



Alternatives Sector Wrap-Up

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Executive Summary

Morningstar has completed qualitative research assessments of 14 alternative investment strategies. This Sector Wrap-Up provides an overview of our key observations and a summary of our Morningstar Analyst Ratings.TM

Firstly, it's worth restating that 'alternative' investment strategies are by their nature heterogeneous and have different investment strategies and approaches to investing. These investments have been attracting interest as investors grapple with what is perceived to be a 'new normal' investment landscape. In this environment of low interest rates, low growth, low returns, and increased volatility, the promise of absolute and uncorrelated returns is certainly enticing.

In the first section of this report, we examine what is meant by an alternative investment, and explore their key characteristics, including their performance and risk profiles. Many of these strategies might reasonably have been expected to take advantage of recent 'risk-on/risk-off' market conditions, and given their flexible approaches, protect on the downside, and we explore and test whether this has been the case.

Investment objectives stated in fund manager literature and marketing materials are not short on ambitious and attractive promises. In the next section of this report, we examine these in more detail, and the fees charged. Given the hefty price-tags and the role they are intended to play in a portfolio, it's essential to ensure that any proposed alternative investment is going to provide a truly different exposure, rather than overcharging for something that may be obtained cheaply through a traditional managed fund or exchange-traded fund.

When considering alternative investment strategies, one of the most important questions to consider is what role they might play in an investor's portfolio. We discuss this issue in some detail, focusing in particular on the two major groupings of managed futures strategies – which have attracted the lion's share of inflows – and fund-of-fund hedge fund and multi-strategy funds. We do not believe that allocations to alternative assets should be incorporated into lower-risk investor portfolios (typically designated 'conservative' or 'moderate'), given the embedded risks and volatility. For 'balanced' (50:50 growth/income split) portfolios, an alternatives allocation of up to a maximum of 10.0 percent could be used to provide additional diversification, and this should come entirely from the growth component. Any less and the benefits of diversification may not be sufficient to warrant inclusion. Any more risks exposing the investor to too much strategy-specific risk. In another global financial crisis, these funds may not be able to deliver what they promise. It is therefore critical that the allocation comes from the growth component of the portfolio.

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What Are Alternatives?

There's no clear agreement about or all-encompassing definition of what constitutes an alternative investment strategy. The sector is highly-diverse. Alternatives vehicles typically implement investment approaches using mainstream asset classes such as equities, bonds, property, and cash, as well as other instruments such as currencies and commodities. Fund managers also often use derivatives (typically options, swaps, and futures) to take both long and short positions, look further afield into more esoteric and less liquid areas than mainstream players (investing into leveraged loans, micro-caps, and 'frontier' markets, for example), and use leverage. Many hedge fund managers also trade far more regularly than traditional fund managers, adopting a shorter-term perspective, although some take a very long-term approach if they hold illiquid securities such as long-dated derivatives.

Property and infrastructure equity investments, through either listed or unlisted vehicles, should not be considered alternative strategies. While each have specific characteristics that affect their value, and may lead them to consequently offer materially different returns to other equities, these investments still represent equity ownership of an asset. As such, they provide the same rights to the residual cashflows as for any other type of shareholder, as well as similar potential risks and returns.

Performance characteristics are also generally considered when assessing whether an investment vehicle should be classed as an alternative. These strategies frequently endeavour to generate returns which are lowly-correlated to traditional asset classes. They often aim to generate 'absolute returns', or positive returns in all market conditions. This philosophy can be seen in return objectives such as cash or inflation plus a nominal hurdle. The establishment of these targets does not of course guarantee their success. The outcome for alternative or hedge fund managers should theoretically rely more on their strategy and skill than market movements ('beta'), and a class of market-neutral strategies attempts to do just that.

In Consultation Paper 174 *Hedge Funds: Improving Disclosure – Further Consultation*, the Australian Securities and Investments Commission proposes a fairly wide-ranging set of considerations when assessing whether a strategy is a hedge fund or alternative investment, stating that "a hedge fund is a registered managed investment scheme that is, or has been promoted as, or is generally regarded as, a hedge fund or a fund of hedge funds". There are a number of factors which can help determine whether an investment strategy should be considered a hedge fund. These include whether the vehicle pursues complex strategies that aim to generate absolute returns, returns with low correlation to equity and bond indices, or a positive return in both rising and falling markets; whether leverage is used to increase investment returns; whether derivatives are used to create complex investment strategies or for gearing purposes; whether the strategy engages in short-selling; and whether the vehicle has exposure to diverse risks and complex underlying investments.

Our approach to ascertaining whether a strategy is an alternative investment is primarily qualitative. We assess the strategy in its entirety and consider a number of factors, including those outlined above. However, the key issue for us is how the strategy is actually managed by the fund manager, and the techniques applied and instruments used in aiming to meet the stated objectives.

We covered 14 strategies in this review, 13 of which can be grouped together in four ways. (The final offering, **Acadian Quant Yield** 16351, is discussed in more detail in the Role in Portfolio section.)

The first group comprises the absolute return/equity bias, long/short tactical, and aggressive asset allocators (**Certitude Asian Opportunities** 18365, **K2 Asian Absolute Return** 10818, **K2 Australian Absolute Return** 10819, and **K2 Select International Absolute Return** 12345). The funds in this group allocate tactically between equities and fixed interest/cash, and employ fundamentally-based security selection. The tactical element attempts to time exposure to capture upside in rising markets and protect capital during downturns. **Certitude Asian Opportunities** 18365 is a long-only approach to investing in Asian securities that trades rapidly over short periods and can alter its cash and bond weightings materially when risk aversion fluctuates. The K2 stable of funds employ a long/short strategy, trade aggressively, and can invest substantially in cash. The returns from these funds will be directed by the market or systematic exposures to a greater extent than the other vehicles we have assessed.

The second group is fund-of-fund hedge fund and multi-strategy funds: **AQR Delta** 17692, **Fauchier Partners Absolute Return** 16255, and **Select Alternatives** 9960. These funds invest in a basket of individual hedge fund strategies and/or asset classes to diversify across the alternatives universe. They typically aim to generate positive returns with lower volatility than equities, and to diversify a broader portfolio's existing risk exposures.

The third group, global macro, is represented by **BlackRock Asset Allocation Alpha** 14264, **BlackRock Scientific Global Markets** 11018, and **BT Global Macro** 16745. These funds seek to exploit perceived inefficiencies and mispricings in markets by using multiple long/short strategies to express views across a broad suite of asset classes – equities, fixed interest, currencies, and commodities. These strategies encompass both directional views about the anticipated performance of an asset class against cash or the relative performance of similar securities, and often use derivatives instruments. Investment time horizons can be both short and longer term.

The final group is managed futures: **AQR Managed Futures** 19089, **Aspect Diversified Futures** 17744, and **Winton Global Alpha** 15811. These funds in their simplest form are systematic trend-following strategies which seek to exploit price momentum across a range of markets including equities, fixed interest, currencies, and commodities. These vehicles can profit from both rising and falling trends. As the name suggests, they rely primarily on futures contracts to implement their positions.

Because downside protection is often cited as a key reason for investing in alternatives, it's instructive to look at the quarterly periods when the world sharemarket lost value. The MSCI World Hedged Index produced negative returns in three of the eight quarters to June 2012, the second and third quarters of 2011 and the second quarter of 2012. During these periods, only two, three, and two of the 13 funds in our sample generated positive returns. However, except for the June 2011 quarter, most strategies that generated negative returns did manage to fall less than the broader world sharemarket. Only **Acadian Quant Yield** 16351 delivered positive returns in all three of these quarters. This was however not surprising, given that it is primarily a cash portfolio supplemented by a varying but limited sharemarket-neutral component.

Managed futures strategies feature prominently among the vehicles which produced healthy uncorrelated returns, although not in all three quarters. **Aspect Diversified Futures** 17744 and **Winton Global Alpha** 15811 produced their highest returns in the quarters when the world sharemarket fell the most, but lost value in the two other quarters. These strategies tend to perform best when medium-term trends (three to six months) align and accelerate, but tend to struggle when markets change direction more frequently, because their positioning is continually being whipsawed. **AQR Managed Futures** 19089 delivered a strong result over the June 2012 quarter. It is, however, important to remember that while these types of strategies have historically displayed low or negative correlations to equities over the long term, their shorter-term returns are frequently volatile. We examine these strategies in greater depth later in this report.

