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Liquid Alternatives: Will This Movie Remake Have a Better Ending?

By Michael Evans

INVESTMENTS & WEALTH INSTITUTE®

Liquid Alternatives

WILL THIS MOVIE REMAKE HAVE A BETTER ENDING?

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Some of us have seen this movie before, the one where market volatility climbs to recently unseen highs and investors turn to uncorrelated assets to fend off portfolio losses.

In the not-so-distant past, private and alternative investments were reserved for institutional and ultra-high-net-worth investors for just this scenario. Uncorrelated and more-liquid product offerings, however, have completed the move down-market for alternative investments. Even exotic alternative strategies are now available to the mass affluent.

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Some credit is due the 2008 Global Financial Crisis, which motivated product manufacturers to create, and investors to shift assets to, liquid alternative funds. Wholesalers and product managers educated advisors about how liquid alternative strategies could generate targeted levels of return with lower volatility than traditional portfolio options over time.

The products mostly worked as promised—until they didn't. Markets bounced back into bull territory, and then investors learned that these products were not optimal for a buy-and-hold strategy. But now, with concurrent equity and fixed-income bear markets, these vehicles are again on the upswing.

Will liquid alternatives rescue portfolios from market and economic pressures this time around? Will there be a better, more satisfying ending? Will advisors continue to buy into the liquid alts story?

This article sizes the liquid alternative fund market, examines advisor usage of these products, highlights marketing best practices, and provides some examples as we get ready for this movie remake. Market sizing is based on FUSE Research Network's analysis of Morningstar data, and advisor usage is derived from a FUSE survey of financial advisors conducted during the first quarter of 2022 in partnership with WealthManagement.com.

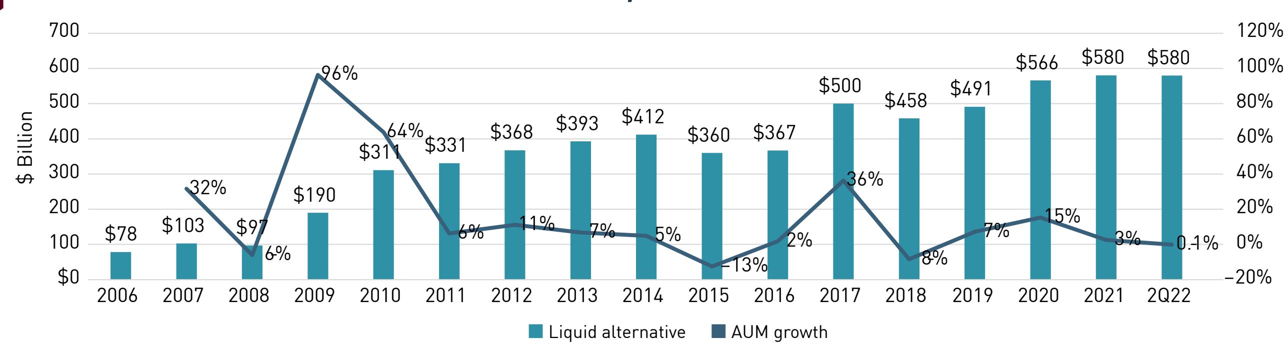
SIZING THE LIQUID ALTERNATIVE MARKET

ASSETS AND NET FLOWS

Unlike classic alternative investments such as hedge funds, private equity, venture capital, and real estate, liquid alternatives offer retail investors significant benefits and reassurance: daily liquidity, lower investment minimums, holdings transparency, and, as registered funds, regulatory oversight. These factors all helped motivate investors and advisors to take a chance on these products (see figure 1). By the end of 2014, liquid alternative funds had managed to quadruple 2008 assets under management (AUM) to $412 billion. There was

Figure 1

GROWTH OF TOTAL LIQUID ALTERNATIVE ASSETS, 2006–2022Q2



Note: Includes mutual fund and exchange-traded fund assets. Excludes fund-of-funds and exchange-traded notes.
Source: FUSE Research Network, Morningstar

another bump to $500 billion in AUM by 2017, and the numbers have been pushing toward $600 billion in the past two years, although leveling off at 0-percent growth since 2021.

