Investing in Funds: A Quarterly Analysis, January 2009

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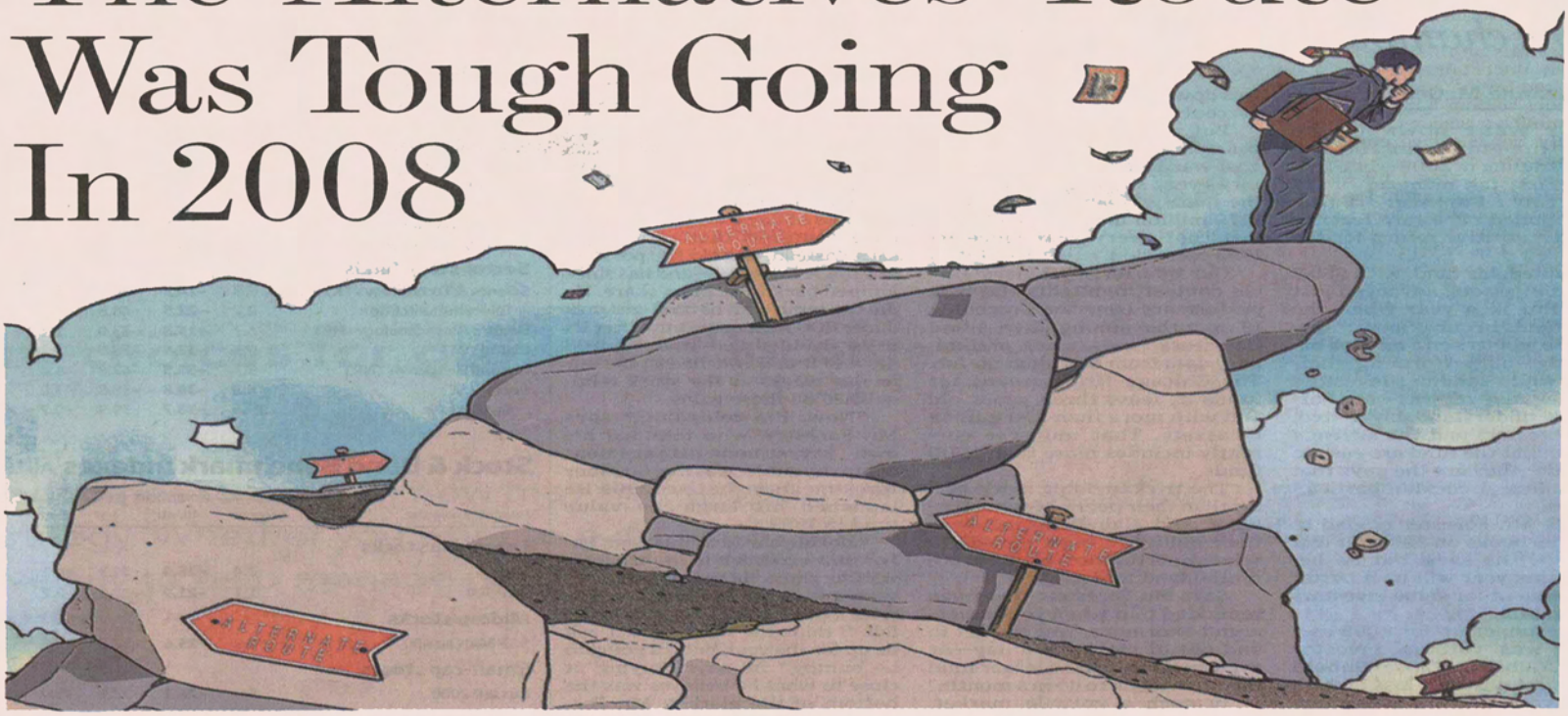
The 'Alternatives' Route Was Tough Going In 2008



Holdings such as real estate and commodities failed to smooth the ride for investors in a rocky year for stocks and bonds

By Shefali Anand

AS THE MARKET crashed last year, investors learned a hard lesson: Efforts to cushion losses don't always work.

