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Regime Change

The Changing Role of Private Real Assets in the 'Traditional' Portfolio

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Regime Change

The Changing Role of Private Real Assets in the ‘Traditional’ Portfolio

Against the current macroeconomic backdrop of ongoing fiscal stimulus, labor shortages, a global energy transition, and heightened geopolitics, we continue to envision a ‘higher resting heart rate’ for inflation relative to the prior cycle in many developed markets. In this environment we believe stocks and bonds are becoming more correlated, an important structural change for asset allocation. This *Regime Change*, as we like to call it at KKR, likely means that bonds, in our view, can no longer act as effective portfolio ‘shock absorbers.’ As such, we continue to favor Real Assets with defensible margins and upfront recurring yields as a potential substitute to traditional fixed income across many types of portfolios. Importantly, not all Real Assets are created equal, and many of the more ‘traditional’ inflation hedges are not performing as expected. Therefore, we believe that an investor must look beyond REITs, TIPS, and Gold towards more collateral-based cash flows linked to nominal GDP, including a mix of Asset-Based Finance, Infrastructure, and select parts of Real Estate Credit and Equities. Beyond the potentially attractive return profile, we also like the diversification benefits that many Private Real Assets bring to a more traditional portfolio.

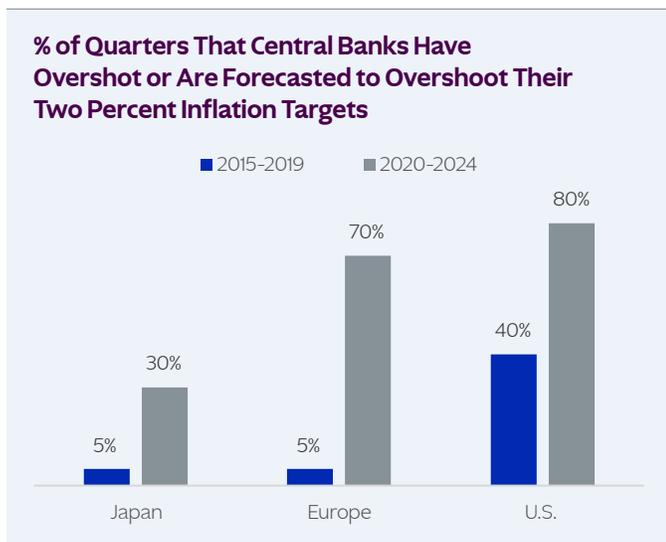
Fortune befriends the bold.

— Emily Dickinson, American poet

With inflation starting to subside from near record levels in influential markets such as the United States, some investors might think that now could be the time to begin to pull back on commitments to Real Assets in their portfolios. That view, however, is not one we hold at KKR. Consistent with our [Regime Change](#) thesis, we still see more catalysts ahead that should make Real Assets continue to be important and necessary components of a diversified portfolio. In the U.S., for example, we think sticky wages will remain an issue, and we do not see capital expenditures falling off as much this cycle, given increased reshoring as well as investment in cybersecurity and the energy transition.

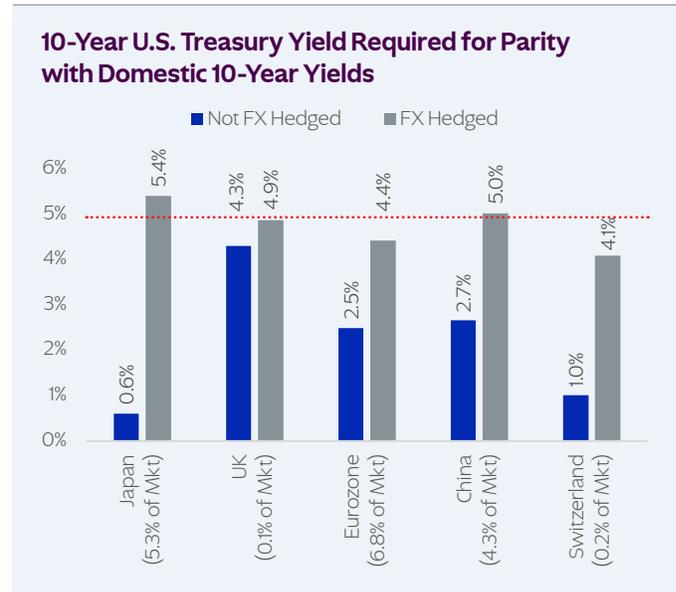
Consistent with our view that this cycle is different, we believe U.S. Real GDP growth will surprise to the upside at 2.4% year-over-year in 2023 versus a current consensus of two percent, and we believe that, while cool beneath the surface, core inflation will remain 'stickier' than many investors may think. Specifically, while we forecast 2023 U.S. CPI to be four percent versus consensus of 4.1%, we still expect 2024 inflation to be 2.7% versus the Fed's target of two percent. Against this backdrop, we have boosted our 2023 year-end 10-year forecast to 4.75% from 4.25% versus a consensus of 3.6%, while our 2024 forecast goes to 4.25% from 3.75% versus a consensus of 3.4%.

EXHIBIT 1: Inflation Will Likely Exceed Central Banks' Target Levels Well Into 2024, a Backdrop That Is Quite Different Than Earlier Periods



Calculated on a quarterly basis. Based on historical data and forecasts: U.S. and Eurozone forecasts per KKR GMAA; Japan forecasts per Bloomberg consensus. Data as at June 30, 2023. Source: Bloomberg, KKR Global Macro, Balance Sheet & Risk analysis.

EXHIBIT 2: We Only Expect an Increased Bid for Treasuries If and When 10-Year Treasury Yields Hit Five Percent

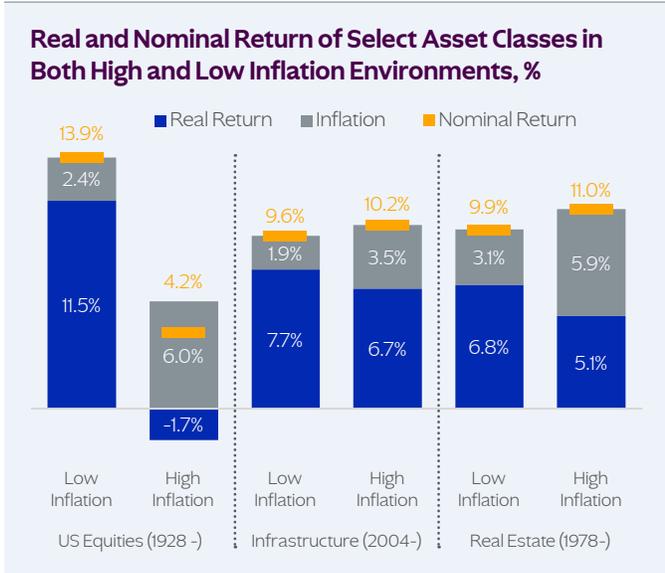


Data as at July 31, 2023. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

However, if we are wrong in our outlook and inflation does subside much faster than we think, our portfolio construction analytics suggest that many parts of Real Assets should continue to perform well in a lower inflationary environment. In particular, there is the potential for a higher Sharpe ratio outcome when Alternatives, including Real Assets, are incorporated into a diversified portfolio, relative to the traditional 60/40 mix (*Exhibit 22*) in a low inflation environment.

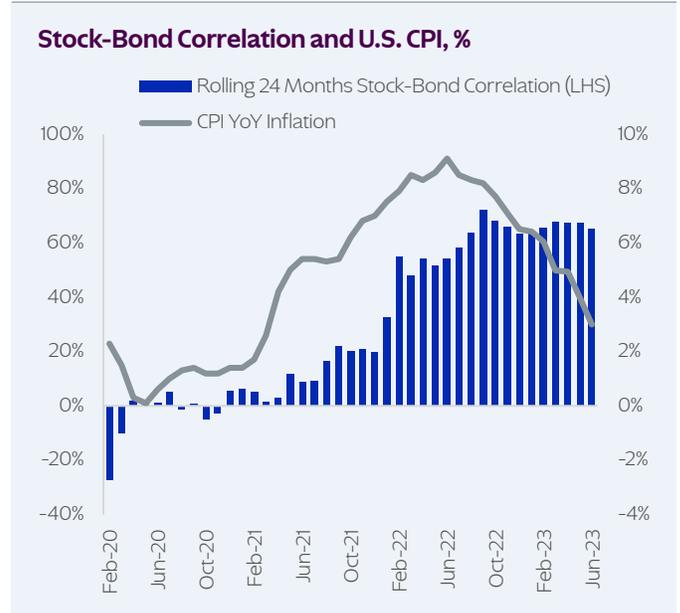
So, while the adaptability of Real Assets to perform across many different economic environments is compelling, our base view remains that we have entered into a period of higher, 'sticky' inflation that should benefit this asset class more than many others, especially conventional fixed income. This viewpoint is largely consistent with our [Regime Change](#) thesis (*Exhibits 4 and 5*). To review, in our first article in this series in May 2022, we argued that Real Assets could help enhance returns of the traditional 60/40 portfolio by providing more upfront yield, enhanced inflation protection in this new macro-economic environment that we continue to envision. Central to our thesis is that liquid government bond portfolios, which in the past have traditionally served as shock absorbers or diversifiers, can no longer fulfill this purpose. This view has been reinforced by the behavior of the bond market in both 2022 and 2023, driven by sticky services inflation, Japan exiting Yield Curve Control, and Fitch's downgrade of U.S. debt.

