4th Quarter 2015

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The Siller & Cohen Report

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Alternative Investments:
Should You Consider Them?

Siller & Cohen
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Alternative Investments: Should You Consider Them?

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Nobel Prize winner Harry Markowitz once advised, "To reduce risk it is necessary to avoid a portfolio whose securities are all highly correlated with each other. One hundred securities whose returns rise and fall in near unison afford little protection than the uncertain return of a single security." Our belief is Mr. Markowitz would agree that a well-diversified portfolio, constructed with an appropriate allocation to alternative investment strategies based on an investor's risk tolerance and financial goals, would provide much needed downside risk protection by offering low correlation. This article will attempt to explain the case for alternative investments within a diversified portfolio. Future articles in this series will examine the various alternative investment strategies.

Alternative investments, which have been used by large institutions and endowments for quite some time, have become more mainstream in recent years. Not only are they more popular among individual investors, but there are also more products available, making investing in alternatives possible for a much broader universe of investors. Given their typical low correlation to more traditional asset classes, they have the potential to improve the overall risk-return characteristics of a portfolio. Alternative investments utilize a significantly different approach to investing than do traditional equity or fixed income investments. This approach may involve holding both long and short positions in securities and holding private securities instead of publicly traded investments, and there may be derivatives or hedging strategies as well. Investors using alternatives may also have a goal of achieving a particular level of absolute return as opposed to relative performance versus an index. As a result of the different investment approach, alternative investments have different risk characteristics than do traditional investments. Often they are less liquid especially in periods of market stress, they tend to be more complex and less transparent, making them difficult for untrained investors to understand; they are more susceptible to investment manager failure; and they may have a complex tax profile.

In the not too distant past, investors could enjoy the benefits of having low correlated assets primarily by holding the time honored 60/40 portfolio allocation (60% equities, 40% long-term high quality bonds). By providing income in a stable interest rate environment, investors could benefit from the low correlation that fixed income securities typically provide (meaning equities and fixed income markets would move generally in opposite directions with respect to return). The problem, in a nutshell, is that persisting historical low bond yields—driven by the Federal Reserve's policy of keeping borrowing affordable by holding rates at or near 0%—combined with historically low stock dividends, have made the model less attractive for investors. Why? As we write this article, in fact, the Federal Reserve has reversed that policy and begun what may be a series of interest rate hikes; rising interest rates will have the effect of depressing bond prices and possibly cause bonds to have over the short-term, higher than normal correlation to equities (meaning the two markets could move more in lock step). This causes their returns to move somewhat in tandem, thereby making the typical 60/40 allocation unattractive to most investors. Hence, the individual investor's need to examine an allocation to alternative investments.

These non-traditional asset classes provide portfolio diversification due to low correlation with traditional asset classes. However, like traditional investments, performance is primarily driven by asset class exposure and manager skill.

An Overview of Alternative Investments

For the purposes of this article, we will highlight three alternative investments. Keep in mind, new approaches to alternatives are constantly being developed, so this list is meant to be illustrative rather than exhaustive. Future articles on the subject will examine the individual strategies more closely.

Managed Futures

An investment strategy that seeks to participate in the trend of multiple asset classes and, possibly, domestic and international financial markets. The portfolio managers use futures contracts as part of their overall investment strategy, thereby allowing them and their investors to participate in the trends of a market or asset class rather than owning a specific investment in any one company. A managed futures account will generally have exposure to markets such as commodities, energy, agriculture and currency. These markets will typically have a low correlation to equity markets, possibly reducing an investor's portfolio risk. Many managers in this space employ sophisticated computer models designed to make their investing more disciplined and remove emotion and certain biases from the decision making process. Many managed futures managers are tax-inefficient and may be best utilized in a qualified account structure.

Private Equity

An investment strategy that seeks to participate in the growth of privately held companies through long-term investments. Private equity is largely an illiquid alternative investment that offers the potential for greater long-term growth of capital and diversification away from public markets. It has until recently been available only to large institutions, endowments and higher-net- worth individuals with more investment experience (referred to as accredited or qualified investors), and at higher minimums.

