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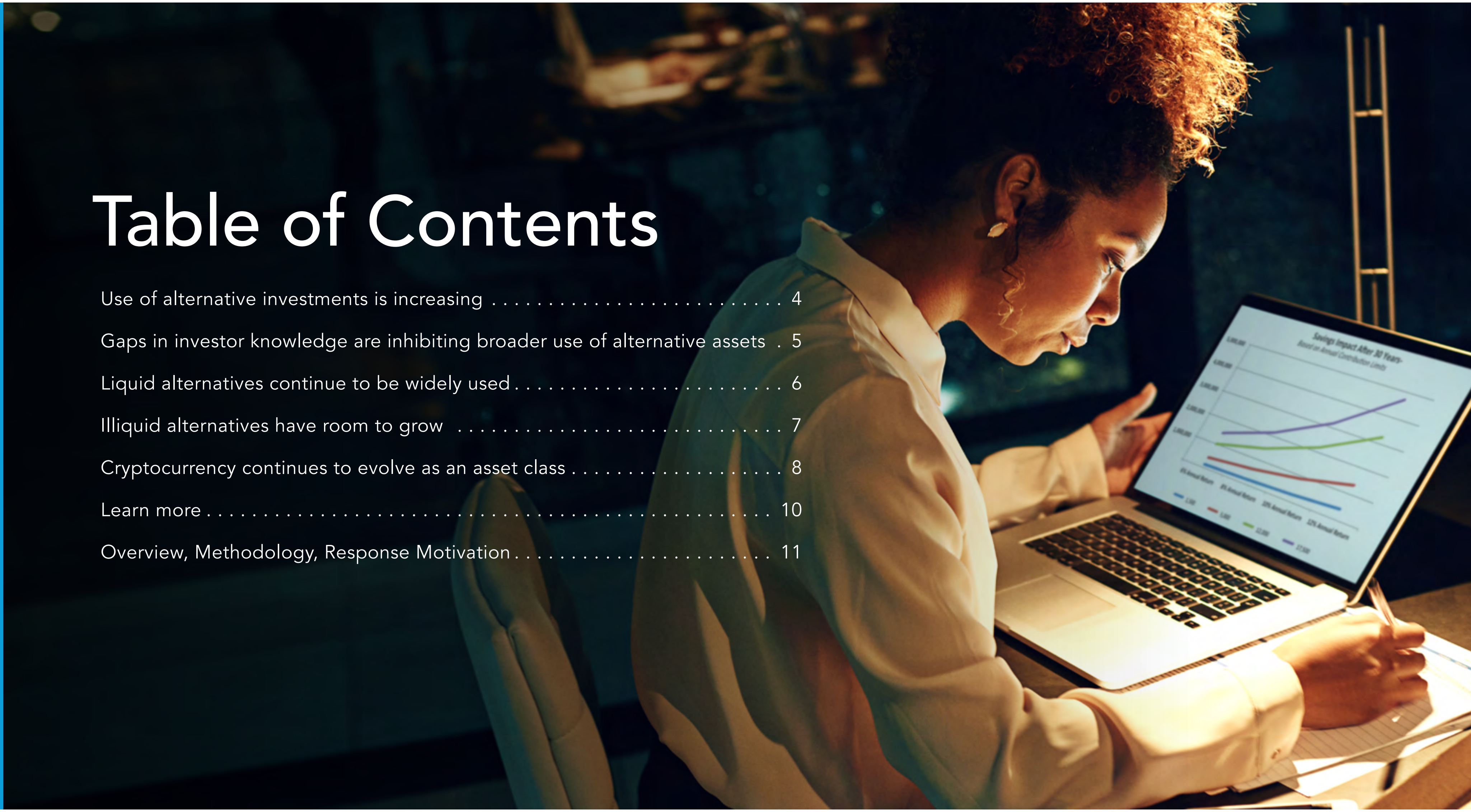
Use of Alternative Investments is Increasing, but There's Still Room to Grow



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Alternative investments continue to become an increasingly important part of advisors' toolkits. Although these vehicles are becoming more widely available, it can be difficult for advisors to put them to optimal use on behalf of their clients. The problem is not necessarily investors' lack of understanding about the need for alternative investments—in fact, many investors are interested in cryptocurrency to support strategic goals that might be better fulfilled by well-established alternative vehicles. But because alternative investments are less familiar to clients, these investments can fuel concerns among investors about liquidity, track record, risk management, and other factors. By working to better understand the products that are available and effectively passing that information on to their clients, advisors can reduce the resistance to alternative investments. As a result, advisors have more latitude to build portfolios best-suited to their clients' needs.

