ALTERNATIVES RESEARCH

An Integrated Approach to Investing in Marketable Alternatives

Summary

As we approach the decade mark of the current economic expansion, institutions are increasingly searching for the most effective way to prepare their portfolios for a possible downturn without prematurely reducing risk. Given the potential importance of hedge funds in that discussion, Wilshire is introducing a new framework for investing in alternative strategies that, based on specific portfolio objectives, takes a more targeted and integrated approach than what is commonly found within today's institutional allocations. As the alternatives industry has evolved, expanding into a more diverse set of investment strategies and structures, investors have the benefit of greater flexibility with their investment approach. As a result, allocators now have a larger variety of options regarding investment terms, liquidity provisions, style exposures and other factors from which to tailor customized solutions. In conjunction, Wilshire has replaced the constricting term, "Hedge Funds," with a broader category we will call "Marketable Alternatives." Marketable Alternatives includes a growing universe of risk premia strategies, alternative mutual funds, traditional hedge funds and hybrid closed-end funds.

Given the extensive array of alternative investments available to investors, Wilshire recommends avoiding general strategy classifications. Instead, we advocate for a classification framework that specifies each strategy's expected role within a broader portfolio. In its simplest form, alternative strategies can be placed into Directional and Diversifying groups, which tend to align more consistently with investor objectives. By adopting this framework, investors have more flexibility to integrate alternatives into their specific portfolios and a more accurate understanding of each investment's purpose. Within this structure, Wilshire has developed a Focus List of highly-rated alternative investment strategies, emphasizing the belief that manager selection is still critical to success. When properly executed, this approach results in more efficient capital deployment according to each investor's specific investment objectives and constraints.

Introduction

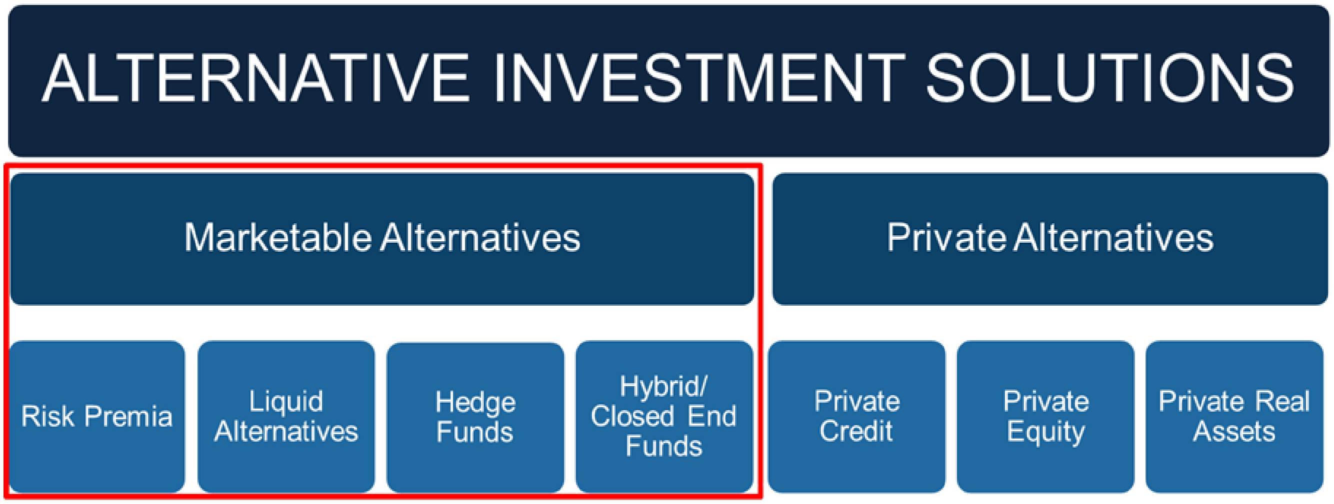
The alternatives industry is evolving. Ten years ago, the common approach to investing in hedge funds, which we refer to as "Hedge Funds 1.0," involved building a segregated, diversified portfolio of hedge funds that aimed to deliver absolute returns with lower volatility than traditional risk assets. Within the last five years, investors have rightly challenged that framework due to a variety of factors, including hedge fund underperformance, high fees, undesirable liquidity characteristics and unintended risk exposures. As a voice of change within this evolution, Wilshire Consulting is advising clients to move away from this inadequate, "one size fits all" investment approach toward an integrated, objectives-based framework that broadens the term "hedge funds" to the more appropriate universe of "marketable alternatives."

