How Alternatives have become mainstream and why they're changing the investment landscape

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CMI

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1. WHAT IS AN ALTERNATIVE INVESTMENT?

A unique macroeconomic climate and the shifting advisory landscape

Before we take a more detailed look at the fastest growing segments within alternatives and the unique features that make alternatives such an attractive asset class, let's take a step back to clarify a topic that's often misunderstood: what exactly constitutes an alternative investment? Simply put, "alternatives" refer to any asset class that falls outside the conventional categories of equity, income, and cash (which includes money market assets such as bonds and currencies.)

Alternative investments tend to be more complex and less transparent in nature than traditional investments, have fairly high investment thresholds and are generally a higher risk option than their traditional counterparts. Alternatives have become an increasingly mainstream investment strategy as investors seek to capitalize on the potential for higher returns and portfolio diversification that can help hedge against the volatility in global stock and bond markets.

Most specialized investment vehicles run by an external manager - such as private equity, venture capital, hedge funds and managed futures, qualify as alternative investments. Hard assets like natural resources, commodities and real estate, as well as collectables like art and wine are also classified as alternatives.

As an advisor, you have seen first hand the dramatic shift in the wealth management landscape over the past decade. Recent events surrounding the COVID-19 pandemic have only exacerbated these market conditions, impacting capital markets and our society as a whole in ways many of us could never have fathomed.

In recent weeks, market volatility and economic uncertainty have become the norm, forcing advisors to navigate in unchartered waters. Many advisors feel as though they are piloting through a minefield, attempting to address and alleviate the ever-changing concerns and issues expressed by clients. Unfortunately, it does not appear that this period of unease will end anytime soon.

Even the Bank of Canada's decisions to ease monetary policy by returning interest rates to all-time lows, last seen during the financial crisis of 2008, have failed to fully abate this market downturn. This has further exacerbated the historically low yields investors have realized via traditional income-generating investments, such as government bonds, over much of the past decade.

It is therefore easy to see why investor preferences have shifted towards more sustainable and higher yield fixed income investments, in an effort to offset increased global volatility in capital markets. The intersection of these two trends poses a significant challenge for advisors- how to deliver high-yields, capital appreciation as well as preservation amid a global climate of low-yields and market uncertainty.

The unmistakable rise of Alternatives: A decade of growth

The last decade has seen an unprecedented rise in the prominence of alternative assets. This is likely driven by changing attitudes of both investors and wealth managers in response to shifts in monetary policy and the macroeconomic environment.The alternatives industry has grown exponentially from $3.1trillion USD in assets under management (AUM) in 2008 to $8.8trillion USD in 2017. And this is just the beginning, total AUM for alternatives is poised to reach $14trillion USD by 2023.[1]

As per a 2018 survey by EY[2], hedge funds, private equity funds and "smart money" investors have a quarter of their portfolios dedicated to alternatives. Real estate continues to be a leading alternative asset in these portfolios (Figure 1).

