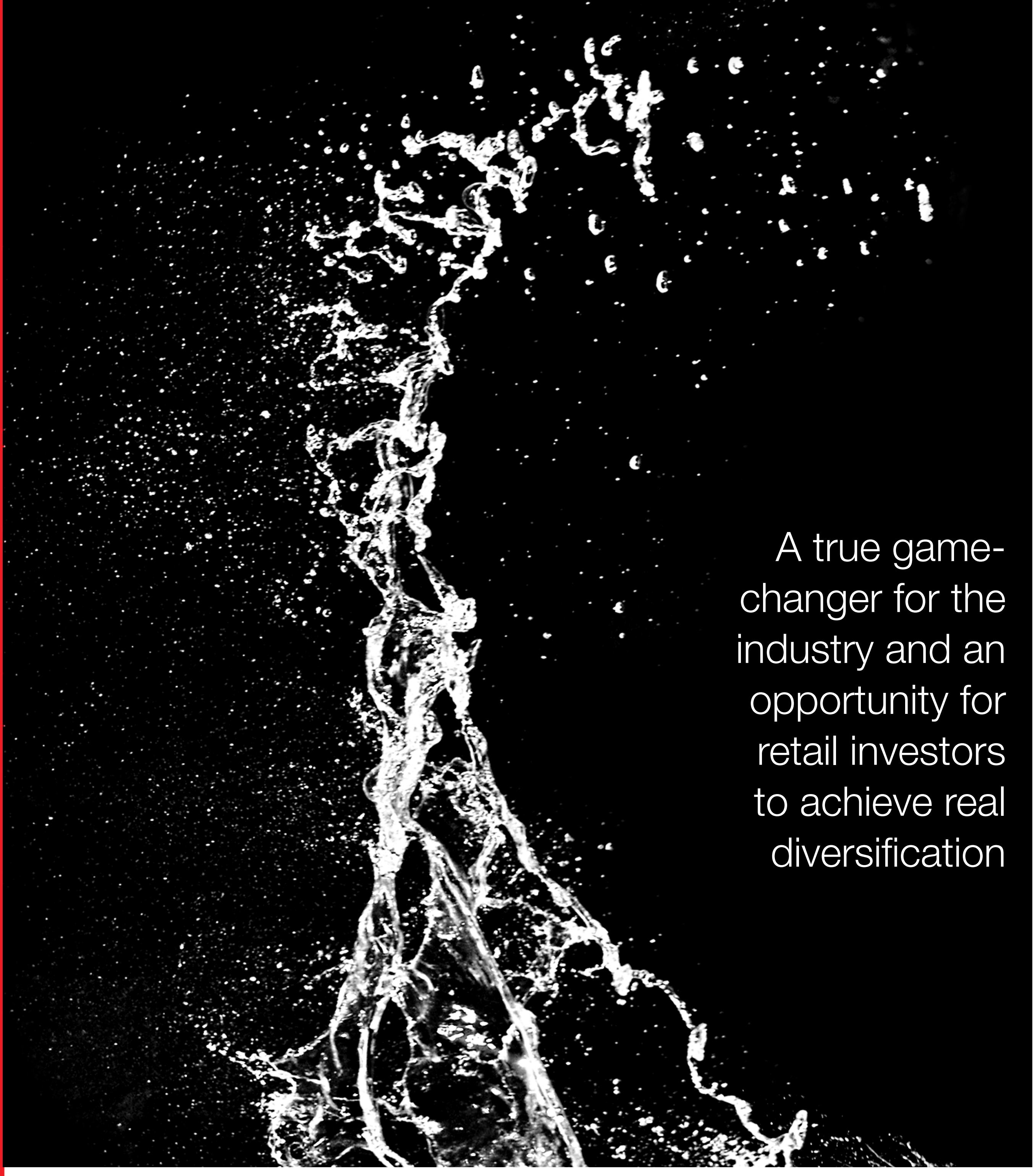
CANADIAN ASSOCIATION OF ALTERNATIVE STRATEGIES & ASSETS

CANADA'S NEW LIQUID ALTERNATIVES



A true game-changer for the industry and an opportunity for retail investors to achieve real diversification

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About CAASA

Inclusive, Active, and Pan-Alternative

The Canadian Association of Alternative Strategies & Assets (CAASA) was created in response to industry requests for a national group to represent the Canadian alternative investment participants, including investors, asset managers, and service providers. CAASA is inclusive in that it welcomes participation from all companies active in the space as well as select individuals (such as those employed by investors) who might want to participate in committees and working groups — or simply attend member events — without their employer being a member of the association.

