Alternative Investments

Non-traditional investments can strengthen individual portfolios. But they must satisfy three key criteria.

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Alternative investing is receiving a lot of attention as an effective source of diversification. Lately much of that attention has been focused on alternative investments available to ordinary investors. Exchange traded funds (ETFs), in particular, have emerged to make alternative investments available to non-institutional investors.

But alternative investments include more than ETFs. The term refers to all investment categories except the most traditional such as cash, stocks, and bonds. Some of the largest and most commonly cited categories of alternative investments are hedge funds, real assets, private equity, structured products and collectibles.

This part of the series on Modern Portfolio Theory (MPT) discusses two somewhat distinct topics: alternative investing and international diversification. At first glance, alternative investments seem to offer the broad diversification that is MPT's primary prescription. We begin with alternative investing and raise the three key issues that should be satisfied before attempting to diversify into one of these new products.

Does the investment offer true diversification? Some alternative investments offer true diversification—the ability of an investor to benefit from adding exposure from investing in underlying assets that are not available through traditional securities. A great example of true diversification is investing in private equity.

Private equity is comprised of shares of common stock just like the shares of common stock available in the public stock markets. The difference is that private equity is not publicly traded and is held by limited numbers of shareholders (such as a few families).

Many hedge funds do not truly diversify because their underlying investment strategies utilize traditional investments.

Since MPT extols diversification, MPT would prescribe investing in private equity for diversification purposes. By purchasing shares of private equity, an investor can diversify into a variety of businesses, especially venture capital and small businesses that offer enormous growth potential.

Hedge funds are another example of private investments—securities that are not purchased and sold in public markets. Hedge funds are somewhat like mutual funds except that they are designed to conform to specific legal requirements in order to avoid heavy regulation designed for investments available to the public. Despite their name, most hedge funds are not fully "hedged"—most contain moderate levels of risk.

In the past, hedge funds were designed primarily for use by institutions and the wealthy, and were not available to ordinary investors.

More recently, products are emerging that are designed for small investors. In particular, ETFs are being created that either invest directly in hedge funds or attempt to directly manage security portfolios based on popular strategies implemented by large hedge funds. In both cases, the underlying securities are publicly traded.

Hedge funds offer new opportunities for investors to participate in sophisticated trading strategies. But not all new opportunities offer true diversification in the MPT sense. Many hedge funds do not truly diversify a portfolio because their underlying investment strategies utilize traditional investments. Even though the hedge fund may utilize an exotic trading strategy that virtually eliminates the correlation of their returns with stocks and bonds, the investor is not receiving the type of true diversification espoused by MPT.

MPT advocates diversifying into virtually every available underlying

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asset in proportion to its size. Hedge funds tend to tremendously overweight some securities and take short positions in other securities. The net result can cause over-concentration rather than diversification.

The key to further diversifying an existing portfolio is to extend into investments that are distinct from the portfolio's original investments—into categories such as private equity. A portfolio that only holds U.S. large cap stocks, for example, can be diversified better by buying non-U.S. stocks and small stocks. Investing in a hedge fund that took large bets on various U.S. large cap stocks would not provide the diversification recommended by MPT to a portfolio already containing large U.S. stocks.

A vegetable analogy and true diversification. The idea that some alternative investments do not truly enhance diversification from an MPT perspective even though they offer unusual returns is complex. Let's consider an analogy.

Suppose that you are trying to eat a well balanced diet including lots of different foods. The doctor asks you to describe what types of vegetables you eat, and you reply, "Corn and lima beans." The doctor comments that those two vegetables do not offer enough variety, and that you should add another vegetable to your diet.

Now suppose that the vegetable you add is succotash, and this succotash is not a fancy succotash. This succotash is just like the type my mother made me eat when I was a kid: 50 percent corn and 50 percent lima beans (and 100 percent bad tasting to a kid).

The question is: has adding this third vegetable truly diversified your diet. Of course the answer is "No." We can "look through" the succotash, and see that it is really just corn and lima beans, so that your vegetable intake continues to really only have two underlying vegetables.

The analogy to investments is straightforward. If a person diversifies fully into stocks and bonds, it probably is not necessary to add a hedge fund that invests in stocks and bonds. The hedge fund is simply a mixture of the same underlying assets that you already own. But worse yet, the hedge fund probably takes large bets on some securities and takes negative bets (short sells) other securities. The net result is a less diversified portfolio from an MPT perspective.

Not all hedge funds have underlying assets dominated by stocks and bonds. Many hedge funds diversify into investments that are typically not available to the small investor. But the new ETFs being offered tend to fall into the category of not offering the type of diversification that ordinary investors should be pursuing according to MPT and as discussed in earlier parts of this series.

Ordinary investors can access various types of traditional real estate properties through REITs.

