Liquid alternatives are hedge funds for today's investor

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Some investors consider hedge funds to be mysterious, aggressively managed investments that may be too risky for the typical portfolio. Skeptics may be surprised to learn that the majority of hedge fund managers focus on providing capital appreciation with lower volatility than the broad markets. After all, Merriam-Webster defines "hedge" as a fence or boundary, as well as an object that is intended to restrict something – such as, in this case, the risks in a portfolio.

Despite the misconceptions, the popularity of hedge funds continues to grow. Hedge fund assets climbed from US$38 billion in 1990 to US$2.8 trillion by 2015[1] representing a significant change in asset allocation and perhaps the most meaningful shift since many investors began moving their money from bonds to stocks in the early 1980s.

The advent of liquid alternatives fund structures – which offer hedge strategies through a managed fund vehicle – has helped drive this shift. These structures provide wider access to hedge strategies and can offer potential benefits in terms of liquidity, fees and transparency.

SOLIDIFYING A CASE FOR HEDGE FUNDS AND LIQUID ALTERNATIVES

Broadly speaking, traditional access to hedge funds via private placement vehicles often meant less liquidity, with redemption periods restricted to monthly or quarterly windows. In addition, visibility into portfolio holdings – or transparency – was limited. Liquid alternatives by contrast offer daily liquidity, security-level transparency and fees that are typically lower than those associated with traditional hedge fund vehicles.

And, unlike hedge funds, liquid alternative portfolios in the United States, for example, must adhere to the same regulatory requirements as US-registered mutual funds, sharing information that private placements are not required to disclose. Such liquidity, flexibility and transparency have persuaded a wider range of investors to use hedge strategies as a complement to more traditional portfolios.

Recently, interest in hedge strategies has intensified as investors are facing a dilemma. They are searching for yield, yet interest rates from fixed income products have generally been low and there is fear associated with volatility in equity markets.

In addition, many investors are looking for greater diversification in their portfolios (i.e. lower correlation[2] to traditional asset classes such as stocks and government bonds). Using non-correlated strategies within a portfolio can help smooth out the ride when one particular asset class or strategy may be experiencing a volatile period. Additionally, hedge

strategy managers can take short positions that benefit from market declines, cushioning a traditional long-only portfolio.

Hedge fund investment strategies are diverse and their returns have often been derived from non-traditional sources. In general, they may seek to take advantage of market inefficiencies such as pricing differences and relative discrepancies between securities such as stocks and bonds, technical market movements, deep fundamental valuation analysis, and other quantifiable trends and/or inconsistencies. Again, the majority of hedge strategies seek to capture gains from market inefficiencies while seeking to reduce market exposure.

Figure 1: Alternative strategies' correlation vs traditional assets
Alternative strategies have had low correlation versus major traditional asset classes
(20-Year) Asset Class Correlations

	Hedge Strategy Composite	Long Short Equity	Event Driven	Global Macro	Relative Value
Hedge Strategy Composite	1.00				
Long Short Equity	0.97	1.00			
Event Driven	0.92	0.89	1.00		
Global Macro	0.63	0.55	0.48	1.00	
Relative Value	0.77	0.74	0.83	0.31	1.00
Global Equity	0.82	0.82	0.78	0.35	0.65
US Equity	0.76	0.77	0.73	0.30	0.59
Global Fixed Income	0.15	0.15	0.11	0.24	0.14
US Fixed Income	-0.01	-0.02	-0.05	0.21	0.08
Commodities	0.48	0.48	0.44	0.36	0.49

High Correlation
Low Correlation

Source: FactSet Research Systems Inc. Hedge Strategy Composite is represented by HFRI Fund Weighted Composite; Global Equity is represented by MSCI The World Index Gross; US Equity is represented by S&P 500 Index; Global Fixed Income is represented by Barclays Global Aggregate; Index, US Fixed Income is represented by Barclays US Aggregate Index, Commodities are represented by DJ UBS Commodity Index Total Return. See franklinresources.com/datasources for additional data provider information. All indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

Four common strategies used by hedge fund managers include long-short equity, relative value, event driven and global macro.

Long-Short Equity

When employing the long-short equity strategy, hedge fund managers take a long position in a stock they think will outperform, while shorting stock[3] that they believe will underperform.

