Insight INVESTMENT

ALTERNATIVES TO HEDGE FUNDS IN THE LIQUID ALTERNATIVE SPACE

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SUMMARY

- Historically, investors moved into hedge funds as a way to access alternative strategies with attractive risk/reward profiles. For various reasons many of these funds have disappointed, and been unable to fully capture the significant gains made by equity markets in recent years
- With valuations across bond and equity markets now stretched, investors are starting to look for different ways to generate returns and there is renewed interest in non-traditional strategies
- Liquid alternative strategies can potentially offer investors access to alternative ways to generate returns, without the sacrifice of liquidity and transparency that many hedge funds require, but there is often a mismatch between fund design and investor expectations
- In our view, the most effective strategies have the flexibility to target allocations across a broad range of beta and alpha strategies so as to have the greatest flexibility to generate returns under various market conditions
- Pursuing such an outcome-oriented approach, targeting tangible cash-plus returns, can help investors to stay on course to meet their financial goals over time with greater certainty

ALTERNATIVES TO HEDGE FUNDS IN THE LIQUID ALTERNATIVE SPACE

LIQUID ALTERNATIVE STRATEGIES OFFER INVESTORS ACCESS TO ALTERNATIVE WAYS TO GENERATE RETURNS, WITHOUT THE SACRIFICE OF LIQUIDITY AND TRANSPARENCY THAT MANY HEDGE FUNDS REQUIRE, BUT THERE IS OFTEN A MISMATCH BETWEEN FUND DESIGN AND INVESTOR EXPECTATIONS.

THE HISTORICAL ALLURE OF HEDGE FUNDS

For investors, hedge funds have the potential to offer many positive attributes. Their use of more sophisticated investment techniques than traditional asset managers means that they can pursue strategies which are less or even inversely correlated with general asset markets, providing diversification benefits and potentially attractive risk-adjusted returns. They can also use leverage to amplify returns, although that also carries dangers, as seen during the financial crisis in 2008 when a number of hedge funds were wiped out. They also provide access to a broader range of assets than traditional mutual fund structures.

However, in order to take advantage of these positives, investors have been prepared to sacrifice transparency, often buying into restrictive fund structures with lock-in periods and low levels of liquidity.

THE EVOLUTION OF LIQUID ALTERNATIVES

As the hedge fund industry has become more competitive, with over 8,000 hedge funds in existence[1], several hedge fund firms have entered the mutual fund arena to offer modified versions of their flagship strategies in order to appeal to a wider range of investors. At the same time, with the use of derivatives becoming more mainstream, a number of traditional asset managers have moved to offer innovative and flexible investment strategies in mutual fund format with the aim of providing access to more outcome-oriented solutions, targeting cash-plus returns.

In the US, this type of mutual fund, which offers very different investment strategies than those offered by traditional, market index-based funds, has been collectively referred to as 'liquid alternatives'. Although the investment objectives and risk/return characteristics of these funds varies drastically, a common objective is the pursuit of outcome-oriented (often cash-plus) investment approaches, with many offering downside protection strategies. The liquid alternative market offers many of the positive attributes associated with hedge fund investment, but does so in a way which is more transparent, offers greater liquidity and via regulated fund structures.

[1] Source: Hedge Fund Research, as of December 31, 2017.

CHANGES WILL MAKE IT MORE DIFFICULT FOR POOR STRATEGIES TO HIDE

Unsurprisingly, as a broader range of investors gained access to these innovative funds, the liquid alternatives market boomed, buoyed by post-global financial crisis demand for products with downside risk management. Unfortunately, this more cautious investment approach meant that a number of funds, which performed extremely well during the market downturn, failed to fully participate in the rebound. Investors became disappointed and perceptions of the liquid alternatives market as a whole became tainted.

