The Natural Plateauing of Liquid Alternative Funds: What Comes Next?

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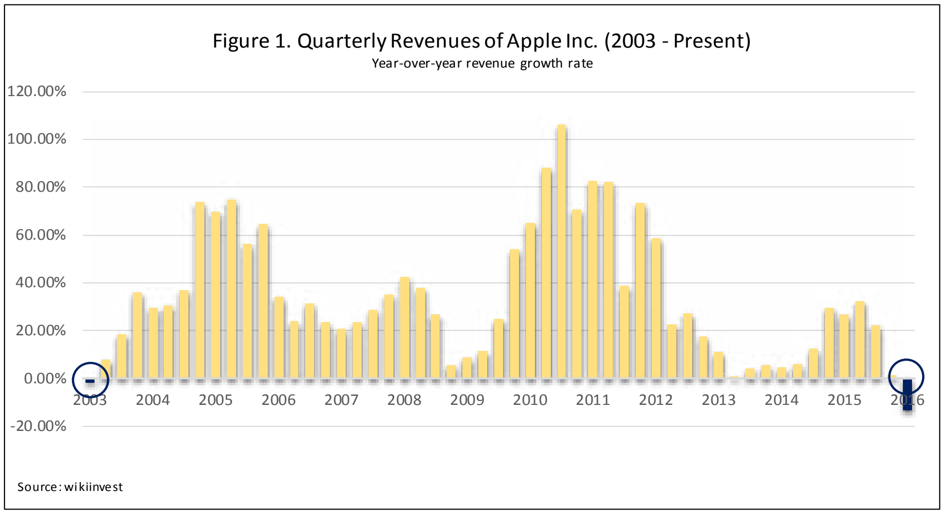
The recent launch of the iPhone 7 came with the usual fanfare. The underlying slowdown in Apple iPhone sales, however, serves as a reminder that very rarely does growth proceed apace in a straight line.[1] Expansion is far more likely to take shape in a stepped approach – with spurts and pauses setting the stage for successive rounds of acceleration. In fact, the continued growth of a product is never assured, as markets remain subject to the downward slope of the demand curve, the introduction of innovation and competition and the inconstant taste of the consumer. In that sense, Apple's first revenue decline in more than a decade can be seen as more a natural phenomenon than the hand wringing pundits might concede.



This mercurial pattern of ascent is recognizable to the mountain climber and the SCUBA diver. In both endeavors, a proper climb is achieved as a series of acclimations and adjustments at different elevations (or depths), endorsing the notion that higher movement is best achieved as a step function. In the case of Mount Everest, for example, climbers typically proceed from a basecamp at 17,000 feet above sea level to the summit atop 29,000 feet by pausing at each of a series of four or five camps, pitched at increasing elevations along the mountain. By traversing from camp to camp, a mountain climber is provided a series of respites -- opportunities to take inventory, to make necessary adjustments for the thinning air and to gather faculties in front of the next stage of the climb.

The U.S. mutual fund business, in contrast, offers a unique and impressive example of growth all its own. Strictly by the numbers, the industry seems to have flourished in a manner suggesting a certain immunity from the stepped approach. In 1975, there were 426 funds with $45 billion in assets under management. Today, there are more than 8,000 funds with $15.6 trillion under management.[2] And, during that same period of time, there were only six instances where total mutual fund assets measured at yearend failed to exceed those at the start of the year.[3] A closer look behind the numbers, however, reveals at least a few fits and starts.

At the outset, comparing the mutual fund market to other markets for products or service is not an apples to apples juxtaposition. The mutual fund product differs from others in significant ways that distort observed measurables. Most notably, a mutual fund is not consumed like other products or

