ALTERNATIVE STRATEGY MUTUAL FUNDS

Opportunity or Mirage?

By Christopher Maxey, CAIA

During the past decade, the inability of traditional stock and bond portfolios to satisfy investor needs led to an evolution of the investment management industry. Investors began to search for other sources of diversification, encouraging asset managers to think about new products and ideas. Alternative investments traditionally were available only to high-net-worth and institutional investors, but the retailization of these solutions is making them available to a much broader portion of the investing public. The move to swing open the doors carries great risk and opportunity for investors, but potentially greater rewards for asset managers.

This article explores the challenges and the opportunities presented by the evolution of alternative mutual funds.

The investing landscape for traditional investments remains fraught; seldom in history have both fixed income and equities been concomitantly priced so richly. Cliff Asness of AQR Capital Management recently said that 98 percent of the time, today’s combined bond/stock portfolio has been available historically at cheaper levels (Strauss 2013). Separately, return forecasts by Research Affiliates suggest that investors can expect a return of 4.4 percent over the next decade for a 60-percent equity and 40-percent bond portfolio (see table 1). That represents the lowest 10-year expected return since the late 1800s. To the extent that consensus is accurate, finding alternate sources of return and diversification is more imperative today than at any point in recent memory. It is thus not surprising to see the appetite for new alternative products so strong.

The Alternative Value Proposition and Historical Access

Applying a standard definition to alternatives is not an easy endeavor, and for Fortigent, alternatives typically satisfy one of several mandates. We view alternative investment managers as having the ability to allocate capital in a less constrained manner using an inherently active approach. Alternative managers are less conscious of benchmarks and maintain the ability to invest long and short across a wide range of asset classes, from equities and bonds to currencies and commodities. Andrew Lo of MIT has stated that the “ability to short assets may be the final frontier of diversification” (AlphaSimplex 2011, 3).

Looking across limited partnership and mutual fund structures, our firm recommends solutions spanning six alternative categories (Mileff and Sonnenberg 2012):

- **Multi-strategy:** Funds with the ability to tactically or dynamically allocate among strategies falling within several traditional hedge fund disciplines, with the objective of producing consistent and positive returns regardless of the directional moves in equity, fixed income, or currency markets.

- **Long/short equity:** The most common of the alternative strategies, designed to maintain long and short positions in equities and equity derivatives. Managers may take on a range of characteristics, including but not limited to domestic and international, sector specific, concentrated, and high or low net market exposure.

- **Event driven:** Strategies that maintain positions in companies currently or potentially involved in a multitude of corporate activities, including mergers, tender offers, restructuring, financial distress, recapitalization, or other capital structure changes.

- **Market neutral/relative value:** Strategies that attempt to exploit valuation discrepancies between securities of any type. This grouping encompasses managers who employ a diver-

<table>
<thead>
<tr>
<th>Decades</th>
<th>Beginning Dividend Yield</th>
<th>Long-Term Real EPS Growth</th>
<th>Implied Inflation</th>
<th>Expected Equity Return</th>
<th>Beginning Bond Yield</th>
<th>Expected 60/40 Return</th>
<th>Realized 60/40 Return</th>
<th>Expected Minus Realized</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average</td>
<td>4.9%</td>
<td>1.7%</td>
<td>1.9%</td>
<td>8.7%</td>
<td>4.8%</td>
<td>7.2%</td>
<td>7.6%</td>
<td>–0.5%</td>
</tr>
<tr>
<td>Current</td>
<td>2.3%</td>
<td>1.7%</td>
<td>2.0%</td>
<td>6.0%</td>
<td>2.0%</td>
<td>4.4%</td>
<td>–</td>
<td>–</td>
</tr>
</tbody>
</table>

Source: Brightman (2012)
**Diversified credit:** Strategies attempting to generate absolute returns by capitalizing on opportunities in global fixed-income markets, including, but not exclusively, global sovereigns, high-yield bonds, bank debt, distressed debt, and special situation credit.

**Trading strategies:** Encompasses a range of strategies in which the investment process is based on capitalizing on changes in fundamental and economic variables and their impact on commodity, currency, equity, and fixed-income markets. This grouping covers strategies such as managed futures, global macro, and discretionary traders.

