AJO
VISTA

FROM: Ted Aronson

DATE: February 23, 2023

RE: **ALTERNATIVES FOR THE MASSES?**

Larry Siegel is an advocate of the so-called Endowment Model (see his spirited debates with Richard Ennis, available on request).

However, Larry argues strenuously that the Model only applies to the institutional world and UHNW folks satisfying the following criteria:

- *Sophisticated investment staff that is large enough to include some experienced specialist in alternative investing;*
- *Long investment time horizon;*
- *High degree of risk tolerance (the ability to incur losses), at least in some part of the portfolio;*
- *The ability to earn new money, attract donations, or cut expenses if investments underperform; and*
- *Sufficient asset size to build a diversified portfolio.*

If you or your client meets all these criteria, skip this article.

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Alternatives for the Masses?

Laurence B. Siegel
February 6, 2023

As a long-standing supporter of the "endowment model," I've spent decades balancing my enthusiasm for active management and alternative investments against my theory- and evidence-based belief in indexing. But my advocacy of alternatives has been targeted to institutions and ultra-high net worth investors. The recent embrace of so-called liquid alternatives by ordinary Americans seeking to fund their retirement is deeply troubling.

I will start with a broad definition of alternative investments and describe their "liquid" manifestation. Next, I summarize the reasons why I've encouraged the most sophisticated investors to explore alternatives as potential enhancements to their portfolios. I then turn to the central question of whether that makes sense for those with less than $10 million in assets.

What are alternative investments?

A traditional investment is a publicly traded stock, bond, or money market instrument, or fund thereof, in any country in the world. Everything else is alternative.[1]

Alternatives, being an "all other" category, are very diverse. They run the gamut from the mundane (rental real estate) to the exotic (fine art, royalties, life settlements). Crypto-currencies are alternative, although calling them investments is stretching a point.

Liquid alternatives

The alternative investments that have recently appealed to individual investors — and that have been pushed by some advisors — are *liquid* alternatives. These are otherwise *illiquid* strategies — primarily private equity, hedge funds, and real estate — that have been repackaged as mutual funds or ETFs so that they are tradeable daily on an exchange. Because of this repackaging, individuals can buy, hold, and sell them with modest amounts of money.[2]

[1] At one time, all investments were alternatives. Then, starting in the late Renaissance, stock exchanges, bond dealers, and other agents began to standardize investment instruments and facilitate trading. These innovators made the old kinds of investment — buildings, farmland, mines, ships, banks, and all kinds of businesses held in a form that we would now call "private equity" — alternative.

[2] I am old enough to remember when European and Japanese stocks were considered liquid alternatives. REITs also used to fit the description. After about 1990, hedge funds that invested in publicly traded stocks and bonds (and sometimes commodities and currencies) called themselves liquid alternatives, on the ground that the underlying assets were liquid even though the fund shares were not. But today, the phrase "liquid alternatives" generally refers to what I cover in this article.

In a fairly recent (July 2021) Morningstar paper, "Liquid Alternative Funds: Is There Any Hope?", John Rekenthaler presented a classification scheme for liquid alternatives, used for organizing Morningstar's reports on these funds. The fund categories, or investment styles, that are in the Morningstar liquid alts database are:

- Equity market neutral
- Event driven
- Macro trading
- Multistrategy
- Options trading
- Relative value arbitrage
- Systematic trend

These strategies are all hedge fund-like. This article focuses only on the liquid-alt versions of these categories. Private equity, real estate, and exotics are excluded, making my analysis more manageable.

My purpose here is not to evaluate liquid alts as a general matter, but to consider their suitability for investors in the $1 to $10 million range, often called high-net-worth (HNW) individuals. In this range, significant capital losses in part of the portfolio can threaten one's ability to retire. Preparing for retirement is, of course, the primary reason that people in that wealth range save and invest.

Investors in higher brackets may still find my comments helpful although they are less limited in their choices. In particular, ultra-high-net-worth (UHNW) investors, with $30 million or more, are more like institutional investors in their skill sets and ability to bear risk. It is reasonable for them to consider both liquid and illiquid alternatives as options.

