RBC Global Asset Management
PH&N Institutional

Alternative investment strategies:
Role and opportunities in the current market environment

Given the significant attention that alternative investments have received over the past decade, alongside the shift in capital markets that has occurred since the beginning of 2022, our recent paper "Strategic asset mix decisions in a new return regime" revisited the role for traditional fixed income and equities in institutional portfolios. In this paper, we turn our attention more fully to the role that alternative investments now play in these portfolios, and offer some thoughts on how alternatives allocations may evolve in the future.

Allocations to alternative investments have grown substantially

The growth in investor demand for alternative investments over the last decade was driven primarily by two factors: the need to sustain returns amidst significantly diminished return expectations from traditional fixed income investments, and the need to limit volatility in higher-risk portfolios adopted by many investors in pursuit of their objectives.

While the intensity of return challenges from traditional asset classes has diminished somewhat recently, alternative assets continue to offer appealing, and in some cases unique, qualities that deliver complementary sources of return and improve portfolio diversification. For this reason, we expect alternative investments will find a permanent place in the policy asset mix of many institutional investors.

The purpose of this paper is to share some high-level observations on how institutional investors have built out their alternative investment portfolios to date, and to offer some perspectives for investors to consider as they refine their alternative allocations going forward. Specifically:

1. While adoption of alternative investments has been relatively widespread, there is considerable variability in the policy allocations to alternatives – what factors influence the allocation decision?

Alternative investments comprise a very broad category of investment strategies and assets that can be divided into two groups – liquid (or public market) alternatives and illiquid (or private market) alternatives.

Liquid alternatives focus on public market securities such as bonds and stocks but are less constrained compared to their traditional counterparts. For example, they may be able to short securities, use leverage, and employ derivatives. This broader toolkit can help managers deliver attractive risk-adjusted returns that are complementary to traditional investments. Examples of such strategies include absolute return, long/short, and market neutral funds.

Illiquid alternatives invest in asset classes that are not accessible through public markets. As a result, private market alternatives provide investors with access to asset classes with risk and return characteristics that are often distinct from traditional public market investments. Examples of such assets include private commercial real estate, private equity, private debt, and private infrastructure.

While alternative strategies can provide important portfolio construction benefits, they may also introduce complexity and costs, and therefore require specialized due diligence and expertise.

2. In establishing dedicated credit allocations, many investors have favoured private over public markets – can public market credit now play a larger role?
3. Liquid alternative strategies have generally been overlooked – what conditions could make them more appealing?

Sizing the allocation to alternative investment strategies

While the inclusion of alternative investments in institutional portfolios is now quite common, this practice remains far from universal. Additionally, policy allocations to alternatives vary significantly across investors, from as low as 10% of plan assets to as high as 50%-60% among some of the largest public sector plans. Recognizing that asset mix policy reflects an investor's specific circumstances, we identify briefly in the box below some of the important considerations that go into establishing an appropriate allocation to alternative investments.

KEY CONSIDERATIONS GUIDING ALTERNATIVES POLICY ALLOCATIONS

Future expenditure objectives: Future expenditure objectives refer to the profile of required or desired future cash flows from an investor's asset base, and specifically whether or not those future cash flows are linked to inflation. For investors with inflation-linked expenditure objectives, a primary investment objective is to grow the asset base in real terms. It is not uncommon for these types of investors to have higher allocations to alternatives in their policy asset mix; infrastructure and real estate in particular are considered to provide superior levels of inflation protection relative to other asset classes.

Governance burden: In addition to the varied investment characteristics across the alternatives universe, there can also be additional complexities related to fees, holdings transparency, fund structures, strategy track record, contracting, and capital draws that, as fiduciaries, institutional investors need to consider before moving forward with an investment. Some investors, particularly smaller ones, have limited their involvement in alternative asset classes or avoided them entirely as a result of these complexities.

Return objectives: Investors with absolute return objectives sitting between traditional fixed income and equities are more likely to establish allocations to core domestic real estate and infrastructure equity, and perhaps certain private credit strategies, in an effort to enhance yields over core fixed income and improve portfolio efficiency by diversifying away from public market equities. Investors with higher overall return objectives are more likely to extend their allocations to a broader range of strategies – including private equity, non-domestic real estate, and value-add infrastructure in the private markets arena, and to a smaller extent absolute return strategies in more liquid alternatives – in an effort to enhance overall returns and diversify away from public equity markets.

