



## **BEYOND STOCKS AND BONDS: POWERFUL ALTERNATIVES FOR PRE-RETIREEES**

Many investors within five to 15 years of retirement are worried. On one hand, they're scared that another sharp market drop could devastate the stocks they're using to grow their portfolios for a comfortable retirement. On the other hand, they see the risk that supposedly safe investments such as Treasuries could fall in value. In this paper we explore how certain alternative investments can reduce this anxiety and boost financial advisors' value in their eyes.

## Skittish investors crave new solutions

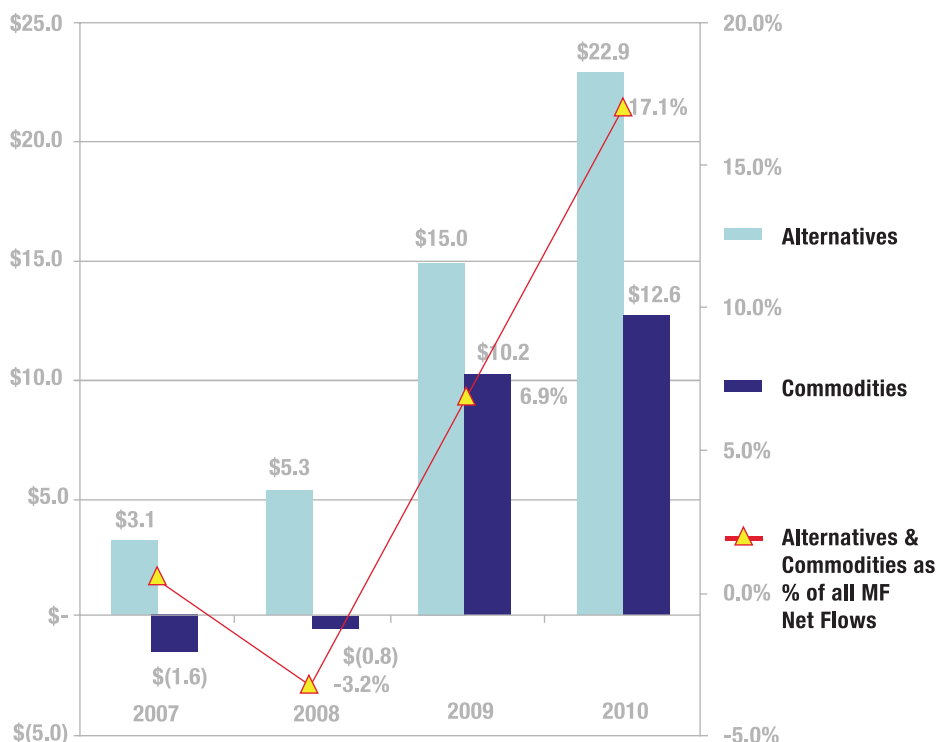
The sharp market decline of 2008 to 2009 derailed the confidence of individuals who'd thought they were on track to a comfortable retirement. Pre-retirees feel especially vulnerable. It takes time to recover from such a drop, and that's something these pre-retirees lack. They differ from young investors who have years to benefit from compounding and employer-matched defined contribution plans. The size of their portfolios also distinguishes pre-retirees from younger folks. Vanguard research on new defined contribution plan enrollees found that "...older investors, who are closest to retirement, were more likely not to hold stocks as a response to market volatility."<sup>1</sup> By their fifties, they may have accumulated significant assets, so they've got a stake in principal preservation, a goal with which conservative alternatives can help.

Bonds, the traditional refuge of skittish investors and income seekers, don't look much more attractive than stocks to savvy investors. U.S. Treasuries appear poised for a fall and all bonds are threatened by inflation, which typically decreases their value. Moreover, an unexpected rise in inflation will mean that formerly adequate income from bonds will fall short.

Individual investors are turning to types of alternative investments that have the potential to offset the weaknesses of stocks and bonds. This is reflected in the large flows into alternatives (see Exhibit 1).

