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THE WORLD OF ALTERNATIVE INVESTMENTS:

What investors need to know

Most people have a good understanding of traditional investments – stocks, bonds and cash – and either own these investments directly or through registered investment companies – a fancy phrase that includes mutual funds, exchange traded funds, closed-end funds and unit investment trusts.

In fact, registered investment companies are so popular that today they collectively hold over $18 trillion in assets on behalf of more than 90 million retail investors. And shockingly there are over15,000 mutual funds alone! Yet there is an entirely different world beyond registered investment companies that investors need to know about – and it's called the world of alternative investments.

A Simple Definition

In simple terms, an alternative investment is an asset that is not one of the conventional investment types (stocks, bonds and cash). Examples include venture capital, private equity, hedge funds, real estate investment trusts, commodities, precious metals, rare coins, wine and art, among others. One significant appeal of alternative investments is that they usually have low correlations to traditional assets, which helps with diversification by lowering risk and increasing return potential. The flip side is that alternatives are often less liquid (i.e., more difficult to buy/sell) and can be quite complicated – so not every investor can access.

Buyer Beware

It is recommended that investors consult a trusted financial advisor on what investments fit appropriately within one's given portfolio and risk tolerance. Most importantly, investors must understand the investment opportunity, how the investment will help access that opportunity and the overall risk. Additionally, although the Securities and Exchange Commission does not regulate most alternative investments, many managers of alternative investments will still register as investment advisers with the SEC or state securities commission, so reviewing their background is essential.

Liquid Alternatives

Liquid alternatives – or liquid alts – are alternative investment strategies that are available through vehicles such as mutual funds, ETFs, and closed-end funds. The reason they are described as liquid is because they allow investors to buy and sell daily – whereas other alternatives usually allow for buying and selling at prescribed (and infrequent) times. And, as you might imagine, the world of liquid alts is large and growing, but I'll leave that discussion for another time. Here are several common types of alternative investments:

Private Equity

Did you know that there are actually more private companies than public companies? And many of them accept investor capital (money). Private equity is a very broad term that covers the entire investment spectrum of the private capital markets. And there are different private equity firms specializing in lots of different investment strategies. Private equity firms typically raise money from both non-institutional and institutional investors and use the money to place investments in what they consider to be promising private companies. Private equity firms and their investors then receive their investment – hopefully with a healthy return – upon an event such as an IPO or acquisition.

It should be noted, however, that private equity firms do receive a management fee much like mutual fund portfolio managers. In addition, private equity firms usually receive a performance fee.

In overly simple terms, look at it this way: Portfolio managers of mutual funds pool shareholder's money and invest in publicly traded companies, thereby allowing their investors to buy and sell mutual fund shares daily. Private equity managers also pool their shareholders' money, but they invest in private companies and do not allow their investors to buy and sell their private equity shares daily.

Venture Capital

This is a subset of private equity specializing in investing in companies that are in the early stages or what is often called the early-growth stage. This capital source is very important for start-ups that have no access to public or bank financing and is typically a risky asset class, although it can produce outsized returns.

Direct Investments in Start-ups & Private Companies

Investors can skip the private equity firms and invest directly into start-ups and private companies. Investing “seed capital” directly in start-ups is sometimes referred to as angel investing. But despite its name, angel investing is a high risk and high return strategy for investors as most startups end up failing.

Many private companies will seek investors through a private placement based on a certain valuation. The challenge for investors is determining the legitimacy of the valuation, because the valuation is often calculated by the owner of the private company – and they often present a rosier picture of their company’s worth.

Private Placement Debt

Investment in private placement debt is a very large market in the alternatives space. Recently, new issues of private placements amounted to over $50 billion, compared with more than $1 trillion in the public corporate bond market, according to Macquarie.

Similar to private placement equity, private placement bonds are not issued or traded publicly and are not required to be rated by a credit rating agency.

Real Assets

Real assets are tangible assets that have intrinsic value (hence the “real”), such as real estate, oil, precious metals, and commodities. Luxury and collectable goods also fall into this category, including antique cars, art, wine, jewelry, rare coins, and baseball cards. Investors can buy real assets directly or through a manager specializing in real assets.

The challenge, as you might imagine, is that real assets are not very liquid and valuations are often challenging to determine. For example, just because I buy 5 rare coins for $100,000 that does not mean that the coins are actually worth $100,000. Remember the old adage: something is worth what someone else is willing to pay for it? Not necessarily what I paid for it.

Hedge Funds

Hedge funds are similar to mutual funds in that they are pooled investment funds that are formed to invest in a variety of strategies and asset types. Hedge funds are different from mutual funds in that hedge funds often employ “riskier” investing strategies – like borrowing, selling short and using derivatives.

It is important to note that hedge funds are generally only accessible to experienced investors – called accredited investors – in part because there is less regulation when compared to mutual funds. Hedge funds are most often established as private investment limited partnerships that are open to a limited number of accredited investors, require a large initial minimum investment, often require investors keep their money in for at least one year, and require that withdrawals may only happen at certain times.

And Finally, Caveat Emptor…Again

Caveat emptor is an ancient principle meaning “let the buyer beware.” It is rooted in what is called information asymmetry – meaning that most often the seller knows way more than the buyer about the quality of a good or service (or alternative investment).

Accordingly, it is imperative that investors and their financial advisors perform their own rigorous and independent due diligence so that the risks and rewards of alternative investments are fully understood.

If you have any questions about the world of alternative investments or are considering accessing this world, please contact our office so that we can discuss.

EVERGREEN™
WEALTH SOLUTIONS

www.evergreenwealthsolutions.com

info@egwealth.com

1000 Commerce Park Drive, Suite 416
Williamsport, PA 17701

Phone: 570.601.6960 | Fax: 570.651.9032