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The Role of Alternative Investments in a Diversified Investment Portfolio

By Baird Private Wealth Management

Introduction

Alternative investments, which have been used by large institutions and endowments for quite some time, have become more mainstream in recent years. Not only are they more popular among individual investors, but there are also more products available, making investing in alternatives possible for a much broader universe of investors. Given their non-traditional approach and their ability to invest in areas and ways traditional investments cannot, they have the potential to improve the overall risk-return characteristics of a portfolio. As such, a modest allocation to alternatives may be prudent for more investors than previously was the case. However, the non-traditional approach and structure of these investments bring with them unique risks of which investors must be aware.

Traditional Investments
Domestic Equity
International Equity
Taxable Fixed Income
Tax-Exempt Fixed Income
Satellite Asset Classes*
Cash

Alternative Investments
Private Equity
Hedge Funds
Managed Futures
Alternative Mutual Funds

**Satellite Asset Classes include Commodities, Global Real Estate, High Yield Fixed Income, and Emerging Markets Equity*

Alternatives Defined

Alternative investments utilize a different approach to investing than do traditional equity or fixed income investments. This approach may involve holding both long and short positions in securities and holding private securities instead of publicly traded investments, and there may be derivatives or hedging strategies as well. Investors using alternatives may also have a goal of achieving a particular level of absolute return as opposed to relative performance versus an index.

Alternative investments have the potential to enhance the risk and/or return characteristics of an investment portfolio. Given their low correlation to traditional investments, they can potentially enhance diversification and reduce risk; with their ability to be more flexible and invest in a wider opportunity set, they can potentially enhance return.

As a result of the different investment approach, alternative investments have different risks and characteristics than do traditional investments. They are often less liquid, particularly in periods of stress; they are generally more complex and less transparent, making them difficult for untrained investors to understand; they are more susceptible to investment manager failure; and they can have a complicated tax profile.

The successful implementation of an alternative investment strategy relies largely on investment manager experience and skill due to the broad range of investment opportunities. This is in contrast to managers specializing in specific asset classes such as commodities, real estate, emerging markets equity and high-yield fixed income. These non-traditional, or satellite, asset classes provide portfolio diversification due to low correlation with traditional asset classes, but like traditional investments, performance is primarily driven by asset class exposure as well as manager skill.

Multiple Manager Approach

Many of these alternative investments are available in a multi-manager structure, such as a fund of funds. A multi-manager approach brings diversification, which can be particularly beneficial in a space where manager skill is paramount. So, while the multiple-manager structure may bring with it additional fees, the diversification benefits may outweigh the added cost, particularly in uncertain or volatile markets.

Types of Alternatives

Below, we highlight several types of alternative investments. However, new approaches are constantly being developed, and this list is meant to be more illustrative than exhaustive.

Private Equity. An investment strategy that seeks to participate in the growth of private companies through long-term investments in private securities globally. Private equity is an illiquid asset class that offers the potential for greater long-term capital appreciation and diversification away from the public markets. It is generally available only to higher-net-worth individuals with more investment experience (often referred to as accredited or qualified investors) at high minimums and often has liquidity restrictions.

Hedge Funds. A managed portfolio of investments that uses advanced investment strategies such as leveraged, long, short and derivative positions in both domestic and international markets with the goal of generating strong returns, reducing volatility or both. They are generally available only to higher-net-worth individuals with more investment experience at high minimums and often have liquidity restrictions.

Managed Futures. An investment strategy that seeks to participate in trends in a large variety of global futures markets. Strategies include the use of stock index, interest rate, currency, energy and commodity futures. Many managed futures traders are systematic in nature, meaning they apply sophisticated computer models designed to invest in a disciplined, unemotional fashion, which often results in lower correlation with traditional assets. Managed futures are relatively tax-inefficient and are thus best utilized in a qualified account structure.

Alternative Mutual Funds. Funds in which the managers are not constrained by traditional portfolio management methods. They have varying approaches, ranging from absolute return, long/short equity, broad mandate or “go-anywhere” funds and hedge fund-like strategies. Many of these funds also have a total return or absolute return objective. They provide access to non-traditional investment approaches while still providing investors with daily liquidity at reasonable investment minimums.

