

# Portfolio Allocation Views: The Search for Risk Premia

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## KEY TAKEAWAYS

- ➔ Even if the Fed embarks on an easing cycle in September—as we now expect—we believe that average interest rates will remain relatively “higher for longer.” If so, we believe that portfolio allocations today should be designed with the expectation of sustained elevated rates in mind. But where can investors find risk premia?
- ➔ High levels of concentration and still lofty valuations (despite recent sell-offs) have combined to narrow the risk premium in public equities. Meanwhile, in public fixed income, still tight spreads have made it difficult to find attractive yields at, in our view, reasonable risk levels.
- ➔ We believe that private markets can offer an alternative to muted risk premia in public markets.
- ➔ Although higher rates pose some challenges to traditional “growth” buyout private equity (especially those not focused on purchase price and, therefore, more dependent on multiple expansion to meet potential return targets), we see attractive risk-adjusted returns in the secondaries markets.
- ➔ On private credit, we believe that an expanding and increasingly diverse addressable market can be a source of attractive risk premia, with opportunities in large corporate direct lending, asset-backed finance, and other areas.
- ➔ We believe replacing a portion of public equity and fixed-income allocations with private assets has the potential to add sources of attractive risk premia today, diversify portfolios, and enhance risk-adjusted returns over time.

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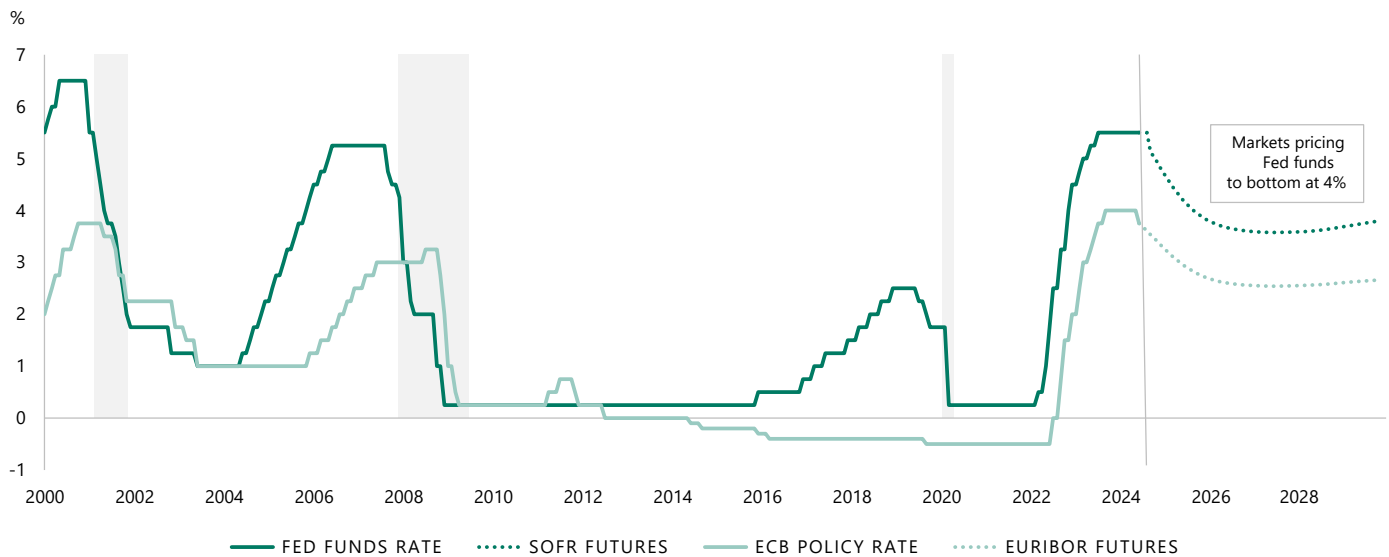
In any market environment, decisions about how to allocate capital can come down to the search for attractive risk premia. The process of creating a portfolio is akin to assembling building blocks, with each block ideally moving the return stream up and to the right of the efficient frontier. Said another way, the goal of every exposure is to enhance the portfolio’s overall potential risk-adjusted returns.

