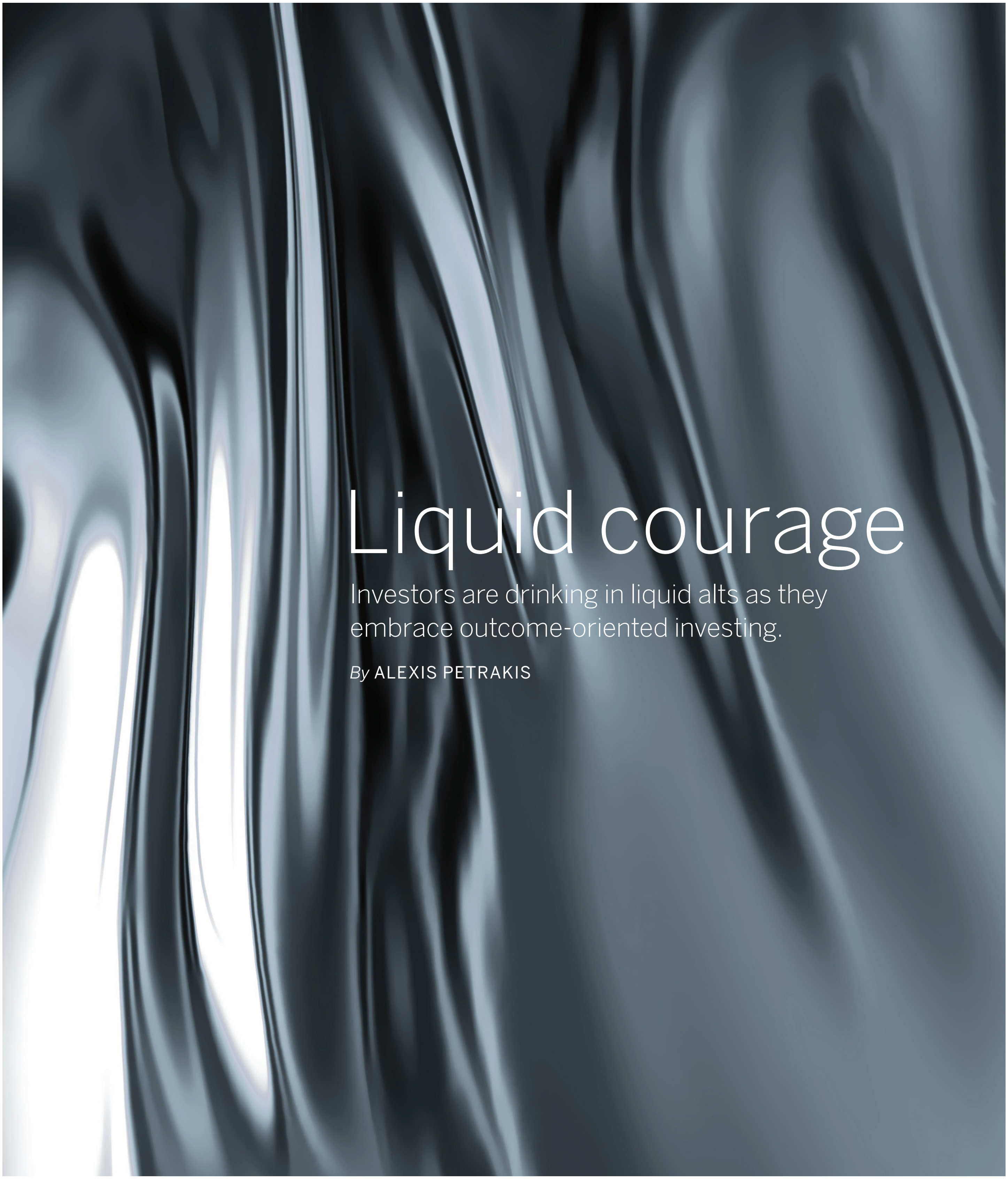

Liquid courage

Investors are drinking in liquid alts as they embrace outcome-oriented investing.

By ALEXIS PETRAKIS

RS Investments™

Rick Brandt is a portfolio manager at RS Investments.

"Simply put, liquid alts offer sophisticated strategies in a more regulated and transparent mutual fund."

IF YOU ASK THE AVERAGE RETAIL INVESTOR to make an allocation to "liquid alts," he or she might give a bemused look, or maybe even ask for a stiff drink. But if you ask that same investor if he or she wants to invest in a fund with the potential to capture equity market gains, but with lower volatility and a lower overall risk profile, that same investor may have a very different reaction.

