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TODAY'S ASSET ALLOCATION
A Look at Non-Traditional Asset Classes

Never put all of your ***investment*** *eggs in one* ***asset class*** *basket*. Plenty of doc.com investors learned that lesson the hard way when the Internet bubble burst shortly after the turn of the decade/century/millennium. Unfortunately, many had short memories and relived the nightmare during the subprime debacle and related credit crisis when many stocks and certain high-yield bonds again fell from grace. And, thus, the search continued for those investments that complement the rest of the portfolio and perhaps even help protect investors from dramatic losses during periods of negative performances in certain markets.

Through the years, investors have built portfolios around the traditional asset classes of stocks and bonds and the various sub-classes of each: large-, mid-, small-cap stocks; value and growth stocks; government-backed, corporate, mortgage-related, and municipal bonds. In recent times, however, many investors have included non-traditional asset classes within their portfolios to achieve even greater diversification and "hedge" themselves during periods of uncertainty that may lead to negative returns incurred by more traditional stocks and bonds. Today more and more investors are turning to international and emerging markets, commodities, and even real estate through vehicles like publicly-traded REITs. Institutional and ultra high net worth investors have also looked more closely at hedge funds and private equity.

A Highly Correlated (or an Inverse) Relationship…

The concept of correlation is critical to structuring well-diversified portfolios with realistic return expectations for the levels of risk investors are willing to accept. It measures the relationship in price movements between different asset classes (securities) over various market environments. After all, true diversification requires ownership of assets that respond differently to fundamental market forces and advisors desire these diverse classes for their clients' portfolios.

A correlation of close to +1.0 (+100%) implies that two assets (classes of securities) will move very similarly regardless of the shift in the economy, the direction of interest rates, or the performances of the overall markets. Therefore, a portfolio that holds several securities with correlations of close to +1.0 will not achieve much diversification as they most likely will perform quite similarly in both positive and negative market environments. (Years ago, some investors thought they were well-diversified by holding a portfolio of multiple dot.coms, only to find that each of these performed poorly when the bubble ultimately burst.)

On the other hand, correlations of close to -1.0 implies an almost inverse relationship between the two assets. When one rises, the other falls. Advisors and their investors should be aware of correlation characteristics when structuring portfolios. In fact, a well-diversified portfolio should always have certain securities performing well, while others are lagging, regardless of the market or economic environment.

Traditionally Non-Traditional…

Many investors have been including certain non-traditional assets in their portfolios because they have lower (or even negative) correlations with traditional stocks and bonds.

- ***International*** and ***emerging market securities*** have allowed for participation in foreign markets that may not be as directly tied to the domestic economy (and the negative impact suffered by companies in the credit crisis).

- Likewise, ***commodities*** like energy, metals, and grains often maintain low or negative correlations to traditional asset classes and have provided strong returns and excellent relief for many in the current environment.
- ***Absolute return investments*** aim to earn positive returns regardless of the market or economic conditions. While they may underperform during strong periods in the equity markets, they can provide excellent stability (and peace of mind) during times of uncertainty.
- ***Hedge funds*** and ***Private equity*** are typically highly illiquid and reserved for only institutional accounts or high net worth investors who do not require periodic cashflow.

Which Brings Us to Real Estate…

While many institutions have sought the appreciation and cashflow potential of real estate investments as a complement to traditional asset classes, the opportunities to participate are limited for most retail investors. They can buy stock of publicly traded developers and builders, though such companies have struggled mightily in the deteriorating housing market. While some individuals choose to own rental properties for appreciation and/or cashflow purposes, time and cost commitments may prohibit them from diversifying into multiple units across various regions.

The most common structure of real estate for the retail investor has been publicly-traded REITs, which essentially are modeled like a mutual fund for real estate in which investors own a pro-rata share of various properties. REITs can invest in a variety of real estate properties: retail centers, office buildings, industrial facilities, multi-family apartments, hospitality (hotels), nursing homes, and even international projects. These investments typically distribute cashflow from the periodic rentals received on the underlying properties. However, like more traditional stocks, public REITS may be subject to the daily pressures and gyrations of the overall markets and may experience price volatility.

Core-Satellite…

For years, individual investors were unable to participate in these non-traditional asset classes because of illiquidity and minimum required investments. However, the relatively recent emergence and popularity of specialized industry sector funds/ETFs, commodity funds/ETFs, country and regional funds/ETFs, and real estate funds/REITs now allow knowledgeable individuals the opportunity to invest in these markets. Advisors often help structure what are known as "core-satellite" portfolios for their clients by complementing the more traditional "core" asset classes like large-cap growth stocks and government bonds, with less correlated "satellite" pieces to provide greater diversification and return potential.

In most cases, the core classes will comprise the majority of the assets within the portfolio, with 10%, 20%, 30% of non-traditional satellite investments making up the rest. In particular, in recent times, the opportunity to own energy-related securities and other commodities has proven quite beneficial as large sophisticated institutional investors have turned to those markets as a hedge against a declining dollar, inflation, and the subsequent equity challenges. Of course, these allocations should only be made based on the goals and financial objectives of the individual investors.

Call to Action…

Financial advisors can prove quite helpful in structuring well-allocated, core-satellite portfolios that include non-traditional asset classes. Let your advisor help explain the concept of correlation, the benefits of diversification, and the implication for your investment portfolios.