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Investment Commentary

UPDATE ON ALTERNATIVE INVESTMENT STRATEGIES

Commonwealth Bank & Trust Company

When the topic of alternative investment strategies comes up, we are often asked the following two questions:

What is an alternative investment strategy? Definitions vary; however, for us it implies investment strategies and asset classes that have a low correlation to the traditional asset classes of publicly traded stocks, bonds and cash.

Why should I be interested? In theory, a good alternative investment when blended with traditional assets can reduce the risk of the overall portfolio and potentially enhance returns.

For our outlook and an overview of the alternative investment strategies we follow, please read on:

Alternative investment strategies continue to be popular among the highly affluent and institutional investors who have access to private partnerships (i.e., hedge funds). We also see strong demand (and supply) in the mutual fund universe, where a growing number of alternative strategies are now available to a broader group of investors through '40 Act structures (named for the act of Congress that created them in 1940). The potential benefits of alternative strategies within '40 Act structures (mutual funds) are: lower minimums, lower fees, more transparency, and more liquidity than hedge funds.

We have followed the growing trend of using alternative strategies in mutual funds for many years and have selectively used a few managers in our portfolio strategies. Our research and search for quality managers in this space is an ongoing process. Since we know many investors are considering adding alternative strategies to their portfolios we thought it would be useful to outline what we believe are some of the key areas to assess, and some of the specific considerations for various types of alternative strategies.

Supply and demand have both exploded in the liquid alternative strategies (i.e., '40 Act mutual funds and, to a lesser extent, ETFs) space since 2008, with the asset class reaching more than $550 billion in size by the end of 2012, according to a 2013 paper published by SEI, "The Retail Alternatives Phenomenon," citing Strategic Insight data. A number of factors (increased regulation of private funds, slower growth in institutional allocations, difficulty fundraising for new hedge funds, etc.) have encouraged some alternative strategies managers to create or subadvise '40 Act offerings, while risk aversion, a desire for diversification, and a generally weak outlook for traditional equity and fixed-income markets has spurred demand from retail investors and their advisors. Whether one believes that supply or demand led the way, the result is a proliferation of choices for investors, covering a broad range that includes single strategy mutual funds and ETFs, multi-strategy mutual funds, hedge fund replication mutual funds and ETFs, and multi-manager mutual funds.

While we generally welcome an increase in the available choices of liquid alternative strategies, assuming increased competition should generally raise the quality and lower the cost, the increase in choice has its downside as well. We have a number of concerns regarding absolute-return-oriented strategies, including the lack of a track record for almost all of the new funds; the complexity of some of the strategies, making them more difficult to evaluate; the typically high cost (though still usually lower than hedge funds); the difficulty associated with determining their appropriate role in a diversified portfolio; and the difficulty in determining appropriate benchmarks, leaving aside the question of whether a specific benchmark is appropriate for every type of strategy. The number of alternative strategy mutual funds that have a substantial track record is still a relatively small group.

Types of Alternative Strategies and Their Applicability to a Mutual Fund Structure

Looking deeper into the underlying strategies, we find a wide variety, each with its own benefits and drawbacks to consider. We present these categories relatively broadly for the purposes of this discussion, acknowledging that different investors may define the categories more narrowly (or possibly more broadly) than our groupings here. We also note that there is usually not a clear dividing line between categories, so any classification scheme is somewhat subjective.

Long-short equity. One of the most popular hedge fund strategies because of its relatively straightforward nature, an equity long-short strategy involves taking long positions in stocks that are expected to increase in value, and short positions in stocks that are expected to decrease in value. Long-short equity translates well to mutual funds because it is typically liquid and doesn't require much, if any, financial leverage to generate attractive returns on equity, *assuming the manager can consistently add value through stock selection*. More generally, performance for long-short equity funds has been relatively weak since the financial crisis until the last year or so, as correlation among stocks has been

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high, lacking price differentiation between good/improving companies and bad/deteriorating ones. (The HFRI Equity Hedge Index has an 11.1% trailing 12-month return compared to a 4.6% annualized three-year return through 9/30/13.) On the positive side, the correlation among stocks has declined this year, providing a better opportunity for managers to add value through stock selection. Long-short equity funds typically benefit from some degree of net long exposure to the market unless they are explicitly market-neutral, so if the market produces negative returns, these funds will face a significant headwind. Other challenges facing these funds include massive competition from other actively managed mutual funds and hedge funds also seeking to identify mispriced stocks, the significant cost of borrowing shares in many highly shorted stocks, and the ultra-low rate environment (resulting in managers earning nothing on any cash they hold from shares sold short).

Event-driven. Event-driven investing also generally fits well in a mutual fund context (assuming one counts "distressed" as a separate category, since that can be illiquid at times). Event-driven investing attempts to profit from some corporate action that the manager believes will be transformative to a company and is not currently reflected in the price of that enterprise's securities. Events can include mergers, acquisitions, spin-offs, re-financings, litigation, etc. The current environment for event-driven investing is largely favorable, with high levels of cash on corporate balance sheets, accommodative credit markets, and activist shareholders clamoring for managers to take action to "unlock shareholder value." However, fund managers in this category who engage exclusively in merger-arbitrage investing are having a difficult time at the moment because deal spreads are at the low end of the historical range.

