RCM Alternatives

RCM Alternatives: June 2016 Whitepaper

Why Alternative Investments?

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"As we move further away from the Great Recession, the traditional 60/40 portfolio faces headwinds that have not occurred for much, if any, of its existence, [mainly] a significant assumption within the 60/40 paradigm — historically strong bond returns with low volatility — is no longer realistic with low bond yields in the current environment.

Modest inflation and an accommodative Federal Reserve partly account for lower yields, but a broader look shows yields have been in a secular decline since the early 1980s. Lower bond yields, combined with a sustained low-interest-rate environment, should prompt investors to question whether a traditional 60/40 approach will continue to work.

Our expectations are that even moderately risky balanced portfolios should expect returns more than 4% lower over the next 10 years compared to what a 60/40 portfolio delivered in the last 35 years. Investors will need to find a way to adapt."

-"Finding a new balance with alternatives", BMO Global Asset Management, April 2016

Section 1: A BIG problem

Most investors are "naturally long" stocks, meaning that even when we don't have a direct investment in stocks and benefit from share prices rising, we have indirect exposure to the stock market via jobs, the real estate market, corporate bonds, and even commodity investments tied to how the global economy is doing. That's a problem because the stock market is known for some rather big down moves and bouts of scary volatility (see the dot.com bubble, credit crisis, or Brexit as examples).

The game anyone who worries about such things plays is finding and creating investments which can reduce the risk of these volatility spikes and big down moves. We all want to sleep a little better at night (and get some better performance and earn some fees; it's not all altruistic). So how can you do that? How do you protect a stock heavy portfolio?

THE BASIC OPTIONS ARE:

1

Do **negatively correlated** stuff, like:

-Exit stocks all together
-Buy insurance (puts)
-Invest in negatively correlated strategies (short bias hedge funds, buy VIX futures)

OR

2

Do **non-correlated** stuff like alternative investments in:

-Commodities;
-Hedge Funds or
-Managed Futures

Turns out this isn't that easy of a game, however. The issue with investing in negatively correlated stuff (puts, short bias, VIX) is it's expensive. It will perform when you need it to, in the bad times – but it costs too much during good times, either through paying premiums or missing out on gains or holding a decaying asset.

And the issue with non correlated stuff is that it won't always be a hedge. Non correlation means an investment will do something different on average, but not always. That 'on average' part is the killer, as it means the correlation will sometimes be positive and sometimes negative, averaging out to around zero correlation (non correlated). Problem is, we don't live in a world of averages. We feel pain in real time, not on a smoothed, average basis – so when our non correlated investment becomes highly correlated over a short period of time, like real estate, commodities, and hedge funds did in 2008, it's at best frustrating – and at worst, a disaster for the portfolio.

What investors really want in an alternative investment is the best of both worlds. They want negative correlation during down turns, and positive or no correlation the rest of the time. Achieving this 'best of both worlds' diversification is the goal of many alternative investments.

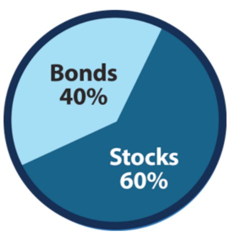
Section 2: Visualizing Alts in a Portfolio

As the old saying goes. Talk is cheap. What's this 'best of both worlds' diversification actually look like? How does a portfolio actually benefit from an allocation to Alternatives?

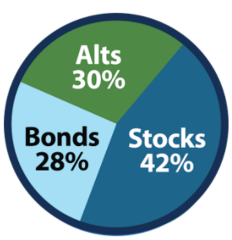
Here's one example, comparing a traditional 60/40 portfolio to a portfolio containing a 30% allocation to managed futures. You can see a drastic difference between the two portfolios, with risk drastically reduced (worst loss going from -32% to -21%, and worst 3 year period from -20% to just single digits at -7%), and returns actually going up. [past performance is not necessarily indicative of future results].

Fig. 1: Portfolio Comparison

STOCKS & BONDS ALONE



STOCKS & BONDS WITH ALTS



FEB 2004-DEC 2015

	ROR	Max Loss	Worst 3yr
Stocks & Bonds Alone	7%	-32%	-20%
Stocks & Bonds with Alts	10%	-21%	-7%

