The Four Essential Things Successful Advisors Need to Know About Alternatives

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By now, every Advisor knows the benefits gained by diversifying a client's portfolio across all asset classes. Unfortunately, as many Advisors are now keenly aware, diversification across the three main asset classes (stocks, bonds and cash) only works to the extent their returns are uncorrelated. In 2008, it seemed as though everything was correlated – and correlated in one direction: down. As a result, Advisors are increasingly in search of a portfolio allocation that provides true downside protection – even in years like 2008 - while still allowing for participation in upward market moves. This conundrum – how to protect wealth while allowing for growth – is one of the most important issues currently facing investors. For decades, pension funds, endowments, foundations and others have used alternative investments as a solution to this problem. Advisors are demanding alternatives in increasing numbers and the industry has responded, creating sophisticated solutions tailored to Advisor needs.

Alternatives, and the tools available to understand and analyze them, are more accessible than ever. Moreover, the benefits these strategies can provide are more important now than ever. However, prior to implementing alternatives, Advisors need to consider four questions:

1) What are the different types of alternative investments?

2) How do I implement alternative strategies?

3) How much should I allocate to alternatives?

4) What should I look for in a manager?

Alternatives are not a recent phenomenon. Institutions have used them for decades and are increasingly implementing alternatives as their benefits become apparent. Family offices and other investors are increasingly incorporating alternatives as well. However, though not new, alternatives are complex. Successful advisors must understand what they are and how to use them both at the individual investment level as well as the portfolio level. The complexities may seem overwhelming, but they are manageable. In this report, we'll take a look at each of these issues, providing you with some of the information used by today's most successful advisors as part of their investment decision process.

1. What are the Different Types of Alternatives?

First, advisors need to understand what alternatives are and the role they play in portfolios. There are a tremendous variety of styles and asset classes that can be categorized as "alternative". Each can play a very different role in one's portfolio.

At the outset, it is important to distinguish between an alternative security and an alternative strategy. It is hard to say with precision exactly what an alternative security is, but one can define it by what it is not: namely, an alternative security is not something that has historically been accessible to the individual investor. Examples include stocks that trade on exchanges, bonds issued by corporations, municipalities or sovereign governments or cash equivalents normally found in the form of time deposits or money market funds.. Alternative securities include real assets such as gold, oil and real estate as well as securities whose value is determined by the price of another security, such as an option or a futures contract. The most common types of alternative securities include:

- REITS
- Options
- Futures
- Swaps
- Over the counter (OTC instruments
- Commodities
- Currencies
- Master Limited Partnerships (MLP's)

Alternative Strategies, on the other hand, may invest in traditional asset classes such as stocks, bonds and cash. However, they utilize non-traditional techniques in managing their portfolios, such as hedging, leverage and short selling. Some target an explicit level of absolute returns rather than simply trying to beat a traditional benchmark. Typical examples of alternative strategies include:

- Long/Short
- Risk/Merger
- Market Neutral
- Convertible Arbitrage
- Sector Focus
- Event Driven
- Real Estate
- Managed Futures
- Private Equity and Venture Capital

Broadly, each type of alternative security and alternative strategy presents a very unique set of risks and rewards. For example, most private equity strategies may be illiquid, require subsequent capital investments and operate at a loss for a period of years. Convertible arbitrage strategies may require substantial leverage to exploit tiny price inefficiencies in order to generate returns – if the price differentials do not behave as expected, leverage can substantially amplify capital losses.

Morningstar has decomposed the alternative strategy universe into 10 different subcategories, much as it decomposes the US Equity universe into nine style boxes. Morningstar created its first alternative category in 2007 with the creation of a Long/Short style group. This group cast a very wide net,, as Morningstar puts it, serving as "…a broad catch-all for anything 'alternative' that sought to hedge risk or generate an absolute return."1 In 2009, the firm added a Currency category followed by Market Neutral in 2010. In June of 2011, Morningstar added three new alternative categories: Managed Futures, Multi-Alternatives (also known as Multi-Strategy) and Long/Short Equity. The new categories also include alternative exchange traded funds (ETFs) as well as actively managed strategies. This expansion in categories mirrors the democratization of alternative strategies. At one point these approaches were available almost exclusively to institutional and ultra-high net worth investors. Today, they are available to all.

