Understanding Alternatives and Their Research Challenges

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Alternative investments generally are defined as strategies other than traditional long-only stocks or bonds, and they continue to be popular among institutional investors who have access to private partnerships (i.e., hedge funds). They also are taking hold in the mutual fund world, where a growing number of alternative strategies now are available to a broader group of investors through mutual funds with lower minimums, more transparency, and more liquidity than hedge funds. (Note however, that the sharp increase in the nontraditional bond category continues to blur the line between traditional and alternative strategies; Morningstar reports 12-month inflows to nontraditional bonds of approximately $55.9 billion as of January 31, 2014.)

We know many advisors are using or considering alternative strategies for client portfolios. Here we present some key areas for these advisors to assess and some specific considerations for various types of alternative strategies. Anyone considering alternatives wants to know how these investments can be expected to behave in various environments and how they can be used to add value to a portfolio. Understanding the strategies and the underlying investments is essential.

Since 2008, both supply and demand have exploded in the liquid alternative strategies space, i.e., mutual funds and, to a lesser extent, exchange-traded funds (ETFs), with the asset class growing to more than $550 billion at the end of 2012.¹ Factors including increased regulation of private funds, slower growth in institutional allocations, and difficulty fundraising for new hedge funds have encouraged some alternative strategies managers to create or sub-advice ’40 Act offerings. In addition, risk aversion, a desire for diversification, and a (thus far largely incorrect) bleak outlook for traditional equity and fixed-income markets have spurred demand from retail investors and their advisors. The result is a proliferation of choices for investors that includes single-strategy mutual funds and ETFs, multi-strategy mutual funds, hedge fund replication mutual funds and ETFs, and multi-manager mutual funds.

We welcome an increase in the available choices of liquid alternative strategies and assume that increased competition raises quality and lowers cost. The increase in choice, however, also has its downside. Our concerns about absolute-return-oriented strategies include the complexity of some strategies that makes them difficult to evaluate; high cost (though it’s still usually lower than hedge funds); the difficulty associated with determining an appropriate role in a diversified portfolio; and the difficulty in determining appropriate benchmarks or whether specific benchmarks are even appropriate. The lack of track record for almost all new funds also has been a concern, though a small number of alternative strategy mutual funds are now old enough to have more substantial track records.

Alternative Strategies and Mutual Fund Structure

Individual alternative strategies vary widely, each with its own benefits and drawbacks to consider. We present the following categories for the purposes of discussion, acknowledging that different investors may define the categories more narrowly (or possibly more broadly). Note the lack of a clear dividing line between categories, making any classification scheme somewhat subjective.

Long-short equity. This is a popular hedge fund strategy because of its relatively straightforward nature. An equity long-short strategy calls for long positions in stocks that are expected to increase in value and short positions in stocks that are expected to decrease in value. Long-short equity translates well to mutual funds because it is typically liquid and doesn’t require much, if any, financial leverage to generate attractive returns on equity—assuming the manager can consistently add value through stock selection. After the financial crisis, long-short equity fund performance was relatively weak until recently. This weak performance was due to high correlations among stocks and poor price differentiation between good/improving companies and bad/deteriorating ones. (The HFRI Equity Hedge Index has a 9.14-percent trailing 12-month return and a 3.23-percent annualized three-year return through December 31, 2013.) On the positive side, correlations among stocks declined in 2012–2013, providing a better opportunity for managers to add value through stock selection. Long-short equity funds typically benefit from some degree of net long exposure to the market unless they are explicitly market-neutral, so if the market produces negative returns, these funds will face a significant headwind. Other challenges facing these funds include

¹ http://www.morningstar.com/products/morningstar/fundresearch/alternativeinvestments.html

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massive competition from other actively managed mutual funds and hedge funds also seeking to identify mispriced stocks, the significant cost of borrowing shares in many highly shorted stocks, and the ultra-low rate environment that results in managers earning nothing on any cash they hold from shares sold short.

Merger-arbitrage and event-driven. Event-driven investing (not including the often illiquid “distressed” category) also works well in a mutual fund context. Event-driven investing attempts to profit from some corporate action that the manager believes will be transformative to a company and is not reflected currently in the price of that enterprise’s securities. Events can include mergers, acquisitions, spin-offs, refinancings, litigation, etc. The current environment for event-driven investing is largely favorable due to high levels of cash on corporate balance sheets, accommodative credit markets, and activist shareholders clamoring for managers to unlock shareholder value. Fund managers in this category who engage exclusively in merger-arbitrage investing, however, have had a difficult time over the past several years because deal spreads have been at the low end of the historical range and volume has remained relatively low until this year.

