Is Wall Street At It Again…?

Lately, I've been reading a lot about Alternative Mutual Funds, and invited Greg McBride, Senior Financial Analyst at Bankrate.com to a discussion on these funds.

An AMF is essentially a regulated mutual fund with the investing freedom and upside of a hedge fund but without many of its downsides. AMFs are open to all investors, not just the rich, charge significantly lower fees, disclose their investments, may be bought or sold daily, and have higher liquidity than hedge funds.

AMFs commonly go long or short stocks, invest in commodities or focus on multiple strategies.

Long-Short

AMFs simultaneously go long (buy stocks for price appreciation) and short (borrow and sell 'over-valued' stocks hoping to buy them back later at lower prices) to enhance returns.

On a long position, shares bought at say $20 could, in the worst case, go to zero. On a short position, instead of falling, shares could rise to say $80 or higher, causing losses of $60 or more. So going short is dangerous and may cause sizable losses if positions are not hedged.

Commodities

AMFs also invest in commodities - natural resources like oil, food items from orange juice to soybeans, precious metals such as gold, silver or platinum, and more.

Commodities do not always move in sync with stocks or bonds, and may thereby add diversification to your portfolio while also reducing volatility. As with every investment, investors must carefully assess valuation and risk. In 2008, investors who bought crude oil by the bucketful at $140 per barrel got crushed when crude fell to $35 per barrel.

Multi-Strategy Fund

A multi-strategy fund – also called an Absolute Return Fund focuses on generating positive returns in every investing environment. Greg adds that multi-strategy funds are not hemmed into any particular asset class – they can go long or short, buy assets or futures, use derivatives and trade less-liquid investments.

Such funds aren't a replacement for other asset classes but should supplement them, and be used as the seasoning to your investment soup, not as basic stock.

Greg warns that multi-strategy funds have higher fees, higher minimum investment amounts and possibly less liquidity than long-only or index funds. If events cause everyone to want to exit at the same time, a fund's price may drop sharply perhaps well below the actual value of its holdings. For example, during the *flash crash* in May 2010, investors simultaneously headed for the exits causing prices to drop precipitously.

Suspect Marketing

Investors have realized that actively-managed mutual funds regularly under-perform the market and so they have moved to less expensive index funds. As a result, Wall Street has lost sizable fee revenues.

Nowadays, investors are clamoring for some assurance in an uncertain world. In response, Wall Street is aggressively marketing AMFs - more for their higher fees than their touted benefits as less volatile and less risky than traditional funds. Whether excess returns justify such higher fees remains to be seen.

Wall Street is a sales culture – they will develop products that seemingly assuage investor fears. Unfortunately, an alternative mutual fund may create more problems than solutions for the small investor at the wrong time. So buyer, beware!