A Short Sell on Why to Invest in Alternatives

Speaker Key:

DP David Pett

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VO Voice Over

Time code	Speaker	Text
00:00:00	DP	From private credit to market-neutral hedging strategies, alternative investing is going mainstream. On this episode of Inside Perspectives, Kevin McCreadie, AGF CEO and Chief Investment Officer, is joined by Bill DeRoche, the head of AGFiQ Alternative Strategies, and Ryan Dunfield, the founder and CEO of the SAF Group, to discuss the growing importance of alternative asset classes and strategies and how to decide which ones may be right for your portfolio.
00:00:34		I'm your host, David Pett. Let's get into it. I want to thank you guys for being here today. We're going to get into the topic of alternatives investing. I want to start with just a couple quick questions for each of you with regard to the short squeezes and the David and Goliath phenomena that we've seen over the past few weeks that's really overrun markets. I'm just wondering what you think about the whole thing.
00:01:00	KM	A lot of people have looked at this and said professionals have said throughout the last nine months that the day trade phenomenon wasn't that big of a deal. And we saw really in April/May of last spring when we saw massive new applications on do-it-yourself brokerage. It was bizarre. We hadn't seen 800,000 new people [unclear] an account at Schwab, and they would participate in buying stocks. You saw in the different thematic trades. They moved on to something else though in the late summer, which was figuring out they can buy out-of-the-money call for a fraction of what they're paying for the stock.

Time code	Speaker	Text
00:01:30		A little bit further out, it's out of the money, and then they hyped it and got it into the money. And they actually profited a fair bit because they knew that the guy who sold them that option had to hedge themself and in fact had to buy it or something like it as well. It was another buying pattern, and what you got into this last period was this fact that they also figured out not only do the capital markets guys have to hedge that, but if we can find names that are overly shorted, somebody is going to have to cover that at point. And so it's transition and buying stocks through the options market. It's what we call gamma.
00:01:59		The difference between the price and the option, how you have to hedge it into this short squeeze, and resulting a lot of volatility at the same… It's absolutely real. Last comment on it. When we look at daily statistics of just trades in the US, because we can get that data, last year the average daily number of shares traded was about 11 billion shares a day. That's a record going back to pre-2008, and then this year, 2021 to date, it's 15 billion shares a day and at the peak of the frenzy 24 billion shares traded on 27.
00:02:30		You can't tell me that these guys aren't the marginal buyer effect.
	DP	And then Bill and Ryan, I'm just wondering, with respect to your day-to-day, how has this impacted, if at all, what you're trying to do?
	BD	From my perspective, there's been very little change. We do have strategies that short stocks, but we're looking at names where the cost to borrow is… Basically, it's called general collateral, so we're paying fractions of a per cent to borrow that stock. Names that are highly shorted, we're going to avoid.
00:03:01		So if you took a name, say, GameStop, where 140% of the shares outstanding were shorted, that would never be a situation we'd be involved in. As a matter of fact, when we look at our short positions, we're okay with them going up just as long as they go up less than our long positions because we're trying to capture the spread between those longs and shorts. Again, we're playing in a very different area. We do monitor what percentage of the float is being shorted, as well as how many days it would take to cover.
00:03:34		Names that get significantly higher, we'll avoid or cover them just so we don't have that type of risk. From our perspective, we did go through our short book in detail just to make sure that all those rules were being kept. And again there weren't any names that we would consider something that a dedicated short person would be focused on. Again, our day-to-day really hasn't been affected.

