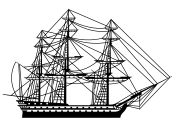
# Learn about alternative investments

Investor education



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# Special investment instruments may help enhance a portfolio

Once the exclusive domain of the ultrawealthy, alternative investments are beginning to have a broader appeal. Your financial advisor has provided this guide to help you better understand some of the most common alternative investments.


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# What are alternative investments?

## Alternative investments offer exposure to investment opportunities not generally available through the traditional fixed income and equity markets.

### Attempting a definition

Many experts agree that it's not easy to come up with a consensus description of alternative investments. So we'll refer to them as private investments that have a less transparent legal structure than many traditional investments.

For many investors, an alternative investment might be described as any investment that is not usually part of a conventional portfolio.

### Alternative investing is generally employed for two reasons:

- To enable greater diversification of a portfolio by providing exposure to investments whose expected returns are not correlated with those of traditional investments and whose expected risk characteristics differ from those of traditional investments.
- To enable an investment manager to use investment strategies designed to produce higher returns within a given investment universe.

Diversification does not ensure a profit or protect against a loss.

## A note about regulations

While alternative investments face more and more regulations as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, they are not as regulated as mutual funds and exchange-traded funds (ETFs), which come under the watchful eyes of the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA).

To protect average investors, many alternative investments are offered through private investment vehicles and are available only to "accredited investors." According to the SEC, an accredited investor is generally one whose net worth is at least $1 million, or whose personal income is at least $200,000 a year.

## A growing, changeable market

The alternative investment market can evolve very quickly, as new products and investment strategies are introduced. Typically these products and investment strategies fall into one of several broad categories.

Access to alternative investments typically is achieved through hedge funds and other partnership vehicles managed by a private investment manager, which provide access to otherwise inaccessible markets, such as private equity; private debt; private real estate; timber; infrastructure; and oil, gas, or mineral partnerships.

It's important to remember that the SEC and FINRA do not endorse, indemnify, or guarantee the types of alternative investments discussed in this guide.

# Common alternative investment strategies

There are dozens of alternative investment strategies. For simplicity's sake, we'll focus on several of the most common.

The descriptions that follow are simplified, so be sure to consult closely with your financial advisor for more detailed information.

# Hedge funds

Hedge funds are lightly regulated investment vehicles that are most commonly used by investment managers to pursue alternative investment strategies not generally available through registered investment companies (mutual funds). Many hedge funds attempt to employ nontraditional investment strategies designed to maximize returns across both traditional and nontraditional asset classes. Hedge funds obtained their name because initially they were designed to engage primarily in hedging techniques, although hedge funds currently are used for any number of alternative investment strategies that do not require hedging. Hedging is the practice of attempting to reduce investment risk by buying offsetting positions to lower exposure to market risk. For example, a hedge fund manager might purchase shares in Ford Motor Company and, at the same time, short-sell shares in Honda, thereby lessening the risk of investing in the auto

industry. However, because the objective of many hedge funds is not necessarily to minimize exposure to market risk but, rather, to maximize investment returns, the term *hedge fund* can be a bit misleading.

Hedge funds typically charge high fees, disclose minimal information about the fund's investment strategies and holdings, and often have investment lockup provisions that can severely limit a fund's liquidity.

There are several types of common strategies employed by hedge funds: market neutral; arbitrage; directional, or opportunistic; and multistrategy, or fund of funds.

Market-neutral strategies are also referred to as nondirectional or absolute-return strategies. Market-neutral hedge funds attempt to neutralize market risk and deliver returns via pure security selection. These strategies more closely resemble the original intent of hedge funds, in that the managers establish both long and short security positions in an effort to minimize risk.[1] Keep in mind, however, that poor predictions of eventual investment outcomes can lead to significant losses.

Arbitrage strategies, which include convertible arbitrage, statistical arbitrage, and merger arbitrage, are designed to place bets on pricing inefficiencies among securities.

Directional, or opportunistic, strategies use an array of investment strategies (including but not limited to long-short strategies, global macro, managed futures, etc.) across markets and asset classes in an attempt to take advantage of market trends. These broad bets can leave a hedge fund highly exposed to various market risks.

Multistrategy, or fund of funds, combines several investment strategies or invests in multiple funds that employ different strategies in one portfolio in an attempt to diversify investments and corresponding exposure to market risk.

1 Short-selling (selling borrowed securities) entails its own risks. Adverse price movements can force an investor to replace borrowed securities by paying a higher price. Losses on a short sale are potentially unlimited because there is no upward limit on the price a borrowed security could attain.

