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Financial Focus

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May 2019

Alternative Investments

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In recent months a wave of new investment products has hit the market. The products are generally categorized as alternative investments. New regulations were implemented in January which started this wave. As it intensifies investors are likely to face more investment options and a little more jargon. To help better understand this development we will spend a bit of time discussing alternative investments.

What are they?

In general there are three traditional asset categories: equities, fixed income and cash. Equities usually refer to stocks. Equities are not guaranteed and can be volatile. If you hear someone speak of the Dow Jones or the S&P/TSX they are referring to different stock markets. Fixed income is usually seen as a low risk investment. Examples of fixed income are bonds and GICs. Cash is simply uninvested capital. Money in a high interest savings account, for example, would be considered cash. A traditional diversified portfolio would include large portions in equities and fixed income investments and a little bit in cash. Alternative investments are typically outside of those three categories.

Alternative investment is a general term. There are thousands of different strategies that fall under that umbrella. Alternative investments are often divided into three groups: alternative strategy funds, alternative assets and private investments.

Alternative strategy funds are essentially mutual funds with more tools. They can use options, futures, leverage, take short positions, make concentrated investments, make big bets on mergers or acquisitions, essentially the portfolio manager has lots of discretion to invest as they see fit. Alternative strategy funds are often called hedge funds.

Alternative assets are direct investments in a variety of assets, they usually include real estate, infrastructure, collectibles, commodities, farmland and natural resources.

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Private investments often include common stock and debt securities that are not publicly traded. Examples are venture capital, mezzanine capital and leverage buyouts.

Why do people use them?

Until recently alternative investments were generally reserved for high net worth investors and large institutions. For example, the Canadian Pension Plan Investment Board (CPPIB), which is tasked with investing all the CPP money, has a quite a few alternative investments. According to their 2018 annual report almost half of their portfolio is outside traditional investments and is in some form of alternative strategy. Alternative investments vary in risk, from very low risk to very high risk. Most of the time they are used because they are not correlated with public markets. So, when combined with traditional investments, alternative investments can lower the risk of the portfolio and help boost the return.

What is available?

For the most part the average investor does not have access to alternative investments. These investments can involve complex strategies, there can be long lock up periods, there are usually large minimum investments, little transparency and in some cases very high risk. The regulators have restrictions in place to minimize the average investors' access to these strategies. The rule changes that were implemented in January allow the average investor to access some alternative investments. Specifically, it allows investors access to some of the tools used in alternative strategy funds. The US made similar rule changes in 2013. Since the rule change there has been a wave of new products. I encourage a cautious approach. Even though we are only exposed to a small portion of the overall alternative market there are still numerous strategies, they are not all the same. As well fees for alternative investments are usually higher than traditional investments. I believe for the average investor having a small portion of their portfolio in an alternative strategy makes sense, but do your homework, talk to your advisor, make sure it is the right fit.

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