What are liquid alternatives?
Often touted as a natural extension of private hedge funds, liquid alternatives have several distinguishing features. Covering a diverse array of investment strategies, they seek to generate returns using complex, nontraditional methods and are frequently marketed as a way to diversify against equity risk or fixed income risk. The common thread is that these strategies can bet against traditional capital markets, use investments outside those markets, and/or tactically move within and across markets. Although their investment focus may be similar to that of hedge funds, liquid alternatives are subject to registered investment vehicle regulations covering liquidity, diversification, and leverage.

Why the fast-growing interest in them?
Steep declines in global equity returns during the global financial crisis—from late 2007 through early 2009—provided the initial catalyst for investor and manager interest in liquid alternative funds. More recently, fears of poor returns in the global bond markets have fueled that interest. For example, during 2013, when interest rates rose, long/short credit funds generally outperformed a global bond benchmark (see Figure 1).

Figure 1. Median total returns for various investment strategies during the global financial crisis and in 2013

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Global financial crisis</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bear market</td>
<td>65.4%</td>
<td>-1.3%</td>
</tr>
<tr>
<td>Global bonds</td>
<td>5.5%</td>
<td>0.6%</td>
</tr>
<tr>
<td>Equity market neutral</td>
<td>-3.8%</td>
<td>-26.7%</td>
</tr>
<tr>
<td>Currency</td>
<td>-4.9%</td>
<td>-34.9%</td>
</tr>
<tr>
<td>Long/short equity</td>
<td>-22.3%</td>
<td>-34.9%</td>
</tr>
<tr>
<td>Multi-alternative</td>
<td>-26.7%</td>
<td>-34.9%</td>
</tr>
<tr>
<td>Global stocks</td>
<td>-22.3%</td>
<td>-34.9%</td>
</tr>
<tr>
<td>Long/short credit</td>
<td>-26.7%</td>
<td>-34.9%</td>
</tr>
<tr>
<td>Global bonds</td>
<td>-34.9%</td>
<td>-34.9%</td>
</tr>
</tbody>
</table>

Notes: Global financial crisis period covers October 2007 through March 2009. Managed futures strategies excluded from figure because only two such funds existed during that period. See Appendix for benchmark indexes used for the returns shown.
Sources: Vanguard calculations, based on data from Morningstar, Inc.
**Response from investors and managers**

Liquid alternatives constitute a new industry with explosive growth. More than 70% of their cash flows and 68% of new product launches have come since 2009; 50% of these flows and products have come just in the three years through 2013, as shown in Figure 2. Product proliferation across a growing array of strategies requires greater due diligence by investors or their fiduciaries.

**Concerns about costs**

Costs are generally higher among liquid alternative strategies than among traditional investment strategies (see Figure 3). Expenses—whether in the form of expense ratios, sales loads, or tax inefficiencies—directly detract from investor performance. Indirect costs should also be considered, such as increased complexity, the lack of an identifiable benchmark index, and higher oversight costs.

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**Figure 2. Cash flows and fund launches have proliferated in the liquid alternatives industry**

![Cash flows and fund launches have proliferated in the liquid alternatives industry](image)

Notes: Data as of December 31, 2013. Percentages may not total precisely 100% because of rounding.
Sources: Vanguard calculations, based on data from Morningstar, Inc.

**Figure 3. Asset-weighted expenses depict a higher hurdle to be overcome**

![Asset-weighted expenses depict a higher hurdle to be overcome](image)

Note: Data as of December 31, 2013. Chart uses average monthly assets for 2013 and prospectus net expense ratio (to exclude short interest expenses).
Sources: Vanguard calculations, based on data from Morningstar, Inc.
Are liquid alternatives worth it?

Although certain alternative strategies may perform better in specific short-term environments, longer-term benefits, covering both bull and bear equity markets and a low-yield environment, have been less clear. Figure 4 shows the performance impact over the last several years of reallocating 10% of a global 60% stock/40% bond portfolio to each liquid alternative strategy (i.e., reallocating 5% each from equity and fixed income). By definition, bear market funds added the most during the financial crisis but have subsequently exhibited the most underperformance. The remaining strategies have had a marginal impact across the board—but certainly not one that would meaningfully alter an investor's savings needs or spending ability for the better. We also evaluated their impact on the Sharpe ratio (a measure of risk-adjusted performance, not shown in the figure) and found that adding liquid alternatives resulted in an equivalent or lower ratio for the full period.

Appendix. Methodology and indexes

We used Morningstar’s U.S. alternative mutual fund category for the liquid alternative funds represented in this paper. We added in funds from the fixed income long/short credit category, which are categorized as a component of taxable bond funds. We excluded funds and exchange-traded funds (ETFs) identified as “trading tools,” including levered and inverse strategies. Performance statistics were calculated using the oldest share class and the median fund return (the time series of returns for the fund with the median return over the period analyzed). Cash flow and expense statistics include all share classes.

Global stocks are represented by a composite benchmark index consisting of 70% domestic index (MSCI US Broad Market Index through June 2, 2013; CRSP US Total Market Index thereafter) and 30% international index (MSCI EAFE + Emerging Markets Index thereafter) and 30% international index (MSCI EAFE + Emerging Markets Index thereafter) and 30% international index (MSCI EAFE + Emerging Markets Index thereafter) and 30% international index (MSCI EAFE + Emerging Markets Index thereafter) and 30% international index (MSCI EAFE + Emerging Markets Index thereafter).

Global bonds are represented by a composite benchmark index consisting of 80% domestic index (Barclays U.S. Aggregate Bond Index through December 31, 2009; Barclays U.S. Aggregate Float Adjusted Index thereafter) and 20% international index (Barclays Global Aggregate ex-USD Float Adjusted RIC Capped Index).
For more information about Vanguard funds, visit vanguard.com, or call 800-662-2739, to obtain a prospectus. Investment objectives, risks, charges, expenses, and other important information about a fund are contained in the prospectus; read and consider it carefully before investing.

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

The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

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