The value proposition for alternatives is evolving as the investor base grows and matures. From the early years of hedge funds through the mid-2000s, alternative investments were designed largely to provide return enhancement. This came in many forms, but was most recognizable by the headline-grabbing nature of events such as George Soros sinking the Bank of England and reaping huge rewards as a result. Tiger Management’s successful attack on the Thai baht in 1997 was a similar event. As institutional investors took a more prominent role in allocating to alternative investments, the mandate slowly shifted. No longer were hedge funds perceived as return enhancers; they became volatility dampeners and capital preservers. That philosophy remains intact today with occasional exceptions.

The value of alternatives now resides in improved risk-adjusted performance and better diversification. Incorporating a 20-percent allocation to alternatives during 1990–2011 resulted in higher returns and lower volatility (see figure 1).

**The Rise of the ’40 Act Alternative Mutual Fund**

Alternative mutual funds are not an entirely new phenomenon, but they did gain prominence and favor following 2008. Many investors were largely unprepared for the scale and scope of the financial crisis in 2008, causing them to \textit{ex post facto} recognize the need for additional sources of diversification and return. Because limited partnership (LP) or fund-of-hedge-fund structures did not ingratiate themselves with investors in 2008 (courtesy of liquidity gates and side-pocketed investments), mutual fund structures became a more popular vehicle.

It is assumed that alternative mutual funds only emerged post-2008, but many underlying funds in the various Morningstar alternative categories launched as far back as 1978 (in the case of long/short equity) and 1989 (market neutral) (see table 2). Alternative mutual funds remained a cottage industry during the intervening years simply as a result of investor appetite for equities and regulatory hurdles that limited the ability to execute particular strategies under the mutual fund framework. A gradual evolution of the regulatory framework made mutual funds a more accommodating structure for strategies such as managed futures, encouraging the rapid post-2008 growth rate.

Since 2008, the number of alternative mutual funds entering the marketplace accelerated. In 2008, a total of 28 alternative funds were launched in the five purely alternative categories tracked by Morningstar. By 2011, that number jumped to 76. At the same time, assets grew at an increasing rate, from $30 billion at the end of 2008 to $139 billion at the end of 2012. By mid-year 2013 that figure rose again to $185 billion (see figure 2).

Despite the rising interest in alternative mutual funds, it remains a small portion of
assets in comparison to hedge funds and the overall mutual fund industry. As of June 30, 2013, more than $2.4 trillion was invested in hedge funds and $13.6 trillion in mutual funds (Investment Company Institute 2013).

**Bridging the Divide between Limited Partnerships and Mutual Funds**  
Mutual fund regulations are designed largely with the interests of investors in mind and, in the process, restrict certain securities or investments from being available to the general public. The growth of alternative mutual funds and subtle changes in the regulatory landscape are blurring the line between what can be accomplished within a mutual fund versus private partnerships.

The regulations most directly applicable to alternative strategies include the following:

- Redemptions must be paid within seven days.
- No more than 15 percent of assets may be invested in illiquid assets.
- Mutual funds should not charge performance fees, unless designed as a fulcrum structure where fees rise and fall dependent on performance of the fund.
- For at least 75 percent of the portfolio, diversified mutual funds may not invest more than 5 percent in any one issuer, may not own more than 10 percent of the outstanding voting securities of an issuer, and may not invest more than 25 percent in a particular industry group.
- May not generate more than 10 percent of income from non-securities, such as commodity futures.
- Mutual funds may employ leverage, as long as it maintains 300-percent asset coverage. For practical purposes, this limits leverage to 33 percent.

In recent years, mutual fund companies adopted mechanisms to bypass portions of the mutual fund regulations. Specifically, fund companies established controlled foreign corporations (CFC) that are wholly owned by the mutual fund and can invest as much as 25 percent of its assets into the CFC vehicle. By investing through a CFC, fund companies no longer are subject to limitations on non-securities-related exposure or the ability to pay performance fees. In addition, fund companies began to use total-return swaps as a means to apply more than 33-percent leverage on portfolios. Total-return swaps do not need to be fully funded and generally require 1-percent to 10-percent margin, thereby allowing managers to obtain implicit exposure to securities in a leveraged fashion.

