MACKENZIE Investments | CONFIDENCE IN A CHANGING WORLD

Dealing with volatility and diversification through the use of alternative investments

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Executive Summary

Over the past eight years, new products and investment styles have emerged that enable the retail investor, usually through a professional advisor, to access markets, asset classes and expertise previously only available to institutional investors. Among these emerging products are liquid alternatives which provide the benefits of holding alternative investments while, at the same time, not requiring the investor to sacrifice liquidity.

Alternative investments are made up of physical assets, such as real estate, and financial assets, such as private equity. Alternative investments focus on delivering uncorrelated sources of performance, mitigating risk and managing volatility.

The interest in alternative investments, of all types, has increased significantly in recent years as institutional and retail investors seek ways to diversify their portfolios, reduce risk and enhance long-term investment returns. The pace of growth of alternative investments in Canada has been slower than in some other markets, although growth is expected to accelerate given continued low yields on fixed income investments, concerns about volatile equity markets and the length of the current bull market.

Introduction

In the years since the market correction of 2008-2009, new product structures and new instruments, such as exchange-traded funds (ETFs), along with heightened investment management expertise and refined techniques, have shaped and developed alternative investments into products that can now be accessed by many investors, particularly those who work with professional advisors.

Traditionally, alternative investments, which include infrastructure projects, private equity and real estate, were only available to accredited investors or to large institutions. The launch of newer products has resulted in the introduction of opportunities for retail investors to broaden their diversification by including a range of liquid alternative investments in their portfolios. Liquid alternatives are investment products that have the primary characteristics of alternative investments, but which have the distinguishing attribute of being held in a unitized and daily liquid structure.

Asset managers and investors, particularly institutional investors in Canada, have recognized the value of alternatives and holdings of these products have continued to increase. As shown in Figure 1, since 2011, Canadian-managed alternative assets have more than doubled from $84 billion in 2011 to $188 billion by June 2016.

FIGURE 1

Alternative Assets Managed in Canada ($ billions)

Source: Strategic Insight
* Month ended June 2016

Although liquid alternatives have become increasingly popular investments, many investors, some advisors and certain regulators have yet to fully embrace them. This somewhat reluctant attitude reflects, to some extent, the limited track record, the perception that such investments are both complex and illiquid, and the overall lack of information about the products and how they might be integrated into a portfolio.

This white paper is designed to remove some of the mystery that surrounds alternative investments and to provide financial advisors and their clients with a primer to better understand this group of investments. In addition, the paper will discuss how Canadian investors can take advantage of the benefits of this increasingly popular asset class through a liquid and unitized structure.

Defining alternative investments

As the name suggests, alternative investments represent an 'alternative' way for investors to diversify their investment portfolios away from their long-standing reliance on traditional stocks, bonds and cash. Alternative investments can be used to potentially generate higher returns, to dampen volatility, and to preserve capital over a long-term horizon. For the purpose of this white paper, alternative investments are divided into two distinct concepts–those of alternative assets and alternative strategies.

Alternative assets

The first group, alternative assets, is comprised of physical and real assets, held either directly or indirectly, the value of which are generally less correlated or uncorrelated with traditional capital markets. Examples may include commodities, infrastructure projects, vacant land and developed real estate (see Figure 2). This category also encompasses special-purpose securities, such as a real estate investment trust (REIT) that owns commercial property; fixed income securities issued by businesses that are established to own, develop and manage infrastructure assets; and units of special-purpose funds that invest in infrastructure projects, such as port facilities and airports.

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

'Investments of Passion', such as precious stones, wine, antiques and art, are also considered to be alternative investments. These articles of value collected by individuals are generally tangible in nature, although some, such as wine, can be held in certificate form. One source has suggested that the total investments of passion held by the global high-net-worth (HNW) community is approximately U.S. $1.1 trillion[1]. Notwithstanding the size of this category of alternative assets, it falls outside the scope of this paper, as these investments are extremely illiquid and cannot currently be accessed through a financial professional.