EXHIBIT 3: Private Real Assets Show Resiliency Regardless of the Inflationary Environment



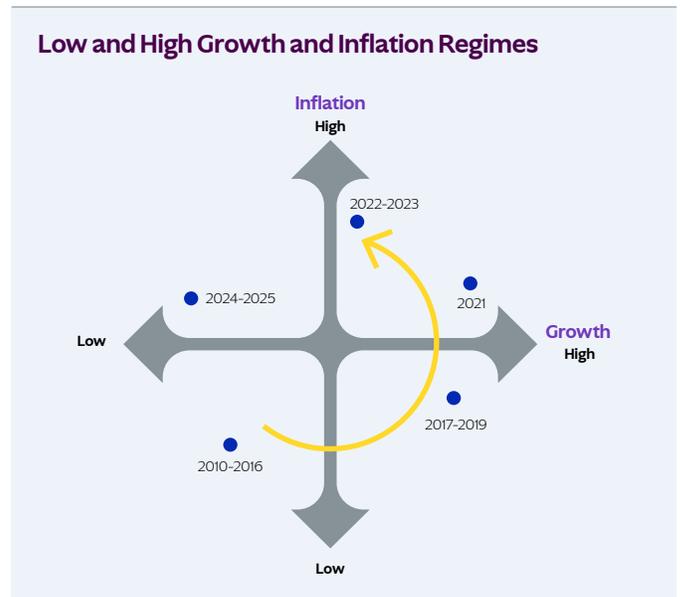
Annual total returns from 1928 to 2021 for the S&P 500 from 1978 to 2021 for Real Estate and from 2004 to 2021 for Infrastructure. Real returns calculated as $[(1+\text{nominal return})/(1+\text{Y/y Inflation}) - 1]$. Inflation component of the asset class return calculated as the difference between nominal and real return over the given period of time. U.S. Public Equities modeled with S&P 500 Index. Private Infrastructure modeled using the Burgiss Infrastructure Index. Real Estate modeled using the NCREIF Property Levered Index. Data as at March 31, 2023. Source: Burgiss, NCREIF, Bloomberg, KKR Global Macro, Balance Sheet & Risk analysis.

EXHIBIT 4: The Relationship Between Stocks and Bonds Is Changing in This Inflationary Environment



Data as at June 30, 2023. Rolling 24 month correlations calculated using monthly total returns from 1978 to 2021. Stocks modeled using the S&P 500 Index and Bonds modeled using the Barclays U.S. Aggregate Index. Source: Bloomberg, KKR Global Macro, Balance Sheet & Risk analysis.

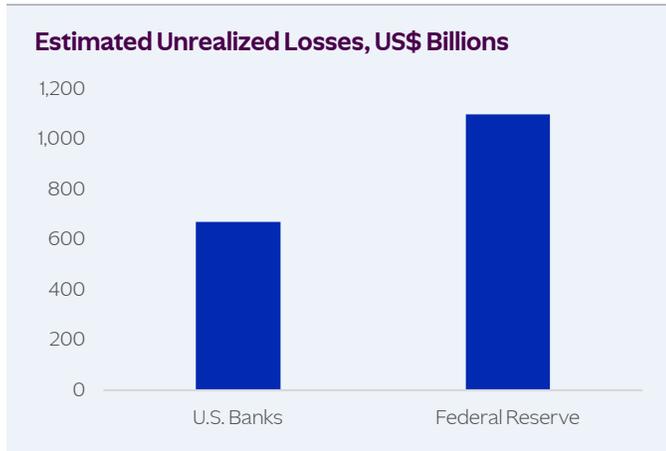
EXHIBIT 5: While Inflation Likely Has Peaked, We Believe a Regime Change Has Occurred



Data as at May 31, 2023. Source: KKR Global Macro & Asset Allocation analysis.

Central to our thesis was that liquid government bond portfolios, which in the past have traditionally served as ‘shock absorbers’ or diversifiers, can no longer fulfill this purpose. This view has been reinforced by the behavior of the bond market in both 2022 and 2023, driven by sticky services inflation, Japan exiting Yield Curve Control, and Fitch’s downgrade of U.S. debt.

EXHIBIT 6: We Have Nearly \$1.8 Trillion in Unrealized Losses Across Financial Institutions in the U.S. Alone. These Holders of Bonds Will Likely Sell Quickly If Prices Do Rally Back



Data as at July 31, 2023. Source: KKR Global Macro & Asset Allocation analysis.

However, even for those who are already believers in our narrative, there is another important wrinkle to this story to consider: *Not all Real Assets are created equal, in our view.* One can see from *Exhibit 7* that many of the more ‘accepted’ inflation hedges such as TIPS and REITs have not performed well this cycle. As a result, allocators could have been right on their inflation call but wrong on their choice of asset class, possibly by relying too much on what worked in the past. By comparison, many Private Real Assets have delivered both strong upfront yield as well as a compelling total return during one of the fastest increases in both interest rates and inflation that we have seen in 50 years. At the moment, we are favoring Asset-Based Finance (ABF), Real Estate Credit, and Infrastructure for investors who have a liquidity budget to spend on enhancing returns. Importantly, these asset classes are largely linked to nominal GDP growth, which we think is a prerequisite for success in the higher resting heart rate for inflation environment that we envision. They also have attractive collateral that should serve as a buffer if financial conditions continue to tighten in 2024.

EXHIBIT 7: The Inflation Hedging Characteristics of Real Assets Have Not All Been Equal During This Cycle

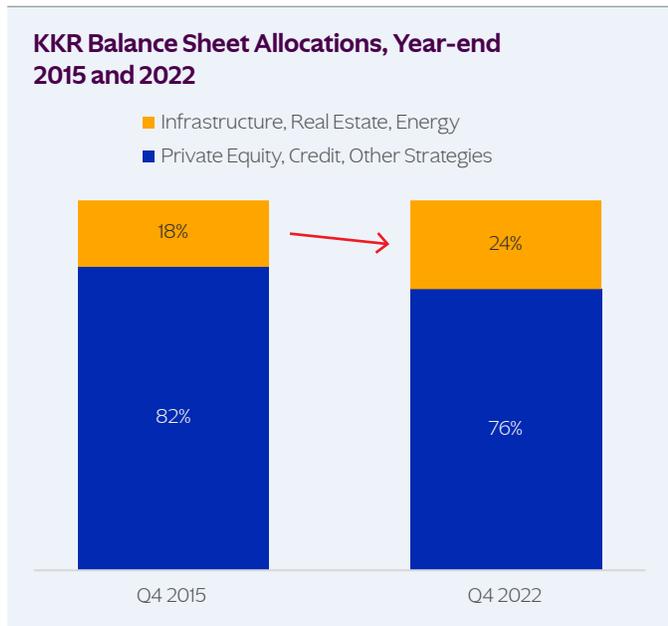


Commodities proxied using the S&P GSCI Spot Index, Global Private Infrastructure is proxied using the Burgiss Global Infrastructure Index, Private Core Real Estate proxied using the NCREIF Property Index, Publicly-Listed Infrastructure proxied using the S&P Global Infrastructure Index, TIPS proxied using the iShares TIPS Bond ETF, US REITs proxied using the MSCI US REIT Index, EU REITs proxied using the MSCI Europe Real Estate Index, US Asset-Backed Securities proxied using the ICE BofA AA-BBB U.S. Asset Backed Securities Index, Bitcoin and Gold spot prices as tracked by Bloomberg. Data as at December 2022. Source: Bloomberg, NCREIF, Burgiss, KKR Global Macro, Balance Sheet & Risk analysis.

Importantly, for us at KKR, favoring Real Assets is not simply a ‘theoretical’ concept. In fact, back in 2019, we began shifting the KKR Balance Sheet towards Real Assets that we believed would perform well in a higher nominal GDP environment. By 2023, we had allocated nearly 25% of our existing capital to our own Real Assets vehicles that we think will deliver strong cash yields as well as provide unique diversification features by being linked to nominal GDP (see *Exhibit 8*). The good news is that we feel better today about these allocations than we did in 2019.

Looking at the bigger picture, we continue to argue for ‘Keeping It Simple’ (for more detail, see our [Outlook for 2023](#) and [Mid-Year Update](#).) In the past decade, higher Beta, more growth-oriented investments have led to outsized performance. It has also reinforced the benefits of taking on more leverage at the company level as well as the fund level. However, it now feels to us that many investors are over-allocated to this area at a time of falling expected future returns. Of all the groups with whom we interact, we think that endowment and foundation managers likely allocated the most to VC, Growth, and Public Equities during the post-COVID run-up.

EXHIBIT 8: Over Time We Have Allocated More Capital On KKR’s Balance Sheet to Real Assets, With More of a Focus On Real Estate and Infrastructure Investments



Information is from KKR & Co. Inc.’s earnings release for its year-end 2022 and year-end 2015 financial results. Nothing herein is a solicitation to buy or sell securities of KKR & Co. Inc. Data as at December 31, 2022. Source: KKR Balance Sheet.

Finally, we would be remiss if we did not address the reality of a more unsettled world. As more regionalization unfolds as countries retreat from globalization, we expect to see more restrictions and scrutiny on the transfer of capital, technology, and data as the desire for economic and technological independence increases. The regionalization of supply chains will add a new dimension to geopolitical rivalries that investors must consider as more industries and sectors become ‘strategic’ from a national security perspective. At the forefront of these trends will likely be energy, water, communications and data infrastructure, to name just a few.

Importantly, favoring Real Assets is not simply a ‘theoretical’ concept for us. In fact, back in 2019, we began shifting the KKR Balance Sheet towards Real Assets that we believed would perform well in a higher nominal GDP environment. By 2023, we had allocated nearly 25% of our existing capital to our own Real Assets vehicles that we think will deliver strong cash yields as well as provide unique diversification features by being linked to nominal GDP.

SECTION I

Why Real Assets?

In the following section we address questions that we have fielded in recent months about Real Assets.

1

How does KKR define Real Assets?

In their broadest sense, Real Assets are investments backed by physical assets that, once constructed, are often leased or contracted out to generate yield-like cash flows, in many instances directly or indirectly indexed to inflation. Importantly, they are often influenced by trends related to the 'geography' of where they are constructed. As a result, Real Assets can offer an attractive combination of income generation, capital appreciation potential, and diversification benefits that are not always available in other asset classes.

