



Marketable Alternatives Investment Strategies

Executive Summary

Marketable alternative investments are generally used by investors to enhance portfolio diversification due to their tendency to exhibit low return correlations (and often low volatility) relative to traditional asset classes. Although the investment objectives, constraints, and risk tolerances of institutional investors vary substantially, many investors choose to maintain some level of exposure to marketable alternatives. Allocations may include funds of hedge funds (FoHFs), direct hedge funds, and tactical, benchmark agnostic mutual funds (hereafter referred to as “liquid alternatives”). RVK believes that marketable alternatives can enhance a portfolio’s risk/return profile, even with a modest allocation.

RVK has recommended marketable alternatives to clients for more than 15 years. However, the optimal implementation strategy depends on each investor’s unique objectives and constraints. Over the past several years, we have found that designing optimal portfolios and communicating the value proposition to clients has become more challenging due to the increasing number of options and complexities in this space. The purpose of this paper is to provide an easily understandable reference that can be used to improve decision-making on either an initial allocation to marketable alternatives or an adjustment to an existing allocation. We first provide a brief overview of marketable alternatives implementation options. We then discuss some of the important ways in which the industry has changed over the past decade. Finally, we conclude with a discussion of some of the pros and cons of different implementation options, and outline a few portfolio structures that we commonly recommend to clients.

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Overview of Marketable Alternatives Investment Strategies

Institutional investors can establish a marketable alternatives allocation using a wide variety of funds. These funds typically fall into one of three categories listed below. The degree to which investors employ each of these investments depends on their unique objectives and constraints.

- **Direct Hedge Funds**—These include investments made in one or more individual hedge funds. This strategy is most often used by larger institutional investors, as size and resource constraints make implementation challenging and cost prohibitive for smaller investors.
- **Funds of Hedge Funds (FoHFs)**—These funds consist of a portfolio of multiple hedge fund investments. Similar to the benefits of a mutual fund in traditional asset classes, the primary benefit of a FoHF is that it provides diversified hedge fund exposure within a single fund.

- **Liquid Alternatives**—These are an emerging class of funds that can provide diversification benefits similar to hedge funds, but in an easier to access mutual fund or commingled fund vehicle. Depending on the strategy, liquid alternatives may also provide more attractive pricing relative to direct hedge funds and FoHFs. Given the sheer number of funds in this area and RVK’s preference for diversified marketable alternatives products, in this paper we focus solely on multi-asset class strategies.^a

