Second engine™

Liquid Alternative Indices

Reliable benchmarks to enhance your asset allocation and manager selection workflows

A division of Picton Mahoney Asset Management

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Introduction

In 2019, the Canadian investment industry underwent a seismic shift with the introduction of a new alternative mutual fund framework, enhancing access to alternative investment strategies that were previously exclusive to high-net-worth and institutional investors. This regulatory change provided investment advisors with tools needed to construct more robust portfolios tailored to their clients' financial goals.

Since then, we have seen a surge in alternative investment solutions, driven by investor demand for these innovative strategies. However, while liquid alternatives have helped address many portfolio construction needs, they have also introduced new challenges. Key questions now facing advisors are how to effectively measure the value provided by these alternatives, and how to appropriately size these allocations in investor portfolios?

With traditional mutual funds, advisors can address those questions by referencing investable indices as benchmarks to support their allocation and often use comprehensive peer groups to assist in manager selection. However, the diversity and sophistication of alternative strategies, coupled with the lack of coverage complicate this approach when navigating liquid alternatives in Canada.

To solve these complexities and address the opaque world of alternatives, Second engine Liquid Alternative Indices ("2e Indices") were launched in 2023 by the Second engine division of Picton Mahoney Asset Management. This thought leadership paper explores the current opportunities and challenges in Canada's liquid alternative market, introduces the suite of 2e Indices, and demonstrates its value in empowering advisors to make data driven decisions in their alternative investments journey.

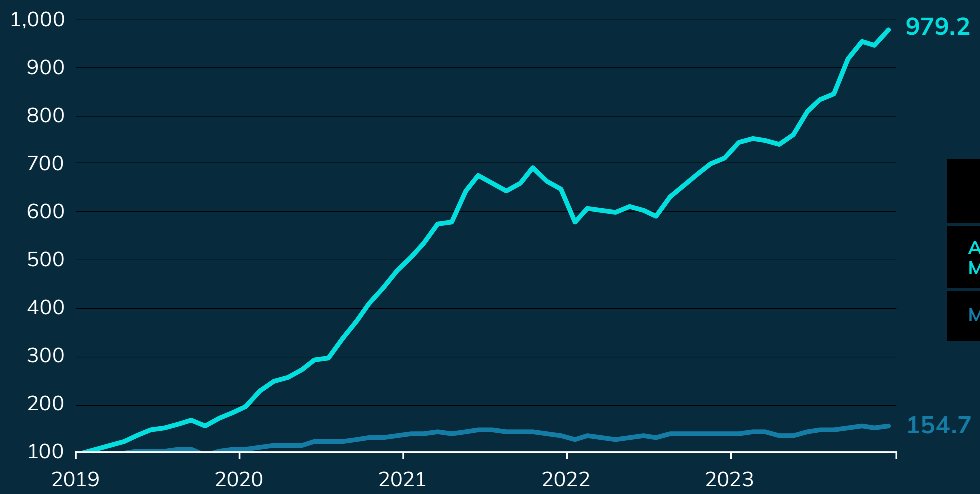
The Opportunity

Since the introduction of Canada's alternative fund framework five years ago, the market for liquid alternatives has expanded nearly tenfold, growing from $4.4 billion to $43.4 billion as of June 30th 2024, representing a compound annual growth rate (CAGR) of 57.8%.

In contrast, the broader mutual fund industry has grown at a CAGR of merely 9.1%. Currently, there are nearly two hundred alternative mutual funds in the market, offered by 57 fund companies, delivering a diverse range of strategies[1].

Figure 1: Cumulative Growth of the Canadian Alternative Mutual Fund Market

(Rebased to 100 on June 30, 2019)



	CAGR	Total AUM (C$ bn)
Alternative Mutual Fund	57.8%	43.4
Mutual Fund	9.1%	1,953.9

Source: Morningstar. From June 30, 2019 to June 30, 2024. Mutual Funds exclude money market and alternative mutual fund categories.

