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Your financial planner: Are alternative investments right for you?

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When I was a kid, picking something off the McDonald's menu was easy because there were limited choices. Today, my kids have several choices and they can even get breakfast for dinner!

For investors, selecting a mix of stocks, bonds, and cash has traditionally enough to create a well-diversified portfolio. Much like the menu at McD of choices for investors has evolved to include several "alternatives" to sa for higher risk-adjusted returns.

So, what are these "alternatives", why are they becoming so popular, and place in your portfolio?

In order to understand what an "alternative" is, it's important to understa investments are categorized. Investments have traditionally been categori known as asset classes. An asset class is a group of investments that share risk/return characteristics and behaves similarly in response to economic events. Stocks, bonds, and cash have traditionally been used as the core b a portfolio because each has different risk/return characteristics and each differently in response to various economic and market events.

An alternative investment is commonly defined as an investment in an as than stocks, bonds and cash.

The list of alternative investments is long. Some are fairly well known and like real estate and commodities. Others are obscure, complex, and may the common investor. Examples of these include hedge funds, private equ products, among others.

One of the primary reasons for the rise in popularity in alternative investr investors are seeking more assets classes that have lower correlations to traditional asset classes like stocks and bonds. Correlation is the statistical factor that measures the relation between two asset classes.

When correlation is high between two asset classes, they typically act similarly during market cycles.

When correlation is low between two asset classes, they typically act dissimilarly during market cycles. Put simply, when one asset class zigs, the other zags.

By adding asset classes with lower correlations to each other, a portfolio becomes more diversified, thus reducing its overall risk. In the case of commonly used real estate and commodities, these asset classes can serve as inflation hedges in addition to providing more diversification.

So, are alternative investments right for you?

Before an investor can understand if alternative investments make sense to include in their portfolio, the investor first needs to understand his own goals and objectives. Once the goals of the portfolio have been established, the investor is then faced with the question of the optimal mix of various asset classes and understanding the role of alternative asset classes within the portfolio. The mix or asset allocation of the portfolio has been shown to account for 88% of the investor returns in studies by Brinson, Hood (1986) and confirmed by Beebower, Wallick (2012).

One of the first barriers in determining the optimal mix is a thorough understanding of the characteristics of the various asset classes.

As investment choices expand beyond traditional stocks and bonds, investors will find that alternative investments come with many different distinct properties. If an investor does not possess a clear understanding of the inherent risks or aspects of a particular investment, they should strongly consider excluding that investment because of the unintended consequences it may have.

Because of the complexity of many alternative investments, special consideration should be given to understanding the nature of these products. This should include but not be limited to liquidity, taxes, impact on estate planning, historical returns, conflicts of interest and fees. These many complexities don’t mean that alternative investments should be excluded, simply that an investor should proceed with caution.

Even if you are ready to go alternative, you may face challenges finding investment opportunities.

Most 401(k) plans, which are the primary savings vehicle for most investors, offer limited alternative investment options. The Government’s Thrift Savings Plan is about as vanilla as it gets with no alternative offerings. If you face this obstacle, look to see if your plan has a self-directed brokerage option where you can gain access to more investment choices. If you are over age 59 ½, some plans allow an in-service withdrawal which can be rolled over to a self-directed IRA where it can be further diversified.

For most though--especially those who want to keep things low maintenance--a simple allocation to stocks, bonds and cash may be a better solution than the inclusion of alternatives.

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