Seeking an Alternative

Understanding and Allocating to Alternative Investments
Summary

In this paper we look at some of the forces that may be inclining individual investors to incorporate “alternative” investments in their portfolio, and then offer some general allocation suggestions on how they may do so.

We think there are several compelling reasons why investors are considering “alts.” While the century is young we’ve already had two severe market declines, and two long, painful recoveries. The result is a world with lower growth, a good deal of uncertainty, and the feeling that traditional investment options alone may not suffice.

We believe some investors are seeking alternative investments to find yield, some for higher returns, or protection from rising rates, or a haven against market volatility—or any combination of the above. Unfortunately there’s no standard approach or “style box” to guide investors on how to reach their goals with alternative investments. We offer up a framework to address this gap.
Seeking an Alternative: Understanding and Allocating to Alternative Investments

Investor PTSD: Laboring to Forget the Turbulent “Aughts”

Let’s look at some of the realities of investing today which are driving investors to consider “alts.”

First, volatility has changed—and has changed us. During the previous decade, we had far more frequent occurrences of extreme (or “fat-tail”) moves in the equity markets, which deeply scarred most investors.

Technically speaking, a fat-tail event is three standard deviations (“three sigma”) away from the mean and has only a 0.1% probability of happening—that is, statistically it should occur only once in every 1,000 periods under analysis. But in reality these “low probability” events occur far more frequently, as they did during the 2008 credit crisis (Display 1).

The display shows that, for U.S. equities, the number of days when markets moved 3% or more reached a peak of 95 in the last decade (the tall grey bar), versus 81 episodes in the previous 50 years all together. More important, we’re still living with the emotional repercussions from that experience.

In the last several years, with the flood of central bank accommodation across developed markets acting as a kind of shock absorber, volatility has tapered off. But the real damage has been done: Investor PTSD will manifest itself for some time in the form of higher sensitivity to market volatility.

DISPLAY 1
Extreme Volatility Leaves Deep Scars

Number of 3% Daily S&P 500 Moves by Decade

Source: Standard & Poor's, Morningstar Direct through 12/31/17.
True Diversification is Harder to Come By

Another post-crisis reality is the rise in correlations across many asset classes and the resulting difficulty investors may face in truly diversifying their portfolios.

In the decade prior to the financial crisis, investors were able to diversify their equity portfolio by allocating, for example, to non-U.S. Stocks, High Yield Bonds, REITs or Commodities—most with correlations below 0.5 relative to the S&P 500 (as shown in the green bars in Display 2).

But since the crisis, correlations across these assets have risen (the blue bars). The data suggest that today only investment grade fixed income remains a compelling diversifier to equities.

But that’s cold comfort for most investors today: the role of bonds as the traditional anchor to windward for equities is shifting, as we now face the likely end of a 30-year bull market in bonds and the prospect of rates rising well into the future.

Display 2
Higher Correlations Leave Nowhere to Hide

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Correlation with S&amp;P 500</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996-2007</td>
<td></td>
</tr>
<tr>
<td>International Stocks</td>
<td>0.8</td>
</tr>
<tr>
<td>U.S. Investment Grade Bonds</td>
<td>0.9</td>
</tr>
<tr>
<td>U.S. High Yield Bonds</td>
<td>0.0</td>
</tr>
<tr>
<td>REITs</td>
<td>0.0</td>
</tr>
<tr>
<td>Commodities</td>
<td>0.0</td>
</tr>
<tr>
<td>2008-2017</td>
<td></td>
</tr>
<tr>
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<td>0.0</td>
</tr>
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<td>0.0</td>
</tr>
<tr>
<td>Commodities</td>
<td>0.0</td>
</tr>
</tbody>
</table>

Source: Morningstar Direct. For International Stocks we use MSCI ACWI ex-U.S.; for Investment Grade U.S. Bonds: Barclays U.S. Agg Bond TR; for U.S. High Yield Bonds: Credit Suisse HY; for REITS: FTSE NAREIT; for Commodities: S&P GSCI TR; Index Definitions provided at the end of this presentation.

Bond Bull Market: A Thing of the Past?