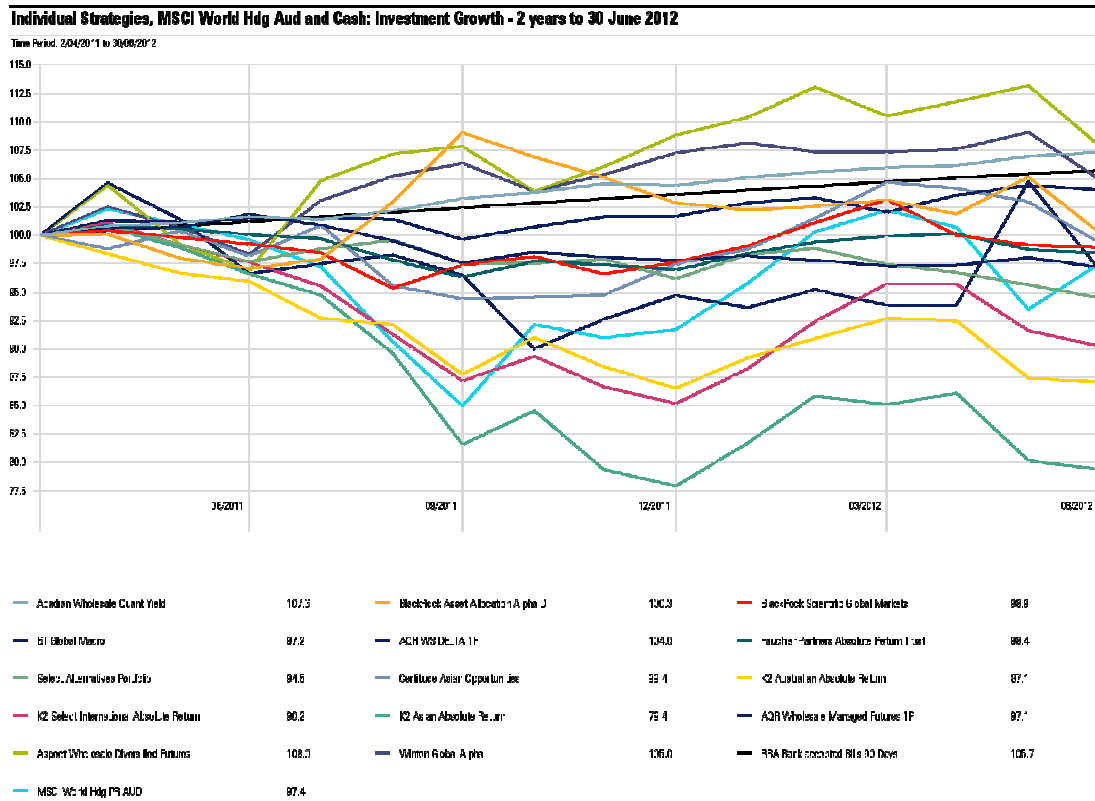
The best multi-strategy funds in this context were **AQR Delta** 17692 and **Fauchier Partners Absolute Return** 16255, which produced gains in two of these quarters. Their returns were however much more muted, in keeping with their broad diversification and lower risk characteristics. AQR's predominantly market-neutral approach helped it post small gains in two of these eight quarters, and limited the downside in the third quarter of 2011. This was the worst quarter for the Fauchier strategy, the result of its greater overall exposure to the sharemarket (although the result was still defensive).

BlackRock Asset Allocation Alpha 14264 was the other notable performer. This vehicle produced its highest quarterly return over the eight quarters to 30 June 2012 in the third quarter of 2011, when the world sharemarket experienced its greatest fall. BlackRock's 12.36 percent return for the September 2011 quarter was the highest in our universe, and it was one of only three strategies to post a positive outcome for those turbulent three months. The performance profile during these three down quarters was not dissimilar to the managed futures strategies. In contrast to the systematic managed futures programs, BlackRock is a discretionary global macro vehicle, but also positions itself for medium-term trends the fund manager identifies through its own research. In this case, the bearish (risk-off) positioning benefitted investors.

While the path of returns is important to understand, the overall outcome is usually of greatest interest to investors. When looking at the two-year returns to 30 June 2012 (Figure 2 over), only two of the 13 alternative strategies were able to outperform cash, and only five posted a positive return. Eight of the 13 outperformed international shares, however. The two-year returns to 30 June 2012 do not however paint a particularly attractive picture for alternatives funds. At a time when investors might reasonably have expected them to deliver better absolute returns, only five strategies produced a positive return. Nevertheless, it is during market environments such as these that fund managers with perceived edges in market timing or stock selection or with a broader toolset should be able to deliver. Investors expecting absolute returns, which many fund managers purport to be able to deliver, are likely to have been disappointed, while those looking for defensive characteristics were better-served.

The eight quarters we have assessed represents only a comparatively short period, and arguably a highly-volatile one. This means that these returns profiles are not necessarily representative of how the funds are likely to behave. What this does show is the extent to which returns can vary across the universe of funds designated as alternative.

Figure 2: Alternative Investment Strategies, MSCI World Index, Cash – Two-Year Returns to 30 June 2012

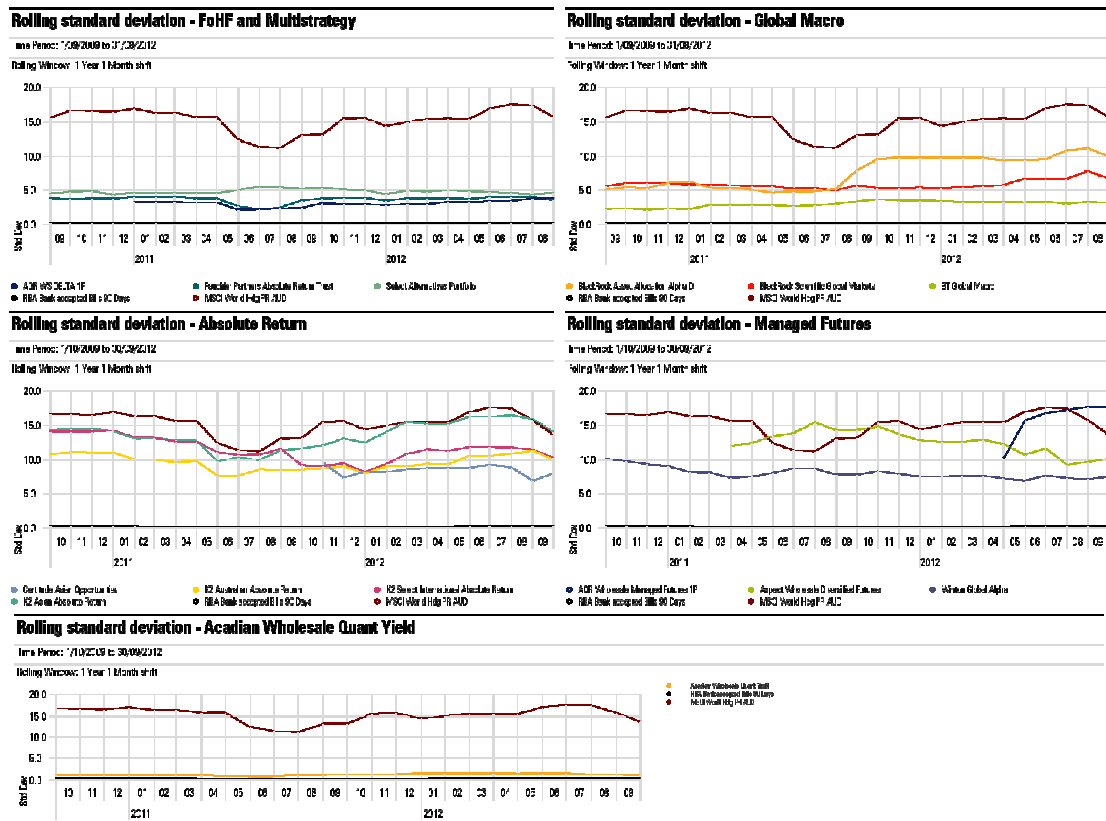


Source: Morningstar Direct™

Risk is another important element in performance assessment. Here again there is plenty of differentiation among the strategies. They often have specific risk targets or risk target ranges, usually measured by standard deviation. This is a particular feature of quantitatively-based strategies, and less important to those of a more discretionary or market-linked nature. The strategies with risk targets generally aim to meet the requirement over the course of a cycle, and so their risks can vary over shorter periods.

