The Evolution of Alternative Investing
New Approaches, New Thinking, New Conversations

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Our firm has recommended the use of alternative investments within diversified portfolios for more than 15 years. Until now, we recommended alternatives exposure via broad category groupings—diversified (absolute return), directional, and managed futures—primarily via funds of hedge funds or mutual fund offerings. The historical advantages of this broad category approach were 1) ease of portfolio construction, 2) the diversification benefits of funds-of-funds, and 3) relatively low investment minimums.

While we still believe this method is robust, we recognize that some advisors and investors might prefer a more flexible approach—one that allows for more customized control over portfolio liquidity, fees, risk-return characteristics, and tactical exposures. We thus have evolved our alternatives allocation philosophy toward a core/satellite approach, which we believe allows for a more-sophisticated implementation and management of alternative investment exposure. In this article we focus on the evolution of building and managing alternatives investment portfolios within the context of this improved investment framework.

What is Core/Satellite in Alternatives Investing?
The concept of core/satellite investing is not new. Within traditional portfolios, core/satellite refers to constructing a strategic "core" of inexpensive, tax-efficient investments and then surrounding that core with more expensive, alpha-seeking "satellite" managers.

The alternatives core/satellite approach is similar in some respects to this traditional concept. But whereas the more-traditional concept focuses on the trade-off between active and passive management, the focus with alternatives is on the customization of risk-and-return characteristics, liquidity, fees, regulatory oversight, and the desire for tactical allocation capabilities.

The alternatives core/satellite framework is designed to offer a less-constrained framework for portfolio construction, with increased ability to manage liquidity, capitalize on manager skill, and take advantage of tactical opportunities (see figure 1).

Defining the Core
The core allocation is the anchor of the alternatives portfolio and it is meant to provide diversified exposure to the “beta” of alternative investments. The solution set for building a diversified core includes the following:

Multi-strategy hedge funds. These direct hedge fund solutions are characterized by an ability to dynamically allocate among multiple investment strategies with the objective of producing consistent and positive returns regardless of the directional moves in equity, fixed income, or currency markets.

Funds of hedge funds. Funds of hedge funds (funds-of-funds) tend to invest in a portfolio of different underlying hedge funds to provide broad exposure to multiple investment strategies and to diversify single-manager risk. The difference between a multi-strategy fund and a fund-of-funds is that the former typically owns or manages all of the underlying strategies while the latter constructs and manages a portfolio of independent third-party funds.

Beta replication. Academic research and factor model analysis suggest that a significant portion of hedge fund/fund-of-funds return comes from beta factors—equity, fixed income, commodities, currencies, volatility, and credit. Hedge fund replication strategies attempt to capture this beta component through the use of quantitative factor modeling and algorithmic trading protocols. These strategies are available in a variety of structures, including limited partnerships, managed accounts, and mutual funds.

Alternative investment mutual funds. These mutual funds employ one or more alternative investment strategies across multiple disciplines, including long-short equity, relative
value, and event-driven investing across both equity and credit markets. Given mutual fund regulations and the daily liquidity offered by these strategies, fund managers may be limited in their use of illiquid investments and leverage. The trade-off is improved liquidity, typically lower fees, and more stringent regulatory oversight.

Defining the Satellites

Satellite allocations are strategy-specific solutions geared toward alpha generation. Core allocations are consistent with the notion of alternative investment beta while satellite allocations are skills-based exposures to active managers in expectation of generating excess return. Satellite strategies generally include the following:

- **Diversified credit.** These strategies attempt to generate strong absolute returns by capitalizing on long and short investment opportunities across the global fixed-income markets.

- **Event-driven.** Event-driven strategies seek to capitalize on price discrepancies resulting from a multitude of corporate events including mergers, tender offers, restructuring, financial distress, recapitalization, or other capital structure changes.

- **Long-short equity.** This is the most common alternative strategy, and a broad array of processes can be implemented—domestic, international, sector specific, concentrated, high/low net, and so forth. Most traditional long-short managers are fundamentally oriented, though quantitatively driven managers and strategies exist.

- **Market neutral/relative value.** Market-neutral and relative-value strategies attempt to exploit valuation discrepancies between securities of any type. In the purest definition, market neutral is a subset of long-short equity, taking offsetting long and short positions in securities perceived to be mispriced relative to each other, whereas relative-value strategies may be somewhat directional in nature and can be employed across the capital spectrum and/or securities markets. We broadly define these strategies to include managers who employ diversified trading strategies with low net exposures and low correlation to market betas.