Liquid alternatives (liquid alts) are mutual funds that employ any number of investment strategies that have historically been available only to institutional and high-net-worth investors. "Simply put, liquid alts offer sophisticated strategies in a more regulated and transparent mutual fund," says Rick Brandt, portfolio manager at RS Investments. "They offer the same daily liquidity as other mutual funds and are subject to the same regulations, so they can be available to more investors."

So why all the fuss around liquid alts? For one, they are seen as a potential means to address the myriad challenges facing investors today. Many investors are coming to the conclusion that conventional approaches to asset allocation and portfolio construction need to be re-evaluated. This rings true for both individual investors with looming retirement needs, as well as pension funds or insurance companies trying to match liabilities and meet the obligations to their constituents.

"We continue to see more and more investors shift their focus to 'outcome-oriented' approaches," says Pete Comerford, head of investment strategy and trading at RS Investments. "The traditional tactic of selecting products that fit into narrowly defined categories is being replaced by a search for products that target returns irrespective of any relative measures. Investors are shifting their focus from beating a benchmark to achieving a desired outcome."

This type of solutions-based approach is a trend that appears to have legs. In their 2014 Global Investor Survey of institutional investors and financial advisors worldwide, eVestment and Casey Quirk[1] reported a continuing shift toward the "implementation of outcome-oriented investing, as the asset allocation and buying behavior of investors continue to diverge at an accelerating pace. This reflects the long-term desire of asset owners worldwide to design policy allocations around specific objectives, which differ from investor to investor."

1 Casey Quirk is a management consultant that focuses solely on advising investment management firms.

eVestment delivers insight and intelligence to the institutional investing community through a comprehensive, global database and cloud-based analytics.

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John Tilney is head of product development at RS Investments.

Desperately seeking solutions

The outcome-oriented approach may be spearheaded by institutional investors, but it's also something that financial advisors and individual investors are heeding. Momentum has been building in the liquid alts category, though some might argue that Wall Street is actually bingeing on these funds. According to data from Morningstar, liquid alts funds have grown from $36 billion in assets in October 2008 to approximately $215 billion as of October 2014.

"That type of explosive growth seems to be driven by a notion that investors are not getting what they need from traditional portfolio allocations," suggests John Tilney, head of product development for RS Investments and an analyst on the growth team. "Of course any time an asset class attracts so much capital so quickly, investors would be wise to do deep due diligence on individual managers and funds."

The potential benefits of any liquid alts fund will vary depending upon the strategy employed and, of course, the manager's skill. With that caveat, what are some of the benefits of different types of liquid alts funds? Some target higher absolute returns, presumably with higher commensurate risk reflecting the use of derivatives or investing in illiquid asset classes. Others pursue equity-type returns with less risk or diversify stock and bond portfolios.

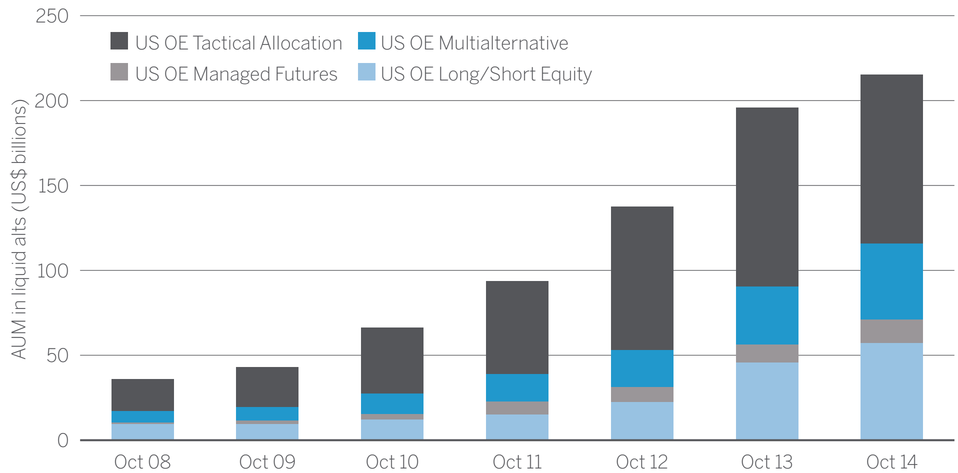
Still others help preserve capital without adding to fixed income exposure. In the appropriate circumstances, liquid alts strategies may be able to address any number of investor needs.

"Liquid alts managers have a great deal of discretion and a more diverse toolbox at their disposal to execute their investment strategies," explains Brandt. "They are not as constrained as equity-focused mutual funds and thus can offer potentially better risk-adjusted returns in certain markets if they execute properly."

One of the most important tools used widely in liquid alts funds is the ability to sell short, which allows a manager to profit if the price of a security declines. This can be especially valuable in falling market environments and offers a chance to hedge some risk from the long-only approach employed by traditional mutual funds. By contrast, in a rising market environment, risk-hedging may lead to somewhat lower returns. On balance, however, risk-hedging seeks to improve overall risk-adjusted returns over a full market cycle.

