

# Demystifying the Role of Alternative Investments in a Diversified Investment Portfolio

By Baird's Advisory Services Research

## Introduction

Alternative investments, which have been used by large institutions and endowments for quite some time, have become more mainstream in recent years. Not only are they more popular among individual investors, but there are also more products available, making investing in alternatives possible for a much broader universe of investors. Given their non-traditional approach and their ability to invest in areas and ways traditional investments cannot, they have the potential to improve the overall risk-return characteristics of a portfolio. As such, a modest allocation to alternatives may be prudent for more investors than previously was the case. However, the non-traditional approach and structure of these investments bring with them unique risks of which investors must be aware.

### Traditional Investments

Domestic Equity  
International Equity  
Taxable Fixed Income  
Tax-Exempt Fixed Income  
Satellite Asset Classes\*  
Cash

### Alternative Investments

Structured Products  
Managed Futures  
Private Equity  
Hedge Funds  
Alternative Mutual Funds  
Exchange Funds

*\*Satellite Asset Classes include Commodities, Global Real Estate, High Yield Fixed Income, and Emerging Markets Equity*

## Alternatives Defined

Alternative investments utilize a different approach to investing than do traditional equity or fixed income investments. This approach may involve holding both long and short positions in securities and holding private securities instead of publicly traded investments, and there may be derivatives or hedging strategies as well. Investors using alternatives may also have a goal of achieving a particular level of absolute return as opposed to relative performance versus an index.

Alternative investments have the potential to enhance the risk and/or return characteristics of an investment portfolio. Given their low correlation to traditional investments, they can potentially enhance diversification and reduce risk; with their ability to be more flexible and invest in a wider opportunity set, they can potentially enhance return; and they can be used to hedge certain portfolio exposures, thereby reducing concentration risk.

As a result of the different investment approach, alternative investments have different risks and characteristics than do traditional investments. They are often less liquid, particularly in periods of stress; they are generally more complex and less transparent, making them difficult for untrained investors to understand; they are more susceptible to investment manager failure; and they can have a complicated tax profile.

The successful implementation of an alternative investment strategy relies largely on investment manager experience and skill due to the broad range of investment opportunities. This is in contrast to managers specializing in specific asset classes such as commodities, real estate, emerging markets equity and high-yield fixed income. These non-traditional, or satellite, asset classes provide portfolio diversification due to low correlation with traditional asset classes, but like traditional investments, performance is primarily driven by asset class exposure as well as manager skill.

### Types of Alternatives

Below we highlight several types of alternative investments. However, new approaches are constantly being developed, and this list is meant to be more illustrative than exhaustive.

**Structured products.** Hybrid investments that combine the characteristics of two or more asset classes in order to provide unique benefits to the investor. They are designed with traditional fixed income features, such as a set maturity date, and can have principal protection, yet their return is generally derived from

the performance of an underlying asset class such as equity or fixed income indices, equity baskets or individual equities, commodities or currencies.

**Managed futures.** An investment strategy that seeks to participate in medium- to long-term trends in global futures markets. Strategies include the use of stock index, interest rate, currency, energy and commodity futures. Most managed futures traders are systematic in nature, meaning they apply sophisticated computer models designed to invest in a disciplined, unemotional fashion. Managed futures are relatively tax-inefficient and are thus best utilized in a qualified account structure.

**Private equity.** An investment strategy that seeks to participate in the growth of private companies through long-term investments in private securities globally. Private equity is an illiquid asset class that offers the potential for greater long-term capital appreciation and diversification away from the public markets. It is generally available only to higher-net-worth individuals with more investment experience (often referred to as accredited or qualified investors) at high minimums and often has liquidity restrictions.

**Hedge funds.** A managed portfolio of investments that uses advanced investment strategies such as leveraged, long, short and derivative positions in both domestic and international markets with the goal of generating strong returns either in an absolute sense or over a specified market benchmark. They are generally available only to higher-net-worth individuals with more investment experience at high minimums and often have liquidity restrictions.

### Multiple Manager Approach

Many of these alternative investments are available in a multi-manager structure, such as a fund of funds. A multi-manager approach brings diversification, which can be particularly beneficial in a space where manager skill is paramount. So, while the multiple-manager structure may bring with it additional fees, the diversification benefits may outweigh the added cost, particularly in uncertain or volatile markets.

