Asset allocation will always be the foundation for sound portfolio construction.

How those assets should be allocated, however, is evolving as time and markets change.

Since the first applications of Modern Portfolio Theory in the mid-20th century, the capital markets have grown increasingly sophisticated. Back then a well-diversified portfolio was considered a sensible blend of bonds, equities and cash.

With today’s globalization of financial markets, such tried and true, buy-and-hold formulas have proven overly susceptible to the downside pressure of transient market events.

FROM DIVERSIFICATION TO OPTIMIZATION

Effective asset allocation has changed. Consequently, the principles behind successful portfolio construction have changed, too.

Employing an investment process that optimizes a portfolio through a thoughtful blend of traditional and alternative investments may be the best way to ensure an investor reaches their long-term goals.

By leaving out asset classes in the alternative space, financial professionals may unwittingly add to a client’s portfolio risk. The wide variety of alternative strategies and vehicles is now making it possible for advisors to design portfolios that provide clients with a greater degree of personalization and diversification.

The good news for today’s investors is that the wide-ranging benefits of alternatives are fast-becoming more accessible.

A new wave of alternative assets, strategies, and products is opening up fresh approaches for optimizing portfolios through strategies that previously had been available only to large institutions.

These approaches – or alternate routes – offer a smart blend of diversification and controls to optimize client portfolios.

DISCOVER FOUR WAYS ALTERNATIVES CAN OPTIMIZE A PORTFOLIO

Alternative investments offer four proven ways to optimize a portfolio to increase the likelihood that a portfolio may support a client’s short- and long-term goals.

To optimize a portfolio, a broader blend of traditional and alternative asset classes must first be reviewed together on the basis of:

• Expected return
• Standard deviation of return
• Correlation with other asset classes
One of the most recognizable graphs in any academic finance class is Markowitz’s Efficient Frontier graph at right. A portfolio that shows the lowest risk level for a given level of return is considered to be “efficient.”

While a traditional, long-only portfolio might hold a combination of cash, stocks, bonds and international exposure, a portfolio that combines alternative strategies with traditional investments may serve to enhance portfolio returns and mitigate volatility.

**HOW ALTERNATIVES CAN OPTIMIZE A PORTFOLIO**

Alternatives can aid in the portfolio optimization process by:

1. Tempering Risk
2. Improving return potential
3. Varying liquidity exposures
4. Creating targeted behaviors

Investor age, goals, risk tolerance and time horizon all continue to factor into recommended allocations; but by expanding into the universe of alternative products, investment professionals and investors can gain a surprisingly new degree of specialized control over portfolio outcomes.

**1. ALTERNATIVE STRATEGIES CAN HELP TEMPER RISK**

By definition, alternative investments differ from traditional asset classes – stocks, bonds and cash. All investments involve risk, of course. And risk is relative. While investors may initially be reluctant to invest is the unfamiliar, it’s important to consider risk in the context of the global marketplace.
Alternate Routes: Four Ways
Alternatives can Optimize a Portfolio

Traditional equities and bonds have demonstrated a high degree of risk for a decade

These charts illustrate just how volatile the conventional markets have been over the past decade. The charts reflect the rolling five-year returns and standard deviations of four traditional investments from 1/1/00 through 12/31/11.

![Chart showing returns and standard deviations of traditional investments](chart.png)

Past performance is no guarantee of future results. Rolling returns based on 12 years of monthly data reflecting 136 separate time periods. U.S. large-cap equity is measured by S&P 500 Index, U.S. small-cap equity is measured by Ibbotson Associates U.S. Small Stock Index, U.S. investment-grade bonds are represented by Barclays U.S. Aggregate Bond Index, and Developed ex-U.S. government bonds are represented by Citigroup WGBI Non-USD Denominated Index.

S&P 500 index is an unmanaged index of U.S. common stock performance. Ibbotson Associates U.S. Small Stock index is an unmanaged index that measures the performance of the small-cap segment of the U.S. equity universe. Barclays U.S. Aggregate Bond index is an unmanaged index of domestic debt issued by the U.S. government, its agencies, and U.S. corporations. Citigroup WGBI non-USD Denominated index is a market capitalization-weighted index of the global government bond markets.

By adding alternative investments to a traditional portfolio, an investor may reduce portfolio volatility and improve the opportunity to experience increased returns over the long term.

Beyond their ability to reduce risk as portfolio diversifiers, many alternative strategies exhibit very low volatility when considered in isolation. An alternative strategy with low or even negative correlation to market returns can and will reduce the potential volatility of an investment portfolio.

In an environment of higher volatility, lower interest rates and unreliable correlations, investors must look beyond yesterday’s asset allocation strategies. The objective of including alternatives in a risk-managed portfolio is to pursue adequate levels of return under normal to favorable market conditions, but seek to limit losses when market conditions are poor.

Alternative categories like commodities, real estate, private investment and structured financing represent alternative asset classes that have a low correlation historically to traditional asset classes.
Each of these alternative categories and classes may offer greater risk management potential than a portfolio comprised of traditional assets only.

