Blackstone

PRIVATE WEALTH SOLUTIONS

Income: A Scarce Resource

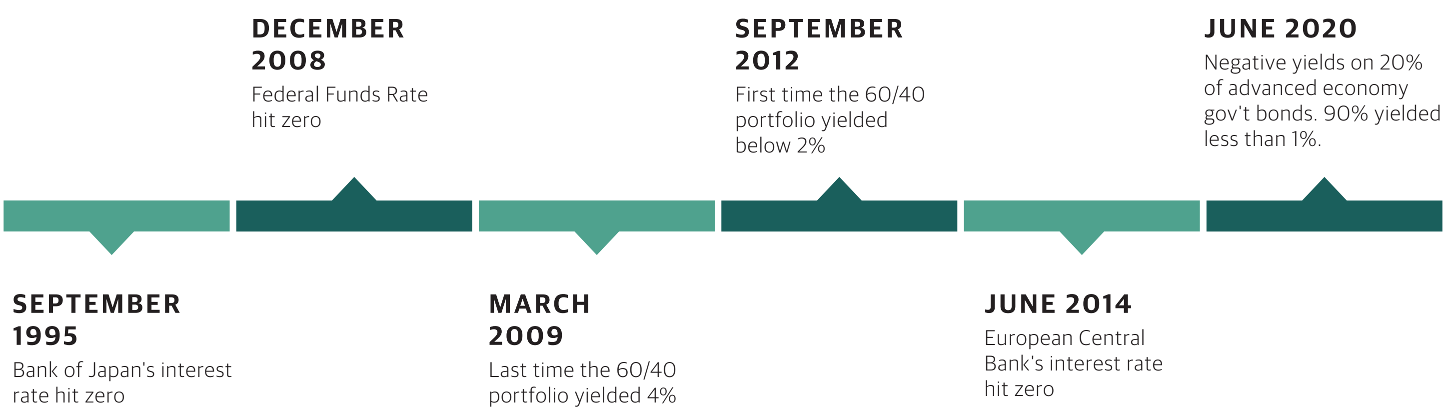
The challenge of finding attractive income sources in a low-yield world has increased to a degree perhaps unfathomable a decade ago.

Income-oriented investors seeking to adapt to this new world should understand that (i) historically, low-rate environments have tended to be remarkably persistent;[1] (ii) many income-oriented portfolios today bear substantial depletion risk;[2] and (iii) alternative sources found in private markets may be part of the answer for yield-starved investors.

I. The Stubborn Persistence of Near-Zero Interest Rates

Low-rate environments tend to be stubbornly persistent. In the U.S. a series of factors have combined to drive interest rates near zero and there is reason to believe they could stay there for some time. Sluggish economic growth could keep a lid on rates with the Federal Reserve expected to hold steady until the end of 2022.[3] Demographics may add an additional headwind to rates. The last of the massive Baby Boomer cohort are not expected to turn 65 until 2030. We believe this generation's desire for retirement income could keep bidding up the prices of income-generating assets and suppress these assets' yields for years to come.[4]

FIGURE 1: Milestones on the Path to Zero / Near-Zero Interest Rates



Source: Federal Reserve Bank of St. Louis, 2020. Morningstar and Bloomberg, as of June 30, 2020. Reuters, 2019.

1. Source: Based on publicly available policy benchmark and interest rate data in Europe and Japan, 1995–2020.
2. Source: Alliance for Lifetime Income, "Americans are Confronted by a Looming Retirement Income Shortfall," July 2019.
3. Source: Board of Governors of the Federal Reserve System, 2020.
4. Source: U.S. Census data, June 2020.

