

# **Alternative Investments and the Semi-Affluent Investor**

**Chapter 1: Introduction**

**Research Report**  
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## I. Introduction

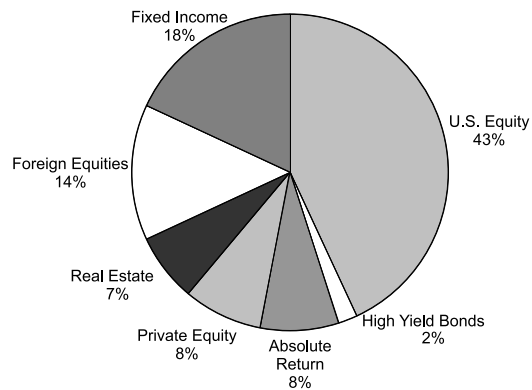
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Alternative investments play an increasingly prominent role in many pension, foundation and endowment portfolios. Attracted by exceptional absolute levels of return and potential diversification benefits, many institutions now allocate more than 23% of their assets to these investments.

**Figure 1.1**

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**Average Asset Allocation of 25 Largest Universities**  
December 2000



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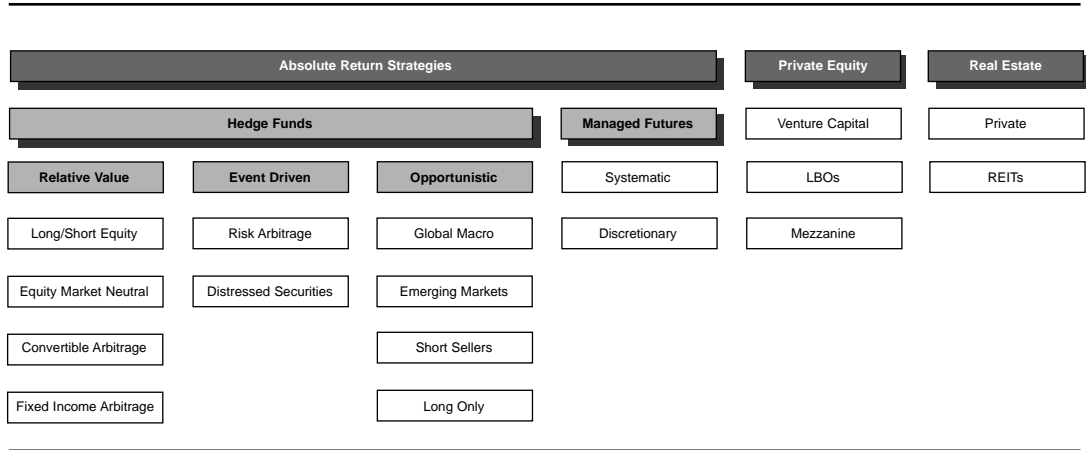
Source: University of Chicago

Allocations to alternative asset classes typically serve one of two purposes: help enhance portfolio returns through higher-risk investment strategies or help diversify portfolios through products that generate returns with very low correlation to traditional asset classes.<sup>1</sup>

**Alternative investments serve one of two purposes: portfolio diversifiers or return enhancers**

Alternative investments can be segmented into three broad categories – absolute return products, private equity and real estate. Absolute return products include hedge funds and managed futures. Private equity includes venture capital, mezzanine financing and leveraged buyouts. Real estate includes private real estate investments and Real Estate Investment Trusts (REITs).

**Alternative Investment Strategies**



**Exhibit 1.1**

**Alternative Investments Can Be Return Enhancers or Portfolio Diversifiers**

	Return Enhancer	Portfolio Diversifier
<b>Absolute Return</b>		
Relative Value		♦
Long/Short Equity	♦	♦
Equity Market Neutral		♦
Convertible Arbitrage		♦
Fixed Income Arbitrage		♦
Opportunistic		
Global Macro	♦	
Emerging Markets	♦	
Short Sellers	♦	♦
Long Only	♦	
Event Driven		
Risk Arbitrage		♦
Distressed Securities	♦	♦
<b>Commodities</b>		
Managed Futures		♦
<b>Private Equity</b>		
Venture Capital	♦	
Mezzanine	♦	
LBO	♦	
<b>Real Estate</b>		
Private Real Estate		♦
REITs		♦

Most absolute return products serve as portfolio diversifiers. They are designed to provide annual returns equal to the long-term performance of equities (10% to 12%) with very low (<.30) correlation to traditional asset classes. They are effective portfolio diversifiers because the sources of their returns are investment strategies unrelated to directional moves of the market.

