Alternative Funds

Most Investment Managers attempt to lower a portfolio's risk by increasing its allocation to Bonds. From our website: "Here is what Warren Buffett wrote about fixed-income investing in his 2012 annual letter to Berkshire Hathaway, Inc., shareholders: They are among the most dangerous of assets. Over the past century these instruments have destroyed the purchasing power of investors in many countries, even as these holders continued to receive timely payments of interest and principal … . Right now, bonds should come with a warning label." That was written before the 35-year bull market in bonds ended in July of last year. On Jan 19, 2018 Bespoke wrote: "When looking at the current levels of longer-term Treasury yields, a bit of perspective is in order. The chart below shows the change in the yield on the 10-year US Treasury since the start of the bull market in stocks, March 2009. During this span, the 10-year has traded in a range from 1.36% on the downside to 3.99% to the upside. Taking the mid-point of those two extremes gives us a mid-point of 2.68%."

So are there alternatives. From Morningstar:

Many Alternative Funds Have Disappointed Investors

By Russel Kinnel | 11-14-17

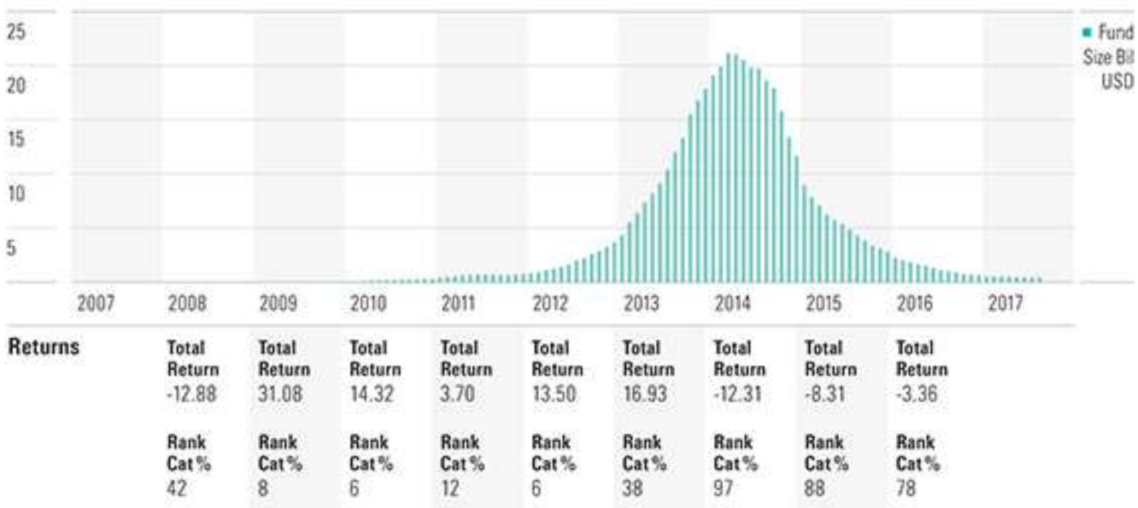
In early 2014, MainStay Marketfield (MFLDX) was a $21 billion alternatives fund behemoth. Today, it's a $500 million fund. MainStay took its name off the fund and returned it to the team at Marketfield. Although MainStay proved quite good at selling the fund, it couldn't prevent the fund from slumping and driving away all those investors who had only recently bought in.

Marketfield is a long-short equity fund that blends macro top-down calls with bottom-up stock selection (recently, it has shifted to a nearly exclusive focus on top-down). From 2008 through 2013, it had a remarkable stretch of outperformance as it handily outpaced its peers each year. In 2009 it trumped the S&P with a return of 31%, and after that returns were excellent until 2014.

Investors and their advisors have sought out alternative funds because noncorrelated assets have the promise of generating positive returns that are not in sync with the stock market. The aim is to have ballast in a portfolio that will give you positive gains when you need them most: in a bear market. That lure draws billions of dollars to alternative funds, and they even tolerate fees that are higher than any other category group.

We liked the fund, too. We rated it Bronze from May 2012 to October 2014. It has been rated Neutral from November 2014 on.