Absolute-return-oriented fixed-income and long-short credit. This is an intentionally broad grouping, with a wide range of strategies that fit under this umbrella. The overarching theme here is that managers typically have a relatively broad mandate to generate returns through bond-market sector and/or credit selection, and potentially through duration management (although this is typically a secondary focus). These types of funds may be attractive since they essentially allow managers to disaggregate the risk factors in fixed income—most importantly separating credit risk from interest-rate risk—and take exposure only to the factors they believe are attractive. The broad flexibility also allows them to invest in areas that may be less efficient than core, investment-grade bonds, such as emerging-markets debt or mortgage-backed/other asset-backed securities. Once again, low "risk-free" rates are likely to be a headwind here since most strategies have some interest-rate exposure and rates are expected to continue on an upward trajectory over the coming years. Further, credit spreads (the amount of yield above the Treasury yield) are relatively tight, offering little, if any, expected gain from spread compression (i.e., a narrowing of the yield differential, which results in appreciation for the non-Treasury bonds). Generating attractive absolute returns without accepting some duration risk and/or credit risk (and likely a higher correlation to equity returns) is very challenging in this environment, particularly while using very little or no leverage.

Macro and managed futures. With liquidity ideally suited for mutual funds because of the high liquidity of the futures contracts they trade, macro strategies try to generate profits by betting on currencies, commodities, equity markets (typically at the index level), interest rates, and other assets. Macro managers may make directional bets (long or short) in any or all of these categories, or they may take relative value positions (e.g., long silver and short gold) to exploit perceived mis-pricings between related assets. Trades may be based on a manager's analysis and judgment (referred to as a discretionary approach) or based on models (called a systematic approach). Historically, many macro managers have been relatively uncorrelated with equity and credit markets, providing valuable diversification to traditional portfolios. However, non-correlated results are only useful in the long term if the expected returns from the strategy are positive. We find it hard to discern whether managers have an edge in making macro judgments (and translating them into profitable positions) consistently.

While there are a multitude of approaches within macro, some successful funds conduct fundamental economic research to generate ideas, then make a number of informed bets in different asset classes, cutting losing positions and "letting winners run," essentially making up for a low hit rate with large gains on successful positions. This is a similar approach to the one followed by a majority of managed futures funds, who typically rely on models to capture price-trend signals instead of fundamental analysis, and whose explicit goal is to follow and profit from these trends. Managers may have differing approaches to portfolio construction and may use other models in addition to trend models, but managed futures funds almost always have a very significant trend-following component. Because they can take a long position in assets that are increasing in price and short assets whose prices are falling, managed futures funds have

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historically been valuable during protracted equity market declines, as they benefit from shorting equity markets during a sustained drawdown. With that said, managed futures have performed poorly for the last several years, largely as a result of the lack of sustained trends in multiple asset classes and multiple sharp reversals in price due to government and central bank interventions.

Stressed and distressed credit. Another classic hedge fund strategy, distressed investing allows managers to generate returns by purchasing securities (usually debt) of companies facing financial and/or operational problems at discounts to par, and then selling at a profit if a recovery happens, or receiving new securities worth more than the price paid for the old ones in a corporate reorganization. The strategy is attractive due to a number of structural factors, including forced selling by ratings-constrained investors who are not permitted to own non-investment-grade issues; the complexity and effort required in understanding and dealing with a potential reorganization (inside or outside of bankruptcy); and the premium that goes along with owning bonds or loans that frequently become significantly less liquid as they slide into distress. Despite its appeal, distressed investing is difficult and requires an understanding, if not mastery, of corporate valuation, the nuances of complex capital structures, the bankruptcy process, and the trading dynamics in an opaque marketplace. As such, it has typically been the exclusive domain of hedge funds, which also have the benefit of longer-duration capital (i.e., initial lock-up periods and limited investor redemptions), and allows them to capture more of the excess returns that typically accrue to investors willing to hold less-liquid assets than mutual funds. However, over the last several years, a handful of mutual funds have launched that focus at least partially on stressed and distressed credit. They are constrained by the fact that they offer daily liquidity, but attempt to address this by limiting the less liquid part of their portfolios (recognizing in severe market stress, liquidity can be fleeting) and typically holding higher cash balances than most traditional funds.

Fixed-income arbitrage and convertible arbitrage. These strategies typically rely on significant leverage to generate attractive returns, and as such tend not to be a good fit for mutual funds, so we will refrain from discussing them in detail, although there are several mutual funds that incorporate these strategies to a small degree within a multi-strategy framework.

Due Diligence on Alternative Strategies Funds

Sensing the massive opportunity in catering to a broader investor base, investment managers have flooded the market with liquid alternative strategies. Our continuing examination of this space has led to the unsurprising conclusion that the quality of offerings varies widely, much the same as the traditional fund space. We have identified a number of strong managers whose businesses are rooted in hedge funds, but are diversifying by entering the mutual fund world, and we also anticipate that a number of high-quality managers who have not yet done so, will start to enter the market. However, there are also countless less-compelling options with high fees, limited track records, and questionable strategies, underscoring the necessity of good research and diligence.

