Litman Gregory Masters Alt Strats Instl MASFX

Strong manager selection puts this fund ahead.

Morningstar's Take MASFX

Morningstar Rating	★★★★★
Morningstar Analyst Rating	Bronze

Morningstar Pillars

Process	Neutral
Performance	Positive
People	Positive
Parent	Positive
Price	Neutral

Role In Portfolio

Supporting

Fund Performance MASFX

Year	Total Return (%)	+/- Category
YTD	3.34	-0.03
2018	-2.08	1.96
2017	4.51	-0.64
2016	6.87	5.49
2015	-0.77	1.81

Data through 2-28-19

3-13-19 | by Jason Kephart

Litman Gregory Masters Alternative Strategies' strong roster of underlying managers continues to give it an edge versus peers. The fund, however, has exhibited a high correlation to risky assets, like high-yield bonds, which limits its usefulness as a diversifier when used in traditional portfolios. A lower correlation to risky assets would boost our outlook. It retains its Morningstar Analyst Rating of Bronze.

The managers have chosen an excellent group of subadvisors. The portfolio is split nearly evenly between five subadvisors: FPA, DoubleLine, Loomis Sayles, Water Island, and DCI. Morningstar gives a Positive People rating to similar funds managed by three out of the five subadvisors.

The subadvisors run fundamentally different strategies and have historically had low correlation to one another, though sometimes their opportunistic bets will overlap. Litman Gregory's managers don't set hard limits to the amount of exposure they have to a single factor or asset class, instead choosing to rely on the processes of the underlying subadvisors, which do have constraints. While this may lead to successful results, it can also lead to increased risk and lower diversification inside the portfolio.

Although the subadvisors run distinct strategies, a common theme is a focus on credit. This has led to a high correlation to below-investment-grade bonds. The average three-year rolling period correlation to the Bloomberg Barclays U.S. High Yield Intermediate Term Index since the fund's inception is 0.86. Given that the fund's purpose is to be a diversifier to traditional asset classes and return drivers, the fund would be more appealing if it had a lower correlation to risky assets.

The fund isn't bolstered by its fees. It carries slightly above-average expenses when compared with peers in the multialternative Morningstar Category. Still, this remains a strong choice for investors who are comfortable with its high correlation to risk assets.

Associate analyst Stefan Sayre contributed to this report.

Process Pillar Neutral | Jason Kephart 03/13/2019

Litman Gregory's manager selection is a clear strength, but it's overshadowed by concerns about the fund's high correlation to risk assets. The fund earns a Neutral Process rating.

The fund is designed to offer an alternative to typical return drivers: namely, equity beta, interest rate duration, and credit. The managers rely on their expertise in manager selection to build and monitor a portfolio of subadvisors, who are selected based on the managers' convictions in their abilities to generate strong risk-adjusted returns as well as how uncorrelated their returns are to one another. This combination is intended to yield consistent returns with limited volatility.

There are currently five subadvisors in the portfolio. FPA runs a contrarian sleeve, Loomis Sayles manages an absolute return fixed-income sleeve, DoubleLine primarily invests in mortgage-backed securities, Water Island manages an event-driven strategy, and DCI runs a long-short credit strategy. Despite the unique approaches taken by the subadvisors, overlap between some of their bets has led to a higher correlation to risky assets than intended. The fund's correlation to global equity markets has consistently been above 0.8 in rolling three-year periods since inception, which exceeds management's expectations of a correlation closer to 0.5 over longer periods. This persistent correlation to risky assets indicates the process has fallen short in producing a diversified return profile.

Management allocates roughly equal amounts to its five subadvisors, believing that each has an equally good chance of meeting or exceeding its expected return target and is relatively uncorrelated with the others. As of the end of February, DoubleLine has the highest allocation at 25% and FPA the lightest at 18%. The remaining three subadvisors each manage 19% of the fund's assets. DoubleLine maintains the most weight because of management's conviction in it to outperform through what it views as the late stages of the credit cycle. FPA has the smallest allocation because it's the most volatile. Management can tilt the weights of the subadvisors but has generally been hands-off.

Most of the subadvisors' portfolios are similar, though slightly different, from strategies they manage in other vehicles. Water Island's portfolio, for example, contains around 20 of its favorite merger-arbitrage and special situation ideas. In their

Neutral-rated Arbitrage Event Driven AEDNX, they typically have between 60 and 90 event-driven ideas in total.