As the markets turned to bullish territory (2016–2019), inflows to alternative mutual funds and exchange-traded funds (ETFs) dropped but are rebounding (see figure 2). After a solid year in 2021, figures for 2022 looked promising as well. Through the first half of 2022 mutual funds gained $19 billion and ETFs gathered $30 billion in sales. Frustrated by negative yields and rising inflation, investors and advisors were once again seeking opportunities to limit the impact of market downturns with uncorrelated assets offering the promise of risk-adjusted returns.

Among alternative mutual funds and ETFs, there are seven broad categories, as noted in figure 3. As of the second quarter of 2022, these categories held $235.4 billion in AUM. Over the past five years, the greatest steady growth has been in risk-managed alternatives, followed by arbitrage offerings. Managed futures products appeared to be gaining interest again in 2022 after peaking at $23 billion in 2017.

Six of the seven broad categories have enjoyed asset gains since June 2021. The alternative credit and currency category was down nearly 18 percent from its $29.8 billion AUM in the second quarter of 2021, finishing the first half of 2022 at $24.6 billion. As investors looked for higher yields in the first half of 2022, macro fixed income experienced rebalancing woes due to struggles with higher inflation, monetary tightening, and economic growth challenges.

FIRM LEADERS

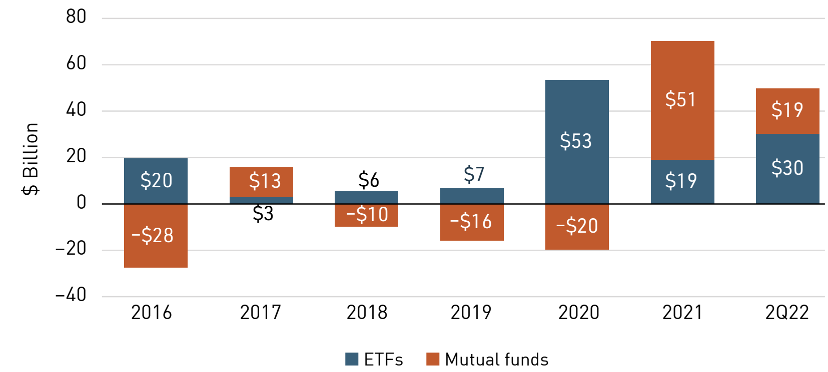
As seen in table 1, the top three leaders managing liquid alternative fund assets as of the second quarter of 2022 were JPMorgan ($39.7 billion), followed by BlackRock ($23.9 billion), and Calamos ($18.9 billion). Given sustained market volatility and rising inflationary pressures, expect current product manufacturers to continue launching new products, with new players entering the fray to take advantage of the heightened interest in uncorrelated assets.

ADVISOR VIEW
STRATEGY USAGE

Bear markets always make it more challenging for financial advisors to stem client and asset outflows. Although advisors always are looking for new ways to compete by differentiating business models and investment approaches, volatile markets test their abilities to manage relationships. Armed with the latest information, technology, and tools, today's advisors can better serve clients by performing targeted research and due diligence to customize client portfolios and reacting

Figure 2

LIQUID ALTERNATIVE NET FLOWS BY VEHICLE, 2016–2022Q2



Source: FUSE Research Network, Morningstar

Figure 3

LIQUID ALTERNATIVE MUTUAL FUND AND ETF AUM BY CATEGORY, 2017Q2–2022Q2

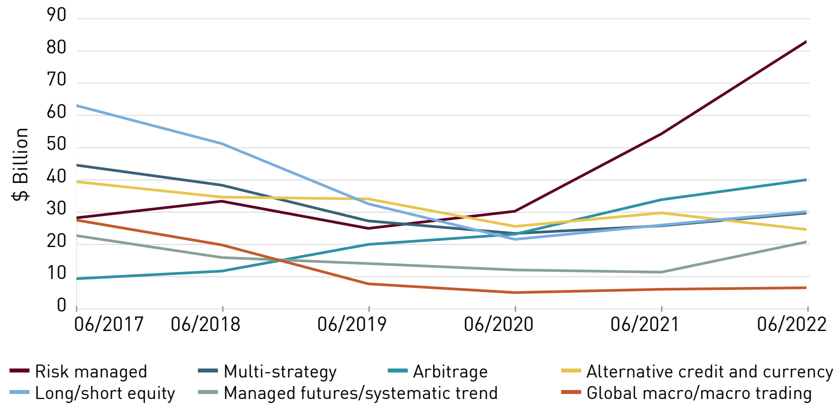


Table 1

TOP 10 ALTERNATIVE STRATEGY MUTUAL FUND AND ETF FIRMS, BY ASSETS

Firm	Assets as of June 30, 2022 ($ billions)
JPMorgan	$39.7
BlackRock	$23.9
Calamos	$18.9
Natixis Distributors	$11.3
Global X Funds	$9.5
First Trust	$9.3
Allianz	$7.8
Goldman Sachs	$7.2
Innovator ETFs	$6.9
Guggenheim Investments	$6.9