From May 20-May 25, 2022, WealthManagement.com and Informa Engage surveyed 459 financial advisors on behalf of Franklin Templeton to gain a more detailed perspective on which alternatives are the most popular, what factors prompt investor interest, and what factors provoke caution. **All charts and data shown and referenced on the following pages are sourced from this survey.**

Use of Alternative Investments is Increasing

A majority of advisors use at least a small allocation in one or more alternatives in their client portfolios. That usage is rising across the board. Advisors expect modest growth in all types of alternative asset categories in the next two years, with the three largest increases anticipated in liquid alternative exchange traded funds (ETFs) (+2.1%), private debt (+2.5%), and cryptocurrency and digital assets (+2.5%).

Liquid Alternative Asset Category	Mean Allocation Today	Mean Allocation - 2 Years	Change Over Time
Liquid alternative mutual funds	10.3%	11.6%	1.3%
Liquid alternative ETFs	7.1%	9.2%	2.1%
Illiquid Alternative Asset Category	**Mean Allocation Today**	**Mean Allocation - 2 Years**	**Change Over Time**
Private equity	8.2%	9.1%	0.9%
REITs	7.7%	9.0%	1.3%
Hedge funds	4.4%	5.8%	1.4%
Private debt	3.3%	5.8%	2.5%
Other Alternative Asset Category	**Mean Allocation Today**	**Mean Allocation - 2 Years**	**Change Over Time**
Cryptocurrency and digital assets	1.3%	3.8%	2.5%

"Alternative investments have become more broadly available in the past 10 to 15 years," says Pierre Caramazza, Head of Global Product, Alternatives at Franklin Templeton. "More recently, institutional quality portfolio teams have begun to participate as well, improving access to and the quality of these products."

The vast majority of advisors (92%) have access to alternative asset categories via their firm's platform. However, their firms have been slow to adopt asset categories outside those that have been historically popular with—and well understood by—advisors and investors. Most advisors offer access to real estate investment trusts (REITs) (72%), liquid alternative ETFs (66%), and liquid alternative mutual funds (63%).

To take better advantage of increased access to alternative investments, advisors need to advocate for them both to their firms and to their clients. As access to alternative asset categories continues to increase and advisors are better able to educate clients about them, more opportunities will arise to use them effectively in clients' portfolios.

Gaps in Investor Knowledge are Inhibiting Broader Use of Alternative Assets

A majority of advisors report that they include alternative investments in portfolios for diversification or uncorrelated return. Risk mitigation, upside growth potential and income generation also influence their decision-making process.

Interestingly, clients don't seem to be connecting these strategic drivers to use of alternatives. Advisors say their clients' biggest concerns regarding investing in alternative assets revolve around risk management (29%) and market volatility (27%), areas that presumably should be sufficiently addressed by assets devoted to risk mitigation and volatility hedging.

One way to close this gap may be to better educate clients on the connection between risk mitigation and a broader risk management program. This type of discussion could also include the use of uncorrelated assets to mitigate volatility risk, particularly in terms of how these assets work in the context of a broader portfolio strategy, rather than in isolation.

