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ALTERNATIVE STRATEGY MUTUAL FUNDS:
Opportunity or Mirage?

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INTRODUCTION

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 were traditionally only available 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 both great risk and opportunity for investors, but potentially even greater rewards for asset managers.

In this paper, we will explore the challenges and the opportunities presented by the evolution of alternative mutual funds. This is the first part in a series of white papers that will discuss the alternative mutual fund industry, concerns that investors need to be aware of, and, ultimately, intelligent ways to implement liquid alternatives within a fully diversified portfolio.

On a forward-looking basis, the investing landscape for traditional investments certainly remains fraught with potholes. Seldom in history have both fixed income and equities been concomitantly priced so richly. Cliff Asness of AQR Capital Management recently wrote that 98% of the time, today's combined bond/stock portfolio has historically been available at cheaper levels. Separately, return forecasts by Research Affiliates suggests that investors can expect a return of 4.4% over the next decade for a 60% equity and 40% bond portfolio. That represents the lowest 10-year expected return since the late 1800's. To the extent that consensus is accurate, finding alternate sources of return and diversification are 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.

Expected Return for 60% Equity/40% Bond Portfolio								
Decades	Beginning Dividend Yield	Long-Term Real EPS Growth	Implied Inflation	Expected Equity Return	Beginning Bond Yield	Expected 60/40 Return	Realized 60/40 Return	Expected Minus Realized
Average	4.9%	1.7%	1.9%	8.7%	4.8%	7.2%	7.6%	-0.5%
Current	2.3%	1.7%	2.0%	6.0%	2.0%	4.4%	--	--

Source: Research Affiliates

THE ALTERNATIVE VALUE PROPOSITION & 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 alternatives as having the ability to manage 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. Professor Andrew Lo of MIT has stated that the "ability to short assets may be the final frontier of diversification." Alternative assets certainly represent an avenue toward that end.

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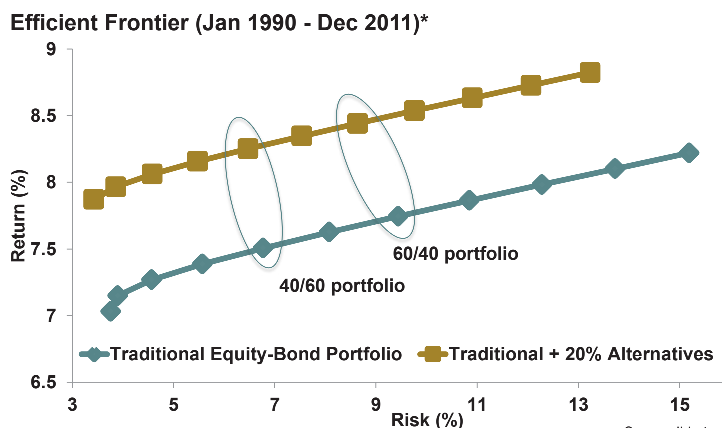
Looking across both Limited Partnership and mutual fund structures, Fortigent recommends solutions spanning six alternative categories[1]:

- *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 diversified trading strategy with low net exposures and low correlation to markets.
- *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-2000's, alternative investments were largely designed 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 another similar type 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, but rather volatility dampeners and capital preservers. That philosophy remains intact today, with occasional exceptions.

In the current environment, the value of alternatives resides in improved risk-adjusted performance and better diversification. Incorporating a 20% allocation to alternatives over the period from 1990 through 2011 resulted in higher returns and lower volatility.



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 *ex post facto* recognize the need for additional sources of diversification and return. Since limited partnership

[1] Mileff and Sonnenberg. *The Evolution of Alternative Investing.* Fortigent, LLC, 2011.

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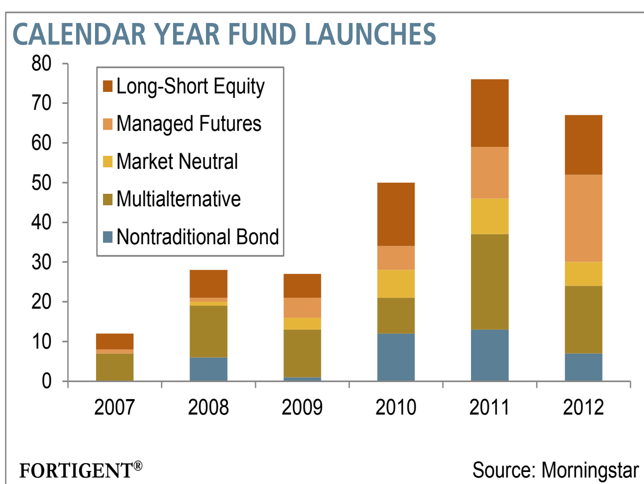
(LP) or fund of hedge fund (FOHF) structures did not ingratiate themselves with investors in 2008 (courtesy of liquidity gates and side-pocketed investments), mutual fund structures became a more popular vehicle.

