LIGHTBULB PRESS®

GUIDE TO ALTERNATIVE INVESTING

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DISB
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AND BANKING

GUIDE TO ALTERNATIVE INVESTING

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An Introduction to Alternatives

You can diversify your portfolio by selecting a wide variety of investments.

When you describe an investment as *alternative*, what you're saying is that it is an alternate to, or different in some essential ways from stocks, bonds, and cash. Most traditional investments are publicly available to any investor who has money to pay for them, and **liquid**, which means they can be bought and sold when you wish, though not always at the price you would like.

Most alternative investments, on the other hand, are sold by broker-dealers or financial advisors. In most cases, you must meet net worth or income requirements to be able to invest and be willing to hold the investment for a specific period, which may be as long as ten years or more. That's why the majority of these products are described as **illiquid**.

Though they share similarities, alternative investments are not all alike. There's significant variety, just as there is among traditional investments, in the ways they generate returns and the levels of risk to which they expose you.

PUBLIC OR PRIVATE

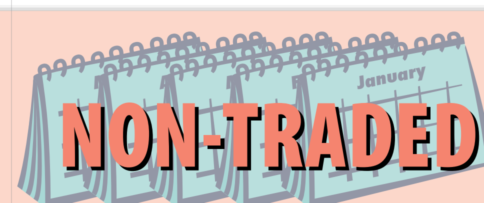
Some alternative investments are **public** and others are **private**.

Public investments must register with the Securities and Exchange Commission (SEC) or the Commodity Futures Trading Commission (CFTC) and the securities regulator in the states where they are offered for sale. The sponsors must provide a prospectus or offering circular to potential investors and file regular financial reports, such as an annual audited Form 10-K, with the SEC.

Private investments, on the other hand, are exempt from registration with a federal regulator. The financial reporting that's required varies from product to product and state to state.

All investments, public or private, are subject to federal and state anti-fraud regulations.

The relationship of an investment's return to the return of another investment is called **correlation**. If the returns are driven by the same market forces, the correlation is positive. But when the returns respond to different forces, then the returns are **non-correlated**.



A **traded** investment is one that is listed on a public securities exchange, such as the New York Stock Exchange (NYSE) or the Nasdaq Stock Market, or on an OTC market. In the case of stock, for example, trading begins following listing on an exchange. While trading in these securities may occur in many venues, your order to buy or sell one of them will be acted upon immediately in the case of a market order or as soon as the security is available at the price you specify in a stop, limit, or conditional order.

Not all traditional investments are traded. Mutual funds are sold and repurchased by the investment company that sponsors them even when you purchase them through a broker-dealer. But alternative investments are rarely traded. The exception is alternative mutual funds, known as liquid alts.

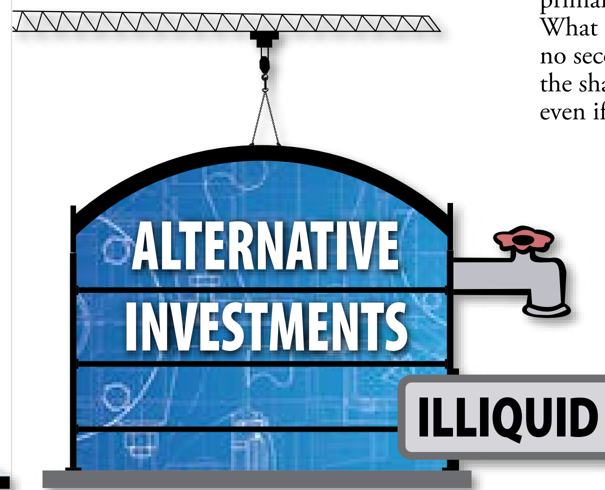
A **non-traded** investment, on the other hand, is not listed on an exchange or sold OTC. Rather than an IPO, there is an offering period, sometimes rather lengthy, during which broker-dealers and financial advisors raise capital by marketing the product to eligible investors.

Some types of investments, such as real estate investment trusts (REITs) and business development companies (BDCs), may be either traded or non-traded. The former are considered traditional investments and the latter alternative investments.

MINIMUM INVESTMENTS

Most alternative investments set minimum investment requirements, ranging from as little as $2,000 to as much as $2 million or more. Investors may be able to reinvest distributions from the investment to buy additional shares, sometimes at a discount.

With some alternative investments there's potential for appreciation at the end of a specific term, often seven to ten years though it may be longer. With others, the return is limited to cash distributions during the term.



MADE IN THE USA

Limited partnerships are a uniquely American business structure. They were created in colonial times, when the British refused to issue charters for new companies. Entrepreneurs, determined to move forward, pooled their capital and credit to share operational and financial risks. Their ingenuity laid the groundwork for what became formal partnership agreements.

UNDERSTANDING ILLIQUIDITY

Lack of liquidity is often cited as a primary risk of investing in alternatives. What illiquidity means is that there's no secondary market where you can sell the shares or units you have purchased even if you need the money. Some investment sponsors do have redemption programs, which may give you the opportunity to sell back your shares. But these programs aren't required and those that may be offered can be suspended at any time. The sponsor may buy back only a limited number of shares at any given time, and the purchase price may be less than the actual value of the shares provided in your account statement.

On the other hand, a primary attraction of illiquid alternative investments is that they can help diversify an investment portfolio. That's because historically their returns have had limited if any correlation to the return on traditional investments as measured by a relevant benchmark, such as the S&P 500 index for large-company stocks.

Lack of correlation results because the factors that influence an alternative investment's performance are different from those that influence traditional investment performance. For example, the changing dynamic of supply and demand impacts the daily price of a traded investment. But in a non-traded investment share price may not fluctuate because there is no secondary market trading.

Sponsors of alternative investments can benefit from illiquidity too because they have an extended period to turn a profit for investors and a buffer against the volatility that is often a feature of conventional markets.

ALTERNATIVE INVESTMENTS

REITs

Commercial real estate can help diversify a traditional portfolio.

A real estate investment trust (REIT) is a corporation that invests in commercial real estate. The REIT raises capital from a group of investors and uses it to buy buildings if it's an equity REIT or loans on buildings if it's a mortgage REIT. Hybrid REITs typically own both properties and mortgages on properties.

A REIT's goal is to provide a steady stream of income and potential capital gains to its shareholders. With an equity REIT, the income comes from the rent its buildings' tenants pay. A mortgage REIT generates income by collecting interest and principal payments on the loans it owns.

A REIT OVERVIEW

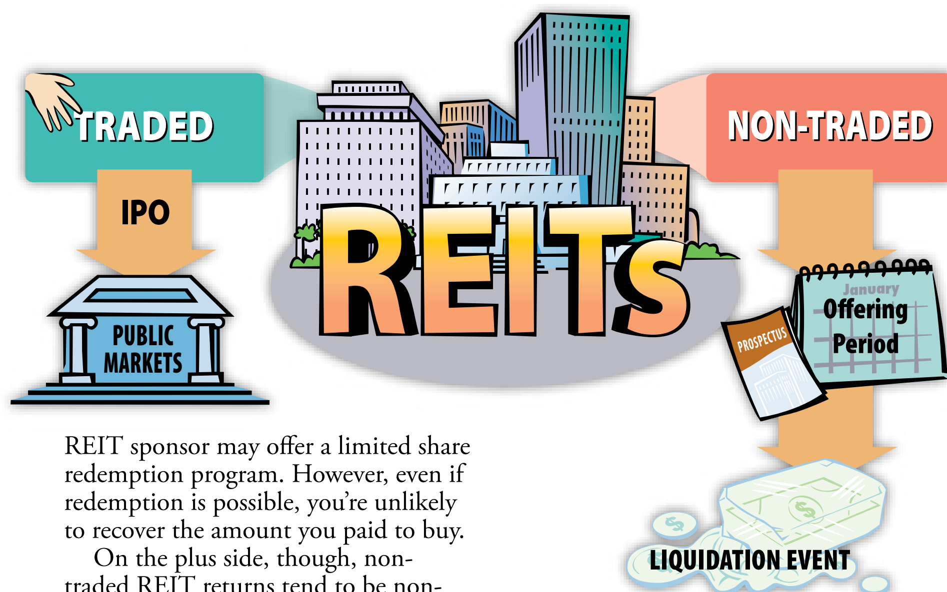
Most REITs are public corporations that register with the SEC, abide by its regulations, and file regularly updated quarterly and annual financial reports. A smaller number are private companies.

Some public REITs are traded, the way that stocks are, after being listed on a national exchange. Others are sold over-the-counter (OTC). You can buy and sell shares at any time for the current market price.

But some public REITs are non-traded. They aren't listed or sold OTC, and there's no IPO. Instead, they're offered to investors by **prospectus**, an official document that explains the REIT sponsor's investment strategy, the types of properties it will buy, and how it will finance its investments. These REITs, which you buy through a broker-dealer or financial advisor, are available during a multi-year offering period.

A distinguishing feature of non-traded REITs is that there is no formal secondary market where you can sell your shares. Since a REIT's investment term is typically at least five years and may be longer, you must be able to commit the capital you're investing for that period. The only possible exception to this **illiquidity** is that the REIT sponsor may offer a limited share redemption program. However, even if redemption is possible, you're unlikely to recover the amount you paid to buy.

On the plus side, though, non-traded REIT returns tend to be non-correlated with returns on conventional investments and so help to diversify your portfolio.



