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Making the case for alternatives

By Jeff Benjamin

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If ever there was a time to embrace investments in alternatives, this is it. More than 300 distinct open-end mutual funds now are available across seven alternatives subcategories, according to Morningstar Inc., making the days when only the ultrarich and well-connected could access noncorrelated and hedging strategies seem like ancient history.

Still, the vast majority of financial advisers are only dipping their toes into the registered-alternative-investment waters.

In fact, only 14% of advisers at more than 300 advisory firms said that at least 76% of their clients have an allocation to alternative investments, according to the 2011 Rydex|SGI Advisor Benchmarking study, which was released in October.

That figure is unchanged from 2010.

To be sure, more investors are dabbling in alternatives. The Rydex|SGI survey found that 17% of advisers said their clients have no allocation to alternatives, down from 28% in 2010.

The data further show that while 26% of advisers surveyed are not recommending the use of alternatives to their clients, that figure is down from 30% the year before.

“Ultimately, we know that less than 10% of advisers are really using alternatives for their clients,” said Jerome Abernathy, managing director of alternative investments at Rydex|SGI.

The key, according to Mr. Abernathy, is to use alternatives in place of the riskiest portfolio assets (usually equities) and to “do enough to make a difference.”

From January 2008 through last November, Morningstar calculated monthly returns of the S&P 500, the Barclays Capital Aggregate Bond Index, short-term Treasuries as a proxy for cash and five equal-weighted alternatives indexes.

Over that period, a 60% stock, 30% bond and 10% cash allocation would have produced an annualized return of 1.2%, with a standard deviation of 12.7%.

A 45% stock, 30% bond, 5% cash and 20% alternatives allocation would have produced an annualized 1.3% gain, with a standard deviation of 12.1%

Finally, a 35/30/5/30 allocation would have produced an annualized return of 1.5%, with a standard deviation of 11.3%

“We know that 5% to 10% in alternatives doesn't really do enough,” Mr. Abernathy said. “But when you get to 20% or greater, you start to see a material difference.”

Advisers using alternatives say the best reasons for doing so are diversification, risk management and volatility reduction.

“I think financial advisers are starting to embrace alternatives, but it's an education process because they see a lot of moving parts in these products,” said Gregory Adams, manager of the Alger Dynamic Opportunities Fund (SPEDX), a long-short equity fund launched in 2009 by Fred Alger Management Inc.

The $23 million fund is the first foray into alternatives for the $15 billion asset management firm.

Through last Tuesday, the fund was down 4.5% for 2011. Over the same period, the long-short equity fund category average, as tracked by Morningstar Inc., was down 2.3%, compared with a 2.7% gain by the S&P 500.

In fact, all seven of the Morningstar alternative subcategories are negative this year, ranging from a 0.2% decline in market-neutral funds to a 20% drop in equity precious metal funds.

It's an irony of sorts, but that negative performance is precisely the reason advisers should be considering alternatives. They zag when pretty much everything else zigs. They should be valued for their noncorrelation, not their returns.

The monthly total returns of alternatives funds tracked by Morningstar between December 2008 and November illustrates their appeal.

Not surprisingly, bear market funds, which are essentially a direct bet against long equity market exposure, were the least correlated to the S&P 500 over the period, coming in at a negative 98% correlation.

Among other categories, the lowest correlations were shown by managed-futures funds at just 15%, followed by market-neutral funds at 20% and equity precious-metals funds at 35%.

The most-correlated alternative-fund categories were multialternative and long-short equity, both at 94%.

It is important to consider correlation among alternatives categories.

Long-short equity funds, for example, are just 18% correlated to managed-futures funds and 37% correlated to market-neutral funds.

Advisers who want to do best for their clients should consider alternatives regardless of their performance at any point in the market cycle.

Questions, observations, stock tips? E-mail Jeff Benjamin at jbenjamin@investmentnews.com