HEALTH WEALTH CAREER

THE ROLE OF LIQUID ALTERNATIVES IN WEALTH MANAGEMENT

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In this short paper, we focus on liquid alternative products and will,

1) explain the investment theses for investing in alternatives;

2) provide an overview of the current liquid alternatives landscape; and

3) provide a sample framework of how to allocate to alternatives.

It's no secret that investors are looking for uncorrelated return sources for their portfolios. Low interest rates and the experience of the global financial crisis are leading many to include "liquid alternatives" in their toolbox. At Mercer, we define liquid alternatives broadly as strategies that follow alternative strategies, such as those typically used by hedge funds, and that are available as commingled/pooled funds that trade at least weekly. Much of the product growth was born of the crisis: since 2009, assets in alternative '40 Act funds[1] increased from $97 billion to over $420 billion in 2014. Some call it the "democratization" of the investment world — providing all investors with access to managers and strategies that were once restricted to only the ultra-wealthy or large institutional investors. This is fitting, as these individual investors now have more responsibility for securing their retirement outcomes. Individuals, defined contribution plans, nonprofits, and even corporate pensions that desire liquidity are beginning to consider whether liquid alternatives can help them better execute their overall investment strategy.

ALTERNATIVES INVESTMENT THESIS

Investors make allocations to alternative investments for one or more of the following three reasons: growth, diversification, and inflation protection

Investors make allocations to alternative investments for one or more of the following three reasons: growth, diversification, and inflation protection. The appropriate alternatives strategy is driven by the intended objective. For those investors with a growth objective, manager selection is the primary driver of success; for those with an inflation protection — although manager skill is still important — the desired mix of inflation-sensitive assets is the more critical driver.

Although there are three main theses for alternatives, the predominant role is to provide **diversification away from traditional return sources**. Traditional return sources are those that, generally speaking, can be achieved with long-only exposure to traditional asset classes, such as equities and credit. By introducing new, lowly correlated, or uncorrelated return drivers, the portfolio relies less on the direction of capital markets. Importantly, this risk-reduction capability does not necessarily come at the cost of lower expected returns, making alternative strategies one of the more compelling investment opportunities available.

The equity risk premium is a common building block for many growth portfolios, and we believe there is a logical and sensible rationale for the premium persisting. However, it is also clear that if we can identify and capture other sources of return then we can build a growth portfolio with more attractive risk/return characteristics than one simply reliant on the traditional long-only equity and fixed income markets. For this reason, we see alternative strategies forming a compelling part of most growth portfolios.

Rather than view portfolios from the perspective of capital structure (equities, fixed income, etc.), Mercer finds it more appropriate to consider each asset's role within the portfolio. "Growth" assets include public equities, alternatives, and growth-oriented

1 The Investment Company Act of 1940, passed into law by the United State Congress on August 22, 1940.

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fixed income (defined as credit-oriented assets that seek to generate returns above those from investment-grade credit, such as high yield, emerging markets local currency debt, and private debt). Broadly speaking, we look to the alternatives portfolio to generate alpha that has low correlation to the returns of the public equity and credit portfolios. A possible secondary role is to provide access to strategies likely to assist in tail-risk hedging.

A few of the differentiated return sources that alternative strategies are seeking to capture include:

- Less-constrained security selection.
- Variable beta.
- Deal risk premium.
- Complexity risk premium.
- Liquidity risk premium.
- Spread risk premium.

When investing in liquid alternative strategies, the investor must also consider the following factors:

- **Fees:** Alternatives managers typically charge higher fees than traditional strategies, so focusing on the net-of-fee performance is important. Note that mutual fund regulation requires funds to include dividend and interest expenses on shorted securities in their stated expense ratio. Also, astute eyes are needed to identify hidden fees.
- **Transparency** can be an issue, and this is particularly true of fund of funds, for which the look-throughs may not be readily available. Although registered mutual funds are required to provide underlying holdings, interpretation of this information can be difficult.
- **Asset/liability matching:** Understanding the liquidity terms and ensuring they are consistent with the liquidity of the underlying assets is vital. For prudent alternative managers, daily/weekly liquidity may limit the ability to exploit some of the desired differentiated return sources. For others, a potential undesirable asset/liability mismatch could materialize.
- **Liquidity terms** allow for “gates” etc. — under normal circumstances, these funds should provide daily/weekly liquidity, but under extreme circumstances liquid funds have terms that allow for liquidity restrictions such as gates, penalties, or anti-dilution levies. Understanding the liquidity terms and ensuring they are consistent with the underlying investments is important. Although these terms may appear disadvantageous, they actually serve to protect the interests of and fairly treat both redeeming and remaining clients.

