For many years, hedge funds and other alternative investments have been the exclusive domain of institutional and ultra-high-net-worth investors due to substantial income requirements, lofty investment minimums, and liquidity constraints, among other factors. However, as investors of all stripes increasingly have sought out potential sources of uncorrelated returns and lower portfolio volatility, ever greater numbers of investment companies have made alternatives available to individual investors through mutual funds in the United States and through Undertakings for Collective Investment Trusts (UCITS) vehicles in Europe.

Taking the swift spread of alternative UCITS funds in the post-financial crisis timeframe as a leading indicator for their U.S. brethren, we believe that alternative mutual funds are poised for substantial growth in the years ahead—particularly as investors gain a greater appreciation for the products’ potential risk-return and diversification benefits and increasingly view them as options for efficiently constructing a portfolio that can perform in a range of market climates. Key to this growth, then, are advisors that can identify, source, package, and monitor high-quality alternative investment managers working within a mutual fund structure and provide an ongoing communications and education program that meets investors’ demands for transparency and deepens their understanding of this rapidly evolving space.

Certainly, the growth of alternative investment options is to an extent a product of the expansion of mutual fund and UCITS offerings in general.

Figure 1 illustrates the historical growth of the broader universe of mutual funds in the United States and UCITS funds in Europe, and figure 2 shows the alternative funds within each category.

Note that total UCITS and mutual fund assets were not far apart as recently as late 2008 (figure 1). Since that time, however, they have diverged so that mutual fund assets total almost $8.3 trillion vs. $5.5 trillion for UCITS funds as of January 2012. In contrast, figure 2 shows that assets for alternative UCITS and alternative mutual funds also once were nearly equivalent, but post-crisis there has been a notable uptick in UCITS inflows vs. their mutual fund brethren. In the coming years, we expect to see a significant growth in the number of alternative mutual funds offered.
especially given the larger universe of mutual funds involved.

At the same time, as illustrated in figure 3, the ratio of alternative assets to total assets for both mutual funds and UCITS funds also ran in lockstep until the early post-crisis period. Since then, alternative UCITS have nearly tripled. Alternative mutual funds, by comparison, have increased steadily but at a relatively smaller rate since September 2011. We believe that this expansion trend will continue, however, because many of the same drivers that have supported alternative UCITS growth also apply to alternative mutual funds.

Indeed, the data above show that while combined assets in traditional UCITS and mutual funds have increased by 25 percent from January 2006 to January 2012, assets in alternative UCITS and U.S. funds have risen 451 percent during that same time.

New fund launches—a key indicator of industry growth — also paint an optimistic picture. More than 745 alternative UCITS funds were operating in Europe as of the end of 2011, according to the “UCITS Alternative Index Quarterly Report,” published in January 2012 by Alix Capital (http://www.alternativeucits.com/files/presse/UAI-Industry-Survey-2012Q1-Final.pdf), with new fund launches increasing that total by 17 percent during the year. Of the more than 300 alternative mutual funds in the United States, according to Morningstar, a record 78 were launched in 2011.

Against this backdrop, the Financial Planning Association’s “2011 Alternative Investments Survey,” conducted in May 2011 (www.fpanet.org/professionals/Learn/ResearchCenter/ResearchPublications/Investing), found that correlation was the most-important criteria for respondents in evaluating alternative investments. More than 71 percent of financial planners surveyed ranked correlation among their top five criteria, followed by risk (68 percent) and liquidity (62 percent). These responses are complemented by the results of a survey published in November 2010 by Strategic Insight and Global Custodian magazine, “Alternative and Hedge Fund UCITS in the Next Decade” (http://svs-blog.com/IMG/pdf/Alternative_and_Hedge_Fund_Ucits_in_the_Next_Decade.pdf), which found that liquidity, a strong regulatory framework, transparency, and the UCITS brand are the four most-important factors supporting the growth of alternative UCITS. Institutional investors polled in a KPMG survey, “Transformation: The Future of Alternative Investments” (http://www.kpmg.com/BS/en/IssuesAndInsights/ArticlesPublications/Documents/Transformation.pdf), conducted in 2010, also cited transparency as the primary challenge facing the alternative investment industry.

With investors and their advisors placing a high priority on transparency, liquidity, and reduced volatility in the wake of the global financial crisis, it’s no surprise that vehicles such as alternative mutual funds and UCITS funds are attaining critical mass in the marketplace.

The Growth of UCITS vs. Alternative Mutual Funds

The history of mutual funds stretches back more than 100 years, and modern mutual fund structure was defined by the Investment Company Act of 1940. UCITS, on the other hand, are a more recent phenomenon. First established in 1985 with the goal of being able to operate and be sold freely across the European Union (EU), UCITS funds came into their own after the so-called UCITS III directives in 2001 encouraged greater investment flexibility and jump-started the development of European alternatives products. European regulators in July 2011 implemented new regulations—known as UCITS IV (http://ec.europa.eu/internal_market/investment/legal_texts/index_en.htm)—beneficial to the continued growth of the space. Key features of the new rules include the introduction of a management company passport applicable across EU jurisdictions, establishment of frameworks for fund mergers and master-feeder structures, rollout of a key investor information document, a new cross-border regulator notification procedure, and improved supervisory cooperation processes.

