CLIFFORD SWAN
INVESTMENT COUNSELORS

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ALTERNATIVE INVESTMENTS: WHAT ARE THEY AND DO THEY BELONG IN YOUR PORTFOLIO?

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Many investors have seen or heard periodic ads for alternative investments or read about them in various business and investment sources. The natural questions are: *What exactly are alternatives, and do they belong in my portfolio?* These are specialized investments, and while they have some attractive qualities and can serve a valuable role in an overall investment portfolio, they are not for everyone.

What Are Alternative Investments?

Basically, alternatives are any investment outside of traditional asset classes. Traditional assets include stocks, bonds, and cash. Returns on these conventional investments will have fairly predictable return ranges (in statistical jargon, they have assumed *normal* distributions with a bell shape representing historical outcomes). Alternatives encompass everything else, including real estate, commodities, private equity, private credit, hedge funds, farmland, and intellectual property.

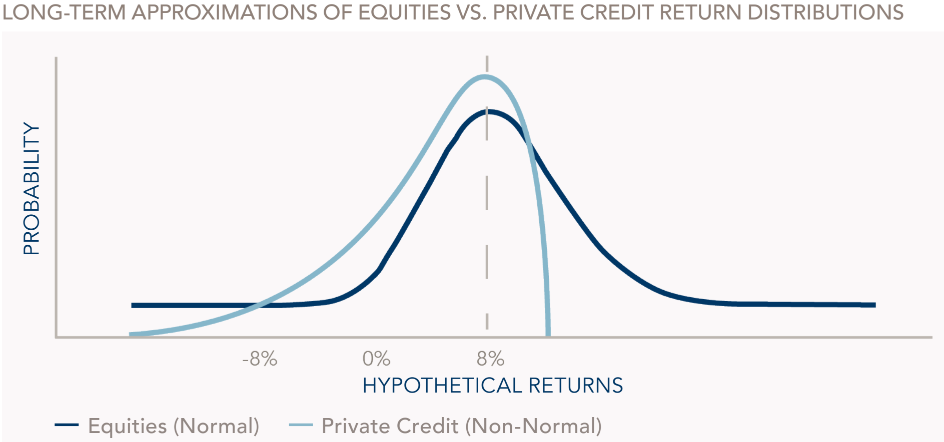
Role of Alternatives in a Portfolio

Traditional assets (stocks, bonds, cash) are the basic building blocks we utilize within an investment portfolio, especially looking to stocks for growth and return. Under typical financial conditions and in normal market cycles, stocks and bonds tend to move in opposite directions. When stocks go up, bond prices may go down; alternatively, when stocks go down, bond prices go up. That is, they tend to counterbalance each other within a portfolio, usually smoothing out the portfolio's performance by minimizing the very high swings up and the very low swings down, making the whole portfolio less volatile. In addition, some investors may add small capitalization or international stocks to increase the potential for higher returns. Maintaining higher cash levels can also further diversify a portfolio. Notably, 2022 was an unusual year when both stock and bond prices went down.

Alternative investments may be used as a diversifier and to enhance both income and total return. However, investors would need to accept that the return on alternative investments is *non-normal*; that is, the spread or distribution of the returns are not symmetrical like those of stocks and bonds and may have extreme ranges.

NORMAL VS. NON-NORMAL DISTRIBUTIONS

LONG-TERM APPROXIMATIONS OF EQUITIES VS. PRIVATE CREDIT RETURN DISTRIBUTIONS



Note: For illustrative purposes only. Data is approximated and based on observed and theoretical long-term patterns; it does not represent actual performance.
Sources: UBS, Investopedia

Types of Alternative Investments

Real estate has been used in investment portfolios for several generations, typically providing both income – from charging rents for the use of physical space – and appreciation from the value of tangible property going up. The other options, such as real estate financing, are less familiar.

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Commodities are investments in many of the materials and metals used in production (e.g., iron ore and copper), and in metals used as stores of wealth (e.g., gold and silver).

Private equity typically (but not exclusively) represents ownership in start-up or early-stage companies that do not trade on public stock exchanges, such as the New York Stock Exchange. A private party provides capital to a small company, for example, with the expectation of selling the company in conjunction with it going public. Many of today's publicly traded companies started this way.