Liquidity needs: Many alternative investments are considerably less liquid than traditional fixed income and public market equities; as a result, the liquidity demands on an institutional portfolio are a critical consideration when establishing an appropriate allocation to alternative investments. While allocations to alternative investments in institutional portfolios are growing overall, some mature defined benefit pension plans that need liquidity are actually reducing their allocations to alternative investments as return expectations for traditional fixed income and equities have improved.

There are a number of quantitative and qualitative factors that influence the wide range of observed allocations to alternative investments across institutional investors. The methods and processes used to evaluate these factors is an important subject on its own, and one that we will expand on in a future paper. Matching the liquidity profiles of investments to the needs of the asset base in particular is an area of opportunity for investors, given the additional financial flexibility that many appear to have today compared to the recent past. In the following sections of this paper, we explore two potential refinements to existing alternative allocations, each of which stand to increase portfolio liquidity.

Competitive credit opportunities in alternatives are not restricted to private markets

Policy allocations to credit became increasingly common during the 2010s and early 2020s in response to the return limitations within traditional fixed income markets during that period. And although not a universal practice, many investors tilted their credit portfolios to private market alternative strategies.

The bias toward private credit markets is understandable. In the wake of the 2008 credit crisis and the heightened regulatory requirements that resulted, many banks pulled back from corporate lending, creating a significant opportunity for institutional investors to step in and fill the lending gap. As a result of the arguably outsized returns available from private lending markets, combined with suppressed yields in global fixed income markets, many investors skipped over the public credit markets altogether.

However, as competition within private credit has increased, and interest rates across global public markets have normalized, there may now be a greater role for public market credit. Indeed, as illustrated in Figure 1, certain segments of public credit markets such as high yield, securitized credit, and emerging market debt (EMD) now offer appealing all-in yields relative to five years ago. So, while return expectations from private markets continue to exceed those available in public markets, the higher yields currently available in public market credit open the door for investors to invest in this area alongside private alternatives, increasing portfolio liquidity while still meeting their overall return objectives.

The investment opportunity set within public credit markets is both large and broad; it includes sovereign and corporate credit, and spans developed and emerging markets.

Investors can access these markets individually, or alternatively, via multi-asset credit (MAC) strategies, which typically have broad investment mandates and are able to use market hedges and derivatives to manage interest rate, credit, and broad market risks in response to changing market conditions over time.

In summary, private market credit has gained prominence over the past decade and is now included in the alternative investment portfolios of many institutional investors. However, like real estate, infrastructure, and private equity, private credit is an asset class that reduces overall portfolio liquidity. The recent increase in yields within public credit markets offers investors an opportunity to reinstate some liquidity into their portfolios while still achieving their return objectives.

Liquid alternatives have often been overlooked in favour of private markets

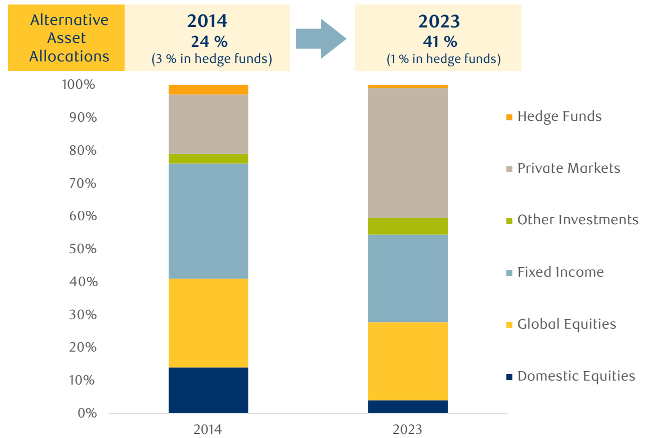
While alternatives comprise a broad range of investment opportunities across both private and public markets, to date, it is private market alternatives that have captured most of the attention from institutional investors.

As illustrated in Figure 2, on average, institutional investors in Canada currently hold more than 40% of their assets in private market investments, roughly double the average allocation from just nine years ago. The experience with liquid alternatives, however, has been quite different. While many of the larger Canadian pension funds invest in liquid alternatives or absolute return strategies, uptake across the broader institutional landscape has been relatively less common. Indeed, as Figure 2 shows, allocations to hedge funds have remained relatively unchanged over the period illustrated.

