Lazard Insights

Liquid Alternatives: The Next Wave in Asset Allocation

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Summary

- Liquid alternatives have similar structural characteristics to traditional US mutual funds but employ non-traditional or alternative investment strategies.
- Long/short equity is one of the most popular alternative strategies and has provided significant downside protection over the last twenty-five years.
- Adding a liquid alternative to a traditional portfolio of stocks and bonds can potentially enhance the portfolio's efficient frontier, improving its risk-return profile.
- Liquid alternative funds are growing rapidly. In the last five years, assets under management in these funds have increased significantly.
- In the United States, growth is expected to continue, driven by demographics, as a significant number of individuals are aging into retirement.

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Alternative investments are a broad category of investment strategies that can include hedge funds, private equity, real estate, commodities, and even exotic assets such as art (as opposed to traditional assets such as equities, bonds, or cash). However, many investors only consider hedge funds when they think about alternatives, as there are roughly 9,000 hedge funds operating worldwide. In terms of structure, liquid alternatives[1] are mutual funds, thus sharing the advantages provided by these vehicles. Unlike hedge funds, liquid alternatives tend to be accessible to all investors and, importantly, offer daily liquidity, which most limited partnership (LP) hedge funds do not allow. In addition, liquid alternatives have the same transparency requirements as traditional US mutual funds, are required to register with the Securities Exchange Commission (SEC), provide 1099 tax reporting (opposed to K-1 reporting), and, unlike most LPs, do not charge performance fees (Exhibit 1).

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Exhibit 1
Liquid Alternative Vehicles Share the Advantages of Traditional Mutual Funds

Defining Liquid Alternatives

	Traditional Mutual Funds	Liquid Alternatives (40-Act Funds that employ non-traditional or alternative strategies)	Hedge Funds
Product Structure	Mutual Funds		Limited Partnerships/Private Placements
Availability	Available to most investors		Available only to accredited investors
Minimums	Low		High
Liquidity	Daily		Generally quarterly or monthly at the discretion of the fund (with lock-up provisions)
Transparency	Mandated to release quarterly holdings		Holdings available at the discretion of the fund's management
Oversight	Registered under the 1940 Act and are subject to federal Securities laws and oversight by SEC		Limited SEC oversight and registration not required
Taxes	1099 reporting		K-1 reporting
Fees	No performance fees		Typically 1.5% or 2% management fee and 20% performance fee annually

For illustrative purposes only.

Benefits of Liquid Alternatives

Liquid alternatives may enhance investors' portfolios. Their potential benefits may generally include:

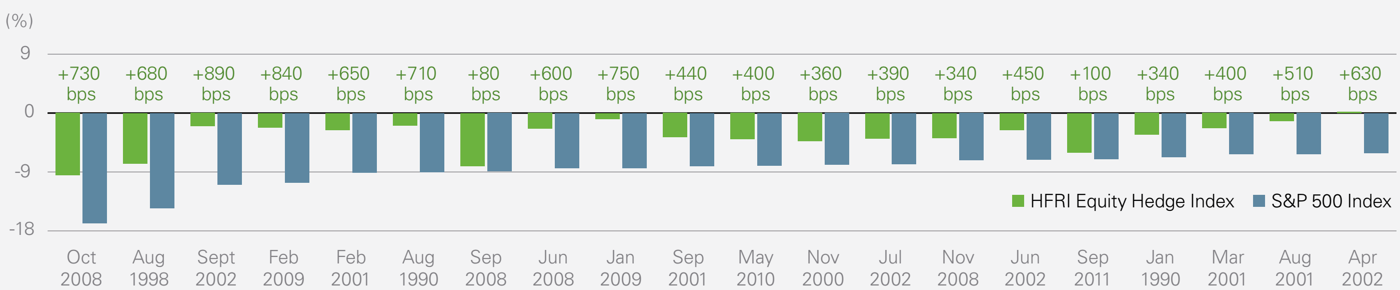
- Improved historical downside protection as compared to long-only strategies.
- Increased diversification in a portfolio context—through lower historical correlation to traditional asset classes.
- Improved risk-adjusted returns, as historical results show favorable upside participation with lower volatility.