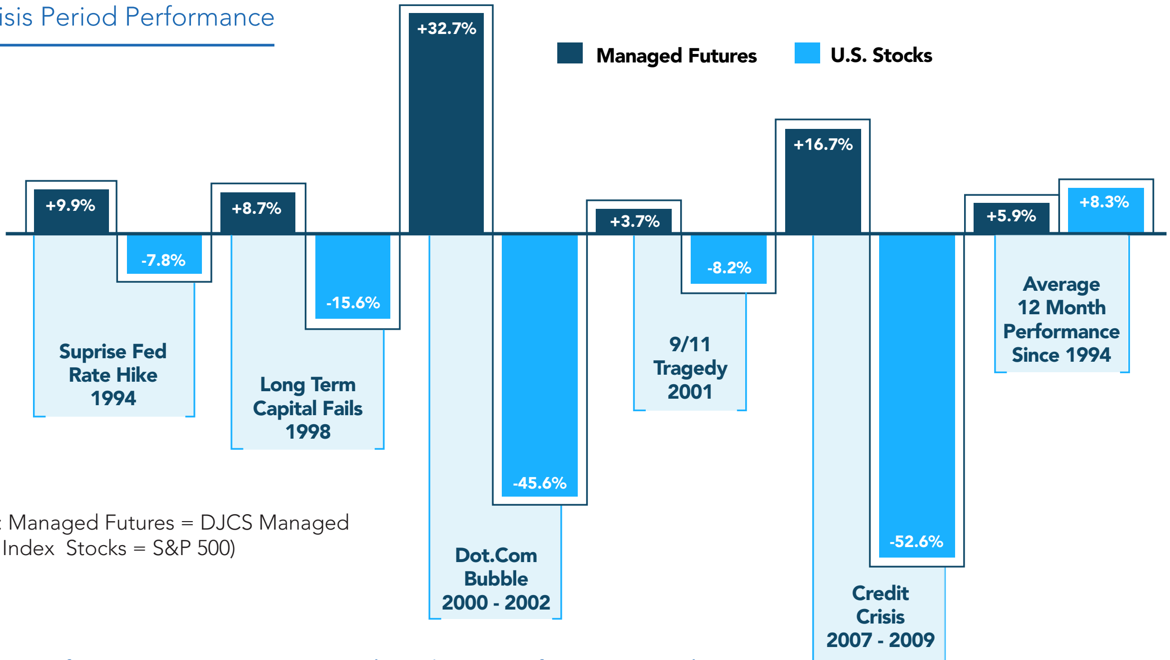
60/40 = 60% Stocks (S&P 500) + 40% Bonds (Barclays U.S. Aggregate Bond Index)

42% Stocks (S&P) + 28% Bonds (Barclays)+ 30% Alts (CTA Index)

How does Managed Futures achieve that type of diversification? It isn't magic. These strategies are typically involved in dozens of markets around the globe, riding both up and down trends as they occur. They capture these moves by participating in hundreds of market moves year in and year out. They'll be wrong quite often, when a move doesn't become a large trend. But by keeping losses to a minimum when they're wrong, and letting profits run when they're right – they're able to be in the right position to capture the big moves.

This can be seen in the statistics, where they're particularly good at capturing profits during big global sell offs, as seen below [past performance is not necessarily indicative of future results]:

Fig. 2: Crisis Period Performance

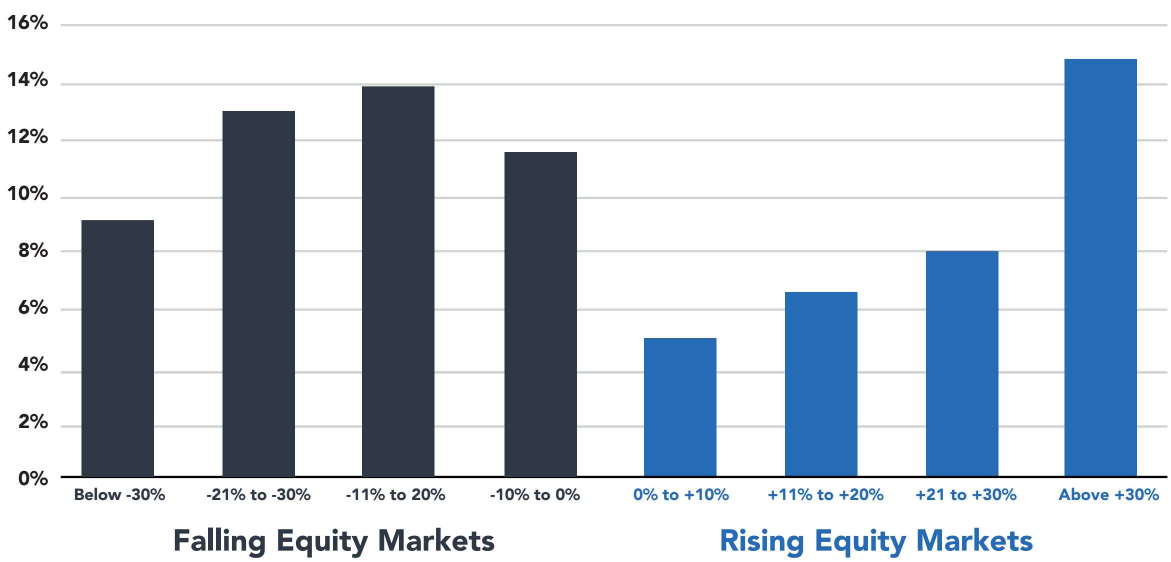


(Source: Managed Futures = DJCS Managed Futures Index Stocks = S&P 500)

Past performance is Not Necessarily Indicative of Future Results

But, of course, capturing returns in stock market crisis periods doesn't do all that good if you give all the returns back in good times. A true Alternative Investment needs to be a true two-way player - able to play both offense and defense. Here's how Managed Futures looks across the full spectrum of stock market cycles.

