SARVER VROOMAN
WEALTH MANAGEMENT GROUP
of Wells Fargo Advisors

9237 Ward Parkway, Suite 320 | Kansas City, MO 64114

Peter Vrooman, CFA®, CIMA®, CRPC®
Partner, Wealth Advisor
Fundamental Choice Portfolio Manager
816-601-1152
peter.vrooman@svwealthadvisors.com

Jonathan Sarver, CPWA®
Partner, Wealth Advisor
Fundamental Choice Portfolio Manager
816-601-1151
jonathan.sarver@svwealthadvisors.com

Alternative Investments

Advantages, Challenges, and Strategies for Investors Who Want to Diversify Like a University Endowment or Pension Fund

WHAT IS AN ALTERNATIVE INVESTMENT?

An *alternative investment* is an investment that does not fall into the three traditional categories of stocks, bonds, or cash, and is often added to an investment portfolio for the purpose of reducing risk with non-correlated strategies or enhancing returns with leverage (Chambers, D.R., Anson M. J. P., et. al. 2015); (Chen J. 2019 — alternative investments). Historically, alternative investments were only reserved for pension funds, endowments, institutional investors, and accredited investors. Accredited investors are defined as individuals with a net worth over $1,000,000.00, exclusive of their home equity, or with a minimum income level of $200,000.00 (Chen, J. 2019 — alternative investments). For example, a 2018 report by Yale University (about the Yale University Endowment) shows only a 25% allocation to traditional asset classes (foreign equity 15.5%, domestic equity 3%, bonds and cash 6.5%), with the remaining allocation to alternatives as follows: absolute return 26%, venture capital 18%, leveraged buyouts 15%, real estate 9.5%, natural resources 6.5% (Peart, K. N. 2018).

WHAT ARE THE POTENTIAL ADVANTAGES FOR INVESTORS IN ALTERNATIVES?

#1

Non-correlation

Often alternative investment strategies move independently from the traditional investment categories of stocks, bonds, and cash. The reason why alternatives are able to potentially appreciate when other asset classes decline is because some alternative strategies employ investment methods that can profit from market declines such as shorting stocks, buying futures contracts, or purchasing put options, and other tactical forms of active management. Furthermore, certain types of alternatives such as Real Estate and Commodities historically have had an inherently low correlation to traditional asset classes. The Dow Jones Wilshire REIT Index or real estate investment trust index, has had a .28 annual correlation to US stocks from 1973 to 2007 and the S&P GSCI commodity index has had a -.3 annual correlation to the S&P 500 stock market benchmark (Swedroe, L. E. & Kizer, J. 2008). According to Modern Portfolio Theory (MPT), the risk or standard deviation of a portfolio of investments is not solely based upon the weighted sum of the variances of each asset class, but also takes into account the correlations among the asset classes of the portfolio. (Chen, J. 2019 – Modern Portfolio Theory) By utilizing asset classes that exhibit a low correlation to each other, investors have the potential to optimize their risk-reward trade off and lower their risk without necessarily compromising their returns.

#2

Higher Return Potential

While some types of alternative investments have higher return potential than traditional asset classes, it is important to note that often there is *greater risk* assumed in the form of both illiquidity and leverage, which will be discussed below in the "challenges" section.

#3

Exclusivity

Often strategies are only available to institutions, endowments, and accredited investors. Of course this benefit is only practical if it happens to be a strategy that can only be executed independent of traditional asset classes or investment structures. Status or "bragging rights" is not a practical advantage.

#4

Absolute Return

Often traditional stock and bond strategies will benchmark their risk and reward goals to an index and focus on the *relative return* of the strategy. An *absolute return* strategy will focus on achieving a positive return commensurate with its risk profile, regardless of what is happening in the stock market and the bond market. Alternative strategies that focus on achieving an *absolute return* have the potential to profit in declining markets too.

#5

Available as "Liquid Alternatives"

Historically, alternative investments were limited to being offered as hedge funds or private pools of capital in the form of a limited partnership solely for institutions, endowments, and accredited investors. Hedge funds are meant to be long term investments and typically have long required holding periods or "lock up" periods and often can restrict sales during times of market distress. However, today many different types of alternative investments are offered to the general public in the structure of mutual funds and as ETFs, which have daily and intra-day liquidity respectively. Regulatory requirements for mutual funds/ETFs limit the use of leverage and the amount that can be held in illiquid investments. For this reason, it should not be assumed that liquid alternatives are able to directly mimic the strategies utilized in traditional alternative investments.

