Alternative investments are becoming a more realistic option for small institutional investors in Canada. This article summarizes the types of alternative investments as well as their benefits and disadvantages.
Road acceptance of alternative investments has been slow in coming, but they now represent a material allocation for several large institutional investors. Today, large investors that don’t have a meaningful alternative allocation appear to be outliers. Smaller investors are becoming more interested in alternatives, driven by the knowledge that a portfolio of traditional equities and fixed income has risk and return limitations. New solutions and approaches make alternatives a realistic option for smaller investors that will contribute to their future growth.

**Mixed Bag of Options**

The term *alternatives* is applied to a mixed bag of different types of investments. Private equity, hedge funds and real estate are familiar to the average investor. More recent alternative investment options include infrastructure and timberlands. An overview of the most popular alternative investments is summarized in the table.

Investors should match their needs to the function a specific alternative investment can fulfill. Many investors venture into alternatives first by investing in private equity, which offers direct investment in private companies. The available opportunity set is one key difference between private equity and public equity investments. Private equity investments are often one-time opportunities compared with public equity (i.e., stock exchange-listed companies) for which the opportunity to invest is available at any time, as evidenced by the names in the Canadian S&P/TSX Composite Index being largely unchanged for many years.

Hedge funds target positive returns in absolute terms rather than relative to a benchmark. This absolute-return focus adds diversification to a portfolio through uncorrelated returns relative to other investments. A hedge fund’s return generation emphasizes manager skill rather than market exposure, resulting in returns that are often indifferent to the direction of the market. Operating across a broad range of strategies, hedge funds add a degree of complexity compared with other alternative investment choices.

Interest in private equity and hedge funds waned somewhat following the 2008 financial crisis. As a result, investor focus shifted to real estate and infrastructure.

A portfolio of real estate holdings is simply investment in land and buildings, typically 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 involves investment in monopolylike assets such as roads, power plants and airports and has recently gained popularity based on positive outcomes experienced by some of Canada’s largest and pioneering pension plans. Infrastructure investments generate income by charging customers for access to a facility, such as airport charges on airline tickets. As investors look for greater choice within alternatives, specialist asset classes such as timberlands are experiencing heightened interest. These investments produce commodities that are sold to generate income.

**Evolution, Not Revolution**

While alternative investments now represent a material allocation for many large institutional investors, it

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**TABLE**

<table>
<thead>
<tr>
<th>Private Equity</th>
<th>Hedge Funds</th>
<th>Real Estate</th>
<th>Infrastructure</th>
<th>Timberlands</th>
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<tbody>
<tr>
<td>• Direct investment in private companies</td>
<td>• Absolute return focus vs. benchmark focus</td>
<td>• Investment in land and buildings</td>
<td>• Monopolylike assets such as power, roads, schools and airports</td>
<td>• Investment in natural and seminatural forests</td>
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<tr>
<td>• Capital used to acquire ownership from existing shareholders or finance future growth</td>
<td>• Return generation more heavily geared to manager skill vs. market exposure</td>
<td>• Can diversify by sector (office, retail, industrial), region, country and strategy</td>
<td>• Managed for wood, nonwood products and environmental benefits</td>
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has been a slow asset allocation evolution. A recent Towers Watson study highlighting allocations to alternatives by the largest major global pension plans underlines the slow shift to alternatives. Since 1995, global institutional allocations to alternatives increased by 14%, representing an average of 18% of total assets at the end of 2013.

The study showed that large plans in Canada have invested more significantly in alternatives, with those surveyed allocating 21% of total assets to alternatives at the end of 2013. Small investors have not yet invested as heavily in alternatives, but that is expected to change.

**Time to Diversify**

Diversification is the most common reason large plan investors turn to alternative investments. This was also the key reason cited by attendees surveyed during the 47th Annual Canadian Employee Benefits Conference in Calgary in August 2014. About 47% cited diversification, while 31% saw alternatives as an important source of added value. 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 (DB) 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.

Today’s low-interest-rate environment challenges investors to decide whether their key investment objective is to manage risk or achieve a reasonable return. Unlike fixed income investments, many alternatives are not as directly affected by interest rate changes and, as such, can provide both risk management and return enhancement benefits.

**Not Without Challenges**

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 investors, their illiquidity is still a commonly cited issue. In fact, 46% of the Annual Conference attendees surveyed cited illiquidity as their biggest concern, while 23% cited transparency and another 23% cited the time taken to invest as the key concern.

Other barriers also must be overcome. Because private equity investments are typically structured as closed-end funds, investment committees don’t have an opportunity to view preexisting portfolio holdings, unlike when they invest in public equities. Committees instead must rely on a manager’s past success 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. Although hedge funds historically have allowed investors to immediately put their money to work, many investors take issue with the lack of transparency about how hedge funds are invested and their higher investment management fees.

The increased level of interest in both real estate and infrastructure has created supply and demand imbalances for these assets. As a result, the biggest challenge for new investors is getting committed money invested in a timely manner. A major discussion point when potential new investors are considering an investment manager revolves around the number of new investment opportunities the manager has lined up. 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 real estate and infrastructure as an asset class.

The time required to set up an alternative investment allocation poses challenges for smaller investors as they frequently lack the internal resources to devote to such tasks as completing contracts. The administration time is often the same whether they invest $500 million or $5 million into alternatives and has led many smaller investors to conclude the time required did not merit the dollars invested.
What's Changed?

New types of investment vehicles and approaches make it easier to develop an alternative investment exposure.

Real estate and infrastructure managers are increasingly offering open-ended funds alongside closed-end funds. An open-ended fund reduces the governance burden for smaller investors by simplifying administrative tasks. 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 associated with a closed-end fund.

Hedge funds can provide a unique source of diversification by generating returns unrelated to other markets. The industry has improved the transparency of returns in the last few years and has lowered fees. For example, within the hedge fund marketplace, consulting firms have added services to assist investors. One such service is creating customized portfolios of individual strategies through a managed account structure. These structures alleviate some of the transparency concerns and higher fees associated with fund-of-fund hedge funds.

Smaller investors also can choose to delegate the construction of an alternative investment exposure to a third party, such as a fiduciary manager. The alternative investment portfolio is based on the investor's specific objectives and risk tolerance. By delegating the construction to a specialist group of professionals, investors have more time to focus on strategic decisions, rather than spending a disproportionate amount of time building the alternatives exposure.

Opportunities Whether Big or Small

Alternative investments can offer a range of return-enhancement and diversification solutions for investors that may be concerned about the prospect of low fixed income returns in the future 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.

Endnotes

2. The survey was conducted during the "Can Alternative Solutions Become the New Traditional Solution?" session held at the 47th Annual Canadian Employee Benefits Conference.

BIO

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