Fig. 3: Performance when Stocks go up



This table shows the average 12 month return for managed futures, as represented by the BarclayHedge CTA Index during periods when the 12 month return for the S&P 500 falls into the listed performance buckets. Data is from 1983 through 2015.

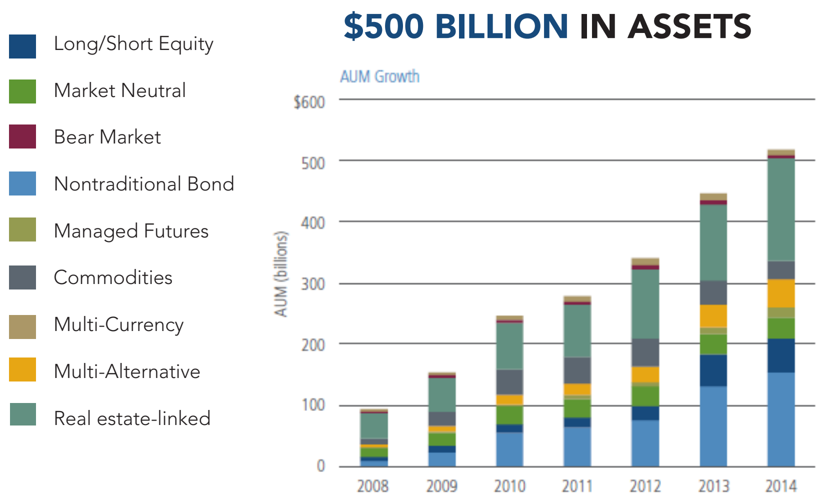
Past performance is Not Necessarily Indicative of Future Results

Section 3: Why investors like Alternative Investments

There's no doubting the growth in investor appetite for Alternative Investments, with assets in so called 'Liquid Alternatives' (Alternative Investments in a mutual fund) climbing to over half a trillion according to a Pimco report (September 2015).

The reasons for this growth are many, and for sure doing something about the "BIG problem" of natural stock market exposure outlined at the beginning of this paper is chief among them. But there's more to like from Alternative Investments according to investors in a recent Preqin report*. Asked why investors choose Liquid Alternatives, respondents had the following answers:

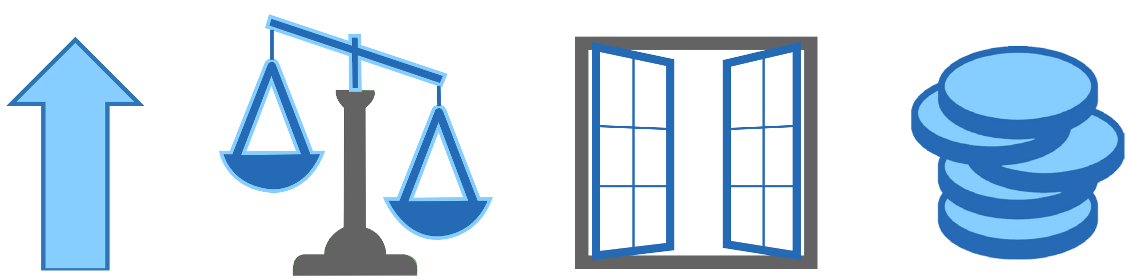
Fig. 4: Growth and Assets



Source: https://www.pimco.com/insights/viewpoints/in-depth/liquid-alternatives-considerations-for-portfolio-implementation

