liquid alternative mutual funds have become a popular investment category, but they are not easily described by a single label. “Liquid alts” tend to exhibit risk, return, and regulatory characteristics unique to particular strategies.

Most advisors view liquid alts as a potentially useful way to diversify portfolios. This article outlines the risk, return, and regulatory characteristics of 10 liquid alternative strategies and describes how they differ from traditional mutual funds and alternative strategies housed in traditional, less-liquid structures.

Liquid Alternative Similarities
Because of their legal structure and status under the Investment Company Act of 1940 (‘40 Act), funds investing in alternative strategies and asset classes share the following characteristics.

Daily pricing and liquidity. Liquid alternative mutual funds must calculate net asset value every business day and offer daily share redemptions with timely payment. To support daily liquidity, a 15-percent limit is imposed on the portion of the fund’s underlying portfolio that can be invested in illiquid securities.

Limitation on composition of underlying investments. To maintain qualification as a regulated investment company (RIC) and favorable tax treatment under the ’40 Act, a fund must derive at least 90 percent of its income from permitted sources. This requirement is commonly referred to as the “income test,” and it is particularly relevant to many alternative strategies that require significant market exposure to commodity investments. Gains from trading in commodities—whether from physical holdings, commodity futures, or options—are classified as “bad income” and cannot be counted toward the 90-percent requirement of the income test without the use of specialized fund structures.

Mandated standards of oversight and transparency. Portfolio holdings must be filed quarterly with the Securities and Exchange Commission (SEC) and made available to the public. Funds must be overseen by an independent board of directors, which owe a fiduciary duty to shareholders and must avoid conflict of interests. Fund investment strategies must be consistent, predictable, and aligned with the specification of the fund prospectus.

Prohibitions on portfolio concentration. Funds are required to maintain a specified level of diversification as mandated by the “asset diversification test,” which prohibits investing more than 25 percent of the fund’s portfolio with a single issuer or security. Some relief from this prohibition is possible if a large position is held in underlying funds that are themselves diversified, such as exchange-traded funds tracking a broad market index.

Limitations on leverage, shorting, and derivatives. The ’40 Act limits funds’ use of leverage, short sales of securities, and derivative transactions. Leverage is limited to 33 percent of the gross asset value of the fund, using either derivatives or securities as margin collateral. Short sales of securities are limited as a proportion of the overall portfolio and require a tri-party agreement between the RIC, a prime broker, and an independent bank custodian. Derivatives trades require the use of segregated funds and asset coverage with liquid securities, designed to prevent excessive risk of loss and serve as a “practical limit on the amount of leverage the investment company may undertake.”

Fee structure. Federal law imposes a fiduciary duty on a mutual fund’s investment advisor regarding the compensation it receives from the fund, typically in the form of a management fee. This differs from hedge funds, where performance fees can reach 20 percent in addition to a management fee.

Lack of minimum eligibility requirements. Average retail investors have access to a broad spectrum of alternative strategies historically available only to institutional investors and high-net-worth individuals. The
lack of minimum eligibility requirements also opens the door to the inclusion of liquid alternative strategies within defined contribution retirement plans. Widespread offering of liquid alternative strategies within employer-sponsored defined contribution retirement plans could transform the asset-management industry at large, considering that U.S. 401(k) plans contained more than $4.4 trillion in assets as of the second quarter of 2014 (ICI 2014).³

Liquid Alternative Strategy-Class Differences
To better understand where liquid alternative investments may be appropriate in portfolios, consider the risk, return, and regulatory characteristics of the following 10 major liquid alternative strategies and how they differ from traditional mutual funds and alternative strategies housed in less-liquid structures.

Long/Short Equity
Equity long/short strategies construct portfolios consisting of both long and short positions in equity securities and equity-linked derivatives but maintain an overall long bias with significant positive correlation to the overall equity market. This type of fund might be utilized to provide some equity-market beta and allow the fund manager to try to add alpha by identifying overvalued and undervalued securities. Long/short funds with a target beta less than 1.0 also can be considered for use in a wider portfolio to assist in dampening portfolio volatility and providing some elements of diversification.