**Today’s Landscape**  
The alternative investment mutual fund universe remains a work in progress, but a wider subset of managers and trading styles is becoming available. Long/short equity represented the most seamless strategy to transition to the mutual fund structure and represented one of the most popular categories from an adoption perspective.

Structures more or less appropriate for particular strategies include those shown in figure 3.

In addition, the regulations most directly applicable to alternative strategies include the following:

- May not generate more than 10 percent of income from non-securities, such as commodity futures.
- Mutual funds may employ leverage, as long as it maintains 300-percent asset coverage. For practical purposes, this limits leverage to 33 percent.

Based on the mutual fund requirements, certain strategies are housed more naturally in the purview of a mutual fund structure. In particular, we believe the most easily adoptable alternative strategies for a mutual fund are long/short equity, long/short credit, managed futures, and, to a slightly lesser extent, global macro. Strategies less effective within a mutual fund are those that require higher levels of leverage and illiquidity to realize their full potential, such as distressed, market neutral, relative value, and multi-strategy—each of which require either some use of leverage and/or involve liquidity constraints. Although these strategies are less attractive for a mutual fund, certain aspects of the illiquidity or leverage...
inherent in those approaches can be replicated under mutual fund regulations using some of the structuring techniques discussed above.

Alternative mutual funds may be structured as single-manager mutual funds (similar to a direct hedge fund) or multi-manager funds (similar to a fund of hedge funds). Single-manager funds most often are focused on a particular category or sector of the market, such as long/short equity or health care. Multi-manager funds generally are constructed in a multi-strategy framework with exposure to several alternative investment categories.

Through the adoption of multi-manager funds, the number of hedge fund managers willing to consider participation in a mutual fund is greatly increased. This is primarily a function of the operational burden that accompanies the management of a mutual fund and the need for distribution. From a hedge fund manager’s perspective, the ability to outsource those functions is attractive and lends itself to better managers entering the space. A given manager participating as a sleeve in a multi-manager mutual fund product also poses less of an immediate risk to that manager of cannibalizing its core hedge fund business where direct access requires higher fees.

Benefits of the single-manager approach are a lower fee structure, client-directed selection of investment style, and greater access to the investment team. Benefits of the multi-manager approach include potentially improved caliber of investment talent, access to less-common mutual fund strategies, full transparency through separate accounts, and sharing of illiquidity or leverage budget among managers. The advantage of a multi-manager fund is that 1940 Act requirements do not need to be applied to each individual manager. For instance, a credit subadvisor could allocate more than 15 percent of his portfolio to illiquid securities, assuming the overall fund allocation does not exceed 15 percent. Multi-manager mutual funds are inherently more expensive given the multiple layers of participants being paid and are more operationally intensive.

**Fees**

Alternative investments typically are complex and sophisticated in approach; ’40 Act alternative mutual fund products therefore demand commensurate administrative and operational complexity. As such, these strategies typically command a pricing premium. Hedge funds historically were structured to charge 2-percent management fees along with 20-percent incentive fees. Alternative mutual funds, on the other hand, are not able to participate in performance fees except in special circumstances, but they still command a premium relative to traditional long-only stock and bond mutual funds. The average alternative mutual fund will charge 1.25–2.0 percent, but some funds charge as much as 3+ percent.

Multi-manager solutions typically will be the most costly, because underlying managers collect 0.75–1.25 percent, in addition to the fees collected by the mutual fund company for distribution, operations, and oversight.

Although mutual funds are not able to charge performance fees, with the exception of the fulcrum approach mentioned above, certain funds use the CFC to invest with managers that charge performance fees (see table 3). By owning and investing in the CFC, underlying fees are no longer visible to regulators. Some compliance professionals believe regulators will examine this issue soon, so advisors and investors should stay vigilant.

