Understanding the Complexities of Liquid Alternatives

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Preface: Key Takeaways

- There is no exact definition of a "liquid alternative." It is essentially any publicly-registered fund that employs a strategy or invests in ***anything other than long-only stocks or bonds.***
- Liquid alternatives fall under the category of complex if one looks at the definition of liquid alternatives through the eyes of FINRA and the SEC.
- According to the SEC, an alternative fund is generally understood to be a fund whose primary investment strategy falls into one or more of the following three buckets: 1) non-traditional asset classes (such as currencies), 2) non-traditional strategies (such as long/short equity positions), and/or 3) illiquid assets (such as private debt).
- According to an Investor Alert issued in 2013 and reissued in 2017, FINRA defines liquid alternatives as those that are: 1) publicly offered, 2) SEC-registered; 3) hold more non-traditional investments, and 4) employ more ***complex trading strategies*** compared to traditional mutual funds.
- Over the past few years, we have seen an uptick in regulatory activity around liquid alternatives. FINRA's reissued Investor Alert reminds members that, compared to a traditional mutual fund, an alternative fund typically holds more non-traditional investments and ***employs more complex trading strategies***. Investors considering alternative mutual funds should be aware of their unique characteristics and risks***. Before investing, an investor should keep in mind the fund's investment structure, strategy risk factors, investment objectives, operating expenses, fund manager experience and performance history***.
- In 2017, FINRA introduced an Alternative Mutual Funds e-learning course in which participants are "presented with scenarios designed to ***emphasize the complexity*** of alternative mutual funds and the importance of performing a thorough suitability analysis when recommending these products."
- ***The regulators have provided clear guidance on the responsibilities of advisors and broker-dealers related to investment structures they consider complex.*** If the trend continues towards heightened scrutiny of liquid alternatives, one may want to veer on the side of safety in understanding, supervising and training on these funds prior to offering them to investors.
- The potentially limitless liquid alternatives universe may be narrowed down to the ***Morningstar Alternatives category, closed-end funds (including interval funds), and non-traditional ETFs, including leveraged, inverse, and commodity-linked ETFs.***
- There is significant variation in the types of liquid alternatives funds and countless investment strategies that may be used. It's critical for investors and advisors to understand the nuances of the strategies as well as how they perform in different market scenarios to make appropriate portfolio decisions.
- While each liquid alternatives strategy has its own risks based on the type of strategy used and the underlying investments, there are common risks amongst the liquid alternatives universe. Investors

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should be aware of these risks and ***check each fund's prospectus to determine if a specific fund is exposed to these and/or other types of risks.***

- Considering the regulators may view liquid alternatives as complex, it is important to fully understand the unique characteristics and risks of a fund. Proper training for registered persons should be considered. Additionally, ***all aspects of the due diligence process should be documented.***

In this white paper, we will discuss:

- The definition of liquid alternatives
- Complexity and why this is important
- The liquid alternatives universe
- Liquid alternative strategies common risks
- Action steps to protect your business

Introduction

The use of alternative investments in client portfolios has grown substantially over the last two decades through the use of liquid alternatives. As the world's financial markets have become increasingly connected, so has the use of more sophisticated, complex investments and trading strategies that were once only available to institutions and ultra-high-net-worth investors.

According to the Hedge Fund Journal's "Going Mainstream" report from 2014, the four primary drivers of the growth in liquid alternatives over the last decade include increased investor awareness of the role that liquid alternatives play in portfolio construction, slow growth in the hedge fund industry, challenged business models of fund of hedge funds, and investor and advisor preference for the liquidity, transparency and lower minimums of publicly registered funds.[1]

The tech bubble and Great Recession highlighted the need for diversification in client portfolios. There is ample research to illustrate that the use of alternative investments can improve the risk/return profile of a portfolio over the long term by helping to reduce volatility, differentiate sources of returns and create a more consistent return stream.[2] Considering all the potential contributions to a client portfolio, who wouldn't want to use these strategies, especially if they come packaged in an SEC-registered, liquid fund structure.

Liquid alternatives - which are essentially any funds that utilize a strategy or invest in assets other than long-only stocks or bonds - provide access to strategies previously only available to high-net-worth investors and institutions, including hedging strategies, currencies, credit strategies, real estate, infrastructure and other real assets. The most common registered liquid alternatives structures are open-end mutual funds, closed-end funds (including closed-end interval funds) and certain exchange-traded funds.

Liquid alternatives are a "*bright, shiny object… but they are a sharp object*."

-Andrew J. Bowden, Director of the Office of Compliance Inspections and Examinations of the SEC.

Access to strategies that intend to help investors grow and protect their portfolios may be beneficial, although it is not without

[1] https://www.thehedgefundjournal.com/content/going-mainstream
[2] https://www.gsam.com/content/gsam/us/en/advisors/resources/investment-ideas/liquid-alternatives/liquidaltscenter.html

risk. Liquid alternatives managers may invest in complex strategies and securities that investors are unfamiliar with, which could lead to a misunderstanding of how a fund will react in different market conditions leading to inappropriate buys, sells, and allocations to a fund. In March of 2014, Andrew J. Bowden, Director of the Office of Compliance Inspections and Examinations (OCIE) of the SEC described liquid alternatives as the "bright, shiny object… but they are a sharp object."[3] Just because a fund is registered and traded on an exchange does not mean it isn't complex. Complex products require heightened supervision, adequate due diligence, training of registered persons and documentation of these processes.

In this white paper, we will discuss the definition of liquid alternatives and the universe, how they may be viewed as complex and why this is important, review the regulatory guidance related to complex products and liquid alternatives, discuss the liquid alternative categories and common risks in order to help advisors and investors set appropriate performance expectations, and review action steps for protecting your business when using liquid alternatives.

What is a Liquid Alternative?

