EXPECTATIONS MANAGEMENT

Despite some turbulence here and there, investors have mostly enjoyed a relatively smooth ride since 2009 with both equity and bond markets delivering very strong returns as well as very few scary corrections. As a result, typical balanced portfolios (the well-known 60/40 mix between equities and bonds) have generated very healthy risk-adjusted returns. However, there is a real danger that investors might focus too much on the recent past and lose sight of the more distant past as well as, most importantly, what likely lies ahead of us in coming years.

The truth is that 60/40 portfolios have experienced significant drawdowns in the past and, given current valuation levels, are unlikely to deliver robust returns going forward. As shown in the table below, investors have enjoyed very strong (and atypical) returns over the past six years and very low (and atypical) volatility. Since the bottom of the financial crisis, a 60/40 portfolio has more than doubled (+133%) and its worst drawdown stands at only 8.2% during that period.

In the following sections, we will take a closer look at the key issues inherent to a 60/40 equity/bond allocation, discuss expected returns for the next few years and lay out the case for adding alternative investments in order to enhance risk-adjusted returns in the future.

WHAT'S WRONG WITH A TRADITIONAL BALANCED PORTFOLIO?

For starters, a traditional balanced portfolio is not actually balanced, as the performance and risk are very much a function of the 60% allocation to equities. Indeed, the correlation of monthly returns with the S&P500 stands at 97.6% over the past 40 years. This means that the coefficient of determination (the square value of the correlation ratio) is equal to 95.2%. In plain English, this means that 95.2% of the monthly returns for a 60/40 portfolio can be explained by the monthly returns of the S&P500 index. Another way to measure the lack of true diversification is to analyze how balanced this portfolio might be from a risk perspective. While balanced from an allocation perspective (60% equities, 40% bonds), it is far from being balanced from a risk perspective. Since 1976, the annualized volatility of monthly returns for a 60/40 portfolio stood at 9.7%, but the 60% equity exposure accounted for 96.7% of the total portfolio volatility.

Unsurprisingly, this portfolio has historically suffered during equity bear markets or short-term corrections, as can be seen in the following charts on page two.
To be fair, adding bonds to equities does provide some level of diversification as can be seen from the very low correlation ratio between both asset classes as well as from the total volatility of the portfolio, which at 9.7% stands 1.5% below the weighted average of both assets’ volatility, i.e. 11.2% (with no diversification benefits, the volatility would have amounted to the sum of 60% equity volatility and 40% bond volatility).

A near-zero correlation ratio over the past 40 years is nevertheless an average. Looking at 24-month rolling correlation, one can see that equities and bonds go from being relatively highly correlated to being negatively correlated. As we will discuss later, the key question for asset allocators is to be able to forecast the correlation going forward, i.e. in which “regime” will financial markets be operating going forward. Equities and bonds have moved higher in tandem most of the time between 1982 and 2000 as the massive disinflationary trends we witnessed during that period pushed bond yields significantly lower and at the same time led to a re-rating of equity valuations. Bonds have historically acted as good diversifiers during economic recessions (negative correlation with bond prices moving higher and equity prices going down). The current situation is atypical as global central banks have played a key role in supporting equity markets in recent years by keeping bond yields at extremely low levels. As we have witnessed since the 2013 taper tantrum, one of the major risk factors for equity markets (particularly at current valuation levels) is the outlook for bond markets. Higher bond yields (negative bond performance) could very well act as a major headwind for equity prices going forward, resulting in positive correlation and a lack of diversification benefits going forward.

It is also true that global diversification does help in order to build more balanced portfolios.
It is true within equities and within bond markets. While economies and financial markets globally have become more integrated in recent years, investors can still benefit from global diversification as business and monetary cycles are not fully synchronized on a global basis and other factors such as valuations, investor sentiment and fund flows can lead to large performance differentials on a global basis. The diversification benefits of investing globally are more obvious during bull markets and/or periods of relatively low volatility levels.
Unfortunately, during bear markets and periods of heightened risk aversion, correlation levels tend to move significantly higher, reducing the benefits of diversification. This was particularly true and painful during the most recent financial crisis in 08/09.

As can be seen in the charts on page 3, these traditional asset classes may not offer the type of diversification most investors need.