[1] Knight Frank, Wealth Report, 2015

Alternative strategies

The second group of alternative investments is represented by alternative strategies (see Figure 3). In these strategies, investment vehicles are structured to hold a wide range of financial assets – both traditional and non-traditional – but which are managed using non-conventional methods. Unlike traditional 'long-only' portfolios, these vehicles may have fewer restrictions on liquidity, foreign currency exposure and trading, leverage, securities lending and short-selling, to list a few examples. Common vehicles in this category include hedge funds, private equity funds, and funds that are focused on distinct financial assets, such as distressed debt.

Hedge funds are the most well-known type of alternative strategy vehicle and are usually only available to accredited investors, such as institutions and individuals with sufficient capital. These funds seek to 'hedge' their investments by employing a combination of alternative strategies to generate returns, such as through the use of derivatives and leveraged trading. Hedge funds are comparatively less liquid than mutual funds, however, as they typically require investors to hold their positions over a set period. Although these vehicles have been criticized for both their high fees and unreliable performance, it was estimated that, at the end of 2015, the total global hedge fund market was U.S. $3.2 trillion, with inflows in that year of approximately U.S. $71.5 billion.[2]

There are also strategies and holdings that are typically underrepresented within standard investment portfolios and can, therefore, be viewed as alternatives to traditional equities and bonds. These include non-traditional forms of debt, such as asset- backed securities, leveraged loans, floating-rate loans, and inflation linked bonds, as well as other strategies that seek to isolate credit versus general rate risk. Non-traditional strategies may also focus on equity sectors that have lower correlations to traditional large-cap equities. These may include micro-cap equities, preferred shares and other specialty equity vehicles.

Figure 3: Examples of Alternative Strategies

Long/Short	A long/short equity strategy seeks to profit from stock gains in the long positions as well as stock price declines in the short positions.
Benchmark Agnostic	A benchmark agnostic strategy is one that does not use the benchmark as a starting point to build the Portfolio, but rather to measure relative performance over time (e.g. absolute return; unconstrained)
Market Neutral	A market-neutral strategy seeks to profit from both increasing and decreasing prices in one or more markets, while attempting to avoid some specific form of market risk. The goal is to achieve a beta as close to zero as possible.
Managed Futures	Managed futures take long and short positions in futures markets to provide portfolio diversification among various types of investment styles and asset classes in ways that are not possible via direct investments.
Distressed Assets/Debt	Distressed securities are instruments issued by governments or companies that are experiencing severe financial challenges, including bankruptcy proceedings. Investment in distressed securities carry significant risk, as the securities may become worthless.
Private Equity	Private equity is an illiquid asset class consisting of equity and debt securities in operating companies that are not publicly traded on a stock exchange. The attraction to investors is the potential for substantial long-term gains.
Non-traditional Debt and equity	Convertible debt, floating rate loans, asset-backed debt, micro-cap equities and, preferred shares.

[2] The 2016 Preqin Global Hedge Fund Report

The Demand for Alternative Investments Is Increasing

To some Canadian investors, the topic of alternative investments is relatively new; however, at a macro level, most individuals are already exposed to these types of assets. For example, some Canadians are exposed to alternatives through a capital investment in a private business; via the purchase of a rental property and land; or, most probably, through participation in the Canadian Pension Plan, which holds over 50% of its net investible assets in alternatives[3].

The Canada Pension Plan Investment Board (CPPIB), the plan's manager, leverages scale to access opportunities in various alternative assets and strategies. For example, in 2016, the CPPIB private investment team, which accounts for 20% of the fund, made direct, private equity investments in large and prominent U.S. companies, such as Petco Animal Supplies Inc. and Cablevision. This team also invested in infrastructure projects, such as Associated British Ports, a U.K.-based group that owns and operates 21 ports across the U.K. In addition, the CPPIB has a real estate team that manages approximately 15% of total fund assets. It should also be noted that the CPPIB holds public market investments and investment partnerships, which are, at times, managed using alternative strategies.

