Are You Ready for an Alternative?

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KLINGENSTEIN FIELDS
WEALTH ADVISORS

Introduction

The use of alternative investments has increased dramatically in recent years. Once largely restricted to sophisticated institutions and accredited individuals, alternatives are now relatively commonplace in the portfolios of both wealthy and mass affluent investors. Alternatives have even been added as investment options to an increasing number of 401(k) and other qualified retirement plans.

The widening acceptance of alternatives has been driven by investors' need for protection from significant market downturns, as well as their desire for better returns in a protracted low interest rate environment. Experience has shown that an allocation to a carefully selected mix of alternatives can significantly improve the risk/return profile of a portfolio of traditional stock and bond investments helping smooth volatility, improve returns, and contain losses in adverse markets.

In recent years, providers of alternative products have made access much easier for individual investors. Most notably, a growing number of investment management companies have introduced Liquid Alternative funds that package alternative investment strategies in a mutual fund structure. These products are highly regulated, offer daily liquidity, and are available at lower minimum investment amounts, eliminating many of the traditional barriers to the direct purchase of alternatives.

The popularity and ready availability of alternative investments have raised the question for many investors of whether an allocation to alternatives is advisable for them. This paper is designed as a first step in helping investors answer this question by introducing readers to alternative investments, explaining what they are, and what different types are currently available in the market. It highlights the principal characteristics of alternatives relative to traditional investments, including the risks, and explains how they are used and what benefits they offer. Finally, it examines the available options in purchasing alternative investments with particular focus on publicly traded liquid alternative mutual funds.

What is an Alternative Investment?

Simply put, an alternative investment is an investment product other than so-called *traditional* investments, which are generally considered to include stocks, bonds or cash in an unleveraged portfolio.

There are a wide variety of alternative investments, each of which is distinguished by the type of security purchased and/or the strategy used to trade it. The table below identifies the investments that are typically included in the alternative universe.

Alternative Investment Strategies

Hedge Fund Strategies		
Opportunistic Equity	**Enhanced Fixed Income**	**Absolute Return**
Long/Short Equity	Distressed Securities	Equity Market Neutral
Global Macro	Global/ Emerging Market Debt	Convertible Arbitrage
Short Equity	Structured Credit	Fixed Income Arbitrage
Long/Short Specialty	Long/Short Credit	Statistical Arbitrage
Long/Short International	Leveraged Loans	Event Driven
	Loan Origination	Managed Futures

Private Strategies		
Real Estate	**Private Equity**	**Energy & Natural Resources**
Long/Short REIT	Early Stage Venture	Long/Short Energy
Real Estate Partnerships	Late Stage Venture	Exploration & Production
Infrastructure	Growth Capital	Midstream Energy
	PIPEs	Services & Technology
	Buyouts	Commodities
	Distressed	
	Secondaries	

Hedge funds are investment vehicles, often structured as limited partnerships or LLCs, which pool capital from a number of investors to invest in securities or other instruments. As the table suggests, hedge funds employ a wide variety of different strategies to achieve their objectives. Unlike mutual funds, hedge funds are not closely regulated by the government, and as a result are permitted more latitude in their trading practices. For example, they may build more concentrated portfolios, utilize more leverage, or take larger short positions. Different hedge fund strategies tend to target different return rates and/or degrees of risk management. In this regard, they differ from traditional investments whose performance is typically measured against commonly accepted market benchmarks such as the S&P 500 or the Barclays Aggregate Bond Index.

Private strategies are investments in real assets including real estate, non-public companies or commodities. These investments may be made directly or through pooled vehicles such as limited partnerships or LLCs. Examples include Real Estate Investment Trusts (REITs) or Venture Capital Funds.

Alternative investments are often viewed from the standpoint of their contribution to an overall portfolio that includes traditional investments as its core. From this perspective, alternatives generally fall into one of two broad categories: *risk reducers* (or portfolio diversifiers) or *return enhancers*. From the table on the previous page, Absolute Return, Real Estate and selected Energy and Natural Resource strategies are typically used as risk reducers. Because these strategies do not depend on the

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direction of stock and bond markets for their returns as do traditional investments, their addition to a portfolio can often reduce the risk of all portfolio holdings suffering similar losses at the same time. In contrast, Opportunistic Equity and Private Equity are generally considered return enhancers. These investments are influenced by many of the same factors that drive the public markets so they are not the best portfolio diversifiers. But, for a variety of reasons, these strategies can often contribute higher than market returns at similar or lower risk levels.