Consider a hypothetical example. If computer tablet sales are projected to rise and desktop computer sales are expected to fall, a hedge fund manager may buy shares of a company that develops tablet devices and sell borrowed stock of a company that produces desktop computers. The hedge fund manager seeks to take advantage of the expected increase in tablet sales - and any corresponding rise in the tablet company's share price, while capitalising on a projected decrease in desktop sales and any resulting drop in the desktop maker's stock price.

Within the long-short equity strategy, there are generalists, geographic specialists such as Asian emerging markets, and sector specialists such as technology sector and health-care sector hedge funds. The long-short equity strategy generally has performed well in flat to rising equity markets that are driven by corporate fundamentals.[4]

Relative Value

The relative value strategy encompasses a wide range of investment techniques that focus on pricing inefficiencies between two similar securities.

Hedge fund managers occasionally use convertible bonds to deploy this strategy. Convertible bonds, which are bonds that may be exchanged for a specific amount of a company's stock at a future date, may be priced inefficiently compared with the value of a company's stock or its straight bonds. All things being equal (if, in other words, the coupons are the same), if the durations[5] are the same, a convertible should be priced at a premium to straight debt because there is, presumably, value in the potential for the underlying equity option embedded in the convertible.

Consider a hypothetical example. During the financial crisis in 2008, the convertibles of a large manufacturer were yielding 14%, while its straight debt was yielding 11%. That scenario presented a relative value opportunity because the market was pricing the convertible 300 basis points lower (3%) than the equivalent duration straight debt. Relative value managers could have taken a simultaneous long position in the manufacturer's convertible bonds and offset it with a short position in the company's equivalent duration straight debt to capture the 300 basis-point price differential.

The relative value strategy generally has performed well during periods of equity market uncertainty and in flat to rising bond markets.[6]

Event Driven

Event-driven managers invest in securities of companies in the midst of corporate events such as bankruptcies, changes in capital structure, or mergers and acquisitions.

For example, when a firm announces that it plans to acquire another company, the target company's stock will generally rise in value, while the acquiring company's will fall, typically due to the uncertainty surrounding any acquisition and because the acquirer usually has to pay a premium over what the target company is worth. The event-driven manager would likely take a long position in the target company's stock and sell short the acquiring company's shares.

Please note that the trade would occur after the announcement, not because the managers were speculating on rumour. The key risk of such a position is a deal falling apart. Event-driven strategies tend to have performed best when markets have rallied, but also may work when corporate activity is high.[7]

Global Macro

Global macro strategies focus on top-down macroeconomic opportunities with numerous markets and numerous investments, including currencies and commodities. When considering their investment choices, global macro managers take into account many factors, which may include a country's or region's economic indicators, as well as central bank trends and divergences.

A popular theme for global macro managers in 2014 might be summed up by the headline "Developed Markets Rumble, Emerging Markets Tumble." In response, a global macro manager may have taken a long position in a MSCI World Index exchange traded fund (ETF) and a short position in a MSCI Emerging Markets Index ETF.[8]

Global macro may be used in conjunction with the three other strategies discussed, and it generally has performed well in periods when markets have marked trends, either up or down.[9]

Multi-Manager Approach

While the strategies employed by hedge fund managers are diverse, traditional hedge funds typically offer a single manager and a single strategy. Granted, some hedge fund managers may invest in multiple strategies, but, in the end, an investor is still left with the style of just one manager. In contrast, many liquid alternatives funds are multi-strategy funds that invest in different managers within the same strategy, or different managers within different strategies.

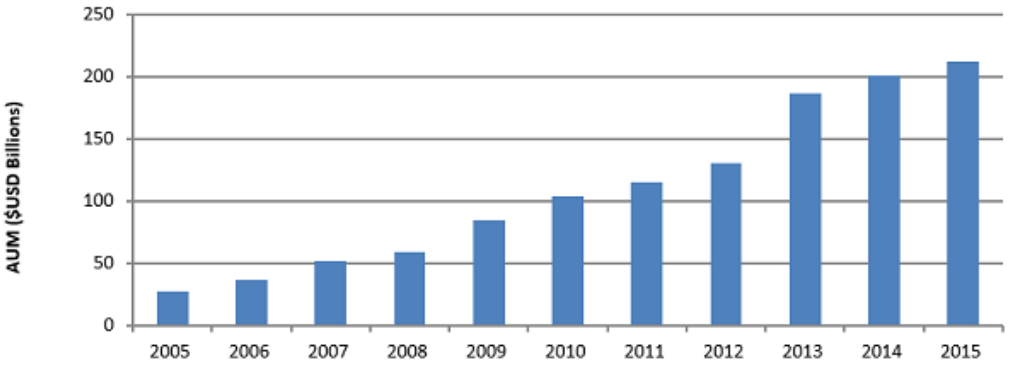
A multi-strategy approach strives to provide a constructive level of diversification within a portfolio.[10] Further, diversification through selecting multiple managers within each strategy may also help mitigate manager-specific risks.

