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LIQUID ALTERNATIVE INVESTMENT STRATEGIES

Part 1: An introduction to Liquid Alternative Strategies and the forces behind their growth

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Introduction and background

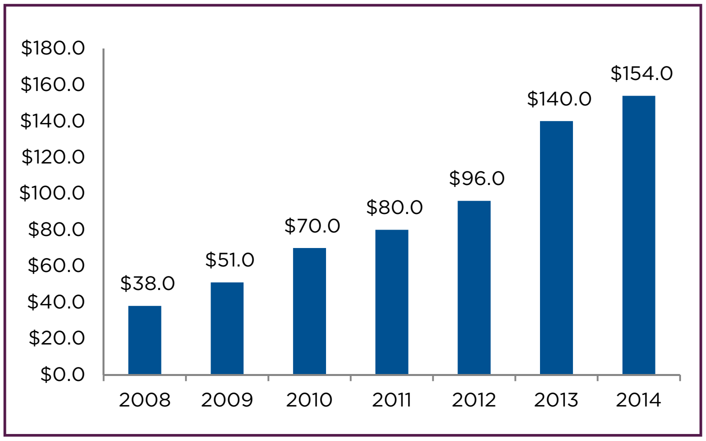
Alternative assets are an important component of an institutional investment portfolio as they can add true diversification to portfolios and reduce reliance on long positions in stocks, bonds and cash for total return.

The recent growth of liquid alternative investments and strategies is a top-of-mind subject that has investment committees inquiring about their effectiveness, investment management firms scrambling to create new products, and media sensationalizing the idea as new and innovative. New? Not really, because REITS were created in 1960 when President Eisenhower signed the REIT Act title contained in the Cigar Excise Tax extension into law. Innovative? Maybe, because alternative investment strategies that previously were available only to large institutions and accredited investors are now accessible to smaller institutions and individuals.

This research note will examine the growth in assets and number of liquid alternative offerings over the recent past, the reasons behind the growth and the variety of ways for investors to access alternative strategies through daily liquid funds.

Liquid alternative funds offer asset managers another avenue for growth at a time when competition among firms is increasing dramatically. These funds often are confused with general multi-asset funds, which frequently fail to meet the investor's risk or return objectives. The definition of a liquid alternative fund is perplexing and unclear with no strong consensus forming among institutional investors, asset managers and consultants. Recent articles highlighting liquid alternatives generally refer to liquid hedge fund strategies, often neglecting real assets and other important alternative assets and strategies. In 2006, Morningstar broadly defined liquid alternatives as any fund that "hedges" risk or attempts to generate absolute return. Since then, the assortment of liquid alternative funds has expanded at an accelerated pace, making a clear definition challenging.

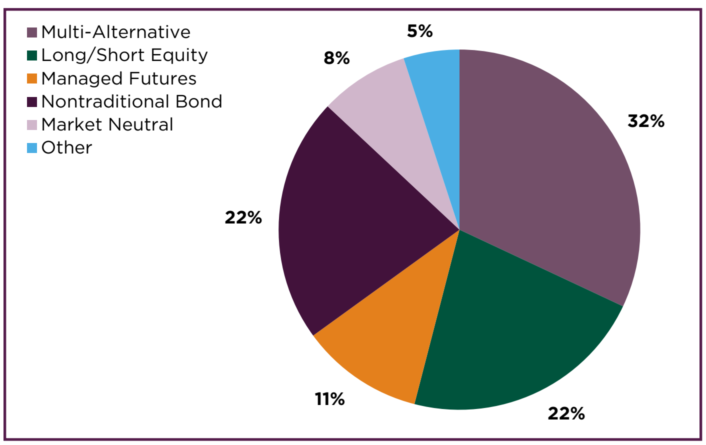
Growth of Liquid Alternatives



Source: Morningstar

The growth of liquid alternative strategies has been impressive. Through mid-2014, Morningstar estimates the number of liquid alternative investment funds operating globally at approximately 455, more than double the amount, 217, at the end of 2008. Additionally, assets in these funds have more than quadrupled from $38 billion to $154 billion during the same time frame. Morningstar breaks down alternatives mutual funds into 14 categories with the largest categories being multi-alternative, long/short equity, managed futures, non-traditional bond, market-neutral and bear market.