## Alternative and Commodity Mutual Fund Net Flow and % of Industry Total 2007 -2010

Exhibit 1



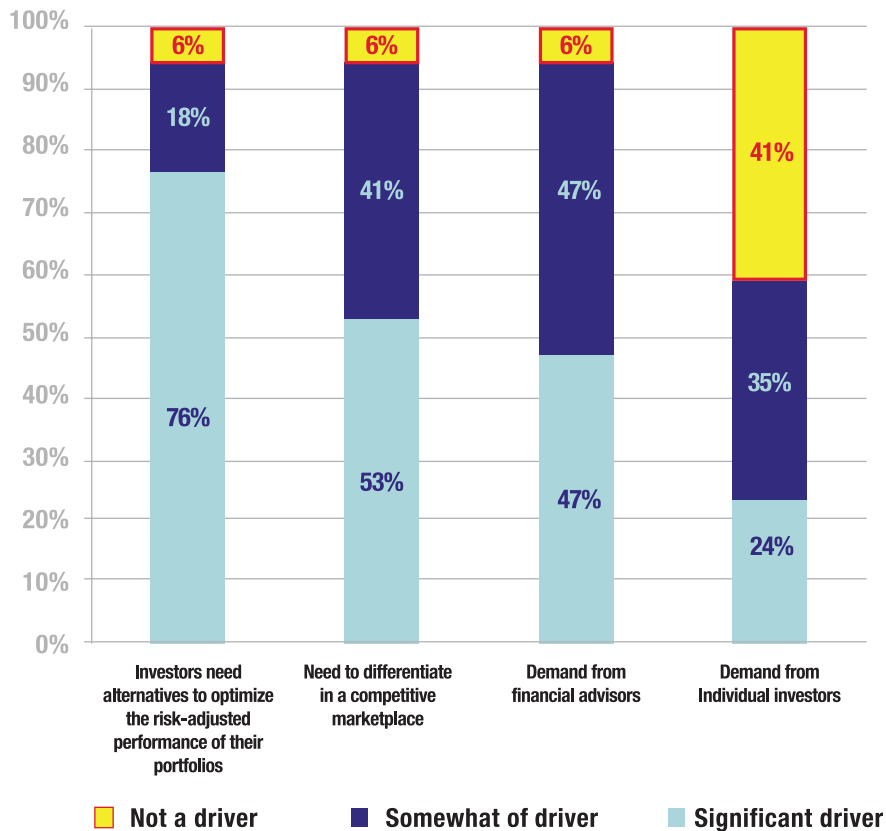
Source: Morningstar Direct

<sup>1</sup>"Generations: Key drivers of investor behavior" (Spring 2011), p. 4.

The trend is driven partly by investor demand, but even more by advisors’ recognition that “Investors need alternatives to optimize the risk-adjusted performance of their portfolios,” as revealed by a Cerulli Associates study (see exhibit 2).

## Key Drivers of Interest in Alternative Investments

Exhibit 2



Source: Cerulli Associates

For the purpose of this paper, we define alternatives as investments that use tools not traditionally available in mutual funds. They’re a diverse bunch, but fall into three major categories, including the use of shorting, leverage, and financial engineering, which includes instruments such as derivatives, puts, calls, futures, and forwards. This is not a homogeneous category.

Here's how Envestnet views alternatives in terms of strategies:

Exhibit 3

Strategy	Objective
Enhanced Equity	<ul style="list-style-type: none"> <li>▪ Increase the outperformance potential of a portfolio</li> </ul>
Hedged Equity	<ul style="list-style-type: none"> <li>▪ Limit equity market exposure while staying invested in stocks</li> </ul>
Market Neutral	<ul style="list-style-type: none"> <li>▪ Capitalize on a non-trending equities market by singling out stock picking ability and targeting zero equity beta</li> </ul>
Bear Market	<ul style="list-style-type: none"> <li>▪ Take advantage of declining market periods</li> </ul>
Strategic Income	<ul style="list-style-type: none"> <li>▪ Tactically position bond exposure to take advantage of opportunities</li> </ul>
Multi-Strategy	<ul style="list-style-type: none"> <li>▪ Diversify across different alternative strategies to provide broad exposure or</li> <li>▪ Tactically shift the allocation to Capture opportunities</li> </ul>
Hedged Equity	<ul style="list-style-type: none"> <li>▪ Tap into an additional asset class to access unique beta and potential alpha</li> </ul>

## Help pre-retirees with volatility and inflation

The alternative investments discussed in this white paper aren't the aggressive investments aimed at speculators or the very wealthy. Instead, they offer a range from low to negative correlations with traditional investments. Investments that behave differently can offer the greater stability that near-retirees crave and need. This means alternative investments can dull the impact of volatility and inflation on portfolios. They can enhance income as well as returns. They may even offer positive returns when traditional investments sink. Of course, there's some trade-off in the sense that alternatives may underperform when a traditional portfolio shines.

