

PERSPECTIVES

Transparency: Why it matters for alternative investments

By Greg Bassuk, Managing Director, Head of Liquid Alternative Strategies
Originally published on fsinvestments.com

With markets becoming less predictable, investors need a clear understanding of the features and risks of their investments—especially their alternative investments—to help them best manage their portfolios.

When it comes to market volatility, 2017 was the calm before the storm. We said goodbye to historically low levels of volatility in the very first quarter of 2018 as markets experienced rising turbulence. This resulted from a convergence of factors, including increasing global trade tensions, profit taking in technology stocks and a dampened outlook for global growth.

“As liquid alts continue to gain momentum, the need for information about alternative investment strategies, structures, underlying assets, fees and related details is escalating.”

The rise in volatility is sparking investor uncertainty and increased focus on diversification. Investors are looking beyond traditional stocks and bonds for alternative sources of return. One place they’re turning is to liquid alternatives. Liquid alts are designed to offer alternative sources of returns, low volatility and low correlation to traditional equity and fixed income markets through structures that provide daily liquidity, such as mutual funds and exchange-traded funds.

As liquid alts continue to gain momentum, the need for information about alternative investment strategies, structures, underlying assets, fees and related details is escalating. As a result, transparency has become the top consideration for many investors when analyzing investment options and reviewing portfolio allocations.

Transparency tops investment considerations

Institutional and retail investors have long sought transparency when making investment decisions and monitoring their investments. But the 2008 financial crisis moved transparency from a “nice to have” to a necessity. The crisis shined a spotlight on the

extremely high levels of opacity of many investment products. This opacity hampered investors’ ability to gauge or communicate their portfolio exposures with sufficient assurance or speed, preventing them from exiting investment positions without excessive losses.

Following the financial crisis, pensions, endowments, foundations and other institutional investors vowed to ascribe transparency a top slot among their criteria for investment decision making, as did the broader investing public.

Over the last decade, demand for greater levels of transparency continued across investor types, strategy categories (traditional and alternative) and geographies. Today, as the chart below illustrates, investors report transparency as the most important investment consideration.

PERCENTAGE OF INVESTORS REPORTING FACTORS AS “VERY IMPORTANT INVESTMENT CONSIDERATIONS”



Source: Economist Intelligence Unit (EIU), Transparency in Alternatives Investing Survey, 2017.

“Transparency is intrinsic to investor education as it is paramount for investors’ understanding and analysis of their investment choices.”

Meeting high transparency demands

Liquid alternatives offer heightened levels of transparency to precisely convey the details of the investment and to offer investor protections in compliance with regulations. Transparency is intrinsic to investor education as it is paramount for investors’ understanding and analysis of their investment choices. As such, it remains a core tenet underlying investor education, due diligence, selection, asset allocation and post-investment monitoring of liquid alternatives.

Transparency allows investors to understand whether an alternative investment strategy appropriately matches the liquidity or other key characteristics of its structure. Likewise, it enables investors to determine optimal allocations within a portfolio, when to buy and sell the investment, whether the manager meets criteria imposed through effective due diligence, and how the fund is performing.

Alternative mutual funds are governed by the Investment Company Act of 1940 (the '40 Act). The '40 Act laid the foundation for the governance and transparency of the modern mutual fund and established requirements for mutual fund transparency for investors. One requirement is that mutual funds must file a prospectus and statement of additional information, which disclose a fund's structure, strategy, fees, financial condition, investment policies, risks, management team and other details for investors.

Further, a mutual fund's annual and semi-annual reports are readily accessible to investors. These and other regulatory filings and materials are available free of charge through the SEC's online EDGAR database, a fund's website or both. Likewise, the publication of a fund's holdings, daily NAV, historical performance and expense ratios adds to its transparency and keeps investors educated and informed.

The '40 Act's regulations are designed to ensure that conflicts of interest are minimized, investors are informed and funds are being managed in the best interests of shareholders.

