DRS vs. Liquid Alternatives

Compare and Contrast Strategies

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One of the challenges facing today's investors and financial advisors has to do with understanding the role of alternative investments within a portfolio.

To address this challenge, Swan Global Investments will provide a series of blog posts over the coming months to compare and analyze various types of alternative strategies and categories. We seek to answer the most important questions in each type of strategy, namely:

1. What are the drivers of returns in each strategy?
2. What are the risks in each strategy?
3. What role does a given strategy play within a portfolio?
4. How does the given strategy compare to the Defined Risk Strategy?

Making Space for Athletes on the Team

Every winter, college football fans around the nation eagerly await National Signing Day, when the nation's top prospects announce their initial commitment to a university. I'm always intrigued by those kids who aren't recruited to play a specific position, but are simply listed as an "athlete."

When it comes to judging the potential of a quarterback or defensive end, the analytical metrics used are pretty standardized and straightforward: speed, strength, body dimensions, etc. But with certain prospects it's hard to know just where they should fit on a team. Offense or defense? Every-down player or specialty situations? Everyone knows Christian McCaffrey or Jabrill Peppers will make a team better, but not everyone knows how to best utilize a multi-dimensional talent on a team.

These athletes are hard to classify, just as liquid alternatives are hard to classify.

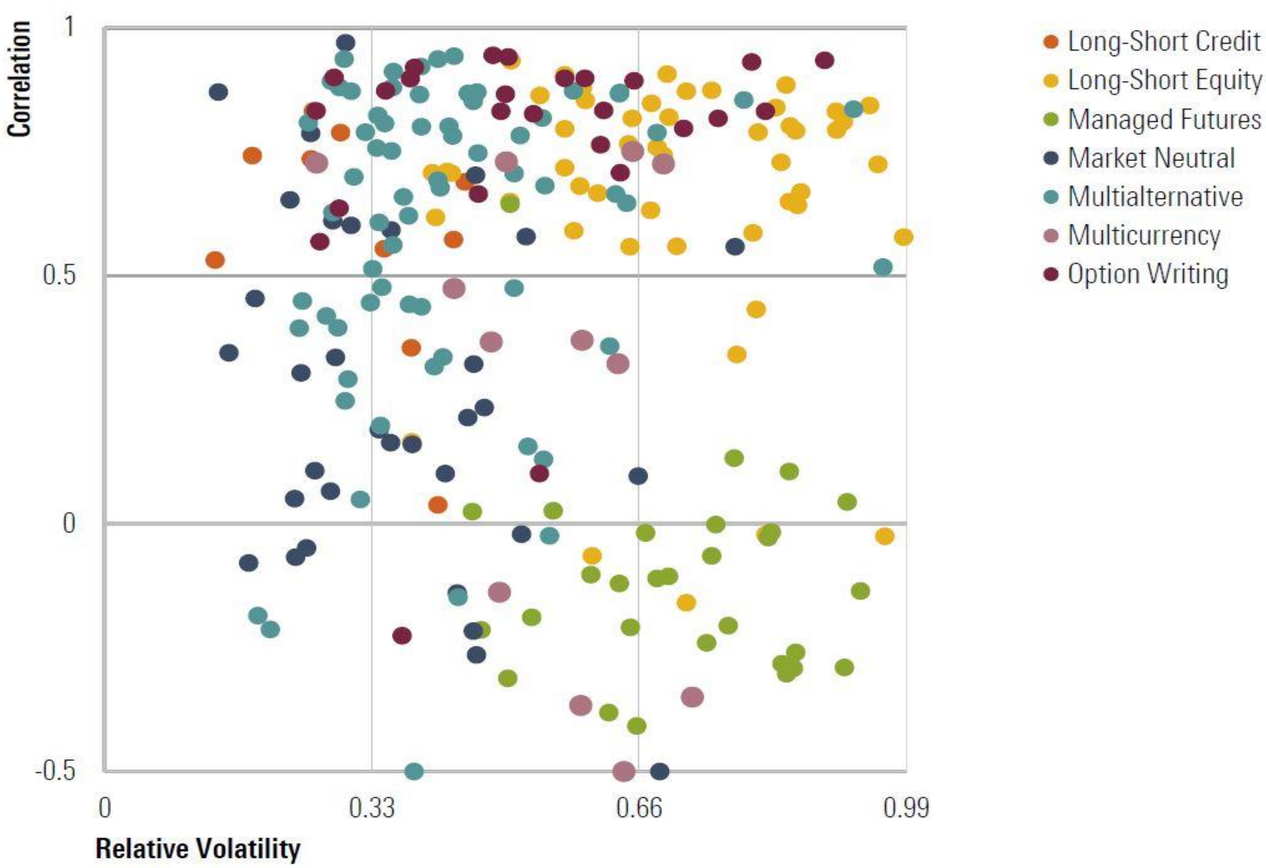
Since the Financial Crisis of 2007-09 when most equity managers lost money in lock-step with the broad market, there has been an explosion of strategies whose only common thread or similarity is that they are "doing something different."