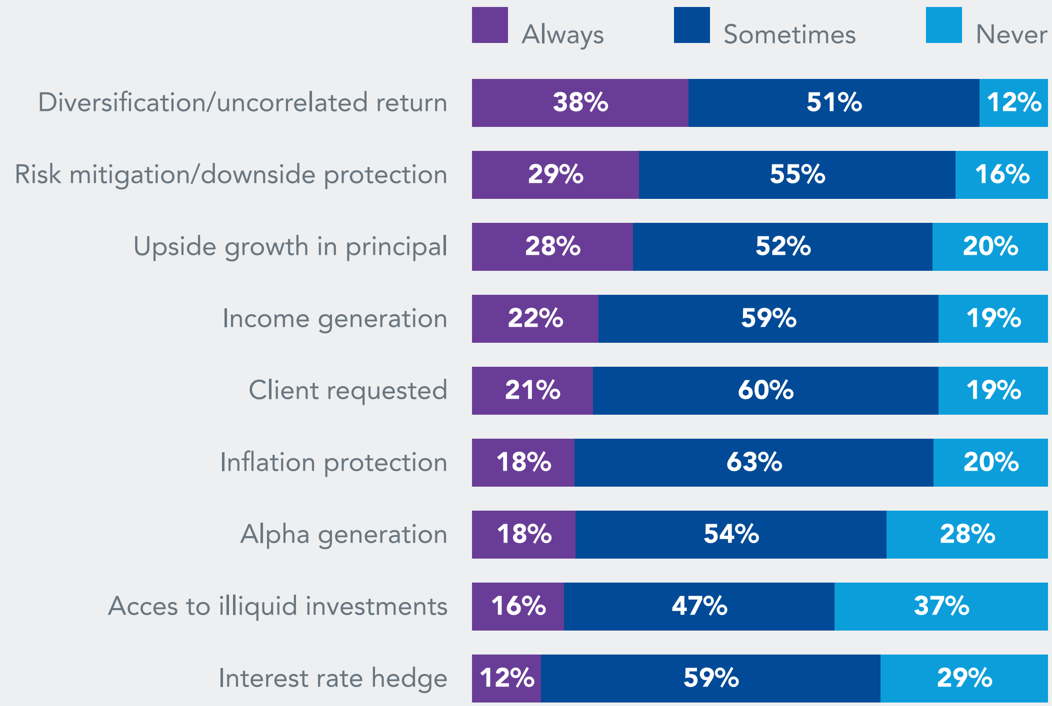
The use of alternative investments to seek enhanced returns offers another area ripe for better investor education. As private market investments become more easily available, advisors will need to overcome investors' reticence toward less-liquid assets.

Alternative Investment Usage

Question: For which of the following purposes, and at what frequency, do you use alternative investments?

The alternative investments respondents used most commonly include:

- Diversification/uncorrelated return
- Risk mitigation/downside protection
- Upside growth in principal



Liquid Alternatives Continue to be Widely Used

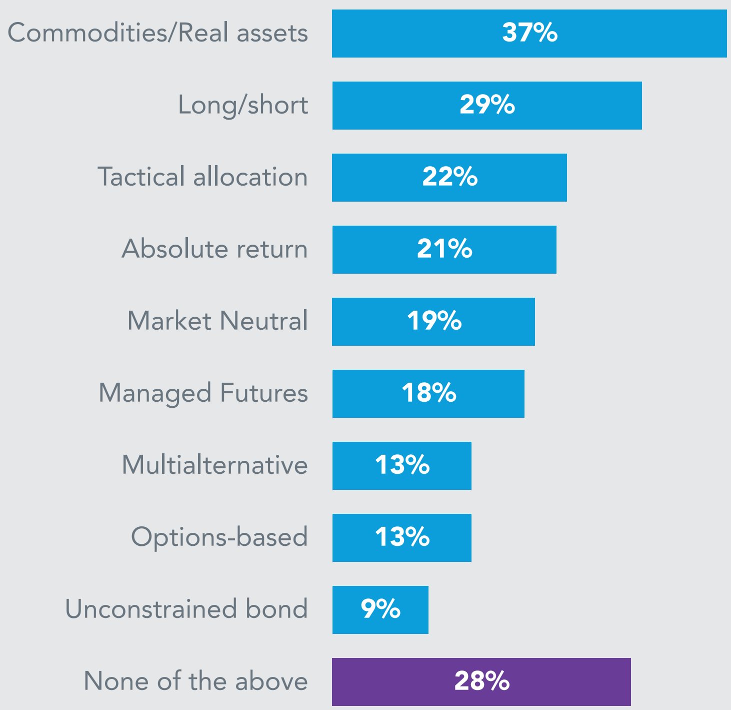
In recent years, liquid alternatives such as commodities and real estate have emerged as the most popular alternative asset class. Nearly three in four advisors surveyed (72%) report using at least one liquid alternative in their portfolios. Commodities and real assets are the most common, followed by long/short strategies.

