

The AIMA logo consists of a dark blue square with the word "AIMA" in white, sans-serif, uppercase letters. Below the square is a horizontal purple bar.

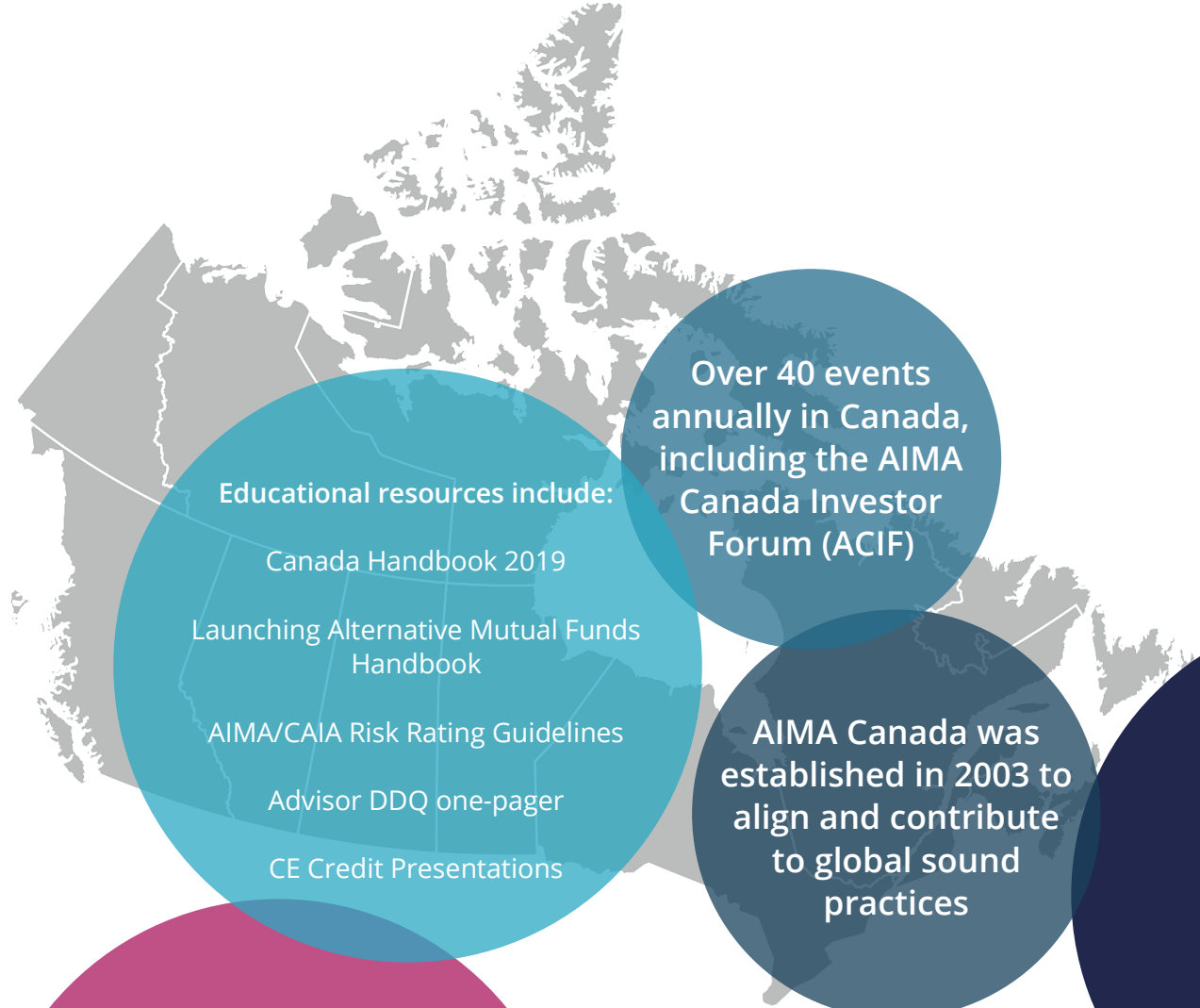
AIMA

AIMA Canada Handbook 2019:

A Report on the Canadian Alternative Investment Landscape

Presented with:

ScotiabankTM



Educational resources include:

- Canada Handbook 2019
- Launching Alternative Mutual Funds Handbook
- AIMA/CAIA Risk Rating Guidelines
- Advisor DDQ one-pager
- CE Credit Presentations

Over 40 events annually in Canada, including the AIMA Canada Investor Forum (ACIF)

AIMA Canada was established in 2003 to align and contribute to global sound practices

Local committees include:

- Legal, Finance & Compliance Committee
- Investor Engagement
- Quebec Regional
- Education & Research
- Programming & Events
- Western Regional

AIMA Canada shares guidance with CSA regulators, including OSC & AMF

Investor focus includes institutional, family offices and retail investors

Over 140 corporate members in Canada, including institutional and retail investors

For more information about AIMA Canada:

Claire Van Wyk-Allan, CAIA

Director, Head of Canada, AIMA

cvanwykallan@aima.org | 416-453-0111

AIMA
THE ALTERNATIVE
MANAGEMENT

AIMA Canada is a subsidiary of
the Alternative Investment
Management Association

AIMA was
originally founded
in 1990

AIMA's quarterly
Journal shares
thought leadership
published by
members

Access to over 25
industry guides,
modular DDQ for
investment managers
and 8 other DDQs

Globally, AIMA has
offices in New York,
Washington DC,
London, Brussels,
Singapore, Hong Kong,
Shanghai, Sydney and
Tokyo

AIMA has over 900
regulatory and
policy contacts

Global Groups include:

Investor Steering Committee

Investor Relations & Business Development

Sounds Practices

Next Generation Manager

Digital Assets & Blockchain

Operational Due Diligence

AIMA holds over
250+ events globally,
including over 10
flagship events





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Introduction: AIMA's Head of Canada



By: Claire Van Wyk-Allan,
CAIA

Director, Head of Canada,
AIMA



THE EVOLUTION OF ALTERNATIVE INVESTMENTS IN CANADA

When the Alternative Investment Management Association (AIMA) first opened a branch in Canada 16 years ago, the hedge fund sector was small but burgeoning. Back in 2003, AIMA had just 38 corporate members in Canada, many of whom were niche hedge fund managers selling only to wealthy high net worth clients.

Today, with approximately 140 Canadian member firms and approximately 2000 members globally, AIMA's network has never been stronger. Our membership has evolved like the industry it supports, with institutional investors, family offices and private debt managers becoming key parts of its membership, alongside the traditional asset managers who are increasingly entering the world of alternative investments with newly regulated alternative mutual funds and ETFs (liquid alts). So much is the focus by our members on private debt strategies that AIMA launched a dedicated private debt body – the Alternative Credit Council (ACC), which has now proudly come to Canada with a local committee.

As identified in AIMA's recent research paper [*Perspectives: Industry Leaders on the Future of the Hedge Fund Industry*](#), the next level of industry transformation will be client- and technology-driven. Both in Canada and around the world, alternative investment management firms are evolving rapidly to meet changing client demands and expectations. The pace of technological change and the rise of disruptive technologies like artificial intelligence (AI) are pushing hedge

fund firms to re-evaluate who they hire, how they operate and how they invest. From "AI" and algorithm-based strategies to cryptocurrencies and automated portfolio management, the next iteration of alternatives offerings must innovate to retain their competitive advantage. At the same time, hedge funds have to contend with increasing investor demands for ESG considerations and more responsible investment. It's no longer just enough for hedge funds to do better—they must do good as well.

Canada is well-placed to thrive during this next phase of innovation as our country has long been a pioneer in the hedge fund and alternatives space, led by the strength of our pension system and proliferation of specialised talent. Many Canadian asset managers focus on both institutional and advisor channels, while the retail client base continues to evolve with liquid alternatives steadily growing in numbers and popularity. The true beneficiaries of these developments are investors, who have greater access than ever before to products that can offer the diversification, reduced volatility and non-correlated return benefits they deserve.

With that backdrop in mind, we are thrilled to bring you this *AIMA Canada 2019 Handbook: A Report on the Canadian Alternative Investment Landscape*, capturing these aforementioned current themes and more. Following the last edition in 2014, it updates key regulatory considerations and gives a very investor-focused picture of the world of alternatives in Canada.

With any industry, the real value is its people. This is equally true of our AIMA Canada community who collaborate and contribute to help push our industry forward for the better, together. I am grateful, passionate and proud to serve your behalf, working persistently towards our vision, to lead the alternative industry in Canada toward an increasingly bright future while lowering barriers between jurisdictions; our local and global mission with an unwavering focus on educational programming and regulatory advocacy; and our purpose, to bring the best of alternative investments to all investor portfolios.

Whether you are an investor, manager or service provider, we hope that this handbook enlightens you on our vibrant and growing industry and the talent within it. And whether you are based locally or abroad, AIMA Canada remains steadfast in our commitment to help lower barriers between jurisdictions, bringing the best of our alternative investment industry to the world, while also enticing the best of the world to come to Canada.

