Liquid Alternative Investments: Build Your Own Fund of Funds with ETFs

By:
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Seeking attractive alternative investments

- Ideally, alternative investments would combine
  - **High returns**
  - **Low correlations** with stocks and bonds
- In reality, few such investments have been found

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What is an “alternative” investment?

- Investopedia: “an investment that is **not…traditional**…stocks, bonds or cash.”
- The dividing line between “traditional” and “alternative” is **subjective**.
- The **attributes** that commonly characterize an alternative investment are:
  - Alternative-type asset classes (e.g., commodities and real estate)
  - Alternative-type forms of ownership (e.g., private partnerships)
  - Illiquidity
  - Short selling
  - Leverage
  - Incentive fees
  - Accredited investors
- The **objective**: improve the return/risk tradeoff

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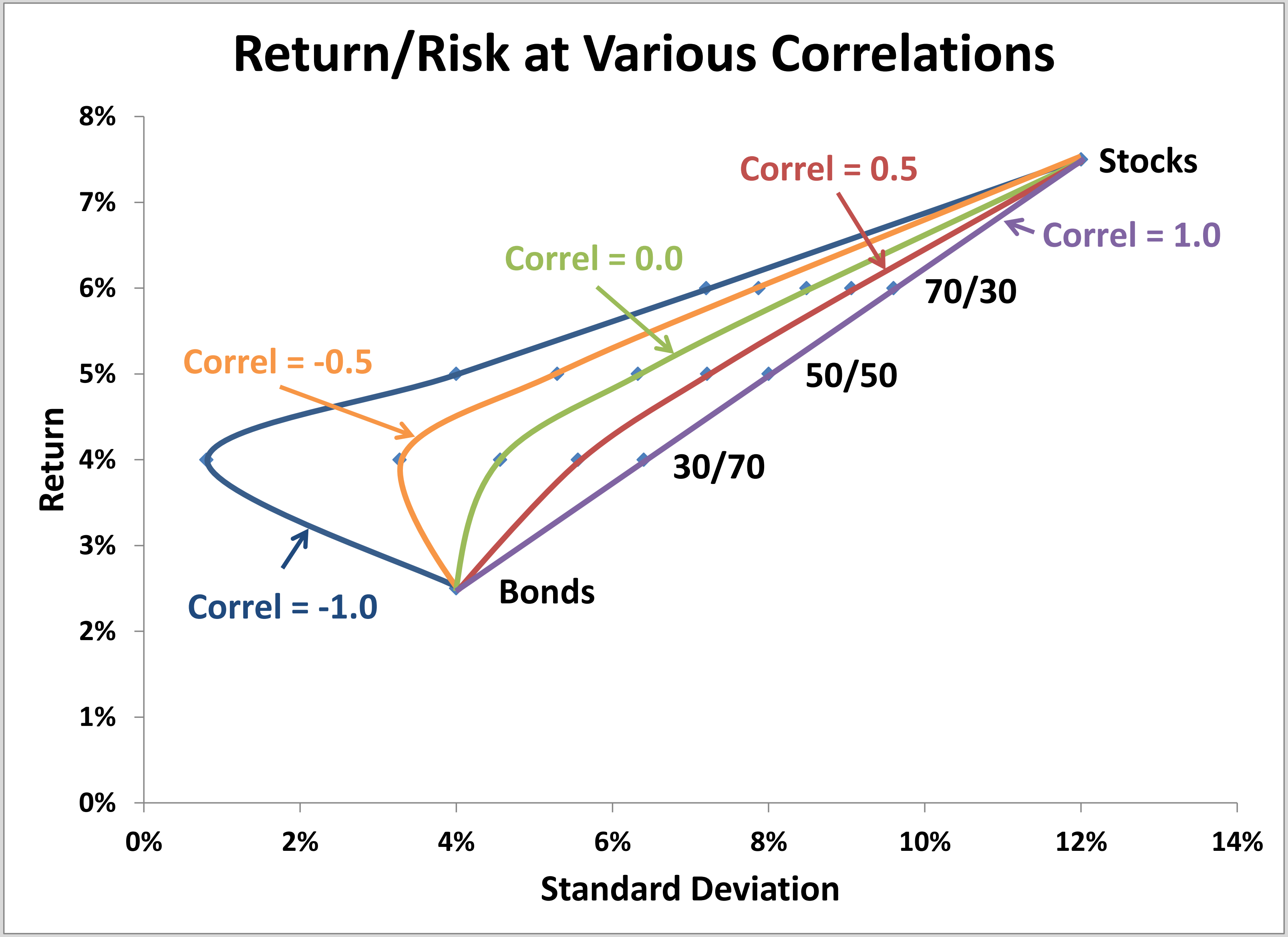
Low correlations improve the return/risk tradeoff



Most alternative return indexes are completely unreliable

- **Private real estate**—NACRIEF is based on appraisals and is a small sample of mostly office properties. REIT indexes are preferable and investable through ETFs
- **Private equity**—No recognized index, and the few that exist (e.g., Cambridge) are full of biases. Listed private equity indexes are preferable and investable through ETFs
- **Hedge funds**—even "investable" indexes really aren't
    - Most widely-cited indexes (HFRI, Credit Suisse) have enormous bias
    - Investable sub-indexes (HFRX) have no tracker funds for U.S. investors
    - Live performance of the few UCITS funds fall far short of their investable hedge fund benchmark indexes

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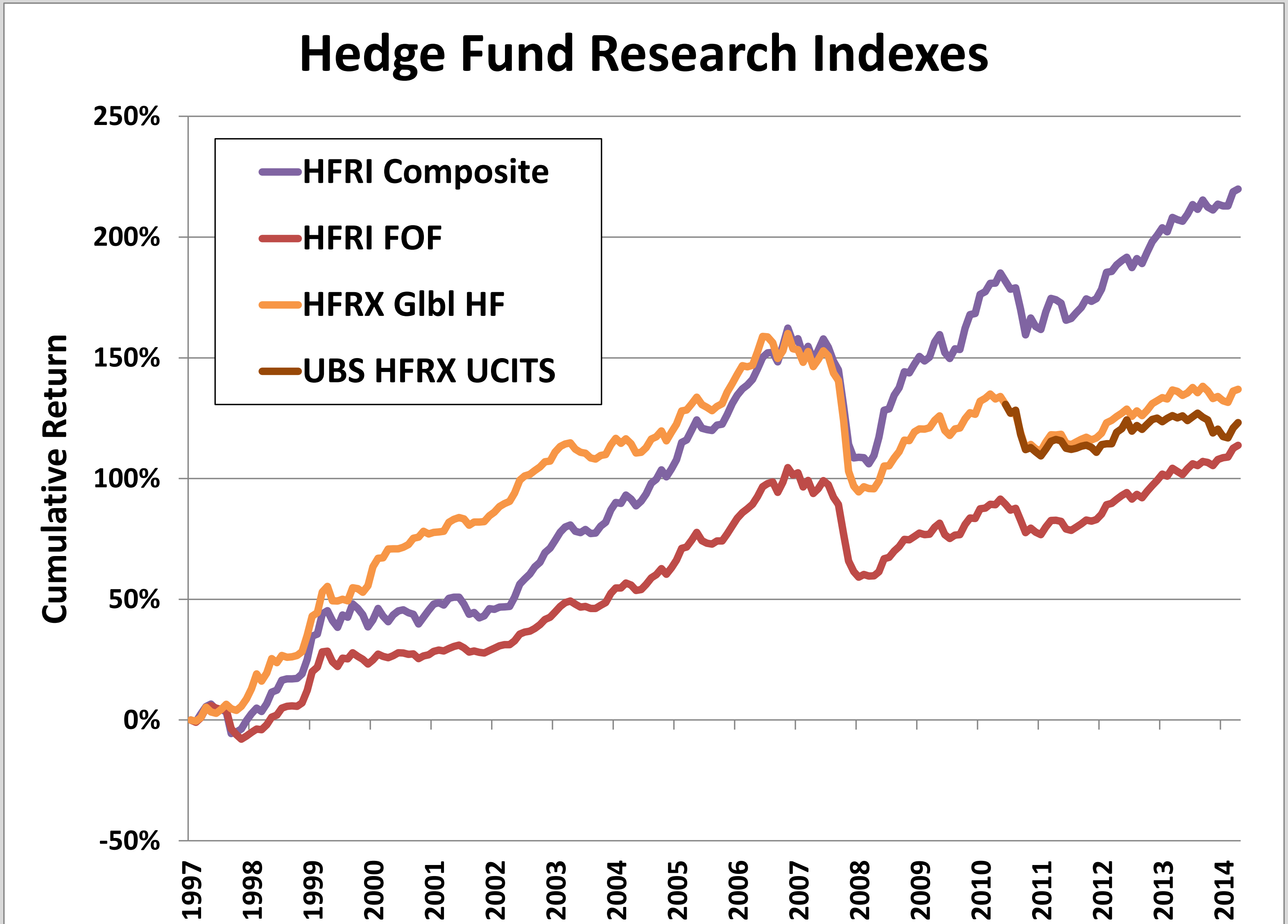
HFR is the leading provider of hedge fund indexes



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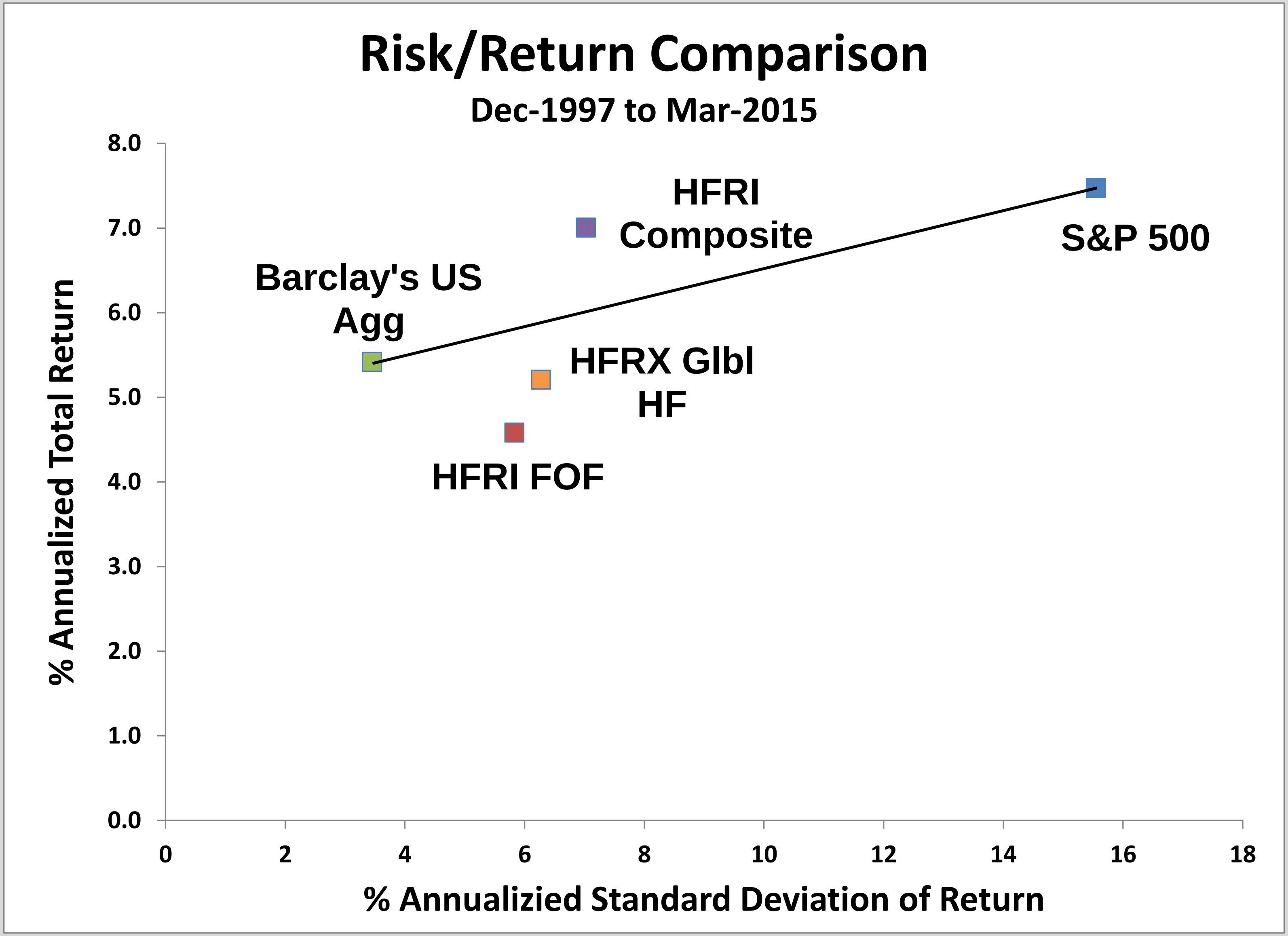
On average, hedge funds have not helped investors