Needless to say, in selecting alternative investments, it is important for investors to fully understand the strategy that is being considered, the risks taken and the returns that may be expected. It is equally important to view these elements with regard to the role the investment may play in the investor's overall portfolio.

The Role and Benefits of Alternatives

In broadest terms, alternative investments offer the potential to lower risk and enhance returns when added to a portfolio of traditional assets. Since they tend to derive their returns from different sources or in different ways, alternatives are often able to balance the return patterns of traditional investments thereby lowering volatility and improving overall results. To understand how this works, it is necessary to examine the basic concepts of diversification and correlation in the context of portfolio construction.

Diversification and Correlation

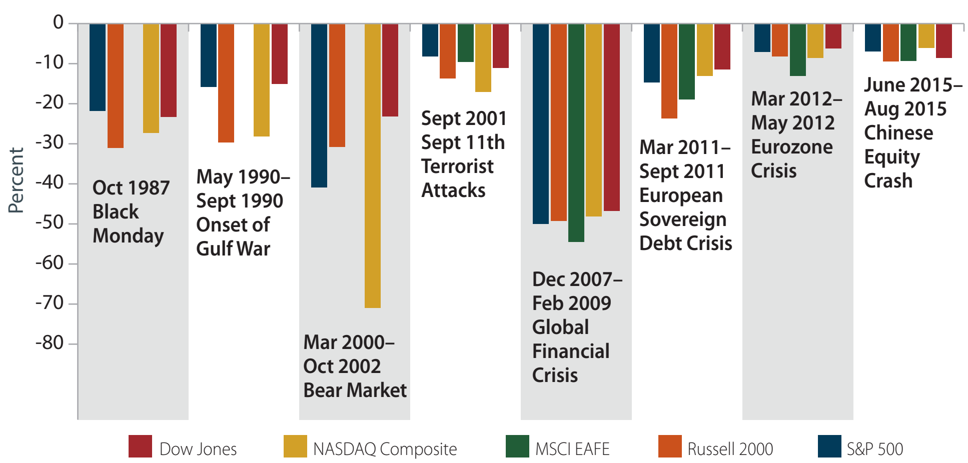
Most of us are familiar with the old adage, "Don't put all your eggs in one basket." This warning alerted us to the danger of catastrophic loss if something adverse should happen like dropping the basket or having it stolen. On the other hand, if we spread the eggs around in multiple baskets, the likelihood of serious loss due to some particular negative circumstance is significantly diminished.

This principle applies as well to investing. Instead of buying a single security or a handful of similar securities, prudent investors more broadly *diversify* their holdings. They may, for example, systematically buy a mix of securities that represent multiple industries or spread holdings across companies of various sizes or in different geographic regions. Indeed, the mutual fund was created largely to make diversified portfolios available at smaller minimum investments to a broader swath of the investing public.

As portfolio design became more sophisticated, investors added fixed income securities of various types, as well as international and emerging market equities to US domestic equity portfolios to improve diversification. This approach worked reasonably well, but over time has proven to have some serious shortcomings.

Historically, in periods of extreme market stress, many of the asset classes in traditional investment portfolios tended to react similarly. Large and small capitalization domestic stocks, international stocks, and sector stocks all dropped in near unison. It was as if most of the eggs in many investors' portfolios were all back in the same basket again. As a result, investors who thought they were adequately diversified and thereby protected from substantial loss, suffered serious losses anyway.

High Correlation of Equity Markets in Periods of Recent Crisis

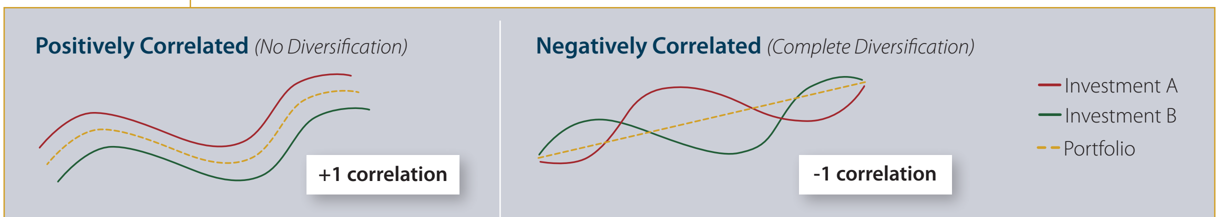


Source: Dow Jones, MSCI, NASDAQ, Russell Investments, Standard & Poor's

The chart above shows how close the alignment of returns has become in market downturns. The latest and most extreme example is the financial crisis of 2007-2009. During that period, broad market indices representing US large cap stocks, US small and mid cap stocks, and international stocks all fell by between 45% and 55%. Diversification among traditional assets in these circumstances did not appear to materially lower risk or prevent near catastrophic loss.

