FINANCIAL ADVISOR
FA

PORTFOLIO SPOTLIGHT


Jeremy DeGroot

Litman Gregory Masters Alternative Strategies Fund

TICKER	MASFX			
ASSETS	$1.8 billion			
PERFORMANCE	YTD **1.68%**	1 yr. **6.75%**	3 yr. **3.15%**	5 yr. **4.48%**

As of 4/30/17. Three-year and five-year figures are annualized. Source: Morningstar

SUB-ADVISORY FIRMS	DoubleLine, FPA, Loomis Sayles, Passport Capital, Water Island Capital
CONTACT INFO	925-254-8999; mastersfunds.com

TARGET ALLOCATION & SUB-ADVISORS

Opportunistic Income *Jeffrey Gundlach, DoubleLine*	**25%**
Contrarian Opportunity *Steven Romick & Team, FPA*	**20%**
Absolute Return Fixed Income *Matt Eagan & Team, Loomis Sayles*	**25%**
Long-Short Equity *John Burbank, Passport Capital*	**10%**
Arbitrage and Event-Driven *John Orrico & Team, Water Island Cap.*	**20%**

As of 3/31/2017.
Source: Litman Gregory

Alternative Strategies, Multiple Managers

This Litman Gregory fund has managed to rise above the competition. **By Marla Brill**

ALTERNATIVE STRATEGY MUTUAL funds, which focus on long/short, market neutral, option writing, merger arbitrage and other non-traditional strategies, have been swimming upstream lately. After taking in over $13 billion in 2015, the funds saw outflows of $4.7 billion in 2016, marking the worst showing for the group since 2005. It was the beginning of a pattern that has extended into this year.

Returns for the group are usually pretty modest next to those of stock funds; investors need to be willing to accept that trait as a trade-off for low stock market correlation and low volatility. But even those grounded investors with realistic expectations must have been disappointed by the three-year annualized returns of less than 1% for the average fund in Morningstar's multi-alternatives category.

Still, the Litman Gregory Masters Alternative Strategies Fund has managed to rise above the competition. A $10,000 investment in the fund at its inception in September 2011 would have grown to $13,389 by April 2017, while the average multi-alternative fund would have grown to only $10,908 over the same period. Moreover, the fund's Sharpe ratio, a measure of risk-adjusted returns, was also significantly higher and Morningstar has awarded it five stars.

Litman Gregory chief investment officer Jeremy DeGroot emphasizes that blazing performance in bull markets isn't the goal here. Instead, the fund looks to build solid long-term performance with a lower-risk alternatives portfolio that holds up well in equity bear markets and has a relatively low correlation and beta to stocks and bonds.

The fund is set apart by a team of five sub-advisors—it doesn't rely on a single shop. DeGroot, along with a handful of researchers and due diligence analysts, is responsible for selecting and monitoring those sub-advisors and determining how much of the fund pie they will manage.

The firm's decision to use multiple sub-advisors came about when a search for an alternative strategies fund yielded what DeGroot and others at the firm considered a subpar field of candidates with shallow track records, mediocre sub-advisors and high fees. "We wanted to construct the fund with highly skilled, proven managers that have demonstrated strong risk management skills first and foremost, because a main objective of this fund is lower volatility," says DeGroot.

Because the sub-advisors the fund eventually selected all had extensive track records that showed off their strengths and weaknesses under various market conditions, DeGroot could extrapolate how they might play off one another. "We need to understand what drove past performance and why they made mistakes," he says. "At the end of the day, we have to feel very confident that the sub-advisor has an edge that is understandable and sustainable."

Another distinguishing feature of the fund is its somewhat unorthodox definition of "alternative." Litman Gregory chose to tap advisors from a variety of complementary disciplines whose returns have a low correlation with one another. "We didn't want to fill in a pie chart by throwing together a bunch of managers who specialize in what most people consider the usual alternative strategies," he says.

Some of the sub-advisors, such as FPA Funds, are known to the public mostly for more traditional stock investing through their mutual funds. Others, including hedge fund firm Passport Capital, fall squarely in the alternatives camp. For the Litman Gregory fund, each firm runs a concentrated version of its strategy with its best ideas. The fund's low volatility is evidence that over the years the sub-advisors have done a good job of balancing one another out.

Still, a couple of metrics are unusual. One is that the fund has a 0.79 correlation to stocks, which is well above its target. DeGroot points out that since the financial crisis in 2008, correlations among various asset classes have risen, and he expects them to vary over time. The fact that U.S. stocks had much higher returns than other asset classes, and that some sub-advisors might have tailored their strategies accordingly, probably explains the higher-than-expected correlation with stocks. He points out, however, that the fund has fallen only about one-fifth as much as the stock market during downturns and is much less volatile.

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Given that two of the fund's sub-advisors are fixed-income specialists, its slightly negative correlation to bonds also comes as something of a surprise. "The sub-advisors take a flexible approach to managing credit risk, currency risk and portfolio duration," DeGroot explains. "So we expect their performance to be quite different than the investment-grade bond market."

The five sub-advisors include some of the most recognizable names in the fund industry, as well as a couple of lesser-known managers. All of them have a free hand to change their tactics and exposure, depending on where they see the best opportunities and greatest risks.

DoubleLine Capital's Jeffrey Gundlach runs the opportunistic income strategy, which has a target allocation of 25%. It is very similar to a successful private partnership strategy that he has managed for the past 25 years, first at TCW and now at DoubleLine.

Gundlach aims for much higher returns here than he does in his well-known total return bond mutual fund strategy, and with somewhat higher risk. He is free to invest in asset-backed securities, domestic and foreign investment-grade corporate bonds, high-yield corporate bonds, municipal bonds, emerging market bonds and mortgage-related securities. Mortgage-based securities, where DoubleLine has a particular expertise, are by far the biggest component of this sleeve of the portfolio. Its duration is flexible, and a modest amount of leverage is allowed.

FPA's Steven Romick, Brian Selmo and Mark Landecker manage 20% of the fund with their contrarian opportunity strategy. (The team also oversees the FPA Crescent Fund and a hedge fund strategy.) The team includes veteran bargain hunters. They seek out companies whose short-term problems belie the fact that they have solid balance sheets and great management. The managers might also seek out lesser-quality companies with strong long-term upside potential.

But the FPA group is also willing to move to cash if conditions warrant and may short stocks, sell options or own less liquid investments such as real estate loans. "Romick and his team are not going

Risk

Annualized Standard Deviation	**3.28**
Sharpe Ratio (Annualized)	**1.59**
Beta To Russell 1000	**0.25**
Correlation To Russell 1000	**0.79**
Upside Capture Vs. Russell 1000	**31.45**
Downside Capture Vs. Russell 1000	**27.64**

Since inception 9/30/2011.
As of 3/31/2017. Source: Litman Gregory

Purchase/Expense

Minimum Investment	**$100,000***
Sales Load	**None**
12b-1 Fees	**None**
Net Expense Ratio	**1.47%**

*$5,000 retirement accounts.
As of 3/31/2017. Source: Litman Gregory

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to take on a lot of risk unless they are extremely confident they can earn an equity-like return," says DeGroot.

The Loomis Sayles team of Matt Eagan, Kevin Kearns and Todd Vandam run another 25% of the fund, which is devoted to absolute return, or "strategic alpha" fixed income. Instead of being managed relative to an index, this portion of the portfolio is designed to achieve positive total returns with relatively low volatility over a full market cycle.

To do that, the managers identify the key short- and longer-term macroeconomic themes behind the portfolio's interest rate, currency and credit strategies. They pair the broad view with fundamental analysis of individual securities, which can include investment-grade and below-investment-grade bonds spanning the global fixed-income universe, as well as preferred securities. Derivatives such as currency-forward contracts and interest rate futures help hedge out risk.

Passport Capital's John Burbank pursues a long/short equity strategy for a targeted 10% of the portfolio. The San Francisco-based hedge fund firm, which Burbank founded in 2000, relies on identifying key shifts in economic and political trends to home in on secular changes that could either help or hurt stock prices. Quantitative tools and bottom up stock picking round out the investment arsenal, which can include equity derivatives, private companies and swap contracts. The goal here is to produce low double-digit returns over a full market cycle with low volatility.

Manager
Jeremy DeGroot

Age
53

Education
Bachelor's degree, University of Wisconsin, Madison; Master's Degree, University of California Berkeley

Professional Background
Economic consulting services manager, KPMG Peat Marwick; senior economist, Law & Economics Consulting Group. Joined Litman Gregory in 1999 and became a principal in 2003.

Outside Interests
Spending time with family, listening to music.

Water Island Capital's John Orrico, Todd Munn, Roger Foltynowicz and Gregg Loprete manage another 20% of the fund with an arbitrage strategy, which looks at the stocks and bonds of companies undergoing such transitions as mergers, acquisitions, restructurings and reorganizations. Merger arbitrage, the primary focus of this portion of the portfolio, involves profiting from the difference between the lower price of a target company when a merger is announced and the higher price it enjoys after the deal is completed. The spread occurs because investors demand compensation for the risk that the deal may fail to close and for the time it takes to complete the merger. Return expectations for the strategy are in the mid- to upper-single digits.

Even with an all-star cast, an alternatives fund might seem like a difficult sell when the stock market hasn't experienced a prolonged downturn since 2008. However, the fund has seen a steady flow of new investors over the last year and is considered one of the most successful liquid alternative funds out there. Perhaps, DeGroot speculates, they are keeping an eye out for the day when the stock market finally runs out of steam and bond prices fall.

"With bond yields even lower than they were five years ago and stocks quite overvalued in our view, we believe the fund is very well positioned to add value," he says. "Going forward, there are plenty of reasons to look beyond the standard asset classes." FA