THE LIQUID ALTS SPIGOT IS ON (October 2008—October 2014)

The growing popularity of liquid alts funds is evidenced by fund flows.



Source: Morningstar.

> "Used effectively by a skilled manager, these tools may offer an array of *potential* benefits that can help investors home in on desired outcomes."

The use of leverage[2] and the ability to access unconventional, even arcane, asset classes are other approaches employed by liquid alts managers. Used effectively by a skilled manager, these tools may offer an array of *potential* benefits that can help investors home in on desired outcomes. As always, there are never any guarantees and the effectiveness of various liquid alts strategies may vary depending on the market environment.

The question of skill is no small matter, especially when considering how many investment managers new to liquid alts are implementing strategies. Some long/short approaches aim to generate alpha[3] by shorting equities, which is very challenging given the simple fact that historically the overall market has gone up more than down. It's more expensive to short stock, and trying to add value on the short side is very difficult due to a host of other reasons. A smarter approach, according to Brandt, may be to short stocks as a means to reduce exposure to market risk factors, while using the long side of the portfolio to try to capture alpha. Failure to make this one distinction could impede the ability of a long/short fund to produce the desired results.

2 Liquid alts mutual funds are still subject to the constraints on leverage and use of derivatives set forth in the Investment Company Act of 1940.

3 Alpha (annualized) is a statistical measurement used to quantify the value added or subtracted by a portfolio manager. Specifically, alpha measures the portfolio's actual return against the portfolio's expected return given the risk of the portfolio as defined by its beta.

All-weather approach?

For many investors, one of the most appealing types of liquid alts strategies is a hedged equity approach that uses both long and short positions in an attempt to deliver positive outcomes in both rising and falling market environments. Typically, hedged equity strategies (also known as long/short funds) will have positive exposure to equity markets along with some percentage of assets apportioned to shorting stocks. The goal is to maintain exposure to rising stock prices while aiming to provide some level of downside management. The resulting overall portfolio will thus not have full exposure to all the risk of a long-only fund.

"By their very construct, many long/short or other hedged equity strategies will not deliver the entire upside in any bull market run," explains Brandt. "However, they are built to outperform when volatility returns and markets are struggling. Given where we are now, with the equity markets having been on a strong run for six years, that's something investors might consider when making investment decisions."

New tools, new benefits

Because of their expansive toolkit and diversity of approaches, liquid alts are gaining traction thanks to an attractive array of potential benefits. These might include:

> An ability to lower the overall risk of a portfolio and smooth returns over time

> Improved diversification and returns with lower correlations to other asset classes

> Potential increased effectiveness in a wider variety of market environments

> Ease of access with lower minimum investments as compared to hedge funds

> Daily liquidity and potentially greater transparency than typical hedge funds since liquid alts funds must report positions quarterly, the same as any other mutual funds

The growing popularity is evidenced by both investor attitudes and asset flows, and as a result liquid alts are assuming a larger role in modern-day portfolio construction. But given the individualized nature of any solutions-oriented approach, not to mention the potential for risk diversity within the liquid alts category, there is no single model portfolio for investors to follow. Typical recommendations for incorporating liquid alts into a portfolio vary widely, though some questions remain regarding whether a cursory 5% allocation will be enough to effect a desired outcome.

The “F” word

As with any asset class attracting a great deal of capital, investors must pay close attention to expenses and fees. For example, the nature of borrowing stock to execute short strategies or trading in less liquid securities will result in higher costs than the average plain vanilla large-cap equity mutual fund. That’s a given. But at the same time, investors should evaluate whether the potential performance and other benefits of a liquid alts fund are appropriate relative to the fees charged. In many cases this may prove to be an attractive trade-off. In addition, it’s important to remember that the fees associated with liquid alts may be higher than those of traditional mutual funds, but they are likely much lower than the compensation structure associated with hedge funds.

Investor scrutiny also needs to go beyond analyzing fees, especially given the proliferation of funds in this space. Some liquid alts managers may be entering this arena with limited experience managing and distributing mutual funds. Investors would be well-advised to investigate each manager’s track record. Does the manager have experience in the strategy and the infrastructure in place to handle daily flows? These are just some of the hard questions investors should be asking before allocating capital to any liquid alts manager.

Although alternative investment strategies may not be for all investors, they are no longer the exclusive domain of institutions and high-net-worth individuals. In fact, liquid alts can be invaluable building blocks for investors who are updating their portfolios and adopting an outcome-oriented investment approach. As ever, education and careful manager selection are of paramount importance. RS

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