RIA's Guide to Alternative Investments

By *ADISA's RIA Advisory Council*

As investment advisors, you strive to help your clients reach their investment objectives by designing portfolios that are commensurate with your clients' time horizon and risk tolerance. The pursuit of an appropriate portfolio is not unique in the RIA space. However, what is very different is how we source and allocate to investments, achieve a proper balance and produce what we hope to be a winning formula for our clients.

When it comes to investment solutions, many advisors use mutual funds, ETFs, SMA managers, UMA programs, and UITs; perhaps you build your own models with stocks and bonds. What may be missing from your opportunity set of investment solutions are alternative investments. The term "alternative investment" is a broad definition that includes multiple asset classes, spanning multiple structures and strategies. The purpose of this document is to be an initial guide to assist you in incorporating alternative investments into your practice.

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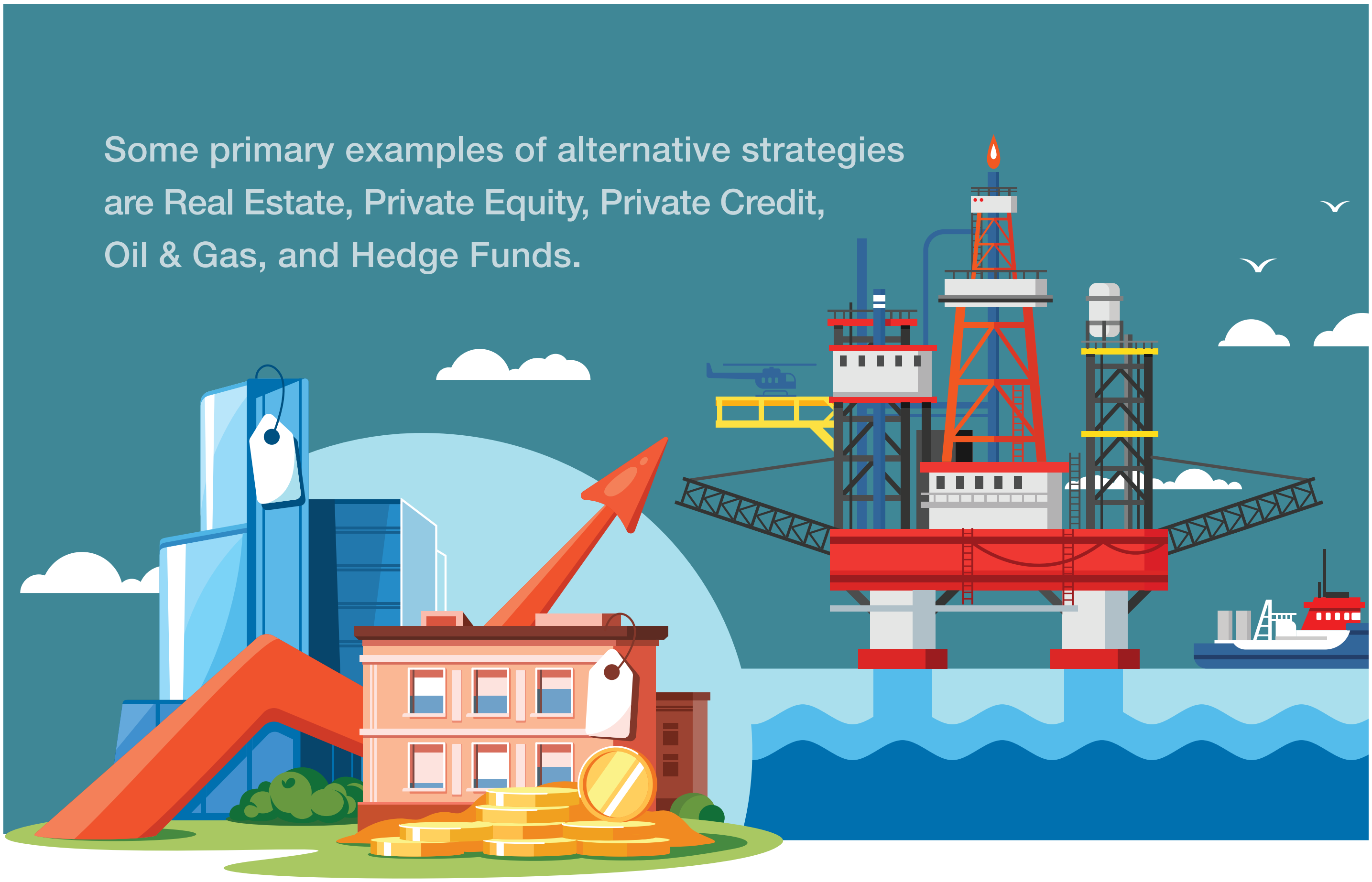
What are Alternative Investments?

