Investment Guidance on Alternative Funds

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After the market's crash in 2008, many investors turned to alternative funds as a way to protect their capital in the event of another downturn. Although these investments can be used to further diversify and protect investors, their wide range of non-traditional investments and complex trading strategies may not be suitable for all clients.

In 2013 FINRA released an 'Investor Alert' concerning what advisors and clients should know about funds focused on alternative investment strategies. Although these funds are publicly offered and SEC-registered, they differ from the more traditional strategies predominant in the mutual fund industry.

What are Alternative Funds?

Alternative funds (mutual funds, exchange traded funds and closed-end funds) encompass a wide range of investments with each containing its own set of systematic and unsystematic risks. As their name implies, alternative funds seek to accomplish various investment objectives through non-traditional investments and trading strategies. Alternative funds can invest in asset classes such as global real estate, commodities and leveraged loans. They may also invest in start-up companies and unlisted securities that offer exposure beyond traditional stocks, bonds and cash.

Some alternative funds also implement more complex trading strategies, hedging and leveraging positions through derivatives, short selling and "opportunistic" strategies that change with market conditions as various opportunities present themselves. Some funds employ a 'single strategy' offering full exposure to one investment type, for example currencies or distressed bonds, market-neutral or "absolute return" strategies using long and short positions in stocks to generate returns. Other funds may employ a 'multi-strategy' approach, combining market-neutral strategies and various arbitrage strategies. Still others are structured as a mutual fund of hedge funds with higher fees and expenses.

The primary objectives of these funds can be quite different. Some attempt to generate above-market returns and others attempt to help investors better manage risk with strategies designed to smooth out volatility or offer greater diversification.

Alternative Funds are not Hedge Funds

Although the strategies and investments used in alternative funds may be similar to hedge funds, the two should *not* be confused. Alternative funds are regulated under the Investment Company Act of 1940, which limits their operations in ways that do not apply to unregistered hedge funds. These protections include:

- limits on illiquid investments;
- limits on leveraging;
- diversification requirements, including limits on how much may be invested in any one issuer;
- daily pricing and redeemability of fund shares;
- investment advisers to mutual funds are not permitted to charge a performance fee (typically referred to as a "2/20 fee", equaling 2 percent of the hedge fund's assets, plus 20 percent of gains).

Alternative Funds have Unique Risks

Like any investment, alternative funds have their pros and cons. Before you invest in an alternative fund, here are some points to keep in mind:

- **Investment Structure**
  Be advised that an alternative 'fund of funds' structure may offer greater diversification than a single-strategy or even multi-strategy alternative fund. At the same time, this greater diversification may lead to reduced returns or less transparency. There may also be an inability to re-allocate or adapt in a way that is beneficial to the overall performance of a particular fund of funds.

- **Strategy Risk Factors**
  In addition to the usual market and investment specific risks a typical mutual fund has, alternative funds can carry unique risks. For example, market-neutral funds tend to have significant portfolio turnover risk that can result in higher costs. Similarly, a distressed bond fund is likely to have significant credit risk.

- **Investment Objectives**
  Alternative funds have a wide range of investment goals. Be sure to understand your selected fund's objectives. One fund might be designed to capitalize on management expertise in a specific area, for example distressed companies. Another might seek to provide what the fund's managers believe to be more complete diversification through exposure to commodities, currencies and other alternative investments.

- **Operating Expenses**
  Alternative funds can be pricey relative to their traditional managed fund peers. It is common for alternative funds to have annual operating expenses well above industry averages for traditional equity funds.

- **Fund Manager**
  Learn as much as you can about the fund manager, such as how long he or she has managed the fund and any additional fund management or professional experience. A fund manager's professional background can be found using FINRA BrokerCheck®, which is accessible at http://www.finra.org/Investors/ToolsCalculators/BrokerCheck.

- **Performance History**
  Many alternative funds have limited performance histories. A fair number were launched after 2008, so it is not known how they will perform in a down market. They may underperform broad indexes such as the S&P 500 — particularly after considering expenses. And like all investments, performance will fluctuate.

In conclusion, clients should take caution and weigh all of the unique risks associated with an investment in alternative funds. If it is determined that certain strategies are suitable, take care to use them in a prudent manner and within a properly diversified asset allocation strategy. If you have any questions regarding Alternative Funds, please contact your Oppenheimer Financial Advisor.

The Standard & Poor's (S&P) 500 Index is an unmanaged index that tracks the performance of 500 widely-held large-capitalization U.S. stocks. Individuals cannot invest directly in an index.

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Keep in mind that diversification does not guarantee a profit or protect against a loss.

Investing in securities is speculative and entails risk. There can be no assurance that the investment objectives will be achieved or that an investment strategy will be successful. **Investors must carefully consider an investment company's investment objectives, risks, charges and expenses of the investment before investing. This and other information, including a description of the different share classes and their different fee structures, are contained in a fund's prospectus. You may obtain a prospectus from your Oppenheimer Financial Advisor. Please read the prospectus carefully before investing.**