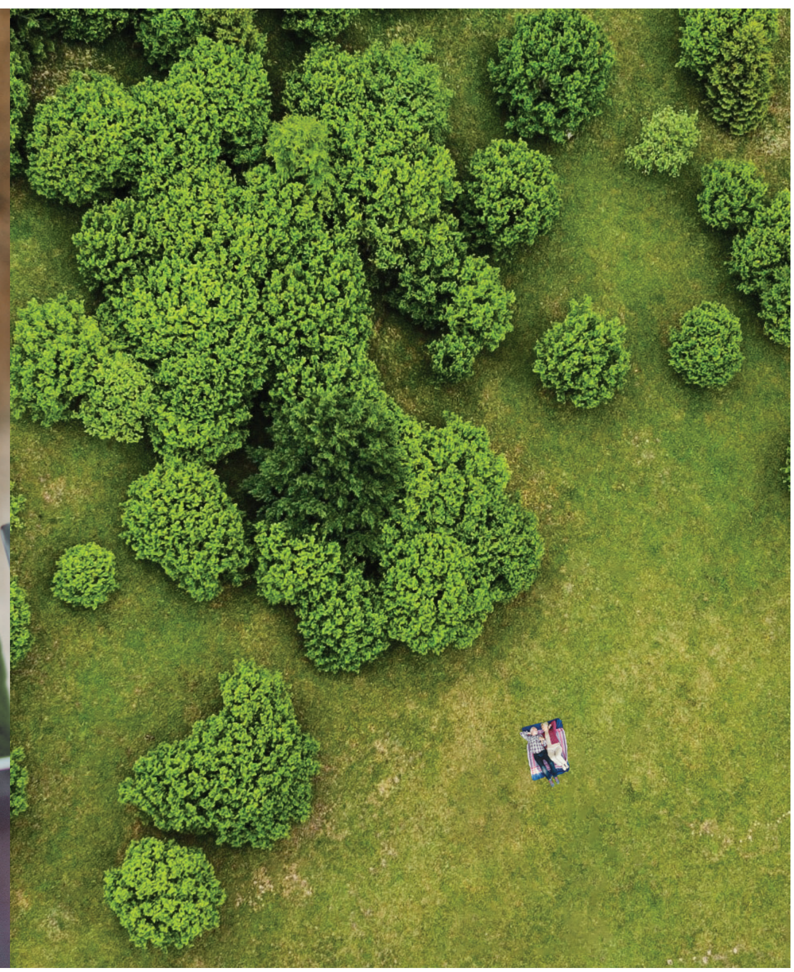
PORTFOLIO GUIDE

Connor Clark & Lunn Private Capital

Beyond stocks and bonds

How to build a diversified portfolio with alternative investments



A Wealth of Thinking

COVID-19 taught us the importance of being prepared for the unexpected. For individual investors, we cannot overstate this truth.

In the early days of the pandemic, stock markets plunged, sparking jaw-dropping headlines and anxiety among investors. While stock markets rebounded quickly, the ripples highlighted the potential volatility of an equities-based investment portfolio. Yet with bond yields declining, many investors rely on equities to grow their wealth; however, other options can provide more stable returns.

For individuals close to retirement or those who wish to use their investments for income, relying primarily on equity investments can be problematic. Losses can seriously impact short-term returns and the sustainability of their incomes. These investors typically need a portfolio that provides stable and predictable returns. It is particularly true for high-net-worth individuals who may require a significant income to maintain their lifestyle, hope to leave a wealth legacy for their children or support philanthropic endeavours. However, in today's investment environment, returns can be difficult to come by when investors also want lower risk.

For years, pension funds and institutional investors have embraced alternative investment strategies. Now, investment managers are providing access to alternative asset classes to individual investors, allowing them to follow in the footsteps of their institutional counterparts. To make sure they are making the right decisions, individual investors need to understand their options fully.

This Portfolio Guide highlights key factors affecting the investment landscape, outlines alternative investment approaches, and shows how we are using these approaches to help investors enhance their portfolio strategies.

