7 Things to Know About Investing With Liquid Alts

The why, what and how of the new breed of mutual funds

Liquid alts blend the risk-control orientation of hedge funds with the advantages of mutual funds: liquidity, transparency, SEC oversight and lower fees.

Highlights

The concept: diversify with low-correlation return streams.

Choosing from the wide and rapidly evolving array of strategies.

The keys to measuring performance and evaluating strategies.

Incorporating liquid alts into an existing asset allocation framework.

Just 10 or so years ago, only large institutional investors and very wealthy individuals were talking about alternative investing. Today it's a hot topic in investment circles of all types—and with good reason. While alternative investments were once available only to "accredited" investors who qualify to invest in hedge funds and other private partnership vehicles, the rise of liquid alternatives (liquid alts) is a game changer.

Now all investors can endeavor to manage risk and pursue their financial goals with the same kinds of tools used by the largest and most sophisticated investors. Liquid alts can also help investors build "all-weather" portfolios that are more resilient and have a higher probability of achieving their long-term objectives than traditional stock and bond portfolios.

As the term implies, liquid alternatives arose from the merging of two concepts:

Alternative means investments that employ a strategy other than traditional stock and bond investments. The key to their appeal is that they generally exhibit performance patterns different from those of the mainstream markets. That is why large investors have long used alternatives to hedge against market volatility, find new sources of growth and income, and help protect assets against inflation.

Liquid is a defining characteristic of mutual funds and exchange-traded funds (ETFs), which offer daily pricing and shares that can be purchased or redeemed at any time. Mutual funds offer other investor-friendly features, too, including lower fees than hedge funds, lower minimum investments and greater regulatory oversight. Liquid alts must meet the same legal and regulatory requirements as any other mutual fund.

Institutional investors have increasingly used alternative investments with the aim of "de-risking" their portfolios.

Liquid alts, then, are a new breed of mutual funds and ETFs that provide access to alternative investment strategies, including those similar to hedge fund approaches. Dating back to the early days of the millennium, the trend gained steam after the 2007-09 financial crisis, when many investors began looking in earnest for ways to protect their assets from steep and broad market declines. In the decade between 2004 and the end of 2014, the number of alternative mutual funds and ETFs exploded, and their assets grew tenfold.[1]

Still, "liquid alts" isn't exactly a household phrase. Representing only a small fraction of the U.S. fund industry's more than $17 trillion in assets,[2] these hybrid funds are unfamiliar to many investors. Liquid alts are also the subject of some confusion and more than a few misconceptions—which is understandable given how rapidly the category has grown and evolved.

As specialists in liquid alternatives, we at Forward hear many questions about what defines them, how they work and what they are designed to do. We've stitched our answers into this compilation of fundamentals that we think every serious investor should know.

1. Alternatives are designed to control risks—not chase higher returns.

Since alternative mutual funds are a relatively recent phenomenon, the word "alternative" has been associated primarily with the hedge fund industry. It has also been colored by a few hedge fund managers renowned for their audacious currency or commodity bets. Because hedge funds are less constrained by regulation than mutual funds, their managers are free to pursue high-risk, high-reward strategies, and some do. This is one reason why hedge funds are only open to large and ultrawealthy investors.

But this does not mean that alternatives—or even hedge funds—are inherently risky. Hedge funds were created in the late 1940s as vehicles that could pursue positive absolute returns regardless of the direction of the capital markets. They were designed for very wealthy investors who cared more about avoiding losses than about beating the market.

