

Alternatives ... Compared To What?

By Craig L. Israelsen, PhD

The term “alternative investment” only makes sense in relation to some other type of investment—that is, a set of non-alternative core asset classes. The implication is that the non-alternative investments are more traditional or more generally accepted than the alternative investment.

This article utilizes the terms “core asset class” and “diversifier asset class,” which are meant to be understood as being different from alternative asset classes.

The core asset classes in this study include U.S. equity (large, mid, small), non-U.S. equity (developed), U.S. bonds, and cash. The diversifier asset classes in this study include emerging stock, real estate, natural resources, commodities, Treasury inflation-protected securities (TIPS), and non-U.S. bonds.

The alternative asset classes included in this study were defined as such by Lipper and include: active extension, credit focus, currency strategies, equity market neutral, event driven, global macro, long/short equity, managed futures, and multi-strategy.

An important premise of this study is that core and diversifier asset classes should be present in any well-diversified portfolio, and that alternative asset classes might be used selectively as satellite positions around the diversified core.

Core Asset Classes

Large-cap U.S. stock is a traditional and widely accepted investment asset. The S&P 500 Index is the most common representation of large-cap U.S. stock. Thus, including large-cap U.S. stock in a portfolio is considered a core or fundamental starting point for most portfolios that include an equity allocation.

The next most fundamental or core equity asset classes in a portfolio typically might include small-cap U.S. stock and non-U.S. stock. Typical indexes representing these two asset classes would be the Russell 2000 Index and the Morgan Stanley Capital International EAFE (Europe, Australasia, and Far East) Index.

These three equity asset classes (large-cap U.S. stock, small-cap U.S. stock, and non-U.S. developed market stock) typically are available in most 401(k) menus—suggesting that they are viewed as core equity asset classes. Mid-cap U.S. stock likely also would be considered a core asset class. A representative index would be the S&P MidCap 400 Index.

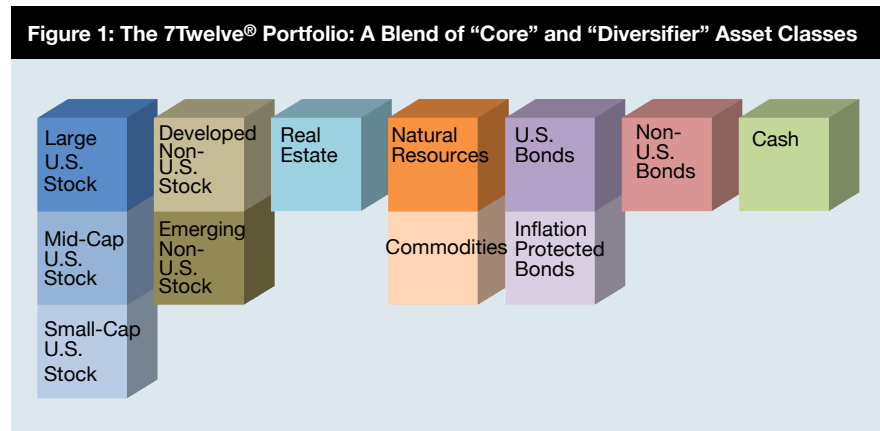


Table 1: Performance of Separate Asset Classes and 7Twelve® Portfolio, 2004–2013

Asset Class (The performance represented by ETFs)	Return in 2008	10-Year % Annualized Return	10-Year Standard Deviation of Annual Returns (%)	Return per unit of Volatility (higher is better)
Large U.S. Stock	-36.7	7.35	18.71	0.39
Mid U.S. Stock	-36.3	10.03	20.85	0.48
Small Value U.S. Stock	-32.3	9.66	21.05	0.46
Non-U.S. Developed	-41.0	6.69	20.88	0.32
Non-U.S. Emerging	-52.3	10.55	34.71	0.30
Real Estate	-37.0	8.40	22.97	0.37
Natural Resources	-42.9	10.67	24.61	0.43
Commodities	-31.7	8.51	20.99	0.41
U.S. Bonds	8.5	4.53	3.08	1.47
TIPS	-0.5	4.68	6.57	0.71
Non-U.S. Bonds	4.2	3.75	6.18	0.61
Cash	2.8	1.74	2.04	0.85
7Twelve Portfolio	-24.6	8.17	13.53	0.60

U.S. bonds and U.S. cash are virtually always present in a 401(k) menu suggesting that they are also core asset classes. Representative indexes would be the Barclays Capital Aggregate Bond Index and the three-month U.S. Treasury bill (or essentially a typical money market mutual fund).