Absolute-return-oriented fixed income and long-short credit. A wide range of strategies fit under this umbrella. The overarching theme here is that managers have a broad mandate to generate returns through bond-market sector and/or credit selection, and potentially through duration management (although this is usually a secondary focus). These types of funds may be attractive because they essentially allow managers to disaggregate the risk factors in fixed income—most importantly separating credit risk from interest-rate risk—and take exposure only to the factors they believe are attractive. The broad flexibility also allows them to invest in areas that may be less efficient than core investment-grade bonds, such as emerging-markets debt or mortgage-backed/other asset-backed securities. Once again, low risk-free rates are likely to be a headwind here because most strategies have some interest-rate exposure and rates are expected to continue on an upward trajectory over the coming years. Further, credit spreads (the amount of yield above the Treasury yield) are relatively tight, offering little, if any, expected gain from spread compression, i.e., a narrowing of the yield differential, which results in appreciation for non-Treasury bonds. Generating attractive absolute returns without accepting some duration risk and/or credit risk—and a likely higher correlation to equity returns—is very challenging in this environment, particularly when using little or no leverage.

Macro and managed futures. Macro strategies try to generate profits by betting on currencies, commodities, equity markets (typically at the index level), interest rates, and other assets. Liquidity is ideally suited for mutual funds because of the high liquidity of the futures contracts they trade. Macro managers may make directional bets (long or short) in any or all of these categories, or they may take relative value positions (e.g., long silver and short gold) to exploit perceived mispricings between related assets. Trades may be based on a manager’s analysis and judgment (referred to as a discretionary approach) or based on models (called a systematic approach). Historically, many macro managers have been relatively uncorrelated with equity and credit markets, providing valuable diversification to traditional portfolios. Of course, noncorrelated results are useful in the long term only if the expected returns from the strategy are positive, and we typically find it difficult to assess the sustainability of discretionary macro bets.

Macro strategies comprise a multitude of approaches. Some successful funds conduct fundamental economic research to generate ideas, then make a number of informed bets in different asset classes, cutting losing positions and letting winners run, essentially making up for a low hit rate with large gains on successful positions.

Similarly, a majority of managed futures funds use trend-following strategies for at least a part of the portfolio, relying on models to capture price-trend signals that they then follow. Managers may have differing approaches to portfolio construction and may use other models in addition to trend models, but managed futures funds almost always have a significant trend-following component. Because they can take a long position in assets that are increasing in price and short assets with falling prices, managed futures funds historically have been valuable during protracted equity market declines. Yet managed futures have performed poorly the past several years, largely due to the lack of sustained trends in multiple asset classes and multiple sharp reversals in price after government and central bank interventions.

Distressed credit. Distressed investing is a classic hedge fund strategy. It allows managers to generate returns by purchasing securities (usually debt) of companies facing financial and/or operational problems at discounts to par, then selling at a profit if a recovery happens, or receiving new securities worth more than the price paid for the old ones in a corporate reorganization. The strategy is attractive because of a number of structural factors, including forced selling by ratings-constrained investors that are not permitted to own non-investment-grade issues; the complexity and effort required in understanding and dealing with a potential reorganization (inside or outside of bankruptcy); and the premium that accompanies owning bonds or loans that become significantly less liquid as they slide into distress. Despite its appeal, distressed investing is difficult and requires an understanding, if not mastery, of corporate valuation, the nuances of complex capital structures, the bankruptcy process, and the trading dynamics in an opaque marketplace. It typically has been the exclusive domain of hedge funds, which have the benefit of longer-duration capital (i.e., initial lock-up periods and limited investor redemptions), and allows them to capture more of the excess returns that usually accrue to investors willing to hold less-liquid assets than mutual funds. However, over the past several years, a handful of mutual funds have begun to focus at least partially on stressed and distressed credit.
To address their daily liquidity constraints, these mutual funds limit the less-liquid parts of their portfolios (because in severe market stress, liquidity can dry up dramatically) and hold higher cash balances than traditional funds.

**Fixed-income arbitrage and convertible arbitrage.** These strategies involve long and short positions in related fixed-income securities and a convertible bond and its corresponding stock, respectively, to profit from relative mispricings between the two. These strategies typically rely on significant leverage to generate attractive returns, so they tend to be a poor fit for mutual funds that are trying to produce equity-like returns, though several mutual funds incorporate these strategies to varying degrees within a multi-strategy framework.