**AVOIDING LARGE LOSSES IS THE MOST IMPORTANT FACTOR FROM A RISK MANAGEMENT PERSPECTIVE**

From an asset allocation perspective, the proponents of a “buy-and-hold” strategy point to the danger of tactically getting out of equity markets as potentially missing out the best 10 or 20 months could significantly hurt performance. I have always found this argument particularly silly as it is so obvious – if you are so unlucky that you manage to pick specifically only the best 20 months over the past say 25 years to be out of the market, then it shouldn’t come as a surprise that your compounded return will take a significant hit. That being said, the counter-argument against buy-and-hold would be that you could also be so lucky that the only 20 months you are out of the market just happened to be the worst 20 months out of the entire period. Actually, the benefits (in terms of total compounded return) of being able to (magically) avoid the 20 worst months are by far superior to the cost of missing out on the best 20 months. This can be explained by two key observations:

First, markets tend to go down more violently than they go up. The worst monthly return for the S&P500 since 1990 was down 16.94% whereas the best monthly gain was “only” up 11.16%. The second reason is that recovering from a large decline is a very painful process which also requires staying invested (obviously, your portfolio will not rebound if you get out of the market) and not panicking (and certainly not near the bottom). If your portfolio goes down 30%, it will have to go up by 43% before you recover from that loss, and if it falls by 50%, your portfolio will need to climb back by 100% before you recoup that hefty decline.

As can be seen from the table below, the buy-and-hold strategy for the S&P500 (price returns only) would have generated an annualized return of 7.3% since 1990. Missing the 20 best months brings that return down by 6.4% to only 0.9%, while avoiding the 20 worst months increases the compounded return by 8.2% up to 15.5%. The other obvious conclusion from looking at this table is that I wish I had a $1 million to invest back in January 1990 as it would be worth $5,963,186 today (or $39 million if someone could have told me when to get out or if an older me could have travelled back with the Wall Street Almanac, like Biff Tannen in the first Back to the Future).

<table>
<thead>
<tr>
<th>Data since 1989 for S&amp;P 500</th>
<th>Annualized Return</th>
<th>Final Value of Initial $1,000,000 investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Return</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Buy and Hold</td>
<td>7.3%</td>
<td>5,963,186</td>
</tr>
<tr>
<td>Missing the 10 best months</td>
<td>3.6%</td>
<td>2,468,117</td>
</tr>
<tr>
<td>Avoiding the 10 worst months</td>
<td>10.6%</td>
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</tr>
<tr>
<td>Missing the 20 best months</td>
<td>0.9%</td>
<td>1,240,839</td>
</tr>
<tr>
<td>Avoiding the 20 worst months</td>
<td>15.5%</td>
<td>39,055,766</td>
</tr>
</tbody>
</table>

While I do believe it is possible to reduce a portfolio’s exposure to equities ahead of and even during bear markets through a disciplined process, this analysis also shows how dangerous it can be when you end up being wrong. On the other hand, behavioral finance has demonstrated that investors have a tendency to throw in the towel usually at the worst possible time, particularly when they have suffered from significant losses and markets are nearing their lows. Because of this emotional bias and because of the steep gains one would need to generate in order to offset a large portfolio decline, investors would benefit from implementing strategies that would lead to a smoother path and provide better protection during steep selloffs.
GOING FORWARD, A 60/40 BALANCED PORTFOLIO IS UNLIKELY TO GENERATE THE LONG-TERM RETURNS INVESTORS EXPECT OR NEED.

Last quarter, I made the case that the current equity bull market was structural/secular in nature and, as a result, it could go on for a few more years. Bull markets usually end with the next economic recession and the odds of one developing in the medium term remain quite low. I still believe that the current economic expansion will rank among the longest in history, with inflation and policy rates likely to remain low for quite some time. Indicators which have historically preceded a peak in equity markets (such as rapid credit growth, a flat-to-inverted yield curve, a sharp increase in real rates, euphoric investor sentiment, or a positive output gap) are simply not present yet.