REIT RETURNS AND RISKS

One significant feature of the REIT structure is that the corporation must distribute at least 90% of its taxable income to shareholders every year as distributions to avoid federal corporate income tax. As a result, investment income from a REIT may be higher than most other corporations provide. But, of course, this income isn't guaranteed.

Equity REIT distributions depend on having a full complement of paying tenants, operating efficiently, and being able to increase rents. There are risks, however. Rents, and therefore distributions, may drop in a market downturn if rental space remains empty. Distributions may also be disappointing if the properties the REIT owns aren't attractive to potential tenants or if the market for a particular type of property is saturated.

Income is only part of the total picture however. Total return is a combination of current income and any capital gain on the principal you invest. With a non-traded REIT, whether or not there's a capital gain depends on the **liquidation event** that occurs at the end of the multi-year investment term.

The REIT typically has three alternatives for liquidation: converting the REIT to publicly traded status using a listing on an exchange, participating in a merger with or acquisition by another REIT, or selling off the properties the REIT holds individually or in small lots.

The preferred exit strategy, which would produce the greatest gain, may or may not be feasible at the time a REIT is ready to liquidate. Among the factors that come into play are the current market interest in traded REITs, the marketability of the properties the non-traded REIT owns, and the general state of the economy. These are things that can't be predicted at the time you buy REIT shares, also known as units.

INVESTMENT FOCUS

Most equity REITs, the most common type of REIT, specialize in a particular type of real estate, such as hotels, shopping centers, self-storage centers, office buildings, or medical facilities, and they may concentrate their purchases in a specific geographic area.

BEFORE YOU INVEST

As with any other investment, you and your broker-dealer or financial advisor should research a non-traded REIT before you make a decision. This process includes reviewing the experience and track record of the management team, the REIT's business plan, and its sources of outside capital.

Some of your evaluation will be facilitated by new FINRA rules governing the responsibilities of a non-traded REIT sponsor. Specifically, the sponsor must:

- Report the net investment value of a REIT to provide a more accurate ongoing sense of its actual value. Among other things, this means accounting for the impact of commissions and fees.
- Disclose that distributions may include return of capital and so reduce the per-share value.
- Clarify that, if redemptions are allowed, the share redemption price may be less than the per-share estimated value provided in your account statement.

TAX ISSUES

The tax you owe on REIT distribution income is figured at the same rate you pay on your ordinary income, not at the lower long-term capital gains rate that applies to qualified dividends. But you should consult your tax advisor about the possibility of claiming **depreciation** of real estate assets against REIT income or other tax-saving opportunities. Alternatively, you may hold the REIT in a tax-deferred account, so that tax rates are not an issue.

Business Development Companies (BDCs)

These companies focus on providing investment capital to small- or mid-cap firms.

A BDC is a closed-end investment company that pools the money it raises from investors to purchase the debt or equity of qualifying thinly traded or privately held companies. This approach is attractive for small or mid-sized firms, which would otherwise have limited access to capital. It also offers individual investors access to a potentially lucrative market in which they otherwise would be unable to participate.

BDCs generally are public companies that are registered with the SEC and subject to the regulations that govern investment companies. There are two types. Traded BDCs are listed on a national exchange or trade over-the-counter (OTC). In contrast, non-traded BDCs are sold through broker-dealers and financial advisors to investors who meet suitability standards based on their income, net worth, or the percentage of assets already committed to alternative investments.

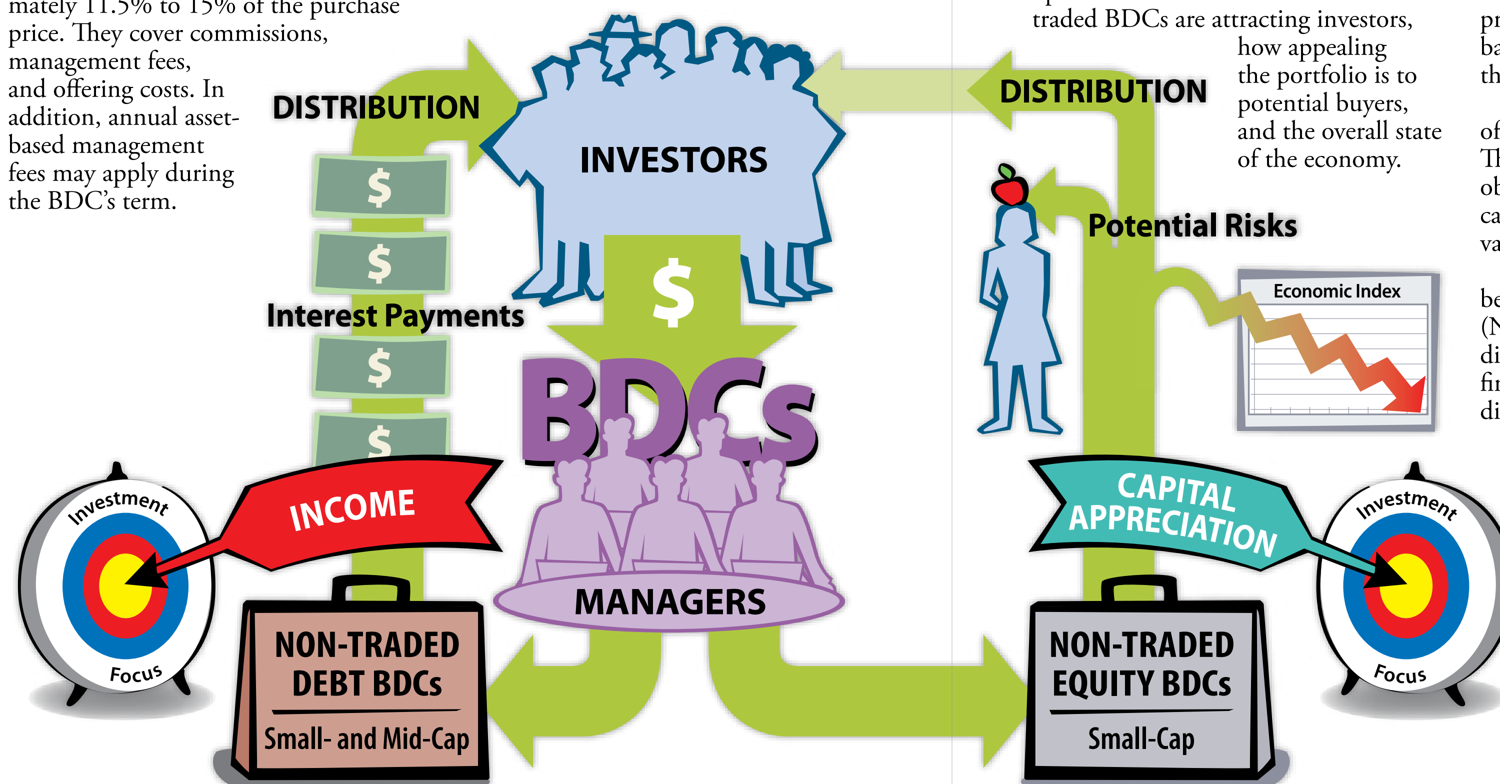
The upfront fees associated with non-traded BDCs average approximately 11.5% to 15% of the purchase price. They cover commissions, management fees, and offering costs. In addition, annual asset-based management fees may apply during the BDC's term.

DEBT AND EQUITY

Before a BDC is offered to investors, its sponsor decides whether the company will invest primarily in debt or equity. It must also decide whether to focus on companies in a particular industry or with specific characteristics, such as size or debt level.

Debt BDCs, which are more common at present, are primarily income investments. A BDC's managers buy debt securities issued by its portfolio companies, anticipating regular interest payments that can be passed through to investors. The managers may also sell some securities to realize capital gains that can be passed on to investors.

Managers of a debt BDC choose a risk-return profile, which determines the types of debt it buys. If it selects unsecured debt, it will expect to realize more income than if it concentrates on the companies' long-term secured debt. But it will also run a greater risk that some of the companies may default. This would reduce the interest income and return of principal it was anticipating.



Equity BDCs focus on capital appreciation, or growth in the market value of its portfolio companies. The companies are typically small and often fairly young. This means dividends are rare and distributions are uncommon. But the managers anticipate that at least some of the companies will prosper and provide substantial capital gains during the program's term, as a result of its exit strategy, or both.

Equity BDCs may be riskier than debt BDCs. That's the case in part because if a portfolio company fails, stockholders—in this case the BDC—are unlikely to recover their principal, which goes first to secured bond holders. In addition, because the companies typically have limited reserves, they could be vulnerable in an economic downturn.

FINDING AN EXIT

Non-traded BDCs often have finite terms, of ten years or maybe longer. The end-date, or liquidity event, depends on several factors including the managers' exit strategy. There are generally three alternatives—converting the non-traded BDC to a traded BDC and listing it on an exchange, selling the entire portfolio or merging it with another BDC, or selling off the assets individually or in small lots.

Among the factors that influence the option the BDC chooses are whether traded BDCs are attracting investors, how appealing the portfolio is to potential buyers, and the overall state of the economy. None of those could have been accurately predicted when the BDC was offered initially.

THE CASE FOR BDCs

Non-traded BDCs have several features that make them attractive to investors seeking income and increased diversification.

BDCs must distribute at least 90% of their taxable income to shareholders each year to avoid federal corporate income taxes. And they typically distribute all of it, which allows them to avoid excise taxes. This has the potential to be a substantial annual amount, though, of course, there is no guarantee it will be.

