AGF INSIGHTS

The Fourth Allocation

Why alternatives are becoming mainstream with investors

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Stocks, bonds and cash have long been the chosen trinity of portfolio construction, but over the past decade, a fourth allocation known as "alternatives" has taken hold, promising greater diversification and a more dynamic asset mix to weather volatile times.

For their part, investors, both big and small, are piling in. Alternative assets under management reached US$8.8-trillion globally last year and are expected to hit US$14-trillion by 2023, according to Preqin, an alternatives research firm. And while most of the interest to date is being driven by large pension plans, endowment funds and other institutions, the burgeoning market for liquid alternatives is also giving retail investors a growing opportunity to get involved.

Members of AGF's Board, executive and investment management teams recently sat down for a special roundtable to discuss the growing influence of alternatives and what investors need to know before adding them to a portfolio.

Questions and answers that follow have been edited for clarity and length.

Why is the demand for alternatives so strong?

Adrian Basaraba (AB): I think the seminal moment – and what has driven the growth in alternatives over the past decade at least – was the financial crisis in 2008. People became hypersensitive to the vagaries of the equity market in particular and realized that, globally, cross correlations were a lot higher than assumed. Since then, investors have been keen to find new ways of mitigating the risk of another major downturn through non-traditional asset classes and strategies that have the potential to provide uncorrelated – or at least low correlation – returns to stocks and bonds.

Jane Buchan (JB): As traditional asset classes have become more correlated over the years due to better information and globalization, investors are searching for new diversifying strategies in order to build a better balanced portfolio. Also, we now have in some cases more than twenty years of institutional investing data in order to better evaluate opportunities.

Bill DeRoche (BD): The financial crisis definitely accelerated the move towards alternatives, which has been building for the better part of the past 25 years. Real estate, for instance, has long been a way for people to diversify their core equity and fixed income portfolio. That said, the alternatives space has become much more democratized and much more diverse in terms of what's available – whether it be a structured "liquid-alt" product like a long/short ETF, or a privately-held asset class like real estate or infrastructure.

Steve Bonnyman (SB): By extension, what we've seen since the financial crisis is an opening up of the opportunity set to a broader base of investors than was traditionally the case. In the past, alternatives was primarily the domain of high net-worth investors or institutions focused on investments that would help them manage wealth across multiple generations or match long-term liabilities, rather than those that might just outperform the benchmark. So, it was rather exclusive, but that is now starting to change.

AB: It's not unlike other investment trends. Alternatives started with larger institutions and the asset class is now filtering down to the retail investor.

Alternative assets under management

2018

$8.8T

2023

$14T

Source: Preqin, *Future of Alternatives Report*, October 2018.

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>
> **– Adrian Basaraba**

What other factors are helping drive the growth of alternatives?

BD: Regulation has certainly played a huge role. The liquid alternatives market, in particular, is the direct result of changes made in the U.S., Europe and now Canada that provide mutual funds and exchange traded funds (ETFs) greater flexibility as to the types of assets they can invest in and the strategies they can deploy, such as leverage, shorting and the use of derivatives for hedging and non-hedging purposes. This is exciting to me as a portfolio manager.

AB: We've seen regulatory changes impact the demand for less liquid, private alternatives as well. For instance, increased banking regulations following the financial crisis tightened restrictions on capital requirements that limited bank lending to certain sectors. This has given a lift to the private debt space that is helping fill the funding gap, providing loans to companies, especially those in emerging industries.

SB: And I think investors are demonstrating demand. In general, investors are far more comfortable with complexity than ever before. They may not understand all of the ins and outs of the alternatives landscape, but they recognize the potential value involved and the market has responded in kind with a growing suite of asset classes and strategies for them to choose from.

BD: And most of the liquid-alt strategies now available to everyone are being created in a very thoughtful manner, for instance, in terms of how much leverage they use, so retail investors can feel pretty comfortable about what they're investing in.

And as a result of this growth, the definition of an alternative investment continues to expand as well.

