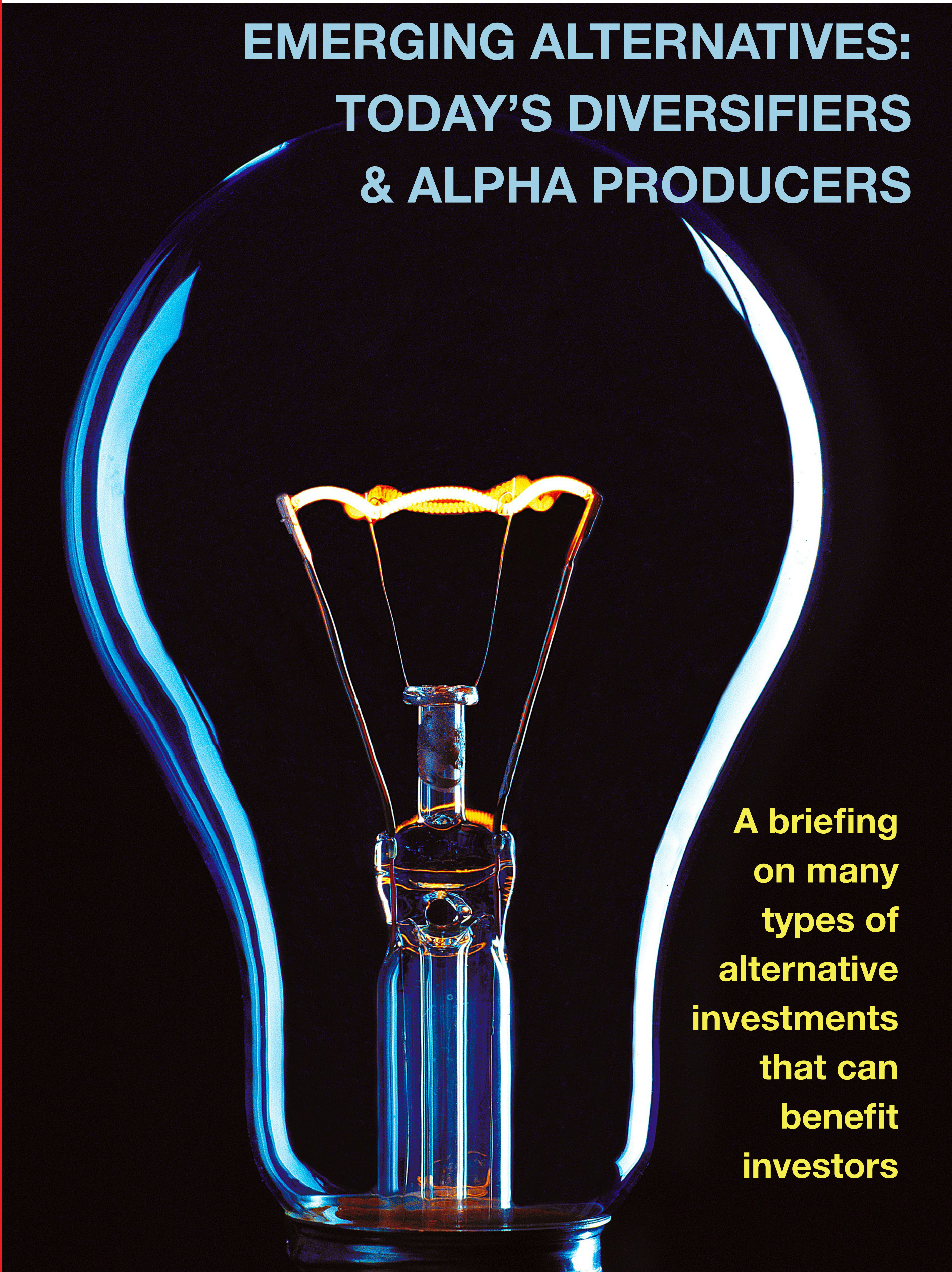
CANADIAN ASSOCIATION OF ALTERNATIVE STRATEGIES & ASSETS



EMERGING ALTERNATIVES: TODAY'S DIVERSIFIERS & ALPHA PRODUCERS

A briefing on many types of alternative investments that can benefit investors

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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 (375+ members in 2022) 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 numerous conferences, webinars, socials, and podcasts throughout the 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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Foreword

