



NOVEMBER 2015

# Liquid Alternatives: Improving Portfolio Risk Management

Ben Cheng, *Chief Investment Officer*

Financial advisors  
want to deliver  
attractive long-term  
investment returns  
to their clients.

Given past market conditions and worries over future shocks, the importance of risk management and capital preservation has been made abundantly clear. Investing in “liquid alternatives” offers a potentially powerful way to pursue these goals. Liquid alternatives, which use strategies similar to hedge funds but in a mutual fund structure, aren’t well known in Canada. However, these funds have a longer history in the U.S. and are increasingly accessible in Canada. Advisors need to understand these funds to assess how they might increase their clients’ opportunities to achieve their financial goals.

# Contents

---

01	Liquid Alternatives: Fastest Growing Category in the U.S.	2
02	What Are Liquid Alternatives?	3
03	Benefits of Including Liquid Alternatives in Your Portfolio	5
04	Risks	8
05	Education to Help Yourself and Your Clients	9
06	Why Invest Now?	9
07	Why Aston Hill?	10

---

## 01

## Liquid Alternatives: Fastest Growing Category in the U.S.

**As a financial advisor, you strive to stay current on new developments that may benefit your clients.**

The rapid growth of liquid alternatives has made it the fastest growing category among institutional and high-net-worth investors both in the U.S. and globally for the past several years. This is the culmination of a massive shift—one of the furthest-reaching developments in global institutional investing over the last 25 years—into alternative investments as a whole over the past decade. The move, first by global institutional investors and then by retail investors, into traditional alternative investments shows that this is a trend that Canadian investors should consider.

In the first wave of growth, alternative assets rose from US\$2.9 trillion to US\$5.7 trillion between 2005 and 2007, according to McKinsey & Company. The second wave began after a pause in 2008, while investors regained their bearings from the market decline caused by the financial crisis. That drop in asset prices drove home the importance of portfolio diversification, including alternatives' non-correlation and hedging ability. Global alternative assets then rose to a record level of US\$6.5 trillion by the end of 2011, with a growth rate far outpacing that of traditional asset classes. We are now in a third wave of global growth in alternative investments, as the migration of alternatives from institutional to retail markets gains momentum. And with that migration, the term liquid alternatives was born. The term marries the alternative strategies used by traditional hedge funds, with the liquidity and transparency of retail mutual funds. Liquid alternatives currently make up the fastest growing category in the U.S., with inflows of more than US\$40 billion in 2013 and another US\$37 billion in 2014. A McKinsey & Company study noted that "Alternatives are rapidly moving into the mainstream retail market....as retail investors, confronted with volatile financial markets and the underfunding of their own retirements, follow the path blazed by institutional investors".<sup>1</sup>

Some Canadian investors—especially institutional investors—are catching up with their American peers. For example, the Ontario Teachers' Pension Plan has allocated 37% to alternative assets, while OMERS' allocation is 47%. This is comparable to the Yale Endowment Fund and Harvard Endowment Fund, who have allocated 58% and 40% to alternatives, respectively.<sup>2</sup> However, adoption by Canadian advisors and retail investors has been slower.<sup>3</sup> This follows the common pattern of institutions adopting innovations first, followed by individual investors once pricing and packaging evolved to meet their needs.

<sup>1</sup> Source:  
*The Mainstreaming of Alternative Investments: Fueling the Next Wave of Growth in Asset Management* (McKinsey & Company, 2012) p. 2.

<sup>2</sup> Source:  
Howard Atkinson, "Alternative Shouldn't Be a Dirty Word," (Feb. 14, 2014). <http://www.advisor.ca/investments/market-insights/alternative-shouldnt-be-a-dirty-word-144333>

<sup>3</sup> Source:  
Claude Robillard, "The Rise of Alternative Investments in Canada: The Case for Emerging Managers," (2012) p. 54. [http://www.iamgroup.ca/doc\\_bin/AIMA\\_Canada\\_Handbook\\_20121.pdf](http://www.iamgroup.ca/doc_bin/AIMA_Canada_Handbook_20121.pdf)

## 02

## What Are Liquid Alternatives?

**Liquid alternatives essentially offer alternative-style investment strategies in a mutual fund structure.**

In terms of investment strategy, they go beyond traditional long-only portfolio management strategies to use additional tools such as short-selling, derivative strategies including options (puts/calls) and forward contracts, and investing in private securities (see Figure 1: Portfolio Management Tools for Liquid Alternatives vs. Hedge Funds). They use these techniques in moderation, in keeping with regulatory limits on their use. These additions to traditional portfolio management offer the potential for enhanced risk management and capital preservation, similar to traditional alternatives. Their goal is to help investors protect their assets and decrease the overall risk of a portfolio while still participating in market gains.

