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FINANCIAL PLANNING ASSOCIATION

LONGBOARD

Journal of Financial Planning
EXPANDING THE BODY OF KNOWLEDGE IN THE FINANCIAL PLANNING PROFESSION

ASSESSING AND ALLOCATING TO ALTERNATIVES

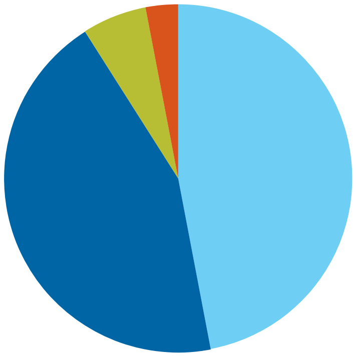
2017 TRENDS IN INVESTING WHITEPAPER

Introduction

Only about 8 percent of financial planners will add alternative investments to their portfolios in the next 12 months, according to new survey research released in June 2017. For those surveyed, alternatives could be anything outside traditional stocks and bonds, from real estate to managed futures or convertible arbitrage.

Here are some practical tips for choosing an alternatives strategy and asset manager that best suits a clients' needs. In addition, we'll examine the common pitfalls in identifying quality within the category and allocating appropriately to receive a meaningful, diversification benefit.

QUESTION: Are you currently looking for new ways to diversify portfolios?



Answer Options	Response Percent
Yes	47%
No	44%
No, but expect to soon	6%
Don't know	3%

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Seeking a Common Definition

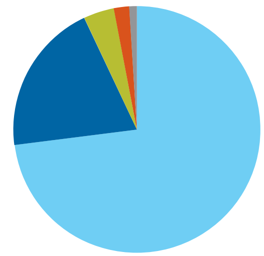
The financial services industry has talked about "alternatives strategies" for years without consensus about what that actually means. No wonder 77 percent of those advisers surveyed said that they use less than 10 percent alternatives in a strategy. Are alternatives an asset class, an investment strategy or an investment structure?

Investopedia states: "hedge funds are alternative investments using pooled funds that may use a number of different strategies in order to earn active return, or alpha, for their investors." But hedge funds and alternative investments aren't interchangeable terms.

And that's just defining the category. We're not even close to defining quality within it yet.

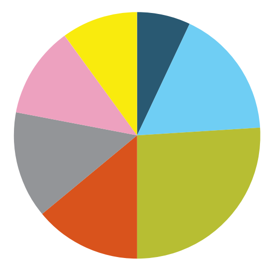
So how can you find the right diversifying assets for your clients?

QUESTION: How much of your clients' portfolios are currently allocated to alternative investment vehicles?



Answer Options	Response Percent
1-10%	73%
11-20%	20%
21-30%	4%
31-40%	2%
More than 40%	1%

QUESTION: How confident are you in the ability of the traditional 60/40 stocks and bonds portfolio to provide similar returns as it has historically?



Answer Options	Response Percent
Very confident	7%
Confident	17%
Somewhat confident	26%
Neutral	14%
Somewhat doubtful	14%
Doubtful	12%
Very doubtful	10%

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Taking a Different Type of Risk

The No. 1 thing financial planners said they want from an asset manager is risk-adjusted returns. Advisers also discuss with their clients how to achieve those returns through properly diversified portfolios:

- Nearly 90 percent of financial planners talk to clients about why diversification works
- Nearly 70 percent discuss non-correlated investments, and another 70 percent discuss the emotional challenges of diversification
- 60 percent discuss traditional diversifiers like REITs and gold with clients, while 40 percent discuss non-traditional diversifiers like private equity and managed futures

Investors are looking for any investment they make to deliver both performance (returns) and diversification (risk management).

A traditional portfolio takes:

- equity risk by offering clients the ownership risk tied to the change in stock prices.
- bond risk, or lending risk tied to the creditworthiness of the borrower and interest rate environment to counterbalance it.

If the point of a diversifier is to produce returns and manage risk with a different type of strategy, that strategy has to take a different type of risk in order to diversify against the other parts of the portfolio.

QUESTION: What topics do you discuss around diversification with your clients? (Select all that apply)

Answer Options	Response Percent
Non-correlated investments	68%
Why diversification works	89%
Emotional challenges of diversification	71%
Traditional diversifiers (such as bonds, REITs, gold, etc.)	64%
Nontraditional diversifiers (such as liquid alternative investments, private equity, MLPs etc.)	44%

Diversifying In Name Only

Financial planners surveyed thought REITs are the best diversifier, despite a nearly 60 percent correlation to a stock and bond portfolio from 2000 - 2017. Financial planners ranked MLPs, gold, and managed futures as the least effective diversifiers, though these asset classes have had the lowest correlation with stock and bond portfolios.

Some of the most prevalent alternative investment strategies are simply DINOs: diversifiers in name only.

