

# The strategic case for public market alternatives in Canadian institutional portfolios



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As alternative investments have grown to become an increasingly important component of institutional portfolios, we have aimed to produce insightful publications that enhance investors' understanding of how this asset class can help them achieve their investment objectives. In our paper *Alternative investment strategies: Role and opportunities in the current market environment*, we argued that despite improved outlooks in fixed income and equity markets, alternative investments would continue to deliver important portfolio benefits through enhanced diversification and superior risk-adjusted returns. More recently, our annual *Private Markets Report* examined foundational private asset classes; namely, real estate, infrastructure, and commercial mortgages. In this paper, we shift our focus to public market alternatives – also known as liquid alternatives or hedge funds – and explore why we believe this category of investment strategies warrants a larger role in institutional portfolios going forward.

## An often-overlooked investment capability and portfolio tool

Constructing optimal portfolios to meet institutional investors' long-term objectives requires access to diverse investment capabilities and intellectual capital. Public market alternatives represent an important yet often overlooked capability set that provides access to differentiated return streams and risk characteristics that are complementary to both traditional asset classes and private market alternatives.

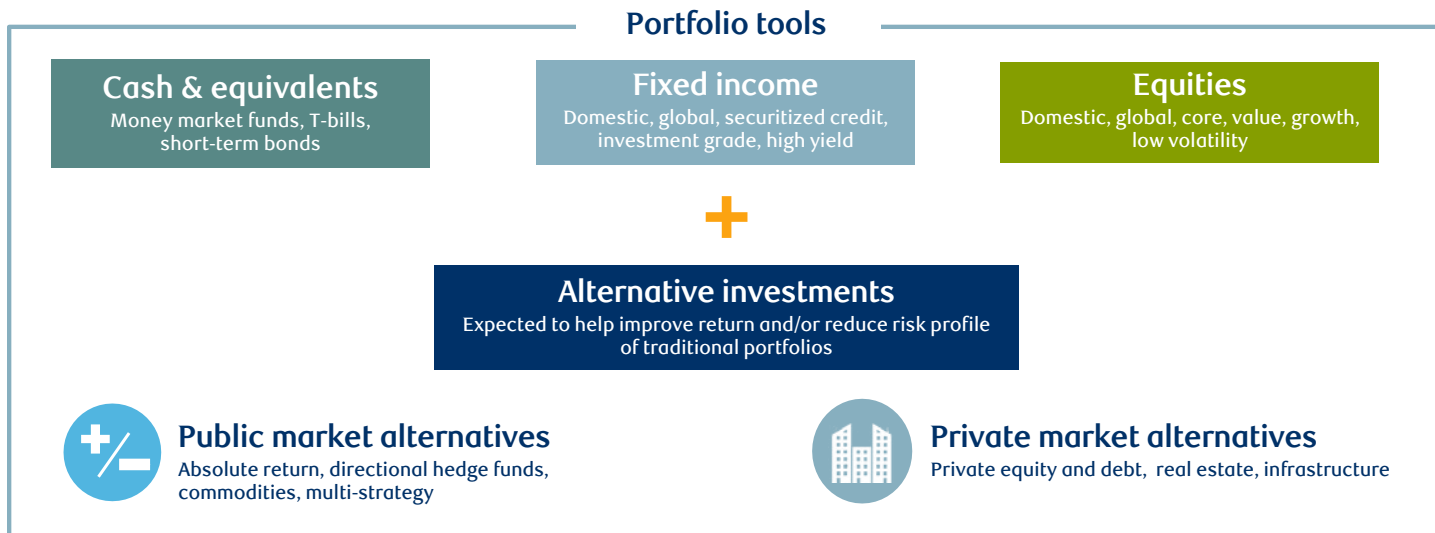
While Canada's largest institutional investors have been successfully allocating to public market alternatives for decades, adoption across smaller and mid-sized institutions has been more limited, likely due to the perceived complexity, costs, and governance requirements often associated with these strategies. Over time, alternative investment managers have evolved their offerings to address some of these challenges, developing more accessible strategies with enhanced transparency and robust risk management frameworks. While we recognize these allocations may require additional considerations

and expertise, we believe the benefits – enhanced diversification, improved risk-adjusted returns, and greater market resilience – make these strategies worthy of serious consideration.

## A broad category of investment strategies

Liquid alternatives comprise a diverse collection of investment strategies that vary in their return drivers and risk profiles but can be broadly categorized as either absolute return or directional strategies.