There is no exact definition of a "liquid alternative." It's a broad category that is essentially any publicly-registered fund that employs a strategy or invests in anything other than long-only stocks or bonds. This could encompass hedge fund strategies, which are normally employed in unconstrained structures, real assets, non-traditional bonds, currencies, and complex ETF strategies such as inverse and leveraged ETFs.

In the past, alternative investments were primarily offered in a limited partnership (LP) structure. This structure and others can be exempt from registration with the SEC, which allows maximum flexibility in terms of holding strategies, leverage, liquidity, concentration and redemptions. Many LPs offer little or no liquidity for periods of months or years to match the illiquidity of the underlying assets. LPs typically incentivize managers with high fees to attract top talent, the most common of which is the "2 and 20" fee structure (2 percent of the fund's assets, plus 20 percent of its gains).

Since liquid alternatives are funds that are registered under the Investment Company Act of 1940 ('40 Act) they are subject to greater restrictions on investments and strategies than unconstrained LPs, including limits on leverage and holding illiquid investments, diversification

Key Mutual Fund Requirements

Diversification Unless a fund classifies itself as "non-diversified," the fund can hold no more than 5% in the securities of any one issuer and no single investment can comprise more than 10% of the total outstanding voting stock of the issuer.

Leverage Limits 33.33% of the portfolio value (300% asset coverage ratio).

Illiquid Securities No more than 15% of net assets can be held in illiquid securities.

[3] http://clsbluesky.law.columbia.edu/2014/08/04/katten-discusses-secs-focus-on-liquid-alternative-funds-market/

requirements, daily pricing and redeemability of fund shares. Liquid alternatives managers are also limited to certain fees and are unable to charge the typical 2 and 20 fees.[4]

There is much debate about whether hedging strategies can be fully replicated in a registered fund structure given the additional limits and requirements placed on them in this type of structure, particularly the daily pricing and redeemability requirements. The daily redeemability requirements of mutual funds may force liquid alternatives managers to invest in lower-returning, more conservative liquid assets or hold extra cash to meet redemption requests and lower volatility, which could create a drag on returns. Leverage limits may have some impact on a manager's ability to boost returns, although liquid alternatives managers can get around these limits using derivatives, which are not subject to the leverage limits. This creates additional risk for a liquid alternatives fund, however, as it exposes the fund to potentially significant losses in the event of a market shock accompanied by large redemptions (as a manager looks to cover margin calls). According to a 2013 study conducted by Cliffwater, LLC, private alternative funds outperformed their liquid alternatives counterparts by approximately 0.98 percent over the past 10 years, stating "we believe that the 1 percent performance deficit found in our study will be viewed by both private partnership investors and retail investors as a reasonable price to pay for enhanced liquidity."[5]

Alternative Investment Fund Structures

	Hedge Fund	Non-Traded REIT	Open-End (Mutual) Fund	Closed-End Fund	Closed-End Interval Fund	Exchange Traded Fund
Registration	Private	Public	Public	Public	Public	Public
Structure	Partnership	Corporation, Trust, or Association	Open-end Regulated Investment Company (RIC)	Closed-end RIC	Closed-end RIC	Open-end RIC
Financial Suitability	Accredited Investors or Qualified Purchasers	$70K Income & $70K NW or $250K NW	None	None	None	None
Offering Period*	One-time	One-time	Continuous	One-time	Continuous	Continuous
Valuation	Varies	Periodic by Prospectus	Daily	Daily	Daily	Daily
Pricing	Varies	Offering Price or NAV	NAV	Market	NAV	Market
Minimum Investment	High	Low	Low	Low	Low	Low
Fees**	2 and 20	Varies	Expense Ratio	Expense Ratio	Varies	Expense Ratio
Liquidity	Limited	Periodic and Limited	Daily	Exchange Traded	Periodic and Limited	Exchange Traded
Direct Redemption	Yes	Yes	Yes	No	Yes	No
Maximum Illiquid Investments	No Limit	No Limit	15%	No Limit	No Limit	No Limit

[4] https://www.sec.gov/about/laws/ica40.pdf
[5] Cliffwater, LLC "Performance of Private versus Liquid Alternatives-June, 2013," https://cliffwater.com/research

Maximum Leverage	No limit	75%	33.33%	33.33%	Debt: 33.33% Preferred: 50%	No Limit
Transparency	Varies	Public Filings	Public Filings	Public Filings	Public Filings	Public Filings
Strategy Change	No Approval Needed	Shareholder Approval	Shareholder Approval	Shareholder Approval	Shareholder Approval	Shareholder Approval
Diversification Requirements	None	None	Individual Issuer Limits	None	None	None
Tax Forms	K-1	1099	1099	1099	1099	1099

*Offering periods may be extended.
**Fees vary and may not include subadvisor or underlying investment fees.

Complexity

It's critical for investors, advisors and broker-dealers to understand that regulators view some of these products as complex regardless of the liquidity and other benefits of the registered fund structure. One needs only to look at the definition of liquid alternatives through the eyes of FINRA and the SEC to understand this perspective.

Liquid alts as defined by the SEC. *W*hile there is no clear definition of "alternative" in the fund space, according to the SEC, an alternative fund is generally understood to be a fund whose **primary** investment strategy falls into one or more of the three following buckets:

1. Non-traditional asset classes (such as currencies);
2. Non-traditional strategies (such as long/short equity positions), and/or
3. Illiquid assets (such as private debt).

It's important to note that liquidity is not the only factor in determining if a fund is a liquid alternative. If a fund meets any one of these criteria, it may be considered a liquid alternative.[6]

Liquid alts as defined by FINRA. According to an Investor Alert issued in 2013 and reissued in 2017, FINRA defines liquid alternatives as those that are:

1. Publicly offered;
2. SEC-registered;
3. Hold more non-traditional investments, and
4. Employ more complex trading strategies compared to traditional mutual funds.

