



# The Endowment Way of Investing

The media frequently spotlight the investment performance of some of the largest institutional investors, most notably university endowments. For years, some of the largest U.S. endowments have enjoyed very attractive and consistent investment returns. Part of this success can be attributed to endowments' investments in non-traditional asset classes, including the use of alternative investment strategies.

Alternative investment strategies utilize trading techniques generally unavailable to retail investors. These strategies, often structured as private partnerships, can exploit investment and trading strategies generally not found in traditional investment vehicles.

In the past, replicating alternative investment strategies has been difficult for individual investors, even those with substantial net worth. However, high net worth investors are now increasingly gaining access to alternative investment strategies, and individuals now have the opportunity to invest in the same manner as many of the largest and most respected U.S. educational endowments.

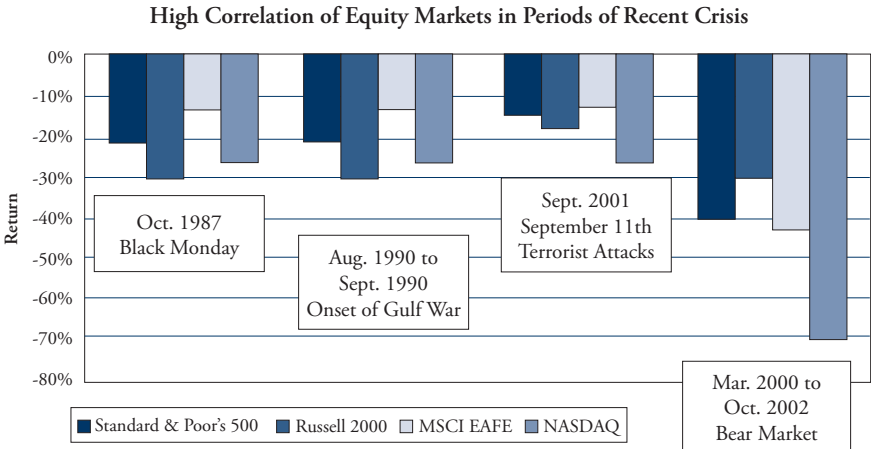
To achieve superior and differentiating returns, educational institutions like Yale, Harvard and Stanford strive to adhere to an investment discipline with critical criteria. The most compelling of these criteria include:

- Mitigating risk, preserving capital and building wealth
- Achieving significant diversification
- Accessing the brightest and best managers

## The Power of Consistent Compounding

Reducing the frequency and severity of negative returns in a portfolio lowers the volatility of investment returns and can improve the compounding power of an investment over time. Diversification among traditional equity asset classes has historically been utilized to reduce the severity of investment downdrafts. However, by only diversifying among equity asset classes, investors run the risk that all of their equity asset classes will similarly perform during traumatic market periods, thus eliminating much of the expected value of equity diversification efforts.

The chart on the right illustrates the high level of correlation in investment returns between U.S. and foreign equity markets during recent periods of market trauma. The illustrated pattern shows the limitations of traditional diversification when it is solely limited to traditional equity investments. Investment allocations to alternative investment strategies, like commodities, in addition to traditional diversification vehicles like fixed income, may benefit investors in varying market conditions because these investments behave differently from traditional investments and may produce a wider variation of returns. By achieving greater diversification, an investor increases the opportunity to minimize the severity of portfolio losses, thereby improving the positive compounding power of his or her investment returns over time.



The above information is hypothetical and is meant as an illustration only. Unmanaged indexes are for illustrative purposes only. An investor cannot invest directly in an index. Index performance does not reflect the deduction of fund fees and charges. Past performance is not an indicator of future results.





## The Importance of Diversification

As with traditional investments where diversification among investment strategies is prudent, diversification among various alternative investment strategies is also important. The largest U.S. educational endowments diversify their alternative investment holdings through strategies such as:

- Opportunistic trading strategies
- Hedging strategies
- Private equity investments
- Public and private real estate investments
- Public and private natural resource and energy investments

Investors who include these alternative investment strategies in their portfolios benefit because of the expected low correlations in their various holdings (for more information on traditional diversification, ask your financial advisor for a copy of 1st Global's white paper, "Asset Allocation: Your Critical Investment Decision"). Alternative investment strategies historically have not only shown low correlations to traditional investments but often maintain low correlations to one another. Additional diversification within each alternative strategy may also be beneficial. Broad diversification, careful manager selection and disciplined due diligence help minimize the risk of the individual investment manager failures that are often highlighted in popular media.

Diversification of your overall investment portfolio does not assure a profit or protect against a loss in declining markets.

## The Increased Importance of Manager Skill

The difference between top performing managers and bottom performing managers has historically been significant, especially among certain hedging and private equity strategies. This dispersion of results highlights the need to employ processes to identify and access only the most skillful alternative investment managers. Access to these managers is often difficult, as many are either inaccessible to new investors or have minimum investment amounts that are prohibitive even to high net worth investors.

Individual investors can overcome this challenge through the use of a "fund of funds." A fund of funds is comprised of a diversified mix of alternative investment managers. By combining the pooled financial resources of the fund, a fund of funds approach allows investors to bypass excessive minimum investment requirements. A fund of funds approach can help achieve greater diversification both across and within broad alternative investment strategies. Additionally, this approach is often the preferred method of accessing alternative investment managers and strategies for investors who do not have the time or expertise to research, hire and manage a diverse collection of individual alternative investment managers and strategies.

### *Summary*

The inclusion of alternative investment strategies as a portion of an overall investment portfolio can be beneficial to sophisticated investors who understand the benefits and risks of these strategies. To find out if an allocation to alternative investment strategies is right for you, contact your wealth management advisor today.





## The Risks of Alternative Investments

Hedge funds are speculative investments and are not suitable for all investors, nor do they represent a complete investment program. The funds are only open to qualified investors who are comfortable with the substantial risks associated with investing in hedge funds. The funds' investment program is speculative and entails substantial risks. Specific risks associated with underlying securities that populate the hedge funds in which the fund invest include:

1. Risks inherent in an investment in securities: loss of money, illiquidity, volatility;
2. Specific risks associated with limited liquidity: underlying securities may not be available to sell for long periods of time thus limiting exit strategies and redemptions;
3. The use of leverage: leverage compounds returns by adding exposure which can enhance performance but also exacerbate losses;
4. Short sales: risks are illiquidity, use of leverage and unlimited loss potential;
5. Options and futures: risks are volatility, illiquidity and substantial loss of money beyond initial investment;
6. Derivative instruments: risks are volatility, illiquidity and substantial loss of money beyond initial investment;
7. Investments in non-U.S. securities: risks are illiquidity, currency fluctuations, lack of transparent management and geopolitical;
8. "Junk" bonds and illiquid investments: risks are loss of money, inability to sell securities and legal issues. Corporate malfeasance, bankruptcy proceedings and volatility otherwise not associated with bonds.

Investors should recognize that they will bear asset-based fees and expenses at the fund level, and indirectly, fees, expenses and performance-based compensation of the investment funds in which these funds invest. In addition, the overall performance of a fund of funds is dependent not only on the investment performance of individual managers, but also on the ability of the fund's advisor to allocate the fund's assets amongst such managers on an ongoing basis. Investors should understand that they will likely be required to obtain extensions of the filing date for their income tax return due to possible K-1 delays. Investors could lose some or all of their investment.