Fig. 5: Why Investors like Alternative Investments

53% 31% 28% 19%



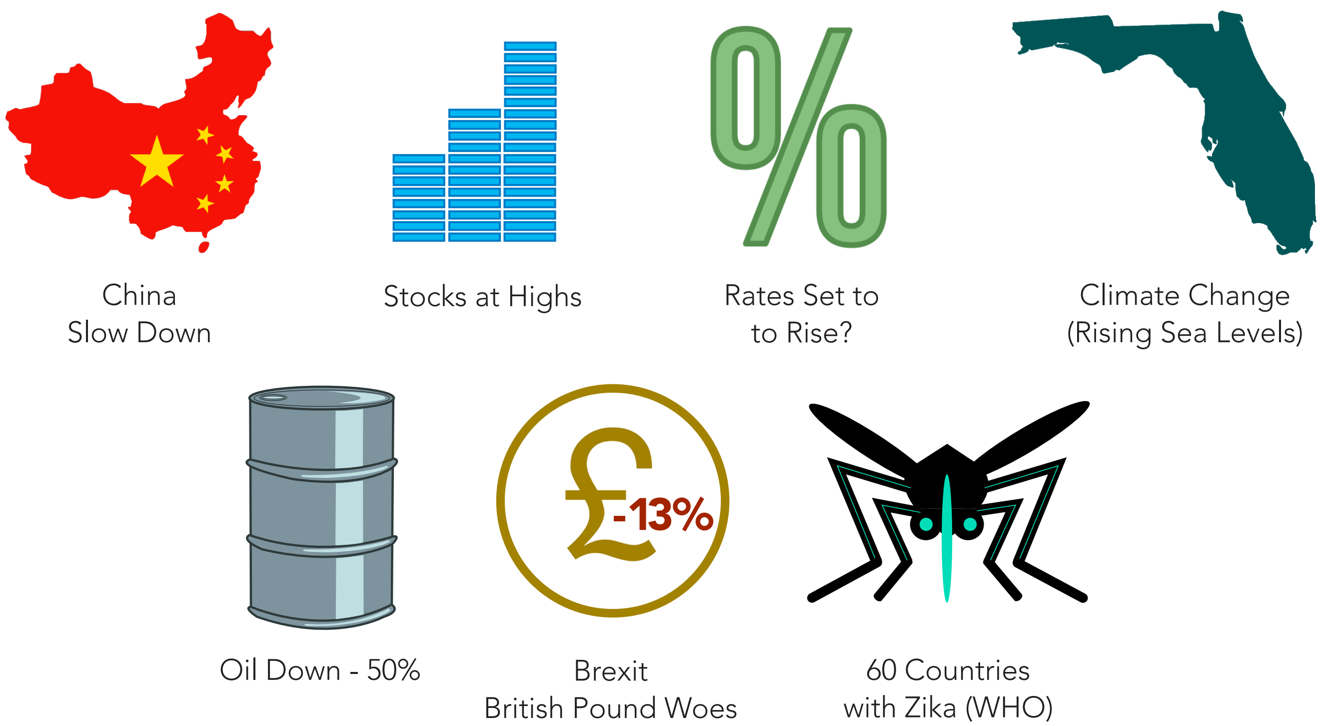
Increased Liquidity | Increased Transparency | Regulated Nature of the Structure | Lower Costs Involved

*Source: Preqin Liquid Alternatives Report, April 2015

Beyond these more operational reasons dealing with how investors access Alternatives, there's also portfolio level reasons to consider. Many investors we speak to at RCM Alternatives, ranging from the wealthy dentist to multi-billion-dollar school endowment, have quite a simple reason for diversifying into Alternatives. It allows them to do something about market uncertainty.

We've all heard the refrains before – what do you do when stocks are near all time highs, interest rates at all time lows, and the global financial system seemingly always on the edge of disaster awaiting the next European vote, Fed meeting, OPEC production, and so forth. Alternatives let investors do something about global uncertainty inlcuding some of today's leading concerns (as of June 2016):

Fig. 6: Global Uncertainty



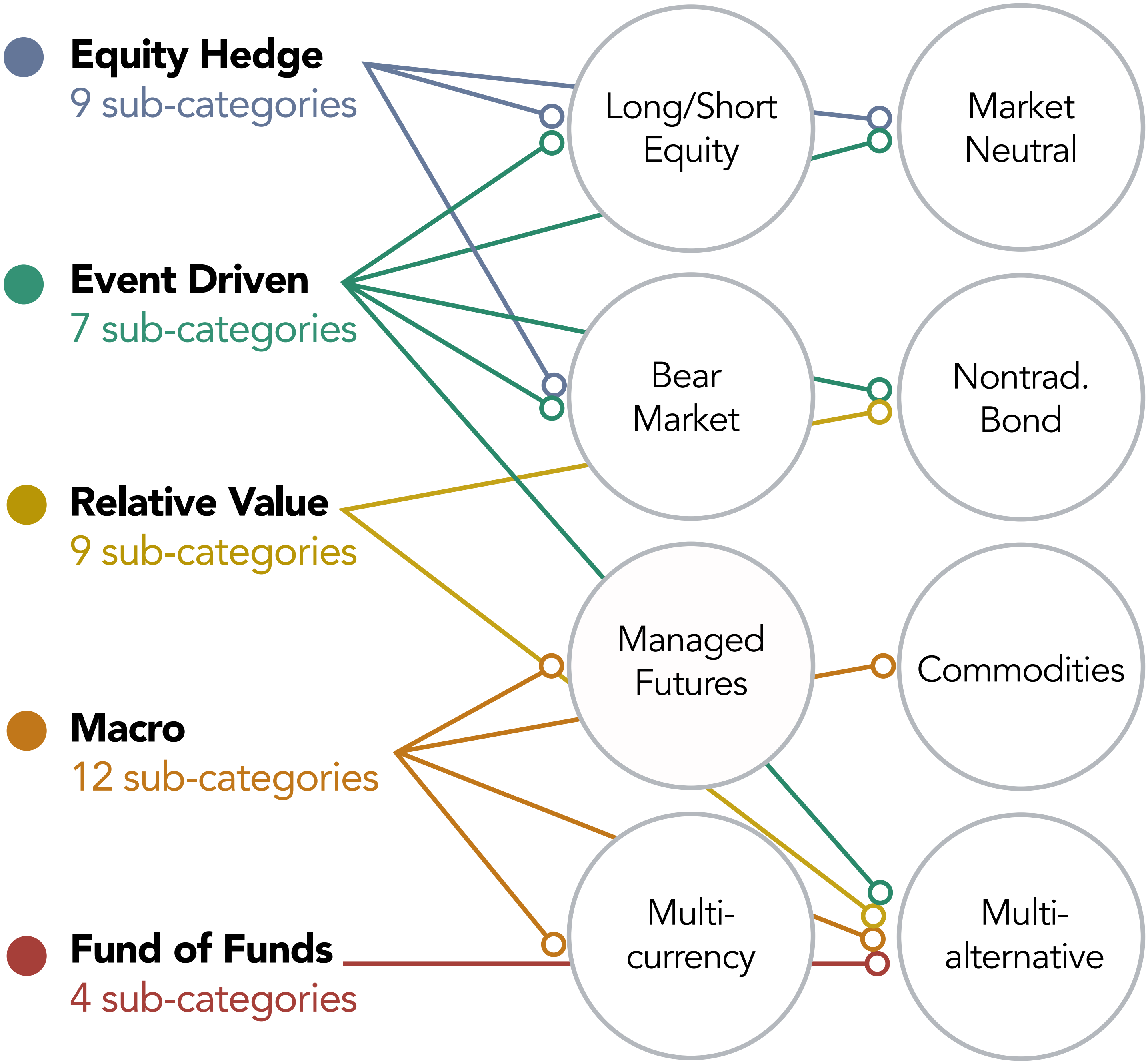
Section 4: Types of Alternative Investments

