CNL Securities

SPECIAL REPORT

Exploring Alternative Investments

Many investors today are considering alternatives to traditional investments like stocks and bonds to diversify their portfolios and mitigate overall portfolio volatility. But what exactly are alternative investments, and what potential benefits can they offer? This report explores why interest in alternatives continues to increase among investors, as well as the potential benefits and risks of these types of investments.

Alternative investments represent asset classes of just about anything outside the realm of traditional stocks, bonds and mutual funds. These investments include tangible assets such as real estate, precious metals, art, antiques, coins and even stamps. Other kinds of alternative investments include financial assets such as traded hedge funds, commodities and managed futures, private equity and debt, distressed securities, carbon credits and financial derivatives.

THE POPULARITY OF ALTERNATIVES

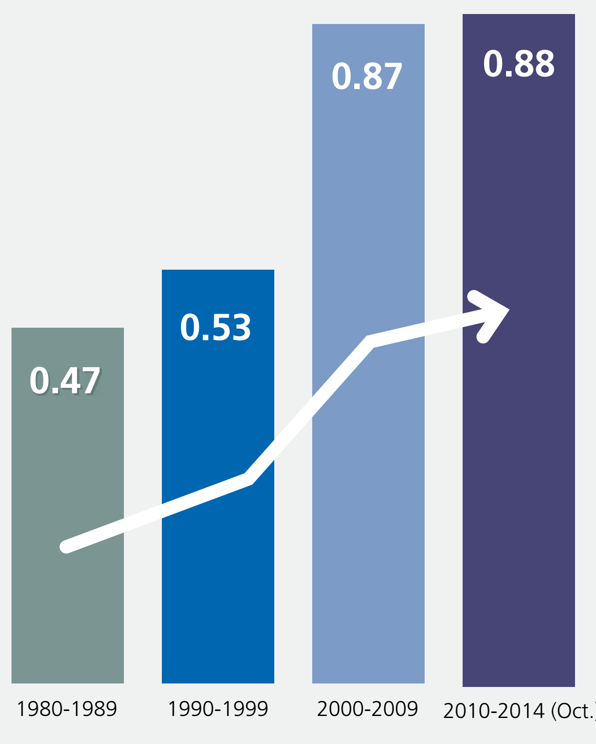
Previously available almost exclusively to accredited and institutional investors, more and more alternatives are finding a home in the portfolios of retail investors. Recent changes in today's investment landscape have contributed to this growth in popularity, the most noteworthy of which was the impact of the 2008 economic downturn on investment portfolios. As Figures 1 and 2 illustrate, investors who historically relied on a traditional 60/40 portfolio (i.e., one that consists of 60 percent U.S. stocks and 40 percent bonds) witnessed the effects of greater traded market volatility and correlation in their investments following the onset of the Great Recession in 2008. Even international stocks, historically used as a diversifier, have seen their correlations to U.S. equities increase significantly since then.

As a result, in the bear market that began in 2008, many retail investors suffered much larger losses than expected and began reevaluating their investment strategies. This opened the door for newer alternative offerings that often seek to reduce correlation and volatility in an investment portfolio.

"More and more alternatives are finding a home in the portfolios of retail investors."

Figure 1

Correlation of U.S. and International Stocks



The correlation, or extent to which values move in tandem, between U.S. and international stocks nearly doubled from a low of .47 in the 1980s to a high of .88 between 2010 and 2014 (Oct.).

Note: Investors cannot invest directly in an index; past performance does not guarantee future results.

SOURCE: MSCI EAFE Index and S&P 500 Index, November 24, 2014.

Figure 2

Correlation Between Hypothetical 60/40 Portfolio and S&P 500

Traditionally diversified 60/40 hypothetical portfolios showed strong correlation to the Standard and Poor's (S&P) 500 index between 1999 and 2013.

Note: Investors cannot invest directly in an index; past performance does not guarantee future results.
SOURCE: S&P 500 Index and CITI U.S. BIG Index, 1999–2013.