We look forward to welcoming you here!

Best,

A handwritten signature in dark ink, reading "Claire Van Wyk-Allan". The signature is written in a cursive, flowing style.

Claire Van Wyk-Allan, CAIA
Director, Head of Canada, AIMA

Introduction: AIMA Canada's Board Chair



By: Belle Kaura,
BCL, LLB, LLM, ICD.D
VP Legal,
Chief Compliance Officer
Third Eye Capital
Chair, AIMA Canada
(2018-2020)



CHARTING A COURSE FOR THE FUTURE

This is an unprecedented time of innovation and opportunity for Canada's alternative investment management industry.

We are nearing the end of a decade-long bull market during which alternative assets experienced exponential growth and popularity worldwide. Alternative assets are increasingly becoming a mainstream integral part of investor portfolios with allocations rising across a broader investor base – forecasted to hit \$14 trillion by 2023.

In this late-cycle as we head into a more challenging market environment, with global quantitative tightening, trade wars and escalating macro-economic concerns, investors need to prepare for volatility of equity markets and declining fixed income returns. Investors can no longer rely on the traditional 60/40 public markets model.

The stage is set for a dominant role to be played by alternative assets – alternatives can provide resilience and returns. Investors are looking for ways to diversify their portfolios and protect against downside risk through non-correlated risk-adjusted returns. History has proven that unlike public markets, alternatives have delivered returns in positive and negative economic conditions.

The right mix of alternative assets in a diversified portfolio can provide investors with defensive and offensive investment solutions. Disciplined allocation will empower investors to target desired returns, risk reduction and liquidity management to meet their investment needs.

Core assets like real estate and quality private credit can generate income streams and provide stable returns with modest leverage. Market neutral strategies also act as a hedge to volatility. Market volatility creates opportunities for tactical strategies that capitalize on market inefficiencies. Short-term short statistical arbitrage, merger arbitrage and factoring hedge funds exploit inefficiencies. Relative value strategies are designed to perform in uncertain conditions. Strategies such as distressed debt target opportunities in downturn conditions and can act as return enhancers.

This year marked a landmark change for Canada as retail investors gained access to the benefits of alternative strategies for the first time. The advent of liquid alternatives is transformational for retail investors and the asset management industry.

Retail investors are now better able to seek risk adjusted returns and build a balanced portfolio to meet their financial goals through the use of alternatives.

Retail demand is expected to drive widespread adoption of liquid alternatives which is forecasted to be a \$100 billion market by 2025. Advisors and investors are navigating changes to the market, the regulatory landscape and a myriad of new hedge-fund like products being launched by both boutique managers and traditional asset managers. Distribution channels are expected to expand as dealers implement AIMA / CAIA risk rating parameters that ensure investors have more fair access to alternative strategies. We will see growth and diversification in the number and type of investment strategies which will bring new challenges of distribution and market saturation which could lead to erosion of private hedge fund sales in Canada.

The technological revolution is giving rise to an era of innovation and disruption. The digital transformation phenomenon is a double-edged sword as the industry races to meet the challenges it presents and embraces the transformative potential of technology to gain competitive advantage. The winds of change will force managers to dial into the technology disruption for fear of being left behind. The industry will be re-shaped by managers harnessing the power of data analytics to find investment opportunities, enhance portfolio management and improve investor reporting. We are just on the cusp of major disruption with only a small margin of 10% of managers using artificial intelligence and machine learning today. Technology will be the single most important wave of the future.

There has been a remarkable rise of environmental, social and governance (ESG) which now accounts for over \$20 trillion in AUM - a quarter of all professionally managed assets in the world. Markets are now grasping that integration of ESG leads to better investor returns, more sustainable markets, reduced risks, and better outcomes for societies. Integration of ESG is becoming more mainstream with a shift in perspective by managers viewing ESG as a positive strategic objective rather than a tick-the-box necessity of doing business. Allocators are forcing the alternative industry to catch up with ESG trends in other markets by demanding ESG incorporation.

Sophisticated institutional investors with enhanced expectations are driving changes to usher in a new equilibrium. Closer alignment of investor and hedge fund manager interests is being created through the push for: bespoke investment mandates; co-investing options; value advisory services; better more transparent communication; and deeper partnerships. Investors are exerting fee pressure on managers resulting in more use of tiered fees and hurdle rates – with the 2 and 20 model quickly becoming a thing of the past. This quest for greater alignment underscores experienced investors demand for greater value for their dollars.

The alternative industry is facing headwinds from all sides with stretched valuations; intense competition; rising investor demands; closer alignment of interests; fee pressures; and increasing pressure to deliver results – all making it harder to generate alpha. Asset classes are also facing a range of issues specific to their arena.

Changing investor expectations for greater transparency and value, investor demands for responsible investing and the broadening of the investor base will drive the necessity to adapt and force firms to re-think the investment solutions offered. The pace of change and innovation will be intensified by the strong force of technology disruption. The bar will be raised on the skill level, knowledge and judgement asset managers must possess in the new normal. The shifting landscape will require the industry to display a high level of versatility and adaptability. To meet the evolving challenges the industry must embrace foresight and innovation. From creating new investment solutions to implementing new technology - investment firms are readying themselves to meet the challenges of the future.

Canada has a long-history of excellence in alternatives, as seen by the success of early adoption by Canadian pension plans. The regulatory sentiment supports the growth of the industry with the launch of the alternative mutual fund framework earlier this year. Canada has an extensive talent pool in alternative investments and new channels for growth in the retail market. The Canadian alternative industry is poised for success on the private and public alternative front and is ready to enter the new era of innovation.



AIMA is the pre-eminent global voice of the alternative asset management and is committed to playing a pivotal leadership role in promoting and shaping the Canadian alternative industry. AIMA Canada members have the benefit of the global reach of a world-class association as markets around the world become increasingly interconnected and firms operate in a global environment. To better serve private lenders and managers in the burgeoning private debt space, AIMA launched a Canadian committee of the Alternative Credit Council (ACC) this year. This Canadian contingent of the global ACC benefits from global expertise and relationships while providing the local market an opportunity to bring the Canadian context to the forefront. I am proud to champion this expansion into Canada, as both Chair of AIMA and as part of a Canadian private credit shop.

We will continue to strive to deliver on AIMA's global and local proposition through efforts to advance the industry and promote broad distribution of alternatives in Canada. We are grateful for your support and honoured to represent your interests. We hope that you will find this report developed with the insights and support of our Canadian members to be a helpful resource.

Sincerely,

Belle Kaura
VP Legal & CCO, Third Eye Capital & Chair, AIMA Canada
Board of Directors & Executive Committee, 2018-2020

Introduction: AIMA Global Sponsoring Partner, Scotiabank



By: Daniel Dorenbush,
MBA, CFA

Managing Director, Head of
Canadian Prime Services,
Scotiabank Global Banking
and Markets

AIMA Canada Executive Committee
Member 2018-2020

ScotiabankTM

Scotiabank is proud to sponsor this *AIMA Canada Handbook 2019* to help investors better understand the Canadian alternative investment landscape, and support fund managers who create and manage the products that make it an exciting place to invest.

At Scotia, we are committed to thought-leadership in alternative mutual funds and hedge funds, and excellence in delivering comprehensive transaction expertise and innovative ideas to help these funds succeed.

This is an exciting time for alternative fund managers – and for investors – in Canada. Earlier this year, Canadian securities regulators published important reforms that created alternative mutual funds, or “liquid alts”. These new products open up hedge fund-style strategies to the Canadian retail market – a market that is dominated by large asset managers, with the top-15 institutions managing c. 95% of the \$1.57 trillion mutual fund market in Canada¹. Today, a broader range of retail investors can benefit from the many advantages an alternative fund can provide, including enhanced returns, lower volatility and risk, and diversification.

We have seen a number of traditional hedge fund and mutual fund managers diversify the investment solutions on their shelf by adding liquid alts to their product line-up.

Since the launch of this new prospectus fund category, the alternative mutual fund market has reached more than \$4.5 billion (September 2019²), made up of a combination of both organic investment and reallocation of assets under management from both existing mutual funds and hedge funds.

To support awareness and adoption of these new products, we are proud to have launched the Scotiabank Alternative Mutual Fund Index. The first and only of its kind, our Index lets investors track the performance of Canadian Liquid Alternative Funds, and demonstrates Scotiabank’s commitment to leadership in the alternative fund space.

As the alternative fund industry in Canada grows, industry associations like AIMA become more valuable than ever. Scotiabank is excited to partner with key industry players, both fund managers and investors, to encourage growth and innovation into the future.

¹ Source: IFIC; company reports; Scotiabank Global Banking and Markets

² Source: Company reports, Scotiabank Global Banking and Markets

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Opportunities for managers, as Canadian pensions adapt



By: Alana Johnston Gould,
CPA CA

Director, Prime Services
Capital Introduction,
Scotiabank Global Banking
and Markets

Scotiabank™

Canada is home to some of the largest and most sophisticated investors in the world. The most prominent of these investors are Canada's pensions, with the top 10 collectively managing over CAD\$1.5trn in assets¹.

