

Adding Alternative Investments to a Stock/Bond Portfolio

An Interview With Phil DeMuth, Ph.D.

Article Highlights

- Portfolios with lower levels of beta (volatility) have historically delivered similar returns to those with higher levels of beta.
- The diversification characteristics of real assets, such as commodities and REITs, justify a small allocation.
- Hedge fund strategies, now available through mutual funds and ETFs, generate returns that are different than stock or bond returns.

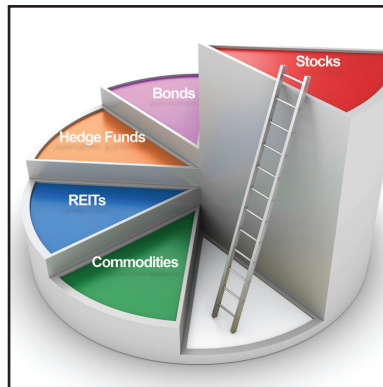
Phil DeMuth is a registered investment advisor with Conservative Wealth Management LLC and co-author with Ben Stein of "The Little Book of Alternative Investments" (John Wiley & Sons, 2011). I recently spoke with Phil about ways investors can expand their portfolios beyond stocks and bonds.

Charles Rotblut, CFA

Charles Rotblut (CR): In your book, you argue that the traditional allocation of 60% stocks and 40% bonds has some weaknesses. Can you briefly explain why you think that and what some of those weaknesses are?

Phil DeMuth (PD): While there's a great deal to love about the classic 60/40 stock/bond portfolio, the principal downside we see with it is that really, almost all of the volatility comes from the stock side. Depending on what your starting and ending points are, anywhere from 85%–95% of the day-to-day fluctuations of the portfolio comes from stocks. And that means that a bad year for stocks is going to be bad for this portfolio, pretty much no matter how the bond market does. The bond market is almost irrelevant. It acts, for better or worse, like a stock portfolio. And with that comes the big problem, which is that when bad times hit, investor's portfolios are down, and it's typically a bad time for the economy in general: People's jobs are looking tenuous, their spouses' jobs are looking tenuous, credit is hard to come by, the value of their house is down—the roof all falls in at the same time.

This gave us the impetus to look for alternative investments that might provide a cushion, or have at least an alternative series of returns than we would get just from the



stock side. Another way of saying this is: "2008." The year 2008 really showcased the limitations of equities and of traditional ways of trying to diversify. We were trying to see what else is out there that might have helped. That brought us to alternatives.

CR: You're looking basically creating a portfolio with lower beta that still gives you a similar level of returns, is that correct?

