



Alternative Answers

The Class Divide in Investing, and How You Can Close It

Bob Rice

Harvard's biggest single financial bet is on timber, not stocks. Yale has just 6% of its endowment in US equities; instead, it's long "absolute return," "private equity," and real assets. Each is up more than 100% over the past decade.

In the meantime, typical investors have, at best, treaded water.

And that's no anomaly. In 7 of the 11 decades since 1900, the classic 60/40, stock/bond portfolio has returned an average real return of a whopping... 1%. Yes, those other four decades were big winners; but then those gains were walloped by the kinds of big crashes that are only becoming more frequent.

Fact is, a class system has developed among investors over the past few decades. Elite money managers have used a proprietary set of tools to ride economic cycles up, but also to avoid big losses during downturns. Meanwhile, the rest of us all thought that “investing” was synonymous with simply buying stocks and bonds, with maybe a bit of real estate tossed in.

The recent run up in the market actually underscores the point nicely. Should an investor jump in now, or is it too late? For sophisticated investors, it’s not such a tough call: they can invest via “long/short” funds that participate if the market gains, but limit losses should it turn. This—the original hedge fund strategy—has been both unavailable and unknown to average investors.

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Institutional-strength, non-traditional options are now available to almost all investors, and the mass affluent have an especially rich menu from which to choose. Many of these new options take the form of mutual funds and ETFs; others employ “registered private” versions of classic hedge, private equity funds; and still others use feeder and piggyback structures for access to strategies and managers previously reserved to only the very largest investors.

Moreover, numerous alternative strategies are available to match each of the “big four” portfolio goals: current income with minimal interest-rate risk; better protection against market downturns; generating much higher long-term returns; and insulating existing wealth from inflation and currency devaluation. As a result, today it’s not so terribly difficult for average investors to create custom portfolios of alternatives that suit their individual needs.

Let’s take a quick look at how some of these “alternative” strategies both make money, and avoid losing it.

The most classic alternative strategy is that “long/short” approach. Surprisingly, perhaps, the idea was pioneered by none other than Benjamin Graham—the grandfather of value investing and hero of Warren Buffet. He assembled an investing consortium back in the Roaring Twenties to buy stocks he viewed as inexpensive and simultaneously sell short those he deemed pricy.

Provided only that the long positions do relatively better than the shorts (that is: go up more in a bull market; fall less in a bear market), the strategy generates profits regardless of market direction. For trivia buffs, by the way, the term “hedge fund” first appeared in a 1962 Life magazine article about the amazing returns of a disciple of this style.

Variations on this sort of long/short strategy dominate hedge funds, and largely explain why, despite all the bad PR, as a group they have indeed outperformed long-only stock strategies over time. Simply put, they lose less in crashes—and loss avoidance is indeed the biggest single secret to long term wealth.

Still, such strategies are just one arrow of the alternatives investments quiver.

Perhaps the most pressing investment issue of the day is how to generate meaningful current income without interest rate and duration risk. Bonds, after a 40 year bull run, will lose tremendous amounts of value if rates tick up at all, certainly a very plausible scenario given the Fed’s loose money policies and some early signs of economic recovery. In these circumstances, most investors are clueless about where to turn for real yield... but the smart money does know where to look.

Royalties paid on assets ranging from pharmaceutical products to mineral rights provide strong income streams with little interest rate or credit risk. Peer-to-peer lending has a proven record of delivering high single digit returns from fully amortizing, short-term loans. Midstream MLPs generate reliable current yield from pipelines and distribution facilities without much exposure to the ups and downs of the commodities that they transport; and, because the big energy companies are the ones paying the freight, there's very little risk of non-payment. All these strategies, and numerous others, are today available in fully registered, liquid formats.

But the real investing upside for institutional investors has been provided neither through stock strategies nor income instruments. Instead, it's been delivered by direct investment in wealth creation via private equity and venture capital.

