ALTERNATIVES

Why Liquid Alternatives Now

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David Saunders
Founding Managing Director
K2 Advisors®

K2 Advisors' Founding Managing Director David Saunders is speaking at the prestigious SALT conference this month in Las Vegas, where he'll discuss the liquid alternatives landscape and why he thinks now's the time for investors to consider this asset class. He believes the macro environment appears to be setting up well for certain hedge strategies within this space.

K2 Advisors seeks to add value through active portfolio management, tactical allocation and diversification across four main hedge strategies: long-short equity, relative value, global macro and event driven.

Truth be told, 2016 was not a stellar year for hedge funds, as unceremoniously summed in this headline from *The Economist* on December 19, 2016, "Multi-manager hedge funds lost cash, cachet in 2016."

That said, a new leaf seems to have been turned this year with hedge funds returning to positive flows in the first quarter of 2017.[1] Renewed interest has been spurred by the election of Donald Trump as president of the United States, which some industry experts are predicting should bring meaningful tax reform, deregulation and infrastructure spending that we think could prove a boon to hedge strategies.

While we are in the early days of this new administration and Trump's presidency has already faced some challenges, we are optimistic about the future of the hedge-fund industry. We think many strategies could perform better this year, as increased volatility and dispersion among equities (generally a good thing for hedge-fund managers) should persist, reversing a multi-year trend.

Furthermore, with US equity markets reaching new highs and the interest-rate environment looking negative for bonds, we believe investors will seek out product offerings from alternative managers that can offer access to alpha[2] across alternative asset classes.

Below, we have highlighted a few key macroeconomic trends and themes we have been following at K2 that we feel may be of interest. But before we get into those, we think it is important to take a step back and assess how we got to where we are today.

Factors Driving Continued Interest in Alternatives

In the wake of the 2008–2009 Global Financial Crisis (GFC), there were several market forces at work that still persist today, driving strategic long-term interest in the category.

According to McKinsey, disillusionment with traditional asset classes and products has been pushing an increasing number of investors to use alternatives (particularly hedge strategies) as a way to help dampen portfolio volatility and generate a steady stream of returns.[3]

Demand for alternative credit products has been particularly strong, driven by challenges posed to long-only fixed income strategies in the current low (but uncertain) interest-rate environment.

Post-GFC, the shift from relative return benchmarks to concrete outcomes tied to specific investor needs has also kept the utility of alternatives in view. Alternative strategies have been seen by some as more precise tools for delivering the outcomes many investors want. For example, real estate and infrastructure can provide inflation-protected income, and hedge funds can help manage volatility.

Furthermore, an expanding interest in state-of-the-art portfolio construction has many investors seeking to complement the low-cost beta (market return) achieved through index strategies with the "diversified alpha" and "exotic beta" of alternatives.

In addition, some of the most sophisticated institutions in recent years have abandoned traditional asset-class definitions and instead embraced risk factor-based methodologies, a trend that repositions alternatives from a niche allocation to a central part of the portfolio.

Current Outlook for Hedge Strategies

For now, the gap between political expectation and political reality has narrowed a bit, at least as it pertains to the 45th president of the United States. However, there seems to be a prevailing market view that the administration will likely be successful in implementing the so-called "Big Three"— namely tax reform, deregulation and infrastructure spending—that we think could prove a boon to alternative strategy performance.

Moreover, these initiatives have the potential to galvanize the US economy and support current market valuations. Stocks enjoyed a three-month rally following Trump's election win. Time will tell whether hope and speculation are rewarded by the reality of his governing.

Regardless of what the future holds in terms of political results, from a market standpoint we anticipate more volatility going forward—and this can be a good thing for hedged strategies.

Remember, alpha is a byproduct of an inefficient market, and in our view higher volatility is an indication of greater market inefficiency—hence greater opportunity for active investments like hedged strategies to succeed.

Clearly Trump's victory did represent a seismic shift, and while markets are discovering where this shift will ultimately lead, we anticipate sharp moves along the way—and in both directions. We also expect measurable dispersion on a sector and security basis. In these circumstances, investment managers with more latitude in trading may be better able to capitalize on price dislocations and trends.

Apropos, we believe these changes have all been positive for alternative investment strategies generally and three hedge strategies that we think could see renewed interest are outlined below.

