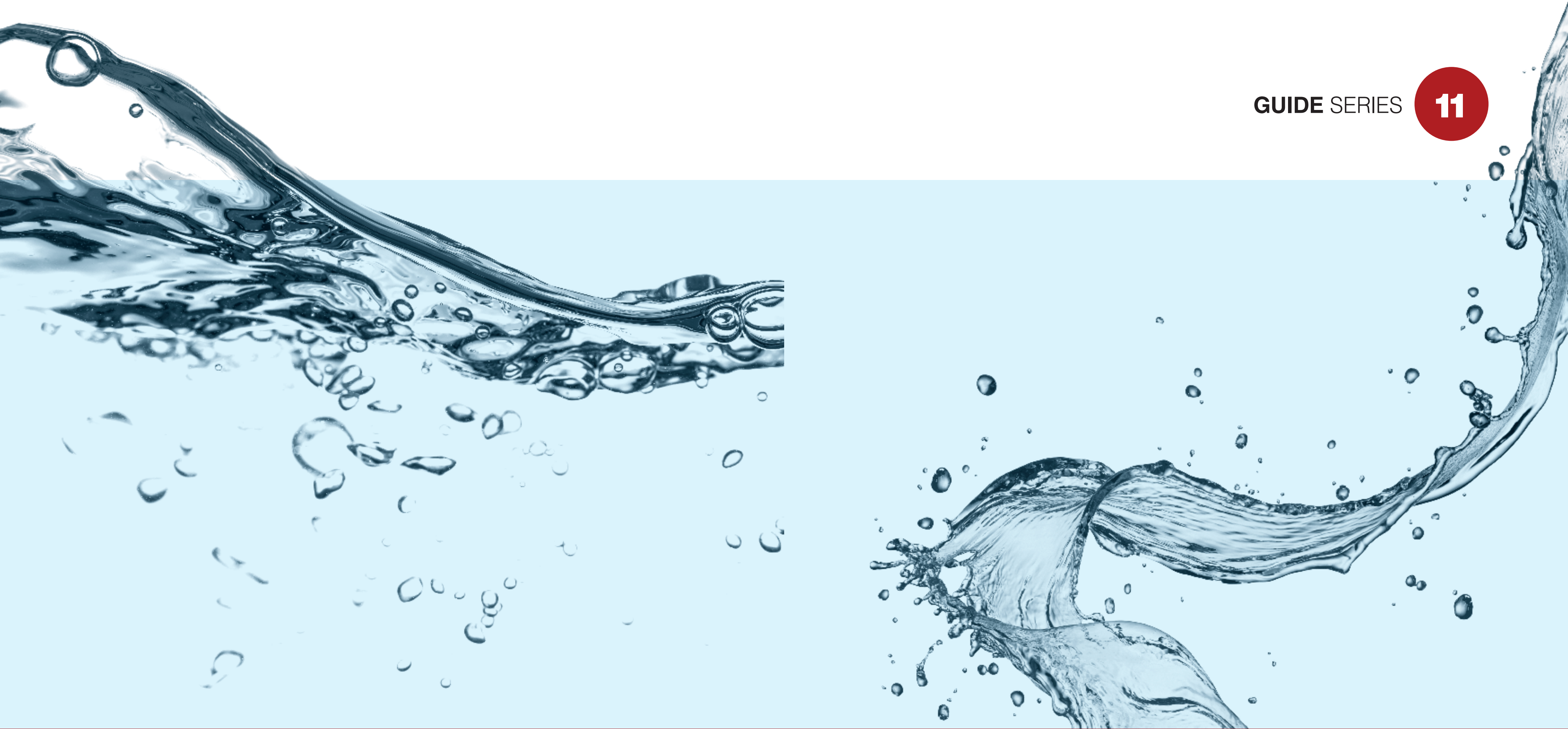

GUIDE SERIES 11

FINANCIAL STANDARD GUIDE TO

Liquid Alternatives

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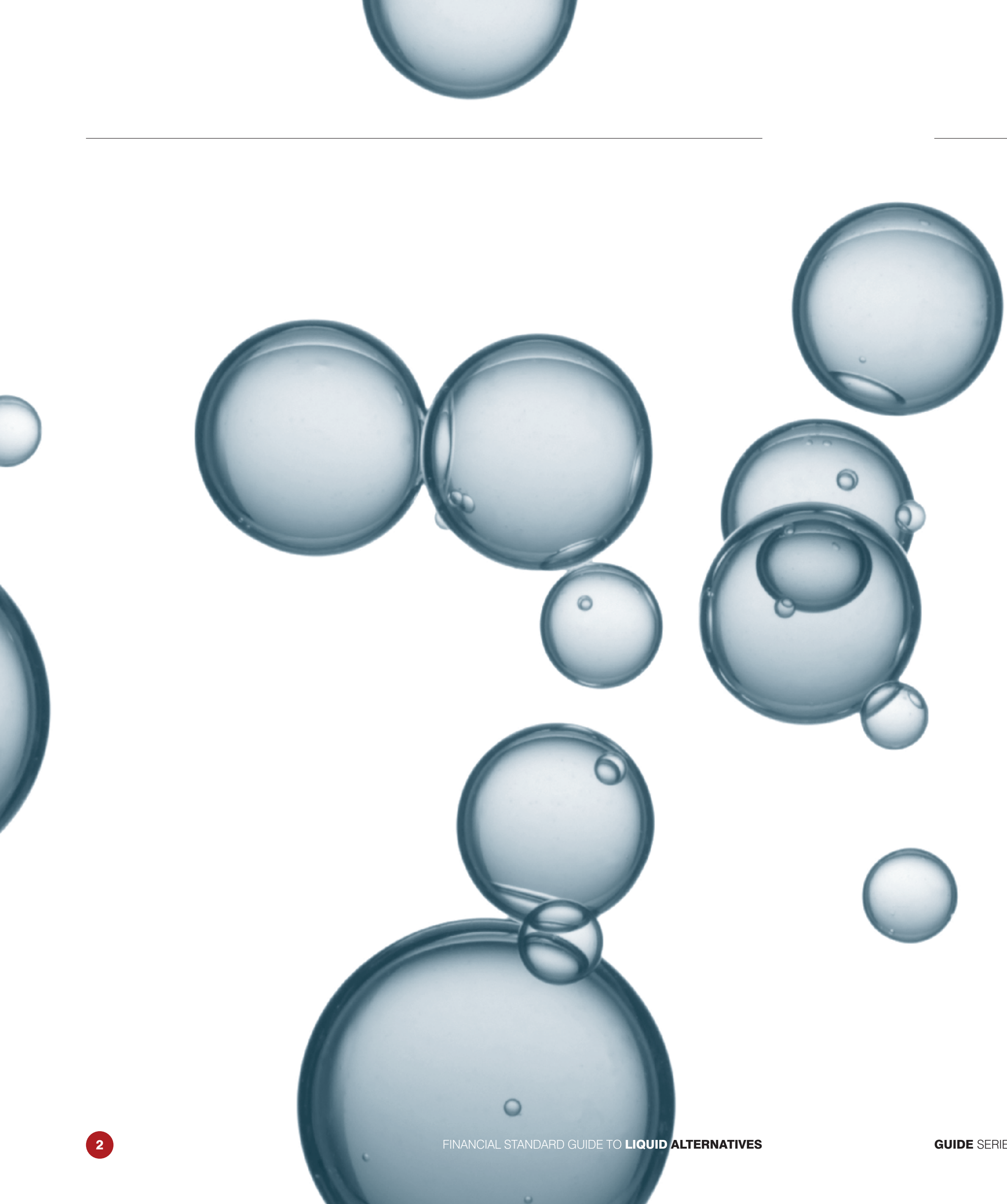


Introduction

Liquid alternatives are becoming an important part of the adviser's toolbox when considering how to deliver better, and more diversified, returns to clients. Offering all of the benefits of the wider alternatives universe with the added advantage of liquidity, these strategies are an effective means of enhancing an existing investment portfolio. In this guide, we explain what they are, how advisers can use them and what to consider when it comes time to choose your approach.

The main purpose of alternative investments is to provide new sources of return for a portfolio, while diversifying risk away from traditional assets.

