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Should Alternative Investments Be Part of Your Asset Allocation?

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Alternative investments are so named because they can employ non-traditional assets (rather than stocks, bonds or cash) and often pursue non-traditional strategies. In the past, alternatives were used primarily by institutional investors or accredited, high-net-worth individuals because of their perceived complexity and often higher risks. However, these investments have become increasingly accessible to more investors over the years – and recent market volatility has shown that the nature and behavior of certain alternatives can actually help mitigate risk in a broader, more traditional portfolio.

Because alternatives generally offer a wider universe in which to invest, they may also offer higher performance potential.

What You Should Know:

1. It's all about correlation.

Correlation, or the extent to which specific investments behave similarly under the same environmental conditions, is the basic idea behind the concepts of asset allocation and diversification. In order to help reduce the risks presented by price fluctuations during cyclical volatility or periods of strength and weakness within specific investment types or market sectors, a mix of assets with different characteristics is recommended.

- Financial market volatility since the Great Recession has spotlighted the increasing complexity and interconnected nature of the global marketplace.
- Equities in particular have seen increased correlation, although many market swings during the last four years have cut across traditional asset classes, impacting stocks, bonds and commodities.
- While alternative investments alone may experience higher volatility than more traditional investments, because they often have low correlation with traditional asset classes, their inclusion in a broader portfolio of traditional assets can help reduce overall volatility.

2. There are numerous alternatives.

Not all alternative assets or investments are the same and, depending on your situation and objectives, the characteristics of specific alternatives will help determine their potential appropriateness for you.

- Private equity investments are stakes in funds that invest in privately held companies selected based on growth potential. Investors make a total commitment of capital that can be called over time by the fund's management team. These assets are illiquid and typically longer-term. Returns can exceed broader market returns, but there are substantial business and financial risks that could result in losses.

- Special situation funds are traditionally structured mutual funds that employ non-traditional strategies. They have the flexibility to operate like hedge funds in pursuit of returns under various market conditions, but offer the same liquidity benefits as mutual funds. Also, because they are regulated like mutual funds, they provide greater transparency and tend to be less complicated come tax time.
- Hedge funds employ a wide range of investment and trading strategies intended to achieve returns regardless of broader market performance. A fund of hedge funds is a group of single-strategy hedge funds overseen by an individual manager. By combining different strategies in the same portfolio, the fund seeks to help investors avoid the risk of placing all their eggs in a single strategy basket.
- Structured products combine the characteristics of two or more asset classes. They are designed with traditional fixed income features, including set maturity dates, but returns are generally derived from various sources such as equity and fixed income indices, commodities, currencies or some combination thereof. The goal is to combine the potential benefits of stocks and bonds for investors.
- Managed futures investments employ a strategy that trades in a large range of futures, including physical commodities, interest rates, currencies and stock market indices. They are typically managed by a Commodities Trade Advisor using computer models to follow market trends in an effort to capture profits when markets move up and down. They can carry significant expenses and higher potential risk.

What You Should Do Now:

Alternative investments do not only provide potential diversification benefits. Because they generally offer a wider universe in which to invest and do not have some of the same investment constraints as traditional vehicles (they can short and hedge, for instance), they may also offer higher performance potential. However, each also has unique considerations – such as potentially high investment minimums, illiquidity and adverse or complex tax implications – investors must take into account when determining if an investment or strategy is appropriate.

With an understanding of your specific situation, goals and time horizon, your Financial Advisor can help you determine whether alternatives have a place in your portfolio and which specific investments or strategies are the right fits for you. ■

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