The Expanding Alternative Investment Space

At the most basic level, investing has always involved searching for returns, but in application it always means preventing against losses as well. As everyone knows, every percentage of portfolio loss requires an even more positive return to just getting back to where you began. This leads to the idiom of being "well diversified" often being thrown around. For sophisticated investors, this doesn't mean just having different types of stock exposures or just having bonds in their portfolio. Diversification comes in the form of many asset classes, including those commonly known as "alternatives". The goal of these, according to the modern portfolio theory, is always to introduce assets with low correlations to others so as to reduce the volatility, and, therefore, improve the efficiency of the portfolio.

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In May of this year, the S&P 500 hit a new record high, and since March 9, 2009, it had a cumulative return of over 255%. In the investment world, the "all good things must come to an end" mindset is quickly becoming more prevalent. Investors who still remember 2008 well are becoming concerned about protecting their portfolio against another precipitous drop, and so they are searching for an investment alternative to the traditional equity markets. However, unlike 2007, ten-year US Treasuries are yielding only around 2.3%, and the Fed Funds rate has long been near zero and certain to rise. With bonds seemingly also unattractive from a return perspective, many savvy investors are searching for assets classes that have a low correlation to both stocks and bonds. This search is leading them towards their old favorite alternative investment, hedge funds.

Hedge funds have certainly lacked great appeal in recent years. Since March 2009, while the equities markets have rallied, hedge funds, as measured by the HFRI Composite Fund of Funds Index, have returned only 35% cumulative. However, after extended periods of strong equity returns when valuations can become inflated, and volatility intensifies, hedge funds have often provided downside protection compared to the stock market. Following the bull periods from 1987-2000 and 2002-2007, over the next 12 months the HFRI FoF Composite outpaced the S&P 500 by 23.1% and 29.7% respectively. Traditional hedge funds do not come without drawbacks, many of which makes the typical investor unable to rebalance quickly to the asset class when they desire to protect their portfolio from downside risk. Among these hedge fund detractors is their typical Limited Partnership structure that requires qualified purchaser status and causes liquidity constraints. Typically a hedge fund in an LP format has withdrawal notification requirements and holdbacks that inhibit investor's flexibility. In 2008 many hedge funds, even those with seemingly liquid strategies (e.g. long-short equity), put up gates prohibiting investors from making redemptions. Also, hedge funds tend to be very tax inefficient due to frequent trading and can be very expensive due to high management fees coupled with performance fees. Over time, market ingenuity has led to the rise of new products that mitigate some of these inefficiencies. In recent years, traditional hedge fund strategies such as equity long-short, managed futures and merger arbitrage have begun to be offered in open-end mutual fund structures. These "liquid alternatives" have quickly become vogue in the investment world. These funds provide access to many of the diversification benefits hedge funds long have but with daily liquidity, low minimums and simple tax filings via Form 1099. As mentioned above, one infamous hurdle that has always been present in the

hedge fund space is the high level of fees. The typical 2% management and 20% performance fee is well known. Many of the strategies employed are considered more complex than traditional equity investing and, therefore, draw some of the top talents that demand higher compensation. Although the liquid alternative space is substantially cheaper than the typical hedge fund, they are not considered inexpensive when compared to traditional investment solutions. The Morningstar Multi-alternative Category has an average net expense ratio of 1.67%, which is not cheap by any regard for mutual funds, but in context it is certainly competitive with the overall alternative space. Ultimately, the goal of any alternative investment is to introduce a return stream to the portfolio that has a different driver of returns than traditional equities and bonds. Over the last five years, the HFRI FoF Composite has exhibited a 0.82 correlation to a portfolio of 40% Barclays 5 Year Municipal Bond Index and 60% MSCI All-Country World Index. Over the same period, of the 38 funds existing in the Morningstar Open End Mutual Fund Malt alternative category, 23 or 60% of them have exhibited a lower correlation to the same portfolio. Today that same category has bloomed to over 149 unique strategies. Certainly there currently exists more solutions to introduce non-traditional correlations to your exposure than any other time in history. Given the liquidity, low minimums and cheap trading costs of these new products they can be used for a host of new applications. Now even a relatively small portfolio can implement a more diversified portfolio using liquid alternatives in order to mitigate drawdown risk. By using these new products, something as simple as a $10,000 trust for a minor can have access to some of the same strategies as a $100million portfolio. However, it is important to note that not all strategies used by traditional hedge funds can be replicated in a liquid format due to regulatory constraints associated with liquidity requirements placed on "40 Act" funds. Investing in certain illiquid assets is just not possible in the liquid alternative space, thus eliminating that opportunity set. As with any alternative investment, liquid alternatives do not come without some systematic risk. Therefore, as always, it is important to conduct proper due diligence on any investment to eliminate any unsystematic risks. Historical performance is especially not indicative with the short track records of many liquid alternatives. You should always contact your investment advisor for my information if considering entering any alternative investment.

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