Both UCITS and alternative mutual funds must comply with certain liquidity, diversification, leverage, and portfolio holding constraints. Of course, the financial crisis dramatically altered many investors’ views of risk and led to these types of issues assuming far greater importance in the investment decision-making process. While investors still sought absolute returns, some were less inclined to turn directly to...
traditional hedge funds or funds of hedge funds to access alternative strategies, given performance and redemption restrictions during the financial crisis—thus opening the door further to alternatives in a UCITS or mutual fund format, with the more extensive regulatory regimes behind them offering additional reassurance to a number of investors.

Concerns consistently have been raised about regulations and structural limits on leverage, liquidity, and portfolio holdings potentially weighing down the performance of the new breed of alternative funds vs. their more-unconstrained hedge fund brethren. However, a study, “Will Alternative UCITS Ever Be Loved Enough to Replace Hedge Funds?” published in September 2010 by Nils S. Tuchschmid, a professor at Haute Ecole de Gestion in Geneva, Erik Wallerstein, an analyst at Credit Suisse, and Louis Zanolin, a managing partner at Alix Capital, did “not find any conclusive evidence that the less regulated hedge funds outperform alternative UCITS funds on a risk-adjusted basis.”

Tuchschmid et al. (2010) also reported that particular hedge fund strategies have the potential to outperform alternative UCITS funds on both an absolute basis and a risk-adjusted basis—due, in part, to the fact that approaches that can take on more risk and less-liquid markets sometimes have the capacity to garner higher returns. Such differences support the notion that investors should utilize these new products for potential diversification and risk management purposes rather than solely as a pure performance play, and that these alternative funds as they become more established do not represent a substitute for private placement hedge funds. Instead, they can serve as another valuable option as investors pursue strong risk-adjusted returns, with the understanding that there is no guarantee that any investment will achieve its objectives, generate profits, or avoid losses.

Another example of alternative mutual funds coming of age is the fact that their classification via industry databases has come to more closely resemble established hedge fund indexes (see figure 4). The mutual fund industry standard for market data, Morningstar, has granted its imprimatur to alternative mutual funds by producing dedicated data for the offerings, and in May 2011 revised its categorization of these funds to incorporate more strategies. Room for refinement remains: Morningstar’s multi-alternative category, for example, is a bit of a catch-all that comprises a disparate group of strategies, but these types of issues likely will be resolved as more funds are launched within and across alternative strategies.

Among Morningstar’s categories, managed futures represent a particularly fast-growing area, with assets under management increasing more than 420 percent since January 2009. By comparison, long/short equity is the most popular strategy among alternative UCITS, according to data from PerTrac (www.pertrac.com) as of January 2012, with managed futures running second.

Strategy Focus: Long/Short Equity and Managed Futures
Given its explosive growth, managed futures is a strategy worth examining in more detail. Managed futures managers are primarily trend-followers who utilize systematic, computer-driven trading models to identify and react to market trends and corresponding price movements. These managers may trade long or short across all four major asset classes: stocks, bonds (interest rates), currencies, and commodities—thus allowing them to potentially profit from both positive and negative developments in multiple markets and asset classes simultaneously. Most futures contracts are exchange-traded, resulting in highly liquid markets. This factor also can serve to reduce counterparty risk and enhance transparency for investors.

Long/short equity is another relatively liquid strategy that investors increasingly can access via mutual funds or UCITS. Long/short, often considered the core of hedge fund investing, historically represents more than half of all industry assets. Managers in this category typically go long equities they expect to increase in value while selling short equities they expect to decrease.
A look at the risk-return figures for long/short equity funds illustrates the importance of accessing the strongest managers within a given classification. Figure 6 shows the range of returns and standard deviations for managers pursuing this strategy within a mutual fund format. While the funds on a composite basis offer a compelling profile, particularly with regard to volatility, the dispersion between the best- and worst-performing managers is considerable. (Past performance is not indicative of future results. Source: Morningstar.) This performance discrepancy highlights the importance of manager selection in the investment process.

Moreover, it’s essential that advisors institute robust education and communications programs to ensure that these clients understand the products and strategies available to them, as well as the broader market trends and long-term portfolio management approaches that they should consider. A client-focused investment process is critical to ensure alignment with the client’s objectives.

FIGURE 5: MANAGED FUTURES AND LONG/SHORT EQUITY HAVE GROWN SUBSTANTIALLY (JANUARY 2008–FEBRUARY 2012)

Growth of Managed Futures ($B)

Growth of Long-Short Equity ($B)

Source: Morningstar, Alix Capital

Partnersing with an Alternatives Expert

With the universe of managers accessible via mutual fund vehicles expanding rapidly, the key for investors is to find the most-talented managers and then design a method of accessing them. That means in some cases partnering with advisors with comprehensive expertise in alternatives who can identify and provide an entree to the premier managers globally.

