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Hedge fund replication and liquid alternatives.

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Hedge funds are appealing to institutional and accredited investors because they have the potential to deliver differentiated investment returns, but they are often expensive, illiquid (cannot be bought and sold as easily as more traditional investments) and opaque (it can be difficult to get precise information about the underlying investments). Hedge fund replications strategies seek to deliver investment returns that are comparable to hedge fund returns while providing greater liquidity, transparency, and lower costs, thus making hedge fund-like strategies available to retail investors.

Hedge fund returns and liquid alternatives.

How then does a retail investor access hedge fund-like returns? The answer: by way of liquid alternatives or "liquid alts." Liquid alts are unique in that they provide investors with access to diversified investment strategies that are intended to behave differently than long-term investments in stocks or bonds. There are various approaches that a liquid alts fund manager may take to achieve this goal, such as shorting stocks or trading futures (amongst others). The manager may even employ more than one strategy to achieve its investment objective. Until recently, alternative strategies were available only through private investment vehicles such as hedge funds and were reserved for qualified institutions or ultra-high-net-worth individuals. Now, the expansion of liquid alternative funds allows retail investors access to alternative-type strategies in a regulated mutual fund format. Put simply, liquid alternatives offer retail investors the investing benefits of an alternative strategy with daily liquidity.

What is hedge fund replication?

Hedge fund returns can be segregated into dynamic broad market exposures and security selection. We distinguish between two types of dynamic exposures: strategic market exposures and tactical market exposures. Strategic market exposures reflect how much beta or systematic risk is carried in a portfolio across multiple asset classes. They are slow moving and play out over the longer term, anywhere from six months to two years. Conversely, tactical market exposures are fast-moving and typically fluctuate over the short term (two to six weeks). Both types of dynamic market exposures can be estimated via a quantitative model by observing historical hedge fund returns and replicated by using futures and other liquid investment instruments. Exhibit 1 highlights the various types of returns.

By definition, the security selection component of returns cannot be replicated. This is arguably the most valuable component of hedge fund returns and for those funds that generate high returns from security selection, replication is no substitute. However, for many hedge funds, returns from dynamic market exposures dominate (especially after deducting fees) and replication can capture a large portion of their returns.

Exhibit 1: Composition of hedge fund returns

Dynamic Market Exposures		Security Selection
Strategic market exposure	Tactical market exposures	Idiosyncratic opportunities
Slow moving (6-24 months)	Fast moving (2 weeks to 6 months)	Captured by individual managers
• Equities vs bonds • U.S. vs international • Growth vs value • Large capitalization vs small capitalization	• Bonds long/short • FX long/short • Equity indices long/short • Commodities long/short	• Long shares (or bonds) in company A vs. short shares (or bonds) of company B

Source: SEI. For illustrative purposes only.

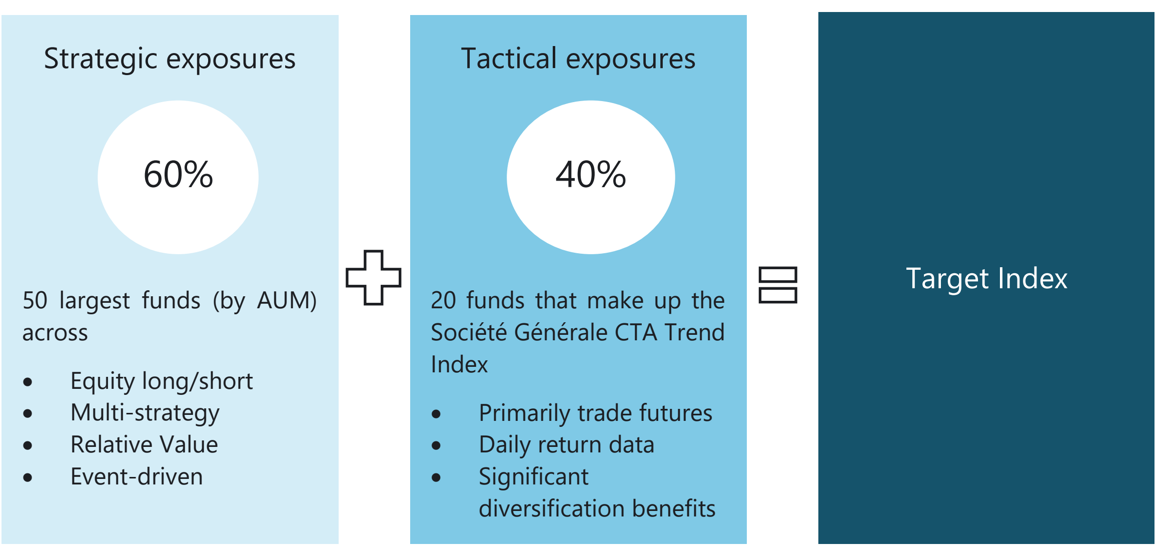
What is the target index for replication?