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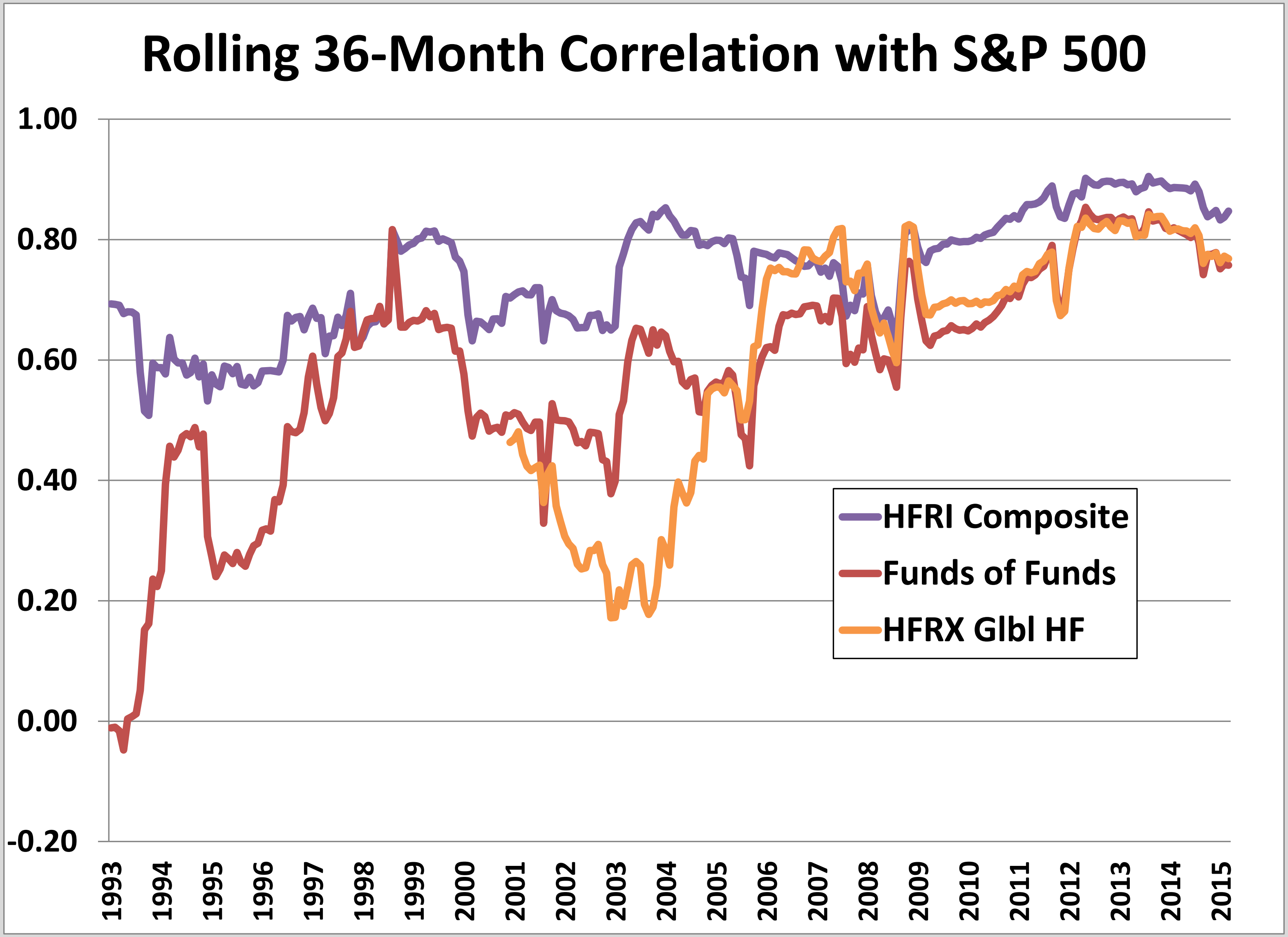
Hedge funds have provided limited diversification in recent years



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There are many reasons why investors avoid private alternatives

- The published **returns** for private alternative indexes **are unreliable**
    - Returns are biased upward
    - Volatilities are biased downward
- **Other problems** with private alternatives:
    - Lack of liquidity (notice periods, holdbacks, gates, etc.)
    - Lack of pricing transparency
    - Lack of regulation/fear of fraud
    - Tax headaches (K-1s, filing extensions)
    - High income/net worth requirements
    - High minimum investments
    - High fees
- **Liquid alternatives** satisfy these concerns

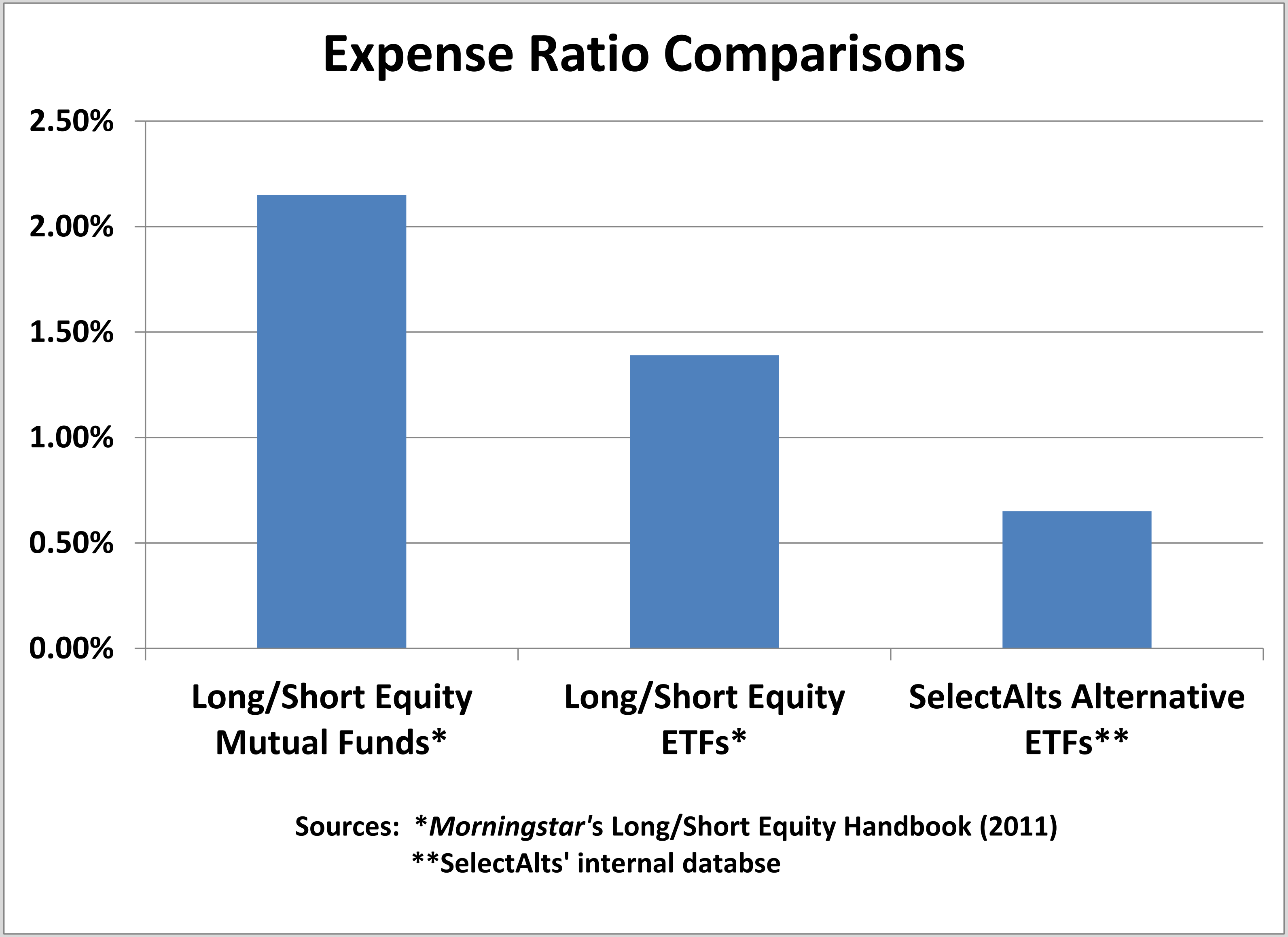
Liquid alternatives include mutual funds and ETFs

- **Morningstar categories** of 1,591 alternative **mutual funds:**
  - Bear market (net short or inverse)
  - Long/short equity (largest category)
  - Managed futures (commodities are a separate category)
  - Market neutral (mostly MN equity)
  - Multi-alternative (FOF or multi-strat)
  - Multi-currency (i.e., currency strategies)
  - Trading-inverse (e.g., debt or commodities)
  - Trading-leveraged (e.g., 2x or 3x)
  - Volatility (truncate downside with options or futures)
- Morningstar does not include **global TAA** funds as alternatives
- Morningstar uses the same categories for 311 alternative **ETPs**

Exchange-traded products (ETPs)

- **ETF** = Exchange-traded fund
  - Owns a portfolio of assets like a mutual fund
  - Most are passively managed to an index
- **ETN** = Exchange-traded note
  - Exposes investors to the credit risk of the issuer
  - Often used for illiquid indexes or for tax reasons
- **ETP** = Exchange-traded product
  - ETPs = ETFs + ETNs
  - Most people use "ETFs" generically to include ETNs
- ETPs are slightly more **tax-efficient** than mutual funds
- **Benchmark indexes** provide meaningful history even for new ETFs
- **Passive management** keeps costs down

Mutual funds tend to be more expensive than ETFs



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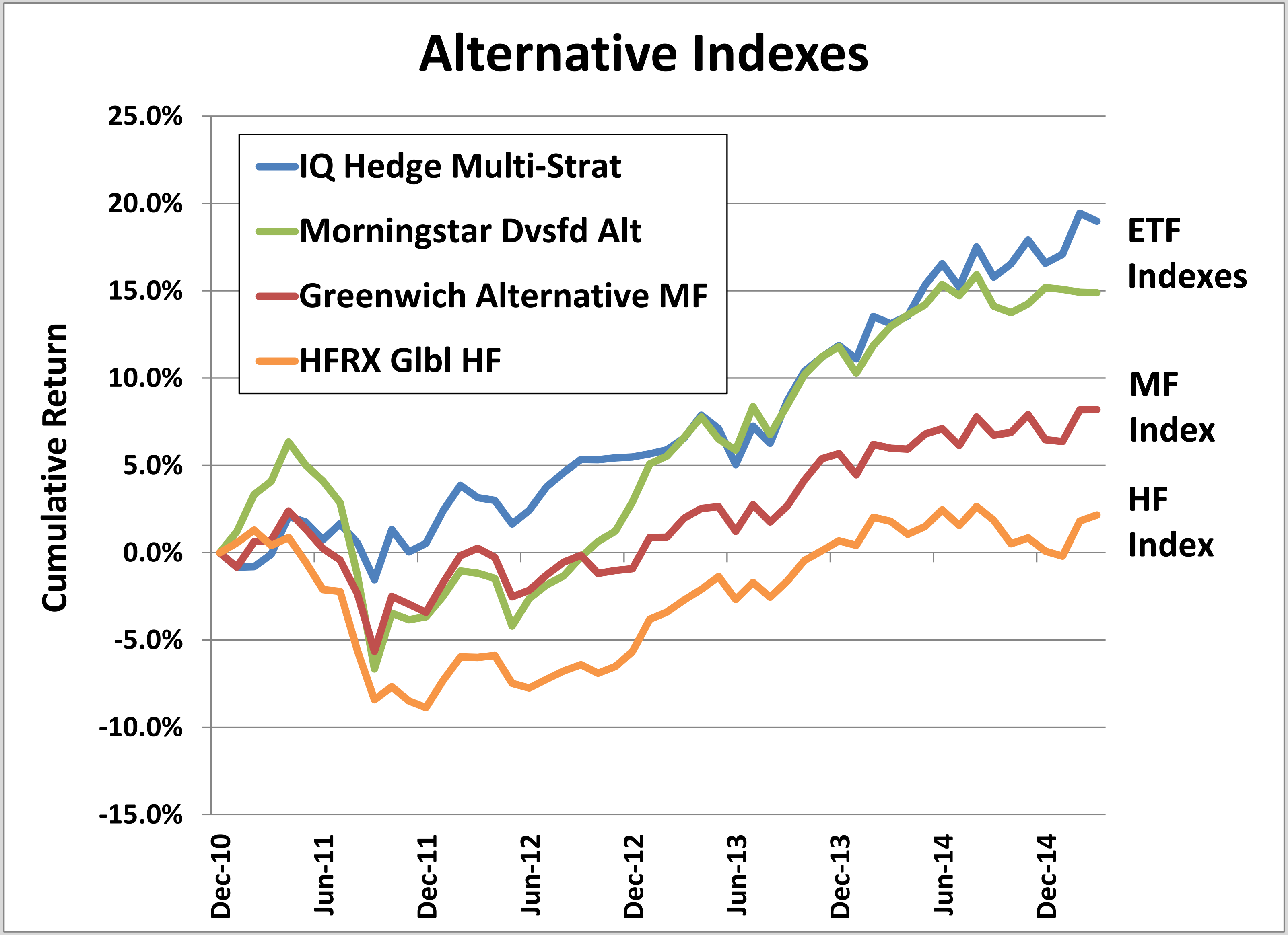
ETFs have provided superior returns



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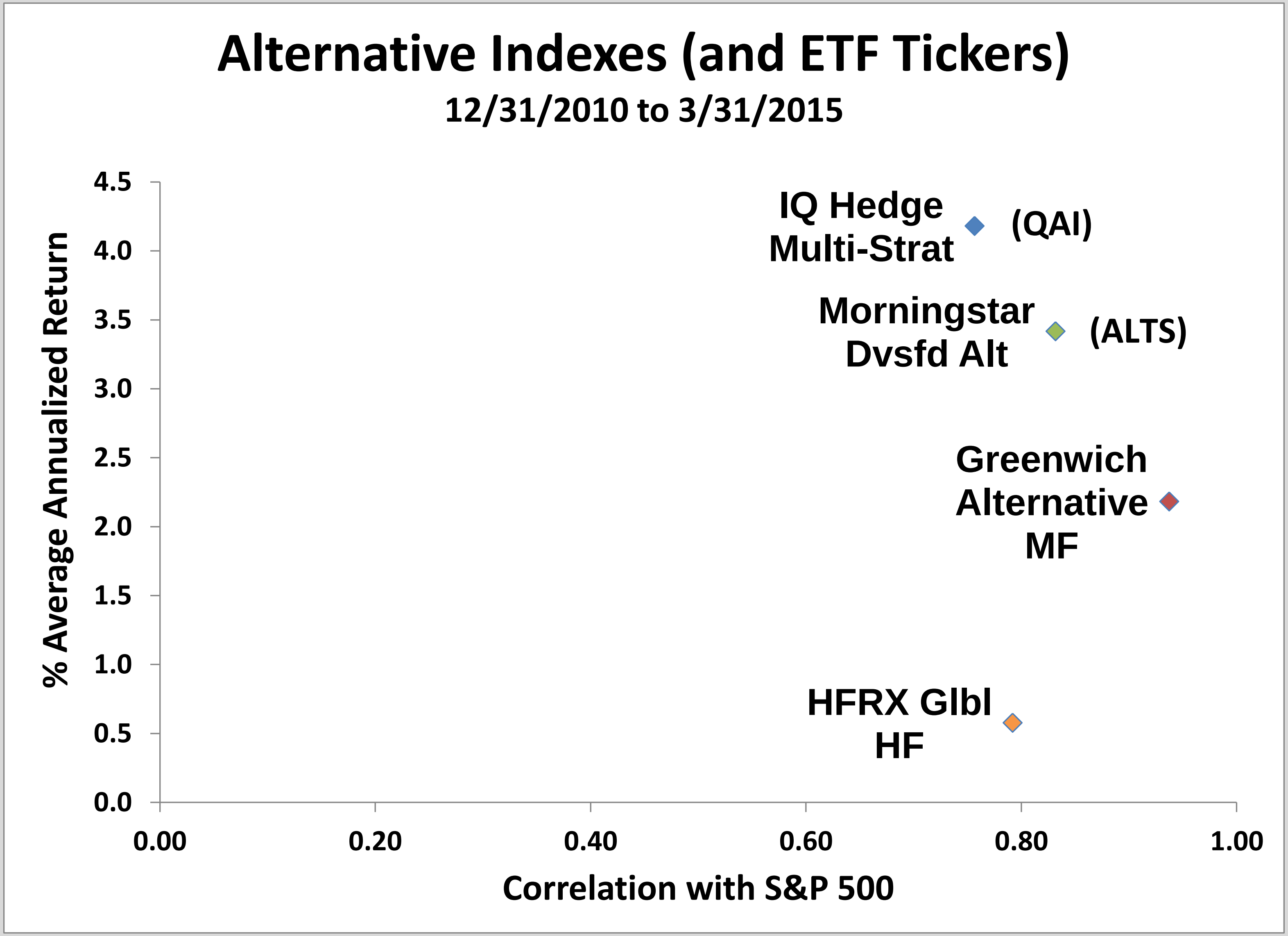
But diversified indexes and funds provide only limited diversification



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Lower correlations can be found in certain alternative strategies.

- Strategy-specific HFRX (investable) indexes provide an indication of potentially attractive alternative strategies
- Most HFRX sub-indexes start on 12/31/2004
- 11 of them had S&P 500 correlations of .5 or below

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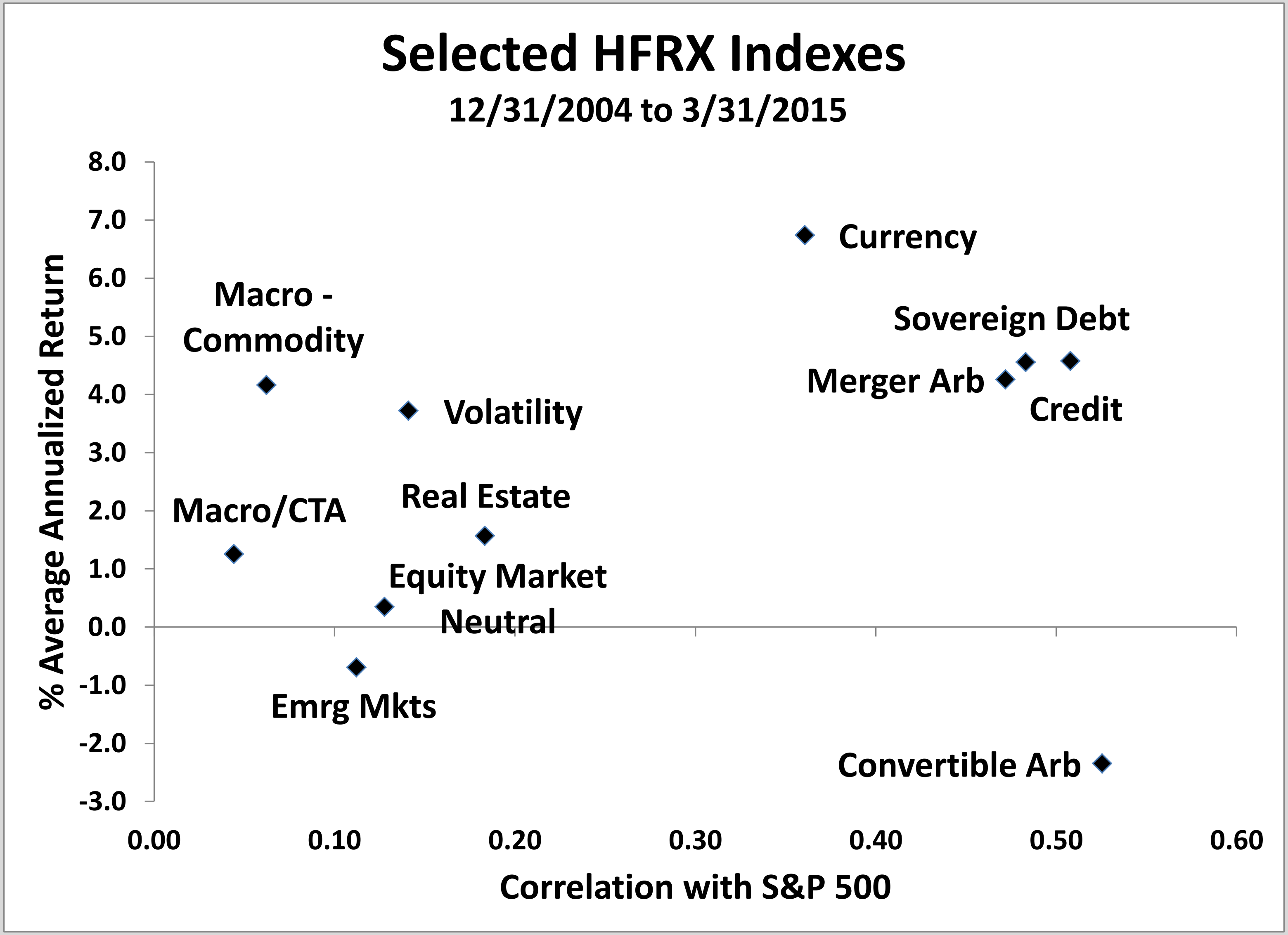
HFRX index characteristics suggest which strategies might be attractive



