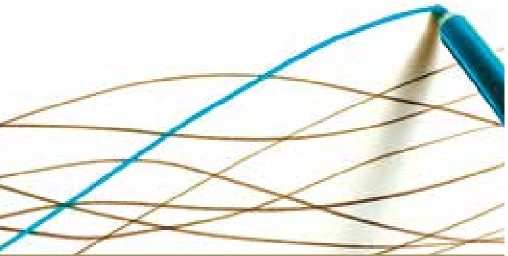

Help or Hype—Advisor Perceptions of Alternative Investments

Alternative investments are popular portfolio diversification tools, yet there is still confusion over what they are and what they do. The following white paper explains what the current alternative investment landscape looks like and identifies the hot-button issues for advisors, broker-dealers, registered investment advisors (RIAs) and investment fund managers.

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As one financial services industry executive recently remarked when reflecting on the economic crisis of 2008, "Those supposedly non-correlated asset classes sure were correlated."

The non-correlated asset classes to which he refers include alternative investments. Traditionally, alternative investments have been defined as products and strategies associated with hedge funds. However, the definition has evolved to include liquid alternative mutual funds, as well as illiquid investments such as hedge fund-of-funds, offshore funds, private equity, limited partnerships and limited liability corporations, non-traded real estate investment trusts, public direct participation programs, private debt and managed futures, among others.

Managed futures, in particular, is an alternative investment asset class widely considered to be the only one that performed to expectations during the economic crisis. Not unexpectedly, however, it has generally underperformed in the years since as global markets and economies recovered.[1]

The tepid performance of alternative investments as a whole left some broker-dealer representatives, RIAs and other industry professionals skeptical of their effectiveness in mitigating volatility while increasing return. But is this perception warranted?

Alternative investment managers and product providers maintain that they have taken steps to incorporate lessons learned from 2008. As a result, they advocate heavily for a percentage of the portfolio to be allocated to various alternative asset classes, depending on the investor's individual situation, investment objective and risk tolerance. A major reason is the significant rise in both stock and bond market correlation. Correlation is defined as a measure of how asset classes or securities move in relation to one another. In recent years, they have increasingly moved in tandem, which has significantly lowered risk-adjusted returns. Most recent statistics bear this out. Research firm Morningstar Inc. reports that, over roughly two decades, correlations between individual stocks in the S&P 500 rose from 10% in 1994 to 66% at the end of 2011.[2]

[1] "The Case for Managed Futures in a Bull Market." Seekingalpha.com. April 8, 2015.

[2] "The Correlation Conundrum and What to Do About It," Morningstar.com. May 19, 2012.

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"Clearly, one year, 2008, does not a history make," Lara Magnusen, portfolio manager and portfolio strategist at Altegris Advisors, stated when suggesting advisors look to the bigger picture.

Indeed, alternative investments had a strong showing as recently as the first quarter of 2015.

January saw the S&P 500 drop by 3%, yet most broad-based hedge fund indices gained between 1.0% and 1.5%, *InvestmentNews* reported in February. Of the seven primary alternative mutual fund categories tracked by Morningstar, only long-short equity was negative, posting a 1.4% decline. In other words, overall, alternative investments as an asset class acted exactly as it should, moving independently of the broad market in a non-correlated fashion.[3]

"It only takes a few days of hot weather to prove that air conditioning is a good idea," Bob Rice, managing director of Tangent Capital, told the publication. "January is highly instructive—all the more so because the results simply correspond to common sense."

FOR 2015

70%

of advisors plan to maintain the status quo relative to alternative allocation weightings in their client portfolios.

In a follow-up piece, *InvestmentNews* went so far as to describe the alternative investments market as "booming."[4]

"The amount of assets in alternative mutual funds grew from $76 billion at the end of 2009 to more than $311 billion at the end of 2014," the article continued. "A lot of investors are speaking with their wallets."

So, are the arguments made by alternative investment advocates valid in light of these findings? Are advisors and the investing public more open to the concept of alternative investments as the events of 2008 recede further from the collective memory? Are usage rates therefore increasing? If so, are liquid or illiquid alternative investments getting the lion's share of assets?

Through original research and interviews with various industry stakeholders—including advisors, broker-dealer and RIA executives, alternative investment managers and product providers—the following white paper will answer these questions. It will also provide an overall sense of the direction in which the alternative investment market is headed.