The key language here is the word "more." While many traditional funds can use complex strategies, and include related risk disclosures in their prospectus, liquid alts managers hold *more* non-traditional investments and utilize *more* complex strategies.

Because alternative mutual funds, closed-end funds, and closed-end interval funds are registered and regulated under the '40 Act, they are often grouped into the non-complex category. Until recently, regulators were less clear about whether they considered these products complex or required any

[6] https://www.sec.gov/news/speech/2014-spch091114nc

heightened due diligence or supervisory requirements. However, over the past few years, we have seen an uptick in regulatory activity around liquid alternatives.

- In June 2013, FINRA issued an Investor Alert, *"Alternative Funds Are Not Your Typical Mutual Funds."* This alert was reissued by the SEC in February 2017.[7] The alert states alternative or "alt" mutual funds are publicly-offered, SEC-registered funds that ***use investment strategies that differ from the buy-and-hold strategy typical in the mutual fund industry***. "Compared to a traditional mutual fund, an alternative fund typically holds more non-traditional investments and ***employs more complex trading strategies***. Investors considering alternative mutual funds should be aware of their unique characteristics and risks. Before investing, an investor should keep in mind the fund's investment structure, strategy risk factors, investment objectives, operating expenses, fund manager experience and performance history."[8]
- In 2014, the OCIE began a "concentrated review" of liquid alternatives, focusing on their leverage, liquidity, and valuation policies, among other things, such as their marketing to investors, including the representations and recommendations made to investors concerning the suitability of the investment.[9] In his March speech in which he described liquid alternatives as the "bright, shiny object," Andrew J. Bowden, Director of the OCIE, goes on to say "the use of hard-to-value and/or illiquid securities in an open-end mutual fund, which requires daily valuation and offers daily liquidity, is fraught with risk."[10]
- In September 2014, Norm Champ, the Director of the Division of Investment Management for the SEC, stated, "***alternative mutual funds present heightened risks*** in the areas of compliance programs, conflicts of interest, valuation, portfolio management and marketing."
- In remarks made at the SIFMA Complex Products Forum in October 2014, Mr. Champ discussed that SEC staff raised concerns that there could be a disconnect between the strategies and risks a fund discloses in its prospectus versus the strategies the fund employs, and that such a disconnect would make it even more difficult for investors to determine whether a product is suitable. Additionally, he stated that he "cannot emphasize enough the importance of ensuring retail investors have the information they need to make informed investment decisions, especially with respect to ***alternative mutual funds and other complex products.***"
- In 2017, FINRA introduced an Alternative Mutual Funds e-learning course in which participants are "presented with scenarios designed to emphasize the ***complexity of alternative mutual funds and the importance of performing a thorough suitability analysis when recommending these products***."

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[7] https://www.sec.gov/oiea/investor-alerts-bulletins/ib_altmutualfunds.html
[8] http://www.finra.org/newsroom/2013/finra-issues-new-investor-alert-alternative-funds-are-not-your-typical-mutual-funds
[9] http://www.pwc.com/us/en/financial-services/regulatory-services/publications/assets/fs-reg-brief-sec-sweep-liquid-alternative-funds.pdf
[10] http://clsbluesky.law.columbia.edu/2014/08/04/katten-discusses-secs-focus-on-liquid-alternative-funds-market/

Are Liquid Alternatives Complex?

FINRA's Investor Alert: Alternative Funds are Not Your Typical Mutual Funds (2013 and 2017) states: "*Compared to a traditional mutual fund, an alternative fund typically holds more non-traditional investments and* ***employs more complex trading strategies****. Investors considering alternative mutual funds should be aware of their unique characteristics and risks. Before investing, an investor should keep in mind the fund's investment structure, strategy risk factors, investment objectives, operating expenses, fund manager experience and performance history*."

Why Does Complexity Matter?

The tech bubble burst in the early 2000's highlighted the need for diversification in client portfolios. This prompted the development of products that brought complex strategies and investments to retail clients, such as non-traded REITs and registered hedge funds-of-funds (a fund whose portfolio consists of shares in a number of hedge funds[11]). As this was happening, regulators took notice. In 2003, FINRA (then the NASD) issued Notice to Members 03-07, which reminded members of their obligations when selling hedge funds and fund-of-funds, including performing proper due diligence and training associated persons. The Notice, which was the first of many related to complex products, was issued out of "concern that members may not be fulfilling their sales practice obligations when selling these instruments, especially to retail customers.[12]

FINRA Regulatory Notice 12-03 states "any product with multiple features that affect its investment returns differently under various scenarios is potentially complex. This is particularly true if it would be unreasonable to expect an average retail investor to discern the existence of these features and to understand the basic manner in which these features interact to produce an investment return." Additionally, former FINRA Chairman and CEO Richard G. Ketchum stated in a presentation at the SIFMA Complex Products Forum in 2012 that, while there is no legal definition of complex, he suggests a basic guide, "a product **might be considered complex** if the average retail investor probably will not understand how its features will interact under different market conditions, and how that interaction may affect potential risk and return. ***These types of products merit heightened supervision***."[13]

The reason why it matters that liquid alternatives may be considered complex from a regulatory standpoint is simple. The regulators have provided clear guidance on the responsibilities of advisors and broker-dealers related to investment structures they consider complex. If the trend continues towards heightened scrutiny of liquid alternatives, one may want to veer on the side of safety in understanding, supervising and training on these funds prior to offering them to investors.

