Alternative Facts:
How Alternative Asset Classes Are Improving Portfolios

The days of the 60/40 portfolio may be numbered.

It's true that over the long-term, this type of portfolio has done relatively well, with the 60% equities portion participating in market gains and the 40% bond portion providing income and some downside protection. However a number of factors – namely, historically low yields and rising correlations – have made this traditional portfolio less attractive of late.

Enter alternative assets: hedge funds; agricultural land; real estate; private debt and private equity; and infrastructure assets, just to name a few. These non-traditional asset classes have increased in importance in institutional portfolios, thanks to their diversifying effect and ability to improve risk and reward dynamics.

In this paper we discuss the types of alternative assets that are becoming more commonplace, the benefits and drawbacks of owning them, and will explore why investors are increasingly allocating capital to them.

Breaking Down Alternative Assets

The major benefit of alternative assets is that they are less correlated or sometimes even negatively correlated to traditional asset classes such as public equities and bonds. Thus, adding them to a portfolio provides a significant boost to the risk/return profile, which we'll demonstrate soon. Moreover, the returns from alternative assets are often linked to inflation, helping to provide a modicum of protection to the real value of portfolios. Finally, because of the lack of retail investors in the space, alternative assets are less crowded than equities and bonds; this results in a less efficient market and therefore more opportunities for experienced managers to profit.

It's also important to understand the major drawbacks of alternatives in general. For example, because of a lack of a marketplace, alternative asset pricing is performed through valuations with built-in assumptions instead of being priced simply off the market bid for the asset as with publicly traded investments. This can result in increased opacity in the alternative asset market.

> "Non-traditional assets have increased in importance in institutional portfolios, thanks to their diversifying effect and ability to improve risk and reward dynamics."

Perhaps most importantly, private alternative liquidity is generally less prevalent than publicly-traded assets, once again due to a lack of a marketplace. While this drawback can be managed with good planning and a proper long-term strategy, investors must understand that liquidity might be a constraint before making the investment. This makes scrutinizing the manager's liquidity management practices essential, as is understanding the long-term commitment necessary to make holding these assets beneficial.

Below is an admittedly non-exhaustive list of the major benefits and drawbacks of some of the major alternative asset classes, as well as the reasons behind increasing investor interest in them.

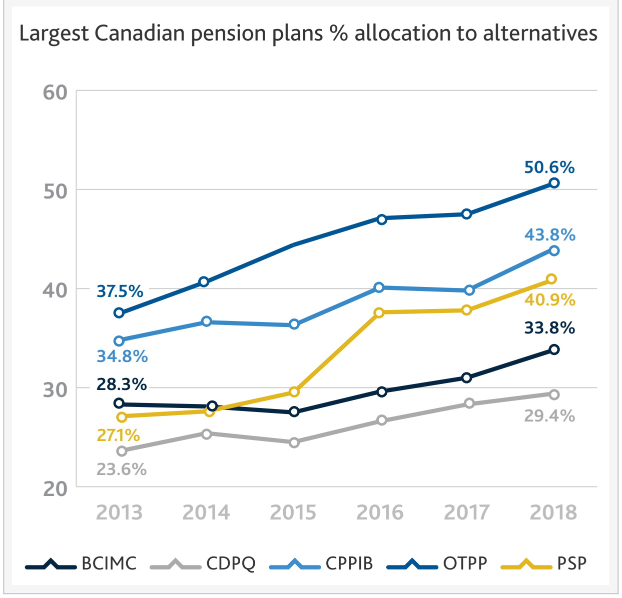
Type	Benefits	Drawbacks	Drivers of Investor Interest
Hedge Funds	• Potential to generate risk-adjusted absolute returns in any market scenario • Multiple types of strategies provide many investment options	• Success is highly dependent on the skill of the particular manager and the effectiveness of the strategy	• Regulations easing investor access
Agricultural Land	• Land values are resilient through economic cycles • Land prices generally more stable than the commodities the land produces • Strong correlation with inflation	• Unsustainable business practices could reduce asset value if not managed properly • Uncontrollable factors such as climate can have large effects	• Demographic trends such as population growth, rising incomes and urbanization are making arable land more valuable
Infrastructure	• Regulated/contracted revenue streams produce stable cash flows • Underlying assets' revenues generally linked to economic growth and inflation	• Higher exposure to risk of idiosyncratic events such as labour disruptions and government actions	• Aging infrastructure coupled with a decline in government spending and increasing privatization of infrastructure assets around the world
Private Equity	• Returns generally higher than public equities over long time frames • Returns generally more resilient than public equities during downturns • Revenues of underlying assets usually linked to inflation • Ability to access unique investment opportunities	• Currently, high valuations due to influx of institutional capital over the last few years	• Attractive risk/reward characteristics and long-term horizons are attracting pension funds • Increasing interest towards longer time horizons in equities, i.e. "patient capital"
Private Debt	• Generally based on floating rate loans, so portfolios are shorter duration • Higher yields than similar risk corporate bonds • Significant opportunities in Asia and LatAm, as alternative lenders are rare	• Rising valuations driven by increasing investor interest • Increasing investor interest has brought about many new funds with inexperienced investment teams; few regulations make manager selection crucial	• Capital requirements are lessening banks' ability to lend, leaving a gap in the market for loans to corporations
Real Estate	• Can be inherently diverse if invested across residential, commercial and industrial • Can choose from varying degrees of risk & return (eg. Equity vs debt; safer core strategies vs riskier speculative ones)	• Default rates may increase in a rising rate environment / as borrowing rates increase	• Investors' increasing interest in less volatile assets; real estate is historically one of the most stable asset classes