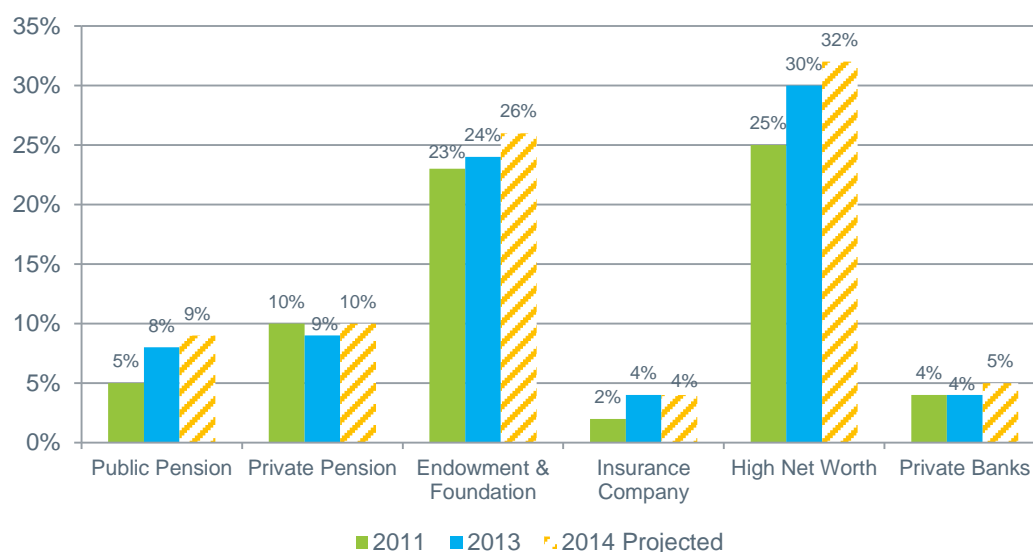
Key Market Trends

Over the past decade, the marketable alternatives asset class has expanded and matured, with notable acceleration occurring in the five years following the global financial crisis. Changes in the market continue to impact strategies employed by institutional investors. We believe that investors should be cognizant of four trends in particular, which we have outlined on the next several pages.

Trend #1: Increasing Allocations by Institutional Investors

Marketable alternatives have gained in popularity for many years among institutional investors.^b **Figure 1** shows the increasing exposure to hedge funds in the last three years alone among various types of institutional investors. The primary driver of this increase appears to be the desire to add diversification and reduce total portfolio risk.¹ There may also be somewhat of a herd mentality, as many investors seek to replicate the strategies of famed investors, such as David Swensen. Regardless of the cause, the increasing popularity of marketable alternatives has several implications. On a positive note, growth and increased competition (through institutional adoption of such portfolios) may exert downward pressure on fees and provide investors with greater leverage in their efforts to customize portfolios. On a negative note, growth may be impairing the ability of managers to generate excess return, as markets in which managers operate become more efficient, while rapid asset growth simultaneously dilutes the potential impact of inefficiencies that remain.

Figure 1: Allocation to Hedge Funds by Investor Type



Source: Barclays (2014).²

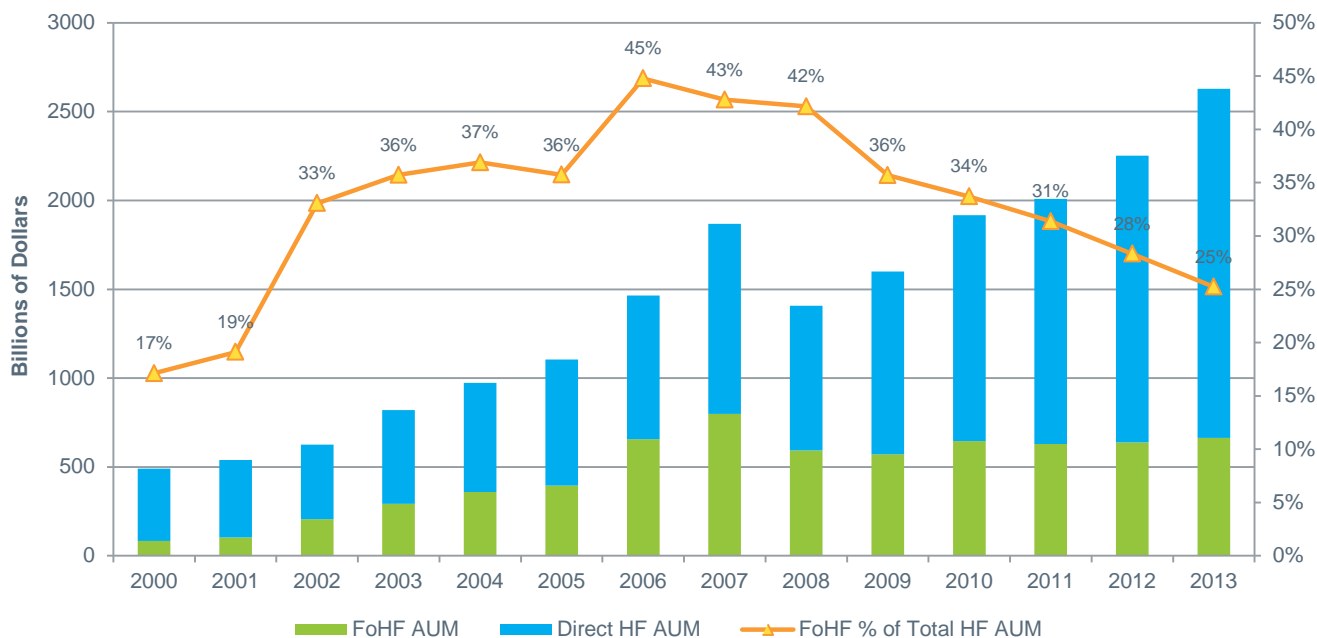
^a These observations are generalizations. RVK also has larger clients that have chosen to invest in liquid alternatives.