[11] https://www.barclayhedge.com/research/educational-articles/hedge-fund-strategy-definition/hedge-fund-strategy-fund-of-funds.html
[12] http://www.finra.org/sites/default/files/NoticeDocument/p003358.pdf
[13] http://www.finra.org/industry/notices/12-03

- FINRA's Notice to Members 03-07 (2003) provides guidance on obligations for members when selling hedge funds to include performing a reasonable basis suitability determination, supervising associated persons selling hedge funds ***and training associated persons regarding the features, risks, and suitability of hedge funds***.[14]
- FINRA's Regulatory Notice 09-09 (2009) reminds member firms of their requirement to "have reasonable grounds to believe that all material facts are adequately disclosed and provide a basis for evaluating a program…including the financial stability and experience of the sponsor and the program's risk factors, as well as the amount and composition of dividend distributions."[15]
- FINRA's Regulatory Notice 10-22 (2010) provides clear guidance on the due diligence requirements for Regulation D private offerings, reminding members they have an ***obligation to conduct a reasonable investigation of the issuer and the securities they recommend***.[16]
- FINRA's Regulatory Notice 12-03 (2012) provides guidance to firms about the heightened supervision requirement for complex products, which may include a security or investment strategy with ***novel, complicated or intricate derivative-like features, such as structured notes, inverse or leveraged exchange-traded funds, hedge funds and securitized products, such as asset-backed securities***.[17]
- FINRA's Investor Alert: Non-Traded REITs – Perform a Careful Review Before Investing (2016)[18] suggests performing a careful review of a non-traded REIT before investing. The alert also discusses the ***complexities and risks***, including a lack of liquidity, high fees and concentration risk.

The requirement for heightened due diligence, training and supervision for complex products is relatively clear. Therefore, if the trend continues towards heightened scrutiny of liquid alternatives, one may want to veer on the side of safety in understanding, supervising and training on these funds prior to offering them to investors.

Why It Matters if Liquid Alternatives are Considered Complex?

"A product **might be considered complex** if the average retail investor probably will not understand how its features will interact under different market conditions, and how that interaction may affect potential risk and return. ***These types of products merit heightened supervision***."

-Former FINRA Chairman and CEO Richard G. Ketchum

[14] http://www.finra.org/industry/notices/03-07
[15] http://www.finra.org/sites/default/files/NoticeDocument/p117795.pdf
[16] http://www.finra.org/industry/notices/10-22
[17] http://www.finra.org/industry/notices/12-03
[18] http://www.finra.org/investors/alerts/public-non-traded-reits-careful-review

The Universe of Liquid Alts Funds

With a broad definition and a potentially limitless universe of funds that may fall into the "anything other than long-only stocks and bonds" category, the following may assist those wishing to narrow the liquid alternatives universe:

1. **Morningstar's Alternatives Category.** This category currently includes 514 separate and distinct mutual funds in 17 separate sub-categories. The SEC and FINRA often refer to the Morningstar Alternatives category when issuing alerts or comments regarding liquid alternatives. While there may be open-end funds outside of this category that employ complex strategies, these are the funds regulators have focused on in some of their regulatory guidance.[19]

2. **Closed-end Funds (including Interval Funds).** Two other common fund structures in which managers implement liquid alternatives strategies include closed-end funds and a sub-structure of closed-end funds called interval funds.[20] These structures are regulated by the '40 Act, which requires greater transparency in holdings and pricing, as well as limits on leverage. However, they have fewer restrictions on the amount of illiquid assets they can hold and are often considered the most flexible registered fund structure, which makes them ideal for implementing alternative investing strategies.[21]

3. **Non-traditional ETFs including Leveraged, Inverse and Commodity-linked ETFs.** This one is relatively clear and has been for almost a decade now. FINRA issued Regulatory Notice 09-31 along with an accompanying Investor Alert in 2009 to remind members of their sales practice obligations relating to leveraged and inverse exchange-traded funds. The notice states, "in particular, recommendations to customers must be suitable and based on a full understanding of the terms and features of the product recommended; sales materials related to leveraged and inverse ETFs must be fair and accurate; and firms must have adequate supervisory procedures in place to ensure that these obligations are met."[22] Additionally, FINRA Regulatory Notice 10-51 addresses sales and training practices for broker-dealers selling commodity futures-linked securities, including ETFs.[23]

Understanding Liquid Alternatives Investment Strategies

In its 2013 Investor Alert, "Alternative Funds Are Not Your Typical Mutual Funds", FINRA outlined several specific characteristics investors should be aware of before investing in liquid alternatives, including a fund's investment structure, strategy risk factors, investment objectives, operating expenses, fund manager experience and performance history. This should serve as a basic outline for an understanding

[19] http://www.morningstar.com/
[20] https://www.dlapiper.com/en/us/insights/publications/2017/02/interval-funds-handbook/
[21] https://www.managedfunds.org/wp-content/uploads/2013/09/Citi-40-Act-Funds-White-Paper-July-2013-2.pdf
[22] http://www.finra.org/industry/notices/09-31
[23] http://www.finra.org/industry/notices/10-51

of liquid alternatives. FINRA also states in its Investor Alert that an investor should understand the "unique characteristics and risks" of a fund.[24] ***Understanding the unique characteristics such as a fund's fees, manager experience and performance history would require one to review that fund's prospectus and other public offering documents.***

Types of Investment Strategies: Performance Expectations, Risks and Portfolio Applications

There is significant variation in the types of liquid alternatives funds and countless investment strategies that may be used. It's critical for investors and advisors to understand the nuances of the strategies as well as how they perform in different market scenarios to make appropriate portfolio decisions. Unfortunately, many investors look to implement alternative investment strategies when markets have already declined. While there is no ideal time to add alternative investments to diversify a portfolio, a more appropriate time may be when markets have appreciated and there is potentially more downside risk. This is a tough discussion to have with clients and can be especially difficult if the decision to add alternatives is followed by an extended period of equity out-performance (in which alternatives could potentially underperform). Some of this difficulty can be alleviated by setting appropriate performance expectations prior to using liquid alternatives.

The liquid alternatives market includes hedging strategies such as long-short equity, unconstrained bond, market neutral/absolute return, multi-alternative, currency, managed futures, and bear market as well as real asset categories such as commodities, currencies, and real estate.

