ALTERNATIVES

Trending in the Right Direction

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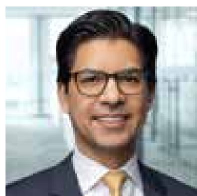

Ash Lawrence
Head of AGF Capital Partners

Private markets and hedge fund strategies have seen unprecedented growth over the past decade as institutional capital diversified in the wake of the GFC in a search for uncorrelated alpha generating strategies.

Private markets and hedge fund strategies have seen unprecedented growth over the past decade as institutional capital diversified in the wake of the Global Financial Crisis (GFC) in a search for uncorrelated alpha-generating strategies. As with all asset classes, that growth was further fueled by the expansionary policies of global central banks and world governments – that were first put in place following the GFC and then supercharged during the COVID pandemic – leading to an even greater increase in fundraising and performance during the peak years of 2021 and parts of 2022. Preqin, a UK-based data provider in the alternatives space, predicts global private alternatives and hedge fund assets under management (AUM) to grow from roughly US$13 trillion in 2024 to over US$23 trillion by 2029, an annual growth rate of 11.5%.[1]

While there's no denying the beneficial impact of government and central bank policies, the catalysts for investing in alternatives that first drove the portfolio construction decisions of certain U.S. endowments and institutions more broadly continues to hold true today. In fact, if diversification, low correlation to traditional equities and fixed income, and the long-term potential to generate attractive returns is what lit the fuse for institutional adoption of "alts" from the start, they are also the primary factors flaming the more recent acceptance of them among other types of investors.

This is especially the case for family offices that have taken a more prominent role over the past couple of years as institutions slowed down new commitments to alternatives funds. Globally, family offices have allocated 42% of their portfolios to alternative strategies, and that grows to a whopping 59% for U.S-based family offices.[2]

Furthermore, the wealth advisory services channel is arguably the most important growth engine for alternative assets going forward. Retail and high-net-worth (HNW) individuals have become much more inclined to allocate a portion of their portfolios to them in recent years, particularly as more managers launch evergreen fund structures that provide some limited liquidity versus classic closed-ended drawdown vehicles that do not. A recent ISS Market Intelligence survey of Canadian full-service dealers indicated that alternative assets under management grew at a 22% compound annual growth rate between 2019 and 2023.[3]

The past few years of higher inflation and aggressive rate hikes created an especially challenged environment that quickly dampened fundraising and performance

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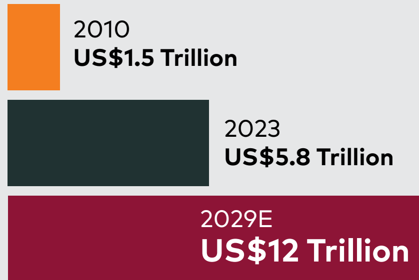
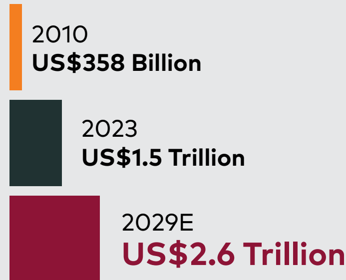
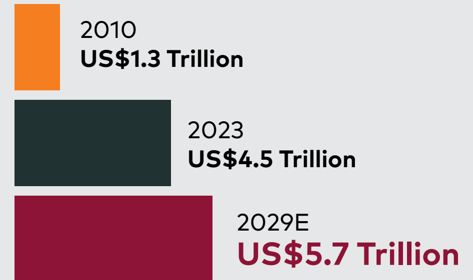
Alternatives Assets Under Management: Past, Present, Future?
(In trillions of U.S. dollars)







Source: Preqin, The Future of Alternatives 2029, September 2024.

across many alternative strategies. However, we also saw certain alternative strategies prove their worth as their performance provided a counterweight to public securities in 2022. Private credit, and more specifically private debt, continued to perform well as it filled a gap in the capital stack as traditional lenders retreated.

Additionally, multi-strategy hedge funds helped to materially limit drawdowns versus public equities. Global investment consultant bfinance's hedge fund composite index for 2022 showed a positive 3.4% return versus public equities indexes that were all pushing up to 20% losses on the year.

So, what's next for alternatives now that central banks are back in rate-cutting mode and the new U.S. White House administration seems set, starting in January, to enact sweeping new government policies?

To answer that question and more, we recently sat down with experts from AGF Capital Partners' Affiliate Managers to examine the issues and trends that have shaped the alternatives market to this point, but are also likely to play a role in the development and performance of some of its key sectors in the future.