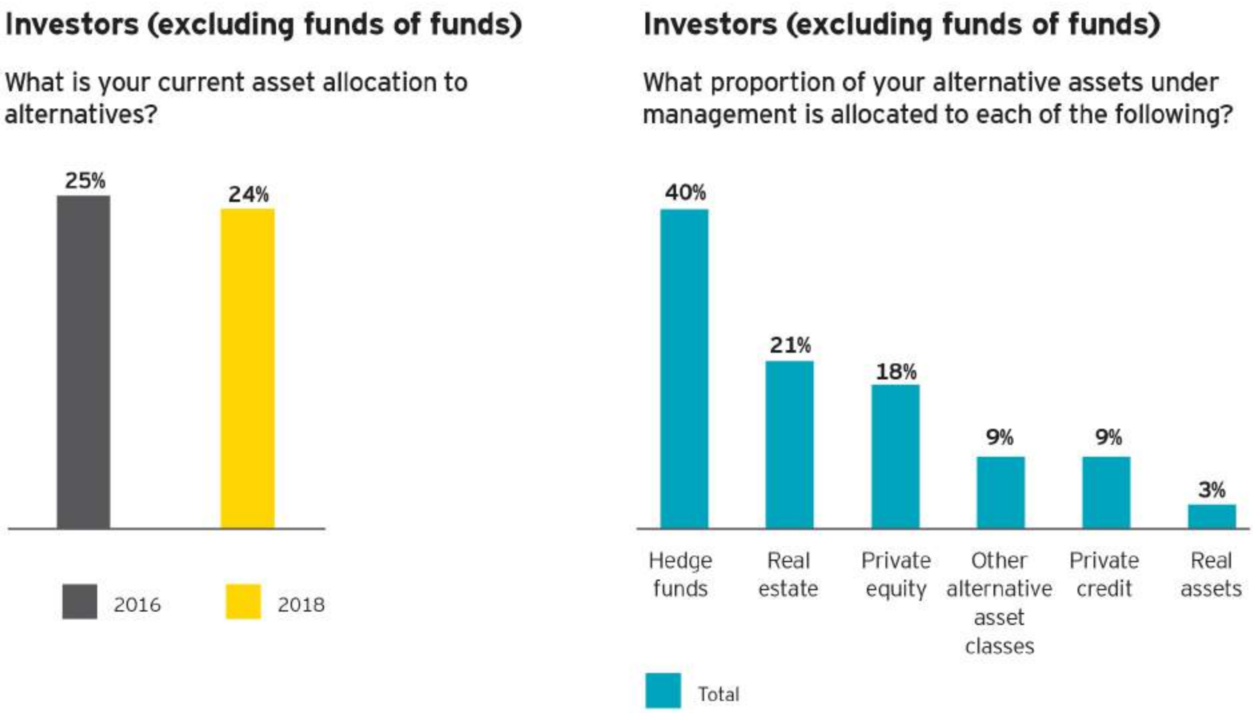

Figure 1: "Smart Money" Investors: Asset allocation to Alternatives. Research by EY surveyed "smart money" investors, demonstrating that a quarter of their portfolios are dedicated to alternatives. (Figure obtained from EY report.[2])

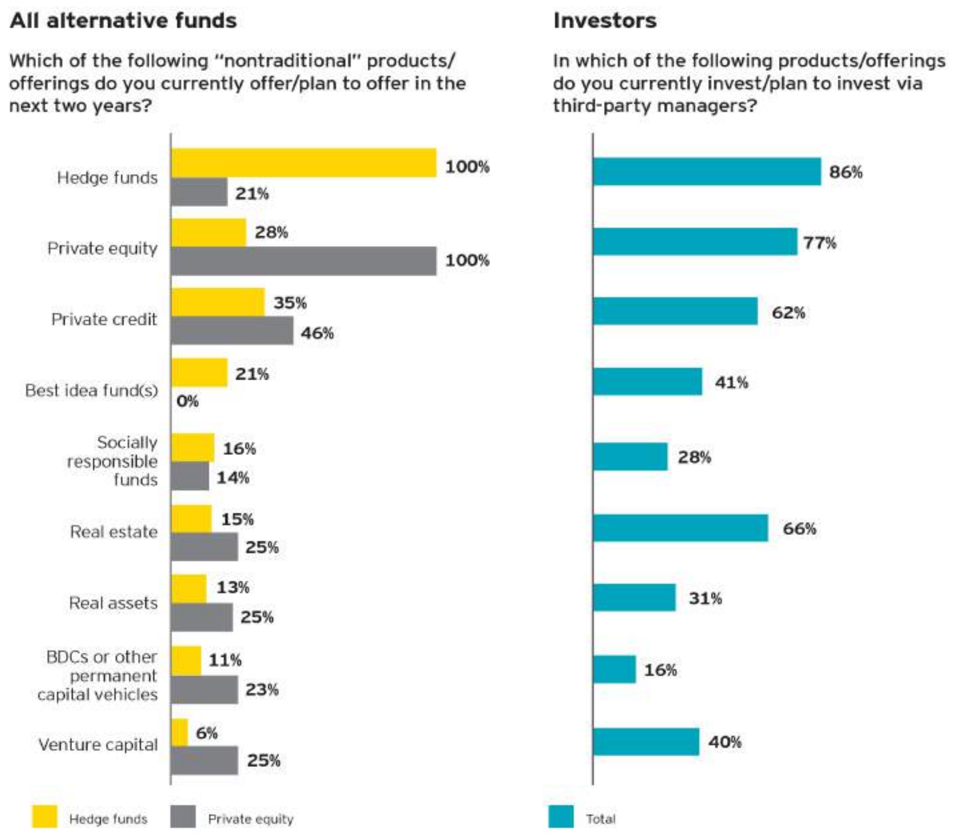

Figure 2: "Smart Money": Alternative investment allocations by asset class. Real estate continues to dominate the portfolios of two thirds of "smart money" investors surveyed by EY. (Figure obtained from EY report.[2])

2. ALTERNATIVE INVESTMENTS, DIVERSIFICATION AND PORTFOLIO STRATEGY

Unique features of Alternatives: The potential for absolute returns

The universe of alternative investments is comprised of a wide and varied sub-segment of asset classes. They are characterized by three key features that offer advisors a powerful opportunity to mitigate risk exposure through portfolio diversification while delivering higher yields.