With that in mind, how are we thinking about portfolio allocation in today’s market environment?

Our current view is that average interest rates will remain “higher for longer.” This means that, in the short term, the question of whether the US Federal Reserve starts cutting

rates in September—which we now expect they will do—is less relevant because, in our view, average rates will stay higher than they were in the past, say, 15 years even after the Fed is done with its easing cycle. If so, we firmly believe that portfolio allocations today should be designed with the expectation of sustained elevated rates in mind. Why? Because we believe interest rates are being pushed higher by several powerful, secular forces, including de-globalization, costs associated with the energy transition, increased defense spending, and potential new restrictions on immigration. All these factors will, in our view, continue to put upward pressure on inflation and keep base rates relatively high (**Exhibit 1**).

**Exhibit 1: Macro trends are pushing interest rates higher for the long term**



Data as of June 2024.  
Source: Bloomberg, Apollo Chief Economist

## Searching for Risk Premia

So how do we approach the search for risk premia in these conditions? Using the capital asset pricing model as a guide, we start with a risk-free rate of approximately 5.2% as of this writing.<sup>1</sup> Although that looks enticing on its own, it’s much less attractive when you factor in current inflation at 3%,<sup>2</sup> which leaves a real pre-tax return of about 220 bps. Net returns after income taxes are, of course, even lower. We believe that such return rate is unlikely to get most investors to their desired destinations.

The question then becomes: Which assets currently offer the level of risk premia that can be captured and assembled into a portfolio to get investors to the places they’d like to be? In the remainder of this paper, we discuss our views on how to answer this question based on our current views of both public and private markets.

<sup>1</sup> Source: [https://home.treasury.gov/resource-center/data-chart-center/interest-rates/TextView?type=daily\\_treasury\\_bill\\_rates&field\\_tdr\\_date\\_value=2024](https://home.treasury.gov/resource-center/data-chart-center/interest-rates/TextView?type=daily_treasury_bill_rates&field_tdr_date_value=2024)

<sup>2</sup> As measured by the consumer price index (CPI) for June 2024. Source: Bureau of Labor Statistics (BLS)

## Public Equities

For starters, we believe that opportunities in public equity markets appear limited. As shown in **Exhibit 2**, public equity markets have reached a level of concentration not seen in decades.

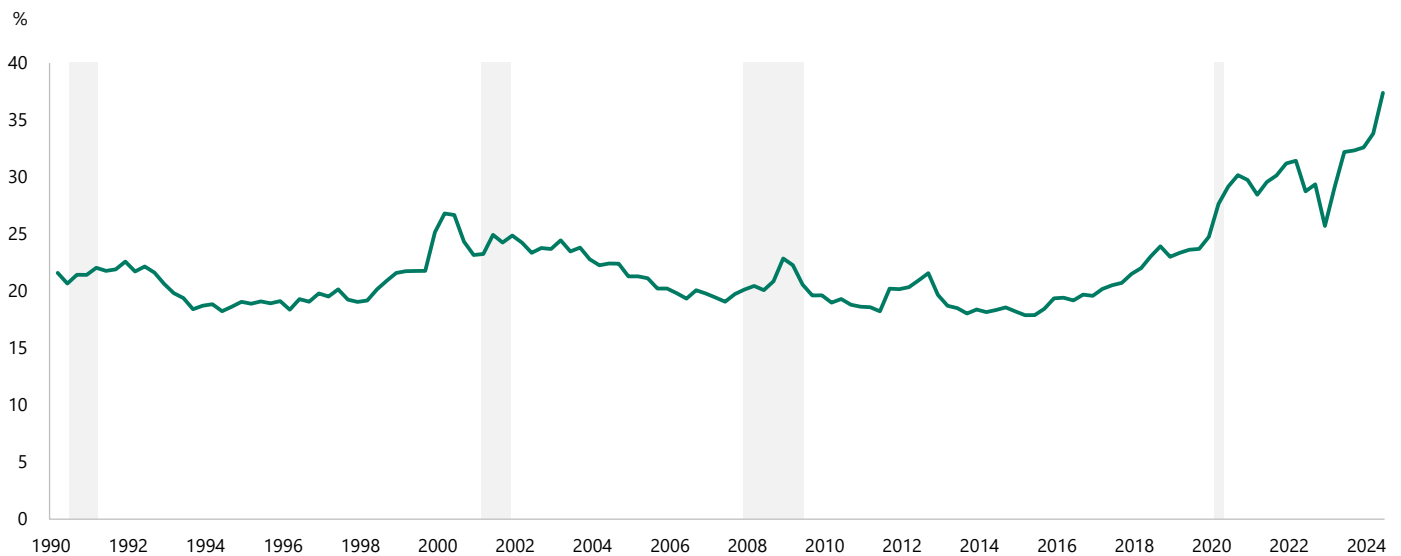
Currently, the “Magnificent 7”—consisting of Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla—represent approximately 30% of the S&P 500 index weighting.<sup>3</sup>

