The Invesco White Paper Series

Liquid Alternatives – More Than Just Return Potential

Institutional investors, mostly in Europe and the US, have been increasing their exposure to alternatives to improve diversification, better mitigate risk and enhance return potential. But many alternative investments are fairly illiquid. This is where so-called liquid alternatives come in.

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As we will discuss here, liquid alternatives are hedge fund-like strategies that typically consist of publicly traded equity and fixed income investments. They are a collection of unconventional actively managed strategies, using a variety of exposures (long, short, market neutral) and financial instruments to extract different returns at different times.

As with most alternative strategies, historically liquid alternatives have tended to be lowly correlated with traditional equity and fixed income investments.[1] But whereas many alternative strategies, such as real estate and private equity are often fairly illiquid, liquid alternatives are not.

Usually, liquid alternatives are managed without the significant constraints that typically accompany traditional fixed income and equity investments, allowing for greater return potential. As a result, historically, liquid alternatives were solely considered "return" generators, but since the financial crisis of 2007-2008 their risk-diversifying attributes have attracted greater attention.

The incorporation of liquid alternatives into asset allocation has evolved over the years from investing in single funds as a component of the broader alternatives category to being carved out as a separate asset class with a pre-specified percentage allocation that could be implemented with a more integrated, multi-strategy approach. More recently, a customized multi-strategy approach is being promoted that seeks to align investment goals with their expected outcomes. This approach allows for a more expansive use of liquid alternatives as complements or substitutes to a traditional fixed income and equity allocation. The original goal of diversified incremental returns and risk mitigation remains, but may now lead to greater utility from portfolios.

Why liquid alternatives have become popular

We believe several key factors have led to the current market appetite for liquid alternatives. Most notably is the rise and fall of global equity markets over the past 15 years, as well as the current low interest rate environment, which has encouraged investors to seek innovative ways to balance risk and reward. Increasing product availability within better-regulated funds – UCITS in Europe and mutual funds in the US – has also enhanced investor willingness to adopt these strategies. Historically, they were primarily available through private, unregulated hedge funds. Greater accessibility has also heightened investor interest because the regulated funds also carry meaningfully lower investment minimums than private hedge funds, which typically have had higher investor qualifications. Lastly, greater transparency, which provides investors with the ability to look through to underlying holdings, and the ability to sell their investment on short notice relative to private hedge funds, has also created an increased comfort level with liquid alternatives.

The case for liquid alternatives

Today, the primary case for investing in liquid alternatives is diversification. Liquid alternatives' historical return pattern has tended to be complementary with traditional equity and fixed income returns. Historically, these returns have also been achieved with lower downside risk – that is, lower risk when equity markets were not performing well. Better downside risk management, which can involve avoiding losses in stressed market conditions, has historically resulted in better performance during market downturns for liquid alternatives relative to traditional equity and fixed income allocations.

To most investors, the benefit of diversification is obvious and has been recognized for over a half a century. As shown in Figure 1, there are many layers of diversification within equities, fixed income and alternatives. Investing in these categories has diversified beyond geography to include market or risk-based factors that drive returns, such as size and style within equities, and interest rates and credit within fixed income.

Figure 1 — Diversification, Diversification, Diversification

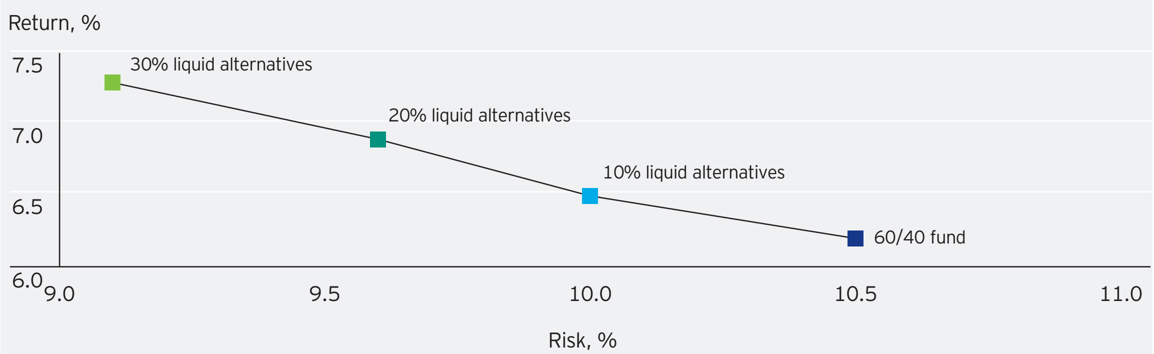
	Diversification properties	
Equity	– Country/region – Capitalization (large vs. small) – Value vs. growth – Sectors/industries	
Fixed income	– Regions – Interest rates – Credit – Currencies – Sectors	
Alternatives	– Real estate – Private equity – Infrastructure – Liquid alternatives/hedge funds	– Other: - commodities - MLPs - risk parity

