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Fixing Morningstar: There Aren't as Many Liquid Alternative Mutual Funds as You Think

Confusion around classifying liquid alternatives has created misunderstandings of this innovative area of the asset management industry. Here's the solution.

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As liquid alternative offerings continue to grow, investors are charged with the task of determining which funds are appropriate for inclusion in their portfolios. One of the primary areas of confusion surrounding liquid alternatives is exactly how many exist as true alternative offerings.

A significant portion of the confusion can be attributed to database provider Morningstar, which remains the primary source for mutual funds research. While we have great respect for Morningstar as an institution, we believe the company's inability to correctly create and classify alternative strategies has had a direct impact on this growing field. Unfortunately for the industry, Morningstar is not dedicated to the alternative investment business but rather the mutual fund business as a whole. Their classifications are largely tied to specific asset classes, which lends itself well to long-only investing but falls short when it comes to hedge fund strategies. We believe a key flaw in Morningstar's methodology is the inability to bucket liquid alternatives into traditional hedge fund categories. This makes it difficult for investors who are both new and experienced in the space to find the solutions they are looking for.

Many others have recognized this issue with Morningstar. Goldman Sachs and Wilshire Associates, among others, have taken their own steps to define this universe, while other firms, such as Morgan Stanley, continue to rely on Morningstar's classifications. Goldman Sachs and Wilshire use traditional hedge fund categories that hedge fund investors can easily identify. As you would expect in an endeavor where investors are looking to define the investment universe, the results vary widely, as shown below:

Strategy	Goldman	Wilshire	Morningstar
Long/Short Equity	100	173	164
Event Driven	42	36	---
Relative Value	34	97	---
Global Macro	83	88	---
Multi-Strategy	78	110	157
Nontraditional Bond	---	---	131
Trading/Leveraged/Inverse	---	---	67
Market Neutral	---	---	58
Managed Futures	---	---	56
Bear Market	---	---	27
Multi-Currency	---	---	17
Total	**337**	**504**	**677**

Balter Liquid Alternatives' research into the area most closely aligns with Goldman's findings. We think that Nadia Papagiannis, director of alternative investment strategy for third party distribution at Goldman Sachs (formerly of Morningstar), has done an excellent job of reclassifying the liquid alternatives universe, producing a focused list half the size of that offered by Morningstar.

Even with Goldman Sachs' reduced list, we believe there are fewer funds with true alternative mandates. Our view is that for a mutual fund to be truly categorized as a liquid alternative, we have to better define what "alternative" means.

For example, diversified long/short funds that hedge exclusively with market indices do not belong in the alternative category. Outlined below are characteristics of funds that we would exclude from consideration as liquid alternatives:

- Shorting limited to market indices only
- Duration hedging
- Inverse funds or indices
- Option overlays
- Hedge fund replication
- 130/30 funds

Below are the buckets we would use to categorize the "true" liquid alternatives universe:

- **Long/Short Equity**
    - Dedicated short portfolio focused
- **Event Driven**
    - Capital structure agnostic
    - Special Situations
    - Merger Arbitrage
    - Long Biased
- **Relative Value**
    - Convertible Arbitrage
    - Market Neutral
    - Capital Structure Arbitrage
- **Global Macro**
    - Discretionary
    - Systematic
- **Multi-Strategy**
    - Single Manager
    - Multi-Manager

Using Morningstar's broad categorization of the industry, total assets under management are approximately $300 billion. That figure includes the Non-Traditional Bond category which stands at approximately $120 billion in assets, most of which we wouldn't consider to be truly alternative.

As a percentage of the $9.5 trillion in actively managed mutual funds, liquid alternatives do not even begin to register. We believe that, conservatively speaking, liquid alternatives will represent at least 5% of actively managed mutual funds within the next five years and 10% within the next 10 years, which would equate to ~$500 billion and $1.0 trillion, respectively.

Institutional investors are already responding to the diminished returns produced by the hedge fund industry by demanding reduced fees and seeking out more transparent and liquid investment solutions.

While the supply of liquid alternative products increases, making it ever more essential for investors to stay alert to the differences between true liquid alternative strategies and any cheap copycats looking to get in on the action, the growing demand strongly encourages key research providers to differentiate between the wheat and the chaff.

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Investments in debt securities typically decrease when interest rates rise. This risk is usually greater for longer-term debt securities. Investments in lower-rated and non-rated securities present a greater risk of loss to principal and interest than higher-rated securities. Investing in foreign securities exposes investors to economic, political and market risks, and fluctuations in foreign currencies. These risks are enhanced in emerging markets. The fund may invest in the securities of small and medium sized companies. Small and medium company investing subjects investors to additional risks, including security price volatility and less liquidity than investing in larger companies. Investments in IPOs can be volatile and can fluctuate considerably. IPOs can have a magnified impact on funds with a small asset base. Certain Sub-Advisers may be purchasing securities at the same time other Sub-Advisers may be selling those same securities, which may lead to higher transaction expenses compared to the Fund using a single investment management style.

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