BREAKING: Dow, S&P turn negative; consumer staples, utilities lead declines

Stock market got you down? Take a look at the alternatives

Sarah O'Brien, special to CNBC.com

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If you're disappointed with your portfolio's returns and are looking for other options, there are alternative investments. Literally.

So-called alternative investments are generally defined as anything that falls outside traditional stock and bond investments and whose role is to potentially zig when the broader markets zag. The goal is to mitigate portfolio volatility, hedge against downsides and boost portfolio returns in a way that is not tied directly to the stock market's performance.

"Stock and bond returns will be strained for the next three to five years, so it makes sense to [consider] other sources of returns," said certified financial planner Mark Wilson, chief investment officer for The Tarbox Group. "But be aware of what kind of risk you are adding to your portfolio."

The stock market, as measured by the Standard & Poor's 500 index, gained a meager 1.2 percent last year (including reinvested dividends). And so far this year, the S&P is in negative territory.

The bond market's returns, meanwhile, have languished in the range of 1 percent to 2 percent for at least five years. And although the Fed raised its benchmark interest rate in December, returns on bonds won't change much.

While risk is definitely involved with alternatives, not all are more risky than stocks. And some are more easily understood than others.

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gain?

Wilson explained that, given how poorly the bond market is doing, his firm has moved fixed-income assets for some clients into other investments.

"We're taking a risk, but we don't expect [that risk] to be as high as the stock market," he said.

One alternative his firm increasingly has been using is called an interval fund. These operate largely like traditional mutual funds but invest in less-liquid asset classes, such as reinsurance or various real estate opportunities. And there are only certain times you can buy into the fund or unload your shares (thus, the "interval" tag).

Wilson's firm uses, for example, a reinsurance fund through Stone Ridge Asset Management, which generally offers such funds only to registered investment advisors.

> "I'd be very careful of trying new strategies just because they're new. If it doesn't fit into the strategic framework of the ... portfolio, it really doesn't make much sense to do it."
>
> -Shon Anderson, president and chief wealth strategist at Anderson Financial Strategies

But, Wilson said, "I think this type of fund will become more widely available over time."

Basically, reinsurance is insurance for insurance companies. Just like a person buys homeowner's insurance so he or she isn't bankrupted by a destroyed house, insurance companies buy insurance to protect themselves against being unable to cover claims in the event of a catastrophe. And even those reinsurers buy some kind of coverage.

In simple terms, reinsurance allows the risk to be spread out among insurers rather than borne by just one company. While there is no guarantee of a return, funds that invest in reinsurance are uncorrelated to the stock market.

And in the event of a catastrophe, such as a hurricane or tsunami, a complicated system of contracts among insurance companies allows huge claims resulting from a catastrophe to be absorbed by many insurers on a global scale.

Frontier investors go west ... east, south, north

"The risk is that there would be a string of disasters in any given year," said Jeff Nauta, a CFP and principal with Henrickson Nauta Wealth Advisors. "If you were only exposed to, say, hurricanes in Florida, or to only a tsunami in Japan, or only a plane crash, that would come with significant risk," he said, adding, "But if [the risk] is spread out ... the odds are that all of those catastrophes won't happen in any one year."

Nauta explained that if there is an insurance event, the yield drops. "But in general, we expect about an 8 percent return," he said. "And it has a

Also found in the insurance investment space are life settlements. These involve the sale of a life insurance policy to a third party, typically an investment company. The policy owner gets a cash payment in exchange for surrendering the policy to an investor who takes over paying the premiums and gets the death benefit when the original owner passes away.

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While a bit morbid, the life settlement market exists for a reason: Some policyholders need the cash settlement while they are living, as opposed to leaving money behind.

"We were concerned we'd have some pushback from clients, due to the morbidity of this asset class, as we rolled out our first investment [in this space] over a year ago," Nauta said. "But we haven't had any pushback."

He pointed out that clients can have a hard time understanding some alternatives and their low correlation to the stock market, but life settlements — like reinsurance funds — are fairly easy to grasp.

"They can see there is no tie to the stock market or the fixed-income market; that's when the importance of low correlation is easier to understand," Nauta said.

Woman Center Stage

Why alternative funds are taking center stage

Also becoming more accepted is the idea of peer-to-peer, or marketplace, lending. The idea is that through funds, you lend money to people in the form of unsecured credit.

The two best-known peer-to-peer lending companies are Lending Club and Prosper. You can go to their websites either as a borrower or an investor. In the quarter ended Sept. 30, 2015, Lending Club had funded more than $2.2 billion in loans.

While such investments' worth has yet to really be tested during a market downturn, when consumers are more likely to default on loans, Nauta said that because interest rates on unsecured consumer credit has remained relatively high (compared to, say, mortgages), even defaults can still translate, in the aggregate, to a respectable return.

"The idea is that we're spreading our money out among hundreds of different loans," Nauta said. "And depending on the credit risk, the return can still potentially be much higher than what you'd earn in any kind of similar fixed-income investments."

LendingClub reports first profit since IPO

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CFP Shon Anderson, president and chief wealth strategist for Anderson Financial Strategies, takes a different alternative strategy to seeking higher returns for clients.

"We're taking some equity allocation, and instead of using [exchange-traded funds] or mutual funds that have hundreds of positions, we are taking very specific risk," Anderson said.

Basically, he allocates up to 10 percent of a client's portfolio to 10 stocks that he deems as potential big performers.

"They are deep-value, swing-for-the-fences kind of stocks," Anderson said. "If done correctly, you can add one or two percentage points to a diversified return."

Hedge Fund **Time for investors to place bets on hedge funds?**

Whe[illegible] stocks hit the target price — determined by an average industry analyst perspective — the gains are taken, and new deeply disco[illegible]d stocks are screened for their worth.

Anderson said if an investor has the time and interest to pay close attention to their portfolio and to market dynamics, it's possible to find stocks that fit this strategy.

He and other advisors caution that investors should never just jump on a potential investment without fully researching it first, just because others are doing it.

"I'd be very careful of trying new strategies just because they're new," Anderson said. "If it doesn't fit into the strategic framework of the [investor's] portfolio, it really doesn't make much sense to do it."

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