

Playing the percentages: an alternative view

Institutional investors have been investing major sums of money in alternatives for some time without compromising their portfolios. As more and more wealthy individuals join in, Rodrigo Amaral asks just how much of your portfolio you should gamble

With private equity companies delivering annual returns over 30% in Europe, property prices booming in many parts of the world and commodity markets boosted by an apparently insatiable China, alternative investments seem to be the current toast of wealth managers everywhere. What is not clear, however, is if such products, which sometimes bring the promise of high profits but also the risk of painful losses, are to everyone's taste.

Big institutional investors have been playing the alternative investment game for some time already, capable as they are of betting huge amounts of money without compromising their portfolios. But now, a growing number of wealthy individuals are following suit. Research by Capgemini and Merrill Lynch estimates that, in 2005, 36% of assets belonging to individuals with more than \$1 million were kept in alternative investments, against 25% three years before. These investors are wooed by performances such as the 187% increase in UK house prices in the 10 years to September 2006, or the 1000% growth of the Merrill Lynch Gold & General commodity fund since it was launched in 1988.

On the other hand, it is salutary to remember the other side of the coin – there are cases where investments in alternative products bring nothing but pain. You just have to look at American hedge fund Amaranth, which took daring positions in the gas market last year; as the price of this commodity took a dip, it lost more than \$3 billion. Poor performances by commodity indexes early this year, frequent warnings about the imminent burst of property bubbles and a growing distaste for private equity firms by the public in several countries may also create doubts inside the cautious investor's mind.

MONEY MAKES MONEY

It seems clear, though, that the days when a wealthy individual would be happy with a simple but efficient formula of asset allocation – say, 40% equities, 40% bonds and 20% cash – seem over. The particular challenge presented by alternative investments is how to take advantage of them while avoiding the hazards that lie on the way to potential riches.

At present, investors still seem to be erring on the cautious side. A recent survey by Morningstar found out that the portfolio of an average American investor would have no more than 10% of assets allocated to alternative investments. But many portfolio strategists believe that at least a fifth of an individual's assets should have that destination in order to bring optimum returns, and that is particularly true of the very rich.

"If you don't have a lot of money to invest, it is probably better to avoid alternative investments", says Nicolas Sarkis, a partner at London-based wealth management advisors AlphaOne. "But for those who have enough to spread their bets judiciously, alternative investments provide a powerful tool to boost performance and reduce risks."

"How much of a portfolio goes to alternative investments will inevitably be conditioned to investors' appetite for risk"

This is far from an isolated view. Specialist firms like Deutsche Bank Private Wealth Management are reportedly recommending that up to 30% of a portfolio be kept in alternative investments (including hedge funds), while Citigroup Private Bank considers that some clients are in a position to allocate 20% of their assets in private equity and other illiquid investments. The same share is also going to hedge funds, which used to be the preserve of the most reckless investors, but now, with the spreading of funds of hedge funds, have become very much mainstream.

RISKY BUSINESS

Wealth managers will usually concede that it is impossible to come up with a one-size-fits-all formula. The decision of how much of a portfolio goes to alternative investments will inevitably be conditioned to investors' expectations and their appetite for risk.