The Morningstar Categories Explained:

Bear Market: As its name implies, these strategies are dedicated to short positions in the equity markets. If the market declines, these strategies should profit. However, short selling exposes investors to tremendous risk. Potential gains are limited to the difference between the price of the stock and zero whereas losses are potentially infinite. Moreover, as John Maynard Keynes once said, "the market can be wrong longer than you can be solvent" – even if the investor is absolutely correct in her appraisal that a stock might fall, it can rise indefinitely. In an attempt to mitigate this risk, many managers invest the proceeds of their short sales into low risk assets such as cash or take long positions in equities. Funds in this category are typically 60-85% short the market, though can be 100% short or greater. While these strategies may be appropriate to hedge exposure to equities, they can be tremendously risky.

[1] http://news.morningstar.com/articlenet/article.aspx?id=383066&pgid=rss

Currency: These strategies invest in currencies using money markets, derivatives, swaps, options and cash.

Long-Short Equity: Created in 2007, this is the most tenured - and broadest -Morningstar alternative category. It includes all managers that hold both long and short equity positions. Some members of this group may use macroeconomic data to increase or decrease the ratio of long to short positions. Others use short selling as a means of eliminating market risk from the stocks they buy, seeking to eliminate beta (market related risk) while generating alpha or excess return. Typically, 75% of the assets in these strategies are in equities or equity derivatives.

Long-Short Debt: These strategies take long or short positions in debt securities but do not necessarily take offsetting positions. Some members of this group may invest in emerging markets, US or other debt securities. Subsets of this group include mezzanine financing and debtor-in-possession strategies.

Market Neutral: By offsetting long positions with short positions, these strategies attempt to eliminate or significantly minimize market risk from their portfolios. By minimizing exposure to factors such as style, country, or market risk, these strategies typically seek to produce stable, consistent returns regardless of the direction of the broad equity markets. As one would expect, Market Neutral strategies exhibit very low beta exposure relative to the markets. The manager's ability to select outperforming securities and hedge market exposure is critical for success in this space.

Multi-Alternative: These funds provide exposure to multiple alternative managers or strategies. Though they may have some exposure to traditional approaches, they tend to invest the lion's share of their assets in alternative approaches. Additionally, Multi-Alternative managers may rotate their allocations to different types of strategies or managers based on their expectations for each particular subcategory.

Equity/Precious Metals: As its name implies, these strategies invest in companies that mine precious metals like gold, silver and platinum as a means of generating exposure to those commodities. Some do invest directly in the metals themselves. Of course, stocks issued by mining companies may not always track the price of the underlying commodities. Companies can be mismanaged or outmaneuvered causing their stock price to fall, even if their underlying commodities rise in price.

Managed Futures: These strategies invest in futures and other derivative securities. Many employ trend-following or mean-reverting approaches designed to take advantage of the tendency of prices to either follow a particular path or return to norms, respectively.

Volatility: Volatility strategies seek to exploit returns by trading on the expected volatility implied in options prices or the difference in volatilities between similar securities.

Trading Strategies: Finally, Morningstar categorizes a number of funds that are trading securities that are either leveraged or they short particular indices or asset classes. These funds are typically designed as ETF's. What's particularly important about them is that many re-price on a daily basis. Thus, even if the fund is 2 times leveraged to and index such as the S&P 500, its price will reset on a daily basis resulting in significant performance disparities from the underlying asset over time. In other words, a 2 times leveraged ETF will not necessarily produce twice the returns of the S&P 500 over the course of a month if the S&P itself rises.

A full description of Morningstar's categories can be found on their website under their methodology papers[2].

