Financial Planning Newsletter

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Alternative Assets

What are Alternative Assets?

Alternative assets are best defined by what they are not. Generally speaking, alternative assets are all non-traditional assets and strategies. As Figure 1 illustrates, traditional assets include (fully paid for, long-only) stocks, bonds, and cash assets while the alternative assets class is comprised of a number of unconventional subcategories:

Figure 1.

(Fully Paid For, Long-only) Traditional Assets	
Stocks	
- Individual stocks:	GE, IBM, MSFT
- Mutual funds:	Jensen Quality Growth Fund (JENSX)
- ETFs:	iShares MSCI EAFE ETF (EFA)
- Other:	Long call on a stock or index
Bonds	
- Individual bonds:	Apple Inc. 3.85%, 5/4/43, Sr. Unsecured Bond (037833AL4)
- Mutual funds:	PIMCO Total Return Fund (PTTDX)
- ETFs:	Vanguard Total Bond Market ETF (BND)
- Other:	Convertible debt, Preferred stock
Cash	
- Certificate of Deposit	
- Money Market Funds	

(Non-Traditional) Alternative Assets	
Alternative Strategies	
- Active Currency	- Managed Futures
- Convertible Arbitrage	- Market Volatility
- Distressed Debt/Equity	- Merger Arbitrage
- Dynamic Allocation	- Multi-Strategy
Hard Assets	
- Antiquities/Collectables	
- Commodities	
- Precious Metals	
- Real Estate	
Hedge Funds	
- Global Macro	
- Market Neutral	
- Long/Short Bond	
- Long/Short Equity	
Private Equity	
- Buyout	
- Private Equity	
- Special Situations	
- Venture Capital	

While a variety of alternative strategies invest in traditional assets (e.g. long-short stock funds), they employ a diverse set of “alternative” tools and techniques typically not utilized by traditional long-only investment strategies. Some of these tools and techniques include:

- Short selling (i.e. borrowing a stock in return for paying a fee and simultaneously selling the security with the intention of buying it back at a lower price)
- The use of leverage (i.e. the use of debt to amplify returns)
- Significant use of derivatives (e.g. options, futures, structured notes, and swaps)
- Unique mandates (e.g. Fama-French Factors and tactical view).

Alternative assets also encompass certain traditional “satellite” assets, such as master limited partnerships (MLPs) and real estate investment trusts (REITs). As with traditional stocks and bonds, satellites are long-only and have representation in traditional benchmarks, but they are differentiated by their investment structure, underlying asset exposures, and intrinsic supply and demand characteristics.

Liquid Alternatives

Historically, alternative assets were largely confined to hedge funds, private equity, and private real estate due to their legal structure as private placements. As such, these investments were only available to very high-net worth investors and institutions (endowments, pensions, insurance companies, etc.). Over the past decade, however, there has been a proliferation of publicly available investment structures designed to track private investment strategies. The most common of these vehicles are “liquid alternative” mutual funds (aka liquid alternatives). The market share of liquid alternatives, which stands at 2% of the current $15.8 trillion mutual fund market (up from 0.2% in 2002), is expected to more than double by 2018[1].

Since liquid alternatives are mutual funds, they fall under the 1940 Investment Companies Act (aka ’40 Act), which is an extensive set of rules and regulations governing all publically available pooled investment vehicles (open-end funds, closed-end funds, ETFs, and unit investment trusts). All investment companies must register any pooled investment vehicle to be sold to retail and institutional investors in the open markets with the Security and Exchange Commission (SEC), which has oversight over this legislation. The ’40 Act also requires full disclosure of all material information (e.g. financial conditions, investment objective/policies, related risks) via a publically

[1] GSAM Perspectives, December 2013 Issue No.2

available prospectus prior to the initial offering of shares as well as regular information disclosures aimed at *ensuring that potential investors and fund shareholders receive timely and accurate information that promotes informed decision-making* and *prohibit self-dealing, in which people or entities related to the fund use the fund to their own advantage*[2].

Technically, privately offered funds, such as private equity, hedge funds, and private real estate funds, fall within the definition of an "investment company," but the '40 Act contains an exemption for these vehicles. As such, the creation of these entities (typically a limited partnership) and their regulatory oversight are substantially different relative to liquid alternatives. Other key differences between liquid alternatives and private investment funds are outlined in Figure 2 below.

Figure 2.

