GUIDE TO ALTERNATIVE INVESTMENTS

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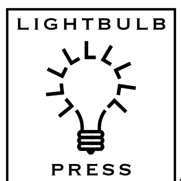

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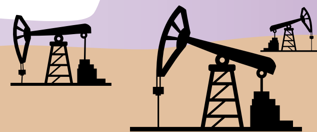
ALTERNATIVE INVESTMENTS

A Range of Alternatives

Investors seeking greater portfolio diversification are increasingly moving into alternative investment programs.



ENERGY

EQUIPMENT LEASING

One feature that makes investments described as alternative different from those considered traditional is—in most cases—the degree to which an investor is directly exposed to the success or failure of a specific undertaking.

ENERGY INVESTMENTS

Alternative energy programs raise money to invest directly in exploring and drilling for oil or natural gas. The program buys or leases land under which its sponsor or management team believes hydrocarbons can be extracted profitably. It also secures the necessary permits and installs the equipment required to drill wells, pumps the oil or gas to the surface, and arranges for its transportation to storage and refining facilities. If the venture is successful, the program provides income over the productive life of the well or wells. If it's not, for whatever reason, the program yields a loss.

Energy programs are generally structured as **limited partnerships**, with one or more **general partners** and a number of **limited partners**. The general partner is responsible for running the project and is personally liable for its potential losses. The limited partners provide investment capital, which they could lose, but have no control over the decisions the partnership makes and no responsibility for any debts it may incur.

Partners in an energy program may enjoy a number of tax benefits, including deductions for intangible drilling costs (IDC), a depreciation allowance for the tangible drilling costs, and a depletion allowance. All these can reduce taxable investment income. However, while general partners may take these deductions and allowances against ordinary income, limited partners may take them only against passive income. And the rules are complicated, so claiming these benefits requires the advice of a tax professional.

While there may be significant profits from successful energy programs, there are also significant risks. These include, among others, production risks, operational costs, fluctuations in market price, and the consequences of potential spills or other adverse affects on the environment.

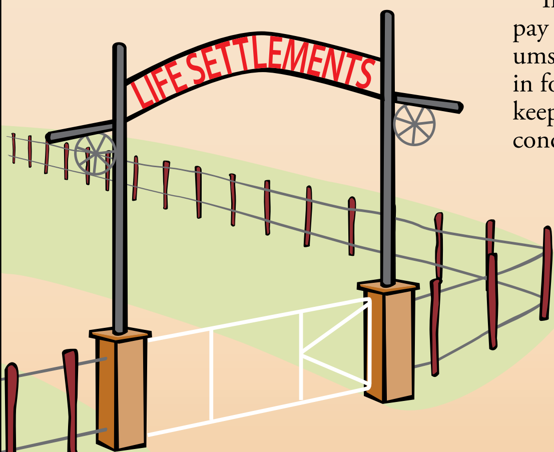
LIFE SETTLEMENTS

In a **life settlement**, the owner of a life insurance policy sells it for more than the cash settlement value he or she would receive for surrendering the policy but less than the face value that the beneficiary would receive at the insured's death. The policy owner and the insured may or may not be the same person.

The third-party purchaser is typically a company known as a life settlement originator or provider. The firm works with life settlement brokers to identify policies to buy and sells either individual policies or interests in its portfolios of policies to investors. Some but not all originators are licensed or regulated by the state where they operate.

Investors make a cash payment and pay their share of the ongoing premiums that keep the underlying policies in force and the administrative costs of keeping track of the insured person's condition, obtaining death certificates, and valuing the policies.

The investment return on a life settlement is a pro-rated share of the death benefits when the insured parties die. The risk is that more time will pass before the deaths occur than investors were led to expect. This increases the amount that must be paid in premiums but not the death benefit. There's also a risk the insurance company that issued the policy will refuse to pay the death benefit or that the insured's heirs will challenge the sale.



EQUIPMENT LEASING

Equipment leasing programs offer businesses an alternative to purchasing hard assets that may be extremely expensive, likely to become obsolete quickly, or both. The programs raise capital to purchase the equipment from investors who expect to receive a steady stream of income as a pass-through from the payments the lessees, or equipment users, make.

The contracts that govern these arrangements specify the lease term, the recurring payment, and termination provisions, which may include returning the asset in good condition, the option to renew at a favorable rate, or the right to buy the equipment.

In addition to regular income, participating in leasing programs may be attractive for the potential tax benefits, specifically, accelerated depreciation of an investor's share of the cost of the equipment. In addition, equipment leasing programs can serve as a hedge against both inflation and recession, and when interest rates are low, be an attractive substitute for conventional fixed-income investments.

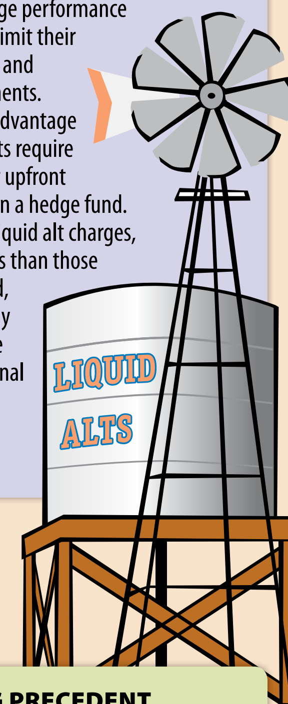
There are risks, however, that may reduce cash flow or put capital at risk. While equipment can be reclaimed in a default, the process can be protracted and costly. Outdated or damaged equipment can be difficult to re-lease or sell. And, in the absence of a secondary market, an investment in a leasing program is generally illiquid.