The (Not So) New Asset Class

Let's be clear: alternative investments are not a new thing; institutional investors have owned alternative assets in their portfolios for decades. Some research suggests that 80% of institutional investors are invested in at least one alternative asset, and over half are invested in three or more[1].

Canadian pension plans in particular have been world leaders in terms of alternative investments. Recognizing the benefits they can provide, the country's major pension plans have significantly increased their allocations to alternative assets.

Canadian pension plans increasingly allocating to altenative assets



Source: Fiera, Individual pension plans' annual reports. CDPQ & OTPP have been moved up one year to compensate for earlier fiscal year end dates. Some of the allocations required manual calculation due to the manner in which they were presented. Allocations between pension plans are not necessarily comparable due to differences in calculations of real assets for each plan.

High net worth investors also have access to these strategies through hedge funds or other types of vehicles invested in these asset classes. However, regulations have kept these assets out of the hands of all but the wealthiest and/or accredited investors, as governments deemed the assets too sophisticated for the everyday investor.

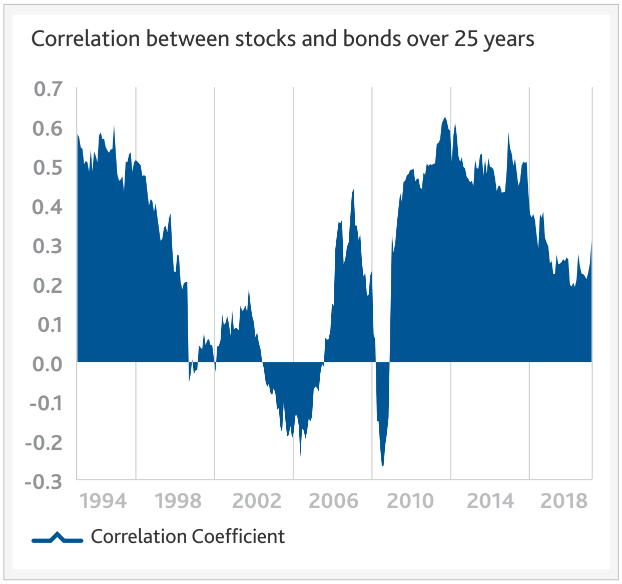
What is relatively new is the increasing interest among everyday investors in alternative assets. The so-called "democratization of finance" is being driven largely by two factors: regulatory changes which are making it easier for investors to access the markets; and technological advances which have enabled investors to more easily (and cheaply) price complex financial instruments and parse vast amounts of data.