There is much discussion of the 'maple' model of Canadian pension investing, the pillars of which include sophisticated global investing teams, extensive use of alternative investments, political independence, and comprehensive due diligence and risk management.

Canadian pensions are facing a raft of new opportunities and challenges, including growing geopolitical risk, expanding external manager programs, increasing emerging market exposure, enhanced risk management, and commitment to sustainable investing. As these much-admired investors consider those emerging themes, we see considerable opportunities for managers to create partnerships with Canada's pensions.

Growing geopolitical risk

"As an organization nearly 85% invested outside of Canada, we... pay close attention to the geopolitical environment. In fiscal 2019, this theme loomed especially large, with the growth of protectionism, trade uncertainty and growing trade tensions – particularly between the United States and China."

(CPPIB Fiscal 2019 Annual Report, pg. 5)

Canadian pensions have been key beneficiaries of globalization, capitalizing on their ability to access investments on a global scale – specifically via direct investment in infrastructure and real estate. However, their significant global investment programs, most of which are in long-term assets, have also increased their exposure to geopolitical risk. These risks involve both developed and developing markets and are expected to be the biggest challenge for Canadian pensions.

Rising political instability, including policy uncertainty, has come to the forefront recently. Contributors to this rise in geopolitical risk include: the US/China trade dispute, Brexit, international sanctions and growing sovereign debt.

While Canadian pensions operate at arm's length from governments within Canada, their investments could be materially impacted by both foreign and domestic government policy.

To mitigate the risk, it is crucial for Canadian pensions to understand the challenges in each market where they invest and their potential impact on both returns and future opportunity sets. One of the ways they are doing this is by hiring on-the-ground expertise, including external fund managers. Managers who can demonstrate their expertise in specific jurisdictions, and emerging markets in particular, are better positioned to develop long-term investment and co-investment relationships with Canadian pensions.

Expanding external manager programs

“Ontario Teachers’ selectively allocates capital to key external managers in order to access specialised talent and investment opportunities where it is not efficient or practical to maintain the equivalent in-house.” (Ontario Teachers’ Pension Plan 2018 Annual Report, pg. 23)

“[Healthcare of Ontario Pension Plan] is growing our Derivatives and Fixed Income department and we have added an External Managers program to the group. The program will provide HOOPP with an attractive and diversifying return-to-risk profile that complements our internal trading program. The mandate involves making long-term direct investments and investments on a managed account platform.” (HOOPP job posting – PM, External Managers Program, Derivatives and Fixed Income)

One of the pillars of the Canadian pension model has been hiring in-house investing teams to develop sophisticated global investment programs. These internal teams have helped keep costs down, while also developing best-in-class investing expertise. To supplement their in-house teams, most of Canada’s largest pensions have also established external manager programs. These programs are always looking for alpha-generating external managers with capabilities that complement their internally managed portfolio.

When managers frame their conversations with Canadian pensions, they should keep in mind how they add value. Canadian pensions are very interested in managers and strategies that add additional coverage for large markets and provide ‘on the ground’ experts in geographies where pension funds do not have a physical presence. They are also attracted by managers who cover niche sectors where the individual investments are too small on an individual basis to be covered in-house but, once aggregated, are meaningful enough for portfolio allocation. Finally, Canadian pensions seek managers who cover specialized markets and strategies where significant experience is required.

Once managers are identified, Canadian pensions conduct extensive investment and operational due diligence. In our experience, this process can be intensive and lengthy, but the end result is aimed at creating long-term partnerships with sizeable investments and co-investments potential. Managers should be prepared for a significant up-front time commitment along with annual on-site due diligence reviews and ongoing investment monitoring.

Increasing emerging market exposure

“Pillars of our 2025 plan include investing up to one-third of the Fund in emerging markets such as China, India and Latin America, increasing our opportunity set and pursuing the most attractive risk-adjusted returns.” (CPPIB F2019 Annual Report, pg. 9)

Canada’s pensions are not immune to the search for attractive risk-adjusted returns in the current low interest rate environment. Emerging markets are a growing economic power that can provide both yield and growth opportunities in public securities, private markets, infrastructure and real assets.

One of the largest opportunities as developing economies advance and modernize, is the need for significant investment in infrastructure and real assets. Canadian pensions find these investments attractive due to their long-term nature, risk/return potential, diversification, and the lack of correlation to the global equity markets.

Increasing sovereign debt loads have also made these private/public partnerships attractive to governments for projects where they may not have considered private investment in the past.

Canadian pensions are using both in-house and local resources to understand the potential in each specific emerging market, and the risks that must be managed before, during and after investment. We believe there is considerable opportunity for partnerships with managers who have a strong local presence or have significant expertise in these markets.

¹ Source: Pension websites and annual reports



Enhanced Risk Management

“La Caisse attaches great importance to risk management, which is an integral part of its activities in both its portfolio management and business processes... In managing its risks, la Caisse takes into account factors such as global economic conditions, changes in financial markets, and sectoral and geographic concentrations in the portfolio.” (Caisse de dépôt et placement du Québec 2018 Annual Report, pg. 53)

As Canadian pensions have evolved, so too have their risk management functions. The amount and quality of data available for analysis has increased dramatically as technology and software advancement allow for a near-infinite amount of reporting. Risk teams work with both internal and external investment managers to identify and track risks at both the portfolio and plan level. As a result, Canadian pensions are demanding greater transparency in their investments.

To help manage the volume of data and extract valuable reporting, several Canadian pensions have created partnerships with one or more managed account platform providers. These service providers offer comprehensive portfolio aggregation, plus risk management and reporting solutions. As a result, we have seen a shift from co-mingled LP investments to separately-managed accounts (SMA) and Funds-of-One. These structures can provide increased transparency, additional control over fees, and the ability to more easily conduct portfolio aggregation risk assessments. Managers should be prepared for these structuring, transparency, and risk discussions when engaging with a Canadian pension.

Commitment to Sustainable Investing

“As a Principles for Responsible Investment (PRI) signatory since 2010, AIMCo has committed to considering environmental, social and governance (ESG) factors across investment processes, to foster sustainable, long-term growth while capturing risk-adjusted returns.” (AIMCo 2018 Annual Report, pg. 39)

Canada's large pensions have been early adopters of environmental, social and governance (ESG) principles in their investing process.

We believe this is the result of several factors. First, sustainability is a key factor when analysing long-term investments. Second, pensions are increasingly aligning their investment philosophy with the values of their annuitants. Finally, as industry thought leaders, we believe Canadian pensions enjoy being at the forefront of investment analysis, with ESG factors incorporated directly into investment analysis, rather than serving as a stand-alone category of investment.

Looking Forward

Canadian pensions have a proven ability to innovate, whether with infrastructure and real asset partnerships, SMAs, ESG risk assessments, or on-the-ground offices in emerging economies. As they continue to adapt to current opportunities and challenges, we believe there are significant opportunities for managers to offer their expertise and create long-term, mutually beneficial partnerships.

Putting Alternatives to Work in Your Portfolio

AIMA



Think of your balanced portfolio like a HOCKEY TEAM

3-4 lines of talent

- ✓ 2 wingers
- ✓ 1 balanced/all-around centre
- ✓ 2 defence
- ✓ 1 goalie



Similar to a team, an investment portfolio requires that you balance who is playing offence (getting returns) versus defense (protecting on the downside).

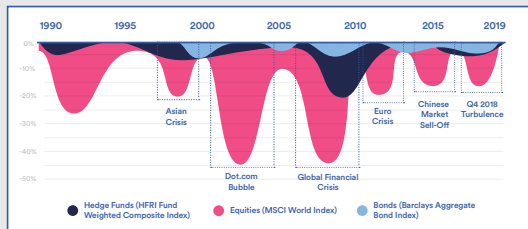
Most hedge funds act like your defence or goalie. They can still score goals, but are mostly working to protect the downside.

?

Did you know? Investors value the broader toolkit available to alternative investment managers for the diversification, volatility reduction, downside protection and non-correlated return benefits they can provide.

Market volatility happens. Then what?

Hedge funds and alternative investments provided better protection than equities and bonds in periods of extreme market volatility.



Hedge funds and alternative investments helped protect on the downside.

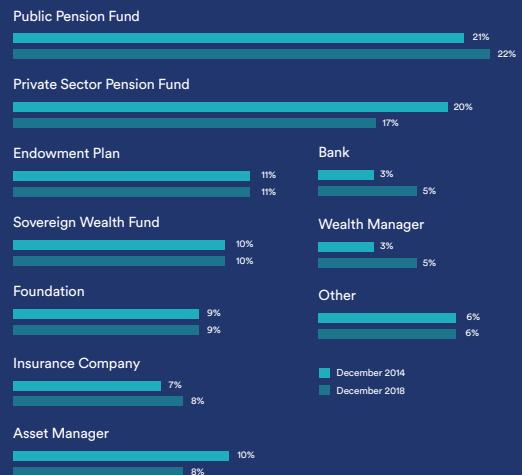
Think of it as buying insurance for your home: Alternatives can act as insurance to minimize losses during market corrections.