Investors have long understood fixed income’s primary role as a diversifier to equities. But they have also grown to expect from their bond allocation a robust source of return for the portfolio as well—historically a rare combination (Display 3).

Over the last several years they’ve had to unlearn this second benefit, with rates near zero and investors starved for yield. Moreover, with rates on the rise, many of these investors may begin to suffer through the first-ever extended period of losses in their bond holdings.

As the longer history of the 10-Year Treasury yield shows, bonds may not always be a support to total return. And based on forecasts, if there is one thing tomorrow’s investors will need, it may be a boost in returns for their overall portfolio.

Most analysts agree that equity returns in the U.S. may be constrained by slower growth in the economy going forward.

A common way to generate this type of forecast is to look at the equity risk premium based on three underlying components: a reasonable discount rate (Treasuries), overall economic...
Performance Headwinds Ahead

growth (GDP), and the valuation dynamics (price-to-earnings ratio) of equities (Display 4). All three of those measures—low current yield, tepid economic growth, and relatively high equity valuations—suggest anemic returns for equity markets ahead. It’s no surprise then that some analysts see lower returns over the next several years—with U.S. equities projected to earn a nominal return of 3% and a combined 60/40 stock/bond portfolio returning just over 2.5% over the next 5 years.¹

Alternatives as Complements to Traditional Strategies

But first a problem of definition: A common mistake investors make is to treat alternative investments as a homogeneous category. The reality is alternatives are not a single asset class. Alternatives include an array of assets, strategies, and structures and should not be construed as some monolithic investment or a single slice in the allocation pie.

That said, alternatives do share some characteristics that may position them as potential complements to traditional investments (Display 5). For example, traditional investments are typically very liquid, can be accessed easily and often at low cost: They provide passive shareholders with efficient exposure to “beta” or “the market.”

Alternatives offer different attributes. Instead of simply replicating the market, managers are less constrained, are often activist in their approach, and their performance tends to vary substantially. As a result, returns tend to be less correlated to the beta of traditional market investments and are more dependent on the individual manager’s skill.

Alternative managers can also use additional tools, including leverage and shorting, and have the benefit of less liquid capital, which they can deploy at will and without having to be as concerned that investors will run for the exits before their investment theses play out.

Essentially, it’s about some informational or trading advantage—a manager’s particular edge—that gives these strategies their unique and attractive characteristics.

Display 4
Economic Backdrop Suggests Anemic Future Returns

<table>
<thead>
<tr>
<th>1985-2007</th>
<th>2008-2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. GDP Growth</td>
<td>Valuations Rising</td>
</tr>
<tr>
<td>3.2%</td>
<td>6.5%</td>
</tr>
<tr>
<td>1.4%</td>
<td>2.6%</td>
</tr>
<tr>
<td>1.4%</td>
<td>2.6%</td>
</tr>
<tr>
<td>Interest Rates Falling</td>
<td>S&amp;P 500 Price / Earnings Ratio</td>
</tr>
<tr>
<td>21.4</td>
<td>26.6</td>
</tr>
</tbody>
</table>

Source: Morningstar Direct, as of 12/31/2017. Index definitions are provided at the end of this paper.

¹ The quoted returns represent asset class forecasts as estimated by Goldman Sachs (Investment Strategy Group: Outlook, January 2018). Goldman Sachs forecasted a 5-year nominal return for U.S. Equities, as measured by the S&P 500 at 3.0%. Their 5-year forecast for Municipal Bonds was a nominal return of 2.0%. In line with these forecasts, a 60/40 Portfolio of U.S. Equities and Municipal Bonds has a 5-year forecasted nominal return of 2.6%. There can be no assurance that any alternative asset class will achieve its objectives or avoid significant losses. There can be no assurance that the forecasts will be achieved. These comparisons are provided for informational purposes only and should not be relied upon as a benchmark or target for any index or Blackstone fund. There is no assurance that an allocation to alternatives would provide higher real returns. Please consult your own third-party advisors before making any investment decisions based on this information.
A Divergence in Alternative Allocations

Institutional investors in general, including pensions, endowments, and sovereign wealth funds, have increasingly used alternatives to help achieve their target returns. Endowments, for example, with their longer investment horizon and thus greater tolerance for illiquidity, have allocated aggressively to alternatives, with 52% of their portfolios on an asset-weighted basis now given over to hedge funds, private equity, and private real estate. Meanwhile, pensions today have on average 28% of their portfolios allocated to alternatives (Display 6).