In addition, the returns on a non-traded BDC are typically non-correlated with returns on traditional investments because they're not subject to the same market pressures. So they can provide valuable diversification that may help to reduce portfolio risk. That diversification can be enhanced, at least to some extent, by investing in several differently focused non-traded BDCs simultaneously.

ASSESSING THE RISKS

Non-traded BDCs expose investors to potential risks. Chief among them is **illiquidity**. There is no secondary market for non-listed BDC shares. Even if the BDC offers a redemption program, it is likely to limit share buybacks and pay a discounted price for those it repurchases.

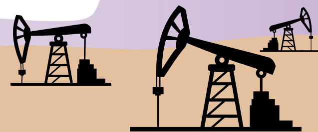
Potential defaults or limited growth of portfolio companies are also risks. The BDC may not be able to meet its obligations to lenders or investors if its cash flow drops, its investments lose value, or both.

Further, a BDC's offering price must be at least equal to its net asset value (NAV), excluding commissions and discounts. This means investors may find that the value of their shares is diluted if the NAV falls after purchase.

There's also the possibility that the BDC's exit strategy will result in a disappointing profit, or none at all, either because the managers have misjudged the market, its portfolio is unattractive, or the economy is weak. This is a serious issue since total return depends on the combination of income and capital gains.

A Range of Alternatives

Investors seeking greater portfolio diversification are increasingly moving into alternative investment programs.



One feature that makes investments described as *alternative* different from those considered traditional is—in most cases—the degree to which an investor is directly exposed to the success or failure of a specific undertaking.

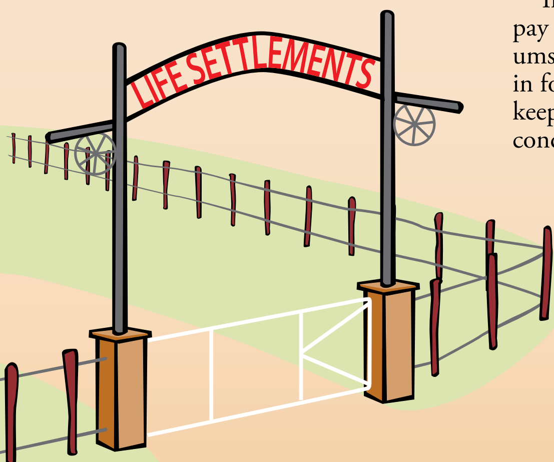
ENERGY INVESTMENTS

Alternative energy programs raise money to invest directly in exploring and drilling for oil or natural gas. The program buys or leases land under which its sponsor or management team believes hydrocarbons can be extracted profitably. It also secures the necessary permits and installs the equipment required to drill wells, pumps the oil or gas to the surface, and arranges for its transportation to storage and refining facilities. If the venture is successful, the program provides income over the productive life of the well or wells. If it's not, for whatever reason, the program yields a loss.

Energy programs are generally structured as **limited partnerships**, with one or more **general partners** and a number of **limited partners**. The general partner is responsible for running the project and is personally liable for its potential losses. The limited partners provide investment capital, which they could lose, but have no control over the decisions the partnership makes and no responsibility for any debts it may incur.

Partners in an energy program may enjoy a number of tax benefits, including deductions for intangible drilling costs (IDC), a depreciation allowance for the tangible drilling costs, and a depletion allowance. All these can reduce taxable investment income. However, while general partners may take these deductions and allowances against ordinary income, limited partners may take them only against passive income. And the rules are complicated, so claiming these benefits requires the advice of a tax professional.

While there may be significant profits from successful energy programs, there are also significant risks. These include, among others, production risks, operational costs, fluctuations in market price, and the consequences of potential spills or other adverse affects on the environment.



LIFE SETTLEMENTS

In a **life settlement**, the owner of a life insurance policy sells it for more than the cash settlement value he or she would receive for surrendering the policy but less than the face value that the beneficiary would receive at the insured's death. The policy owner and the insured may or may not be the same person.

The third-party purchaser is typically a company known as a life settlement originator or provider. The firm works with life settlement brokers to identify policies to buy and sells either individual policies or interests in its portfolios of policies to investors. Some but not all originators are licensed or regulated by the state where they operate.

Investors make a cash payment and pay their share of the ongoing premiums that keep the underlying policies in force and the administrative costs of keeping track of the insured person's condition, obtaining death certificates, and valuing the policies.

The investment return on a life settlement is a pro-rated share of the death benefit when the insured party dies. The risk is that more time will pass before the death occurs than investors were led to expect. This increases the amount that must be paid in premiums but not the death benefit. There's also a risk the insurance company that issued the policy will refuse to pay the death benefit or that the insured's heirs will challenge the sale.

EQUIPMENT LEASING

Equipment leasing programs offer businesses an alternative to purchasing hard assets that may be extremely expensive, likely to become obsolete quickly, or both. The programs raise capital to purchase the equipment from investors who expect to receive a steady stream of income as a pass-through from the payments the lessees, or equipment users, make.

The contracts that govern these arrangements specify the lease term, the recurring payment, and termination provisions, which may include returning the asset in good condition, the option to renew at a favorable rate, or the right to buy the equipment.

In addition to regular income, participating in leasing programs may be attractive for the potential tax benefits, specifically, accelerated depreciation of an investor's share of the cost of the equipment. In addition, equipment leasing programs can serve as a hedge against both inflation and recession, and, when interest rates are low, be an attractive substitute for conventional fixed-income investments.

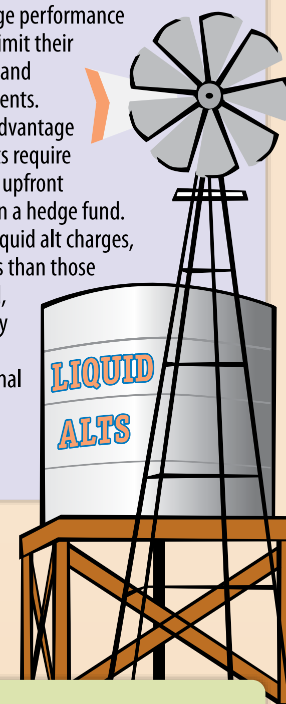
There are risks, however, that may reduce cash flow or put capital at risk. While equipment can be reclaimed in a default, the process can be protracted and costly. Outdated or damaged equipment can be difficult to re-lease or sell. And, in the absence of a secondary market, an investment in a leasing program is generally illiquid.

ALTERNATIVE MUTUAL FUNDS

An investment in an alternative mutual fund, or liquid alt, means putting capital to work in a non-traditional way since the fund invests using hedge fund strategies or attempts to reproduce hedge fund returns. But, unlike most direct investing programs, a liquid alt shares many features with conventional mutual funds, including their liquidity.

Among other things, they must comply with SEC regulations that require transparency, disclosure, and daily calculation of net asset value (NAV). They can't charge performance fees and must limit their use of leverage and illiquid investments.

A primary advantage is that liquid alts require a much smaller upfront investment than a hedge fund. But the fees a liquid alt charges, while much less than those of a hedge fund, are substantially higher than the fees on traditional funds with no guarantee of a higher return.



A LEASING PRECEDENT

From the carriages and the horses that pulled them in the 1700s to the railroad cars and the engines that powered them in the late 1800s, leased equipment has been an integral part of US business. Today's equipment leasing programs, with their third party investors, evolved gradually as a way for businesses, such as airlines, to secure necessary equipment without huge capital outlays.

Private Placements

Some investment opportunities are offered privately to a group of investors.

An investment described as *private* is one that qualifies to be exempt from registering with the SEC. It does not have to provide prospectuses or other detailed offering information to investors in most cases or file regular financial reports. The exemption is usually based on the amount of money the sponsors will raise, the financial standing of the investors who will be offered the opportunity to participate, or both.

While private placements are exempt from federal regulatory oversight, they must comply with the federal anti-fraud provisions of the Exchange Act of 1934.

GETTING ORGANIZED

Many private investments are organized as limited partnerships under the laws of the state where they are based. While these partnerships are exempt from SEC registration, they may be regulated as securities by their home states.

In a limited partnership there is always a general partner—or partners—and one or more limited partners. The general partner actively operates the business and is personally responsible for its actions and debts. Limited partners, on the other hand, are passive participants whose only job is providing the capital that the partnership needs to run its business. The most they can lose is the amount they invest.

PRIVATE ENERGY INVESTMENTS

Private energy programs, like all private placements, are exempt from SEC registration, though the SEC may require that potential investors be accredited. In some cases, however, up to 35 non-accredited investors may participate. For these investors, the program sponsor must provide a prospectus, financial statements, and other information comparable to what's required in a registered public program.

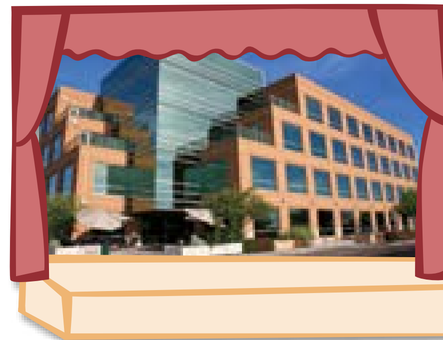
Some energy partnerships, private as well as registered, offer an interest conversion feature that allows investors who join the partnership as general partners for tax reasons to switch to limited partnership status after the drilling phase of the program ends. This arrangement exists because general partners are entitled to use intangible drilling costs (IDCs) incurred during drilling to offset active income, including wages and other earnings. Limited partners can use IDC deductions to reduce only passive income.