Figure 1: Global yields have changed dramatically since 2019

Source: RBC GAM, FTSE, Bloomberg and JP Morgan. As of September 30, 2019 to September 30, 2024. Note: see Appendix for index names. Yields are in local currency. EMD: Emerging Market Debt.

Figure 2: Shifting alternative asset allocations among institutional investors



Source: RBC GAM, Coalition Greenwich, Canadian Institutional Investor Research, 2023. Private markets includes private debt, private equity, private real estate, and infrastructure.

A number of factors can explain the bias toward private markets. Perhaps most importantly, the long-term nature of assets such as real estate and infrastructure, alongside their favourable cash flow characteristics, are a good structural match to the liabilities or expenditure objectives of many institutional asset bases. Private markets also offer access to different sectors of the global economy where public markets are less prominent (e.g., mass transit, ports), and an additional return premium because they are less liquid.

WHAT ARE ABSOLUTE RETURN STRATEGIES?

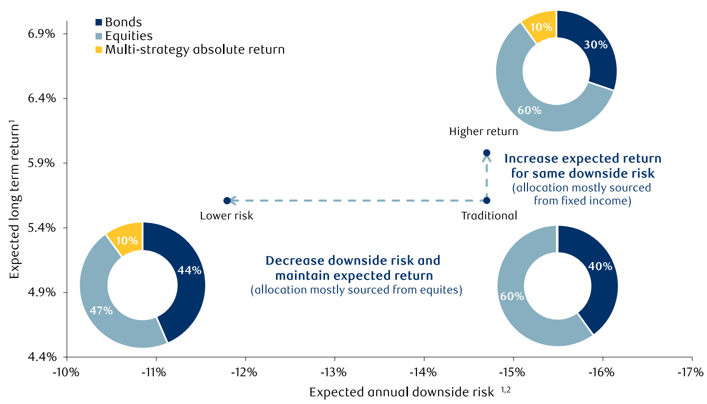
Typically, these are flexible and relatively liquid strategies that can take both long and short positions, and use derivatives, market hedges, and leverage in an effort to deliver consistent positive returns with relatively low correlation to traditional equities and fixed income.

While a long-term investment horizon allows many institutional investors to accept a certain amount of illiquidity in their portfolios, there are limits, and some recent experiences in the Canadian market have highlighted the additional cash flow uncertainties that can be associated with private market investments. Certain strategies have struggled to meet redemptions, or to exit investments within expected timelines, causing delays for investors waiting to receive their invested capital. Liquid alternatives offer a potentially appealing complement to private markets by offering different sources of portfolio diversification while, depending on the strategy, increasing overall portfolio liquidity.

Liquid alternatives, or absolute return strategies, generally invest in public market securities, and aim to generate attractive risk-adjusted returns across different market environments with low return correlation to traditional asset classes and moderate drawdown risk.

These characteristics make certain absolute return strategies suitable for use in both a liability-driven investing context (as part of a portable-alpha strategy, for example), as well as an asset-only context. Figure 3 illustrates how a diversified absolute return allocation can be utilized to either improve the return profile (if capital is sourced from lower-returning assets such as fixed income) or reduce risk (if capital is sourced from higher-risk assets such as equities).

Figure 3: Impact of allocation to multi-strategy absolute return



Source: RBC GAM.
[1] Refer to appendix for modeling assumptions and disclosures.
[2] CVaR95, which represents the expected loss during the worst 5% of return outcomes.
Bonds represented by “universe bonds,” equities represented by “Canadian equities” and “global equities”. Hypothetical performance analyses are for illustrative purposes only and there is no guarantee that hypothetical returns or projections will be realized.

Because individual absolute return strategies tend to be specialized and narrow in their scope, an appropriately diversified exposure is typically made up of several such funds. Larger institutional investors with the resources and specialist investment knowledge to do so tend to build out such allocations themselves; however, for smaller and mid-sized investors, the diversification and governance simplicity offered by multi-strategy funds with broader mandates can make them more suitable.

In summary, most institutional investors have concentrated their alternative investment allocations in private market strategies such as real estate, infrastructure, private equity, and debt. To date, these allocations have generally served investors well, but recent experiences in certain asset classes have highlighted potential liquidity challenges. Liquid absolute return strategies represent an opportunity for investors to increase diversification and add liquidity within their portfolios.

