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ASSET MANAGEMENT

Portfolio construction and the practical applications of alternative investments

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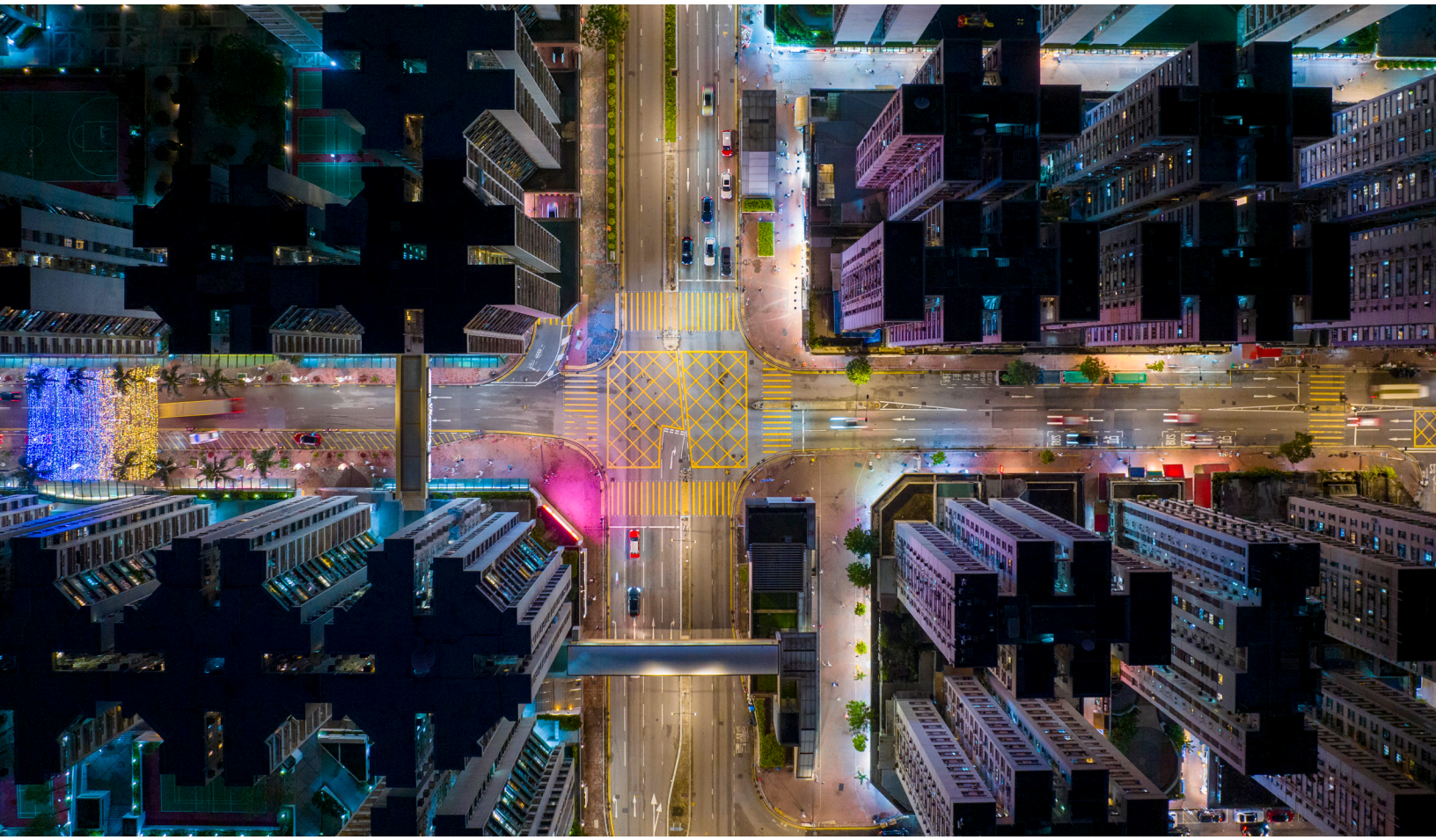

In this module of CIBC Global Asset Management's Alternatives Academy, Jon Erlichman is joined by three senior investment professionals to discuss how alternative investments can be used in portfolio construction. The conversation focuses on practical implementation, including asset allocation, diversification, due diligence, manager selection, client communication, liquidity, rebalancing, and ongoing monitoring.