DoubleLine runs an opportunistic mortgage-backed security strategy that manager Jeffrey Gundlach has run in a hedge fund since 1991. DCI runs two market-neutral credit strategies composed of a mix of cash bonds and credit default swaps.

Performance Pillar Positive | Jason Kephart 03/13/2019

The fund aims to outpace a traditional 60%/40% balanced fund on a risk-adjusted basis, targeting annualized volatility in the range of 4%-8%. Since its inception in September 2011, the fund's annualized return of 4.62% is in line with management's target and tops the multialternative category average of 1.59%. Its risk-adjusted returns, as measured by Sharpe and Sortino ratios, are also well above most peers and passive 60%/40% funds, which hold a mix of U.S. and non-U.S. stocks and bonds. The fund scores a Positive rating for Performance.

The subadvisors have done a good job of balancing each other out. The fourth quarter of 2018 is only the second quarter since the fund launched in which four of the five subadvisors saw negative returns. FPA's equity-heavy sleeve--with sector bets in financials, technology, and industrials--was hit the hardest, losing 10.65% for the quarter. Water Island, Loomis Sayles, and DCI brought in losses of 0.49%, 1.75%, and 2.75% for the quarter, respectively. DoubleLine returned 1.17%, largely on the outperformance of agency residential MBS.

Even though returns have been strong, the fund has not been a good diversifier. Since its inception, its average three-year rolling correlation to the Bloomberg Barclays U.S. High Yield Intermediate Term Index is 0.86. Investors should keep its correlation to risk assets in mind when allocating to the fund.

People Pillar Positive | Jason Kephart 03/13/2019

The investment team's keen eye for quality managers has led to a standout portfolio. The fund earns a Positive rating for People.

Led by CIO Jeremy DeGroot, the investment team comprises six individuals. They collectively oversee manager selection and monitoring. Before new subadvisors can be added to a portfolio, the analyst assigned to them must make a case to the research team, and all members must agree before a subadvisor can join the lineup. The average tenure of the group is approximately 13 years, and the team has seen no changes in the past five to six years. The group's stability is a promising sign.

Three of the five subadvisors earn Positive People ratings on similar mutual funds they manage. Steven Romick of First Pacific Advisors and the team at Water Island Capital are all veteran managers. Jeffrey Gundlach, CEO of DoubleLine, has a storied career investing in MBS, and the strategy he runs here relies heavily on that background.

DCI LLC, a long-short credit focused firm, was added as a subadvisor in 2017. Three individuals from DCI are on the manager roster, including the chief investment officer and head of research. The team at Loomis Sayles--Matt Eagan, Todd Vandam, and Kevin Kearns--was given a Positive People rating on Loomis Sayles Strategic Alpha before it was dropped from Morningstar's coverage in April 2018.

Parent Pillar Positive | Jason Kephart 03/12/2019

Founded in 1987, Litman Gregory has its genesis as a private wealth management firm for individual investors. It rolled out its first mutual fund in 1996 and has since launched six more (but merged away two large-cap funds in 2013). Today, Litman Gregory manages approximately $5 billion in client assets, plus nearly $3 billion in its five mutual funds.

The firm's mutual funds, which employ a series of underlying subadvisors, were each created to meet unfilled client needs. Litman Gregory takes a conservative approach to launching new products. It most recently launched the Masters High Income Alternatives fund in September 2018, its first new strategy in seven years.

It has changed its subadvisor lineups over the years, but the firm generally maintains long-term relationships with its managers. The firm's manager-selection and monitoring effort is well supported by six individuals, with an average tenure at the Registered Investment Advisor of 13 years. Litman Gregory has proved committed to limited fund sizes and has previously closed two equity funds (both are now smaller and open).

Most of the firm's funds look pricey. Given that flows are increasingly going to lower-priced products in the market, a higher fee proposition could be a competitive disadvantage. Still, the quality of the underlying managers has helped the lineup stand out. Overall, Litman Gregory maintains a Positive Parent rating.

Price Pillar Neutral | Jason Kephart 03/13/2019

This fund isn't a bargain. It is offered in two share classes. The majority of assets (90%) is in the Institutional share class, which has a prospectus net expense ratio of 1.46%, excluding short interest and dividend costs. This puts it just above the median expense ratio for similarly distributed peers in the multialternative category. The remaining assets are in the Investor share class, which has a prospectus net expense ratio of 1.70%, just below the most-expensive quartile of all similarly distributed funds in the category. Middle-of-the-road pricing warrants a Neutral Price rating.