Democratizing Alternative Investments

Anthony B. Davidow, CIMA®

In today's ever-changing market environment, investors have evolved their asset allocation beyond traditional stock and bond portfolios. Increasingly, they have sought nontraditional investments to help mitigate risk, provide access to opportunities, and pursue non-correlating investment returns. These alternative investment strategies are becoming more mainstream and accessible for investors of all sizes and sophistication.

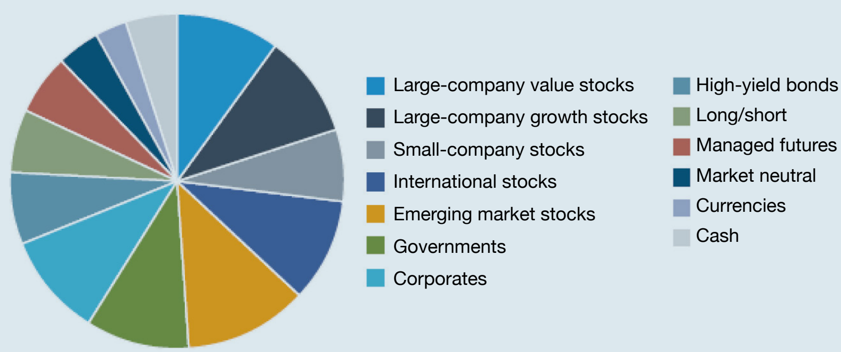
Alternative investments have long been the exclusive domain of institutions and family offices. With the introduction of liquid alternative strategies, mutual funds, and exchange-traded funds (ETFs), it is easier for individual investors to gain access to the same types of strategies. This article explores the role and growth of liquid alternative strategies and considers the following issues:

- What are alternative investments?
- What are liquid alternatives?
- How can the structures be evaluated?
- What role do alternatives have in a diversified portfolio?
- How can the performance of these strategies be evaluated?

What Are Alternative Investment Strategies?

Alternative investment strategies are nontraditional investments designed to provide a different risk and return pattern over time. They often are able to accomplish this by being long and short securities or segments of the markets. These strategies typically involve buying stocks, bonds, commodities, and currencies, among other investments. We believe that they should represent a portion of a diversified portfolio and that they can help in dampening clients' overall risk. Most alternative strategies historically have delivered low correlation to traditional investments. They provide the diversification benefits necessary to build optimal portfolios. It is important to note, however, that not all alternative investments are created equal. Depending on the nature of the strategy, some alternatives perform better in rising markets and others earn their value in falling markets. We would suggest diversification across alternative investment strategies (see figure 1).

Figure 1: Asset Allocation Today



Source: Schwab Center for Financial Research. For illustration purposes only.

Alternative strategies can be divided up a number of ways. One way is to group them broadly among directional and non-correlating strategies. Directional strategies include long/short, dedicated short bias, event-driven/distressed, event-driven/merger arbitrage, convertible arbitrage, global macro, fixed income arbitrage, and multi-strategy, among others (see table 1). These strategies seek to take advantage of market inefficiencies or price disparities in the marketplace. They typically exhibit higher equity beta, but they still serve to dampen portfolio volatility by being long and short.

Non-correlating strategies include market-neutral, managed futures, and currency-hedging strategies, among others (see table 2). They deliver low to negative correlation to traditional equity beta and serve to help protect portfolios in falling market conditions.

Hedge funds typically are structured as limited partnerships (LPs) or limited liability companies (LLCs), known collectively as "private funds." In recent years, more alternative strategies have been available in mutual funds or exchange-traded funds, also known as "liquid alternatives." Alternative investments also represent non-correlating securities such as private equity, venture capital, real estate, timber, currencies, gold, and other natural resources. Certain of these investments—private equity, venture capital, timber, and private real estate—require expertise when evaluating the options and tend to have longer holding periods.

