Why the democratization of alternative investments needs to accelerate

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The democratization of alternative investments has just begun in Canada with the increasing availability of "liquid" alternatives – funds that make use of hedge-fund-like investment strategies – which debuted in January for Canadian retail investors. Prior to this, they had been mostly within the domain of large, sophisticated institutional investors, such as public pension plans, sovereign wealth funds, endowments and foundations, and high-net worth individuals.

In fact, our largest Canadian public pension plans have led the way in investing in alternatives, such as real estate, private equity, infrastructure, commodities and absolute return strategies, with typical allocations ranging from 30 per cent to 50 per cent. Direct alternative investments have grown globally from US$2-trillion to US$15-trillion this century. This democratization needs to accelerate if Canadians are to maximize their retirement income. Further, access to these types of investments for retail investors will be even more crucial as we reach the later stages of a historic stock market bull run, possibly resulting in more modest returns from the public markets for equities - and perhaps even fixed income - over the next decade than the previous ten years.

Alternative investments – investments that either make use of sophisticated stock market strategies or invest in non-equity assets like real estate and infrastructure - can be very effective portfolio building blocks. They offer expanded investment return opportunities and lower correlations to traditional equity and fixed income markets and aim to achieve higher risk-adjusted returns over time.

Canadian investors could benefit from gaining access to these types of asset classes to help ensure a smoother journey towards retirement and have more security after they retire too.

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Liquid alternatives have been popular in the U.S. over the past decade

In the U.S., the popularity of liquid alternatives - both ETFs and mutual funds - began shortly after the financial crisis, when it became apparent that the sophisticated institutional and high-net worth investors were hurt less than retail investors by the market crash due to their exposure to alternatives.

From 2009 to now, liquid alternatives ETFs and mutual funds within the U.S. retail channels have grown more than four-fold from US$160-billion to over US$700-billion and are expected to reach US$1-trillion in short order.

There are two categories of liquid alternative investments: liquid alternative strategies and liquid alternative asset classes; both are effective portfolio building blocks that can help maximize risk-adjusted returns for retail investors with an initial 5-10-per-cent allocation in their portfolio.

Liquid alternatives expected to hit $100-billion in Canada

Liquid alternative strategies are now available to Canadian retail investors via mutual funds and ETFs – thanks to the new rules that took effect at the beginning of this year.

These types of investment strategies can employ hedge fund-like strategies such as leverage and shorting - for example, long/short, market neutral, global macro, and managed futures. They have the potential to play a critical role helping diversify risk in an investor's portfolio, similar to what institutional investors have been adopting for years, and what qualified high-net worth investors have been utilizing in Canada through Offering Memorandum (OM) vehicles.

Much like in the U.S., Canadians can now also invest in alternative asset classes through ETFs and mutual funds that have alternative investments but in liquid form - listed infrastructure securities, REITs, public-private equity, micro-cap listed stocks, commodities, etc.

While liquid alternative asset classes do not perfectly replicate the direct investments that large investors make into private and real asset classes, they can be highly correlated to the risk and return patterns of these investment categories and can nicely complement the "traditional" stocks and bonds to improve the risk-return profile of one's overall portfolio.

The liquid alternatives category is off to a fast start in Canada - 37 solutions are currently available to retail investors with more expected in the second half of the year. They currently account for $3.4-billion in assets under management. Experts estimate that this pool of assets will hit $100-billion in due course.

Like with any new investing option, it will be important for Canadians to familiarize themselves with liquid alternatives. They should sit down with their financial adviser and learn about how liquid alts can work as part of their portfolio. Ask questions about the fund managers (liquid alts are highly complex investment vehicles so you need professionals with proven expertise), gain an understanding of what will impact the fund's performance and inquire about any fund performance fees.

It is important for the democratization of alternative investments to continue to thrive in Canada. All Canadians need access to the widest array of investments to meet their retirement goals. It's their right to have the same investing opportunities that sophisticated investors have had access to for years.

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