Diversifier Asset Classes

What would be the diversifiers to these six core equity asset classes? As already noted, the diversifier asset classes (and representative indexes) include the following: emerging stock (MSCI EM Index), real estate (DJ US Select REIT Index), natural resources (S&P North American Natural Resources Sector Index), commodities (Deutsche Bank Liquid Commodity Index), TIPS (Barclays US TIPS Index), and non-U.S. bonds (Barclays Global Treasury ex-US Index).

The combination of these six core asset classes with these six diversifier asset classes is known as the 7Twelve® Portfolio (www.7TwelvePortfolio.com) (full disclosure: the author is the designer of the 7Twelve Portfolio). The 7Twelve model is depicted in figure 1. Each of the 12 asset classes is equally weighted at 8.33 percent and is rebalanced annually. Performance of the 7Twelve Portfolio in addition to all the separate ingredients is reported in table 1. (Return per unit of volatility is calculated by dividing the 10-year annualized return by the 10-year standard deviation of annual returns—the higher the number the better).

Putting It All Together

Table 2 shows the performance, volatility (standard deviation), and return per unit of volatility of the 7Twelve Portfolio as well as a host of alternative funds. The 31 alternative funds in table 2 represent the universe of alternative funds with a 10-year history (as of December 31, 2013). Lipper for Investment Management was used as the mutual fund database for this study and may not have an exhaustive list of all available alternative funds.

The key information included for each alternative fund is its category, fund name, ticker symbol, minimum initial investment, performance in 2008, 10-year average

annualized return as of December 31, 2013, 10-year standard deviation of annual returns, and 10-year return per unit of volatility. Finally, the 10-year correlation of each alternative fund to the 7Twelve Portfolio was calculated and is shown. The minimum initial investment of \$12,000 for the 7Twelve Portfolio assumes a \$1,000 investment into each exchange-traded fund (ETF) representing the 12 asset classes.

The boxes in table 2 that are highlighted in yellow indicate outperformance in comparison to the 7Twelve Portfolio. For example, all but five of the alternative funds performed better in 2008. Only two of the alternative funds had a superior 10-year annualized return. Twenty-five of the 31 alternative funds had lower standard deviation than the 7Twelve Portfolio. Six of the alternative funds had a more favorable return per unit of volatility.

The final analysis is presented in table 3. Each of the 31 alternative funds is blended with the 7Twelve Portfolio in a 60-percent/40-percent allocation—representing a “core-and-explore” investment approach. The order in which the alternative funds are listed is based on the 10-year 60/40 Portfolio Return—from high to low.

The 7Twelve Portfolio represents the 60-percent core allocation (in which diversifiers are also included) and the alternative funds represent the 40-percent explore allocation. The yellow highlighting shows that only two of the alternative funds, when blended with the 7Twelve Portfolio, produced a 10-year average annualized return that was an improvement on the 8.17-percent return of the 7Twelve Portfolio by itself. Those two alternative funds were Robeco Boston Partners Long/Short Equity Fund and Guggenheim Alpha Opportunity Series.

When blended with the 7Twelve Portfolio, these two alternative funds produced a higher standard deviation than the 7Twelve Portfolio by itself. For the remaining 29 alternative funds, when each was combined with the 7Twelve Portfolio the 10-year annualized return declined below

that of the 7Twelve Portfolio be itself, and the standard deviation of annual returns declined in all but three cases.