By comparison, individual investors continue to allocate substantially less of their portfolios to alternatives. Some believe that’s about to change, with individual investors embarking on an allocation shift akin to the one institutions have made over the last 5-10 years. But for that to happen, investors and advisors need to overcome a key impediment: their awareness of and comfort with alternative investments.

Lack of “Alts” Education a Key Impediment

While investors and advisors alike are expressing greater interest in alternatives, considerable confusion remains about the specific nature of alternatives—particularly for individual investors. A recent study looked at the reasons advisors and institutions might hesitate to invest in alternatives. The study found that in one category—education—there was a clear gap between advisors and institutions (Display 7). Individuals (and their advisors) are far more likely to hesitate putting money into an alternative investment due to a feeling of uncertainty around the benefits of alternatives, and a lack of clarity on how specific strategies “work” in the portfolio. In part this is an industry failing. By labeling these offerings “alternatives” we make them seem more different than they actually are and may over-complicate them in the process. This argues for the need to clarify (and simplify) how we think and talk about “alts.”
Integrating Alternatives into the Traditional Portfolio

One way to describe the relationship between traditional and alternative investing is to consider the “barbelling” of investment value, with liquid “public market” exposure on one end and alternatives on the other (Display 8).

First, on the left side, traditional investment vehicles allow liquid, tax-efficient access to precise slices of market beta. With equities, investors can easily access U.S. market exposure, large or small, and with a growth or value orientation. Similarly, with fixed income and real assets, investors can cobble together precise exposures across the major “buckets” of the asset allocation. Each of these component allocations solves a particular investment problem or targets a particular goal.

On the other side, we think investors need to look beyond the “Alternative” monolith and consider aligning individual alternative strategies with their appropriate asset class categories.

For example, if an investor is looking to achieve a higher equity-like return target, he might consider growth-oriented private equity, typically known as Venture Capital, or value-oriented private equity, more associated with traditional PE or Leveraged Buyout funds. For a more liquid solution, there’s long/short equity, which investors may employ as a more efficient substitute for some of their long-only equity allocation.

Next, take a look at the traditional fixed income allocation, ranging from sovereign and investment grade bonds to high yield and emerging debt. In the face of current low yields and the potential vulnerabilities of their traditional fixed income portfolio, investors might look to incorporate strategies that have higher yield or that mitigate the portfolio’s exposure to rising rates. They might consider event-driven credit hedge funds, with very low correlation to the rest of their portfolio, or the higher yielding opportunities offered by mezzanine and distressed debt, which also tend to do well in periods of rising rates and higher inflation.

Finally, there’s the real asset category, including real estate and commodity-oriented investments. Again, for their alternative complements, investors might look to private real estate, private energy funds, or Commodity Trading Advisors (CTAs) for potentially diversified (and diversifying) real asset exposures.

Seen this way, there’s substantial variety under the hood of the singular category of “alternatives.” But with this framework in mind, and using an approach familiar from their work with traditional investments, advisors may begin to build out a comprehensive and more precisely calibrated alternative allocation for their clients.

“Investors need to consider individual alternative strategies alongside their traditional asset class siblings—and allocate to them accordingly.”
**The Specific Benefits (and Risks) of Alternatives**

If investors begin to look at alternatives using this simplified, goal-oriented approach, they may seek out targeted exposures to deliver on the specific benefits that alternatives offer (Display 9).

For example, if an investor is keen to achieve equity-like growth while maintaining spending power, and he can tolerate some illiquidity, he may consider Private Real Estate and Energy funds. If he is looking to maintain his current allocation to equities but wants to diversify that exposure and reduce the risk of severe declines, then long/short equity hedge funds may be appropriate.