Developments

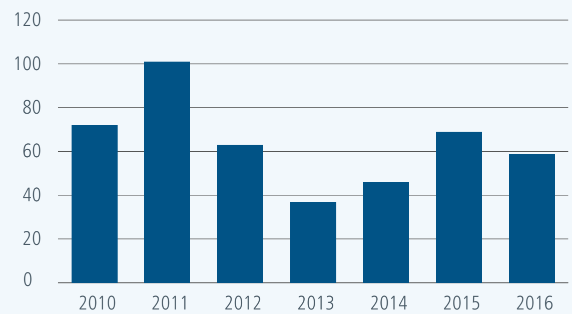
The increased interest in alternative investment opportunities reflects three primary developments, other than the wider availability through structures such as mutual funds.

Firstly, the market disruption of 2008-2009, and the periods of volatility that followed, have encouraged retail investors to search for ways to limit their market risk and to identify investments that are unlikely to move in lock-step with the public markets.

Volatility provides an indication of the stability of an investment as determined by the fluctuations in return; the greater the change (within a period) from its average return, the greater the volatility. As seen in Figure 4, an analysis of the period 2010 to 2016 shows that the S&P/TSX experienced price volatility on a number of trading days as the changes in price were uncharacteristic when compared to the average daily returns.

FIGURE 4

Number of Volatile Trading Days



Source: Google Finance, February 2017

A volatile market environment can affect investors who are either risk averse or who lack the discipline to hold portfolio positions for the long term. For instance, volatility cuts both ways: in 2015, the S&P/TSX lost 10% in value over the year while recording 69 volatile trading days; by contrast, in 2016, the index recorded 59 volatile trading days but produced an annual gain of 18%.

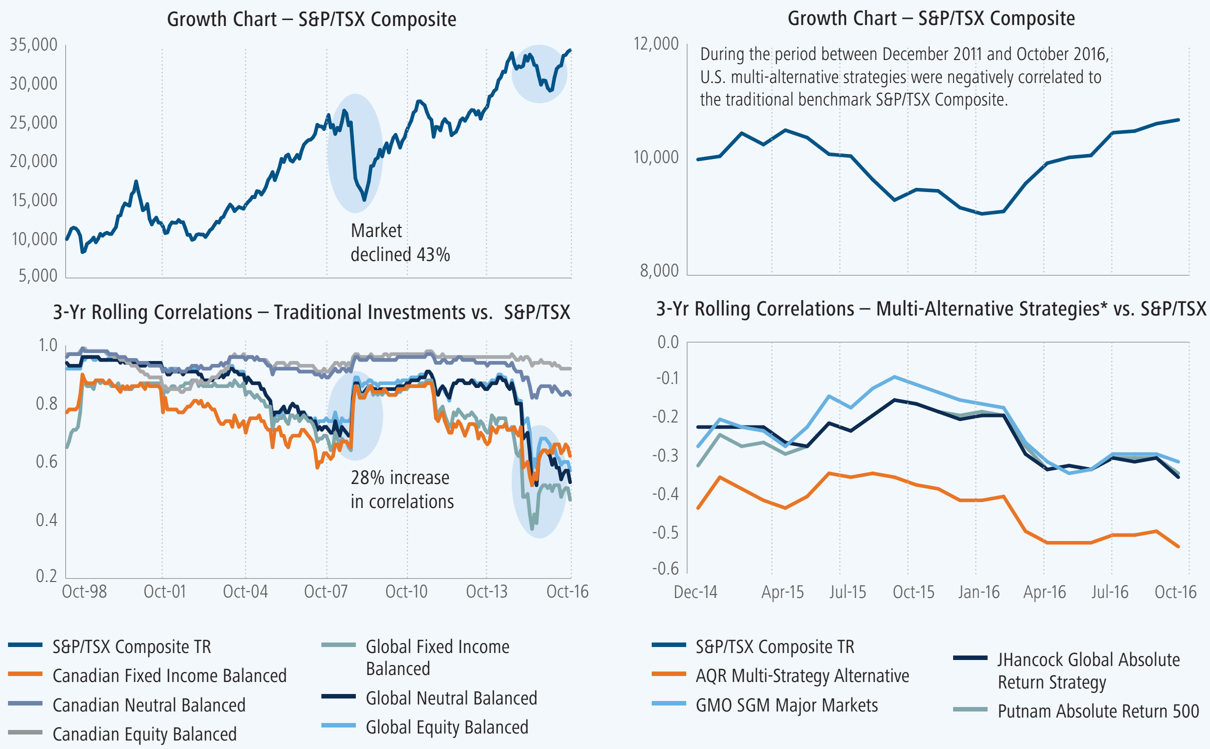
As expected – and demonstrated in Figure 5 – the correlation of traditional investments to equity markets, such as the S&P/TSX, is significant, especially during the periods of weakness in the markets. Conversely, some alternative strategies, such as the U.S. multi-alternative strategies presented in Figure 5, demonstrated negative correlation to the S&P/TSX Index, confirming their value as a tool to manage volatility risk.