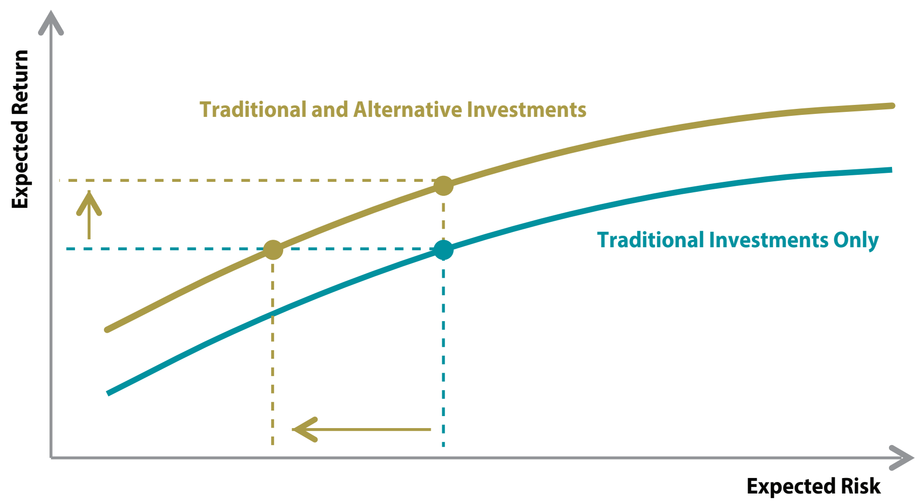
Benefits of Alternative Investments

Despite unique risks and considerations, alternative investments can be useful tools to improve the risk-return characteristics of an investment portfolio. They can increase diversification and reduce volatility, given low correlations to more traditional investments, and they can offer the potential for enhanced returns due to the wider investment opportunity set.

Graph 1 illustrates a sample Markowitz efficient frontier, representing all portfolios with the lowest risk (as measured by volatility) for a given level of return, or conversely all portfolios with the highest return for a given level of risk.[1]
The inclusion of alternative investments can move the efficient frontier up and to the left, so for a given level of return, risk is lower, or for a given level of risk, return is higher.

GRAPH 1:

Markowitz Efficient Frontier



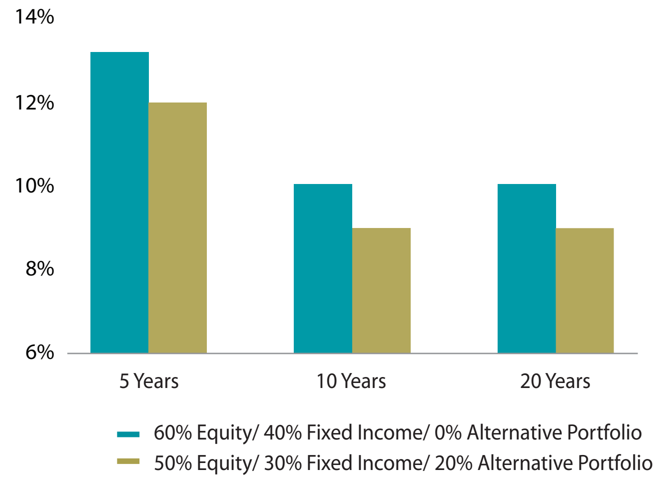
For illustrative purposes only – not drawn to scale.

[1]Harry Markowitz was an economist renowned for his research on Modern Portfolio Theory. He received the Nobel Prize in Economics in 1990 for his work in this area.

Diversification. While alternative investments on their own may have higher volatility than more traditional investments, particularly fixed income, they typically have low correlations to, or do not move in lockstep with, more traditional asset classes. As such, their inclusion in an investment portfolio tends to result in lower overall volatility (Graph 2).

GRAPH 2:

Standard Deviation**
as of 9/30/2012

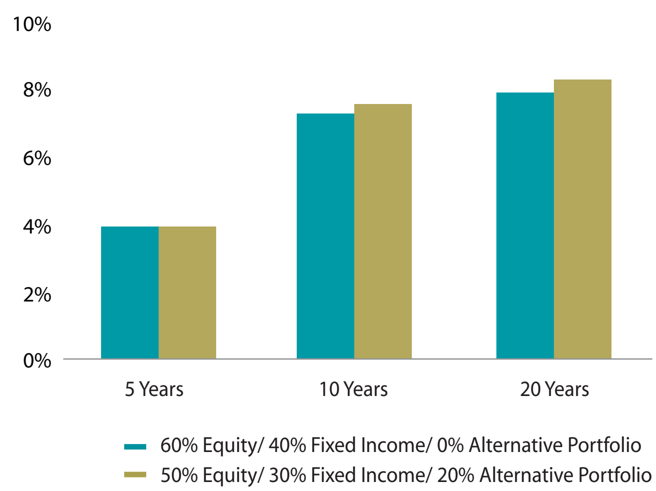


**Asset Classes represented by various indices, defined on page 6.*
***Hypothetical portfolios represented by S&P 500 (equity), Barclays Capital US Aggregate Bond (fixed income). Additional standard deviation data available on page 7.*