**Alternative mutual funds.** Funds in which the managers are not constrained by traditional portfolio management methods. They have varying approaches, ranging from absolute return, long/short equity, broad mandate or “go-anywhere” funds, and hedge fund-like strategies. Many of these funds also have a total return or absolute return objective. They provide access to non-traditional investment approaches while still providing investors with daily liquidity at reasonable investment minimums.

**Exchange funds.** Special purpose funds that may allow holders of concentrated positions, often accompanied by a low cost basis, the ability to diversify by exchanging their stock for shares of a diversified fund without triggering a taxable event. (The cost and availability may vary.)

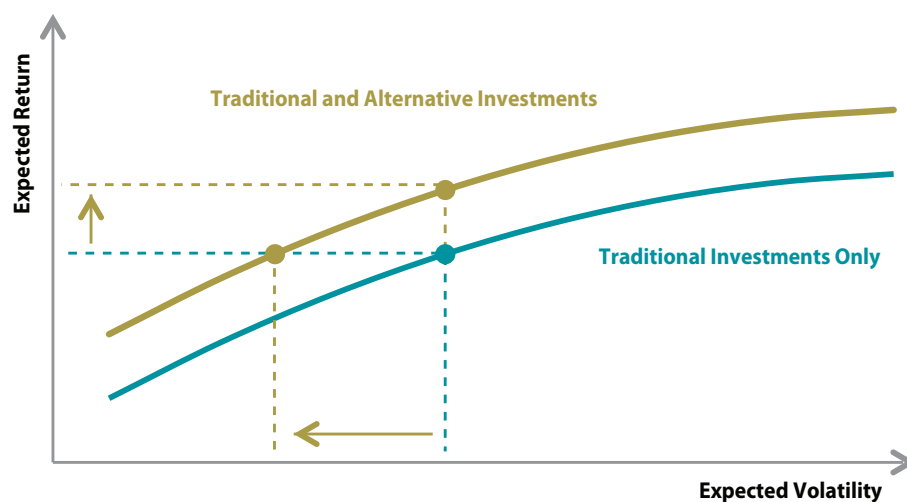
## Benefits of Alternative Investments

Despite unique risks and considerations, alternative investments can be useful tools to improve the risk-return characteristics of an investment portfolio. They can increase diversification and reduce volatility, given low correlations to more traditional investments; they can offer the potential for enhanced returns due to the wider investment opportunity set; and they can hedge certain portfolio exposures, thereby reducing concentration risk.

Graph 1 illustrates a sample Markowitz efficient frontier, representing all portfolios with the lowest risk (as measured by volatility) for a given level of return, or conversely all portfolios with the highest return for a given level of risk.<sup>1</sup>

GRAPH 1:

### Markowitz Efficient Frontier



*For illustrative purposes only, not drawn to scale.*

<sup>1</sup>Harry Markowitz was an economist renowned for his research on Modern Portfolio Theory. He received the Nobel Prize in Economics in 1990 for his work in this area.

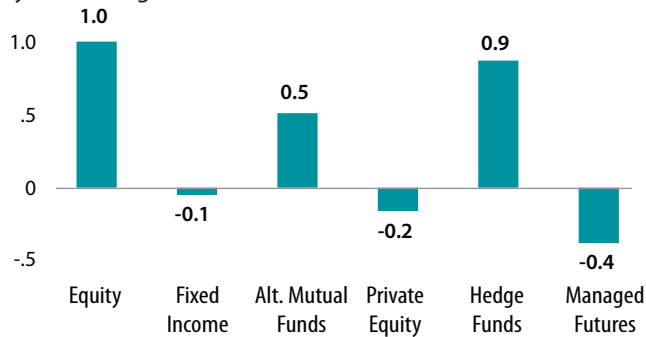
The inclusion of alternative investments can move the efficient frontier up and to the left, so for a given level of return, risk is lower, or for a given level of risk, return is higher.

**Diversification.** While alternative investments on their own may have higher volatility than more traditional investments, particularly fixed income, they typically have low correlations to more traditional asset classes. As such, their inclusion in an investment portfolio tends to result in lower overall volatility (Graph 2).