SUMMARY

The asset mix policies of Canadian institutional investors have evolved considerably over the past decade. During this time, allocations to alternative investments increased meaningfully in order to address the return challenges associated with traditional fixed income, and to diversify portfolios away from equity market risk.

Despite the corrections in both fixed income and equity markets during 2022 – which significantly improved the forward-looking return expectations for these asset classes – alternative investments continue to provide important portfolio benefits through enhanced diversification and return expectations. Going forward, we expect that most investors will likely maintain their allocations to alternatives in some form, though the composition of these allocations may shift.

While private market investments such as real estate, private equity, and private credit received most of the attention as interest in alternatives grew, allocations to liquid alternatives have been less common. We believe there is scope for liquid alternatives to play an important role in institutional portfolios as investors refine their allocations to the alternatives asset class.

Appendix 1

Indices referenced in Figure 1:

- Canada investment grade corporates: FTSE Canada Universe Corporate Bond Index
- U.S. investment grade corporates: Bloomberg Barclays U.S. Corporate Bond Index
- Global high yield: Bloomberg Barclays Global High Yield Index
- U.S. high yield: Bloomberg Barclays U.S. Corporate High Yield Index
- Financial capital bonds: ICE BofAML Contingent Capital Index
- EMD corporates (hard currency): JP Morgan CEMBI Broad Index
- EMD sovereigns (hard currency): JP Morgan EMBI Global Diversified Index
- EMD sovereigns (local currency): JP Morgan GBI-EM Diversified Index
- Securitized Credit (BBB CLOs): JP Morgan Collateralized Loan Obligation Index

Appendix 2

Detailed allocations and risk/return metrics for illustrative portfolio in Figure 3.

Modeled Expectations[1]	Traditional	Lower Risk	Higher Return
Long-Term Return	5.6%	5.6%	6.0%
Annual Downside Risk[2]	-14.7%	-11.8%	-14.7%
Annual Volatility	9.0%	7.5%	9.1%
Sharpe Ratio	0.29	0.35	0.33
Fixed Income	**40%**	**44%**	**30%**
Universe Bonds	40%	44%	30%
Equities	**60%**	**47%**	**60%**
Canadian Equities	20%	16%	20%
Global Equities	40%	31%	40%
Alternatives	0%	**10%**	**10%**
Multi-Strategy Absolute Return	0%	10%	10%

Asset Classes	Representative Data Series	Expected Long-Term Return	Expected Annual Volatility	Expected Annual Downside Risk
Universe Bonds	FTSE Canada Universe Bond Index	3.6%	5.2%	-7.7%
Canadian Equities	S&P/TSX Composite Index	7.7%	16.8%	-26.1%
Global Equities	MSCI World Index (CAD)	5.8%	14.2%	-24.1%
Multi-Strategy Absolute Return[1]	Custom Index[2]	7.5%	5.2%	-5.4%

[1] Expected long term annualized return net of fees.
[2] 5% FTSE Canada 30 Day TBill Index, 5% PH&N High Yield Mortgage Strategy, 8% BlueBay Investment Grade Absolute Return Bond Strategy (CAD-H), 7% RBC QUBE Market Neutral World Equity Strategy (CAD), 9% BlueBay Global Sovereign Opportunities Strategy (CAD-H), 25% BlueBay Credit Alpha Long Short Strategy (CAD-H), 7% BlueBay Event-Driven Credit Strategy (CAD-H), 28% PH&N Absolute Return Strategy and 6% RBC Canadian Core Real Estate.

Correlations				
	Universe Bonds	Canadian Equities	Global Equities	Multi-Strategy Absolute Return
Universe Bonds	**1**			
Canadian Equities	0.1	**1**		
Global Equities	0.2	0.7	**1**	
Multi-Strategy Absolute Return	0.1	0.6	0.5	**1**

Capital market assumptions represent the views of PH&N Institutional for the purposes of illustrating and understanding the potential risk-reward trade-off of different portfolio decisions and are established by considering a variety of qualitative and quantitative sources of information including: different forecasting models; internal and external research; existing and implied future conditions as priced by capital markets; and internal views of our fund managers. Expected long term annualized returns are for a 10 year forecast time horizon. Volatilities, downside risk and correlations are estimated from historical data and adjusted as required to reflect future market conditions. Investors should be aware of the limitations using forward-looking assumptions in that there is absolutely no guarantee that future performance will occur according to any ex-ante expectation.

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