Wilshire does not consider hedge funds as a distinct asset class, but instead views them as a particular investment structure that represents a broad range of directionality, risk, exposure and liquidity characteristics. As a result, the "hedge fund" label is naturally expanded to include traditional hedge funds, alternative mutual funds, risk premia strategies and closed-end hybrid funds, all of which we classify within the dynamic Marketable Alternatives toolkit. Wilshire uses the flexible nature of Marketable Alternatives to achieve customized portfolio objectives. Instead of building a static, diversified portfolio of hedge fund investments, we employ a diverse array of strategies to drive returns, hedge downside risks, or pursue a combination of these seemingly competing objectives.

Consistent with a shift from an investment framework based on fund structure to one focused on the intended role of marketable alternatives within client portfolios, Wilshire recommends segregating the hedge fund universe into "Directional" and "Diversifying" groups. Rather than relying on traditional strategy classifications, which are often misleading and/or overly broad, the Directional/Diversifying segmentation more consistently aligns with investor objectives. By assessing the expected role of each marketable alternatives strategy, we are able to dynamically structure customized alternatives portfolios that can naturally evolve to holistically meet investment goals as the exposures and risk factors change within a broader institutional portfolio. In addition, this approach gives investors more flexibility as they are able to integrate certain alternatives within traditional asset class categories should those strategies provide the appropriate liquidity and exposure characteristics. This approach is intended to create a more efficient, flexible investment process while delivering better risk-adjusted returns that are in line with individual investor expectations. Nonetheless, manager selection remains a critical factor for success when investing in alternatives regardless of the investment framework employed.