However, investors should realize that limited time, they have unlimited liability for partnership debts and other obligations.

RELP IS ON THE WAY

Real estate limited partnerships (RELPs) are organized to develop and manage commercial real estate projects. While some are public, about half are privately placed. As with other limited partnerships, there is a general partner and a number of limited partners.

RELPs own and manage income-producing properties or, less frequently, own mortgages on properties. Generally the specific



properties haven't been identified at the time the sponsor sells partnership interests, which makes it difficult to assess what the quality of the RELP portfolio will be and whether the acquisition costs turn out to be reasonable. Other factors that influence whether or not a RELP is a good investment are how much debt the program takes on, the upfront and ongoing fees, and the experience and skill of the managers.

Limited partners may or may not receive distributions of project income, at the discretion of the general partner. But returns are often substantial. In addition, partners can deduct depreciation allowances and other expenses against the income they receive, and they may be eligible for tax credits if the project rehabilitates properties that it owns. The general partner can also pass through losses, which can be used to offset gains. But claiming these benefits can be complex and requires the advice of a tax expert. Total return is determined only when all the properties have been liquidated.

As is the case with other alternative investments, there are upfront fees and commissions. With RELPs they may be as high as 20% to 25% of the amount invested plus ongoing costs during the term. In addition, there is no organized secondary market, so RELPs are illiquid.

EXEMPTION STANDARDS

Two regulations of the Securities Act of 1933, Reg A and Reg D, account for the vast majority of exempt investments. Reg D exemptions are more common, and most of them are granted under Rule 506 of the regulation.

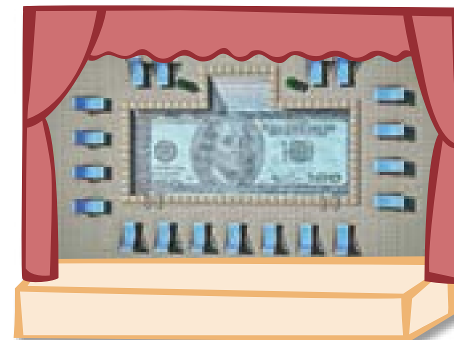
Rule 506 allows issuers to raise an unlimited amount of capital. Section (c) of the rule allows issuers to advertise, but sales may be made only to accredited investors, and audited financial statements or balance sheets are required.

Reg A exemptions apply small offerings, whose issuers raise no more than $5 million in a 12-month period. Issuers must provide an offering circular. Investors don't have to be accredited and audited financial statements aren't required.

In 2015, Reg A was updated to allow issuers to raise substantially more capital.

Under Tier 1, a company can raise up to $20 million in a one-year period. It must provide an offering circular that's filed with the SEC, is subject to SEC oversight and the states where the offering is made, and provide a final report.

Under Tier 2, a company can raise up to $75 million in a one-year period. It must provide an offering circular and is subject to SEC but not state oversight. The company must also file regular reports during the offering and a final report.



PRIVATE EQUITY

Private equity is an umbrella term for firms that raise capital to invest in business ventures. These pooled investment funds are typically organized as limited partnerships, with the owners of the firm as general partners and the investors as limited partners.

Some firms specialize in venture capital, or investing in new or small companies they believe will be successful and yield a significant profit. Others are buyout firms. They focus on buying existing public or private companies, restructuring them, and either selling them to other private investors or taking them public.

To participate in a private equity offering, investors must be accredited. Minimum investments are substantial, typically much higher than other alternative investments with the exception of hedge funds. Fees average 1% to 2% of assets as an annual management fee plus a percentage of profits, often 20% or more.

Like other alternatives, private equity investments are illiquid. Passive partners typically receive no payouts until the investment term ends, often eight to ten years after inception. But while there's no guarantee, eventual returns may be significant, especially with firms that have established a strong reputation for success.

Like-Kind Exchanges

Being able to defer certain taxes encourages investment.

In a like-kind exchange (LKE), also known as a 1031 exchange, an investor or business owner who sells investment real estate and replaces it with a like-kind asset of equal or greater value within 180 days can defer taxes on up to 100% of any capital gain on the sale.

Among the immediate benefits of tax deferral are that LKEs make more capital available for business investment, increase investment velocity, and reduce reliance on debt financing. Increased investment, in turn, has the potential to create jobs, stimulate the economy, and boost gross domestic product (GDP).

The economic principle underlying like-kind exchanges is that capital gains are not taxable until they are realized. Provided any paper profit on relinquished properties is reinvested in full to acquire new property, it remains a paper, or unrealized, profit.

To ensure that none of the cash is ever available for other uses, like-kind transactions must be handled within a strict legal framework.

In addition, while there is no specific timeframe for holding an asset acquired in a like-kind exchange, the assumption is that the business owner is making an investment. Acquiring a property and then selling it within a short period could raise red flags that the transaction was designed with flipping in mind. If an IRS audit concluded this were the case, the transaction would no longer qualify for tax deferral and capital gains taxes would be due.

It's important to remember that deferring taxes doesn't necessarily guarantee the business or investor will save money, either immediately or in the long run. It's always possible that the cost of replacing an asset or upgrading the new asset—as in the case of renovating a building, for example—could cancel out any saving realized by postponing taxes. It's also possible that the capital gains tax that's eventually paid could be higher than the amount on the original transaction.

DEFINING LIKE-KIND

How similar must assets be to meet the like-kind standard of an LKE? In the exchange of real property, there's actually a great deal of flexibility. The IRS's position is that most real estate is like-kind to other real estate, regardless of quality or grade. For example, residential rental property can be exchanged for vacant land or an office building can be exchanged for a factory, provided, in every case, that both are located within US borders. But US real properties are not like-kind with similar properties located outside the United States. Nor are they like-kind with personal property.

All of the properties that qualify for LKEs, though, must have a **business or investment purpose**. Property that's held for personal use, such as a primary residence, is not eligible for this type of exchange.

HOW A LIKE-KIND EXCHANGE WORKS

AN IMPORTANT INTERMEDIARY

To ensure that all rules are followed and prevent errors that either result in unexpected tax liability or invalidate the exchange, business owners must hire a **qualified intermediary (QI)**, also known as an accommodator or a facilitator, to handle all the LKE details. In fact, the intermediary must be on board throughout the process, before any part of the exchange occurs.

IT'S ALL IN THE TIMING

In an LKE, selling one asset and acquiring a like-kind asset doesn't have to occur in a single transaction. But if they're not simultaneous, deadlines apply. If these milestones aren't met, any gain on the relinquished asset becomes taxable.

Deadline 1: Identification of potential replacement property or properties in writing within 45 days of the date of sale. It can be one property or up to three, provided at least one of the three is acquired as the replacement. Other approaches permit naming an unlimited number of properties provided either that their combined fair market value isn't more than 200% of the fair market value of the properties being sold or that replacement properties actually acquired have a fair market value equal to 95% of all the properties identified.

Deadline 2: Completion of the exchange for the property identified earlier—or one that's substantially the same—either within 180 days after the sale of the relinquished property or by the date that the business owner or investor's income tax return is due, including extensions, for the year in which the sale took place, whichever comes sooner.

These periods are concurrent, so if the replacement properties are not identified until day 45, just 135 days remain to complete the exchange.

BEWARE THE BOOT

If an LKE transaction is handled incorrectly at any point or if a business owner replaces property with like-kind property of lesser value, the cash that's realized in the transaction—described as boot—is potentially taxable in the year the exchange occurred.

For example, while certain closing costs involved in acquiring the replacement property may be paid with the gain realized on the relinquished property, others may not. Some acceptable costs include broker's commissions, recording fees, and fees for professional advice on the sale. But it is unacceptable to pay pro-rated property taxes, mortgage-related fees, or insurance premiums.

On the other hand, there are occasions when taking boot deliberately—such as if replacement property of equal or greater value is unavailable—makes financial sense because the capital gains on the portion of the transaction that qualifies for an LKE exchange can be deferred.

ALTERNATIVE INVESTMENTS

Investing With a DST

LKEs offer access to valuable investment assets.

When a sponsoring real estate or investment firm acquires a property—or three to five properties—through a Delaware Statutory Trust (DST), the property qualifies as a replacement property for a 1031 like-kind exchange. Investors with properties they want to relinquish on a tax-deferred basis use the amounts they realize from the sales to buy beneficial interests in the DST. Other investors interested in adding real estate to their portfolios and the passive income the venture provides may purchase an interest directly.

Any taxable capital gain on the properties that are sold is deferred for the duration of the DST's holding period, which is typically five to ten years.

CONDITIONS APPLY

A DST sponsor designates a trustee to manage its property on its behalf. The trustee collects the rents and oversees general operations. But to comply with Treasury regulations about what qualifies as a direct interest in real estate for LKE purposes, the trustee must avoid actions, generally described as the seven deadly sins, that could put the DST's legal standing at risk. The trustee cannot:

1. Accept any capital contributions by current or new beneficiaries after the initial offering period ends
2. Renegotiate the terms of any mortgage loan or arrange any new mortgage financing unless a tenant is bankrupt or insolvent
3. Enter into new leases or renegotiate existing leases unless a tenant is bankrupt or insolvent
4. Reinvest the proceeds from the sale of its real estate
5. Authorize capital expenditures that are not used to carry out normal repair and maintenance, make minor non-structural capital improvements, or cover repairs or improvements required by law
6. Invest reserves or other cash in anything but short-term debt
7. Fail to distribute all cash, other than reserves, in a timely way

To protect investors against trustee error or other threats to the trust property, a DST trust agreement may include a provision that allows the DST to convert to a Springing LLC that is considered the same entity for legal purposes. Among the differences that such a conversion would make is that the seven deadly sins no longer apply, so the sponsor can arrange for new financing, renegotiate the leases, and raise new capital.

