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Expanding the Toolkit

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Stock and bond markets have rallied significantly since 2009 when central banks cut interest rates to zero and increased the money supply through quantitative easing programs. More than 10 years later, most of this stimulus is still in place. Traditional balanced portfolios consisting of publicly traded equity and fixed-income securities have worked well in recent decades, but our view is that they are not expected to provide similar returns in the future. Active asset allocation and a new, modern approach to portfolio construction are needed. Portfolios should be thoughtfully constructed to achieve a structurally better risk-return outcome. One way to achieve this is to complement traditional actively managed equity and fixed-income investments with alternative strategies.

Alternative strategies go beyond the traditional approach of investing primarily in publicly traded stocks and bonds. They are not considered to be an asset class in themselves but include a range of asset classes with different characteristics. Alternative investments fall into two broad categories: liquid and illiquid. Illiquid investments require investors to remain invested for a specified time period and cannot be quickly converted to cash if a situation occurs where an investor wishes to sell. Illiquid alternatives include private equity, private debt and direct investments in real estate and infrastructure. These strategies invest primarily in the equity and debt of private corporations or properties. Liquid alternatives allow investors to buy and sell on a daily basis and invest primarily in the same securities found in traditional strategies, but can engage in short selling, leverage (the use of derivatives or borrowed capital to enhance returns) and the expanded use of derivatives and other financial market instruments.

Due to their use of leverage and less liquid nature, alternative investments have the potential to provide higher returns compared to traditional investments. Prudently applied leverage can increase returns similarly to purchasing a home. If you buy a house for $1 million and its value increases by 8%, your gain is $80,000. If you used only $200,000 of your own money to purchase the house and borrowed the rest, you would have made 40% (less borrowing costs).[†] The extra return private market assets may generate over their public market equivalents can be thought of as the additional compensation required for investors to commit their capital for a longer period.

Alternative investments can reduce volatility compared to traditional investments and provide a smoother return profile due to the fact that their assets are not priced on a daily basis. The ability to short individual securities and markets also provides the opportunity for a smoother return profile and less correlation to traditional investments. Managing volatility and protecting against market downturns becomes increasingly important as we progress through the later stages of an economic cycle. Steady income and protection against inflation are additional potential benefits of certain alternative investments. For example, the cash flows supporting infrastructure investments are often tied to inflation and real estate can provide investors with steady income.

In 2018 and 2019, we introduced alternative investments across our solutions and expect to continue to prudently increase these allocations over the coming months and years. We take a long-term view when assessing alternative strategies but also consider the valuation of asset classes, which will change over time. We also evaluate how the allocation complements the traditional strategies in our portfolios and its impact on total portfolio risk and return.

†*For illustrative purposes only.*

Combined top 15 equity holdings as of December 31, 2019 of the Evolution 40i60e Standard portfolio with Alpha-style exposure:

1. Microsoft Corp.	6. Alphabet Inc.	11. Canadian Pacific Railway Ltd.
2. Canadian Natural Resources Ltd.	7. Apple Inc.	12. Gilead Sciences, Inc.
3. Enbridge Inc.	8. Toronto-Dominion Bank	13. Ashtead Group PLC
4. AltaGas Ltd.	9. E-L Financial Corp.	14. ATCO Ltd.
5. iA Financial Corporation	10. Royal Bank of Canada	15. Bank of Nova Scotia