Defining *Marketable Alternatives*

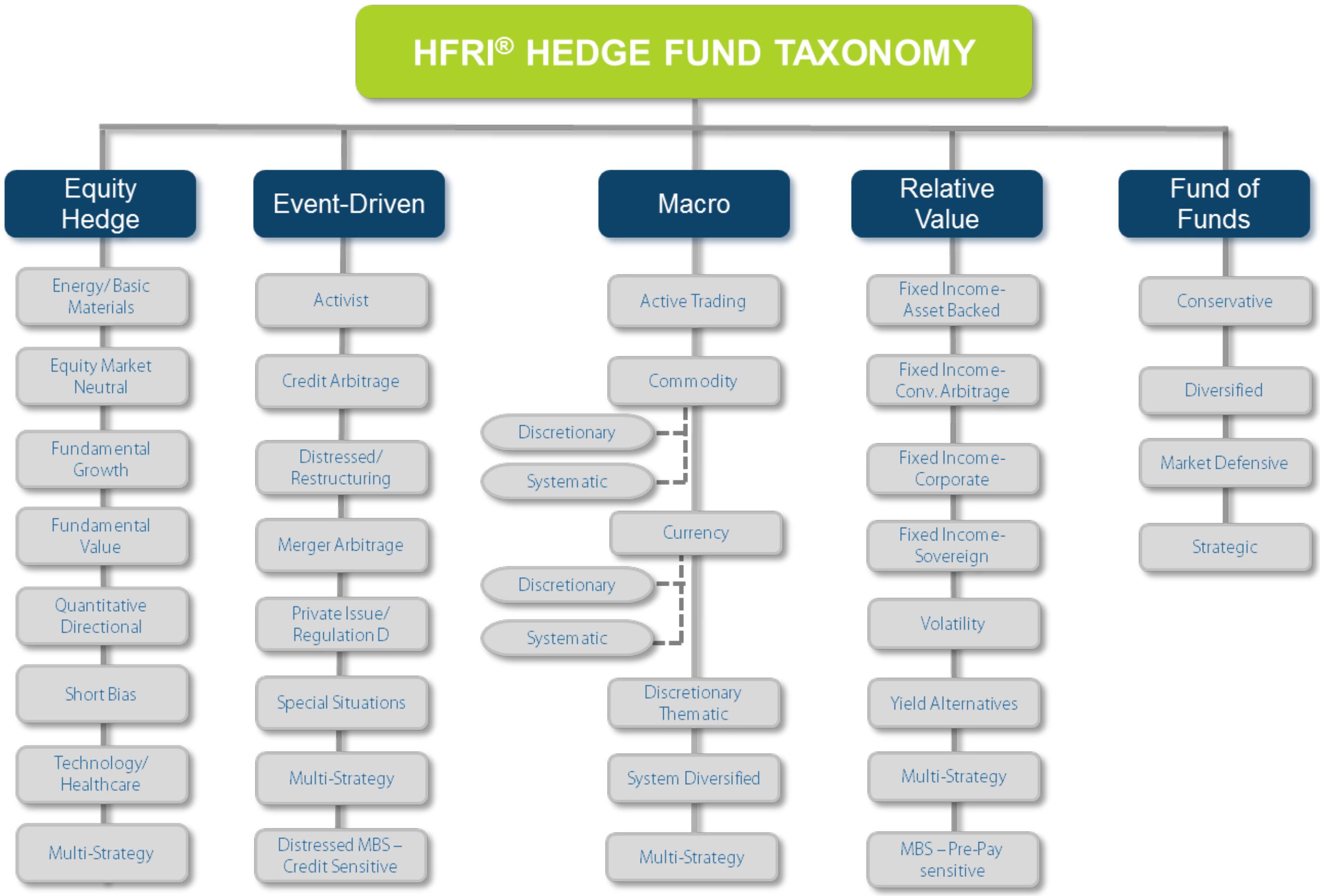
Wilshire distinguishes Marketable Alternatives from traditional investments and private alternatives. We generally define Marketable Alternatives as benchmark-agnostic strategies with liquidity provisions less than or equal to five years. By contrast, traditional investments generally offer daily liquidity and are tied to specific market benchmarks, while private alternatives generally have lock-ups longer than five years. It is worth noting that the terms themselves provide no information regarding return expectations, risk expectations, fees or asset class exposures. Indeed, each of these characteristics can differ significantly according to the specific underlying strategy associated with each of these categories. The diagram below outlines the distinction between Marketable Alternatives and Private Alternatives within the broader alternative investment universe.



While hedge funds have been rightfully maligned in years past, the industry has evolved to broaden the array of investment solutions that fit a variety of portfolio constraints and considerations. Onerous hedge fund terms paved the way for **liquid alternatives**, also known as alternative mutual funds, which offer liquid long/short investment strategies in a fund structure with lower fees and better liquidity than the average hedge fund. The lack of alpha generated by hedge funds eventually led to the emergence of **risk premia strategies**, which offer exposure to alternative market beta at a lower cost and with better liquidity terms than the average hedge fund. Lastly, many of the current **hybrid funds** have replaced what was formerly known as a "side pocket" by offering investors exposure to less liquid, longer-term investments in a separate, more fee-friendly structure that does not affect the liquidity of other comingled funds. This gradual progression has broadened the investor toolkit and unlocked the universe of marketable alternatives to a much more diverse investor base that now has the ability to customize their alternatives portfolio according to specific investment objectives and constraints.

Redefining Strategy Groups According to Portfolio Role

The traditional strategy classifications commonly used to label hedge fund strategies are *Equity, Event-Driven, Relative Value,* and *Macro*. Hedge Fund Research® (HFRI®) uses these four strategy categories, as well as numerous other sub-categories to group individual hedge funds. While some of these labels are technically accurate, there is a wide assortment of hedge funds within each style header, representing varying characteristics related to market exposure, investment approach, and portfolio construction guidelines. As a result, two different hedge funds within the same *Relative Value* strategy category can generate significantly disparate risk and return outcomes. In addition, the sheer number of strategy categories makes it very challenging to translate those options into a focused investment portfolio. The traditional hedge fund taxonomy is depicted below.



