THE HARRIS
PLATINUM ADVICE SERIES

Exploring Alternative Investments:

Going Beyond Stocks, Bonds and Mutual Funds

By Jack Ablin, CFA
Chief Investment Officer

Alternative investment strategies have become increasingly popular in recent years, spurred by the potential for higher returns or the promise of positive returns with lower relative risk.

Broadly speaking, alternative investments are those that do not trade publicly on an organized exchange. Examples include private equity, real estate and hedge funds.

This paper will review the major strategies used by alternative investment managers, the advantages and limitations of each, and highlight the factors that investors should keep in mind before exploring these types of investment vehicles.

DIRECTIONAL VS. MARKET NEUTRAL STRATEGIES

Overall, alternative investments fall into two major categories: "directional" and "market neutral" strategies.

Directional strategies invest in a particular style or investment strategy. While their returns will depend on the performance of that asset, they will also be influenced by the overall direction of the market. Real estate, venture capital, commodities and some hedge funds are examples of directional strategies.

Market neutral or absolute return strategies seek to eliminate the risk of market movement from returns by using various hedging techniques. Instead, they focus on generating absolute positive returns for investors. Most hedge funds fall into this category.

Any private investment is considered to be an alternative strategy, but alternatives do not necessarily have to be private investments. For example, there are alternative strategies that involve publicly-traded securities such as Real Estate Investment Trusts (REITs). However, in general, alternative investments, regardless of their strategies, are usually offered as private partnerships, where investors are the limited partners and the sponsors or principals, are the general partners.

Investors pay management fees to the sponsors that often include a fixed fee to cover the day-to-day operations of the fund and a profit participation fee that can be as high as 20 percent of the fund's profits above some pre-determined targeted rate of return.

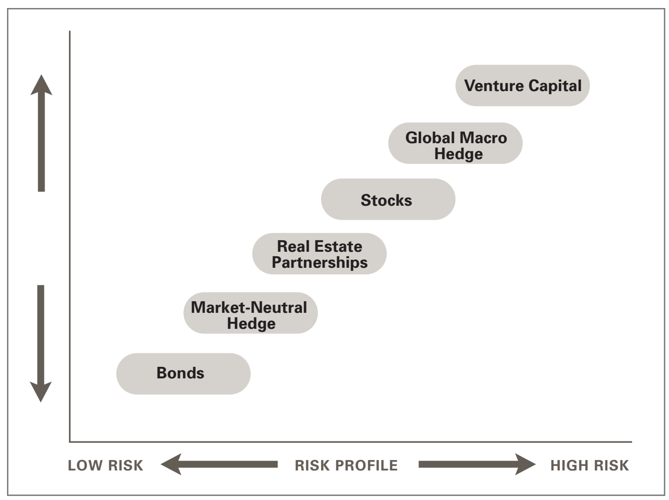
Since alternative investment partnerships are private, many are not currently registered with the Securities and Exchange Commission. To participate, you must be an "accredited" investor, meaning you must have the financial wherewithal to withstand the illiquidity and other risks associated with these vehicles. Typically, accredited investors must have at least $1 million of investable assets or annual incomes in excess of $200,000.

WHY USE ALTERNATIVE INVESTMENTS?

Alternative investments are another tool that can help broaden the diversification of your portfolio. Some alternative investments offer the potential for higher returns than publicly-traded stocks and bonds. Others offer the opportunity to eliminate market risk and provide steady, predictable returns. Both can be an important part of your asset allocation, since their returns often do not mirror the overall direction of broader stock and bond markets.

Market-neutral hedge funds, for example, can be a useful vehicle when you feel the markets are too volatile. They can allow you to sit out a turbulent market yet still earn returns in excess of what you would earn on cash.

RISK-RETURN PROFILE OF ALTERNATIVE INVESTMENTS



Another appealing feature of absolute return strategies — which attempt to remove market risk from their returns — is that they can deliver positive results in either up or down markets.

PRIVATE EQUITY

Private Equity is a directional strategy and represents one of the largest alternative asset classes. Private Equity involves ownership shares of private companies.

The return profile of Private Equity is similar to that of publicly traded stocks, but due to the unique nature and illiquidity of this marketplace, investors demand higher returns. Successful private investing requires an experienced management team as well as a healthy public equity environment.

