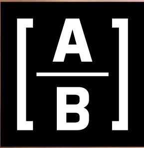


BERNSTEIN

When There Is No Alternative

Optimal Allocation

Executive Summary

- Incorporating alternative (or "private") asset classes in your asset allocation can be a challenging endeavor. But the potential enhancements these assets bring suggest that the extra effort is worthwhile.
- Is now the time for private assets? The secular macroeconomic and geopolitical backdrop suggests that investors may need to position for a different environment in the coming decades compared to the past. Plus, the evolution of capital markets over the past thirty years has shifted much of the demand for capital to private markets, offering lucrative reward potential to those willing to embrace illiquidity.
- Many of the most compelling opportunities in today's market—and indeed, for much of the past few years—have been found in private markets.
- Despite sharing many of the same underlying economic exposures as their public counterparts, private equity and private debt markets offer a distinct profile when it comes to risk and reward potential. They are not just public assets in a different wrapper and cannot be treated as such in an asset allocation.
- Private markets add complexity when it comes to liquidity and cash management, but this can be navigated methodically. Most investors will find that the benefits of private assets outweigh the challenges.
- The advantages of private assets can be further amplified by structuring holdings in a tax-efficient manner. Certain types of private assets, such as private credit, are most effective when held in specific structures.

At Bernstein Private Wealth Management, our collaborative culture is ingrained in the cutting-edge research that defines our brand. Both our investment and wealth strategists partnered to develop the innovative wealth management perspectives and solutions detailed in this white paper.

If asset allocation is as straightforward as it sounds, why do so many investors' portfolios contain odd positions that don't seem to fit with their stated goals? While many investors have found successful strategies for traditional asset classes, the challenges intensify when adding exposure to alternative assets (or as we call them, "private assets"). In the realm of private assets, having a cohesive strategy is crucial. We believe that incorporating a thoughtful structure for both public and private assets in your portfolio can help ensure it aligns with your true financial objectives.

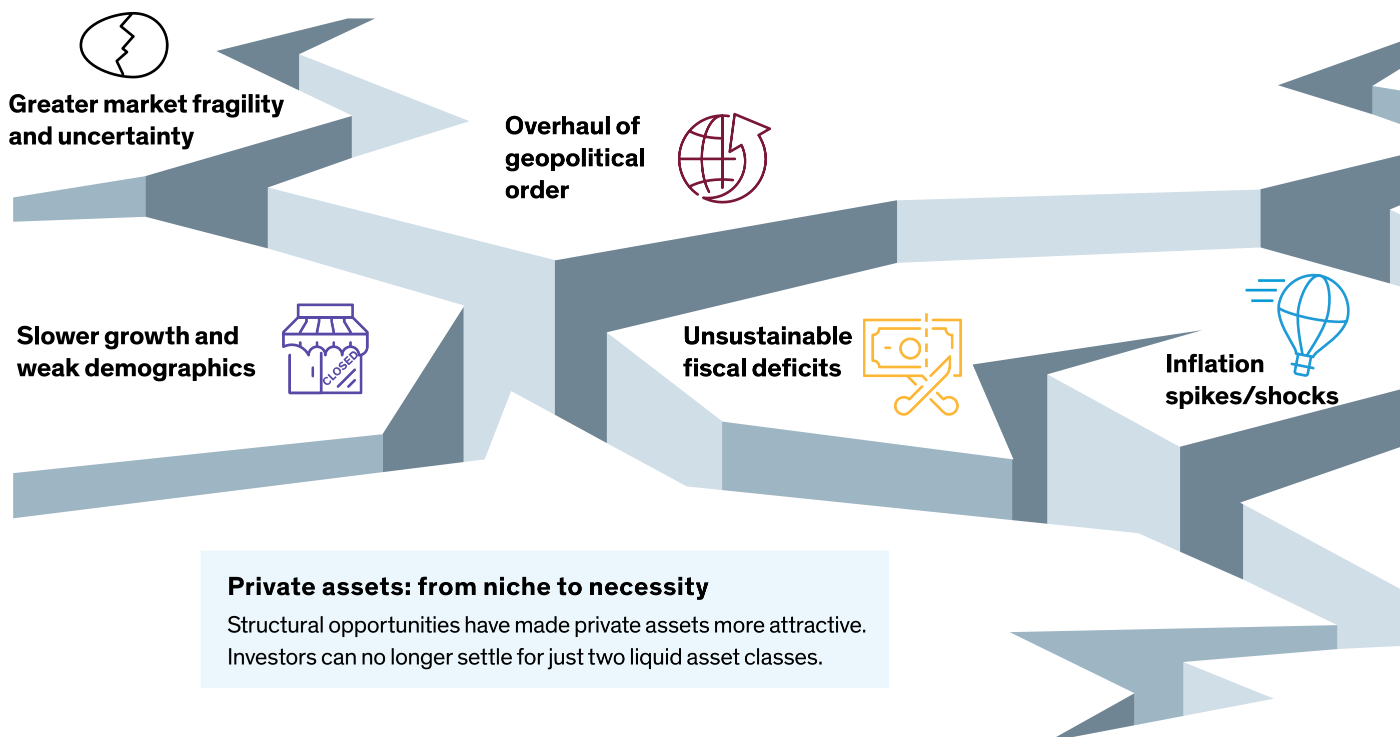
A Brave New World in Risk, Opportunity…and Uncertainty

Most investors who came of age in the past few decades have grown accustomed to a favorable economic backdrop, occasionally interrupted by brief crises, with sharp interest rate cuts to counteract downturns. As some have described it, since the 1980s, we've all enjoyed the "Volcker inheritance"—a mainly positive macroeconomic environment and the ability to implement stimulative policies without immediate repercussions. While we believe that world remains intact for now, it is more fragile today than at any point in the decades leading up to the pandemic.

Inflation expectations have eased back to normal levels following a post-pandemic surge, yet they still appear more susceptible to shocks due to the recent spike. Fiscal deficits have been accumulating for years in the developed world without triggering major crises, but they could signal potential problems in the years ahead. Weak demographics are setting the stage for slower growth. And the global geopolitical order may be on the brink of its greatest overhaul since the late 1980s. All these factors raise the risk that the next decade may be markedly different than the ones that shaped investors' formative experiences (*Display 1*). Shouldn't portfolio positioning adapt accordingly?

The next decade may be markedly different. Shouldn't portfolio positioning adapt accordingly?"

DISPLAY 1: AMID SEISMIC SHIFTS, SHOULDN'T YOUR PORTFOLIO CHANGE TOO?



For illustrative purpose only.

Source: Bernstein analysis

The shift to a more uncertain world has made diversification imperative. While bond yields have thankfully risen compared to the decade before the pandemic, they still fall short of driving meaningful portfolio growth. What's more—though not our baseline—there's an increased risk that bond yields rise from here, due to inflationary and other pressures, which could diminish their appeal. Meanwhile, our projected long-term returns for stocks are somewhat higher than those for bonds. But they still lag significantly behind their historical levels and offer relatively little in the way of incremental compensation for added volatility.

In addition, with the top 10 stocks currently accounting for roughly 35% of the S&P 500, investors may need to look beyond public equities to achieve proper diversification and avoid excessive risk from any single name or theme.

To achieve their financial goals, those who limit themselves to liquid asset classes may find themselves forced to take on more risk than they'd like. Such positioning could lead to nagging discomfort or costly mistakes down the line. In contrast, investors who expand their universe to more fully tap into private markets are more likely to stay on track with their financial goals, even during downturns.

Structural changes in today's market have also unlocked significant opportunities across the private investment landscape. The post-pandemic rise in interest rates has created a liquidity crunch, with substantial upside potential for liquidity providers. Private lenders can thrive in this tight lending environment. What's more, real estate valuations have plummeted, with a fair number of stressed capital structures presenting attractive openings for those with fresh capital. And the recent lack of private equity exits has further stoked the high demand for liquidity, favoring patient capital. Investors who can handle illiquidity are primed to seize attractive long-term opportunities. And many more can manage it than they realize.

Many investors, especially large institutions, are already well down this path. Meanwhile, ultra-high-net-worth investors are often just starting out. How do we bridge this gap?

Setting the Base with Liquid Assets

Before delving deeper into the private assets that seem well suited for the current market, let's briefly review how we think about the components of a portfolio. This will also help explain why we consider private assets at a later stage in the process compared to liquid assets.

Ultimately, most investors aim to grow their wealth over time or gradually minimize its decline as they spend down their portfolio. To achieve this, we spend considerable time understanding what drives an investor's financial goals and needs, their investment horizon, and potential ways to minimize their portfolio's tax drag (for more on these, see Investor Considerations, page 3).

With that in mind, we explore all available return streams, aiming to combine them to best meet an investor's goals. These returns are primarily the byproduct of economic activity—which is why understanding the macroeconomic backdrop, government policies, corporate fundamentals, and household finances can enhance reward potential.

By understanding the waves rippling through the world, how they may break across specific sectors or firms, and strategically positioning within the capital structure (or using derivatives), investors can capitalize on key trends or protect against major risks. While each investment firm approaches this in its own way, over the years, we've structured ourselves to offer a carefully curated selection of strategies designed to help investors achieve their goals. Our choices are rooted in the areas and drivers where we have the highest conviction. And the managers we appoint to handle specific stocks, bonds, and other assets share that research-driven lifeblood as they pursue enhanced returns beyond what the market typically offers.

Importantly, some of the return streams we consider are found in public markets, while others are exclusive to private markets. Though the macroeconomic and fundamental risks are consistent in both, the distinction between public and private markets becomes crucial at the investor level.

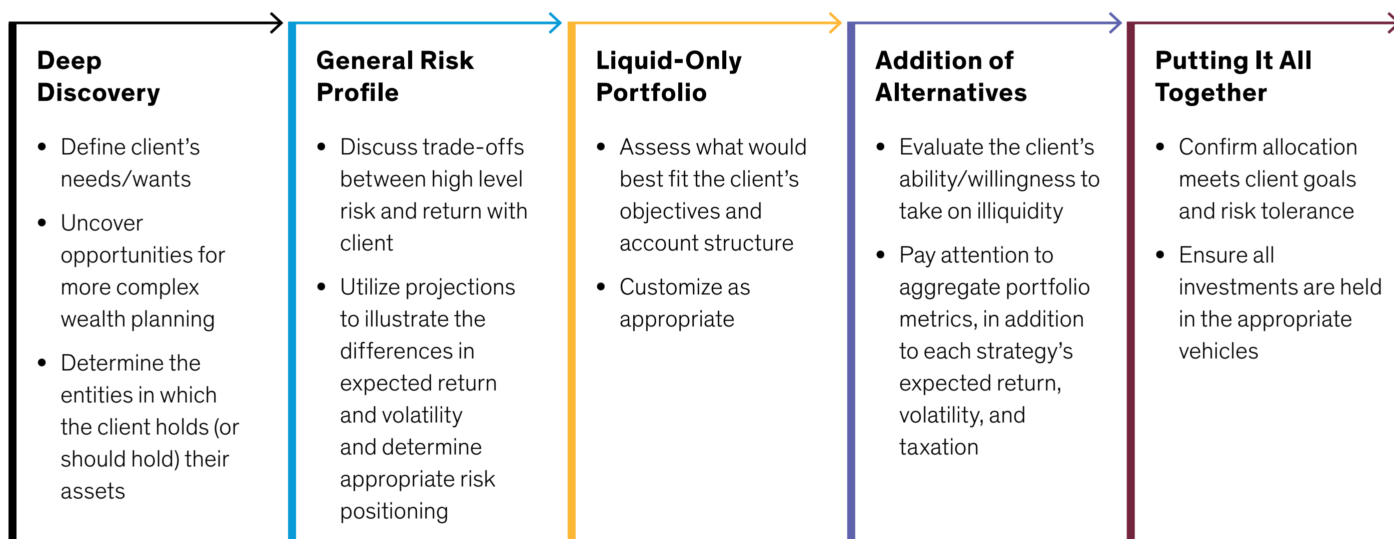
What do we mean by this? A chain of hospitals, restaurants, or stores faces the same risks to its equity cash flows whether its shares trade publicly or privately. The same applies to technology or defense

Investors who can handle illiquidity are primed to seize attractive long-term opportunities. And many more can manage it than they realize."

companies—the business and cash flow risks aren't changed by their listing status. What differs is the level of liquidity available to investors and the regulatory framework governing the holdings, which shapes the balance of supply and demand for capital in that sector. Even among publicly traded firms, many small- or mid-cap companies offer limited liquidity for investors looking to buy or sell significant stakes.

The differing balance of supply and demand for capital can impact potential risk-adjusted returns, often making private assets more favorable than public ones. Yet in our investment process, certain opportunities in private markets are only suitable for or accessible to specific investors or accounts. Because of this, we find it beneficial to set a portfolio baseline using liquid assets, and then enhance it using a mix of private assets tailored to the individual investor (*Display 2*).

DISPLAY 2: A ROADMAP TO AN ALLOCATION



Investor Considerations: Understanding an Investor's "Why"

With so many return streams available, how do we find the right combination for each investor?

Our first priority is to uncover the full spectrum of a client's values and personal situation. This information allows us to define the investment objective and map out their portfolio's key characteristics, including risk and return parameters, liquidity considerations, personal risk tolerance, and other constraints like taxes. Think of this as the "engineering" side when optimizing a portfolio.

While growing the pool of capital is often central to an investor's financial goals, true financial success lies in aligning wealth with values. When a financial plan is rooted in values, wealth becomes a means to foster intergenerational unity and purpose, rather than being an end in itself. These core values will determine who benefits from the family's wealth, to what extent, and when.

For instance, a family that values altruism may dedicate a sizable portion of their wealth to lifelong philanthropic endeavors.

Conversely, families with a legacy-minded approach, valuing self-determination and innovation, may prioritize intergenerational wealth transfer and tax minimization. While this may seem unrelated to designing an asset allocation strategy, understanding the specific stakeholders and entities involved in a family's financial plan becomes vital as the allocation process unfolds.

Understanding the specific stakeholders and entities involved in a family's financial plan becomes vital as the asset allocation process unfolds."

Investor Considerations: Managing Specific Risks

The early steps in our allocation process tend to reveal sensitivities to various risks that we may need to deliberately manage. Two of the most important considerations are inflation and growth shocks.

Equities represent claims on the factors of production—both real assets and labor. While that doesn't give them absolute pricing power, they still serve as potent inflation hedges. The more a portfolio skews towards equities, the less worrisome inflation should be. Similarly, investors in the early stage of their career—with the potential for real (after-inflation) income growth—are likely to be less sensitive to inflation. On the other hand, consider a retired investor who relies on their portfolio and holds a sizable portion in nominal bonds. That investor may derive an outsized benefit from adding inflation protection.

One of the greatest fears for most investors is a growth shock—a recession or depression. Much of our asset class balancing focuses on mitigating this risk, as it arises regularly and often leads to the largest drawdowns, disrupting portfolios, especially for those spending from them. Yet beyond a balanced portfolio's natural diversification and risk management, there are additional strategies to provide a buffer during deeper drawdowns, which are more likely to prompt panicked selling. These include tactical trading (whether systematic or discretionary), strategic overweights to duration (interest rate sensitivity, which benefits from falling rates) and volatility, along with options strategies.

Differences in Risk Exposures

While public and private markets may share some common economic or sector risks, their overall risk exposures are distinct. This difference stems from the unique constituencies they serve—companies seeking capital in the private markets are not the same as those in public markets, and the investors in these arenas, though sometimes overlapping, also differ. What's more, capital flows between the markets tend to take time, allowing imbalances to persist for extended periods.

In the past, companies above a certain size struggled to secure sufficient capital from private equity or debt markets and were compelled to offer their securities publicly for significant capital raises. Yet, as private markets have evolved in recent decades, this is increasingly no longer the case. Today, private market investors can underwrite substantial capital raises, making private markets more essential than ever. As a result, more major companies and entities are opting to keep their financing within the private markets.

Nonetheless, size differences remain. When we compare private equity and private credit markets to their public equivalents, we find that private markets tend to skew toward smaller companies. What's more, the sector mix in private markets better represents the real economy compared to what we see in public markets.

Diving further into the realm of private markets, several asset classes stand out for their notable differences in risk exposures:

For instance, **private equity** often involves higher debt loads than you'd see in public markets, primarily due to the prevalence of leveraged buyouts. At the same time, **private credit** departs notably from liquid credit in ways that can prove quite meaningful in certain economic environments. That's because unlike bonds, which have a fixed interest payment, private credit tends to consist of loans with floating interest rates. This can prove beneficial when rates rise.

From a risk exposure standpoint, **real estate** is better viewed as a sector than an asset class. It encompasses a wide range of geographies, quality levels, and subsectors, including single family residential, multi-family residential, office, datacenters, storage, or logistics. Investors can access real estate through both public and private markets, with much of the world's real estate held privately. And, like other corporate cash flows, real estate can be divided into equity and debt claims in their respective markets. Essentially, the return and risk exposures are more influenced by the underlying asset cash flows and the capital structure than by whether the investment is public or private. It's also worth noting that wealthy investors sometimes opt to invest directly in real estate rather than through a diversified fund. This approach can add significant idiosyncratic risk to their portfolios—for better or for worse.

Alternative/private markets also include **hedge funds and other strategies** that are less correlated or uncorrelated to traditional markets. While these strategies may invest in liquid markets, their private structure and the liquidity and regulatory frameworks they operate under align them more closely with private markets.

One final overarching distinction exists between public and private assets. In public markets, investors usually have efficient ways to gain passive exposure. However, by their very nature, private markets require investors to either invest directly—relying on their own expertise—or through an active manager.

Relatedly, while manager selection is important in public markets, it's absolutely critical in private markets. Because investors usually need to invest through a manager—and performance can vary dramatically from the top quartile to the bottom quartile—manager selection becomes even more essential when investing in private markets.