Does the investment have reasonable fees and expenses? Institutions and other large investors have the resources and size to invest directly in alternative assets. They also have the expertise to analyze sophisticated opportunities carefully including expenses and fees. Large investors may even be able to negotiate improved deals through lower fees.

Most ordinary investors must access hedge funds and several other alternative assets using publicly traded investment vehicles such as ETFs. The reasons that small investors may be unable to directly assemble portfolios of alternative investments are that many alternative investments have very high initial minimum investments and require very sophisticated analysis.

Many popular ETFs offer attractive investment opportunities with reasonable fees. But some ETFs, like some mutual funds and other products, have management fees and other expenses that are high and likely erode any advantages offered by their underlying portfolios.

Hedge funds and private equity funds often have large fees. Typical fees are 2 percent of assets each year and 20 percent of profits. This contrasts unfavorably with low cost traditional mutual funds that charge less than .5 percent of assets per year and 0 percent of profits. However, hedge fund and private equity managers with truly superior skills are well worth their high fees when they can implement tremendously successful trading strategies and pass huge gains onto their investors.

The question is whether truly superior managers will ply their trade for the benefit of ordinary investors rather than for the benefit of super wealthy and sophisticated institutions, sovereigns, and families. I would not bet on it. But can an ordinary investor successfully identify the most talented fund managers especially when there are limited performance histories available?

Some types of alternative assets are available through well known, popular, and cost-effective investment vehicles. An example is real estate investment trusts (REITs). Ordinary investors can access various types of traditional real estate and even newer opportunities such as timberland through REITs. Investors can easily compare expense ratios and invest directly in REITs or can access portfolios of REITs selected by investment companies by purchasing ETFs or mutual funds of REITs.

Generally speaking, investment opportunities available to small investors that have high fees are not

a good bet. The key is to do your homework about management fees and total expense ratios for each investment product being considered

Trust mostly in investments with observable market prices. Many alternative investments are not publicly traded, and so investors can not observe reliable prices set by intense competition in financial markets.

Competitive trading in public markets provides a number of benefits. First, it is nice to buy a security knowing that there are thousands of very intelligent investors and speculators who are regularly buying and selling the same asset at the same price. When I buy shares of stock in a large U.S. stock, I can take comfort in knowing that if the stock were clearly and tremendously overpriced, there would be tons of experts making a big fuss about how overpriced the stock is and exerting all sorts of downward pressure on its price by establishing massive short positions. Second, I can watch the price through time to develop an indication of its risk. So I am unlikely to buy the proverbial "pig in a poke."

In the 1980s, Wall Street firms sold billions of dollars of limited partnerships that were marketed to ordinary investors as offering the benefits of investing in real estate, oil and gas ventures, and just about any other "hot" idea. The investments appeared to offer diversification and exposure to a sector that was generating great returns. In most cases of these products that were sold to the public, small investors ended up with disastrous losses.

I have examined many of these limited partnerships very closely. In my opinion, many of them were scams or "fee traps." The fees were so numerous, large, and multilayered that they made the chance of receiving a competitive return almost nonexistent. The conflicts of interest between the investment managers and the limited partners were severe. In some cases, it was simply common sense that the worst properties that the "smart money" owned would be dumped into the partnerships' portfolios and pawned off to the public at inflated prices.

There have clearly been some frauds in recent years in the alternative investments space. Most famously and recently, the Ponzi scheme perpetrated by Bernard Madoff involved an estimated $50 billion of investors' money. However, most products in alternative investments have been reasonably well designed and reasonably successful. One of the best ways to minimize the risk of falling into a fraudulent or overpriced scheme is to invest in securities that are publicly traded.

More and more alternative investments are likely to be offered, sometimes quite attractively, to ordinary investors. The wise investor should carefully consider adding each opportunity to obtain diversification—if and when that opportunity can be obtained cost-effectively and reliably.

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The start of an era. Alternative investments span a broad and ever-changing spectrum. One of the most sophisticated types is structured products.

Structured products refer to innovative products such as securitized assets, derivatives, and special purpose vehicles (e.g., the notorious CDOs involved in the subprime meltdown). Structured products containing underlying loans, mortgages, and other receivables can offer competitive returns and true diversification, and are entirely appropriate even for the typical investor. However, as with some other types of alternative investments, the analysis required is highly complex, and there are few small investors with the time and necessary expertise.

Unfortunately, new alternative investments and investment companies have been slow to offer safe and cost-effective access to the products for small investors. And there's not a lot of good information about them out there. However, Vanguard, an investment company with an excellent track record, and Morningstar, a popular investment information company, are helping to make alternative investments understandable and accessible to the ordinary investor.

