Industry Overview
Liquid Alternative

Alternative Income Group

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Executive Summary

In early 2019, Canadian regulators amended certain investment restrictions on Canadian mutual funds allowing investment managers to invest in certain alternative strategies and creating an Alternative Mutual Fund structure, commonly known as "Liquid Alts". The Liquid Alternative structure is a big step towards democratizing access to alternative investments. Strategies that have historically been limited to institutional investors are now available to all Canadians, albeit in a modified form.

Alternative strategies vary greatly in liquidity and some strategies are a better fit for the liquid alt structure than others. Hedge fund strategies that utilize public equity, public bonds, managed futures, and Insurance Linked Securities ("ILS") are inherently a better fit for this type of structure due to their liquidity.

The investment goal of a typical liquid alternative strategy is to generate absolute returns or achieve downside protection. As such, these investments have historically provided low correlation to public equities and bonds. When considered in a portfolio, it is expected to further reduce volatility, while generating a stronger risk-adjusted return.

Liquid Alts are designed to provide investors access to traditional alternative strategies while maintaining liquidity. In most cases, these strategies offer daily liquidity. With increased flexibility compared to traditional mutual funds, retail investors are able to access strategies similar to those that have only been available through hedge funds.

In order to operate as a Liquid Alt, a fund must meet restrictions on leverage, liquidity and borrowing, amongst others. These limitations were designed to protect investors from the potential losses associated with hedge fund mismanagement. Unfortunately, in addition to limiting downside risk, these restrictions have impacted how some strategies achieve their return. It is important for investors to understand how the original alternative investment worked and then evaluate whether or not the liquid alternative version is an appropriate proxy for the return profile.

As these products tend to be more complex than traditional mutual funds, investors interested in alternative investing should speak with their financial advisor to navigate the nuances of these products and obtain advice on appropriate portfolio allocations.

What is a Liquid Alternative?

Beginning January 3, 2019, certain investment restrictions on Canadian mutual funds were amended, allowing investors to gain access to alternative strategies through Alternative Mutual Funds or Liquid Alternatives. These new rules allow for a type of mutual fund structure to pursue alternative strategies by employing leverage through cash borrowing, short selling, and specified derivatives up to an aggregate limit of 300%, among other changes[1]. Operating under this new regime, mutual fund providers introduced strategies to the retail market that had typically been reserved for institutional and high net worth investors.

Table 1: Liquid Alts vs Conventional Funds[2]

	Liquid Alternative Funds	Conventional Mutual Funds
Borrowing	50% of NAV	5% of NAV with restrictions
Short Selling	50% of NAV, cash cover not required	20% of NAV, 150% cash cover
Access to Physical Commodities	Generally limited to 10%	No limit
Leverage	300% of NAV	None
Illiquid Assets	20% of NAV at time of purchase	20% of NAV at time of purchase

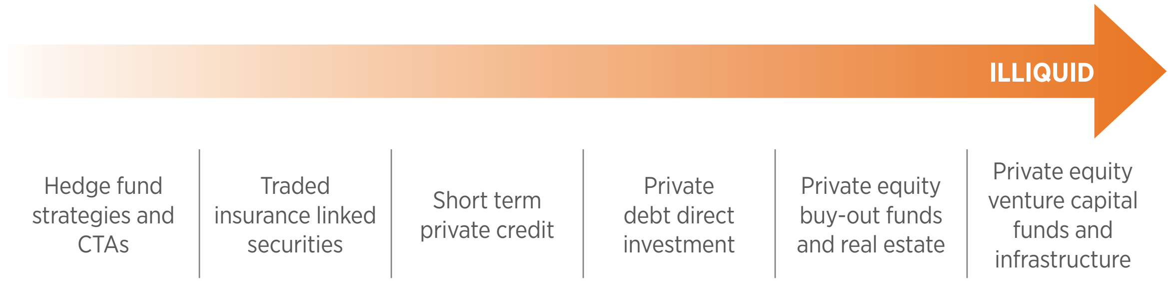
Liquidity is defined as the speed and relative cost at which an investment can be converted to cash. Liquid alternatives, as the name suggests, have a strict liquidity threshold to adhere to in order to qualify, offering daily redemptions in many cases. As discussed in a previous paper "The Liquidity Myth"[3], investment liquidity has many benefits, however, it comes at a cost and some strategies do not translate well to a liquid fund structure.