Firstly, most alternatives have a low correlation with traditional capital markets and asset classes, which means that alternatives tend to fluctuate independently from stock and bond markets. This characteristic ensures that alternative asset classes remain largely immune to the volatility in stock and bond markets, which reduces market risk exposure for investors. This makes alternatives the ideal asset class for portfolio diversification - without compromising potential returns.

Secondly, "hard asset" alternatives like collectables, commodities and real estate offer the added advantage of effectively hedging against inflation. The value of these tangible assets will usually increase due to inflation, ensuring they will move together with currency values and the consumer price index. As such, hard assets minimize portfolio volatility during times of inflation.

Finally, alternatives by definition tend to be less efficiently priced than traditional assets. For investors, it's this inefficiency that presents the opportunity to generate higher returns compared to publicly traded securities.

Pricing Inefficiencies: Why Alternatives outperform public markets

To understand inefficient markets (and how they're beneficial to investors), we must first define an efficient market. Efficient markets like traditional public markets are characterized by a large number of participants, high liquidity, easy access to information and low transaction costs.

In efficient markets, supply and demand function to adjust prices in order to reach a market equilibrium. This ensures that assets are always priced at a "fair market value". However, this feature makes it difficult for investors to outperform the market by buying below and selling above the fair market price of an asset.

In contrast, inefficient markets like alternatives are characterized by high barriers to entry, high transaction costs, a limited number of participants and lower liquidity, all of which prohibit the market from reaching an equilibrium. Consequently, the actual prices of alternative assets may differ from their expected valuations.

For experienced wealth managers, this pricing inefficiency provides an opportunity to leverage one's knowledge and expertise to identify under valued assets that can generate higher returns for their clients. Ultimately highlighting their value and experience in amassing wealth, which directly contributes to increasing the manager's AUM. Buyers in private markets are also compensated for pricing inefficiencies through "illiquidity premiums". This enables private market investments to generate higher returns without necessarily increasing risk exposure.

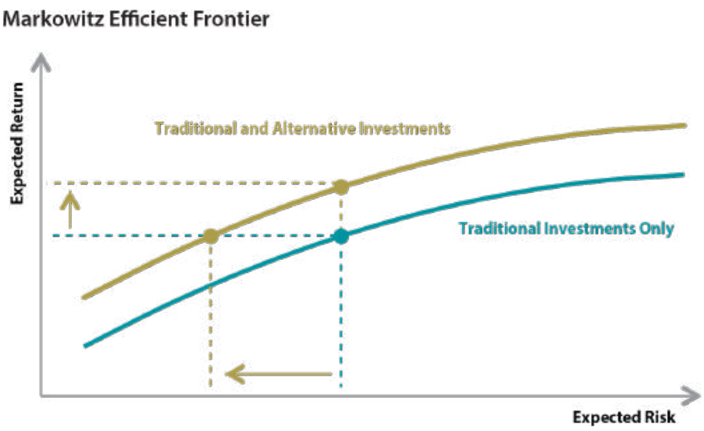

Figure 3: Inefficiencies in Traditional vs. Alternative markets. Inefficiencies in private markets can be compensated by higher returns without increasing risk exposure. (Figure obtained from Baird Private Wealth Management report.[3])

Therefore, including alternatives within a portfolio reduces overall portfolio risk and volatility through diversification of assets with a low correlation to capital markets, provides an opportunity to enhance returns via pricing inefficiencies, and in the case of hard assets, acts as an effective hedge against inflation.

For advisors, the implications are clear: inefficiencies within private and alternative markets enable investors to achieve returns far beyond what is structurally possible in efficient capital markets. The rationale for this is fairly straightforward. Public markets and the securities industry were not originally designed to be "wealth creators" for individuals. On the contrary, they were created for the specific goal of raising capital to finance businesses, and fostering a supporting ecosystem through stocks and bonds.

"Smart Money" Investors: How the wealthy make their wealth

To understand how wealth is created one must look to the wealthy - or the "smart money" investors: investment banks, pension funds and others who are the engine behind the world's wealth. Examining their investment strategies offers a valuable lesson. After all, this group of elite financiers are called "smart money" investors because they have the necessary wealth, experience and access to information that enables them to execute high performing investment strategies.

These "smart money" investors have a clear strategy in response to the environment of compressed bond yields: rethinking overall portfolio construction through a growing reliance on the alternatives asset class.