Note: Assets as of June 30, 2022

Source: FUSE Research Network, Morningstar more quickly in unpredictable market conditions. With the ability to scale investment processes, advisors have more time for client communication and relationship management. Greater access to alternative strategies at the retail level gives advisors more options to protect clients from fickle markets.

The sales pitch of managed futures as alternative funds for client portfolios was promising in a bear market and served as a decent hedge—until the markets began to recover.

Strategies such as managed futures were used by advisors in the late 2000s for downside protection. The sales pitch of managed futures as alternative funds for client portfolios was promising in a bear market and served as a decent hedge—until the markets began to recover. It was the same with merger arbitrage, which was a decent alternative for fixed income at the time. Looking at the 10-year performance of these types of investments from certain managers shows many with negative returns, despite positive one- and three-year numbers.

Advisors who have experienced at least two bear markets intuit the benefits of liquid alternatives but have reservations about certain strategies. One advisor we spoke with candidly said, "Strategies may work well when the market is down, but if up, what is the point?"

Some seasoned advisors noted that they keep watch lists, but their use of liquid alternatives is restrained. Other veteran advisors said their success with these products comes down to more than knowing how and when to employ them to maximize advantages. They say it's also critical to read through the offering materials in order to deeply understand how these vehicles are designed to work—and recognize when the design is flawed. "When you look through some of these products, they are so convoluted, I just don't want to spend the time," pointed out one advisor.

So, with the benefit of hindsight from difficult market cycles, what strategies are advisors using today?

To answer this question and many more, we turned to the results of the FUSE/WealthManagement.com survey. As previously noted, the survey was conducted during the first quarter of 2022 on emerging products including alternative strategies, alternative asset classes, and new product structures. The goal was to obtain financial advisors' rationales for product and strategy usage, availability, obstacles, traditional alternative leaders, and preferred product wrappers.

Advisors appear to have similar liquid alternative strategy preferences across channels. In the current market cycle, overall, they are favoring commodities and real assets (36 percent) and long-short funds (28 percent), followed by tactical allocation (21 percent), absolute return (20 percent), market-neutral (18 percent), managed futures (17 percent), multi-alternative (12 percent), and options-based (12 percent). The strategy with the least appeal to advisors was unconstrained bond (9 percent).

As advisors use new liquid alternatives in client portfolios, more time and attention are required to assure clients and instill confidence in selected strategies. Conversations between advisors and clients move from specific security performance to the impact of the security as an uncorrelated asset within the portfolio. Simply put, alternatives have different measurements of success that require explanation and education. One advisor said that certain clients need more education and relationship management effort after investing in liquid alternatives.

In addition to the rationales for use and fundamentals of alternative strategies, the attractiveness of these vehicles is dependent upon the extent to which advisors who used them in response to the 2008 financial crisis felt the products delivered. Experienced advisors are using historical data from traditional alternative product indexes for comparison to consider the impact of similar liquid products on client portfolios. Advisors also are benefiting from longer performance track records. The investment options of 2008 were more blindly accepted and posed higher risk. Several of today's offerings have 10-year track records, which provide advisors with more insight about the product and its abilities under certain market conditions. Advisors are also diversifying across several funds of a similar strategy, as institutional investors have done with traditional alternative offerings, to smooth the impact of a single fund's performance within the strategy allocation.

PLANNED INCREASES

Despite the challenges of understanding and explaining liquid alternative strategies, advisors anticipate increasing allocations to certain strategies during the next two years (see figure 4). Surveyed advisors noted continued support for commodities and real assets (35 percent), followed by investments in absolute return strategies (20 percent). Advisors were mixed among the other seven strategies, each with less than 20 percent interest, except unconstrained bond, which was the least favored for increased allocation (8 percent) in the near term.

