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Beyond Traditional Asset Classes: Exploring Alternatives

Stocks, bonds, and cash are fundamental components of an investment portfolio. However, many other investments can be used to try to spice up returns or help reduce overall portfolio risk. So-called alternative assets have become popular in recent years as a way to provide greater diversification.

What is an alternative asset?

The term "alternative asset" is highly flexible; it can refer to almost anything whose investment performance is not correlated with that of stocks and bonds. It may include physical assets, such as precious metals, real estate, or commodities. In some cases, geographic regions, such as emerging global markets, are considered alternative assets. Complex or novel investing methods also qualify. For example, hedge funds use techniques that are off-limits for most mutual funds, while private-equity investments rely on skill in selecting and managing specific businesses. Finally, collectibles are included because the value of your investment depends on the unique properties of a specific item as well as general interest in that type of collectible.

Each alternative asset type involves its own unique risks and may not be suitable for all investors. Because of the complexities of these various markets, you would do well to seek expert guidance if you want to include alternative assets in a portfolio.

Hedge funds

Hedge funds are private investment vehicles that manage money for institutions and wealthy individuals. They generally are organized as limited partnerships, with the fund managers as general partners and the investors as limited partners. The general partner may receive a percentage of the assets, fees based on performance, or both.

Hedge funds originally derived their name from their ability to hedge against a market downturn by selling short. Though they may invest in stocks and bonds, hedge funds are considered an alternative asset class

because of their unique, proprietary investing strategies, which may include pairs trading, long-short strategies, and use of leverage and derivatives. Participation in hedge funds is typically limited to "accredited investors," who must meet SEC-mandated high levels of net worth and ongoing income (individual funds also usually require very high minimum investments).

Private equity/venture capital

Like stock shares, private equity and venture capital represent an ownership interest in one or more companies, but firms that make private-equity investments may or may not be listed or traded on a public market or exchange. Private-equity firms often are involved directly with management of the businesses in which they invest.

Private equity often requires a long-term focus. Investments may take years to produce any meaningful cash flow (if indeed they ever do); many funds have 10-year time horizons, and you may not have access to your funds when you want them. Like hedge funds, private equity also typically requires a large investment and is available only to investors who meet SEC net worth and income requirements.

Real estate

You may make either direct or indirect investments in buildings — either commercial or residential — and/or land. Direct investment involves the purchase, improvement, and/or rental of property. Indirect investments are made through an entity that invests in property, such as a real estate investment trust (REIT), which may be either publicly traded or not. Real estate not only has a relatively low correlation with the behavior of the stock market, but also is often viewed as a hedge against inflation. However, bear in mind that physical real estate can be highly illiquid, may involve more work on your part to manage, and may be subject to weather hazards, rezoning, or other factors that can reduce the value of your property. The value of a traded REIT will depend on



Funds of hedge funds

You may be able to find a fund that invests in multiple hedge funds and requires a lower minimum investment, though that minimum usually is still higher than most mutual fund minimums. By investing in multiple investing styles, managers, and strategies, a fund of funds may provide greater diversification than a single hedge fund. Be aware that a fund of funds may or may not be registered with the Securities and Exchange Commission (SEC); be sure to check. Even if it is registered, any SEC protections apply only to the fund of funds, not necessarily to the underlying funds in which it invests. Also, you will pay fees charged by both the fund of funds and each underlying fund.

Before investing in a mutual fund or ETF, including one that invests in any kind of alternative asset class, carefully consider its investment objectives, risks, fees, and expenses, which can be found in the prospectus available from the fund. Read it carefully before investing. REITs are also sold by prospectus. Asset allocation and diversification are methods used to help manage investment risk; they do not guarantee a profit or protect against investment loss.

There are inherent risks associated with real estate investments and the real estate industry, each of which could have an adverse effect on the financial performance and value of a real estate investment. Some of these risks include: a deterioration in national, regional, and local economies; tenant defaults; local real estate conditions, such as an oversupply of, or a reduction in demand for, rental space; property mismanagement; changes in operating costs and expenses, including increasing insurance costs, energy prices, real estate taxes, and the costs of compliance with laws, regulations, and government policies. Real estate investments may not be appropriate for all investors.

fluctuations in the value of its real estate holdings as well as investor sentiment and market volatility. The value of a nontraded REIT is directly based on the value of its underlying real estate holdings. All REITs are subject to the risks associated with the real estate market in general. Also, some types of REITs are considered more illiquid than others, which could mean problems if you need to sell quickly.

Precious metals

Investors have traditionally purchased precious metals because they believe that gold, silver, and platinum provide security in times of economic and social upheaval. Gold, for instance, has historically been seen as an alternative to paper currency and therefore may help hedge against inflation and currency fluctuations. As a result, gold prices often rise when investors are worried that the dollar is losing value, though prices can fall just as quickly.

There are many ways to invest in precious metals. In addition to buying bullion or coins, you can invest in futures, shares of mining companies, sector funds, and exchange-traded funds (ETFs).

Natural resources/equipment leasing

Direct investments in natural resources, such as timber, oil, or natural gas, can be done through limited partnerships that provide income from the resources produced. In some cases, such as timber, the resource replenishes itself; in other cases, such as oil or natural gas, it may be depleted over time. Timberland also may be converted for use as a real estate development. Some limited partnerships pool your money with that of other investors to invest in equipment leasing businesses, giving you partial ownership of the equipment those businesses lease out, such as construction equipment.

Commodities and financial futures

Commodities are physical substances that are fundamental to creating other products and are basically indistinguishable from one another. Examples include oil and natural gas; agricultural products; livestock such as hogs; and metals such as copper and zinc.

Commodities are typically traded through futures contracts, which promise delivery on a certain date at a specified price. Futures contracts also are available for financial instruments, such as a security, a stock index, or a currency. Though the futures market was created to facilitate trading among companies that

produce, own, or use commodities in their businesses, futures contracts also are bought and sold as investments in themselves, and some mutual funds and ETFs are based on futures indexes.

Futures allow an investor to leverage a relatively small amount of capital. However, they are highly speculative, and that leverage also magnifies the potential for loss in a relatively short period of time.

Art, antiques, gems, and collectibles

Some investors are drawn to these because they may retain value or even appreciate as inflation rises. However, those values can be unpredictable because they are affected by supply and demand, economic conditions, and the quality of an individual piece or collection.

Why invest in alternative asset classes?

Part of sound portfolio management is diversifying investments so that if one type of investment is performing poorly, another may be doing well. As previously indicated, returns on some alternative investments are based on factors unique to a specific investment. Also, the asset class as a whole may behave differently from stocks or bonds.

An alternative asset's lack of correlation with other types of investments gives it potential to complement more traditional asset classes and provide an additional layer of diversification for money that is not part of your core portfolio.

Tradeoffs you need to understand

Alternative assets can be less liquid than stock or bonds. Depending on the investment, there may be restrictions on when you can sell, and you may or may not be able to find a buyer. Performance, values, and risks may be difficult to research and assess accurately. Also, you may not be eligible for direct investment in hedge funds or private equity.

The unique properties of alternative asset classes also mean that they can involve a high degree of risk. Because some are subject to less regulation than other investments, there may be fewer constraints to prevent potential manipulation or to limit risk from highly concentrated positions in a single investment. Finally, hard assets, such as gold bullion, may involve special concerns, such as storage and insurance, while natural resources and commodities can suffer from unusual weather or natural disasters.

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