[3] "Alternatives Earning Their Keep So Far in 2015." Investmentnews.com. February 16, 2015.

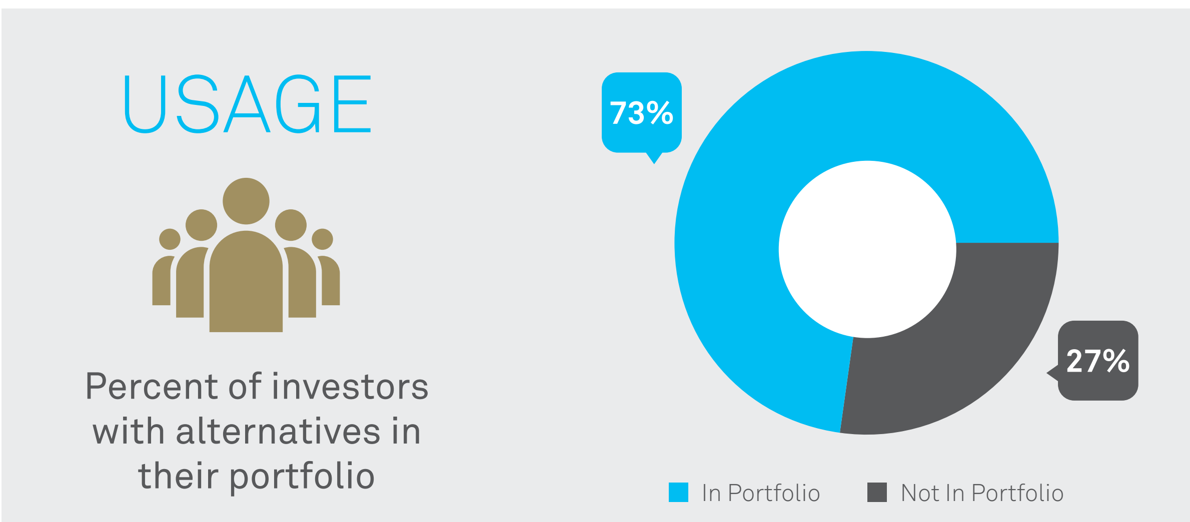
[4] Alts Now on Regulators Radar." Investmentnews.com. May 4, 2015.

Survey Says

Once reserved mainly for institutional investors, qualified investors and large endowments, alternative investments have come down market in recent years. They are more available to the general public, mainly due to the advent of liquid alternative investments. So how are advisors and the investing public responding?

A recent survey conducted by Pershing, a BNY Mellon company, in conjunction with Beacon Strategies, LLC, of 1,200 advisors about their perception and use of alternative investments revealed the following:

- Nearly three out of four advisors surveyed use some form of alternative investments in investor portfolios.
- The majority of respondents said their primary goal in using alternative investments is to reduce volatility and diversify investor portfolios.
- For advisors currently using alternatives, 73% of their clients have at least one type of alternative investment in their portfolio.
- 55% of advisors currently using alternatives believe that investors should have 6% to 15% of their portfolios dedicated to alternative investments; 18% recommend 16% to 25%.
- 70% of advisors plan to stick with their current recommendations regarding alternative investment allocations in the coming year.
- 56% of advisors see value in allocating illiquid alternatives to investor portfolios.
- Liquidity and performance are the main drivers behind the decision to use liquid or illiquid alternative investment allocations in investor portfolios.
- The experience of the alternative investment manager, along with the diversification potential of alternative investment options, are the main drivers in product selection.
- Product expense, along with disagreement over the viability and basic premise of alternative investments, are the most-common barriers cited by advisors who do not currently recommend alternative investments.



Breaking Through the Barriers

It is this last bullet point of the findings that represents one of the most significant barriers-to-entry for the advisors surveyed. Specifically, the second part, "the viability and basic premise of alternative investments." This would point to a possible lack of education and training in alternative investments, or a lack of exposure or experience with the asset class. Respondents who use alternative investments said their primary sources for alternative investment knowledge are third-party research providers and product wholesalers (78% combined).