- **Absolute return strategies** aim to generate consistent positive returns with relatively low correlation to traditional equities and fixed income, typically by taking both long and short positions, using derivatives, and implementing market hedges.
- **Directional strategies**, on the other hand, seek to profit from anticipated trends in markets, sectors, or individual companies but may also experience larger drawdowns compared to absolute return strategies if anticipated trends do not play out as expected.



Source: RBC GAM, for illustrative purposes only

The table below provides a comparison of these two broad categories of alternative strategies.

	Absolute return strategies	Directional strategies
<i>Primary objective</i>	Aim to produce positive returns regardless of market direction	Aim to capitalize on anticipated market movements and trends
<i>Return profile</i>	Aim for steady, consistently positive returns and lower drawdowns	Expect more volatile returns tied to market cycles
<i>Risk profile</i>	Low, with emphasis on capital preservation	Generally lower than long-only strategies
<i>Market exposure</i>	Market neutral or low net exposure	Generally long or short market exposure
<i>Correlation to markets</i>	Low correlation to traditional asset classes	Moderate to high correlation to traditional asset classes
<i>Strategy examples</i>	<ul style="list-style-type: none"> <li>• Market neutral equity</li> <li>• Relative value credit</li> </ul>	<ul style="list-style-type: none"> <li>• Long/short equity</li> <li>• Event-driven credit</li> </ul>
<i>Expected performance in rising markets</i>	Moderate gains consistent with primary objective	Potential for strong gains; performance relative to broader markets influenced by risk exposure
<i>Expected performance in falling markets</i>	Designed to preserve capital and deliver positive/flat returns during market sell-offs	Expected to be more resilient than broader risk markets, but may still experience losses

### Relevance in the current market environment

Since the start of this decade, institutional investors have faced an increasingly complex landscape marked by:

- **market uncertainty** stemming from geopolitical tensions, trade wars, and monetary policy shifts;
- **rising correlations** and diminishing diversification benefits from traditional asset classes during periods of stress;
- **elevated valuations** in select parts of equity and fixed income markets; and

- **liquidity limitations** imposed by growing allocations to private markets.

While liquid alternative strategies are typically designed to perform reasonably well in a broad range of market conditions, some are particularly well suited to address the challenges institutional investors face in volatile or uncertain environments. On the following page are three examples of strategies that we believe are especially relevant today.

### Strategy highlight: Market neutral equity

Market neutral equity strategies target absolute returns (typically 3-5% above cash), regardless of market direction. They aim to deliver on this objective by taking long positions in a portfolio of stocks expected to outperform while simultaneously shorting a similarly sized portfolio of stocks expected to underperform, seeking to profit from both positive and negative investment views. The overall portfolio maintains very low to no underlying market exposure.

Because these strategies are often benchmarked against cash as opposed to traditional market indices, managers can take more meaningful active positions (absolute over- and underweights) to maximize returns while maintaining market neutrality (and therefore low correlations to broad equity markets). The flexibility to invest both long and short can be especially useful in periods of elevated market concentration and potential overvaluation in certain sectors.

Market neutral equity

- **Return range:** cash + 3-5%
- **Volatility:** Fixed income-like
- **Correlations:** Low

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Typical market neutral structure

Portfolio of stocks expected to outperform

+100% Long

-100% Short

Portfolio of stocks expected to underperform

=

Relative performance drives returns

Independent of market returns

Source: RBC GAM, for illustrative purposes only

### Strategy highlight: Long/short credit

Similar to market neutral equity, long/short credit strategies also aim to capitalize on both positive and negative views on credit markets. Certain long/short credit strategies can be considered absolute return in nature, as they often have the flexibility to calibrate overall interest rate and credit risk exposure and minimize downside risk through the use of market hedges and derivatives.

Trading strategies commonly employed by long/short credit funds include relative-value credit – taking long positions in undervalued credits while shorting overvalued ones – and long/short sovereign credit, where a similar trading approach is applied to government bonds. These strategies can be an attractive complement to long-only credit exposure, particularly during periods of elevated valuations.

Long/short credit

- **Return range:** 8-10%
- **Volatility:** 8-10%
- **Correlations:** Low to moderate

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Sample strategies

Relative value credit

Long / short credit

Market hedges

Source: RBC GAM, for illustrative purposes only

### Strategy highlight: Special situations

Special situations strategies aim to take advantage of idiosyncratic credit opportunities across all market cycles, and to capitalize on volatility and dispersion in corporate credit markets. Strategies may focus on one or several areas including event-driven, stressed, and distressed situations.

