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# ALTERNATIVE INVESTMENTS FOR INDIVIDUAL INVESTORS: A STARTING POINT FOR DISCUSSIONS WITH YOUR FINANCIAL ADVISER

by Thomas Collimore, CFA, Director, Investor Education

Alternative asset classes can provide you with a means to diversify your portfolio. As you review your options, you should recognize that mutual funds often are an efficient vehicle for investing in alternative assets. They offer professional management, liquidity, and portfolio diversification that would be difficult and expensive to achieve through direct investment, futures transactions, or hedge funds.

## COMMODITIES

Commodities historically have had low correlations with stocks and bonds and therefore can be used to reduce the overall volatility in your portfolio. They also serve as a hedge against inflation. On their own, however, commodities can be very volatile, exposing investors to the potential loss of a large part of their investment. An additional caution is that, as additional investors have sought the advantages of investing in commodities, one might expect some of the historical strengths of the investment (e.g., strong returns, low correlations) to diminish.

### INVESTMENT INSIGHT

Correlation is a statistical measure of how the performance of one security impacts the performance of another, within a range of -1 to 1, with 0 indicating no relationship. You generally look for uncorrelated assets in order to reduce the chance of sharps drops in portfolio value. The following are examples of possible correlations:

- Correlated securities: stocks of two U.S. homebuilding companies; both rely on demand for housing
- Uncorrelated securities: a high-grade utility bond and a gaming stock; no obvious links
- Negatively correlated securities: petroleum exploration and gasoline-powered automobile manufacturer stocks; as oil prices rise, the shares of each will likely move in opposite directions.

Mutual funds provide options for individual investors who want the benefits of the asset class without having to enter the futures market. You can choose a fund that invests directly in commodities, in commodity futures, or in natural resource companies.

On the one hand, if you are concerned about expense ratios, you may choose to invest in commodity ETFs (exchange-traded funds) or an index mutual fund (a passive strategy). On the other hand, if you believe the skill of a manager can add value (net of additional expenses), you can invest with a professional manager (an active strategy).

Another way to participate in commodities is through investing in sector funds. A sector fund is a mutual fund that invests in only one industry or a single country (such as Australia or Canada); some of the more popular sector funds focus on gold, energy, and precious metals. You should be alert to differences between commodity fund investment strategies as well as to possible concentrations in particular assets and asset types (e.g., gold and energy). Regardless of the strategy, you may achieve a level of diversification that would be difficult to achieve on your own, and at a lower cost than through a hedge fund.

## DISTRESSED DEBT

Managers of distressed securities funds invest at a discount in companies that are operating under financial stress. In mutual fund terminology, you may see funds that invest in this assets class referred to as "special opportunity" or "special situation" funds. The companies may have defaulted on an obligation, have filed for bankruptcy (or reorganization), or be on the brink of filing.

Distressed-debt investors believe the securities are undervalued because the company's prospects are better than generally understood or that the estimated liquidation value of the company exceeds its market value. Investors buy these securities at a discount to the stated, or par, value and hope to earn a coupon or dividend, plus any appreciation in the security. These securities tend to be illiquid, and their risk should be seen as elevated and highly correlated with the overall market during extreme conditions.

As you read the distressed fund prospectus, you will encounter the following key concepts:

- Priority of Payment: The bankrupt company pays senior creditors ahead of junior, or subordinated, creditors. The first group can include senior bank debt, senior bonds, and certain taxes. Pre-bankruptcy obligations are typically subordinated to post-bankruptcy obligations.

- Recovery Value: A key skill for Investors in distressed companies is to estimate the default probability and then to estimate, given default, how much their securities will be worth. A recovery value of 40¢ means that the investor expects to receive, over time, 40 percent of the obligation's face value.

Real estate investors often cross over into distressed debt by buying mortgages at a discount in order to acquire the real estate collateral.

## REAL ESTATE

Real estate, like commodities, is a popular class of sector funds. There are many funds to choose from in this category, ranging from actively managed open-ended funds to index funds and ETFs. The index and exchange-traded funds in this segment typically track a group of publicly traded real estate companies and real estate investment trusts, or REITs. A REIT is an investment trust that owns and operates a pool of commercial properties, mortgages, and other income-producing real estate assets, such as apartments, shopping centers, offices, and warehouses. REITs may offer investors high yields, in part because they are required to pay out at least 90 percent of their income to shareholders in the form of dividends. You can learn more about REITs from the National Association of Real Estate Investment Trusts (NAREIT) website www.reit.com, an industry-sponsored group that represents publicly traded real estate companies.

Something to keep in mind: If your home is currently your single-largest investment, this asset class may provide minimal diversification value to your portfolio.

This article highlighted some of the alternative investment options available to the retail investor. A high degree of volatility can be involved with some of the options presented, and these investments aren't suitable for all investors. As always, be sure to read the prospectus and speak with trusted experts.

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