Defining Alternative Success
By Andrew Dudley, CFA
June 2016

"Wall Street sells stocks and bonds, but what it really peddles is hope. The investing public wants to believe in magic, and the financial industry profits from staffing an endless parade of people who claim to know the future and to be able to perform miracles. Whatever you do, don't follow the procession."

- Jason Zweig, Jr., Introduction, The Devil's Financial Dictionary

Introduction

Jason Zweig's cynical view of the investment world might be hyperbole for effect, but he raises a good point. Wall Street leans on the "hope" of an investing public, as investors seek "magic" in new investment products. To a large degree, all kinds of active investment strategies are presented to investors in ways that play on this optimism for their potential to succeed. And nowhere is the investor's hope for magic greater, and the resulting potential for disappointment equally large, than in the pursuit of liquid alternative strategies that are supposed to add return and diversify their portfolios.

Recently, the impressive growth of liquid alternatives has given way to performance disappointment and significant questions about their value. At Context Asset Management, far from giving up on the pursuit of better portfolios through alternatives, we see an opportunity in the industry turmoil. There is an opening to help investors re-set the way they think about liquid alternatives. Instead of walking away from industry, investors need a more specific criteria with which to consider alternatives. Choosing a fund with "alternative" in the name, and relying on "hope" won't work. In that way, Zweig's sentiment is right: "…don't follow the procession." But with insightful guideposts that can help identify funds that deliver those characteristics that are valuable, investors can improve their chance of enjoying a satisfying outcome with liquid alternatives. In this paper, we propose a simple and measurable framework to define and measure for alternative success. This framework is at the core of how we approach our business as an "open source" alternative mutual fund company. Using this framework, investors may have an opportunity to make more informed choices.

Growth

In the last few years, the interest in alternative investment "magic" has been strong. Historically, absolute-return investment strategies were primarily available to large accredited investors in private account structures with restricted liquidity. More recently, mutual fund versions of alternative strategies have become increasingly available to a broader range of investors. According to Morningstar, by the end of 2015, U.S. alternative mutual funds across all Morningstar categories, including Nontraditional Bond and Commodities, totaled $293 billion, compared to $312 billion at the end of 2014, and $157 billion at the end of 2010. While the growth has slowed, investor interest (or is it "hope") has remained high.

Disappointment

But currently, this trend is being tested. Along with new products and asset growth, there have been inevitable disappointments, and investors and market observers have noticed. Specifically, the alternative industry has suffered some dramatic high profile performance failures, most notably in event driven strategies. And even in liquid alternatives, more diversified alternative categories such as Multialternative have generally delivered lackluster results and Morningstar has recently offered sharp commentary.

These disappointments are especially noteworthy against a backdrop of resilient performance for traditional risk assets – investments driven by equity and credit related risk taking. This view of raw underperformance has led many market observers to frame their discussion by proclaiming that alternative strategies have "failed" by the way they've lagged large cap equities or classic 60/40 portfolios' performance.

But is this really a fair critique? Alternatives seek absolute-return and risk objectives that are meant to be much less dependent on traditional market driven outcomes. In most cases, alternative strategies are not designed to outperform broad equity market indices anyway, especially when those markets perform well. Let's be clear: identifying that alternatives have simply underperformed traditional forms of market risk actually misstates the problem. This is NOT the only "underperformance" that investors should be worried about.

The real "underperformance" of alternatives is more subtle, but equally troubling. It has to do with the potential for their role as a portfolio diversifier. If you've followed the industry closely, you might know that many high profile alternative industry leaders – Cliff Asness, Jim Chanos, and Tony James, among others – have become critics of the industry themselves. To paraphrase, they have noted that the industry risk taking has evolved to become far too overlapping with traditional risk assets. We agree. In short, many alternatives categories have become too correlated to traditional market risks, certainly relative to the higher cost to investors. And alternative strategies with measurable market risk don't make good diversifying investments. For us, it's this troublesome development which is the real danger and taints the alternative brand. To summarize, as an industry, many alternatives have lagged in raw returns AND, more importantly have provided less and less diversification benefits for investors. It's no wonder so many investors have grown increasingly skeptical that ANY allocation to alternatives makes sense. "…don't follow the procession", indeed.

