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Why alternatives to stocks and bonds can calm your portfolio



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Unfortunately, access to private equity, real estate limited partnerships and other alternatives is hard for retail investors who don't meet the minimum investment thresholds that come attached to them.

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There's perhaps nothing more comforting in volatile times than knowing there's an option to sell all of your investments at a moment's notice, but having an entire basket of completely liquid assets may actually increase portfolio volatility, not reduce it, in more turbulent times.

"Liquidity paradoxically increases the formal definition of risk," said John Nicola, founder and chief executive of Nicola Wealth Management in Vancouver.

Mr. Nicola said highly liquid assets such as stocks and government bonds generally deviate more from average market returns and, therefore, have greater volatility compared to less liquid alternative assets, including private equity, real estate and infrastructure.

To illustrate this point, he recently compared the performance of Great West Lifeco's pooled real estate fund with the S&P/TSX total return index during a 30-year period between 1982 and 2012.

Both indexes provided similar returns — 8.5% and 8.6%, respectively — but the road to those gains was far less volatile for GWL's segregated fund than it was for the popular equity benchmark.

"I'm getting almost the same return, but I'm reducing the capital volatility by about 60% and the income volatility is 90% less volatile," he said.

Mr. Nicola also examined the performance of the Realpac/IPD Canada Quarterly Property Index versus the S&P/TSX capped REIT index at the time of the financial crisis.

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The former fell 4% in 2008, while the latter dropped 33%. In the following year, the IPD index went up 8%, and the TSX went up 35%.

“The [REIT] market decided that it should trade up and down in these extreme amounts even though the underlying real estate market did not,” he said. “A lot of that is related to investor behaviour.”

Many other asset managers feel the same way and similarly advocate investors buy some less-liquid assets.

But access to private equity, real estate limited partnerships and other alternatives is hard for retail investors who don't meet the minimum investment thresholds that come attached to them. Products like Great West Lifeco's pooled fund are available at a

reasonable minimum, but such options remain few and far between.

At the same time, not everyone is convinced that liquidity, or lack thereof, plays much of a role in the volatility of an asset.

“In our view, it is smoke and mirrors,” said Bob Sewell, president of Bellwether Investment Management Inc. in Oakville, Ont. “If you're not pricing in an open market minute by minute and day by day, then yes, you're not seeing the volatility, but it's still there.”

That doesn't mean Mr. Sewell thinks investors should avoid less-liquid investments altogether.

He said they can benefit a long-term portfolio, particularly if they help keep an investor from selling at inopportune times. But, he adds, “If there is less liquidity, then I need to expect to get a better return.”



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