In addition to the typical considerations that apply to all funds (e.g., manager skill, competitive edge, fees, organizational stability), the alternative strategies landscape requires us to take additional factors into account:

Translation of strategy to mutual fund format. We mentioned elements of this consideration in the strategy discussions above, but it is worth reviewing here since this is a key focus as we evaluate alternative strategies funds. The primary constraints on managers operating these strategies in mutual funds are liquidity and leverage. These factors typically play a role in the ability of hedge funds to generate attractive returns, though the combination of illiquidity and significant leverage is a toxic mixture that is frequently a cause of hedge fund blow-ups. The limitations on these factors in mutual funds is, on the whole, probably a benefit to investors since most non-professional investors do not have the experience to assess how responsibly and effectively a manager is using them, but it does limit how effectively some strategies can be implemented. Distressed investing involves the assumption of some illiquidity in most cases, so managers operate at a disadvantage to their hedge fund and private equity fund cousins because they must be mindful of the requirement of daily liquidity. However, there are liquid parts of the distressed landscape in which a manager may invest, typically in larger, relatively well-known situations (e.g., the liquidating estate of Lehman Brothers, or the major electrical utility firm Energy Future Holdings Corp., commonly known as TXU). Concerning leverage, as we previously mentioned, most arbitrage strategies typically require leverage to make them competitive with long-

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term equity returns, and so limits on leverage result in the strategies having somewhat lower return expectations (but correspondingly less volatility) when executed inside of mutual funds.

Attention to liquid strategy. Managers who run a number of investment vehicles naturally must divide their focus among the different funds and, like any good parent with multiple children, will say that they love them all equally. However, when a liquid alternative strategies fund is a small part of a large business, and/or is less attractive from a fee perspective since it does not pay an incentive fee (e.g., the 20% of profits in the infamous "2 and 20" hedge fund fee structure), the natural tendency is for that fund to receive less attention, even if it is not a conscious decision. We try to assess the manager's commitment to their various strategies throughout the research process by trying to understand their internal motivation, sense of fiduciary duty, as well as examining the track records of different funds to the extent this is possible, but this is admittedly difficult and imperfect.

Role in portfolios. When considering absolute-return-oriented strategies factors to consider are risk management, correlation with other asset classes, and the related choice of what to sell in order to fund such an investment. With the broadening of the investment universe to other alternative strategies, these issues become even more complicated. A low-volatility, non-traditional bond fund may be a relatively easy substitute for index-like fixed-income exposure when rates are low, but from which asset class should an investor finance an allocation to a managed futures fund or an event-driven fund? Is our alternative strategies allocation for offense or defense? Can we rely on the historical statistics (if there are any) to accurately inform our estimate of potential downside scenarios? Will the correlations remain true going forward? All of these questions again highlight the importance of understanding the underlying return drivers of the strategy rather than just relying on historical statistics, and understanding the manager's risk/reward calibration. While we try to make some estimates of the likely range of outcomes, we have an intense aversion to false precision and recognize that we will almost certainly be wrong, so it is important to be able to at least bracket the downside risk in reasonable scenarios.

Style-box purity. This is a slightly more subtle consideration, but one that we believe is important to examine. When entering the mutual fund world, managers obviously want to attract a large amount of assets to compensate for the lower fees compared to hedge funds. As such, they may adjust their strategy to make it simpler for investors and consultants to pigeonhole an asset allocation framework, thus reducing their ability to be nimble and add value by moving to where opportunities are most attractive *(assuming the manager has the resources and expertise to invest more broadly)*. We have observed this to be a problem even in the hedge fund universe, where "style drift" can be a capital offense (pardon the pun), so managers often stay huddled within their tightly defined investment universe for fear of drawing the ire of the style-box police and possibly provoking redemptions.

Concluding Comments

Alternative strategies are not a magic bullet that will solve all investment problems, but they can be valuable pieces of a diversified portfolio. In our view, a "democratization" of alternative strategies is generally a good thing; however, not all strategies are created equal. Many fund companies will follow the money, selling whatever they think investors will buy, particularly if it has an air of exclusivity and mystique that can command a premium price. As such, doing the research to understand the manager and strategy are more critical than ever. Investors should also temper their expectations regarding returns, both for the structural reasons mentioned previously, and the simple fact that a flood of capital to an attractive opportunity has historically reduced its attractiveness going forward. Although baseball season has ended, we are reminded of Yogi Berra's paradoxical explanation of why he no longer patronized a restaurant, "Nobody goes there anymore. It's too crowded." While we believe we're far from the point of not wanting to go there anymore, the alternative strategies scene is beginning to fill up, so we're continuing to work hard to identify more great opportunities before that happens.

– Steve Giacobbe, CFA, CFP®
Chief Investment Officer

Sources: (Litman/Gregory, Morningstar Direct)