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Alternatives Take Center Stage In The Quest For Alpha

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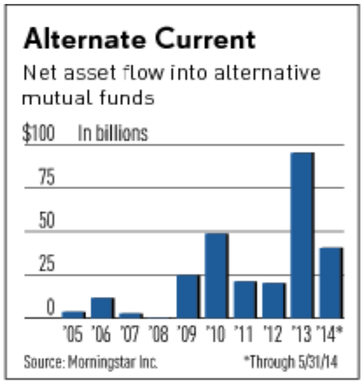

The heart attack years. That's how some financial professionals describe down markets, and that's what 2001-2002 were for George Kiraly.

Kiraly runs LodeStar Advisory Group, a New Jersey wealth management firm whose clientele consists of individual investors and small-business owners. That made it doubly hard when portfolios, already sinking fast after the tech bubble burst, took another big hit in the market slump after 9/11.

"I swore to myself I would never have myself or my clients go through something like that again," said Kiraly, a fee-only financial adviser registered with the National Association of Personal Financial Advisors.

He decided to change the way he did business — by focusing on risk management. To that end, he started to include long/short equity exchange traded funds, hedges and other alternative strategies in client portfolios. When the market crashed in 2008, his clients found to their surprise that their investments were up 60% to 90%. Then Kiraly explained to them the power of the leveraged inverse funds that saved their portfolios.

Alternative Choices

Many financial advisers like Kiraly have discovered the allure of nontraditional investments. These include commodities, real estate, private equity, distressed securities, hedge funds, venture capital and financial derivatives. With returns from stocks, bonds and cash lower and more volatile than expected, alternative strategies look increasingly attractive. They promise to enhance diversification in portfolios while offering the potential for higher returns with lower risk.

These vehicles are growing at a rapid clip. According to a recent McKinsey & Co. report, global assets in alternative investments reached an all-time high of $7.2 trillion in 2013 and they now account for 30% of total industry revenues.

Both institutions and financial advisers are mining the trend. A Morningstar nationwide survey conducted in March found that mutual funds continue to be advisers' preferred tool to access alternative strategies. More than a quarter of the 301 advisers surveyed said the poor fixed income outlook was driving their interest in alternative investing. With interest rates expected to rise, they worry about a drop in bond prices.

The prospect of a market drawdown may also be bringing back memories of the 2008 fiscal crisis.

"Financial advisers are looking for strategies that are lowly correlated to the market," said Josh Charney, an alternatives investment analyst with Morningstar.

And alternatives fit the bill. A low correlation among asset classes benefits portfolios: because the investments don't perform in the same way under the same market conditions, poor performance in one can be offset by a better showing in another. For example, in the bear market of 2007 to 2009, returns on alternative investments were down 12% on average, while broad stock market returns plunged 39%. Bond market returns rose 5% in the same period.

In seeking out alternative strategies, financial advisers also may be copying institutional investors, Charney added. That's true for Carl Macko, president of Synergy Capital Management in Atlanta. "I look at what the big operators do," the fee-only, NAPFA-registered financial adviser said about his use of nontraditional asset classes. "I have been able to replicate that for some of my clients." Macko started to use alternative investments five years ago, after the 2008-09 market shock. He is cautious with their use, holding Pimco CommoditiesPLUS Strategy and Dreyfus Global Real Estate Securities at 5% to 10% weightings in moderate growth portfolios.

PCLAX, a hybrid fund, invests in commodity futures backed by an actively managed, low-volatility portfolio of fixed income instruments. While the commodities component offers diversification in relation to stocks and bonds, the bond element is designed to accentuate returns, Macko explained. DRLIX invests in domestic and international real estate investment trusts (REITs), including shopping malls, rentals and storage facilities. REITS offer a way for small investors to invest as a group in commercial real estate, which may otherwise be financially out of reach.

Macko admits that mention of nontraditional investments makes some clients nervous. The complex nomenclature — terms such as "managed futures" and "market neutral" abound — can intimidate mom-and-pop investors. These vehicles also have relatively high fees, which the Morningstar survey found was a sticking point with financial advisers. And with returns for many alternative products lagging gains in the broader stock market, enthusiasm for the segment may be cooling.

Notwithstanding the limitations, Macko said he explains to his clients: "Having a small portion of alternative investments in a broad-based portfolio, you will be able to sleep better at night."

For Kiraly, ETFs provide a way to pursue alternative strategies. He uses ProShares Large Cap Core Plus (CSM) and ProShares Short 7-10 Year Treasury (TBX). A long-short equity fund, CSM aims to profit both from price gains in the long positions and price declines in the short positions. Kiraly uses TBX, an inverse bond fund, to short Treasuries, so his clients profit from declines in bond prices.

"It's all about risk management," Kiraly said. While inverse leveraged funds prevented losses in his clients' portfolios in 2008, he said he would only ever use them for a short-term play in bear markets.

As institutions' and advisers' appetite for alternatives grows, many of the newer funds require minimum investments of only a few thousand dollars. This has opened up the liquid alternatives space to smaller investors. Not surprisingly then, alternative investments now have a permanent spot in some advisers' financial toolbox.

"We almost had a 100% correlation across all asset classes in 2008," said Kiraly. "The only things that buffered that, were these alternative ETFs. They just performed remarkably well."

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