THE LEISURE CAPITAL GUIDE TO

ALTERNATIVE INVESTMENTS

WHAT they are, **HOW** we use them, and **HOW** they can add value to your portfolio

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Introduction

You may be wondering why I chose to write a book (even a short one) about the relatively obscure topic of alternative investments. It's a fair question. In fact, when I first began toying with the idea, I wondered if our clients would even care! But the more I thought about it, the more I was certain that this information was too important to leave sitting in a drawer.

In recent years, alternatives have grown in popularity. Large asset managers have launched new alternative investment funds. Financial advisors are increasingly using alternatives to solve problems for their clients. There are even a growing number of retail offerings that provide access to investors managing their own portfolios. The result: according to investment data company Preqin, alternative investment assets under management are projected to reach $23.3 trillion by 2027—nearly double 2021 levels. Given the prevalence, complexity, and novelty of alternatives, I believe it is more important than ever that investors who hold them know what they are, how they work, and why they matter.

At the highest level, alternative investments present one of the most predictable methods available for improving risk-adjusted return in a diversified portfolio. And yet, despite their success rate at achieving this goal, it has been challenging for investors (including many experienced advisors) to get beyond the basic definition of alternatives. This is largely because the world of alternative investments is rarely explained well—if at all. My goal is to move the needle in that regard, starting by opening a window into the world of alternative investments for our clients at Leisure Capital.

Inquisitive investors want to know how their money is invested—and why. I hope this book achieves the goal of answering your ques-

tions in a way that makes alternative investments accessible, understandable, and even a little fun. To anyone who wants to expand their knowledge of investing by diving deeper into the unique world of alternative investments, this book is for you.

I hope you enjoy it!

Patrick

Alternative investments mean different things to different people. At Leisure Capital Management (LCM), we take a somewhat unique approach to applying 'alternatives' as part of our investment strategy—one that is designed to address the specific needs of our client family.

While alternatives aren't for everyone, they can serve as a valuable diversification tool that brings one more welcome layer of protection to your overall investment portfolio.

Alternatives (in a nutshell)

Broadly speaking, alternative investments include any investment option that doesn't fit squarely into the three most common investment categories: stocks, bonds, and cash. The category of alternatives is broad and includes a wide range of assets such as real estate, commodities, private equity, hedge funds, art, collectibles, cryptocurrencies, and more.

The value of these non-traditional investments is that, in general, they behave differently than stocks and bonds. And because alternatives don't necessarily follow the same trajectory as the general market, they can help dampen volatility (a measure of risk) within a portfolio. This is a benefit many investors appreciate—especially in times of market uncertainty.

Are alternatives hedge funds?

Just as 'all apples are fruits, but not all fruits are apples,' all hedge funds are alternatives, but not all alternatives are hedge funds. That said, there are favorable characteristics of hedge funds—particularly the ability of certain hedge fund strategies to dampen negative returns when combined with stocks—that make them ideal for our client portfolios today.

Other examples of alternative investments include private equity, venture capital, direct real estate investing, infrastructure funds, and art & collectibles. Due to their long lock-up times and high level of risk, we do not currently include these other categories of alternatives in our investment strategy.

Alternatives can help dampen portfolio volatility—a benefit for which many investors are grateful in times of market uncertainty.

While alternatives can play an important role in your investment strategy, there are many things they decidedly are not:

- Alternatives are not a direct hedge against a down market (though, by name alone, hedge funds certainly imply the opposite!).
- Alternatives are not insurance against market losses.
- And, like equity and bond investments, alternatives are not guaranteed.

What they *are* is a supplemental strategy to traditional positions in stocks and bonds (both of which focus on long-term growth) and cash. In contrast, alternatives are more active, return-seeking strategies with different risk characteristics than these common asset classes that are often the 'bread and butter' of most portfolios.

Importantly, alternatives often exhibit what's called a low *correlation* with stocks and bonds, meaning that when stocks and bonds go up or down (usually in opposition to each other), alternatives rarely follow the same trajectory.

To build on that strength within our own portfolios at LCM, we strive to select funds that demonstrate very low correlation to stocks and bonds while simultaneously delivering positive returns. Though actual returns vary, alternatives tend to deliver a level of risk and return somewhere *in between* stocks and bonds. Among these three asset classes, stocks are considered the riskiest with potential for the highest returns, bonds offer the least risk but with lower returns, and alternatives deliver a level of risk and return that lies somewhere between the two.

Why correlation matters

While low correlation isn't always needed, there are times when using three different methods to work toward the same goal can have a tremendous impact.

Say you're going skydiving. For maximum safety, you employ the principle of triple redundancy by having three different experts, each with varied training, pack your parachute. In mid-air, if one parachute fails, the others serve as backups, with each prepared for different scenarios. Similarly, in a diversified portfolio, when one asset falters, others might remain stable, providing a protective safety net. And while it is certainly possible, it is highly unlikely that all methods will fail at the same time.

Correlation is an important measurement because it demonstrates the level of diversification within a portfolio. Remember that the lower the correlation is between two assets (or groups of assets), the less likely they are to move in the same direction under similar market conditions. This diversification can help protect the portfolio from significant losses when one asset type underperforms.

For example, two high-flying technology stocks are likely to have a very high correlation—as high as the maximum correlation of 1.0. The reason for this high correlation is that they share common traits, including investor sentiment toward the technology sector, sector-specific headwinds, and exposure to the same underlying economic events and conditions.

However, the correlation between one of those technology stocks and a US government bond would be significantly lower. This is because the investment outcomes of US government bonds are influenced by very different factors than technology stocks, including interest rates, inflation expectations, creditworthiness of the US government, global economic conditions, and investor sentiment towards riskier assets.

When building a diversified portfolio, adding investments that display low correlation to other assets in the portfolio creates attractive risk and return characteristics—and almost certainly improves the portfolio's risk-adjusted return.

It is important to note that this attractive low correlation of alternatives to traditional investments means that alternatives have a better chance of not moving downward at the same time as traditional investments. This characteristic is invaluable for most alternative strategies (including the LCM Alternatives Collection) because they are intended to dampen negative returns to a portfolio when combined with stocks, while also contributing to overall returns when things are going well.

