Demystifying Alternative Investments

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The market goes up. The market goes down. All the while the American public—52% of whom are "in the market" in some way[1]—get anxious about the next down day, the next correction, the next bubble to burst. It seems to too many investors that the quality of their retirements rests in "the market," a vague concept that rarely reflects or acts on the best interests of these investors. What too many don't understand is that alternative investments provide growth for their nest eggs without depending on "the market." Better yet, they also allow investors to take significant risk out of their portfolios.

Here are seven points to consider about alternative investments:

There is Not Just One Market. "The market" provides a snapshot of a snapshot of a thumbnail sketch of another snapshot of financial activity that day. The derivatives market, for instance, is worth about $1.2 quadrillion,[2] many times bigger than the world economy. But it only gets a mention in the news if something goes wrong in it. And don't forget the bond market, the FOREX, commodities markets, and many others. Of course, most people interpret "the market" to be the stock market; the place where they can buy shares in a company and participate in the company's growth. It's an easy concept to understand.

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[1] http://www.washingtonpost.com/blogs/wonkblog/wp/2013/03/11/graph-of-the-day-who-actually-benefits-from-a-stock-market-boom/
[2] http://www.dailyfinance.com/2010/06/09/risk-quadrillion-derivatives-market-gdp/

Correlation is Key. What an investor is looking for in an alternative investment is something that doesn't correlate with his or her other holdings. Many people own stock or bond fund investments in their 401(k) accounts; one investment generally goes up when the other goes down. The best alternatives have low-to-no correlation with a portfolio's stock and bond holdings. Nobel Prize-winning economist Harry Markowitz, father of Modern Portfolio Theory, determined that portfolios perform better and experience decreased volatility by being diversified among asset classes that don't correlate.[3]

Schools Can Still Teach You Something. A person who's been out of school for decades can still learn something from America's higher education institutions. In 1830 a gentleman named Frances Amory was hired to manage a trust for Harvard College. His charge was to invest Harvard's money in "approved" vehicles like government securities, the same way English courts had limited trustees' investments of English schools funds.[4] But Mr. Amory strayed from historical precedent and invested Harvard's money in the stock of manufacturing and insurance corporations. Since then the Harvard Management Company (HMC) portfolio has swelled to $32.7 billion with an average annual return of just below 12% over the past 20 years.[5] An awesome performance considering that period included the bursting of the tech bubble and the financial meltdown of 2008. Aside

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[3] http://www.attaincapital.com/alternative-investment-education/benefits

[4] books.google.com/books?id=fk-rYsLrekAC&pg=PA546&lpg=PA546&dq=origin+of+prudent+man+rule&source=bl&ots=MPtAB-fray&sig=ejHAJaATIAFxCkWfjH3Cv5aoY68&hl=en&sa=X&ei=V97oT5nNL8fi2QXPluTQDQ&ved=0CFkQ6AEwAg#v=onepage&q=origin%20of%20prudent%20man%20rule&f=false

[5] http://money.cnn.com/2013/09/25/news/companies/yale-harvard-mit-endowment/

from domestic stock and bond exposure, HMC holds myriad alternatives the world over.[6]

The Risk Is In Not Using Alternatives. As an endowment, HMC's portfolio gets some tax advantages the individual investor doesn't have. But don't let that get in the way of the bigger message: An investor runs more risks by not getting into alternatives. A recent study covering returns from 1998–2012 revealed that hedge funds and stocks offered nearly identical annual returns, but stocks were more than twice as volatile.[7] Diversifying with alternatives during that 15-year period meant valuable returns and stability during a historically tumultuous time for stocks.

Types of Alternative Investments. Commodities, precious metals, collectibles, private equity (including venture capital), hedge funds, crowd funding, limited partnerships, real estate investment trusts (REITs) and other real estate holdings all qualify as alternatives. No single alternative holding should take up more than 15% of a portfolio,[8] but they can provide much-needed diversification.

Don't Be Looking for Liquid. Jane Mendillo, President and CEO of HMC, calls it an "illiquidity premium."[9] In short, she expects her company's alternatives to pay off handsomely because those investments are indeed for the long term. Hedge funds

[6] http://www.hmc.harvard.edu/docs/Final_Annual_Report_2012.pdf
[7] https://www2.blackrock.com/us/financial-professionals/tools/alternative-investments-education-center/market-volatility-can-erode-a-portfolios-value
[8] http://www.profutures.com/article.php/219
[9] http://www.forbes.com/sites/chriswright/2013/11/12/why-yale-harvard-and-sovereign-funds-are-changing-their-views-on-alternative-assets/

generally require that investors stay put for twelve months,[10] while a two-year or longer lockup used to be common.[11] Private equity firms often hold onto investment money for many years.[12] Generally, alternative investments call for patience and often require the investor to pay a premium to withdraw before a certain period of time has elapsed.

Alternatives Used to Be Only for High Net Worth Investors, But Not Today. For decades alternative investments have been the purview only of the well heeled. But that seems to be changing as a hedge “fund of funds” is often open to an investor. It’s also possible to purchase the stock of a legendary private equity company like KKR or participate in something like their Alternative High Yield Fund.

Index investing legend Jack Bogle is credited with hammering home the point that, since 1928, the return on the Total Stock Market has been an impressive 10.2%.[13] But think about all the volatility in the stock market over that time and all the investors who bailed out as their portfolios sank in value. Financial meltdown, anyone? Alternatives provide a great way for long-term investors to mitigate such swings and see a more consistent rise in the value of their investments.

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[10] http://adf.ly/1998268/banner/http://atozinvestment.blogspot.com/2012/08/lock-up-period.html
[11] http://www.hedgefundlawblog.com/hedge-fund-lock-up-period.html
[12] http://www.reuters.com/article/2012/09/21/uk-hedgefunds-liquidity-idUSLNE88K01O20120921
[13] http://www.cbsnews.com/news/john-c-bogle-on-the-sp-500-vs-the-total-stock-market/