Savvy investors have long known about the benefits of allocating to alternative strategies and assets. They allow an investor to find options that best suit their investment objectives, whether that means aggressively pursuing alpha, or whether that means finding investment assets whose returns are totally unrelated to the direction of the public markets, and can therefore truly diversify an investor's portfolio.

It's no wonder that the so-called smart money – institutional investors with large research teams – is heavily allocated to alternatives. One such group, the Maple Eight, some of the world's largest and most sophisticated investors, allocates 35% - 50% (or more) to alternative strategies and assets.

The field of alternative investments advances every day. Traditional options such as: private equity, private credit, real estate, and infrastructure remain available and a solid addition to any portfolio.

But in 2023, truly maximizing returns and diversification means looking beyond well-understood options and towards the cutting edge.

Whether it's funds that service previously-underserved markets, funds that use cutting-edge technology like machine learning, funds that deliver sought-after social impact, or funds that provide instant exposure to a portfolio of alternatives while taking advantage of world-class talent to handle the due diligence, one needs to look beyond the ordinary and at today's diversifiers and alpha-producers to maximize your returns.

James Burron, CAIA
Co-Founder & Partner, CAASA

The case for alternatives in 2023

It's important to remember that a given fund or asset may play different roles in a portfolio, depending on an investor's investment objectives. The division between diversifiers and alpha producers is not ironclad. When it comes to alternatives, a single asset may fill different roles in a portfolio.

But in today's public markets, the case for alternatives couldn't be more clear. In early 2023, the financial markets were chaotic. The collapse of Silicon Valley Bank created a fear of contagion. Many investors with cash kept it on the sidelines and every day seemed to bring a new bad financial headline.

Many investors look to escape this volatility. Alternatives can be a way to mitigate the rollercoaster stock markets and deliver attractive risk-adjusted returns at the same time. And with more and more capital pouring into traditional alternatives, such as private equity, private credit, and infrastructure, the case for investigating emerging alternatives gets stronger every day.

Investment in alternatives can be complex, however, so investors should do their due diligence before making an investment, either on their own or through a trusted financial advisor.

"I don't think return enhancers versus diversifiers is a false dichotomy, but do think it's important to note that diversifiers in a well-constructed portfolio both give you lower correlations to public markets, and the chance to earn 10-12%."

Jeffrey Shell
Head of Alternatives, Commercial ESG & Innovation
BMO Global Asset Management

Mitigating volatility

Investors looking for stability in today's chaotic markets would be well-served to consider absolute return strategies that exhibit low levels of volatility. And there is an absolute return strategy with an excellent pedigree, endorsed by none other than Warren Buffett himself: merger arbitrage.

Merger arbitrage is the practice of investing in specific corporate events, such as a mergers and acquisitions. By purchasing shares of a target company at a discount to the price that an acquirer has contractually agreed to pay, an arbitrageur can earn a return that is independent of the direction of the market when the transaction closes. And because merger arbitrage funds invest in publicly-listed securities they enjoy a liquidity advantage over many other alternatives.

Although this strategy has been around for decades, it is still under-utilized in investors' portfolios today. This strategy is also newly available to a greater number of investors, thanks to the advent of so-called liquid alternatives, which allow non-accredited investors to invest in hedge-fund like strategies.

"An investor can target a different and unique source of returns and risk with alternatives, potentially achieving a return stream with lower correlation to traditional strategies and asset classes – resulting in a modern diversified portfolio. For instance, with arbitrage we are targeting specific corporate events, such as mergers and acquisitions to earn a return. We profit when the merger we are invested in closes successfully, regardless if the general market goes up or down."