The long/short vehicle provides additional flexibility that allows active managers to generate positive (or negative) alpha by trying to identify undervalued securities for purchase and overvalued securities to sell short. Investment in this type of strategy requires a belief that active management can add value through stock selection, sector allocation, and market timing.

After the 1997 repeal of the "short-short rule," which allowed only 30 percent of fund income to be generated from short sales, this type of single-name focused equity long/short strategy became relatively easy to adapt to the ‘40 Act vehicle. We have seen many equity fund managers experienced with traditionally actively managed mutual funds transition to this space.

We believe that selecting long/short managers is similar to selecting traditional long-only active managers. First, the selection process should determine if managers under consideration are indeed able to generate legitimate alpha. Given the particular risk management challenges associated with shorting securities, a manager's risk management track record and acumen should be considered carefully. Second, managers have discretion in the amount of leverage employed by going long and short, and advisors should seek clarification on the amount of leverage employed.

Equity Market Neutral
Like the long/short category, equity market-neutral funds take long and short positions in equity market securities and derivatives. The difference lies in the absence of a systematic long-equity bias. The exact level of market exposure separating the two categories is somewhat subjective. The Morningstar fund classification system specifies equity index betas between –0.30 and +0.30 for consideration in this category. Fund returns are driven primarily by the fund manager’s ability to generate positive alpha in excess of fees. Fund strategies typically attempt to accomplish this through prescient stock selection, sector allocation, and market timing.

These types of strategies often are considered to be diversifying elements in a portfolio and a potential absolute return vehicle, ideally delivering pure alpha and low correlation to major asset classes. Because equity market-neutral strategies provide a larger role for short positions in the portfolio and focus on delivering absolute returns relative to long/short strategies, we believe manager vetting for risk management and alpha generation ability is even more important than for long/short manager selection.

Options and Volatility Strategies
Other equity funds may add option hedges in an effort to dampen portfolio volatility, generate alpha, and reduce tail risk. Option hedges provide a vehicle for potential alpha, allowing tactical managers to express multi-dimensional views on security price, volatility, and time. Systematic option strategies—which include covered-call, collar, put-writing, and more-complicated strategies—allow managers to potentially exploit the nonlinear characteristics of option payoffs to shape the return distribution.

Selling options generally allows for capture of volatility risk premia, which like the equity risk premium tend to capture positive returns over time, albeit with some level of volatility and risk.

It is our belief that buying options can function as a form of insurance, offering the ability to hedge against large market moves in either direction. The combination of buying and selling options on different securities, expiration dates, and strikes allows for a wide range of possible return profiles. Advisors should seek guidance from fund managers as to the level of upside and downside participation targeted by the manager. We believe these products can be useful in producing various risk/return distributions that can be tailored to individual circumstances and risk tolerances.

Beyond traditional index options strategies, several funds are now deploying single-name equity-options strategies. In addition, a number of mutual funds provide investment exposure to volatility-based futures contracts and exchange-traded notes that are tied directly or indirectly to the CBOE Volatility Index® (VIX®) and similar indexes. These volatility-futures funds differ from options-based long/short equity strategies in that volatility is considered to be an entirely separate asset class managed without integrated positions in the underlying securities. Some of these strategies maintain systematic long exposure to the volatility indexes to hedge against unforeseen disaster in the equity market. Others maintain systematic short exposures to try to capture the volatility
Retail investors and wealth managers need more detailed information about more types of risk because of the much longer average holding periods they maintain for their portfolios.

Unconstrained Fixed Income

The unconstrained bond label is applied to fixed-income funds not tied to a traditional bond market benchmark. Much of the recent interest in these strategies stems from widespread concern about the potential performance of traditional index bond managers in a rising-rate environment. These alternative fixed-income funds often have freedom to shift allocations across multiple segments of the fixed-income universe. Many employ derivatives and short positions. Some fund prospectuses even allow for negative duration in some extreme examples. For example, a strategy adopted by an unconstrained bond might isolate the credit risk of corporate bonds by holding a diversified collection of corporate bonds and simultaneously maintaining a short position in U.S. government bonds (to reduce the interest-rate risk of holding corporate bonds with multiple years to maturity).