WHAT ARE THE MAJOR CHALLENGES FOR INVESTORS IN ALTERNATIVES?

#1

Leverage

Many alternative investments regularly use leverage in an effort to profit from market inefficiencies or arbitrage opportunities. "Private Equity" investing, "Managed Futures," and a "Global Macro" strategies are examples of alternative investments that potentially could be using a great deal of leverage. Leverage is a "double edged sword." Leverage will enhance returns and magnify the positive performance of active managers when their methods are working. However when their investment style or performance is negative their losses are magnified too! The quintessential example of the danger of leverage was the 1998 collapse of the hedge fund Long Term Capital Management. Although the fund included two economists who both won the Nobel Prize, the fund's method of highly leveraged arbitrage (or trading to take advantage of pricing anomalies of securities) led to the fund's demise. In its last year of existence it had leverage of 25 to 1! (Swedroe L. E. & Kizer J.)

#2

High Fees

Traditionally many alternative investments in the form of "private equity" or "hedge funds" had a structure of "2 and 20" which refers to a 2% management fee and 20% of the profits above the "high water mark." This does not even take into account the trading costs of administrative fees charged to the funds. Also some funds will charge a "placement fee" or an "upfront fee" to participate. Finally "funds of funds" will have an additional management fee. Since each alternative investment offering is unique and not standardized, it's important for investors to be cognizant of fees, and weigh the fee structure against other lower cost or liquid alternatives and the need for diversification or other benefits the alternative investment could potentially provide.

#3

Illiquidity

Often alternative investments are structured with long "lock up periods" where investors are required to wait up to ten years or longer to be able to gain access to their funds. Private Equity and many private real estate offerings are long term commitments for investors. Illiquidity may mean that there is no way to sell an investment immediately, or it could mean that if sold too quickly the price would be severely depressed. The only silver lining for the illiquidity of many alternative investment strategies is the *illiquidity premium* or excess return that is expected, though not guaranteed, from investing in more illiquid assets.

#4

Lack of Transparency

Unlike mutual funds and ETFs which both regularly report their holdings, some hedge funds may not be required to register with the SEC or publicly report their holdings. This can be problematic for investors who want to better understand what they own for assessing risk, potential return, or asset allocation. (SEC.gov / Hedge Funds 2012)

#5

High Minimums or High-Net-Worth Qualification

Alternative Investments that are not in the "liquid" form (a mutual fund or ETF) are mostly offered solely to accredited investors, endowments, and institutions. Some alternative investments are offered only to investors with a net worth of over $5 million dollars. Often there are minimums imposed of $100,000.00, $500,000.00, or $1,000,000.00 or no minimum or a very modest one and no net worth qualification for buyers.

#6

Timing or Valuation

One drawback with alternative investments, especially alternatives that lack transparency, is that they are difficult for investors to determine if they are undervalued or overvalued. Since many alternatives rely upon a trading strategy or trying to find anomalies or arbitrage opportunities, how can investors determine if an alternative investment is undervalued or if it's a good time to buy, sell, or rebalance? There's no easy answer to this question.

WHAT ARE SOME OF THE DIFFERENT CATEGORIES OF ALTERNATIVE INVESTMENTS?

#1

Real Estate

While many investors may consider real estate a traditional asset class, we have included it as an *alternative investment* because of its historically low correlation to U.S. stocks. Investors can access real estate as an asset class through multiple investment vehicles including, individual stocks, public REITS or real estate investment trusts, and private offerings too. Often, investors perceive real estate as being a "safe investment" because it is a tangible or "hard asset." However, real estate can have risk or volatility similar to or even greater than U.S. stocks, such as the period from 1978 through 2007 when the standard deviation for investing in real estate as measured by the Dow Jones Wilshire REIT Index was 17.5 vs. the standard deviation of 15.3 for the US stock market.