It's important to have regard for the level of risk taken when considering returns. If two funds returned the same amount but one took half as much risk, all other things considered, it would be preferable to hold the lower-risk investment. Assessment of the level of targeted risk should also help frame expectations about future returns. Figure 3 shows the rolling one-year standard deviations of the alternative strategies, grouped into the four sub-categories, over the two years to 30 June 2012. (**Acadian Quant Yield 16351** is shown separately.)

Figure 3: Alternative Investment Strategies – Rolling Standard Deviations, 1 September 2009 – 31 August 2012



Source: Morningstar Direct™

There are three distinct levels of risk within the global macro group. **BT Global Macro** 16745 targets a risk level of between five and eight percent. The level of actual risk has been quite steady and has been tracking below that level. **BlackRock Scientific Global Markets** 11018 targets eight percent per annum volatility, and the same pattern can be observed as for the BT offering. **BlackRock Asset Allocation Alpha** 14264 has a higher target risk level of 12.0 – 15.0 percent, but its volatility has fluctuated to a greater degree, reflecting the more discretionary nature of the process compared to the first two offerings, which are quantitatively-based.

The strategies in the fund-of-fund hedge fund and multi-strategy group all operate with relatively stable volatility and at much lower levels than the strategies in the other groups. This is because of portfolio diversification and portfolio construction techniques. These fund managers generally invest in a range of underlying managers or strategies which are lowly-correlated, and which therefore act to reduce overall volatility.

Managed futures strategies operate at generally higher levels of volatility than those in the global macro and fund-of-fund hedge fund sectors. **Winton Global Alpha** 15811, **Aspect Diversified Futures** 17744, and **AQR Managed Futures** 19089 all have specific targets (10.0 percent, 17.0 percent, and 17.0 percent respectively). All three have produced volatility below these targets. However, the volatility of AQR Managed Futures spiked up far more aggressively in May and June 2012 than its counterparts. The AQR vehicle remains comparatively young, so it's not clear whether this will persist.

Finally, the strategies in the absolute return group generally follow the path of equities, as they generally run net equity exposures well over 50.0 percent. They operate by allocating tactically between equities and cash or taking other defensive measures aimed at managing risk and protecting capital. However, their volatility will be driven by sharemarkets and the level of net exposure a strategy has at any given time.

We take a closer look at correlations between the strategies with equities and each other in the Role in Portfolio section, but it's important to remember these volatility characteristics when considering alternatives funds. Volatility is an important issue to consider when assessing how a strategy could function in a portfolio. Some explicit targets can be achieved fairly accurately, and with a high degree of consistency over time, while other strategies fluctuate or are more influenced by their net long exposure to sharemarkets.

Fund Fees and Objectives

In alternatives as with all investments, it's important to consider total associated costs, as high expenses can really drag on returns. To determine whether the funds in our alternatives universe represent good value propositions, we looked at each strategy's base management fee in conjunction with its performance fee structure. In general, we consider alternatives funds to be expensive relative to most other asset classes. However, we also recognise that investors pay a premium for the complexity of the underlying process, the skillsets of alternatives portfolio managers, and for obtaining exposure to sophisticated investment products and strategies usually beyond the reach of retail investors.

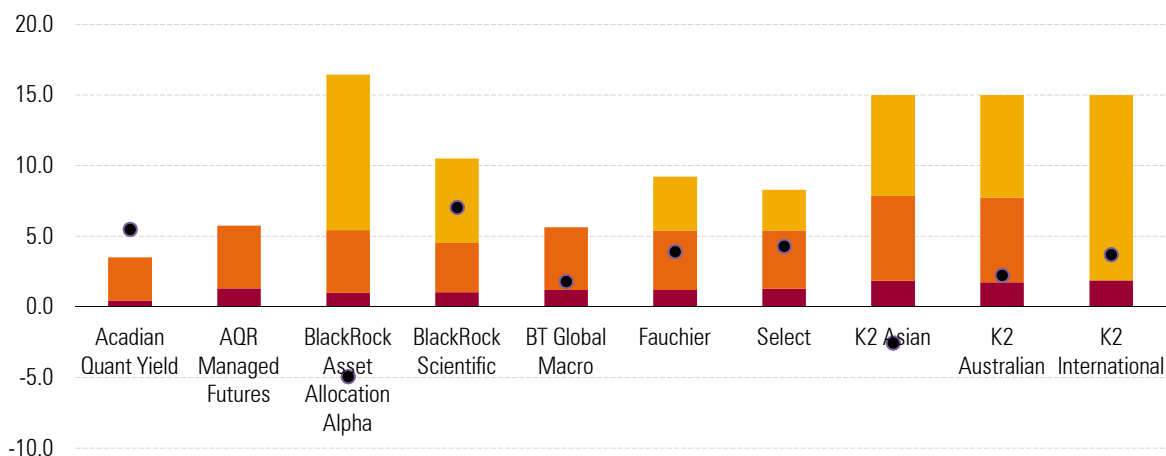
The base management fees for our 14 alternative strategies range from 0.45 to 1.89 percent. While we consider most of these base fees steep, the addition of performance fees can make these investments particularly costly. Twelve of our 14 funds have performance fees. However, their dissimilar structures make it hard to make direct comparisons. The key issues investors and advisers need to consider are benchmark suitability, performance fee quantum, hurdle rate, and the existence or otherwise of a high watermark. (We discussed this in more detail in the paper *Best Practices in Managed Fund Performance Fees* in April 2011.)

Performance fees should incentivise and reward fund managers for outperforming an appropriate index. However, unlike standard asset classes, the heterogeneous nature of the alternatives sector means that there is rarely an obvious best-fit index against which to benchmark a performance fee. This provides fund managers with a greater degree of discretion to structure performance fees, resulting in some unsuitable frameworks. For example, funds benchmarked against cash (eight of the strategies in our universe) should also have a material hurdle rate over cash, given the risks taken, but this is rarely the case in practice. For some strategies, the combination of a cash and equities benchmark (whichever is the higher) with appropriate hurdles may be more appropriate.

Most alternatives funds also have heterogeneous objectives. A fund's objective outlines its goal or desired result, and can be found in its Product Disclosure Statement. We caution that higher and more ambitious objectives do not guarantee greater returns. We also believe that an appropriately set objective should be practical, realistic, and tie in with targeted risk levels, providing a true representation of the underlying strategy. It should also align with the fund's benchmark and fee structure (especially important given that some funds can still levy performance fees even though they have failed to meet their objectives). We observe a number of conflicts with these principles in practice.

Figure 4 below juxtaposes the performance fee hurdles against the stated objectives of those funds which possess them. The maroon segment of the bar shows the base fee paid regardless of performance. The orange segment shows the hurdle rate before a performance fee can be charged, and the yellow segment the strategy's overall objective over the performance fee hurdle and base fee. The black dot represents the three-year total return to 31 July 2012.

Figure 4: Alternative Investment Strategies – Performance Fee Hurdles, Three-Year Returns to 31 July 2012



Sources: Morningstar Direct™, Morningstar Research Reports, Fund Manager Product Disclosure Statements

The investment objectives are eye-catching and in most cases set at very attractive levels. They're also well in excess of the stated hurdle rates: for example, the K2 suite of strategies aim for 15.0 percent annualised returns despite materially lower hurdle rates. **Acadian Quant Yield** 16351, **AQR Managed Futures** 19089, and **BT Global Macro** 16745, however, simply strive to beat the hurdle rate. In effect, the yellow segment represents the band where the fund manager can underperform its stated objective but still get paid a potentially handsome performance fee. Fund managers should align performance fees more closely with objectives, to avoid being rewarded for falling short of their own objectives.

The three long/short strategies offered by K2 are among the most expensive of our alternatives funds. Their base management fees range from 1.73 to 1.87 percent, and are high relative to peers. These three strategies also have identical performance fee rates of 20.50 percent. While **K2 Asian Absolute Return** 10818 and **K2 Australian Absolute Return** 10819 have hurdle rates of six percent, **K2 Select International Absolute Return** 12345 can levy a performance fee on any absolute return after fees. We take issue with all these structures, preferring lower base fees to offset the performance fees, and the introduction of a material absolute benchmark in conjunction with an equities-based hurdle for all three strategies. The three funds also have identical objectives, of generating 15.0 percent per annum over three- to five-year investment cycles. We consider this target ambitious, and note that each fell well short of this goal over the past three and five years. This emphasises our earlier point that higher objectives do not imply superior returns.

