

ALTERNATIVE INVESTMENTS: IMPLEMENTATION SOLUTIONS  
BY SAM MASEMER, CFA, CFP® AND ALYSSA BALLIN, CFS



QUAKER® FUNDS

**THE ALTERNATIVE INVESTMENT VALUE PROPOSITION**

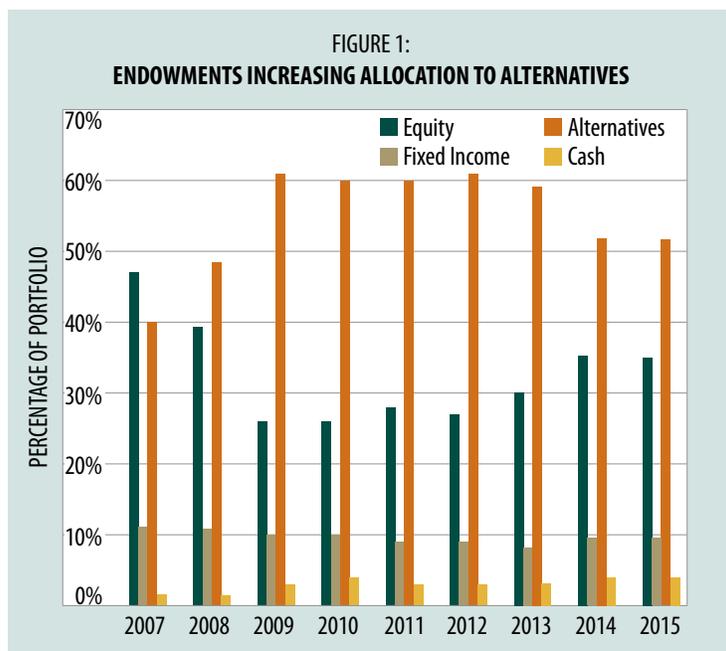
Heightened volatility and increased correlations<sup>1</sup> across equity markets have investors searching for non-traditional methods to enhance diversification within asset allocation models. Historically, alternative investments<sup>2</sup> have satisfied this enhanced diversification desire, but were only available to wealthy individuals and institutions. Today, alternative investments are available in a traditional mutual fund format for all investors. So how does an investor transition from a highly correlated portfolio to one that is well-diversified by allocating to alternative investments? One approach would be to study the asset allocation models of endowments.

“The allocation shift from equities to alternative investments by endowments appears to coincide with **rising equity correlations.**”

**ENDOWMENTS AND ALTERNATIVE INVESTMENTS**

Endowments have utilized alternative investments for diversification purposes for decades. In fact, the percentage by which they have allocated assets to alternative investments has recently spiked.

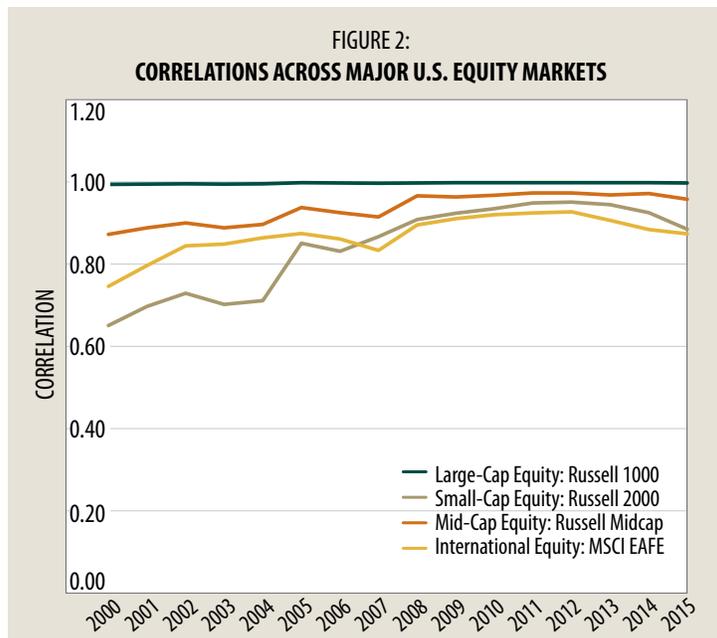
Figure 1<sup>3</sup> illustrates how endowments dramatically increased their allocation to alternative investments from 2007 to 2015. The primary funding vehicle utilized to increase the allocation to alternative investments was the equity portfolio. During this nine-year period, the percentage of total allocation to alternative investments increased, at times, by as much as 19% while equities decreased by as much as 17%. These allocation trade-offs were made in response to the rising correlations of traditional equity asset classes, which spurred endowments’ efforts to pursue greater diversification within their asset allocation models.



