portfolio construction forum

A real alternative for all

Ian Haas & Fred Ingham | Neuberger Berman | 05 August 2015

With both bond and equity markets trading at high valuations, investors are increasingly seeking out strategies that are not tied so tightly to market performance. A decade ago, this might have led them to a fund of hedge funds allocation or, if that was not desirable or not accessible to them, perhaps a long-only, multi-asset absolute return strategy. Since then, the rise of liquid alternatives has made hedge funds more investor-friendly, creating a genuine extra choice on the absolute return menu.

INTRODUCTION

Since the financial crisis, there has been a quiet revolution going on in hedge fund investing. Investors have continued to allocate, according to Morningstar and Barron's 2013-14 Alternative Investment Survey of US Institutions and Financial Advisors which surveyed nearly 700 participants. Some 60% of financial advisers were allocating between 6% and 20% to alternative investments, with almost one-in-five institutions allocating more than 40%. But the way they are allocating is changing.

The same survey uncovered growth in alternatives wrapped in mutual fund structures, from less than US$50 billion under management in 2008 to almost US$300 billion by mid-2014. Assets under management in long/short equity US mutual funds' leapt 80% during 2013 alone. The proportion of advisers citing mutual funds as their product of choice to gain access to long/short equity or debt strategies jumped to 73% in 2013, from 57% in 2012. Looking more broadly, Strategic Insight's SIMFUND database reveals a similar trend, showing the number of liquid alternative European UCITS and US 40-Act mutual fund products having tripled to well over 1,500 since 2008.

As the SIMFUND figures indicate, following on from the initial move into the US 40-Act mutual fund world, hedge fund strategies are now taking it a further step, into international regulated fund structures such as Europe's UCITS and UK and Australian unit trusts.

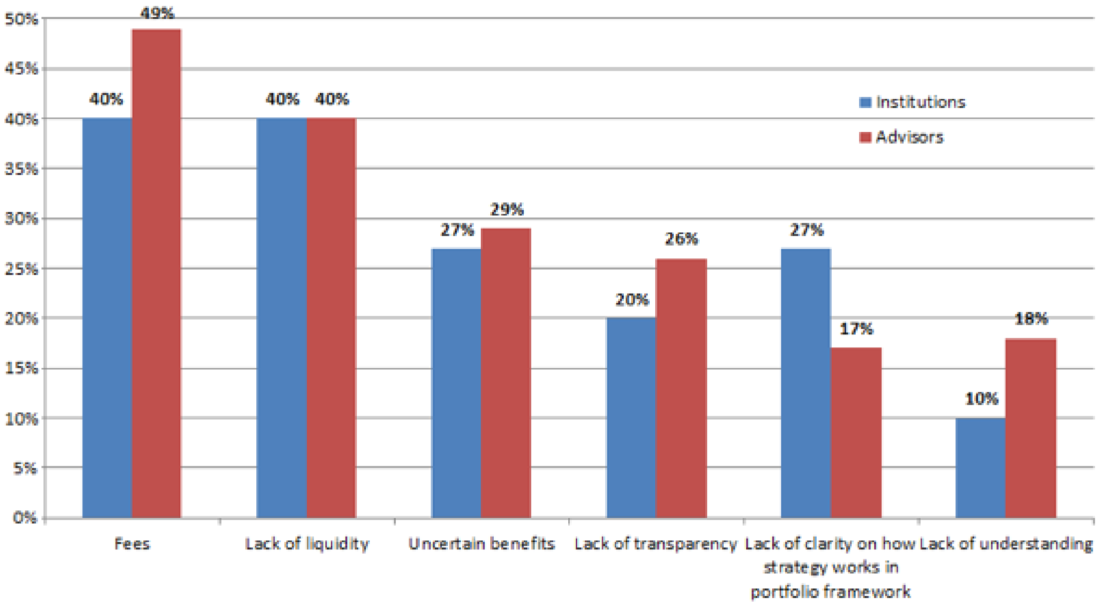
This reflects some very valid lessons from 2008-09. Hedge fund performance disappointed, but thoughtful investors looked past the headlines. Hedge funds comfortably outperformed equity markets and losses were certainly not universal. Some strategies posted record returns amid the turmoil. Importantly, for many investors, it was not performance that hurt most but rather: the lack of transparency, which led to surprises about inappropriate exposures and an inability to see what was going on in their own portfolios; the gating of redemption requests; careless mixing of liquid and illiquid strategies and poor asset/liability management; or, damaging counterparty exposures resulting from poor operational risk management and governance.

Moving these strategies into the regulated fund world helps address these issues without throwing the baby out with the bathwater. It is a trend symptomatic of an increasingly competitive hedge fund industry – managers are both more willing to adapt their terms to match those of regulated funds and more willing to launch regulated funds to access a bigger pool of investors, with neither a transition of injurious hedge fund-style terms into regulated fund structures nor a watering-down of strategies to fit this new market. This growing phenomenon has earned its distinguishing descriptor – liquid alternatives.

1. LIQUID ALTERNATIVES VERSUS TRADITIONAL HEDGE FUNDS

As well as asking how much they invested, the Morningstar and Barron's survey also looked at why participants hesitate before making alternatives allocations (Figure 1). Reasons related to hedge fund strategies themselves included a lack of understanding of them or how they relate to the rest of their portfolios, for example. But the more regularly-cited reasons – fees, lack of liquidity, lack of transparency – have more to do with hedge fund structures.

Figure 1: Top reasons to hesitate to invest in alternatives
(% of respondents)



Source: Morningstar and Barron's, "2013-2014 Alternative Investment Survey of U.S. Institutions and Financial Advisors, July 2014". 372 institutional investors and 301 advisers participated.

