ANALYTICS INVESTMENT ADVISORS, LLC

ALTERNATIVE INVESTMENTS

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In seeking a different investment path, one may wish to consider alternative investments that sidestep the traditional asset classes, such as real estate, cash, stocks and bonds. In doing so the goal is to obtain a greater return from a more complex and potentially riskier set of circumstances. While Analytics Investment Advisors, LLC does not generally employ many of the options summarized below, certain techniques have periodically been efficacious, an example of which is presented at the end of this commentary.

Hedge funds, private equity funds and venture capital funds. These distant cousins of mutual funds are not for the average investor and offer the possibility of superb returns at considerable risk. Generally speaking, it takes a lot of money to get into one of these funds and they are not for the skittish. [1,2]

Oil and natural gas programs. Direct participation oil and gas investments can produce great returns, or miserable ones - depending on the temperament of the energy markets. Oil and gas investment programs often have high minimums, and navigating these programs can require a veteran eye.

Timber investing. Timber REITs (real estate investment trusts) allow the small investor to participate in this asset class. Timber has historically had very low correlation with the stock, bond, and commercial real estate markets and inflation.[3,4]

REITs. Real estate investment trusts (which can be private or publicly traded) allow the small investor a way to participate in the commercial real estate sector without the burden of property management. REITs must pay out about 90% of their annual income, so they are encouraged to pay high dividends to unit-holders. The drawback is that the IRS regards that annual dividend as taxable income.[5,6]

Options and LEAPS. Options contracts give the holder an option to buy (a call) or sell (a put) a specific amount of a stock, ETF, currency, debt instrument or commodity at a specific price within a specific period of time. High net worth investors consider option contracts because of the potential income from covered calls, the possibility of locking in some profits as a consequence of buying puts, the chance to hedge by selling covered calls and buying puts simultaneously, and the opportunity for added portfolio diversification. Long Term Equity Anticipation Securities (LEAPS) are long-term options contracts (commonly 2-year options).

Futures and E-mini futures contracts. Retail futures traders try to speculate on price movements of all manner of commodities and even gauges of volatility. A small investment of thousands of dollars may allow an investor to control a futures contract worth many times more, so the leverage is really significant. But losses can be significant as well. E-mini futures are smaller versions of larger futures contracts. They generally have a lower minimum than standard futures contracts, but are also potentially subject to the well-publicized shocks of electronic trading rather than the action in the old-school trading pit.

Managed futures. Investing in managed futures means selecting a rigorously regulated professional money manager – a commodity trading advisor, or (CTA) – that invests in commodity, currency and even equity index futures on your behalf. Most CTAs do this through proprietary trading systems. It generally takes $50,000 or more (sometimes much more) to invest in a managed futures account. As this is commodities trading, substantial and sudden losses may occur, as well as substantial and sudden gains.[7]

Real-return securities. Also known as inflation-indexed securities, these are typically notes or bonds with coupon payments linked to inflation rates. The issuer guarantees that the security's return will outperform inflation if the security is held to maturity.[8]

Market-neutral funds. Cautious investors have looked into these vehicles, which are sometimes called long-short funds. Their money managers commonly work with a goal of buying call options to capture some upside and buying put options and derivatives to hedge on the downside. Unsurprisingly, some of your potential for gains may be tempered as a result, and returns may be underwhelming when the bulls are running.[9]

Global macro funds. These are actually hedge funds that seek to take positions in the markets according to macroeconomic principles.

Business development companies (BDCs). These corporations are cousins to venture capital funds. BDCs have to invest 70% of their assets in private or public corporations and pay out 90% or more of their taxable income as dividends. [10]

Currency funds. Mutual funds and ETFs that invest in foreign currencies gain allure when the dollar weakens. These funds are run by an investment manager and employ some tactics of hedge funds, yet are available to the small retail investor.

Collectibles. By acquiring seasoned knowledge of supply and demand forces and trends in the coin, stamp, art and hobby markets, profit can be made far from Wall Street; it may take years of insight (and great instincts) to truly come out ahead.

The advent of exchange traded funds (ETFs) has made participation in many of the alternative investments described above easier to effectuate and more manageable by providing greater transparency. For example, investors now have the ability to leverage purchases of ETFs to double or triple returns. While this seems like a good idea for long-term investors, rebalancing can cause serious long-term compounding issues generally referred to as "constant leverage gap". The predominant conclusion from most studies of leveraged ETFs is that long-term investors need to be cognizant of volatility levels and devise a strategy which anticipates and accounts for this phenomenon.

One such technique is the use stop orders based on the standard deviation of specific leveraged ETFs. By placing a stop order, an investor makes a decision about the selling point before the actual sale, and in so doing, reduces the risk of significant portfolio diminution. But, while losses cannot be eliminated by assuming the normal distribution of price movement, it is possible to predict a range of outcomes. For example, if an investor is willing to accept a 16% chance to be stopped out due to random volatility, a one standard deviation stop order would be the decision rule. Probabilities of 7% and 2% correspond to 1.5 and 2.0 standard deviations, respectively. Having applied this methodology recently for several clients (with a high risk tolerance) to QLD (ProShares Ultra; ProShares QQQ x 2) has generated an annual return of 50.5% since March 2011.

Citations.

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