Introduction to Alternative Investments

Alternative investments are a group of investment options that can offer **diversification benefits** to those with **sufficient resources** and **investment expertise.**

These investments have risk and return characteristics that are different from the normal asset classes. The overall goal is to reduce the correlation to the traditional equity and bond portions of the portfolio.

Common Features

Alternative investments vary by type, but share the following features:

Illiquidity

Traditionally, alternative investments have time requirements that do not permit withdrawals unless substantial notice is given or only permit withdrawals at specific times. However, this is recently changing with many mutual fund types of alternative investments.

Diversifying potential

Alternative investments have a low correlation relative to a portfolio of stocks and bonds, and therefore can add significant return while reducing risk.

Difficult performance appraisal

Only periodic returns may be available, making daily and even monthly performance analysis impossible. Appropriate benchmarks for performance comparison may also be difficult to establish due to a lack of historical data.

Tax Considerations

Tax issues are always a critical consideration, and alternative investments are no exception. Some investment vehicles are structured as complex partnerships. Sometimes in these situations, the investments generate taxable gains without making any distributions (also known as K1 income). Some of the newer, lower cost mutual fund type of alternative investments can now function by using ordinary investment income as the treatment.

Types

The following list includes the most popular alternative investment asset classes:

Real estate

This includes direct or indirect ownership interests in land and structures on that land. Exposure to real estate is gained via direct purchase, investments in REITs (real estate investment trusts), CREFs (commingled real estate funds), separately managed accounts or investment in real estate stocks. While real estate stocks do provide some exposure to this market, their performance is more closely tied with that of stocks than real estate,

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which limits their effectiveness as an alternative investment. Real estate is a critical diversifier within an investment portfolio.

Private equity (PE)

An investment fund that purchases and sells ownership interests in equity that is not publicly traded. Strategies for PE firms vary, from investments in startup companies to large corporations. Investments in PE can be expensive due to management and incentive fees. It is extremely difficult to determine the performance of a private equity fund due to limited valuation updates for private companies. Furthermore, PE investments are highly illiquid as withdrawals are very restricted. The high expected return on PE investments is mirrored by the higher risk associated with investments in small or newly created companies.

Commodities

A tangible asset such as agricultural goods, metals, etc. There are many ways to gain exposure to commodity investments. The most direct way to do so is by purchasing and storing the actual commodity, or buying futures contracts associated with that commodity. As many individual investors do not have the ability to do this, mutual funds and ETFs provide this exposure. The downside of ETFs is the fee charged on investment and reduced correlation with commodity performance, which limits the diversification potential. Commodities can have an important role as a diversifier within the portfolio and are a good hedge against inflation.

Hedge funds

Loosely regulated investment vehicles that look to add value by taking advantage of market inefficiencies. Hedge funds have experienced remarkable growth over the past 20 years. There are many types of hedge fund investment styles, which can greatly influence the role they play within a portfolio.

Managed futures

Pooled investment vehicles in the futures, options and other derivative markets. These investment vehicles have typically been referred to as skill-based investment strategies and not tied to market movements. Like hedge funds, there are a number of different strategies in this market and therefore, their effect on the portfolio varies. However, managed futures as a whole may be useful in diversifying away risk even in a diversified portfolio of stocks, bonds and hedge funds.

Role in the Portfolio

The most essential part of considering an investment in any asset or asset class is assessing its role within the portfolio and the overall affect it will have on risk and return. Alternative investments can be divided by their primary role in a portfolio. First, they may be included to provide exposure to economic drivers that are not easily accessible through traditional stock and bond funds. This generally includes real estate and commodities. While there are stocks available for companies involved in these markets, the performance of these stocks has historically been more closely tied with the performance of equity markets as opposed to real estate or commodities. Second, these investments can provide exposure to specialized investment strategies that hedge funds and managed futures can provide. The value that is added by these investments is heavily dependent upon the skill of each individual manager. Finally, alternative investments can combine the first two roles. Investments in private equity can serve both roles.

Risks

Like any other investment, investing in alternatives comes with its own particular set of risks. These funds may be able to lower the overall risk in the portfolio while potentially increasing return prospects, but still have the following individual risk characteristics:

Limited Historical Data

Most alternative investment funds have a short amount of historical performance, usually less than 8 years. This can be a dissuading factor when trying to determine the track record of a fund manager.

Liquidity

In some cases, funds have lock-up periods, which make it impossible to withdraw funds without notice. Time frames for withdrawals can be quarterly and even annually.

Leverage

Some funds have historically taken tremendous amounts of leverage in an effort to take advantage of cyclical changes in the markets. The downside is that losses can also be magnified.

Key Points to Remember

- Alternative investment types can vary widely and should not be thought of as one homogenous asset class.
- Carefully consider your ability to take risk, cash flow constraints, investment time frame and portfolio objectives before making an investment decision.
- These investments can be useful diversification tools with the potential to increase portfolio returns and decrease volatility.
- Investment choices are optimally made with a focus on the entire portfolio.