3. ALTERNATIVE INVESTMENTS AND PUBLIC PENSION FUNDS (PPFS)

PPFs rethink Asset Allocation, relying heavily on Alternatives

Since 2008, "smart money" investors have responded to the unconventional monetary policy by shifting asset allocation away from fixed income assets to alternatives. However, nowhere is this trend more marked than with public pension funds (PPFs. Between 2008 and 2016, the average PPF's asset allocation to alternatives grew from 11.7% to 16.2%, driven largely by growth in private equity, infrastructure and real estate.

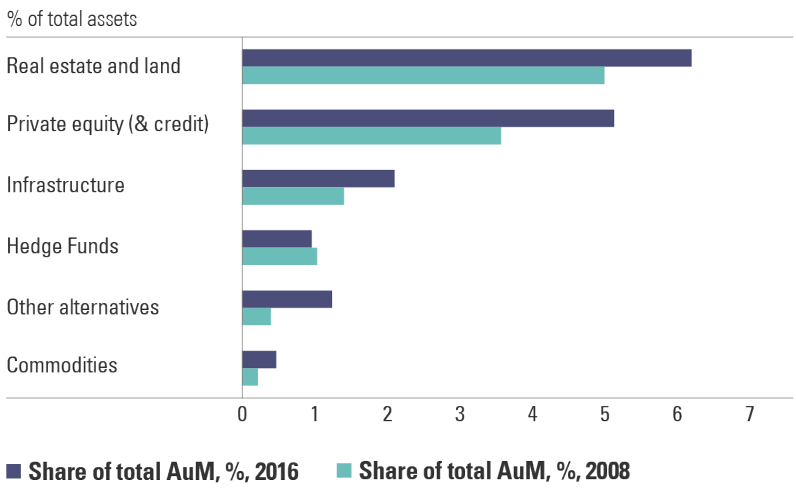

Figure 4: PPF average Alternatives allocation by asset class. Real estate and land continue to lead for asset allocation by alternatives in PPFs.[4]

Currently, the two largest global PPFs have over 40% of their assets invested in alternatives. [4] Real estate makes up the largest share of alternative assets in PPF portfolios, at 6.3% of total AUM and 38% of all alternatives. The portfolio domination by real estate is hardly surprising given it is an effective hedge against both inflation and market volatility.

Case Study: PSP Investments

To better understand why pension funds and other "smart money" investors choose to rely so heavily on alternatives, let's consider a case study. The Public Sector Pension Investment Board (PSP) is one of Canada's largest pension funds, with a mandate from the Government of Canada and over $168billion CAD AUM as of March 31, 2019.[5]

Mirroring the trends seen with global PPFs, a core element of the PSP's strategy since 2017 has been to diversify away from public equities with an increasing allocation to alternatives. To further this mandate, PSP has focused on expanding their Policy Portfolio, which is backed by alternative assets including real estate, private equity, infrastructure and private debt.

Figure 5: PSP Asset Allocation. PSP's investment strategy has been to diversify away from public equities with increasing allocations to alternatives.[5]

Policy Portfolio: An enhanced risk-return profile

The PSP's Policy Portfolio is currently constructed with the specific purpose of serving as a "more diversified, resilient and liability-aware portfolio", with the objective of achieving "a return greater than the Reference Portfolio with a lower or equal level of pension funding risk."[5]

With the expansion of the Policy Portfolio, the PSP aims to improve diversification and enhance the risk/return profile at the overall portfolio level, by leveraging the unique features of alternative assets.

- Over time, the lower liquidity of these assets is expected to be compensated with higher returns.
- Investing in real assets such as real estate, infrastructure and natural resources offer long-term inflation protection. This better matches the liabilities of the pension plans and lowers the risk of a deficit.[5]

Strategic Success: Policy Portfolio and Alternatives drive fund growth

The PSP's strategy certainly seems to be working. In 2019, a return of 8.8% was driven primarily by the strong performance of the following asset classes: private debt (14.2%), infrastructure (12.7%), natural resources (12.0%) and real estate (11.8%).[5]

Figure 6: PSP Alternatives Allocation by Asset Class. Real estate continues to be a pillar of the PSP's alternative allocation strategy.[5]

The PSP's increasing reliance on alternatives mirrors the larger trend seen with "smart money" investors. Allocations to alternatives are only expected to increase in the coming years, particularly as the low-bond yield environment persists and investors are pushed to seek higher returns.

Furthermore, as the alternatives industry naturally matures and evolves, it will offer investors greater accessibility and lower fees to better meet their needs. Demand and market participation will grow even further under these conditions, particularly with governments predicted to relax regulatory frameworks and as developing economies begin to open up to external investments.

