BALTER
LIQUID ALTERNATIVES

125 High Street
Oliver Street Tower, Suite 802
Boston, MA 02110

tel: 617 742 4226
fax: 617 742 4224
web: www.balterliquidalts.com

Rebuttal from Participants in the Liquid Alternatives Industry on Common Misconceptions

The Liquid Alternatives industry has experienced exceptional growth over the past several years, in terms of both aggregate assets as well as the number of fund offerings. Titans of the hedge fund industry who have a vested interest in maintaining the status quo are rightfully alarmed about this trend. This concern was most recently highlighted by Skybridge Capital, who penned a brief article titled, "Why Alternative Investments and Daily Liquidity Shouldn't Mix." Many brand name, widely recognized hedge fund firms have participated in mutual fund space, albeit more often than not providing a watered-down skeleton of their higher fee vehicles. Those looking to discredit alternative mutual funds continue to offer tired arguments that are at times overly broad, can be entirely misleading.

While Balter Capital Management (BCM) has its roots in the traditional hedge fund consulting business, we have always made a concerted effort to embrace change, particularly when that change can be beneficial for clients. Our involvement in the '40 Act Fund space dates back to 2012 when we began introducing liquid alternative mutual funds into client portfolios to complement their traditional hedge fund investments. We took our involvement in alternative mutual funds a step further in 2013, with backing from a multi-billion dollar family office, and formed Balter Liquid Alternatives (BLA). Our objective was to offer genuine hedge fund portfolios, in mutual fund form, to the investor community. We made a material and lasting philosophical change about the way we would allocate capital to hedge fund managers going forward. This change is best described via BLA's Inaugural Letter, which forced many traditional hedge fund allocators to question their beliefs about the way they approach investing in hedge fund strategies.

Below we have summarized many of the common objections that we hear directed at alternative mutual funds. We have tried to address each of these points objectively with the intention of fostering honest and constructive conversation about an important growth area of the asset management business.

Argument: "Alternatives were designed for sophisticated investors and are not mainstream products."

We believe the notion that only the ultra-wealthy should have access to alternative styles of investment management is entirely arrogant. Net worth as a measure of investing intelligence has always seemed a bit of a nonsequitur to us but unfortunately the measure of a "sophisticated investor" is typically defined as someone who has more than $5 million in investible assets. By definition, this limits most traditional hedge fund strategies to the wealthiest 1% of our country. There are a countless number of baby boomers entering retirement and we believe they should have the ability to invest their retirement savings in more than just traditional equity and bond funds. With market valuations high and interest rates currently near all-time lows, diversification is difficult to come by.

Investment strategies utilized by hedge fund managers span an extremely wide range, from incredibly simple to the highly complex. Perhaps the most perplexing question is trying to understand how hedge fund fees and terms have stayed generally unchanged over the last 30 years. We feel that describing ’40 Act Funds as “sexy high-fee alternatives” is a manipulative tactic intended to compare them to long-only mutual funds. Perhaps a true comparison should be to that of the average hedge fund fees of a 1.7% management fee and 19% incentive fee, according to a recent JPMorgan survey.

Many opponents of ’40 Act Funds have noted that hedge fund strategies are “highly complex.” We would argue that we’ve seen far more masquerading coming from the hedge fund side than vice versa. We’ve asked hundreds of managers why they require a hedge fund structure given their portfolio attributes. Complexity is rarely the reason. Long duration locked up capital that provides management fees plus incentive fees would seem a far more logical reason to “masquerade” at this point in the lifecycle of the hedge fund industry.

We at BCM and BLA recognize that there are some strategies that are not suitable for the ’40 Act wrapper. We recognize that the LP format is a necessary presence for the protection of investors when utilizing strategies that are highly leveraged, illiquid or some combination thereof. In those cases, as a firm we do utilize and continue to recommend such investments. To initiate an investment, we must believe we have both the correct fit of the manager and the wrapper.

Argument: “Liquidity terms offer protection for invested parties and provide a competitive advantage for hedge fund managers”

Perhaps at one point in time this statement was true – but we no longer feel this point is valid. If this were the case, then every money manager who utilizes a lock-up structure should have superior returns compared to their daily liquidity counterparts. Even in those cases where the investment return is “superior”, the combination of management and incentive fees commonly negates any potential outperformance.

If we go down the liquidity path argument, then we have to ask: Did the gating behavior of 2008/2009 on the part of hedge funds during and after the financial crisis benefit the investor or the hedge fund more? Was it really done to protect investors in all cases?

In our opinion, the majority of hedge funds do not need the sort of liquidity provisions that their documents so generously provide. We often hear from institutional consultants, “but our clients don’t need daily liquidity”, when presented with a compelling liquid alternative solution. This misses the point entirely. We believe the restrictive liquidity terms are more often than not for the benefit of the manager and not the investor. We do recognize that there are some investment strategies that do need to limit liquidity based on the nature of the investments they make. However, our research indicates this is rarely the case for many hedge fund strategies and we believe they have the ability to run their funds inside the confines of the '40 Act restrictions.

Argument: “Mass proliferation of liquid alt funds creates systematic risk in financial markets”

This may be our favorite objection to the growth of alternative mutual funds. The argument that Skybridge presents here is the exact same one that the traditional investment community presented to hedge fund investors back in 2007. We all remember quite clearly that systemic risk was most likely a result of overleveraged banks and not from the hedge funds. One could argue hedge funds may have facilitated liquidity in areas where none existed. The liquid alternatives universe currently represent somewhere between $200 and $300 billion in assets under management. We believe, as a percentage of the ~$15 trillion mutual fund industry, liquid alternatives (excluding ETF's) don't even register as a topic worthy of discussion from a systemic risk perspective.

Argument: "Liquid Alternatives have not lived up to their expectations"

On the surface we can see the point some people are making with this comment. That said, it is a much more complex discussion than saying that performance has simply fallen short of expectations. The reality is that the alternative mutual fund space is evolving very quickly and the quality of the funds currently available is not consistent. Many new participants in the space are looking to deliver "hedge fund lite" products that do not offer all of the potential advantages of traditional hedge funds. We believe their reasoning for offering these products has more to do with not wanting to provide a product that competes with their core business, rather than legal restrictions. Other participants are offering "multi-strategy" funds that overdiversify in order to gather the maximum amount of assets possible. We believe the victors in the alternative mutual fund market will be those firms that provide genuine, pari-passu hedge fund strategies, often capacity constrained – but always pure.

including statements of opinion/belief contained herein are subject to a number of assumptions and inherent uncertainties. There can be no assurance that targets, projects, or estimates of future performance will be realized.

3456-NLD-7/27/2015