CHAPTER 1

Definitions and Methodology

Synopsis

This book defines liquid alternatives as hedge fund strategies used in a '40 Act wrapper, and it uses Lipper data to evaluate 11 different alternative classifications. The analysis focuses on the risk and return of each classification, and the 10 largest funds. The methodology uses factor exposures to analyze fund returns, and to identify different roles that liquid alts can play in portfolios. These roles include portfolio diversifier, equity complement, fixed income complement, tactical hedge, and directional bet.

Readers may wish to read this book straight through, skim through the chapter summaries, or use it as a reference tool. Each chapter is written as independently as possible, while adhering to a comprehensive framework for studying liquid alternatives.

DEFINITIONS

Alts Democratized defines liquid alternatives as hedge fund strategies in an Investment Company Act of 1940 ('40 Act) wrapper, such as an exchange-traded fund (ETF) or a mutual fund. This description concurs with the 11 alternative classifications used by Lipper, and the definition emphasizes the investment strategy rather than the legal structure.

The term *hedge fund strategies* includes a broad range of investment vehicles that operate in a different legal structure. Hedge funds are usually pooled vehicles with investments managed in a general partner/limited partner structure, and held by a limited liability company. These funds have fewer restrictions on the investment strategy, manager compensation, and public disclosures than do '40 Act investments.

Traditional hedge funds are designed for accredited investors, and typically have high minimum investments, limited liquidity, and long lockup periods. Investors get K-1 statements that can make tax reporting difficult, and the paperwork and suitability requirements are demanding.

When we mention "traditional alternatives," this refers to single-manager hedge funds, fund-of-funds hedge funds, private equity, and privately held real estate. These traditional alternatives are usually available only to high-net-worth investors, and this gives wide latitude to hedge fund managers.

In contrast, '40 Act investments are meant for the masses, and have strict regulatory requirements, including limits on leverage and illiquid assets. For example, '40 Act funds can have borrowings of no more than one-third of total assets, and this reduces their ability to replicate certain hedge fund strategies that rely on high leverage (credit arbitrage). Also, '40 Act investments limit holdings of illiquid assets and transactions with affiliated persons, which makes it difficult to participate in private equity strategies such as venture capital. And '40 Act funds have strict disclosure requirements about the positions they hold and the compensation paid to investment managers, and these disclosures are made through the filing of the prospectus, annual report, and statement of additional information. These funds usually offer daily liquidity to investors who seek redemptions, though this is not true for closed-end funds or interval funds. There are many other legal nuances that distinguish traditional and liquid alts, but the main differences involve fees, liquidity, transparency, and taxation.

Today the lines between '40 Act funds and limited partnerships are blurring as traditional alternative fund managers enter the '40 Act space in search of broader distribution. The entrance of traditional alternative managers is leading to product innovation and a breadth of new choices for advisors and investors, and this requires new approaches to fund research and deeper levels of fund manager due diligence.

LIPPER CLASSIFICATIONS

This book uses Lipper classifications to define liquid alts, and these classifications exclude certain assets that some investors define as alternative. The Lipper classifications used in this book exclude real assets of all types—commodities, precious metals, master limited partnerships (MLPs), real estate investment trusts (REITs), privately held real estate, infrastructure investments, and Treasury Inflation-Protected Securities (TIPS). These securities are generally considered real assets in the framework used by institutional investors.

THE FUTURE

There is currently no industry standard for exactly what constitutes an "alternative" investment. The definition of liquid alts is continually evolving, and precise classifications are in the eye of the investor.

The future of liquid alts is likely to include some form of private equity, such as leveraged buyouts, mezzanine financing, infrastructure, and venture capital. These are now difficult to package effectively in a '40 Act structure, but strong investor demand suggests that this is a large potential market for product providers that can innovate.

The definition of liquid alts may also expand to include forms of so-called smart beta. Smart beta uses rules-based approaches to define factor exposures, such as indexes that are not weighted by market capitalization, but by equal weights or fundamental factors such as sales, profits, or price-to-book ratios. Smart beta also includes sophisticated algorithms for optimization, such as minimum variance, maximum diversification, and risk-efficient indexes.

The factor exposures discussed in this book may overlap with some forms of smart beta. Chapter 7 discusses Alternative Equity Market Neutral Funds, and includes the PIMCO Fundamental Advantage Absolute Return Strategy Fund (PFATX). This fund has long exposure to a smart beta strategy, a fundamental equity index called the Enhanced Research Affiliates Fundamental Index (Enhanced RAFI 1000). PFATX also has a short exposure to the Standard & Poor's (S&P) 500 index, so the fund seeks to capture the return premium of an index that is weighted according to fundamentals over an index that is weighted according to market capitalization. This is an example where liquid alts and smart beta converge, and there is room for disagreement as to the demarcation between smart beta and liquid alternatives.