Smoothing the ride in volatile markets

In general, stocks and bonds have a push-pull relationship in an investment portfolio. When stocks are stronger, bonds are typically weaker. The same is true in reverse. This is precisely why a diversified portfolio includes both asset classes. By bundling assets that behave in opposite ways to the same market or economic conditions, a diversified portfolio is more likely to deliver positive returns over the long term. However, as 2022 illustrated all too well, this push-pull dynamic doesn't always hold true. There are times when stocks and bonds both lose value at the same time, washing away the diversification power of the 'normal' stock-bond relationship. When this happens, alternatives can help smooth the ride for investors.

Averting the sting of a down market

Though there is no way to predict how the market will behave at any given time (if only we had such a crystal ball!), 2022 illustrated how alternatives can smooth the ride for investors—even in an extreme market environment.

In a snapshot, the graphic on the following page shows the returns for that particularly grim year. As you can see, while alternatives were not a silver bullet for investors, those who included Managed Futures (one of our preferred alternative investments) as part of their strategy would have felt a bit less of a sting from otherwise dismal returns.

The LCM approach

Alternative investments are used in different ways to achieve a wide variety of goals. At LCM, our primary goal when using alternatives is to have a tool in place that allows us to easily 'trim the sails' to help our portfolios stay on course. Just as weather forecasts can only provide an educated guess of how strong the winds of a storm may be, even the most knowledgeable and experienced market analysts cannot consistently predict the future in investment markets. To be prepared for whatever weather lies ahead, we apply a carefully curated group of alternatives that exhibit traits most of our clients desire and demand. These select alternatives are:

- Easy to apply in a managed account structure
- Consistently more liquid than many other alternative investment options
- Held and visible in the same trusted custodial account
- Easy to incorporate in tax reporting as part of an existing 1099

Importantly, we use alternative investments as a supplemental strategy to help improve risk-adjusted return. In other words, we use alternatives to better balance the equation between potential profit in the portfolio and the degree of risk that must be accepted in order to achieve that profit. As well, we use alternatives to improve risk-adjusted return not only in portfolios with equity exposure (where alternatives are often touted as having the greatest impact), but also to help protect assets in fixed-income portfolios that are especially susceptible to fluctuations in interest rates.

When alternatives are combined with traditional asset exposure, risk is reduced meaningfully, with only a small sacrifice made to returns.

We believe in the value of alternatives, in part because classic academic research demonstrates that when alternatives are combined in a portfolio with traditional asset exposure, risk is reduced meaningfully, with only a small sacrifice made to returns. However, not all alternatives work in the same way, nor do they deliver the same outcomes. Some alternative funds are designed to generate returns by taking advantage of market volatility to provide short-term protection during equity and fixed-income slumps. Others are more focused on generating profit in a way that is completely unrelated to coexisting investments.

In this way, the alternatives universe is similar to a massive toolbox that contains a variety of tools that work in slightly different ways. Just as a handyman chooses between needle-nose pliers or locking pliers based on the specific task at hand, we select alternative investments based on their unique attributes and how they fit into a client's financial strategies. And while you wouldn't (or shouldn't!) use needle-nose pliers to grip a rounded bolt tightly, we wouldn't choose an investment with high liquidity risks for a client who needs short-term accessibility. The key lies in understanding the investment tools that are available and selecting those that are precisely tailored to the task. For our clients, we believe the most beneficial approach is to allocate a portion of a portfolio (typically about 20%) to alternative funds that aim specifically to *reduce risk while preserving return*. We strive to achieve this ideal by:

- Using a small subset of the many available alternative investments to create a curated mix of assets that supports the objectives and liquidity preferences of many of our clients
- Taking a flexible approach that gives us the freedom to change the categories, specific groupings, and weight within the portfolios over time as new categories emerge and circumstances shift
- Applying our preferred mix of alternatives differently depending on whether the goal of the portfolio is growth or income

A word (or two) about risk

It is easy to misunderstand the sources of risk in a portfolio. The reason: while a portfolio that is 50% equities and 50% bonds may sound 'balanced,' roughly 90% of the total portfolio risk is driven by equities. Why? Because equities present significantly higher risk compared to bonds.

This difference in risk is clear to anyone who drives a car. While the gas and brake pedals look similar, the function of each pedal—accelerating and braking—present very different levels of risk when they malfunction. If the gas pedal fails, while inconvenient, you can simply pull over to the side of the road without danger. If the brake pedal fails, the consequences can be severe. Even though both pedals play crucial roles, the impact of their failures isn't equal.

Similarly, even if you have an equal split between equities and bonds in a 'balanced' portfolio, the risks these assets present aren't equivalent. Like the brake pedal in a car, equities contribute significantly more to the overall risk than bonds. For this reason, it would be misguided to design an alternatives portfolio that focuses equally on managing the risk from equities and bonds.

Fine tuning risk

While it's true that alternative strategies should not be viewed as a direct hedge against a down market, it is also true that alternatives can be highly effective at easing the impact of negative returns when they are used as part of a diversified portfolio. To understand how this works, it can help to address this basic question:

How do alternative strategies remain resilient in down markets?

The answer is often through the act of 'short selling' or 'shorting.' Because this practice is often misunderstood, it is worth a brief discussion here.

- ***Buying long*** is the act of buying an asset with the expectation that the price of the asset will increase over the holding period (ignoring income or yield for the sake of this example). When an investor 'buys long', the potential loss is limited to the initial purchase price of the asset, and there is no limit to the potential growth over the long term. Most equities assets in a typical investment portfolio are purchased with the goal of benefiting from the long-term exposure that is achieved by *buying long*.
- ***Short selling*** is quite different. In this case, there is an expectation or concern that the price of the asset will not increase, but decline. Though it may seem counterintuitive, short selling can help bolster a portfolio by effectively 'borrowing' (and immediately selling) shares of a stock or other assets that are expected to decrease in value and later re-purchasing shares at the lower market price to repay the loan.

Short selling can be used in different ways depending on the goal of the transaction. Perhaps the most simplified method of short selling (also called 'naked short selling') is a high-risk approach often used by aggressive traders seeking short-term profits.

A high-risk approach to short selling

Let's say a portfolio manager has a very high degree of confidence that the price of a certain healthcare stock will decline significantly after the company's next earnings call. If he has $0 in his account, he can 'borrow' 1,000 shares of that stock from his custodian for the current price. If the price is $100/share, he immediately receives $100,000 in his account—as if he had sold the shares. (Note that in this example, no collateral is required.)