However, even in the absence of an imminent recession threat, traditional balanced portfolios are likely to face a more challenging environment, both near term and longer term. In the near term, more frequent and more significant corrections (within the context of an ongoing bull market) are increasingly likely, particularly as we will soon witness the end of the Fed’s experiment with ZIRP (Zero Interest Rate Policy). Although monetary conditions will still be very accommodative, volatility and risk aversion will inevitably move higher as this will not only be the first rate hike in nearly a decade but also the beginning of a normalization process after years of unorthodox monetary policies. Increased volatility and more frequent corrections can potentially be very damaging for some investors who could overreact and doubt that these episodes are merely corrections. They could be tempted to sell during a correction if they believe we are experiencing the beginning of a new and nasty bear market.

Intra-Year Corrections are very typical, even during strong bull markets
S&P500 Price Returns: Full Calendar Year Performance and Worst Intra-Year Correction
Longer term, the outlook for US stocks will be challenged by current valuations. While valuations are unlikely to derail the current bull market in the near term, they will limit expected returns going forward. Given the current dividend yield of around 2%, earnings growth potential at best in line with nominal GDP growth (as profit margins have most likely already peaked in this cycle) and P/E ratios likely to come down over the next few years, total equity returns are likely to average 6% over the next 10 years. As for bond markets, the yield to maturity for the Barclays Aggregate index currently stands at around 2.5% and this is likely a good forecast for the return that can be expected from this index going forward. For a 60/40 portfolio, this would translate into a 4.6% annualized total return over the next decade.

These returns are likely to be enhanced through global diversification (equity valuations are more attractive outside the US) as well as through active duration and credit management within bonds (sectors such as high yield corporate bonds and EM debt offer better yields). However, as we have seen previously, only high-grade bonds have provided real diversification during steep market declines. This diversification today comes at a hefty cost – 2.5% potential returns going forward – along with added risk and uncertainty. Indeed, a selloff in bond markets could very well
be the major risk for equity markets – higher bond yields could darken the economic outlook as well as provide a more attractive alternative to equity markets. The diversification benefits of bonds are not only becoming expensive in terms of opportunity cost, but also in terms of the potential for bonds to deliver bouts of negative returns going forward. Indeed, given today’s depressed bond yields, a move higher in bond yields across various maturities and sectors will very quickly generate losses for investors (as shown in the previous table which also highlights bond returns during the “taper tantrum” in 2013). Given the structural decline in bond yields over the past three decades, most investors are not very familiar with the notion that bonds might not be as safe as they used to be.

**THERE IS AN ALTERNATIVE**

The basic tenets of Modern Portfolio Theory are that, in the long run, there is an inherent trade-off between risk and return and that adding uncorrelated assets to a portfolio will help reduce the overall portfolio’s volatility, thereby improving diversification and risk-adjusted returns.

For decades, alternative investments such as hedge funds, private equity and managed futures have been a staple of institutional investors such as endowments and foundations, as well as family offices and high-net-worth individuals. Following the technology bubble burst in 2000, the hedge fund industry experienced significant inflows as investors looked for ways to be better positioned during future market declines. Indeed, from 2000 to 2002, the S&P500 total return index declined for three consecutive years producing a cumulative loss of 38%. During the same time frame, diversified hedge fund portfolios produced cumulative gains anywhere from 8% to 13%, depending on which index was used.

While hedge funds fared better than most other asset classes during the most recent financial crisis, they nevertheless failed to provide much needed diversification. Investors’ enthusiasm for hedge funds took a significant beating in light of these disappointing returns as well as liquidity constraints imposed on redemptions (gating). This disappointing performance nevertheless has to be put in context – the near collapse of the financial sector during the ‘08/’09 crisis was a “4 sigma (volatility) event” expected to happen only once every century at most, and significant dislocations were seen across a broad range of asset classes.

In recent years however, alternative strategies have gathered renewed momentum with investors refocusing on risk management and looking for ways to reduce portfolios’ volatility, particularly downside or drawdown risk. For long-term investors, the most important risk
management tool is indeed the ability to prevent large drawdowns. From a behavioral perspective, investors are much more likely to stick to their plan and stay invested during market selloffs if the magnitude of the drawdown is more limited. From a statistical perspective, the probability of achieving long-term goals is enhanced through a reduction in the volatility of returns.

