CANADIAN ASSOCIATION OF ALTERNATIVE STRATEGIES & ASSETS

DEMOCRATIZED ALTERNATIVES: LIQUID ALTERNATIVES IN THE CANADIAN MARKET

An investor guide to these innovative strategies - now available to Canadian retail investors and their advisors.

We would like to thank the following CAASA members for helping to make this paper possible:

www.nextedgecapital.com

www.cibcmellon.com

www.maxamcm.com

www.ehpfunds.com

About CAASA & This Paper

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, organizing about 50 podcasts and 200 webinars, either as stand-alone or as part of our seven conferences 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.

As with all our papers, we use an external writer to draft it from interviews with participating members and it represents, in the end, our views and not necessarily that of every participating member.

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

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Thanks to Hill + Knowlton Strategies for their part in interviewing our participating members and drafting this primer.

www.hkstrategies.ca

Foreword

As many know, the CAASA team was involved in the industry outreach that was part of creating the new liquid alts rules - and the final product was quite impressive. It allowed many alternative strategies to be traded in a prospectus vehicle (i.e., mutual fund), thus granting every investor in Canada access to sophisticated investment strategies that can provide lower volatility returns which are less correlated to the rest of their investment portfolios.

From the beginning, the regulators had in mind a registration regime that would allow a significant number of alternative strategies to be offered via prospectus. Of course, the underlying assets would need to be liquid (hence the name) but with that caveat they were open to so-called exemptive relief to be sought and possibly obtained by asset managers who believed that their strategy would be appropriate for retail investors.

CAASA produces a monthly **Liquid Alts Update** which lists all of the funds offered by each asset manager in the category, as well as their AUM, asset class, fees (some information limited to members only). Since its promulgation on January 3, 2019, liquid alts AUM has grown to about $20 billion which is below initial targets of $100 billion after 3-5 years but if there is one thing that investors and advisors are known for: it's that once in motion, they stay in motion - and the momentum behind liquid alts (*66% growth* in the year ended Dec 31, 2021) foretells growing allocations to liquid alts going forward.

James Burron, CAIA

Co-Founder & Partner, CAASA

What are liquid alts?

Alternative strategies and assets have long been a key part of the portfolios of accredited and institutional investors. While alternative strategies are most commonly associated with hedge funds – which, per their name, deploy alternative strategies to either 'hedge' against a falling market or drive more explosive alpha – they are leveraged by every class of institutional investor, including investors with a conservative and long-term view like pension funds.

But until recently, alternatives have been limited to accredited and institutional investors, who regulators gauged to have a sufficient level of sophistication to understand the product they were buying, and the risks and rewards entailed.

The arrival of liquid alternatives onto the Canadian market changed this. Since 2019, under a new regulatory regime passed by the Canadian Securities Administrators (or CSA, an umbrella body for all provincial securities regulators), investors at any level have gained access to alternative strategies through alternative mutual funds also known as liquid alts.

These funds – which can be purchased directly from an institution or through a financial advisor – are differentiated from traditional mutual funds in that they are able to short sell, deploy leverage, and invest in certain kinds of derivatives. This makes several alternative strategies available to the retail investor.

These strategies include:

Directional Strategies which aim to generate returns by taking advantage of market movements. Among these strategies are long-short strategies, where a fund generates returns holding both long and short positions in a portfolio, benefiting from both increases and decreases in the price of various securities. Long-short strategies can be employed with any type of security, whether it is equity or fixed income, and can sometimes come with a sector focus, such as biotech, where companies will look to differentiate based on their expertise and knowledge of the sector. In Canada, much of the investment into liquid alternatives has been into directional equity strategies.

Non-Directional Strategies which mean to to generate returns irrespective of whichever way is the market is trending, generating a source of returns uncorrelated to the performance of the market at large. Among these strategies is merger arbitrage, which looks to exploit the difference between the market price of a security that is the target of an announced acquisition and the price that the acquirer will pay for it. These strategies are useful when it comes to offsetting the risk that comes with market exposure and finding a source of non-correlated return.

