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ASSET MANAGEMENT

Liquid alternatives and absolute return strategies

Liquid alternatives and absolute return strategies are increasingly vital tools for portfolio diversification, alpha generation, and downside protection. Unlike traditional asset classes, these strategies target specific returns independent of benchmark indices and offer readily available liquidity, making them accessible and flexible for a wide range of investors and institutions.

What are liquid alternatives?

Liquid alternatives are investment funds that use strategies like those in hedge funds, but with the liquidity and transparency of mutual funds. These strategies may include absolute return strategies, long-short investing, leverage, derivatives, arbitrage, and active risk management across a range of asset classes such as equities, fixed income, currencies, commodities, etc.

Key features of liquid alternatives

- **Liquid:** Investors can typically buy and sell shares on a frequent basis, unlike traditional hedge funds or private assets that may have lock-up periods.
- **Diversification:** Liquid alternatives often have lower correlation to traditional asset classes which can help reduce overall portfolio risk and smoother returns, especially during market volatility.
- **Transparent:** Liquid alternative mutual funds are regulated and regularly report what they hold and disclose their fees.
- **Accessibility:** Liquid alternatives are available to a broad range of investors, not just institutions or accredited investors, with generally lower account minimums making them more accessible.

Portfolio allocation considerations

When incorporating liquid alternatives into a portfolio, careful planning is essential to maximize their benefits and manage risks. Investors may want to consider how they can:

- **Compliment traditional and private market assets:** Liquid alternatives in particular serve as a liquid sleeve within the alternatives strategies which can help manage liquidity gaps and provide flexibility during periods of market stress or over-allocation to privates.
- **Diversify:** Liquid alternatives can help reduce overall portfolio risk and smooth returns, especially during volatile market conditions due to their distinct sources of returns and risk exposures.
- **Increase accessibility:** Liquid alternatives are available to a broad range of investors, often with lower minimum investments compared to private alternatives.

Associated risks and considerations liquid alternatives

Liquid alternatives provide valuable diversification and liquidity; however, investors should be aware of the specific risks and considerations associated with these strategies. Understanding these factors can be crucial to making informed investment decisions.

Risk consideration	Explanation
Liquidity constrained by the underlying assets	• While liquid alternatives are more liquid compared to direct and closed ended funds, their liquidity can be lower than that of public market funds and strategies due to the underlying assets that the liquid alternative may be exposed to.
Strategy and performance risk	• Performance depends on the manager's skill, the effectiveness of the strategy, and market conditions. • Strategies may underperform during certain market environments or if the manager's views are incorrect.
Complexity and transparency	• Can require robust systems and controls which can lead to operational losses. • Some strategies may lack full transparency regarding holdings and risk exposures.
Fee risk	• Liquid alternatives often have higher fees than traditional mutual funds.

What are absolute return strategies?

Absolute return strategies are investment approaches that aim to generate positive returns regardless of overall market direction. Unlike traditional strategies that seek to outperform a benchmark through the use of relative returns, absolute return strategies focus on achieving positive performance regardless of market direction, and can feature characteristics of liquid alternatives.

Common types of absolute return strategies

Absolute return strategies feature various actively managed solutions to generate returns regardless of market direction. Some of the most common strategies include:

Market neutral	Long / short	Global macro	Event driven	Arbitrage
Seeks to offset long and short positions to eliminate market risk.	Looks for long positions in undervalued equities and short positions in overvalued equities.	Invests based on macroeconomic trends, often across multiple asset classes.	Exploits pricing inefficiencies related to corporate events (e.g., mergers, restructurings).	Profits from price differences between related securities.

Key features of absolute return strategies

- **Market neutral:** These strategies are designed to be less dependent on market movements, often using hedging techniques to reduce exposure to market risk.
- **Active management:** Employs sophisticated strategies such as leverage, arbitrage, short selling, and derivatives. The use of leverage is capped at 300% allowing for the potential to achieve positive performance regardless of market direction. The capping of leverage can also act as a "safety belt" for the strategy to prevent overallocation or increased volatility.[1] Portfolio construction is rigorous, with a strong emphasis on risk management and drawdown control.
- **Flexible asset allocation:** Strategies may invest across a variety of asset classes (equities, fixed income, currencies, commodities) and geographies.

Portfolio allocation considerations

When integrating absolute return strategies into a portfolio, thoughtful planning is essential to maximize their benefits and manage risks. Investors may want to consider:

- **Alignment with objectives and risk tolerance:** Absolute return strategies may not fit with all investor goals, liquidity needs, and risk appetite.
- **Multi-strategy approach and diversification:** Absolute return strategies can deliver consistent returns by combining different strategies to help reduce volatility in a portfolio.
- **Low market beta:** Absolute return strategies aim to reduce the impact of overall market directions to help smooth returns.
- **Drawdown protection:** Absolute return strategies are designed to deliver positive returns even when traditional markets decline, with robust risk controls and portfolio monitoring.

Associated risks and considerations for absolute return strategies

Absolute return strategies offer the potential for positive returns in a variety of market environments, but they also come with unique risks that investors should understand. Careful consideration of these factors can be essential before incorporating absolute return strategies into a portfolio.

Risk consideration	Explanation
Less liquid	• Absolute return strategies may offer less liquidity than traditional instruments.
Less transparent reporting	• Counterparty risk exists due to the use of derivatives and or trading with other financial institutions which may result in default. • These strategies may require robust systems and controls which can result in operational losses. • Strategies may underperform if the manager's views are incorrect.
Complexity and transparency	• Absolute return strategies often use derivatives, leverage, and short selling, which can make them more complex. • Some strategies may lack full transparency regarding holdings and risk exposures.
Fee risk	• Due to their complexities, these funds often have higher fees compared to traditional mutual funds.

The bottom line

Liquid alternatives and absolute return strategies can enhance diversification and portfolio resilience, but require informed selection and ongoing oversight. When considering liquid alternatives and absolute return strategies, investors should focus on aligning their strategy choices with their objectives, risk tolerance, liquidity needs and desired outcomes.

For more information on liquid alternatives and absolute return strategies, speak to your Advisor, or visit cibc.com/gam-alternatives

[1] Under Canadian regulations (NI 81-102 for Alternative Mutual Funds), a fund's aggregate exposure—which includes the total market value of short positions, investment borrowings, and the notional value of derivative positions (excluding those used strictly for hedging)—must not exceed 300% of the fund's net asset value (NAV).

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