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LIQUID ALTERNATIVES

THE NEXT DIMENSION IN ASSET ALLOCATION

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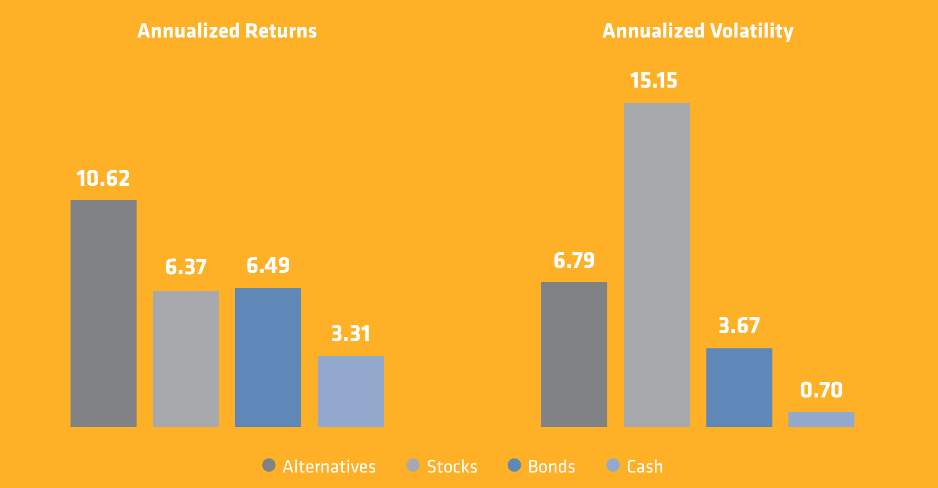
IN THIS PAPER: Liquid alternative investments are a fast-growing category that can help investors build better, more diversified portfolios. But incorporating them requires a disciplined framework that should include defining an investment objective, determining how to allocate, deciding how to source the funding and choosing the right managers.

The 2008 global financial crisis marked a turning point for investors, bringing new focus to the search for diversifying and transparent investment options. Since then, the availability of liquid alternatives—mutual funds that implement hedge fund strategies—has grown by leaps and bounds.

Some investors have embraced these new strategies, but a lack of clarity about how they operate has hampered widespread acceptance. The industry has been slow to coalesce around a standard definition or classification for liquid alternatives, so investors don't have a consistent framework for incorporating them into their asset allocations.

Adding a liquid alternative allocation to a traditional portfolio has the potential to enhance long-term portfolio returns and reduce risk—and it may lower sensitivity to market and interest-rate fluctuations. Over the last 20-plus years, alternatives have provided better returns than stocks, bonds or cash, with less than half the volatility of stocks (*Display 1*). Liquid alternatives' diversification and transparency can benefit a broad range of investors, and add a new dimension to asset allocation.

DISPLAY 1: ALTERNATIVES—ATTRACTIVE OPPORTUNITY
1990–2014 (%)



Past performance does not guarantee future results.
An investor cannot invest directly in an index and its performance does not reflect the performance of any AB portfolio. Alternatives are represented by HFRI Fund Weighted Composite; stocks by MSCI World; bonds by Barclays US Aggregate Bond; and cash by BofA Merrill Lynch 0-3 Month US Treasury Bill.
Source: Bank of America Merrill Lynch (BofA), Barclays, Hedge Fund Research (HFR), MSCI and AB

INVESTORS ARE LOOKING FOR NEW SOLUTIONS

After a 30-year bull market for bonds and a strong, multiyear recovery for equities, many investors wonder what lies ahead for capital markets. It's unlikely that the future will resemble the past. We believe that investors must find new ways to complement their traditional asset allocations in order to achieve their investment objectives, and that alternative mutual funds may meet that need.

In many ways, individual investors are benefiting from the groundwork laid by institutional investors in the alternative arena. Institutional allocations to alternative strategies have grown to an average of 25% over the last several years, according to *Pensions & Investments*. Institutional interest in hedge funds increased significantly in the early 2000s, in the aftermath of the technology bubble. During that time, most hedge fund strategies were able to preserve capital, and many skilled managers generated positive returns despite significant equity market declines. Interest in alternatives has continued to grow, driven by institutions' desire for enhanced portfolio diversification in today's capital-market environment.

As institutions invested more heavily, they became more demanding of hedge fund managers, so hedge funds have had to make concessions in areas such as transparency, fees and lockup periods. This evolution, coupled with greater regulatory scrutiny, has opened the door for managers to start offering their strategies in more liquid investment structures—particularly mutual funds.

The result? More investor interest in, and higher allocations to, liquid alternatives and a growing number of mutual fund launches compared with the overall fund industry (*Display 2*).

LIQUID ALTERNATIVES OFFER SIGNIFICANT BENEFITS

Alternative mutual funds are relatively new. However, they're the latest evolution of hedge fund investing, so the underlying strategies have been tested over time. These new offerings combine attractive risk-adjusted returns with greater liquidity and transparency. And since they are mutual funds, these strategies previously offered to only a limited investor base are now available to a much broader audience. Unlike hedge funds, liquid alternatives don't have asset or income qualification requirements.