Exhibit 1 The Rise and Fall of Marketfield Fund



After MainStay acquired the fund, it introduced higher-cost share classes, and yet even more people came. The fund was less than $1.0 billion in 2011, but it took in $3.3 billion in 2012 and a stunning $13.2 billion in 2013. But 2014 proved to be a bitter disappointment as the fund lost 12.3% while the S&P 500 gained 13.7%. In 2015, it lost 8.3% and then lost 3.3% in 2016. The S&P 500 gained 1.4% and 12%, respectively. Thus, the noncorrelated performance delivered losses even as stocks were going higher. Flows quickly reversed direction. The fund shed $7.8 billion in 2014, $6.3 billion in 2015, and $1.6 billion in 2016 as MainStay made a hasty retreat. Thus, investors managed to largely miss out on the fund's strong performance while selling after poor performance and missing out on a strong rebound so far in 2017.

Exhibit 2: Performance Versus S&P 500

	2016	2015	2014	2013	2012	2011	2010	2009	2008
Marketfield I	-3.36	-8.31	-12.31	16.93	13.50	3.70	14.32	31.08	-12.88
Vanguard 500 Index Admiral	11.93	1.36	13.64	32.33	15.96	2.08	15.05	26.62	-36.97

Source: Morningstar Direct and relevant fund company websites.

What happened? Although asset bloat was likely a problem, the fund also suffered from bad macro bets. The past history of funds that try to make big macro bets shows it's much harder to consistently add value than with issue-selection. But macro bets aren't correlated with the stock market, so they were central to the fund's appeal as well.

It's not alone. Hussman Strategic Growth (HSGFX) was a bear-market hero that grew to $6.8 billion in 2010, but dismal performance has caused an exodus that has brought the fund down to $366 million—a threshold it last crossed in 2002.

These are extreme cases, but a rapid ascent followed by a quick reversal is all too common in alternatives land. The 30 largest alternative funds as of February 2014 had $121 billion in assets; today, those same 30 have $74 billion, and three no longer exist. Only seven of the 30 have grown, while 16 have shrunk by more than $1 billion.

By comparison, the 30 largest equity funds from February 2014 had $1.9 trillion at that time and have $2.8 trillion today. And all 30 are still around. ...

There's a lot of disappointment in alternatives land for a number of reasons. Let's look at each.

Belief in the Free Lunch. Whether implied by fund companies or simply inferred by investors who want to believe market cycles can be engineered away, there's a common hope that alternative funds can have nearly all the upside of equity funds without any of the downside. When 130/30 funds first came out, I spoke to many investors and reporters who thought they would be good bets in down markets or up markets—until I explained that 130/30 funds are 100% long and therefore have greater downmarket risk than the typical equity fund, which at least has around 3% in cash.

High Fees. Hedge funds have historically charged 2% of assets and 20% of profits. Although that's starting to come down, some firms crossing into the mutual fund world to launch alternative funds have kept something similar to the 2%, though you can't also charge a percentage of profits in a mutual fund. If you're running a strategy that generates 5% annualized, that 2% is a huge cost for shareholders to bear.

Complexity. Many alternative strategies are incredibly complex. Naturally, it's harder for advisors and investors alike to set realistic expectations for such funds. Our alternatives analysts invest quite a bit of time understanding very involved processes. Consider this snippet from our process description of Natixis ASG Managed Futures Strategy (ASFYX) (One of two Managed Futures OEFs which we track. We will be discussing Managed Futures in a future post.):

This fund's process relies on the systematic use of trend-following models in multiple asset classes, subject to a standard deviation target of 12% (with a 17% maximum). The process combines conventional multitrend models (25% of the risk), adaptive horizon models (40%), and short-term models (35%). They work in tandem to produce entry and exit signals to profit on sustained market trends on the upside or the downside. Adaptive horizon models are one of the differentiating factors here, as they analyze previous market patterns and modify positioning if the past patterns provide clues for the future. It's an adaptive process where management evaluates the models' efficacy across multiple horizons in an effort to optimize long-term strategic shifts with new information. The process is a combination of conventional methods and more distinctive ideas.

Investors tend to go in expecting the work of genius, and they go out when the fund loses money, thus proving that the manager is human after all. Of course, complexity also means high fees, so the alternative fund world loves complexity even if it makes for bad results.

Short-Termism, Part 1. The pace of change in the alternative fund space is amazing. Funds get launched, change strategies, and then get liquidated in the space of three years. In addition, alternative fund companies are often looking for a quick score and sell themselves to another firm or go around buying other firms with strong records. The result is you have a lot of funds where the current manager has a very short record, so you don't have much to go on for a huge number of funds. The average manager tenure in alternative is 4.4 years, versus 6.8 years for equities.