Travis Dowle
President and Fund Manager
Maxam Capital Management

Underserved markets

One of the benefits of private investments is the ability to spot underserved markets, service them, and allow investors to reap the rewards. And a class of agricultural lenders does just that. About one in three farmers is offside with one of their covenants with a traditional financial institution or just doesn't exist in a financial institution's traditional covenant space.

These covenants are sometimes unmet because of mismanagement of the farm operation. But sometimes, they are unmet because of Mother Nature. Farmers, more than many other businesses, are exposed to the risks posed by extreme weather – for example, many farmers in Abbotsford in British Columbia had their farms entirely flooded.

These lenders – agricultural bridge lenders – exist to fill that gap.

Prior to 2017, Farm Credit Canada, and a collection of smaller credit unions, filled this gap. But following regulatory changes in 2017, with stricter depository rules, this source of credit dried up – and private farm lenders filled the gap. Today, private lenders represent about $12 billion of the $136 billion of debt in the agricultural space today.

But despite being lenders, these funds are not just diversifiers. Through active management, they create alpha. Upon taking a bridge loan, these funds can deploy teams of experts to determine where operations can be improved and ultimately create more value for investors, and for the public, who will enjoy greater food security and greater prosperity as a result of improved agricultural productivity.

Agriculture is, of course, not the only economic sector to be underserved by traditional lenders. The U.S. mid-market – firms with $10 billion to $15 million in earnings - are underserved as well. They are too small to go through an IPO, to raise a high yield bond offering, or to tap the credit markets. The institutions like small regional banks that previously provided these loans have largely disappeared, and with the ongoing U.S. banking crisis, credit will be harder and harder to come by leaving a gap in the market for alternative funds to fill.

The firms that fill this gap differ from other private lenders in fundamental ways. Traditional private lenders typically loan to private equity-owned companies which means that investors in these traditional lenders are indirectly creating exposure to private equity where none may be wanted.

"Forty years ago, a good growing business, non-sponsored, could go across Main Street, and likely find a three-times-levered loan from their local bank. Unfortunately, they can't anymore. So if you have a team, as we do, that's been doing this for 30 years, we've built up a lot of relationships, and helped a lot of the growing non-sponsored businesses grow. And we can provide the financing they need with speed, with certainty to close, and maybe flexibility … that's very valuable to these companies. If they could get what they need cheaply from a bank, they would. But the world has really changed quite dramatically since the savings and loan crisis. … So as a result, the banks really aren't there anymore."

Greg Racz
President and Co-Founder
MGG Investment Group

"A healthy relationship between a farm lender and a farming borrower isn't simply transactional. The analysis isn't solely quantitative. It's about walking lockstep with a borrower through every stage of the arc of a file, compiling information, gaining context, and getting the farmers and their families to a better place."

Robb Nelson
Chief Executive Officer
AgriRoots Capital Management

"If you apply to a large Canadian bank, and you're self-employed, and you say, 'Listen, I can afford this', the bank can say, 'I have to see it on a notice of assessment or a T4 or I just can't do anything.' But companies like ours can say, 'we have a lender that will be able to give you a mortgage – you stay with them three years, then you come back to the big bank.'"

Will Granleese
Portfolio Manager
Antrim Investments

Leveraging technology

So-called quantitative investment funds have been around for a long time. These funds use algorithms and vast quantities of data to try and deliver superior returns to their investors. In 2023, the cutting edge of data science is machine learning and artificial intelligence (AI), and a new class of investment funds is leveraging those new technologies to deliver returns for investors.

Traditional quantitative investment funds operate on an assumption that the past is the best predictor of the future, and that the relationship between the various factors that determine a stock price can be worked out through math. Through quantitative analysis, the algorithm determines which factors emerge as relevant and use those factors to direct investment.