Improved risk-adjusted returns: Alternative strategies have generally provided higher risk-adjusted returns than traditional asset classes, as demonstrated by their higher Sharpe ratios over the last 20-plus years. This has been achieved by using flexible investment approaches and by opportunistically exploiting mispricings within and across asset classes. Absolute returns have been attractive, as shown in Display 1, but the pattern of returns has also been

POTENTIAL BENEFITS OF LIQUID ALTERNATIVES

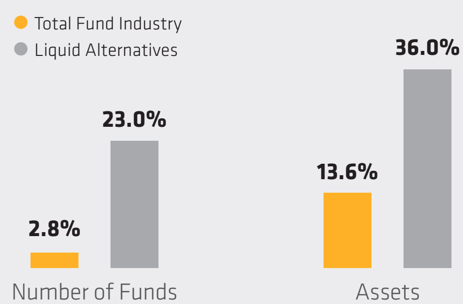
+ Improved risk-adjusted returns
+ Reduced downside
+ Lower sensitivity to market and interest-rate movements
+ Daily liquidity and transparency

CHALLENGES TO ADOPTION OF LIQUID ALTERNATIVES

+ No common industry definitions
+ Limitations of liquid vehicles
+ Difficulty translating hedge fund classifications
+ Nonstandard performance benchmarks

DISPLAY 2: LIQUID ALTERNATIVES HAVE GROWN SIGNIFICANTLY

Annualized Growth Rate, 2009–2014



Through December 31, 2014
Total fund industry includes mutual funds and exchange-traded funds (ETFs).
Liquid alternatives include mutual funds and ETFs in the following Morningstar categories: bear market, long/short equity, managed futures, market neutral, multialternative and nontraditional bond.
Source: Morningstar and AB

Despite the benefits, many investors aren't taking full advantage of this growing opportunity.

beneficial. On average, alternatives haven't been up as much as stocks in bull markets, but they also haven't been down as much in bear markets.

Reduced downside: Alternative strategies have historically preserved capital by losing less than traditional equity strategies during times of market stress. In 2001 and 2002, as markets struggled to recover after the dot-com bust, alternatives provided more downside protection. And in 2008, alternatives lost less than stocks.

Lower sensitivity to market and interest-rate movements: Investors want more diversification in their portfolios; they're looking for strategies that provide returns that are driven not by market movements but by a manager's skilled decision making. Many alternative strategies have been designed to maintain a low beta, so they move less like the market, providing diversification and the potential for protection in down markets. Alternative strategies tend to produce different performance patterns than stocks and bonds under the same market conditions.

Daily liquidity and transparency: The mutual fund vehicle (established by the Investment Company Act of 1940) provides daily liquidity and pricing, as well as transparency. Liquid alternatives offer low leverage, improved corporate governance and 1099 taxation treatment (*Display 3*). In contrast, many hedge funds have historically preferred to limit the transparency of holdings and exposures. However, the requirement of daily liquidity means that liquid alternatives may have a more limited investment universe.

CHALLENGES TO ADOPTION OF LIQUID ALTERNATIVES

Despite the substantial benefits of liquid alternatives, many investors aren't taking full advantage of this growing opportunity for a number of reasons.

No common industry definitions: Investors are often unclear about the differences between traditional alternative asset classes and liquid alternative strategies. Alternative asset classes are commonly defined as real estate, infrastructure, commodities and currencies. Alternative investment strategies have historically been offered solely

DISPLAY 3: ALTERNATIVE MUTUAL FUNDS AND HEDGE FUNDS HAVE DIFFERENT STRUCTURES

	Alternative Mutual Funds	Hedge Funds
Liquidity	Daily liquidity	Typically monthly or quarterly May have lockups
Pricing	Daily NAV	Typically monthly NAV
Taxes	1099	K-1
Availability	Available to most investors	Limited to accredited investors and qualified purchasers*
Minimums	Low, typically < $10,000	High, typically > $100,000
Fees	Typically higher than for traditional mutual funds but lower than for hedge funds	High, management fee + performance fee
Usage of Leverage	Borrowing limited to 33% of assets	Unlimited
Regulation	Subject to Investment Company Act of 1940	Most must register with regulators

*An accredited investor is an individual with yearly income of more than $200,000 ($300,000 with spouse) or net worth of more than $1 million, excluding primary residence; a qualified purchaser is an individual with a liquid net worth of at least $5 million.
Source: AB

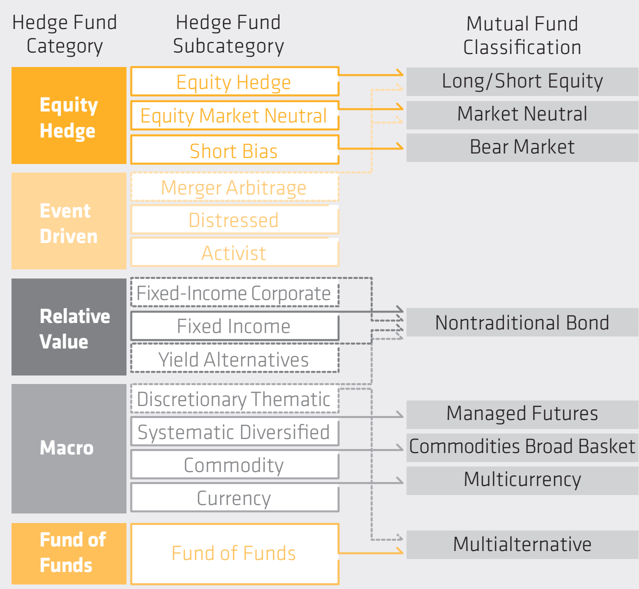
in private, less liquid vehicles like private equity, private credit and hedge funds. Liquid alternatives encompass alternative investment strategies, primarily hedge fund strategies, including real estate and real assets, that can be implemented in a registered mutual fund.

Limitations of liquid vehicles: Investment strategies for alternative mutual funds and hedge funds can be broadly similar, but there are distinctions. Leverage is limited in alternative mutual funds, whereas hedge funds can use unlimited borrowing to magnify returns (and risk). And the requirement that 85% of holdings meet daily liquidity provisions changes how alternative mutual funds can be invested. As a result, it's difficult to replicate some hedge fund strategies in liquid form. These include a subset of event-driven strategies known as distressed investing, which focuses on companies in bankruptcy, as well as activist strategies that build up concentrated positions of public equity. Any hedge fund strategy that has historically used significant amounts of leverage to generate returns would also be difficult to replicate.