**Due Diligence on Alternative Strategies Funds**

Our continuing examination of this space has led to the unsurprising conclusion that the quality of offerings varies widely, much the same as the traditional fund space. We have identified a number of strong managers whose businesses are rooted in hedge funds, who are diversifying by entering the mutual fund world, and we also have had a number of conversations with high-quality managers who have not yet done so but are considering managing or subadvising a mutual fund. However, countless less-compelling options with high fees, limited track records, and questionable strategies underscore the necessity of good research and diligence.

In addition to the typical considerations that apply to all funds (e.g., manager skill, competitive edge, fees, organizational stability), the alternative strategies landscape requires us to take the following additional factors into account:

**Translation of strategy to mutual fund format.** This is a key focus as we evaluate alternative strategies funds. Liquidity and leverage are the primary constraints on managers operating these strategies in mutual funds. Liquidity and leverage also are factors in the ability of hedge funds to generate attractive returns; the combination of illiquidity and significant leverage is a toxic mixture that is frequently a cause of hedge fund blow-ups. The limitations on these factors in mutual funds is probably a benefit to investors because most nonprofessional investors do not have the experience to assess how responsibly and effectively a manager is using them, but the constraints do limit how effectively some strategies can be implemented. Distressed investing usually involves the assumption of some illiquidity, so managers operate at a disadvantage to their hedge fund and private equity fund cousins because they must be mindful of daily liquidity requirements. However, managers may invest in liquid parts of the distressed landscape, typically in larger, relatively well-known situations (e.g., the liquidating estate of Lehman Brothers, or the major electrical utility firm Energy Future Holdings Corp., commonly known as TXU). Concerning leverage, most arbitrage strategies require leverage to make them competitive with long-term equity returns, and so limits on leverage result in the strategies having somewhat lower return expectations (but correspondingly less volatility) when executed inside of mutual funds.

**Attention to liquid strategy.** Managers who run a number of investment vehicles naturally must divide their focus among the different funds and, like any good parent with multiple children, will say that they love them all equally. However, when a liquid alternative strategies fund is a small part of a large business, and/or is less attractive from a fee perspective because it does not pay an incentive fee (e.g., the 20 percent of profits in the “2 and 20” hedge fund fee structure), the natural tendency is for that fund to receive less attention. We try to assess managers’ commitment to their various strategies throughout our research process by trying to understand their internal motivations and senses of fiduciary duty, as well as examining the track records of different funds to the extent possible.

**Role in portfolios.** With the broadening of the investment universe to other alternative strategies, the issues of risk management, correlation with other asset classes, and the related choice of what to sell in order to fund such an investment become even more complicated. A low-volatility, nontraditional bond fund may be a relatively easy substitute for index-like fixed-income exposure when rates are low, but from which asset class should an investor finance an allocation to a managed futures fund or an event-driven fund? Is our alternative strategies allocation for offense or defense? Can we rely on the historical statistics (if there are any) to accurately inform our estimate of potential downside scenarios? Will the correlations remain true going forward? All these questions highlight the importance of understanding the underlying return drivers of the strategy (rather than just relying on historical statistics) and understanding the manager’s risk/reward calibration. We try to estimate the likely range of outcomes, but we are averse to false precision and recognize that we almost certainly will be wrong. So we believe it is important to be able to at least bracket the downside risk in reasonable scenarios.

**Style-box purity.** This is a slightly more subtle consideration, but an important one. When entering the mutual fund world, managers obviously want to attract a large amount of assets to compensate for the lower fees compared to hedge funds. As such, they may adjust a strategy to make it simpler for investors and consultants to pigeonhole an asset allocation framework, thus reducing the ability to be nimble and add value by moving to where opportunities are most attractive (assuming the manager has the resources and expertise to invest more broadly). We have observed this to be a problem even in the hedge fund universe, where style drift can be a capital offense (pardon the pun) and managers often stay huddled within their tightly defined investment universes for fear of rousing the style-box police and provoking redemptions.

**Concluding Comments**

Alternative strategies are not a magic bullet that will solve all investment problems, but Continued on page 54
they can be valuable pieces of diversified portfolios. In our view, democratization of alternative strategies is a good thing; however, not all strategies are created equal. Many fund companies will follow the money, selling whatever they think investors will buy, particularly if it has an air of exclusivity and mystique that can command a premium price. This is why doing the research to understand the manager and strategy is more critical than ever. Investors also should temper their expectations regarding returns, for the structural reasons described and because a flood of capital to an attractive opportunity typically reduces its attractiveness going forward.

We are reminded of Yogi Berra’s explanation about why he no longer patronized a restaurant: “Nobody goes there anymore. It’s too crowded.” We believe we’re far from the point of not wanting to go there anymore, but the alternatives strategies scene is beginning to fill up, so we’re continuing to work hard to identify more great opportunities before it gets too crowded.

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Endnote