2. A COMPLEMENT OF ALTERNATIVES CAN IMPROVE A PORTFOLIO’S TOTAL RETURN

Diversifying beyond the traditional investments like stocks, bonds and mutual funds has been a critical element in the investment success of institutions for scores of years.

Institutional allocations to alternatives have not only been outstripping traditional equity and bond investments over the two years, the pace has been accelerating.

The reason:
- The returns on most fixed income vehicles are negligible
- Equity exposure is still proving too volatile for many

<table>
<thead>
<tr>
<th>Traditional assets</th>
<th>Alternative categories</th>
<th>Alternative assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stocks</td>
<td>Commodities</td>
<td>Precious metals</td>
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<tr>
<td></td>
<td></td>
<td>Oil and gas</td>
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<tr>
<td></td>
<td></td>
<td>Managed futures</td>
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<tr>
<td>Bonds</td>
<td>Real estate</td>
<td>Residential</td>
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<td></td>
<td></td>
<td>Commercial</td>
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<td>Deeds of trust</td>
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<tr>
<td>Cash</td>
<td>Private investment</td>
<td>Private equity</td>
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<td></td>
<td></td>
<td>Private debt</td>
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<tr>
<td></td>
<td>Structured financing</td>
<td>Structured settlement</td>
</tr>
</tbody>
</table>

University endowments overwhelmingly favor alternatives in portfolios designed to last centuries

<table>
<thead>
<tr>
<th>Alternative strategies</th>
<th>53%</th>
</tr>
</thead>
<tbody>
<tr>
<td>International equities</td>
<td>17%</td>
</tr>
<tr>
<td>Domestic equities</td>
<td>16%</td>
</tr>
<tr>
<td>Fixed income</td>
<td>10%</td>
</tr>
<tr>
<td>Short-term securities and cash</td>
<td>4%</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
</tr>
</tbody>
</table>

Alternatives are the favorite choice for major university endowments

For institutions still concerned that alternatives may represent too great a departure from conservative money management principles, a recent endowment report underscored the fact that the impact of alternatives on portfolios has actually provided more upside potential and less downside risk.

According to the NACUBO Commonfund Study of Endowments®, a membership organization representing more than 2500 colleges and other education service providers, endowments returned an average of 19.2% net of fees during the 2011 fiscal year,1 the most recent data published. Of course, past performance is no guarantee of future results.


The robust growth of alternatives is putting a large flow of assets directly within reach of many investment managers and sponsors. Among the highest flows to alternatives, according to McKinsey and Company’s Mainstreaming of Alternative Investments, are those asset classes in private equity and real estate.
Alternate Routes: Four Ways
Alternatives can Optimize a Portfolio

By end of 2013, institutions are expected to increase their allocations to almost all forms of alternatives to 25% of portfolio assets, up from 23% in 2011.

There are other ways alternatives can contribute to an attractive degree of risk-adjusted return:

- **Cost-efficiency** Low fees contribute to higher returns. Holding alternative investments can be time-consuming and expensive. Utilizing a custodian like Equity Institutional that specializes in alternative investments can prove much more cost-effective. For a reasonable all-inclusive fee, clients receive unlimited transactions, too. (And, of course, we do not sell products or otherwise compete for your client’s attention.)

- **Ideal for optimizing retirement plans** Thanks to IRS rules surrounding acceptable investments in IRAs, you can tap into the multi-trillion retirement market. We’ll show you how to include popular alternatives like real estate, precious metals and other commodities into your retirement plan strategies. The IRS code does however exclude collectibles and life insurance from allowable investments. Equity Institutional’s experienced professionals can help clarify for you whether a specific investment can be held in a retirement plan or not.

3. **VARY LIQUIDITY EXPOSURES FOR GREATER PORTFOLIO DIVERSIFICATION**

From private placement products to managed futures mutual funds and everything in between, alternatives offer professionals and investors a wide variety of ways to vary their liquidity exposures.

For daily liquidity, look to alternative mutual funds. Fully liquid, non-correlated assets can help financial professionals provide their clients with a tool to let them access their resources without sacrificing a lot of return potential.

To lock up an investment to let it grow over time, limited liquidity has its advantages, too. Restrictions on liquidity to quarterly or annual redemptions provide a money manager with a greater degree of control over managing the portfolio to increase return.

**Without having to maintain a substantial cash position to meet shareholder redemption demands, a manager can then make larger and more lasting commitments to a real estate or private investment strategy.**

Limited liquidity investments are appropriate for well-capitalized investors who do not require continuous access to their assets. University endowments, for example, increasingly prefer private equity holdings to publicly traded equity shares. Information is available through Equity Institutional on the various types of liquidity features available through alternative investments.

