Monthly Newsletter

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The Benefits of Alternative Investing

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One of the lessons learned in recent decades, as a result of multiple market corrections and periods of increased volatility is that portfolio management has become more dynamic. Traditional asset allocation models of equities, fixed income, and cash equivalents may not be sufficient for more growth and income oriented portfolios. In certain cases, alternative investment strategies may be appropriate as a means to supplement a proper asset allocation.

So what are "*Alternative Investment*" strategies? The term alternative can mean funds invested in numerous areas such as ***Arbitrage Funds, M&A Strategies, Managed Futures and Long/Short Investing***. One of the more prominent approaches in recent years is that of a long/short strategy. A long short strategy is traditionally something associated with a hedge fund. In such a strategy a portfolio manager may opt to buy equities and fixed income investments they feel are appreciating, while simultaneously shorting some of these holdings that they feel are going to decline. Hedge funds for many years have utilized this approach while maintaining much greater flexibility to choose an investment strategy that can quickly adapt to a rapidly changing environment. Due to their fairly limited regulatory oversight, their ability to stay nimble is unlike that of a traditional equity mutual fund manager whom must stay fully invested at all times. A hedge fund may have the ability to move assets in any direction or potentially stay in cash at times where they feel value is difficult to find.

As financial planners we generally do not advocate that clients actively attempt to time financial markets. Even the best mutual fund managers do this with very limited success. In fact we often weight portfolios heavily towards ETF's and index funds because there is so little evidence that an active equity manager will outperform their benchmark. Historically about 60% of large cap fund managers will *not* outperform the S&P 500 index. More recently, the data has been even less favorable to traditional equity managers. Aside from the higher costs associated with these funds, managers are typically obligated to remain fully invested even at times when they may not see value in the market. This greatly impairs the ability of an active manager to implement their best ideas. So if one were to advocate indexing through ETF's, then what relevance is a long/short strategy in a portfolio? It would seem to be the antithesis of the data previously mentioned. Yet, recent evidence from the last two decades indicates that when combining a long/short approach as a percentage of your portfolio to a traditional asset allocation, you actually reduce volatility while having a nominal impact on net returns. In other words, this approach may provide a similar level of overall long term returns, with reduced shorter term volatility.

So should the average investor attempt to invest in a hedge fund as a mechanism to lower overall portfolio volatility? This is not likely a practical solution for most investors. Hedge funds often have limited disclosure, and extremely high minimums that make them inaccessible to the general public, and not suitable for the average investor. However, in recent years the mutual fund industry began to recognize the demand for such solutions among the general public. They began to create long/short mutual funds that are now available to the general public as an alternative asset class, with the traditional disclosures you would expect from traditional asset classes. Along with these higher disclosure requirements, they are not quite as flexible as a traditional hedge fund. Nevertheless, they have been able to provide more overall portfolio flexibility to an active manager. Some of the recent data from the 2008 correction demonstrated most long/short strategies failed to produce positive returns in all market conditions. However, the record also clearly indicated that they tend to be useful at limiting losses in declining markets and producing relatively low volatility returns that can pay off with more consistent performance over time.

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- We act exclusively as fiduciaries on our clients behalf.
- We custodian all client assets with TD Ameritrade.
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Inside This Issue

When examining the benefits, it is useful to look at the data immediately after a major market correction as to not skew performance results after a significant market rebound. Consider that over the 10 year period ended September 30, 2009, the **Credit Suisse Long/Short Equity Index** generated an annualized return of **8.01%**, with an annualized volatility of **9.96%**. That compared with the **Russell 3000 Index** annualized return of just **0.73%** and an annualized volatility of **16.57%**.

Of course, it should be noted that this 10 year period was an unusually weak period for stocks which saw two major market corrections beginning in 2000-2002 and again in 2008.

When examining more recent data after a significant market rebound, we find that the **Russell 3000 Index** for the 10 year period ending December 31st 2015 realized returns of **7.94%**. While the **Credit Suisse Long/Short Equity Index 6.53%**. So while the returns are clearly not a strong in more positive economic environments, the evidence suggests an approach that produces more consistency.

While this evidence shows the long/short strategy seems to fare better in periods of great stress, it's important to be cautious about overweighting such a strategy, because not all market environments are periods of great stress. However, maintaining a portion of assets in such a strategy in conjunction with a traditional asset allocation has been shown to reduce overall portfolio volatility without significantly impairing returns.

The premise of asset allocation is to not time markets, but rather to manage risk by combing assets of a lower correlation amongst each other. The consistent reallocation of these asset classes requires constant selling into strength and buying into weakness. But over the years, as our economies have become more global, correlations have increased. This has made it harder for financial planners and independent investors to limit risk. This approach is simply an additional piece of the asset allocation pie rather than a single independent investment strategy.

What are the risks? Competitive demand for new products has created a rush to bring some of these products to the marketplace. Many mutual fund companies assigned managers to alternative mutual funds with little experience in the non-traditional investment space. However, there are several management teams whom have shown an excellent long term track record to date. The total collective suggested portfolio exposure to all forms of alternative assets is debatable, and dependent on one's tolerance for risk. As a general rule, we attempt to limit exposure to these type of alternatives to between 5-10% of a client's holdings, dependent upon their objectives.

Lowering portfolio correlations

An additional reason for limiting exposure to these types of holdings relates to the inherently higher cost structure involved in the managing of these underlying strategies. It is not uncommon for such holdings to have nearly double the expenses of a traditional actively managed mutual fund. As a result, we attempt to limit exposure to an amount that can justifiably lower portfolio correlations without significantly increasing overall portfolio expenses.

The historical track record tells us that this combination of traditional asset allocation models that incorporate alternative strategies as part of a multi asset approach not only lowers correlations across the sum of the portfolio, but also improves the probability of maintaining an income plan. Investors who experience lower volatility with only a nominal impact on longer term returns can more readily sustain a cash flow which is being proportionately withdrawn from a portfolio.

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