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FINANCIAL PLANNING PERSPECTIVES

ALTERNATIVES TO TRADITIONAL INVESTMENTS

Investors sometimes get bored with traditional investments, such as U.S. stocks, investment-grade bonds, and the mutual funds that are invested in those asset classes. Especially when such investments fail to generate adequate returns as they did in 2005. And when that happens, investors often tend to hunt for what some refer to as “alternative” investments, investments with exotic names that hold out the promise of higher returns.

Alternative investments are, in simple terms, nothing more than investments that offer investors the chance to diversify their portfolio with instruments that may reduce overall risk of the portfolio and potentially improve returns. Typical alternative investments include hedge funds, commodities (futures and options), direct ownership of real estate, REITS (public and private), limited partnerships, private-equity funds, venture capital or angel investing, mutual funds (absolute return funds, long-short funds, and covered writing funds) and managed futures.

Besides the potential for higher returns and lower portfolio risk, alternative investments also have these general characteristics: higher fees, higher investment minimums, minimum net worth and income requirements for investors, and illiquidity (3 to 5 year commitments are not uncommon). In addition, investors may find it difficult to find appropriate benchmarks against which to measure performance and risk, unlike, for example, using the Dow Jones Industrial Average or the S&P 500 to measure the performance of stocks.

As with all investments, alternative or not, it would be useful to remember what the Romans used to say: “caveat emptor” - or “let the buyer beware” – when researching such investments.

So, if you are considering adding alternative investments to your portfolio be sure to get a sense of your current assets’ combined potential for return and risk and consider whether it would be realistic to make changes that could significantly enhance your potential return without an excessive increase in your potential risk. Often, a major benefit of adding alternative investments is that it tends to reduce the overall risk of a portfolio because the value of such investments doesn’t always follow that of stocks and bonds. In other words, traditional investments and alternative investments are not “correlated.”

Here’s a closer look at some of the more common alternative investments out there:

Hedge Funds. Hedge funds are nothing more than investment partnerships and, as such, are often precursors of mutual funds. Some do nothing more than allow the investor to share the results of the expertise, experience and talents of a respected manager. Others may pursue very conservative strategies focused on principal protection. The key thing to recognize, according to financial planners, is the focus on absolute returns as opposed to relative returns and benchmarking. That said, it’s important to note that hedge funds may resemble mutual funds but are far from identical. For instance:

- The costs of owning them are a lot higher because they not only charge annual management fees (around 1-2 percent), they also commonly charge performance fees of 20 percent of the funds’ profits.
- They may use speculative techniques, such as borrowing money to supplement investors’ money and investing in illiquid securities that can make them more risky.
- Neither the funds nor most hedge fund managers are required to register with the SEC.
- Because of their higher level of risk and little or no SEC oversight, hedge funds tend to be made available only to the wealthy—those who have net worth of at least $1 million.
- They may only accept redemption requests quarterly, as opposed to daily, and may impose “lockup” periods of a year or more during which no shares may be redeemed.

Futures and Options. Futures contracts commit you to buying or selling something for delivery in the future at a certain price while options contracts give you the right—but not the obligation—to do so.

Once primarily used for agricultural commodities, futures contracts now are also available in a growing variety of markets from metals and fuels to financial instruments including foreign currencies, U.S. and foreign government securities, and U.S. and foreign stock indices.

Prices can be highly volatile to reflect ever-changing balances between supply of and demand for the underlying assets.

Precious Metals. The volatility of the price of gold, for example, the most widely watched metal worldwide, illustrates why it is, at best, a speculative asset when not purchased for actual use. Now trading near $600 an ounce, it remains far below its all-time high of around $1,000 about 25 years ago—but more than double its most recent lows around $250 at the end of the 1990s.

Anyone who bought gold 25 years ago as a long-term investment and held it would have lost a lot of money if he or she sold today—not to mention the missed opportunities for capital gains in securities. The lesson to be learned is that alternative investments are available for those who want to diversify their portfolios, however, they should be fully understood before you invest in them.

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