BD: That's absolutely true and I think it has led to some confusion among investors. The word alternatives covers a huge swath of investments that all come with their own unique characteristics. A privately-held fund in an asset class like infrastructure, for instance, is very different than a publicly-traded managed future or ETF that uses a market-neutral structuring. Further, they are not only structured very differently but they have different levels of risk and also have very different investment objectives. So, it's important for investors to understand these differences in order to make informed decisions.

JB: There is no clear, universally accepted definition of alternatives, but what most of us mean are strategies involving securities outside of standard stocks and bonds or else strategies which involve going long and/or short in stocks and bonds. Importantly, alternatives cover a variety of risk and return combinations – some contain more risk and are higher return, whereas others have relatively low risk and produce a corresponding, lower return. Regardless, most alternatives are less correlated with traditional investments.

AB: The distinction between public and private alternatives is really crucial because it ends up narrowing the universe of options available to a lot of investors – and what's suitable to them as well. Private equity or debt is still the reserve of institutional and accredited investors and those who can afford the tens of thousands of dollars to satisfy minimum investment amounts that these types of funds require. There's also the question of liquidity. The private market is far less liquid than the public market and usually

demands lock-up periods that can be seven to ten years. That illiquidity risk means that you may be able to capture a premium on the return side, but it's not for everyone.

SB: I like to think of it as a continuum that ranges from publicly-traded long-only portfolios on one end to private bespoke investments in specific assets or asset classes like real estate on the other end. And in between, you now have liquid alts with different risk/reward structures helping fill in the gap between these two extremes. As an investor, this is empowering, but it's important to understand what you're actually getting involved in and what trade-offs you're potentially making in choosing one part of the continuum from another.

BD: And that's why the experience of the person or team managing the alternative is so important. For instance, we're going to see a fair number of hedge funds trying to get into the liquid alts space, but many are not going to have the systems in place to strike daily net asset values (NAVs) in the way that a traditional mutual fund does. Conversely, a lot of mutual fund firms that are going to try to get into the space just don't have the experience dealing with derivatives, options, prime brokers and the overall skill set to manage these types of strategies.

With this in mind, how do investors go about incorporating alternatives into an overall portfolio?

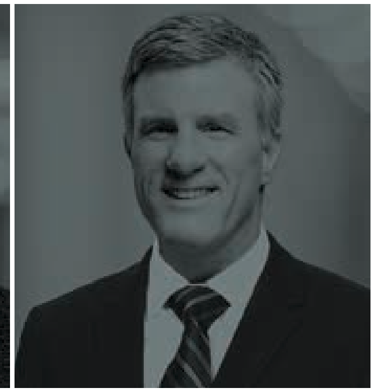
JB: Alternatives should be seen as an addition. Many investors may benefit from including diversifying assets. How much and which ones are highly dependent on risk tolerance, liquidity constraints and time horizons.

BD: I think there are a number of questions: How does it fit into my overall portfolio? How does it change the return profile that I would expect to generate when it's combined with my other investments? How does it affect my liquidity profile? Obviously private investments are great and I have some of my own, but at the end of the day you've locked up money for quite some time. So, investors need to evaluate and then figure out what fits best for them.

SB: The level of liquidity required is a big consideration, but a lot will be determined by the type of investor you are and your investment goals. A 35-year old may want to add more torque to their portfolio, whereas as a 65-year old is going to be looking for much steadier returns and definitely doesn't want their portfolio to blow up on them.

AB: Other considerations might include what part of the capital structure you want to play in or what type of return profile you want. There's a lot to consider and it might serve some investors well to get advice in terms of the specific investments they can and should choose from across the spectrum.

> Allocating to alternatives shouldn't be a conversation around market timing.
>
> **– Bill DeRoche**



SB: Alternatives can be built to achieve a whole different set of results and there will be a time and place for almost any one of them. So, there is no easy answer to the question of when one type of alternative investment should be added to a portfolio over another.