**Conducting Due Diligence**

The due diligence requirements for alternative investments generally are more arduous and time consuming than traditional investing when executed properly. Alternatives do not have to be inherently complex, but many strategies include aspects of investing about which clients may have little familiarity. To conduct effective due diligence, one should utilize as standardized a due diligence process as possible but maintain flexibility to adapt to an evolving landscape.

Our firm relies upon a seven-step due diligence process to ensure a consistency of approach and philosophy (see figure 4). Nuances to the process will occur depending on the strategy but, for the most part, the overarching approach is designed to remain consistent.

The first two steps easily can become the most challenging aspect of any due diligence
process. Ideas are sourced through any number of channels, but maintaining and cultivating a network of contacts is crucial, particularly with alternative investments.

In Step 3, we begin to look at the historical risk and return profile of a manager. As we indicated previously, alternative mutual funds are growing rapidly, leading to an outsized number of managers with short track records (see figure 5). In many instances, however, managers run comparable limited partnership products with similar investment mandates. Reviewing those products and returns is one means to becoming more comfortable with the manager’s track record. In reviewing the limited partnership vehicle, one needs to understand how closely the product can be replicated under 1940 Act regulations—in many cases, managers are providing mutual fund investors with 75–80 percent of the investment strategy accessed by LP investors. The missing 20–25 percent can be the difference between a great track record and one that is simply mediocre. One of the most common differences pertains to the short portfolio, where managers will eliminate single name shorts in favor of index and sector hedges. That may greatly reduce potential manager alpha and expected return.

Quantitative analysis of alternative strategies is important, but it can rarely tell the full story. Assuming a manager passes the necessary criteria from a quantitative standpoint, a deeper review of the people, philosophy, investment process, and risk management becomes essential. From there, a thorough review of operational and compliance activities is conducted. Because certain strategies are potentially complex, the operational infrastructure takes on a more important role than in traditional equity and fixed-income funds.

We focus on several key red flags when conducting due diligence on alternative mutual funds, particularly:

- Limited track record. This pertains more to experience across different types of market environments and investment cycles (although this is not always realistically possible) than to a specific period of time.
- Long-only managers launching alternative funds despite limited experience with shorts or derivatives.
- Operational infrastructure and its impact on a manager’s ability to establish quality counterparty relationships.
- Disparity of style and approach across time (style drift).
- Personnel turnover.
- Investor turnover or sudden loss of assets.
- Strategies that we do not believe have the potential to perform well within the constraints of the mutual fund structure.

Alternative Mutual Fund Performance

Over the past decade, alternative mutual funds delivered mixed performance, with certain strategies performing more comparably with hedge fund peers and others lagging widely. Market-neutral mutual funds are the lowest-performing strategy with an annualized return of 1.0 percent. Structural challenges make market neutral a difficult strategy to execute efficiently in a mutual fund. Market-neutral hedge funds rely on moderate amounts of leverage to enhance the return spread between securities, and the inability to successfully do that in a mutual fund limits the return opportunity.

Other strategies provided a better investor experience, particularly in periods of stress (see table 4). The nontraditional bond category returned 3.7 percent during our analysis period from August 2003 through July 2013.

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**Table 3: Average Category Fee**

<table>
<thead>
<tr>
<th>Category</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Morningstar Long/Short Equity</td>
<td>2.5%</td>
<td>2.0%</td>
<td>1.9%</td>
<td>1.9%</td>
</tr>
<tr>
<td>Morningstar Nontraditional Bond</td>
<td>1.2%</td>
<td>1.3%</td>
<td>1.2%</td>
<td>1.3%</td>
</tr>
<tr>
<td>Morningstar Market Neutral</td>
<td>1.8%</td>
<td>1.8%</td>
<td>1.7%</td>
<td>1.7%</td>
</tr>
<tr>
<td>Morningstar Managed Futures</td>
<td>2.1%</td>
<td>2.0%</td>
<td>2.6%</td>
<td>2.6%</td>
</tr>
<tr>
<td>Morningstar Multi-alternative</td>
<td>1.6%</td>
<td>1.6%</td>
<td>1.6%</td>
<td>1.7%</td>
</tr>
<tr>
<td>Large-Cap Blend</td>
<td>1.1%</td>
<td>1.1%</td>
<td>1.1%</td>
<td>1.1%</td>
</tr>
<tr>
<td>Intermediate-Term Bond</td>
<td>0.9%</td>
<td>0.9%</td>
<td>0.9%</td>
<td>0.9%</td>
</tr>
</tbody>
</table>

