

Introduction to Alternative Investments: Strategies & Benefits

Manager Working Group in Support of Wealth Advisors



Contributions by:



Alternative Investments Profile



Profile

Alternative Investments



Alternative investments are differentiated from traditional investments by:

- Short selling
- Leverage
- Greater derivative use
- Risk profile
- Liquidity
- Absolute vs relative returns
- Performance fees
- Offering Memorandum

Note: Liquid Alternatives (Alternative Funds) are alternative investment type strategies in a mutual fund wrapper (discussed later)



Service Providers



- **Prime Broker:** securities finance, trade execution, clearing & settlement, capital introduction services
- **Custodian:** holds assets, settlement of securities, collateral management, securities lending
- **Fund Administrator:** NAV calculation, shareholder reports, payment of fund expenses, filing of reports/statements, return calculations
- **Auditor:** review of fund financial statements, tax services, verify NAV & AUM
- **Legal:** Set up legal structure, offering documents, general counsel

Benefits of Investing in Alternatives



Benefits of Alternative Investments



- ▶ Diversification
- ▶ Risk reduction & volatility reduction
- ▶ Downside protection & capital preservation
- ▶ Low to non-correlated returns
- ▶ Return enhancement
- ▶ Niche access to different investment opportunities
- ▶ Protection from rising interest rates & inflation