CAASA is very active with 12 committees and working groups, organizing approximately 50 events each year. Pan-alternative, for CAASA, encompasses all alternative strategies and assets including hedge funds/alternative trading strategies, private and public real estate (funds and direct), private lending, private equity, infrastructure, development and project finance, digital assets/crypto-assets, weather derivatives and cat bonds, and all aspects of diligence, trading, structuring, dealing, and monitoring alternatives in a stand-alone portfolio and as part of a larger investment strategy.

For more information, please visit www.caasa.ca.

Table of Contents

Foreward

For about 70 years, hedge funds have been the exclusive domain of institutional and high-net-worth investors, plying strategies that mix leverage, shorting, and derivatives. These sophisticated portfolio management techniques provide, depending on the market regime and investor type, amplified returns, reduced volatility, and/or uncorrelated performance, which can temper losses during a market downtown.

On January 3, 2019, amendments to Canada's "National Instrument 81-102: Investment Funds" and to related national instruments made liquid alternative strategies, previously only available to wealthy hedge fund investors, available to all Canadians. An added bonus, many of the funds created thus far have daily liquidity and 2-day settlement vs. the up to 2-month wait and monthly redemption windows afforded many hedge fund investors.

Some asset management companies started the process of creating these funds up to 2 years before the rules were confirmed and promulgated, using that time to hire subject-matter expert personnel, implement appropriate back-office processes, and engage proficient service providers. Others already had these areas ready and focused on areas such as product offering and education of their wholesalers, dealers and advisors, and end clients/investors.

On the investment side, a number of asset managers had existing talent to bring to bear on these strategies – both in their Canadian and foreign offices – while others looked to external sub-advisors to provide the expertise necessary. Still others are in acquisition mode (for both companies and personnel/teams) to add to their bench.

As an investment strategy, liquid alternatives have many advantages compared to traditional stock and bond investing, including:

- Increased ability to meet and exceed return targets
- Greater downside protection
- Low correlation to public markets
- Diversification of sources of risk and return
- The ability to use leverage and shorting to produce higher and/or less volatile return
- Greater options for adjusting the risk/return profile of your portfolio
- Opportunity to tap into the success of traditional hedge fund strategies

While there are many advantages to utilizing liquid alternative strategies in a portfolio, they are best suited to certain strategies and use more complex trading techniques than a typical mutual fund and, as such, may not be suitable for all retail investors. Essentially, they differ from traditional mutual funds and stock and bond portfolios:

- They are a relatively new investment vehicle and not yet well understood by all in the asset management, investment advisory, and retail investor areas
- Liquid alternative funds may carry higher fees than a traditional mutual fund, due to its use of performance fees instead of simply AUM-based fees
- By themselves, employing leverage, shorting, or derivatives can produce 'riskier' returns – and using them together does not guarantee a smooth ride nor positive returns when markets are plunging

In this primer gives a history of the evolition of liquid alts over many years, what the rules are currently, the efficacy of the space with regard to investor requirements and preferences, and a look at how a credit manager uses various techniques to skillfully extract uncorrelated returns from the bond market.

Ultimately, we make the case for why liquid alternatives are a great way to bring diversification and attractive non-correlated returns, as well as downside protection, to your portfolio.

Thank you to Corey Goldman of Goldman Communications for wrting and edititing this piece and, of course, to our member participants whose information and insight into this area is invaluable.

