FRONTIER ADVISORS

Alternatives & Innovation Quarterly

January 2016

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Welcome to this edition of Alt IQ.

Alt IQ provides Frontier's up-to-date thinking on opportunities and innovations in alternative and emerging asset classes, strategies and markets.

In this Alt IQ, we take a look at three liquid alternative strategies that use a range of asset allocation and portfolio construction approaches with varying risk/return targets, complexity of implementation, leverage and fees.

While there are a wide range of strategies that can be considered to be liquid alternative strategies (e.g. alternative beta or trend following systematic strategies), we have chosen to focus on three strategies that are predominantly driven by a discretionary mix of fundamental and technical market factors.

These strategies are: Directional Multi-Asset (DMA) Strategies, Liquid Diversifying Strategies (LDS) and Global Macro strategies (Macro).

The less well known strategy of the group is what we have termed LDS, a lower cost, liquid strategy that is interesting on a number of fronts. LDS funds have the potential to provide solid returns during normal markets, participate in the upside but, importantly, experience small falls (or profits) during volatile markets.

We believe LDS funds warrant further discussion. Therefore, in the final section we take a closer look at LDS including the performance over time with a focus on the 3rd quarter of 2015 in the face of severe equity market gyrations.

Liquid Alternative Strategies – Smoothing the Ride

Liquid Alternative Strategies

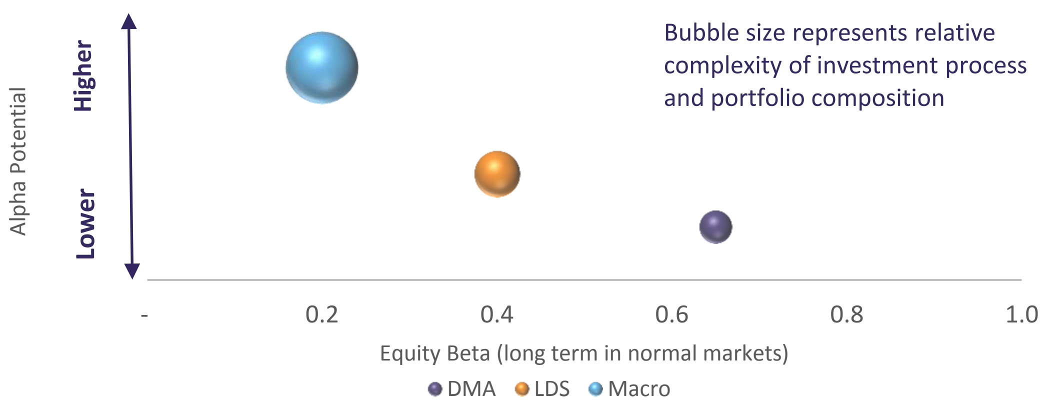
We have grouped the following three strategies together as they all typically use a predominantly discretionary investment process driven by micro and macroeconomic factors, relative asset class valuations, fundamental analysis and/or technical market factors (e.g. momentum or sentiment). The strategies offer highly liquid return streams with varying levels of beta to equities. Each of the strategies typically invests in major macroeconomic markets such as currencies, interest rates, equities, credit and commodities and ranges in complexity, time horizon and fees.

Directional Multi-Asset (DMA)

The simplest strategy is what we have termed DMA. DMA funds are also commonly known as diversified growth funds or new balanced funds. DMA funds are differentiated from traditional balanced funds through the use of active dynamic asset allocation, predominant use of direct (rather than fund) allocations and, in some cases, use of downside hedging.

DMA has an investment approach based on changing asset allocations according to medium-term fundamental views (sometimes referred to as themes – e.g. low inflation for longer leading to a central bank retaining an easing bias) and technical (i.e. momentum and sentiment) market views as well as relative valuations across and within asset classes. In doing so, a DMA fund generates its returns by changing the directional asset class exposures (e.g. increasing exposure to bonds if expected forward returns for equity market betas are poor relative to bonds). They will generally have a relatively high equity beta (circa 0.5 to 0.8) given the primarily long-only nature of the portfolio and expected return profile (e.g. cash + 4% p.a.). A higher beta would be expected during periods when equities are predicted to outperform and a lower beta when equity performance is expected to be relatively benign. The instruments used include physical investments (including active and passive funds), futures, interest rate swaps or currencies. Value-add from security selection within a market tends to be a minor part of the process. Our preferred managers have demonstrated an ability to change allocations (sometimes materially and quickly) across and within asset classes which has led to smoother returns over time with reduced drawdowns during equity market falls. The relative simplicity of DMA funds also generally makes them the cheapest strategy out of the spectrum of strategies discussed in this Alt IQ.