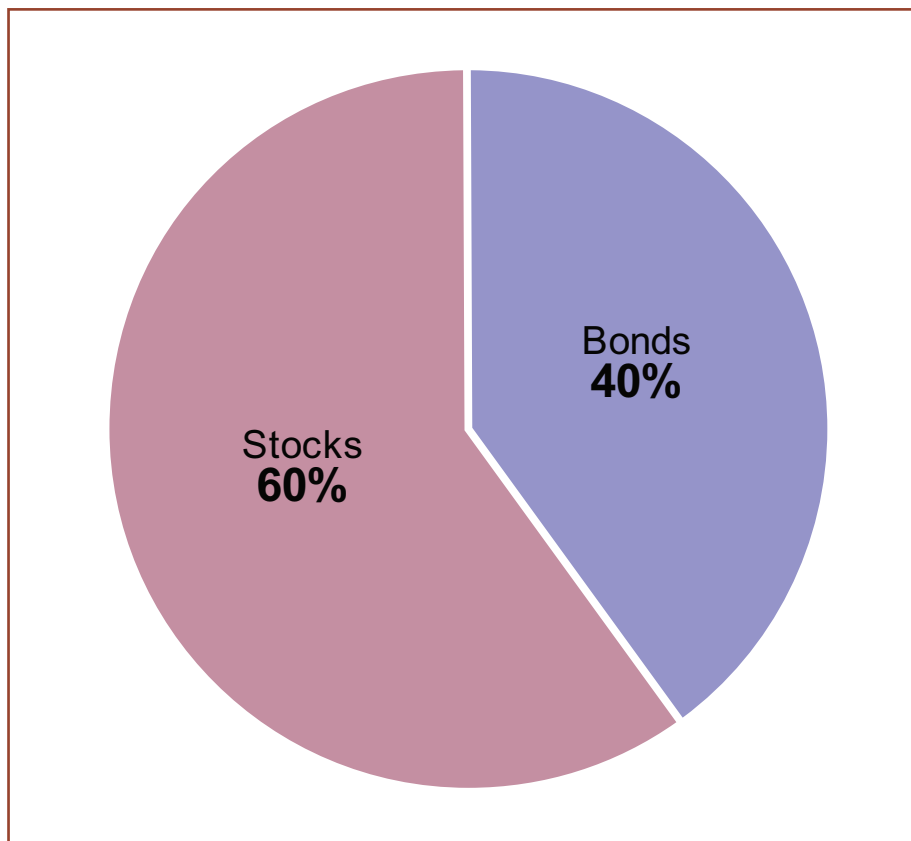
PD: Right, which is interesting, because, even historically, lower-beta portfolios (portfolios with less volatility than stocks) have tended to return about the same as higher-beta portfolios, which is an anomaly of stock market returns. So we like lower-beta portfolios, generally.

CR: Early in your book, you suggest commodities and real estate. Commodities are obviously in the news as we speak in late May, especially with gold floating around \$1,500 an ounce. Could you talk about the role that commodities would play in a portfolio?

PD: Unfortunately, as you say, commodities are very hot news right now, and especially gold—which, from my point of view, means it's time to head for the hills. The time to be excited about gold, just thrilled with hoarding as much gold as you could, was when it was selling for \$200 an ounce. By the time it's wallpapered on TV and everybody's telling you how to buy gold and so forth, that's the time when its expected returns are very, very low, as people found out in the 1970s. We are not at all gold bugs.

That said, we do feel that commodities have a small role to play in a portfolio, and that they do offer the potential for some diversification. They are real assets, they tend to hold up

Figure 1. The 60/40 Portfolio



very well in inflationary environments, such as your readers who are on the cusp of retirement might be experiencing. So we like a small allocation to them. But we would go for a commodity index fund that has a broad diversification; we're not trying to guess about cocoa beans or zinc or natural gas. We don't have any particular expertise in picking one commodity versus another; we would just buy a broad index for a small portion.

Now, commodities did terribly in 2008; they diversified you down. But in a lot of other financial crises, like during the 1970s, when equities got cut in half, commodities did well. We like them for that reason.

CR: Regarding commodities index funds, both in terms of mutual funds and exchange-traded funds (ETFs), I've read some concerns about losing some performance when the futures contracts actually expire and the fund manager has to go out and buy some new ones. Is there any concern about that?

PD: There's always concern about

that. Again, what is your alternative? Your alternative would be to hire a commodities trading adviser, but then you're paying fees of 2% front-end load and 20% of profits, or 3% front-end load and 30% of profits; that's going to be very hard to do. You could buy commodities that have what is called a positive roll return, like copper, oil and sugar. On the other hand, with mutual funds, if they have a broad basket, they can take advantage of the inherent volatility among commodities, and they could be rebalancing them as they go along, selling off higher ones to buy some lower ones. There are trade-offs.

[Editor's note: At expiration, a futures contract converges to the current, or "spot," price of the underlying asset. A positive roll means the futures contract is originally worth less than the asset and eventually rolls up to the spot price at expiration. If the spot price falls, the futures contract will roll down to that price, or have a negative roll.]

CR: What about REITs? What's your

rationale for holding real estate investment trusts?