Within the Private Markets, there are a few ways to get access to Real Assets:

- **In aggregate, Real Estate is one of the largest individual Real Asset classes**, providing investors the opportunity to tailor their exposure by choosing among various risk levels across diverse property types. Core and Core Plus managers offer attractive yields from stable assets (targeting returns closer to 8-10%, often with a substantial yield component), while Opportunistic managers target higher returns by increasing leverage and managing more complex opportunities such as lease-ups, platform build-outs, public-to-private transactions, and distressed properties (which is likely where we think the industry is headed in the Office sector, for example). In addition to taking advantage of the pullback in bank lending of late, investors can also reduce risk by allocating to Real Estate Credit assets that offer attractive yields, structural seniority, and contractual protections. Importantly, there are many choices along the risk-return spectrum from which investors can choose. For example, there are lower-risk options that include Single-Asset, Single-Borrower (SASB) and Conduit CMBS where funds often target six to eight

percent total returns driven mostly by the yield component. By comparison, for investors who have more risk tolerance and fewer liquidity constraints, there is the subordinated 'B-Piece' CMBS tranche, which usually targets low-teens total returns and double-digit yields.

- **Private Infrastructure, another large Real Asset class, includes Power and Energy-Related assets, Digital Infrastructure, Telecommunications, and Transportation**, among many themes. As we are seeing from our perch at KKR, Infrastructure is an evolving asset class with new sectors like Healthcare, Education, Logistics, and Industrial Operations increasingly being recognized as attractive investment sectors for this asset class. Core and Core Plus managers, on the lower risk end, use moderate leverage to purchase existing stabilized assets or make minor improvements to 'brownfield' assets that are already partially operational, typically generating inflation-linked cash flows. Value-Add and Opportunistic managers, at the higher risk end, often use more leverage to make significant enhancements to existing assets or develop new 'greenfield' or immature assets, which may take years to start generating revenue and may face greater demand risk in the competitive merchant market.

As we are seeing from our perch at KKR, Infrastructure is an evolving asset class with new sectors like Healthcare, Education, Logistics, and Industrial Operations increasingly being recognized as attractive investment sectors for this asset class.

EXHIBIT 9: There Are Many Nuances to Real Assets That Can Help Investors Achieve Their Risk, Return, Yield and Diversification Goals

Summary of Common Types of Real Assets				
	Core (Most Conservative)	Core-Plus (Conservative / Moderate Risk)	Value-Add (Moderate Risk)	Opportunistic (Most Risky)
Private Real Estate (\$1.6 Trillion USD Global AUM)	<ul style="list-style-type: none"> Stabilized, well-leased assets with low vacancy rates located in prime locations and requiring little operational work. Managers utilize low levels of leverage. Advantages: Low risk, 'bond-like' defensive assets that produce the majority of their returns from rental income generated by high-quality tenants. 	<ul style="list-style-type: none"> Mostly stabilized, well-leased assets with low vacancy rates located in mostly prime locations. Managers utilize low-to-moderate levels of leverage. Advantages: Low risk, defensive assets that generate predictable income from high-quality counterparties. 	<ul style="list-style-type: none"> Assets that tend to be exposed to leasing, renovation, and / or development risk. Managers utilize moderate levels of leverage. Advantages: Significant potential for managers to provide value-add through their strong track record of improving and repositioning properties as well as from selecting attractive geographies, property types, and themes. 	<ul style="list-style-type: none"> Transitional assets requiring significant CapEx spend to stabilize the asset. Often involve complicated situations like platform build-outs, aggregation strategies, public-to-private transactions, structured investments, or distressed situations. Advantages: Greatest potential for managers to add alpha and are more 'equity-like' with much more upside potential than core assets.
Private Infrastructure (\$1.2 Trillion USD Global AUM)	<ul style="list-style-type: none"> Mature, cash yielding operating businesses located in Developed OECD countries. Deals utilize low levels of leverage. Advantages: Low-risk 'bond-like' defensive assets that generate attractive yields from inflation-linked contracts with high-quality counterparties or regulated assets. 	<ul style="list-style-type: none"> Mature, cash yielding operating businesses located in Developed OECD countries with some additional complexity requiring asset management. Advantages: Typically higher returns than core assets with more capital appreciation. Start Investments after appreciation. Investments continue to be underpinned by long-term contracts, tariffs, and regulated rates of return. 	<ul style="list-style-type: none"> Assets may require greater scale and value-added capabilities to tackle the complexity of the transaction. Deals may involve 'greenfield' (new development) risk. Advantages: Hard assets with higher levels of growth than core/core-plus assets but also have visible cash flows and higher barriers to entry. 	<ul style="list-style-type: none"> Typically greenfield assets requiring significant development expenditure. Generally requires substantial leverage / financing. Potential purchases from distressed sellers. High risk assets that often generate uncontracted cash flows and may be subject to significant commodity price / merchant risk. Advantages: Highest potential manager value-add through navigating complex transactions, operational changes, and operating / development projects.
Private Asset-Based Finance (\$5.2 Trillion USD Market)	<ul style="list-style-type: none"> Backed by hard and financial assets that generate contractual cash flows. Bespoke, privately originated, and negotiated by an investment manager who can diversify exposures. A wide variety of hard assets including aircraft leasing, renewables and other green energy, rail cars, car loans, containers, and home rentals. This variety of investments diversifies risk exposures, as does the large number of underlying individual asset exposures within each subcategory. Hedging inflation: The value of collateral, particularly hard assets, tends to rise along with consumer prices, meaning that ABF investments can offer some degree of inflation protection. Risk levels may vary depending on the level of subordination and structuring embedded in the securities. 			
Other Real Assets	May include oil, gas, metals, and agricultural products as well as MLPs and Private Energy Funds, etc.			

Beyond Real Estate and Infrastructure, there are other segments to consider too. We note the following:

- **While it is often classified under Private Credit (see our Private Credit focused [Regime Change](#) paper), we think it's worth thinking about Asset-Based Finance when discussing Real Assets as well.** Investments in this strategy can be privately originated and negotiated or can be done in securities format. These investments finance or acquire large and diversified portfolios of assets such as residential mortgages, single-family homes, auto loans, aviation leasing, renewable projects and royalty streams such as music. These assets tend to be associated with predictable, recurring and sometimes even contractual cash flow streams. These products also have a degree of inflation-linkage, given they are backed by hard assets that tend to rise in value with consumer price increases and often have floating coupons that may benefit lenders during periods of rising rates.
- **Investors can also access Real Assets through other assets** such as commodities producers, energy-related master limited partnerships or 'MLPs,' and Private Natural Resources and Energy funds. These assets have significant variability and can be highly complex and will be tackled in a later paper.

Even if Real Assets are often talked about in an all-encompassing sense, one can already see from the above descriptions that nuances exist and that the level of expected risk, return, yield and diversification achievable within each of these asset classes can vary. The informed investor can efficiently allocate to the sub-asset classes that best fit one's total portfolio objectives and constraints, as we discuss later under *Question 3*.

2

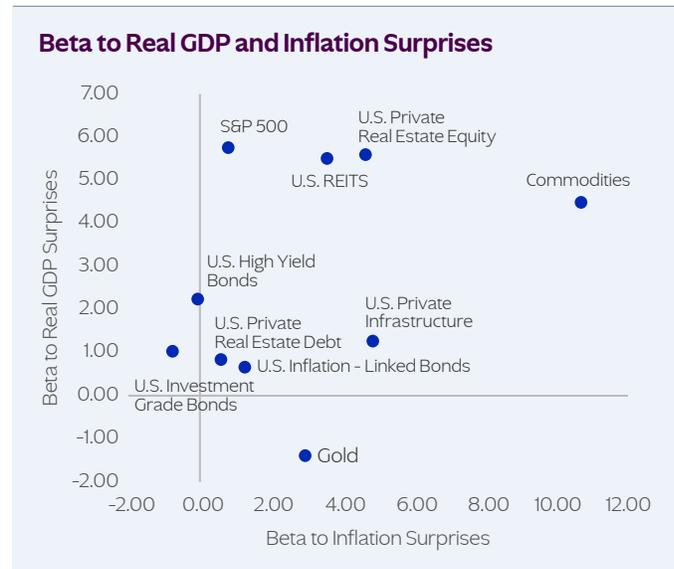
Why should Private Real Assets be included in a portfolio and how do they complement traditional asset classes like Public Equities, Bonds, and Public Real Assets?

Point #1: Real Assets offer a strong inflation linkage, which helps to protect returns in the more volatile environment we envision

In a volatile economic environment involving a higher resting

heart rate for inflation, having cash flows that are stable and tend to grow with inflation (due to inflation protection built into contracts and pricing) is highly attractive.

EXHIBIT 10: Infrastructure and Real Estate Have Historically Had Greater Positive Responses to Upward Inflation Surprises Than U.S. Public Bonds and Stocks



Betas calculated using a multivariate regression to quarterly real GDP surprises, inflation surprises, and interest rate surprises over the last 30 years, or the longest history available for each asset class. Data as at March 31, 2023. Source: Bloomberg, Survey of Professional Forecasters, Burgiss, Giliberto Levy, KKR Global Macro, Balance Sheet & Risk analysis.

TIPS, Gold, and Public REITs, while historically seen as attractive inflation hedges (*Exhibit 10*), have not performed as expected in the recent inflationary environment (*Exhibit 7*). This deviation in performance may be explained by several factors.

Firstly, many of these assets are sensitive to rising real rates, which have trended upward during the recent global Central Bank hiking cycle. TIPS, specifically, serve as a medium-to-long term inflation expectation hedge and therefore might not always correlate with spot inflation. As we have seen over the last few years, it is possible for there to be a sharp increase in spot inflation without an equivalent change in the inflation expectations priced into these bonds, rendering TIPS less effective.

Public securities such as REITs inherently derive value from Real Estate, which is often perceived as a traditional inflation hedge by asset allocators. However, the publicly traded nature of REITs exposes them to broader equity market volatility. This can sometimes dilute their direct link to real estate values and therefore their effectiveness as a pure inflation hedge.

REIT-specific factors such as property management performance, geographic concentration, and tenant mix can further influence REITs' response to inflationary pressures.

The current ongoing inflation episode has been coincidental with post-COVID stress in the Office sector due to work-from-home. Whether in Public REITs or Private Real Estate, an allocation overly concentrated in the Office sector could have seen its inflation hedging benefits impacted by negative performance, further calling for, we believe, appropriate diversification in the inflation hedging approach.