However, the Springing LLC is a tax partnership and not eligible to execute a 1031 like-kind exchange. So investors whose interest is no longer in the trust but in the Springing LLC will not qualify to have the taxes on their gains postponed when they ultimately sell their interests in the Springing LLC.

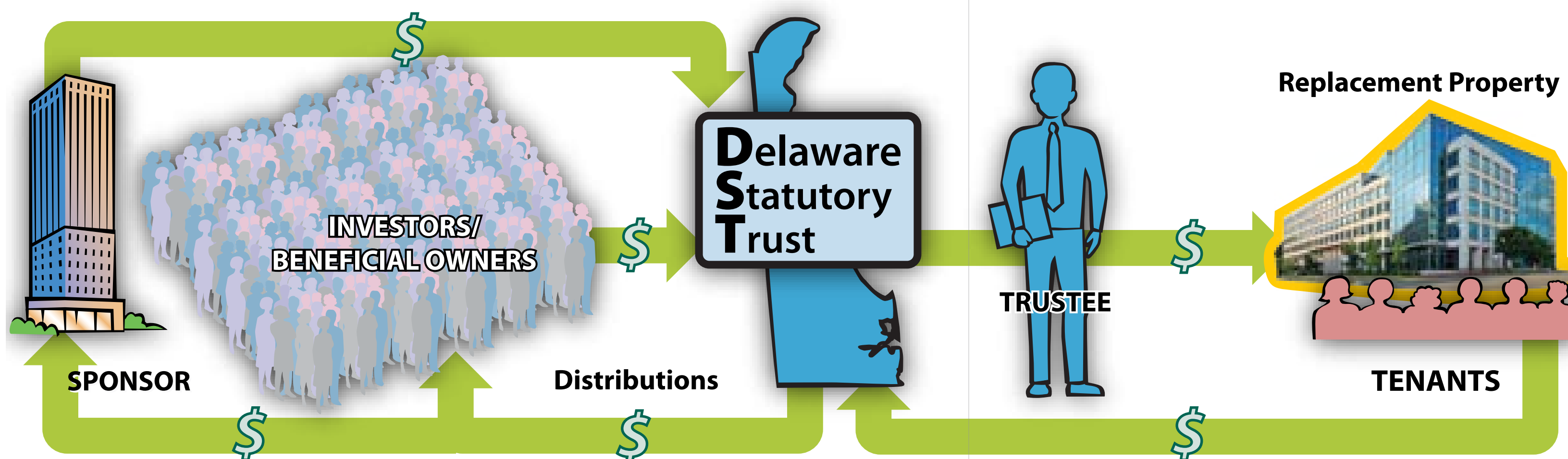
DST PROPERTIES

A DST typically owns large, expensive commercial properties rented to creditworthy tenants who can sign triple net (NNN) long-term leases. Under the terms of the lease, the tenant assumes responsibility for property maintenance, taxes, and insurance. For example, typical tenants of individual properties may be national retail chains such as restaurants, pharmacies, or big box stores.

In some cases, typically multi family housing or multi tenant shopping centers, the sponsor acts as the master tenant and agrees to pay a specific amount of rent to the trust for distribution to investors. In this arrangement, the master tenant signs subleases with individual tenants and is free to either renegotiate those leases or sign new leases with replacement tenants as long as the terms of the master lease are not altered.

But whatever the property type, a DST provides investment opportunities that are otherwise available only to extremely wealthy individuals or corporations.

HOW A DELAWARE STATUTORY TRUST WORKS



REWARD vs. RISK

Investors expect to profit from participating in a DST not only by postponing recognition of gain but also from receiving regular income from rental assets. Further, they benefit from the expertise of the investment professionals who identify, acquire, and arrange financing for quality real estate without shouldering the responsibility of managing property themselves.

Because minimum investment amounts are low, especially in light of the high-quality properties a DST typically owns, it's possible to diversify through a number of DSTs that invest in different asset types. Further, adding this non-correlated asset to an investment portfolio may help to reduce its volatility and protect its value.

There are risks, however, as there are in any investment, including the risk of losing principal.

For example, there is no guarantee that anticipated distributions will be paid. This disruption in income could be the result of tenant defaults on rent, properties that remain unoccupied, increased operating costs, or misjudgments on the part of the trustee, among other reasons.

In addition, while interests in a DST are transferrable, there's no organized secondary market in which they trade. So investors should be confident they have sufficient liquidity for the trust's term before they invest.

END GAME

When a DST's term ends, beneficial owners have options. They may cash out their investment and pay the deferred taxes and potential depreciation recapture that will be due. Or, they can roll over their pro rata share to purchase an interest in a new DST to extend the tax-deferred investment and collect the income the DST provides.

If a beneficial owner dies during a DST term, his or her interest can be bequeathed to an heir, who receives it at a step-up in basis to the fair market value at the time of the original owner's death. If the new owner chooses to sell, and can find a buyer, no capital gains tax or depreciation capture will apply.

ALTERNATIVE INVESTMENTS

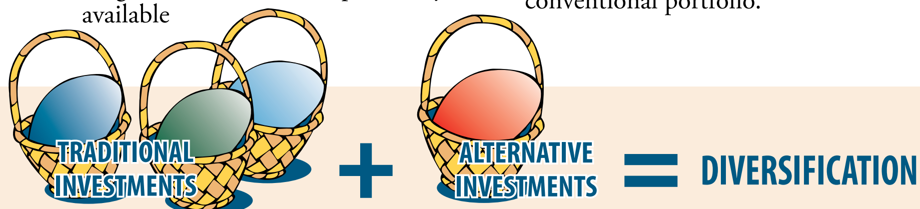
Alternative Appeal

The growing popularity of alternative investments is a testament to their attractive features.

Investors who add alternatives to their portfolios want to:

- Diversify their holdings
- Increase their income and total return
- Manage their income tax liability
- Hedge against inflation, recession, or both
- Capitalize on access to a broader range of assets than were previously available

Of course, no single investment, whether alternative or not, is appropriate for achieving all these objectives. And some alternatives are better suited for meeting specific goals than others. But individually, and as a group, non-traditional investments offer benefits with the potential to strengthen the performance of an otherwise conventional portfolio.



DIVERSIFICATION TOPS THE LIST

The benefits of diversification—its potential to reduce portfolio risk and increase investment return—position it as a primary strategy for thoughtful investors, including those choosing alternative products. Its primary limitation is the temptation to expect too much. As important as diversification is, it doesn't guarantee a positive return or prevent losses in a falling market.

The particular benefits that alternative investments add to a portfolio stem from returns that are non-correlated with the returns on traditional investments and—curious as it may seem—their illiquidity. These features are in addition to the classic benefit of diversification: By owning a variety of investments that respond differently to changing market conditions, investors position themselves to reap the rewards of whatever asset class or subclass is performing well while also having a stake in whatever class or classes will gain strength as the market moves into the next phase of its cycle of ups and downs.

What non-correlation adds to the mix is that alternative investment performance is driven by different factors than the ones that impact publicly traded products. For example, while alternative investment performance is not totally divorced from factors such as rising interest rates or falling employment rates, their impact tends to be more muted than for stocks or bonds.

Nor is performance vulnerable to changing investor sentiment. Rather, it's impacted primarily by the quality of a program's underlying investments and the effectiveness of its management team.

Illiquidity, of course, has drawbacks, but also a potential benefit. Unlike publicly traded corporations whose management is always under pressure to enhance short-term return, managers of non-traded investments have an extended period to achieve their goals.

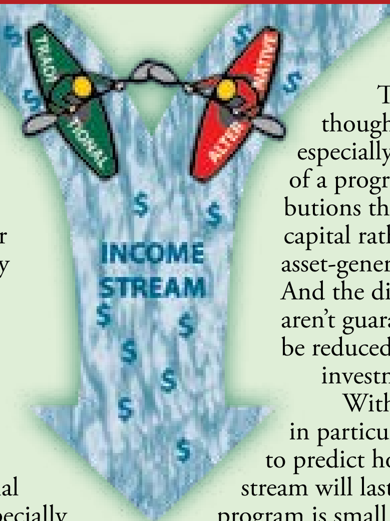
TAX REDUCTION TOOLS

It's relevant to note that distributions from alternative investments are taxed, in most cases, at the same rate as the investor's ordinary income rather than at the lower rate that applies to qualified dividends.

On the other hand, many alternative investments offer substantial tax relief, especially early in the program, through a variety of allowances and deductions for, among other things, depreciation and depletion. The rules for claiming these benefits can be complicated and differ from product to product, so the advice of a tax professional is essential.

Capital gains, which are possible with some alternative products, and may be offset by capital losses, do qualify for the lower, long-term capital gains tax rate.

WELCOME INCOME STREAMS



Many, though not all, alternative investments provide a regular stream of income, a benefit that attracts substantial investor interest. Non-traded equity REITs and debt BDCs, energy drilling programs, and equipment leasing programs all strive to be income producing. In fact, income from alternative investments may be higher than from traditional fixed income products, especially in a low interest rate environment.