Note: This book focuses on the track record of funds through year-end 2013. We occasionally note subsequent events, such as the departure of Bill Gross from PIMCO (see PFIUX in Chapter 9), and the downturn in returns at MainStay Marketfield (see MFLDX in Chapter 10). These events highlight the need for ongoing due diligence of liquid alternatives, especially for funds that give broad discretion to the portfolio manager.

This book focuses on funds that Lipper classifies as alternative, and the underlying factor exposures of these funds. This provides a clear, functional, and comprehensive map of the liquid alts space. These classifications will continue to evolve, and may eventually include smart beta and private equity. The authors believe that the Lipper data provide a useful framework and functional tools for asset allocation and fund selection, and the Lipper classification methodology is among the most practical and accurate systems that are widely available at this point in time.

METHODOLOGY

This book is aimed at financial advisors and sophisticated investors and it assumes familiarity with basic investment concepts. It is meant to be a practical tool, so we stick with a simple framework and we disclose our key assumptions.

How to Use This Book

The chapters in this book can be read independently, and the authors intended each section to serve as a reference tool. Advisors are busy, and may want a quick overview of a classification and the funds in it. Advisors may choose to read the synopsis at the beginning of each chapter, just to get a feel for the key takeaways.

The book does have a comprehensive framework for liquid alts that starts at the 10,000-foot level, and eventually offers granular detail about individual funds. Some advisors may be interested in only a road map for the alternatives space, and how the classifications fit into the investment landscape. Other advisors may want to understand the specific factor exposures and fund selection process for a given Lipper classification, in order to augment their existing due diligence process.

We offer a framework as a guide, mainly to clarify our assumptions and prevent misunderstandings. We are not looking to either encourage or discourage the use of liquid alternatives, and we are not promoting one investment approach over another. We hope that clear definitions and a clearly articulated structure allow for a coherent discussion, even for advisors who operate with a different investment philosophy and a different set of assumptions. We may agree or disagree with other investors about the proper definition, purpose, and role of liquid alternatives. Our main goal is to provide a framework that is internally consistent, and that provides a springboard for advisors who want to put these products to work for their clients.

Or perhaps an advisor will review the data and conclude that liquid alts are not worth their time and energy, given their clients' needs and their firm's resources.

Illustrations, Not Recommendations

This book offers a process for asset allocation and fund selection, and discusses specific ETFs and mutual funds. Any analysis or example in this book is for illustration purposes only, and is not an investment recommendation for any advisor or investor.

All written content is for informational purposes only. Material presented is believed to be from reliable sources, but the authors make no representations as to its accuracy or completeness. Individual investors should discuss all information and ideas in this book in detail with their individual advisor prior to implementation. Investment advisors should note that their parent firm may strictly limit the use of certain funds described in this book. This is especially true for leveraged and inverse ETFs. Both individual investors and investment advisors should note that certain leveraged products may rapidly lose value and are not suitable for all investors.

Legal Disclosures

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Right Blend Investing, LLC, may have long positions in the ETFs and mutual funds described, and these positions may change without notice. Mr. Martorana believes that the position sizes at his firm are too small to have a material impact on any fund described in the book.

GUIDE TO CHAPTERS 3 THROUGH 13

Chapters 3 through 13 review each of the 11 Lipper classifications in detail. This analysis forms the core of this book, and the following describes each of the subsections in these chapters. We briefly explain why we used certain data, and some of the pros and cons of our choices.

The authors thank Tom Roseen, Head of Research Services at Lipper, for providing the data used throughout this book.

Synopsis

We offer a synopsis at the beginning of each chapter that covers the highlights and summarizes the key takeaways. This material may overlap with the conclusion of the chapter. But the synopsis is meant as a summary, while the conclusion focuses more on how advisors would use funds, and it presumes that advisors have actually read the chapter.

The synopses can be read as freestanding content, and the advisor should not have to read the entire chapter to get value. *The synopses are written in general language, and may be particularly helpful when advisors are creating talking points for clients*. If the client has follow-up questions, the advisor can be confident that the chapter explains the concepts in detail and offers a supporting rationale for the trends, themes, and investment conclusions.

Definition

We start with the definition of each Lipper classification, supplemented by a working definition derived from the fact sheets and disclosure documents of the most popular funds. These chapters assume a strict adherence to the

Lipper classification system. So while we acknowledge that some funds and strategies may have fuzzy boundaries, we aim first and foremost to explain the funds that each Lipper classification includes.

Total Net Assets and Net Flows

This section examines the history of total assets in each classification and their development over the past 10 years. We evaluate trends in assets, net flows, fund launches, and fund closures. This analysis gives a sense of how investor interest in the classification has waxed and waned in light of market returns and the returns for the classification.

This section also explores the depth and breadth of fund choices for investors. Are there many funds with a variety of strategies? Or is the classification relatively homogeneous, with different flavors of the same basic strategy?

As part of this process, we note any blockbuster funds that dominate the Lipper classification. The dominance of blockbuster funds is critical to understand, since some funds comprise 50 percent or more of the assets and net flows in a classification. This may give a distorted impression of the trends in the classification, since the asset growth may be dominated by a single fund. It can seem that a certain strategy is growing rapidly, and is worthy of deep investigation. The truth may be that a certain fund is popular because of recent investment performance, and the popularity of the classification may rest on the success or failure of a single portfolio manager.

