Segal Rogerscasey Canada

INVESTMENT
BRIEF

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Alternative Mutual Funds: A Viable Liquid Substitute for Hedge Funds?

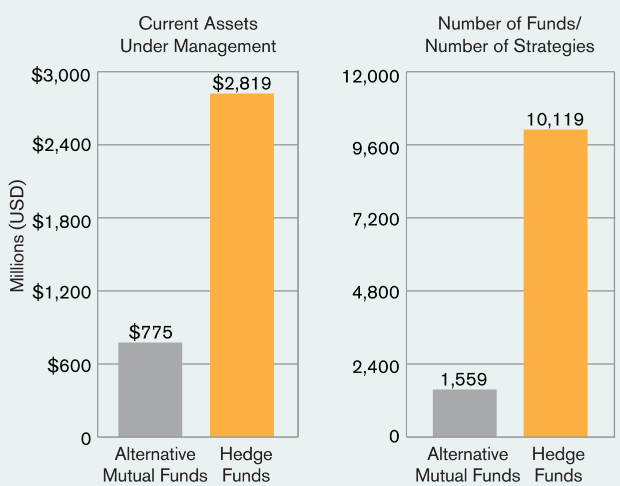
Alternative mutual funds have proliferated in recent years, providing broad access to alternative investment strategies once available only to high-net-worth individuals and institutions. These more-liquid vehicles aim to provide benefits similar to hedge funds, including enhanced returns and portfolio diversification. However, whereas hedge funds are generally unconstrained, U.S. mutual funds are subject to the Investment Company Act of 1940 (the '40 Act), which includes strict rules on liquidity, leverage and fees.

This *Investment Brief* compares alternative mutual funds to the hedge fund strategies they emulate. It also notes some of the key results of Segal Rogerscasey's in-depth analysis of both universes, based on U.S. data.

Characteristics of the Two Universes

The alternative mutual fund universe is relatively young and thinly populated compared to the hedge fund industry in terms of total assets and the number of strategies, as shown in the graph below.

Selected Alternative Mutual Fund and Hedge Fund Data, as of September 30, 2014



Sources: Hedge Fund Research and Morningstar

In addition, a number of important structural differences between alternative mutual funds and hedge funds should result in differing risk and return characteristics over time. Key areas of distinction include:

- ***Investor Qualifications*** Alternative mutual funds have virtually no investor qualifications other than meeting the investment minimum, making them a more broadly accessible and attractive option relative to hedge funds. By comparison, investors in hedge funds are required by U.S. federal rules to qualify for "accredited investor" or "qualified purchaser" status, which set seven-figure minimum thresholds on the investor's net worth or investment assets.
- ***Fees*** Alternative mutual funds also have proportionately much lower fees than hedge funds. For alternative mutual funds, the average annual net expense ratio is 169 basis points, including an average management fee of 104 basis points. For hedge funds, the average net fee consists of a 1.5 percent to 2.0 percent management fee plus a 20 percent performance fee. Mutual funds do not charge performance fees.
- ***Investment Limitations*** The mutual fund structure under the '40 Act limits investment managers' ability to execute certain strategies that regulators may view as excessively risky or highly speculative, particularly relating to liquidity and leverage. For example, U.S. mutual fund regulation limits how much of a fund's assets can be invested in illiquid securities such as distressed debt — historically one of the top-performing hedge fund strategies — as well as a fund's use of leverage, including short sales, swaps, options and other derivative instruments that have long been viewed as key contributors to hedge fund returns. In addition, because hedge funds come with more onerous liquidity terms, including monthly to annual redemption frequencies, they do not have to worry about the daily valuations[1] and capital fluctuations that alternative mutual funds face, and can therefore execute strategies with medium- to longer-term investment theses in place.
- ***Risk and Return Expectations*** In general, expectations are for hedge fund strategies to produce greater returns, with greater risk, as they are less constrained in their use of illiquid investments and leverage.

[1] Mutual funds are required to provide daily liquidity and cash for redemption requests within seven days.

Performance of the Two Universes

Segal Rogerscasey compared the performance of the two universes over the five years that ended on September 30, 2014.[2] The firm used the Morningstar universe of mutual funds, focusing on the open-ended U.S. funds, to create custom groupings of alternative mutual funds that resemble respective Hedge Fund Research indices as closely as possible. Segal Rogerscasey then analyzed the historical performance statistics of these custom groupings versus the corresponding hedge fund indices. The following are key findings of that analysis:

- Alternative mutual funds and hedge fund indices have proven to be highly correlated.
- On average, hedge fund strategies outperformed their alternative mutual fund counterparts. (Relative to the S&P 500® and the MSCI World indices, both hedge funds and alternative mutual funds have significantly underperformed, on average, over the past five years.)
- The Sharpe ratios[3] are comparable, presenting investors with a choice of higher returns at higher levels of risk in hedge funds or somewhat lower returns at lower volatility levels from alternative mutual funds.

Portfolio Appropriateness

Historically, alternative strategies have proven to complement investments held in traditional portfolios, both enhancing diversification and outperforming traditional asset classes in down markets.

Alternative mutual funds have been, and likely will continue to be, an area of significant growth in terms of both assets and the number of vehicles coming to market. Through alternative mutual funds, retail investors will now have the opportunity to improve their portfolios' return potential, without significantly increasing risk. We also expect that alternative mutual funds will become more widely used by defined-contribution plan participants as more established hedge fund managers launch liquid vehicles or participate in funds that invest in multiple strategies.

Institutional investors may find use for more-liquid versions of hedge fund strategies as a way to hold cash or bridge investments. Should an institution need to invest excess capital or seek a short-term investment while rebalancing its portfolio, alternative mutual funds can fulfill these roles.

[2] For the purposes of its analysis, Segal Rogerscasey looked only at U.S. mutual funds — as opposed to other vehicles.

[3] Sharpe ratio is a measure of risk-adjusted performance; calculated by taking the excess return above a risk-free rate divided by standard deviation.

Conclusion

Segal Rogerscasey Canada sees the applicability and attractiveness of these strategies primarily for retail investors and high-net-worth individuals, and perhaps for select institutions that may want to take advantage of the vehicles' liquidity, transparency and/or more modest investment minimums. However, medium and large institutional investors should carefully consider the relative strategy-implementation limitations of alternative mutual fund vehicles as potential performance headwinds, and maintain an appropriate level of exposure to hedge fund strategies. Ultimately, manager selection will remain just as important in evaluating alternative mutual funds as it is for hedge funds, with proper due diligence being paramount when sourcing best-in-class managers. ■

For a more detailed discussion of alternative mutual funds, see Segal Rogerscasey Canada's December 2014 *Investment Focus*, "Liquid Alternatives — Alternative Mutual Fund Primer." That publication presents the full results of Segal Rogerscasey's analysis comparing four custom groupings of alternative mutual funds — Equity Long/Short (151 distinct strategies), Event Driven/Credit (107 distinct strategies), Global Macro (63 distinct strategies) and Multialternative (118 distinct strategies) — to corresponding hedge fund indices.

Questions? Contact Us.

For more information about alternative mutual fund strategies, contact your Segal Rogerscasey Canada consultant or one of the following investment professionals: Kathleen Pabla at 416.642.7791 or kpabla@segalrc.com or Charles Colfer at 203.621.3636 or ccolfer@segalrc.com.

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