Key Difference	Liquid Alternatives	Private Investment Funds
Accessibility	Broad; dependent upon fund minimums	Accredited investors only
Fees	Mutual funds are prohibited from charging management fees; the investment manager/sub-advisor typically charges a combined management fee of 100-200bps of the fund's AUM (Citi Prime Finance, July 2013)	Typically a 2% management fee and 20% share of upside over a predetermined rate
Leverage	Leverage limted to 33% of the gross asset value of the fund (i.e. gross leverage of 133%)	Unlimited although data compiled by Morgan Stanley suggests average gross leverage among hedge funds is 153%
Liquidity	Must provide daily liquidity to investors; maintain 85% of portfolio in liquid assets; no more than 15% of assets in illiquid securities (instruments that take longer than 1 trading day to liquidate)	Typically monthly/quarterly liquidity; advanced notice required for redemptions
Transparency	Full disclosure of all material information that an investor would require in order to make the most informed decision about an invsement; regular disclosure requirements	Less onerous disclosure requirements although recent changes to the general solicitation rules contained within the private placement exemption have resulted in greater regulatory oversight
Taxes	Form 1099 reporting	Form K-1 reporting

Why Invest in Alternative Assets?

The common characteristic shared among all alternative assets is their differentiated return patterns relative to traditional stocks and bonds. These differentiated returns can be driven by the unique supply and demand characteristics of the underlying asset/strategy or by the tools and techniques implemented by the investment manager. Since alternative asset returns are shaped differently relative to traditional assets, they provide the opportunity for additional diversification benefits when added to a traditional investment portfolio as they have potentially lower overall volatility and lower asset correlations. As Figure 3 demonstrates, alternative assets tend not to move in lockstep with traditional assets classes (i.e. have correlation coefficients of less than +1.00 as reflected in the correlation matrix) while also exhibiting (in some cases) lower annualized volatility of returns.

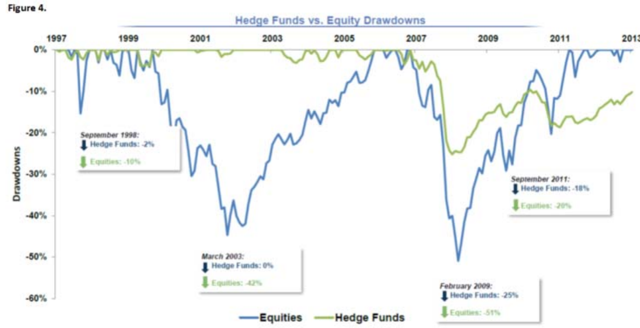
Figure 3.

	U.S. Large Cap	EAFE	EME	Bonds	Corp. HY	Munis	Currcy.	EMD	Cmdty.	REITs	Hedge Funds	Eq Market Neutral*	Ann. Volatility
U.S. Large Cap	1.00	0.89	0.77	-0.26	0.76	-0.11	-0.48	0.58	0.30	0.77	0.81	0.61	16%
EAFE		1.00	0.90	-0.16	0.77	-0.03	-0.57	0.66	0.20	0.70	0.88	0.54	20%
EME			1.00	-0.03	0.81	0.10	-0.62	0.79	0.09	0.62	0.90	0.54	25%
Bonds				1.00	-0.02	0.84	0.02	0.35	-0.17	0.03	-0.21	-0.33	4%
Corp. HY					1.00	0.19	-0.55	0.85	0.11	0.71	0.77	0.63	12%
Munis						1.00	-0.02	0.54	-0.26	0.09	-0.04	-0.12	4%
Currencies							1.00	-0.48	-0.39	-0.47	-0.65	-0.67	6%
EMD								1.00	0.05	0.65	0.65	0.49	9%
Commodities									1.00	0.49	0.18	0.47	21%
REITs										1.00	0.57	0.61	26%
Hedge Funds											1.00	0.64	8%
Eq Market Neutral*												1.00	14%

Calculated based on quarterly total return data for period 12/31/03 to 12/31/13; Source: JPAM Guide to the markets 1Q14

In addition to providing the potential to improve portfolio diversification, alternative assets can mitigate the effects of severe drawdowns particularly as they relate to equities. Drawdown is a measurement of decline from an asset's peak value to its lowest point over a period of time. As Figure 4 illustrates, hedge funds experienced significantly less maximum drawdowns as compared to the S&P 500. Reducing the level of drawdown via the inclusion of alternative assets into a traditional asset portfolio allows investors to stay invested during periods of uncertainty and potentially participate in subsequent rebounds (e.g. the post-February 2009 market rebound).