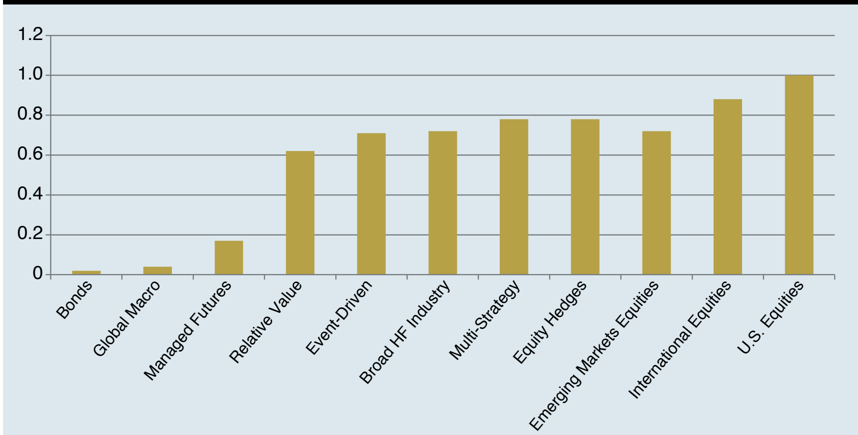
Table 1: Directional Strategies

Directional	Objective/Description	Portfolio Goal
Long/short	Buy securities that are expected to appreciate and hedge (short) those securities anticipated to depreciate.	Improve risk-adjusted returns over a market cycle.
Dedicated short bias	Short (sell) securities, or the market(s), that are expected to depreciate over time.	Reduce portfolio volatility. Offers the potential to profit in falling markets.
Event-driven/distressed	Profit from the transactions and events involving financial restructuring and recapitalization.	Benefit from successful completion of transactions.
Event-driven/merger arbitrage	Purchase the stock of the target company and short the stock of the acquirer to capture the premium associated with an M&A transaction.	Reduce the overall risk of a portfolio while seeking to capitalize on M&A activity.
Convertible arbitrage	Profit from the spread between a convertible security (bond) and the stock of the same company.	Reduce the risk of the overall portfolio while seeking consistent positive returns.
Global macro	Portfolio is designed to benefit from anticipated movements in global markets—equities, fixed income, commodities, and currencies.	Typically a defensive portfolio designed to hedge against global risk, but may profit from market dislocations.
Fixed income arbitrage	Exploit mispricing and inefficiencies in the spreads between fixed income securities or sectors.	Reduce the risk of the overall portfolio while seeking consistent positive returns.
Multi-strategy	Employ multiple strategies that seek different sources of returns. Benefit from diversification across strategies.	Reduce the risk of the overall portfolio while seeking consistent positive returns.

Table 2: Non-correlating Strategies

Non-correlating	Objective/Description	Portfolio Goal
Market-neutral	Capture the difference in performance of individual stocks or sectors of the overall market while maintaining a neutral exposure.	Reduce the risk of the overall portfolio while seeking positive consistent returns.
Managed futures	Systematically exploit rising and falling prices—commodities, currencies, equities, and fixed income. These are typically trend-following strategies.	Typically a defensive portfolio designed to hedge against global risk but may be able to profit from market dislocations.
Currency hedging	Typically long and short multiple currencies, seeking to take advantage of yield spreads across various currencies.	Typically a defensive portfolio designed to hedge currency exposures but may be able to benefit from currency fluctuations.

Figure 2: 10-Year Historical Correlations of Alternative Investment Strategies vs. the S&P 500® Index



Source: HFR, Wilshire, and Morningstar Direct. 2015 calendar-year performance (total return). Broad industry: Wilshire Liquid Alternative, HFRX Global Hedge Fund Index; Global macro: Wilshire Liquid Alternatives Global Macro, HFRX Macro/CTA Index; Equity hedge: Wilshire Liquid Alternative Equity Hedge, HFRX Equity Hedge Index; Relative value: Wilshire Liquid Alternative Relative Value, HFRX Relative Value Arbitrage Index; Multi-strategy: Wilshire Liquid Alternative Multi-strategy, HFRX EH: Multi-Strategy Index; Event-driven: Wilshire Liquid Alternative Event Driven, HFRX Event Driven Index. Past performance is no guarantee of future results.