As of August 5, 2024, Nvidia alone represented roughly 33% of index gains, and the so-called “Fab 5” (Nvidia, Microsoft, Amazon, Alphabet, and Meta) accounted for approximately 56%.<sup>4</sup>

That level of concentration might be less concerning if valuations weren’t rich. However, price/earnings (PE) ratios are quite elevated relative to historic norms. As of this writing, PE ratios on S&P 500 stocks currently average 25.4, well above the historic average of 19.9 going back to 1990.<sup>5</sup> At these valuations and with these levels of concentration, we do not see the equity risk premium in public equities as attractive.

### Exhibit 2: Public equity markets are highly concentrated

S&P 500 share of top companies by market cap



Data as of June 30, 2024.

Source: Bloomberg, Apollo Chief Economist

Public equity markets have reached levels of concentration not seen in decades.

<sup>3</sup> Data as of July 23, 2024. Source: Apollo Chief Economist

<sup>4</sup> Data as of August 5, 2024. Source: Apollo Chief Economist

<sup>5</sup> Data as of July 25, 2024. Sources: Bloomberg, Apollo Chief Economist

## Public Fixed Income

Credit spreads on both investment-grade and high-yield corporate bonds have tightened considerably over the past two years, and, as shown in **Exhibit 3**, are now well below historic averages.

At current spreads, we believe it is difficult to find attractive yields at acceptable risk levels, and we don't expect that situation to change much through the rest of this year. We think that when rate cuts do come, they will be smaller than some people expect. As a result, based on average coupons on corporate bonds as of this writing, we do not believe public credit offers an attractive risk premium over Treasuries in the near to intermediate term.

## Private Markets

Overall, we believe it has become increasingly difficult to secure returns commensurate with risk in public markets. For that reason, when seeking out new exposures—from putting cash “to work” to considering shifts in existing allocations—we believe private markets can present opportunities to capture attractive risk premia.

