October 5, 2018 Emma Querengesser

Alternative Investments – A Focus on Risk-Adjusted Returns

There is little question that investors have been handsomely rewarded by equity markets over the last decade, with the US bull market recently becoming the longest one in history. This September marked the 10th anniversary of the collapse of Lehman Brothers, a challenging and unforgettable period of time for a large part of the investing community. Needless to say, markets have continued to grind higher since the lows of 2009, and every day it seems that we're faced with headlines of "markets hitting all-time highs". In fact, over the last 10 years, an investor in the S&P 500 Index (C$ Hedged), S&P TSX Capped Composite Index, and FTSE TMX Canada Bond Index would have earned a total return of 186%, 84% and 54%, respectively – an equal-weight portfolio of these indices would have produced a 10-year annualized return of 9.5%. It may seem futile to debate whether or not this bull market will continue or if we are late in the cycle and the next bear market is on the horizon; however, for an investor questioning the expectation of future capital market returns from traditional asset classes, the discussion of alternative investments should be at the forefront.

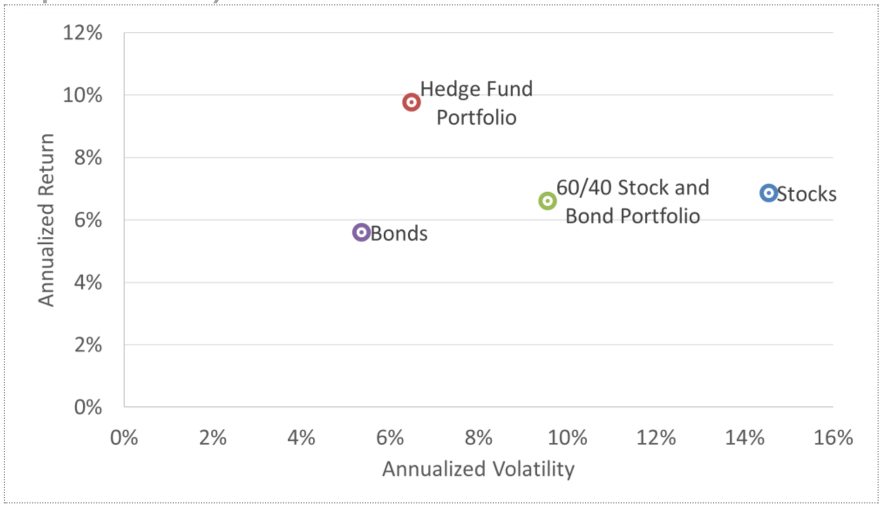
What Is an Alternative Investment?

Broadly speaking, an alternative investment is a type of asset other than stocks, bonds and cash, or a type of investment that uses non-traditional strategies to achieve its investment objective. A number of alternative investments offer investors exposure to real assets such as private equity, real estate and infrastructure assets, while hedge funds on the other hand are pools of capital and span a wide range of strategies. Some of these funds are more equity-focused such as long/short equity or market neutral strategies where the fund attempts to hedge varying degrees of market exposure by profiting from securities that go up in value as well as down in value (via short selling). While not all alternative investments are created equal or serve the same investment purpose, including them in one's portfolio can serve to increase diversification, lower correlation, reduce volatility, provide downside protection and enhance returns.

Rethinking the "60/40" Portfolio

As one can infer from above, the traditional balanced portfolio – think 60% equities and 40% fixed income – has historically been a reliable source of investor returns. With equity markets at historic valuations/record levels, interest rates in decline since the 1980s, rising consumer debt loads, and increased correlation between traditional asset classes, investors can look to include alternative investments to further diversify and optimize the risk-adjusted performance of their portfolio. Some of the most sophisticated investors in the world are already following this approach. In fact, according to Preqin, approximately 45% of the total institutional investor universe, 83% of endowments and 66% of foundations actively invest in hedge funds. According to the 2018 CPPIB Annual Report, the Canadian Pension Plan (which manages pension retirement assets for over 20 million Canadians) allocated more than 50% of its assets to alternative investment strategies. For investors that are seeking steadier returns with lower