In the hedge fund and liquid alternative universes long/short strategies represent one of the largest categories and we will focus the rest of our analysis on proxies for these investments. Notably, many of liquid alternatives' benefits are obtained from the ability to short securities.

Shorting securities gives managers greater flexibility to use their insights and to potentially profit not just from their positive outlook/views on companies or markets but also from their negative views. As a result, these funds generally provide lower correlation to broad market indices, lower volatility than traditional long-only equity funds, and generally protect capital in negative market environments better than long-only equity strategies.

Since 1990, long/short equity strategies (as represented by the HFRI Hedge Index) have provided significant downside protection, which can be seen during the twenty worst performance months of the S&P 500 Index (Exhibit 2). For instance, during the global financial crisis of 2008, investors who had exposure in hedged investments fared better than those that only had long-only equity exposure (this is illustrated by the October 2008 and February 2009 data points in Exhibit 2) .

Exhibit 2
Equity Long/Shorts Have Historically Protected Capital in Down Markets



As of 31 October 2015

The performance quoted represents past performance. Past performance does not guarantee future results. For illustrative purposes only. This information is not representative of any product or strategy managed by Lazard. The index is unmanaged and has no fees. One cannot invest directly in an index. HFRI Equity Hedge Index incepted on 31 December 1989 and is an index of 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. EH managers would typically maintain at least 50%, and may in some cases be substantially entirely invested in equities, both long and short.

Source: Bloomberg, Standard & Poor's

Of course, this downside protection can be partly attributed to the ability of long/short managers to short stocks, sectors, or the market itself. This downside protection is significant because investors often underestimate the importance of capital preservation. In addition to avoiding emotion-based decisions, investors with lower exposure to market downturns do not need to take the outsized risks necessary to rebuild wealth after significant losses. After all, a 50% decline in a portfolio cannot be recovered through a 50% gain. Rather, the value of the remaining investment will have to double—or rise 100%—to make the portfolio whole again.

One of the most important roles liquid alternative funds can fulfill in portfolios is as a potential diversifier to other asset classes. Over a twenty-year period through 31 October 2015, long/short managers (as represented by the HFRI Equity Hedge Index), in aggregate, have generated low correlations to the S&P 500 Index and the Barclays US Aggregate Index of bonds, of 0.76 and -0.03, respectively.[2] As a result, adding a long/short strategy can raise a portfolio's efficient frontier (Exhibit 3). In other words, based on historical data, an allocation to long/short equities can provide a more optimal overall portfolio structure offering a higher expected return for a defined level of risk. When considering liquid alternatives, due diligence is required, particularly as liquid alternative managers can employ many different strategies. As such, when investors are researching these investment opportunities, it is important to understand whether the potential investment can generate a favorable pattern of returns over time and if the investment is closely correlated with other investments within their portfolios. If investors have redundant exposure within their portfolios, they will not receive the appropriate diversification benefits.

In addition to discussing how alternative strategies have historically protected capital during downturns better than long-only equity investments, these strategies have also participated in the upside. Over the long term, hedged alternative strategies have outperformed major equity indices and have done so with substantially lower volatility, on average (Exhibit 4). These results highlight favorable risk-adjusted performance.

While long-only portfolios will typically benefit from a rising market, they will also likely be hurt by a falling market—a rollercoaster ride in performance that most investors would prefer to avoid. Extreme market downturns have occurred a number of times over the past 25 years (i.e., the tech bubble burst, the global financial crisis, and the correction earlier in 2015). For long-term investors, market declines are not a matter of if, but when (Exhibit 5, page 4). Therefore, the characteristics of liquid alternative strategies have the potential to fill a number of roles in portfolios as a core equity allocation, a portfolio diversifier, and a potential buffer to equity market downturns.