© PortfolioConstruction Forum 2015

1.1 High, complex and variable fees

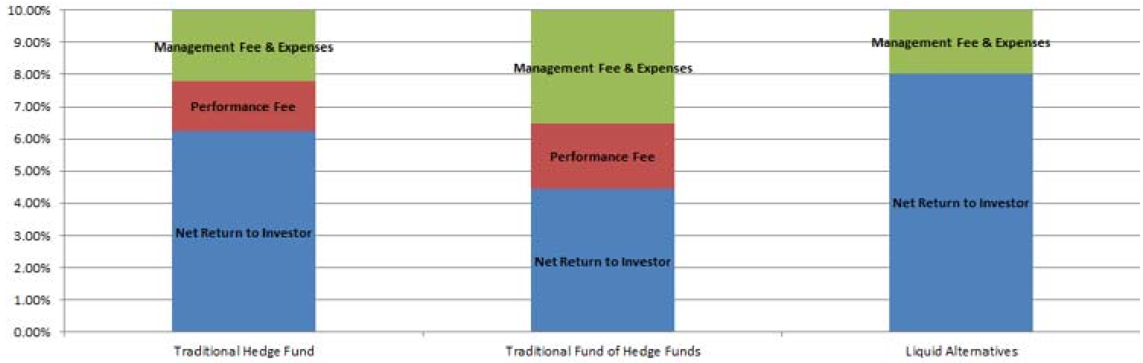
The typical fee for a hedge fund was 2% per annum with a 20% performance fee on top. Investing through a fund of hedge funds structure at peak pricing could have added a further 1% per annum and 10% performance fee. Competition has brought costs down, but they remain high – and the addition of hurdle rates and high watermarks on performance fees has added complexity and variability.

By contrast, management fees on liquid alternative products are typically much lower, to make them competitive against other specialist regulated funds, while performance fees are unusual. US mutual fund prospectuses must have stated expense ratios and outline all fees. Overall, investors can expect alternative mutual fund charges to be in-line with or slightly higher than those of other specialist active strategies. This is not universally the case with non-US regulated liquid alternatives funds. Many UCITS and UK and Australian unit trusts still charge hedge fund fees, although some providers are bringing charges in line with US practice.

Figure 2 indicates the difference a more competitive fee structure can make to an investor's net return.

Figure 2: Example of how lower fees from a liquid alternatives product can make a big difference to net returns

	Gross return (%)	Underlying Mgmt Fee & Exp (%)	Net return (%)	Underlying Perf Fee (%)	Net return (%)	Mgmt Fee & Exp (%)	Net return (%)	Perf Fee (%)	Total Net return (%)
Traditional Hedge Fund	10.00	2.20	7.80	20.00	6.24	N/A	6.24	N/A	6.24
Traditional Fund of Hedge Fund	10.00	2.20	7.80	20.00	6.24	1.30	4.94	10.00	4.45
Liquid Alternatives Fund	10.00	1.00	9.00	0.00	9.00	0.95	8.05	0.00	8.05



Source: Neuberger Berman. Perf = Performance. Mgmt = Management. Fees cited are approximate and illustrative only as different managers will receive different fees. The Liquid Alternatives fee and expense structure is based on the Neuberger Berman Absolute Return Multi-Strategy Fund, a multi-strategy, multi-manager product. Potential fee benefits at 10% gross return: +1.81% over traditional hedge funds, +3.60% over traditional fund of hedge funds.

1.2 Illiquid redemption terms

Many hedge funds allow only monthly or quarterly redemption and often include longer-term lock-ups after initial commitments. During the stressed markets of 2008, some hedge funds gated redemptions, only allowing a certain amount of cash to be withdrawn at any one time.

Because they tend to invest in only the most liquid hedge fund strategies, liquid alternative solutions can offer daily Net Asset Value (NAV) and more frequent redemptions. (Again, while this is the norm for US mutual funds, it is not always the case for regulated funds in other jurisdictions). Many hedge fund strategies are replicable with minimal tracking error under these liquidity constraints. Those that are excluded tend to be focused on the less liquid parts of the credit market, such as distressed debt, or use very high levels of financial leverage. A multi-strategy, multi-manager liquid alternatives product offering daily redemptions at NAV should be able to invest in well over two-thirds of the 10,000-plus hedge fund strategies available globally, minimising selection bias.

1.3 Lack of transparency

Hedge funds often only report to investors once a month, with a delay - and even then, position-level transparency is not the norm. The reporting required of regulated funds and the use of separate managed accounts by many multi-manager liquid alternatives providers can deliver real-time, position-level transparency into underlying portfolios.

© PortfolioConstruction Forum 2015

1.4 Poor corporate governance

It is not always clear that hedge fund directors are sufficiently engaged in governance. In multi-manager strategies, investors have little oversight of the selection of service providers such as prime brokers, administrators and auditors. Regulated funds are required to be overseen by independent boards. This can help improve the process of monitoring service providers selected by underlying managers in the multi-manager context, but investors can take this a step further by choosing a multi-manager that invests in underlying strategies via separate managed accounts. This way, the liquid alternatives provider owns the underlying structures and has total control over the assets and choice of service providers.