“Access to knowledge is a big issue for advisors,” Magnusen of Altegris agreed. “Especially with managed futures, which are more sophisticated and are subject to different regulations,” due mainly to the underlying commodities that fuel the product, as well as complex swaps that occur as a result.

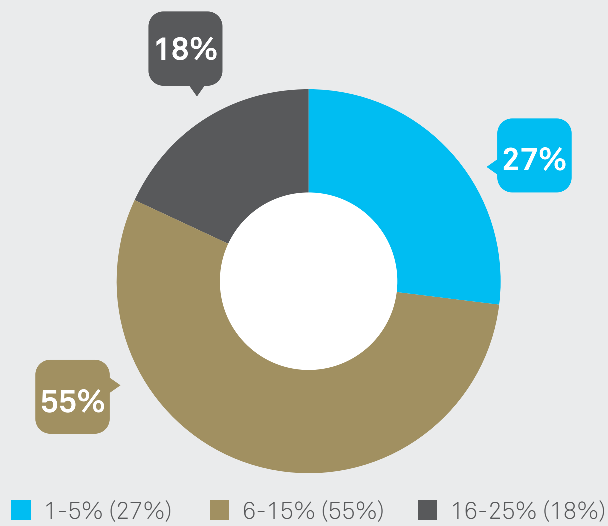
She also referenced the aforementioned non-correlation inherent in alternative investments as a current barrier to entry, arguing that the S&P 500, which has gone straight up for the past six years, has made it hard to illustrate the need for alternative investments.

Another objection was the administration of liquid versus illiquid products. Although the majority of alternative investment assets are invested in illiquid products (one product provider estimated illiquid investments to account for between two-thirds and three-fourths of the alternative investment landscape), the difficulty in diversifying assets once they are invested in illiquid products was a notable theme among advisors.

Specifically, illiquid alternatives’ penchant for releasing various series of investment opportunities was mentioned. For instance, four different investors might be in the same investment, but in four separate series over four separate years. To receive comparable performance, each investor would, instead, have to place a certain percentage of assets in each of the series over the four-year period. The resulting time and extension to illiquidity had one advisor note that sometimes complicated administration issues arise.

OPTIMIZED ALLOCATION

55% of advisors recommend alternative allocation of 6%-15%; 18% recommend 16%-25%



Another respondent agreed, but noted the importance of alternative investments in mitigating the risk of experiencing what analyst Nassim Taleb called more *Black Swan* (or unforeseen, often catastrophic) market events.[5]

“Will 2008 happen again?” the respondent quipped. “Who knows? But we’re glad we have them [alternative investments].”

He added that while he is still invested in certain illiquid products, he has also increased his allocations to liquid alternatives “since 2011 and 2012, which was right around the time that really good choices in liquid alts became available.”

Another RIA noted that between 10% and 25% of his firm’s portfolio under management is in alternative investments, in line with the overall findings of the survey.

[5] Nassim Taleb. *Fooled by Randomness: The Hidden Role of Chance in Life and in the Markets*. New York, 2001.

What Works, What Doesn't

In addition to advisor attitudes regarding illiquid and liquid alternatives, another objective of the study was to identify products and strategies that work well in an illiquid structure versus those that work well in a liquid structure.

"Steben & Company has a long history in alternative products and we recently made the strategic decision to enter the liquid alternative space," says John Dolfin, chief investment officer. "This decision was driven in part by our view of the growing demand for liquid alternatives, and we expect our liquid products should scale quickly.

"For those investors who are appropriately qualified, we always encourage them to look at less liquid products first because they can access a wider range of investment strategies and managers. Many successful managers are unwilling to offer their flagship programs at low fees and with the daily liquidity necessary for liquid alternative structures," he added.

Dolfin explained that some credit- and event-driven strategies, particularly those that involve illiquid underlying securities, such as structured credit and distressed debt, are better suited to the illiquid space. He believes the liquidity of the fund structure constrains the suitable set of securities and derivatives that can be traded, which must be at least as liquid.

"Another area where liquid alternatives may not work is in fixed income relative value, where managers, for instance, might try to play Spanish bond yields against German bond yields," Dolfin said. "Leverage is used to boost volatility and hence targeted returns, which may not fit in with the more modest leverage constraints in most liquid alternative products."

Finally, products with high investment turnover, like statistical arbitrage in equities, typically have low capacity, so successful managers often prefer to offer these in less liquid fund structures that can pay incentive fees, rather than give up that precious capacity to mutual funds with only flat management fees.

So what does fit well into a liquid format?

"It sounds basic, but any investment strategy without an illiquidity premium would work well," added Simeon Hyman, head of investment strategy with ProShares. "You can't just put a gate around a liquid strategy and expect to get an illiquidity premium. The only things that don't work well in a liquid format are those that are truly private, like private equity and private real estate. Liquid products that mimic those types of investments can play useful roles in portfolios but won't generate the illiquidity premium that their private counterparts may be able to generate."

For his part, Dolfin points to long-short equity products, managed futures and investments that are not subject to capacity issues as being suitable for liquid alternative fund structures.

"Global macro strategies that trade in large, international markets work well. In the equity world, large caps work well because they aren't restricted by capacity. With small caps and microcaps, capacity runs out fairly quickly."

Getting Serious

Alternative investment performance, of course, was a major topic with respondents. Karl Frank, president of RIA firm A&I Financial Services, has a 6% alternative asset allocation target within his model portfolios. He seeks a 9% to 10% return with low corresponding risk, which usually means a beta of 0.2.

His alternative allocations have exceeded his expectations for the past year-and-a-half, providing a 15% return in 2014 and a 10% return year-to-date. He has used limited partnerships (an equipment leasing company) as well as some business development corporations in the past, but recently reduced those allocations in favor of higher-performing non-traded REITs.

"How have our alternative investments performed? Amazingly. They have absolutely done what they said they would. They've proven their usefulness as a non-correlated asset class and are absolutely part of our diversification strategy," Frank noted.

While performance dominated discussion with advisors, operational issues with alternative investments were routinely mentioned by a number of broker-dealers and large RIAs. Specifically, they reported four hot button areas—processing, pricing/time to settlement, tax reporting and new regulation.

"The big issue we see [with alternative investments] is that the pricing at the sponsor firm might be completely different than when the investment is finally delivered to the custodian," said the head of the investment platform at a major Midwestern firm, who asked not to be identified. "Also, alternative investments sometimes delay 1099s from being sent because providers might re-characterize their distributions, which obviously affects tax reporting."

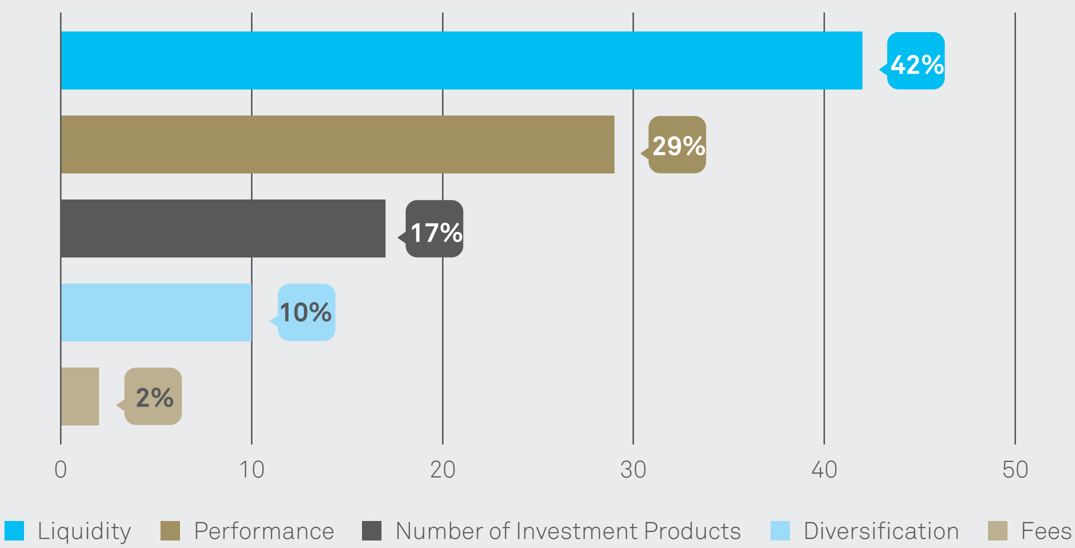
In addition to 1099s, difficulties arise when issuing K-1 forms, which often cause shareholders to refile their taxes or wait to file, which can be frustrating and time-consuming.