**Smoother
Return
Experience**



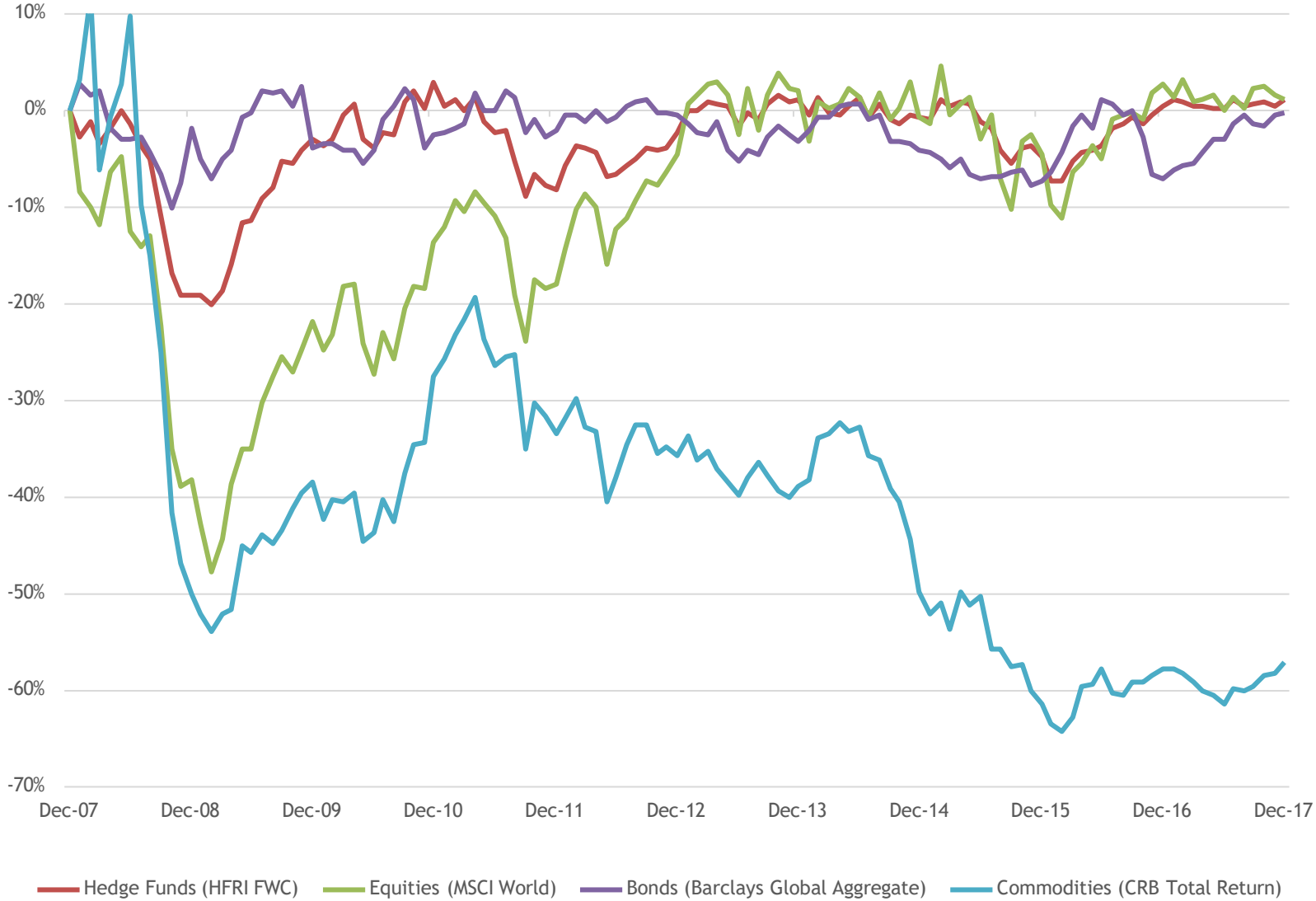
10 year cumulative returns



Lower Drawdowns



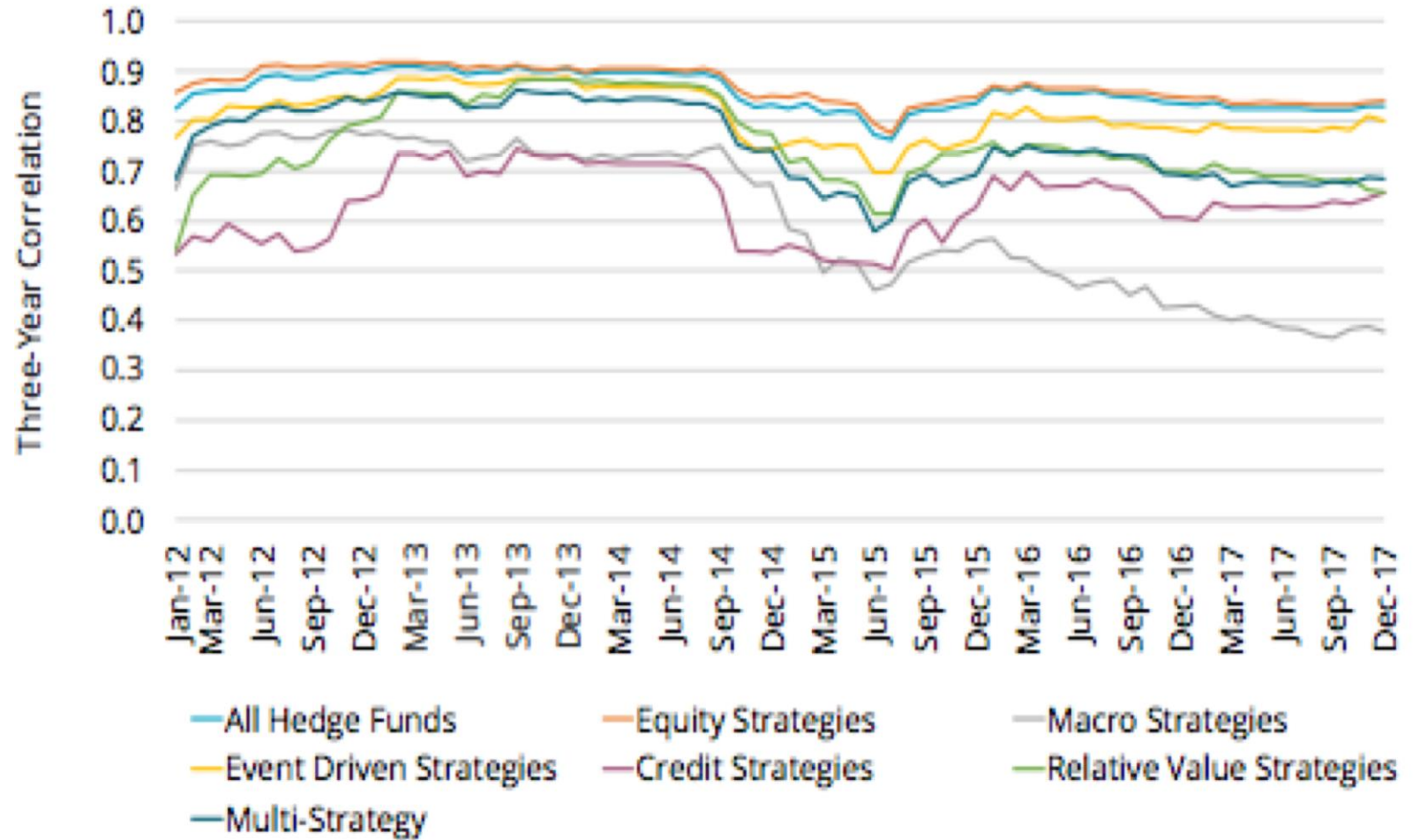
Hedge fund and various asset drawdowns



Correlations

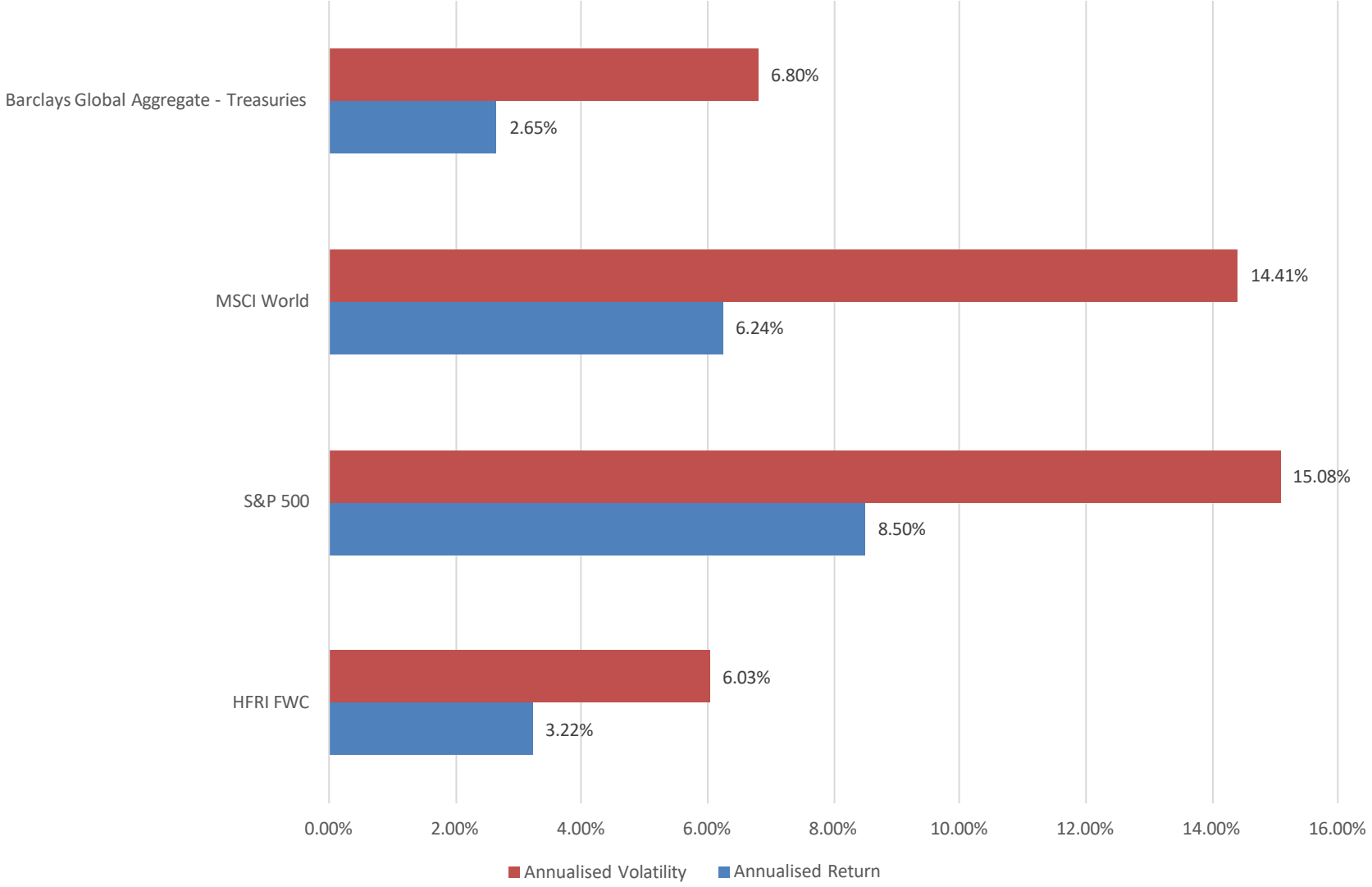


Fig. 4.9: Rolling Correlation of Hedge Funds to the S&P 500 PR Index, 2012 - 2017



Source: Preqin Hedge Fund Online

10-year annualised risk and return



Annualised Risk & Return

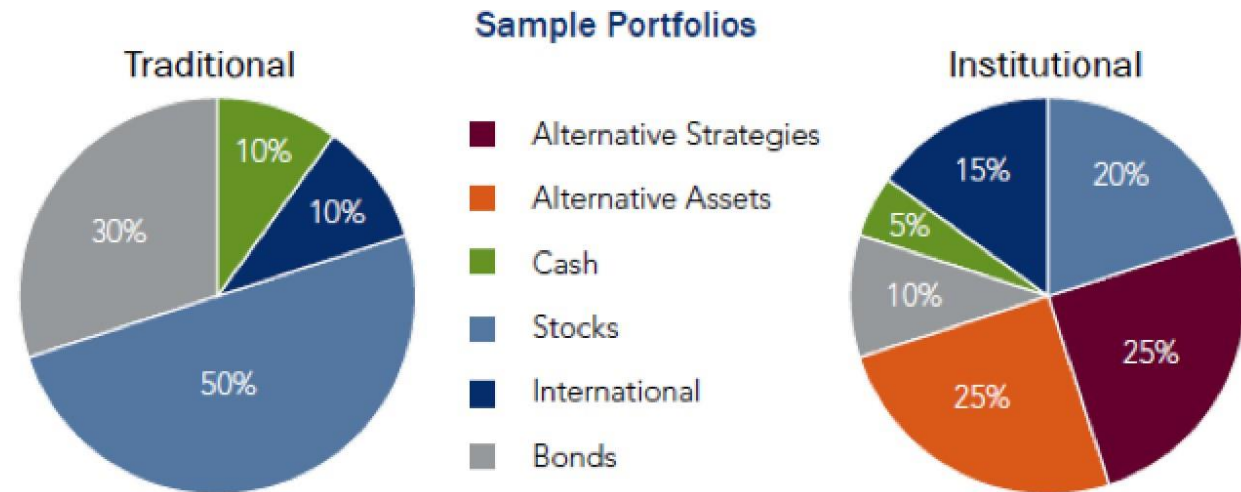


Role of Alternative Investments In Asset Allocation



Endowment Model

No longer: 60-40

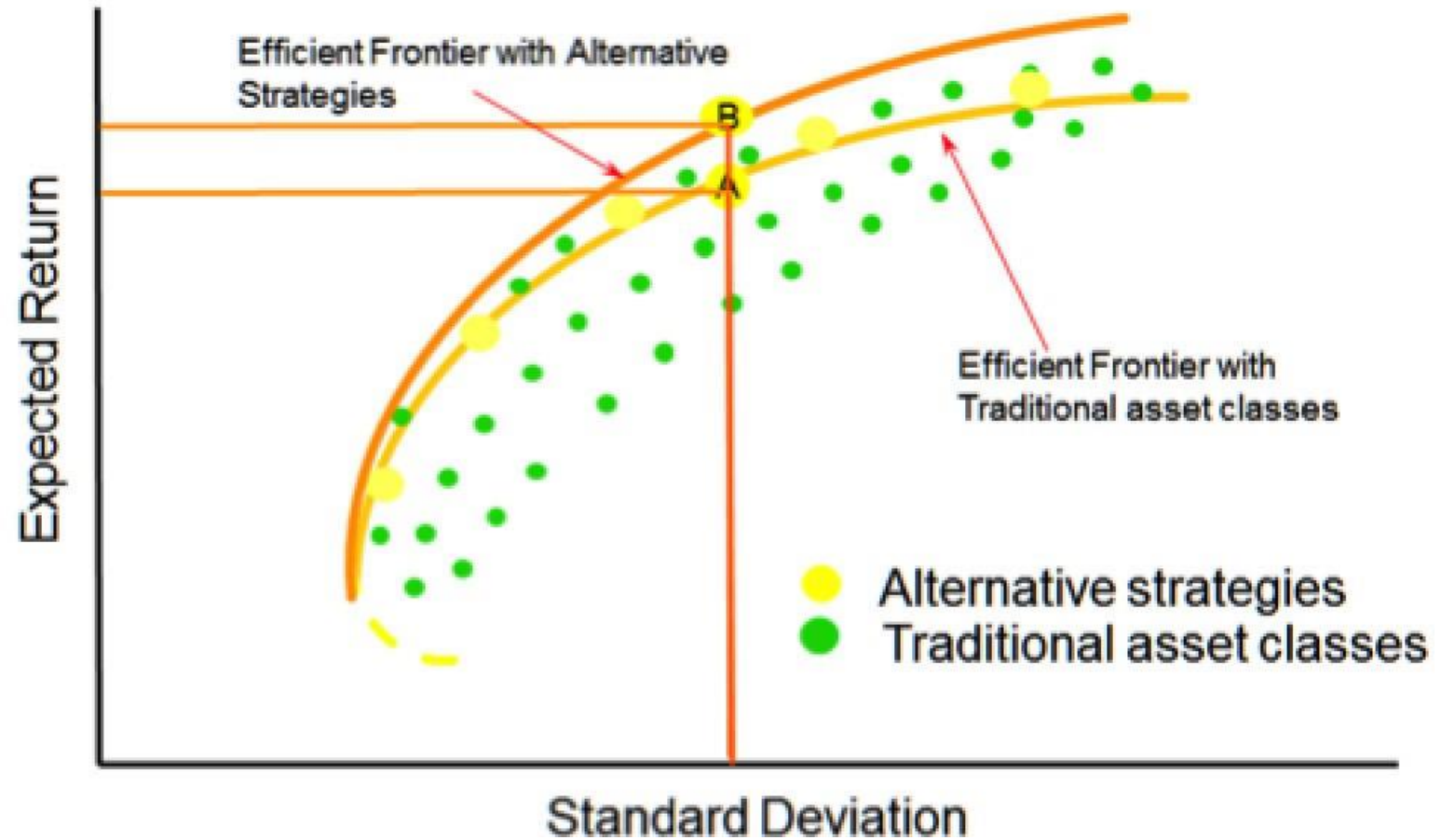


	TRADITIONAL	INSTITUTIONAL
Allocation	Static allocation targets—50/30/10/10 “typical” moderate portfolio	Adjustable allocations—driven by market environment and risk targets
Exposure	Uses traditional stocks, bonds, international and cash	Blend of traditional assets, alternative assets and alternative strategies
Risk	Result of market conditions	Focus on controlling risk by adjusting to market conditions
Rebalance	Rebalanced quarterly/annually	Ongoing allocation adjustments and rebalancing

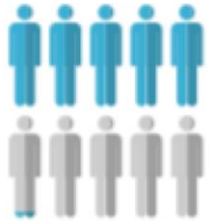
The portfolios are hypothetical examples provided for illustration purposes only. No assumptions should be made that similar asset allocations will be profitable, suitable or perform as indicated above. Allocations and their percentages should change based on an individual investor’s needs.

