Alternative investments enhance risk management

Of all the lessons learned from the 2008 market dislocation, one of the most lasting for many of us may be the realization that our tolerance for risk is actually lower than we previously imagined. Yet as the markets have recovered, we may also have learned to accept that some risk may be required to achieve the returns we seek.

These are reasons why living with risk—and therefore taking steps to manage it—may be a priority for you. Portfolio diversification is one way to hedge against risks associated with individual securities. Equity investors spread risk around by owning stocks from different sectors and geographies. Fixed income investors do the same thing by purchasing bonds from different issuers with different credit ratings and maturities.

But what happens when broad price swings rema in commonplace for stocks? And when bonds and cash seem "stuck" in a low interest rate environment? How does one protect against these types of more systemic risks?

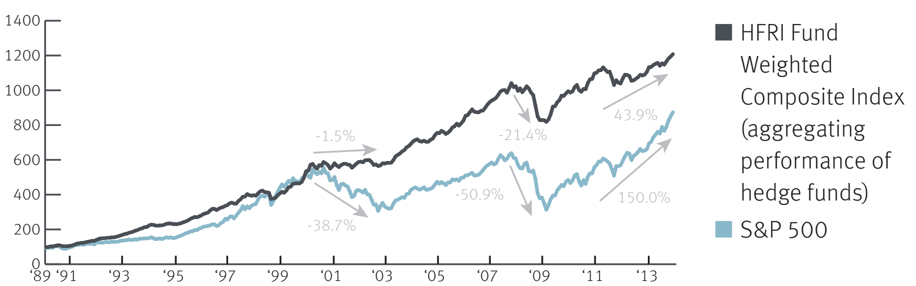
Alternative investments may offer a solution. They can be defined in simple terms as any investment outside ownership of publicly traded stocks, bonds and cash. Some examples include real estate, commodities, hedge funds, managed futures, private equity and real assets.

By allocating a portion of your portfolio to alternative investments, you may lower your risk exposure by taking advantage of what are often called "non-correlated asset classes." This term is used for alternative investments because their performance is less likely to correlate with performance of the broader stock, bond and cash markets.

To help respond to equity market volatility, an alternative investment that reduces the magnitude of price fluctuations—both up and down—may help improve overall returns. By losing less value (compared to a volatile benchmark) an investment can recover faster—and grow more quickly. Even if the rate of growth is lower than that of the volatile benchmark.

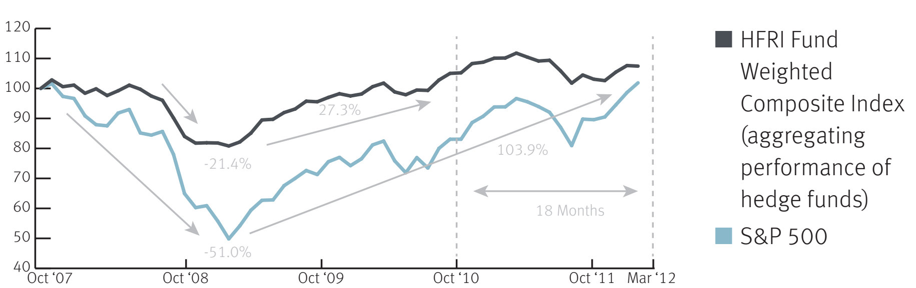
Differentiated sources of return

Resulted in 330% difference over 24 year period



Limited downside protection

Resulted in faster recovery from market dislocation
Drawdown period = October 2007 to March 2012



For example, since 1989, an index aggregating the performance of hedge funds captured about 50% of the upside and about 25% of the downside of the S&P 500 Index returns. Yet hedge funds as a whole still outperformed the S&P 500 by around 330% over the same period. Limited downside protection also resulted in a faster recovery from the 2008 market dislocation (see charts below).*

Of course, past performance does not guarantee future results. These examples are intended to highlight a strategic concept. In the very same way that the hedge fund index "gained more by losing less" during periods of volatility (compared with the broader market index), allocating a portion of your stock portfolio to a hedge fund may offer additional diversification to help smooth out the harmful effects that wide-ranging price variations may have over time. Alternative investment strategies are available to help you manage risk and improve returns for your fixed income portfolio as well.

Alternative investments do come with important considerations to understand before investing. Not all strategies are alike or serve the same purpose. Some may use leverage or other complex financial structures that involve risk, and some may be illiquid and difficult to value. As a result, they are subject to different securities industry regulations, and due diligence is critical for manager selection. Because of these considerations, alternative investments are suitable only for investors who meet minimum investment experience and asset level requirements.

However, mutual funds holding alternative investment positions are also available to almost any investor seeking further diversification opportunity. So whether you are an "accredited investor" who can demonstrate the proper qualifications or an "everyday investor" looking to expand your possibilities, there may be an alternative investment solution that is appropriate for your individual circumstances, goals, risk tolerance and liquidity needs.

To learn more about alternative investments, please call your RBC Wealth Management® financial advisor.

* Source: Zephyr Analytics, HFR Hedge Fund Indices – HFRI Fund Weighted Composite Index. Past performance is not indicative of future performance. No chart/graph should be used as investment advice.

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