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# **High-Cost Beta Masquerading as Alpha:** The Institutional Illusion of Alternative Investing and the Need to Return to Basics

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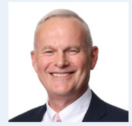
## EXECUTIVE SUMMARY:

Institutional investors have dramatically expanded their exposure to alternative investments, now allocating as much as 30–50% of total portfolios to private equity, hedge funds, real estate, infrastructure, and private credit. While these asset classes once offered genuine alpha through access to inefficiencies and niche strategies, they are now increasingly crowded, financialized, and expensive. This paper argues that much of what is currently labeled "alternative" is no longer truly alternative. Many institutional scale alternatives now deliver high-cost beta—returns driven by financial engineering and leverage—while charging alpha-level fees. For example, hedge funds returned just ~5% annually over the past 5 years (HFRI FWC), compared to a 60/40 stock-bond portfolio at approximately 7% (Vanguard estimate). Net-of-fee private equity performance, meanwhile, has hovered around ~10%. With dispersion declining and fee drag rising, institutional portfolios face a reckoning.

The solution lies in redirecting capital toward truly uncorrelated, undercapitalized strategies and smaller, niche managers. These strategies often demand more complex underwriting but offer the genuine diversification and return potential that alternatives once promised.



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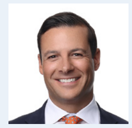

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## INTRODUCTION - THE RISE OF ALTERNATIVES:

Pension plans, endowments, and sovereign wealth funds have rapidly increased allocations to private equity, hedge funds, private credit, infrastructure, and real estate. For many institutions, "alternatives" now comprise 30–50% of total assets. The rationale has been clear:

- Public markets are saturated, short-term, and prone to crowding.
- Alternatives offer the promise of alpha and uncorrelated returns.
- Illiquidity is seen as a premium-worthy feature.

Yet this thesis is increasingly at odds with reality. Alternatives have become mainstream, institutionalized, and—to a large extent—commoditized. The alpha that once justified high fees and complex structures is disappearing, leaving behind beta in disguise.

## RETURN DECOMPOSITION: ALPHA OR LEVERAGED BETA?

As alternative strategies have matured, their return drivers have become more transparent—and less impressive.

### Hedge Funds vs. 60/40 Portfolio (5-Year Annualized)

| Strategy | 5-Year Annualized Return | Source |
|---|---|---|
| HFRI Fund Weighted Composite | ~4.9% | caia.org |
| 60/40 Stock / Bond Portfolio | ~7.0% | Vanguard |

### Private Equity Long-Term Performance

| Horizon | PE Net IRR | S&P 500 Total Return |
|---|---|---|
| 10 Years (through Q1 2018) | 10.34% | 10.20% (Cambridge Associates) |
| Calendar Year 2023 | 9.3% | Outperformed by Public Markets |

Numerous studies have shown that the majority of "excess" return in private equity and hedge funds is attributable to systematic risk premia rather than skill.

- In private equity, most outperformance relative to public markets disappears after accounting for leverage, size, and illiquidity (Harris, Jenkinson & Kaplan, 2020).
- Ludovic Phalippou (2020) has shown that net-of-fee private equity returns often underperform a leveraged small-cap public benchmark.
- Hedge fund returns, once hailed as uncorrelated alpha sources, now track closely with equity beta, credit spreads, and momentum factors.

The implication is sobering, most alternative returns are just expensive beta—amplified by leverage, hidden by opacity, and marketed as alpha.

## STRUCTURAL SATURATION: TOO MUCH CAPITAL, TOO LITTLE ALPHA.

The very success of alternatives has undermined their ability to generate excess return. With over $20 trillion now allocated globally across private markets, capital has outpaced opportunity. Consequences include:

- Entry multiples in private equity have steadily risen, compressing returns.
- Private credit faces yield compression as capital floods into the space.
- Real estate and infrastructure assets now trade like bond proxies, offering little true diversification.

## THE RECKONING: WHEN EVERYTHING IS ALTERNATIVE, NOTHING IS.

At this point, many alternative strategies have become indistinguishable from traditional investments—except in cost and complexity. Institutions are:

- Overpaying for market risk.
- Accepting opacity in lieu of volatility.
- Holding illiquid assets that underperform public benchmarks.

## THE SOLUTION: REDISCOVERING TRUE ALTERNATIVES.

To break free from the illusion of alpha, institutions must return to what made alternatives compelling in the first place: access to unique, uncorrelated, and capital-constrained opportunities. This requires several major shifts:

- Target underfinancialized, underexplored markets (e.g., farmland, lower market PE).
- Back smaller, niche managers with unique domain expertise.
- Seek uncorrelated return drivers.
- Accept complexity and operational burden.
- Redefine success away from scale.
- Prioritize operational expertise versus financial engineering and access to leverage
- Focus on sectors with demonstrable discounts and drivers for mean reversion

## CONCLUSION: TIME TO RETURN TO BASICS.

Alternative investing was born from a desire to invest differently—to find value where others weren't looking. Large institutions now hold portfolios of expensive, opaque, leveraged beta. They are paying 2-and-20 for the privilege of underper-forming public benchmarks while locking up capital and absorbing reputational risk. If institutions want to justify their fees, mandates, and risk assumptions, they must stop chasing consensus and rediscover what made alternatives worth pursuing to begin with.

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