



Including alternative investments in your portfolio

BY GREG CRAWFORD

As a portfolio manager and former hedge fund founder it is always interesting to gauge the public appetite and interest in alternative investments. Public interest usually directly correlates with overall economic activity. In booming economic periods people seem more interested in alternative investments because of either the well-publicized outsized returns from certain managers or the general appeal of being involved with something unique. In lean times people tend to shy away from alternative investments due to liquidity and transparency concerns. However, seasoned investors understand that the role of alternative investments in a portfolio does not change with the ebb and flow of the overall economic outlook.

An alternative investment can be described as an investment vehicle outside of traditional investments such as stocks, bonds or currency. The most common alternative investments include hedge funds, private equity and venture capital. While certain assets such as art work, stamps and real estate are often classified as alternatives, for this article I will define alternatives as the more liquid investments mentioned previously. Additionally, fund of funds, which serve as a vehicle to mix several alternative strategies into a single diversified investment vehicle, can also be considered within this group.

Finding the right alternative investments to complement your portfolio can be overwhelming. Here are eight key concepts to consider when evaluating which alternative investments will best meet your investment needs.

It starts with diversification

When considering alternative investments, the real question to ask is "Can I better diversify my portfolio if I include alternative investments?" For many qualified investors, particularly those

with large investable asset bases, the answer is often "yes." When asking this question consider the performance characteristics of risk and return with the individual alternative investment. Also, consider how the alternative investment will change your overall portfolio and investing strategy.

When looking for alternative investments to potentially lower your overall risk and/or increase your returns, it is important to explore alternatives that have a low or negative correlation to your existing investments. Assess alternative investments that behave differently than the traditional stocks and bonds that comprise the majority of most portfolios.

Strategy and style Every investment has a strategy that can dictate return potential, or the size of the fund. Conservative fully-hedged, market-neutral funds can perform a role similar to other conservative investments in a portfolio. Extremely aggressive funds can use leverage to amplify returns. Some may have broad-based strategies and others can be very specific. It may be necessary to seek a third-party opinion when deciding which funds may complement your portfolio the best.

Risk and performance Every investment strategy carries risk. In fact, the key difference I see between institutional investors and individual investors is how they think about risk. For institutional investors, risk is the primary consideration. Individual investors too often focus first on returns and consider risk only during periods of market stress. The relationship between risk and performance is constant and must always be considered.

Fees There are few young people on Wall Street who do not dream of someday launching and managing a hedge fund. This is not surprising, since out of any common investment

vehicle, hedge funds offer the most attractive compensation structure for fund managers. This is not necessarily a problem if the manager and fund are creating the desired performance characteristics. However, if you are shopping for a hedge fund, the same diversification dynamics may be available elsewhere for a much more reasonable fee.

Redemption terms and liquidity These can vary widely, but liquidity is almost always more limited with alternative investments than other more common investments. Often times there are lock-up periods or fees associated with redemption. Also, liquidity may only be once every few months, with a substantial amount of notice needed to be given to the manager in writing.

Due diligence This is critically important. There are certain aspects of publicly traded investments that are sometimes not openly offered in the alternative investment world. While most funds and fund managers are legitimate, some are not. You bear the responsibility to do your own due diligence, or hire the proper people, when assessing these types of investments. Simply reviewing the fund's offering and subscription documents is not enough. At a minimum, you should review audited financial statements, perform a background check on the firm's principals, review a portfolio statement received from the fund's prime broker, ask to contact references and review all required regulatory filings. Without exception each hedge fund should have a compliance manual and code of ethics for you to review. Ask for these when you visit the offices to review their operations—any transparent firm should be able to accommodate these requests.

Sizing Investments Sizing investments is one of the most frequent mistakes I see in portfolio

design; both in alternative and traditional assets. Well-regarded academic research suggests that an allocation of 10-20 percent in the alternative class can improve the risk and return performance of portfolios. Certain types of perpetual investment pools, such as endowments, allocate 30 percent or more to the class. This is not a suggestion, but a data point to consider. If you have 30-50 percent of your portfolio in a single investment, you are making a bet, not an investment. It may produce returns, but it dramatically increases the risk of your portfolio.

Correlations can shift Asset correlations are not set in stone. One of the main traps we have seen in recent years is the belief in an old assumption that the historical correlations of various investment styles and asset classes will remain constant. This is not the case and your portfolio management and design must address this.

Alternative investments can play an important role in a well-structured, sophisticated portfolio for qualified investors with significant assets. While the rewards can be great, the level of expertise needed and effort required to be successful in this style of investing is much higher than in other areas of your portfolio. Bottom line, consult an advisor with extensive experience when evaluating or considering adding alternative investments to your portfolio.

Greg Crawford is the founding partner and chief investment officer of Sierra Nevada Wealth Management and a former partner at Litchfield Capital Management LLC. Contact him at 297-4682 or greg.crawford@snwmllc.com.

