Alternative Investments: Closing the Knowledge Gap for Mainstream Investors

It used to be that alternative investments were considered an appropriate strategy for only a small portion of investors. This is no longer the case. In recent years, alternative investments have moved into the mainstream, and today’s investors have access to a broad range of liquid alternative investment options.

However, while investors’ access to alternatives has grown quickly, their knowledge of and comfort with these strategies has not necessarily kept pace. This paper will give financial professionals an understanding of investors’ current attitudes about alternatives, and help them close the knowledge gap that many people have about this important topic.

Alternatives are investments that are alternative to traditional investments, and may offer more risk to the investor. Alternative products typically hold more non-traditional investments and employ more complex trading strategies, including hedging and leveraging through derivatives, short selling and opportunistic strategies that change with market conditions. Investors considering alternatives should be aware of their unique characteristics and additional risks from the strategies they use. Like all investments, performance will fluctuate. You can lose money.

Background
Invesco recently teamed with Market Strategies International to conduct a survey of 429 investors with at least $250,000 in investable assets who work with financial advisors. The findings provide financial advisors and others in the investment community with fascinating insights into high-net-worth (HNW) and affluent investors’ attitudes and behaviors related to alternative investments.

Key findings
1. Alternative investments are still foreign to a majority of investors despite working with a financial advisor.
2. As with other complex investment products, advisors are the driving force behind investors’ knowledge, comfort and usage of alternative investments.
3. Investors’ understanding of alternative investments is fairly narrow and has not adapted with the growth and evolution of alternatives. The majority of investors are only aware of specific alternative asset classes (e.g., real estate investment trusts [REITs], commodities, etc.) rather than general alternative strategies (e.g., long/short equity, market neutral, etc.)
4. Investors continue to associate the alternative category with high risk despite the frequent use of alternatives to mitigate risk in portfolios.
5. A lack of alternative knowledge among investors is the greatest obstacle asset managers and advisors need to overcome to drive growth in the alternative category. In fact, investors are looking for products that provide many of the potential benefits that alternatives may offer; however, they aren’t aware that they may be able to access these benefits through alternatives.

---

1 Investable assets includes all cash, savings, mutual funds, stocks, bonds, retirement accounts (such as IRAs, 401(k)s, 403(b)s, etc.), and all other types of investments, but excludes home and other real estate value.
2 High-net-worth investors are defined as those with $1 million or more in investable assets.
3 Affluent investors are defined as those with investable assets between $250,000 and $1 million.
Alternative investments may include asset classes such as private equity, currencies, commodities, real estate and bank loans, as well as investment strategies such as long/short equity, market neutral, global macro and hedged equity.

**Detailed findings**

**Opportunity to increase alternative usage**

Alternative investments are an appropriate investment option for many HNW and affluent investors. However, the vast majority (77%) of individuals who work with financial advisors and have investable assets of $250,000 or more are not even familiar with the term “alternative investment.”

Of the remaining investors who are aware of alternative investments (and who are the focus of this paper), just 4 in 10 currently use them. And alternatives comprise 16% of their total investable assets.

The main barrier to more widespread use of alternatives appears to be lack of knowledge. Only 10% of investors feel they have a high level of understanding about this investment category. When asked how they would describe an “alternative investment,” investors were most likely to provide a broad, non-descript answer: “asset classes that aren’t stocks, bonds or cash”, as shown in Figure 1. Of specific products, REITs were the most cited. HNW investors are able to identify a wider range of alternatives than affluent investors.

**Figure 1 — How Investors Define Alternative Investments (Top Responses)**

<table>
<thead>
<tr>
<th>Response</th>
<th>(% of Investors)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not Stocks/Bonds/Cash</td>
<td>29</td>
</tr>
<tr>
<td>Real Estate Investment Trusts (REIT)</td>
<td>27</td>
</tr>
<tr>
<td>Precious Metals/Gems</td>
<td>25</td>
</tr>
<tr>
<td>Commodities</td>
<td>15</td>
</tr>
<tr>
<td>Hedge Funds</td>
<td>14</td>
</tr>
<tr>
<td>Non-Traditional Strategies</td>
<td>14</td>
</tr>
</tbody>
</table>

Interestingly, 5% of investors named money market funds as an alternative investment, indicating some confusion about what is and isn’t an alternative.

While alternative investments can be classified as both asset classes (e.g., REITs) and strategies (e.g., market neutral), just 14% of investors are aware of alternative investments strategies. This indicates an opportunity for financial advisors to help their clients understand the breadth of the alternative category and the variety of ways they can help meet portfolio objectives.