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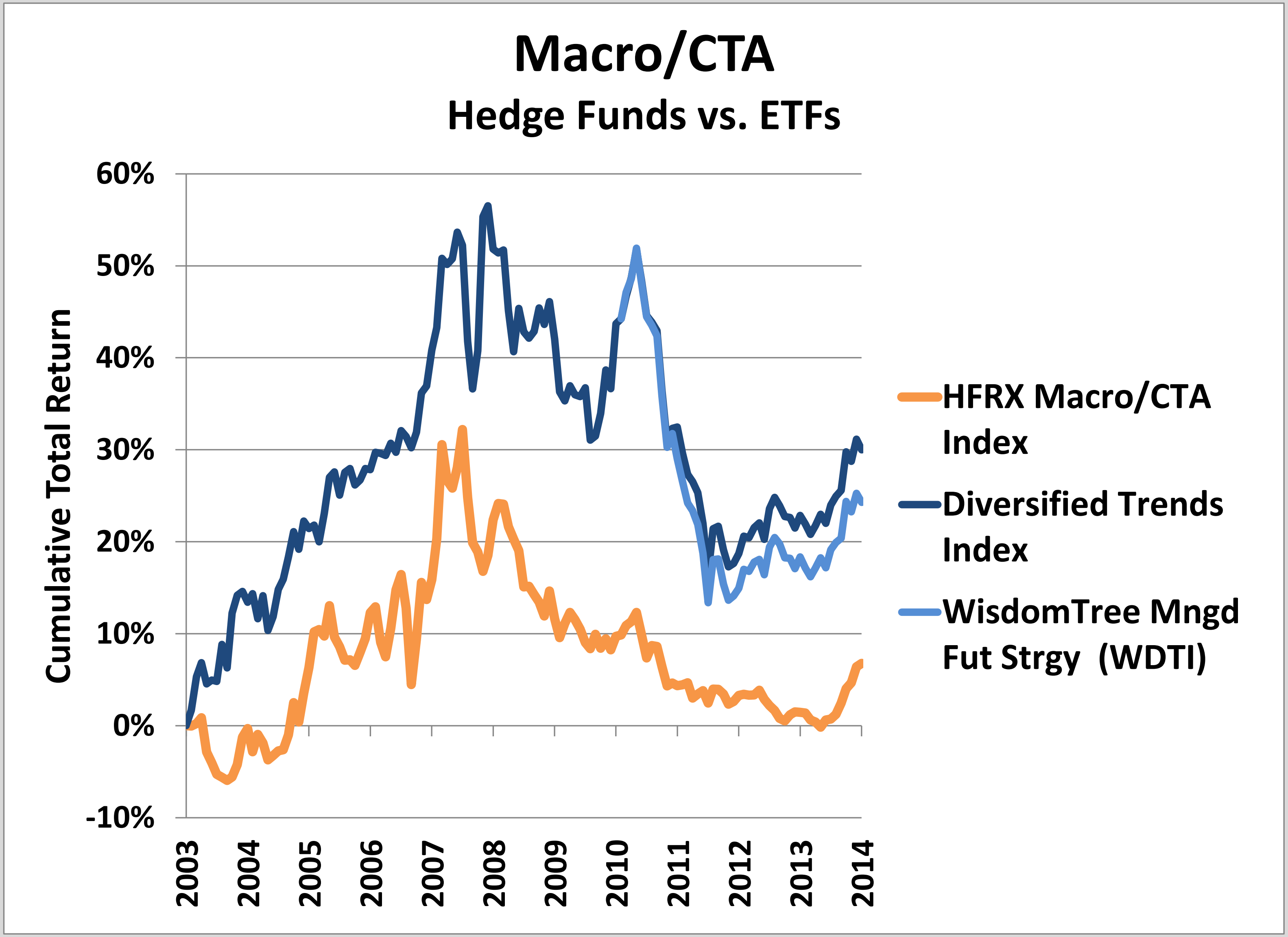
How does the performance of ETFs compare with hedge funds?

- 11 strategy-specific HFRX (investable) indexes had S&P 500 correlations of .5 or below
- ETFs in these categories generally had higher returns
- Often only one ETF in a category exists
- Where there was more than one I chose the largest and most liquid
- The average expense ratio for all ETFs shown below is 0.59%
- All expense ratios are under 1.00%
- Most HFRX sub-indexes start on 12/31/2004
- Almost no alternative ETFs were around back then
- However the benchmark indexes for many ETFs have a long history
- A good pro-forma approximation for ETF historical returns is:

    Benchmark index return – expense ratio = pro-forma fund return

WDTI invests long/short in commodities, currencies and Treasuries



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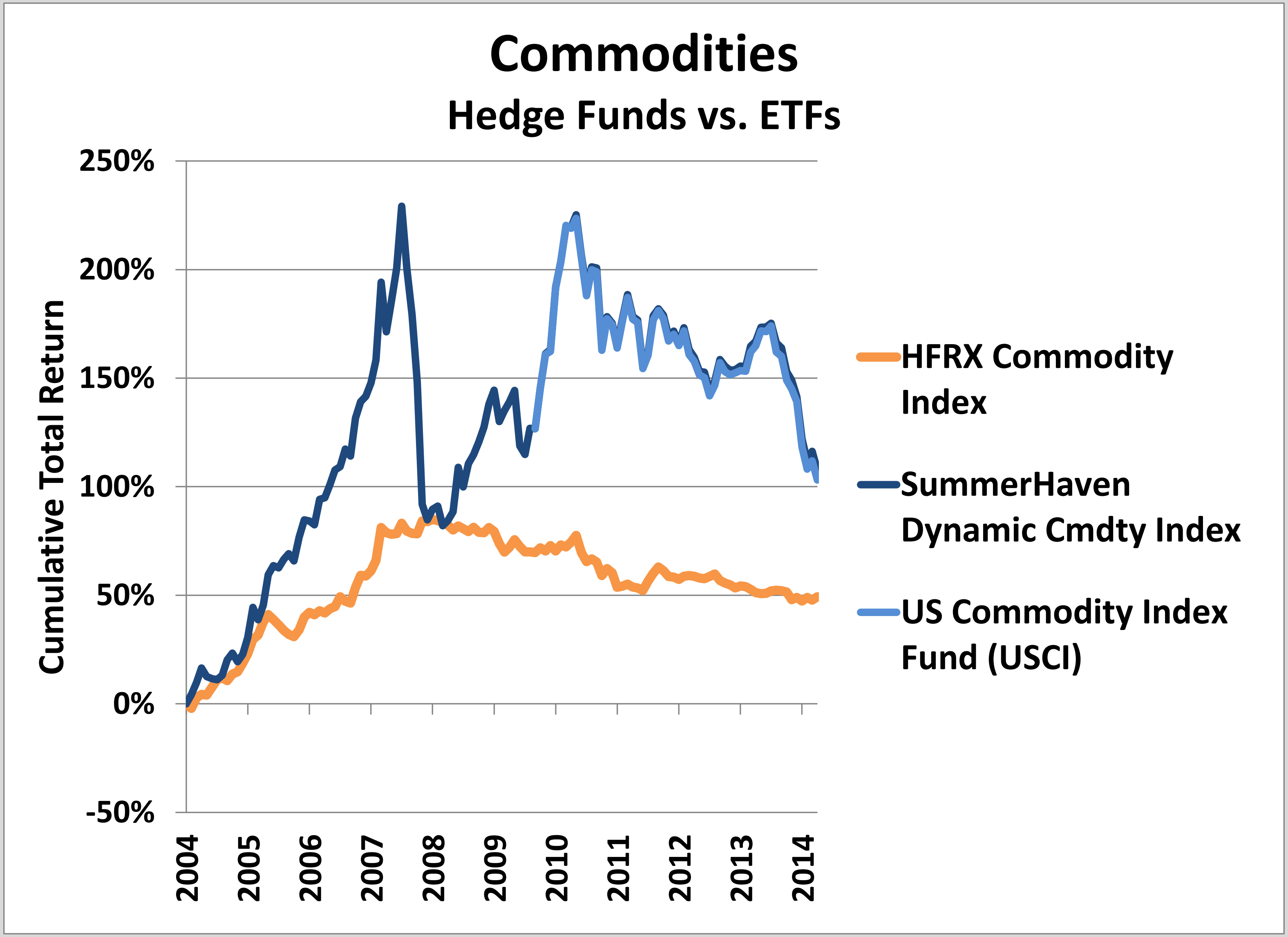
USCI selects 14 from 27 commodities based upon roll yield and momentum



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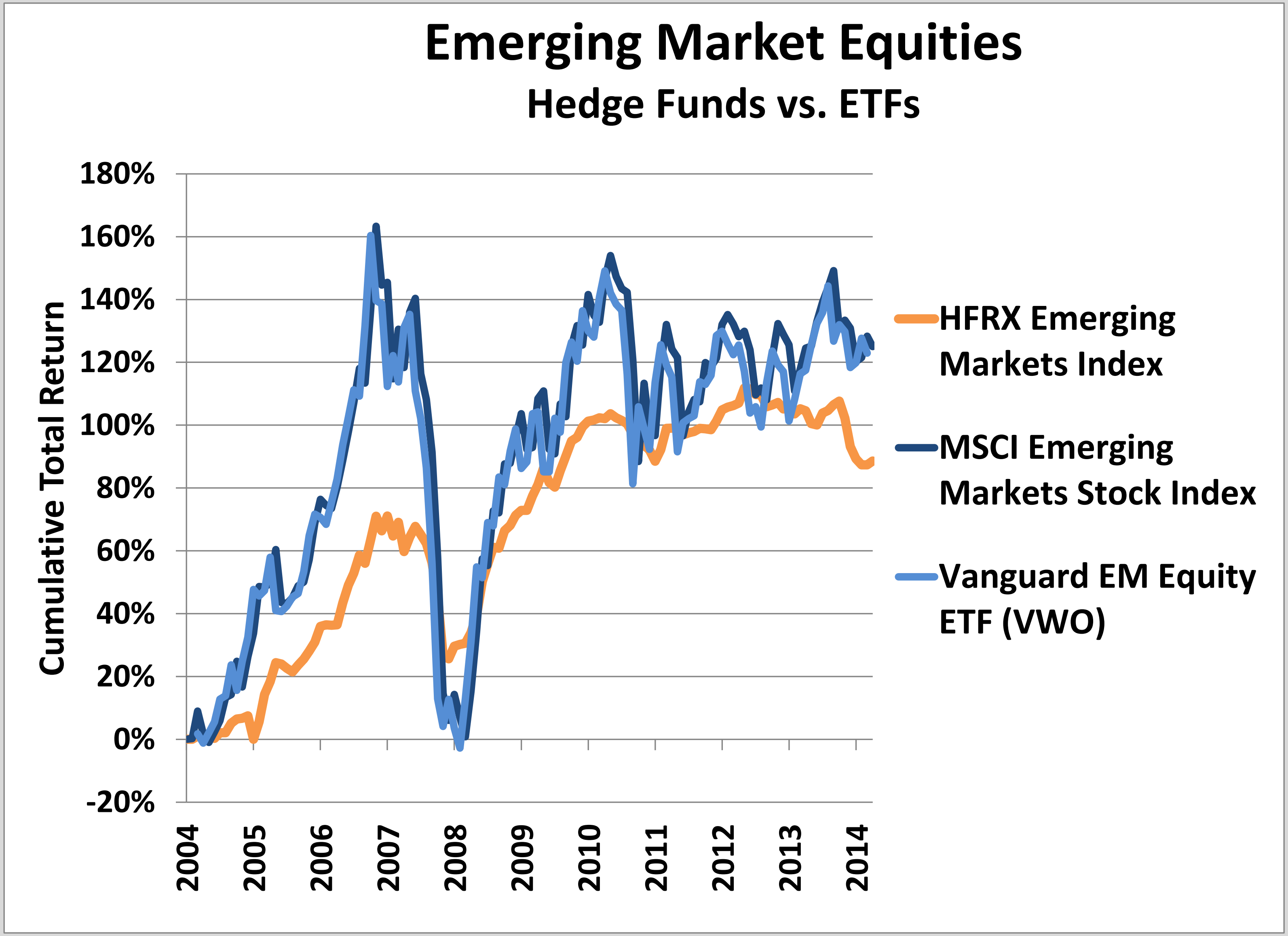
The cheap generic (VWO) beat the average (expensive) hedge fund



