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Redefining Absolute Returns in the Liquid Alternative Era

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Introduction

The past few years have seen a considerable convergence between traditional and alternative asset management. Driven by fee compression, an appetite for a broader client base and regulatory changes, several hedge fund firms have entered the mutual fund arena offering modified versions of their flagship strategies to a wider range of investors. At the same time, traditional asset managers that have long delivered their strategies in mutual fund formats have started to offer more innovative and flexible investment strategies to meet the demand of investors who have concerns over protecting portfolios from downside risks.

These colliding forces have given birth to new categories of strategies in the mutual fund space, collectively referred to as liquid alternatives, with varying risk/return profiles and different approaches to investing. The rapid growth of liquid alternatives is evidence, in our view, that institutional and retail investors alike continue to embrace the concept of accessing alternative strategies in a mutual fund format; after all, several alternative strategies are compatible with a daily liquid, transparent and regulated fund format. There are many other alternative strategies, however, that are not a natural fit. Limitations in terms of liquidity, types of investments and regulatory constraints make some strategies unfit for mutual fund formats.

Nevertheless, the number of alternative strategies now being offered in mutual fund formats continues to rise, and includes funds with drastically different approaches, investment objectives and risk/return characteristics. Choosing from the growing list of available strategies can be difficult and ultimately depends on what objective an investor is looking to achieve by incorporating liquid alternatives into a broader portfolio.

One common objective—and the topic of this paper—is the pursuit of absolute returns. The concept of "absolute returns" has traditionally been associated with a diversified approach to alternative investing, resulting in low volatility and uncorrelated return streams. Over time, however, the term has been misused to describe many different approaches, some of which have delivered the low volatility and uncorrelated returns that are intended, but many more that do not. This has led to a mismatch between investor expectations and the outcomes actually achieved.

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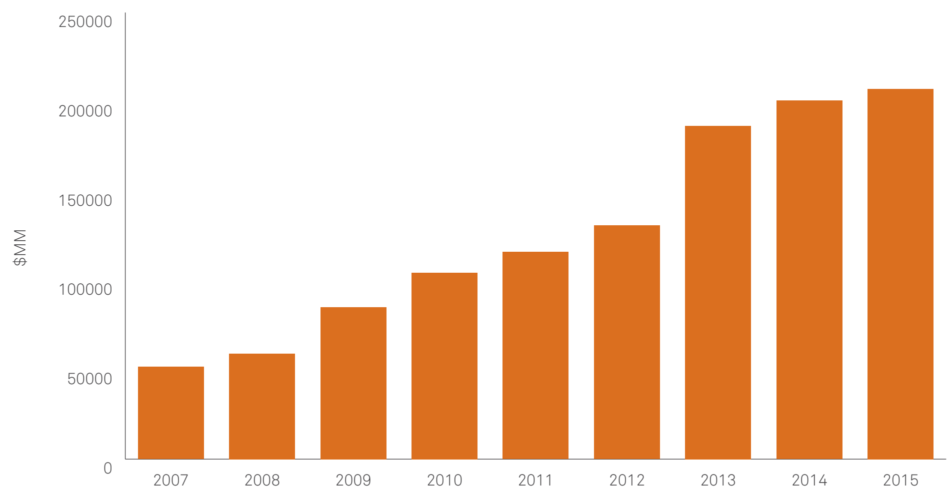
Critical to achieving a true capital-preservation goal is diversification within an alternatives allocation.

In this paper, we look at the evolution of absolute return strategies and their more recent manifestation as a subset of the liquid alternatives universe (Figure 1). Absolute return strategies can meaningfully reshape the risk profile of a portfolio by dampening volatility—an important characteristic, especially during volatile times.[1] However, investors must maintain a clear understanding of the objectives and limitations of such a strategy.

Not everything labeled "absolute return" can actually deliver that return profile. We will discuss key aspects of absolute return investing and attempt to provide thoughtful questions to help investors identify true absolute return strategies.

Figure 1. Growth in the Alternative Mutual Fund Space



Source: Morningstar as of 9/30/15.

Absolute Returns in the Hedge Fund Era

The growth of the hedge fund industry attests to the decades-long understanding of high-net-worth individuals and institutional investors for the need to diversify beyond the traditional 60/40 equity-bond split. Alternatives, particularly hedge funds, have long served a crucial drawdown-limiting role in many institutional portfolios. While a diverse investment universe, most hedge fund strategies are not meant to solely deliver outsized returns; rather, their ability to employ flexible investment strategies or techniques—such as shorting or the use of derivatives—means that they can potentially deliver returns with an added goal of capital preservation.

Critical to achieving a true capital-preservation goal, however, is diversification within an alternatives allocation. Single strategies bear the idiosyncratic risks of both the manager and the strategy and are thus, with few exceptions, unlikely to provide sufficient diversification to generate absolute returns in all market environments. Within a hedge fund structure, this diversified approach and the resulting absolute return profile is often built through a fund-of-funds approach, which aims to provide diversified alternatives exposure through a single investment, albeit at the cost of two layers of fees.

[1] With a prolonged period of rising interest rates forecast, the natural presumption for markets is an equally prolonged period of volatility. The number of days on which U.S. Treasuries moved by 10 basis points or more in the first half of 2015 exceeded the volatile days of 2014 in total.

The value proposition of a diversified alternatives allocation is clearest when downside protection and diversification are needed most. Figure 2 shows the performance of the aggregated hedge fund universe compared to the S&P 500® through the post-dot-com bubble recession and subsequent bear market. While the S&P plummeted from then-all-time highs, losing 45% of its peak value, the HFRI Fund Weighted Composite Index declined less than 4% from the S&P's peak to trough. [2]

This dot-com-era performance drove an enormous wave of investment in the hedge fund industry. When the global financial crisis (GFC) hit, however, the aggregated hedge fund universe was not able to sidestep it as neatly as it had the dot-com bubble. As global equity indices plummeted, with the S&P 500 index losing over half of its value between 2007 and 2009, the HFRI composite index also lost 21%. While sophisticated institutions that had employed hedge funds for their ability to generate uncorrelated, risk-adjusted returns were on the whole satisfied with the hedge funds' performance, as the value of these investments fell less than half that of global equity markets, the losses nevertheless revealed structural concerns that forever reshaped the hedge fund industry.

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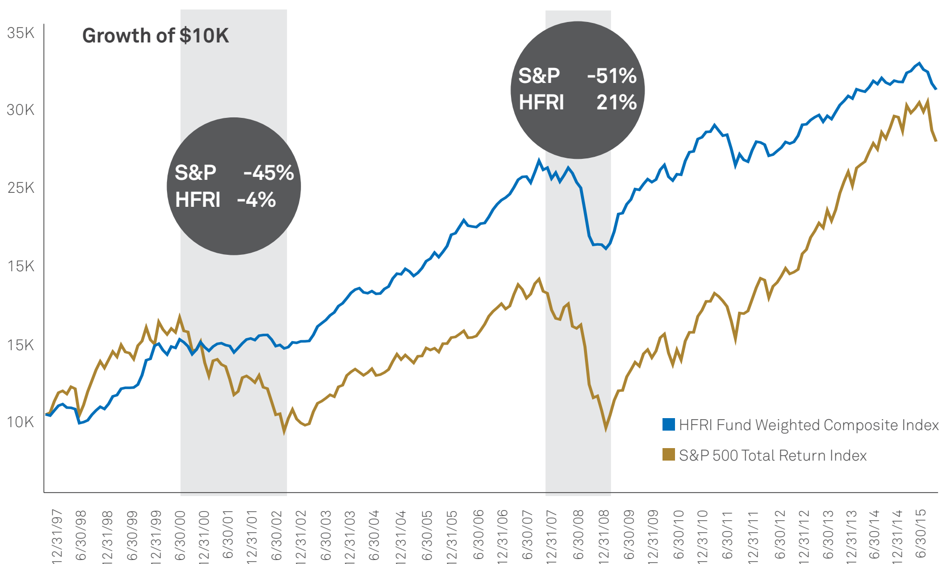
Figure 2. A Tale of Two Crises



Source: Factset as of 9/30/15.
Investors cannot invest in an index. Results would be different for other time periods. **Past performance is not a guarantee of future results.** Graph is for illustrative purposes only. Actual returns will vary.