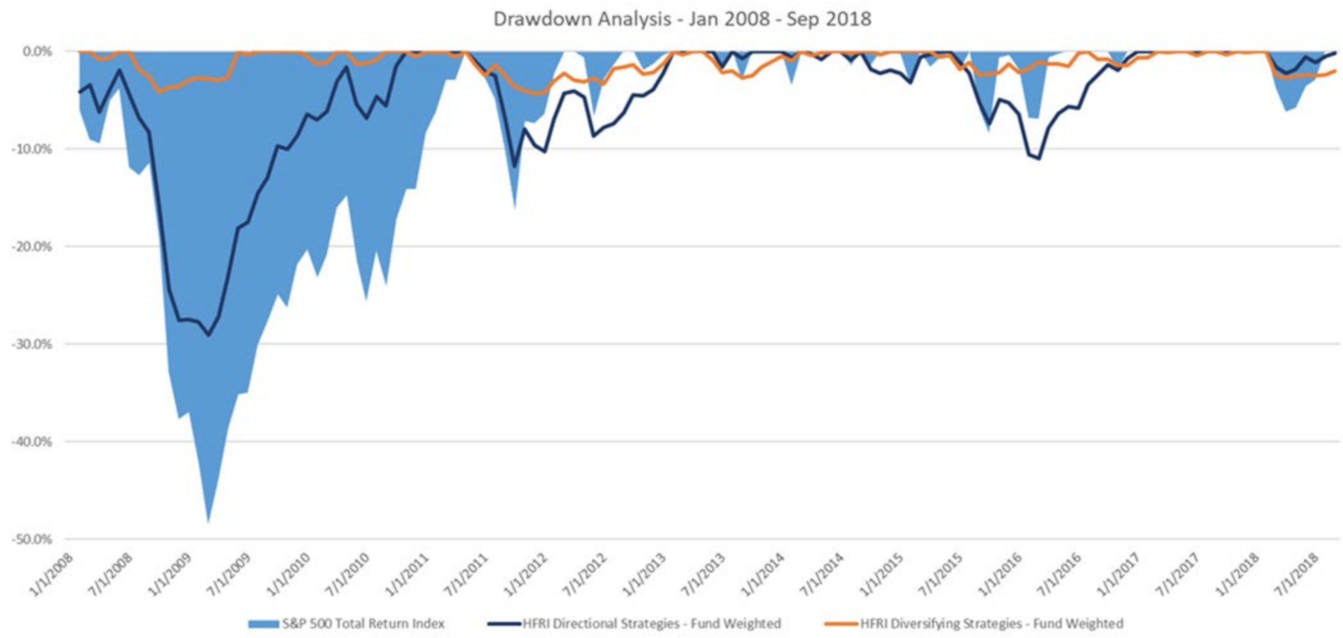
In order to align strategy characteristics with investment expectations, Wilshire has reorganized the traditional HFRI® hedge fund segmentation into ***Directional*** and ***Diversifying*** groups. While these groups are still subject to specific investor customization, they provide more context regarding the intended role within a client portfolio as it relates to traditional risk asset exposures. The revised *Directional/Diversifying* hedge fund taxonomy is included in the Appendix.

Wilshire's Directional and Diversifying Strategy Groups

In addition to reorganizing the HFRI hedge fund taxonomy, Wilshire has developed general definitions for *Directional* and *Diversifying* alternative strategies that are supported by relative quantitative data. *Directional* strategies tend to be directionally long risk assets and exhibit a higher correlation to broad equity indices than the global hedge fund index, though some may exhibit lower beta. More specifically, these are strategies that generally maintain net exposures over 50% net-long, with equity market correlations of 0.75 or more and betas that generally range from 0.25 to 0.75. As it relates to generic strategy classifications, these funds often fall within the *Equity Hedge* and *Event Driven* segments.

Diversifying alternative strategies are those that utilize arbitrage opportunities, dynamic directional exposures and/or specific market inefficiencies to generate returns. As a result, these strategies tend to exhibit both low betas (<= 0.25) and low correlations (<= 0.5) to equity markets. These *Diversifying* strategies often map within the *Global Macro, Equity Market Neutral, Merger Arbitrage* and *Relative Value* segments of the traditional hedge fund taxonomy.

To provide context around the risk characteristics of the Directional and Diversifying segments, the chart below shows the historical drawdowns of the S&P 500 Total Return Index from January 1, 2008 to September 30, 2018. In addition, the Wilshire "Directional" and "Diversifying" groups are also depicted to illustrate the different downside characteristics of each index relative to equities.



Data source: Hedge Fund Research, Inc.

As the chart indicates, the "Directional" group has exhibited some correlation to equity markets while protecting capital in pronounced market downturns, while the "Diversifying" group has exhibited very little correlation to equity markets during periods of negative performance and has consistently protected capital in most downside scenarios.

Similarly, the tables below provide the total return experiences of the S&P 500 Index, Barclays Global Aggregate Bond Index, Wilshire "Directional" group, and Wilshire "Diversifying" group during various time periods. Wilshire selected three bear market or challenging periods for equity markets, as well as three bull market or distinct positive periods.

Total Returns in Negative Periods for Equity Markets

From	To	S&P 500	Barclays Agg.	HFRI Directional	HFRI Diversifying
Nov-07	Feb-09	*(50.95%)*	0.69%	(29.03%)	2.95%
May-11	Sep-11	*(16.26%)*	0.97%	(11.79%)	(3.56%)
May-10	Jun-10	*(12.80%)*	(0.06%)	(5.33%)	(1.17%)

Total Returns in Positive Periods for Equity Markets

From	To	S&P 500	Barclays Agg.	HFRI Directional	HFRI Diversifying
Mar-09	Apr-11	*93.95%*	24.57%	53.44%	16.98%
Oct-11	Jul-15	*101.77%*	(0.49%)	31.84%	11.57%
Oct-15	Sep-18	*61.43%*	6.05%	23.32%	6.06%

Data source: Hedge Fund Research, Inc.