Panelists:

- **Philip Colussi**, Head of Portfolio Consulting, CIBC Global Asset Management
- **Michael Sager**, Managing Director and Chief Investment Officer, Multi-Asset and Currency Management, CIBC Global Asset Management
- **Michael Keaveney**, Portfolio Manager, Total Investment Solutions, CIBC Global Asset Management

Portfolio construction: starting with client objectives

Q: Why is portfolio construction so important to investor outcomes?

Sager: Portfolio construction is fundamental because it begins with understanding what the client is trying to achieve. That includes whether the goal is capital accumulation or income generation, the client's time horizon, and the risks they are most sensitive to. Once those pieces are understood, advisors can build a portfolio that is aligned with the investor's specific needs. Every investor is different, so portfolio construction sits at the core of good advice and long-term outcomes.

Q: How should advisors think about introducing alternatives into a traditional portfolio?

Colussi: A practical starting point is the traditional 60/40 portfolio and then assessing how alternatives may complement it. The first questions are: what objective is not being fully met today, how large should the alternatives allocation be, and where should it come from? That allocation could come from equities, fixed income, both, or even from cash. The source matters because it changes the portfolio's overall risk profile. For example, replacing part of fixed income with private credit may increase risk, while funding it from equities may reduce overall portfolio risk.

Q: Why has the traditional 60/40 portfolio come under greater scrutiny?

Keaveney: Periods like 2022 reminded investors that stocks and bonds can decline at the same time. That challenged the longstanding assumption that fixed income will always offset equity weakness. As a result, more investors and advisors have started asking what other tools can diversify portfolios and provide access to opportunities that may not exist in public markets.

Sager: It is also important to remember that portfolio construction is not a one-time exercise. Markets change, client circumstances change, and new investment tools emerge, so portfolios should be reviewed regularly.

Diversification, correlation, and portfolio benefits

Q: What role do alternatives play in diversification?

Colussi: Diversification is the main reason many clients and advisors consider alternatives. The goal is to add investments that have lower correlation to traditional stocks and bonds, and can help improve portfolio resilience, especially in periods when bonds do not provide the diversification investors expect. Increasingly, advisors are using alternatives to replace both fixed income and equity components. Instead of thinking only in terms of a 60/30/10 structure, advisors should consider a broader whole-portfolio approach.

Keaveney: In practice, allocations can vary widely depending on the portfolio type and investor profile. In some portfolio solutions, alternatives may represent only a low single-digit allocation because of regulatory constraints or design parameters. In ultra-high-net-worth portfolios or custom mandates, allocations may be meaningfully larger, sometimes in the 10% to 20% range across private equity, private debt, infrastructure, private real estate, commodities, liquid alternatives, and hedge fund strategies. Each sleeve may be relatively small on its own, but together they can provide meaningful diversification and return enhancement.

Q: What are advisors typically trying to achieve when they add alternatives?

Keaveney: In many cases, the interest begins with the advisor, who is looking for tools that can either reduce overall portfolio risk, expand the opportunity set, or enhance return potential. Private equity, for example, can provide exposure to sectors and businesses that are not available in public markets, while also giving managers the ability to influence outcomes at the company level. Other strategies, such as commodities or multi-asset hedge funds, can introduce exposures and return drivers that public markets alone may not offer.

Sager: The starting point is not to use alternatives for their own sake, but to identify a specific gap in the portfolio and determine whether alternatives can fill it. That gap could be concentrated public equity exposure, a need for stronger income, or the desire to reduce the impact of a positive stock-bond correlation environment. Private markets can sometimes help address those needs in a purposeful way. Asset allocation should be viewed in risk terms: what risks the investor wants exposure to, how much of that risk is appropriate, and how each holding contributes to the overall portfolio.