Event-driven investments focus on credits where there is a near- to medium-term event such as an asset sale, refinancing, or M&A, or where an operational or financial turnaround is anticipated. Stressed and distressed situations often involve idiosyncratic issues that require recapitalization or corporate restructuring.

Access to these unique investment opportunities can provide additional sources of returns not available in core credit markets, and improves overall portfolio diversification.

Special situations

- **Return range:** 10%+
- **Volatility:** Equity-like
- **Correlations:** Moderate

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Sample strategies

Stressed

Distressed

Event driven

Source: RBC GAM, for illustrative purposes only

### Case for a strategic allocation to liquid alternatives

Looking beyond the merits of individual strategies, we see a strong case for a strategic allocation to public market alternatives in general, and absolute return strategies in particular, which can be a source of diversification that can reduce total portfolio risk while contributing positively to returns.

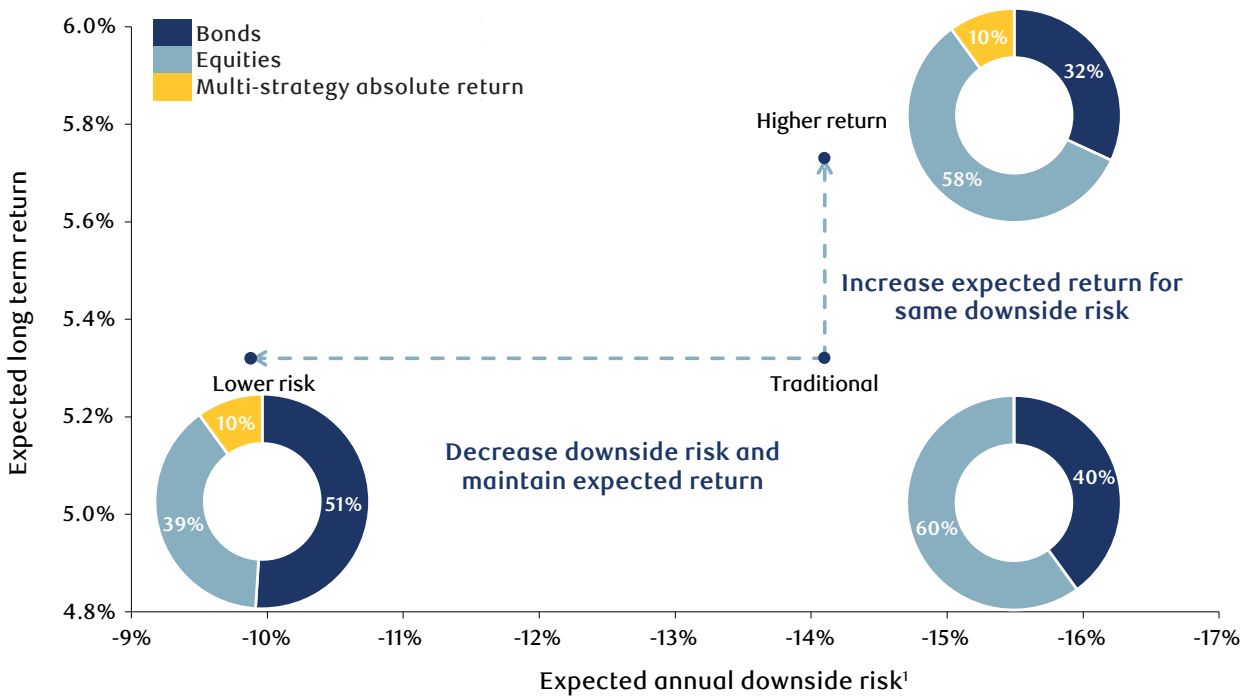
Figure 1 illustrates how a diversified absolute return allocation can be used to either improve a portfolio's return profile (if capital is sourced from lower-returning assets such as fixed income) or reduce its risk (if capital is sourced from higher-risk assets such as equities).

Over the 2020-2025 period – which includes pandemic market disruptions and the volatile market environment that followed – the performance of liquid alternative strategies has generally been consistent with these expectations. Broad

hedge fund indices provide an imperfect view of the actual investor experience due to significant dispersion in risk and return characteristics across hedge fund strategies, even within the same category. Despite these limitations, Figure 2 on the following page illustrates the key benefits that such allocations can provide.

These charts show that diversified and absolute return strategies generated reasonable returns net of fees, with superior drawdown resilience in what was a turbulent period for both stocks and bonds. Moreover, these returns were achieved with moderate to low correlations to traditional asset classes in a period of elevated uncertainty and significant market shifts. To the extent that some of these conditions persist or re-emerge in the future, we expect public market alternatives to continue to provide a source of uncorrelated returns and diversification.