WHY THIS ARTICLE IS CONSISTENT WITH MY INVOLVEMENT WITH THE ENDOWMENT MODEL

In the past, I've been a vocal supporter of the "endowment model" for large perpetual institutions. Do I believe my own prior words?

I do.

HNW individuals preparing for retirement are *very* different from large perpetual institutions. My background is as an institutional investor. I worked for 15 years at the Ford Foundation, which was an early adopter of private equity and a later adopter of hedge funds. It has held real estate for almost the entire life of the organization.

At Ford, I learned enough about the endowment model, most eloquently described by the late Yale CIO David Swensen,[3] to defend it against its many attackers. My defense has appeared in a public and sometimes testy print debate in 2021 with the esteemed consultant Richard Ennis, who advocated only indexing.[4]

What criteria does an institution or wealthy individual need to satisfy for the endowment model to make sense? One needs to have:

- Sophisticated investment staff that is large enough to include some experienced specialists in alternative investing;
- Long investment time horizon;
- High degree of risk tolerance (the ability to incur losses), at least in some part of the portfolio;
- The ability to earn new money, attract donations, or cut expenses if investments underperform; and
- Sufficient asset size to build a diversified portfolio.

If you or your client meets all these criteria, skip this article. If not, be aware that most alternatives, liquid or illiquid, that are available to HNW investors involve high explicit fees and often high additional hidden fees; unfamiliar risks, such as crowded-trade, counter-party, and short-squeeze risks; and liquidity that is less than hoped for or advertised. If you're not scared yet, you should be.

In addition, all liquid alts are active management in some form, an actively managed investment being anything that is not a broad market index fund. The usual caveats about active management rarely beating index funds in the long run apply.

LIQUID ALTERNATIVES PERFORMANCE, RISK, AND DIVERSIFICATION POTENTIAL

But enough about me. Rekenthaler began his analysis as follows:

> Almost all liquid alternatives funds are new, created after the 2008 global financial crisis. They were, quite literally, an afterthought — a reaction to the stock market's tumble. The pitch: These funds would protect everyday investors' portfolios, just as hedge funds did for institutions and wealthy individuals.

It is not a big surprise that a protective or countercyclical product introduced *after* and *because of* the stock market's previous "tumble" — an understatement because it was the

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[3] Swensen, David F. 2000. *Pioneering Portfolio Management*: *An Unconventional Approach to Institutional Investment.* New York: Simon & Schuster. Second edition, 2009.

[4] Siegel, Laurence B. 2021 a. "Don't Give Up the Ship: The Future of the Endowment Model." *Journal of Portfolio Management* Investment Models 2021, vol. 47, issue 5, pp. 144-149, https://jpm.pm-research.com/content/47/5/144. Siegel, Laurence B. 2021 b. "The Endowment Model Is Just Active Management." *Journal of Investing*, vol. 30, issue 5 (August) pp. 8-13, https://joi.pm- research.com/content/30/5/8. Siegel, Laurence B. 2021 c. "The Market Portfolio Is Bigger Than You Think." *Journal of Investing*, vol. 30, issue 5 (August), pp. 21-26, https://joi.pm-research.com/content/30/5/21.

worst bear market since the Great Depression — might struggle to compete with the unexpectedly vigorous market recovery that started in 2009. A hedged product is not supposed to match, much less beat, a nearly straight-up stock market. What we need to know is: Are liquid alternatives an effective diversifier against traditional investment (stock and bond market) risk? Are they offered at reasonable fee levels? Do HNW individuals have too much of them?

Performance

To determine the effectiveness of liquid alts as portfolio diversifiers, it would be helpful to study detailed performance data, but I don't have the period-to-period data that would make such a study useful. Exhibit 1 provides summary data over the period from June 1, 2011 to May 31, 2021.