Looking at historical data, the logic for adding alternative strategies to a portfolio of global equities and bonds is straightforward. Over the past 20 years, a typical portfolio of 60% equities (measured by the MSCI World index) and 40% bonds (measured by the Barclays Capital US Aggregate index) produced returns of 6.7% annually with an annualized volatility of 9.3%. By comparison, a portfolio comprised of only 47% equities and 30% bonds but with a 23% exposure to various alternative assets and strategies would have produced a higher return (7.3%) with a lower volatility (8.3%). As previously discussed, the case is even more compelling going forward. Given current equity market valuations, subpar economic growth, extremely low bond yields and the beginning of an interest rate normalization process, we forecast below-average returns and above-average volatility for stocks and bonds in coming years. Our 10-year forecasts indicate that a typical 60/40 would produce annualized returns of only 4.5% with a volatility of roughly 12%.

The challenge for traditional asset allocators today is quite obvious. With nominal bond yields barely above zero and future returns highly sensitive to the prospect of rising interest rates, should they reduce their exposure in favor of stocks after a powerful six-year bull run (and a roller-coaster ride for the past two decades) or should they move money in cash yielding negative returns when adjusted for inflation?

In this context, an allocation to alternative strategies seems to once again make a lot of sense. These strategies are now available to most investors with the introduction of alternative '40 Act Mutual Funds and exchange-traded funds. But before we get there, we should first review exactly what we mean by alternative investments.

Although there is no universal definition of alternative investments, the easiest way to define these investments is probably by exclusion. Alternative investments therefore include asset classes and investment strategies that share the common property of having different risk/return characteristics than long-only equity or bond investments.

Given this definition, certain investments such as real estate investment trusts, currencies, infrastructure, private equity and commodities are truly alternative asset classes, while hedge funds should be seen as alternative strategies – these strategies invest predominantly in the same markets as traditional investments, but do so in a different way,
using long/short strategies or leverage for example.

Broadly speaking, alternative strategies can be divided into four main categories: Relative Value, Event Driven, Equity Hedge, and Macro. Each category is further subdivided into several sub-strategies.

**Relative Value strategies** aim to take advantage of pricing inefficiencies between related financial instruments such as stocks and bonds. Managers in this category will typically go long and short on various securities expecting prices to converge towards a relative equilibrium level. Relative value is often referred to as market neutral or arbitrage as these strategies have typically very little or no directional market exposure. The most common strategies in this category include fixed income arbitrage, convertible arbitrage, credit arbitrage and volatility arbitrage.

**Event Driven strategies** seek to exploit relative mis-pricings between securities whose issuers are involved in mergers, divestitures, restructurings, bankruptcies or other corporate events. The most common strategies in this category include merger arbitrage, special situations, activist and distressed debt.

**Equity Hedge strategies** combine both long and short positions in stocks with the objective of minimizing the exposure to the broad market as well as to benefit from both long positions (stocks considered to be undervalued) and short positions (stocks considered to be overvalued). Equity Long/Short strategies tend to maintain a net-long exposure and are therefore considered directional strategies (although the net-long exposure is managed dynamically). Equity market neutral strategies typically maintain a very minimal net exposure and are therefore predominantly impacted by the manager’s stock-picking (alpha) expertise. At the other end of the spectrum, short-sellers seek to benefit from declines in stock prices.

**Macro strategies** involve taking positions across a broad array of asset classes and markets. Discretionary macro managers base their investment decisions on an in-depth analysis of underlying macroeconomic trends as well as other quantitative and fundamental factors. CTA (Commodity Trading Advisor), also known as managed futures, is a strategy investing in futures contracts on financial, commodity and currency markets globally, where trading decisions are based on quantitative, algorithmic and technical models. These strategies are often referred to as “trend-followers” as they tend to benefit most from an environment characterized by persistent and discernable trend behaviors. These strategies use a combination of short, medium and longer-term models.
ALLOCATING TO ALTERNATIVE STRATEGIES

As highlighted above, alternative strategies help overall portfolio diversification given their relatively low correlation with traditional asset classes such as bonds and equities. Most strategies can also act as return enhancers given their ability to generate positive returns in various market environments (and not only when prices are going up). It is also important to recognize that these strategies are not homogenous and they each have specific characteristics and a specific role to play within a traditional balanced portfolio. We believe that the best way to allocate to these strategies is by looking at which role they can fulfill within a portfolio: fixed income diversifier/complement, equity diversifier/complement or overall risk management.