#2

Managed Futures

Managed futures is an *alternative investment* strategy known for its extremely low correlation to the traditional asset classes of stocks, bonds, and cash. Typically, managed futures funds are run by commodity trading advisors or CTAs and they have the potential to profit whether markets are advancing or declining by investing in commodity futures focused on the long and short movements of energy, agriculture, precious metals, stock and bond market indices, and currencies. This can be a difficult asset class for investors to own because while the standard deviation can be similar to the U.S. stock market, the low correlation benefit may be underappreciated by investors during long flat or down periods for the managed futures asset class. Most of the managed futures funds utilize a significant amount of leverage which could be risky when trends shift and losses are magnified by leverage. Often, managed futures funds use a "trend following" approach which is a form of *technical analysis* where CTAs make decisions to buy or sell futures of particular index, currency, or commodity based upon volume and price charts. On this topic, investors should note that technical analysis is only one form of analysis. Investors should also consider the merits of Fundamental and Quantitative analysis when making investment decisions. Technical analysis is based on the study of historical price movements and past trend patterns. There is no assurance that these movements or trends can or will be duplicated in the future.

#3

Commodities

Commodity prices tend to appreciate when inflation is rising or the economy is expanding (Levine, A., Ooi, Y. H., Richardson, M. & Sasseville, C. 2018). From 1877 through 2015, the arithmetic mean return for commodities was 4.6% and the geometric mean return for commodities was 3.1% for an equal weighted commodity portfolio (Levine, A., Ooi, Y. H., Richardson, M. & Sasseville, C. 2018). Commodities can be extremely volatile at times, as demonstrated by the 24.5 standard deviation for the S&P GSCI commodity index from 1973 to 2007 (Swedroe L.E. & Kizer J. 2008). From July of 1959 through December of 2004 Commodities had a -.42 correlation to stocks, a -.25 correlation to bonds and a .45 correlation to inflation for a holding period of five years (Swedroe L.E. & Kizer J. 2008). While the alternative asset class of commodities is often a subset of *managed futures funds*, commodity exposure can be obtained through other structures including individual stocks, ETFs, and mutual funds.

#4

Private Equity

Private Equity can include both bonds and stocks that are not publicly traded on an exchange. Often it is referred to as *venture capital* when it is used to support a new business. An example would be the investments made by Mark Cuban in the popular TV show *Shark Tank*. When it is utilized to purchase an existing business it is called a *leveraged buyout*. *Distressed debt* is also considered a form of *private equity* and it focuses on companies that are in financial trouble and could file for bankruptcy protection. (Chambers, D.R., Anson M. J. P., et. al. 2015) There is high standard deviation of returns in excess of 100% for private equity funds (Swedroe, L. E. & Kizer J. 2008). Since the return historically has been lower than that for U.S. small cap stocks, investors may tread lightly when looking to invest in private equity funds (Swedroe L. E. & Kizer J. 2008). While a "fund of funds" structure can mitigate risk, it can also add an additional layer of fees.

#5

Long / Short

Long / Short alternative strategies or funds have the potential to profit whether the securities they invest in are appreciating or declining. They can be long and short bonds, stocks, or hybrid securities. *Long* means that the investor owns the security for the potential price appreciation. *Short* is a strategy where the investor is hoping to profit from a decline in the price of the security by borrowing the security and selling with the intent to buy it back at a lower price and profit from the difference. This strategy can be found today in the form of hedge funds, ETFs, and mutual funds alike.

#6

Merger Arbitrage

Merger Arbitrage is an alternative strategy that focuses on companies that are undergoing a merger. A recent example would be the merger announced between Sprint and T-Mobile that was approved by the United States Justice Department on July 26th of 2019. Typically, there is a *spread* between the offer price made by the acquiring company and the trading price of the target company that represents the *deal risk* (the risk that the deal will not be approved by regulators and shareholders) and the time risk (the risk that it will take a long time for the deal to go through.) The operators of a merger arbitrage alternative strategy will often buy the target company and short the acquiring company or use options to do so. This strategy is available in ETF, mutual fund, and hedge fund form.

#7

Convertible Arbitrage

Convertible Arbitrage is a type of long / short alternative investment, where the investment manager will buy convertible bonds and simultaneously sell short the corresponding common stocks to take advantage of mispricing of the convertibles (Chen, J. 2018). Often, convertible arbitrage managers use leverage to enhance their returns. The strategy is run by both mutual funds and hedge funds.

#8

Global Macro

Global Macro is really a long short fund that focuses more on global economic trends for stocks, bonds, commodities, and interest rates. These funds focus on *macro trends* or systematic risks and rewards in the U.S. and abroad. They will shift their focus to different asset classes and geographies both long and short. Strategies that can go long and short are also known as *absolute return* strategies or methods that focus on achieving a positive return regardless of how the market(s) are performing, rather than *relative return* strategies that are only trying to beat an index return regardless of whether the return is positive or not.

