Strategic Perspectives

September 2017

Everything You Wanted to Know About Liquid Alternatives… But Were Afraid to Ask

Got questions? We've got answers! We're taking a different approach to our monthly communication this time around. Instead of our typical research style format (trust us, this is a departure for us as we're research nerds at heart), we thought we would turn the tables in order to address investors' concerns. We have put together the most frequently asked questions by advisors regarding the asset class and its starring role in a well balanced portfolio. We understand that financial advisors and their clients often have a lot of questions about liquid alternatives, and we hope that this serves to provide clarity on an asset class that when used properly, can be an effective tool to mitigate risk, provide diversification, as well as potentially enhance returns.

Q: What are liquid alternatives?

A: Liquid alternatives (also called "alternative mutual funds") are registered investment products where the investment manager utilizes investment strategies typically seen amongst privately managed hedge funds. These strategies may include, but are not limited to, shorting securities, holding concentrated positions, trading in niche asset classes, buying and selling options, pairs trading and hedging portfolio risk using market indices. While they have evolved signficantly since their infancy, liquid alternatives came about as a combination of industry shifts and regulatory changes post the financial crisis that resulted in alternative investment firms entering the mutual fund market.

Q: How are hedge funds and liquid alternatives similar? How are they different?

A: Similar to hedge funds, liquid alternatives have the ability to provide a differentiated return stream from traditional asset classes, particularly during difficult times in broad capital markets, reduce overall

portfolio risk and mitigate the effects of severe drawdowns, most notably in the equity market. That is where the similarities end. Different from hedge funds, they are regulated, have daily liquidity, are far more simplistic from a tax perspective, offer greater transparency, and may have lower fees.

Q: Ok, I get how hedge funds and liquid alternatives are different. But what I really want to know is the difference between traditional mutual funds and liquid alternatives.

A: Traditional mutual funds, in our view, are simply long-only, fully-invested "index-huggers." Don't be fooled by the warm and fuzzy moniker. Traditional mutual funds cannot take advantage of a poorly performing company, and are most typically fully invested in public equities or bonds. Liquid alternatives on the other hand can utilize investment strategies traditionally only found in hedge funds. This includes utilizing leverage, derivatives, and short-selling, allowing managers to potentially enhance returns, mitigate risk, as well as profit in declining market environments. Liquid alternatives may also utilize cash as a hedge. That is, if they don't see anything worth buying, they will hold onto cash until they find compelling opportunities.

In addition, liquid alternatives have access to a wide range of traditionally exclusive hedge fund strategies, including long/short equity, merger arbitrage, convertible arbitrage, and global macro. Traditional mutual funds cannot, and do not, employ these strategies. Simply put, liquid alternatives offer signficantly more flexibility than traditional mutual funds.

Q: How many different liquid alternative strategies exist?

A: Mutual fund research database provider Morningstar classifies liquid alternatives into eight different categories. However, their strategy classifications are largely tied to specific asset classes, which lends itself perfectly fine to long-only investing but falls short when it comes to hedge fund strategies, which at times may be agnostic across the capital structure (Event Driven or Multi-Strategy) or utilize different instruments to best express its view (Global Macro). As Morningstar is not dedicated to the alternative investment business, it's no surprise that they do not bucket liquid alternatives into traditional hedge fund categories. We believe that this makes it difficult for investors new to - or experienced in - liquid alternatives to find the solutions they are looking for.

Our view is that for a mutual fund to be truly categorized as a liquid alternative, we must define what "alternative" means. This would exclude shorting limited to market indices only, duration hedging, inverse funds or indices, option overlays, hedge fund replication, as well as 130/30 funds.

Our views and research instead closely align with that of Goldman Sachs' Asset Management Liquid Alternative Investments MAPs' framework. They re-classify the liquid alternatives universe into the following five categories: Long/Short Equity; Event Driven; Relative Value; Global Macro, and Multi-Strategy. In our view, this best aligns with how we evaluate varying strategies within the more traditional hedge fund universe, and applies quite nicely to the liquid alternative world.

Q: What is the benefit of adding liquid alternatives to my portfolio?

A: Liquid alternatives can offer a compelling risk/return profile with the potential to increase diversification, reduce volatility, and provide a return stream that exhibits low correlation to traditional asset classes, particularly to a traditional stock and bond portfolio. Said another way, it is intended to provide the appreciation potential and diversification benefits of hedge funds, while enabling investors to buy or sell them easily with daily liquidity, a hallmark feature of traditional mutual funds. We believe that the opportunity to access differentiated return streams and risk profiles can work in tandem with various long-only strategies in a portfolio. As the availability of liquid alternative vehicles has expanded meaningfully since its inception, the quality and pedigree of managers available has also signficantly improved.

Q: Could you give me an example of how the addition of a liquid alternative fund would be beneficial to my portfolio?