	“Typical” Mutual Fund/ Liquid Alternatives	“Typical” Hedge Fund
Shorting	✓ ... up to 20%	✓
Options	✓ ... all strategies except writing “naked” calls	✓
Privates	✓ ... up to 10%	✓
Leverage	✗ ... not allowed	✓

Figure 1: Portfolio Management Tools for Liquid Alternatives vs. Hedge Funds

As liquid alternatives expand the range of investment techniques available to investors, their structure also offers advantages over hedge funds, the traditional vehicle of investors in alternatives (see Figure 2: Structure of Liquid Alternatives vs. Hedge Funds, page 4). Alternative investments used to be available only to institutional investors and ultra-high-net-worth investors because of their complex nature and relative lack of liquidity. Specifically, alternatives require high levels of investable assets for investors to achieve status as a “qualified investor,” impose high initial investments (typically \$25,000 and up), and entail an onerous subscription process laden with paperwork. Other limitations of hedge funds include limited opportunities for purchases and redemptions, lengthy notice periods to redeem, and hefty fees, including a performance fee that gives the manager 20% of the fund’s returns (on top of the hedge fund’s investment management fee). Due to less regulatory oversight, hedge funds also tend to be guarded in sharing information about their strategies and sources of performance.

Packaged for the mainstream retail investor, liquid alternative funds make alternative investments accessible to any investor who can afford their initial purchase amounts, which often run as little as \$1,000. Once investors have bought into a fund, they also enjoy daily liquidity to make additional purchases or redeem their holdings. Moreover, investors in liquid alternatives don't pay performance fees; they keep all of the fund's gains. Liquid alternatives also offer the advantage of more robust reporting than hedge funds about their strategies and performance, as required by fund regulators.

These advantages mean that advisors, even those with access to hedge funds, increasingly use liquid alternatives to access alternative investment strategies.<sup>4</sup>

<sup>4</sup> Source:  
"Seeking safe havens?  
Analysts, advisors point to  
liquid alternative funds,"  
CNBC (November 24, 2013).  
[http://www.cnbc.com/  
id/101188025](http://www.cnbc.com/id/101188025)

	"Typical" Mutual Fund/ Liquid Alternatives	"Typical" Hedge Fund
Purchases	Daily, no paperwork	Monthly, lots of paperwork
Liquidity	Daily	Monthly
Redemptions	Daily, no notice required	Monthly, with 30–90 days' notice
Performance Fee	None	20% of the fund's return
Investor Type	All investors	Only accredited investors
Purchase Amount	\$1,000	\$25,000

Figure 2: Structure of Liquid Alternatives vs. Hedge Funds

## 03

## Benefits of Including Liquid Alternatives in Your Portfolio

It's time for advisors to look beyond the traditional 60–40 portfolio of stocks and bonds to incorporate investments that can improve investors' outcomes.

If your clients seek enhanced risk reduction and the potential to improve the risk-adjusted performance of traditional portfolios, then they are candidates for using liquid alternatives. While liquid alternatives are a relatively new category, the benefits of the underlying strategies—traditional alternatives—have been tested over time. These investments have proven their ability to add diversification, improve risk-adjusted returns, reduce downside, and lower sensitivity to both market and interest rate moves.

