Alternatives Evolved: New Structures for a New Age

Let's make one thing clear: Alternative investments are not right for every investor.

Alternatives are typically more intricate than ETFs, they generally have less liquidity than mutual funds, and they should never constitute a majority of an investor's portfolio. However, we believe that modern alternative investments offer more benefits than at any other previous time.

Like all investments products, alternatives are about tradeoffs. What do alternatives offer that more liquid products don't? They allow retail investors to access markets previously only available to institutions, they are designed to be uncorrelated with the broader equity markets, and they may be able to a generate higher yield. Investors who can handle the trade-offs can take advantage of the benefits that alternative investments can provide.

From the moment alternative investments came to the marketplace, they have been surrounded by certain assumptions. For a long time, many of those assumptions were true, alternative investments were rather complex, opaque investments reserved for the extremely wealthy. As time has gone on, asset managers have continually refined the structure of their funds to make alternatives much more accessible to the individual investor and an option for many different styles of portfolios.

As investors have become more sophisticated, they have increasingly focused on a total portfolio view. That is, they have generally shifted their priorities away from a return focus and now weigh diversification and downside management's effect on their overall portfolio as allocation factors.

As a result, alternative managers have focused on two structures to make it easier for retail investors to incorporate alternative strategies into their allocations: Interval Funds and Liquid Alternatives

Interval funds: This structure offers individual investors access to illiquid asset strategies such as credit and real estate. Interval funds are professionally managed investment companies registered as closed-end funds under the Investment Company Act of 1940 and can be purchased like open-ended mutual funds. They have no limits on illiquid asset concentration, other than the requirement to maintain sufficient liquid assets to fulfill repurchase requests. Investors can redeem shares in periodic repurchase offers between 5 and 25% of fund assets per year at NAV. These intervals can be every three, six, or twelve months as designated by the fund, although in practice nearly all interval funds offer a tender every three months.

Liquid Alternatives: This structure offers individual investors access to alternative strategies typical of hedge funds. Liquid alternatives are alternative investment strategies that are available through investment vehicles such as mutual funds, ETFs, and closed-end funds that provide daily liquidity. Liquid alternatives are also classified as 1940 Act funds and are regulated accordingly.

The new wave of alternative vehicles seeks to solve many of the pain points of the previous generation of alternatives. In this article we compare the previous generation of alternatives–hedge funds, direct participation programs, venture capital, and private equity—to more modern options.

BARRIERS TO ENTRY

Old Alternatives Problem

Many of the older generation of alternatives were not available to individual investors at all, limiting participation to accredited investors. In the United States, to be considered an accredited investor, one must have a net worth of at least $1,000,000, excluding the value of one's primary residence, or have income at least $200,000 each year for the last two years (or $300,000 combined income if married) and have the expectation to make the same amount this year.

Modern Alternatives Solution

The modern class of alternative investments no longer feature prohibitive net worth restrictions and allow for many more individuals to utilize alternative strategies. While suitability remains a very important consideration, the allocation process for the modern alternatives is focused on things like investors' time horizon, risk profile, and portfolio concentration. Like mutual funds, both liquid alternatives and interval funds do not carry any net worth or annual income requirements for purchase. With the Fed expected to continue raising the fed funds rate during the remainder of 2018 and into 2019, it is reasonable to expect interest rates 12 months from now to be higher than they are today.

LARGE INVESTMENT MINIMUMS

Old Alternatives Problem

The old guard of alternatives are synonymous with large investment minimums. From $100,000-$250,000 for venture capital and private equity programs up to $500,000-$1,000,000 and beyond for hedge funds, the alternatives of old were simply unreachable for a typical individual investor.

Modern Alternatives Solution

New 1940 Act structures have brought alternative assets within reach of individual investors with minimums a fraction the size of those previously associated with alternative assets. A typical interval fund minimum investment is $2,500 for non-qualified accounts and just $1,000 for qualified retirement accounts. Liquid alternatives, as publicly traded stocks, have no minimum investment requirement (provided an investor has enough capital to purchase a single share).

LACK OF TRANSPARENCY

Old Alternatives Problem

For those wealthy enough to participate in first generation alternatives, major trust must be placed in the manager due to the absence of regulation and minimal transparency provided to investors. Major concerns for participants in these programs include irregular updates on performance, minimal information on underlying asset holdings, absent information on portfolio leverage and exposure, pricing and valuation gaps, and a lack of uniform reporting standards.

Modern Alternatives Solution

As 1940 Act investment companies, the new alternative structures are held to the same reporting standards as mutual funds. Interval funds and liquid alternatives offer regular SEC filings containing information on holdings, leverage, and audited financials. They also publish daily NAV, bringing full transparency to performance which is available from public sources for shareholders or potential investors conducting due diligence.

TOTAL ILLIQUIDITY

Old Alternatives Problem

Perhaps the most infamous caveat to investing in one of the alternatives of old is the minimal access, or in many cases complete absence, of liquidity. Owners of such programs are typically subject to a lock-up period of one year or more upon initial investment in which they are unable to withdraw funds without penalty, if at all. When shareholders are out of the lock-up period and wish to exit their position, they must submit a request to the manager to redeem their shares. On average, investors wait 173 days to receive their money back.*

Modern Alternatives Solution

Liquidity is often one of the first concerns of investors considering including alternatives into their portfolio mix. Asset managers have taken notice of this in offering their strategies in the form of interval funds and liquid alternatives. Interval funds are required by law to offer to repurchase a minimum of 5% of fund shares from investors at NAV during each repurchase interval. These intervals can be every three, six, or twelve months as designated by the fund. Liquid alternatives are just that, liquid. Their shares can be sold any day that the securities they are traded on is open for trading.

As with any investment, there are certain risks associated with alternatives. The underlying investment strategies will differ between funds and should be understood and taken into consideration. Additionally, alternatives with limited liquidity are best suited for investors with longer-term investment horizons. In the post-crisis environment characterized by low yields from traditional debt, heightened volatility, and concerns about cross-asset correlation, it's no surprise that investors are looking to diversify their portfolios away from the typical mix of stocks and bonds. For a long time, the playing field was not level. Institutions had access to options that would be inaccessible to all but the wealthiest of individual investors. Now asset managers have made their institutional strategies available to individuals in the form of liquid alternatives and interval funds. Welcome to the new age of alternatives.

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* Source: SEC – "Hedge Funds: Portfolio, Investor, and Financing Liquidity" George O. Aragon, Tolga Ergun, Mila Getmansky, and Giulio Girardi. May 17, 2017