An Alternate Approach to Alternative Investments

INSIGHTS

This *Insights* takes a look at "liquid alternatives" and the potential diversification benefits they may bring to a portfolio.

VIRAJ B. PATEL, CFA®
Director of
Asset Allocation

WAYNE SPRAGUE
Executive Vice President,
Director of Strategic
Advisory Services

Today's financial markets present a unique set of challenges for risk-averse investors. Caught between the inherent volatility of the equity markets and low-yielding fixed income investments, many investors are seeking additional diversification as a way to potentially smooth out performance gaps and help reduce overall risk.

Q. Why have liquid alternatives recently gained popularity?

Wayne: Alternative investments and hedge funds have existed since the 1940s, but the category has rapidly expanded over the past decade into a $3 trillion industry. Hedged investments tend to provide returns that are less correlated to those of traditional asset classes, such as stocks and bonds, making them a desirable option especially when other asset classes are moving in tandem.

In recent years, we have seen the emergence of so-called "liquid alternative" strategies as an extension of the hedge fund asset class. These strategies have made some alternative investments accessible to a broader group of investors.

Viraj: Generally, an investment is considered "alternative" if it is a non-traditional asset class such as commodities or currencies, it practices non-traditional trading strategies—including shorting or hedging—or it holds illiquid assets, such as private equity or debt.

The low correlation of some alternative investments to traditional investments stems from these different types of underlying investment vehicles as well as a less-regulated, non-registered structure, enabling alternatives to generate investment opportunities that are substantially distinct from other asset classes.

Q. How do alternative investments fit into Fiduciary Trust's investment management thinking?

Viraj: In our view, alternative investments that offer hedged strategies may be an attractive addition to a diversified portfolio. Hedge fund investments have proven to have a higher ratio of performance to risk versus traditional stocks and bonds—meaning, investors earn more potential return for the level of risk the hedge fund investment assumes than they would for an investment in stock or bond investments with comparable risk levels.

Let's illustrate this from the risk side since that is our primary motive. On an annualized basis over the past 20 years, hedge fund strategies have exhibited superior risk-adjusted returns when compared to equity investments—about half as much risk as US and global stocks.[1]

Wayne: We believe the addition of hedged strategies as a complementary investment in a traditional multi-asset class portfolio will lead to risk mitigation, downside protection, diversification benefits and increased portfolio efficiency for clients.

Q. Why have alternative investments historically been limited to very large or institutional investors?

Wayne: Alternative investments generally have high investment minimums, typically over a million dollars. Even if an investor can meet the minimum, many of the most sought-after hedge funds also remain difficult to access.

Additionally, high fees, cumbersome tax reporting, and even a particular fund's characteristics such as low transparency into the underlying investments, may make the investment less suitable for certain individual investors.

Viraj: Illiquidity can also be an issue. Alternative investments have historically required a long time horizon and investors have been restricted in their ability to liquidate their investments. In fact, liquidity management took center stage during and after the global financial crisis, where access to funds became constrained in some instances.

Q. How have liquid alternatives made the alternative investments asset class more widely accessible to investors?

Wayne: Over the past several years, hedged strategies, broadly characterized as "liquid alternatives," have become available. We believe that these investments provide investors access to the unique characteristics and most of the advantages associated with the hedge fund asset class.

This class of alternative investments is usually in the form of a mutual fund or ETF, so the investment minimum is much lower than for traditional hedge funds. Easily purchased and redeemed in the marketplace, they enable investors to participate in the alternative asset class without the risk of not being able to access their capital in a timely manner.

