THE REAL DEAL

Broad adoption of investment in alternative investments has been slow in coming, but they now represent a material allocation for many large institutional investors. Smaller investors' interest in alternatives has also increased, driven by the risk and return limitations of investing in a portfolio of traditional equities and fixed income.

New solutions and approaches now make alternatives a viable option for smaller investors, allowing them to benefit from the diversification characteristics of these assets.

EVOLUTION OF ALTERNATIVES

The term *alternative* is applied to a mixed bag of different types of investments whose popularity has evolved over time (see timeline below).

PRIVATE EQUITY

- Direct investment in private companies
- Capital used to acquire ownership from existing shareholders or finance future growth

HEDGE FUNDS

- Absolute return focus vs. benchmark focus
- Return generation more heavily geared to manager skill vs. market exposure

REAL ESTATE

- Investment in land and buildings
- Can diversify by sector (office, retail, industrial), region, country and strategy

INFRASTRUCTURE

- Monopoly-like assets such as power, roads, schools and airports

TIMBERLAND

- Investment in natural and semi-natural forests
- Managed for wood, non-wood products and environmental benefits.

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 global financial crisis. Investor focus shifted to real estate and infrastructure. Steady investment flows to these assets suggest they have now become the "real deal".

A typical portfolio of real estate holdings invests in land and buildings, usually diversified by sector (office, retail, industrial), as well as region and type of strategy. While real estate experienced its own setback following the recession in the early 1990s, interest in the asset class has rebounded strongly, leading to significant institutional investment.

Infrastructure, which involves investment in monopoly like assets such as roads, power plants and airports, has recently gained in popularity due to the positive outcomes experienced by some of Canada's largest and pioneering pension plans.

Infrastructure investments generate income either by charging customers for the use of the facility (i.e. an airport charge on an airline ticket) or its output (i.e. the sale of electricity from a power generation asset under an off-take agreement), or by charging an availability payment to a government entity in return for building and operating the asset (i.e. a fixed availability payment for the construction and operation of a hospital).

The global infrastructure market is divided into three categories: emerging, maturing and mature. The most significant number of infrastructure deals occurs at the mature stage. At the forefront of the mature market are Australia, the UK and Canada. Consequently, unlike most other asset classes, Canada represents a much larger proportion of the global market.

DIVERSIFICATION NEED

Diversification is the most common reason large plan investors turn to alternative investments. There is an expectation that investing in alternatives will lead to a better portfolio risk-adjusted return outcome relative to a benchmark, or relative to liabilities in the case of defined benefit pension investors.

When added to a traditional portfolio comprised of public equities and fixed income, alternatives diversify a portfolio and, in varying degrees, provide a hedge against inflation concerns.

In the current low-interest-rate environment investors are challenged to decide what their key investment objective is: to manage risk or achieve a reasonable return. Luckily, unlike fixed income investments, many alternatives are not as directly affected by interest rate changes and, can therefore provide both risk management and return enhancement benefits.

However, investing in alternatives is not without its challenges, the most common being the illiquidity of these investments. Other barriers include the type of investment vehicle, such as a closed-end fund structure, timely allocation of capital invested and other supply and demand imbalances.

The current popularity of real estate and infrastructure has been fuelled by the recognition of the diversification benefits these asset classes offer. The increased level of interest in both these asset classes has, however, created supply and demand imbalances. As a result, the biggest challenge for new investors is committed money being invested in a timely manner.

Matt O'Brien, President of Connor, Clark & Lunn 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 timeframe 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, notes, "Real estate returns for the last few years have been strong, which often leads to speculation that markets are overvalued. Going forward, investors should expect lower returns, but still respectful high single-digit performance, plus the potential added value from active management."

WHAT ELSE HAS CHANGED?

New types of investment vehicles and approaches make it easier to add exposure to alternative investments.

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[1] commonly associated with a closed-end fund.

The set-up time required for an alternative investment allocation can pose challenges for smaller investors, who frequently lack the internal resources to devote to such tasks as completing contracts. Whether they invest $500 million or $5 million into alternatives, the administration time is often the same, leading many smaller investors to conclude the time required does not merit the dollars invested.

Another approach to address the administrative challenge for 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 an alternative investment portfolio is based on the investor's specific objectives and risk tolerance. Delegating the implementation allows the investor to focus on strategic decisions.

REAL OPPORTUNITIES WHETHER BIG OR SMALL

Alternative investments may offer a range of return enhancement and diversification solutions for investors that may be concerned about the future prospect of low fixed income returns or believe that equities are too volatile.

The introduction of investment vehicles better suited to smaller investors and a number of new approaches available for constructing portfolios mean alternatives are no longer just an option for the largest funds. Today, all investors can take advantage of the risk and return merits offered by alternative investments.

For further discussion on this article contact:

Peter Muldowney
Senior Vice President, Institutional Strategy
416-304-6810 | pmuldowney@cclgroup.com

[1] A closed-end fund is where there is no pre-existing portfolio of holdings that an investor can review. Instead, there is only the reliance on past success that the investment manager has had in allocating capital for other closed-end funds.

Crestpoint Real Estate Investments Ltd., and Connor, Clark & Lunn Infrastructure Ltd. are part of the Connor, Clark & Lunn Financial Group Ltd. whose affiliated investment managers are responsible for the investment of approximately $57 billion in assets on behalf of institutional, private and retail clients.

Crestpoint REAL ESTATE INVESTMENTS LTD.

CONNOR, CLARK & LUNN INFRASTRUCTURE