James Burron, CAIA

President, CAASA

A Briefing on the New Rules

In March 2013, the Canadian Securities Administrators (or CSA, an umbrella organization consisting of all of Canada's provincial and territorial securities regulators) published a proposal for comment from the Canadian asset management industry and interested stakeholders. Framed as the "modernization of the Canadian investment funds industry", this piece of legislation had the potential to put true diversification into the hands of Canadian retail investors - not unlike the sea-change that occurred when mutual funds were embraced by asset managers, advisors, and investors from the mid-1990s. Dozens of comment letters, multiple public town-hall meetings, and many more private discussions brought together all types of stakeholders and provided a great deal of clarity on what was intended, how the infrastructure of the Canadian securities markets operate, and how best to deliver these strategies to investors - including educatinoal requirements of those entrusted with advising upon their use.

A second iteration (as a proposal for comment) ensued and the final rules were promulgated on January 3, 2019 (although some asset managers received permission to issue products under these rules throughout 2019). In essence, the rules stated:

- That these 'alternative mutual funds', which we will refer to as liquid alts/alternative funds, were open to investment by true retail ('mom and pop') investors. Previously, only Accredited Investors (which is a small sub-set of the wealthy of Canada), could gain access to these investment strategies.
- These funds could be sold through the IIROC (Investment Industy Regulatory Organization of Canada, or broker-dealers) channels, and not MFDA (Mutual Fund Dealers Association) companies.
- The investment restrictions differed from mutual funds in order to allow alternative strategies to be employed by the asset managers.
    - Maximum leverage (long and short) of 300% of Net Asset Value (NAV), net of hedging trades - leverage is not allowed for conventional mutual funds
    - No limit, subject to the limit above, on the amount shorted - conventional mutual funds are limited to 20% of NAV
    - Shorted securities' amounts do not require a 'short cover' amount held in cash - conventional mutual funds required 50% of the amount shorted to be held in cash

- Maximum concentration of 20% in the securities of any one issuer - conventional mutual funds are only allowed 10% concentration
- Maximum of 20% of NAV in illiquid assets - conventional mutual funds were limited to 20% of NAV (realistically, virtually all AUM of Canadian hedge strategies is liquid)
- The legislation is silen on fees, which allows flexibility for a combination of management fees and/or performance fees (which may have a hurdle rate)

Over the last year or so, some asset managers have sought and received exemptions (for specific funds) that allow the following:

- No limit (subject to the 300% overall cap on leverage) on shorting of debt issued by Canada or a federally-guaranteed entity
- Through a fund strucutre, allows greater than 300% leverage - this in the case of a Commodity Pool that uses futures to express its market views
- Although daily subscriptions and redemptions are not required, one fund was allowed to restrict new investments to once per month and redemptions to monthy, subject to a 20 business day notice period. Another fund allows subscriptions and redemptions both once per week and once per month.

As can be inferred from above, the new rules allow liquid alts to be a powerful and dynamic tool for asset managers to bring the most appropriate strategies to bear on markets that are increasingly correlated, volatile, and prone to manic-depressive movements. It also shows the regulators' commitment to making available, to all Canadian investors, products that can really provide value and stability in times of market turmoil.

The Efficacy of Liquid Alts

Alternative investments are often thought of as an entirely separate asset class from traditional equity and fixed income products. While they may incorporate different tools for managers to take advantage of, including the ability to go long or short, use leverage and provide access to private markets, they can also serve as an additive to a traditional approach rather than an outright replacement.

Institutional investors and high net worth individuals have been using alternatives as a structural tool to enhance traditional stock and bond portfolios for some time. With the introduction early this year of Alternative Mutual Funds, or Liquid Alternatives, now all investors have the same opportunity to take advantage of these more sophisticated tools and structures within their portfolios.

Structurally, alternatives can be separated into two distinct categories: diversifiers and substitutes.

As diversifiers, liquid alts employ strategies that bring a different risk/return profile to more conventional long-only equity and bond portfolios. Because of their ability to tap into different pockets of return potential that traditional portfolios may not be able to access, alternatives can be used to alter and optimize the risk/return profile of a portfolio within a variety of economic and financial market environments.

In the current environment of slowing growth, lower bond yields, and record levels of global debt, having access to additional investment vehicles that offer liquidity is a big win for investors and their Advisors. In addition to acting as portfolio diversifiers, liquid alternatives can also incorporate tools within traditional asset classes to potentially improve returns without taking on additional risk, or maintain existing return levels while lowering portfolio risk.