Industry snapshot

Offering investors the potential for strong long-term returns, liquidity, and diversification benefits with low correlation to traditional asset classes, it's easy to see why alternatives are gaining significant traction in the Australian market.

Alternatives comprise a wide range of investments, including private equity, hedge funds, managed futures, forestry products and commodities – in fact, anything that isn't traditional shares, bonds or cash.

The main purpose of alternative investments is to provide new sources of return for a portfolio, while diversifying risk away from traditional assets. When shares and bonds fall, alternative investments can still rise.

Events such as the global and Asian financial crises, Brexit and the election of Donald Trump have all caused extreme equity market, and therefore, portfolio volatility.

These events have highlighted the importance of constructing well-diversified portfolios, and the increasingly valuable role non-traditional asset classes play in helping to potentially protect portfolios against losses during uncertain times.

Alternatives in Australia

The Australian superannuation industry currently has approximately $271 billion invested in alternatives, comprising private equity, infrastructure and other asset classes including hedge funds. This amounts to approximately 18 per cent of total investments.

Interestingly, this demand for alternatives has continued to grow exponentially, despite the attractive post-GFC returns from local and global equities.

This handbook provides a general guide on this particular segment of the alternatives universe – liquid alternatives.

Universe of alternatives

Alternatives are generally classified as investments with a low correlation to more traditional investments such as shares and bonds, and include a wide range of financial instruments and strategies.

Some of the more common alternative investments include hedge funds, managed futures, infrastructure, commodities, real estate investment funds and private equity.

The role of alternatives in client portfolios is generally the same, regardless of the actual asset class: they introduce new sources of return that can help to mitigate against losses and protect capital when traditional asset classes underperform.

One of the greatest misconceptions about liquid alternatives is that they're high-risk, when in fact, it's more appropriate to think of them as risk diversifiers.

What are liquid alternatives?

Liquid alternatives are a specific type of investment in the alternatives universe.

Their distinct characteristic is their "liquid" component, designed to provide investors the freedom to exit the investment whenever they want, rather than have their capital locked away for a set period of time.

Since the GFC, investors are more aware of the importance of capital preservation, downside protection and diversification – and liquid alternatives are attractive for their ability to help with all three of these areas.

They also are typically structured as managed funds, offering transparency and a higher level of governance than might be found in other types of alternative investments.