**DIVERSIFICATION INCREASINGLY DIFFICULT TO ATTAIN**

Approximately a decade ago, a modicum of diversification was achieved by investing across domestic equity market capitalizations, foreign equities, and fixed income.

Figure 2<sup>4</sup> demonstrates how investors’ ability to achieve diversification in the equity portion of an allocation has clearly changed, as the correlations of all domestic equity market capitalizations and foreign equities have increased significantly versus large cap domestic equities. The allocation shift from equities to alternative investments by endowments appears to coincide with rising equity correlations.



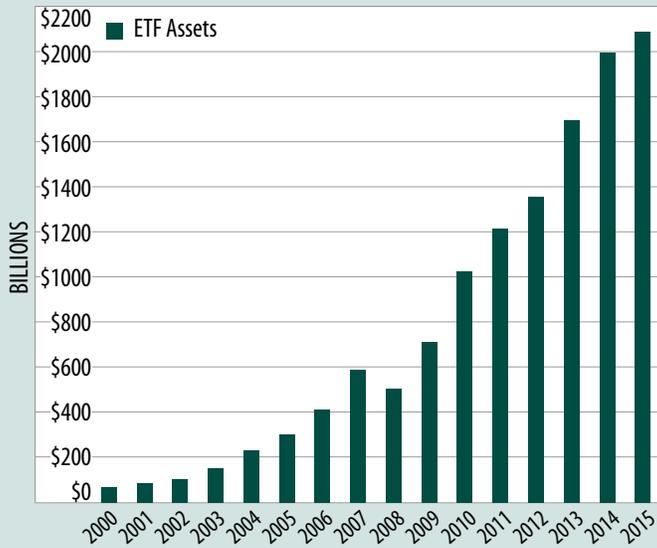
“...investing in lower market capitalizations no longer achieves the same level of **diversification.** The residual effect is primarily increased **volatility.**”

**ARE HIGH EQUITY CORRELATIONS HERE TO STAY?**

It is difficult to believe there could be a meaningful decrease in correlations in the near term. It is our observation that one of the main causes of rising correlations in equities is the proliferation of exchange traded fund (ETF) assets. There appears to be a causal effect between increasing assets under management of U.S. ETFs and rising correlations across equity market capitalizations.

Figure 3<sup>5</sup> illustrates the explosive increase in the growth rate of ETFs. This continued growth year after year leads us to conclude that high equity correlations could be here to stay.

FIGURE 3:  
GROWTH OF U.S. ETF ASSETS

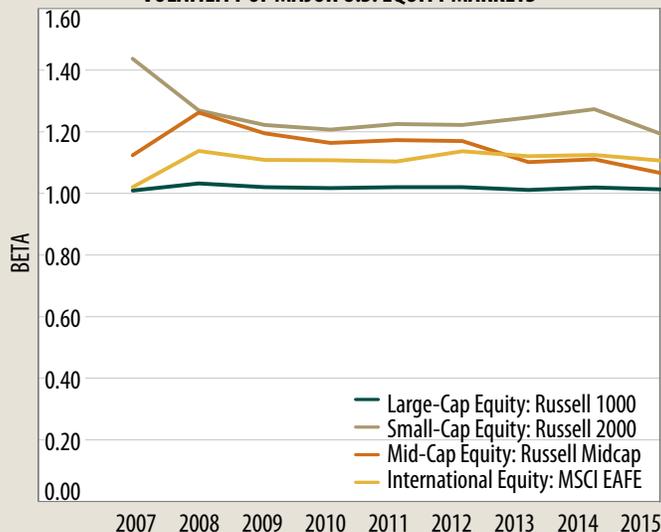


### HOW CAN INVESTORS INCREASE THEIR ALLOCATION TO ALTERNATIVE INVESTMENTS?

Pairing asset classes and investments that are lowly correlated can potentially reduce portfolio volatility. We have demonstrated how endowments have decreased their exposure to equities by redistributing these assets to alternative investments.