One of the most appealing aspects of alternative investment strategies has been their diversification benefits. Because of their long/short nature and ability to access virtually any segment of the market, many of these strategies historically have provided low correlation to traditional investments. As shown in figure 2, the correlation across alternative strategies varies a great deal. Global macro and managed futures have correlations near zero, and equity hedge and multi-strategy have much higher correlations to traditional equities. Note, however, that even though their correlations are higher, they are still less correlated than other global equities (international 0.88 and emerging markets 0.72).

The reduced correlation of alternative investments can serve as a valuable diversification tool in building portfolios. Because alternative investments don't move in lockstep with traditional investments, they can serve as a risk-management tool, lessening the overall risk of a portfolio. This concept has served as the basis for modern portfolio theory (MPT) for many years.

In recent years there has been a great deal of interest in liquid alternatives—mutual funds or ETFs that attempt to mimic alternative investment strategies. Not all alternative investment strategies translate well into a liquid structure, but they make it easier for an investor to access these types of strategies.

Evaluating the Structures

Many investors shy away from alternative investments because of concerns they may have regarding the structure. Many investors assume that alternative investments and hedge funds are the same. Hedge funds typically structure their investments as limited partnerships (LPs) or offshore limited liability companies (LLCs) collectively known as "private funds." The hedge funds often carry a high management and performance fee structure (such as "2 & 20," meaning a 2-percent management fee and 20-percent performance fee) and aren't required to disclose holdings to investors.

Private funds often limit the ability of investors to redeem their interests in the fund, and they typically have provisions detailing the timing of redemption notices. As we experienced after 2008, hedge funds often retain the ability to "gate" investors (i.e., hold back funds for a period of time to avoid hurting other investors). Investors found out that they couldn't get their money back until the hedge fund decided to release it. Hedge funds are privately offered under Regulation D of the Securities Act of 1933, and all investors must be accredited investors. Many funds also require that investors be qualified purchasers as defined in Section 2(a)(51) of the Investment Company Act of 1940.

> *"Liquid alternatives have democratized these once-exclusive strategies and have removed many of the structural impediments that investors had objected to in a post-Madoff world."*

Liquid alternatives address investors' concerns regarding the perceived excessive fees and the lack of liquidity and transparency discussed above. Liquid alternatives have democratized these once-exclusive strategies and have removed many of the structural impediments that investors had objected to in a post-Madoff world. (It's worth noting that Madoff's scam was not technically structured as a hedge fund.)

Table 3 provides a structural comparison of liquid alternatives (mutual funds), registered investment companies (RICs), and hedge funds. As you can see, investors need to be aware of a number of significant structural differences before investing. In particular, investors need to understand the liquidity and lock-up provisions before investing. Investors need to understand the fee structure and how performance fees are calculated. Lastly, investors need to understand the tax-reporting differences. K-1s are often late or subject to revisions, and investors may need to seek extensions for filing their tax returns.

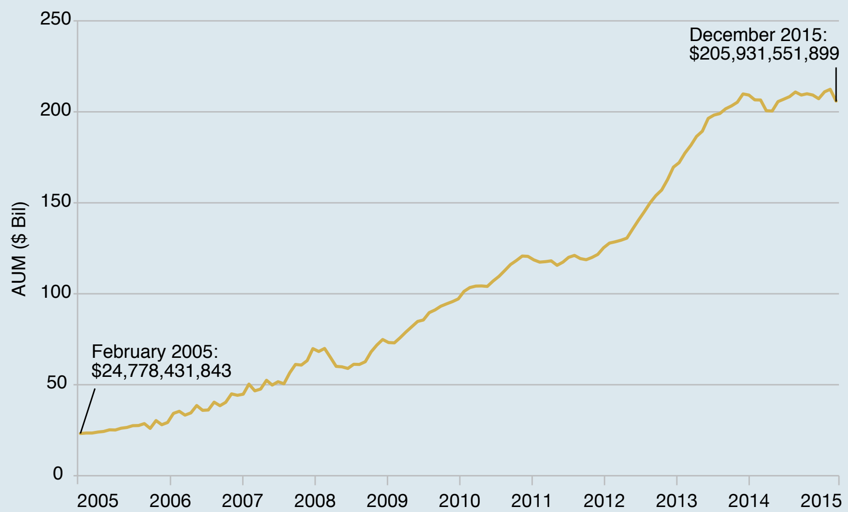
Liquid alternatives also have allowed investors to allocate more effectively across substrategies. Rather than allocating assets to a fund of funds that typically would allocate among 30–100 underlying managers, investors can allocate assets more easily. Most importantly, they can access their money immediately and see their underlying positions without having to pay excessive fees. Liquid alternatives help in democratizing investments by providing exposure to the types of strategies once limited to institutions and ultra-high-net-worth investors.

