Inside Litman Gregory's High Income Alternatives Fund

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by Robert Huebscher

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Jeremy joined Litman Gregory in 1999 and became a principal in 2003. He is responsible for overseeing the firm's manager due diligence, asset class research, and portfolio allocation decisions. Jeremy is also portfolio manager of the Litman Gregory Masters Alternative Strategies Fund and co-portfolio manager of the Litman Gregory Masters Equity, International, Smaller Companies and High Income Alternatives funds. He is frequently quoted in the national media in the areas of asset allocation and manager selection.

The Litman Gregory Masters High Income Alternatives Fund (MAHIX, MAHNX) seeks to generate a high level of current income from diverse sources, consistent with the goal of capital preservation over time. Capital appreciation is a secondary objective. It was launched on September 28, 2018.

I interviewed Jeremy last week.

You've recently launched the new Litman Gregory Masters High Income Alternatives Fund. What was behind the decision and what does the new fund seek to accomplish?

There were several factors behind our decision to launch the High Income Alternatives Fund. First and foremost, whenever we are considering creating a new Masters fund, we view it through the lens of Litman Gregory's role as an independent investment advisor and fiduciary, managing diversified portfolios for our clients. We ask ourselves, "Does this fund deserve to exist from a fundamental investment perspective? Are there clear and compelling reasons to invest in it? Does the fund merit a meaningful allocation in our client portfolios and our own personal portfolios?" The High Income Alternatives Fund passed this test.

Litman Gregory has been investing in income-oriented strategies beyond traditional core investment-grade bond funds for many years. These investments have benefited our client balanced portfolios – improving their returns and diversifying risks. And we expect them to continue to play an important strategic portfolio role in navigating interest rate and credit cycles. We view the High Income Alternatives Fund within that context, as part of our diversified income exposure.

In addition, from a more tactical perspective, with interest rates currently low and rising, traditional core bond investments face meaningful interest rate risk. Yet, there are also clear risks to investors who reach-for-yield in this environment. So, investing with skilled, experienced managers that have a strong, fundamental, research discipline and risk management focus is critical.

Given our experience and expertise in this area *and* our access to top tier managers in these asset classes, we saw an opportunity to build a distinctive, income-oriented fund. And one that we could offer at a competitive fee, particularly given the quality of the sub-advisors/managers.

The four managers on the fund run differentiated strategies that provide access to non-traditional sources of income and less-efficient areas of the financial markets that investors may not otherwise own. Together in a single fund, we've created a diversified portfolio of income-producing investments, while also keeping an eye on volatility and downside risk.

Over a full market cycle, the fund targets annualized total return and income significantly higher than core investment-grade bonds and competitive with high-yield bonds, but with volatility and downside risk meaningfully lower than high-yield bonds.

What are the different strategies in the fund? Overall, how is this fund unique from other income-oriented funds?

There are four underlying strategies in the fund, each of which is managed by a proven team that we selected based on our rigorous due diligence process. Each manager is running a distinct separate account strategy specifically designed for this fund; the managers do not run stand-alone mutual fund versions of these strategies. There are few other funds that are combining non-traditional income strategies with the quality and reputation of the managers we've assembled. And the funds we view as our closest competitors are much more expensive.

Ares Management is running an "alternative equity income" strategy that invests in specialty income-generating public securities – primarily business development companies (BDCs), master limited partnerships (MLPs), and mortgage real estate investment trusts (mREITS). They may also invest selectively in credit-based closed-end funds and other opportunistic income investments. We expect the Ares portfolio to be the highest yielding and returning over a cycle, but also the most volatile. This is the key reason we give the strategy a lower target allocation in the fund (15%) compared to the other three managers. While we expect BDCs to typically be Ares' largest portfolio exposure, they have significant latitude within their mandate to actively manage the exposures based on their assessment of the relative risks and opportunities across their investment universe.

Brown Brothers Harriman (BBH) is running an absolute-return oriented "credit value" strategy. They can invest across a range of fixed income sectors, but their primary focus is on asset-backed (ABS) and corporate securities. Their bottom-up investment process tends to emphasize A/BBB-rated ABS and BBB/BB-rated corporate securities because these "crossover" ratings segments have historically offered attractive risk-adjusted returns, along with low default rates and limited drawdowns. This is a best-ideas portfolio that we expect to hold around 80 securities. BBH's target allocation in the fund is 32.5%.

Guggenheim Partners is running a "multi-credit" strategy. This is a flexible, unconstrained, income-focused strategy that seeks attractive risk-adjusted returns in all market environments. It is not constrained by duration or credit quality and has the flexibility to invest across the fixed-income market, including corporate bonds, loans, structured finance investments, US government/agency, mezzanine and preferred securities, and convertible securities. Guggenheim will be very active in allocating capital and managing credit exposure in this strategy, reflecting their opportunistic yet risk-averse mindset. Guggenheim's target allocation is 32.5%.

Neuberger Berman is running a fully-collateralized "option income" strategy. The strategy writes (sells) out-of-the-money put options on US stock indexes and invests the collateral in a portfolio of short-duration US Treasuries. This generates income from both the receipt of option premiums (similar to an insurance premium) and interest earned on the collateral portfolio. This is a systematic approach that takes advantage of the market's tendency to overpay for downside protection. It's a high risk-adjusted return strategy. To manage risk and reduce path dependency, the Neuberger Berman team diversifies their option portfolio across multiple dimensions, such as strike price and expiration date. Neuberger Berman's target allocation in the fund is 20%.

How does it differ from your Alternative Strategies Fund?

The two funds differ across multiple dimensions. They have different strategies, different managers, different investment approaches and performance objectives, different investment universes and opportunity sets, and different drivers of risk and return.

The Litman Gregory Masters Alternative Strategies Fund (MASFX) is more absolute- and total-return oriented. For example, most of the strategies on the fund have long/short exposures and beta hedges, or may hold significant cash positions when absolute values are unattractive. The strategies on the fund are also very diverse and highly differentiated from each other. And they are intended to generate returns that are not highly dependent on or driven by the direction of the bond and stock markets.

The High Income Alternatives Fund focuses on income-generating strategies, and income is likely to be the primary source of return over time. While the strategies are highly differentiated and flexible, they do not directly hedge credit or equity risk exposures, although they can hedge interest rate risk.

Within our Litman Gregory client portfolios, we put the Alternative Strategies Fund in our liquid alternatives category. We categorize the High Income Alternatives Fund within our diversified fixed income bucket.

What is the risk management process for the fund?

There are three layers to the fund's risk management process. First, each manager has a distinct mandate for their strategy that is consistent with the fund's overall risk and return objectives. Each mandate includes risk (and return) expectations that Litman Gregory and the manager have agreed on. Generally, Litman Gregory asks that each manager focus on delivering strong income-oriented returns over a market cycle while protecting against permanent loss of capital. Given their mandate, the managers have significant flexibility to execute and implement their strategy and each have their own processes for managing risk. Our due diligence with each manager spent considerable time focusing on -- and ultimately gaining confidence in -- their approach to risk assessment and management. This included analyzing how their strategies performed during various historical periods of market volatility.

Second, Litman Gregory applied strategic risk management in our construction of the fund: in our selection of the strategies and managers, and determining their target allocations. In determining the manager allocations, we incorporated both qualitative and quantitative inputs. These included our forward-looking risk and return expectations for each strategy individually and the fund overall, across various macro and market scenarios. We also utilized historical performance data for similar strategies run by the managers. After considering all the data and our qualitative judgements, we arrived at the manager weightings we believe can best achieve the fund's performance targets I noted above.

Third, the Litman Gregory portfolio managers actively monitor each sub-advisor's performance, portfolio positioning and exposures. Remember, we have full (daily) transparency into their activity if need be. We also utilize a portfolio and risk analytics tool from State Street that gives us additional perspective on the fund's risk exposures by manager, asset type, and at the individual security level.

How do you expect advisors to use this fund in their clients' asset allocations?

Given the composition of the fund, it doesn't fit neatly in a typical asset classification box or asset allocation pie chart. But broadly speaking, we see the fund as part of an investor's diversified fixed income allocation, offering access to proven managers with expertise in non-traditional income markets and niches.

In Litman Gregory's private client portfolios we use the fund as a long-term strategic allocation that complements our more-traditional core bond investments and other income-oriented investments. Advisors might also use the fund to diversify and replace some of their high-yield (or higher-yielding) fixed income allocation or traditional equity-income allocation. Given our fund's income objective, it may be beneficial in enhancing yield in portfolios for income-focused clients, or as part of endowment or trust portfolios that have recurring income-distribution requirements.

Litman Gregory is known for its manager due diligence – how did you go about selecting managers for the Litman Gregory Masters Funds? What are the criteria you use for hiring and firing managers?

Our manager selection process incorporates both qualitative and quantitative aspects, though our final opinion rests heavily on our qualitative assessment of an investment team. The process begins with idea generation, which is accomplished through a combination of quantitative performance screens, industry contacts, and publications, all of which help us monitor the opportunity set.

Once we identify a manager to research, our process is extensive and intensive. We spend many, many hours over multiple months, if not years, with an investment team, understanding their investment philosophy, process and decision-making. Ultimately, we are trying to assess whether or not they have an investment edge. If we do identify an edge, which is seldom, we strive to be as specific as possible about the factors that constitute that edge and that should enable it to persist over time.

Our process is team-oriented within Litman Gregory. Each manager is covered by at least two Litman Gregory analysts, and throughout our due diligence process the broader research team is involved in the vetting, typically playing a devil's advocate role to ensure the primary analysts are not missing something in their analysis.

If we believe we have identified an exceptional manager and can clearly articulate the factors behind our conviction (as well as what could erode that edge), we will consider investing with them and, at the highest level hiring them on a Masters fund -- although we think of it much more as partnering with them rather than hiring them.

After we invest with a manager we continuously monitor them to ensure our thesis remains intact. This work is as important as the initial due diligence and involves frequent contact with the manager, listening to quarterly conference calls, reading commentaries, monitoring performance, etc.

Regarding our sell decision, there are a variety of reasons that could lead us to replace a manager. Some reasons are more obvious and would include the departure of key investment-team members. Other reasons could include a clear deviation from the investment process, significant asset growth that limits the opportunity set upon which their successful track record was built, distractions or dilution of focus such as from the introduction of additional products, or a change in broader firm culture that misaligns shareholder and manager incentives. The less obvious reasons get back to us being as specific as possible about what makes a manager exceptional. This speaks to *our* edge. By being clear in our reasons for recommending a manager, we can more easily determine if changes to the process, the team, the firm, etc., erode or reinforce an edge.

As a fund-of-funds, your success depends on your ability to identify, in advance, managers who will outperform the market on a risk-adjusted basis. Many advisors are skeptical of the ability to do this, especially given the academic literature that favors passive management. How do you respond to those concerns?

First, I would make the important point that we are *not* a fund-of-funds, and in some ways this distinction is important to how we are able to add value in selecting managers. As noted in my earlier response, the fund is comprised of managers each running a unique separate account portfolio for us. We select managers where our intensive due diligence identifies a sustainable edge that we believe will enable them to perform better than a passive benchmark over the long term. But in combining managers into a fund we also assess how they fit together as a whole with respect to overall diversification. Having a higher level of overall diversification enables us to give individual managers more room to be opportunistic than they could be in a single-strategy vehicle and invest more in their highest conviction ideas – whether individual securities or areas of the market within their opportunity set. To test this, we can compare the performance of managers running distinct sleeves for us against their broader single-strategy portfolios, such as their own public mutual fund if they have one. And our batting average in selecting managers that beat their own funds is very high, which tells us the Masters structure itself adds value.

That alone won't generate alpha – we still have to get the managers right in the first place. And it has certainly been a tough stretch for active fundamentally-based equity managers since the financial crisis, as huge amounts of monetary stimulus and repressed interest rates have distorted financial markets and asset prices. That said, an area of particular success for us has been on the actively-managed fixed income side. Markets there are more driven by fundamentals in that bonds are more mathematical in how they are priced and with defined maturities. There are also many niche areas within fixed income that are less efficient, and specific strategies that can capitalize on mispricing and relative values across fixed income market segments. We look for managers with strong expertise in their areas of focus that allows them to add value. We want managers who are risk-aware – meaning they won't take on excess risk just to try to meet arbitrary yield or return targets -- but who are also opportunistic and can seek higher returns when conditions are sufficiently compelling.

Our success in selecting managers in less traditional areas of the market is validated by our Alternative Strategies Fund, which has the highest risk-adjusted return since its inception of any fund in its Morningstar Multialternatives category. Our High Income Alternatives Fund draws on similar work to identify managers in non-core and niche areas of fixed income, as well as other less traditional income-generating market segments like option writing, BDCs, MLPs, and mortgage REITs. We have similarly high confidence that we can add value with the High Income Alternatives Fund as we have done with our Alternative Strategies Fund.

Another concern that I often hear from advisors is that liquid alternative funds are vulnerable to a mismatch in liquidity. The fund allows daily redemptions but often the underlying investments don't trade frequently, which can lead to problems in times of stress, especially if the fund faces redemptions. What guidance can you offer to advisors who have this concern?

This is an area we spent a lot of time thinking about and addressing with the sub-advisors on our fund. First and perhaps most importantly, the two credit managers on the High Income Alternatives Fund -- BBH and Guggenheim -- have deep experience, having managed through stress periods like 2008, 2011, and 2015. They are well aware of the potential for certain areas of the credit markets to become less liquid during crises, and factor that into their portfolio and risk management decision making. In general, although BBH and Guggenheim will be relatively concentrated compared to typical fixed income portfolios, their portfolios will still consist of well over 50 positions each, meaning that at the fund level, single positions on average should be under 1%.

Further, the fund's strategy is not to own loans that are extremely thinly traded, or illiquid credit positions in the midst of restructurings, both of which could become nearly impossible to trade in an orderly fashion in a stressed market. The fund does intend to participate in somewhat less-trafficked areas of structured credit that are less efficient than the mainstream ABS sectors (student loans, credit cards, prime auto loans), as well as in high-yield and crossover names (i.e., issuers on the cusp of investment-grade and high-yield) in the corporate credit space. However, there is a wide spectrum of liquidity between Treasuries and truly illiquid positions that trade by appointment only, and the sub-advisors are experienced, sophisticated market participants who understand how to build portfolios that have an appropriate mix of opportunism and liquidity to support the requirements of a 40 Act mutual fund.

The Ares strategy will generally be liquid, with the BDC allocation the limiting factor on how much they can manage without impacting their approach. They have analyzed liquidity based on their expected allocation to BDCs (including other accounts aside from their sleeve of MAHIX), position sizing and the BDC market's size/trading volume, and determined the amount of capital they can manage, which is multiples of their current size.

Neuberger Berman's strategy is highly liquid, consisting of listed index options and short-duration Treasury securities. In a severe stress case, it could even serve as a short-term source of cash for the portfolio since the collateral required against the written options is far less than the 100% (fully collateralized) it will generally hold.

The fund also has access to a $75 million line of credit provided by State Street to help meet short-term redemptions, if necessary. Litman Gregory also regularly reviews the fund's liquidity using reports provided by State Street, the fund's custodian.

As fund families go, you are relatively small, but you've attracted some of the most highly regarded managers in the industry. Your Alternative Strategies Fund has over $2 billion in assets. How have you been able to do this?

In terms of attracting highly-regarded managers for our Masters funds, I think this speaks to the depth and quality of Litman Gregory's due diligence, the patience and discipline with which we execute our investment process, and the structure and environment we have created with the Masters Funds that allows our subadvisors the flexibility to invest in their highest-conviction ideas without detrimental and artificial short-term performance concerns or benchmark-tracking constraints.

I think there are several drivers of our Alternative Strategies Fund's success. There is a strong strategic case to be made for the benefits of adding well-executed alternative strategies to client portfolios beyond traditional stocks and bonds. We launched the fund after several years of researching alternative options in the 40 Act mutual fund space and finding very few high-quality offerings with reasonable fees. So, we decided to build our own all-weather, lower-risk, alternatives fund that could serve as a core alternatives holding in our client balanced portfolios. As you note, we were able to identify and partner with a group of skilled, experienced managers, who are running separate account strategies unique to our fund. The fund's performance has been strong since its inception, it has met its risk and return objectives, and it's a 5-star fund in its Morningstar category. As such, it has attracted a nice base of assets, with shareholders ranging from RIAs, private banks, regional broker-dealers and consultants in the defined contribution/defined benefit areas. And with low expected returns for US stocks and core bonds looking out over the next several years, we think the fund can play a particularly valuable role as part of a traditional balanced portfolio.

Why are diversified income sources important for investors?

The fixed income market has become far more diverse over the last 10+ years, particularly as banks and other lenders have pulled back from areas they had traditionally financed. This has created a huge opportunity for investors to help fill those gaps. Some opportunities require private, longer-duration capital to access, but some, like non-traditional ABS, can be included as part of a more liquid portfolio. Some income investment options like BDCs and mortgage REITs address some of these voids with permanent capital vehicles which are then themselves publicly traded.

