nvest
WEALTH STRATEGIES

September 2008

From time to time, we are asked about owning, or our thoughts about using investment alternatives in portfolios. We offer a few thoughts on that subject. Some of these thoughts were gathered from research we receive from Advisor Intelligence, who permits publishing their thoughts (in whole or part).

MUTUAL FUNDS THAT INVEST IN ALTERNATIVES

"Alternatives" have become something of a buzz word in the investment world, as recent low returns from stocks and bonds have created a marketing opportunity for strategies that take unconventional approaches to earning returns that are not dependent on or correlated with the returns from stocks and bonds. We have looked at a number of alternatives funds to date (including Diamond Hill Long-Short Fund which we utilize in many client portfolios). It is common for people to label any fund as alternative if it doesn't fall into the traditional, long-only mutual fund strategy. Practically speaking, the alternative universe consists of various strategies reflecting different opportunity sets and investment objectives. These range from various hedge-fund-like strategies (such as long-short, market neutral, event-driven, and hedge fund replication) to currency strategies, and leveraged and inverse strategies. Some advisors even classify real estate (REITs) and private equity investments as "alternatives".

We focus our investment efforts on the strategies most likely to fit within our traditional overall approach. We expect to include, from time to time, no-load mutual funds that assist our client portfolios achieve attractive risk-return characteristics given a future market outlook.

Delivering financial peace of mind.

We approach our review of "alternatives" with an open mind, but also with caution. Most skilled managers who run hedge fund strategies can make much more money with a true hedge fund structure (a private partnership or LLC) without all reporting requirements of public funds (transparency, independent boards, etc.). So the skilled managers may be hard to find in the public fund world. We also believe that the wave of alternative funds launched in the last several years reflect marketing opportunities more than merit. Importantly, we do not believe investors need to own alternative funds for the sake of allocating some portion of a portfolio to a new, popular asset class (albeit one that can't even be defined cleanly)

As stated in brief earlier, our research focuses on finding strategies that will either increase our portfolios' expected returns or reduce their risk (or a combination of both). As with all fund searches, before allocating any money to a fund we need comfort that highly skilled managers with a proven track record of delivering performance consistent with the strategy's mandate are at the helm. It is likely that many of these new funds simply do not have a sufficiently long track record for us to evaluate. That said, we remain open minded for "alternative" fund ideas, and will continue to utilize no-load funds of different styles and philosophies to diversify risk.

ASSET CLASSES

REITs—We currently believe REITs or direct investment in real estate partnerships are in a fair-value range and priced to generate returns in the mid to upper single-digit range, which is in line with equities, but more attractive than bonds over our five-year time horizon. This conclusion is based on several scenarios we've run with varying growth and interest rate assumptions. Importantly, if interest rates were to increase over a five year period, it would act as a headwind for returns. Also, we are considering whether REITs should be included as a strategic (default) asset class in our neutral model-portfolio allocations, and if so, how we should fund the allocation. Though REITs have bond-like characteristics in the form of a significant dividend yield, their volatility and downside risk are in line with the broader equity market, and their correlations with equities are not stable. Thus we would most likely utilize them as equity alternatives. REIT or real estate mutual funds are more appealing to us than direct investment in real estate partnerships as we have much better liquidity and marketability; partnerships are hard to sell when exit is desired and returns are not proven to be better.

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ASSET CLASSES (CONTINUED)

High-Yield—In terms of risk, we think of high-yield bonds as comparable to a mix of stocks and bonds. They become more "stock like" with expected returns, when yield spreads over Treasury securities is very wide. Right now, on a relative basis high-yield looks fairly attractive in terms of potential returns. But this is looking out over a number of years. The near-term risks remain significant, from our perspective. Ideally, we'd want to invest at the point where the default cycle is close to a peak; that often occurs when high yields interest rate spread has widened toward 1,000 basis points above comparable Treasury yields. Spreads are widening as investors become more risk adverse, but timing is not yet. In the meantime, we continue to watch the asset class closely, as it is possible that an opportunity could be created quickly if investors turn sharply negative. Heretofore, we have utilized high yield bond funds in client accounts that are seeking aggressive returns, as an equity substitute.

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