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Using Alternative Investments to Build a Stronger Portfolio

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Among the core set of investing tenets conveyed by financial professionals to their clients, perhaps none have resonated more than diversification: the age-old notion that investing in a portfolio of assets is more effective at reducing risk than holding any one single asset. Often summarized by the cautionary phrase *don't put all your eggs in one basket*, this concept has passed down through generations and today's financial professionals use advanced statistical measures derived from this same basic principle.

However, despite years of earnest attempts at diversification, the rash of correlated losses experienced in 2008 left many confused investors feeling as if they *had* been putting all their eggs in one basket, and prompted dismayed financial professionals to consider whether "*diversification is dead.*" Most assuredly, the answer is *no*. Rather, diversification is evolving to accommodate an ever-expanding investment universe, and investors are only now beginning to explore and gain access to new and alternative sources of diversification. In this environment, financial professionals are shifting their focus to a more pressing question: *is diversification optimal?*

Optimizing diversification

Historically, a portfolio consisting of stocks and bonds, small- and large-cap, domestic and international, was thought to be diversified and capable of weathering all types of markets. This approach seemed to work until the recent market crisis revealed the strength of correlations among these traditional assets, exposing a structural weakness even within a *seemingly* well-diversified portfolio.

For many investors, this shortfall in diversification has been perpetuated by lack of access to truly non-correlated assets and investment strategies – the alternative components that can provide exposure to new market betas and offer better risk-adjusted returns. But combining these new and alternative sources of diversification with the well-known traditional components may be the key to optimizing diversification.

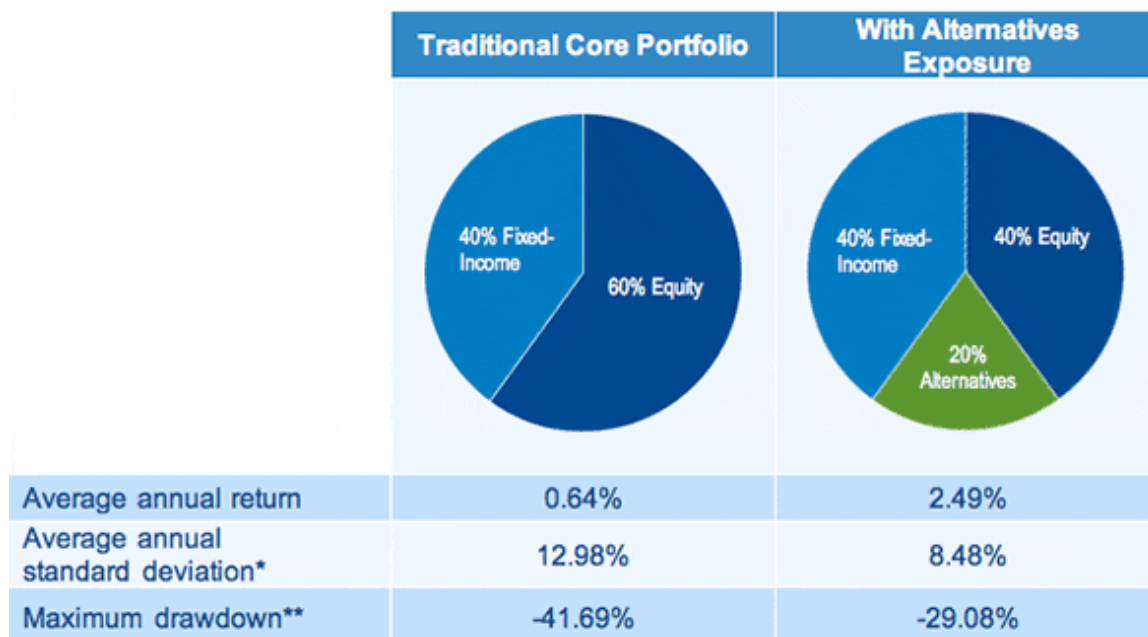
One way to evaluate the effect of alternatives on a portfolio is to run the numbers. These charts compare two hypothetical portfolios over the past ten



years – a period of negative performance for the S&P 500. We’ve used a standard 60/40 stock and bond allocation (S&P 500 and Barclays Aggregate Bond Index) in the first scenario, and a 40% stock, 40% bond and 20% alternative allocation (HFRI Fund of Funds Index) in the second scenario. The portfolio with alternative exposure fared better on every measure – higher return, lower standard deviation and lower drawdown.