RICs are an increasingly popular structure for investors to access alternative investment strategies. RICs combine many of the benefits of liquid alternatives with the investment flexibility of traditional private fund structures. RICs are available at lower minimums and offer more-attractive

Table 3: Structural Comparisons

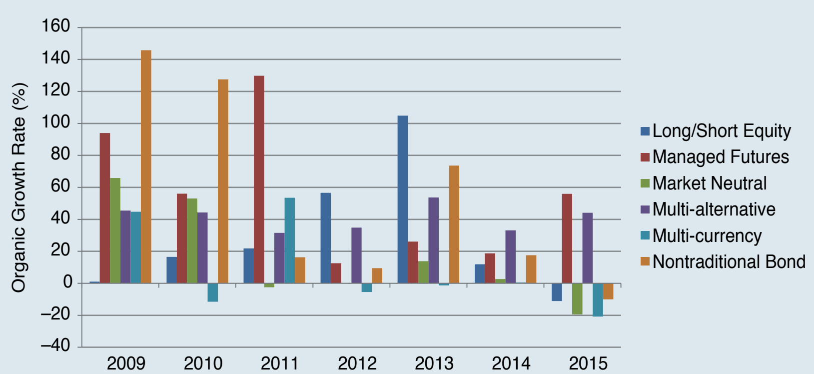
Characteristics	Mutual Funds	Registered Investment Companies (RICs)	Hedge Funds (LPs)
Investor types	All	May have some asset or income restrictions	Accredited investors, qualified purchasers
Minimum investment	Low	Medium	High
Pricing	Daily	Monthly	Monthly
Liquidity	Daily	Monthly or quarterly	Quarterly or longer
Lock-up	No	Varies	Yes
Performance fee	No	Varies	Yes
Transparency	High	High	Typically low
Tax reporting	1099	1099 or K-1	K-1
Leverage	Limited	Unlimited	Unlimited
Use of derivatives	Limited	Limited by margin	Limited by margin

Figure 3: Assets Under Management Growth of Liquid Alternative Strategies



Source: Morningstar Direct

Figure 4: Organic Growth Rates for Subcategories



Source: Morningstar Direct

liquidity provisions than private funds. RICs also can invest in many strategies that are unavailable through mutual funds, such as distressed hedge funds or private equity. RICs must be registered with the Securities and Exchange Commission and comply with additional investor protection measures, similar to liquid alternatives.

As figure 3 shows, liquid alternatives grew to roughly $206 billion by the end of 2015. The number and types of liquid alternatives have been growing rapidly over the past several years. Morningstar categorizes strategies into several large buckets: nontraditional bond, multi-currency, multi-alternative, market neutral, managed futures, long/short equity, and bear market. Multi-alternative and managed futures have seen the largest inflows recently. The organic growth for these subcategories is shown in figure 4.

McKinsey (2014) reported that alternative investments will continue to be embraced by large institutions and family offices and will experience significant growth among individual/high-net-worth investors. McKinsey speculated that "the next wave of growth in alternatives will be driven disproportionately by a 'barbell' comprised of large, sophisticated investors … and smaller investors who are first-time buyers."