In the Alternative Fixed Income category, an advisor looking to mitigate the risk of rising rates could seek to diversify the traditional bond allocation with exposures to event-driven credit or commercial real estate debt. And so on across the matrix below.

Of course, these benefits come with corresponding risks, some alluded to earlier, which can include illiquidity, lack of transparency, higher fees, tax inefficiencies, and other characteristics that some individual investors would prefer to avoid.

But by focusing on the specific objective they are trying to achieve, investors can make more informed and targeted allocations to what many generically label “Alternative Investments.”

It may help to step back for a moment and see the broad impact of a comprehensive re-allocation to alternatives.

### Display 9
**Alternatives May Solve for Specific Investor Objectives**

<table>
<thead>
<tr>
<th>STRATEGY</th>
<th>DISTRIBUTION</th>
<th>POTENTIAL RETURN</th>
<th>POTENTIAL RISK</th>
<th>LIQUIDITY</th>
<th>DIVERSIFICATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alternative Equities</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long/Short Equity</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private Equity</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private Equity Sec</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Alternative Fixed Income</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Event-Driven Credit</td>
<td>X</td>
<td></td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Mezzanine &amp; Distressed Debt</td>
<td>X</td>
<td></td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Commercial Real Estate Debt</td>
<td>X</td>
<td></td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Alternative Real Assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private Real Estate</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private Energy</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Managed Futures/CTAs</td>
<td>X</td>
<td></td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
</tbody>
</table>

Please see disclaimers at the end of this presentation for additional information on the views expressed herein.

**Alternatives Can Make an Impact**

Display 10 below offers a generalized view of the benefits achieved by adding a diversified mix of alternatives to different traditional portfolios comprised of just equity and fixed income.

Starting from the bottom left, on the red line, we plot a “low risk” portfolio of 80% bonds and 20% stocks. On the same line to the right we illustrate the inverse of that portfolio, 80% stocks and 20% bonds—an example of an investor with higher risk tolerance.

The blue line illustrates the same portfolio with a 20% allocation to alternatives, broken up equally across Private Equity, Distressed Debt, Real Estate and Hedge Funds. The result here, for both lower- and higher-risk investors, is a reduction in risk and increase in return for the portfolio. But it’s one thing to build the allocation into an efficient frontier chart and quite another to actually incorporate these investments in a client’s portfolio, especially given the illiquid or episodic nature of private market funds.

**Display 10**
**Alternatives May Help Improve the Efficient Frontier**

![Efficient Frontier Chart](chart.png)

The chart above illustrates the potential benefits of adding alternative investments to traditional portfolios. The blue line represents a portfolio with a 20% allocation to alternatives, which shows a significant improvement in risk-adjusted returns compared to the red line, which represents a traditional portfolio.

**Notes:**
- The chart compares a 20-year investing period from 1/1/98 through 12/31/17.
- There can be no assurance that an allocation to alternatives would provide higher real returns. Please consult your own third-party advisor before making any investment decisions based on this information.
- Past performance is not necessarily indicative of future results and there is no assurance that any index or fund will achieve comparable results or avoid substantial losses.
- The performance information presented above is that of the identified market indices and funds, which may not be available for investment by any prospective investor. The stated indices are for informational purposes only and not available for investment.
- The data is based on historical performance of major alternative asset classes: Private Equity, Distressed Debt, Real Estate and Hedge Funds.
- The chart uses the Morningstar Direct indices as a proxy for traditional assets given these indices are typically used by the market. 20% Alternative Investments comprised of: 5% Private Equity, 5% Real Estate (Cambridge REI), 5% Distressed (HFRI Distressed Restructuring), 5% HFRI Fund Composite. This mix was used to capture alternative investments broadly across the major alternative asset classes: Private Equity, Private Real Estate, Distressed Debt, and Distressed Credit Funds.
Building a Comprehensive Alternatives Allocation

There is no simple approach to building a comprehensive, diversified allocation to alternative investments—one that considers investors’ distinct liquidity, return goals, and varied time horizons. But we’ve developed a framework that may help.

We return to the asset class breakdown discussed earlier—identifying the alternative “complements” to traditional asset classes. We then go on to break the alternative strategies into more liquid, continuously offered solutions and less liquid, episodic funds (Display 11).

