

Alternative Investments



DR. RON MILLER CFP®, AIFA®

The recent market turmoil caused most investors, investment advisors and money managers to review their basic belief about investment principals. Included in those reviews was evaluating the use of alternative investments as a larger part of investment portfolios.

Alternative investments can add different asset classes to your portfolio that may have low correlations with the asset classes you already have in the portfolio. These added asset classes almost always reduce volatility and increase long term returns of a portfolio. Many of these alternatives have been around for quite some time and others are relatively new. Some have

proven to be excellent additions to almost any portfolio and others have proven to be flawed and have little to no chance of helping anyone but the individuals promoting and selling the product.

Alternative investment choices are numerous and cannot all be covered in one article. Highlighted are a few of the excellent choices and those it would be wise to avoid.

EXCELLENT CHOICES

Treasury Inflation Protected Securities (TIPS): These government guaranteed bonds have existed in the USA since 1997 but were available a decade earlier in many other developed countries. Their primary advantage of TIPS is that they will help pro-

tect your portfolio from sudden unexpected surges in inflation. TIPS pay a nominal interest rate (lately similar to what five year treasury bonds pay) plus the inflation rate for the year. In many ways this asset class is a alternative to owning gold. Unlike owning gold though, every year there is at least a nominal annual interest rate paid and there are no storage costs. The ETF (Exchanged Traded FUND) symbol TIP or mutual fund VAIPX are excellent funds for holding this asset class in your portfolio. Tips are best purchased and held in tax-sheltered accounts. A position of twenty-twenty five percent of the fixed asset part of your portfolio in this asset class is appropriate if you suspect there will be high inflation in the years ahead.

Emerging Markets: This asset class is noted for its volatility. However, over the long term accepting that volatility has rewarded investors in this asset class with exceptional returns. Unlike most other foreign asset categories, emerging market countries have not been directly involved in the subprime mess. Countries like India, China, Brazil, Viet Nam and Turkey are just a few of the markets that comprise this asset class. They are poised to have excep-

Continued on next page

References

Continued from previous page

1992; 20(6):313-21.

39. Demers M, Brodeur JM, Mouton C, Simard PL, Trahan L, Veilleux G. A multivariate model to predict caries increment in Montreal children aged 5 years. *Community Dent Health* 1992; 9(3):273-81.

40. Disney JA, Graves RC, Stamm JW, Bohannon HM, Abernathy JR, Zack DD. The University of North Carolina Caries Risk Assessment study: further developments in caries risk prediction. *Community Dent Oral Epidemiol* 1992; 20(2):64-75.

41. Steiner M, Helfenstein U, Marthaler TM. Dental predictors of high caries increment in children. *J Dent Res* 1992; 71(12):1926-33.

42. Steiner M, Helfenstein U, Marthaler TM. Validation of long-term caries prediction in children (abstract). *Caries Res* 1995; 29(4):297-8.

43. ter Pelkwijk A, van Palenstein Helderma WH, van Dijk JW. Caries experience in the deciduous dentition as predictor for caries in the permanent dentition. *Caries Res* 1990; 24(1):65-71.

44. Main P, Azarpazhooh A. Risk assessment for the prevention of dental caries

within the Children's Oral Health Initiative (COHI): evidence-based report. Prepared for Dental and Pharmacy Programs, Primary Health Care and Public Health Directorate, First Nations and Inuit Health Branch (FNIHB), Health Canada; March 2007. p. 47.

45. Castillo JL, Milgrom P. Fluoride release from varnishes in two in vitro protocols. *J Am Dent Assoc* 2004; 135(12):1696-9.

46. Eakle WS, Featherstone JD, Weintraub JA, Shain SG, Gansky SA. Salivary fluoride levels following application of fluoride varnish or fluoride rinse. *Community Dent Oral Epidemiol* 2004; 32(6):462-9.

47. Shen C, Autio-Gold J. Assessing fluoride concentration uniformity and fluoride release from three varnishes. *J Am Dent Assoc* 2002; 133(2):176-82.

48. Hawkins R, Noble J, Locker D, Wiebe D, Murray H, Wiebe P, and others. A comparison of the costs and patient acceptability of professionally applied topical fluoride foam and varnish. *J Public Health Dent* 2004; 64(2):106-10.

49. Kallestall C, Norlund A, Soder B, Nordenram G, Dahlgren H, Petersson L, and others. Economic evaluation of dental caries prevention: a systematic review.

Acta Odontol Scand 2003; 61(6):341-6.

50. Sködl L, Sundquist B, Eriksson B, Edeland C. Four-year study of caries inhibition of intensive Duraphat application in 11-15-year-old children.

Community Dent Oral Epidemiol 1994; 22(1):8-12.

51. Vehmanen R. An economic evaluation of two caries preventive methods [dissertation]. Turku (Finland): University of Turku; 1993.

52. Quinonez RB, Stearns SC, Talekar BS, Rozier RG, Downs SM. Simulating cost-effectiveness of fluoride varnish during well-child visits for Medicaid-enrolled children. *Arch Pediatr Adolesc Med* 2006; 160(2):164-70.