Among the managed futures strategies, the fee structures of **Aspect Diversified Futures** 17744 and **Winton Global Alpha** 15811 are more comparable than that of **AQR Managed Futures** 19089, as the former do not have explicit quantitative objectives (the reason they do not appear in Figure 4). They have performance fees of 20.0 percent or more on positive futures trading returns, but Winton's 1.88 percent base fee makes it the most expensive option. Aspect has a cheaper base fee of 1.63 percent, but is still expensive in absolute terms and relative to this group's cheapest option. We'd prefer to see lower base fees for both strategies and a hurdle over cash. The AQR vehicle is more attractive from a cost perspective, with a lower base fee of 1.30 percent, a lower 10.0 percent performance fee, and a cash hurdle rate, although even here a hurdle over cash would be more appropriate given the elevated levels of targeted volatility.

BlackRock's global macro funds, **BlackRock Asset Allocation Alpha** 14264 and **BlackRock Scientific Global Markets** 11018, have reasonable base management fees of one and 1.025 percent respectively. However, their performance fees of 20.0 percent above cash lack meaningful hurdles. We also consider BlackRock's objectives to be arbitrary. Asset Allocation Alpha targets a 12.0 percent return above the UBS Bank Bill Index over rolling three-year periods, and Scientific Global Markets has a target of seven percent per annum above the Reserve Bank of Australia Cash Rate over rolling three-year periods. Despite never having achieved this to date, a performance fee structure unrelated to the objective enables fund managers to charge performance fees while underdelivering against their own stated objectives. This again highlights the irrelevant role objectives can play.

In the fund-of-fund hedge fund/multi-strategy group, **AQR Delta** 17692, **Fauchier Partners Absolute Return** 16255, and **Select Alternatives** 9960 have similar base management fees, ranging from 1.20 to 1.30 percent. AQR Delta remains one of the few alternatives funds devoid of a performance fee structure, while the Fauchier and Select vehicles have performance fees of around 10.0 percent on returns above cash. These vehicles' fee structures enable the shops to levy fees on returns above cash despite falling short of their respective cash plus four and five percent objectives. This demonstrates the lack of alignment between some performance fee structures and objectives.

Of the remaining strategies, **Certitude Asian Opportunities** 18365 has the most expensive base management fee of 1.89 percent. While we acknowledge the absence of a performance fee, we still believe this is excessive. Although **Acadian Quant Yield** 16351 is at the other end of the spectrum, with the lowest base fee of 0.45 percent, the introduction of a 20.0 percent performance fee over cash also makes this a potentially expensive strategy. The existing structure enables Acadian to unjustifiably charge performance fees on returns below the Reserve Bank of Australia Cash Rate, because the hurdle is gross of the annual management fee. With the cash rate at 3.50 percent and an annual management charge of 0.45 percent, the performance fee should not kick in until a return of the target plus the annual management fee has been achieved at the very least. To put this in context, if Quant Yield generated a gross return of four percent, Acadian could charge 10 basis points in performance fees $((4.0 - 3.50) * 20.0 \text{ percent})$, and then charge a further 45 basis points, meaning that once the total charge of 55 basis points has been deducted, the net return to investors would be 3.45 percent. Acadian would therefore garner an extra reward while the investor suffers a return below the stated hurdle. (Acadian is not alone in this unfair practice. The BlackRock Scientific vehicle is also a notable culprit, while both Aspect Managed Futures and Winton Global Alpha have performance fees charged on performance of gross futures trading profits.)

Overall, we believe that the higher price-tag attached to alternatives funds should give investors and advisers reason to do their homework, judiciously assess a fund's merit, and ensure that they're getting the proverbial bang for their buck. In doing so, we also urge investors and advisers not to give undue weight to a fund's objective. As we've seen in this discussion, the objective may be out of sync with the fee structure, and can be a poor representation of the underlying strategy's potential performance outcomes, especially after fees.

Managed Futures Funds

Managed futures vehicles have been attracting attention of late, and the universe of opportunities has grown significantly. In the United States, for example, there are now over 30 such strategies, whereas as recently as 2007 they were barely accessible, if at all, to the average investor. These US mutual funds had about US\$7.80 billion in assets at 29 February 2012, almost half of which was pumped in during 2011. In Australia, managed futures funds have been attracting most of the inflows into the alternatives sector, as Table 1 below shows.

Table 1: Alternative Investment Strategies – Net Assets, Three-, Six-, 12-Month Net Flows A\$m

Name	Ticker	Fund Size A\$m	Date	Net Flow A\$m 3 Mth	Net Flow A\$m 6 Mth	Net Flow A\$m 12 Mth
Acadian Wholesale Quant Yield	16351	35.74	30-Sep-12	3.69	5.04	13.61
AQR Wholesale Managed Futures 1P	19089	7.60	30-Sep-12	-0.19	-0.19	-0.04
AQR WS DELTA 1F	17692	6.11	31-Aug-12	2.18	2.92	4.56
Aspect Diversified Futures - Class A	17744	193.81	30-Sep-12	41.17	67.20	109.21
BlackRock Asset Allocation Alpha D	14264	255.27	31-Oct-12	-15.69	-21.26	-23.92
BlackRock Scientific Global Markets	11018	44.16	31-Oct-12	-3.03	-27.13	-12.55
BT Global Macro	16745	19.04	30-Sep-12	-24.83	-24.27	5.85
Certitude Asian Opportunities	18365	14.20	31-Oct-12	-	-	-
Fauchier Partners Absolute Return	16255	754.62	31-Aug-12	-26.61	-25.61	-
K2 Asian Absolute Return	10818	114.36	31-Oct-12	-7.87	-21.81	-28.35
K2 Australian Absolute Return	10819	341.93	31-Oct-12	-6.53	-144.02	-142.50
K2 Select International Absolute Return	12345	213.57	31-Oct-12	-8.30	-8.88	-9.56
Select Alternatives Portfolio	9960	52.71	30-Sep-12	-9.43	-12.52	-9.40
Winton Global Alpha	15811	772.59	31-Oct-12	36.86	59.14	143.34