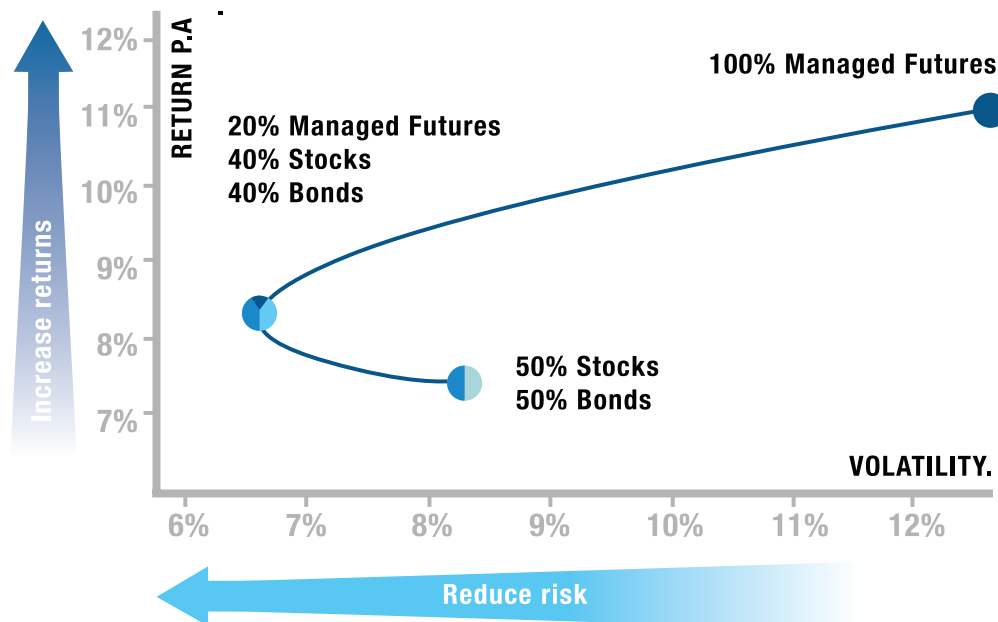
## Reducing volatility

Alternatives can enhance portfolio diversification, improving the risk-return tradeoff. As Goldman Sachs Asset Management has noted, “Historically, alternative investments such as hedge funds have had lower volatility levels than equities, and they have generally delivered attractive risk-adjusted returns. Over the past decade, hedge funds, as measured by the HFRI Fund Weighted Composite Index, have returned 6.1% on an annualized basis with 6.6% standard deviation, compared to the S&P 500, which has returned -1.5% annualized returns with a 16.1% standard deviation.”<sup>2</sup> Hedge funds also outperformed global stocks for the three-year and five-year periods ending Dec., 31, 2010.<sup>3</sup>

Exhibit 4 shows an example of how incorporating one kind of alternatives—managed futures—influences a portfolio’s risk and return. The optimal mix of stocks, bonds, and managed futures would have significantly lowered risk while boosting return over the decade ending Feb. 2008.

### Optimum Portfolio Mix (01/1987 - 02/2008)\*

Exhibit 4



- \*1) Managed futures: CASAM CISDM CTA Equal Weighted
- 2) Stocks: MSCI World
- 3) Bonds JP Morgan Government Bond Global

Source: Bloomberg

It’s commonly accepted that adding investments that are less correlated—or negatively correlated—is one of the better ways to reduce volatility. Certain alternative investments fit this bill. For example, the correlations of Morningstar’s hedge fund indexes have ranged between 0.87 to 0.04 over the eight years since inception in Jan. 2003<sup>4</sup> (See Exhibit 5).