Extending the Efficient Frontier with Addition of Alternative Strategies

Extend the Efficient Frontier



Investment in Alternatives



51%

of public pension funds actively invest in hedge funds.



\$2.06tn

Amount of capital invested in hedge funds by institutional investors.

Institutions & Endowments

Nearly infinite time horizon, low appetite for risk, enhance risk adjusted returns to fund long term liabilities

Low or negative correlation to the rest of their investments

Family Offices

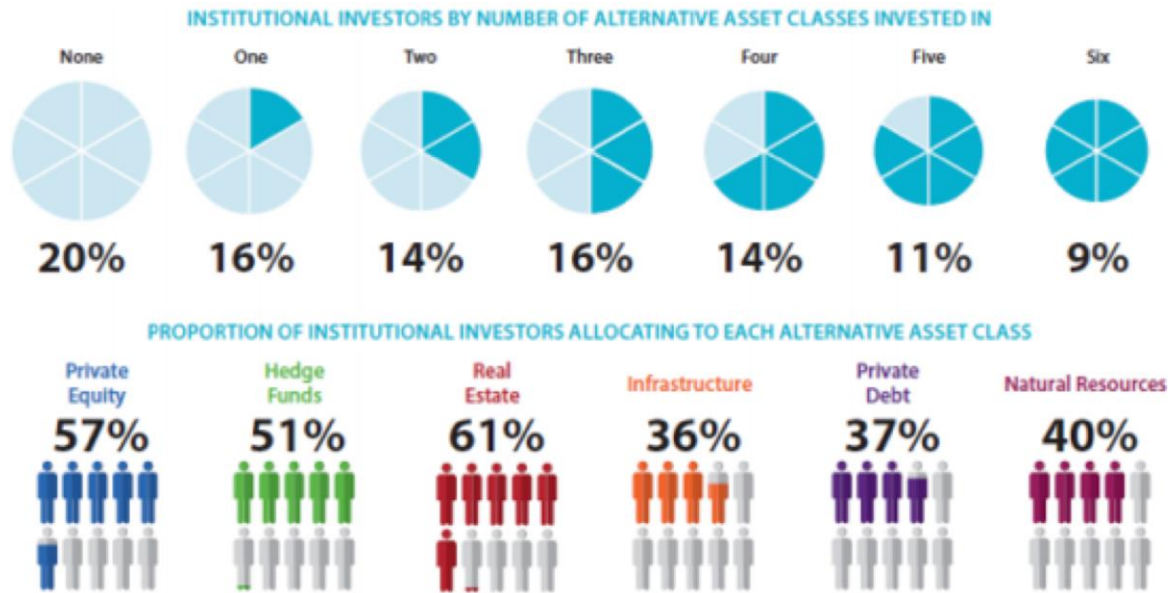
As a way to gain access to the best minds in the investment universe

Enhance diversification to increase total returns over time by reducing overall volatility

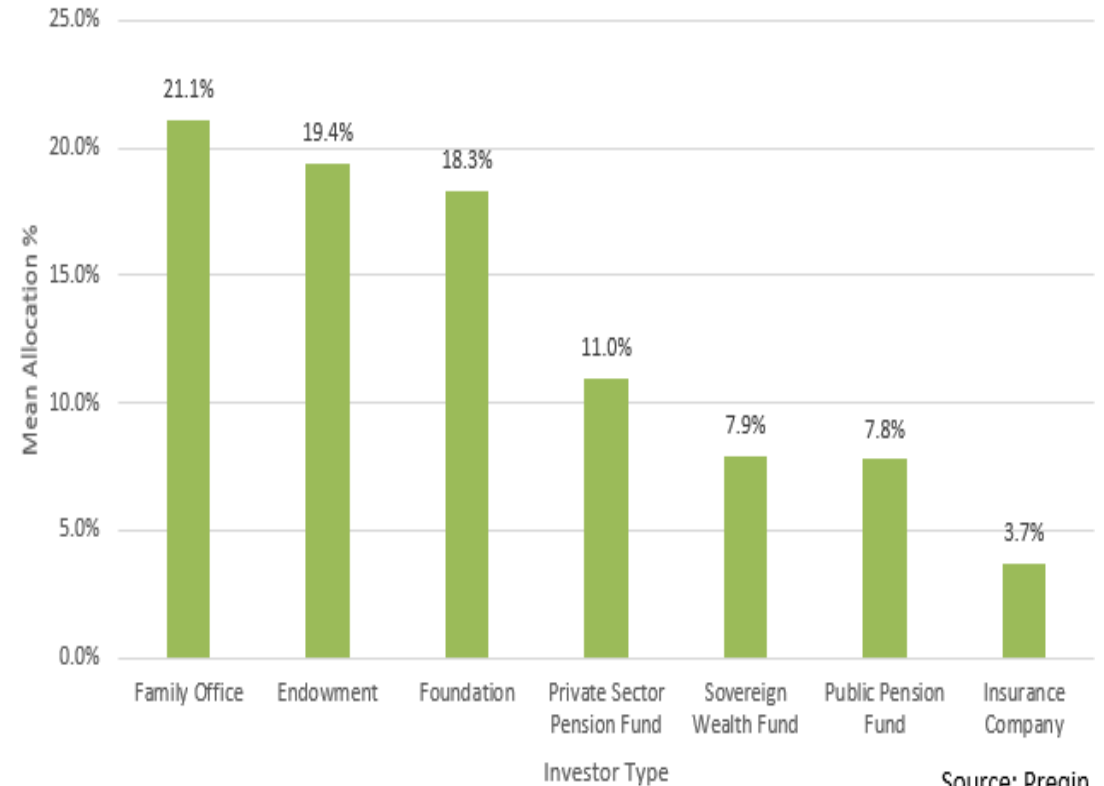
Consistency and reliability of returns

Alternative Allocations

What Professional Investors want to accomplish

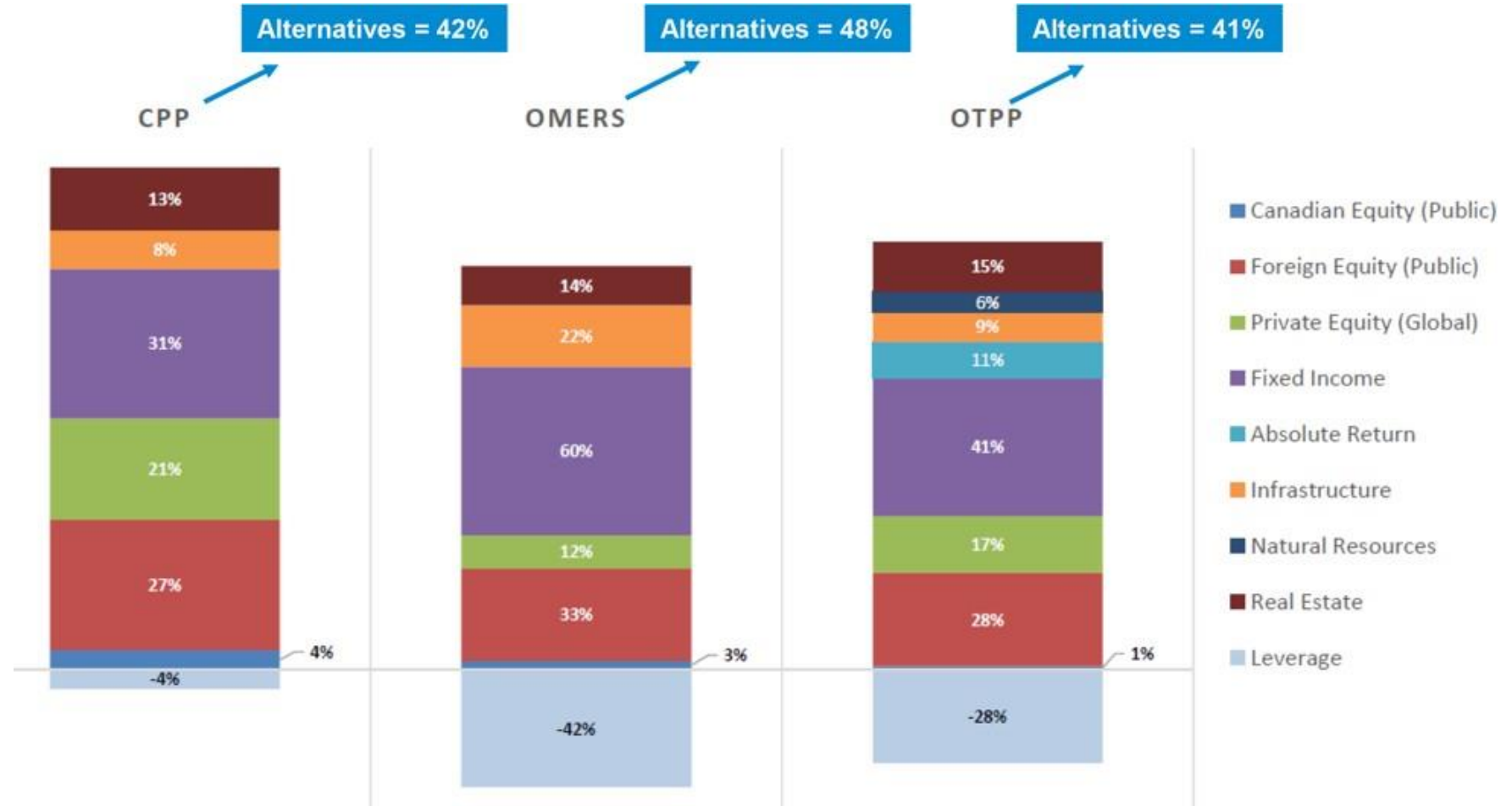


Mean Allocation to Hedge Funds by Investor Type, YTD 2018



Canadian Pensions

Fiscal Year End December 31 2015 (CPPIP Fiscal Year End March 31 2016)



Notes: Asset allocation presentation is designed for illustrative and comparative purposes only. Most recent asset allocations used.

