

THE H. KENT BAKER INVESTMENTS SERIES

**THE SAVVY INVESTOR'S  
GUIDE TO BUILDING WEALTH  
THROUGH ALTERNATIVE  
INVESTMENTS**

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**THE SAVVY INVESTOR'S  
GUIDE TO BUILDING WEALTH  
THROUGH ALTERNATIVE  
INVESTMENTS**

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INVESTOR IN PEOPLE

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# ACKNOWLEDGMENTS AND DEDICATION

*“Writing is easy. All you have to do is cross out the wrong words.”*

Mark Twain

In writing *The Savvy Investor’s Guide to Building Wealth Through Alternative Investments*, we kept Mark Twain’s comment in mind. Hopefully, we crossed out the wrong words and kept the right ones. However, the publication of this book was a team effort. Everyone at Emerald Publishing involved with this book provided exceptional guidance, especially Charlotte Maiorana (Vice President), Hayley Coulson (Content Development Editor), and Lidiya Prince (Copy Editor). We also owe our respective institutions – the Kogod School of Business at American University, the Black School of Business at Penn State Behrend, and the Frank G. Zarb School of Business at Hofstra University – a debt of gratitude. Finally, we thank our families for their support and understanding: Linda and Rory Baker; Mickey, Judy, Janis, Aaron, Andrea, Kyle, and Grant Filbeck; Terry, Harrison, Teresa, Robin, Kate, and Hudson Spieler.

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# INTRODUCTION

*“Listening to uninformed people is worse than having no answers at all.”*

Ray Dalio, American Billionaire Investor, Hedge Fund Manager, and Philanthropist

When you think about investing, what types of investments come to mind? Despite the broad range of investment options available, most individual or retail investors usually think of stocks and bonds. You might also keep some savings in a bank or similar instrument, also known as “cash and equivalents,” which, along with stocks and bonds, make up the three main asset investment classes called *traditional investments*.

Let’s briefly look at each type of traditional investment. A *stock* is a type of investment that represents an ownership share in a company. Investors buy stocks that they think are likely to increase in value over time and perhaps provide income by paying dividends. A *bond* represents a loan funded by an investor to a borrower, such as a corporation or government. Investors buy bonds because most bonds offer a predictable income stream. Also, by holding the bonds until maturity, they get back the entire principal. Thus, bonds provide a way to preserve capital while investing.

*Cash equivalents* are short-term securities, which have high credit quality and are highly liquid. Examples of cash equivalents include certificates of deposit, money market funds, and Treasury bills. Still, these cash equivalents may not even keep up with inflation. *The Savvy Investor's Guide to Building Wealth Through Traditional Investments* discusses investing in stocks, bonds, and cash equivalents.

Instead of investing in individual stocks and bonds, many individuals invest in pooled investment vehicles (PIVs) through their retirement plans. PIVs are investment funds that commingle many different investors' monies to buy portfolios that reflect specific investment objectives. PIVs offer such advantages as professional management, diversification, government regulation, low initial investment, and liquidity. They can also involve high costs, including management and performance fees and a lack of choice and control over the fund's assets. *The Savvy Investor's Guide to Pooled Investments* focuses on five popular PIVs: open-end funds, more commonly called mutual funds, closed-end funds, exchange-traded funds (ETFs), unit investment trusts, and real estate investment trusts.

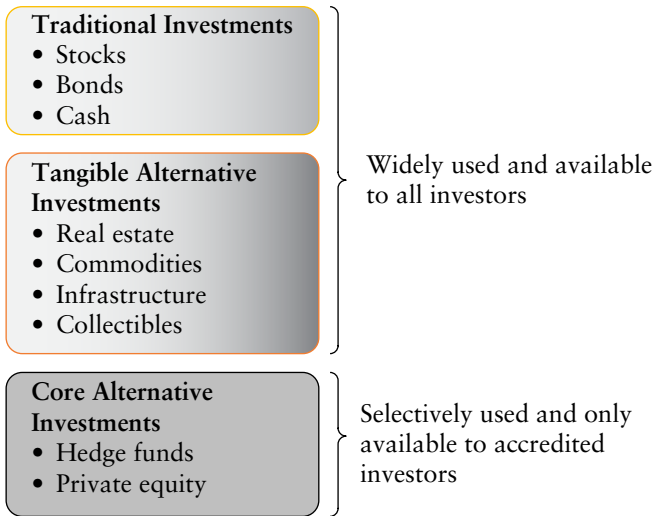
If you're new to investing, traditional investments are a great place to start building your portfolio and planning for retirement because of their many advantages. Although cash and bonds are relatively safe investments, the stock market can be risky and subject to considerable volatility. Of course, you can lose money if a stock's market price declines, but you can also lose money if you sell a bond before its maturity date for less than what you paid for it or if the issuer defaults on its payments.

