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Understanding Alternative Investments

By Alex Grotevant, Associate Financial Planner

As financial innovation continues to occur at a rapid pace, today's investors are faced with unprecedented amounts of investment opportunities. Among the many options available to investors are what have become known as alternative investments. As the name suggests, alternative investments serve as alternatives to traditional investments such as equities, fixed income, and cash. While this is a rather broad definition, what all alternative investments have in common is their potential to simultaneously maximize a portfolio's return and minimize a portfolio's risk. Given the attractiveness of these two advantages to investors, the logical question to ask becomes, "What are the different types of alternative investments that exist today?"

This article in particular will focus on four distinct categories of alternative investments. It is important to note that this list is not all-inclusive, nor is it universally accepted. In other words, since the alternative investments market is relatively young and dynamic, some people may disagree with a given item and believe it to be a traditional investment rather than an alternative. Nevertheless, the following is a list of five investments that are commonly believed to be alternatives:

1) Real assets are considered alternative investments because, by definition, they are the opposite of financial assets. As opposed to financial assets such as stocks and bonds, real assets involve a more direct ownership and "tend to represent more direct claims on consumption." For example, real estate, which encompasses owned land as well as any infrastructure built on the property, is the most popular type of real asset.

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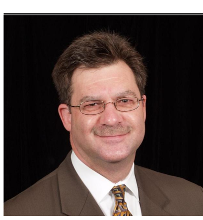

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Understanding Alternative Investments, continued

Other examples of real assets include "investable infrastructure opportunities," which can be either the privatization of existing infrastructure to earn revenue or the creation of private infrastructure, as well as intangible assets such as intellectual property rights.

2) Hedge funds are among the most commonly used alternative investments. Put simply, they are privately organized investment vehicles that utilize a tremendous amount of investment strategies to minimize risk while attempting to preserve capital and generate positive returns. Hedge funds are able to employ such a wide array of strategies because they are not subject to the same degree of rules and regulations that apply to mutual funds and other investment vehicles. As a result, successful hedge funds have the potential to generate positive returns regardless of whether or not traditional markets are performing well.

3) Commodities are raw materials such as oil, wheat, and gold that can be bought in large quantities. Since these raw materials contribute to the production of countless other goods, they present individuals with a variety of investment opportunities. Not only can investors purchase commodities on the spot market as if they were stocks that can either appreciate or depreciate in value, but commodities are frequently used in futures contracts. Futures contracts are essentially contracts between two parties to either buy or sell a certain asset (in this case a commodity) at a predetermined price in the future. With futures contracts, the investor's profit is contingent on whether the asset's value increases or decreases from the day the contract was agreed upon to the future date that was established.

4) Private equity is essentially an asset class of both equity and debt positions in companies that are not publicly listed. It encompasses various sectors, each of which carry their own degree of risk and return. Among the most popular divisions of private equity are venture capital, leveraged buyouts, mezzanine debt, and distressed debt. Venture capital refers to the equity financing of "start-up companies that do not have a sufficient size, track record, or desire to attract capital from traditional sources." Leveraged buyouts occur when a company and all its equity are purchased using a combination of equity and debt with the intention of making the firm private. Mezzanine debt is a special type of financing that presents lenders with the opportunity to convert their debt to ownership if a company is unable to meet the terms of its loan. Finally, distressed debt is a type of debt issued by companies that have already filed for bankruptcy or are likely to file for bankruptcy in the near future.

Now that you have a basic understanding of the various types of alternative investments that exist, you may be wondering why you should consider them when investing. Regardless of the investment strategies you employ, they all carry a certain degree of risk. With traditional investments such as stocks and bonds, risk typically stems from equity beta and interest rates. However, the risks, and ultimately the returns, associated with alternative investments vary greatly depending on the nature of the investment. Therefore, specific alternative investment strategies can be used in practically any portfolio to hedge against risk. Essentially, they offer a degree of portfolio diversification that cannot be achieved by the traditional sources of investment, and for this reason they have become increasingly popular among investors. As alternative investments become even more prevalent in the financial markets in the upcoming years, it will be important for investors to understand the potential benefits and risks associated with the inclusion of them in their portfolios.

Monthly Market Commentary

This month, it seems that good news is bad news once again. A series of positive economic data (mainly stronger employment growth) lit up markets with fear that growth would rebound sharply in the summer months, just like in 2014, and that a better economic situation would likely push the Fed over the edge and force its first rate increase by September. Potential homebuyers are likely entering full panic mode as they scramble to get a deal done before that happens.

GDP: The first-quarter GDP growth rate was revised from a measly 0.2% to an outright decline of 0.7%. However, this decline was modestly better than the previous consensus forecast of a 1% contraction. Weather, port strikes, and a shifting energy market made a modestly slowing economy look worse than it really was. Second-quarter growth should look more like 2.5%–3%, as consumers rebound and net exports weigh less heavily on the data.

Employment: The U.S economy added 280,000 nonfarm payroll jobs in May, surpassing the consensus estimate of 220,000. Certainly there was some help from the addition of summer jobs in some industries, but generally it was a very strong and clean report. The jobs data also exceeded the 12-month average of about 255,000 jobs per month. And like so many other data points, it appears that the economy is coming off its weather and West Coast port issues that temporarily depressed a wide range of economic statistics.

The job growth average for January through April was a mere 200,000 or so jobs per month, well below the annual average and a sharp falloff from a very strong autumn. Viewed on a year-over-year average basis, the jobs market has been consistently strong since September 2014. Private-sector employment has been growing at a rate of about 2.6%. Adding in the lethargic government sector, nonfarm payrolls have been expanding at a very healthy 2.3% rate.

Wages: While the market always focuses on the jobs number, wage growth is nearly as important. Month-to-month wage progression was also robust at a 0.3% monthly rate (3.6% annualized) and the year-over-year hourly wage growth rates also appear to be improving, although in a less dramatic fashion.

Consumption and Savings: Monthly consumption data looked stagnant in April. Consumers are not spending all of their real income growth (which includes investment and rent income) or wage growth. Whenever that gap has become that wide in the past, there has been a combination of a downward revision to earnings and an acceleration in consumer spending. We saw this very pattern last summer. Morningstar economists don’t believe that consumers have become prolific savers. Instead, the more likely reason may be a physical inability to spend money (poor weather, lack of imported goods) and a mismatch of when the GDP report suggests consumers are spending their money and when those bills are actually paid. (February's nasty utility bills, which counted in February consumption reports, were likely paid in April, potentially dampening April retail sales and consumption reports, as well).

Housing: For a big change, all of the recent housing data showed a housing market that is accelerating across the board. Home price data, pending sales of existing homes, and new home sales all showed surprising strength and generally exceeded analysts’ expectations. An improving housing market is the linchpin to the economy maintaining its 2.0%–2.5% growth rate in 2015, even in the face of a decline in real GDP in the first quarter. A 3% direct impact on GDP may seem small, but if the sector can manage 15% overall growth, that would amount to a 0.5% contribution to GDP. While that may not sound like a lot, a 0.5% contribution in a world of 2.0%–2.5% growth is a big deal. (Housing's contribution in 2014 was a mere 0.1%.) Also, demographics will continue to keep a lid on growth that is still not fully appreciated by the market.

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