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Know Your Alts:

CONSIDER THIS WHEN INVESTING IN PRIVATE ALTERNATIVES

High-interest and inflationary times have led many investors to reconsider the traditional stocks-and-bonds approach to their portfolios. Some have increased their cash holdings; others have eyed treasury bills and other assets. No matter their response, it is increasingly clear that investors are searching for profitable strategies. With alternative assets, they may find just that.

“Alternatives” can describe assets that don’t fall into traditional investment categories and include private companies that are not traded on an exchange or stock market. In recent years, institutional and individual investors have significantly increased their allocation to such assets. More than **four-fifths of Canadian advisors** said they plan to increase their exposure to alternative assets in the near future. Furthermore, almost 40% said they are considering larger positions in private real estate.

Though these increasingly popular and accessible investment vehicles can differ widely, investors employ them for many of the same reasons — diversification chief among them. Most offer exposure to assets with low correlation to stocks and bonds and tend to be actively managed. Additionally, private alternatives can offer the potential for higher returns than traditional asset classes like stocks, bonds, or cash. It is easy to see why private alternatives are top of mind.

Before exploring alternatives, it is important to consider the role such an investment can play in your client’s portfolio. Is your client’s objective to unlock stable cash flow, achieve long-term growth, or simply to diversify their holdings? How will an investment fluctuate as the economic environment shifts — can it safeguard your client’s capital when other asset classes are down? And are you familiar with the risks associated with alternative investments?

As with all investments, due diligence is necessary before suggesting a private alternative to a client. Depending on the category, clients may also have to meet certain investor requirements. Advisors with a strong understanding of alternative investments and their risks can employ their key characteristics to help mitigate the effects of inflation and fluctuating interest rates, producing exceptional value for their clients. With that in mind, we discuss four popular private alternative investments and some of their key considerations.

Private Equity Real Estate

Private equity real estate companies raise capital to invest in real estate properties and/or developments. Most actively manage their investments and create value for investors over the long term through a combination of rental income and capital appreciation. As such, investors will turn to private equity real estate funds for long-term wealth creation and cash flow that can potentially beat the public markets.

Diversification: Real estate is a broad industry. Private real estate companies can focus on a single category of real estate — multi-residential (e.g. apartments), industrial, commercial, office, and so forth — or a combination thereof. Note that a private real estate company built around a single category can still offer diversification through varied geographies, building types, and other factors. Others can diversify their activities through development, the management of properties, and more.

Hedge against inflation: If a private company holds rental properties, such as multi-residential properties, consistent annual rent increases can offer a hedge against inflation. Commercial, industrial, and office property types typically hold longer lease periods that must be considered.

Stability: Canadian private real estate has historically been characterized by low volatility, even through periods of heightened economic uncertainty.

Accessibility: Traditionally, private real estate investment meant large sums of capital up front — $250,000 and up — and long lock-up periods. As the popularity of private real estate increases, more companies are asking for smaller up-front investments.

ECONOMIC INDICATORS TO WATCH:

Immigration: Immigration to Canada is set to reach all-time highs. A rapidly growing population has induced excess demand for residential real estate.

Interest rates: Increased lending costs can put pressure on a private real estate company's ability to acquire or build properties, thereby slowing growth. The knock-on effects of high interest, such as slowed consumer spending or job losses, can negatively impact commercial and office sectors. Successful real estate companies can continue to grow value through activities such as renovating existing properties, collecting rent, acquiring discounted properties, and diversifying their holdings.

Inflation: The costs associated with building maintenance and operation, construction labour, and asset management can increase during inflationary periods. Companies can mitigate increases to ongoing costs through operational efficiencies, such as in-house property management and other cost-saving measures.

Government policy: Canadian governments at all levels have made efforts to hasten the development and construction of residential properties. Purpose-built rentals in particular have received a boost in recent months.

Mortgage Investment Corporations

Mortgage investment corporations (MIC) are alternative lenders who offer investors exposure to a portfolio of mortgage loans secured to real estate. MICs pool investors' capital to finance loans that generate a combination of interest income and borrowing fees. Generally, investors will turn to MICs when seeking predictable and stable cash flow.

Loan risk: MICs offer mortgages with flexible financing terms that may be considered riskier than what major institutions might offer, often to subprime borrowers who do not qualify for bank loans. To mitigate risk, MICs typically focus on shorter-term residential mortgages with loan periods of six to 36 months. These are perceived as safer due to their shorter time frame.