Commodities have also historically been a robust inflation hedge (see *Exhibit 10*). Some, like oil and wheat, have also recently benefited from supply-chain disruptions post-pandemic that were further magnified by shortages due to the Ukraine/Russia conflict. However, despite their historical reliability in hedging against inflationary periods and external shocks, commodity spot prices are inherently volatile, (*Exhibit 11*) and as such, they may increase the risk to a portfolio, especially during recessionary environments when demand often softens. Moreover, various hard-to-predict factors, such as weather patterns, OPEC+ production decisions, and evolving energy transition dynamics, can also impact commodity prices. Hence, while there are reasons for commodities to hold a place in a diversified inflation-hedging portfolio, active management of this exposure becomes crucial.

EXHIBIT 11: Commodity Price Bellwethers Like the GSCI Experienced Nearly Twice as Much Volatility as U.S. Stocks Over the Last 20 Years, While Generating Less than Half the Returns

	S&P GSCI Commodities Spot Index	WTI Crude Oil	Wheat	Copper	[Memo]: S&P 500 Index
Average Annual Returns	4.4%	4.6%	2.9%	8.0%	10.0%
Annual Volatility	27.8%	42.8%	29.9%	29.8%	15.9%
Returns / Volatility	0.16	0.11	0.10	0.27	0.63
Worst Quarter	-43.9%	-66.5%	-23.4%	-51.0%	-21.9%
Best Quarter	29.0%	91.7%	61.3%	40.6%	20.5%

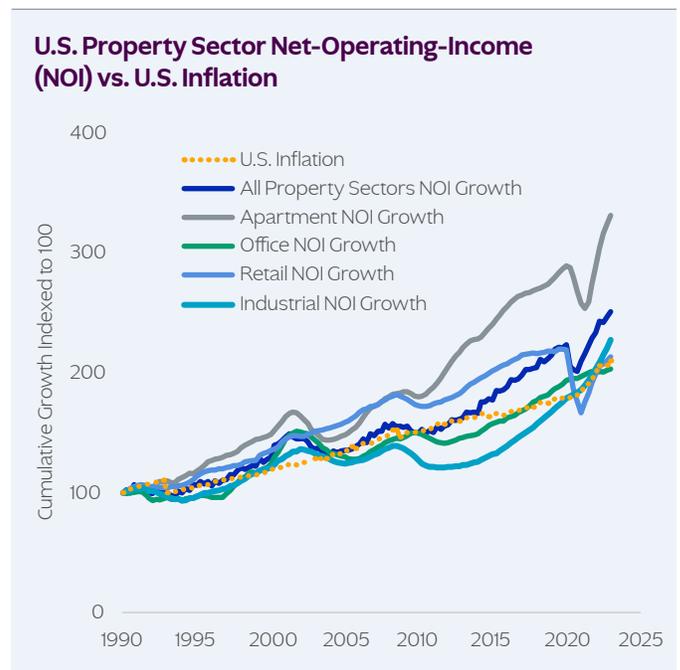
Average annual returns, volatility, and worst/best quarters estimated using quarterly returns of each index and futures contract prices for individual commodities over the last 20 years ending in June 30, 2023. Source: Bloomberg, KKR Global Macro, Balance Sheet & Risk analysis.

Private Infrastructure and Real Estate have fared better for many reasons, we believe. Why? Many of the Real Assets that have outperformed this cycle have the ability to defend their margins in a rising rate and rising commodity price environment.

This resiliency of cash flows has been particularly true across themes that Private Market investors currently favor, such as Single-Family Rental Properties and Industrial Warehouses.

Private Real Estate investments offer inflation protection through property value appreciation and recurring cash flows. Property values generally appreciate with inflation due to rising construction costs, limiting new supply, and putting upward pressure on property prices. Additionally, rental income often increases with inflation, as landlords adjust rents to maintain purchasing power, providing investors with growing cash flows, which we can see in *Exhibit 12* across many property types.

EXHIBIT 12: NOI Growth Across Industrial and Residential Properties Has Kept Up With Inflation Over the Long Run. The Same Is True for Office and Retail Sectors, Albeit With Some Significant Volatility Along the Way



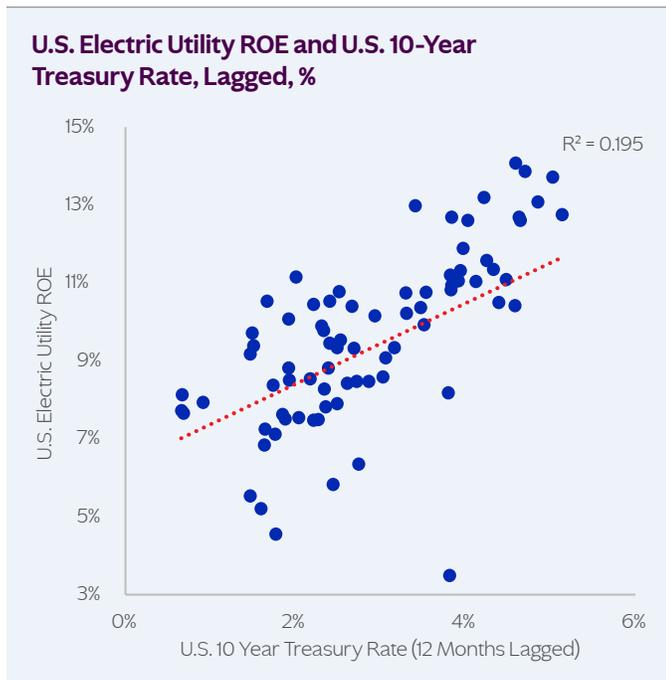
Cumulative 'same-store' Net Operating Income (NOI) growth of properties in the NCREIF Index versus cumulative U.S. CPI growth, indexed to 100. Data as at June 30, 2023. Source: NCREIF, Bloomberg, KKR Global Macro, Balance Sheet & Risk analysis.

Meanwhile, Private Infrastructure investments can also provide an effective inflation hedge. Indeed, many Infrastructure projects feature inflation-linked revenues, with contracted fees and tariffs that are frequently adjusted to keep up with inflation. Furthermore, since Infrastructure assets often support essential services in areas with high barriers to entry, the operating companies are often enabled to adjust their rates alongside rising prices to preserve their margins, which helps

them deliver long-term, predictable cash flows.

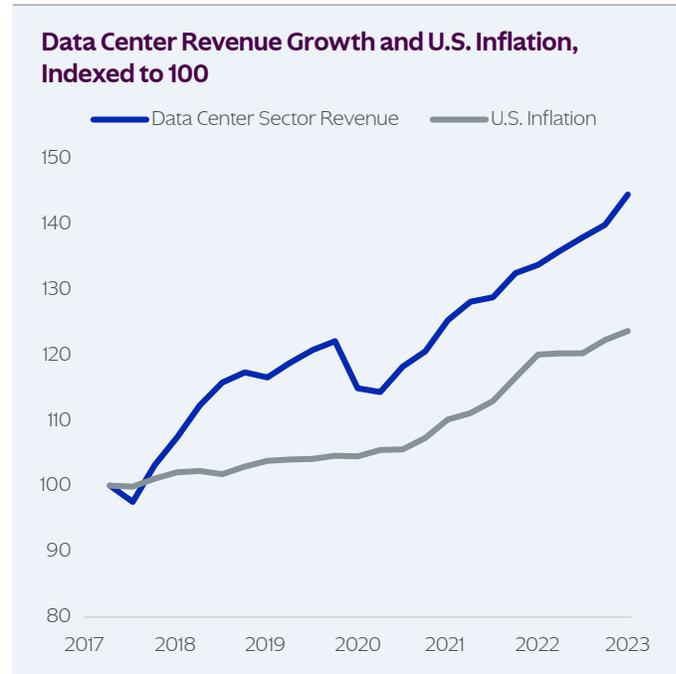
Within the more conservative universe of Private Infrastructure we track, Utilities are a good example of assets whose margins are resilient to rising inflation and costs of financing. Government regulators typically allow Utility companies that reliably provide essential services to their customers to adjust their prices with higher rates and inflation. In many jurisdictions, the price they can charge is calculated as a function of the inflation-adjusted value of the company's service-producing assets and an allowed rate of return that is determined in relation to the risk-free rate. This pricing framework provides a direct link between Utility revenues and rising inflation and interest rates, so long as the regulators view the Utility as 'doing right' by their customers.

EXHIBIT 13: Regulated Utilities Are Infrastructure Assets That Benefit From Having Cash Flows That Are Reset Formulaically When Both Inflation And Interest Rate Levels Rise



Data as at June 30, 2023. Source: Bloomberg, MSCI, KKR Global Macro, Balance Sheet & Risk analysis.

EXHIBIT 14: Data Center Revenue Growth Has Kept Pace With Inflation Over the Last Five Years On Solid Demand From Growing Data Usage



Data center sector revenue derived from the FTSE NAREIT Equity Data Center Sub-Industry Index. Data as at June 30, 2023. Source: Bloomberg, KKR Global Macro, Balance Sheet & Risk analysis.

Meanwhile, Private Infrastructure themes that generate strong secular growth have also helped protect and enhance value during this most recent inflationary episode. There are a number of significant long-term tailwinds for Digital Infrastructure assets like fiber optic and data center projects, driving growth in global data usage. Across U.S. Data Centers, for example, leasing activity and rental growth have been robust as a result of growing demand for data and significant supply constraints. While linkage to inflation may not be as formulaic as Regulated Utilities, these types of assets may generate enough growth to increase the real value of their businesses over time.

Bottom line: While numerous assets are supposed to hedge against inflation, their effectiveness can vary considerably. Public asset classes like TIPS, Gold, REITS, and Commodities, despite their historical track records of hedging inflation, come with their own nuances and risks, that in our view, may weaken this linkage. A prudent strategy would be to diversify among investments that possess a strong fundamental linkage to inflation, which may include Private Real Assets, increasing the likelihood of achieving genuine inflation protection in a portfolio.

