

**Expanding Horizons:
The Alternative Investment Landscape**

By
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Executive Summary

In pursuit of attractive risk-adjusted returns and diversifiers to traditional portfolio holdings, investors and their advisors are seeking alternatives. Commodities, hedge funds, and managed futures provide independent return streams with low correlations to both stocks and bonds. Especially in this environment of subpar equity returns and historically low Treasury yields, the alternative asset class offers upside potential and downside protection.

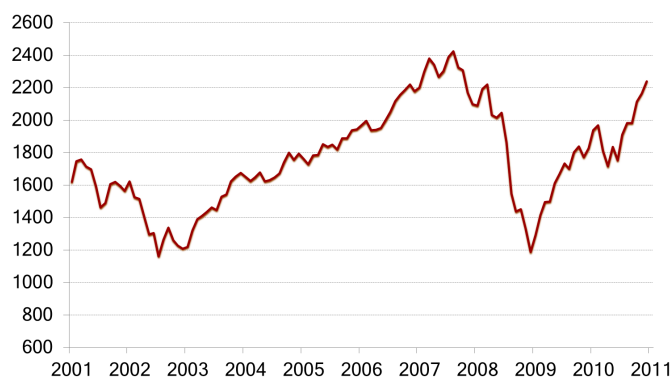
Alternative strategies’ diversification benefits and attractive risk-adjusted returns have helped grab investors’ attention. Once available only to institutions and ultra-high net worth individuals, alternatives are now accessible to virtually all investors. With increased participation, the alternative market has developed, becoming increasingly liquid and offering improved transparency and pricing integrity without a degradation of quality.

This paper will provide an introduction to alternative investments—defining alternatives, highlighting their benefits, and discussing investor access to the burgeoning market.

Backdrop

During the last decade, the U.S. stock market endured two gut-wrenching declines, bond yields reached historic lows, and housing values plummeted. The average U.S. home price fell 15% over the last three years.¹ The charts below show stocks’ weak returns and bonds’ secular low interest rates. The S&P 500 is up only 2.62% over the last ten years.² U.S. Treasury yields continue to hover just above inflation rates.

U.S. Stock Returns



Source: Bloomberg, Pelagos Capital

10-Year U.S. Treasury Yield



Source: Bloomberg, Pelagos Capital

¹From \$313,600 in 2007 to \$272,200 in 2010. U.S. Census. Available online at: <http://www.census.gov/const/uspriceann.pdf>.

²Ten-year annualized S&P 500 total return through February 28, 2011.

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Until recently, stocks and bonds appeared to satisfy the bulk of investor needs; stocks provided roughly 10% long-term returns, while bonds offered some downside protection. Then came 2008, when stocks plunged 38% and even a 40% allocation to the Barclays Aggregate Bond Index³ didn't prevent significant losses. The traditional 60%/40% mix of stocks and bonds failed to provide the downside protection expected from these allocations, accelerating the search for additional diversifiers to stocks.

Defining Alternatives

Broadly speaking, alternative investments provide returns that are primarily generated from sources other than traditional long-only exposure to stocks, bonds, and cash. Equities generate returns from revenues, earnings, and management capability, while bond and cash returns are dependent upon interest rates levels, inflation expectations, and issuer credit quality.

The alternative asset class is variously defined, but generally thought to be composed of assets—commodities, real estate, private equity, art, and collectibles—and strategies, such as shorting, hedging, leverage, and arbitrage. Of course, some alternative investments may use both alternative assets and strategies.