Ultimately, private assets' risks and returns are largely driven by the same common factors as those in liquid markets. Yet due to liquidity, regulatory, and implementation challenges, it's useful to treat them separately. Private assets should be considered distinct from public assets in terms of risk-adjusted returns, managers' ability to add value, and their role in a portfolio. This distinction arises from their regulatory segregation and the inherent dynamics in supply and demand for capital in private markets compared to public markets.

While manager selection is important in public markets, it's absolutely critical in private markets."

Optimizing Cash Management with Private Assets

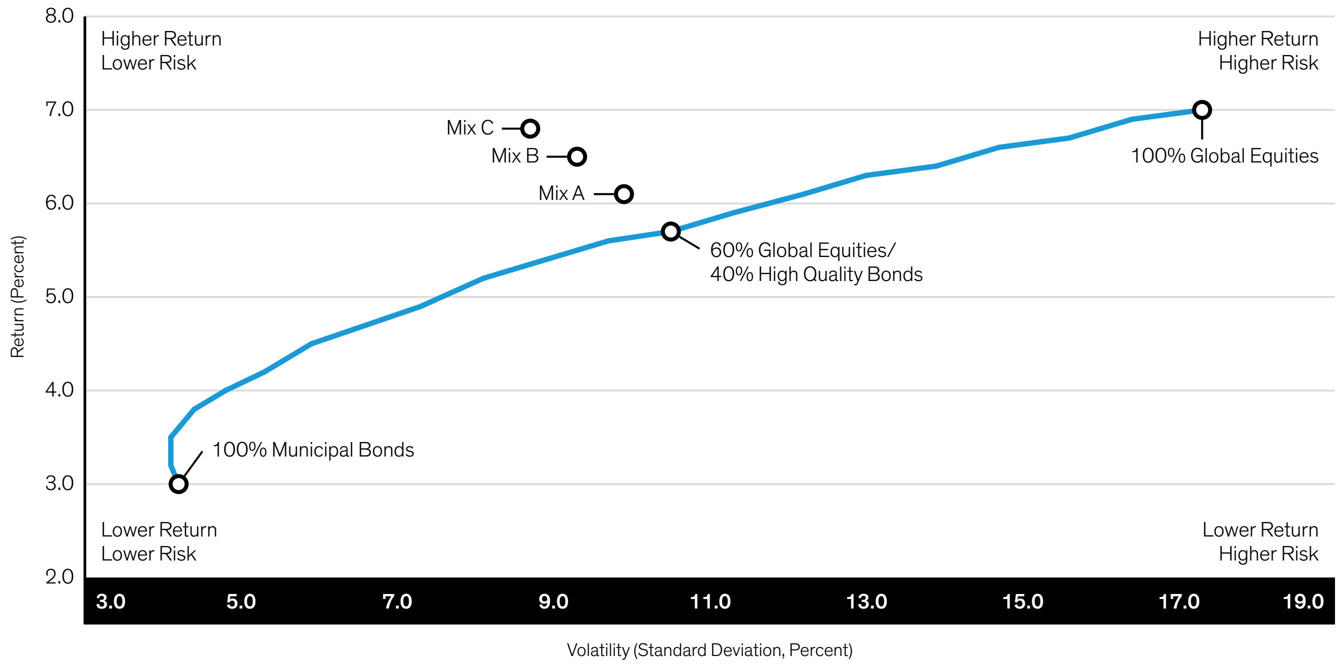
Our capital markets forecasts suggest that adding private assets to portfolios can enhance risk-adjusted returns and, for most investors, boost total returns as well (*Display 3,* page 6). However, they also introduce complexity when it comes to portfolio management.

In particular, three cash-related considerations deserve attention:

1. **Liquidity constraints**: Most private asset strategies lack daily liquidity. Some may offer liquidity on a weekly, monthly, or quarterly basis, while others may lock capital up for years.
2. **Vintage diversification**: Strategies like private equity, which require vintage diversification, involve allocations over the course of multiple fundraising years to reach target levels. In addition, private equity and other strategies may never actually require 100% funding of capital commitments, as they often begin distributing capital in their middle years, while still making new investments. This is also common in real estate equity, direct lending, and secondaries strategies.
3. **Capital calls**: Most private strategies do not call and invest all the committed capital at once. Instead, investors must contribute capital as the fund manager finds attractive investment opportunities. Since investors must manage their interim cash, funding accounts can help ensure cash is effectively allocated until called.

Given these nuances, funding accounts must strike a balance between minimizing shortfall risk and maximizing interim returns. Holding cash in a money market fund is a conservative approach, but it sacrifices long-term market returns and may even deliver a negative yield in an inflationary environment. For longer-term funding, diversified fixed income or equity exposures can enhance returns, often using passive vehicles for efficiency. We typically recommend avoiding the sale of highly appreciated assets to fund accounts, as this can incur significant tax liabilities. Instead, for some investors, margin loans may prove more advantageous than asset sales.

DISPLAY 3: ADDING PRIVATE ASSETS CAN INCREASE RETURNS AND LOWER VOLATILITY



	Return (%)	Volatility (%)
Mix A	6.1	9.9
Mix B	6.5	9.3
Mix C	6.8	8.7

Forward-looking 10-year projections. This is not a guarantee of future returns or risk. Based on Bernstein's Capital Market Engine as of December 31, 2024. Municipal Bonds are modeled as Barclays Municipal Index Inter-Short (1-10). Global Equities are modeled as MSCI AC World IMI. Mix A consists of 35% municipal bonds, 55% global equities, 2.5% hedge funds, 2.5% private real estate, 2.5% private equity, 2.5% private debt. Mix B consists of 30% municipal bonds, 50% global equities, 4% hedge funds, 5% private real estate, 6% private equity, and 5% private debt. Mix C consists of 25% municipal bonds, 45% global equities, 6% hedge funds, 7% private real estate, 9% private equity, and 8% private debt.

As of December 31, 2024 | **Source:** Bernstein analysis

The Hidden Value of Illiquidity

When it comes to private investments, it's crucial to carefully evaluate each account's liquidity requirements and constraints. For instance, a core portfolio that's intended to meet ongoing spending needs may have less room for illiquid investments compared to a multi-generational trust. And while tax-deferred retirement accounts can be an efficient place to hold tax-inefficient private investments, investors must be mindful of any annual distribution requirements. Likewise, many popular wealth transfer strategies—like GRATs or installment sales—have a schedule of mandated distributions that could be hindered by illiquidity.