Luckily for him, his bet was correct! Following the earnings call, the company's stock drops to $75/share. He now decides that it's time to repay the loan by purchasing 1,000 shares of the company and delivering them to the lending custodian. Of the $100,000 he received earlier, he spends $75,000 to acquire the shares, and then pockets the difference. Though the stock dropped in value, he made $25/share and earned a quick $25,000.

It sounds almost too good to be true. But as you can see in the example, the portfolio manager must have an extremely high level of confidence in the outcome of the transaction for this approach to

deliver benefits. Not only are declines in a specific stock price difficult to predict, but while the risk of loss when buying long is limited to what you pay for the investment, the risk of loss when short selling is theoretically infinite since the price of the 'shorted' security can climb indefinitely. For this reason, naked short selling is a strategy that should only be undertaken by experienced traders and investors.

So why does short selling make sense as part of an alternatives strategy? Is it worth the risk?

While naked short selling might be attractive to investors seeking large, quick profits, it introduces an inappropriate level of risk for our clients. From our perspective, naked short selling is not worth the risk. But there is another approach to short selling that involves much less risk and is much more suitable for alternative strategies like our own.

The goal of short selling in most alternative strategies, ours included, is to help mitigate risk—not increase risk in hopes of great rewards.

The goal of short selling in most alternative strategies, ours included, is to help mitigate risk—not increase risk in hopes of great rewards. Owning a combination of long and short positions allows a skilled fund manager to use short selling to maintain exposure to the risk factors they want to own and eliminate those they do not.

Short selling to mitigate risk

Using the same example of the healthcare stock above, let's say the portfolio manager has the same high degree of confidence that the price of the stock will decline in the near future. Unfortunately, he already owns 100 shares of the stock, so if he is correct about the drop in price, he faces a potential loss.

To reduce exposure to that holding, he can short sell the same stock to 'borrow' 100 shares at the current price. If the stock then drops to $75/share, the loss in value in the shares he already owned will be offset by the profit made with the short position, keeping his portfolio value intact. It's like selling an extra concert ticket at a high price today because you expect it will be cheaper tomorrow—a strategy that, when done right, leaves you neither richer or poorer.

While there are funds that focus 100% on short selling, few of these are successful at delivering meaningful returns. The reason: while there is inherent risk in investing, most assets have a positive return over reasonably long holding periods. Short selling is going against the very nature of most investments. A manager that only sells short must have an excellent research process—and excellent timing. Short selling shines in risk management, where a combination of investing long and short is used to achieve a precise risk exposure that makes sense for the particular investment strategy.

As you've now seen, short selling can be used to reduce risk exposure to a specific stock. But what if the entire sector experiences a downturn? Here, too, short selling can be beneficial.

For instance, say that I hold a strong opinion that one stock is likely to perform well relative to its peers. However, I have concerns about some downward pressure on the overall sector. In this case, I might choose to purchase the stock of the company I favor, but then balance that risk by taking a short position on the sector as a whole. Using this strategy, I'm able to focus my risk exposure on how my favored stock performs—even if its peer group experiences a downturn.

Global Macro is another alternative strategy that relies on short selling to seek to capitalize on large-scale economic trends and events. The goal of a Global Macro alternatives strategy is to profit from broad market shifts caused by geopolitical, economic, or financial events. For instance, during the 2008 global financial crisis, many macro investors anticipated the severe repercussions of the US housing bubble burst and the subsequent risk of a global recession. As banks faced liquidity crunches and markets became volatile, some macro strategists took short positions in overleveraged banks or went long on safe-haven assets like gold and US Treasuries. Similarly, in the wake of the Brexit vote in 2016, global macro strategists who foresaw the potential for a decline in the British pound took positions that would profit from its depreciation.

The goal of a Global Macro alternatives strategy is to profit from broad market shifts caused by geopolitical, economic, or financial events.

In both examples, the objective was not just to profit, but also to hedge against widespread market downturns and reduce the overall risk to their portfolios.

Short selling with Global Macro

Suppose a portfolio manager believes that Japanese interest rates will fall. Because bond prices typically rise when interest rates fall, this makes it desirable to own Japanese Government Bonds.

However, let's also suppose that, at the same time, this US-based manager believes the Japanese Yen will fall relative to the US Dollar. An available strategy would be to buy the bonds and short the Yen. This trade would position the fund to benefit from falling Japanese interest rates while eliminating the risk of a declining Yen. Assuming this manager used many trades of this nature, the overall portfolio would be a combination of many long and short positions.

Many hedge funds (an educated guess points to more than half of all funds) engage in short selling at some level. Most investors are more concerned with the returns generated by these strategies, and less focused on the mechanics of how the returns are actually achieved. The most important thing to understand is that, for long-term investors in alternative strategies, the availability of shorting increases the odds of successfully growing assets while reducing overall portfolio risk.

As you can see, this is a complex strategy best left to the experts. It requires a deep understanding of financial markets and portfolio construction, as well as a robust risk management process. At LCM, we work with trusted fund managers with long track records of success with these sorts of strategies. As experienced portfolio managers, we can then determine how best to apply the strategy—including where and how much—to effectively fine tune the level of risk within our client portfolios.

Alternatives: a top-notch tool for diversification

Thanks to the many examples of alternatives performing well when equities perform poorly, these assets are considered to be excellent diversifiers that help reduce risk exposure for portfolios that tilt heavily toward equities.

The fact that alternatives also tend to deliver positive returns when equities are up makes them especially valuable in a portfolio. By providing access to categories of assets that are not contained in the traditional, long-only investment buckets of stocks, bonds, or cash—and that have the potential to move in opposite trajectories compared to these traditional investments—alternatives are one of the best diversification tools available to investors today.

Top-notch indeed!

On 'beating the market'

In some forums, alternatives (specifically hedge funds) are presented as tools to help investors 'beat the market.' While there are certain alternatives that are used in an effort to achieve this goal, at LCM, using alternatives to outperform the market is not our focus—and not our goal.