Those funds available in more liquid structures tend to include quasi-public hedge fund services, in areas like long/short equity, event-driven credit, and liquid real estate debt. Less liquid, private market funds focused on buyouts, private real estate, or distressed debt may take more time to achieve the desired allocation, due to the timing of their fund-raising and an uncertain pace of investment.

In this way, by allocating across the major alternative asset categories in both liquid and less liquid vehicles, advisors and investors may establish and maintain a comprehensive and strategic exposure to alternatives to complement their traditional allocation.

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Glossary

Index Definitions

Alpha: Alpha is a measure of the return due to active management, rather than market exposure, or beta. It is often used to refer to the value added by a manager's skill.

Alternative Investments: Investment categories other than traditional securities or long-only stock and bond portfolios; they include hedge funds, venture capital, private equity, and real estate. Alternative investments often employ strategies typically unavailable to long-only managers, such as the use of derivatives, the ability to short, and the ability to hold illiquid assets.

Beta: Beta is a measure of the sensitivity of a security or portfolio to broad market movements. The beta of the market index is 1.0. A security with a beta of greater than 1.0 tends to rise or fall more than the market, a security with a beta of less than 1.0 tends to rise or fall less than the market. The term “beta” can also indicate the portion of portfolio returns that result from market exposure, rather than from manager strategies or skill (alpha).

Correlation: A measure of how the returns of two or more assets perform in relation to one another. Assets with a correlation of 0.0 move in lock step. Those with a correlation of 0.9 have a random relationship to each other.

Hedge Fund: A private investment portfolio that uses non-traditional techniques (such as short sales and leverage) to preserve and/or generate capital. Hedge funds are generally considered part of the alternative investments asset class. In many jurisdictions, they are more loosely regulated than long-only portfolios and are restricted to larger or more sophisticated investors.

Illiquid Alternatives: Investments that invest in illiquid assets and offer limited liquidity to investors. Many illiquid alternatives require investors to make capital commitments over several years that cannot be redeemed in the short term. Illiquid alternatives can include venture capital, private equity, and direct real estate.

Private Equity: A type of investment that seeks return by acquiring companies and restructuring them, with the goal of improving or realizing value. The companies are sold at the conclusion of their restructurings. Private equity investors are illiquid and, by definition, are not publicly traded.

Standard Deviation: Standard deviation is applied to assets or asset categories to calculate the risk associated with those assets or categories. It is a measure of the historical volatility of investment returns. The higher the standard deviation, the greater the risk.

Volatility of returns; Restrictions on transferring interests in a fund; Potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized; Note: Certain of these risks may include:

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Standard & Poor's 500 Index: The S&P 500 index was created in 1976, although it has been extrapolated backwards to several decades earlier for performance comparison purposes. This index provides a broad snapshot of the overall U.S. equity market; in fact, over 70% of all U.S. equity is tracked by the S&P 500. The index selects its companies based upon their market size, liquidity, and sector.

Restructuring Strategies employ an investment process focused on corporate fund fixed income instruments, primarily on corporate credit instruments trading at significant discounts to their value at issuance or obligor (par value) at maturity as a result of either formal bankruptcy proceedings or financial market perception of near-term proceedings. Managers are typically actively involved with the management of these companies, frequently involved on creditors' committees in negotiating the exchange of securities for alternative obligations, either swaps of debt, equity, or hybrid securities. Managers employ fundamental credit processes focused on valuation and asset coverage of securities of distressed firms; in most cases portfolio exposures are concentrated in instruments that are publicly traded, in some cases actively, and in others under reduced liquidity, but in general for which a reasonable public market exists. In contrast to Special Situations, distressed strategies typically employ primarily debt (greater than 65%) but also may maintain related equity exposures.

Cautions

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Notes and Disclaimers

The FTSE NAREIT is an adjusted, capitalization-weighted index of U.S. equity real estate investment trusts (REITs). A measure of how the returns of two or more assets perform in relation to one another. Assets with a correlation of 0.9 move in lock step. Those with a correlation of 0.0 have a random relationship to each other.

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