

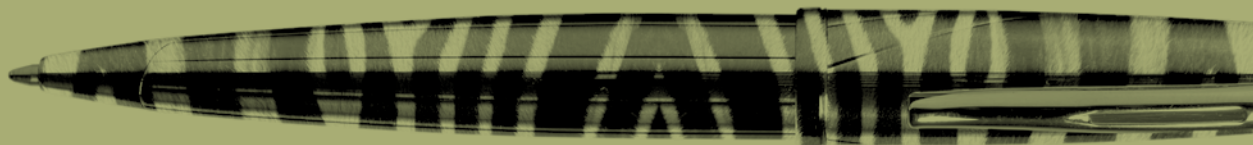


## Exotic to Mainstream

Growth of Alternative Mutual Funds in the U.S. and Europe

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## Introduction

The trend of packaging alternative strategies in U.S. mutual fund and European UCITS formats is quickly gaining steam. Indeed, in the U.S., 2009 marked a watershed year for alternative mutual fund growth. But competing in an emerging fund category is challenging, and those wishing to succeed in the alternative mutual fund space will need to clear some hurdles while heeding the lessons of the past.



## Executive Summary

The financial crisis caused investors to reconsider several fundamental investment tenets – with some even questioning the legitimacy of modern portfolio theory and its diversification underpinning. Nonetheless, respected investment strategists have concluded that diversification remains a valid approach although it has become more difficult to achieve and warrants incorporation of a broader set of risk exposures and asset classes, both long and short, in investor portfolios. Against this backdrop and in light of a restless, empowered investor base facing fund sponsors, the SEI Knowledge Partnership joined forces with Strategic Insight to evaluate the opportunity and challenges associated with launching and distributing alternative investment strategies in a mutual fund format in the United States and in Europe.

# Key Findings

**EVOLVING INVESTOR DEMAND IS DRIVING CONVERGENCE OF TRADITIONAL AND ALTERNATIVE INVESTMENT PRODUCTS IN THE UNITED STATES AND EUROPE.** Due to a combination of bruising market losses, high-correlation among asset classes, unexpected illiquidity and epic scandals, the investment management industry faces a restless, empowered investor base. In this *Era of the Investor<sup>SM</sup>* power has shifted from investment managers to investors and their advisors. In addition to a focus on transparency and liquidity, retail investors and their advisors as well as smaller institutional investors have become more focused on absolute returns and investment strategies uncorrelated with long-only equity and bond indices. They also are increasingly open to sophisticated asset allocation strategies. These trends are accelerating the demand for products that combine access to non-correlated strategies and asset classes with the liquidity and transparency of registered investment products.

**THE TREND TOWARD “MAINSTREAM ALTERNATIVES” HOLDS SUBSTANTIAL APPEAL FOR INVESTMENT MANAGERS.** For alternative managers facing a predominantly institutional investor base, offering their strategies in a mutual fund structure opens up a substantially broader market opportunity. Meanwhile, traditional managers see an opportunity for increased fund flows, potentially higher margin products, and revenue diversification.

**ALTERNATIVE MUTUAL FUNDS AND UCITS ARE ATTRACTING SIGNIFICANT FLOWS.** In 2009, investors poured more than \$110 billion into alternative mutual funds, with the largest flows going into long/short, market-neutral, commodity, and currency funds.

- Approximately two-thirds of these net new flows (\$75 billion) went into alternative-style U.S. mutual funds and ETFs, and one-third (\$35 billion) into European mutual funds (UCITS) and ETFs.
- 2009 marked a watershed year for U.S. alternative mutual funds, which attracted record net inflows of \$25 billion.

- Nearly 5% of U.S. retail alternative mutual funds and ETFs had net inflows of \$1 billion or more in 2009; in contrast, approximately 3% of all traditional long-term U.S. mutual funds and ETFs had inflows exceeding \$1 billion.

**WHAT'S THE SIZE OF THE OPPORTUNITY?** It's difficult to precisely measure it, but the potential may be significant as evidenced by the fact intermediaries are modifying their model portfolios and recommended lists to accommodate alternatives – typically at the expense of the equity portion of the portfolios. While there is no universally accepted definition of alternatives, the allocation to “alternatives” typically ranges from 3% to 30% – depending on the firm's definition of alternatives and an investor's risk tolerance, investment horizon, and other factors. Additional growth is likely to come from allocations to alternative strategies in customized target-date funds.

**A DIVERSE GROUP OF STRATEGIES AND MANAGERS ARE ALREADY EXPERIENCING SUCCESS WITH THESE PRODUCTS IN THE U.S. AND EUROPE.** Successful strategies include long/short, pair trades, global tactical asset allocation, volatility arbitrage and managed futures. Sponsors are geographically dispersed across the United Kingdom, France, Sweden, Switzerland and the U.S. Some of the successful products include:

- Europe – FAST (Fidelity Active Strategy), SEB Asset Selection, Blackrock UK Absolute Alpha, Amundi Dynarbitrage Volatility, Dexia Index Arbitrage.
- US – Hussman Strategic Growth, PIMCO Commodity Real Return, Rydex SGI Managed Futures, AQR Diversified Arbitrage, Putnam Absolute Return Series, Turner Spectrum Fund.
- Europe and U.S. – JPM Highbridge Statistical Market Neutral.

**MANAGERS ENTERING THIS SPACE MUST ADDRESS SEVERAL CONSIDERATIONS.** Firms must initially determine whether offering an alternative mutual fund fits their branding and long-term strategy. In addition, there are several other factors to consider:

- **Filling skill and expertise gaps** – Traditional managers may lack the requisite investment expertise such as shorting skills, and their choices are to acquire those skills (i.e., buy an alternative manager or lift-out a team), seed products and build expertise with existing personnel, or outsource this capability by hiring a sub-adviser. Alternative firms, on the other hand, frequently have limited experience with retail distribution or the level of regulatory scrutiny associated with registered products.
- **Regulatory considerations** – The threshold consideration for managers is whether the strategy fits within the relevant regulatory construct. Among other requirements, funds must satisfy certain liquidity, diversification, leverage, and tax requirements. For firms managing similar strategies in both hedge fund and retail fund formats, infrastructure must be put in place to avoid potential conflicts of interest.
- **Operational considerations** – The operational complexities may include the use of a prime broker for shorting (perhaps multiple prime brokers), which increases the number of position and income reconciliations and requires managing additional cash balances.
- **Distribution considerations** – In an environment characterized by product rationalization, any new product launch is subject to significant hurdles. The distribution challenges in this case include lack of a track record although centralized research groups are willing to consider composite performance when selecting funds for inclusion in model portfolios and recommended lists. A significant hurdle is education of the manager's sales force as well as advisors and investors – in particular, how these products may perform in various market conditions. In this regard, the managers should heed lessons from the European absolute return fund boom and bust cycle and the 130/30 dud in the U.S. earlier this decade.