Short-Termism, Part 2. There is no second act in alternatives, because investors and advisors bail at the first sign of trouble. If investors are looking at three- and five-year performance in the rest of the fund world, 12 months seems to be everything in alternatives. LoCorr Market Trend (LOTIX) was launched in July 2014 and enjoyed a good 18 months out of the gate, drawing $856 million in 2015 and $288 million in 2016. However, the fund lost 9.5% in 2016, and it has seen about $500 million in redemptions the past 12 months. Blackstone Alternative Multi-Strategy (BXMIX) enjoyed $2.8 billion in inflows in 2015—its first full year. Now it has seen about $300 million in outflows the past 12 months. All told, 68% of alternative funds with three-year track records have been in redemptions for the past 12 months.

Low Yields. Many absolute return strategies were designed when yields on bonds were significantly higher than they are today. Now that yields on almost everything are low, the strategies don't work very well. In addition, fees haven't come down as much as yields, so managers would have to be practically magical to match past performance from the higher-yield era.

Finding Good Alternative Funds

So, how can you wisely use an alternative fund? Let's start with being realistic about the downside. I looked at the maximum drawdown for funds with records dating back to July 2007. Sure enough, it doesn't look like a free lunch at all. There's a big survivorship bias here, as the worst funds naturally were killed off, so I wouldn't consider this a worst-case scenario but a pretty bad scenario.

Exhibit 3 The Downside of Alts Funds

Morningstar Category	Max Drawdown % 08/01/07–08/31/17	Largest %	Smallest %
Long-Short Equity	-28.99	51.11	13.78
Market Neutral	-17.89	51.36	6.41
Multialternative	-32.03	60.25	11.90
Multicurrency	-23.48	35.60	11.60
Option-Writing	-29.46	40.10	24.10

Note: There are only three option-writing funds with records going back to 2007.

Next, do the same things you do for any other fund. Look for low fees, good management, a sound process, and a good parent company. Process is probably the trickiest bit. You don't necessarily need to understand every little detail, but you need to understand it well enough to see how it will work in your portfolio and how you can judge performance. If you can't, move on.

Finally, don't forget that high-quality bonds are another asset that isn't correlated with the stock market. If you have an equity-heavy portfolio, simply adding a high-quality short- or intermediate-term bond fund could do the job for you. They have low costs and produce positive returns most years. Even their down years are usually pretty small. (Again from our website: "Given the way that bond prices move inversely to interest rate changes, intermediate-term bonds could lose half their value if their annual yield rises to their long-run average rate of 6.75%. One should keep in mind that real Treasury bond returns were negative for the next 45 years following similar valuation levels as exist today." That was written when the US 10-year Treasury yield was 2.7%.) ...

Our thoughts

From Morningstar: "Unlike the backward-looking Morningstar Rating (often referred to as the "star rating"), which assigns 1 to 5 stars based on a fund's past risk- and load-adjusted returns versus category peers, the Analyst Rating is the summary expression of Morningstar's forward-looking analysis of a fund. Morningstar analysts assign the ratings on a five-tier scale with three positive ratings of Gold, Silver, and Bronze, a Neutral rating, and a Negative rating.

The Analyst Rating is based on the analyst's conviction in the fund's ability to outperform its peer group and/or relevant benchmark on a risk-adjusted basis over the long term. If a fund receives a positive rating of Gold, Silver, or Bronze, it means Morningstar analysts think highly of the fund and expect it to outperform over a full market cycle of at least five years."