We think investors should take advantage of this increased opportunity set for both greater income and potential diversification benefits, rather than be constrained to traditional government, investment-grade corporate, and Agency mortgage bonds, especially now since those sectors are subject to much higher interest rate risk. We believe the opportunities for skilled, active managers to improve returns are meaningful. Additionally, adding a systematic, insurance-like component (collateralized index put-writing) to a diversified income strategy further expands the opportunity set, while increasing liquidity and reducing the dependence on credit markets for yield.

What are your thoughts on the U.S. fixed income market right now, in particular the recent rise in rates? Jeffrey Gundlach of Doubleline, who is one of the managers you use, has firmly stated that the bond bull market is over and that rates bottomed in July of 2016. Do you agree with him?

The 30-plus year secular tailwind of declining rates is over, and so is the bond bull market. Today, traditional core investment-grade bonds trade at historically low yields with historically high levels of interest-rate sensitivity (high duration). Over the next five or so years, we believe this segment of the bond market (represented by the Bloomberg Barclays Aggregate Bond Index) will generate annualized returns in the low 3% range, well below their historical average. With rates expected to increase further, we have been, and continue to be meaningfully underweight to core bonds in our Litman Gregory client balanced portfolios. But importantly, we retain some core bond exposure as we expect them to serve as ballast in the event of a sharp stock market decline.

Regarding below-investment-grade credit sectors such as high-yield bonds and floating-rate loans, we believe we are in the late innings, but wouldn't be surprised if this credit cycle extended a bit farther. In general, fundamentals remain relatively healthy, though risks are increasing. On the positive side, the economy continues to grind ahead (which is good for credit), issuer earnings have been strong, interest coverage is healthy (thanks in part to significant levels of lower-cost refinancing over the past few years), maturity calendars are benign, access to financing is readily available, defaults will remain low over the next year, and valuations are fair though certainly not cheap. On the concerning side, higher rates will put downward pressure on fixed-rate corporate bond prices and raise the cost of future borrowing, and the quality of deals coming to market have been issuer-friendly, i.e., covenant-lite.

Overall, we'd say navigating the fixed-income markets is more challenging today than in the past, offering lower returns with more risk. This is another reason we particularly like the risk-conscious credit managers and strategies we have chosen for our High Income Alternatives Fund.

Where do you see compelling investment opportunities? Where do you see reason for concern?

In the current credit market, we see few *compelling* total return opportunities given valuations and other risks. But we have identified several areas where we believe we will achieve *relatively* attractive mid-single-digit type returns with minimal interest-rate risk. These areas include floating-rate loans and non-traditional segments of the bond market. Specific to floating-rate loans we believe the fundamental backdrop will remain supportive over the near-term. The floating-rate nature of loans will benefit as coupons would reset higher should rates increase. As we mentioned previously, we think fundamentals are healthy overall, but there are some peripheral concerns that we are monitoring. Based on our analysis of the asset class, we expect mid-single-digit returns with a very low duration profile. To gain exposure to the asset class our preference is actively managed funds targeting high current income with a commitment to bottom-up research and a risk-conscious approach.

We also have exposure to non-traditional bonds in our client portfolios. In this category we include structured securities such as collateralized loan obligation (CLOs), asset-backed securities, and non-agency mortgage securities. The total return and yield-duration characteristics of these areas are similar to floating-rate loans. We achieve this exposure via actively managed funds with flexible mandates, including the Litman Gregory Masters High Income Alternatives Fund.

BDCs and MLPs are both currently attractive, according to Ares, trading at valuation discounts to their historical averages and offering well-covered dividend yields in the high-to-very-high single digits.

Moving on to the equity markets, from a medium-term perspective we are concerned about stretched US stock market valuations on top of historically-elevated profit margins and earnings late in the cycle. Our base-case expectation is that the S&P 500 will deliver a very low, if not zero, annualized return over the next five or so years. As such, we are underweighted to US stocks, and we view developed international and emerging-markets stocks as relatively attractive over that time horizon. We also continue to like select alternative investments that we believe can outperform a mix of stocks and core bonds over the remainder of this cycle while also providing portfolio diversification benefits as well.