How Should Advisors Evaluate Alternative Investments?

As previously discussed, alternative investments represent an array of strategies and shouldn't be grouped as a single solution. Not all alternative investments will provide the same results in a given investment environment. We generally accept the value of diversifying our equity exposure across large and small, domestic and international, and developed and emerging markets, yet investors often think of alternative investments as a single investment decision.

Advisors should determine the appropriate benchmark before investing in a strategy. In recent years advisors have been critical of alternative investment performance. Most of the criticism is because these strategies generally have lagged the S&P 500. But is the S&P 500 the appropriate benchmark for an alternative investment? Not for most strategies. Remember, these strategies are often hedging exposures and are seeking to reduce risk rather than outperform the equity markets.

Critics of liquid alternatives have speculated that these strategies will underperform their hedge fund equivalents because of the incentives built into the hedge fund structure and limited amount of leverage they can apply. Cliffwater (2013) evaluated the performance differential between private and liquid alternative strategies over the 10-year period ending in March 2013. This research showed an approximate 1-percent performance differential between the private alternative (i.e., hedge fund) and its liquid cousin. Cliffwater viewed the 1-percent discount as reasonable.

Cliffwater reported differences across the strategies, with event-driven and market neutral generating the highest excess return (2.26 percent and 2.24 percent, respectively), and macro and managed futures generating the smallest excess return (0.22 percent and 0.48 percent, respectively). Cliffwater also noted that the results vary over time and that "the discount declines when market stress increases, consistent with the notion that investors value

Table 4: Performance Comparison of Indexes Tracking Liquid Alternatives and Hedge Funds

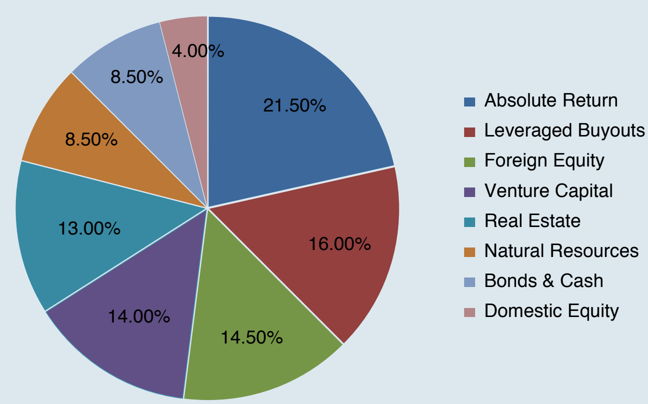
Index	2015	2014	2013	Performance Difference
Wilshire Liquid Alternative Relative Value	–2.80%	1.00%	1.99%	3.48%
HFRX Relative Value Arbitrage	–3.10%	–3.15%	2.96%	
Wilshire Liquid Alternative Global Macro	–2.96%	6.56%	1.65%	3.76%
HFRX Macro/CTA	–1.96%	5.24%	–1.79%	
Wilshire Liquid Alternative	–3.47%	1.51%	4.09%	–0.37%
HFRX Global Hedge Fund	–3.64%	–0.58%	6.72%	
Wilshire Liquid Alternative Equity Hedge	–5.04%	2.11%	7.98%	–5.18%
HFRX Equity Hedge	–2.33%	1.42%	11.14%	
Wilshire Liquid Alternative Event Driven	–4.00%	–1.04%	2.84%	–5.07%
HFRX Event Driven Index	–6.94%	–4.06%	13.87%	
Wilshire Liquid Alternative Multi-Strategy	–2.95%	0.52%	5.46%	–22.78%
HFRX EH Multi-Strategy	7.48%	1.85%	16.48%	

Source: HFR, Wilshire, and Morningstar Direct. 2015 calendar-year performance (total return). Broad industry: Wilshire Liquid Alternative, HFRX Global Hedge Fund Index; Global macro: Wilshire Liquid Alternatives Global Macro, HFRX Macro/CTA Index; Equity hedge: Wilshire Liquid Alternative Equity Hedge, HFRX Equity Hedge Index; Relative value: Wilshire Liquid Alternative Relative Value, HFRX Relative Value Arbitrage Index; Multi-strategy: Wilshire Liquid Alternative Multi-strategy, HFRX EH: Multi-Strategy Index; Event-driven: Wilshire Liquid Alternative Event Driven, HFRX Event Driven Index. Past performance is no guarantee of future results.

liquidity more during periods of market stress."