Multi-strategy funds which deploy multiple strategies within their portfolio of assets, which certain investors may find fits their individual needs.

Similar to hedge funds which deploy comparable strategies, liquid alternatives have more than one use in an investor's portfolio – they provide additional tools for the investor to achieve their objectives. While some hedge funds are focused on downside protection, others look to drive significant alpha. Liquid alts are similarly diverse: the strategies provided in the market are varied, and their use will depend on investor objectives, risk tolerance, and time horizon.

These strategies enable investors to enhance the traditional long-only 60/40 portfolio. They provide investors with a wide array of choices – which may be important as we enter uncharted economic territory.

"Liquid alternatives are an alternative investment that are often used by investors looking for investment opportunities or to weather market volatility really well. They were brought to market here in Canada after years of consultations with the regulators on how to add additional asset classes and investment strategies to give investment managers an opportunity to improve overall diversification of their portfolios. This is true both from the perspective of extending their ability to drive alpha through leverage, and at the same time provide downside protection. This is sometimes achieved through shorting or through using some sort of derivative that would bring returns contrary to the market."

Ronald C. Landry
Head of Product and Canadian ETF Services
CIBC Mellon

The uses of liquid alts in a portfolio

Liquid alternatives are not a single type of asset or strategy. Rather, they are a set of unique strategies that are newly available to non-accredited investors – and the appropriate tool depends on what the investor's objectives are, their tolerance for risk, and the time horizon against which they operate.

Reducing risk and finding uncorrelated returns

The traditional 60/40 portfolio – that is, a portfolio that has 60% of its value allocated to equities, and 40% of its value allocated to bonds – is based on a historically observed inverse correlation: as equities gain in value, bonds usually lose their value, and vice-versa. This observation underpins decades of investment wisdom and personal finance advice.

But in the environment investors find themselves in today – with historically low interest rates and action from central banks driving government bond yields ever-lower – will this inverse correlation hold up? Do traditional assets no longer deliver the diversification benefits they once did?

And for investors heavily invested in fixed-income securities, are there sources of return that are being left on the table?

Institutional investors believe so.

According to a 2021 analysis by the Bank of Canada, the majority of Canadian private pension plans analyzed – 64% – have been moving away from the traditional 60/40 portfolio, searching to replace the low yields of government bonds with alternative assets and strategies.

Previously, retail investors did not have access to alternative assets and strategies. But through the use of market-neutral strategies like merger arbitrage, certain liquid alternative funds can generate absolute returns that are entirely uncorrelated with market movements, allowing retail investors to follow their institutional counterparts and replace under-performing bonds with funds that can generate absolute returns.

Amplifying alpha

Liquid alternative funds can also be used to magnify the returns on a high-performing security – through this does not come without risk. These gains can be secured either through the use of leverage, or the use of a long-short strategy.

Leverage refers to the use of credit to expand the amount of investable capital an investor has available to them. This naturally amplifies the reward on any given investment – but it also magnifies the risk. Prior to the introduction of liquid alternatives into the Canadian market in 2019, the use of leverage in mutual funds was limited – at present, the use of leverage in liquid alts is limited to 300%. This allows unaccredited retail investors to make use of this tactic, but in a limited way.

Equity and Credit Long-Short Strategies seek to deliver returns to investors by taking long positions in securities that they believe will rise in value, and short positions in securities that they believe will fall in value. (There is a different class of long-short strategies that seeks to hedge against market exposure by looking to have Long and Short positions offset each other.)

This is differentiated from the traditional long-only strategy in that it is able to take advantage of every sort of mispricing, whether a security is priced too low, or too high.

"There are many different traditional investment strategies available to investors. Likewise within the alternative fund space – hedge funds, liquid alternatives – there are also many different strategies with varying degrees of risk and return opportunities. It is not a homogenous space. As an alternative investment fund manager, the liquid alternatives regime allows us the flexibility to use all of the tools available to today's modern investor – our hands are not tied with respect to seeking returns nor, importantly, with managing risks."