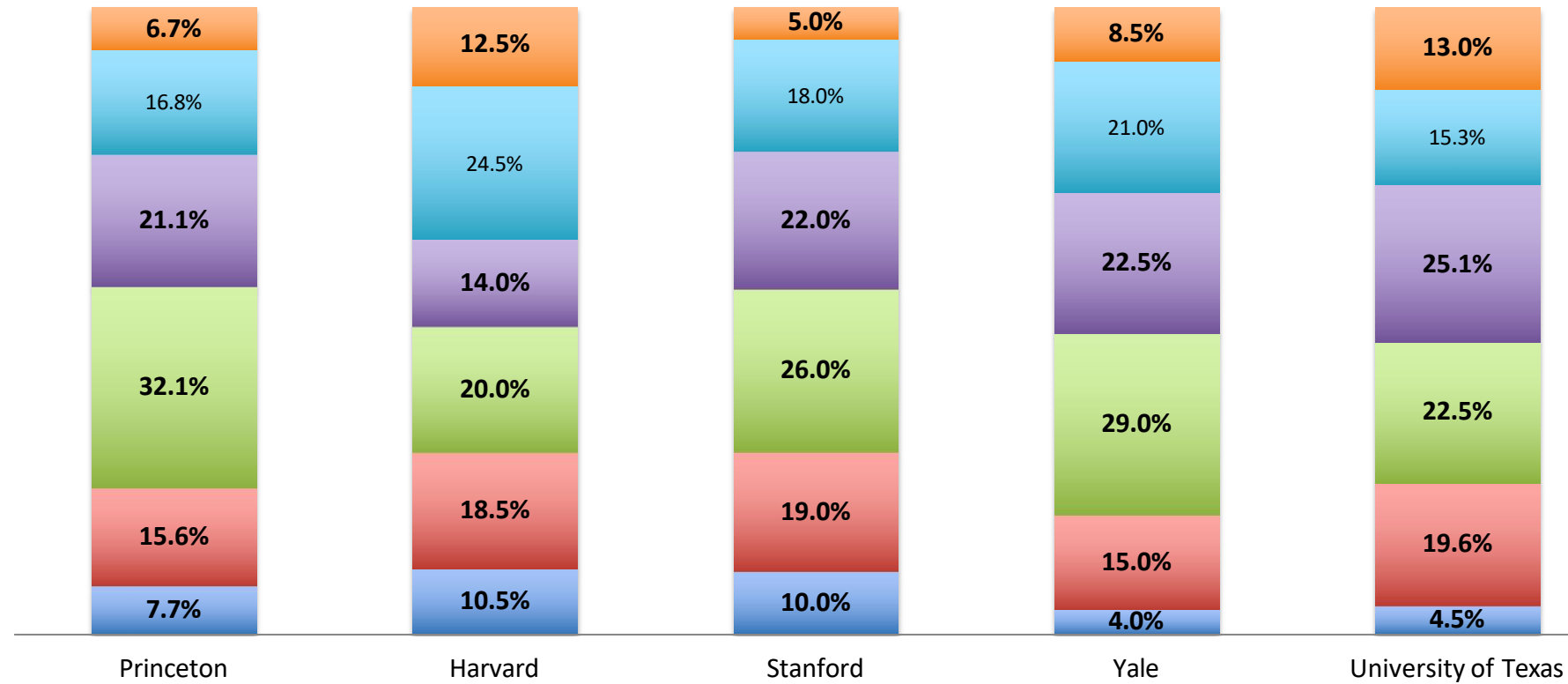
Source: CPP Investment Board 2016 Annual Report, OMERS 15 Annual Report, Ontario Teachers Pension Plan 2015 Report

CPP - Canadian Pension Plan Investment Board, OMERS - Ontario Municipal Employees Retirement System, OTPP - Ontario Teachers Pension Plan

US University Endowment Portfolio Asset Allocation



■ Domestic Equity
 ■ Foreign Equity
 ■ Private Equity
 ■ Absolute Return
 ■ Real Assets
 ■ Fixed Income and Cash



Source:

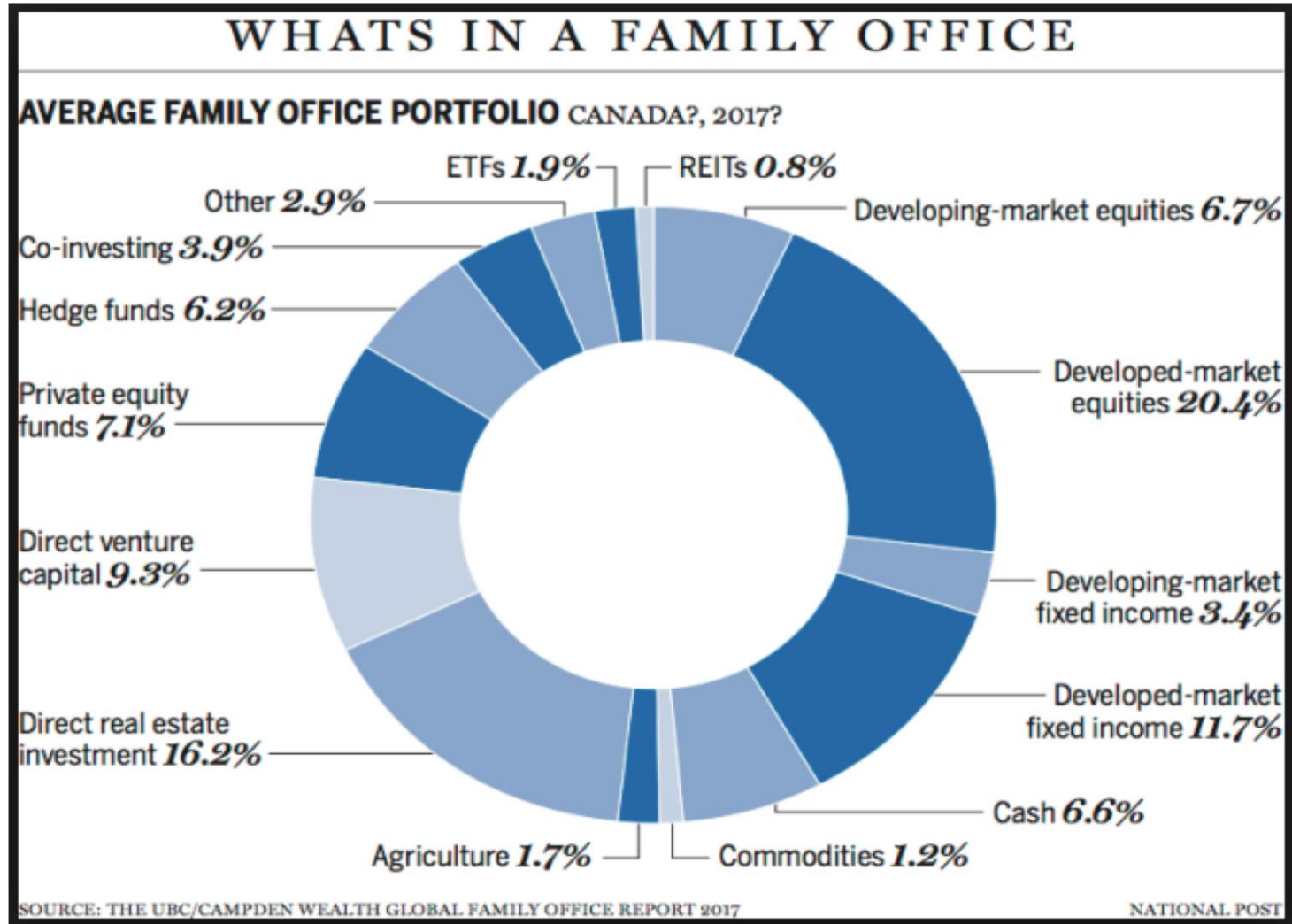
Princeton: Report to the Treasurer 2014 - 15, Princeton University.
 Harvard - A Letter from Stephen Blyth PhD 92', President and CEO of Harvard Management Company, September 2015. Harvard University
 Stanford - Stanford Management Company Annual Report June 2015
 Yale - 2014 The Yale Endowment (report used for Asset allocations). <http://news.yale.edu/> (Used for Returns)

*University of Texas - <http://www.utimco.org/>. Audited Financial Statements - Year End August 31.