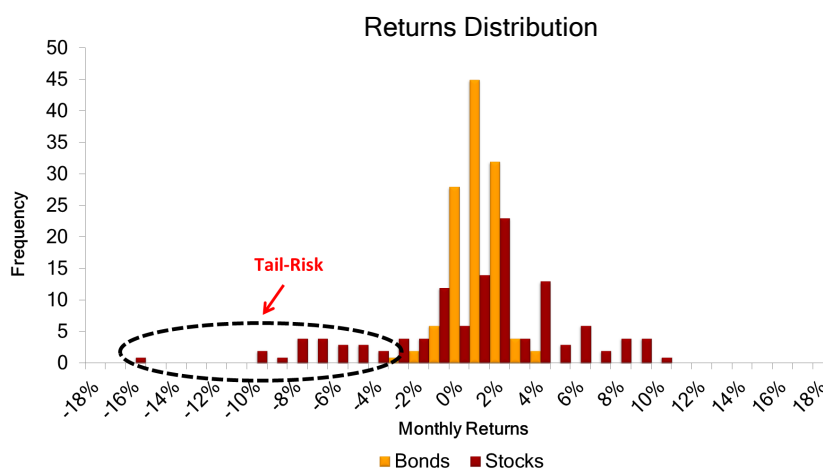
Commodity sectors include agriculture, energy, industrial metals, livestock, and precious metals. Real estate assets can be land, buildings, infrastructure, real estate investment trusts (REITs), partnerships, or secondaries (like mortgage-backed securities). Timberland and agricultural farm land also are available to investors. Private equity encompasses venture capital, mezzanine capital, distressed investments, and leveraged buyouts. Hedge funds and managed futures are alternative strategies, employing options, futures, and structured products in the global equity, fixed income, currency, and commodity markets.

Because venture capital, private equity, art, collectibles, direct real estate, and timber are generally unable to provide investors a comfortable combination of liquidity, transparency, and pricing integrity available with other alternatives, stocks, or bonds, we focus our further analysis on managed futures, hedge funds, and commodities.

Benefits of Alternatives

The primary attraction of alternative investments stems from their distinct sources of return relative to traditional investments.

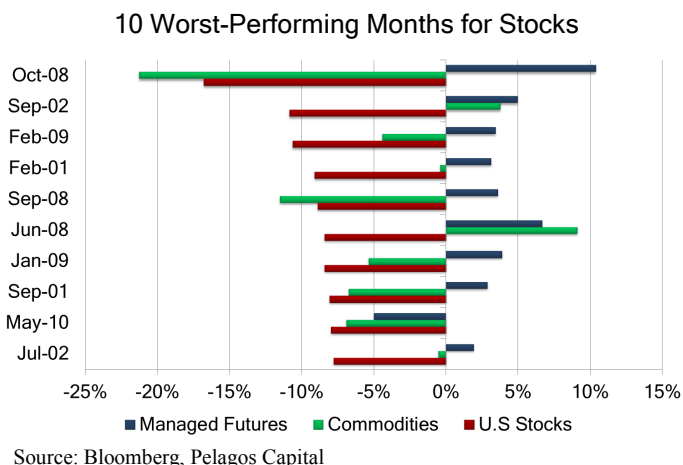
Alternatives provide the same type of benefit that bonds historically offered—diversification to equities and some protection against downside tail risk (see chart on the right).



Source: Bloomberg, Pelagos Capital

³In 2008, the index was still called the Lehman US Aggregate Bond Index.

By minimizing losses during the rough months, alternatives minimize drag on overall portfolio performance. The chart to the right illustrates that in the last ten years, when equities have tumbled, managed futures and commodities have performed relatively well. Even when the global equity markets have been reeling, managed futures have often contributed positive returns. Not only do alternatives provide diversification benefits versus stocks, they can also generate attractive risk-adjusted returns.



One often-cited measurement of diversification is correlation. Although not perfect, it does provide some insight as to how the returns of two asset classes or strategies moved in relation

10-Year Correlation Matrix through 2010

	U.S. Stocks	International Stocks	Bonds	Commodities	Hedge Funds	Managed Futures
U.S. Stocks	1.00	0.89	-0.09	0.40	0.63	-0.36
International Stocks		1.00	0.02	0.53	0.75	-0.27
Bonds			1.00	0.03	-0.01	-0.13
Commodities				1.00	0.63	0.25
Hedge Funds					1.00	0.06
Managed Futures						1.00

to each other. A correlation of +1.00 implies returns are in lock step with each other, while -1.00 implies an inverse relationship. A correlation of 0.00 may indicate no relationship; returns can be independent of each other. The matrix on the left highlights the correlations of various combinations of asset classes.

