Other Strategies

Hybrid Vehicles

Some mutual funds are extremely focused, investing in a specific, sometimes narrowly defined group of securities, such as a particular industry or geographic region (Mexico, Asia, utilities, telecommunications, Gold, healthcare). There are even funds out there that are said to replicate hedge funds (we're silent on whether that is a good thing!) The benefit of a given specific fund is that it may perform extremely well when their area does. The risk, however, is that they are not diversified, so they may be very volatile in value.

Variable Annuities

Annuities are tax-deferred retirement savings plans, but they're also insurance policies. The advantage is that they have a market-related underlying investment (often mutual funds), which can benefit the policyholder. Your client invests a certain amount of money. In return, the insurer promises to make regular payments that are guaranteed to last for life. Or, the money can be withdrawn as a lump sum after10 or 20 years.

Variable annuities are useful as a way to accumulate tax-deferred earnings, as well as a way to collect an annuitized income. They have the tax advantage of no tax on growth until withdrawals occur. However, there is no set rate of return.

Clients diversify among several investment options like mutual funds and the return is based on the performance of the underlying investments. Because the return is not guaranteed, other than for a minimum amount established by the respective states, a variable annuity has a higher level of risk than a guaranteed investment, but it also should have a greater potential return. Given the wide variations in terms, such as time period to be locked up, minimum returns after the first year, and various and sundry handcuffs, no 2 annuities are alike either (look to our class on "Demystifying Annuities" for an unbiased explanation). Basically, though, if the underlying investments outperform lower paying investments, the client benefits. If the underlying investments underperform, the amounts available for repayment will be lower.

Advantages and Risks of Variable Annuities

Some allow reallocation and asset shifting, as financial circumstances change. They have a likelihood of beating inflation. They protect your client's purchasing power. However, the size of the monthly check will vary. Your client may not count on a fixed amount of money.

Although the contract will probably specify the minimum payment to be received, no matter how poorly your portfolio performs your client could end up with significantly less income than expected. It can be harder to compare variable annuities since they don't provide a fixed rate of return. Instead; You, the consultant, have to examine the investment options each contract offers. Look for a variety of investment choices with lower costs, and the ability to reallocate.

Note: It is easier to examine the relative merits of an annuity if the funds are recognizable mutual funds. Consider are each fund's objective, its past performance, and the portfolio manager's strategy.

Leveraged Strategies

Leverage requires borrowing or buying more than you actually have. High return potential, but at a price of much higher risk. You are subject to market risk, currency risk, interest rate risk. In other words, not for any other that the more sophisticated investor.

Gold

Precious metal funds trade chiefly in mining stocks though they may hold some gold bullion. Some investors may buy these funds as protection against turmoil in financial markets, but they can be extremely volatile. Assets in Gold funds and partnerships increased 45% in 2010. While often seen as a hedge against inflation, gold is volatile. For example, the Lipper Gold index was down -17.1 in Aug. 2002, yet in 2010, it was at all-time highs, up more than 28%.

The investment in gold may be Mining Stocks or in the commodity, but, mining stocks magnify gold's moves. Small moves in price of gold have huge effect on mining stock. It is, however, a safe harbor in catastrophic times (war or economic crises). In these circumstances, prices will soar. Gold funds take the usual fluctuations of gold market & put them on steroids. Now, there is a new vehicle: gold commodity ETFs.

If combined with other, more conservative investments, such as Treasuries, in a mix (for example 80% UST and 20% Gold) would increase the return over by 8% over 18 years, but at what cost of volatility?

Another new vehicle is known as BUGS (Basket of Unhedged Gold Stocks). Mining can't hedge on current production more than 18 months in the future, so they can be hurt by fluctuations in the price of the mineral. So BUGS may more closely track the price of Gold, but are still volatile. When considering Gold as a hedge be informed and be careful.

REITS

REITS are pools of real estate investments, which own and manage real properties (malls, hospitals, apartments, office buildings, and so on). In 2003 the REIT index rose 37% (total return). There are 180 registered REITS with nearly 70% trading on major exchange. They must distribute 90% of their income, and generally pay high dividends. However, they are fully taxable at income rates.

Currency Trading

A sophisticated strategy in which investors trade currencies of various countries. It is highly risky, extremely volatile, and requires a high skill level on the part of the consultant.

IPOs

Initial Public Offerings were discussed in the previous session under new offerings. There are currently reforms under way to ensure a fair allocation procedure. They include no market orders on the first day of trading and more information available to all investors. According to the investment advice column by the Motley Fool, "If you're able to get your hands on some IPO shares, it means nobody else wanted them, and you shouldn't either."

International

We discussed international investing strategies briefly in the previous session. As a strategy, international offers some advantages as a completion phase. If the dollar declines, international stocks and bonds will be cheaper, and more in demand. A possible conservative International strategy (relatively conservative at least) is to buy companies that have big foreign components. An interesting related phenomenon involves a St Louis Bank, Everbank.com, which offers CDs denominated in foreign currency. This presents currency risk as a factor along with interest rate risk.

Hedge Funds

A Hedge Fund is a limited private partnership that invests common assets, which can be leveraged in various ways. In practice, a hedge fund behaves like a mutual fund with margin, options, and short positions. There are more than seven thousand Hedge Funds operating in the United States, with an average asset base of approximately 100 million dollars each.

Because they differ so much from traditional investments, Hedge Funds can be difficult to fit into a portfolio without the assistance of a specialized Hedge Fund manager. Using leverage, Hedge Funds can produce phenomenal results, and often perform well in periods of market downturn due to low correlation with traditional investments. The combination of low correlation and high return has drawn much investor interest, and Hedge Funds are growing in popularity.

However, Hedge Funds are not appropriate for every investor. They have higher investment minimums than Mutual Funds or managed accounts (typically over $250,000), and they are more risky than traditional investments. Many Hedge Funds are offshore and all are currently unregulated (although this will surely change in the near future). Hedge Funds also have very limited liquidity or complete illiquidity, and a complex fee structure, which is different from the fee structure of traditional funds (typically 3% of assets plus 20% of the profits). They are inherently more prone to fraud (See Madoff and "Somebody Else's Money" course).

Performing Due Diligence is exceptionally difficult and requires up to three times as long as with a traditional fund or money manager. Risk monitoring is also difficult, because investors do not generally see the composition of the portfolio, and cannot independently track the underlying securities; therefore advisor and client alike are completely dependent on the vendor and manager for performance reporting and record keeping purposes. New SEC rules for 2011 should increase the transparency and lower (somewhat) the risk potentials.

Funds of Funds

Funds of Funds (called FoFs or FoHFs) are funds which own Hedge Funds hand picked and monitored by an intermediary with minimums as low as $25,000. The Fund of Funds strategy is effective for adding diversification, although the client is subjected to an additional layer of fees, and can provide access to high-end money managers not otherwise available. Funds of Funds also enable the client to spread risk and enhance return, because of negative correlation among funds. Losses in one fund may be offset by gains in another. The risks of Funds of Funds include all of the risks associated with Hedge Funds, as described above, plus the added complications of increased fees, a further level of decreased transparency, and even less client (or consultant) control over the investments.