FINANCIAL PLANNING
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Against the Grain

By Susan B. Weiner
March 1, 2009

Alternative investments less correlated to major market indexes are gathering momentum in the advisor community. Two trends are fueling the movement. First, the sharp market declines since September 2008 have boosted the attraction of strategies that don't dive along with the stock market. "This year, people are looking to dial down risk in their portfolios," says Bill Harding, director of research at Morningstar Investment Services in Chicago. Second, these strategies are increasingly available to those who don't qualify as accredited investors (with investable assets of $1 million or more).

The recent spate of hedge fund scandals—including the Madoff mess—increases the appeal of mutual funds and other regulated instruments for implementing alternative investment strategies. "It's significantly more difficult to engage in fraud on the mutual fund side," says Randal Golden, managing director of FGMK/Preservation Capital Partners in Bannockburn, Ill.

A Returns Cushion

Traditional diversification across stocks and bonds hasn't cushioned portfolios much in recent months, so advisors are considering a broader range of investments. Back Bay Financial of Boston uses absolute return strategies, such as the Absolute Strategies and Absolute Opportunities funds managed by Absolute Investment Advisers, says wealth manager George Padula. His firm is also using or considering hedged equity, commodities, inversely correlated and managed futures funds plus structured notes. The firm's portfolios are targeted to hold 20% to 23% in alternatives.

Fairport Asset Management sees strong interest in absolute return multi-strategies, which, in the firm's experience, returned -15% to -20% for 2008. Fairport is also interested in managed futures, which were positive, and look attractive versus the S&P 500's 37% decline. Long-short hedge funds' returns in the negative mid-20s seem to fall short in clients' eyes, says Greg Althans, executive VP and CIO of the Cleveland firm.

Some firms are moving toward a focus on absolute performance instead of measuring their performance versus traditional benchmarks, Golden says. His clients are invested about 20% to 40% in fixed income, 20% to 40% in hedged equities (mostly mutual funds) and the rest in alternatives.

Easier Access

Alternative strategies have long been available via hedge funds. But they may be more appealing as mutual funds. "Open-end mutual funds work better for advisors and clients due to better liquidity, lower expense ratios and more transparency," Padula says. The number of mutual funds offering alternative strategies is growing. Morningstar's long-short mutual fund category grew from 25 funds with 47 share classes at its creation in February 2006, to 68 funds with 170 share classes as of Dec. 11, 2008.

Cerulli Associates director Cindy Zarker says mutual funds make such strategies available for the first time to the mass affluent who can't qualify as accredited investors. Her firm's data shows asset managers and advisors expect higher alternative allocations. Some funds already benefit, like Rydex's managed futures mutual fund and the Natixis Gateway Fund, a hedged equity fund. Mutual funds let investors bypass some complications of limited partnerships which, Althans says, include one-year lockups, annual/quarterly redemptions and tax filings that may be extended.

Mutual funds also offer daily liquidity. Brian Ullsperger, managing director at Capital Fiduciary Advisors in Leesburg, Va., says liquidity is very important right now, as people are moving from index mutual funds to ETFs, so they can buy and sell their investments during the day, at prices that are set intraday instead of only at day-end. "The issue with Madoff....will only bring more focus on transparency, liquidity and finding access to less correlated asset strategies without going the route of limited partnerships or black box-type investments," he says.

Hedge-Ability

ETFs don't yet play a big role in alternative-style investing. "Unless you're doing a pure short, it's difficult to utilize ETFs. And if you're looking for negative exposure to the market, like the S&P 500, you're probably a little too late to the game," he adds. ETFs could prove useful, though, if a manager wants to buy certain ETFs long and short others to replicate hedge fund strategies. But advisors like Back Bay's Padula don't want the responsibility of making those decisions. This is an opportunity for replication strategy managers like IndexIQ, which launched the IQ Alpha Hedge Strategy mutual fund in 2008 and plans to launch an ETF of ETFs in 2009, according to Tony Davidow, executive director and head of distribution.

Due Diligence Required

Once advisors decide to invest in alternative funds, they've got homework to do. FGMK/Preservation's Golden looks for hedge funds that also run mutual funds. Padula learns about funds through his Zephyr and Morningstar research, participation in conferences and study groups, and from the funds themselves.

But before investing, it's important to understand the strategy. "As Madoff has proved to all of us, you really have to understand how that person or management team is generating those returns," Ullsperger points out.

Morningstar's Harding says advisors should look carefully at the underlying strategies of funds in Morningstar's long-short category. All funds aren't created equal. "Long-short funds have varying degrees of long exposure," he says. For example, a 130-30 fund has a net long exposure of 100%, so the investor essentially has marketlike exposure. His firm looks for net long exposure below 100% when populating its Absolute Return strategy. Risk controls are also essential for short-selling funds. "Shorting stocks carries quite a bit of risk," Harding says.

After making an asset class decision, Ullsperger sees "if the fund has proved to have low correlation and to reduce some of the portfolio's volatility," he says. "We look at how the returns have been in different market conditions." That can be tough, given the funds' short track records. When a fund hasn't been around long, Padula looks at how the manager performed with the strategy elsewhere. Or with the Rydex Managed Futures Fund, which seeks to track the S&P Diversified Trends Indicator, he looks at the underlying indicator.

Advisors may have to get used to paying more for these funds, which typically come with higher expense ratios than traditional funds. Still, the fees are much less onerous than the traditional "two and 20" fees of hedge funds, ranging up to 2.75% for a sampling of funds used by the advisors interviewed for this article.

"You can't just look at the fees," Ullsperger notes. "If someone said they could consistently get you 8% to 10% a year after fees, if that fee was 2%, would it matter?" Padula says overall expenses remain reasonable when these funds represent little of the total portfolio.

Alternatives' Challenges

However, many are wary of alternatives because they don't understand them. "We're in the very early innings of not only public education but of investment advisor education," Althans says. Both individuals and professionals may assume that alternatives are riskier than traditional long-only investments. In fact, alternatives' standard deviations are lower, Althans says. Plus, investments, like managed futures, are difficult for clients to understand.

These newer funds have risks too. "My concern is that everyone will run to invest in an environment where long-only investments are poised to perform better over the long run," Althans says. He also worries about regulatory risk as the SEC and Congress ramp up their scrutiny of alternatives. "You could invest in a strategy that gets regulated to the detriment of the fund," Althans warns. Investors got a taste of that when the SEC restricted short selling in 2008.

In addition, the recent travails of endowments, which had been famous for earning big returns with alternatives, may make advisors pause, Zarker says. In early December 2008, Harvard announced an $8 billion (non-Madoff) loss from July 1 through Oct. 31, 2008. Zarker also notes that some less correlated strategies, such as commodities, haven't worked lately. But funds that can go short, like the Direxion Commodity Trends Strategy, can get around that.

Mutual funds that invest in alternatives aren't always better than limited partnerships. They face greater constraints on investments, and their use of leverage and ability to invest in private equity is limited, Althans notes. "That could be a good thing, but it could also be a bad thing."

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