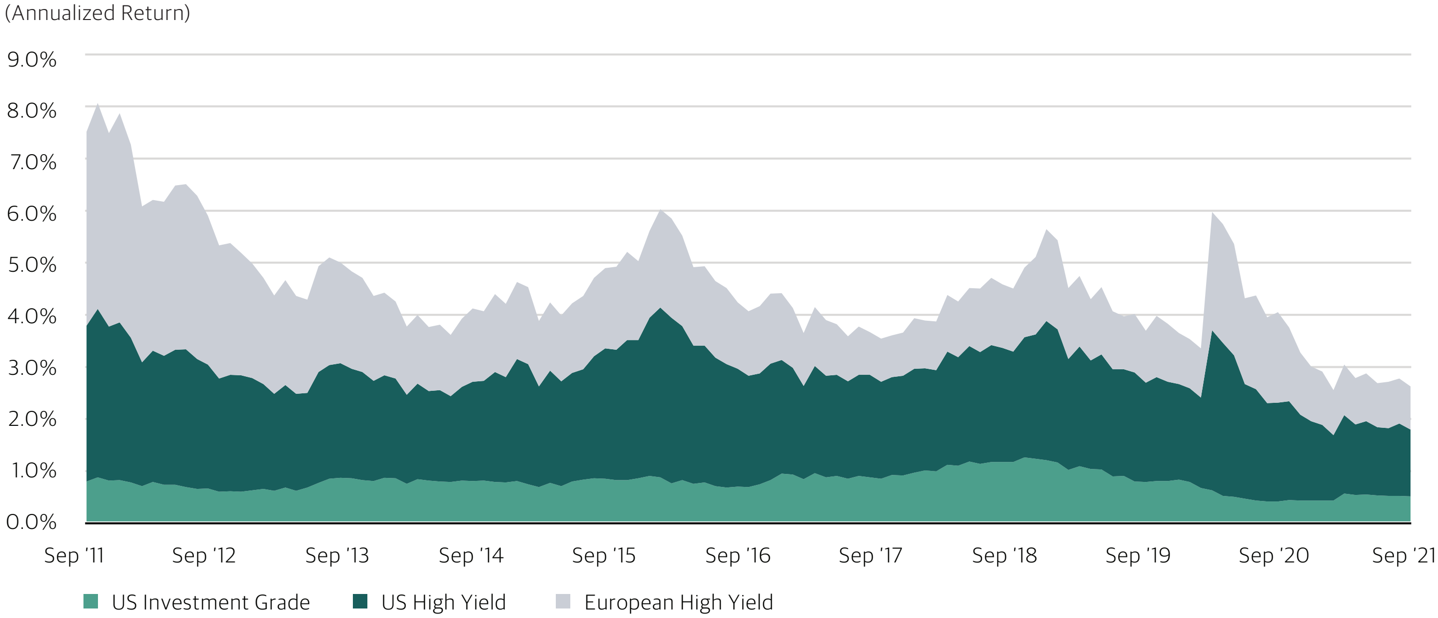
II. Significant Portfolio Depletion Risk

Accordingly, in our view many income-oriented portfolios today may face substantial depletion risk. That is, we believe portfolios may be at risk of being exhausted or permanently impaired while their owners still face financial obligations that they intend to meet with portfolio income.

The income generated by a representative yield-oriented portfolio (Figure 2) has fallen considerably over the last decade. This portfolio, which is weighted equally between U.S. high yield bonds, U.S. investment grade bonds, and European high yield bonds, has seen its yield fall from a decade high north of 8% in 2011 to 2.6% as of September 30, 2021.

As a result of this decline, portfolios which are designed with the goal of generating significant portfolio yields may be at risk if investors continue to take distributions at rates similar to a decade ago. The drop in yield may force those investors to rely on market appreciation and/or drawing down capital to meet their anticipated living needs.

FIGURE 2: Income from Representative Income Portfolio, 2011-2021



Source: Bloomberg, Morningstar, as of September 30, 2021. Hypothetical portfolio allocated 33.3% to the Bloomberg U.S. Aggregate Bond Index, 33.3% to the Bloomberg U.S. Corporate High Yield Bond Index, and 33.3% to the Bloomberg Pan-European High Yield Index. Yields are shown from September 2011 to September 2021.

This may be particularly risky at a time of heightened market volatility. Sharp drops in asset value in our opinion only serve to heighten depletion risk, since the withdrawal of a fixed percentage after a market decline all else holding equal represents a larger relative percentage of the total portfolio.

Income-oriented investors today may want to revisit private market alternatives as a potential solution for their yield challenges. In particular, portfolios with private credit and private real estate allocations compared to a traditional portfolio (Figure 5) may offer greater yield potential and a higher likelihood of closing the above-discussed income gap.

