What are alternative asset classes?

Beyond the three primary asset classes—stocks, bonds, and cash—many other types of investments can be used to diversify investment portfolios. The term "alternative assets" is highly flexible. It may include specific physical assets, such as natural resources or real estate, or methods of investing, such as hedge funds or private equity. In some cases, even geographic regions, such as emerging global markets, are considered alternative assets.

Alternative assets often are highly dependent on novel investing strategies or individual skill in selecting specific investments. For example, hedge funds (see below) exist to pursue investing strategies that often rely on the manager’s judgment and that may be difficult or impossible for a mutual fund; with collectibles such as art or antiques, the value of your investment depends on the properties of a specific work. As a result, even if you are very knowledgeable about a specific asset class, you might do well to seek out expert advice and guidance when selecting alternative assets for inclusion in your portfolio.

Why invest in alternative asset classes?

Their lack of correlation with other types of investments may help increase or stabilize portfolio return.

Part of sound portfolio management is diversifying investments so that if one type of investment is performing poorly, another may be doing well.

Both institutional and individual investors have increasingly begun to explore alternative assets in recent years as a way of trying to increase returns and/or diversify risk. In a global economy, traditional asset classes such as stock and bonds are increasingly linked. However, in many cases, an alternative asset’s performance is often highly dependent on the qualities of the individual investment, as opposed to being highly correlated to an overall market. In other cases, such as precious metals, the asset class as a whole may behave differently from stocks and bonds.

Many alternative investments attempt to achieve their returns not from the activity of the market but by using unique investing strategies to exploit market inefficiencies that the markets haven’t perceived. As a result, alternative assets can provide an additional layer of diversification and complement more traditional asset classes. However, diversification alone cannot guarantee a profit or ensure against a loss. While alternative assets offer potential for returns that aren’t highly correlated with other markets, their unique properties also mean that they can involve a high degree of risk.

They can take advantage of different or looser regulatory provisions.

Hedge funds have greater latitude than mutual funds in pursuing investing strategies, and have had to provide less disclosure to investors. This greater freedom gives them capabilities that may be off-limits to other investment companies, such as selling securities short. It also reduces the chance that a proprietary strategy may be adopted by competitors or become so widely known that it loses any market advantage.
They may provide pride of ownership. In addition to their investment value, some alternative investments, such as art, antiques or gems, may simply be a pleasure to own. Also, certain types of alternative assets, such as revenue from timber harvests, receive favorable tax treatment.

**Tradeoffs**

Alternative assets often are less liquid than stock or bonds.

Depending on the alternative asset, you may or may not be able to find a willing buyer when you’re ready to sell. Also, some hedge funds may require investors to stay invested for a certain period of time.

Accurately assessing values and risks may be difficult.

The performance of an alternative asset can be challenging to research, price, and understand. You may not have access to a given investment unless you meet suitability requirements for investing, including income level and minimum investment, you may not be permitted to invest in a hedge fund.

Greater investing freedom can increase potential for mismanagement or loss from sector exposure.

Because they are subject to less regulation than many other investments, there are fewer constraints to prevent potential manipulation or to limit risk from highly concentrated positions in a single investment. Also, hard assets such as bullion, antiques, art or gems are subject to physical risk and may involve special considerations such as storage and insurance, while timberland may be subject to natural disasters.

**Hedge funds**

Hedge funds are private investment vehicles that manage money for institutions and wealthy individuals. They generally are organized as limited partnerships, with the fund managers as general partners and the investors as limited partners. The general partner may receive a percentage of the assets, additional fees based on performance, or both. Hedge funds originally derived their name from their ability to hedge against a market downturn by selling short. Though they may invest in stocks and bonds, hedge funds are typically considered an alternative asset class because of their ability to implement complex investing strategies that involve many other asset classes and investments.

**Private equity**

Like stock shares, private equity represents an ownership interest in a company. However, unlike stocks, private equity investments are not listed or traded on a public market or exchange, and private equity firms often are more directly involved with management of the business than the average shareholder. Private equity often requires a long-term focus before investments begin to produce any meaningful cash flow—indeed they ever do.

