Alternatives Investor Letter

Mid-Year 2023
Marketing material

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Dear Investors,

Over the past year, global macroeconomic uncertainty has seeped into alternatives markets, compounded by sticky core inflation, banking sector turmoil, a faltering recovery in China, and shocks from the ongoing Russo-Ukrainian war. Yields on private debt have increased amid tighter central bank policy, a pullback from some traditional lenders, and heightened risk aversion. Higher interest rates have filtered into private real estate, causing prices to drop roughly 20% around most of the world; listed property has also struggled as shorter-term rates have increased and secured lending standards have tightened, stressing holders of floating rate debt. With global growth slowing, both private and listed infrastructure have come down from the energy-driven highs of 2022, and commodities and producers have sustained losses amidst a weakening global demand outlook.

As the saying goes – "no pressure, no diamonds." Where pressures abound, so too do opportunities, several of which we are particularly excited about heading into the second half of 2023 and beyond:

- There is ample demand for credit from the real economy and probably less supply from banks – hence, a great opportunity for alternative asset managers. An imbalance of supply and demand for credit will create attractive opportunities for alternative lenders across the capital structure. We see notable opportunities in digital and energy transition infrastructure. In real estate, we favor whole loan and stretched senior loans in preferred sectors (logistics and residential), as well as manage-to-green strategies and some construction projects. In the direct lending market, we favor industries with recession resilient cash flows, high margins, and the ability to pass on higher costs.
- An imminent end to the U.S. tightening cycle should remove a key headwind. With yields up 100-150 basis points from a year ago, real estate has in many cases priced-in today's interest rates, in our view. Rent growth may slacken amid slower economic growth, and in the U.S., a short-term surge of COVID-delayed apartment and warehouse supply. But provided labor markets remain reasonably resilient, any leasing pullback should be mild. Meanwhile, lower prices and tighter financing are squeezing construction starts, paving the way for fundamentals to re-tighten next year. Across listed property markets, fundamentals are already healthy (if perhaps, moderating) or improving across select sectors - data centers, core apartments, and senior housing REITs in particular remain healthy or appear poised to strengthen. Importantly, public REITs retain healthy access to capital markets, with unsecured debt markets proving to be a competitive advantage.
- Themes underlying the European transformation will be an important growth driver. Industrial and residential properties, fueled by structural tailwinds, screen attractively while a flight to quality has created opportunities for office refurbishment in Europe, where many cities (e.g., Paris and Berlin) suffer a dearth of prime, ESG-friendly options. The energy transition also impacts an ever-broadening range of sectors which require capital, including energy efficiency, energy management services and alternative fuels. Decarbonization and supply-chain resilience add further tailwinds to multi-modal assets, particularly those which support the shift of freight transportation from roads to rail. On the commodities side, natural gas is a critical bridge toward a "net-zero" future that will help replace coal.

> "NO PRESSURE, NO DIAMONDS."
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> -Thomas Carlyle

In this challenging investment climate, DWS Alternatives remains focused on innovative opportunities to invest beyond traditional strategies and we expect to deliver strong results for clients. With a 50-year investment heritage, a deep global network, and a dynamic suite of alternatives products, the DWS Alternatives business is uniquely placed to provide access and expertise through a variety of economic cycles, and to engineer forward-looking solutions to meet complex global needs. We have a solid forward pipeline of alternatives flows, which we expect to drive positive flow momentum in 2H 2023. This is further supported by new product launches that support clients' investment needs with a strong focus on alignment with the DWS European transformation program.

On behalf of the DWS Alternatives business, we thank you for your continued trust and partnership in a constantly changing world. Above all else, we are defined by our commitment to our clients as we work to deliver outstanding results. With an extensive global research team, a deep understanding of risk across alternatives markets, and a disciplined yet dynamic investment approach, DWS Alternatives is prepared to help shape our clients' financial future as markets evolve. We look forward to shaping that future with your best interests at heart.

Sincerely,

Paul Kelly
Global Head of Alternatives

Insights by Asset Class

Private Real Estate

Higher interest rates have filtered into private real estate over the past year, causing prices to drop roughly 20% around the world (with the notable exception of Japan, where rates have barely moved). Meanwhile, fundamentals have remained generally robust, evidenced in low vacancy rates and sustained rent growth. There are exceptions: Offices in the U.S. are languishing due to remote work, exacerbated by layoffs in the technology and financial industries (conditions are stronger in Europe and Asia where return-to-office rates are higher). Yet e-commerce, coupled with efforts to bolster supply chains, continues to drive demand for warehouses. And chronic housing shortages exist across most major European, Asian, and U.S. cities.

We believe that the outlook is positive for the next 12 months. With yields up 100-150 basis points from a year ago, real estate has in many cases priced-in today's interest rates, in our view. Rent growth may slacken amid slower economic growth, and in the U.S., a short-term surge of COVID-delayed apartment and warehouse supply. But provided labor markets remain reasonably resilient, any leasing pullback should be mild. Meanwhile, lower prices and tighter financing are squeezing construction starts, paving the way for fundamentals to re-tighten next year. Another move higher in long-term interest rates could hamper a pricing rebound. At the same time, rent growth could profit from more persistent inflation.