### Higher Return Potential

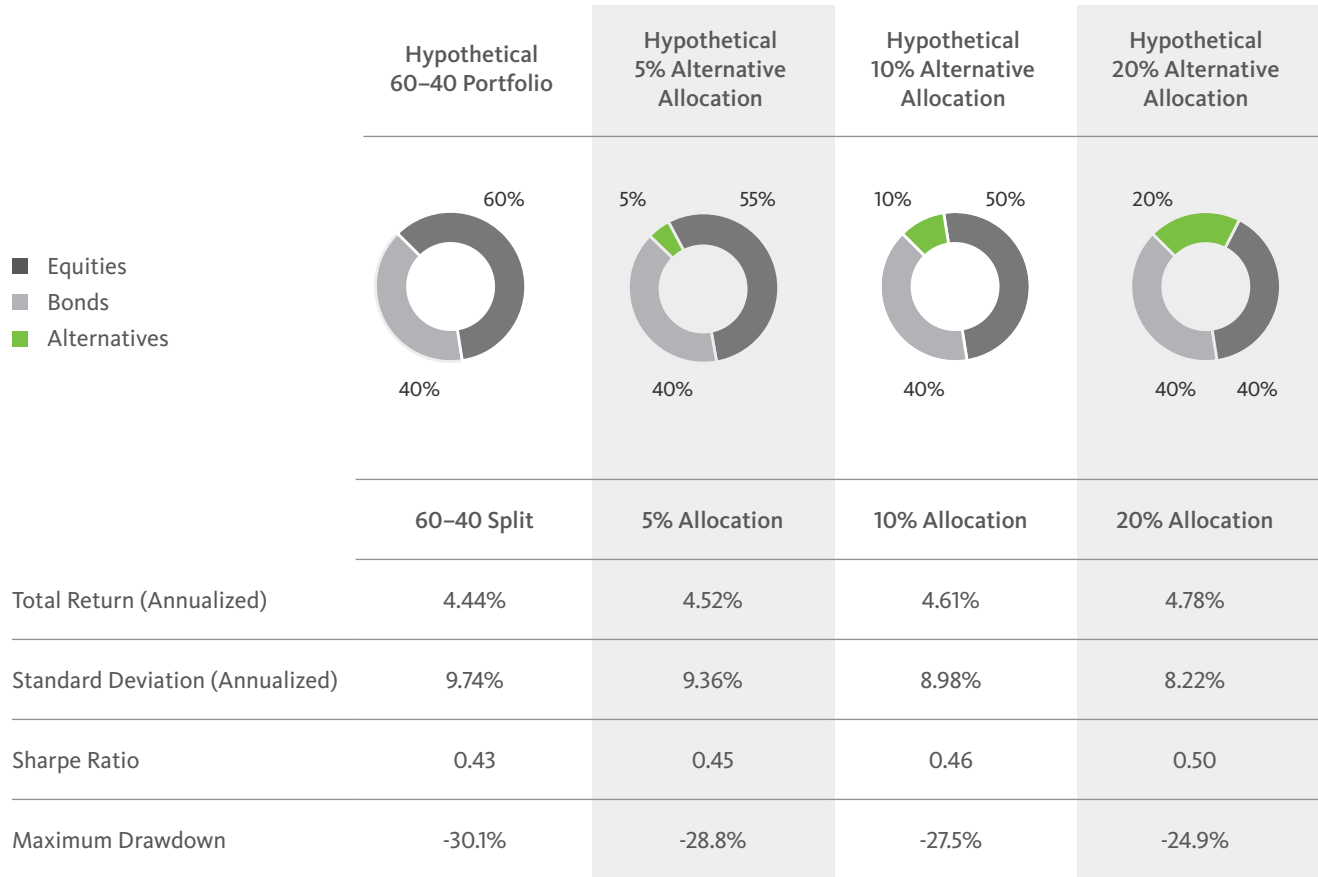
Advisors understand the power of diversification to reduce risk and smooth returns. To fully appreciate the value of alternatives, one must see their impact over time on a portfolio. Figure 3 on the next page shows the impact of alternatives on a traditional 60–40 portfolio of stocks and bonds over a 15-year period ended October 31, 2015, which includes the sharp drop in asset prices related to the savings and loan crisis, the dot-com bubble, the 2008 financial crisis and the summer sell-off in 2011. The hypothetical portfolio with alternatives achieved higher returns, lower volatility (as measured by annualized standard deviation), a higher Sharpe ratio, and a smaller loss at its lowest point. These are all highly desirable results.