Private equity also typically requires a relatively large investment and is available only to qualified investors such as pension funds, institutional investors and wealthy individuals. Private equity can take many forms. The following are some examples:

• Angel investors are individual investors who provide capital to startup companies and may have a personal stake in the venture, providing business expertise, industry experience and contacts as well as capital.

• Venture capital funds invest in companies that are in the early to mid-growth stages of their development and may not yet have a meaningful cash flow. In exchange, the venture capital fund receives a stake in the company.

• Mezzanine financing occurs when private investors agree to lend money to an established company in exchange for a stake in the company if the debt is not completely repaid on time. It is often used to finance expansion or acquisitions and is typically subordinated to other debt. As a result, from an investor’s standpoint, mezzanine financing can be rewarding because the interest paid on the loan can be high.
Buyouts occur when private investors—often part of a private equity fund—purchase all or part of a public company and take it private, believing that either the company is undervalued or that they can improve the company’s profitability and sell it later at a higher price. In some cases, the private investors are the company’s executives, and the buyout is known as a “management buyout (MBO).” A leveraged buyout (LBO) is financed not only with investor capital but with bonds issued by the private equity group to pay for purchase of the outstanding stock.

Real estate
You may make either direct or indirect investments in buildings—either commercial or residential—and/or land. Direct investment involves the purchase, improvement, and/or rental of property; indirect investments are made through an entity that invests in property, such as a real estate investment trust (REIT). Real estate has a relatively low correlation with the behavior of the stock market and is often viewed as a hedge against inflation.

Natural resources
Most investments in natural resources such as timber, oil or natural gas are done through limited partnerships. In some cases, such as timber, the resource replenishes itself; in other cases, such as oil or natural gas, the resource may be depleted over time. Timberland produces income from the trees harvested, but may also grow in value and be converted for use as a real estate development.

Art, antiques, gems and collectibles
Some investors are drawn to investment-grade collectibles because they may retain their value or even appreciate as inflation rises. If you are a knowledgeable collector or have expert advice, they may generate high returns. However, their value can be unpredictable and can be affected by supply and demand, economic conditions, and the condition of an individual piece or collection.

Gold and precious metals
Investors have traditionally purchased precious metals such as gold, silver, platinum, and palladium because they believe that precious metals provide security in times of economic and social upheaval. Gold, for instance, has historically been seen as an alternative to paper currency and therefore a hedge against inflation and currency fluctuations. If paper currency becomes worth less and less because of inflation, investors perceive that gold will retain its value. As a result, gold prices often rise when investors are worried that the dollar is losing value.

However, the price of gold is volatile; its value may rise and then fall quickly. In recent years, the price of gold has been particularly difficult to predict and has shown little correlation with inflation. There are many ways to invest in precious metals. In addition to buying bullion or coins, you can also invest in futures, shares in mining companies, sector funds, and exchange-traded funds.

Commodities and financial futures
Commodities are physical substances that are fundamental to the creation of other products or to commerce generally. Unlike most other products that are bought and sold, a commodity is basically indistinguishable from any other commodity of the same type. Examples of commodities include oil and natural gas; agricultural products such as corn, wheat, and soybeans; livestock such as cattle and hogs; and metals such as copper, nickel and zinc.

Commodities are typically traded through futures contracts. Futures are contractual agreements that promise future delivery of something upon a certain date, at a specified price. For example, a commodities futures contract might involve wheat, corn, oil or natural gas, among others. Futures contracts also are available for financial instruments, such as a stock index or a currency. Futures contracts are standardized and are traded on organized exchanges. Although the futures market was originally created to facilitate trading among individuals and companies who produce, own, or use commodities in their businesses, the market has expanded to include individuals and companies that buy and sell futures contracts as a way of investing.

Like options, futures are considered derivatives because their value is based on some other security. Futures allow an investor to leverage a relatively small amount of capital. However, they can be highly speculative and are not suitable for all investors.

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