**KEY SUCCESS FACTORS.** Key success factors include having an educated sales force and the infrastructure necessary to effectively support advisor and investor education (e.g., thought leadership content, advisor-dedicated micro-site, etc.). Firms also should position their strategies first as diversification tools and second as alpha generators as investors primarily utilize alternative strategies for diversification purposes. And for firms without preexisting distribution relationships to leverage, focusing on independent registered investment advisors, many of whom pride themselves on portfolio construction and the ability to pick undiscovered gems, may make the most sense – particularly given the minimum fund size screen of at least \$50 million imposed by several intermediaries. Traditional firms, leveraging their existing distribution relationships and advisor support infrastructure, have had the most success to date.

**IMPORTANT CAVEATS.** First, not all strategies fit within a registered fund format. Second, the U.S. Securities and Exchange Commission (SEC) is reviewing the use of derivatives by U.S. mutual funds and ETFs. It's not clear how this review, if at all, will impact all mutual funds and ETFs that use derivatives, including alternative mutual funds and ETFs, but sponsors should be aware of the SEC's review.

**CONCLUSION.** Demand for alternative or non-correlated strategies in U.S. mutual fund and European UCITS formats is real as reflected by the net inflows into existing products, the growing accommodation for such strategies in the model portfolios and recommended lists of intermediaries, and investor demand for a broad set of diversification tools. Given their experience in educating investors and advisors and their pre-existing distributor relationships, traditional fund managers will continue to have the most success in the retail alternative fund business in the near term. As a result, alternative managers' best opportunity in the near term may be to sub-advise or partner with an existing retail manager. Such an approach can also be a win for traditional firms that may lack the requisite investment skill or expertise.

## Era of the Investor and Convergence

Whatever analogy is used to describe the market decline of 2008 – tsunami, meteor strike, meltdown – it caused investors to question long-held assumptions about their investments. While the markets generally have snapped back sharply and mutual fund and hedge fund flows have stabilized, the combination of bruising losses, illiquidity and epic scandals has empowered investors and given rise to a new *Era of the Investor*. In the *Era of the Investor*, investors are seeking to enhance transparency, improve returns and manage volatility by adding investments with low correlations to stocks and bonds. In addition, investors and their representatives increasingly dictate how they access a manager’s strategy, forcing managers to embrace flexible product packaging.

The effects of the *Era of the Investor* are already being felt with investors putting an impressive \$110 billion into alternative mutual funds in 2009. This includes \$75 billion going to U.S. mutual funds and ETFs registered under the Investment Company Act of 1940 (“40 Act”) and \$35 billion to European mutual funds or UCITS (Undertakings for the Collective Investment in Transferable Securities), including ETFs.

As detailed on page five, such meaningful asset flows are a signpost of a post-crisis environment marked by an accelerating convergence of institutional and retail

investment approaches, of traditional and alternative investment products, and of trends in the U.S. and Europe. Preferences for more transparency and liquidity have created a much greater opportunity for alternatives within well-regulated formats.

As noted, another aspect of the *Era of the Investor* is convergence from several perspectives.

### CONVERGENCE OF INSTITUTIONAL AND RETAIL.

While not quite ready to adopt institutional practices such as risk budgeting in a portfolio, financial advisors are more open to mixing beta exposure and alpha strategies. A blind adherence to style-box investing, chasing “hot dots,” and a single-minded emphasis on relative returns are out of favor in the retail space. Outcome-oriented investing, separating portfolios into core and satellite holdings, and building long-term solutions are in – paving the way for introduction of “alternative” sleeves, long the domain of institutional investors, in retail portfolios.

### CONVERGENCE OF TRADITIONAL AND ALTERNATIVE.

Individual portfolios are becoming more complex, shifting towards core-satellite construction – but what comprises the core or the satellite depends on the investor or the investor’s financial advisor. What is clear, however, is that those strategies offering



less correlation to stock and bond returns, including long/short, absolute return and commodities, are increasingly being included in retail portfolios alongside traditional strategies. Alternative investment managers have been launching retail funds to access a new large investor base, while traditional mutual fund managers have been wading into alternative products seeking additional fund flows, potential higher margins, and revenue diversification.

**CONVERGENCE OF U.S. AND EUROPEAN MARKET TRENDS.** The same trends are driving investor behavior in the U.S. and Europe. In the wake of

2008’s market plunge and the Madoff scandal, investors are focusing more on volatility, transparency, control, and liquidity. These factors have helped drive capital into “alternative” strategies compliant with the UCITS requirements in Europe and the ‘40 Act requirements in the U.S., as these provide regulated and well-known structures that evoke investor confidence (e.g., independent custody). Additionally, while the UCITS and ‘40 Act regimes differ, they are sufficiently similar to permit the exportation of strategies and competencies from one region to the other to serve complementary sets of investors.

**OPPORTUNITIES ARISING FROM CONVERGENCE**

Convergence of institutional and retail investing approaches	Retail investors are more open to sophisticated asset allocation strategies and less focused on relative returns
Convergence of traditional and “alternative” spaces	Greater demand for non-correlated strategies/asset classes in a liquid, registered format
Convergence of U.S. and European fund market trends	Investment managers can export similar strategies consistent with similar regulatory regimes



## Definition of Alternatives: Towards Greater Clarity

The lack of definitional rigor around the many different types of alternative strategies remains a barrier to broader acceptance. In databases and fund-screening solutions, the same alternative fund may be defined as “aggressive growth” in one classification scheme and “specialty” in another. For example, are products offering exposure to hard commodities “alternative”? Are leveraged loans an alternative asset class? How about infrastructure? The “alternative” categories of some well-known fund data providers omit many 130/30 funds, for example, lumping them with more traditional equity funds despite the potentially greater risks and costs associated with shorting.

For the purposes of this paper, the alternative universe is defined as registered products that seek a lower-correlation with long-only stocks and bonds, whether

delivered in mutual fund or ETF structure. In Europe, alternative investments often refer to hedge fund-like strategies, such as long/short, global macro or absolute return, exemplified by such products as the JPM Highbridge Statistical Market Neutral Fund, but may also include infrastructure, commodities and inverse strategies. In the U.S., alternatives include hedge fund-like strategies as well as commodities, real assets and currencies – in products ranging from the PIMCO Commodity Real Return Fund to Putnam Investments’ absolute return fund series to IndexIQ’s Hedge Multi-Strategy Tracker ETF. In neither the U.S. nor Europe do we include real estate, high-yield bonds or emerging markets investments, as these have become traditional – if not “core” – asset classes for many investors.