Key factors driving changes in the investment market

It is harder than ever for investors to achieve their desired returns from the traditional stock and bond investment portfolios that have performed in the past. This is because the investment environment has evolved significantly over the past twenty years, with several factors changing portfolio dynamics in ways not expected to reverse anytime soon. Six key factors affecting the investment market are:

1 Low interest rates

While the Bank of Canada overnight interest rate reached a high of 21.75% in 1981, it has declined considerably since. Over the last decade, 1.75%[1] is the highest the Bank of Canada has set the overnight rate. However, the bank has held the rate at a historical low of 0.25% since late March 2020, when the first wave of COVID-19 hit Canada. Looking forward, while the rate may increase marginally, it is not expected to rise significantly over the next few years.

2 Decreasing bond yields

The challenge for investors today is that declining interest rates have significantly eroded the ability for bonds to generate returns. In 2020, bond yields fell to record lows. They have recovered from those depths; however, they remain low and offer very little return for investors. We expect that bond yields will remain at these low levels.

Historical Canada 10 year bond yield

From January 1986 to May 2021. Source: Refinitiv

3 Stock market volatility

The last eighteen months have highlighted the potential volatility of equity investments. For example, the S&P 500 Index fell almost 30% in March 2020, including losing 15% over two days. Approximately a year later, the index was up 80% against its 2020 low[2]. Other events over the years – including the dot.com bubble burst and the Great Financial Crisis – have also impacted stock market performance and equity investments. This level of volatility can be uncomfortable for investors watching short-term portfolio performance. It is why some consider a move away from higher-risk asset classes as they become more dependent on their investment income.

[1] Interest rates were 1.75% from October 23, 2018 until March 3, 2020. Source: Refinitiv
[2] Source: Refinitiv

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Interconnected economies

Investors have greater access to global equity markets than ever before. However, it can be difficult to diversify portfolios and mitigate potential risks due to markets' increasing interconnectedness. The potential issues affecting one market can easily influence others due to interdependencies between established economies and within global supply chains.

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Ongoing search for income

There has been a search for income as investors have experienced extremely low interest rates for many years now. Changing demographics have only added to the sense of urgency. Ageing baby boomers want their investments to drive income in place of work to support their lifestyle. With low bond yields and equities viewed as high risk, investors are increasingly looking for better performing yet safer investment options.

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Democratization of smart money

Traditionally, individual investors have had little access to the broader range of asset classes available to institutional investors and "smart money". Asset classes like infrastructure and real estate have typically been the purview of institutional investors like pension funds. Recently, however, the search for income combined with innovative responses from investment managers has led to a democratization of smart money, opening the door to these alternatives to individual investors.

New world, new investment approaches

Historically, individual investors interested in generating safe and stable returns looked to the bond market, which performed predictably and provided investors with a comfortable and low-stress retirement. The 21st century, however, brought with it declining interest rates, lower bond yields, and little indication that the investment environment will revert to easier times.

For investors, this shift means they can no longer rely on what has worked in the past. Investors that want to grow their portfolio or draw stable income from it while maintaining a palatable level of risk need to consider other options. To help, innovative investment managers have developed "alternative" investment approaches that investors can integrate into a portfolio strategy.

1 Alternative investments

Alternative investments refer to any investment strategy that does not take a conventional approach to investing in traditional equities or bonds. Each class of alternatives works to address some of the variety of challenges that investors face while providing diversification benefits within a portfolio and return opportunities. Real estate, private infrastructure, and private equity are the most common forms of alternatives. Others, including hedge funds, alternative income sources, and equity investments in emerging economies, are also gaining attention.

Alternative asset classes have been well-researched, their merits and value proven with institutional investors. Alternatives are commonplace in the portfolios of notable and sophisticated institutional pension funds, such as the Canada Pension Plan, the Ontario Teachers Pension Plan, and the British Columbia Investment Management Corporation.

The main barrier to alternative asset classes has been accessibility for individual investors, with minimum investment thresholds often beyond reach and no public exchange for buying and selling assets cost-effectively. With growing demand, some Canadian investment managers have embraced innovation, introducing several alternatives for potential inclusion in the portfolios of their high-net-worth investors.

Our approach to alternative investments

At CC&L Private Capital, we have a long history of providing alternative investments to institutional investors. We have taken a leadership role in giving individual investors access to these asset classes without losing the pension-calibre approach. For over a decade, the challenges associated with balancing return and income objectives with risk have been at the forefront of our client conversations. During that time, we have expanded our investment platform to give our clients access to a broader range of alternatives while educating them on how they play into meeting their long-term objectives.

