A Closer Look

Alternative Investments and Wealth Planning Opportunities

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In Brief

- **Alternative investments, such as private equity, real assets, and hedge funds, offer many potential benefits, including portfolio diversification, enhanced returns, and an expanded range of investment opportunities. Challenges include access, liquidity, and tax considerations.**
- **In this *A Closer Look*, we offer some high-level thoughts on how alternative investments work, along with planning ideas that can be used across generations to protect and compound wealth.**

Alternative Investments Defined

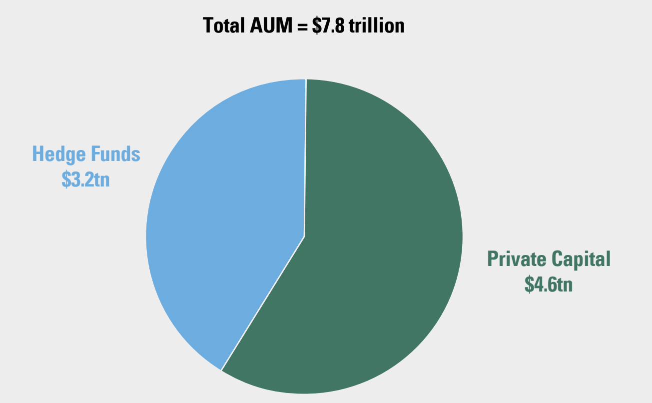
Alternative investments may include any investment or investment strategy outside of conventional long-only investments in stocks or bonds. They offer access to some of the most active and unconstrained strategies in financial markets.

Private equity, venture capital, real assets, and hedge funds are commonly recognized types of alternative investments. Private equity funds invest directly in companies or other private assets, while hedge funds typically invest in public securities. Private equity offers a different approach than the public equity markets in that managers can invest in a wider array of companies throughout their life cycle (from start-ups to pre-IPO companies, to mature cash-flowing businesses, to companies in distress) and, through direct ownership, can greatly shape the evolution of the business. Real assets include longer-term commodity-related investments, various forms of energy and real estate assets, and other enterprises focused on physical assets.

Alternative investments should not be considered a separate asset class but an access point to certain investment strategies that may produce return streams different from those of traditional stock and bond investments. Alternative investments have been adopted swiftly post the global financial crisis as investors have sought out their benefits. Exhibit 1 shows recent market-size metrics.

Alternative investments are typically owned through a partnership or limited liability company (LLC) and are offered on a limited basis under private placement rules to qualified investors under U.S. securities regulations. Given the limited offering of these partnerships, alternatives managers are often granted wide latitude in how capital is invested — this could range from owning physical assets to concentrated portfolios, to assets with a longer time horizon.

Exhibit 1: Industry AUM, Alternative Investments



As of December 31, 2016. AUM stands for Assets Under Management.

Source: 2017 Preqin Alternative Assets Performance Monitor, 2017 Preqin Global Hedge Fund Report

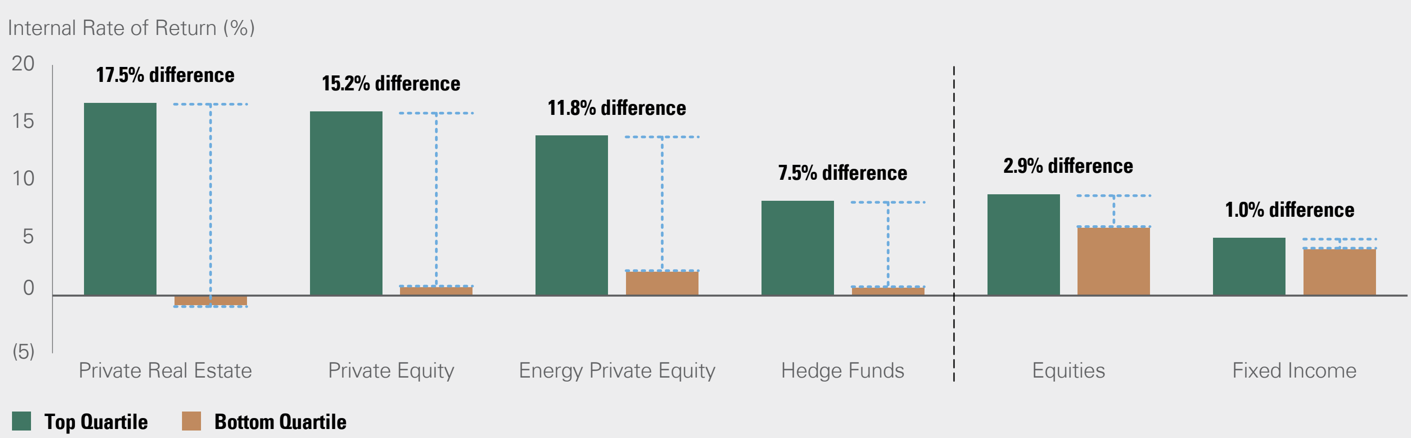
Benefits of Investing in Alternatives

Return enhancement. The range of results, or dispersion, among alternatives managers is much wider when compared with more traditional asset managers (Exhibit 2). This dispersion provides the opportunity to generate enhanced rates of return if an investor can properly identify and gain access to the best managers.