Figure 1: Relative complexity, equity beta and alpha potential of Liquid Alternative Strategies



Liquid Diversified Strategies (LDS)

The next strategy in order of complexity is LDS which, like DMA, utilises a mix of medium-term fundamental themes and technical market views, as well as exploiting relative valuations across and within asset classes.

Managers of LDS express these views using both directional and relative-value trades. This generally leads to comparatively lower equity beta (typically below 0.5) due to the use of relative value strategies, although this can increase in stressed markets. The beta can vary depending on expected specific equity market performances. While the thematic/technical/valuation approaches may be the same for LDS and DMA, it is the expression of these views via granular trades which differentiates the two.

LDS are generally more agile, able to take specific positions in a particular market (i.e. not just the broad market beta but more specific, such as a particular segment of a yield curve) and use shorting to profit when one market outperforms another (e.g. long Germany versus short France to profit from an improving German economy relative to France; long quality versus junk stocks etc).

In addition, LDS managers will usually express their trade ideas with the use of some downside protection element (e.g. using put options for an equity trade structure) as well as utilising tail risk hedging at the portfolio level.

Global Macro Strategies

At the "hedge fund" end of the spectrum, Macro strategies are the most complex macro-driven approaches, are far more agile and have a mix of short and medium investment horizons.

They also have the highest fees with higher base fees as well as performance fees; managers justify the extra fees based on the active trading element of the process with market-timing and the overall expectation of a higher return and Sharpe ratio. The focus on non-equity markets (e.g. currencies) and the active trading approach generally leads to low to zero beta to equities.

Macro funds can be considered higher returning, more complex and a shorter term strategy versus LDS. Macro funds may use a multi-portfolio manager approach or a CIO (and co-CIO) approach to portfolio construction.

Comparing the Strategies

Table 1: Liquid Alternative Strategies on the complexity & fee spectrum

Complexity/fee spectrum	Less complex / lower fees	⟷	More complex / higher fees
Strategy	DMA	LDS	Macro
Target returns	Cash + 4-6% p.a.	Cash + 4-6% p.a.	Cash + 6-12% p.a.
Target standard deviation	4-8% p.a.	4-8% p.a.	6-12% p.a.
Return drivers	Fundamental and technical market views; relative and absolute asset class valuations	Fundamental and technical market views; relative and absolute asset class valuations; trade structuring (i.e. relative valuation trades)	Fundamental and technical market views; relative and absolute asset class valuations; trade structuring (i.e. relative valuation trades); active trading
Complexity level	Simpler dynamic asset allocation approach and implementation	Complexity in trade structuring and portfolio risk management	Complexity from trade structuring, active trading and multi-portfolio manager model
Risks	Rapid equity market falls before DMA has reduced equity beta; assumed diversifications (e.g. bonds versus equities) reverse to be risk additive	Use of relative value trades exposes portfolio to leveraged losses should both sides of trade move the wrong way	Leveraged losses from concentrated positions and use of relative value trades; correlated moves across markets; rapid short-term market moves leading to short-term losses
Equity beta	Dynamic based on allocations across and within asset classes and ranging between 0.5 to 0.8	Dynamic based on using equity indices to express themes but relative-value trades and use of non-equity markets reduce beta to 0.3 to 0.5	Active-trading and focus on non-equity markets drives low beta to equities circa 0 to 0.3
Liquidity	Highly liquid	Highly liquid	Highly liquid
Fees	Base: 0.5-0.8%	Base: 0.6%-0.9%. Some have perf. fees (10-20% above cash)	Base: 1-2% Perf: 10-20% above cash

Strategy in Focus – Liquid Diversified Strategies

Strategy in Focus

We focus on LDS in this section, particularly the performance over time and during the volatile period of the 3rd quarter 2015. We think these strategies have merit for institutional investors in offering diversified return streams that are liquid and at relatively moderate fee levels (in general, LDS managers pass the new Frontier Fee Principles). LDS funds are also expected to offer an asymmetric return stream that participates in equity rallies but reduces the loss potential during large equity market downturns, with the caveat that returns will also be driven by manager skill in selecting markets and trades. The experience during the 3rd quarter was consistent with this expectation, with LDS funds experiencing little to small losses and outperforming equities by more than 5%. In contrast, a number of DMA, and indeed Macro funds, underperformed over this period.