In either case, liquid versions of such alternatives provide managers with a broader range of tools to structurally optimize their portfolios to not only withstand – but excel – as the decade-long tailwind dies down and global economic outlook becomes more muted.

“The biggest misconception regarding liquid alternatives is that they all share a common investment strategy, which they do not,” says Tim Elliott, President of investment manager Connor Clark & Lunn. “Liquid alternatives are a structure – a type of investment vehicle that provides all investors with access to alternative strategies that they could not otherwise access. Investors will have to evaluate each strategy independently to determine: i) what role it can play in their portfolio, and ii) how likely it will be to achieve its’ investment objectives over time.”

“It is clear that return expectations for traditional, long-only stock and bond portfolios are anticipated to be lower over the next 10 years. Investors will need to evaluate accepting lower return expectations or embracing new types of investment solutions – such as liquid alternatives – as a way to maintain return objectives without a corresponding increase in risk.”

Tim Elliott
President
Connor Clark & Lunn Funds Inc.

Fixed Income / Credit Long-Short

Equities and bonds have enjoyed solid returns in 2019. But as we flirt with all-time highs in stocks and all-time lows in bond yields, investors may be wondering where best to invest in an increasingly uncertain world. Bond investing in particular can be challenging, with yields on many traditional Canadian funds falling below 2%. Will fixed income able to satisfy the income needs of investors when investment grades bonds are offering such low yields?

In order to boost the overall yield in a fixed income portfolio of public securities, investors have traditionally had two options: either move into lower quality securities like high yield/junk bonds or to extend duration by moving into longer maturity bonds. In both scenarios, portfolio yield is increasing, but at the expense of higher expected volatility and reducing both the safety and security of getting paid a consistent return in varying market environments. Reducing the average credit quality of one's portfolio increases the risk of a default, which can heighten the expected drawdown in a market selloff when high yield default rates are spiking. Increasing the average bond duration may offer a higher yield profile, but also increases the sensitivity to changes in yield, whether that's driven by credit spreads widening or interest rates rising.

Under Canada's new liquid alternatives regulation implemented last year, managers now have access to a range of tools previously only available to sophisticated investors and proprietary traders within banks – the use of leverage being the biggest change – that allows fixed-income investors to maximize yield on particular credit positions without having to take on additional default or interest rate risk.

Short dated investment grade credit is by nature a high-quality asset class that alternative fixed income fund managers like Lawrence Park believe has been ignored in traditional fixed income mutual funds and ETFs. With credit spreads so tight, the yield that remains once the interest rate exposure has been eliminated from an investment grade corporate bond is not very attractive on an absolute basis, ranging between 0.5-2% in most securities. However, under the new guidelines, managers can use leverage to enhance the expected portfolio yield while keeping the low risk characteristics of high quality short dated bonds.

The ability to use leverage on short-dated bonds rather than buying unlevered longer-dated bonds not only acts to enhance yield but the high concentration in short-dated bonds increases the flexibility for the portfolio managers in difficult market environments. A portfolio of high quality short-dated bonds is generating cash at a much higher rate than a portfolio of longer dated bonds, allowing the portfolio manager to reinvest at higher yields during market selloffs, and nimbly adapt to changing market conditions to reduce portfolio volatility.

Effectively, these strategies function as a volatility reduction substitute for domestic equities and high yield, while also playing the role of a yield enhancement substitute for traditional fixed income strategies. An alternative credit fund introduces a low correlated strategy to a portfolio that can participate with the equity markets but reduce volatility in periods of market weakness.

The active security trading component of liquid alt fixed-income strategies can be broken down into two primary trading strategies: relative value trading and new issue trading, both of which offer a potential for fixed income alpha with low correlation to traditional fixed income returns.

Relative Value Trading

Relative value trading looks to capitalize on mis-pricings between different bonds from the same issuer. Active managers can exploit the price inefficiency by buying the “cheap” bond and short selling the “expensive” bond. Once the market corrects the mispricing, the trade can be closed for a profit.