Given today's investment environment, financial professionals increasingly appear more comfortable presenting alternative investments as options to help diversify the portfolios of certain qualified investors. According to its annual survey of investment advisors, Natixis Global Asset Management reveals that 83 percent of financial advisors say they talk to clients about using assets that aren't directly correlated to the traded market.[1]

In addition, a report by Barron's in January 2014 looked at average asset allocations made by 40 of the largest wealth advisory firms.[2] The report found a 20.4 percent average allocation to alternatives. More significantly, net inflows into the category topped $40 billion in 2013, up from $14.6 billion the year before. The findings in the Barron's report are consistent with those discussed in a 2012 McKinsey & Company white paper. According to the financial services firm, alternatives will account for one-quarter of retail investments by 2015.[3]

Finally, interest in alternatives continues to increase among high-net-worth individuals, thus adding to the prevalence of these investments in the marketplace. A 2013 survey of wealthy investors by MainStay Investments found that 60 percent of high-net-worth individuals who currently use alternatives have increased their allocations to these investments over the past three years, with an average portfolio allocation of approximately 20 percent.[4] The survey results found that these investors are turning to alternatives hoping to find diversification and investment growth, as well as to protect principal.

This finding is consistent with those found in the *2014 World Wealth Report* by Capgemini and RBC Wealth Management.[5] According to this study, alternatives represented 27 percent of high-net-worth assets in North America, a 4 percent increase from the previous year. The study, which analyzed data from more than 4,500 millionaires in 23 countries, also found that alternatives represent 32 percent of all investments around the world, up 2 percent from 2013.

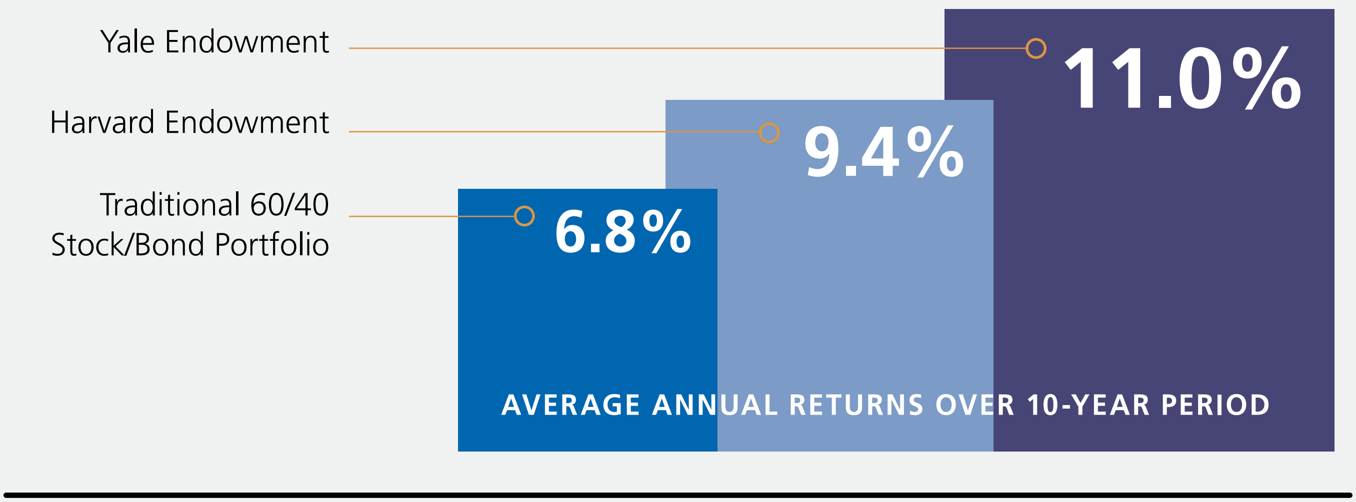
ALTERNATIVE INVESTMENTS AND THE ENDOWMENT MODEL

Despite their growing popularity in the last couple of years, alternative investments have been benefitting institutions for several decades. As covered earlier, traditional portfolios tend to follow the 60/40 rule, which represents the ratio of assets invested in U.S. equities and debt. Often cash is added to the mix to increase liquidity.