Building a diversified portfolio with alternatives

Q: What does the portfolio construction process look like when alternatives are being considered?

Colussi: The process often begins with analytics on the existing portfolio. That can include stress tests, forward-looking analysis, back-tested returns, and Monte Carlo simulations to identify blind spots, biases, and unmet needs. Once those gaps are identified (such as an income shortfall or a growth shortfall) the advisor can determine which type of alternative strategy may be the best fit. After that, the portfolio can be re-analyzed to understand how the addition may change expected outcomes under different market conditions. Optimization work can then help determine the right allocation size based on the client's constraints and objectives.

Q: Why is it important to distinguish among different types of alternatives?

Keaveney: Alternatives are not a single uniform category. Private equity, private credit, commodities, hedge funds, liquid alternatives, and real assets all behave differently and serve different roles. Some may resemble public equity more closely, while others have very different risk and return patterns. Building with alternatives therefore requires careful judgment around how much of each strategy to use, what role each one will play, and which vehicle structure is most appropriate—from traditional drawdown funds to evergreen structures to liquid alternatives with more frequent dealing.

Q: How do time horizon, liquidity, and minimums affect implementation?

Keaveney: These are critical practical considerations. Some vehicles may only be available to accredited investors and may carry high minimum investment requirements. Others have broadened access through lower minimums and more flexible structures. Advisors need to consider whether the investment size is workable relative to the client's portfolio, whether the client can tolerate the liquidity profile, and whether the investment vehicle matches the portfolio's intended role. The growing democratization of alternatives has increased the number of options available, making these solutions relevant for a broader set of investors than in the past.

Due diligence and manager selection

Q: Why is due diligence especially important in private markets and alternatives?

Sager: Due diligence is essential in all investing, but it is especially important in private markets because the opportunities are often more complex and less transparent. Advisors and allocators need to understand whether that complexity is likely to be rewarded, whether barriers to entry create a genuine advantage, and whether the manager has the skill, process, and resources to keep exploiting that advantage over time. This requires close examination of the investment process, the team's experience and stability, and the reasons that manager should be expected to succeed where others may not.

Keaveney: Due diligence can be thought of in two broad categories: investment due diligence and operational due diligence. Investment due diligence focuses on the strategy, the investment thesis, and whether the manager is genuinely skilled in their area of specialization. Operational due diligence focuses on whether the firm can reliably execute and safeguard the strategy—such as confirming ownership of assets, understanding controls, and evaluating how the strategy is administered. In alternatives, operational due diligence is especially important because failures often stem from operational weaknesses rather than from the investment thesis itself.

Q: Why does manager selection matter so much in private markets?

Colussi: Performance dispersion across private market managers can be much wider than it is in public equities or public fixed income. That means manager choice can have an even greater impact on outcomes. Selecting the right private equity or private credit manager can significantly improve returns and portfolio quality, while selecting the wrong one can lead to materially weaker performance and greater risk. Ongoing due diligence is also important to ensure that the manager's process remains consistent and that the strategy continues to behave as intended through changing market environments.

Keaveney: Advisors often ask how long the firm has been investing in the asset class, whether the team has managed through multiple market cycles, how deals are originated, and how selective the investment process is. In private equity, advisors also want to understand how the manager improves the businesses they acquire and what resources or operational expertise they bring to those companies. These questions help reveal whether the manager has a repeatable edge and whether their approach is likely to support future results.

Q: Why can it be helpful to partner with a large investment organization in private markets?

Sager: For individual investors and advisors, it can be difficult to conduct sufficiently robust due diligence on private opportunities independently. The breadth of analysis required across investment and operational dimensions often calls for substantial internal resources. Working with a qualified firm that has dedicated teams and a disciplined process can therefore be a meaningful advantage.

Client communication, suitability, and implementation

Q: How should advisors explain alternatives to clients?