Commercial Real Estate: An asset class that provides stable income and return potential, although not commonly held by individual investors due to the value of most transactions and the difficulty associated with gaining significant diversification. At CC&L Private Capital, our real estate investments include over 235 commercial and residential properties across Canada. They give our clients access to a diversified source of portfolio growth and cash flow, with rent escalation clauses in lease agreements hedging inflation. Our real estate investments include office buildings, industrial manufacturing facilities, distribution warehouses, retail centres, and multi-unit residential properties – assets typically outside the reach of most individual investors.

Infrastructure: Traditional infrastructure and energy assets are a less familiar option for most high-net-worth investors, given the complexity and high cost associated with access to the asset class. Institutional investors, however, have proven the value of infrastructure investments. For investors who do not require their capital in the short term, infrastructure can be a relatively safe and low-risk way to generate income and long-term growth. Infrastructure investments have the added benefit of acting as a buffer from economic turbulence in an investment portfolio. At CC&L Private Capital, our infrastructure investments are primarily in Canada, the US, and Chile. We expect to add infrastructure assets in other geographies over time in a measured and disciplined way.

Our portfolio is focused mainly on small- and medium-sized traditional infrastructure projects (e.g., roads, rail, hospitals) and energy infrastructure projects (i.e., hydro, wind, and solar).

Private loans: Lending to private, middle-market companies is a way for investors to obtain stable interest payments secured by liens against corporate assets. It makes private loans a reasonable fixed income alternative given declining bond yields. While it is not a common asset class in Canada, it is often seen in other markets, such as the USA and Europe. Private loans also contribute to the diversity of a portfolio, providing an uncorrelated source of income. At CC&L Private Capital, we offer private loans to middle-market Canadian companies, typically in the range of $20 to $60 million.

Hedge strategies: The use of hedge strategies offers investors enhanced diversification in their portfolio by providing an uncorrelated source of return driven by analyst insights rather than by market-driven factors. At CC&L Private Capital, we use three distinct hedge strategies in our portfolio—Canadian small-cap equities, a range of Canadian and global bonds, and global equities —in a manner that can decrease a portfolio's exposure to core bonds.

Private Equity: Providing capital in exchange for equity in private Canadian companies can be an excellent source of potential return for investors when coupled with the oversight of experts. At CC&L Private Capital, we utilize the team at Banyan Capital Partners part of the CC&L Financial Group. Banyan invests in companies with a historical track record of strong operations and consistent cash flow – working with owners and managers to drive efficiencies and spur growth.

Alternative asset classes provide investors with portfolio diversification and other investment characteristics, which can help achieve financial portfolio objectives even in a changing investment landscape. Alternative investments more broadly diversify risk in a portfolio and may protect value in periods of uncertainty, given they have relatively high and stable income levels.

The investment market is expected to continue to shift in the future. That is why, at CC&L Private Capital, we are committed to embracing innovation to evolve our investment platform so that we can provide our clients with unique alternatives to include in their portfolios.

2 The new frontier

In developed markets, equity diversification has changed significantly in recent years. Traditional investments are now less diversified due to the increasing integration of global supply chains and global markets' interconnectedness.

To combat this fact and provide the prudent benefits of diversification, some investment managers have focused on identifying opportunities in economies that are still in their infancy in terms of development. These "frontier" markets are less developed than emerging markets like China or Brazil. However, they have large and growing populations and low but increasing income levels. As incomes rise, these countries are expected to see an increase in consumer spending on goods and services. It should increase the profitability and business maturity of local companies able to meet rising consumer demand – making such companies ripe for investment.

