canada life™

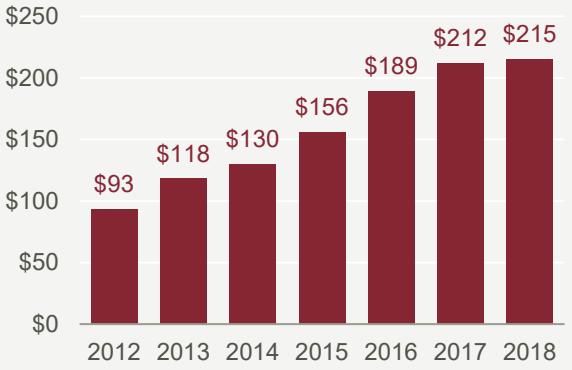
The case for liquid alternative strategies

What are alternative investments?

Since the 2008-2009 market downturn, many investors have tried to limit risk by using investments that move less in sync with stock markets. The investment industry responded by developing more alternative products for investors. In fact, Canadian-managed alternative assets more than doubled from $93 billion in 2012 to $215 billion in 2018.

Alternative investments are made up of both assets and strategies. Alternative assets may include commodities, infrastructure projects, vacant land

Alternative assets managed in Canada ($ billions)



Growth rates: 1YR 1.4%, 5YR CAGR 12.7%. Source: Investor Economics, Managed Money Advisory Service as of December 2018. This data accounts for all alternative strategies which include hedge funds, real estate, private equity and infrastructure.

and developed real estate. Alternative strategies, which are generally offered via hedge funds or liquid alternative strategies, are structured to hold a wide range of financial assets – both traditional and non-traditional – while using non-conventional methods such as leverage and short-selling in their search for absolute returns. For the sake of this paper, we'll be focusing on alternative strategies.

Examples of popular alternative strategies include:

Long/short equity or credit funds take long positions in securities that are expected to appreciate (undervalued) and short positions in securities that are expected to decline (overvalued). Their goal is to minimize market exposure and take advantage of profit opportunities from both under- and overvalued securities. These funds invest in equities, bonds, ETFs, and related derivatives, use leverage and vary the long and short exposures according to forecasts.

Market-neutral funds are a form of long/short funds that attempt to be hedged against general market conditions. This is done by taking a zero-net exposure to the market itself by having the total value of the long positions equal the total value of the short positions.

Global macro funds base holdings primarily on the overall economic and political views for various countries. They take positions (either long or short) based on their views on the direction of a market, a currency, an interest rate, a commodity, or any macroeconomic variable.

Event-driven funds take bets on some event specific to a company or a security, typically in the form of either distressed securities funds or risk arbitrage in mergers and acquisitions.

Why invest in alternative strategies?

Wider breadth of return streams and investment tools

Liquid alternatives cover a wide variety of strategies that invest in a diverse set of instruments and markets not available within traditional asset classes, such as derivatives, leverage, mortgages, currencies and commodities. This allows the portfolio to seek benefit both from rising and falling prices across a wider range of asset classes and helps create the ability to control the exposure to traditional market factors.

Improved diversification via risk and performance characteristics

The usual argument in favour of alternative strategies as an asset class is illustrated in Exhibit 2, which gives the performance and risk estimates for a variety of indexes

Exhibit 2: Risk and performance characteristics of various market indexes

(Aug. 31, 2000 – Aug. 31, 2020) in U.S. Dollars

	Credit Suisse Liquid Alternative Beta Index[1]	MSCI World Index	S&P 500 Index	MSCI EAFE Index	FTSE Canada Universe Bond Index
Average annualized return	5.03%	5.44%	6.34%	3.92%	5.38%
Annualized volatility (standard deviation)	5.46%	15.45%	15.02%	16.63%	19.79%
Correlation with MSCI World Index	0.82	1.00	0.97	0.96	0.86
Beta with MSCI World Index	0.29	1.00	0.95	1.03	1.10
Sharpe ratio	0.65	0.32	0.38	0.22	0.29

over a 20-year period. The first observation is that the volatility of the liquid alternative index is considerably smaller than that of the market indexes. Another interesting observation is that the correlation of the liquid alternative index with the MSCI World Index is lower than all the other indexes, including the FTSE Canada Universe Bond Index. Part of the explanation for low correlation with the global index is the fact that alternative strategies do not experience big negative returns or drawdowns in periods where equity markets drop. When estimating correlation over shorter periods, the correlation tends to decrease in periods of bear markets and increase in periods of bull markets.[1] In the last row of exhibit 2, with the Sharpe ratio, the average return earned in excess of the risk-free rate per unit of volatility or risk, for the liquid alternative index is superior to that of all the other indexes.

