Many investors realize they need an allocation to alternatives to diversify their traditional portfolios of stocks and bonds. They may even recognize that a well-constructed allocation should include multiple alternatives. However, figuring out which ones to include can be tricky. To understand how you might begin to think about building an allocation, take a look at how Morningstar does it.

**Morningstar® Diversified Alternatives Index℠**

The Morningstar® Diversified Alternatives Index℠ follows a five-step process to build and regularly adjust a portfolio of seven types of alternatives that broadly represent the alternative landscape.

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**Step 1: Risk and Return Assumptions**

Estimate the expected risk and return of each type of alternative and their correlations to stocks, bonds and one another. This is done using a combination of historical data and current market information.

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**Step 2: Strategic Asset Allocation Weights**

Determine the optimal weight for each alternative in the index, considering how the final portfolio of alternatives would perform relative to stocks and bonds within a larger portfolio.

<table>
<thead>
<tr>
<th>Risk Managers</th>
<th>Return Seekers</th>
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<tbody>
<tr>
<td>Hedge Funds</td>
<td>Private Equity</td>
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<tr>
<td>Long/Short Equity</td>
<td>Global Infrastructure</td>
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<tr>
<td>Merger Arbitrage</td>
<td>Managed Futures</td>
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<tr>
<td></td>
<td>Breakeven Inflation</td>
</tr>
</tbody>
</table>

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**Step 3: Dynamic Asset Allocation**

Apply overweights or underweights to each alternative based on momentum signals—market events and investor reactions—observed over the prior 12 months. Use a rigorous risk-management process to ensure the final index weights don’t stray too far from the strategic weights.

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**Step 4: Portfolio Construction**

Build a portfolio using a variety of ETFs representing the types of alternatives selected, applying the strategic weights and momentum overlays determined in steps 2 and 3.

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**Step 5: Monitor**

Review and adjust the strategic weights annually based on updated risk and return assumptions and rebalance the portfolio monthly based on momentum signals.

Alternatives attempt to either manage risk or enhance returns. For many investors, a well-balanced allocation should include a combination of both and needs to be monitored and repositioned regularly to keep up with changing market conditions.
The Takeaway

Many investors need alternatives to diversify traditional portfolios. You should also diversify your alternatives allocation and adjust it on an ongoing basis.

ProShares Morningstar Alternatives Solution (ALTS) is an ETF that allocates for you, based on the Morningstar Diversified Alternatives Index.

- ALTS follows the Morningstar Diversified Alternatives Index, which allocates among a comprehensive set of seven ProShares alternative ETFs designed to enhance risk-adjusted returns when added to a traditional portfolio of stocks and bonds.
- ALTS comes with the liquidity, transparency and cost effectiveness of ETFs.

For more information, visit ProSharesALTS.com.