Which brings us to trying to decipher the spaghetti dinner which is the dozens of types of Alternative investments out there. We've most all heard of hedge funds by now, but does everyone know the difference between relative value and event driven strategies? Are investors aware of which Alternative strategies are likely to perform in a stock market sell off and which aren't (see our infographic exploring that question)? Do investors know that private equity isn't even categorized as an alternative?

Here's BMO Global Asset Management on the problem:

> "Distinguishing among strategies and identifying their sources of return and risk is challenging. The categorization of alternative strategies can be confusing. Hedge Fund Research lists four broad categories and 37 subcategories (plus four types of fund of funds); these do not always square with Morningstar's system of categories (see Figure 7 on the next page). Investors may not know what they're getting."

Fig. 7: Mapping Mayhem

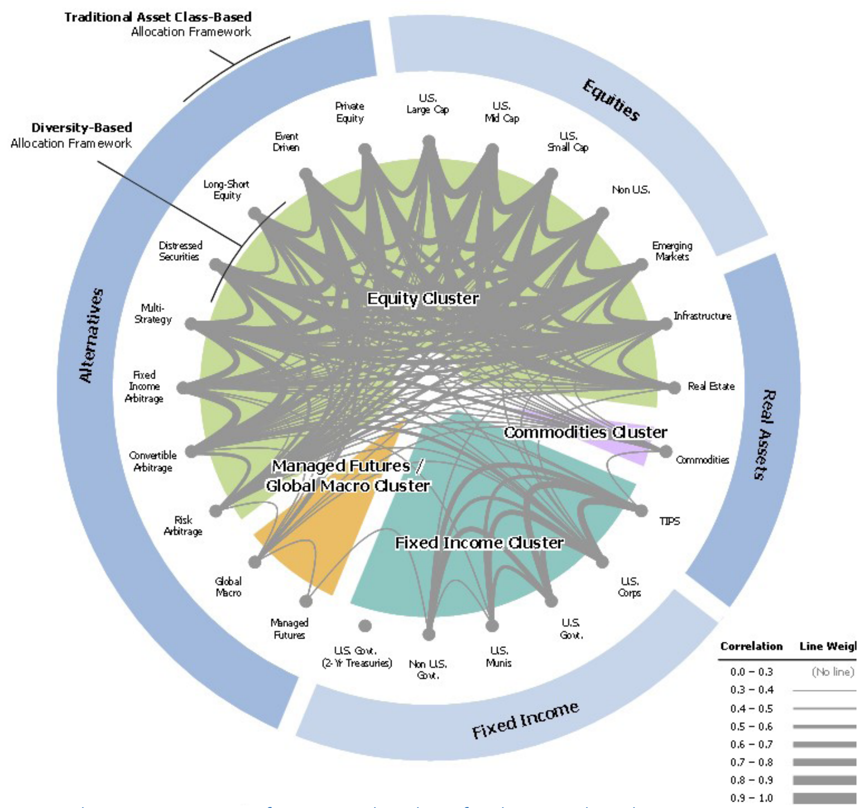


Source: bmogamviewpoints.com/finding-a-new-balance-with-alternatives

A more helpful approach may be to consider not what different types of Alternatives are called or categorized as; but rather how they correlate with one another and what type of diversification they provide.