The potential for high investment returns is the single most important reason for investing in private equity. These strategies offer significant return potential, but with substantially limited liquidity. It is not unusual for private equity partnerships to require a minimum seven-year investment. Therefore, allocating a portion of your portfolio to alternatives such as Private Equity can have a big impact on your overall portfolio returns.

This potential for higher returns is appealing since the long-term outlook for stocks over the next 10 years, while positive, is expected to be lower than what investors have enjoyed over the past decade.

"This strategy offers significant return potential, but with substantially limited liquidity."

PRIVATE EQUITY INVESTMENTS

There are two types of Private Equity investments: management buyout and venture capital.

Management buyout is the most common. A buyout helps existing management buy an existing business. The business could be part of a public company or part of a purchase from the original owners to management.

The buyout market has been around since the 1960s, but has evolved. Early on, the 1960s and 1970s were characterized as the age of conglomerates. Large corporations bought and sold public and private companies. Often, the acquiring company had little or no background or expertise in the acquired company's industry. The 1980s brought leveraged buyouts, or LBOs. These acquiring companies structured acquisitions with little or no equity, financing their purchases with excessive amounts of low quality debt.

By the 1990s, investors concentrated on unwinding the mistakes of the 1980s and enjoyed robust earnings as the public equity markets rallied. Today, since buyout investments often fund existing, mature businesses, investors' expectations for returns are usually more moderate.

Venture capital has been part of the American investment landscape for decades. Venture capitalists invest both time and money into emerging companies in an effort to launch the next Microsoft or Google. This high risk strategy involves funding companies with nothing more than a few bright entrepreneurs and a business plan. Since this is a risky strategy, investors require substantial returns from these funds. Venture capitalists create value through careful deal organization and evaluation or perhaps via syndication to share risk and improve access to capital.

Management oversight and incentives are particularly important in venture capital deals. Often, the participation of venture capitalists, and their ties to accountants, underwriters, and lawyers, signals the quality of a deal.

Investing in venture. Venture capitalists tend to specialize in certain areas and provide capital to support promising, but risky, ventures. Specialization tends to be by industry, or particular investment stage such as start-ups and later-stage deals, and some venture capitalists concentrate on geographic areas. As a result, investor diversification is critical in this space.

Venture investors need to carefully evaluate certain deal characteristics such as the sponsor's track record, geographical and industry concentrations. Also, because venture capitalists tend to make their investment at one particular time, the "vintage" year of an investment is important, too. For example, a telecom deal formed in 2001 when the telecom market was retrenching would likely not do as well as one formed in 2004, when the market had recovered.

Venture capital returns are extremely volatile over time and exhibit cycles of investing similar to that of the public equity markets. History suggests that returns are not uniformly distributed. We would estimate that approximately 50 percent of all gains are derived from seven percent of the invested deals. About one-third of venture capital investments lose some money, and up to one-tenth lose 100 percent of their value.

Ultimately, venture capital returns depend on two factors: first, the company financials or the business success of the individual firm; second, the performance of the financial markets. Historically, when public equity markets are strong, venture performs well.

REAL ESTATE INVESTING

Real Estate partnerships represent another directional strategy that invests in institutional quality projects. While a partnership offering may specialize in a particular segment of the real estate market, real estate offerings can be as varied as the market itself.

During recent times, commercial real estate has provided competitive returns for high-net-worth investors. Because real estate offers income-oriented returns, historical volatility has been lower than that of comparable public markets. In addition, real estate has historically performed well in periods of inflation, offering private investors purchasing power protection over extended investment time periods.

There are several ways to invest in real estate partnerships:

COMMINGLED FUNDS. A commingled fund invests in a portfolio of high-quality institutional assets. Commingled funds are offered privately, and are similar to private equity partnerships. They require accredited investors to complete a subscription agreement, and they often have up to a 10-year investment period.

DIRECT REAL ESTATE INVESTMENTS do not involve advisors or funds. Investors have complete control and management responsibility for the project. Direct investment involves special risks, some of which may be determined by unique, local factors.