You're in good company.

Who invests in alternative investments globally?

Hedge funds play a vital role globally for the institutions that look after everyone's pension and savings.



Average allocation to alternatives by advisors globally: **10%**

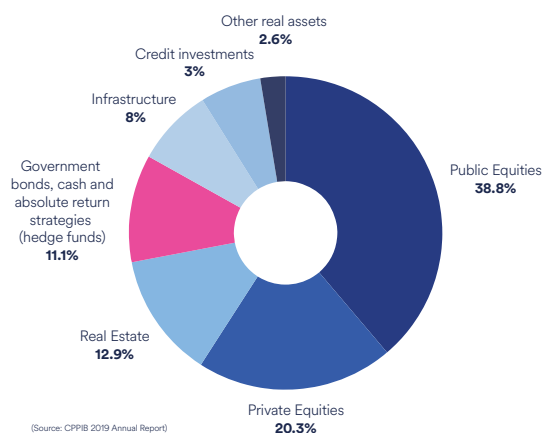
(Source: Preqin)



Alternatives are closer to home than you think.

Everyday Canadians already invest in alternative investments.

CPPIB Portfolio and Performance



Popular hedge fund strategies in Canada.

Alternative CIFSC Category	Offering Memorandum	Prospectus
Equity Focused	85	21
Credit Focused	23	8
Multi-Strategy	27	17
Market Neutral	16	4
Other	49	12

*Reporting to Fundata, as at August 8, 2019

Before you allocate, what should you look for in a hedge fund manager?

Investment Manager



What is the background and experience of the investment manager & the investment team?



What is the governance surrounding the investment manager & investment team?



How do they manage risk? (independent reporting lines, operational risk management, conflicts of interest, etc.)?



What is their compliance culture?



Are members of the senior investment management team personally invested in the fund?



Investment Strategy



- ✓ What is the fund's investment objective and principal investment strategies?
- ✓ From where are the underlying positional data, market data and any underlying models sourced for this strategy?
- ✓ Are there position limits and how are they monitored?
- ✓ How much financial leverage does the fund use on average? Limits? Sources?
- ✓ Are there any capacity constraints?
- ✓ Performance history? In what type of markets would this strategy be expected to outperform or underperform?
- ✓ How long would it take in normal market conditions and stressed market conditions to liquidate the fund without incurring unusual costs?
- ✓ Have the objectives of the investment strategy changed in the past 5 years? Has there been any style drift?
- ✓ Who makes the portfolio management decisions and how are they made?
- ✓ What method(s) does the investment manager use to measure the total risk of a portfolio using this strategy?
- ✓ Offering documents, subscription agreements, and process for purchases and redemptions? Fees? Performance fees and calculation methodology?
- ✓ What is the fund's valuation policy and the frequency of valuation?
- ✓ What portfolio data does the investment manager provide to investors, and with what frequency and time lag?
- ✓ Who are the outsourced service providers of the fund (i.e., prime broker, auditor, custodian, administrator, legal)?

Not all alternatives are alike.
To learn more about alternative investments:

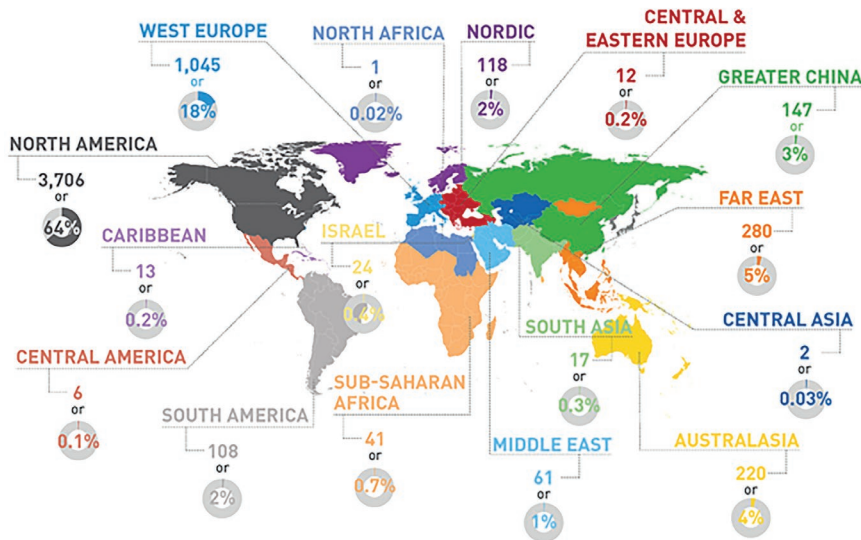


Visit aima.org for more information and resources

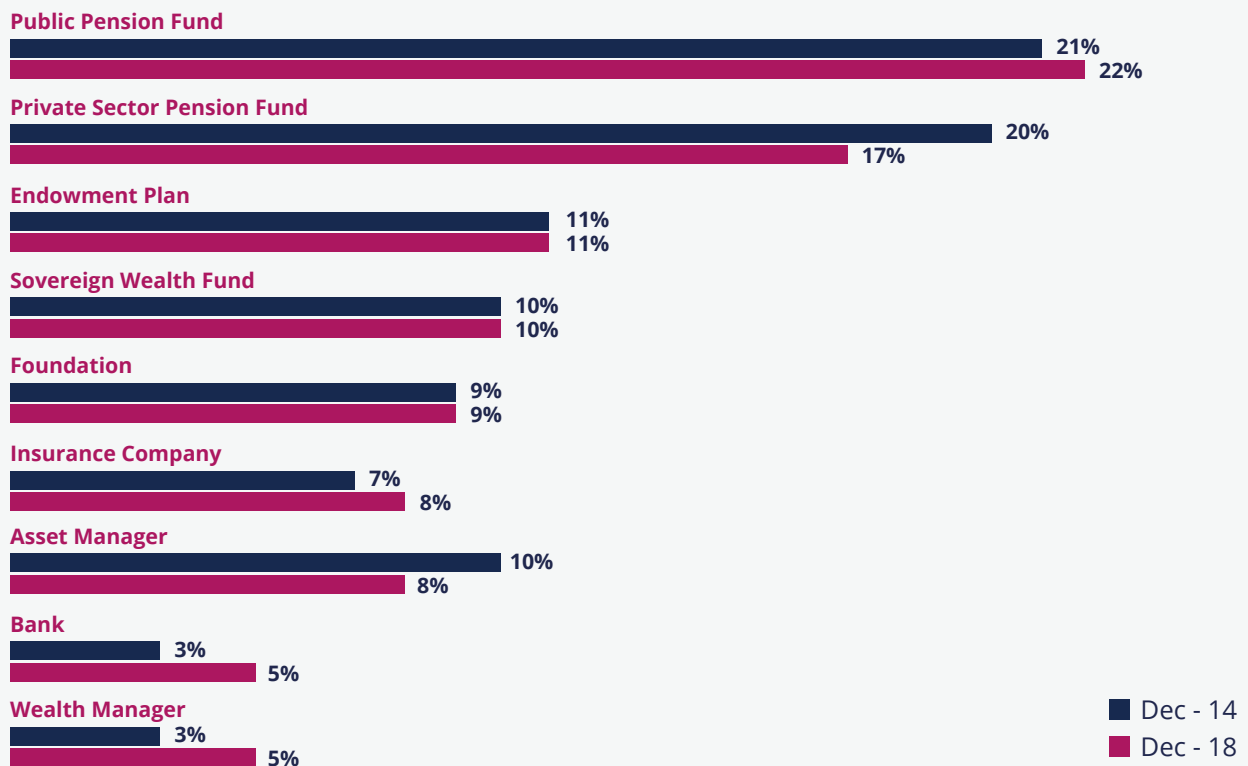


3

Global Investors in Alternative Investments



Source of Capital that Allocates to Hedge Funds by Investor Type



Source: Source: AIMA Research, Preqin

4

Investors in Canada

The Canadian alternative investment market is split between two important investment groups: institutional and retail investors. Many AIMA Canada manager members often focus their attention on both and it's worth noting that both channels typically have longer sales cycles than traditional investments.

INSTITUTIONS: PENSIONS, ENDOWMENTS, FOUNDATIONS

Canada's largest pensions have long employed a maple model, with Ontario Teachers' Pension Plan leading the way. Many of Canada's small-mid size pensions, foundations, and endowments are at varying stages of following suit in making key allocations to hedge funds, private credit, private equity, real estate & infrastructure.

"...skilled management using long/short strategies in public markets can add value whether markets are rising or falling. Such pure alpha return is extremely valuable. When properly controlled, it adds relatively little to total risk in the portfolio while contributing significantly to total return. Skillfully selecting, negotiating, financing and managing individual private equity and debt investments. As owners with large stakes – and in some cases board representation – we can make meaningful contributions to improving the operation of businesses and properties. Not being forced to sell, we can exit or realize investments at a time of our choosing."