For purposes of this discussion, we will focus on the hedging strategies, which tend to have some of the greatest dispersion in performance from traditional stock and bond investing. For each category we will review the following questions, which we believe are questions that advisors and investors should be asking prior to using a liquid alternatives strategy in order to properly set performance expectations:

- Investment Strategy - How will the alternative investment manager look to capture returns?
- Performance Expectations - What are the expectations for returns during various market conditions?
- Strategy Risks – What primary (and secondary) risks should investors be aware of? While alternative strategy funds have several common risks, each strategy is exposed to specific risks related to the strategy employed or the underlying investments.
- Portfolio Application - When should a strategy be used in a portfolio? Liquid alternatives have very different investment objectives but generally serve a specific purpose within a portfolio. The primary portfolio applications for liquid alternatives include equity diversification, fixed-income diversification, overall portfolio diversification, risk reduction, and inflation hedge.

[24] http://www.finra.org/newsroom/2013/finra-issues-new-investor-alert-alternative-funds-are-not-your-typical-mutual-funds

Equity Long-Short

Investment Strategy. Long-short managers look to capture equity returns through long positions in stocks they expect to increase, while hedging some of the downside risk through short positions in stocks they expect to decline. Equity long-short managers can shift between long and short positions depending on their macro outlook, and tend to base decisions on top down (economic) or bottom up (company-specific) research.[25]

Performance Expectations. Long-short managers tend to have a net-long equity position, so their returns could be expected to be directionally correlated to the equity markets. In up markets, equity long-short funds may move up as well, but to a lesser extent as the short positions dampen the upside. Conversely, long-short funds may decline in a down market, although theoretically less than the equity markets as a result of the short positions.[26] In general, the performance of long-short strategies could be expected to perform in a similar pattern as the equity markets, just within a tighter, smoother range. A small sub-set of the long-short category are the short-biased funds, which tend to be short and may increase in a down market but decline in an up market. These strategies are somewhat rare.[27]

Strategy Risks. The primary risks for the long-short category include manager risk due to the manager's decisions on long and short positions, equity market risk, and derivatives risk from the exposure to short positions.

Portfolio Application. Equity diversification. Based on their correlation to the equity markets, long-short funds tend to be best used to diversify an equity portfolio. These types of funds should be used as a complement to long-only equity positions within a portfolio. Investors should expect some downside participation in bear markets and less upside potential than the equity markets.

Unconstrained or Non-Traditional Bond Funds

Investment Strategy. Unconstrained bond funds invest primarily in global or domestic fixed-income instruments with the intent to profit from changes in the credit and interest rate markets. Unconstrained bond funds look to hedge some of the interest rate, duration risk or credit risk associated with traditional fixed-income investing. This may be achieved by investing in shorter or longer-duration bonds or lower-quality bonds than the market indices, or by using derivatives or swaps, which are often a key component of an unconstrained bond strategy.[28]

Performance Expectations. Unconstrained bond funds tend to have a low-to-medium correlation to the equity markets and, more importantly, a low or medium correlation to the fixed-income markets. In a strong fixed-income market, these funds may underperform due to their hedges, but could reduce

[25] https://www.barclayhedge.com/research/educational-articles/hedge-fund-strategy-definition/hedge-fund-strategy-equity-long-short.html
[26] http://advisor.morningstar.com/uploaded/pdf/Alt_Long-ShortEquity.pdf
[27] https://www.hedgefundresearch.com/sites/default/files/pdf/HFR_strategy_classifications.pdf
[28] http://www.morningstar.com/cover/videocenter.aspx?id=699123

downside risk in difficult bond markets. Unconstrained bond funds may help reduce interest rate risk in rising rate markets, and may enhance returns in periods of extended low interest rates.

Strategy Risks. Unconstrained bond funds tend to have high liquidity risk, as the credit markets tend to be less liquid than the equity markets. This is especially true for funds that invest in thinly traded lower quality or foreign credit instruments. These holdings tend to pay high yields in exchange for the high amount of risk.

Portfolio Application. Fixed-Income Diversification. Unconstrained bond funds may be used primarily to diversify a fixed-income portfolio. Unconstrained bond managers tend to focus more on reducing correlations to the fixed-income market as opposed to generating high current income, so these funds may not serve to diversify an income-producing fixed-income portfolio but rather as an overall diversifier for a bond portfolio.[29]

Managed Futures

Investment Strategy. Managed futures funds use technical algorithms to buy long into markets that are trending higher and sell short into markets that are trending lower. This is also referred to as "trend following." Managed futures managers implement this strategy by trading futures contracts in the global equity, commodity, interest rate and currency markets. The algorithms used are typically proprietary and not often shared, as once they are discovered and implemented by others, they tend to lose their effectiveness.

Performance Expectations. Managed futures funds attempt to limit downside risk and reduce overall portfolio volatility through a low-to-medium correlation to the equity markets. Managed futures funds tend to outperform the equity markets in downturns, but will most likely underperform in rising equity markets. Managed futures funds may underperform in periods of high volatility, as the trend following algorithms struggle to predict trends. Managed futures funds are only appropriate for investors who understand the performance may be very different than equity or bond markets.

Strategy Risks. Managed futures funds are heavily dependent on the people developing the algorithms, so they have significant manager risk. Managed futures funds are also exposed to derivatives risk, interest rate risk, currency risk and more macro-economic risk than other liquid alternatives peers due to their commodities and currency exposure. This exposure also makes managed futures inherently concentrated.

Portfolio Application. Overall Portfolio Diversification. Managed futures funds tend to invest in the commodity, currency, or other hard asset futures which are not correlated to the traditional stock and bond markets. Therefore, managed futures may be best used to diversify the returns of an overall portfolio.