EXHIBIT 15: Private Real Assets Tend to Provide Substantial Diversification Compared to Public Market Investments Like Global Stocks, Fixed Income Securities, and Even REITS

Return Correlations by Asset Class, %										
	Global Private Infrastructure	Global Private Real Estate	U.S. Floating Rate ABS	Global Government Bonds	Global Inflation-Linked Bonds	Global IG Corporates	Global HY Corporates	US Public REITS	Global Public Equities	Commodities
Global Private Infrastructure	100%	69%	38%	10%	39%	33%	43%	52%	46%	46%
Global Private Real Estate	69%	100%	18%	-2%	25%	11%	19%	40%	39%	28%
U.S. Floating Rate ABS	38%	18%	100%	-26%	26%	26%	73%	54%	51%	47%
Global Government Bonds	10%	-2%	-26%	100%	75%	78%	30%	22%	13%	-5%
Global Inflation-Linked Bonds	39%	25%	26%	75%	100%	89%	70%	61%	54%	38%
Global IG Corporates	33%	11%	26%	78%	89%	100%	77%	67%	59%	29%
Global HY Corporates	43%	19%	73%	30%	70%	77%	100%	85%	79%	57%
U.S. Public REITS	52%	40%	54%	22%	61%	67%	85%	100%	97%	55%
Global Public Equities	46%	39%	51%	13%	54%	59%	79%	97%	100%	50%
Commodities	46%	28%	47%	-5%	38%	29%	57%	55%	50%	100%

Correlations calculated using 20 years of quarterly total returns. Global Private Infrastructure is proxied using the Burgiss Global Infrastructure Index, Private Real Estate proxied using the Burgiss Global Real Estate Index, Global Government Bonds proxied using the Bloomberg Global Aggregate Treasury Index, TIPS proxied using the iShares TIPS Bond ETF, Global IG & HY Corporates proxied using the Bloomberg Global Aggregate Corporate Index and Bloomberg Global High Yield Indices respectively, U.S. Public REITS proxied using the MSCI U.S. REIT Index, Global Public Equities proxied using the MSCI World Index, Commodities proxied using the S&P GSCI Spot Index. Data as at March 31, 2023. Source: Bloomberg, NCREIF, Burgiss, KKR Global Macro, Balance Sheet & Risk analysis.

Point #2: Real Assets can add strong diversification to a portfolio, which can often lower portfolio risk, in our view

Diversification has been referred to as ‘the only free lunch’ in investing. Owning asset classes that zig when others zag across the economic cycles, tends to stabilize returns over time and offers more predictability of performance and risk. Partly as a result of this inflation linkage and the protection offered from being backed by hard assets, Real Asset investments tend to perform differently across various economic environments than traditional Public Equity and Debt investments. As we can see in *Exhibit 15*, the realized correlations between the returns of Private Real Assets like Infrastructure and Real Estate and conventional asset classes like Global Investment-Grade and High-Yield Corporates are low-to-moderate, between 10-40% over the last 20 years.

There are also benefits to building global portfolios of Real Assets, as these investments are often influenced by local

factors that will vary across regions like consumer and demographic trends, regulations and laws, and even weather patterns, to name a few. One example of the regional diversification effect in action is in the global Office Real Estate sector. While in the U.S. large metros like New York City and San Francisco have seen Office vacancy rates reach 15% to 30% as a result of post pandemic work-from-home trends, Asian Office assets in cities like Tokyo, Singapore, and Seoul, where workers are returning to the office, have been comparably resilient (see *Exhibit 17*). A similar story holds true in Europe too, we believe.

What these diversification benefits mean for investors is that the attractive risk-adjusted returns of Real Assets, coupled with their less than perfect correlations with stock and bond portfolios, will likely shift the efficient frontier out. In other words, by adding Real Assets to a portfolio as part of a long-term ‘All Weather’ allocation, investors may be able to achieve higher returns without having to take on additional risk.

EXHIBIT 16: We Think There Can Also Be Substantial Diversification Benefits From Allocating to Private Real Assets Across Strategies And Geographies

Return Correlations by Asset Class by Geography, %						
	North American Real Estate	European Real Estate	Asian Real Estate	North American Infrastructure	European Infrastructure	Asian Infrastructure
North American Real Estate	100%	67%	80%	57%	44%	13%
European Real Estate	67%	100%	70%	67%	83%	26%
Asian Real Estate	80%	70%	100%	66%	50%	35%
North American Infrastructure	57%	67%	66%	100%	55%	29%
European Infrastructure	44%	83%	50%	55%	100%	34%
Asian Infrastructure	13%	26%	35%	29%	34%	100%

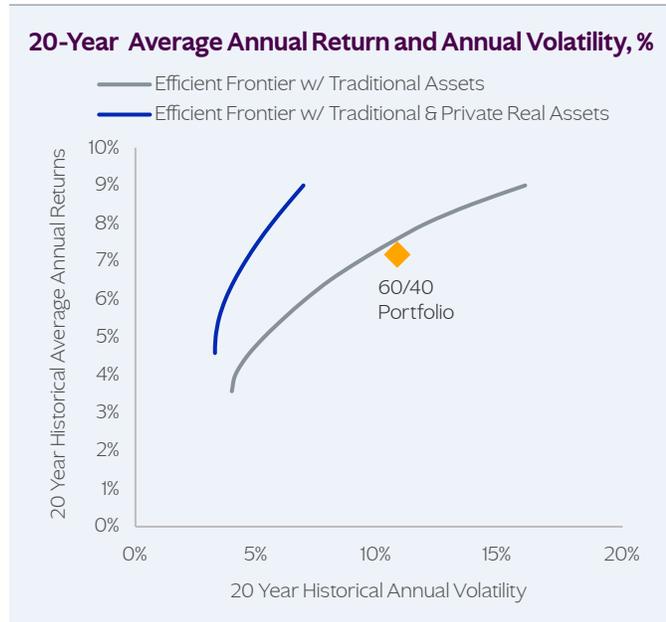
Correlations calculated using 20 years of quarterly total returns. Private Real Estate and Private Infrastructure allocations are proxied by the North American, European, and Asian equivalent private market indices from Burgiss. Data as at March 31, 2023. Source: Bloomberg, Burgiss, KKR Global Macro, Balance Sheet & Risk analysis.

EXHIBIT 17: While There Are Challenges Ahead in the U.S. Office Sector Due to Work-From-Home Trends, Office Assets in Asia Have Been Resilient



Data as at June 30, 2023. Source: CBRE, JLL, KKR Global Macro, Balance Sheet & Risk analysis.

EXHIBIT 18: Private Assets Often Enable Investors to Build Portfolios With Higher Realized Returns While Also Reducing Volatility



Efficient frontier calculated using quarterly total returns over the last 20 years ending in March 2023. Traditional asset efficient frontier constructed using the MSCI World Index for Global Equities, the Bloomberg Global Aggregate Treasury Index for Global Government Bonds, the iShares TIPS Bond ETF for TIPS, and the Bloomberg Global Aggregate Corporate Index and Bloomberg Global High Yield Index for Global IG and HY Corporates. Efficient frontier with traditional and Private Real Assets uses all of those indices, plus the MSCI U.S. REIT Index for Global REITS, Commodities proxied using the S&P GSCI Spot Index, Global Private Infrastructure is proxied using the Burgiss Global Infrastructure Index, Private Real Estate proxied using the Burgiss Global Real Estate Index, and the Giliberto Levy Commercial Mortgage Index for Private Real Estate Debt. Data as at March 31, 2023. Source: Bloomberg, Burgiss, Giliberto Levy, KKR Global Macro, Balance Sheet & Risk analysis.

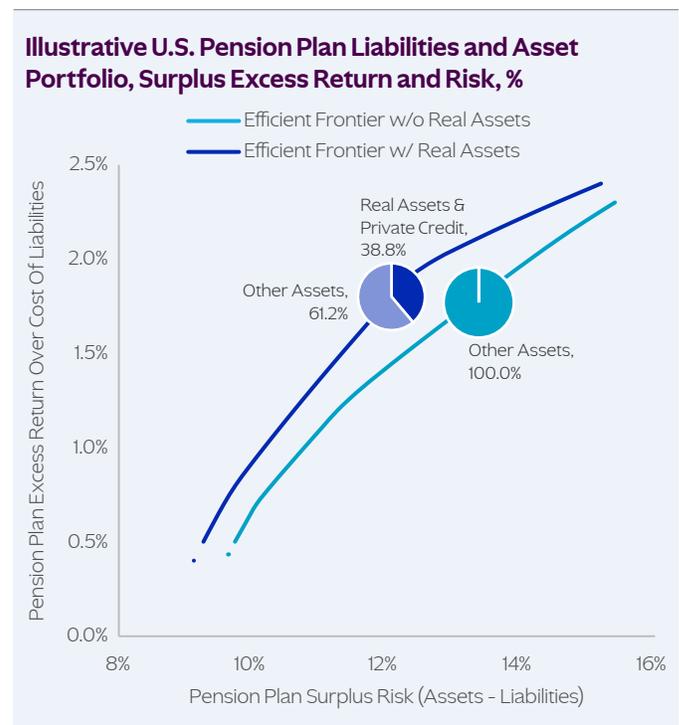
Point #3: Real Assets have characteristics that may solve some investors' current challenges, including generating stable, inflation-linked income that can match liability payments

The substantial variation in strategies, risk-levels, and ability to invest across the capital structure in Real Asset classes allows investors to tailor allocations to align with their long-term goals. Importantly, some institutional investors may find that Real Assets can also address their financial challenges. Pension funds, for example, typically seek to buy stable, yielding assets that can generate cash flows that match required payments to their beneficiaries. While not uniform globally, many pensions have liabilities that are subject to cost-of-living-adjustments or other escalators that may result in higher payments when inflation rises.

In the past, traditional liability driven investing (LDI) approaches would typically use long-duration bonds to manage the long duration liabilities. However, during this most recent cycle the traditional LDI approach showed its weakness as inflation and rates sharply rose. For instance, in the U.K. pensions commonly have used swaps and other derivatives to replicate the bond positions necessary to hedge their liabilities. As interest rates soared in 2022, the value of these leveraged derivatives positions declined significantly, generating significant mark-to-market losses and creating a short-term liquidity crunch for U.K. pensions utilizing significant leverage.