## Why Launch Retail Alternatives Funds? What’s the Opportunity?

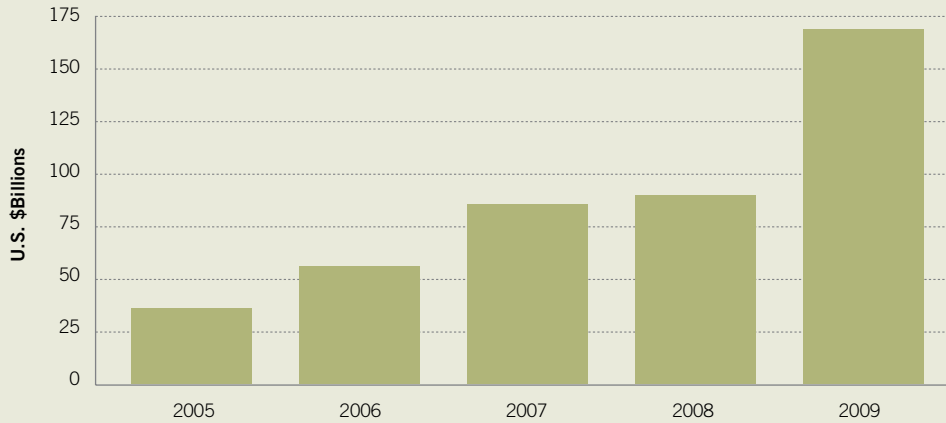
**ALTERNATIVE MANAGERS.** From the viewpoint of alternative investment managers, the chief lure is a retail audience larger than that of high net worth individuals. Also, retail alternatives can help satisfy smaller institutions, which may not be able to gain access to many alternative investment products because of their size, but are increasingly seeking alternative investments that are liquid and transparent. In the U.S., where some hedge funds are offered on managed account platforms that provide investors with transparency, liquidity and control, it’s not such a leap to ‘40 Act requirements. Plus, from the manager’s perspective, a pooled vehicle typically is preferred to a separate account. In addition, as hedge funds face a future of increased regulation in both the U.S. and Europe, ‘40 Act and UCITS funds are often logical product packaging extensions.

**TRADITIONAL MANAGERS.** From the perspective of traditional fund managers, alternatives represent

another set of investor needs that they may be able to address whereas the market for traditional equity and core bond products is already crowded. As retail investing shifts more towards outcome-oriented solutions, traditional investment managers increasingly need to expand their toolbox to provide a broader array of standalone funds and investment options to fit into target-date funds and other packaged solutions. In addition, such funds may help traditional managers distinguish themselves in a crowded marketplace.

At the same time, a number of factors are combining to produce continued pressures on profit margins throughout the industry: the growth of passives; rising fee scrutiny (particularly in the U.S.); and outsized demand for lower-margin fixed-income funds. Many investment managers are looking to alternatives as higher-fee products with potentially greater profit margins to help offset shrinking margins elsewhere in their businesses.

## U.S. Alternative Mutual Fund / ETF Assets



Source: Strategic Insight

As the chart above shows, the U.S. alternative mutual fund/ETF universe exploded in 2009, growing from \$90 billion in assets at the end of 2008 to \$168 billion in nearly 400 funds at the end of last year. Most of that growth came in record net new flows, led by \$39 billion in flows into commodity products spurred by inflation worries and largely enabled with ETFs, bear-market funds (\$23 billion) and long/short and absolute return strategies (\$12 billion). With \$25 billion in net flows and AUM doubling, 2009 marked a watershed year for alternative *mutual funds* in the U.S.

In Europe, alternative and absolute return UCITS funds now total nearly \$200 billion of assets across more than a thousand funds, which together collected \$35 billion of flows during 2009. Of this universe, 140 funds were introduced last year capturing \$10 billion. Although the expanded investment flexibilities of the UCITS III directive instituted nearly a decade ago gave rise to the initial wave of absolute return strategies, today hedge fund managers are seriously considering the structure to meet widespread demands for transparency and liquidity. Hedge fund managers also realize they potentially can reach a broader client base and build a stable revenue source with a more heavily regulated and widely-accepted format. Estimates suggest at least two hundred hedge-derived

UCITS funds with around \$40 billion in assets (as a subset of the wider alternatives field of \$200 billion). Their growth suggests that the convergence between alternative and traditional fund management, slowly underway for a decade in Europe and centered around UCITS, may be accelerating. Innovation and competition are also giving rise to new types of hybrid alternative strategies and structures, including hedge fund ETFs.

While it's difficult to precisely measure the opportunity, the prospects may be significant as evidenced by the fact intermediaries are modifying their model portfolios and recommended lists to accommodate alternatives – typically at the expense of the equity portion of the portfolios. Although there is no universally accepted definition of alternatives, the allocation to “alternatives” typically ranges from 3% to 30% – depending on the firm's definition of alternatives and an investor's risk tolerance, investment horizon, and other factors. Additional growth is likely to come from allocations to alternative strategies in customized target-date funds.

## Inspiring Confidence: Mutual Fund Structure and the UCITS Reputation

Though many in the investment management industry welcome a broader selection of alternatives through retail fund structures, others are concerned about possible damage to the reputation of the industry and respective brands – particularly the UCITS brand. Some industry participants worry that some hedge fund managers, driven by business pressures and pending regulations such as the European Union’s Alternative Investment Fund Managers (AIFM) directive, might offer strategies less suited to the UCITS format, and which might have insufficient liquidity during times of stress thereby damaging the UCITS brand.

Wealth advisors and investors meanwhile are being selective and gravitating towards a few established products, mostly from well-known managers. Distributors generally have been slow to accept hedge fund managers whom they believe do not know what it takes to support fund selection units and advisors. They want to offer low-correlated diversification options to clients, but are not yet confident that hedge fund providers fully understand their needs. Global investment managers with strong pre-existing distributor relationship that offer alternative capabilities, therefore have an edge over specialty hedge fund firms – at least for now.

## ETFs and Commodities Play Leading Roles in U.S. Alternative Fund Surge

To put last year’s growth in perspective, 18 U.S. retail alternative funds topped the \$1 billion mark in net inflows in 2009, led by the \$13.6 billion taken in by the SPDR Gold Shares ETF, one of the few retail vehicles for investing directly in gold bullion and the second-biggest-selling fund in the U.S. behind PIMCO Total Return. That means roughly 5% of retail alternative funds topped \$1 billion in net inflows. In contrast, only 3% of all long-term mutual funds in the U.S. (including ETFs) topped \$1 billion in net inflows. This is yet another indication of the demand experienced by alternatives last year.

Other big-selling ’40 Act alternatives included: the eight-year old PIMCO Commodity Real Return Strategy, which drew \$6.7 billion net inflows to its commodity-linked derivatives approach in 2009; Hussman Strategic Growth (\$1.9 billion in net inflows),

the long/short flagship of the quant boutique; and the Rydex SGI Managed Futures Fund, investing in financial and commodity futures (\$1.1 billion).

The popularity of the ETF format for alternatives was underscored by the presence of 12 ETFs or ETNs among the 18 alternative funds drawing \$1 billion+ in 2009. Some of these, including the ETNs, are not technically ’40 Act funds, but they are sold to retail audiences similar to ETFs. Most ETFs that offer alternative exposure provide either hard commodity plays, like the SPDR Gold Shares, currency strategies, or bear-market strategies, like the ProShares UltraShort 20+ Year Treasury and many other inverse ETFs. As far as commodities are concerned, many investors are satisfied having some beta exposure to these assets and for them passive ETFs have sufficed.