4. **EMPLOY ALTERNATIVES TO CREATE TARGETED BEHAVIORS**

Unlike the adverse perception of some investors that alternatives are confusing and complex, these investments, in the hands of an experienced professional, can be employed in very strategic ways to achieve certain targeted and measurable portfolio objectives.
Alternate Routes: Four Ways
Alternatives can Optimize a Portfolio

By working with an alternative investment expert, investors can pursue such goals as these:

• Diversifying assets away from riskier portfolio components to preserve capital
• Adding strategies that can act as a hedge in the event of a market crisis
• Deploying opportunistic allocations to an off-setting alternative asset when appropriate

OPTIMIZING PORTFOLIO CONSTRUCTION

<table>
<thead>
<tr>
<th>1. Opportunistic</th>
<th>2. Designated</th>
<th>3. Mandate aligned</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not tied to the traditional equity and fixed income portfolio allocation, an alternative strategy can provide a client with a specific way to pursue a targeted total return or risk mitigation objective.</td>
<td>Where an allocation has been designated for an alternative, the advisor has a vast array of assets, strategies and investment structures from which to select.</td>
<td>More alternative-minded advisors will look to infuse a portfolio with a broad blend of alternative strategies to more fully engage with traditional long-only strategies already positioned in the portfolio.</td>
</tr>
</tbody>
</table>

| Description | Wants to add something special and differentiated for exceptional return potential | Looking for combination of alternative assets as well as a structured financing allocation to off-set a portfolio position | Looking to more fully complement each portfolio mandate with a specific alternative strategy |

<table>
<thead>
<tr>
<th>Alternative strategies</th>
<th>Commodities</th>
<th>Commodities</th>
<th>Commodities</th>
</tr>
</thead>
</table>
| 1. Opportunistic       | • Precious metals  
                         | • Oil and gas     | • Managed futures  
                         |                         | • Oil and gas         | • Managed futures  
                         |                         | • Oil and gas         |                         | • Precious metals |
| 2. Designated          |                         |                         |                         |
| 3. Mandate aligned     |                         |                         |                         |

<table>
<thead>
<tr>
<th>Matching Investor Profiles to Alternative Strategies</th>
</tr>
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</table>

Characteristics such as liquidity, transparency and regulatory oversight are paramount in determining the suitability of specific alternative investments to an individual investor’s objectives.

Much as a fingerprint provides unique identifying information for an individual, this type of multi-faceted analysis can provide guidance toward optimizing a portfolio for specific outcomes. Decreasing the risk of large drawdowns due to equity market volatility is crucial. In this regard, some alternatives might be able to help portfolio, but require careful selection, rigorous modeling and continuous monitoring.
A robust effort to implement alternative strategies can underscore the increased value advisors bring to their client relationships.

TIME TO CONSIDER THE ALTERNATIVES

Many private investors who have become successful and are no longer preoccupied with meeting their own lifestyle expenses turn their attention to providing for their beneficiaries. The capability for offering alternatives to offset the volatility of the markets while trying to improve investment returns can give a knowledgeable advisor a key competitive differentiator to offer their clients.

Optimal portfolio construction today requires the knowledge and expertise of professionals who know how to successfully select and deploy alternatives.

DISCOVER THE ALTERNATIVE LEADERSHIP ADVANTAGES OF EQUITY INSTITUTIONAL

As you consider the alternatives, take a closer look at the leading custodian in alternative investments: Equity Institutional.

When you put our powerful alternative investment capabilities to work for you and your clients, you immediately open up passageways between investment professionals and the marketplace and investment sponsors and new sources of funding.

Our firm is committed to creating a flexible and versatile business model for you that will bring new, alternative investment vehicles to the market through one integrated, passive custodian service resource designed to support you in what you do best: develop and distribute alternative investments.

Equity Institutional is especially qualified to facilitate the inclusion of a wide range of alternative categories in both qualified and non-qualified plans. As a back-office service resource, we are well-positioned to provide a seamless operational, administrative and business development alternative capability to:

- Advisors
- Broker-Dealers
- Investment Sponsors
- Precious Metals Brokers

YOUR VISION. OUR SOLUTIONS.

We’ll help financial advisors become more proficient in presenting the benefits of alternatives as they become more familiar with the roster of proven products available on our platform and expand their roles as trusted fiduciaries.

For investment professionals and sponsors who don’t want to get caught behind the curve, the shortest route to building a successful presence in the growing world of alternative investments is a near-term business partnership with Equity Institutional.
For broker-dealers, Equity Institutional can help optimize operational processes, while providing a valuable measure of compliance oversight in this evolving and complex marketplace.

For investment sponsors, we can serve as a catalyst for new funding opportunities as well as a platform for your core competencies.

For precious metals brokers, we serve as a proven back office resource to the nation’s largest precious metals providers.

FIND OUT WHY 10,000 FINANCIAL PROFESSIONALS HAVE CHOSEN EQUITY INSTITUTIONAL

As a division of Equity Trust Company, Equity Institutional is the industry’s oldest, largest and most-experienced custodian specializing in alternative investments. Since 1974, we have been serving institutional clients while setting the industry standard for outstanding service and leading-edge technology.

Our mission continues to focus on making it easy for clients to manage their alternative investment portfolios. With more than $12 billion under custody, our 130,000 clients include more than 10,000 of the nation’s leading financial professionals.

Why not consider an alternative investment strategy with Equity Institutional today? We’re here to help you take your business to the next level.

Equity Institutional is a passive custodian and does not provide tax, legal or investment advice. Any information communicated by Equity Institutional is for educational purposes only and should not be construed as tax, legal or investment advice. Whenever making an investment decision, please consult with legal, tax and accounting professionals.