Compared to buy-and-hold bond investing, relative value trading presents a more consistent opportunity set, with more potential for uncorrelated returns relative to bonds and equities, and subsequently the ability to make profits in both rising and falling market environments. As this strategy does not depend as much on whether or not the particular company succeeds or fails, it also offers a minimal individual issuer risk relative to traditional bond investments.

A relative value approach lends itself particularly well to the liquid alts structure, as there is more flexibility to invest both in long and short securities.

New Issue Trading

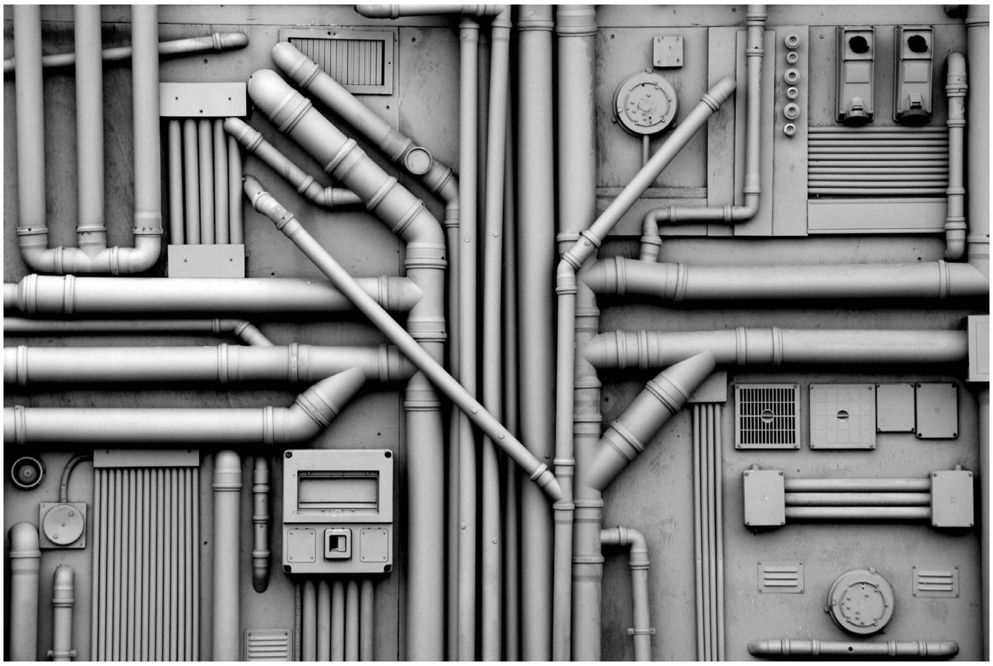
New issue trading looks to participate in attractively priced new issue deals, and also to trade in the secondary market to exploit mis-pricings driven by passive retail investing. The goal of this approach to active trading is to buy either discounted new issues, or to look for existing issues at new, discounted prices in the secondary market. Managers can then sell the new issue at a profit, or, by adding bonds in the secondary market, increase the risk-adjusted yield of their portfolio.

Relative to a traditional buy-and-hold approach, new issue trading allows active managers to take advantage of passive retail flows through active secondary trading, going either long or short. Additionally the ability to use leverage allows managers to buy new issues without being forced to sell existing positions which may not have reached their fair value yet.

The rollout of liquid alt fixed income strategies allows investors and advisors to actively take advantage of mis-pricing and inefficiencies in the bond and credit markets in ways that traditional buy and hold fixed income strategies cannot. As markets become increasingly volatile, and as investors continue to search for more diversification and flexibility within their broader asset allocation, liquid alt fixed income provides a complimentary way to increase diversification, earn returns, and mitigate risk.

"This is a trading style that hedge funds have been using for two decades, that the regulator has now made available to a broader range of investors. Canadians can take advantage of this opportunity to diversify away from the risks of traditional fixed income strategies."

