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Benefits of Alternative Investing for Portfolio Diversification

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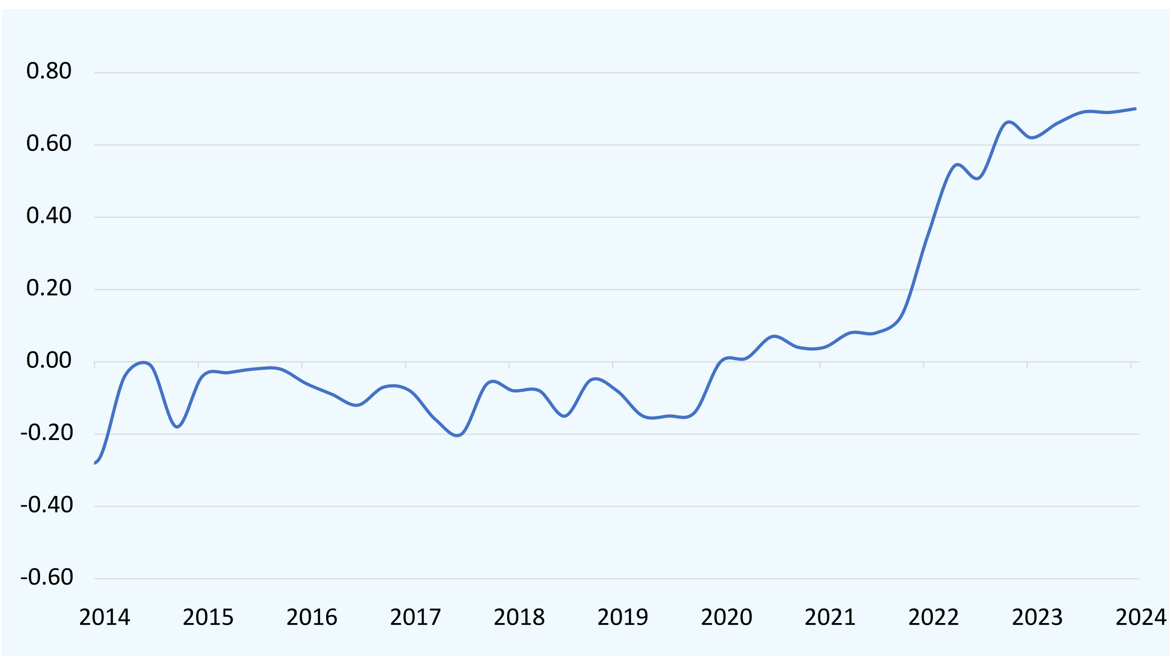
Dynamic Portfolio Perspectives: Why "Alts" & Why Now?

In a global market environment with more than 80 major stock exchanges and millions of stocks, bonds, exchanged traded funds and other instruments traded daily, the potential for diversification can seem like a foregone conclusion.[1] However, for investors and their advisors seeking to diversify portfolios to hedge against risk, true diversification isn't as easy to achieve as it might seem.

Between 2013 and 2023, half of the asset classes identified by Guggenheim Investments were closely correlated with the performance of the S&P 500.[2] These classes include global stocks, long/short stocks, international stocks, hedge funds, event-driven equity neutral hedge funds, REITs, and even some notable fixed income classes. That means half of all available categories of assets are closely correlated to the performance of the S&P 500, and this has only become more prevalent over the last couple of decades due to increased globalization through the intertwining of the worldwide economy.[3]

Stock vs. Bond Correlation



Source: Morningstar Direct as of 7/31/2024. Stocks represented by SPY ETF and Bonds represented by AGG ETF.

When asset classes are closely correlated, they tend to perform in lock step, which means that when one closely correlated asset class is down, others that are closely correlated fall too. The same is true on the upside.[4] Increases in market-wide asset class correlations has the consequence of exacerbating the overall market volatility we have recently experienced.

To help achieve better diversification in a portfolio, it is important to intentionally reduce the correlations between investments. As diversification opportunities become more scarce, intelligent portfolio managers and investors may look in non-traditional areas of the market to protect their portfolio exposures. This is where alternative investments that are designed to be uncorrelated have been a recent bright spot for mindful diversifiers seeking opportunities in an increasingly correlated environment.

In this blog post, we'll explore the universe of alternatives and how these types of investments might help investors and their advisors increase their diversification prospects and decrease potential risk.

Alternatives: A Brief Introduction

There are a variety of investment types classified as alternatives. These include commodities, real estate, collectibles, private debt, structured products, private equity and hedge funds.[5] While many investors might not consider investments traditionally associated with fabulous wealth, such as private equity and hedge funds, there are potentially ways to invest in those alternatives without large initial investments or inconvenient capital lockup periods. Within the universe of private equity, hedge funds and private debt, there are a variety of different niches that could possibly benefit investors' portfolios.

However, such alternatives can be more difficult to evaluate due to the fact that they are not publicly traded within traditional stock exchanges and are held to weaker regulatory disclosure standards than more traditional investments. In addition, alternative investments can lack readily-accessible liquidity and require a long-term commitment of capital to the funds, making investor funds inaccessible for a time without paying heavy penalties, or at all.[6] They also tend to be less tightly regulated by bodies like the Securities and Exchange Commission (SEC). There are advantages and disadvantages to every investment and alternatives are no different. As they say in the business, "there is no such thing as a free lunch."

Several different types of alternatives are available through ETFs, mutual funds and other types of pooled accounts such as separately managed accounts (SMAs), including commodities and real estate in the form of real estate investment trusts. These types of investments are traded on traditional stock exchanges or available through online investment platforms, are highly liquid and are more traditionally regulated.

Alternatives May Provide Diversification

The main benefit of investing in alternatives is the potential for diversification. Alternatives can help investors and their advisors achieve this goal because they have a lower correlation to stocks and bonds than do traditional asset classes. That means that when stocks and bonds are dropping, alternatives are either rising or are stable. And when stocks and bonds are rising, alternatives may be stable or falling. This offsetting behavior is the goal of diversification.

Investors may want their portfolios to always increase—but that is not a realistic hope. If you have a portfolio that behaves as such, you may not be correctly diversified. Stocks and bonds go up and down and if they go down at the same time, it can put an investor's goals at risk. In fact, it can be difficult to recover from a significant drop in the market, especially if that decline occurs right before or after retirement. This is known as sequence of returns risk.[7]

To help achieve diversification, it can make sense for investors and their advisors to add at least a small allocation to alternatives. Such an allocation should be in line with the investor's specific risk tolerance and overall goals and objectives..

A Final Word

In a market environment rife with volatility and uncertainty, diversification is a tried-and-true strategy that can help balance risk in a portfolio. As diversification opportunities decrease in a more closely correlated world, investors and their advisors should look to less-traditional market segments to help protect portfolios. Diversification can help even the most nervous investors sleep better at night and avoid making emotional decisions that might be contrary to their financial goals.

Invest with Intention.

Sources

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As always, Dynamic recommends staying balanced, diversified and invested. Despite short-term market pullbacks, it's more important than ever to focus on the long-term, improving the chances for investors to reach their goals.

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