What Every Investor Should Know About Alternative Investments

Alternative investments are complex investments that involve significant fees and risk of loss. Alternative investments are investments other than one of the three conventional asset classes: common stocks, bonds and cash. For example, venture capital investments, private equity, hedge funds, exchange-traded notes, limited partnerships, structured products are alternative investments. There are many others. In the current low-yield, highly volatile market environment, alternative investments are aggressively sold to individual investors seeking higher yields and lower volatility. Unfortunately, alternative investments present a number of risks and problems that are recognized by experts, but poorly understood by most financial advisors and investors.

The risks and problems associated with alternative investments may include one or more of the following:

- *"Alternative investments are speculative and include a high degree of risk. They are typically highly illiquid. …. Most alternative investments are also very volatile. Investors could lose all of, or in some cases more than the original amount of, their investment. For these reasons, they are suitable only for experienced and sophisticated investors who are capable of understanding and assuming the risks involved and who are willing to forgo liquidity and put capital at risk for an indefinite period."* ("Wave Theory for Alternative Investments – Riding the Wave with Hedge Funds, Commodities, and Venture Capital," by Stephen Todd Walker).

- Alternative investments are complex. It is important to understand that *"[t]he more complex the product, the more likely it is that the complexity is designed in favor of the seller or issuer, not the investor."* ("The Only Guide to Alternative Investments You'll Ever Need – The Good, The Flawed, The Bad, and The Ugly," by Larry E. Swedroe and Jason Kizer).

- *"America's retail investors are not accustomed to the realities of alternative investments: portfolios of illiquid securities; the use of substantial leverage; concentration of investments; and excessive compensation arrangements detrimental to their interests."* (Joseph P. Borg, the Director of the Alabama Securities Commission and former President of the North American Securities Administrators Association (NASAA)).

- 52 percent of financial advisors admit they do not *"feel as knowledgeable about alternatives as they would like to be."* ("Alternative investments aren't for everyone," MarketWatch).

- Alternative investments typically have high fees and commissions, which both reduce returns and incentivize selling agents to sell the product regardless of its unsuitability for the customer.

- Alternative investments are illiquid investments with long lock-up periods making them hard to cash out.

- Alternative investments are complex and opaque, making them difficult for brokers and investors to understand how they work and what the risks are.

- Alternative investments are volatile. The apparent stability of some alternative investments may be an illusion caused by illiquidity and related valuation problems. Many brokers misleadingly value illiquid non-traded REITs, hedge funds, limited partnerships, and private (Reg D) offerings at cost, regardless of significant changes in the values of the underlying assets.

- Derivatives (options and swaps contract) are frequently imbedded within alternative investments. Derivatives greatly increase the amount of leverage and volatility, and greatly decrease transparency with respect to pricing and the quality of the underlying assets.

- Claims of upside potential are often exaggerated as high fees and expenses may significantly erode returns.

- Claims of downside protection are misleading. Alternative investments have to make risky bets to earn the same return as index funds net of fees and expenses. They often use risky derivatives and leverage, and dangerous strategies such as going short - i.e., selling a security you do not own and hoping to buy it back later at a lower price. Even alternative investments are with guarantees of principal protection are merely the unsecured obligation of the issuer, which may default on the "guarantee," as holders of Lehman Brothers 100% Principal Protection Notes discovered.

- Performance fee triggers may incentivize managers to take unsuitable risks with other peoples' money to reach the performance trigger.

- Claims that alternative investments enhance diversification of a portfolio because they are not correlated with traditional stocks and bonds are often false. For example, many hedge funds crashed along with the stock market.

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