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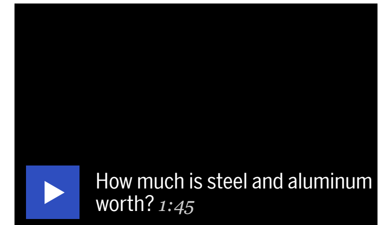

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Stocks? Bonds? Meh. Leery but savvy investors can use several kinds of alternative investing strategies to help their portfolios ride through times of market volatility

By Robert Thompson

Investing used to be about finding the right shares and going long. Now it is about considering alternatives. As president and portfolio manager for Toronto-based MacNicol & Associates Asset Management, David MacNicol recognized a couple of years ago that clients were becoming discouraged with traditional means of investing. Bonds yielded too little and equities were increasingly too volatile, leaving disenchanted investors in their wake. “It takes a lot of patience to ride out what we’ve been through,” MacNicol says. “The demands of clients and the volatility in the markets are

More

leading us to look at other options."

Those other options include myriad possibilities depending on the amount of money at your disposal, risk tolerance and the time you or your manager have to handle your investments. While perhaps not as bullish as others, MacNicol began moving up to 10% of his investors' portfolios into alternative investments, a nebulous segment that can mean buying assets such as gold or real estate, but also includes writing options, investing in catastrophe bonds or investing in a private business.

The simple reality is that even for investors only involved in registered retirement plans, there are plenty of alternatives to traditional long plays – equities and bonds — if they can handle the risks. "A lot of the wealthier families we deal with have moved a certain percentage of their investments out of the market," says MacNicol, whose firm's clients must make investments of at least $300,000, but they typically put in an average of about $1 million. "In a lot of ways we've become risk managers for our clients."

Risk is the key consideration, agrees Adrian Mastracci, president of Vancouver-based KCM Wealth Management Inc. Investors unwilling to risk failure exceeding that of traditional equities markets should stay away from alternatives. "You might have complete failure of what you invest in, so if you can't stomach that then this isn't for you," he says. "Expect strikeouts. There's nothing that says you'll make money all of the time. The alternative stuff has more aggressive strategies and can be tough to wrap your head around."

The possibility of failure is one reason why anyone investing in alternatives needs to have a portfolio founded in more traditional investments, says Eric Kirzner, a professor at the Rotman School of Management in Toronto and the John H. Watson chair in value investing. He suggests a majority of investments should stay in some form of a balanced portfolio. But the other constant of alternative investing, MacNicol says, is that those pursuing such a strategy

either need to spend more time focused on it or pay someone to do it for them. "The investor needs to know what they are investing in and they need constant interaction," he says. "You have to align yourself with people you know and trust and recognize that the liquidity you see in the equities markets won't always be there."

Here's a look at five alternatives.

Options

Options are a viable alternative for some investors, though perhaps not the sexiest one, says Mike Roberts, a financial advisor at Canaccord Capital based in Waterloo, Ont. "If the concept is applied to medium-to-lower risk names, it can be quite profitable," he says. "But you're going to get better premiums on volatile names."

Roberts, who notes financial advisors need specific training to be able to

utilize financial derivatives for clients, is particularly keen on writing call options as a means of mitigating risk while potentially increasing profits within volatile markets. Simply put, the client owns shares of a particular company and a contract is then written on the shares with a strike price. If the shares hit the strike price within the defined time period of the contract, the shares are likely to be sold (called). The call option contract also reduces clients' losses if the share price declines, because they have been paid for writing the contract by the purchaser.

Options

"If you recognize you are changing your asset mix, then you're okay," says Eric Kirzner, Rotman School of Management

But writing options is safest on stable shares, and writing covered calls means the investor needs to own the stock in question. "You have to have sizeable capital to do it," says Roberts. "A lot of people don't have a lot of patience because you don't get rich off it. You have to have a diversified portfolio, so it is tricky."

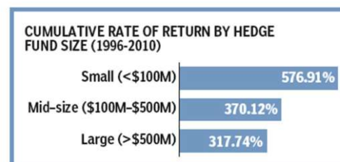
There are also no guarantees. "The worst-case scenario in a covered situation is you'll have lowered your average cost, but you're still exposed to the downside," Roberts says. "You lowered what you paid for the shares, but you are exposed to the losses. It reduces your downside risk, and in some ways limits the upside risk."

Kirzner says derivatives let investors hedge their portfolios, but aren't considered assets themselves. For warier investors interested in derivatives, there are also exchange-traded funds that have covered options components. "If you recognize you are changing your asset mix, then you're okay," Kirzner says. "You're changing the nature of your investment into a fixed income."

Hedge funds

Few investing schemes are more divisive than hedge funds. To say some investment gurus are down on hedge funds would be an understatement. "I like hedge funds in theory, but performance is so awful," Kirzner says. "There are occasionally good ones, but the bad ones so outnumber the good ones."

That distinction isn't always an issue because accessing hedge funds is outside many Canadians' buying power given securities restrictions. The Ontario Securities Commission, for instance, says a hedge fund buyer must be an "accredited investor," which means having financial assets of more than $1 million, or net assets of at least $5 million. The



Hedge Funds

investor can also have an annual income in excess of $200,000, or a household income of at least $300,000. What those figures really suggest is that investors must have the ability to withstand potentially significant losses and some knowledge. “You aren’t supposed to check off that [accredited] box unless you can come in and teach my introductory lessons,” Kirzner says. “I’d say nine out of 10 investors don’t really know how hedge funds work.”