Long-term, unconstrained mandates. The structural benefits of alternative investments allow for more flexible, longer-term, active, and unconstrained investing — beyond what can be done in the traditional public markets. Alternatives managers do not have to be invested all the time as traditional managers typically do; they can be flexible within portfolios based on their view of the market, valuations, and opportunity sets. Semi- or fully committed capital structures allow managers to hold more complex or unloved assets while they work to unlock full value for their investors. For example, private equity managers typically have control or board seats and therefore can influence how companies mature, develop, or exit. Often these managers offer much more than capital — such as internal operational and technical resources — to help new and growing companies develop more rapidly than could be expected without such resources.

Diversification. Alternative investments are often used as complements to traditional investments. Alternatives historically have realized low correlations to traditional asset classes and may improve risk-adjusted returns when added to a portfolio. For example, the performance of certain hedge fund strategies could diverge from stocks and bonds, contributing to a portfolio's overall performance in different market environments, especially on a risk-adjusted basis.

Exhibit 2: Dispersion of Returns Among Alternatives Managers



Each of the quartiles in the graph is based on annualized returns for the trailing 20 years through December 31, 2016.

Source: Cambridge Associates, Lipper, HFR, EurekaHedge

Challenges of Investing in Alternatives

Liquidity. The open-end and closed-end structures used in alternative investments result in less liquidity (i.e., ability to buy and sell as desired) for investors versus traditional investments like stocks and bonds (Exhibit 3). By way of definition, open-end investments are available for purchase and sale on a regular frequency, like most hedge funds. These structures typically come with an initial and subsequent lock up to give managers some assurance that they have somewhat patient capital to make investments; after the lock-up period, investors may sell their interests on a periodic basis. Closed-end investments, also known as committed capital or drawn down funds, are offered on a limited basis and, once "closed," typically do not allow new investors. Private equity is normally offered in a closed-end structure, and it remains illiquid for several years, including the period during which the client is investing capital needed for new investments.

Access. Access refers to the ability of an investor to source, research, and commit money to a manager. Other barriers to participation include high investment minimums, less transparency, and a limited amount of public information. Further, alternatives are only available to accredited investors and/or qualified purchasers who can understand the investment offering and tolerate the reduced liquidity profile. Most importantly, top-tier managers with long track records are difficult to access as they already have deeply entrenched investor relationships and may have no need to expand their investor base.

Taxation. Alternative investment partnerships issue K-1s, which can delay tax filings. Also, given the nature of their trading, hedge funds may offer a less tax-efficient approach than other vehicles.

Manager selection. As noted in Exhibit 2, significant dispersion exists between the top- and bottom-performing alternative investment managers, making a robust manager selection and due diligence process critical. This process requires professionals with specialized skill sets spending meaningful time and effort to source and research each manager.

Exhibit 3: Investment Liquidity Spectrum

Source: Bessemer Trust

Allocating to Alternatives Within Client Portfolios

Deciding the appropriate amount, if any, to allocate to alternatives is inherently a personal discussion between a family and its advisors, given the benefits and challenges we have noted. It is important to understand each family's specific situation and goals to determine the optimal allocation. Risk tolerance and liquidity needs are crucial considerations. What is the family's spending rate? Are there considerations with a family structure that make alternatives attractive or challenging?

In the context of the overall portfolio, an important consideration is how to source funds from other asset classes. For example, private equity funding may be sourced from what would otherwise be public equity exposure, given the similar risk associated with these assets. However, since private equity is invested incrementally over time, clients may need to commit more initially than it would seem they should from the standpoint of their final allocation. For hedge funds, meanwhile, funds often can be sourced from a combination of equity and bonds given the diversified return streams from unconstrained managers.

Investing Through a Family LLC

Families can invest in alternatives in different ways — by investing directly, by investing through a trust, or by investing through a family partnership, or LLC. While each can make sense in differing circumstances, we note that family LLCs create some unique benefits that we believe merit exploration.