Features of LDS Products

The key components of the investment process for LDS products are as follows.

Identification of investment idea: This is a key part of the process since it drives the return potential for the product. Investment idea identification will rely on fundamental factors such as valuations, flows, central bank activity as well as technical factors such as momentum and market sentiment.

Investment idea expression: Implementing ideas into trades tends to be advanced by being more granular and targeted. We have observed a number of combinations and permutations of different markets that the LDS managers target to identify profitable opportunities. Trades can include a mix of directional and relative-value strategies. This breadth is one of the appeals of LDS managers.

Trade structuring for asymmetric payoffs: LDS funds' instruments of choice are usually derivatives (e.g. futures, options) as they provide high liquidity and, in the case of options, asymmetric return profiles. The use of options to change the risk/return profile at the trade level is a strong value-add of LDS managers.

Disciplined approach to risk management: In addition to managing the risks of individual trades in trade structuring, LDS managers implement portfolio-level risk management. This involves sizing, diversifying across themes and trades, portfolio analytics to understand how the portfolio may suffer in all scenarios, and structuring the portfolio to remove unexpected/unwanted risks (includes tail risk hedging).

Strategy in Focus – Liquid Diversified Strategies

Performance of LDS

LDS funds are relatively new. Several funds have track records of more than five years; otherwise, most LDS funds have shorter track records. We have observed that LDS funds have generally performed in-line with expectations – participating in market rallies, providing solid returns during normal market conditions and, importantly, experiencing small losses and, in some instances, profits during heightened market volatility coupled with quick market falls (e.g. August and September 2015).

Chart 1 provides rolling 12 month returns for several preferred LDS managers (for which we have a Positive View or have rated Buy or Neutral Plus) as well as for the MSCI World (local currency) index while Chart 2 displays the rolling 12 month standard deviations for the same managers.

Both charts depict return profiles that are consistent with the target returns of around cash plus 4-6% and also relatively low standard deviations and small losses or indeed profits during volatile periods. However, standard deviations are not a good measure of the risks inherent with these strategies but rather a mathematical outcome of the return pattern. The "real" risks with LDS and other similar strategies tend to be organisational or operational in nature or around the manager's ability to implement including risks in the use of leverage to effect trades.

Chart 1: Rolling 12 month returns relative to MSCI World (to end Nov 2015)

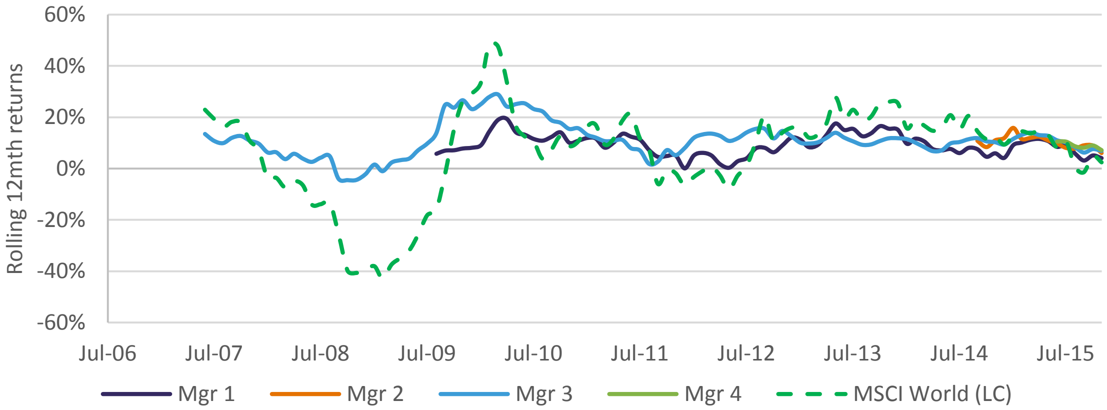
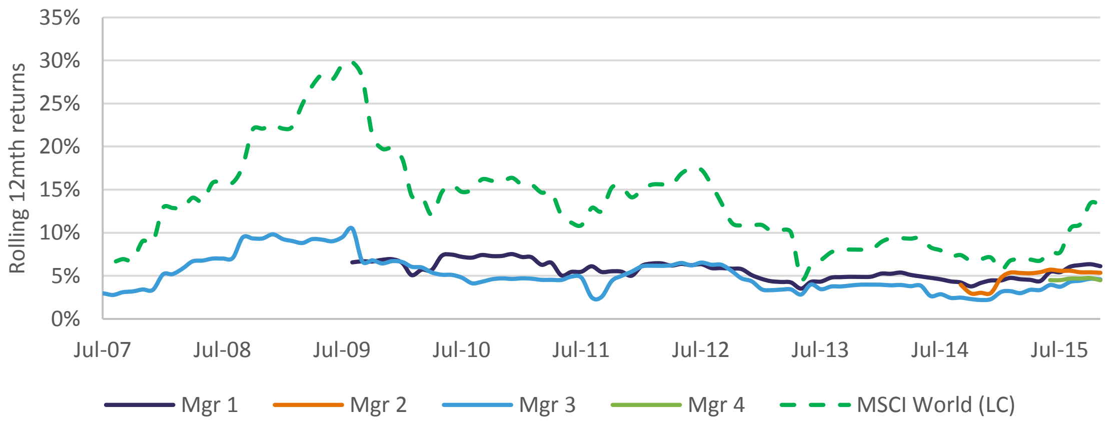