Taxes: Due to their capital structure, MICs distribute all or almost all income to investors in the form of dividends. As such, they avoid paying income tax. However, these capital gains do not receive the preferential tax treatment of other dividends in the hands of the investor. Instead, they are **generally taxed** as interest income.

Diversification: A mix of mortgages spread across regions and term lengths mitigates default and prepayment risk, which can decrease anticipated returns.

Cash flow: MICs feature a fixed price per share and an exceptionally stable cash flow. For this reason, MICs are often seen as an alternative to fixed-income investments, such as bonds.

ECONOMIC INDICATORS TO WATCH:

Interest rates: The cost of borrowing follows the movement of interest rates. Although MICs stand to make stronger returns during periods of high interest, the opposite also holds true. Sudden interest-rate increases can increase the risk of default.

Home prices: Volatility in the residential housing market, strongly correlated to interest rates, can cause unexpected changes to the value of a property used to secure a mortgage. **This can impact a MIC's profitability**.

Mortgage delinquencies: An uptick in mortgage delinquencies can indicate heightened risk for a MIC.

Private Lending (or Private Credit)

In private credit or lending, an investor makes a private loan to a business or individual seeking capital. The investor receives interest income on the loan less management fees, often at a much higher interest rate than most banks or credit unions would charge. This premium reflects the inherent riskiness of private loans. Investors seeking the stability and predictability of fixed-income assets, but with significantly higher potential returns, may turn to private loans.

Predictability: Borrowers can be required to repay the private loan on a set payment schedule, offering investors a predictable cash flow.

Default risk: Borrowers turning to the private credit or lending market often have difficulty accessing a loan through a more conventional means. Distressed borrowers or borrowers with low creditworthiness pose a higher risk of default.

Loan terms: Each borrower has unique circumstances. When writing a loan, it is possible to define repayment terms that are favourable to both the lender and the borrower. This can reduce obstacles to repayment and minimize default risk.

Illiquidity: Giving a loan requires the lender to part with their capital. Depending on the terms of the loan, the lender may wait years for its return. Until then, they are unable to redeploy it.

ECONOMIC INDICATORS TO WATCH:

Interest rates: An increase in interest rates can positively impact the returns on a private loan. Private loans will typically feature floating interest rates, providing significant upside potential should rates go up and interest losses when they go down. However, unexpected interest-rate increases can increase the risk of default should rates exceed borrowers' ability to repay.

Private Equity

This type of alternative extends beyond real estate. Generally, private equity firms acquire business assets (private or public companies), manage or restructure them, then sell them. Investors are rewarded through the payment of dividends or distributions from the resulting capital gains. Given the broad category that private equity occupies, a specialty fund exists for just about every sector and business maturity. Investors may turn to public equity to achieve outsize returns not typically possible in the public markets.

Long holding periods: It can take a significant amount of time and capital to create value from a company that private equity has acquired. For this reason, investors can expect lock-up periods of approximately 10 years or more, which allows the private equity firm ample opportunity to grow the investment.

Acquisition risk: Buying the right company can increase the fund's value. On the other hand, a poorly selected business — one with significant debt or low likelihood of being turned around — can saddle a private equity firm with losses.

Extracting value: Private equity's extraction-based business model may not sit well with some investors. Cost-cutting measures, layoffs, and debt restructuring are some of the potentially controversial tactics some firms may employ to create value.

ECONOMIC INDICATORS TO WATCH:

Interest rates: Private equity firms use significant debt and very little equity to finance transactions. High interest rates make debt financing more expensive, impacting both a private equity firm's ability to make acquisitions and decreasing its ability to sell assets quickly and at a profit.

Labour metrics: When reviewing a private equity fund, it is important to consider labour costs, productivity, and other metrics that can help determine the long-term profitability of underlying businesses.

Inflation: Likewise, inflation can significantly impact the operating costs, and therefore profitability, of underlying businesses. Inflation also erodes private equity's purchasing power and overall returns. Accordingly, high inflation may prompt a firm to exit a position sooner than intended.

Mergers and acquisitions: Mergers and acquisitions activity can hint at a private equity firm's ability to buy or sell in the current environment.

Private alternatives offer the risk and reward today's investors are seeking

The above are only some examples of private alternatives that can add significant value to a client's portfolio. Real estate can offer exceptional stability and diversification, while private equity is known for its considerable growth potential. Meanwhile, private lending and mortgage investment corporations can unlock bond-like cash flow under the right conditions. Each type of investment carries its own risks — and the potential for double-digit returns. An informed and open conversation can help determine the alternative assets best positioned to help your client achieve their objectives.