Besides the higher fees associated with hedge funds, these concerns mainly centered around:

Opacity: The explosion in demand for hedge funds after the dot com bubble tipped the balance of power firmly in their favor, and many managers were able to avoid disclosing even modest holdings information to investors. In the wake of the GFC, investors became significantly more vocal in their demands for transparency, particularly in terms of the funds' holdings.

[2] Factset as of 9/30/15. Dot-com bubble performance spans 9/2000-9/2002; GFC performance spans 11/2007-2/2009.

> "...the massive surge in demand for liquid, capital-preservation-seeking investment products from institutional and retail investors alike, helped fuel the growth of 'liquid alternatives.' "

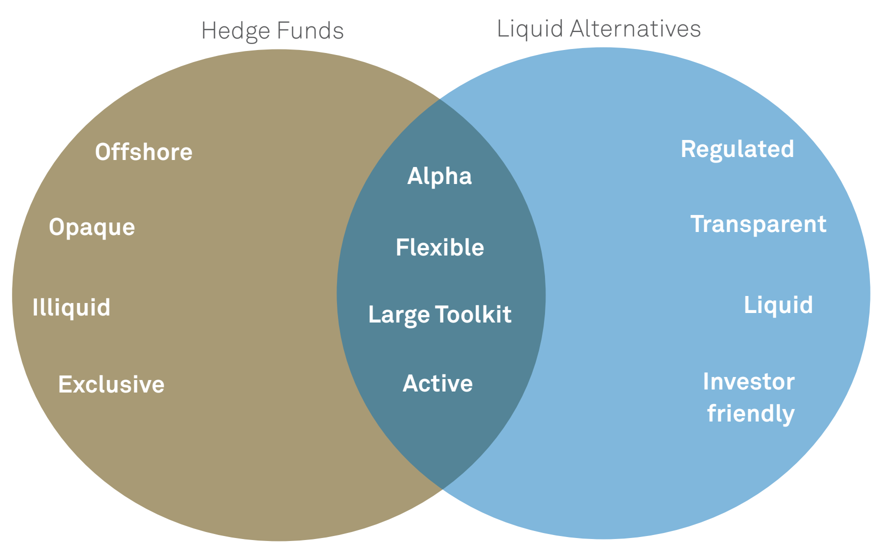
Portfolio Liquidity: When asset managers faced redemption pressures and found limited liquidity in markets they were forced to sell less liquid assets for pennies on the dollar or instituted gates, blocking investors' access to their own capital. After the GFC, investors increased their awareness of, and demand for, liquidity.

Regulatory oversight: While operational due diligence existed before the GFC, it may not have ranked high on the concerns of investors, as the fund-of-fund intermediary model had been intended to capture due diligence requirements. The crisis changed this dynamic enormously. It was described by one pension consultant as "a bomb going off in the industry." [3]

The Emergence of Liquid Alternatives

The need for a solution to these concerns, along with the massive surge in demand for liquid, capital-preservation-seeking investment products from institutional and retail investors alike, helped fuel the growth of "liquid alternatives." These products may be structured within the confines of the Investment Act of 1940 in the United States or with UCITS (Undertakings for Collective Investment in Transferable Securities) rules in Europe. However, they are also able to employ many of the flexible investment strategies used by hedge funds, such as the use of shorting, derivatives and leverage (albeit with at far lower levels). This gives retail and institutional investors alike a way of accessing certain alternative strategies in regulated and transparent vehicles with ready liquidity[4] —something that was missing from the less liquid, opaque hedge fund world, where investment performance at times trumped every other concern, including liquidity management and transparency to investors.