In Welton Investment Corp's 'Diversification, Often Discussed, but Frequently Misunderstood', they explore grouping investments by their diversification instead of their arbitrary asset class categorization, resulting in this fabulous graphic:

Fig. 8: Diversification



See Source & Endnotes on page 11 for a complete list of indices analyzed.

Past performance is not necessarily indicative of future results.

You can see in their work how many things we may consider alternative, like real estate, long/short equity, and fixed income arbitrage; actually fall into the equity cluster when considering how much statistical diversification they provide through measuring their cross correlations with all of the other possible investments out there.

The takeaway from our standpoint, if you're trying to diversify from equity exposure (the BIG problem outlined in the beginning of this paper); make sure you're doing something outside of the equity cluster. That doesn't mean there's anything wrong with those Alternatives in the equity cluster – they just act like equities more than one might assume. They are more suitable as equity replacement, than an equity hedge.

Section 5: How much to allocate?

While everything we've discussed so far may help investors to understand that putting alternatives in their portfolios is a good move from all sorts of perspectives; that begs the question of How Much to invest in Alternatives?

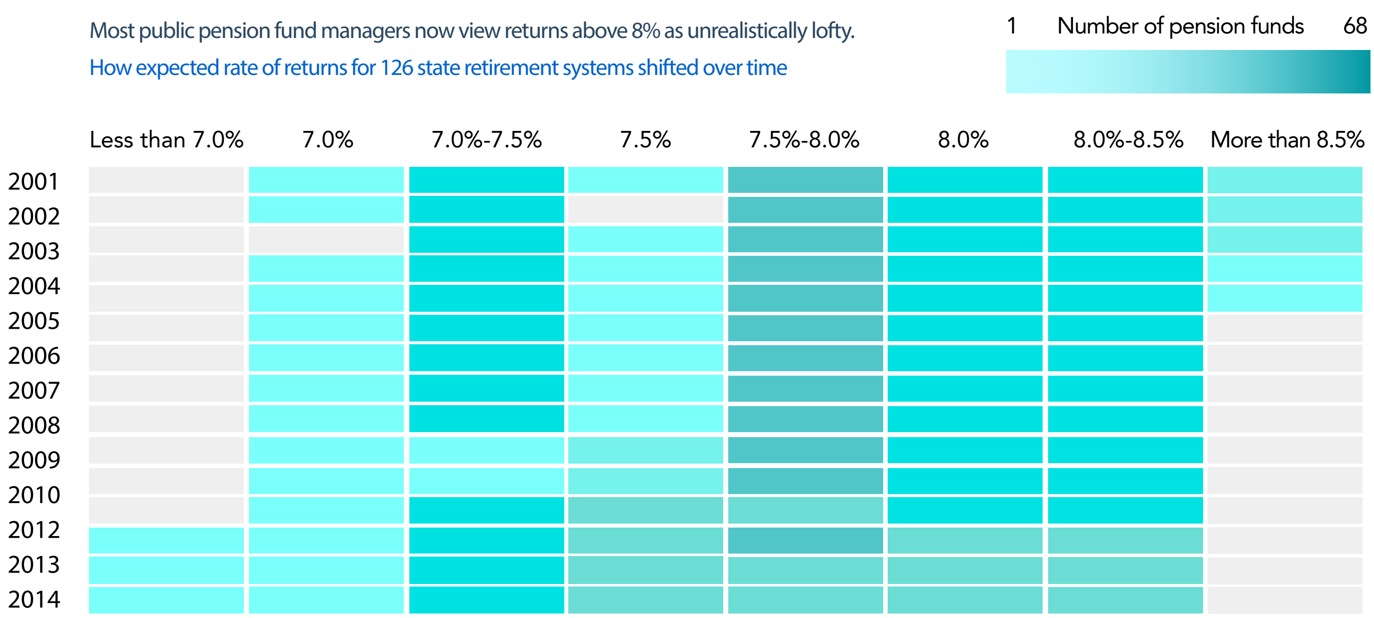
As a firm registered to introduce Alternative Investments to clients ranging from high net worth investors to pension plans, we couldn't agree more with Investment News' answer as to the best percentage to allocate.

> "The trouble is, unlike more homogeneous long-only stock and bond products, alternatives come in a lot of different flavors. And unlike the oversimplified asset allocation strategy that loosely divides a portfolio of stocks and bonds based on an investor's age, so far there is no such rule when it comes to alternatives."
>
> "How much to allocate is both an unanswerable question in general and one that absolutely needs to be addressed for each client."
>
> **- Investment News, Oct 2015**

The general rule of thumb we see from clients is a very big thumb, ranging from 5% to 50%; with people basing that on everything from how much of the rest of their portfolio they're willing to make room for an alternative allocation, to a more statistical approach, like the efficient frontier.