## Private Equity

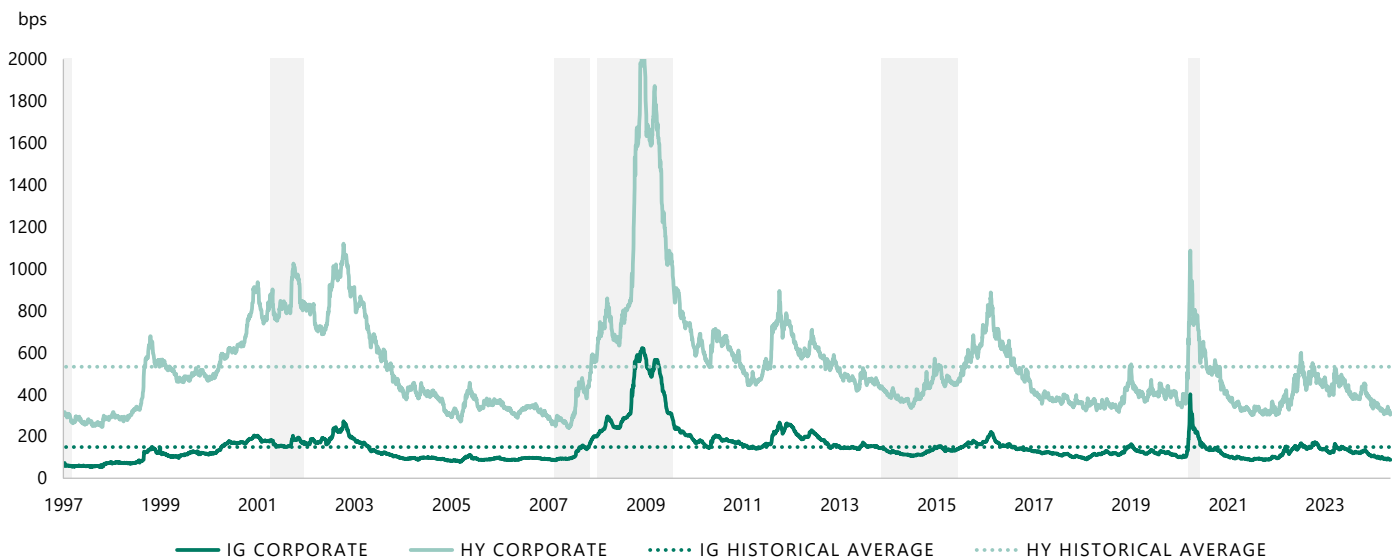
Conditions in traditional buyout private equity—especially “growth” PE—have changed dramatically since the Fed began raising rates. Prior to 2022, historically low interest rates produced strong tailwinds for private equity in the form of cheap capital, modest equity contributions, and consistent multiple expansion. Now that rates are higher and those conditions have dissipated, it may be harder for the “growth” PE market to replicate the level of returns generated in that more favorable environment.

That said, we see opportunities to find attractive risk premia in private equity. In the new environment, we believe accessing those opportunities will require special attention to purchase price and a deep analysis of existing corporate structures to ensure that they're adequate for an environment of higher rates for longer.

Further, we believe that the flexibility to invest opportunistically across the capital stack can allow for “hybrid” opportunities that can maximize potential gain while minimizing risks. Also, distressed opportunities could become a source of multiple opportunities if interest rates remain high.

### Exhibit 3: Credit spreads have tightened significantly

US investment-grade and high-yield spreads



Data as of June 14, 2024.

