

April 2016








For professional investors and advisers only

# Schroders

## Liquid Alternatives



# Schroders

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## Introduction

# to liquid alternatives

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Investors and their advisers are increasingly recognising the value of ‘liquid alternative’ investment strategies as they look to achieve superior risk-adjusted returns from portfolios.

“The role liquid alternatives can play in building robust, diversified portfolios fit to withstand a range of different market environments is something investors cannot afford to ignore.”

The financial crisis permanently changed investors’ perceptions of important concepts such as diversification and correlation. Investors who had, up to this point, slept soundly in the knowledge they had a ‘diversified’ portfolio, found that many seemingly uncorrelated assets, such as equities and bonds, could in fact move in unison – just at the moment they needed diversification the most.

At the heart of liquid alternatives lies a fundamental rethinking of the balance between risk and return. Investors may still retain long-term ambitions to generate income and/or capital growth but there is now also a much greater awareness of the importance of capital preservation, downside protection and genuine diversification.

This is an exciting new era for liquid alternative strategies as they are becoming ever more relevant, with concerns growing over historically low bond yields, elevated equity valuations and increased volatility across the board. The role liquid alternatives can play in building robust, diversified portfolios fit to withstand a range of different market environments is something investors cannot afford to ignore.



## What are **liquid alternatives?**

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“Liquid alternative strategies can enhance the risk-adjusted returns of an existing balanced portfolio.”

While there is no universal definition for liquid alternative investments, these strategies are typically benchmark unconstrained, aim to generate a total or absolute return and can have the ability to take both long and short positions. These strategies may also give investors access to traditional alternative asset classes with improved liquidity, offering daily, weekly or twice monthly dealing.

Unlike traditional alternative investments, liquid alternatives are structured within a regulated mutual fund format. This means investors may expect all the benefits associated with mutual funds, such as greater transparency, minimum investment levels as well as leverage and concentration limits. Furthermore, compared to traditional alternative vehicles, liquid alternatives possess a higher degree of governance, that set out how the funds should be structured and managed, as well as how the underlying assets should be safeguarded.

Liquid alternative strategies can enhance the risk-adjusted returns of an existing balanced portfolio. This should offer investors genuine diversification within a portfolio, reduced volatility and decorrelation characteristics, while offering potential downside protection when markets are distressed.



## How do they work?

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“Liquid alternative strategies may employ certain investment techniques that differ from traditional funds.”

By definition, alternative investing involves seeking out diverse sources of alpha with strategies that demonstrate reduced correlation to broader financial markets. To do this, liquid alternative strategies may employ certain investment techniques that differ from traditional funds. Examples of these include:

**Long/short investing:** This is an investment technique that can be used to generate additional returns as well as to provide flexibility and downside protection to a portfolio. A strategy that takes both long and short positions offers the potential for investors to take advantage of falling as well as rising markets and, subsequently, to manage market volatility more effectively compared with traditional long-only strategies.

**Leverage:** This is an investment technique that seeks to increase exposure and enhance returns through the use of borrowed capital. In the case of liquid alternatives this is achieved through the use of derivative instruments. Leverage can be applied on both the long side and the short side and, when managed carefully, can be an effective technique for magnifying the return potential of a portfolio.

**Derivatives:** Derivatives are contracts between two or more parties, whose value is derived from the underlying asset of the contract, such as stocks, bonds and commodities, among others. Fund managers often use derivatives in order to hedge risk within the portfolio, such as interest rate, inflation or currency risks.

For example, the fund manager may use swaps – whereby a variable rate payment is exchanged for a fixed rate or vice versa – in order to mitigate the impact of rising or falling interest rates.

Similarly, if a fund manager wants protection against a possible fall in a stock's price, they may purchase a put option. This provides the holder with the right, but not the obligation, to sell the underlying security at an agreed price within a given period of time.

Additionally derivatives may be used to make active investment decisions, for example, using a short derivative position to express a negative view on a company.





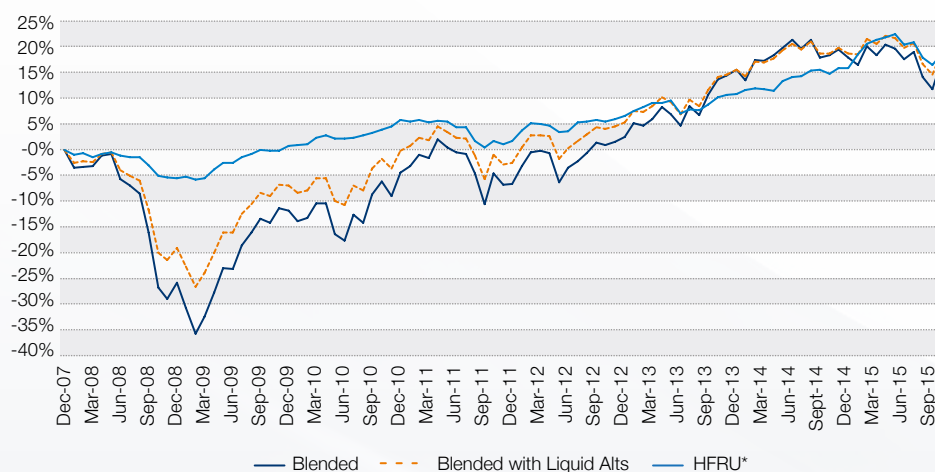
## Performance characteristics of liquid alternatives

The fact that liquid alternative strategies cover such a broad range of asset classes with such diverse performance patterns mean they can be tailored to suit the needs of individual portfolios. For example, long/short investing can be more focused on capturing growth potential while hedging market exposure through short selling; commodities strategies can look to mitigate inflation risk; while others, such as catastrophe bonds, are largely uncorrelated with macroeconomic factors, bringing valuable diversification in times of economic uncertainty.

While investment portfolios have traditionally been built around bonds and equities, there is a growing body of research that shows how the introduction of an allocation to liquid alternative investments can serve to improve returns and reduce risk over the long term.

Since 2008, as Figure 1 illustrates, a portfolio of liquid alternatives would have consistently outperformed a traditional balanced portfolio (split 60% to equities and 40% to fixed income). Furthermore, the chart shows how, by shifting part of an equity or fixed income allocation into liquid alternatives (in this case allocating 30% into liquid alternatives, 40% into equities and 30% into fixed income), investors can boost portfolio performance over time and reduce volatility compared with a traditional balanced portfolio.

**Figure 1: Liquid alternatives industry performance since January 2008**

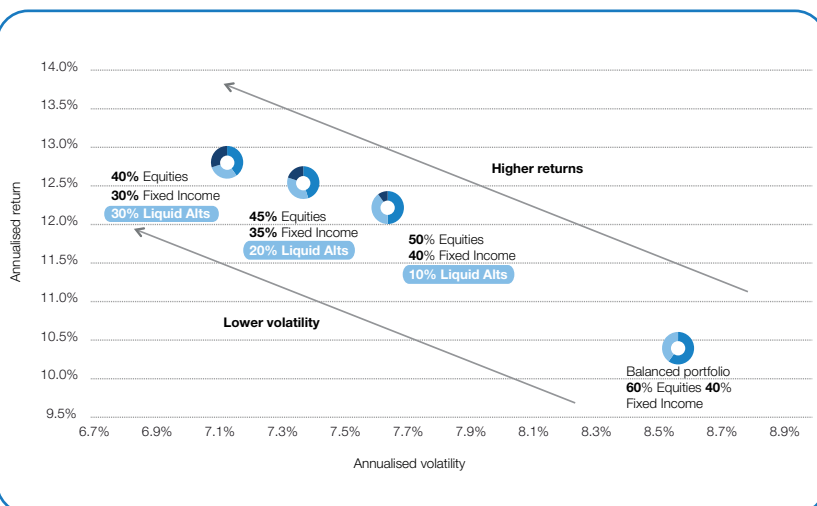


Source: Schroders, Hedge Fund Research, as at 31 March 2016. \*HFRU Indices are performance benchmarks for hedge funds compliant with established UCITS guidelines. HFRU Indices are representative of the complete universe of UCITS hedge funds.

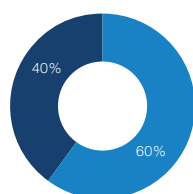
Figure 2 reinforces this point by showing how the introduction of a 30%, 20% or 10% liquid alternatives allocation to a traditional 60/40 balanced portfolio can, in each instance, help to boost returns, dampen volatility and heighten resilience.

**Figure 2:**  
**Performance**  
**analysis – effects**  
**of different liquid**  
**alternatives**  
**allocations**

Source: Schroders,  
Hedge Fund Research,  
MSCI, Barclays,  
29 February 2015 –  
29 February 2016.  
For Fixed Income,  
Barclays Capital Global  
Aggregated Bond Index  
has been used, for  
Equities, MSCI World  
Index has been used and  
for Alternatives, HFRU  
Index has been used

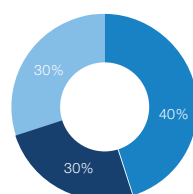


Balanced



Equities Fixed income

Balanced with Liquid Alts

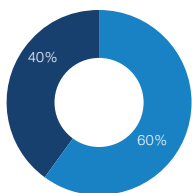


Equities Fixed income Alternatives

30%  
allocation

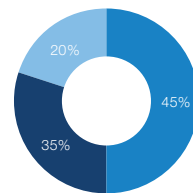
	Annualised return	Annualised volatility
Balanced	10.4%	8.6%
Balanced with Liquid Alts	12.8% ▲	7.1% ▼

Balanced



Equities Fixed income

Balanced with Liquid Alts

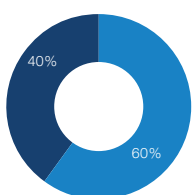


Equities Fixed income Alternatives

20%  
allocation

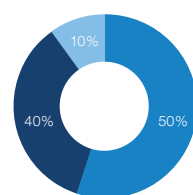
	Annualised return	Annualised volatility
Balanced	10.4%	8.6%
Balanced with Liquid Alts	12.5% ▲	7.4% ▼

Balanced



Equities Fixed income

Balanced with Liquid Alts



Equities Fixed income Alternatives

10%  
allocation

	Annualised return	Annualised volatility
Balanced	10.4%	8.6%
Balanced with Liquid Alts	12.2% ▲	7.6% ▼



## How to apply liquid alternatives

Traditionally liquid alternatives have been viewed as a distinct stand-alone asset class, however investors are now realising the attractiveness of combining them with their traditional asset class allocation. The graphic below shows how liquid alternatives can be considered alongside a portfolio's equity and fixed income allocation.

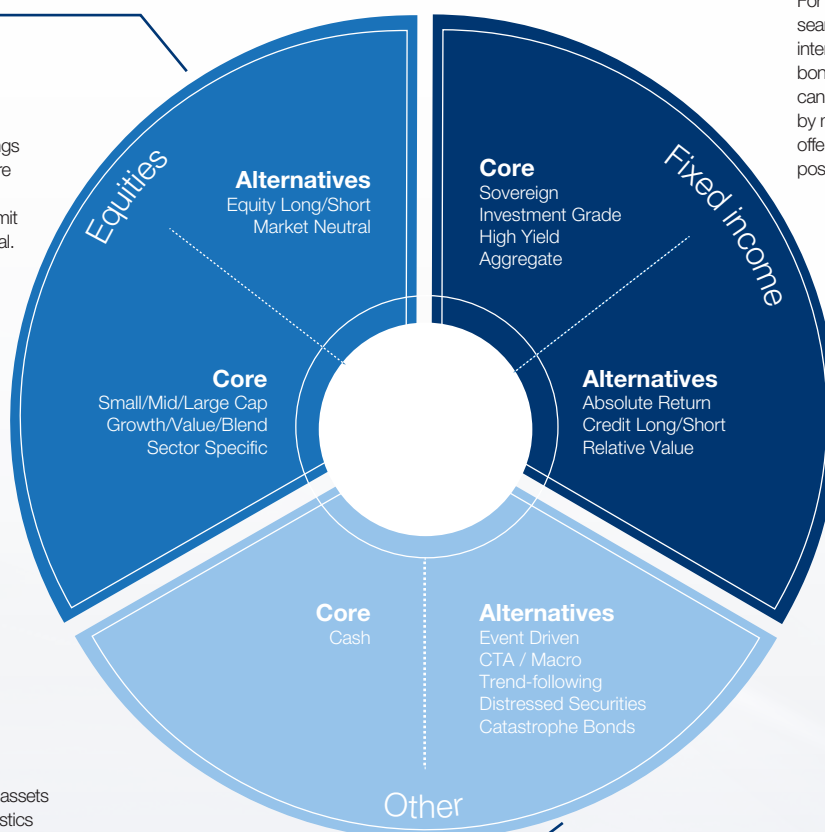
The way investors choose to use liquid alternatives will depend, however, on their particular investment objectives, since liquid alternatives have the ability to play a variety of roles within a portfolio. For example, they can provide access to diverse sources of alpha, reduce volatility and directional market risk, offer protection in falling markets and are a simple but flexible approach to enhancing diversification.

Whatever liquid alternatives investors use, the ultimate aim for investors should be to build a well-diversified portfolio that is sufficiently robust to withstand a variety of market conditions. An integral part of this process must always be the careful evaluation of the different risk and return characteristics of liquid alternatives to determine how they may best fit within a portfolio.

**Equity alternatives:** Equity alternatives can be used in a number of ways within a portfolio. Some strategies seek, for example, to take advantage of equity volatility by participating in market upswings while minimising downside risk. Others are independent of market direction, such as market-neutral strategies, which aim to limit overall risk while protecting return potential.

### **Fixed income alternatives:**

For investors who are, for example, searching for yield or wary of the impact interest rate rises may have on their bond holdings, fixed income alternatives can help to provide valuable protection by managing drawdown risks while still offering the potential to generate positive returns.



**Other alternatives:** Investors may also enhance portfolio diversification by using assets with a distinct set of risk/return characteristics that are largely uncorrelated with conventional financial markets. Such an approach may include, for example, the use of catastrophe bonds, convertibles or strategies that employ a range of different asset classes to provide portfolio diversification.





# Schroders and liquid alternatives

**\$16BN\***  
OF LIQUID ALTERNATIVE  
**ASSETS**  
UNDER MANAGEMENT

\*As at 31 December 2015

Schroders has a wealth of experience and expertise in liquid alternatives.

We manage a range of strategies across a variety of different asset classes, allowing investors to create increasingly nuanced and targeted portfolios.

We offer a global platform of leading, externally-managed hedge funds through our GAIA range. Schroder GAIA is a regulated, liquid and transparent way for investors to access hedge fund strategies within a UCITS framework.

We've also extended this platform into the non-UCITS arena, through Schroder GAIA II. Within the hedge fund landscape, we recognise there is a variety of compelling investment strategies, some of which may not naturally fit within a UCITS framework. In order to offer a more complete and diverse suite of hedge fund strategies, we established Schroder GAIA II, a non-UCITS platform.

Both of these platforms combine the strengths of Schroders, as an experienced and established asset manager, and those of a carefully selected group of top-quality hedge fund managers with proven track records.

## Our liquid alternatives range

UCITS	Internally managed	Externally managed
<b>Equity based strategies</b>	Schroder ISF <sup>1</sup> European Equity Absolute Return Schroder ISF European Alpha Absolute Return* Schroder ISF European Total Return Schroder ISF QEP Global Value Plus Schroder ISF QEP Global Absolute Schroder ISF Asian Total Return**	Schroder GAIA Egerton Equity* Schroder GAIA Sirios US Equity Schroder GAIA Paulson Merger Arbitrage
<b>Fixed Income based strategies</b>	Schroder ISF Strategic Bond Schroder GAIA Global Macro Bond Schroder ISF Asian Bond Absolute Return Schroder ISF Emerging Markets Debt Absolute Return	Schroder GAIA BSP Credit Schroder GAIA KKR Credit
<b>Other strategies</b>	Schroder ISF Global Property Securities Schroder ISF Asia Pacific Property Securities Schroder GAIA Cat Bond	Schroder GAIA BlueTrend
Non UCITS	Internally managed	Externally managed
<b>Equity based strategies</b>	Schroder AS <sup>2</sup> UK Dynamic Absolute Return	
<b>Fixed Income based strategies</b>		
<b>Other strategies</b>	Schroder AS Agriculture Fund Schroder AS Commodity Fund Schroder IF <sup>3</sup> Flexible Cat Bond	Schroder GAIA II NGA Turnaround

<sup>1</sup> Schroder International Selection Fund is referred to as Schroder ISF throughout this document

<sup>2</sup> Schroder Alternative Solutions is referred to as Schroder AS throughout this document

<sup>3</sup> Schroder Investment Fund is referred to as Schroder IF throughout this document

\*Hard closed \*\*Hard closed from 13 Dec 2010 except for C and I share classes which are soft closed



# Schroders

## fund sketches

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### Equity alternatives

**Schroder ISF European Equity Absolute Return** aims to deliver positive returns throughout the market cycle by investing in large or mid-cap companies across Europe and the UK.

**Schroder ISF European Alpha Absolute Return** aims to deliver consistent returns in all market conditions, from rising and falling equity prices. The fund invests primarily in medium-sized European companies but may also invest in larger companies.

**Schroder ISF European Total Return** invests in European companies and aims to deliver low volatility, equity-like returns while providing downside protection.

**Schroder ISF QEP Global Value Plus** aims to deliver above-market returns over the long term, through maximised exposure to long-term value opportunities. The fund's ability to short low quality stocks acts as a diversifier and a return driver.

**Schroder ISF QEP Global Absolute** is an absolute return equity strategy that seeks to capture the most attractive opportunities across a universe of over 15,000 stocks to provide positive returns in all market conditions.

**Schroder ISF Asian Total Return** aims to provide capital growth through investment in equity and equity-related securities of Asia Pacific companies. The fund also aims to offer a degree of capital preservation through the use of derivatives.

**Schroder GAIA Egerton Equity** is a fundamental equity long/short strategy investing predominantly in large cap equities with a global focus.

**Schroder GAIA Sirios US Equity** is a fundamental equity long/short fund, which focuses on mid- to large-cap equities primarily in the US, but also in Europe and Asia.

**Schroder GAIA Paulson Merger Arbitrage** offers investors exposure to Paulson's flagship strategy, an all-encompassing approach to merger arbitrage investing primarily in North America and Europe. The fund aims to generate above average returns with low volatility and low market correlation to broad equity markets.

**Schroder AS UK Dynamic Absolute Return** is an equity long/short, all-cap strategy with a bias towards small and mid-cap companies. The fund primarily aims to capture the alpha opportunity in small-cap markets.

### Fixed income alternatives

**Schroder ISF Strategic Bond** is a highly diversified, 'best ideas' fund that targets the most attractive opportunities across global bond and currency markets to deliver consistent returns across all market conditions.

**Schroder GAIA Global Macro Bond** aims to generate consistent incremental returns by exploiting opportunities in all alpha sources available to a fixed income manager.

**Schroder ISF Asian Bond Absolute Return** seeks to capitalise on fixed income opportunities, investing in a broad range of fixed and floating securities issued by governments, government agencies, supra-national and corporate issuers in Asia excluding Japan.

**Schroder ISF Emerging Markets Debt Absolute Return** offers access to a broad range of local and external bonds, and currencies, from some of the world's most dynamic countries. The fund aims to generate high absolute returns with limited volatility over a market cycle.

**Schroder GAIA BSP Credit** is a US focused, credit long/short strategy which aims to maximise returns while limiting downside risk. The fund aims to achieve this without taking directional views on the long or short side to produce a return profile uncorrelated with market indices.

**Schroder GAIA KKR Credit** offers investors exposure to a liquid, unbiased, 'all weather' approach to long/short credit investing predominantly in Europe. The fund invests in liquid corporate, financial and sovereign credits while hedging out any interest rate and currency risk.

### Other alternatives

**Schroder ISF Global Property Securities** invests primarily in the shares of property companies and Real Estate Investment Trusts (REITs), offering access to a globally diversified, highly liquid and actively managed portfolio.

**Schroder ISF Asia Pacific Property Securities** invests in equity securities of Asia Pacific property companies. The fund provides exposure to prime property portfolios that cannot otherwise be accessed through direct property funds.

**Schroder GAIA BlueTrend** is a trend following strategy that invests across a broad range of markets, including equities, bonds, commodities, interest rates and currencies. The fund seeks to take advantage of upward or downward market trends by analysing the price movement, rather than the fundamentals, of the underlying asset.

**Schroder GAIA Cat Bond** invests in a diversified portfolio of tradable insurance-linked securities (ILS), with a focus on natural catastrophes and offers low correlation to traditional asset classes.

**Schroder GAIA II NGA Turnaround** is a long/short, liquid distressed debt and equity fund, that seeks to maximise returns from bankruptcies, distressed companies and turnaround situations, with a focus on the US corporate sector.

**Schroder AS Agriculture Fund** aims to give investors a diversified exposure to agriculture, via agriculture commodity futures and agriculture-related equities. This is an enhanced beta product with the objective of outperforming the Rogers International Agriculture Index, with lower volatility.

**Schroder AS Commodity Fund** offers investors a diversified exposure to commodities through commodity futures, with equal emphasis on agriculture, energy and metals. This is an enhanced beta product that aims to outperform the average of the four main commodity indices, with lower volatility.

**Schroder IF Flexible Cat Bond** invests in insurance-linked securities, primarily focusing on natural catastrophe risk and gaining exposure through cat bonds investments. To enhance diversification, it has the flexibility to invest in private placement cat bonds.

## About Schroders



€425.4bn managed across equities, fixed income, multi-asset, alternatives and real estate.



An extensive global network of 3,700+ employees.



38 offices in 28 countries across Europe, the Americas, Asia, the Middle East and Africa.



Over 200 years' experience of investment markets.

Source: Schroders, as at 31 December 2015.

To find out more please visit

[www.schroders.com/liquidalternatives](http://www.schroders.com/liquidalternatives)

or speak to your local Schroders representative



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