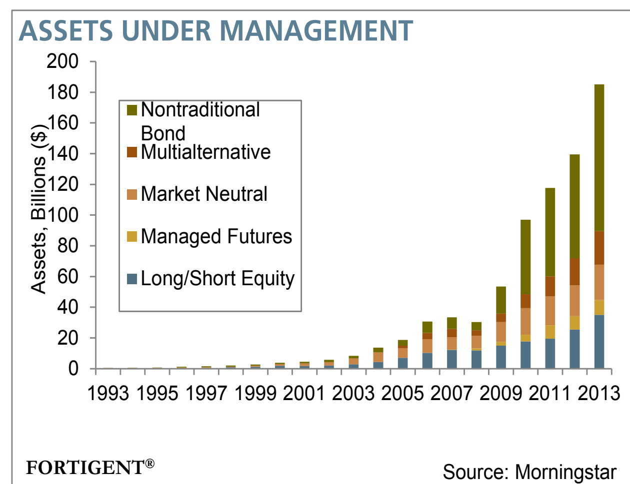
While it is assumed that alternative funds only emerged post-2008, many of the underlying funds in the various Morningstar alternative categories launched as far back as 1978 (in the case of long-short equity) and 1989 (market neutral). Alternative mutual funds remained a cottage industry during the 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 like managed futures, encouraging the rapid post-2008 growth rate.

Category	Launch of 1st Fund
Long-Short Equity	Jan-78
Market Neutral	Feb-89
Managed Futures	Apr-07
Multialternative	Jan-01
Nontraditional Bond	Feb-96

Source: Morningstar

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.





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, there were more than $2.4 trillion invested in hedge funds and $13.6 trillion in mutual funds[2].

BRIDGING THE DIVIDE BETWEEN LIMITED PARTNERSHIPS AND MUTUAL FUNDS

Mutual fund regulations are largely designed 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% of assets may be invested in illiquid assets;

[2] Investment Company Institute

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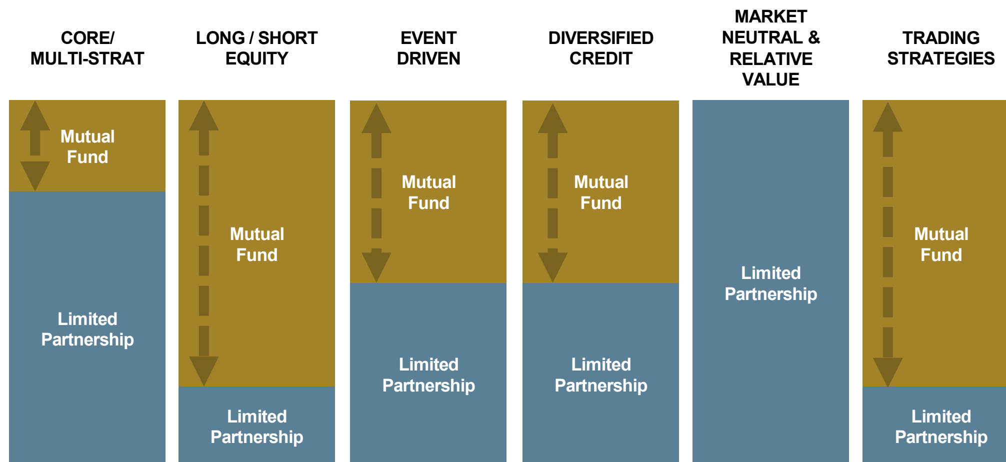
- Mutual funds should not charge performance fees, unless designed as a fulcrum structure where fees rise and fall dependent on performance of the fund;
- For at least 75% of the portfolio, diversified mutual funds may not invest more than 5% in any one issuer, may not own more than 10% of the outstanding voting securities of an issuer, and may not invest more than 25% in a particular industry group;
- May not generate more than 10% of income from non-securities, such as commodity futures;
- Mutual funds may employ leverage, as long as it maintains 300% asset coverage. For practical purposes, the most conservative interpretation of this rule limits leverage to 33%.

In recent years, mutual fund companies adopted mechanisms to by-pass 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% of its assets into the CFC vehicle. By investing through a CFC, fund companies are no longer 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 applying greater than 33% leverage on portfolios. Total return swaps do not need to be fully funded and generally require 1% to 10% margin, thereby allowing managers obtain implicit exposure to securities in a leveraged fashion.

CURRENT 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:



Based on the mutual fund requirements, certain strategies are more naturally housed 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. Despite the fact 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.