In general, the concept of 'beating the market' is best applied to traditional investment strategies, simply because only portfolios that are heavily weighted in equities can be properly compared to the overall 'market.' For instance, it is quite common for managers of US stock funds to compare their portfolio performance to the performance of the S&P 500 over windows of 1, 3, 5, and 10 years. This is because, as a collection of large-cap US stocks, the S&P 500 provides a very simple comparison.

However, despite the sensical need to compare apples to apples—or equities to equities—even the financial press often make the mistake of comparing the performance of alternative strategies to the S&P 500 when trying to uncover which horse has 'won the race.' But this apples-to-oranges comparison can be misleading. This is especially true if alternatives are being applied with the goal (our goal!) of achieving a better risk-adjusted return to smooth the ride for the investor.

Consider the goal

Imagine entering a bakery and comparing a rich chocolate cake to a multigrain loaf of bread based on their relative sweetness. The cake would undoubtedly 'win' on that front! But if you compared the two based on their nutritional value, the bread would be the clear 'winner.'

Judging the performance of alternative strategies against the S&P 500 is like comparing cakes with breads based solely on sweetness rather than on the unique qualities and purposes of each. What's true in the bakery is also true in your balanced portfolio.

To illustrate this point, let's look at two investment scenarios over a 10-year window.

- In the first scenario, an investor is using a balanced strategy that includes 50% equities and 50% bonds. The strategy achieves its goal of delivering 10% growth, but market fluctuations cause significant highs and lows over the course of the decade.
- In the second scenario, alternatives are added to the mix to maintain a similar return profile, while also reducing the risk of the portfolio throughout the same 10-year timeframe. This strategy also achieves its goal of delivering consistent growth, but the highs and lows experienced using the traditional strategy are mitigated, eliminating the need to aggressively adjust (trade) the portfolio amid volatility.[1]

To some, that smoother ride may not seem particularly important at first glance. After all, both approaches deliver the same return over the long run. However, in our experience working with hundreds of investors, remaining comfortable amid market volatility is much easier said than done. This is true even for some of the most savvy, affluent investors. In theory, riding out market fluctuations may sound simple—even easy. In practice, even the normal ups and downs of portfolio values can be challenging. Not only can market fluctuations keep investors up at night, but short-term reductions in the value of a portfolio can also have a direct impact on liquidity.

[1] This claim is valid as of the end of 2022, looking back 10 years, using the HFRI Hedge 'Fund of Funds' Index for the comparison. HFRI represents comparable exposure to the asset mix included in our alternatives portfolios, including a broad bucket of strategies that are not overly exposed to equity risk factors.

Reduced liquidity and the wealthy investor

Imagine this scenario: A real estate developer had his assets invested in a traditional 50/50 stock and bond portfolio. In September of 2022, he was presented with an opportunity to make a key land purchase and needed liquidity to cover the costs. Unfortunately, the market turned down at just the wrong moment.

If he had opted to sell at the time, he would have converted temporary losses into permanent ones by selling securities at a low. If, on the other hand, his portfolio included a 50%/30%/20% respective mix of equities, bonds, and diversifying alternatives, his downside would have potentially been lower, helping provide liquidity for his real estate transaction.

Whenever liquidity is needed—for everything from a real estate investment to a home remodel to college tuition—including alternatives can help dampen downside risk.

Our goal when adding alternatives to the equation is not to beat the market, but to help our clients improve risk-adjusted return throughout the life of their portfolios. By doing so, we are able to dampen portfolio drawdowns, potentially provide greater liquidity and, ultimately, make it easier for our clients to stay invested by smoothing the ride—no matter where or when the market takes a turn.

Accelerating the power of active management

In its simplest form, active portfolio management means that an investment manager is 'actively' making buy, sell, and hold decisions about the assets in a portfolio with the goal of increasing returns. Active management should yield an investment portfolio that is different from its benchmark. How active management is approached, however, can vary widely, and the resulting portfolios vary as well.

As discussed earlier, our goal at LCM is to improve our clients' risk-adjusted return. Alternatives are one of the best tools in our arsenal to help achieve this goal. In many ways, alternatives are the purest example of active management.

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In discussions about the value of active management, you may sometimes hear investment returns categorized as 'beta' and 'alpha.' In general, passive management strategies rely on 'beta' and active management strategies strive to achieve 'alpha.'

- 'Beta' measures the degree to which a portfolio's movements are driven by moves in the broad market. Beta is often referred to as 'systematic market risk.' Similar to a weather forecaster looking at severe or calm weather patterns, beta is a measure of predicted high (or low) volatility of an investment.

- 'Alpha' measures performance—or the 'excess return' on an investment that is generally driven by active investment decisions. Alpha increases to the degree that a strategy exceeds the return attributable to the movement of the overall market (the beta) during a specific period. Achieving 'high alpha' in the investment world is the equivalent of finding the golden fleece.

By their nature, hedge funds are more focused on delivering alpha rather than beta. The primary goal of removing or reducing risk, or 'hedging', is to limit volatility caused by broad shifts in the market (beta). In certain instances, specific hedge fund strategies aim to remove beta entirely (e.g., Market Neutral hedge funds). The remaining (or excess) return on the portfolio is the alpha that active managers strive to achieve.

Alpha comprises more of the total return for alternative investments than it does for traditional investments.

While hedge funds are one category of alternatives that help explain alpha and beta, as we've discussed, alternatives come in many other shapes and sizes. Though the percentage of alpha may vary considerably within this category, alpha comprises more of the total return for alternative investments than it does for traditional investments. And though no investor would want to rely solely on alpha (the power of the capital markets should never be denied!), when applied as part of a balanced, risk-adjusted portfolio, alternatives effectively add alpha to the beta returns that are already in place. Icing on the cake, perhaps, but icing that adds those two key ingredients—diversification and improved risk-adjusted return.

Flexibility is another attribute of alternatives that supports active management. At LCM we currently apply two strategies: one to pair with portfolios oriented for growth, and one to pair with portfolios focused on generating income. In both cases, alternatives allow us to easily adjust the strategy depending on our clients' needs. Having the freedom to 'pull the levers' at any time helps accelerate the power of active management and, ideally, increase the alpha component of our portfolio returns.

