ALTERNATIVE INVESTING
FREQUENTLY ASKED QUESTIONS

New regulatory changes proposed by the Canadian Securities Administrators may have a significant impact on the Canadian investment industry. We've answered some commonly asked questions to help you and your clients gain a better understanding of the risks and opportunities of alternative investing.

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WHAT REGULATORY CHANGES ARE ANTICIPATED?

In September 2016, the Canadian Securities Administrators (CSA) proposed amendments to National Instrument 81-102, Investment Funds (NI 81-102) that would increase the number of investment tools investment fund managers can use within a mutual fund construct. The proposed alternative fund framework allows alternative funds (commonly referred to as "liquid alternatives") to use leverage and borrowing, and to increase the use of shorting. In addition, these alternative funds will be available to the mass market under a Canadian prospectus and other related documents. The proposed framework means transformative change for the industry with the introduction of new, more robust investment products.

For the purpose of this document, we will refer to liquid alternatives as "alternative funds" (as referenced in the proposed CSA framework).

WHAT ARE LIQUID ALTERNATIVES?

Liquid alternatives are alternative funds that retail investors that can purchase or redeem on a frequent basis (typically daily). They typically employ alternative investment strategies that are more complex than a traditional "long only" portfolio and/or invest in asset classes other than the typical stocks, bonds, and cash that make up most mutual funds. The scope of liquid alternatives typically includes traditional hedge fund strategies such as long/short equity, market neutral, diversified strategies, and many more.

WHAT DOES THE ARRIVAL OF ALTERNATIVE FUNDS MEAN FOR INVESTMENT ADVISORS?

In the current interest rate environment, it is becoming increasingly difficult for traditional investment approaches to meet return expectations, creating a cautious curiosity about alternative funds.

The proposed introduction of alternative funds broadens the opportunity landscape for advisors by offering products that have different investment objectives than typical mutual funds. Alternative funds can help advisors provide diversification and risk mitigation to their clients' portfolios — which is not always the case with traditional long-only or long-biased mutual funds.

With the increased number of tools used in alternative fund investing, advisors may be faced with questions from their clients, and may need to help them understand the intricacies of the new products. To help educate your clients on the nuances of alternative investing, it is advisable to partner with an experienced alternative investing firm that can support you with your client education efforts in this new investing arena.

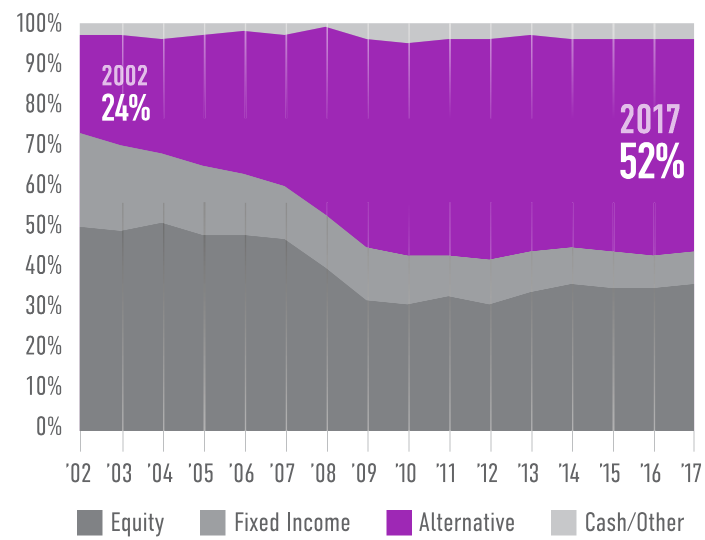
WHAT ARE THE IMPLICATIONS OF ALTERNATIVE FUNDS FOR INVESTORS?

With the proposed introduction of alternative funds, everyday retail investors will have the opportunity to benefit from investment strategies and asset classes traditionally only offered to institutions and high net-worth investors. The everyday retail investor will now have more product options and, more importantly, options that can enhance diversification, lower risk and correlated returns, and improve risk-adjusted returns.

HOW MUCH SHOULD AN INVESTOR ALLOCATE TO ALTERNATIVE INVESTMENTS?

The percentage of assets that an individual investor should allocate to alternative investments should always be determined on a case-by-case basis by the investor and his or her investment advisor. Institutions and high net-worth individuals often use alternatives to help achieve their investment goals. The endowment model in the U.S., for example, has demonstrated a history of allocating to alternatives, and we have seen this allocation steadily grow since 2002. In 2002–2017, the allocation to alternative strategies more than doubled, largely at the expense of traditional fixed-income exposure.

Asset Allocation History (2002–2017) U.S. College/University Endowments



Source: National Association of College and University Business Officers (study as at June 30, 2017, representing 809 respondents with total assets of ~US$566 billion).

Retail and institutional investors typically have similar investment objectives; however, the products and strategies available to each investor type have differed, primarily due to industry and regulatory constraints. With alternative funds, retail investors may be able to now construct more diversified portfolios, more closely aligning themselves to the institutional approach.

WHAT ARE THE POTENTIAL RISKS ASSOCIATED WITH ALTERNATIVE FUNDS?

As with any investment, there are always risks to consider. Since the proposed amendments to NI 81-102 increase the freedom to use tools such as shorting and leverage, there will inevitably be some investment managers who excessively increase risk through the use of inappropriate amounts of leverage — in an attempt to increase returns — at the expense of investors. Accordingly, it is imperative to understand each investment strategy and to recognize that these tools, if used properly, can be used to lower risk and market exposure.