Families whose goals include preserving wealth and curbing beneficiary spending may lean into illiquidity."

But illiquidity isn't always a drawback. Families whose goals include preserving wealth and curbing beneficiary spending may lean into illiquidity. Because the assets cannot be readily sold, the inclusion of illiquid investments may encourage spending discipline and impose a long-term perspective.

Indeed, traditional financial theory often underscores the illiquidity premium. But some investors may discover intrinsic value in illiquidity itself, as a safeguard against their own animal spirits.

Core vs. Surplus Capital

How much capital do I need? This is one of the most common questions investors ask when planning their financial future. We refer to the amount of wealth an investor should set aside to have a 90% chance of securing their lifestyle spending as "core capital." The remainder is considered "surplus capital."

Core capital should be sized conservatively to withstand deep bear markets, periods of high inflation that may trigger increased spending, and the risk of living longer than expected. Three main factors influence core capital: spending, age, and, to a lesser extent, risk profile. The more you spend, the larger the pool of capital needed to secure that spending. Similarly, the longer your time horizon for spending, the greater your core capital needs will be.

Unlocking the Full Potential of Alternative Investments

While many ultra-high-net-worth investors look to private assets for diversification and alpha generation, other compelling use cases often go overlooked. Beyond their traditional roles, alternative investments can be strategically employed for wealth transfer, offering considerable tax advantages and control over asset distribution.

The high relative growth potential of private investments makes them natural candidates for wealth transfer. Moving assets while values are low or discounted ensures future growth occurs off the investor's balance sheet to benefit designated beneficiaries. Early-stage private investments—and those depressed due to market conditions or long lock-up periods—often have a low value relative to expected return, allowing investors to retain more applicable exclusion amounts for other gifts.

For instance, by placing private assets within a trust, investors can minimize estate taxes. Specific strategies, such as hedge funds, generate considerable income tax. Transferring such assets to an irrevocable grantor trust allows the grantor to retain the tax liability, enabling the trust to grow income-tax free without using the grantor's applicable exclusion amount. Life insurance wrappers represent another sophisticated strategy. By integrating private investments into life insurance policies, investors can benefit from tax-deferred growth and potentially tax-free distributions.

Additionally, the volatility and illiquidity of private assets are less problematic for younger beneficiaries with long investment horizons.

Ultimately, while private investments are often viewed through the lens of diversification and excess reward potential, their utility in wealth transfer strategies offers a sophisticated avenue for preserving and growing family wealth across generations.

While an investor's risk profile is a factor, its impact may be more modest than you'd expect. With a more conservative posture, the core capital requirement increases because the growth of the assets is likely to be more muted, requiring a larger initial reserve. Conversely, as you add a higher proportion of growth assets, like stocks or private equity, core capital declines, but only slightly. While stocks tend to outperform bonds by a healthy margin in normal markets, they may significantly underperform in the worst-case scenarios.

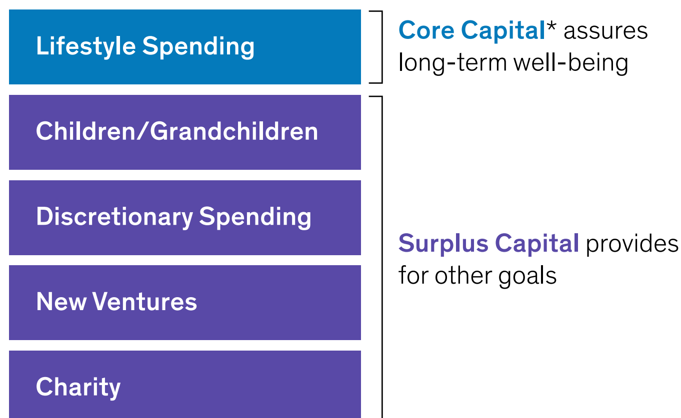
What about surplus capital? That may be earmarked for secondary objectives such as discretionary spending, family wealth transfer, or charitable donations, among others. By considering these goals alongside your established wealth objectives and tolerance for complexity, you can determine which other entities—beyond basic retirement accounts—may be included in your investment strategy (*Display 4*).

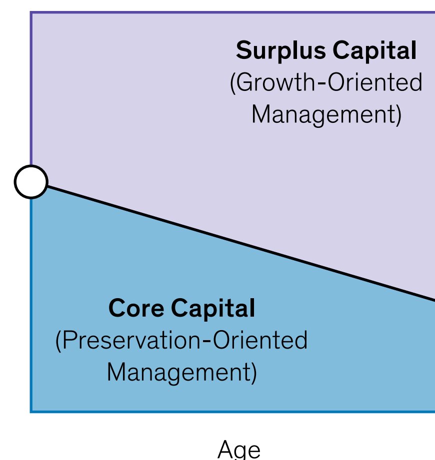
The core/surplus framework plays a crucial role in shaping your optimal allocation. In the core portfolio, assets needed for spending within the next five to ten years should be more liquid, ensuring they are readily accessible when needed. In contrast, assets earmarked for core spending needs far in the future can afford to be less liquid. Surplus capital, however, may be able to handle higher levels of illiquidity, as long as it aligns with account-specific constraints.

One common misconception is that core capital cannot be allocated to riskier assets, particularly private asset classes. This can lead to suboptimal portfolio allocations, as investors may overly compartmentalize their investments and lose sight of the bigger picture. This often results in an underweighting to private markets, with investors attempting to fund and manage liquidity and risk from only one part of their portfolio. In reality, private assets can actually boost surplus capital by improving the portfolio's efficiency and reducing the core capital requirement. To do this properly, it's essential to consider private assets across the entire portfolio.

Don't fall for the misconception that core capital cannot be allocated to riskier assets, especially private asset classes."

DISPLAY 4: CORE AND SURPLUS CAPITAL





For illustrative purposes only.

*The amount needed to support your lifestyle as long as you live

Source: Bernstein analysis

Sizing Portfolio Weights

Asset weightings are the name of the game in the allocation world. Some asset classes deserve more weight, depending on an investor's goals and constraints (*Display 5*). Likewise, within each asset class, certain strategies may warrant a larger share of their asset class weight than others.

The weight given to each strategy within an asset class usually depends on how closely the strategy aligns with the broader asset class and its level of diversification. Diversified strategies form the core[1] of each asset class allocation. Meanwhile, niche and undiversified strategies tend to serve as attractive satellites, amplifying exposure to less efficient sub-markets without unduly increasing the portfolio's overall risk.

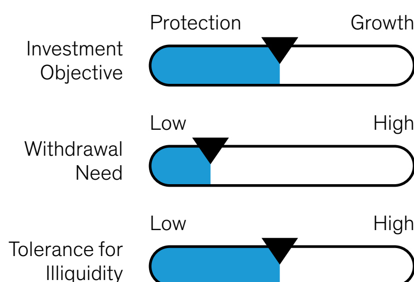
Investors must carefully distinguish between core and satellite strategies in their portfolios. While an aggressive investor might choose to materially overweight a satellite position, they must remain acutely aware of how much risk this position contributes to the overall portfolio. Ignoring this raises the probability of an unexpected event in that asset class, potentially pushing the investor past their thresholds for risk and forcing a costly emergency rebalancing down the line.

Many investors overestimate their tolerance for the risk associated with equities and other risk assets (like cryptoassets, which are currently in the spotlight). Too much in these high-risk buckets can eventually exceed an investor's real-world risk and loss tolerance, compelling them to become uneconomic sellers or buyers in the future. Similarly, underestimating future cash flow needs for private assets can lead to eventual fire sales in illiquid positions, forcing investors to sell at marked discounts.

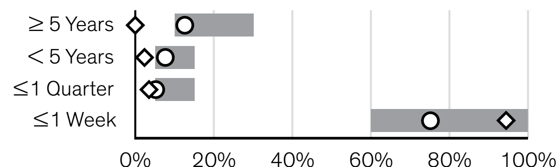
In our experience, most individual investors lack optimal exposure to private market assets. Yet we do occasionally encounter those who have overextended and need to scale back. Miscalibrations in either direction can be costly.

DISPLAY 5: DEFINING YOUR RECOMMENDED ASSET CLASS EXPOSURES

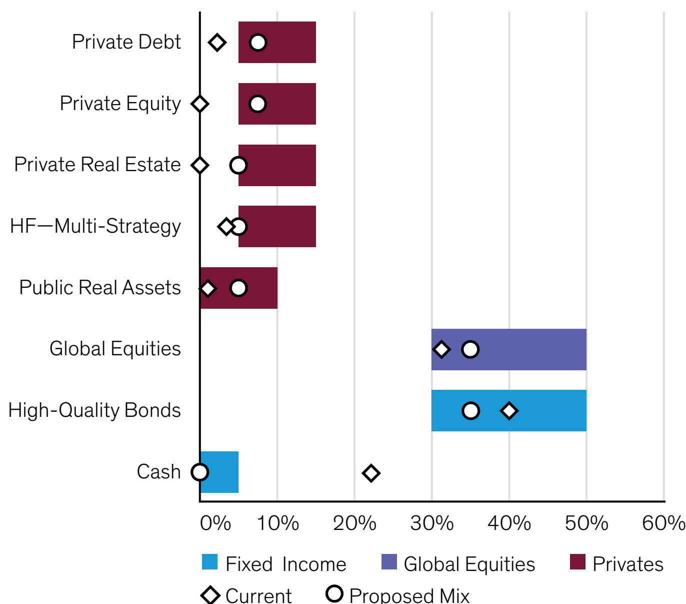
Your Parameters



Implied Liquidity Ranges



Aspirational Allocation Ranges



For illustrative purposes only.

Source: Bernstein analysis

1 "Core" in the case of core-satellite allocation differs from "core" in the case of the core/surplus framework. Investors are fond of the word "core." In the case of core-satellite, the matter at hand is position sizing. In core/surplus, we're talking about the risk of running out of money before the end of an investor's life.

Do You Have the Right Tools?

Asset allocation tools come with high fixed development costs, making them more practical for institutional investors or industry advisors. By applying these tools across large asset pools or numerous clients, these professionals can leverage economies of scale, maximizing the tools' efficiency.

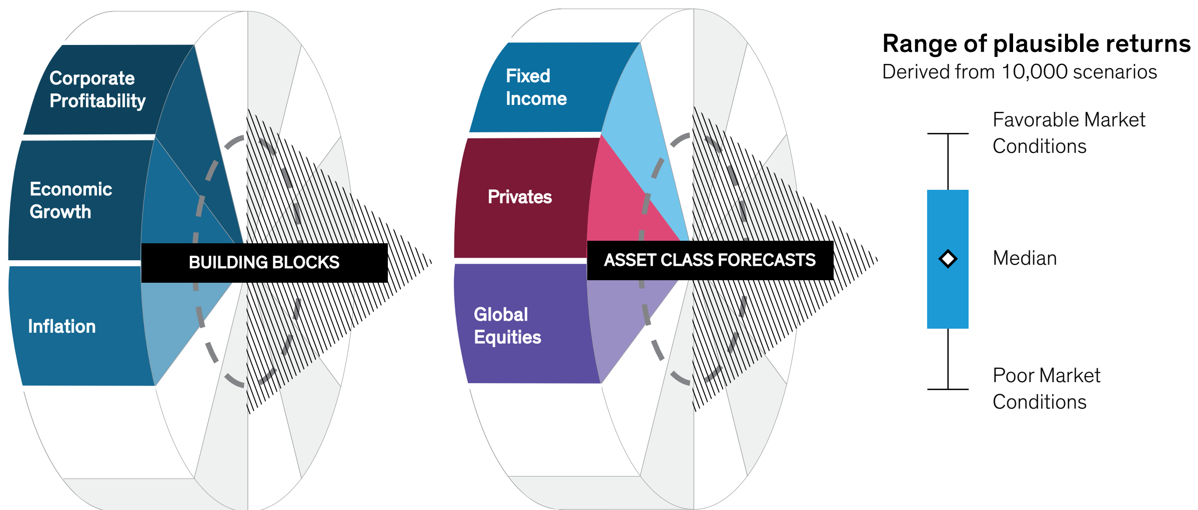
Tools available in the investment industry vary widely in their structures and assumptions—as well as their quality. After decades of developing our own tools, we've identified several critical aspects that stand out (*Display 6*) . In our view, these tools should:

