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An Alternative Universe

"A ship ought not to be held by one anchor, nor life by a single hope" – Epictetus

In recent reviews with clients I have introduced the concept of alternative strategies and their use in portfolios. I wanted to spill some ink highlighting why I believe they are both important and timely.

First, a definition. An alternative strategy employs methods other than the standard practice of buying assets when they are cheap and selling them when they are expensive (or as cynics label it, buy and hope).

The shortcomings of the traditional method of buy low and sell high were on display in 2000 and again in 2008 when financial assets began to move as one in a downward direction. We may own stock in the best company in the world, but in times of extreme stress (panic) it matters little. During these times we stand on the tracks hoping that the light at the end of the tunnel doesn't have Southern Pacific stamped on the front of it.

The alternative strategies that we currently use give the manager(s) more tools to manage risk and look for opportunities. The traditional stock or bond mutual fund manager is largely controlled by the flow of money into (or out of) his/her fund. After periods of great performance, money floods into these funds when the target assets are already highly priced. The manager has no option (by prospectus) other than to continue to buy assets that are already expensive. The opposite is also true, after a market meltdown, money pours out of these funds forcing the manager to sell assets exactly at a time when he/she wants to buy. Alternative strategies reduce some of this pressure by allowing the manager(s) to enter different markets (futures, currencies, etc.), take advantage of pricing inefficiencies (arbitrage), or bet against companies that look too expensive (short selling) depending on the strategy. Because these strategies are more flexible than traditional buy and hold, money flowing into such funds can be put to good use in most any market condition.

Here's the timely part. Based on a number of valuation methods, the stock and bond markets are not cheap. The Shiller P/E index (which uses a methodology to smooth out current earnings back 10 years) suggests that the expected average return for the S&P 500 index for the next 10 years is .9% annually. Another well respected source, the GMO Seven Year Asset Class Forecast, calls for US large company stocks to return -.6% and US bonds -.8% annually. Yes you read that right. According to these prognosticators, US stocks and bonds are predicted to return less than 1% annually for the next seven to ten years (that, however, hasn't dampened the enthusiasm of the average investor who poured in a five year record high amount of money into US equity mutual funds in January – beads of sweat are forming on fund manager foreheads).

Now of course these are forecasts, and predicting future performance is a lot like predicting the weather, but like the weather patterns have a way of repeating themselves.

So what to do – abandon all hope? Hardly. It means, if these smart folks are even close to being correct, that we need to be a bit more creative than just buying large indiscriminate baskets of stocks or bonds and hoping that the rising tide will lift us to the shore. It means we have to be selective in the stocks and bonds we do own and deploy other methods (alternatives) to reduce risk and seek out returns in non-traditional venues. It means we need more anchors.