Addressing the Top Misconceptions about Alternative Investments

by Edward Egilinsky

Alternative strategies have the potential to be a viable way for investors, whether institutional or retail, to reduce risk in their investment portfolios. Nevertheless, many still harbor mistaken assumptions about alternatives. Listed below are some of the most commonly stated misconceptions, followed by explanations.

Misconception #1: Alternative strategies are too volatile and only suited for aggressive investors.

Both advisors and investors tend to use alternative strategies as a way to mitigate risk, and these strategies have displayed the ability to dampen volatility when added to traditional stock and bond portfolios. A conservative investor could potentially be just as suitable to using alternatives as a more aggressive investor. Most investment firms tend to include alternative strategies as part of a client's overall asset allocation regardless of risk profile. Institutions have incorporated the use of alternatives within their portfolios partly for capital preservation.

Misconception #2: All alternative investment strategies are created equal.

It is important to recognize that certain alternative strategies might have different risk/return characteristics. This means that certain alternatives and their appropriate percentage allocations depend on the individual investor's risk profile.

In a number of cases, some alternative strategies have a low correlation to each other as well as to stocks and bonds. This is why investment firms' asset allocation models recommend allocating across multiple alternative investment categories.

Misconception #3: Alternative investments are only geared toward high-net-worth and institutional investors and are off-limits to retail clients.

Although this might have been true for most alternative strategies some time ago, different types of alternative investments have been made available to retail clients within mutual funds and ETFs over the last few years. Alternative strategies such as absolute returns/hedge funds, managed futures, currencies, commodities, long/short equities and global macro have become available to the retail investor. The liquidity, transparency and regulatory oversight with alternative mutual funds and ETFs have made investing in alternative strategies more palatable to both retail and institutional clients. In fact, the emergence of alternative strategy mutual funds was made evident by Morningstar and Lipper creating distinct categories for different alternative strategies.

Misconception #4: Alternative investments should be viewed as standalone investments.

Although some alternative strategies have different risk/return profiles, when looking to add them to a portfolio, they should be viewed more as part of an overall portfolio mix. Institutions have utilized this idea for some time now, but retail advisors have only recently done so, primarily because financial advisory firms are doing a good job of educating their advisors about the need for alternatives and the impact they have within portfolios.

Misconception #5: Absolute returns/ hedge funds have to show positive returns in every calendar year.

Although the mandate of an absolute return strategy is to try to generate positive returns regardless of market environment, there are periods of time when these strategies might produce negative returns, albeit on a relative basis. For example, in 2008, although the broader hedge fund benchmarks and most individual hedge fund strategies were all down for the year, the broader hedge fund indices were down significantly less than the S&P 500.

Misconception #6: Incorporating a small percentage of alternatives investments within a portfolio constitutes an adequate level of diversification.

Academic studies have substantiated the belief that at least a double-digit percent allocation is necessary in order for alternatives to have a meaningful impact on an overall portfolio. Although this will vary depending on a client's objective, on average, most investment firms recommend anywhere from a 10 percent to 30 percent allocation to various alternative strategies within an overall portfolio. This will hopefully help reduce the overall risk of the portfolio and potentially enhance the returns over time.

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