Over the past few years, investors and financial advisers have been pouring more and more money into commodities, real estate and other vehicles that were once niches for the well-to-do. The idea? These "alternative" investments were supposed to diversify their portfolios and cushion the shock when stocks and bonds took a dive.

That's the theory, anyway. But last year, commodities, real estate and other alternatives fell along with the stock and bond markets. For instance, mutual funds that invest in real estate and commodities were down on average 40% to 50% in 2008, according to data from Morningstar Inc.

Judith Shine, of Shine Investment Advisory Services Inc. in Lone Tree, Colo., allocated about 20% of her typical client's portfolio to alternatives. But now, she laments, "we wish we had gone into three-year Treasurys as an alternative investment." U.S. debt was one of the few assets that rose in value in 2008.

Still, Ms. Shine is keeping a 15% allocation in alternative investments, hoping they will turn around in the future. "We could be sitting here a year from now and saying, 'Boy, that was all nasty, but it all worked out,' " she says.

For an idea of just how popular alternatives have become, consider this: Nearly a quarter of the 600 mutual funds, exchange-traded funds and exchange-traded notes launched last year were real estate, commodity and hedge-fund-like funds, according to Morningstar. Most alternatives were in the form of ETFs, which are basically mutual funds that trade like a stock.

All that activity was the culmination of a very busy stretch: Over the past five years, financial companies have launched hundreds of alternative products—some of them much more arcane than real estate and commodities. Last year, in fact, Morningstar added an "alternative" asset class to its fund-classification system. The grouping includes funds that invest in currencies and those that use "long short" or "bear market" strategies—approaches that bet against specific stocks or the

Are 'Alternatives' a Good Way to Go?

market itself, either by shorting or by buying instruments such as derivatives.

Those types of complex alternatives are getting more popular as real estate and commodities tank. In part, that's because financial advisers are scrambling to find ways to make money in this market, and obscure instruments seem to offer a solution. For instance, many advisers are piling into "managed futures" funds, in which the manager buys futures and other derivatives based on proprietary computer models that indicate when to enter or exit the market. Many of these funds—which are mainly private funds and hedge funds—delivered positive returns in 2008.

"Folks are definitely looking for strategies that can do well in sideways to difficult markets," says John Moninger, head of advisory services at broker-dealer LPL Financial Corp., which is headquartered in Boston, San Diego and Charlotte, N.C. He says sales of managed-futures products have gone "through the roof" over the past year.

However, individuals should be cautious about jumping headlong into these and other alternative investments. For one thing, many of the funds that bet against stocks haven't been around long enough for advisers to make conclusions about their risk or return patterns.