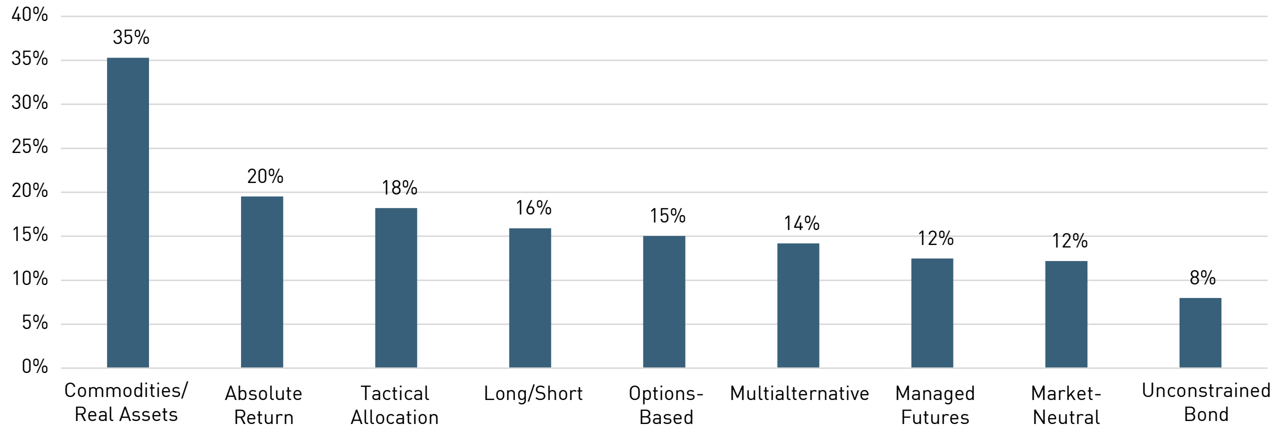
LIQUID ALTERNATIVE LEADERS

Investments

Advisors have many more asset managers to select from for liquid alternatives

Figure 4

ANTICIPATED INCREASED USAGE OF LIQUID ALTERNATIVES IN 2022 AND 2023



Source: FUSE Research Network, WealthManagement.com

than they did 15 years ago. When asked which asset managers advisors most turned to for liquid alternatives (see table 2), a considerable 41 percent chose BlackRock, followed by Blackstone (16 percent), JPMorgan (14 percent), PIMCO (13 percent), and Fidelity (12 percent).

Table 2

ADVISOR VIEW: LIQUID ALTERNATIVE LEADERS

Investment Leaders		Education Leaders	
BlackRock	41%	BlackRock	21%
Blackstone	16%	JPMorgan	8%
JPMorgan	14%	Blackstone	8%
PIMCO	13%	Goldman Sachs	6%
Fidelity	12%	PIMCO	6%
Vanguard	10%	Fidelity	5%
Goldman Sachs	8%	First Trust	4%
Calamos	7%	Vanguard	3%
AQR	6%	Calamos	2%
First Trust	6%		

Source: FUSE Research Network, WealthManagement.com

Advisors want to know that they are not placing clients in a theoretical strategy but rather one that can be explained clearly and has a demonstrated, repeatable process. Firms such as AQR and JPMorgan specifically were cited during advisor interviews as having impressed target audiences with their abilities to meet these expectations. Other asset managers were said to be losing trade opportunities due to overly complicated products, underperformance, and churn among sales and service people.

Education

Advisors today are bombarded with calls about new alternative products. They complain that distributors only call when their funds are doing well. Distribution professionals who have never experienced a bear market and follow a script or speak theoretically are especially irksome to busy advisors. Securing mental shelf space for liquid products among advisors takes an established relationship, a deeper dive into the product rationale and mechanics via direct access to the portfolio managers, and a proven track record with strategies and alternative investments. One advisor said, "I find that several firms will give me a technical explanation about their product, but not the rationale (as an alternative)."

Advisors appreciate wholesalers' honesty and distributors' education processes and explanations. They do not necessarily need to comprehend all the complexities, but they do need to understand and be able to retell a powerful story. That said, distributors selling to advisors with less experience may have an easier time because the audience lacks the perspective of multiple market cycles and an appreciation for the nuances of product design.

