"MEET THE NEW BOSS – SAME AS THE OLD BOSS"
-THE WHO

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When it comes to diversifying an investment portfolio, the lyrics from the classic song by The Who – "Won't Get Fooled Again" come to mind. The objective when allocating investment dollars really hasn't changed, investors are still looking for solutions to maximize returns and reduce risk. The way we seek to accomplish this objective, however, has evolved. The goal remains the same: marrying an acceptable amount of risk with an acceptable and sometimes necessary amount of return.

Formal asset diversification began with the development of Modern Portfolio Theory (MPT) in 1952. Harry Markowitz developed the groundbreaking theory and went on to win a Nobel Prize. His work was revolutionary considering it was done almost 40 years prior to the mass production of the personal computer and 50 years prior to widespread use of the internet. Today, markets have become increasingly intertwined with the development of higher frequency computer trading systems and global connectivity. Investors need more explicit expressions of diversification to continue the goal of maximizing returns and minimizing risk.

This white paper will address the evolution of choices within the semi-liquid to liquid alternatives asset classes, including Tactical ETF managers. Risk Paradigm Group, LLC (RPg) maintains that by properly combining alternatives including hedge funds, liquid hedge funds and tactical ETF managers, investors can create similar risk/return characteristics historically sought after within hedge funds with greater liquidity and transparency, yet at a lower cost to the investor.

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Democratization of Hedge Funds

While hedge funds date back to the late 1940's, the 1990s introduced the democratization in the hedge fund industry as access grew and minimums fell making the asset class more accessible. With the benefit of hindsight, that period in time was also the time where hedge fund correlations began to converge with traditional stock and bond managers. This led investors to believe that they were more diversified than they actually were which was especially amplified during the credit crisis of 2008.

The attractive risk/return characteristics of hedge fund investing were compelling to long-term investors like pension funds, endowments, and high net worth investors. Those who didn't have an allocation to hedge funds in the 90s wanted one, and those who were already allocated to the space were looking to increase their allocation. Today, lower expected returns on traditional investments present challenges to individual and institutional investors in meeting their spending and funding objectives. The idea of increasing allocations to alternative investments like hedge funds would seem intuitive as they may help investment portfolios meet their objectives in a risk efficient manner.

However, investing in hedge funds historically meant utilizing private investment funds with initial lock ups, fixed liquidity windows, high qualifications and minimums, potential gates and side pockets, annual performance fees and higher management fees as listed in Table 1. While we would argue that there are a few managers worth investing with despite these legacy issues, the landscape of managers offering true diversification is changing and the model for structure is evolving to become more in line with the demands of liquidity, alignment and transparency to the individual investor.

Table 1

Old Paradigm vs New Paradigm	
Old	New
➢ Initial lock ups ➢ Fixed liquidity windows ➢ High qualifications and minimums ➢ Gates and side pockets ➢ Annual performance fees ➢ High water marks ➢ Compensation is cash based and annual	➢ Abbreviated to no lock up period ➢ Rolling liquidity periods, or daily liquidity ➢ Low to no qualifications and minimums ➢ No gates ➢ No side pockets ➢ No high water marks ➢ Complete transparency

While CIO's and other allocators are under pressure to deliver returns, lower return expectations for US equities and debt are forcing allocators of capital to look for alternatives. However, when considering how to invest in the asset class, fiduciaries need to fully understand the investment process before committing to it which can be difficult when allocating to a complex asset class. Other considerations include hedge fund lock ups, liquidity windows, potential gates and side pockets and you can see how a chasm between allocators and the hedge fund asset class has been formed.

RPg asserts that liquidity terms should reflect underlying portfolio liquidity, investor liquidity requirements and investment horizon. If we hadn't learned this before, the lessons of 2008 taught us the value of liquidity. Hedge fund investors lose the ability to redeem when they invest with a manager who has an initial lock up period, or when they invoke a gate or side pocket provision. Investors should be compensated via higher returns, or lower fees (or both) for the lack of liquidity.