[2] http://corporate.morningstar.com/us/documents/MethodologyDocuments/MethodologyPapers/MorningstarCategory_Classifications.pdf

2. How Do I Implement Alternative Strategies?

Rather than following the traditional structure of putting implementation last, we feel it should follow immediately the discussion of categories. The reason? Different types of alternatives can have very different effects on a client's portfolio. In our experience, advisors begin using alternatives by using anywhere from one to three mutual funds rather than developing a sophisticated optimization model. Building an alternative allocation model from scratch is very time consuming and comes with a "cost" typically in the form of an opportunity cost related to delaying a decision. Moreover, the characteristics of certain alternatives may result in perverse optimization outcomes unless the advisor understands how alternatives work and how their risk/reward patterns may affect optimization routines. Also, time is of the essence- once the need for alternatives becomes apparent, delaying the implementation of the portfolio results in an opportunity cost. This is especially important in today's volatile markets.

When exploring implementation processes, advisors who are using alternatives effectively proceed through three stages. As in all aspects of their business successful advisors tend to methodically progress through the stages.

The Apprentice – understands all of the basics in the category and has a firm grasp on the needs of their clients including investment goals. The apprentice has learned to navigate the alternative space by matching portfolio goals with alternative investments. For example, a Market Neutral strategy may be best for a mandate that calls for a low correlation designed to increase a portfolio's ability to preserve capital and reduce overall risk. Another thing the apprentice does well is to make the most of their limited choices. They focus on broadly diversified funds or funds with multiple underlying strategies. As a result, Apprentice Advisors tend to select the Multi-alternative, Long/Short Equity and Market Neutral categories. It may surprise some that Managed Futures did not make the initial list. This is primarily due to the number of sub-categories making the space more suitable as your allocations grow.

The Journeyman – has successfully started using alternatives in their portfolio and now is actively expanding their search to include more esoteric strategies such as Arbitrage Funds and Managed Futures. They've also typically begun to add Long/Short debt and are considering additional funds within categories they have already filled, but with complementary strategies. In addition to realizing the investment benefits of alternatives in client portfolios, the Journeyman has also begun to realize how alternatives benefit their business. They've typically been able to separate themselves from their competition by attracting and retaining clients using alternatives.

Master – is a serious student of the alternative space. As with large endowments & foundations such as Yale's and Harvard's, Masters use alternatives as a "core" holding in portfolio. They have established their models and they actively hire and fire managers. Clients approach Masters based on their knowledge of the alternative space. With larger allocations, Masters are able to take advantage of a very wide variety of alternatives serving many different mandates. Masters typically employ a team of analysts that screen and monitor new products.

Regardless of your "alternative stage" it is important to remember the successful advisors start simply and then evolve as they gain access to additional information. Inevitably a question you should ask yourself is, "regardless of my experience level in regards to the categories, how much of the portfolio should I allocate to alternatives?"

3. How Much Should I Allocate to Alternative Strategies?

Alternative strategies have a long history of benefiting client portfolios. However, determining the right amount to allocate to alternatives can be tricky. Your client's personal predilections, objectives and risk aversion go a long way to determining what amount should be allocated. Moreover, as discussed earlier, the type of strategy is also critical in determining the appropriate size of the allocation.

Factors to consider in determining an allocation include:

- The type of alternative strategy: All alternatives are not the same. Some are highly volatile, others seek stable returns. Some hedge for inflation. Others are illiquid. For example, a 20% allocation to a Bear Market funds will have a very different impact on a client's portfolio than a 20% allocation to a Market Neutral fund.

- The strategy's transparency: How well do you understand what the strategy is invested in and what it is attempting to accomplish? What are the manager's goals? How well do you understand how the manager should perform in a given market environment? Does the strategy meet your client's goals?

- Liquidity: Some alternative strategies are highly illiquid. Thus, even if their risk/reward and correlation characteristics look compelling, tying up client assets in a portfolio with lockups and other restrictions might be problematic. Endowments, foundations and defined benefit plans typically have more predictable cash flows so liquidity may not be as important to them. Newer alternative strategies can offset this problem by providing ready liquidity.