Alternative investments are typically described as being any asset class that is not common equity, bonds, and cash[4]. This loose definition allows for a vast universe of potential investment options to fall under the "alternative" umbrella. A true alternative should provide a reduction in correlation to traditional public equities and bonds. As we will discuss later, not all liquid alts offer the true benefits of alternative investing.

Liquid Alternative Investment Strategies

Some alternative investment strategies are a better fit for the liquid alt structure than others. Hedge fund strategies, futures trading funds run by Commodity Trading Advisors ("CTAs"), and some ILS strategies are a good fit due to their inherent liquidity. Investments such as private debt, private equity, infrastructure and direct real estate are not good candidates for liquid alternatives. These strategies involve investing capital where there is little to no secondary market, and therefore impossible to adhere to the strict liquidity definition of a liquid alt.

Figure 1: Alternative Strategies Across the Liquidity Spectrum

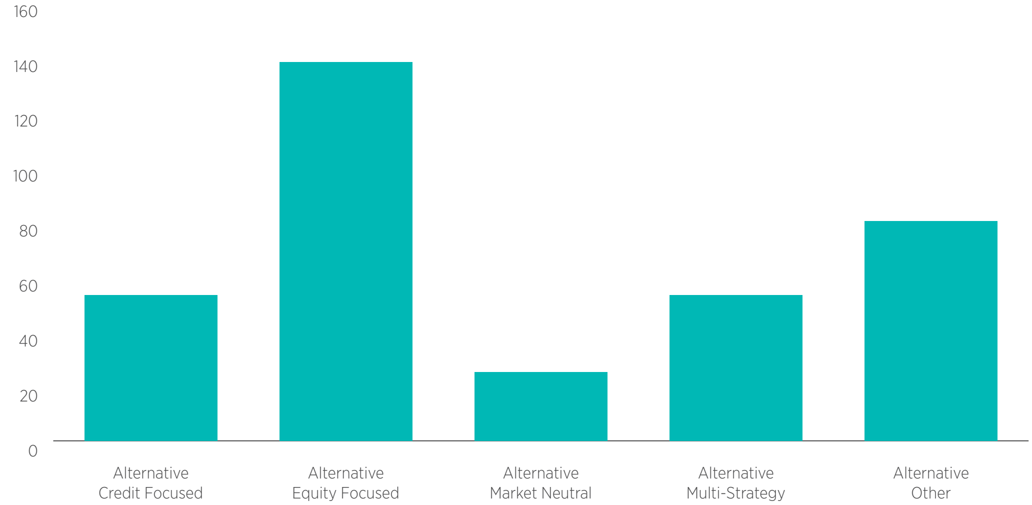


Source: KPMG: Pulse of Fintech H2'19 Global Trends.

The most frequently employed strategies for Liquid Alts today are variations of typical hedge fund strategies. These include long/short, market neutral, global macro, or some combination of these in a multi-strategy fund[5]. Each of these include short selling securities to reduce market correlation and to leverage the strategy. For example, a market neutral strategy endeavors to purchase securities expected to grow in value, while short selling securities expected to decrease in value, all while maintaining a market beta of 0.

Managed future strategies are another popular liquid alternative because of the inherent liquidity in the exchange traded futures market. Many contracts are traded globally six days per week on the Chicago Mercantile Exchange[6], giving traders more opportunity to buy and sell contracts than even the most liquid equity. Futures are also traded on margin, which has historically allowed hedge funds to employ mass amounts of leverage to enhance returns.