In theory, hedge funds are supposed to match their name: hold a variety of investments and short — or hedge — the market if a downturn cycle occurs. Kirzner questions whether, in most instances, that is actually the case, but the hedge fund industry is trying to dispel what it considers to be long-held myths. James Burron, chief operating officer at Alternative Investment Management Association in Toronto, says hedge funds have seen rapid growth in Ontario, jumping from about $5 billion in 2006 to about $30 billion now. “Maybe we should occupy the OSC,” he says. “If you want to keep people out of the 1%, keep rules that are so stringent that they can’t get at these investments. Even if they don’t perform at the market, but with lower risk, that’s a good thing.”

Those who can’t afford to enter the hedge fund market can turn to funds such as Man Investments Canada’s AHL Diversified Programme. Holding a wide array of investments in numerous sectors, Man says its fund has an annualized return of 15.8% since its inception 15 years ago. “Our fund is much more diversified and indifferent to the long/short markets,” says Toreigh Stuart, CEO of Man Investments Canada, one of the industry giants. “[The AHL fund] puts more money to where it is trending, and therefore has far less risk than the traditional markets.”

Real estate

One key alternative investment MacNicol is focused on is real estate. Most investors don’t have enough capital to diversify when entering the real estate market, MacNicol explains, but his company has been seeking properties in the United States where the rental market is strong even though housing prices may be depressed. Real estate isn’t mark-to-market, but MacNicol has developed a sizeable holding called the 360 Degree U.S. Realty Income Fund, an open-ended, private real estate fund focusing on value-added projects split largely between commercial and rental properties that generate revenue until they can be sold. MacNicol’s fund expects to have an overall annual return of 8%, driven by real estate gains in excess of 12% in 2011.

Real Estate

Most investors don’t have enough capital to diversify in the real estate market, says David MacNicol of MacNicol and Associates Asset Management Inc.

MacNicol admits real estate isn’t a liquid investment and is not for the impatient. “You end up with 10% of your portfolio that you can’t cash in tomorrow,” he says. It is also more costly for his firm, MacNicol says, because of the expense of locating properties, maintaining them and the fees involved

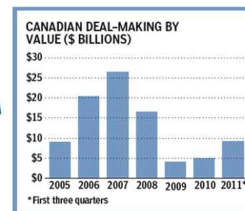
in eventually selling them. “It is a much more costly process for us,” he says. “But the demand and the volatility in the markets are leading us here.”

Kirzner agrees that real estate exposure is important for investors, but shies away from the concept MacNicol espouses in favour of adding real estate income trusts as 10% to 15% of a portfolio. “One of the key features of real estate is the invisible volatility, which is a positive,” he says. “Nobel Prize winners will say the more you look at your portfolio, the more risk averse you become. And one feature of real estate is you don’t see the price changes, so you don’t do foolish things.”

Private equity

Investing in a business — or investing in your own business — is always a possibility worth considering, experts agree, and comes with a potentially large payoff. “If you can put aside enough money, it might be the way to go,” Adrian Mastracci says. “However, you need a lot of money to get into this space. Most people need $500,000, but $200,000 might be the starting point.”

Private Equity



There are a wide variety of private-equity scenarios, Mastracci says, ranging from investing in established businesses to angel investing (providing capital for early-stage enterprises). The payoff can be significant, but Mastracci suggests anything less than 20% isn’t worth the risk: Private equity isn’t a liquid investment, and getting one’s money out or finding a buyer can be a challenge.

His suggestion for interested investors is to look to what they know and use their expertise to recognize opportunities in related businesses. “If they have some acumen, people can invest in businesses they understand because they know the acumen it takes,” he says. “You have a little more chance of adding to the equation.”

Catastrophe bonds

Generally held by large investment funds, catastrophe bonds — more familiarly known as cat bonds — were created to offset the risk of natural disasters on insurance companies. The upside to cat bonds is based on the likelihood that a catastrophe will occur, such as a one-in-100-year event versus a one-in-five-year event. If the disaster doesn’t occur, investors are paid a sizeable return; if it does, the insurance companies can use some or all of the principal to cover the resulting losses. Retail investors typically haven’t been involved in cat bonds, but a recently-launched fund — the GAM Star Cat Bond fund, managed by a company that has a portfolio of upwards of 40 cat bonds — allows investors to gain access to the market for an investment of $10,000.

"If you are looking for something not linked to typical asset classes, cat bonds are unique," says Ryan Bisch, director of Exotic Alternatives at Mercer Investment Consulting. "At the same time, investors are getting exposure to very large events. If the big one hits San Francisco, clients will always want to know what that is going to mean to them."

While Bisch notes that cat bonds have historically been an asset class for very sophisticated investors, alternatives such as the GAM Star Cat Bond fund are on the rise. It's important to note that rarer catastrophic events pay less, while more frequent events pay greater returns, with some bonds promising up to 14%. Overall, the cat bond market has returned about 7% per year since the Swiss Re Cat Bond Total Return Index started tracking the financial results. Though some experts suggest the more traditional reinsurance market might prove stronger over time, cat bonds are just one more asset investors can put in their portfolios.

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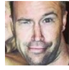

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