Figure 3: The best of both worlds

	Traditional Regulated Fund Investing	Liquid Alternatives Investing	Traditional Hedge Fund Investing
Return Objective	Relative returns		Absolute returns
Benchmark	Market benchmark constrained		Unconstrained by market benchmark
Investment Strategies	Limited strategies; long-only; no leverage		Flexible strategies; long and short positions; leverage
Market Beta	High beta to traditional asset classes		Generally low beta to traditional asset classes
Performance	Dependent on market direction		Often independent of market direction
Management Fees	Asset-based fee; often no performance fee	«« Combines the best of both worlds »»	Generally higher asset-based fee plus performance fees
Liquidity	Often daily at net asset value		Liquidity restrictions and lock-ups
Investment Size	Small minimum investments		Large minimum investments
Investor Base	Publicly available		Available only to qualified investors
Transparency	Regular position-level transparency		Limited or no position-level transparency

Source: Neuberger Berman

2. ABSOLUTE RETURN OR LIQUID ALTERNATIVES? WHICH TYPE OF LIQUID ALTERNATIVE?

Bringing hedge fund strategies into the regulated fund world puts them in genuine competition with other absolute-return solutions. Even under the liquid alternatives rubric, an investor can choose from single-strategy funds, multi-strategy single-manager funds, and multi-strategy multi-manager products. Add the plethora of multi-asset absolute return, tactical allocation and diversified growth funds, some long-only and some long/short, some investing across all markets and some focusing on global fixed income, and the options quickly proliferate.

2.1 Strengths and weaknesses of liquid alternatives

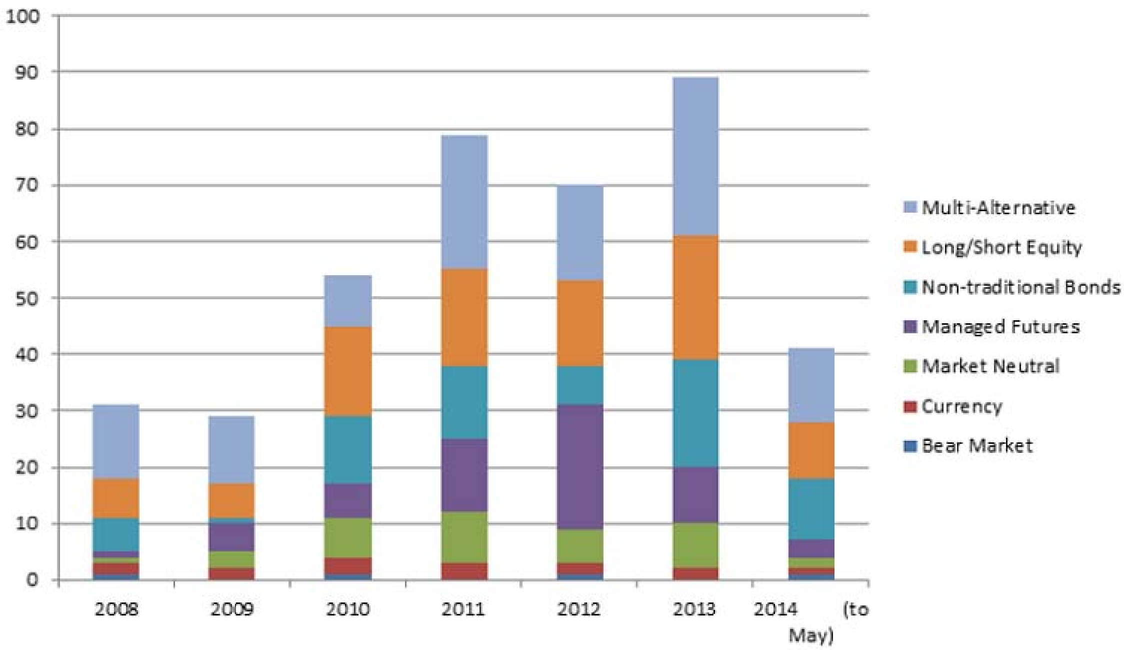
Firstly, compared to the range of long-only strategies, liquid alternatives benefit from the ability to sell short which, in exchange for slightly higher fees and a modest increase in operational risk, can enhance the ability to preserve capital in difficult markets and result in lower levels of correlation with traditional investments.

When it comes to choosing from within liquid alternatives, an investor looking to build a portfolio of alternatives to augment specific risks in their core portfolio may wish to select from single strategies, in the sizes that suit the purpose. On the other hand, for those looking to make a broader, absolute-return allocation, the diversification of exposures in a multi-strategy product and its capacity to allocate tactically over the cycle better fulfils the brief.

It is notable that the three types of products leading in terms of launches, according to the Morningstar and Barron's survey, were long/short equity, multi-alternative and non-traditional bonds (Figure 4). These were also cited by survey respondents as "top strategies for investment over the next five years". Long/short equity is the best-known hedge fund strategy and also the most obvious way to try to improve the risk/return ratio of a core equity allocation. Non-traditional bonds helps solve the problem of maintaining fixed income and credit exposure without being at the mercy of prevailing low yields. These products meet clear and specific portfolio risk-management needs. The multi-alternative products, by contrast, meet the needs of those looking for a broad allocation with low beta to equities and bonds.