**Fixed Income Complement**

We believe that investors would usually benefit from shifting part of their fixed income allocation into a combination of various relative value (or market neutral) strategies. These strategies have historically produced returns uncorrelated from bond markets but with bond-like volatility characteristics (4.2% over the past 20 years). In today’s environment, these strategies are likely to generate enhanced risk-adjusted returns compared to long-only bond investments and better protect investors against rising interest rates, as well as offer an alternative source of yield. Traditional bond investments offer only two sources of potential return – periodic coupon payments (currently at historically low levels) and price appreciation (this would require a further unlikely drop in bond yields). By comparison, relative value managers can implement low volatility strategies and generate returns from a variety of exposures and independent of interest rate movements (e.g. credit spreads, yield curve, pair-trades, and volatility strategies).

**Equity Complement**

We also recommend shifting part of a portfolio’s allocation in equities into alternative equity hedge strategies. These strategies include long/short equities and event driven. From a strategic perspective, we believe that most investors should look at their equity exposure in terms of beta (exposure to the underlying trends in markets) and alpha (exposure to stock picking expertise of managers). We believe that index products such as exchange-traded funds (ETF) are the purest and the most cost efficient way to achieve the exposure to various markets on a global basis. As we like to say, whatever your view is in terms of the relative attractiveness of various markets and sectors, there is an ETF for that. Active long-only managers will try to add additional layers of performance by picking stocks they
believe are likely to outperform the broader market. As documented by various studies, most active managers tend to underperform the broader market over a full business cycle and picking the right manager at the right time is a notoriously difficult task (most of the time, investors tend to pick managers after a period of outperformance, which might very well be followed by a period of underperformance). The fact that markets are broadly efficient adds an additional headwind for these managers. This is not to say that markets are totally efficient and some factors have historically outperformed the broader indices, such as value, momentum or low-volatility strategies. But once again, if you want exposure to these factors, there is an ETF for that. Compared to long-only active managers, long/short managers have a key advantage which should not only help them generate a more consistent alpha but also help them in various market environments. These managers can go long stocks they perceive to be undervalued (similar to long-only managers) but they can also simultaneously short those stocks they deem to be overvalued (something long-only managers are not able to do). Their net long exposure can also be dynamically managed based on the opportunities available at any given time. Contrary to traditional mutual funds, long/short managers can therefore dial up or down their overall market exposure (or “beta”, see chart) based on the attractiveness of one particular market at any given time. From a tactical perspective, asset allocators can also alter the mix of their long-only positions (ETFs or mutual funds) and long/short positions based on their own degree of bullishness/bearishness. By adding equity hedge strategies to traditional equity investments, investors should therefore be better positioned during market selloffs but will also remain invested through the cycle and benefit from the upside as well as managers’ expertise in delivering alpha through a combination of long and short positions.

Event driven strategies have the potential to further enhance returns and equity diversification by exploiting pricing inefficiencies stemming from corporate actions such as mergers, financial distress, security issuance or other capital structure adjustments.

**RISK MANAGEMENT AND PORTFOLIO DIVERSIFICATION**

Macro strategies have historically provided significant downside protection in times of great market stress. The main benefit of adding macro strategies to a balanced portfolio is the potential to decrease portfolio volatility. This risk reduction is possible because these managers can trade across a wide range of global markets that have virtually no long-term correlation to most traditional asset classes. These strategies are especially beneficial during adverse economic or market conditions for equities and bonds, thereby providing excellent downside protection in most
balanced portfolios. Similar to other alternative strategies, macro managers can generate profits in either rising or falling markets due to their ability to either go long or short various market exposures. Another benefit of macro strategies for long-term investors comes from their investment horizons (short to medium term) and their ability to react much faster to changing market trends. As a result, macro managers tend to suffer from smaller drawdowns in times of crisis and recovery times are usually shorter. Given these characteristics, most investors should have a specific allocation to macro strategies (discretionary and managed futures), funded by a reduction in both equities and fixed income.

