ClarkCapital
MANAGEMENT GROUP

NavigatorInsights

K. Sean Clark, CFA
Chief Investment Officer

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 has been quoted in a number of articles in nationally distributed business journals and newspapers.

Liquid Alternatives – Here to Stay

Alternative investing has just about become a household name as more investors have gained access to alternatives. In the last several years, alternative strategies have 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."

According to Morningstar, $38.7 billion flowed into alternative investment mutual funds and ETFs over the year ended April 30, 2014. That's about a 36% increase over the prior year and more than a 100% increase over the past two years.

Retail investors and asset managers 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 liquid vehicles provides advisors and investors with the tools needed to build better portfolios.

A liquid structure creates some tradeoffs. Since underlying investments need to be liquid, liquid alternatives cannot invest in some of the less liquid instruments that have historically generated high returns in hedge funds. They also cannot use the same amount of leverage to goose returns. On the other hand, they typically offer a number of appealing features such as daily liquidity, lower minimum investments, transparency, lower fees and 1099 tax reporting instead of K-1s.

The goal of Modern Portfolio Theory (MPT) is to blend different asset classes into a portfolio that seeks to reduce overall portfolio risk and volatility and maximize return. Historically, the addition of non-correlating assets in a portfolio has seemed to lower 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 over the past five years. The matrix highlights that correlations vary greatly among alternative strategies when measured against traditional market indexes and against each other. Alternative asset classes have generally been negatively correlated to bonds and not highly correlated to equities, thus providing diversification benefits when allocated to a portfolio.

Alternative Correlations

5 Years Ending 12/31/2013

	S&P 500	Barclays US Agg Bond	MSCI World Ex US	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 US Agg Bond	-0.03	1.00											
MSCI World Ex US	0.91	0.05	1.00										
HFRX Absolute Return	0.40	-0.23	0.32	1.00									
HFRX Equity Hedge	0.77	-0.11	0.79	0.53	1.00								
HFRX Equity Market Neutral	0.24	-0.20	0.16	0.42	0.28	1.00							
HFRX Event Driven	0.67	-0.17	0.70	0.46	0.78	0.21	1.00						
HFRX Global Hedge Fund	0.71	-0.09	0.77	0.49	0.93	0.26	0.88	1.00					
HFRX Macro Commodity	0.37	-0.11	0.36	0.32	0.38	0.19	0.36	0.41	1.00				
HFRX Macro Currency	0.15	-0.12	0.20	0.19	0.29	0.26	0.26	0.34	0.28	1.00			
HFRX Macro Multi-Strategy	0.48	0.16	0.57	0.27	0.55	0.36	0.50	0.56	0.26	0.19	1.00		
HFRX ED Credit Arbitrage	0.68	0.01	0.75	0.19	0.71	0.07	0.80	0.80	0.28	0.14	0.59	1.00	
HFRX Fixed Income-Credit	0.51	-0.04	0.61	0.21	0.66	0.05	0.80	0.83	0.27	0.20	0.46	0.84	1.00

Source: Morningstar Direct

How Much of a Diversified Portfolio Should be Invested in Alternatives?

There is no single answer as it depends on each client's return objectives and risk tolerance, but we generally advocate that between 5 to 20% of a client's allocation be to alternatives. For many investors who have enjoyed the run higher in global stocks over the past five years, it makes sense in our view to reduce risk and lower overall portfolio volatility by adding alternatives, especially given the current equity valuations and concerns over rising interest rates. The weight given to alternative investments can come from either stocks or bonds, or a combination of both with more coming out of traditional fixed income which is what we generally advocate.

Investors have a dilemma. We believe they recognize that traditional fixed income may not provide the same diversification benefits it has in 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, they 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 and investors are addressing this dilemma by using alternatives.

The days of buying gold and real estate and calling it a day are long gone. The proliferation of ETFs investing in non-traditional asset classes has democratized investing in alternative asset classes. We advocate allocating to a broad set of alternative investments in an effort to gain robust exposure to the category and realize the diversification benefits of alternatives that were not possible for most investors before the introduction of liquid alternatives. We think it makes sense to take a core and explore approach to the category by allocating to a handful of core alternatives to gain beta and then tactically managing long/short exposure in currency, commodity, equity, and fixed income allocations. In our view, ETFs make tactically allocating attractive and cheap. No longer does an investor need to allocate to a managed futures manager and pay high fees to gain access to the space.

In our opinion, a practical way to allocate to liquid alternatives is through a manager with a seasoned track record in the space.

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