[29] https://www.gsam.com/content/dam/gsam/pdfs/us/en/fund-literature/brochure/liquid-alternative-investments-maps.pdf?sa=n&rd=n

Market Neutral/Absolute Return

Investment Strategy. Funds in these categories attempt to eliminate the risks of a market by investing in offsetting long and short positions within that market. These managers look to buy long securities in a market that are undervalued while at the same time taking an equal short position in a security in the same market they consider to be overvalued.[30] Funds in these categories can trade in any market including equity, fixed income and currencies. A subset of this category are the merger arbitrage funds, which seek to capture price differentials between securities related to corporate events.[31]

Performance Expectations. Due to their offsetting long and short positions, funds in this category tend to have the lowest correlation to the equity and fixed income markets. They tend to outperform during periods of high volatility and in bear markets. Conversely, funds in these categories will underperform in bull markets, which is something investors need to understand. Market neutral managers seek positive total returns in both up and down markets (remember, not high returns, but positive nonetheless), while absolute return managers seek a specific return target over time - often specific basis points over treasuries. Merger arbitrage funds tend to have a low correlation to the equity and fixed-income markets, but could experience greater volatility depending on the concentration of holdings in the fund.

Strategy Risks. Funds in these categories are dependent on manager security selection, so they have significant manager risk. They're also exposed to derivatives risks as shorting is a key component of the strategy, as well as leverage and company-specific risks. The primary risk these funds attempt to remove is overall market risk (beta).

Portfolio Application. Risk Reduction. Funds in these categories should be used to limit or hedge overall portfolio volatility.[32] Depending on the strategy, they can be part of an equity or fixed-income portfolio, as long as an investor is fully aware they will underperform in rising markets.[33]

Currency

Investment Strategy. Funds in this category will invest in currency futures or contracts across the globe. The funds bet on either an appreciating or declining U.S. dollar versus other currencies to capture returns. Other strategies in the category include momentum strategies that attempt to go long on increasing currencies while going short on declining currencies. These funds can either be actively or passively managed (passive once an algorithm is set).[34]

Performance Expectations. These funds have a medium-to-low correlation to equities and tend to perform best in strong economic conditions or inflationary environments. Funds in this category can

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[30] http://www.morningstar.com/InvGlossary/market_neutral_funds.aspx
[31] https://www.gsam.com/content/dam/gsam/pdfs/us/en/fund-literature/brochure/liquid-alternative-investments-maps.pdf?sa=n&rd=n
[32] https://www.barclayhedge.com/research/educational-articles/hedge-fund-strategy-definition/hedge-fund-market-neutral.html
[33] https://www.bnymellon.com/us/en/our-thinking/redefining-absolute-returns-in-the-liquid-alternative-era.jsp
[34] https://www.gsam.com/content/dam/gsam/pdfs/us/en/fund-literature/brochure/liquid-alternative-investments-maps.pdf?sa=n&rd=n

decline in bear markets. Performance can also be impacted by geopolitical events, which are difficult to predict and can make performance sporadic.

Strategy Risks. The primary risk for these funds is currency risk as global currencies can be somewhat volatile and unpredictable. Other primary risks include geopolitical risk, interest rate risk, sovereign risk, and derivatives risk.

Portfolio Application. Portfolio Diversification. May be used to diversify equity exposure or to hedge against interest rate risk in fixed-income portfolios.

Bear Market

Investment Strategy. Funds in this category have one primary objective - invest in short positions in the equity markets to take advantage of anticipated market or stock declines and to deliver positive returns when equities are negative. Short holdings typically account for 60 to 85 percent of active exposure.[35]

Performance Expectations. As it's implied by the name, these funds should outperform in a deteriorating market scenario and should underperform or even decline modestly in a rising market.

Strategy Risks. Bear market funds are exposed primarily to the risk that markets will appreciate. Most bear market managers will shift positions in strong bull markets to reduce the risk of declining in these types of markets, which exposes them to style drift risk.

Portfolio Application. Risk Reduction. Bear market funds have a negative correlation to the equity markets. Therefore, these funds should only be used to lower overall equity portfolio risk.

Multi Strategy

Investment Strategy. Multi-strategy funds generally seek to reduce overall portfolio risk and diversify return streams through exposure to various alternative strategies. Funds in this category will invest in at least two of the investment strategies discussed above to offer diversified alternatives exposure. Many multi-strategy funds are managed by different subadvisors and the allocations between subadvisors is either static (minimal changes over time) or tactical (changed often in response to market movements).

Performance Expectations. The funds in this category vary significantly by investment strategy, manager, and underlying investments, so the performance expectations will vary as well. Investors looking to use multi-strategy funds would be wise to research how a fund is managed, either static or tactical, who manages the allocations to the different strategies, as well as the track record of the underlying subadvisors, if applicable.

[35] https://www.gsam.com/content/dam/gsam/pdfs/us/en/fund-literature/brochure/liquid-alternative-investments-maps.pdf?sa=n&rd=n

Strategy Risks. These funds are exposed to the risks associated with all underlying strategies in the funds. In addition, they are exposed to manager allocation risks and style drift risk, as well as potentially higher fees due to fund and subadvisor fees.[36]

Portfolio Application. Portfolio Diversification and Risk Reduction. These funds tend to be best used for diversification of smaller portfolios and for clients who wish to gain access to alternatives, but may be limited in the number of individual strategies they can use. These are also appropriate for clients who are concerned about selecting alternatives strategies and wish to leave this to the managers.

Common Risks

While each liquid alternatives strategy has its own risks based on the type of strategy used and the underlying investments, there are common risks amongst the liquid alternatives universe. Investors should be aware of these risks and check each fund's prospectus to determine if a specific fund is exposed to these and/or other types of risks.

