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FINANCIAL GROUP

PERSPECTIVES

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Each month, our experts decipher trends, opportunities and strategies shaping the financial universe of informed investors. Discover nuanced analysis and insights to guide your wealth management decisions. Forged by experience and driven by innovation, our perspectives help you build a sustainable financial legacy.

ALTERNATIVE INVESTMENTS: LOOKING BEYOND COMMON MISCONCEPTIONS

Investors are increasingly asking themselves how to achieve higher returns when stock markets are volatile and bonds do not necessarily cover inflation. Institutional investors have found an answer: in exchange for less liquidity, alternative investments offer significantly greater returns than traditional assets.

From 2004 to 2023, alternative investments outperformed traditional assets by 4%, according to research quoted by the Chartered Alternative Investment Analyst Association. Pension funds and university endowments understood this advantage several years ago, in some cases allocating up to 50% of their assets to alternative investments.

This strategy is now gradually becoming more widely available to individuals, whose investments in this area still represent only a tiny fraction of their assets—barely 2% in 2020, according to consulting firm McKinsey. While this trend has gained more momentum in the United States and the United Kingdom, significant work remains to be done in Canada and Quebec to raise awareness of these opportunities among the investing public.

Genuine diversification: moving on from the 60/40 model

Investors have long believed that the traditional portfolio model, with 60% equities and 40% bonds, provides adequate diversification. Today, a more sophisticated approach can be found. Alternative investments not only provide access to assets with lower correlation to traditional markets but also allow investors to invest in asset classes that are not as accessible to individual investors, such as infrastructure and private equity.

The unique combination of low correlation and access to new asset classes is central to the appeal of alternative investments for a truly diversified portfolio. Some of these assets, particularly infrastructure, also offer natural protection against inflation thanks to indexed contracts, a valuable benefit for both institutional and retail investors. However, diversification does not end here; it must also be applied within alternative investments themselves. A well-constructed portfolio therefore combines different alternative asset classes, each meeting specific needs, to maximize diversification.
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Lower volatility and superior adjusted returns

This diversification brings a tangible benefit: volatility that is often lower than that of public markets. Contrary to a popular assumption, alternative investments do not necessarily carry more risk than traditional assets. These assets are priced monthly, quarterly, or annually, rather than daily; as a result, they do not react to daily market fluctuations or breaking news. In addition, the combination of this stability and low correlation contribute to portfolios' Sharpe ratio (a key indicator of risk-adjusted return). And that is precisely what institutional investors are looking for: a greater return for a given level of risk.

The illiquidity premium: a return justifying the risk

The main source of superior returns in alternative investments results from the illiquidity premium. While a traditional bond portfolio may carry an expected annual return of 3% to 4%, private credit strategies, for example, can easily aim for twice that, a difference that can be explained by the longer investment horizon.

This is because banks have become more cautious, lending less from their own balance sheets. The resulting void is therefore filled by private credit managers, who are willing to fund quality companies while maintaining disciplined risk management.

Not surprisingly, the question of investment horizon raises the issue of liquidity, which has historically hindered the adoption of alternative investments among individual investors. While traditional products have typically involved 10- to 15-year horizons, a structure well suited to pension funds but less so to individuals, things are quickly changing. For example, large U.S. institutions have begun creating alternative funds offering monthly liquidity, thereby meeting investor needs while maximizing sources of potential returns.

This difference in requirements is reflected in the recommended allocations. While we advocate for individuals to allocate 5% to 20% of their portfolio to alternative investments, it is not uncommon to see institutional investors, such as pension funds, allocate 30% to 50% of their assets to alternative investments. With such flexibility, previously inaccessible opportunities become possible, including access to world-class companies that are not publicly traded, such as OpenAI, SpaceX, or the UFC.

Disciplined selection: complementarity is key

To take full advantage of these opportunities, complementarity is a fundamental principle in building a performing alternative portfolio. Simply investing in alternative investments is not enough; it is also necessary to ensure that the chosen strategies do not overlap.

In private equity, for example, several approaches can coexist within the same portfolio. While some strategies target larger, more mature companies, others focus on the secondary market, where existing stakes (sometimes at a discount) can be found, thereby reducing the investment horizon. Finally, venture capital focuses on early-stage, fast-growing companies.

This search for complementarity also applies to private credit and real estate. A diversified private credit portfolio, for example, can include corporate debt, real estate debt, and perhaps even more niche assets such as music royalties. The real estate sector also allows traditional residential assets to be combined with specialized assets, such as seniors' housing.

Incidentally, Quebec is home to an attractive ecosystem of alternative managers. Cogir, for example, has made a name for itself in residential real estate and seniors' housing, while Axium has earned a reputation as one of the world's best managers of core infrastructure—stable and predictable assets, such as wind and solar farms, that generate both recurring and stable income. Inovia Capital, specializing in private equity and venture capital, is also worthy of mention. Such diversity in managers and strategies helps build genuinely complementary portfolios.

A few risks to consider

Although alternative investments offer an attractive risk-return profile, they carry certain specific risks. Managers' internal valuations may artificially smooth volatility and only partially reflect actual market conditions. In addition, certain funds may impose closure mechanisms that temporarily limit redemptions, while operational risks related to the manager (key team changes, compliance, governance) and sector risks (venture capital technology cycles) remain factors to monitor closely.

Our approach to trends shaping the future

We feel that two asset classes stand out in the current market environment: private credit and infrastructure. The first benefits from the gradual withdrawal of banks, creating an opportunity for private credit managers. The second is driven by exponential demand for data centres and renewable energy, fuelled by artificial intelligence and the energy transition. Major technology companies—Google, Microsoft, OpenAI, Meta—are investing heavily in these essential infrastructures, creating sustained demand. Conversely, traditional commercial real estate—office towers and shopping malls—continues to face challenges related to remote working and online business.

Eterna's alternative investment strategy spans the main asset classes in this sector: infrastructure, private credit, private equity, and real estate. These strategic choices are based on three factors that, over extended periods, generate superior adjusted returns: the illiquidity premium, diversification, and low correlation with traditional assets.

Alternative investments are no longer the preserve of large institutions. With proper structures and disciplined selection, they are an appealing component of a modern portfolio. While access to these investments keeps growing for retail investors, joining well-established institutional players, the field remains largely unexplored.

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