In 15 cases (or for nearly half of the alternative funds), the model consisting of 60-percent 7Twelve/40-percent alternative produced a higher return per unit of volatility. Historically, the material inclusion of alternative funds within a broadly diversified core portfolio was beneficial primarily in terms of risk (or volatility) reduction and return per unit of volatility, rather than in raw performance enhancement. Of course, this analysis says nothing about the future performance of any of the asset classes being studied.

Summary

Over the past 10 years, nearly all funds that are classified as alternative have underperformed a broadly diversified 12-asset portfolio. To their credit, alternative funds tend to have lower volatility than a broadly diversified portfolio of core and diversifier asset classes. From this 10-year period of time, we observe that blending alternative funds with a broadly diversified portfolio of core and diversifier asset classes had more beneficial impact on volatility than on performance.

The inclusion of alternative asset classes into a broadly diversified portfolio is justified on the basis of their performance in 2008. The average return in 2008 for 31 alternative funds was –13.5 percent—a material improvement compared to the return of –36.7 percent for large-cap U.S. equity or –24.6 percent for the broadly diversified 7Twelve Portfolio. Alternative asset classes may well provide the hoped-for low correlation in times of market turmoil. But, as always, time will tell. ●

Craig Israelsen, PhD, is an executive-in-residence in the Financial Planning Program at Utah Valley University. His research interests include analysis of mutual funds and design of investment portfolios. He earned a PhD in family resource management from Brigham Young University, and a BS in agribusiness and MS in agricultural economics from Utah State University. Contact him at craig@7twelveportfolio.com.

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Table 2: 7Twelve® Portfolio vs. Alternative Funds, 10-Year Performance from 2004–2013

Funds highlighted in yellow had better performance than the 7Twelve® Portfolio (performance and/or volatility and/or return per unit of volatility)

CATEGORY	FUND	Ticker	Minimum Initial Inv.	Performance in 2008	10-Year Annualized Return	10-Year Standard Deviation	Return per unit of Volatility (higher is better)	10-year Correlation to 7Twelve
Multi-Asset Portfolio "Core and Diversifier"	7Twelve® Portfolio	—	12,000	-24.62	8.17	13.53	0.60	—
Performance of "Alternative" Funds by themselves								
Credit Focus Funds	AllianceBernstein Unconstrained Bond Fund;A	AGSAX	2,500	-16.52	4.03	8.98	0.45	0.92
Credit Focus Funds	DWS Unconstrained Income Fund;A	KSTAX	1,000	-8.66	6.43	8.14	0.79	0.84
Credit Focus Funds	FPA New Income Fund	FPNIX	1,500	4.31	3.03	1.60	1.90	-0.15
Credit Focus Funds	Hartford Unconstrained Bond Fund;A	HTIAX	2,000	-11.93	4.22	8.18	0.52	0.80
Credit Focus Funds	MainStay Unconstrained Bond Fund;A	MASAX	25,000	-13.19	6.07	10.36	0.59	0.85
Currency Strategies Funds	Franklin Templeton Hard Currency Fund;A	ICPHX	1,000	1.08	3.44	5.55	0.62	0.31
Currency Strategies Funds	Lord Abbett Emerging Markets Currency Fund;A	LDMAX	1,000	-11.90	2.79	9.70	0.29	0.80
Equity Market Neutral Funds	Calamos Market Neutral Income Fund;A	CVSIX	2,500	-13.28	3.44	7.18	0.48	0.89
Equity Market Neutral Funds	Gateway Fund;A	GATEX	2,500	-13.92	4.09	6.75	0.61	0.90
Equity Market Neutral Funds	GMO Alpha Only Fund;Ill	GGHEX	10,000,000	12.08	1.92	5.85	0.33	-0.74
Equity Market Neutral Funds	JPMorgan Multi-Cap Market Neutral Fund;A	OGNAX	1,000	-0.33	1.04	3.62	0.29	0.16
Equity Market Neutral Funds	JPMorgan Research Market Neutral Fund;Inst	JPMNX	3,000,000	-0.55	2.26	5.14	0.44	0.51
Equity Market Neutral Funds	Vanguard Market Neutral Fund;Institutional	VMNIX	5,000,000	-8.27	2.59	8.11	0.32	0.16
Event Driven Funds	Arbitrage Fund;R	ARBFX	2,000	-0.63	2.92	3.67	0.80	0.45
Event Driven Funds	Gabelli Enterprise Mergers & Acquisitions Fund;A	EMAAX	1,000	-26.72	4.83	13.49	0.36	0.93
Event Driven Funds	Merger Fund;Investor	MERFX	2,000	-2.26	3.54	3.74	0.95	0.70
Event Driven Funds	Quaker Event Arbitrage Fund;A	QEAAX	2,000	-25.74	6.13	15.59	0.39	0.93
Long/Short Equity Funds	Aberdeen Equity Long-Short Fund;C	MLSCX	1,000	-14.55	3.07	7.82	0.39	0.83
Long/Short Equity Funds	Caldwell & Orkin Market Opportunity Fund	COAGX	25,000	-4.66	3.81	11.10	0.34	0.17
Long/Short Equity Funds	Diamond Hill Long-Short Fund;A	DIAMX	2,500	-23.65	7.75	14.04	0.55	0.82
Long/Short Equity Funds	Dunham Monthly Distribution Fund;A	DAMDX	5,000	-23.31	1.68	9.91	0.17	0.90
Long/Short Equity Funds	Forester Value Fund;N	FVALX	2,500	0.39	4.96	9.47	0.52	0.46
Long/Short Equity Funds	Guggenheim Alpha Opportunity Series;A	SAOAX	100	-35.13	9.56	18.35	0.52	0.87

