Will clients embrace alternatives?

New class of mutual funds gives investors access to defensive strategies such as short-selling, leveraging and use of derivatives

BY MICHELLE SCHRIVER

INVESTORS WHOSE NEW year's resolution is to avoid portfolio losses have a new tool at their disposal in 2019: alternative mutual funds.

Effective Jan. 3, amendments to National Instrument 81-102: Investment Funds, and to related national instruments, made "liquid alternatives" (a.k.a. "liquid alts") available to all Canadian investors.

Within these funds, portfolio managers have greater flexibility to use alternative strategies — such as short-selling, leveraging and derivatives — compared with conventional mutual funds. Previously, these alternative strategies were restricted to accredited or institutional investors. The new rules democratize the market and are an important development for your clients who seek returns that don't correlate with those of stocks and bonds.

Liquid alts can shine during periods of volatility, says Jason Mann, co-founder, partner and chief investment officer of **EdgeHill Partners** in Toronto, who notes the serendipitous timing. "These products are coming out at [a time that] is potentially the end of the 10-year bull market," Mann says, when many clients are looking for defensive strategies.

Alternative strategies are required to maintain return expectations as the bull market ends and interest rates rise, says Tim Elliott, president of **Connor, Clark & Lunn Funds Inc.** in Toronto: "Returns from traditional stock and bond markets are going to be lower in the next five and 10 years than they have been."

Although Elliott generally tells clients to avoid unnecessary complexity in their portfolios, he makes an exception in the case of liquid alts.

Investors increasingly consider risk management as volatility rears its head, but may be unsure how to allocate liquid alts, says Som Seif, president and CEO of **Purpose Investments Inc.** in Toronto. Investor education is required so clients understand why a hedging strategy provides downside protection but underperforms in a bull market.

Within a portfolio, Elliott says, liquid alts fall into two broad categories: diversifiers and substitutes. As diversifiers, alternative funds employ strategies that deliver a risk/return profile that's different from those of long-only equity and bond funds. As substitutes, alternative funds incorporate tools within traditional asset classes to deliver potentially better risk-adjusted returns. Client expectations must be set in accordance with the strategy used, he says.

For financial advisors, Elliott adds, "the key question to ask when considering a strategy is: 'What's the strategy doing for the portfolio that I don't already have?' If that answer isn't obvious, then probably it's not worth the effort to do your due diligence."

But if the strategy could lower portfolio risk for the same returns or enhance returns for the same risk, the next thing to consider is the probability of those objectives being achieved. Key to that assessment will be the fund portfolio manager's track record.

Seif anticipates that given the fierce competition in the investment industry, many asset-management firms will bring new products to market, and their success in doing so will depend on a proven record of providing expected returns.

Furthermore, says Elliott, strategies such as short-selling and leveraging have unique risks relative to long-only portfolios. The potential for inexperienced portfolio managers to fail to execute a strategy could affect the adoption of these funds as they hit the market this year, he says.

James Burron, president of the **Canadian Association of Alternative Strategies & Assets** in Toronto, expects new products will offer plenty of choice for advisors, as portfolio managers take advantage of market opportunities to offer alternative mutual funds directly, subadvise or provide strategies through active alternative ETFs, and thus be able to reach global investors.

Portfolio managers of alternative funds also will benefit from conventional funds being able to invest 10% of their net asset value in alternative funds. These opportunities mean U.S. and other foreign portfolio-management firms will look to partner with Canadian mutual fund companies and banks, Burron says.

Canadian hedge fund growth suffers from distribution challenges inherent in offering memorandum (OM) funds with their greater regulatory burden and paperwork, Burron adds. Thus, he anticipates a greater rate of growth now that prospectus-based funds are on offer.

If you avoid OM funds because of potential liability, you may be attracted to liquid alts, says Mann. He estimates that such advisors represent about half of new fund flows into his firm's liquid alts. (EdgeHill received an exemption to offer the new funds ahead of the new rules being in force.)

Mann forecasts that long-only mutual funds could lose market share as investors opt for either higher-fee, higher-value products such as liquid alts or cheaper, long-only passive products such as ETFs.

A white paper published by **Bank of Nova Scotia** in October 2018 states liquid alts are likely to experience organic market growth as assets shift from existing mutual funds and hedge funds. Based on what's happened in the U.S., where liquid alternative strategies have been available to retail investors for a decade, the paper states, Canada's liquid alts market could grow to more than $20 billion within five years. Other analysts estimate market penetration of $15 billion to $100 billion or more, the paper adds.

In comparison, Canada's mutual fund market comprises $1.5 trillion and the hedge fund market accounts for about $40 billion.

Elliott anticipates adoption of the funds will take time as dealers and advisors learn about the strategies and portfolio managers. Market share also will depend on when the bull market finally ends.

"If we do see more volatility and lower returns from traditional assets," Elliott says, "[that] probably will increase adoption." **IE**

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