The Chosen One

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While acceptance may have been slow in coming, alternative investments have now reached the 'chosen one' status, representing a material portfolio holding for many large plans. Today, not having a meaningful alternative investment allocation implies being an outlier, relative to other large institutional investors. Interest from smaller investors is also on the rise as they recognize that a portfolio of just traditional equities and fixed income has limitations.

Evolution, Not Revolution

A recent Towers Watson study highlighting allocations to alternatives by the largest major global pension plans suggests that the shift to alternatives has evolved fairly slowly. Since

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1995, global institutional allocations to alternatives increased by 14 per cent, representing an average of 18 per cent of total assets at the end of 2013 (see *Chart 1*). In Canada, usage of alternatives has been more significant, with the large plans surveyed allocating 21 per cent of total assets to alternatives at the end of 2013. Alternative investments are also expected to be the beneficiaries of future allocations.

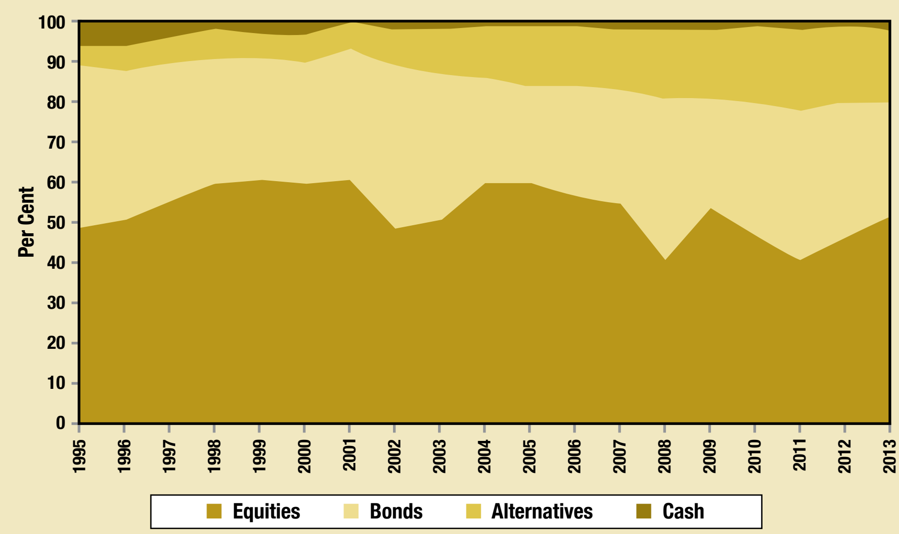
The term ‘alternatives’ is applied to a mixed bag of different types of investments. Consequently, investors need to match their need to the role that a specific alternative investment can fulfill. The popularity of different types of alternative investments has also evolved due, in part, to a difficult market environment and fall-out from the global financial crisis of 2008/2009. *Chart 2* provides a broad timeline for investor acceptance of the more popular alternative investment asset classes, as well as an overview of each asset class.

Private equity offers direct investment in private companies. For many investors, private equity was their first foray into alternatives, aided by the ease of understanding how its returns are generated. The attraction of hedge funds was the diversification merits of their absolute-return focus and uncorrelated returns relative to other investments. Interest in private equity and hedge funds waned somewhat following the challenges experienced during the financial crisis. As a result, investor focus shifted to real estate and infrastructure.

While real estate experienced its own setback following the recession in the early 1990s, interest in the asset class has come back strongly, leading to significant institutional allocations. Infrastructure has also gained broader popularity as many institutional investors witnessed the positive experience of some of Canada’s largest and pioneering pension plans. As investors look for greater choice within alternatives, specialist asset classes such as timberland are also seeing more interest.

Chart 1

Aggregate Allocation Of Largest Major Pension Markets*



*Towers Watson defines the largest seven pension markets to be Australia, Canada, Japan, Netherlands, Switzerland, UK and U.S.
Source: Towers Watson Global Pension Asset Study 2014.

Time To Diversify

If you ask investors what drove them to alternative investments, the most commonly cited reason is diversification. The expectation is that investing in alternatives should lead to a better portfolio risk-adjusted return outcome relative to a benchmark or relative to liabilities in the case of defined benefit pension plans. When added to a traditional portfolio comprised of equities and fixed income, alternatives act as a portfolio diversifier and, in varying degrees, provide a hedge against inflation concerns.

Investing in alternatives is not without its challenges. While alternatives may be a good fit with the longer-term investment time horizon of DB pension plans, a commonly cited challenge is still the illiquidity of these investments. There are other barriers that have to be overcome as well (see *Chart 3*). For example, investment in private equity is often gained through a closed-end fund structure. In contrast to investment in public equities, where a committee can see pre-existing portfolio holdings, there is no such opportunity at the outset with closed-end funds. Instead, there is only the reliance on past success that the manager has had in allocating capital for similar private equity closed-end funds.