**Adding alternative investment products to portfolios can increase returns and lower risk**

Investments in real estate also provide diversification benefits to portfolios. They also can serve as a form of insurance against either inflation or deflation. An asset class with both equity and fixed income return characteristics, real estate has historically generated lower returns than absolute return strategies.

Above market-level returns are largely sought through higher-risk private equity investments and some absolute return strategies. These products often rely on financial leverage and derivatives to generate exceptional levels of investment performance.

**Alternative Investments Have Reduced Risk and Increased Returns**

By combining the different aspects of alternative investment products, investors have historically increased returns and decreased risk (as measured by standard deviation) in portfolios. Using historical return data from 1990 to 2000 for traditional asset classes and the three alternative investment strategies, we created five sample portfolios to use as examples. As shown in Figure 1.2, in every sample portfolio, adding an allocation to alternative investments produced higher overall returns with lower volatility.

**Table 1.1**

**Benefits of Making Allocations to Alternative Investments  
1990 - 2000**

	U.S. Core Equity	U.S. Small Equity	U.S. Fixed Income	International Equity	Real Estate	Private Equity	Absolute Return Products		
Index Used	S&P 500	Russell 2000	Lehman Aggregate	MSCI EAFE	NCREIF NPI	Cambridge PE	HFR Composite		

	Type of Investor	Allocation Percentages							Annual Return	Standard Deviation of Returns
Traditional Investment Portfolio	Aggressive	50.00	20.00	15.00	15.00	N/A	N/A	N/A	12.36	11.91
	Moderately Aggressive	55.00	10.00	25.00	10.00	N/A	N/A	N/A	12.16	10.46
	Moderate	47.50	15.00	32.50	5.00	N/A	N/A	N/A	12.04	9.76
	Moderately Conservative	50.00	10.00	35.00	5.00	N/A	N/A	N/A	11.95	9.41
	Conservative	42.50	10.00	45.00	2.50	N/A	N/A	N/A	11.48	8.33
Portfolio Allocation with Alternative Investments	Aggressive	42.50	15.00	10.00	7.50	2.50	10.00	12.50	14.53	10.06
	Moderately Aggressive	45.00	12.50	17.50	5.00	2.50	7.50	10.00	13.99	9.60
	Moderate	50.00	5.00	25.00	5.00	2.50	5.00	7.50	13.47	9.08
	Moderately Conservative	47.50	7.50	30.00	2.50	2.50	2.50	5.00	13.13	8.77
	Conservative	40.00	7.50	42.50	2.50	0.00	2.50	5.00	12.31	7.64

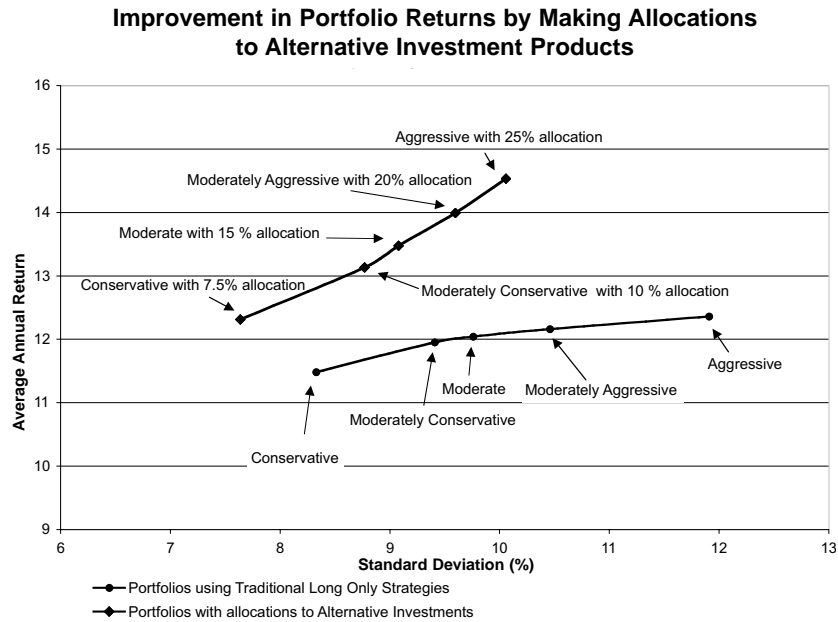
Source: Standard & Poor's Micropal, Hedge Fund Research, Inc., NCREIF

For an aggressive investor, we used a portfolio with an 85% allocation to equities (50% U.S. large cap, 20% U.S. small cap and 15% International) and a 15% allocation to U.S. fixed income. We compared its returns with a portfolio that included a 25% allocation to alternative investments, made up of 12.5% to absolute return products, 10% to private equity and 2.5% to private real estate.