Advantages of using the family LLC structure include the following:

- **Access to asset classes that may be beyond the reach of some family members.** While one family generation may meet the "accredited investor" and "qualified purchaser" standards, the next generation may not. Using a properly structured LLC to make investments could allow an individual's children to own indirect interests in alternative assets. Aggregating assets can also allow the family to meet higher minimums and, in some circumstances, access lower fees.

- **Preservation and enforcement of investment philosophies.** An LLC can serve as a focal point for family members who want to be engaged in the family's investments — bringing the family together in terms of investment acumen and creating educational opportunities for spouses, children, and grandchildren. It can be a place where members can share opportunities they see and build an analytical framework around decision making.

- **Centralized and streamlined management of assets.** Managing the assets centrally can significantly reduce administration for the family. Offering documents, money flows, and taxes can all be simplified, as we show in Exhibit 4.

- **Management-succession plan.** Serving as a vehicle that lives beyond any one family member, a family LLC can create a management-succession plan for future generations.

- **Protection from outside events.** The LLC structure provides its members with liability protection, meaning that members are not personally liable for business debts, such as court judgments or legal settlements obtained against the LLC. As such, an LLC may serve to shield assets from depletion in divorces and other creditor actions.

- **Valuation discounting opportunities.** If properly structured, an LLC may provide valuation discounting opportunities for estate and gift tax planning purposes.

While many advantages exist, some drawbacks must be considered:

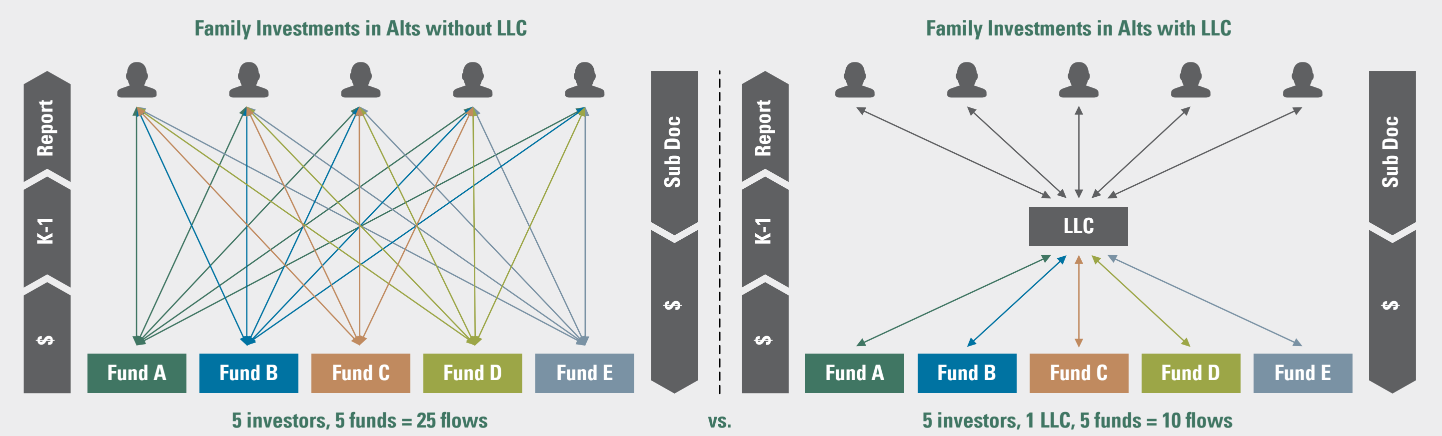
- The added complexity associated with operating an entity and the attendant administrative burdens on the members.

- The difficulty with navigating the U.S. securities law regime.

- The potential for extra IRS scrutiny if valuation discounts are taken.

Of these, the IRS's antipathy toward valuation discounts is likely the biggest concern. Alternative investments themselves (without the LLC) qualify for a certain level of discounting based on the nature and structure of the investment (i.e., investors have no control over the underlying assets, they are unable to withdraw from the

Exhibit 4: Streamlined Management Through a Family LLC



Source: Bessemer Trust

investment except under limited circumstances, and the investments themselves typically have no established secondary market in which they can be easily traded).

Wrapping such assets in an LLC may result in an even larger valuation discount because of a member's lack of control over the operations of the LLC and lack of marketability of the membership interest. This can reduce a taxpayer's taxable gift if interests are transferred during life and/or the taxpayer's taxable estate if the interests are retained until death. A business appraisal firm will be needed to determine the appropriate discount to report to the IRS. From the IRS's perspective, an abuse exists where the valuation discount is too high and does not reflect a true diminution of fair market value but only a reduction for tax purposes. The higher the discount, the more likely it is that the IRS will object.