Figure 2: Alternative Mutual Funds in Canada by Strategy

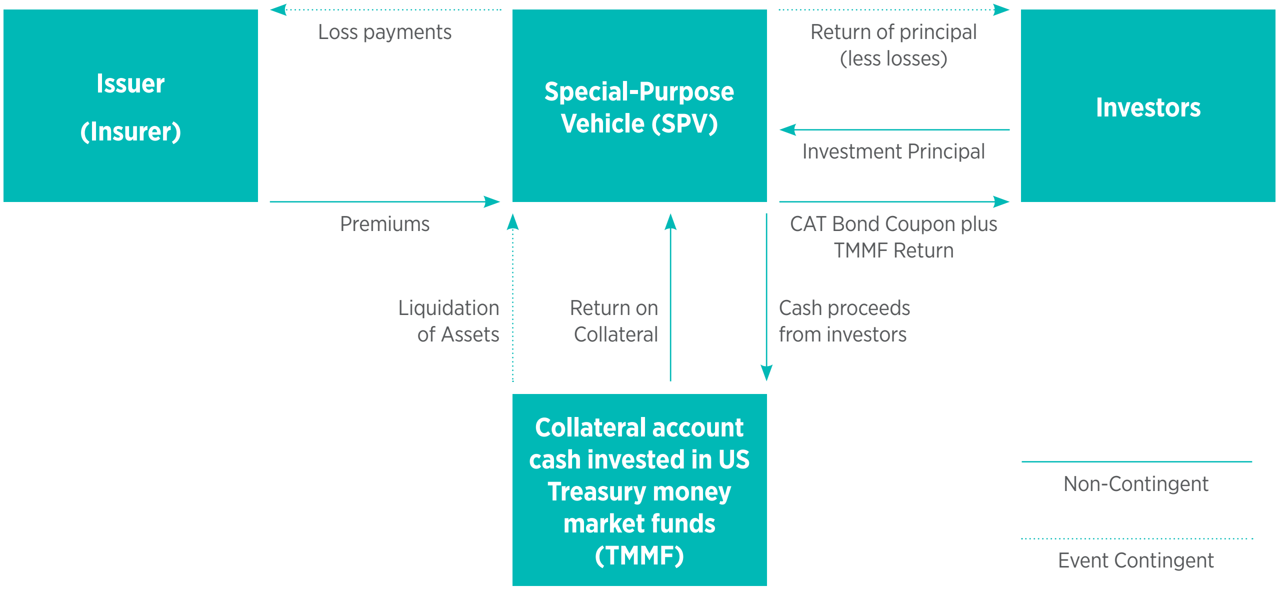


Source: Canadian Investment Funds Standards Committee.

Canadian Liquid Alts in the insurance linked securities space are rare, however, with recent market volatility, catastrophe bonds ("cat bonds") are an attractive asset. Liquid Alt products in the United States and Europe have been investing in the space for some time. Cat bonds are similar to plain vanilla bonds issued by insurance companies except that the principal repayment is linked to a specified event. The cat bond pays the investor a fixed or floating coupon until expiry and principal is repaid, however if a prespecified event, "the catastrophe", occurs, then all or a portion of the principal is forfeited and used to pay claims associated with that event.

For example, an insurance company sells hurricane insurance in Florida, and then sells cat bonds that are triggered in the event of a category 3 hurricane making land fall in Tampa Bay. Investors are compensated not only for the insurance company's credit risk, but also the risk of the catastrophic event taking place – providing enhanced return with the risk of loss completely uncorrelated to market events.

Figure 3: Catastrophe Bond Structure[7]



Source: Chicago Fed Letter, No 405, 2018.

While many think of private assets as traditional alternative assets, there are strategies that employ liquid assets like stocks and bonds to generate returns with limited correlation to broad indices. These strategies are often derived from traditional hedge fund alternatives which fit well within the new Liquid Alternative definition.

Why Invest in Liquid Alternatives?

Diversification

Liquid alternatives can be a powerful investment in any portfolio. These strategies aim to have low correlations to equity and fixed income indices and can be used as a long-term diversification tool. Like traditional alternative investments, liquid alternatives aim to provide downside protection and/or absolute returns in any market environment. Table 2 highlights the performance statistics of U.S. Equities and Bonds, as well as typical hedge fund strategies including CTA strategies (Systematic, Currency and Global Macro) and ILS. Despite achieving lower annualized returns, in most cases, these strategies generate stronger risk-adjusted returns on a standalone basis. The primary reason being that these strategies typically exhibit lower volatility compared to investments in the public market and thus can provide investors with further diversification to their portfolio.

Table 2: Liquid Alternative Strategies Statistics vs. Public Market Indices

	U.S. Equities	U.S. Corporate Bonds	Systematic Trading	Currency	Global Macro	ILS
Annualized Return	6.8%	5.8%	2.9%	2.6%	3.5%	3.9%
Volatility	15.5%	6.1%	8.1%	2.4%	4.7%	3.3%
Sharpe Ratio	0.35	0.73	0.19	0.52	0.45	0.77
Max Drawdown	(48.2%)	(15.4%)	(12.7%)	(3.0%)	(8.1%)	(12.5%)
Correlation with Equities	1.0	0.40	0.0	(0.24)	0.60	0.12
Correlation with Bonds	0.40	1.0	0.16	(0.10)	0.49	0.15

Source: Bloomberg.

Returns from January 2007 – August 2020.

Indices used: S&P 500 Index, Bloomberg Barclays US Corporate Index, BarclayHedge MPI Elite Systematic Traders Index, BarclayHedge Currency Traders Index, BarclayHedge Global Macro Index & Eurekahedge ILS Advisers Index.

As these investments have low historical correlations to public investments, they can provide significant downside protection and reduce portfolio drawdown during market corrections. On average, these strategies outperformed the S&P 500 by 23.4% during market corrections. An allocation to Liquid Alts in a portfolio is expected to increase risk-adjusted returns and reduce max drawdown while maintaining liquidity.

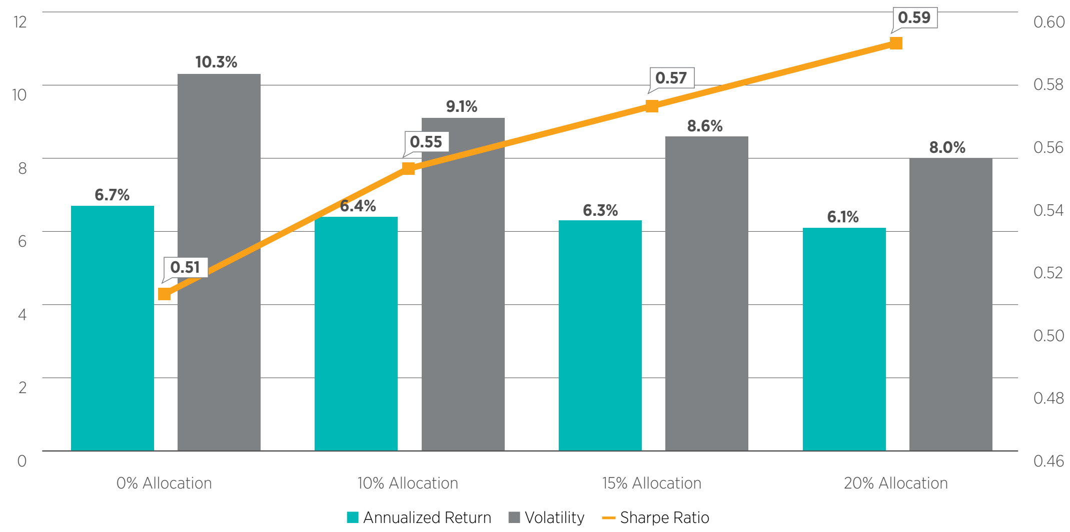
Table 3: Liquid Alternative Strategies and Public Equity Drawdown Comparison

	Equity	Systematic Trading	Currency	Global Macro	ILS
Nov 07 – Feb 09	(52.6%)	19.6%	3.3%	(2.3%)	6.1%
Added Value		**+72.2%**	**+55.8%**	**+50.2%**	**+58.7%**
May 10 – Aug 10	(11.6%)	1.1%	0.3%	(0.4%)	1.7%
Added Value		**+12.7%**	**+11.9%**	**+11.2%**	**+13.3%**
May 11 – Sep 11	(17.0%)	(3.2%)	(0.8%)	(5.3%)	2.3%
Added Value		**+13.8%**	**+16.2%**	**+11.7%**	**+19.3%**
Oct 18 – Dec 18	(14.0)	(3.1%)	1.2%	(4.9%)	(5.4%)
Added Value		**+10.9%**	**+15.1%**	**+9.1%**	**+8.6%**
Jan 20 – Mar 20	(20.0%)	(4.0%)	5.8%	(4.1%)	0.2%
Added Value		**+16.0%**	**+25.8%**	**+15.9%**	**+20.2%**

Source: Bloomberg.

Indices used: S&P 500 Index, BarclayHedge MPI Elite Systematic Traders Index, BarclayHedge Currency Traders Index, BarclayHedge Global Macro Index & Eurekahedge ILS Advisers Index.