The flip side of index funds

Is active management better than passive management? Why not just use an index fund? These are questions investors love to debate, and the infamous story of the 'Warren Buffett bet' has only added fuel to the fire. If you're unfamiliar with the story, here's the short version:

The Warren Buffett bet

In 2008, Warren Buffett challenged the hedge fund industry to a race against time. Buffett agreed to pay $1 million if a professional could build a portfolio of hedge funds that could outperform an S&P 500 index fund over a 10-year period. His goal was to pit expensive and often complex hedge fund strategies against inexpensive and passive stock market exposure.

Just shy of the end of the 10-year mark, the hedge fund manager conceded defeat. Of the five hedge funds chosen for the bet, the best one averaged 6.5% a year, or about 88% compounded. The worst returned 0.3% a year, or 2.8% compounded. The representative S&P 500 index fund generated an 8.5% annual return and about 125% compounded for the decade—a rate of return that would have resulted in a $1 million investment doubling to about $2.25 million.

It's a compelling story, but it doesn't tell the whole story. At first glance, the results can be interpreted to mean that simply investing in a market index fund always wins, and that investors are better served avoiding hedge funds entirely. But here's the caveat: while hedge funds are most often used in portfolios to complement existing stock market exposure, in this case, the hedge fund manager was focused on selecting funds that he believed could achieve the singular goal of outperforming the stock market. Any other approach would guarantee that he would lose the bet!

Still, this 'win' for the index fund might lead an investor to wonder if an indexed approach is the superior choice for all investment strategies. This line of thinking may also beg the question: why not apply a passive index strategy to alternative investments? Could an investor harness the power of alternative investments by using a low-cost, indexed approach?

The short answer is no, simply because alternatives are not assets that can be indexed. This is true for any active management strategy that delivers value through complex risk management techniques designed to produce return streams that deviate from buy-and-hold strategies that can be mimicked by index funds. Because an alternative fund's asset mix and strategy will usually be very different from the asset mix within an index, comparing alternative funds to common market indexes is both extremely difficult and largely irrelevant.

While Buffett's challenge spotlights the strengths of index fund investing in certain contexts, it shouldn't be seen as a blanket indictment of all active investment strategies. This is especially true in the realm of alternative assets which, by their nature, require a nuanced understanding that goes far beyond simple comparisons with traditional market indexes.

All that said, most hedge funds or alternative investments are not used to achieve the goal of outperforming (or beating) the market. As

mentioned earlier, the value of these strategies is realized when they are combined with traditional assets. When applied as a tool within a broad portfolio, hedge funds create the potential to earn more return while taking the same risk—while often decreasing drawdowns along the way.

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Index investing is a low-cost, passive option. For this reason, it may be a good option available to investors with limited assets and lots of time. But for wealthy investors seeking to improve risk-adjusted return and add unique sources of return while also maintaining their goals of investment growth and capital preservation, using only passive index funds simply leaves too much on the table. Only by adding truly unique and uncorrelated strategies does an investor have a meaningful chance of maintaining their return objectives while mitigating portfolio risk—a suit tailor-made for alternative investments!

Unique strategies to address diverse goals

The goals of our clients have a direct influence on how and when we apply alternatives within a portfolio. Whatever your personal goals may be, we offer different alternative strategies from which to choose at any point in your financial journey.

In general, our clients typically fall into two groups: those who are focused on asset growth, and those who are focused primarily on capital preservation and income. It is important to note, however, that these two groups are not defined by simple traits such as age, assets, or whether they are actively earning an income. Instead, what often dictates the most appropriate investment strategy—including the addition of an alternatives strategy—are the client's specific short- and long-term investment goals.

Whatever your personal goals may be, we offer multiple alternatives strategies from which to choose at any point in your financial journey.

Many of our older, retired clients view capital preservation as their primary objective. The same is true, however, for many of our ultra-high-net-worth clients who have no need to grow their assets. And while many younger, high-earning professionals are striving to grow their portfolios aggressively, we also have older clients who, having accumulated a high level of wealth, are willing to take on greater risk in order to leave behind a more substantial legacy to future generations.

Whenever the primary investment objective is to grow and preserve assets, investors are likely to benefit most from active management using a strategy that applies alternatives to help limit the impact of large market declines on their significant portfolios. For clients focused on capital preservation and income, we adjust the type and amount of alternatives in their fixed-income portfolios to help preserve assets using the risk-mitigation benefits that are particularly appropriate for them.

The LCM Alternatives Collection

At LCM, we include a 'Multi-Strategy' bucket of assets within our portfolios. A key component of this asset set, the LCM Alternatives Collection is used to create the flexibility and liquidity needed to support our clients' unique goals.

The LCM Alternatives Collection consists of the following strategies, including six that are in use currently, as well as to-be-determined categories that may be added in the future:

- **'Fund of Funds'** The dispersion between the best and worst performing funds in traditional assets such as stocks and bonds is wide, leaving investors with the challenge of finding managers that will consistently perform well. This challenge is even more difficult among hedge fund strategies. Hedge 'Fund of Funds' strategies offer broad exposure to a variety of hedge fund strategies that are chosen by expert investors with deep experience in hedge fund manager selection.
- **Managed Futures** Managed Futures strategies are generally synonymous with 'trend following.' The trend-following strategy seeks to profit from the reliable trending nature of markets, which is largely driven by investor behavior. These strategies are able to go long when a market has been increasing in value and, conversely, are able to go short when a market has been decreasing in value. The ability to profit from both a rising and a falling market is a large part of what makes Managed Futures investing so attractive. Further, trend following tends to perform well when stocks and bonds are at their worst—a rare quality for an investment strategy and incredibly valuable for a diversified portfolio.
- **Global Macro** As discussed earlier, this strategy is built around predictions and projections of global events—macroeconomic and geopolitical trends that impact interest rates, currency exchange rates, stock markets, and international trade. There are many types of Global Macro strategies. LCM has focused on Global Macro strategies which are diversified across regions and asset classes, broadening the opportunity set.

Though each of these strategies is included in the LCM Alternatives Collection, how and when we apply them is fluid base on current economic trends.

- **Risk Parity** Most portfolios are constructed and diversified by considering the dollars invested, or the notional exposure across investment categories. The Risk Parity strategy attempts to take diversification a step further, recognizing that some investments exhibit much more risk than others, and thus diversifies based on the amount of risk that an investment contributes to a portfolio. This portfolio is designed to maximize the diversification benefit of combining different asset classes—often touted as the only 'free lunch' in the investment world.