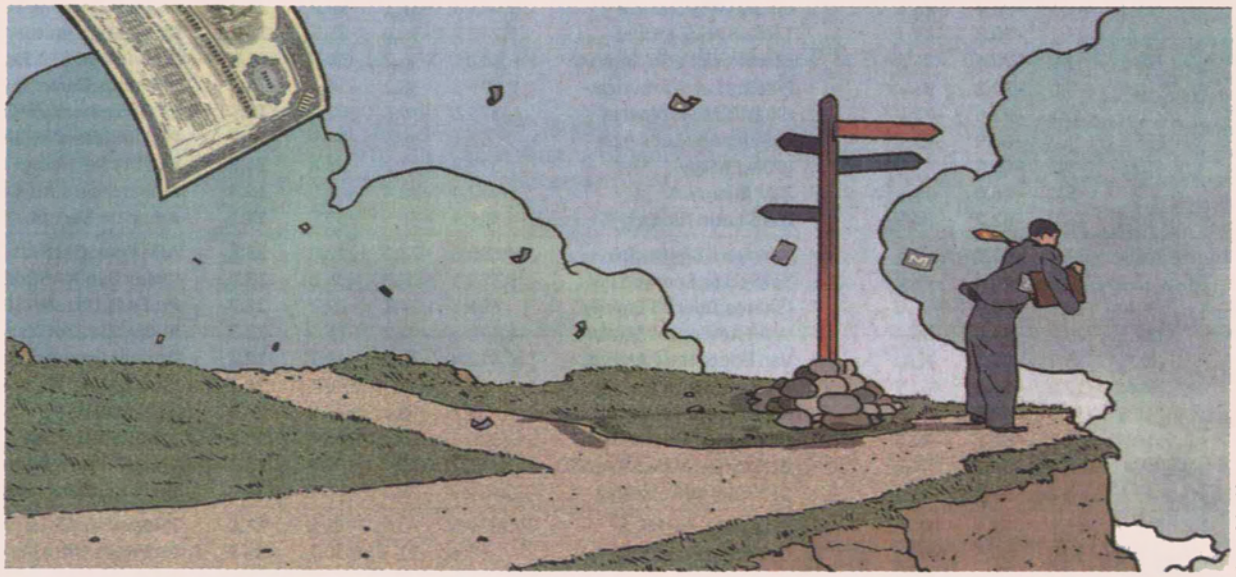
"They're all interesting strategies, but we'd have to see a lot more history before we would be ready to make any substantive commitment to them," says Harold Evenksy, a financial planner in Coral Gables, Fla., with Evensky & Katz Wealth Management.

If you want to add alternatives of *any* kind to your portfolio, financial advisers suggest starting with a small allocation of 5% or so. "Get your toe wet first, so you develop an understanding" of these products, says Mr. Evensky.

Below, we'll look at the main types of alternative investments out there—and their outlook after last year's market meltdown.

REAL ESTATE

Individuals have been able to invest in real-estate securities for more than a dozen years, primarily through real estate investment trusts and mutual funds. In fact, many advisers don't even consider real estate an "alternative" because it's been around so long.



Jason Schneider

In the past, real-estate investments have often performed differently than stocks and bonds. In 2000 and 2001, for instance, REITs made money even as the Standard & Poor's 500-stock index crashed after the technology bubble burst.

The winning streak of real-estate funds continued through 2006, sparking a flurry of new products. There are now nearly 100 real-estate mutual funds and ETFs, which primarily provide exposure to commercial properties. There are also 62 funds and ETFs focused on foreign real estate, mostly launched in the past three years.

But since 2007, these funds have been among the worst performers, thanks to the crash in the real-estate market. The average real-estate fund fell 40% last year, more than the S&P 500's 37% decline (including the reinvestment of dividends).

Since many advisers have owned real-estate securities for years, and benefited from strong returns, they are sticking with their real-estate investments for now. They believe that this is an unusual time, and that these investments will pay off over the next few years as the government's fiscal measures work their way through the system, making it easier for investors to borrow again. In the meantime, advisers point out, REITs have healthy yields—now upward of 8%.

"If anything, we're a little bit more aggressive," says Jason Thomas, chief investment officer of Aspiriant, a wealth-management firm in San Francisco and Los Angeles. A typical client at Aspiriant has about 10% to 15% in real estate, both publicly traded and private investments. Advisers at the firm are planning to add more U.S. real estate to portfolios this year, because they believe the prices are very low, and thus there's better return potential from here on.

However, for many financial advisers, the interest in foreign real estate has fizzled, as the strengthening of the U.S. dollar has hurt returns in foreign currencies. For instance, Mr. Thomas plans to cut back on foreign real estate to add to U.S. real estate.

"It's been a painful ride because the losses are substantial," says Mark Balasa of Balasa Dinverno Foltz LLC, an investment adviser in Itasca, Ill., who started investing in foreign REITs in 2007. His target 3% allocation to foreign real estate is down to 2.5%, even though he added money to it twice last year.