The rapid expansion, albeit from a small base, reflects the market's growing demand for alternative investment options within the retail space. One reason we have been hearing from advisors is that investors are increasingly worried about the high correlation between stocks and bonds in recent years, which exposes investor portfolios to higher market risks, increasing the potential for large losses like what we have seen in 2022.

Liquid alternatives, on the other hand, provide access to strategies and assets that have historically shown lower correlation to traditional assets. By integrating these alternatives to portfolios, investors aim to reduce overall exposure to systematic risks.

The good news for advisors is that this rapid growth has attracted a significant number of asset managers, enriching the diversity and depth of available solutions.

As a result, advisors are now able to add more value to clients and build true weather-proofing portfolios.

[1] Source: Morningstar Inc. As of June 30, 2024.

The Problem

Fulfilling the need for advanced tools

While the growth of the liquid alternative market presents a significant opportunity, it also introduces a new challenge. Unlike traditional mutual funds that rely on standard indices for performance evaluation, liquid alternative strategies demand more nuanced and targeted benchmarks.

Investment advisors frequently face several critical questions when considering the integration of alternative strategies into client portfolios:

- **Objective Allocation Assessment:** What is a sensible allocation to alternatives at the portfolio level?
- **Manager Evaluation:** How to objectively evaluate fund performance and manager skill?

These seemingly straightforward questions are often difficult to address due to the lack of data, which hinders advisors' ability to construct efficient multi-asset and multi-strategy portfolios for their clients.

Recognizing this gap firsthand through our extensive interactions with advisors across Canada, we have identified the pressing need for a more reliable method to assess the impact of incorporating liquid alternatives into portfolios.

Our Solution

Introducing the Second engine Liquid Alternative Indices

To address this challenge, we launched the Second engine Liquid Alternative Indices in late 2023. These indices are constructed to fill this critical information gap and support advisors in integrating alternative strategies into their client portfolios.

The 2e Indices consist of an aggregate index representing the overall liquid alternative market, along with a series of seven strategy-based and three goal-based indices.

Figure 2: **Second engine Liquid Alternative Indices Overview**

Overall Market Index

The **Second engine Liquid Alternative 35 Index™** serves as an aggregate benchmark, encompassing the top 35 liquid alternative mutual funds by assets under management. This index represents a diverse array of strategies, providing a comprehensive view of the overall market performance.

Strategy-Based Indices

Strategy-based indices are constructed around distinct investment strategies. Each strategy-based index includes liquid alternative mutual funds that align with specific strategies, based on their stated investment objectives and risk-reward profiles. By constructing appropriate peer groups for comparison, these indices are designed to effectively isolate performance differentials and evaluate managers' alpha generation ability relative to their peers.

Goal-Based Indices

Goal-based indices prioritize investors' needs, by categorizing liquid alternative mutual funds based on the distinct roles that alternative strategies play in portfolio construction. These indices include the ten largest funds within each category, ensuring they are both investable and representative.

By taking a goal-based approach to alternatives, investment advisors can better ensure that they are choosing strategies that are aligned with the desired outcomes of their alternative investment program.

Key Features and Construction Principles

The primary objective of the index suite is to measure the performance of liquid alternative managers at both market and individual strategy levels. Constituents in the indices are equal-weighted to minimize overconcentration. There is a quarterly rebalancing and semi-annual reconstitution cycle to strike a balance between investability and responsiveness to new fund launches. For more details on index construction, please refer to the **Index Methodology Guide**.

To ensure these indices are as useful and relevant to advisors as possible, we have closely followed the guidelines stated in the CFA Institute's best practices for benchmarking[2] during our index construction process.

Figure 3: **Best Practices for Benchmarking**

Relevant
The benchmark aligns with the manager's investment style or area of expertise, ensuring meaningful comparisons.

Measurable
The benchmark is quantifiable on a reasonably frequent basis, allowing for timely and accurate performance evaluation.

Unambiguous
Constituents of the investable universe are clearly identified and priced, ensuring transparency and reliability.

Investable
The benchmark is designed to be investable, enabling investors to replicate it as a representation of the investment segment.