Managers can have varying styles or approaches within the same hedge strategy, possessing expertise within a certain area (e.g. region, sector or financial instrument). Among the various types of hedge strategies, each may perform differently in a given market environment, so we would argue it's key to tilt toward strategies that have the largest potential opportunity set for returns in a current market environment and in the forward-looking market environment.

LIQUID ALTERNATIVES – DISPELLING THE MYTHS

The rapid growth of liquid alternatives (Figure 2) has resulted in increased attention and scrutiny of this class of investment vehicle. Some market analysts have cited concerns over liquid alternatives, suggesting their structure may result in compromised return potential, lower manager quality and limitations on trading strategies. These criticisms may in some cases be overstated. However, let's begin by clearly defining what is meant by the term "liquid alternatives".

Figure 2: Rapid growth of liquid alternative funds (US Mutual Funds and Exchange-Traded Funds)
(2005-2015)



Source: Morningstar. Historical assets held in publicly offered US alternative '40 Act mutual funds and ETFs, as defined by the Morningstar US Open-Ended Multi-Alternative Category.

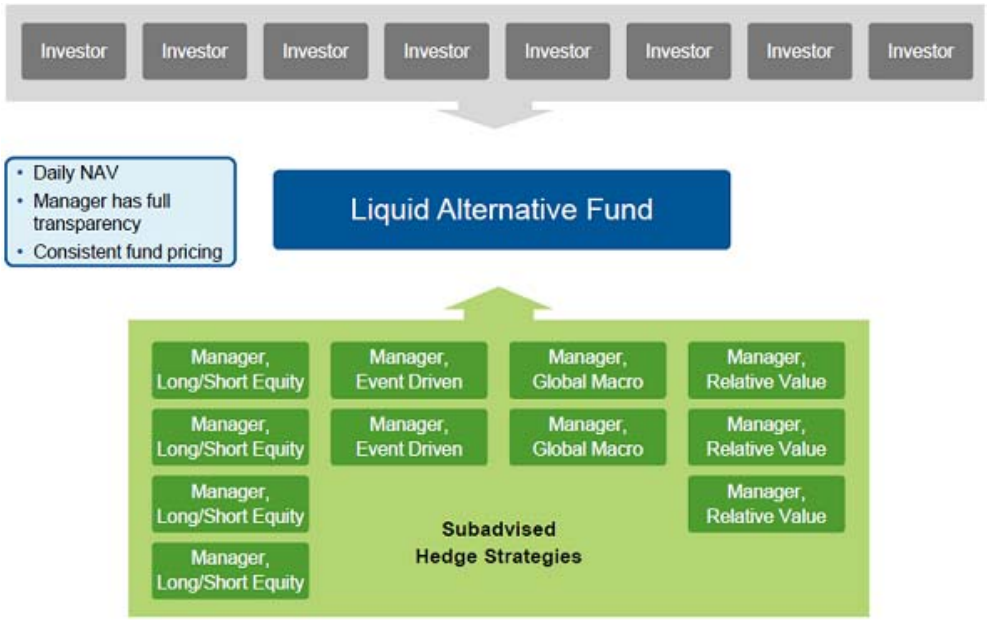
A multi-strategy, multi-manager structure

As defined for the purpose of this paper and shown in Figure 3, a multi-strategy, multi-manager liquid alternative portfolio consists of several distinct hedging strategies (the multi-strategy component) that are managed on a day-to-day basis by outside hedge fund

managers (the multi-manager component). Each of these third-party managers specialises in one or more specific hedging strategies. In this way, investors are offered access to institutional-quality hedge fund investment expertise with the benefits of daily liquidity provided by the managed fund structure.