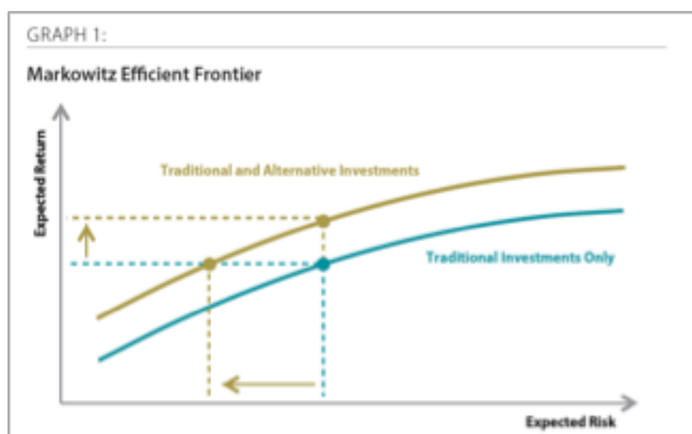
Liquid Alternatives (Alternative Mutual Funds)

Liquid alternatives provide exposure to alternative investment managers in a liquid format (mutual fund, typically) providing investors the best of both worlds – the flexibility and convenience of mutual funds and the potential advantages of alternative investments. Similar to illiquid alternative investments, managers in this space are not constrained by traditional portfolio management methods. The approaches available range from absolute return, long / short equity, and hedge fund-like strategies. These funds can provide investors access to non-traditional investment strategies while still providing daily pricing and liquidity, low investment minimums, fewer investor pre-qualifications, and efficient 1099 reporting.

Benefits of Alternative Investments

Despite the unique risks and considerations (reviewed below), alternative investments can be useful tools to improve the risk-return characteristics of the portfolio. Given their lower correlations to more traditional investments, they increase diversification and can reduce portfolio volatility. Due to the wider opportunity set of investment possibilities, alternatives can offer the potential for enhanced returns.

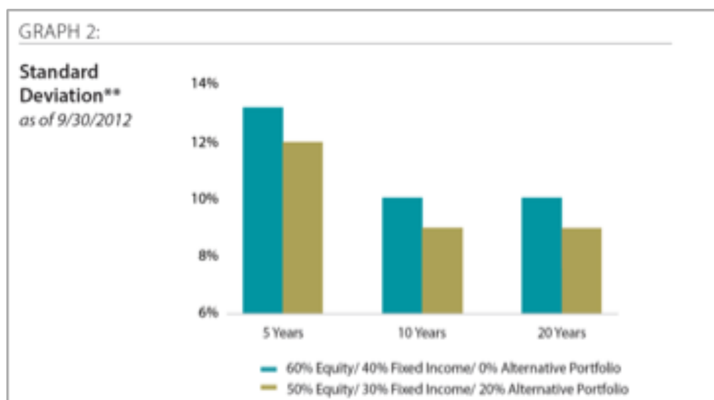
The graph below illustrates the potential benefit of adding alternatives to a portfolio. The inclusion of alternative investments can move the efficient frontier up and to the left – so, for a given level of return, risk is lowered; or for a given level of risk, return is higher.



For illustrative purposes only - not drawn to scale.

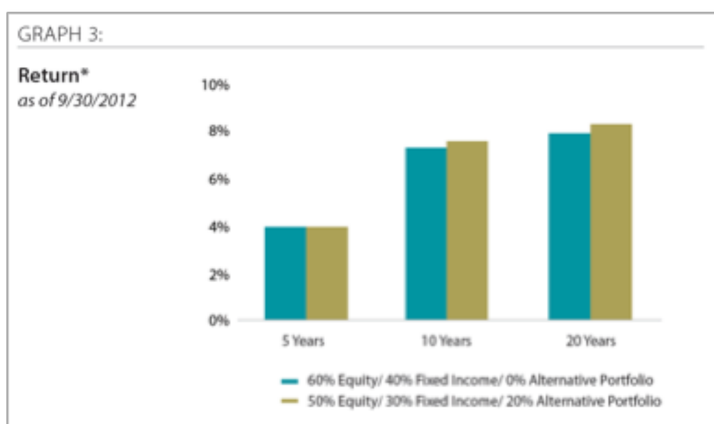
[1] *Harry Markowitz was an economist renowned for his research on Modern Portfolio Theory. He received the Nobel Prize in economics in 1990 for his work in this area.*

While alternative investments on their own may have higher volatility (as measured by standard deviation) than more traditional investments, they typically have low correlations to more traditional asset classes. As such, their inclusion in an investment portfolio tends to result in lower overall volatility (Graph 2).



*Asset Classes represented by various indices
**Hypothetical portfolios represented by S&P 500 (equity), Barclays Capital US Aggregate Bond (fixed income)
Additional standard deviation data available at the end of this document

Since they have a wider universe of investment options from which to choose (public and private entities) and do not have the same investment constraints (can short and hedge using derivatives), alternative investments may have the potential for higher long-term performance than traditional investments.