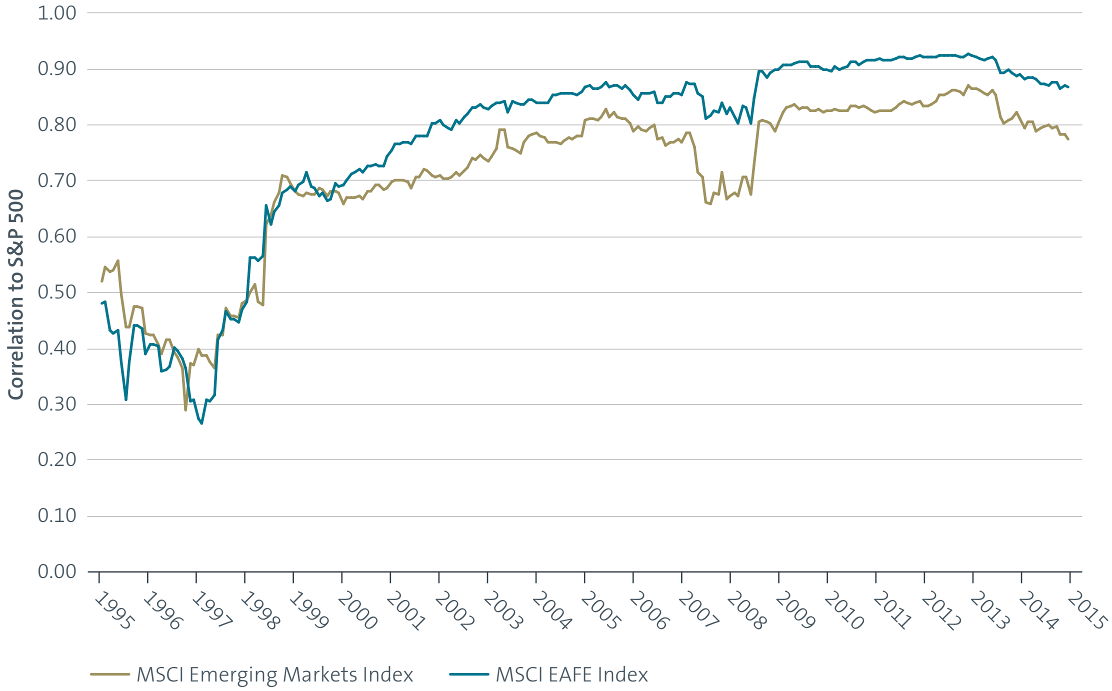
Since the turn of the millennium, large endowments, pension funds and other institutional investors have increasingly used alternative investments with the aim of "de-risking" their portfolios. That is, they have sought to lower their overall risk of losses by putting some share of assets into investments with low correlations to the mainstream markets (that's why they're called "alternative").

Liquid alts blend the risk-control orientation of hedge funds with the advantages of the mutual fund structure: liquidity, transparency, heightened regulatory oversight and lower fees. You could say liquid alts offer hedge-fund-like strategies for the rest of us.

FIGURE 1

Rising Correlations Among U.S. and Global Markets

Five year rolling periods, March 31, 1995 – March 31, 2015



Sources: Morningstar, MSCI and Standard & Poor's
Past performance does not guarantee future results.

2. Alternatives are designed to make diversification more effective in any market climate.

Low-correlation asset classes have different drivers of risk and return than traditional stocks and bonds.

Diversification is a core tenet of Investing 101, but not all forms of diversification are equal. For example, a traditionally diversified portfolio incorporates both global and U.S. exposure. But with economic globalization and the rise of the Internet, the U.S. market has become more correlated with developed overseas markets and emerging markets than in the past *(Figure 1)*.

Alternative strategies are designed to help investors diversify in ways that may help reduce risks at a portfolio level. The idea is to put some share of a portfolio into asset classes that move in different patterns than mainstream markets. These low-correlation asset classes have different characteristics—different drivers of risk and return—than traditional stocks and bonds, so they respond differently to economic and market conditions.

For example, commercial real estate and infrastructure asset classes have long-term income streams that have helped them generate relatively consistent returns in the past. Commodities and managed futures are two asset classes that historically have done well in times of rising interest rates and inflation. Another good example is frontier markets—a diverse group of rapidly growing, early-stage economies that react differently to global trends than developed international markets.

Some alternative strategies are also adaptive, meaning they have the flexibility to respond to market change. Long/short strategies, for example, allow managers to profit from declining securities or downward-trending markets. When managers believe a stock is on the way down, they short the stock by selling borrowed shares and subsequently replace them with shares bought at a lower price. Research has shown that hedge funds were able to reduce their losses during the 2007-09 financial crisis by quickly selling stocks at the first signs of a broad market downturn.[3]

De-risking strategies allow investors to keep all their assets working while also lowering their risk profile.

