alpha
Institutional Investor's

BlackRock, AQR, and Others Get Into the Liquid Alts Game

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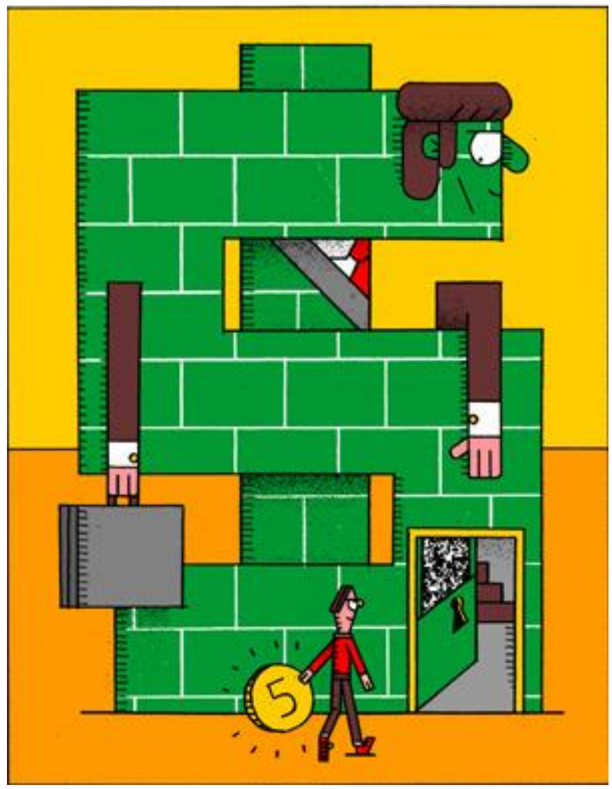
Large asset management firms are serving up hedge-fund-like mutual funds to their clients. But are these funds worth the money — or just a way for asset managers to fatten their coffers at investors' expense?



When Blackstone Alternative Asset Management, which oversees $49 billion across a range of hedge fund strategies and managers, decided to join the move into new alternative mutual funds with daily liquidity, it figured it could gain traction by hooking up with a major mutual fund company more familiar with marketing to the retail sector. On August 3 the New York–based firm launched the Blackstone Alternative Multi-Manager Fund and docked it on the Fidelity Investments fund platform. Within three days the new Blackstone fund had reached $1 billion in assets. The fund now manages $1.14 billion; it posted a 0.67 percent gain in January, when the S&P 500 fell 3.46 percent. As far as Blackstone is concerned, that's just the beginning.

"We would expect to see the asset base grow pretty well," says John McCormick, head of global business strategy at BAAM. "We have a big vision for this business. I expect we will have multiple funds and multiple strategies."

Welcome to the world of liquid alternatives, where marquee hedge fund management firms with the right offering and marketing can quickly attract significant investment capital to new hybrid mutual funds. Their success at asset gathering has rivaled that of well-known managers launching traditional hedge funds. Over the past year a slew of new liquid alternative mutual funds offering hedge fund strategies have popped up, run by a variety of financial concerns: hedge fund firms, funds of hedge funds, mutual fund companies, insurance companies and major investment banks. Often the new liquid alt mutual funds, as they are called, involve a partnership or cooperative agreement between two types of firms, as the new Blackstone fund does.

Proponents of these new liquid alternative mutual funds say they give individual investors a chance to diversify their portfolios with hedge fund strategies the way institutions and wealthy individuals do. But critics say the limitations placed on mutual funds that do not exist for hedge funds make these new liquid alternatives little more than watered-down hedge funds that underperform while charging higher fees than traditional mutual funds.

Chicago-based mutual fund industry tracker Morningstar counts more than 400 liquid alternative mutual funds in the U.S., up from about two dozen in 2003, with new offerings being launched at a rapid clip. J.P. Morgan, in an overview of the market published last spring, cited statistics suggesting that liquid alts would grow from 2.8 percent of mutual fund assets to 15.8 percent over the next decade. Analysts of the sector predict that liquid alts will become another trillion-dollar asset class.

The bull market in stocks has helped fuel interest in liquid alt funds, particularly as a way for retail investors to hedge their long bets, much the way institutions have used hedge funds to provide noncorrelated returns. But no one knows yet how well these hedge-fund-like products will perform in a down market, when they are supposed to be better equipped to protect capital. And if they do perform much the same way effective hedge funds do, what impact will liquid alts have on traditional hedge funds, which have higher fees and longer lockups?

