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Understanding Alternative Investments

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As financial innovation continues to occur at a rapid pace, today's investors are faced with unprecedented amounts of investment opportunities. Among the many options available to investors are what have become known as alternative investments. As the name suggests, alternative investments serve as alternatives to traditional investments such as equities, fixed income, and cash. While this is a rather broad definition, what all alternative investments have in common is their potential to simultaneously maximize a portfolio's return and minimize a portfolio's risk. Given the attractiveness of these two advantages to investors, the logical question to ask becomes, "What are the different types of alternative investments that exist today?"

This article in particular will focus on four distinct categories of alternative investments. It is important to note that this list is not all-inclusive, nor is it universally accepted. In other words, since the alternative investments market is relatively young and dynamic, some people may disagree with a given item and believe it to be a traditional investment rather than an alternative. Nevertheless, the following is a list of five investments that are commonly believed to be alternatives:

1) Real assets are considered alternative investments because, by definition, they are the opposite of financial assets. As opposed to financial assets such as stocks and bonds, real assets involve a more direct ownership and "tend to represent more direct claims on consumption." For example, real estate, which encompasses owned land as well as any infrastructure built on the property, is the most popular type of real asset.

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Other examples of real assets include "investable infrastructure opportunities," which can be either the privatization of existing infrastructure to earn revenue or the creation of private infrastructure, as well as intangible assets such as intellectual property rights.

2) Hedge funds are among the most commonly used alternative investments. Put simply, they are privately organized investment vehicles that utilize a tremendous amount of investment strategies to minimize risk while attempting to preserve capital and generate positive returns. Hedge funds are able to employ such a wide array of strategies because they are not subject to the same degree of rules and regulations that apply to mutual funds and other investment vehicles. As a result, successful hedge funds have the potential to generate positive returns regardless of whether or not traditional markets are performing well.

3) Commodities are raw materials such as oil, wheat, and gold that can be bought in large quantities. Since these raw materials contribute to the production of countless other goods, they present individuals with a variety of investment opportunities. Not only can investors purchase commodities on the spot market as if they were stocks that can either appreciate or depreciate in value, but commodities are frequently used in futures contracts. Futures contracts are essentially contracts between two parties to either buy or sell a certain asset (in this case a commodity) at a predetermined price in the future. With futures contracts, the investor's profit is contingent on whether the asset's value increases or decreases from the day the contract was agreed upon to the future date that was established.

4) Private equity is essentially an asset class of both equity and debt positions in companies that are not publicly listed. It encompasses various sectors, each of which carry their own degree of risk and return. Among the most popular divisions of private equity are venture capital, leveraged buyouts, mezzanine debt, and distressed debt. Venture capital refers to the equity financing of "start-up companies that do not have a sufficient size, track record, or desire to attract capital from traditional sources." Leveraged buyouts occur when a company and all its equity are purchased using a combination of equity and debt with the intention of making the firm private. Mezzanine debt is a special type of financing that presents lenders with the opportunity to convert their debt to ownership if a company is unable to meet the terms of its loan. Finally, distressed debt is a type of debt issued by companies that have already filed for bankruptcy or are likely to file for bankruptcy in the near future.

Now that you have a basic understanding of the various types of alternative investments that exist, you may be wondering why you should consider them when investing. Regardless of the investment strategies you employ, they all carry a certain degree of risk. With traditional investments such as stocks and bonds, risk typically stems from equity beta and interest rates. However, the risks, and ultimately the returns, associated with alternative investments vary greatly depending on the nature of the investment. Therefore, specific alternative investment strategies can be used in practically any portfolio to hedge against risk. Essentially, they offer a degree of portfolio diversification that cannot be achieved by the traditional sources of investment, and for this reason they have become increasingly popular among investors. As alternative investments become even more prevalent in the financial markets in the upcoming years, it will be important for investors to understand the potential benefits and risks associated with the inclusion of them in their portfolios.