Despite the widespread use of liquid alternatives, however, nearly a third of respondents (32%) feel they don't know enough about them. This reveals a key opportunity for firms to educate advisors about the strategic and tactical use of these assets, knowledge they could in turn pass along to their clients. Perhaps as a result of this relative lack of knowledge, advisors largely expect liquid alternative asset allocations to remain stable or increase over the next two years, with the bulk of the growth in commodities and real assets.

Liquid Alternative Category Usage

Question: Which of the following liquid alternatives categories are you currently using?

Three in four of respondents (72%) currently use at least one liquid alternative category, most commonly commodities/real assets (37%), followed by long/short (29%).



Illiquid Alternatives Have Room to Grow

Despite their potential for return enhancement, advisors appear to use illiquid alternatives under narrow circumstances. Two in three advisors report using at least one hedge fund strategy in their portfolios. Nearly seven in 10 (69%) use real assets strategies as well, predominantly involving private real estate and commodities. Only about half (49%) use private equity strategies and even fewer (42%) make use of private debt strategies.

The primary objection to the use of illiquid alternatives is, as the category's name implies, a lack of liquidity. High fees and expenses and a lack of an established track record also pose challenges to a majority of advisors.

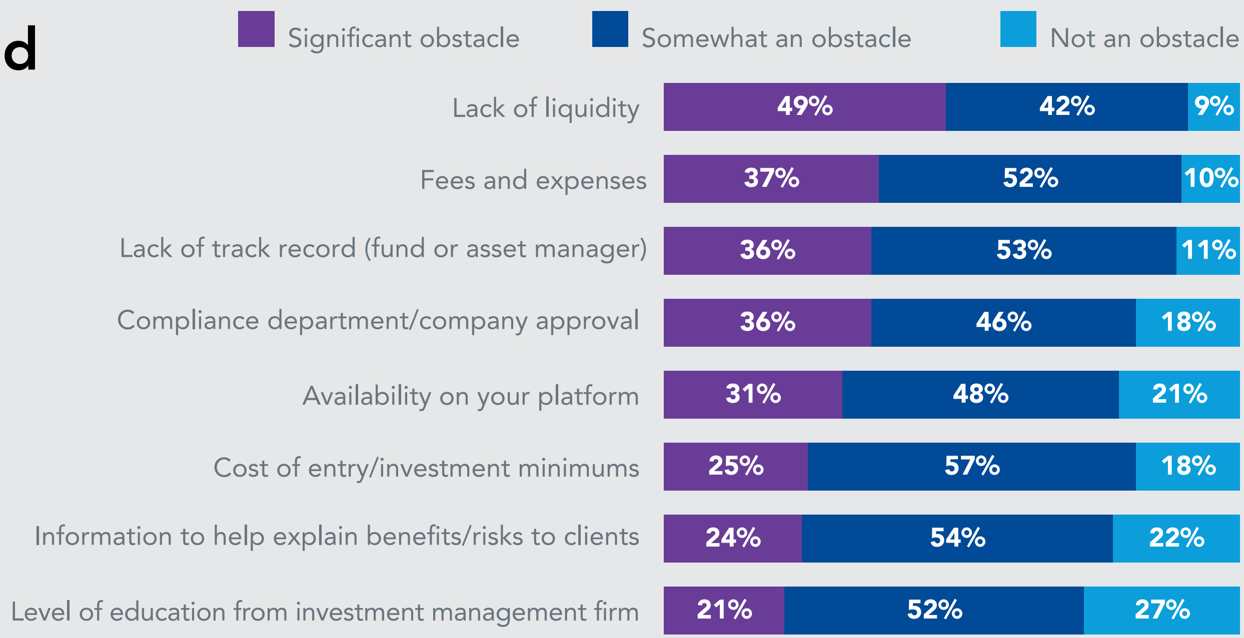
These use patterns suggest that investors are willing to accept illiquid assets under specific circumstances. For example, they may see a lack of liquidity as a necessary tradeoff when investing directly in real assets, since the assets themselves are illiquid by definition. In other cases, however, it's up to advisors to make a case for the advantages of an illiquid alternative investment. "It's important to let investors know that when you build their portfolio, you can sometimes improve the risk return profile of their investment by giving up near-term liquidity," says Caramazza.