Figure 1. Hypothetical Risk/Return of a 60/40 Stock and Bond Portfolio Compared to a Hedge Fund Portfolio (January 1990 – September 2018)



Source: Bloomberg, HFRI. "Hedge Fund portfolio" is the HFRI Fund Weighted Composite Index / "Bonds" is the Bloomberg Barclays Global-Aggregate Total Return Bond Index (Unhedged USD) / "Stocks" is the MSCI World Total Return Index (USD) / "60/40 Stock and Bond Portfolio" is 60% MSCI World Total Return Index (USD) and 40% Bloomberg Barclays Global-Aggregate Total Return Bond Index (Unhedged USD).

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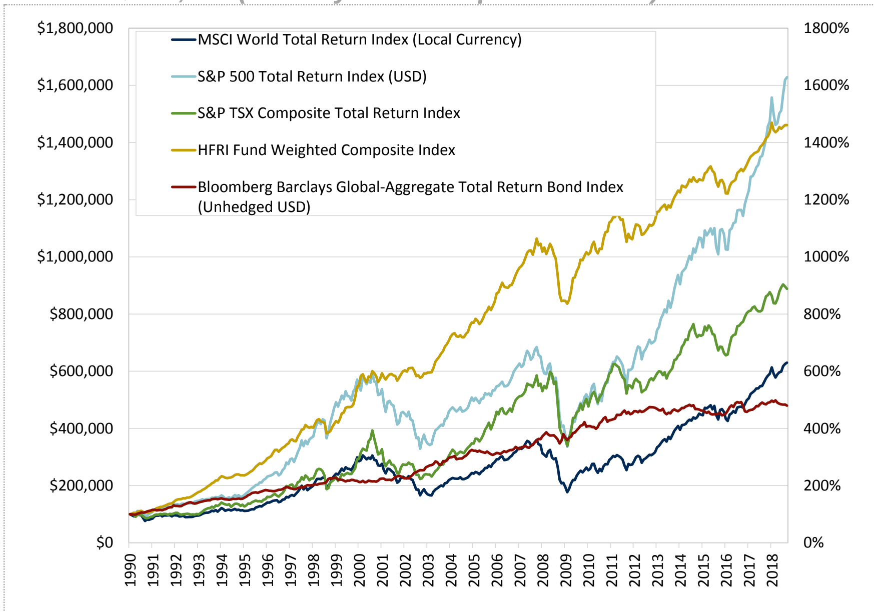
volatility, alternatives can be an excellent complement to equity or fixed income holdings. You can see from Figure 1 above that hedge funds can help to increase portfolio efficiency. Since 1990, exposure to a hedge fund portfolio resulted in a higher annualized return than stocks or the 60/40 portfolio, and it achieved this with substantially less volatility than an all stock or 60/40 portfolio.

Figure 2. Hedge Funds Versus Traditional Asset Classes
Value of $100,000 (January 1990 – September 2018)