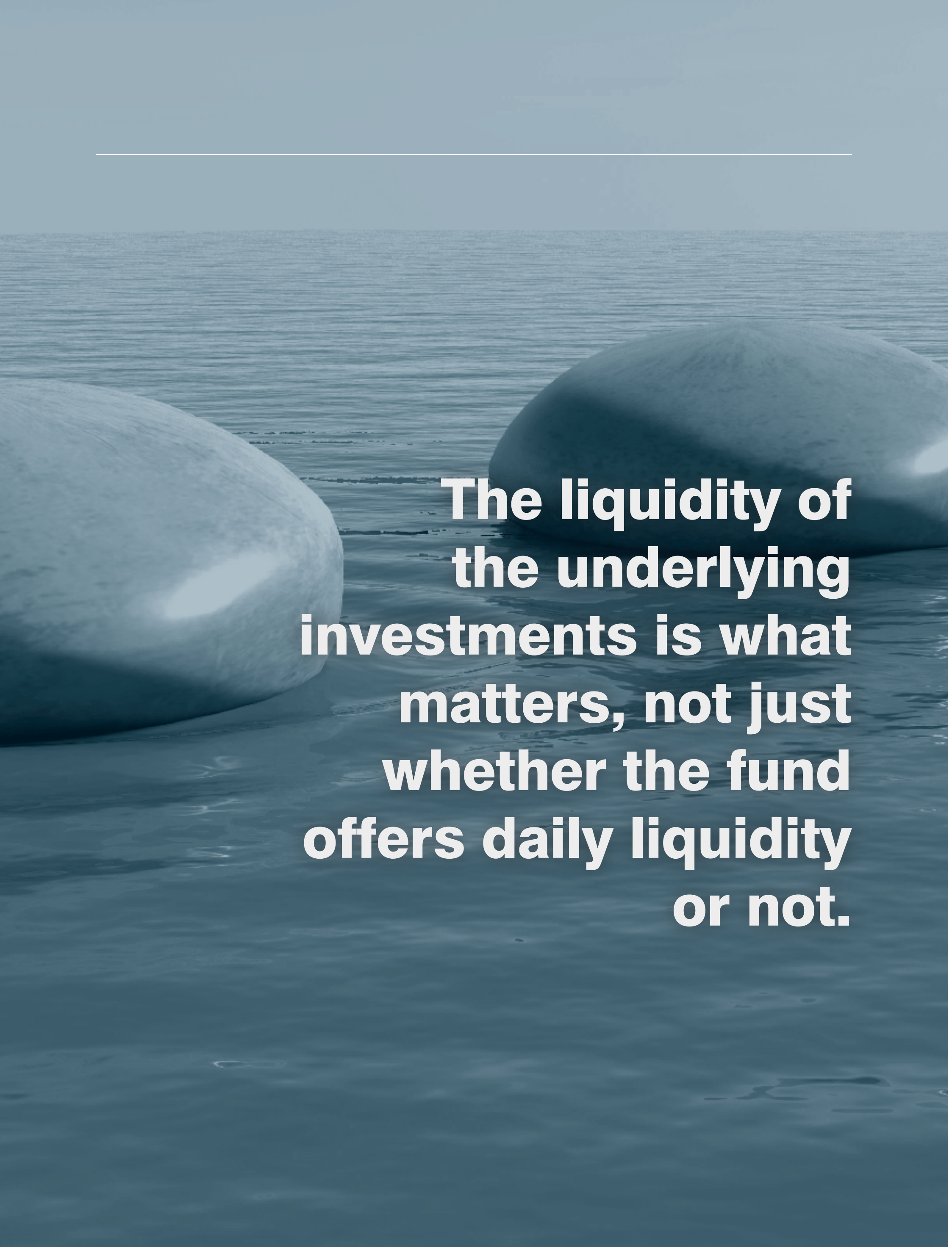
Liquid alternatives encompass different investments and strategies, such as managed futures, market neutral, multicurrency, multi-asset and long/short equity.

Beware the illiquidity trap

Advisers are increasingly recognising the importance of liquidity, and must remain aware of the real dangers of illiquidity traps.

For example, when UK voters opted to leave the European Union in 2016, seven substantial UK property managers, representing about $24 billion in assets, suspended their funds fearing they wouldn't be able to meet redemption requests.

Clients need to be educated about liquidity risk, as it's often assumed they will be able to exit their investments whenever they like.



Key benefits of liquid alternatives

As the above example and the GFC demonstrated, this isn't always possible, and highlights the need for allocations to truly liquid investments.

The liquidity of the underlying investments is what matters, not just whether the fund offers daily liquidity or not.

Liquid alternatives share many of the positive characteristics of other alternatives, but their key distinctive benefit is liquidity – that is, the ability of investors to redeem their investment on a daily basis.

Additional benefits include ability to:

- Enhance investors' portfolios. This is largely achieved through creating alternative return profiles by accessing investments that, either on a standalone basis or when combined, provide an 'alternative' return to that of traditional assets such as equities and bonds. Liquid alternatives also provide a broader mandate and access to more financial instruments, tools and strategies.

- Improve downside protection when compared to traditional long-only strategies. The ability of liquid alternatives to employ long/short strategies can enable downside protection.

- Increase diversification by providing lower correlation to traditional asset classes. Historical data has shown that adding liquid alternatives to a portfolio can help to optimise portfolios by offering higher risk-adjusted returns

- Improve risk-adjusted returns with lower volatility. Liquid alternatives can be used in portfolios for diversification purposes, as a hedge against traditional investment market downturns, and as a core investment to generate returns. Effective liquid alternatives, when combined with traditional investments, improve risk adjusted returns with lower volatility.

- Utilise flexible strategies: Depending on the strategy, liquid alternatives may apply leverage, actively trade derivatives, establish short positions, and hold relatively concentrated positions.

While liquid alternatives can be considered standalone investments, they can really shine when combined with traditional asset classes to improve returns and reduce portfolio risk over time.

Because of the range of strategies available, liquid alternatives can be tailored to suit individual clients' objectives and portfolios.