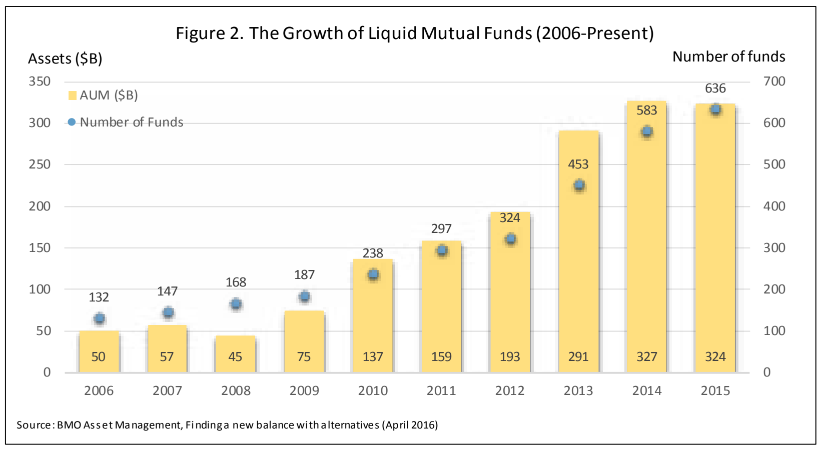
[1] See generally Adam Satariano, *Apple Falls After Forecast for First Sales Drop Since 2003*, Bloomberg (Jan. 26, 2016) (observing that Apple is "no longer benefitting as much from the rapid adoption of smartphones around the world.").

[2] *See* 2016 Investment Company Fact Book, INVESTMENT COMPANY INSTITUTE (56th ed. 2016) at 170.

[3] *Id.*

services. Instead, a fund is purchased with an expectation that its underlying portfolio of assets will grow. Additional confusion results from the fact that mutual funds are offered in different size and shapes, with dramatically disparate investment objectives and underlying portfolios and subject to all manner of market gyration, good or bad. Fortunately, the full mutual fund data set includes information related to net flows and the number of new fund creations. Each of these categories helps to better inform investigation into the overall trends and prospects for the industry.

One category of fund that seems top of mind these days is the so-called liquid alternatives mutual fund. To date, the growth of the category has been impressive by any measure. From roughly $60 billion in AuM in 2006, these funds today account for more than $300 billion of assets.[4] The asset gathering is all the more impressive against the lukewarm success of actively managed mutual funds more generally during the same period.



Overall, investor demand for mutual funds declined in 2015, with net redemptions of $102 billion for the year.[5] As the recent Investment Company Institute's Fact Book described:

> "Some of the outflows from long-term mutual funds in 2015 reflect a broader shift, driven by both investors and retirement plan sponsors, toward other pooled investment vehicles. This trend is reflected in the outflows from actively managed funds and the growth of index mutual funds, ETFs, and collective investment trusts (CITs) since 2007."[6]

In fact, fundamental questions for the industry continue to mount. Chief among the concerns is the issue of whether the products – as currently constructed and sold – meet the needs of an investing public increasingly conscious of fee levels, skeptical of the value of active management and in search of a more tailored and tactical set of solutions.

There is no denying, at least as an academic exercise, that the injection of an alternative stream of return into the traditional 60/40 portfolio has a profound effect on the efficient frontier – offering the investment set more expected return per unit of risk expended. Since Harry Markowitz won his Nobel Prize, the concept that risk and reward behave in concert has been embedded in the heart of modern finance.[7] An efficient portfolio is one seeking to reduce overall risk without sacrificing expected return.[8] This may be achieved, in principle, by combining assets with returns that are

[4] *See* Lowell Yura, Kristina M. Kalebich, Kristi Hanson and John Lennox, *Finding a new balance with alternatives*, BMO Asset Management (April 2016) at 1.

[5] *See* 2016 Investment Company Fact Book, *supra* note 2 at 26.

[6] *Id*. at 44.

[7] *See, e.g.* Sarah Max, *Alternative Investments: Surfing the Market*, BARRON'S (Oct. 24, 2015) (discussing Modern Portfolio Theory as the philosophy underpinning liquid alternative mutual funds).

less than perfectly correlated; that is by adding to an existing portfolio an asset whose returns do not move in lock-step, thereby reducing the risk of the original portfolio.[9] This observation may explain the impressive growth of the liquid alternatives category to date.[10] For, any advisor worth her salt will caution that the traditional blend of the fixed income and equities asset classes leaves an investor more exposed than is wise when the correlation of the traditional asset classes might increase during periods of market turbulence. And, there remains a dearth of product able to provide reliable non-correlation benefits to the average investor.

Perhaps the most compelling attribute of the typical liquid alternative mutual fund is the potential to achieve returns less correlated to major equity and fixed income markets. Indeed, this is the value of portfolio diversification. Diversification into less correlated assets and strategies should improve the profile of an investor's overall portfolio. Alternative funds include illiquid assets such as real estate, venture capital, commodities, and collectibles, as well as other more liquid "hedge fund" strategies such as event-driven, global macro and managed futures.[11] Until recently, such non-correlated returns were difficult for the masses to access, remaining available only to high-net worth individuals and institutions in the offerings of those private funds or partnerships with the expertise to access and manage these streams of return.[12] With the limited partnership representing the most likely conduit, investors were left to contend with relative illiquidity and higher fees. In a sense, the liquid alternatives movement represents the natural response to the desire for non-correlation at a reasonable price and with improved liquidity.