Figure 3. Hedge Funds and Liquid Alternatives Compared



Source: Insight Investment

[3] Citi Investor Services. "Opportunities and Challenges for Hedge Funds in the Coming Era of Optimization," 2014.
[4] Mutual fund redemptions are made at current NAV, which may be more or less than original cost.

This coupling of alternative strategies with regulation and ready liquidity and transparency requirements has caused rapid growth in product offerings. In fact, the Morningstar Alternative category has experienced a 19% growth rate over the past five years ending December 31, 2014.[5]

Liquid Alternatives: Finding a Sweet Spot

Alternatives are not an asset class. Rather, they are a set of diverse strategies that share the common virtue of aiming to deliver differentiated returns from traditional bond and equity investments, and thus can be used as a tool to enhance returns or reduce risk. These diverse strategies have not only different objectives, but also different return drivers and investment characteristics. Depending on the expected sources of risk and return, some alternative strategies may be better suited for a hedge fund structure. For example, strategies like distressed debt or relative value arbitrage that generate returns derived from an illiquidity premium or are amplified through the use of significant leverage are best executed in a hedge fund structure, where they can take advantage of the freedom to apply leverage and exploit the illiquidity premium without concern about offering fund investors the ability to redeem their investment on a daily basis.

Even among strategies that are compatible with a mutual fund structure, delivering a true alpha value proposition is not a straightforward process.

Moreover, even among strategies that are compatible with a mutual fund structure, delivering a true alpha value proposition is not a straightforward process. Liquid alternatives require a very different approach from that used in managing either a hedge fund or a traditional benchmark-driven mutual fund, with significant operational and liquidity management considerations and risks. These considerations require experience both in managing mutual funds and executing complex alternative strategies, and an operational infrastructure capable of managing multiple compliance, transparency, trading and risk-management components. Not every manager has the resources to successfully execute a liquid alternative strategy. Those that do typically have an institutional heritage and experience managing money for sophisticated investors.

Understanding the various strategies covered by liquid alternatives and the capabilities of different managers helps investors gain a nuanced picture of the landscape. But investors also need to have a clear understanding of what they want to get from their allocation in the liquid alternative space. With so many different strategies available on the market,[6] each behaving differently in the pursuit of different objectives, serious diligence must go toward aligning the strategy with the investor's desired outcome. In our view, by virtue of the possibility for risk reduction through lower volatility and low correlation to traditional asset classes, one particularly good fit between strategy and outcome in this space are liquid alternatives that take an absolute return approach.

Absolute Return

The term "absolute return" remains vague and often misused, with a great deal of confusion as to what the return profile of an absolute return investment strategy should look like, and what drivers are actually behind those returns. The term is essentially a mission statement, leaving any number of asset classes, investment strategies or techniques that could be used to fulfill such an objective. Many funds label themselves absolute return and employ an unconstrained mandate, as well as a performance benchmark in excess of the risk-free rate (e.g., 400-600 bps in excess of cash). While these are common features of absolute return strategies, a true absolute return product

[5] Source: Morningstar. Data include ETFs and exclude fund of funds.
[6] Alternative strategies that have come into the liquid alts space include equity, macro, credit, event-driven, relative value and niche strategies, as well as multi-strategy funds, with 798 active UCITS funds and 348 liquid alternative '40 Act funds on the market since the beginning of 2015, according to Preqin.

The central question for absolute return funds should not be: "Is this fund going to outperform an index?" but rather "How well will my investment be protected?" and "Will returns be correlated with traditional asset classes?"

is one that also seeks to generate positive returns irrespective of the wider market environment, with low volatility and minimal correlation with traditional asset classes.

