

ALTERNATIVE INVESTMENTS

Myths & misconceptions

Many investors mistakenly think of alternative investments as being only for ultra-high-net-worth individuals and institutions. The truth is that alternative investments come in a variety of packages, include many strategies and are available to nearly all investors. In the following pages, we explore common myths associated with alternative investing and discuss how alternatives can play an integral role in your portfolio.

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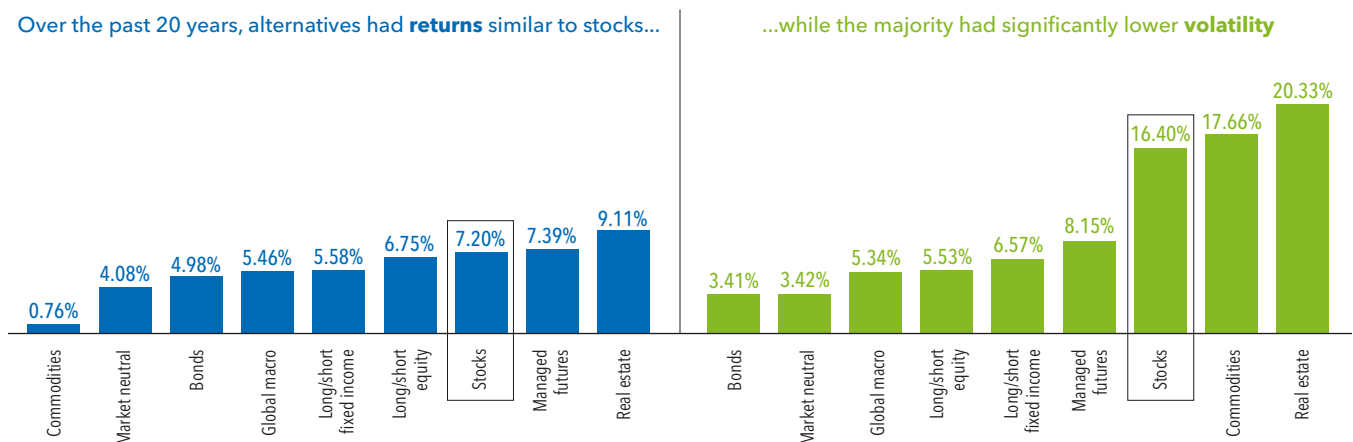
Myth: Alternative investments are more volatile than stocks and bonds.

Reality: It depends on the investment, but alternatives often have the potential to reduce a portfolio's volatility.

While some alternative investments can experience higher levels of volatility than traditional stocks and bonds, as a group, they are no more volatile than any other investment. In fact, many alternatives experience far less volatility than the stock market. Additionally, because they can use a number of different strategies and asset classes, alternatives can produce returns that have low correlations (or go up and down at different times) with traditional stocks and bonds. Adding alternatives to a portfolio containing only traditional stocks and bonds has the potential to lower its volatility.

Potential for lower volatility and enhanced returns

Returns and volatility of major asset classes (1998-2017)



Source: Informa Investment Solutions. Investing involves risk. Past performance does not guarantee or indicate future results. For information on indices used, please see the Important notes. It is not possible to invest directly in an index. The performance information above is based on annualized quarterly returns from 1998-2017. Use of other beginning or ending points, or of a longer or shorter period, would result in different relative performance among the asset classes. Indices of managed products, and hedge funds in particular, have material inherent limitations and should not be used as a basis for investment decisions. The index definitions associated with the data in this chart can be found on page 5.

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Myth: Alternative investments are a unique asset class.

Reality: Alternatives represent different approaches to investing across a variety of markets and vehicles.

Many consider investments like hedge funds and private equity as stand-alone asset classes that have little to do with traditional stocks and bonds. However, alternatives actually represent different approaches to investing across a variety of markets and vehicles.

A useful way to think about alternative investments is to differentiate between “contents” and “containers.” Certain investments, such as currency or commodities, are truly alternative asset classes and behave very differently than stock or bond investments. Then there are alternative strategies, like long/short, that trade in stocks, bonds or sometimes even alternative asset classes, but approach them in innovative ways. Either way, it is an investment’s “contents” that determines how it could contribute to the diversification of an overall portfolio.

“Containers” refers to the vehicles these investments might be found in, such as hedge funds, private equity funds and mutual funds. These vehicles may include similar investments, but can encompass many styles of investing across different markets, resulting in a variety of management, liquidity, legal or regulatory effects. Hedge funds, for example, are grouped together because of their less-regulated legal structure and not because their underlying “contents” are all the same.

Accessing alternative investments

Contents versus containers



Contents

Selection based on anticipated behavior –
e.g., correlation; risk/return

Alternative assets

Currency • Commodities • Real estate
Infrastructure • Real assets

Alternative strategies

Long/short (e.g., equity/credit)
Arbitrage (e.g., fixed income)



Containers

Selection based on fund type/legal structure –
often dictates access to capital

Private equity

Funds and direct investments in private companies

Hedge funds

Invest and trade in a variety of securities and markets
using leverage and/or short-selling

Mutual funds

Invest in relatively liquid strategies and assets

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Myth: Investing in one alternative fund will diversify my portfolio.