We increasingly find that Real Asset return vehicles such as Core Infrastructure and Real Estate Debt, both of which generate stable income while having some inflation protection may help pensions reduce surplus volatility as well as generate higher yields to better achieve their funded status goals with less complexity.

EXHIBIT 19: Increasing Private Real Assets and Private Credit in a Pension Portfolio May Increase Excess Returns Over Liability Costs While Reducing Surplus Risk



The analysis models the example pension liabilities as a short position in a bond with coupon payments over 50 years that escalate annually. Surplus excess returns and surplus risk are estimated as the difference in returns between an underfunded portfolio and the modeled pension liabilities. Data as at June 30, 2023. Source: KKR Global Macro, Balance Sheet & Risk analysis.

Our bottom line: Given that we see a structurally higher resting heart rate for inflation this cycle, we believe investors should protect their purchasing power by diversifying portfolios to include more Real Assets linked to nominal GDP. We think Real Assets also help investors manage the risks of both the asset and liability sides of their balance sheets in ways that traditional investments cannot. So, not only will the inflation and diversification benefits of Real Assets enhance risk-adjusted returns in adverse economic environments, but we think these features could also help solve many of the investment challenges that clients face.

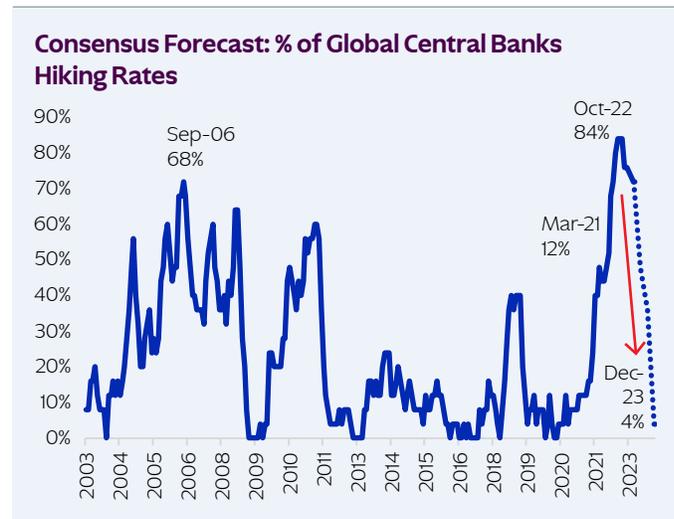
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How has the current economic landscape changed since the last Regime Change paper and what are the implications for the Real Assets component of the original 40/30/30 portfolio?

Simply stated, we have even higher conviction today than we did when we first advanced the notion that investors should consider branching out beyond a 'traditional' stock/bond portfolio. Aiding our cause has been the strong and persistent inflation across most regions around the world, resulting in a record pace of tightening by nearly all developed markets central banks. As we show in *Exhibit 1*, we estimate that most of the largest central banks will miss their inflation targets through at least the end of 2024. Without question, the post-BREXIT United Kingdom has unsurprisingly emerged as the most problematic inflation 'hot spot', though services inflation in most parts of the developed economy remains challenging.

As a result of this shift in global monetary policy, the bond component of the traditional 60/40 portfolio has proven far from the promised hedge.

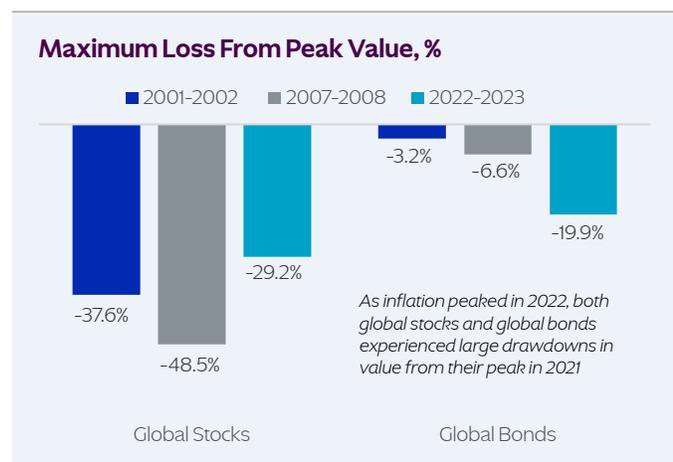
EXHIBIT 20: Good News: Global Central Banks Have Chopped a Lot of Wood, but Both Pace and Level of Rates Still Matter



'Hiking' defined as an increase in the policy rate over the last three months. Uses Bloomberg consensus forecast for top 25 global central banks excluding the Federal Reserve. Data as at May 29, 2023. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

As a result of this shift in global monetary policy, the bond component of the traditional 60/40 portfolio has proven far from the promised hedge. Indeed, Global Bonds experienced a drawdown of nearly -20% from January to October 2022, while at the same time Global Stocks fell nearly -30%, hitting a bottom in 3Q22 before starting to recover in 2023. At the same time, there are some early indications that the enhanced 40/30/30 portfolio we introduced in our first publication in the Regime Change series is adding value. Our 40/30/30 portfolio is predicated on enhancing the equity and debt components of the traditional 60/40 with asset classes that are more likely to appreciate in both inflationary and rising rate environments. To recap, we think adding Private Credit for its yield and typically floating rate coupons could enhance the 40% Fixed Income component of the typical 60/40, while Real Assets can enhance the 60% Equity slice due to their inflation protection and diversification potential. In addition, for investors that have a higher risk tolerance, a longer-term investment horizon, and that are more focused on compounding at a higher rate of return, the value of the illiquidity premium from Private Equity and Opportunistic Real Assets also becomes significant in a world where aggregate returns are falling.

EXHIBIT 21: Historically, Adding Bonds to a Portfolio Would Have Provided Stability Amid Market Turmoil; However, During the Most Recent Cycle That Has Not Been the Case



Global stocks proxied using the MSCI World Index, Global Bonds proxied using the Bloomberg Global Aggregate Bond Index. Maximum drawdowns that each index experienced within 3 periods, 12/31/2000 to 12/31/2022, 6/30/2007 to 12/31/2009, and 12/31/2021 – 3/31/2023. Data as at March 31, 2023. Source: Bloomberg, Global Macro, Balance Sheet & Risk analysis.

The main counterargument to increasing allocations in Private Markets is that they reduce the amount of liquidity within the portfolio, and therefore might not be suitable for every investor. While liquidity considerations are central to any asset allocation strategy, they are influenced by a number of investor-specific factors, making it hard to define a one-size-fits-all rule. There are some trends by investor type to consider.

- For institutional investors, such as endowments and foundations, their long investment horizons and typically small short-term liquidity requirements mean they can afford to allocate more significantly to illiquid Alternatives. Pension funds, while they do have certain liability and yield requirements, generally also have a long-term perspective that allows them to diversify into less liquid investments such as Private Credit and Core Real Assets without unduly compromising their overall financial position.
- Individual investors, on the other hand, must evaluate their personal liquidity needs closely. Those with a high risk tolerance and a longer time horizon until retirement might be more inclined to invest in illiquid assets, seeing potential for greater returns that compound over a longer period of time. In contrast, retirees or those nearing retirement might prioritize assets that provide a steady stream of dividends or periodic payouts, offering consistent cash flow to support their retirement lifestyles.

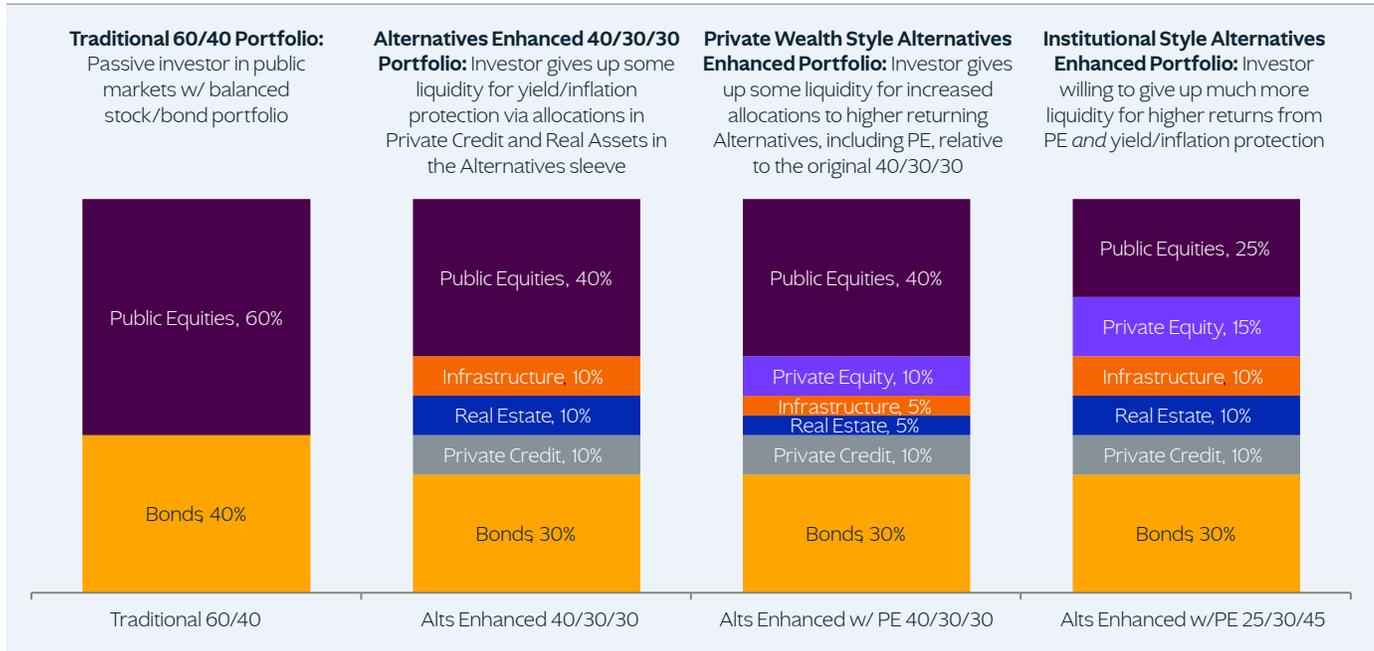
Furthermore, the broader economic environment can influence allocation decisions. The fact that highly liquid U.S. Treasury Bills currently yield over five percent sets a high bar for allocating to less liquid investments. As highlighted in our KKR Mid-year Update *Still Keeping It Simple*, we think investors can currently earn strong risk-adjusted returns without needing to stretch in terms of capital structure or counterparty risk. This backdrop puts assets like Real Estate Credit, Asset-Based Finance, and most parts of Infrastructure near the top of our list, particularly for income-oriented investors who are more focused on generating attractive yields and reducing portfolio risk.

