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Principal Asset Management℠

Investment education

Acting on alternatives: Your toolkit for guiding clients into real estate and private markets

HIGHLIGHTS

- **You can take multiple avenues when introducing alternative investments to private wealth clients, each with pros and cons.**
- **Your clients may have misconceptions about alternatives. Debunking those myths is an important step before taking action.**
- **A good investment management partner will help you find client-appropriate options and help you discuss them with your clients.**

For clients seeking diversification beyond public stocks and bonds, real estate and private markets can present a compelling opportunity. These alternative investments can provide a wider set of options for clients looking for uncorrelated returns, real income, and long-term capital appreciation.

At the same time, these investments can be unfamiliar to both advisors and their clients, which can lead to many misconceptions. But the right information, tools, and support can help you feel confident putting the power of real estate and private markets to work in client portfolios.

Accessing real estate and private markets: Direct vs. indirect

Investing in real estate and private markets can mean selecting individual companies or properties, but it doesn't have to. Advisors and clients have multiple options for gaining exposure to real estate and private markets, each with different levels of potential returns, control, and operational complexity.

Direct investments

Direct investment strategies involve buying physical property or participating in direct private equity and debt deals or co-investment opportunities.

+ **PROS:** Direct control, potential for higher returns.

– **CONS:** High minimum investment amounts, extensive need for due diligence, significant legal, administrative, and operational responsibilities, which can eat into returns.

Even for the wealthy, true direct access to institutional-level real estate or private markets investments is uncommon. These opportunities are typically reserved for institutions or ultra-high-net-worth investors with the ability to make large commitments while still maintaining a diversified portfolio.

PRACTICE INSIGHT:

Direct investments may be appealing for high-net-worth clients who want maximum control, but properly sourcing and vetting them can be challenging—and costly.

Indirect investments

Indirect investments allow investors to access diversified portfolios managed by professionals. Indirect investments via funds include REITs (Real Estate Investment Trusts), private real estate funds, private equity/credit funds, and interval funds. You can also access fund of funds, which package together multiple strategies.

+ **PROS:** Lower minimums, broader diversification, professional oversight.

– **CONS:** Layered fees and less investor control over individual assets.

Indirect investments typically involve multiple levels of fees. These fees might include management, performance, platform, or advisory fees. Gauging the impact of these fees, and whether they are justified by performance, is critical to using these vehicles successfully.

PRACTICE INSIGHT:

Gross-to-net return differences can be substantial depending on the structure and fees. Working with a seasoned manager can help you choose wisely and avoid unnecessary fee drag.

Debunking common myths about alternative investments

Many misconceptions prevent advisors and clients from fully embracing real estate and private market strategies.

MYTH 1: Alternatives are too risky.

REALITY: When professionally managed and appropriately integrated into a portfolio, alternative investments can reduce overall portfolio volatility. Their returns often have low or even negative correlation to traditional asset classes like public equities and bonds. This diversification benefit can help smooth out returns across market cycles.

For example, real estate and private credit strategies may continue to generate income even during equity market downturns. Furthermore, a capable investment manager can use tools like due diligence, rigorous underwriting, and long-term investment horizons to potentially enhance risk-adjusted performance.

MYTH 2: Only ultra-wealthy clients can access alternatives.

REALITY: New products and technologies have significantly lowered the barriers to entry for a wider range of investors. Vehicles such as interval funds and feeder funds now allow accredited – and in some cases, non-accredited – investors access to private market strategies with minimums starting as low as $2,500.

These products are often regulated under the Investment Company Act of 1940, offering more regulatory oversight and liquidity features than traditional private placements.

MYTH 3: Alternatives lack transparency.

REALITY: While private investments may not offer the daily pricing and public disclosure of listed securities, transparency has improved dramatically with the development of new product options. Reputable managers provide detailed reporting, audited financials, independent valuations, and frequent updates to attract a wider audience.

Many platforms also offer digital dashboards that allow advisors and clients to track performance, capital calls, distributions, and underlying portfolio holdings. This level of transparency is especially beneficial to investors who are using alternatives for the first time.

MYTH 4: Alternative investments are too expensive.