PD: Even though REITs, in theory, would be covered just by holding an index fund of equities, they do tend to behave a little bit differently from stocks, more like an equity-bond hybrid. Historically, they have had sensational performance since being launched. And again, I'm thinking of people who are possibly close to retirement, and I think back to the 1970s, when REITs were the single best-performing asset class—even better than owning gold during the high inflation. I think that they also could be a very good hedge.

REITs did nothing for you in 2008; they diversified you down. But not every bad year is going to be like 2008. There are going to be other years where REITs are going to come through for you, as they often have in the past. So again, we like a small allocation to a REIT index fund. I think that clever individual investors can also select individual REITs and do well that way.

CR: Do you have any preference between residential and commercial REITs?

PD: We look at the commercial real estate investment trusts. I don't know about the residential ones. I would put hotels and apartments in the equity REIT category. I'm not particularly big on mortgage REITs; that's kind of a hybrid security that's tough to analyze, although I know some of them have done very well.

CR: And what if interest rates rise? Any worries about that and its impact on REITs?

PD: Yes, rising interest rates are pretty much bad for everybody. I think REITs will do less badly in that circumstance, as in the 1970s they did well, just because REITs have the ability to re-price their rentals. And all REITs are not created equal in this regard: An industrial REIT might have a very long-term lease on some factory, but a hotel REIT can basically reset its rates every night if it wants to. In other words, different REIT categories act like bonds of different durations, and you could, if you wanted to pick individual REITs,

select those—like apartment REITs and hotel REITs—that tend to be at the short end and have the ability to raise rents as they go along, with rising interest rates. Even REITs with longer-term rentals often have inflation escalation clauses in their leases.

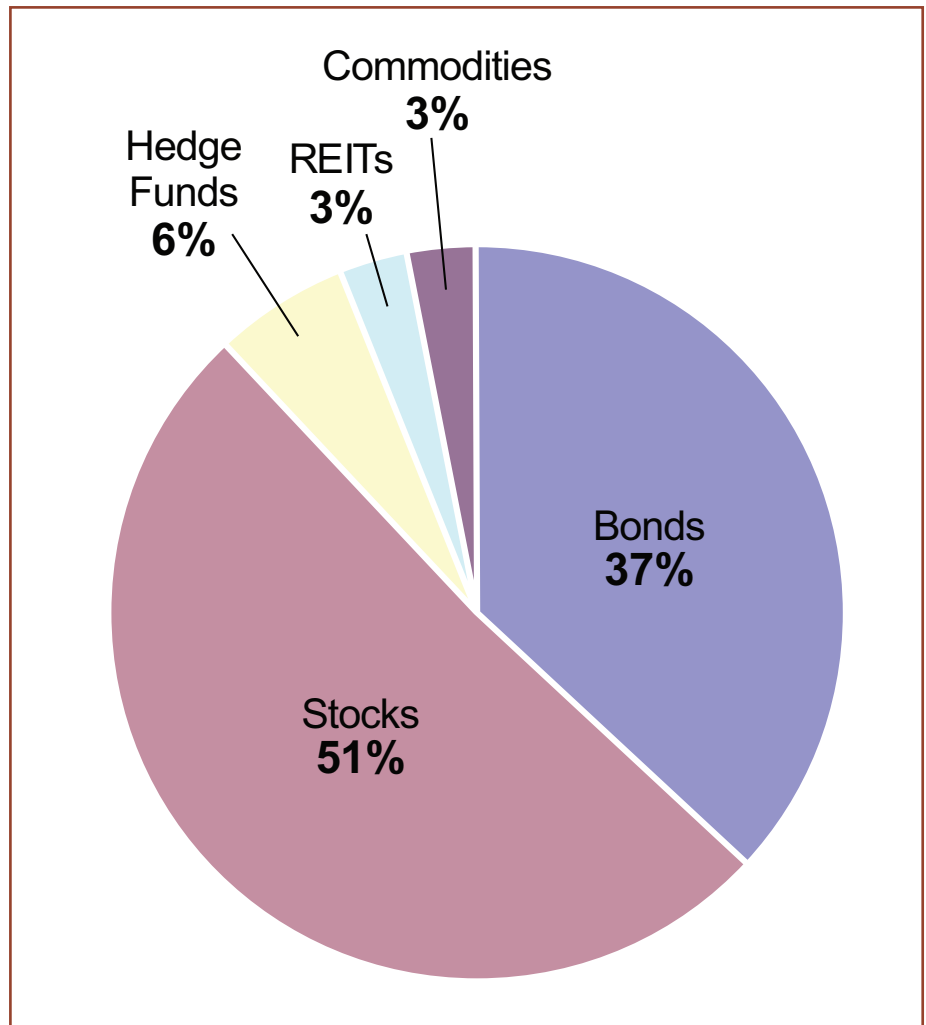
CR: *Let's just stay on the topic of interest-producing investments. You discussed convertible bonds in the book. Can you explain what those are and how they work?*