What we don't see a ton of investors doing is matching their allocation percentage with their return expectations. What are return expectations? If you're familiar with pensions, they are rather well known for having target return numbers, so they can meet their liability stream (pension payments), and equally well known for missing those targets terribly. In figure 9 you'll see a recent WSJ piece showing how those targets are coming down over time.

Fig. 9: Downshift



Source: National Association of State Retirement Administrators

Chart Courtesy: Wall Street Journal, Sept. 2015

The issue for individual investors is that there is no committee or in-depth tables by the Wall Street Journal evaluating their return expectations. Because of this, most investors are left disappointed their alternatives are not providing the cushion they thought it would.

If I ask you right now, off the top of your head, how much return you need from a 5% allocation to Alternatives to hit your 10% target portfolio return, assuming stock and bond returns are 6.5% annually, do you know? The answer is an annual return of 76.50%… Wowsers. That means your institutionalized, low vol, Alternatives investment targeting 8% annual returns is going to leave you rather short on your target return. Here's the full table (amended from work by www.welton.com), where you can see some outrageous numbers needed to achieve target returns.

Fig. 10: Allocations

...To get this return

...With this much allocated to Alternatives

		ALLOCATION TO ALTERNATIVES							
		5%	10%	15%	20%	25%	30%	40%	50%
Target Portfolio Return	7.50%	26.50%	16.50%	13.17%	11.50%	10.50%	9.83%	9.00%	8.50%
	10.00%	76.50%	41.50%	29.83%	24.00%	20.50%	18.17%	15.25%	13.50%
	12.50%	126.50%	66.50%	46.50%	36.50%	30.50%	26.50%	21.50%	18.50%
	15.00%	176.50%	91.50%	63.17%	49.00%	40.50%	34.83%	27.50%	23.50%

...The Alternatives will need to make this much

Assumes 60/40 stock / bond portfolio return of 6.5%

Past performance is not indicative of future results.

This is just math (all of us can do it), but we'd like to think when we're presented with this type of information, our expectations change. It isn't understood nearly enough that a nominal 2% or 5% allocation to alternatives isn't really moving the needle at all.

And what about alternatives being non-correlated and showing up in a crisis?

For example, if you don't want to be down more than -5% in a bear market when the 60/40 portfolio is off -12.5%? Then you're going to need a 34% allocation to an Alts product designed to make 10% during such a crisis period (hmm, hmm, better look up managed futures for that one).

Here's the table on that one. Again, it's just math… but worthwhile to put down on paper:

Fig. 11: Alternative Performance

...Making this much

		ALTERNATIVES PERFORMANCE					
		-10%	-5%	0%	5%	10%	15%
Target Bear Market Return	>0%	na	na	100%	72%	56%	46%
	>-5%	na	100%	60%	43%	34%	28%
	>-10%	100%	100%	20%	15%	12%	9%

Past performance is not indicative of future results.

To get this return...

...You'll need this much allocated to Alternatives

Assumes a bear market return of -12.5 % for a 60/40 stock / bond portfolio

The bottom line – if you want more return from a portfolio containing alts, you'll need to either have high risk/ high reward alternatives in the portfolio, or allocate more to the ones that are in the portfolio. The power of a diversified portfolio having alternatives may mean 3 + 3 + 3 equals 10… but this analysis shows us not to expect 3+3+3 to equal 20 or more.

Section 6: Conclusion

We'll leave you with another line from BMO Global Asset Management on figuring out the Alternative investment puzzle:

> "A good alternative option should give the portfolio either a higher return for the same amount of risk or the same return for a lower amount of risk.
>
> To meet today's diversification challenges, investors will need to distinguish liquid alternative strategies that rely on new market exposure, such as volatility and frontier markets, and those that rely on manager skill, such as market neutral, 130/30, long/short equity and macro strategies. Here it is important to note that many "new market exposures" may already appear in investors' portfolios — REITs and commodities are two common examples. The difficulty of finding truly new exposures, then, encourages a longer look at active management, where sources of return and risk are less dependent on market movement.
>
> Manager selection in the alternatives space is arguably more difficult than in traditional long-only strategies because the stakes are higher. This is because the dispersions of both returns and levels of market exposure among alternative managers are greater than those in traditional long-only managers."
>
> **-"Finding a new balance with alternatives", BMO Global Asset Management , April 2016**

Bottom line – It's prudent to consult with an alternatives pro who can take a good look under the hood for you (hey, we know a pretty good one).

