The Rise (and Risks) of Alternatives

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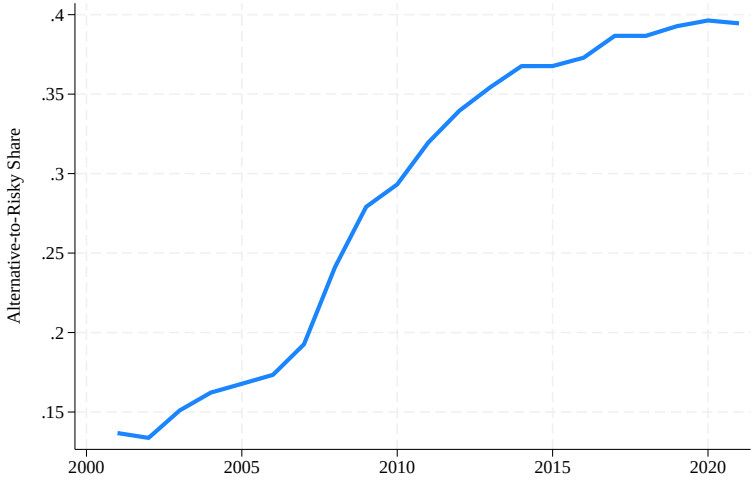
*This presentation draws on research with Danny Barth, Juliane Begenau, Pauline Liang, Phillip Monin, and Adi Sunderam. All views and interpretations are my own.

Background Facts

The way U.S. public pensions take risk has fundamentally changed

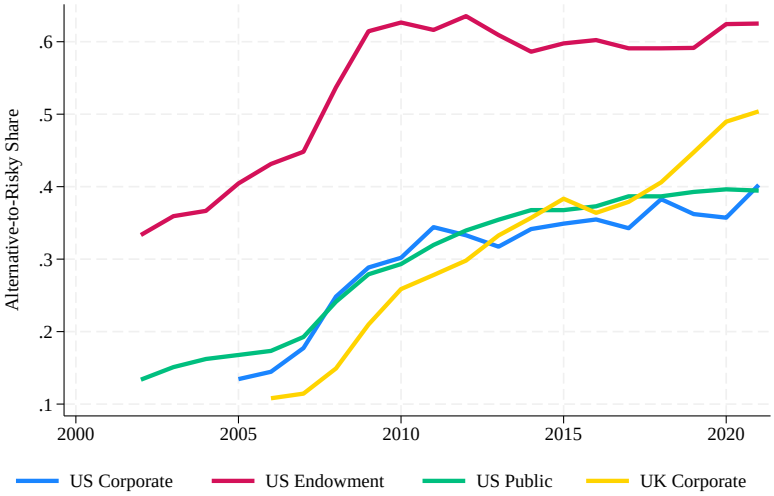
Alts = private equity/credit + real assets + hedge funds

Risky share = 1 - (fixed income + cash share)