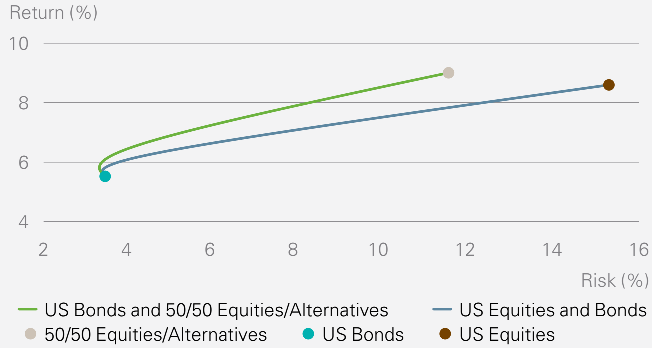
Common Misconceptions about Liquid Alternatives

There are three misconceptions about liquid alternatives. First, like certain other products offered in the past, some believe liquid alternatives are a fad. Since some of the best minds in the asset management industry have committed to this area and investors will be afforded more choices as a result of increased competition, we believe liquid

Exhibit 3

Potentially Raising a Portfolio's Efficient Frontier through a Long/Short Allocation

Efficient Frontier, 1995–2015



As of 31 October 2015

US Equities = S&P 500 Index Total Return; US Bonds = Barclays US Aggregate Bond Index; Alternatives = HFRI EH Index. The performance quoted represents past performance. Past performance does not guarantee future results. For illustrative purposes only.

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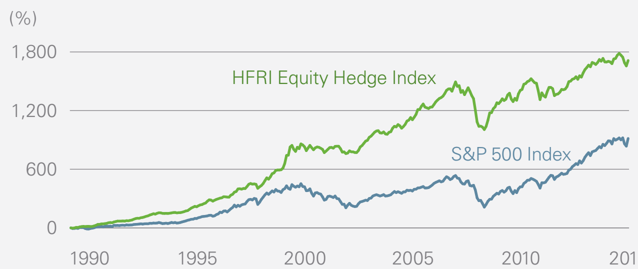
Efficient frontier is key a concept from modern portfolio theory that defines a group of portfolios with the highest level of expected return for a given level of risk (or lowest risk for a given level of return).

Source: Bloomberg

Exhibit 4

Long/Short Equity Strategies: Higher Historical Returns, Lower Risk

Cumulative Returns of the S&P 500 Index and the HFRI Equity Hedge Index, Since Inception



	Annualized Return (%)	Annualized Volatility (%)
S&P 500 Index	9.4	14.6
HFRI Equity Hedge Index	11.9	8.9

As of 31 October 2015

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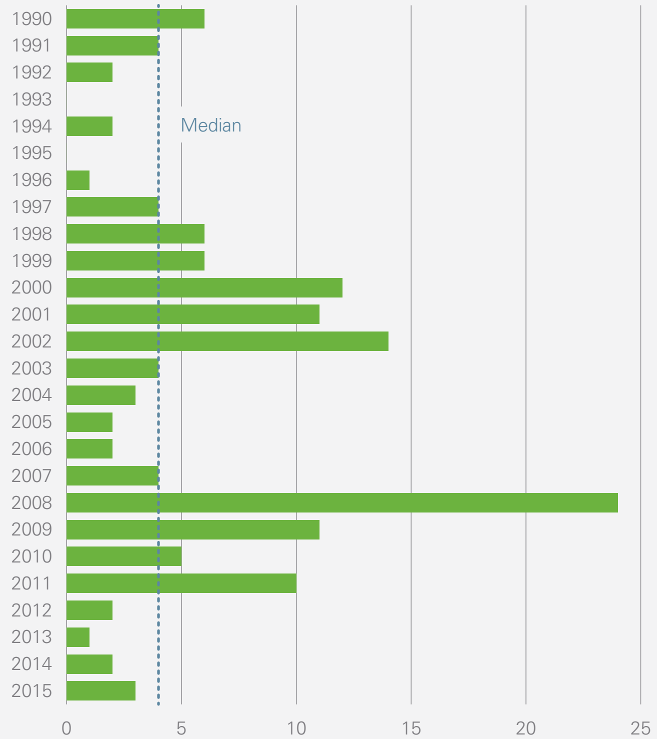
Source: Bloomberg, Citi Research, Standard & Poor's