PRIVATE REAL ESTATE INVESTMENT TRUSTS (REITs) are a third way to invest in real estate. REITs are companies, sometimes traded publicly, that manage a portfolio of real estate assets to earn profits for shareholders. REITs make investments in a diverse array of real estate from shopping centers to office buildings to apartment complexes and hotels. Similar to commingled partnerships, private REITs employ a portfolio strategy.

Finally, there are PUBLIC REITS AND REIT MUTUAL FUNDS, which offer investors the most liquid avenue for investing in real estate. Given the nature of public REITs, like close-end mutual funds, they can trade at a substantial premium or discount to the underlying net asset value of the portfolio.

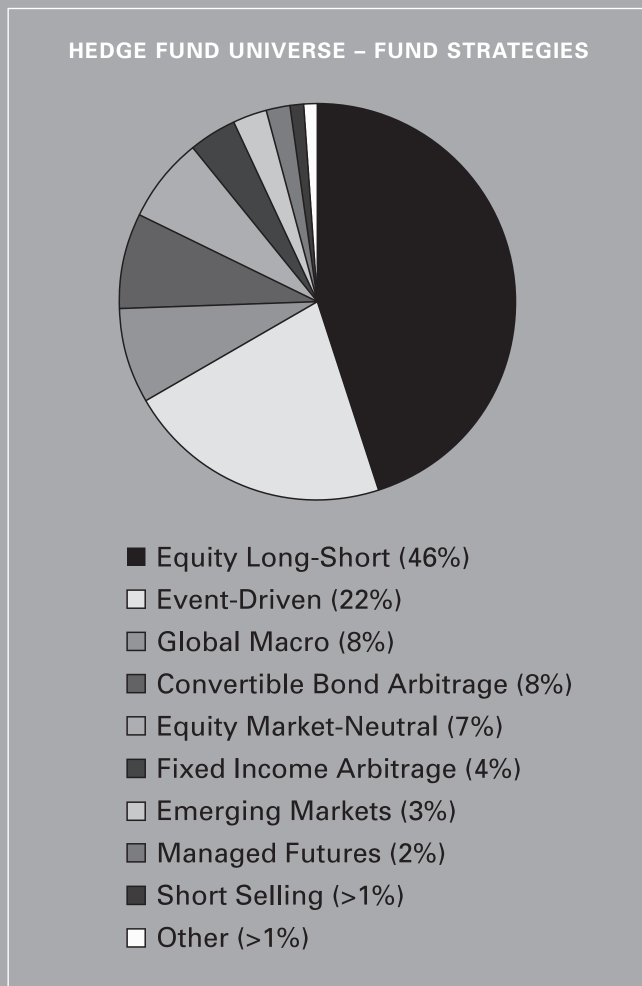
Generally speaking, real estate investing is expected to be less volatile than traditional asset classes because it is based on appraisals for market valuation, rather than a market-based, fluctuating valuation. Thus, with less correlation to the general market, real estate can provide good diversification for your portfolio.

HEDGE FUND STRATEGIES

Alfred Jones is credited with establishing the first hedge fund in 1949, and since then, hedge funds have become increasingly popular. Again, the general investment strategy here is to provide investors with returns that do not mirror the stock and bond market.

Jones established his hedge fund as a limited partnership, using leveraging and short selling to magnify returns and limit losses. This resulted in a portfolio that was less dependent on market fluctuations and more dependent on a manager's skill at analyzing individual securities. In addition, Jones introduced an innovative feature for the time: a performance-based fee. He also kept much of his personal money in the fund. Both of these factors ensured that his goals were aligned with those of the investors.
After his strategy was publicly disclosed in the mid-1960s, hedge fund partnerships gained popularity. By 1968, there were some 200 hedge funds. Today, that number has swelled to over 6,000 funds overseeing more than $500 billion worldwide.

Most hedge funds are considered market neutral or "absolute return", but there are exceptions. Absolute return strategies attempt to deliver absolute, positive returns regardless of the direction of the overall market.



NEUTRALIZING MARKET RISK

Traditionally, returns from investments in equity portfolios are derived from two sources, the beta component, or the return from the underlying market or benchmark, and the alpha component, or the increased performance above the benchmark, which represents the skill of the manager. Absolute return strategies isolate the alpha return component by neutralizing market risk.