Ultimately, planning with alternative assets requires careful consideration of the tax and securities regulations and laws. No action should be taken without first consulting experienced advisors specializing in these areas of law.

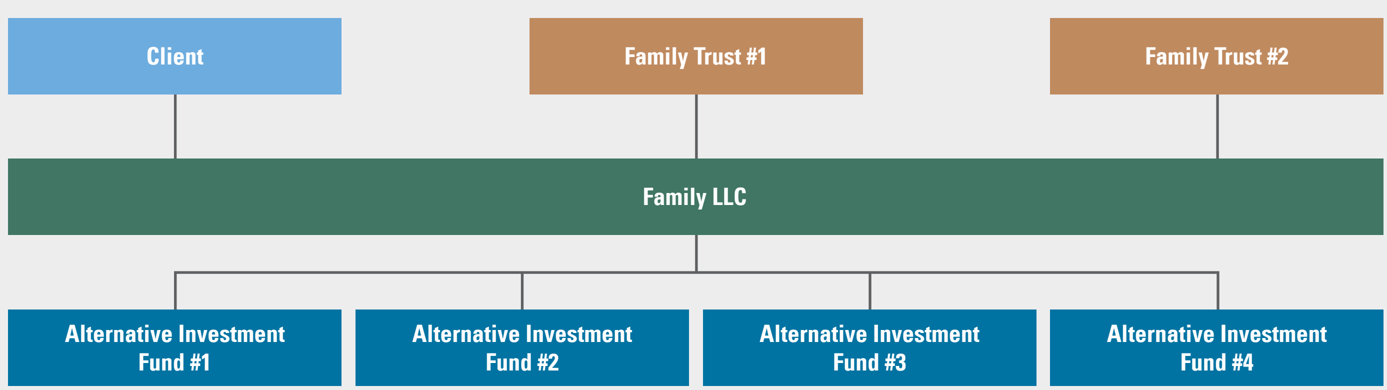
Case Study: Using an LLC

Bessemer recently worked with a Midwestern family interested in taking advantage of the benefits of alternative investments but struggling with challenges of access and administration. The first generation wanted to incorporate its own assets along with two family trusts into an investment vehicle that would (1) enable the family trusts to participate in alternative investments, (2) allow the client to control the investments of the entity, and (3) pool assets to allow for greater investment diversification. They decided to use an LLC (Exhibit 5).

The matriarch selected a portfolio of alternative investments for the LLC and managed the LLC's assets. She also managed the ongoing administration of the entity and ensured that it was run in accordance with the formalities set forth in the LLC operating agreement. The independent trustee of the family trusts also served as distribution manager of the family LLC. In this capacity, he was in charge of distributions, which were typically made in a pro rata fashion.

Once the structure was in place, the client gifted a portion of her LLC interests to the family trusts and thus retained an appraisal firm to value the interest. The resulting report showed that a 30% discount was appropriate given the lack of control and marketability of the LLC interests. While the IRS may still scrutinize this discount, the clients and family trusts have taken a number of positive steps to help insulate themselves from a possible challenge. Specifically, the clients and the family trusts had several legitimate and significant non-tax reasons for creating the LLC, and each of them received LLC interests commensurate with their initial capital contributions. Moreover, the members are adhering to the terms of the LLC's operating agreement and

Exhibit 5: Using an LLC to Hold Alternative Investments



Source: Bessemer Trust

respecting its separate legal existence. Finally, having an independent trustee act as distribution manager ensures that any strings of control with respect to distributions are held by an independent person.

Concluding Thoughts and Next Steps

Often, families amass "collections" of alternative investments, typically based on an idea they had or personal connections — sometimes resulting in hundreds of investments across multiple managers and entities, creating an administrative burden that can be overwhelming. It is important for families to work with their advisors to review and rationalize holdings, review existing managers (and if appropriate, augment or help exit some of these holdings), evaluate new managers, and make decisions on asset allocation. A family may also consider getting help in facilitating capital calls and distributions, forecasting cash flows, monitoring liquidity terms, and identifying estate planning opportunities.

If you would like to learn more about alternative investments in the context of your personal situation, please reach out to your Bessemer advisor.

About Bessemer Trust

Privately owned and independent, Bessemer Trust is a multifamily office that has served individuals and families of substantial wealth for more than 110 years. Through comprehensive investment management, wealth planning, and family office services, we help clients achieve peace of mind for generations.