Liquid Alternatives

Registered hedge funds and funds of hedge funds have recently gained more visibility to investors looking to invest in alternative investments. Registered funds are registered as an investment company under the Investment Company Act of 1940 and offer some unique benefits to investors when compared to non-registered funds:

- They generally offer lower investment minimums
- There is no limit to the number of investors in the fund
- They can be sold to a much broader range of investors
- Registration generally means there is increased transparency when compared to unregistered funds
- Registered hedge funds and funds of funds generally use similar investment strategies and tools as traditional hedge fund strategies
- Limitations on the amount of leverage within a registered fund

The notion of "alternative" investing is often misunderstood. Gaining access to different types of investments is an approach that almost everyone should employ, and many strategies are now available to a broad range of individuals in a registered format. One lesson we learned coming out of the financial crisis was the failure of portfolio construction. Many investors thought they were diversified by portfolio holdings, but in reality they simply didn't have exposure to enough different asset classes.

Even those who had the foresight to call the crisis may have had the right thesis, but not had the right security selection. When we think of incorporating liquid alternatives, what we really mean is incorporating a much wider range of strategies and assets as part of a core investment strategy. Portfolio construction is hard to begin with, and it's even harder during times of crisis when correlations can work against investors.

One benefit to utilizing liquid alternatives is transparency. This can be useful when correlations rise because when markets become more volatile, asset classes that were already correlated can become more correlated. By utilizing liquid alternatives, an investor can get position detail and compare a funds position to the rest of their portfolio. Without transparency, an investor can think they are diversified by utilizing what they think is a different asset class, but in reality the risk factors that drive correlations can be very similar.

Retooling the "Alternative" Structure

We expect alternative asset managers to continue to evolve their construct over the coming years creating more liquid versions of their core competency. Particularly those firms where legacy private offerings account for the bulk of their current revenues. Alternative asset management firms will adapt to market influences and create more liquid products, and traditional asset managers will adapt their investment engines to include tools and investment approaches from the "alternative" investment world in an effort to stay relevant.

These initiatives will evolve over long periods of time as the legacy offerings are where current revenue resides, and new/future offerings will be where growth resides. This is not easy to do as most of the time, new skills will need to be employed in order to execute with the integrity of their core (legacy) skill set. A firm that spent 10 years in the private placement environment and starts trading their strategy in a registered 40-Act vehicle has new leverage constraints, new and different counter party issues, and a whole new set of operational demands, administrative demands, and compliance requirements.

Likewise, the traditional manager who may be used to all the operational issues may not be as familiar with short-selling, managing net exposure, or seeking absolute returns rather than being marked to a benchmark. Credibility is one of the most relevant factors a traditional asset manager will have to contend with if they cross over to become an active manager.

Think Function, Not Form – Introducing Tactical ETF Managers

ETF managed portfolios offer investors an investment universe that comes with; increased liquidity, transparent construction, generally lower fees and in many cases these solutions are seeking similar risk/return characteristics of the legacy hedge fund structures/managers. Proper utilization of ETF managed portfolios can help investors construct more risk balanced portfolios and mitigate the tendency to make ill-timed policy changes because of the transparency that the SMA/UMA structure offers.

ETF managed portfolios can range from Tactical to Strategic. Tactical managers will fall on the more active end of the ETF managed portfolio spectrum while Strategic managers will seek to establish and maintain a more static allocation relative to the group of Tactical managers.

Historically, active managers were described as a long-only manager who had some degree of freedom to deviate from his or her benchmark in an effort to achieve alpha. On the other end of the long-only spectrum is the passive fund, or an index fund where there are zero degrees of freedom from the index and the goal is to track the index at a low cost.