Figure 4: Alternative mutual fund launches

	2008	2009	2010	2011	2012	2013	2014*	Total
Bear Market	1	0	1	0	1	0	1	4
Currency	2	2	3	3	2	2	1	15
Market Neutral	1	3	7	9	6	8	2	36
Managed Futures	1	5	6	13	22	10	3	60
Non-traditional Bonds	6	1	12	13	7	19	11	69
Long/Short equity	7	6	16	17	15	22	10	93
Multi-alternative	13	12	9	24	17	28	13	116
Total	31	29	54	79	70	89	41	



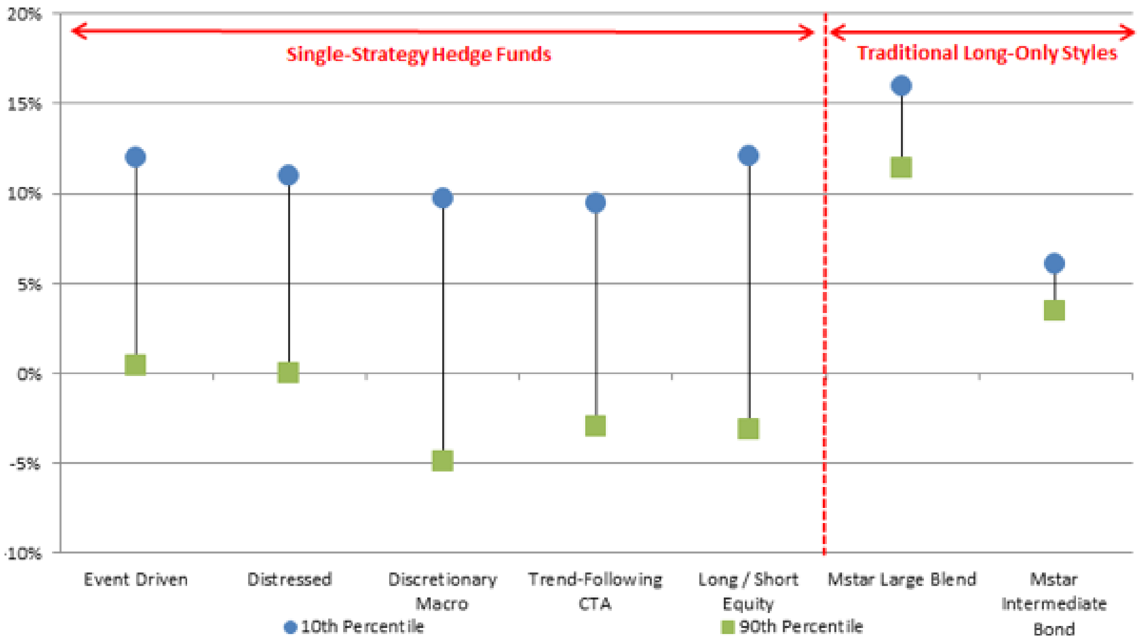
Source: Morningstar and Barron's, "2013-2014 Alternative Investment Survey of U.S. Institutions and Financial Advisors, July 2014". 372 institutional investors and 301 advisers participated. * To May 2014

The investor who requires a multi-strategy fund can choose between a single- or a multi-manager product. Some multi-manager products will be more expensive than single-manager products because of the fees being paid to underlying managers. However, it is also the case that some multi-manager providers are able to operate more cost-effectively because of the power they have to negotiate terms with underlying managers – power that is limited when a fund is dealing with in-house strategies. Costs should therefore be compared on a case-by-case basis. A multi-manager solution can deliver the benefits of mitigating idiosyncratic manager risk, providing an additional layer of oversight and outsourcing the manager-selection process to a specialist.

3. LIQUID ALTERNATIVES MANAGERS REQUIRE BOTH HEDGE FUND EXPERTISE...

Why is this more important for hedge funds than for traditional long-only funds? Hedge fund managers enjoy many more degrees of freedom than long-only managers, which cannot sell short and are often limited in the risk taken against benchmark. As Figure 5 shows, this results in a considerable difference in dispersion between the top and bottom managers in each discipline.

Figure 5: Dispersion of hedge fund and long-only fund returns
(5 years ending 31 December 2014)



Sources: Neuberger Berman Alternatives Proprietary Peer Groups, Morningstar Direct. Includes all funds with an institutional share class in the Morningstar Intermediate-Term Bond and Large-Cap Value categories.

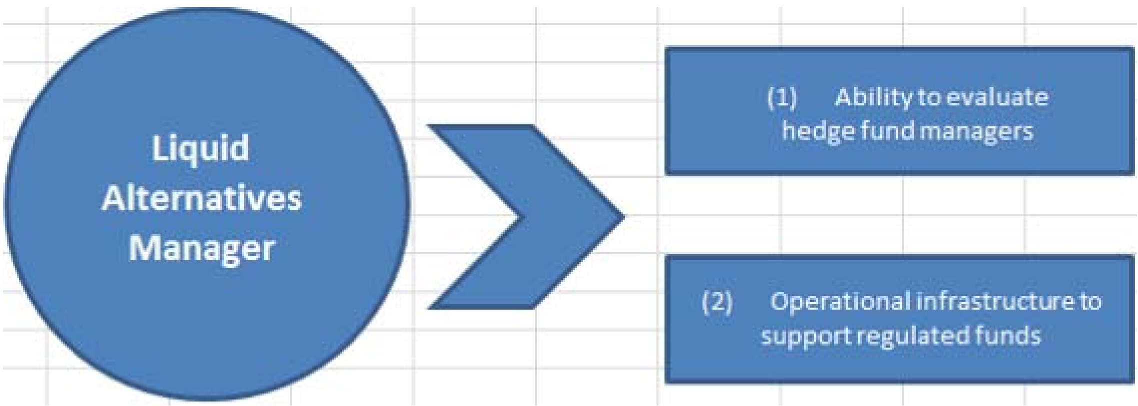
This should act as a warning – selecting hedge funds can go badly wrong and careful consideration should be given to selecting the selectors. A manager with an established investment process to manage traditional fund of hedge funds products is more likely to understand how to evaluate hedge fund managers properly, looking out particularly for excessive use of leverage, portfolio concentration, asset/liability mismatches, overexposure to market directionality, and lapses in operational oversight.