– CPPIB Annual Report 2019

Characteristics of the Canadian Model of Public Pension Investment

Relative to smaller and more traditional pension funds, the Big Eight are characterized by a greater

- use of internal management made possible by their economies of scale;¹
- reliance on investment strategies designed to capture the liquidity premiums offered by less-liquid alternative assets;
- diversification across a broader set of asset classes, investment styles and geography;
- use of leverage and derivatives designed to improve returns and mitigate risks;
- reliance on in house risk-management functions; and
- competitive compensation with the private sector to attract and retain talent.

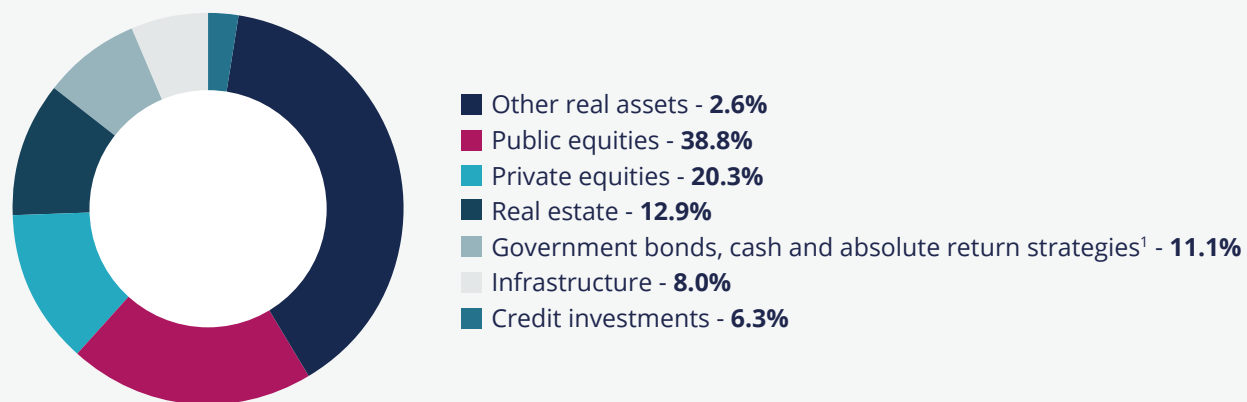
¹ External managers can, however, offer a welcome complement in some niche markets or as partners in co-investment schemes.

Source: <https://www.bankofcanada.ca/wp-content/uploads/2016/06/fsr-june2016-bedard-page.pdf>

CPPIB Portfolio and Performance

Asset Mix

As at March 31, 2018

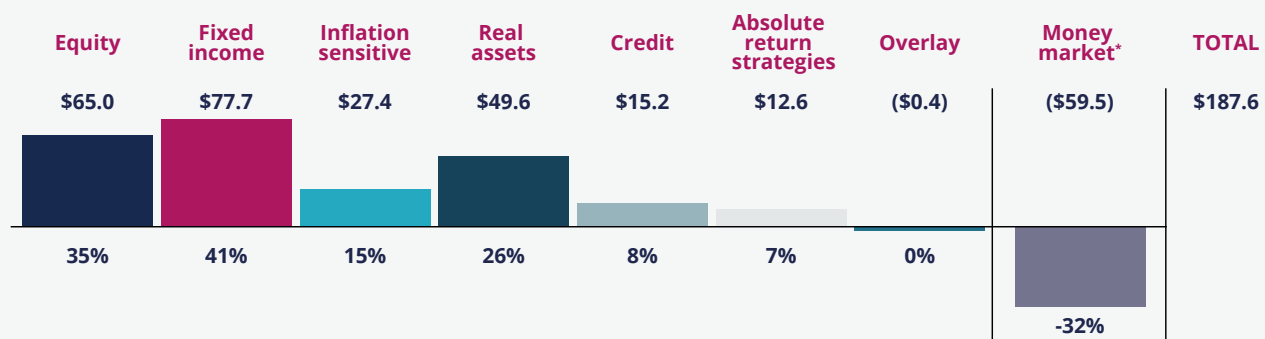


¹ Net of external debt issuances.

Source: CPPIB Annual Report 2019

OTPP Net Investments

As at December 31, 2018 (Canadian \$ billions)



Source: OTTP Annual Report 2018



5

Canadian Institutional Investor Profiles

By: CIBC Capital Markets

Authors: Atif Ayub (Executive Director) with Silke Bertsch (Associate)
& Zhibai Tang (Associate)



CPP Investment Board (CPPIB)

The CPP Investment Board was established by an Act of Parliament in December 1997. CPPIB is accountable to Parliament and to federal and provincial ministers who serve as the CPP stewards. However, CPPIB is governed and managed independently from the CPP itself, and operate at arm's length from governments.

CPPIB invests globally across a wide range of asset classes through both passive and active investing. CPPIB adopts a truly global perspective as they invest across a wide range of asset classes.

CPPIB oversees and invest a contributory, earnings-related social insurance program on behalf of employees in all provinces and territories except Quebec.

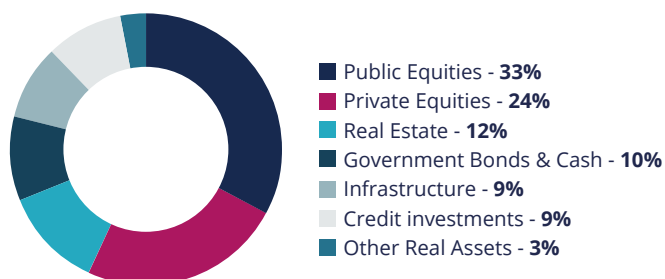
Key Data

Total AUM	CAD \$392 bn
Total Investments	CAD \$495 bn
F19 Rate of Return	8.90%
10 Year Rate of Return	11.10%
International Offices	<ul style="list-style-type: none"> - Hong Kong - London - Luxembourg - Sydney - New York - Mumbai - Sao Paulo

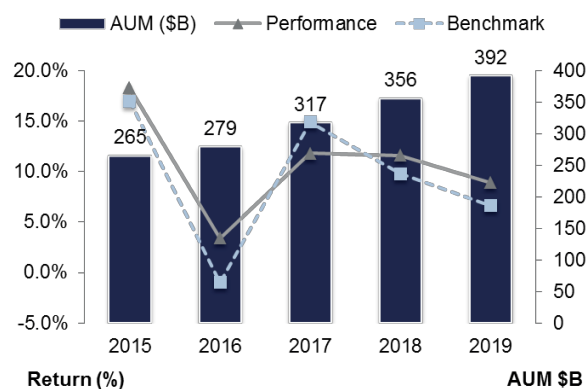
Asset Mix

By Asset Class

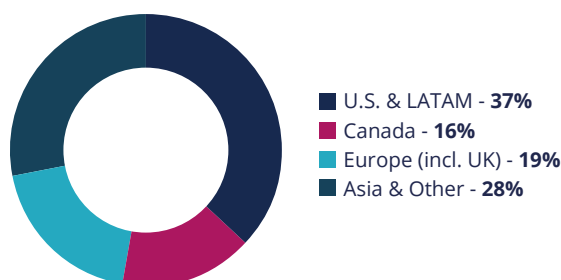
As at March 31, 2018



AUM & Historical Performance



By Geography



Note: Hedge Fund allocation is not explicitly split out in the asset mix.

Public Sector Pension Investment Board (PSP)

The PSP Investment Board was established by an Act of Parliament in September 1999. The responsible Minister is the President of the Treasury Board. However, The board is managed by a board of eleven directors, including the chairperson, appointed by the Governor in Council. PSP is operating at arm's length from governments.

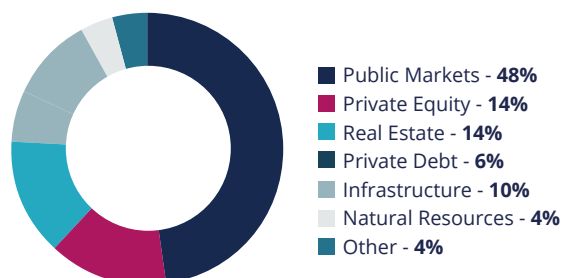
PSP manages a diversified global portfolio composed of investments in public financial markets, private equity, real estate, infrastructure, natural resources and private debt.

PSP invest fund for the pension plans of the Public Service, Canadian Armed Forces, the Royal Canadian Mounted Police and the Reserve Force.