BD: Depending on what an investor's needs are, they could wind up with an allocation to alternatives that is extremely unique and it could involve asset classes as well as structuring to give them the return stream that they're looking for. In fact, customization is one of the things we work with clients on quite a bit. Some are looking to customize allocations to offset large exposures within their portfolios and manage risk while others are looking to tilt portfolios further towards specific factors in an effort to generate greater returns.

How much of an allocation to alternatives should investors consider in a portfolio?

BD: When you look at the some of the most sophisticated institutions or something like the Yale Endowment Model, most of the heavy lifting is being done by core exposure to equity and fixed income with supplementary allocations to alternatives in the range of 15 to 20 percent to help manage overall volatility in the portfolio. I think this makes a lot of sense for retail investors too, although perhaps to a lesser degree.

AB: Over the past few years, there have been a lot of institutional surveys that have asked the question, "Do you plan to increase your allocation to alternatives," and of the ones I've read, about 70 to 90 percent of the participants answer, "yes." That doesn't mean we're going to see alternatives dominating portfolios, but allocations may increase, on average, and become more significant.

BD: I could definitely see some institutions ending up with a much greater portion of their portfolio in alternatives, especially in the scenario where the goal is to match future liabilities. But I think it makes sense especially for retail investors to keep the bulk of their assets in core equity and core fixed income with a smaller allocation to liquid alternatives.

JB: I have seen some large university endowments that contain over 50% alternatives and I have seen a few with a relatively low allocation of 5-10%. Again, they are potential components as part of an overall investment plan.

SB: One of the more popular gold strategist has, in the past, recommended a two to five percent allocation to gold, which in many ways is the oldest and simplest alternative out there. I think this level of strategic allocation is a good starting point for retail investors regardless of the type of non-correlated asset or strategy they're using as a diversifier.

BD: I like this idea too because I think a lot of times investors view alternatives as something to own only when the market is going down and this type of tactical approach can be really hard to implement in practice. Allocating to alternatives shouldn't be a conversation around market timing.

How does the risk/return profile of a portfolio change when alternatives are added to a portfolio?

BD: A lot of investors have a preconceived notion because of the leverage or the shorting, that alternatives are high-risk, high-return investments. In some instances, sure, but more often than not they are engineered to reduce risk in a portfolio, often at the expense of potentially higher returns. Like any investment, a lot depends on the asset class and/or strategy and how much is being allocated.

JB: It can be shown mathematically that when one adds investments that have similar risk and return characteristics, yet are diversifying – i.e. have a correlation less than one – that the overall risk of the portfolio should go down without sacrificing return. Of course, this applies in theory and doing good research on the choice of alternatives is critical in terms of assessing both the return and the risk profile.

SB: If we consider Modern Portfolio Theory and the concept of an efficient frontier, what investors do when they introduce alternatives to a portfolio, is potentially improve their ability to earn the highest possible return with the lowest possible risk in terms of volatility. In today's market, for instance, an investor probably wants to have exposure to robust equity sectors like technology and healthcare, but it may be optimal to offset that exposure, at least partially, with something that has a low correlation to stocks, maybe some gold bullion or another hard asset.

AB: What [alternatives] are likely to add is downside protection, which may limit some upside, but also potential drawdowns. In turn, investors are more likely to stay invested longer, which is one of the keys to keeping returns consistent over time and accumulating wealth.

BD: Of course, some investors might not feel that way. Why worry about protecting the downside when equity markets have done so well? And the further away the financial crisis gets in the rear view mirror, the less they worry about it. But stocks can't go higher forever and there's a huge benefit to making sure drawdowns are as small as they possibly can be. Think about it: If your portfolio drops 50%, you need 100% return to get back to even. If anything, that's why investors need alternatives.

Adrian Basaraba, CPA, CA, CFA®

Senior Vice-President
and Chief Financial Officer,
AGF Management Limited

Adrian was appointed Chief Financial Officer of AGF Management Limited in July 2016. He is a member of the Executive Management Team and oversees AGF's financial management, corporate development, reporting, treasury, taxation and investor relations functions.