Travis Dowle
President & Fund Manager
Maxam Capital Management

"In each of the areas that our funds focus on, there are vast mispricings and vast inefficiencies. Some of these mispricings are on the long side, but some are on the short side as well. We believe that the best way to gain exposure to those areas is through an opportunistic approach. This means a manager that truly understands this space, as opposed to a passive ETF. A manager can be very opportunistic and take advantage of not just longs but shorts in the area as well."

Robert Anton
President & Founding Partner
Next Edge Capital

Liquid alternatives or OM funds?

The use case for liquid alternatives for everyday retail investors is clear: there is now a range of strategies available to them that was previously unavailable.

But is there a use case for accredited and institutional investors?

Liquid alts have key advantages over those offered via Offering Memorandum (which are not available to retail investors):

Liquidity: Liquid alternatives are, as the name suggests, liquid: they can be bought and sold on a much more frequent basis than traditional alternatives, many of which can be difficult to exit. This provides the investor with several advantages: they are more agile, able to adjust to changes in market conditions or priorities, and they take on less liquidity risk with liquid assets. An investor enjoys the flexibility of being able to 'cut their losses', and likewise to take advantage of a buying opportunity.

Low barrier to entry: OM Funds, such as private debt, private equity, or hedge funds typically require a high minimum investment (from $25,000 to $1,000,000). Liquid alternatives are usually offered with the same minimums as mutual funds - as low as $500. This reduces the barrier to entry, giving investors considering investing in alternatives the ability to invest at their comfort level and with a diverse basket of funds for the same amount as a single allocation to one OM fund.

Lower risk: – All investment involves risk – but certain alternative strategies, like the use of leverage, carry more risk than most. Under Canada's liquid alternative regime, the use of leverage in liquid alt funds is capped at 300%, limiting the risk an investor might be exposed to.

Transparency and regulation: Like all mutual funds, liquid alt funds are offered by prospectus and regulated by the various provincial securities regulators. This means that prior to investment, an investor receives a fund's prospectus and Fund Facts (disclosing the fund's attributes and risks) in order to better understand its investment approach and accompanying potential risks and rewards.

New rewards and new risks

The use case for liquid alts is that it provides an alternative investment strategy – a way to derive returns aside from traditional long-only investing. But new investment strategies come with new risks, and it is incumbent on the investor to understand the risk of the particular strategy they wish to adopt.

Some of these risks are straightforward – leverage, for example, amplifies both risk and reward – but using leverage to initiate short positions can (and very often does) reduce the overall volatility of the portfolio, limit the severity of drawdowns (or peak-to-trough losses), and lower the correlation of the portfolio with the overall markets – all being hallmarks of lower risk.

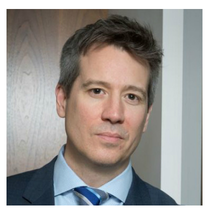
Other risks are specific to a strategy. Merger arbitrage – an alternative strategy that looks to derive an absolute return for an investor – exploits the difference between the market price of stocks in an acquired company and the price that will be paid by the acquirer after an acquisition or merger is announced. This is a useful source of uncorrelated returns for an investor, but it comes with the risk that the deal does not close.

One risk that should be absent in liquid alts funds in liquidity risk. The rules limit the amount of illiquid (or easily-priced/readily sold) assets in these funds and these and other daily metrics and tests (e.g., leverage) are required in order to ensure they are within these bounds and compliant at all times.

As with all investments investors must fully understand the product they are buying before they invest.

"If you're a fan of the endowment asset allocation approach followed by some of the most sophisticated institutions in the world, then it makes sense for you to consider liquid alternatives. However, investors do need to be mindful when considering the different strategies available to them. Some seek high returns and come with significant volatility, while others offer low-volatility and consistent returns. And manager experience is vitally important as well – especially in the liquid alts space that is relatively new and fast growing. We've been managing alternative strategies for more than a dozen years – this isn't just something new that we decided to try our hand at."