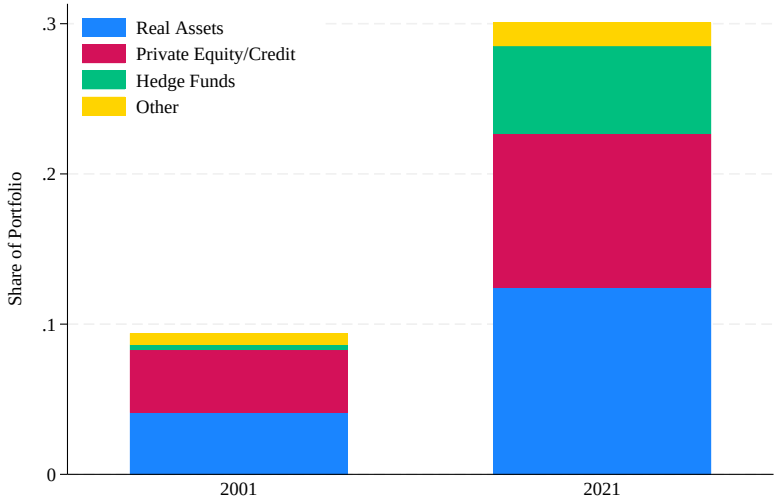


The rise of alternatives is a broader phenomenon

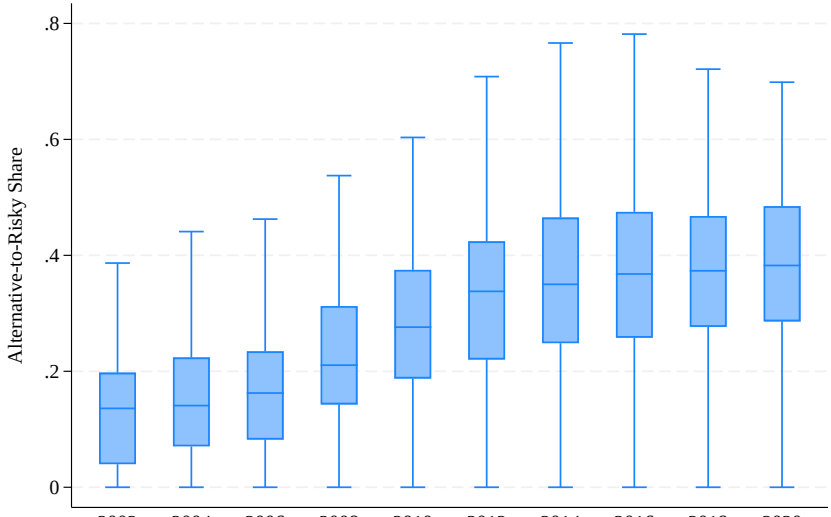
(See also Ivashina and Lerner, 2018)



Hedge funds and private capital funds are driving the shift (at least in the U.S.)



Alternative adoption in the U.S. varies widely across pensions



And many public pensions are new to alternatives

State	Share in Alternatives (%)		
	2006	2021	Change
South Carolina	0	29	29
West Virginia	0	30	30
New Jersey	1	35	34
Maine	3	55	52
Arizona	5	43	38

Today

1. What factors are behind the rise of alternatives?

2. And what risks does it potentially bring?

What drives alternative use?

Possible Explanations

1. Portfolio theory (mean-variance optimization, widely used by pensions)
   - Beliefs: pensions expect alternatives to deliver large risk-adjusted returns ("alpha")
   - Risk-seeking: pensions want more risk (e.g., reach-for-yield), but total risky share is capped (e.g., by mandate)

2. Agency frictions
   - Illiquidity and lack of market pricing obscures risk, inflating performance

3. Supply-side factors
   - Pensions may be "holding the market" as alternatives become a larger share of the economy

The Evidence (Begenau, Liang, and Siriwardane, 2025)

1. Portfolio theory
   - **Beliefs**: central driver, shaped by consultants, peers, and 1990s experience
   - Risk seeking: little empirical support

2. Agency frictions
   - May contribute to aggregate trend, but unlikely to explain cross-pension behavior

3. Supply-side factors
   - Growth of private markets alone cannot explain rise, as pensions now overweight alternatives

What are the potential risks?

Will highlight three potential risks

1. Overoptimism

2. Illiquidity

3. Opacity

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- Excessive fees (already ~7% per year)
  - U.S. pensions invest roughly $2.1 trillion in alternatives
  - 2 pp of alpha overestimation → $42 billion in excessive fees per year (~10% of payouts)

    (Assumes competitive capital supply as in Berk and Green,2004)

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Key question: how likely is it that beliefs about the alpha of alternatives are too optimistic?

Why optimism about alpha may be misplaced

1. **Hidden risk**
   - Many alternative strategies rely heavily on leverage, which mechanically adds risk
   - Illiquidity can obscure these risks (Couts et al., 2020; Stafford, 2022)
   - Agency frictions also incentivize managers to take undetectable risks (Rajan, 2005; Barth et al., 2025)

Why optimism about alpha may be misplaced

1. **Hidden risk**

2. **Improper benchmarking**
   - Example: does private credit carry credit or equity-like risks?
   - Often marketed as a credit product, but first principles suggests exposures to equities
   - Apparent alpha disappears after accounting for equity exposure (Erel et al., 2024)

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3. **Over-extrapolation (history > future)**
   - Many pensions now follow the "Yale" endowment model (alts-heavy)
   - Worked well in the 1990s-2000s, when alternatives were nascent and less competitive
   - Industry is now larger and more mature → alpha is harder to find → pensions late to the party?

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3. **Over-extrapolation (history > future)**

Overoptimistic beliefs → capital misallocation + low future returns + excessive fees

Risk #2: Illiquidity

- Private capital funds last 10+ years → capital is locked in once committed
- Pensions justify this horizon on the grounds of being long-term investors
- U.S. endowments made similar claims, but now face liquidity shocks from Trump-era policies
  - Compounded by lack of exits in private equity
  - Forced to instead sell stakes at steep discounts to raise cash
- Are pensions equipped to handle liquidity shocks with such a heavy alternatives tilt?
  - Especially given many are new to alternatives
  - And cash buffers are relatively small (2.4% of aggregate U.S. portfolio)

Risk #3: Opacity

- Contracts that govern fees and investor rights in alternative funds are complex and opaque
- In turn, pensions cannot easily evaluate or monitor the true costs of these investments (SEC, 2015)
- Begenau and Siriwardane (2024): pensions in the *same* fund often pay *different* fees
- Negotiation dynamics favor larger and more sophisticated institutions (distributional effects)

Final Thoughts

- Alternatives have become central to public pension portfolios, driven largely by beliefs about their future outperformance (Begenau et al., 2025)
- Three interrelated risks: overoptimism, illiquidity, and opacity
- Policy developments: U.S. moving toward allowing alternatives in 401(k) and other DC plans
- The risks I've highlighted are likely amplified for households

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