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Liquid alternative strategies

Part 1: What can they do for a portfolio?

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What can they do for a portfolio?

Liquid alternative mutual funds and ETFs are simply strategies that may use leverage and shorting (in a constrained way) as tools to help them achieve their investment objectives. This makes them different from traditional mutual funds, which generally do not have access to these tools. Alternative investment strategies typically aim to deliver higher risk-adjusted returns than traditional strategies.

Given these additional tools, liquid alternatives can potentially deliver three key benefits when added to traditional portfolios:

1. **Return enhancement**
2. **Risk management**
3. **Income enhancement**

These benefits are not mutually exclusive: some funds may offer a combination of these benefits; others may emphasize one, potentially at the expense of another.

In order to determine what role a liquid alternative fund might play in a portfolio, it is critical to understand its value proposition along these lines.

Alternative mutual funds may use constrained doses of leverage and shorting to enhance returns, manage risk and/or generate higher levels of income for investors, when combined with traditional mutual funds and ETFs.

Return enhancers

For a new investment to be return enhancing to an existing portfolio, it simply needs to be able to offer a higher expected return over time than the assets used to fund the investment. A liquid alternative fund can potentially be return enhancing through the levering up of return drivers that may already exist in a portfolio or by bringing new ones to the table that were previously inaccessible.

Risk managers

Risk management includes seeking to dampen portfolio volatility over time and reduce the impact of negative market shocks. Liquid alternatives can help reduce total portfolio risk along the following dimensions:

- By providing return streams with low correlations to an existing portfolio
- By providing return streams that are less risky than an existing portfolio

Volatility and correlation are both important considerations when it comes to risk management in portfolio construction, and neither should be looked at independently.

Correlation is useful as it describes the tendency of two things to move in the same direction. Generally speaking, and all else equal, the lower the correlation between a new fund and an existing portfolio, the more helpful it can be from a diversification and risk management perspective. With a low enough correlation, even a highly volatile investment has the potential to be risk mitigating when added to a larger portfolio (if sized and funded correctly). Liquid alternatives can deliver those low correlation returns by targeting risk factors that are less prevalent in traditional portfolios and by deliberately hedging away the risks that are most prevalent there (such as equity market risk).

But a low correlation is not necessarily required for an alternative fund to be risk mitigating. If the alternative fund in question has a conservative enough risk profile on its own, it could be expected to lower total portfolio risk, even if it has a strong positive correlation to the rest of the portfolio. If the alternative fund can deliver a high return per unit of risk (Sharpe ratio), the lower risk may not necessarily come at the expense of returns.

Income enhancement

In addition to portfolio enhancement from a total risk and return perspective, liquid alternatives also offer numerous ways to raise the effective yield of a model portfolio. Raising the yield of a portfolio can also impact its expected risk and return, so it is important that income focused alternative funds are also evaluated from a total risk and return perspective. What can alternative strategies do to enhance the yield of a traditional asset mix?

- Use leverage in asset classes that pay a regular income
- Opportunistically allocate to asset classes offering the most attractive yields at any given time
- Engage in relative value trades that seek long exposure to higher-yielding assets and short exposure to lower-yielding assets
- Other activities that involve the transfer of future risk and return potential in exchange for compensation today, such as put and call option writing

The benefits that liquid alternatives can bring to a portfolio are significant and the strategies they use to deliver them are wide-ranging. The “How” behind these benefits is the subject of the next article in our series.