Figure 4.

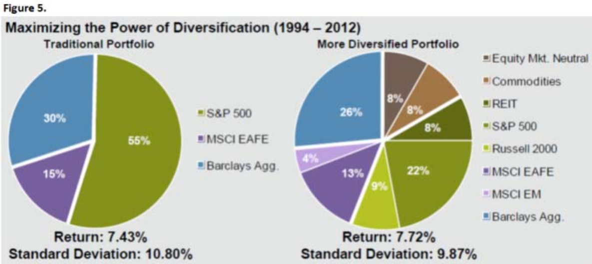


Equities: S&P 500 & Hedge Funds: HFRX Global Hedge Fund Index; Source: GSAM An Introduction to Liquid Alternatives February 2014

[2] Investment Company Act of 1940 [As Amended Through P.L. 112-90, Approved January 3, 2012]; sec.gov

By enhancing diversification and mitigating the effects of severe drawdowns, the inclusion of alternative assets provides the potential to increase portfolio returns and reduce total volatility over the long-term. Historical data since 1994 suggests that a portfolio with more diversified holdings, including non-correlated liquid alternative strategies, resulted in less volatility and a higher return (Figure 5).

Figure 5.



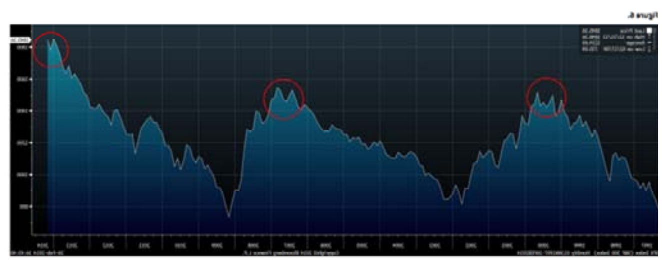
Source: JPMorgan Asset Management Guide to the markets 1Q14

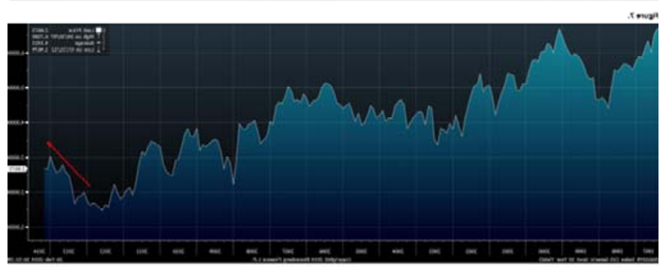
While historical relationships and return patterns help with constructing more efficient portfolios, they provide no guarantee of future results. Thus it is imperative to monitor the robustness of asset correlations and the mean reverting tendencies of return patterns as they compare to strategic, long-term expected returns and volatility values and to adjust client portfolios accordingly. It is also important to ensure diversification and appropriate position sizing within a portfolio's alternative assets allocation to reduce the unique risk exposures associated with this asset class. As reflected in Figure 3 above, commodities have low correlations to U.S. large cap stocks and bonds, thus providing substantial diversification benefit, but at the expense of higher annualized volatility, which can enhance both the upside and downside return potential of a portfolio. In addition to high volatility positions, other commonly shared risks among alternative assets include leverage, less-familiar asset class exposure, and counterparty risk.

Clarity Wealth Advisors Strategy for Alternative Assets

The use of alternative assets to enhance diversification and expand potential long-term risk-adjusted return is not a new concept. Thought leading, long-term oriented investors, such as sovereign wealth funds, endowments, and foundations, have been active investors in alternative assets for close to a decade. As of fiscal year 2013, the average non-development Western sovereign wealth fund allocated 21% of its assets to alternatives (+26% year-over-year) while the average endowment and foundation allocated 53% to alternatives (-1.9% year-over-year)[3].

As depicted in Figure 6 and Figure 7, investors find themselves at a crossroads with the S&P 500 trading near an all-time high and the 10-year Treasury rate in the process of normalizing. This double whammy of potential valuation concerns in equities and expected rising interest rates provides an ideal time to increase exposure to alternative assets as alternatives may help hedge volatile equity exposure in periods of uncertainty (see Figure 4. above) and potentially enhance returns in an environment of falling bond prices.





