Alternative Assets For Average Investors

Alternative assets can bring significant benefits to investment portfolios through diversifying exposure away from traditional fixed-income and equity assets. Moreover, alternative assets are no longer the exclusive province of the super-wealthy; if fact, the average retail investor can avail him- or herself of a wide range of alternative asset strategies through traditional vehicles, including mutual funds, exchange-traded funds (ETFs) and exchange-traded notes (ETNs).This article will serve as a guide to understanding different types of alternative assets and how they can be effectively used to enhance portfolio diversification. (For more on the basics of asset allocation, read *Asset Allocation Strategies*.)

Defining Alternative Assets
What's an alternative asset? We can perhaps start by explaining what an alternative asset is *not*: it is not a direct fixed-income or equity claim on the assets of an issuing entity. For example, a holder of a senior secured bond owns a claim on certain specified assets of the issuer, like residential property or farm equipment. In the event of liquidation, an issuer's secured and unsecured bondholders are paid off according to the seniority of their claims. Equity investors, by definition, own a claim on the residual net worth of the company after all its liabilities have been paid off, whether this amount is a lot or nothing at all.

Single-Asset Alternatives
Alternative assets are none of the above, which is why they are called "alternative". An example of an alternative asset is a commodity futures contract. The contract gives its owner the obligation to take delivery of some object of value, like gold or pork bellies or Japanese yen, at some specified point in the future. An option on this futures contract would confer the right (not the obligation) to exercise the contract at one or more defined times during its life or to let the option expire worthless. Options and futures are derivatives: they derive their value from an underlying source, such as gold or pork bellies. (To learn the basics of derivatives, read *The Barnyard Basics Of Derivatives* and *Are Derivatives Safe For Retail Investors?*)

Pooled Vehicles
In addition to single-asset instruments, the term "alternative assets" also refers to pooled investment vehicles (multiple investors' money is pooled by one manager) constructed to possess a different risk/reward matrix from traditional debt or equity investments. Pooled alternative vehicles can come in the same forms as their traditional counterparts - such as SEC-registered mutual funds or separately managed accounts (SMAs). They can also be unregistered vehicles like hedge funds, venture capital or private-equity funds. These funds typically employ a combination of securities, some standard and some alternative. (For more on SMAs, read *Separately Managed Accounts: A Mutual Fund Alternative*.)

Low Correlation and Absolute Return
Alternative assets come in many varieties, but a common thread is their low correlation coefficients with both equities and fixed income. Consider the following chart:

Correlation Matrix
June 1998 - April 2008

	(1)	(2)	(3)	(4)	(5)	(6)
Calmaos Market Neutral Income	1.00					
Hudson Investment Partners, LP	0.62	1.00				
Dryden Global Real Estate	0.39	0.38	1.00			
Oppenheimer Commodity Strat Total Return A	0.07	0.20	0.03	1.00		
Lehman US Aggregate Bond Index	0.07	-0.13	0.01	0.03	1.00	
Russell 3000	0.61	0.55	0.45	0.04	-0.23	1.00

Figure 1
Source: Zephyr & Associates LLC

Figure 1 shows the pair wise correlation between four pooled alternative asset vehicles, the bond market (as shown by the Lehman U.S. Aggregate Bond Index) and the equity market (represented by the Russell 3000 stock index). Correlations can range between 1 (perfect positive correlation) and -1 (perfect negative correlation). In this case, all four alternative investments show virtually no correlation with the bond market and show moderate-to-weak correlation with equities.

By contrast, traditional long-only funds tend to show much stronger positive correlations to their benchmarks; consider the following two long-only equity mutual funds benchmarked to the Russell 3000:

Correlation Matrix
June 1998 - April 2008

	(1)	(2)	(3)
Legg Mason Partners Capital	1.00		
American Funds Fundamental Inv. A	0.88	1.00	
Russell 3000	0.89	0.95	1.00

Figure 2
Source: Zephyr & Associates LLC

Low correlation is an important positive attribute when considering assets for inclusion in a portfolio. The advantage gained by owning alternative assets (that are relatively uncorrelated with both stocks and bonds) is the reduction in exposure to systematic market risk factors. Investment strategies seeking a low correlation to systematic risk are known as absolute return strategies, and their key objective is to attain relative independence from the performance of underlying equity or fixed-income market benchmarks. (Read more about lowering systematic risk in *Diversification Beyond Equities*.)

The other side of the absolute return argument, however, is potential constraint on the upside. For example, if the broader stock markets are rallying, then the inclusion of low-correlation alternatives could weaken portfolio performance relative to the traditional long-only equity funds. Absolute return may be desirable in negative market climates, but can underperform relative return (benchmarked) strategies during positive economic climates. (For more, read *What's the difference between absolute and relative return?*)

Alternative Assets, Risk and Return

Let's go back and take a closer look at the strategies represented by the four pooled investment vehicles introduced in Figure 1. In the chart below we show the annual average risk-adjusted returns (using standard deviation as the risk measure) for each of these strategies over a 10-year period.