They can offer protection in a falling market, enhance diversification, reduce volatility, seek out alternative sources of alpha and reduce correlation with broader financial markets.

Long/short equity strategies, for example, are able to focus on capturing growth while simultaneously protecting against potential downturns through short selling. And managed futures strategies can profit from falling markets.

Portfolio construction strategies

Liquid alternatives seek to generate returns through using strategies that have a reduced correlation to broader financial markets.

Long/short investing aims to provide both upside market participation and downside protection. This is because a strategy implementing both long and short positions gives investors the opportunity to take advantage of both rising and falling markets. It also aims to manage market volatility more effectively compared with long-only strategies.

Managed futures strategies involve the active trading of futures and forward contracts on physical commodities, financial assets and foreign exchange. They have historically provided diversification to a traditional portfolio of stocks and bonds, especially during prolonged market falls.

Market-neutral strategies seek to provide limited equity beta by taking equal long and short positions, thereby isolating the alpha component of an equity strategy.

Multi-alternative strategies seek attractive risk-adjusted returns with modest volatility and limited downside potential by allocating across a broad range of absolute-return oriented strategies.

Global macro strategies involve managers that research the global economic landscape and seek to profit from macroeconomic pricing imbalances or geopolitical events. They are generally considered higher returning while more complex and may use a multi-portfolio manager approach.

Managing downside risk once retired can be approached through an allocation to liquid alternatives.

Accumulation versus retirement

How assets are managed in the retirement phase presents different challenges to how they are managed during the accumulation phase. A key challenge is that retirees are usually unable to rebuild their wealth once they start selling their assets or drawing an income to fund their lifestyle. This means their risk threshold is reduced and their investment strategies need to reflect this.

During the accumulation stage, investors have more access to funds through employment and can take advantage of market volatility by buying more investments when prices fall. But once retired, when prices fall, assets are unable to be replaced.

Managing downside risk once retired can be approached through an allocation to liquid alternatives, which can also help reduce volatility while generating returns and preserving capital.

Dispelling the myths

While liquid alternatives are gaining more appeal, misconceptions still exist. Below we distinguish the facts from the fiction.

Myth 1: Liquid alternatives are more volatile than a portfolio of stocks and bonds

While some alternative investments have the potential to be more volatile than stocks, generally they are not and in some cases they can display significantly less volatility depending on management style or the type of market in which they are trading.

In fact, as alternatives often use a range of different strategies and asset classes, they can produce returns that have low correlations to more traditional portfolios involving shares and bonds. Therefore, the impact of adding alternatives to such a portfolio can be to lower overall volatility without an offsetting reduction in return.

And with liquid alternatives offering daily liquidity, investors have the added benefit of knowing they can generally exit their investment at the time of their choosing.

Myth 2: Liquid alternatives are unique asset classes

It's very easy to fall into this simplistic categorisation of liquid alternatives. The truth is that they are alternative approaches of investing into many existing asset classes.