Kirk Hamilton, Managing Director at Kensington Capital Partners, provided keen insights into private equity, the largest of the alternative classes by assets under management. Mike Scott, Managing Director at SAF Group, weighed in on private debt, where much attention was directed during the recent rate-hiking cycle, while Scott Radke, CEO and Co-CIO of New Holland Capital, explained the ins-and-outs of the multi-strategy hedge fund universe that has benefited substantially from capital flows in the past few years.

Ultimately, it's been a tremendous run for alternatives investing over the past 10 years. But as the conversation with our panel articulates, there are reasons to believe that the asset class (along with its various parts) can remain an attractive piece of any well-constructed portfolio and may have plenty of momentum still on its side.

– **Ash Lawrence,**
Head of AGF Capital Partners

[1] Preqin, The Future of Alternatives 2029, September 2024.
[2] UBS, Global Family Office Report 2024, May 2024.
[3] ISS Market Intelligence, Special Feature: Retail Brokerage and Distribution Alternatives Overview Spring 2024.

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Central bank policy has been a hot topic for investors over the past couple of years, particularly as it relates to the rise in interest rates to fight rising inflation. How has this shift to less accommodative monetary conditions affected the alternative strategies that each of you manage?

Kirk Hamilton (KH): The prolonged period of lower rates post-GFC fueled an extended period of asset price appreciation in private equity. A large influx of capital was chasing limited opportunities, which led to competitive situations and full valuations for sellers. As rates increased rapidly over 2022 and 2023, fears of a hard landing from a slowing economy also increased, and many private equity firms were forced to become more judicious about their underwriting and how they approached mergers and acquisitions (M&A).

This led to a kind of deal paralysis, whereby sellers were expecting valuations that were equivalent to what was the norm in the earlier era of near-zero rates, but buyers were being more disciplined. More recently, to bridge this value gap, we've seen the creation of more complex transaction structures, some of which include earnout provisions or structured equity solutions that provide sellers the potential to earn future compensation if certain goals are met, while still protecting buyers from downside risks that may be involved.

Scott Radke (SR): The investment strategies in our portfolio are generally insensitive to the absolute level of interest rates, but the pivot from near-zero rates, which we experienced for more than a decade following the Global Financial Crisis, to a higher rate environment did create opportunities.

For example, strategies like Quant Macro produced exceptional returns in 2022 because of the rapid rise in rates and the dislocations this causes in the public markets. And the same was true of many Fixed Income Relative Value strategies.

Increased rate volatility tends to be advantageous for these strategies, whether in the context of rising or falling rates, since it creates more relative value and directional trading opportunities for portfolio managers to exploit. Movements in rates, foreign exchange and the prices of fixed income

securities all encourage end investors to make adjustments in their portfolios, and many hedge fund strategies profit from the liquidity provision associated with facilitating those changes.

Mike Scott (MS): The obvious answer is that elevated interest rates drove up the cost of debt capital and when that occurs it can often cause stress, particularly as it relates to borrowers that are more levered. For borrowers that are not as levered, higher rates haven't been too much of an issue.

In fact, we really haven't seen an acceleration in the level of defaults through this cycle, with the exception perhaps being the real estate sector, where leverage is germane to the investment strategy and where valuation methodologies are more tied directly to interest rate levels. We would have expected to see more defaults in the leveraged buyout (LBO) market, but highly levered LBOs tend to be more of a U.S. phenomenon than they are here in Canada, where private equity sponsors are generally more conservative with the use of leverage and have deep, supportive relationships with the Canadian banks.

Beyond that, higher rates also had an impact on activity levels as some borrowers hit the pause button, maybe because of higher hurdles related to M&A and/or organic growth initiatives, as Kirk noted earlier. So, we just had to work harder to deploy capital than we do today, now that rates are starting to decline.

KH: Another facet of the near-zero interest rate environment was the reliance on inexpensive credit to scale private equity portfolio companies through M&A. What we're seeing now in this higher rate environment is a greater emphasis on organic growth and value creation planning. Sponsors are focused on having a well-defined playbook ahead of getting a deal done, which has often resulted in lengthened deal timelines.

As two of you mentioned (and most investors also likely know), central banks have started cutting interest rates now that inflation has fallen and seems to be under control. How does a monetary easing cycle potentially affect your strategies moving forward?

KH: We expect the M&A environment to come back to life with more capital available for deals and in turn drive the private equity community to sell assets in their portfolio which are ripe for exit. This would lead to higher distributed to paid-in capital (DPI), which in turn would likely lead to a more buoyant fundraising environment for private equity firms to raise capital.