Chart 2: Rolling 12 month standard deviations (to end Nov 2015)



Strategy in Focus – Liquid Diversified Strategies

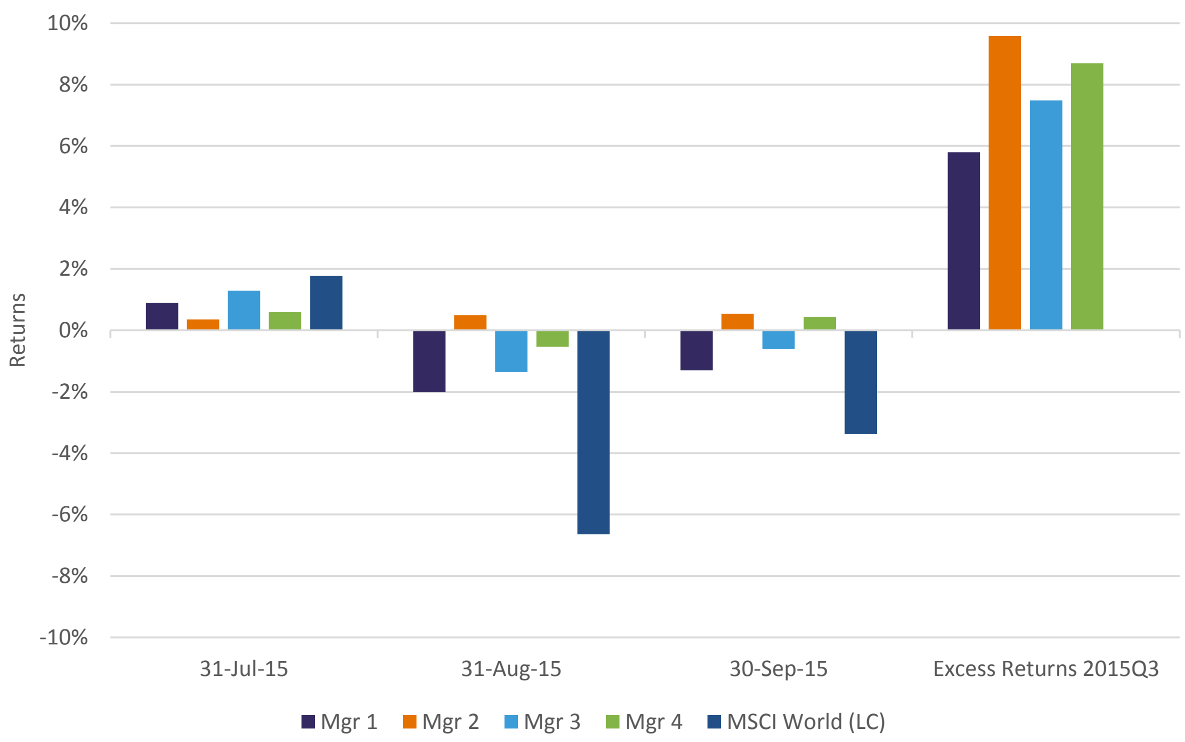
One recent volatile period was the 3rd quarter of 2015. The months of May and June were already relatively volatile (German Bund rally reversing dramatically in late April/early May followed by the Greek crisis reaching a crescendo in late June/early July) however there were two key announcements in August and September which severely roiled markets in general.

