



Alternative Asset Class Mutual Funds Are Helping Defined Contribution Plans and Smaller Foundations Diversify Portfolios & Lower Volatility

BY ANNETTE BIDART

Investment Committees overseeing defined contribution plans, and Trustees of smaller foundations and endowments have been seeking prudent alternative investments that offer low correlation to their current holdings of “traditional” stocks and bonds. The purpose of adding “alternative” investments to their existing portfolios and line-ups is to offer greater diversification, lower portfolio risk and provide for potentially higher

Alternatives

“Alternatives” to traditional asset classes such as stocks and bonds can be defined as public and private real estate, private equity, currencies, infrastructure and commodities such as energy, land, livestock and precious metals. These alternative strategy funds typically incorporate unconstrained investment mandates, which seek high excess returns with lower correlation to traditional markets. Another characteristic is the flexible investment processes that can adjust to changing economic conditions. These alternatives can employ leverage and use options, swaps, futures, private placements and REITs (Real Estate Investment Trusts) to meet objectives. These strategies can invest in hard assets like private real estate, oil, infrastructure, land, timber and gold.

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long-term returns. The challenge for plan sponsors and trustees managing these portfolios has been to identify investment vehicles that offer liquidity, transparency and daily pricing with accounting and administrative ease that can be clearly articulated to the end investor. Based upon growing client and industry demand for these types of products, there are more open-end mutual funds carrying the “alternative” asset label available for consideration by these entities.

In addition, alternatives can be defined by their investment strategies which invest in traditional asset classes like domestic and international fixed income and equities, but use derivatives to achieve their objective of low correlation to the traditional markets. These strategies can be labeled as long/short funds, merger/arbitrage, event driven, global macro, relative value, absolute return, and market neutral, or be offered in a multi-strategy approach in a fund of funds structure.



These alternative asset classes and strategy approaches have been traditionally structured in hedge funds or private equity and limited partnership deals. Investment vehicles of this nature call for investors to either be legally accredited or qualified and require high minimum investments. In addition, these funds may or may not be:

- registered
- transparent
- illiquid
- valued frequently/daily

Combined, investment vehicles like hedge funds and private equity become imprudent for the defined contribution and smaller foundation markets.

Certain Alternative Strategies May Not Be A Fit For Mutual Funds

Unlike Hedge Funds - Mutual Funds Require Registration

The Securities Act of 1933 requires that mutual funds sold to the public be registered with the Securities and Exchange Commission (SEC), and that they provide investors with a prospectus that discloses relevant facts about the investment. The Securities and Exchange Act of 1934 requires that these mutual funds regularly report to their investors. It also created the Securities and Exchange Commission, which is the principal regulator of mutual funds. The Revenue Act of 1936 established guidelines for the taxation of mutual funds, while the Investment Company Act of 1940 governs their structure.

Not all alternative and hedged strategies may lend themselves to the more highly regulated mutual fund structure. For example, distressed debt, global macro and fixed-income arbitrage have generally operated with less transparency, invested in less liquid securities and often use more leverage than would be allowed under a registered mutual fund. By law, hedged mutual funds are constrained in their ability to use such features,

potentially limiting their ability to add alpha in these strategies.

The Investment Company Act of 1940 severely restricts a mutual fund's ability to leverage or borrow against the value of securities in its portfolio. The SEC requires that funds engaging in certain investment techniques, including the use of options, futures, forward contracts and short selling "cover" their positions. The effect of these constraints has been to strictly limit the use of leverage by mutual fund portfolio managers.

Leveraging in hedge funds is a hallmark of hedge fund management, but traditionally shunned and limited by law in a mutual fund. Hedge funds were originally designed to invest in equity securities and use leverage and short selling to "hedge" the portfolio's exposure to movements of the equity markets. Today, however, advisers to hedge funds utilize a wide variety of investment strategies and techniques. Many are very active traders of securities and may not be appropriate in a mutual fund structure.

Private equity and hedge funds are often difficult to value. Both vehicles periodically need to employ a number of investor constraints like "lock ups" due to the illiquid assets in which they invest. These strategies are designed with a very long-term focus, and are difficult to package into an open-end mutual fund.

A Caution on Commodities*

Commodity mutual funds come with their own particular issues that mutual fund companies must manage, but which do not apply to hedge funds and private placements. Commodities, futures on commodities, and swaps on commodities produce "bad income" for purposes of qualifying as a regulated investment company under the Internal Revenue Code (IRC). In order to create "good income" when investing in

commodity linked instruments, mutual funds invest in structured notes or through an offshore subsidiary.

Structured notes qualify as securities under the 1940 Act if certain requirements are met, but create their own unique credit risk for the mutual fund investor. If swaps are used to gain commodity like returns, they are limited to twenty five percent of the fund's assets. The mutual fund then must set up an offshore fund and the income and gain are treated as ordinary income with no limitation on income from commodity sources; however, it must comply with certain 1940 Act requirements.

Advantages

With the challenges and constraints noted above, mutual funds do offer a few advantages in the alternative arena namely through fees, pricing and liquidity.

Fees

Federal law imposes a fiduciary duty on a mutual fund's investment adviser regarding the compensation it receives from the fund. Mutual fund sales charges and other distribution fees are subject to specific regulatory limits under National Association of Securities Dealers (NASD) rules. Mutual fund fees and expenses are disclosed in detail, as required by law, in a fee table at the beginning of every prospectus. They are presented in a standardized format, so that an investor can easily understand the figures and can compare expense ratios among other mutual funds. With hedge funds, there are no limits on the fees managers can charge, and most charge both an asset management and performance-based fee to their investors.