- **Diversified Income** To further mitigate risk within the portfolio, Diversified Income funds invest in a broad set of assets, including everything from foreign and domestic bonds and stocks to assets like real estate securities, corporate bonds, Treasuries, and money market funds. Because these funds don't focus on a specific industry, sector, or asset class, they can support higher yields while avoiding overconcentration to one risk factor.

- **Unconstrained Bond Funds** As 2023 illustrated all too well, interest rate fluctuations can have a significant impact on the broad market—and on investors' portfolios. Unconstrained Bond Funds separate what's called bond 'duration' (sensitivity to increases in benchmark yields) from credit exposure, opening the door to an unconventional approach to bond investing that may include taking short positions on bonds. This mechanism allows the strategy to maintain exposure to favored sectors and earn yield while reducing some of the broad interest rate risk that is found in traditional fixed income portfolios.

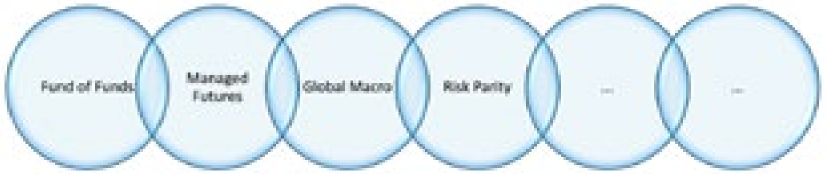
- **To-be-determined Categories** The global menu of investment categories is highly dynamic. As traditional portfolio strategies evolve, so does the set of risks that accompany this approach. This is why our strategy to help manage those risks must evolve as well. At LCM, our alternatives portfolio has changed significantly over the decade-plus of implementing the strategy. It will come as no surprise to see more new categories arrive in the future that may be beneficial to our strategy and, ultimately, to the portfolios of our clients.

Though each of these strategies are included in the LCM Alternatives Collection, how and when we apply them is fluid based on current economic trends. For instance, if interest rates are poised to sharply increase, we may bump up our use (or exposure) of Unconstrained Bond Funds. And in times of geopolitical turmoil, we may rely more

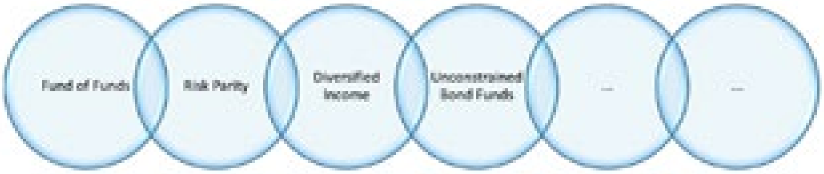
heavily on our Global Macro strategy to use changes in the valuation or devaluation of certain global currencies to our advantage.

As discussed earlier, the most appropriate mix of these asset categories depends on the client's preference for asset growth or capital preservation and income. While other strategies may be added in the future, this is how our Growth Strategy and Income Strategy are structured today:

- **Growth Strategy** Designed for portfolios with a higher percentage of equities holdings, our Growth Strategy focuses on mitigating risk associated with factors that impact the value of those assets over time. The following are examples of the types of sub strategies that typically comprise our growth-focused alternatives strategy:



- **Income Strategy** Designed for portfolios with a higher percentage of fixed income assets, our Income-focused Alternatives Strategy focuses on mitigating risk associated with rising interest rates and other factors that are likely to impact these types of assets. Examples of funds in our income-focused alternatives strategy include:



Uncertainty and risk are what make investing challenging. By widening our scope of assets to include alternatives in the mix that address our clients' unique needs, we can increase the potential for reducing risk within our client portfolios while maintaining the desired level of return. Alternatives help us smooth the bumps in the road, making it much easier to help steer you towards your financial goals and focus on the things in life that matter most to you.

Controlling fees

When alternatives are discussed in the media, one of the noted downsides to the approach is the built-in fees that drive up costs. In the standard, privately placed approach to alternatives, this criticism is absolutely valid. Historically, fees for alternatives have been higher than fees for indexed or actively managed buy-and-hold investment strategies. One reason for this is that executing an alternatives strategy requires a high level of experience and expertise. Another is that alternative strategies—including how they are priced—can be downright confusing, so many investors lack a clear understanding of what they do or what they cost.

The complexities of costs

This isn't the only area where fee structures seem almost designed to be confusing. Consider airline tickets. Figuring out the best time to buy (6 months ahead? 2 weeks ahead? On a Tuesday?) is just the first step. Even when you find a well-priced ticket, you must navigate all the added fees. Baggage fees (for checked bags and even carry-ons!). Seat fees. In-flight meals or snacks. Some airlines even charge for printing your boarding pass at the airport. And if you need to change or cancel your flight, you may be hit with the heftiest fees of all. By the time all these costs are added up, the actual price of your flight can be significantly higher than you thought. It's a perplexing, frustrating, and expensive process.

Hedge funds are a good example of how certain alternatives can introduce high costs. The typical fee structure for a hedge fund is referred to as the '2 and 20' structure. Up front, there is an annual 2% fee charged on the assets managed by the fund. Then comes another '20' from a secondary fee, called a 'performance fee'—a percentage of the fund's profits that rewards the manager for positive returns on investments. The performance fee pays the hedge fund manager 20% of all profits over a reporting period (when the account value is above a previously achieved 'high water mark').

Alternative strategies—including how they are priced—can be downright confusing, so many investors lack a clear understanding of what they do or what they cost.

Hedge fund managers tout this fee as only being charged when the investment has made money, however it's wise to acknowledge two critical considerations with the performance fee structure:

- First, the 20% share of profits is quite large. The investor is only participating in 80% of the upside of their investments, significantly limiting the total return on the investment.
- Second, this structure allows hedge fund managers to use investors' capital to take risk while also receiving 20% of any resulting profits. This is often criticized as creating a perverse incentive in which managers may take too much risk in order to achieve their fee or take the exact opposite action by toning down risk immediately before the end of a reporting period to 'lock-in' the performance fee they have already generated.

Performance fees are NOT charged for mutual funds—the method through which we buy the vast majority of our alternatives.