Strategy	Pre- Crisis		Post- Crisis		Total
	Count	Percent	Count	Percent	
Long-Short Equity	21	16.5%	106	83.5%	127
Managed Futures	4	7.5%	49	92.5%	53
Market Neutral	17	34.7%	32	65.3%	49
Multi-alternative	30	21.7%	108	78.3%	138
Option Writing	8	14.5%	47	85.5%	55
Tactical Allocation	32	28.3%	81	71.7%	113
Total	**112**	**20.9%**	**423**	**79.1%**	**535**

Source: Morningstar Direct, as of 12/31/2016. Table assumes March 9, 2009 as dividing line between pre- and post-crisis

The loose definition of alternative or liquid alt makes understanding or analyzing them very tricky. These strategies are unique and wide-ranging. In 2016, Morningstar expanded their liquid alternative framework by adding several new categories and creating an alternative style box to complement their work in traditional investments.

Exhibit 1 The U.S. Liquid Alternative Universe



Source: Morningstar Direct, as of 7/31/2016

Drivers of Returns

The “value proposition” of alternatives varies greatly.

For example, some strategies try to short underperforming stocks as well as own outperforming stocks. The drivers of return in long/short strategies are primarily at the individual stock level.

Other strategies make top-down decisions and reallocate their portfolios based upon the anticipated relative performance of asset classes.

The fate of tactical asset allocators or market timing strategies is driven by systematic, market factors. We cover this in more detail in a recent blog post.

Market neutral strategies might try to have very low exposure to market movements.

Option-based strategies are influenced by “the Greeks” of option pricing models - i.e., Delta, Gamma, Theta, Vega, and Rho.

The multi-alternative category tries to replicate the “fund of funds” structure employed by hedge funds by rolling many of the above strategies together in one package.

I could go on, but the point is that broad definition of “liquid alternatives” encapsulates many different strategies and trying to understand all the factors at play becomes very difficult to manage.

Sources of Risk

Any experienced financial professional will tell you return is closely related to risk.

The risks will be directly linked to how they generate returns.

> *If a long-short strategy has a value-bias, what happens when growth is in favor?*
>
> *What happens when a tactical asset allocator’s predictive model breaks down?*
>
> *What happens to an option strategy when a short position goes in-the-money?*

These are the kinds of things that will be explored in a case-by-case analysis.

Role Within a Portfolio

As with return and risk, the role of an alternative within a portfolio will vary depending upon the broad type of strategy and the unique characteristics of an individual strategy. Broadly speaking, most professionals view alternatives as either beta-reducers or alpha-drivers…defense or offense, to return to our football analogy.

However, the biggest problem is that alternative investments typically don't make up a large enough allocation to have a significant impact on the end results of a portfolio.

If alternatives are used, they tend to be in the 10%-20% range of an overall portfolio. Moreover, many practitioners divvy up their alternative allocation amongst several or many managers, diluting the impact any one manager can have on a portfolio.

How Do Liquid Alternatives Relate to the Defined Risk Strategy?

When Swan first developed the Defined Risk Strategy, the original intent was that it would be a total portfolio solution. These days, we most frequently position the DRS as a core equity position - one with large cap characteristics, downside protection, and a significant weighting in a portfolio.

That said, the use of options and the fact that the DRS return patterns don't closely track the S&P 500 when using metrics like beta, R-Squared, and correlation leads some to classify the DRS as a liquid alternative. These themes are explored in-depth in Swan's recent white paper, "Where Does Hedged Equity Fit?"

Given the lack of understanding of alternatives and the challenges described previously, perhaps it is no surprise that many investors have been reluctant to dedicate a significant allocation to strategies that are "different."

To return to our original analogy, Stanford or Michigan wouldn't have won as many games had they kept McCaffrey or Peppers on the bench. Those kinds of players were game-changers *only* when they were in the game.

The objective of this upcoming series of blog posts is to help investors understand these non-traditional strategies, so that they can play a meaningful role in a portfolio.

Feel free to review more information on the Defined Risk Strategy performance, or its components, call 970.382.8901.

About the Author:

Marc Odo, CFA®, CAIA®, CIPM®, CFP®, Director of Investment Solutions, is responsible for helping clients and prospects gain a detailed understanding of Swan's Defined Risk Strategy, including how it fits into an overall investment strategy. Formerly Marc was the Director of Research for 11 years at Zephyr Associates.

Important Notes and Disclosures: