

Weighing up alternative investments

The term alternative investments is increasingly being used within the investment industry to describe types of investments that are not typically included in the portfolio of the average investor. Most of these investments have long been available to corporate or professional investors but due to their complexity or structure are generally not directly available to the general public.

Access to alternative investments has widened in recent years as investment managers have set up funds to specifically invest in non-traditional asset classes and financial instruments such as derivatives. This article provides examples of alternative investments, the role they can play in an investment portfolio as well as the opportunities and risks associated with these types of investments.



What are alternative investments?

A broad definition of alternative investments includes any type of investment other than traditional investment in shares, cash, bonds and property. Examples of investments that may be considered as alternative include hedge funds, currency funds, managed future funds, derivatives, private equity, assets such as gold and other precious metals and financial instruments such as options and futures.

Alternative investments often require either a large amount of capital or a detailed knowledge of the relevant markets for the investor to have a chance of success.

Unlike traditional investment portfolios such as balanced or growth funds, whose performance is largely dependent on the direction of the share and bond markets, many alternative investment strategies seek positive returns regardless of the status quo of market or economic environments.

Some investments that used to be regarded as alternative are now in common use. For example, international equities and high-yield bonds once fell into the alternative investment category but now are commonly held by Australian investors in superannuation funds.

The role of alternative investments in a portfolio

Sophisticated private investors have used alternative investments for many years to help build, diversify, hedge and maintain their wealth. However, the complexity, high cost of entry and the lack of information about alternative investment products have inhibited most investors from exploring the potential of this investment avenue. In addition, some alternative investments such as private equity often need to be held for more than two or three years before positive returns can be achieved.

One of the key attractions of alternative investments, is that the financial performance of these investments often behave very differently and sometimes completely opposite to traditional investments. Managers of alternative investments, can generate returns independent of traditional equity and fixed-income markets, enabling portfolios to better weather adverse market conditions. This may make these types of investments good candidates to diversify a portfolio and help produce more consistent returns.

Gold is a good example. Over the long term gold's correlation with shares, fixed interest and property markets is low. Because gold is perceived as a store of value it can perform well when other markets do poorly. In recent years, the price of gold has largely moved inversely to the US Dollar. Supply and demand factors are also currently working in gold's favour with higher investment demand for bullion, lower sales of the precious metal from European central banks and an expected fall in gold mine production over the next few years.

The combination of these factors means that for some investors gold is an alternative investment that may help diversify their investment portfolio, boost returns and also protect it against the impact of a significant fall in the value of the US Dollar.



Another alternative investment, hedge funds, are commonly perceived as very risky but many investors are now using these vehicles to reduce the risk and boost returns of their portfolios. The reason is that some hedge funds seek to preserve capital while providing investors with positive returns in any market environment. Hedge funds do carry high levels of risk but their low correlation with traditional investments can make them attractive for investors looking to diversify their portfolios.

Opportunities and risks associated with alternative investments

For investors with large portfolios, the addition of alternative investments can mean the difference between a fully diversified portfolio and one that is not invested across the widest range of potential alternatives. Alternative investments also give investors access to a unique class of investment managers drawn from a variety of wide-ranging disciplines. These managers are typically distinguished by the depth, breadth and scope of their experience.

Alternative investments can produce higher returns than traditional investments although the investor must be prepared to take on higher risk associated with these types of investments. Nearly every investment has an element of risk. Investors need to understand the risk associated with different types of investments and decide whether the possible return justifies the risk.

Like any investment, the merits of allocating funds to one or more alternative investments should not be assessed on their own. They should be considered as part of an overall portfolio. A decision to buy alternative investments must also be consistent with an investor's financial goals and appetite for risk.

One misconception about alternative investments is that they all aim to generate high returns. In fact, alternative investments can range from low risk to high risk and all along the risk/return curve. However, alternative investments are not for everyone. Some types of alternative investments carry a high degree of risk that may make them unsuitable for investors close to retirement or investors whose portfolios are too small to absorb this level of risk. There are a number of risks associated with alternative investments and these should be carefully considered.

For example, some alternative investments by their nature are very illiquid. This means an investor may be restricted in gaining access to their funds until a certain time period has elapsed. Clearly these types of investments are only suitable for investors who do not need immediate access to their funds/money. In addition, government regulation of alternative investment products is sometimes non-existent and many are sold pursuant to exemptions from regulation. Investors need to recognise and be willing to accept that these investments will have less safeguards than traditional investments.

The higher levels of expertise required to invest in alternative investments usually means the fees associated with alternative investments are more than the fees for traditional investments. Therefore, investors need to be comfortable that their investment has a reasonable chance of generating a return that will justify higher fees. It is also sometimes difficult to determine the current market value of the underlying positions held in many alternative investment vehicles. This can pose an extra level of risk for investors compared to investments made in traditional asset classes which are far more transparent.

Determining whether alternative investments are suitable for you may or may not be something you feel comfortable doing for yourself. Most investors would be well advised to seek out the services of a financial adviser to help evaluate any opportunities to allocate funds to alternative investments.