While we have focused our analysis primarily on alternative strategies, real estate investment trusts and commodities also fall into this category of portfolio diversifiers also given their long-term diversification benefits and exposure to specific return drivers.

**INTRODUCING THE “NEW BALANCED” – ENHANCING A 60/40 PORTFOLIO WITH ALTERNATIVE ASSETS AND STRATEGIES**

In the chart on the next page, we highlight the changes we suggest most balanced portfolios would benefit from by adding a combination of alternative asset classes and strategies. This new balanced portfolio should be seen as the framework for strategic asset allocation decisions and represents our best thinking when it comes to building portfolios for the long run. These allocations still need to be dynamically and tactically managed based on short and medium term considerations. Similar to traditional asset classes, the outlook for alternative investments and strategies is also impacted by factors such as the business cycle, liquidity conditions, technical factors and relative valuations.
As previously indicated, we believe most investors would benefit from implementing the following changes in order to enhance risk-adjusted returns, limit the extent of future drawdowns, benefit from a smoother path (the journey matters as much as the destination), increase the likelihood of staying invested through an entire market cycle and better diversify their exposure towards alternative sources of risk and return:

1) Shift part of the long-only equity exposure into equity hedge and event driven strategies. These strategies have historically delivered equity-like returns (10.1% for Equity Hedge and 9.9% for Event Driven vs. 9.1% for the S&P500 over the past 20 years) with only roughly half the volatility (9.2% for Equity Hedge and 6.7% for Event Driven vs. 15.2% for the S&P500).

2) Shift part of the long-only fixed income exposure into relative value/market neutral strategies. These strategies have historically delivered higher returns with bond-like volatility and are less exposed to the risks coming from rising bond yields and the interest rate normalization process.

3) Add portfolio diversifiers and risk enhancing assets and strategies such as REITS, commodities and global macro/managed futures strategies. In particular, global macro and managed futures have demonstrated their ability to greatly protect balanced portfolios during significant market declines. In the long run, these strategies have generated strong and uncorrelated risk-adjusted returns.

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IMPLEMENTATION AND OTHER CONSIDERATIONS

The asset allocation presented in the previous section is not earth shattering by any means. Indeed, family offices, foundations and endowments have moved away from traditional asset classes in a big way for many years already. The famous Yale Endowment model is a case in point with very minimal exposure to bonds and a substantial allocation in hedge funds, private equity, real estate and other hard assets. For most investors, accessing these asset classes was, until recently, a lot more complicated, if not outright impossible due to a variety of factors (more on this topic later). Real estate investment trusts and commodity funds have been around for quite some time and have allowed investors to gain exposure to these asset classes. With the recent introduction of liquid alternatives, most hedge fund strategies are now also available for almost any investor. This development can be compared with the introduction of stock and bond mutual funds several decades ago and will lead to the democratization and mainstreaming of alternative strategies in coming years. Today, the “new balanced” portfolio is not virtual anymore – it is available to any investor concerned with reducing volatility, and not just an option for super wealthy individuals or well-connected institutions.

As painful as the financial crisis was for every investor, it played a significant role in the emergence of liquid alternative mutual funds (a.k.a. alternative ‘40 Act funds). These funds are pooled investment vehicles, offered by a registered investment company (as defined in the 1940 Investment Companies Act), that apply an investment strategy that does not purely pursue long-only investments in stock or bond instruments. These mutual funds deliver hedge fund strategies in an easy-to-use mutual fund structure that offers daily liquidity, competitive pricing, low investment minimums, no investor requirements, increased transparency and simplified tax reporting. Before the financial crisis, hedge funds were the main vehicles through which investors were able to gain exposure to alternative strategies. However, for most investors, accessing hedge funds was constrained by a variety of factors, such as investor qualification (typically limited to accredited investors or qualified purchasers) and high investment minimums (in some cases as high as $1 million). Set up as limited partnerships, hedge funds can also impose limits on an investor’s ability to withdraw capital such as notice periods for redemptions or mandated lock-up periods. During the financial crisis, hedge funds became a lot more illiquid than expected – as many hedge funds were faced with a wave of redemptions, investors were locked up or gated for several months and even years. Liquidity had become a critical risk factor for traditional hedge fund investors. In the wake of the financial crisis, liquid alternative funds quickly emerged as the obvious solution for investors looking for the benefits of alternative strategies with the ability to liquidate or shift their money around at any time. Additionally, liquid alternatives provide investors with a few other benefits (lower management fees, no performance fees, transparency, and no K-1 tax form requirement).

