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Liquid alts are showing their value as portfolio diversification tools

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Liquid alternative investment funds, better known as liquid alts, officially became available to Canadian retail investors in Jan. 2019. But it wasn't until the COVID-19 stock market downturn earlier this year that these products demonstrated their value in limiting downside risk. As such, financial advisors should consider including liquid alts when building portfolios for their clients.

In short, liquid alts are mutual funds and exchange-traded funds that use alternative investment strategies – such as long-short, market neutral and managed futures, among several others – to infuse portfolios with more advanced methods of risk reduction, diversification and downside protection.

The advantage for advisors and their clients is that these funds can move independently of the markets, have a low average correlation to traditional indexes and are designed to stabilize portfolios when markets drop. They generally aim to produce mid- to high single-digit returns, with similar volatility over a stock market cycle. As well, some of these funds are absolute return funds for which performance is not based on whether they beat a relative benchmark. These attributes make them valuable tools for portfolio construction.

These strategies have been available to Canadian institutional investors and U.S. retail investors for decades. In fact, there were more than US$700-billion in liquid alt assets under management (AUM) and strategies in the U.S. at the end of 2019. However, advisors in Canada couldn't consider them for clients' portfolios until the Canadian Securities Administrators made them available to retail investors last year.

It turned out that 2019 was an ideal time to democratize liquid alts and make them accessible to retail investors. Many advisors and investors were nervous about how inflated the markets had become and were looking for ways to generate better risk-adjusted returns. In just 18 months, the liquid alts market accumulated $8-billion in AUM. The Canadian Association of Alternative Strategies & Assets and other market observers say that number could top $100-billion by 2024.

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Pandemic tests performance

Then, the pandemic hit and stock markets around the world plummeted more than 30 per cent. It was the first real test for Canadian liquid alts. So, how did they perform?

Broadly, they did what they were supposed to do. In March, the Scotia Alternative Mutual Fund Index, which tracks about 40 Canadian liquid alt funds of various styles and investment objectives, was down 6.61 per cent while the S&P/TSX Composite Index was down 17.74 per cent and the S&P 500 fell by 8.23 percent (in Canadian dollars). Funds with an absolute return focus tended to be better performers during this difficult period.

By the end of June, once stock markets have stabilized, the Scotia Alternative Mutual Fund Index had fallen just 2.14 per cent year to date compared to 9.7 per cent for the S&P/TSX Composite Index and a gain of 0.29 per cent for the S&P 500 (in Canadian dollars).

All things considered, liquid alts held up well in what may be the worst economic downturn of our lives.

Putting portfolio construction in focus

If we've learned anything about investing during the past few months, it's that portfolio construction really does matter. Investors in equity-focused asset mixes saw big losses in March while those in more diverse portfolios – a mix of fixed income, certain lower correlated alternative assets and absolute return strategies – generally held up better.

Advisors should think of liquid alt strategies – and absolute return strategies, in particular – as another investment option in their diversification toolbox. That's not unlike how they may already be using alternative real assets, such as gold or real estate. These absolute-return strategies, which give retail investors another sophisticated, institutional-grade investment option, allow for outcome orientations that strive to be disconnected from general market return patterns.

Just like you wouldn't put all a client's portfolio in gold, you wouldn't put everything in liquid alts, either. Some experts recommend investing between 10 per cent and 20 per cent of a client's assets into liquid alts, which should be enough to reduce volatility without disrupting returns.

With the impact of COVID-19 still being felt, market volatility will be with us for a while. Liquid alts will be tested again. But if the past few months are any indication, they should help balance the ups and downs in clients' portfolios in ways other traditional benchmark-following assets cannot.

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