This year, he hopes to add a real-estate fund that provides exposure to U.S. real estate because he believes it's "going to come back at some point," he says.

COMMODITIES

Funds that provide exposure to commodities like oil and natural gas and precious metals like gold were red-hot until mid-2008. Commodities had been on a tear for nearly five years, and fund companies launched a number of funds, ETFs and exchange-traded notes to provide individuals access to all types of commodities. There are now 238 such investments, including several niche ETFs and ETNs that invest in single commodities like silver, cocoa and livestock.

But in the summer of 2008, commodity prices did an about-face amid worries that a global economic slowdown would reduce demand for these products. Also, the broader credit crunch led to heavy redemptions at large commodity funds and hedge funds, causing them to sell their commodity positions at fire-sale prices. This pushed commodity prices lower.

Crude oil is down nearly 70% since its peak in July. The average natural-resources fund, which invests in energy-related company stocks or commodity derivatives, was down 49% last year, according to Morningstar, with one fund, Guinness Atkinson Alternative Energy fund, down 66%. Precious-metals funds held up somewhat better, with the average fund down 30%.

Typically, funds that invest in stocks of energy or mining companies performed worse than funds or ETNs that invest in commodities directly or through derivatives. This is partly because stock funds are affected by broad trends in the stock market. (On the flip side, the stock funds gained more in the bull market.)

Some advisers who espoused commodities in recent years have buckled under the weight of recent price drops. Louis Stanasolovich, president of Legend Financial Advisors Inc. in Pittsburgh, liquidated all his clients' commodity positions in September and October because they were moving like the stock market. He says he's not "negative on commodities" but for now prefers to get this exposure through managed-futures funds that may dabble in commodity futures and a fund that partly bets against commodities. He invests 12% to 16% of client portfolios in such funds.

Others, however, say that in the long run, commodities will live up to their role as a diversifier. For instance, some advisers

worry that the current low interest rates could cause inflation in the next couple of years, and commodities typically do well in inflationary environments.

Research shows that "eight times out of 10, when equities have a negative year, commodities have been positive," says Patrick J. DiNuzzo, president of DiNuzzo Investment Advisors Inc. in Beaver, Pa. So, despite the recent downturn, he's sticking with his allocation to commodities, which equals 10% of the client's stock exposure and is made primarily through a broadly diversified mutual fund.