One caveat with liquid alternatives comes from the fact that many of these funds are, by definition, relatively new and therefore have not yet been tested in real life during various market environments. Moreover, because of the liquidity provided by these funds, some strategies are not easily replicated in these vehicles, such as distressed debt or some highly levered market neutral strategies. Returns generated within a liquid vehicle might therefore trail a little behind the returns which can be generated in less liquid private partnerships (the typical hedge fund structure). However, many alternative strategies invest in highly liquid markets and are therefore easily replicated within a mutual fund context. This is particularly the case for managed futures, equity long/short, convertible and credit arbitrage, nontraditional bonds as well as several event driven strategies. While liquid alternative mutual
funds might have a limited track record, they are more often than not an offspring from long standing hedge fund structures and usually managed by the same experienced team of portfolio managers. For investors looking to benefit from the risk/return characteristics of hedge funds but unwilling or unable to access these vehicles, the trend is your friend. Liquid alternatives represent the fastest growing area for mutual funds and the opportunity set will continue to grow in coming years, both in quantity and in quality.

### Annualized Performance Table during various market cycles

<table>
<thead>
<tr>
<th>Best</th>
<th>S&amp;P 500 TR USD 23.6</th>
<th>US Agg 10.1</th>
<th>World Equities 18.9</th>
<th>Managed Futures 10.0</th>
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<tr>
<td>Equity Hedge 22.5</td>
<td>Relative Value 9.2</td>
<td>Event Driven 14.9</td>
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<td>World Equities 17.3</td>
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<td>Event Driven 16.8</td>
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<td>US Agg 5.9</td>
<td>World Equities -16.7</td>
<td>US Agg 4.1</td>
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<td>Managed Futures 2.1</td>
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<th>00-02 Tech Burst</th>
<th>03-07 Debt Run-Up</th>
<th>08-09 Crisis</th>
<th>Current Bull</th>
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KEY TAKEAWAYS

• The introduction and rapid growth of liquid alternatives is a transformational event as it will foster greater understanding, acceptance and use of alternative strategies for a vast array of investors. For decades, hedge funds have been a staple of institutional investors and high-net-worth individuals, but remained inaccessible to retail investors.

• The benefits of adding alternative investments and strategies to balanced portfolios are well documented - they help improve risk-adjusted returns and provide better downside protection as well as exposure to non-traditional sources of returns.

• A 60/40 mix between stocks and bonds is not as diversified as it may look, even when allocations are made on a global basis and across various fixed income sectors. These portfolios are balanced from an allocation perspective, but not so much from a volatility perspective. Moreover, as evidenced during the most recent and painful bear markets (’00-’02 and ’08-’09), correlation among traditional asset classes tend to rise substantially during falling markets.

• Although the overall logic for utilizing alternatives should be sufficient, the current outlook for stocks and bonds makes the case even more compelling. US equity markets have delivered stellar returns over the past six years and valuation levels have expanded beyond long-run averages. Bond yields are trading at record low levels and a process of interest rate normalization will lead to above-average volatility and negatively impact future expected returns.

• We have presented the framework for allocating to various alternative strategies based on the specific roles they play from an overall asset allocation perspective (equity or bond alternative and overall risk management). Broadly speaking, these strategies should help deliver a smoother return path and limit the magnitude of large drawdowns. Most investors tend to overact when markets are in a freefall and usually throw in the towel at the worst possible time. Protecting portfolios against these violent corrections should help investors weather the storm and stay invested.

• Complacency is always an investor’s worst enemy. Alternative strategies should allow investors to enjoy the sunny weather while it lasts but also be better prepared for the next storm.

FOR MORE INFORMATION CONTACT YOUR WEBSTER PRIVATE BANK PORTFOLIO MANAGER OR EMAIL US AT PBINFO@WEBSTERBANK.COM.