Myth 3: Investing in one alternative will diversify my portfolio

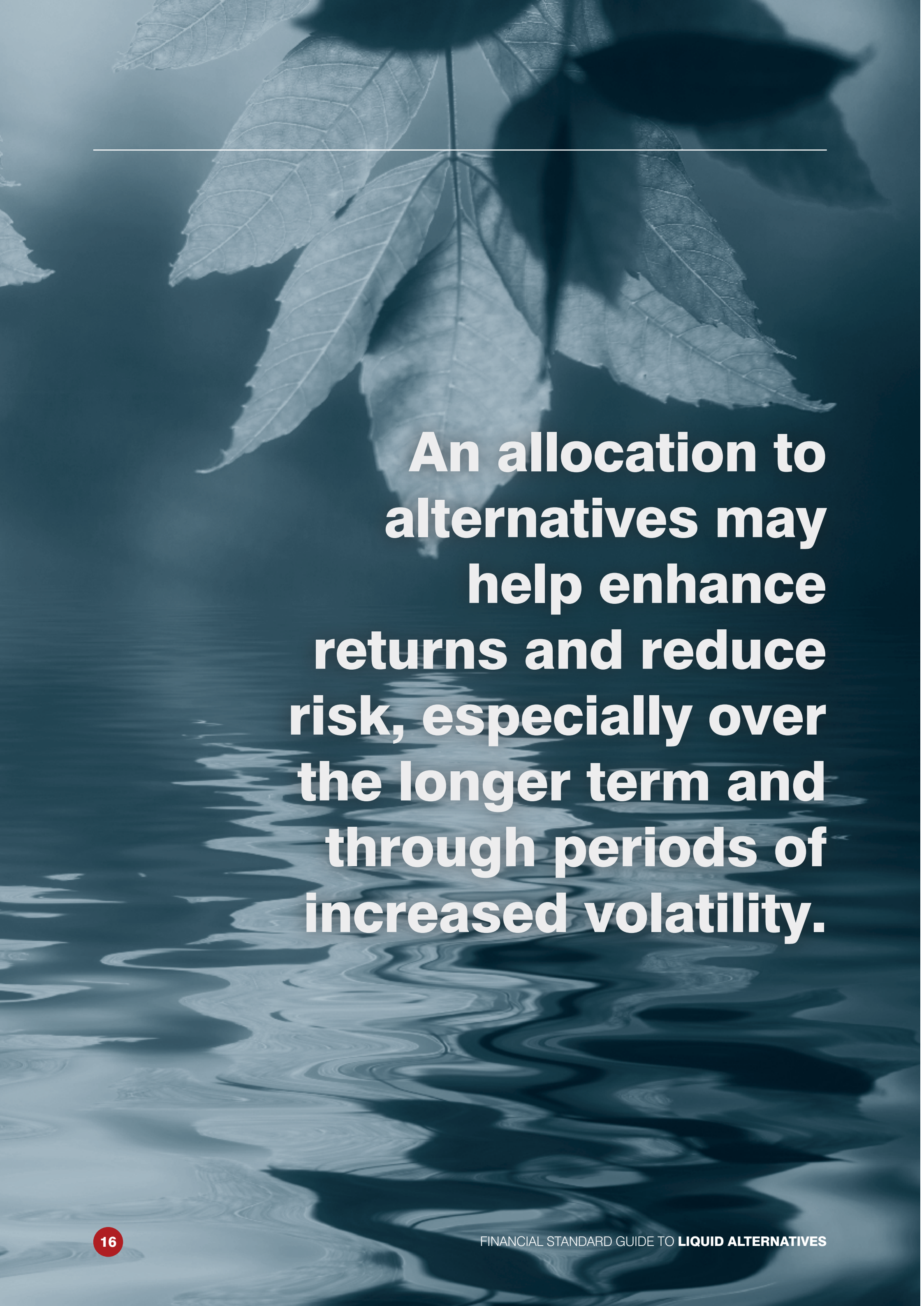
Investing in only one alternative strategy can offer investors significant diversification benefits, but depending on the strategy it may also have the danger of concentrating other risks. Alternatives can be very different from each other and hence this depends on which particular alternative strategy is involved.

A strategy that includes a number of funds that offer access to a broad range of alternatives can increase diversification. But importantly each alternative strategy should be carefully selected on its merits before inclusion.

There are two ways that investors can build their allocation of alternative investments. They can either invest themselves by selecting individual managers, or use a multi-strategy fund where a professional manager builds and runs the fund. While it is easy for investors to opt for the latter, there is a cost that needs to be taken into consideration.

Myth 4: Investors cannot access their money if they invest in liquid alternatives

Liquidity levels vary across different types of investments, whether they are traditional or alternative. The distinction here is to ensure that financial advisers and their clients select 'liquid alternatives' if they want the convenience of exiting their investment whenever they want.



An allocation to alternatives may help enhance returns and reduce risk, especially over the longer term and through periods of increased volatility.

Myth 5: Only institutional investors and ultra-high-net worth individuals can access liquid alternatives

In the past institutional investors tended to be the main users of alternatives – largely because of the costs and expertise involved - but this is changing, a situation largely attributable to greater innovation around product design.

This greater innovation has resulted in a wide range of options becoming available to retail investors, offering a range of different investment strategies to suit different needs and goals.

Individual investors have greater access to liquid alternatives than ever before.