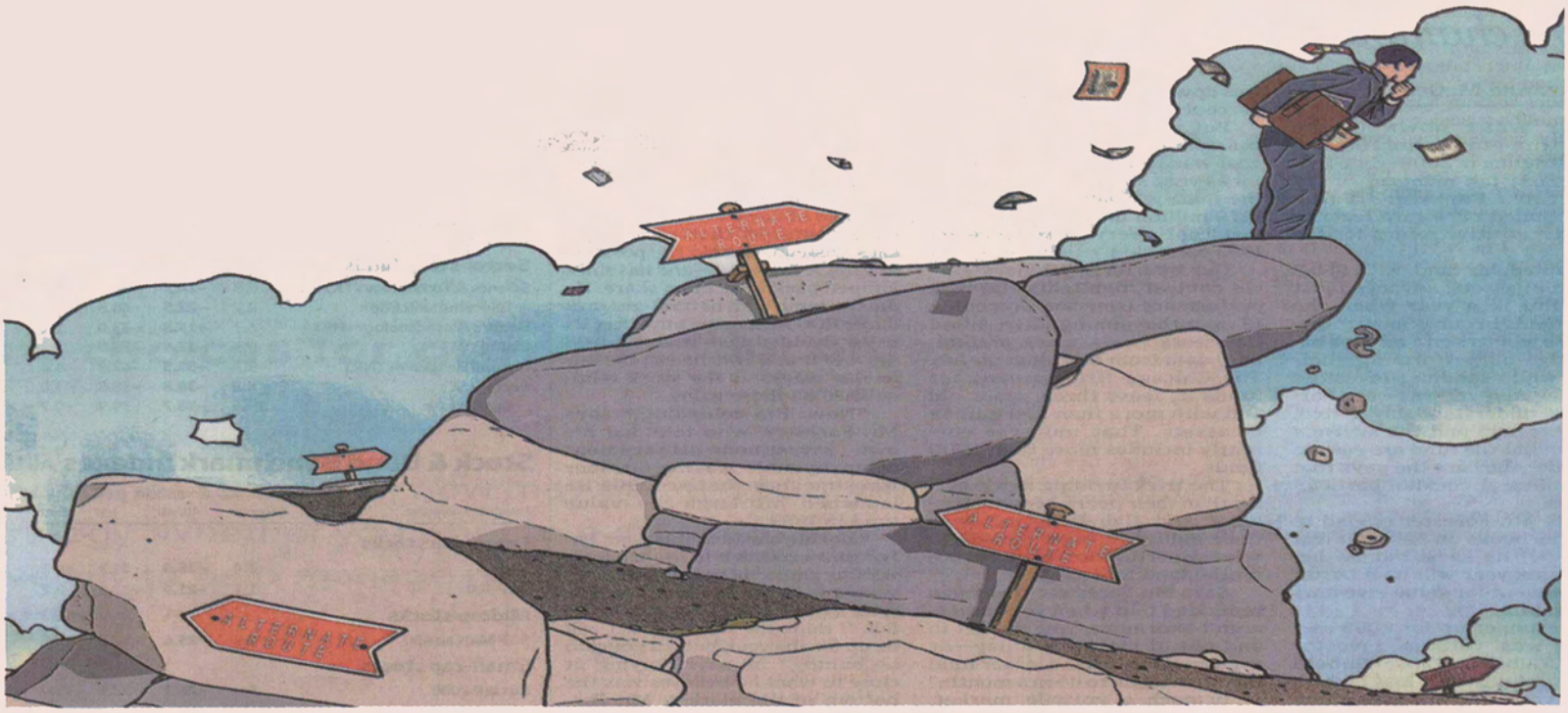
HEDGE STRATEGIES

In the past several years, a number of mutual funds have been launched that attempt to follow strategies used by hedge funds. "Bear market" funds aim to move in the opposite direction from specified market indexes. Many "long short," "market neutral" and "absolute return" funds aim to fall less than the stock market in bad times; some say their objective is to provide positive returns regardless of the stock market.

Overall, there are about 180 mutual funds, ETFs and ETNs in Morningstar's long-short and bear-market categories, and an additional 35 products that provide exposure to currencies.

Some bear-market funds have been very popular with advisers over the past year as a way to reduce a client's exposure to stocks without selling a fund—and thus avoiding any capital-gains tax. Earlier, these funds were the tools of traders and investors with short-term views, but in 2008 "the more buy-and-hold sort of adviser has started to dabble" in these funds, says David Reilly, director of portfolio strategies at Rydex Investments, which offers bear-market funds.

These hedge-fund-like mutual funds are among the newest types of alternative investments available to individuals—and perhaps the most debated of them all. Many advisers felt that strategies like market neutral and long short should have shined in a down market. But the average fund in Morningstar's long-short category fell 15% in 2008, with a few, like the Icon Long/Short fund, down as much as 40%.

Some experts, however, point out that these investments fell less than the market—which should support the case for owning them. A small chunk of the funds—around 10% of the mutual funds in Morningstar's long-short category—even ended the year positive.

Absolute-return and market-neutral funds "didn't live up to the expectation that they would provide absolute returns in all market environments," says Christopher Cordaro, a planner at Morristown, N.J., firm Regent-Atlantic Capital LLC. Still, he continues to invest 10% of client portfolios in these funds, because they've fallen less than the market. He allocates another 10% to commodities and real-estate investments, though he's been cutting back on commodities and adding to real estate since July.