GRAPH 2:

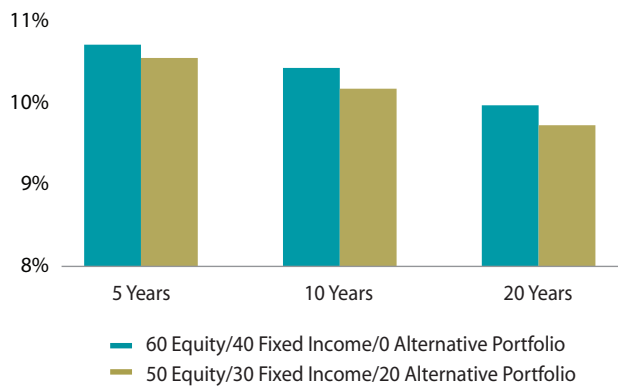
**Correlation with S&P 500 Index\***

5 years ending 12/31/2009



**Standard Deviation\*\***

as of 12/31/2009



\*Asset Classes represented by various indices, defined on page 6.

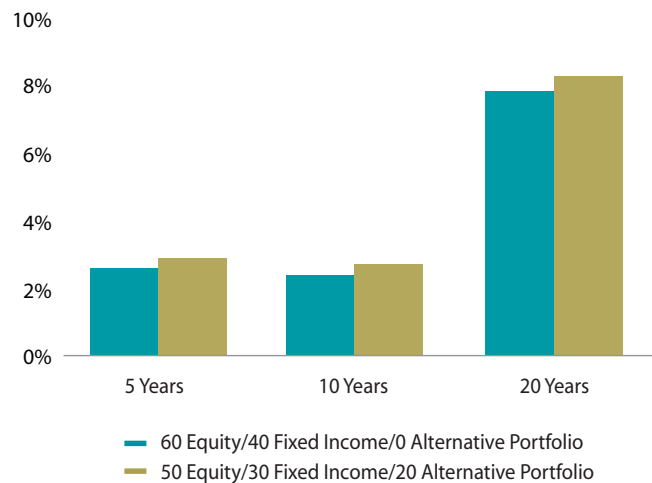
\*\*Hypothetical portfolios represented by S&P 500 (equity), Barclays Capital US Aggregate Bond (fixed income) and HFRI Funds Weighted Composite Index (alternatives).

**Return.** Because they have a wider universe in which to invest (public and private) and do not have some of the same investment constraints (can short and hedge), alternative investments have the potential for higher performance than traditional investments (Graph 3).

GRAPH 3:

**Return\***

as of 12/31/2009



\*Hypothetical portfolios represented by S&P 500 (equity), Barclays Capital US Aggregate Bond (fixed income) and HFRI Funds Weighted Composite Index (alternatives).

Past performance is not a guarantee of future performance.

**Hedge.** There can be circumstances in which an investor has a concentrated position in a single stock and is unwilling or unable to sell in order to diversify the portfolio due to, for example, sizable tax consequences associated with selling a security with a low cost basis or restrictions from selling based on his or her role at a public company. In these cases, using alternative investments to hedge the exposure can reduce overall portfolio risk.

#### Benefits

Diversification  
Return  
Hedge

#### Risks

Fees  
Complexity  
Transparency  
Liquidity  
Tax Consequences  
Potential Not to Perform as Expected

### Risks of Alternative Investments

There are several risks associated with alternative investments above and beyond the typical risks associated with traditional investments.