^b While there is a trend toward increasing allocations, we acknowledge that one high profile investor (CalPERS) decided to end its hedge fund allocation in September 2014. While this announcement is significant, it is unclear whether it will spark a reversal of the overall trend of increased allocations.

Trend 2: Increased Investment in Direct Hedge Funds at the Expense of FoHFs

FoHF asset growth has suffered in the aftermath of the global financial crisis. As shown in **Figure 2**, although total hedge fund assets have nearly doubled since 2008, all of the growth is attributable to direct hedge fund investments. A steady trend of outflows has effectively capped FoHF assets at 2008 levels.

Figure 2: Global Hedge Fund Assets Under Management



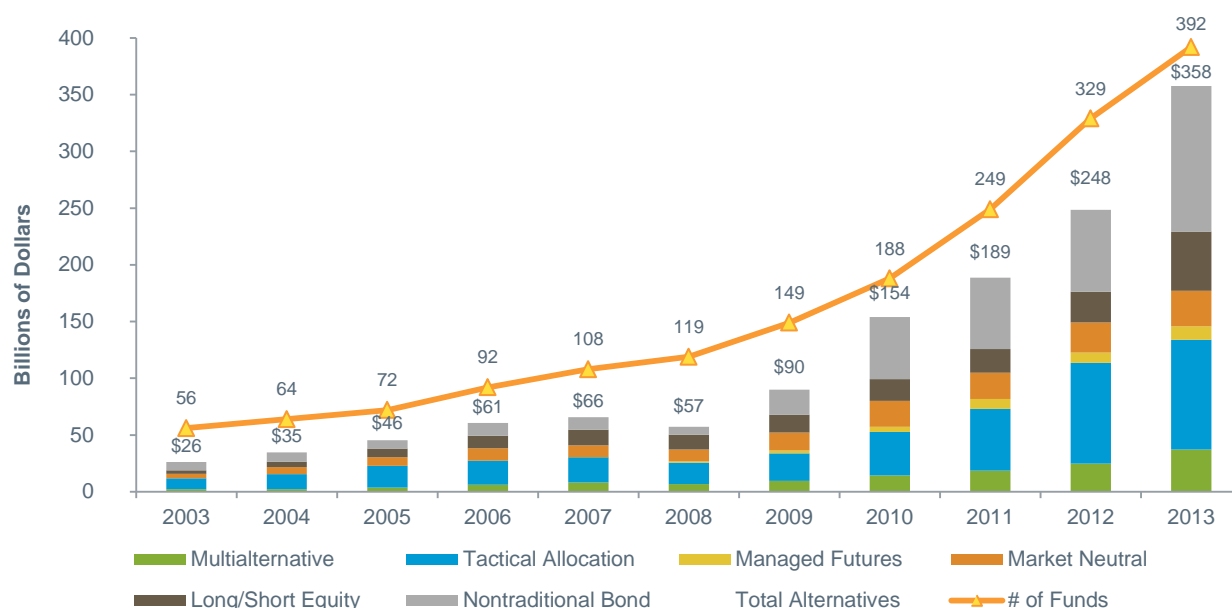
Source: HFR, RVK, Inc.³

The struggles of FoHFs can be attributed to several causes. First, investors are increasingly skeptical of the “access benefits.” Ten years ago, a key selling point for FoHFs was the privileged manager access they could provide to investors. However, over the past five years, many top-tier hedge fund firms have made concerted efforts to build their institutional client bases directly. Although it is fair to say that access benefits may still exist to a degree, such disintermediation efforts certainly weaken the FoHF advantage. The second cause is lackluster performance. During the four years following the financial crisis, many individual hedge funds and liquid alternatives funds outperformed FoHFs by a wide margin. Although drivers of this outperformance vary, it is undeniable that the additional fees charged by FoHF’s (typically 1% of assets plus 5-10% incentive fees) account for a meaningful portion of the difference. In the case of liquid alternatives, the fee differential has an even greater impact, as many funds can be accessed for all in fees around 100 basis points, while FoHFs may have all in fees that can easily add up to 350 basis points. The third cause is the increased transparency provided by direct hedge funds due to regulatory reporting and investor pressure. Historically, a key value proposition of FoHFs was the ability to gain access to information that the individual investor lacked the time or expertise to analyze, and then effectively interpret and present strategy exposures, risks, and performance. As hedge funds increase their transparency and many investors become more sophisticated, the perceived value of FoHF due diligence and reporting consolidation has diminished.

Trend 3: Growth in Tactical, Liquid Alternative Mutual Funds

In our opinion, the rapid proliferation of liquid alternative funds is the most notable development in the marketable alternatives asset class. Broadly defined, liquid alternative funds incorporate sub-categories that include: single hedge fund strategies, “Tactical Allocation” funds, and FoHFs in mutual fund vehicles. While definitive growth trends are difficult to approximate given the variety of funds and how they are categorized, we estimate that assets in liquid alternative funds (broadly defined) have quadrupled between 2009 and 2013. **Figure 3** shows the growth of assets in liquid alternatives.