While it's important to keep in mind that institutions have different goals and longer investment horizons than individual investors, many institutions have relied more heavily on alternative investments, while still achieving positive yields. In fact, some endowments, like those of Harvard and Yale, invest a smaller percentage of their assets in U.S. stocks and bonds and rely, instead, on long-term alternative assets such as natural resources, private equity and real estate to generate returns that may outpace those of traditional 60/40 portfolios.

Figure 3

Comparison of Traditional 60/40 Portfolio to Harvard and Yale Endowments



Endowments, like those of Harvard and Yale, invest a smaller percentage of their assets in U.S. stocks and bonds and rely on alternative assets to generate higher returns than those of traditional 60/40 portfolios.

Note: CNL Securities is not affiliated with the Yale Endowment or Harvard Endowment, and neither endowment invests in retail investments. The chart is for illustrative purposes only. Investors cannot invest directly in an index. These unmanaged indexes do not reflect the fees and expenses that are associated with some investments. Past performance does not guarantee future results.

SOURCES: (Yale endowment data) *The Yale Endowment 2013 Performance*, Yale University, 2013. (Harvard endowment data) *Harvard Management Company Endowment Report*, Harvard Management Co., September 2013. (Traditional 60/40 data) *Yahoo! Finance*, March 31, 2014, http://finance.yahoo.com. Citigroup Global Fixed Income Index, April 8, 2014, http://www.yieldbook.com/m/indexes/citi-indices.

Broadly speaking, this method of investing divides a portfolio into five or six roughly equal parts and invests each in a different asset class. This strategy, often referred to as the endowment model, may not be for retail investors and typically avoids asset classes with low-expected returns. The model has been considered controversial as it invests in instruments with limited liquidity, with the intended goals of reducing volatility and increasing yields with an illiquidity premium.

Although historical results vary for long-term endowments and institutions, and are not necessarily an indicator of future performance, Yale's nearly $21 billion endowment experienced a 12.5 percent return in 2013 and 11 percent annually for the past 10 years.[6]

Similarly, Harvard's $32 billion endowment yielded a return of 11.3 percent in 2013 and a 10-year average of 9.4 percent.[7] This compares to an average of 6.8 percent for a typical 60/40 portfolio during the same period.

It is important to keep in mind that endowments have more leverage due to their size, different investment goals and longer investment horizons than individual investors. However, including alternatives may help enhance a portfolio's overall performances.

TRADED VS. NON-TRADED ALTERNATIVES

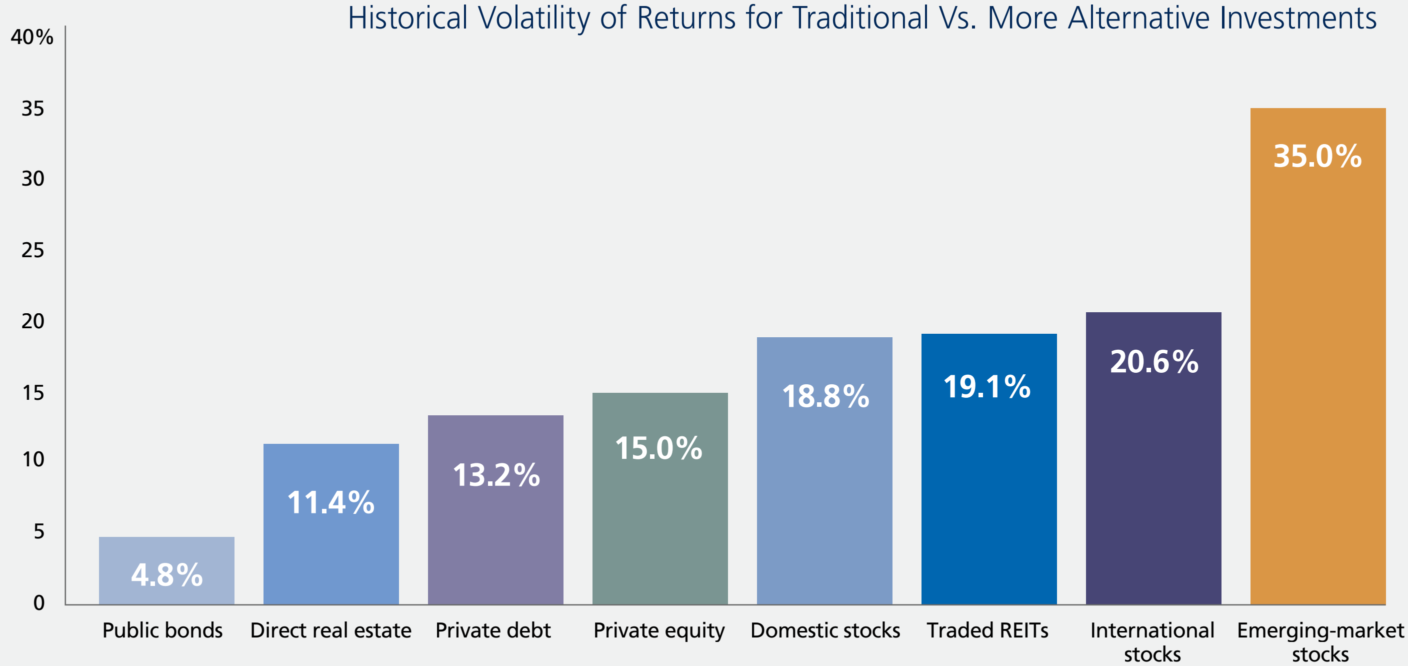
As alluded to earlier, alternative investments can be traded and non-traded. However, there are three features that differentiate a traded versus non-traded alternative investment. These are **liquidity** (i.e., the ability to convert an investment or asset into cash), **correlation** (i.e., the asset's price fluctuation based on market performance) and **market timing** (i.e., the buying and selling of securities to optimize the market's performance).