Honing in on target

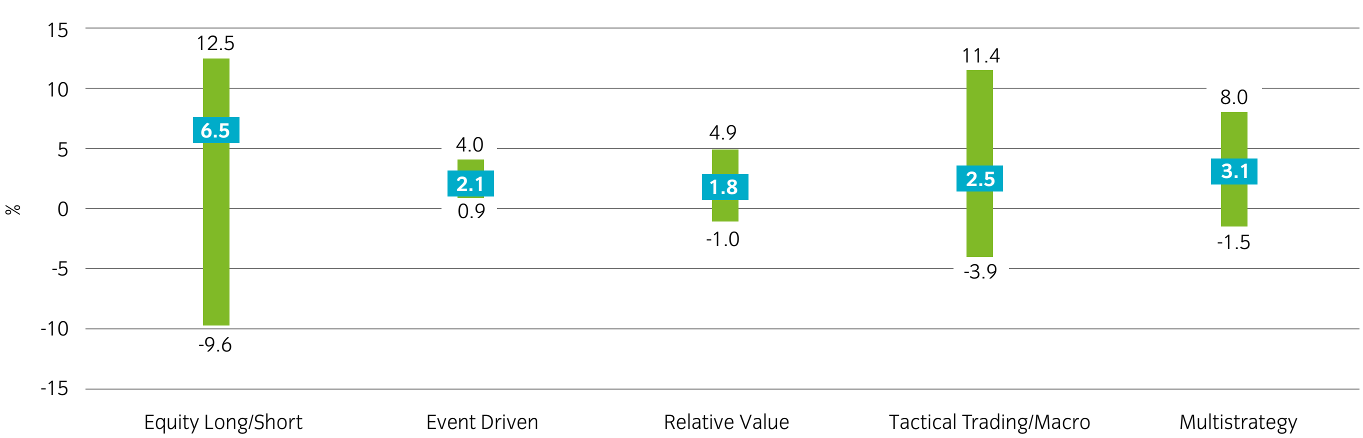
One problem which exacerbated this was the perception that categorization was insufficient to allow investors to properly differentiate between the options available to them. Liquid alternatives capture such a wide range of strategies that a single category could contain funds with quite diverse objectives. Over time this led to highly dispersed returns. For example, in the five years to the end of 2017, an investor choosing the best performing long/short equity strategy would have gained an annualized 12.5%, whereas an investor choosing the worst-performing strategy in the same category would have lost an annualized 9.6% (see Figure 1). In the same period the S&P 500 Index returned a significantly higher annualized return of 15.7% on a total return basis.

Recent actions by Morningstar are designed to provide a solution to the categorization problem, making it more difficult for poorly performing funds to hide by allowing investors to more clearly define peers. Five additional subcategories were added on April 30, 2018 and there was a review of existing categorizations to ensure that funds are appropriately defined. Multi-alternative funds have been subcategorized into either multi-strategy or global macro, while new multi-asset income, multi-asset inflation protection and multi-asset retirement income subcategories have been added. The provision of a second layer of description will allow investors to compare funds according to their stated outcome-based objectives rather than holdings and should ensure that investors know what to expect from the funds they invest in, especially important given the retail investors involved in these funds.

We have observed that some investors are now slowly returning to liquid alternatives

With global asset prices experiencing such an extended rally, and valuations elevated across bond and equity markets, interest in alternative ways to generate returns has grown. Some investors are starting to look for ways to sustain investment growth but at the same time manage downside risk. This has led to some renewed interest in the liquid alternatives space with inflows of $6bn in 2017 and $2.8bn in the first half of 2018[3].

Figure 1: Five-year high/low and average annual returns in liquid alternative categories[2]



[2] Source: Goldman Sachs. Data as of December 31, 2017. [3] Source: Morningstar.

THE IMPORTANCE OF OUTCOME-BASED OBJECTIVES

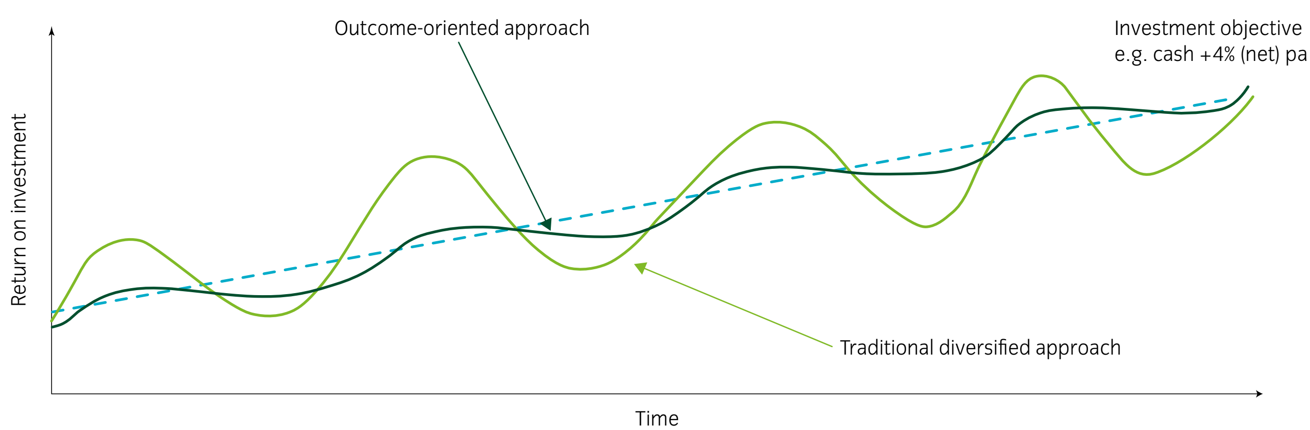
Before allocating into the liquid alternative space, investors need to have a clear understanding of what they are trying to achieve. Then, with so many different strategies available on the market, each behaving differently in the pursuit of different objectives, serious due diligence must go toward finding the strategy which most aligns with that desired outcome.