Although most investors are generally satisfied with portfolios consisting of traditional investments, others may want their portfolios to include other investment opportunities.

A whole world of investment options awaits you that extends beyond stocks and bonds. Any financial asset that falls outside traditional investment categories is an *alternative investment*. In practice, the lines between traditional and alternative investments are not universal.

Alternative investments can either be public or private investments. Previously, some of these alternative investments and their associated strategies were only available to institutional and high-net-worth investors. Today, more retail investors have access to alternative investments or other investment vehicles that employ techniques previously confined to alternative investments. However, just because such vehicles exist doesn't necessarily mean that they're right for you. Although alternative investments are often inappropriate for smaller portfolios, they often play a role in more sizable portfolios. Generally speaking, retail investors should allocate only a small percentage (5%–15%) to such investments.

The core alternative investments are hedge funds and private equity, primarily venture capital and buyout funds. Although these alternative investments are unavailable to all investors, they have historically played a critical role in the industry's evolution. Additionally, these categories accounted for much of the capital allocated to alternative investments. Tangible alternative investments consist of real estate, commodities, infrastructure, and collectibles. Each category of alternative investments has a distinct set of attributes. For example, alternative investments differ from traditional investments due to their higher fees and different legal structures. However, not all real assets are tangible such as patents and copyrights. Introduction [Fig. 1](#) shows various categories of traditional and alternative investments.



**Introduction Figure 1. Types of Traditional and Alternative Investments**

*Source:* Adapted from World Economic Forum. Retrieved from [http://www3.weforum.org/docs/WEF\\_Alternative\\_Investments\\_2020\\_An\\_Introduction\\_to\\_AI.pdf](http://www3.weforum.org/docs/WEF_Alternative_Investments_2020_An_Introduction_to_AI.pdf)

Here's a brief overview of each alternative investment category.

- Core alternative investments
  - *Hedge funds.* A *hedge fund* is typically a limited partnership that uses various strategies and tactics to invest its clients' money to generate investment gains or provide a hedge against unforeseen market changes. Hedge fund managers invest in numerous financial instruments such as stocks, bonds, complex derivatives, options, commodities, and other esoteric investments. Although a hedge fund's initial intent was to protect investment portfolios from market uncertainty (thus

the name “hedge”) while generating positive returns in both up and down markets, most hedge funds don’t hedge risk. Hedge funds cater to investors with ultra-deep pockets. Although the lowest minimum investment starts at \$100,000, most require at least \$1,000,000. Thus, for most individual investors, these amounts are hardly spare change.

- o *Private equity.* *Private equity* is a generic term referring to the funds used by investors to invest in private companies (i.e., firms not publicly-traded on a stock exchange) or to engage in buyouts of publicly-traded firms with the intent of taking them private. Two major types of private equity are venture capital and buyout (leveraged buyout). *Venture capital* refers to an investment in small, early-stage to growth-stage companies without obtaining majority control. Investors can directly invest in start-ups and private companies or use venture capital funds. A *buyout* or *leveraged buyout* is a financial transaction that involves buying a controlling interest of an existing or mature firm, often using high levels of debt to finance the acquisition, and then taking the company private. As a private entity, owners structure the company intending to sell it in the future at an anticipated profit. Using a substantial amount of debt enables the acquirer to increase potential returns by leveraging the seller’s assets.
- Tangible alternative investments
  - o *Real estate.* Real Estate investing involves the purchase, ownership, management, rental, or sale of real estate to earn a profit. The four major categories of real estate are residential, commercial, industrial, and land. Investors may hold such investments in various structures,

including individual properties, limited partnerships, private and publicly-traded securities backed by pools of properties or mortgages, and real estate backed loans.