AI-driven investment funds, on the other hand, can leverage the information-processing ability of quant funds but utilize fundamental analysis. They are able to examine fundamentals like cash flow, but also systematically analyze the myriad of different definitions of cash flow against the myriad of other variables and determine the most relevant way to invest.

While AI tools are able to perform complex calculations; they must still be shaped by humans. The unique AI-driven funds that now exist in Canada have been shaped, influenced and developed by some of the world's leading fundamental analysts at major Canadian pension plans.

"The primary centre of gravity of a typical quant fund is the assumption that the past is the best predictor of the future and that the relationship between various factors which affect or determine a stock price can be mathematically expressed. So - the best way to predict the future is to data mine the past . But at the end of the day, the math is well-known, the data-sets are public, and, as a result, excess returns from quantitative funds have been arbitraged away. Certain funds are harnessing AI and applying it on a fundamental analysis basis. This is completely new. It's not simply data-mining the past."

David Jarvis
Founder and Principal
Corton Capital

"You can have thousands upon thousands of different ways of expressing cash flow, and that's the power of AI. It has the capacity to carry millions upon millions of relationships that cannot be carried in the human brain. In that sense, the human aspect is understanding the relationships and the creative process. The AI has the ability to manage those millions upon millions of possibilities – whether it's cash flow, sales or risk."

David Jarvis
Founder and Principal
Corton Capital

An affordable alternative

Investors have traditionally used real estate as a portfolio diversifier. Investors looking for exposure to real estate may enjoy its strong cash flows, the fact that it's a tangible, real asset, and the strong fundamentals driven by supply dynamics and population growth.

A new generation of investors is interested in Environmental, Social, and Governance (ESG) factors – under the belief that socially- and environmentally-responsible investment not only matches their values, but ultimately will deliver attractive returns. In real estate, this can be achieved by investing in affordable housing.

This may seem counterintuitive but investors in affordable housing are making a rational investment decision. By providing high-quality housing that is similar to market housing, but at discounted and regulated rates, the property will likely have higher occupancy rates with less cyclical swings, meaning the returns are more stable and more reliable. As a result, there is better downside protection than conventional multifamily while still enjoying the inflation-linked cash flows that attracted investors to multifamily real estate.

There are, however, regulatory barriers to entry into this sector. In the U.S., for example, transfer consents are typically required by government regulatory bodies and industry specific expertise is required to navigate the agreements that stipulate the affordability restrictions as outlined in the affordable housing program making affordable housing investment funds an attractive, and lower-barrier, way to invest in this sector.

Providing lower-income tenants with dignified places to live can be an attractive, and socially responsible, source of returns. Providing prospective homeowners with financing when they may not otherwise qualify for it can also provide attractive returns and help close a pressing social gap.

The vast majority of Canadians purchase real estate with a mortgage. But some Canadians, due to various factors beyond their control, may not qualify. Among many others, this includes newcomers to Canada with a limited local credit history and self-employed Canadians who do not meet regulatory requirements for mortgages.

This gap in the market is one that has been filled by alternative mortgage providers. By asking for a substantially higher down payment than traditional mortgage providers, they are able to provide financing to people who would otherwise qualify, but for regulatory or other reasons are unable to secure a loan.

Investing in this sort of alternative mortgage allows an investor to avoid the volatility of the public markets, secure a very attractive return, and gain exposure to real estate – all at the same time.

"Affordable housing can be a good option for investors looking for strong, uncorrelated returns while also having a positive social impact. On the risk side, supply-demand imbalances are driving strong occupancy trends and persistent rent growth. Affordable housing is also often more resistant to market fluctuations and economic downturns. And on the return side, we believe affordable housing can generate returns as high or higher than conventional market-rate multifamily, so you don't need to sacrifice returns in order to have a social impact."

Robert Lee
Managing Partner
Spira Equity Partners

"The number one reason the private mortgage market has increased is because there are more new immigrants coming to Canada, and there's more people that are self-employed. These people will have a hard time with the banks, so there's more borrowers."