![Figure 1 — How Investors Define Alternative Investments (Top Responses)](image)

Just 1 in 4 investors who work with an advisor are aware of the term ‘alternative investment.’

**The important role of financial advisors**

Financial advisors are far and away the most significant factor influencing general perceptions and use of alternative investments. Sixty-five percent of HNW individuals and 52 percent of affluent investors named their advisor as a primary driver of their decision to add alternatives to their portfolio. Further proof of the value of professional advice is that 7 of 10 investors who use
alternatives say they talked to their advisor about them, while 7 of 10 investors who don’t use this investment vehicle did not have a conversation about them with their advisor.

Alternative investments can be complicated, especially without the guidance of an advisor. That may be why more than a quarter of investors who didn’t talk to their advisors about alternatives say they don’t use them due to complexity. Similarly, 60% of investors who didn’t discuss alternatives with their advisor feel they don’t know enough about them to add them to their portfolio.

Financial advisors play a key role in influencing investors’ attitudes about alternative investments, as shown in Figure 2. Investors who talked about alternatives with their advisors are more likely to see the value in having a mix of asset types. A change in attitude due to a conversation with the financial advisor can lead to increased usage of alternatives: Investors who talk about this asset type with their financial advisor are far more likely to increase their allocation to alternatives over the next year.

Financial advisors definitely have a hurdle to overcome with investors not currently invested in alternatives. Just 4% say they’d like more information from their advisor about alternatives; although this is the case with many “new” investment products.
Detailed findings (continued)

The narrow alternative focus

There is a considerable amount of opportunity for advisors to inform their clients of the broad range of products available under the alternative umbrella, and the unique potential benefits of each. Results suggest that investors have a very narrow view of alternatives both in the investments they own and the purpose of the category.

As shown in Figure 4, REITs and commodities are two of the more traditional types of alternative investments, so it’s to be expected that they are the most utilized. Almost half (46%) of investors using alternatives have REITs in their portfolio, while 36% use commodities.

Investors indicate less frequent use of alternative investment strategies, which is not surprising since most investors think “product” when asked to define alternatives.

When asked why they added alternative investments to their portfolio, almost half of investors cited diversification, as shown in Figure 5. This number rises to 61% for HNW investors. Other popular answers included: to help with inflation protection, to provide downside protection/risk management and to achieve enhanced returns.

The clustering of these results points to the need for additional education on the type of alternative products available and the unique benefits of each type of alternative investment. Also illustrating the need for greater communication: 6% of investors with alternatives in their portfolios don't know which type of alternative investment they own, and 7% of investors holding alternative investments don't know why they have them.
Attitudes about alternatives vary widely

As might be expected, investors holding alternatives, and those more likely to have spoken with their advisor, have more positive attitudes about alternatives than non-users do. One-third of investors with alternatives in their portfolios feel they are an important part of a well-developed portfolio. In sharp comparison, just 4% of non-users see alternatives as a portfolio “must.” Likewise, twice as many investors using alternatives as those who aren’t agree that an effective portfolio includes both traditional and alternative products.

A diversified portfolio containing traditional investments and noncorrelated alternatives may help mitigate volatility and may potentially generate long-term gains — a point that does not appear to be communicated well to the retail investor. This is a perception advisors, along with other financial institutions, should focus on educating investors around as 80% of those surveyed viewed alternative investments as riskier than traditional investments.

<table>
<thead>
<tr>
<th>Figure 6 – Attitudes About Alternative Investments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investors Not Using Alternatives</td>
</tr>
<tr>
<td>-----------------------------------</td>
</tr>
<tr>
<td>(%)</td>
</tr>
<tr>
<td>0</td>
</tr>
<tr>
<td>10</td>
</tr>
<tr>
<td>20</td>
</tr>
<tr>
<td>30</td>
</tr>
<tr>
<td>40</td>
</tr>
<tr>
<td>50</td>
</tr>
<tr>
<td>60</td>
</tr>
</tbody>
</table>

- I only consider investments that greatly exceed benchmarks.
  - 12% (4%)

- It is important to have noncorrelated asset classes in my portfolio.
  - 12% (27%)

- I think alternative investments are an important part of a well-developed portfolio.
  - 4% (32%)

- An effective portfolio includes a balance of traditional products and alternative investments.
  - 26% (52%)

One-third of investors not using alternatives say they believe in investment strategies that minimize the impact of market volatility on their portfolio. However, only 12% of this group feels it’s important to have noncorrelated asset classes in their portfolio; in fact 30% actually disagree with the idea of holding noncorrelated assets. This disconnect indicates a lack of understanding among non-users in how alternative investments and strategies can help them reach their goal of minimizing market volatility.