- **Long Short Equity** appears attractive, particularly as it relates to opportunities in Europe currently. After underperforming the United States over the past 10 years, European equity valuations in our view appear more favorable on a historical relative basis. Furthermore, beyond the encouraging political environment, positive economic and technical factors may be a tailwind for Europe as well.
- **Event Driven** managers may benefit from two potential US tax code changes that could act as catalysts for US corporate activity:
    - A tax holiday allowing overseas cash to be repatriated, and
    - A significant reduction in corporate tax rates. One or both of these could free up corporate cash for events (e.g., special dividends, acquisitions, stock buybacks) that would likely appeal to event driven hedge-fund managers.
- **Relative Value** strategies could benefit from divergent paths of central banks in major economies around the world, especially following the change in the political landscape in the United States following the election in November. As such, we expect cross-border valuations could create an excellent opportunity set for astute relative value hedge fund managers. We believe corporate activity will remain robust in 2017 and potentially increase as the year progresses as the new administration is expected to employ more business-friendly policies (less regulation), especially as it relates to antitrust.

Liquid Alternatives vs. Traditional Hedge Funds: Dispelling Myths

For the rest of 2017, we believe that strategic long-term interest in allocating to alternatives will persist and that market conditions could be setting up for some hedge strategies to potentially perform better in the near term.

Coupled with this, we also believe it is important to dispel a few myths as to where we feel the hedge-fund industry is heading and how we feel liquid alternatives will likely play a bigger part of this mix.

Clearly, the availability of liquid alternative vehicles has expanded rapidly over the past decade, paired with a strategic interest to provide retail investors with access to diversified sources of potential alpha to complement their traditional portfolios.

While interest in liquid strategies waned in 2016, in line with traditional strategies, overall industry growth in recent years has stimulated increased attention and scrutiny, and indeed criticism. Some market analysts have suggested their structure may result in compromised return potential, lower manager quality and limitations on trading strategies. We believe these criticisms to be overstated.

For the purpose of this piece, we would like to focus on one in particular: liquidity.

One of the most common critiques we hear about liquid alternative funds is that their daily liquid structure will result in watered-down performance due to the constraints such a structure will place on a traditional hedge-fund manager's investment process.

This naturally begs the question: How illiquid are traditional hedge funds in the first place? Based on our analysis, while some strategies by their nature may lend themselves toward less liquid holdings than others—distressed debt for example—the majority of hedge-fund managers that we review trade in highly liquid securities most of the time. This analysis suggests that the illiquidity premium may be limited in practice.

The perception of traditional hedge funds being illiquid likely stems from the legal terms they function under, which require in most cases a one- to three-month notice period prior to redemptions. This represents illiquidity at a structural level, but not at a holdings level, which we believe has a more direct impact on performance and is where the supposed illiquidity premium arises.

US mutual funds are required to invest at least 85% of their net assets in liquid assets, but our analysis of traditional hedge funds we follow indicates that very few of them are significantly different, with very few regularly allocating more than 15% of their portfolios to illiquid holdings for longer than three months. Again, some traditional hedge strategies by nature may lend themselves toward less liquid holdings, but in general our analysis indicates that any given traditional hedge-fund strategy may not have the supposedly advantageous exposure to illiquid holdings that many critics assume.

The Path Forward

We will close by quoting Albert Einstein who famously said, "Thinking like we (always) have is what got us where we are. It is not going to get us where we are going."

The hedge fund industry is changing. Old ways of thinking must give way to new ideas. New ideas will create the future. We are optimistic about what that future will offer to investors.

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There can be no assurance that the investment strategies employed by hedge fund and liquid alternative managers will be successful. It is always possible that any trader could generate a loss if the manager's expectations do not come to pass.

Hedge strategy outlooks are determined relative to other hedge strategies and do not represent an opinion regarding absolute expected future performance or risk of any strategy or sub-strategy. Outlook and sentiment are determined by the K2 Advisors' Research Group based on a variety of factors deemed relevant to the analyst(s) covering the strategy or sub-strategy and may change from time to time at sole discretion of the analyst.

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1. Source: Based on the HFRI Fund Weighted Composite Index. The HFRI Fund Weighted Composite Index is a global, equal-weighted index of over 2,000 single-manager funds that report to Hedge Fund Research Inc. database. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. Unlike most asset class indexes, HFR Index returns reflect fees and expenses. Past performance is not an indicator or guarantee or future performance.

2. Alpha is a risk-adjusted measure of the value that a portfolio manager adds to or subtracts from a fund's return.

3. Source: McKinsey & Co, "The $64,000 Trillion Question: Convergence in Asset Management," February 2015.