Source Invesco, April 2014. For illustrative purposes only.

Even the alternatives category was generally diversified across a broad collection of investments. Harry Markowitz's Modern Portfolio Theory (MPT), published during the 1950s, suggested that a properly diversified portfolio comprised of lowly correlated assets, would earn a return equal to the weighted return of all of the component assets, but with lower portfolio risk overall than the weighted risk of each individual security.

As shown in Figure 2, incrementally adding a liquid alternatives allocation to a 60/40 portfolio would have improved absolute returns, lowered portfolio volatility, and thereby increased risk-adjusted returns from January 1997 through December 2013. A 100% allocation to the MSCI World Index, would have delivered an annualized return of 6.6%, but with substantially higher volatility, about 16%, resulting in a lower Sharpe ratio of about 0.25.

Figure 2 — Adding Liquid Alternatives may have Risk/Reward Benefits



	60/40 Portfolios	10% Alternatives 54% Stocks 36% Bonds	20% Alternatives 48% Stocks 32% Bonds	30% Alternatives 42% Stocks 28% Bonds
Return (%)	6.20	6.50	6.90	7.30
Risk (%)	10.50	10.00	9.60	9.10
Sharpe ratio	0.35	0.40	0.45	0.51

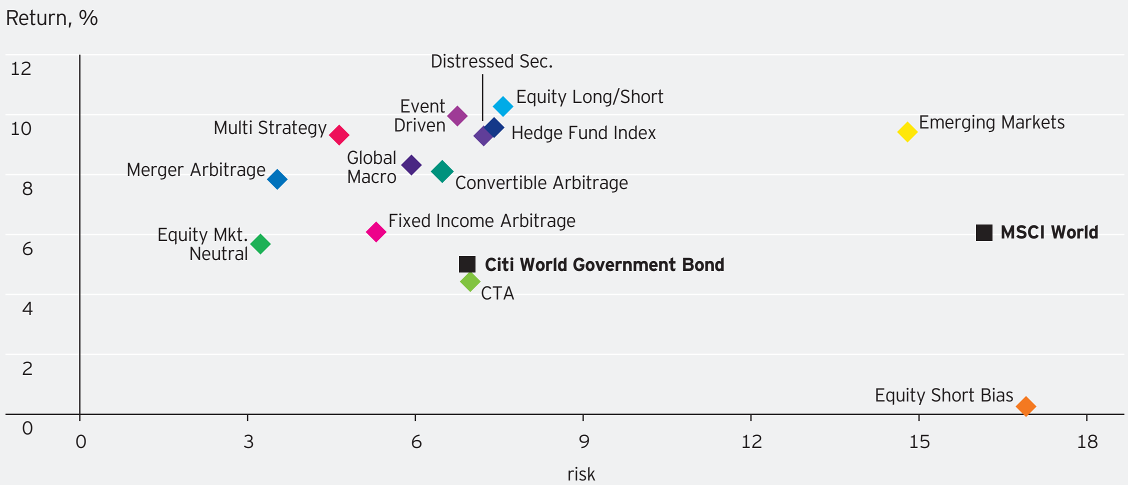
Source: Zephyr StyleADVISOR. "60/40 fund" refers to the returns of a portfolio that is 60% MSCI World (net of dividends) and 40% Citigroup World Government Bond Index; "Liquid alternatives" refers to the returns of the BarclayHedge Hedge Fund Index, which serves as a proxy. An investment cannot be made directly into an index. Risk is the annualized standard deviation of monthly returns. Return and risk are annualized and stated in USD. Assumes quarterly rebalancing to targets. This hypothetical example is presented for illustrative purposes only and does not represent the performance of any particular investment. Past performance is not a guarantee of future results.