There can be issues, though. Some alternatives, especially in the early years of a program, pay distributions that derive from capital rather than from asset-generated income. And the distributions aren't guaranteed and could be reduced or end if the investment fails.

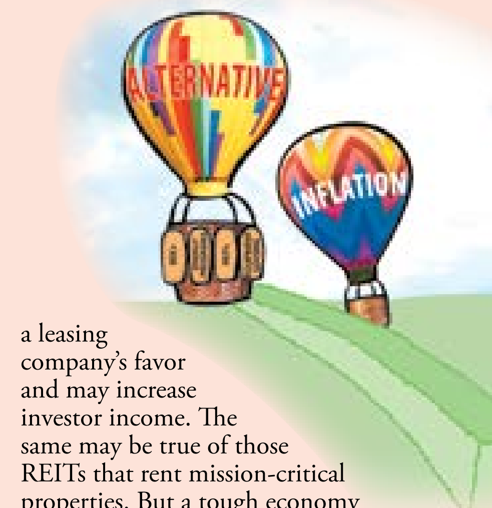
With energy programs in particular, there is no way to predict how long an income stream will last, especially if the program is small and operates a limited number of wells.

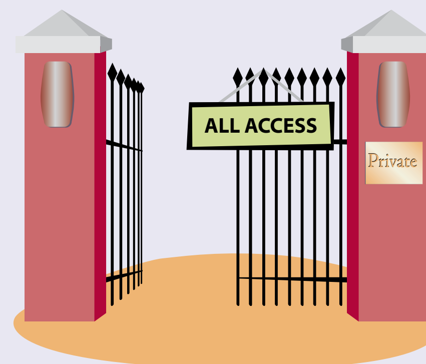
BUILDING A HEDGE

Another benefit some alternative investments provide is a hedge against inflation or recession—or, in the case of equipment leasing, perhaps both.

Real return, or the percentage gain investors realize after the inflation rate is subtracted from reported return, is vulnerable to rising inflation rates. But if a REIT increases the rent it charges its tenants, or a equipment leasing company increases its fees in the new contracts it signs, and the company distributes those increases to shareholders, the impact of inflation can be offset.

Conversely, in a recessionary period, companies still need equipment to operate and may be even less inclined to purchase outright than they are when the economy is healthy. This works in a leasing company's favor and may increase investor income. The same may be true of those REITs that rent mission-critical properties. But a tough economy also increases the potential for default.





INCREASED OPPORTUNITIES

One benefit of alternatives that may be overlooked as they gain widespread acceptance is that these pooled investment structures provide investment opportunities that were until recently available only to high net worth individuals and institutions.

The access to commercial real estate through non-traded REITs and private equity ventures through non-traded BDCs are perhaps the clearest examples of the democratization of the capital markets. But they aren't the only ones. The same is true of equipment leasing, energy exploration, and other ventures exempt from registration with the SEC but open to non-accredited investors. When these investors participate, however, the sponsor must provide the same offering information and financial statements that would be required if the offering were registered.

Measuring and Monitoring

Keeping track of performance is a key component of successful investing.

A relevant question investors must ask as they evaluate investment performance is whether the assets in their portfolios are meeting the objective for which they were purchased. The objective may have been increasing diversification and so helping to moderate risk. It may have been producing current income or enhancing long-term return.

Unlike traditional investments whose performance can be tracked every trading day, investors are often uncertain if an illiquid investment is living up to expectations. In the most transparent cases, non-traded BDC assets are assigned a fair market value each quarter. Non-traded REIT sponsors will have to provide valuations to investors. But many other alternatives are valued on a per-share basis more rarely, if at all.

What's more, total return—the sum of distributions and any change, positive or negative, in investment value—can be determined readily for traditional investments even though the gain or loss may remain unrealized. But for alternatives that involve a liquidity event, as REITs and BDCs do, total return can be calculated only when the investment term ends. So performance can be evaluated only in retrospect.

DEFINING RETURN

A complicating factor for investors accustomed to evaluating relative return, or how an investment performs in relation to a benchmark, is that there aren't appropriate benchmark indexes against which to measure alternative investment performance. And since one of the primary advantages of alternatives is that they're non-correlated with the performance of publicly traded investments, the benchmarks that are relevant for traded securities aren't relevant for non-traded alternatives.

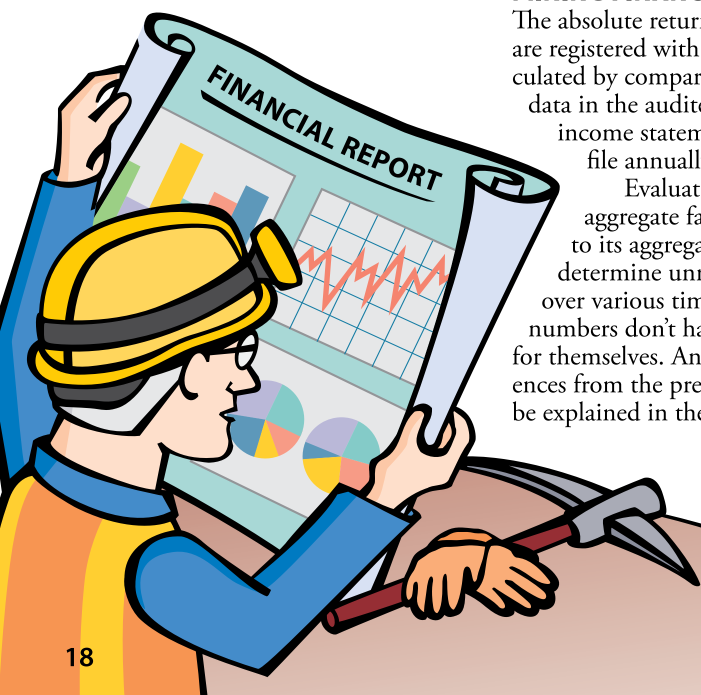
For example, the NCREIF Property Index, published by The National Council of Real Estate Investment Fiduciaries, tracks the quarterly rate of return on a sample of investment grade commercial properties. It's sometimes used to measure non-traded REIT return, but impressions can be misleading because the index doesn't account for fees or leverage, both of which have a major impact on performance.

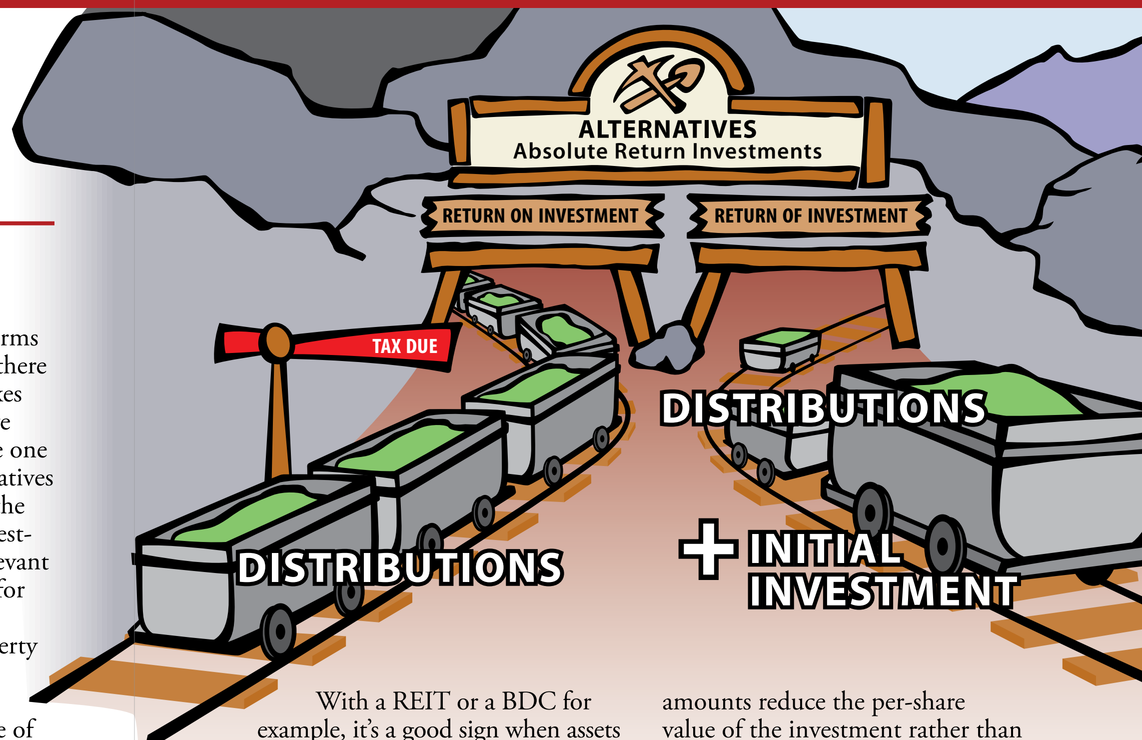
This helps to explain why alternatives are often described as absolute return investments. This means that gain or loss in value is measured in relation to the investment's previous value, not to the performance of a benchmark or a comparable investment.

MINING FINANCIAL REPORTS

The absolute return of investments that are registered with the SEC can be calculated by comparing the year-over-year data in the audited balance sheets and income statements their sponsors file annually with the agency.