One example would be a long-short strategy that involves hiring an investment manager who understands the healthcare market extremely well. This manager would "go long" (invest) in a stock he expects to do well (company "A") and "go short" or bet against a stock or an index for the healthcare market he thinks will fall (company "B").

Typically an equal amount would be invested in both long and short positions. If the market drops by 10%, what you would lose on one stock would be made up in the other, short position, and vice versa. With the overall direction of the market out of the equation, a skillful manager earns a positive return on the spread between the choices of stocks he or she makes.

Thus, offsetting long positions with short positions effectively removes general market risk. By hedging away market risk, non-directional strategies can dramatically reduce a portfolio's dependence on the market's direction.

Another benefit of investing in a market neutral hedge fund is diversification. Investing in a vehicle with a positive expected return yet a low correlation to traditional markets will add to portfolio efficiency.

Absolute return strategies can be organized into two broad categories.

"By hedging away market risk, non-directional strategies can dramatically reduce a portfolio's dependence on the market's direction."

TWO CATEGORIES OF MARKET RISK

Market neutral. As described above, these long-short or non-directional strategies attempt to extract value from a large number of offsetting positions. By combining long and short positions, equity market neutral funds speculate on the price differential between securities. These strategies can employ public equities, fixed income securities as well as convertible bonds. By coupling modest returns with leverage, these funds seek to produce high absolute returns that are not correlated with the overall market.

Event-driven funds. These funds attempt to profit by investing during corporate events such as mergers, acquisitions, bankruptcies, leveraged buy-outs (LBOs) or corporate restructurings. Prices of securities invested in a strategy of this nature are influenced by the dynamics of a unique situation rather than the market in general. Event-driven managers often require legal and credit expertise to effectively evaluate a situation.

Event-drive strategies are designed to offer moderate returns with low expected correlations. These strategies are hard to characterize due to their unique associated risks. These risks involve special situations like a merger, the outcome of a distressed company and other specific events related to the investment situation. As a result, the correlation of this strategy is especially low when measured against the overall market. It should be noted, however, that in times of a financial crisis, the correlation of event-driven strategies with market risk can increase to uncomfortable levels.

DIRECTIONAL HEDGE FUNDS

Finally, there are Global macro funds. This broad category of hedge funds attempts to take advantage of global market movements by tracking relative valuations and directional trends. Generally referred to as macro funds, this strategy utilizes fundamental and technical analysis to evaluate currencies, interest rates, equity markets and commodities. Funds take long and short positions based upon economic trends and often trade their holdings based upon new information. George Soros's Quantum Fund is a well-known macro fund. Given their directional nature, macro funds tend to be high risk, high return vehicles.

TRANSPORTING THE ALPHA RETURN

The talents of a successful manager can be transported to other asset classes.

Hedge fund managers can capture the incremental return or spread between individual securities, independent of the return of the overall market from which these securities are selected.

For example, suppose you identify a manager who can deliver positive returns of 3% over the small-cap index with reasonable consistency. Yet you feel the outlook for the small-cap index, in general, is negative. You can invest with this small-cap manager and at the same time "short" the overall small-cap index with a similar investment, against that manager. Now, you are investing in the spread between that small-cap manager's performance and the small-cap index as a whole. If the index goes down 20 percent, and your small-cap manager's fund is down only 17 percent, you've made three percent.

The return from this type of long-short spread can be transported to other asset classes by combining the underlying long-short portfolio with other investments, such as futures or exchange-traded funds, to provide market returns plus an incremental, "alpha" return.

Thus, the talents of an outstanding stock picker are not confined to the equity markets but are "transportable" to other asset classes.

"The talents of a successful manager can be transported to other asset classes"

OPPORTUNITIES AND CHALLENGES FOR INVESTORS

There are many ways to take advantage of alternative investments, ranging from a fund of funds (see next page) approach with a minimal entry point to highly sophisticated private equity deals that can require several million dollars in investment.

Therefore, as a prudent investor, you should consider dividing your investment portfolio into two pools. The first pool should be managed to provide for your financial well being. The second pool can be considered "wealth surplus." This portion of the portfolio can be invested in alternative strategies.

Short of creating a wealth surplus, high net worth individuals, foundations and family offices often invest only a portion of their overall portfolio in alternative investments, due to the risk level and lack of liquidity.