Complete & Representative
The benchmark is designed to provide a broad representation of the segment of the market to which it pertains, offering comprehensive coverage of the market segment.

[2] Index construction is consistent with the principles articulated in the 'Guidance Statement on Benchmarks for Firms' published by the CFA Institute in 2021.

USE CASE 1

Enhance Asset Allocation Decisions

> *One problem that asset allocators are facing is, how can we assess the value that alternative strategies bring to traditional portfolios in an objective manner, without exposure to fund biases?*
>
> – **Pawan Vatvani**, CFA, FRM
>
> Director, Portfolio Construction, Second Engine, Picton Mahoney Asset Management

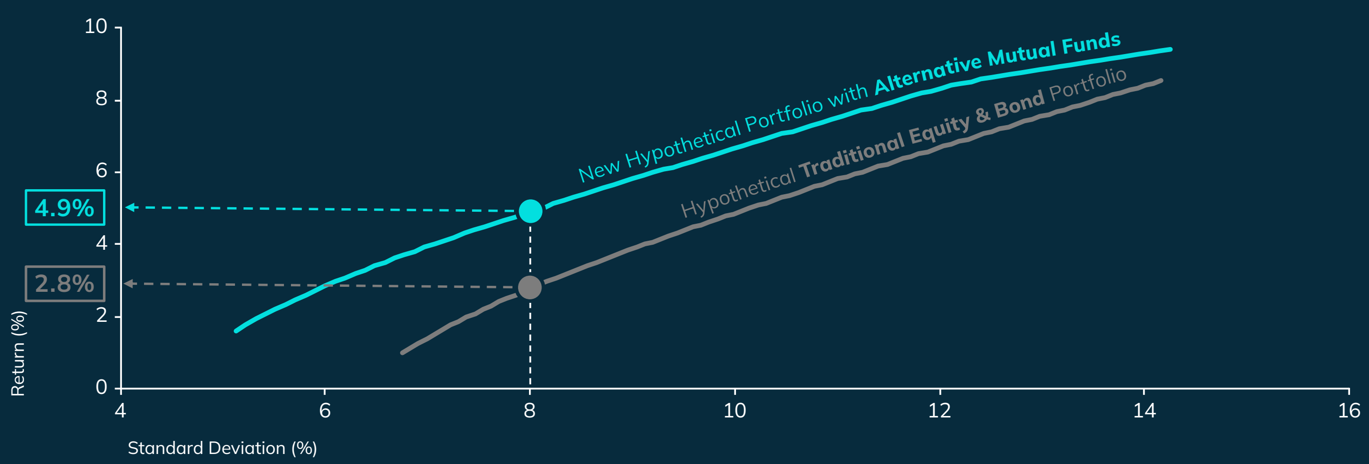
As of June 30, 2024, most 2e Indices have five years of performance data. During this period, there have been no shortage of major market events such as a once-in-a-lifetime global pandemic, unprecedented quantitative easing, decades-high inflation prints, rising geopolitical tension, and equities constantly breaking new highs. In the same timeframe, traditional stocks and bonds have often moved in tandem.

These extreme tail events and vigorous market movements have posed challenges for asset allocators, whose primary responsibility is to maximize returns for clients at various given levels of risk. In other words, there is an urgent need to add portfolio diversifiers, and alternatives could be one of the solutions.

With the introduction of 2e Indices, advisors are now able to objectively assess the impact of allocating to alternatives, free from bias towards specific funds or asset managers.

The chart below compares two sets of efficient frontiers (EF): the **grey EF** is constructed using hypothetical portfolios of stocks and bonds, represented by market indices. On top of that, the **blue EF** incorporates alternative mutual funds (capped at 30%), constructed using the 2e goal-based indices. The gap between the two lines indicates that even a moderate amount of exposure to liquid alternative mutual funds has led to significantly higher returns at all risk levels.