Source: Bloomberg, Pelagos Capital

Not long ago, international stocks provided some diversification to U.S. stocks, but the correlation has trended higher over time. After all, both are advanced economy equity exposures, increasingly subject to a globalized economy. The chart below shows the rising rolling three-year correlations of international stocks (MSCI EAFE) and U.S. stocks (S&P 500).



Source: Bloomberg, Pelagos Capital

Alternatives can provide a better antidote to portfolio volatility. Note the low correlation of commodities and managed futures to stocks and bonds (in the chart above). Even though managed futures strategies often use commodities, the correlation of commodities to managed futures also has been low. The two alternatives may complement each other at the same time they diversify a traditional stock and bond portfolio.

Alternatives offer valuable benefits, while not giving up strong performance potential. Commodities tap into different markets than traditional stocks and bonds. The asset class has been bolstered by robust emerging market demand, as developing countries, such as China and India, build their infrastructures, boosting demand for industrial metals. Agricultural commodities have also been strong performers as the middle class in developing countries broaden their diets. Prices for crude oil and its refined products have been escalating as global demand remains strong and supply concerns linger. Each of these factors will likely continue to support commodity prices in the coming years.

Another great advantage of alternatives is that hedge funds and managed futures enable investment managers to profit not only when markets are appreciating, but when securities and markets depreciate. Long positions only allow investors to make uni-directional bets. Hedge funds and managed futures can dynamically implement short positions across a variety of markets, providing the potential for positive returns when markets are under downward pressure.

The mosaic below highlights the rotation of annual returns of both traditional investments and alternatives. Commodities, hedge funds, and managed futures have often been the strongest-performing asset classes. Both bonds and alternatives offer diversification benefits versus stocks, providing protection against portfolio volatility. However, alternative investments more often present the opportunity for outperformance.