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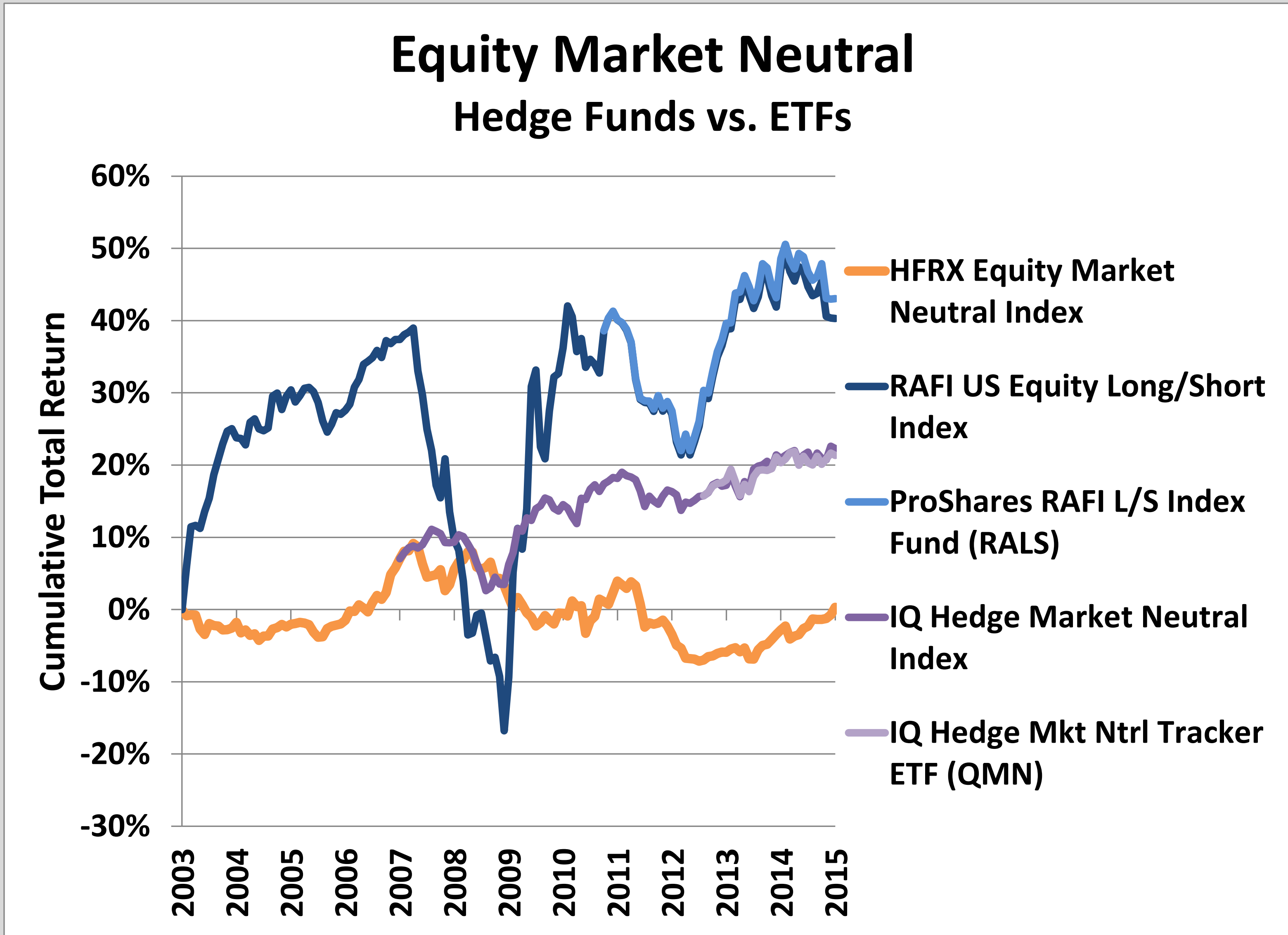
The two largest MN ETFs trounced the hedge fund competition



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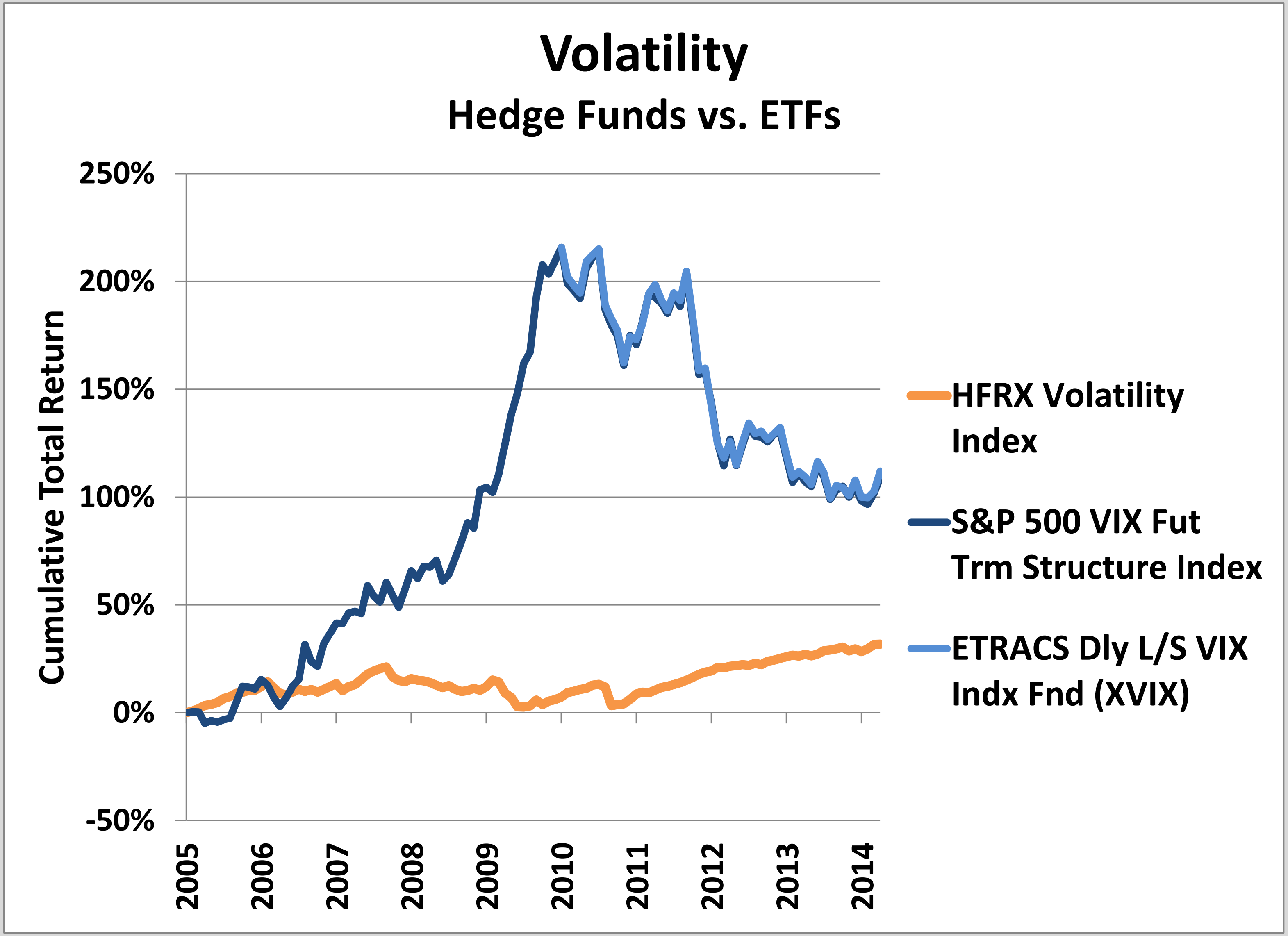
XVIX combines long medium-term VIX with short near-term VIX futures



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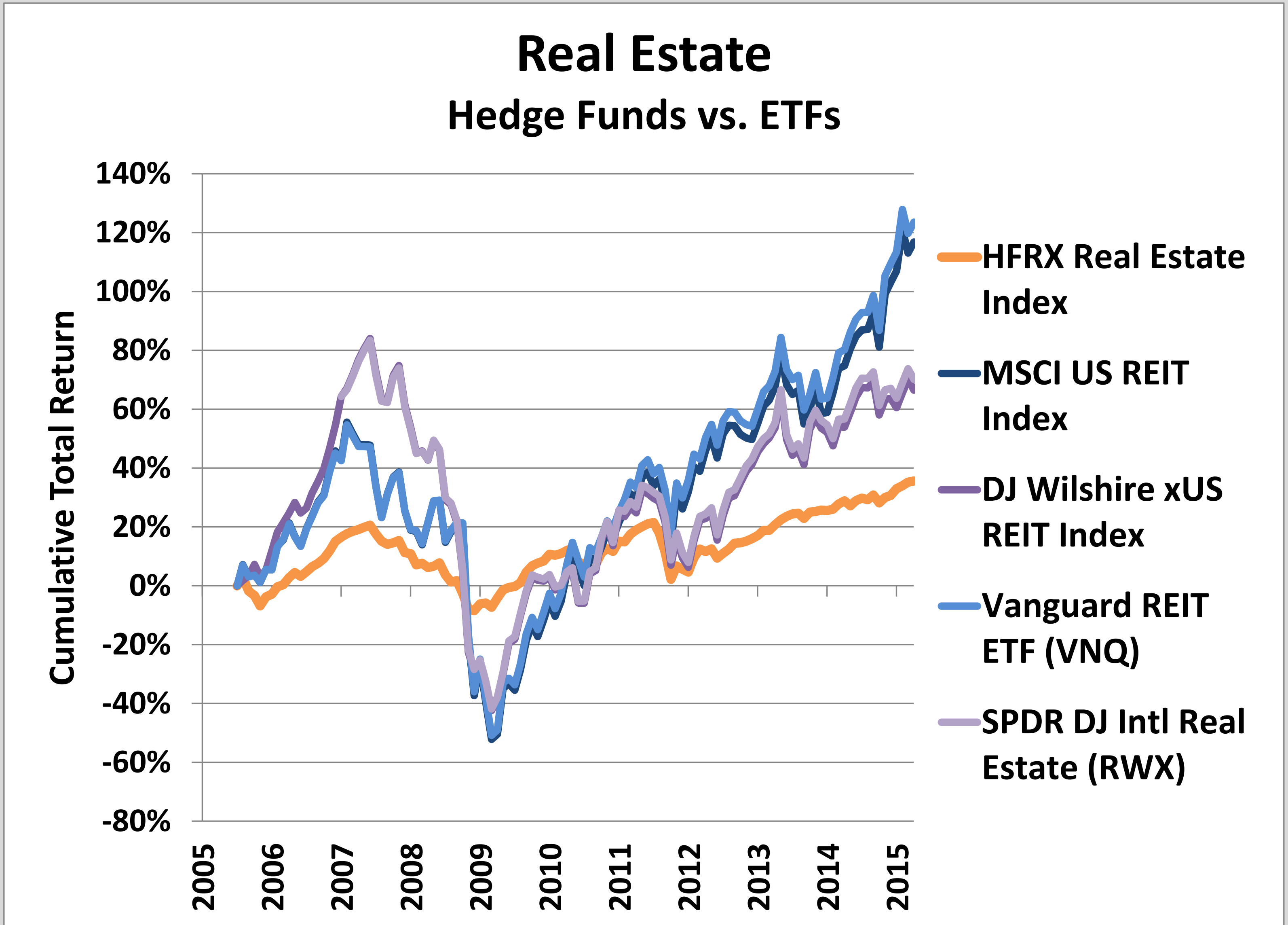
VNQ (US) and RWX (int'l) both handily outperformed the avg. hedge fund



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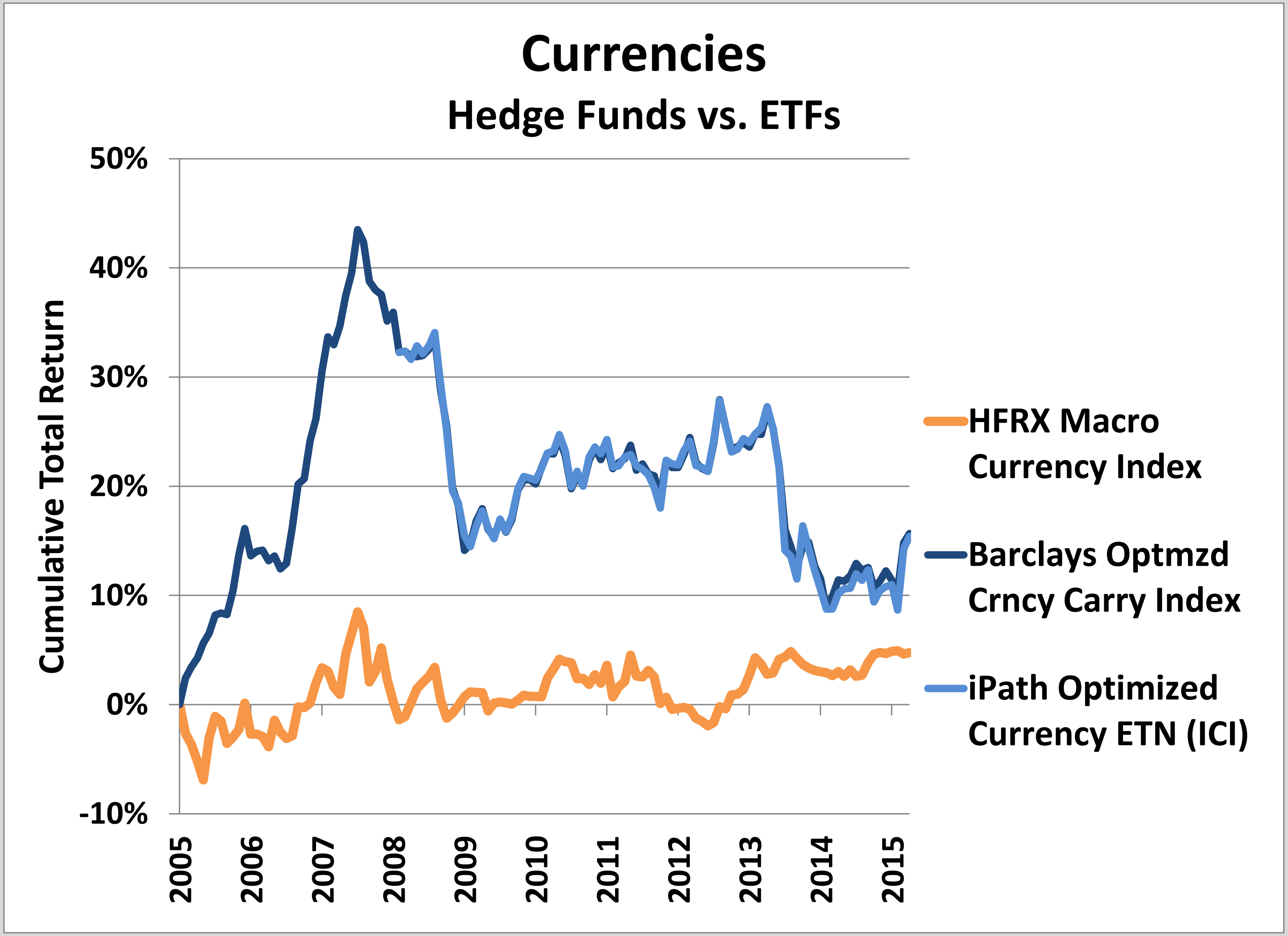
ICI utilizes a long/short "carry trade" in the G10 currencies



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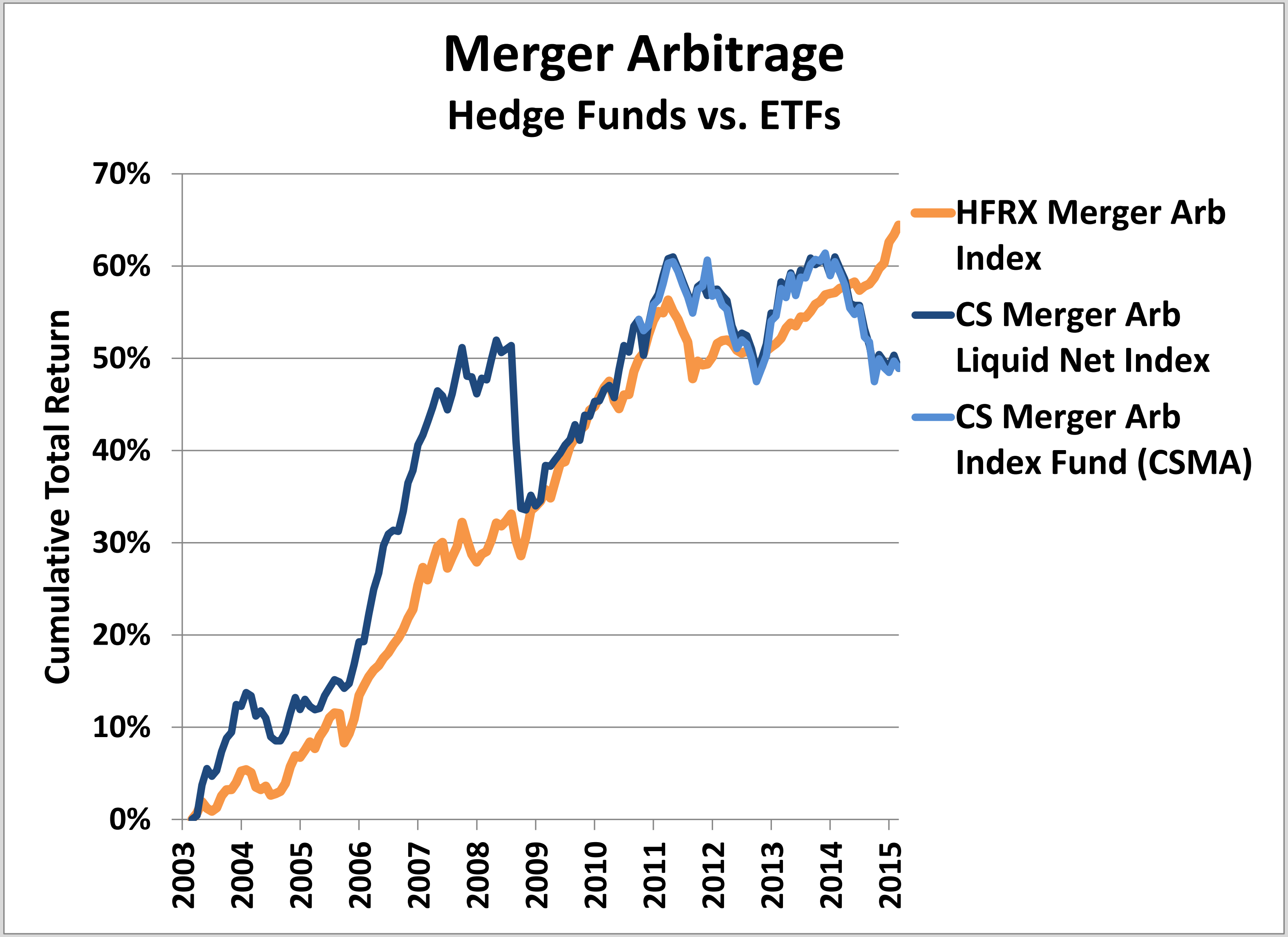
CSMA buys the acquisition targets and shorts the acquirers



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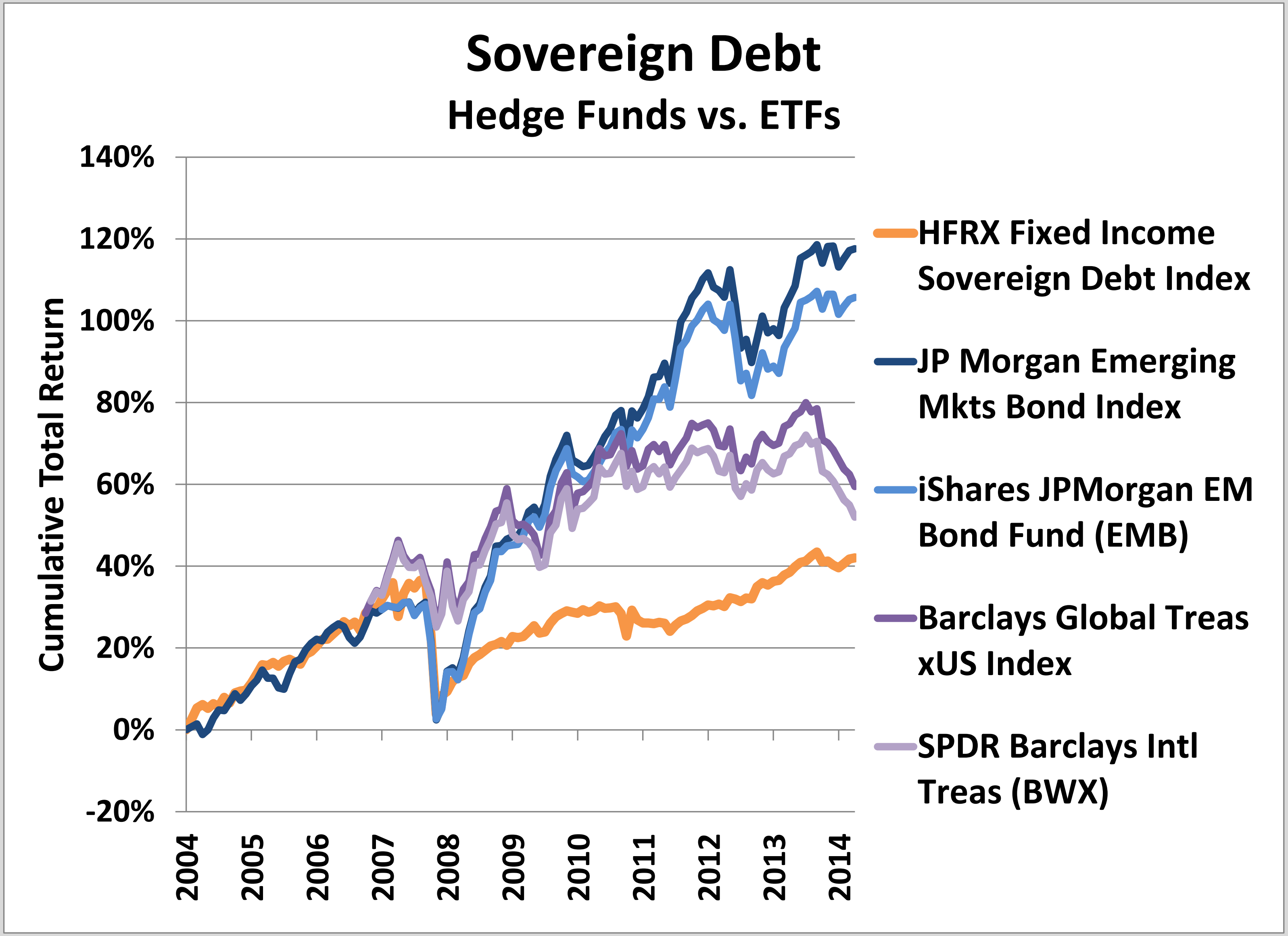
BWX (developed) and EMB (emerging) just buy (long) their bond markets



