# Hear ye, Hear Ye, individual investors:  Be wary of new investment asset classes

**Category : Asset Allocation and Personal Investment Risk Tolerance Articles**

**Published by** The Skilled Investor on Jun/6/2007

Hear ye, Hear Ye, individual investors:  Be wary of new investment asset classesMany promoters in the financial services industry have shown a strong proclivity in recent years to invent and to market supposedly "new" investment asset classes. Industry advocates will claim that these new asset classes deserve some minimum percentage allocation within your investment portfolio. These supposed new asset classes have included "commodity futures," "managed futures," "precious metals," the 57+ varieties of "hedge funds," and other asset class inventions. While some of these investments are newer, many, such as commodity futures, have been around for a very long time. What tends to be "new" about these asset classes is the increased effort by the industry to sell them to "retail" or individual investors through the broker and advisor channels. Oddly, these newly discovered asset classes for individual investors also have been characterized by relatively high sales charges, high broker/advisor compensation incentives, and high ongoing professional management costs -- all paid by guess who?  ... You.   The primary theoretical justifications for promoting these new, alternative asset classes to individual investors have been two-fold. First, risk-adjusted historical returns for these new asset classes may have seemed higher than returns for the traditional cash, bond, and stock portfolio asset classes. Second, the volatility of returns for these new asset classes might have been relatively uncorrelated with the price fluctuations of the more traditional bond and stock portfolio assets of individual investors. Many individual investors are susceptible to sales pitches for new asset classes, because these investors have heard that they need to allocate their investment portfolio across asset classes to achieve diversification and to align their personal tolerance for investment risk with the risk characteristics of their portfolio assets. Investments that historically have been considered to be much more speculative and only appropriate for more sophisticated investors have been declared new asset classes. If these securities instruments are sold as asset classes, then they may find their way more easily into the average investor's portfolio. If something is an asset class, then gosh, you just gotta have some percentage of your portfolio invested in that asset class, don't you? Perhaps. Perhaps not.   In addition, many individual investors naively extrapolate superior historical price trends into the future. They repeatedly chase performance from one investment to another. Since a great number of investors are always looking to beat-the-market, these investors are already primed to listen to a pitch about a new asset class with unusually high historical returns.

In a similar vein, many investors strongly prefer investments with superior historical returns, yet do not realize that historical performance tends to be largely useless in selecting investments that will have superior performance in the future. This explains much of the widespread mania to select only mutual funds, ETFs, and stocks with 4 star and 5 star Morningstar Ratings. Objective, independent studies have indicated that mutual fund investments with high star ratings tend to lack predictive power. These studies have show that these simplistic star ratings themselves are highly unstable over time. Individual investors rarely hear about this. Instead, brokers and investment advisors know that individuals think 4 and 5 stars are better, so that is what they feed to their clients for easier sales. (For more information on these ratings, see  *The Skilled Investor's* articles in this category:  Rating Services - Morningstar [16 articles]. )Since these investors have naive faith (often undampened by past failures to beat the market) that they are going to beat the market in the future, they may be willing to pay much more to the industry to aid them in these attempts at market beating. Many investors do not stop to ponder why financial industry sales people show up to sell them something. Not surprisingly, financial sales people get paid to sell and those who listen to them tend to foot the bill. If there is no sales incentive, no one would show up to tell these individuals what to buy. Unfortunately, these new alternative asset classes being promoted may have very high investment costs. One of the most durable findings in the scientific finance literature is that higher costs create a greater drag on your likely net returns. (For more information on investment costs, see *The Skilled Investor's* articles in this category: Controlling Investment Costs [15 articles]. ) Another justification for these new asset classes is their supposed contribution to diversification and overall portfolio risk reduction. Volatility of returns for these new asset classes may have had a lower or even negative correlation in the past relative to the traditional stock/equities asset class. This less than 100% correlation allegedly would reduce the risk of your overall portfolio in the future. Whether this is likely to be true cannot be known until the future arrives. (For more information on diversification and securities market returns, see *The Skilled Investor's* articles in these categories: Diversify Assets [12 articles], Returns and Risk Premiums [10 articles], and Securities Valuation [4 articles]. ) These new asset classes also may have relatively high standalone "asset class" price volatility. If the new "asset classes" have relatively high standalone price volatility, then they could add to rather than reduce the inherent risk of your portfolio. Equities volatility tends to increase significantly at the bottom of market cycles, just when you do not want it to. What might happen to the price volatility of these new asset classes at the bottom of the same market cycles? Will their volatility offset the increased volatility of stock-equity securities? Or, will the volatility of these new asset classes increase in the same down cycles? (For an article on stock volatility across market cycles see *The Skilled Investor's* article: How do changes in common stock price volatility affect portfolio diversification? ) Finally, the financial science to support these new asset classes may also be weak. Perhaps even some data mining was used, when these new asset classes were recently discovered. Data mining involves statistically analyzing a broad range of historical trends and then selecting only those that allegedly demonstrate superior historical trends that have "beat-the-market" in the past. New asset class sales presentations might include some discussion of the "alpha" that this asset class would have delivered to investors in the past. (Alpha is a term used to describe an investment manager's supposed skill-based contribution in excess of some appropriate passive market return benchmark.) Whether appealing historical price growth trends for these new asset classes will continue into the future is anyone's guess. Whether lower price volatility correlations with the traditional bond and stock asset classes will continue into the future is anyone's guess. Whether the new asset class investment manager will exceed an appropriate benchmark index in the future by enough of a margin to exceed his much higher costs is anyone's guess. A skeptic might bet against these guesses and keep a tight hand on his investment wallet. (See these related investment skill and investment cost articles on *The Skilled Investor* website: Luck versus Skill [4 articles] and Controlling Investment Costs [15 articles]. )