ALTERNATIVE INVESTMENTS, AT A GLANCE

What are they? How do they differ from "traditional" investments?

Presented by GRAnderson Wealth Management Group, Inc.

If you're seeking a different investment path and have a large amount of money to invest, you may already be considering an alternative investment. Alternative investments sidestep the traditional investment paradigm, such as real estate, cash, stocks, and bonds; they seek a greater return from a more complex (and, it must be said, riskier) set of circumstances. Here is a brief overview of some investment options within a vast and complex financial arena.

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 unitholders. 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.

Who can explore these "alternatives"? Those who meet account minimums are eligible to invest in managed futures and some other forms of alternative investments thanks to niche mutual funds, REITs and ETFs. However, in many cases individuals and investment companies have to meet strict criteria demanding proof of assets in the millions and/or income in the hundreds of thousands to qualify.

This is but an overview. Anyone wishing to enter the alternative investment arena should speak with financial, legal and tax professionals familiar with its nuances.

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Neither the information, nor any opinion expressed in this article constitutes a solicitation for the purchase of any futures contract or security. It should not be assumed that the investment options referred to in this article will be profitable or that they will not result in losses. Examples presented in this article are for educational purposes only. There is a high degree of risk in trading activity and there are frequently sharp differences between hypothetical performance results and the actual results subsequently achieved by any trading program.

Different alternative investment instruments involve different levels of exposure to risk. This brief statement cannot disclose all of the risks and other significant aspects of trading in derivative products. In light of the risks, you should undertake such transactions only if you understand the nature of the investment (and any contractual relationships) that you are entering into and the extent of your exposure to risk. There is a risk of total or significant loss resulting from the use of Financial Derivative Instruments ("FDIs") for investment. You are advised to consider if you have sufficient net worth to be able to assume the risks and bear the potential losses of trading in these investment products. You should carefully consider whether trading is appropriate for you in light of your experience, objectives, financial resources, and other relevant circumstances. Although derivative instruments can be utilized for the management of investment risk, some of these products are unsuitable for many investors.

Some commodity-based securities use futures contracts to track the underlying commodity, adding a layer of complexity. You should be aware of the implications of investing in these types of securities. A commodity futures-linked security does not necessarily track the spot price (or current settlement price) of the commodity, and performance of the security can deviate substantially from the performance of the commodity being tracked, i.e., you can experience unexpected gains or losses.

Options carry a high level of risk and are not suitable for all investors. The risk of loss in financing a transaction by depositing of collateral or by trading options is significant. You may sustain losses in excess of your cash and any other assets deposited as collateral. Market conditions may make it impossible to execute contingent orders, such as "stop loss" or "stop limit" orders. You may be called upon at short notice to make additional margin deposits or interest payments. If the required margin deposits or interest payments are not made within the prescribed time, your collateral may be liquidated without your consent. Moreover, you will remain liable for any resulting deficit and interest charged. Therefore, you should consider carefully whether such a financing or trading arrangement is suitable in light of your own financial position and investment objectives.

With long options, investors may lose 100% of funds invested. Covered calls provide downside protection only to the extent of the premium received and limit upside potential to the strike price plus premium received. Writing uncovered options involves potentially unlimited risk. Purchasers and sellers of options should familiarize themselves with the type of option (i.e., put or call) which they contemplate trading and the associated risks. You should calculate the extent to which the value of the options must increase for your position to become profitable, taking into account the premium and all transaction costs. If purchased options expire worthless, you will suffer a total loss of your investment, which will consist of the option premium plus transaction costs. Selling ("writing" or "granting") an option generally entails considerably greater risk than purchasing options. Although the premium received by the seller is fixed, the seller may sustain a loss well in excess of that amount. The seller will be liable for additional margin to maintain the position if the market moves unfavorably. The seller will also be exposed to the risk of the purchaser exercising the option; when that happens, the seller will be obligated to either settle the option in cash or to acquire or deliver the underlying interest. If the option is "covered" by the seller holding a corresponding position in the underlying interest, in a futures contract, or in another option, the risk may be reduced. If the option is not covered, the risk of loss can be unlimited. Only experienced persons should contemplate writing uncovered options, and then only after securing full details of the applicable conditions and potential risk exposure.

Citations.

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