Research conducted by the Schwab Center for Financial Research found that some of the liquid alternatives outperformed their hedge fund cousins. Table 4 shows the performance results vary by strategy and year. The liquid versions of relative value and macro outperformed over the three years ending in 2015. Conversely, for multi-strategy, event-driven, and equity hedge, the hedge fund strategies outperformed the liquid funds; for multi-strategy it was by a wide margin. The differences may be attributable to a number of factors including structural limitations, the use of leverage, and the need to meet redemptions among others.

Figure 5: Yale Endowment Fiscal Targets for 2016



Source: *Yale News*, September 24, 2015, http://news.yale.edu/2015/09/24/investment-return-115-brings-yale-endowment-value-256-billion

Of course, there is no guarantee that liquid alternatives will continue to perform well in the future, but even if they provide comparable performance investors can benefit from the broader diversification. The value of an alternative investment strategy isn't necessarily in outperforming the market but rather in helping to dampen the overall volatility of a portfolio by providing diversification benefits.

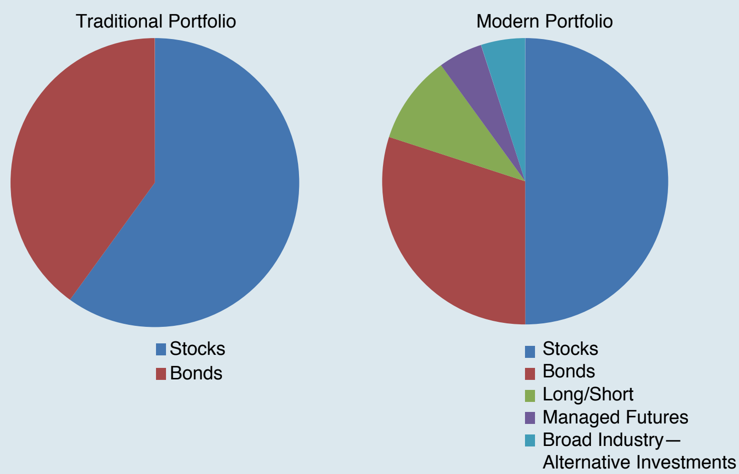
Even if an illiquidity premium exists as Cliffwater suggests, we would argue that there is still value in providing a return pattern different from that of traditional investments. Before 2008, investors weren't concerned about liquidity. When they sought to redeem, they realized they were unable to access their money. We don't believe it's an either/or decision. Rather, investors should evaluate how to access both liquid and illiquid strategies. Each has merits and limitations.

Putting the Pieces Together

Harry Markowitz (1952) introduced the concept of diversification as a risk-management tool. He suggested that by constructing a portfolio of two risky investments that have low correlations to one another, an investor could reduce the overall risk of a portfolio. This served as the foundation of modern portfolio theory (MPT) for many years.

Much of the early research done on asset allocation focused on allocations across stocks, bonds, and cash. Institutions were early to embrace nontraditional investments as an enhancement to MPT, and with the proliferation of products, advisors also have begun to embrace an array of strategies. Asset allocation has evolved as

Figure 6: Sample Portfolios—Traditional Portfolio vs. Modern Portfolio



Traditional portfolio allocated to 60-percent stocks (equities) and 40-percent bonds. Modern portfolio allocated to 50-percent stocks (equities), 30-percent bonds, 10-percent long/short, 5-percent managed futures, and 5-percent broad industry alternative investments. For illustrative purposes only.

the landscape has changed, and the ability to access strategies and markets has accelerated.