Morningstar's Analysts currently have a positive rating on 1,254 OEFs. The categories of OEFs that Morningstar classifies as Alternative are shown to the right. Within these categories, 34 OEFs are recommended. If we restrict the list to those OEFs that have a performance rating of at least 4 stars, and don't have a load, which, once again, you should never pay, the list narrows to 20:

Bear Market
Long-Short Credit
Long-Short Equity
Managed Futures
Market Neutral
Multialternative
Multicurrency
Options-based
Single Currency
Trading--Inverse Commodities
Trading--Inverse Debt
Trading--Inverse Equity
Trading--Leveraged Commodities
Trading--Leveraged Debt
Trading--Leveraged Equity
Trading--Miscellaneous
Volatility

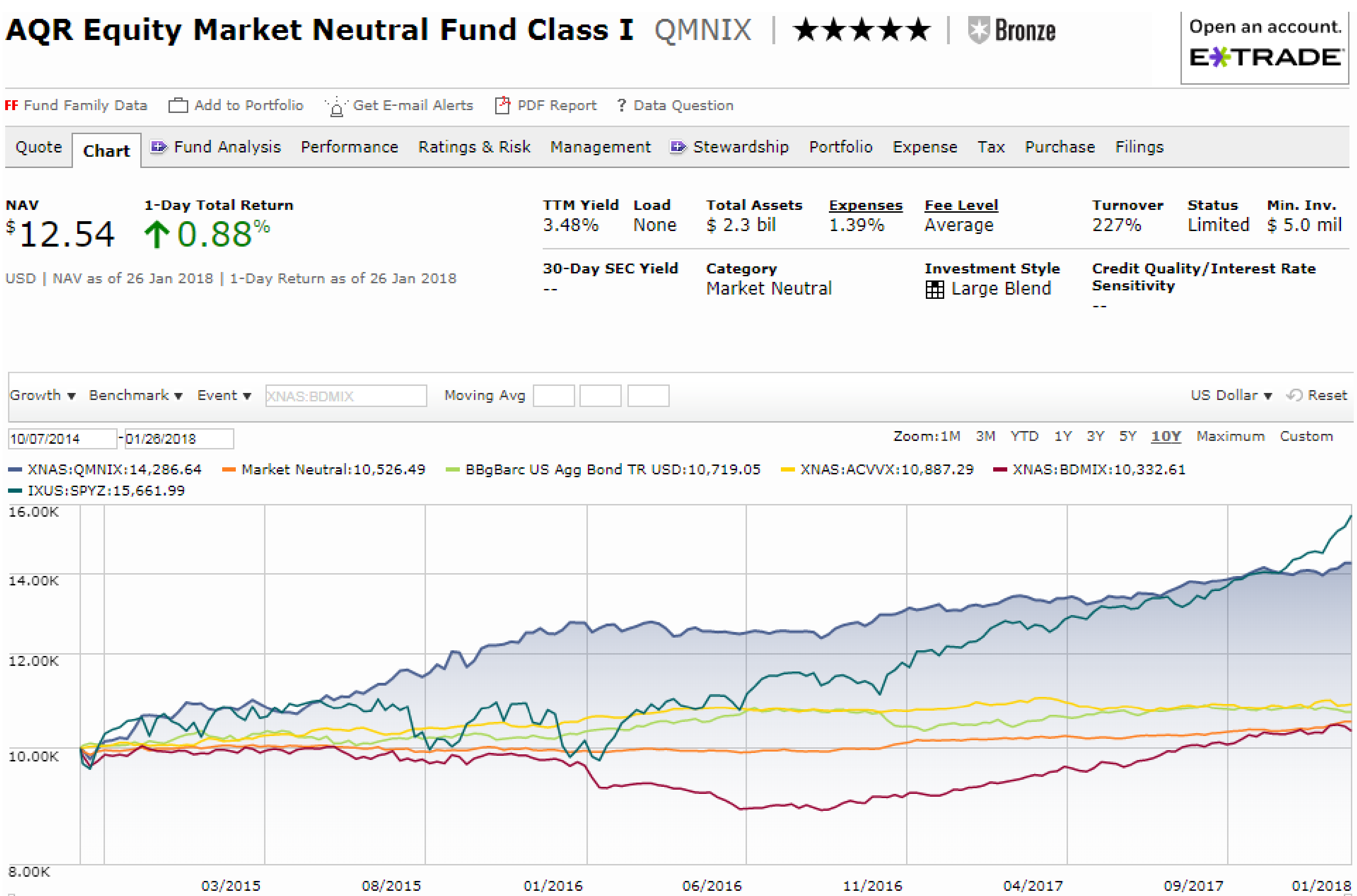
Fund Name	Ticker	Rating	Analyst	Category	Exp.	Assets ($ Mil)
AC Alternatives Market Neutral Val Inv	ACVVX	★★★★	Bronze	Market Neutral	1.64	541.81
AQR Equity Market Neutral I	QMNIX	★★★★★	Bronze	Market Neutral	1.28	2,324.58
AQR Long-Short Equity I	QLEIX	★★★★★	Bronze	Long-Short Equity	1.28	6,135.16
AQR Multi-Strategy Alternative I	ASAIX	★★★★★	Bronze	Multialternative	1.97	3,083.22
AQR Style Premia Alternative I	QSPIX	★★★★★	Silver	Multialternative	1.49	5,014.66
AQR Style Premia Alternative LV I	QSLIX	★★★★	Silver	Multialternative	0.83	481.19
Arbitrage R	ARBFX	★★★★	Bronze	Market Neutral	1.48	1,943.49
BlackRock Global Long/Short Equity Instl	BDMIX	★★★★	Bronze	Market Neutral	1.62	673.25
Boston Partners Global Long/Short Instl	BGLSX	★★★★	Bronze	Long-Short Equity	1.74	1,039.57
Boston Partners Long/Short Equity Instl	BPLSX	★★★★	Bronze	Long-Short Equity	2.46	1,022.55
Boston Partners Long/Short Rsrch Instl	BPIRX	★★★★	Silver	Long-Short Equity	1.41	7,371.71
Credit Suisse Managed Futs Strat I	CSAIX	★★★★	Bronze	Managed Futures	1.30	405.28
Dreyfus Global Real Return I	DRRIX	★★★★	Silver	Multialternative	0.90	1,574.63
GMO SGM Major Markets III	GSMFX	★★★★	Bronze	Multialternative	0.85	1,912.66
JPMorgan Hedged Equity I	JHEQX	★★★★	Silver	Options-based	0.59	1,761.41
Litman Gregory Masters Alt Strats Instl	MASFX	★★★★	Bronze	Multialternative	1.47	2,066.92
Natixis ASG Managed Futures Strategy Y	ASFYX	★★★★	Bronze	Managed Futures	1.49	3,813.87
Principal Global Multi-Strategy Instl	PSMIX	★★★★	Bronze	Multialternative	1.61	2,773.14
Schwab Hedged Equity	SWHEX	★★★★	Bronze	Long-Short Equity	1.33	257.96
Touchstone Merger Arbitrage Instl	TMGLX	★★★★	Bronze	Market Neutral	1.28	188.92