In investment parlance, the problem was a long-term secular rise in the correlation across traditional asset classes. Correlation is a measure of how the returns of two investments move together, that is to say, whether their returns move in the same or opposite directions and how closely they do so. Correlation is measured on a scale of -1 to +1. When assets move in the same direction, proportionately and at the same time, they are perfectly positively correlated (+1). When one asset moves up as another goes down, they are negatively correlated (-1).

A portfolio consisting of investments that are highly correlated suffers from higher risk due to lack of diversification – all eggs in one basket. This was the problem for many investors when correlation of traditional asset classes rose dramatically in the financial crisis. The solution to this risk mitigation challenge is to find investments that are less correlated with traditional investments or even negatively correlated.



Alternatives may be the answer. Since alternatives utilize different strategies than traditional investments or invest in different types of things, the returns of alternatives can vary significantly from traditional investments. In other words, market forces that determine values in the traditional stock and bond markets do not necessarily influence alternative investments in the same way or to the same degree. This tends to lower the correlation of alternative investments with traditional investments.

Historical Correlations: 12/2005 to 12/2014

	Bonds	Cash	Commodities	Dedicated Short Bias	Equity Market Neutral	Event Driven	Global	Hedge Fund	International Equity	Long/Short Equity	Managed Futures	REITs	S&P 500
Bonds	1.00												
Cash	0.06	1.00											
Commodities	-0.01	0.24	1.00										
Dedicated Short Bias	0.24	0.54	-0.11	1.00									
Equity Market Neutral	-0.17	0.16	0.68	-0.37	1.00								
Event Driven	-0.16	0.01	0.60	-0.65	0.70	1.00							
Global	-0.57	-0.12	0.52	-0.59	0.81	0.79	1.00						
Hedge Fund	-0.13	0.14	0.68	-0.58	0.86	0.94	0.83	1.00					
International Equity	-0.34	0.12	0.63	-0.61	0.84	0.93	0.91	0.96	1.00				
Long/Short Equity	-0.35	0.13	0.62	-0.60	0.82	0.91	0.90	0.97	0.96	1.00			
Managed Futures	0.26	0.18	-0.62	0.32	-0.57	-0.53	-0.58	-0.46	-0.59	-0.44	1.00		
REITs	0.04	-0.22	0.15	-0.56	0.62	0.65	0.63	0.68	0.65	0.59	-0.20	1.00	
S&P 500	-0.35	-0.24	0.47	-0.77	0.84	0.83	0.93	0.88	0.89	0.90	-0.53	0.73	1.00

- Barclays US Agg Bond TR
- Barclays US Treasury Bill 1-3 Mon TR
- S&P GSCI TR
- Credit Suisse Dedicated Short Bias
- Credit Suisse Equity Market Neutral
- Eurekahedge Event Driven HF NR LCL
- BofAML Global Market TR
- Credit Suisse Hedge Fund
- MSCI EAFE GR
- Credit Suisse Long/Short Equity TR
- Credit Suisse Managed Futures
- MSCI US REIT GR
- S&P 500 TR

Source: Barclays, Standard & Poor's, Credit Suisse, Eurekahedge, Bank of America, MSCI, Klingenstein Fields Wealth Advisors

The table on the previous page shows the correlation of returns of different investments or asset classes. It is clear that many types of alternatives such as commodities, short bias and market neutral equities, and managed futures historically have had low or negative correlation with the broad US or International equity markets and may work well as portfolio diversifiers. These same alternatives, as well as REITs, long-short equities and event driven also have had low or negative correlation with traditional long only bonds, helping to diversify a more balanced equity/bond traditional portfolio.

Lowering Volatility

Alternatives may lower risk when working as portfolio diversifiers by lowering the possibility that market conditions that negatively impact one type of investment will impact the whole portfolio in the same way and to the same degree. But some alternatives may also be less volatile than traditional investments on a standalone basis. Adding alternatives to a traditional portfolio, then, may help lower the volatility of the overall portfolio, create a more consistent return pattern, and ultimately improve long-term results.