It's important to note that conferences, in-person or via webinar, are considered worthy of advisors' time if the educational experience is succinct and easy to understand.

Table 2 shows that advisors consider BlackRock (21 percent), JPMorgan (8 percent), Blackstone (8 percent), Goldman Sachs (6 percent), and PIMCO (6 percent) as preferred firms for educating them about liquid alternatives. Each of these firms has the requisite levels of strong relationship management and support available to advisors as they navigate the investment options.

MARKETING

There are no shortages of marketing efforts and support for liquid alternative products. Successful product manufacturers keep the pitch simple, clearly explain the risks, justify higher fees, and tamp down the hype.

BEST PRACTICES

When it comes to marketing liquid alternative options, today's distribution teams have greater advantages than their 2008 brethren. They are equipped with on-demand tools for pitch books and hypotheticals that make the sales process much faster and easier from a technology standpoint. However, given the complexities of these products, the higher fees involved, and the wild fluctuations in the markets, marketing is still time-intensive and relationship-driven.

After examining marketing efforts of select product manufacturers and speaking with advisors, we note that certain marketing approaches and collateral are more effective and appreciated than others. All of today's product manufacturers maintain websites with links to their alternative products and liquid funds, but many go above and beyond to support advisors in due diligence, investment education, and knowledge-sharing.

One huge challenge for advisors is simply finding and getting through all the information available about these alternatives. Streamlined access to information, reliable updates with dependable information, facilitated education, and a solid story are key marketing best practices, according to advisors.

EXAMPLES OF BEST PRACTICES

Streamlined information that is instantly available makes advisors happy. For example, on its website, Calamos offers an "Insight" tab specific to alternatives, with fund profiles, "Ask the Manager" videos with transcripts, and a free subscription to "What Happened This Week in Liquid Alts." The firm also maintains a "Weekly Alternatives Snapshot," continuing education presentations, portfolio analytics services, and current blog posts.

Organization, repeatable processes, and predictable performance win over advisors. JPMorgan's high-touch approach includes quarterly update meetings and distilling huge datasets into single-page takeaways. Advisors applauded the firm's relationship management wholesaling staff for consistency, escalating concerns, and delivering immediate answers and guidance as needed.

Specialized education by asset managers with experience and expertise in specific areas also improves the marketing opportunity. For example, when advisors need information about real estate alternative investments, many turn to Hines, a $90-billion Houston-based global real estate asset manager. Some advisors said that the firm provides thoughtful and helpful periodic communications about an investment area that does not have tremendous transparency.

Another firm that advisors appreciate for its deep knowledge of alternative investments is $146-billion AQR Capital Management of Greenwich, Connecticut. AQR maintains a tab on its website dedicated to education, which includes the following: Featured Thinking, Research, Data Sets, Learning Center, Quick Clips, and Podcasts, in addition to musings by firm leader Cliff Asness intended to "make a point or start a conversation."

Finally, the marketing story must be clear, concise, and compelling. Wellesley Asset Management and the Miller Family of Funds, a $2-billion convertible bond business in Wellesley, Massachusetts, was cited by advisors for its compelling story. Greg Miller started the firm after selling an unrelated business. Miller wanted to grow his nest egg and avoid his family's curse of losing small fortunes. He discovered convertible bonds and realized they could provide investment performance with protection. Then he developed and refined a convertible bond strategy that has evolved into a differentiated, disciplined, and repeatable process that has worked for clients for more than 25 years.

Many firms take approaches similar to these example firms and are improving upon their advisor distribution plans. When asked about marketing preferences, one advisor summed it up:

> *Just don't send me endless piles of marketing materials to go through and have a wholesaler who has never lived through a bear market call me about the flavor-of-the-month alternative fund. Don't invite me to a conference when your fund performance has been lagging. Good or bad news, I need someone with whom I have built a trusted relationship who calls on me with honest advice and guidance, who can help me navigate the details and complexities of these products and help me communicate their investment story to my clients so that it doesn't sound like a cheap panacea.*

OUTLOOK

The shift away from the 60/40 portfolio continues, and advisors keep looking for more and better ways to meet target investment goals in today's volatile markets and interest-rate environments. It remains to be seen whether the latest versions of liquid alternatives will perform as advertised, and whether advisors will find success deploying them in client portfolios. Nonetheless, the outlook appears to be generally positive in the near term.

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