A: Certainly. For example, a long/short equity fund focused on smaller capitalization companies could replace existing exposure to a long-only equity strategy. Long/short equity investing provides the opportnity to profit on both over and underpriced securities. Furthermore, the Russell 2000 Index, which typically serves as a benchmark for small-cap stocks in the United States, tends to be made up of companies that have signficantly less analyst coverage than its larger cap counterparts. This results in greater potential for structural inefficiencies as well as more opportunities for alpha generation for those willing to do the work to exploit these inefficiencies. Additionally, as there are both good and bad companies in the small cap universe, the shorting element allows for downside protection, as it would allow a manager to take advantage of profiting from poorly managed companies. Long-only funds can only avoid them, but not profit from them. Long/Short Equity funds typically have a net equity exposure of 40% - 70% while Long-Only Equity funds are often close to 100% long. In other words, a lower net exposure should lead to reduced volatility and drawdowns over time as an integral part of a balanced portfolio. Please keep in mind that this is only an example – as each investor has different objectives and tolerance – we can absolutely provide more granularity specifically tailored to each client's needs. Please feel free to reach out.

Q: What questions should we be asking a potential liquid alternative provider?

A: When evaluating liquid alternative providers, advisors should be seeking to understand what they are truly getting. Be skeptical. True to our roots, we believe it is of utmost importance to look under the hood and conduct deep due diligence on all potential investments. Is it a true pari-passu (side-by-side) strategy, or is it watered-down in nature where all of the longs are represented but shorts are only indices? Does the manager or sub-advisor have a substantial historical track record that demonstrates the manager's ability to effectively manage capital during various market cycles? Does the strategy fit into a mutual fund format? If so, how did the manager handle - and perform - in a highly stressed scenario? How many other funds does the manager sub-advise for? What is the manager's motivation for creating such a vehicle? Are they looking to raise unlimited assets, or is it a structurally inefficient area that is capacity constrained? Most managers are unwilling to venture into areas of the market that can only accommodate a finite amount of capital as they prefer to asset gather with more "scalable" strategies. We, on the other hand, have long maintained that we are more than happy to sacrifice scale for the prospect of superior returns. We believe answers to these questions will steer investors in the right direction.

Q: Is manager selection important?

A: Yes, it is extremely important. In addition to accessing the right alternative strategies, we believe it is important that investors also focus on accessing the right managers within those strategies. As traditional hedge fund vehicles offer managers greater flexibility (and compensation) in implementing their strategies, it has attracted the industry's highest quality managers. They have the ability to be unconstrained in their pursuit of the highest risk-adjusted returns. As the industry has evolved, more hedge funds are also choosing to manage liquid mutual funds (whatever form it may be in). However, this potentially leads to negative selection bias amongst hedge fund managers who choose to do so. While there are certainly high quality managers who run liquid vehicles, we believe that the number of managers will likely be meaningfully lower than in the traditional hedge fund space. As a result, we believe it is important for investors to conduct the necessary due diligence not just on the strategies but on the managers as well.

Q: What are unique risks to investing in liquid alternatives?

A: While many hedge fund strategies can potentially fit comfortably into a '40 Act structure, we recognize that not all of them truly do. Knowing what can and cannot operate in a liquid alternative mutual fund wrapper is key. We firmly believe that highly concentrated, highly leveraged and illiquid strategies should instead remain in a limited partnership hedge fund vehicle. There are certain strategies, such as long/short equity and global macro, that lend itself well to the liquid alternative framework for example. Others, such as asset-based lending, would not, as there is aggressive asset/liability mismatch. Put simply, it is important to understand the strategy limitations that are inherent in daily liquid structures. We have always been major proponents of finding the correct fit for the strategy and the wrapper, and have intentionally avoided managers desperately trying to force a square peg into a round hole.

Q: Why are the fees so high?

A: When considering fees, it is important to take into account the evolution of fees within the hedge fund industry. Historically, hedge funds encompassed highly research intensive investment processes that ultimately required specialized investment personnel. As can be expected, in order to attract and retain such talent, hedge funds charged high fees in order to pay top dollar for their most coveted star performers. This has resulted in the notoriously high fee construct we see today amongst hedge funds. More recently it has evolved, particularly as additional hedge fund managers consider managing liquid alternative mutual funds.

We agree that some liquid alternative mutual fund fees are too high. That said, liquid alternative mutual funds generally have lower fees than their hedge fund counterparts, but in comparison to traditional long-only mutual funds, they are less straightforward. There are certain asset classes with structural inefficiencies that are difficult to access. It may also be an area that is capacity constrained. In order to entice managers to devote resources to these areas, managers often need to charge a higher fee in order to justify the strategy economically. In addition, some strategies may incur additional costs - costs that traditional long-only managers would not typically incur. For example, a long/short equity strategy would potentially incur short-selling, derivative and trading related costs as it seeks to hedge the portfolio as well as potentially profit from a declining market environment.

In all, while important, a fund's expenses should not be the only consideration when analyzing and comparing potential investments, as investors must consider a number of other factors, which includes each fund's risks, volatility, and its impact to each client portfolio's diversification. Furthermore, strategies need to be evaluted on an aggregate net fee basis. While fees may potentially be higher, if the end result blended creates a more efficient portfolio allocation, then the fees are ultimately justified.