That said, we can make some general observations:

1) Over 1/3 of Institutional respondents to a recent Morningstar Survey report that over 25% of their holdings are in alternatives.[3]

2) About 90% of the heads of family offices report that they will increase their allocations to alternatives, according to a piece in the June 15th, 2011 New York Times.[4]

3) According to a survey by Aon Hewitt, 21% of institutional respondents increased their allocations to alternatives in 2010, 19% expect to increase their allocations in 2011.

4) General Motors has allocated about 13.5% of its assets to hedge funds (a subset of alternatives), almost double the industry average of about 7%. [5]

Clearly, all types of investors are increasing their allocation to alternative strategies and are using them to play a variety of roles in client portfolios.

4. What Should I Look For In a Manager?

Top advisors know that choosing funds in the alternative space is somewhat different than choosing traditional funds. Three key considerations in selecting an alternative manager include:

1) *Overcoming a lack of fund track record* - One of the challenges all advisors face when allocating to alternative mutual funds is a general lack of data relative to traditional strategies. Style groups are relatively new and have short records. This is primarily due to the fact that the space is emerging. That said, alternatives have a long history in the institutional space and many managers

[3] Morningstar 2010 Alternative Investments Survey of US Institutions and Financial Advisors.

[4] http://dealbook.nytimes.com/2011/06/15/family-offices-look-to-add-more-hedge-funds/.

[5] *Pensions & Investments,* February 7, 2011.

have significant experience managing assets. Looking past a short track record and learning to interview managers and exploring their experience is a common skill set possessed by successful advisors (for the ten toughest questions we've ever been asked by an advisor call us at 1-866-361-1720).

2) *Categories, Strategies and Sub-Strategies Oh My!* - As discussed earlier in the paper defining the categories in the alternative space is somewhat easy but navigating through the various strategies to achieve a specific mandate can be very difficult. Top advisors develop an understanding of what the strategy is trying to achieve and then measure the strategy against those goals. Be sure you understand the strategy, understand how it has performed and should perform. Understand how it fits your client's needs and what benefit it will bring to the portfolio. Understand hidden risks such as leverage, liquidity and transparency. Know what the best-case and worst-case scenarios are for the strategy. By understanding the answers to these questions, you can be confident in your allocations and recommendations.

3) *Merchandising* - Finally, buy the steak, not the sizzle. Demand for alternatives has attracted a tremendous number of players. Today, there are more hedge funds than mutual funds. Some of these firms may be too large and cumbersome to successfully manage an alternatives platform. Some of the best players in the industry, however, are smaller firms. Firms that can be nimble and focus entirely on alternative strategies tend to outperform some of the largest firms in the industry, especially in this niche. A recent headline in Pensions & Investments says it all: "Small Managers outperform large managers."[6]

[6] Pension and Investments, Small managers outperform large managers, June 1st

Conclusion

Investors of all types are increasingly recognizing what some of the world's most sophisticated investors have known for many years: alternatives add value. This is more relevant now than ever before, especially given today's market turmoil. However, an understanding of how to answer The Four Questions (of Alternatives) will go a long way in helping you understand how to analyze, select and implement an alternatives strategy. Top advisors thoroughly understand the key elements discussed in this report which help them to navigate the numerous options available and choose the right allocation to fit their clients' needs. For additional research and information regarding this topic please call us at 1-866-361-1720.

About 361 Capital

361 Capital's mission is to create alternative investment vehicles that provide 7-day liquidity or better.

As Advisors struggle to implement alternative investments, 361 Capital leverages its long history working with institutions to provide solutions that impact client portfolios, reducing risk and providing the opportunity to make money in both up and down markets.

Furthermore, 361 Capital's products are designed with these four mandates in mind:

- Consistent Positive Return
- Low Correlation
- Low Volatility
- Investor Friendly Structure

Why should institutions be the only ones to benefit from alternative investments?

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