Time code	Speaker	Text
00:03:58	DP	And then Ryan, private credit, just curious from your perspective, when you look at this and see the headlines, what comes to mind?
	RD	Certainly, given the asset class that we look at, we've been enjoying the fireworks from a safe distance and observing some of the reminiscence of Occupy Wall Street and some of the behaviours of these WallStreetBets chatrooms and others on Reddit. The only way it remotely starts to touch our world is take a company like AMC that had a shelf prospectus filed and suppose we were looking at trying to make a credit investment with AMC, their cost to capital dramatically changed overnight.
00:04:36		And within 24 hours of filing a shelf, their at-the-money offering had cleaned out the entire shelf, which in an example like that would mean that opportunity for us to lend in a nano second would've faded away from us. We've generally been just watching this from a distance.
	KM	There're a couple firms that, Ryan's point, took the opportunity to actually raise capital in here, and the bond investor actually came out better because these things get somewhat de-risked.
00:05:03		You saw, AMC, one of their big investors converted shares and sold into this. And so if you're thinking about it, some of the credit investors actually made out all right. It wasn't just the folks who sold the stock.
	DP	And then, Kevin, let me just stick with you for just one second. As Bill mentioned, we do have some strategies that use short positions. Do you worry at all that people, when they see what's going on, that that they start to conflate short sellers, hedge funds that are defined as short sellers, with what we're doing in some of our strategies?
00:05:33	KM	It is a concern that people take a tag, and they apply it generically. We're billed as this is very rules based, a lot of risk management around it. It's not trying to find a position to exploit a one-way short. It's a market-neutral strategy but again with a lot of risk management. But people hear the word short, and they generically apply a tag. I would say the last piece on the short thing for me is, when we buy a stock long in our portfolios, we buy something at $10.
00:06:02		If it goes to five… And let's assume at $10, it was a 2% position. At $5, every dollar down it goes, and it can go to zero, that's our maximum pain. But every dollar it drops, the weight goes down, so it hurts us less. The opposite effect happens if you short something at ten. If it

Time code	Speaker	Text
		goes to 20, the weight has gone up significantly in your portfolio and the pain is even higher. And so there is an asymmetry to pain, and that's why I think people can't confuse just a strategy that's market neutral that's short versus somebody who's taking a position to fully take on that risk but knowing that they're very asymmetric.
00:06:35	DP	Let's talk a little bit more broadly about the alternative investment universe, and clearly it goes way beyond using short positions within strategies. Ryan, as we mentioned earlier, your world is private credit, and what you're doing is considered an alternative. But it's completely different to the strategies that Bill might be focused on. Maybe you can just talk a little bit about private credit and the market and how it works.
00:07:01	RD	When we look at private credit, that means, through highly structured investment and loan agreements, we're directly lending to borrowers that are predominantly private companies. But certainly, in some cases, they're also public companies. More often than not, these companies approach organisations like ourselves if they're looking for transitionary capital, if they're growing at a fairly rapid clip that's exceeding the backward-looking calculations the banks provide and these companies need to capitalise on opportunities to support their business growth.
00:07:35		Or project finance capital which more often than not is more highly structured investments that have an array of project-related risks that sometimes banks just aren't the right partners for those opportunities. From the investor's standpoint and especially in today's environment, our loans outside of being highly structured are often protected against inflation. Our rates can be floating rates or often have resets based on overnight lending rates or even in some cases CPI.
00:08:07		With that, you tend to see a lot less volatility in the face value of those loans as compared to, say, the bond market or the general fixed income market. Because a lot of these borrowers don't have the scale or size to access the bond market to substitute the bank market, you also have competitive pressures in your favour to negotiate higher rates than sometimes you would see inside of the fixed income market.
00:08:31		We're also more often than not secured lenders, so that in itself means less volatility in the face value of your loans or the price of your loans. And of course, in the unfortunate circumstances of defaults, the loss attributed to direct lending, because of your secure position, is often much, much lower than what you would see inside of the unsecured or the general bond market. We also tend