Unconstrained fixed-income strategies come in many different flavors. Tactically focused funds can take advantage of the additional flexibility to dynamically adjust exposure to interest-rate, currency, inflation, and credit risks at the manager’s discretion. Some credit risk specialists focus on high-yielding or distressed credit situations and eliminate duration risk entirely via derivatives.

Investors in unconstrained fixed-income funds are taking the view that the fund manager will be able to minimize volatility and generate risk-adjusted returns in excess of a traditional index. Especially when evaluating funds investing in distressed credit or structured products, the true liquidity of the underlying fixed-income instruments must be evaluated. This issue is particularly critical given the current corporate bond trading environment. Many of the largest buy-side participants in this space have expressed concerns that the pullback by the larger banks from the dealer role in the wake of Dodd-Frank has negatively impacted the overall liquidity and health of the corporate bond marketplace. There is also concern that a rising-rate environment might expose vulnerabilities, weaknesses, and risks in the current trading regime that may have been masked in recent years in the fog of a zero-interest-rate environment.

Managed Futures

Managed futures strategies date back several decades to the emergence of commodity trading advisors, which were first formally defined as a structure by the Commodity Futures Trading Commission Act of 1974 (CFTC). This type of strategy is also often offered through commodity pool operator vehicles, which are a similar and interrelated designation also primarily regulated by the CFTC.

As the description implies, managed futures funds invest primarily in futures contracts, although many also use options and over-the-counter derivatives. Most of these funds employ trend-following strategies, although a few also utilize other quantitative methods or fundamental analysis. Managed futures strategies structured within an RIC often adopt a relatively complex legal structure to comply with the U.S. tax code. In response to the “Qualifying Income Test” enumerated in Internal Revenue Code section 851(b)(2), many of these funds are structured with wholly owned offshore subsidiaries designed to pass trading gains back to the parent fund as dividend income.

The large number of underlying indexes, commodities, and securities now covered in the global futures markets allows managed futures funds to trade and provide a proxy for a large set of asset classes including...
Alternative-Asset Beta
A family of related liquid alternative strategies invests in alternative assets such as foreign exchange, commodities, and energy infrastructure. Ideally, these investments will provide attractive risk-adjusted returns that are uncorrelated with traditional equity and fixed-income markets.

In terms of daily volume, foreign exchange is the most active of all markets, with an average daily spot-market volume exceeding $5 trillion. A number of liquid alternative funds specialize in exposure to foreign exchange, typically aiming to exploit interest-rate and relative-value differentials between currencies. A portion of these funds specialize in emerging market currencies, which can be viewed as a risk asset and typically offer higher interest rates than more developed economies.

Despite structural requirements for offering commodity exposure through an RIC vehicle and several years of trailing returns for broad-based commodities investments as an asset class, a number of commodity-focused alternative strategies are available. Some of these funds combine investments in derivatives tied to the underlying commodity with equity investments in correlated industry sectors.

We believe that funds specializing in master limited partnerships (MLPs) are best classified within the liquid alternatives universe as a class of alternative beta. MLPs are publicly traded limited partnerships that can offer the tax characteristics of a limited partnership with the liquidity of an exchanged-traded instrument. U.S. law allows for corporate pass-through treatment for MLPs engaged in a specified set of business activities, primarily the extraction, processing, and transport of energy resources. As many of these companies are structured around low volatility “toll” businesses such as pipelines, MLP investments often are considered a diversifier and potential fixed-income substitute.

Investment in individual MLPs offers tax benefits to individual investors in certain circumstances, but investors should be aware of potential complications. These were highlighted during Kinder Morgan’s 2014 acquisition of its subsidiary partnerships, which triggered unanticipated taxable events for many investors. Mutual funds that take positions in a portfolio of MLPs face an entirely different set of tax challenges because any distributions from the constituent MLPs must pass through the mutual fund’s corporate entity.

Dynamic Asset-Allocation Strategies
Several types of strategy groups invest across multiple asset classes, dynamically adjusting relative exposures at the discretion of the manager. Two commonly offered dynamic asset-allocation strategies are tactical and global macro.

