

Fund Industry Intelligence

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Shift To Alternative Strategies Raises Red Flag

The accelerating shift to alternatives funds has raised a red flag among financial advisors, consultants and analysts, who said firms are underestimating the business risk these products carry. While the number of mutual fund launches has plummeted 51% for the 12 months ending June 30, and 78% since 2007, the percentage of new products that fall within alternative asset classes—such as absolute return, equity market neutral, long/short and global flexible—has nearly doubled to 23% of the overall pie from 12% in 2007, according to **Lipper**.

Brand loyalty and asset-gathering capabilities hang in the balance for investment management firms that pursue objectives-based marketing campaigns coupled with inadequate education, they said. Some firms are heeding the message by including more details on portfolio holdings and investment strategies on their websites, including **MFS Investment Management** and **Putnam Investments**, according to **Michael Herbst**, analyst at **Morningstar**.

Jeff Carney, head of global marketing and products at Putnam, said the firm has ramped up its one-on-one meetings between wholesalers and financial advisors regarding its four absolute return funds and how they fit in an overall portfolio. The funds have amassed \$3.7 billion in assets and are nearing their three-year anniversaries. Calls to MFS were not returned.

Herbst declined to identify laggards, whom he said are focusing on selling products based on their objectives and disseminating limited portfolio details. These firms, he said, will ultimately pay the price by being unable to compete for assets from the financial advisory community, which is screaming out for more education about alternatives funds and how to position them in their portfolios.

While 78% of all retail advisors have some allocation to alternatives, they have invested just 1-4% of all the assets they manage in the sector, according to **Cogent Research's** 2011 *Advisor Brandscape* report. The report identifies education as the main hurdle to further investment in the sector.

Fifty-two percent of current alternative product users indicated that a lack of client knowledge and sophistication has prevented them from embracing the sector further, said **John Meunier**, principal. Yet, 41% of advisors now using alternatives indicated they will increase their use of exchange-traded funds in the sector, and 25% said they intend to increase their use of alternatives mutual funds, he added, calling the trend the “retailization” of alternatives.

“The allure of these funds is very strong now, but the business risk is huge,” Herbst warned. “It’s very real because investors could end up in these funds for the wrong reasons and get burned down the line—creating a perception that could take years for a manager to overcome. There are a wide range of strategies, and that means a wide range of risks.”

Morningstar is communicating daily with firms on the issue, voicing its objections to the plethora of marketing materials that focus on a desired objective, rather than the strategies that it will use to obtain that outcome. The marketing material for many absolute return funds, for example, center on the goal of positive returns, Herbst noted. “The idea of obtaining a positive return sounds great, but that’s everyone’s goal.”

Morningstar is requesting greater detail on portfolio holdings, which it uses to categorize funds, and the amount of flexibility afforded to investment managers regarding tactical allocation shifts, Herbst said.



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