As fiduciaries, we are keenly aware of fees, and our approach is designed to reduce the impact of fees in two ways. Because of our experience in performing due diligence on investment funds of all sorts, we have a sense of what 'fair' is with respect to fee structures, and we have seen (and can see through) the many clever caveats that allow fund managers to disguise fees.

Also, we evaluate all investments on a 'net-of-fee' basis—meaning that we view an investment as attractive if the return after fees would be beneficial for our client portfolios. In addition to the way in which we research investment options, the very nature of our business offers us the ability to invest in funds at a lower cost than a retail investor.

Hidden performance fees

Though performance fees are nearly absent from mutual funds, we do have to keep our eyes open for hidden fees within certain alternatives.

The Investment Company Act of 1940 allows funds (referred to as '40 Act funds') to include up to 15% of illiquid assets in funds that are otherwise required to remain liquid. This clause has made it possible for some fund managers to use complicated and illiquid investments (usually total return swaps) which embed performance fees within that illiquidity allowance.

At LCM, we are well aware of this practice and do not buy funds that use this strategy to 'hide' performance fees. If fees are hiding, we *will* find them!

Traditional and alternative fund managers recognize that wealth managers like us, Registered Investment Advisors (RIAs), have the ability to direct larger dollar amounts than a single retail investor and that we are more likely cost-sensitive, so a wholesale discount is inherently built into our model. The cost of the funds we use (often called Institutional Share classes or Advisor share classes) is almost always less than what an independent retail investor would pay for the same strategy. The strength of our assets under management (AUM) gives us added influence over the prices we pay.

At LCM, we do not charge our clients a separate fee to include alternatives in their portfolios.

The cost of alternatives can be controlled, but because indexing is not an option (a topic we tackled earlier), costs cannot be eliminated completely. When used wisely and strategically, however, we believe that the cost of alternatives is a small price to pay for the level of value they provide.

As experienced asset managers, our team at LCM is armed with information and insights that help us keep that price as low as possible. As fiduciaries, we also have a legal obligation to ensure the investments we select for our clients are serving their best interests—and that the costs of these investments are fair and reasonable. At LCM, we do not charge our clients an additional fee to include alternatives in their portfolios. Because we believe alternatives are one of the most useful tools available to help reduce risk exposure and improve risk-adjusted return, we consider them to be a vital component of our asset mix—and deciding to build an expertise in the asset class well over a decade ago was viewed as a simple cost of doing business.

Our fees are fair, reasonable, and never hidden.

The good, the bad, and Bernie Madoff

Unscrupulous fee structures are one reason investors have learned to be wary of hedge funds and other alternatives. The other is bad actors, with Bernie Madoff often the first name that comes to mind.

Unfortunately, Madoff was not the first and will surely not be the last to make false promises to investors and defraud investors. However, this and other incidents of fraud and theft have led to stronger regulations aimed at preventing investors from falling victim to Ponzi schemes. These regulations are enforced by several organizations, including the Securities and Exchange Commission (SEC), the Financial Industry Regulatory Authority (FINRA), and other federal and state agencies.

Even so, safeguards are rarely foolproof. Investors should always conduct their own due diligence when making investment decisions. In the private alternative investment sphere, it is often required to give custody to the investment manager—trusting them not only to execute the investment strategy, but further trusting that there are controls and processes in place to prevent outright fraud.

At LCM, almost all of our client portfolios, including the alternative investment portion within them, are held at Charles Schwab & Co. As a custodian under strict regulatory oversight and a long-standing reputation, investments held at the firm are considered to be safe from fraud. That said, there is a very real possibility that a private investment may arise that is not held with Charles Schwab & Co, yet after aggressive due diligence, we decide would be an ideal addition to our alternatives portfolio.

Should that happen, our clients can trust that Leisure Capital will have our fiduciary duty (and legal responsibility!) front of mind in the due diligence process. Though risk is always present when investing, we will always do everything in our power to protect our clients from the risk of theft or fraud.

That we can guarantee.

The changing liquidity equation

Liquidity is not a trait that is commonly attributed to alternatives. In fact, most alternatives are not at all liquid.

At LCM, our alternatives are designed explicitly to provide a relatively high level of liquidity simply because that is what most of our clients require today—and it is what the market and the economic environment currently promote. That said, for a variety of reasons, the liquidity equation for our portfolios will likely shift over time.

One reason we may opt to decrease the liquidity of our portfolios is to bolster what's called the 'liquidity premium' to increase the potential for growth. At the highest level, the liquidity premium is the incremental return that compensates the investor for owning an asset that lacks liquidity. In other words, investors are inherently rewarded for giving up access to their assets for longer periods of time.

We will always apply our deep expertise to dissect the details of every asset under consideration to ensure the liquidity level is aligned with the overall goals of each of our alternative strategies.

Bank CDs (certificates of deposit) are a perfect example of liquidity premium. In general, the longer the term of a CD, the higher the guaranteed rate of return, so a 3-month term returns less than a

6-month term, which returns less than a 5-year term.[2]

At LCM, our clients tend to have complex financial lives that demand a higher level of liquidity than many investors. That does not mean, however, that the entire portfolio must be fully liquid, but rather that the liquidity of the portfolio must match the needs of the investor. This is just one component of the process of getting to know our clients to ensure that the portfolios we construct are maximizing growth in the context of the risk tolerance, liquidity preference, time horizon, and other unique requirements of our client base.

Another reason we may opt to adjust the level of liquidity in our alternatives portfolios is that the method of how alternatives are accessed is changing rapidly. As technology continues to advance, the overall investing process has shifted from a primarily paper-based process to a digital one. Just as Docusign has eliminated the need to physically sign investment paperwork, making it faster, easier, and more secure than sending documents via mail or courier, the investment industry is increasingly streamlining the process of buying and selling available investments. To better serve their customers, many, including Charles Schwab & Co., have focused on the low-hanging fruit of mutual funds. As new products are added to the digital model, we anticipate less-liquid alternatives to be as easy to buy and sell as mutual funds are today.

As new products are added to the digital model, we anticipate less-liquid alternatives to be as easy to buy and sell as mutual funds are today.

[2] 2023 was a notable exception as the yields on certain short-term savings vehicles yielded slightly more than long-term savings vehicles. By April 2023, rising interest rates caused the spread between 2- and 10-year Treasury yields to finish at -103.7 basis points—a spread that hadn't occurred since September 1981.

