

# Alternative mutual funds – Long/short equity

*Northwestern Mutual Wealth Management Company (NMWMC) periodically prepares information for its clients on a variety of securities-related topics. This document is meant to provide clients with important information about long/short equity alternative mutual funds. This material is not intended as an endorsement or recommendation of any particular investment or security.*

## Long/short equity alternative mutual funds

A “mutual fund” is a company that pools money from many investors and invests the combined holdings in a single portfolio of securities that is professionally managed. To manage risk, the fund’s manager attempts to diversify the fund’s investments according to the fund’s investment objective. Individual investors own shares of the fund, while the fund or the investment company owns the underlying investments chosen by the manager.

Many mutual funds are actively managed, meaning that fund managers may purchase or sell securities in the fund portfolio in an attempt to take advantage of changing market conditions.

Alternative mutual funds (often referred to as liquid alternatives) aim to provide differentiated exposure to traditional asset classes, such as equities, credit, and interest rates. While the underlying asset classes may be similar, the way these exposures are implemented can differ meaningfully. A key distinction is that many alternative strategies both buy (go long) and sell short securities. Unlike traditional investments, which generally benefit when prices rise, short positions increase in value when the price of the underlying security declines. Additionally, some managers use derivatives or options to adjust portfolio exposures or manage risk. As a result, alternative funds often have different return drivers than traditional strategies and may have lower correlation and beta relative to broad markets. In turn, they can help reduce overall portfolio risk through diversification and potentially improve risk-adjusted returns, particularly during periods of market stress.

Because of the strategies employed and the risks associated with them, alternative mutual funds are subject to certain regulatory constraints, including limits on illiquid investments, leverage, and diversification. Compared to hedge funds and other private investment vehicles, alternative mutual funds typically offer greater liquidity and transparency, as well as lower fees. However, they may still carry higher fees than traditional mutual funds.

One of the more popular liquid alternative strategies is long/short equity. As the name implies, these funds take long positions in securities expected to increase in price and short positions in those expected to decline. Most long/short managers maintain a net long market exposure, meaning that the risk from long positions is not fully offset by the short positions. As a result, returns are typically driven by a combination of overall market exposure (beta) and the manager’s ability to add value through security selection and timing (alpha). Long/short strategies can generate gains from both long and short positions.

Because long/short equity funds typically maintain less than full market exposure, they are generally expected to lag traditional equities in strong up markets but may outperform in down markets and have lower overall volatility. That said, they may still experience meaningful losses during broad market declines, particularly when net exposure is elevated.

Long/short equity strategies can be differentiated in a variety of ways, including sector focus, investment philosophy, or geographic exposure. They can also differ in how short positions are used. In some strategies, short positions are intended to generate additional returns (alpha). In others, they are primarily used to hedge long positions and reduce overall market exposure.

## Risks

The risks associated with long/short equity alternative mutual funds may vary significantly from one fund to another. As a result, it is important to have a complete understanding of the investment strategies and underlying products or index from which a mutual fund derives its value to evaluate the risks. These risks are outlined in full in the prospectus and/or statement of additional information. No investment strategy can guarantee a profit or protect against loss, including loss of principal.

**Currency** | The risk that fluctuations or changes in the exchange rates between different currencies held in a mutual fund may negatively impact an investment. A fund may be subject to currency risk because it has invested assets in currency-related investments and may invest in securities or other instruments denominated in or receive revenues in foreign currencies.

**Derivatives** | Derivatives, such as options, swaps, futures and forward contracts, are investments whose value depends on (or is derived from) the value of an underlying instrument, such as a security, asset, reference rate or index. Derivative strategies often involve leverage, which may exaggerate a loss, potentially causing the fund to lose more money than it would have lost had it invested in the underlying instrument. Derivatives may be difficult to sell, unwind or value. Swap transactions tend to shift the fund's investment exposure from one type of investment to another and therefore entail the risk that a party will default on its payment obligations to the fund.