Introducing liquid alternatives into asset allocation

Liquid alternatives have gained acceptance in recent years, but questions still remain about the best ways to incorporate them into an asset allocation strategy. Once the case for liquid alternatives is made and the risks and the benefits of diversification have been discussed, the next logical step to consider is how to build a portfolio that includes them. Asset allocation in the traditional framework is challenging because liquid alternatives are a disparate collection of strategies with different return streams that vary over time, so it is difficult to bind them together as one asset class, comparable to fixed income or equities.

Figure 3 illustrates the risk/return achieved from January 1997 to December 2013 using a sample of the liquid alternatives strategies available in the BarclayHedge Alternative Investment database. This demonstrates that most of these strategies have historically been less volatile than global equities, however, the range of realized returns has varied significantly.[2]

Figure 3 – A Sampling of Liquid Alternative Strategies
BarclayHedge Alternative Investment Database: risk vs return (January 1997 - December 2013)



MSCI World and Citi World Govt Bond are shown for comparison.
Source: BarclayHedge Alternative Investment Database. This computerized database tracks and analyses the performance of 6,723 hedge fund and managed futures investment programs worldwide. BarclayHedge has created and regularly updates 18 proprietary hedge fund indices and 10 managed futures indices. Please note: BarclayHedge is not affiliated with Barclays Bank or any of its affiliated entities. Performance for funds included in the BarclayHedge indices is reported net of fees. Past performance is no guarantee of future results.

This illustration typically elicits many questions about how to determine what type of liquid alternative strategies would best meet their return and risk objectives, as well as the optimal asset allocation percentage.

While frequently discussed, there still is not a consensus among asset allocation practitioners on what the optimal asset allocation to liquid alternatives should be.

To help answer these questions, investors would likely benefit from establishing a framework to use them in their portfolio. The true benefit of liquid alternatives is how they perform in combination with the entire portfolio, including how they balance risk and return.

Just as it's necessary to select an optimal mix of equities and fixed income investments that are consistent with the investor's goals, a similar philosophy holds for selecting a diversified mix of liquid alternatives. That's because a strategy that only focuses on buying alternatives is likely to be insufficient and could lead to disappointment.

Figure 4 illustrates how to identify a range of options for closer consideration using an approach that is more aligned with historic realized risk or standard deviation. One key risk measure could be ascertained by understanding either the directionality or the degree of exposure a strategy has to movements in the equity and fixed income markets. Another measure of risk could be ascertained by analyzing downside correlation or performance in different economic regimes or market cycles, while paying particular attention to strategies that perform best when equity markets overall are not performing well. In addition to standard risk measures, it is also important to investigate the historical pattern of major losses or extreme outcomes in a strategy, as event risk can be high. Once these risk measures are assessed, it may be easier to choose liquid alternatives for inclusion in a portfolio as complements or surrogates for equity and fixed income allocations. Investors can also consider investing in these strategies tactically based on varying economic circumstances related to growth and inflation.

Figure 4 – A Framework for Investing in Liquid Alternatives

	Absolute return	Macro	Opportunistic
Role in portfolio	Hedge equity/fixed income risk	Hedge macro environmental and equity risk	Hedge equity risk
Liquid alternative strategies	– Relative value – Market neutral – Fixed income arbitrage	– Global macro – Managed futures/CTA – Multi-strategy	– Long/short – Event driven – Non-fixed income arbitrage – Distressed
Directionality*	Low: 0 to 20% market exposure	Medium: varies based on manager insights	High: > 60% exposure to market movements
Expected long-term risk	≈ Fixed income risk	≈ Fixed income risk	< Equity risk
Typical allocation bucket	Absolute return	Absolute return	Equity or absolute return

* Directionality measures the degree of exposure a strategy has to movements in the equity and fixed income markets.
Source: Invesco, April 2014. For illustrative purposes only.