Independent operational due diligence reviews of underlying managers' infrastructure – organisational structure, compliance and legal functions, trading infrastructure and processing, pricing and NAV calculation, collateral management – are essential. This entails the capacity to assess the suitability of underlying managers' third-party service providers, including administrators, custodians and prime brokers. Indeed, if the liquid alternatives multi-manager is accessing the underlying strategies via managed accounts it will need to approve and potentially select these providers itself, as the owner of the account. Experienced hedge fund selectors are also more likely to enjoy the industry name recognition that facilitates access to the most sought-after funds.

4. ... AND REGULATED FUND OPERATIONAL INFRASTRUCTURE

Just as it is fatal to assume a traditional regulated fund manager can successfully select hedge funds, it is dangerous to assume a hedge fund manager can support a regulated fund business. Managing a regulated fund's operational infrastructure involves several additional requirements including: managing daily cash flows from investor activity, daily reconciliation with managers, custodians, administrators and counterparties; daily NAV calculation; developing and implementing price-verification and variance-testing methodologies; and, regulated fund compliance.

Figure 6: Liquid alternatives managers need expertise from two different fund cultures



Source: Neuberger Berman

5. LOOKING BEYOND FIXED INCOME FOR DIVERSIFICATION

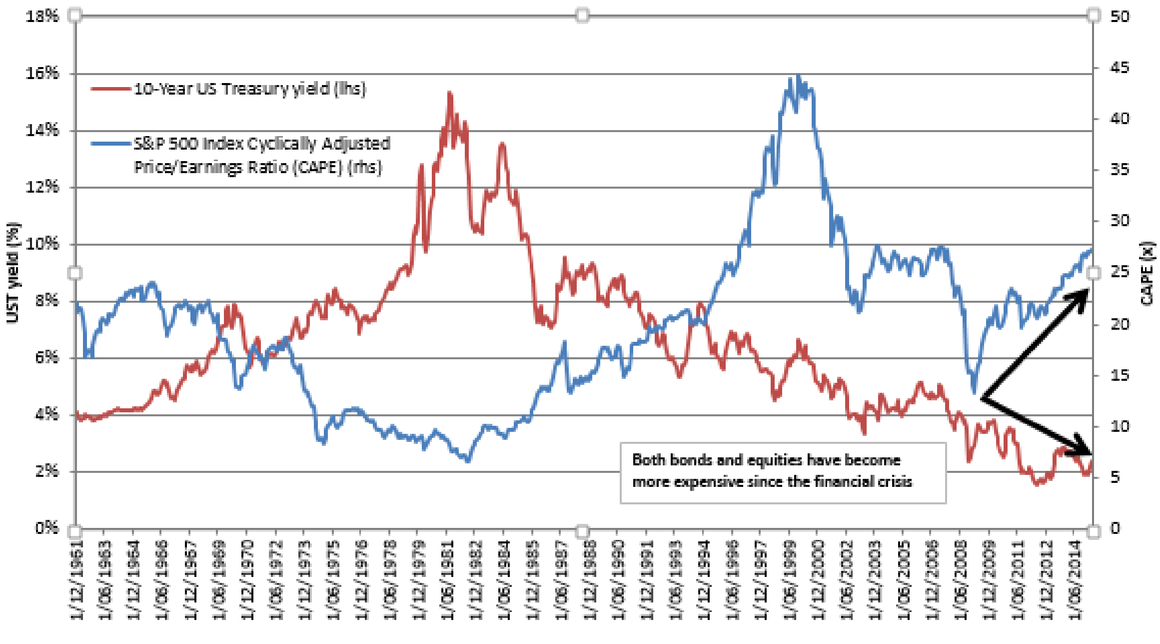
In short, investors looking at hedge fund strategies are increasingly demanding that they come with regulated fund protections, terms and conditions.

But what if you have yet to invest? Would you allocate to hedge funds at the tail-end of a multi-year trend? Quite the opposite - a strong argument can be made that, after some years of less-than-exciting performance, these strategies could come into their own.

One of the great enduring investment myths of the 2008-09 market crash is that "diversification didn't work" or "correlations all went towards 1.0" during this period. While many risk assets that had previously seemed to move independently of one another all fell in value together (equity and commodity indices, for example), the classic diversifying asset - government bonds - performed handsomely.

It would be brave, however, to assume that government bonds will do so again the next time equities hit a bear market. Since 2009, both asset classes have become more expensive. As Figure 7 shows, while the cyclically-adjusted price-to-earnings ratio of US equities (CAPE) has been falling back up to pre-crisis levels, the 10-year US Treasury yield has tumbled to record lows. Neither makes a compelling case for investing or for utility as a diversifier.