Risk Table Annualized (July 2000-August 2015)

	Compound Annualized Return	Standard Deviation Annualized	Sharpe Ratio*	Sortino Ratio*
Eurekahedge** Fixed Income Hedge Fund Index	8.38%	3.73%	1.844	1.840
HFRI Equity Hedge (Total) Index**	4.70%	8.14%	0.394	0.394
HFRX Absolute Return Index**	2.18%	3.18%	0.218	0.222
S&P 500 Index	2.48%	15.00%	0.066	0.066
Vanguard Long Term Bond Index	7.40%	9.50%	0.628	0.628

*Sharpe and Sortino ratios measure investment return per unit of volatility or risk. Higher numbers indicate greater return levels for the risk taken.
**Eurekahedge (a subsidiary of Mizuho Bank) and Hedge Fund Research (HFR) are established leaders in providing hedge fund data and indices to the investment community.

Source: Eurekahedge, Hedge Fund Research, Standard & Poor's, Vanguard, Klingenstein Fields Wealth Advisors

Standard deviation is a measure of volatility, that is, how often and to what degree returns in an investment go up and down. The Sharpe and Sortino ratios are measures of return relative to volatility. The Sharpe ratio measures return per unit of volatility (or the risk taken) while the Sortino ratio measures return per unit of downside volatility. In other words, each ratio is quantifying how much return an investment provides relative to how much risk it takes.

It is clear from the chart that in the period shown, equity hedge funds and absolute return funds had return rates that were higher or near the rate of the S&P 500 traditional stock benchmark. But the returns of these alternative funds were achieved at significantly lower levels of volatility. Indeed, the standard deviation of the Absolute Return Index was just one-quarter that of the S&P 500. At the same time, the Sharpe and Sortino ratios for these alternative indices were multiples higher than similar ratios for the S&P 500 indicating that the alternative investment provided substantially more in returns for the amount of risk taken.

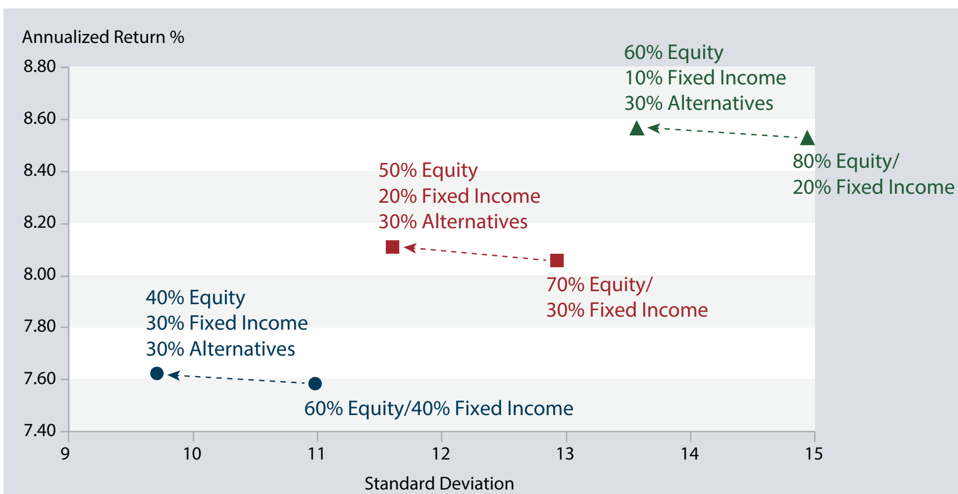
What it All Means

Because of the distinct performance characteristics of alternative investments and how they compare to those of traditional investments, the careful addition of an allocation of alternatives to a typical portfolio of traditional investments may substantially improve overall outcomes.

The table below illustrates what an allocation to alternatives of 30% in a portfolio of traditional investments can do over time to the relative risk/return profile of the portfolio overall. Three typical traditional portfolios with varying stock and bond allocations (60/40, 70/30, and 80/20) are examined. In each case, adding alternatives to the portfolios increased the overall returns while at the same time reducing the risk taken (shown in the chart as standard deviation). Thus, for example, the annualized return of the traditional 60/40 portfolio was 7.59% with a risk measure of 11.00%. Adding an alternative allocation of 30% to the portfolio increased the annualized return to 7.63%, while reducing risk to 9.70%.

The Value of Adding Alternatives to an Asset Allocation Strategy

Improved Performance for Portfolios That Add Alternatives



Source: Klingenstein Fields Wealth Advisors, Standard & Poor's, Barclays, Eurekahedge
Equities are represented by the S&P 500 Index; Fixed income is represented by the Barclays US Aggregate Bond Index and Alternatives are represented by the Eurekahedge Hedge Fund Index.