4. THE CASE FOR CMI'S MICS

The MIC offered by Canadian Mortgages Inc. (CMI) has consistently outperformed traditional markets over the last 5 years, delivering annualized yields of 8-9% (8.6% in 2019).[6] With a minimum investment of only $5,000 CAD, CMI's MIC products offer an affordable way for retail investors to access Canada's booming property and mortgage market. CMI MICs are fully secured by real estate, with properties and borrowers thoroughly scrutinized through an extensive due diligence and qualification process.

Figure 7: CMI's MIC Products: Stable yields and a clear growth trajectory. In 2019 alone, CMI's assets under management grew by 130%. Investors continue to benefit from steady annual yields of 8-9% that are paid out as a monthly dividend.[6]

Managerial competence: Adding value to net returns

It isn't strictly strong yields and the tremendous growth in AUM that has contributed to CMI's stellar track record. CMI's experienced management, underwriting and servicing teams are behind much of their success. A thorough due diligence process has helped add tremendous value to this fund. In the alternatives market, managerial competence is more than simply an extra layer of security for investors. Instead, this advisory expertise and market knowledge translate directly to enhanced returns for investors.

CMI's strict mortgage origination guidelines are backed by highly experienced underwriters. They are very proficient at as-sessing the liquidity of each property, its growth projections plus the applicant's ability to service the debt. At the same time the servicing team ensures any issues are resolved quickly and efficiently, while management oversight helps source and acquire attractive assets that offer the greatest potential for higher yields, long-term growth and risk mitiga-tion.

Diversified risk exposure and enhanced liquidity

CMI actively mitigates risk by maintaining a diversified pool of stable, high-growth and recession-resistant residential mortgages across Canada. Furthermore, no single mortgage is allowed to exceed more than 10% of the book value of the portfolio.

To further enhance their risk profile, CMI targets moderate-risk mortgages while striving for a weighted-average portfolio loan-to-value target of 75%. Risk exposure is also mitigated across geographies, with properties selected from across Ontario, Nova Scotia, British Columbia, Alberta and Newfoundland. CMI's MICs also enhance liquidity by maintaining appropriate amounts of cash reserves, ensuring investors can make redemptions from the fund at any time throughout the year.

The lesson from PPFs and other "smart money" investors is clear. In today's low-yield environment, a growing investor appetite for sustainable, higher yield fixed income strategies has pushed wealth managers to look beyond conventional assets and traditional markets. In Canada, this trend is expected to become more pronounced as an aging population of investors pushes wealth managers to seek lower risk and higher return assets to compensate for their changing cash flow needs. Therefore, advisors who understand and take advantage of the benefits of alternatives within an investment portfolio structure will have a competitive advantage over their more traditional counterparts.

Added to this are the implications and potential fallout from the COVID-19 epidemic. Market volatility is unfortunately more than just a short-term reality, one that will wreak havoc as advisors strive to generate positive, appreciable returns for their clients.

The current economic climate makes a strong case for MICs. They provide a low risk investment option that is secured by collateral, giving your clients a portfolio solution that offers more protection and peace of mind. The diversification of a portfolio in this manner can help elevate strategic offerings above other more traditional formats. In this COVID-19 era, it's also important to note that MICs like CMI's, that are focused on the residential mortgage market, help to mitigate risk and defaults when compared to those focused on commercial mortgages.

This is due in large part to the many protective measures that the federal and provincial governments have put in place for tenants when it comes to commercial properties. These include provisions for the deferral of rent payments, rent control, elimination of late fees and penalties, cessation of tenant evictions among other measures. At the same time, residential mortgage clients can benefit from the deferral of property taxes in many jurisdictions, thus reducing the risk of default.[7]

In this unique macroeconomic climate, alternative investment products in general - and real estate products in particular - will continue to dominate investor portfolios. MICs will be attractive to investors seeking to benefit from its inherent characteristics of low market correlation, portfolio diversification and the opportunity to take advantage of pricing inefficiencies through illiquidity premiums.

With minimum investments as low as $5000 CAD, MICs enable your clients to benefit from the alternatives market without incurring a large cash outlay or the requirement to invest in individual mortgages. MICs give advisors the ability to offer a low risk and higher return investment solution, with yields paid out as stable monthly dividends. In addition, MICs are qualified investments for RDSPs, RRSPs, RRIFs, TFSAs and RESPs, making them suitable to include in a wide variety of client portfolios.

Contact CMI for more information on our MIC family of funds and how it can be the right investment solution for your clients.

Endnotes

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6 Canadian Mortgages Inc, 2019 https://cmimic.ca/

7 Osler, COVID-19: Key developments and considerations for real estate stakeholders, 2020

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