Clark Capital MANAGEMENT GROUP

NavigatorInsights

Liquid Alternatives

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As Clark Capital's Chief Investment Officer, Sean oversees all of the Firm's investment activities and heads the Firm's portfolio team. Sean joined the Firm in 1993 and is responsible for asset allocation and investment selection for Navigator Investment Solutions as well as directing ongoing market research and contributing to the development of proprietary products. Sean is a member of the Clark Capital Management Committee and the Board of Directors. He graduated from the University of Delaware, earning a B.S. and an M.A. in Economics. Sean is a Chartered Financial Analyst and a member of the CFA Institute (formerly AIMR) and the Financial Analysts of Philadelphia, Inc. Sean is considered an industry expert and is often asked to appear on CNBC and Bloomberg television to share his views on the market. In addition, Sean was featured in an article in Barron's and has been quoted in a number of articles in nationally distributed business journals and newspapers.

No longer is the world of hedge fund strategies confined to accredited investors and institutions through limited partnerships, and no longer does the investor pay a 2% management fee and relinquish 20% of the profits. In the last several years, the market for alternative strategies has exploded into the retail marketplace. This growth has resulted in a wide variety of hedge fund type strategies being available through mutual funds and ETFs dubbed "Liquid Alternatives." Retail investors now have access to managed futures, market neutral, long/short equity, fixed income, and many other strategies in a mutual fund wrapper — the same strategies institutional investors and endowments have been using for years. In our view, access to these strategies via mutual funds provides financial advisors with the tools needed to build better portfolios. It also may allow them to satisfy the liquidity needs of the retail investor.

During the last two years, 121 alternative funds were launched, increasing the universe of alternative funds by 60%. In 2012, $14 billion flowed into alternative funds, and the Morningstar category has grown to over $90B billion in assets. The flows have propelled the liquid alternative space into the fastest growing Morningstar category, and assets have doubled in the last three years. In fact, more money flowed into the alternative category than into the entire U.S. equity category. With the growth in liquid alternative options and adoption rates comes many challenges. Researching and understanding these investments can be daunting to financial advisors for several reasons.

The challenges start with deciding how much to allocate to alternatives in a client portfolio, and they grow from there. The median age of the alternative funds in the Morningstar category is just three years. The short track record of these funds compounds the research process. An important concept to understand when evaluating alternative funds is their correlation to other asset classes as well as their correlation to other alternative funds. We believe one of the primary reasons for adding alternatives to a portfolio is to achieve non-correlation to traditional asset classes. If the asset classes in your portfolio are highly correlated, it is hard to discern the benefits of diversification during years like

Exhibit 1: **Alternative Correlations**
5 Years Ending 12/31/2012

	S&P 500	Barclays U.S. Agg Bond	MSCI World Ex U.S.	HFRX Absolute Return	HFRX Equity Hedge	HFRX Equity Market Neutral	HFRX Event Driven	HFRX Global Hedge Fund	HFRX Macro Commodity	HFRX Macro Currency	HFRX Macro Multi-Strategy	HFRX ED Credit Arbitrage	HFRX Fixed Income-Credit
S&P 500	1.00												
Barclays U.S. Agg Bond	0.21	1.00											
MSCI World Ex U.S.	0.93	0.29	1.00										
HFRX Absolute Return	0.49	0.07	0.45	1.00									
HFRX Equity Hedge	0.80	0.18	0.84	0.76	1.00								
HFRX Equity Market Neutral	0.01	-0.31	-0.02	0.07	0.07	1.00							
HFRX Event Driven	0.73	0.17	0.79	0.65	0.88	-0.04	1.00						
HFRX Global Hedge Fund	0.72	0.19	0.80	0.77	0.96	0.00	0.93	1.00					
HFRX Macro Commodity	-0.19	-0.11	-0.09	-0.10	-0.03	0.09	-0.10	-0.03	1.00				
HFRX Macro Currency	0.03	-0.07	0.12	-0.06	0.19	0.34	0.19	0.17	-0.06	1.00			
HFRX Macro Multi-Strategy	0.32	0.15	0.44	0.22	0.42	0.01	0.37	0.38	0.28	-0.05	1.00		
HFRX ED Credit Arbitrage	0.68	0.00	0.72	0.43	0.69	-0.16	0.75	0.73	-0.02	-0.09	0.45	1.00	
HFRX Fixed Income-Credit	0.65	0.11	0.70	0.58	0.76	-0.17	0.88	0.87	-0.15	0.04	0.31	0.87	1.00

Highly Correlated
Nuetral
Not Correlated

Source: Morningstar Direct

2008. Historically, the addition of non-correlating assets in a portfolio has lowered overall portfolio volatility and improved the risk/return profile. Exhibit 1 shows the correlation matrix between several alternative indexes from Hedge Fund Research and general market indexes. The matrix highlights that correlations vary greatly among alternative strategies when measured against traditional market indexes and against each other.

We sense that financial advisors are in a dilemma. We believe they recognize that traditional fixed income may not provide the same diversification benefits of the last 30 years due to historically low interest rates combined with the threat of future inflation and rising interest rates. At the same time, advisors need to find ways to lower portfolio volatility and risk without adding fixed income. The growth of the liquid alternatives asset class appears to indicate that advisors are addressing this dilemma by using alternatives.

In our view, the research process for selecting an alternative fund or ETF does not lend itself to most traditional methods. Expertise in alternatives and hedge funds is often needed to understand alternative strategies' investment methodology, research process and implementation. More importantly, the risks associated with investing in an alternative strategy are often not transparent.

Typically, institutional investors have considerable expertise or hire experts with deep experience in alternative investments. To fully understand the risks and potential benefits of liquid alternatives, financial advisors may follow institutional investors' research model by tapping into investment advisory firms that offer alternative strategies. With the proliferation of innovative funds designed to bring alternative strategies to the investing public, we believe it is essential for financial advisors to gain the insight and foresight necessary to make informed decisions.

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