Evaluating a portfolio's aggregate fair value in relation to its aggregate cost is one way to determine unrealized gain or loss over various time periods. And the numbers don't have to speak entirely for themselves. Any significant differences from the previous period should be explained in the footnotes.





With a REIT or a BDC for example, it's a good sign when assets are gaining value, income is increasing, and debt ratios are stable. The opposite is true when income is flat or falling and debt ratios are increasing. The state of the economy may be a contributing factor, of course, but it's also relevant that the investment and management decisions made by a program's administrators have a major impact on its performance, as do the fees investors pay.

Many non-registered private placements, however, aren't required to report on their operations or finances, making measuring and monitoring performance difficult if not impossible.

INCOME VARIETY

Yield is another way to measure investment performance, and it's a relevant indicator for alternatives, which are often described as income investments.

A complicating factor is that income from an alternative investment may be either a return of investment or a return on investment. The former means investors are getting their capital back, and the latter means they are receiving profits their capital has generated.

REITs and BDCs, for example, are required to distribute at least 90% of their taxable income each year to avoid paying corporate income tax. This is a return on investment. But, in the early years of most of these programs, the sponsors may pay distributions from the capital they have amassed during the offering period if their investments are not yet generating a profit. These amounts reduce the per-share value of the investment rather than increase the yield.

Equipment leasing and energy programs have more flexibility in making distributions. In a leasing program, for example, there may be a revenue sharing arrangement structure so that during the active operation of the business, the manager takes 1% of the cash distribution and 99% is passed on to the investors. Once an investor has received the equivalent of 100% of his or her investment, plus an 8% return on investment, then the manager takes 10% and the remaining 90% is distributed to investors.

Return **of** investment is generally not taxable. Return **on** investment is usually taxable, though investors may be able to offset the income with depreciation and other allowances when they file their tax returns.

THINKING AHEAD

The challenges of assessing performance during the term of an alternative investment illustrates why pre-purchase due diligence is critical. While the past performance of a sponsor or management team can't guarantee future results, it may be a key component in selecting among alternatives with the same focus.

It may also be smart for investors to put money into several alternatives of the same type, such as REITs or BDCs, rather than into just one. Then, if one provides disappointing distributions or a negative total return, others may live up to expectations.

Suitability and Accreditation

Alternative investments require thoughtful consideration.

An investment portfolio of traditional investments may provide satisfactory investment returns. But allocating a percentage of the portfolio to alternative investments may provide the opportunity for greater diversification, more current income, and the possibility of substantial capital gains. That's the premise underlying the increased attention to alternatives over the past decade or two.

However, investing in alternatives isn't as straightforward as buying a stock or a bond, a mutual fund, or even an equity option. So the sponsors who offer these investments and the broker-dealers and financial advisors who market them are responsible for making sure that investors understand the risks as well as the potential return of committing their capital. Broker-dealers and advisors are also required to determine whether an investment they may recommend is suitable for a particular client.

THE ROLE OF A BROKER-DEALER

Suitable, in the context of the financial marketplace, means that an investment is an appropriate choice for an investor to make.

As a first step, there must be a thorough evaluation of the offering or program using the materials the sponsor makes available and what can be discovered through independent assessment, often by engaging the services of a third-party expert. This process, known as due diligence, involves reviewing the prospectus, offering circular, or private placement memorandum, and other public materials when they're available, researching the investment's sponsor and the management team, and, in some cases, conducting on-site inspections and interviews.

But that's only half the task. The broker-dealer's second responsibility—as laid out in FINRA Rule 2111—is having reasonable assurance that an investment deemed suitable in its own right is appropriate for a specific investor based on a number of factors including the investor's age, other portfolio holdings, risk tolerance, financial situation, and liquidity needs. In doing a suitability assessment, a broker-dealer must also consider whether the individual understands illiquidity, how fees affect return, and the potential tax consequences of making the investment.

FINRA doesn't require broker-dealers to keep documents showing an assessment was made, though keeping good records can be important if a recommendation is questioned. On the other hand, FINRA maintains that having documentation of an assessment is not an acceptable remedy for an unsuitable recommendation.

Under state regulations, special suitability rules requiring that the broker-dealer or financial advisor know the investor personally may apply to certain private placements. And in some cases, investors may be required to seek advice from a knowledgeable person who can evaluate the investment independently.

The bottom line is than an investment that's perfectly suitable for one client may not necessarily be suitable for another or in his or her best interest.

Of course, investors bear some responsibility for assessing the wisdom of adding particular securities to their portfolios. This is especially true in the area of potential liquidity needs, which may be difficult for an outside observer to judge.

THE SPONSOR'S ROLE

An investment's sponsor who sells interests in an alternative or employs people who do is responsible for making a reasonable effort to determine whether an investment is suitable for prospective investors and that they understand the risks and benefits that are involved. In addition, the sponsor must confirm in the final prospectus their responsibility to assess suitability. They must also retain records of the information they use to make a suitability determination for a minimum of six years.

Investors may be required to sign a subscription agreement to acknowledge that they have read the prospectus and understand the degree of an investment's illiquidity. However, they will not be asked to sign anything that holds them to a subjective statement, such as whether or not they believe the investment is suitable for them.

PRIVATE PLACEMENTS

Although the issuer of a security that's exempt from registration and available only to accredited investors doesn't have to provide a prospectus or audited financial reports, the FINRA suitability rule applies when broker-dealers recommend the placement to an existing or potential customer—provided the customer acts on the recommendation and buys the security through the broker-dealer.

FINRA recognizes, though, that customers may not share all relevant information with a broker-dealer, limiting his or her ability to come to an accurate conclusion. So the regulator generally requires reasonable diligence as the basis for determining suitability and best interst, provided no obvious red flags are overlooked.

OTHER PROTECTIONS

The SEC and NASAA set certain standards that individuals must meet to invest in alternative investments that don't apply when they buy traditional securities.

To invest in a private equity partnership or a hedge fund, investors must be **accredited**. The SEC defines accreditation as having a net worth of at least $1 million excluding the value of the investor's primary residence or an annual income in the most recent two years of $200,000 for singles or $300,000 for married couples. Investment professionals in good standing who hold licenses based on passing Series 7, 65, or 82 exams are considered accredited, as are officers of the company selling a security and its knowledgeable employees.

To participate in certain private placements, investors must be considered **sophisticated**, which means, according to the SEC, that they have enough knowledge and experience in financial and business matters to be able to evaluate the merits and risks of an investment. And to invest in large hedge funds, investors must be **qualified purchasers**, with an investment portfolio worth $5 million not including fine art, real estate, or personal property.

NASAA guidelines for investment in non-traded REITs are currently a minimum net worth of $250,000 or an annual income of $70,000 plus a minimum net worth of S70,000. The organization has proposed increasing those amounts.

Some state regulators require that investors commit no more than a specific percentage of their portfolios to alternative investments, although those standards vary.

SEC AND NASAA FINANCIAL STANDARDS

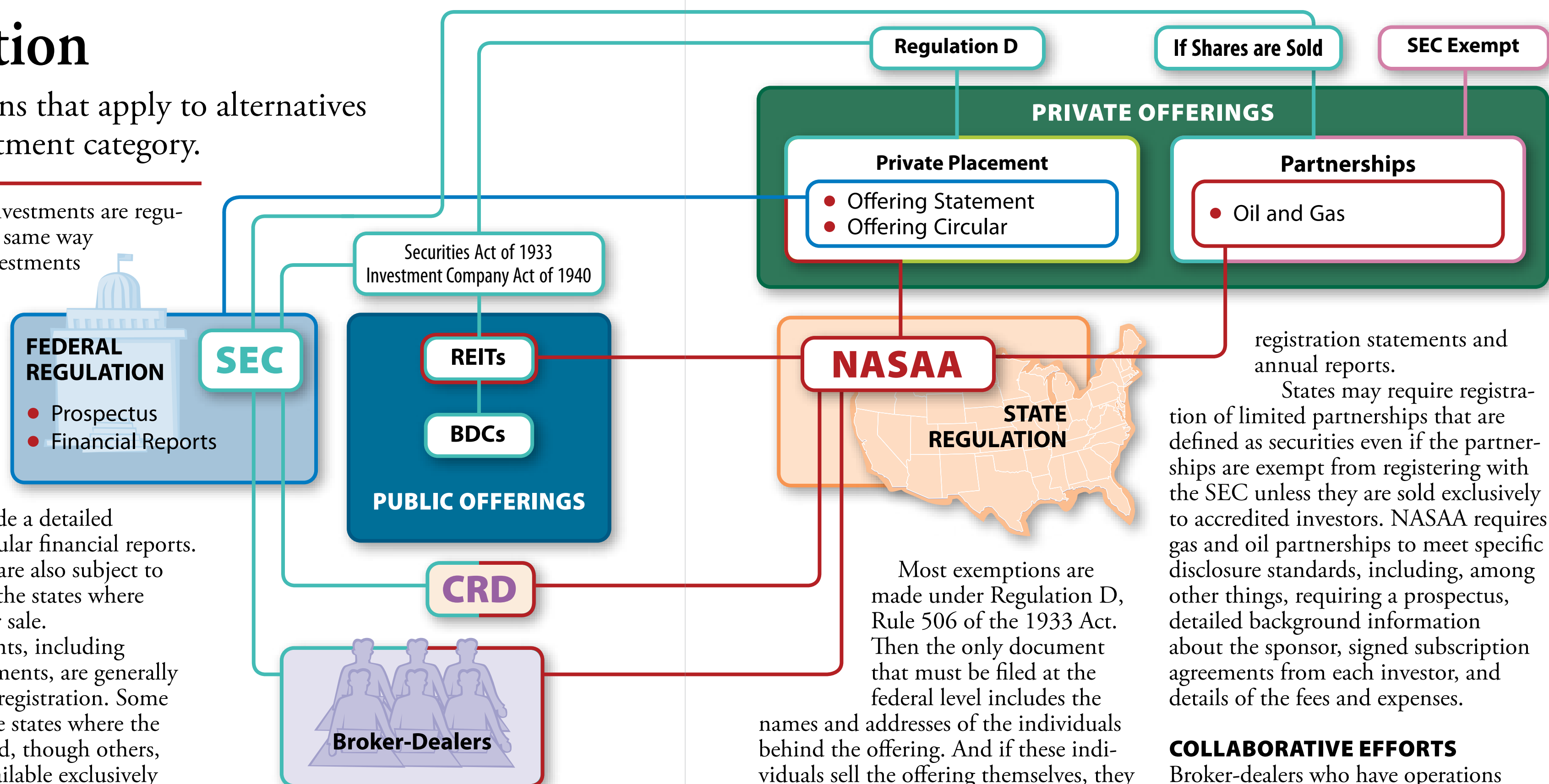
	Net Worth at Least:	Annual Income at Least:
Accredited	$1 Million	$200,000 Single $300,000 Married
Non-Traded REITs	$250,000	
	or $70,000	$70,000