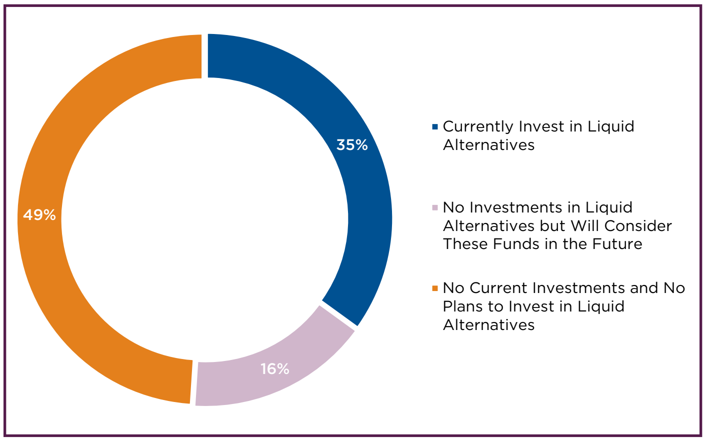
Breakdown in Liquid Alternative Strategies



Source: Morningstar, June 2014

Not included in these categories, but a large part of the liquid alternatives space, are ETFs and UCITS[1], which add an additional $100 billion of assets, as of June 30, 2014. Citibank, which includes ETFs and UCITS Funds in its definition of liquid alternatives, forecasts the growth in liquid alternative assets to reach approximately one trillion by 2017, which would make up over 40% of today's current hedge fund assets. In July, 2014, Preqin conducted a survey of investors with 35% responding they had an allocation to UCITS-compliant hedge funds or alternative asset mutual funds. An additional 16% responded that they are willing to consider liquid alternatives in the future. It appears the growth of liquid alternative strategies will continue to be strong in the foreseeable future.

Hedge Fund Investor Allocations to Liquid Alternatives (Alternative Mutual Funds and UCITS Hedge Funds)



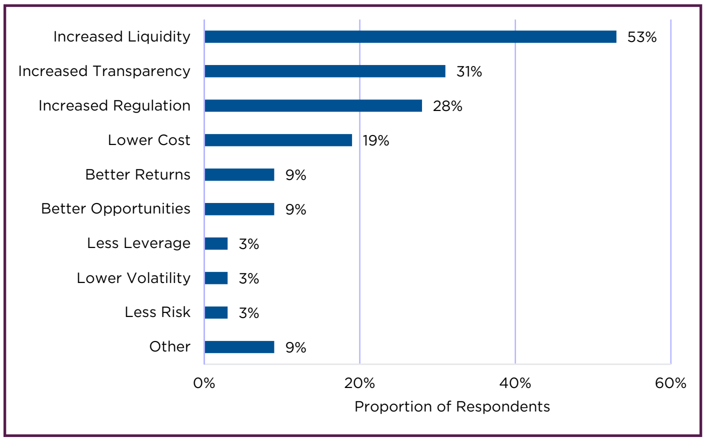
Source: Prequin Investor Interviews, July 2014

What is driving investor interest?

The obvious answer to what is driving investor interest is the financial crisis of 2008. Institutional investors realized they had underestimated liquidity risk and found themselves upside down on private real estate and private equity commitments relative to their investment policy. Certain hedge funds and fund of funds exercised "gates" and placed assets into "side pockets", preventing limited partners from redeeming their interest in the fund. Post crisis, investors began to demand better access to their capital and improved portfolio transparency.

However, liquidity risk isn't the only reason assets have been pouring into liquid strategies. The Preqin survey in July 2014 asked investors why they allocated capital to these strategies. While increased liquidity was cited as a key reason by more than half the respondents (53%), increased transparency and regulation also were identified as important criteria as investors are looking for assurances in the terms and conditions of how their capital is invested. Surprisingly, less than 20% of respondents cited lower cost as a reason for investing.

Investors' Reasons for Investing in Liquid Alternatives



Source: Prequin Investor Interviews, July 2014

Significant modifications in the regulatory environment, highlighted by the Dodd Frank Act in 2010, have changed the dynamics of alternative investing, making liquid alternative structures more interesting to all investors.

Accessing liquid alternative investment funds

Liquid alternative investment funds can come in many structures and forms. Due to their strong regulatory frameworks, UCITS-compliant hedge funds in the European Union and 1940 Act mutual funds in the United States have been the preferred structure, with ETFs also seeing a boom in recent years. Other common types of investment vehicles include multi-manager open or closed-end mutual funds, ETFs, open or closed-end REITS, multi-manager mutual funds, and managed accounts.

Conclusion

As we continue to analyze the evolution of alternative investment opportunities, a few interesting trends are becoming clearly evident. Firstly, assets will continue to migrate toward the liquid alternative market where liquidity, transparency, control and regulation are offered. Secondly, identifying the most relevant, top-tier liquid strategies for classic commodity, infrastructure, hedge fund, private equity and real estate investors has a challenging outlook due to the proliferation of liquid options. Thirdly, the wave of changes in the regulatory environment that has swept through the alternative asset industry since 2008 has been a major tailwind in the growth of liquid alternative strategies.

1 "Undertakings for Collective Investments in Transferable Securities". UCITS are open-ended European investment funds available to European Union domiciled investors and sometimes to U.S. investors when offered as a private fund.

This strategic research note is the first in a series of papers focusing on liquid alternative funds and strategies. In the next Strategic Research Note we will review the breakdown of strategies available in liquid alternative funds and analyze their role in an institutional portfolio and retirement saving plan.

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