- simulate realistic scenarios and use a sufficient number of trials to ensure efficiency and effectiveness;
- look forward based on macroeconomic and capital market building blocks, rather than simply extrapolating historical data or asset class return patterns;
- incorporate basic principles of asset location and tax efficiency;
- span the entire investable universe, including both public and private assets;
- incorporate both asset class returns and the potential for alpha generated by above-median managers, to the degree possible;
- allow investors to not only generate suggested portfolio weightings but also to pre-experience different versions of the future while comparing various portfolio outcomes.

By using our tools—or similar ones from industry consultants and other firms—investors can generate aspirational ranges for various asset classes. While positions in some asset classes can then be established immediately, fully deploying capital into private markets usually takes time. In those cases, ranges still provide a clear direction for investors as they work toward their target portfolio weights.

DISPLAY 6: BERNSTEIN'S CAPITAL MARKETS ENGINE FUELS OUR ADVICE

A distinctive, time-tested model

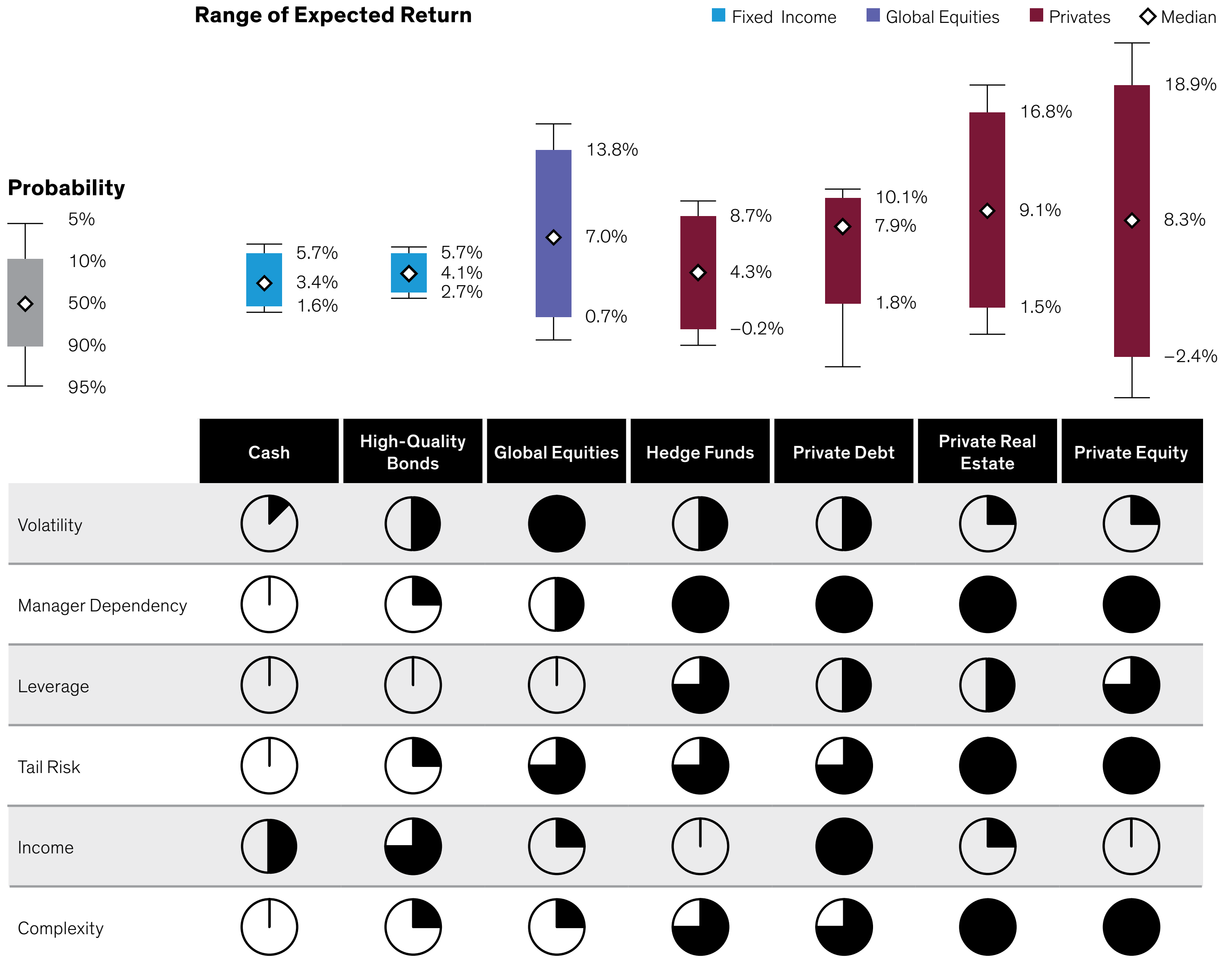


Simulated or hypothetical performance results have certain inherent limitations. Simulated or hypothetical trading programs in general are also subject to the fact that they are designed with the benefit of hindsight. No representation is being made that any account will or is likely to achieve returns or a volatility profile similar to those being shown.

Source: Bernstein analysis

DISPLAY 7: CAPITAL MARKETS ASSUMPTIONS AND INSIGHTS

Over a Strategic 10-Year Horizon



For illustrative purposes only. There can be no assurance that any investment objectives will be achieved.