The average annual return during the 11-year period for the traditional equity and fixed income portfolio was 12.36%, versus 14.53% for the portfolio with a

25% allocation to alternative investments. This increased return was achieved with almost 20% less volatility, thereby dramatically improving the risk/return characteristics of the portfolio.

**Figure 1.2**



Source: Standard & Poor's Micropal, Hedge Fund Research, Inc., NCREIF

For a more conservative portfolio (55% equities and 45% fixed income), a 7.5% allocation to alternative investments (5% absolute return products and 2.5% private equity) would have had similar beneficial effects. Its overall returns would have risen from 11.48% to 12.31% and its volatility would have been about 9% less.

**Advisors Have Largely Avoided Alternative Asset Classes**

Despite their growing popularity, one group of institutional investors – financial advisors – has largely ignored alternative asset classes to date. They have generally limited their portfolios to traditional investments such as mutual funds, private accounts and individual securities.

**The extraordinary performance of the equity markets over the last ten years has allowed advisors to ignore alternative assets**

Extraordinary performance of the broad equity markets during the past decade has been the biggest explanation for why advisors have avoided alternative asset classes. During this time period, the S&P 500 generated average annual returns in excess of 18%. And the NASDAQ rose from 425 in 1990 to 5048 in March of 2000, an annual rise of more than 26%.

Such abnormally high equity market returns (the S&P 500 30-year historical average for the 30 years prior to 1990 was about 7.15%) have allowed advisors to concentrate their client assets in long-only investments. Advisors had little incentive to broaden their investment horizons when using simpler, traditional choices more than exceeded their clients' absolute return requirements and expectations.

However, the investment climate has changed significantly during the last 12 months. Equity markets suffered their largest correction since the great bear market of 1973 to 1974. The S&P 500, after producing returns of 20% or greater in 1996, 1997, 1998 and 1999, declined to -9.11% in 2000. The NASDAQ, after producing a return of 85.9% in 1999, declined to a return of -38.8% in 2000. For the first time, many advisory clients are experiencing the trauma of net negative portfolio returns.

### **Advisors Reevaluating Approach to Investment Management and Asset Allocation**

#### **Advisors are re-evaluating their approach to investment management and assets allocation**

Two challenges are forcing advisors to reevaluate their approach to investment management and asset allocation. First, after an extended period of intoxicatingly high absolute returns, the prognosis for the equity market's performance over the next three to five years is not particularly encouraging.

Several market experts believe the equity markets will generate mediocre absolute returns for some time. For example Bill Gross, widely regarded as one of America's most influential authorities on the bond market and a portfolio manager at Pacific Investment Management Company (PIMCO), has forecasted absolute annual equity market returns of less than 6% for the next five years. Vanguard Chairman John Bogle is more pessimistic and believes equity returns will be about 3% per year for the next five years. Robert Arnott, Managing Partner of First Quadrant, L.P. reaches an even more dire conclusion. "Our expectation is that the return over the next five years should be zero or less."

### **Shrinking Equity Premium**

These experts' concerns stem in part from several recent academic studies that argue that the equity premium – the spread between the average stock return and the risk free rate – has fallen to between 2.55% and 4.32%. The research suggests that the abnormally high realized equity returns of the 1990s were primarily the result of a surge in demand for equities.

As the academics explain it, equity market participation by individuals and institutions broadened significantly during the last 10 years. Increased demand for equities led to a supply/demand imbalance that resulted in a decline in the implied discount rate used by equity investors to discount future cash flows. As the implied discount rate fell, the prices on individual stocks surged and caused abnormally high near-term rates of return in the equity markets.<sup>2,3</sup>

Unless a similar surge in demand for equities occurs again – with a resulting drop in the expected rate of return – these academics argue the realized rates of return from equities could fall significantly. A 3% equity premium during a period of low inflation could result in total returns from equities less than 6%.