**Counterparty** | The risk that the counterparty (the party on the other side of the transaction) on a derivative transaction will be unable to honor its contractual obligations to the fund.

**Inflation/deflation** | Inflation risk is the risk that the value of assets or income from investments will be worth less in the future as inflation decreases the present value of future payments. Deflation risk is the risk that prices throughout the economy decline over time (opposite of inflation).

**Liquidity** | A mutual fund may not hold more than 15% of its net assets in illiquid investments so a fund can be prepared to return shareholder money within seven days of the redemption request. An illiquid investment is one that cannot be disposed of within seven days in the ordinary course of business at approximately the amount at which the fund has valued the investment. Many derivatives are tailored by fund managers to serve a specific purpose in each portfolio, so they may be difficult to sell, unwind or value and therefore may be deemed illiquid.

**Leverage** | Leverage is the use of borrowed funds to purchase securities with the belief that the income from the security or price appreciation of the security will be more than the cost of borrowing. Leverage magnifies profits when the returns from the underlying asset more than offset the cost of borrowing. On the flip side, leverage also magnifies losses when the returns from the underlying asset are less than the cost of borrowing.

**Market** | The risk that the overall market will decline bringing down the value of the investments held by the mutual fund and, in turn, the mutual fund's value. This may result from increasing/decreasing interest rates, a recession or changes in the rate of inflation, each of which can impact the financial markets.

**Short selling** | Short selling is the sale of a security that is not owned by the seller or that the seller has borrowed. Short selling is a belief that a security's price will decline in value, enabling the seller to purchase the security back at a lower price, thereby making a profit. When a security sold short increases in price, the fund may have to cover its short position at a higher price than the short sale price, resulting in a loss. The fund may have substantial short positions and must borrow those securities to make delivery to the buyer. In turn, the fund may not be able to borrow a security that it needs to deliver, or it may not be able to close out a short position at an acceptable price and may have to sell related long positions before it had intended to do so. Thus, the fund may not be able to successfully implement its short-sale strategy due to limited availability of desired securities or for other reasons. The fund also may be required to pay a premium and other transaction costs, which would increase the cost of the security sold short. The amount of any gain will be decreased, and the amount of any loss increased, by the amount of the premium, dividends, interest or expenses the fund may be required to pay in connection with the short sale.

**Tax** | The fund's investments and investment strategies may include transactions in options and futures contracts and may be subject to special and complex federal income tax provisions, the effect of which may be: (1) to disallow, suspend, defer or otherwise limit the allowance of certain losses or deductions; (2) to accelerate income to the fund; (3) to convert long-term capital gain, which is currently subject to lower tax rates, into short-term capital gain or ordinary income, which are currently subject to higher tax rates; (4) to convert an ordinary loss or a deduction into a capital loss (the deductibility of which is more limited); (5) to treat dividends that would otherwise constitute qualified dividend income as non-qualified dividend income; (6) to produce income that will not qualify as good income under the gross income requirements that must be met for the fund to qualify as a regulated investment company (an "RIC") under Subchapter M of the Internal Revenue Code of 1986, as amended (the "Code"). Furthermore, to the extent that any futures contract or option on a futures contract held by the fund is a "section 1256 contract" under Section 1256 of the Code, the contract will be marked to market annually, and any gain or loss will be treated as 60% long-term and 40% short-term, regardless of the holding period for such contract. Section 1256 contracts may include fund transactions involving call options on a broad-based securities index, certain futures contracts and other financial contracts.

**Valuation** | A mutual fund must calculate its net asset value on a daily basis at readily available market prices. The value of securities like exchange-traded futures and options can be determined by simply looking the price up on the relevant exchanges at the end of each day. However, if market prices are not available for a security, such as a derivative or thinly traded bond, the fund's board of directors must make a good-faith determination of the "fair value" of the security. OTC derivatives are often valued by using dealer quotes or by modeling the performance (or underlying inputs) of the derivative. Dealer models and quotes are less accurate than market-based quotes and present conflicts of interest for the parties involved.

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