One-third of investors who don’t use alternatives believe in minimizing the impact of market volatility on their portfolios. This could represent an opportunity to educate them on alternatives that seek to mitigate volatility.
Detailed findings (continued)

Communicating about alternatives

With non-users resistant to learning more about alternatives, financial advisors will have a tough sell in convincing them of the role and value of alternative investments. However, there is good news: A quarter of these investors feel that investment providers should educate investors about the benefits of alternative investments, and a quarter agree that an effective portfolio includes a balance of traditional products and alternative products/strategies – so there might be some opportunity with this audience once they're educated.

Not surprisingly, the research findings show that HNW investors have a somewhat better understanding of what alternatives are and the value in using them, which might indicate that this group receives more thorough communication on the topic than affluent investors. However, as these products are more widely available, information should become readily available to all investors.

Those looking to educate investors about alternatives should keep in mind the following key communication messages:

- **Alternatives do not work the same way as traditional asset classes.** Many investors focus on factors like track record and fees when assessing all investment options, and they tend to believe they are just another tool for diversification. However, alternative investment products and strategies cannot be evaluated in the same way as traditional asset classes as they serve a variety of purposes.

- **Alternatives may provide preservation in adverse market conditions.** Investors frequently agree that the biggest shortfall of traditional stock and bond investments is that they don't provide enough protection in adverse markets. However, they don't appear to understand that the nature of noncorrelated asset classes makes them an ideal complement to traditional investments in many adverse markets.

- **Today's alternatives offer more liquidity.** Some investors fear that they will be “locked into” alternatives, which used to be more common. Many of the alternative investments available on the market today give investors the same amount of flexibility as the traditional investments they are used to.
Conclusion
Despite the significant growth in the breadth of alternative products available and the usage of alternative investments over the past seven years, the majority of affluent investors still have a fairly limited understanding of the alternative category. Asset managers, financial advisors and third-parties should seize the opportunity to inform investors of the range of benefits available from alternative products as well as correct some apparent misconceptions. Investors need to understand that not all alternative products are created equal, and investors’ misconceptions surrounding the risk level of the alternative category in total needs to be corrected.

Investors are interested in volatility mitigation and they have a mindset that aligns with some of the potential benefits of certain alternatives. For example, investors believe traditional stock and bond portfolios will not protect them in adverse markets. Advisors and asset managers may be able to assuage those concerns by educating investors on the role of noncorrelated asset classes and long/short strategies.

Results also suggest that there is additional opportunity for advisors to either improve their knowledge of alternatives or improve their approach to discussing the category with their clients. As a key driver of adoption for the majority of alternative users, advisors need to not only understand how these products work and how they complement other products in a portfolio, but also be able to educate their clients and prove the need for such products in a well-developed portfolio.
About the study
The data examined for this report comes from investor research conducted by Market Strategies International in October 2013. Research took the form of a preliminary market assessment and a national online, blind survey with a representative sample of 301 high-net-worth and 152 affluent advised investors, both using and not using alternative investments.

Explore Intentional Investing with Invesco®

Brought to you by Invesco Risk Institute

NOT FDIC INSURED | MAY LOSE VALUE | NO BANK GUARANTEE

Note: Not all products, materials or services available at all firms. Advisors, please contact your home office.

All material presented is compiled from sources believed to be reliable and current, but accuracy cannot be guaranteed. This is not to be construed as an offer to buy or sell any financial instruments and should not be relied upon as the sole factor in an investment-making decision. As with all investments there are associated inherent risks. Please obtain and review all financial material carefully before investing. This does not constitute a recommendation of the suitability of any investment strategy for a particular investor. The opinions expressed herein are based on current market conditions and are subject to change without notice. Past performance is not a guarantee of future results.

Alternative products typically hold more non-traditional investments and employ more complex trading strategies, including hedging and leveraging through derivatives, short selling and opportunistic strategies that change with market conditions. Investors considering alternatives should be aware of their unique characteristics and additional risks from the strategies they use. Like all investments, performance will fluctuate. You can lose money.

Invesco Distributors, Inc. is not affiliated with Market Strategies, Inc. nor Cogent Research.


invesco.com/us
RIALTS-WP-2 05/14
Invesco Distributors, Inc. 6019