Similarly, *private credit* is when a non-bank entity (such as an individual or limited partnership with investable cash) provides loans and credit outside of traditional funding sources (such as banks and finance companies). Interest rates are usually higher than the traditional funding sources.

Hedge funds are basically investment pools (limited partnerships) that have specific objectives and a lot of leeway to make investments. It could be a fund focused on preferred stocks or convertible bonds, or on investing in various companies that are merging. Other funds might invest in currencies (e.g., British pound sterling, U.S. dollar, euro, Japanese yen) or in a pool of non-investment grade bonds and assorted bond structures (subordinated, senior, etc.). Others may make investments based on global trends and dynamics, shifting assets from different financial areas and different countries to other countries or asset types. Some purchase a significant minority stake in a publicly traded company to change how it is run as an activist investor. Overall, a wide diversity of strategies is utilized by hedge funds with the best ones typically having a consistent focus and identity.

Finally, there is a general *miscellaneous group* that includes farmland and timberland (e.g., Iowa corn fields and Oregon pine forests), as well as intellectual property such as a songwriter's portfolio of music (for example, Michael Jackson bought the rights and royalties to The Beatles' music).

> *"Investors would need a higher tolerance for risks (of various types), acceptance of more limited liquidity, and patience as some alternative assets have long life cycles."*

There are also funds of these alternative assets, known as a *fund of hedge funds*, that invest in the various types of these investments to provide a broad portfolio of alternative investments. The fund could, for example, include private credit, private equity, commodities, and hedge funds, all in one aggregate pool of assets.

Keep These Qualities in Mind

There are special considerations with respect to alternative investments. These include reduced liquidity (ability to sell quickly), higher management fees, minimum investment sizes (e.g., minimum $100,000), and an extensive due diligence review of managers, structure, accounting, operations, and other key factors. Due diligence reviews help make sure that everything is operating above board and transparently.

As a result of these unique aspects, alternatives are not for everyone. Investors would need a higher tolerance for risks (of various types), acceptance of more limited liquidity, and patience as some alternative assets have long life cycles.

Alternatives We Invest In

Clifford Swan has historically offered alternative investments in instances when we think they can be helpful to a client's goals. We primarily look to alternatives to limit the potential downside when added to a typical stocks/bonds/cash portfolio by reducing correlations between asset classes and dampening overall volatility. Specific investments include real estate – including single property ownership and pooled investments through limited partnerships – as well as liquid commodities funds, namely those focused on precious metals. Even so, alternatives require a cautious approach. We favor assets that are conducive to fundamental analysis (e.g., real estate and private equity) or have a long history from which we derive comfort (e.g., gold and silver). In considering external managers to work with, we have exacting standards, typically looking at those with a track record of investment style discipline, a repeatable process, and strong accounting and operational systems.

Alternatives are not for everybody, but they could make sense if approached in a thoughtful way with an appreciation for the risks. Your investment counselor would be happy to discuss this asset class with you in the context of your financial goals.

NURTURING PROSPERITY: THE JOURNEY OF WEALTH MANAGEMENT ACROSS LIFE'S STAGES

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Imagine a journey where your financial success knows no bounds and your potential is limitless. You are an achiever, and your ambition is the driving force behind your success. Now, let's channel that energy into your financial roadmap with the guidance of a dedicated investment counselor. We'll explore how, together, you can create a narrative of prosperity, financial growth, and an inspiring legacy.

From youth to retirement, each life phase presents unique financial challenges and exciting opportunities. As life becomes more complex over time, there are numerous strategies and considerations that can make your financial aspirations a reality. The path to financial well-being is a profoundly personal journey that must adapt to your changing needs as you progress through various life stages.

Life Stage 1: Nurturing Prosperity, Family, and Dreams

In the early stages of your financial journey, your primary focus is on capital accumulation. This is when you should invest in yourself to boost your income, plan for expenses, manage debt, and build savings. It's also the right time to initiate long-term financial planning. You may be beyond this phase, but note that any major life change, like a divorce or a change in your health, can throw you back into this stage. During this period, begin thinking about medical, disability, auto, and life insurance policies to ensure you can pay for large expenses, and your loved ones can cover expenses, should something happen to you. You'll continue to review and revise your coverages throughout the rest of life's stages.