Figure 4: Model Portfolio Allocation to Liquid Alternative Strategies



Source: Bloomberg. Ninepoint Partners.

Indices used: S&P 500 Index, Bloomberg Barclays US Corporate Bond Index, BarclayHedge MPI Elite Systematic Traders Index, BarclayHedge Currency Traders Index, BarclayHedge Global Macro Index & Eurekahedge ILS Advisers Index.

Allocation to Systematic Trading, Currency and Global Macro are taken from the equity allocation. Allocation to ILS is taken from the fixed income allocation. 0% allocation to liquid alts is represented by a 60% equity and 40% fixed income portfolio.

Liquidity

Liquid Alts provide investors with access to alternative strategies that in most cases will have daily liquidity. One of the considerations that high net worth investors battle with when allocating to traditional alternatives is the lack of liquidity. Bridging the gap between hedge funds and mutual funds, these strategies will allow investors to reap some of the benefits from traditional alternatives without the liquidity concerns. However, it is important to note that there is a trade-off. These strategies may become diluted in order to provide the necessary liquidity.

New Asset Classes and Strategies

Under the liquid alt structure, investment managers can create investment vehicles with more flexibility than a mutual fund. Retail investors are now able to access new strategies that they were not able to previously. In most cases, traditional alternative structures were accessible through hedge funds which have numerous investor restrictions. Now, managers can offer strategies with increased leverage, long/short flexibility, concentration limits and borrowing compared to mutual funds. Such strategies can include long/short equity or fixed income, CTA strategies, ILS and arbitrage strategies. This is a new opportunity for investors to expand their investment portfolio by including more sophisticated strategies.

What to watch for when evaluating Liquid Alternatives

With Liquid Alternatives gaining popularity among investors and fund managers, more strategies are coming to market every month. Alternative investments tend to be more complex than traditional mutual funds, and Liquid Alternatives are no different in that respect. There are a few common pitfalls to avoid when investing in Liquid Alternatives. It is always to best to consult a financial advisor to get advice that best suits your individual needs.

As more strategies are launched under the Liquid Alternative structure, it is key for investors to focus on the fund structure versus the underlying strategy. Most alternative strategies have long lock-in periods and leverage requirements, which do not qualify for liquid alternative structures. Some managers have adjusted their strategy to fit the Liquid Alternative structure, thereby diluting its efficacy as a true alternative. For example, hedge strategies that employ leverage will often exceed the limit of 50% enforced under the Liquid Alternative structure. This forces the manager to change their strategy to fit in the Liquid Alternative box, which can change the risk-return profile of the portfolio. This tradeoff between strategy and liquidity is what we consider to be a diluted strategy. The benefits of the true alternative are reduced in order to fit the Alternative Mutual Fund definition.

Hedge Funds typically outperform liquid alternatives following the same strategy, with more dispersion between top and bottom performers[8]. This is due in part to the dilution of the hedge fund strategy when converted to a liquid alternative. The strategy is forced to operate more like a typical mutual fund, therefore reducing the diversification benefit of the strategy.

Like most actively managed funds, the strategy's relative performance is a direct result of manager skill. With the recent popularity of Liquid Alternative funds, forecasted to grow to over $20 billion in assets by 2025[9], managers are looking to take advantage of this opportunity. Before making any decision to invest, investors need to consult their financial advisors and do full due diligence on the strategy and the manager. ■

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FOOTNOTES

[1] https://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20181004_81-102_alternative-mutual-funds.htm#4140s2anna
[2] https://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20181004_81-102_alternative-mutual-funds.htm#4140s2anna
[3] https://ninepoint.com/alt-thinking/
[4] https://marketbusinessnews.com/financial-glossary/alternative-investment/
[5] AIMA & Scotiabank Global Banking and Markets: Handbook to Launching Alternative Mutual Funds in Canada.
[6] https://www.cmegroup.com/trading-hours.html
[7] https://www.chicagofed.org/publications/chicago-fed-letter/2018/405
[8] The wrapper matters: Comparing liquid alternatives and hedge funds, Vanguard Research.
[9] AIMA & Scotiabank Global Banking and Markets: Handbook to Launching Alternative Mutual Funds in Canada.

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