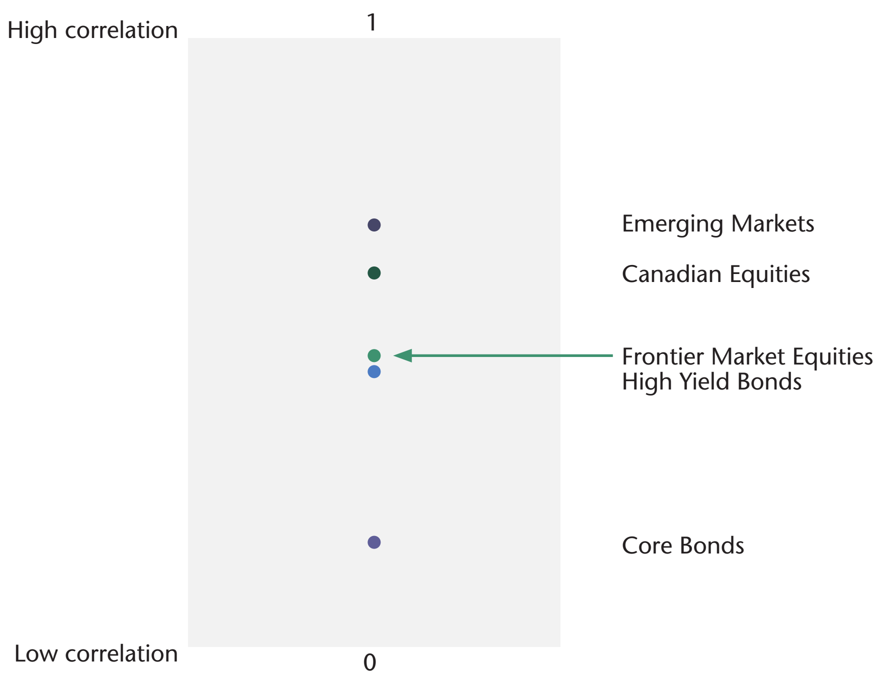
Our approach to frontier markets

Unlike emerging markets, there is no clear and standard definition of frontier markets. We consider frontier markets to be unclassified markets or markets that are not represented well in the emerging markets index, such as Indonesia, the Philippines, Vietnam, Ghana and Kenya.

While many of these countries are high risk due to their low level of economic maturity and potential political instability, their economies are highly localized and disconnected from global trends, making them a viable mechanism for diversifying portfolios. Investing in frontier markets can also generate social benefits, injecting much-needed capital into underinvested companies and helping drive regional economic development and the maturation of key industries.

To mitigate risk, the companies we invest in are typically consumer-focused – with offerings that meet local consumption demand rather than global supply needs.

Diversification benefits: Correlation of asset classes versus global equities



Source: MSCI, FTSE, Merrill Lynch, S&P, Refinitiv.

The benefits for investors

Frontier investments are a relatively volatile asset class; however, their risks are unique compared to traditional assets, giving investors enhanced diversification. The long-term return potential is also significant, given low levels of market maturity and projected growth trajectories. By investing in early-stage companies before they become institutionalized and before their local market matures, investors are positioned to see returns over the long term.

At CC&L Private Capital, we believe that adding a modest allocation to frontier markets can help improve the robustness of a portfolio under certain circumstances. However, any frontier investments need to be made based on a fulsome discussion of the risk and return trade-offs.

Embracing ESG principles to build portfolio strength

At CC&L Private Capital, we include environment, social responsibility, and governance (ESG) factors within all of our investment analytics for traditional and alternative asset classes. This process identifies good environmental stewards that pay strong attention to health, safety, and social issues and are well-governed.

By integrating ESG factors into our investment approach, we reward companies embracing good corporate citizenship and provide the impetus to change to those that may be lagging. In a world where ESG issues are growing in importance, we believe this focus will drive meaningful differences in risk and return over the long term.

Moving forward with confidence

From our recent experience with COVID-19, we have learned that anything can happen. While the future is uncertain, individual investors have more options than ever for enhancing their portfolio strategies. The right investment manager can help investors understand the alternatives and trade-offs available to them. They can also explain how different strategies can work together to create a robust portfolio strategy positioned to deliver returns while reducing risks.

In our Portfolio Guide, *How to future-proof your investment portfolio*, we examine how the changing investment environment alters what investors need from their investment advisors. It also identifies key attributes investors should look for when evaluating potential investment managers to assist them in reaching their financial goals.

Helping you achieve your investment goals

At CC&L Private Capital, we are committed to giving clients confidence that their investment portfolio will meet their desired objectives. We also empower clients to make financial decisions about what their wealth can afford them. To learn how we can help you get more from your investment portfolio, **please get in touch.**

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