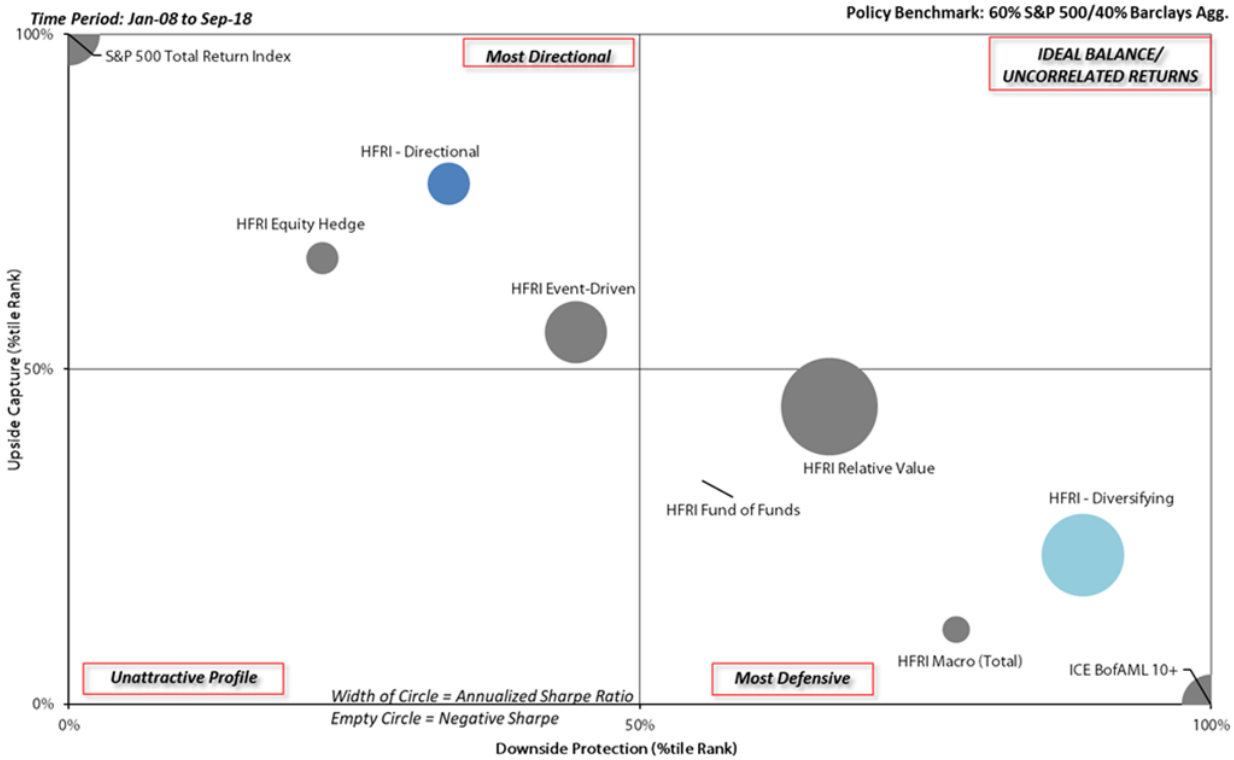
As the tables illustrate, the “Directional” group captures a significant portion of upside performance in positive equity market environments while preserving capital in periods of challenging equity market returns. The returns of the “Diversifying” group, as its title suggests, are essentially flat during the selected periods of negative equity market returns, yet the index also captures a portion of the upside during positive periods for equities. As we will reiterate shortly, manager selection is still a primary component of expected performance, and these groups only serve as very broad indicators of the different marketable alternative strategies available to investors.

Integrating *Directional* and *Diversifying* Strategies within a Broader Portfolio

One of the primary benefits of Wilshire’s *Directional/Diversifying* hedge fund framework is its adaptable nature within a variety of investment portfolios. Marketable Alternatives no longer need to be segregated as a separate asset class with high barriers to entry. Instead, *Directional* alternatives can compete alongside traditional assets according to their underlying market exposures and strategy characteristics. In addition, *Diversifying* strategies have the ability to serve the same role that traditional portfolio hedges look to achieve. The chart below illustrates the role of the HFRI “Directional” and “Diversifying” strategies within a simple 60/40 portfolio of equities and bonds. We have also included the traditional HFRI strategy indices for comparative purposes. More technically, the Y-axis within the chart represents Wilshire’s proprietary upside capture score when the policy benchmark is positive, while the X-axis represents Wilshire’s proprietary downside protection score when the policy benchmark is negative. The size of each circle within the chart represents the Sharpe Ratio of that index; the larger the circle, the higher the Sharpe Ratio.

As the chart indicates, the “Diversifying” group represents a defensive portfolio of investments relative to a traditional portfolio of 60% U.S. stocks and 40% global bonds. In addition, the “Diversifying” group provides greater downside protection than both the HFRI Relative Value and HFRI Macro indices while generating an attractive Sharpe Ratio. Concurrently, the “Directional” group delivers greater upside capture than both the HFRI Equity Hedge and HFRI Event-Driven indices while offering greater downside protection than the HFRI Equity Hedge Index.

Upside Capture/Downside Protection Analysis



As discussed previously, an important and differentiating element of the *Directional/Diversifying* framework is its ability to support Wilshire's highly customized Hedge Fund Advisory service. For example, the structure easily accommodates the common portfolio construction approach of carving hedge funds out as a distinct allocation sleeve. In such cases, the idea of "integrating" *Diversifying* and *Directional* alternative strategies involves analyzing the correlation, beta, and other risk factors of the alternative holdings relative to the broader client portfolio; however, the alternatives portfolio maintains its own risk and return assumptions.