EXHIBIT 22: Based on Historical Returns, the Addition of Private Equity to Portfolios Can Often Help Achieve Better Risk-Adjusted Performance

	Return	Volatility	Sharpe Ratio	Δ vs. 60/40	% Liquid Assets	Cash Yield
All Periods by Portfolio						
60/40	9.3%	12.7%	0.73	-	100%	2.6%
40/30/30	9.6%	9.6%	1.00	0.26	70%	3.6%
Private Wealth	10.6%	10.6%	1.00	0.27	70%	3.2%
Institutional	10.9%	9.2%	1.18	0.45	55%	3.5%
High Inflation by Portfolio						
60/40	1.5%	12.5%	0.12	-	100%	2.6%
40/30/30	4.3%	8.8%	0.49	0.37	70%	3.7%
Private Wealth	5.3%	9.1%	0.57	0.45	70%	3.2%
Institutional	6.9%	8.6%	0.80	0.68	55%	3.5%
Low Inflation by Portfolio						
60/40	11.0%	11.5%	0.96	-	100%	2.6%
40/30/30	10.5%	9.1%	1.16	0.21	70%	3.6%
Private Wealth	11.5%	10.2%	1.13	0.18	70%	3.1%
Institutional	11.4%	9.3%	1.23	0.27	55%	3.5%

Portfolio returns and volatility modeled using annual total returns from 1928 to 2021 for the S&P 500, from 1978 to 2021 for Real Estate, from 2004 to 2021 for Infrastructure, from 1928 to 2021 for Bonds, from 1981 to 2021 for Private Equity, and from 1987 to 2021 for Private Credit. Assumes continuous rebalancing of the portfolios. U.S. Equities modeled using the S&P 500 Index. Bonds modeled using a mix of 50% U.S. T-Bonds and 50% Baa Corp. Bond annual returns, computed historically by Aswath Damodaran (NYU Stern). Real Estate modeled using the NCREIF Property Levered Index. Private Infrastructure modeled using the Burgiss Infrastructure Index. Private Equity modeled using Burgiss North America Buyout Index. Private Credit modeled using the Burgiss Private Credit All Index. Cash yields modeled using annual data from 2000-2021 for all asset classes with the exception of Private Real Estate (2005-2021), Public Equity using S&P 500 12M gross dividend yield, Private Equity proxied using S&P Small Cap 12M gross dividend yield, Private Infra proxied using S&P Infrastructure 12M gross dividend yield from 2006 onwards and 2000-2006 back filled using S&P Utilities, Public Credit based on Bloomberg Aggregated Credit yield to worst, Private Credit using Cliffwater Direct Lending Index Income Return, Private Real Estate based on NCREIF NPI cap rate. Source: Burgiss, Aswath Damodaran, Bloomberg, NCREIF, KKR Portfolio Construction analysis.

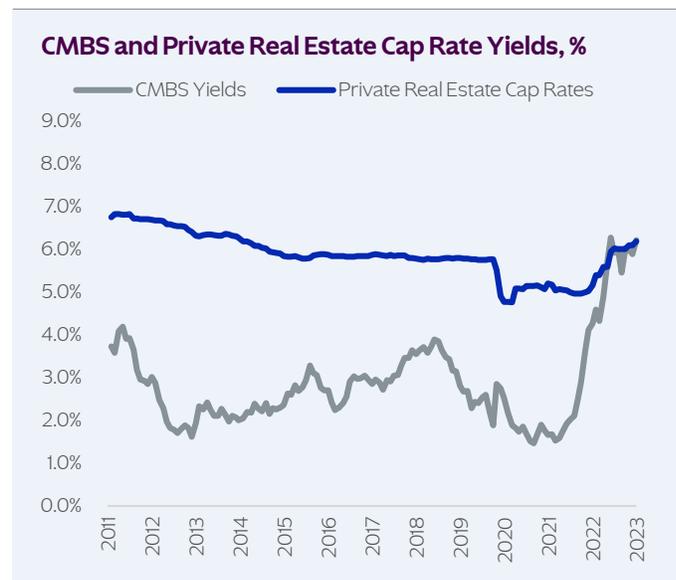
EXHIBIT 23: Alternatives Can Play a Significant Role in Enhancing Income As Well As Overall Total Returns in Many Diversified Portfolios



Note: Not every investor will want or need up to 30% Alternatives in their portfolio, depending on risk tolerance, liquidity needs, and portfolio strategy. Some sub-strategies may not be implementable by all investors. Data as at March 31, 2023. Source: KKR Global Macro, Balance Sheet & Risk analysis.

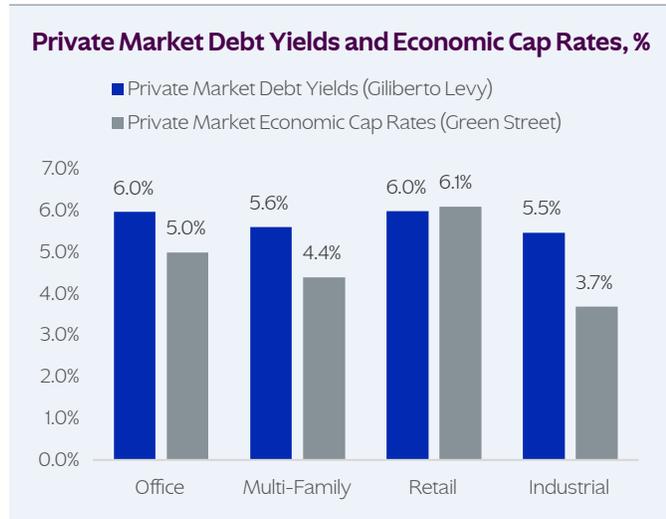
As one example of relative value within Real Assets, we think that Real Estate Credit appears more compelling at current levels than Real Estate Equity. One can see this in both the U.S. public and private CMBS markets (*Exhibit 24*), as the debt yields currently offers better relative value than Real Estate Equity and some particularly attractive yield opportunities, we believe. One can see this in both the U.S. public and private CMBS markets, as the debt yields currently exceed cap rates, which are the net operating income yields on unlevered properties. This high cost of debt can make it more difficult for Real Estate Equity investors to make levered investments without assuming exceptionally high growth rates, while today, Real Estate Credit investors may get commensurate returns with more downside protection, given placement in the capital structure. As such, taking some of an income-oriented investor’s long-term strategic allocation to Real Estate Equity to create a ‘tilt’ towards Real Estate Credit assets like Single-Asset, Single-Borrower and B-Piece CMBS may allow them to take advantage of these currently attractive yields.

EXHIBIT 24: For the Average Commercial Property CMBS, Yields Are Currently Roughly Equivalent to Cap Rates On the Underlying Property



Data as at March 31, 2023. Source: Bloomberg, Greenstreet, KKR Global Macro, Balance Sheet & Risk analysis.

EXHIBIT 25: We Also Find That Yields On Private Real Estate Debt Today Exceed Cap Rates On the Underlying Properties Across Most Sectors

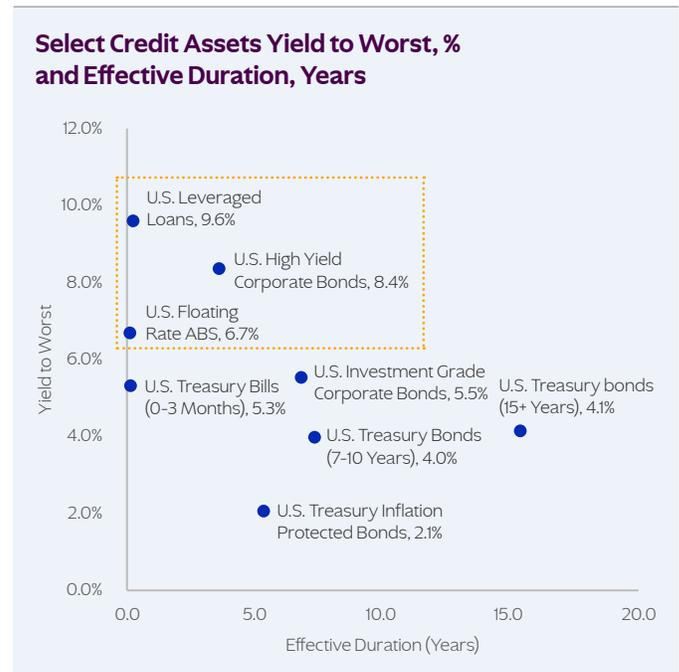


Data as at March 30, 2023. Source: Gilberto Levy, Green Street, KKR Global Macro, Balance Sheet & Risk analysis.

We also believe that Asset-Based Finance stands out for many of the same reasons. First, floating rate structured products are similarly priced at very high yields relative to other assets and with a much lower level of interest rate sensitivity than other more conventional fixed income products. Second, many of the hard assets that collateralize these investments, such as single-family homes and used cars, tend to have prices that rise with inflation, and in the case of shipping containers they may provide some resiliency against supply chain disruptions. Indexing the value of the debt coupons to short-term interest rates provides protection against central bank rate hikes, while having collateral that tends to increase in value with inflation provides some compelling evidence for why Asset-Based Finance can add stability to a portfolio.

