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Everyday Investors Should Avoid Alternative Investments

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Investors and investment advisors alike are bombarded with information about the benefits of alternative investments, or "alts." Because these investments tend not to correlate with the stock market, they bring diversification to portfolios.

Alts are also branded as “sexy” investments for only “sophisticated” investors. This makes them attractive to retail investors who want to invest like the big boys — the pension plans and college endowments — that can afford the high investment minimums.

But should you really consider adding alternatives to your portfolio? The short answer is no. Between the high fees and taxes and their lack of transparency and efficiency, there are important reasons why most everyday investors should steer clear.

What are alternatives?

The term encompasses a wide range of products, but essentially, they’re any investment outside of publicly traded products, such as stocks or bonds. Technically even real estate is considered an alternative, but most financial professionals would consider publicly traded real estate investment trusts — which allow investors to participate in income-producing real estate investments — a more traditional form of stock investing.

Some alternatives require large upfront investments or that you be an “accredited investor": someone with an annual income of more than $200,000 or a net worth of more than $1m, among other requirements. But they're increasingly bundled into mutual-fund-like products available to all investors.

Here’s a look at a few types of alternative investments:

Nontraded REITs: These real estate investment trusts are usually composed of a group of properties owned and run with the intent to resell them for profit in the future. Like REITs, nontraded REITs are often sold by stockbrokers and other investment advisors. But, unlike REITs, they're not traded on a securities exchange.

Private placements: These are investments in companies that haven't registered with the Securities and Exchange Commission. Accordingly, they're high-risk: The sellers know much more than the buyers. They might be offered by stockbrokers and other advisors but are generally only sold to a select group of investors, not for sale on the open market.

Hedge funds: These funds typically invest in traditional securities in non-traditional ways. For example, they might make a positive bet by buying certain stocks while, at the same time, making a negative bet by "short selling" (borrowing the shares from a broker, then buying them at a reduced price for a profit). They tend to have high expenses and often lock up your money for years. You would invest in a hedge fund directly through the firm managing it, but “funds of funds” — funds that invest in hedge funds — are sold through traditional brokerages.

Venture capital funds: Venture capital firms invest in early-stage companies in exchange for partial control of the company. There are a number of venture capital funds, but they're usually only available to larger investors.

Private equity: Private equity firms fund private companies and help take them public, or sell stock on the open market. Unlike traditional bond and stock investing, a private equity investment is in a company that's not publicly traded.

The downsides

Each type of alternative investment will impact your portfolio differently, but they do share common characteristics and downsides.

High (and sometimes hidden) fees: Many of these investments pay large fees to a long chain of salespeople, including your advisor or broker. And these investments' internal expenses are usually high and hard to determine. That means their costs to you will be high as well. For example, it's common to see hedge fund fees of 2 per cent annually, plus 20 per cent of profits. In contrast, it's easy to invest in global stock and bond funds for well under 1 per cent a year.

High taxes: You have no control over taxable earnings of most alternative investments. They may have a great deal of internal turnover, triggering short-term, highly taxed gains. But with traditional stock and bond investing, you can keep your money in tax-deferred accounts and often time taxable gains to your advantage.

Opaque: You have little control over or insight into what vendors are doing with your money in an alternative investment. For example, a fund manager might buy securities from a particularly risky sector in order to increase risk and hopefully return — all without your knowledge. But there's a great deal of public information about the strategy behind and valuation of traditional mutual funds, stocks and bonds.

Usually illiquid: Once you've invested in most alternatives, you can't have your money back without paying a high price, if you can have it back at all. On the other hand, you can always sell a stock or a bond. You might lose money or have adverse tax consequences, but nothing prevents you from getting your money out.

Inefficient markets: When you make an alternative investment, you’re investing against sophisticated institutions that are much more likely to have insider information than you are. This may be quite likely with alternative real estate investments. However, most publicly traded equity and fixed-income markets are considered "efficient" because there's so much information available.

Steer clear

Unless you have more than $100m and a team of professional investors working for you — and even if you do — alternative investments are usually bad news. For instance, the California state pension system recently concluded that much of its investment in hedge funds was expensive and had terrible returns. And it had a legion of analysts and advisors that you don't.

In contrast, investing in widely traded stocks and bonds is transparent and inexpensive. You can diversify easily, control taxes to a great extent and have daily liquidity.

I strongly recommend that you avoid alternative investment choices. And if your advisor recommends them, you might want to consider a change.

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