Armed with this information, investors can also establish a framework (as shown in Figure 5) that aligns the categories shown in Figure 3 with their investment goals – generally identified as income, growth or opportunistic. Investors will likely benefit from a practical, common sense approach that also considers risk tolerance rather than a single objective of return, as not all alternatives are equal, or attractive, investments when used at same time.

Figure 5 – Aligning Investor Goals with Liquid Alternatives

	Income	Growth	Opportunistic
Role in portfolio	– Risk diversifier – Return enhancer	– Risk diversifier – Return enhancer	– Risk diversifier – Return enhancer
Liquid alternative strategies	– Relative value – Market neutral – Fixed income arbitrage	– Long/short – Global macro – Managed futures/CTA – Multi-strategy	– Event driven – Non-fixed income arbitrage – Distressed
Expected long-term total return	> Fixed income yields	60% equity/ 40% fixed income	Equity plus

Source: Invesco, April 2014. For illustrative purposes only.

Hurdles to investing in liquid alternatives

Thankfully, the major hurdles of availability, accessibility, transparency and liquidity have been remedied. But, as one would suspect, a few manageable challenges remain. For example, liquid alternatives are often misunderstood, but ongoing education can help to lessen investor concerns. The education gap can be considerable, and understanding the return/risk profile of the various strategies and marrying them with the investor's individual goals and objectives is a complicated, but is a necessary next step that should be a pre-requisite before investing.

Investors also have a heightened sensitivity to alternatives due to the headline risk associated with fraud cases and manager misconduct played out in the media. The use of derivatives and leverage is often perceived negatively as well, without the consideration of their accompanying attributes of liquidity and enhanced return potential. However, these risks are likely exaggerated given the disclosure and reporting requirements for regulated vehicles. Ironically, Figure 2 illustrates that when liquid alternatives are systematically combined with core holdings, aggregate portfolio risk can be reduced. Figure 3 illustrates that, historically, the realized risk of any one liquid alternative strategy, as measured by standard deviation is lower relative to global equities as measured by the MSCI World Index.

While it is true that regulated liquid alternative funds often have higher management fees than traditional investments, they could be substantially lower than fees for private hedge funds, which generally have a two-tiered fee model that includes management, plus performance fee incentives.

The near future for liquid alternatives

With expectations that we'll be in a low-return environment for the next several years, interest in alternative investments is only expected to heighten. In fact, institutional investment globally in hedge funds may rise from about USD1.5 trillion in 2012 to USD2.3 trillion by 2017, according to a 2013 report by Citi Prime Finance.[3]

The financial crisis taught investors enduring lessons, one in particular was how highly correlated markets can be in a downturn. Because alternatives have the ability to offer a different return pattern at different times than traditional asset classes, they can be a reasonable complement or surrogate for equity and fixed income market exposure.

In our experience, such capabilities, along with their increased accessibility, have made liquid alternatives attractive to a wider range of investors in the US and Europe, who are allocating assets to such strategies for many of the same reasons as institutional investors – diversification, risk mitigation and enhanced return potential. In fact, much of the growth in assets that we expect to be allocated to alternatives over the next few years could come from non-traditional alternative investors.

Conclusion

The evolution of more accessible and transparent liquid alternative investments may help make alternative strategies suitable for more investors, depending on their goals, risk tolerance and expectations. They may provide an added element to volatility management or another opportunity for enhanced return potential.

It is important to take the lessons learned from the financial crisis to heart, and therefore, look to cushion one's investments from the asset correlation and volatility that may occur on short notice. Investors can be better prepared for a variety of market environments by including liquid alternatives in their portfolios.

1 Source: BarclayHedge Indices: correlation of monthly hedge fund returns versus MSCI World Index and Citi World Government Bond Index. January 1997-December 2013
2 It should be noted that manager databases or peer groups are typically used to measure performance of liquid alternative strategies; there is no standard investable index. While these databases report performance net of fees, they are fraught with high survivorship bias from managers and /or funds that close and stop reporting fund information, which could result in inflated returns. In addition, there is limited homogeneity, meaning that no one strategy is alike even within major categories, resulting in wide dispersion between top- and bottom-performing managers.
3 Citi Prime Finance, The Rise of Liquid Alternatives & the Changing Dynamics of Alternative Product Manufacturing and Distribution, May 2013.