Exhibit 1
Summary statistics of long-term returns on liquid alternatives by Morningstar category

	Compound annual total return (%)	Standard deviation (%)	Equity market beta
	(10 years ended 5/31/21)	(3 years ended 5/31/21)	(3 years ended 5/31/21)
Equity market neutral	0.33	7.33	0.04
Event driven	4.16	7.02	0.28
Macro trading	2.23	7.63	0.26
Multistrategy	2.47	7.77	0.31
Options trading	4.17	10.68	0.43
Relative value arbitrage	4.16	6.09	0.24
Systematic trend	0.13	10.01	0.07

Morningstar's Rekenthaler summarized:

> During the 2010s, liquid alternatives funds averaged an annualized gain of 1.66%, which placed them behind every fund category save for a few specialty groups, such as energy, precious metals, and Latin American stock funds, and three flavors of short-term bond funds.

Liquid alts are designed to be, and marketed as, uncorrelated investments with little net exposure to broad stock or bond market moves. Finance theory tells us that the benchmark for such an investment is the riskless (U.S. Treasury bill) rate, which was 0.55% per year over that period.[5] Thus liquid alts, as a group, beat the *riskless* rate by just over 1% per year while taking *considerable* (although not extraordinary) *risk*.

An asset that is highly correlated with equities has risk in that it does not diversify away from the investor's equity exposure, which is (and should be) the reason investors seek out alternatives. Only the equity- market-neutral and systematic-trend categories had the low correlations with equities that denote an effective diversifier. Those two categories also had the lowest returns. The alts managers did not prove to be very skilled at generating returns that were unrelated to the large rise in the equity markets over the period shown in Exhibit 1.

Of course, past performance over a particular 10-year period is not a forecast. But the results suggest that the managers relied on some amount of equity or equity-like exposure to make money in this period.

ARE FUND FEES REASONABLE?

Mutual fund returns are reported net of fees. I'll analyze fees in some detail in a moment. For now, though, let's just use the average expense ratio (which includes fees) of the liquid alt funds in Morningstar's database, which was 1.66% (that was Rekenthaler's estimate; mine, covering a longer period, is a little lower). We just saw that, coincidentally, this was the after-fee performance of the funds as a group. Thus, the funds were able to extract 3.32% per year from the market, of which fund shareholders got half. Rekenthaler asked sarcastically:

> For each dollar that shareholders have earned, the fund company collects a dollar for itself. A 50/50 split. What could be fairer?

The words in the subtitle of Rekenthaler's article, "a fund-industry flop," are apt.

LIQUID-ALT PERFORMANCE WHEN BOND MARKETS DECLINED

To ascertain the diversification potential of liquid alts, we'd need to know how well they performed in down markets. Without detailed return data, we can't tell. But Morningstar again gives a clue, showing — in Exhibit 2 — the returns on several of its alt indices in periods of rising interest rates (that is, falling *bond* markets):

[5] Bloomberg Barclays US T-Bills (1-3 Month) index. Money market funds follow the Treasury bill rate very closely and are the usual vehicle for individual investors to hold riskless assets.

EXHIBIT 2
RETURNS ON SELECTED MORNINGSTAR LIQUID ALTERNATIVES INDICES IN PERIODS OF RISING INTEREST RATES

	5/1/2013 - 8/31/2013: Taper Tantrum	4/1/2015 - 6/30/215: Eurozone Stress	8/1/2016 - 12/31/2016: Trump Election	1/1/2018 - 10/31/2018: Powell Rate Hike	1/01/2021 - 3/31/2021: Post-Pandemic Reflation
US Fund Equity Market Neutral	0.0	-0.3	0.9	0.2	2.9
US Fund Event Driven	1.2	-0.2	1.8	1.8	2.7
US Fund Relative Value Arbitrage	-0.2	0.1	1.8	0.9	1.4
US Fund Options Trading	0.0	0.1	0.9	-1.2	2.9
US Fund Multistrategy	-1.3	-1.2	0.3	-2.6	2.8
Morningstar Global Core Bond GR Hedged USD	*-2.8*	*-2.2*	*-2.4*	*-0.2*	*-2.5*

Source: Morningstar Inc., "2021 Global Alternatives Landscape." Reprinted with permission.