Figure 3: Growth in Liquid Alternative Mutual Funds



Source: Morningstar, RVK, Inc.

The growth of this market is not surprising given the potential advantages, which we outline in greater depth on **page 7**. Similar to hedge funds, liquid alternatives may also be benefitting from a herd effect, as some investors chase the performance of top performing funds without considering the appropriateness of such funds in their portfolios.

Trend 4: Fund of Hedge Funds Industry Evolution

As illustrated in **Figure 2**, the FoHF industry is facing significant headwinds, as investors place greater value on the advantages offered by direct hedge funds and liquid alternatives. In response, many FoHFs are changing their business models. Changes primarily revolve around customization and specialization. In terms of customization, larger FoHF firms are increasingly designing custom portfolios in an advisory context, directly competing with specialist consultants/advisors that construct portfolios of direct hedge funds. In some cases, FoHF's do not charge an additional advisory fee, thus offsetting their total effective fee. In terms of specialization, FoHF's are striving to add value beyond what institutional clients could experience by investing directly in hedge funds. Many FoHF managers are offering custom funds that consist entirely of top-conviction underlying managers at favorable terms. Other FoHF's are moving away from the large, diversified hedge funds that have received the bulk of recent inflows. Their resulting portfolios can be complementary in nature for clients that have allocated to larger, well-established direct hedge funds. Finally, some managers are also delving into strategies that they avoided in the past, such as hedge fund seeding and co-investing; however, while these initiatives may add value if well-executed, they also increase portfolio complexity.

In summary, while the degree of adaptation varies by manager, FoHFs are becoming more aggressive in changing their business models to continue meeting evolving client demands and compete successfully with direct hedge funds and liquid alternatives.

Marketable Alternatives Design Framework

We believe that each of the three implementation structures outlined in this paper can provide meaningful value to clients. However, the optimal approach depends on the degree to which clients value different attributes, as each option presents trade-offs. **Figures 4, 5, and 6** summarize the core attributes and trade-offs associated with each vehicle.

Figure 4: Direct Hedge Funds

Overview

Direct investments in hedge fund strategies offer a compelling mechanism to build an allocation to marketable alternatives. However, this strategy is often only advisable for large investors (perhaps \$50-100 million+ in hedge fund assets). Investors that fall too far below this threshold may lack the required resources and budget to operate a direct hedge fund strategy prudently.