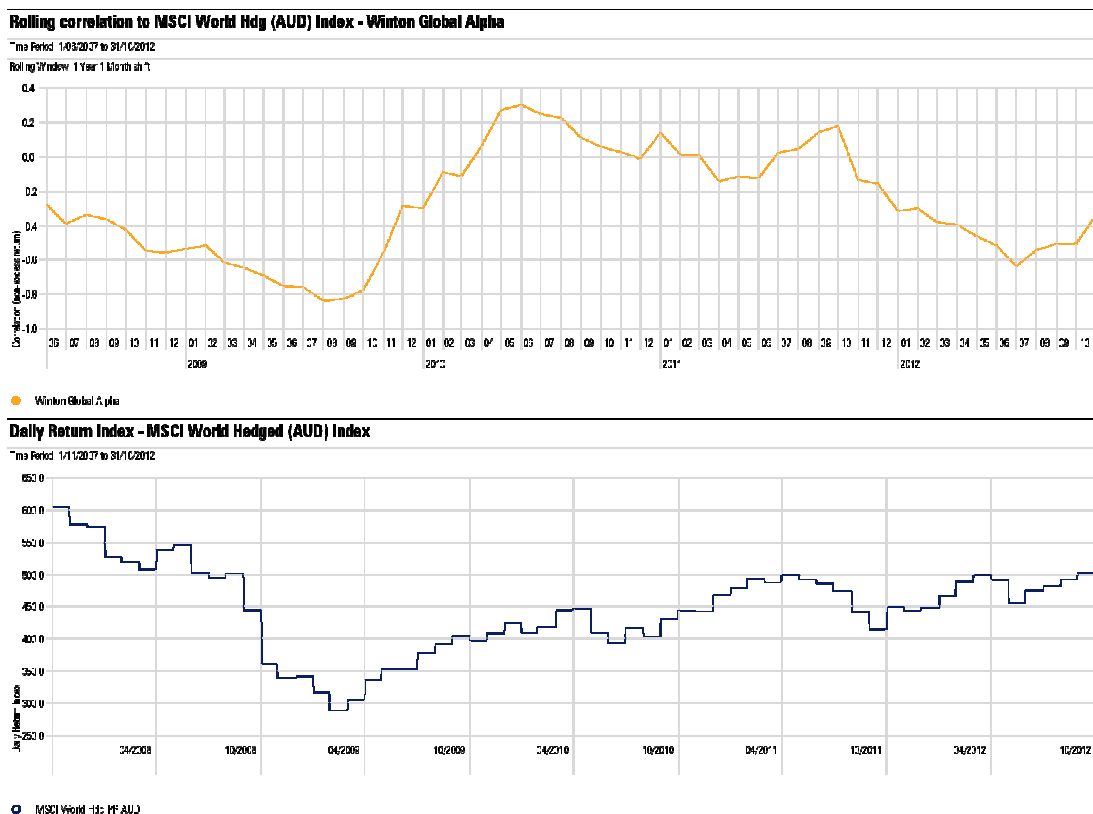
Source: Morningstar Direct™

As with alternatives strategies generally, it's difficult to generalise. However, the three strategies we cover qualitatively in Australia (**AQR Managed Futures** 19089, **Aspect Diversified Futures** 17744, and **Winton Global Alpha** 15811) can broadly be described as diversified systematic trend-following programs. They follow a range of trends, whether positive or negative, and short-, medium-, or long-term, across a range of markets (equities, fixed interest, currency, and commodities, for example), and seek to profit from using complex quantitative systems which aim to identify trends, manage risk, construct optimal portfolios, and trade efficiently. Given the complexity of these systems, fund managers are reluctant to divulge too much information for fear of disclosing their intellectual property, and as a result being subject to replication. Given this opaque structure, why the sudden interest?

Other than the potential transparency issues, managed futures strategies tick a number of boxes when it comes to investor expectations, especially when considered relative to other alternative strategies. Firstly, they're highly-liquid: the underlying instruments traded are generally futures contracts, which means that managed futures funds can offer daily liquidity. This means that there should be little risk of unit redemption restrictions or embargos. Secondly, some fund managers in the sector can point to very successful longer-term track records, in some cases stretching back well over a decade. Finally, because they can profit from both rising and falling markets, managed futures strategies offer a potential source of return uncorrelated to mainstream investments.

Winton Global Alpha 15811 has the longest history in Australia. This offering's performance in 2008, when it rose 25.65 percent at the same time as the MSCI World Hedged Index fell 40.49 percent, and its 11.71 percent per annum return over the five years to 31 July 2012 (compared to the world sharemarket index's 3.53 percent loss) have highlighted the obvious return and diversification qualities of managed futures funds. Figure 5 below shows the rolling correlation between the daily returns of the Winton vehicle and the MSCI World Hedged Index. The graph shows that Winton's correlation became increasingly negative from the end of 2007 through to early 2009, at the same time as the world sharemarket index was falling, helping the managed futures strategy generate a strong positive return. As the world sharemarket recovered, the correlation began to increase, but the Winton strategy produced a small 3.81 percent loss in 2009. Sharp reversals in sharemarkets are particularly dangerous for managed futures strategies, an issue we discuss in greater detail later in this report. However, the overall result during this period indicates that managed futures strategies can act as effective diversifiers in portfolios.

Figure 5: Winton Global Alpha – Rolling Correlation to MSCI World Index, 1 June 2007 – 31 October 2012

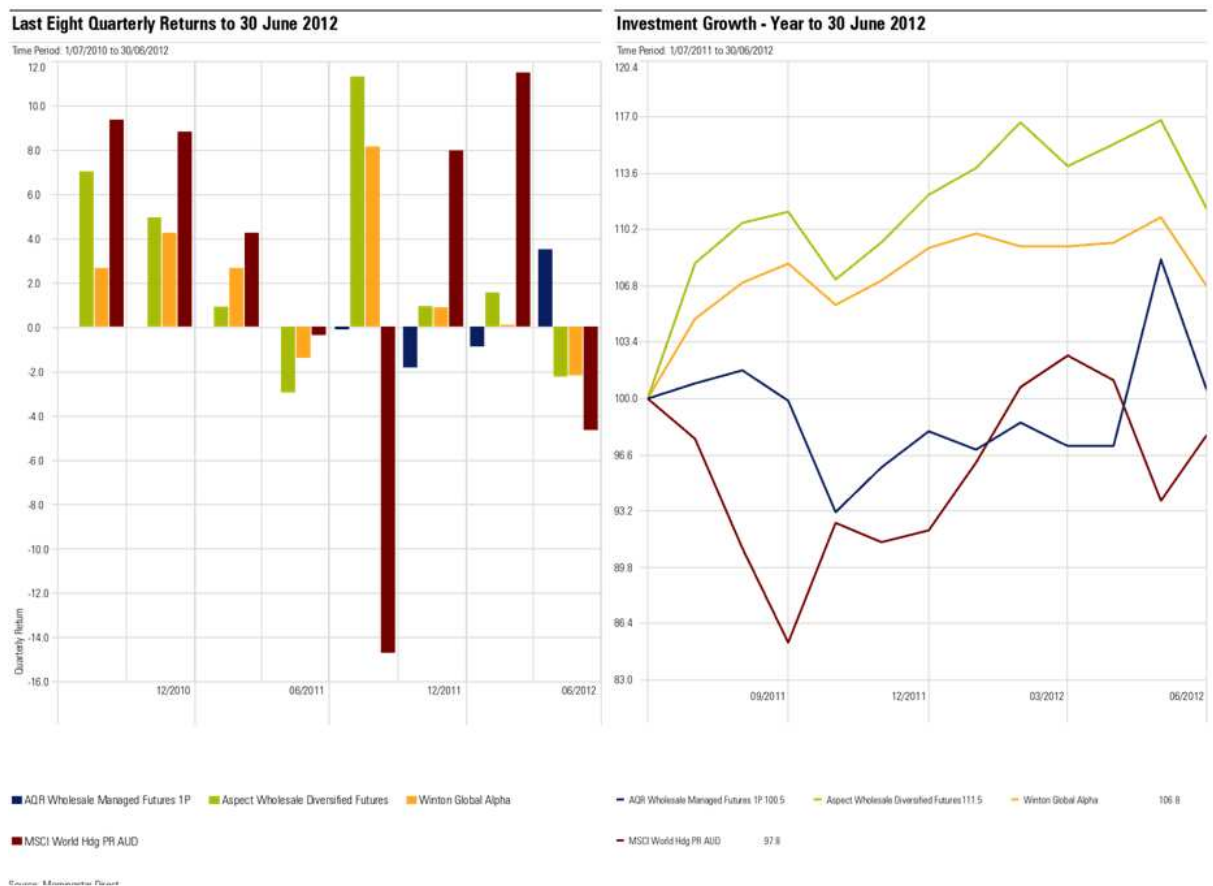


Source: Morningstar Direct™

Although the benefits of including a managed futures strategy in an investment portfolio may appear substantial, it's also important to remember the risks, that not all strategies are created equal, and that they are still comparatively new to this market. The two principal associated risks are trendless market conditions, and conditions where trends reverse rapidly, either in one violent move (as happened in March 2009), or a series of them. Managed futures strategies can be whipsawed during market inflection points.

