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Liquid alternative strategies

Part 2: How do they do it?

How do they do it?

Generally, there are four areas where liquid alternative funds could potentially apply their tools of leverage and shorting to deliver on their value propositions of return enhancement, risk management, and/or income enhancement.

1. **Strategic asset allocation**
   Long-term unconditional broad asset class exposures
2. **Dynamic asset allocation**
   Deliberate deviations from strategic asset class exposures
3. **Security selection and relative value trading**
4. **Other options-based risk management activities**

Leverage and short selling can be applied to activities related to strategic asset allocation, dynamic asset allocation, security selection/relative value trading and other options-based risk management activities to improve investor outcomes.

Strategic asset allocation: In the context of liquid alternative mutual funds, these exposures could be leveraged, unleveraged, positive or negative. They could include equity, fixed income, currency and/or commodity investments.

Dynamic asset allocation: Instead of simply over- and under-weighting asset class exposures versus a benchmark, dynamic asset allocation within liquid alternatives can take this a step further. In some cases, it can involve moving from long exposure, to short exposure, to no exposure at all.

Liquid alternative strategies can engage in a form of security selection known as **relative value trading**, by going long one and short another related security. Trading currency and commodity pairs are a common form of relative value trading and this can also be done at the individual security or index level in equity and bond markets. The ability to invest long and short allows an investor to capture the relative return spread in-between two related assets and potentially generate a positive return, even if both assets and/or the asset class at large decline in price.

Options-based risk management activities involve the transfer of future risk or return potential from one party to another in exchange for compensation today. Options contracts that give buyers the right but not the obligation to buy or sell an asset at a pre-determined price before an expiration date are examples of this kind of return driver. This is akin to insurance being bought and sold by market participants. Premiums for insurance sold can be a source of income for one fund, whereas premiums for insurance purchased can be an ongoing cost and source of downside protection for another. The side of the transaction will depend on the mandate of the fund in question, if this return driver is present in a funds design.

- If positive returns can be generated from these activities and amplified with leverage and/or shorting, alternative strategies can be **return enhancing**.
- If returns from these activities can be of relatively low risk and/or behave differently from those of a traditional long only portfolio, they can be diversifying and **risk mitigating**.
- If attractive income can be manufactured from these activities and amplified with leverage and/or shorting, alternative strategies can be **yield enhancing**.

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How can alternative strategies utilize their additional tools to enhance these benefits versus traditional portfolios? Below are some examples:

	Return enhancement	Risk management	Income enhancement
Strategic asset allocation	An alternative fund could potentially offer leveraged exposure to broad asset classes that have a positive expected return associated with them.	An alternative fund could provide leveraged exposure to an asset class with low volatility, a high sharpe ratio and low correlation relative to an investor's portfolio.	An alternative fund could provide leveraged exposure to asset classes that pay a regular income.
Dynamic asset allocation	Short-term asset allocation trades could be amplified with leverage and expanded to be able to profit from negative-performing asset classes through shorting.	Through an investment strategy that will systematically change its asset allocation over time in response to market sentiment or through any other asset allocation strategy that exhibits complementary correlation and volatility characteristics relative to an investor's portfolio.	By opportunistically allocating to a wide range of asset classes offering the most attractive yields at any given time, without being tied to a benchmark.
Security selection and relative value trading	The short side of relative value pair trading is unlocked with the ability to short sell. The expected value added from security selection can be amplified with leverage. If dispersion of returns exists within an asset class, relative value trading can be very rewarding, even if the aggregate asset class is flat or negative.	A long/short strategy that can successfully generate returns in a market neutral fashion will be very diversifying to a traditional portfolio which is heavily exposed to market risk.	Relative value trades can be structured to generate a positive net income. This can be accomplished by investing long in higher yielding securities and shorting lower yielding securities.
Options based risk management activities	Selling insurance or market upside to other investors can be a new return source for investors with the risk tolerance to take it on.	Options strategies that are neutral to market value movements can be diversifying sources of return to traditional balanced portfolios. Buying portfolio insurance through put options can be an effective way to build explicit downside protection into a portfolio.	Selling future market downside protection or market upside to other investors can produce a positive yield now (put and call option writing).

Understanding how a fund expects to deliver on its value proposition is an important step in the due diligence process. Knowing how much to invest and how to fund the position is also very important. This is the subject of the next article in our series: How much to invest and how to fund?

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