Source: Morningstar

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**Figure 4: Seven-Step Due Diligence Process**

1. **Idea Sourcing**
   - We use proprietary databases, industry contacts and publications, direct solicitation, and ideas from our community of advisors

2. **Quantitative Screening**
   - Comprehensive, subtractive process utilizing the foremost industry databases

3. **Risk Analysis**
   - We focus on multiple measures of risk (volatility, drawdowns, upside/downside ratios, Sharpe, tail risk, etc.)

4. **Qualitative Analysis**
   - Evaluation of the investment professionals, philosophy, process and investment approach, and risk management

5. **Operational & Compliance Analysis**
   - Focus on trading, risk management, portfolio management, and firm integrity

6. **Onsite Verification**
   - Onsite visits serve to revalidate the quality of the investment team, business, and investment solution

7. **Formal Approval**
   - Two-level approval process—research team and executive team
relative to a 4.9-percent return for the Barclays Aggregate Bond Index. In the equity universe, the long/short equity category generated a 2.8-percent return, well below the 7.6-percent gain for the S&P 500 Index, but not surprising for strategies that hold short positions during a period of strong performance for equities. The peak drawdown of the long/short category was 23 percent against a 51-percent loss in the S&P 500.

The necessary distinction is that Morningstar categories simply represent the average return. The importance of due diligence cannot be stressed enough. In the long/short equity category, the top-performing strategy during the past five years returned 18.8 percent and the worst-performer lost 9.9 percent (see table 5). Top-quartile managers returned 7.0 percent versus an S&P 500 return of 8.3 percent, and bottom-quartile managers returned 1.3 percent annualized.

**Figure 5: Alternative Funds Still Lack Performance History**

<table>
<thead>
<tr>
<th>Category</th>
<th>&lt; 3 Years</th>
<th>3 to 5 Years</th>
<th>5 to 10 Years</th>
<th>&gt; 10 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Managed Futures</td>
<td></td>
<td></td>
<td></td>
<td>0%</td>
</tr>
<tr>
<td>Multi-alternative</td>
<td></td>
<td></td>
<td></td>
<td>2.8%</td>
</tr>
<tr>
<td>Nontraditional Bond</td>
<td></td>
<td></td>
<td></td>
<td>3.7%</td>
</tr>
<tr>
<td>Long/Short Equity</td>
<td></td>
<td></td>
<td></td>
<td>2.8%</td>
</tr>
<tr>
<td>Market Neutral</td>
<td></td>
<td></td>
<td></td>
<td>1.0%</td>
</tr>
</tbody>
</table>

Source: Morningstar

**Table 4: Risk/Return Statistics, August 2003–July 2013**

<table>
<thead>
<tr>
<th>Category</th>
<th>Annualized Return</th>
<th>Annualized St. Dev.</th>
<th>Sharpe Ratio</th>
<th>Max Drawdown</th>
</tr>
</thead>
<tbody>
<tr>
<td>Morningstar Long/Short Equity</td>
<td>2.8%</td>
<td>5.9%</td>
<td>0.2</td>
<td>–22.9%</td>
</tr>
<tr>
<td>Morningstar Nontraditional Bond</td>
<td>3.7%</td>
<td>4.1%</td>
<td>0.5</td>
<td>–16.3%</td>
</tr>
<tr>
<td>Morningstar Market Neutral</td>
<td>1.0%</td>
<td>2.2%</td>
<td>–0.3</td>
<td>–6.1%</td>
</tr>
<tr>
<td>Morningstar Managed Futures</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Morningstar Multi-alternative</td>
<td>2.8%</td>
<td>6.6%</td>
<td>0.2</td>
<td>–27.0%</td>
</tr>
<tr>
<td>Barclays Aggregate Bond</td>
<td>4.9%</td>
<td>3.4%</td>
<td>1.0</td>
<td>–3.8%</td>
</tr>
<tr>
<td>HFRI Fund of Funds Composite</td>
<td>3.8%</td>
<td>5.5%</td>
<td>0.4</td>
<td>–22.2%</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>7.6%</td>
<td>14.6%</td>
<td>0.4</td>
<td>–51.0%</td>
</tr>
</tbody>
</table>