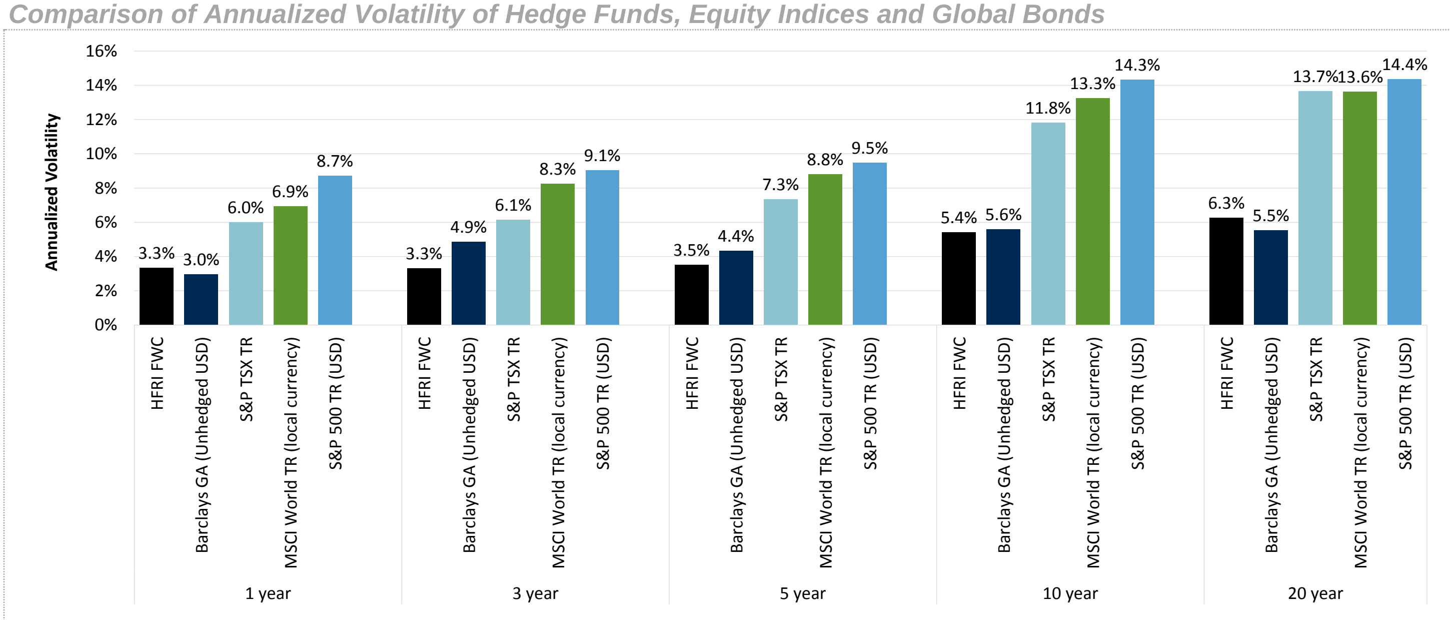


Source: Bloomberg, HFRI

Recent Challenges

In recent years, there has been no shortage of negative (and often misleading) connotation associated with the term "hedge fund", so much that many hedge funds have abandoned the use of the word altogether and instead now highlight their solutions as alternative investments, hoping to avoid any misconceptions about their offerings. Whether it be that all hedge funds are risky, use excessive leverage, are unregulated, charge excessive fees, or always underperform the market over time, their wider spread adoption in an investor's portfolio has been largely curtailed. On the contrary, many hedge funds use strategies that strive to achieve superior risk-adjusted returns for investors and offer significant correlation benefits. Like any investment, proper due diligence is required to seek out investment managers and strategies that are designed to meet an individual investor's financial objectives.

Figure 3. Hedge Funds are Not "Risker" Than Traditional Asset Classes
Comparison of Annualized Volatility of Hedge Funds, Equity Indices and Global Bonds