This strict definition is important, as often in journals and media outlets the term "liquid alternatives" is used more broadly, perhaps incorporating global allocation funds, long-only strategies focused on real estate investment trusts (REITs) and/or commodities. While these and other strategies can be considered to be "alternative", as they are alternative asset types, they are not alternative strategies and as such are not included in this discussion of liquid alternatives. These other strategies do not employ trading strategies that would be found at a traditional private hedge fund, which use a variety of asset classes, trading techniques such as shorting, and leverage to seek to achieve enhanced risk/return profiles.

Figure 3: A multi-strategy, multi-manager liquid alternative fund structure



Source: Franklin Templeton Investments

Criticisms of liquid alternatives – the illiquidity premium

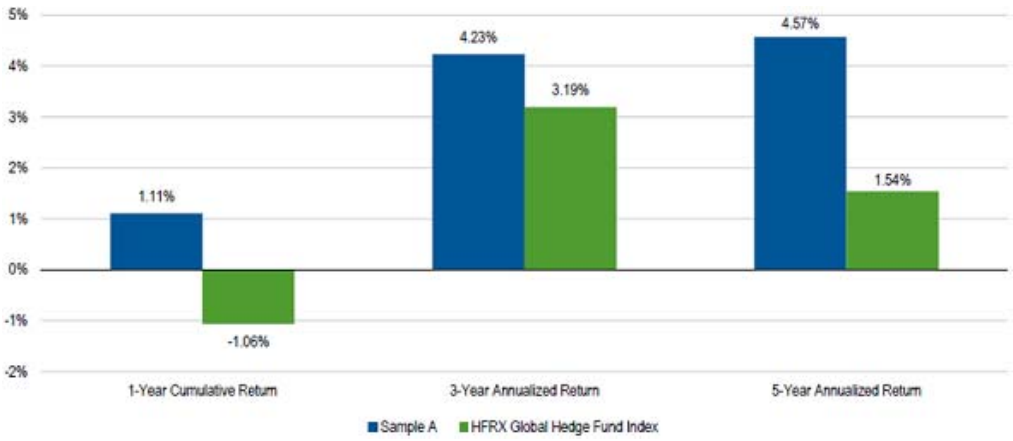
Liquid alternative funds can deliver many benefits. Among them, as the name of the investment vehicle suggests, is daily liquidity which traditional hedge funds do not offer. However, this benefit has sometimes generated criticism, such as the suggestion that the daily NAV structure may compromise return potential. This concept is often called the "illiquidity premium" which refers to the perceived advantage that a traditional, less liquid hedge fund has in its ability to lock up capital for longer and, consequently, invest in longer-duration assets that may have an enhanced return profile.

However, empirical examination of the actual performance and composition of liquid alternative funds and their traditional hedge fund counterparts illustrates the illiquidity premium may be overstated and, in fact, very little is lost in terms of investment performance on the part of liquid alternatives.

Figure 4 compares various historical performance metrics of liquid alternatives to those of traditional hedge funds. Liquid alternatives are represented by a sample peer group of multi-strategy, multi-manager liquid alternative mutual funds that fall under the definition we discussed previously.[11] Traditional hedge funds are represented by the HFRX Global Hedge Fund Index. The HFRX index was chosen as a performance benchmark for current strategies because of its representation of investable vehicles, more stringent screening criteria and low level of reporting biases.

As Figure 4 highlights, liquid alternatives outperformed traditional hedge funds over the historical one-, three- and five year periods to 30 June 2015, by margins of 217, 104 and 303 basis points, respectively. It is important to note that the sample size in the analysis is small and the time period somewhat limited. Over longer horizons, we may expect results to vary, with quite a bit of return dispersion between the proxies included in the sample. Nonetheless, if there was a consistent drag on the performance of liquid alternatives associated with any sort of illiquidity premium, one would have expected to see some small degree of evidence in the data sampled. In fact, the opposite is observed.

Figure 4: Historical returns of liquid alternatives and traditional hedge funds
(As at 30 June 2015)



Source: Morningstar. Sample A is composed of all 10 mutual funds within the Morningstar US Open-Ended Multi-Alternative Category that meet this paper's definition of multi-strategy, multi-manager liquid alternative mutual funds, based on their prospectus disclosure. The data is shown net of fees. Class A shares were used as the primary class. For funds not offering Class A shares, Class I shares were used. No fee adjustments were applied to Class I shares. For illustrative purposes only.