Lack of clarity causes problems for investors on two grounds. The wake of the GFC created an explosion in demand for alternatives in general, and investment managers sought to capitalize on this by labeling their offerings as "absolute return" regardless of whether or not their products could be fairly described as such. The subcategories for these funds have become catch-alls, and care must be taken in approaching them. Consider the Lipper Absolute Return category, where the funds can range from multi-strategy to managed futures, long/short equity, or even short-biased funds, among a host of others that may rely on directional beta for their returns and thus can have sharper drawdowns with sudden unexpected market movements.

These funds have come under heavy scrutiny. While some of the critiques are fair, too often they are leveled at fund performance, which has on average lagged major market indices through the recent equity bull market. The central question for absolute return funds should not be: ***Is this fund going to outperform an index?*** but rather ***How well will my investment be protected?*** and ***Will returns be correlated with traditional asset classes?***

The same beta exposure that boosts returns in a bull market will be the cause of drawdowns in turbulent market environments, so a true absolute return fund behaving as advertised should indeed trail equity indices in a bull market. Its stated aim should not be relative outperformance, but rather delivery of steady gains.

Assessing the performance of an absolute return product is more complex than for a benchmark-oriented equity or fixed income fund, but a true absolute return fund seeks to deliver three vital characteristics:

- **Positive returns over a rolling 12-month period**
- **Low volatility**
- **Low correlation to traditional asset classes**

Achieving this outcome requires a rigorous focus on downside protection and risk management, with tight constraints on what risks are acceptable in any given market condition. Attribution analysis for the returns of various funds, considering manager skill and market movements—alpha and beta—shows that some of the registered funds currently available that call themselves "absolute return" have delivered healthy returns on a stand-alone basis, but they have done so with relatively high equity market beta.

If a fund is appreciating because the overall equity market is appreciating, then it is likely to also experience drawdowns triggered by unanticipated market declines or corrections. While a strong return profile (especially through a bull market) can be tempting, the flip side of products with a high beta is that they will inevitably decline in value if the equity market pulls back. Yet these are the market conditions against which absolute return funds are meant to protect.

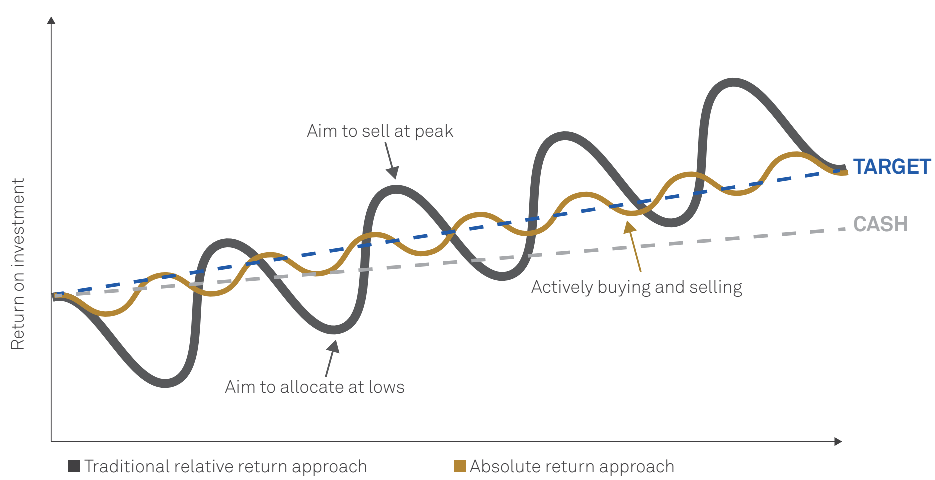
A directional beta component can sometimes be desirable. Managers can profit on high-conviction trades. But because the overall equity market tends to be quite volatile, being tethered to that market (high equity beta) leads to a volatile portfolio—meaning the value of the portfolio can change dramatically over a short period in either direction. This makes entry and exit points a critical consideration, with significant timing risk. One of the distinguishing features of absolute return products, on the other hand, is that they aim to achieve their investment goals without regard to broad market movements.