In terms of performance, although most hedge funds lagged equity markets and certain liquid alternative strategies since the 2008 market crisis, longer-term risk/return profiles are more attractive. Therefore, the case for investing in hedge funds remains intact. That said, the dispersion in performance between top performing funds and bottom performing funds remains very wide, which significantly raises the stakes for institutions engaging in direct hedge fund strategies. While the potential value of effective manager selection is significant, the cost of bad manager selection can be costly.

Primary Benefits

1. **Greater Cost Efficiency**—Larger investors can often achieve significant savings by eliminating the fee drag of a FoHF manager. These savings are partially offset by the increased investment in staff, consulting, and due diligence costs.
2. **Access to Niche Markets**—Investors can access niche markets, such as highly-specialized distressed debt funds, which may enhance diversification benefits and alpha potential.
3. **Tactical Control**—Investors can more easily customize hedge fund exposures based upon their unique objectives and investment theses.

Primary Drawbacks

1. **Manager Risk**—Dispersion between high and low performing funds is much greater than that seen with traditional asset classes. All else being equal, this increases the impact of fund selection, which can have serious consequences if poorly executed.
2. **Liquidity**—Most direct hedge funds have material liquidity restrictions (often quarterly or annually), which may increase further in stressed markets.
3. **Asset Size Constraint**—Direct hedge fund investments require a substantial investment in due diligence and staff. In addition, funds must have a relatively sizable allocation in order to establish adequate manager diversification. As such, direct hedge fund programs are usually only advisable for larger investors.

Figure 5: Funds of Hedge Funds (FoHFs)

Overview

Over the past several years, investors have increasingly questioned the value of FoHFs due to substantial all-in-fee drag, coupled with recent underperformance relative to direct hedge funds and liquid alternatives. While we continue to believe that top-tier FoHF firms can provide a valuable service, we acknowledge that the value proposition must be strong and appropriate to the investor in order to overcome these disadvantages.

Regarding fees, RVK recognizes that FoHF fees are higher than those charged by direct hedge funds and liquid alternatives, as these do not require two layers of asset management fees. In addition, we believe that the historical FoHF fee structure, which commonly entailed a 1% management fee and 10% incentive fee, is no longer competitive. As such, a key element of any FoHF due diligence should involve aggressive fee negotiations. In addition, investors should review the fees paid by FoHFs to their underlying managers. In some cases, we have discovered that the combined, all-in-fee of a FoHF is similar to, if not less than, the fee a client would pay if implementing on a fully direct basis at standard hedge fund fee levels.

In summary, we continue to advocate the use of FoHFs, provided that such strategies are appropriate for an investor's objectives and constraints. We also support the efforts of FoHF's to evolve with the changing needs of institutional investors; however, we caution these firms to evolve in a manner that is in the best interest of existing clients. Overall, given the dynamic nature of this industry, we continue to monitor it closely and will adapt our advice accordingly.

Primary Benefits

1. **One-Stop Diversification**—FoHFs offer access to a diversified portfolio of hedge fund investments within a single investment vehicle. This is particularly attractive to smaller investors that are unable to diversify effectively in a direct hedge fund strategy due to size constraints and limited budget for due diligence.
2. **Due Diligence Resources**—Institutional-quality FoHFs perform valuable services that small clients may find very challenging, such as manager research, operational due diligence, and aggregated risk reporting.

Primary Drawbacks

1. **Liquidity**—Most FoHFs have liquidity restrictions (often quarterly or annually), which may increase in stressed markets. These terms are more restrictive than liquid alternatives.
2. **High Fees**—The additional layer of management fees creates a high performance threshold for FoHFs. We do note this is mitigated somewhat by select FoHF providers that have successfully negotiated fees with underlying managers.