PD: A convertible bond is typically issued by a company, typically a growth company of some kind, that needs to raise capital, but doesn't have access to traditional financing at very attractive rates because the company is somewhat risky. Their best way of raising money is to issue what is called a convertible bond, which is like a regular bond. It probably has a higher yield, to attract investors who otherwise wouldn't take a look at it. But then, even beyond that, they add a kicker, which is that they give buyers the option of converting the bond into stock, into equity, if the company stock reaches a certain price. A convertible bond is really a hybrid product. It's partly a bond, and then it's also got this option stapled to it.

Now, there are funds where you can just buy convertible bonds. But that's not what you would call an alternative strategy. The alternative strategy—the strategy that is practiced by hedge funds that deal in convertible arbitrage—is based on the fact that when a convertible bond is newly issued, it actually sells at a small discount to the sum of its parts. It sells at a discount to what the bond part is worth and to what the stock is worth if priced separately.

These hedge fund guys are very smart: They buy the convertible bond, they short the stock, they hedge the interest rate risk; they've got it wired every which-way so that whatever happens to interest rates, no matter what happens to the price of the stock, they are guaranteed to eke out a small profit. This is not something that you and I could just do by calling up our broker, because the transaction expenses to do this would be very high. But if this is

Figure 2. A More Risk-Diversified Portfolio (Dollar Weights)



your whole life's work, and you've got just millions and millions of dollars devoted to nothing but a portfolio of convertible arbitrage funds, you can do this, you can make a little bit of money, and if you leverage that, you can make a respectable amount of money.

This is just a typical strategy that a hedge fund might employ that will then give you returns that are not linked, necessarily, to how the S&P 500 is doing. I saw that in 2008, when everything collapsed, convertible bond hedge funds lost money, but they lost in the order of, say, 13%, as opposed to 40% or 50%. Relatively speaking, they were a friend in a time of need.

CR: *And you think that, because they are hedging, if interest rates rise, these funds*

are basically protecting themselves against any type of market movement, right?

PD: Correct. Although there are expenses involved—the more hedges and protections you put on, the less your profit is going to be. So they don't in all cases put all hedges in place. Like everything else, it's not perfect. There's not always a great supply of convertible bonds to work with, which means many of these funds also engage in other kinds of trading activities. But it's a help.

CR: *Staying on the topic of hedge funds, the minimums for getting in these hedge funds are pretty expensive, but there seems to be a growing number of ETFs and mutual funds that replicate them. Can you discuss what these strategies are and what they are trying to do?*

PD: That's really what interested us

in writing the book. Hedge funds had been the province of the very wealthy, people who had an incredible amount of assets and could devote a few million dollars to different hedging strategies. That was great for them, but now it's coming down-market. It's coming from Greenwich, Connecticut, to Main Street. These strategies have been repackaged into ETFs and mutual funds, which have a number of safeguards in place and are much friendlier to the individual investor.

There are basically two different approaches that these kinds of funds are taking. The first one is a very simple mathematical regression model. They take a look at hedge fund databases (databases of all the hedge funds that are reporting) to see what the returns have been. They then look at other publicly traded securities they can use to try to mimic this same performance. So they might own totally different kinds of assets than the hedge fund owns, but they can still kind of triangulate and get you to roughly the same place. This is a clever strategy, and there are a number of mutual funds and ETFs that follow this strategy. It would be called a hedge fund beta replication approach. They don't know what the hedge funds are doing, they just see a series of monthly total returns, and they're trying to mimic that series using whatever instruments they find that will work to do it.

This is nice. One thing we notice about it, though, is that these strategies tend to have relatively high correlations to the stock market as a whole. For example, they might have a 0.7 correlation, which is not a perfect correlation and doesn't really give you the kind of deep diversification that you would want. Basically, when stocks are up, these indexes are going to be up; when stocks are down, they'll be down, just maybe not quite as much.

The second way to go is to simply try to copy the same strategy that most hedge fund managers are using, but do it inside a mutual fund wrapper. So there are funds that will try the convertible arbitrage strategy that I just described. You can buy a hedge fund, and there's

also a fund you can buy that will try to replicate that same strategy in an open-ended mutual fund instead. These managers are coming down-market and they're reaching out to the masses, and not just the millionaires.

CR: *Are there any concerns that, if more of these funds are actually replicating these strategies, some of the return advantages will be reduced?*

PD: Well, certainly that's true in the hedge fund world. Everybody piles in. Human beings are competitive and they're always looking over their shoulder to see what the next guy is doing. And if what he's doing is working better than what we're doing, we tend to drop what we're doing and do what he's doing. Hedge fund managers are the same way. They may be working in very esoteric niches of the market. But if something starts working and gets noticed, a lot of heads are going to be turning and pretty soon everybody's going to be trying to do the same thing, and that's going to wash out returns.

This, in fact, has happened over the last 20 years. You basically see that hedge fund returns have been less spectacular over time, and they may get less spectacular going forward, as these trades become more crowded. That certainly is a danger. I think we haven't reached that point yet. There's still plenty of money that could be put into these strategies, and we can make money doing it. The people that are there sooner will make more money than the people who get there later.

CR: *I know a lot of these funds don't have long histories. For some of these funds that are newer, given the lack of a long track record, how does an investor go about choosing among them?*

PD: Well, it's not easy, which is part of the reason we wrote the book. I mean, there are hundreds of funds like this, but we do not have a very long list of funds we recommend. Our general approach has been to look at the strategy that the manager is following. If the fund seems to be following a well-known strategy in the field that seems likely to produce

a long-term benefit, then we would be more inclined to endorse it.

For example, there's a long-short exchange-traded fund that buys small and value-oriented stocks and shorts larger growth stocks. Of course they end up shorting Google (GOOG) and they short Apple (AAPL). You think, "Oh my gosh, these people must be nuts!" But we know that over long periods of time, small value stocks have done better than large growth stocks, because people get excited about large growth stocks and they have to pay too much money for them. Not every year, but over time, small value does better than large growth. So this ETF is selling large growth and buying small value, and over time they will harvest that difference. Not every year, but for example: If the stock market is down 50% one year, if small value stocks are down 49% and large growth is down 51%, that fund is going to have a 2% return that year, less expenses. Any fund that's following a mechanical strategy like this that is trading off of a well-known market effect is a fund that we would look at more seriously.

What we don't want, what we try to avoid, is what everybody wants, which is hedge fund alpha. We're trying to avoid the manager with a hot hand, the magical wizard who somehow is going to see the future and make the right move at the right time. God bless you if you can find such a person. We don't feel we're capable of finding that person, so we're looking more for a strategy that seems bankable, rather than a wizard.

CR: *Regarding allocations, if an investor is looking at some of these alternatives, how do they allocate? It looks like in your book, you had pulled quite a bit of money out of the equity side.*

PD: One of the myths about hedge funds is that they just produce spectacular returns. In practice, hedge funds deliver returns that are somewhere between the returns of stocks and bonds. If you want to keep the same kind of risk/return profile for your existing portfolio, we would recommend pulling about half the money from equity side

and half the money from the fixed-income side, and then putting that into a hedge fund allocation. Even there, we're quick to stress that just as you should not drive beyond your headlights, you really shouldn't invest in these products beyond what you understand about them. So if you don't really get them, you probably shouldn't be involved with them. If you want to read up on them and get a basic understanding of what they're doing and how they make money, then you might be comfortable putting some part of your portfolio in them.