Filling a Need

Of course, the gaining popularity of alternative assets isn't being driven purely by increasing supply. Rather, there is a growing investor demand, driven by macroeconomic factors. Specifically, fixed income investors who typically rely on corporate and/or government bonds to generate income have had to search elsewhere thanks to historically low yields. Rising inflation is also not helping, as investors see the real value of their portfolios decline.

Possibly the most important factor from the demand side has been non-negative correlations between traditional equities and bonds. While investors typically think of bonds as negatively correlated with equities, offering some diversification in down markets, in fact the diversification benefits aren't as strong as once thought. Going back to 1990, world bonds have been positively correlated with world stocks 83% of the time. With correlations being positive so often, the benefits of having a traditional fixed income allocation in a portfolio are significantly reduced.

Correlations aren't as low as one would think



Source: 36-month rolling correlations from Jan.1 1990 to October 31, 2018 (monthly data via Bloomberg). Indices: world bonds, Bloomberg Barclays Global Aggregate Total Return Unhedged USD; world equities, MSCI ACWI Gross Total Return USD Index.

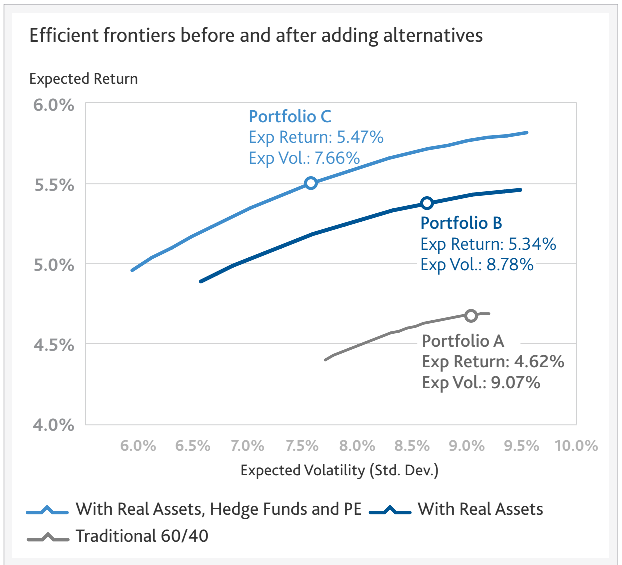
1 Source: Preqin, Preqin Investor Outlook: Alternative Assets, H1 2018

Building Better Portfolios

Would adding alternative assets improve risk/reward profiles? To answer this, we tested the risk/reward of a portfolio made of Canadian Universe bonds and Canadian and Global stocks using Fiera Capital internal assumptions of various asset classes' future returns and volatility. We then optimized the portfolio by adding in allocations to some of the aforementioned alternative strategies: non-traditional income (real assets such as real estate, agriculture and infrastructure) and non-traditional capital appreciation (private equity; hedge funds).

We can see the results below in the form of several efficient frontiers; adding in alternative assets moves the frontier up and to the left, or towards portfolios with better returns and less risk.

Adding alternative improves portfolio risk/reward dynamics

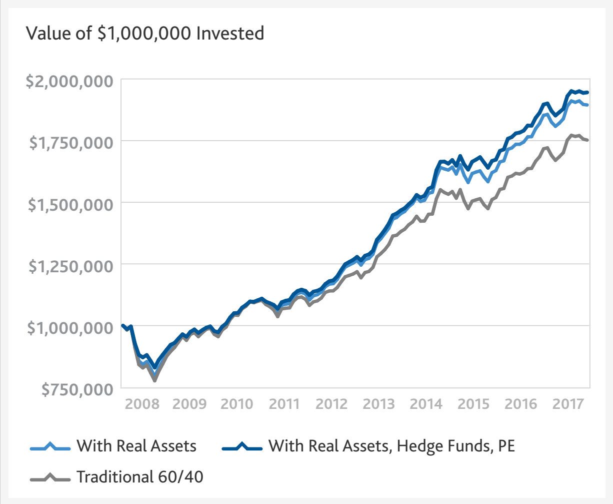


Source: Fiera MACS. Risk-return projections and efficient frontier based on the current yield curve environment and the 2018-2025 Fiera Global Financial Forecast as of June 30,2018

For example, portfolio A is a traditional portfolio 60% in stocks and 40% in bonds. Portfolio B is on a new efficient frontier which includes a 20% allocation to real assets, replacing a portion of the traditional fixed income and equities. Portfolio C is on a third efficient frontier which also adds on an allocation to hedge funds and private equity, with a further reduction in traditional equities. Moving from Portfolio A to Portfolio C, we can see that thanks to the diversifying nature of the non-traditional assets, one could pick up 85 additional basis points of return with 1.41% less risk than the traditional portfolio – this comes despite a reduction in the "safer" traditional fixed income segments.