As of December 31, 2024 | **Source:** Bernstein analysis

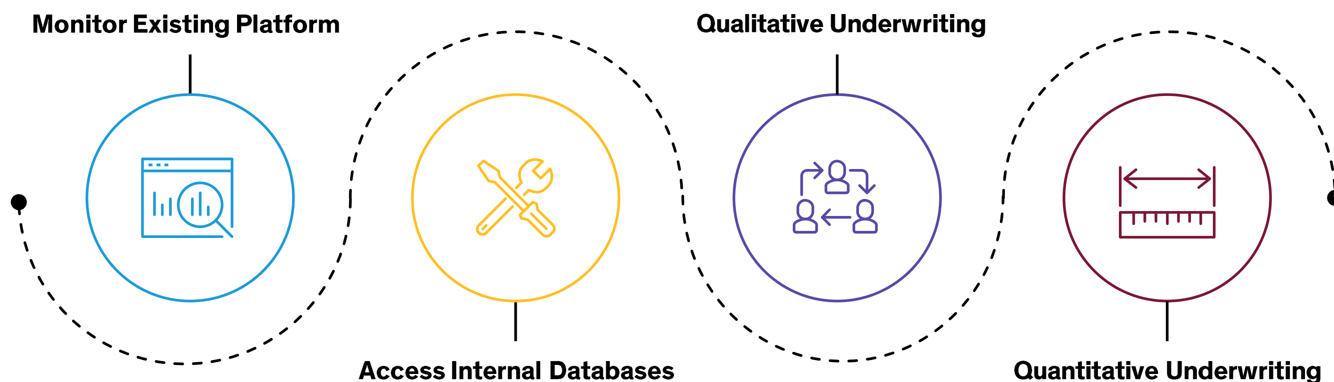
These simulations then allow investors to pre-experience different future scenarios, ensuring that their asset mix aligns with their objectives and constraints (*Display 7,* page 11). Key questions might include:

- How does the portfolio perform on both a nominal and real basis, not just in a median case, but also in the best and worst-case tail scenarios?
- What's the range of expected performance? What type of volatility should you expect?
- What is the probability of a shortfall in portfolio value compared to the expected liabilities that it needs to cover?
- How much can we improve performance by adding inflation protection or other risk management strategies?

Investors can also consider portfolio tilts. Should they stick to global benchmark weights in terms of geography, size, and factor exposure—or do they believe they can enhance performance by skewing their portfolio in a specific direction? Are they interested in tactically overweighting one private asset class over another based on the relative attractiveness of the opportunities?

Besides tools, teams also matter. We've already highlighted the importance of manager selection when it comes to private assets, given the need for active management in these allocations. To make informed decisions when selecting managers, investors need data, skills, and a dedicated manager research team to continuously review managers' processes and performance (*Display 8*).

DISPLAY 8: MANAGER RESEARCH PLAYS A CRITICAL ROLE



Source: Bernstein analysis

Using Holding Structures to Minimize Taxes

The allure of high returns from private assets often comes with a downside: a hefty tax bill. However, there are strategies to mitigate this, focusing on both near-term income taxes and long-term estate taxes.

When it comes to income tax, one effective approach is to house certain assets, like private credit strategies, within a retirement account. This can shield them from immediate taxation. For those who can't fit all their tax-inefficient, high-growth investments in retirement accounts, there are other options. Consider utilizing private placement life insurance or a private placement variable annuity (PPLI/PPVA). These tools can be highly advantageous for qualifying investors, as they allow access to investments through low-cost policies. If properly structured, these entities won't be subject to income taxation and, when held until death, will also pass to the beneficiaries free of income tax.

For those benefiting from meaningful long-term appreciation from private assets, positioning assets outside of an estate to minimize future estate taxes often proves advantageous. One approach is to use irrevocable trusts. Specifically, an intentionally defective grantor trust (IDGT) can be a powerful way to double down on the potential estate tax savings. While the assets are excluded from the taxpayer's estate for estate tax purposes, the taxpayer remains responsible for paying income taxes on any income generated inside the trust. This arrangement allows the assets in the trust to grow virtually tax-free, while the taxpayer's payment of income taxes further reduces their taxable estate.

By combining the use of a PPLI/PPVA structure for tax-inefficient, high-growth assets with a trust that exists outside of your estate, you can effectively avoid the trade-off between today's income tax and tomorrow's estate tax.

The world is constantly changing, and while investors must adapt, certain principles of asset allocation—prudence, quality, growth, valuation, and diversification—remain timeless."

The Work Is Never Done

Portfolio management doesn't end with asset allocation. Investors must continuously monitor the evolving economic and market dynamics, and ensure their active managers are meeting performance expectations amid the prevailing market environment. Periodic updates to macroeconomic and capital market assumptions are essential, as is the ongoing rating and re-rating of the most and least attractive opportunities in the investment universe.

Two key ongoing activities include rebalancing portfolios and managing taxes. Once a portfolio is established, market movements will inevitably cause actual exposures to drift from their targets. In an ideal world—where we could fully process all the latest information instantly, have perfect liquidity, and face no taxes or fees—we'd reset our targets every day based on the latest insights. Yet in reality, investors don't usually reassess portfolio weights that frequently. Instead, they simply allow the weights to drift until rebalancing is triggered. Even then, taxes and fees create friction that precludes a full return to the original targets. In fact, we generally find it's more effective to trade roughly halfway back to target weights.

While investors aim to maximize portfolio gains, they also seek to minimize the realized gains and accompanying tax bill. Some opt to address this at the end of the year, though we find it more efficient to actively harvest tax losses throughout the year. Doing so affords us greater flexibility in reducing the tax drag from realizing gains.

A Strategic Imperative for Long-Term Value

The world is constantly changing, and while investors must adapt, certain principles of asset allocation—prudence, quality, growth, valuation, and diversification—remain timeless.

Over the past several decades, private markets have evolved into vital sources of both capital and attractive returns. Including these assets in portfolios has become essential for improving risk-adjusted returns and enhancing diversification. Private markets can also serve as a bulwark against some of the increased risks investors face today. More importantly, the potential return streams from these markets are essential for powering capital appreciation in a world where public equity and bond returns may be lackluster. Whether investors are excited or skeptical about private markets, we believe that a deliberate approach to incorporating them can add meaningful value in the years to come.

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Notes on the Bernstein Wealth Forecasting System℠

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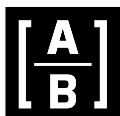

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