Sources: Bloomberg, Apollo Chief Economist

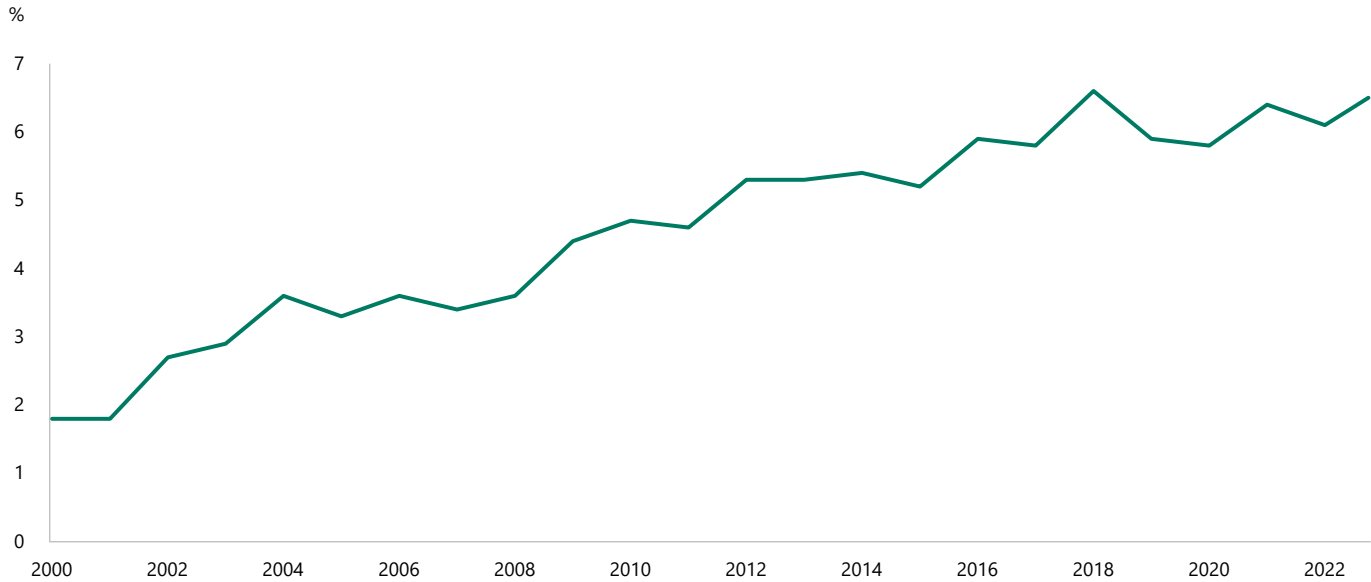
## PE Secondaries

We also see potential attractive risk-adjusted returns in private equity secondaries. These strategies have benefited from being reliable providers of liquidity for both general partners

(GPs) and limited partners (LPs) in a challenging exit environment, having substantially increased their share of the overall private equity market (**Exhibit 4**).

### Exhibit 4: Opportunities are growing in private equity secondaries

Secondaries AUM as a % of private equity AUM



Data as of May 2024.

