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# A World of Alternatives That Goes Beyond Stocks and Bonds

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As the stock market continues to roil with no sign of abating, many investors have turned to alternative investments in hedging strategies.

These nontraditional vehicles often move in the opposite direction from stocks and bonds, and offer diversification in currency, commodities, real estate and other assets.

Individual investors have had plenty of reasons to flee the old-school portfolio model of stocks and bonds. The European debt dilemma and the prospect of a global economic slowdown have led to an exodus from traditional mutual funds.

Almost $11 billion flowed out of long-term funds in the week of Oct. 5 — nearly double the amount from the week before — according to the Investment Company Institute, the trade association based in Washington. Surprisingly, $6 billion of that outflow left taxable bond funds, compared with nearly $4 billion from stock funds.

In an extreme crisis, nearly every stock may decline in lockstep, as occurred in 2008. Yet investors may still be in the dark about the breadth of the possible decline. Only half of investors surveyed said they fully understood their portfolio's risk, according to a recent study by Natixis Global Asset Management, the global money manager, and knowledge of alternatives was even lower: Only 7 percent of high net-worth investors said they understood these investments "very well."

Locking in a static mix of stocks and bonds may not provide a sufficient buffer against volatility. Creating a lower-risk portfolio using alternative investments may provide more stability than the traditional tactic of moving money from stocks into bonds, as new risks emerge among troubled global credit markets.

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"In times of crisis, credit and equity risk are highly correlated, meaning they go down together," said Na or of alternative fund research for Morningstar, the financial research company in Chicago.

"We must now think about interest rate risk, and how that can cause losses in bonds across the board, r stments offer risk-managed approaches to both stocks, bonds and also nontraditional asset classes, including currencies and managed futures/commodities." (Disclosure: I occasionally write for Morningstar.com on a freelance basis.)

What's the best way to dip your feet in the alternatives pool? Start by acquainting yourself with the different asset classes, which include commodities, real estate, currencies and timber. Commodities and real estate, for example, may move in the opposite direction of stocks.

You can also choose strategy-oriented funds to offset stock market risk. It's possible to pick funds that can go long and short at the same time, gain only in bear markets or are market-neutral — producing a small return in any market climate.

Some funds may focus on one theme, like distressed companies or those likely to be acquired or merged. It's also possible to take several bets in multistrategy funds that mimic hedge fund management.

The most telling indicator for how an alternative may offer refuge from stock market risk is how it moves relative to a benchmark like the Standard & Poor's 500-stock index of the largest United States companies. For insulation from stocks, you want assets that move in the opposite direction or do not closely echo the S.& P. index.

The Dow Jones/UBS Commodity Index, for example, has shown a monthly correlation of 0.39, with 1.00 being a perfect tracking of the S.& P. index, said David Reilly, a chartered financial analyst and president of Decision Critical Resources in Boston. The American dollar, as measured by the U.S. Dollar Index, follows stocks even less — with a negative 0.34 correlation, Mr. Reilly found in a study of the period from June 30, 2001, through June 30, 2011.

Alternative funds allow you to choose specific areas to reduce stock, credit, political or currency risk.

Concerned about currency risk when the dollar loses value to other denominations? The Merk Hard Currency Fund (MERKX) manages a basket of currencies that may do well when the dollar is down, and offers a small allocation to gold.

The Wasatch Long/Short Fund (FMLSX), has the ability to buy stocks and bonds and sell short in securities its managers think are overvalued. The fund has beaten the S.& P. 500 over the last five years, returning 3.25 percent, compared with a negative 1.18 percent for the S.& P. through Sept. 30.

Bets on the price trends in things as diverse as stock indexes and commodities can be represented by a derivatives-trading fund like the AQR Managed Futures Strategy Fund (AQMIX).

A market-neutral fund, which aims to produce a modest return in most market climates, is also a worthy consideration. The 22-year-old Merger Fund (MERFX), for example, is managed to “produce positive returns under a wide variety of market conditions.”

Be careful when you enter the alternatives universe, though. These funds may involve high-risk, complex hedging and leverage strategies (using borrowed money) that you may not understand. They also tend to be more expensive, with annual expense ratios often double those of plain-vanilla managed stock mutual funds, Morningstar has found.

Every alternative fund also has a unique risk-return portfolio. Some may move in the opposite direction of bonds, while others may only equal returns on Treasury bills. No single fund is risk-free, and there’s always an additional cost for the ability to hedge an asset class.

Since there is no such thing as an off-the-shelf all-in-one alternatives fund, your portfolio purchases will be need to be customized to complement what you already own and your financial goals. Don’t choose just one fund to represent alternatives; diversify among different strategies. There are many moving parts.

Most of all, be aware of the steep learning curve for alternatives. They are too complicated for casual market timers. If you are not comfortable with getting up to speed on them, work with a fiduciary adviser such as a certified financial planner, registered investment adviser or certified financial analyst to build the right portfolio for you. An adviser may be able to buy lower-cost share classes of these funds, to save you money on annual expenses and find the best managers.