The liquid alts shown in Exhibit 2 were miserable diversifiers against long-term interest rate (bond) risk, except during the early 2021 episode that Morningstar labeled as "post-pandemic reflation." During that latter period, liquid alts performed admirably, rising 2.5% on average in a quarter when the Morningstar global bond index fell by a comparable amount.

The most recent episode of rising rates was much more dramatic than any of the episodes shown in Exhibit 2; in 2022, the bond index fell 12.6%, its worst year ever, as rates normalized from historically low levels. In an article bravely entitled, "Alternatives are Winners in 2022," Morningstar's Katherine Lynch reported that "the average alternatives fund is down 2.74%." That's better than the plummeting stock or bond market, but it's not a win. A win for a diversifying asset is a *positive* return when traditional assets decline.[6]

ASSETS UNDER MANAGEMENT AND FUND FLOWS

Do individuals have too much in liquid alts? Are they continuing to invest, or are they redeeming?

[6] https://www.morningstar.com/articles/1128843/alternative-funds-are-winners-in-2022. By cherry picking, we can find a big winner in the alts universe in 2022. "The third-largest category of alternative strategies with $27 billion in assets, systemic trend funds, are up an average of 17.15% so far this year," reported Lynch on December 8, 2022. Taking this victory lap a little too seriously, Morningstar executive Jason Kephart said, "It's been a golden age for alternatives this year… because they have very little interest rate risk…" No, it hasn't.

As of November 30, 2022, U.S. liquid alts — to be precise, alternative open-end mutual funds and ETFs — had $183,661,347,469 in total net assets.[7] That sounds like a lot of money, but if the aggregate value of U.S. liquid alts were a company, it would be only the 52nd largest company in the MSCI ACWI index of global equities.[8] Liquid alts thus account for only 0.5% of total mutual fund and ETF assets under management. If this number is representative of what individual investors hold, we don't have much of a problem.

But other evidence suggests that we do have a problem. The Motley Fool reported that, as of 2022, HNW individuals had 26% of their assets allocated to alternatives broadly construed (not just liquid alts), and that the percentage for UNHW individuals was 50%. It's true that these percentages count all alternatives, including directly held real estate, direct hedge fund holdings, private equity, commodities, and so forth, and that these more venerable alternative categories are much larger slices of the capital markets than liquid alts.

But how many investors with under $10 million, preparing for retirement and getting investment guidance from advisors, own significant amounts of these old-style alternatives? Isn't it more likely that they've followed advisors' recommendations and bought liquid-alt shares, which are easy to obtain and easy to follow in mutual fund data sources?

To answer this question, I have to look at anecdotal evidence, because no direct data are available. Way back in 2015, Josh Charney of Morningstar wrote,

Most advisors (59%) allocate between 6% and 20% to alternatives… [O]rganic growth rates for liquid alternative mutual funds during 2014 are still larger than any other broad Morningstar Category.

As we'll soon see, fund flow data strongly suggests that these numbers have either remained stable or grew since 2014, rather than shrinking.

With liquid alts making up a tiny fraction of total fund assets but representing a considerable chunk of advisor recommendations, it's hard to avoid the conclusion that they have become concentrated in portfolios — retirement-focused HNW portfolios guided by advisors — that are owned by the investors least well equipped to understand the products, handle the risks, and afford the fees. This is supported by logic and the quantitative evidence I've been able to gather. If it's true, HNW investors should hold much less in liquid alts. Sometimes I think they shouldn't have any at all.

FUND FLOWS

Fund flows into and out of a category of mutual fund or ETF provide information about investor reaction to returns. It is widely believed that investors buy assets that have recently risen in value, and sell assets that have fallen, with the consequence that investor performance is worse than the performance of the assets themselves.

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[7] Source: Morningstar Direct.

[8] Where companies are ranked by market cap.

Morningstar's Russel Kinnel documented this for various categories of mutual funds, including liquid alts, using data for the 10 years ending on December 31, 2018. Exhibit 3 shows the results.