Investors that have a preference for and/or a requirement for liquidity should consider liquid alternatives as an allocation within their portfolio.

THE LIQUID ALTERNATIVES LANDSCAPE

According to Lipper, from 2009 to 2014 assets in liquid alternative mutual funds quadrupled, with total assets of $422 billion reported in 2014. In comparison, over the same time period, assets in non-alternative mutual funds grew by only 50%. International multi-asset, global macro, and credit-focused funds saw the largest increases in assets. Driving the growth in these categories is the desire for more professionally managed, broadly diversified portfolios (multi-asset class) and the low-interest-rate environment coupled with the fear of rising rates (credit-focused funds).

Mercer uses the following classifications for liquid alternatives (for a complete list of definitions and descriptions, please see the Appendix):

- Equity hedge (long/short equity: directional or market neutral).
- Event-driven and credit (distressed debt, long/short credit, and event-driven).
- Fund of funds (directional, market neutral).
- Multi-asset.
- Multi-strategy (directional, market neutral).
- Trading (active currency, managed futures, long/short commodities, and fundamental macro).
- Other.

The sheer number of funds now available presents an opportunity but also a challenge in identifying the most talented managers and best-suited funds to complement an investor's traditional asset portfolio. Just as successful hedge fund investing is predicated on investing with the best active managers in the world, the same is true in the liquid alternatives space — manager selection is vital. It goes without saying that proper due diligence — from both an investment and operational perspective — is a necessary condition for success in alternatives investing. Although private hedge fund managers launching a mutual fund will generally have verifiable track records for their strategies, traditional asset managers launching funds may not. As more investors demand liquid alternatives, talented managers will be increasingly attracted to the liquid alternatives space.

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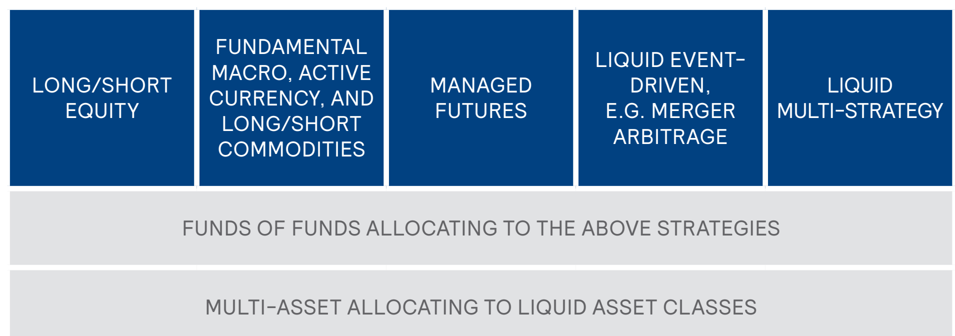
A number of global hedge fund managers already offer a liquid alternative, either in the form of a UCITs or a mutual fund ('40 Act Fund). Most of those funds make daily pricing and daily liquidity available. Generally, managers have indicated that they have not observed outflows from their less-liquid strategies into more-liquid versions, which is indicative of new investors entering these strategies rather than investors moving between vehicles. Following recent trends, the number of new liquid alternatives will continue to grow despite challenges like the cost of creating and maintaining a strategy and daily liquidity requirements. Mercer recognizes that a sub-set of alternative strategies lend themselves well to use in liquid vehicles — notably trading strategies and long/short equity — because the underlying instruments they trade are naturally liquid (see table below).

FIGURE 1 Strategies Suited to Liquid Structures



HOW TO ALLOCATE TO ALTERNATIVES:
PORTFOLIO EXAMPLE

Now that we've discussed the **why** for alternatives, now we can review the **how**. Although there are many factors that determine the overall portfolio's allocation to alternatives, we generally suggest allocating 10%–30% to alternatives. The actual allocation depends on a variety of factors, including the client's comfort with the strategy and manager. The allocation can be built over time; creating a diversified alternatives portfolio is important, but it is important not to over-diversify away your alternatives exposure.

Generally speaking, we believe in taking a portfolio approach in allocating to alternatives. Developing a mix of the diversifying risk sources discussed above offers the ability to reduce risk while having as many "ways to win" as possible.

We think the following framework is useful when thinking about alternatives portfolio construction.