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

FIGURE 5

When the market declines, correlations of traditional investments increase…

…While alternative strategies are negatively correlated to traditional benchmarks

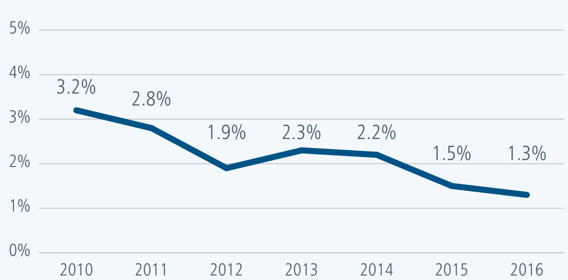


Source: Morningstar Direct, October 31, 2016

Secondly, traditional portfolios have often failed to generate the risk adjusted returns and income required to meet the needs of Canadian investors - primarily those who have sought to generate reliable income in retirement. These developments, to an extent, have been driven by a weak domestic economy and an extended period of low interest rates. As seen in Figure 6, the average 10-year Government of Canada Benchmark Bond Yields declined to historic lows by the end of 2016, reinforcing a need for many investors to supplement fixed income returns.

FIGURE 6

Average 10-Year Government of Canada Benchmark Bond Yields

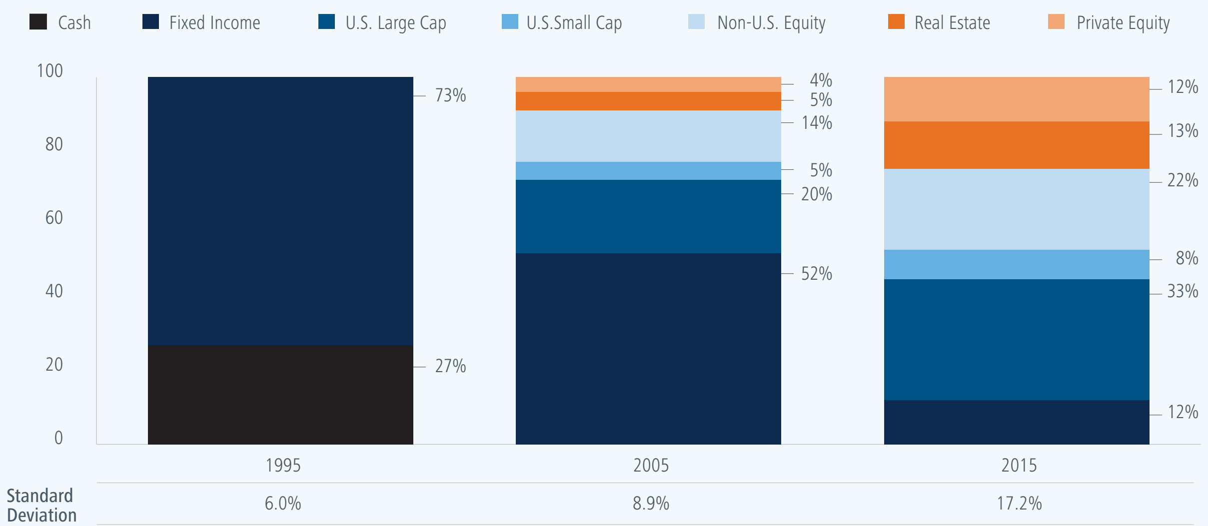


Source: Bank of Canada, February 2017

Investors and their advisors have sought to diversify risk and enhance return in their portfolios through new approaches to asset allocation which go beyond the use of conventional money market instruments, bonds and equities. As seen in Figure 7, Callan Associates calculates that investors now require meaningful allocations to alternative asset classes in their portfolios in order to maintain a 7.5% nominal rate of return, a level that was attainable with just bonds and cash as recently as 1995! And even today's much more diversified portfolios, Callan estimates that the level of risk an investor must take on in order to achieve that 7.5% return has nearly tripled over that time period.

FIGURE 7

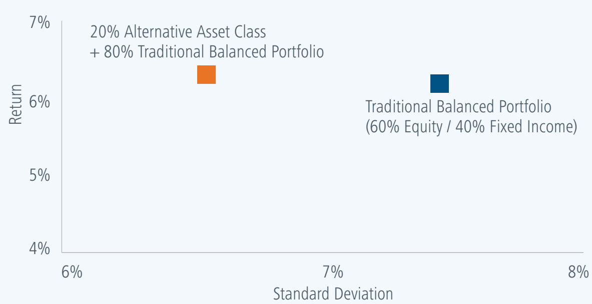
Estimate of asset allocation needed to earn 7.5%



Source: Callan Associates 2016 Capital Market Projections, February 25, 2017

FIGURE 8

Risk-return of Adding Alternative Assets to a Traditional Balanced Portfolio



Source: MSCI, BofAML, HFRI, January 2008 - December 2016
Traditional balanced Portfolios comprised of 60% in the MSCI Index and 40% of the Bank of America Global Broad Market Total Return, Alternatives are represented by the HFRI Index

In the absence of allocating to Alternatives, today's investors are faced with a potential return shortfall that comes with elevated volatility. Alternatives represent a viable tool that can be used to provide enhanced diversification to a portfolio and potentially improve a portfolio's risk-adjusted return. As seen in Figure 8, a 20% allocation to alternatives is capable of changing the risk-adjusted return of a traditional balanced portfolio. By adding a 20% allocation to a broad basket of alternative investment strategies, the portfolio now generates a higher return while incurring less risk (standard deviation).