Depending on the strategy employed, alternatives may seek to:

- Provide some cushion against market downturns.
- Blunt the effects of inflation or rising interest rates.
- Temper overall volatility.
- Respond tactically or systematically to changing economic or market conditions.

We believe the effort to de-risk—that is, to diversify effectively—is as important in a bull market as at any other time. In a bear market, investors tend to go to cash. In a bull market, investors know that the timing of a major market correction or sudden downturn is impossible to predict, but they don't want to chance missing out on market gains. De-risking strategies allow investors to keep all their assets working while also lowering their risk profile. This approach can give some comfort to investors who might otherwise stay awake at night, wondering "what if..."

3. History suggests alternatives have mostly performed as intended.

Because hedge funds provide the longest-running look at alternatives in practice, broad hedge fund indices are often used to show that alternatives historically have delivered attractive returns with lower volatility than traditional, long-only strategies.

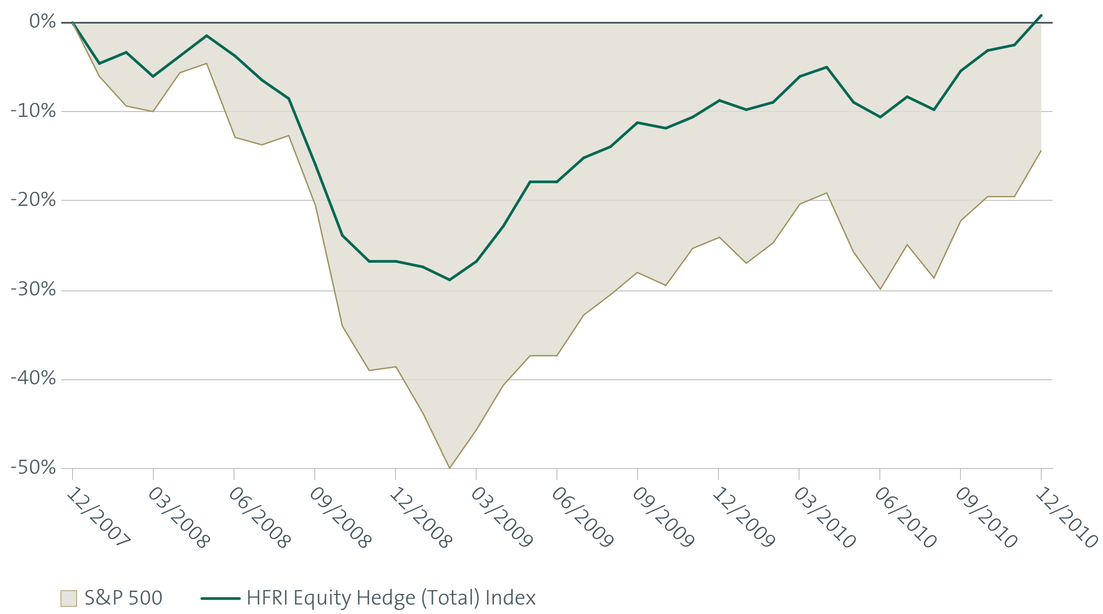
However, that yardstick is far from ideal. For one thing, hedge funds have no constraints on their use of leverage to amplify returns. Being more regulated, mutual funds cannot be expected to match the performance of hedge funds using similar strategies. It's also true that broad indices such as the HFRX include a wide mix of strategies, including equity and fixed-income approaches. Thus, their volatility-reducing effect might be at least partly attributable to the blending of stocks and bonds, as in a traditionally diversified portfolio.