Source: Preqin

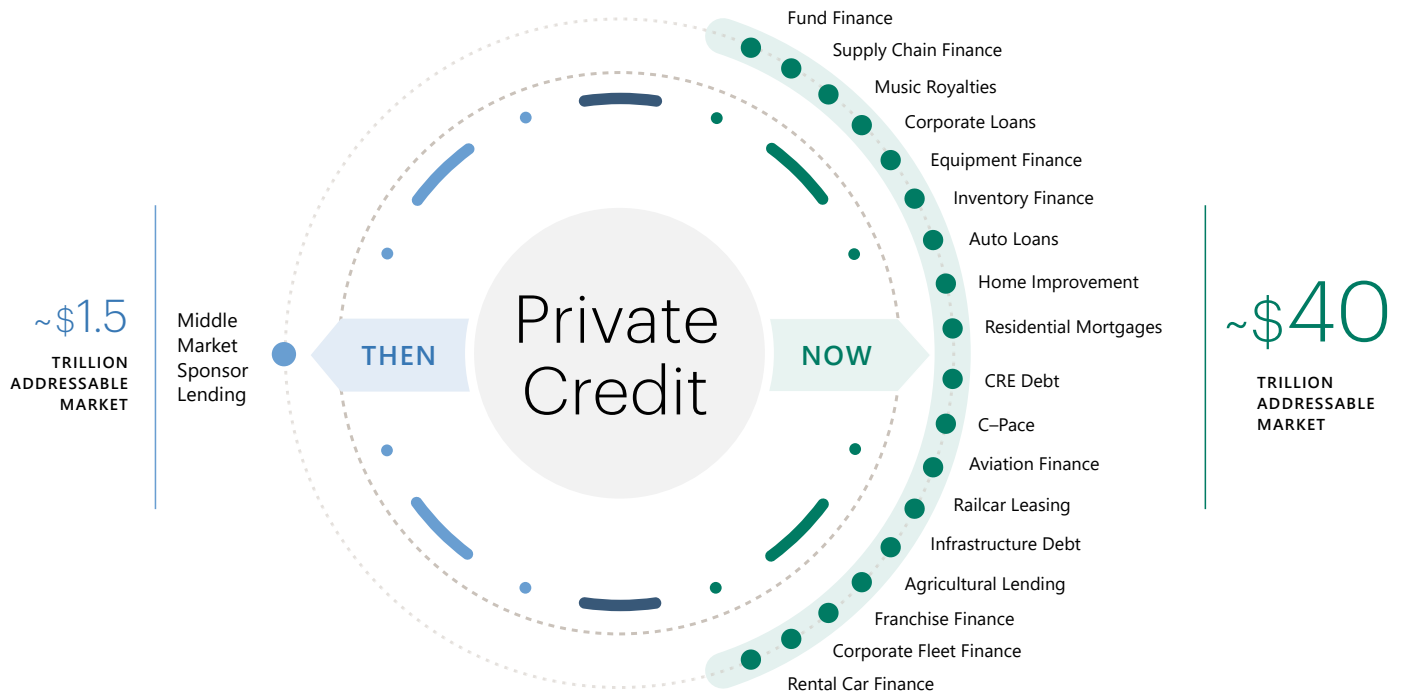
## Private Credit

We believe private credit markets also currently represent a potential source of attractive risk premia and investment opportunities. Before we explore the details of that assessment, it's important to consider that the private credit market we are looking at today bears little resemblance to the private credit market of 20 or even 10 years ago.

Traditionally, when people talked private credit, they were usually referring to middle-market sponsor lending—

a business historically associated with higher levels of risk than one would find in traditional public investment-grade credit. Today, private credit is a much more diverse market, representing an opportunity set of some \$40 trillion, in our view (**Exhibit 5**). More importantly, we believe that opportunities in private credit today run the risk spectrum similarly to public credit, meaning from investment grade to high yield.

Exhibit 5: Private credit is more than direct lending



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How did the private credit market get here? Two main factors are at work:

- Government policy:** Regulators have demonstrated that they prefer to have assets in many categories in the hands of investors, as opposed to depository banks. Said another way, regulators through a variety of means have expressed a desire to have investors hold long risk exposures, rather than banks backed by short-term deposits. To a large extent, recent growth in private credit markets is the direct and expected result of policies enacted to decrease the level of leverage in the banking system in an effort to mitigate systemic risk (**Exhibit 6**).
- Investors’ search for attractive risk-adjusted returns:** With base rates elevated, rising all-in returns—and attractive risk-adjusted returns relative to other classes—have driven a steady increase in investor demand for private credit. Additionally, industry innovation has enabled growth. The introduction of perpetual private credit vehicles, for example, has allowed qualified individuals to invest in the space (previously the purview primarily of institutional investors). This “democratization of finance” has facilitated access and, we believe, will continue to fuel growth of the asset class in years to come.

Exhibit 6: Financial markets are undergoing a transition

	IMPLICATIONS	IMPACT ON BANK LENDING
<p><b>Dodd-Frank Act</b> (2010)</p>	<ul style="list-style-type: none"> <li>• Smaller balance sheets</li> <li>• Less inventory</li> </ul>	
<p><b>Basel IV</b> (ONGOING)</p>	<ul style="list-style-type: none"> <li>• Higher capital requirements</li> </ul>	
<p><b>Rate Increase</b> (2022–PRESENT)</p>	<ul style="list-style-type: none"> <li>• Higher cost of funds</li> <li>• Deposit flight</li> </ul>	

The ability of the banking sector to supply credit is expected to be constrained in both the near- and long-term and profitability sector-wide is impaired

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## Sourcing Opportunities for Risk Premia in Private Credit

With that expanded market in mind, let's return to our discussion about the search for risk premia in the current market environment. A look across the broad spectrum of private credit presents attractive opportunities. Here we highlight a few we perceive to be appealing today:

- Large corporate direct lending:** As the private credit market evolves, so does the opportunity for investors to lend directly to large corporations. Specifically, we believe that private loans made in size and at scale to large companies can generate attractive risk-adjusted returns, with the additional potential benefit of other lender-friendly traits, such as first-lien exposure, covenants, among others. Also, managers today have the ability to create structured solutions that can be beneficial for lenders and borrowers alike (e.g., nimble execution at scale, debt restructuring plans, etc.). We believe that spread levels—which, as of August 2024, are around 500-550 bps over the Secured Overnight Finance Rate (SOFR)—can offer an attractive alternative for investors. That said, selectivity is key.
- Asset-backed finance:** The growth of the private asset-backed finance market is another area where we see attractive risk premia today. ABF allows investors to explore potential opportunities in auto fleet leasing, aircraft finance, mortgages, consumer finance, and many other assets. Importantly, these risk-adjusted returns, which can come from investment-grade assets, have historically been uncorrelated to both traditional and leveraged lending. That is because—unlike traditional bonds—lending here is, as implied, backed up by assets or cash-flow streams that, combined, tend to mitigate risk for investors. **Exhibit 7** shows how asset-backed securities across the risk spectrum tend to have low correlation to US corporate credit from a historical perspective.

### Exhibit 7: ABF instruments exhibit low correlation to traditional US corporates

Asset-backed spreads trailing 12-month correlation to US corporates

Rating	US BSL CLO	US Conduit CMBS	US Private Student Loan ABS	US Prime Auto ABS
AAA	0.51	0.69	0.63	0.40
AA	0.59	0.65	0.70	0.56
A	0.69	0.70	0.72	0.67
BBB	0.74	0.73	0.70	0.65
BB	0.66	NA	NA	NA
<b>Average</b>	<b>0.64</b>	<b>0.69</b>	<b>0.69</b>	<b>0.57</b>

Sources: J.P. Morgan and Bank of America from January 1, 2012, through May 5, 2023. US Corporates are represented by the ICE BofA US Corporate Index; US broadly syndicated loan (BSL) CLOs from J.P. Morgan – CLO spread data; US Conduit CMBS from Bank of America spread data (OTR LCF 10-year fixed-rate conduit spreads); US Prime Auto ABS from historical spreads reported by J.P. Morgan Research; US Student Loan ABS from historical spreads reported by J.P. Morgan Research. There can be no assurance that historical trends will continue.

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## Equity and Fixed Income Replacement Strategies

Since we believe the existence of attractive risk premia in private markets warrants an allocation to the asset class, the next question is: How can investors think about taking on exposure to private assets?

We believe that private assets can be used to replace a portion of public equity and fixed income exposures, instead of being relegated to an “alternatives” or a “private markets” sleeve of a portfolio.

Replacing public equity and fixed-income exposures with allocations to private assets has the potential to diversify portfolios, mitigate against volatility and inflation, and enhance risk-adjusted returns, in our view. Recognizing those potential benefits, some experienced institutional investors have recently increased allocations to private assets to up to 20% to 40% of their portfolios as of this year.<sup>6</sup> For investors without existing allocations to private credit, taking on a small exposure to private markets can provide an opportunity to experience the potential benefits of those markets, while also gaining experience. Over time, new and additional exposures can be added through the capital allocation process as building blocks, each with the potential to add meaningful risk premium to the portfolio.

<sup>6</sup> <https://www.calpers.ca.gov/page/newsroom/calpers-news/2024/calpers-will-increase-private-markets-investments>

## Conclusion

Our view is that base rates will remain elevated on a relative basis for the foreseeable future. The question now facing investors is: Where can I find attractive risk premia for my portfolio in a higher-for-longer rate environment? We believe current conditions in public equity and fixed income markets offer limited opportunities. However, we do see a more compelling situation in private markets. In private equity, select segments like the growing universe of secondaries can represent attractive options. Private credit markets, which are expanding and evolving, can offer a broader set of opportunities, including those in large corporate direct lending and asset-backed finance. For this reason, we believe risk premia can be accessed by replacing some public equity and fixed income exposures with allocations to private assets.

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Alexander Wright is Partner, Global Wealth Strategist in the Client and Product Solutions group at Apollo. Previously, Alexander was the Co-Head of Yield Products and a portfolio manager for Apollo’s closed end funds, CLOs, and private BDC. Prior to joining in 2011, he was with GSC Group where he served in a variety of different roles, most recently as Chief Administrative Officer, Chief Financial Officer, and Head of US Corporate Debt. Before that, Alexander was with IBJ Whitehall Bank & Trust Corporation and Chemical Banking Corporation.

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