> *"...any major life change, like a divorce or a change in your health, can throw you back into this stage."*

Financial discipline, early investing, and risk management are all factors that can contribute to your financial success. As time passes, your financial journey may expand to include family and personal dreams. As your family grows, so do considerations like purchasing a home, saving for college, and ensuring the financial well-being of your loved ones through insurance and estate planning, all while maintaining a commitment to nurturing prosperity.

Life Stage 2: The Career Pinnacle and Midlife Harmonies

Midlife marks the peak of your career. During this stage, establishing work-life harmony and living within your means becomes essential. Focus on optimizing investment strategies, managing taxes, and continuing disciplined wealth accumulation. This is the phase where you hopefully start reaping the benefits of your established financial status.

Many self-made clients with substantial wealth have experienced significant liquidity events in their lives. These events may include selling company shares or businesses. However, even if you haven't encountered such a windfall, it's still possible to grow your net worth considerably through a disciplined approach, the right investment strategy, and sufficient time.

Thanks to the magic of compounding returns, the sooner you start investing and the longer you remain invested, the higher your potential returns. Compound interest lets your assets grow exponentially over time. The amount of interest you earn keeps getting bigger because you're earning interest on both your original investment and the interest you've already earned. Over time, your money grows faster and faster. This, in turn, fosters a stronger mechanism for generating wealth.

Life Stage 3: Retirement and Preserving Wealth

Ideally, the peak of your career gracefully evolves into the smooth cadence of retirement. Here, the composition of your income-generating assets may include a combination of retirement accounts, pension plans, real estate investments, company stock plans, and brokerage accounts. In addition, a well-balanced retirement plan includes a comprehensive tax and estate strategy to safeguard your wealth and legacy for future generations.

Nurturing Prosperity | Continued on page 4

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Working closely with your investment counselor can help to develop a big-picture strategy that aligns with your overarching financial objectives. At Clifford Swan, our role uniquely enables us to facilitate in-depth analysis and coordination of your advisory team to communicate strategies and identify issues that overlap with other disciplines. In one instance, we might see an opportunity for a tax strategy a CPA may miss due to the typical tax filing schedule or having a narrower relationship focus. In another example, we might realize that a drafted estate document may work to save estate taxes but subsequently leave a surviving spouse short of needed funds. Similarly, we may be able to recognize when there is a gap in insurance coverage.

Life Stage 4: Legacy, Philanthropy, and Living Out Your Values

Looking beyond personal prosperity, one's aspirations often turn towards philanthropy and the nurturing of legacies. In this part of life, the focus is on crafting legacy plans, endowing charitable legacies, and revising trusts. This final stage is all about reflection, making an impact, and living out your values while enjoying your financial security.

Navigating Life's Transitions

Life doesn't always follow the path you intend, and navigating through life's transitions is a part of the deeply personal narrative. Successfully managing and adapting to the various changes that occur in life can play a key role in your financial well-being. Life's transitions, both expected and unexpected, require resilience, flexibility, and the ability to plan for and adapt to new situations.

This may include changes in education, career, relationships, and health, among many others. For example, the birth of a child may involve significant changes to your career, income, benefits, and expenses. Along a different path, a new job can entail tactical courses of action around salary negotiations, new and old retirement plans, and new employer benefits to name a few. Finally, the loss of a loved one at any stage of life is painful and difficult. In addition to coping with your grief and potentially planning a memorial service or funeral, there are often many financial decisions that follow soon afterward. Your financial life needs to be able to adapt and prepare for these various types of situations as well.

> *"...a new job can entail tactical courses of action around salary negotiations, new and old retirement plans, and new employer benefits to name a few."*

We all have unique financial journeys that require personalized, stage-specific planning. Investment counseling isn't just about maximizing portfolio returns; it's also about adapting your financial resources to life's circumstances as they unfold. The key is to recognize that financial planning is an ongoing, comprehensive process, and with the right partner you can navigate each stage with confidence.

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