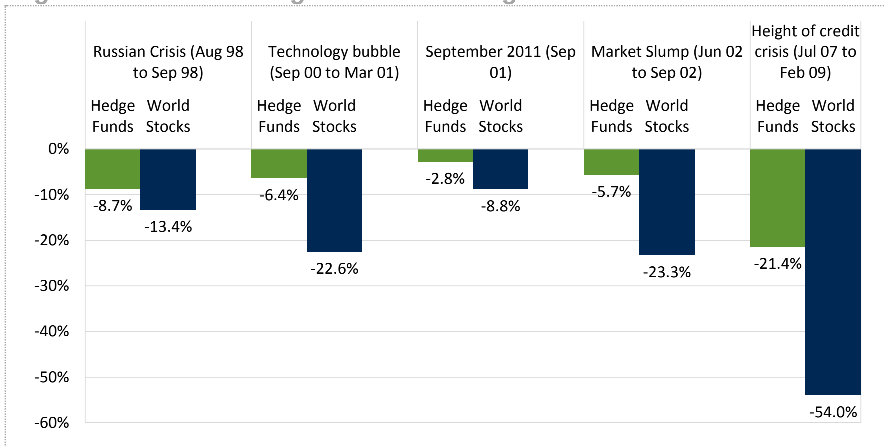


Source: Bloomberg, HFRI

Understanding Performance

In our view, the biggest challenge to more widespread adoption is a result of investors comparing their performance (or underperformance) to passive indices without taking into account the level of risk that delivered the respective return i.e. risk and return have been separated when evaluating hedge funds, with the former factor largely being overlooked. In other words, investors have mostly looked at the alternatives space as one that has been "underperforming the market" despite the lower volatility and inherent portfolio diversification benefits that many of these vehicles offer. Alternatives have not been alone in this plight – according to Morningstar, a total of $692 billion flowed into passive funds in 2017 while almost $7 billion flowed out of actively managed funds.

Figure 4. Peak to Trough Losses – Hedge Funds vs World Stocks



Source: HFRI (Hedge Funds: HFRI Fund Weighted Composite Index), Bloomberg (World stocks: MSCI World Net Total Return hedged to USD)

If one is of the view that we are in the later stages of the market cycle and the level of returns we have realized over the last decade may be challenged going forward, the average investor needs to refocus his attention to optimizing *risk-adjusted* returns, not just pure performance. After all, the goal for most hedge funds is to earn attractive risk-adjusted, absolute returns, rather than outperforming a specific benchmark. For investors who experienced the volatility of the 2008 global financial crisis, many would agree that they'd rather avoid going through those types of steep market declines again. Fortunately, there are a variety of alternative investment strategies that have the ability to achieve steadier, uncorrelated returns and help protect investors from steep declines in markets. Warren Buffett once said, "the two golden rules of investing are number one – don't lose money and rule number two – don't forget rule number one!".

No Longer Just for the "Accredited Investor"

One of the limitations of investing in hedge funds has been that these products have historically been reserved for sophisticated, high net worth, better known as "Accredited" investors. In late 2016, the Canadian Securities Association proposed an amendment to NI 81-102 Investment Funds, which governs all publicly offered mutual funds. Under this framework, a new class of investments called "liquid alternatives" or "liquid alts" would be created, allowing retail investors to access some hedge fund strategies that have historically been unavailable to them. Now, two years later, the final form of this proposal has been announced with the changes going into effect in early January. According to CIBC, it's expected that the demand for liquid alternatives will exceed $100 billion in Canada alone, so the significance of this development and what it means for investor portfolios moving forward should not be underestimated. Some additional benefits of the new structure include lower minimum investment thresholds, increased liquidity, and additional transparency. We should expect to see new liquid alt products being launched by traditional mutual fund companies that can now offer these strategies in prospectus format, as well as from existing alternative asset management firms that will now be able to accept investments from a wider range of investors.

Conclusion

The last few years have been extremely fruitful for equity investors and have generally been characterized by a period of low volatility, declining interest rates, accommodative fiscal and monetary policy, and outperformance of low-cost, passively managed investments. Despite some of the mystery surrounding alternative investments, due to increased education and awareness, more investors are demanding the inclusion of non-correlated assets in their portfolios. According to a recent survey by JP Morgan, 2017 saw net capital inflows of $9.8 billion into hedge funds, bringing the total industry assets to roughly $3.2 trillion, with investor sentiment towards alternative investments on the rise. While there have been dispersions in returns amongst fund managers and strategies, with proper due diligence and diversification across a variety of alternative strategies, these vehicles can serve to optimize traditional portfolios.

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