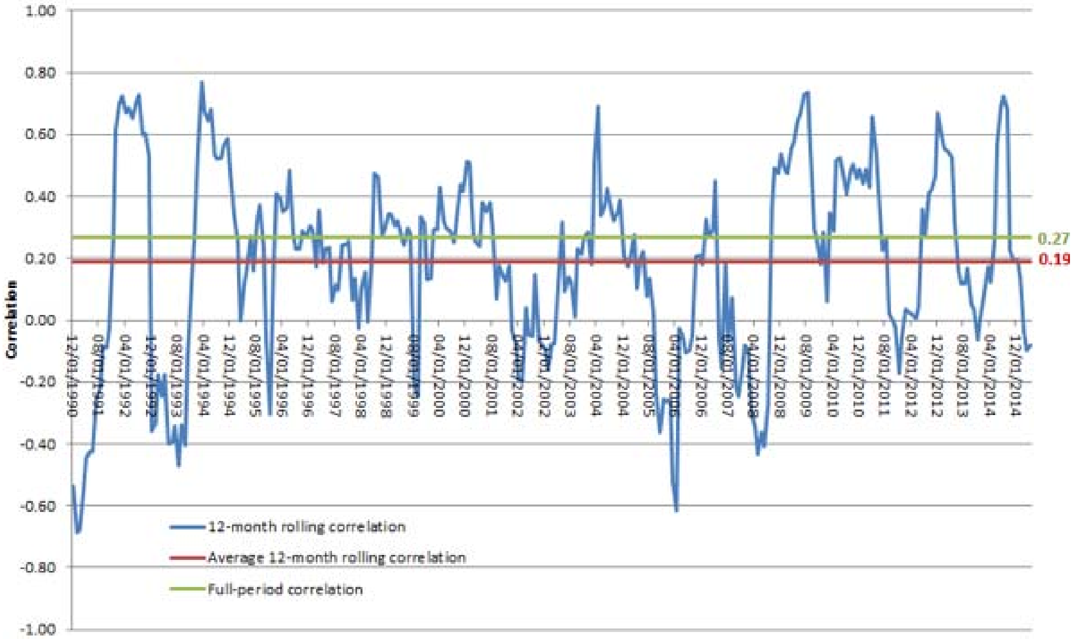
Figure 7: Long-term measures of equity and bond market valuations are high



Source: Federal Reserve; Robert Shiller

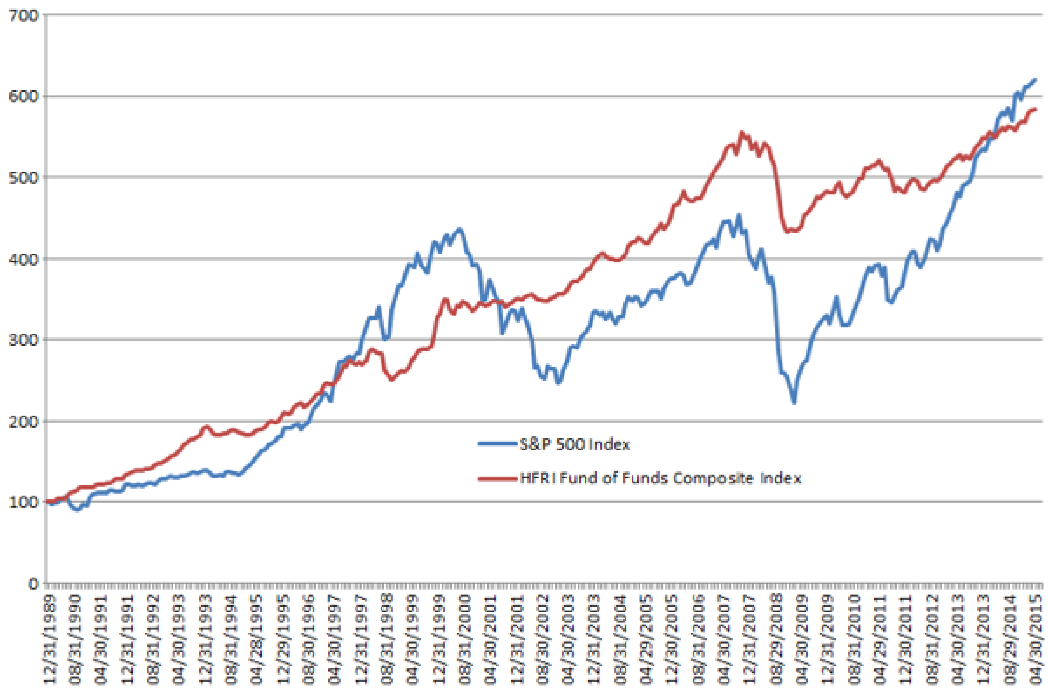
This is when alternatives such as hedge funds can look compelling. While a fund of hedge funds allocation, as defined by the HFRI Fund of Funds Composite Index, can exhibit a relatively high correlation with equity markets, on average it has remained in the range of 15% to 30% (Figures 8a and 8b).

Figure 8a: Fund of hedge funds have exhibited low correlation with equities since 1990



Source: Neuberger Berman; Bloomberg; HFR. Correlations of monthly returns, S&P 500 Index and HFRI Fund of Funds Composite Index