Most experts in the alternative-investment field say there is enough difference between liquid alt mutual funds and hedge funds to leave room for both. But as liquid alts grow more sophisticated and attract higher-quality managers, even some institutional investors are starting to rethink the need for pricey hedge funds, with their extra layer of performance fees and limits on liquidity.

The 2012 Morningstar Barron’s Alternative Investment Survey, released last June, found that of the institutions surveyed that invest in long-short funds, 45 percent used mutual funds as their primary vehicle for long-short equity strategies, compared with 25 percent using hedge funds. In 2010, 38 percent used mutual funds and 61 percent used hedge funds for long-short. The survey polled some 235 investors representing pension plans, insurance companies, foundations and other institutions.

“We have seen some institutions now choosing long-short equity mutual funds over hedge funds,” says Josh Charney, an alternative-investment analyst at Morningstar. “There has always been a dearth of talent [in liquid alts], but now for the first time there is a decent amount of talent in the space. There is a wide variety of managers with good track records that now offer lower fees than hedge funds, not to mention daily liquidity.”

For alternative-investment firms looking to get into the liquid alt game, the challenge of running such a vehicle with the same managers who simultaneously oversee hedge fund strategies can be tricky. Robert Leonard, global head of capital services at Credit Suisse, says many firms are wary of offering in a mutual fund the same or very similar investment guidance that is being provided at a premium price to hedge fund customers. “If you are not careful, you could end up cannibalizing your own existing hedge fund,” Leonard says.

But the allure of raising new capital — particularly from retail investors — through liquid alt mutual funds has proved to be a strong motivation for hedge fund firms and other asset managers to jump in. One of the most aggressive to move into the sector is AQR Capital Management, the Greenwich, Connecticut–based firm co-founded by veteran manager Clifford Asness. A pioneer in expanding from hedge funds to mutual funds, AQR now runs 24 mutual funds, including seven that it classifies as liquid alts. Its long-short equity mutual fund, launched last July, has soared to more than $6 billion in assets and was up 11.17 percent through the end of 2013.

Newport Beach, California–based Pacific Investment Management Co. is another early adopter. The fixed-income giant now manages more than $100 billion in liquid alt strategies.

AQR and Pimco are already leaders in the liquid alt sector, illustrating that a few players are starting to dominate. According to New York–based investment bank and investment services firm Brown Brothers Harriman & Co., 60 percent of the $53 billion that flowed into liquid alternative mutual funds in the first half of 2013 went to just ten firms.

The target of much of this new liquid alt formation: retail investors. In a presentation last May, Blackstone cited statistics showing that individual investors had dropped as a share of hedge fund assets from 48 percent of hedge fund assets in 2001 to 23 percent in 2011, whereas institutions surged from 52 percent in 2001 to 77 percent in 2011. Liquid alts are seen as a way for hedge funds or managers using hedge-fund-like strategies to recapture some of those individual investors.

Liquid alts — frequently referred to as 40 Act funds after the 1940 legislation that governs mutual funds — were an investment curiosity until very recently. Morningstar counted only 67 such funds in 2002. But they have gained traction with investors over the past few years. Registered investment advisers (RIAs), who typically represent individual clients, are becoming increasingly interested as they try to help smooth out returns for their client portfolios, which often revolve around stocks and bonds. Those portfolios got hammered in the 2008 economic meltdown.

A few key factors distinguish hedge funds from their liquid alternative kin. Hedge funds have limits on liquidity, with lockups and redemption periods that can be quarterly, semiannual or even annual. The liquid alts being launched now are aimed at the retail market, with the characteristics of a general mutual fund, including low initial investment and daily liquidity. In addition to management fees of 1.5

to 2 percent, hedge funds charge performance fees that can run from 15 percent to as high as 50 percent of profits. Liquid alts typically don't carry performance fees, although their management fees tend to be higher than typical mutual fund fees. Morningstar estimates that no-load liquid alt management fees average 1.4 to 1.7 percent, compared with 1.1 percent for a large mutual fund. Many liquid alts carry loads and additional fees that can make them a good deal more expensive than mutual funds — but still cheaper than hedge funds.

