| DISPERSION IN ALTERNATIVE STRATEGIES

The beginning of 2016 has been a bear for equity markets (almost literally). Given these volatile times, I thought it would make sense to discuss alternatives… not why they should be in a portfolio—that's something we covered early last year—but one of the reasons an allocation to alternatives requires significant time. The differences between alternative funds are significant—even within the same category—and those differences show up in the **dispersion of returns**.

| DISPERSION, DEFINED

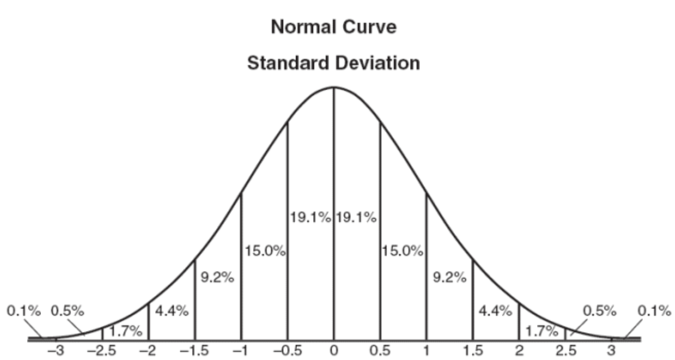
Dispersion in statistics is defined by Merriam-Webster as "the scattering of the values of a frequency distribution from an average." Dispersion, among many things, can tell us how accurately an average can describe one of its members. If, on average, the weather is 60 degrees next weekend but one day is 110 and another day is 10 then that "60" by itself means very little. What clothes would you pack?

That same analogy can be applied to many aspects of life: Casinos generate more consistent profits as they grow because the dispersion of outcomes shrinks; an irregular income stream can make it more difficult to obtain a mortgage; and the line at the DMV at lunchtime (sometimes it's 10 minutes; other times… well, I hope you took the afternoon off).

Dispersion can tell us how accurately the average describes one of its members.

We like to use dispersion to explain many things in the world of investments, and there are lots of ways to explain dispersion. The most commonly known (and widely used) is a Gaussian distribution. Remember this graph?

Figure 1: A "Normal" Gaussian Distribution



Source: Everywhere on the Internet

A normal distribution describes the frequency of a range of outcomes in a random walk. But not all distributions are "normal"…

| NOT ALL ALTERNATIVES ARE CREATED EQUAL

Put simply, using the category average is not a good representation for alternative strategy performance. I've created a chart to best demonstrate the difference between alternative and

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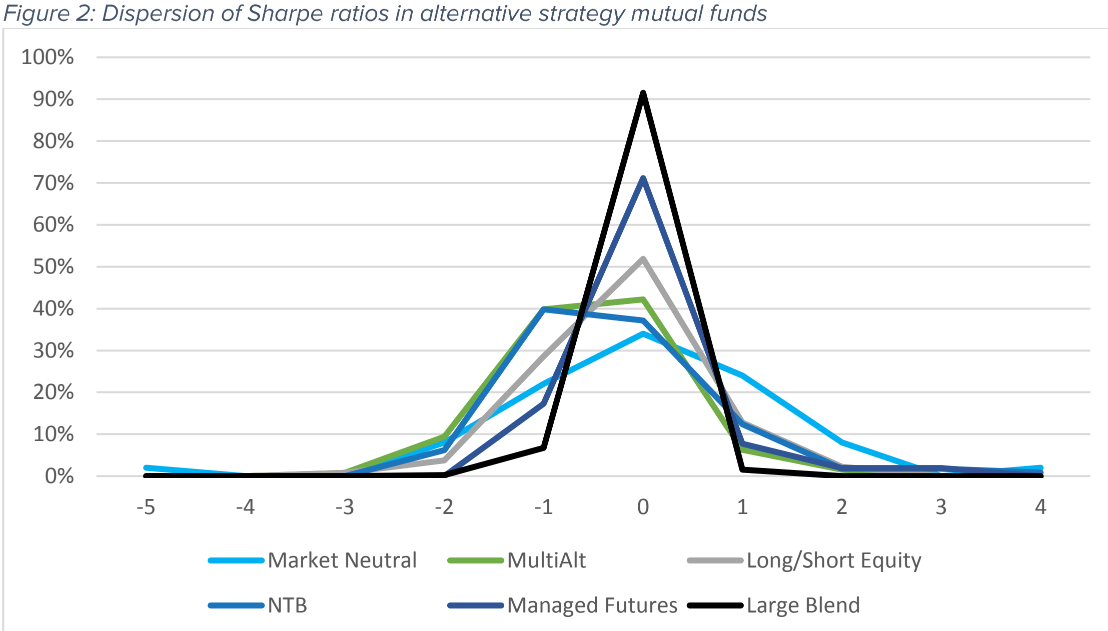
traditional categories, similar to the chart above. I've charted Sharpe ratios[1] for alternative strategy mutual funds in 2015, separated by Morningstar category: Market Neutral, Multialternative, Long/Short Equity, Nontraditional Bond, and Managed Futures. Also included is Large Blend, representative of large-cap US equities.

Using the category average is not a good representation for alternative strategy performance.

Figure 2: Dispersion of Sharpe ratios in alternative strategy mutual funds



Source: AlphaCore Capital, as of 12/31/2015

Figure 2 should help to reveal two observations almost immediately:

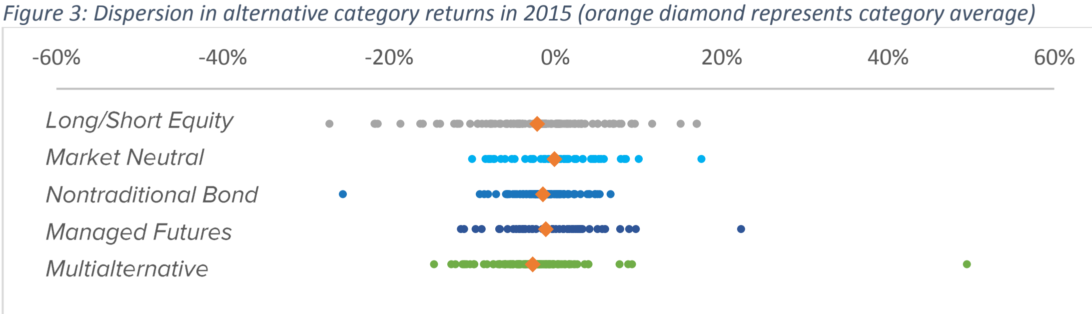
1) Large Blend (the black line) is a tight distribution, meaning the average Large Blend return does a good job of describing a fund within the category. Conversely:

Alternative funds are very different from one another—even when they are in the same category!

2) Alternative strategy funds have wide distributions of returns, meaning the average does not do a good job of describing a fund's return. In fact, alternative strategy funds are very different from one another *even when they are in the same category.*

Given the second observation, I think a caveat emptor is appropriate—because of the dispersion, I humbly suggest the alternative strategy space is best accessed by an expert.

Figure 3: Dispersion in alternative category returns in 2015 (orange diamond represents category average)



Source: AlphaCore Capital, as of 12/31/2015

[1] A fund's Sharpe ratio is equal to return/risk, where the risk is the fund's annualized volatility for the year.

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Digging into the data a little, Sharpe ratios varied quite considerably for the year in alternative strategy funds, ranging from -7.2 to 3.8—a range of 11—conversely, Large Blend managers had Sharpe ratios between -1.8 and 0.6—a range of just 2.2!

Figure 3 is yet another way of looking at the disparate returns of alternative strategies in 2015. I've taken those same category fund returns above and plotted the funds individually in the chart below. Orange diamonds are the category's return for the year. While the averages on their own look unimpressive, remember: High dispersion makes the average less relevant.

| TRADING MARKET RISK FOR MANAGER RISK

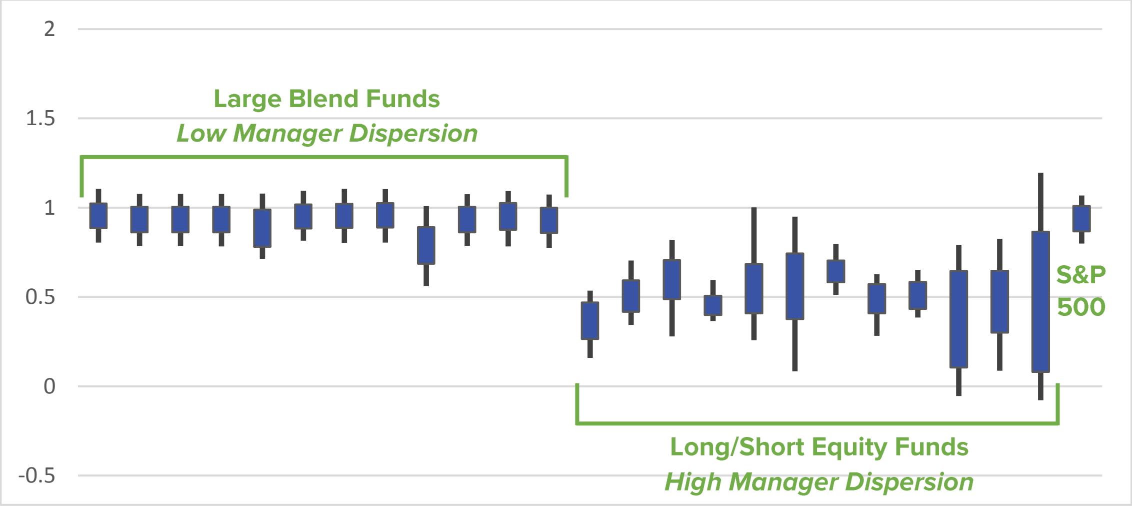
Lack of understanding almost always leads to poor decision-making. It is very possible an investor has a bad experience with a good fund.

So why is the dispersion in alternatives strategies funds between two to four times greater than in most traditional strategies?[2] Is it because most alternative strategy mutual funds invest in strange and illiquid instruments or take on obscene amounts of leverage? Absolutely not! Instead, it is the inherent flexibility in many of these strategies that causes the dispersion... and flexibility comes at a cost. Often times, when describing an allocation to alternative strategies, we liken it to "trading market risk for manager risk." In that sense, we believe "how & why" a manager is successful (or underperforms) is the most important part of the manager selection process. To understand the drivers of an alternative strategy is crucial because every strategy underperforms at some point, and a lack of understanding almost guarantees an investor will sell at the wrong time. Put another way, **it's very possible an investor has a bad experience with a good fund.**

Below is a chart that shows the range of exposure to global equities for the largest Large Blend and Long/Short Equity mutual funds with at least a three year track record. While Large Blend funds lack differentiation, certain long/short equity managers have significant flexibility.

Long/short equity managers have significant flexibility

Figure 4: Global Equity Beta Range of Large Blend and Long/Short Equity Mutual Funds



(Source: AlphaCore Capital, as of 12/31/2015. The blue bars represent the fund's beta[3] to global equities 70% of the time; the black lines represent the fund's beta to global equities the rest of the time.)

[2] Source: AlphaCore Capital, as of 12/31/2015

[3] Beta is a measure of exposure to a particular risk factor. For example, a fund with a beta of 0.5 to the S&P 500 should rise 5% if the S&P rises 10%, and should fall 5% if the S&P 500 falls 10%.

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When managers maintain different amounts of equity exposure, they carry different return streams. Finally, we perform this type of analysis not just on equities, but also around other investable (and non-investable) factors like value, momentum, duration, volatility, inflation, commodities… 15 factors in total and more than can be covered in a short article. We encourage you to reach out to us and learn more about our manager selection and portfolio construction process.

All the best,

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All investments involve risks, including possible loss of principal. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions.

Alternative investments may not be suitable for all investors and only suitable for investors who can bear the risks associated with the illiquidity of fund investments and should be viewed as long-term investments.

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