ALTERNATIVE MUTUAL FUNDS

An investment in an alternative mutual fund, or liquid alt, means putting capital to work in a non-traditional way since the fund invests using hedge fund strategies or attempts to reproduce hedge fund returns. But, unlike most direct investing programs, a liquid alt shares many features with conventional mutual funds.

Among other things, they must comply with SEC regulations that require transparency, disclosure, and daily calculation of net asset value (NAV). They can't charge performance fees and must limit their use of leverage and illiquid investments.

A primary advantage is that liquid alts require a much smaller upfront investment than a hedge fund. But the fees a liquid alt charges, while much less than those of a hedge fund, are substantially higher than the fees on traditional funds with no guarantee of a higher return.



A LEASING PRECEDENT

From the carriages and the horses that pulled them in the 1700s to the railroad cars and the engines that powered them in the late 1800s, leased equipment has been an integral part of US business. Today's equipment leasing programs, with their third party investors, evolved gradually as a way for businesses to secure necessary equipment without a huge capital outlays or being saddled with obsolete property.

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Suitability and Accreditation

Alternative investments require thoughtful consideration.

An investment portfolio of traditional investments may provide satisfactory investment returns. But allocating a percentage of the portfolio to alternative investments may provide the opportunity for greater diversification, more current income, and the possibility of substantial capital gains. That's the premise underlying the increased attention to alternatives over the past decade or two.

However, investing in alternatives isn't as straightforward as buying a stock or a bond, a mutual fund, or even an equity option. So the sponsors who offer these investments and the broker-dealers and financial advisors who market them are responsible for making sure that investors understand the risks as well as the potential return of committing their capital. Broker-dealers and advisors are also required to determine whether an investment they may recommend is suitable for a particular client.

THE ROLE OF A BROKER-DEALER

Suitable, in the context of the financial marketplace, means that an investment is an appropriate choice for an investor to make.

As a first step, there must be a thorough evaluation of the offering or program using the materials the sponsor makes available and what can be discovered through independent assessment, often by engaging the services of a third-party expert. This process, known as due diligence, involves reviewing the prospectus, offering circular, or private placement memorandum, and other public materials when they're available, researching the investment's sponsor and the management team, and, in some cases, conducting on-site inspections and interviews.

But that's only half the task. The broker-dealer's second responsibility—as laid out in FINRA Rule 2111—is having reasonable assurance that an investment deemed suitable in its own right is appropriate for a specific investor based on a number of factors including the investor's age, other portfolio holdings, risk tolerance, financial situation, and liquidity needs. In doing a suitability assessment, a broker-dealer must also consider whether the individual understands illiquidity, how fees affect return, and the potential tax consequences of making the investment. FINRA doesn't require broker-dealers to keep documents showing an assessment was made, though keeping good records can be important if a recommendation is questioned. On the other hand, FINRA maintains that having documentation of an assessment is not an acceptable remedy for an unsuitable recommendation.

Under state regulations, special suitability rules requiring that the broker-dealer or financial advisor know the investor personally may apply to certain private placements. And in some cases, investors may be required to seek advice from a knowledgeable person who can evaluate the investment independently.

The bottom line is than an investment that's perfectly suitable for one client may not necessarily be suitable for another.

Of course, investors bear some responsibility for assessing the wisdom of adding particular securities to their portfolios. This is especially true in the area of potential liquidity needs, which may be difficult for an outside observer to judge.

THE SPONSOR'S ROLE

An investment's sponsor who sells interests in an alternative or employs people who do is responsible for making a reasonable effort to determine whether an investment is suitable for prospective investors and that they understand the risks and benefits that are involved. In addition, the sponsor must confirm in the final prospectus their responsibility to assess suitability. They must also retain records of the information they use to make a suitability determination for a minimum of six years.

Investors may be required to sign a subscription agreement to acknowledge that they have read the prospectus and understand the degree of an investment's illiquidity. However, they will not be asked to sign anything that holds them to a subjective statement, such as whether or not they believe the investment is suitable for them.

PRIVATE PLACEMENTS

Although the issuer of a security that's exempt from registration and available only to accredited investors doesn't have to provide a prospectus or audited financial reports, the FINRA suitability rule applies when broker-dealers recommend the placement to an existing or potential customer—provided the customer acts on the recommendation and buys the security through the broker-dealer.

FINRA recognizes, though, that customers may not share all relevant information with a broker-dealer, limiting his or her ability to come to an accurate conclusion. So the regulator generally requires reasonable diligence as the basis for determining suitability, provided no obvious red flags are overlooked.

OTHER PROTECTIONS

The SEC and NASAA set certain standards that individuals must meet to invest in alternative investments that don't apply when they buy traditional securities.

To invest in a private equity partnership or a hedge fund, investors must be **accredited**. The SEC defines accreditation as having a net worth of at least $1 million excluding the value of the investor's primary residence or an annual income in the most recent two years of $200,000 for singles or $300,000 for married couples.

To participate in certain private placements, investors must be considered **sophisticated**, which means, among other things, having a minimum net worth of $2.5 million and an annual income of $250,000. And to invest in large hedge funds, investors must be **qualified purchasers**, with an investment portfolio worth $5 million not including fine art, real estate, or personal property.

NASAA guidelines for investment in non-traded REITs are currently a minimum net worth of $250,000 or an annual income of $70,000 plus a minimum net worth of S70,000. The organization has proposed increasing those amounts.

Some state regulators require that investors commit no more than a specific percentage of their portfolios to alternative investments, although those standards vary.

SEC AND NASAA STANDARDS

	Net Worth at Least:	Annual Income at Least:
Accredited	$1 Million	$200,000 Single $300,000 Married
Sophisticated	$2.5 Million	$250,000
Qualified Purchaser	Investment Portfolio of $5 Million	
Non-Traded REITs	$250,000 or $70,000	 $70,000

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