Q. What alternative investment strategies do you recommend for portfolios?

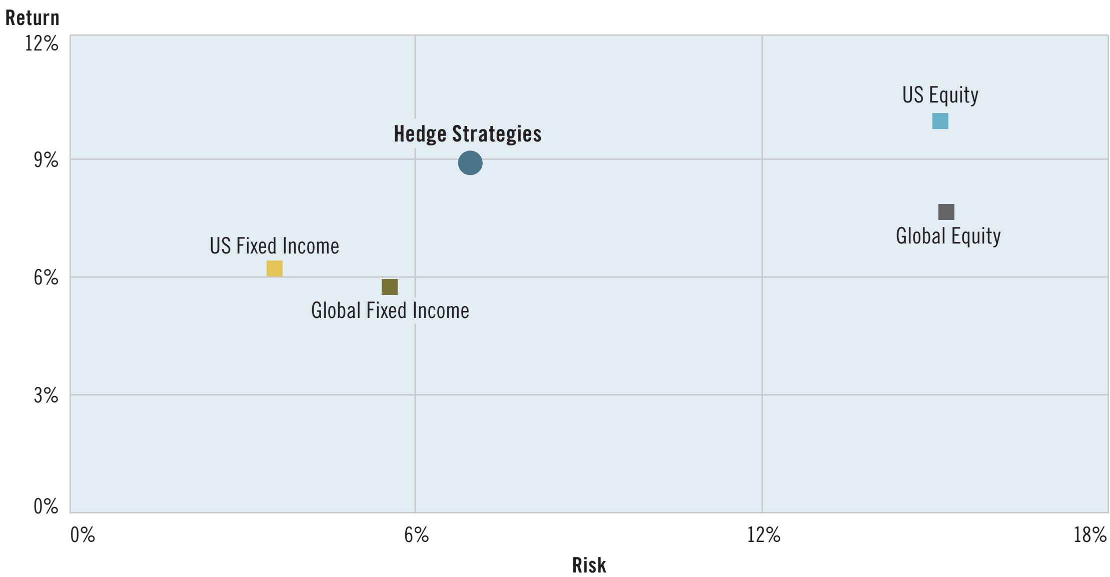
Wayne: Hedge funds come in many shapes and sizes but broadly follow one of four strategies: 1) long/short equity: long and short investments in stocks and indexes; 2) relative value: intended to profit from pricing inefficiencies; 3) event driven: investing in securities of companies undergoing corporate events; or 4) global macro: focusing on macroeconomic opportunities. In most cases, the investment universe typically involves marketable securities.

Rather than investing in any one of these strategies on their own, we prefer to broadly capture opportunities across all these strategies through multi-manager, multi-asset class exposures. Since the performance of the various hedged strategies can vary broadly, the combination of all four strategies can provide access to each strategy's performance, while reducing the impact of any single underperforming segment and/or investment manager—potentially smoothing out performance gaps and reducing overall volatility.

Viraj: As with any investment decision, we encourage you to speak with your portfolio manager to determine if adding exposure to the alternatives asset class makes sense for your particular situation.

HEDGE STRATEGIES HAVE HISTORICALLY OFFERED LONG-TERM EQUITY-LIKE RETURNS WITH LESS RISK

Risk vs. Return Comparison (20-Year Period Ending December 31, 2014)[1]



1. Source: FactSet. US Equity is represented by the S&P 500 Index. Global Equity is represented by the MSCI World Index. US Fixed Income is represented by the Barclays US Aggregate Index. Global Fixed Income is represented by the Barclays Global Aggregate Index. Hedge Strategies are represented by the HFRI Fund Weighted Composite Index. Indexes are unmanaged and one cannot invest directly in an index. While the information is based on index returns and does not represent an actual investment performance, it provides a general indication of the risk/return profile of hedge fund strategies. Returns data represents average annual total returns and assumes reinvestment of interest or dividends. Risk is measured by the annualized standard deviation of monthly total returns.

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Fiduciary Trust International Offices

New York, NY
(877) 384-1111

Boca Raton, FL
(561) 988-8460

Coral Gables, FL
(800) 618-1260

Fort Lauderdale, FL
(561) 988-8460

Los Angeles, CA
(800) 421-9683

San Mateo, CA
(877) 284-2697

St. Petersburg, FL
(800) 618-1260

Washington, DC
(888) 621-3464

Wilmington, DE
(866) 398-7414

Hong Kong
(852) 2877-1931

London
(44) 20-7073-8500

Fiduciary Trust Company of Canada Offices

Calgary
(800) 574-3822

Toronto
(800) 574-3822

FTCI (Cayman) Ltd.

Grand Cayman
(877) 384-1111

(212) 632-3000
(calling from outside the US)