INVESTING

ALTERNATIVE ALOTMENT

Alternative Investments finding their way into Portfolios

By Jeffrey Vollmer

MARKET GYRATIONS have investors feeling like roller coaster riders. And many investors have climbed off feeling more than a bit ill. But not everyone.

College endowments saw portfolios return 16.9 percent in the 2007 fiscal year, reports InsideHigherEd.com. Unlike individual investors, the average endowment allocated 42 percent of its capital to alternative investments. And wealthy investors noticed.

The increasing acceptance of alternative investments is rooted in the bull market of the 1990s. As market indices pushed upward, investors abandoned diversified portfolios and sought out concentrated positions in "new economy" stocks. Then the bubble burst. The ensuing bear market provided a painful reminder of the folly of investment concentration. The discussion returned to modern portfolio theory. Asset allocation. Diversification.

Advances in technology enhanced the ability to track market correlations, the degree to which different asset classes move with one another. This led to a better understanding of how the addition of non-correlated asset classes could reduce risk. Investors realized that the correlations among traditional asset classes were at times greater than originally thought. Studies by the Journal of Financial Planning show that, during bear markets, the correlations between small, medium and large company stocks increased. So reducing protection against market downturns.

The increased demand for low-correlated investment strategies goes beyond providing a hedge for market downturns. It reflects a desire to achieve positive returns each year regardless of U.S. market performance. If the S&P 500 is down 10 percent, the fact that your large cap growth fund is only down nine percent is of little solace.

Capital preservation is not enough.

The financial services industry answered the call by introducing asset classes and investment strategies that fall into four categories:

1. **Real estate-related investments like REITS, limited partnerships and foreign real estate**

2. **Commodities-related investments like futures and mutual funds**

3. **Non-traditional asset classes linked to stock and bond assets, like emerging growth, emerging market and micro-cap stocks, as well as foreign bonds**

4. **Non-traditional investment strategies, which invest in traditional asset classes like stocks and bonds, but do so in ways not generally used by traditional portfolio managers, like hedge funds, fund of funds, private equity and venture capital deals**

Alternative investments share identifying principals. Lower correlations with traditional asset classes. They are generally not listed on exchanges. They often lack transparency and are less regulated. Finally, alternative investments can be complicated, subject to higher fees, and they tend to be less liquid than traditional investments. Still, these investments are proliferating as investors search for ways to reduce volatility and enhance returns.

The acceptance of non-traditional asset classes has forced investors to rethink portfolio construction. Advisors will often create two portfolios. A "core" portfolio of traditional investments meant to capture the market movements of the underlying indexes. And a "satellite" portfolio which is invested tactically in low-correlated investment strategies, enabling the portfolio to benefit by inefficiencies in market movements over time.

The availability of alternative investments has blossomed with the creation of vehicles that bring the risk management benefits of alternatives to mainstream investors.

"If we step back and look at the big picture, we are mid-stream in the biggest fundamental asset allocation realignment in the last 20 years," said Glenn Davis, of Eager, Davis and Holmes. "The Movement to alternatives is as big as the movement to international that gained traction in the 80's or the movement to equities with the passage of ERISA."

The alternative investments groundswell represents a fundamental shift in the means by which investors save, invest, and plan for the future. Used properly, alternative investments can enhance a core portfolio, helping to lower risk and improve returns in any market environment.

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S&P 500 INDEX FUNDS

By Howard McEwen, CFA

PASSIVE investment advocates, media pundits, and mutual fund expense hawks often hype the value of S&P 500 Index funds for simplicity and low costs. And investors have listened. The total dollars in S&P 500 Index Funds has gone from $19,639,000 in 1993 to $385,984,000 in 2007.

While investing in an S&P 500 index fund may be better than not investing at all, investors have found problems. The Investment Company Institute's 2007 Mutual Fund Fact Book details that, while other index funds grew between 2005 and 2007, cash flowed out of S&P 500 Index during the same period.

DEFINITION

S&P 500 Index funds invest in the companies listed on the S&P 500 Index. Those companies are chosen annually by an eight-member committee of employees of Standard & Poor's – a division of McGraw-Hill Publishing. Dave Guarino, spokesman for Standard & Poor's said the firm doesn't release the names of committee members.

MECHANICS

S&P 500 Index funds are not evenly diversified, but weighted. Stocks with higher market capitalizations - total number of shares issued multiplied by the price per share -make up a higher portion of the index. As of August 27, the index's top 10 holdings made up nearly 20% of the value of the index. The remaining 80% is split up among the 490 other companies.

ADVANTAGES

The index is low cost and easy to understand. Because it is tied to the S&P 500 stock index, its make up is not controlled by fund managers and the index's low portfolio turnover rates mean less taxes passed on to the investor.

DISADVANTAGES

Some of the advantages of the S&P 500 Index also work to disadvantage. Index funds are low cost, but there is still a cost. Fund companies tout that their funds track the S&P 500, but they will always fall just a bit short- the tracking error. The costs associated with buying all the stocks in the S&P 500 are naturally going to lower – just slightly – the returns. Needless to say, an index fund is never going to beat the index. Announcements of changes in index companies drives down the price of those being removed and artificially inflates the prices of those being added.

S&P 500 COMPOSIT INDEX PERFORMANCE

TOTAL RETURN (AS OF 6/30/08)	
1 YEAR	-13.22%
5 YEARS	7.58%
10 YEARS	2.88%
SINCE INCEPTION	11.49%

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