Travis Dowle
President & Fund Manager
Maxam Capital Management



"With respect to liquid alts, one of the dangers, from a client perception perspective, is that if you don't understand why you're buying the liquid alts, you may encounter periods where you're confused as to why it's not working as well as you expected. We've been in an environment like that more recently, where all the stocks that are working the best in the stock market happened to be expensive growth stocks. But [for certain liquid alternative funds], that is not what you're buying these for. You're really replacing bond allocations or defensive allocations. But if you don't understand what you're buying, there can be a risk of getting rid of your insurance just before the house burns down."

Jason Mann
Co-Founder & CIO
ehp Funds

Who should be investing in liquid alts?

Liquid alternatives are newly available to retail investors. Should retail investors allocate money to them?

There is a strong case in favour of liquid alts in 2022 and beyond. As the Omicron variant throws the world economy back into turmoil and increases uncertainty across the board, and as inflation hits economies across the world due to central bank action and supply chain challenges, the question of how the traditional 60-40 portfolio – and particularly the 40% allocated to bonds – will perform is in question.

This is an area where liquid alternatives can shine. For example, by reallocating 10% each from the equity and debt portions of the portfolio to alternatives – creating a 50-20-20 portfolio – investors can look to hedge against inflation and under-performing bonds by gaining a source of returns entirely uncorrelated to either.

If retail investors were to adopt this model – to invest more heavily in liquid alternatives – they would be following the lead of their institutional counterparts, who tend to be between 25% and 50% invested in alternatives, in search of differentiated returns in a low-interest rate environment.

"Many of the major institutions in Canada have a significant allocation to alternatives in their portfolio. I would say that the average retail investor is vastly underinvested relative to the average institutional investor and Canada. With respect to a percentage allocation, this should be based on comfort level and your level of understanding of what you're investing in. There's no one set allocation that fits everyone."

Robert Anton
President & Founding Partner
Next Edge Capital

"If you look at the pension funds – like CPP, or Ontario Teachers, or OMERS, and certainly the bigger ones in the US, they are quite heavily invested in alternatives. Now it may not be liquid alts specifically, but there's no question they are using the same types of strategies that we use in our funds in their portfolios. So whether they do that in-house, or whether they've outsourced it, or if they are in an alternative asset class like private equity or infrastructure, I'd say pension funds have a lot of exposure. I think the individual retail advisors and their clients should think about why that is.

And it's quite simple: if you look at the allocations over time of these large institutions, it has shifted from traditional long-only bonds to alternatives, and it's because we're in an interest rate environment where the yields and the risk don't match up with their with their needs. Those risks are no different for the individual."

Jason Mann
Co-Founder & CIO
ehp Funds

Growing Pains

Past performance may not predict future outcomes, but it is a critical datapoint. Unfortunately, liquid alternatives are new in the Canadian market, and any given liquid alternative fund will only have a few years of performance data to refer to.

However, there are other potential data points that can be used when assessing a given fund. In particular, investors should look to ensure that fund managers offering a particular strategy have experience deploying that particular strategy, to ensure that their money is in experienced hands.

Hedge fund managers looking to offer a liquid alternative fund should ensure that they work with partners that can meet their asset servicing needs, including administrative needs, custodial needs and trade execution needs. Offering a liquid alternative fund to the market can be complicated, but the right partner can make it simple.

"If you are a traditional mutual fund manager looking to introduce a liquid alternative fund, you need to ask yourself a question. The question is: do you have the skill set to manage a liquid alternative portfolio, or do you have to go and get that skill set? If you're a hedge fund manager who's never worked in the regulated fund industry, there's a learning curve: the concept of a custodian, the need to have addition administration resources, the need to file a prospectus, the need to deal with auditors.

The additional compliance rules, including concentration limits, exposure limits, leverage limits, etc... are all things that are unique to liquid alternative funds, which hedge fund managers may not be used to. So there's a large learning curve and there's additional cost that they need to take into account."

Ronald C. Landry
Head of Product and Canadian ETF Services
CIBC Mellon

CAASA MEMBER COMPANIES

Investors & Allocators:
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Alberta Teachers' Retirement Fund
Albourne Partners
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