The first was China's surprise devaluation of the Yuan in August which followed significant A-Share losses. The second announcement was the Federal Reserve's comments at its September meeting that it would now incorporate China's economic performance into its deliberations on interest rates. Equity markets were down heavily over that two month period (e.g. MSCI World (Local Currency) down 8% over Q3 and nearly 10% over August and September).

The performance of our preferred LDS funds was interesting (see Chart 3), in particular the manner in which performance was generated. This was a mix of asymmetric returns from trade structuring (e.g. options helping to dampen losses at the trade level), the mix of themes at the portfolio level (i.e. themes specifically introduced for risk-off markets performing very well relative to themes that perform poorly in these markets) as well as portfolio tail risk hedges.

We would of course caution this is but one instance of these LDS funds performing relatively well during this type of stress but it is nonetheless an interesting period which supported our views about how these strategies are likely to perform.

Chart 3: Performance of LDS managers (AUD returns) during volatile Q3 2015



Strategy in Focus – Liquid Diversified Strategies

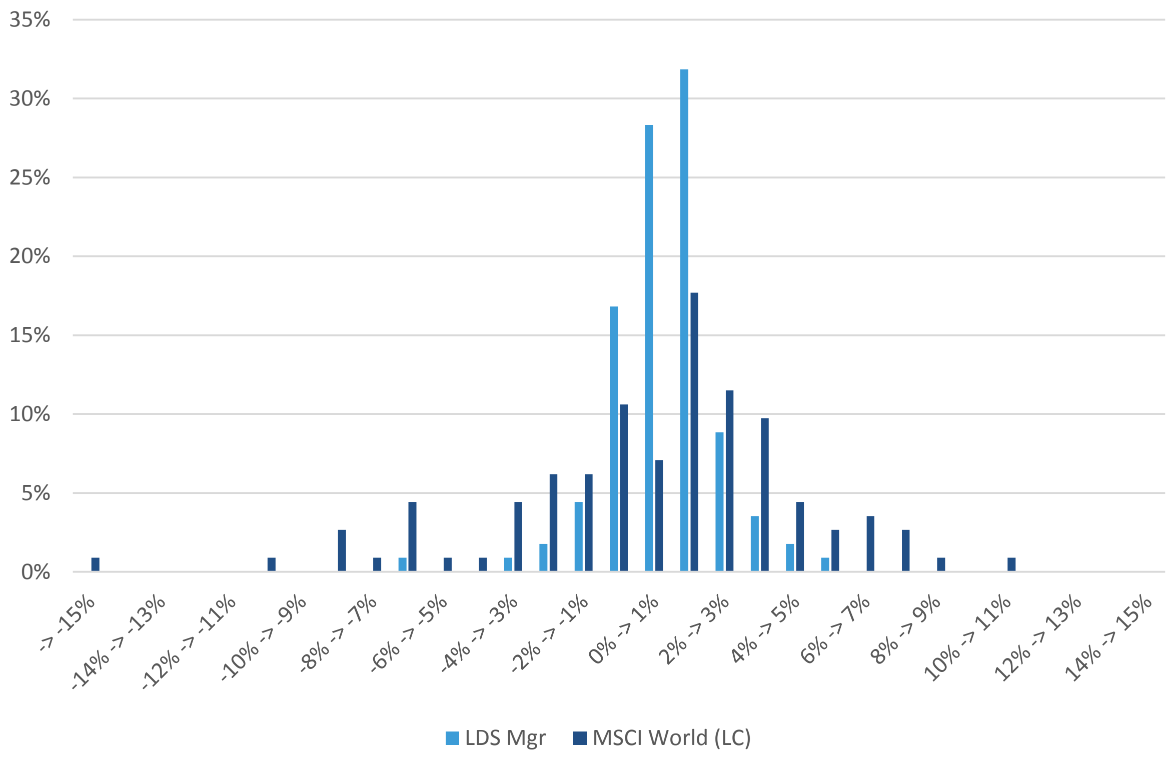
LDS managers have shown a tendency to avoid large monthly losses and to have more positive months than negative months (% of positive months for the preferred LDS managers ranged between 67% and 82% compared with 61% for MSCI World (LC)).