Risk and Return

We discuss the returns of each classification over the past year, three years, five years, and 10 years. Some classifications have a limited history, so the data are absent and there are blank spaces in some of the exhibits.

Our analysis focuses on the overall level of returns and on the dispersion of returns, which may be wide or narrow depending on whether the classification is homogeneous or heterogeneous. We also note when returns tend to cluster around some type of benchmark, reflecting the underlying factor exposures. Some classifications have high beta and high correlations to an index, whereas others are driven by idiosyncratic risks and decisions by the portfolio manager.

When we compare returns in the classification to the underlying factor exposure, we usually offer a comparison to the S&P 500. As a convenience, data on the S&P 500 appears as a table in each chapter, so the reader does not have to flip through the book to find out how the classification compared to the equity market under different market conditions.

We also show measures of risk: Sharpe ratios, Sortino ratios, and maximum drawdowns. There are many measures of risk we could have used, but our experience with these funds showed that returns and drawdowns were generally the most useful. These offer a thumbnail guide to whether the funds are offering an attractive mix of risk and return, though we must offer a major cautionary note: The five-year data coincide with a bull market, and this makes nearly all alternative strategies look poor in comparison to equities. Unfortunately, many of these products have not existed for a complete cycle of bull and bear markets, so it is impossible to definitively say how they might perform in a crisis.

Factor Exposures

This section of each chapter is intended to help advisors understand what drives the risk and return of each Lipper alternative classification. Fund performance can often be explained by equity beta, credit risk, and other factors, and these help determine the role that each fund plays in an investor's portfolio.

This book often refers to analysis by the research staff at Lipper, which has done extensive work on factor exposures. We discuss this in detail in Chapter 3, Absolute Return Funds, and this chapter is the best starting point for a detailed discussion of how factor exposures affect the risk/return profile of alternative mutual funds and ETFs. The authors wish to thank Andrew Clark, PhD, Manager of Alternative Investment Research, for his assistance in helping to understand and interpret Lipper's research in this area.

Asset Allocation and Fund Selection

This section helps the advisor understand the proper role of each fund in a portfolio. It starts with the factor exposures that drive the classification, and it uses these to determine a process for evaluating a fund's track record. We discuss how some funds have stood out from the crowd, and we assess the degree to which this might be explained by top-down factors. Each classification is driven by different factors, so we discuss how to evaluate the effectiveness of funds using different strategies.

This book assumes that alternative funds have different roles in the portfolio: portfolio diversifier, equity complement, fixed income complement, directional bet, or hedging of tail risk. Chapter 18 on fund selection discusses these roles in detail. Chapter 15 discusses the process, and it assumes the same roles for alts in a portfolio.

Top Ten Funds

This section reviews the assets, net flows, and investment performance of the top ten funds in each classification. The authors chose to focus on the top ten funds by assets because we believe this is an objective standard that can be used across classifications.

Each Lipper alternative classification is driven by different factors, and the funds play distinct roles in portfolios. This makes it difficult to use a quantitative ranking method that is both fair and comprehensive. It is difficult for a single book to discuss the complete range of alternative strategies using a single measure of risk and return. For example, if we had ranked funds based on returns we would have favored funds with high equity beta, while a ranking based on low max drawdowns would have favored funds with low equity beta.

The downside to our approach is that we seem to be favoring the largest funds in each category. This was not our intent, and we encourage advisors to use their own due diligence and the processes described in this book to uncover hidden gems in each classification that will help their clients reach their goals.

Blockbuster and Spotlight

This section discusses the largest fund in each classification—the blockbuster. The dominance of certain alternative funds may be a sign of investors chasing the hot performance or a popular fund manager. Or it may be a sign that a fund has earned the top spot because of a sustainable investment process. The analysis of blockbusters also helps in understanding investor demand, and may reveal larger trends about issues such as risk tolerance.

The authors also choose a spotlight fund in each classification to allow a deeper dive into the process of a single fund. This fund may have a particularly impressive track record, or it may simply be a good representative of the strategy and investment process that typifies the Lipper alternative classification. This analysis also offers the opportunity to contrast the approach by the blockbuster fund, and to show how the classification has room for a variety of strategies. The main purpose of the spotlight discussion is to show how an advisor might uncover an attractive fund in the classification, depending on the role of the alternative fund in a portfolio and the goals of a particular investor.

SUMMARY

This book attempts to offer practical information to a wide audience, and is designed to help investors consider how they might use a fund in their portfolios, or to help advisors consider how they might use liquid alts in their practices. Each investor has different goals, and each advisor has a different value proposition. Some readers may be new to liquid alts whereas others may already have an established process. The authors recognize this range of expertise, and show how liquid alts might be used accordingly. We aim for this book to be both a practical tool and an authoritative source of information, and we hope you find it useful.