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Risk-adverse investors still have alternative options

For several years now, returns on stock investments have been highly disappointing.

Since the markets peaked in March 2000, the Standard & Poor's 500 Stock Index has lost nearly half its value, while tech stocks and many other market sectors have plummeted even further. Meanwhile, the investment outlook remains particularly challenging. Current yields on money market funds are not much more than 1 percent, and most bonds pay little more. Given the wobbly economy, stock prices that are still high by historical standards, and dicey political conditions, many investors — institutional investors, as well as individuals — are hard pressed to find attractive opportunities for their capital.

Over the past several years, nontraditional investments — often referred to as alternative investments — have been garnering increasing attention. Examples of such alternatives include venture capital, private equity, and hedge funds.

These alternative investments are generally structured as limited partnerships. They are often exempt from many of the rules and regulations that govern traditional stocks, bonds and mutual funds. Historically, they have been available only to high net worth investors who meet minimum asset and income levels. However, with recent innovations, more investors are now getting access to them.

Alternative investments use a variety of strategies to achieve their results. Most focus on a specific investment strategy, such as financing for start-up companies, leveraged buyout transactions, or "long-short" strategies — hedge funds that both buy and sell specific securities in the attempt to profit regardless of whether the markets are going up or down.

There are many favorable aspects to alternative investments. Historically, many have generated very high returns. During the 25-year period from 1973 to 1998, Yale University's endowment achieved average annual returns of nearly 30 percent on its private equity holdings, according to David Swensen, CIO of the fund. In addition to high returns, alternatives may provide the benefits of reducing portfolio risks through diversification, and generating favorable returns at times when traditional stock and bond markets are performing poorly.

INVESTMENT ALTERNATIVES



Roy A. Hamrick



- **Liquidity** — investors may be unable to back out of an investment when they want to.

- **Transparency** — investors are often unable to know what is held in their funds, or even get accurate valuations of what they are worth.

- **Fee structures** — usually substantially higher than those of traditional mutual funds.

- **Leverage** — such funds often use borrowed money in their strategies that can rapidly result in outsized gains — or huge losses. As recently reported in *The Wall Street Journal*, a Japanese hedge fund generated a 76 percent in 2002, followed by near total loss in the first seven days of 2003.

For investors who are frustrated with their traditional stock and bond portfolios, but reluctant to take on some of these risks, there are a few alternatives to alternatives to consider, including publicly traded securities that may boost portfolio returns or reduce risk, without some of the problems associated with hedge funds and other non-traditional investments. Investors may seek out individual securities in these areas, although major no-load mutual fund companies have funds available in these categories, that have low expenses, good performance records, and can easily be traded and monitored:

- **Real Estate Investment Trusts (REITs)**. These are publicly traded stocks in companies that invest in real estate or loans secured by real estate. They are attractive for their dividends (frequently around 7 percent per annum, or even higher), growth poten-

tial, as well as properties of diversification, since their performance is often significantly different from that of the overall stock market.

- **Treasury Inflation Protected Securities (TIPS)**. These U.S. government bonds pay semiannual interest. What is unique about them is that when they pay semiannual interest and repay principal at maturity, that amount is adjusted upward for inflation.

- **Foreign bonds**. Bonds of foreign governments and other entities often pay interest that is higher than that on U.S. bonds. If they are denominated in a foreign currency, investors can capture additional gain if the U.S. dollar weakens against that currency. Investors can also lose out, however, if the dollar goes the other way.

- **Convertible securities**. These are bonds or preferred stocks that pay generous current income, and also give investors the right to exchange their holdings for a set number of shares of common stock in the issuing company. They offer the stability of current income, with upside potential if the underlying common stocks perform well.

- **High-yield (junk) bonds**. There are bonds of corporations that are strapped for cash. They offer investors higher yields than bonds of financially sound companies. If such companies go into default, investors may incur losses of both principal and interest. If the economy remains firm, however, and the issuing companies are able to meet their obligations, high yield bonds can provide investors generous returns.

When it comes to investments, there are few guarantees. Nevertheless, for investors who are looking for creative ways to invest, but reluctant to jump into hedge funds or other nontraditional investments, they might consider some of these alternatives to alternatives as they seek to improve returns on their portfolios.

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