## US RETAIL ALTERNATIVE FUNDS: DOZEN TOP SELLERS OF '09

Fund	Category	2009 Net Inflows \$B	Dec. 2009 Assets \$B
SPDR Gold Shares*	Commodities Precious Metals	\$13.6	40.2
PIMCO CommdtyRealReturn Strategy	Commodities Broad Basket	6.7	16.1
US Natural Gas*	Commodities Energy	5.3	4.5
ProShares UltraShort 20+ Year Treasury*	Bear Market	3.1	4.6
PowerSharesDB U.S. Dollar Bull*	Bear Market	2.9	3.2
ProShares UltraShort S&P500*	Bear Market	2.9	2.9
PowerSharesDB Commdty Index Track*	Commodities Broad Basket	2.7	4.4
Hussman Strategic Growth	Long/short	1.9	5.4
Direxion Daily Financial Bear 3X*	Bear Market	1.8	1.1
ProShares Short S&P500*	Bear Market	1.6	1.5
PIMCO Fundamental Advtg Tot Return	Long/short	1.5	1.8
JPMorgan Highbridge Stat Mkt Neutral	Long/short	1.4	3.3

\*Fund is an ETF or ETN; Source: Strategic Insight

Only a few hedge-like ETFs have been launched so far, and because ETFs are mostly index products, most of them passively replicate hedge fund returns. This has been the strategy in the U.S., where IndexIQ launched the first hedge-replicating ETFs, which seek to synthetically reproduce the returns and portfolio characteristics of hedge funds without investing in hedge funds. It was followed by Credit Suisse's Long/Short Liquid Index ETN and the Dreyfus Dynamic Alternatives Fund, both hedge replication portfolios.

ETFs generally may provide limited opportunities for alternative funds beyond passive "exposure" strategies, given the short track record for actively managed ETFs. In addition, any ETF launch must include an evaluation of whether the underlying

holdings are liquid such that there will be tight trading spreads, the tax benefits of in-kind redemptions will exist and if any competitive disadvantage arises due to daily holdings disclosure.

On the other hand, in Europe, Deutsche Bank's db Hedge Fund Index ETF is a passive ETF investing in a mix of regulated, actively managed hedge funds. It launched on the Deutsche Börse in 2009 and grew to almost \$1 billion in assets. One exception comes from U.K. hedge fund manager Marshall Wace, which announced plans to launch a UCITS ETF version of its successful TOPS hedge fund strategy – but will charge an un-ETF-like 1.75% management fee and 20% performance fee.

## Entering the Retail Alternatives Market

To enter the retail alternative market, investment managers can acquire, build, or outsource the necessary capability.

**Acquisition** is one route to launching an alternative fund strategy for the retail market. Indeed, while many investment managers are evaluating whether to enter the retail alternative space, the past year provides several examples of convergence in action whereby alternatives managers combined or partnered with traditional managers. These include: BNY Mellon acquiring Insight Investment Management, a specialist in LDI and alternative investments; Affiliated Managers Group, which already owns stakes in hedge fund firms, purchasing private equity fund-of-funds manager Pantheon Ventures; and mutual fund manager Forward Management buying a stake in alts manager Broadmark Asset Management.

A successful example of an earlier acquisition involves JPMorgan Asset Management, which bought a majority stake in hedge fund manager Highbridge Capital in 2004. JPMorgan increased its stake gradually over the years and took complete ownership of Highbridge in 2009. JPM Highbridge launched versions of the Statistical Market Neutral Fund in both '40 Act and UCITS formats in November 2006, and as discussed above, remains among the biggest retail alternative funds in the U.S. and in Europe.

Hiring the right personnel to **build** a retail alternative capability in-house is also a popular method. Hedge fund manager AQR (see case study on page 11) hired a senior executive from the mutual fund industry to lead the launch of its '40 Act funds. In the case of DWS Investments, existing managers running

institutional portfolios were tapped to manage the firm's alternative '40 Act funds, and the firm's existing mutual fund wholesalers were trained intensively on alternatives to market the products.

Another way to enter the retail alternatives space is using an alternatives manager as a sub-advisor (**outsourcing**). Forward Management has a history of using subadvisors and a limited history in alternatives, so when it launched a long/short fund last year, the Forward Tactical Growth Fund, it hired Broadmark (in which Forward is an investor) to sub-advise. More recently, Eaton Vance launched a commodities fund in April, the Eaton Vance Commodity Strategy Fund, using hedge fund manager Armored Wolf as sub-advisor. We believe using sub-advisors may become more popular as the industry continues to shift toward best-of-breed standards and firms concentrate on their core competencies. Additionally, as firms with established retail distribution relationships and the necessary infrastructure to support advisor and investor education have had the most success to date, sub-advisory relationships may be an ideal way for traditional and alternative firms to jointly exploit this opportunity.

Lastly, under limited circumstances, a firm can convert an alternative portfolio into a '40 Act or UCITS fund. For example, New York-based Bull Path Capital Management converted a long/short equity hedge fund to a long/short mutual fund in June 2009. It ended the year with a meager \$13 million in assets. Because of the limited ability to use the predecessor hedge fund's track record, and the costs of such a conversion, we expect conversions to be rare.

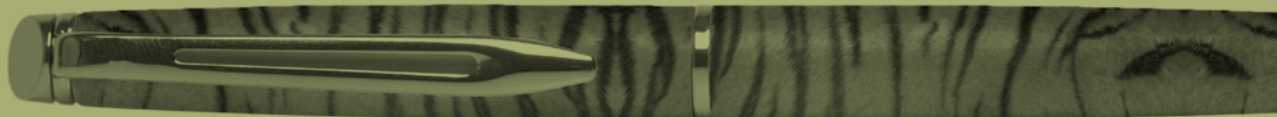
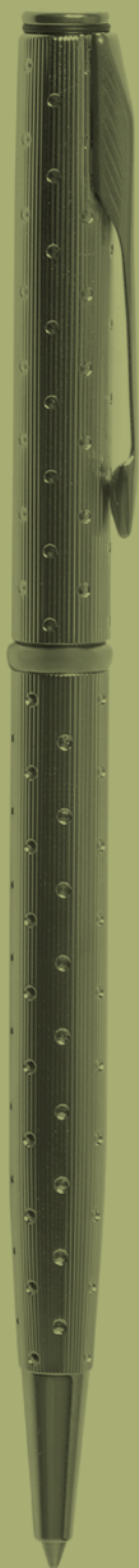
## Case Study: AQR's Diversified Arbitrage Fund

US-based AQR Capital Management is a quant-driven firm, partly owned by Affiliated Managers Group, offering alternatives strategies and traditional strategies. In January 2009, it became one of the first hedge fund managers in the U.S. to launch a retail mutual fund, introducing a '40 Act version of its diversified arbitrage strategy. AQR subsequently launched five other '40 Act mutual funds, one of which was alternatives-focused. By the end of 2009, the AQR Diversified Arbitrage Fund had drawn \$236 million in net inflows, the 39th best launch among 510 new funds introduced in the U.S. during the year.

AQR undertook this effort by hiring personnel with retail mutual fund experience to lead the sales effort, including a wholesale distribution force that had experience with both alternatives and mutual fund wholesaling. Importantly, the firm put compliance structures in place to eliminate potential conflicts arising from the same portfolio managers running the '40 Act and hedge fund versions of the arbitrage strategy. Of course, AQR already had the trading infrastructure used for managing a complex mix of arbitrage strategies, including convertible arb and merger arb, which can have 250+ long positions and 150+ short positions, and deploy leverage.