Tactical funds are typically long-focused and dynamically adjust relative exposures to various asset classes based upon systematic models. The returns of these strategies greatly depend on the ability of these systematic models to successfully time the market. In some extreme cases, mistimed allocations can result in losses even during periods when all underlying assets rise.

Global macro managers take discretionary positions based on the manager’s macroeconomic and political views, taking long and short positions in a wide variety of instruments including equity, fixed income, foreign exchange, and commodities. These strategies often make significant use of derivative contracts. Many global macro strategies can offer low correlation to traditional asset classes, but returns and risk profile depend largely on the skill of the manager.

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Risk Parity
The risk-parity portfolio technique offers an alternative portfolio construction methodology to heuristic rules such as “60/40” and traditional quantitative portfolio construction techniques such as mean-variance optimization. Proponents of risk-parity portfolios argue that the traditional 60/40 allocation historically has exposed investors disproportionately to equity market risk and that volatility in these historical returns has been driven primarily by variation in equity market prices.

Risk-parity portfolio construction methodology first divides the world of investable assets into a set of desired asset classes and adjusts the portfolio allocation so that the expected risk contribution of each asset class is equal. This optimal portfolio is then levered, typically using futures contracts in some way, to achieve the desired overall level of risk exposure.

In practice, this technique results in portfolios more heavily weighted toward fixed income than traditional portfolio schemes. Many risk-parity portfolio models also include commodities as an asset class, and some will even incorporate more exotic strategies such as a trend-following component.

It is important to note that the resulting portfolio and performance will be very
The multi-alternative fund sector attempts to achieve returns through exposure to an aggregated portfolio of different alternative investment strategies. Although some index providers use the multi-alternative label to describe a wide swath of investing strategies, the term probably is most accurately attached to liquid alternative funds of funds, funds utilizing multiple submanagers, and statistical factor replication strategies.

The more straightforward multi-alternative approach is through a fund of funds structure, in which a parent RIC holds a diversified portfolio of more-specialized liquid alternative funds. This method facilitates transparency into the quarterly holdings of the composite portfolio and can provide a convenient vehicle for exposure to multiple alternative strategies. Other funds take a multimanager approach and take on a set of several subadvisors, often from existing hedge-fund or alternative investment management firms, and allocate a portion of assets to be managed by each submanager. Investors investigating the quarterly position statements of this type of multimanager fund typically will see the aggregated positions of all submanagers, which can slightly complicate performance attribution for investors in the parent vehicle. In both fund-of-funds and multimanager situations, consideration of the fees and investment selection ability at the parent and constituent levels of management is important.

Funds utilizing the statistical factor replication approach try to recreate the statistical factor exposures of an alternative index through a combination of traditional securities. Andrew Lo of MIT is one early and particularly prominent advocate of this approach to alternative strategy replication, in the academic literature and through association with investable products. There is a legitimate concern that most factor replication strategies are exposed to the desired statistical factor exposures in only a linear fashion and may not capture the nonlinear exposures inherent in many underlying strategies that make significant use of options and other derivatives. Some approaches that fit models to the historical properties of aggregated alternative indexes may lack sufficient forward-looking ability, which is arguably one of the most valuable services provided by a skilled asset manager. The statistical factor replication approach may seem to offer the benefit of eliminating the extra layer of fees incurred by some fund-of-funds structures, but this may not be the case if the strategy implements its factor exposures via esoteric exchange-traded funds on the higher end of the expense-ratio spectrum.

Conclusions
We believe the availability of alternative investment strategies in the convenient, transparent, and highly regulated environment of a ’40 Act fund is changing the way wealth managers and clients approach investing. In the present environment of historically low interest rates and relatively high equity valuations, having the flexibility to choose strategies once available only to institutions and ultra-high-net-worth investors has democratized investing and offers the potential to reduce portfolio risk, increase returns, or both.

At the same time, however, we have seen that the “liquid alternative” umbrella covers a range of strategies and assets, each with its own risk/reward dynamics, and requires thoughtful consideration. For wealth management professionals, the old-fashioned admonitions of “know your customer” and “investigate before you invest” never have been more timely.

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Endnotes

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