Figure 6: Liquid Alternatives

Overview

RVK has been monitoring the universe of tactical, benchmark agnostic mutual funds for over ten years, and many of our clients have enjoyed attractive risk-adjusted results by investing in this area, long before the term “liquid alternatives” was coined. Recommended funds are well-diversified across asset classes and provide multiple layers of potential value add. Sources of return typically include market (or “beta”) exposure across a variety of asset classes, top-down tactical asset allocation decisions, and excess return from active management of underlying security exposures.

As highlighted in **Figure 3**, the number of funds in this area has grown substantially, and some well-regarded hedge fund and FoHF firms have launched vehicles. While the quality of liquid alternative funds has improved, we remain skeptical of many of these funds given that most have relatively short track records and have not yet weathered a severe market downturn. Nevertheless, we continue to advocate the use of certain liquid alternative funds, particularly in the case of smaller investors with limited ability to invest in direct hedge funds or for investors (of all sizes) with strict liquidity constraints.

Primary Benefits

1. **Lower Fees**—Liquid alternatives can offer attributes, such as diversification and alpha generation, that are similar to hedge funds and FoHFs, but at a much lower fee. Typical fees of RVK recommended funds average around 100 basis points, while all-in-fees for direct hedge funds and FoHFs can range between 250 and 350 basis points, respectively.
2. **Greater Liquidity**—Liquid alternatives are typically much more liquid than direct hedge funds and FoHFs, with many liquid alternative funds providing daily liquidity.
3. **DC Plan Viability**—The continued shift of assets away from defined benefit plans has made defined contribution plans an enormous growth market. While investment constraints generally prevent plan sponsors from adding FoHFs to plan line ups, liquid alternatives are viable options.

Primary Drawbacks

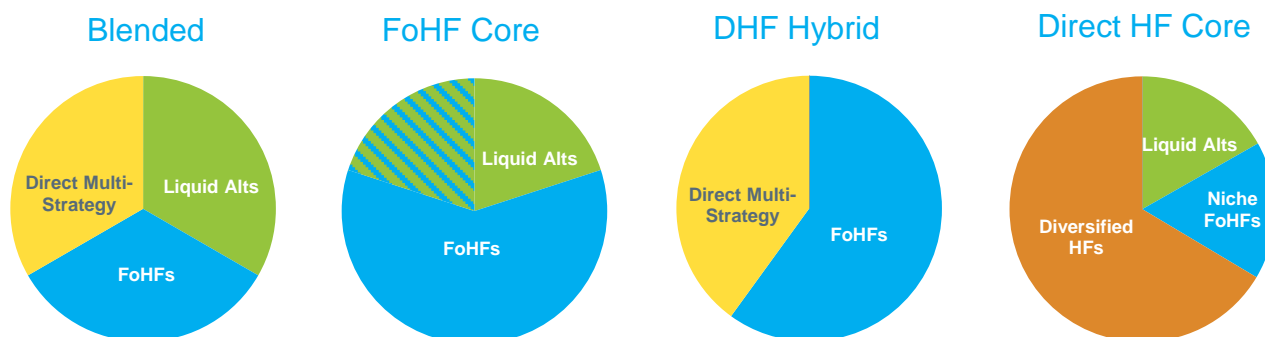
1. **Limited Manager Diversification**—Liquid alternatives investors typically invest in 1-2 investment managers, as opposed to FoHFs and Direct Hedge Fund Strategies, which may have exposure to several dozen managers.
2. **Limited Strategy Diversification**—Given their liquidity profile, many liquid alternatives products are unable to access niche strategies often found in FOHFs and Direct Hedge Funds, such as distressed debt, which may dilute their diversification benefits and alpha potential.
3. **Limited Track Records**—Many liquid alternatives are relatively new in the market, which gives investors limited visibility into how they will perform in different market cycles.

Designing Marketable Alternatives Portfolios

As we explained previously, designing an optimal marketable alternatives portfolio depends entirely on an investor's unique objectives, constraints, and the perceived value of the various trade-offs. For smaller investors, the optimal approach is likely to select 1-2 liquid alternatives or FoHFs, as these investors lack the scale and resources required to manage a more complex portfolio. For larger investors that maintain substantial allocations to marketable alternatives, there are a wide variety of prudent strategies.