When it comes to investing, however, hedge funds have several advantages over mutual funds. For example, hedge funds are not constrained in their ability to use leverage. Mutual funds are allowed to borrow no more than 50 percent of their capital, and some have guidelines that are even more restrictive. In addition, mutual funds are allowed to borrow only from banks. Hedge funds are free to invest in illiquid securities like derivatives, whereas mutual funds can have no more than 15 percent of their net assets in illiquid securities. And hedge funds often realize their biggest gains from concentrated bets; the common diversified mutual fund can't put more than 5 percent of its assets in any one issue.

"These daily liquid alt funds are not going to be pure hedge funds," says Lawrence Restieri Jr., head of alternative-investment sales for global third-party distribution at Goldman Sachs Asset Management, which has been in the liquid alt game since 2008 and launched its newest fund last year. "They can't be. They have to be more liquid. The concept with liquid alternatives is to bring some of the return characteristics and the portfolio diversification benefits that hedge funds can deliver in a package that everyone can own."

Nadia Papagiannis, director of alternative-investment strategies and third-party distribution at GSAM, says two distinct issues confront investors as they shop the liquid alt market. "You have long-only managers getting into alts, but they don't have the tools, they don't have the experience shorting and how to measure risk," she explains. "The other problem is that you have hedge fund managers launching products that are watered down or diluted, so you are not getting a good proxy for what their flagship fund offers."

To some observers the restrictions that govern mutual funds represent significant drags on liquid alts, making them perform more like other mutual funds than like hedge funds. That makes liquid alts look less like a bargain and more like an expensive mutual fund with questionable added benefits.

"There is just nothing there that should appeal to the mom-and-pop investor," says Barry Ritholtz, chairman and chief investment officer of Ritholtz Wealth Management in New York and a financial blogger whose commentary is widely followed. Ritholtz says liquid alts have a history of mediocre performance despite charging higher fees than mutual funds. "What is it about overpaying for fees and getting underperformance that anyone thinks appeals to the common man?" he says. "There is nothing appealing there other than the illusion of access."

Even some investment advisers who have placed client money with liquid alt mutual funds lament the difficulty in finding enough appealing offerings. Jeffrey Buck, a principal at Diversified Trust Co. in Atlanta, which advises high-net-worth individuals, says his firm has looked into hundreds of liquid alt mutual funds and found only one so far that it feels is suitable for its clients: the Whitebox Tactical Opportunities Fund, run by Andrew Redleaf's Minneapolis-based Whitebox Advisors. The fund, an opportunistic investment vehicle that moves among different asset classes and markets and uses the same investment managers who run its hedge fund strategies, rose 15.41 percent in 2013. It manages about $435 million in assets.

"There has been so much launched in this space in the past two years, but it is still slim pickings," Buck says. "We would agree that there is not a lot that is appealing within this alternative space."

Despite the generally lackluster results for liquid alt mutual funds, a growing segment of the retail investment world has been steadily adding money to the sector. William Hayes, a principal at Charles Carroll Financial Partners in Annandale, Virginia, says he started shopping for liquid alts a few years ago to help add balance to his clients' largely long-only equity portfolios. Today three quarters of his clients have liquid alts in their portfolios and those liquid alts make up 15 to 20 percent of individual accounts.

"The opportunity in liquid alts is outstanding," Hayes says. "The products have evolved to the point where I find them to be excellent opportunities for clients to participate in actively managed positions that can reduce risk in the marketplace at any time."

His first liquid alt, the Virtus Dynamic AlphaSector Fund, is run by F-Squared Investments, a quant shop based in Wellesley, Massachusetts, that operates primarily as a subadviser to other funds. F-Squared took over management of the Virtus fund in 2012. At the time, the fund managed about $15 million. Today it is one of the fastest-growing liquid alts, with $2.3 billion in assets. Part of its success in attracting new investors stems from the stellar returns it posted in 2013: It ended the year up 36 percent, outpacing the S&P 500, which rose 32 percent.

Characterized as a long-short equity mutual fund, the Virtus fund invests primarily through sector exchange-traded funds, using algorithms to help track trends and volatility. The goal is to capture and exploit trends without being harnessed to market movements and thus provide an alternative to the long-equity bias in most individual client portfolios — an alternative to bonds and bond funds.