MS: The private debt market has been highly active over the past six months or so. I believe that is clearly a function of rates coming down, but also reflects on balance a relatively stable outlook about the broader macro environment. Plus, borrowers can only hit the pause button for so long. At some point, they just have to say, "This is the new normal and I need to move on." So, I believe that's also a contributing factor as to why activity is up today from where it was this time last year.

Of course, declining rates will also have impact on performance, not just activity levels. And on an absolute basis, it's easy to forecast that private debt investors can expect lower absolute returns. But we expect the asset class will continue to outperform other fixed income options on a relative basis. In fact, our experience suggests private lending can drive wider spreads in a low-rate environment than it can in a higher rate environment because borrowers focus more on the all-in cost of capital versus the credit spread.

SR: Again, it's not the absolute level of interest rates but the moves in interest rates that generally matter more to some of our strategies. And even if the trajectory of interest rates becomes a little more uncertain – perhaps because of the new U.S. administration and its policies – we think that's probably good for future hedge fund returns.

More specifically, what are the most likely opportunities and risks associated with some of President-elect Donald Trump's potential policies?

SR: I believe corporate activity was suppressed heading into the U.S. election because of the uncertainty around it, but now that it's over, we're likely to see the market "unlock" to a certain extent, particularly around M&A activity, as Kirk noted already.

It can also be expected that the regulatory regime under a Trump administration will be more accommodating to deal completion than has been the case under the Biden administration. That's likely going to help strategies like merger arbitrage and other event-driven strategies.

Moreover, a robust equity market has been encouraging secondary issuance, and companies are preparing to test the waters for initial public offerings (IPOs). So, that could help equity capital markets (ECM) strategies that are trading in those situations.

KH: When we think about the potential cornerstone policies of the new Trump administration, we're focused on import tariffs (i.e. increased input costs) and immigration (i.e. wage pressure), both of which could have consequential impacts on price inflation and margins of companies across both public and private equity.

We're also interested to see the reaction of individual U.S. states to potential new federal policies and whether that could lead to a fractured regulatory environment. If some states decide to act independently of the federal government, for instance, that could create risk around some private equity portfolios.

That said, we play in the mid-market so we're generally less susceptible to some of the broader tariff issue, but nobody will be necessarily immune given the scale being talked about by the incoming administration.

Let's talk about some of the trends that are influencing each of your areas of expertise. Kirk, starting with you, why are continuation vehicles (CVs) becoming more prevalent in private equity markets?

KH: It's partly a product of the higher-rate environment and lack of M&A activity that we spoke of earlier. Many sponsors have been reluctant to take businesses in their portfolios to market, but they still need to provide DPI to their investors who either need liquidity or don't mind taking another "lap of the track" if that means more value from the investment can be extracted. So, the option to transfer assets of an existing fund to a new fund through a CV has become an increasingly attractive way for general partners (GPs) to accomplish this balancing act.

For instance, a GP might say to its current investors, "We're going to put together a syndication of new investors that will invest in the existing assets that we continue to have conviction in going forward. You can either roll your equity into this new vehicle, or our new investors will provide liquidity to you if that's what you prefer instead."

Ultimately, CVs are an opportunity for GPs to "take the bull by the horns," which is a positive in my opinion. Moreover, they can help GPs build out a broader base of investors who may not be involved in the existing fund, but may now be prospects for future funds.

Mike, how does the trend towards more stringent bank regulation, particularly in Canada, potentially affect the prospects of private debt?

MS: I think the short answer is the continuation of increased bank regulations within Canada will likely further drive the development and expansion of our Canadian private credit market, which is a positive for investors.

Historically, private credit has been more of a niche strategy within Canada with the market largely being dominated by the Canadian banks. What we have seen over the past few years, however, and is now really starting to accelerate, is increasingly stringent capital and liquidity requirements are causing the lending capacity of the traditional banks to be reduced, and thus creating a funding gap, or shortage, for middle-market businesses within Canada.

This is very similar to what we saw in other global economies following the GFC. While Canada is quite behind our global peers, we are very much in 'catch-up' mode which provides an increasingly attractive environment for private credit investors as we see the Canadian banks retreat from certain lending activities due to capital constraints.

Scott, turning to you now, multi-strategy funds have attracted significant inflows in recent years, which, at times, has resulted in crowded trades. What is the potential implication of this dynamic on your strategies?