Because they're generally new products, we are trying to err on the side of being conservative and thinking that if investors end up putting about 10% of the risky side of their assets (if they had a 60/40 portfolio, 60% equities, they would want to take the equivalent of 10% of the equity portion—6% of the total portfolio—and put that in hedge funds. Taking 3% from the equity side and 3% from the bond side is probably not a terrible place to start, if you know a little bit about them and want to follow them and learn more.

CR: *And what about allocating toward REITs?*

PD: We would propose a similar amount of money put toward real assets. So we would take another 6% (10% of the stock portion of your 60/40 portfolio), take 6% and put it toward real assets, which might be divided between 3% to commodities and 3% to REITs.

There's nothing magical about these numbers. We just think having a little bit of exposure there is great.

CR: *I know you didn't cover this in your book, but if someone also holds annuities and master limited partnerships (MLPs), how would they fit into the equation?*

PD: It depends. If it's a fixed annuity, it would come out of the bond

side of your portfolio. If it's a variable annuity, the allocation between stocks and bonds inside the annuity would be mirrored in your regular portfolio, other things equal. But other things may not be equal, since you might want to use the annuity's tax-deferred wrapper to park more tax-intensive assets.

As for the master limited partnerships, I'm not that great at picking individual MLPs. I would be more inclined to use perhaps an exchange-traded fund that specializes in this area, and just get a generic exposure to the space. Some people would consider those to be part of the alternative universe; we don't really explore them in the book. We talked about them a little bit more in our book on income investing, "Yes, You Can Be a Successful Income Investor: Reaching for Yield in Today's Market" (New Beginnings Press, 2005).

CR: *For the MLPs, would you just pull money out of stocks for those, or follow a more hybrid approach?*

PD: They're kind of a combination of real assets, like commodities; but they also have payouts, more like fixed income. I don't see them as being a risk-free asset by any means, so I would probably put them more in the stock camp. But I haven't thought about this. You could probably convince me that I'm wrong.

CR: *Finally, you suggest the first step that investors should take is to just get their basic allocation correct, before attempting to diversify into alternative investments—is that right?*

PD: Absolutely. There is a tendency to get excited about whatever is the latest hot new thing. And in many cases, instead of looking where you can buy gold coins on TV, you'd be better off taking a look at what you currently own and asking, does this make sense, given your time horizon and the kind

of payouts you want to be getting for your portfolio (for most of us, funding retirement is the big kahuna).

Also, you want to make sure that you're constitutionally capable of living with the risks that you're assuming. So you don't want to do the crime if you're not willing to do the time. You don't want to take on so much equity risk that you're going to commit the worst mistake, which is to panic and then sell out at the bottom, as many people unfortunately did.

CR: *Even if they're going with alternative investments, the rules about periodically rebalancing and adjusting it for their age and risk tolerances still apply, correct?*

PD: Of course. The beauty of the alternatives is that in many cases they actually should lower your risk profile—which is why high net-worth investors got into them originally. It was not only a way of trying to amplify their returns but, more than that, they were trying to buy a product that wasn't going to collapse when the stock market collapsed, so it would literally hedge (as in a hedge fund) their downside risk.

CR: *Is there anything else that I haven't asked you?*

Well, I think that the premise of these alternative funds is a sound one. There are some very smart people who are putting together mutual funds for the individual investor in this area. And they don't necessarily get the attention they deserve because the media focus is always on who had the best returns last quarter. But these funds are being engineered by mathematically sophisticated people to have low correlations to the stock market, low volatility. And I think over time these funds are going to be playing an increasing role in most investors' portfolios. That's the hope. ▲

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