Notes:

Asset allocations are for illustrative and comparative purposes only.
 Target allocations presented vs actual allocations where available (Princeton, Stanford, Yale)
 Harvard asset allocation presented as average of target range
 *University of Texas allocations based on average from the Permanent University Fund and the General Endowment Fund.
 *University of Texas endowment total size is the sum of Permanent University, General Endowment, Permanent Health, and Long Term Funds
 ** Princeton University does not report real estate and natural resource allocation breakdowns. Reports total "Real Asset" Allocation.

Canadian Family Offices



Wealth Managers

Why do they invest in
alternatives



Investment Advisors

Client Experience

- Whether to enhance returns, dampen volatility or smooth out returns
- HNW/UHNW or sophisticated client base client-base
- Reduce statement shock

Value Proposition

- Unique story that not all advisors are telling
- Engage conversations with HNW or UHNW families

Grow a stable, differentiated business with off-the-run solutions that appeal to wealthy clients/prospects

Private Banks i.e.: JP Morgan, Citi, Morgan Stanley

- Cater to UHNW individuals who want downside protection and to partially participate rising markets
- Seek protection and growth of wealth for today and for future generations

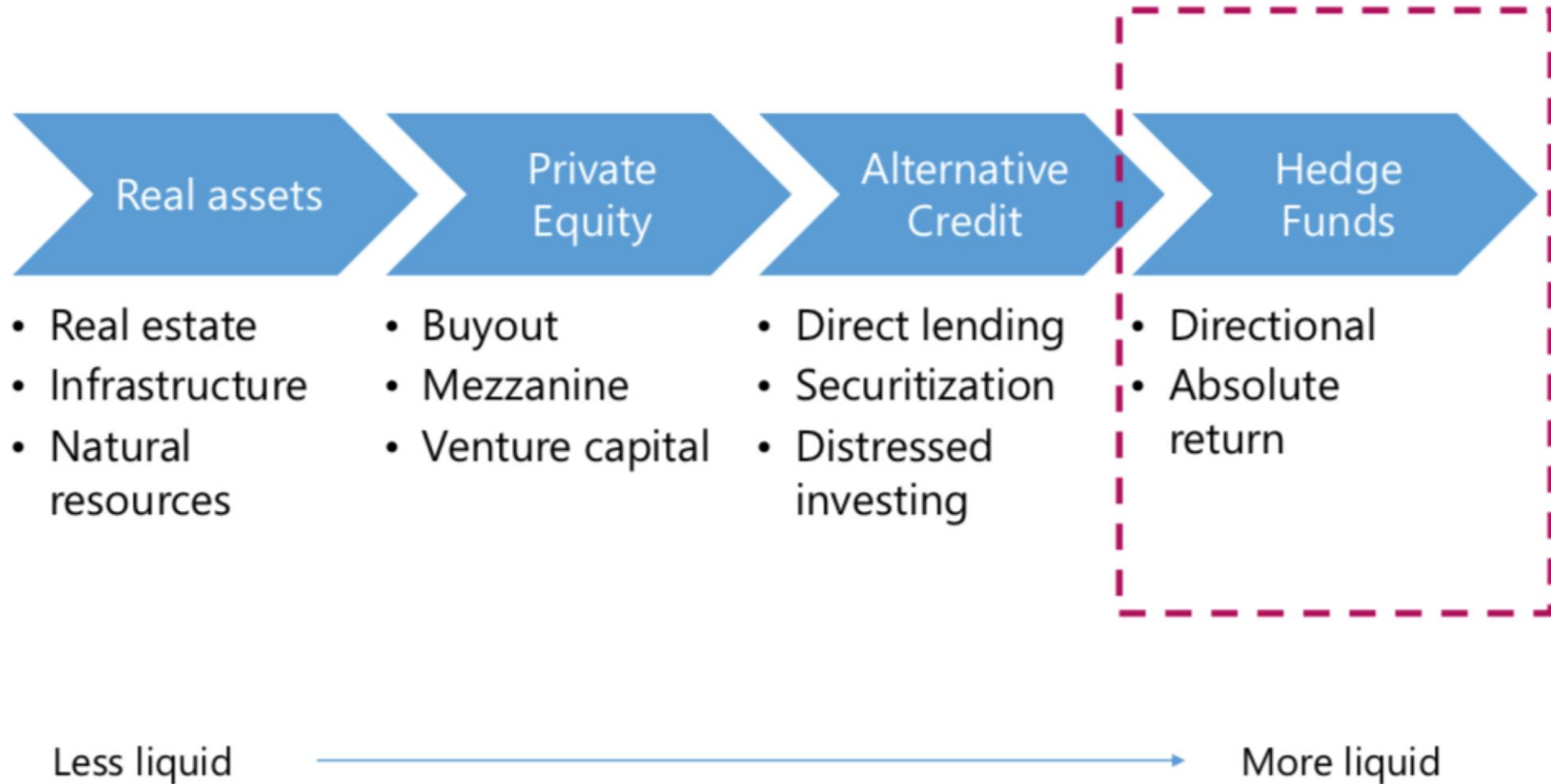
Hedge Fund Allocations: Substitutes & Diversifiers

Substitute	Diversifier
Long/Short Equity	Global Macro
Long/Short Income	Managed Futures/CTA
Event driven	Equity Market Neutral
Fixed income arbitrage	
Convertible arbitrage	
Emerging markets	

Types of Alternative Investment Strategies & Asset Classes



Alternatives Investments



Asset Classes & Strategies



	MACRO STRATEGIES	EQUITY STRATEGIES	MULTI-STRATEGY	RELATIVE VALUE STRATEGIES
Industry Assets by Strategy	\$1,054bn	\$894bn	\$485bn	\$354bn
Change over 2017	▲ 8%	▲ 9%	▲ 14%	▲ 4%

Real Estate

- Private Equity
- Public Equity
- Private Debt
- Public Debt

Private equity, lending & credit

- Venture Capital
- Mezzanine
- Leveraged Buyout
- Leveraged Loans

	CTAs	CREDIT STRATEGIES	EVENT DRIVEN STRATEGIES	NICHE STRATEGIES
Industry Assets by Strategy	\$279bn	\$251bn	\$206bn	\$24bn
Change over 2017	▲ 11%	▲ 6%	▲ 17%	▲ 64%

Hedge funds

- Fixed Income /Credit Arbitrage
- Market Neutral Strategies & Long/ Short
- Risk/Merger Arbitrage
- Event Driven
- Multi Strategy
- Global Macro
- Managed futures

Real Estate



Investors looking for income, inflation protection & diversification can access RE via Private, direct properties, debt instrument and/or publically traded REITs



Source: Preqin 2018

Fixed Income/Credit Alternatives



Fig. 8.20: Performance of Credit Strategies Funds by Sub-Strategy (As at December 2017)*

Q1 2017	Q2 2017	Q3 2017	Q4 2017	2017	3-Year Annualized	3-Year Volatility
Specialist Credit 4.07%	Mortgage-Backed Strategies 2.64%	Fixed Income 2.13%	Specialist Credit 1.84%	Specialist Credit 9.46%	Specialist Credit 7.85%	Asset-Backed Lending Strategies 0.85%
Fixed Income 2.77%	Asset-Backed Lending Strategies 1.92%	Long/Short Credit 1.66%	Fixed Income 1.59%	Mortgage-Backed Strategies 8.54%	Asset-Backed Lending Strategies 7.41%	Mortgage-Backed Strategies 2.17%
Mortgage-Backed Strategies 2.69%	Specialist Credit 1.75%	Asset-Backed Lending Strategies 1.55%	Long/Short Credit 1.58%	Fixed Income 8.18%	Mortgage-Backed Strategies 6.66%	Fixed Income 2.26%
Long/Short Credit 2.63%	Fixed Income 1.45%	Specialist Credit 1.50%	Mortgage-Backed Strategies 1.51%	Long/Short Credit 7.17%	Fixed Income 6.64%	Long/Short Credit 2.62%
Asset-Backed Lending Strategies 2.26%	Long/Short Credit 1.12%	Mortgage-Backed Strategies 1.45%	Asset-Backed Lending Strategies 1.00%	Asset-Backed Lending Strategies 6.90%	Long/Short Credit 5.15%	Specialist Credit 3.92%

Source: Preqin Hedge Fund Online

*Please note, all performance information includes preliminary data for December 2017 based on net returns reported to Preqin in early January 2018. Although stated trends and comparisons are not expected to alter significantly, final benchmark values are subject to change.

- Absolute returns in falling & rising interest rate environment
- Outright value, Relative Value & Active Trading
- Currency hedging
- Invest long and short in credit securities & sectors

Market Neutral & Long/Short Equity



Seeks to eliminate or minimize the impact of market risk on portfolio returns

- ▶ Heavily reliant on the portfolio manager's skill and/or supportive technology
- ▶ Managers take long and short positions in related financial securities that appear to be mispriced and hedge out undesired market exposures
- ▶ Broad spectrum of strategies like equity pairs, fixed income spreads, quant models, fundamental, global macro, directional, low net etc..

Managed Futures



- Active trading of futures and forward contracts on physical commodities, financial assets and exchange rates to earn the risk and return of active management within the futures market
- Also known as CTA funds (Commodity Trading Advisor)
- Tend to be based on systematic trading more than discretionary trading
- Generally categorized into three groups:
 - Trend-following
 - Non-trend following
 - Relative value

Global Macro



- Managers research global economic landscape for best ideas
- Seek to profit from any macro-economic imbalances and/or geopolitical events
- Often no limitation in terms of the types of instruments, asset classes, markets and geographies that they can invest in
- Broadest investment mandate of major hedge fund strategies

Event Driven, Risk/Merger Arbitrage, Distressed Securities, Special Situations



Risk/Merger Arb attempts to benefit from a corporate merger or acquisition by taking a long position on the target company and, if applicable, short selling the acquiring company capturing the spread between the prices as the market reacts to a given deal

Event-Driven strategies identify specific corporate events as they occur in the markets attempting to profit from trading in and around the capital structure of these special situations in a corporate life cycles (acquisitions, spin-offs, changes in capital structure, etc.).