SR: The significant capital inflow into multi-strategy funds is being driven primarily by two factors. The first is more muted expectations for future returns in traditional 60/40 portfolios of long-only stocks and bonds, and the second is the strong performance of multi-strategy funds over recent years, including in difficult markets like 2022.

Obviously, we view this trend as a net positive, but it does have implications for our process as it relates to strategy selection, risk management and talent acquisition.

In particular, the trend has encouraged us to create a portfolio that has a different strategy allocation than most other "multi-strats." We do this by emphasizing less scalable strategies that are less of a focus of larger funds. This helps avoid some of the crowding issues that may arise among multi-strats and reduces the risk of getting caught in correlated "unwinds."

And that's my second point about risk. Multi-strategy funds, as a rule, use cutting position sizes as one of the principal tools for risk management, however, cutting risk in the face of losses becomes a self-reinforcing cycle as more capital pursues the same kinds of trades and seeks to shed the same type of risk simultaneously.

In terms of talent acquisition, we've all seen the headlines of eye-popping guarantees to poach traders from one platform to the next, but we've tried to sidestep this by focusing on experienced traders who want to run their own business, a part of which includes investing for New Holland, rather than being an employee of one of the large multi-strategy funds.

Another aspect of alternatives investing that is garnering headlines is liquidity, or lack thereof, as access to strategies becomes more readily available to a wider base of investors, including retail and high-net-worth individuals. What is your take on the tradeoffs involved in this debate?

SR: Liquid "alts" managers that provide daily liquidity are becoming more prevalent in the hedge fund universe that New Holland often gets categorized. Typically, these are quantitative strategies that tend to offer daily liquidity and focus on the deepest, most liquid markets where alpha generation is particularly challenging. Our focus has been to offer liquidity terms to our investors which allows us to concentrate on markets that may be slightly less liquid, but that we believe are more fertile areas for investment.

KH: It's great that the private equity space is evolving such that more people can access investments that were once reserved for institutions and extremely wealthy individuals and family offices.

A big part of that is the growing prevalence of evergreen funds (versus more traditional closed-end funds), which provide some level of liquidity. Ultimately, though, we believe investors should consider private equity as a long-term investment because value creation isn't linear and liquidating the investment prematurely will likely lead to a suboptimal outcome. This may be especially true nowadays given the current climate of higher rates and weaker M&A activity, which has made exiting positions more complicated.

MS: Picking up on Kirk's comments, the evergreen structure is incredibly attractive for investors. There is a surprising amount of natural liquidity within them, and there are some studies showing that investing in an evergreen structure versus a closed-ended structure may produce higher returns, in part, by allowing investors to put capital to work sooner and remain fully invested throughout their investment time horizon.

For managers though, there are some challenges to evergreen funds around managing liquidity and deployment. In a closed-ended vehicle, you control when to go out to the market to raise capital, but also how much and from whom you are raising capital. The key then, in an evergreen strategy, is to be hyper-focused and disciplined to ensure that you're matching fundraising with deployments and not bringing in more capital than needed for your investment thesis.

Final question: What do you think are the reasons to allocate capital to alternatives, particularly at a time when more traditional investments like publicly traded equities have performed exceptionally well over the past couple of years?

SR: The goal of our strategies is to produce a return stream that has attractive expected returns while being diversifying to the equity risk that dominates most investors' portfolios. So, if you're at all concerned about the future returns from more traditional asset classes, then exposure to alternatives like hedge funds can be an important tool to capture different sources of alpha and return for your portfolio.

KH: Private equity has proven over decades that as an asset class it can generate exceptional returns if held over the medium to long term, which is why we believe for retail investors that it lives in a portfolio somewhere between your house, the ultimate illiquid asset, and public equities that you can buy and sell daily.

MS: Everyone's investment situation is unique and there are always going to be periods of time when one asset class or sector is going to outperform another, followed by periods when the opposite is true. But we believe private debt is an attractive option for an investor that is seeking to generate attractive risk-adjusted returns over the long-term versus trying to time the market.

It's an all weather asset class that we view as being "boring," and you're very unlikely to see huge wins, but what you're potentially going to get is steady risk-adjusted returns throughout different economic cycles, with low correlations to other asset classes and a consistent cash yield.

Please see Disclaimer section for full disclosure.

CONTRIBUTORS

Ash Lawrence

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As Head of AGF Capital Partners, Ash and his team identify tenured managers with demonstrated investment expertise in their fields, structuring partnerships to offer long-term strategic support, resources and capital to sustain and enhance the partners' growth. Ash and his team are continually looking to diversify and expand the business' capabilities and alternatives offerings to meet clients' evolving needs.

