Fixing Morningstar

Its inability to correctly create and classify alternatives is hurting this growing field.

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 I have great respect for Morningstar as an institution, 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 strategy lends itself well to long-only investing but falls short when it comes to hedge fund strategies.

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, which has resulted in a number of groups attempting to better refine the universe. Even so, there are fewer funds with true alternative mandates. For a mutual fund to be truly categorized as a liquid alternative, we have to better define what "alternative" means.

Outlined below are characteristics of funds that should be excluded 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 that should be used 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 AUM is approximately $300 billion. About $120 billion of that is the nontraditional bond category, most of which should not be considered true alternatives.

As a percentage of the $9.5 trillion in actively managed mutual funds, liquid alternatives do not even begin to register. Conservatively speaking, liquid alternatives will represent at least 5 percent of actively managed mutual funds within the next five years and 10 percent within the next 10 years, which would equate to $500 billion and $1 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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