At Context, we have a different reaction…

But should investors respond by giving up on alternatives altogether? At Context Asset Management, we have a different reaction. We see an opportunity. On the one hand, we embrace the skepticism and believe it is totally appropriate for investors to be wary. We wholeheartedly agree that recent evidence shows that the successful execution of alternative strategies as diversifiers is difficult. For us, that's not a surprise. At the same time, investors should NOT conclude that the pursuit of a more diversified portfolio through alternatives is somehow altogether wrong by definition. Just because the broad industry's execution of liquid alternative strategies has performed poorly doesn't make the pursuit of what is worthwhile about alternative exposure any less valuable.

What remains true is that the math still works. The "magic" of alternatives lies in the math of diversification – it can improve portfolio efficiency and should be a crucial objective for investors. The introduction of an uncorrelated, asymmetric return stream to a traditional portfolio will even out and improve the overall portfolio efficiency. The need for new and different sources of risk and return - investments that complement, not compound, traditional market risk - is greater than ever. Traditional risk assets continue to dominate most investors' portfolios, and investors would clearly benefit from a new way to diversify that risk. Choosing to depend primarily on a high quality bond allocation, especially at the current level of interest rates, as a reliable source of portfolio stability and diversification in the future, may come with certain unwanted risks of its own. And while risk assets appear to be resilient in face of potential slower economic growth, finding creative ways to deliver investment "ballast" relative to those risk assets is more important than ever.

But don't just "hope" for magic

In the current confusion about alternatives, we believe that there is an opportunity for investors to get better at screening for alternative success. At Context, we aim first to improve investor understanding of what success means for alternatives. Given that the need for diversification remains, what's actually missing are simple ways to increase insight into the potential for success of alternatives. Investors need markers that help identify the funds that might work as true diversifiers and providers of capital protection. In addition to the poor performance referenced earlier, the industry has done a poor job defining what "success" for alternatives really means. As noted above, in the absence of a useful guide, investors and the press have primarily looked to raw performance as the main criteria to judge alternative success. Raw performance comparisons are not enough. The nature of alternative investments, and their complete associated set of RISK related objectives, should lead investors to consider other important criteria in their due diligence of alternative strategies.

Aiming for success

We offer a simple approach. Successfully executed, alternative strategies serve as ballast in a diversified portfolio. An alternative allocation only makes sense if investors receive the RISK related characteristics from alternatives that make alternatives valuable. Alternatives should deliver some or all of the following three return characteristics:

- Differentiation – an idiosyncratic return profile, with less correlation to traditional market risks, especially risk assets

- Asymmetry – skew in positive direction, either absolute or relative to market risk, or both
- Efficiency – potential risk adjusted return that is higher than traditional market risks.

This simple checklist defines the specific nature of the potential for alternative investment success. The framework outlined here can help investors intelligently sort through the universe of alternative products to find the funds that exhibit a history of delivering on the alternative objectives that make them valuable. Taken together, these measures provide a more complete scorecard for alternative investment outcomes. More than that, these measures go right to the heart of the value that alternatives are meant to provide: a portfolio stabilizer when your traditional market exposures underperform.

Importantly, these measures do not require overly sophisticated calculations, or even detailed holdings information. Instead, investors can harness publicly available historical return information for alternative mutual funds to measure these characteristics, and use that information as an indicator for alternative success in the future.

Investors can measure for these three additional risk related criteria, using the following historical risk measures:

Characteristic	**Risk Measure**
Differentiation	the correlation of returns relative to traditional market risks
Asymmetry	the upside / downside distribution in absolute, and relative terms
Efficiency	the return relative to the absolute risk (Sharpe Ratio) of the investment

*Please see page six for additional information.