But far from being frustrated with alternatives, he understands the potential—and the need.

"Every product has its complications and drawbacks and, specific to alternative investments, it always seems that they have to be resolved on a tight deadline," he added. "These are not generic, large-cap products that are always out there. But they are solid products, especially in the illiquid space, for high-net-worth portfolios."

DECISION DRIVERS

Liquidity and performance are the primary drivers when advisors are deciding between liquid or illiquid alternative investments



What about product and settlement issues with illiquid versus liquid products?

"It's not really relevant from an operational standpoint. That's really more of a supervisory sales manager issue. The sponsors are good about notifying us of upcoming events so, in that regard, we have great relationships with great product providers," the firm executive added.

In other words, communication, product understanding and a smooth operational process seem to be instrumental in addressing these issues.

As for the immediate future, he identified new pricing requirements for 2016 that are expected to cause paperwork and operational issues to spike, something for which operations departments across the industry are now preparing for.

Unsurprisingly, regulation was an issue mentioned by every firm that was interviewed, and specifically what one compliance officer at a large broker-dealer in the Southeastern United States referred to as "the evolution of product manufacturing driven by new regulation."

FINRA Regulatory Notice 15-02 was also repeatedly mentioned. In October 2014, the SEC approved amendments proposed by FINRA to promote greater transparency for shareholders of certain non-traded investments.[6]

"It's the focus of everyone right now," one firm's compliance officer commented. "We're forming a task force by bringing in a representative from each department to offer their area of expertise. We don't want to miss anything. This is one area that unites everyone at our firm in order to deal with the requirements."

Despite these issues and natural regulatory and market ebbs-and-flows, alternative investment asset growth continues unabated. Morningstar data indicates that alternative funds have grown from approximately $62 billion in assets at the end of 2008 to $179 billion as of the end of 2013, mirroring flows reported by *InvestmentNews*.[7] Additionally, all RIAs and broker-dealer firms interviewed said the need for alternative investments is clear. Most feel alternative investments are "here to stay," and all the firms interviewed plan to continue to include alternative products to varying degrees in their overall investment product offerings to serve their advisors and the investor.

Conclusion

Are alternative investments more help than hype? Performance history and survey findings indicate a strong yes. Despite lingering skepticism over the effectiveness of alternative investments because of relatively recent lukewarm performance, the majority of advisors surveyed still see the need for non-correlated asset classes within their investors' portfolios. As correlations among stock and bond markets, as well as entire sectors, continue to increase, the role of alternative investments in smoothing volatility and assisting in diversification should only increase. Yet challenges remain for alternative investments to be incorporated seamlessly into investor portfolios. Chief among them are regulatory and suitability issues, as well as paperwork, processing and operational concerns. Proactive measures taken by many of the firms interviewed are serving to mitigate, but not eliminate, these challenges. Overall results indicate that the viability of alternative investments remains strong.

Alternative investments are speculative, involve a high degree of risk and may engage in the use of leverage, short sales and derivatives. These investments are designed for investors who understand and are willing to accept these risks. Performance may be volatile, and an investor could lose all or a substantial portion of his or her investment.

[6] "Understanding NASD Rule 2340 and FINRA Rule 2310." cnlsecurities.com.

[7] "Alternative Investments: History of Performance and Their Risk-Return Frontier." Dailyalts.com. 2014

Survey Methodology

Over the course of two months in the winter and spring of 2015, Beacon Strategies, in conjunction with Pershing, surveyed over 1,200 financial advisors and RIAs. Simultaneously, expansive interviews were conducted with individual advisors and RIAs, as well as with alternative investment fund managers, to address both quantitative and qualitative aspects of the underlying research.

Beacon Strategies, LLC is a premier research and consulting firm that specializes in technology developments for the financial services industry. Founded in 2006, the firm focuses on strategic and tactical decisions that banks, broker-dealers and advisors face in an increasingly fast-paced and hyper-connected business environment. Beacon Strategies delivers critical thought-leadership insight in print, in person and online through publications, website content, consulting assignments and industry-leading conferences and events.

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* Based on number of broker-dealer clients, *InvestmentNews* 2014.

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