Difficulty translating hedge fund classifications: Historically, institutions and traditional hedge fund managers have classified hedge funds using definitions developed by industry group Hedge Fund Research (HFR) (*Display 4*). Hedge funds can be grouped into five broad categories (with further subclassifications): fund of funds, equity hedge, event driven, relative value and macro. But as alternative mutual funds were launched, new classifications emerged, and they have continued to evolve as the industry has grown. To date, hedge fund categories haven't translated clearly into mutual fund classifications.

Display 4 highlights the difficulty: alternative mutual funds that now fall into the same broad peer groups may include different investment strategies. The straight lines show categories that have mapped logically; the dotted lines highlight categories that haven't. Merger arbitrage strategies, which make money by correctly predicting the outcome of merger arbitrage deals, are typically placed in the same classification as very different equity market–neutral strategies, which take long and short equity positions and seek to eliminate all market exposure.

DISPLAY 4: MAPPING HEDGE FUNDS TO MUTUAL FUNDS ISN'T STRAIGHTFORWARD



As of December 31, 2014
The display above does not show an exhaustive list of subcategories.
Source: HFR, Morningstar and AB

The industry has had particular difficulty translating relative-value fixed-income strategies cleanly into a liquid classification: they end up in the catchall nontraditional bond category along with macro strategies. Category confusion is a significant challenge for investors trying to evaluate a strategy, since peer performance comparisons can result in an inaccurate assessment.

Nonstandard performance benchmarks: Most investors use a standard stock or bond benchmark (such as the S&P 500 Index or the Barclays US Aggregate Bond Index) to measure the effectiveness of a traditional investment or the skill of an investment manager. But the goal of alternative strategies is not to outperform

DISPLAY 5: A FRAMEWORK FOR IMPLEMENTING LIQUID ALTERNATIVES

Source: AB

a standard benchmark by a set amount—it's to perform well as defined by a particular strategy. Many alternative strategies use a cash benchmark, and offer performance expectations above the cash benchmark that vary widely. Others use an HFR index or a custom benchmark. This lack of traditional benchmarks can make alternatives much harder to assess than traditional mutual funds and may lead to inappropriate comparisons to a standard index, especially over short time horizons.

Benchmarking versus an appropriate peer group is also challenging. In the traditional mutual fund world, choosing a US large-cap value manager, for example, would likely mean looking at Morningstar or Lipper categories of similar funds, most of which share a Russell Value benchmark. Investors can easily access a well-defined peer universe of funds that have similar investment styles and, often, multiyear—or even multidecade—track records.

Liquid alternative categories are not as well established. Some peer groups exist, but they're often ill defined and require a more manual review to isolate their true structural or strategic peers. For example, nontraditional, or alternative, fixed-income funds are often grouped together with alternative income, credit long/short, global macro and unconstrained strategies—even though these strategies vary widely. An added challenge is that liquid alternatives are a relatively new and growing segment, so most of these funds have short track records.

A FRAMEWORK FOR IMPLEMENTATION

We believe that the benefits of investing in alternative strategies outweigh the challenges, but incorporating them requires a sound process. We suggest using a four-step framework (*Display 5*).

Define an investment objective: The liquid alternative universe features diverse investment styles and strategies, each with its own expected risk/return profile—investors can't simply allocate broadly to "alternatives." Rather, they should start by identifying a specific objective: protecting against rising rates, reducing portfolio downside or increasing portfolio diversification, for example. Strategies that are selected must be well suited to meet the objective. This requires researching the historical risk/return characteristics of individual strategies and what drives those returns in different market conditions.

Display 6 shows how some alternative strategies might solve for certain investment objectives. The appendix on page 13 provides a more complete list. Of course, these solutions aren't definitive: the more research investors have on the design of specific strategies, the better prepared they'll be to make investment decisions.

Allocate to liquid alternatives: Once an investor decides on an objective and a specific liquid alternative strategy, the next decision is whether to allocate to a single broadly diversified strategy (to "buy" a multi-manager portfolio) or to individual strategies (to "build" a portfolio) (*Display 7*).

It's interesting to note that institutional investors initially focused on allocating to hedge funds through multi-manager hedge funds of funds. As institutions grew more familiar and comfortable with alternatives, many began to build—investing directly in the underlying hedge funds. For most individual investors, the experience has been reversed: so far, investors have built instead of bought. There are benefits to both approaches.

ALLOCATING TO A MULTI-MANAGER STRATEGY: BUYING

Some investors, especially those who are new to liquid alternatives, may want to allocate to a multi-manager strategy (a subset of the multialternative category). These strategies offer an experienced portfolio manager who diversifies across multiple hedge fund categories and managers. Selecting a multi-manager strategy gives investors exposure to diverse managers and strategies, potentially including equity hedge, event driven, relative value and global macro. Such an allocation may also give investors access to hedge funds that aren't offered in stand-alone strategies. In addition, it allows investors to rely on a portfolio manager's expertise to provide institutional due diligence on underlying managers, determining allocations to them and rebalancing the strategy over time.

Investing in a multi-manager approach often provides more diversification than buying individual funds, which can be valuable in an arena where manager skill is crucial and the returns of individual strategies can vary greatly. No single alternative strategy wins consistently, since performance patterns differ, but investing in a diversified approach may enhance long-term performance.

Among multi-manager funds, some are designed to diversify broadly across all alternative strategies, while others focus on a single category, such as long/short equity or relative value/credit.