Overall, these three factors—potentially lower volatility, higher returns, and enhanced diversification – represent the drivers behind the development of liquid alternative products.

Challenges of investing in alternatives

While alternative assets and strategies have proven to offer a number of benefits, there are challenges that have historically impeded or dissuaded retail investors from taking advantage of these opportunities. The challenges include the difficulty of accessing the investments, valuing the investments, the liquidity of invested capital, the need to adopt a long-term investment horizon, the often high initial investment and the relatively high cost of participation, in the form of both management and performance fees (see Figure 9).

Figure 9: Examples of Challenges of Investing in Alternatives

Difficult to Access	Investment vehicles that provide access to alternatives are not widely available and easily understood, are often restricted to accredited investors only via Offering Memorandum, or are simply unavailable to retail investors (like buying an airport, for example).
Difficult to Value	Data is not usually available on private equity deals or infrastructure projects as they are very diverse in nature, leading to difficulties in valuation.
Liquidity	Many hedge fund, real estate and private equity structures typically require that the invested assets be held for extended periods without redemption rights and thereafter can only be redeemed at set periods, such as quarterly, semi-annually, or annually.
Long-term Horizon	Infrastructure requires investors to adopt a long-term investment horizon, as these projects can take years to complete. Fund managers often employ a lock-up period during which the investor is prevented from redeeming their investments.
Large Initial Investment	Many structures require large initial investments, often in the six figure range. One prominent Canadian manager places a $25,000 minimum on contributions made by accredited investors.
High Cost	A typical hedge fund offered by a Canadian manager will charge a 2% management fee plus a 15%-20% performance fee. Some structures require investors to pay fees on committed capital even before the capital is fully invested.