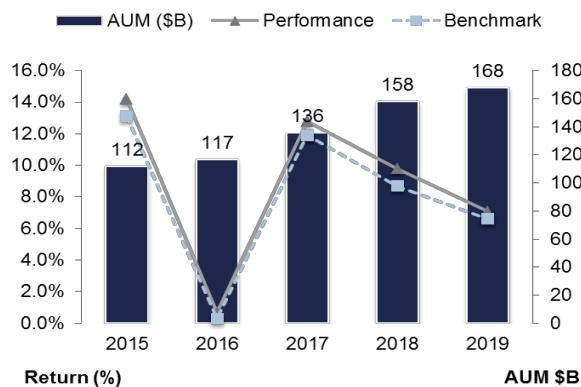
Key Data

Total AUuM	CAD \$168 bn
Total Investments	CAD \$168 bn
F19 Rate of Return	7.10%
10 Year Rate of Return	10.70%
International Offices	- New York - London - Hong Kong

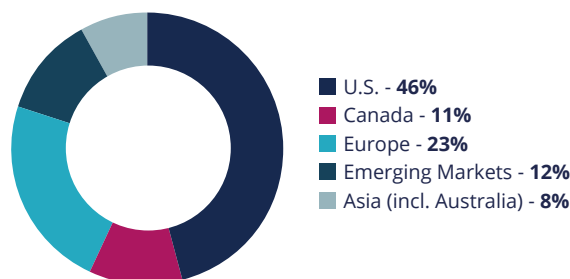
Asset Mix By Asset Class



AUM & Historical Performance



By Geography





Ontario Municipal Employers Retirement System (OMERS)

The Ontario Municipal Employees Retirement System (OMERS) was created by statute in 1962. OMERS is governed by the Ontario Municipal Employees Retirement Act, 2006, an Ontario law which superseded the older Ontario Municipal Employees Retirement System Act. OMERS is composed of the Administrative Corporation which provides strategic, risk and operational management and the Sponsors Corporation which provides oversight and decision-making.

OMERS investment strategies cover a diverse range of assets in public and private markets.

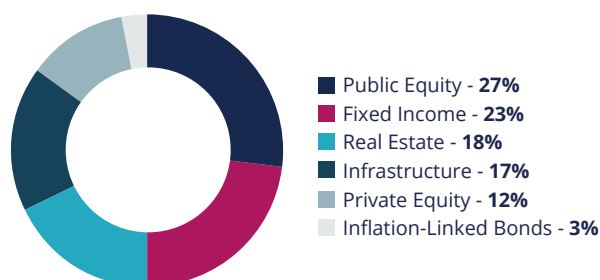
OMERS manages the retirement benefits of members employed by municipals, school boards, transit systems, electrical utilities, emergency services and children's aid societies.

Key Data

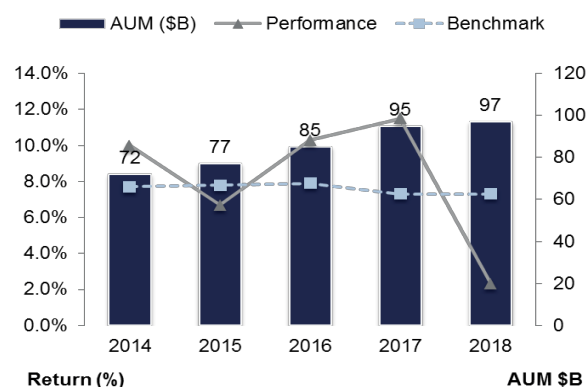
Total AUM	CAD \$97 bn	
Total Investments	CAD \$105 bn	
F18 Rate of Return	2.30%	
10 Year Rate of Return	8.00%	
International Offices	- New York - London - Sydney	- Amsterdam - Luxembourg - Singapore

Asset Mix

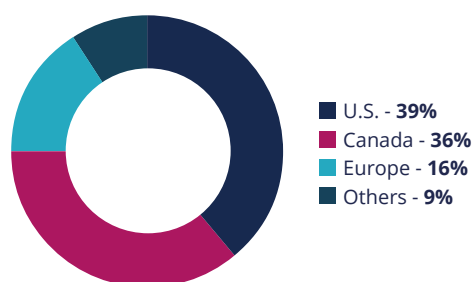
By Asset Class



AUM & Historical Performance



By Geography



British Columbia Investment Management Corp (BCIMC)

British Columbia Investment Management Corporation (BCI) began operations under the Public Sector Pension Plans Act in 2000 to provide investment services to British Columbia's public sector. BCIMC has a seven-member Board of Directors, structured in accordance with the Public Sector Pension Plan Act. Two representatives on the board are appointed by the four largest clients, the other are appointed by the Minister of Finance.

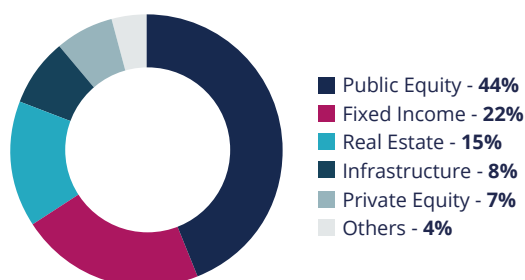
BCI is an active, in-house asset manager investing globally across a range of asset classes.

BCI invests globally on behalf of public sector clients, which includes 11 public sector pension plans, 583,000 pension plan beneficiaries and 2.3MM BC workers.

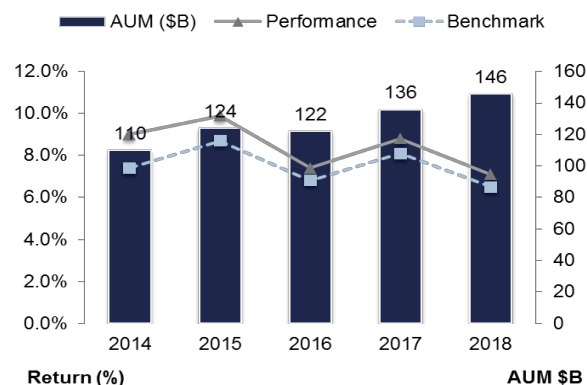
Key Data

Total AUM	CAD \$146 bn
Total Investments	CAD \$146 bn
F18 Rate of Return	9.00%
10 Year Rate of Return	7.40%
International Offices	- None

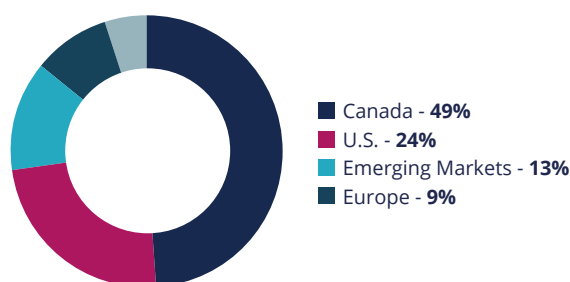
Asset Mix By Asset Class



AUM & Historical Performance



By Geography





Healthcare of Ontario Pension Plan (HOOPP)

The Healthcare of Ontario Pension Plan was established January 1, 1960 under the Pension Benefits Act. The board of Trustees govern all aspect of the HOOPP Plan and the HOOPP Fund. The Board is made up of 16 voting members, eight trustees are appointed by the Ontario Hospital Association and four unions each appoint two trustees.

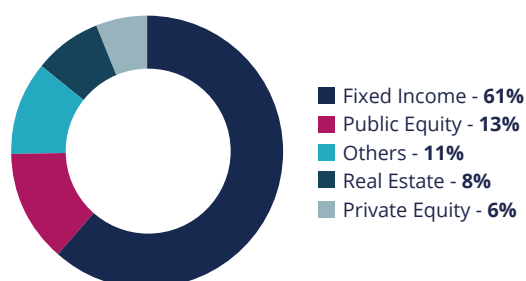
HOOPP's Liability Driven Investing approach divides investments between tow portfolios. The Liability Hedge Portfolio which is designed to offset major risks like inflation and interest rates. The Return Seeking Portfolio invests in assets and strategies designed to earn additional return.

HOOPP is a multi-employer contributory defined benefit plan for Ontario's hospital and community-based healthcare sector with more than 580 participating employers.

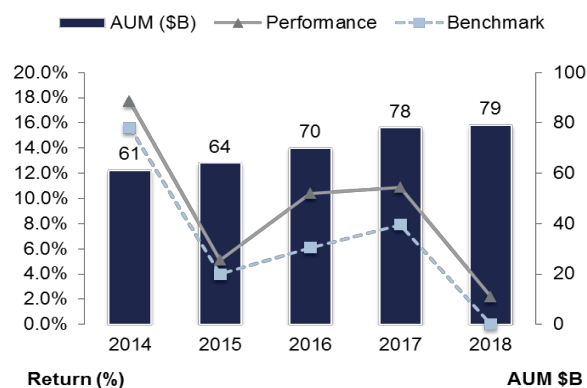
Key Data

Total AUM	CAD \$79 bn
Total Investments	CAD \$79 bn
F18 Rate of Return	2.17%
10 Year Rate of Return	11.19%
International Offices	- None

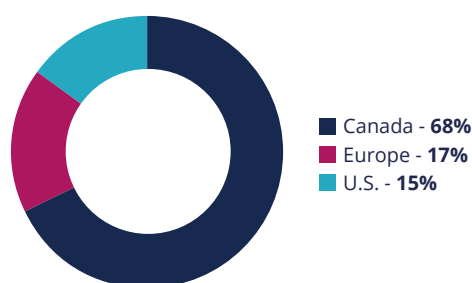
Asset Mix By Asset Class



AUM & Historical Performance



By Geography



Ontario Teachers' Pension Plan (OTPP)

The Ontario Teachers' was established on January 1, 1990 as a multi-employer pension plan jointly sponsored by the Government of Ontario and the Ontario Teachers' Federation. The six-member Partners' Committee (made up by members of the OTF and the government) set benefit levels, establish contribution rates and manage funding. OTPP is run by an independent Board of eleven members, appointed by the Ontario Teachers' Federation and the Ontario government.

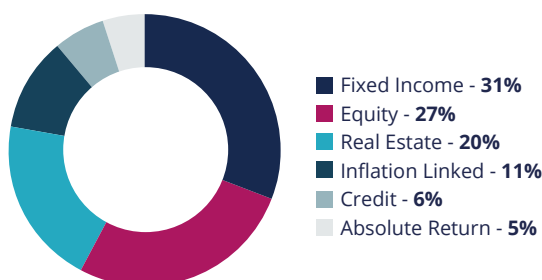
OTPP owns and manages a diversified portfolio of Canadian and international assets. It also owns a real estate subsidiary - Cadillac Fairview.

OTPP pay defined benefit pensions and invest plan assets on behalf of their 327,000 members, retired and working teachers of Ontario.

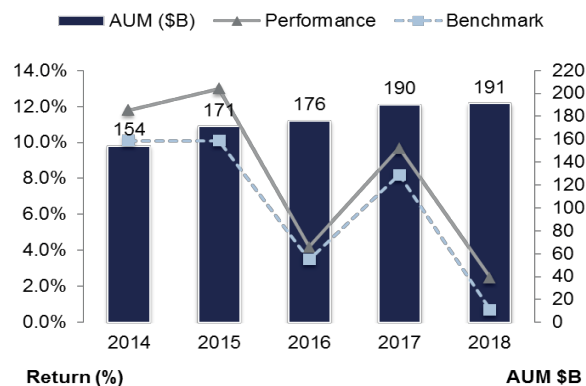
Key Data

Total AUM	CAD \$191 bn
Total Investments	CAD \$191 bn
F18 Rate of Return	2.50%
10 Year Rate of Return	10.10%
International Offices	- London - Hong Kong

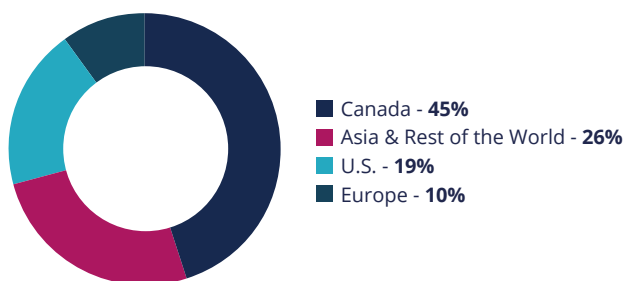
Asset Mix By Asset Class



AUM & Historical Performance



By Geography





Caisse de dépôt et placement du Québec (CDPQ)

Caisse de dépôt et placement du Québec (CDPQ) was founded in 1965 and is headquartered in Quebec City, Quebec. Caisse de dépôt et placement du Québec (CDPQ) is Canada's lead private equity investor, one of the largest institutional fund managers in North America, and one of the 10 largest real estate asset managers in the world. CDPQ has three subsidiaries: Ivanhoe Cambridge, Otera Capital and CDPQ Infra.

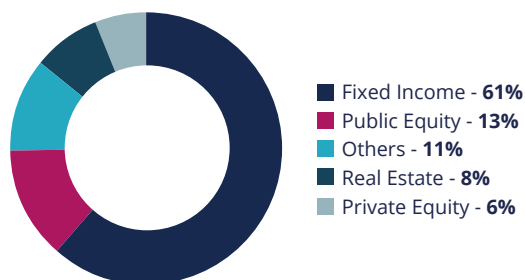
CDPQ manages several public and parapublic pension plans and insurance programs in Quebec. CDPQ invests its depositors' funds for the benefit of 6 million Quebecers that covers more than 40 retirement and insurance plans funds. CDPQ invests the funds in both Quebec's economy and in more than 60 countries.

Key Data

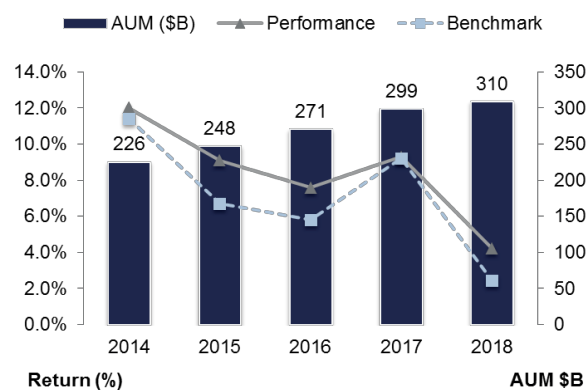
Total AUM	CAD \$310 bn	
Total Investments	CAD \$342 bn	
F18 Rate of Return	4.20%	
10 Year Rate of Return	9.20%	
International Offices	- London	- New York
	- Mexico	- Paris
	- New Delhi	- Shanghai
	- Sao Paulo	- Sydney
	- Singapore	- Washington

Asset Mix

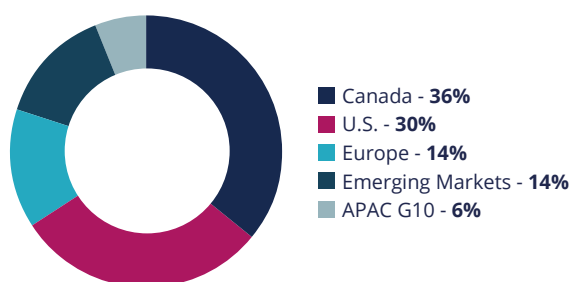
By Asset Class



AUM & Historical Performance



By Geography



Alberta Investment Management Corporation (AIMCo)

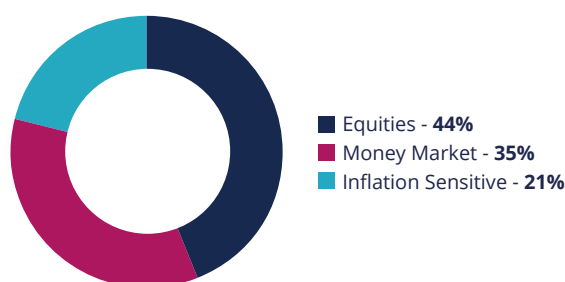
AIMCo was established as a Crown corporation on January 1, 2008 after passing legislation creating AIMCo in 2007. AIMCo is responsible for the investments of 31 pension, endowment, government and specialty fund clients in Alberta, helping to ensure prosperity for more than 300,000 public sector employees, and all Albertans benefitting from the Alberta Heritage Savings Trust Fund. AIMCo places investments across all asset classes and markets to maximize return on risk.

AIMCo is one of several “pooled investment portfolios” in Canada that allow for “client-controlled asset allocation for multiple public-sector pension plans and investment funds. Through pooled asset management, these entities achieve sufficient scale to produce significant cost savings”.

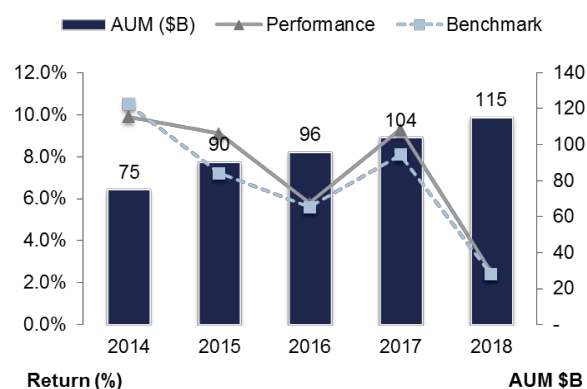
Key Data

Total AUM	CAD \$115 bn
Total Investments	CAD \$115 bn
F18 Rate of Return	2.50%
5 Year Rate of Return	10.30%
International Offices	- London - Luxembourg