DESIGNING AN ALTERNATIVE STRATEGY FROM INDIVIDUAL FUNDS: BUILDING

Building a liquid alternative portfolio involves selecting a range of strategies that address an investor's specific objectives. This approach provides full control over manager selection and allocation, and allows the investor to choose a focused set of strategies. It also gives investors the flexibility to design the portfolio's risk and return objectives themselves. However, it requires much more due diligence on the specific strategies and asset-allocation policies, as well as rebalancing and implementation.

Though the buy or build decisions are distinct, they're not mutually exclusive. Investors may consider allocating to a multi-manager strategy as a core alternative allocation while selecting individual funds as satellite investments to further customize their portfolio to meet risk/return objectives.

Choose a source for the alternative allocation: Once an investor decides whether to buy or build, the next step is to decide how to incorporate the new allocation into the portfolio. One way is to allocate to alternatives as a distinct category. Another is to source from the part of the portfolio that aligns with its replacement liquid alternative in order to keep the risk/return profile consistent (*Display 8*). For instance, some strategies (such as long/short equity)

DISPLAY 6: LIQUID ALTERNATIVES CAN HELP SOLVE FOR INVESTMENT OBJECTIVES

Objective	Liquid Alternatives
Increase Alternative Diversification	Multi-Manager
Achieve Equity Growth	Long/Short Equity
Reduce Exposure to Market Volatility	Long/Short Equity Equity Market Neutral Multi-Manager
Protect Against Large Losses	Equity Market Neutral Managed Futures
Reduce Sensitivity to Interest Rates	Nontraditional Bond Equity Market Neutral Multi-Manager

Source: AB

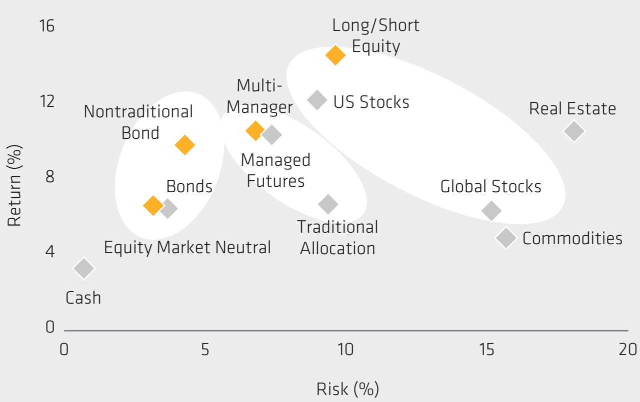
DISPLAY 7: BUY OR BUILD? BOTH HAVE BENEFITS

Buy	Build
Allocate to a Multi-Manager Fund	Allocate to Individual Funds
+ Diversification across multiple liquid alternative strategies and managers	+ Allocation divided among individual liquid alternative funds
+ Access to hedge fund managers who may not be available in individual funds	+ Control over manager selection
+ Institutional due diligence	+ Management of asset-allocation and rebalancing decisions
+ Simpler implementation and rebalancing	+ Significant time and skill required

Source: AB

DISPLAY 8: ALIGN ALTERNATIVE SOLUTIONS WITH RISK PROFILES

Risk and Return, 1990–2014



Past performance does not guarantee future results.
Through December 31, 2014
Cash is represented by BofA Merrill Lynch 0-3 Month US Treasury Bill; bonds by Barclays US Aggregate Bond; global stocks by MSCI World; US stocks by S&P 500; multi-manager by HFRI Fund Weighted Composite; equity market neutral by HFRI EH: Equity Market Neutral; nontraditional bond by HFRI Relative Value; long/short equity by HFRI Equity Hedge; traditional allocation by 60% stocks and 40% bonds; managed futures by HFRI Macro Systematic Diversified; real estate by FTSE NAREIT All Equity REITs; and commodities by Dow Jones-UBS Commodity.
Source: Barclays, BofA, FTSE, HFR, MSCI, S&P Dow Jones and AB

have higher return levels, similar to those of stocks. These may be funded from traditional equity allocations.

Other strategies (such as market neutral or nontraditional bond) have lower risk/return profiles that are more similar to those of bonds: these could be sourced from a traditional bond allocation. Multi-manager strategies that seek to both enhance returns and reduce volatility while providing broad diversification may be funded across stock and bond allocations. Of course, sourcing decisions can change depending on market conditions, investment outlooks and an investor's risk tolerance. For example, given current low interest rates, sourcing a proportionally greater amount from a bond allocation may be more appropriate now than in previous periods.

The average allocation to alternatives for institutions and high-net-worth investors ranges from 15% to 25%, which is large enough to affect portfolio performance but small enough to avoid materially shifting a portfolio's risk profile. Allocations of this size are generally made across several managers, although an allocation to a multi-manager strategy can be larger than allocations to individual strategies, given the multi-manager strategy's inherent diversification.

Let's examine three hypothetical case studies that provide perspective on how investors might define their objective, choose an alternative strategy and source their allocation. The performance data for all three case studies are shown in *Display 12, page 11.*

CASE STUDY 1: A MULTI-MANAGER ALLOCATION

A diversified, multi-manager approach may be the answer for investors interested in diversification and exposure to a variety of managers, or for those with little experience evaluating alternative managers. Allocating to a multi-manager strategy makes implementation and rebalancing easier. With this choice, an investor gives the responsibility for analyzing alternative classifications to a portfolio manager.

Multi-manager strategies offer exposure to a variety of liquid alternative investments in a single fund. This range can be beneficial, because challenging investment periods turn up unexpectedly—and can be prolonged by poor economic conditions. Since investors don't know what lies ahead, allocating across strategies with diverse performance patterns makes sense (*Display 9*). A multi-manager strategy (represented by the orange boxes in the display) has maintained relatively steady performance over the past 14 years.