#9

Market Neutral

Market Neutral funds are often purchased for their low correlation to the systemic risk of the stock market and their low correlation to the interest rate risk of the bond market. However, while the funds take a neutral stance, they are still subject to investment risk. Market Neutral strategies are a form of a long / short alternative investment with a neutral stance. Today there is availability in the form of ETFs, mutual funds, and hedge funds for investors to participate in a market neutral strategy. Some funds will use options to write or sell *covered calls* on dividend paying stocks and use the *premium income* from the sale of the *call options* to buy *hedged puts*. This strategy effectively creates a ceiling and a floor around the stocks, creating a trading range or what is called a *zero cost collar*.

#10

Fixed Indexed Annuity

This strategy is similar to a *principal protected note* or bond. An insurance company will guarantee the principal amount invested, and provide an annual credit up to a specified cap or limit, based upon the performance of an index that was selected, such as the S&P 500. The investor usually must commit to a long term investment of 5 years or greater and the investor is subject to steep surrender charges should they want to liquidate the annuity prior to the term. Investors must realize that they do not receive the dividends and are capped on the upside in return for the principal protection. Often a fixed indexed annuity does not guarantee a positive return or one that will necessarily have a return greater than a CD. Given that the focus of a *fixed indexed annuity* is on principal protection, it is most likely more useful after long bull market run than after market decline. Also, investors must be aware that money cannot be withdrawn from an annuity prior to 59.5 unless periodic lifetime payments are made, without incurring a 10% premature distribution penalty.

#11

Hedge Fund

A *hedge fund* is more of an investment structure than an investment style for alternative investing. It's a private pool of capital that typically invests both long and short and has more flexibility to utilize options and futures contracts, as well as leverage. According to the SEC, "hedge funds are not subject to some of the regulations that are designed to protect investors" (sec.gov / hedge funds 2012). "Without the disclosure that the securities laws require for most mutual funds, it can be more difficult to fully evaluate the terms of an investment in a hedge fund" (sec.gov / hedge funds 2012).

Bibliography

BlackRock (2019). What are Alternative Investments? Retrieved from: https://www.blackrock.com/us/individual/education/what-are-alternative-investments

Chambers, D. R., Anson, M. J. P., Black, K. H., & Kazemi H., (2015). Alternative Investments CAIA Level I. Third Editiion. Wiley.

Chen, J. (2019). Alternative Investment. Investopedia. Retrieved from: https://www.investopedia.com/terms/a/alternative_investment.asp

Chen, J. (2019). Modern Portfolio Theory (MPT). Investopedia. Retrieved from: https://www.investopedia.com/terms/m/modernportfoliotheory.asp

Levine, A., Ooi, Y. H., Richardson, M., & Sasseville, C., (2018). Commodities for the Long Run, Financial Analysts Journal, 74:2, 55-58, DOI: 10.2469/faj.v74.n2.4. Retrieved from: https://tandfonline.com/doi/pdf/10.2469/faj.v74.n2.4?needAccess=true

Peart, K. N. (2018). Investment return of 12.3% brings Yale endowment value to $29.4 billion. Yale News. Yale University. Retrieved from: https://news.yale.edu/2018/10/01/investment-return-123-brings-yale-endowment-value-294-billion

Sang, H. L. (2015). 7 Common Alternative Investments That all Investors Should Know. The Street. New York, NY. Retrieved from: https://www.thestreet.com/story/13155301/1/7-common-alternative-investments-that-all-investors-should-know.html

SEC.gov / Hedge funds (2012). Retrieved from: https://www.sec.gov/fast-answers/answershedgehtm.html

Swedroe, L. E. & Kizer, J., (2008). The Only Guide to Alternative Investments You'll Ever Need. The Good, The Flawed, The Bad, and the Ugly. The Way Smart Money Diversifies Risk. Bloomberg Press, New York, NY.

Asset allocation and diversification cannot eliminate the risk of fluctuating prices and uncertain returns nor can they guarantee profit or protect against loss in declining markets. Investments in commodities, futures, and managed futures are speculative, involve substantial risk, and are not suitable for all investors. Investors should be aware that such investments can quickly lead to large losses as well as gains. Additionally, restrictions on redemptions may affect your ability to withdraw your participation. Further, there may be substantial fees and expenses. Please see the disclosure documents for a complete description of investment objectives, risks, charges, and expenses.