Return. Because they have a wider universe in which to invest (public and private) and do not have some of the same investment constraints (can short and hedge), alternative investments have the potential for higher long-term performance than traditional investments (Graph 3)

GRAPH 3:

Return*
as of 9/30/2012



**Hypothetical portfolios represented by S&P 500 (equity), Barclays Capital US Aggregate Bond (fixed income) and an equal-weighted blend of alternatives comprised of HFRI Fund Weighted Composite (hedge funds), Barclays CTA (managed futures), and Cambridge U.S. Private Equity (private equity). Past performance is not a guarantee of future performance. Additional return data available on page 7.*

Benefits
Diversification
Return

Risks
Fees
Complexity
Transparency
Liquidity
Tax Consequences
Potential Not to Perform as Expected

Risks of Alternative Investments

There are several risks associated with alternative investments above and beyond the typical risks associated with traditional investments.

- **Higher fees.** Alternative investments can have higher fees. For example, fees can include an annual management fee (1–2%) and an additional incentive fee (10–20%). Fund of funds may also charge yet another management fee. While higher than traditional investments, these fees may or may not be justified when comparing returns net of fees.
- **More complicated.** Alternative managers may invest in a wide variety of investments, including derivatives, and utilize short selling. Understanding complicated investment strategies requires more upfront and ongoing due diligence.
- **Less transparent.** There can be limited transparency into the underlying holdings of these investments. Additionally, many manager evaluation tools are not as well suited for alternative investments, making a manager's investment ability more difficult to assess. Also, some alternative investments are largely unregulated.
- **Less liquid.** Limited partnerships may hold illiquid investments and as such restrict an investor's ability to redeem money. For example, managed futures only offer monthly liquidity; many funds of hedge funds do not allow redemptions in the first year and only annual or quarterly thereafter; and private equity may not allow redemptions for seven or more years. The underlying investments used in an alternative investment strategy may also be exposed to a significant lack of liquidity in stressful trading environments.
- **Less tax-friendly.** Most alternative investment strategies have little to no focus on minimizing taxes. Also, those whose legal structure is a partnership issue a K-1 statement rather than a 1099.
- **May disappoint in strong up markets.** Investments that seek to generate an absolute return often use short selling strategies, and as such tend to lag long only strategies in strong up markets, which may discourage some investors.
- **May not diversify risk in extreme down markets.** In periods of dislocation, the correlations of many types of investments, including alternatives, may increase significantly, as was the case in the extreme down market of 2008.

Often clients and their financial advisors come to the conclusion that the benefits of alternatives warrant the added risk.

Incorporating Alternatives into Portfolios

We believe there are four primary considerations to keep in mind when incorporating alternatives into an investment strategy.

1. **Conservative approach.** By definition, alternative investments use a non-traditional approach to investing. Additionally, performance is largely dependent on manager skill, unlike traditional investments, in which much of the performance is driven by asset class exposure. Therefore, it is prudent to take a

conservative approach, opting for those strategies with a proven track record and stable investment team and process. With new products being offered regularly in this fast-growing space, it is wise to exercise caution, having a bias toward offerings with demonstrated success, as opposed to "paper" portfolios or back-tested track records.

2. **Appropriate allocation.** Generally allocating 10–20% of a portfolio to alternative investments is most appropriate, although the allocation can be higher in unique situations. This is a large enough allocation to be impactful in terms of enhancing returns or helping to reduce risk, without being so large that it dominates the overall portfolio.
3. **Proper funding.** Different alternative investments have different objectives, and should therefore be funded differently within a portfolio. Those seeking enhanced returns, such as private equity, should be funded from the equity portion of a portfolio. Conversely, those seeking an absolute level of return regardless of market environment may be better funded from the fixed income portion of a portfolio. Alternative investments that seek to both enhance returns and reduce volatility can be funded proportionately from the equity and fixed income portions of an investment portfolio. For example, in a portfolio consisting of 60% equity and 40% fixed income, to add a 20% allocation to alternative investments, 12% could come from traditional equity and 8% from traditional fixed income.
4. **Suitable structure.** Historically, alternative investments were available only through private partnerships with high-net-worth requirements and limited liquidity, but they have become more accessible in the recent past. However, this accessibility comes with trade-offs that must be carefully considered. For example, lower-net-worth requirements and increased liquidity through the use of an alternative mutual fund versus a limited partnership may come at the price of higher fees or a more restricted investment approach. Determining the most appropriate structure based not only on net worth levels, but also on liquidity needs and overall risk and return objectives is an important part of incorporating alternative investments into a portfolio.