- o *Commodities.* *Commodities* typically refer to physical (hard) assets used in production, such as agricultural products, energy, and metals. Commodities don't generate cash flows and often involve storage, transportation, and insurance costs not found in other assets. However, the Commodity Futures Trading Commission decided that virtual currencies such as bitcoins could also be considered commodities.
- o *Infrastructure.* *Infrastructure* refers to long-lived assets that provide basic structures and facilities needed to operate a society or enterprise, such as transportation, communication, sewage, water, and electric systems. Although infrastructure is often built or managed by governments and funded publicly, infrastructure can also be financed privately or through public-private partnerships.
- o *Collectibles.* A *collectible* is an item that can be worth more than its original selling price because of its rarity or popularity. Thus, collectibles are physical goods that have

*“Remember, people don't invest in collectibles, they spend money on them.”*

Andrew Beattie

value only because of a widely shared emotional or societal attachment. Examples of items in this asset class include art, antiques, wine, jewelry, rare coins, vintage or exotic cars, and baseball cards.

Although collectibles may sound more fun and interesting than other types of investments, this book

excludes them. Why? Collectibles are less illiquid than traditional securities, and owners don't receive income from collectibles. Some collectibles can be costly. You can also lose money if the collectible is damaged or demand wanes. More importantly, you won't necessarily make a good return. Overall, collectibles have lower returns than a money market account, most bond funds, and stock market index fund. Although investing in collectibles adds diversification to your portfolio, perhaps the primary reason for buying collectibles is that you enjoy owning them beyond the potential return you may receive from selling them. Some people are passionate about collectibles and enjoy gaining the required specialized skill and knowledge to succeed in this volatile market segment. Otherwise, you could get burned if you don't know what you're doing in a specific marketplace. You should also be aware that this market is teeming with conmen. Thus, if you think you can invest in collectibles the same way you invest in stocks or bonds, you'll likely encounter some unexpected challenges. Without being a real expert, you unlikely to experience any return on your investment. From an investment perspective, the bottom line is that collectibles' unique risks often outweigh the financial rewards.

Many other alternative investments are available to investors beyond the five major types discussed in this book. For example, investment banks create structured products by combining two or more assets, and sometimes multiple asset classes, that payout based on those underlying assets' performance. Structured products include different types of collateralized debt obligations and other derivatives. These alternative investments, including more exotic alternative investments, are beyond the scope of this book.

Before investing, you should understand the differences between traditional and alternative investments. Compared with traditional investments, alternative investments tend to be less liquid, more opaque, more challenging to value, and offer investors limited access to information. Because alternative investments are subject to less regulation, potential investors face a greater risk of investment scams and fraud if they don't perform sufficient *due diligence*, which means exercising reasonable care before buying or making an investment. Some alternative investments, such as hedge funds and private equity, also have limited and possibly biased historical returns data. Another problem is that measuring historical risk and benchmarking can be problematic. Additionally, alternative investments involve higher fees and have more restrictions on redemptions and unique tax considerations. Further, managers tend to be highly specialized and hold relatively more concentrated portfolios.

For some alternative investments, such as hedge funds and private equity funds, only accredited investors can invest directly in the assets and are out of reach of most individual investors. An *accredited investor* is a person or a business entity who is permitted to invest in non-registered securities. Accredited investors have more than \$1 million of assets (excluding their primary residence) or an annual income of more than \$200,000 (\$300,000 if married) to invest in non-public companies. Thus, those primarily engaging in such alternative investments are high-net-worth or sophisticated individuals, registered brokers, investment advisors, and institutions such as pension funds, sovereign wealth funds, banks, insurance companies, foundations, and endowments.

Despite their drawbacks, some can make a strong case for including alternative investments in a portfolio. The primary reason investors add

*“Building wealth is a marathon not a sprint. Discipline is the key ingredient.”*

Dave Ramsey