Understanding Alternative Funds

361 CAPITAL®

As alternative mutual funds proliferate, Morningstar faces a classification conundrum: How can single categories include funds with entirely different characteristics?

The question has deep implications for advisors, who will have to look beyond star ratings or past performance and get a deeper sense of an alternative strategy's inner workings before deciding whether it matches a client's objectives.

We don't dismiss Morningstar's value to the advisory industry. For years, its database and star rankings have helped guide advisors in seeking equity or bond funds for clients. But this is an easier task when it comes to long-only, traditional asset classes.

Funds in the U.S. large-cap value, or international small-cap growth category, for example, will have relatively similar characteristics, making long-term ratings of such funds a more appropriate gauge of fund quality.

When it comes to categorizing alternative funds, however, Morningstar faces an unenviable task, and one that doesn't provide easy answers or fixes. There's simply much more variance in the fund characteristics of alternative strategies than long-only funds.

Often, the fund objectives and risks are so entirely different, one could argue they don't belong in the same category at all. But where else should they be placed? And if funds are so different, how much value is there in comparing apples and oranges in a side-by-side comparison?

Morningstar's long/short equity category provides an example of the classification conundrum, though there are big differences in individual fund characteristics within other alternative categories as well. Within the long/short category, gross exposure ranges between 14% to 342%. Net exposures range from 14% to 137% according to data from Morningstar's database. Differences in beta are equally staggering, ranging from as low as 0.07 to as high as 0.90.

Adding to the confusion, long/short equity funds within the same category invest across entirely different markets. Many long/short funds are domestically focused, though the fund category also includes global, and even sector-specific funds.

KEY TAKEAWAYS

- There is much more variance in fund characteristics of alternative strategies than long-only funds.
- Given the vast differences among individual alternative funds, we believe advisors should only use Morningstar categories as an initial starting point in their search for the right fund.
- Advisors will need to dig deeper to understand individual funds' differences and how they might perform relative to expectations.

Given the vast differences among individual alternative funds, understanding them can be a challenge so we believe advisors should only use Morningstar categories as an initial starting point in their search for the right fund. Advisors will need to dig deeper to understand individual funds' differences and how they might perform relative to expectations.

The stark contrast in fund characteristics within alternative categories means advisors must look beyond rankings or performance numbers.

Going back to the long/short equity example, a fund with a high gross exposure means the strategy may be highly leveraged to a particular factor, such as size or momentum. The fund may have performed well in recent years if the factor was in favor, but high gross exposure also comes with higher risk. If the factor the fund is seeking to monetize falls out of favor, it could lead to large underperformance. Advisors considering the fund will need to be aware of the environments in which it will underperform, and make sure they can stomach such periods.

A suitable net exposure, meanwhile, depends on where the advisor will place the fund within a client's portfolio. Higher net exposure means the fund captures more of the equity market's return. If the advisor plans for the long/short equity fund to sit within a client's equity sleeve, high net exposure is desirable. If the advisor plans to use the long/short strategy as a diversified return stream and places it within an alternatives allocation, a lower net exposure is preferable.

Different beta levels also suggest the fund is capturing more or less of the equity market's return and play a role in determining where the long/short equity fund belongs within the portfolio. Meanwhile, varied past performance among long/short funds can often be explained by the markets in which they are focused.

The stark contrast in fund characteristics within the long/short category—or other alternative categories, for that matter—mean advisors must look beyond rankings or performance numbers to fully understand alternative funds and ask what they want the alternative fund to achieve within a broader portfolio. Alternative strategies can provide value for clients, but only when the individual fund characteristics are understood and matched with appropriate expectations.

For more insights:
Call 866.361.1720 or visit 361capital.com.

About 361 Capital

361 Capital is a leading boutique asset manager focused on alternative solutions that seek to deliver meaningful alpha, manage risk and offer diversification potential to investor portfolios. Founded in 2001, we offer a suite of investment products including Long/Short Equity and Managed Futures.

July 2019

361 Capital | 4600 South Syracuse Street, Suite 500, Denver, CO 80237 | 866.361.1720 | 361capital.com | Follow us: