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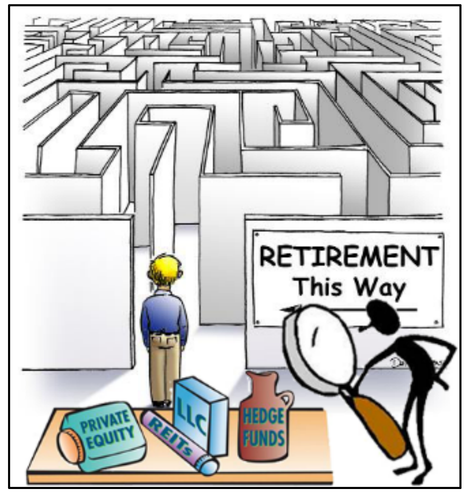
Alts: The expensive way to diversify your portfolio

"There are no bonus points for complicated investments."

– *Warren Buffett (in his 1994 Letter to shareholders)*

Navigating the Retirement Maze



With the stock market's downward trend the past several months, you may be concerned that the six year bull market is over. Not surprisingly, the investment industry has been increasing its pitch for "alternative investments," also known as "alts." For investors who are accustomed to think of portfolio diversification as "stocks + bonds," this is a novel concept. Plus, the pitch for alts can be seductive: funds that can gain in good markets and bad, and reduce overall portfolio risk.

Before you go and drink the "Alt Kool-Aid," however, you should first understand the characteristics of alternative investments: what they hold, how they perform, and the cost owning them. If you're not an Ivy League endowment, I believe that there are better and less expensive ways to achieve portfolio diversification without unduly enriching Wall Street firms at your expense.

What's an alt?

Alternative strategy mutual funds is a label applied to a broad range of investments that can be best thought of as "other." Morningstar, an investment research firm, includes in this category such exotica as long-short equity (which can sell short stocks), managed futures (betting on the direction of commodities, currencies, etc.), "bear market" funds (betting on down markets), market neutral funds (supposedly profiting in both up and down markets), currencies, hedge fund strategies, private equity, and multi-alternative (some or all of the above). While there are exchange traded fund (ETF) versions of these strategies that are passively managed, the majority of alts are actively managed.

Each type of alt strategy is promoted as having different type of diversification. I often see investment firms recommending that a portfolio needs to include at least 20 to 25 percent of alts in order for them to have the desired diversification effect. But there are a few unspoken truths about these funds that they'd rather not have you know about: their fees and their performance.

The price you pay

The stated management fees of alts are quite high compared to other mutual funds. The Investment Company Institute, an association of investment companies, cites asset-weighted figures for 2013 of 1.34 percent for the average alt equity fund, compared to 0.74 percent for equity mutual funds, and many exceed 2 percent. What doesn't show up in this fee disclosure, however, is the cost involved in executing a particular alt strategy. To figure this out requires going to a fund's prospectus, and even this doesn't list the entire cost of doing business (for which you, as shareholder, foot the bill). Take, for example, a market neutral fund rated five stars by Morningstar. Morningstar shows a management fee of 2 percent for this fund, but the fund management company reports a considerably higher figure of 8.4 percent. Trading in and out of esoteric financial instruments isn't cheap. It also kills tax efficiency. The fund has an annual turnover rate of over

600 percent (i.e., average holding period for each security is less than two months), so it is best held in an IRA, if at all.

Managed mediocrity

So what do these high fees buy you in returns and diversification? On average, not much. The majority of alts have delivered neither strong performance nor high diversification. Alts usually demonstrate their value when the markets are down, but over long time periods the high fees tend to kill any performance advantage they might have. Morningstar reports that over the past ten years, 10 of 13 alt categories have underperformed the S&P 500 and the Barclay Aggregate Bond Index.

The appropriate way to use alts in a portfolio is to allocate a percentage of assets to alts and maintain that percentage. However, investors tend to chase the performance of alts like they do with other investments, with disastrous results. For example, one long-short equity fund grew to $21.5 billion in assets in 2014 based on its strong five-year performance through 2013. Most of their asset growth came during 2013 and early 2014. However, fund performance collapsed during 2014, when the fund was down over 12 percent, trailing the S&P 500 by 26 percent. By the beginning of 2015, investors were fleeing the fund in droves.

It's nearly impossible to choose the best performing alt funds in a given year, which is why the best strategy for using them is a "buy and hold" approach. But because the category has exploded in new offerings – growing from 163 funds to 435 in less than six years, according to Morningstar – most alt funds have short track records.

So do alt funds help diversify your portfolio? Sometimes. The correlations of alt funds to equity and bond funds are usually low. However, because of their high fees and so-so performance, they tend to produce a long-term performance drag on your returns that will dampen whatever gains you achieve with your other investments.

Better ways to diversify

I create portfolios for my clients that I consider to be adequately diversified, using only ETFs and some closed-end funds. They include domestic and international securities, both equity and debt. Plus, they hold real estate, resources, and some precious metals. Actively managed, low fee bond funds provide some debt diversification where appropriate, and we maintain a small cash allocation for buying opportunities. When I run these portfolios through an analyzer, it shows good overall diversification and a low average fund management fee, all without relying on alts.

Albert Einstein once said: "Things should be as simple as possible, but not simpler." Alts would most certainly flunk his test, as they should yours.

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