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ETFs Make Alternative Investments More Accessible

By Randy Myers

It's getting a lot easier to fit alternative investments into the average investment portfolio. For investors worried about the rising threat of inflation, anxious to hedge against soaring energy prices or just eager to diversify their holdings as broadly as possible, they're also making a lot more sense.

Alternative investments are investments that fall outside the three traditional asset classes: stocks, bonds and cash. While still a loosely defined term, alternative investments can include physical assets, such as real estate, precious metals, and energy and agricultural commodities, as well as specialized investment vehicles, such as hedge funds, private equity funds and managed futures accounts.

For years, many of these types of investments were out of reach — too expensive, illiquid or opaque — for all but the wealthiest and most sophisticated investors. In the case of hedge funds, they were, and remain, available only to what the Securities and Exchange Commission identifies as "accredited" investors. In a nutshell, that means banks and other institutions, or individuals with either a net worth in excess of $1 million, excluding their primary residence, or annual income of at least $200,000 in each of the last two years ($300,000 for married couples).

All that began to change in 2004 with the introduction of the first commodity-based exchange-traded fund, or ETF, called the SPDR Gold Trust. The trust invests directly in gold bullion, and its shares fluctuate with the market price of gold (less the fund's operating expenses). It is the second-largest ETF in the world, with more than $55 billion in assets as of April 1.

ETFs are similar to mutual funds, pooling money from many investors to be managed by a professional. Unlike mutual funds, though, which can only be bought and sold at the end of the trading day, ETFs trade throughout the day on an exchange, just like a stock. Also unlike mutual funds, they must disclose their holdings on a daily basis. Most are designed to track an index, and on average they feature lower expenses than mutual funds.

"Investors appreciate ETFs because they offer benefits — liquidity, transparency, low costs — that many competing investment vehicles do not," says Tom Anderson, global head of the ETF Strategy and Research Group at State Street Global Advisors, which markets the SPDR Gold Trust.

Getting into Gold

The benefits of ETFs have been particularly welcomed in the alternative investments marketplace.

Investors initially flocked to SPDR Gold Trust, for example,

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because it offered a simple, transparent way to invest in the precious metal. Prior to its debut, investors could buy the metal in the form of coins or bullion, but then had to stuff it in a closet or pay someone else to store and insure it. Alternatively, they could buy shares in a gold mining company or a mutual fund that invested in gold mining stocks, knowing that the value of those investments could fluctuate based on factors other than the price of gold, such as how adept a mining company was at finding the metal or how efficient it was at extracting it. Or they could buy gold options or futures contracts, assuming they had the stomach, savvy and resources to play in that volatile marketplace. For many investors, none of these options were terribly appealing.

More recently, investors have poured money into gold ETFs because gold itself has been rocketing higher in value. Prices have been racing up on fears that massive borrowing by the U.S. and other governments will inevitably lead to high inflation. Inflation typically punishes traditional investments, but drives prices for gold and other commodities higher.

Diversification Tool

Financial services firms have launched an array of ETFs that invest in a wide range of other commodities, including silver, platinum, palladium, oil, natural gas and many agricultural crops. They also have introduced ETFs that seek to mimic hedge fund investment strategies, and still others that invest in real estate and currencies. In short, ETFs have become everyman's gateway to alternative investments.

Today, some investors are using these ETFs simply to participate in the strong markets for commodities. Other investors are turning to alternative investment ETFs in response to seeing their stocks and bonds battered during the financial crisis of 2007-2009. Even though many alternative investments suffered during that extraordinary period as well, long-term returns for alternative investments have historically had a low correlation to returns for stocks and bond. Accordingly, investors are embracing alternatives as a way to more broadly diversify their investment portfolios.

"Today about 10 percent of ETF assets are in commodity-oriented ETFs," Anderson notes. "They've gone from being a brand new category in 2004 to 10 percent of the overall market."

Broader Market Exposure

Certified Financial Planner Cathy Pareto, president of Cathy Pareto & Associates Inc. in Coral Gables, Fla., says that while traditional investments should continue to play the biggest role in most portfolios, alternative investments deserve a place, too. As the economy and financial markets become more global, she says, returns within traditional markets appear to be growing more correlated. While she has long used mutual funds to give her clients exposure to commodities, she has more recently been using ETFs to give them exposure to gold and other precious metals.

She particularly favors using a gold ETF that invests directly in the underlying asset, noting that "stocks and futures contracts don't always behave like the metal itself."

Not all commodity-based ETFs do invest in the physical asset they are designed to track. Many opt instead to invest in futures contracts based on those assets. This is particularly common where the fund sponsor has no practical way to buy and store the asset itself — live cattle, perhaps, or crude oil. While this can be an efficient strategy, an ETF built on futures contracts may not always track the value of the underlying commodity as closely as one that invests directly in that commodity. In fact, there have been instances in which commodity-based ETFs that use futures strategies have actually gone down in value when the price of the commodity they were designed to track was going up.

Whatever their investment strategy, ETFs focused on alternative investments are, in many cases, offering investors a chance to participate in markets or market sectors that simply aren't available to them in any other form.

"We're seeing more and more interest in these products as investors look at what happened in 2008 and continue to try to diversify their portfolios," Anderson says. "We expect that to continue."

Randy Myers is a freelance writer whose work has appeared in Barron's, CFO, Corporate Board Member *and other prominent business publications.*

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