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Alternative Funds Are Not Your Typical Mutual Funds

Alternative or "alt" mutual funds are publicly offered, SEC-registered funds that use investment strategies that differ from the buy-and-hold strategy typical in the mutual fund industry. Compared to a traditional mutual fund, an alternative fund typically holds more non-traditional investments and employs more complex trading strategies. Investors considering alternative mutual funds should be aware of their unique characteristics and risks.

What Are Alternative Funds?

As their name implies, alternative mutual funds seek to accomplish the fund's objectives through non-traditional investments and trading strategies. Alt funds might invest in assets such as global real estate, commodities, leveraged loans, start-up companies and unlisted securities that offer exposure beyond traditional stocks, bonds and cash.

The strategies alternative mutual funds employ tend to fall on the complex end of the spectrum. Examples include hedging and leveraging through derivatives, short selling and "opportunistic" strategies that change with market conditions as various opportunities present themselves. Some alt funds employ a single strategy (single-strategy funds). For instance, they may offer 100 percent exposure to currencies or distressed bonds, or employ a market-neutral or "absolute return" strategy that uses long and short positions in stocks to generate returns. Others may employ multiple strategies (multi-strategy funds) such as a combination of market-neutral strategies and various arbitrage strategies. Still others are structured as a fund containing numerous alternative funds, a special type of "[fund of hedge funds](#)."

In some cases, the fund's primary objective is to generate above-market returns. In other cases, a fund's main goal is to help investors better manage risk with strategies designed to smooth out volatility or offer greater diversification.

How Do Alt Funds Compare with Hedge Funds?

Although the strategies and investments of alt funds may bring to mind those of hedge funds, the two should not be confused. Alternative mutual 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; and
- daily pricing and redeemability of fund shares.

Furthermore, investment advisers to mutual funds, including alternative funds, are not allowed to charge investors a "2/20" performance fee for advising the fund, as their private hedge fund adviser peers can. Hedge fund advisers often charge a fee equal to 2 percent of the fund's assets, plus 20 percent of gains that the fund produces during a given period.

Before You Invest

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

- **Investment Structure:** An alternative fund of funds may offer greater diversification than a single-strategy or even multi-strategy alt fund. At the same time, this greater diversification may lead to a flattening of return and potentially 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 mutual funds have, alt funds carry additional risks from the strategies they use. 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:** One fund might be designed to capitalize on management expertise in a specific area (investing in distressed companies, for instance). 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 mutual funds can be pricey relative to their traditional managed fund peers. It is common for alt funds to have annual operating expenses of around 1.5 percent per year, and some funds are considerably more expensive.
- **Fund Manager:** Learn as much as you can about the fund manager, such as how long has he or she managed the fund and additional fund management or professional experience. Research the professional background of a fund manager using [FINRA BrokerCheck](#).
- **Performance History:** Many alternative funds have limited performance histories. For example, 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. Like all investments, performance will fluctuate. You can lose money.

So do your homework and comparison shop. There may be other investment options to alt mutual funds that that are less complicated and cost less, but still help you accomplish your financial objectives.

Additional Resources

- FINRA Alert, [Funds of Hedge Funds—Higher Costs and Risks for Higher Potential Returns](#)
- Investment Company Institute, [The Differences Between Mutual Funds and Hedge Funds](#)
- Securities and Exchange Commission, [Invest Wisely: Mutual Funds](#)

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