Consider the Alternatives!

By Kerry Pechter *Fri, Aug 1, 2014*

Liquid alts are the hottest topic in mutual funds. Some have suggested that they can solve sequence risk and temper longevity risk in retirement portfolios. To demystify this topic, RIJ called Keith Black, a Certified Alternative Investment Analyst.

Only yesterday, everybody seemed to be talking up “managed-vol” funds as a retirement portfolio’s best remedy for unpredictable markets. Now the buzz is all about taming volatility by replacing up to 20% of a traditional stock and bond portfolio with “liquid alts.”

Liquid alts are actively managed mutual funds or ETFs that give retail investors indirect access to the assets and strategies—timberland, hedge funds, private equity, managed futures—that sophisticated institutional investors and wealthy individuals use to smooth their returns.

Exotic and unfamiliar to most people, liquid alts have put their noses under the retirement income tent. They’re showing up as investment options in variable annuities that don’t have living benefits. The rationale, not yet proven, is that liquid alts might reduce volatility well enough to make income guarantees unnecessary as protection against longevity risk.

To learn more about alternatives, and to find out if the claims that liquid alts offer “better returns with less risk” are too good to be true, we talked to Keith Black of the CAIA Association in Amherst, Mass. It sponsors the Chartered Alternative Investment Analyst designation.

Our takeaway: Liquid alts don’t offer a free lunch. Because their price movements aren’t correlated with those of stocks, they’ll tend to reduce losses in down markets. But they’ll also tend to reduce gains in up markets. And liquid alts tend to underperform true alts, which aren’t available to most retail investors.

RIJ: Is it true that I can increase my returns and lower my risk if I swap out some of the stocks and bonds in my portfolio for liquid alts? That seems like a violation of the law of risk and return.

Black: We aren’t saying, for instance, that you’ll get a higher return, with less risk, from alts than from stocks. When you hear that the portfolio’s risk and return will be better, that might only mean that your risk went down by 4% but your return only went down by 2%. Because you have a lower standard deviation of risk with an alt, you could have a lower absolute return but a higher risk-adjusted return. You might get higher returns from private equity investments than from stocks, but they would typically come with higher risk and less liquidity than stocks.

RIJ: And this has something to do with non-correlation of returns, right?

Black: A prudently chosen package of alts should lower the risk of an equity-dominated portfolio, simply because you're going into something different. What we care about is correlation, and to the degree that the package of real estate or commodities is doing something different from stocks, you should get enhanced diversification, which should reduce your investment risk.

RIJ: So where do I put liquid alts on the spectrum from very risky to very conservative?

Black: The risk and return profile of most alternatives will be between that of stocks and bonds. Most alts will underperform stocks in a big bull market, but they will tend outperform stocks in a down market. In 2008, for instance, long stocks were down 40% but hedge funds were down only 20%. Alts preserve value better in a bear market. When we say that the risk and return of alts is between stocks and bonds, we're talking across all managers and all strategies. If you pick one commodity fund at random or one long/short equity fund, we couldn't guarantee that any single fund will be more or less risky than stocks.

RIJ: How much of my portfolio should I allocate to alternatives?

Black: On average, institutional investors allocate over 20% of assets to alternatives. If you're talking about universities like Harvard with billion-dollar endowments, alternatives might account for more than half of the assets. But those are perpetuities, not individuals. Right now we see retail investors averaging five percent of assets in alternatives. But to invest directly in alts, you need to be an accredited investor, which means you need to have $1 million in assets outside of your resident, or at least $200,000 in personal income. If you can't meet those requirements, you can't do it."

RIJ: Right. If I invest in liquid alts, do I get the same benefit that the endowment fund managers get?

Black: The liquid alts would have lower returns because there are limits on the amount of illiquidity, leverage and concentration they can have. If you compare the five-year return on a limited partnership hedge fund with the five-year return on a liquid exchange-traded fund that invests in hedge funds, the liquid version will underperform on average by 50 to 150 basis points. Equity long/short funds or managed futures funds will underperform by 40 to 100 basis points over five years. With event-driven or multi-strategy funds, the difference might be as large as 200 basis points over five years."

RIJ: That's good to know. How should I now what to expect from liquid alts?

Black: A long/short equity fund might be 100% long and 50% short, so on average it will be 50% net long. Last year, when stocks were up 32%, that long/short fund would have been up 16%. But in 2008 it would have been down only 20% instead of 40%. Commodities can be as volatile as stocks, but in the opposite direction, so you'll get volatility dampening. If the situations in Gaza and Syria and the Ukraine get uglier, the stock market might go down but commodities would probably rally.

RIJ: We keep hearing that bonds are not portfolio diversifiers any more. If stock prices fall, the Fed won't be able to boost bond prices by lowering interest rates, because interest rates can't go any lower. Is that right?

Black: For the last couple of years, people said bond yields can only go up and prices can only go down. But if there's a flight to the safety of U.S. Treasuries, you could see higher bond prices. So there's still a diversification possibility in bonds. But the return expectations of bonds will be very low. If you own a 3% bond, the best that you'll get is 3%. If you're running a pension fund that has a 7% target return, bond yields aren't helping you diversify.