Myth 6: Many alternatives failed to protect investors during financial crises

The alternatives universe by definition is very diverse. Anything that is not a traditional equity or bond portfolio is an alternative. Hence manager and strategy selection is very important in this space.

Some alternative investments failed during the 2008 financial crisis, in particular those using excessive leverage or exposed to structure credit products.

However other alternatives performed strongly and protected portfolios during the 2008 financial crisis, for example some managed futures funds. This was because managed futures strategies were able to profit through the market declines of this period.

Therefore an allocation to alternatives may help enhance returns and reduce risk, especially over the longer term and through periods of increased volatility.

Myth 7: Alternatives are too expensive

Fees for alternatives vary widely, just like they do for any traditional investment product. Fees for alternatives tend to be higher than traditional investments.

The higher fees are attributed to the fact alternatives often involve more sophisticated approaches, increased regulatory demands, and offer potential returns that are uncorrelated than traditional investments.

Fees can include management as well as performance fees – although managers are generally only compensated on the performance component when they exceed a specified hurdle. It's very important for investors to understand the fee structure of these investments and why they are set at the levels they are.

Fees for alternatives vary widely, just like they do for any traditional investment product.

Fees for alternatives vary widely, just as they do for any traditional investment product. One of the reasons for the variation is how the different investments are and how they are structured.

Fees generally include management and performance fees. The management fee is generally between 0.5 per cent and 2 per cent of funds under management. They are charged to cover the operating costs of the manager and are usually paid monthly or quarterly. Managing alternative investments, such as hedge funds, is complex, so a higher fee reflects the higher complexity involved.

Often the fee includes a performance fee if the manager meets a specified target, such as delivering returns in excess of a benchmark. This can be 10 per cent to 20 per cent of the investment return. While high, a performance fee can help align the interests of the managers and the investors. If the performance target or "hurdle" isn't met, the fee isn't charged.

There are various forms of protection for investors around performance fees. For example, many hedge funds have a "high watermark". A high watermark means if the investment, such as the hedge fund, drops in value, investors do not pay the performance fee again until the fund's value reaches its previous peak value.

While a higher fee can be justified by the additional return offered, this isn't always the case. Therefore it's important for advisers to discuss the strategy behind alternatives and how they can benefit a client's portfolio. An explanation of the manager's fee compared to the value created is also important, arguably the primary focus should be on returns after fees as this is what the client gets

Good quality strategies can be subject to "capacity" constraints, that means that there is a limit to the amount of funds the can be managed under the strategy before the ability to generate returns is impaired. In such cases the manager may be able to command a higher fee.

The cost of alternatives has risen since the GFC as managers invest in people and technology to enable them to comply with new regulatory requirements and increased regulatory demands.

Other fees that may be applicable include an establishment fee, switching or withdrawal fee, and administration fee.

There are various forms of protection for investors around performance fees.

Legal, compliance and tax considerations

The world of alternatives offers more complexity than traditional investments. Therefore it's important to choose established managers who have strong track records in compliance and legal matters. Fund manager selection is a compliance and risk issue for advisers, and if they get it wrong, it can be problematic.

Outsourcing the selection of alternatives to a fund manager means advisers can focus on adding value to other parts of the client experience.

With alternatives, it's not just about accessing funds with the best historic performance, it's also about understanding the objectives of the investment and finding funds that best suit investors' goals and risk profiles.

This challenge is why alternative investments undergo due diligence that is deeper and longer lasting than it has ever been previously. Advisers need to carefully consider how different funds and strategies provide varying characteristics, benefits and risk and reward profiles.

One area to look out for is managers who have prepared compliance plans for their funds that have been lodged with ASIC. Such plans generally set up the compliance procedures that are followed to ensure the fund complies with the Corporations Act and the fund's constitution.

The tax consequences around alternative investments are a key consideration for individual investors. For example, investors who hold managed funds may find their assessable income includes some net capital gains. They may also be liable for capital gains tax arising from the sale of assets. This is where finding product providers that have the scale and the resources to assess this component of the investment process can make a big difference.

The legal and compliance issues highlight the importance for advisers to consider well-resourced fund managers with the scale and resources to help deliver results, or those who can assist in choosing the appropriate managers for their needs.

