

Alternative Investments and the Semi-Affluent Investor

Research Report
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Executive Summary

The financial advisory industry grew up during the greatest bull market in history. For more than a decade, long-only investments such as mutual funds and separate accounts have been more than sufficient to meet clients' performance expectations. Development of a global economy has been just slow enough to enable long-only diversification strategies to succeed.

But the 1990s are over. A two-pronged challenge is forcing financial advisors to rethink their traditional approach to investment management.

Challenge #1 – Shrinking Equity Premium

Potentially lower future equity market returns may make many advisory firms' current approach to investment management inadequate. A collection of market experts and leading economists has forecast equity returns ranging from 0% to 5% over the next five years. And while no one can precisely predict the returns of any market for the next five minutes, much less the next five years, there are several factors that lend credibility to these prognosticators' forecasts.

First, the equity market's returns of the 1990s (more than 18% annually for the S&P 500) were nearly 11% higher than the average from 1961 to 1990. Any regression to the mean would suggest significantly lower near-term returns. Second, corporate earnings and dividends did not grow at rates even close to approaching equity returns during the 1990's. A large part of this exceptional level of investment performance was instead due to a surge in demand for equities by institutions and individuals that created a supply/demand imbalance.

Unless a similar increase in demand for equities occurs again this decade, academic research suggests that annual equity returns will likely exceed the risk free rate by only 3%. With continued low inflation, the resulting 5% to 6% returns from the equity markets will force advisors to seek new opportunities in order to meet their clients' return expectations.

Challenge #2 – Globalization of world economy

Globalization of the world's economy is an equally vexing challenge to many advisory firms' current approach to investment management. As companies compete more frequently in a worldwide market for labor, materials and sales, sector and country characteristics are less dominating factors in stock performance. The correlation coefficient of the returns of the S&P500, NASDAQ, MSCI EAFE and Russell 2000 has jumped significantly over the last decade, increasing the systematic risk of diversified long-only portfolios. Advisors must now look beyond traditional asset classes to find ways to reduce this risk.

Alternative Investments – A Potential Solution, But Proceed with Caution

To meet these challenges, many advisory firms have turned their attention to alternative asset classes – hedge funds, managed futures, private equity and real estate. Historically the sole province of institutions and high net worth investors, alternative investments have enhanced investors' returns while reducing overall portfolio risk. These benefits have made alternative asset classes standard allocations of many major institutional investors – and several leading universities currently have allocations in excess of 20% to these products.

Alternative investments, however, are not a panacea for advisory businesses. While they may offer potential benefits to their users, alternative asset classes are fraught with risks for the unknowledgeable investor.

- ◆ Alternative asset classes are largely unregulated products. And there are numerous examples of fraud and even outright theft by some alternative investment managers.
- ◆ Manager evaluation and selection is as much an art as a science. Unlike open-end mutual funds that must disclose their investment performance in a statutorily prescribed manner, alternative investments are mostly private partnerships that have no legal reporting requirements. Consequently, there is only limited accurate and publicly available data.
- ◆ Inclusion of alternative asset classes in a portfolio is complicated, and constructing allocations to these products requires an extensive understanding of their investment strategies and risks. Unlike traditional mutual funds and private accounts, alternative investments – from a portfolio construction standpoint – are not designed to be standalone assets. Instead, successful institutional investors use several different alternative strategies at once that, in the aggregate, produce a desired return pattern.

- ◆ Access to the best managers is a critical factor in such strategies, as the difference between a first and fourth quartile alternative investment manager can often be the difference between success and disaster. Successful manager selection of traditional asset classes can boost returns by as much as 3% annually over time. By comparison, many first quartile venture capital partnerships over the last five years delivered returns in excess of 1000% while several fourth quartile funds generated net losses for their investors.
- ◆ Advisory clients are typically semi-affluent investors (\$1mm to \$10mm). Unlike institutions or the super wealthy, semi-affluent investors can invest only limited amounts in such products and have greater liquidity needs. The risk profile of many alternative products may make them unsuitable for this kind of investor.
- ◆ Advisors must also address a series of legal, tax and operational issues before they can include alternative asset classes in their clients' portfolios.

Alternative Investments Will Differentiate Advisory Firms

Advisors faced similar problems before, however, and overcame them. The 1970s produced a prolonged period of dismal equity returns. A handful of today's most successful advisory firms ventured into the realm of alternative investments by necessity back then to counteract the malaise of traditional markets. Their ability to learn how to effectively invest in alternative asset classes was a key factor to their survival, much less their success.

A common trait of future successful advisory firms will likewise be an ability to effectively invest in alternative asset classes. When correctly used, these products can improve risk-adjusted performance for investors, and the successful inclusion of alternative asset classes in portfolios will be a distinguishing factor between advisory businesses. Similar to their institutional counterparts, successful advisory organizations will not consider alternative asset classes to even be "alternative." They will instead serve as simply additional investment choices that can be used in constructing optimal portfolios.

Future successful advisory firms will also determine the role their organizations will take in harnessing the benefits of these asset classes. The decision will reflect the firms' investment and operational capability, as well as their willingness to incur additional liability.

For example, some organizations will develop proprietary funds of funds and directly invest client assets into investment partnerships or transactions. Others will sub-contract these investments to third-party organizations that specialize in selecting and monitoring alternative asset class managers. Regardless of which path is chosen, successful advisory firms will develop an expertise on these asset classes and how they are most effectively used in client portfolios.

Unsuccessful or improper use of alternative investment products will also be a distinguishing factor between advisory firms. Organizations that fail to complete the lengthy and complicated due diligence process on the asset classes – as well as on individual products and managers – prior to investing will inflict irreparable harm on their clients' portfolios and the future of their advisory businesses.

While they are complicated and even risky products, alternative investments have become a regular part of successful institutional portfolios. Advisory firms cannot ignore their existence. Nor can they consider using them without first devoting an immense amount of time and resources to develop an understanding of them.

This report is designed to serve as a first step in many advisory firms' research into alternative investments. It includes a detailed review of the benefits and risks of various investment strategies and products and how they might fit into a portfolio allocation. It also examines many of the non-investment issues involved with these asset classes and identifies several choices available to advisory firms. Finally, the report includes a lengthy bibliography of recent research on alternative investments that may serve as a resource to firms seeking to proceed further in their due diligence efforts.