Comparison of hypothetical asset allocations

(12/1/1999 – 11/30/2009)



* Standard deviation – measures total volatility. ** Maximum drawdown – measures worst-case performance.

Past performance is no guarantee of future results.

Source: Natixis Global Associates, S&P 500 Index, Barclays Capital Aggregate Bond Index, HFRI Fund of Funds Index.

Improved access to alternatives

By contrast, institutional investors have sought out the historically low correlation and risk management features of alternatives for years, while capitalizing on a key advantage over individual investors: access. Whether it is alternative assets (commodities, currencies, real estate), alternative investment strategies



(long/short, hedging, replication), or the prudent use of alternative instruments (options, futures, forwards), institutions, by virtue of their size and sophistication, have enjoyed unfettered access to these alternative sources of diversification.

The good news for today's investors is that the wide-ranging benefits of alternatives are fast becoming more accessible. There is a new wave of innovative products being launched that offer the same strategies previously available only to large institutions. These products can serve as specialized satellite complements to core traditional investments, or as a core component comprising the benefits of both traditional and alternative investments. To further broaden access and appeal, more asset managers are turning to *mutual funds* as the investment vehicle choice, making it easier for financial professionals to administer alternatives across all client portfolios.

Alternative strategies in a mutual fund package

Alternative strategy mutual funds run the gamut from those that practice trading strategies using options to "short" the market (also known as hedging) to those that include exposure to non-traditional asset classes such as commodity futures and currency forwards. Some even seek to capture the average risk and return of hedge funds through replication strategies. The goal of these alternative products is diversification through lower correlation, along with the added benefits of daily liquidity, transparency, and lower cost structure inherent in mutual funds.

For financial professionals considering alternatives for their clients, the challenge lies in identifying and selecting the appropriate types of investments. Given the relative complexity of alternatives, even the largest institutions have hired investment consultants with analysts dedicated to researching alternatives and evaluating the different assets and investment strategies. In this regard, many institutions have elected to outsource the alternatives portion of their portfolios while concentrating on the more traditional components.

Financial professionals may find themselves in a similar situation, with robust capabilities for evaluating traditional investments, but neither the time nor the wherewithal to apply the same rigorous analysis and due diligence to alternatives. And while the decision to outsource the alternatives component to an investment manager may be the best option, it can be difficult to get started. Fortunately, there are a number of resources available.

Building alternatives into your practice

One avenue for financial professionals is to outsource manager due diligence to a consultant with expertise in this area, or to rely on existing research support from a Turnkey Asset Management Program (TAMP) or custodial partner to



evaluate and compare alternative investment strategies. Professional buyers at these intermediary platforms constantly research and add new alternative managers to complement their line-ups of traditional investments, and have provided much of the legwork to help advisors with the decision-making process.

If using outside research is not an option, consider reaching out to trusted wholesalers of leading alternatives providers. Today's wholesalers understand the value of alternatives and, through their extensive training, can be a rich source of information for financial professionals seeking to incorporate alternatives into their practices. Asset managers are keenly aware of the relative complexity of these products, and many firms offer a range of educational materials for different points on the alternatives learning curve – from client-friendly introductory pieces to more complex technical analysis.

By reaching out to asset managers, financial professionals can pursue an alternatives education by choosing from an array of time-saving materials including whitepapers, webinars and portfolio manager conference calls. They can leverage the firms' wholesalers as conduits for additional product education, comparative analysis, and updates. In addition, many wholesalers have created regional advisory boards covering topics such as alternatives, offering financial professionals the opportunity to share best practices and learn about product implementation from peers. Leveraging these resources can help demystify the complexity of these investments and maximize time spent on client servicing.

Portfolio construction to help manage risk

Today's financial professionals are no longer chasing the "hot" asset class. Instead, they are focused on implementing new portfolio construction techniques that use alternative sources of diversification that seek to deliver consistent risk-adjusted returns for clients. In doing so, advisors benefit both clients and themselves. After all, successful investment results ultimately create a win-win scenario for clients and their advisors.

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