The introduction of business development companies (BDCs) and interval funds are beginning to make the illiquidity premium more obvious. These products generally allow trading on a regular basis in return for a slightly lower premium and may help ease investors' concerns. The better advisors understand the premia available through illiquid alternatives, however, the easier it becomes to educate clients about their potential benefits and their strategic use in helping clients achieve their financial goals.

Obstacles to Using Illiquid Alternative Investments

Question: To what extent are the following factors obstacles to using illiquid alternative investments?

The primary obstacle to using illiquid alternative investments is the lack of liquidity, followed by fees and expenses, and lack of track record.



Cryptocurrency Continues to Evolve as an Asset Class

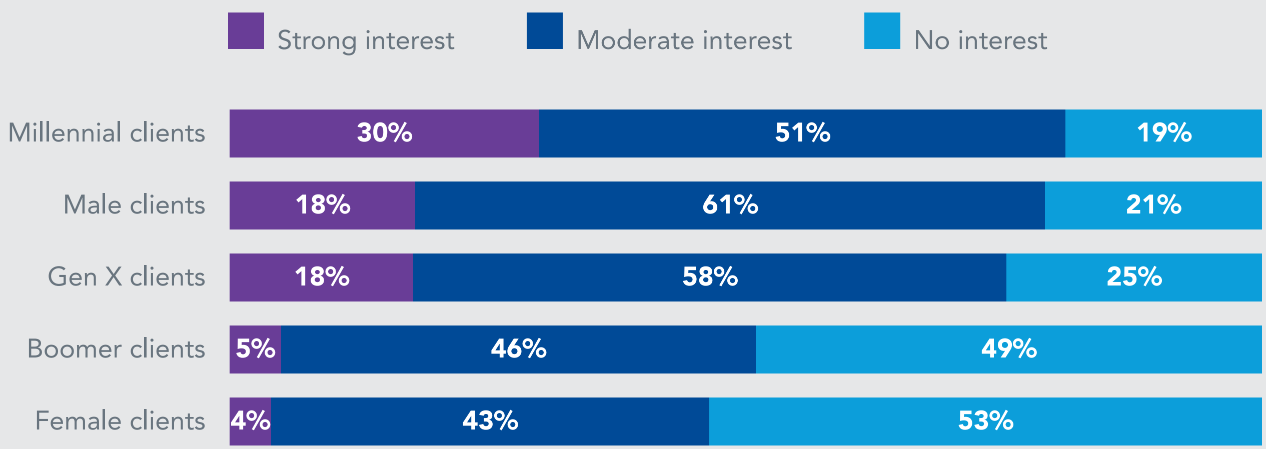
Despite the recent extreme volatility in cryptocurrency markets, big firms have continued their due diligence in the space. Digital assets and blockchain technology have also emerged as an area of interest for advisors and investors. "In contrast to other alternative asset categories, investor interest in cryptocurrency has generally been ahead of advisors," Caramazza says. Part of that trend may be due to the ongoing evolution of the cryptocurrency ecosystem, which initially pitched itself directly to investors and only recently has begun to find its way into a limited set of institutional offerings.

To date, interest in cryptocurrency has skewed strongly toward younger and male clients, with millennials expressing the most interest.

Interest in Cryptocurrency & Digital Assets by Segment

Question: How much interest are you receiving from the following groups to include cryptocurrency and digital assets in their portfolios?

Respondents report their Millennial clients express the most in interest in cryptocurrency and digital assets in their portfolios, followed by male clients and Gen X clients.



A majority of advisors (58%) indicate they are open to investing in cryptocurrency. However, they express no clear preference in terms of how to gain exposure to the asset class. The most common methods include actively managed direct investment in cryptocurrency or digital assets (16%), ETFs that hold cryptocurrency futures (12%) or spot crypto ETFs that actually hold cryptocurrencies (19%).

Whether or not cryptocurrency becomes an alternative asset class on par with better-established vehicles, its popularity may offer advisors another avenue to educate their clients about alternative strategies. Although cryptocurrency holds the potential for uncorrelated performance and outperformance that many advisors seek in other alternative strategies, it has key shortcomings. For one thing, it remains loosely regulated, if at all, making it generally more risky than more traditional alternative investments, which offer investors greater protection from fraudulent activity.

Furthermore, the relative lack of friction in the buying process and the broad democratization of the tools needed to access cryptocurrency and digital assets has played a considerable role in driving investor interest, often without the advice of a financial manager. "Hedge funds aren't marketing on TikTok," Caramazza points out. "Cryptocurrency is."

They don't necessarily need to take their message to social media channels, but financial advisors have an opportunity to use the intense interest in cryptocurrency as an introduction to the benefits alternative investments can offer in a portfolio. By connecting the selling points of cryptocurrency to broader investment principles such as risk management and return enhancement, advisors can help educate their clients about the growing range of tools available to achieve those outcomes in the context of a broader financial strategy.

These efforts can help ensure that advisors have access to all the tools necessary to build portfolios tailored to their clients' specific needs.

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Alternatives by Franklin Templeton

Alternatives by Franklin Templeton is a $200+ billion platform that brings together the expertise of multiple specialist investment managers to offer clients a diverse range of alternatives solutions. Our strategies span real estate, private equity and credit, real assets, hedged solutions, venture capital, digital assets and more. Our alternatives managers include Clarion Partners, Lexington Partners, Benefit Street Partners, K2 Advisors and Franklin Templeton.

To learn more, please visit franklintempleton.com/alts.

All investments involve risks, including possible loss of principal.
An investment in certain alternative securities or vehicles which invest in them, should be viewed as illiquid and may require a long-term commitment with no certainty of return. The value of and return on such investments will vary due to, among other things, changes in market rates of interest, general economic conditions, economic conditions in particular industries, the condition of financial markets and the financial condition of the issuers of the investments. There also can be no assurance that companies will list their securities on a securities exchange, as such, the lack of an established, liquid secondary market for some investments may have an adverse effect on the market value of those investments and on an investor's ability to dispose of them at a favorable time or price.

The technology industry can be significantly affected by obsolescence of existing technology, short product cycles, falling prices and profits, competition from new market entrants as well as general economic conditions. Buying and using blockchain-enabled digital currency carries risks, including the loss of principal. Speculative trading in bitcoins and other forms of cryptocurrencies, many of which have exhibited extreme price volatility, carries significant risk. Among other risks, interactions with companies claiming to offer cryptocurrency payment platforms or other cryptocurrency-related products and services may expose users to fraud. Blockchain technology is a new and relatively untested technology and may never be implemented to a scale that provides identifiable benefits. Investing in cryptocurrencies and ICOs is highly speculative and an investor can lose the entire amount of their investment. If a cryptocurrency is deemed a security, it may be deemed to violate federal securities laws. There may be a limited or no secondary market for cryptocurrencies.

Overview

Methodology, data collection and analysis by WealthManagement.com and Informa Engage on behalf of Franklin Templeton.

Data collected May 20, through May 25, 2022.

Methodology conforms to accepted marketing research methods, practices and procedures.

Methodology

Beginning on May 20, 2022, WealthManagement.com emailed invitations to participate in an online survey to active users.

By May 25, 2022, Informa Engage had received 459 completed surveys.

Response Motivation

To encourage prompt response and increase the response rate overall, a live link to the survey was included in the email invitation to route respondents directly to the online survey.

The invitations and survey were branded with the WealthManagement.com name and logo in an effort to capitalize on user affinity for this valued brand.