Trading strategies. This broad group of strategies attempts to anticipate and capitalize on changes in fundamental and economic variables that impact global commodity, currency, equity, and fixed-income markets. Trading substrategies include the following:

- Macro strategies, which incorporate a big-picture analysis of global markets in order to capitalize on perceived investment opportunities in almost all types of securities. Macro strategies are characterized by significant flexibility and a lack of investment constraints as they attempt to analyze global political and economic events to determine potential impact on equity, fixed-income, currency, and commodity markets.

- Commodity trading advisors (CTAs), who use global futures markets to express investment views, can be either systematic or discretionary; the majority are systematic. Systematic traders typically use technical price- and market-specific information to make trading decisions, while discretionary managers often take a more fundamentally oriented approach. Systematic strategies are designed to identify and capitalize on trending or momentum-driven markets, using both long and short exposure. While often volatile in nature, well-constructed CTA allocations historically have proven to possess excellent portfolio diversification characteristics.

From a portfolio construction perspective, we recommend each satellite “bucket” contain both less-liquid (hedge fund or fund-of-funds) and more-liquid (mutual fund) strategies. This provides appropriate exposure while leaving “dry powder” for liquidity needs or tactical rebalancing. The events of 2008 and early 2009 are a strong reminder of the importance of maintaining sufficient liquidity and having the ability to opportunistically reposition portfolios to take advantage of market trends.

Core/Satellite Portfolio Construction

The core/satellite portfolio construction approach is as much intuitive as it is quantitatively based. The following are, however, a number of fundamental tenets to which we adhere:

- The core allocation should be between 30 percent and 50 percent of the overall alternatives allocation. A robust core allocation is critical for maintaining broad hedge fund strategy exposure and diversification.

- Illiquidity can be a significant return driver and should be considered when skilled managers can be accessed. Different investors possess different appetites/tolerances for portfolio illiquidity.

- Where skill-based solutions exist in both mutual fund and hedge fund/fund-of-funds solutions, we are indifferent as to which is employed.

- Liquid alternative investment strategies should be included in every component of the core/satellite framework.

- At least 30 percent of the overall alternatives portfolio should be invested in liquid strategies. This allows for tactical management within and across the portfolio while maintaining ready access to liquidity when needed.

- Trading strategies should represent at least 10–25 percent of the satellite portfolio allocation.

- Long-short strategies are appropriate within these portfolios even if they also are employed as part of the equity and fixed-income exposure within the traditional portion of the overall portfolio (e.g., even if equity
long-short is considered part of the overall portfolio equity allocation, we suggest using high-alpha long-short managers as satellite managers.¹

- No single investment should be more than 10 percent of total portfolio assets, in order to mitigate single-manager risk.¹

- The composition of the core is largely dependent on the investor’s objectives regarding liquidity, fees, and risk-return characteristics, and likely will be some combination of multi-strategy funds, funds-of-funds, and beta replication or mutual funds.

- Most investors should include appropriate strategic and long-term allocations to satellite strategies.

Table 1 highlights a representative but hypothetical portfolio consisting of 30-percent core alternative investments and 70-percent satellite investments.¹

The core/satellite approach allows for greater control over four primary factors of the portfolio construction process: return, risk, liquidity, and fees (see figure 2). This allows for more thoughtful discussions regarding appropriate trade-offs within investor portfolios.

**Liquidity Decisions**

Less liquidity may be appropriate when there is an expectation for higher returns from a specific strategy or greater returns from a less-liquid manager in comparison to a more-liquid manager. A few examples include the following:

- Some event- or arbitrage-driven mutual funds are more limited in their ability to use leverage or invest in less-liquid opportunities. Investing with a high-quality hedge fund manager likely will generate better returns.

- Certain market-neutral or relative-value strategies require a high degree of leverage to implement successfully. Fixed-income relative-value trading or basis trading requires more leverage than typically is employed in most mutual funds. In the relative-value space, the hedge fund manager universe is currently more robust than the mutual fund universe.

- Most discretionary traders and fundamentally oriented global-macro managers require time and stability of capital for their trading ideas to play out. In addition, most “best-of-breed” managers are accessible only via hedge fund vehicles at this time. With that said, several global-macro mutual funds have either recently opened or are in registration, and that likely will challenge our opinion going forward.