One way to define Alternative investments is to define what they are not. A general definition for alternative strategies is an investment in assets other than long-only stocks, bonds, and cash. Some primary examples of alternative strategies are Real Estate, Private Equity, Private Credit, Oil & Gas, and Hedge Funds.

Why allocate to alternatives?

Alternatives in clients' accounts can be very effective in reaching investors' objectives. The use of alternative investments can bring added alpha, income, and diversification to the traditional asset portfolio. *JP Morgan, Jamie Kramer, Pulkit Sharma*. The unique risk-return qualities of alternative investments can address gaps and vulnerabilities in traditional portfolios. In addition to these portfolio



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benefits, certain alternative investments such as DST 1031s and Oil & Gas programs may provide significant tax benefits.

Sourcing Alternative Investments

The private nature of some alternative investments can be an obstacle to your selection process. Information about these investments tends to be decentralized and not readily available within advisors' commonly used research tools and platforms. However, industry conferences such as ADISA can be a valuable resource to sourcing offerings. Multiple 3rd party due diligence firms also hold events that offer RIAs access to senior management teams and provide a forum to learn more about each strategy. Many of these events are free for RIAs and Family Offices. The ADISA website provides a list of the 3rd party due diligence firms and other service providers within the *Products & Services Directory*. Relatively new to the marketplace, alternative investment turnkey investment platforms, such as iCapital and CAIS, offer access to alternative investment managers along with education and due diligence support.

Due Diligence

Due diligence means conducting a reasonable investigation of the issuer and the offered security (FINRA, 2010). In 2019, the SEC clarified the fiduciary duty that an investment adviser owes to its clients under the Investment Advisers Act of 1940. The Duty of Care requires an adviser to conduct a reasonable investigation into a product or strategy as a prerequisite for investment advice to be considered in the best interest of a client. Some of the factors an adviser should consider before recommending an alternative investment are cost, investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility, likely performance in a variety of market and economic conditions, time horizon, and cost of exit.

In addition, FINRA has provided examples of what a reasonable investigation in Reg D offerings might consist of for each of the below topics in FINRA Regulatory Notice 10-22(2010). https://www.finra.org/rules-guidance/notices/10-22

- the issuer and its management;
- the business prospects of the issuer;
- the assets held by or to be acquired by the issuer;
- the claims being made: and
- Intended use of the offering proceeds.

To demonstrate that you have performed a reasonable investigation, you should document both the process and results of your due diligence.

Due Diligence Resources

The due diligence process can be overwhelming and time consuming. Many advisors leverage the services of 3rd party due diligence providers. These firms typically generate reports focused on the specific offering as well as the issuer. The primary reasons for outsourcing due diligence resources are examiner expertise, well-documented diligence, cost-effectiveness, and efficiency. As mentioned earlier in the "sourcing alternative investments" section, AI platforms such as iCapital and CAIS, provide due diligence resources for products available on their turnkey platforms. A thorough advisor review, understanding and consideration of any investment product is required prior to making a recommendation to a client, the documentation of that process is also vital. Therefore, ensure that you can easily retrieve evidence of your review and decision-making process.

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Custodians

Before you decide to invest a client's assets in an alternative program, please check with your custodian and make sure the programs you intend to use are approved and accepted. Generally, custodians like Schwab, TD, and Fidelity have a list that they can provide to you. However, there are also trust companies that have less stringent policies and could also be much less expensive in this regard. ADISA conferences frequently hold sessions devoted to such subjects, and your attendance at these will provide an excellent education.

Holding alternative investments in a portfolio can be challenging because the alternative investment's market is not standardized. Advisory firms that use alternative investments often find they need to work with multiple custodians to effectively maintain their client portfolios. This makes reporting a key element in choosing a custodian. When picking a custodian, make sure to consider the following:

- Cost to Your Client: Custodians have different prices—some can be expensive.

- Reporting: You may need to be able to see your client's assets in a portfolio. Many custodians integrate with reporting software (e.g., Albridge, eMoney, Black Diamond, etc.). If you do not have automated reporting, you may have to manually track your client assets.