Hedge funds pursue a wide range of strategies and thus have a broad range of risk and return attributes for investors to consider. Historically, many pension plan fiduciaries have taken issue with the lack of transparency regarding how hedge funds are invested and their higher investment management fees. A positive outcome from the financial crisis, when many hedge funds struggled, is improved transparency and fee compression.

Real estate and infrastructure are currently the ‘chosen ones’ within alternative asset classes and, perhaps, for good reason. Investors are readily able to understand the portfolio diversification benefits gained from investing in buildings, power sources, roads, and bridges. However, the increased level of interest in both real estate and infrastructure has created supply and demand imbalances for these assets, with the biggest challenge for new investors being the timeliness for getting committed money invested.

Matt O’Brien, president of Connor, Clark & Lunn Traditional Infrastructure Ltd, notes, “a major discussion point when we meet prospective clients revolves around our investment pipeline and sources of deal flow. Investors want to know that their assets will be invested in a reasonable time frame in order to get the full benefit of the desired exposure to infrastructure as an asset class."

Another concern resulting from supply and demand challenges is the upward pressure it creates on valuations. Kevin Leon, president of Crestpoint Real Estate Investments Ltd, a real estate specialist manager, says "the returns for the last few years from real estate have been very strong, which often leads to speculation that markets are overvalued. Going forward, investors should expect lower returns from real estate, but still a very respectful high single-digit return, plus the potential added value from active management."

Not Just For Big Funds

The types of investment vehicles and the approaches to incorporating an alternative investment allocation have also evolved. Real estate and infrastructure managers are increasingly offering open-end funds alongside closed-end funds. An open-end fund reduces the governance burden for smaller investors by simplifying the administrative tasks involved with the investment. Also, open-ended funds that are up and running have the added benefit of providing access to existing fund holdings, enabling new investors to avoid committing to a blind pool.

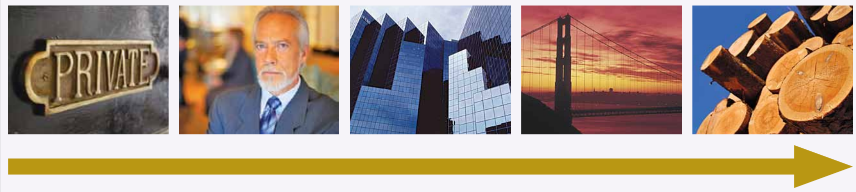
Within the hedge fund space, consulting firms have increased their resources to assist investors with the creation of customized portfolios of individual strategies through a managed account structure. Such structures alleviate some of the historical concerns with respect to the lack of transparency and higher fees associated with some fund-of-fund hedge funds.

As Martin Gerber, CIO and president of Connor, Clark & Lunn Investment Management Ltd, says, hedge funds can "provide a unique source of diversification by generating returns unrelated to equity markets. Historically, these uncorrelated returns came with a lack of transparency, which has been addressed and improved significantly in the last few years"

Another approach available to smaller investors is to delegate the development, selection, and oversight of an alternative investment portfolio to a third party, such as a fiduciary manager. The establishment of the alternative investment portfolio is based on the investor's specific objectives and risk tolerance, but by delegating the implementation, investors have more time to focus on strategic decisions.

Chart 2

Alternative Investment Timeline And Overview



Private Equity	Hedge Funds	Real Estate	Infrastructure	Timberland
• Direct investment in private companies • Capital used to acquire ownership from existing shareholders or finance future growth	• Absolute return focus vs. benchmark focus • Return generation more heavily geared to manager skill vs. market exposure	• Investment in land and buildings • Can diversify by sector (office, retail, industrial), region, country and strategy	• Monopoly-like assets such as power, roads, schools and airports	• Investment in natural and semi-natural forests • Managed for wood, non-wood products, and environmental benefits

Chart 3

Key Risks

Private Equity	• Illiquid, so requires long-term commitment • Depending on the type of investment, returns may not materialize for several years
Hedge Fund	• Use of leverage that imply a broad range of risk and return profiles • Lack of transparency
Real Estate	• Illiquid, so requires long-term commitment
Infrastructure	• Illiquid so longer-term commitment focus • Depending on the stage of investment (i.e., greenfield vs. brownfield), returns may not materialize in earliest years
Timberland	• Economic supply and demand factors • Mother nature factors, such as fire, weather, disease, and insect infestation

Source: Connor, Clark & Lunn Financial Group.

The Choice Is Yours

With current fixed income returns being too low and equities deemed too volatile for some investors, alternative investments may offer both return enhancement and diversification solutions for investors. With the addition of vehicles suited to smaller investors and a number of approaches available for implementation, alternatives are no longer just an option for the largest funds. Today, all investors have both the choice and ability to make alternative investments a core portfolio holding. BPM

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