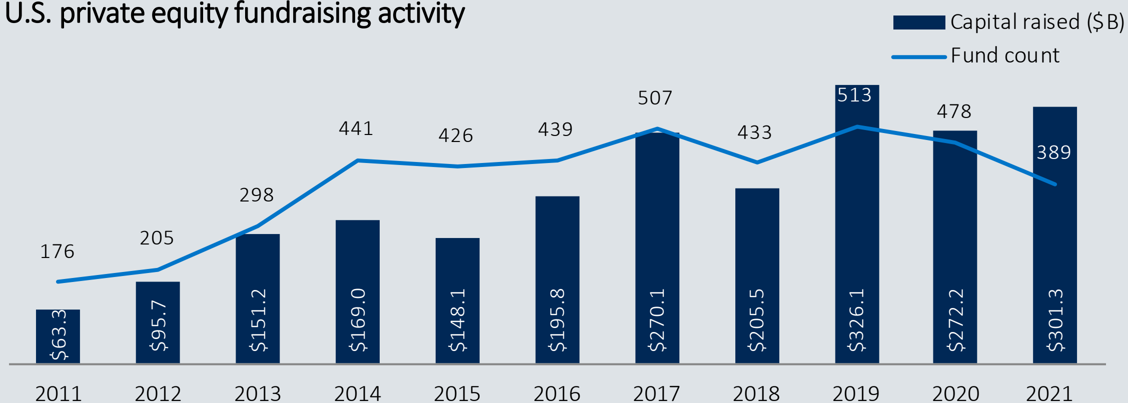
protection. At a time when traditional 60/40 returns have been lackluster, particularly within fixed income, we advocate for an allocation to diversifying strategies that provide clients with a more attractive risk-adjusted return in the face of macroeconomic and market volatility.

> *"...long/short equity managers that have blended exposure to factors and sectors can strengthen a diversified portfolio."*

We continue to believe long/short equity managers that have blended exposure to factors (growth, growth at a reasonable price (GARP) and value) and sectors can strengthen a diversified portfolio. Long/short equity managers are able to use leverage—represented by gross exposure—and short equity positions to profit from a decline in equities. The difference in performance between top performers and bottom performers in the market generates a diversifying return, one driven more by stock selection than overall market direction, allowing long/short equity managers to protect capital on the downside while also capturing gains during the rebound. At times, technical pressures and short-term data may take precedence over fundamentals, causing long/short equity strategies to be challenged. However, we expect that, in time, fundamentals will be rewarded.

Private Equity Push

Historically high investment levels and stiff competition for top funds are fueling sizeable surges in private capital fundraising.



Source: PitchBook | Geography: United States. Data as of Dec. 31, 2021.

Meanwhile, private markets continue to be a source of diversification, lower price volatility and relative outperformance by top-quartile managers in exchange for illiquidity and exit risk. Through the end of the third quarter, private equity capital raised remains at elevated levels, signaling continued strength and demand for investments across the liquidity spectrum. As both institutional and retail inflows increase and innovation continues to propel the asset class further, we believe private opportunities will provide an attractive avenue for diversification alongside public equities in a portfolio.

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Similarly, diversifying strategies such as event-driven and multi-strategy have shown to be less correlated to equity and fixed-income markets and provide sufficient portfolio diversification. Event-driven funds are able to accomplish this by focusing on specific fundamentals or company catalysts to capitalize on merger arbitrage deal spreads. Multi-manager strategies have also exceled in their ability to pivot exposure by sub-strategy or style depending on medium-term trends of what is in or out of favor. Looking ahead, these strategies, albeit with more risk than traditional investments, may continue to outperform during prolonged periods of higher volatility, like what we’ve seen in early 2022.

Scouting for Skilled Managers

In 2021, OAM Alternatives conducted nearly 600 manager meetings in an effort to identify unique and attractive strategies for our platform. Each fund added to the platform is assessed alongside our current lineup and how a diversified portfolio would benefit from adding them. Our process allows our offerings to be complementary in nature and seeks to fill the gaps in a portfolio’s risk and return expectations.