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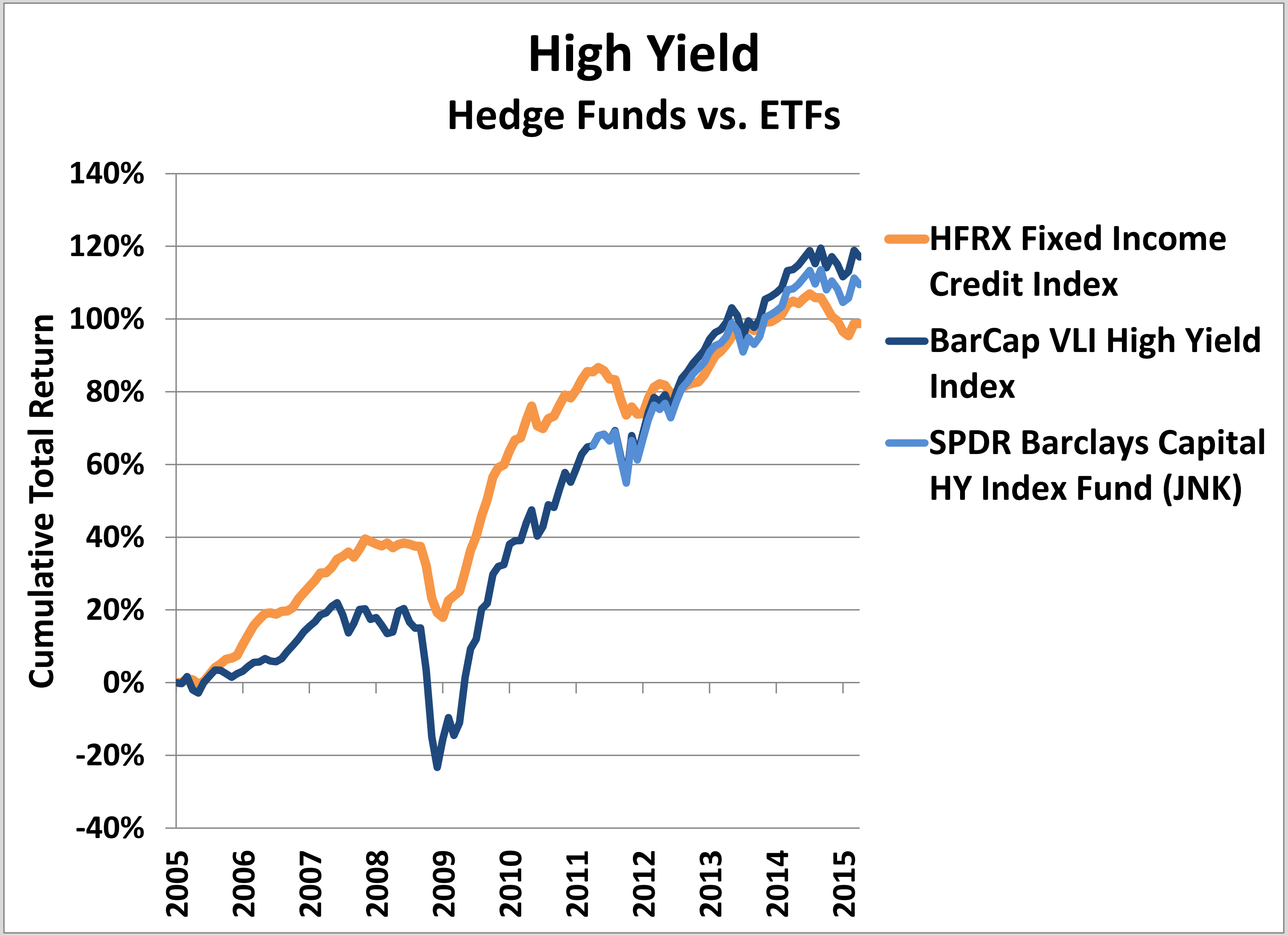
JNK owns (long) the largest and most liquid high-yield bonds



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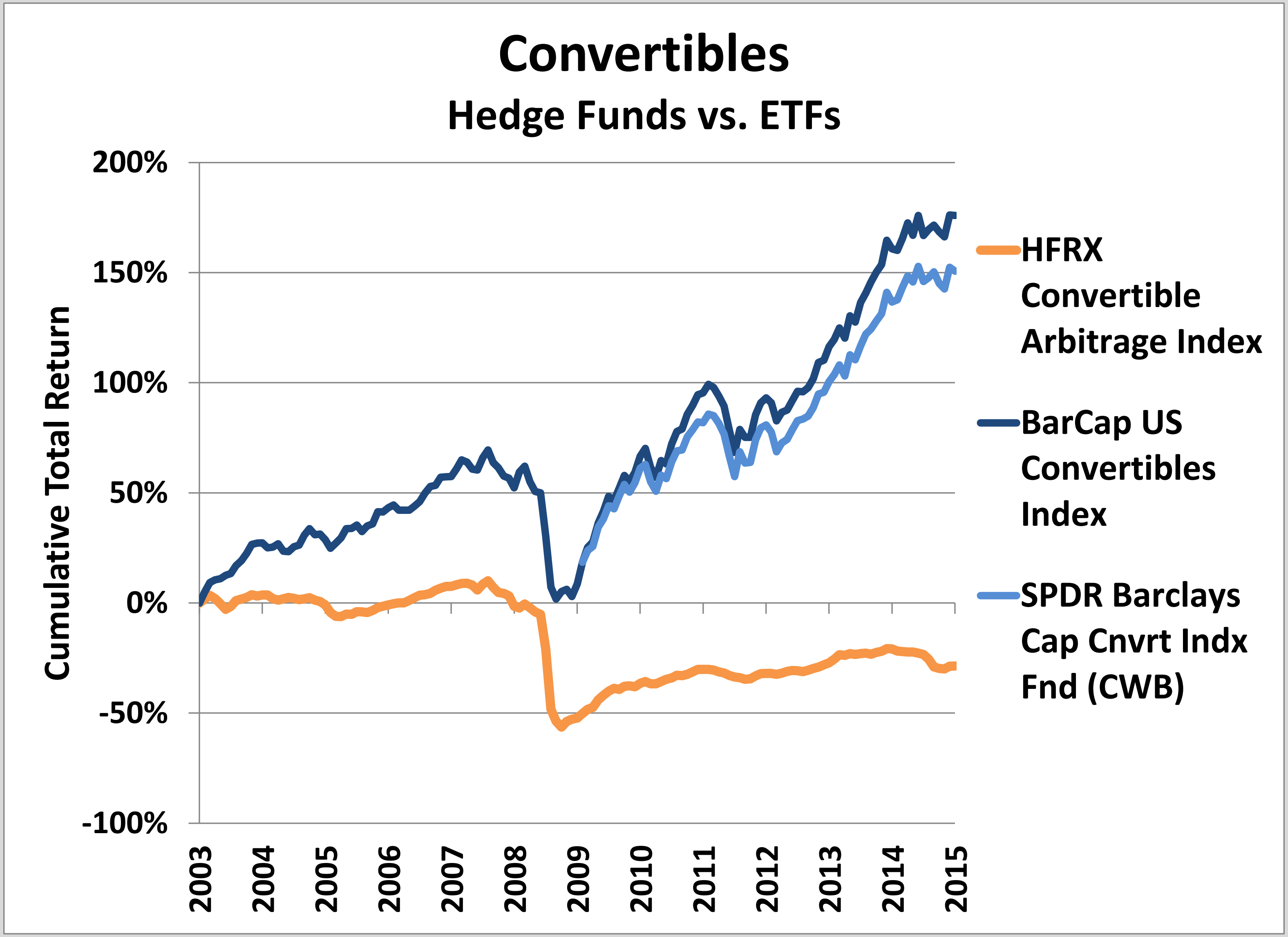
CWB owns (long) the largest and most liquid convertible securities



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Many other alternative ETFs are available.

- BIZD and PSP – Listed private equity
- BKLN – Bank loans
- CSLS – Long/short equity
- ALFA and GURU – hedge fund 13f holdings replication
- PBP – Buy write
- HVPW – Put write
- IAU and GLD – physical gold
- PKW – stock buybacks
- FM and FRN – frontier markets
- WOOD – timber
- FPX – IPOs
- IWC – micro-cap
- MTUM and PDP – momentum
- CSD – spinoffs
- VLUE - value

How much should I allocate to alternatives?

- Answer #1—what are others doing?
  - In a 2012 survey, college and university endowments allocate 11% to 80%.[1, 2]
  - A recent survey of pension plans cited an average allocation of 17.3%.[3]
  - Alternative mutual funds are very popular with individual investors.
  - In all cases, allocations to alternatives have been increasing.

- Answer #2—what is the "market" allocation?

[1] http://www.nacubo.org/Documents/research/2012NCSEFinalPressReleaseJanuary292013.pdf

[2] http://investments.yale.edu/images/documents/Yale_Endowment_12.pdf

[3] http://www.pionline.com/gallery/20121129/SLIDESHOW/112909999/3

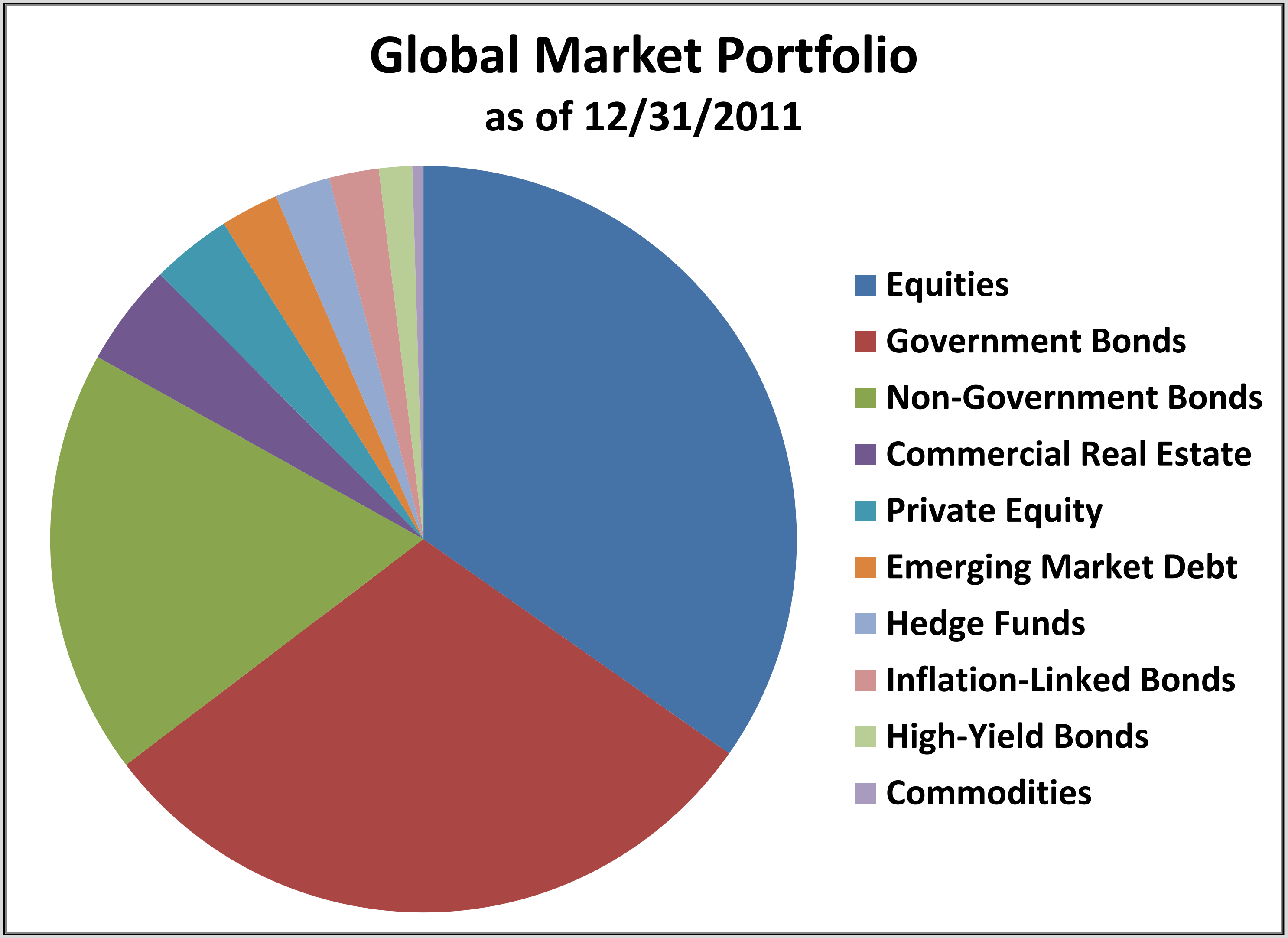
The market allocation to alternatives (broadly defined) is roughly 17%

Global Market Portfolio as of 12/31/2011

Asset Class	Category	$Trillion	% of Total
Equities	Equity	29.0	34.7
Government Bonds	Debt	25.0	30.0
Non-Government Bonds	Debt	15.4	18.4
Commercial Real Estate	Alternative	3.7	4.4
Private Equity	Alternative	2.9	3.5
Emerging Market Debt	Alternative	2.1	2.6
Hedge Funds	Alternative	2.0	2.4
Inflation-Linked Bonds	Alternative	1.8	2.2
High-Yield Bonds	Alternative	1.2	1.4
Commodities	Alternative	0.4	0.5
Total Equity		29.0	34.7
Total Debt		40.4	48.4
Total Alternative		14.1	**16.9**
Grand Total		83.5	100.0

Source: Doeswijik, Lam, and Swinkels; *Strategic Asset Allocation: The Global Multi-Asset Market Porfolio 1959-2011;* November 2012 (http://ssrn.com/abstract=2170275)

Investments other than stocks and investment grade bonds are alternatives.