Most alternative strategies focus on offering positive absolute returns that are independent of market direction and come with lower volatility when compared to a traditional balanced portfolio. The goal is to maintain low correlations or low beta to a global stock and fixed income markets and provide consistent returns regardless of market direction. This allows these strategies to act as a stabilizer when added as an allocation within a traditional portfolio.

How are liquid alternatives different from hedge funds?

Alternative strategies can be accessed either via a hedge fund or a liquid alternative. Although similar in strategy, accessibility, legal structures, transparency and regulatory landscapes of these two options differ greatly.

Hedge funds

- Hedge funds generally come with high minimum investments, performance fees and illiquidity through monthly or quarterly redemption periods – putting them out of reach for many investors.
- Hedge funds are typically structured as limited partnerships or offshore corporations, allowing for limited regulation and transparency.

Liquid alternatives

- The Canadian investment market only recently (2019) made the regulatory changes that introduced the ‘alternative mutual fund’ category under National Instrument 81-102 – allowing for greater access to alternative strategies to Canadian retail investors who were not able to access via the hedge fund alternatives due to the reasons noted above. See Exhibit 3 for highlights of National Instrument 81-102.
- Liquid alternatives can offer similar strategies without the high minimums and liquidity constraints; they generally offer daily liquidity. In exchange illiquid holdings are generally much smaller in liquid alternative funds, and the total extent of leverage is more constrained.

Exhibit 3: Highlights of National Instrument 81-102

	Alternative funds	Conventional Mutual Funds & ETFs
Borrowing	50% of NAV[2]	5% of NAV with restrictions
Short selling	50% of NAV[4] (cash cover not required)	20% of NAV 150% of cash cover
Access to physical commodities	Generally limited to 10%	No limit
Concentration in one user	20%	10%
Leverage (gross aggregate exposure)	3x	None
Illiquid assets	10% of NAV	10% of NAV

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The case for liquid alternative strategies

- Liquid alternative mutual funds, under the recent regulatory changes, are subject to similar ongoing disclosure requirements as conventional mutual funds. These regulations impose high standards of transparency and independent oversight, along with constraints set of things such as leverage and short selling (where hedge funds have no constraints set on them).

How to access these sophisticated investment strategies

Liquid alternatives are sophisticated and highly complex investment vehicles, so you need professionals with proven expertise to invest in them on your behalf.

So how can you access them? With Canada Life Risk-Managed Portfolios. This new suite of all-in-one fund solutions are specifically designed to help Canadians **protect their hard-earned savings by limiting the impacts of volatility while still allowing them to participate in the markets** to help them achieve their goals. **To drive towards specific outcomes and help meet investors' risk, return and income objectives,** the risk-managed portfolios use sophisticated portfolio construction techniques, including an allocation to liquid alternatives.

The **Mackenzie Multi-Strategy Absolute Return Fund** is one of the underlying funds in Canada Life's Risk-Managed Portfolios. This fund provides a simple way for investors to access a liquid alternative allocation with a number of alternative strategies. Mackenzie has a team of portfolio managers and asset allocation specialists with significant expertise investing in liquid alternatives. Mackenzie's specialists are trusted partners in providing investors with the alternative assets and strategies that can help the m achieve their goals.

1. Source: CFA Institute. CFA Program Curriculum, Volume 6: Level 1 2012, Derivatives and Alternative Investments
2. Source: Morningstar Direct
3. The Credit Suisse Liquid Alternative Beta Index seeks to replicate the return of the overall hedge fund industry, as represented by the Credit Suisse Hedge Fund Index. The Credit Suisse Liquid Alternative Beta Index reflects the combined returns of the individual LAB strategy indices – Long/Short, Event Driven, Global Strategies, Merger Arbitrage and Managed Futures – weighted according to their respective strategy weights in the Credit Suisse Hedge Fund Index.
4. 50% combined between borrowing and short selling