MONTRUSCO BOLTON Solutions

White Paper

Prudent Alternative Portfolio Management

Confidential Document

Alternative investments are often touted as an asset class that has little correlation with traditional investments, namely stocks and bonds. Investors allocate assets to private debt, private equity, real assets and hedge funds based on the premise that negative returns in equity markets and compressed bond yields will likely have little effect on the performance of alternative investments. Although this characteristic of non-traditional assets may prove to be true over time, extremely adverse market conditions do impact alternative investments, particularly during short periods of less than one year. The objective of this paper is to explore how prudent portfolio management can protect against macroeconomic risk while providing a certain level of liquidity to investors.

When things go sour

2018 proved to be a challenging year for traditional assets and provided a case in point of how alternative investments can be a safeguard against negative performance in public equity markets. Stock indices were hit hard worldwide, but private investments saved the day for several pension plans and other investors who have dedicated a sizeable portion of their portfolios to alternative investments. However, it is important to note that, while stocks performed poorly during the last quarter of 2018, the first quarter of 2019 swiftly provided the largest quarterly rebound in stock prices in the past decade. Perhaps the sell-off was so abrupt and short-lived that active asset allocators did not have quite enough time to react to this spike in market volatility by reducing their exposure to equities.

But what would have happened if the sell-off had lasted more than one quarter? The last time the US equity markets experienced two consecutive negative quarters was in the first half of 2015. How did North American alternative investments fare? Infrastructure, private equity and private debt all showed negative returns, while real estate was positive. Similar numbers were posted in 2011 when the S&P 500 was sharply down in the third quarter after a marginally negative second quarter, which begs the question: what happened during the financial crisis of 2008-2009? As you might suspect, three out of the four sub-sector alternative investments, namely private equity, private debt and real estate were in negative territory by the end of the first quarter of 2008, and within six months, all sub-sectors were in the red for the following three quarters until the S&P 500 emerged out of its deep slump.

The key takeaway here is that alternative investments provide some safety and help overall portfolio performance due to their overall low correlation with stock markets in a normal environment. However, in dire market conditions, there is usually nowhere to hide when it comes to risky assets. Even when an alternative investment strategy remains resilient after a difficult quarter for equity markets, investors would be keen to cash in on their profits and adopt a defensive stance if markets continue to do poorly. This selling action could then trigger a domino effect across most, if not all asset classes, as companies start defaulting on loans and the revaluation of less liquid debt instruments results in large paper losses on securities holdings. The ensuing marking to market in consolidated balance sheets would then create a vicious circle, resulting in more asset sales as corporations and financial institutions attempt to reduce their exposure to risky assets.

This chain reaction would also be fuelled by poor economic conditions, which will likely have a negative impact on private equity firms' ability to successfully exit investments made within older vintages and would inhibit the growth of debt-laden companies acquired within more recent vintages. Even

infrastructure and real estate funds are not immune to these severe downturns as projects stall, revenues that are not concession-based shrink and projects are written down. Furthermore, the fall in alternative asset prices is exacerbated by the lack of an effective secondary market, which becomes even more problematic as liquidity premia increase. Indeed, it is in times of crisis that it becomes crucial to have a prudent strategy in place, particularly in the context of alternative investments.

Prudent and active portfolio management benefits investors

The first line of defense against market downturns is sensible diversification, coupled with a thorough selection and due diligence process for underlying strategy managers. Not only is the Montrusco Bolton Alternative Fund (MBAF) an innovative investment solution that brings together a range of attractive alternative illiquid strategies (private debt, private equity, infrastructure, real estate) and liquid strategies (hedge funds), but it also is the fruit of the solid partnerships that Montrusco Bolton has developed in recent years with boutique and entrepreneurial firms that specialize in alternative investments.

In essence, the MBAF includes a variety of illiquid and liquid strategies that do more than simply have low correlations among each other and with traditional asset classes. Indeed, the MBAF manager adds value by performing due diligence on all underlying strategies. The firms offering these strategies must employ strong and distinctive investment processes, and their managers must have skin in the game by allocating personal capital to their strategies in order for interests to be aligned with those of investors. In addition, proximity with underlying strategy managers provides the MBAF manager with added insight on their investments and performance, which directly benefits investors.

Another key element to sensible diversification is the ability to dynamically allocate capital to each strategy. This is more desirable than having a static allocation that doesn't adapt easily to changes in the market cycle. By dynamically allocating assets to each strategy, the MBAF manager aims to generate the highest return possible for a specific degree of risk while maximizing the liquidity provided to investors. Essentially, even though the MBAF allocates a portion of its assets to illiquid strategies, investors benefit from quarterly liquidity as a result of the MBAF's Liquidity and Deployment Management Portfolio (LDMP). The LDMP's function is twofold:

1. Provide liquidity by maintaining a reasonable allocation in cash and investing a portion of assets in short-term instruments (money market securities, preferred shares, short-term corporate bonds and customized instruments provided by Montrusco Bolton partners).
2. Partially replicate the risk-return profile of illiquid strategies when capital committed to these strategies is not fully deployed and the MBAF is awaiting drawdown.

In addition, around 35% of the MBAF's target asset allocation is dedicated to alternative liquid strategies, which offer frequent liquidity, usually on a monthly basis. These strategies are often structured as open-end hedge funds that invest in publicly-traded securities and generate absolute returns with little or no correlation relative to other investment strategies.

Layered risk management for increased protection

The second line of defense when investing in alternative strategies that have a varying degree of sensitivity to severe market conditions is the use of derivatives to hedge against systematic risk. Essentially, even though strategy managers perform risk management to protect their investors, the managers of investment vehicles that combine alternative liquid and illiquid strategies need to be cognizant of the risks that may impact their overall portfolios. Therefore, it is important to adequately assess current and potential macroeconomic risks and structural changes, which could negatively impact the illiquid positions in the portfolio. By conducting a series of stress tests and scenario analyses, the MBAF manager maintains a solid understanding of how the overall portfolio may react to extreme market conditions and is ready to put in place an effective hedging strategy.

MBAF – a compelling alternative investment strategy

The measures outlined in this paper are part of the MBAF's value proposition. The Fund offers exposure to alternative investments through an actively managed hybrid solution structured as an open-end fund and composed of liquid and illiquid strategies. Please refer to our website for more detailed information.