Table 2, continued

CATEGORY	FUND	Ticker	Minimum Initial Inv.	Performance in 2008	10-Year Annualized Return	10-Year Standard Deviation	Return per unit of Volatility (higher is better)	10-year Correlation to 7Twelve
Long/Short Equity Funds	Guggenheim Long Short Equity Fund;H	RYSRX	2,500	-40.23	5.12	19.11	0.27	0.94
Long/Short Equity Funds	Hussman Strategic Growth Fund	HSGFX	1,000	-9.02	-0.92	6.71	-0.14	0.50
Long/Short Equity Funds	ICON Long/Short Fund;C	IOLCX	1,000	-40.41	4.20	18.48	0.23	0.84
Long/Short Equity Funds	PTA Comprehensive Alternatives Fund;I	BPFIX	100,000	-23.00	2.03	11.80	0.17	0.83
Long/Short Equity Funds	Robeco Boston Partners Long/Short Equity Fund;Inst	BPLSX	100,000	-21.15	12.72	26.96	0.47	0.71
Long/Short Equity Funds	Schwab Hedged Equity Fund	SWHEX	100	-20.51	5.71	11.13	0.51	0.90
Long/Short Equity Funds	Virtus Dynamic AlphaSector Fund;A	EMNAX	2,500	-6.09	2.34	13.16	0.18	0.31
Long/Short Equity Funds	Wasatch Long/Short Fund;-Investor	FMLSX	2,000	-20.93	6.82	13.20	0.52	0.87

Raw data source: Lipper for Investment Management and author

Table 3: Blended Portfolios—60% 7Twelve® Portfolio/40% Alternative Fund

Funds highlighted in yellow had better performance than the 7Twelve® Portfolio (performance and/or volatility and/or return per unit of volatility) Table Ranked by 10-Year Annualized Return (2004–2013)