Liquid alternative, multi-strategy, multi-manager funds may exhibit even more attractive characteristics when fees are included in the analysis. Accessing alternative strategies through a traditional fund-of-hedge-funds structure often results in higher fees than a liquid alternatives mutual fund, and the resulting fee-and-expense drag can have a pronounced effect on returns over time. Figure 5 illustrates hypothetically the cost benefit of a given liquid alternatives mutual fund compared to a similar strategy accessed through a traditional fund-of hedge funds. This assumes an annualised gross return of 10%, which is reasonable based on historical data for similar investment products.

Figure 5: The cost advantage of liquid alternative funds has a positive impact on returns

The multi-strategy, multi-manager liquid alternative fund has less fee-and-expense drag than any traditional funds-of-hedge funds

Traditional Fund of Hedge Funds	Fees and Expenses	Return
Gross Annual Return		10.00%
Typical Hedge Fund Management Fee (2%)	2.00%	8.00%
Typical Hedge Fund Performance Fee (20%)	1.60%	6.40%
Typical Fund-of-Hedge-Funds Fee	1.00%	5.40%
Management Fees	4.60%	
Other Expenses	0.50%	
Total Expenses	5.10%	
Net Annual Return		4.90%

Multi-Strategy, Multi-Manager Liquid Alternative Mutual Fund	Fees and Expenses	Return
Gross Annual Return		10.00%
Management Fees	2.05%	7.95%
Other Expenses	0.47%	7.48%
Total Expenses	2.52%	
Net Annual Return		7.48%

Cost Advantage: 2.58%

Source: Franklin Templeton. For illustrative purposes only. Fees paid by investors in hedge funds vary significantly and, while 2% management fees and 20% performance fees have historically been considered typical for the industry, certain investors may pay lower fees. Performance fees for hedge funds may also be subject to a rate of return hurdle, which would have the effect of reducing the performance fees paid by investors at any assumed gross return. Investors in multi-strategy, multi-manager liquid alternative funds may invest in different share classes which may pay different fee and expenses than those shown above. In addition, investors may also be subject to an initial sales charge. Investors should consult the prospectus for a given multi-manager liquid alternative fund for more information about all of the fees and expenses paid by such fund.

Examining this dynamic further, assume that the traditional fund-of-hedge fund maintains a 20% allocation to illiquid holdings not available to the liquid alternatives fund. If the impact of fees results in a 258-basis point difference in net return, as indicated in Figure 5, the illiquid holdings would need to earn an additional 26.10% in incremental performance for the

traditional fund-of-hedge fund to overcome the structural cost advantage of liquid alternatives.

How illiquid are traditional hedge funds really?

This discussion also raises the question of the extent to which traditional hedge fund models actually use their ability to invest in illiquid holdings, a capacity which underlies the theoretical advantage of the illiquidity premium.

While some strategies by their nature may lend themselves toward less liquid holdings than others - distressed debt, for example - many hedge fund managers trade in highly liquid securities most of the time. This suggests that the illiquidity premium may be limited in practice, due to the observed investment practices of traditional hedge funds.

The perception of traditional hedge funds being illiquid likely stems from the legal terms they function under which require, in most cases, a one-month to three-month notice period prior to redemptions. This represents illiquidity at a structural level, but not at a holdings level, which has a more direct impact on performance and is where the supposed illiquidity premium arises. US mutual funds, for example, are required to invest at least 90% of their portfolios in liquid assets, but analysis of many traditional hedge funds indicates that very few are significantly different, with very few regularly allocating more than 15% of their portfolios to illiquid holdings for a long period, greater than three months. Again, some traditional hedge strategies by nature may lend themselves toward less liquid holdings, but in general a given traditional hedge fund strategy may not have the supposedly advantageous exposure to illiquid holdings that many critics assume.

Figure 6 looks at 85 long/short equity funds. Roughly 67% of the aggregate holdings in these funds could be fully liquidated within one to five days, with 84% able to be liquidated within 10 days, and 91% within 20 days.

As previously mentioned, some trading strategies are less liquid by nature, such as certain specialist credit funds, but in general these represent the minority. As such, the supposed advantage of illiquidity may in practice be very limited.