If an investor wants to benefit from growth via risk assets, directional beta portfolios may be the first sector they start to research. Managers can profit on high-conviction trades. But risk markets tend to be quite volatile – 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.

For example, 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 incurred significant losses if invested in either equities or lower-grade credit. While some investors can tolerate higher levels of risk and drawdown, many – principally those nearing retirement age – may be simply incapable of stomaching a loss over multi-year periods and would be forced to sell and realize a loss prematurely.

In our view, in the liquid alternatives space an investor can seek growth via risk assets, but via the use of an outcome-oriented approach with a cash-plus objective. Funds that have a more outcome-oriented approach tend to have a tighter distribution of returns over time, 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 2: An outcome-oriented approach will typically aim to stay as close as possible to the investment objective[4]



[4] For illustrative purposes only. Does not reflect trading or a strategy, fund or client account managed by Insight.

ACCESSING A BROAD OPPORTUNITY SET

In order to be confident of delivering a targeted return through a wide range of market environments while managing volatility, it is important that a fund is able to access the broadest possible opportunity set. As market conditions change, the manager can then potentially allocate towards those assets or strategies that should be best positioned to benefit from the investment environment (see Figure 3).

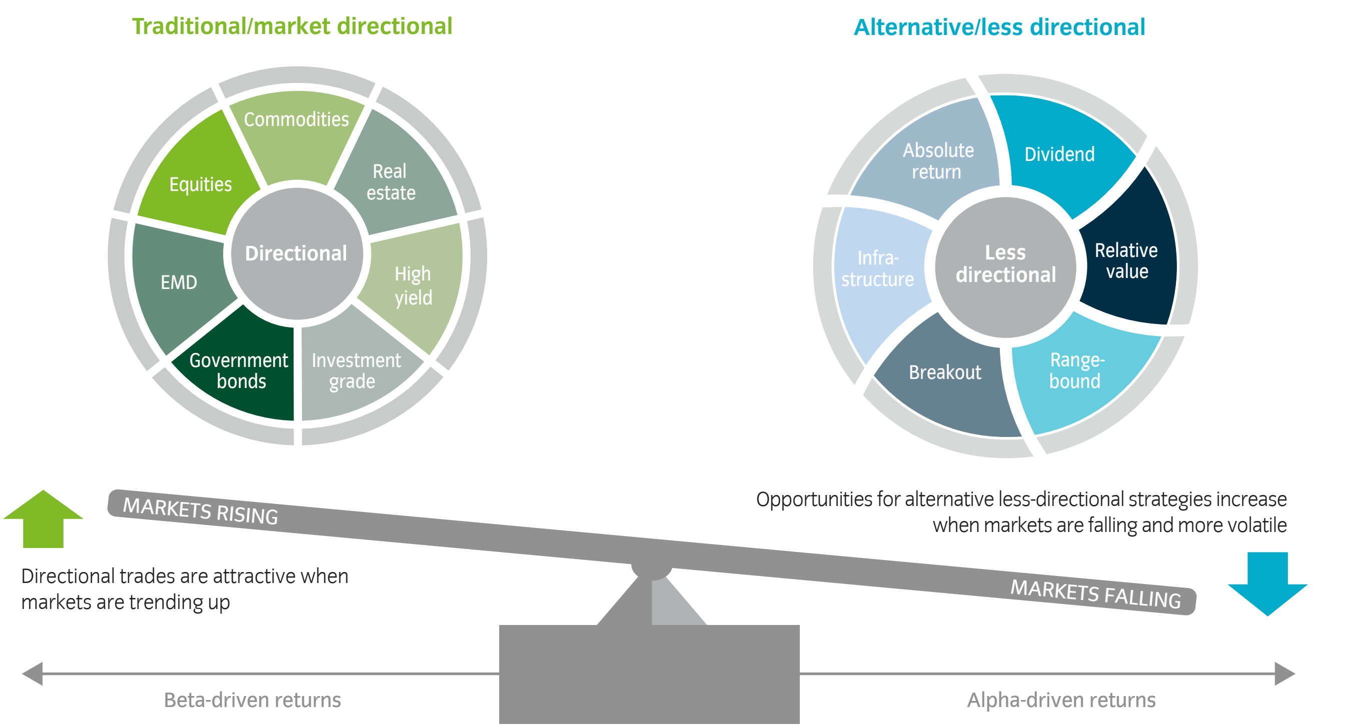
Access to alpha-based strategies also introduces new ways for investors to make money. Many investors assume that to make money they need a market to rise or fall but, using combinations of exchange-traded options, it is possible to pursue, for example, range-bound strategies. A range-bound strategy is one where the investor expects an index or currency to trade within a range over a period of time, perhaps as a period of consolidation following a directional move. An investor can sell a call and a put option on either side of the range, collecting the premium if the asset trades within the range at expiry. More complex strategies have the potential to take advantage of issues such as the term structure within option pricing.