Diversifying a hypothetical portfolio with a 20% allocation to a multi-manager strategy, sourced equally from stocks and bonds, would provide better performance and lower volatility—translating to a higher Sharpe ratio (Display 12, page 11).

In addition, a diversified approach can improve the chances of a portfolio performing well across various market conditions, because the likelihood is that not all strategies will be in or out of favor at a given time. Allocating across multiple managers minimizes the impact of underperformance from any one manager. Also, recent developments in the structure of liquid alternatives mean that getting this diversification via a multi-manager strategy can be less expensive than doing so via a hedge fund of funds, as investors won't necessarily pay two layers of fees.

DISPLAY 9: RETURNS ACROSS ALTERNATIVE STRATEGIES FLUCTUATE

- Relative Value
- Equity Hedge
- Event Driven
- **Multi-Manager**
- Global Macro

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
	12.18	7.44	25.33	15.01	10.60	15.33	11.11	4.83	25.81	11.86	0.15	10.59	14.28	5.70
	8.92	5.44	21.42	**9.03**	**9.30**	**12.89**	10.48	–18.04	25.04	11.43	–3.30	8.89	12.51	3.98
	6.87	**–1.45**	20.54	7.68	7.29	12.37	**9.96**	**–19.03**	24.57	10.45	–4.16	7.41	**9.13**	**3.00**
	4.62	–4.30	**19.55**	5.58	6.79	11.71	8.94	–21.82	**19.98**	**10.25**	**–5.25**	**6.36**	7.07	1.80
	0.40	–4.71	9.72	4.63	6.02	8.15	6.61	–26.65	4.34	8.06	–8.38	–0.06	–0.44	0.93
Stocks	–16.82	–19.89	33.11	14.72	9.49	20.07	9.04	–40.71	29.99	11.76	–5.54	15.83	26.68	4.94
Bonds	8.44	10.26	4.10	4.34	2.43	4.33	6.97	5.24	5.93	6.54	7.84	4.21	–2.02	5.97

Past performance does not guarantee future results.
Through December 31, 2014
Relative value represented by HFRI Relative Value; equity hedge by HFRI Equity Hedge; event driven by HFRI Event Driven; multi-manager by HFRI Fund Weighted Composite; global macro by HFRI Macro; stocks by MSCI World; and bonds by Barclays US Aggregate Bond.
Source: Barclays, HFR, MSCI and AB

CASE STUDY 2: SOURCING AN ALTERNATIVE ALLOCATION FROM STOCKS

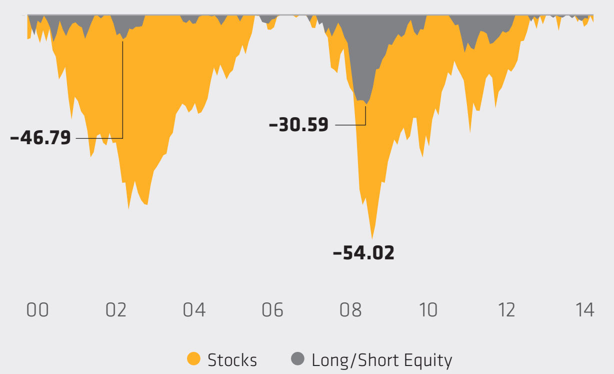
Investors have a difficult time enduring the significant declines that periodically disrupt the stock market and produce capital losses. They're searching for strategies to help reduce potential drawdowns during these periods. One option is an allocation to a long/short equity strategy, one of the most well-known equity-related alternative strategies.

Long/short equity strategies seek to profit from stock gains in long positions and price declines in short positions, while limiting overall market exposure. Adding exposure to a long/short equity strategy may help an investor who's concerned about equity market volatility or risk yet still looking for long-term growth through stock exposure.

But what may ultimately matter most to investors is reducing equity drawdowns—the losses suffered from market peaks to market troughs. Long/short strategies have reduced losses compared with the broader stock market in key drawdown periods, including the savings and loan crisis, the dot-com bubble and the 2008 financial crisis (*Display 10*).

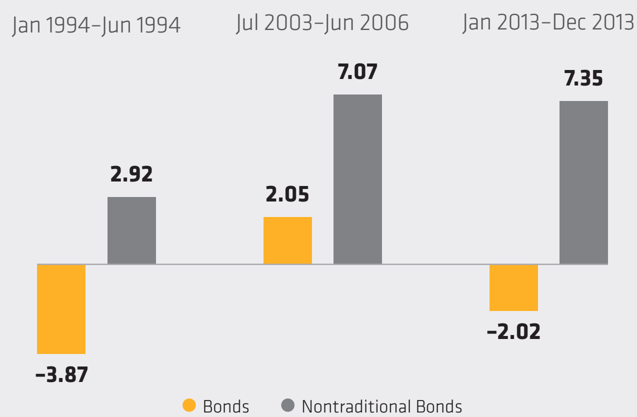
An investor who diversifies a stock portfolio by adding a 20% allocation to a long/short equity strategy may see meaningful benefits. Returns can improve and volatility can be reduced—a combination reflected in an increased Sharpe ratio. It's critical, though, that the 20% allocation not be made to only one manager.