Most financial planners surveyed feel that REITs are the best diversifiers, despite the fact that these real estate investments have been highly correlated with traditional portfolios since the turn of the century. In fact, we have a special name for such investments, DINOs: diversifiers in name only. Almost as surprising, most financial planners ranked MLP's, gold, and managed futures as the least effective diversifiers, even though these investments have long had very low correlations with traditional assets.

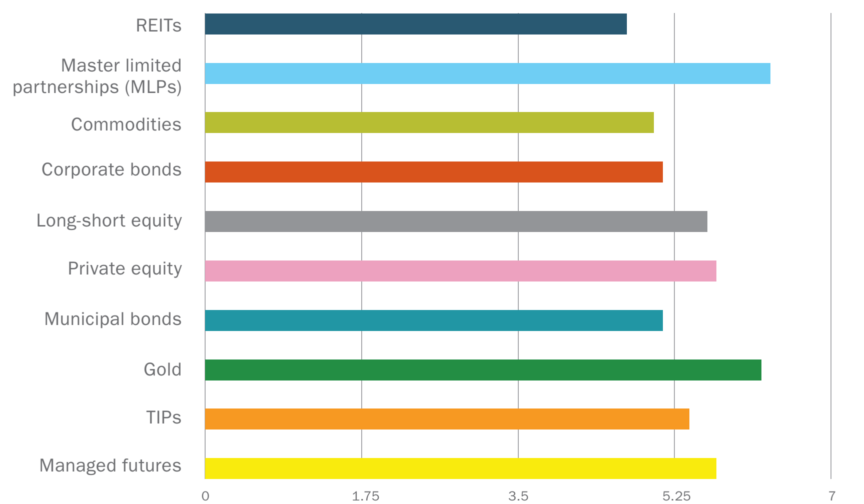
Investment strategies that historically deliver both lower risk (through lower correlation in declining markets) and increased returns are the most effective diversifiers.

Now is a good time to discover your options, especially since more than 1 in 4 advisers believe diversification is harder in today's market.

QUESTION: What topics do you discuss around diversification with your clients? (Select all that apply)

Answer Options	1	2	3	4	5	6	7	8	9	10	Rating Average
REITs	17	12	16	26	17	12	15	7	8	6	4.73
Master Limited Partnerships (MLPs)	4	5	14	10	20	22	9	13	18	18	6.29
Commodities	9	16	14	20	18	19	19	3	11	4	4.98
Corporate bonds	18	17	18	14	10	13	11	11	13	12	5.05
Long-short equity	15	13	14	8	13	12	19	17	8	16	5.58
Private equity	15	14	9	12	10	11	14	18	21	11	5.74
Municipal bonds	14	20	13	11	15	12	17	10	18	4	5.11
Gold	11	14	7	9	10	15	18	16	9	29	6.24
TIPs	9	10	19	22	14	12	8	23	13	7	5.42
Managed futures	25	14	9	6	10	9	8	14	16	25	5.66
Other (please specify)											

QUESTION: What topics do you discuss around diversification with your clients? (Select all that apply)



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Choosing Specialists

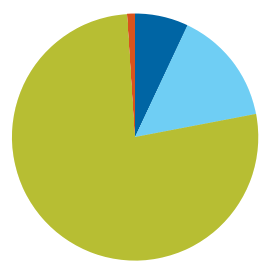
In the alternatives space, specialization matters. You want people who have the technical expertise and disciplined commitment to manage what can be complex investment strategies. People who invest in the funds they sell. A firm that offers alternatives as just one of many products may be less committed to that strategy when it matters most.

Financial planners ranked lack of client understanding as the biggest barrier to adding a new investment vehicle into the portfolio. Plenty of alternatives managers have deep academic backgrounds, but have less experience trading in the real world. Look for solutions with a solid management team that has a long history of managing assets, not running back tests. This is probably also why nearly 8 out of 10 advisers believe that a blend of passive strategies and active strategies, usually the work of field specialists, yields the best performance.

To get this information, ask:

1. What is the background of your portfolio manager?
2. How long has the portfolio manager been managing client assets?

QUESTION: In general, which type of management do you think provides the best overall investment performance taking into account costs associated with each management style?



Answer Options	Response Percent
Active management	7%
Passive management	15%
A blend of the two	77%
Don't know	1%

Demanding Transparency

After risk-adjusted returns, the second most important thing financial planners said they want from asset managers was transparency into their strategies. It's crucial to demand this from portfolio managers, especially in the broad alternative investments space.