CATEGORY	FUND	Ticker	Minimum Initial Inv.	10-Year Annualized Return	10-Year Standard Deviation	Return per unit of Volatility (higher is better)
Multi-Asset Portfolio "Core and Diversifier"	7Twelve® Portfolio	—	12,000	8.17	13.53	0.60
"Alternative" Funds blended with 7Twelve Portfolio in a 60/40 allocation (60% 7Twelve, 40% Alternative Asset Fund)				60/40 Portfolio Return	60/40 Portfolio Volatility	60/40 Portfolio Return per Unit of Volatility
Long/Short Equity Funds	Robeco Boston Partners Long/Short Equity Fund;Inst	BPLSX	100,000	10.23	17.5	0.58
Long/Short Equity Funds	Guggenheim Alpha Opportunity Series;A	SAOAX	100	8.82	15.0	0.59
Long/Short Equity Funds	Diamond Hill Long-Short Fund;A	DIAMX	2,500	8.07	13.1	0.62
Long/Short Equity Funds	Wasatch Long/Short Fund;Investor	FMLSX	2,000	7.68	13.0	0.59
Credit Focus Funds	DWS Unconstrained Income Fund;A	KSTAX	1,000	7.57	11.0	0.69
Credit Focus Funds	MainStay Unconstrained Bond Fund;A	MASAX	25,000	7.40	11.9	0.62
Event Driven Funds	Quaker Event Arbitrage Fund;A	QEAXX	2,000	7.39	14.1	0.52
Long/Short Equity Funds	Schwab Hedged Equity Fund	SWHEX	100	7.22	12.3	0.59
Long/Short Equity Funds	Forester Value Fund;N	FVALX	2,500	7.09	10.4	0.68
Long/Short Equity Funds	Guggenheim Long Short Equity Fund;H	RYSRX	2,500	7.05	15.5	0.45
Event Driven Funds	Gabelli Enterprise Mergers & Acquisitions Fund;A	EMAAX	1,000	6.86	13.3	0.52
Long/Short Equity Funds	ICON Long/Short Fund;C	IOLCX	1,000	6.71	14.9	0.45
Long/Short Equity Funds	Caldwell & Orkin Market Opportunity Fund	COAGX	25,000	6.70	9.9	0.68
Credit Focus Funds	Hartford Unconstrained Bond Fund;A	HTIAX	2,000	6.68	10.9	0.61

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Table 3, continued

CATEGORY	FUND	Ticker	Minimum Initial Inv.	10-Year Annualized Return	10-Year Standard Deviation	Return per unit of Volatility (higher is better)
Equity Market Neutral Funds	Gateway Fund;A	GATEX	2,500	6.61	10.6	0.62
Credit Focus Funds	AllianceBernstein Unconstrained Bond Fund;A	AGSAX	2,500	6.56	11.5	0.57
Currency Strategies Funds	Franklin Templeton Hard Currency Fund;A	ICPHX	1,000	6.49	9.1	0.71
Event Driven Funds	Merger Fund;Investor	MERFX	2,000	6.48	9.2	0.70
Equity Market Neutral Funds	Calamos Market Neutral Income Fund;A	CVSIX	2,500	6.36	10.8	0.59
Credit Focus Funds	FPA New Income Fund	FPNIX	1,500	6.36	8.0	0.80
Event Driven Funds	Arbitrage Fund;R	ARBFX	2,000	6.26	8.9	0.70
Long/Short Equity Funds	Aberdeen Equity Long-Short Fund;C	MLSCX	1,000	6.21	10.9	0.57
Equity Market Neutral Funds	Vanguard Market Neutral Fund; Institutional	VMNIX	5,000,000	6.18	9.2	0.67
Currency Strategies Funds	Lord Abbett Emerging Markets Currency Fund;A	LDMAX	1,000	6.11	11.4	0.54
Long/Short Equity Funds	Virtus Dynamic AlphaSector Fund;A	EMNAX	2,500	6.10	10.9	0.56
Equity Market Neutral Funds	GMO Alpha Only Fund;III	GGHEX	10,000,000	6.07	6.6	0.92
Equity Market Neutral Funds	JPMorgan Research Market Neutral Fund;Inst	JPMNX	3,000,000	5.99	9.3	0.64
Long/Short Equity Funds	PTA Comprehensive Alternatives Fund;I	BPFIX	100,000	5.77	12.3	0.47
Long/Short Equity Funds	Dunham Monthly Distribution Fund;A	DAMDX	5,000	5.62	11.8	0.48
Equity Market Neutral Funds	JPMorgan Multi-Cap Market Neutral Fund;A	OGNAX	1,000	5.54	8.5	0.65
Long/Short Equity Funds	Hussman Strategic Growth Fund	HSGFX	1,000	4.71	9.7	0.49

Raw data source: Lipper for Investment Management and author