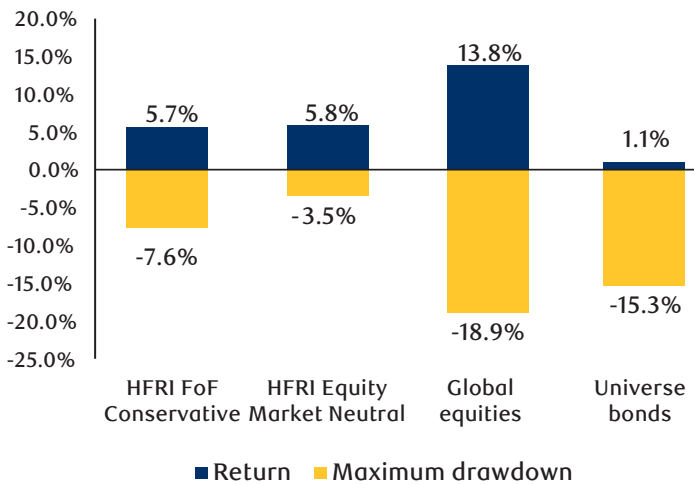
Figure 1: Strategic allocation to multi-strategy absolute return



Source: RBC GAM, as at December 31, 2025. See appendix for modelling assumptions and disclosures. 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.

¹ CVaR95, which represents the expected loss during the worst 5% of return outcomes.

Figure 2: Liquid alternatives performance and correlations 2020-2025



Correlations	Universe bonds	Global equities
Universe bonds	1.0	0.6
Global equities	0.6	1.0
HFRI Equity Market Neutral	0.1	0.4
HFRI FoF Conservative	0.2	0.6

Source: RBC GAM, HFR Indices, MSCI, and FTSE Global Debt Capital Markets Inc, from January 1, 2020 to December 31, 2025. Global equities are represented by the MSCI World Total Return Net Index (CAD), and universe bonds are represented by the FTSE Canada Universe Bond Index. Returns for HFRI indices are reported in U.S. dollars, however, because hedge fund strategies are often hedged to investor home currency, this is not expected to have a material impact on the correlations or performance shown above. Past performance is not indicative of future results.

### Public market alternatives can provide a complementary source of portfolio liquidity

In addition to their performance and correlation characteristics, public market alternatives typically offer greater liquidity relative to their private market counterparts, allowing investors to retain the diversification benefits associated with private market investments without taking up as much of their liquidity budget. While liquidity terms vary, The table on the right illustrates a general comparison of the time it takes to liquidate various types of investments under normal and stressed conditions. The superior relative liquidity typically offered by public market alternatives can be especially valuable during periods of market stress, when access to capital may be needed for rebalancing and/or other portfolio management or funding needs without forcing sales of other liquid securities that may be underperforming.

Public market alternatives vary in their risk, return, and correlations characteristics, and therefore can fulfill a number of different roles in investment portfolios while providing an additional source of liquidity. Ultimately, the strategy selection, sizing, and source of capital should be informed by the investor’s overall objectives, liquidity needs, and governance considerations.

Asset class	Time to cash (normal)	Time to cash (stressed)
Public fixed income	1 day	1 day
Public equities	1 day	1 day
Private markets (open-ended)	3 months	1+ years
Private markets (closed-ended)	5-10 years	8-10+ years
Public market alternatives	3 months	3 months

Source: RBC GAM, for illustrative purposes only. These liquidation scenarios are estimates only and based on certain facts and assumptions. No guarantees that all of the above will be achieved.

## Role of public market alternatives in institutional portfolios

1. **Accessing new, uncorrelated return sources**  
Some liquid alternatives strategies can offer access to unique investment opportunities and trading styles that provide distinct return streams that can enhance overall portfolio diversification.
2. **Managing volatility and uncertainty**  
Unlike long-only strategies that are typically fully exposed to downturns, liquid alternatives use hedging and short positions to manage downside risk while still capturing upside in favourable conditions.
3. **Capitalizing on opportunities**  
Skilled managers can identify mispriced securities and generate returns through both long and short positions across various market environments, rather than relying solely on broad market appreciation.
4. **Maintaining liquidity**  
Liquid alternatives typically invest in public securities and offer monthly or quarterly liquidity terms, allowing investors to effectively manage their overall portfolio liquidity and access to capital.

