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Are alternative investments right for today's investors?

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Market volatility in the wake of the Great Recession left many investors searching for ways to temper risk and increase yield. One strategy that is increasing in popularity is alternative investments – non-traditional investments that have historically performed differently than stocks and bonds under similar conditions. Although these investments can entail greater risk on an individual basis, when taken as a smaller part of an asset allocation, they can potentially reduce overall risk in a portfolio.

What's unique about the recent market environment is that both equities and bonds continue to experience volatility.

What You Should Know:

1. How do alternative investments work?

The recent economic downturn showed just how interconnected portfolio holdings can be. Classic diversification strategies, which spread out assets among different investment types in the hope that losses in one area are offset by gains elsewhere, were not always effective. Alternative investments became a more popular tool to increase diversification.

- Alternatives are investments that take a non-traditional approach to building wealth, investing in areas and ways traditional investments cannot. Common alternatives include private equity, hedge funds, managed futures and special situation funds, but can also include buy-and-hold investments in assets like gold, stamps and comic books.
- Because their performance tends to move independently from traditional asset classes, market swings that cut wide swaths through stocks and bonds may have little or no impact on alternative investments.

2. Are alternatives appropriate in today's environment?

Historically, investors concerned about market volatility could shift to the safety of bonds, and vice versa. What's unique about the recent market environment is that both equities and bonds continue to experience volatility: ▶

- Recent gains in equities, while impressive, are built on weak GDP growth and five years of Federal Reserve intervention. With the Fed announcing plans to scale back stimulus, it's unclear how the equity market will respond.
- Uncertainty over the Fed's exit strategy is also fueling volatility in bonds, which had enjoyed a three-decade bull run until talk of QE tapering earlier this year.
- Alternatives can be used to hedge against widespread uncertainty. These investments can carry unique disadvantages, though, including less transparency and higher fees. Also, just as their performance may not suffer in a down market, alternatives may not necessarily participate when markets are surging.

3. Why haven't I heard of alternative investments before?

Alternatives have traditionally been accessible only to institutional and ultra-high-net-worth investors who could withstand illiquidity. More recently, however, they have become available to more investors.

- One of alternatives' most significant drawbacks was illiquidity: assets committed to an investment could be locked up for years. Now investors can access alternative investments with weekly or even daily liquidity.
- Alternatives are now options in many companies' retirement plans, creating greater control and flexibility.
- Largely as a result of the above, by 2012, assets in alternative investments have reached a record $6.5 trillion, with a five-year growth rate far outpacing that of traditional asset classes.

What you should do now:

As a smaller part of an asset allocation, alternative investments can help mitigate risk in a broader, more traditionally diversified portfolio. A Financial Advisor can help you decide if alternatives have a place in your portfolio and which specific investments are right for you. ■