Will Granleese
Portfolio Manager
Antrim Investments

One-stop shop

Investors and analysts making the case for alternatives often speak of the '50-50-20'. The new 60/40 portfolio can allow investors to take advantage of the diversification and superior alpha created by alternatives, while still having the majority of their capital allocated to securities purchased from public markets.

However, within that alternative bucket, further diversification is necessary as investors must divide it between various types of alternative investment, whether that is private equity, private credit, real estate, or infrastructure.

Given the breadth and complexity of the suite of available alternatives, correctly selecting a portfolio that meets your risk tolerance and investment objectives can be difficult. Selecting the right partner, and right asset manager, can be paramount.

There are now products available that simplify this process including funds that are invested across the various categories of alternative. Investors in these funds enjoy instant diversification. But they also enjoy the expertise of world-class asset managers who can perform due diligence, select excellent investments and ensure that investors who buy into the fund are getting the diversification and return enhancement they are looking for.

"It all works together beautifully because you've got a portfolio manager who is able to see every single deal that comes through globally and decide how much is appropriate for the fund on behalf of investors. In the absence of that, you've got to manage it all yourself – diligence of all sorts of different managers, manage the operational complexity of capital call type structures including ensuring sufficient resources to fulfil calls, how to redeploy returned capital, … These funds offer a simple and elegant diversified solution to what otherwise would be complex and cumbersome."

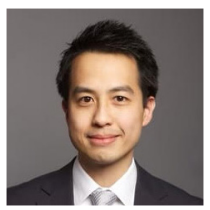
Jeffrey Shell
Head of Alternatives, Commercial ESG & Innovation
BMO Global Asset Management

Allocating to emerging alternatives

There is no right way to invest in alternatives. It is such a broad category that the right mix depends heavily on an individual's investment objectives. In general, it is best for an individual to know why they are investing in alternatives.

This is doubly true with emerging alternatives. Some of the alternatives now available on the market use sophisticated technology to enhance returns. Others look to serve under-serviced markets – and so provide strong cash flow and strong returns at the same time. Others, like real estate, provide a source of value that is uncorrelated with the public markets and in the case of agricultural real estate, uncorrelated with the housing market as well.

Setting investment objectives can help an investor, with the aid of a trusted advisor, select a mix of alternatives that fit their investment objectives – and enjoy the diversification, or alpha, they are looking for.



"Investors are going into the alternative space to earn excess returns from a traditional portfolio. However, to outperform, investors need to try and stay out of the commoditized areas. Our view is that the alpha is created in the niches, and affordable housing is just that."

Robert Lee
Managing Partner
Spira Equity Partners

"We advise that if you're not experienced, use an advisor. Start small and diversified. Over time you can become educated and learn from experience and your own preferences, because there's no one size fits all. Request sound advice, get a counsellor, an advisor who's experienced in a range of alternatives, and never put all your eggs in one basket"

Greg Racz
President and Co-Founder
MGG Investment Groop

"Alternative strategies should be considered in many portfolios. That said, there are exogenous factors that influence returns. It's been tougher sledding for some managers in periods of irrationally low interest rates, an environment we've witnessed until recently. Niche alternatives like farm lending deserve a look in any market cycle. They often present differentiated exposures, and they focus on important themes like food security, global supply chains and, critically, Canadian farmers and their communities."

Claude Robillard
Principal & Founder, 43 North Group
Board Member, AgriRoots Capital Management

"Alternative strategies such as private equity, real estate and arbitrage can, and arguably should, all happily coexist in a modern portfolio. Each one of these alternatives is going to aid in portfolio diversification because they generate returns in different ways, and they perform in different environments – they exhibit lower correlation to each other and to traditional equities and bonds. For example, arbitrage is a strategy where absolute returns have historically improved in higher interest rate environments."

Travis Dowle
President and Fund Manager
Maxam Capital Management

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