Hypothetical portfolios represented by S&P 500 (equity), Barclays Capital US Aggregate Bond (fixed income) and an equal-weighted blend of alternatives comprised of HFRI Fund Weighted Composite (hedge funds), Barclays CTA (managed futures), and Cambridge U.S. Private Equity (private equity).
Past performance is not a guarantee of future performance. Additional return data available at the end of this document.

Risks of Alternative Investments

As with any investment, there are several risks associated with alternative investments beyond the typical risks associated with traditional investments.

• Higher Fees – Alternative investments can have higher fees. For example, historically fees have included an annual management fee (1-2%) and an additional incentive fee (10-20%). Today's liquid alternatives options tend to have lower costs similar to that of many mutual funds.
• More complicated – Alternative managers may invest in a wide variety of investments, including derivatives, and utilize short-selling. Understanding complicated investment strategies requires more upfront due diligence and ongoing monitoring.
• Less transparent – There can be limited transparency into the underlying holdings of these investments. Evaluation tools that are typically applied to traditional investments may not be well suited for alternative investments. The need for an advisor's oversight becomes paramount.
• Less tax-friendly – Most alternative investment strategies have little to no focus on minimizing taxes. Also, those whose legal structure is a partnership issue a K-1 statement rather than a 1099.
• May disappoint in strong up markets – Many alternative strategies seek to provide protection from downside returns in the equity markets. As such, during times of strong markets to the upside, these strategies may lag the overall market.

Conclusion

Alternative investments, when used appropriately, can potentially enhance the overall risk-return profile of an investment portfolio. There are unique benefits but also non-standard risks associated with these non-traditional investment strategies, and as such, it is paramount that investors do the appropriate due-diligence when incorporating alternatives into their investment strategy. As alternative investment strategies flow increasingly into the mainstream, investors will enjoy access to premier alternative investment managers, in a liquid mutual fund format. The democratization of the hedge fund universe allows investors to potentially infuse their portfolio with more flexibility, reduce correlations to traditional investments and, potentially, improve their risk-return profiles.

Standard Deviation and Returns

	5 Years		10 Years		20 Years	
as of 9/30/2012	Return	Std Dev	Return	Std Dev	Return	Std Dev
S&P 500 TR	1.1%	21.9%	8.0%	17.0%	8.5%	16.8%
Barclays US Agg Bond TR USD	6.5%	3.3%	5.3%	3.3%	6.3%	3.8%
Alternatives Blend (PE, HF, MF)	3.0%	6.1%	7.1%	5.8%	9.0%	5.4%
60/40 Portfolio	3.7%	12.9%	7.2%	10.1%	7.9%	9.9%
50/30/20 Portfolio	3.7%	11.7%	7.4%	9.2%	8.3%	9.0%

Source: The source is a Zephyr analysis study by Baird Wealth (2012). The Standard Deviation and Returns for Alternatives are defined as follows: Alternative Mutual Funds: Style-specific universe of mutual funds categorized by Morningstar, which included 306 funds as of December 31, 2012, but only 115 for the trailing five-year period and only 48 for the trailing ten-year period. Private Equity: Cambridge Associates
Private Equity Index – based on data compiled from 823 U.S. private equity funds, including fully liquidated partnerships, formed between 1986 and 2012. Returns are net of fees, expenses and carried interest.
Hedge Funds: HFRI Funds Weighted Composite Index – designed to reflect hedge fund industry performance by constructing equally weighted composites of constituent funds, as reported by the hedge fund managers listed within HFR Database; encompasses more than 2000 funds.

Alternate investments may be subject to special risks, such as illiquidity. There is no assurance that the stated investment objectives will be met. Clients must meet specific suitability standards before investing. Suitability may vary by state. Units or shares of these types of investments may fluctuate in value so that at redemption may be worth more or less than the original amount invested. Prospectus containing complete information including risks, fee and expenses will be available. Please read these carefully before investing.

ABOUT SILLER & COHEN

Siller & Cohen is a boutique family wealth advisory firm providing financial solutions for the past twenty-five years to institutions and high net worth individuals. We combine the detail and careful attention of a smaller firm with the deep resources of a national organization. Our team includes CPAs[1], Certified Investment Management Analysts, and attorneys.[1]

While we offer our clients the full range of planning services, our core areas of expertise include wealth transfer, investments, and business succession planning.

This is the 11th year in a row that Barron's Magazine has recognized a member of Siller & Cohen as being among the top advisors in the nation.[2]

[1] Licensed, not practicing
[2] The list was compiled by RJ Shook, Financial Industry Consultants. This is an objective ranking based on assets under management.

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CRN-1376567-121815