With correlations among traditional investments rising in recent years, investors have sought investment options that historically have exhibited low correlation to one another. Many alternative investments provide lower correlations than their traditional counterparts (see figure 2) and therefore provide diversification benefits to an overall portfolio.

A number of asset allocation approaches have gained popularity in recent years, and investors have sought to mimic approaches used by some of the most successful investors. The endowment model gained popularity in the late 1990s and early 2000s. It is based on the extraordinary results delivered by the Yale endowment, and many investors have sought to match these allocation decisions.

As figure 5 illustrates, the Yale endowment has large allocations to alternative investments, including venture capital, leveraged buyouts, absolute return (hedge funds), real estate, and natural resources (timber, commodities, real estate, etc.). It has successfully employed a philosophy that leverages alternative investments for many years. The Yale endowment target allocation for 2016 is 73 percent to alternatives. Its equity and fixed income allocations are relatively low, with a higher equity allocation to foreign stocks.

It's instructive to know what some of the largest and most-sophisticated investors are doing, but it's just as important to recognize the differences between Yale and the average high-net-worth investor. Yale's time horizon is perpetuity, and if it needs additional funds, it can always reach out to alumni. Because of the size of Yale's endowment ($25.6 billion as of June 2015), it has significant scale and access advantages relative to most investors. It also receives favorable terms and fees on many of its investments.

We believe it's important to develop asset allocation strategies that meet each individual's goals and objectives. Individuals are different from institutions in their time horizons, access, and appetites for risk. Allocation models should incorporate the optimal blends of a diverse set of asset classes. An individual investor should determine the right blend based on individual time horizon, cash-flow needs, and risk profile. Figure 6 shows two sample portfolios. The first pie chart shows a traditional 60/40 portfolio and the second shows a modern portfolio including alternative investments.

Figure 7 shows that adding a small percentage of alternatives can help dampen a portfolio's overall volatility. To show the value of diversification, we compared the traditional 60/40 portfolio with the modern portfolio, which provides a modest exposure to alternative investment strategies to access better returns and less risk (standard deviation) than the traditional portfolio. This is due to the alternative strategies' relatively low correlation to stocks and bonds.

In recent years, investors have been critical of alternative investment performance. We view the inclusion of alternative investments as a valuable risk-management tool. They help dampen volatility and reduce risk in falling markets. Although equity returns were strong from 2009 to 2014, we all remember the volatility and carnage created in 2008. Managed futures actually delivered positive results in 2008, and other alternatives lost less than the overall market.

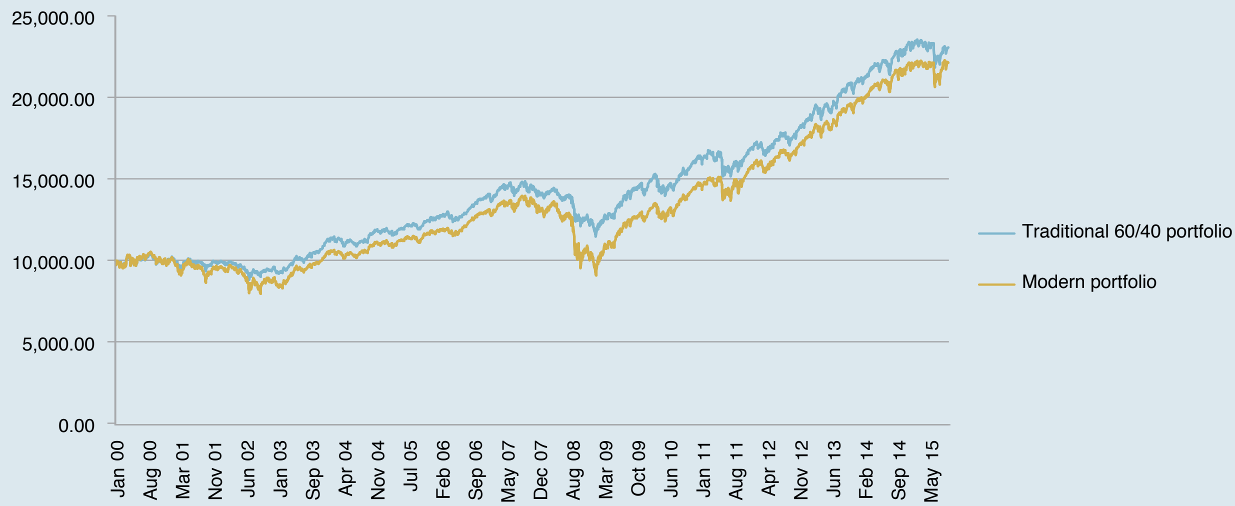
We believe that asset allocation needs to evolve beyond traditional stock, bond, and cash allocations. Alternatives represent a valuable diversification tool for portfolios. With the growth of liquid alternatives, available at lower minimums, advisors can diversify across alternative exposures (long/short, global macro, managed futures, merger arbitrage, etc.).