Figure 4: **Case Study Using Hypothetical Portfolios - Influence of Alternatives in Traditional Portfolio**



Source: Morningstar Inc. From June 30, 2019 to June 30, 2024. Equity is represented by S&P/TSX Composite Index, and Fixed Income is represented by ICE BofA Canada Broad Market Index. Past performance is no guarantee of future performance. Alternative assets compose of the 3 goal based indices from Second engine, i.e. Second engine Equity Enhancer 10 IndexTM, Second engine Fixed Income Enhancer 10 IndexTM, Second engine Diversifier 10 IndexTM. Weight for each asset is capped at 80%. Weight for Alternatives are capped at 30% in total. The portfolios used in this efficient frontier is hypothetical in nature, calculated using the historical returns of the underlying indices. Indices are unmanaged, are not available for direct investment, and are not subject to management fees, transaction costs or other types of expenses that a portfolio may incur. Therefore, performance of actual portfolios can differ significantly.

In terms of asset allocation, key benefits of the 2e Indices include:

- **Better Understand Correlation:** Gain insights into liquid alternative strategies' correlation with traditional assets.
- **Objectively Evaluate Alternative Strategies:** Assess the impact of specific alternative strategies using strategy-based indices.
- **Clarify Roles in Portfolio Construction:** Clearly understand the specific roles these alternatives can achieve in portfolio construction through goal-based indices.

USE CASE 2
Effective Evaluation of Manager Performance

Once advisors have decided on a specific alternative strategy, the next step is to choose the right alternative mutual fund within the strategy. Selecting the right fund requires a comprehensive evaluation of the manager's performance, which is where indices play a crucial role.

The Need for Benchmarking Manager Performance

Evaluating manager performance goes beyond simply looking at returns. It involves a holistic assessment of various risk and return metrics. Indices provide a standardized benchmark that allows for an objective comparison of fund performance and other key metrics such as standard deviation, max drawdown, Sharpe ratio, etc. By using these metrics, advisors can have a more comprehensive understanding of a manager's performance, beyond just raw returns.

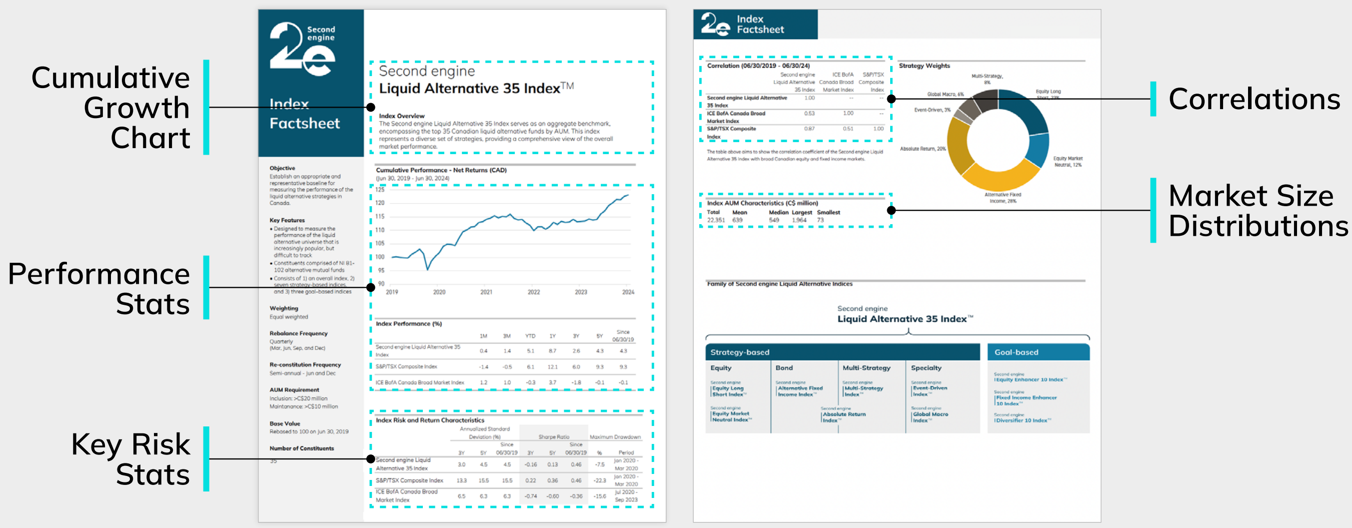
The 2e Indices are designed to facilitate this comprehensive evaluation. The strategy-based indices allow advisors to compare funds within the same strategy, providing a relevant benchmark for assessing performance. By isolating performance differentials and evaluating managers' alpha generation abilities, these indices offer a clear and objective reference point.