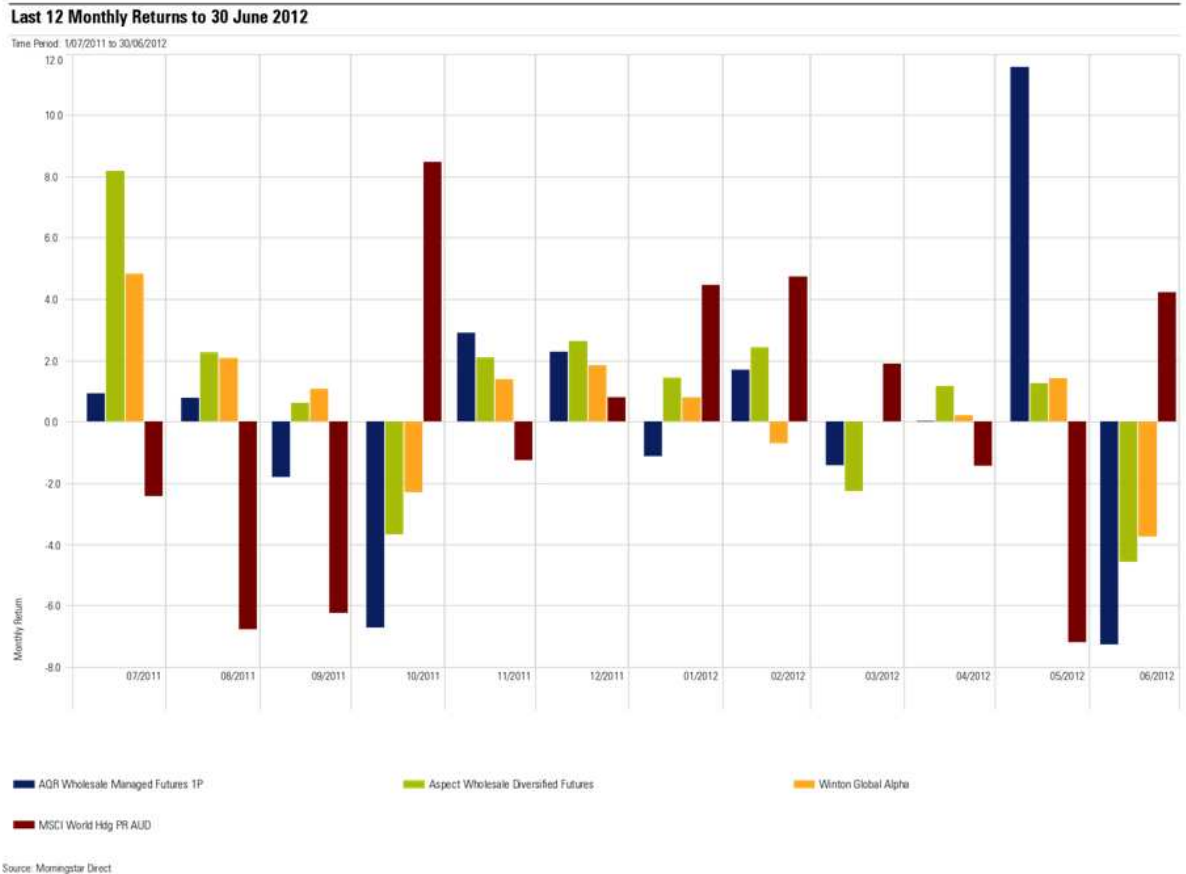
Figure 6 below shows the eight quarterly returns for the managed futures strategies in our alternatives universe to 30 June 2012 and those of the MSCI World Hedged Index. There was no obvious pattern of returns for the three funds relative to the world sharemarket, although all three managed to generate positive returns for the year to 30 June 2012. **Winton Global Alpha 15811** and **Aspect Diversified Futures 17744** appear to be more correlated to each other than to **AQR Managed Futures 19089**. The former operate in a much more similar fashion, especially in terms of timeframe and risk budgets, while Winton has a lower overall risk target, helping explain its lower volatility. The dispersion in monthly returns between the strategies is shown more vividly in Figure 7 over.

Figure 6: Managed Futures Strategies – Eight Quarterly Returns, Investment Growth Year to 30 June 2012



Source: Morningstar Direct™

Figure 7: Managed Futures Strategies – 12-Month Returns to 30 June 2012



Source: Morningstar Direct™

Figures 6 and 7 show that there is little uniformity in the approaches used by managed futures funds or the outcomes produced. The key differences between these three strategies include their volatility targets (as measured by standard deviation), the weightings apportioned to short-, medium-, and long-term trends, and the relative exposures to the various asset classes. All of these characteristics are dynamic and will vary over time depending on the underlying strategy's conviction, portfolio construction, and risk management. **Aspect Diversified Futures 17744**, for instance, targets annualised volatility of around 17.0 percent, whereas **Winton Global Alpha 15811** has a 10.0 percent target.

Two other points are worth considering. Firstly, the managed futures sector has enjoyed spectacular assets growth over the last few years. An estimated US\$250.0 billion is now chasing returns. This doesn't necessarily mean that returns will be eroded, but is something of which to be mindful as the sector becomes ever more competitive. Staying ahead of the game and evolving as market dynamics change is imperative. It's also important to ensure that the vast majority of returns are being generated by pure trend-following, and that these strategies don't morph into something else.

The other main point is a common criticism levelled at alternatives funds in general – that they don't come cheaply. Management fees range from 1.30 percent base plus 10.0 performance fee (**AQR Managed Futures 19089**) to 1.88 percent base plus 20.50 percent performance fee (**Winton Global Alpha 15811**). All three are expensive on an absolute basis, even if AQR has a meaningful headstart relative to the other managed futures strategies.

So where does this leave an investor considering the addition of such a strategy to their portfolio? It's important to note that Morningstar does not treat alternative investments as an asset class, and as such they are not included explicitly in our strategic asset allocations and model portfolios. We believe that the incorporation of alternative assets in a portfolio is best approached as a product selection issue rather than an asset allocation one, given the heterogeneous nature of most alternatives products. It follows from this that the appropriate role for an alternative vehicle in a portfolio depends on its specific characteristics. We consider managed futures funds to be growth vehicles, and therefore that any allocation should be from the growth component of a portfolio. We also believe that given their complexity and potential volatility, managed futures strategies are not suitable for investors with low tolerance for risk. We recommend no more than a 10.0 percent portfolio allocation to alternative assets in general.

Fund-of-Fund Hedge Funds/Multi-Strategy Funds

There are a number of meaningful challenges when considering an investment in alternatives, as we have already seen. Investors and advisers must also sift through the types of approaches on offer – which in Australia as outlined previously include absolute return/equity bias, long/short tactical, and aggressive asset allocators; fund-of-fund hedge fund and multi-strategy funds; global macro offerings; and managed futures vehicles – and then compare the strengths and weaknesses of the various fund managers.

The issue is complicated further by the fact that most alternatives funds on offer in Australia have relatively short track records and opaque portfolios. While there's no one-size-fits-all solution to those problems, fund-of-fund hedge fund/multi-strategy vehicles can simplify the process by narrowing strategy and manager selection down to just one decision. These funds attempt to provide a 'one-stop shop' for alternatives exposure by allocating to an assortment of strategies (long/short equity, market-neutral, global macro, and so on). They typically have a fund-of-fund structure and can be internally-managed, externally-managed, or both. The idea is to provide a diversified array of uncorrelated alpha sources without the hassle of selecting individual managers.

Despite this apparent benefit, these offerings have not been particularly popular with Australian investors and advisers in recent years. The three such strategies we cover – **AQR Delta** 17692, **Fauchier Partners Absolute Return** 16255, and **Select Alternatives** 9960 – collectively suffered a modest outflow over the year to 31 August 2012. Local market participants have been more interested in managed futures strategies, probably on the basis of marketing of their lack of correlation to international shares during the global financial crisis. The multi-alternative approach has resonated much more with US investors, where this category received US\$4.40 billion in inflows in 2011.

Fund-of-fund hedge fund/multi-strategy funds do have several important drawbacks investors and advisers should consider carefully. First and foremost, their fees are typically very high. Investors pay for the portfolio manager's allocation expertise and individual manager selection in addition to underlying fund fees. Fauchier, for example, carries a 1.20 percent management fee and a performance fee of 10.0 percent on returns above the UBSA 90-Day Bank Bill Index. These are on top of the fees charged by the underlying strategies, which will have already reduced Fauchier's return, and may amount to one to two percent or more.

Secondly, some fund-of-fund hedge fund/multi-strategy funds allocate a portion of their assets to traditional long-only equities or commodities, exposures investors may already have in their portfolios. **Select Alternatives** 9960, for example, can have long exposures to commodities, gold shares, and infrastructure. Given the hefty price-tags and the role they are intended to play in a portfolio, it's essential to ensure that these offerings are providing truly different exposures, rather than overcharging for something that may be obtained cheaply through a traditional managed fund or exchange-traded fund.

Thirdly, daily liquidity is not a foregone conclusion. **AQR Delta** 17692 and **Fauchier Partners Absolute Return** 16255 offer two-weekly and quarterly redemption terms. Extended lag periods are not necessarily a bad thing – they help manage and more closely match the underlying liquidity profile – but investors and advisers need to be aware of such terms, and be prepared to hold through periods of stress to avoid being disadvantaged or disappointed.

Despite these drawbacks, there are some fund-of-fund hedge fund/multi-strategy funds worth considering. **AQR Delta 17692**, for example, allocates to nine different hedge fund strategies, including global macro, managed futures, and convertible arbitrage. AQR states that these nine strategies represent core hedge fund betas that it tries to capture. The underlying strategies are managed in-house, which eliminates any underlying fund fees and helps make this the cheapest multi-strategy vehicle we cover. AQR Delta has a short but promising track record, having delivered a cumulative 16.67 percent gain from 1 January 2010 to 31 August 2012 with a low standard deviation of 3.17 and a low beta to the MSCI World Hedged Index. The world sharemarket index gained 16.04 percent over the same period, but had about five times the volatility. The Reserve Bank of Australia Bank Accepted Bills 90 Day Index gained 12.65 percent with almost no volatility as would be expected. AQR Delta has a Morningstar Analyst Rating™ of Bronze.

