Relief from Market Volatility within Self Directed IRAs

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Self-directed IRAs allow for a variety of investments, beyond the traditional securities markets (namely stocks, bonds, and mutual funds), which provide for greater portfolio diversification within your self-directed IRA. All individual retirement accounts (such as Traditional IRA's, Roth IRA's, Health Savings Accounts, Coverdell Education Savings Accounts, to name a few), allow for investors to invest in traditional and alternative investments on a tax advantaged basis as specified by Internal Revenue Code within Publication 590.

Diversification is a familiar term to most investors. In the most general term, it can be summed up with the phrase: "Don't put all your eggs in one basket." Certainly that statement depicts the essence of the issue, but it affords little guidance or insight into how to assemble a true diversified portfolio. The lack of education regarding true diversification is a common issue for many investors.

Diversification is a key component of a solid investment strategy. In order to properly diversify an investment portfolio you must consider many different asset classes with low correlation to the whole portfolio. Although many Investment Advisors will advise it, diversifying across many mutual funds or individual equities, this is only a limited version of true diversification. Modern Portfolio Theory (as documented by Harry Markowitz) tells us that holding a well-diversified 'basket' of investments can be one of the best ways for individual investors to reduce portfolio risk for a given level of performance. But a portfolio comprised of only stocks, bonds and mutual funds may not be sufficient enough to provide true diversification.

Many investors that primarily invest in mutual funds believe that by investing in two or more mutual funds, they increase the level of diversification in their portfolios. Make note that most stock mutual funds own dozens or even hundreds of individual stocks. The added diversification benefit you get from adding yet another stock to your portfolio becomes less significant as the number of stocks you own grows. For instance, you might benefit greatly by increasing the number of stocks you hold from 4 – 20, but going from 100 to 200 may not have as great of an impact. Another consideration, many mutual funds may own exactly the same securities. For example, if you own an S&P 500 index fund and a mutual fund that focuses on large-cap technology companies, the odds are that both of them will own the same company's stocks.

Diversification can be thought of in different ways. Many investors can determine how to put together a well diversified mutual fund portfolio compared to the typical models, but they tend to fail in diversifying their assets with low correlation funds. Correlation is the degree to which different asset classes move in a similar manner.

A Non-Correlated Portfolio: True Portfolio Diversification

The Modern Portfolio Theory says that the risk of any investment can be reduced and/or performance increased by forming a portfolio of diverse and non-correlated assets. A truly diversified portfolio contains not only a range of different asset types, but also assets that have low correlation to one other. Constructing a portfolio this way will reduce the likelihood that our assets will move in tandem.

Alternative assets (defined by many as anything beyond the assets of CD, stocks, bonds and mutual funds) may be a good way to diversify a portfolio due to their low correlation to the performance of publicly-traded securities. Alternative investments can provide qualified investors viable options to the securities market and may help respond to different market conditions.

Some alternative investments have shown strong positive historical performance. But as with all investments it is important to remember that past performance is not a guarantee of future results. A key point is that some have historically proven to have low correlation with the activity of the broader securities market. For this historical low correlation, alternative investments may be an attractive addition to traditional portfolios. Integrating alternative investments into a portfolio may also have diversification benefits. For the right investor, allocating a portion of your overall portfolio to alternative investments may help create a portfolio with the potential for improved performance in both bull and bear markets. (Please note, correlations may change over time. Not all alternative investments provide low correlation to traditional markets.)

So, what is an alternative investment? Many have their own definition of an alternative investment, but it is best defined from the eye of the investor. Someone who is ultra-conservative might consider stocks and mutual funds to be alternative investments when compared with fixed-income investments such as Certificate of Deposits and Treasury Bills. On the other end of the spectrum, a very sophisticated investor may not consider the well-known alternative investments, such as hedge funds, futures, and options to be alternative, since they may work with them frequently.

An extension to the term “alternative investment” would be “non-correlated alternative investments” as any investment in which a successful performance does not correlate to the movement in the broad securities market.

Most are familiar with the basic list of so-called alternative investments such as: options, futures, precious metals, hedge funds and managed futures funds. Contrary to popular belief, due to the lack of knowledge and/or limited guidance by financial firms that create and/or sell investment products, the list of alternative investments within self-directed IRAs is endless (with exceptions as prescribed in Publication 590).

Examples of Alternative Investments for a Self-Directed IRA-

- Residential/Commercial Real Estate
- Foreclosures

- Business Start ups
- Franchises
- Tax liens, business loans, and mortgage
- Private Mortgages
- LLC’s
- Private Stock Offerings
- Horses
- Domain names
- Invest in what YOU know (within the guidelines of the IRC)

Why the resistance and reluctance?

When an investor discusses with their Investment Advisor, or their appropriate investment professional about these alternative investments, especially from within a self-directed IRA, there are a few hurdles and challenges one has to understand:

1) Limitations Imposed by Firm: Many of the firms providing investment advisory services have direct or indirect affiliations with various product firms, some of which provide incentives directly or indirectly to the advisors to promote their products. Investment advisors managing products should be aptly named investment product specialists or investment product advisors, a very important group of individuals and firms that are required to help understand the products that they provide, including risk factors associated with such investments. Typically advisors for such firms are limited to self directing clients to only products that are only available through the firm or their affiliates.

2) Limitation of Experience: Structuring an alternative investment within a self-directed IRA requires experience, knowledge, including rules, regulations and particulars of the tax code and sometimes a team effort of working with other professionals such as attorneys, mortgage specialists, and accountants in a single transaction, which traditional investment advisors are typically not accustomed to.

3) Limitation of Incentive: While most traditional investments provide certain monetary incentives for investment professional (with appropriate licenses), alternative investments may not provide such an incentive to that investment professional.

In conclusion, this overview of diversification and the importance of non-correlated alternative investments is not intended to discourage securities investments-but rather to argue for a more balanced, well-rounded, and non-correlated portfolio of investments.

About Innovative Advisory Group

Innovative Advisory Group, LLC (IAG), Innovative Advisory Group, LLC (IAG), an independent Registered Investment Advisory Firm, is bringing innovation to the wealth management industry by combining both traditional and alternative investments. IAG is unique in that they have an extensive understanding of the regulatory and financial considerations involved with self-directed IRAs and other retirement accounts. IAG advises clients on traditional investments, such as stocks, bonds, and mutual funds, as well as advising clients on alternative investments—something most banks, brokerage firms and other IRA sponsors won't permit you to do. IAG has a value-oriented approach to investing, which integrates specialized investment experience with extensive resources.

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