Let's examine each characteristic in more detail.

Differentiation

Is the return stream overlapping or different relative to investments you already own? Investors should begin their analysis of an alternative strategy by asking if it appears to harness some measurable portion of traditional market risk to achieve its return. The very name "alternative" implies that the investment has the potential to provide a return stream that is separate from traditional risk taking. Investors can do this by measuring return correlation. The return correlation of an alternative fund relative to traditional market risks—the degree to which that investment moves in the same direction at the same time, or not—is the key to understanding whether or not that investment will provide a diversification benefit to a traditional portfolio. The most basic potential source of value for alternatives is their potential to be different. Investors may want to seek lower correlation investments precisely because this attribute intends to help guard their capital when traditional markets suffer. Absolute return strategies that explicitly market themselves as "different" should actually behave differently, relative to traditional risks. A strategy's returns should reflect a lower or negative correlation to risk assets in order to deliver on the potential diversification benefits in a broad portfolio. By examining historical correlation over a range of time periods, investors may begin to gauge the ability of a strategy to deliver a return stream that is truly different.

We should note that many alternatives are VERY correlated to risk assets. For instance, Long/Short Equity strategies and many multi strategy funds with substantial equity related strategies tend to be net long equity risk and it shows up in higher correlations. But that means these strategies need to achieve in a more substantial way on the other two characteristics (Asymmetry and Efficiency) in order to make the grade in our eyes. To date, the most notable area of under-achievement for many liquid alternative products in general has been the relatively high correlation (0.5 or greater) to risk assets, like equities or high yield credit, that has been observed among much of the existing alternative offerings, without the corresponding effort to manage investor expectations. The failure of much of the alternative mutual fund universe to provide a true source of diversifying risk, or at least manage the expectations of investors about their real diversification potential, has been at least as damaging to investor perceptions of these kinds of investments as the middling to poor absolute returns. In general, investors should not be paying dramatically higher fees for a muted version of equity or credit risk. In many cases, they could re-create that exposure more cheaply elsewhere.

Asymmetry

Whether an alternative strategy is correlated to risk assets or not, it should seek an upside return profile that is larger than the downside risk. Thought of in terms of a distribution of returns, alternative strategies should seek an asymmetric return distribution that is positively skewed. This objective may seem obvious, but explicitly looking for asymmetry is a straightforward way to identify if a manager's active choices are creating value. Very often, the source of this asymmetry lies in the investment flexibility of alternative strategies —the ability to hedge with short positions, to use derivatives, to trade tactically, all of which can create positive convexity, i.e. less downside risk than upside potential. Investors should look for strategies that avoid large drawdowns, both as a general characteristic of the strategy but also, perhaps more importantly, relative to market environments where traditional market exposures suffer. Stated differently, investors should evaluate the potential to deliver a positive expected return, but with some measurable degree of downside risk protection. Ultimately, the goal is to deliver *less* downside for investors in all environments, but especially when traditional risk assets are performing poorly.

And in the case where the alternative strategy has notably high correlation to traditional market risks (as noted above), the measurement for asymmetry takes a slightly different form. The strategy is measured for its "upside" vs. "downside" capture relative to the associated highly correlated market risk. A positively skewed conditional "capture" is another measure of useful asymmetry for alternatives with a highly correlated profile. As an example, long/short equity strategies often seek 80% upside vs. 50% downside relative to large cap stocks. While not diversifying, this return profile can improve the efficiency of a portfolio.

Efficiency

Investors can measure return efficiency by adjusting raw returns of a strategy by the amount of return variability. Specifically, investors often use the Sharpe Ratio, developed by William Sharpe, which divides returns that are above the risk-free rate by the level of return volatility for a given period. This adjustment of returns has the added benefit of viewing investments with different absolute-return outcomes more comparable.

