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These ETFs let you invest like the rich — but you might want to keep your money

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Above-average management fees for overvalued investments are a toxic mix

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SPX +0.15%

Alternative investments has become one of the fastest-growing segments for retail exchange-traded funds. Individual investors likely will regret this.

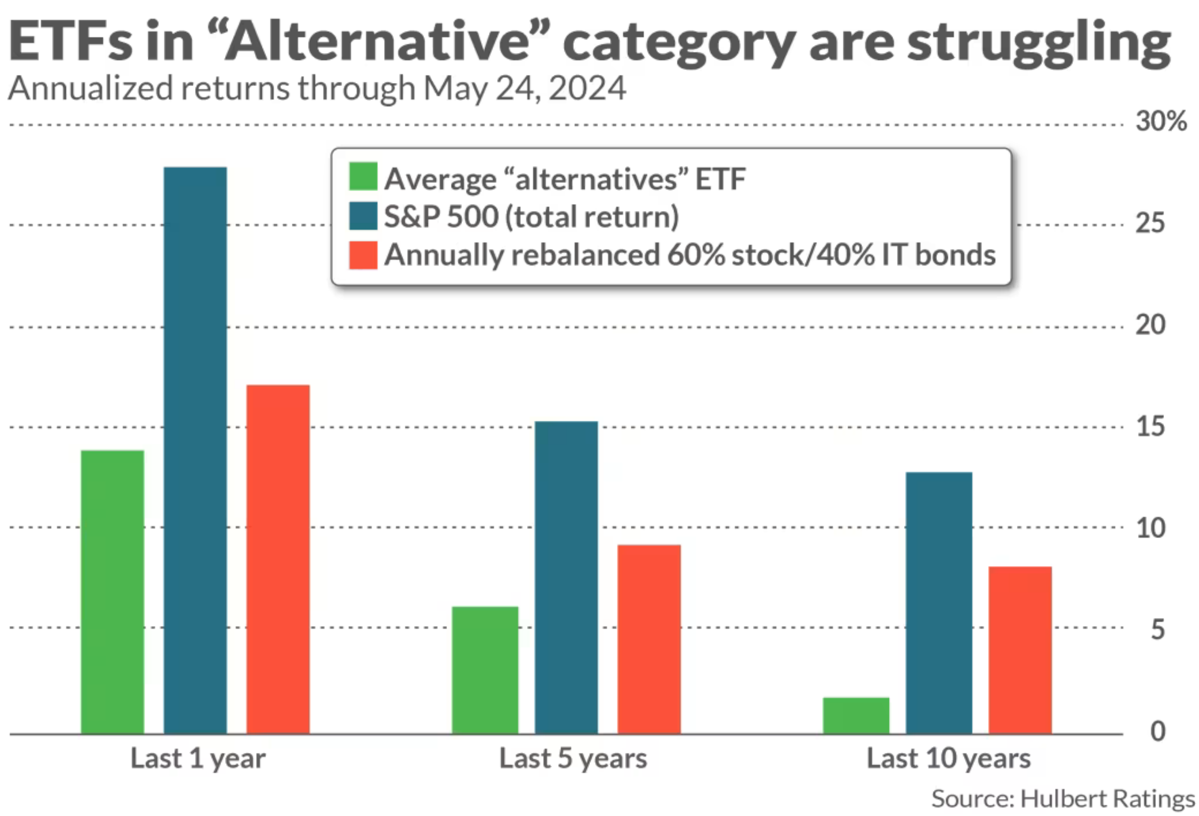
Charles Schwab, the largest U.S. discount broker, recently announced that later this year it will launch “an alternative investments platform for individual investors” (according to a report in the Wall Street Journal). The platform would give investors access to alternative investments including “private equity, venture capital, private credit and hedge funds.”

The allure of such alternative investments is undeniable, especially now that the U.S. stock market appears overvalued and the bond market is struggling. For many years these investments were only available to the wealthy, and the category for a time produced some huge successes — notably Yale University’s endowment under the direction of the late David Swenson.

But the alternatives category has struggled over at least the past decade —and there is irony in alternative asset managers deci[illegible]en their doors to once-excluded to share the wealth.

investments. Richard Ennis, co-founder of one of Wall Street's first investment consulting firms and a former editor of the Financial Analysts Journal, was quoted last year in Institutional Investor as saying that "alpha appears to respond to the presence of alts [alternative investments] as if the latter were kryptonite — the greater the exposure, the harsher the effect on alpha."

So it's hardly a surprise that individual investors have struggled in the alternative investment space as well. Consider the performance of the 50 ETFs in VettaFI's "Alternatives" category. As you can see from the chart below, these funds on average have lagged the S&P 500 SPX over each of the past one, five- and 10-year periods. They have also consistently lagged behind the traditional 60/40 stock-bond portfolio.



High fees hurt returns

Cynicism is also justified by the large number of recently launched alternative ETFs with high expense ratios. Researchers have found that such funds lag the market for up to five years after they are launched, on average.

This is for two interrelated reasons, each tracing to ETF providers choosing to launch new higher expense ratios. But higher expenses create a stiff headwind on a fund's performance. In addition, because these ETFs own the most popular investments, their

Among the 50 ETFs in VettaFI's "alternatives" category, 11 are less than one year old and 26 are less than three years old. The average expense ratio among these 50 is 1.05% of assets — far higher than the 0.16% average for equity ETFs, according to ETF.com. Among the newest ETFs in this category, those less than a year old, the average expense is even higher at 1.21%.

Paying above-average management fees for overvalued investments is a toxic combination, according to recent research in the Review of Financial Studies. Entitled "Competition for Attention in the ETF Space," the study was conducted by Itzhak Ben-David and Byungwook Kim of The Ohio State University, Francesco Franzoni of the University of Lugano in Switzerland, and Rabih Moussawi of Villanova.

In an email, Ben-David said: "Given that so many alternatives-focused ETFs have been launched recently, with high fees, it's a good bet that they will be disappointing performers for at least the next couple of years. Our study shows that the best investment strategy in industry and thematic ETFs is shorting them."

Mark Hulbert is a regular contributor to MarketWatch. His Hulbert Ratings tracks investment newsletters that pay a flat fee to be audited. He can be reached at mark@hulbertratings.com

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