Reality: Investing in only one alternative strategy may provide some diversification benefits, but can also concentrate risks.

Just as adding one stock or mutual fund does not lead to significant diversification, we believe an investor should add more than one alternative investment to reap their benefits.

There are two ways that investors can build their allocation to alternatives. One is to do it themselves by selecting the individual funds and managers they want to invest in and monitoring their performance, making changes as necessary. The other option is to invest in a multi-strategy fund where a professional manager builds and runs a fund of different alternative assets and strategies, performing due diligence on the managers and making allocations based on market conditions. While a multistrategy allows an investor to quickly get a diverse exposure to alternative investments, it usually comes along with slightly higher fees.

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Myth: Investors cannot access their money if they invest in alternatives.

Reality: Liquidity levels vary between investment options.

The liquidity of alternative investments depends on the individual investment, with some offering daily liquidity while others are restricted. As with all aspects of investing, there is a tradeoff between risk and return and liquidity is no different. When investing in less liquid options, investors expect to be compensated with improved returns. This is called an “illiquidity premium”.

Historically, alternatives have been structured as limited partnerships, which impose limits on the investor’s access to their investment. Those restrictions can be as short as 30 days or longer than 10 years (for some private equity partnerships). When worked into a portfolio, the tradeoff of lower liquidity for better diversification and returns could make sense for a long-term investor.

There are also newer alternative investment “containers” that are designed to provide greater liquidity. Alternative mutual funds, for example, can trade daily. However, structures that allow increased liquidity do tend to come with regulatory restrictions that can limit the manager’s investment opportunities.

The table on the following page shows different considerations for investors to think about when choosing between investment “containers.”

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Myth: Only institutional and ultra-high-net-worth investors can access alternatives.

Reality: Individual investors have greater access to alternatives than ever before due to relatively recent innovations in product structures.

In the past, institutional investors have used alternatives more than individuals due to limited availability. Fortunately for investors, today these same institutional investment capabilities can be accessed through a number of investment “containers,” making them available to nearly everyone.

Alternative investments structured as partnerships, such as registered closed-end funds and unregistered funds, have some limits on who can access them but offer investment teams the largest opportunity set. While alternatives in mutual funds have fewer types of investments they can make, they give the same capabilities to nearly every investor in a structure they are already using.

The table below shows different considerations for investors to think about when choosing between investment “containers.” Individual investors should seek the guidance of a professional manager when exploring investment options.

A wide range of options to invest in

	← Access, transparency, liquidity	Greater investment opportunity and potential for excess returns →	
	Open-end mutual funds	Registered closed-end funds	Unregistered private funds
Accessibility (Investor qualifications)	No / low barriers to investing	Typically requires the investor to be an “Accredited Investor” (Has \$1 million or more in net worth and/or a pre-specified annual income)	Usually requires the investor to be an “Accredited Investor” or sometimes a “Qualified Purchaser” (Has \$5 million or more in investable assets)
Investment universe	More constrained by regulatory restrictions	Broader opportunity set	Largest opportunity set
Transparency	High	Moderate to high	Typically limited
Minimums	Low (Typically starting at \$1,000)	Moderate (Typically \$10,000-\$50,000)	High (Typically \$100,000 or more)
Liquidity	Daily	Periodic (Typically monthly to quarterly)	Periodic (Typically quarterly or longer; capital may be “locked up” for a specified length of time)
Fees	Management fee + other expenses	Management fee + other expenses; may be distribution and/or performance fees	Management fee + other expenses; likely to be distribution and performance fees
Tax reporting	Form 1099	Form 1099 or Schedule K-1 (varies by product)	Schedule K-1

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Myth: Alternatives failed to protect investors during market downturns.

Reality: Many alternative investments saw smaller drawdowns than stocks in 2001 and 2008.

It is true that correlations across nearly all investments tend to converge under periods of extreme market stress. Even during crises, however, history shows that alternatives have not typically fallen as far as stocks, providing a cushion for investors. As the table below shows, they lost less during the 2001 and 2008 stock market drawdowns.

2001 Recession maximum drawdown		2008 Recession maximum drawdown	
Stocks	-14.68%	Real estate	-58.31%
Commodities	-13.54%	Commodities	-52.61%
Long/short equity	-5.91%	Stocks	-38.09%
Managed futures	-3.87%	Long/short equity	-23.96%
Real estate	-2.62%	Long/short fixed income	-12.13%
Long/short fixed income	-1.74%	Market neutral	-8.82%
Bonds	0.00%	Global macro	-4.94%
Market neutral	0.00%	Managed futures	-3.97%
Global macro	0.00%	Bonds	-1.50%

Source: Informa Investment Solutions. Past performance is no guarantee of future results.

