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Investing: How Alternatives May Help Your Portfolio

Investors have traditionally split their portfolios between the two major asset classes, stocks and bonds (I will leave cash out of this discussion.) More recently, a third asset class has been pushing its way into the portfolios of individual investors and, unlike fashions that come and go, this trend of investing in so-called 'alternatives' seems here to stay. What are these alternatives and what role can they play in your portfolio?

Alternative assets are, simply, an alternative to stocks and bonds. This implies that if we put into this box everything that does not belong to the other two, we'll end up with a large collection of heterogeneous assets, including real estate, commodities, hedge funds, private equity, collectibles… you name it. Some of these alternatives are very liquid, have low annual costs, and can be bought with little capital, such as investments in gold and real estate investment trusts (REITs.) Others are illiquid, have high annual costs, and require large investments (e.g., physical real estate and hedge funds.)

Why Alternatives?

Unfortunately, many people invest in alternatives for the wrong reasons. A very typical mistake is to invest in, say, gold because you think that its price is about to go up. But the truth is that there is massive evidence indicating that both individual and institutional investors are unable to successfully and consistently forecast financial variables. Sad but true.

I know, you may think that your insight, or that of someone you know, is superior; that you do know what's coming next. But there's also massive evidence indicating that most people are overconfident, meaning that they think they know more than they really do. Again, sad but true.

To cut to the chase: If you plan to invest in alternatives because you think that a given price will go up, just don't do it. That said, here's a good reason for investing in alternatives: Diversification. Alternatives tend to have low correlations to stocks and bonds, which implies that they may play the useful role of diversifying your portfolio, even if their return performance is not spectacular.

Performance During Crises

Most people tend to say "I've had enough, I'm selling," only after suffering deep losses, which means they sell low. And to add insult to injury, they do not get back into the market until the bull is raging, which means they buy high. Buying high and selling low does not seem to be the road to riches, does it?

Interestingly, a proper allocation to alternatives may help your portfolio when you need it the most, during volatile periods, and particularly during crises. Remember, nobody bails out of a portfolio in good times, but the temptation to do it in bad times is strong. Hence, an asset that mitigates loses in bad times may be particularly valuable. And here's, precisely, where alternatives may play an important role in your portfolio.

In recent research in the Journal of Wealth Management, I explored the role that an allocation to gold played in a portfolio during the last two crises: The bear market after the internet bubble

(Crisis 1, Aug/2000–Sep/2002) and the more recent global financial crisis (Crisis 2, Oct/2007–Sep/2009). Consider a $100 investment at the beginning of each crisis (at the top of the market) and held through the end of each crisis (the bottom of the market) in three portfolios: 100% in stocks (S&P 500); 60% in stocks and 40% in bonds (60-40); and 40% in stocks, 40% in bonds, and 20% in gold (40-40-20). The exhibit below summarizes the performance of these three portfolios.

	***Crisis 1*:**	S&P 500	60-40	40-40-20	***Crisis 2*:**	S&P 500	60-40	40-40-20
TV		55.3	85.4	98.0		49.1	76.7	90.6
PL		64.0	64.0	56.0		75.0	68.8	68.8
AL		−5.2	−1.8	−1.0		−6.3	−3.1	−2.0

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'TV' indicates the terminal value of these three portfolios, and as you can see, in both crises the portfolio with gold fell a lot less than the other two. In the first (second) crisis, stocks lost almost 45% (over 50%); the 60-40 portfolio lost almost 15% (over 23%); and the portfolio with gold lost only 2% (less than 10%).

Not only that, in both crises the portfolio with gold reduced both the proportion of months with losses (PL) and the average monthly loss (AL) in those months with losses. In short, when investors needed protection the most, gold played the valuable role of mitigating losses, and therefore investors' urge to sell (low!)

I finish with a caveat. Gold, and alternatives more generally, are somewhat controversial assets; whether they are beneficial to you depends on many factors that I have not addressed here. Consult with your advisor whether or not, given your goals, holding period, and tolerance for risk, alternatives belong to your portfolio.

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