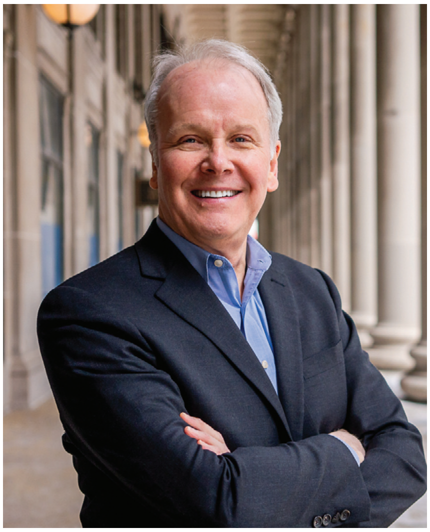

Liquid Alternatives: Is Now the Right Time to Invest?

With economic uncertainty looming, are liquid alternative investments key to protecting your clients' portfolios? As history shows us, these nontraditional investments might deserve another look.

Mark J. Gilbert, CPA/PFS, MBA
President, Reason Financial Advisors
mgilbert@reasonfinancial.com
ICPAS member since 1982

Liquid alternative investments, aka liquid alts, have been around for years, growing in popularity during and after the 2008 financial crisis. And, with traditional equity and bond holdings suffering substantial losses throughout 2022 so far, the use of these nontraditional investments is once again gaining ground in the financial planning community. As we find ourselves in another uncertain economic environment, investors are eagerly looking for ways to stem the flow of losses as well as further diversify their portfolios.

Here are a few things to consider before advising your clients where to put their money next.

WHAT ARE LIQUID ALTS?

Liquid alts describe a broad range of investments, which either: (1) provide retail investors an alternative to only holding traditional stocks, bonds, and cash, or (2) employ alternative investment strategies that are typically associated with hedge funds (think short selling strategies and futures trading) and are usually packaged in a mutual fund or exchange-traded fund (ETF) vehicle to provide liquidity on a daily basis.

The draw to these types of investments has historically been driven by their low or inverse correlation to the broader stock and bond markets. For instance, when broad stock market indexes trend lower, bond market indexes generally rise. Usually, the conditions for that to occur are a weak economic outlook, with a moderate-to-low outlook for interest rates. Of course, in the first half of 2022, we've seen a weakening economic outlook (bad for stocks) coupled with a rising outlook for interest rates (bad for bonds and stocks). In other words, neither the broad stock market indexes nor the bond market indexes are producing gains, so investors are increasingly looking for a perceived safe haven. Enter liquid alts, whose strategies "tend to focus on capital preservation, long-term portfolio diversification, or enhanced risk-adjusted returns in isolation or combination," according to Morningstar.

Per Investopedia, Morningstar previously identified 12 liquid alts categories, five of which accounted for some 80% or more of the various liquid alts funds:

- Long-short equity funds concentrate on equity securities and derivatives and combine a mix of long and short positions based on the fund's outlook that may be achieved through holding various ETFs, options, or stock positions.
- Nontraditional bond funds take unconventional approaches to bond investing to achieve returns that aren't correlated with the bond market.

- Market neutral funds seek to generate positive returns in upward or downward trending environments, often using paired long and short positions.
- Managed futures funds invest primarily through derivatives, including listed and over-the-counter futures, options, swaps, and foreign exchange contracts. Most use momentum approaches, while others follow mean-reversion or other strategies.
- Multialternative funds combine different alternative strategies, such as those listed above. They may have fixed allocations to set strategies or vary their approaches depending on market developments.

Morningstar has since consolidated its liquid alts categories to better define and differentiate the strategies employed by these funds, supposedly helping investors make better comparisons and investment decisions. Morningstar's new liquid alts categories include Equity Market-Neutral, Event-Driven, Macro-Trading, Multistrategy, Options-Trading, Relative Value Arbitrage, and Systematic Trend. Regardless of what the funds are called or how they're classified, the important consideration is whether they work.

ARE LIQUID ALTS WORTH IT?

There are mixed answers as to whether liquid alts prevent client losses or achieve their stated strategies. I, for one, have long been a skeptic of the benefits of liquid alts.

According to Morningstar, several of its liquid alts categories saw better returns than its U.S. Market Total Return average of -21.3% for the six-month period ended June 30, 2022. However, over two-, three-, and five-year periods, essentially none of the liquid alts category averages outpaced the general stock market.

As with traditional stock and bond investments, success in using liquid alts really comes down to whether or not the type of investment product or strategy employed is in favor. For example, the two liquid alts categories whose average returns were positive during the first half of 2022 were Equity Market-Neutral and Systematic Trend. Alongside traditional stock and bond investing, these alternative funds employed two strategies known as momentum investing and short selling:

1. **Momentum investing:** This strategy targets stocks that are appreciating in price. Fund managers buy and hold these stocks until the momentum slows, then sell the stocks and redeploy the proceeds to other stocks that are showing momentum.
2. **Short selling:** This is the practice of selling borrowed stock and repurchasing it later. Short sellers profit when prices of the borrowed stock fall and can be repurchased at a lower price than when they sold it.

During the first half of 2022, certain legacy energy providers' and defense contractors' stocks exhibited momentum characteristics, while much of the stock market was fertile territory for short selling. Notably, well-managed funds that followed these two strategies would've easily posted strong returns over this time.

These performance results are encouraging enough for us to take another look at using liquid alts in diversified client portfolios. After all, 2020 and 2021 produced substantial gains across the broad stock market, which were helped by federal government spending and the easing of monetary policies by the Federal Reserve. It's highly unlikely that such accommodative actions will be taken again in the near term, as the Federal Reserve is now being driven to tighten monetary conditions in the wake of historic rising inflation. In other words, I think it's time to seek some alternatives.