Alt 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 are most often focused on a particular

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category or sector of the market, such as long/short equity or healthcare. Multi-manager funds are generally constructured 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 perspective, the ability to "outsource" those functions is attractive and lends itself to better managers entering the space. For a given manager to participate as a "sleeve" in a multi-manager mutual fund product also poses less of an immediate risk to that manager of canibalizing 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 desired, 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 sub-advisor could allocate more than 15% of his portfolio to illiquid securities, assuming the overall fund allocation does not exceed 15%. Multi-manager mutual funds are inherently more expensive given the multiple layers of participants being paid and are more operationally intensive.

FEES

Alternative investments are typically 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 were historically structured to charge 2% management fees along with 20% 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 between 1.25% and 2.0%, but some funds cost as much as 3%+.

Multi-manager solutions will typically be the most costly, as underlying managers collect 0.75% - 1.25%, 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 before, certain funds use the CFC to invest with managers that charge performance fees. By owning and investing in the CFC, underlying fees are no longer "visible" to regulators. Some compliance professionals believe this issue will soon be examined by the regulators, so advisors and investors should keep aware of ongoing changes to the regulatory environment.

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Average Category Fee				
Category	**2009**	**2010**	**2011**	**2012**
Morningstar Long/Short Equity	2.5%	2.0%	1.9%	1.9%
Morningstar Nontraditional Bond	1.2%	1.3%	1.2%	1.3%
Morningstar Market Neutral	1.8%	1.8%	1.7%	1.7%
Morningstar Managed Futures	2.1%	2.0%	2.6%	2.6%
Morningstar Multialternative	1.6%	1.6%	1.6%	1.7%
Large Cap Blend	*1.1%*	*1.1%*	*1.1%*	*1.1%*
Intermediate-Term Bond	*0.9%*	*0.9%*	*0.9%*	*0.9%*

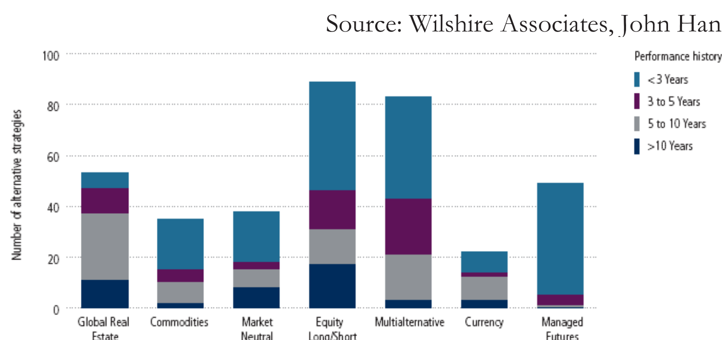
Source: Morningstar

CONDUCTING DUE DILIGENCE

The due diligence requirements for alternative investments are generally 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. In order to conduct effective due diligence, one should utilize as standardized a due diligence process as possible, while also maintaining the flexibility to adapt to an evolving landscape.

Fortigent relies upon a seven step due diligence process to ensure a consistency of approach and philosophy. 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 can easily become the most challenging aspect of any due diligence process. Ideas are sourced through any number of channels, but particularly in the case of alternative investments, maintaining and cultivating a network of contacts is crucial.



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. In many instances, however, managers run comparable limited partnership products with similar investment mandates. Reviewing those products and returns are one means to becoming more comfortable with the manager's track record. While reviewing the limited partner-

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ship 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% of the investment strategy accessed by LP investors. The missing 20-25% 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 become essential. From there, a thorough review of operational and compliance activities is conducted. Since certain strategies are potentially complex, the operational infrastructure takes on a more important role than in traditional equity and fixed income funds.

There are several key red flags Fortigent focuses on when conducting due diligence on alternative mutual funds, particularly:

- Limited track record. This pertains less to a specific period of time, but rather, experience across different types of market environments and investment cycles (although this is not always realistically possible).
- Long-only managers launching alternative funds despite limited experience with shorts or derivatives;
- Operational infrastructure and its impact on a managers 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 on a more comparable basis with their hedge fund peers and others lagging by a wide margin. Market neutral mutual funds are the lowest performing strategy with an annualized return of 1.0%. 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. The nontraditional bond category returned 3.7% during our analysis period from August 2003 through July 2013, relative to a 4.9% return for the Barclays Aggregate Bond Index. In the equity universe, the long/short equity category generated a 2.8% return, well below the 7.6% gain for the S&P 500 Index, but not surprising for strategies that hold short positions during a period of strong performance for equities. But, the peak drawdown of the long/short category was 23% against a 51% loss in the S&P 500.