Before taking on this role, Adrian held various positions within the firm and served most recently as Senior Vice-President of Finance.

Adrian joined AGF in 2004 and has been an integral part of AGF's senior leadership team for the past decade. Prior to joining AGF, he held progressive roles with increased responsibility at PricewaterhouseCoopers and Canada Life.

Adrian served as a Member of the Board of Directors for Toronto Finance International (TFI) from January 2013 to February 2019. TFI is a public-private partnership between Canada's largest financial services institutions and the government. Adrian was the Chair of the Audit Committee for TFI from December 2016 until February 2019.

Adrian received his chartered accountant designation in 1998 and is also a CFA® charterholder. He graduated from The University of Western Ontario with a degree in Finance and Economics.

Steve Bonnyman, MBA, CFA®

Co-Head North American Research
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AGF Investments Inc.

Stephen Bonnyman is Co-Head, North American Equity Research and Portfolio Manager of AGF's Canadian and global resources portfolios. Working closely with the AGF research teams, Steve focuses on identifying resource companies with solid balance sheets, advantaged cost structures, attractive valuations or unrecognized growth.

Steve is a member of the AGF Asset Allocation Committee (AAC), which is comprised of senior portfolio managers who are responsible for various regions and asset classes. The AAC meets regularly to discuss, analyze and assess the macro-economic environment and capital markets in order to determine optimal asset allocation recommendations.

He joined AGF in 2013 with more than 20 years of buy and sell side experience covering the global materials industry, including five years of institutional money management. Prior to joining AGF, Steve was Managing Director and Mining Analyst at a major financial institution, responsible for global company research coverage and equity market analysis. Prior to that, he was an analyst and portfolio manager at two leading asset management firms.

Steve has a B.Sc. in Geology from McMaster University and an MBA from Dalhousie University and is a CFA charterholder.

Jane Buchan, PhD, CAIA (2017)

Member, AGF Management Limited
Board of Directors and Chief Executive
Officer, Martlet Asset Management LLC

Ms. Buchan is the Chief Executive Officer of Martlet Asset Management, an independent asset management firm focused on liquid alternatives. Until August 1, 2018, she was CEO of PAAMCO.

She served as Director and Chairwoman of the Board for the Chartered Alternative Investment Analyst Association (CAIA) until 2018. She also serves as a member of the Board of Directors for Torchmark (NYSE: TMK), is a founding Angel for 100 Women in Finance, is an active board member for Girls Who Invest, is a trustee for the Standards Board of Alternative Investments and she serves on the Advisory Board for the Journal of Alternative Investments.

Bill DeRoche, MBA, CFA®

Chief Investment Officer,
AGF Investments LLC and Head of
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Bill is co-founder of AGF Investments LLC, a Boston-based investor advisory firm founded in 2009 and subsidiary of AGF Management Limited. He is a leader of AGF's quantitative investment platform, known as AGFiQ. AGFiQ's team approach is grounded in the belief that investment outcomes can be improved by assessing and targeting the factors that drive market returns. Bill has long-tenured expertise employing quantitative factor-based strategies and alternative approaches to achieve a spectrum of investment objectives.

Previously, Bill was a Vice-President at State Street Global Advisors (SSgA), serving as head of the firm's U.S. Enhanced Equities team. His focus was on managing long-only and 130/30 U.S. strategies, as well as providing research on SSgA's stock-ranking models and portfolio construction techniques. Prior to joining SSgA in 2003, Bill was a Quantitative Analyst and Portfolio Manager at Putnam Investments. Bill has been working in the investment management field since 1995. Prior to 1995, Bill was a Naval Aviator flying the Grumman A-6 Intruder as a member of Attack Squadron Eighty-Five aboard the USS America (CV-66).

Bill holds a Bachelor's degree in Electrical Engineering from the United States Naval Academy and an MBA from the Amos Tuck School of Business Administration at Dartmouth College. He is a CFA® charterholder and holds FINRA licenses 7, 63 and 24.

For more information, visit AGF.com

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