LIQUIDITY VS. ILLIQUIDITY

Traded alternative investments, such as real estate investment trusts (REITs) and business development companies (BDCs), can be bought and sold just like stocks or bonds on public exchanges. The advantage here is that investments in traded alternatives are more liquid than their non-traded counterparts. On the other hand, there is no secondary marketplace for their non-traded alternatives, which are typically only available to qualified investors through their financial professionals, making the non-traded investments comparatively illiquid.

Figure 4

Historical Volatility of Returns for Traditional Vs. More Alternative Investments



Note about Figures 4 and 5: The indices used for real estate and private debt differ from non-traded REITs and BDCs in many ways, including not incorporating brokerage fees or taking into account market valuation in the event of a public offering. Capital gains and dividends received may be taxed in the year received. The real estate index reflects investment-grade, income-producing properties typically acquired on behalf of institutional, tax-preferred investors. Returns also are depicted net of property-level management fees. The private debt index reflects a 50/50 combination of institutional leveraged loans and the broad high-yield loan market. Diversification does not eliminate the risk of experiencing investment losses. An investment cannot be made directly in an index. Past performance is not a guarantee of future results. This is for illustrative purposes only and is not indicative of any investment. The information, data, analyses and opinions contained herein do not constitute investment advice offered by Morningstar and are provided solely for informational purposes. 7/1/2014

SOURCE: Morningstar, 2014. (Refer to "Morningstar Chart Dataset Information" for additional content on this chart.)

If liquidity is the primary goal, traded alternatives may be the preferred choice. However, traded alternatives may respond to market fluctuations in the same way other traded investments do, and may not provide the diversification benefits of lower correlation and volatility. For example, traded REITs have historically shown volatility that is similar to that of the overall stock market (refer to Figure 4). Therefore, while traded alternatives may provide liquidity, they may not meet the diversification needs of some investors.

HIGH VS. LOW CORRELATION

Non-traded alternative investments are sometimes used as tools to reduce overall portfolio volatility through diversification because they may provide lower correlation with traditional financial investments, such as stocks and bonds. The cornerstone of portfolio diversification is the inclusion of a variety of low-correlated assets, or assets with values that do not move up and down in tandem in response to changes in the market.