Ultimately, most alternative strategies lend themselves to the mutual fund framework. Some strategies, however, face greater constraints in the generation of returns comparable to those of less-constrained hedge fund strategies. We recommend an appropriate balance between both mutual fund and hedge fund strategies.

**Benefits of a Core/Satellite Approach**

There are multiple benefits of a core/satellite approach to alternative investing. Foremost, it provides a robust implementation framework with enough flexibility to satisfy individual client preferences with respect to fees, liquidity, and risk-return characteristics. While we recommend a diversified mix of both hedge funds/funds-of-funds and mutual funds, the framework can be successfully implemented whether the portfolio consists solely of hedge funds or, at the other extreme, solely of mutual funds.

By using mutual funds within the framework, investors establish permanent and readily available liquidity for tactical rebalancing or cash needs in the

### TABLE 1: HYPOTHETICAL 30% CORE/70% SATELLITE PORTFOLIO

<table>
<thead>
<tr>
<th></th>
<th>Hedge Fund/Fund-of-Funds</th>
<th>Mutual Fund</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>CORE: 30%</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Diversified Alts (Multi-Strategy)</td>
<td>15.0%</td>
<td>15.0%</td>
<td>30.0%</td>
</tr>
<tr>
<td><strong>SATELLITE: 70%</strong></td>
<td></td>
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</tr>
<tr>
<td>Event-Driven</td>
<td>7.5%</td>
<td>*</td>
<td>7.5%</td>
</tr>
<tr>
<td>Long/Short/Equity</td>
<td>7.5%</td>
<td>5.0%</td>
<td>12.5%</td>
</tr>
<tr>
<td>Diversified Credit</td>
<td>10.0%</td>
<td>5.0%</td>
<td>15.0%</td>
</tr>
<tr>
<td>Market Neutral/Relative Value</td>
<td>10.0%</td>
<td>*</td>
<td>10.0%</td>
</tr>
<tr>
<td>Trading Strategies</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Global Macro</td>
<td>6.5%</td>
<td>*</td>
<td>6.5%</td>
</tr>
<tr>
<td>Managed Futures</td>
<td>7.0%</td>
<td>5.0%</td>
<td>12.0%</td>
</tr>
<tr>
<td>Discretionary</td>
<td>6.5%</td>
<td>*</td>
<td>6.5%</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>70.0%</td>
<td>30.0%</td>
<td>100.0%</td>
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</tbody>
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### FIGURE 2: FOUR FACTORS OF PORTFOLIO CONSTRUCTION

<table>
<thead>
<tr>
<th></th>
<th>Hedge Fund/Fund-of-Funds</th>
<th>Beta Replication/MF</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>BY RETURN</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Higher Expected Return</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lower Expected Return</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>BY RISK</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Higher Expected Risk</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lower Expected Risk</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>BY LIQUIDITY</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Higher Expected Liquidity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lower Expected Liquidity</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>BY FEES</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Higher Expected Fees</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lower Expected Fees</td>
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event of a market disruption. One of the more challenging aspects of hedge fund and fund-of-fund investing is that cash is not always available when investors need it the most. Using daily liquid mutual funds mitigates this challenge.

The period 2008–2009 is a good example. As dislocation in the credit markets created market price declines and broad-based illiquidity, hedge funds and funds-of-funds were hit with the combination of significant redemption requests and dramatically falling asset prices. Many investors who wanted their money back were turned away as funds “gated” on withdrawal requests. As a result, most managers did not have cash available to take advantage of the undeniable opportunities that emerged early in 2009. A core/satellite framework would have provided a means to take advantage of the tactical opportunities by providing a pool of liquid assets that could have been put to work in early 2009 in opportunistic areas such as distressed credit and event-driven equities.

Core/satellite portfolios provide investors with conscious choices related to portfolio allocation, access to manager skill, liquidity profile, and fees spent on strategies. The flexibility of the core/satellite approach puts control back in the hands of the client in each of these areas.

Opportunistic Investing

Another advantage of the core/satellite alternative framework is the ability to modify portfolio exposures as opportunity sets change throughout a market cycle. This framework can be used as a means of over- and underallocating to specific strategies as market environments dictate.

During environments with limited tactical investment opportunities, we suggest portfolios with a greater percentage to satellite investments at the expense of the core investment allocation.