Figure 8b: Capturing much of the upside while avoiding some of the downside

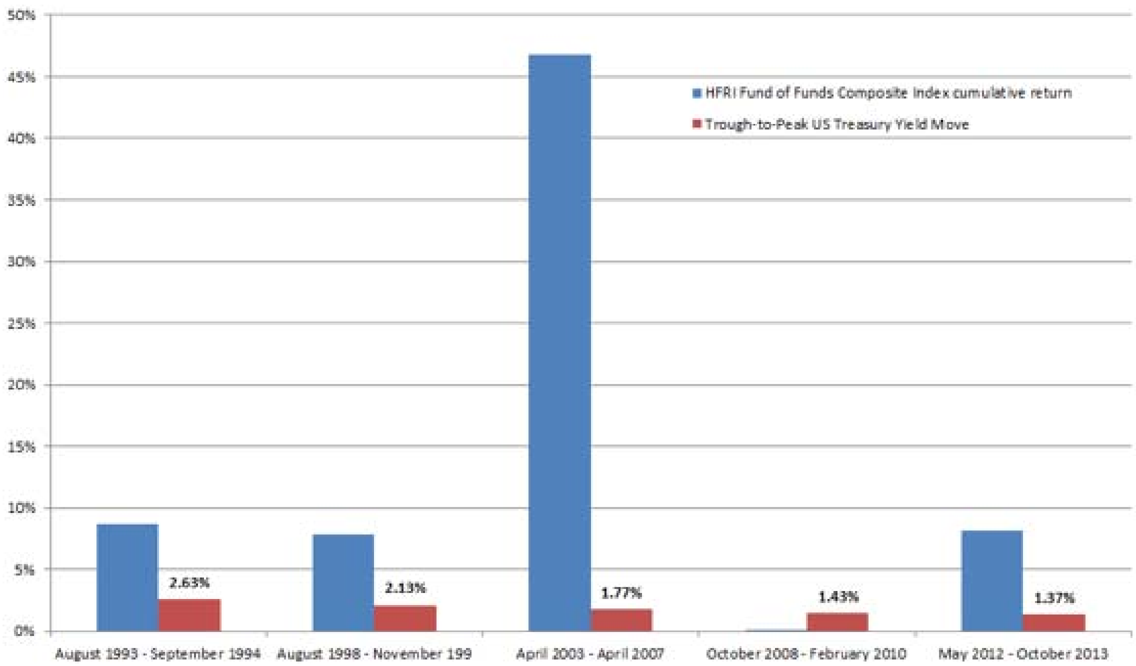


Source: Neuberger Berman; Bloomberg; HFR

Figure 9: Average fund of hedge fund has generated positive returns during periods of rising 10-year treasury yields

Source: Federal Reserve; HFR

Figure 10: Fund of hedge fund cumulative return during periods of rising yields



Source: Federal Reserve; HFR

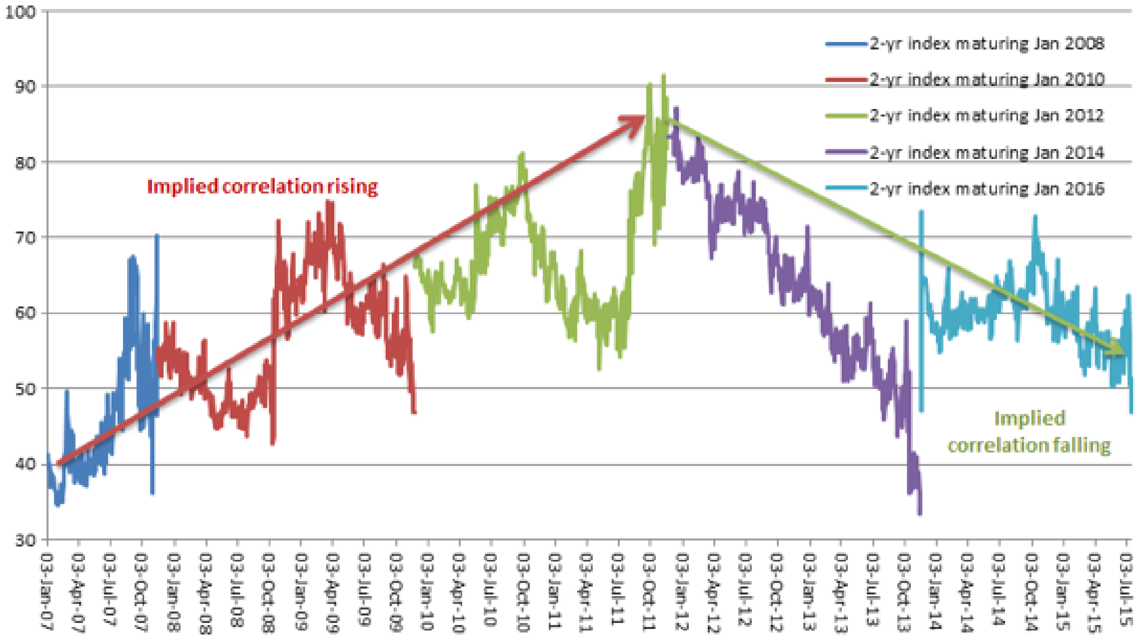
For some time, investors have signaled their appreciation that alternatives might help to diversify portfolios in a way that avoids reliance on expensive fixed income markets. The

Morningstar and Barron's survey cited above found that almost a quarter of advisers and one-in-six institutions cited a poor bond market outlook as a "top driver of investments in alternatives" which may explain the surge in non-traditional bond alternatives that the survey uncovered.

6. A MORE FAVOURABLE MARKET ENVIRONMENT FOR MANY HEDGE FUND STRATEGIES

Nonetheless, investors should not confine themselves to thinking about alternatives as an exclusively defensive move. The current environment is also creating positive opportunities for some hedge fund strategies. Consider, for example, long/short equity. Historically, it has been difficult to generate excess return as the entire market traded up and down with the prevailing macroeconomic sentiment. During 2013-14, some of that correlation began to break down. As overall market valuation edged upwards, there were nonetheless sell-offs in small- and mid-cap stocks, health care, consumer and, of course, energy businesses. As interest rates rise, a higher cost of capital should also begin to put lesser-quality companies under pressure, adding to stock-level performance divergence.