REALITY: Alternatives often come with higher headline fees due to the active management, operational complexity, and illiquidity premium they offer. However, costs should not be viewed in isolation.

Net-of-fee returns are the critical metric. Private equity, infrastructure, and certain real estate strategies have demonstrated the ability to outperform traditional benchmarks over long periods, even after fees. In addition, many alternatives deliver value in the form of lower volatility, enhanced income, or tax efficiency – factors that are not always reflected in headline returns but are crucial to portfolio outcomes.

PRACTICE INSIGHT:

Ask clients their perceptions of private investing—their answers may offer insight into the products or opportunities that will best fit their needs and you can tackle any concerns head on.

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Talking to clients about incorporating alternatives

Real estate and private markets can seem complex to clients who are used to public securities. When talking with clients, focusing on a few key messaging points will help align expectations:

→ **Diversification:** Describe how these investments impact portfolio diversification, and what that implies about risk and volatility.

→ **Access:** Indicate the spectrum of investment options that may not be available in the public markets, noting market inefficiencies and opportunities for asymmetrical returns.

→ **Long-term perspective:** Set clear expectations around limited liquidity and longer holding periods.

PRACTICE INSIGHT:

- Frame alternatives as complements to traditional investments, not replacements.
- Highlight the importance of due diligence and professional management.
- A knowledgeable investment manager can equip you with educational materials, data, and performance models that help clients feel confident in their choices.

The bottom line: Why partnering with an experienced investment manager matters

Real estate and private markets can offer compelling benefits—but they come with complexities. Sourcing deals, conducting due diligence, understanding financing structures, and managing reporting are just a few of the many layers that need to be addressed.

For that reason, partnering with the right investment management firm or firms is an important choice for every advisor. You'll need providers with experience who can offer strategic insight into key sectors, access to institutional-quality deal flow, robust due diligence and research capabilities, and support in portfolio construction and client education. They can also help in navigating ongoing operational, compliance, and reporting obligations.

Ultimately, with the right partner, you can confidently expand your offerings and bring sophisticated, diversified solutions to your clients.

If you have questions on how real estate and private markets alternatives can fit into your clients' investment approach, contact your Principal Asset Management representative today.

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Glossary of common real estate and private market terms

Helping clients become familiar with key terminology is essential in navigating the world of alternatives.

Real estate investments: The four quadrants

Real estate investments are commonly categorized into four quadrants:

Private equity real estate: Direct ownership of properties through private funds or partnerships, such as through a private multifamily residential fund.

Private debt: Lending secured by real estate assets, such as mezzanine loans or bridge loans.

Public equity: Shares in publicly traded REITs.

Public debt: Assets like mortgage-backed securities or real estate bonds traded in public markets.

Within these quadrants, investment strategies can be further divided by risk and return profiles:

Core: Low-risk, income-focused, stable assets.

Core plus: Slightly riskier, with some potential for value appreciation.

Value-add: Moderate risk, often involving renovations or operational improvements.

Opportunistic: High-risk, high-return projects, often involving development or distressed assets.

Private markets beyond real estate

Private markets also encompass:

Private equity: Ownership in private companies, often via buyouts or growth capital.

Private credit: Non-bank lending including direct loans and mezzanine financing.

Venture capital: A form of private equity that refers specifically to early-stage investments in startups.

Infrastructure: Long-term investments in essential assets like utilities, transportation, and energy, often supported by government or corporate investment too.

Liquidity terms

A key consideration of real estate and private markets is that investments are typically less liquid, in that there are practical hurdles or contractual limitations on when and how clients can access their invested funds. It's important to discuss these terms with clients so they understand their liquidity risks.

Lock-Up period: This is a common feature of many private market funds, referring to an initial period during which the client cannot sell or withdraw money from their investment.

Liquidity rules: Some fund structures use to determine who is first in line to take advantage of liquidity opportunities.

Illiquidity premium: The potential for higher returns that investors might expect as a trade off for investing in less liquid assets.

Commitment period: A period of time over which investor capital is committed to remain in the fund, often three to five years.

