AMI INVESTMENT MANAGEMENT
Registered Investment Advisor

Memo to: Clients and Contacts
From: AMI Investment Committee
Re: Alternative Investments
Date: November, 2015

So-called "alternative investments" have become increasingly popular among investors. Pioneered, with success, by institutional investors like Harvard and Yale, investors have become enamored with the idea of adding diversifying investments to their portfolios which may be less driven stock prices or interest rates. Fund companies ask, "Why settle for boring stocks and bonds when you can have these sexy investments?" Unfortunately, in practice this often translates into overpriced, inefficient investment products.

The theory is attractive – by adding investments to your portfolio that behave differently from stocks and bonds, you can reduce risk without adversely affecting return. Three good things is decidedly better than two good things. But as Yogi Berra once said, "In theory there is no difference between theory and practice. In practice there is."

To begin, we take issue with the term alternative investments. What does it mean? Does it simple mean "not stocks or bonds"? Or does it mean expensive and illiquid hedge funds or private equity funds? The answer is that it means different things to different people, and there are a huge swatch of very different types of investments that get grouped under a single term, a disservice to investors.

First and foremost, investors should differentiate between *alternative asset classes* and *alternative investment structures*. Alternative asset classes refer to types of investments that one would expect to behave differently than stocks and bonds in response to certain economic variables. Examples include real estate, high yield bonds and commodities. Alternative investment structures refer to the type of investment vehicle, such as a mutual fund or a limited partnership (i.e. hedge fund or private equity fund). An alternative asset class may reside in a traditional investment vehicle and vice versa. For instance, a mutual fund, which is considered a traditional investment structure, may invest in exotic assets such as commodities futures or distressed debt and a hedge fund, which is an alternative investment structure, may invest in traditional assets such as stocks and bonds.

In any event, we believe that most investors need not worry much about either area. Members of both typically come with elevated expenses and often don't deliver the necessary returns or diversification to justify their fees. Occam's razor dictates that the simplest path should be chosen among competing hypotheses. The time-tested stock/bond portfolio will be tough to beat long-term.

That being said, some "alternatives" aren't really that alternative at all, and there is no reason the disciplined investor can't consider their merit. Consider real estate investment trusts (REITs). REITs trade just like a stock, the only difference being that they don't pay corporate-level taxes. They are essentially regular businesses who just happen to be in the business of owning real

Phone: (260) 347-1281 · Fax: (260) 347-1282 · P.O. Box 247 · 710 North Krueger · Kendallville, IN 46755
www.AMIinvestment.com

estate. Owning real estate is by no means a bad thing, and it isn't that different from owning a stock or a bond. The REIT investor owns an interest in real property that produces income and pays dividends. REITs also have an added benefit: theory predicts that during times of elevated inflation, REITs should hold up better than stocks or bonds, adding a layer of protection to the portfolio. And REITs can be accessed in a low-cost manner.[1]

Similar arguments could be made for high yield bonds, treasury inflation protected securities (TIPS), and some other "alternative" investments. If accessed in a low-cost vehicle, there isn't a strong reason to exclude these assets from an investor's portfolio. That being said, there isn't necessarily a strong reason to include them either, and investors run the risk of distracting themselves from their core long-term goals by making their investment strategy more complicated then needed.

We approach the topic in the following way: We keep these investment options in our toolbox, utilizing them during periods of market extremes, when a conservative projection of returns on the given alternative investment far outpaces an aggressive projection of returns on a stock/bond mix *with a similar risk profile*. If inclusion is limited to such periods, and costs are kept low, these "alternative" investments could add value to a portfolio without increasing risk; indeed, they could actually help reduce risk. But it is incredibly important that the investor understand what he is buying and be able to articulate why he expects attractive long-term returns from the investment.

Very often hedge funds and private equity funds end up owning nothing more than stocks and bonds. There can be interesting investment opportunities in these fields, but they are often associated with several drawbacks, including high fees, illiquidity and opaqueness. They can offer intriguing investment partnerships and attract some of the most talented investment managers, but they should be approached with great caution and care. Again, investors don't need these structures to be successful, and minefields abound.

[1] The Vanguard REIT index fund charges just 0.12% per year.