## Implementation considerations

Because individual public market alternative strategies tend to be specialized and narrow in their scope, an appropriately diversified exposure typically comprises several such funds. Larger institutional investors with ample resources and specialized investment knowledge tend to build out such allocations themselves through stand-alone strategies or separately managed accounts (SMAs) to achieve greater transparency and control.

However, for smaller and mid-sized institutional investors, the diversification and governance simplicity offered by multi-strategy funds with broader mandates can be more suitable, especially for investors that do not have an established allocation to hedge funds. Under a multi-strategy fund approach, a manager sets its allocation to a mix of strategically selected alternative strategies and manages the strategy mix, oversight, risk management, and other critical functions on an ongoing basis to ensure the portfolio is well positioned to deliver on its objectives.

## Due diligence considerations

Manager selection is an especially critical step in developing a successful allocation to public market alternatives. Because a meaningful portion of returns is expected to come from manager skill (alpha) rather than market performance (beta), manager performance can vary significantly, even amongst funds pursuing the same strategy.

In addition to the standard due diligence process, below are a few high-level questions that trustees and stewards of institutional capital should ask when reviewing liquid alternatives strategies:

- **What is the investment strategy and is it durable?** Understand how the strategy generates returns, how it performs in various environments, and whether it is sustainable.
- **What are the different types of risk associated with the strategy and how are they managed?** Understand the primary sources of risk and the risk management process, including governance and oversight.
- **What are the liquidity terms?** Some strategies are more liquid than others – it is vital for investors to understand subscription and redemption terms and the length of time to access capital.
- **What is the fee structure?** It is common for hedge funds to charge performance fees; investors should ensure they understand the terms and conditions associated with them.

## Conclusion

For Canadian institutional investors navigating elevated uncertainty, rising correlations, and liquidity constraints, public market alternatives merit serious strategic consideration. These strategies typically enhance diversification, improve risk management, and access new return sources while maintaining portfolio liquidity, yet despite their potential benefits, they remain underutilized, especially among small and mid-sized institutions.

The resilience of liquid alternative strategies through recent market turbulence demonstrates their value. As portfolio complexity increases and traditional diversification becomes less reliable, we expect liquid alternatives to play an increasingly important role in institutional portfolios as investors continue to refine their approach to portfolio construction and seek to balance return objectives with liquidity and operational requirements.

# Appendix 1

## Capital market assumptions and disclosures

Modelled expectations <sup>1</sup>	Traditional	Lower risk - Absolute return	Higher return - Absolute return
Long-term return	5.3%	5.3%	5.7%
Annual downside risk <sup>2</sup>	-14.1%	-9.9%	-14.1%
Annual volatility	8.9%	6.7%	8.9%
Sharpe ratio	0.20	0.27	0.25
<b>Fixed income</b>	<b>40%</b>	<b>51%</b>	<b>32%</b>
Universe bonds	40%	51%	32%
<b>Equities</b>	<b>60%</b>	<b>39%</b>	<b>58%</b>
Canadian equities	20%	13%	19%
Global equities	40%	26%	39%
<b>Alternatives</b>	<b>0%</b>	<b>10%</b>	<b>10%</b>
Canadian core real estate	0%	0%	0%
Commercial mortgages	0%	0%	0%
Global infrastructure	0%	0%	0%
<b>Multi-strategy absolute return</b>	<b>0%</b>	<b>10%</b>	<b>10%</b>

<sup>1</sup>Refer to appendix for modelling assumptions and disclosures.

<sup>2</sup>CVaR95 which represents the expected loss during the worst 5% of return outcomes.

Hypothetical performance analyses are for illustrative purposes only and there is no guarantee that hypothetical returns or projections will be realized

Asset classes	Representative data series	Expected long-term return	Expected annual volatility	Expected annual downside risk
Universe bonds	FTSE Canada Universe Bond Index	3.8%	4.7%	-6.3%
Canadian equities	S&P/TSX Composite Index	6.0%	16.8%	-25.3%
Global equities	MSCI World Index (CAD)	5.7%	14.1%	-23.7%
<b>Multi-strategy absolute return<sup>3</sup></b>	<b>Custom Index<sup>4</sup></b>	<b>8.4%</b>	<b>6.6%</b>	<b>-9.0%</b>

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<sup>3</sup>Expected long term annualized return net of fees.

<sup>4</sup>2% FTSE Canada 30 Day TBill Index, 5% PH&N High Yield Mortgage Strategy, 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), 10% BlueBay Event-Driven Credit Strategy (CAD-H), 10% BlueBay Structured Credit Opportunities Strategy (CAD-H), 4% CISDM Equity Long/Short Index (CAD) and 28% PH&N Absolute Return Strategy.

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