As new entrants begin to crowd the space, identifying the most talented managers and the alternative funds best suited to complement investors' traditional asset portfolios will become more challenging. The number of investment managers and products will increase alongside the rise of more alternative strategies, ultimately mounting the challenge of distinguishing between established, experienced, and proven manager capability and those entering this complex investment arena for the first time. Investors should seek the guidance of their advisors to ensure they are adequately informed, and a proper due diligence process takes place before selecting any alternative funds.

IMPORTANT QUESTIONS TO CONSIDER WHEN CHOOSING AN ALTERNATIVE FUND.

WHAT IS THE FUND'S INVESTMENT OBJECTIVE, AND DOES IT SUIT THE INVESTOR'S NEEDS?

Understanding a fund's objective and how it aligns with the investor's investment goals is imperative. Alternative funds aim to solve different needs through holding several asset classes or using various types of strategies. Accordingly, it is important to study them individually in order to learn how the fund should behave, and what needs it addresses. For example, a market neutral strategy typically aims to have an average equity market beta of 0, offering risk mitigation, and is therefore a complement to typical long-biased portfolios heavily exposed to equity market risk. An active extension strategy, meanwhile, typically aims to generate an attractive risk-adjusted rate of return in excess of the equity market, while maintaining similar volatility (market beta of 1.0). Both of these strategies use hedging tools such as shorting and leverage and can be classified as alternative funds; however, their primary objectives differ significantly. All else being equal, the market neutral strategy aims to lower volatility for the investor, while the alpha extension strategy aims to improve return potential for the investor.

DOES THE INVESTMENT MANAGER HAVE PRIOR EXPERIENCE WITH ALTERNATIVE INVESTMENTS/HEDGING?

As previously stated, the alternative funds opportunity will attract many investment managers who rely heavily on their brand reputation in the traditional investment space to gain market share, but will have little or no experience managing alternative funds.

Be aware that the majority of Canadian traditional mutual funds do not actively short securities or use active hedging tactics within their funds. It takes years of practice, both strategically and operationally, to develop and refine the unique skill sets required for these hedging strategies and apply them within new or existing funds. Chose a firm whose investment professionals have extensive experience with alternative investment strategies. Most traditional investment firms tend to rely on long-only track records, with limited attention to shorting and other risk management capabilities. Shorting, leverage, and borrowing have been allowed within hedge funds for decades, but traditional mutual funds have largely been managed without using these tools. It is unlikely that managers who suddenly start using these sophisticated tools in their portfolios will succeed on beginner's luck.

DOES THE INVESTMENT MANAGER HAVE A TRACK RECORD THAT I CAN REVIEW?

Some managers may claim to have experience with alternative investments and hedging tools, but few may have tangible track records to reference. In some cases, the expertise has been "imported," through the hiring of a new manager but this raises a question as to whether the firm has the infrastructure in place to support the new hire. There is a significant difference between a manager who occasionally hedges as part of fund's strategy and managing a fund in which hedging tactics and strategies are applied regularly for risk management. Advisors and investors should be wary of managers who claim to have experience in the alternative space. Thorough due diligence is advised to ensure the manager has a proven, transparent, and lengthy track record of managing alternative strategies. Of course, viewing the track record of a manager hedging within a hedge fund will not tell the whole story of that manager's capabilities in the new alternative fund framework. A look at that manager's total skill set is also required.

HAS THE INVESTMENT MANAGER APPLIED HEDGING STRATEGIES WITHIN A MUTUAL FUND CONSTRUCT?

Many niche and alternative investment managers may lack familiarity with the mandatory regulatory filings that are required within a mutual fund construct. The increased transparency and number of disclosure documents required for mutual funds can help inform investors. However, if investment managers are not accustomed to these additional requirements – including, but not limited to, investment restrictions and daily liquidity—they may lack the resources necessary to handle the increased operational requirements. Because alternative funds have an increased ability to borrow and use leverage compared with traditional mutual funds there are additional operational considerations—especially in ensuring the daily liquidity to which mutual fund investors are accustomed. And when considering a prime broker or custodian, established counterparties must also be trusted. During the financial crisis, there was a well-documented instance in which a prime broker froze assets, compounding an already difficult situation for an investment manager sustaining investment losses.[1] When choosing to partner with an investment manager, it is essential to establish who bears the ultimate risk, and whether the firm has an independent risk committee with the oversight and authority to ensure investor protection.

HAS THE INVESTMENT MANAGER OR FIRM PRACTISED HEDGING STRATEGIES WITHIN THE CANADIAN REGULATORY ENVIRONMENT?

U.S. fund managers may see regulatory change as an opportunity to enter the Canadian market. While some have credible investment management experience, few may have experience operating within the Canadian regulatory environment. U.S. entrants may not have extensive knowledge of Canadian tax laws and the potential implications for investors. Moreover, counterparties (prime brokers, custodians, and transfer agents) and trade settlement mechanisms could differ significantly. Even for existing Canadian-domiciled managers, these counterparty considerations may be new, or more complex than in their historical lines of business. The importance of experience in dealing with all aspects of the infrastructure supporting an alternative fund cannot be understated.

DON'T EXPERIMENT WITH INEXPERIENCE. SEEK EXPERT ADVICE.

Picton Mahoney Asset Management is the innovator who brought Authentic Hedge® investment principles and practices to Canada more than 14 years ago. Since 2015, we have applied those hedging principles to our Fortified Mutual Funds, demonstrating our ability to effectively execute hedging strategies within the traditional mutual fund construct. The new alternative fund framework is an exciting opportunity to apply this expertise in a less constrained manner – helping investors achieve their investment goals with greater certainty.

416-955-4108 1-833-955-1344
service@pictonmahoney.com
pictonmahoney.com

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[1] Source: The Globe and Mail, October 2008.