ACTIVE MANAGEMENT

There are now two main styles of management for portfolios with alternative investments (active and passive). Given that investors can select alternative mutual funds, diversification has become easier to achieve. Mutual funds are quite common and owned by many investors, whether as part of a retirement plan or in a non-retirement account such as a wrap account or fee-based account. Mutual funds have plenty of attractive features. However, performance tends to vary, sometimes outperforming the indexes while other times failing to outperform them. Alternative mutual funds are no different. Persistence also is an issue. While one might have an initial aversion to investing in a leveraged buyout fund (private equity funds as they are frequently called), private equity or a leveraged buyout funds can be defined as: To briefly review the concept, in an LBO a small group of equity investors, usually including current management, acquires a firm in a transaction financed largely by borrowing. The debt is serviced with funds generated by the acquired company’s operations and, often, by the sale of some of its assets. Generally, the acquiring group plans to run the acquired company for a number of years, boosts its sales and profits, and then take it public again as a stronger company.1
LBO mutual funds are new and might be incorporated into a diversified portfolio of funds. To further show the importance of alternative investments, a comparison was run with six different portfolios both with and without alternative investments over a decade ending December 31, 2010. Diversification with alternative investments and asset allocation is important. Likewise, active management with alternative investments has its merits as compared to passive management. That is, manager selection appears to play an important role with alternative investments. While there are numerous funds and investment options that one can select, certain funds were selected merely for illustrative purposes. The funds selected are all liquid, have low minimums, and available to most investors.

**Portfolio 1**: The first asset allocation (#1) has all equities, no bonds, and no alternative investments. This portfolio did well in the final year but poorly over the other times periods and averaged 2.71 percent return over the decade. A passive equity index fund was used called Vanguard 500 Index Admiral. Risk was somewhat high and the Sharpe ratio one of the lowest over the times period.

**Portfolio 2**: The second allocation (#2), on the other hand, was comprised of all fixed income and did not include equities or alternative investments. The Vanguard Long-Term Bond Index was used. Over a decade, the index averaged 7.13 percent return with lower risk and a Sharpe ratio of .55.

**Portfolio 3**: The third asset allocation (#3) included 50 percent fixed income and 50 percent equities, using the same passive index funds of #1 and #2 allocations. The returns were in between allocations #1 and #2 with averaging a 5.36 percent return.

**Portfolio 4**: The fourth allocation (#4) used 25 percent fixed income, 25 percent equities, and 50 percent alternatives (25 percent REIT and 25 percent commodities). Passive indexes were selected for the alternative investments. The Vanguard REIT Index was used for REITs and the Powershares DB Commodity Index was used for commodities. The returns for allocation (#4) surpassed the previous combinations of all stock, all bonds, or a 50 percent stock/50 percent bond combination, with the new stock, bond, and alternative portfolio averaging 7.88 percent over the decade. While the three-year number underperformed, all other time periods did