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What are Marketable Alternative Investments?

Greg A. Goldfeder, CFA

Marketable alternative investments consist of a number of investment strategies including: long/short equity, merger arbitrage, global macro, distressed securities, long/short credit, convertible arbitrage, managed futures, and more. Access to some of these types of investments is unavailable through the public markets, but there has been a proliferation of registered mutual funds investing in alternative strategies during the past few years.

From a portfolio diversification standpoint, alternatives may be attractive due to their potentially lower correlations to traditional asset classes (stocks, bonds, and cash). By introducing securities that behave differently from other investments, investors are likely to experience less volatility. That is, they may well reduce portfolio risk.

The universe of alternative investments is complex and varied. Structuring an allocation to alternatives requires a solid understanding of the diverse type of alternative investments available, plus the ability to research and understand the managers who employ unique approaches to particular strategies. Listed below are descriptions of some of the strategies that make up the marketable alternative investment allocation at The Proper Analysis.

Marketable Alternative Investments

- *Long/Short Equity* – this is an investment strategy that involves owning (being "long") stocks that are expected to increase in value while simultaneously selling (being "short") stocks that are expected to decrease in value. The short positions in the portfolio reduce market risk, and the manager seeks to add value through stock selection in both the long and short portfolio.

- *Merger Arbitrage* – this strategy consists of buying shares of the target company in a proposed merger, and fully or partially hedging the exposure to the acquirer by shorting the stock of the acquiring company or other means. Usually the price of the stock of a company being acquired trades at a discount to the expected deal price. The merger arbitrageur's objective is to capture the difference between the price of a stock after a deal is announced and the price at which the deal actually closes.

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- *Global Macro* – this investment strategy consists of taking, on a large scale, positions around the world using economic theory to justify the decision-making process. The strategy is typically based on forecasts about interest rate trends, movements in the general flow of funds, political changes, government policies, inter-government relations, and other broad systemic factors.

- *Distressed Securities* – this strategy focuses on being long and/or short the bonds of a company trading at a steep discount to its stated maturity value. It involves intense analysis of credit quality and the likelihood of a restructuring of the company that issued the bonds.

- *Long/Short Credit* – this is an investment strategy that involves owning (going "long") fixed income securities believed to be undervalued and expected to increase in value while simultaneously selling (being "short") fixed income securities that are considered overvalued and expected to decrease in value.

- *Convertible Arbitrage* – this strategy involves the simultaneous purchase of convertible securities and the short sale of the same issuer's common stock. The premise of this strategy is that the convertible security is sometimes mispriced relative to the company's underlying stock, for reasons that range from illiquidity to market psychology. The goal is to capture income as well as profit from changes in the relative values of the convertible bond and the related stock.

- *Managed Futures* – this strategy seeks to generate positive long-term absolute returns. It entails trading in more than 100 futures contracts across four major asset classes: equities, currencies, fixed income and commodities. Trading can occur on either a systematic or discretionary basis. Trend-following is a major component of the strategy. Managers using a managed futures strategy can take long or short positions in any of these instruments, and thus seek to benefit both if the price of the underlying instrument rises or falls. Managed futures funds were one of the few types of strategies that performed well during the financial crisis of 2008 as they were short many of the major futures contracts throughout the year.

The Proper Analysis has organized its marketable alternative investments category into <u>three distinct buckets</u>: low risk strategies, diversified multi-strategy managers, and low correlating strategies.

1) Low-Risk Strategies – These strategies are included as a substitute for fixed income securities. Return are expected to be higher than bonds and lower than

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stocks with a risk level close to that of bonds. Additionally, at times these strategies may move in a different rhythm than the stock or bond market, which may reduce the overall level of risk in client portfolios. Strategies currently used in this area include:

- Arbitrage Strategies

2) Diversified Multi-Strategy Managers – These are managers that invest in multiple alternative strategies within the same mutual fund. They seek to provide long-term capital appreciation with emphasis on absolute return and reduced correlation to the traditional stock and bond markets. Some of the many underlying strategies used by these managers are described above. Returns are expected to be higher than that of bonds and that of the low-risk alternative strategies but lower than that of equities. Risk is expected to be lower than stocks and somewhat higher than bonds. As with the low-risk alternative strategies, the returns in this segment do not always move in sync with the traditional stock and bond markets. This helps provide portfolios with lower overall volatility. Strategies currently used in this area include:

- Diversified Funds of Hedged Strategies Utilizing Separately Managed Accounts
- Diversified Funds Owning Other Mutual Funds That Use Hedged Strategies

3) Low Correlating Strategies – These are strategies that seek to generate positive long-term absolute returns in all market environments. The direction of the returns environment in the traditional stock and bond markets often has little impact on these investment strategies. Put another way, securities exhibiting low correlation often zig when the stock and bond markets zag. The strategies included in this area often do well during periods when there are pronounced trends – both positive and negative – in the different markets in which they invest. On the flip side, they may do relatively poorly during times where there are few trends. Low correlating strategies are included because they offer the potential for gains during large declines in the equity markets. The returns for managed futures indices and the S&P 500 were only negative during the same month 16% of the time between January 1980 and September 2010. Strategies used in the low correlation area include:

- Managed Futures
- Diversified Trading Strategies

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Why Invest in Marketable Alternative Investments?

A legitimate question to ask is why invest in marketable alternative instruments when the cost of these funds is higher than traditional stock and bond mutual funds. The Proper Analysis has decided that these investments make sense for our clients for three reasons: the current low interest rate environment, the differentiated strategies they offer, and their potentially low correlation to more traditional investments.

1) Low Interest Rates – Interest rates on government bonds are hovering near 50-year lows at roughly 3.5% on the 10-year U.S. Treasury bond. Low bond yields typically predict relatively low nominal bond returns during the following five to ten year period. Additionally, if interest rates increase significantly over a short period of time, bonds will have negative total returns (price change plus income received) during those times. By investing in alternative strategies, The Proper Analysis is seeking to generate higher returns than are currently available in the fixed income markets. The Proper Analysis is investing in strategies that may protect our clients' portfolio value better than bonds if interest rates rise.

2) Different Strategies – Many of the alternative investment mutual funds offer different strategies than are available in traditional stock and bond mutual funds. These strategies often offer a different risk/return profile not available in more traditional investments. A perfect example of this is merger arbitrage which has its own return profile somewhat independent of what is transpiring in the stock and bond markets.

3) Low Correlation – Outside of U.S. Treasury bonds, there are few if any traditional investment strategies that have a low correlation to equities. As stated above, we expect total returns on high quality bonds to be low for the next several years. Within the marketable alternative investment category there are a number of strategies that have the opportunity to generate positive returns if either the stock or bond markets exhibit negative returns.