<sup>2</sup>Breaking with Tradition: Mutual Funds Offer an Alternative Route” (September 2010), p. 4.

<sup>3</sup>Morningstar Alternative Investments Observer (First Quarter 2011), p. 22.

<sup>4</sup>Morningstar Alternative Investments Observer (First Quarter 2011), p.26.

Correlation of Hedge Funds to U.S. Stocks and Bonds	S&P 500 Correlation (USD)			BarCap US Agg Correlation (USD)		
	3-Year	5-Year	Since Index Inception 01-01-2003	3-Year	5-Year	Since Index Inception 01-01-2003
Morningstar 1000 HF USD	0.81	0.79	0.77	0.28	0.18	0.17
Morningstar Convertible Arbitrage HF USD	0.72	0.70	0.65	0.44	0.37	0.30
Morningstar Corporate Actions HF USD	0.75	0.74	0.73	0.25	0.16	0.13
Morningstar Debt Arbitrage HF USD	0.71	0.69	0.65	0.42	0.35	0.34
Morningstar Distressed Sec HF USD	0.66	0.66	0.66	0.03	-0.03	-0.01
Morningstar Dvlp Asia Equity HF USD	0.81	0.76	0.70	0.30	0.21	0.11
Morningstar EM Equity HF USD	0.80	0.76	0.74	0.24	0.15	0.17
Morningstar Equity Arbitrage HF USD	0.64	0.61	0.58	0.36	0.21	0.22
Morningstar Europe Equity HF USD	0.76	0.74	0.72	0.28	0.16	0.16
Morningstar Global Debt HF USD	0.72	0.70	0.67	0.37	0.30	0.29
Morningstar Global Equity HF USD	0.82	0.79	0.79	0.29	0.18	0.13
Morningstar Global Non-Trend HF USD	0.48	0.44	0.43	0.37	0.23	0.28
Morningstar Global Trend HF USD	0.11	0.17	0.21	-0.01	-0.06	0.08
Morningstar Multi-Strategy HF USD	0.78	0.76	0.73	0.23	0.13	0.15
Morningstar Short Equity HF USD	-0.05	-0.06	-0.04	-0.41	-0.35	-0.23
Morningstar US Equity HF USD	0.88	0.88	0.87	0.11	0.05	0.04
Morningstar US Small Cap Equity HF USD	0.89	0.88	0.87	0.12	0.06	0.03

## Offsetting inflation

Some kinds of alternatives offer the potential to outpace inflation and bond returns, when investors are willing to take on additional risk. For example, by going short, a manager could create a fund with a negative duration. Because duration is a measure of bonds' sensitivity to interest rates, such a fund could provide protection against rising interest rates. An alternative manager may also go long and short on specific bonds to take advantage of spreads that seem out of line with historical norms. Another possibility is to take advantage of global interest rate inequities by going long and short on interest rate futures.

## Presenting different risks

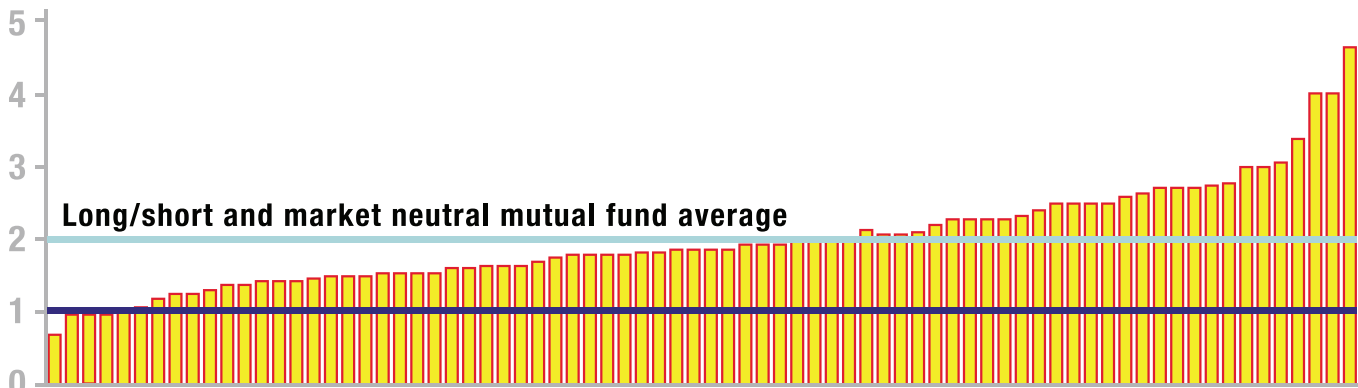
There's no free lunch. Alternative investments come with costs and risks. Alternative investments, even when packaged as mutual funds or ETFs, charge higher expenses than traditional investments (see Exhibit 6). However, mutual funds and ETFs charge less than hedge funds' traditional "two and twenty," a 2% management fee on assets and 20% performance fee.

