

# ManagersINSIGHT

Managers Investment Group Research and Analysis

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## The Increasing Importance of Alternative Strategies

“Alternatives” is currently the hot buzzword in the investment industry. Having survived the market crash of late-2008/early-2009, investors have realized that portfolios consisting of traditional long-only asset classes may not provide the expected diversification benefits during periods of extreme market turmoil. As a result, investors are seeking ways to better insulate themselves from market volatility going forward.

The definition of what an alternative

investment is has changed over the years. Whereas historically investors have considered such non-traditional asset classes as real estate or commodities as being “alternatives”, today’s investors increasingly define alternatives as investment strategies that have positive expected alpha and a near-zero correlation with traditional asset classes. These strategies tend to utilize derivatives and often mimic hedge fund strategies that have historically been un-

available to the average investor. While this definition tends to generalize alternatives, the result is that it encompasses a plethora of different strategies that have many different objectives. (Chart 1)

The list in Chart 1 is neither exhaustive nor are the listed strategies mutually exclusive. For example, an alternative product can be categorized as both Long/Short and Absolute Return solutions.

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Chart 1

Alternative Strategy	Description
Long/Short	Investment strategy that involves buying securities you expect to increase in value and selling short those expected to decrease in value. Trades may be paired or the portfolio may be positioned in a strategic manner to limit beta exposure.
Absolute Return	Aims to produce a positive absolute return regardless of the direction of financial markets. Often combine short and long positions or invest across multiple asset classes.
Arbitrage	Attempts to exploit price inefficiencies across markets. Convertible arbitrage is a common example. Convertible arbitrage is an approach that invests in convertible bonds and common stock to exploit mispricing across vehicles.
Bear Market	Intended to perform best during negative market environments. These products often short market indexes or invest in vehicles that perform well when markets depreciate.
FX Currency	Intended to capitalize on inefficiencies in the global currency markets. Currency markets are very liquid and all participants do not have the same objectives, which can create an attractive alpha opportunity for investors.
Managed Futures	Takes long and short positions by utilizing futures, forwards, and options to invest in currency, interest rate, equity, and commodity markets. These accounts are managed by Commodity Trading Advisors (CTAs) that are specifically licensed to operate in these markets.
Market Neutral	Strategy’s objective is to exploit specific investment opportunities while maintaining a neutral exposure to broad markets. Pair trades are often an important component of market neutral portfolios to hedge beta exposure.
Merger/Risk Arbitrage	This is a specific arbitrage strategy that attempts to profit from proposed mergers. To profit from mispricing the manager may purchase the target and short the acquirer.
Volatility	Attempts to profit from market volatility by using various different derivative contracts. Strategy attempts to exploit deviations in implied, realized, and historic market volatility.



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### Increasing Access to Alternatives

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Until recently most investors have found it difficult to access these investments in a format that provides the liquidity and low-cost that they are accustomed to in their more traditional

investments. Historically, only very large investors had access to a limited number of hedge fund investment opportunities. Moreover, hedge fund investments were notoriously high-priced and lacking in both transparency and liquidity. Today,

most investors can access some or all of these strategies through 1940-Act mutual funds, which reduce/eliminate many of the drawbacks associated with hedge funds. (Chart 2)

Chart 2

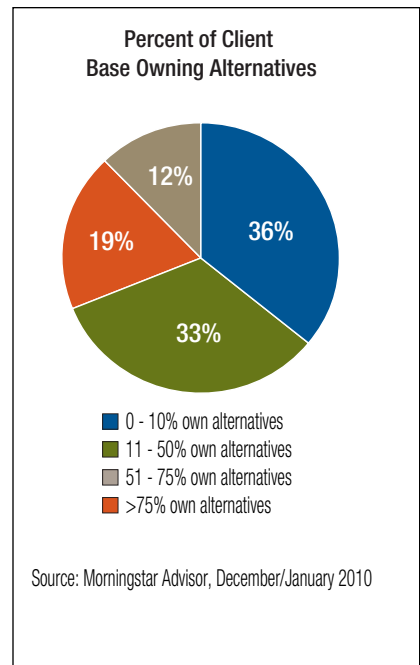
FUND TYPE ▼	Liquidity	Fees	Transparency	Regulation	Minimum Investment	Accredited Investor	Tax Form
Mutual Fund	Daily	1% - 2%	High	High	Low	No	1099
Hedge Fund	Varies — Lockups Common	2% + Performance Fee	Low-to-None	Low-to-None	Often High	Yes	K-1