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- Answer #2—what is the "market" allocation?

- Answer #3—what would have been the optimal historical allocation?

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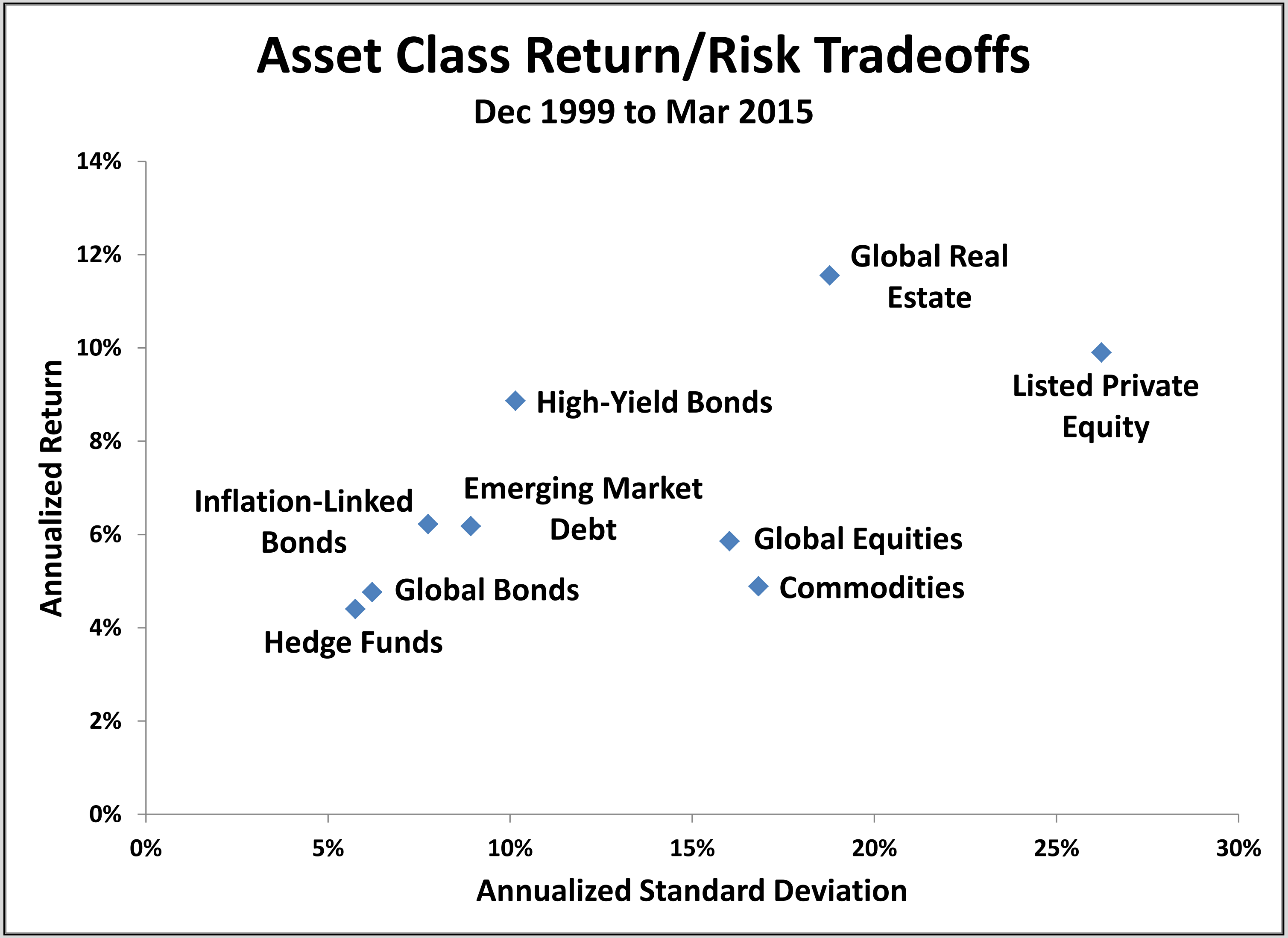
Liquid, tradeable, daily-priced indexes are available for all asset classes

Global Market Portfolio
Dec 1999 to Mar 2015

Asset Class	Category	Index Name	Std. Dev.	Return
Global Equities	Equity	MSCI AC World Daily TR Net USD	16.02%	5.86%
Global Bonds	Debt	Barclays GlobalAgg Total Retur	5.75%	4.40%
Global Real Estate	Alternative	EPRA/NAREIT Dev TR USD	18.77%	11.55%
Listed Private Equity	Alternative	S&P Listed Private Equity Inde	26.24%	9.90%
Emerging Market Debt	Alternative	S&P/Citigroup International Tr	8.92%	6.18%
Hedge Funds	Alternative	HFRX Global Hedge Fund Index	6.21%	4.76%
Inflation-Linked Bonds	Alternative	Barclays Global Inflation-Link	7.75%	6.22%
High-Yield Bonds	Alternative	Barclays Global High Yield Tot	10.15%	8.86%
Commodities	Alternative	DJUBS Commodity TR	16.82%	4.89%

Their long-term return/risk characteristics are reasonable



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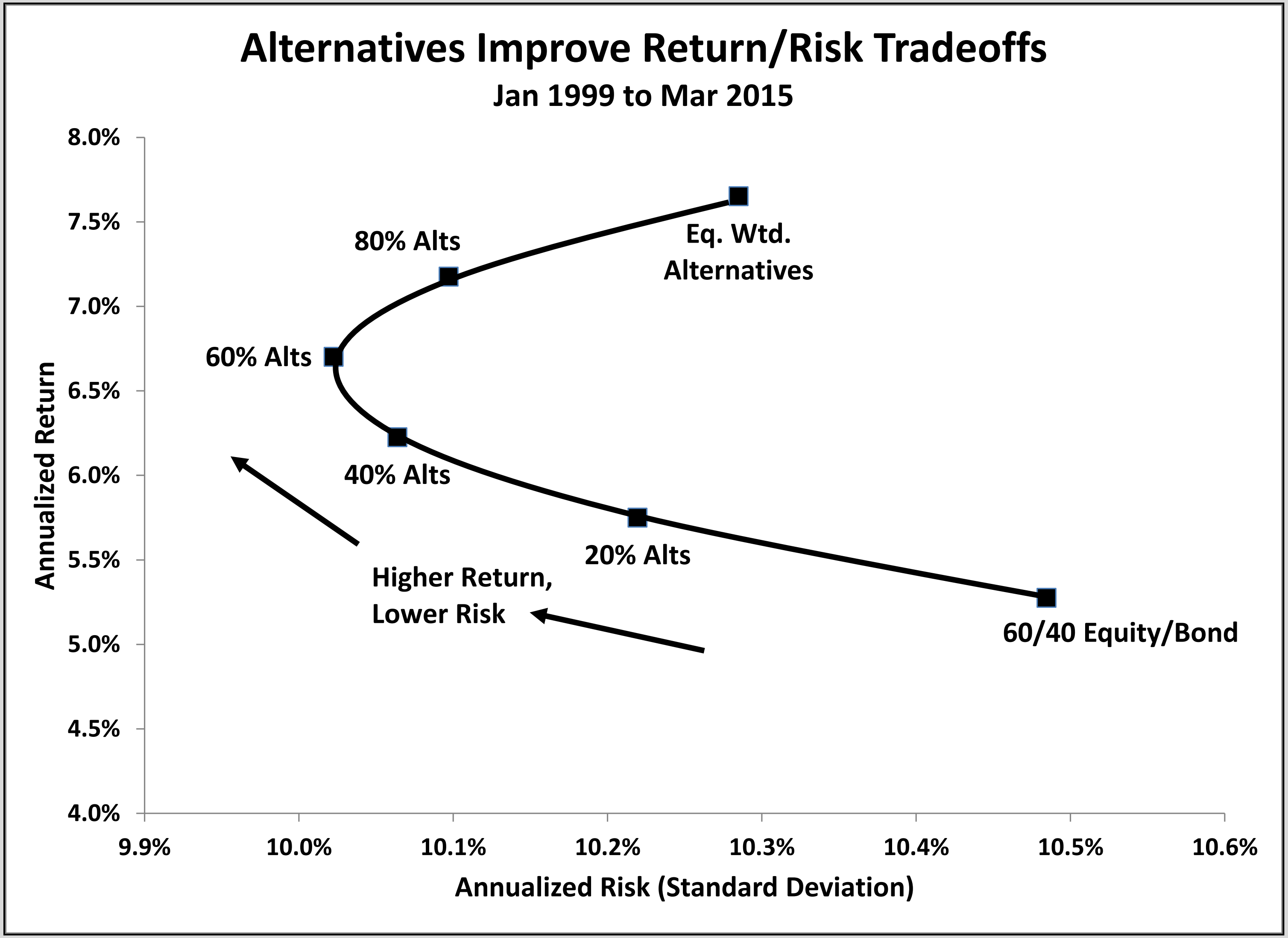
A 60/40 traditional portfolio and an equal-weighted mix of alternatives

Core-Satellite Portfolio

Weight	Asset Class	Category	Asset Class	Index Name
	Core			
60.0%	Global Equities	Equity	Global Equities	MSCI AC World Daily TR Net USD
40.0%	Global Bonds	Debt	Global Bonds	Barclays GlobalAgg Total Retur
100.0%				
	Satellite			
14.3%	Global Real Estate	Alternative	Global Real Estate	EPRA/NAREIT Dev TR USD
14.3%	Listed Private Equity	Alternative	Listed Private Equity	S&P Listed Private Equity Inde
14.3%	Emerging Market Debt	Alternative	Emerging Market Debt	S&P/Citigroup International Tr
14.3%	Hedge Funds	Alternative	Hedge Funds	HFRX Global Hedge Fund Index
14.3%	Inflation-Linked Bonds	Alternative	Inflation-Linked Bonds	Barclays Global Inflation-Link
14.3%	High-Yield Bonds	Alternative	High-Yield Bonds	Barclays Global High Yield Tot
14.3%	Commodities	Alternative	Commodities	DJUBS Commodity TR
100.0%				

60% in alternatives was the minimum optimal allocation historically



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  - Alternative mutual funds are very popular with individual investors.
  - In all cases, allocations to alternatives have been increasing.

- Answer #2—what is the "market" allocation?—**17% to 25%**

- Answer #3—what would have been the optimal historical allocation?—**60% to 100%**

[1] http://www.nacubo.org/Documents/research/2012NCSEFinalPressReleaseJanuary292013.pdf

[2] http://investments.yale.edu/images/documents/Yale_Endowment_12.pdf

[3] http://www.pionline.com/gallery/20121129/SLIDESHOW/112909999/3

Conclusion: build your own fund of funds with ETFs

- Alternative ETFs provide **low-cost building blocks** for an alternative portfolio
- One option: a **strategic** alternative ETF portfolio of ETFs with the lowest correlations with the S&P 500 and with each other
  - Equal-weight the 14 ETFs discussed above (for example)
  - Rebalance annually
- Another option: an actively managed **tactical** alternative ETF portfolio of ETFs with the highest expected returns
  - Opportunistically select from a larger universe of ETFs
  - Estimate returns with combination of value and momentum
- Either way, the result will be **far better** than nearly any other approach
  - Save 1%-3% annually on fees
  - Concentrate on strategies with the best diversification
- Just do it!

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