Exhibit 5
Market Drawdowns Are a Normal Part of the Cycle

Number of 5% Pullbacks per Year in the S&P 500 Index



As of 30 September 2015
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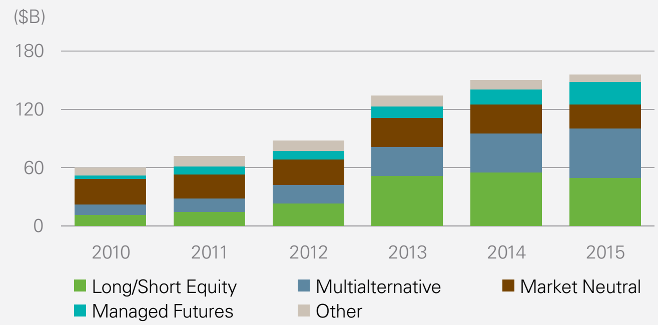
Source: FactSet, J.P. Morgan Asset Management, Standard & Poor's

alternatives are here to stay. In addition, the growth in assets in liquid alternatives and the fact that institutional investors have long considered alternative assets cement liquid alternatives' place. Second, some consider liquid alternatives to be "hedge fund lite," unable to provide the same exposures as true LP hedge funds. This may be true for some strategies to a certain degree since liquid alternative mutual funds have leverage restrictions and are limited by the amount of illiquid investments in their allocations. Therefore, certain hedge fund strategies, like distressed debt, are not appropriate for liquid alternative funds. But for the largest and most recognizable hedge fund investing strategy—long/short equities—liquid alternatives are well suited to provide this exposure. Not surprisingly, since 2008, the return streams look pretty similar for hedge funds and liquid alternatives that follow long/short strategies. Because of such similarities, the third misconception is that liquid alternatives are just for retail investors. However, because of the added benefits of liquidity, transparency, and no performance fees, institutional investors and the investment consultants that advise institutional investors have been allocating more assets to liquid alternatives.

Exhibit 6
AUM in Liquid Alternatives Has Increased Significantly in Five Years



As of 30 September 2015
"Other" includes: multicurrency, bear market, volatility and trading inverse debt.
Source: Morgan Stanley, Morningstar Direct

Liquid Alternatives Demand and Drivers

Not surprisingly, because retail investors have historically held underweight allocations to alternative investments, and due to the increased interest among institutional investors, liquid alternatives have experienced rapid growth in assets in recent years. In the last five years, assets under management in liquid alternatives have increased by 160% (Exhibit 6). Investors now have more strategies to choose from as both global asset management firms and hedge funds continue to launch new products.

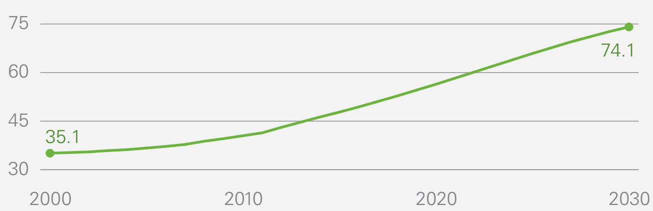
We believe the aging baby boomer population is a key driver of demand (Exhibit 7, page 5). Each day roughly 10,000 people turn 65 in the United States, which will occur every day for the next fourteen years.[3] Baby boomers will need investment solutions to provide for retirement—that is, assets with characteristics such as lower volatility return streams, some measure of capital preservation during negative market environments, and diversification. Liquidity, transparency, and fees will also play an important role in their investment decisions and we believe liquid alternative funds will be a solution that is increasingly part of the asset allocation decisions for millions of Americans.

Conclusion

We believe an allocation to liquid alternatives can benefit investors by providing greater portfolio diversification, stronger risk-adjusted returns, and protection from drawdowns. Liquid alternatives can serve as a core holding for investors with low risk tolerances and, unlike their hedge fund peers, have the added benefit of daily liquidity and increased transparency. Over the last five years assets in liquid alternatives have grown significantly and this is expected to continue. Demographic trends imply that the millions of individuals are reaching the threshold of retirement age, where an allocation to non-traditional investments in transparent vehicles represents a sensible solution.

Exhibit 7

Population 65 Years and Over Is Expected to Grow Significantly



As of December 2014

Source: Haver Analytics, US Census Bureau

Notes

1 For the purposes of this paper, liquid alternative funds are described in the 40-Act US mutual fund vehicle.

2 Source: Bloomberg

3 Source: Pew Research Center

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Published on 19 November 2015.

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