The legal and compliance issues highlight the importance for advisers to consider well-resourced fund managers with the scale and resources to help deliver results.

Case Study

WLM Financial director Matthew Walker is something of a champion for liquid alternatives. He believes that following the GFC, advisers have been reconsidering how they manage risk for clients, and now that markets are beginning to look expensive, "they're questioning whether or not the returns are going to be available from traditional asset classes."

Walker's alternatives allocations stem from WLM's goals-based advice approach, where advisers target a specific outcome relative to a client's specific financial needs.

"In order to do that," he continues, "you need to have a very broad mindset around what you can invest into. And alternatives clearly come to the fore in that regard, because if you don't believe you're going to get the return from the share market, you've got these other boxes you can look at."

Walker sees the rise of goals-based advice as being directly responsible for the increase in uptake of liquid alternative strategies for retail investors. He's noted major wealth management groups like CBA and NAB, along with smaller self-licensed firms, ramping up their goals-based advice services, "and alternatives are becoming a big part of that conversation."

Of course, in order to use liquid alternatives as a means of delivering predetermined outcomes, Walker thinks you need to know what you're doing.

"It's not a meaningful value-add if they're not doing anything," he says. "There are a lot of products out there that have done zero to cash and that adds no value to anyone's portfolio, especially given the fees.

"But overall, people are happy to pay the fee if they see how these strategies can deliver much better (diversified) returns. You definitely need to talk your client through that idea, because the dumbing-down of risk on the back of the GFC is not actually helping to provide a viable solution going forward."

Gain an investment edge

DIVERSIFY WITH LIQUID ALTERNATIVES

At Macquarie Investment Management, we are committed to delivering relevant and differentiated investment solutions that give your clients an investment edge.

That's why we have built a comprehensive suite of liquid alternatives strategies – to meet growing demand for solutions offering the potential for strong long-term returns, daily liquidity and diversification benefits with low correlation to traditional asset classes such as equities and bonds.

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Macquarie Professional Series searches the world to uncover differentiated investment solutions, enabling local investors to access strategies from world-class fund managers. We leverage our insights from the local investment landscape, seeking to anticipate investment needs and identify relevant opportunities currently overlooked in the market.

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- Specialist investment strategy: access Winton's scientific approach to investing
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- Potential long-term absolute returns: low correlation to equities, bonds and other alternative strategies

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- Global FX exposure: aims to capitalise on macroeconomic and financial factors through foreign exchange markets
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- Potential for long-term absolute returns: low correlation to equities, bonds, and other alternative strategies

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Glossary

Absolute return
Where the source of the investment's return is not connected to traditional investments. The aim is to offer positive returns whether share or bond markets rise or fall.

Alternatives
Investments that have a low or negative correlation to the broader share and bond markets. Some of the most common include hedge and absolute return funds, managed futures, commodities, private equity, infrastructure and property.

Alpha
A positive alpha is a measure of how much a fund has outperformed its benchmark while a negative alpha is a measure of how much a fund has underperformed.

Correlation
If two investments move up and down at the same time, they are said to be correlated. Two investments that move with no relation to each other are said to be uncorrelated. Two investments that move in opposite directions are said to be negatively correlated.

Derivatives
Contracts between two or more parties, whose value is derived from the underlying asset of the contract, for example, shares, bonds or commodities.

Hedge funds
A fund that uses a number of different hedging or leveraging techniques to manage and grow its value.

Leverage
A way of increasing exposure and enhancing returns through the use of borrowed capital. With liquid alternatives, this is achieved through derivatives.

Liquid alternatives
Alternative investments that offer daily liquidity. The most common vehicles include managed funds or ETFs.

Liquidity
The ease with which an investment can be redeemed without an impact on its price.

Long/short investing:
A strategy that takes both long and short positions to generate additional returns as well as provide flexibility and downside protection to a portfolio.

Managed futures
The use of futures contracts to implement various types of investment strategies across many different asset classes to generate returns.

Private equity investments
Equity investments in private companies, which are alternatives to publicly listed companies.

Risk-adjusted returns
A way of measuring the value of a return in terms of the degree of risk taken.

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