ALTERNATIVE INVESTMENTS

ALTERNATIVE INVESTMENTS

Regulation

The regulations that apply to alternatives vary by investment category.



Some alternative investments are regulated in exactly the same way that traditional investments are. At the federal level, this means the issuer or sponsor must register with the Securities and Exchange Commission (SEC), abide by its rules, and provide a detailed prospectus and regular financial reports. Some investments are also subject to state regulation in the states where they're available for sale.

Other investments, including most private placements, are generally exempt from SEC registration. Some are regulated by the states where the investments are sold, though others, including those available exclusively to qualified investors, are not. While each state has its own regulator, and its own rules, many collaborate on a number of important issues as members of the North American Securities Administrators Association (NASAA).

Broker-dealers who sell alternative investments are regulated as well at both the federal and state levels. They must register with the Financial Industry Regulatory Authority (FINRA), which is under the jurisdiction of the SEC, and with each state where they operate.

NON-TRADED REITs AND BDCs

Non-traded REITs and BDCs appear similar in some ways, but the regulations that apply to them do differ based on the way the businesses are organized. Both must register with the SEC, REITs under the Securities Act of 1933 and BDCs under both the 1933 Act and the Investment Company Act of 1940.

Non-traded REITs aren't listed on a national exchange, so they must register in states where they're sold. All offerings must be made by prospectus, following specific SEC guidelines for the information that must be provided and the format that must be used. There's specific focus on distributions, regular valuations, and the history of the redemption program, if the program includes one. NASAA policy governs the make-up of the board of trustees, and sets standards for sales materials, fees and other compensation, investment restrictions, and suitability.

A BDC must provide a prospectus that describes its objectives and business plan, the amount of leverage it plans to use, and its fees and other expenses. The majority of its board of trustees must be independent, which means they have no connection to the sponsor or management team, and the board must provide a fair market value for each of its holdings every quarter. BDCs are also subject to state regulation, though the NASAA guidelines that apply are less specific than those that apply to non-traded REITs. State rules also vary. However, broker-dealers must meet the same FINRA suitability and other due diligence requirements that apply to REITs.

PRIVATE PLACEMENTS

To raise money from investors without using a public offering, as non-traded REITs and BDCs do, sponsors may offer an investment privately. This is legal provided the investment qualifies for an exemption from registration with the SEC.

Most exemptions are made under Regulation D, Rule 506 of the 1933 Act. Then the only document that must be filed at the federal level includes the names and addresses of the individuals behind the offering. And if these individuals sell the offering themselves, they don't have to register or be regulated as broker-dealers.

If the issue is offered exclusively to qualified investors, the issuers can decide how much information to provide. The only rule that applies is that there must be no fraud involved. These offerings aren't subject to state regulation, except in the case of fraud. However, if non-qualified investors are included in the offering, more oversight documentation is required.

Exemptions from registration are available under a number of other SEC regulations as well. For example, small businesses may raise limited amounts of capital by filing an offering statement and a prospectus-like document called an offering circular. These investments must be registered with the states where they are offered. Certain types of offerings, specifically those with drilling and mining operations, are excluded from exemption under NASAA's Statement of Policy.

LIMITED PARTNERSHIPS

Limited partnerships are created under state law and must register with the SEC if they sell shares to investors and don't qualify for an exemption from registration. Specific disclosure rules apply for gas and oil companies in filing registration statements and annual reports.

States may require registration of limited partnerships that are defined as securities even if the partnerships are exempt from registering with the SEC unless they are sold exclusively to accredited investors. NASAA requires gas and oil partnerships to meet specific disclosure standards, including, among other things, requiring a prospectus, detailed background information about the sponsor, signed subscription agreements from each investor, and details of the fees and expenses.

COLLABORATIVE EFFORTS

Broker-dealers who have operations in more than one state can file a single registration rather than a separate one for each state. And, in most states, the firm's representatives can meet the licensing qualifications by passing a Series 63 or Series 66 examination, which FINRA administers for NASAA. Most states also rely on the Central Registration Depository (CRD), an electronic registration and record keeping system for broker-dealers, which FINRA and NASAA developed collaboratively and which FINRA administers.

There's also a consolidated review process for issuers wishing to offer a program in several states. The issuers file a single application and are promised a response within 60 days. Two participating states lead the review, and when these reviewers approve the offering, all the participating states approve it at the same time.

THE CARDINAL RULE

Investor protection is the primary focus of securities regulation in the United States, at both the federal and state levels. The key to protection is ensuring investors have access to accurate and timely information that enables them to make informed decisions.

Accredited investor meets minimum income, net worth, or knowledge standards the Securities and Exchange Commission (SEC) requires for investing in certain private placements. Offerings made to accredited investors do not require the same level of disclosure that is required for non-accredited investors.

Due diligence is the thorough investigation of an investment offering to evaluate the issuer's financial and legal standing, the business plan, and other factors that may influence the success or failure of the venture.

Exempt security is one that is not required to register with the SEC based on criteria such as the investors who will qualify to participate, the amount of money the issuer intends to raise, and in some cases the period over which the fund raising will take place.

Fiduciary is a person or institution responsible for advising an investor about financial decisions and is legally obligated to act in the investor's best interest at all times. Some but not all investment professionals are fiduciaries.

Illiquid describes an asset that cannot be converted to cash quickly and easily at its fair market value.

Limited partnership (LP) is a business entity with one or more general partners who manage its operations and are legally liable for its debts, and one or more limited partners who have no management responsibility and no liability. An LP is organized under the rules of the state where it is established.

Liquidity event occurs at the end of a non-traded REIT or BDC term, when the investment's managers follow an exit strategy to dispose of the program's assets. Any net gains from the disposition are passed on to investors as part of their total return.

Net asset value (NAV) is what one share, or unit, of a pooled investment is worth at any given time, based on the value of the pooled investment's holdings. With a traded investment, the fund managers calculate NAV at the end of every trading day by dividing the aggregate market value of the fund holdings, minus expenses, by the number of outstanding shares. With a non-traded investment, NAV is usually calculated less frequently and typically can't be determined by market price.

Non-correlation is when the returns of two different categories of investments do not move up or down in tandem. That's because the return on one category is not impacted by the same market forces that impact the return on the other. For example, the return on a non-traded REIT is not correlated with the return of publicly traded large company stocks as measured by the S&P 500.

Non-traded describes an investment that is not listed on a national exchange or traded over-the-counter (OTC). Rather, it is sold in an extended offering period and is designed to be held for a specific term, often in the 7 to 12 year range.

Private placements are investments that are not required to register with the SEC, are not publicly traded, and are typically offered only to investors who meet certain income and net worth standards or have allocated no more than a set percentage of their portfolios to non-traded securities.

Program is a non-traded investment that is sponsored by an offering company and sold to individual and institutional investors through a participating broker-dealer.

Prospectus is a written document that is required to provide enough detail about an investment offering, including its objective, risk profile, and fees, to enable potential investors to make an informed decision about whether to purchase it or not.

Return of investment means an investor is repaid investment principal. This amount is not usually taxable, though there may be exceptions.

Return on investment is the gain an investor realizes on investment principal. This amount is usually taxable, at whatever rate applies, when the investment is held in a taxable account. When the investment is held in a tax-deferred account, no tax is due immediately and the return becomes part of the account balance and is taxed at withdrawal.

Sponsor is the person or firm that creates non-traded investment programs and offers shares, or units, to potential investors. In some programs, the sponsor is the general partner.

Total return is the combination of return on investment and any capital gains realized during the investment term or as the result of a liquidity event.

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GUIDE TO ALTERNATIVE INVESTING provides an overview of the range of alternatives that are available to investors, including REITs and BDCs, energy and leasing programs, alternative mutual funds, and private placements.

Included are discussions of diversification, income streams, and tax reduction tools. Also discussed is investor suitability, regulation, and the importance of pre-investment investigation as well as tracking performance.

- **NON-TRADED REITs**
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