### Protection When Markets Fall

Downside protection and capital preservation motivate many advisors moving their clients into liquid alternatives. Historically, liquid alternatives have performed best during market downturns, which is exactly when investors need them the most. This approach makes sense to individual investors. “Still scarred by the plummet of almost all assets in the 2008 financial crisis, investors are looking for less volatile, uncorrelated returns from their existing holdings,” according to an article in *The Financial Times*.<sup>5</sup> Nearly four in five investors globally would take safety over performance if forced to choose, according to the 2014 Global Survey of Individual Investors, conducted by Natixis Global Asset Management. Liquid alternatives also allow investors to participate in market appreciation. Although, they're not likely to keep up in bull markets, many investors care more about avoiding catastrophic losses during market sell-offs than capturing every penny during market gains.

<sup>5</sup> Source:

“Wealthy investors' alternative direction,” *The Financial Times* (March 25, 2014). <http://www.ft.com/intl/cms/s/2/439874e6-aba6-11e3-90af-00144feab7de.html#axzz39kuv8M5e>



The above returns are back-tested returns based on the following parameters, and are presented for illustrative purposes only. In all the above hypothetical examples, the Equity allocation is represented by a 50% allocation to the S&P 500 Index and a 50% allocation to the S&P/TSX Composite Index. The Bond allocation is represented by a 100% allocation to the Barclays Aggregate Bond Index. The Alternative allocation is represented by a 100% allocation to HFRI Fund Weighted Composite Index. Data is for the period from December 31, 1999 to October 31, 2015. Source: Bloomberg, PerTrac, Aston Hill.

Figure 3: Increasing the Allocation to Alternatives

### Clients Stay Calmer and Invested

When liquid alternatives reduce volatility and provide downside protection, they help investors achieve better outcomes. This is partly a statistical phenomenon, as shown by measures such as standard deviation and Sharpe ratios of a portfolio, but it also involves investor psychology. When markets fall or swing wildly, investors tend to panic and sell their holdings at the worst time. Their aversion to more losses often keeps them out of the market until its recovery is well established. Thus, investors lose by poorly timing their selling and buying. Along with the wise counsel of a financial advisor, liquid alternatives can help to break this pattern of investor behavior. As liquid alternatives reduce the impact of market downturns on investors' portfolios, they can reduce investors' anxieties and keep them fully invested. Tempering the emotional aspect of investing can help boost long-term investment returns.

**Sharpe ratios** characterize how well the return of an asset compensates the investor for the risk taken.

## Case Study:

### A Long/Short Equity Strategy Can Reduce Drawdowns

Investors are searching for strategies that can help protect their portfolio from capturing all of the downside during a market drawdown. What matters most is reducing the losses suffered from an equity market peak through to the bottom. One option to achieve this outcome is an allocation to a long/short equity strategy. A long/short equity strategy seeks to limit overall market exposure by its ability to take both long and short positions.

Typically a manager will short individual stocks they feel are overvalued and have weakening fundamentals not fully priced or recognized by the market; or if a manager has a negative view on an entire sector or asset class, they can reflect this broader outlook by shorting an exchange-traded fund.

Compared to a long-only equity strategy, long/short equity strategies have proven their ability to reduce losses when compared with the broader stock market during historical drawdowns (see Figure 4: Equity Drawdowns from 1990 to 2014). If an investor is concerned about equity volatility and risk, but still wants exposure to stocks, adding an allocation to a long/short equity strategy may help achieve this outcome.