Source: FactSet

**Table 5: Long/Short Equity Percentile Return (through July 2013)**

<table>
<thead>
<tr>
<th></th>
<th>YTD</th>
<th>1 Year</th>
<th>3 Year</th>
<th>5 Year</th>
<th>7 Year</th>
<th>10 Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maximum</td>
<td>25.0</td>
<td>33.6</td>
<td>22.2</td>
<td>18.8</td>
<td>13.8</td>
<td>12.6</td>
</tr>
<tr>
<td>5th Percentile</td>
<td>21.2</td>
<td>26.0</td>
<td>15.9</td>
<td>11.3</td>
<td>9.8</td>
<td>12.6</td>
</tr>
<tr>
<td>25th Percentile</td>
<td>12.6</td>
<td>16.8</td>
<td>11.5</td>
<td>7.0</td>
<td>5.8</td>
<td>9.3</td>
</tr>
<tr>
<td>50th Percentile</td>
<td>8.2</td>
<td>10.0</td>
<td>6.3</td>
<td>4.1</td>
<td>3.0</td>
<td>5.0</td>
</tr>
<tr>
<td>75th Percentile</td>
<td>4.4</td>
<td>6.0</td>
<td>3.2</td>
<td>1.3</td>
<td>1.5</td>
<td>4.2</td>
</tr>
<tr>
<td>95th Percentile</td>
<td>(2.2)</td>
<td>(1.1)</td>
<td>(3.8)</td>
<td>(2.0)</td>
<td>(0.1)</td>
<td>1.1</td>
</tr>
<tr>
<td>Minimum</td>
<td>(27.8)</td>
<td>(30.3)</td>
<td>(20.0)</td>
<td>(9.9)</td>
<td>(2.8)</td>
<td>0.2</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>19.6</td>
<td>25.0</td>
<td>17.7</td>
<td>8.3</td>
<td>6.3</td>
<td>7.6</td>
</tr>
</tbody>
</table>

Source: FactSet

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formance of 1 percent for hedge funds (Cliffwater 2013). Strategies necessitating higher leverage usage or greater illiquidity naturally outperformed in the hedge fund structure by a wider margin, but more liquid strategies such as managed futures and global macro demonstrated a narrower performance spread.

Risks
When a traditional capital allocator hears the word mutual fund, s/he thinks safety, comfort, oversight, and regulatory protection. The introduction of alternative investing styles to mutual funds brings about a new set of complexities and intricacies, however, that advisors need to consider when selecting these strategies for client portfolios. The following list, though not all-encompassing, provides a review of issues investors should consider when allocating to alternative mutual funds.

Regulatory
Regulatory constraints. Mutual funds are subject to specific Securities and Exchange Commission (SEC) requirements, particularly regarding leverage and illiquidity. The regulatory environment is in a regular state of change, raising the possibility that acceptable styles of mutual fund investing today will be less acceptable in the future.

Liquidity. Mutual funds are required by law to offer daily liquidity to investors, but this does not prohibit mutual funds from owning less-liquid securities. As much as 15 percent of a particular fund may be invested in illiquid assets, defined as those securities that don’t have a readily available price or cannot be sold within seven days. Redemptions, however, must be paid to investors within seven days. Additionally, during periods of crisis, liquid securities quickly can become illiquid, causing a fund manager to cross the 15-percent illiquidity threshold.

Multi-manager solutions. If a manager is hired to subadvise a sleeve of assets within the mutual fund, that firm must adhere to 1940 Act requirements, including registering with the SEC, not charging a performance fee, and receiving approval from the board of directors and shareholders. Managing portfolios with a diverse set of underlying strategies and managers requires operational and infrastructure requirements that most firms are unable to handle. Carefully reviewing the back-office capabilities of firms with multi-manager funds is of critical importance when conducting due diligence.