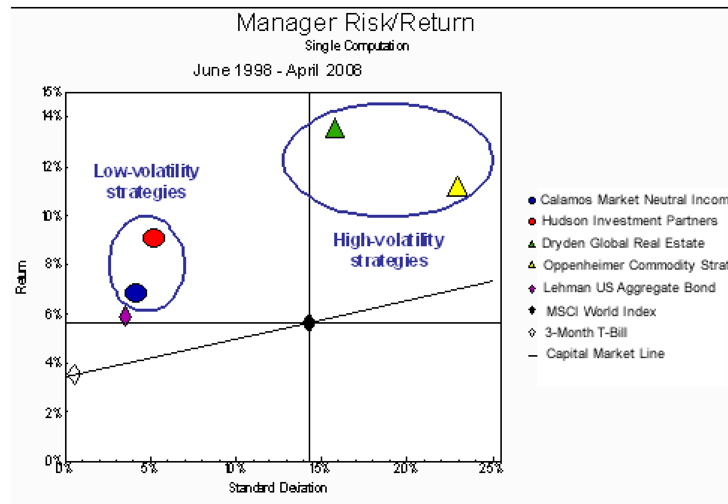

Figure 3
Source: Zephyr & Associates LLC

What is immediately clear from this picture is that two of the strategies exhibit low, bond-like volatility characteristics, while the other two show much higher volatilities. The two lower-volatility investments are representative of hedge strategies. For example, the market neutral strategy (as described above) involves setting long and short equity positions to achieve an objective such as beta neutrality or currency neutrality. (For more on using beta to gauge risk, read *Bettering Your Portfolio With Alpha And Beta*.)

Other hedge strategies include:

- Merger Arbitrage - taking long and short positions on either side of a proposed merger
- Buy-Write - taking a long stock position while simultaneously writing a call on the same stock
- Fixed-Income Arbitrage - for example, hedges between duration, interest rate or credit-quality exposures

These strategies seek to lock in fleeting profit opportunities arising from perceived mispricing in the securities where they are positioned. A multi-strategy fund will typically hold positions that employ a combination of hedge strategies, often through investing directly in other hedge funds (called a fund of funds approach). (For more on this hedge strategy, read *Fund Of Funds - High Society For The Little Guy*.)

The higher-volatility alternative investments seen in the above chart represent directional strategies. Whereas hedge strategies rely on locking in profits from temporary mispricing between offsetting exposures (resulting in no directionality), directional strategies profit from the movement of certain asset classes - in the case shown above, these funds are exposed to commodities and global real estate. Their higher volatility relative to hedge strategies comes from the fact that these are relatively risky asset classes, more like equity than like fixed income. (For more on the unique role global real estate could play in your portfolio, read *The Emergence Of Global Real Estate*.)

Investing In Alternative Assets

Traditionally, alternative assets have been the province of high net worth investors; these assets' illiquid secondary markets and high minimum investment sizes serve as a deterrent to participation by a broader retail market. However, the evolution of global financial markets continues to provide an ever-greater breadth and depth of products through which more investors can add alternative assets to their portfolios. Mutual funds, exchange-traded funds (ETFs) and exchange-traded notes (ETNs) all offer various exposures to directional alternative assets like commodities, real estate and foreign currencies, as well as certain hedge strategies like buy-write. (For more on ETNs and ETFs, read *Exchange-Traded Notes – An Alternative To ETFs*.)

In the example of alternative funds we have used throughout this article, three of the four vehicles (market neutral, commodities and global real estate) are accessible via traditional A-share mutual funds, and are available to retail investors for minimum investment sizes of typically no more than $2,500. The fourth (the multi-strategy fund of funds) is a hedge fund with a minimum investment size (generally $1 million) targeted to higher net worth investors. (For related reading, see *Are Derivatives Safe For Retail Investors?*)

Benefits Over Time

In the chart below, we illustrate the tangible advantage of adding both low- and high-volatility alternative assets to a portfolio. The gold-colored diamond situated in the upper left-hand quadrant represents a portfolio comprised of equal parts (25% each of the commodities, global real estate, multi-hedge and market neutral strategies).

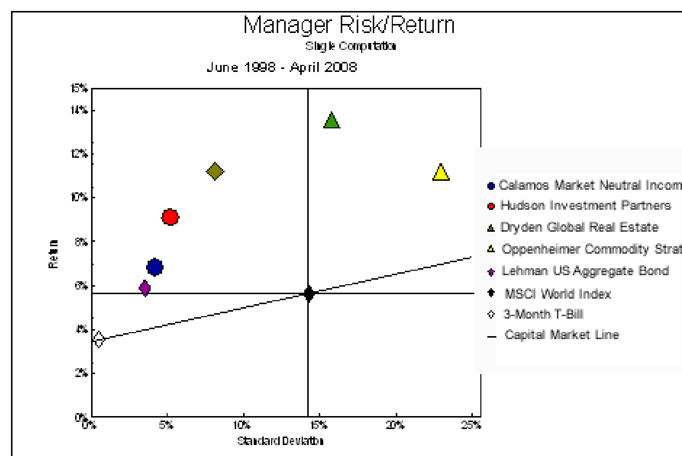

Figure 4
Source: Zephyr & Associates LLC

The strong risk-adjusted performance of this portfolio derives from the individual risk and return properties of each of the investments along with their low correlations to bonds and equities.

During the particular window of time graphed here, the performance of equities was relatively weak - an average annual return of less than 6% over a 10-year period is low by historical standards. The attractiveness of alternative, low-correlation strategies will tend to be more visibly apparent when equity market performance is relatively weak. (Using historical levels to estimate future values can be a valuable tool for investors. Read *Using Historical Volatility To Gauge Future Risk* to learn more.)

Conclusion

There are many varieties of alternative assets, but a common feature and key benefit is a low level of correlation with fixed-income and equity markets, and therefore a measurable degree of independence from systematic market risk factors. Alternative assets can further be categorized into non-directional or hedge strategies, which profit from the construction of offsetting positions in equity, fixed income or other instruments, and directional positions in asset classes such as commodities, global equities and real estate.

Alternative assets are accessible via traditional retail products, such as mutual funds and hedge funds, and other vehicles targeted to sophisticated high net worth investors. Combining different types of alternative assets into a portfolio can produce a more optimal asset allocation and resulting performance benefits that are particularly visible during sustained periods of weak equity market performance.

For more tips on safeguarding your portfolio from risk, read our *Risk And Diversification* tutorial.