

Business Forum: Balance stocks, bonds with alternatives

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The bad news is starting to hit: The Minneapolis Teachers Pension fund is underfunded by more than \$851 million; the Bloomington Fire Department's fund is one of the poorest performers in the state, and nationwide, pension funds are struggling to meet future obligations, the result of higher benefits in many cases and almost always lower-than-expected returns.

What's going on here? Five years of lackluster returns in the stock market coupled with low bond yields that provide precious little income for funding current obligations. It's the same problem facing millions of individual investors caught with too much money in their company's stock or in a lopsided mix of mutual funds. This lack of diversification exposes everyone to the same volatility – and mediocre returns – now plaguing the broader equity and fixed-income markets.

The more volatility in an investment portfolio, the greater the risk you won't meet your financial goals. This is why in the past several years the most sophisticated investors have embraced alternative assets.

Everyone should pay attention: Alternative investments are a very big deal, equal in magnitude to the emergence of mutual funds and managed assets. And while some funds have suffered with a more traditional mix of assets, many pension funds have not. In fact, the average pension fund has a remarkable 35 percent of its assets in alternative investments.

Alternative assets are any investments that exhibit a low "return correlation" with stocks, bonds and cash, which is a fancy way of saying that when your stock and bond portfolios zig, alternative assets zag.

Real estate, perhaps the most common alternative investment, ranges from raw land – highly illiquid and speculative – to apartment and office buildings, strip malls, warehouses and industrial parks. It comes packaged as individual properties or as part of a pool of capital managed by real estate professionals, with fractional shares sold to individuals or as

part of a real estate investment trust, or REIT. These investments help diversify a portfolio by providing an alternate source of income (from rents) and capital appreciation.

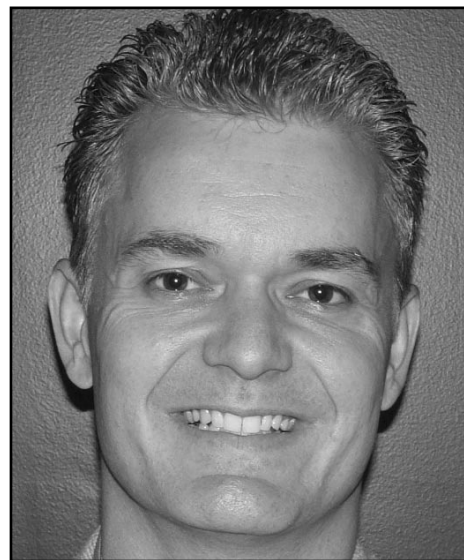
But there's a vast array of other, lesser-known investments that fall into the "alternative" category. Among them:

Inflation-indexed bonds. Common in other countries for decades (and in the United States during colonial times), such U.S. bonds, called Treasury inflation-protected securities, or TIPS, have been available in the modern era only since 1997. TIPS are an excellent balance for conventional bonds because they tend to move counter to traditional Treasuries and corporate bonds when inflation expectations increase. When inflation goes up, the prices of bonds – and most stocks – go down. TIPS tend to increase in value.

Commodities. When the values of financial assets are falling, investors buy things they can touch, burn or eat. These include industrial metals, such as steel and aluminum; precious metals, such as gold, silver and platinum; agricultural commodities such as corn, wheat and livestock, and, finally, energy. For example, gold prices tend to move in the opposite direction as the value of the dollar. When the dollar is weakening against other currencies, as it has for the past four years, gold prices go up.

Hedge funds. These are private pools of capital that once were the preserve of institutional investors and very wealthy individuals but recently have opened their doors to investors of more modest means. Hedge funds span the risk spectrum, ranging from the relatively tame, such as "merger arbitrage" and "convertible arbitrage," to those that invest in emerging or global markets using borrowed money to increase their potential returns – the downside being that this same borrowing also increases potential losses.

Virtually all these funds try to capture "absolute return" by not relying on the broad movement of markets (the idea that a "rising tide lifts all boats"). They rely instead on emphasizing research and insight into individual securities.



Venture capital and private equity investments. These help diversify a portfolio in part by changing the time horizon of an individual's portfolio. Venture capital investors search out young but promising companies, focusing on new technology, products and markets. Both venture capital and private equity are highly illiquid investments – similar to raw land – that often require an investor to lock up a considerable sum for as long as 10 to 12 years. Both of these categories in particular offer the potential of high returns but also higher risks.

Remember: Markets are in a constant search for certainty. Its absence – triggered by storms, energy price spikes, interest-rate uncertainty – demands that individual investors and their professional advisers be willing to think outside the box.

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