FIGURE 2 Alternative Portfolio Construction Framework*

Liquidity	GROWTH	DIVERSIFICATION	INFLATION PROTECTION
MORE LIQUID	Core multi-asset	Idiosyncratic multi-asset trading strategies (fundamental macro/ managed futures/ active currency)	Liquid real assets (REITs/natural resource equity/commodities) TIPS
	Directional long/short equity directional long/short credit activist	Long/short equity long/short credit equity market neutral	Directional long/ short commodities
	Event-driven distressed multi-strategy		Core real estate
	Mezzanine debt secondaries		
LESS LIQUID/ ILLIQUID	Buyouts distressed for control growth equity venture capital		Infrastructure/energy/ PE/timber/agriculture/ non-core real estate

**Estimate of the liquidity profile for illustrative purposes only; may differ at the individual strategy level. Additionally, axis scale may not be in alignment for directional and market neutral*

Looking at the toolbox above, the drawers are divided into the three main reasons for allocating to the alternatives highlighted earlier: growth, diversification, and inflation protection. Generally speaking, the first two rows of drawers represent liquid alternative options.

It is important to note that vastly different risk/reward profiles may exist within each alternative strategy highlighted within the toolbox. Thorough due diligence is necessary to understand these varying risk/reward profiles.

CONCLUSION

Liquid alternatives have opened new opportunities for investors that require/desire liquidity and/or have smaller asset bases. These funds offer access to strategies that provide additional sources of growth, diversification, or inflation protection. After the explosive growth of the past few years, investors have approximately 900 mutual funds to choose from. The widespread availability of liquid strategies presents an opportunity for investors who have traditionally been limited to more traditional asset classes. Although liquid alternatives present a large opportunity set, an even broader opportunity set is available for those investors who can tolerate the illiquidity and reporting requirements of less liquid funds. No matter where a client sits on the liquidity spectrum, Mercer believes an allocation to alternatives warrants consideration.

APPENDIX A

Q&A

Q **Do traditional hedge funds that offer less liquid terms have the ability to take part in opportunities with the potential for greater rewards than are possible with liquid alternatives?**

Not necessarily. Although such funds would have the ability to participate in capturing a liquidity premium that isn't prudently available to liquid alternatives, liquid assets offer ample opportunities to achieve higher returns.

Q **Do traditional hedge funds that offer less-liquid terms have the ability to provide a greater diversification benefit relative to traditional assets than liquid alternatives?**

Yes. The liquidity constraint will inherently limit the opportunity set for diversification; however, it does not eliminate this opportunity set. Liquid alternatives can still satisfy the diversification mandate through the utilization of the strategies located in the first two drawers within the diversification column of Figure 2 (page 5).

Q **Are liquid alternatives a vehicle best suited for retail investors or can they also play a meaningful role in institutional portfolios?**

The appropriate allocation to alternative investments, liquid or otherwise, is fully dependent on the objectives, constraints, and tolerances of each specific investor. That said, liquid alternatives can have a meaningful role within any portfolio. As many institutional investors learned during the financial crisis, understanding and managing the liquidity profile of the overall portfolio is critical, and liquid alternatives offer a tool in this process.

Q **Will the "best" investment talent work only for traditional hedge funds, and not for liquid alternatives?**

As the landscape has evolved, we have seen more high-quality managers enter the space. Additionally, we believe that although a large amount of the first liquid alternatives strategies were created by more retail houses, there is a growing trend for the traditional hedge fund community to offer more liquid versions. Consequently, we believe the issue regarding talent is ultimately unfounded.

APPENDIX B
GLOSSARY AND DESCRIPTIONS

LIQUID ALTERNATIVES EQUITY HEDGE
Liquid long-short equity strategies OR liquid equity market neutral strategies.

LIQUID ALTERNATIVES EVENT-DRIVEN AND CREDIT
Liquid strategies investing in securities impacted by certain company-specific events or catalysts OR liquid opportunistic strategies investing in a broad range of debt instruments, using a variety of methods.

LIQUID ALTERNATIVES FUND OF FUNDS
Liquid multimanager fund of hedge fund strategies.

LIQUID ALTERNATIVES MULTI-STRATEGY
Liquid single-manager, multi-strategy hedge fund categories.

LIQUID ALTERNATIVES MULTI-ASSET
Liquid multi-asset strategies with absolute return objectives; including diversified growth funds, idiosyncratic multi-asset strategies, etc.

LIQUID ALTERNATIVES OTHER
All liquid hedge fund or absolute return strategies that do not fit into any of the other categories.

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