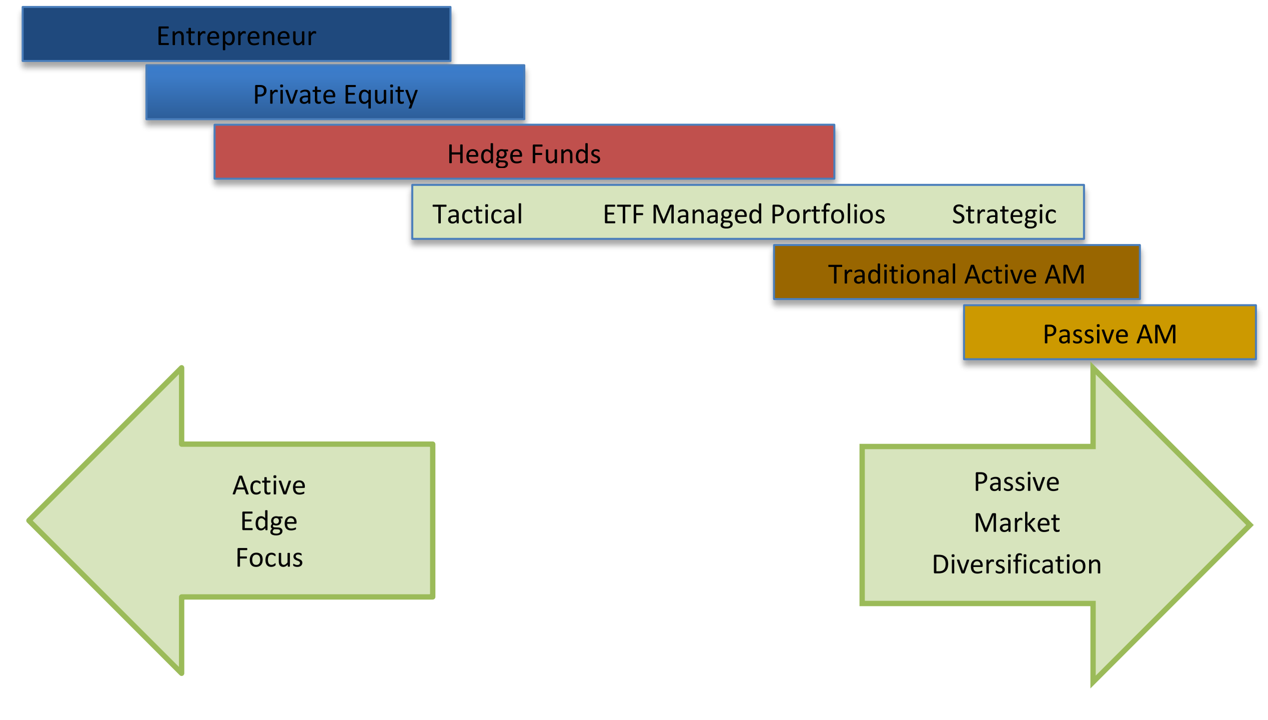
ETF managers can overlap with hedge funds as well as traditional active asset management depending upon the strategy and market. For example, in an equity bear market where the market falls 50%, a so-called "active" long-only manager is hardly distinguishable from an index fund. Both funds will suffer losses very close to 50% of capital.

A hedge fund and a Tactical ETF manager on the other hand, may experience a reduction in losses when the market falls. Both the hedge fund manager and the Tactical ETF manager have discretion of their whole portfolio and they may have hedged all equity exposure or even have been short on a net basis.

Given that the long-only portfolio and index fund have very similar risk characteristics in a period of stress, we suggest considering both the hedge fund and Tactical ETF managers active, and the index fund passive when discussing asset management styles.

Table 2 is one way to illustrate the difference between active and passive management and where there is potential for overlap. Tactical ETF managers have the freedom to aggressively de-risk and while the majority of ETF Managed portfolios don't short securities (some may employ inverse ETFs to benefit from a bear market), they will go to cash which is the ultimate diversifier when correlations are rising. As well, the Tactical ETF manager doesn't have the added pressure of getting the call right and getting the security selection right that the hedge fund universe has.

Table 2



Source: Adapted and modified from Jaeger (2003) and Rolf Banz, Pictet Asset Management

Simply stated, active management is dependent on the willingness to embrace change and, more importantly, to capitalize on it. Hedge funds and Tactical ETF managers have a lot in common in this capacity as they are both applying a skill that seeks to carry a reward in the market within a specific opportunity set. In both cases, the reward from skill is not constant. Profitable ideas, approaches and techniques need to be dynamic to survive and remain of value, otherwise they will be copied and markets may become immune to the applicability of the skill.

When allocating investment dollars, the objectives haven't dramatically changed. Investors are still looking for solutions to maximize investment returns while effectively managing risk. Yet today we don't have to get "fooled again" as the ETF managed portfolio affords investors more transparency. Through this lens, investors can see how different their asset classes are (or are not) and plan accordingly to gain true diversification within their asset allocation modeling when correlations rise.

Important Disclosures

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