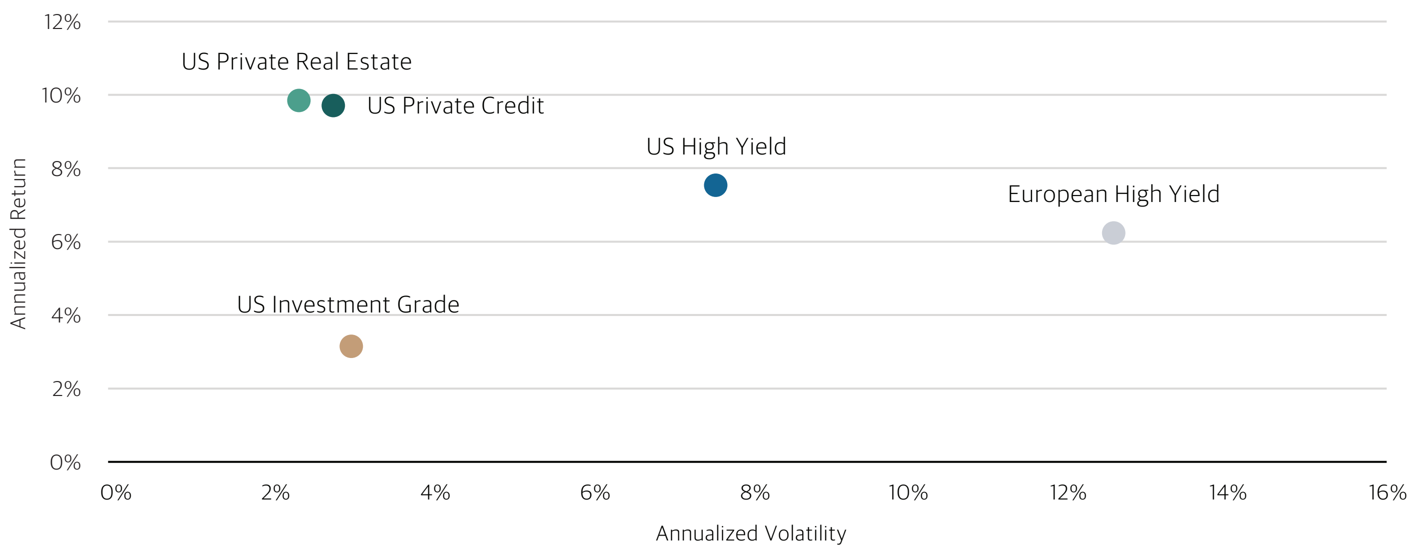
Allocating just a portion of the same portfolio to asset classes such as private real estate and private credit may bring significant potential yield enhancement. In the hypothetical illustration the portfolio yield rises 150 basis points (bps), to 4.1%.

As a trade-off of investing in private market alternatives, capital is often locked up for specified periods. This means investors must plan around the lack of liquidity of the investment.

We see private real estate as a compelling portfolio holding, one with attractive total return potential, a considerable portion of which may be delivered in the form of income. Private credit in our view is primarily a source of high income potential, and also warrants consideration as a long-term portfolio holding.

In practice, this often means investors must source liquidity from other parts of their portfolios. For some investors, a semi-liquid investment structure may represent a middle ground between liquid and illiquid investments.