Time code	Speaker	Text
		to benefit for investors, being the only investor inside of these agreements.
00:09:01		We're the only lender. And so again, when we start thinking of downside risk, which is pretty much all we think about as a private credit investor, being able to control the loan agreement and work out the loan as opposed to being a small percentage of a bond or a publicly traded instrument means we can really drive and effect change to protect the investment that you otherwise would struggle inside of a public bond.
00:09:27		And of course we tend to have covenant structures that are much tighter around the business's operations, that gives us a little bit of a forecast when clouds or storms are coming on the horizon.
	DP	Bill, Ryan has described something that is, in my mind and I think a lot of people listening, very different than what you are doing with some of your strategies. And yet your strategies, long, short, market neutral, they have their own nuances themselves. I'm wondering if you could just maybe go through some of those nuances in terms of how you look at the alternative space and how your strategies apply to it.
00:10:03	BD	At the end of the day, we always start with an investor's core portfolio, whether that's core equity and/or core fixed income, and we're looking to provide something that they could add to that, that could either increase returns or reduce risk or even both. We have lots of levers that we can control to help with that. For us, we're always going to be focused in the public market.
00:10:29		The idea is that we're going to create something that's highly liquid, that investors could move in and out of, as necessary. But if you just take two examples here. If we look at a traditional equity-market-neutral portfolio, as Kevin alluded to earlier, where the long portfolio's beta is nearly equivalent to that of the short portfolio. And as a result, the net market exposure or the net beta is zero.
00:10:55		When you add that to an existing core equity portfolio, you're going to have significant risk reduction from that equity-market-neutral, zero-beta portfolio, as well as affecting the returns. If we just slightly take the same portfolio that the equity market neutral consisted of but increase the amount of dollars that we put into the long side, we're going to end up with a long/short portfolio. And that long/short portfolio would have a beta that's greater than one. And when we combine that with an existing core equity portfolio, we're

Time code	Speaker	Text
		going to end up with a very different result.
00:11:33		We're going to end up with higher volatility, more market exposure. Just by turning some dials, I think, is the message I want to leave folks with. We can basically fine tune the exposure that the investor wants at the end of the day in terms of risk and reward in their portfolio.
	DP	Clearly, we've got an alternative universe and asset class that is far from homogenous. We've just touched on a couple of examples, and there's many in between what we've talked about so far.
00:12:01		Kevin, from an asset allocation standpoint, someone who wants to get into the alternative asset class, what's the criteria? What do they need to be looking at in terms of how they choose between, say, private credit or a long/short strategy or infrastructure, for instance?
	KM	First of all, the alternatives word is a big, big word, and it means different things to different people. I think of it… It's a way to get an alternative method of getting a return. Something that has a different correlation than your traditional portfolio.
00:12:32		It's something that when you add it, it improves that relationship between return and risk, giving you more optimal portfolio. And so when I think of… We're using asset classes today that probably didn't exist. We didn't call it some of stuff, but we do today. But as time goes on, and you also have look at the environment that we're about to go into, each individual investor has to figure out what's the problem they're trying to solve, what is the tool that improves their ability to solve it and meet their objective in a lower risk way. If I take the example of private credit right now, interest rates are anchored at zero by central banks around the world.
00:13:04		Individual investors are struggling to get income. We've talked about this on other podcasts. The 60/40 portfolio is going to be challenged. The private credit offers a way to get you some return, for instance, but without some of the risk maybe inherent duration-wise you take in a bond portfolio. As interest rates go up, a bond portfolio goes down and creates a loss instead of giving you income you need. But I think you have to look at the problem you're trying to solve. I think you have to look at a combination of things.
00:13:30		Think about infrastructure. Infrastructure is a classic one. If you believe, in the world, it's going to be more inflationary, a lot of the

Time code	Speaker	Text
		things that are in infrastructure funds, add an inflation adjustment. The toll roads get inflation adjustment. Do you own a port? You get inflation adjustment. There are ways to use alternatives to protect against something else. I'd say it's not one thing. It's a very broad set of things and category. But the ultimate goal is to improve that return and risk combination.
	DP	Does that mean that someone who is adding alternatives as an asset class…? Does it mean you're looking to add just one of these types of alternatives?
00:14:01		Or does it make more sense to have a smattering because they all have their own outcomes attached to them?
	BD	When we talk to investors, we try to understand what problem they're trying to solve, to Kevin's earlier point. Since that alternative asset class or strategies cover such a wide range of investments, there'll be certain types that would solve the problem that they have and others that would be completely inappropriate. So I don't think a smattering.
00:14:31		In some cases, they could be offsetting one another. From my perspective, I'd rather sit down, understand what the issue is that they'd like to solve, and then provide something that's more targeted, that provides those specific exposures, that can fix that particular issue that they're looking to resolve.
	DP	And then, Ryan, maybe I'd just ask you to pick up on that. Just curious, in terms of the people that might be getting involved in private credit, what's the make-up of that investor? What are they looking to do when they venture into the private credit arena?
00:15:02	RD	Historically, our investor base has been overwhelming institutional, and that has changed with time, as we've able to bring this product to a broader investor base. And what has created a bit of a Goldilocks for private credit, if I can ride Kevin's coat-tail for a moment, is the function of just low interest rates with the potential of inflation on the horizon or in some time in the future, where private credit does just offer better duration profile inside of the investments.
00:15:29		And quite frankly, as rates have moved lower and folks have tried to hit their 60/40 or at least fill up their allocations to fixed income, it's just driven rates lower and lower. And those ultimately hit 0%, or the credit spread you're earning on the risk-free rate is so low, the next spigot to turn is risk, which is covenant. And so we're seeing these incredible bond deals that are at terribly low rates for just a small credit spread, and covenant structures are quite frankly non-