- **Higher fees.** Alternative investments can have higher fees. For example, fees can include an annual management fee (1–2%) and an additional incentive fee (10–20%). Fund of funds may also charge yet another management fee. While higher than traditional investments, these fees may or may not be justified when comparing returns net of fees.
- **More complicated.** Alternative managers may invest in a wide variety of investments, including derivatives, and utilize short selling. Understanding complicated investment strategies requires more upfront and ongoing due diligence.
- **Less transparent.** There can be limited transparency into the underlying holdings of these investments. Additionally, many manager evaluation tools are not as well suited for alternative investments, making a manager’s investment ability more difficult to assess. Also, some alternative investments are largely unregulated.
- **Less liquid.** Limited partnerships may hold illiquid investments and as such restrict an investor’s ability to redeem money. For example, managed futures only offer monthly liquidity, many funds of hedge funds do not allow redemptions in the first year and only annual or quarterly thereafter, and private equity may not allow redemptions for seven or more years. The underlying investments used in an alternative investment strategy may also be exposed to a significant lack of liquidity in stressful trading environments.
- **Less tax-friendly.** Most alternative investment strategies have little to no focus on minimizing taxes. Also, those whose legal structure is a partnership issue a K-1 statement rather than a 1099.
- **May disappoint in strong up markets.** Investments that seek to generate an absolute return often use short selling strategies, and as such tend to lag long only strategies in strong up markets, which may discourage some investors.
- **May not diversify risk in extreme down markets.** In periods of dislocation, the correlations of many types of investments, including alternatives, may increase significantly, as was the case in the extreme down market of 2008.
- **Credit risk.** For some structured products, notes in particular, principal protection guarantees are limited to the credit worthiness of the issuer.

Often clients and their financial advisors come to the conclusion that the benefits of alternatives warrant the added risk.

## Incorporating Alternatives into Portfolios

We believe there are two main considerations to keep in mind when incorporating alternatives into an investment strategy.

1. **Conservative approach.** By definition, alternative investments use a non-traditional approach to investing. Additionally, performance is largely dependent on manager skill, unlike traditional investments, in which much of the performance is driven by asset class exposure. Therefore, it is prudent to take a conservative approach, opting for those strategies with a proven track record and stable investment team and process. With new products being offered regularly in this fast-growing space, it is wise to exercise caution, having a bias toward offerings with demonstrated success, as opposed to “paper” portfolios or back-tested track records.
2. **Appropriate allocation.** Generally allocating 10–20% of a portfolio to alternative investments is most appropriate, although the allocation can be higher in unique situations. This is a large enough allocation to be impactful in terms of enhancing returns or helping to reduce risk, without being so large that it dominates the overall portfolio. Typically alternatives can be funded proportionately from the equity and fixed income portions of an investment portfolio. For example, in a portfolio consisting of 60% equity and 40% fixed income, to add a 20% allocation to alternative investments, 12% could come from traditional equity (includes satellite asset classes) and 8% from traditional fixed income.

## Conclusion

When used appropriately, alternative investments can potentially enhance the overall risk-return profile of an investment portfolio. There are unique benefits but also unique risks associated with these non-traditional investment strategies, and as such it is paramount that investors be comfortable with alternatives when incorporating them into their investment strategy. Therefore, it is important to discuss alternatives with your Financial Advisor to determine the suitability of incorporating them into your existing investment approach, as each individual’s circumstances are unique.

## Definitions

Correlation: the extent to which the values of different types of investments move in tandem with one another in response to changing economic and market conditions.

Standard Deviation: a gauge of risk that measures the spread of the difference of returns from their average. The more a portfolio's returns vary from its average, the higher the standard deviation. It is important to note that higher than average returns affect the standard deviation just as lower than average returns.

## Asset Class Index Proxies

Equity: S&P 500 Index – a representative sample of 500 leading companies in leading industries of the U.S. economy; considered a large-cap index.

Fixed Income: Barclays Capital US Aggregate Bond Index – comprised of approximately 6,000 publicly traded bonds, including U.S. Government, mortgage-backed, corporate, and Yankee bonds with an average maturity of approximately 10 years.

Alternative Mutual Funds: Style-specific universe of mutual funds categorized as Long-Short by Morningstar, which included 99 funds as of May 31, 2010.

Private Equity: Cambridge Associates Private Equity Index – based on data compiled from 823 U.S. private equity funds, including fully liquidated partnerships, formed between 1986 and 2009. Returns are net of fees, expenses and carried interest.

Hedge Funds: HFRI Funds Weighted Composite Index – designed to reflect hedge fund industry performance by constructing equally weighted composites of constituent funds, as reported by the hedge fund managers listed within HFR Database; encompasses more than 2000 funds.

Managed Futures: S&P 500 Diversified Trends Indicator – composed of 14 sectors, equally divided between physical commodities and financial futures.

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