Alternative investments, such as hedge funds, funds of hedge funds, managed futures, private capital, real assets and real estate funds, are not suitable for all investors. They are speculative, highly illiquid, and are designed for long-term investment, and not as trading vehicle. These funds carry specific investor qualifications which can include high income and net-worth requirements as well as relatively high investment minimums. The high expenses associated with alternative investments must be offset by trading profits and other income which may not be realized. Unlike mutual funds, alternative investments are not subject to some of the regulations designed to protect investors and are not required to provide the same level of disclosure as would be received from a mutual fund. They trade in diverse complex strategies that are affected in different ways and at different times by changing market conditions. Strategies may, at times, be out of market favor for considerable periods with adverse consequences for the fund and the investor. An investment in these funds involve the risks inherent in an investment in securities and can include losses associated with speculative investment practices, including hedging and leveraging through derivatives, such as futures, options, swaps, short selling, investments in non-U.S. securities, "junk" bonds and illiquid investments. The use of leverage in a portfolio varies by strategy. Leverage can significantly increase return potential but create greater risk of loss. At times, a fund may be unable to sell certain of its illiquid investments without a substantial drop in price, if at all. Other risks can include those associated with potential lack of diversification, restrictions on transferring interests, no available secondary market, complex tax structures, delays in tax reporting, valuation of securities and pricing. An investment in a fund of funds carries additional risks including asset-based fees and expenses at the fund level and indirect fees, expenses and asset-based compensation of investment funds in which these funds invest. An investor should review the private placement memorandum, subscription agreement and other related offering materials for complete information regarding terms, including all applicable fees, as well as the specific risks associated with a fund before investing.

Hedge funds trade in diverse complex strategies that are affected in different ways and at different times by changing market conditions. Strategies may, at times, be out of market favor for considerable periods which can result in adverse consequences for the investor and the fund. There is no guarantee any hedging strategy will be successful or not incur loss. Hedge fund strategies, such as Equity Hedge, Event Driven, Macro and Relative Value, may expose investors to the risks associated with the use of short selling, leverage, derivatives and arbitrage methodologies. Short sales involve leverage and theoretically unlimited loss potential since the market price of securities sold short may continuously increase. The use of leverage in a portfolio varies by strategy. Leverage can significantly increase return potential but create greater risk of loss. Derivatives generally have implied leverage which can magnify volatility and may entail other risks such as market, interest rate, credit, counterparty and management risks. Arbitrage strategies expose a fund to the risk that the anticipated arbitrage opportunities will not develop as anticipated, resulting in potentially reduced returns or losses to the fund.

Investment in real estate securities include risks, such as the possible illiquidity of the underlying properties, credit risk, interest rate fluctuations, and the impact of varied economic conditions.

Real Estate Strategies

Core investments in real estate are considered less risky and are characterized as having lower risk and lower return potential. There is no guarantee any investment strategy will be successful under all market conditions. The value of any property may decline as a result of a downturn in the property market, and economic and market conditions. The value-added strategy seeks to add value by making enhancements to properties. These properties may have operational issues and usually require additional leverage to acquire. There is no guarantee value appreciation will be achieved and the operating company may be forced to sell properties at a lower price than anticipated. An opportunistic investment style bears the highest level of risk among real estate strategies as it typically involve a significant amount of "value creation" through the development of underperforming properties in less competitive markets or other properties with unsustainable capital structures. Although these investments have the potential to generate income, there is no guarantee they will do so over their investment time periods. In addition, private real estate is considered illiquid, there is no assurance a secondary market will exist and there may be restrictions on transferring interests. Since the opportunistic properties have little to no cash flows at time of acquisition, higher leverage is often employed and sponsors may be subject to less favorable debt terms and higher interest rates than more stabilized properties. All investments may be negatively impacted by varied economic and market condition which may be unpredictable.

There are risks particular to investments in commercial real estate securities as well as in direct real estate investments, including, without limitation, changes in property values or revenues due to oversupply, changes in tax laws and interest rates, environmental issues and declining rents. No assurance can be given that the investment objectives described herein will be achieved and investment results may vary substantially on a quarterly, annual or other periodic basis. The funds engage in leveraging and other speculative investment practices that may increase the risk of investment loss. The funds may invest in derivative instruments, which may be more volatile and less liquid, increasing the risk of loss when compared to traditional securities.