DISPLAY 10: A LONG/SHORT EQUITY STRATEGY REDUCED
Drawdowns, 2000–2014 (%)



Past performance does not guarantee future results.
Through December 31, 2014
Stocks are represented by MSCI World; long/short equity by HFRI Equity Hedge.
Source: HFR, MSCI and AB

DISPLAY 11: A NONTRADITIONAL BOND STRATEGY OUTPERFORMED IN RISING-RATE PERIODS
Returns (%)



Past performance does not guarantee future results.
Through December 31, 2013
Bonds are represented by Barclays US Aggregate Bond; nontraditional bonds by HFRI Relative Value.
Source: Barclays, HFR and AB

CASE STUDY 3: SOURCING AN ALTERNATIVE ALLOCATION FROM BONDS

Over the last 15 years, a core bond portfolio (as represented by the Barclays US Aggregate Bond Index) produced consistent and strong performance, with steadily falling rates boosting returns. But by the end of 2013, the index's yield had fallen to 2%—resulting in its first negative calendar-year return since 1999, and its worst year since 1994. Today, investors are rethinking their approach to their bond allocations.

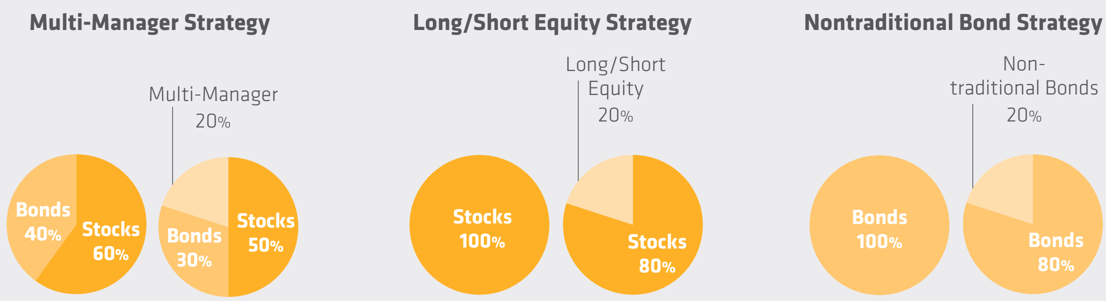
The most pressing concern today is the potential for rising interest rates, and many investors are looking to nontraditional bond strategies as a way to sidestep the negative returns that can come from falling prices. These approaches typically use methods that manage interest-rate sensitivity. When we look at how nontraditional bond strategies performed versus US bonds in past rising-rate environments, the benefits of allocating some fixed-income exposure to alternatives are clear (*Display 11*). Allocating 20% of a bond allocation to nontraditional bond strategies results in higher portfolio returns, lower volatility and an improved risk/return profile.

Select the right managers: Alternative strategies typically invest across a wider investment universe and have more flexibility than traditional strategies. For alternative managers, the portion of returns attributable to market movements, or beta, is often much lower than it is for traditional equity or bond managers—manager skill is often the main driver of long-term returns. As a result, the returns among alternative strategies tend to show much wider dispersion than returns among traditional investments. So, the manager you select may affect portfolio performance more than the particular strategy (*Display 13*), as not all managers have the same degree of skill.

The reliance on manager skill in alternative investing also makes implementing a passive approach less effective. Alternative strategies do exist in ETFs and other passive vehicles, but the options are limited. Passive strategies often attempt to replicate index results without accounting for how much the individual strategies within an index vary.

In our view, successful alternative managers need to distinguish themselves in three key areas: experience, track record and infrastructure.

DISPLAY 12: BENEFIT OF IMPLEMENTING ALTERNATIVE STRATEGIES OVER THE PAST 20-PLUS YEARS



			Benefit			Benefit			Benefit
Return	6.84%	7.63%	**+0.79%**	7.03%	8.13%	**+1.10%**	5.86%	6.67%	**+0.81%**
Risk	9.60%	9.10%	**–0.46%**	15.20%	13.70%	**–1.50%**	3.76%	3.39%	**–0.38%**
Sharpe Ratio	0.48	0.58	**+0.1**	0.36	0.46	**+0.1**	0.88	1.2	**+0.32**

Past performance does not guarantee future results. These returns are for illustrative purposes only and do not reflect the performance of any fund. Diversification does not eliminate the risk of loss. An investor cannot invest in an index. These figures do not include sales charges or operating expenses associated with an investment in a mutual fund, which would reduce total returns.
Return, risk and Sharpe ratio are from January 1, 1990, through December 31, 2014. Stocks are represented by MSCI World; multi-manager by HFRI Fund Weighted Composite; long/short equity by HFRI Equity Hedge; bonds by Barclays US Aggregate Bond; nontraditional bonds by HFRI Relative Value.
Source: Barclays, HFR, MSCI and AB

Look for experience: Since a manager's skill is often honed over time, experience is the most important factor to consider in choosing a manager. By and large, the strategies in the liquid alternative space today are run by two types of management teams: those with traditional experience and those with hedge fund experience. Both have the potential to deliver on their portfolio objectives, but an investor should evaluate each with different criteria.

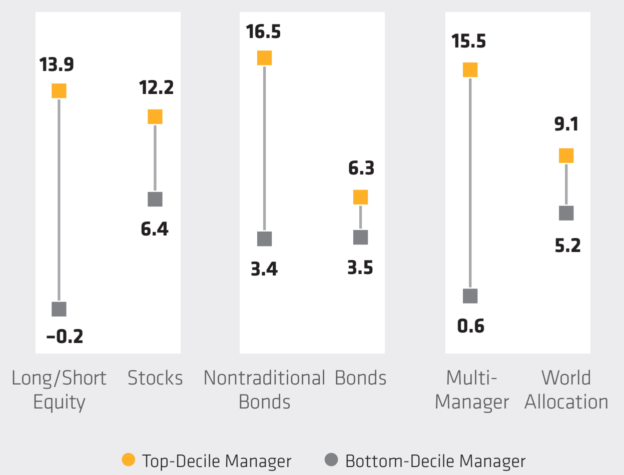
Investors should look for specific skill sets when choosing strategies run by former traditional managers. For instance, an investor who has decided on a long/short equity strategy should look for skill in shorting. An investor looking for a managed futures strategy should seek managers with skill in derivatives. Regardless of the alternative strategy, a risk-management mind-set is crucial. Does the traditional manager have a strategy and the right systems in place to monitor the more extensive risks presented by alternatives and to protect investors on the downside? Transitioning from a mind-set in which outperforming a benchmark means success to one in which absolute returns take precedence is one of the biggest challenges for traditional managers.