EXHIBIT 3
INVESTORS' (DOLLAR-WEIGHTED) RETURNS ON BROAD CATEGORIES OF MUTUAL FUNDS COMPARED TO RETURNS ON THE FUNDS THEMSELVES (TIME-WEIGHTED), 2009-2018

Broad Category Group	Investor Return	Total Return	Gap
Allocation	5.54	5.32	0.22
Alternative	-2.05	-0.61	-1.44
Equity	6.25	6.82	-0.56
Fixed Income	3.39	3.95	-0.55

Source: https://www.morningstar.com/articles/942396/mind-the-gap-2019

The widely held belief was confirmed: Mutual fund investors underperformed the funds themselves. For liquid alts, the underperformance was 1.44 percentage points per year, a significant margin (13.5 percentage points) when compounded over the decade. In equity, fixed income, and allocation funds they did better — although not well. Investors and their advisors were mostly unsuccessful at timing fund flows.

If investors are found behaviorally to be bad at something, they should not do it. Discretionary timing of alts fund purchases and sales is one of those things. They should, instead, rebalance to a fixed allocation — which forces a buy-low, sell-high discipline — or else not hold the asset.

In 2022, however, cash inflows to liquid alts were roughly equal to market losses in that sector: Inflows $27.1 billion, market losses $28.6 billion (both numbers through November 30).

The 2022 result, that investors bought instead of selling into a falling market, was an improvement on earlier behavior, when investors did the opposite.

LIQUID ALTERNATIVE FUND FEES AND EXPENSES

Fees and other investment expenses — the "expense ratio" in mutual fund parlance — are key to understanding the hazards of liquid alternatives. The "dimensions of active management," as described by Barton Waring and me in a widely circulated 2003 article, are alpha, active

risk, and fees. For brevity of language let's just call all mutual fund expenses paid by the investor "fees," even though that is not precisely accurate.[9]

Some things should be expensive. A predictable stream of positive alphas is one of them. A manager who can produce such a stream is worth high fees, probably higher than any existing manager charges. The highest fee schedule I've ever heard of was charged by Renaissance Technologies' Medallion Fund at one time in its history: a 5% flat fee and 55% of profits. Despite what appeared to be highway robbery, investors earned some of the highest *after-fee* returns ever generated. Medallion, at least at that time in history, was just that good.[10] (Medallion is not a liquid alternative and is not available to HNW investors.)

But most funds should not be expensive. Index funds set a benchmark of what managers should charge for average performance: almost nothing. Remind yourself that the average return of all active managers *has to be*, by mathematical certainty, the return on the market — minus fees.[11]

Exhibit 4 shows basic statistics of the expense ratios of the 726 share classes of liquid alt funds for which Morningstar provided data.[12] The spread between the most expensive and the cheapest funds is astounding, a nearly 16-to-1 ratio:

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[9] Some investment expenses that are included in the expense ratio are paid by the manager to third parties, and are thus not kept by the manager as revenue; and some expenses are frictional, such as trading costs. These, too, are not revenue to the manager.

[10] I break my rule of not mentioning specific funds or managers because this story is background, and does not reflect on any fund in Morningstar's liquid alts universe. "As Greg Zuckerman noted in *The Man Who Solved the Marke*t," writes Ritholtz Wealth Management's Nick Maggiulli in his blog Of Dollars and Data, "Renaissance's flagship Medallion Fund generated 66% annualized returns (before fees) and 39% annualized returns (net of fees) from 1988-2018. To put this performance in perspective, $1 invested in the Medallion Fund from 1988-2018 would have grown to over $20,000 (net of fees) while $1 invested in the S&P 500 would have only grown to $20 over the same time period."

[11] Sharpe, William F. 1991. "The Arithmetic of Active Management." https://web.stanford.edu/~wfsharpe/art/active/active.htm. Reprinted with permission from the *Financial Analysts Journal*, vol. 47, issue 1 (January/February).