In general, alternative strategies should search for a more efficient return profile, relative to more passive market exposures. Alternative fund managers that obtain proportionately higher returns with less risk have offered the chance to deliver investors a smoother ride. If a fund manager takes a high amount of risk to achieve higher returns, he or she may incur the downside risk that comes with a two-sided market. However, it is even possible for funds that produce a slightly lower average return, but require a proportionately lower amount of risk to do so, to produce better (or worse) long-term outcomes. We believe higher Sharpe ratios should be an explicit goal of alternative investing.

The next step

If investors decide to commit to an alternative-funds allocation, a strong understanding and evaluation of the full set of dimensions of alternative investment success may improve their chances for fully realizing the benefits of that allocation. More than that, finding managers who explicitly seek and have delivered a less-correlated, asymmetric, and more efficient return profile may provide a more satisfying investment experience by placing return outcomes in a more thoughtful context.

In our next paper, we will go a little deeper on the nature of these characteristics. Furthermore, we will apply this framework in the marketplace to show how it can be a useful guide for investors.

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Definitions

Upside/Downside Capture illustrates whether a given fund has outperformed--gained more or lost less than--a broad market benchmark during periods of market strength and weakness, and if so, by how much.

Sharpe Ratio is a risk-adjusted measure that is calculated by using standard deviation and excess return to determine reward per unit of risk. The higher the Sharpe ratio, the better the fund's historical risk-adjusted performance.

Important information:

Before investing you should carefully consider the Context Macro Opportunities Fund's investment objectives, risks, charges and expenses. This and other information about the Fund is in the prospectus, a copy of which may be obtained by calling 1-844-511-9653. Please read the prospectus carefully before you invest.

Diversification does not assure a profit or protect against a loss in a declining market.

An investment in the Fund is subject to risk, including the possible loss of principal amount invested. Risks are detail in the prospectus and include, but are not limited to, the following: **Asset-backed and mortgage-backed securities** are subject to risk of prepayment. **Credit default swap agreements** involve special risks because they may be difficult to value, are highly susceptible to liquidity and credit risk, and generally pay a return only in the event of an actual default by the issuer of the underlying. The prices of **futures** can be highly volatile, using futures can lower total return and the potential loss from futures can exceed the Fund's initial investment. The Fund's **derivative investments** have risks, including the imperfect correlation between the value of such instruments and the underlying assets of the Fund. The risk of investing in **foreign companies** involves certain risks not generally associated with investments in the securities of U.S. companies. In addition, individual international country economies may differ favorably or unfavorably from the U.S. economy in such respects as growth of gross domestic product, rates of inflation, capital reinvestment, resources, self-sufficiency and balance of payments position. **Emerging markets** investments are subject to greater political and economic uncertainties as well as a relative lack of information about companies in such markets.

Hedging is a strategy in which the Fund uses a derivative to offset the risks associated with other Fund holdings. There can be no assurance that the Fund's hedging strategy will reduce risk or that hedging transactions will be either available or cost effective. The use of **leverage** has the risk of capital losses that exceed the net assets of the Fund. Leverage may involve the creation of a liability that requires the Fund to pay interest. The Fund may experience difficulty in selling **illiquid** investments in a timely manner at the price that it believes the investments are worth. In addition, market conditions may cause the Fund to experience temporary mark-to-market losses, especially in less liquid positions, even in the absence of any selling of investments by the Fund. The Fund is "**non-diversified**", investing in fewer securities at any one time than a diversified fund. A decline in the value of or default by a single issuer makes the Fund more susceptible to financial, economic or market events impacting such issuer. **Short selling** involves unlimited risk including the possibility that losses to the Fund may exceed the original amount it invested. Investments in **small and medium capitalization companies** may be less liquid and their securities' prices may fluctuate more than those of larger, more established companies. **Newly organized** Funds have no assurance that active trading markets will be developed or maintained.

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