The *Directional/Diversifying* framework also supports those investors who prefer to embed marketable alternatives within their traditional asset class structure. This implementation approach typically appeals to investors with fewer/smaller hedge fund holdings and is particularly appropriate when those underlying strategies are long-only equity funds, directional credit funds, etc., which more closely align with traditional asset class risk exposures.

Manager Selection: A Critical Success Factor in Marketable Alternatives Integration

While reclassifying alternative investment strategies based on anticipated portfolio roles should clarify investment expectations, even those classifications can be quite broad. As a result, manager selection is critical to success regardless of the investment framework employed. In conjunction with individual strategy classifications according to their expected roles, Wilshire has developed and maintains a proprietary *Marketable Alternatives Focus List* of highly rated strategies. This list, which serves as a menu of evaluated funds/vehicles, is categorized within Wilshire's *Directional/Diversifying* framework for consistency. As such, the *Focus List* framework marries traditional strategy categories with descriptions of each strategy's intended role. The framework is illustrated below with one or more strategies/funds supporting each of the italicized categories.

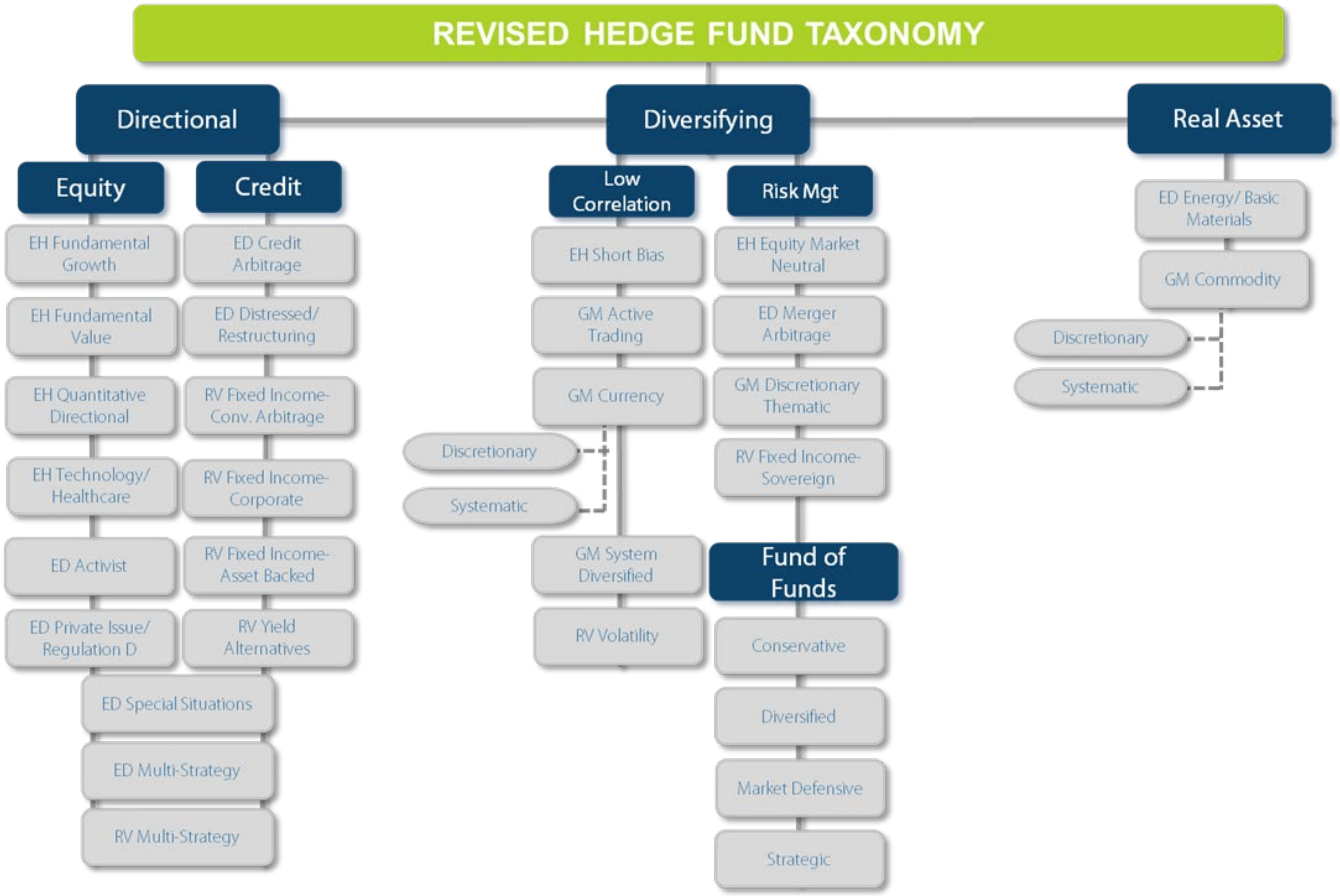
Wilshire's Marketable Alternatives Focus List Framework