A traditional equity portfolio can be expected to have a wide dispersion. An investor who moved to cash immediately before the financial crisis, and subsequently reinvested in March 2009, would have done very well. But one who invested in November 2007, on the eve of the crisis, would have lost over half of the portfolio value and would have remained in the red until mid-November 2012.[7] While some investors can tolerate this level of risk and drawdown, many—principally those nearing retirement age—may be simply incapable of stomaching a loss over five years and would be forced to sell and realize a loss prematurely.

Absolute return approaches tend to have a tighter distribution of returns, with fewer losing periods than either global equities or bonds, and with far lower average losses during those periods.

Absolute return approaches, on the other hand, tend to have a tighter distribution of returns, with fewer losing periods than either global equities or bonds, and with far lower average losses during those periods. This means that timing risk is much less of a factor. There is also a potential behavioral benefit—assuming no sharp drawdowns, investors are less tempted by fear or financial constraints to sell at the worst possible time. This helps them stay on course to their financial goals.

Figure 4. Absolute Return Seeks to Provide a Smoother Investment Ride Than Traditional Long-Only Strategies



For Illustrative Purposes Only. Diagram intends to show how an absolute return approach may be able to deliver a less volatile outcome.

[7] Based on the returns of the S&P 500 Index.

Conclusion

Faced with the volatility that is likely to accompany the end of an unprecedented era of central bank intervention and a decades-long secular decline in interest rates, investors are seeking strategies that can be resilient through volatile market periods. That is particularly true for those looking to preserve wealth. By aiming to offer positive returns, diversification, low volatility and low correlation with traditional asset classes, absolute return liquid alternatives have the potential to reduce the risk of capital loss from sudden market downturns.

But because not all liquid alternatives are created equal, and the term "absolute return" is not always used accurately, investors need to understand the composition of the liquid alternatives space, the objectives and limitations of each strategy, and what part it can play in delivering the risk/return profile that they are seeking. Used properly, however, absolute return liquid alternatives mark an important stage in the evolution of asset management away from peer group or market measures of performance and toward the imperative of outcomes.

Not all liquid alternatives are the same—five questions to consider

With the widely misused application of the term "absolute return" and the diversity of strategies available under the liquid alternatives umbrella, investor education becomes an important step in aligning strategy with goals. By asking the following five questions, we believe investors can better understand how a liquid alternative investment works, and whether it can help them achieve their objectives.

IS YOUR STRATEGY SUITABLE FOR A LIQUID ALTERNATIVE FORMAT?

Not all hedge fund approaches can be implemented in liquid alternative funds. Given the limitations in liquidity, leverage and use of certain instruments are key to determining whether a fund's underlying strategy is suitable for a liquid format. Furthermore, offering increased liquidity could come at the cost of reduced returns, and how a portfolio aims to meet daily redemption requirements is important. Finally, it is also important to know that appropriate processes and procedures are in place to ensure that all regulatory requirements are fulfilled.

WHAT IS THE FUND'S BENCHMARK AND INVESTMENT TIME HORIZON?

A strategy's benchmark gives an indication of the manager's flexibility. Liquid alternative managers may manage their funds against different benchmarks. Some may aim for a positive return or to exceed a cash return over a specified time period, while others might aim to outperform relative to a specific index. For strategies aiming to outperform cash, the manager starts with a blank sheet of paper: every investment decision is an active decision.

The investment time horizon is important as it can affect a manager's attitude to risk. Managers who aim to deliver returns over a short time horizon, such as rolling 12-month periods, will typically have a lower tolerance for risk than those who focus on a longer time horizon.

WHAT ARE THE CHARACTERISTICS OF THE RETURNS THE FUND TRIES TO ACHIEVE?

Understanding a manager's attitude toward volatility, capital preservation and correlation with the market is crucial. The manager may believe higher volatility or loss of capital in the short term is acceptable in pursuit of a longer-term performance target, but this could make their fund unsuitable for some investors.