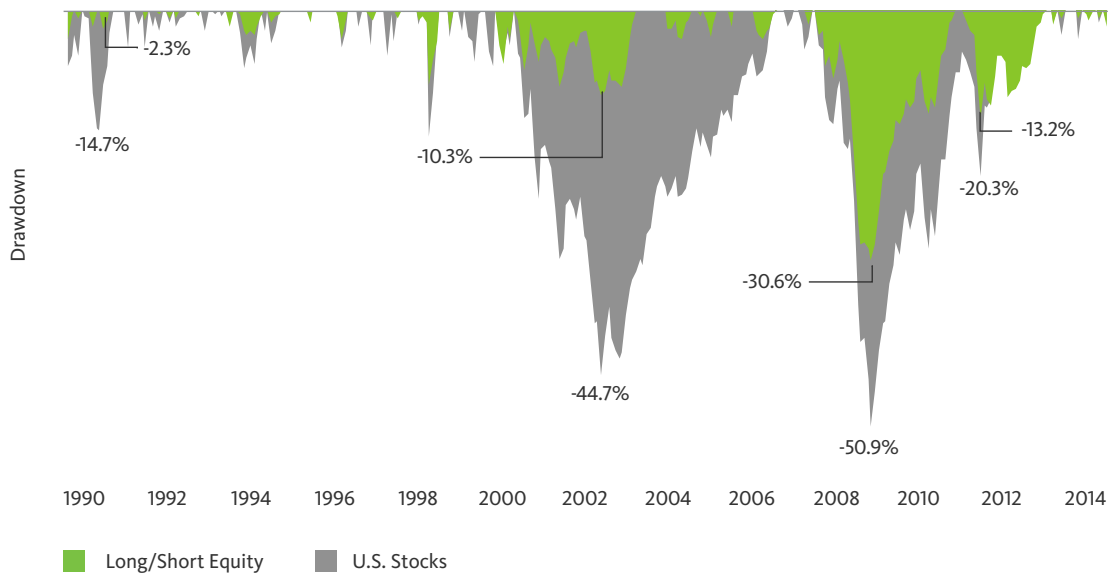


Figure 4: Equity Drawdowns from 1990 to 2014

*Past performance does not guarantee future results. Through September 30, 2014.*

*U.S. Stocks are represented by S&P 500 Total Return Index; Long/Short Equity by HFRI Equity Hedge.*

*Source: HFR, Bloomberg, PerTrac, Aston Hill.*



## 04

# Risks

**Like any investment vehicle, there are risks associated with liquid alternatives and it is critical for advisors to educate themselves on these risks in conjunction with understanding the benefits.**

Morningstar succinctly summarized the primary disadvantage of liquid alternatives: “The biggest risk is underperformance.”<sup>6</sup> On average, alternatives haven’t returned as much as stocks in bull markets. But they also haven’t been down as much as stocks in bear markets. It’s important to remember the role liquid alternatives play within a portfolio, which is that of providing risk-reduction and decreasing volatility of the overall portfolio. By design, liquid alternatives shouldn’t be the primary contributor to capital appreciation.

As a relatively new category, short track records and lack of appropriate benchmarks are two other risks for investors to consider. Manager selection is also an important factor for advisors to explore when selecting a liquid alternative to which to allocate.

One significant risk that liquid alternatives in Canada *do not share* with their U.S. counterparts is the risk associated with leverage. In the U.S., mutual funds are allowed to employ a certain amount of leverage whereas in Canada the use of leverage within mutual funds is prohibited. This includes the use of margin (borrowed capital) as well as writing uncovered calls. An uncovered call is inherently risky as there is theoretically unlimited downside potential. Accordingly, any call writing needs to be ‘covered’ by owning the underlying security. The inability to use leverage reduces the risk of Canadian liquid alternatives comparable to these same funds in the U.S.

<sup>6</sup> Source:

“Advisers turn to alternative mutual funds on U.S. rate rise fears,” *Reuters* (June 18, 2014). <http://www.reuters.com/article/2014/06/18/us-investing-hedgedmutualfunds-idUSKBN0ET2Y520140618>

## 05

## Education to Help Advisors and Your Clients

**Education matters. Investing in alternatives can be intimidating, even for financial professionals.**

Education will give you the knowledge you need to respond to investors' unwarranted fears, and make recommendations for reducing risk within their portfolios. Education will also help you understand why you should incorporate alternatives into portfolios.

Individual investors' lack of knowledge about alternatives may cause them to view this category as risky and expensive. According to the *2014 Global Survey of Individual Investors*, conducted by Natixis Global Asset Management, 82 percent of respondents said "they would need to learn more about alternatives before investing," but "they would consider alternative investments if their advisor recommended them." This is a telling insight into the important role played by advisors who educate their clients, and Aston Hill is committed to supporting this education.

## 06

## Why Invest Now?

**Looking forward, we see the potential for increased volatility and corrections in both equity and bond markets.**

Experts agree: In an article titled *The Future of Asset Management* published by the CFA Institute in 2013, almost two-thirds (66%) of asset managers, pension consultants, and other industry professionals globally said they expect two or more systemic crises over the next decade.<sup>7</sup> While we remain optimistic about U.S. and Canadian markets generally, future corrections of varying magnitudes are a reality. A little advance preparation by incorporating liquid alternatives holds the potential to ease the sting when stock or bond prices fall. It's important to act early. By the time the market declines, investors may have missed their best opportunity for downside protection. Think of it this way: You already want to have bought home insurance *before* your house catches fire.

