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Liquid alternatives
: product attributes and demand

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Executive Summary

Highly liquid, highly transparent hedge fund strategies called liquid alternatives are gaining prevalence in the US and Europe. Given the need for ratings of individual managers' skills, wrap accounts may be the best way to popularize liquid alternatives in Japan.

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A stringently regulated form of hedge fund

Traditional hedge funds (HFs) that pursue absolute returns are privately offered to family offices and institutional investors such as pension funds. HFs are distinguished by the following characteristics.

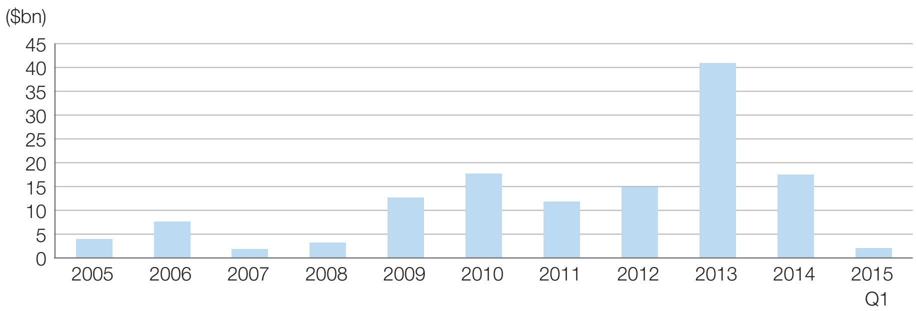
- Lenient investment restrictions: HFs use derivatives, short positions and leverage, enabling them to tactically reposition their portfolios, utilize diverse investment ideas, achieve greater scalability and, in turn, increase expected returns.
- Restrictions on solicitations, sales and redemptions: HFs are closed to ordinary retail investors and impose redemption restrictions[1] even on institutional investors to ensure stable capital. These restrictions enable HFs to maintain positions even during market turbulence and amass AUM (assets under management) under favorable terms.
- Performance-based compensation: HFs charge investors a fixed management fee (e.g., 2% of NAV per year) plus a percentage of returns (e.g., 20% of annual returns in excess of a high-water mark[2]).

NOTE

1) Such restrictions include lockup clauses and gate provisions (which limit withdrawals from a fund even during redemption periods) imposed at the fund or investor level

2) A high-water mark is a fund's peak NAV from inception to date. A hedge fund can charge performance fees when its most recent NAV is above its high-water mark.

Exhibit 1. US liquid alternative funds' net inflows



Note: Estimated net inflows in the "alternative" category of US open-end mutual funds. Values are in billions of dollars. Data for 2015 are through March (not annualized).
Source: NRI, based on Morningstar Direct data

- Lenient disclosure and reporting requirements: To protect their investment strategies from replication by others, HFs do not actively disclose their portfolio holdings or positioning.

In recent years, a category of investment products called liquid alternatives has seen continuous asset inflows in the US and Europe[3] (Exhibit 1). Liquid alternatives offer investors exposure to non-long-only investment strategies and/or asset classes (alternative investments). They are also highly liquid for investors in terms of both entry and exit. Liquid alternatives are often structured as mutual funds, ETFs or UCITS funds. Many of them employ investment strategies offered by hedge funds (e.g., long-short).

3) Providers of liquid alternatives include not only traditional hedge fund managers but long-only managers also.

Liquid alternative funds are structured to comply with various restrictions that do not apply to traditional HFs. For example, liquid alternatives in the form of mutual funds organized under the US Investment Company Act 1940 are required to calculate daily NAVs, provide daily redemption liquidity, and post 100% margin against short positions. They are subject to a leverage limitation of 33% and cannot invest more than 15% of their assets in securities that cannot be liquidated within one business day. They cannot charge performance-based fees, only fixed-rate management fees. They are also subject to external audits and various disclosure requirements. In sum, liquid alternatives are subject to substantially stricter regulations than traditional HFs.

