

# GOING LONG

Detterbeck Wealth Management, Inc.



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## ALTERNATIVE INVESTMENTS

*By Les Detterbeck* Strategic portfolio construction is the most important step that investors take. Most people have their Christmas Wish List for their investments: higher returns and lower risk. Believe it or not, there may be a Santa Claus in alternative investments. When added to traditional assets, they may actually increase return and lower risk. Here's why.



Most people think of stocks and bonds as the "traditional" asset classes. Alternative investments can include real estate, hedge funds, equipment leasing, private equity, commodities, oil and gas programs, closely held companies and other investments.

The addition of alternative investments to a portfolio can provide not only diversification but also attractive returns and lower portfolio volatility. The key is that many of these investments have a low correlation to stocks and bonds. Hence, for example, when stocks are down, other assets, such as private real estate or equipment leasing may be up.

On the other hand, the problem with alternative investments is that generally they are by themselves riskier and less liquid than traditional investments. Hence, a diversified portfolio of stock and bonds should be the core of an investment portfolio; alternative investments should complement the core holdings and generally not exceed 30% of the portfolio.

Here is some brief information and examples of alternative investments:

**Private real estate** - Real estate is a tangible asset that has the potential to produce income and increase in value over time. Real estate investments can help investors preserve capital, stay ahead of inflation, generate income and create capital appreciation. Because movements in the real estate market have traditionally had a low correlation to the movements in the stock and bond markets, many investment professionals consider real estate a key component of a fully diversified asset allocation plan. Private real estate is not as liquid as stocks and bonds and often is concentrated in a few specific properties.

**Publicly traded real estate** - These are generally organized as Real Estate Investment Trusts (REITs). The good news is that they trade like stocks, so they are very liquid. The bad news is that they are correlated more closely to the stocks (.52 to 1) and bonds (.34 to 1) than private real estate (that has roughly a zero correlation to stocks and bonds). REITs are required to distribute 90% of their taxable income, so investors typically plan on receiving cash distributions of 6% or more of their investment.

**Hedge funds** - During the past decade, hedge funds have gained in popularity, as indicated by their large increase in assets under

management from \$40 billion in 1990 to an estimated \$600 billion in 2002. Our newsletter article in May 2002 provided many details concerning hedge funds. Generally, hedge funds attempt to eliminate market risk, through use of short positions and augment returns using leverage. In effect, market risk is replaced by security selection risk and leverage risk. So, when the stock market is weak, hedge funds perform well, though they are less likely to perform relatively well when the market rises. While the returns of certain funds has been consistent, overall returns for hedge funds over the last six years are not necessarily any better than mutual funds and, according to some studies, not as good.

**Equipment leasing** - Eight out of ten businesses lease some of the equipment needed in their business. Investors provide the capital for this equipment. Their yield on investment is based primarily on rent payments that must be made regardless of business conditions and residual values at lease end. Many of these programs pay regular monthly cash distribution averaging 8-9% annually. Again, this is not a liquid investment as the investment term is usually five to ten years. Also, due to depreciation on the equipment, there are tax advantages which may include, for example, that the cash payments in early years are tax deferred.

**Private equity** - The popularity of the venture capital and leveraged buyout (LBO) businesses, which comprise the private equity market, has cooled in recent years. The buyout industry first had problems in the late 90s and early 00's with astronomical pricing and then, when the bubble burst, lack of profitable companies looking to sell. For an investor in private equity, there is the hope for improved returns over traditional assets. However, private equities are not only illiquid and typically have a long time horizon, but the valuation of private equity is more subjective due to the infrequency of interim valuations.

Index	Average Return ('90-'02)	Standard Deviation ('90-'02)
S&P 500	11.29	18.53
Lehman Brothers Aggregate Bond Index	8.41	5.64
NAREIT Real Estate Investment Trusts	11.59	16.41
NCREIF Property (Commercial Real Estate)	6.62	6.39
Nat'l Assn of Realtors (Residential housing)	4.54	2.53
Cambridge Associates Private Equity Funds	13.45	13.75
HFRI Fund Weighted Composite Hedge Fund	15.05	11.68
HFRI Fund of Funds	10.62	9.81
Barclay Commodity Advisors	7.23	6.41

**Commodities** - Assuming that price increases will flow through commodities, investors typically consider using commodity investments to hedge against unexpected inflation, so that if stocks and bonds are losing value because of inflation, commodity contracts would be increasing in value. We have no clients that invest directly in commodities. However, we have looked at commodity indexes for some. Commodity indexes emulate direct commodity investment because they are based upon either commodity futures contracts or cash markets. There are subindexes in agriculture, energy, industrial metals, livestock, energy and precious metals. Although these indexes underperformed on an absolute basis nearly every other investment class from 1990 to 2001, they can represent a positive addition to a portfolio because they are slightly “negatively correlated” to stocks. So, for example, if inflation occurs and drives the stock market down, commodities (and their indexes) will go up. Hence, an addition of commodities can reduce a portfolio’s standard deviation while maintaining its expected return.

**Oil and gas programs** - Another advantage of alternative investments can be the tax benefits. Oil and gas programs are an excellent example. Certain oil companies use outside investments to fund their drilling programs. Oftentimes, these are development wells (in already producing areas) and dozens of wells are drilled so that one or a few dry holes is not a problem. Furthermore, much of the investment is allocated to “intangible drilling costs” (“IDC”) the first year. The IDC is fully deductible to the investor and therefore, investors typically receive a 100% write-off of their original investment. As oil is produced in subsequent years, a depletion deduction of 15-25% will shield part of the distributions from tax. This investment is also a bit of a “commodity” play, since investors will receive additional revenue in the future if oil costs increase.

**Closely-held companies** - Fortunes have been made and lost in closely-held companies. Returns on assets and returns on equity can far surpass other investments. Furthermore, if the owner manager knows “his business”, he or she will hopefully have a greater return for their time and investments than any other investment. The problem is that oftentimes their “company” may represent almost their entire investment

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portfolio and also be the source of almost all of their annual income. When this investment is performing poorly, it can mean disaster. Hence, it should be a strategy of the prudent business owner to start to diversify his or her portfolio into other assets, and in many cases to traditional stocks and bonds, as soon as possible. A sale of a portion of stock to an Employee Stock Ownership Plan with a tax-free reinvestment of the proceeds can be an excellent way to start this diversification.

In summary, we hope we have given you a quick recap of alternative investments and their advantages and disadvantages. Since we have just finished Thanksgiving, maybe we can think of it this way. Stocks and bonds should be the turkey and potatoes (with apologies to the vegetarians and dieticians) of the investment portfolio. However, don’t forget to include the alternative investments that can represent the cranberries, green bean casserole, and pumpkin pie. Depending on your palate, this can produce a much more rewarding dining and investing experience.

Please call us if you have any questions.



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