Naturally, the constitution of an investor's existing traditional portfolio and the mix of alternative investments that are selected as diversifiers or return generators will impact the overall results. However, the utilization of alternatives may allow investors to better manage risk and to more effectively target returns to meet their needs.

Understanding the Risks and Challenges of Alternative Investing

Popular media has often given a distorted picture of the risks inherent in alternative investments. Outsized losses in some hedge funds like Long Term Capital Management, Amaranth Advisors or, most notoriously, Madoff Investment Management, have led many investors to question the safety of all alternatives and have dissuaded them from investing in markets or instruments that are not fully transparent and closely regulated.

However, these disastrous examples resulted from managers taking on excessive risks or complete fraud, and a broader examination of performance results of alternative investments paints a different picture. In general, there is a reasonable balance in most alternative markets between risk and return, and, while there are wide variations in talent among managers, the vast majority are reputable and manage assets as prescribed in offering documents. Nonetheless, alternative investments do have distinctive risks that should be clearly understood as should the unique challenges of investing in alternatives.

Risks

Neither hedge funds nor private equity investments are highly regulated by government agencies. This is because they are typically sold as private placements and their sale is restricted to investors that are considered wealthy enough to withstand a loss of the investment. These higher net worth or institutional investors are also generally deemed more sophisticated by governmental bodies, and therefore able to perform more rigorous due diligence on private placement opportunities.

> *Alternative investments do have distinctive risks that should be clearly understood as should the unique challenges of investing in alternatives.*

The reduction in oversight allows managers to limit their public disclosure of holdings and investment practices leading to less transparency in many alternative investments than would be the case in more regulated vehicles such as mutual funds. Less transparency may make it more difficult, in some instances, for investors to assess trading strategies, the level of diversification in a portfolio, specific holdings or other factors that might be relevant to a reasoned investment decision.

Certain types of hedge funds and other alternative investments have tended to invest in underlying securities with higher risk than would be incurred in traditional long-only stocks or bonds. Such securities may include high yield bonds, distressed securities, and derivatives based on subprime mortgages or other lower rated instruments.

Hedge funds may also incur greater risk either from an increased use of leverage or from significant short-selling. Borrowing on holdings to boost returns can magnify losses beyond available capital if investments unexpectedly decline. Similarly, losses incurred in an ill-advised short-selling play (if the short position is not directly hedged by a long position) can be significant.

Other Issues

Besides unique risks, there are other characteristics widely shared by alternative investments that have tended to restrict wider use.

Historically, direct investment in alternatives has been largely confined to institutions and accredited or high-net-worth individuals. Only recently have alternatives been made available in structures accessible to the broader investor market.

Many alternative products have also been less liquid than public securities, requiring, at times, substantial "lock up" periods when investments are unavailable for resale or trade, and access to their cash value is restricted.

Because of the focus on high-net-worth investors, minimum investments have tended to be high. Many alternative products have also been less liquid than public securities requiring, at times, substantial "lock up" periods when investments are unavailable for resale or trade, and access to their cash value is restricted. Markets for some alternative investments may be relatively illiquid such as for real estate or some commodities, potentially limiting the ability to quickly sell assets if needed.

Finally, the limited regulatory framework covering alternatives may lead to higher prices. While fees in some cases have declined, many hedge funds still charge substantial management and performance fees, reducing the potential investment gains due to the investor. Typical performance fees cluster around 20%.

With the rising interest in alternatives, distributors and managers of these products have searched for ways to make them more accessible and acceptable to a broader segment of the investing public. The most prominent development in this effort has been the introduction of the Liquid Alternative.

