Investment Alternatives to Reduce Portfolio Risk

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Most investors have concerns about the global economy. We are almost a decade removed from the 2008 financial crisis and have witnessed the S&P 500 index appreciate in excess of 250 percent. Interest rates remain low by historical standards, and the threat of increasing rates presents the potential for bonds' returns to disappoint investors interested in reducing equity exposure.

Central banks and governments throughout the globe have implemented an array of measures to stimulate growth in their respective local economies. The United States financial markets have responded favorably to a multi-year trend of government spending. However, the days of artificial stimulus from the Federal Reserve appear to be coming to an end. In 2014, the Fed announced the end of its long running bond purchase program, and in 2015, the FOMC raised short term interest rates for the first time in nearly a decade.

Most economists anticipate the Fed will announce a series of increases to the Federal Funds rate through 2018 after a single rate hike in 2016 and two additional increases in 2017. Removing the market's safety net may amplify the volatility of equities and force the U.S. economy to stand on its own.

Investors with a desire to reduce risk face a dilemma. A rising interest rate environment is typically not favorable for traditional bond investments, as bond prices and interest rates have an inverse relationship. For these reasons and many others, it is crucial that well-informed investors, including physicians, adjust their investment behavior accordingly.

Investment Theory for Physicians

Savvy doctor-investors understand that portfolio diversification is a key consideration to reducing some of the risk of loss. In historically volatile markets, mitigation of loss has not been a luxury; it is a necessity. Most educated investors who assumed they were *adequately diversified* still lost nearly half their portfolio value in 2008 and 2009. How did this happen? Most investors were diversified *within* the stock market with holdings in various sectors. What these investors suffered was *market risk*. The entire market came crashing down, and so did all investors within the market.

Affluent individuals should approach investing with the goal of diversifying risk through non-correlated assets, allowing their funds to compound over time by achieving positive returns net of taxes and inflation with reduced volatility. This strategy does not suggest opportunity should be ignored; it simply states that risk must be properly managed and allocated. Generally, this strategy is suitable for physicians of all ages for different reasons.

An established physician less than ten years from retirement has likely accumulated significant assets and now needs to limit the range of possible outcomes for his or her established wealth. A young or middle-aged physician's greatest asset is their ability to generate future earnings. A higher risk tolerance is appropriate for a doctor in this demographic, because the income earned will be significant enough throughout their career. With proper savings and risk management, the younger physician has no need to participate in speculative investments. Consistent after-tax returns and proper planning will be sufficient to allow a young physician to retire comfortably and maintain an appropriate standard of living.

What you should understand is that diversification need not be limited to securities like traditional stock and bond investments or bank deposits. Proper diversification must be ***across*** investment classes and not just ***within*** a class (such as securities or real estate)—especially in volatile markets that return periodically throughout an individual's lifetime. A balance of domestic and foreign securities, real estate, small businesses, commodities, and other alternative investments would prove to be much less volatile than holding most of your investments in real estate and securities (which is what most doctors do).

Most doctors who contact our team are either affluent and want to fine tune their planning, or they are getting more involved in their financial planning and want to know the secrets of the more financially successful. Subsequently, many of our physician clients have taken a more active interest in surgery centers, medical office buildings and other healthcare related real estate. This strategy contradicts the idea of achieving portfolio diversification, by having a disproportionate amount of capital dependent upon the success of a single industry. One strategy of portfolio diversification for doctors is to avoid all healthcare related investments. The theory is that doctors already have a large portion of their income related to healthcare.

Alternative Investments

According to results of a 2016 world wealth report[1], the allocation of the world's high net worth individuals is expected to include a 15 percent allocation to alternative investments. A key benefit of alternative investments is the low correlation to broad equity markets. Non-traded alternative investments can provide a variety of roles in a physician's portfolio.

In the past, certain categories of alternatives have successfully served as a hedge in client portfolios. In 2008 when multiple stock indices declined by nearly 50 percent from their peak values, most managed futures strategies offered positive returns. Past performance does not provide assurance of future success. However, a hedging technique that helped minimize damage during the worst financial crisis most of us have experienced in our lifetime certainly warrants consideration. Master limited partnerships, business development companies, long/short strategies, and certain hedge funds are additional examples of vehicles that have demonstrated a low correlation to traditional stocks and bonds.

For doctors who cannot build or participate in surgery centers or other profitable healthcare investments, a popular investment strategy is to take advantage of different investment programs that are not traded on a public exchange. Non-Traded Real Estate Investment Trusts (REITs), and Business Development Companies are a few examples. As with any investment, there are pros and cons for each type of offering.

Given recent market conditions, many physician investors have been attracted to non-traded programs because they offer a sense of stability. Most of these programs are available to investors at a flat price, for example $10 per share, during the offering period. An advantage to these programs is that their performance is not correlated with any particular market or index, making

[1] Capgemini Wealth Report 2016

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them an additional form of diversification. Holding non-correlated offerings may help reduce the "volatility rollercoaster" of a traditional portfolio. They should be an additional allocation in your portfolio, not a substitute for proper allocation.

Private investments generally offer a premium for the lack of liquidity. If proper due diligence is performed, an astute investor can identify these opportunities and will be compensated in the form of enhanced yield. Alternative investments provide physicians access to strategies not available to the retail investor, investments that have traditionally been reserved for large endowments and institutions.

Word of Caution

It is important to note that one of the advantages of a non-traded offering is also a disadvantage. There is typically no market for shares of these programs. As an investor, you are expected to hang on to the security for the life of the investment, which can be as long as four-to-ten years. This makes your investment illiquid. In addition, these programs are not without risk. Your hedge fund could use a high degree of leverage, have a concentrated strategy, and actually add to the volatility of your larger portfolio. Like any other investment class, some offerings are more aggressive than others, and none make any guarantee about future performance. As with any investment, make sure you understand the investment and associated ancillary costs and fees, along with how it fits within your portfolio before committing to the strategy.

The Time is Now

There has never been a better time to focus on investment risk management and tax reduction planning. For physician-investors seeking ways to diversify traditional stock and bond portfolios and reduce portfolio volatility while possibly reducing unnecessary taxes, non-traded investments are an attractive alternative. Please contact the authors to see if alternative investments or other planning strategies might possibly reduce your investment risk, reduce your taxes and increase the total after-tax return of your portfolio.

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