Mutual funds and ETFs using alternative strategies face more constraints than hedge funds, especially when it comes to shorting and leverage. This may cause them to underperform their more freewheeling peers.

Alternative investments will sometimes underperform their traditional peers. It's part of the inevitable cycle of investments going in and out of favor due to market conditions.

## Fees Charged By Hedged Mutual Funds (Percent)

Exhibit 6



Sources: Company websites, Investment Company Institute, Morningstar, Finadium

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### Myths about alternatives

- **Alternative investments are only for rich folks.** Once upon a time these investment strategies were mainly available in limited partnerships for the very wealthy. You needed big bucks to qualify to invest. No longer. Today these strategies are available as mutual funds and, to a lesser extent, exchange-traded funds (ETFs) with much lower investment minimums than hedge funds. They also offer investors ongoing access to their assets, another advantage over hedge funds, which limit redemptions.
- **Alternative investments are a magic bullet.** There is no investment that will protect you—and maximize your returns—in all market environments. In a year when all other investments tank, alternatives are likely to suffer, too. However, they may fare better than traditional investments, as we saw in 2008-2009.
- **Alternative investments are Ponzi schemes.** The Bernie Madoff scandal misleadingly associated hedge funds with fraud. The vast majority of hedge funds are legitimate. In addition, mutual funds and ETFs using alternative strategies, as required by law, disclose much more than hedge funds.
- **Alternative investments will complicate your tax reporting.** If you invest in alternatives using mutual funds or ETFs, you'll avoid the need to file for a tax-filing extension due to late-arriving K-1 tax forms issued by hedge funds. Mutual funds and ETFs aim to issue their tax documents by the end of January.

## How to use alternatives in pre-retiree portfolios

Investors could typically trim some of their allocations to stocks or bonds to invest in alternatives. Alternatives are a complement to—not a replacement for—traditional investments. Actual allocations depend on risk tolerance and other needs and circumstances. For example, for an investor who's leery of volatility, they may replace part of the allocation to stocks with an allocation to managed futures, which have been negatively correlated with stocks.

Given a choice, it's probably best to put alternatives in the non-taxable portion of a portfolio. Alternative strategies tend to generate short-term capital gains because of their high turnover.

The percentage allocation to alternatives will vary with the size of the portfolio and other circumstances. Generally a range of 10%-30% makes sense. It probably makes sense to decrease and adjust the allocation as clients near retirement, becoming more income-oriented. For example, the portfolio might shift out of more aggressive strategies, such as long/short equity and managed futures into more conservative strategies, such as fixed income arbitrage. This is mainly true for individuals who lack the liquid assets to fund their retirement spending out of their pre-retirement portfolio.

There's typically no minimum account size for using alternative investments in the form of mutual funds or ETFs, unlike the \$1 million investable assets minimum imposed by the SEC for hedge funds. However, investors may use \$250,000 as a rough minimum. This lets them create a portfolio that's well-diversified across traditional asset classes before they dip their toes into alternatives. It also allows them to afford the higher investment minimums that alternative mutual funds or ETFs may impose. Once an investor's liquid net worth rises above \$2 million to \$5 million, it may be time to consider limited partnerships for their greater investment flexibility. Again, it's a matter of minimum investments, which may run \$500,000 to \$1 million for limited partnerships.

Due diligence is essential. All alternatives are not created equal. Even within the same category, portfolio managers use diverse strategies and produce widely varying results in terms of both risk and return. So advisors need to research which managers are most appropriate for their clients' needs. ■

### Disclaimer

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