A better indicator might be how a narrower subset of hedge funds weathered the 2007-09 financial crisis. As shown in Figure 2, hedge fund equity indices experienced significantly smaller

FIGURE 2

How Hedge Funds Fared vs. the S&P 500 During the Financial Crisis

December 31, 2007 – December 31, 2010



Sources: World Bank, as of 12/31/13; iShares, as of 02/28/15

Alternatives historically have delivered attractive returns with lower volatility than traditional, long-only strategies.

losses and lower maximum drawdowns than the S&P 500 Index. While the S&P 500 lost 54% of its value from the beginning of 2008 to the market bottom in March of the following year, the HFRI Equity Hedge Index lost 29% during the same period and losses in the HFRI Equity Market Neutral Index never exceeded 7%.

The best indicator, of course, is an index composed of liquid alternatives themselves, rather than a proxy—and at this point, we have almost 15 years of results to go on, as the Wilshire Liquid Alternative Index dates back to January 2000. Wilshire's broad index comprises five sub-indices: Equity Hedge, Event Driven, Global Macro, Multi-Strategy and Relative Value.

Given widespread concern over equity market volatility, we modeled long-term performance of a hypothetical equity portfolio incorporating a 20% allocation to the Wilshire Liquid Alternative Equity Hedge Index *(Figure 3)*. In the 15 years from 1999 to 2014, this portfolio generated a cumulative total return of 87%, on par with the S&P 500 (TR) Index over the same period. It managed to achieve this return with considerably less downside, however. This is clearly visible at the end of 2008, when the combined portfolio was down 16% while the S&P 500 was down 28%.

FIGURE 3

Adding Liquid Alts Exposure Tempered Volatility

December 31, 1999 – December 31, 2014

Sources: Standard & Poor's and Wilshire

Note: Total return data from December 31, 1999, when Wilshire Liquid Alternative Index data first became available. Allocations rebalanced annually.

Past performance does not guarantee future results.

As yet there is no industry standard for how liquid alternatives are categorized.

4. Liquid alt strategies come in many flavors and serve a variety of objectives.

The liquid alts universe comprises a wide array of distinct investment strategies, which can be used to address a range of investment objectives as well as to help de-risk portfolios *(Figure 4)*. What's more, strategies continue to proliferate and evolve.

Some liquid alts invest in traditional stocks and bonds but use a hedged or otherwise risk-managed approach. Others invest in nontraditional asset classes, such as real estate, commodities or emerging market corporate debt. Many adapt popular hedge fund strategies to the mutual fund format (though not all strategies translate; by law, mutual funds may employ only relatively modest leverage and can invest only in securities with daily pricing). Like hedge fund strategies, liquid alts may also be original and idiosyncratic, as they can blend different approaches, asset classes and techniques in virtually limitless ways.

However, it's vital to look beyond how strategies are labeled, for two reasons:

- As yet there is no industry standard for how liquid alternatives are categorized, or even which strategies the liquid alts universe encompasses. Morningstar, for example, operates with a narrowly defined universe that doesn't fully align with its hedge fund categories. Wilshire Associates and others use different schemes. Figure 5 shows the categorization we at Forward have developed to reflect our own thinking. Categorization of liquid alts will no doubt remain a moving target as the funds evolve.
- Strategies and performance characteristics vary widely within categories, making comparisons difficult. Indeed, in some cases categories may even be somewhat misleading, lumping an out-of-the-box strategy in with others it only superficially resembles.

Some strategies just don't fit neatly into any category, meaning investors need to look closely at the specifics of each strategy's workings and performance and rely on categories only as a rough guide.

FIGURE 4

Matching Liquid Alts Strategies to Investor Objectives—Some Examples

Objective	Liquid Alts Category
Inflation protection	Currency Managed Futures Equity Long/Short (Tactical)
Stabilizing income	Nontraditional Bond
Balancing income with growth	Market Neutral Multi-Alternative Managed Futures
Achieving "all-weather" growth	Equity Long/Short Global Macro
Enhancing returns	Global Macro

FIGURE 5

The Liquid Alts Universe

Directional Trading	Event Driven	Equity Hedge	Alternative Income	Alternative Beta	Real Assets	Multi Strategy	Private Equity
Global Macro	Merger Arbitrage	Equity Long/Short	Credit Long/Short	Momentum	Commodities	Multi Manager	
Managed Futures	Convertible Arbitrage	Market Neutral	MLP	Volatility	Real Estate	Single Manager	
Currencies	Special Situations	Sector Focus	Unconstrained Bond	Risk Parity			
Total Return	Activist	Short Bias	Emerging Market Debt				
		Frontier Equity					

Source: Forward

5. Measuring performance is less straightforward with liquid alts than with traditional mutual funds.

An important consideration is how much risk a strategy is assuming to earn the returns delivered.