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It is notable that the growth of liquid alternative mutual funds accelerated in the years following the financial crisis, as their case was bolstered immeasurably by the relative performance of non-traditional assets during the most recent period of turbulence.[13] In fact, the acceleration of the category represents the tangible manifestation of the non-correlation that is fast becoming a portfolio requirement.[14] Also, liquid alternative mutual funds are enabled by both a renewed emphasis on the structuring of funds and an ever expanding menu of possibilities attributable to advances in both available return streams and the manner in which they might be captured.

Despite all the fanfare, however, the most perceptive observers of the liquid alternatives movement have recognized a recent plateauing of the flows into the space.[15] While new market entrants continue to be drawn to the category and new fund creation progresses in earnest,[16] Goldman Sachs began a recent report on the industry with the following disquieting statement: "After the turbulent markets of 2015, many liquid alternative fund investors, especially those new to the asset class, may be wondering whether these investment vehicles work."[17] A Financial Times article echoed the sentiment, pronouncing that "[t]he asset management industry's hopes of bringing hedge fund strategies to the American mass market have stalled in the face of miserable returns and skepticism from investors."[18] And, a recent Morningstar report reveals data that might

[8] For a thoughtful reflection on the developments of Modern Portfolio Theory, *see generally* Frank J. Fabozzi, Francis Gupta and Harry M. Markowitz, *The Legacy of Modern Portfolio Theory*, J. INVESTING (Fall 2002) at 7 *et seq*.

[9] *Id. at 8.*

[10] *See, e.g.* Rob Copeland, *Can Hot New Bond Funds Burn You?*, WALL ST. J. (Apr. 6, 2015) ("The liquid-alternatives pitch is simple: portfolio diversification.")

[11] *See Allocating to "Liquid Alternatives"*: *The Importance of Correlation*, EQUINOX FUND INSIGHTS (Apr. 11, 2016) at 3.

[12] *See, e.g.* Max, *supra* note 7 ("for decades, hedge funds were solely the domain of big institutions and the very wealthy.")

[13] In 2008, for example, the S&P500 Total Return Index lost 37.00% of its value while the Barclays BTOP 50 Index, representing the largest commodity trading advisors, returned 13.58%. *See generally Managed Futures: The Potential Benefits of a Short and Long Term Perspective*, EQUINOX FUND INSIGHTS (2016) at 4-5. See also Smith, *infra* note 23 ("the liquid-alts sector took off after the financial crisis of 2008, when investors intensified their search for funds that could protect them from the full force of severe stock market decline.

[14] *See* Morningstar and Barron's, *2014-2015 Alternative Investment Survey of U.S. Institutions and Financial Advisors* (July 2015) at 37 ("Once again, diversification/low correlation remains the top driver for investing in alternatives.").

[15] *Id.* at 16 ("While this sudden deceleration is significant, alts still grew at the fastest clip relative to all other asset classes.").

[16] *Id.* at 5 (suggesting that "[e]ven as flows have moderated, fund companies continue to launch funds at a record clip.").

[17] *Liquid Alternative Investments Market Analysis & Performance Summary*, Goldman Sachs Asset Management (2015 Year End) at 1.

bespeak a plateau.[19]

It happens that the first meaningful interruption in the impressive growth of liquid alternative mutual funds might now be upon us. Before guessing as to how quickly and at what measure prospects might improve, it is wise to examine the reasons for the current abeyance. In particular, three questions deserve consideration:

1. **Why has the liquid alternatives movement stalled?**
2. **Does the slowdown represent the top of the mountain for these alternative funds, or a respite before the ascent continues higher?**
3. **Are there structural improvements that might encourage such an ascent?**

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The Morningstar report highlights many of the headwinds that liquid alternatives are now confronting. First, the robust and sustained performance of the equity markets since 2008 has deemphasized the need for protection within a portfolio in the minds of many investors.[20] Adding to the skepticism of would-be investors is the fact that, on a relative basis, non-traditional asset classes have now provided performance disappointments for several years.[21] By one accounting, over the past five years, funds in Morningstar's alternatives category have underperformed the S&P 500 by more than 1300 basis points.[22] Of course, any wise and grizzled veteran of financial services will warn that past performance is not necessarily indicative of future results and will understand that long-term planning based on short-term performance numbers is of limited utility.

