THE OPPORTUNITY WITH ALTERNATIVES

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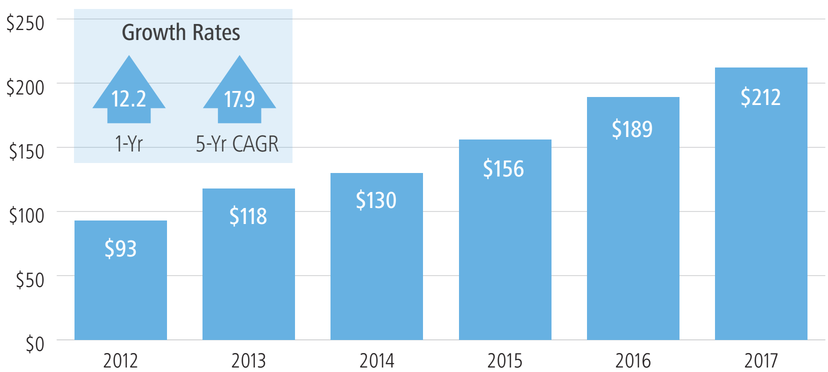
Key Takeaways

- Alternative investments are designed to help lessen the negative impact of market volatility, enhance a portfolio's diversification and improve returns in a portfolio.
- More investors now have access to alternative investments, particularly those investors who work with professional financial advisors.
- A liquid alternative mutual fund is an efficient way to invest in a diversified range of alternative assets and strategies.

Alternative investments offer investors different kinds of assets and strategies to enhance their portfolios beyond traditional stocks, bonds and cash. Alternatives can be used to try to generate higher returns, reduce volatility and preserve capital over the long term.

To some investors, alternative investments are relatively new, but many Canadians are already exposed to these assets. For example, participants in the Canada Pension Plan are indirectly invested in alternatives because the CPP holds over 50% of its net investible assets in alternatives[1]. In fact, Canadian-managed alternative assets more than doubled from $93 billion in 2012 to $212 billion by December 2017.

Figure 1: Alternative Assets Managed in Canada ($ billions)



Source: Strategic Insight, Managed Money Advisory Service as of December 2017. This data accounts for all alternative strategies which include hedge funds, real estate, private equity and infrastructure.

[1] Canada Pension Plan Investment Board (CPPIB), Annual Report, 2016

Understanding Alternative Investing

Alternative investments are made up of both assets and strategies. Alternative assets may include commodities, infrastructure projects, vacant land and developed real estate (see table).

Figure 2: Examples of Alternative Assets

Commodities	Crude oil, gold bullion,livestock and agricultural products
Infrastructure	Airports, toll roads, small hydro-electric facilities
Land	Agricultural, timber
Real Estate	Commercial buildings, condominium rental units

The values of these assets are generally less correlated (or not correlated at all) with the movements of traditional financial markets.

Alternative strategies use non-conventional methods to manage investment vehicles that may hold both traditional and alternative assets including a wider range of asset classes and sophisticated investments.

Some of the major differences between alternative and traditional investments centre on performance and liquidity. Alternative investments typically react contrary to traditional investments, so when markets are volatile, alternative investments tend to outperform more traditional vehicles and vice versa. Traditional investments are also easier to redeem. An investor who needs to liquidate a traditional investment like a mutual fund would have a much easier time redeeming that investment than they would an alternative investment, which by its very nature, would be difficult to liquidate on short notice.

Advantages of Liquid Alternatives

Since the 2008-09 market downturn, many investors tried to limit risk with investments that move less in sync with stock markets. The investment industry responded by developing more alternative products for investors, particularly those who work with financial advisors. New mutual funds give investors access to alternatives without giving up liquidity, or the ability to buy or sell the fund quickly. These are called “liquid alternatives”.

Figure 3: Alternative Mutual Fund - Underlying Investments

Non-traditional equities and fixed income securities	Mutual funds that invest in alternative assets or strategies	ETFs that track alternative assets or strategies	Special-purpose securities	Other securities, currencies, and derivatives

Alternative strategies that can be employed by the fund manager

A liquid alternative mutual fund offers advantages to investors:

- Easier to gain access to the alternative space and cash in the investment when necessary
- Lower management fees and no performance fees
- Better transparency and reporting

Liquid alternative funds give investors efficient access to diversified alternative investments.

The Risks of Liquid Alternatives

While alternative investments offer an opportunity to achieve significant returns, they are not without risks. These risks depend on the nature of the alternative investments and the strategies that they use.

Leverage

Leverage involves borrowing funds to invest and is common with alternative investments. The payoff from leveraging can be more significant than traditional investments, but the downside risk is also amplified. Leverage is also limited in alternative mutual funds.

Use of Shorts

An investor will short a security when they believe that the price of the security will fall. Shorting involves borrowing a security and selling it in the open market. The investor repays the loan of the security by purchasing the security at a later time.
If the price of the security falls during that time, the investor earns a return; however, if the price has increased, the investor loses money and paying back the loan will now be more expensive. There is a limit to how much the investor can profit because the price of the security cannot fall any further than zero. On the other hand, the value of the security can continue to rise, meaning the investor can take on more losses.

Mitigate Risks with Derivatives

Derivatives are investment strategies that enable an investor to swap, buy or sell a security in the future at a price that is set today. They are classified broadly as options, forwards, futures or swaps, and are frequently used as part of alternative strategies.

Summary: Opportunities in the Alternatives Space

Growing interest in alternative investments is creating opportunities for retail investors. Liquid alternative funds are a viable solution to enhance diversification and potentially improve a portfolio's risk-adjusted return by providing more potential sources of return and increasing a portfolio's stability so investors are better positioned to reach their long-term goals.

Explore whether alternative investments are an appropriate choice for you.
Speak to your financial advisor today.

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