In order to demonstrate this, we have shown the monthly return profile to end November 2015 of an example LDS manager versus equities in Chart 4. We are limited in this analysis due to the relatively short performance track records and so we caveat our observations accordingly.

Finally, analysis of the returns for each preferred LDS manager during negative months to end November 2015 for the MSCI World gives a good indication of how well these strategies can reduce losses from equities.

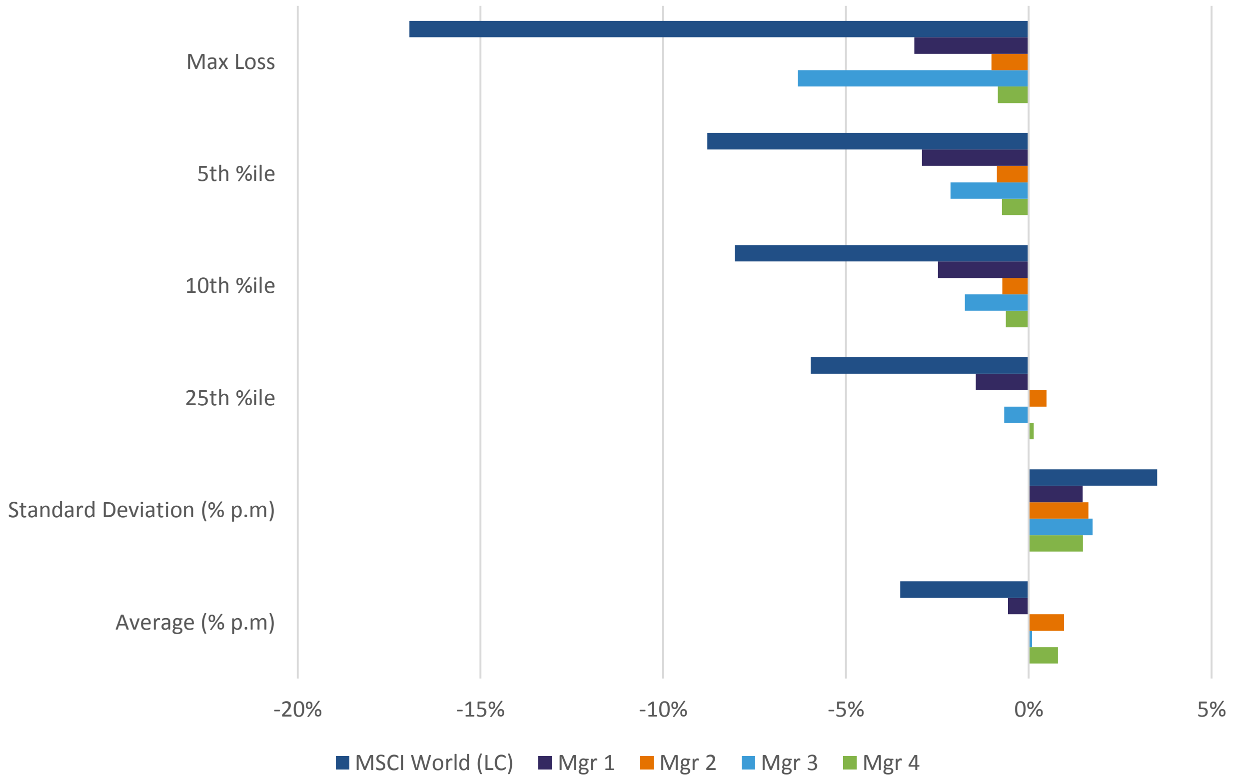
Chart 5 shows how stark the difference is between LDS managers and MSCI World (LC) with reduced losses for all statistics, a smaller monthly standard deviation and a small average loss or return during negative equity months.

Chart 4: Histogram of monthly returns of an example LDS manager vs MSCI World (local currency)



Strategy in Focus – Liquid Diversified Strategies

Chart 5: Performance of each LDS manager during negative equity months



Conclusions

We view LDS funds as lower-cost, liquid strategies with an expected return stream that should provide reasonable diversification benefits versus equities. LDS funds have the potential to provide solid returns during normal markets, participate in the upside but, importantly, experience small falls (or profits) during volatile markets. This is due to the calibre of the people as well as the investment process, which benefits from sensible fundamentally or technically driven investment ideas, smart trade-structuring to create asymmetric return profiles and prudent portfolio construction/risk management.

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