In recent years, we have increasingly worked with clients to design hybrid portfolios that leverage the unique advantages of each strategy. **Figure 7** shows a few such strategies. In some circumstances, we may recommend a combination of direct hedge fund and FoHF investments, illustrated as "DHF Hybrid Approach." In these scenarios, the objective is to use direct investments where they offer a distinct competitive advantage and/or unique skill, and FoHF's only when they provide a skill set not otherwise available through direct investments. Other investors may invest in a diversified pool of direct hedge funds and allocate to a FoHF that focuses on niche strategies or smaller, emerging hedge fund managers. An example of this structure is shown as "Direct HF Core." The "Blended" approach is yet another structure that seeks to access some of the benefits of liquid alternatives in addition to FoHFs and Hedge Funds. One clear benefit of the approach is that the liquid alternatives provide greater liquidity if it is ever needed or desired.

Figure 7: Sample Portfolio Structures



Source: RVK, Inc.

In summary, there are many ways to access marketable alternatives. Despite some of the recent skepticism about the value proposition, we continue to advocate for the use of marketable alternatives. We also acknowledge the significant trade-offs, costs, and risks of such strategies, which justifiably raise the stakes of such investments. As such, we only recommend allocating to these strategies if such an allocation is clearly appropriate given each investor's objectives and constraints. We caution investors to avoid performance chasing and to avoid entering an asset class without a clear understanding of fit in their portfolio. For investors who are considering an allocation to marketable alternatives, we encourage them to review the self-assessment on the following page. The assessment includes the types of questions that we typically ask clients to shape their marketable alternatives strategy.

Figure 9: Marketable Alternatives Strategy Self-Assessment

Instructions: The goal of this self-assessment is to help investors structure a marketable alternatives strategy once the decision is made to allocate to this asset class. Answering these questions accurately is an important first step for investors considering an allocation to marketable alternatives.

Questions		Yes	No
1.	Does our fund have the ability to invest in less liquid investments (i.e., potentially 1 or 2 year lock ups)?	<input type="checkbox"/>	<input type="checkbox"/>
2.	Does our governance structure allow for manager decisions outside of the regular meeting schedule?	<input type="checkbox"/>	<input type="checkbox"/>
3.	Is our committee comfortable with the idea of adding direct hedge funds with potentially complex strategies to the portfolio?	<input type="checkbox"/>	<input type="checkbox"/>
4.	Is the plan staffed to support (or willing to outsource) the required oversight associated with a direct investment program?	<input type="checkbox"/>	<input type="checkbox"/>
5.	Is the plan well equipped (and funded) to retain talent that oversees a direct investment program?	<input type="checkbox"/>	<input type="checkbox"/>
6.	Is our fund able to accept the higher level of idiosyncratic manager risk (and potential headline risk) associated with these strategies?	<input type="checkbox"/>	<input type="checkbox"/>
7.	Is our committee comfortable with the level of fees associated with hedge funds and FoHF's?	<input type="checkbox"/>	<input type="checkbox"/>
8.	Are we comfortable with higher beta products in the marketable alternatives allocation?	<input type="checkbox"/>	<input type="checkbox"/>
9.	Is our plan comfortable with limited partnership structures?	<input type="checkbox"/>	<input type="checkbox"/>
10.	What is the \$ amount of the target allocation to marketable alternatives?	\$ _____	

Source: RVK, Inc. (2014)

Endnotes

¹ Preqin Ltd. "Preqin Special Report: The Real Value of Hedge Fund Investment." June 2014.

² Barclays Capital Solutions – Hedge Fund Pulse. "Waiting to Exhale – 2014 Global Hedge Fund Investor Trends and Allocation Outlook." January 2014.

³ HFR. "Strong Inflows Drive Hedge Fund Capital to New Record in 1Q14." April 21, 2014.

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