Debt terms

Direct lending: A form of private credit where non-bank institutions (such as private debt funds) provide loans directly to middle-market companies, bypassing traditional banks.

Senior secured loans: Loans that have the highest priority in the capital structure – this means they are first to receive a payout during a liquidity event - and are backed by collateral (assets of the borrower).

Financial covenants: Conditions set by lenders in loan agreements that require the borrower to maintain certain financial metrics (like a minimum interest coverage ratio or maximum leverage ratio).

Loan-to-value (LTV): A financial ratio used by lenders to assess the risk of a loan that compares the amount of a loan to the appraised value or purchase price of the asset being financed – typically real estate – whichever is lower.

Enterprise value multiples: Financial metrics used to assess a company's valuation by comparing its enterprise value to various performance indicators.

Loan spread: The difference between the interest rate charged on a loan and a benchmark interest rate – such as the Secured Overnight Financing Rate (SOFR), or U.S. Treasury rate.

Original issue discount (OID): The difference between a bond's face (par) value and its original issue price when the bond is sold for less than its face value.

Cash-flow lending vs. asset-backed lending: Cash-flow lending relies on the borrower's projected future cash flows to repay the loan whereas asset-backed lending is secured by specific collateral such as accounts receivable, inventory, equipment, or real estate.

General concepts

Catch-up provision: A clause commonly found in private equity, real estate funds, or profit-sharing agreements that allows a fund manager (General Partner or GP) to "catch up" and receive a larger share of profits after investors (Limited Partners or LPs) have received their preferred return.

Carried interest: The portion of the profits that a fund manager (General Partner or GP) receives from an investment, typically in private equity or hedge funds, above their initial capital contribution.

Capital distributions: The payments or distributions made by an investment fund or business entity to its investors from its profits or proceeds.

Drawdowns: The peak-to-trough decline in the value of an investment or portfolio before it recovers to a new peak. It measures risk and volatility.

EBITDA (earnings before interest, taxes, depreciation, and amortization): A financial metric that shows a company's operating performance by excluding non-operating expenses and non-cash charges.

IRR: The discount rate that makes the net present value (NPV) of all future cash flows from an investment equal to zero. It measures the annualized return expected from an investment.

Standard deviation: A statistical measure of the dispersion or variability of a dataset or investment returns to indicate the volatility or risk of an asset.

Valuation methods: Approaches used to determine the economic value of a business, asset, or company. Management fees can affect valuation by reducing the overall return. There are two common valuation approaches – notional value and equity value.

Notional value vs. equity value: Notional value is the estimated value of an enterprise, including both debt and equity. It represents the total exposure or size of a transaction, not necessarily the actual cash value. Equity value is the value attributable to shareholders excluding liabilities and debt. It is the most relevant measure when evaluating investor returns.

Distributed paid-in capital (DPI) vs. terminal value to paid-in capital (TVPI): DPI is a private equity performance metric that measures the amount of capital returned to investors relative to the amount of capital they contributed. TVPI is a performance metric used in private markets to measure a fund's overall performance. It represents the total value of a fund, both realized and unrealized, relative to the total amount of capital contributed by investors.

PRACTICE INSIGHT:

Depending on the area of real estate or private markets you think is most appropriate for your clients' objectives, familiarize them with the appropriate terms above to aid in their understanding of the potential opportunities and risks associated with this area of the market.

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Risk Considerations

Investing involves risk, including possible loss of principal. Past Performance does not guarantee future return. Real estate investment options are subject to some risks inherent in real estate and real estate investment trusts (REITs), such as risks associated with general and local economic conditions. Investing in REITs involves special risks, including interest rate fluctuation, credit risks, and liquidity risks, including interest conditions on real estate values and occupancy rates. Private market investments, unlike publicly traded stocks, involve various risks due to illiquidity, lack of transparency, and higher minimum investment requirements. These risks include liquidity risk, market risk, capital risk, and regulatory risk. Additionally, private market investments often involve higher fees and expenses and may have longer investment horizons. Investment risk may be magnified with alternative investment strategies due to their use of arbitrage, leverage, and derivatives. Asset allocation and diversification do not ensure a profit or protect against a loss.

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