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Further frustration with liquid alternative funds derives from their complexity and high cost.[23] As one commentator described, the individual strategies embedded in these funds are "unfamiliar at best, incomprehensible at worst."[24] And, despite their relative cheapness when compared to hedge funds, mutual funds remain an expensive investment wrapper. The first versions of liquid alternative mutual funds have not been particularly sensitive to fees, as they have tended toward the high end of the mutual fund fee continuum.[25] This makes some sense in light of the relative newness of the category, with managers less concerned with fee levels than with simply gaining acceptance among a new swath of investors. Even allowing for the general prohibition on most forms of incentive fees in a mutual funds, the combination of manager fees and funds fees in many of the liquid alternatives offerings compromises returns. And, a particular sensibility to fees is both reasonable and likely to persist, especially if we are to remain in a period of lower global growth and correspondingly lower market returns.

To date, liquid alternative mutual funds have been forced to contend with a growing wave in favor of passive over active management. As we have commented previously (see Some Thoughts on the Evolution of the Design of Financial Products), in calendar year 2015, passive index mutual funds and ETFs brought in $365 billion of new money while actively managed funds lost $147 billion in net flows.[26] Here, simpler product and less manager discretion might be the order of the day. Thus

[18] Stephen Foley and Mary Childs, *Liquid alternative mutual funds leave investors disappointed*, FINANCIAL TIMES (May 22, 2016).

[19] *See* Morningstar and Barron's, *supra* note 14.

[20] *Id.* at 4.

[21] According to the Financial Times, "the average fund [in the category] lost money regardless of whether the sector is measured over one, three, five or 10 years." See Foley and Childs, *supra* note 18.

[22] *See* Max, *supra* note 7.

23 *See* Randall Smith, *Investors Stick With Assets that Mimic Hedge Funds*, NY Times (Sept. 15, 2016) (quoting an analyst who observed "painting with a broad brush, performance has really benn underwhelming, and the fees are probably still too high.")

[24] *Id.*

25 *See generally* Smith, *supra* note 23 Dan Weil, *Alternative mutual funds: Are they worth it?*, Bankrate.com (Oct. 16, 2014) (reporting average expense ratio of 1.3 percent for liquid alternative funds versus 0.77 percent for actively managed funds).

26 Eric Balchunas, *Passive Revolution*, BLOOMBERG BUSINESSWEEK (Dec. 14-20, 2015).

far, however, liquid alternative managers have been slow to respond. Finally, flow trends suggest that certain investors “aren’t always taking a long-term approach to alternatives,” instead favoring a more tactical approach.[27] Such an investment philosophy seems at odds with the perpetual nature of the current set of mutual fund offerings, the rhythm of the offering calendar and their underlying fee schedule.

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A growing preference for simplicity and an interest in tactical investing should inform those designing the next generation of liquid alternatives. One might look to the structured notes market that regularly brings product with a fixed investment term and risk parameters designed around investment in a pre-determined underlying asset and geared to a particular risk tolerance. Such products eliminate much of an investor’s guesswork resulting from a manager’s unfettered discretion.

Some complement of products with this kind of definition may help revive the interest in and utilization of liquid alternative funds. In a sense, liquid alternative mutual funds might simply be in a pause – before making the necessary adjustments to resume their ascent. To be sure, there remains an identifiable and growing appetite for something beyond the traditional mutual fund. Surveys suggest that advisors are interested in liquid alts for their clients, with 63% of advisors planning to allocate more than 11% of their portfolios to the category in the next five years.[28] At the same time, prolonged disappointments are not easily forgotten. In any case, an average expense ratio for liquid alternative funds that is 40 basis points higher than the average actively managed equity fund is almost certain to be under attack.[29]

Most importantly, the biggest test for liquid alternative mutual funds likely lays in the near future. The heady days enjoyed by domestic equities for almost the entire life of these funds will not last forever. And, the relationship between bond yields and stock prices will also confront its natural limit. It is at precisely that time that the efficacy of the non-correlation that these funds tout will be tested.

27 Morningstar and Barron’s, *supra* note 14 at 4.

28 *Id*. at 15

29 *See generally*, Weil, *supra* note 24

ABOUT OLDEN LANE

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