Andrew Torres
Founding Partner & Chief Executive Officer
Lawrence Park Asset Management



The plumbing of liquid alternatives

The introduction of liquid alternatives as an investment structure has created new and exciting opportunities for Canadian investors. However, as asset managers have moved to add these more liquid and diversified strategies to their repertoire, both custodians and prime brokers have been faced with new challenges – and opportunities – in terms of how to support traditional hedge fund strategies in a liquid-alt form, and how to assist asset managers of all stripes in both offering and operating their funds.

Traditional hedge fund managers are well-acclimated to working with a prime broker as well as a custodian to help them do everything from pricing and settling trades, to utilizing leverage, to ensuring correct NAV pricing and valuation of underlying securities and positions. The advent of liquid alts strategies and their availability to retail investors, however, means new requirements and expectations for managers and their service providers.

Custodians and prime brokers have had to adapt their offerings to accommodate both traditional and alternative asset managers who, with the amendments to National Instrument 81-102 to include Alternative Mutual Fund classification (aka Liquid Alts), are now able to offer alternative strategies to non-accredited investors, but at the same time are also now required to ensure compliance with the regulations – through more frequent reporting, expanded transparency, as well as valuation, leverage and liquidity parameters that traditionally were not required.

The new liquid alts rules in Canada have generated both challenges and opportunities to provide solutions that make it easier for asset managers to enter the liquid alts space – and to structure solutions in such a way that they are economically viable within the parameters of a liquid-alt strategy.

“Creating a liquid-alt structure opens the door for retail investors who may not have been able to access certain alternative strategies in a traditional hedge fund structure,” says Ron Landry, Head of Product and Canadian ETF Services with CIBC Mellon. “We are seeing a number of existing asset managers responding to the demand and seeking to create or expand offerings in this space. For many managers, however, a key challenge is to put in place both the expertise and the operational support to fulfill the objectives of their target strategy across functions such as leveraging, long/short, futures that are enabled by the legislation.”

In terms of reporting and filing standards, traditional hedge fund managers looking to get into the liquid alt space face an array of new requirements, including the need a prospectus, get receipted, submit regular filings and annual statements, provide quarterly reporting and pay all the additional costs that come along with it.

That has made it more challenging for traditional hedge fund managers looking to offer a liquid alt fund. “You’re now working within a much structured and regulated framework – tri-party oversight requirements, increased filing requirements increase legal and audit interaction, increase regulatory reporting and compliance, which may be new ground for a traditional hedge fund manager,” Landry says.

Custodians are also building new operational support models to support efficient liquid alternatives administration and enable managers to leverage relationships with multiple prime brokers, with the custodian acting as a primary point of contact for trade execution. These operational approaches are designed to enable data flow, reporting and allow the operational model to remain consistent, while enabling custodians to work directly with prime brokers. In addition to benefits such as enabling an efficient operating model for trade execution and movement of collateral positions, managers can work with an array of prime brokers based on their investment objectives, and – particularly relevant for established managers launching liquid alternatives funds – build on their existing custody relationships.

While traditional hedge fund managers are generally familiar and acclimated with the multiple-prime broker model, many traditional asset managers would not typically engage with a prime broker unless they had been utilizing existing shorting rules available under the non-liquid alts regulations.

“The goal is to deliver a more streamlined approach and provide asset managers looking to get into this space for the first time with the support they need to navigate the regulatory space,” says Landry.

To date, some 85 liquid-alt products have been rolled out in Canada, with more on the way as commodity pools previously under the regulatory umbrella of NI 81-104 renew their prospectuses and are reclassified as liquid alts.

And there are more to come, if the U.S. experience is any guide. While challenges remain in terms of how asset managers roll them out and maintain them – and how investors and advisors take to them, particularly in the midst of the longest bull market in history, and incorporate them into their asset mix – they do offer a flexible alternative to traditional hedge fund strategies that work well for both asset managers and investors alike.

“The ongoing roll out of liquid alts in Canada is going to be built around education: raising the knowledge of the players on the asset management side, as well as helping advisors and investors understand what the structure is and what it enables. Not every liquid alt fund is created equally – investors and managers alike really need to ensure the strategy fits with their objectives.”

Ron Landry
Head of Product and Canadian ETF Services
CIBC Mellon

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