Putting Alternative Mutual Funds into Perspective

We believe the rapid advent and adoption of alternative mutual funds is a positive development and represents the next phase of alternative investing. Product producers will continue to bring mutual fund solutions to market as fast as possible to capitalize on growing investor demand. As with all investment products, however, “new” does not necessarily mean “good,” and caveat emptor applies.

There are numerous additional alternative investment strategies which, until recently, were available only to hedge fund investors—including long-short equity, long-short credit, event-driven, market neutral, and CTA/global macro. That landscape has evolved dramatically, and mutual fund choices in each of these strategies proliferate. Investors would be mistaken, however, if they equate “mutual fund” with “requires less due diligence.” We argue that the due diligence requirements are every bit as extensive for mutual funds as they are for hedge funds, though the focus is different.

Many alternative investment mutual funds are new, are not of the highest quality (though very good ones exist), and few have significant long-term track records. Further, regulatory-driven constraints mean investors should not expect mutual funds to generate performance comparable to that of hedge funds on a consistent basis, even if the vehicles are managed by the same firm. This means that a thorough evaluation of the firm, strategy, objective, process, and implementation is critical, and so is fully understanding any limitations the mutual fund structure might impose on strategy success.

The events of 2008 resulted in dramatically increased due diligence requirements for hedge funds and funds-of-funds, especially operational due diligence. Somewhat ironically, the growth in alternative mutual funds also dramatically increases due diligence requirements—but on the investment characteristics of the strategy. As more heavily regulated entities, mutual funds may carry less operational risk than hedge funds or fund-of-funds, but those same regulatory constraints potentially translate into performance that is significantly different than hedge funds/funds-of-funds operating in the same investment space.

Today, there are good mutual fund solutions within most of the alternative asset classes. For many investors, even a modest decrease in expected performance between the mutual fund and a similar hedge fund/fund-of-funds is outweighed by the increased liquidity and the perceived relative safety of a mutual fund investment. In our experience, investors increasingly are choosing to use mutual funds to complement existing hedge fund positions.

Lastly, the growth of mutual funds does not mean the death of traditional funds-of-funds. We believe they remain viable solutions for many investors. Good fund-of-funds managers have survived for a reason. They have proven adept at identifying and gaining access to high-quality managers, making allocation decisions, and managing risk. Even after an additional layer of fees, quality funds-of-funds can deliver important return and diversification benefits to well-constructed portfolios.

Summary and Conclusions

The discussion between advisor and investor regarding alternative investments has fundamentally changed. Advisors serving investors who avoided alternative investments because of an aversion to limited partnerships now have the means and tools to reintegrate the conversation. Advisors now can customize alternative investment allocations to meet specific investor objectives with respect to risk, return, liquidity, and fees. Advisors also have
increased ability to take advantage of tactical opportunities in the alternative investment space.

A core/satellite approach allows advisors to structure highly customized alternative investment portfolios that meet specific investor objectives. The result is better understanding, better fit, deeper conversations, higher satisfaction, and stickier client relationships.

Advisors who adopt the core/satellite approach must understand that they now have far more control and, therefore, far more accountability and responsibility for the performance and risk of the resultant portfolio. This is a positive development in an industry where “advisor as portfolio manager” is a distinct trend. With our revised approach, advisors now will have the tools to take control of both the traditional and alternative components of client portfolios.

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Endnotes

1 Historically, we categorized liquid real assets (commodities, real estate investment trusts, and energy master limited partnerships) as “alternative” investments. While we continue to advocate the use of liquid real assets within diversified portfolios, we suggest no longer considering them as “alternatives.” They should instead be considered traditional asset classes that may deliver enhanced diversification and risk-reduction benefits within overall portfolios.

2 “Hedge fund” means a limited partnership, or LP investment vehicle.

3 This is not meant to be an exhaustive list of the opportunity sets. Neither does this solution-set eliminate multi-strategy or fund-of-funds solutions; some strategies may be better suited for a satellite allocation based on their risk-reward and/or liquidity characteristics.


5 For a total portfolio with 40 percent allocated to alternatives, no direct manager allocation should be greater than 25 percent of the alternative investment portfolio (25% of 40% of the alternatives allocation = 10% maximum weight).

6 This hypothetical portfolio is for illustration purposes only and does not represent investment advice.