[12] The Morningstar liquid alts database includes a large number of "options trading" funds that have a share class for each option expiry date. Most of these are buffer funds, which deliver the return on an index or benchmark within a pre-specified range over a pre-specified period of time, and provide (full or limited) downside protection and reduce (or eliminate) upside capture if the index return is outside that range. Because options trading funds follow a relatively simple strategy, they generally (but not always) have lower expense ratios than the other six categories of funds. The large number of share classes for these funds skews the average expense ratio down. This may be one of the reasons that the weighted average expense ratio that I calculated (1.46%) is lower than the average cited by Rekenthaler (1.66%). Another reason may be that my calculation goes through December 31, 2022 while Rekenthaler's only goes through May 31, 2021.

EXHIBIT 4

STATISTICS OF EXPENSE RATIOS (IN % PER YEAR) FOR LIQUID ALTS FUNDS REPORTED BY MORNINGSTAR AS OF YEAR-END 2022 (WEIGHTED BY AUM)

Mean	1.46
Median	1.29
Standard deviation	0.76
Maximum	4.75
Minimum	0.30
Number of funds	409
Number of share classes	726

An expense ratio of 4.75% per year? Really? Ignoring compounding and market profits, that fee schedule would transfer *all* of the client's money to the manager in 21 years! The profits had better be lavish; they were not. The performance of that fund was not shameful, but if the expense ratio had been at the median, 1.29%, it would have been impressive for a portfolio with a beta of only 0.14. (The low beta indicates that some diversification was achieved.)

The manager consumed the lion's share of the profits from the fund's trading strategy. Don't recommend funds with sky-high fees! As we saw with Medallion, a fund will occasionally be worth its high fees, but only rarely and we don't know in advance which funds they will be.

Because most of the funds are small in terms of AUM, it's worth inquiring whether one can save on fees and expenses by only investing in the biggest funds. Exhibit 5 shows the statistics for the 30 funds with over $1 billion. As in Exhibit 4, each share class is weighted according to its AUM:

EXHIBIT 5

STATISTICS OF EXPENSE RATIOS (IN % PER YEAR) FOR LARGE (OVER $1 BILLION AUM) LIQUID ALTS FUNDS

Mean	1.42
Median	1.51
Standard deviation	0.76
Maximum	3.52
Minimum	0.33
Number of funds	30
Number of share classes	102

The statistics for the funds over $1 billion are almost identical to those for all funds. Only the maximum expense ratio is significantly different (because the biggest outliers are small funds). Thus, investing only in the biggest funds does not save the investor money.

To summarize this fee discussion, I quote Cliff Asness, that wise and witty provider of, among other things, liquid-alternatives funds, who has said that no investment strategy is so good that it is still good after subtracting an indefinitely large fee.

LIQUID ALTERNATIVES AND FIDUCIARY DUTY: SHOULD ADVISORS OFFER ALTS BECAUSE CLIENTS AND PROSPECTS WANT THEM?

I've covered return, risk, fees, AUM, and funds flows (this last item testing the hypothesis that flows follow performance, so that returns to the typical investor are lower than returns to the fund). Let's turn to the suitability of liquid alt funds for the class of clients serviced by the advisor community.

Writing in the December 13, 2022 issue of *Investment News*, the reporter Mark Schoeff, Jr., recommended that advisors include alternatives, including liquid ones, in their quiver of arrows for attracting and retaining HNW clients. Although that shouldn't be an absolute no-no, the alternatives allocations of many individual investors are way too high. According to Schoeff, Stephen Soper, a senior vice president at Wright Investors' Service, claimed at a planners' conference that "[HNW] investors allocated about 26% of their portfolios to alternative investments in 2020, while [UHNW] investors allocated about 52%."[13]

Advisors to HNW individuals should not encourage such risky behavior. While it's theoretically possible for alternatives to reduce overall portfolio risk through low correlation to stocks and bonds, that claim is made far too often. Moreover, advisors and their clients are in a poor position to evaluate it. Investors should assume that the risk of a liquid alternative is what it appears to be from the standard deviations. Any diversification benefit is gravy. Funds that zig when others zag are the Holy Grail, but (as we learned from Indiana Jones) it's hard to find the Holy Grail.