Figure 11: Equity market valuation dispersion is high
(CBOE S&P500 Implied Correlation Indices, 2007-2015)

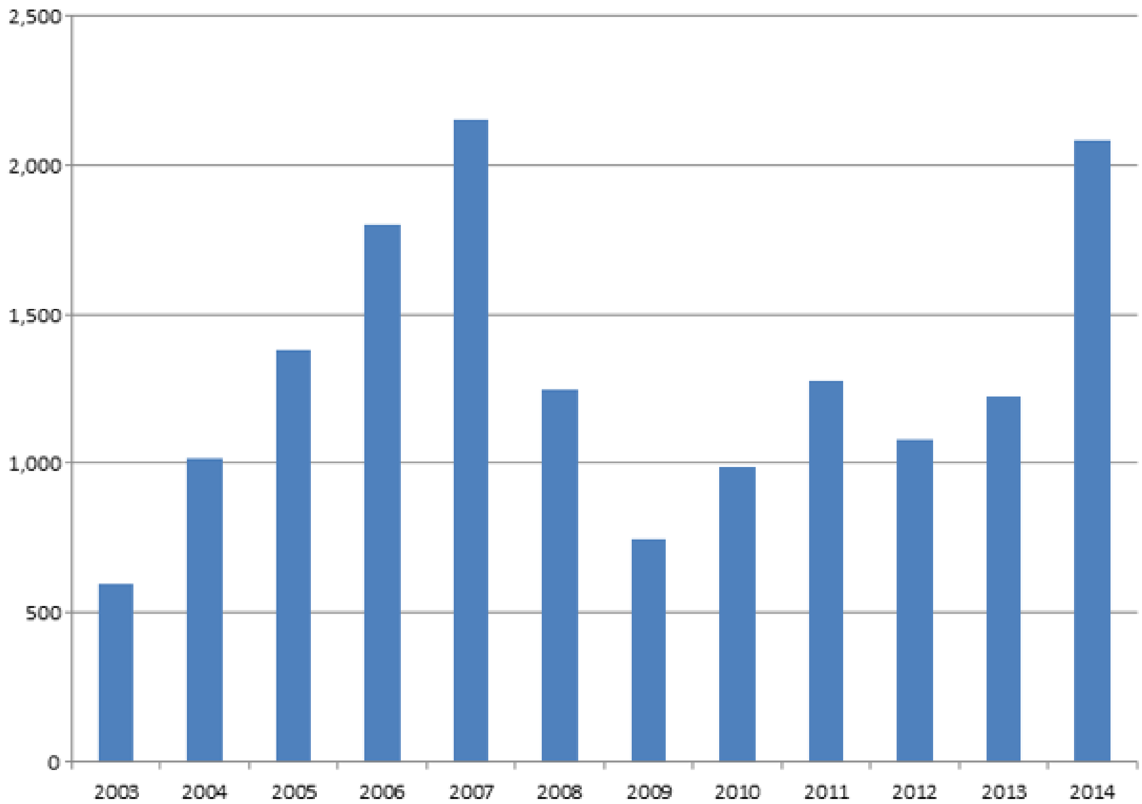


Source: Chicago Board Options Exchange. The CBOE S&P 500 Implied Correlation Indices represent a market-based estimate of the average correlation of stocks, using S&P500 Index options prices, together with the prices of options on the 50 largest stocks in the S&P 500 Index.

Prospects for macro strategists appear more favourable too. Globally-coordinated central bank activity and a lack of sustained market trends since 2008 have led fixed income and currency volatility to be anchored at historically low levels. But, as an improving US economy leads to the US Federal Reserve to raise interest rates while other major central banks remain highly accommodative, that volatility could continue to rise.

Finally, high corporate and private equity fund cash balances combined with improving corporate sentiment looks set to re-ignite the appetite for mergers and acquisitions, presenting opportunities for event-driven strategies. The pace of corporate activity has accelerated as the prospect of higher interest rates prompts companies to secure cheap financing for deals.

Figure 12: Corporate activity has been increasing
(North American M&A Volume (US$bn))



Source: Bloomberg.

CONCLUSION

Traditional asset classes look expensive at present and, as a function of that, promise poor diversification. However rising volatility, stock performance dispersion and M&A activity present richer pickings for hedge fund managers than has been seen for many years.

However, the decision to allocate to alternatives is just the first of many. Institutional investors now have a real choice between traditional offshore hedge fund structures and onshore liquid alternatives regulated funds, and advisers and retail investors have a new range of strategies to add to the existing menu of multi-asset absolute return products. Those who choose to invest in liquid alternatives face a further decision as to whether to do so via single-strategy, multi-strategy or multi-manager solutions. Only then can they turn to assessing which managers combine the necessary mix of hedge fund expertise and regulated-fund infrastructure to meet the challenge of providing a successful liquid alternatives product.

As always, more choice introduces more complexity. But the payoff is the ability to construct portfolios that better reflect the needs of investors, particularly in difficult times for asset allocation. The rise of less costly and more transparent liquid alternatives products brings that choice to a larger pool of investors, on more favourable terms, than ever before.

© PortfolioConstruction Forum 2015

DISCLAIMER

This material is provided for informational purposes only and nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security. Information is obtained from sources deemed reliable, but there is no representation or warranty as to its accuracy, completeness or reliability. All information is current as of the date of this material and is subject to change without notice. Any views or opinions expressed may not reflect those of the firm as a whole. Neuberger Berman products and services may not be available in all jurisdictions or to all client types.

Investing entails risks, including possible loss of principal. Investments in hedge funds and private equity are speculative and involve a higher degree of risk than more traditional investments. Investments in hedge funds and private equity are intended for sophisticated investors only. Indexes are unmanaged and are not available for direct investment. Past performance is no guarantee of future results.

This material is being issued on a limited basis through various global subsidiaries and affiliates of Neuberger Berman Group LLC. Please visit http://www.nb.com/Pages/Public/global/disclosure-global-communications.aspx for the specific entities and jurisdictional limitations and restrictions.

The "Neuberger Berman" name and logo are registered service marks of Neuberger Berman Group LLC.

© 2015 Neuberger Berman Group LLC. All rights reserved.

Ian Haas is Head of Quantitative and Directional Strategy Research, NB Alternative Investment Management. Fred Ingham is Head of International Hedge Fund Investments, NB Alternative Investment Management.