Investment
Performance dispersion. The performance differential between top-tier and bottom-tier alternative mutual funds can be very wide in a given year. In 2009, as an example, the long/short equity category had a top performer that gained more than 82 percent and several laggards that experienced losses. The implication is that an investor theoretically could make the right decision in allocating to a particular strategy but not experience the benefit should manager selection be poor.

Style drift. Monitoring alternative strategies requires an investment of time. All investment strategies have the inherent danger that a manager will drift from the original investment style. This problem is compounded when trying to monitor alternative strategies given the complexity and opacity of this style.

Asset constraints. Due to the complexity of alternative mutual fund strategies and the smaller markets in which some of these asset managers invest, capacity can and, in many cases, should be limited. That has not precluded many larger firms from pushing the envelope and accelerating asset growth to a point where performance deteriorates.

Operational
Tax considerations. Alternative strategies will tend to have higher turnover, reducing tax efficiency. In addition, certain structures used by alternative investment mutual funds, such as the CFC, block favorable tax treatment and require a realization of ordinary gains or losses.

Transparency. Although mutual funds are required to file holdings on a quarterly basis, understanding the filings can be challenging. Funds investing through derivatives may disclose positions but not the nature of those positions.

Fee hurdle. Traditional equity and fixed-income products have been experiencing fee compression since exchange-traded funds came to market. In alternatives, slight fee compression is occurring, but these products generally demand a premium

Continued on page 47

Table 6: Average Difference between Private and Liquid Alternatives

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Annualized Return</th>
<th>Annualized St. Dev.</th>
<th>Beta</th>
<th>Alpha</th>
<th># of Pairs</th>
<th>Median Return Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Strategies</td>
<td>1.0%</td>
<td>0.2%</td>
<td>−0.01</td>
<td>1.0%</td>
<td>148</td>
<td>0.9%</td>
</tr>
<tr>
<td>Equity Long/Short</td>
<td>1.1%</td>
<td>0.0%</td>
<td>0</td>
<td>1.0%</td>
<td>49</td>
<td>0.5%</td>
</tr>
<tr>
<td>Credit</td>
<td>1.0%</td>
<td>1.0%</td>
<td>−0.01</td>
<td>1.1%</td>
<td>22</td>
<td>0.7%</td>
</tr>
<tr>
<td>Market Neutral</td>
<td>2.2%</td>
<td>−0.9%</td>
<td>−0.01</td>
<td>2.2%</td>
<td>10</td>
<td>0.9%</td>
</tr>
<tr>
<td>Multistrategy</td>
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<td>0.0%</td>
<td>−0.2</td>
<td>1.3%</td>
<td>3</td>
<td>2.2%</td>
</tr>
<tr>
<td>Managed Futures</td>
<td>0.5%</td>
<td>0.8%</td>
<td>−0.01</td>
<td>−0.2%</td>
<td>22</td>
<td>0.4%</td>
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<tr>
<td>Macro</td>
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<td>−0.06</td>
<td>1.5%</td>
<td>23</td>
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<tr>
<td>Event Driven</td>
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<td>0.6%</td>
<td>0.05</td>
<td>1.7%</td>
<td>15</td>
<td>1.6%</td>
</tr>
</tbody>
</table>

Source: Cliffwater
ALTERNATIVE STRATEGY MUTUAL FUNDS
Continued from page 24

based on their higher operational and investment hurdles. The Morningstar multi-alternative category, for instance, carried an average expense ratio of 1.7 percent in 2012.

Conclusion
Alternative offerings are one of the few growth engines in the mutual fund universe. By some estimates, alternative mutual funds will grow to represent 13 percent of mutual fund assets by 2015, up from 6 percent at the end of 2010. The universe of solutions is bound to grow in complexity as the years progress, creating a situation whereby investors and clients need to move cautiously. With unique sources of return becoming more difficult to locate, it will be imperative for investors to spend the time necessary to cull through the increasingly fragmented universe of alternative mutual funds in search of uncorrelated performance. Determining which managers offer a truly competitive product will not be easy, however, and due diligence is going to be more critical than ever.

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