Prior to joining AGF Investments, Ash spent 16 years with Brookfield Asset Management working in real estate investments and portfolio management in North America and Brazil, ultimately leading the Canadian real estate business. Ash also has experience in financing municipal infrastructure projects and developing infrastructure and transportation solutions for private and public sector clients.

Ash earned an MBA from the Rotman School of Management and a Bachelor of Applied Science in Civil Engineering from the University of Waterloo.

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As Managing Director at Kensington Capital Partners, Kirk is focused on private equity and sits on the board of several Kensington investments including Resolute Health Corp., White Swan Environmental, AGNORA and Clearpoint Health.

Prior to joining Kensington, Kirk led M&A for global commodity trader Stemcor Holdings, based in London, United Kingdom. While at Stemcor he worked through two global restructurings and the sale to Apollo Global Management. Kirk started his career working in London in the European investment banking and M&A teams for Scotia Capital and RBC Capital Markets focusing on natural resources M&A and ECM as well as with a UHNW family office where he worked on a number of major transactions in the mining, oil & gas, and industrials sectors.

Kirk holds a B.Sc. Eng. (Civil) from Queen's University.

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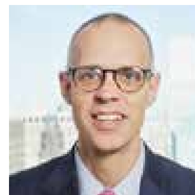
As Managing Director at the SAF Group, Mike is focused on origination, structuring and portfolio management and is responsible for management of the AGF SAF Private Credit LP.

Prior to SAF, he was the National Head of CIBC's Leveraged Finance Group – a business focused on executing senior and mezzanine debt placements to support leveraged buyouts within Canada and the United States. Also integral to his role, Mike oversaw all private equity investments. Prior to CIBC, he held a finance and operations role with a national retailer and served in a corporate banking role with a Canadian chartered bank.

Mike holds a BBA in Finance from Simon Fraser University and is a Chartered Financial Analyst.



Scott Radke

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As CEO of New Holland Capital (NHC), Scott is responsible for leading, implementing, and growing the firm's business activities. As Co-CIO, he is responsible for portfolio management, investment research and portfolio risk with a focus on both liquid and illiquid strategies.

Prior to the launch of NHC in 2006, Scott was a member of the Hedge Fund Group within a Dutch pension. Before that, he was a VP at Citigroup Global Markets and previously an Associate within the Insurance-related Structured Transactions Group at Goldman Sachs.

Scott graduated magna cum laude from the University of Michigan with a BSE in Mechanical Engineering and received an MBA in Finance with distinction from the Wharton School of the University of Pennsylvania.

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AGF Capital Partners is AGF's multi-boutique alternatives business with diverse capabilities across both private assets and alternative strategies. Clients benefit from the specialized investment expertise of Affiliate Managers combined with the organizational support and breadth of resources of AGF Management Limited (AGF). With over 18 years average experience, AGF Capital Partners Affiliate Managers' Kensington Capital Partners Limited, New Holland Capital, LLC and SAF Group manage approximately C$13.5 billion in alternative AUM and fee earning assets on behalf of institutional and retail clients. Affiliate Manager AUM may not be consolidated into AGF Management Limited's reported AUM. US AUM converted FX rate at December 31, 2024 (1.44).

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Kensington Capital Partners is a leading independent Canadian investor in alternative assets. Since its inception in 1996, and with offices in Toronto, Vancouver, and Calgary, Kensington has invested over $2.6 billion in private equity, venture capital, and other alternative assets. Kensington's active management and relationship-driven approach have consistently delivered top-quartile returns for investors. Kensington is affiliated with AGF Management Limited, a $45 billion globally diverse asset management firm serving over 800,000 investors across public and private markets. For more information, visit https://kcpl.ca/

About New Holland Capital, LLC

New Holland Capital, LLC is an alternative investment manager that manages over US$6B in absolute return strategies for institutional clients. The firm seeks to generate alpha across a wide set of diversifying strategies, with a preference for niche, capacity constrained opportunities often with emerging portfolio managers. For more information visit https://newhollandcapital.com/

About SAF Group

Founded in 2014, SAF Group is one of Canada's leading alternative credit providers having committed approximately $4 billion investment capital across 50+ transactions to date. SAF's team manages structured credit and equity investments across various industries. With 40 professionals across offices in Calgary and Vancouver, SAF leverages a deep bench of investment professionals to provide flexible and long-term capital solutions to public and private corporations while providing stable and attractive risk-adjusted returns for investors. For more information visit https://safgroup.ca/

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