Our top picks include industrial and residential properties, fueled by structural tailwinds. A flight to quality has created opportunities for office refurbishment in Europe, where many cities (e.g., Paris and Berlin) suffer a dearth of prime, ESG-friendly options. The renaissance of U.S. retail, which has now largely adapted to e-commerce (transitioning to services and online fulfillment), is also frequently overlooked. And migration continues to fuel demand across sectors in the southern U.S.

Private Infrastructure

While having come down from energy-driven highs of 2022, private infrastructure has posted robust returns over the first half of 2023, showing a strong inflation pass-through capability. To be sure, the market has cooled: Transactions volumes are down, and some assets that are unable to quickly boost cashflows to offset higher interest rates have repriced. Overall, however, multiples achieved in the closed deals seen so far in 2023 remain strong and in line with historical averages.

We believe that private infrastructure's strong recent performance, healthy levels of dry powder, investors' perceived under-allocation to the asset class, and more stable – albeit still uncertain – interest rate environment, will fuel stronger transaction activity in the second half of the year and into 2024. As for performance, infrastructure's defensive characteristics will likely come to the fore as economic growth slows, particularly for the regulated or contracted portfolios which underperformed merchant assets in 2022.

Our investment themes remain focused on the opportunities presented by the European mid-cap market. The energy transition offers an ever-broadening range of sectors which require capital, including energy efficiency, energy management services and alternative fuels. Decarbonization and supply-chain resilience add further tailwinds to multi-modal assets, particularly those which support the shift of freight transportation from roads to rail.

Private Debt

Yields on private debt have increased over the past year amid tighter central bank policy, a pullback from some traditional lenders, and heightened risk aversion. Within infrastructure, yields average 5%-6% for investment grade credit compared to 2%-3% in early 2022, while high yield strategies offer yields of 7%-8%, a premium of 100-150 bps over comparable public bonds. In the direct lending market, spreads have increased by around 50bps, subject to business models, leverage and covenants. In real estate, concerns around collateral values have increased spreads across the capital structure, especially for higher-risk financing (e.g., mezzanine and construction loans).

Prospects for private debt appear favorable in our view. Higher base rates, coupled with healthy spreads, we expect to deliver competitive returns for lower-risk investments. While high-yield strategies carry greater macroeconomic risks, these are in many cases mitigated by the defensive characteristics of the collateral or industry (e.g., contract utilities and health care) or otherwise compensated for through elevated spreads (e.g., real estate construction).

Over the next 6 to 12 months, we believe that an imbalance of supply and demand for credit will create attractive opportunities for alternative lenders across the capital structure. We see notable opportunities in digital and energy transition infrastructure, where we prefer senior debt to emerging biogas, battery storage and energy efficiency services. In real estate, we favor whole loan and stretched senior loans in preferred sectors (logistics and residential), as well as manage-to-green strategies and some construction projects. In the direct lending market, we favor industries with recession resilient cash flows, high margins, and the ability to pass on higher costs, such as IT and non-discretionary services.

Liquid Real Assets

Higher real rates have proven a formidable headwind this cycle, and real assets have not been immune to broader market pressures. TIPS have helped investors preserve capital. Global infrastructure securities have sustained on recovery strength out of Europe and transports; this has been balanced by weakness from communications and Americas midstream energy. Listed property performance has been pressured as shorter-term rates have increased across much of the globe and secured lending standards have tightened, stressing holders of floating rate debt. Finally, following standout performance in 2022, commodities and natural resource equities have come under pressure from a weakening global demand outlook as China's recovery stagnates.

In our view, there are reasons to be optimistic from here. Terminal interest rates from global central banks appear closer, and an imminent end to U.S. tightening should provide support for listed property markets, along with moderating yet healthy fundamentals across select sectors. Importantly, public REITs retain healthy access to capital markets, with unsecured debt markets proving to be a competitive advantage. Listed infrastructure should also benefit given their inflation passthrough traits and necessity-based assets. For commodities, major market themes include China's re-opening scope and pace, developed market economies' growth trajectory, dearth of capacity growth due to low capex levels, weather, and the Russia-Ukraine war.

Looking ahead, we expect performance dispersion to remain pronounced at a stock and sector level, affording experienced active managers opportunities to create alpha on behalf of clients. We favor property sectors such as data centers, core apartments, and senior housing where sector fundamentals remain healthy or appear poised to strengthen. We are cautious on midstream energy infrastructure given decelerating global growth, preferring the relative stability of utilities and inorganic growth prospects within towers. Within commodities, opportunities exist, though mixed signals in the face of slowing demand and elevated geopolitical risks suggest caution is warranted. We expect gold will remain an attractive safe-haven as the market sorts out re-opening crosscurrents and developed markets' recession risk. Finally, a holistically managed real assets allocation can offer an attractive combination of growth and defensiveness and a strong income and liquidity profile – all powerful tools for managing aggregate portfolio risk.

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