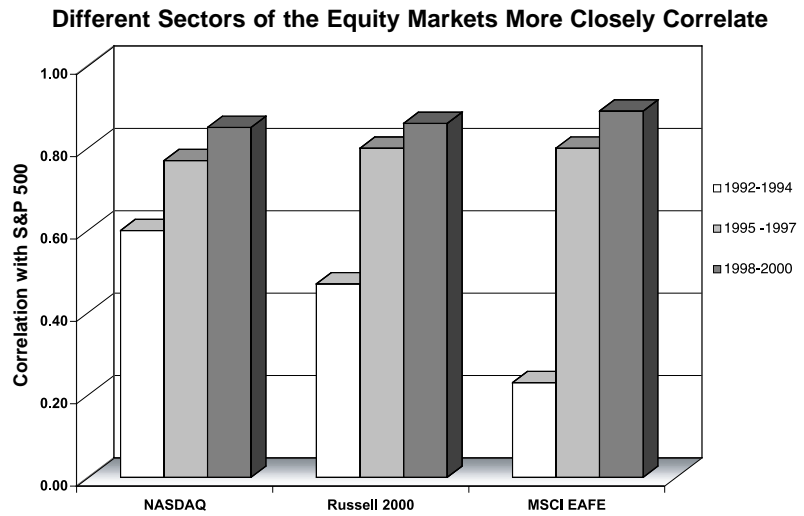
### **Higher Correlation Between Asset Classes**

The second factor forcing advisors to rethink their approach to investment management and asset allocation is that traditional approaches to port-

folio diversification are not as effective in reducing the overall systematic risk of a portfolio as they once were.

Typical advisory portfolio construction involves selecting several long-only mutual funds or private account managers that compare themselves against different benchmarks of the equity and fixed income markets. The primary goal has been to ensure that a client's investments are not over-concentrated in any one segment of the market.

**Figure 1.3**



Source: Standard & Poor's Micropal

**The returns of the S&P 500, NASDAQ, Russell 2000 and MSCI EAFE more closely correlate**

**Diversification Within Long-Only Investments Provides Less Value**

Globalization of the world's economy has lessened some of the diversification benefit from investing in different parts of the world and segments of the long-only market. As companies make and sell products throughout the world and currencies unify, returns from equity asset classes have increasingly correlated. As shown in Figure 1.3, during the last eight years, the correlation of the S&P 500 with the NASDAQ, Russell 2000 and MSCI EAFE returns has jumped significantly.

More importantly, recent experience from the 1998 meltdown of Long Term Capital Management (LTCM) suggests that correlation of traditional asset classes increases even further during times of crisis – the exact points in time when diversification benefits are most needed.

**Alternative Investments An Option for Advisors**

One option for advisory firms is to broaden their investment choices to include allocations to alternative asset classes. Some of these products have substantially enhanced the returns of other institutional investors while others have lowered risk through their diversification benefits.

From the perspective of these institutional investors, the term "alternative investments" is a misnomer. They view these asset classes as other types of investments that make up diversified portfolios. And, as they learn more about them, many are increasing their allocations to alternative asset classes.

### **Limited Partnership Debacle Makes Many Advisors Cautious**

At the same time, however, many advisory firms are understandably hesitant, given their previous experience with what appears to be related investment products. During the mid-1980's, limited partnership investments sold largely by brokerage firms became almost synonymous with "a bad deal for the client."

Advisors are also reluctant to consider these asset classes because most have never included alternative investments in their portfolios and they know very little about them. Evaluating managers and incorporating different strategies into an asset allocation program are complicated tasks, even for organizations whose sole objective is to research these products.

**The list of challenges advisors face when allocating to alternative investments is endless**

The list of challenges advisors face is seemingly endless. Alternative asset class managers operate in a largely unregulated environment that is fraught with risk for inexperienced or unknowledgeable investors. They also pose a series of tax, suitability and operational issues not common to traditional asset classes. And many of the best alternative asset managers set absolute dollar minimums that exceed any kind of prudent allocation for a semi-affluent client.

### **Three Part Paper**

Alternative investments are not a panacea for advisory investment management and allocation problems. Rather, they are analogous to prescription drugs. Used correctly, and under the guidance of a knowledgeable professional, they can create incredibly positive outcomes for their users. Used incorrectly, they create disasters.

A common trait to future successful advisory businesses will be the use of alternative investments in client portfolios. But only the firms that undertake comprehensive due diligence processes to develop sufficient insight about these asset classes will help enhance their clients' portfolios instead of wrecking them. This paper is intended only as a first step in this learning process.

The first part of the paper provides a broad overview of alternative asset classes in general. It offers a detailed look at many of the sub-categories of alternative investments – their strategies, risks and the roles that they can serve as part of an asset allocation.