The manager's attitude toward correlations is also important. A typical investor might want a fund that is uncorrelated to falling markets but is correlated to rising markets. The attitude a fund manager takes to this dichotomy can be instructive: some will emphasize a lack of overall correlations over time, while others may aim to change a fund's correlation to markets dynamically.

HOW WILL THE FUND ACHIEVE THOSE RETURNS?

The manager's answer to this question can indicate whether they emphasize returns based on manager skill (alpha) or those driven by markets (beta). Liquid alternative fund managers often speak of "dynamic beta," which is an active decision (alpha) for the manager to take a view on the market. Managers will further differentiate themselves according to how they generate returns driven by alpha or beta. A helpful supplementary question is what investment freedom—including investment universe and investment techniques— do the managers have for generating returns? How likely are they to use these freedoms? It can be instructive to ask them for historical minimum and maximum exposures that their fund has taken.

HOW IS THE FUND EXPECTED TO PERFORM IN DIFFERENT MARKETS?

No manager will guarantee future returns, but asking this question can offer insight into their portfolio. If global equities rise by 30%, does the manager expect to participate in that rise, or will the returns of their fund remain completely independent of the market? If markets decline, what does the manager expect to happen?

Terms and Definitions

Alpha is a risk-adjusted performance measure. A positive (negative) alpha indicates stronger (poorer) fund performance than predicted by the fund's level of risk (measured by beta). Alpha and beta are more reliable measures when used in combination with a high R2 which indicates a high correlation between the movements in a fund's returns and movements in a benchmark index. Alpha is annualized. **Beta** is a Modern Portfolio Theory measure of a security or portfolio's volatility, or systematic risk. The beta coefficient measures a security or portfolio's volatility relative to an index. A beta of 1 indicates that the security's price will move with the market. A beta less than 1 means that the security will be less volatile than the market. A beta greater than 1 indicates that the security's price will be more volatile than the market. **Correlation** measures the degree to which the performance of a given asset class moves in relation to another, on a scale of –1 to 1. Negative 1 indicates a perfectly inverse relationship, 0 indicates no relationship and 1 indicates a perfectly positive relationship. **Drawdown** is the peak-to-trough decline during a specific record period of an investment, fund or commodity. A drawdown is usually quoted as the percentage between the peak and the trough.

HFRI Fund of Funds composite index (USD) is an equal-weighted, total return index comprising over 500 constituent funds, all of which are Funds of Funds, and have at least $50 million under management. It includes both domestic and offshore funds, all reported in USD, net of all fees. It is reported monthly. Hedge Fund Research, Inc. (HFR) utilizes a UCITSIII compliant methodology to construct the HFRX Hedge Fund Indices. The methodology is based on defined and predetermined rules and objective criteria to select and rebalance components to maximize representation of the Hedge Fund Universe. HFRX Indices utilize quantitative techniques and analysis; multi-level screening, cluster analysis, Monte-Carlo simulations and optimization techniques ensure that each Index is a pure representation of its corresponding investment focus. **HFRI Equity Hedge Index** Investment Managers who maintain positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations and valuation ranges of typical portfolios. The **S&P500 Index** is a U.S. stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ. Its components and their weightings are determined by S&P Dow Jones Indices.

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Equity funds are generally subject to market, market sector, market liquidity, issuer and investment style risks, among other factors, to varying degrees. The use of **derivative instruments**, such as options, futures and options on futures, forward contracts, swaps, options on swaps, and other credit derivatives, involves risks different from, or possibly greater than, the risks associated with investing directly in the underlying assets. A small investment in derivatives could have a potentially large impact on the fund's performance. **Short sales** may involve substantial risk and "leverage." Short sales expose the fund to the risk that it will be required to buy the security sold short at a time when the security has appreciated in value, thus resulting in a loss. **Leverage Risk** additionally, some derivatives involve economic leverage, which could increase the volatility of these investments as they may fluctuate in value more than the underlying instrument. Certain derivatives have the potential for unlimited loss, regardless of the size of the initial investment. **Diversification** and **asset allocation** cannot ensure a profit or protect against loss of principal.

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