Index Definitions: **Bonds** are represented by the unmanaged, market-weighted Bloomberg Barclays US Aggregate Bond Index, is composed of investment-grade corporate bonds (rated BBB or better), mortgages and US Treasury and government agency issues with at least 1 year to maturity. **Commodities** are represented by the unmanaged Bloomberg Commodity Index, which reflects the return on fully collateralized positions in the underlying commodity futures. **Managed Futures** are represented by the HFRI Macro: Systematic Diversified Index, which is composed of strategies that seek to profit from opportunities in markets exhibiting trending or momentum characteristics across individual instruments or asset classes, including equity, fixed income, hard currency and commodity markets. **Long/Short Fixed Income** is represented by the HFRI Relative Value Fixed Income Corporate Index, which is composed of strategies that seek to profit from a spread between related financial instruments in which one or multiple components of the spread is a corporate fixed income instrument. **Global Macro** is represented by the HFRI Macro Index, which is composed of strategies that seek to profit from predicted or future movements in underlying economic variables and their subsequent impact on equity, fixed income, hard currency and commodity markets. **Long/Short Equity** is represented by the HFRI Relative Value Index, which is composed of strategies that seek to profit from a pricing discrepancy between multiple related securities, ranging broadly across equity, fixed income, derivative or other security types. **Market Neutral** is represented by the HFRI Equity Hedge: Equity Market Neutral Index, which includes strategies that employ sophisticated quantitative techniques of analyzing price data to ascertain information about future price movement and relationships between securities, select securities for purchase and sale. **Real Estate** is represented by the FTSE NAREIT All Equity REITs Index, a free-float adjusted, market capitalization-weighted index of U.S. Equity REITs. Constituents of the Index include all tax-qualified REITs with more than 50 percent of total assets in qualifying real estate assets other than mortgages secured by real property. **Stocks** are represented by the unmanaged S&P 500 Index, a capital-weighted index that includes 500 stocks representing all major industries. Returns are denominated in USD and include dividends. The Index is a proxy of the performance of the broad US economy through changes in aggregate market value.

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Myth: Alternatives are too expensive.

Reality: The fees for alternative investments vary and depend on the fund's structure.

An alternative investment's "container" usually indicates the fees an investor can expect to pay once they are in the fund.

If the investment is set up as a partnership, typical of private equity and hedge funds, there are generally two main fees: management fee and performance fee. The management fee is calculated based on the dollar amount invested in the fund. Many funds also charge a performance fee on the profits the fund generates for investors. Unlike the management fee that is paid annually, the performance fee is only paid in years where the fund has positive returns. Also, funds sometimes have minimum returns they have to meet before they earn their performance fee. The purpose of this is to incentivize management teams to make more for their investors, aligning their interests.

In a mutual fund structure, alternatives are regulated similar to stock and bond funds in that they charge a management fee but cannot charge a performance fee. While this means that alternative investment mutual funds typically charge fewer fees than other "containers," it comes with limits on what the fund can invest in, potentially reducing return potential.

A discussion of fees and how they may impact a portfolio should be an important part of an investor's conversation with their financial professional.

Next steps

Of course, this is only a starting point for a conversation about investing in alternative investments as part of a broadly diversified portfolio (remembering, of course, that diversification does not ensure profit or protect against loss in declining markets).

We would encourage investors to discuss this material and the risks described in the "important notes" section with their financial professional to determine how alternatives may complement their current investment strategy and potentially enhance the diversification and risk/reward potential of their portfolio.

Important notes

Utilizing alternative investments involves substantial risk and presents the opportunity for significant losses including the loss of your total investment. Alternative investments have experienced periods of extreme volatility and in general, are not suitable for all investors. Alternative investments incorporate speculative strategies which may subject an investor to greater volatility than traditional securities, and in some cases of extreme volatility, market conditions may result in rapid and substantial valuation increases and/or decreases. Alternative investments take on higher costs and risks in return for the potential of higher returns.

Hedge funds and hedge funds of funds may not be suitable for all investors and often engage in speculative investment practices which increase investment risk; are highly illiquid; are not required to provide periodic prices or valuation; may not be subject to the same regulatory requirements as mutual funds; and often employ complex tax structures. Utilizing private equity involves significant risks along with the opportunity for substantial losses.

The indices used herein are for illustrative purposes only to provide an indication of historical performance of various asset classes and are not meant to represent the performance of any particular investment. It is not possible to invest directly in an index. Indices are unmanaged and cannot be used to predict the future results of any investment. An index's returns may not reflect the deduction of any sales charges or other fees and expenses, which could be substantial for alternatives investments and would reduce actual returns.

Indices of managed products, and hedge funds and private equity in particular, have material inherent limitations and should not be used as a basis for investment decisions. Performance of unmanaged indices (such as those representing commodities and real estate) does not include consideration of investment management and/or performance fees that would be attributable to managed accounts. Other indices (such as those representing private equity and hedge funds) are composed of investment funds and performance is calculated net of attributable management and performance fees and expenses. In addition, the basis for calculating performance differs, as between private equity, which is calculated based on dollar-weighted periodic IRRs, and the other asset categories, which are based on time-weighted total returns, and may not provide meaningful comparisons. Indices that purport to present performance for the overall hedge fund, private equity or other alternative investment industries may actually present performance that differs materially from the overall performance of such alternative investment industry due to issues of selection and survivorship bias.

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