Time code	Speaker	Text
		existent.
00:16:02		We don't necessarily have that same level of fund flow pressure, where we can loosen up the underwriting standards or the adjudication process we have when building our credit agreements.
	DP	Ryan, you mentioned that a lot of your clients are institutional in nature, and it was the case years ago and probably still now to a certain degree that alternatives were the domain of the institutional investor. And yet we are seeing a bit of a democratisation of that. What's driving that trend?
	RD	I think that we've learned that institutional investor always tends to lead.
00:16:32		We've seen some of the trade-off that we learned over the past couple decades about more allocation to alternatives. But people starting also to think about liquidity aspect. How much do I want on my portfolio illiquid at one time? Because there are liquidity parameters around some but not all. Bill talks about. We think about a spectrum of things that you need to mix in there. Bill does. Can be offered in a liquid alternative, meaning it's daily price. Some of the things Ryan thinks about can be offered with some forms of liquidity and some other versions of things really shouldn't be touched for ten years.
00:16:58		And so we start to get the individual investor to think more like an institution because there's an ability to capture that return and again minimise some of the risk because you can meet some of the objective functions a little bit better. I don't call it democratisation. I call it institutionalisation of the retail investor. Start thinking more like an institution to get those return objectives met in a less risk way.
	DP	You mentioned… Liquidity obviously is a big factor in this. Are there particular alternative assets right now that just they can't be made liquid, and so it prevents them from some retail investors getting access to?
00:17:32		Or do you envision a time where you'll have a variety of things? Most things will… There'll be some version of it that is liquid in nature.
	RD	I always worry about the other piece of this. There are parts of things that have different liquidity profile. Public equity or bond, we can typically sell in the market today. If I was running a real estate fund, not sure I can sell an office tower today for what I think it's worth without fire sale. And there's [unclear] period, closing period that's

Time code	Speaker	Text
		different than [unclear] plus two.
00:18:01		I think every asset class has different liquidity, for sure. But I think also people recognise… And where it's gone wrong is they package more illiquid things in truly liquid [unclear]. And you saw that in this last go-round. Maybe we shouldn't have put illiquid real estate in an instrument that trades daily because the underlying ticker may trade. But the assets below it don't. I'd say that over time there are going to be different things that are more or less liquid. But there are ways and there will be ways of merging, I'd say, over the next couple years for investors to access liquidity buffers around some of these.
00:18:34		We may see a world where it may be that the longest-dated asset can still be offered in something that you gives you some form of liquidity. It may not be daily. May not be monthly. May not even be semi-annual.
	DP	We'll end our conversation today with just a thought from each of you in terms of trends that you're seeing in this particular asset class. Ryan, I think I know where you might be heading with your answer, but perhaps beyond private credit or within private credit, are there areas that you see as being particularly attractive or maybe providing some better opportunities than others going forward?
00:19:07	RD	Yes, for sure. Tactically, there's two themes that we're playing inside of private credit today, and if I can be a Calgarian and use a sailing reference, I don't know if that's faux pas, but we're putting our Spinnaker out on. And that is the Canadian bank market going through some pretty large changes where banks are pulling back their traditional lending. That is creating an opportunity where good businesses aren't having the same level of access to credit despite their idiosyncratic risk not changing.
00:19:35		We think that's a wonderful opportunity to put out some investments into. And then secondly, which is much more of a short-term theme is playing the post-COVID recovery, where you're going to see there's surely businesses that have been extremely impacted by COVID. But there's also a lot of businesses that might be mildly affected from COVID. Or in fact some businesses that are growing in this COVID environment, where their traditional lending relationships are so backward looking, which they often are, that those banks or traditional lenders aren't able to support the growth inside of those businesses.
00:20:09		We're certainly spending a tremendous amount of time understanding the best envelopes to fit into this current COVID and