FIGURE 3: Annualized Return and Volatility (Standard Deviation),2011-2021

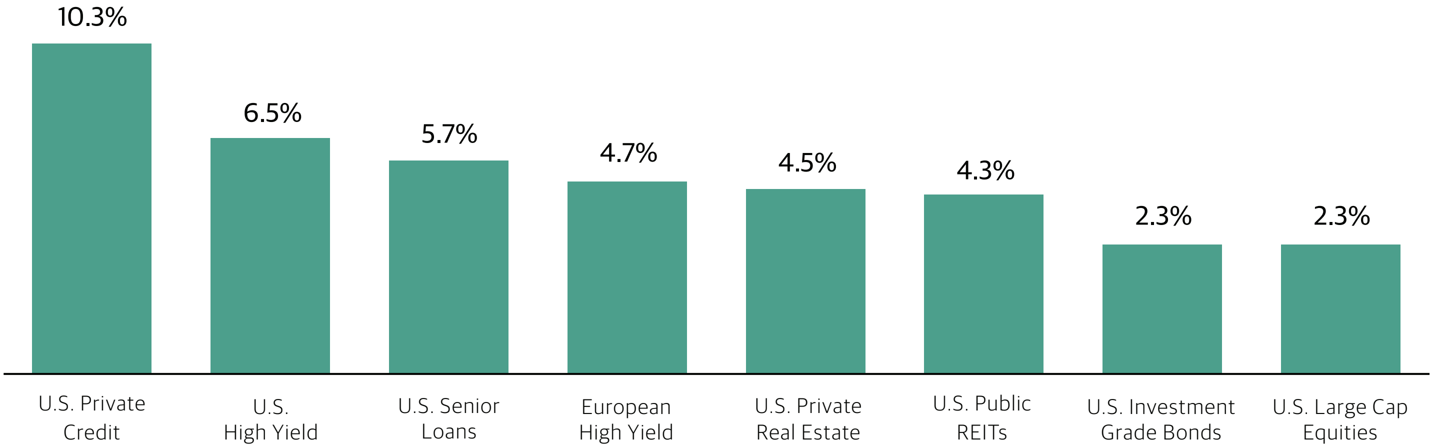


Source: Bloomberg, Morningstar, as of September 30, 2021 . The returns and volatility of the asset classes presented are based on the following indices: For U.S. Private Credit: Cliffwater Direct Lending; for European High Yield: Bloomberg Pan-European High Yield; for U.S. High Yield: Bloomberg U.S. Corporate High Yield; for U.S. Private Real Estate: NCREIF ODCE; for U.S. Investment Grade: Bloomberg U.S. Aggregate. Annualized returns and volatility are based on quarterly returns over the 10-year period ending September 30, 2021.

III. Potential Solution: Introducing Alternative Sources of Income

FIGURE 4: Yield Comparison

(Average Annual Yield, Trailing 10 Years as of Q3 2021)



Source: Morningstar, Bloomberg, Cliffwater as of September 30, 2021.

The yields of the asset classes presented are based on the following indices: For U.S. Private Credit: Cliffwater Direct Lending; for European High Yield: Bloomberg Pan-European High Yield; for U.S. Senior Loans: S&P/LSTA Leveraged Loan; for U.S. High Yield: Bloomberg U.S. Corporate High Yield; for U.S. Private Real Estate: NCREIF ODCE; for U.S. Public REITs: MSCI US REITS; for U.S. Investment Grade: Bloomberg U.S. Aggregate; for U.S. Large-Cap Equities: S&P 500; for U.S. Treasuries: Bloomberg Intermediate Treasury;

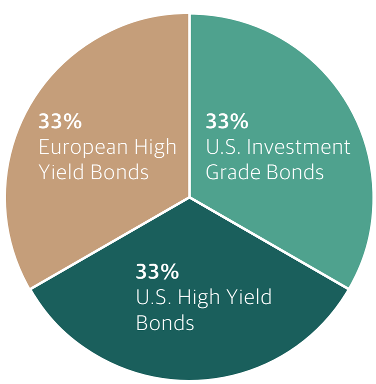
FIGURE 5:

Representative Yield-Oriented Portfolio

5.7%
Annualized Return

6.4%
Annualized Volatility

2.6%
Annualized Yield

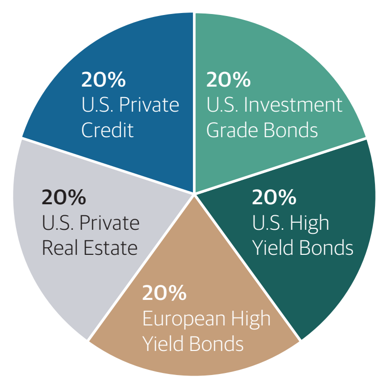


Portfolio with Private Market Alternatives Allocation

7.4%
Annualized Return

4.2%
Annualized Volatilty

4.1%
Annualized Yield



Source: Morningstar, Bloomberg, Cliffwater, as of September 30, 2021.

The yield on the Representative Yield-Oriented Portfolio was calculated using the annualized yield of the Bloomberg Pan-European High Yield Index, Bloomberg U.S. Aggregate Bond Index, and Bloomberg U.S. Corporate High Yield Bond Index. Yield of the Portfolio with Private Market Alternative Allocation was calculated using the annualized yield of the Bloomberg Pan-European High Yield Index, Bloomberg U.S. Aggregate Bond Index, Bloomberg U.S. Corporate High Yield Bond Index, Cliffwater Direct Lending Index, and NCREIF ODCE Index. Annualized yields, as of September 30, 2021. Annualized returns and volatility are based on quarterly returns over the 10-year period ending September 30, 2021.

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