One issue is what to measure. Traditionally, investors have paid the most attention to returns. But when evaluating or comparing investments, an important consideration is how much risk a strategy is assuming to earn the returns delivered. Thus, we believe it makes sense to evaluate a strategy based on its risk-adjusted return as measured by the Sharpe ratio, a standard industry metric, or the information ratio, which takes into account the share of return due to active management. Other risk metrics such as maximum drawdown or downside capture ratio (a measure of how well strategies fared versus the market during down periods) can also help put returns into perspective.

What's different about alternatives is that they seek to reduce risk ***at a portfolio level***. This suggests that their performance should be judged not just in isolation, but also in terms of their impact on a portfolio's overall characteristics and performance over time. Moreover, depending on the nature of the strategy, measuring its results over a market cycle, or under the conditions it's designed to address, may be the most valid approach.

The second major issue that arises concerning liquid alts' performance is ***how best to measure it***. Most liquid alts were launched in recent years and lack the long-term track records most traditional mutual funds have amassed.

Moreover, finding appropriate benchmarks for liquid alts has been a challenge. Traditional benchmarks aren't appropriate points of comparison, since they don't reflect use of instruments or techniques (such as short selling) that liquid alts are able to employ. A hedge fund index isn't the best yardstick for a liquid alt either, even if it's based on funds using a similar strategy. Liquid alts cannot be expected to match the performance of hedge funds, which are free to amplify leverage and use other potentially return-boosting techniques that mutual funds cannot.

Fortunately, two providers—the Liquid Alternative Investments Company and Wilshire Associates—have introduced indices that track funds within a number of liquid alternative categories. These indices will help investors get closer to apple-to-apple comparisons, depending on the nature of the strategy.

6. Alternatives are not a separate asset class and can fit neatly into an existing asset allocation.

Many advisors recommend an allocation to alternatives of at least 20% to have a meaningful impact on portfolio outcomes.

Diversifying a traditional portfolio with liquid alternatives may seem a daunting task. But it need not be. While it involves some research, just like any other investment, it does not require recasting your entire asset allocation.

We believe the key is to recognize that alternatives are not a distinct asset class. Like hedge funds, liquid alts are a type of investment vehicle that spans many asset classes.

Since liquid alts function as portfolio diversifiers, they can be treated as such—that is, used to diversify allocations within an existing portfolio framework *(Figure 6)*. For example, one could:

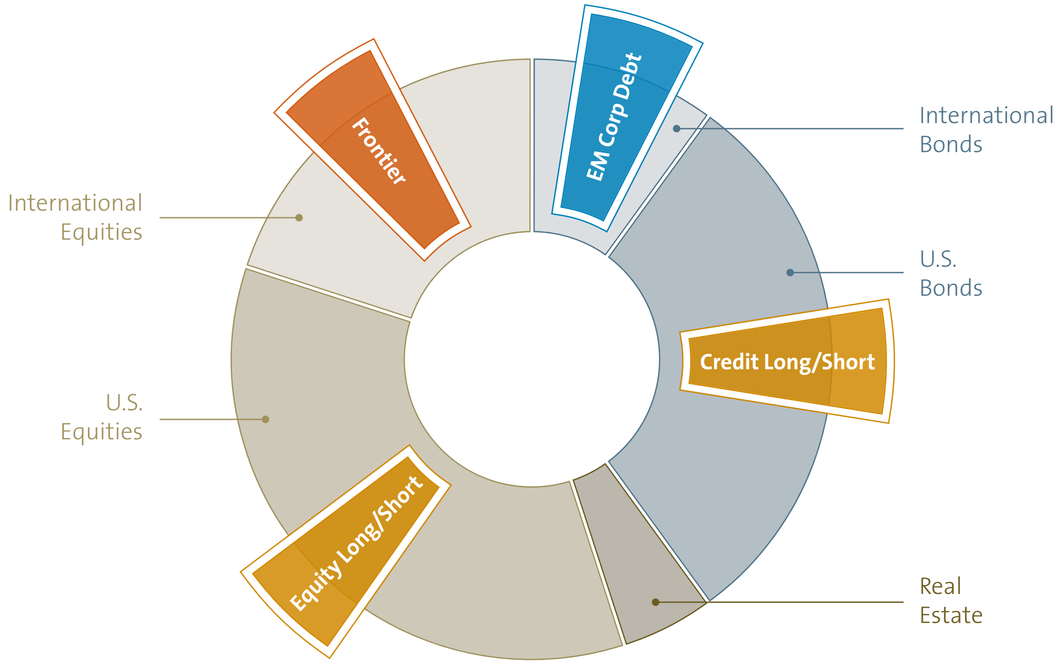
- Use a nontraditional bond or multi-asset income strategy to diversify the income streams produced by a bond allocation, thereby aiming to decrease its sensitivity to interest rate shifts.
- Incorporate a U.S. equity long/short strategy to cushion an equity allocation against market downturns.
- Use a global macro strategy to diversify an equity allocation while targeting higher returns.
- Diversify an international equity allocation with a strategy focused on emerging markets.

A frequent question is how much to allocate to liquid alts overall. The answer depends on your objectives and risk tolerance. Many advisors recommend an allocation of at least 20% as the minimum required to have a meaningful impact on portfolio outcomes. A recent RIA Database survey of 1,000 advisors found that 33% allocate more than 10% of client assets to alternatives, and 43% expect to increase their alternative allocations within the next 12 months.[4]

We believe a 20% allocation, as recommended by several of the largest financial advisory firms, is a good starting point for discussion. Someone with a lower-than-average risk tolerance may want to allocate a higher percentage to alternatives, with a bias toward strategies with strong risk management features.

FIGURE 6

A Sample Allocation to Liquid Alternatives



Note: This graph is for informational purposes only. It is not a recommendation to buy.

7. To evaluate a liquid alt, you must understand how its strategy works.

Strategies vary greatly, even within categories, and so does their performance.

Assessing a liquid alt requires a somewhat different thought process than you'd apply to a traditional style-box strategy. Few liquid alts have long track records. Traditional benchmarks and risk measures typically don't fit the intent and performance characteristics of a liquid alt. And strategies vary greatly, even within categories, and so does their performance.

Figure 7 shows the dispersion of returns and correlations for the five most correlated and the five least correlated funds within a single liquid alts category. It graphically illustrates why close, specific scrutiny of any candidate fund is needed. To aid that process we've provided our list of recommended question to ask.

Checklist for Evaluating Individual Funds

1 Consider your investment objectives and which liquid alternative strategies might contribute to achieving them.

2 Screen funds based on their track record to date. Look for acceptable levels of return, limited drawdowns and low correlations to stock and bond markets.

3 Explore each candidate fund more fully.

- *What are its performance characteristics and objectives?*
- *How does its strategy operate? Does it reflect any unique insights?*
- *How well thought out is the strategy's investment process?*
- *What is its approach to risk management?*
- *How experienced is the team? To what extent might its expertise confer a competitive advantage?*

4 Compare returns and risk-adjusted returns against available benchmarks, using those based on liquid alts peer groups whenever possible.

