



Compiled by  
Michael Lannon

# ALTERNATIVE INVESTMENTS

## can reduce risk

*"October. This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August and February."*  
– MARK TWAIN

**The above humorous** quote has been credited with creating a phenomenon called the 'Mark Twain effect' where the returns in some stock markets are lower in October than in other months. This belief has been further fuelled by the fact that the serious stock market crashes of 1929, 1987 and 2008 all occurred in October. Personally, I am not suggesting that October is any riskier than any other month but now that I have your attention I would like to elaborate on last month's article regarding alternative investments and how they can be used to lower your portfolio risk.

Last month, I attempted to dispel some myths surrounding hedge funds or absolute return funds. The most common belief is that absolute return funds are extremely risky. However, it has been proven that allocating a portion of your investments to alternative assets that are not positively correlated to other asset classes such as shares can lower your overall portfolio risk whilst increasing your returns. Recently, the Bank of America Merrill Lynch Global Research identified the key reasons cited by institutional investors for investing in hedge funds as increased diversification, uncorrelated returns and a focus on absolute returns.

This month, I will attempt clarify the nature of the relationship between risk and return and look at how an allocation of a portion of your portfolio to alternative investments can aid in diversification. My experience is that many investors fail to adequately understand risk which can result in some very unpleasant investment outcomes.

One key factor facing investors considering alternative investment strategies is how to identify investment products and managers that actually mitigate risks whilst providing enhanced returns. In reality there are a limited number of providers that can provide this type of diversification and deliver consistently high returns. Investors need to consider the talent and track record of the fund managers involved. Often highly skilled managers will have substantial amounts of their own net wealth invested in their own funds. This serves to align the managers' interests with those of their customers.

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If you were to create the perfect investment it would provide you with high returns and have low risk. In reality these sorts of investments are almost impossible to find and often involve an element of luck rather than investment selection skills. Most professional investors rely on investment theories and processes that allow them to optimize the amount of risk which is commensurate with return. The concept of building a diversified portfolio is the basis of a Nobel Prize winning economic concept called Modern Portfolio Theory (MPT).

**MODERN PORTFOLIO THEORY**

Modern portfolio theory was first developed by Harry Markowitz and published in the 1952 *Journal of Finance* under the title 'Portfolio Selection'. MPT says that investors need to look at more than the expected risk and return of one particular stock and instead consider that an investor can reap the rewards of diversification by investing in several stocks. Using mathematical analysis Markowitz showed that the risk in a portfolio of diverse individual stocks will be less than the risk inherent in holding any one of the individual stocks (provided the risks of the various stocks are not directly related). Consider a portfolio that invests in two risky stocks; one that benefits if it rains and one that does well if the sun shines. In this case the portfolio will do well regardless of the weather. Adding one risky asset to another can reduce the overall risk in a portfolio as the opposing risks cancel each other out. In other words, Markowitz showed that investment is not just about picking stocks, but about choosing the right combination of stocks among which to distribute one's investments.

**TYPES OF RISKS**

Modern portfolio theory states that the risk for individual stock returns has two components:

**Systematic risk** – These are market risks that cannot be diversified away. Interest rates, recessions and wars are examples of systematic risks.

**Unsystematic risk** – Also known as 'specific risk', this risk is specific to individual stocks and can be diversified away or reduced as you increase the number of stocks in your portfolio. This risk represents the component of a stock's return that is not correlated with general market moves and is specific to that particular stock selection.

For a well-diversified portfolio, the risk of each stock contributes little to portfolio risk. Instead, it is the difference – or covariance – between individual stock's levels of risk that determines overall portfolio risk. As a result, investors benefit from holding diversified portfolios instead of individual stocks.

**HOW DO I IDENTIFY THE BEST LEVEL OF DIVERSIFICATION?**

I am often asked "What is the best level of diversification for a stock portfolio?" Some fund managers like to have widely diversified portfolios holding 50 or 60 stock positions while others like to concentrate their holding across 15 to 20 stocks. Once you understand the benefits of diversification it becomes clear that there is a limit to how much risk you can eliminate through diversification alone. As you increase the number of investments the covariance between additional investments begins to increase making it hard to find additional investments that actually increase diversification. At some point the incremental reduction in risk through further diversification is negligible and investors have to look elsewhere to improve the risk profile of their portfolio. However, using mathematical modelling the optimal portfolios can be plotted along a curve to show which portfolio has the highest expected return possible for the given amount of risk. This is known as the efficient frontier and is illustrated in Figure 1.

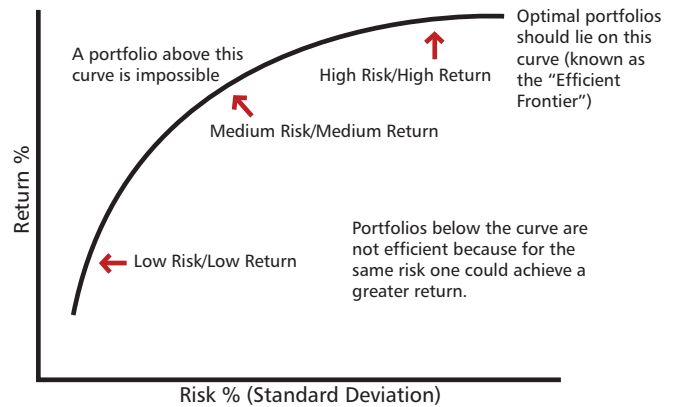


Fig 1.