The AQR Diversified Arbitrage Fund capped its fees at 1.5% for the retail share class, but the real key was educating advisors about the product. The firm targeted sophisticated RIAs, mutual fund wrap platforms, and broker-dealer due diligence/gatekeeper departments that had familiarity with alternatives. AQR found a number of firms that already used alternatives in a limited partnership format and were looking to offer alternative strategies to a broader spectrum of investors via the '40 Act structure.

Education continues to be a priority, to both explain that the low-correlated strategy still carries risk, and to help advisors understand how the Diversified Arbitrage Fund fits best into portfolios. The educational effort appears to be working. For example, Litman/Gregory Advisor Intelligence, an investment research and due diligence service for independent RIAs, recently added the AQR Diversified Arbitrage Fund to its Approved List. In January 2010, AQR launched its second retail alternative fund, the AQR Managed Futures Strategy Fund, which had \$71 million in assets two months later.



# Rough Road to the Top: Diverse Experiences in Europe

Attention continues to build in Europe around hedge fund managers offering UCITS (often called “Newcits”), but many of the newer offerings recorded fewer sales than expected. In fact, only 3% of all alternative and absolute return UCITS funds have surpassed \$1 billion in assets, and nearly 75% have not yet raised \$100 million. Thus, the competitive landscape is still in its formative stages, allowing new entrants opportunities to establish leadership positions over time. With \$200 billion of total assets combined, alternative and absolute return UCITS represent a small portion of the \$7.5 trillion UCITS industry – but their share will rise if the strategies deliver on expectations.

**WHO’S BEEN SUCCESSFUL TO DATE?** So far strong gains have been achieved by traditional managers extending their ranges into alternative strategies, especially those who started years earlier, understood channel needs and took advantage of their existing distribution relationships. For instance, JPMorgan Highbridge Statistical Market Neutral, introduced in 2006 has \$4 billion in assets under management in Europe (it also has a U.S. mutual fund version of the strategy with another \$3 billion in assets). But in its first year, the UCITS version exceeded \$10 billion. Then during the subprime crisis, which severely affected many quantitative strategies, investors pulled billions from the fund in just a few months. The fund lost 70% of its peak assets to redemptions.

Nonetheless, the JPM Highbridge UCITS delivered positive returns during the challenging year of 2008, and subsequently recaptured some inflows again. JPM also launched two more quantitative long-only portfolios that now have an additional \$700 million. Interestingly, the JPM Highbridge UCITS delivered noticeably higher returns over the past three years compared to the U.S. mutual fund version, in part reflecting differences in strategy implementation and regulatory compliance.

**OTHER SUCCESS STORIES.** Another success story is Fidelity’s FAST Europe fund, which started in 2004 but became UCITS compliant in 2008. Aided by a three-year track record and targeted promotional efforts, this short extension vehicle went from negligible flows during 2007-2008 to \$1.7 billion in net gains during 2009, before soft closing. Another product that demonstrated remarkable progress is SEB Asset Selection, a managed futures strategy packaged as a multi-asset solution, and referred to as the largest “hedge fund” in the Nordic region, but available on a retail basis and sold cross-border.

The JPM Highbridge, FAST, and SEB strategies all have been extended to additional product variations by their respective sponsors. Similarly, the Julius Baer Absolute Return Bond Fund gave rise to a suite of offerings. With a long/short overlay and limited leverage, it straddles the increasingly blurry line between alternative and traditional. It is subadvised by Augustus Asset Management, a London-based fixed income specialist with single-strategy hedge offerings, spun off by Julius Baer and acquired in 2009 by GAM. The portfolio now has \$5 billion in assets after benefiting from \$1.4 billion of inflows in 2009. Between 2006 and 2008, Julius Baer added three more Augustus-advised products to its absolute return bond range, which have also become sizeable funds.

Other UCITS funds with an alternative bent that have raised meaningful assets include Amundi Dynarbitrage Volatility, Dexia Index Arbitrage, FAST (Fidelity Active Strategy) Europe and SEB Asset Selection. These offerings reflect a diverse range of strategies, including long/short, pair trades, global tactical asset allocation, volatility arbitrage and managed futures. Although the home bases of the fund managers are diverse, spanning the UK, France, Sweden, Switzerland and the United States, all of these products are sold cross-border.

SELECTED ABSOLUTE RETURN AND ALTERNATIVE UCITS FUNDS

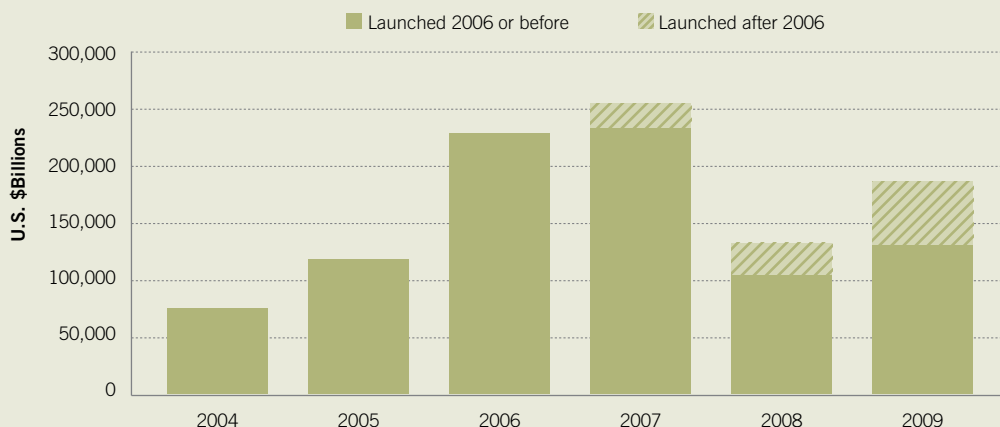
Fund	Launch	AUM	Key strategies
Julius Baer BF Absolute Return	2004	\$5.0 bil	Global fixed income long/short
JPM Highbridge Statistical Market Neutral	2006	\$3.5 bil	Quantitative market neutral
Amundi Dynarbitrage Volatility*	2004	\$3.4 bil	Volatility arbitrage on forward financial instruments and convertible bonds
Blackrock UK Absolute Alpha	2005	\$2.9 bil	Long/short, pair trades, ability to take 100% cash position
FAST – Europe	2004	\$2.5 bil	Equity short extension
Dexia Index Arbitrage	2003	\$2.3 bil	Equity market neutral, focusing on arbitraging inefficiencies generated by readjustments in equity indices
SEB Asset Selection	2006	\$2.2 bil	Multi-asset long/short futures strategy

\*Amundi Dynarbitrage Volatility product includes both a French domiciled fund and a Luxembourg domiciled fund, both UCITS compliant.

**EXPECT A LONG AND WINDING ROAD?** The growth of alternative and absolute return UCITS also have taken a very different course than in the U.S., with an earlier start and pronounced uptake in 2006, followed by a sharp decline the following summer. This partly reflected broader difficulties in the European investment management industry, but also disappointment with many first-generation absolute

return strategies. Yet as shown in the chart below, alternative and absolute return UCITS introduced after 2006 have made progress, together accumulating nearly \$60 billion in assets since 2006. Although pre-existing funds achieved net new flows last year, the newer funds captured almost twice as many inflows during 2009 (totaling \$22 billion) compared to the older products (\$12 billion).