<sup>7</sup> Source:  
"The Future of Asset Management," by Maha Khan Phillips, *CFA Institute Magazine* (Jan/Feb, 2013), <http://www.cfapubs.org/doi/pdf/10.2469/cfm.v24.n1.9>

## 07

## Why Aston Hill?

### Liquid alternatives aren't just a trend to us.

Our managers have been incorporating hedge fund strategies within their mutual funds since they first joined Aston Hill. Our mutual funds offer retail investors the benefits of alternative strategies typically only available to institutional and ultra-high-net-worth investors, at a lower cost than a traditional hedge fund, and with the benefits of a traditional mutual fund: daily liquidity, increased transparency, a low minimum investment, and no performance fee. We seek to complement good security selection with options strategies (buying and selling puts and covered calls), short-selling, and, when appropriate, managing our funds' allocation to cash and exposure to currency.

A recent Morningstar survey on alternative investing found that, "When selecting alternative products, both advisors and institutions agree that manager experience trumps other evaluation metrics." To this point, several of our managers came to Aston Hill from prominent Canadian and U.S. hedge funds. These managers had the foresight to see the opportunity in offering a product that applies the risk management tools of an alternative product to a traditional mutual fund. The collaborative approach amongst our managers led to these hedge fund strategies permeating through all of our mutual funds.

Think of our funds as alternative strategies in a mutual fund wrapper, with the underlying objective of reducing volatility and providing downside protection.



## About Aston Hill

Aston Hill Financial (TSX- 'AHF') is a publicly traded asset management firm with offices in Toronto and Halifax. Aston Hill is committed to meeting the financial needs of our clients, focusing on capital preservation with the objective to deliver long-term investment returns.

Founded in 2001, Aston Hill has grown to \$3 billion in total assets under management. The firm offers a suite of investment funds, including mutual funds, closed end funds, and hedge funds, manages portfolios for institutional investors, and provides portfolio advisory services. With over 150 years of collective experience among the senior leadership team, Aston Hill has extensive investment knowledge across all industries and asset classes. Aston Hill has a proven track record of adding value to our client portfolios through changing investment and economic cycles.

Aston Hill is an entrepreneurial partnership amongst proven industry leaders and is quickly establishing itself as Canada's premier wealth management firm. We believe that our clients are our financial partners, and that our employees should invest their personal wealth alongside our clients in our own funds. This philosophy helps ensure that every investment decision is made with our partners' best interests in mind.

### NOTE TO ALL READERS:

*This white paper was originally published in October 2014 and was updated on November 1, 2015 to reflect updated industry statistics. The information contained here reflects the views of Aston Hill Asset Management Inc. ("Aston Hill") or its affiliates and sources it believes are reliable as of the date of this publication. Aston Hill makes no representations or warranties concerning the accuracy of any data. There is no guarantee that any projection, forecast or opinion in this material will be realized. Past performance does not guarantee future results. The views expressed here may change at any time after the date of this publication. This document is for informational purposes only and does not constitute investment advice. Aston Hill does not provide tax, legal or accounting advice. It does not take an investor's personal investment objectives or financial situation into account; investors should discuss their individual circumstances with appropriate professionals before making any decisions. This information should not be construed as sales or marketing material or an offer or solicitation for the purchase or sale of any financial instrument, product or service sponsored by Aston Hill or its affiliates.*

*Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments and the use of an asset allocation service. Please read the prospectus of the mutual funds in which investment may be made under the asset allocation service before investing. The indicated rates of return are the historical annual compounded total returns assuming the investment strategy recommended by the asset allocation service is used and after deduction of the fees and charges in respect of the service. The returns are based on the historical annual compounded total returns of the specified allocation strategy including changes in unit value and reinvestment of all distributions and do not take into account sales, redemption, distribution or optional charges or income taxes payable by any securityholder in respect of a specified allocation strategy that would have reduced returns. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated.*

77 King Street West,  
Suite 2110, PO Box 92  
Toronto, ON  
M5K 1G8

Tel: 1 (800) 513-3868  
or (416) 583-2300  
funds@astonhill.ca  
[www.astonhill.ca](http://www.astonhill.ca)