

Alternative Investment Survival Guide

Part I: Investment Sectors and Client Objectives

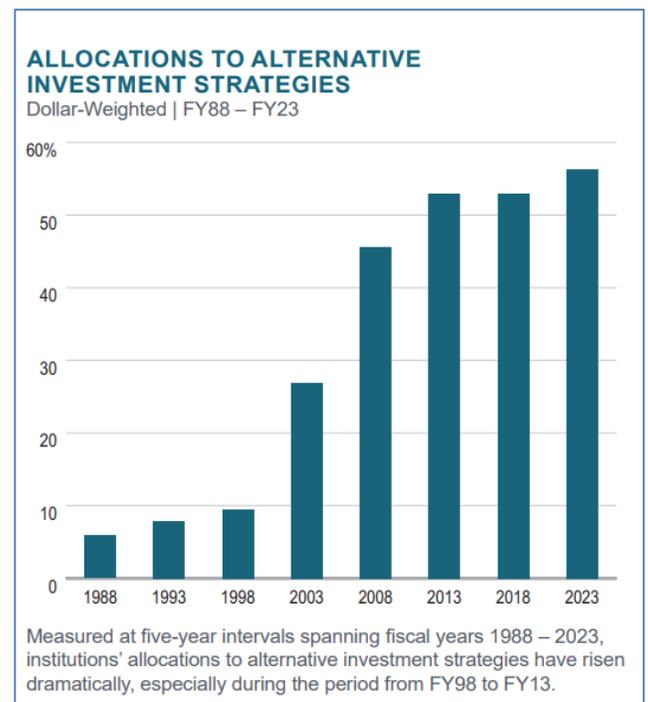
by Larry Eiben

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As an RIA, you are likely getting inundated with alternative investment offerings (often referred to as “Alternatives”). It’s a complex universe with a wide array of strategies and structures. Whether you are an experienced investor or someone new the space, it’s a daunting research challenge. The key question - What is the best way to categorize and analyze these investment tools to effectively deploy them in client portfolios? Also, what are the implications of the various vehicle structures, and which are best for my clients? In this two-part series, we’ll delve into these questions and offer some thoughts on best practices for investing. In our view, client objectives and liquidity requirements dictate investment strategy and structure.

In this first article we will cover some key differences between investment sectors along with sector-specific due diligence considerations. We will follow with an article discussing structure implications before finishing with some common allocation strategies. As a quick review, the main argument for using Alternatives (i.e., alternatives to exchange traded stocks & bonds) is born from Modern Portfolio Theory. That is, combining non-correlated investments shifts the “Efficient Frontier” thereby improving returns for any given level of portfolio risk.¹ While delving into the specific correlation metrics of various investments is beyond the scope of this article, we would argue that the growth in alternative strategy usage among sophisticated institutional investors validates their utility. Institutional investors, like university endowments, have steadily increased the use of these strategies such that the average portfolio allocation is now above 50% (See Figure 1).²

Figure 1



Categorizing Alternatives

Taking a step back for a moment, Alternatives is a flawed term that is counterproductive to the end goal of tactical deployment in portfolios. It’s an overused descriptor that attempts to gather a vast array of strategies and sectors into a single bucket. We find this to be a flawed approach as these investments have substantially different risk/return characteristics and, consequently, different utility in portfolios. In this article, we are going to cover a subset of the overall Alternatives universe. Specifically, we will focus on investments that are privately negotiated equity or credit securities and the various structures that hold portfolios of these securities. We will refer to this subset as “Private Securities.”

Categorizing Private Securities is this month’s main topic, and our advice is to follow the lead of the institutional investing world by first organizing these investments based on what they are (e.g., equity vs. credit) and their expected utility within portfolios (e.g., income vs. growth). Moreover, we suggest ranking them based on risk. Figure 2 shows the basic investment categories ranked by risk.

Figure 2

<i>Higher Risk</i>	Alternative Investment Category	Equity or Credit	Portfolio Utility
	Venture Capital	Equity	Growth
	Private Equity	Equity	Growth
	Real Estate Equity	Equity	Growth or Growth + Income
	Private Corporate Credit (Including Bank Loans & CLOs)	Credit	Income
	Asset Backed Credit (Including Real Estate Credit)	Credit	Income
<i>Lower Risk</i>			

Admittedly, Figure 2 is an over-simplified picture of the Alternatives industry. Risk, in fact, can vary materially within each of the above categories and, as we indicated, we’ve left off many (more esoteric Alternatives) common to hedge funds (e.g., hedged equity, managed futures, derivatives). We’ll save all of those for a future “Insight.” Regarding the risk of the categories listed, beyond diligence on the fund manager, below are a few key questions that we might use to further delineate investment risk/return profiles within categories.

PE/Venture Capital Funds

1. How speculative are the companies (e.g., early stage or late stage, pre-cash flow or stable cash flow)?
2. What is the level of sector diversification in the portfolio?

Real Estate Equity Funds

1. How speculative are the projects (e.g., ground-up construction or a value-add with existing cash flows)?
2. What is the level of diversification in the portfolio (e.g., deal, sponsor, sector and geographic)?