The exact target for replication is a matter of choice. The following describes SEI's choice of a target index.

Funds included in the replication target index fall into two categories, shown in Exhibit 2. The first group consists of the 50 largest hedge funds by assets, which report returns across four distinct strategies: equity long/short, multi-strategy, relative value, and event driven. These tend to be run by recognizable firms with decades of professional investment management experience. By virtue of their size, they also arguably reflect the investment experience of many hedge fund investors. Their replicable returns tend to be dominated by the slower moving strategic market exposure described above. They have a 60% weight in the bespoke target index.

The second component of the target index (40% weight) reflects the faster-moving, tactical market exposures. This component consists of the 20 funds in the Société Générale CTA Index[1]. These 20 funds primarily trade futures typically using a quantitative investment model and tend to shift exposures across relatively short time horizons. These strategies do not generate returns from security selection and are therefore particularly well suited to replication. They also have unique diversification benefits because they tend to do well in difficult market environments. Together, these 70 underlying funds become SEI's target index.

Exhibit 2: Target hedge fund index for replication



Source: SEI. For illustrative purposes only.

[1] The Société Générale (SG) CTA Trend Index provides the market with a reliable daily performance benchmark of major commodity trading advisors (CTAs). The SG Trend CTA Index calculates the daily rate of return for a pool of CTAs selected from the larger managers that are open to new investment.

The history of SEI's liquid alternatives strategy.

SEI's liquid alternatives strategy had relatively modest beginnings: in 2015 it was launched in the U.K. in a UCITS[2] format and offered to existing clients. In 2018, we began to offer the strategy to non-SEI clients as a standalone product. Interest for the strategy gained momentum starting in the early 2020s, with strategy assets reaching close to a billion dollars at the end of 2023. A U.S.-based 40-act fund was launched in 2023, while a Canadian fund was added in 2024.

Exhibit 3: The story so far

Source: SEI. For illustrative purposes only.

Why liquid alternatives?

We see several reasons why investors may be interested in a liquid alternatives strategy. First, the strategy is highly liquid and transparent: it is composed primarily of exchange-listed futures and cash. As such, this type of strategy is accessible to retail investors. Second, fees are transparent and competitive. Last, the strategy serves to provide diversification benefits: it can take both long and short positions and thus, potentially benefit from rising and falling prices.

[2] Undertakings for the Collective Investment in Transferable Securities. It is a European Union regulatory framework that allows for the sale of cross-boundary pooled funds. UCITS were created so that retail investors have transparent, regulated, and cross-border investment opportunities.

Important information

SEI Investments Canada Company, a wholly owned subsidiary of SEI Investments Company, is the Manager of the SEI Funds in Canada.

The fund is an alternative mutual fund and is permitted to invest in asset classes and use investment strategies that are not permitted for other types of mutual funds. The fund uses derivatives and in turn leverage to a greater degree than a traditional mutual fund. As a result, the risks associated with derivatives and leverage are amplified, and therefore the fund may have a heightened risk of investment loss as compared to a traditional mutual fund.

The fund seeks to provide long-term capital appreciation by implementing a strategy that seeks to approximate the returns of a model portfolio of funds that employ alternative investment strategies. The fund will take long and short positions in investments that provide broad exposure to the global equity, fixed income, and currency markets. The fund will invest primarily in exchange-traded derivative instruments, including futures, options, and swaps, but to a lesser extent may invest in derivative instruments that are traded over-the-counter, such as forwards. The fund primarily will hold cash and/ or invest in money market instruments to collateralize its derivative positions. Additionally, the fund may invest from time to time in shares of exchange-traded funds (ETFs), such as U.S. or non-U.S. corporate bond ETFs. Leverage may be created using derivatives, but the aggregate notional value of the Fund's specified derivatives positions excluding any specified derivatives used for hedging purposes, must not exceed 300% of its net asset value, calculated on a daily basis. The fund employs a manager-of-managers approach to investing whereby the portfolio manager may, at its discretion, hire or replace the subadvisors to achieve the fund's objectives.

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There are risks involved with investing, including loss of principal. Diversification may not protect against market risk. There may be other holdings which are not discussed that may have additional specific risks. In addition to the normal risks associated with investing, international investments may involve risk of capital loss from unfavourable fluctuation in currency values, from differences in generally accepted accounting principles, or from economic or political instability in other nations. Bonds and bond funds will decrease in value as interest rates rise.

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