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Using Alternatives in Practice

By Jerry Kerns

Advisors and clients need to understand what they're buying and the role a strategy has in a portfolio.

The number of liquid alternatives offerings has skyrocketed since the 2008 financial crisis. Not satisfied with the performance of their traditional stock and bond portfolios, many advisors and investors have sought out the sophisticated strategies that hedge funds and institutional investors have been using for decades. Mutual fund and exchange-traded-fund firms quickly answered the call. The fund industry has launched hundreds of alternative offerings of varying strategies and asset classes over the past five years. To get a practical view of this burgeoning segment of the industry, we interviewed three professionals who have many years of experience investing in alternatives for clients.

Bradley Alford founded Alpha Capital Management in 2006, a registered investment advisor based in Atlanta. He is the portfolio manager of Alpha Opportunistic Growth ACOPX and Alpha Defensive Growth ACDEX. Richard Raby is a portfolio manager for Creative Financial Group, also based in Atlanta. The firm provides financial planning and investment advisory services for high-net-worth clients. Richard Bregman is the founder and CEO of MJB Asset Management, a RIA firm based in New York City.

The three will appear together June 13 at the 2013 Morningstar Investment Conference in Chicago.

Jerry Kerns: What is your definition of an alternative investment?

Bradley Alford: The term *alternative investment* is used to describe both asset classes and investment strategies. Alternative asset classes are those other than the three traditional asset classes, which are stocks, bonds, and cash. Examples of alternative asset classes are private equity, real assets, and commodities. Alternative strategies are those that use management techniques other than long-only, such as leverage and short selling. The term *hedge fund* is generally used to describe the vast array of alternative investment strategies. It's worth highlighting that alternative investment strategies are implemented using traditional asset classes, as well as alternative asset classes.

Richard Raby: An alternative investment is any investment outside the standard, long-only investments in equities and fixed income. This would include precious metals, futures, short positions, options, and asset-allocation strategies that can use those same vehicles.

Richard Bregman: Alternatives are not *investments* per se, but rather are strategies that incorporate some element of hedging, whether through individual short sales or by use of derivatives, such as options, futures, swaps, etc. From this perspective, there are three categories of investments: equity (ownership), debt (lending), and insurance (short sales and derivatives). So-called long positions in equity and debt are typically referred to as traditional investments; alternatives incorporate that third category—insurance as a hedge against security, industry, and systemic risks. Alternatives by themselves are not an asset class. For example, from this perspective, a long-only commodities fund is a traditional equity portfolio in that you own a basket of stocks, metals, or contracts. Long-only REIT funds are traditional equity funds because you own positions in REITs. An emerging-markets bond fund is a traditional fixed-income portfolio because you are lending to emerging country governments or corporations. By contrast, a long/short commodities fund, or a long/short REIT fund, or a long/short emerging-markets bond fund is an alternative strategy, as the funds contain traditional positions in stocks and bonds but also contain short positions as insurance. Adding that third category—insurance—typically will reduce correlations with traditional strategies and reduce volatility relative to traditional strategies.

Kerns: What role should alternative investments play in a portfolio?

Alford: Alternative investments are intended to generate returns that are far less dependent

Bradley Alford

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Richard Raby

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on stock- and bond-market exposure. It is getting more and more difficult for investors to meet their objectives with a traditional 60/40 stock/bond portfolio—equities keep rising but that can't last forever, and bonds are a poor investment as the 30-plus-year bull market in interest rates comes to a close. I view alternatives as the necessary third component to a diversified portfolio. Alternatives can play many different roles in a portfolio, from return enhancer, to fixed-income substitute, to diversifier; one thing each alternative asset class has in common is the ability to provide investors with insurance against declines in a 60/40 portfolio. Combining non-correlated investments can create a portfolio with better risk-adjusted returns.

Raby: They are a means to mitigate downside risk, maximize risk-adjusted returns, and minimize correlation to the market.

Bregman: Risk mitigation in the form of limiting overall portfolio volatility, for starters. Curtailing volatility can provide an investor with the opportunity to limit downward movements and position the portfolio for gains in the future.

Kerns: How has the environment changed over the past 10 years for alternative investing?

Alford: I have been investing in alternatives for more than 20 years, so I have witnessed an incredible amount of change, but especially in the past 10 years. There has been a mainstreaming of alternatives, particularly due to the availability of liquid alternative mutual funds. Ten years ago, alternatives were confined to the biggest institutions, but they have now become an accessible component of a diversified portfolio for all investor types.