Alternative and Absolute Return UCITS Assets in Europe



Source: Strategic Insight

# Hurdles, Challenges, Considerations

## Regulatory Considerations for Launching Retail Alternatives

The threshold consideration for managers contemplating a registered, retail alternative fund launch is whether the strategy fits within the '40 Act or UCITS regulatory construct. Among other requirements, funds regulated under the '40 Act and UCITS regimes must meet liquidity, diversification and leverage limitations. For firms managing similar strategies in hedge fund and retail alternatives fund format, structures also must be put in place to avoid potential conflicts of interest.

From a liquidity perspective, a mutual fund registered under the '40 Act must provide daily liquidity and satisfy investor redemption requests within seven days (although redemptions are typically satisfied on a T+3 basis). UCITS funds, on the other hand, must provide liquidity no less than twice a month and the period between receiving a redemption notice and satisfying the redemption request cannot exceed 14 days. Nonetheless, European investors typically expect redemptions to be satisfied on a more frequent basis. Hedge funds in contrast often provide monthly or quarterly liquidity.

In light of the prescribed redemption requirements, a U.S. mutual fund may not invest more than 15% of its assets in illiquid securities while a UCITS fund has a limit of no more than 10%. Consequently, some alternative strategies such as distressed securities or private equity strategies are unlikely to fit within the applicable regulatory regimes.

While some managers see the UCITS flexibilities as an opportunity to offer innovative products, others see the framework as restrictive on their ability to generate alpha. Leverage through derivatives is capped at two times assets (100% of NAV). Unlike in the U.S., direct short sales are not permissible for UCITS funds. Short positions can, however, be achieved synthetically using total return swaps, options, futures, and contracts for difference, for example. Some assets are not eligible for investment, such as unregulated hedge funds, illiquid commodities or property, but exposures to these can be attained through indices, certain

regulated structures, delta one notes, structured swaps, and other derivative or asset-structuring techniques, albeit with increased management complexity and costs.

Sophisticated UCITS also must implement rigorous risk measurement and management methodologies, generally involving Value at Risk (VaR). Risk tracking can be done either using Absolute VaR (in which case the variance is limited to 20% of NAV), or through a Relative VaR approach (the ratio of UCITS fund VaR to a benchmark or comparable derivatives-free portfolio, limited to two times), with additional requirements such as 99% confidence, stress tests, back testing, and more.

Similarly, there are other U.S. regulations that must be considered for '40 Act alternative funds. These include the limits on leverage whereby no more than 33% of a mutual fund's assets generally may be leveraged, including short sales, swaps, options and other derivative instruments. Funds that use leverage must either segregate liquid assets at the fund's custodian or earmark liquid assets on the fund's books to cover the exposure. Tax requirements must also be considered for both structures. For example, in the U.S., mutual funds providing commodity exposure can cause a fund to be subject to onerous tax consequences unless structured appropriately.

These and other details make it a challenge to offer certain alternative funds in a UCITS or '40 Act structure. Even if existing considerations are addressed, non-traditional funds may still be vulnerable to new regulatory actions.

For instance, the SEC announced in late March that it was slowing the approval process for new funds and ETFs that use derivatives extensively while the agency studied "additional protections" that may be needed for mutual funds and ETFs that invest in derivatives. This delay could affect the launch of any number of alternative funds and ETFs in the pipeline.

## Operational, Governance and Product Development Considerations

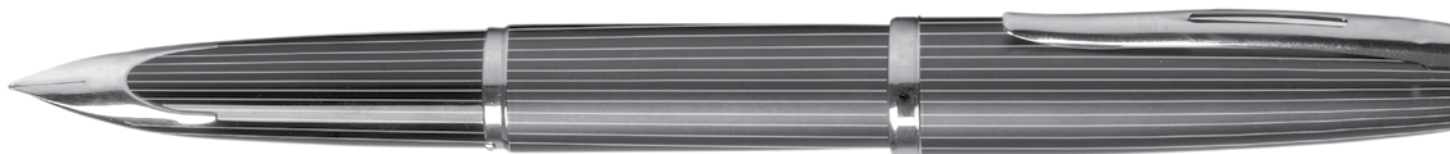
Beyond regulatory considerations, there are operational, governance, and product development matters that must be taken into account regarding retail alternative funds. For example, simply because a traditional investment manager has passed the compliance hurdles necessary to add shorting to its strategies, that does not mean that manager has the skill to effectively execute short strategies, or that a retail fund that uses shorting meshes well with the firm's brand or corporate strategy.

Senior managers should carefully consider the firm's objectives and capabilities. A successful example is Putnam Investments, which launched four absolute return '40 Act funds in the U.S. in early 2009 that gathered \$1 billion in assets by year-end. The firm was not known for alternatives, but had experience managing an institutional absolute return portfolio and decided that the products were a reasonable extension of Putnam's brand and another way to deploy its active management expertise.

From an operational perspective, traditional investment managers who have not operated in the alternatives space may spend months finding a prime broker and setting up tri-party agreements (which allow long positions to be held at a custodian and shorts to be held at a prime broker). In addition, using both a custodian and a prime broker results in additional cash reconciliations and the managing of more complex cash balances. Having service providers that understand the nuances of traditional and alternative products is critical to the success of these hybrid products.

From a governance perspective, traditional long-only managers should expect questions from fund boards regarding managers' ability to effectively execute the investment strategy. For example, the manager's ability to employ derivatives, use leverage and, to the extent shorting is used, not only identify short candidates but the skill to know when to open and close short positions. Handling new types of securities, new accounting, more complex risk management, and new dimensions of compliance will all be areas of board scrutiny.

From a product-development perspective, one question for firms is whether to launch a single-strategy or multi-strategy fund. DWS Investments in the U.S. launched a multi-strategy alternative '40 Act fund (the DWS Alternative Asset Allocation Plus Fund) and found that many advisors who used that fund to learn about alternatives investment strategies later wanted single-strategy alternative funds to customize alternative-exposure solutions for clients. Other retail alternative funds are intended to be a small piece of a portfolio providing a hedging function. For instance, the proposed AllianceBernstein Volatility Management Portfolio, a fund that will invest in a range of fixed income, commodities, currencies and other assets, is – according to its registration statement – intended to only be used as one portfolio within other AllianceBernstein funds-of-funds, not as a standalone vehicle.



## Distribution Considerations

**UNITED STATES.** In the U.S., the potential audience for '40 Act alternative funds is broad, including independent registered investment advisors (RIAs), broker-dealer firms and fee-based mutual fund wrap programs. The primary channel for '40 Act alternative funds may be independent RIAs, many of whom pride themselves on portfolio construction and the ability to pick undiscovered gems. Many RIAs have used hedge funds in the past but are finding it easier in the *Era of the Investor* to interest clients in '40 Act regulated products. Although the independent RIA channel is the smallest single mutual fund distribution channel, it is the fastest-growing. Independent RIAs often tend to be smaller firms, but they can be reached by marketing through significant RIA custodial platforms such as those offered by Charles Schwab, Fidelity and others as well as turnkey asset management providers such as Lockwood and Envestnet.

