FINANCIAL ADVISOR

Leading Advisors Say Alternatives Provide Income Clients Need

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Advisor interest in alternatives tends to fluctuate with market behavior; when traditional asset classes fail to perform, advisors look for other options.

A changing market reality and projections of poor long-term performance for traditional fixed income have forced advisors to look beyond stocks and bonds for client portfolios, said panelists taking part in the discussion “Top Advisors Explain Where Alternatives Fit In” at Financial Advisor’s Inside Alternatives and Asset Allocation Conference at the Wynn Hotel in Las Vegas last week.

“We have assets across all categories: equities, fixed income and alternatives,” said Paul Pagnato, founder and CEO of PagnatoKarp. “Our mindest is, if you go back to Harry Markowitz and William Sharpe, the Nobel laureates who did the work that led to modern portfolio theory, the rule of thumb was a 60-40 portfolio. If you looked at all the assets available to you as a benchmark, you ended up with a 60-40 allocation in the S&P 500 and an aggregate bond index.

“Fast-forward to today, and only 5 percent of the investible world is in the S&P 500, and less than 10 percent is in U.S. fixed income. It's changed dramatically.”

Laura Tarbox, founder and CEO of Tarbox Family Office, said that she has used alternatives regularly since founding her firm, but traditionally used both equity- and bond-like alternative investments to diversify client portfolios.

Today, most of Tarbox’s alternative investments are in income-providing asset classes.

“We’re not looking for double-digit returns from one of our alternative allocations,” said Tarbox. “I believe in the equity markets for those. For the past 90-plus years, you consistently get 10 percent returns from stocks if you allocate through small- and mid-caps and international. I feel like, over time and through cycles, the stock market is going to give us good returns.”

Yet many advisors’ clients remain in balanced or target-risk portfolios that use heavy allocations --sometimes 60 percent or more -- to fixed income investments to provide capital preservation and an income stream.

That choice makes little sense, said Pagnato, amid a low-but-rising yield environment. As things stand, there’s no guarantee that traditional bonds will provide sufficient income or the capital preservation clients demand.

“We have a hard time with our clients who have the stable portfolio model where so much is in fixed income, because that fixed-income allocation will be challenged going forward,” said Tarbox. “That’s pushed us into more fixed income-like alternatives. I have no bonds in my portfolio, I tell that to clients. Our alternatives have been outperforming our bond allocations.”

Nevertheless, Tarbox only allocates a small portion of her client portfolios to alternatives, while Pagnato may devote up to 30 percent of a portfolio to alternatives, depending on the clients’ needs and biases.

Tarbox remains hesitant to use alternatives in a more significant manner due to their lliquidity and difficulty in finding reliable managers with suitable strategies. “We’ve had a lot of problems when we’ve had lockups and clients couldn’t get their money out,” said Tarbox. “For our core allocations, we only use 40-Act mutual funds that have quarterly liquidity. Right now we have three alternative funds that we allocate to across about 50 percent of our models.”

Currently, Tarbox uses an alternative lending fund, a reinsurance fund and an institutional real estate fund to provide extra income for her clients.

Pagnato, on the other hand, casts a broader net when considering alternative investments. “We have a formal investment committee; we’re looking at everything from farmland to micro-lending to traditional private equity,” said Pagnato. “We want to consider the whole spectrum that’s available.”

Pagnato also employs a private fund of high-yield municipal bonds that create tax-advantaged income greater than that of traditional municipal bonds but that share the municipal sector’s low chances of default.

One sector of alternatives both panelists tend to avoid? Hedge funds.

“The performance has not been there and the 2 and 20 fees are pretty high,” said Pagnato.

“Family offices now have less than 5 percent of their allocations in hedge funds.”

Since both their firms tend to serve high-net worth individuals, the tax treatment of alternative investments is of particular importance.

“Our clients care more about taxes most of the time than returns, so we’re challenged to put anything into the alternative space,” said Tarbox. “There isn’t much where you can have both liquidity and a favorable tax treatment. All of our clients have complicated tax situations.”

Employing alternative investments within their portfolios requires that Tarbox and Pagnato conduct careful due diligence of fund providers. Pagnato suggested hiring a third party to take a deep dive into the experience and background of any manager.

Aside from taxes, both advisors argued that accessible and transparent management are key to making good alternative investment choices – Tarbox also recommended avoiding smaller, less known providers.

Pagnato and Tarbox diverged on cryptocurrencies. Pagnato argued that cryptos are already an investible asset class.

“We view cryptocurrencies as a separate asset class,” said Pagnato. “It’s been around for nine years now, we’re in the digital era, and at the end of the day this asset class is going to serve real purposes.”

For example, cryptocurrencies offer a secure mode of transaction for the two billion to three billion global citizens who lack access to a bank, and they should grow in stability and adoption over time, said Pagnato, who is allocating 1 to 2 percent of client assets into cryptos.

Tarbox was unconvinced. “We’re looking at it, but I don’t feel like we need to be the first ones in,” said Tarbox. “A lot of our clients don’t have the appetite for it.”