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Eclectic strategies can bolster returns

Investors are looking at nontraditional areas to bolster portfolio performance in this low-return expectation, low-interest-rate environment. Many strategies have merit, but it's important to understand the advantages and disadvantages of each.

PERSONAL FINANCE

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- Non-U.S. bonds offer potential for enhanced returns and another opportunity set for investors. Correlation is low compared to the U.S. capital markets, but currency risk can be significant and volatility is typically double that of the U.S. bond market.
- High-yield or "junk" bonds also improve portfolio diversification and offer a high level of income. However, many high-yield bonds are relatively illiquid, which is a concern because of the increased credit or default risk compared to investment-grade bonds. High-yield bonds are generally less risky than stocks, but the characteristics can look more like stocks than bonds as the economy goes through cycles.
- Real Estate Investment Trusts (REITs) offer access to different property types and liquidity. Investors do get some diversification benefit, but REITs are often highly correlated to small and mid-cap equities. Volatility is high and some exposure to REITs may exist through other equity products.
- Hedge funds offer potential for higher risk-adjusted returns. Typically, hedge funds offer reduced volatility and attractive correlations to traditional stock and bond markets. Hedge funds, however, can be illiquid and have high fees relative to the public markets. Some of the risks, such as potential for fraud, cannot be quantified, and returns are reliant on a manager's skill to produce positive returns in a variety of market environments.

Private equity can offer higher returns than public equities and add additional portfolio diversification as well.

- Private equity can offer higher returns than public equities and add additional portfolio diversification as well. Fees are high relative to the public markets and the investments are generally illiquid. Investors must have a strong, long-term commitment. Investment patterns can produce losses in early years, and the median diversified fund has underperformed the traditional markets through the years.

Each strategy may have merits for investors, but diversification is crucial for each one. Owning a single high-yield bond or hedge fund strategy can be incredibly risky. Using pooled or mutual funds and, in some cases, fund of funds should be considered unless the investment is sizable — often tens of millions of dollars.

Generally, these eclectic strategies should be a relatively small component of a portfolio. The only exception may be with hedge funds, as each underlying strategy may be highly complementary to the next.

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