National broker-dealers ("National BD"), the single largest distribution channel for '40 Act funds, offer another natural audience in the U.S. Use of '40 Act alternatives appears to be growing at these firms, according to data from Coates Analytics (for more information, see [www.coatesanalytics.com](http://www.coatesanalytics.com)). At the end of 2009, National BD programs tracked by Coates had an estimated 2% of client assets in '40 Act alternatives funds, up from 1.5% at the end of 2008. Although that seems like a small portion, the number is expected to grow, as alternatives represented nearly 4.7% of new fund sales in National BDs tracked by Coates in the fourth quarter of 2009. To put alternatives' share in context, bear in mind that

Small Cap Growth Funds, for example, make up an estimated 2.1% of assets at National BDs.

In the U.S., where funds are sold both via fee-based and commission-based models, having share classes that accommodate fee-based distribution is crucial for '40 Act alternative funds. Less than 1% of retail alternative portfolios are offered through commission-based share classes only. Meanwhile, roughly 20% of '40 Act alternative funds are offered only in no-load share classes, which require them to be sold in fee-based models. ETFs are used almost exclusively in fee-based programs.

**BOTH THE U.S. AND EUROPE.** In Europe and the U.S., educational efforts are critical components of a successful distribution strategy, as alternatives are a new area for most retail investors as well as for many advisors. Some financial advisors will need to be introduced to alternatives, and how specific products might fit into investors' portfolios. Advisors will need educational materials on alternatives for use with investors. Firms such as Gartmore and Putnam have launched micro-sites that offer support materials online, including video presentations from portfolio managers, fact sheets, prospectuses, and in-depth performance metrics. In the U.S., the Marketfield Fund offers advisors a daily-updated blog. Going beyond advisors, Rydex even launched the GetAlts.com Web site last year to educate investors about the basics of alternative investments. These online outreach efforts are not unusual in the world of retail mutual funds, but hedge fund managers have not, as a whole, focused as intently on accessible sales support.



## CONSIDERATIONS FOR LAUNCHING RETAIL ALTERNATIVE MUTUAL FUNDS

Strategic	<ul style="list-style-type: none"> <li>• Do UCITS and/or '40 Act alternative funds fit with the firm's brand and value proposition?</li> <li>• Does the firm have the portfolio management expertise to manage alternative asset classes or strategies?</li> </ul>
Regulatory and Operational	<ul style="list-style-type: none"> <li>• Can the firm effectively manage retail alternative funds while meeting the liquidity and other regulatory requirements?</li> <li>• Does the firm have the necessary operations infrastructure?</li> </ul>
Pricing	<ul style="list-style-type: none"> <li>• Is there a competitive fee structure and an ability to explain it to advisors and investors?</li> </ul>
Distribution	<ul style="list-style-type: none"> <li>• Does the firm have the right distribution capabilities (and sales personnel) in Europe and/or the U.S.?</li> <li>• Has the firm set out a credible plan for supporting sales efforts and educating advisors?</li> </ul>

**EUROPE.** Distributors in Europe consistently cite greater transparency as one of the key features they seek from investment products, and the UCITS format as a more desirable vehicle because of the greater transparency that it offers. However, some hedge fund sponsors of UCITS (so-called Newcits) have not provided the same level of transparency as typically made available by managers more experienced in retail fund distribution. The best practices employed by the most successful UCITS managers include frequent, detailed performance attribution analysis, manager interviews and webcasts, and financial advisor micro-sites. All of these practices support distributors and investors during the decision-making process – helping them to understand the product and the manager, and establish trust in both.

### Getting the Price Right

Although retail alternative funds – excluding ETFs – can cost investors more than traditional funds, they also can be more expensive to operate. A number of '40 Act alternative funds spend 150 to 250 basis points on dividend, borrowing and

brokerage expenses related to shorting. In fact, U.S. alternative mutual fund managers are often absorbing management fee waivers of 1%+ to reduce the cost to investors. While many alternative funds seem expensive relative to other '40 Act or UCITS funds, they're often inexpensive compared to the 2-and-20 fee structures of hedge funds. Of course, this comparison has to be explained to retail investors used to cheaper traditional offerings.

Nonetheless, questions about high fees, and the resulting negative effect on returns, will continue to be a hurdle. There are additional compliance and operational costs involved in running a UCITS fund versus an unregulated hedge fund, but the problem seems more about perceptions than reality. Among European alternative and absolute return UCITS, fees vary widely across products and share classes, but the median management fee is less than 1.3%, and total expense ratios average 1.5%, similar to traditional equity UCITS. A few portfolios have total costs approaching or exceeding 3%, but this is not uncommon for many traditional funds as well.

However, in the U.S., the fee disparity between alternative and long-only traditional mutual funds is wider. The median net expense ratio of long/short and market neutral funds, for example, ranges from 1.6% to over 2.0%, while median net expense ratios for traditional long-only equity funds typically run from 0.70% to 1.20%.

From the manager's perspective, one of the advantages UCITS funds have compared to U.S. mutual funds relates to greater fee structure flexibility. Alternative UCITS usually charge a management fee between 1.5% and 2.0%, plus a 10% to 20% incentive fee on benchmark outperformance, not very different from hedge fund norms.

In contrast, performance fees in U.S. mutual funds are rare, and in cases where implemented, they typically are restricted to "fulcrum" fee structures that rise and fall proportionately with performance. A typical example in the U.S. is the Fidelity 130/30 Large Cap Fund, which charges a base management fee of 86 basis points plus a performance fee of +/- 20 bps based on performance relative to the S&P 500 benchmark over three years. This business flexibility for managers may make Europe more attractive as the center of alternative innovation and convergence in the years ahead.

### Performance Matters, but the Competition Might Surprise You

Although alternative UCITS are battling perceptions that they will fare poorly compared to their unregulated versions because of greater investment compliance constraints and higher costs, hedge funds are not necessarily their primary competition. Rather, alternative UCITS often will be compared to long-only

equity and balanced strategies. In 2009, for example, the average absolute return fund returned 9% versus nearly 30% for the average equity fund. This disparity correlates well with investor flow activity: traditional equity UCITS funds raised \$140 billion of inflows last year, several times higher than the alternatives.

Perhaps more important was the proportion of funds that lost money. Around 15% of absolute return UCITS funds had negative returns last year, compared with just 2% of global equity funds. Although any fund can suffer losses, the *expectation* among most investors still is that "absolute return" would have a lower chance of losses. Absolute return and alternative strategies are often hard to understand, and therefore hard to sell even when they do well. But if they produce a negative return while equity and bond funds rise strongly, as they did in 2009, investors will quickly opt for mainstream as opposed to exotic.