Finally, alternative investments include collectibles—which can be everything from rare coins and stamps to antique automobiles and artwork. There is no doubt that collectibles diversify. But there are two problems with investing in them.

First, collectibles can often be overpriced. In competitive financial markets, there are natural forces that tend to prevent absurd pricing levels. But there are few if any such mechanisms in practice that can prevent gross overpricing of collectibles.

One of the most often cited examples of ridiculously high price levels occurred in Holland in the early 17th century when tulip bulbs became a collectible investment craze. More recently, various collectibles catch the interest of the public causing dramatic price rises, frenzied interest, and eventual price collapses and disappointment.

The second problem is that collectibles offer some or all of their return in the intangible form of the pleasure of their ownership. Collectible prices reflect the pleasure of ownership—so people buying collectibles need to enjoy the items as collectors and not only for their potential price appreciation. To the extent that a person is willing to pay the price of a collectible purely for personal pleasure, then it makes

sense as a form of consumption, but not as a form of investment on which one depends for future income.

Alternative investing for ordinary investors is in its infancy. In most cases, the time has not yet come for ordinary investors to make bold moves into alternative investments. However, innovative products are beginning to make additional alternative investments more available and more attractive for small investors.

International Investing MPT tells investors to diversify into every competitively priced asset that can be cost-effectively accumulated and managed. It also says that every asset should be held in proportion to its total value. An asset such as shares of Apple, Inc., for example, should be a much larger part of each investor's portfolio than shares of a small firm.

But even the most ardent supporters of MPT struggle with the idea of holding foreign stocks in proportion to their size. For U.S. investors, this means placing about 35 percent of one's portfolio of risky assets into U.S. investments and 65 percent into foreign assets. For a resident of a small nation, it means putting 95 percent or more of risky assets into foreign stocks since their nation's stocks represent a tiny portion of the global market portfolio.

Investing in foreign stocks appears to subject an investor to enormous risks of foreign currency exchange rate fluctuations. But a stock is more of an investment in future profits than it is in a particular currency. Does it really matter whether you invest in an automotive company that is domiciled in the U.S. and sells its cars in U.S. dollars or in an automotive company that is domiciled abroad and sells its cars in other currencies? In each case, what matters most is the profit potential, not the currency.

International investing is clearly a wise move according to MPT and from a perspective of enhancing diversification. The prescription from MPT is clear: Invest in all available regions, countries, and individual assets in proportion to their size. If the stock market of Japan is 10 times the size of the stock market in Australia, for example, then the perfectly diversified market portfolio should contain 10-times more exposure to the Japanese market than the Australian market.

There are numerous cost-effective mutual funds and ETFs that offer excellent diversified exposure to international investing much in line with the prescriptions of MPT. Unlike alternative investing, international investing in traditional securities is well developed and appropriate as a major source of potential diversification even for relatively small and unsophisticated investors.

There also is the political risk that the host government will restrict a foreign investor from free access to his or her assets.

The Home Country Bias The home-country bias is the universal tendency of people to invest more of one's wealth in the currency and risky assets of one's home country rather than to allocate the wealth throughout the world based on relative sizes. There are rational reasons for a home-country bias.

One reason is fear of political risks. One political risk is that a host nation will nationalize the underlying assets of an investment or otherwise confiscate or prevent the transferring of the wealth of investors, especially foreign investors. There also is the political risk that the host government will restrict a foreign investor from free access to his or her assets. The same thing could happen in an investor's home country, but generally nations are more likely to confiscate assets of foreigners. Political risk also includes adverse economic outcomes in particular nations because of events such as political turmoil.

The second reason for a home-country bias involves fear of the unknown and overconfidence in the value of one's knowledge about investing in one's home country. Some investors feel that they can do better by buying stocks and investing in markets with which they are familiar. There is not much logic to this. Remember, the idea of MPT is to diversify into everything that is competitively traded, offers true diversification, and is cost-effective. I really don't need to know much about the U.K., Germany, Japan, or Switzerland to invest there. I simply purchase the international mutual funds of an investment company that I trust that has a history of very low fees and competent management.

Finally, a reason for a home-country bias is to ensure that your wealth level varies more in tandem with the people around you. Researchers note that financial satisfaction depends more on peoples' wealth relative to others than their absolute wealth. In other words, investors feel best when their investments perform at or above the level of their neighbors, friends and colleagues.

Many Americans today are unhappy with their current income and wealth even though their standard of living (food, shelter, clothing, entertainment, health care, etc.) vastly exceeds the standards of living of most of the other people in the world today. Their unhappiness with their finances occurs when their standard of living compares unfavorably with their contemporary fellow countrymen.

The home-country bias can be linked to our attempt to match the investment performance of the people around us to ensure that our investment returns are in line with our primary comparison groups.