Keaveney: A helpful approach is to begin with what alternatives have in common with traditional investments before focusing on the differences. For example, private equity can be explained as ownership in a business, much like public equity, except the business does not trade on a stock exchange. Establishing that common ground can make the discussion more accessible. At the same time, communication needs to be more proactive because private investments do not generate the same steady stream of public information that listed securities do. Advisors therefore need to bridge the information gap by regularly reinforcing why the investment is in the portfolio, what role it is meant to play, and whether it is progressing as expected.

Colussi: Liquidity is one of the most important client considerations. Advisors need to assess whether a client may need access to capital on short notice and ensure that the portfolio's liquidity profile reflects that need. Liquid alternatives have expanded the available toolkit by offering access to certain alternative strategies with more frequent dealing, which can help in some cases. At the same time, limited liquidity should not automatically be viewed as a drawback. In some situations, reduced liquidity can help discourage emotional selling during market stress and support better long-term investment behaviour.

Q: How should advisors address concerns about fees?

Colussi: Alternatives may come with higher fees than traditional public market exposures. However, the more important question is whether the investment improves net-of-fee outcomes. If an alternative strategy helps generate better income, stronger diversification, downside protection, or improved growth potential, then the higher fee may be justified. The discussion should remain focused on whether the client is receiving value after fees, not simply on whether the stated fee is higher.

Q: What misconceptions about alternatives are worth clarifying?

Sager: Access has broadened meaningfully through lower minimums and structures with less restrictive lockups, making alternatives more available than in the past. However, broader access does not remove the need for suitability and purpose. Alternatives should still only be used where they address a real portfolio need.

Keaveney: Two common misconceptions are that lower liquidity is always a flaw and that alternatives are a cure-all. Advisors should explain liquidity clearly and frame it in a way clients can relate to, such as comparing it to familiar assets that do not trade daily. They should also be clear that alternatives are not a panacea. They can be valuable tools, but only when used intentionally and with a full discussion of both risks and opportunities.

Monitoring, rebalancing, and ongoing oversight

Q: How should advisors think about rebalancing when alternatives are part of the portfolio?

Keaveney: Rebalancing becomes more complex when some holdings do not have daily pricing or offer only periodic subscriptions and redemptions. That said, many newer evergreen structures provide more flexibility than older private market formats, and liquid alternatives can also help maintain some rebalancing agility. Advisors may also be able to use incoming cash flows to support rebalancing over time. The key is recognizing that alternatives can require more planning and more attention than listed securities.

Colussi: Alternatives can provide another lever within the portfolio. If a traditional portfolio's major holdings are all moving in the same direction at the same time, there may be fewer opportunities to rebalance effectively. Greater diversification across alternative asset classes can create additional sources of return and risk, which may improve the ability to rebalance under different market conditions.

Q: What operational considerations matter when rebalancing less liquid portfolios?

Sager: Advisors need to allow for enough flexibility around target allocations because less liquid holdings can drift away from strategic weights before they can be rebalanced. Wider allocation bands may be appropriate, with the understanding that the portfolio can be brought back toward target over time when the rebalancing window becomes available.

Final takeaways for advisors and investors

Q: What are the main lessons for advisors and investors considering alternatives?

Sager: Markets and investment opportunities continue to evolve, and investors should continue to expand their diversification toolkit where appropriate. Alternatives can offer meaningful benefits, but they also introduce greater complexity and, in some cases, lower liquidity. Those trade-offs may be worth accepting if they help improve diversification, enhance income, or broaden the opportunity set.

Colussi: Advisors should focus on intentional risk allocation rather than simply allocating capital by dollars alone. The question is not only how much to allocate to alternatives, but whether that allocation is increasing or decreasing total portfolio risk and whether that result is aligned with the client's objectives.

Keaveney: Portfolio construction is ultimately the art, science, and craft of matching investor objectives to the best available tools. Alternatives can play an important role, but they should always be evaluated in the context of the total portfolio. The key question is not what a single holding does in isolation, but whether it improves the portfolio as a whole.



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