It is interesting to note that 5 of these OEFs come from AQR, and all 4 of those rated 5 stars for past performance. From Morningstar: "AQR boasts a strong quantitative research culture, competitive fees, and high manager retention, warranting a Positive Parent Pillar rating. Quantitative research underpins all of the firm's strategies. It offers traditional equity and alternative strategies in both hedge fund and mutual fund formats. The firm puts a strong emphasis on infrastructure and efficient execution. ...

The leadership team has close ties to academia. In fact, 11 of the firm's 26 principals have doctorate degrees, and five are current or former professors. The principals own most of the firm, and the three remaining founding principals have final decision-making authority. Equity ownership and attractive compensation have promoted high manager retention (99% over the past five years).

... The firm has kept fees generally reasonable with three quarters of its share classes featuring below-average fees for their distribution channels. Even though AQR has been attentive to capacity in the face of rapid asset growth in its liquid alternative products, capacity concerns may be an obstacle for return generation in the future."

In terms of Category, 7 of these OEFs are Multialternative (none of which compare favorably with QMNIX), and 5 each are Market Neutral and Long-Short Equity. It is important to note that Morningstar's Categories are not necessarily defined by Process. Three of the Market Neutral OEFs (ACVVX, QMNIX, BDMIX) use a "Long-Short" Process, but with no net long exposure, which keeps them out of the "Long-Short Equity" Category. It is appropriate to compare these 3 OEFs, but not against those in the higher risk Category of "Long-Short Equity". Morningstar's chart compares QMNIX (blue line), our favorite Fund for reducing a portfolio's Risk, to its peers (orange line) and benchmark (green line). We have added ACVVX (yellow line), BDMIX (maroon line), and the S&P 500 TR index (turquoise line).



QMNIX is a Global, Factor-driven Quantitative OEF with 0 Risk, when defined as Maximum Drawdown relative to S&P 500 declines of at least 10%. Fortunately, we began buying it for clients in April of 2016, well before Morningstar's 5 star rating debuted in October of 2017, which was after it had already Soft Closed.