Conclusion

Alternative investments serve a valuable role in risk management. With lower historical correlation to traditional investments, alternatives can dampen overall portfolio volatility. As pointed out throughout this article, not all alternatives are created equal. Certain strategies tend to perform better in rising market conditions and others tend do a better job protecting in falling markets.

Not all alternative strategies translate well into a liquid structure, and there may be trade-offs in a manager's ability to use illiquid investments and leverage, but these strategies certainly have provided diversification benefits to investors over time.

Figure 7: Growth of a Hypothetical Traditional Portfolio and Modern Portfolio



Name	Cumulative Return	Annualized Return	Initial Value	Ending Value	Total Return	Standard Deviation
Traditional 60/40 Portfolio	118.86%	5.02%	10,000.00	21,885.52	5.02%	9.01%
Modern Portfolio	127.96%	5.28%	10,000.00	22,795.51	5.28%	6.99%

Source: Morningstar Direct. January 1, 2000, to December 31, 2015. Traditional and modern portfolio allocations are the same as the sample portfolios in the prior illustration. Asset classes are represented by the following indexes: Stocks (Equities): S&P 500 Index; Bonds: Barclays U.S. Aggregate Bond Index; Long/Short: Morningstar Global Long/Short Equity Index; Managed Futures: Credit Suisse Managed Futures Index; Broad Industry Alternative Investments: Wilshire Liquid Alternative Index (which is composed of the Wilshire Liquid Alternative Equity Hedge Index, the Wilshire Liquid Alternative Global Macro Index, the Wilshire Liquid Alternative Relative Value Index, the Wilshire Liquid Alternative Multi-Strategy Index, and the Wilshire Liquid Alternative Event Driven Index). Past performance is no guarantee of future results. The example is hypothetical and provided for illustrative purposes only. It is not intended to represent a specific investment product. Dividends and interest are assumed to have been reinvested, and the example does not reflect the effects of taxes or fees. If taxes and fees had been considered, performance would have been lower.

Liquid alternatives should be evaluated like all investments. Advisors should evaluate the historical risk and return characteristics and the underlying investment strategy being deployed. They should understand the fee structure and the ability to access their funds.

With the proliferation of liquid alternative strategies, advisors can tap into these unique strategies and allocate effectively across the various substrategies. We recognize that certain strategies will be accessed more efficiently in private funds and there may be a liquidity premium. Liquid alternatives eliminate many of the structural concerns that investors have expressed about lack of liquidity, lack of transparency, and excessive fees. Liquid alternatives have helped to democratize alternative investments, providing individual investors with access to strategies similar to those that were once the exclusive domain of institutions and ultra-high-net-worth investors.

Anthony B. Davidow, CIMA®, is vice president, alternative beta and asset allocation strategist, with the Schwab Center for Financial Research. He has served on IMCA's board of directors and is a member of the Investments & Wealth Monitor *editorial advisory board. He earned a BBA in finance and investments from Bernard M. Baruch College. Contact him at anthony.davidow@schwab.com.*

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