Figure 6: Most holdings in long/short strategies are liquid (May 2016)

Time	% of portfolio liquidated
Less than 1/2 Day	0%
Between 1/2-1 Day	6.5%
Between 1-5 Days	66.9%
Between 5-10 Days	10.3%
Between 10-20 Days	6.9%
Between 1-2 Months	4.4%
Between 2-3 Months	1.6%
Between 3-6 Months	0.8%
Greater than 6 Months	1.2%
N/A	1.4%
Total	100%

Sources: K2 analysis of RiskMetrics data. Illiquidity is defined as anything taking more than seven days to liquidate. Liquidity is defined as anything taking fewer than seven days to liquidate.

Criticisms of liquid alternatives - manager quality

Sceptics often question the pedigree of the managers that agree to act as subadvisors for liquid alternative funds, suggesting managers have no real incentive to do so if they are successful in the private space.

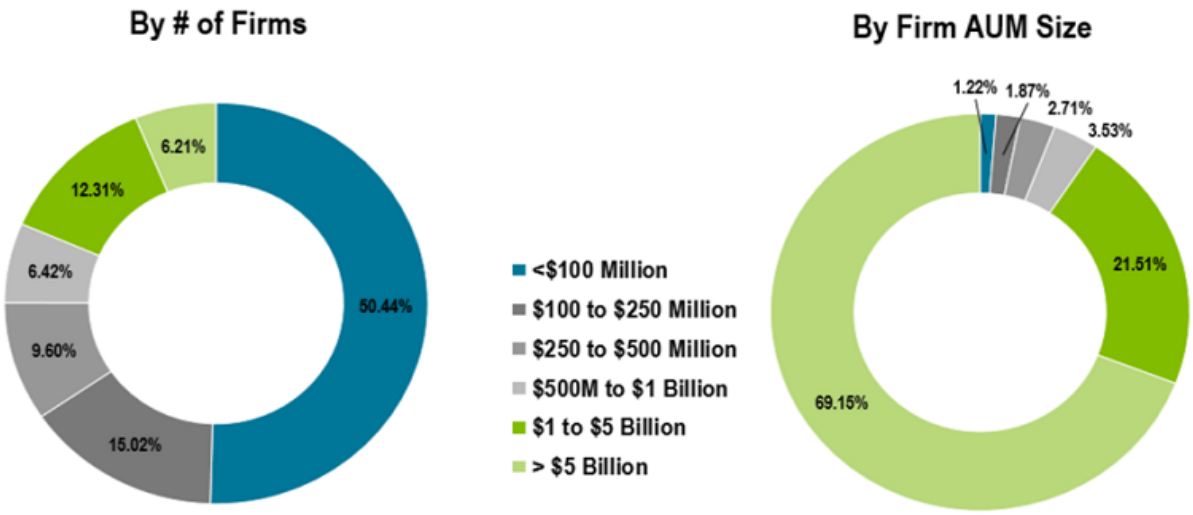
Information from Morningstar shows that such established hedge funds as Wellington Management, AQR Capital Management, Coe Capital Management, Chilton Investment Company, Loomis Sayles, Jennison Associates, Chatham Asset Management, Graham Capital Management and York Registered Holdings all participate in liquid alternative fund structures.[12]

Another issue impacting the breadth of available subadvising managers is the recent growth dynamics in the hedge fund industry as a whole. Investment assets in the sector tend to favour the largest "brand-name" hedge fund managers. Figure 7 illustrates that the largest firms, while making up a minority of the industry, make up an overwhelming share of AUM.

Liquid alternative funds may prove attractive to hedge fund managers with less than $1 billion in AUM, particularly those with less than $500 million, because they offer access to sticky assets that come with the subadvisory relationship. This effect gives liquid alternative funds a rich and diverse array of underlying managers from which to build their portfolios.

One related area of growing interest to many liquid alternative fund managers is the defined contribution pension sector. Alternative strategies are currently finding their way into some target-date funds and other model portfolio structures within this large market, though alternatives largely have not been adopted as standalone options.