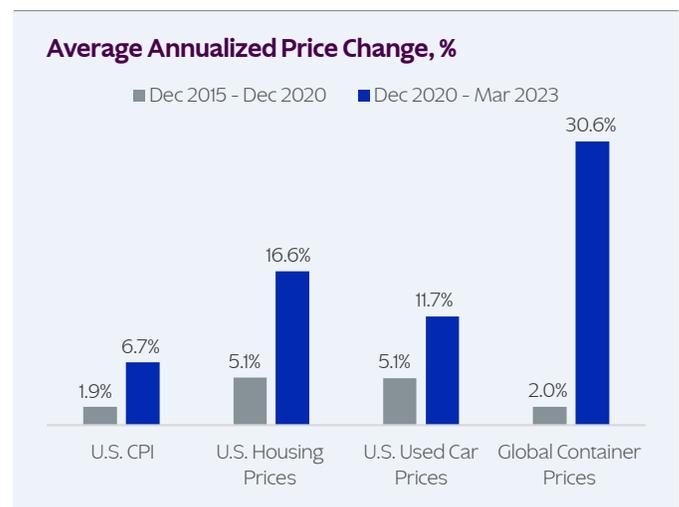
Having collateral that tends to increase in value with inflation provides some compelling evidence for why Asset-Based Finance can add stability to a portfolio.

EXHIBIT 26: Floating Rate Credit Assets Like Leveraged Loans and Asset-Based Securities Currently Trade at Very High Yields Relative to Their Level of Interest Rate Sensitivity Compared to Other Fixed Income Assets



Data as at June 30, 2023. Source: Bloomberg, ICE BofA, LSTA, KKR Global Macro, Balance Sheet & Risk analysis.

EXHIBIT 27: The Value of Common Types of Collateral Underlying ABF Assets Like Homes, Used Cars, and Shipping Containers Rose Significantly Between 2021 and 2022 as U.S. Inflation Soared



Data as at June 30, 2023. Source: Bloomberg, FHFA, Manheim, Container Trades Statistics, KKR Global Macro, Balance Sheet & Risk analysis.

However, we do want to caution that, even within Real Assets, what has worked previously is not guaranteed to work in the future and some themes that appear to be dislocated opportunities may in fact present potential risks that investors will need to navigate. In particular, we think that Real Estate Equity is going to require a much more nuanced approach than in the past. The Office sector, too, will likely remain challenged. All told, our colleague Ezra Max forecasts Office CRE property values to fall by an additional 20-30% from the current levels, which are already 20% down from their peak.

If there is good news, it is that we actually see lower losses across Real Estate this cycle than compared to the Global Financial Crisis (GFC). Specifically, we project aggregate CRE bank loan losses to reach around six percent in our bear case, while they hit nearly 10.5% during the GFC.

EXHIBIT 28: Office Defaults Are a Big Problem for Banks, But CRE Debt Overall Should Hold Up Better Than During the GFC

	Bank CRE Loans			Life CRE Loans		
	Total	Non-Office	Office	Total	Non-Office	Office
Base (~50th %tile)	3.4%	2.9%	5.3%	1.0%	0.8%	1.4%
Bear (~75th %tile)	5.7%	4.60%	9.4%	1.5%	1.1%	2.3%
[Memo]: GFC	10.5%			~0.1%-0.5%		

Data as at April 30, 2023. Source: JPM, BAML, Citibank, Morgan Stanley, Deutsche Bank, KKR Global Macro, Balance Sheet & Risk analysis

Against this backdrop, we expect dislocations in Office to – over time – create substantial near-term opportunities for allocators to become lenders to high quality Real Estate opportunities as the banks retreat further. Moreover, we now see emerging value in the equity of many Real Estate investments, given the pall of negative sentiment and earnings downgrades during the past 12-18 months. Though repricing is starting to emerge in the Private Markets, Public Real Estate Equity markets may currently be an interesting place to search for dislocated opportunities given the heavy losses to their market capitalizations that many REITs incurred in 2022.

4

How can allocators of capital best implement allocations to Real Assets in their portfolios?

The choice of vehicle depends in great part on investor preferences and requirements. Institutional investors that have a large capital base may have the scale required to reliably access Private Real Assets through direct investing alone. Deep-pocketed investors can also access Private Real Assets by offering other LPs liquidity to purchase Private Real Asset fund stakes in the secondary market.

An emerging option for investors who are newer to Private Real Assets, or who would like more control over their liquidity, is a semi-liquid vehicle, which is a hybrid of an open-end fund and closed-end fund structure. These vehicles allow investors to buy into a diversified portfolio on day one and offer some periodic liquidity beyond capital distributions, which enables investors to more directly control their exposure to the asset class over time. These features are an improvement on the closed-end structure; however, they do not offer the same degree of liquidity as a mutual fund or ETF would offer, which is an important consideration for all investors and their advisors to consider. As an example, in 2022 many non-traded REIT investors were taken by surprise when General Partners enacted redemption limits, even though such limits are built into the structure of these vehicles.

Core Real Estate and Core Infrastructure are currently more typically accessed through open-ended vehicles that function similarly to mutual funds and can offer some redemption features, given the high degree of visibility into the underlying cash flows and predictability of yields that can make assets more saleable. On the other hand, certain types of Opportunistic Real Estate and Infrastructure strategies that require many years to develop new projects or to turnaround underperforming assets may benefit from the additional runway and lack of forced sales from a closed-end or draw-down fund structure.

EXHIBIT 29: There Is a Wide Range of Options for Implementing Private Real Asset Investments, Including Funds to Direct Investment

Fund Structure	Description	Advantages	Potential Drawbacks
Closed-Ended Funds	Most common way for investors to access Private Alternatives. Involves an 'investment period' where capital is called then deployed over several years. After a 3-7 year holding period investments are liquidated and the GP will distribute proceeds to investors.	Fund structure eliminates potential for forced sales, giving portfolio companies time to fully realize their growth potential or for distressed investments to execute a turnaround strategy.	Investors have no control over when their capital is called and when they receive distributions, making it harder to target a desired allocation. Does not provide day-one access to Private Markets and requires a ramp-up phase.
Semi-Liquid Vehicles	Open-ended evergreen structures that can invest and hold assets indefinitely and typically offer investors some level of liquidity subject to limits at some time interval.	Gives investors some degree of control over when and how they exchange liquidity. Provides investors with day-one access to an existing portfolio of Private Alternatives. Those features enable investors to reach and maintain a target allocation more easily.	GPs must manage liquidity appropriately to honor the redemptions features. This may require holding liquid assets that can reduce the returns of the vehicle compared to the closed-end solution.
Secondary Market Investments	Opportunities to buy and sell pre-existing investor commitments to Private Alternatives funds. The seller can liquidate stakes in a fund before its term ends, and the buyer takes on an existing exposure along with any unfunded commitments.	Shorter J-Curve with accelerated deployment and earlier distributions of capital. Potential to buy funds at discounted prices from other LPs.	Buyer often has to purchase a pool of fund stakes and co-investments from GPs. The seller seeking liquidity often has to offer discounts to find potential buyers.
Co-Investments	Investors can directly invest alongside a private equity firm in a deal, typically on a deal-by-deal basis.	Investors can allocate to many of the same deals in which the flagship Private Markets fund invests, often times at lower fee and carry rates. Ability to 'size-up' individual deals in-line with the level of conviction.	Investors not always able to invest side-by-side with the fund on all deals. The asset selection decision is left in the hands of investors who must objectively assess their allocation/selection skills.
Direct Investments	Directly investing capital into private companies without the intermediation of a private equity firm.	Investors have full control over all aspects of the investment process.	Requires sufficient scale, resources, expertise to operate such a strategy and to make the economics work.

Data as at August 31, 2023. Source: KKR Global Macro, Balance Sheet & Risk analysis.

SECTION II

Conclusion

At KKR, we continue to believe that a macroeconomic regime change has occurred this cycle, requiring a different approach to asset allocation. Key factors that inform our thinking include: unprecedented levels of monetary and fiscal stimulus; the emergence of the ‘security of everything’ as the global economy transitions from a period of benign globalization to one of great power competition; the global energy transition which, while noble in cause, requires a lot of hard-to-extract commodities; and labor markets that are structurally much more strained in the developed markets post-COVID, which we believe will continue to put upward pressure on wages.

Against this macroeconomic backdrop, we continue to envision a higher resting heart rate for inflation. We also see the nature of inflation changing, which we think is causing stocks and bonds to become more correlated. This means that bonds will no longer act as effective portfolio ‘shock absorbers’, in our view. We also think that, from a strategic perspective, many customary inflation hedges such as TIPS may not perform as well this cycle. Hence, we continue to favor Real Assets with defensible margins, collateral-based cash flows, and upfront recurring yields.

We reiterate our view for a strategic asset allocation that includes some portion of a portfolio in Private Alternatives like Real Assets, including Real Estate Credit, Asset-Based Finance, and Infrastructure. From a tactical perspective, our top-down models suggest that Credit across Real Assets is especially attractive in today’s environment. Key to our thinking is that the recent pullback in bank credit extension has created a compelling opportunity for non-bank lenders to step in and fill that void in a higher interest rate environment.

In terms of implementation, we are encouraged that the market for Real Assets is becoming more favorable. Many products are now incorporating more liquidity features as well as different risk profiles to match the needs of both individual and institutional investors. These include, as examples, semi-liquid structures for the Private Wealth investor and Core open-ended structures for Institutional investors. These structures also enable allocators to reach their desired target allocations with more speed as well as with more precision.

Our bottom line: Our thesis around the differentiated benefits of Real Assets, which has become a more integral part of KKR’s Balance Sheet asset allocation, is playing out nicely, and we see more opportunities ahead given today’s complex macroeconomic environment. However, not all Real Assets are created equal, and we believe an investor must look beyond traditional inflation hedges such as REITs, TIPS, and Gold towards more collateral-based cash flows linked to nominal GDP, including a mix of Asset-Based Finance, Infrastructure, and select parts of Real Estate Credit and Equities.

We reiterate our support for a strategic asset allocation that includes some portion of a portfolio in Private Alternatives like Real Assets, including Real Estate Credit, Asset-Based Finance, and Infrastructure. From a tactical perspective, our top-down models suggest that Credit across Real Assets is especially attractive in today’s environment.

Important Information

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