Wealth Management

Alternative Investments

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The world's financial markets are continually evolving and, as a result, changing the way investment professionals think about asset allocation. No longer limited to stocks, bonds or cash, investors are increasingly looking to alternative or non-traditional investments to build portfolios for all market cycles.

Alternatives can be an important part of an investor's portfolio. Given their non-traditional approach and their ability to invest in ways traditional investments cannot, alternatives have the potential to improve the overall risk-return characteristics of a portfolio. A modest allocation to alternatives may be wise for some investors. However, the non-traditional approach and structure of these investments bring unique risks.

So what are alternative investments? In contrast to traditional stock and bond/mutual fund strategies, alternative investments utilize tools that you will find less prevalent in traditional strategies, like some of the following techniques and characteristics:

1. Shorting (selling a borrowed security with the expectation it will fall in value);
2. Leverage (borrowing with the expectation that it will increase potential investment return);
3. Higher degrees of flexibility in their structures and strategies; and
4. Few ties to traditional benchmarks (investors should understand the benchmark the alternative is aligned with).

Some types of alternative investments include the following (this is not an all-inclusive list). New approaches are constantly being developed.

1. **Hedge Funds.** These investments are managed portfolios utilizing strategies such as long/short, derivatives and leverage. The goals are typically to reduce volatility and/or produce stronger returns. Most of the time these are only available to high-net worth investors and have high minimums and liquidity restrictions.
2. **Managed Futures.** These investment vehicles seek to participate in a variety of global futures markets, i.e., stock indexes, interest rates, currencies and commodity futures. Computer modeling is often utilized in these vehicles to offer a disciplined, unemotional approach to the strategy.
3. **Private Equity.** This strategy lets investors participate in the growth of private companies. This is an illiquid asset class offering the potential for long-term capital appreciation. It is usually only available to high-net worth investors, with high minimum investment sizes and liquidity restrictions that can be up to seven to 10 years.
4. **Alternative Mutual Funds.** These are publicly-traded funds where the managers are not constrained by typically "going long" portfolio management methods. Approaches include the following: long/short equity, absolute return and hedge fund-oriented. They provide access to non-traditional investment approaches while still providing daily liquidity at reasonable investment minimums.
5. **Multiple Manager Approach.** All of the above alternatives can be offered in multiple manager structures, such as fund of funds. These strategies bring diversification to the space. This strategy typically brings additional fees, but an investor may want to look at whether the diversification can outweigh the added cost.

Investors must consider some of the potential risks of alternative investments (this is not an exhaustive list):

1. **Manager experience.** Manager risk includes those that exist within a manager's organization: investment process, personnel and systems. There is also a potential for fund-level risks that arise from the way in which a manager constructs and manages the fund.
2. **Leverage.** Leverage increases a fund's sensitivity to market movements. Funds that borrow money to help generate increased returns can be expected to be more volatile than other funds that do not use leverage.
3. **Non-traditional asset class exposure.** Non-traditional asset classes often engage in practices that are speculative and involve a high degree of risk. Such practices may increase the volatility of performance and the risk of investment loss, including the entire amount that is invested.
4. **Less transparency.** There can be limited transparency into the underlying investments. Also, some alternative investments are largely unregulated.
5. **Liquidity.** Alternatives may contain investments that may be illiquid or that may become less liquid under certain conditions. There is also the risk that there are few liquid funds to be able to pay redemption requests, because of things like unusual market developments or an unusually high number of requests for redemption. This can result in gating – a restriction placed on a fund limiting the amount of withdrawals during redemption periods.
6. **Less tax friendly.** Most alternatives do not focus on minimizing taxes. Also, alternatives set up as partnerships issue K-1 statements rather than 1099s and can require the taxpayer/investor to file for an extension.

Finally, it is important to understand the fee structure of alternative investments. A standard fee structure in the hedge fund industry, for example, is the "2 and 20" annual fee structure. This includes a 2 percent investment management fee based on the fund's net asset value with a 20 percent performance fee. Typically a performance fee is an annual payment made to the fund manager for generating positive returns. It is usually calculated as a percentage of investment profits and it is a way for managers to share in the fund's profits, but not their losses. Critics say that performance fees can tempt fund managers to take extra risks to generate higher returns.