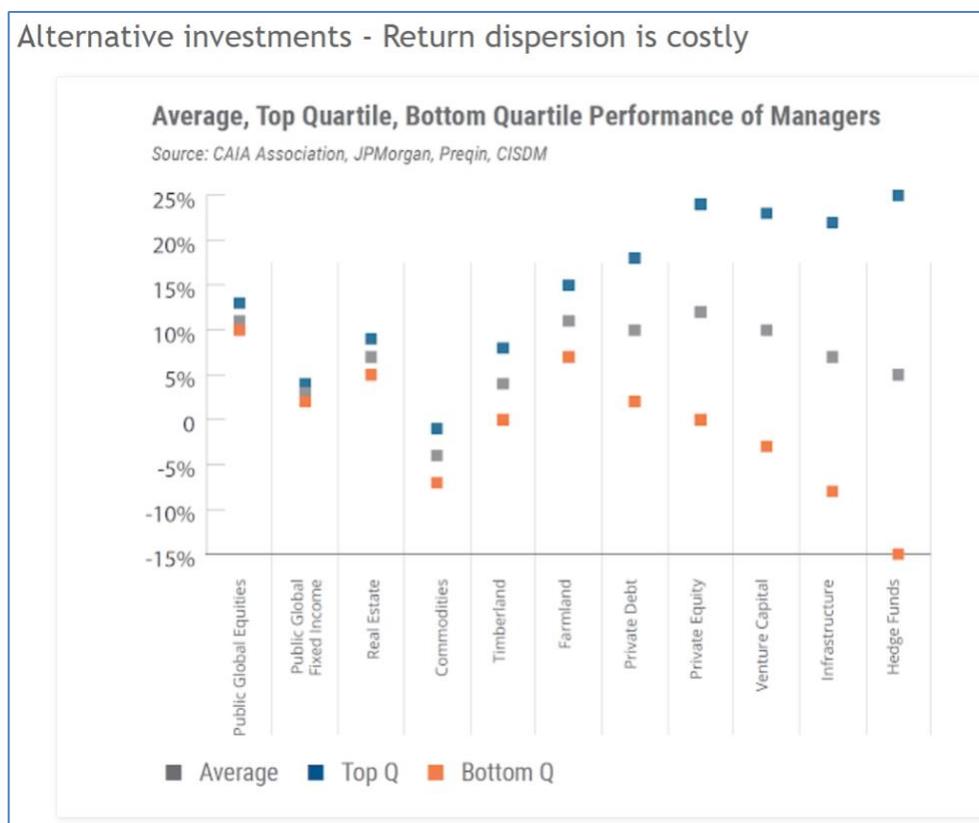
Credit Investment Funds

1. Private Corporate Credit & Real Estate Credit – Credit will generally be lower risk than equity, but the same questions (from above) apply.
2. For Credit Investments Generally:
 - a. What is the asset used as collateral and how volatile is its price?
 - b. Where does the loan sit in the “capital stack” (e.g., senior loans have priority over mezzanine loans and preferred equity)?
 - c. What is the loan to value ratio (e.g., at what level of asset depreciation does the loan risk impairment)?

Dispersion as a Measure of Risk

Since a picture tells a thousand words, let’s look at the variability in performance by investment category (See Figure 3).³ One can think of the variability in performance as the difficulty of performing due diligence effectively (i.e., achieving near, or above, average performance) as well as the potential risk (i.e., the downside loss of being wrong). Investments with a greater dispersion in returns require the greatest allocation of resources to due diligence.

Figure 3



Source: See Footnote #3

Be Realistic about Due Diligence Capabilities

Having a strategy for analyzing Private Securities is only half of the challenge. One also must be able to execute the strategy, and RIA firms should acknowledge that the required diligence will vary depending on the investment categories under consideration. In our view, advisors are best served to restrict investment to sectors where they have proper due diligence capabilities. For most RIAs, choosing investments only in lower dispersion categories will be the best option (e.g., lower risk private debt and real estate equity/credit).

Beware of Adverse Selection

Thirdline Capital is based in Richmond, Virginia, home of a top performing university endowment that we know well. We have observed that the best private investment funds in the most competitive categories (e.g., private equity and venture capital) rarely fundraise outside of existing investors like large institutions. The lesson here is that the “Top Quartile” of fund performers may not even be accessible to most investors, providing a further reason to be cautious in thinking you can succeed in certain higher-risk categories unless you have a concrete plan for avoiding the inherent adverse selection bias.

Don't Forget about Liquidity

Beyond the question of utility and risk, it's important to consider investment liquidity. The legal structure of an investment vehicle can materially affect liquidity, but we'll table that discussion until our next article. Looking exclusively at sectors, there are some general themes to keep in mind.

1. Venture Capital, Private Equity & Real Estate Equity are generally illiquid. These types of investments are not great tools for investors that need to have capital returned by a specified point in time. In general, most of the capital is returned only after transactions occur (e.g., acquisitions or recapitalizations).
2. Private Credit & Real Estate Credit Investments are still “illiquid” but have more attractive liquidity characteristics. That is, credit investments generally receive periodic cash payments and have maturity dates when capital is legally required to be returned. These factors generally allow some degree of periodic liquidity.

In conclusion, Private Investments have a clear place in most investor portfolios. Having a process for organizing and analyzing them is a critical first step in the allocation process. Careful consideration should be given to the due diligence capabilities of one’s firm as the risk of adverse selection is high (especially in sectors with substantial performance dispersion). Next month, we will drill down on the implications of choosing different investment vehicle structures before ending with a few case studies and recommendations.

About the author

Mr. Eiben is Co-Founder and Co-Portfolio Manager at Thirdline Capital, an investment advisor and manager of a real estate credit interval fund and other private real estate investments. Prior to Thirdline, Mr. Eiben spent over 15 years at TFS Capital, a firm that specialized in developing liquid alternative investment strategies, where he served as a Portfolio Manager and Chief Operating Officer.



Notes

1. The Journal of Finance, Harry Markowitz, Portfolio Selection (1952)
2. NACUBO, The-NACUBO-Endowment-Study-A-50-Year-Retrospective (2023)
3. Mark Rzepczynski, Disciplined Systematic Global Macro Views: Alternatives – Return Dispersion is Costly (2020)

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