In typical bull cycles, many absolute return funds will remain disadvantaged unless they provide evidence of high, sustainable "alpha" along with diversification benefits. During periods of uncertainty or in recoveries following market traumas when investors are still risk-sensitive, low-correlation/low-volatility alternatives find broader appeal. But in periods of rising volatility or market crisis, history has shown that absolute return and alternative products can be hit very hard, along with the rest of the industry. Thus, the marketing window for these products is narrow, and the volatility of flows can also be high. To that end, firms also should position their strategies first as diversification tools and second as alpha generators as investors primarily utilize alternative strategies for diversification purposes.<sup>1</sup>

<sup>1</sup>See New Rules for Hedge Fund Investing (Era of the Investor), SEI Knowledge Partnership, January 2010 and The Cerulli Edge (U.S. Asset Management Edition) February 2010.



## Looking to the Future with Lessons from the Past

### DEMAND FOR NON-CORRELATED PRODUCTS.

Prospectively, one of the key drivers of demand for alternatives in UCITS and '40 Act formats will be investor demand for non-correlated products. Over the past decade, not only have equity and fixed-income markets become more closely correlated, but so have global markets (and recent academic research suggests that commodities have become slightly more correlated to stock and bond markets). As a result, retail investors are beginning to appreciate the effect of diversification on returns and volatility. However, they have to look farther afield to find less-correlated investments. This bodes well for alternative mutual funds.

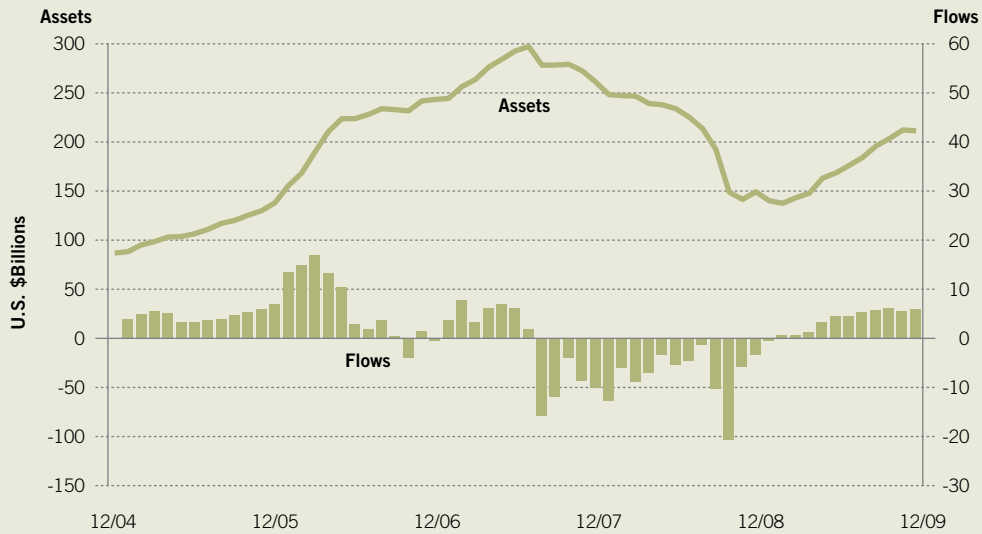
**DC CHALLENGES/OPPORTUNITIES.** A challenge in the U.S. going forward will be expanding distribution of retail alternative funds into retirement plans. The defined contribution (DC) market, including 401(k) plans, drives a large part of the mutual fund market in the U.S., and often provides many retail investors their introduction and only access to mutual funds. Because this market is dominated by so-called average investors who often get minimal advice on their DC investments, it's a difficult market for alternatives as standalone plan offerings. In addition, a growing percentage of DC flows are going into target-date funds, a space where product sponsor concentration is high with only four firms managing nearly 80% of the target-date assets.

Nonetheless, there is a small but growing opportunity among target-date funds that incorporate some alternative strategies as part of their fund-of-funds

approach – that are starting to be adopted among large DC plans in particular. These target-date opportunities are more like institutional sales, where discussions regarding correlation and volatility can be effective. Surveys indicate investment consultants are increasing searches for custom target-date funds that include alternatives. There may also be an opportunity for firms to use their own alternative funds in their proprietary target-date funds – this strategy has worked for Putnam Investments and its absolute return funds, for example.

**EXPECTATIONS MANAGEMENT.** Recalling the European experience a few years ago with absolute return funds, which experienced a significant failure in expectations, will help the industry ensure that the current wave of alternative products do not similarly disappoint investors. Absolute return products in Europe grew with \$45 billion in flows in 2005 and over \$60 billion in 2006. However, the subprime crisis of 2007 triggered NAV declines far beyond expectations among many enhanced cash and absolute return vehicles. Some funds shut down, confidence was lost, and absolute return funds recorded outflows totaling \$140 billion over 17 consecutive months of redemptions. Many investment brands suffered. Looking back, the mistakes and challenges revolved around managing distributor, advisor, and investor expectations, providing insufficient explanations of complex investment approaches, and not adequately clarifying what was meant by “absolute return” and the risk of losses. Managers that survived and learned from these mistakes eventually benefited after the downturn, as inflows returned in 2009.

### The Rise and Fall of Absolute Return in Europe



Source: Strategic Insight

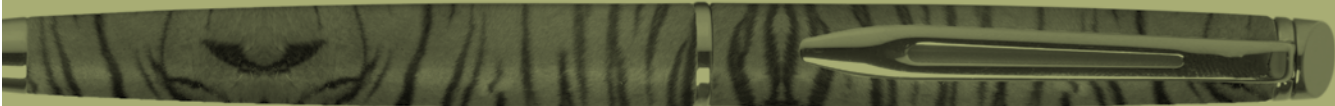
Another cautionary tale is the fate of the U.S. 130/30 mutual fund dud in the U.S. Investment managers launched more than a dozen '40 Act 130/30 equity funds in 2007, arguing that the mix of 130% long and 30% short would be a more efficient way to capitalize on stock-selection skill within 100% net long exposure. The managers suggested that such short extension funds would generate better risk-adjusted returns compared to long-only funds who also measured themselves against large-cap benchmarks such as the S&P 500 and the Russell 1000. Optimism over the strategy led to predictions of explosive growth

for the strategies. But the anticipated boom never occurred, as many 130/30 funds underperformed in both 2007, a year in which the S&P 500 rose 5.5%, and in 2008, when the S&P 500 dropped 37%. Many 130/30 funds also underperformed in 2009. Most of the funds experienced lackluster inflows, and more than half saw net outflows in 2009. A number of mutual fund firms closed or merged away their 130/30 funds just a year or two after inception, and just two new 130/30 funds launched in 2009. While there are now just sixteen '40 Act funds with "130/30" in their names, none has more than \$250 million in assets.

## Conclusion

Demand for alternative or non-correlated strategies in U.S. mutual fund and European UCITS formats is real as reflected by the net inflows into existing products, the growing accommodation for such strategies in the model portfolios and recommended lists of intermediaries, and investor demand for a broad set of diversification tools. Given their experience in educating investors and advisors and their pre-existing

distributor relationships, traditional fund managers will continue to have the most success in the retail alternative fund business in the near term. As a result, alternative managers' best opportunity in the near term may be to sub-advise or partner with an existing retail manager. Such an approach can also be a win for traditional firms that may lack the requisite investment skill or expertise.



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