ALTERNATIVE INVESTMENT STRATEGIES FOR VARIOUS INVESTORS

Investable Assets	Market Neutral Hedge	Global Macro Hedge	Fund of Hedge Funds	Venture Capital	Management Buyout	Co-mingled Real Estate	Direct Real Estate	Private REIT	Public REIT	Alpha Transport
$1mm			x			x		x	x	
$2mm-10mm	x		x			x	x	x	x	
>$25mm	x	x		x	x	x	x			
Family Office		x		x	x		x			x

FUND OF FUNDS

A fund of funds is a private offering to accredited investors that invests in funds of several hedge fund strategies. This approach is not so much a hedge fund strategy as a vehicle for investing in hedge funds. It has advantages for investors with limited resources, and can provide access to the nation's top managers who typically have high minimums.

In each case, the fund of funds manager performs due diligence to identify the best managers with the highest probability of delivering above average investment performance within their specific discipline. The fund of funds manager also provides fund administration and diversification. Minimum investments with some fund of funds can be as low as $25,000.

One disadvantage of fund of funds investing is cost. Most fund of funds managers charge up to 2 percent management fees in addition to an incentive fee of up to 20 percent of the realized profits. There may also be management fees and incentive fees with each of the component funds.

"A fund of funds has advantages for investors with limited resources. It can provide access to the nation's top managers who typically have high minimums."

MANAGER SELECTION

Manager evaluation is critical to success with alternative investments. Effective due diligence can often mean the difference between superior and disappointing investment results. It can also help you avoid undue portfolio risk.

Due to the private nature of these vehicles, however, performance data is not often readily available. For example, hedge funds returns are typically skewed higher due to "survivorship bias" by excluding unsuccessful managers who are no longer in the business. As the size and scale of the hedge fund sector has grown, due to capital inflows and the establishment of new funds, capital may often be invested with unfamiliar managers with limited track records.

Performance is one measurement, but not necessarily the most important. The due diligence process must put performance in context through a qualitative framework that covers manager integrity, manager risk controls, growth plans and specific strategy experience.

On-site interviews, background checks and third-party references are also key elements of the analysis. Finally, once a manager has been selected, ongoing due diligence through manager monitoring is necessary. The emphasis should be on ensuring that managers stay true to their advertised strategy, including return and risk expectations.

Work with an Advisor

High risk, limited liquidity, taxes, limited information and lack of regulation all make investing in alternative asset classes especially challenging without the help of a trusted, professional advisor.

Harris Private Bank can offer you professional guidance along with access to the full spectrum of alternative investment strategies. If you would like more information about pursuing these strategies for your portfolio, please contact your Harris Private Bank representative.

Jack Ablin, CFA, is Senior Vice President and Chief Investment Officer with Harris Private Bank. He is responsible for establishing investment policy and strategy within the Personal Investment Management Group of the Private Bank. Mr. Ablin also serves on the Asset Allocation Committee, which determines the strategy for investment portfolios for Harris Private Bank.

Mr. Ablin joined Harris in 2001 and has more than 20 years of experience in financial services. Mr. Ablin earned a bachelor's degree from Vassar College, New York, where he graduated with honors with an AB in mathematics and computer science. Mr. Ablin received an MBA with honors and graduated cum laude from Boston University and is a member of the Beta Kappa Sigma honors society. He holds the Chartered Financial Analyst (CFA) designation.

Mr. Ablin makes his home in Chicago, where he is a member of the CFA Institute and the Chicago Financial Analysts Society. He appears frequently as a guest commentator on CNBC.

Harris Private Bank brings a unique approach to reaching your financial goals by offering a full suite of wealth management solutions. From individual investment products to private banking, we are dedicated to assisting you in accumulating, growing, and protecting your financial assets.

Harris Private Bank provides flexibility and a broad spectrum of choices, offering everything you need to create financial strategies that work for you now and at every stage of your life. Our team-based approach enables you to move confidently and easily among different types of services and levels of advice.

Please contact us for more information and/or for additional white paper titles or copies.

We look forward to the privilege of serving you.

For more information, visit us at:
www.theharris.com

HARRIS™

37054 (N 7/05)