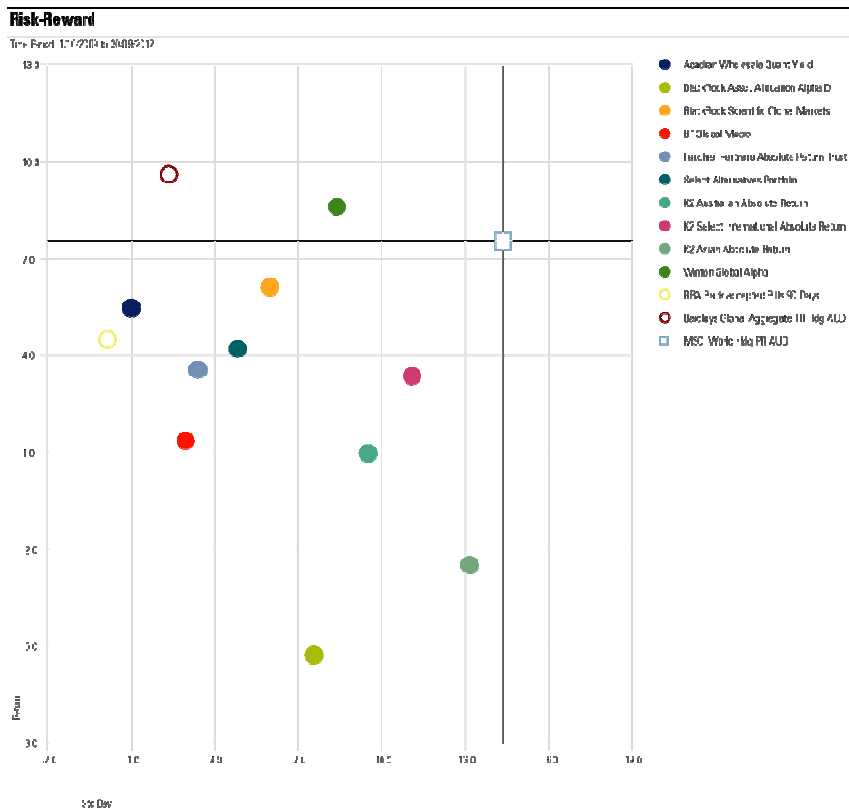
Fauchier Partners Absolute Return 16255 (which also has a Morningstar Analyst Rating™ of Bronze) takes a more fundamental approach. Its management team allocates assets to about 30 external hedge fund managers on the basis of a strategic asset allocation that the fund manager only shifts marginally when its market outlook changes. Fauchier traditionally avoids quantitative managers, notably those pursuing managed futures strategies, and the fund has a relatively high stake in equity long-biased managers. This has fostered a higher correlation to the global sharemarket than exhibited by other fund-of-fund hedge fund/multi-strategy funds we cover, but equity beta has still been quite low. Fauchier's performance record has been mixed. Its cumulative 9.47 percent gain from 1 November 2007 to 30 June 2012 outperformed the -21.49 percent loss from the MSCI World Hedged Index by a wide margin, but lagged the 25.36 percent gain from cash. Still, Fauchier's strong and experienced investment committee combined with its persistent efforts to reduce underlying fund fees augur well for the strategy's future.

Role in Portfolio

We are mindful that adding an alternatives allocation to an investment portfolio is not an exact science, given the complexities of the underlying strategies, their individual characteristics, and the lack of reliable long-term data. This is complicated further by the comparatively limited choice of alternatives funds available in Australia.

Figure 8 below shows key performance and risk statistics over the three years to 30 September 2012 for the 14 alternative strategies we have assessed. It shows that with the exception of **Acadian Quant Yield** 16351, all have been significantly riskier (as measured by standard deviation) than cash, and in most cases fixed interest as well. Only one strategy managed to perform better than international shares, and only three outperformed cash over these three years. The strong performance of **Winton Global Alpha** 15811 came at the expense of nearly three-and-a-half times as much volatility as fixed interest, but nearly half the volatility of international shares. None of the strategies landed in territory where they took more risk than equities, but as mentioned already, only Winton exceeded the return from the international sharemarket. **Acadian Quant Yield** 16351 took the least risk during this period, its risk profile more closely resembling cash than fixed interest, as did its return.

Figure 8: Alternative Investment Strategies – Risk/Reward, Three Years to 30 September 2012



Source: Morningstar Direct™

The upshot is that we do not believe that allocations to alternative assets should be incorporated into lower-risk investor portfolios (typically designated 'conservative' or 'moderate'), given the embedded risks and volatility. High-grade bonds and cash are more appropriate for diversifying these portfolios, given these assets' lower volatility, stable returns primarily from income, and generally uncorrelated nature to other asset classes. However, **Acadian Quant Yield 16351** is an interesting case. This could be deployed in lower-risk profiles, given that the majority of its returns are derived from a cash portfolio and that its ongoing volatility is likely to remain in the range between cash and bonds. However, given that excess returns are generated from a market-neutral portfolio, we consider the Acadian vehicle to be a hybrid approach. Any allocation to this strategy should therefore come equally from the income and growth components of the portfolio and comprise no more than 10.0 percent in total.

For 'balanced' (50:50 growth/income split) portfolios, we believe that an alternatives allocation of up to a maximum of 10.0 percent could be used to provide additional diversification, and that this should come entirely from the growth component. Any less and the benefits of diversification may not be sufficient to warrant inclusion. Any more risks exposing the investor to too much strategy-specific risk. In another global financial crisis, these funds may not be able to deliver what they promise. It is therefore critical that the allocation comes from the growth component of the portfolio.

In general, we recommend allocating to alternatives in a diversified manner, except in the case of **Acadian Quant Yield 16351** as discussed above, or where there is extremely limited choice of strategies we have designated Morningstar Medallists (funds with Morningstar Analyst Ratings™ of Gold, Silver, or Bronze). A case could be made for the sole inclusion of a fund-of-fund hedge fund or multi-strategy vehicle. However, these approaches typically have less favourable liquidity arrangements than other types of strategy, and their high costs erode returns despite having lower volatility and more consistent return profiles. It's also important to monitor the underlying hedge fund exposures. For example, at the time of our assessment, **AQR Delta 17692** had approximately 20.0 percent of its portfolio in managed futures. Adding a dedicated managed futures strategy would increase exposure to this type of asset.

A higher-risk way of achieving alternatives exposure would be to blend two of the single strategies. As these are not as diversified as the fund-of-fund hedge fund/multi-strategy vehicles, they have shown greater volatility in the recent past, which can be expected to continue. This means it is important to find strategies which have low or negative correlations to equities and to each other. Figure 9 below shows the correlations of all the alternative strategies we assessed and the major market indices over the three years to 31 August 2012. Among those we have designated as Morningstar Medallists and with three-year track records, the correlation between **Winton Global Alpha 15811** and **BlackRock Scientific Global Markets 11018** was negative, which could indicate that they would prove a better mix for those willing to shoulder the extra risks of single-strategy offerings.

Figure 9: Alternative Investment Strategies – Correlations to MSCI World Index, Three Years to 31 August 2012

Correlation Matrix v MSCI World Hedged - 3 years												
Time Period: 1/28/2006 to 31/08/2012												
	1	2	3	4	5	6	7	8	9	10	11	12
1 Acadian Wholesale Quant Yield	1.00											
2 BlackRock Asset Allocation Alpha D	0.17	1.00										
3 BlackRock Scientific Global Markets	0.10	-0.05	1.00									
4 BT Global Macro	-0.05	-0.37	0.28	1.00								
5 Fauchier Partners Absolute Return Trust	-0.13	-0.33	0.53	0.46	1.00							
6 Select Alternatives Portfolio	-0.11	-0.01	0.13	0.26	0.59	1.00						
7 K2 Australian Absolute Return	-0.03	-0.27	0.54	0.43	0.79	0.55	1.00					
8 K2 Select International Absolute Return	-0.02	-0.27	0.63	0.40	0.83	0.50	0.88	1.00				
9 K2 Asian Absolute Return	-0.13	-0.36	0.52	0.50	0.82	0.50	0.86	0.90	1.00			
10 Barclays Global Aggregate TR Hdg AUD	-0.11	0.16	-0.26	-0.03	-0.32	-0.05	-0.35	-0.40	-0.28	1.00		
11 RBA Bank accepted Bills 90 Days	0.10	0.12	-0.18	-0.13	-0.16	-0.05	-0.18	-0.07	-0.10	-0.06	1.00	
12 MSCI World Hdg PR AUD	-0.06	-0.43	0.62	0.39	0.85	0.40	0.83	0.88	0.84	-0.41	-0.11	1.00

Source: Morningstar Direct™

Morningstar Medallists

Investment strategies with Morningstar Analyst Ratings™ of Gold, Silver, or Bronze carry the tag Morningstar Medallists. These are the strategies that in our opinion truly stand out, and share common traits including a capable and stable team, robust processes, and an ability to deliver in a variety of market conditions.