Liquid Alternatives – Common Risks

- Manager Risk
- Illiquidity
- Valuation Risk
- Performance Expectations
- Fees and Expenses
- Leverage Risk
- Derivatives Risk
- Short Sales Risk
- Turnover Risk
- Style Drift Risk

- ***Manager Risk***. The top risk all liquid alternative funds have in common is manager risk. These funds are not passive index funds. Managers actively make decisions on the investments or strategies used to achieve performance goals, including the use of derivatives, swaps, and leverage. Even non-traditional ETF funds have manager risk, as someone is making a decision on the amount of leverage to use or the index to short. Therefore, these funds have very high manager risk and it is important for advisors and investors to analyze the background and experience of a liquid alternatives manager, especially during periods of market shock.
- ***Illiquidity***. Liquid alternatives managers may invest in securities that have low trading volumes or may not be traded on exchanges. These holdings may become illiquid, preventing a fund from promptly liquidating unfavorable positions and subjecting the fund to losses. The SEC considers a security liquid if it can be convertible to cash in current market conditions in 7 days or less. Mutual funds' daily liquidity could potentially create a mismatch.[37]
- ***Valuation Risk***. Funds may value certain securities at a higher price than the price at which they can be sold - especially derivatives. This means the published daily NAVs may not accurately reflect the true liquidation value of a portfolio.
- ***Performance Expectations***. There are two primary concerns when it comes to performance expectations. First, investors tend to believe liquid alternatives should outperform the equity and bond indices in all markets. In reality, liquid alts funds can decline in down markets - especially those with higher correlations to the equity markets, and they can - and probably should - underperform in rising markets. Second, due to the liquidity and leverage constraints of

[36] https://www.dailyalts.com/pros-cons-single-multi-manager-alternative-funds/
[37] http://www.wealthmanagement.com/mutual-funds/there-liquidity-risk-liquid-alts

the '40 Act and potential conflicts of interest, alternative strategy funds tend to hold different types of investments than their unconstrained peers. Therefore, alternative mutual fund managers may have more difficulty in replicating the return profile of unconstrained alternative fund managers.[38]

- ***Fees and Expenses***. Liquid alternatives advisors tend to have higher expense ratios compared to long-only strategies - typically at least 70-100 bps higher. Investment advisors of funds or fund-of-funds strategies may have expense ratios that do not include the underlying managers' performance fees you would see when investing in a private hedge fund. However, liquid alts may have other performance-based fee structures, mainly in the managed futures space. While it may be argued that certain performance based fees are crucial to the trading strategy, in general terms, the higher the fee, the greater the effect will be in dampening net returns.[39]
- ***Leverage***. Liquid alts can introduce more complex trading strategies, like shorting, and embed leverage more than traditional mutual funds do. During a market shock, when the risks become more apparent, investors who failed to appreciate the risks of these investments could engage in heavy redemptions, exacerbating the shock. Current rules require liquid alts managers to cover all borrowings with three times as many assets. However, liquid alts managers can use derivatives to effectively lever above the 300 percent coverage rule.
- ***Derivative Risk***. Derivatives are financial contracts with a value that depends on, or is derived from, its relationship with an underlying asset or stream of cash flows. Examples of derivatives include call and put options, futures contracts, warrants, and convertible securities and swaps. Certain derivatives, if they are poorly structured, have the potential for unlimited loss. Derivatives are also exposed to counterparty risk because they are dependent upon the person or institution on the other side of the trade being able to live up to their end of the deal. Companies may be named as counterparty to several derivatives, which could lead to systematic counterparty risk. This could have an impact on the market and affect performance regardless of a fund's exposure to that specific counterparty. Also, as mentioned in the leverage discussion, while the '40 Act limits leverage, this limit does not apply to leverage attained though derivatives.[40]
- ***Short Sales Risk***. Alternative strategy funds may make short sales of securities, which means they may sell an investment they do not own in anticipation of a decline in the market value of the security. The fund borrows the security to deliver to a buyer in a short sale, and the fund will lose money if the price of the security increases between the time of the short sale and the date when the fund replaces the borrowed security. These have special risks because, in theory, the underlying price of a security could go to infinity, therefore generating infinite losses for the fund. The '40 Act regulations require shorted assets to be segregated to cover the positions, which limits the losses to the specific security as opposed to all of the holdings.

[38] https://www.wsj.com/articles/the-success-and-dangers-of-liquid-alternative-mutual-funds-1428375823
[39] http://www.investmentnews.com/article/20160901/FREE/160909996/morningstar-slams-some-liquid-alternative-funds-for-masking-actual
[40] https://www.gsam.com/content/gsam/us/en/advisors/resources/liquid-alts-glossary.html

- ***Conflict of Interest Risk***. Hedge fund managers who manage both a private hedge fund strategy and an alternative strategy mutual fund face conflicts of interest. They could be conflicted in trade allocations because offering a low fee version of higher fee funds may cannibalize their existing client base. To mitigate these risks, managers must clearly disclose trade allocations in fund prospectuses and generally will attempt to clearly delineate the subset of trades or strategies included in mutual funds.
- ***Turnover Risk***. Alternative fund strategies, particularly those that use derivatives, may employ frequent and active trading strategies, which result in increased transaction costs and reduced fund returns.
- ***Concentration Risk***. '40 Act registered funds can be concentrated as long as they register as "non-diversified" with the SEC. All non-diversified funds have concentration risk, but what is different about concentration risk for liquid alternatives is that the underlying holdings may be less liquid than those that concentrate in certain industries or sectors. Investors should know if a fund is concentrated in holdings that have less liquidity or are infrequently traded, such as certain credit strategies or derivatives.
- ***Style Drift Risk***. Hedge fund managers may change strategy to deal with a given market scenario or to mitigate liquidity concerns. With limited transparency, it can be difficult to determine how a hedge fund manager is investing. Investors may end up with a different risk/return profile than they had originally expected. Fund-of-fund strategies may also shift to different managers over time and end up with a higher concentration in a specific manager.

