PROVASI CAPITAL PARTNERS

WHITE PAPER

Diversifying with Alts

Constructing Portfolios that May Reduce Volatility and Fear-based Selling

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Generating stable returns is far from simple

For income-oriented investors, the two most favored words in the English language are "monthly check." We are programmed through our working years to think in terms of monthly income and monthly expenses. We have at our disposal a plethora of budgeting tools and software programs that help us plan and categorize every form of monthly expense we pay and the investments we make. Many of these programs also include basic tools that help us plan for retirement.

But is investment planning really as simple as this basic software implies? If you slow down enough to think carefully, you will probably realize that blindly accepting the program's output is not prudent. The most simplistic software reflects little more than a narrow dogma of diversification; it is not sophisticated enough to help you consider all available options. Pat answers aren't enough to help you select the best solutions for your unique situation.

A common goal for advisors is constructing a portfolio that successfully aligns with the investment objectives of the individual investor. Hopefully, the investor's portfolio will generate a total return consisting of an optimal blend of current yield and capital appreciation. It also would be wise for advisors and their clients to plan investment strategies that take into account what we know about how most investors actually behave.

The powerful influence of fear and greed

Unfortunately, investors usually do the wrong thing at the wrong time. Market research demonstrates that investors persistently buy when the price is high and sell when the price is low. (Source: DALBAR's 20th Annual Quantitative Analysis of Investor Behavior 2014.) Since this approach is likely to promote losses rather than gains, why do investors usually behave this way? In my opinion, the motivation for this self-defeating behavior is straightforward; it is driven by the powerful emotions of fear and greed.

Unless educational efforts address these root causes directly, they seldom succeed in reducing impulsive, fear-based investment decisions. For decades financial experts have talked about the benefits of staying the course during a market correction. But research shows that, in a perceived crisis, most investors ignore this advice.

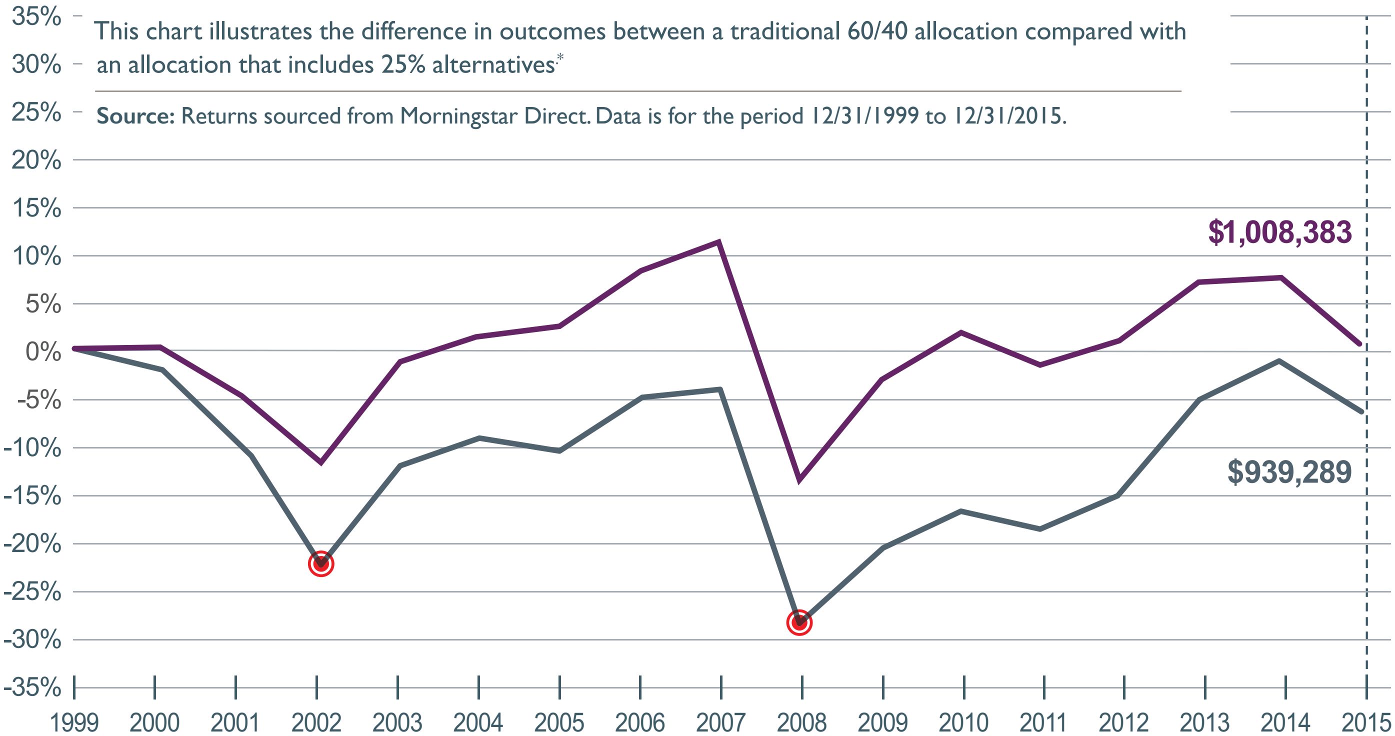
Volatility provokes fear-based selling

Volatility can provoke fear-based selling, which is especially damaging to retirement income portfolios. Fear-based selling can be particularly damaging for those in retirement because they generally have ceased allocating new money to savings and investments, and are spending the dollars they have accumulated.