An individual investor contemplating this same course of action must determine what equity risk profile is appropriate to achieve their goals and if they are comfortable with the associated risk. Figure 4<sup>6</sup> illustrates the volatility (represented by rolling five-year beta<sup>7</sup>) of major equity asset classes as compared to the large-cap domestic equity asset class. The graph illustrates how the highly correlated domestic equity sleeve becomes more volatile as market capitalizations decrease. Therefore, assuming that most investors have an allocation to large-cap equities, investing in lower market capitalizations no longer achieves the same level of diversification. The residual effect is primarily increased volatility.

FIGURE 4:  
VOLATILITY OF MAJOR U.S. EQUITY MARKETS



“By redistributing a portion of the equity allocation to alternative investments, investors could improve their portfolio **diversification** while potentially creating a smoother **return** stream.”

### DIVERSIFICATION THROUGH REDISTRIBUTION OF ASSETS TO ALTERNATIVE INVESTMENTS

Investors looking to redistribute assets to alternative investments can look to the equity sleeve of their asset allocation mixes for highly correlated sources of risk. These highly correlated risks have not provided the desired diversification benefits. Therefore, the transition from high-correlation to diversification can begin when investors determine what portion of their equity sleeve provides tolerable risk/reward characteristics, then consider redistributing the remainder to alternative investments. By redistributing a portion of the equity allocation to alternative investments, investors could improve their portfolio diversification while potentially creating a smoother return stream. 

*One cannot invest directly in an index. Diversification does not assure a profit or protect against loss in a declining market. Alternative investments may result in additional risk due to their complexity and possible illiquidity and require specialized investment expertise. Investments in smaller companies involve additional risk such as limited liquidity and greater volatility than larger companies.*

### ENDNOTES

- 1 Correlation is a statistical measure of how two securities move in relation to each other as measured by the correlation coefficient, a statistic that ranges in value from -1 to +1, indicating a perfect negative correlation at -1, absence of correlation at zero, and perfect positive correlation at +1.
- 2 Alternative Investments are those that fall outside the traditional asset classes of stocks, bonds and cash.
- 3 Asset Allocations by Endowments With Assets Greater Than \$1B from 2007 to 2015. Source: National Association of College and University Business Officers.
- 4 Correlation from 2000 to 2015 (60-Month Moving Windows, Computed Yearly). Source: Zephyr StyleADVISOR®.
- 5 Growth of U.S. ETFs from 2000 to 2015. Source: <http://investwithanedge.com/etf-stats-for-december-2015-actively-managed-etf-assets-overtake-etns>.
- 6 Beta from 2007 to 2015 (60-Month Moving Windows, Computed Yearly). Source: Zephyr StyleADVISOR®.
- 7 Beta measures the variance of a security or portfolio, or its volatility, compared to that of the market as a whole.

**Mutual fund investing involves risk, including the possible loss of principal.**

***Consider a fund's investment objectives, risks, charges, and expenses carefully before investing. The Statutory, and where available, the Summary Prospectuses contain this and other important information and are available for download at [www.quakerfunds.com](http://www.quakerfunds.com) or by calling 800.220.8888. Read carefully before investing.***

Contact us:

Quaker® Funds, Inc.

c/o U.S. Bancorp Fund Services, LLC

P.O. Box 701

Milwaukee, WI 53201-0701

800.220.8888

[www.quakerfunds.com](http://www.quakerfunds.com)

©2016 Quaker® Investment Trust



**QUAKER® FUNDS**

The Quaker® Funds are distributed by Foreside Fund Services, LLC.

QKAI 122015