Clarity Wealth Advisors anticipates increasing its clients' allocation to alternative assets from a current weighting of roughly 2-10%, depending on the underlying investment strategy, to a long-term strategic target of 12-15%. Even though the prevailing weight attributed to alternative assets is 1.6-3.9x higher among the institutional investors cited above, Clarity Wealth Advisors deems this

[3] Invesco Global Sovereign Asset Management Study 2013 and 2013 NACUBO-Commonfund Study of Endowments

strategic target to be prudent given the differentiated time horizon and liquidity needs of its clients relative those of institutions. This target range won't be achieved overnight but rather over a course of months as Clarity Wealth Advisors seeks an optimal mix of alternative assets, which will include the introduction of new alternative assets and strategies and the sale of legacy positions.

The Goldman Sachs Multi-Manager Alternatives Fund (GSMMX/GMAMX)

Clarity Wealth Advisors' recent purchase of this fund reflects its effort to increase clients' exposure to alternative assets in both a thoughtful and measured approach. As a multi-strategy fund-of-funds, GSMMX provides exposure to a number of non-traditional investment strategies including, but not limited to, equity long/short, dynamic equity, event driven and credit relative value, tactical trading, and opportunistic fixed income strategies. Due to its diverse set of exposures, this liquid alternative fund serves as an ideal core alternative assets position from which Clarity can layer more targeted alternative assets and strategies over time.

Even though GSMMX is a relatively new fund (April 2013 inception date), it is managed by the Goldman Sachs' Alternative Investments & Manager Selection (AIMS) group, which is one of the world's largest and most established alternative investment and advisory organizations, with 275 professionals spread across 8 global offices, including San Francisco, New York, London, Hong Kong, and São Paulo. The history of AIMS can be traced back to 1969, and its 10-member investment committee is comprised of a season group of investors with 12 to 26 years of industry experience.

The size and breadth of AIMS and the durability of its franchise provide a competitive advantage over other public or private fund-of-funds managers by enabling comprehensive access to a variety of alternative strategies and high-quality investment managers. This comprehensive access combined with a robust due diligence, portfolio construction, and risk management process has enabled AIMS to generate robust investment returns over a number of market cycles. Figure 8 provides the performance and volatility information for the AIMS private hedge fund opportunities composite strategy, which is a $2.7 billion, global multi-manager investment strategy similar to the strategy employed by GSMMX. As this chart shows, the composite hedge fund opportunities strategy provided equity-like returns, especially on a 'since inception basis', with bond-like volatility. This unique return/risk profile was especially evident during periods of extreme dislocation (e.g. 2008 & 2013). While this is not an apples-to-apples comparison to GSMMX, given the composite's refined focus on hedge funds and the various differences between liquid alternatives and private funds cited in Figure 2, it does provide support for both the durability of the AIMS investment platform and AIMS ability to effectively run multi-manager alternative strategies. Lastly, GSMMXs 2.15% all-in expense ratio[4] appears reasonable considering it's essentially in line with the median multi-strategy peer group value of 2.14%[5].

Figure 8.

Performance Summary — Inception Date: Jan-06

	Return						Annualized				
	YTD 2013	2012	2011	2010	2009	2008	1 Yr	3 Yrs	5 Yrs	Since Inception	S.I. Volatility
GS Composite: Hedge Fund Opportunities (1.00% Mg	9.44%	5.74%	-2.58%	6.30%	11.12%	-11.17%	10.28%	4.86%	5.81%	5.30%	5.68%
MSCI World Index Hedged USD	23.65%	13.13%	-7.53%	8.28%	23.36%	-39.87%	25.82%	10.95%	11.76%	2.73%	15.26%
Barclays Aggregate Bond Index	-1.46%	4.23%	7.86%	6.56%	5.93%	5.24%	-1.59%	3.10%	5.34%	4.98%	3.34%

Hedge Fund Opportunities Composite Strategy performance (net of a 1% management fee & 5% incentive fee) as of 11/30/13; source GSAM

[4] The gross expense ratio for share class I of 2.88% less 0.73% of expense limitations (acquired fund fees/expenses, transfer agency fees/expenses, taxes, interest, brokerage fees, litigation, indemnification, shareholder meeting, and other extraordinary expenses the Investment Adviser has agreed to reduce or limit and effect through at least 4/30/14); class A all-in expense ratio is 2.55%

[5] Source: Bloomberg