PE is a little known but behemoth force in our economy: about one in five American workers is employed by a company owned by a private equity fund. How do they function? Well, the classic deal is a corporate version of a home "fixer-upper." The PE firm uses a lot of debt and a little cash to buy an operating entity (sometimes, as in the current Dell saga, this involves buying all the stock of a public company, delisting it, and so "taking it private"). The buyers work to improve company performance through better management, upgrading the equipment, eliminating unnecessary costs, etc. Then, they resell, perhaps to a strategic buyer, or maybe by going public.

With luck, they do so at a big profit. Such deals have been the biggest contributors of profits for the largest investors over the past decade; but recently, the most famous names in the field, like KKR, Apollo and Carlyle, have all announced new investment vehicles for much smaller investors. Now, as little as \$50,000 will provide access to funds that used to have minimums of \$10 million and up.

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Startups and venture capital are, of course, also famous wealth generators. Apple, Google. and LinkedIn are just the latest volcanic successes. Fact is, entrepreneurs have produced outsized gains for investors since the first VC firm was formed to help returning WWII veterans find work. Here, the big news is that individual investors can now fund these companies directly, through a few major web portals like Gust, AngelList, and Funder’s Club, all of which also provide numerous tools and educational resources for the beginning angel investor.

And how do top investors protect themselves against inflation and currency devaluation? Global currency wars are in full blaze, with governments literally competing to cheapen the value of their money in an effort to revive exports and employment. That's very bad news for savers, who can see the purchasing power of their accumulated wealth go into freefall.

Of course, gold is the classic response, but it doesn't pay a coupon. Moreover, few people know that the U.S. government actually confiscated private gold holdings in the Depression, and could do so again. So gold—especially in ETF format—might not live up to expectations as a wealth safe haven. Many savvy investors add farmland, water rights, art, and infrastructure to their purchasing power preservation formula.

Chess Grandmasters know that the best moves are those that make offensive threats, but beef up the defense at the same time. Some investments, like TIPS and timber (that favorite of Harvard's), are the financial equivalents.

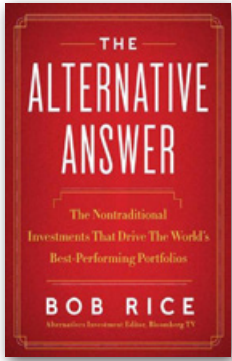
How? Because they'll do well in both inflationary and deflationary periods. TIPS are the ultimate two-way bet, if bought at par. The principle of these instruments is adjusted upwards if inflation rises; but it never decreases below the issue price, providing a windfall in deflationary times. That's an extremely rare "heads I win, tails you lose" proposition. And timber? It's the very rare hard asset (inflation protection) that actually generates annual income (deflation protection).

The world has become radically more... well, complicated. The one thing that's clear is that the velocity of uncertainty is increasing, and that the potential consequences of unforeseeable events is magnified in our interdependent and nearly totally networked world. Indeed, the plausible outcomes are so different from each other that the combined US intelligence agencies entitled their new report on the subject "Alternative Worlds." And by the way, they listed a collapse of the global financial markets as the single biggest current risk.

But at the same time, technology innovations like 3D printing and robotics point the way towards a "post scarcity" society. Emerging economies are likely to produce phenomenal new wealth; new agricultural advances offer promise in feeding the world's growing middle classes; and US natural gas revolution could solve our budget and energy problems. Enormous opportunities abound.

So... what? Well, unless you have a crystal ball that I don't, there's only one rational choice: invest in a way that allows you to participate in all these wonderful profit opportunities, but also guards against the frightening potential outcomes we face. Stocks and bonds alone simply cannot perform those functions well. **The new-generation alternatives—now becoming available to almost all income levels—are, in my view, essential elements of a modern portfolio.** 📈

Info



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ABOUT THE AUTHOR | Bob Rice is Bloomberg TV's Alternative Investments Editor, the managing partner at Tangent Capital, and a board member of investment advisors with more than \$2 billion under management. The positions he has held throughout his multifaceted career have spanned many domains: Wall Street law firm partner; public company CEO; trial lawyer for the U.S. Department of Justice; and technology entrepreneur.

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