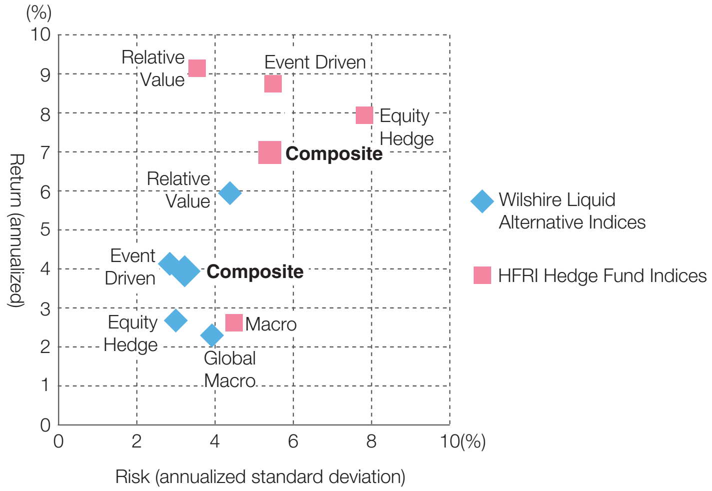
Marketability and performance drag

Some investment strategies used by private HFs cannot feasibly be offered in the form of liquid alternatives. For example, to provide daily redemption liquidity, liquid alternatives must limit their investments to liquid markets and be able to unwind individual investment strategies at any time. They are consequently not suitable for investing in distressed securities or employing certain event-driven strategies that require positions to be held for a certain timeframe.

Comparison of liquid alternative fund indices and HF indices reveals that liquid alternatives are lower-risk, lower-return vehicles than private HFs across nearly all investment strategies (Exhibit 2[4]). This difference may be attributable to investment restrictions, although we cannot be sure because HF indices are not very representative of individual funds. HFs' putative advantage over publicly offered funds is that their lenient restrictions allow fund managers to capture higher returns by giving free rein to their rare skills or unique investment ideas. The fundamental distinction

4) Wilshire Liquid Alternative Indices are NAV-weighted indices (subject to a weighting cap) of liquid alternative mutual funds regulated under the Investment Company Act of 1940 that have a track record of at least six months. HFRI indices are equal-weighted indices. All of the indices track returns net of fees.

Exhibit 2. Performance comparison against traditional HF indices



Note : Based on (USD-denominated) monthly returns (net of fees) from January 2009 through March 2015.
Source: NRI, based on Wilshire Associates and HFRI data

between liquid alternatives and HFs is that the former offer liquidity and transparency in exchange for forgoing some of the freedom afforded to the latter. The performance sacrificed to ensure liquidity is called a performance drag. Liquid alternatives are thus somewhat at odds with the image of traditional HFs.

Is there demand for liquid alternatives even among Japanese retail investors?

Liquid alternatives' minimum investment thresholds are comparable to those of funds that invest in traditional asset classes. Additionally, liquid alternatives typically charge fees of around 1% of NAV, less than HF fees. By virtue of such, assets have been flowing into liquid alternatives in the US, driven largely by investment advisors' recommendations. Liquid alternatives are called "hedge funds for the masses" because they have made HF strategies accessible to retail investors to which such strategies were previously off-limits. In this sense, HFs have started to make inroads into retail investors portfolios also.

Do such funds meet Japanese individuals' wealth-building objectives also? Liquid alternatives' focus on absolute returns would likely be appealing to Japanese investors concerned about over-exuberance in the markets. Additionally, with even retail investors now able to build low-cost beta portfolios with ETFs and other such products, there is presumably latent demand for liquid alternatives that offer a new source of returns in the form of fund managers' skill.

It bears noting, however, that in the case of HF products, manager selection is even more important than strategy selection (manager lineup). Unlike stocks and bonds, which can be counted on to offer positive risk premia as long as capital markets are functioning efficiently, HFs cannot be counted on to deliver meaningful returns unless their managers possess sufficient portfolio management skills. However, it is difficult for retail investors to select fund managers. Without manager ratings and recommendations like those provided by US investment advisors, liquid alternative funds may have difficulty gathering assets from individuals. In this sense, conditions in Japan are not yet ripe for retail investors to embrace such products. Liquid alternative funds would likely have more success gathering assets through wrap account products or funds of funds in Japan.

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