Conclusion

When used appropriately, alternative investments can potentially enhance the overall risk-return profile of an investment portfolio. There are unique benefits but also unique risks associated with these non-traditional investment strategies, and as such it is paramount that investors be comfortable with alternatives when incorporating them into their investment strategy. Therefore, it is important to discuss alternative investments with your Financial Advisor to determine the suitability of incorporating them into your existing investment approach, as each individual's circumstances are unique.

Definitions

Correlation: the extent to which the values of different types of investments move in tandem with one another in response to changing economic and market conditions.

Standard Deviation: a gauge of risk that measures the spread of the difference of returns from their average. The more a portfolio's returns vary from its average, the higher the standard deviation. It is important to note that higher than average returns affect the standard deviation just as lower than average returns.

Standard Deviation and Returns

	5 Years		10 Years		20 Years	
as of 9/30/2012	Return	Std Dev	Return	Std Dev	Return	Std Dev
S&P 500 TR	1.1%	21.9%	8.0%	17.0%	8.5%	16.8%
Barclays US Agg Bond TR USD	6.5%	3.3%	5.3%	3.3%	6.3%	3.8%
Alternatives Blend (PE, HF, MF)	3.0%	6.1%	7.1%	5.8%	9.0%	5.4%
60/40 Portfolio	3.7%	12.9%	7.2%	10.1%	7.9%	9.9%
50/30/20 Portfolio	3.7%	11.7%	7.4%	9.2%	8.3%	9.0%

Asset Class Index Proxies

Equity: S&P 500 Index – a representative sample of 500 leading companies in leading industries of the U.S. economy; considered a large-cap index.

Fixed Income: Barclays Capital US Aggregate Bond Index – comprised of approximately 6,000 publicly traded bonds, including U.S. Government, mortgage-backed, corporate, and Yankee bonds with an average maturity of approximately 10 years.

Alternative Mutual Funds: Style-specific universe of mutual funds categorized by Morningstar, which included 306 funds as of December 31, 2012, but only 115 for the trailing five-year period and only 48 for the trailing ten-year period.

Private Equity: Cambridge Associates Private Equity Index – based on data compiled from 823 U.S. private equity funds, including fully liquidated partnerships, formed between 1986 and 2012. Returns are net of fees, expenses and carried interest.

Hedge Funds: HFRI Funds Weighted Composite Index – designed to reflect hedge fund industry performance by constructing equally weighted composites of constituent funds, as reported by the hedge fund managers listed within HFR Database; encompasses more than 2000 funds.

Managed Futures: Barclays CTA Index – benchmark of representative performance of commodity trading advisors. The index is unweighted and rebalanced at the beginning of each year.

Important Disclosures

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Funds of hedge funds are not appropriate for all investors and should only be considered to compliment an already well-diversified portfolio of traditional investments, such as stocks and bonds. The tax structure of these investments may be complex and there may be delays in receiving important tax information. Funds of hedge funds have many of the same risks and attributes of their underlying investments, such as the use of risky investment strategies, lack of liquidity and high fees. Short selling (the sale of a security you do not own) can expose an investor to substantial losses and the use of derivatives (investments that have no independent value but derive their value from the value of the underlying investment) allows investors the potential to earn large returns from small movements in the underlying asset's price but also exposes the investor to potentially large losses if the underlying investment moves against them significantly.

Managed futures are commodity pools (typically structured as investment partnerships) managed by a futures trading adviser that trade speculatively in various commodities and related futures contracts, spot and forward contracts, options, swaps and other derivative instruments on U.S. and foreign exchanges and markets. Managed futures are not right for everyone. These speculative investments may be appropriate for sophisticated investors with aggressive or speculative investment objectives seeking further diversification through modest exposure to investments designed to have little or no correlation to the general equity and debt markets. Managed futures should be considered long-term investments.