

What It Really Means to Use Alternatives in Portfolios

by Brad McMillan, CFA, CAIA, MAI, AIF®

I spend a lot of time talking with advisers about using alternative investments in client portfolios. Over time, I have found that the first step in any conversation is to define what “alternatives” means.

The term has evolved quite a bit over the years. Not that long ago, “alternatives” might have meant emerging markets. Now common, the asset class was not always so well understood; it was perceived as risky and scary by many clients and advisers. Before that, small-cap stocks met the same criteria: risky, dangerous, and poorly understood. Many investors thought it was much better to stick with safe, large-cap stocks like the Nifty Fifty—those popular NYSE stocks in the 1960s and 1970s with a reputation for being solid buy-and-hold choices. Even before that, stocks themselves were considered an alternative investment. Gentlemen preferred bonds. The decline in the average stock dividend level below bond yields was an aberration and could not last.

The notion of reaching beyond what most people are comfortable with—in asset class or strategy—to an “alternative” has a respectable historical pedigree. It also has a sound theoretical basis. Managers in widely followed and understood investments typically find it difficult to outperform. The more obscure the investment, the more chance for manager alpha and noncorrelated return streams. Note that all of the examples above, in their day, provided exactly that.

Do Alternatives Actually Work?

While we know that past performance is no indicator of future results, the results of our firm’s managed portfolios suggest that alternative strategies do work, with overall risk reduction observed in most portfolios over most time periods compared with similar portfolios without alternatives. Depending on the portfolio objective, alternative allocations range from 15 percent to 23 percent and include strategies such as managed futures, long/short equity, tactical and go-anywhere funds, and others.

It should be clear that I favor the use of alternatives in most, if not all, portfolios. I have a specific objective for these products, though, and a specific definition of what “alternative” should mean. And, I acknowledge that many of these products are much more complicated—in underlying strategy and organization—than traditional investments. The risk levels are higher, not only for the client but for the adviser, too. To go back to the small-cap example, no one ever got fired for buying IBM, but someone might have been fired for buying Kaypro.

My objective for using these products is straightforward: provide noncorrelated return streams that offer real diversification benefits. There are two ways to do this. First, find an asset class that is largely under-owned, where the perception (but not the reality) is that it’s too dangerous or otherwise undesirable for most people. The second way is to find a strategy that will work in a noncorrelated way by design.

For Real Alternative Diversification, Use Strategy

Most asset classes have been pretty well explored and colonized. There are stock and bond funds that specialize in what are now called “frontier” markets. Once you get into Yemen, for example, you’ve pretty much hit the limits of diversification. Likewise, size classes have largely been explored, with company sizes down to micro-cap and all sorts of splits in size, industry, style, and what have you. Moreover, there are real capacity constraints in many asset classes where there is the potential for alpha. Finding a good small-cap fund is a constant challenge, as many of what I consider the best are closed for capacity reasons.

The primary area remaining for real “alternative” diversification is therefore in strategy. The nice thing about this space is that because you are looking at all the different strategies available—which by definition should act differently—you can build the diversification you seek in the portfolio-construction process. While acknowledging the need for asset class diversification, my definition of an alternative is a product or asset class that will react differently to market changes by design, rather than as a historical observation that is assumed to continue. This narrows things down considerably.

What’s New in Alternatives?

Numerous new products designed to provide noncorrelated returns have recently been launched. Many are outgrowths of private alternative products; others have

been created by mutual fund companies as extensions of their existing capabilities. New public but nontraded offerings are also now available that replicate existing public products, much as nontraded REITs did with public REITs.

Here are some of the products that have recently come to market.

Managed Futures. For years this asset class met the “too weird and scary” test for most investors. That aura has faded, and several mutual funds now offer access to managers and strategies that heretofore were only available privately. What makes these offerings interesting is that the strategies are usually purely statistical in nature and can go both long and short. In theory, then, these products could potentially outperform in market downturns, offering real diversification and portfolio risk management. In fact, many of them have done just that. Both theoretically and empirically, this asset class seems to have offered the advantages we are looking for in an alternative investment. The risk, of course, is that as these strategies become more accessible and less scary and the assets invested increase, the alpha will evaporate (among other risk considerations).

Absolute Return Strategies. Many mutual fund companies now offer products that provide a mix of asset classes and strategies designed to produce a stated return level, typically over a full market cycle. Because these products are new, whether they work as intended has yet to be shown, but in theory it could be possible. Typically, return and risk levels are explicitly modeled as a trade-off. The utility of these products usually depends on the strategies employed, which vary per product. As more goal-oriented products, they don't really meet the alternative criteria I have described, in that they are neither “weird and scary” nor do they necessarily employ a strategy designed to generate noncorrelated returns. Thus, when evaluating them, it's necessary to determine exactly what the strategy is and

how it can be expected to act.

Tactical Strategies. Post-2008, the appeal of strategies that get you out before the market crashes became more apparent than it had been in 2004–2007. Per my research and that of others, tactical strategies have typically underperformed in a secular bull market, but they can potentially outperform in range-bound or bear markets. Several products out there based on quantitative strategies have both theoretical and empirical success in limited downside exposure, and several of the more tenured of these strategies have performed as designed. Some of the risks with these products are that they're typically not immune to a short-term slide, such as the 2010 flash crash or the 1987 crash, and that they will underperform in

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structural bull markets.

Illiquid Market Strategies. Good asset class examples of this type of strategy are real estate and whole loan products; product examples include REITs and business development companies (BDCs). The idea behind these products is that there's real potential alpha in asset classes that relatively few understand and in which the assets are both diverse and very different

from each other. This concept has largely played out historically, especially in real estate, which did quite well until the asset class became so popular that prices were driven to uneconomic levels, with results we all know. BDCs are becoming popular now, and while the products seem quite interesting, it's worth remembering that at some point that cycle will turn as well.

Words of Wisdom

For each of these “alternative” asset classes, the lessons are the same as for any traditional asset class. Pay attention to valuations; watch for bubbles; make sure you understand the strategies, risks, and expected results; and always be aware of where the asset class is in the popularity cycle, as that will help determine the potential for alpha. I have made the argument that real estate was not an alternative asset class in 2007, because everyone was doing it! Now, perhaps, the reverse argument could be made—that housing is an alternative asset class because it passes the “weird and scary” test.

Weird and scary or not, the success of alternatives lies in their contribution to the risk-adjusted returns of your clients' portfolios. Many alternatives can provide benefits, but they vary by product and you need to define what you're trying to achieve before you even consider them. Given the range of asset classes, strategies, and product types, it's important to either spend the time to develop your own expertise or rely on others who have it. The one constant among the many varieties of “alternatives” is that it's just as easy to get burned here as with traditional investments.



Brad McMillan, CFA, CAIA, MAI, AIF®, is vice president and chief investment officer at Commonwealth Financial Network®, member FINRA/SIPC, a registered investment adviser, in Waltham, Massachusetts. (bmcmillan@commonwealth.com)