Admittedly, the above efficient frontiers are based on forecasted returns and volatility. For a more concrete example, we backtested the same portfolios to determine the returns one would have achieved had an investor held these portfolios over the last ten years. Beginning in 2008, if you had started with $1 million in the traditional portfolio, that would have become $1.75 million by 2018. The portfolio with an allocation to real assets (Portfolio B) would have become $1.89 million, and that with hedge funds and PE (Portfolio C) would have become $1.95 million. Moreover, thanks to the diversifying benefits, both portfolios with non-traditional assets actually experienced less volatility than their traditional portfolio counterpart.

Adding in alternative assets can increase returns, reduce volatility



Portfolio	Value of $1 million	Volatility	Added Return	Risk Reduction
Traditional 60/40	$1,752,096	6.94%	-	-
Including Real Assets	$1,894,588	6.51%	$142,492.52	-0.43%
Including Real Assets, Hedge Funds, PE	$1,945,345	5.50%	$193,249.93	-1.44%

Source: Fiera MACS. All data from Q3 2008 to Q1 2018. Indices: FTSE Universe (Bonds), Synthetic Benchmark FTSE ST Bond + CMLS Mortgage Spread (Core mortgages), Brookfield Global Infrastructure (Infrastructure), IPD Canada PFI (Real Estate), NCREIF Farmland (Agriculture), S&P/TSX (Canadian equities), MSCI World (Global Equities), Barclay Equity Long/Short (Hedge Funds - Long/Short Equity), Barclay Equity Market Neutral (Hedge Funds - Market Neutral), Cambridge PE Global Buyout Index (Private Equity). All performances in CAD. Quarterly data for Mortgages, Real Estate, Agriculture, Private Equity, all others monthly data.

The results are clear: by adding alternatives – which have attractive risk/return profiles and are not highly correlated to traditional stocks and bonds – portfolio construction can be vastly improved.

In It for the Long Haul

While this is all well and good for large institutions that can allocate billions to multiple alternative assets, the question for smaller institutions becomes: considering its liquidity risks, is there a minimum portfolio size for an allocation to alternatives to make sense?

First off, it is important to understand that illiquidity isn't in and of itself a bad thing, as long as it's managed correctly; after all, the illiquidity premium is one of the main reasons for alternative investments' attractive returns. Nevertheless, it is understandably a drawback when it comes time to sell the asset, especially in the event of a drawdown.

Thankfully, alternative asset funds are now starting to cater to smaller institutions who have different liquidity needs and who can only allocate smaller amounts to alternative assets. Traditionally, alternative assets were built with closed-end fund structures and reserved for only the largest investors, who could allocate billions of dollars and who could stomach long (sometimes 10-15 years) lock-up periods. But more and more funds are using open-ended structures; therefore new investors are constantly adding to the fund, giving current investors who are seeking liquidity the ability to cash out. They are also allowing smaller minimum investments, meaning more and more small institutions are beginning to have investment options outside traditional asset classes. All that said, it should be made very clear that allocations to alternative investments are most effective when treated as long-term commitments, and are generally not suitable for short-sighted investors. So long as investors are taking long-term views, we believe that the diversification and risk/reward benefits that come with an allocation to alternative assets far outweigh the associated liquidity risks.

Bottom Line: Alternative Assets Are Gaining Importance, For Good Reason

Once upon a time, alternative assets were too misunderstood and exotic to be included in typical portfolios. In recent years, however, investors hungry for yield and portfolio diversifiers have increased their allocation to alternatives. The diversifying effect of these assets is unquestionable: properly employed, they have the power to reduce risk and increase potential returns. As the democratization of finance progresses, investors both large and small should continue to see alternative assets increase in importance.

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