Although less correlated to the stock market, non-traded alternative investments present other factors that should be taken into consideration:

- **Some non-traded alternatives require a high gross income or net worth.** To invest in a non-traded REIT or non-traded BDC, individuals must have a minimum net worth of $250,000 (exclusive of home, furnishings or automobiles) or a minimum annual gross income of $70,000 and a minimum net worth of $70,000, among other requirements.
- **Non-traded alternative investments have limited liquidity.** Redemption plans also can be subject to suspension, modification and termination at any time, and liquidation may be less than the original amount invested. Distributions, if applicable, are not guaranteed in frequency or amount and may be paid from other sources besides earnings.
- **The investment may have limited operating history and rely on an advisor,** which might introduce potential conflicts of interest and payment of substantial fees to the advisor and its affiliates.
- **A share price that changes infrequently is not analogous to stability in the underlying value of the assets.** Like other investments, asset values might fluctuate and be worth less than the purchase price.

Figure 5

Historical Correlation of Traditional Vs. More Alternative Investments

	Private debt	Public bonds	Domestic stocks	International stocks	Emerging-market stocks	Traded REITs	Private equity	Direct real estate
Private debt	1.00							
Public bonds	0.06	1.00						
Domestic stocks	0.65	-0.03	1.00					
International stocks	0.66	-0.28	0.77	1.00				
Emerging-market stocks	0.66	-0.23	0.40	0.77	1.00			
Traded REITs	0.64	0.09	0.42	0.42	0.41	1.00		
Private equity	0.42	-0.22	0.79	0.76	0.57	0.41	1.00	
Direct real estate	-0.13	-0.01	0.24	0.24	0.00	0.31	0.47	1.00

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SOURCE: Morningstar, 2014. (Refer to "Morningstar Chart Dataset Information" for additional content on this chart.)

"A potential benefit of investments that do not trade on a public exchange is that investors do not have to time the buying and selling of securities to the market's daily performance."

MARKET TIMING

Finally, another potential benefit of seeking longer-term investments that do not trade on a public exchange is that investors do not have to time the buying and selling of securities to the market's performance. In fact, according to the *20th Annual Quantitative Analysis of Investor Behavior* by Dalbar, many investors often buy and sell securities at inopportune times.

As the study found, the average equity investor has underperformed the S&P 500 index by 4.2 percent for the past 20 years on an annualized basis, while the average fixed-income investor underperformed the Barclays Aggregate Bond index by 5.03 percent during the same time period (refer to Figure 6). In addition, despite guessing correctly 75 percent of the months in 2013, many investors were not successful at timing their cash flows to optimize the market's performance. The average equity investor trailed the equity market by 6.87 percent, and the best performing months in 2013 did not follow significant fund inflows.

Figure 6

Performance of Equity and Fixed-Income Investments

Timeframe	Average Equity Investment Portfolio Vs. S&P 500	Average Fixed-Income Investment Portfolio Vs. Bond Index
20 Year	-4.2%	-5.03%
10 Year	-1.52%	-3.92%
5 Year	-2.73%	-2.15%
3 Year	-5.31%	-2.57%
1 Year	-6.87%	-1.64%

The bond index is the Barclays Aggregate Bond index. Past performance is not a guarantee of future results. The index figures do not deduct the load, fees and expenses of investing. Conversely, average investor returns do deduct the load, fees and expenses of investing. This difference make returns appear to be less than they would be had both numbers been calculated similarly. This data is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index.

SOURCE: "20th Annual Quantitative Analysis of Investor Behavior," Dalbar Inc., 2014.

A WORLD OF POSSIBILITIES

As financial service professionals continue to move beyond the traditional 60/40 portfolio to one that includes allocations to alternative assets, more individuals are becoming educated on and aware of the potential benefits associated with investments that have low correlation to the traded markets. This "democratization" of alternatives — through their availability to individuals other than high-net-worth investors or institutions — will continue to take place in the future as a means to help achieve potential portfolio diversification and investment growth.

Many options exist today to help individual investors balance portfolios, mitigate volatility and help protect against high inflation and interest rates. While traded alternative investments offer liquidity, they also may have higher levels of correlation to traditional equity and debt instruments. Conversely, investors who diversify their portfolios with less liquid alternative investments believe this approach may help lower correlation and smooth market volatility, while providing the potential for returns across varying market cycles. Individual investors in search of similar benefits should work with their financial professionals to identify an alternative investment strategy that fits with their specific investment risk profile.