As investors age, they have less time to recover from the damage done by fear-based selling. For these reasons, retirement income strategies must address the conditions that prompt fear-based selling.

What causes this fear? The most frequent culprit is volatility. Despite what investors may say when completing a questionnaire about their tolerance for volatility, any person's sense of risk changes moment by moment. A questionnaire captures only a single moment in time when the risk is hypothetical; that moment seldom is comparable to a stressful, real-world situation that truly challenges an investor's tolerance to risk.

Broader Diversification Reduces Fear and Promotes More Rational Investor Behavior



Modified Portfolio
37% S&P 500
28% Barclays Agg Bond Index
10% Cash, (at 1% Interest Rate)
25% Alternative

Traditional Portfolio
60% S&P 500
40% Barclays Agg Bond Index

Alternative Portfolio Assumptions (equally weighted): The 25% Alternative Investment allocation is comprised of the following indexes, each representing 2.5% of the total portfolio:

- **Credit Suisse Leveraged Loan**
- **MSCI ACWI Energy**
- Credit Suisse Multi-Strategy
- Bloomberg Commodity
- Credit Suisse Global Macro
- Credit Suisse Convertible Arbitrage
- Credit Suisse Long/Short Equity
- Credit Suisse Event Driven
- S&P Global Gold**
- NCREIF Property

Scenario Assumptions: The sample portfolio has a beginning value of $1 million on 12/31/1999 and assumes the individual commences retirement on 1/1/2000. At the end of the first year, the retiree withdraws 4% of the initial investment and increases the withdrawal amount by 3% for inflation each subsequent year. The portfolio is rebalanced annually at the end of the year.

Past performance is neither indicative nor a guarantee of future results.

Alternative investments may involve higher fees, more limited liquidity, and greater risks, including higher volatility and the opportunity for significant losses, compared to traditional investment strategies. Alternative investments are not suitable for all investors.

The hypothetical portfolios are for illustrative purposes and should not be considered representative of actual investment results. Results will vary based on fees, expenses, and portfolio construction. Historically, the investment objective of equities has been capital appreciation; the investment objective of bonds has been current income; and the investment objective for alternative investments has been portfolio diversification.

Portfolios were constructed using indexes considered to be representative of certain asset classes; indexes are unmanaged and cannot be used to predict future results of any investment. An index's returns may not reflect the deduction of any sales charges or management fees, which may be substantial for alternative investments. Investors cannot invest directly in an index.

**Diversification does not ensure a profit or guarantee against a loss.

**For this index, data for the period up to 12/31/2000 is from the S&P Global Broad Market Index (BMI); data from 1/1/2001 to 12/31/2015 is from the S&P Global Gold Index.

Broader diversification can temper volatility, reducing the perception of risk which often prompts fear-based selling.

Portfolio with traditional allocation of 60% stocks and 40% bonds

Adding non-traditional asset classes and investment strategies may reduce volatility, mute drawdowns in a market downturn and potentially improve long-term performance. For example, the chart on the previous page gives a retrospective view of how the addition of less-correlated asset classes can help dampen drawdowns during retirement. Note the blue line tracking performance over the last 15 years for a hypothetical retiree that followed the standard portfolio model of 60% stocks and 40% bonds. In 2002 and 2008, such a portfolio with would have seen drops of more than 20% in both instances. After 15 years, this hypothetical investor would have had a decline nearly 16%, in addition to annually withdrawing 4% of the principal. Worse yet, it is probable that this volatility also prompted the investor to panic and sell assets at a loss--permanently erasing any chance of regaining asset value once the market revived. Statistics during 2008 show massive net redemptions in equity funds (Source: Morningstar Direct), a clear example of investors doing the wrong thing at the wrong time.

Portfolio with modified allocation of 37% stocks, 28% bonds, 25% alternatives and 10% cash

Consider another hypothetical portfolio with investments held for the same time period. Unlike the previous example, this portfolio includes new asset classes and investment strategies. As correlations tightened in traditional asset classes due to increased globalization during this period, this investor used an expanded definition of diversification to reduce their exposure to the volatility of equities by adding new asset classes while still challenging the portfolio to produce risk-adjusted monthly income. This approach would have produced several benefits. Drawdowns in 2002 and 2008 would have been significantly muted, and this alone may have reduced the temptation to "join the bandwagon" by selling assets during these downturns. Reduced portfolio volatility would have reduced the probability that an investor would develop fear sufficient to motivate a self-defeating decision to sell at the wrong time.

After 15 years, our hypothetical investor would have seen his or her portfolio increase in value, while still taking an annual 4% distribution, , unlike the traditional investor.*

*Past performance is neither indicative nor a guarantee of future results.

Reduce the possibility of fear-based selling

Broader diversification can temper volatility, thereby reducing the perception of risk that often prompts fear-based selling. The potential benefits of broadening the concept of diversification are manifold. Investors who feel particularly compelled to sell during a downturn may be discovering that they have selected an asset allocation strategy that was too aggressive for their risk tolerance. Investments in non-traditional asset classes and strategies have the potential to enhance portfolio diversification. Allocating these assets may help to mitigate volatility and reduce the likelihood of fear-based selling during downturns, potentially reducing drawdowns and improving income in retirement.

The bottom line

What is the best allocation strategy for generating risk-adjusted income in retirement? How can portfolio construction reduce the temptation for investors to stray from their course during a downturn? The bottom line is that there are many assets and strategies under the alternative investment umbrella. Advisors and their clients should seriously consider which combination of these may present the best complement for increasing diversification and reducing volatility within their particular portfolio.

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