



What Are The Alternatives?

Diversification is a portfolio management technique accomplished by investing in a variety of investment instruments/securities thereby reducing risk and earning better returns on the average portfolio than if you had invested in a single instrument or asset class. You can diversify across asset classes, sectors or industries, and countries in order to construct a fully diversified portfolio. For the average investor, achieving a diversified portfolio involves investing in a combination of stocks, bonds and cash. These are referred to as traditional investments. Diversification of a portfolio can be enhanced by investing in nontraditional or alternative investments.

In the broadest of terms, an alternative investment is any investment other than the three traditional asset classes noted above. Examples of alternative investments would include real estate, private equity, venture capital, hedge funds, commodities and art and antiques. Given the very broad definition, this list is by no means exhaustive.

In selecting securities to create a diversified portfolio, the key is to look at the correlation of returns. That is, how closely the prices of these securities move with each other. You would want to choose securities that are uncorrelated or have a negative correlation as this means they will not move in the same direction. When there is no correlation the stock prices will move in an unrelated manner while with negative correlation, as one price goes up the other would tend to go down. So a downturn in one should not be accompanied by an underperformance in the other.

At times of economic turmoil, it has been noted that the performance of traditional assets can become positively correlated. The implication of this occurring is that the diversification advantages that were assumed in constructing the portfolio would be lost. Historically, alternative investments have shown a low correlation with traditional investments and have the potential to yield positive returns in various economic environments. The low correlation with overall stock and bond market activity makes the use of alternative investments particularly attractive as investing in these can lower the volatility of the overall performance of an investor's portfolio.

Real estate is likely the alternative investment with which most individuals are familiar. Some describe their home as their most significant investment. Other investment opportunities in real estate include becoming a partner in a construction project, buying rental property, developing an empty lot or participating in a real estate investment trust (REIT). A major advantage of real estate is that it can provide a hedge against inflation. However, a drawback can be difficulty in selling, particularly at the price you want to. REITs, as an alternative to direct real estate investment, have been increasing in popularity. A REIT is a publicly traded trust or association that trades as a stock would but operates as a mutual fund. Investors' funds are pooled for investments in real estate ventures such as shopping centers, industrial buildings, office buildings, apartments and hotels. The trust makes investment decisions and its shares are traded on the stock market. Investing in a REIT is a liquid means of participating in the real estate market. In addition to being relatively more liquid,

REITs offer an accessible way to invest in real estate as substantial initial investments are not required as would be the case with direct investments in real estate.

Another type of alternative investment is private equity. This is an asset class involving investment in operating companies that are not publicly traded on a stock exchange. Investments are most often in the form of an addition of capital into the operating company or the acquisition of a company. Venture capital is a category within private equity that involves financing for a start-up business or small business with long-term growth potential. There is significant risk involved in this type of investment but so too is the potential for above average returns. Venture capital investors seldom take a majority shareholder position unlike other private equity strategies (for example leveraged buyouts). Private equity investments are illiquid and generally involve significant levels of leverage. Given the risk involved, there are limited ways for a retail investor to enter into the private equity market. With the availability of exchange traded funds (ETFs), however, it is possible to participate in this investment class, for example, through securities such as PowerShares Listed Private Equity ETF (ticker symbol: PSP).

Hedge funds are another type of asset that falls within the alternative investment category. A hedge fund can be compared to a mutual fund as pooled investments that are professionally managed. However, the portfolio is aggressively managed using advanced investment strategies with the target outcome of generating exceptional returns. Hedge funds are usually open to a limited number of investors and the initial investment required is beyond the reach of the average investor. In the United States, accreditation of investors is required by law. Requirements for accreditation include having a net worth of more than US\$1 million, significant investment knowledge and a stipulated minimum annual income. While the name may imply that a fund like this would hedge against risk, that assumption is erroneous as hedge funds actually make quite speculative investments in an attempt to earn above average returns and therefore may actually carry more risk than the market as a whole.

Due to their complex nature, alternative investments are most often held by institutional investors and certain high net worth individual investors. These nontraditional investments are subject to limited regulations and tend to be relatively less liquid as compared to traditional investments.

As with any decision with regard to investing in a particular asset class there are a number of factors to be considered that would determine if investing in alternative investments is suitable for any particular investor. These include the individual's personal financial situation, risk tolerance and time horizon. An investor's personal financial situation should be such that there is a readily accessible source of funds for any unforeseen circumstances. Given the potential downside risk, the size of investment in relation to overall wealth should be considered. It is also important to consider stability of income before allocating funds to alternative investments. Generally, investors considering alternative assets should be ready to hold for a long investment horizon as they are relatively less liquid than traditional investments.

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