LET'S RECAP...

- Liquid Alternatives are also called "alternative mutual funds."
- Liquid Alternatives are registered mutual funds overseen by the Investment Company Act of 1940.
- Traditional Mutual Funds are long-only and fully invested; they are limited to only buying and holding assets.
- Liquid Alternatives on the other hand have access to a wide range of traditionally exclusive hedge fund strategies.
- Liquid Alternatives, unlike hedge funds, have daily liquidity.
- Liquid Alternatives offers a compelling risk/return profile with the potential to increase diversification, reduce volatility, and exhibits low correlation to traditional asset classes.
- It is intended to provide the growth potential and diversification benefits of hedge funds while enabling investors to buy or sell them easily with daily liquidity, a hallmark feature of traditional mutual funds.
- We believe that the opportunity to access differentiated return streams and risk profiles can work in tandem with various long-only strategies in a portfolio.
- The availability of liquid alternative vehicles has grown, and quality and pedigree of managers has also improved.
- Manager selection is extremely important.
- There are unique risks to investing in liquid alternatives. While there are certain strategies that lend itself well to the liquid alternative framework, it is important to understand the strategy limitations that are inherent in daily liquid structures. Not all hedge fund strategies can fit neatly into a '40 Act wrapper.
- Ask your potential liquid alternative provider many questions and don't be afraid to look under the hood.
- Fees for liquid alternatives vary by strategy, as some may incur greater costs because of shorting, trading, or the fact that the strategy can only take in a limited amount of capital.
- Remember that a fund's expenses is not the only consideration when evaluating a potential fund for inclusion in a portfolio.

We hope this has been helpful. We're here for you - don't hesitate to reach out.

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Investing involves risk. Principal loss is possible.

Absolute return strategies are not designed to outperform stocks and bonds during strong market rallies.

Diversification does not assure a profit nor protect against loss in a declining market.

References to other mutual funds or products should not be interpreted as an offer of these securities.

Alpha is the excess return of a fund relative to the return of a benchmark index.

Derivative is a security with a price that is dependent upon or derived upon one or more underlying assets. The derivative itself is a contract between two or more parties based upon the asset or assets. Its value is determined by fluctuations in the underlying assets. The most common underlying assets include stocks, bonds, commodities, currencies, interest rates, and market indices.

Duration is the measure of the sensitivity of the price of a bond to a change in interest rates. Bond prices typically have an inverse relationship with that of interest rates.

Duration hedging is the practice of hedging a portfolio of fixed income instruments from changes in interest rates. This is typically done by paying a fixed rate on interest rate swaps or taking short positions in bond futures.

Event Driven is a strategy that seeks to exploit pricing inefficiencies that may occur before or after a corporate event, such as a bankruptcy, merger, acquisition, or spinoff.

Global Macro is a strategy that focuses on investing in instruments whose prices fluctuate based on changes in economic policies, as well as the flow of capital globally. It utilizes the widest number of instruments of any strategy to express its views long and short, which includes but is not limited to equities, fixed income, currencies, commodities and futures.

A hedge fund is a private investment vehicle that employs numerous different strategies in order to earn an active return, or alpha for its investors. Hedge funds may be aggressively managed, or make use of derivatives and leverage in both domestic and international markets with the goal of generating high returns. Hedge funds are generally only accessible to accredited investors.

Long-Only is a feature or policy of many mutual funds, it refers to a policy of only holding “long” positons in assets and securities. To be “long” an asset, derivative, or security means being a buyer, generally one who benefits from an increase in prices. The opposite is to be “short” which means the holder of the short position gains profits when the prices decrease. A long-only strategy is predicated on positive performance of the prices of assets that are held e.g. in the case of equities a long only strategy will do well during a bull market, but will likely not do well during a bear market.

Long/Short Equity is an investment strategy used primarily by hedge funds that involves taking long positions in stocks that are expected to increase in value and short positions in stocks that are expected to decrease in value.
Multi-Strategy funds are characterized by their ability to dynamically allocate capital among strategies that fall within several traditional hedge fund disciplines. Typically, the diversification benefits helps to smooth returns, reduce volatility, and decrease asset-class and single-strategy risks. http://www.eurekahedge.com

Relative Value arbitrage is an investment strategy that seeks to take advantage of price differentials between related financial instruments, such as stocks and bonds, by simultaneously buying and selling in the different securities.

The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000 is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set.

Short selling is the sale of a security that is not owned by the seller, or that the seller has borrowed. Short selling is motivated by the belief that a security's price will decline, enabling it to be bought back at a lower price to make a profit.

130/30 funds utilize financial leverage to simultaneously to hold both long and short positions on different equities in the fund. A 130/30 ratio implies shorting stocks up to 30% of the portfolio value and then using the funds to take a long position in the stocks that investor feels will outperform the market.

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