Maximizing alternative investments

How to get started with hedge funds, private equity and other alternative investments **Interviewed by Bridget McCrea**

Some of today's more industrious investors are turning to alternative investments like hedge funds and private equity. Expectations are that these higher-risk options will yield returns higher than the stock, bond or real estate markets.

"Traditionally, hedge funds and private equity funds were the domain of high-net-worth individuals and large institutions," says Dan Crawford, managing director at NexTier Wealth Management in Pittsburgh. "Because these options aren't registered securities with the Securities Exchange Commission (SEC), they've always had a certain mystique around them, even though they've been around for 30 or 40 years."

Smart Business spoke with Crawford about the pros and cons of alternative investments.

Dan Crawford
Senior vice president, managing director
NexTier Wealth Management

Why are investors considering alternative investments right now?

These investments have typically enjoyed higher returns than traditional assets (stocks, bonds and money market funds) have delivered. We see reports about how the endowment funds at Harvard and Yale allocate 30 percent of their assets to alternative investments, and how they credit those investments with helping the fund experience above-average returns. We've seen a flood of money going into these asset classes, and it's gotten to the point where we see hedge funds being offered to individual investors for as little as $25,000. The bar has been lowered significantly, thus allowing everyday investors to get a piece of the alternative investment pie.

How impressive are the returns on these alternative investments?

Because of a desire for higher returns, we have seen tremendous growth in the hedge fund industry in recent years.

The hedge fund market has grown to about $1.5 trillion dollars in 2005 (compared to $1.1 trillion in 2004). As a result of this unprecedented growth, hedge fund managers are taking more and more risk to generate those additional returns. It's growing at a good clip, and what we're seeing is that the returns are becoming more and more like your traditional asset classes.

How can business owners take advantage of these opportunities?

First, they should hire an adviser who can walk them through the investment process. They should also understand that there are different types of hedge fund strategies. A 'fund of funds' approach may be most desirable because it may own up to 12 different hedge funds that are then pooled together to achieve greater diversification. This presents less risk than the hedge fund whose manager is focused on a single strategy. To find the best approach, investors need to work with someone who can perform due diligence and analysis to come up with a recommended hedge fund strategy.

How do private equity investments work?

Like hedge funds, private equity investments are also illiquid and are not registered with the SEC. As such, they're not required to tell investors about their performance and activity on a regular basis.

With private equity, fund managers basically go out and raise millions and millions of dollars with one specific objective in mind, such as investing in a specific sector, early- or late-stage companies, or mature industries. The goal is to buy them in a leveraged transaction, clean them up and — several years down the road — take them public or develop another exit strategy. The exit strategy allows original investors to get their money back (original capital commitment plus hopefully profits). The downside is that there is a lot of uncertainty with these investments, as we saw back in 1999-2000 when the tech sector slide took with it a high number of startup companies and their backers.

To avoid getting caught up in such debacles, the key is to invest only a small portion of a total portfolio in these funds (perhaps 5 percent to 10 percent of investable assets), and to use at least an eight-year investment time horizon when considering where to allocate that money.

What else do business owners need to know about alternative investments?

The key is to do your homework and be cautious at this stage of the game. With excess global liquidity chasing returns and more alternative investments being opened up to the average investor, it's easy to get caught up in the whirlwind. Realize that there are good alternative fund managers out there, but it's getting harder to find them, and more difficult to get above-market returns in this asset class because of their growing popularity.

Many of the good hedge fund managers are closed to new investors.

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