MarketWatch

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Know what you own — your broker might not

Commentary: 'No fracking way' you need most alternative investments

By Chuck Jaffe, MarketWatch

BOSTON (MarketWatch) — Somewhere between tee and green, the doctor in David Brady's foursome told the group that his broker had said he "needed a fracking play" in his portfolio, and that he had spread some money across a few different fracking stocks.

So Brady, who runs Brady Investment Counsel in the Chicago area, asked the doc if he knows what fracking is.

After an incoherent sentence and a moment of silence, "it was pretty embarrassing for both of us," Brady recalled. "The problem wasn't just that the doctor didn't know it, but that the broker — the person who was managing all of his money — hadn't explained it well enough for him to know. He was trusting them completely, and the silence was awkward I think because everyone realized how vulnerable that actually makes an investor."

Do I believe most brokers could explain why an investor needs exposure to "hydraulic fracturing" — which is often confused with drilling but technically comes after drilling to break apart rock, release gas and "complete" the process of capturing the natural resources?

No fracking way.

Is it possible ordinary investors are being talked into trouble? You better fracking believe it.

That's not a knock on fracking itself, but rather on the class of investments pure-play fracking stocks belong to — the realm of "alternative" investments.

Unattractive alternatives

A study released last week by American Century Investments indicated that a growing number of financial advisers are using alternative investment strategies. Four out of five study participants currently use "alts" with clients; that grows to nine out of 10 when it comes to brokers from the big investment firms, such as Brady's doctor friend.

Overall, advisers are using alternative strategies with about one-third of their client base, but those with “extensive” experience with alternatives use them with roughly half of their clientele.

More important, however, is that 55% of the advisers surveyed expect to use even more of these investments. In fact, their usage is looking so mainstream that it’s hardly “alternative” at all.

Technically, an alternative investment doesn’t have to be obscure and esoteric. Say “alternative,” and most people think of hedge funds, commodities or funds with hedge-like strategies, effectively the things rich folks used to do that the ordinary investor didn’t have access to until recently.

Other common asset classes — including gold and precious metals, “natural resources”, real estate and real estate investment trusts, currencies, private-equity directly into companies and more — typically fall under the alt umbrella too.

While the advisers still prefer using traditional mutual funds and ETFs for their alternative exposure — and there’s not that much in your typical gold or precious-metals fund that would leave a buyer confused — more than 40% said that regardless of the tools they use, the biggest challenge associated with alternative investments is that it’s “difficult to explain features, benefits and risks to clients.”

Even when they explain it “successfully,” the client might not get it. After all, the doctor’s broker succeeded in getting him to go for the fracking plays, even if he had no real clue of what he was doing.

“The driver toward alternatives is the market volatility of the last few years,” said Chris Doyle, a spokesman for American Century, which just this week announced three new alternative portfolio funds.

“People are looking for ways to create a smoother ride,” he noted. “They want to find whatever that investment is that won’t move the same way as the equity or bond market. They want something that zigs when the rest of the market is zagging. … It’s not about screeching returns, it’s about coming up with something consistent that they can rely on in all market conditions.”

Be a careful buyer

Yet consistency and investing don’t go hand in hand. At the extreme, the promise of consistent returns seduced Bernie Madoff’s clients. They were lured by a strategy that they didn’t understand and couldn’t explain — which Madoff wasn’t actually following anyway as he built the world’s biggest Ponzi scheme — because of a strong and understandable desire consistent returns. They stopped asking questions and suspended all doubt and disbelief.

There’s no comparing Madoff’s billion-dollar fraud with an ordinary precious-metals fund or a natural-resources stock. The comparison lies in the attitude of investors and financial advisers who seem to have forgotten the lessons of the recent past.

“I find it hard to believe — this close to 2008 and Bernie Madoff — that financial planners are finding an appetite for out-of-the-box investments,” said New York Times reporter Diana Henriques, author of “The Wizard of Lies: Bernie Madoff and the Death of Trust.”

“If there was ever a time to get back in the box,” she said, “it would seem to be in the aftermath of ‘08, when we saw so many esoteric investments blow up, and take everyone with them, whether it was sophisticated investors or ordinary people.

Delve into the details

Investment buzz words like “fracking” are portfolio buzzkills. Whether it is “alternative investments” or “fracking,” no one wants to seem like the one at the table who is clueless.

But if you can’t understand what you own, you’re out of control.

“People don’t want to know the details,” Brady said, “so they get fed the latest buzz word, they pick up on it without knowing what it really means and toss it around like it makes them smart, without recognizing that mostly it has generated extra fees for the guy who sold it to them without fully explaining it.

“There’s a good case for fracking stocks,” Brady added, “I just don’t think most people – whether it’s the doctor, the broker or most investment pros — can say why a pure fracking play is ‘necessary,’ how it will impact your returns and smooth things out compared to something else you might own in a diversified portfolio. The same goes for most of the alternative investments being sold today.”

Take the test that the good doctor failed with Brady on the golf course: Look at your portfolio and think about whether you could tell an independent expert what each investment not only does, but how it is supposed to work with other holdings.

Lacking that understanding, the alternative you have invested in is “hope,” as in “I sure hope this turns out right,” because the truth is you don’t have a fracking clue of whether your investments have real potential to deliver you to your financial goals.