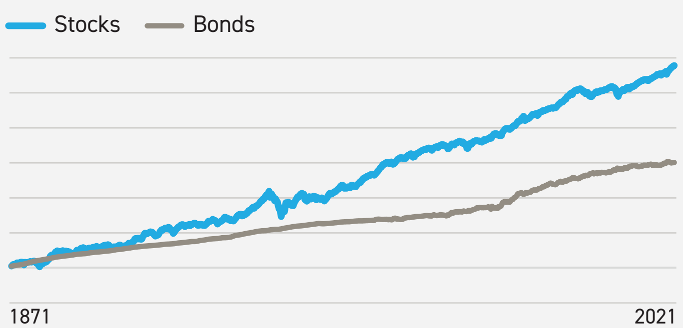
THE BENEFITS OF ADDING ALTERNATIVES TO A PORTFOLIO

An investment portfolio can hold many assets – but most Canadians have just two, stocks and bonds. Historically the two have been a lucrative combination, however in recent years, with low interest rates on bond investments, their combined diversification benefit has been somewhat eroded.

Alternative investments can offer an array of benefits to investors and have become more popular recently given the ease of purchasing them through a prospectus-based offering, and in ETF classes. The democratization of access to alternative strategies and assets can now help the everyday investor in a traditional stock and bond portfolio reduce volatility and stay invested in turbulent market conditions.

Long-term investors have enjoyed an amazing run over the past 35 years with just a simple 60/40 portfolio of global stocks and bonds. Let's consider the long-term returns delivered by these two assets. Over the past 150 years, stocks have returned 9% per year on average, and for the same 150-year period, bonds have returned 4% per year on average.[1]

150 YEARS OF TRADITIONAL ASSET CLASS RETURNS



Historically, stocks and bonds have provided uncorrelated sources of return; that is, the factors that drove returns for these two asset classes were different enough that stocks and bonds provided excellent portfolio diversification, especially during periods of market turbulence and high volatility. Think of them as pistons: when stocks are making positive returns, bonds have typically returned less. That is diversification – and it makes the total return experience a smoother, less volatile ride.

Diversification involves balancing risk and reward in a portfolio by spreading your money across investments that act differently. In early 2018, for example, both stocks and bonds experienced losses simultaneously, causing the performance of a simple stock and bond portfolio to fall considerably in a short period of time. Having a third piston that moved differently would have helped: adding another source of returns to the portfolio could have helped mitigate risk and help provide a smoother investing journey.

Alternative investments (which consist of alternative assets and strategies) are one kind of diversified sources of returns that can mitigate volatility when stocks and bonds correct sharply, thus potentially improving the quality of returns in portfolios. At Picton Mahoney Asset Management, we call this "fortifying" a portfolio. Fortifying portfolios with the use of alternative investments has been our core focus for over fifteen years. We believe that adding alternative investments to a traditional portfolio can help investors achieve their goals with greater certainty.

[1] Source: Robert Shiller, Sterling Professor of Economics, Yale University, http://www.econ.yale.edu/~shiller/data.htm. Return and Volatility performance for "stocks" is based on the monthly historical returns of the S&P 500 Index and Return and Volatility performance for "bonds" is based on the monthly historical returns of US 10-Year Treasury Yields.

Alternative investments are non-traditional investments and strategies that are distinguished from long-only investments in stocks, bonds and cash.

Alternative assets can include:

- Private equity
- Private debt
- Real estate
- Infrastructure
- Commodities
- Derivatives
- Wine, art and other collectables

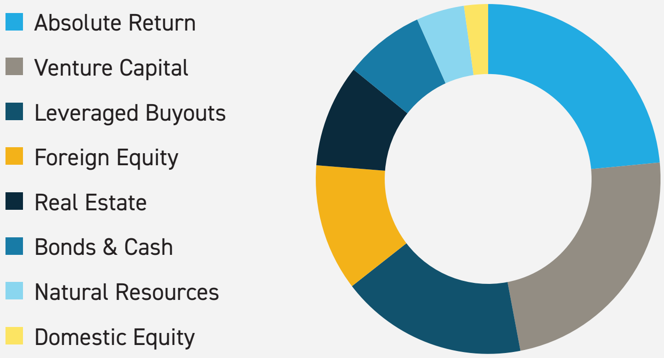
Alternative strategies can include:

- Long/Short Equity
- Long/Short Credit (Fixed Income)
- Market Neutral Equity
- Merger Arbitrage

CASE STUDY: $42B YALE ENDOWMENT

Institutional investors have been taking advantage of alternative investments for decades. Take, for example, the Yale Endowment. Valued at US$42.3 billion as of June 30, 2021, the Yale Endowment is the largest source of revenue for Yale University, supporting faculty salaries and student scholarships.[2] With stakes that high, managing risk is as important as seeking returns. In 1985, 90% of the Yale Endowment was invested in stocks, bonds and cash. By 2020, only 27% of the portfolio remained in those traditional assets. Now the portfolio gets its returns from several sources that all act differently. Over 70% of the Yale portfolio was moved into alternatives: real estate, natural resources, venture capital, leveraged buyouts and absolute return strategies.[3] Some of these investments made more than the stocks and bonds, and some made less. What changed dramatically is that the portfolio now gets its returns from a number of sources that tend to respond differently to market moves and economic events.

YALE CONTINUES TO MAINTAIN A WELL-DIVERSIFIED, EQUITY-ORIENTED PORTFOLIO, WITH THE FOLLOWING ASSET ALLOCATION TARGETS FOR FISCAL YEAR 2021.



[2] https://news.yale.edu/2021/10/14/yale-endowment-earns-402-investment-return-fiscal-2021
[3] 2020 Preqin Global Hedge Fund Report

TODAY, INDIVIDUALS HAVE ALTERNATIVES

Investor portfolios are shifting. Stocks and bonds have historically been a lucrative combination. But in recent years, with low interest rates on bond investments, the diversification benefit has been somewhat eroded.

> **"The goal is to lower risk in the portfolio without sacrificing return potential."**

Regulatory changes in 2018 gave Canadian investors access to a broader choice of investments – including the alternative investments that have benefited institutional investors for years. Since then, individual investors have been fortifying their portfolios, following in the footsteps of institutions by adding more assets and strategies, and choosing to rely less on just stocks for upside potential and just bonds to protect from downswings. As well as stocks, their portfolios now have allocations to real assets, commodities and long/short strategies. Alongside bonds, they are adding absolute return strategies. The goal is to lower risk in the portfolio without sacrificing return potential.

Investors are adding alternatives to stocks and bonds to build the portfolio they need to grow and support their future expenses. Adding more asset classes can help them better weather market storms, decrease volatility and better balance risk and return, for a smoother journey.

PICTON MAHONEY Asset Management

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