> *"Current data platforms and fund comparison tools are challenged in evaluating alternative mutual funds due to both the very narrow range of peer groups and the expanding diversity of alternative strategies themselves. These indices are a much-needed step forward in addressing this challenge, enabling investors and allocators to now compare apples to apples.*
>
> **– Andrew Tyler**
> Head of Product, Picton Mahoney Asset Management

Accessible Information

To support broad retail investors, all relevant information is readily available in the monthly factsheets posted on the Second engine™ website. These factsheets provide detailed performance data, risk metrics, and other essential information, making it easier for investors to make informed decisions.

Figure 5: **Snapshot of 2e Index Factsheet**



USE CASE 3

Navigating the Evolving Landscape of Strategy Options

For the 2e Indices to be useful, appropriate fund categorization is essential. Proper categorization ensures that each liquid alternative mutual fund is classified into a mutually exclusive group, allowing investors to get a better sense of the risk return profile from each category over the long term.

During our index construction process, we referenced the categories adopted by major global hedge fund and liquid alternative index providers and combined that with the current Canadian liquid alternative mutual fund landscape. This approach ensures that our strategy-based indices reflect both international standards and local context.

Available Strategies in Canada and Ongoing Monitoring

The existing 2e Indices highlight the strategies currently available in the Canadian market, covering a broad spectrum of investment approaches and providing a comprehensive overview of the liquid alternative mutual fund landscape.

We are committed to continuously monitoring the space and expanding our list of indices as new strategies emerge. This ongoing effort ensures that the suite of 2e Indices remain relevant, providing investors with the data they need to stay informed about emerging opportunities in the liquid alternative mutual fund market.

Conclusion

Incorporating alternatives into an investment portfolio is becoming table stakes for retail allocators who strive to offer comprehensive solutions for their clients. Alternatives can enhance returns, increase diversification, and/or mitigate risk. This is why established institutional investors typically have substantial exposure to alternative strategies and assets. However, due to the complexity of the alternative space, advisors must adopt a cautious and systematic approach when integrating these strategies into client portfolios.

To address these challenges, the Second engine Liquid Alternative Indices were launched in 2023, providing comprehensive coverage of the space. We also offer regular publications that get into the latest trends and data, further supporting advisors in their journey to liquid alternative investments.

By leveraging the 2e Indices, we hope advisors and investors will be able to:

1. **Navigate the liquid alternative space more effectively**
2. **Make more informed decisions**
3. **Successfully adapt to an evolving market landscape**

Want to learn more about Second engine and the Second engine Liquid Alternative Indices?

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Disclosure

Second engine is a division of Picton Mahoney Asset Management.

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Hypothetical or simulated performance results have certain inherent limitations. Unlike an actual performance record, simulated results do not represent actual trading, but are based on the historical returns of the selected investments, indices or investment classes and various assumptions of past and future events. Simulated trading programs in general are also subject to the fact that they are designed with the benefit of hindsight. Also, since the trades have not actually been executed, the results may have under or overcompensated for the impact of certain market factors. In addition, hypothetical trading does not involve financial risk. No hypothetical trading record can completely account for the impact of financial risk in actual trading. For example, the ability to withstand losses or to adhere to a particular trading program in spite of the trading losses are material factors which can adversely affect the actual trading results. There are numerous other factors related to the economy or markets in general or to the implementation of any specific trading program which cannot be fully accounted for in the preparation of hypothetical performance results, all of which can adversely affect trading results. The simulated performance results also assume that asset allocations, securities or investments would not have changed over time and in response to market conditions, which might have occurred if an actual account had been managed during the time period shown.