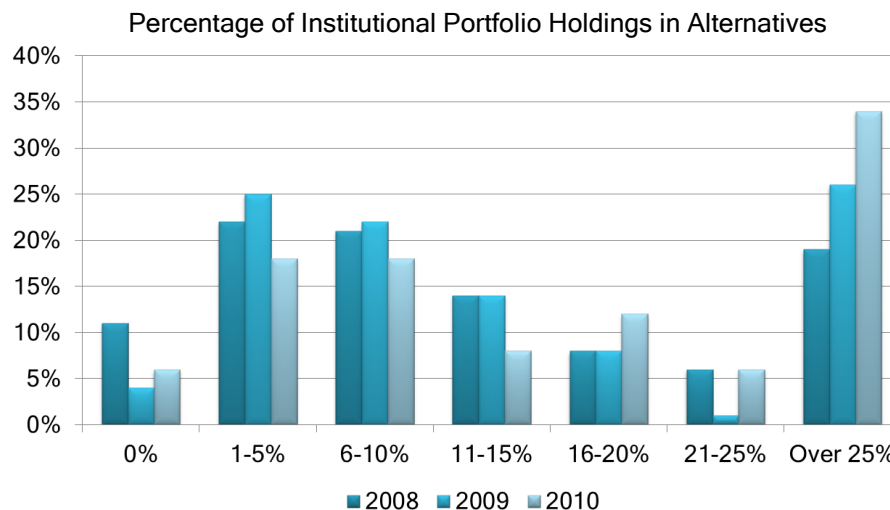
Annual Rotation of Asset Class Returns

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Managed Futures 9.9%	Commodities 25.9%	International Stocks 38.6%	International Stocks 20.2%	Commodities 21.4%	International Stocks 26.3%	Commodities 16.2%	Managed Futures 19.3%	High Yield 58.2%	Commodities 16.8%
Bonds 8.4%	Managed Futures 11.8%	High Yield 29.0%	Managed Futures 11.5%	International Stocks 13.5%	U.S. Stocks 15.8%	Managed Futures 12.5%	Bonds 5.2%	International Stocks 31.8%	High Yield 15.1%
High Yield 5.3%	Bonds 10.3%	U.S. Stocks 28.7%	High Yield 11.1%	Hedge Funds 7.5%	High Yield 11.8%	International Stocks 11.2%	Hedge Funds -21.4%	U.S. Stocks 26.5%	U.S. Stocks 15.1%
Hedge Funds 2.8%	Hedge Funds 1.0%	Commodities 23.9%	U.S. Stocks 10.9%	Managed Futures 7.0%	Hedge Funds 10.4%	Hedge Funds 10.3%	High Yield -26.2%	Commodities 18.9%	International Stocks 8.0%
U.S. Stocks -11.9%	High Yield -1.4%	Hedge Funds 11.6%	Commodities 9.1%	U.S. Stocks 4.9%	Bonds 4.3%	Bonds 7.0%	Commodities -35.6%	Hedge Funds 11.5%	Bonds 6.5%
Commodities -19.5%	International Stocks -15.9%	Managed Futures 10.1%	Hedge Funds 6.9%	High Yield 2.7%	Commodities 2.1%	U.S. Stocks 5.5%	U.S. Stocks -37.0%	Bonds 5.9%	Hedge Funds 5.6%
International Stocks -21.4%	U.S. Stocks -22.1%	Bonds 4.1%	Bonds 4.3%	Bonds 2.4%	Managed Futures 2.1%	High Yield 1.9%	International Stocks -43.4%	Managed Futures -4.9%	Managed Futures 2.5%

Source: Bloomberg, Pelagos Capital

Access to Alternatives

Until recent years, many alternatives were only available to institutional investors or individuals that met certain income and/or net worth thresholds. Especially since the steep losses of 2008, when the search for additional low-correlated assets to stocks accelerated, institutional investors have been shifting money into alternatives (see chart on next page). Now, more than half of institutional investors have at least 16% of their portfolio devoted to alternative investments; a third have committed over 25% to alternatives.

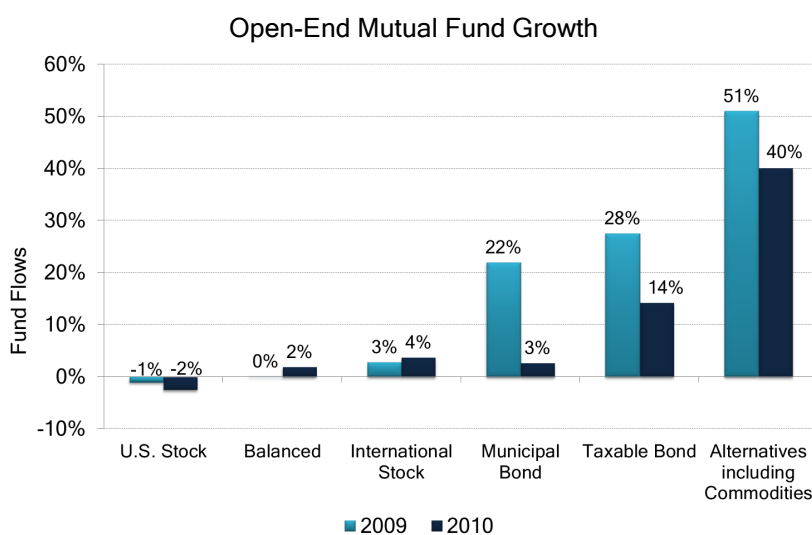


Source: Morningstar, Barron's⁴

Long-term investment horizons of institutional and ultra-high net worth investors afforded them the luxury of placing money in vehicles that were less liquid, marketed privately, and offered the mystique of exclusivity. Unfortunately, the crises of 2008 brought to fore the downside of these characteristics. When needed most, liquidity could not be met. Many hedge funds have only monthly or quarterly redemption options and may also have restrictions on the amount of dollars leaving the funds.

The mutual fund industry responded with several products designed to deliver alternative investment exposure without the risks of private funds. Daily pricing, enhanced liquidity, and requisite transparency of the mutual fund format appear to negate the downside of private vehicles. Considerably smaller fees, lower investment minimums, and favorable tax treatment offer additional benefits.

Commodities, managed futures, and hedge fund-like funds have been launched and are gathering significant assets (as can be seen in the chart to the right). Advisors are increasingly recommending allocations to the asset class.⁵ Now that all investors have access to the powerful diversification benefits offered by alternative investments, more are choosing alternatives to round out their portfolios.



Source: Morningstar

^{4, 5} Morningstar and Barron's 2010 Alternative Investment Survey of U.S. Institutions and Financial Advisors, January 17, 2011. Available online at: <http://corporate.morningstar.com/us/documents/MarketResearchSurveys/MorningstarBarrons2010Survey.pdf>.

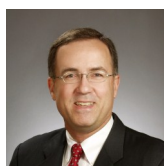
Conclusion

Institutional and ultra-high net worth investors have been taking advantage of alternative investments for years and lately have increased their allocations to the asset class. With the advent of alternative mutual funds, all investors can now tap into the commodity, hedge fund, and managed futures space to get better risk-adjusted portfolio returns.

Industry developments and enhanced oversight have addressed many of the concerns affecting the market and should provide even greater liquidity, enhanced transparency, and more-accurate pricing going forward.

Recent capital market turmoil and secular low interest rates have prompted a search for additional asset classes to not only reduce volatility, but potentially increase performance. Alternatives access new sources of return, providing diversification benefits that enable investment managers to build better-balanced portfolios. Once the sole domain of institutions and ultra-high net worth investors, alternative investments can now be utilized by all investors to build well-diversified portfolios that can minimize volatility and enhance overall portfolio performance.

About the Author



John Pickart, CFA is Co-Founder, Partner, Senior Portfolio Manager, & CFO at Pelagos Capital Management. He designs and manages alternative strategies, using commodities, hedge funds, and managed futures (commodities, equities, fixed income, and currencies). Prior to establishing Pelagos, he was Senior Portfolio Manager at State Street Global Advisors, where he ran a Morningstar-rated four-star mutual fund. He started as a Portfolio Manager while with Mesirow Financial. He also served as Assistant Director of Equity Research & Investment Analyst at First of Michigan Corporation. John received his BS in finance at the University of Tampa and his MBA from The University of Chicago, Booth School of Business. He is a chartered financial analyst and member of the CFA Institute and Boston Security Analysts Society.

Appendix I: Alternative Assets and Strategies

The following is a list of the most common alternative investments; it is a mix of both alternative assets and alternative strategies.

Commodities

These are investments directly in commodities or futures on commodities, and are distinct from equity investments in commodity-oriented companies. Commodities offer broad or targeted exposure across a variety of sectors such as energy, metals, minerals, agriculture, and livestock.

Hedge Funds

These are vehicles that encompass a wide swath of strategies including equity hedge, global macro, convertible arbitrage, relative-value arbitrage, and distressed.

Managed Futures

Strategies designed to seek long or short opportunities around the world across multiple asset classes including equities, bonds, commodities, and currencies.

Private Equity

Investments are in companies with the anticipation of a turnaround of operations and liquidity event for exit strategy. These are typically long-term and illiquid investments.

Timberland

Investments in live timber are often diversified globally. Long growing cycles lead to lack of liquidity in the market and makes frequent pricing difficult.

Venture Capital

Private vehicles invested in early-stage companies in need of growth capital. Companies' lack of development increases risk and often requires years to realize an exit strategy.

Appendix II: Benchmarks Cited in Charts and Text

Bonds: Barclays Capital Aggregate Bond Index (BC Agg)

Commodities: Dow Jones-UBS Commodity Index (DJ-UBSCISM)

Hedge Funds: Hedge Fund Research, Inc. Global Hedge Fund Index (HFRXTM Global)

High Yield: Barclays Capital U.S. Corporate High Yield Index (BC High Yield)

International Equities: Morgan Stanley Capital International Europe, Australasia, and Far East Index (MSCI EAFE[®])

Managed Futures: Standard and Poor's Diversified Trends Indicator (SPDTI)

U.S. Equities: Standard and Poor's 500 Index (S&P 500[®])

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