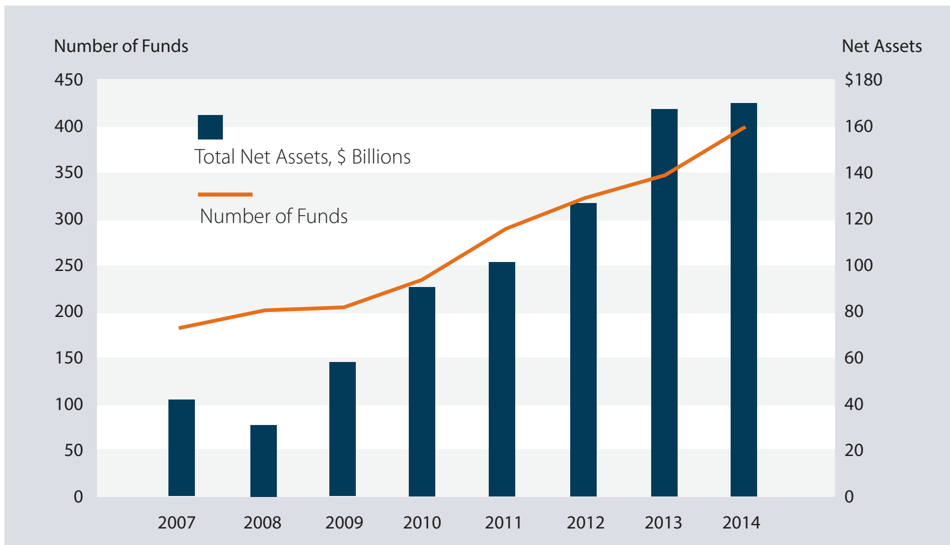
The Rise of Liquid Alternatives

Liquid Alternatives are alternative investment vehicles housed in a mutual fund structure and registered with the SEC under the Investment Company Act of 1940 (the "40 Act"). This is the law that embodies the regulatory framework for mutual funds in the United States. Liquid Alternatives are designed to mimic the risk/return and correlation profiles of non-liquid alternative strategies. But at the same time, these products are regulated by the SEC and offer the features of mutual funds. Among these features are daily pricing and liquidity, transparency, lower minimum investments, and 1099 tax reporting.

Liquid Alternatives are more restricted than normal alternatives with regard to the use of leverage and short-selling. They also have to provide daily liquidity for redemptions and calculate a daily price per share. As a result, some alternative strategies are more amenable than others to being offered as liquid. The primary strategies currently employed in Liquid Alternatives include global macro, long-short equity, and managed futures. Private equity, venture capital, timberland, infrastructure and merger arbitrage are less viable.

Liquid Alternatives address most of the structural hurdles limiting use of alternatives by individual investors, and they address many concerns about regulatory risk and transparency. As mutual funds, the fees of Liquid Alternatives also tend to be lower than direct alternatives with fewer instances of layered performance fees.

Liquid Alternative Mutual Funds: An Increasingly Important Asset Allocation Tool



Source: Investment Company Institute

The benefits of Liquid Alternatives have not been lost on individual or institutional investors. Liquid fund assets have grown substantially in recent years as has the number of fund options. Indeed, new Liquid Alternative funds are being introduced at a rate of about 50 per year.

Multi-Strategy Liquid Alternatives

Among the most popular of Liquid Alternatives are Multi-Strategy Funds. These funds are essentially funds of hedge funds combining a range of alternative strategies in one package.

Multi-Strategy alternative funds provide all the benefits of a 40 Act mutual fund including close regulatory oversight, transparency, competitive pricing and liquidity. But they also offer investors the added value of professional management in selecting the best underlying hedge fund managers and integrating their various strategies into a balanced and diversified portfolio.

Most leading Multi-Strategy funds have developed rigorous and in-depth due diligence processes to identify the strongest performing hedge fund managers in each strategy. After being selected for the fund, a hedge fund's performance is typically closely monitored. If expectations are not met or if circumstances change for the hedge fund manager that cloud future return expectations, hedge fund managers may be terminated. The performance of alternative fund managers can vary widely. It is, therefore, critically important that investors access a manager selection and oversight function that is vigilant and capable.

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Multi-Strategy funds also benefit from the experience of professionals in properly constructing balanced portfolios as well as shifting portfolio allocations across strategies when market conditions warrant.

Overall, Multi-Strategy funds can be an efficient and effective way for investors to get exposure to a prebuilt, regularly monitored, and intelligently diversified portfolio of alternative strategies.

Conclusion

Alternative investments may be an attractive option for investors who wish to improve the risk and return profiles of their traditional stock and bond portfolios. Experience has shown that alternatives can be effective portfolio diversifiers helping to mitigate portfolio risk. The impact of alternatives may be especially valuable in periods of extreme market stress when correlation in the returns of traditional asset classes is at its highest. Alternatives have historically also been shown to enhance returns across market cycles by investing in a wider range of asset types or by employing investment strategies beyond traditional long-only investing.

Once largely restricted to institutions and so-called accredited individuals, new product structures including Liquid Alternatives have made alternatives more accessible to a wider audience. Due to their mutual fund structure, Liquid Alternatives have also helped to address issues of transparency, oversight, cost, valuation and liquidity that have historically prevented investors from moving beyond traditional investments.

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