ALPHA, BETA OR BOTH?

Even with an outcome-oriented approach there is a question as to whether the best choice for the client will be focused on either beta or alpha to generate returns. Beta strategies are directional and based on market returns, but within liquid alternatives this could include strategies designed to protect capital, amplify returns or even strategies with a negative beta, designed to profit when markets fall. Alpha or alternative strategies attempt to generate profits regardless of market direction, often using option strategies or matched long-short strategies to remove directional risk.

It is notable, however, that challenging environments for traditional beta driven strategies (generally characterized by higher volatility) tend to be more rewarding for strategies exploiting alpha and vice versa. This means that there can be prolonged periods where investors focused solely on beta or alpha strategies can face market conditions that are unfavorable.

Figure 3: Different assets or strategies are typically more likely to benefit as market conditions change[5]



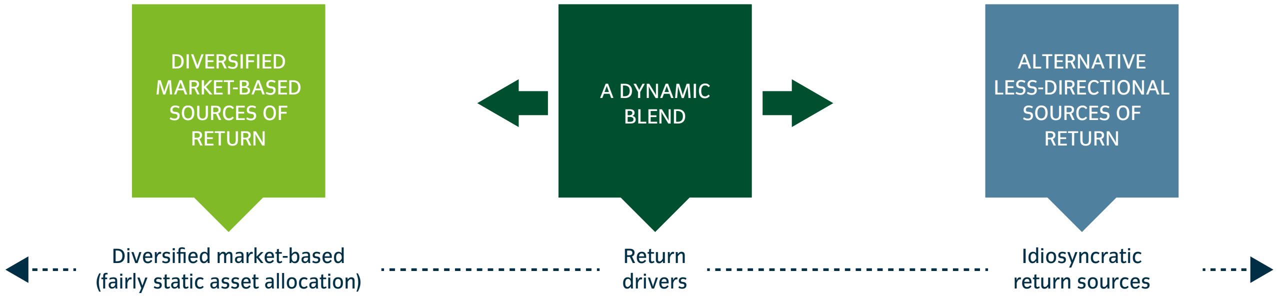
[5] For illustrative purposes only.

At Insight, we believe that the best way to address this problem is for a fund or strategy to be able to dynamically allocate not only within, but also between alpha and beta strategies, depending on market conditions. But even with this ability, timing when to reallocate is difficult. Key to this decision is to pinpoint inflection points in the economic cycle via careful analysis and modelling of economic data trends. Market pricing is also important. When volatility changes, and with it the risk premium embedded in option prices, so the most attractive way in which to express a position may change.

During periods of high volatility for example, reallocating from a beta strategy towards an option-based alpha strategy can provide similar upside exposure, but can also build in an element of capital protection.

This extends the potential for diversification and could afford the possibility of more consistent return generation over a typical economic or market cycle (see Figure 4).

Figure 4: Investors should retain the flexibility to shift the emphasis between market-based and alternative less-directional sources of return[6]



[6] For illustrative purposes only.

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Used properly, 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.

SVEIN FLODEN

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EXPERIENCE MATTERS

Outcome-oriented funds can, over time, remove some of the risks of mistiming market entry points and can provide greater confidence that longer-term goals will be met. Ideally, the ability to dynamically allocate across a broad range of assets and strategies will enable profitable opportunities regardless of the market environment. Critically, managers must be able to demonstrate that they have successfully delivered these returns over long periods of time, including periods of stress such as the global financial crisis.

CONCLUSION

Given the nature of the liquid alternatives market, it was perhaps obvious in our opinion that sentiment would turn more pessimistic following such an extended rally in risk assets. The category contains a huge array of strategies with highly differentiated objectives, and capital preservation and diversification strategies have become a lower concern for investors more worried about participating in equity market upside. The lack of accurate categorization and highly dispersed returns has not helped perceptions, leaving investors struggling to draw up short lists of funds that could meet their objectives.

At this late stage of the cycle, the most powerful element of the equity market upswing is likely to be behind us and now may be the time to look at strategies which continue to provide some upside exposure, but which do so in a risk controlled way.

Although both hedge funds and liquid alternatives provide a way of accessing more outcome-oriented strategies, only liquid alternatives do so in regulated and transparent vehicles with ready liquidity. Used properly, 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.

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