There are a variety of clearing platforms (like Charles Schwab, Fidelity, and TD Ameritrade) that custody alternative investments. While clearing firms are usually the first choice for custody client assets, they are generally selective and will only hold some alternative investments.

If a clearing platform does not hold an alternative asset, you can hold the asset directly at the issuer or the issuer's transfer agent. Make sure you understand what reporting an issuer or transfer agent provides before using them.

If you want to hold an asset in an IRA account, you may need to consider using a trust company. Trust companies can hold most alternative assets. Make sure to understand what reporting the trust company will provide before using them. The ADISA website provides a list of trust companies within the *Products & Services Directory*.

Fee Billing

RIAs should review their practices, policies, and procedures to ensure compliance with their advisor agreements and representations to clients. The SEC has reported fee billing practices as a frequent deficiency. Some of the reported issues identified were:

- Valued assets in a client's account using a different metric that that which was specified in the client's advisory agreement, such as using the asset's original cost to value and illiquid asset rather than valuing the asset based on its fair market value.
- Valued a client's account using a process that differed from the process specified in the client's advisory agreement.

https://www.sec.gov/ocie/announcement/ocie-risk-alert-advisory-fee-expense-compliance.pdf

Reporting

As an advisor, you most likely use a portfolio management system. If your system can allow for reporting alternatives and consolidated statements, great! If not, you may need to choose a system that allows for holding alternative investments and receiving feeds from your custodian that includes data for alternative investments. Platforms like Orion and Black Diamond have experience in this regard and the ability to organize alternatives for consolidated reporting as well as fee billing or the ability to suppress such products from the fee billing.

Compliance

You must also disclose in your ADV part 2 that you offer alternative programs. Your compliance staff should be aware of and properly disclose such investments and the fees you intend to charge. Since private investments require a subscription document and client signature, transactions in these investments usually fall outside the scope of advisor discretion, which also must be clearly stated in the ADV. In addition to disclosures within the ADV, most custodians require additional alternative investment disclosure documents if you are transacting the investment through their platform.

E&O Consideration

Professional Liability Insurance can extend coverage for claims arising out of the recommendation or sale of alternative products. Insurance carriers have specific underwriting criteria when it comes to considering whether, or not, to endorse an E&O policy with alternative investment coverage. RIAs will need to establish the following procedures to secure this endorsement.

- Established and well documented due diligence process along with any investment committee notes and formal approval
- Documented suitability analysis
- Concentration limit tracking
- Disclosure documentation signed by the client before the sale of the alternative products

Underwriters may request additional information before deciding whether to endorse the E&O policy.

Many carriers will be specific with respect to the alternative products they will cover. It is essential to read the policy carefully to confirm which products are covered.

A few carriers may impose concentration limits with respect to the sale of alternative products. For example, if your policy states that coverage is available provided that a client's alternative product concentration is no greater than a specific amount in any one product and in alternatives in total, it is essential that the firm pay close attention to concentration limits.

During the policy period an RIA may add alternative products to its approved product list. Confirm that the E & O policy will extend coverage for any new products added.

If the RIA recruits new advisors, a careful review of the advisor's client portfolios is critical to confirm that they do not contain products which are not covered under the E & O policy.

E & O policies are complicated contracts but are fluid documents that may be modified to fit the needs of the RIA. The key is to read the E & O policy carefully to fully understand the scope and the limitations to coverage, and to have an experienced insurance broker negotiate coverage terms on behalf of the RIA.

Education

These investments tend to be more complex and do require a level of due diligence that RIAs haven't been required to conduct on traditional assets and strategies in the past. While this document provides a high-level overview of what is needed in the alternative investment selection and diligence process, by no means is this meant to be comprehensive. To meet the duty of care standards, an investment advisor will also need to acquire the appropriate knowledge to demonstrate their capacity to make the recommendations. In addition to the industry leading events held by ADISA, members of ADISA also have access to the following educational resources;

- White Papers & Industry articles
- Videos & Webinar series
- AI Quarterly Magazine
- Products & Services Directory
- Industry Resources
- Third-party research and education platforms

Conclusion

As institutional managers become more readily available to individual investors along with the evolution of product structures, there will continue to be a democratization of alternative investments, which will allow RIAs to allocate more within their clients' portfolios. Alternative investments may benefit clients as a part of their overall portfolios, and with the resources, education, and access available, investment advisors will be armed to make appropriate recommendations. ▲