FINANCIAL FLUENCY

Alternative investments for HCPs

BY MIKE MAGREEHAN

The impressive run in stock prices this past decade has led many to question the sustainability of these high equity valuations. With the challenge of an ongoing low interest rate environment that punishes bond investors, we begin to see why many professional money managers have been shifting their investment allocations from the traditional "stock and bond" portfolio to increasingly include another asset class altogether.

Alternative investments offer a strong solution for long-term investors within a well-diversified portfolio, as they aim to achieve attractive investment returns despite the headwinds and direction of public stock and bond markets.

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WHAT ARE ALTERNATIVE INVESTMENTS?

Alternative investments are a distinct asset class altogether and I'd suggest they are designed to be a complement to a traditional balanced portfolio of public stocks and bonds.

Examples of alternative investments include private equity, private real estate (i.e. commercial, apartments, long-term care), private debt (i.e. mortgages, factoring, business loans), real assets (i.e. infrastructure), or hedge funds (i.e. merger arbitrage or market neutral strategies). A deep-dive discussion into the intricacies of each of these very different mandates is vast and beyond the scope of this article. However, each strategy is interesting and provides its own unique aspect to a portfolio and is worthy of exploration.

Alternative investments aim to provide the following key benefits:

- Superior overall returns – a smoother investment experience
- Higher cash flow through a regular stream of rising income – this can be reinvested, allowing successful compounding
- Growing cash flow to maintain portfolio purchasing power – protection against inflation
- Capital protection in times of stock market declines – less swings in portfolio value and less downside portfolio risk
- Enhanced diversification benefits to reduce portfolio volatility and total risk – exposure to assets beyond the traditional sphere

A review of the asset allocations of some of the world's largest pension plans (i.e. Canada Pension Plan and Ontario Teachers) and endowment funds (i.e. Yale and Harvard) reveal that there has been a significant shift underway for over two decades toward an increased allocation to alternative investments. This so-called smart money has already moved into this asset class with great success as they've sought plan stability, higher income for their retirees, and superior returns, often with far less risk when compared to the emotional swings of traditional stocks and bonds.

In their 2019 annual report, Canada Pension Plan's

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allocation to alternative strategies comprised over 30% of total assets (compared to a zero weighting in 1999 when the plan was virtually all government bonds, which would have paid notably higher interest rates than current rates). The Pension Investment Association of Canada, which oversees 140 pension plans in Canada representing $2 trillion in pension assets, shows nearly 30% of total pension plan assets were in alternative investments at the end of 2018.

In fact, many of Canada's largest pension funds have at least a 20% weighting in alternatives. Various studies compiled by industry leading firms such as JP Morgan, Barclays and Morgan Stanley, have shown that a 20% allocation to alternatives has helped provide a higher return with less volatility when compared to a conventional portfolio of stocks and bonds.

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THE ALTERNATIVES LANDSCAPE

There is an expanding roster of strategies and manager styles within the alternatives landscape, each providing their own array of approaches and styles seeking absolute returns. A wise investor should do their homework and consider not only the benefits alternatives may provide, but also the constraints and any negative issues that may arise depending on the structure of the specific alternative mandate.

Many alternative assets are not fully liquid, meaning investors are unable to purchase or redeem their investment as frequently as public investments that are traded on the market. It is not uncommon that liquidity is restricted to monthly or quarterly, but in some cases, liquidity may be offered only after several years. In some ways, this constraint is part of their allure.

There are alternative investment managers that invest in real estate, such as a portfolio of apartment properties or long-term care facilities, and therefore do not offer investors daily liquidity because the underlying asset class is illiquid to begin with. Offering daily liquidity would jeopardize long-term investors at the expense of short-term speculators who wish to trade in and out of the mandate. This would drive up costs within the investment, thereby negatively impacting long-term, loyal investors.

Some investors may view a liquidity constraint as a downside, however, while liquidity is important, this shouldn't be an over weighted factor when selecting appropriate investment vehicles within a diversified portfolio. Pension plans, for instance, do not abandon an investment simply due to it being illiquid; rather, they often prefer illiquid investments because they are not subject to the same emotional gyrations of the market. Oftentimes, they offer much higher income and long-term returns which pension plans desperately require.

Since there is a growing appetite for non-traditional assets among investors, there have been many new firms entering the space in an attempt to capitalize on this trend. It is important to know that not all alternatives are created equal. Some private credit funds are high quality and provide secure collateral and sound covenants for their investors, while some new entrants are 'covenant-light' and may lack experience, which opens up the investor to a number of risks.

Past performance is a positive indicator but not a guarantee of future returns. Having a deep discussion with a manager regarding their philosophy, experience, and pattern of success can help pinpoint worthy candidates for consideration. Understanding how a manager performed during the years when stock markets were negative may demonstrate a stress test for their approach. While traditional stock markets were negative in 2008, 2011, 2015 and 2018, there are examples of many alternative managers that delivered positive returns those years.

It is crucial to know what management teams have been responsible for driving investment returns and if they are still at the helm generating alpha. Gauging the success of a particular strategy and determining the likelihood of a similar outcome in the current climate becomes important to see if the process and strategy remain viable, if the outcome is repeatable and to what probable degree. Ideally, a fund should be owner-operated with managers and key employees investing their own money alongside clients.

WHY ALTERNATIVE INVESTMENTS?

According to Willis Towers Watson, a leading global risk advisory firm, the world's top 100 alternative managers saw their assets surpass $5 trillion. There remains a strong appetite among pension plans, insurance companies, endowments and institutions for alternatives. This demand is likely to persist, because with pension plans, Canadians are living longer than ever before, and plan providers realize that many will spend more years in retirement than they did working. With interest rates still super low, pension investment committees recognize that they need to look beyond traditional bonds for long-term income and will likely continue sourcing attractive assets within the alternative space.

One common misconception about alternatives is that they are only accessible to pension providers and institutional investors. While that may have been true years ago, these investments have become available to a broader range of investors who meet certain eligibility criteria such as income or net worth thresholds. Today, a full service and independent advisor may access a broad range of alternatives for his or her clients with the intention of generating positive returns regardless of the state or direction of the market.

An independent, full-service advisory team should possess the skill and ability to access some of the best-in-class investment opportunities and managers. After conducting rigorous, objective and thoughtful due diligence, a professional advisory team should present clients with a recommended investment solution, including a discussion on the suitability of alternative assets.

Alternative investments can offer an effective avenue for investors to diversify their portfolio so as to achieve the highest success for their desired outcome. CC