The efficient frontier theorises that for every level of return, there is one portfolio that offers the lowest possible risk, and for every level of risk, there is a portfolio that offers the highest return. These combinations can be plotted on a graph. The resulting line is the efficient frontier. Any portfolio that lies on the upper part of the curve is efficient: it gives the maximum expected return for a given level of risk. A rational investor will only ever hold a portfolio that lies somewhere on the efficient frontier. The maximum level of risk that the investor will take on determines the position of the portfolio on the line.

The chart (Fig 2) shows the dispersion of risks in a portfolio and illustrates the concept of asset allocation and how it can affect risk and return in your portfolio.

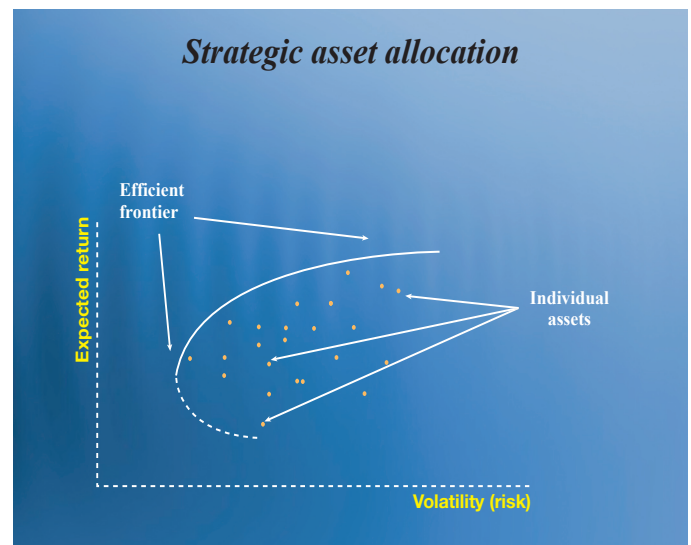


Fig 2. Source: Sigma Investing – Portfolio efficiency.

The individual investments in a portfolio all have their own unique levels of risk but it is the collective risks of the portfolio that are of concern to investors. Through diversification investors are able to reduce their risk by combining risks that effectively cancel each other out.

**DOES ADDING ALTERNATIVE ASSETS TO A PORTFOLIO REDUCE THE OVERALL PORTFOLIO RISK?**

As indicated earlier, the use of alternative asset strategies can reduce the risk in your portfolio. Rather than look at the risk in your stock portfolio consider the risks across your entire portfolio and all of the assets held. Many will ask "How am I supposed to assess the risks of my portfolio?" You need to consider how the returns of your portfolio are linked or interrelated and think about whether or not a decline in one area of investment can be offset by investments that are not closely correlated to that part of your portfolio.

## investment insight

Typically, an Australian investor will have a mix of shares and fixed interest investments (bonds) as well as some property investments. The key to lowering portfolio risk is to combine assets that have different risk characteristics. Historically, stocks and bonds have a negative correlation and an allocation to each asset class has produced some diversification benefit. However, property has a direct correlation to fixed interest or bonds as they are both similarly affected by rises or falls in interest rates.

Managers of futures funds or absolute return funds that utilize highly liquid futures and options are able to construct portfolios that are negatively correlated to the traditional asset classes of stocks and bonds. Absolute return funds are able to produce returns in both rising and falling markets and therefore the addition of a portion of your portfolio to this alternative asset class can effectively reduce the volatility or risk that an investor experiences.

The extreme volatility experienced by investors during the global financial crisis has led many investors to reassess the composition or asset allocation of their portfolios. The graph (Fig 3) shows how adding managed futures or absolute return funds can lower the risk of your portfolio whilst simultaneously increasing your returns.

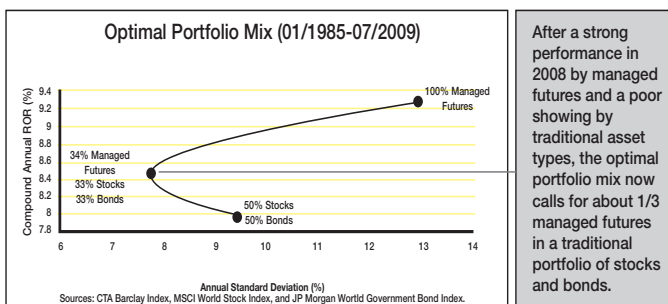


Fig 3.

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**"Broadening the  
asset mix of your  
portfolio can smooth out  
the returns in periods of  
extreme volatility or  
marked uncertainty."**

By allocating up to a third of your portfolio to alternative assets you can produce better investment results. Broadening the asset mix of your portfolio can smooth out the returns in periods of extreme volatility or market uncertainty.

At the moment the global share market remains volatile. Although Australia is the envy of the developed world with a strong economy and low levels of unemployment it would be naïve to think that Australia is immune from events occurring around the world. The uncertainty created by high levels of sovereign debt and the fragility of the global economic recovery have many investors maintaining a sizeable cash balance in their portfolios. Whilst cash may provide stable returns the high level of taxation on interest income makes it a poor choice for high income investors.

Investors need to consider allocating a portion of their portfolio to alternative assets that can enhance their portfolios return whilst simultaneously reducing their overall risk. For my money, rather than "going broke safely", I plan to increase my exposure to absolute return funds in the very near future.

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