Case Study: Concentration and Liquidity Risk in a '40 Act Mutual Fund

Registered liquid alternatives are subject to the concentration and liquidity limitations imposed by the '40 Act rules, which limit funds to a maximum of 15% of assets in "illiquid" assets (tradeable in 7 days), and limits non-diversified mutual funds with respect to the amount of outstanding voting shares of underlying companies. However, the '40 Act protections do not always limit losses for funds employing complex strategies. This was the case with a global credit fund which, despite being in compliance with the '40 Act limits prior to its issues, was forced to halt redemptions (a move that is very uncommon for open-end mutual funds) and eventually close and liquidate the fund's assets after pricing for some of the fund's illiquid assets declined and liquidity tightened up. As investors watched the fund's NAV decline due to the daily pricing mechanism for open-end mutual funds, they started to redeem shares. The fund's managers were forced to sell off the more liquid holdings to cover redemptions, leaving a larger percentage of the fund in illiquid holdings which had deteriorated in value. After losing more than a third of its assets in a calendar year due to redemptions and declining prices, the fund decided to close redemptions to avoid having to sell the less liquid assets at "fire sale" prices and lock in further losses for investors. The fund placed all of its remaining assets in a liquidating trust, and continues to liquidate these assets as they are able to. Important lessons have been learned by the collapse of this fund and it highlighted the risk of holding very illiquid or thinly traded assets in a fund with daily redemptions. For advisors, investors, and regulators, the downfall of this fund highlights the need to view these strategies as complex despite the '40 Act wrapper and to fully understand the risks involved. Interestingly, this fund had disclosed its concentration and liquidity risks in its prospectus.

Suitability and Action Steps When Using Liquid Alternatives

Liquid alternatives funds are registered under the '40 Act, which gives the appearance they may be suitable for most investors. However, it is important to remember that even '40 Act funds fall under the guidance of FINRA Rule 2111, the suitability rule. This rule includes three primary suitability obligations:

reasonable basis (a recommendation is based on reasonable diligence of the potential risks and rewards), customer-specific (a recommendation is based on a client's specific profile), and quantitative (recommendations are not excessive when taken together even if they are suitable in isolation).[41]

Considering the regulators may view liquid alternatives as complex, the following are essential steps to be taken to help yourself and your business comply when using liquid alternatives, to determine if the product is suitable for a client or portfolio based on the guidelines provided in FINRA Rule 2111, and document how you came to this determination.

- **Review the characteristics** of each fund FINRA suggested in its Investor Alert including the fund's ***investment structure, strategy risk factors, investment objectives, operating expenses, fund manager and performance history***.[42] Document that you have reviewed these features.
- **Conduct a comprehensive review** on the fees and expenses of a fund, just as you would analyze the fees of any other complex product. Alternative mutual funds can be pricey relative to traditional mutual funds and often the fees of any underlying subadvisors are not included in the published fees (although they can detract from performance). Make sure you understand any layers of fees and document you understand how this fund compares to its own peer group.
- **Review performance** during different types of market conditions. This step is key to ensure investors fully understand performance. Look at ***up and down capture (the percentage of a rising or declining market that a fund captured), bear market and bull market performance, and performance during periods of volatility.*** Review the performance expectations discussed above and see whether a manager is performing as expected in these types of markets, and if not, ask questions. Unfortunately, a fair number of liquid alts funds were launched after 2008, so it may be difficult to know how they would perform in an extended bear market.
- **Understand the fund's track record** to determine whether a fund is using its predecessor hedge fund track record or if it is using its mutual fund track record only. Some firms will do conversions from a hedge fund to a mutual fund and carry over the track record. While helpful to gain insight into longer-term performance trends, it's important to ask if the manager has made any trading, risk or structural changes to comply with the restrictions of the '40 Act.
- **Read through the prospectus** and search for the risks discussed above. If you're uncertain about how these risks may impact performance, discuss them with an investment specialist from the fund company you're considering. This is a crucial step and must be documented properly. An investor should not only know what risks are there, but should understand how they may impact performance and how they could cause performance to be different than traditional funds.
- **Ensure you are conducting proper background checks** and financial analysis of sponsor/manager firms. Additionally, ask for a firm's written regulatory and compliance procedures including those on conflicts of interest. If you are unable to conduct background

[41] http://www.finra.org/industry/faq-finra-rule-2111-suitability-faq
[42] http://www.finra.org/newsroom/2013/finra-issues-new-investor-alert-alternative-funds-are-not-your-typical-mutual-funds

checks or review procedures, ensure someone is doing this on your behalf (such as home office personnel). Be sure you have evidence this has occurred and that it's acceptable.

- **Ensure an adequate training process is in place** for registered persons and their supervisors.
- **Document everything on this list.** If regulators can't see what you've done to review liquid alternatives, then it will be as if it never happened. Start by putting a folder together (physical and/or electronic) to keep track of everything you review.

Protect Your Business

With more and more regulatory focus on the complexities of liquid alternatives, it may be prudent to implement written policies and procedures for liquid alternatives similar to what is in place for other complex products.

Conclusion

The liquid alternatives market has grown substantially over the last decade as investors and managers embrace the role of alternatives in more transparent, liquid and registered fund structures. However, along with this growth has come increased regulatory scrutiny. In the past, regulators have focused primarily on private placements, non-traded products, and leveraged and inverse ETFs as complex. Regulators have suggested heightened due diligence, supervision, training of registered persons and ongoing monitoring at the fund level for complex products. Guidance also suggests documentation of the process. With more and more regulatory focus on the complexities of liquid alternatives, as well as a recent example of the potential risk of alternative strategies in a '40 Act fund, it may be prudent to implement written policies and procedures for liquid alternatives similar to what is in place for other complex products.

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