Speak with one of our professionals today at:

855-726-0060

Endnotes

Index sources for Figure 9

Equities	
U.S. Large Cap	S&P 500 Index
U.S. Mid Cap	S&P Midcap 400 Index
U.S. Small Cap	S&P Small Cap 600 Index
Non U.S.	MSCI AC World Index Free ex USA Value
Emerging Markets	MSCI EMF (Emerging Markets Free)
Real Assets	
Infrastructure	S&P Global Infrastructure TR Index (12/01 – 6/10)
	UBS Global Infrastructure & Utilities 50-50 TR Index (1/99 – 11/01)
Real Estate	FTSE EPRA/NAREIT U.S. Index
Commodities	Dow Jones - UBS Commodity Index
TIPS	Citigroup U.S. Inflation-Linked Securities Index
Fixed Income	
U.S. Corps	Merrill Lynch Corporate Master Bond Index
U.S. Govt	Barclays Government Bond Index
U.S. Munis	Barclays Municipal Bond Index
Non U.S. Govt	Citi World Government Bond Index
U.S. Govt. (2-Yr Treasuries)	U.S. 2-Year Treasuries (TCMNOMY2)
Alternatives	
Private Equity	Cambridge Associates LLC U.S. Private Equity Index
Event Driven	Dow Jones Credit Suisse HFI Event Driven
Long-Short Equity	Dow Jones Credit Suisse HFI Long-Short Equity
Distressed Securities	Dow Jones Credit Suisse HFI Event Driven -Distressed
Multi-Strategy	Dow Jones Credit Suisse HFI Multi-Strategy
Fixed Income Arbitrage	Dow Jones Credit Suisse HFI Fixed Income Arbitrage
Convertible Arbitrage	Dow Jones Credit Suisse HFI Convertible Arbitrage
Risk Arbitrage	Dow Jones Credit Suisse HFI Event Driven - Risk Arbitrage
Global Macro	Dow Jones Credit Suisse HFI Global Macro
Managed Futures	Dow Jones Credit Suisse HFI Managed Futures

Source: https://www.welton.com/uploads/insight/Welton-Diversification_Often_Discussed_but_Freq_Misunderstood_(Visual_Insight_Series).pdf

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Any specific investment or investment service contained or referred to in this report may not be suitable for all investors. You should not rely on any of the information as a substitute for the exercise of your own skill and judgment in making such a decision on the appropriateness of such investments. Finally, the ability to withstand losses and to adhere to a particular trading program in spite of trading losses are material points which can adversely affect investor performance.

We recommend investors visit the Commodity Futures Trading Commission ("CFTC") website at the following address before trading: http://www.cftc.gov/cftc/cftcbeforetrade.htm Managed futures accounts can subject to substantial charges for management and advisory fees. The numbers within this website include all such fees, but it may be necessary for those accounts that are subject to these charges to make substantial trading profits in the future to avoid depletion or exhaustion of their assets.

Investors interested in investing with a managed futures program (excepting those programs which are offered exclusively to qualified eligible persons as that term is defined by CFTC regulation 4.7) will be required to receive and sign off on a disclosure document in compliance with certain CFTC rules The disclosure documents contains a complete description of the principal risk factors and each fee to be charged to your account by the CTA, as well as the composite performance of accounts under the CTA's management over at least the most recent five years. Investor interested in investing in any of the programs on this website are urged to carefully read these disclosure documents, including, but not limited to the performance information, before investing in any such programs.

Those investors who are qualified eligible persons as that term is defined by CFTC regulation 4.7 and interested in investing in a program exempt from having to provide a disclosure document and considered by the regulations to be sophisticated enough to understand the risks and be able to interpret the accuracy and completeness of any performance information on their own.

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RCM Alternatives

WHAT WE DO

We build diversified portfolios with clients looking to access the Alternative Investment space in a meaningful way. That's been our specialty for more than a decade, with our experienced team up to the challenge of finding unique investments to fit unique needs.

For Investors

Research & Educate

We believe education means more than just a glossy brochure showing how managed futures is non-correlated to the stock market. We believe it means ongoing analysis of what's happening now, not just what happened over the past decade; and we provide daily research and commentary via our popular 'Attain Alternatives' blog covering all things alternative investments, as well as periodic whitepapers digging deeper into topics, guest posts by fund managers, and more.

Scout Talent

You can think of us as talent scouts, helping investors scour the world of alternative investment opportunities in an effort to identify those with robust, consistent performance, sophisticated risk management processes, and well-developed operational infrastructure. This selection is done through our proprietary filtering algorithm before performing one-on-one meetings and "real-time due diligence" where we analyze daily trading.

Tailor Portfolios

Armed with a menu of talented managers, we then provide customized portfolio and strategy advice to better generate target returns and protect principal while meeting the diversification, return, and risk needs of investors ranging from high net worth individuals to pension funds. Clients invest in these portfolios by opening a brokerage account with us, where we earn a portion of the trade-by-trade costs and fees paid to the portfolio managers you enlist. There are never any add-on, portfolio-level fees for our services.

Make It Easier

We make the actual investment part, with the paperwork and funding and all the rest, as easy as possible. We do this by eschewing a 'one size fits all' approach in favor of a consultative approach where we work with clients to find solutions that work for them in terms of structuring the investment. These include vanilla individual futures accounts, to the creation of 'Funds of One' or direct access to managers. The choice of clearing firms considers the investor's requirements for credit rating, balance sheet, and more; while consideration is given to smart collateral options via T-Bills, Notes, Corp. Debt, & Stocks.

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