53. Hiiri A, Ahovuo-Saloranta A, Nordblad A, Makela M. Pit and fissure sealants versus fluoride varnishes for preventing dental decay in children and adolescents. *Cochrane Database Syst Rev* 2006; (4):CD003067.

54. Ahovuo-Saloranta A, Hiiri A, Nordblad A, Worthington H, Mäkelä M. Pit and fissure sealants for preventing dental decay in the permanent teeth of children and adolescents. *Cochrane Database Syst Rev* 2004; (3):CD001830.

Alternative Investments

Continued from page 13

tionally fast growth of their economies and participation in emerging markets will allow your portfolio to take advantage of that growth. Even though the yearly swings in price can be quite dramatic, the average returns over several years is one of the highest of any of the asset category.

It should be mentioned here that modern portfolio theory demonstrates that adding a volatile asset class like emerging markets to a portfolio can actually reduce volatility and increase return in the overall portfolio.

Three to seven percent of a portfolio in this asset class would very likely increase the holder's rate of return. The ETF VWO or DFCEX fund are both low cost ways to gain access to this asset class.

REITs: This is another excellent asset category to include in your portfolio especially if you do not have other investment real estate. REITs' (Real Estate Investment Trust) do not correlate closely with many other asset classes you may have in your portfolio. REITs diversify portfolios. REITs have performed terribly over the last few years. The current prices are probably discounting all the current bad news and then some. This asset class they should be held in tax deferred accounts. If you believe that real estate is still a good long term investment, a four-eight percent exposure to REITs' should be considered for part of your portfolio.

FLAWED TO POOR CHOICES

Hedge Funds: There are very few investments with higher fees, lack of transparency, and more potential conflicts of interest than Hedge Funds. Regardless of these facts, hedge funds have grown from 530 funds in 1990 to close to over 8000 funds by 2008. This tremendous growth was partially due to marketing techniques emphasizing the exclusivity of these funds, but that approach has faded quickly since the Bernard Madoff scandal.

Unless one is a high-net-worth investor, exposure to hedge funds will probably come through a "fund of funds" (a fund that buys a group of hedge funds). The fund of funds adds another layer of fees to the already high fee structure. Fees of one percent to two percent of annual expenses and a 20 percent of profit bonus to the

VOLATILITY AND TOTAL RETURNS			
Year 1	10%	5%	10%
Year 2	10%	20%	35%
Year 3	10%	0%	-15%
Year 4	10%	20%	25%
Year 5	10%	5%	15%
Arithmetic	10%	10%	10%
Annualized	10%	9.70%	8.20%
\$100 grows to	\$161.05	\$158.76	\$148.46

manager is common. With the fund of funds fees, the investor is looking at annual investment expenses that could exceed five percent. Even the most talented of money managers would find it extremely difficult to overcome those costs and produce exceptional returns.

Many investors look at what they perceive as extraordinary rates of return without asking themselves how much risk is being taken to achieve those returns. Many hedge funds use leverage that can cause devastating losses when things do not go well. The recent financial crisis demonstrated this when leveraged positions had to be liquidated and there were no buyers. Some hedge funds ended up closing after quickly losing over 80 percent of investors' money.

Even in stable times, there is a 10 percent to 15 percent annual hedge fund closing rate. The median life time of hedge funds is just 5.5 years. It would be prudent to ask why this is so. It should also be noted that the closed hedge fund returns are not included in the high average returns of all hedge funds you hear about. Survivorship bias of those high average returns is extreme. Conflicts of interest are numerous.

A common conflict is when the manager is close to getting his 20 percent of profit bonus near the end of the year. He may take on even more leverage and risk to achieve the necessary extra return for the bonus. There is little downside for him as the investors are the ones that will be taking all the extra risk. If the extra risk pays off, the investor is rewarded by having to pay 20 percent of the profit to the hedge fund manager. If the extra risk does not pay off and the investors lose, many managers have simply closed the hedge fund down

and formed a new one. The manager does not even have to disclose what he is doing, as hedge funds are not closely regulated like mutual funds are. Look elsewhere if someone tries selling you on the idea of increased returns with the use of Hedge Funds. The odds are stacked against you.

Leveraged and Inverse funds: The concept here is that you can get 1.5 to three times the return up or down from an asset category benchmark using these leveraged and inverse ETFs or mutual funds. With high expense ratios and high volatility, it is difficult to justify this strategy.

For example, leveraged ETFs and mutual funds that track the S&P 500 benchmark and are intended to give twice the return if that benchmark goes up has an expense ratio of 0.95 percent or higher. A similar ETF without leverage has a expense ratio of 0.07 percent.

The second issue is volatility. Yes, the leveraged fund can get you a greater return than what the benchmark increased by, but if the guess of the market direction is wrong, the leverage will also increase the losses. Volatility in a portfolio is the enemy of solid long range returns. (See chart above.) Trying to guess the direction of the market consistently is a loser's game and most will fail.

Consider the above before using a leveraged fund strategy.

For more details on this topic, I highly recommend reading *The Only Guide To Alternative Investments You'll Ever Need* by Larry Swedroe. ■

Dr. Ron Miller is the principal with Resource Management LLC. He can be reached at (808) 429-8123 on Oahu or via his website at www.resourcecm.com.