Raby: People have opened up to the use of alternative, hedged, and flexible strategies a great deal more. The idea of buying and hoping the market will go up while witnessing 2000–2002 and 2008 is a little hard for many to handle. The Jeremy Siegel "Stocks for the Long Run" concept does not apply to many investors as they are not patient enough to hold out for 30 years while the market is down 38% or more. Most retirees, or those approaching retirement, are open to a strategy that does not resemble a roller coaster. In turn, the marketplace has started to provide some viable and dynamic solutions via '40 Act funds, which we like very much. These solutions are in contrast to the lack of transparency, low liquidity, and high expenses in the hedge fund world. Our most important job is the management of risk, not management of returns, to paraphrase Ben Graham. In our opinion, the unregulated world of hedge funds does not fit that profile.

Bregman: The biggest change I have seen is the incredible migration of alternative strategies into the open-end '40 act mutual fund format.

Kerns: What is the biggest challenge to investing in alternatives?

Alford: Due diligence is crucial, but many advisors don't have experience with alternatives. With traditional alternatives such as hedge funds, managers do not offer much transparency into portfolio positions or investment process, making these investments difficult to evaluate. With liquid alternatives, although transparency is high due to the '40 Act fund structure, most products have short track records, making it difficult to judge how these managers will perform over a full market cycle. The dispersion in returns between the best and worst U.S. large-cap equity manager might only be a few percentage points in any given year; in hedge funds, it can be more than 15 percentage points per year. The stakes are high for picking the wrong managers.

Raby: Educating clients on the nuances of alternative funds.

Bregman: The biggest challenge is fully understanding the risk-and-return opportunities of particular strategies in particular market environments.

Richard Bregman

> It is important to roll up your sleeves and do the homework on a strategy to find out what the consequences might be under various circumstances.

Kerns: What do investors and clients fear most about investing in alternatives? How do you deal with this perception?

Alford: In many ways, 2008 represented investors' biggest fears. Some categories of alternatives were hit even harder than stocks and bonds, and previously uncorrelated asset classes showed significantly higher correlations to each other than expected. Additionally, the illiquidity of many alternatives meant that cash-strapped investors had to sell liquid assets at the worst time possible since the money in hedge funds or private equity was locked up, in some cases for multiple years. With liquid alternatives, investors have the flexibility and liquidity to quickly change their portfolio across market cycles.

Raby: They fear the unknown, mostly. Being unlike an index in performance and structure, an alternative investment does not fit into a nice, easy paradigm, so we have to educate them. The best way to educate them is to run through the performance stories during times like 2000 to 2002 and 2008 to 2009.

Bregman: A few clients have feared the word *derivative* and a few have feared anything sounding *quantitative*. If a client has a fear, we see no point in exacerbating it. There are a sufficient number of alternative strategies that we can find several with which a client can be comfortable.

What is the biggest mistake advisors and investors make when investing in alternatives.

Alford: The biggest mistake is not holding alternatives for a full market cycle. For example, long/short equity funds always have a short component and will never keep up with the S&P 500 in an overheated equity market like we have today. Many investors will sell all their alternative funds and just buy long-only equity managers right as the market peaks. They will suffer the greatest in a correction. Alternative managers need to be held for three to five years, even during raging bull markets. Performance chasing is a great way to underperform the markets.

Raby: Advisors make the mistake of not educating their clients on how alternatives work.

Bregman: I believe the biggest challenge for an advisor is not fully understanding the complete risk/return trade-off for various strategies. It is important to roll up your sleeves and do the homework on a strategy to find out what the consequences might be under various circumstances.

Kerns: Who is your favorite alternatives investor? Who has influenced you the most?

Alford: My favorite alternative fund is Robeco Long/Short Equity BPLSX managed by Bob Jones. Not only is his performance excellent over all time periods, but he closed the fund years ago to focus on returns instead of gathering assets for more management fees. I just love it when a manager closes to new investors as it shows his interest is clearly aligned with his investors. Warren Buffett has influenced me the most. He taught me that you don't have to pay a manager 2-and-20 for them to be great. At the Duke Endowment, where I used to manage the alternative investment portfolio, I thought all great money managers had to be hedge funds in a 2-and-20 limited partnership structure. I have opened my eyes to the alternative managers in mutual funds.

Raby: Ryan Caldwell and the Waddell & Reed team are my favorites. Caldwell and Ivy pushed me to jump into asset-allocation strategies because they performed so well in both up and down markets and they were not a huge leap of faith for our clients to make into the scary world of alternatives. As a firm, Research Affiliates and Rob Arnott have been the most influential to us.

Bregman: Benoit Mandelbrot, who developed fractal geometry, has had a huge influence on my views of markets and volatility.

Kerns: What is your best piece of advice for advisors who are considering alternative investments for their clients' portfolios?

Alford: Education, education, education. I like to joke that alternatives compose 20% of a portfolio but will consume 80% of an advisor's time. Both the advisors and the clients need to take the time to understand the risks and benefits of alternatives in a diversified portfolio.

Raby: Review the performance in both up and down markets and do not let expense ratios scare you away from an important asset class.

Bregman: Do your research and make sure you have a clear purpose for using alternative strategies. M

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