



# HOW PRIVATE INVESTMENTS CAN SERVE AS A HEDGE AGAINST INFLATION



Persistently high inflation—and the interest rate hikes aimed at combating it—continue to challenge the economy and financial markets. In response, publicly traded stocks and bonds have experienced heightened volatility and broad declines this year. This environment is leading to greater interest in alternative investment strategies that may help to diversify portfolios and hedge against inflation risk.

The landscape of alternative investments is broad and diverse. This article provides perspective on two areas that BDO Wealth Advisors views as particularly interesting today: private real estate—particularly value-add, multi-family residential properties— and private credit. Both strategies seek regular income that often increases with inflation to enhance total returns and stabilize portfolios in volatile times. Because they provide exposure to different risk and return factors than traditional asset classes, private investments also add another layer of diversification when combined with those assets. But they also come with unique risks that investors should keep in mind.

## PRIVATE REAL ESTATE: VALUE-ADD, MULTI-FAMILY RESIDENTIAL PROPERTIES

**What it is:** Private real estate is not publicly traded, which limits its volatility relative to the stock market but also limits liquidity for investors. A value-add real estate fund generally focuses on purchasing existing properties that aren't being managed to their maximum potential and improving them to increase occupancy and drive higher revenue. Owners often renovate apartments, upgrade common areas, and add new services, ultimately leading to higher rents that can continue rising toward market rates over time. Fund investors receive an allocation of current income (loss) and distributions from rental operations, as well as the potential for higher property values and cash flows in the future.

BDO Wealth Advisors works with private real estate managers that target U.S. rental markets with favorable demographic trends and workforce populations. For example, the high number of hospitals and universities in the Northeast offers access to large employee bases seeking affordable rental housing.

**How it may serve as an inflation hedge:** Rents are variable, and they historically rise at roughly the same rate as inflation. This can help investors keep pace with higher prices and protect their purchasing power, especially given today's elevated inflation rate. Looking ahead, inflation may remain at above-normal levels because rent generally lags other expenses. Any future rent increases could provide investors with a more direct hedge against inflation than other asset classes.

**Additional investment characteristics:** In addition to inflation protection, value-add residential real estate may be relatively recession-resistant. Rents in these properties typically are lower than luxury apartments, a key factor in renewing leases during economic slowdowns and attracting new tenants who are looking to trade down to less expensive living arrangements.

The current shortage of available rental units is also creating investment opportunities. Even before the Federal Reserve (the "Fed") began raising interest rates, demand for rentals was exceeding supply. Now, with home prices still elevated and mortgage rates rising rapidly, renting is becoming a more viable option for many U.S. families.

## PRIVATE CREDIT: LENDING DIRECTLY TO SMALL AND MIDDLE-MARKET COMPANIES

**What it is:** With private credit, investors essentially replace banks as lenders to businesses and earn recurring income as loans are repaid. Following the Sarbanes-Oxley Act of 2002, many banks had to curtail their lending activity to small- and mid-size companies. Others followed suit in the regulatory aftermath of the 2008 global financial crisis, creating a large void that private credit funds fill today.

**How it may serve as an inflation hedge:** Most private credit instruments feature floating interest rates, which means the interest rates borrowers pay tend to move in lockstep with Fed policy. As the Fed has raised rates to battle inflation, investors who diversified into private credit have received higher income to help protect their principal and reduce overall portfolio risk.

**Additional investment characteristics:** There are a wide range of private credit strategies available today. We believe it is prudent to invest with managers that concentrate on higher-quality, creditworthy borrowers who are less likely to default on loans. Fund investors sacrifice some additional yield for a greater likelihood of receiving loan payments.

Most direct loans are classified as senior debt, which means the holders of that debt are the first to be repaid if a company goes out of business. These loans are typically backed by the borrowing company's inventory, property, equipment, real estate, or other assets that can be sold to repay investors, if necessary. In exchange for these factors that help limit risk, senior debt usually carries lower interest rates than unsecured forms of lending.

## RISKS AND OTHER INVESTMENT CONSIDERATIONS

Private investments are inherently different than public investments and come with unique risks. Chief among them is a lack of liquidity. Private real estate and credit funds usually require holding periods of five years or more, making them most appropriate for investors with long-term time horizons and other sources of liquidity. All of these factors emphasize the importance of careful due diligence to understand the strategies, select funds, and monitor managers on an ongoing basis.

Investor eligibility is another consideration. Private real estate funds are typically available only to accredited investors meeting certain income or net worth requirements, while private credit funds may be more broadly accessible.

Finally, it is important to think about the role private assets can play in a diversified portfolio. How do they complement existing holdings? How much should an investor allocate toward them? Where will those funds come from if being taken from other portfolio positions? What are the fees associated with these strategies?

**BDO Wealth Advisors has extensive experience with private investments, including private credit, real estate, and private equity. Please don't hesitate to contact us to learn more or discuss your specific needs.**

BDO Wealth Advisors, LLC is a Registered Investment Adviser dedicated to providing clients with unbiased, personal financial advice. Working in partnership with our clients, our wealth management team helps organize, enhance, manage, and preserve wealth through sound financial strategies. This information is provided by BDO Wealth Advisors for the personal use of our clients and friends. It should not be construed as personalized investment, tax, or legal advice. Information compiled from Ned Davis Research and additional third-parties. Please be sure to consult your CPA or attorney before taking any actions that may have tax consequences and contact BDO Wealth regarding any investment decisions. Every investment strategy has the potential for profit or loss.

At BDO, our purpose is helping people thrive, every day. Together, we are focused on delivering exceptional and sustainable outcomes — for our people, our clients and our communities. Across the U.S., and in over 160 countries through our global organization, BDO professionals provide assurance, tax and advisory services for a diverse range of clients.

BDO is the brand name for the BDO network and for each of the BDO Member Firms. BDO USA, LLP, a Delaware limited liability partnership, is the U.S. member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. [www.bdo.com](http://www.bdo.com)

Material discussed in this publication is meant to provide general information and should not be acted on without professional advice tailored to your needs.

© 2022 BDO USA, LLP. All rights reserved.