This paper also looks at non-investment issues that advisors must consider if they decide to incorporate alternative asset classes into their clients' portfolios. It includes an analysis of the various investment vehicles currently available and the tax, legal and regulatory issues inherent

in investing in these asset classes. It also examines some of the operational issues that may limit an advisor's ability to use different kinds of vehicles.

Finally, it includes a summary of the most recent research on alternative investments. As part of this review, the paper includes a detailed bibliography of articles and books that advisors may find useful in their due diligence efforts to explore these asset classes in greater depth.

## Statistical Profile of Alternative Investment Benchmarks

	Annualized Return (%)				Annualized Standard Deviation (%)				Correlation to S&P 500			Correlation to Lehman Aggregate Bond Index				
	1 Year	3 Year	5 Year	10 Year	3 Year	5 Year	10 Year	3 Year	5 Year	10 Year	3 Year	5 Year	10 Year	3 Year	5 Year	10 Year
<b>Hedge Funds</b>	<b>HFR Indices</b>															
	4.98	12.25	14.88	18.16	10.58	9.12	7.31	0.70	0.69	0.65	-0.11	-0.01	0.11			
	1.97	8.40	10.59	19.33	8.14	8.45	9.38	0.38	0.49	0.41	0.02	0.26	0.36			
	-10.71	-2.29	6.70	16.65	21.96	18.93	16.16	0.64	0.62	0.54	-0.32	-0.15	-0.01			
	-9.04	12.31	15.89	21.95	18.80	16.76	14.01	0.76	0.72	0.72	-0.02	0.01	0.10			
	9.09	22.20	22.35	23.14	13.41	11.35	9.35	0.68	0.64	0.62	0.00	0.03	0.13			
	34.63	0.41	0.18	-1.75	32.34	27.15	23.17	-0.66	-0.62	-0.64	-0.03	-0.01	-0.09			
	2.78	4.80	9.91	16.21	7.85	6.55	6.42	0.53	0.51	0.37	-0.27	-0.18	0.02			
	14.56	9.93	11.51	11.14	4.27	3.62	3.35	0.31	0.30	0.29	0.19	0.26	0.28			
	14.50	12.18	12.76	12.74	4.02	3.33	3.30	0.42	0.41	0.36	-0.23	-0.11	0.20			
	4.78	0.31	3.86	8.72	6.36	5.20	5.05	-0.21	-0.16	-0.08	-0.21	-0.18	-0.25			
	18.02	13.11	14.46	14.45	4.71	3.90	3.44	0.49	0.44	0.33	-0.20	-0.14	0.03			
<b>Managed Futures</b>	7.37	8.26	11.65	11.16	6.06	5.60	4.83	0.59	0.63	0.53	-0.12	0.05	0.19			
<b>Real Estate</b>	26.37	-0.19	10.10	13.60	14.17	13.18	12.52	0.20	0.24	0.29	0.12	0.10	0.23			
	12.07	13.20	12.76	6.69	1.16	1.35	3.91	0.21	0.06	0.02	0.32	0.42	-0.14			
<b>Private Equity</b>	1.26	14.24	19.84	18.11	13.14	11.05	8.51	0.70	0.69	0.57	-0.71	-0.28	-0.15			
	24.82	81.99	63.66	42.43	51.75	41.31	30.71	0.51	0.44	0.42	-0.67	-0.44	-0.24			
<b>Traditional</b>	-9.11	12.26	18.33	17.46	17.67	16.08	13.37	1.00	1.00	1.00	-0.02	0.21	0.32			
	11.63	6.36	6.46	7.96	3.05	3.42	3.74	-0.02	0.21	0.32	1.00	1.00	1.00			
	-14.17	9.35	7.13	8.24	15.98	14.51	14.95	0.78	0.72	0.59	-0.11	0.03	0.15			
	-3.02	4.65	10.31	15.53	24.67	21.30	17.68	0.63	0.62	0.65	0.08	0.06	0.13			
	-38.83	16.74	19.04	21.58	37.22	31.00	23.99	0.72	0.72	0.72	0.04	0.09	0.14			

All return and risk data is current as of 12/00  
 NCREIF, Cambridge Private Equity and Cambridge Venture Capital performance figures are reported quarterly. All other asset classes' figures are reported monthly  
 Source: Standard & Poor's Microcap, Hedge Fund Research, Inc., NCREIF, Zurich Capital Markets (formerly Managed Account Reports)