The process an advisor uses to research, select, and monitor investment managers is critical and should include several important steps. When considering potential alternative strategies, an advisor should perform a continuous, top-down strategy review of the alternative universe, identify alternative strategies capable of delivering sustainable alpha, and analyze proprietary data and other market information to distinguish both quantitative and qualitative return drivers for those strategies. In selecting alternative investments, the advisor should identify the top managers in each strategy, utilize an initial qualitative/quantitative assessment to further narrow the field, and perform a manager review that consists of investment, operational, and documentation due diligence.

Upon selecting and investing in a particular manager, the advisor should conduct regular reviews that include conference calls and on-site meetings, place a special emphasis on material changes by the manager and significant market events, conduct ongoing quantitative and risk analysis, and identify red flags that would trigger a review of the manager’s role within the portfolio.

In addition, particularly as new investors move into the alternatives space, it’s essential that advisors institute robust education and communications programs to ensure that these clients understand the products and strategies available to them, as well as the broader market trends and long-term portfolio management approaches that they should consider. A client-focused investment process is critical to ensure alignment with the client’s objectives.
approach represents an effective business model and can stimulate further expansion of the alternative investment space.

The Role of Alternatives Within a Diversified Portfolio

Critical to an analysis of the impact of UCITS and alternative mutual funds on the investment landscape is the effect of alternatives on a portfolio. Adding alternatives can make a portfolio more flexible and opportunistic, diverge from traditional investments such as stocks and bonds, and produce an additive risk-return profile when paired with traditional investments, regardless of the specific vehicle used to gain the alternative exposure.

Specifically, while there is no guarantee that any investment will achieve its objectives, generate profits, or avoid losses, an alternative allocation added to a traditional portfolio may:

- maintain or increase expected returns;
- lower the overall expected portfolio risk and volatility (reflected by measurements such as standard deviation and worst drawdown); and
- lower that portfolio’s correlation to traditional equities and fixed income.

To illustrate this theme, we compare the historical annualized returns, annualized standard deviations, worst drawdowns, and correlations between the two core alternative investment strategies cited earlier—managed futures and long/short equity—with those of the most traditional investments, U.S. stocks (table 1). While past performance is not indicative of future results, the alternatives strategies compare favorably based on historical data from July 2000 to February 2012.

Conclusion

If the goal is to construct a portfolio that generates strong performance and limits volatility in a number of market conditions, alternatives are a necessary component. Alternative mutual funds also provide the added benefits of daily liquidity, low investment minimums, more flexible investor pre-qualifications, and efficient tax reporting. Key to this approach, however, is a patient, outcome-oriented view of investing—historically more typical of large institutional investors. Within this framework, alternative strategies complement more-traditional portfolios of stocks and bonds and potentially allow an investor to better weather challenging short-term market conditions. As more investors and advisors adopt this approach, alternative mutual funds will evolve to meet increased demand.

Like their European counterparts that have benefited from the spread of UCITS funds, investors in U.S. alternative mutual funds can potentially enhance their ability to achieve strong investment performance in a wide variety of market conditions as the number of products and strategies in this format continues to expand.

TABLE 1: HISTORICAL RISK/RETURN PROFILE

<table>
<thead>
<tr>
<th>Investment</th>
<th>Annual Rate of Return</th>
<th>Annual Standard Deviation</th>
<th>Worst Drawdown</th>
<th>Correlation to U.S. Stocks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Managed Futures</td>
<td>7%</td>
<td>11%</td>
<td>−13%</td>
<td>−0.17</td>
</tr>
<tr>
<td>Equity Long/Short</td>
<td>4%</td>
<td>9%</td>
<td>−31%</td>
<td>0.83</td>
</tr>
<tr>
<td>U.S. Stocks</td>
<td>1%</td>
<td>16%</td>
<td>−51%</td>
<td>—</td>
</tr>
</tbody>
</table>

Past performance is not indicative of future results. The referenced indexes are shown for general market comparisons and are not meant to represent any particular fund. An investor cannot invest directly in an index. Moreover, indexes do not reflect commissions or fees that may be charged to an investment product based on an index, which may materially affect the performance data presented. There is no guarantee an investment will achieve its objective, generate profits or avoid losses. Managed futures represented by Allegro 40 Index; Equity Long/Short represented by HFRI Equity Hedge (Total) Index; U.S. stocks represented by S&P 500 TR Index. Source: Allegro.

These data are from broader hedge fund indexes (rather than mutual fund indexes) with a larger universe of funds and a longer track record. The data illustrate the impact that investments in alternatives strategies such as managed futures and long/short equity may have on a portfolio. As the alternative mutual fund space builds up its own track record and expands its roster of practitioners, these types of data will become more common.
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continue to expand. We believe that alternative investments in general represent the foundation for a diversified portfolio, and we view alternative mutual funds as an increasingly core element in investors’ drive for noncorrelated returns and risk protection.

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References

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