Pricing and Liquidity

Mutual funds are required to value their portfolios and price their securities daily based on market quotations that are readily available at market value and others at fair value, as determined in good faith by the board of directors. Besides timely information regarding the value of their investments, daily pricing is designed

to ensure that both new investments and redemptions are made to reflect accurate prices. Moreover, mutual funds are required by law to allow shareholders to redeem their shares at any time. Comparatively, hedge fund investors may be unable to determine the value of their investment at any given time, as valuations may only be determined intermittently during the year.

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Type of Alternative Funds for DC and Small Endowment and Foundation Investors

So, what type of alternative funds should defined contribution or small endowment and foundation investors look for?

Multi-Strategy Funds

Defined contribution plans are beginning to add multi-strategy, multi-manager alternative funds as a one-stop option to gain access to the alternative space and avoid the pitfalls of participants placing one hundred percent of their assets in one sector fund (i.e. commodity fund, distressed debt, etc.). Smaller foundations are choosing real asset funds that include a combination of commodities, real estate, infrastructure, and Master Limited Partnerships (MLPs) all in one fund to diversify the portfolio, provide an inflation hedge and avoid high minimums. Diversified Inflation fund-of-funds, which include TIPS (Treasury Inflation-Protected Securities), REITs, commodities, emerging market debt, and floating rate bonds are other options to consider.



Long/Short Equity

Long/short equity funds can be a good alternative for these investors to consider. Long/short mutual funds can be marketed as seeking equity like returns with lower volatility, with a different risk and return objective of a market neutral fund that typically equally weights its long and short positions.

The history and objectives of the first long/short hedge fund were to protect investment wealth once it was created. Over time, both hedge funds and long/short equity funds have evolved to provide other risk and return profiles. The objective and the percentage of long versus short will dictate the type of risk the fund may

produce. It is important to clearly identify the objective of each fund before it is offered. Long/short funds labeled as “Absolute Return” need to be clearly articulated in advance because, in reality, the investment strategy is not guaranteed to provide positive or absolute returns in all markets, but as a distinction.

The benefit of long/short funds is that these funds can offer investors lower volatility than long-only funds, combined with downside protection and diversification. In contrast to typical hedge funds, long/short mutual funds offer lower investment fees and expenses, liquidity and transparency.

Alternative Assets In DC Plans And Small Foundations

	5 Year		10 Year	
	HFRX Equity Hedge Index	S&P 500 Index	HFRX Equity Hedge Index	S&P 500 Index
Annualized Return	-1.43	2.94	1.96	2.72
Standard Deviation	9.36	17.88	7.42	15.82
Sharpe Ratio	-0.3	0.15	0.03	0.12
Correlation with S&P 500	0.77	1	0.68	1

Worst Markets		
Since 2000	5 Year	
	HFRX Equity Hedge Index	S&P 500 TR
Annual Return 2008	-25.45	-37.00
Annual Return 2002	2.12	-22.10
Annual Return 2001	8.96	-11.89
Annual Return 2000	16.97	-9.10

Best Markets		
Since 2000	5 Year	
	HFRX Equity Hedge Index	S&P 500 TR
Annual Return 2007	3.21	5.49
Annual Return 2004	2.19	10.88
Annual Return 2010	8.92	15.06
Annual Return 2006	9.23	15.79
Annual Return 2009	13.14	26.46
Annual Return 2003	14.47	28.68

Market Neutral

Market neutral funds with clearly stated goals, such as Libor plus two, three or four percent are typical market neutral objectives. If the fund's goal is to only outperform Libor, then stable value funds may be a better option for the plan sponsor to consider. Regardless of the fund goals, the selection of these funds should be focused on tenured management teams that have a proven track record for creating alpha.

Commodities

The options for actively, well-managed, diversified commodity funds are increasing. These funds may be much better suited to investors than Exchange Traded Funds (ETFs) because of their structure and of the predetermined future's role. Many hedge funds have taken advantage of the inefficiencies in the commodity

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ETF market to the disadvantage of the retail investor. An actively managed commodity mutual fund may employ ETFs and futures opportunistically to create liquidity and diversification as well as buying individual securities (i.e. a copper company vs. the future contract which is hard to access) when appropriate. These are often called hybrid funds, but can provide a real advantage to the end investor.

Alternative Mutual Fund Searches

Whether looking for long-only traditional asset managers or managers of alternative mutual funds, the same five criteria apply in sorting through the options. These five search criteria are:

- **The People** – Tenure, firm size, resources, ownership and key retention policies.
- **The Philosophy** – Every manager should have a clear philosophy on how he or she manage the client's money and why they believe they can make money from the investment for the client.
- **The Process** – Understanding how the manager will employ skill, seek return and mitigate risk is a key component of understanding for the investor. In other words, it is important to understand the process of how they make their investments and how the return is achieved.
- **The Performance** – Each investment should have a clear investment objective and performance benchmark it can be measured against. How the performance was achieved in both absolute and relative returns is a part of fundamental investing. It is important to determine whether the manager brought alpha (risk adjusted returns) to the table.
- **The Price** – Fees are important and should be as competitive as peer comparison. When making the choice between two good investment firms and their investments, fees can be the deciding factor.

In conclusion, more funds are available on the market today that can be a prudent option for the defined contribution and smaller foundation and endowment markets. The alternative asset space does require a high level of due diligence and expertise when trying to decipher the variety of strategies that are available. Furthermore, the end user needs to have a clear understanding of how these types of investments will fit into their overall investment menu or portfolio.



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*Footnote: [11 | Alternative Strategy Mutual Funds: Current Regulatory Issues | May 5, 2011](#)

The volatility experienced in the commodities market may make it inappropriate to offer as a stand-alone option in a typical 401(k) plan, but can be a prudent diversifier within a balanced fund like target date and lifestyle funds.