### Increasing Acceptance of Alternative Strategies

As advisors seek to insulate their clients from the most extreme market movements, they have turned increasingly to alternatives strategies for a portion of their clients' portfolios. A recent Morningstar survey indicated that since the last market crash, nearly 80% of advisors have more conviction that alternatives are a necessary part of their clients' portfolios and nearly 60% have increased their clients' exposure to alternatives. Nearly 2/3 of the advisors that participated in the Morningstar survey reported that at least 10% of their client base owns alternative investments. (Chart 3)

*Since the last market crash, nearly 80% of advisors have more conviction that alternatives are a necessary part of their clients' portfolios and nearly 60% have increased their clients' exposure to alternatives.*

Chart 3



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## *Benefits of Alternative Investment Strategies*

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The need for enhanced diversification was never more evident than during 2008, when the increasingly interdependent nature of global capital markets resulted in disappointing performance for those investors with portfolios that only emphasized equities and fixed income. From late-2007 to early-2009 traditional asset classes moved in tandem more than historical correlation coefficients would have predicted. As a result, alternative investments have become increasingly attractive to investors seeking ways to better diversify their asset-allocation portfolios.

Alternative investment strategies are gaining traction because they have historical correlation coefficients near zero. During 2008, as most asset classes saw their correlations trend toward +1.0, alternative strategies maintained correlations near zero and some even generated positive returns. Well-conceived alternative portfolios are less dependent on the performance in one specific asset class. Instead, some attempt to exploit opportunities across various asset classes and can benefit from positive or negative market movement. While the lack of beta (market exposure) may cause such strategies to lag during broad market ral-

lies, this same lack of beta allows these strategies to act as an excellent diversifier during down markets.

Incorporating a component that offers low-correlations to other asset classes and positive absolute returns can push out the efficient frontier of an investor's broader asset-allocation portfolio. As an example, an allocation to a well-managed market neutral fund during 2008 could have limited portfolio downside and decreased realized volatility. The sharply negative returns experienced during 2008 reinforced the value of downside protection.

## *What is the Appropriate Alternative Allocation?*

As highlighted earlier, the numerous alternative categories, and strategies within the same category, are often quite distinct. Nevertheless, a common mistake investors make when considering adding an alternative component to their broader asset-allocation portfolio is treating all alternatives as equals. It is important that investors understand the differences to determine which strategies provide the most suitable complement to their existing portfolios.

Various approaches can be utilized to gain exposure to alternatives, however

there is no consensus on what the appropriate allocation to alternatives should be or how that allocation should be distributed across strategies. Most allocations range from 5% to 25%, with the larger allocations spread across complementary managers. Where an investor fits within that allocation range will depend on their return objective, risk tolerance, and existing asset allocation. At a minimum, investors should consider allocating a portion of their portfolio to alternatives.

As the growth of alternative funds continues, properly educating investors on the differences among alternative strategies while making appropriate allocations to this category will become increasingly important. The key lies in understanding the uniqueness of each of these strategies and how they can not only potentially complement and diversify the other investments within an asset-allocation portfolio, but also how these funds may complement each other within a broader alternatives allocation.



*Please see Disclosures on back page*

## DISCLOSURES

***There is no guarantee that these investment strategies will work under all market conditions, and each investor should evaluate their ability to invest for a long-term, especially during periods of downturns in the market.*** The investment return and the principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Asset allocation does not protect against the risk of fluctuating prices and uncertain returns.

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