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Risk/Return Statistics - 8/03 - 7/13				
Category	Ann'd Return	Ann'd St. Dev	Sharpe Ratio	Max Drawdown
Morningstar Long/Short Equity	2.8%	5.9%	0.2	-22.9%
Morningstar Nontraditional Bond	3.7%	4.1%	0.5	-16.3%
Morningstar Market Neutral	1.0%	2.2%	-0.3	-6.1%
Morningstar Managed Futures	--	--	--	--
Morningstar Multialternative	2.8%	6.6%	0.2	-27.0%
Barclays Aggregate	4.9%	3.4%	1.0	-3.8%
HFRI Fund of Funds Composite	3.6%	5.5%	0.4	-22.2%
S&P 500	7.6%	14.6%	0.4	-51.0%

Source: FactSet

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%, while the worst performer lost 9.9%. Top quartile managers returned 7.0% versus an S&P 500 return of 8.3%, while bottom quartile returned 1.3% annualized.

Long/Short Equity Percentile Return (through 7/13)						
	YTD	1 Year	3 Year	5 Year	7 Year	10 Year
Maximum	25.0	33.6	22.2	18.8	13.8	12.6
5th Percentile	21.2	26.0	15.9	11.3	9.8	12.6
25th Percentile	12.6	16.8	11.5	7.0	5.8	9.3
50th Percentile	8.2	10.0	6.3	4.1	3.0	5.0
75th Percentile	4.4	6.0	3.2	1.3	1.5	4.2
95th Percentile	(2.2)	(1.1)	(3.8)	(2.0)	(0.1)	1.1
Minimum	(27.8)	(30.3)	(20.0)	(9.9)	(2.8)	0.2
S&P 500	19.6	25.0	17.7	8.3	6.3	7.6

Source: FactSet

MUTUAL FUND VERSUS LIMITED PARTNERSHIP RELATIVE PERFORMANCE

For many investors, the assumed tradeoff between a traditional limited partnership hedge fund and daily liquid mutual fund is performance. There is some element of truth to that statement, but the results to date have not been as disparate as initially supposed.

Consulting firm Cliffwater analyzed 148 instances where firms offered similarly managed hedge funds as well as liquid alternative proxies. They found the performance differential between liquid alternatives and hedge funds to be approximately annual outperformance of 1% for hedge funds[3]. Strategies necessitating higher leverage usage or greater illiquidity naturally outperformed in the hedge fund structure by a wider margin, but more liquid strategies like managed futures and global macro demonstrated a narrower performance spread.

[3] https://www.cliffwater.com/documents/1181513

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Average Difference Between Private and Liquid Alternatives						
	Ann'd Return	Ann'd St. Dev	Beta	Alpha	# of Pairs	Median Return Difference
All Strategies	1.0%	0.2%	-0.01	1.0%	148	0.9%
Equity L/S	1.1%	0.0%	0	1.0%	49	0.5%
Credit	1.0%	1.0%	-0.01	1.1%	22	0.7%
Market Neutral	2.2%	-0.9%	-0.01	2.2%	10	0.9%
Multistrategy	0.6%	0.0%	-0.2	1.3%	3	2.2%
Managed Futures	0.5%	0.8%	-0.01	-0.2%	22	0.4%
Macro	0.2%	-0.2%	-0.06	1.5%	23	0.9%
Event Driven	2.3%	0.6%	0.05	1.7%	15	1.6%

Source: Cliffwater

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 investors need to consider when selecting these strategies for client portfolios. The following list is not designed to be all encompassing, but provides a review of issues investors should consider when allocating to alternative mutual funds.

Regulatory:

- *Regulatory constraints* – mutual funds are subject to specific 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% of a particular fund may be invested in illiquid assets, defined as those securities for which there is not a readily available price, or securities that cannot be sold within seven days. The one stipulation is that redemptions must be paid to investors within seven days. Additionally, during periods of crisis, liquid securities can quickly become illiquid, causing a fund manager to cross the 15% illiquidity threshold.
- *Multi-manager solutions* – if a manager is hired to sub-advise 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 witnessed a top performer gaining more than 82%, while several laggards experienced losses. The implication is that an investor could theoretically 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. There is an inherent danger in all investment strategies that a manager will gradually drift away from his or her original investment style. This problem is compounded when trying to monitor alternative strategies given the complexity and opacity of this style.

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- *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 their 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 are seeing a great deal of fee compression since exchange traded funds came to market. In alternatives, slight fee compression is occurring, but these products generally demand a premium based on their higher operational and investment hurdles. The Morningstar multialternative category, for instance, carried an average expense ratio of 1.7% 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% of mutual fund assets in a few short years, up from 6% 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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- *Often engage in leveraging and other speculative investment practices that may increase the risk of investment loss;*
- *May be highly illiquid;*
- *Are not required to provide periodic pricing or valuation information to investors;*
- *May involve complex tax structures and delays in distributing important tax information;*
- *Are not subject to the same regulatory requirements as mutual funds; and*
- *Often charge high fees.*

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