Are Alternative Investments Right for You?

If the financial crisis of several years ago taught us anything, it is that the traditional stocks-bonds-and-cash investing model may no longer adequately protect many investors from devastating losses in their investment portfolios.

That realization has prompted a surge in the popularity — and availability — of so-called "alternative" investment strategies and vehicles. These alternatives give investors another means to diversify their investment portfolios and thereby to protect those portfolios from downside risk while also hopefully providing a measure of growth on the upside. At least that's how the reasoning goes.

But because alternative instruments can be complex and opaque in how they operate, because some have limited track records, because they often do not behave like traditional stocks and bonds do, and because some may carry investment minimums, they're not suitable for everyone. Indeed, given these factors, it's imperative that investors do their homework before deciding to invest in any kind of alternative vehicle. "You definitely want to consult with a financial professional who's knowledgeable in this area," says Tom Balcom, a certified financial planner at 1650 Wealth Management in Lauderdale-by-the-Sea, Fla., "and doing some research on your own can also be helpful." Balcom also holds a Chartered Alternative Investment Analyst designation.

As a starting point for that research, here's a quick primer on alternatives:

WHAT are alternative investments? In broad terms, alternatives are investments in asset classes that aren't directly linked to traditional stocks and bonds, according to Mark Wilson, co-owner and chief investment officer at Tarbox Group, a wealth management firm in Newport Beach, Calif. The financial and investment research firm Morningstar defines alternatives as investment strategies or asset classes that have low correlations to traditional stock and bond investments, with unique sources of risk and return and thus, the potential for a superior risk-adjusted return in a portfolio.

Vehicles such as managed futures funds, long-short funds, hedge funds (and funds of hedge funds) as well as hedge fund replication strategies and commodities are just some of the varieties that fall into the broad and nebulous definition of alternative investments.

WHY to consider investing in alternative asset classes (and **WHY NOT**)? In most cases, the chief motivation for investing in alternative assets classes is to mitigate the potential for volatility and risk inside an investment portfolio by diversifying with investments whose behavior does not correlate to the behavior of stocks and bonds. "It's about diversifying to reduce downside risk, to dampen volatility so you get a smoother ride, and to earn positive absolute returns within a portfolio," explains Balcom.

Alternative investments do come with unique risks. They may not perform as advertised or expected, notes Wilson. Some can be more gimmick than substance. Some are illiquid, meaning an investor may not be able to promptly and simply sell their stake in an alternative investment when they wish to. Some come with high fees and/or costs to the investor. Some are more tax-efficient than others.

WHO is a good candidate to consider alternative investments (and **WHO ISN'T**)? Alternative investments should be at least a consideration for most investors, according to Balcom. Likewise, Wilson says he uses alternatives with virtually all his clients (most of whom are wealthy). However, he notes, people with less than $100,000 in their investment portfolio might be best served focusing strictly on stocks, bonds and mutual funds.

HOW to access alternative asset classes? Once the exclusive domain of institutional investors (such as pension funds, educational endowments, etc.) and the ultra-wealthy, alternative investments have become accessible to the mainstream via readily available mutual funds and exchange-traded funds (ETFs). In fact, mutual funds and ETFs that invest in alternative asset classes have become one of the fastest-growing segments of the industry.

WHICH alternatives to consider? That depends on a person's circumstances and mindset as an investor. However, given the many varieties and potential complexities of alternative investments, Wilson suggests gravitating toward those that have a clear performance track record along with a clear investment strategy and structure. Look for transparency.

HOW MUCH should you invest in alternative asset classes? Again, it depends on your investment profile and priorities. One rule of thumb from Wilson: "You want to own enough where there's a real benefit to it" — where your portfolio includes a high enough percentage of alternatives to effectively dampen volatility and limit downside portfolio performance when stock and bond investments head south. Among Wilson's high-net-worth clientele, alternatives typically represent 15 to 25 percent of portfolio value, he says.

WHERE to turn for insight and guidance? Is an alternative investment suitable for you, given your investment profile? If so, which type of alternative asset class, and specifically which kind of vehicle or strategy, might be most suitable to your situation, goals and risk tolerance? Because these aren't easy questions to answer, it's best to consult a financial professional with a strong background in "alts" for guidance. To find a CERTIFIED FINANCIAL PLANNER™ (CFP®) professional in your area, check out the Financial Planning Association's national database at www.PlannerSearch.org.