"Many options exist today with the goal of helping individual investors balance portfolios, mitigate volatility and protect against high inflation and interest rates."

Morningstar Chart Dataset Information (1992–2013)

Government bonds are guaranteed by the full faith and credit of the U.S. government as to the timely payment of principal and interest, while returns in stocks, real estate, private debt, private equity and traded REITs are not guaranteed. The private debt index differs from a BDC structured to invest primarily in leveraged loans and high-yield bonds in many ways, as it does not use leverage, it may be less diversified by asset class and typically will not include issuances that are less liquid or not broadly syndicated, such as investments made through the direct lending channel. The real estate index trades in a private asset market, which is different in structure and function from the publicly traded REIT market. The real estate index differs from nonpublic REITs in many ways, as it does not incorporate brokerage fees, take into account market valuation in the event of a public offering or reflect liquidity constraints. Real estate investment options are subject to certain risks, such as risks associated with general and local economic conditions, interest rate fluctuation, credit risks, liquidity risks and corporate structure. International investments involve special risks, such as fluctuations in currency, foreign taxation, economic and political risks, liquidity risks and differences in accounting and financial standards.

- **Private Debt:** Equally weighted composite made up of 50 percent Credit Suisse Leveraged Loan Index and 50 percent Bank of America–Merrill Lynch U.S. High Yield Master II Index.
- **U.S. Aggregate Bond Index:** Barclays U.S. Aggregate Bond Index, which measures investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS, ABS, and CMBS.
- **Domestic Stocks:** Standard and Poor's (S&P) 90® index from 1950 through February 1957 and the S&P 500 index, thereafter.
- **International Stocks:** Morgan Stanley Capital International Europe, Australasia and Far East (EAFE®) Index.
- **Traded REITS:** FTSE NAREIT All Equity REIT Index®.
- **Private Equity:** Cambridge U.S. Private equity index, which is compiled from 883 U.S. private equity funds (buyouts, growth equity, private equity energy and mezzanine funds), including fully liquidated partnerships, formed between 1986 and 2010.
- **Real Estate Index:** Transactions-based Index of Institutional Commercial Property Investment Performance (TBI) from the MIT Center for Real Estate from March 1985 to December 2010 and the NCREIF Transaction Based Index (NTBI), thereafter.
- **Volatility** is measured by annual standard deviation, which measures the fluctuation of returns around the arithmetic average return of the investment. The higher the standard deviation, the greater the variability and, thus, volatility of the investment returns. The data assumes reinvestment of all income and does not account for taxes or transaction costs. An investment cannot be made directly in an index.
- **Disclaimer:** The underlying index series and weightings used to represent the private debt composite were requested by CNL Financial Group. The 1992 start date for this analysis is constrained by the maximum available historical data for the private debt composite.

[1] "Advisors Worry About Investors' Emotional Response to Markets," Natixis Global Asset Management, September 30, 2014.

[2] "The Perfect Storm: Why Alts Make Sense," *Investment News*, March 30, 2014, http://www.investmentnews.com.

[3] "The Mainstreaming of Alternative Investments," McKinsey & Company, June 2012.

[4] Brian Haskin, "MainStay Survey Finds HNW Investors Increasing Alternatives Allocations," *DailyAlts*, March 10, 2014, http://dailyalts.com.

[5] *2014 World Wealth Report*, Capgemini and RBC Wealth Management, 2014.

[6] *The Yale Endowment 2013 Performance*, Yale University, September 2013.

[7] *Harvard Management Company Endowment Report*, Harvard Management Company, September 2013.

This information does not constitute a solicitation of an offer to sell/buy any specific security offering. Such an offering is made by the applicable prospectus only. A prospectus should be read carefully by an investor before investing. Investors are advised to consider investment objectives, risks, charges and expenses carefully before investing. There is no assurance that the stated objectives will be achieved. Broker-dealers and other firms are reminded that offering-specific communications sent to any person must be accompanied or preceded by a prospectus in accordance with federal securities laws.

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