We continue to actively seek strategies across the liquidity spectrum that are able to profit on innovation, long- term secular trends and differentiated viewpoints. In 2022, we are actively seeking to add additional investment opportunities in health care and ESG, areas offering thematic exposure and company-specific access.

"ESG, particularly sustainability and renewable energy, has become a much more accessible portfolio option in both public and private markets."

In recent years, environmental, social and governance (ESG)[1] investments, particularly sustainability and renewable energy, have become a much more accessible portfolio option in both public and private markets. The sector has been at the forefront of legislation in the United States and Europe throughout 2021, as the developed world is increasingly focused on curbing climate change with specific goals for limiting fossil fuels and reaching net-zero carbon emission goals by 2050. In November 2021, the Congress passed a $1 trillion infrastructure bill for investing in the nation's aging infrastructure, which includes funding for sustainable initiatives. Separately, the Build Back Better bill, while it faces strong political headwinds, remains with legislators and could lead to the highest-ever public funding for U.S. climate initiatives.

In addition to public support, private investment flows have spread significantly into ESG, with assets up to $1.82 trillion in 2021. Despite these developments, renewable and sustainability goals are still years away from completion, as sustainable energy generation is modest compared to total energy generation. In fact, during 2021, the EIA forecasts solar power to account for 4% of U.S. electricity generation. Analysts predict that solar generation will make up 20% in 2050, or five times today's penetration. We continue to believe that an ESG-focused allocation—through liquid or non-liquid strategies—will be attractive over time due to its expansive opportunity set.

With an unforeseen pandemic, health-care strategies have drawn increased interest and demand. In just over a year and a half the medical community developed and approved various immunizations and treatments for Covid-19 in record-breaking time, while also making advancements in other areas of research and development. This rollout proved crucial for global recovery and reveals the alpha-generating capabilities of investments in therapeutics, medical devices, health-care services, technology and pharmaceutical subsectors. We believe an aging population, fragmentation and technological advancements serve as a greater signal for the larger opportunity set that exists within the sector. Currently, several of our long/short equity

[1] Environmental, social and governance (ESG) criteria are a set of standards for a company's operations that socially conscious investors may use to evaluate potential investments. Generally speaking, and the specifics differ depending upon the strategy and/or fund, environmental criteria consider how a company interacts with and takes care of the environment. Social criteria examine how it manages relationships with its employees, suppliers, customers, and the communities where it operates. Governance deals with a company's leadership, executive pay, internal controls, and shareholder rights.

and event-driven managers have selective exposure within health care. We believe exposure to this opportunity can be achieved with managers who invest across sectors. We continue to conduct research on the public and private investments for a dedicated health-care offering. However, we expect to avoid higher valuations seen in areas such as biotechnology.

In our view, co-investments and private market investments provide a pathway to direct exposure to unique companies benefiting from fundamental and macro tailwinds. Deal flow and follow-on funding rounds remain attractive, offering multiple ways for a private company to seek exit—acquisition, IPO, SPAC or strategic sale. In the past, OAM has offered clients opportunities across a broad spectrum of themes such as technology, industrials, electric-vehicle charging, consumer, travel and storage. We expect to continue offering access to select high-quality co-investment opportunities.

Further, we seek to avoid certain strategies on the platform, including funds that are heavily reliant on positive market environments, asset classes that remain out of favor, funds that use excessive leverage and managers that do not demonstrate the ability to manage risk effectively. We seek to find managers that rely on their deep relationship networks, employ deal-structuring skills, explore untapped areas of the market with reasonable valuations, and exhibit a strong history of managing risk throughout market cycles.

Anusha Rodriguez is a managing director, head of alternative investments and head of research and due diligence at Oppenheimer Asset Management. Prior to joining Oppenheimer, she was a vice president at Citi Private Bank focused on relative value and multi-strategy managers, as well as external fund of funds. Previously, Anusha was a director at Morgan Stanley focused on various alternative strategies.

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