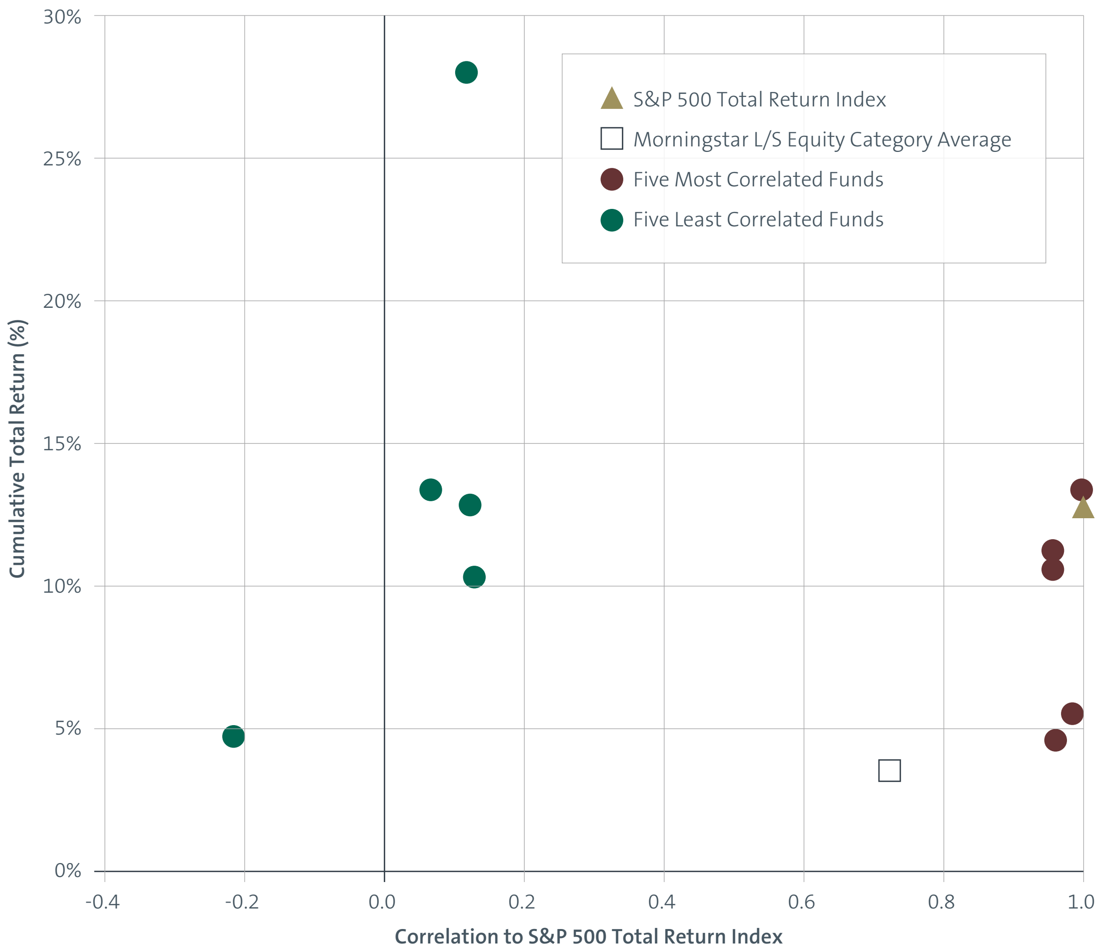
- *Does the fund's performance square with its intentions and targeted characteristics?*
- *How has it fared when facing market headwinds?*

5 Model portfolio impacts of the fund's expected performance characteristics.

FIGURE 7

Why Thorough Fund-Level Evaluation Is Critical

12-month total returns of Long/Short Equity Mutual Funds, March 31, 2014 – March 31, 2015



Sources: Strategic Insight Simfund MF, Morningstar and CBOE

Past performance does not guarantee future results.

Expanding the Toolkit

Of course, the question most relevant to any investor is, "Are liquid alts for you?"

To be sure, they are not for everyone. For those with investable assets of less than $250,000, the results from diversifying with liquid alternatives may not be worth the research effort involved.

We do believe, however, that any serious, long-term investor with substantial assets should be aware of liquid alts and their potential role in risk management. These are uncertain times, as we all know. Liquid alts give investors the tools to do something about it.