To do this, ask for insight into their investment process and for tools that will help you easily explain the strategy to your clients in different market environments using a few simple questions:

1. Will you run scenarios that compare your fund's impact on your portfolio against that of other funds?
2. What's the selection process for choosing an investment in the portfolio? How do you manage risk once those investments are chosen?
3. Can you illustrate the benefit of adding such an alternative to a traditional portfolio?
4. What is the most challenging environment for the strategy? Why?
5. How responsive are the firm's representatives to requests for needed education?

QUESTION: What do you see as the biggest barrier to adding a new investment vehicle to your clients' portfolios? (Rank in order from 1 being biggest barrier to 6 being less of a barrier.)

Answer Options	**1**	**2**	**3**	**4**	**5**	**6**	**Rating Average**
No barrier/I have full discretion to allocate	37	8	6	4	19	69	4.17
Lack of personal understanding	12	16	18	14	36	36	4.17
Lack of client understanding	20	38	35	25	12	3	2.85
Lack of access to new, quality products	6	12	22	43	29	17	3.99
Poor/lack of performance	27	30	34	24	22	6	3.01
Emotional client decisions sabotage possible returns	35	29	27	24	17	10	2.92

Preparing Clients for Uncorrelated Strategies

Talk with clients and have a clear sense of what you need alternatives to achieve in your portfolio. Generally, investors seek alternatives because they deliver returns that are truly uncorrelated to stocks and bonds, especially in down markets.

Decide which factor is most important to clients by asking these questions:

1. What is the most you feel comfortable losing in a single year?
2. How will it affect your retirement goals if you are forced to sell at the bottom to fund income needs?
3. If removing an investment means increasing your portfolio's participation in a declining stock market, even if that investment is lagging behind now, would you still do it?

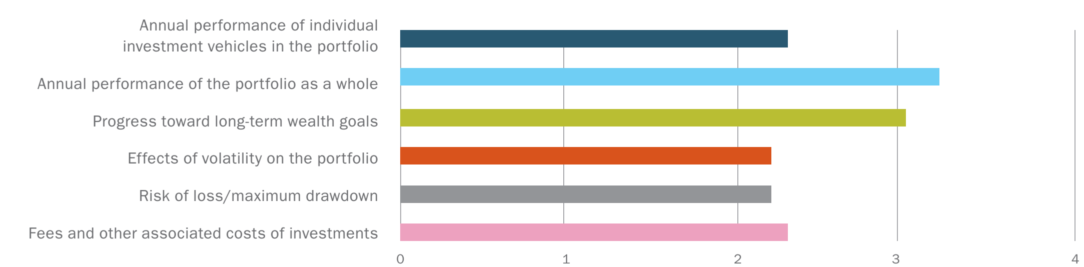
Financial advisers said that frequently clients ask about the performance of individual pieces of the portfolio. However, prospect theory shows that the more investors look at a particular investment's performance, the worse they believe it is performing -- even if it's doing its job in the portfolio.

Being aware of the emotional costs of diversification and echoing those regularly to clients can make holding new products easier.

QUESTION: Which of these factors do your clients ask about when it comes to their portfolio?

Answer Options	Never	Sometimes	Frequently	Always	Rating Average
Annual performance of individual investment vehicles in the portfolio	21	88	36	13	2.26
Annual performance of the portfolio as a whole	2	29	69	61	3.17
Progress toward long-term wealth goals	4	43	68	46	2.97
Effects of volatility on the portfolio	32	79	35	12	2.17
Risk of loss/maximum drawdown	25	94	35	7	2.15
Fees and other associated costs of investments	16	88	40	14	2.33

QUESTION: Which of these factors do your clients ask about when it comes to their portfolio?



Comparing and Contrasting

Use this checklist of questions to find the right diversification strategy for you.

ASPECT	QUESTION	✓
ACCESS	Does this asset manager's product(s) give you access to that competitors can't?	
DIVERSIFICATION	Does its products truly move independently of stocks and bonds that's complementary to their return profiles? Is the performance uncorrelated to other alternatives as well?	
PERFORMANCE	Can its portfolio managers explain performance past annualized returns? Does that performance come from different risk factors your other assets can't access?	
TRANSPARENCY	How does the fund perform when the traditional markets underperform?	
SPECIALTY	Is this asset manager committed to continued excellence in this asset class or is this one of tens or hundreds of other products?	

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Methodology

The FPA & Longboard 2017 Trends in Investing Survey was fielded in March and April of 2017 and received 302 online financial adviser responses overall. Some individual questions received fewer responses, depending on relevance.

We talked to:

- 46 percent RIAs, 25 percent dually registered
- 50 percent with 21+ years in financial services
- 53.4 percent with less than $100 million AUM
- 94.5 percent CFP® professionals

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Longboard is a strategic partner in alternative investments. Our rigorous approach is built on nearly two decades of original research and development. Longboard investments have historically delivered returns at the top of their categories, and have provided non-correlation to the markets and to other alternatives. Learn more at www.longboardfunds.com.

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