We designated five of the 14 alternatives investment strategies we assessed Morningstar Medallists (Table 2 below). None achieved the highest or second-highest possible Analyst Ratings of Gold or Silver. ■■

Table 2: Morningstar Medallists – Alternatives Strategies

Ticker	Fund Manager/Strategy	Morningstar Analyst Rating™
19089	AQR Managed Futures	Bronze
17744	Aspect Diversified Futures	Bronze
11018	BlackRock Scientific Global Markets	Bronze
16255	Fauchier Partners Absolute Return	Bronze
15811	Winton Global Alpha	Bronze

Appendix 1: Basic Data

Fund Manager/Strategy	Ticker	Morningstar Analyst Rating™	Morningstar Analyst	Start Date	Strategy Description
Acadian Quant Yield	16351	Neutral	Darren Cunneen	19-May-08	Cash plus market-neutral
AQR DELTA	17692	Bronze	Julian Robertson	30-Nov-09	Fund-of-hedge funds and multi-strategy funds
AQR Managed Futures	19089	Neutral	Julian Robertson	1-Apr-11	Managed futures
Aspect Diversified Futures	17744	Bronze	Tom Whitelaw	8-Mar-10	Managed futures
BlackRock Asset Allocation Alpha	14264	Neutral	Julian Robertson	13-Apr-06	Global macro
BlackRock Scientific Global Markets	11018	Bronze	Tim Wong, CFA	24-Mar-04	Global macro
BT Global Macro	16745	Neutral	Julian Robertson	11-Aug-08	Global macro
Certitude Asian Opportunities	18365	Neutral	Tom Whitelaw	30-Jul-10	Absolute return/tactical and aggressive asset allocators
Fauchier Partners Absolute Return	16255	Bronze	Julian Robertson	14-Sep-07	Fund-of-hedge funds and multi-strategy funds
K2 Asian Absolute Return	10818	Neutral	Tim Wong, CFA	1-Sep-99	Absolute return/tactical and aggressive asset allocators
K2 Australian Absolute Return	10819	Neutral	Tim Wong, CFA	1-Oct-99	Absolute return/tactical and aggressive asset allocators
K2 Select International Absolute Return	12345	Neutral	Tim Wong, CFA	31-Dec-04	Absolute return/tactical and aggressive asset allocators
Select Alternatives	9960	Neutral	Tim Wong, CFA	25-Jun-03	Fund-of-hedge funds and multi-strategy funds
Winton Global Alpha	15811	Bronze	Tom Whitelaw	28-May-07	Managed futures

Appendix 2: Portfolio Characteristics

Fund Manager/Strategy	Manager Benchmark	Transaction Frequency	Management Fee %	Performance Fee %	Performance Fee Paid Net/Gross of Management Fee	High Watermark	Investment Objective (Sourced from Product Disclosure Statement)
Acadian Quant Yield	RBA Cash Rate Target	Daily	0.45	20.0 over RBA Cash Rate	Gross	Yes	To provide investment returns in excess of RBA cash rate over medium term with relatively low degree of volatility.
AQR DELTA	UBSA Bank Bill Index	Twice-monthly	1.30	N.Ap.	N.Ap.	No	To produce high risk-adjusted returns while targeting a low long-term average correlation to traditional markets.
AQR Managed Futures	UBSA Bank Bill Index	Daily	1.30	10.0 over UBS Bank Bill Index	Net	Yes	To produce high risk-adjusted returns while targeting a low long-term average correlation to traditional markets.
Aspect Diversified Futures	N.Ap.	Daily	1.63	20.0 on futures trading returns	Gross	Yes	To generate significant medium-term capital growth independent of overall movements in traditional stock and bond markets.
BlackRock Asset Allocation Alpha	UBSA Bank Bill Index	Daily	1.0	20.0 over UBS Bank Bill Index	Net	Yes	Targets 12.0% above UBS Bank Bill Index over rolling three-year periods gross of fees.
BlackRock Scientific Global Markets	RBA Cash Rate Target	Daily	1.025	20.50 above RBA Cash Rate	Gross	No	Aims to achieve seven percent per annum net of fees above RBA Cash Rate over rolling three-year periods.
BT Global Macro	UBSA Bank Bill Index	Daily	1.20	20.0 over UBS Bank Bill Index plus base fee	Net	No	Aims to provide return before fees, costs, and taxes that outperforms UBS Bank Bill Index over the medium to long term.
Certitude Asian Opportunities	MSCI Daily TR Gross AC Asia Pacific Euro Index	Daily	1.89	N.Ap.	N.Ap.	No	Aims to access long-only investment strategy designed to capture long-term returns of Asia-Pacific equity markets while constraining volatility through tactical exposure to fixed income and cash.
Fauchier Partners Absolute Return	UBSA 90-Day Bank Bill Index	Monthly	1.20	10.0 over UBS 90 Day Bank Bill Index plus base	Net	Yes	Objective is to achieve an absolute return measured against the UBS 90-Day Bank Bill Index plus five percent per annum.
K2 Asian Absolute Return	Six percent absolute hurdle	Daily	1.86	20.50 above 6.0%	Net	Yes	Aims to preserve capital over medium term and generate a 15.0 percent per annum return after fees over a three- to five-year investment cycle.
K2 Australian Absolute Return	Six percent absolute hurdle	Daily	1.73	20.50 above 6.0%	Net	Yes	Aims to preserve capital over medium term and generate a 15.0 percent per annum return after fees over a three- to five-year investment cycle.
K2 Select International Absolute Return	None	Daily	1.87	20.50	Net	Yes	Aims to preserve capital over medium term and generate a 15.0 percent per annum return after fees over a three- to five-year investment cycle.
Select Alternatives	180-Day Bank Bill Index	Weekly	1.275	10.25 over 180 Day Bank Bill	Net	Yes	Aims to generate attractive returns of four percent above 180-day Australian Bank Bill return over rolling three-year periods.
Winton Global Alpha	Barclays CTA Index	Daily	1.88	20.50 on futures trading returns	Gross	No	To provide returns in excess of RBA cash rate over medium term with relatively low volatility.

Appendix 3: People

Fund Manager/Strategy	Lead Manager(s)	Appointed	Years Experience	Team Size	Avg Yrs Experience	Avg Yrs Tenure
Acadian Quant Yield	Craig Brescianni, Jerome Blair, Katrina Khoupongsoy	2008, 2008, 2009	9, 15, 15	5	10	5
AQR DELTA	Delta Investment Committee	2009	16	12	17	10
AQR Managed Futures	Clifford Asness, John Liew, Brian Hurst, Yao Hua Ooi	2011, 2011, 2011, 2011	21, 18, 17, 7	4	17	13
Aspect Diversified Futures	Risk Management Committee	2007	N.Ap.	4	26	7
BlackRock Asset Allocation Alpha	David Hudson	2006	22	3	20	7
BlackRock Scientific Global Markets	Mike McCorry	1997	15	10	20	12
BT Global Macro	Joe Bracken	2008	17	6	18	9
Certitude Asian Opportunities	Louis-Vincent Gave, Alfred Ho	2006, 2006	15, 20	7	9	3
Fauchier Partners Absolute Return	Christopher Fawcett, Dan Higgins, Clark Fenton	1994, 2005, 2005	28, 19, 8	19	12	6
K2 Asian Absolute Return	Campbell Neal	2005	25	7	19	8
K2 Australian Absolute Return	David Poppenbeek	2004	21	5	20	11
K2 Select International Absolute Return	Nick Griffin	2005	16	9	18	8
Select Alternatives	Dominic McCormick	2012	27	5	12	6
Winton Global Alpha	David Harding	2007	30	100	22	12

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