

'Hedging' The Tumultuous Market

The Value Of Alternative Investments

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The recent activity on Wall Street has permanently changed the U.S. financial landscape, with the impact resounding throughout the marketplace. But even though the tumultuous economy comes with its share of risks, some investors are still confident that opportunity exists – particularly given the growth of the hedge fund industry over the last decade.

The spectrum of alternative investments, ranging from traditional real estate and hedge funds to venture capital and distressed securities, varies widely in terms of risk and return. They can therefore be used to improve the risk/return profile of portfolios, as well as mitigate volatility.

"We really talk about alternatives as a portion of how we plan the financial affairs of our clients," says Don Berghoff, managing director in the Los Angeles office of Convergent Wealth Advisors, which provides wealth management to high-net worth families and institutions. "Hedge funds are really a piece of the puzzle in terms of the long-term planning, so . . . we use, essentially, hedge funds as an ability to further diversify someone's portfolio and hedge their downside."

Berghoff explains that hedge funds are a structure, rather than an asset class. In addition to enhancing risk/return profiles, they have the potential to generate returns in either up or down markets. Moreover, the low correlation to broad equities and fixed-income markets means that hedge funds are not necessarily affected by trends in the broad market as a whole.

"The classic hedge is really a protection, rather than ability to make a lot of money," he says. "When we look at hedge funds, it's really to dampen volatility in people's portfolios more than anything else."

Convergent Wealth Advisors applies two distinct strategies to hedge funds, factoring in long-term goals and how much risk or return each client wants and then appropriately dividing portfolios between equities and fixed income.

Aiming for low or no net exposure, the non-directional strategies have a low correlation to one's investment portfolio, Berghoff says. Historically, hedge funds demonstrate a volatility that is similar to traditional fixed-income instruments and are

therefore used within the conservative portion of a client's portfolio. Over a longer period of time, hedge funds tend to outperform the other markets, he adds, noting that they are even better than bonds because they usually generate higher returns.

"Our idea is to be able to give our clients access to funds that behave similarly to bonds in terms of risk, but have a substantially higher return," he says. "Hedge funds don't necessarily knock the ball out of the park in an up market, but they very much reduce the volatility in a down market."

Investing in alternatives, however, has some trade-offs, Berghoff warns. For example, there is less liquidity, as well as less transparency in terms of knowing what managers are investing in. Certain clients may therefore prefer

to invest in fixed income instead.

Meanwhile, directional strategies display higher levels of volatility than non-directional strategies. Used in the growth portion of one's portfolio and yielding significant net market exposure, directional strategies aim for equity-like returns with downside protection and upside participation.

"The return is fairly high on a consistent basis, but the risk is clearly higher than the bond index [and] substantially less than the S&P 500 Index," Berghoff explains. "We like them because, over a long period of time, . . . you can see how the long directional performance has been very, very solid on a compound basis for exactly the same reason as the non-directional. It's basically consistent returns, less volatility."

For long-term asset allocation, he adds, a client should probably pursue directional and non-directional hedge funds, as well as fixed income, equities and commodities. And by investing in non-correlated asset classes, one can increase portfolio diversification with less risky investments – a strategy that is essential for those seeking to ride out the current economic turmoil.

"When you think about it [over the] long term or short term, we believe that by being able to manage risk and return at the same time through the methodology, which is inclusive of alternatives, there is always a benefit," Berghoff contends. "It's not a fad. It's a long-term strategy that has worked very well for our clients for over 10 years." ■

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