Time code	Speaker	Text
		post-COVID recovery.
	BD	Just to add to that, rather than just focusing on a particular attractive alternative, I would say I look at it the opposite direction. I look at core equity and core fixed income, which has already been mentioned.
00:20:32		But core equity a decade ago was coming off lows. There was lots of room for multiple expansion and earnings growth. When I look at core equity today, multiples are high, so the ability to get both expansion and earnings growth is somewhat limited. Basically, we're looking at earnings growth to basically drive the market higher. We have one arm behind our back in some sense, so my expectations are that looking out, say, ten years for equities, the returns are going to be lower than what we experienced over the past decade.
00:21:04		As with fixed income, we've already hit on that. But yields are lower. Bond maths 101. Yields get lower. Durations extend so that risk-mitigating asset class is riskier, as well as having lower expected returns. And I think the other area that people forget is that your biggest exposure in core equity is exposure to global growth. When global growth diminishes, equities tend to go down. In the past, people would use long treasuries as a hedge for that.
00:21:32		Usually, when global growth went down, real yields would shrink. Yields go down, bond prices go up. That long treasury was always a good hedge, but we're looking at real yields that are negative right now. I worry that hedge isn't going to be there, like it has been over the past decade. I would just encourage investors to look beyond their core equity and core fixed income and look at some alternatives. If we look past back in the last decade, both core equity and core fixed income, it was almost as good as it could get for both of them.
00:22:05		I do think that it's probably time now to re-examine that, and I do think we're going to see some headwinds in both areas, going forward.
	KM	I fully agree with both Ryan and Bill on this point. I think, this decade in front of us, the need for alternatives in a portfolio will never be greater. We're on the back of massive fiscal stimulus around the world to get through COVID. You see deposits and saving rates around skyrocketing because people have pent-up demand. They can't spend it anywhere.
00:22:31		They can't travel and go hotels. We have short rates that have almost been guaranteed for the next two years. When we come

Time code	Speaker	Text
		through this, there'll be a massive pop and a pickup in demand, there'll be shortages, and there'll be inflation. And you've seen central banks, particularly the US Fed, say we're going to let that run for a while. Maybe a good 21, even 22. But then we have got to look out for when we pay for this. Equity returns are at fairly high levels. Bill's right about where the earnings piece of this is going to be, and you're going to have an inflation pickup. You're going to have interest rates back up. There's not going to be a lot of great places to hide.
00:23:01		You're going to have to get your income from private credit portfolio and infrastructure portfolio that gives you credit or gives you income but also hedges out some of that inflation risk. It may even be real estate, which has been so dislocated from COVID, that gives you more of an opportunistic plan on return and even might give you some income. I think we're going to have to mix all of these in, and to Bill's final point, absolute return is going to be a vehicle that replace income. But it's also going to give you some protection in the downward spiral of an equity market. And I think hedge… We haven't talked a lot about. We started with shorting.
00:23:30		But I think hedge-market-neutral-type portfolios are also going to have a place to play. You put it together. I think we never have used more across the spectrum, big institutions all the way down to retail, in alternatives than we will over this coming decade because the problem is going to be very different than the one we have seen in 20-plus years.
	DP	Well said. Let's end it with that. Thanks again to Bill and Ryan for joining us and Kevin. Until next time. For a full transcript of today's episode, visit agf.com/podcast.
00:23:59		And don't forget to subscribe to hear more from us at Apple Podcasts, Spotify, Google Play Music, Stitcher podcast Attic, and Pocket Casts.
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Time code	Speaker	Text
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