When choosing between managers with and without prior hedge fund experience, it's easy to assume that the scales should tip in favor of those with experience. But in reality, there's no guarantee that hedge fund managers can successfully translate their experience to a mutual fund. And there are many variables to consider: How similar are the hedge fund and the mutual fund? How much do the strategies overlap? Do the hedge fund and mutual fund have similar asset sizes? (Size can impact strategy execution.)

Hedge fund experience is useful primarily if it applies to the liquid strategy. Regulations on liquidity, pricing and use of leverage may change the strategy once it's in a mutual fund. In general, the less leverage used in a hedge fund and the more limited the exposure

DISPLAY 13: MANAGER SELECTION IN ALTERNATIVES IS CRUCIAL

Returns 2009–2014 (%)



Past performance does not guarantee future results.
Through December 31, 2014
Long/short equity is represented by HFRI Equity Hedge constituents; stocks by active Morningstar category World Stock constituents; nontraditional bonds by HFRI Relative Value constituents; bonds by active Morningstar category Intermediate-Term Bond constituents; multi-manager by HFRI Fund Weighted Composite constituents; and world allocation by active Morningstar category World Allocation constituents.
Source: HFR, Morningstar and AB

to illiquid securities, the higher the likelihood that investors will see similar results in a mutual fund.

Examine the track record: Track record is another important criterion in evaluating alternative managers. It's important to avoid extrapolating too much from too small a data set, but looking at performance during several episodes that followed the 2008 global financial crisis can help an investor confirm or reject the accuracy of a given manager's return or risk expectations. These include the sharp equity drawdowns in the fall of 2011 and the sharp spike in bond yields in the spring of 2013.

Returns during the strong equity markets of the last few years can also be instructive. If a strategy designed to maintain a low beta to equities managed to outperform or keep pace with stocks during the recent extended rally, the manager may have drifted from the strategy's stated objectives. The returns of related strategies, if they're available, may also provide information, but it's critical to understand any differences in the peer universe or approach.

Infrastructure is important: Infrastructure shouldn't be an afterthought when choosing a manager. Traditional managers typically have strong compliance and middle- and back-office operational capabilities to handle the requirements of the Investment Company Act of 1940 with regard to regulatory reporting and daily pricing. But they may not have risk-management systems in place to handle the required portfolio reporting of shorts, derivatives, options or other nontraditional security types.

Hedge fund firms often have very advanced systems and tools to monitor, manage and report portfolio risks. But they may not be as experienced in handling the pre-trade compliance and regulatory filings required of mutual funds. They may also lack an investor relations staff to handle the heavier client inquiries that a daily return strategy brings.

The ability to bridge these gaps signals a dedication to the liquid alternative business. Investors should do their own research and due diligence, and look for managers who can offer the whole package.

CONCLUSION: LIQUID ALTERNATIVES ARE HERE TO STAY

The growth of alternative mutual funds is a positive development for the investor community, and it adds a new dimension to asset allocation. These funds offer diversification and the potential for stronger risk-adjusted returns to a much wider audience, and they provide the features that investors want: liquidity, transparency, lower minimums and stronger governance. A framework for implementation that includes defining an investment objective, deciding on an allocation, sourcing appropriately and choosing the right managers is crucial.

However, this industry is still in its early stages, and more time, analysis and exposure to market stressors are needed before investors can truly judge its benefits—and understand how to best take advantage of them. Even so, industry signs point to significant interest in, and increased allocations to, liquid alternatives among individual investors, and nascent but growing interest from institutions and defined contribution plans. Over time, liquid alternatives may move front and center and put pressure on the traditional hedge fund industry.

APPENDIX: ALTERNATIVE STRATEGIES AND ASSET CLASSES OFFER SOLUTIONS

Alternative Strategies			
Hedge Fund Category	**Related Mutual Fund Category**	**Definition**	**Investment Objective**
Equity Hedge	Long/Short Equity	Maintain positions both long and short in primarily equity and equity derivative securities. Funds may vary by market exposure, approach to stock selection, geographic focus or sector specialty.	Equity Growth; Reduce Volatility
Equity Hedge: Market Neutral	Market Neutral	Generally take long and short equity positions and attempt to hedge out all market exposure. These funds work to provide small but steady returns in all market conditions.	Reduce Volatility; Protect Against Losses; Lower Interest-Rate Sensitivity
Equity Hedge: Short Bias	Bear Market	Dedicate large allocations to short stock positions in an attempt to take advantage of anticipated market or stock declines.	Protect Against Losses
Event Driven	N/A	Take positions in companies involved in corporate transactions such as mergers, restructurings, financial distress, tender offers, buybacks, debt exchanges, security issuance and other capital structure adjustments. These strategies combine sensitivities to equity markets, credit markets and idiosyncratic, company-specific developments.	Equity Growth; Reduce Volatility
Relative Value	Nontraditional Bonds	Seek to avoid losses and produce returns uncorrelated with the overall bond market, using a variety of methods. Some invest tactically across a wide array of sectors, including high yield and foreign debt.	Lower Interest-Rate Sensitivity; Reduce Volatility
Macro	N/A	Employ top-down investment processes predicated on movements in underlying economic variables. Seek to capitalize on the impact of these macroeconomic movements across various assets classes such as equity, fixed income, currency and commodity.	Protect Against Losses
Macro: Systematic Diversified	Managed Futures	Use futures contracts to mitigate risk and provide portfolio diversification among various types of investment styles and asset classes.	Protect Against Losses
Hedge Funds of Funds	Multi-Manager	Invest with multiple managers, designing a diversified portfolio and thereby lowering the risk of investing with an individual manager. A manager may allocate funds to numerous managers within a single strategy or to numerous managers in multiple strategies. May shift allocations based on market opportunities.	Provide Alternative Diversification; Lower Interest-Rate Sensitivity; Reduce Volatility

Alternative Asset Classes		
Hedge Fund Category	**Definition**	**Investment Objective**
Commodities	Involve the trading of physical commodities, including agriculture, energy, precious metals and livestock, or the derivatives of them, based on their market values.	Hedge Inflation; Lower Interest-Rate Sensitivity
Currencies	Involve the trading of currencies or currency futures on the foreign exchange. May be long only or employ a long and short approach.	Lower Interest-Rate Sensitivity
Real Estate	Invest in commercial real estate properties or the mortgages or mortgage securities tied to those properties. These strategies tend to generate income through rents or financing.	Hedge Inflation; Generate Income; Equity Growth
Infrastructure	Invest in the equity or debt of private, cash-flow-generating infrastructure projects such as toll roads, airports, water, power and other utilities.	Hedge Inflation; Generate Income

As of June 30, 2014
Hedge fund categories delineated with a colon indicate a sub-strategy.
Source: HFR, Morningstar and AB

GLOSSARY

For the purposes of this paper, HFR indices serve as proxies for liquid alternative strategies. Given their longer track records, HFR indices are most representative of performance and markets over time. Investors should note that the actual performance of liquid alternative strategies may differ from the performance presented in the displays.

Barclays US Aggregate Bond Index: A market capitalization–weighted index that is designed to measure US investment-grade bonds of intermediate duration.

BofA Merrill Lynch 0-3 Month US Treasury Bill Index: An index that tracks the performance of US dollar–denominated US Treasury bills publicly issued in the US domestic market with a remaining term to maturity of less than three months.

Dow Jones-UBS Commodity Index: A broadly diversified index that tracks commodity futures.

HFRI EH: Equity Market Neutral Index: A performance index that tracks funds which typically maintain characteristic net equity market exposure no greater than 10% long or short. Funds use sophisticated quantitative techniques to analyze price data and ascertain information about future price movements and relationships between securities for purchase and sale.

HFRI Equity Hedge Index: A performance index that tracks funds which maintain at least 50% redundant exposure to both long and short positions in primarily equity and equity derivative securities.

HFRI Event-Driven Index: A performance index that tracks funds which maintain positions in companies currently or prospectively involved in corporate transactions of a wide variety, including, but not limited to, mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges, security issuance and other capital structure adjustments.

HFRI Fund of Funds Composite Index: An equal-weighted performance index that includes more than 650 constituent funds of funds that report their monthly net-of-fee returns to Hedge Fund Research, have at least $50 million under management, and have been actively trading for at least 12 months.

HFRI Fund Weighted Composite Index: A global, equal-weighted index of over 2,000 single-manager funds that are reported by the HFR Database. Constituent funds report monthly net-of-all-fees performance in US dollars and have a minimum of $50 million under management or a 12-month track record of active performance.

HFRI Macro: Systematic Diversified Index: A performance index that tracks funds which have investment processes typically as functions of mathematical, algorithmic and technical models, with little or no influence by individuals over the portfolio positioning.

HFRI Relative Value Index: A performance index that tracks funds in which the investment thesis is predicated on the realization of a valuation discrepancy in the relationship between multiple fixed-income instruments.

MSCI World Index: A free float–adjusted, market capitalization–weighted index that is designed to measure global developed-market equity performance.

S&P 500 Index: A market capitalization–weighted index which includes a representative sample of 500 leading companies in leading industries of the US economy.

Sharpe Ratio: A measure of an investment's return per unit of risk that is calculated by dividing an investment's return over cash by its volatility.

Standard Deviation: A measure of the variation of the return of a financial instrument from its average (or mean) return over time.

A WORD ABOUT RISK

Active Trading Risk: A higher rate of portfolio turnover increases transaction costs, which may negatively affect portfolio returns. It may also lead to substantial short-term gains, which may result in adverse tax consequences for shareholders.

Derivatives Risk: Investments in derivative instruments such as options, futures, forwards or swaps can be riskier than traditional investments, and may be more volatile, especially in a down market.

Diversification Risk: Portfolios that hold a smaller number of securities may be more volatile than more diversified portfolios, since gains or losses from each security will have a greater impact on the portfolios' overall value.

Market Risk: The market values of a portfolio's holdings rise and fall from day to day, so investments may lose value.

Short-Sale Risk: The risk that a strategy will incur a loss by subsequently buying a security at a higher price than the price at which it sold the security short. The amount of such loss is theoretically unlimited (since it is limited only by the increase in value of the security sold short by the strategy). In contrast, the risk of loss from a long position is limited to the strategy's investment in the long position, since its value cannot fall below zero. Short selling is a form of leverage.

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AB's $18 billion global alternative-investment platform provides investment products for institutional, retail and private clients worldwide. Our broad array of alternative-investment products spans asset classes, liquidity levels and risk/return profiles—including hedge funds, hedge funds of funds, private equity, real estate and private credit. These products are designed to help investors achieve their investment goals.

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