Alternatives explained

Alternative investing: Different and diverse

For many years alternative investment products were only available to accredited investors and institutions. However regulatory changes introduced in early 2019 introduced the alternative mutual fund category to retail investors in Canada, giving them access to sophisticated strategies once only available through hedge funds.

Today, the Alternative mutual fund space in Canada has grown to over $27B in Assets Under Management (AUM)[1] and there are hundreds of alternative mutual funds for investors to choose from.

Alternatives explained

Alternative investments represent a broad category of assets and strategies and are different than the traditional strategies of investing long[2] in stocks, bonds, and cash. The purpose of Alternative investments is to provide growth and reduce risk by investing in non-traditional strategies and assets.

Alternative assets can include:

- Physical commodities or specified derivatives
- Other investment categories such as hedge funds and private equity

The alternative investing category is unique in that it is also comprised of a very diverse range of investment strategies that benefit from tools and flexibility not available to traditional investments. These strategies rely on the investment manager's unique skills and expertise to manage them. Some common Alternative investment strategies include:

- **Long short:** Designed to mitigate volatility and provide downside protection, this strategy employs both long and short positions across a variety of security types, aiming to achieve lower overall market exposure than traditional long-only strategies. By strategically incorporating short positions, the fund seeks to reduce its vulnerability to market downturns and enhance risk-adjusted returns
- **Market neutral:** Aims to minimize exposure to general market movements, targeting a lower beta[3] than the overall market or portfolio benchmark. It involves establishing long positions in securities anticipated to outperform their sector or market benchmarks, while simultaneously taking short positions in those projected to underperform. The objective is to generate returns that are largely independent of the market's direction, focusing on the relative performance of these securities
- **Merger arbitrage:** Also known as risk arbitrage, this strategy focuses on uncovering opportunities and generating positive returns with low volatility in announced, legally binding mergers or acquisitions
- **Multi-strategy:** This strategy invests in various types of assets and sometimes combines alternative strategies as well. Some firms have developed their own proprietary multi-asset strategy

In contrast to conventional Mutual Funds, it's common for alternative funds to charge performance fees given the specialized expertise involved. They include:

- **Performance fee:** Typically paid to the investment manager for generating positive returns
- **Hurdle rate:** The predetermined level of return the Fund must meet for the performance fee to be enacted
- **High watermark:** The highest level in value a Fund has reached and where the Investment Manager must get the Fund above to charge for the next performance fee

Both alternative assets and strategies are a rapidly growing segment of the investment universe that is gaining popularity and use with retail investors[4].

Long short strategy

Why a long short strategy?

In today's evolving investment landscape, the ability to meet and exceed return targets has become more difficult to achieve through "traditional" strategies. Alternatives have increasingly become more popular amongst investors because they provide an expanded opportunity set, new sources of diversification, and potential alpha enhancement[5].

An alternative strategy that continues to gain momentum amongst advisors is the long short strategy, as it aims to capture upside, while limiting downside risk.

The long short strategy can capture the upside potential of markets, while limiting downside risk by focusing on the interplay of characteristics between the long and short positions in portfolios.

On the **long** position, the portfolio manager may pursue undervalued securities that they believe will rise in price.

On the **short** position, they pursue overvalued securities to profit from their mispricing and reduce overall portfolio losses.

To reduce market volatility and potentially enhance returns, leverage and derivatives can be utilized. Generally, the long exposure will exceed the total short exposure, and the net exposure (long minus short) is usually less than a long-only equity strategy.

Features of a long short strategy

Alternatives allocation: Traditional portfolios may not be enough to help investors reach their long-term financial goals. A risk-appropriate allocation to alternative strategies can potentially optimize portfolios through enhanced diversification and/or alpha generating opportunities.

Expanded opportunity set: Through both long and short opportunities versus long only positions.

Portfolio diversifier: Alternatives are typically not correlated with traditional asset classes, appealing to advisors and investors aiming to build potentially more resilient portfolios.

Alpha[5] driver: Provides the opportunity for investors to benefit regardless of the market cycle, via both undervalued and overvalued securities.

Portfolio enhancer: Provides some of the same exposures in traditional investment portfolios, while dampening broad market risk.

Take an alternative approach to your portfolio

Prequin, a U.K. based financial data company, forecasts the alternative market to grow to over $24 trillion by the end of 2028. This anticipated growth[6] highlights the expanding role alternative investment strategies represent within the global financial landscape.

NEI makes investing in Alternatives seamless with NEI Long Short Equity Fund.
Sub-advised by Picton Mahoney Asset Management, a pioneer and specialist in alternative investing in Canada, the Fund aims to capture more upside with less broad market risk.

Visit our website or contact your advisor to learn more.

[1] Source: SimFund/IE as of May 30,2023

[2] Generally speaking, long-only strategies involve purchasing assets with the expectation of capital appreciation over time.

[3] Beta is a statistical measure of the volatility of a stock versus the overall market. A beta above 1 means a stock is more volatile than the overall market. A beta below 1 means a stock is less volatile than the overall market.

[4] https://www.forbes.com/uk/advisor/investing/what-you-need-to-know-about-alternative-investments/#how_big_is_the_alternatives_market

[5] Alpha is the excess return of an investment relative to the return of a benchmark index.

[6] https://delano.lu/article/preqin-alts-2028-report-indust