That does not mean, however, that LCM will use ease of access as a measure of whether or not to invest in a certain asset. Instead, we will always apply our deep expertise to dissect the details of every asset under consideration to ensure the liquidity level is aligned with the overall goals of each of our alternative strategies.

Balancing the tradeoffs

One example of an asset class we may want to consider in the future is private credit. Though not as liquid as other alternatives, the shifting economic environment has made private debt yields increasingly attractive, and favorable bargaining power on financing terms are more common than ever. That fact, combined with variable interest rate structures, low volatility, and the high level of control offered by private debt, may sway us to decide that the benefits of this asset are a reasonable tradeoff for lower liquidity. Only time will tell!

As the investment landscape continues to evolve, new low-liquidity and illiquid options may become available that could be beneficial additions to our Alternatives Collection. While less liquid investments can be frustrating for investors because they limit access to invested funds, it is important to remember that investors are almost always rewarded for giving up liquidity. That fact alone can make them a wise choice when they are considered with great care and diligence.

The magic of 20%

As a general rule, we humans like nice, round numbers. After all, two plus two equals four. We like that ease of understanding. So, it's no mystery that straightforward numbers are used when discussing investment strategies. Investors are very familiar with the 60/40 equation for 'balancing' stocks and bonds in a portfolio—even though few portfolios are structured so simply. Similarly, 20 seems to be the magic number that indicates the percentage of alternatives to include in a 'standard' portfolio.

The challenge, of course, is that there is no real standard. While it's true that several academic papers examining the use of hedge funds have found 20% to be the sweet spot for inclusion within a portfolio, preferred asset allocations change over time due to a variety of factors such as interest rates, changing expected returns, the overall economy, and much more.

As with all components of a well-managed investment portfolio, the use of alternatives is not a 'set it and forget it' proposition.

Investor goals and preferences also play a large role in determining the most appropriate percentage of alternatives. For example, large endowments (such as the Harvard endowment), often include a much higher percentage of alternatives in their portfolios—as high as 40-50% in some cases—to increase returns. But these portfolios are very unlike those of most investors, even highly affluent investors. The reason: unlike individual investors, endowment investment funds

are perpetual, with an unlimited time horizon that allows them to aggressively seek the liquidity premium from a sizable chunk of their portfolio. As such, they are free to 'pull the lever' in favor of alternatives and their potential rewards, regardless of the short-term risk.

So how much is too much... or not enough?

As with all components of a well-managed investment portfolio, the use of alternatives is not a 'set it and forget it' proposition. We've emphasized repeatedly that LCM's goal when using alternatives is to help our clients achieve better risk-adjusted return. Whether we recommend 20%—or much more or less than that amount—will always depend on our research and the percentage of alternatives that we believe is best to help achieve our goals at the time.

It's all about finding the sweet spot.

Are alternatives right for me?

Nearly every one of our clients can benefit from alternatives and, with very few exceptions, are already benefiting from the inclusion of alternatives in their portfolios.

By definition, this group of investors has accumulated a level of investable assets that supports a sophisticated strategy that extends beyond the three traditional investment categories of stocks, bonds, or cash and works to dampen negative returns within their investment portfolios. If you have successfully built substantial wealth and are seeking to reduce risk and improve risk-adjusted return, alternatives may indeed be right for you.

For investors with limited assets or very high liquidity needs, an alternative strategy may not be suitable. Discussions with your financial advisor can help uncover whether alternatives make sense for inclusion in your portfolio. As with any investment strategy, your strategy should be driven by your risk tolerance, liquidity preference, time horizon, and financial goals.

Balancing risk and reward with alternatives

We hope this introduction to alternative investments has provided a depth of information to help guide your thinking and help you appreciate the diversification value of including this group of assets in your comprehensive portfolio. In a world defined by its unpredictability, the diversification provided by alternative investments isn't just advisable—it's essential.

Investing in alternatives to improve risk-adjusted return is a complex process that is best accomplished with the help of an experienced, highly trained financial advisor who is immersed in the evolving landscape of alternative investments, understands the nuances of each fund type and the funds that are available, and who has deep insights into your financial goals, risk tolerance, and investment positions. With that guidance, alternatives can help balance risk, improve risk-adjusted return, and enhance the resilience of your investment portfolio.

Embracing alternative investments isn't just about following a trend; it's about preparing for a future that's anything but predictable. If you would like additional information about the LCM Alternatives Collection or our unique strategy, please contact your advisor.

Our goal, always, is to help you grow and protect your wealth. Alternative investments are just one more tool we use today to help bring that vision to life.

To explore how alternatives may help you invest wisely, live abundantly, and give purposefully, call us today at 714-384-4050.

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A Principal and Senior Investment Officer for Leisure Capital Management, Inc., Patrick has been managing the firm's alternatives portfolio for nearly a decade.

Building on his extensive experience and deep research into the individual strategies in this unique space and the Chartered Financial Analyst (CFA) designation, Patrick earned the Chartered Alternative Investment Analyst (CAIA) designation in 2015—a specialty credential that requires in-depth training on topics ranging from qualitative analysis and trading theories of alternative investments to portfolio construction and benchmarking, as well as assessing the vast menu of available alternative investments.

Patrick's passion for alternative investing is rooted in his observation that many advisors include these complex investments with limited knowledge, even less process, and little or no research. Over the years, he has introduced a level of academic rigor to the LCM process that supports confident decisions regarding why, when, and how to invest in alternatives, as well as which alternatives are most suitable for the firm's high-net-worth clients.

Patrick holds a bachelor's degree in business economics with an emphasis in accounting from the University of California, Santa Barbara. Patrick holds the CFA and CAIA designations, and he is a member of the CFA Institute, the CFA Society of Orange County, and the CAIA Association.

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CAPITAL MANAGEMENT

About Leisure Capital Management, Inc.

Based in Costa Mesa, CA, Leisure Capital Management serves more than 300 clients and manages over $600 Million in assets. Our clients are successful professionals and affluent families with complex financial lives and who share the drive to use their significant assets to ensure their families' financial well being and create a positive impact on the world. To help make that vision a reality, we thoughtfully manage every client's portfolio with personal care using a disciplined, holistic, and tax-aware approach to investing. We were honored to be named as one of America's Top RIA Firms by *Forbes* in 2023.

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