Relative Value



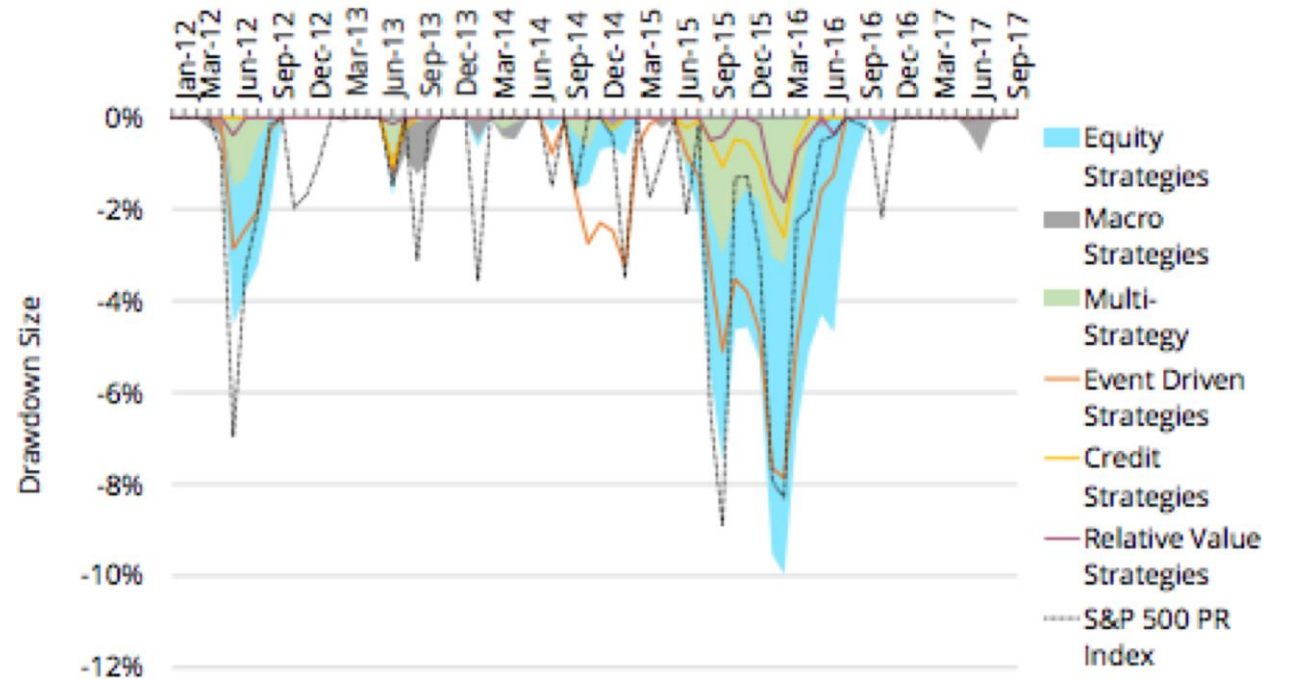
- Seek to take advantage of differences in the pricing of related financial instruments
- Typically have less exposure to underlying equity or bond market than long/short strategies
- Objective is to extract or capture value from any structural anomalies that exist in the markets between related securities

Multi-Strategy



- ▶ Portfolio of strategies to create a stream of returns that is relatively uncorrelated to major asset classes which helps smooth returns, reduce volatility and decrease asset-class and single-strategy risks
- ▶ Capital is allocated dynamically to exploit investment opportunity sets
- ▶ Strategies may include (and are not limited to)
 - Convertible Bond Arbitrage
 - Equity Long/Short
 - Merger Arbitrage
 - Event-Driven
 - Fixed Income Arbitrage
 - Systematic Strategies
 - Private Credit

Fig. 4.10: Drawdowns of Hedge Funds vs. S&P 500 PR Index, 2012 - 2017

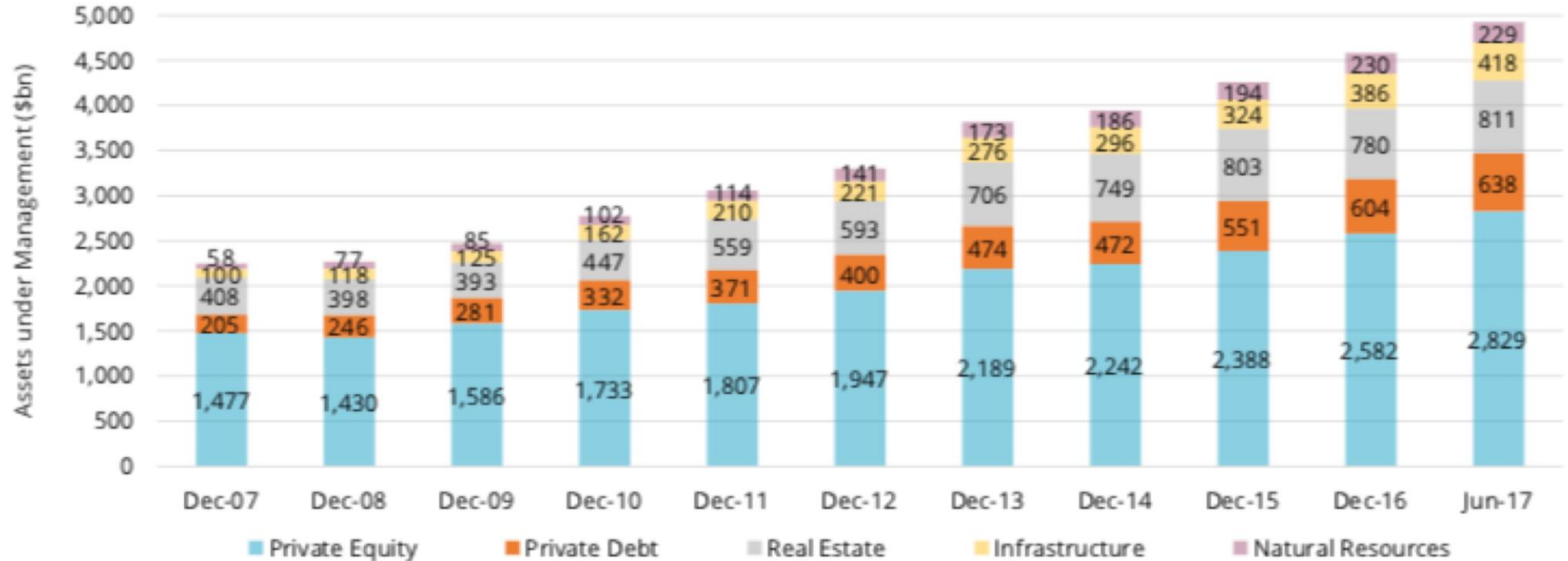


Source: Preqin Hedge Fund Online

Private Credit, Private Equity, Real Estate, Infrastructure, Resources



Fig. 2.1: Private Capital Assets under Management by Asset Class, 2007 - 2017



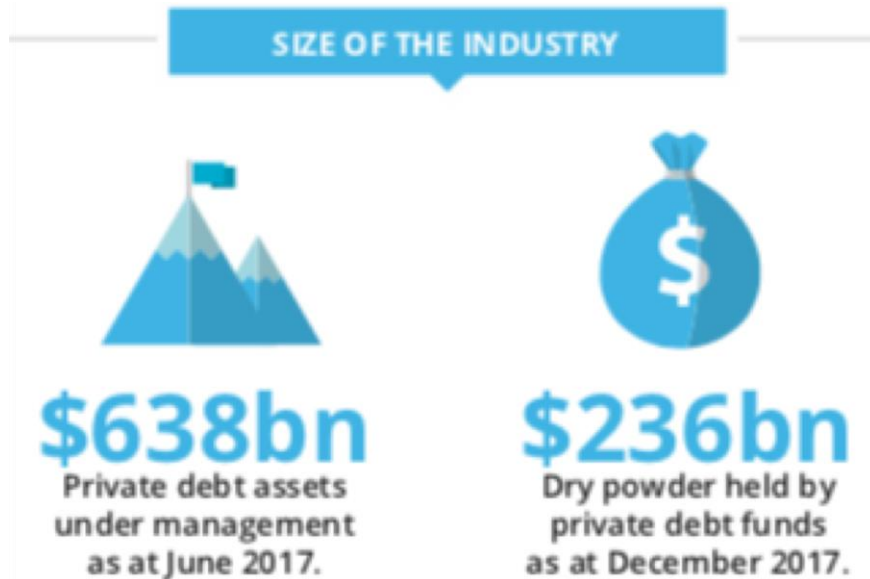
Source: Preqin Online Products

Private Equity



- ▶ Venture Capital invests in start-up companies hoping to gain when eventually company goes public
- ▶ Leveraged buyout borrows money to buy listed companies, takes them private and restructures them, usually hoping to sell and make a profit

Private Debt



Mezzanine (subset of Private Equity)

Funds that provide short term financing to companies going through transformation and venture companies who have a hard time receiving financing from banks

Leveraged Loans

One or more investment banks arrange a loan to a borrower and then sell it to a group (syndicate) of commercial bank and investors