Leveraging transparency

There is a plethora of resources where investors can access clear, detailed information about current and prospective liquid alts. Certain transparency requirements stem from the regulation of mutual funds generally, while others flow from fund company policies, practices and managers. The table below provides some notable resources that are indispensable for the due diligence of potential allocations and for monitoring existing investments.

TRANSPARENCY RESOURCES AND THEIR SIGNIFICANCE

Regulatory-related materials

RESOURCE	SIGNIFICANCE
Investment Company Act of 1940	Regulates mutual funds and includes disclosure and information requirements about a fund's investment objectives, structure and operations
Securities Act of 1933	Requires that investors receive significant information relating to securities offered for sale in the public markets
Prospectus	Provides investors with a description of the fund investment strategy, risks, expenses, manager specifics, and particulars relating to fund purchases, exchanges, trading and shareholder communications
Statement of additional information	Describes fund investment policies and restrictions, board of trustees, code of ethics, service providers, NAV determination and other information useful to investors
Annual report	Details a fund's performance, expenses, financial highlights, financial statements, tax information and other shareholder information
Audited financial statement	Provides mutual fund performance track records that are audited for accuracy

Fund website, collateral + content

RESOURCE	SIGNIFICANCE
Fund web page	Provides specifics on fund performance, share classes, fees and expenses, portfolio holdings, manager information and, for mutual funds, daily NAV
Portfolio holdings	Lists holdings to assist investors in understanding portfolio composition, liquidity, diversification and risk
Fact sheet	Provides details on fund objectives, performance, share classes, fees and expenses, portfolio holdings and the manager
Fund brochure	Delivers information on a fund, its underlying strategy, its investment vehicle or other information
Fund commentary	Explains fund and market performance from the fund manager’s or other expert’s perspective and what investors might expect going forward
Strategy white paper	Educates investors about the investment strategy underlying a fund

Given the lessons learned from the financial crisis and the turmoil that preceded and followed it, it’s no surprise investors covet transparency more than ever. This is especially true for those considering liquid alternatives, which are typically more complex than traditional investments. Access to alternatives has expanded greatly in the last decade, but so has the number of transparency resources available. Making use of them is essential for investors to decide which ones best fit their portfolios and to monitor their investments going forward.



Greg Bassuk
Managing Director, Head of Liquid Alternative Strategies

Greg serves as Managing Director and Head of Liquid Alternative Strategies, overseeing the development and management of the firm’s liquid alternatives platform. As a pioneer and thought leader in this space, he looks to the future of investing trends with a focus on creating access to alternative strategies that can help investors design better, more diversified portfolios. Greg has been recognized for leadership and innovation in financial services and asset management and has been honored for his longtime civic work. He continues to give back to the community through board service and leadership at several local and national civic organizations.

This information is educational in nature and does not constitute a financial promotion, investment advice or an inducement or incitement to participate in any product, offering or investment. FS Investments is not adopting, making a recommendation for or endorsing any investment strategy or particular security. All views, opinions and positions expressed herein are that of the author and do not necessarily reflect the views, opinions or positions of FS Investments. All opinions are subject to change without notice, and you should always obtain current information and perform due diligence before participating in any investment. FS Investments does not provide legal or tax advice and the information herein should not be considered legal or tax advice. Tax laws and regulations are complex and subject to change, which can materially impact any investment result. FS Investments cannot guarantee that the information herein is accurate, complete, or timely. FS Investments makes no warranties with regard to such information or results obtained by its use, and disclaims any liability arising out of your use of, or any tax position taken in reliance on, such information.

Any projections, forecasts and estimates contained herein are based upon certain assumptions that the author considers reasonable. Projections are necessarily speculative in nature, and it can be expected that some or all of the assumptions underlying the projections will not materialize or will vary significantly from actual results. The inclusion of projections herein should not be regarded as a representation or guarantee regarding the reliability, accuracy or completeness of the information contained herein, and neither FS Investments nor the author are under any obligation to update or keep current such information.

All investing is subject to risk, including the possible loss of the money you invest.