Figure 7: Estimated distribution of industry assets by firm AUM tier
(As at Q2 2016)



Source: HFR Industry Reports, © HFR, Inc. 2015, www.hedgefundresearch.com

Another emerging issue impacting smaller managers is infrastructure. Hedge funds launching today face significant expectations of best-in-class operational support from pensions, corporations, endowments and other major institutional-quality investors. The infrastructure needed to fulfil these operational expectations can present a challenge to smaller hedge funds. Being a subadvisor to a public liquid alternative mutual fund provides another way for such a hedge fund manager to raise assets. Through this relationship, the operational, regulatory and other support tasks are typically fulfilled by the liquid alternative fund firm while the hedge fund manager focuses on its core function – portfolio management. Again, this approach provides significant benefit and incentive for quality managers to act as subadvisors in the liquid alternative fund sector.

Criticisms of liquid alternatives – limitations on trading strategies

Another common perception of liquid alternative funds is that their trading strategies are restricted relative to those of private hedge funds. Again, this criticism is overstated and is often based on false assumptions. Much of this criticism is rooted in the belief that liquid alternatives are not allowed to use leverage, a supposed limitation that means a liquid alternative fund's performance potential does not measure up to that of a private hedge fund. However, this interpretation is not accurate – liquid alternative funds can use limited leverage through various vehicles. Through these various forms of economic leverage, liquid alternative funds can and do employ similar trading strategies with similar outcomes as traditional hedge funds.

Furthermore, this criticism over leverage is predicated on the notion that private hedge funds are aggressive users of leverage, but analysis suggests this is not the case. The perception of heavy use of leverage may stem from the legacy left by the Long-Term Capital Management failure of 1998. However, analysis indicates low average levels of leverage – for example, the 85 long/short equity managers examined above exhibit an aggregate leverage level of 1.6 times their capital base.[13] Yet, averages can be deceiving, as some arbitrage strategies employ higher leverage, while others can have less than 100% of the capital invested.

CONCLUSION

Liquid alternative funds have grown in popularity, with their ability to provide exposure to hedge fund strategies and potential returns with low correlations to stocks and bonds, plus the added benefit of daily liquidity. Critics have charged that liquid alternative funds have weaker returns due to their inability to invest in illiquid holdings, may not provide exposure to quality hedge fund managers, and exhibit lower performance potential due to restrictions on leverage. This paper examines each one of these concerns and finds them to be overstated or even untrue.

Liquid alternative funds have the potential to provide significant value for investors, whether on their own or as part of a portfolio with traditional assets. There remain differences between liquid alternatives and traditional hedge fund strategies and, while it is important to continue to monitor and study these differences over time, it is equally important to distinguish fact from mere perception, and to not let common misconceptions about liquid alternatives undermine their potential benefits.

ENDNOTES

1. Source: © HFR, Inc., HFR Industry Reports, as of January 2015, www.hedgefundresearch.com.
2. Correlation will range between 1 (perfect positive correlation, moving in the same direction) to -1 (perfect negative correlation, moving in opposite directions).
3. A short sale is the sale of a security that the seller has borrowed, typically from a broker, and promises to return at a future date. The broker sells the borrowed shares, and the proceeds are credited to the seller's account. On a specified future date, the seller must buy the same number of shares borrowed and return them to the broker. If the share price has dropped in the interim, the seller can now buy the shares back at a lower cost and make a profit on the price difference. If the share price rises in the interim, the seller will pay a higher price for the shares, which will result in a loss.
4. Past performance does not guarantee future results.
5. Duration is a measurement of a bond's—or a portfolio's—sensitivity to interest-rate movements. It measures the number of years required to recover the true cost of a bond, considering the present value of all coupon and principal payments received in the future. Generally, the higher the duration, the more the price of the bond (or the value of the portfolio) will fall as rates rise because of the inverse relationship between bond yield and price.
6. Past performance does not guarantee future results.
7. Ibid
8. Indexes are unmanaged, and one cannot invest directly in an index.
9. Past performance does not guarantee future results.
10. Diversification does not guarantee profit or protect against risk of loss.
11. The sample is composed of 10 mutual funds selected from the Morningstar US Open-Ended Multi-Alternative Category that meet this paper's definition of multi-strategy, multimanager liquid alternative mutual funds, based on their prospectus disclosure. All mutual funds within the Morningstar Multi-Alternative Category that meet this definition are included.
12. Morningstar Inc., as at March 2014.
13. K2 Advisors, Franklin Templeton Investments, as at March 2014.

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