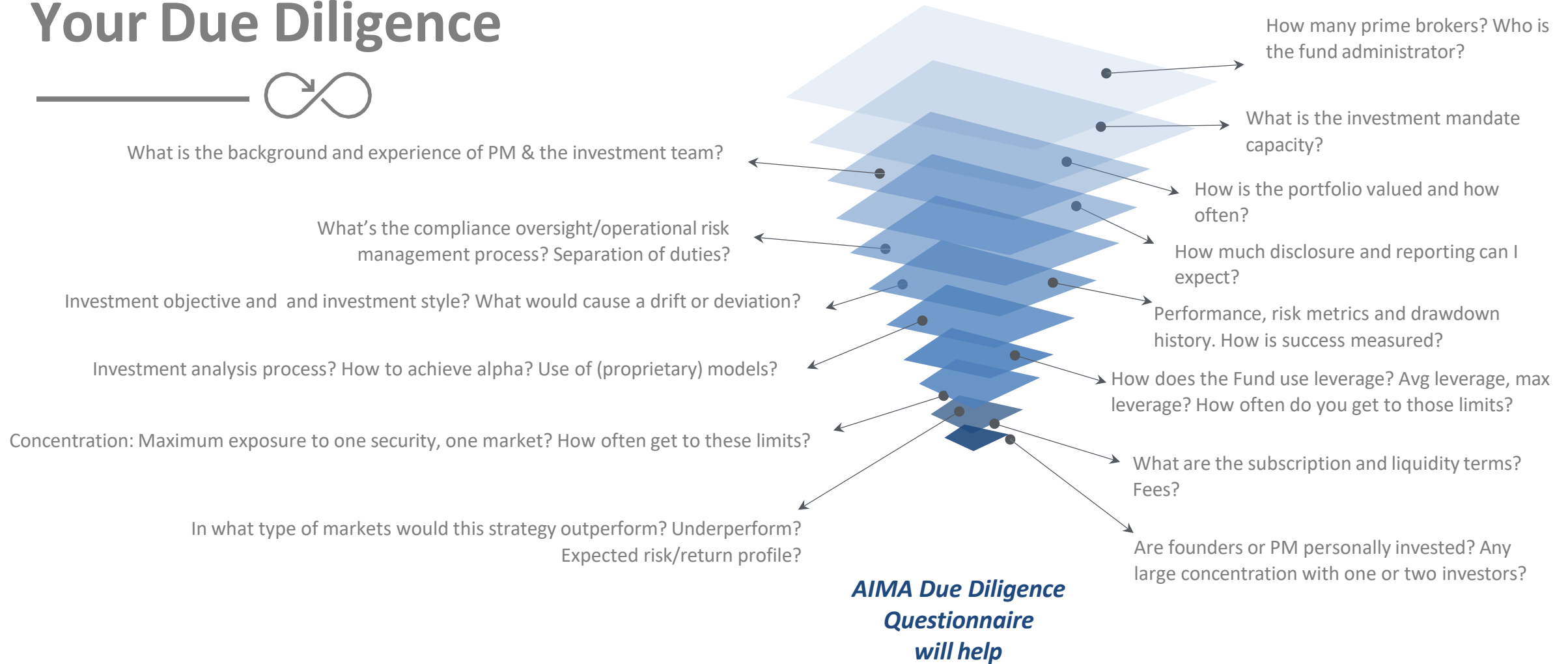
Private Credit

Fund lends to borrowers who cannot access bank either due to riskiness (distressed) or urgency

Due Diligence of Alternative Investments



Your Due Diligence



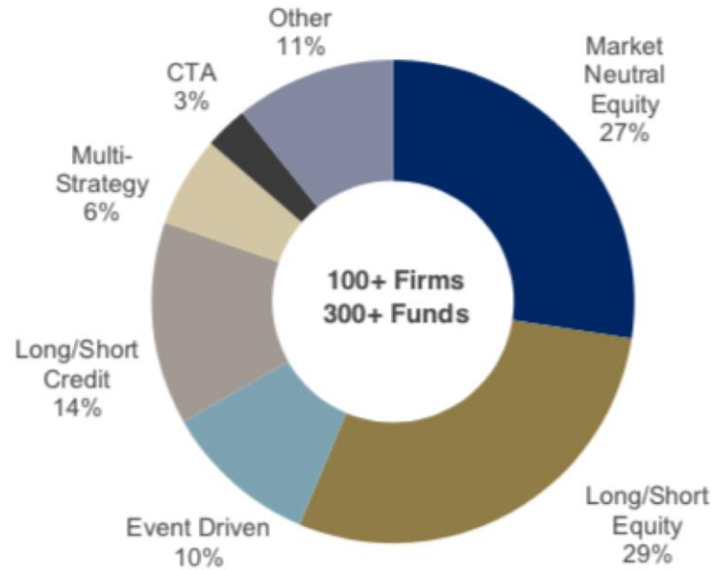
Alternatives Industry In Canada



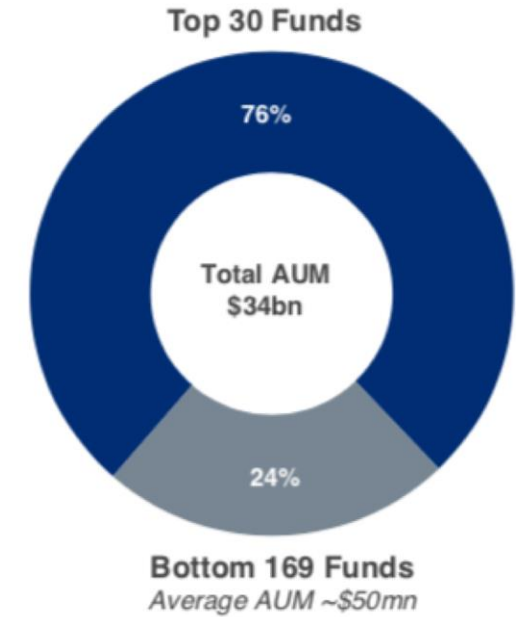
Alternatives in Canada



Assets By Strategy¹



Asset Concentration²



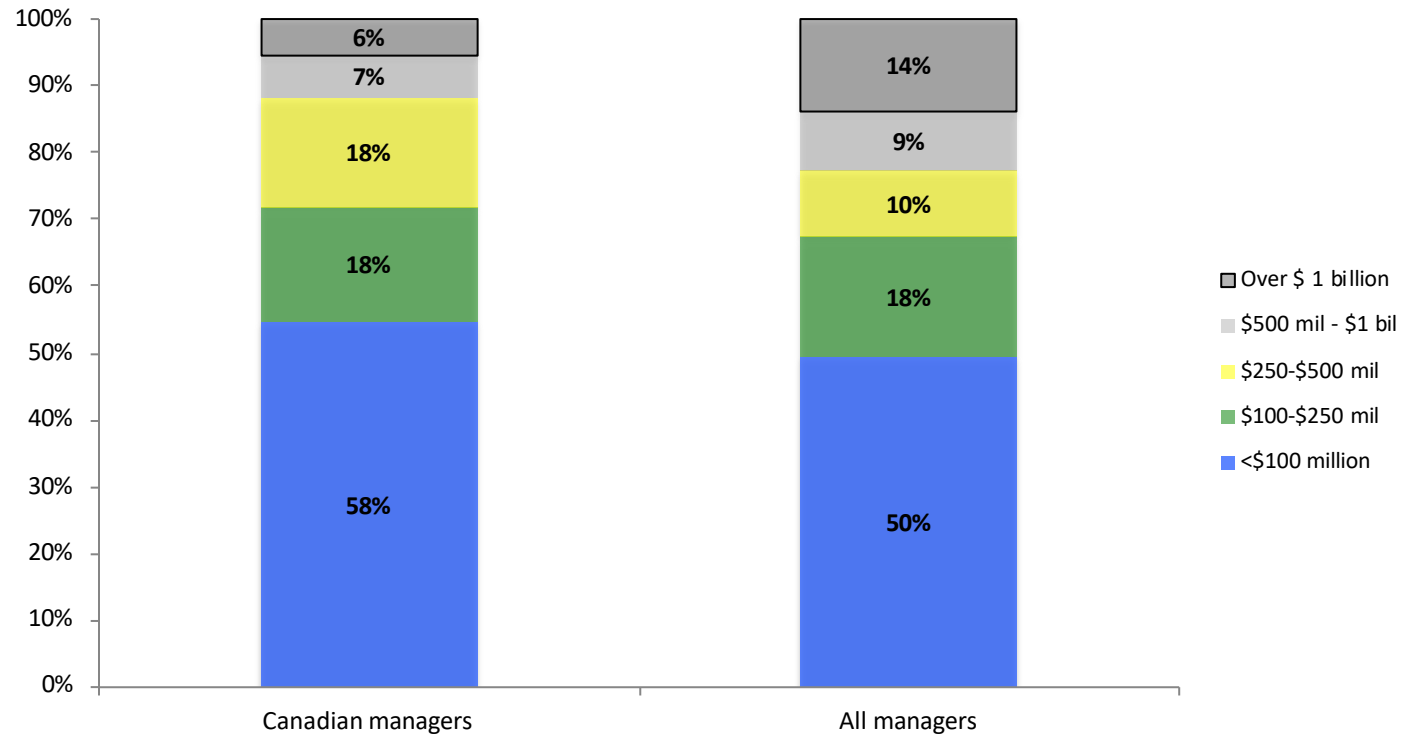
Median Fund Size: \$41 Million

1. Source: Preqin
2. Based on AUM of reporting funds as of February 28, 2018

Canada Alternatives Similar to the World



- Globally, hedge funds under \$100 million AUM are 50% of funds.
- In Canada, 58% of hedge funds have AUM under \$100 million.