As Forward has been among the first wave of mutual fund firms to embrace alternative investing, you can look to us as a resource. If you have general questions or would like to learn more about our unique selection of liquid alt strategies, please call us at (888) 312-4100 or contact your personal sales representative.

1. Morningstar
2. Strategic Insight. Includes all long-term and money market assets for mutual funds and ETFs, as of March 31, 2015.
3. Itzhak Ben-David, Francesco Franzoni and Rahib Moussawi, "Hedge Fund Stock Trading in the Financial Crisis of 2007–2009," Review of Financial Studies, Volume 25, Issue 1, November 17, 2011
4. Julie Cooling, "Advisors Increase Reliance on Alternative Investments in Asset Allocation," Forbes Advisor Network Blog, July 11, 2014.

Definition of Terms

Correlation is a statistical measure of how two securities move in relation to each other.

Drawdown is the gradual decline in the price of a security or other investment between its high and low over a given time period.

HFRX Equity Hedge Index is comprised of private funds with strategies that maintain both long and short positions primarily in equity securities and equity derivatives.

HFRI Equity Market Neutral Index maintains positions in strategies that are constructed to be market neutral and do not have net equity market exposure greater than 10% long or short.

Information ratio measures a portfolio manager's ability to generate excess returns relative to a benchmark and identifies whether a manager has beaten the benchmark by a lot in a few months or a little every month.

Managed futures is a type of alternative investment. Managed futures accounts can take both long and short positions in futures contracts and options on futures contracts in the global commodity, interest rate, equity and currency markets.

MSCI EAFE (Europe, Australasia and Far East) Index is a stock market index that is designed to measure the equity market performance of developed markets outside of the U.S. and Canada.

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

S&P 500 Index is an unmanaged index of 500 common stocks chosen to reflect the industries in the U.S. economy.

Sharpe ratio is a ratio developed by Nobel laureate William F. Sharpe to measure how a fund performs relative to the risk it takes.

Volatility is a statistical measure of the dispersion of returns for a given security or market index.

Wilshire Liquid Alternative Equity Hedge Index measures the performance of the equity hedge strategy component of the Wilshire Liquid Alternative Index. Equity hedge investment strategies predominantly invest in long and short equities.

Wilshire Liquid Alternative Index measures the performance of liquid alternative mutual funds based on their track record, correlation to stocks and fixed income and assets under management. The index is comprised of five sub-indices: equity hedge, event driven, global macro, relative value and multi-strategy.

One cannot invest directly in an index.

You should consider the investment objectives, risks, charges and expenses of the Forward Funds carefully before investing. A prospectus with this and other information may be obtained by calling (800) 999-6809 or by downloading one from www.forwardinvesting.com. It should be read carefully before investing.

RISKS

There are risks involved with investing, including loss of principal. Past performance does not guarantee future results, share prices will fluctuate and you may have a gain or loss when you redeem shares.

Alternative strategies typically are subject to increased risk and loss of principal. Consequently, investments such as mutual funds which focus on alternative strategies are not suitable for all investors.

Short selling, market neutral investments and multi-alternative investments involve additional investment risks and transaction costs, and create leverage, which can increase the risk and volatility of a fund.

Asset allocation does not assure profit or protect against risk.

Diversification does not assure profit or protect against risk.

The new direction of investing

The world has changed, leading investors to seek new strategies that better fit an evolving global climate. Forward's investment solutions are built around the outcomes we believe investors need to be pursuing—non-correlated return, investment income, global exposure and diversification. With a propensity for unbounded thinking, we focus especially on developing innovative alternative strategies that may help investors build all-weather portfolios. An independent, privately held firm founded in 1998, Forward (Forward Management, LLC) is the advisor to the Forward Funds. As of March 31, 2015, we manage over $5 billion in a diverse product set offered to individual investors, financial advisors and institutions.

Forward Funds are distributed by Forward Securities, LLC.

Not FDIC Insured | No Bank Guarantee | May Lose Value

FORWARD®
the new direction of investing

101 California Street
16th Floor
San Francisco, CA 94111

(888) 312-4100
www.forwardinvesting.com

FSD001543
053116