Soper concluded that "if you want to speak to these target markets, you better have alternatives in your mix." Those are strong words, dangerously leading advisors astray.

It may be true that potential clients want large helpings of alternatives, but advisors are bound by fiduciary duty to recommend investments that are good for the client. Soper assured advisors that "liquid alternatives…for the most part don't pose a regulatory risk" to advisors. That's a little like saying that driving 120 miles per hour on the autobahns in Germany doesn't pose a legal risk because there is no speed limit on the autobahns — it misses the point. The risk on the autobahn is physical. Likewise, the risks in alternatives for the masses aren't regulatory or legal; they're market and institutional risks, which we listed earlier.

[13] Those numbers include all alternatives, including real estate, directly held hedge funds and private equity, and so forth — not just liquid alts.

Don't accept Soper's dismissal of legal and regulatory risks. An advisor who places a client in funds with expense ratios toward the high end of the range shown in Exhibits 4 and 5, when index funds average 0.05% and long-only active funds 0.69%, might be in violation of her fiduciary duty to the client and vulnerable to a lawsuit. More to the point, alternative investments can go down — *way* down. One multi- strategy liquid alternatives fund operated by a prestigious manager fell 17.5% per year, compounded, over the three-year period ending September 30, 2020. This was a very strong period for traditional markets (the S&P 500 was up 12.3% per year). Now *that's* diversification! The alts fund zigged when the market zagged, but the result was more like the Temple of Doom than the Holy Grail.

Alternatives are more fun than traditional investments. They make the holder feel sophisticated and special. They foster good conversation at cocktail parties. But a very modest allocation to alts can provide those psychic benefits without costing the investor much money if the returns are bad. A 26% allocation in a HNW investor's portfolio is way too much. And most individual investors would be better off without any.

Conclusion

Alternative investments are not bond substitutes

Alternative investments came into their own as an institutional return booster and diversifier during what Richard Ennis called the golden age of alts, 1994-2008. During that period and, in response to the success of alternatives, more recently, institutions upped their alternatives allocations, sometimes to astounding levels. Meanwhile, they stripped their fixed income portfolios down to almost nothing, reasoning that alts, with their putatively low betas, would provide the "anchor to windward" that had been the traditional role of bonds.

This is a terrible idea for individuals saving and investing for retirement. Alternatives are not bond substitutes. They do not provide a fixed income. They are form of active management, usually active equity management. Alternative investments have their place in certain institutional and UHNW portfolios but, with rare exceptions, do not belong in retirement-focused portfolios of less than $10 million.

After a seemingly endless period of financial repression when bonds yielded nothing (in some countries they actually had negative yields), the bond winter seems to be over. A 4% yield on Treasury bonds is *normal*. And advisors should allocate *normal* amounts to fixed income investments.

Keep alternative allocations low if you can't keep them at zero

Some clients will insist on having alternative investments. To keep them as clients and attract new ones, you may have to respect such demands. For such clients, liquid alts make more sense than the illiquid assets on which they're based, but you should do everything you can to keep the allocation small. The default allocation should be zero. Any nonzero amount should be the exception, not the rule.

BE MINDFUL OF FEES

Finally, of the three principal dimensions of investment management — return, risk, and fees — fees are the only one under the investor's direct control. While some actively managed investments are worth their high fees, we don't know in advance which these will be, so the default presumption should be that low fees are better than high ones.

As Jack Bogle said, "Where returns are concerned, time is your friend. But where costs are concerned, time is your enemy."[14]

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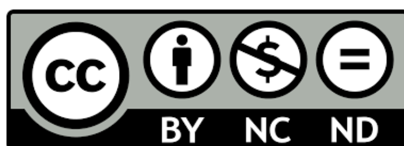

[14] https://awealthofcommonsense.com/2017/10/an-investment-book-for-the-masses/