Retail investors who seek to hold alternative investment positions within a portfolio can mitigate most, if not all, of these challenges by investing in liquid alternative products, which are accessible through either a relationship with a financial advisor or, in some cases, directly from a fund manager.

Liquid Alternatives

One efficient method for retail investors to access multiple alternative investments – other than through participation in a major pension fund – is through a mutual fund that is structured to hold a diversified range of securities.

How they work

The advantages to retail investors of using a liquid alternative product, compared to traditional alternatives, are found in:

- an easier entry point in terms of the initial investment;
- lower management fees;
- the absence of performance fees;
- transparency and reporting demanded by regulation; and
- the ability to move in and out of the investment with relative ease.

It is also the case that development of exchange-traded funds, improvements to analytical and support technology, and the rising level of comfort and expertise in alternatives have allowed portfolio managers to dynamically rebalance holdings across a range of alternative assets in pursuit of their objectives of reduced risk and enhanced returns. The use of a prospectus mutual fund structure assures investors that the liquid alternative product is fully documented and is subject to both regulatory approval and ongoing review.

Liquid alternative products are designed to track the performance of a select or diverse group of alternative investments, or to provide retail investors with the ability to work with a manager who employs a defined investment strategy. For example, a mutual fund can be designed to hold equities of companies that own and operate infrastructure projects, which are illiquid in their own right, but which generate sustainable cash flow and capital appreciation over a long period of time. In another example, the portfolio manager may employ a volatility reduction strategy, such as options trading, to hedge against market or currency risk or to neutralize movement in one sector by an opposite movement in another area of the market. In other cases, multiple alternative investments and portfolio management techniques can be combined within a single structure to create a mutual fund product that has a diversification objective.

As seen in Figure 10, a mutual fund structure can act as an umbrella that enables fund managers to design investment products that invest in several types of liquid alternatives and strategies. In addition, the fund manager has the ability to employ additional overarching alternative strategies to the holdings. This level of diversification can improve the risk-adjusted return for the investment portfolio, as the underlying securities and strategies can be selected based on their low correlation to the public markets.

Figure 10: 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

Price

To many retail investors, alternative investments are synonymous with high management fees and performance fees. While it is true that some alternatives strategies are priced well above conventional mutual funds (which typically charge in Canada between 1.4% and 2.4%[4] of assets), a new breed of alternative-based funds are narrowing or eliminating this price gap by leveraging existing mutual fund models that enable investors to build in an allocation to alternatives with the confidence that their overall portfolio costs should not rise.

In particular, some retail liquid alternative funds have broken ranks with their peers and charge a standard, fixed management fee, rather than fees that vary with the performance of the portfolio. This approach recognizes the need for the standardization of fees, the maturation of the alternative sector and the fact that technology has enabled managers to reduce the costs of managing complex portfolios.

Who should invest?

As liquid alternatives become increasingly available to both advisors and investors, it is important to recognize that while liquid alternatives may be applicable to many types of investors and portfolios, these investments may have greater applicability to distinct investor segments.

Broadly speaking, liquid alternatives will appeal to three specific groups of investors: Firstly, individual investors who possess an above-average understanding of financial markets and techniques that investment managers use in the construction and management of portfolios. Knowledge is important here, as there is a need on the part of the investor to understand the underlying investments and to be able to have a fact-based discussion with their investment advisor about the merits of an investment in an alternatives-based fund.

Secondly, liquid alternatives fit well with investors who are focused on specific outcomes such as improving risk-adjusted returns, greater diversification, and/or income generation.

Finally, reflecting the overall investment objective of these alternative products, retail investors who have a medium-to long-term investment horizon will be the ones best-positioned to benefit from the counter-cyclical nature of many of the underlying investments. In other words, new investors seeking short-term capital gains should consider other mutual funds and ETFs.

[4] Strategic Insight, Investor Economics Insight, January 2017

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