# Private equity

Private equity investments can be defined as capital invested in companies or securities that typically are not listed on a public stock exchange. Private equity investments are generally accessed through a limited partnership, with capital raised through the partnership used to develop new businesses, restructure or acquire existing businesses, or offer additional funding for existing businesses. Private equity generally falls into three broad categories: venture capital, leveraged buyouts, and distressed securities.

Venture capital typically involves funding start-up businesses that the investors believe will continue growing. The venture capitalist's ultimate objective is to guide a growing firm with the intent of selling it either through acquisition or an initial public offering.

Leveraged buyouts typically involve the purchase of a majority of the outstanding shares of a mature public company using a significant amount of borrowed money (bonds or loans) to meet the cost of acquisition. The purpose of leveraged buyouts is to allow companies to make large acquisitions without having to commit a lot of capital.

Distressed securities typically involve the purchase of high-yield bonds in or near default, or equities of companies that are in or near bankruptcy, with the goal of selling the securities at a profit if the firm turns around. The rationale behind distressed securities is that a company's situation may not be as serious as it appears and that the company might either survive or have money left after liquidation to realize a profit.

Investments in bonds are subject to interest rate, credit, and inflation risk. High-yield bonds generally have medium- and lower-range credit-quality ratings and are therefore subject to a higher level of credit risk than bonds with higher credit-quality ratings.

Due to their speculative nature, private equity investments can lead to significant losses. In addition, these types of investments can impose provisions that severely limit liquidity.

# Real assets

Investors in real assets typically invest in partnerships or private placements that are created to own tangible or physical assets. These investments typically fall into four broad categories: commercial real estate; timber and farmland; oil, gas, and mineral partnerships; and infrastructure.

Commercial real estate offers the opportunity to own property, with the primary objective of leasing a structure to a variety of tenants in return for income and the potential for capital gain upon the sale of the property. Commercial real estate can include apartment buildings, retail properties, offices, industrial sites, hotels, health care facilities, and golf courses. Investments can focus on properties in the development stage, mature properties, income-producing properties, and even distressed properties.

Timber and farmland involves purchasing or financing a tract of land used for harvesting lumber or produce.

Oil, gas, and mineral partnerships are formed to finance the discovery, extraction, and marketing of commercial quantities of oil, natural gas, or minerals, such as nickel or copper.

Infrastructure involves purchasing or building infrastructure, such as roads, electric grids, water-treatment plants, sewers, and bridges.

Due to their speculative nature, commercial real estate investments can lead to significant losses. In addition, these types of investments can impose provisions that severely limit liquidity.

# Commodities

An investment in commodities represents a direct investment in raw materials, such as crude oil, natural gas, gold, sugar, wheat, and copper. Although certain participants in the commodity markets buy and sell the physical commodities themselves (oil or gold producers for example), most investors access commodities using the options, futures, or ETF markets. These markets facilitate investing in commodities by offering exposure to the movements and characteristics of the market without the burden of trading the underlying commodities themselves.

Investments that concentrate on a relatively narrow market sector face the risk of higher share-price volatility.

Derivatives are subject to a number of risks, such as liquidity risk, interest rate risk, market risk, credit risk, and management risk. An investment in a derivative instrument could be worth less than the principal amount invested.

Futures trading is speculative in nature and involves substantial risk of loss. Futures are not suitable for all investors.

Options are a leveraged investment and are not suitable for every investor. Options involve risk, including the possibility that investors could lose more money than they invest.

# Important questions to ask

Depending on your time horizon, investment objectives, and tax status, alternative investment strategies can be an additional tool in your portfolio. Before investing in alternatives, you should discuss the possible use of alternative investment strategies in your portfolio with your financial advisor, taking the following important questions into consideration:

- Why are you considering this investment?
- How are the investment's returns generated?
- What are the risks of this investment? When do you expect it to perform well, and when will it perform poorly?
- Does your advisor have access to the alternatives?
- How transparent is the investment?
- How does the investment fit into your overall strategy?
- How do you plan to measure the performance of your investment?
- Under what circumstances would you increase or decrease your position in the investment?
- How might fees and taxes affect your return?
- How big a concern is liquidity or leverage?
- How much access do you have to the top managers and what are the risks of selecting managers outside the top tier?
- How much do you trust the manager?

Alternative investment strategies offer unique opportunities generally not available through traditional markets. However, consult carefully with your financial advisor before investing to determine whether they may have a place in your portfolio.

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