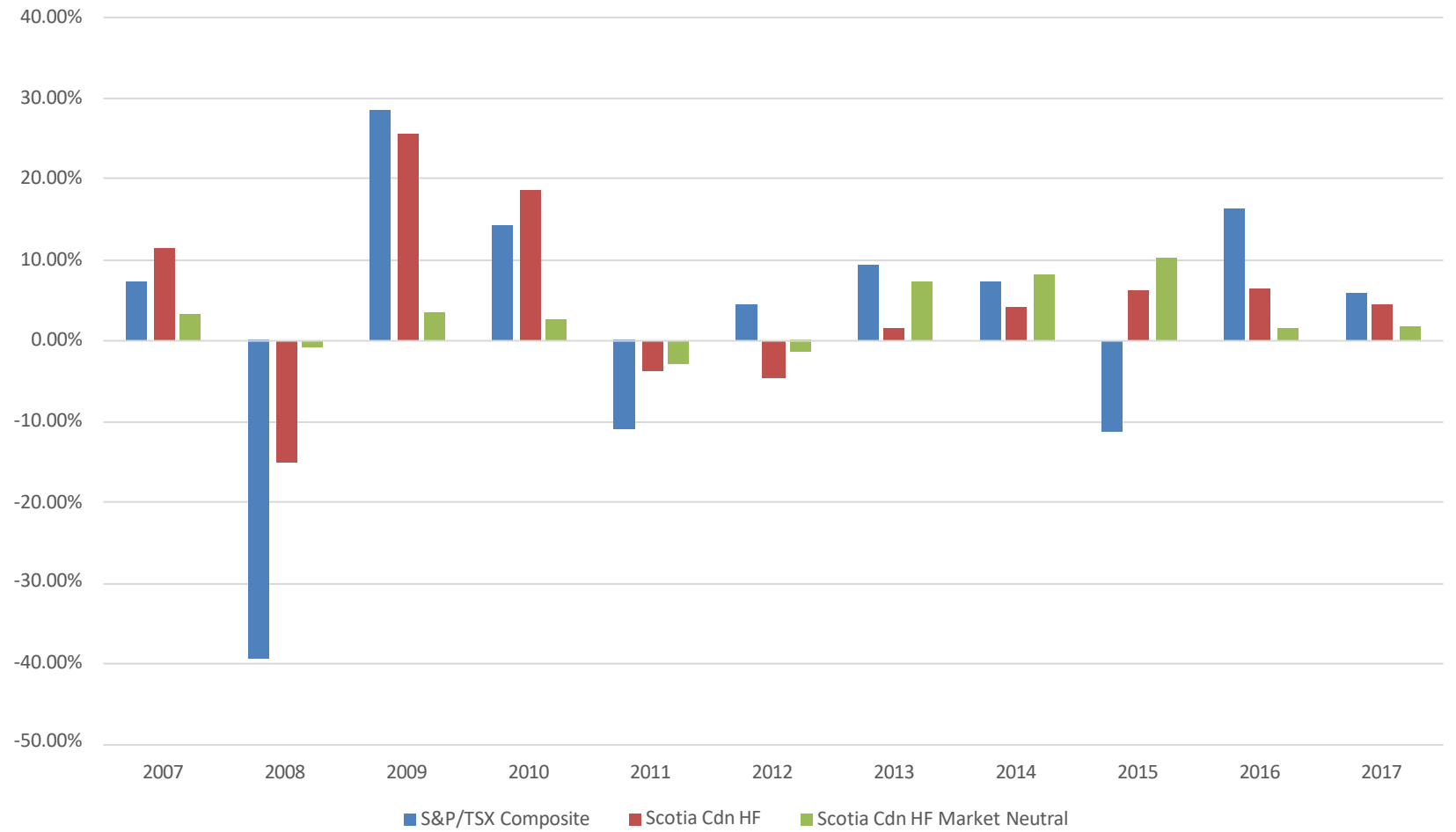


Canadian Alternatives

Cumulative Annual Returns



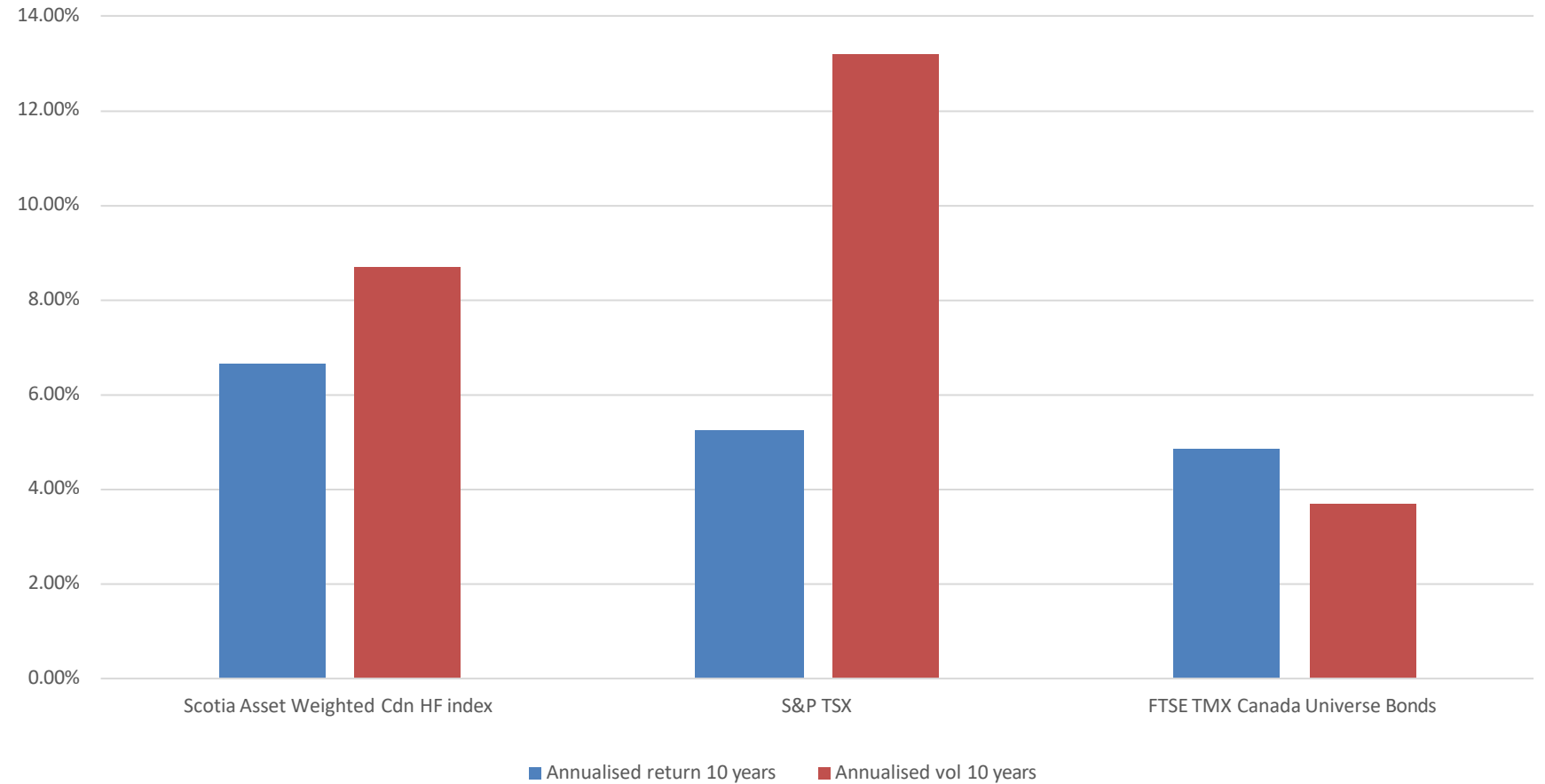
Cumulative annual returns, Cdn HFs, market neutral Cdn HFs, S&P/TSX Composite



Risk & Returns, Canadian Hedge Funds & Securities



Return and risk, Cdn HFs, equities, and fixed income



Source: Bloomberg & Morningstar, as at December 31 2017.

NI 81-102 Alternative Mutual Funds



Restrictions & Obligations	Alternative Mutual Funds
Eligible Investors	Available to the mass market
NAV Calculation	Daily
Redemption Rights	Daily (most common), weekly & monthly could apply as well
Initial Holding Period	Maximum 6-month (at option of manager)
Redemption Proceeds	T+2
Performance Fees	Permitted
Borrowing (cash and / or securities)	Limited to 50% of NAV (Borrowing + Short Selling cannot exceed 50% of NAV)
Short-selling	Limited to 50% of NAV, no cash cover required
Leverage	Maximum of 3X leverage defined as (total short securities + short cash + notional size of derivatives*)/ NAV *excludes derivatives used for hedging
Concentration Limit – issuer level	20% of NAV, subject to carve-outs
Illiquid Assets	10% of NAV at initial investments, 15% hard-cap
Disclosure requirements	Publicly-filed financial statements Top 25 holdings disclosed quarterly Leverage disclosure in annual and interim financial reports

Summary & Other Resources



Summary



- Alternatives play key role in asset allocation for institutional and retail investors
- Alternatives offer important benefits to investor portfolios:
 - Diversification
 - Risk reduction
 - Non-correlated returns
- Alternative strategies are diverse
 - Evaluate as separate products, not as one “hedge fund” bucket
- Due diligence important, as with any investment
- Canada has robust market of Alternatives managers