"People are saying you cannot rely on bonds anymore," says James Celico, head of institutional and alternative investments at F-Squared. "That is fueling a lot of the move toward liquid alternatives: a desire to find some noncorrelated returns.” Liquidity requirements and restrictions on concentration and leverage make some hedge fund strategies difficult to duplicate. That challenge is reflected in Morningstar data indicating that liquid alt mutual fund assets remain concentrated primarily in a few strategies, with the largest chunk held in nontraditional bond funds and long-short equity funds (see table on page 45).

Lausanne, Switzerland–based fund-of-funds specialist Gottex Fund Management spent 18 months researching the field before moving forward. “Equity long-short funds, macro funds, some credit strategies, commodity trading advisers — those are hedge fund strategies that in our research we found do not generally give up returns by adding liquidity,” says William Landes, CIO of the multiasset business at Gottex. “On the other hand, there is difficulty in finding liquid options in distressed credit, mortgage-backed arbitrage — things that have less liquid core markets underneath.”

The Gottex Endowment Strategy Fund, launched at the end of 2013, draws its inspiration from endowment portfolios. It pursues a macro strategy, using a combination of its in-house investment managers and outside managers. The fund has $33 million in assets.

Another well-known fund-of-funds company that has entered the liquid alt fray is Morgan Creek Capital Management. The Chapel Hill, North Carolina, firm launched the Morgan Creek Tactical Allocation Fund last August and has seen it grow to about $50 million in assets. Morgan Creek CEO and CIO Mark Yusko serves as portfolio manager of the new fund, which invests globally through a variety of strategies, including long-short equity, fixed income, currencies and commodities. “I think the 40 Act opportunity is a huge growth business,” Yusko says. “I think you will see us grow the Tactical Allocation Fund into a multibillion-dollar fund. You will see us launch additional 40 Act funds.” The Morgan Creek Tactical Allocation Fund rose 7.9 percent from its launch in August through the end of the year.

Winning over investors with newly launched liquid alts is not a simple matter, though. RIAs say they find it difficult to fully review and analyze these funds because most have such short track records. Although many liquid alt sponsors point to their histories running hedge fund strategies, investment advisers say those do not necessarily translate into being effective in a more liquid mutual fund environment.

Most new funds have to prove themselves before investors will place assets. The Whitebox fund, for example, launched in December 2011, finished 2012 with less than $30 million in assets. It finally got on the radar screens of investors last year, and its assets zoomed to $435 million. Even the new Blackstone liquid alt mutual fund, despite its swift rise in assets, was the result of more than three years of research and development. Whitebox recognized the challenge of raising assets from thousands of retail investors instead of the small group of accredited investors and institutions that make up a hedge fund capital base. The firm elected to market its fund independently, hiring a four-person sales and marketing team to handle its distribution. Some mutual fund firms and insurance companies that have entered the liquid alternative space have either acquired hedge fund companies to run their strategies or hired hedge funds as subadvisers to manage them.

"Everyone is asking, 'Do we build it?' 'Do we go the subadviser route? 'Do we buy it?'?" says Michael Coffey, head of mutual fund distribution at Whitebox. "We have committed to getting into the distribution business." The firm is now raising assets for its second liquid alt vehicle, the Whitebox Long Short Equity Fund, which it converted from a hedge fund.

Whereas Whitebox opted to build its own mutual fund distribution network, Franklin Templeton Investments of San Mateo, California, opted to marry its distribution capability with the expertise of a fund-of-funds firm, purchasing a majority stake in Stamford, Connecticut–based K2 Advisors. In November, Franklin launched a multimanager liquid alt fund, the Franklin K2 Alternative Strategies Fund, with the strategy run by K2. The fund has about $130 million in assets but is intended to be a billion-dollar vehicle. K2 co-founder William Douglass says that although his firm continues to offer its commingled funds, advisory services and customized fund-of-funds products to institutional investors, it also sees potential for institutions to invest in liquid alts. "We have institutions really interested in daily liquidity, daily NAV and single custodian," he adds.

Like Douglass, GSAM's Restieri hopes to see significant growth as investors continue to pour money into these new mutual funds. "We are at the very early stages of this part of the industry," he says. "The key to success is going to be delivering consistent alpha and returns. I don't know if we can call who the winners will be just yet."