Directional		Diversifying	
Equity	**Credit**	**Capital Preservation**	**Low Correlated Yield**
Long-Biased	**Alternative Yield**	**Equity Market Neutral**	*Reinsurance*
Activist	*Direct Lending*	*Fundamental*	*Litigation Finance*
Fundamental	*Structured Credit*	*Quantitative*	**Dynamic Correlation**
Quantitative	**Long/Short Credit**	**Multi-Strategy**	**CTA/Trend Following**
Medium Net	*Distressed*	*Event-Driven*	*Long Term*
Event-Driven	*Fundamental*	*Relative Value*	*Medium Term*
Fundamental	*Multi-Strategy*	*Risk Premia*	*Short Term*
Quantitative	**Multi-Asset Class**	**Relative Value**	*Exotic Markets*
	Equity Focus	*Merger Arbitrage*	**Discretionary Macro**
	Credit Focus	*Convertible Arbitrage*	**Long Volatility**
		Volatility Arbitrage	**Systematic Macro**
			FX
			Multi-Strategy
			Trend Anticipation

Conclusion

While the hedge fund industry has progressed to become a seemingly complex universe of various structures and strategies, Wilshire has developed a simple, integrated investment framework to capitalize on the breadth of alternative investments available to our clients. Marketable Alternatives can serve various roles within a broader portfolio, such as a driver of portfolio returns or a hedge against multiple risk factors. We believe alternative investments are a key component to a diversified portfolio, and Wilshire's *Directional/Diversifying* framework provides flexibility and access to alternatives for a wide array of investor types and sizes. Given the significant dispersion of returns across strategy types and fund structures, manager selection remains a critical element of a successful investment portfolio. Consequently, Wilshire maintains a *Focus List* of highly-rated Marketable Alternative strategies within the *Directional/Diversifying* investment framework, thereby providing the requisite flexibility to meet a wide variety of customized client objectives.

Appendix


REVISED HEDGE FUND TAXONOMY
Directional
Diversifying
Real Asset
Equity
Credit
EH Fundamental Growth
EH Fundamental Value
EH Quantitative Directional
EH Technology/ Healthcare
ED Activist
ED Private Issue/ Regulation D
ED Credit Arbitrage
ED Distressed/ Restructuring
RV Fixed Income-Conv. Arbitrage
RV Fixed Income-Corporate
RV Fixed Income-Asset Backed
RV Yield Alternatives
ED Special Situations
ED Multi-Strategy
RV Multi-Strategy
Low Correlation
Risk Mgt
EH Short Bias
GM Active Trading
GM Currency
Discretionary
Systematic
GM System Diversified
RV Volatility
EH Equity Market Neutral
ED Merger Arbitrage
GM Discretionary Thematic
RV Fixed Income-Sovereign
Fund of Funds
Conservative
Diversified
Market Defensive
Strategic
ED Energy/ Basic Materials
GM Commodity
Discretionary
Systematic

Important Information

7762343 G0520

More information

For more information, please contact us directly:

T +1 310 451 3051

Wilshire

1299 Ocean Avenue, Suite 700, Santa Monica, CA 90401

wilshire.com