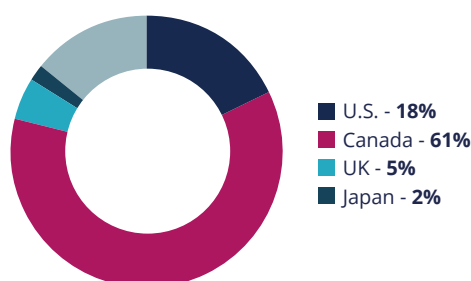
Asset Mix By Asset Class



AUM & Historical Performance



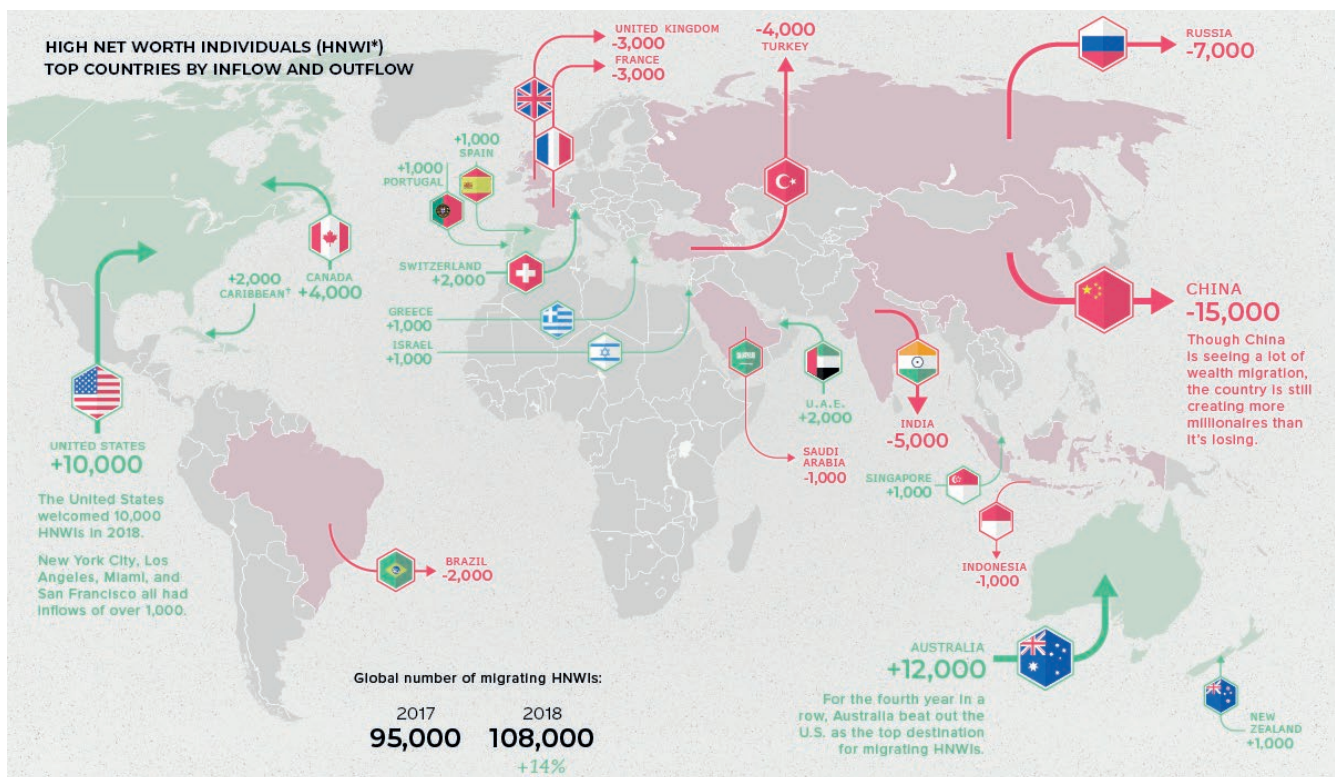
By Geography



6

Single Family Offices, Multi-Family Offices & Ultra-High-Net-Worth Investors

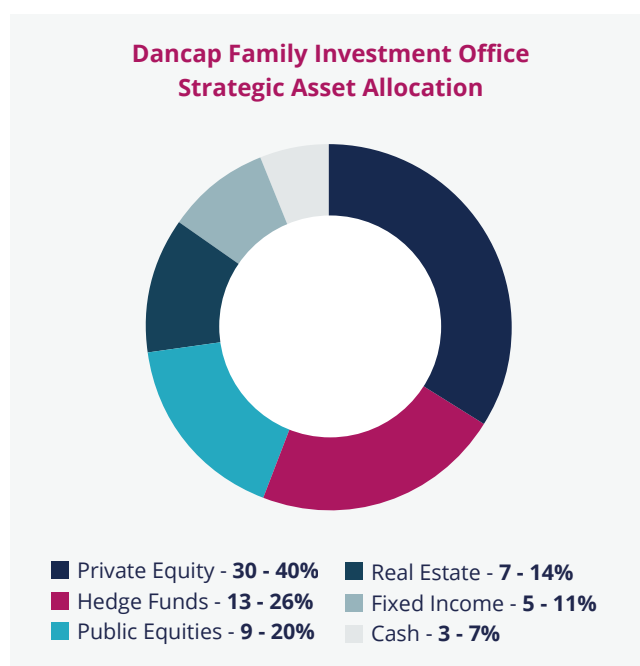
There are dozens of family offices who would be considered institutional-quality in their approach of asset allocation to alternative investments. Increasingly, this represents another important distribution channel for Canadian investment managers. According to New York-based research firm Wealth X, Canada ranks fifth in the world (2017) when it comes to the number of ultra-high-net-worth people living in a country with at least \$30 million USD, ahead of both Switzerland and Hong Kong. The number of high net worth individuals continues to grow in recent years, as shown below.



Source: <https://www.visualcapitalist.com/global-migration-of-millionaires/>

"Our portfolio allocation is optimized across all asset classes in order to maximize returns, minimize volatility and maintain enough liquidity to adjust the portfolio tactically and invest in new opportunities as we see fit."

– Dancap Family Investment Office



Source: https://www.dancap.ca/asset_allocation.htm

Whether it be a pension, family office or IIROC investment dealer, each investor will have varying degrees of investment criteria before managers might be able to consider seeking and securing access to a platform or an investment, outside of passing due diligence review. Often cited are a 3-year track record, a base level of AUM (approximately \$250M or \$300M), ability to do separately managed accounts and/or co-investments, a certain number of committed/interest investors, amongst others. However, there are certainly exceptions to these general guidelines especially as manager, firm and strategy experience are considered on a case by case basis.

Many notable family offices offer support for emerging alternative investment managers and engage with AIMA Canada directly through membership and/or participation at key events.

" Portfolio management has gone through a lot of changes over the years. At their base, most popular portfolio structures use Modern Portfolio Theory (MPT), which was developed by Harry Markowitz in the 1950's. MPT states that for any given expected return, one can design an optimal portfolio that generates the lowest risk, or, standard deviation. From this concept, the classic balanced portfolio of 60% broad market equities and 40% fixed income was formed. The balanced portfolio is designed to be easy to follow and to generate an approximation to an efficient return profile.

The markets have evolved since MPT was created, and so has portfolio management – to some extent. Many investors still allocate their portfolios on a 60/40 basis, albeit some will skew their portfolio toward specific goals. The underlying assets, equity and fixed income, remain the same.

Over the years, professional managers, working for large institutions, have been adopting a different approach to their portfolio construction, incorporating Alternative asset classes to further diversify returns. These Alternatives tend to be uncorrelated to public markets and therefore, when added to an existing portfolio, have the potential to reduce risk while maintaining their return. This effectively creates a new frontier for the optimal portfolio pioneered by Harry Markowitz's MPT.

Without incorporating Alternatives in their portfolios, individual investors may find they are putting their wealth at greater risk than they are being compensated for. In order to protect their assets and properly diversify their portfolios, investors should look to the allocation specialists at the national pension funds and insurance companies for direction and speak with their financial advisors on how Alternative investments may benefit their own portfolios. "

– Jalaj Antani, Director, Business Development, Ninepoint Partners

7

Retail Distribution Channels



By: **Dennis MacPherson**
Senior Vice President,
SGGG Fund Services Inc.



Canadian investors of all types and sizes enjoy a broad range of robust options that comprise the retail distribution marketplace. For a fund manager looking to raise money in Canada, it is important to first have a clear strategy on where the money will be coming from. Understanding this will allow the fund manager to focus on the correct channel and maximize the chance of success.

The largest channel (and therefore generally most attractive for fund managers) is the *Investment Industry Regulatory Organization of Canada (IIROC)*. IIROC is a national Self-Regulatory Organization (SRO) which oversees all investment dealers and trading activity on debt and equity marketplaces in Canada. IIROC members consist of all the major banks and other independent brokerage houses, servicing various operating models. Fund purchases made in IIROC investor accounts are held in “Nominee” form, meaning there is no requirement for investor documentation (other than Subscription Agreements, if applicable) to be forwarded to the fund manager.

Full-Service Advisors

By far the most sought-after type of broad distribution is the retail advisor channel. In this scenario the fund manager markets their fund to the advisors, who in turn would purchase the fund on behalf of their investors. The fund manager has no direct interaction with the investor, and they are not considered a “client” of the fund manager. The dealer firm handles all account

opening Know Your Client (KYC) and Anti-Money Laundering (AML) and provides all output such as account statements and transaction confirmations.

Advisors have varying business models. Some may manage each investor account individually and have conversations with the client before making investment decisions. These advisors will typically opt for “Class A” of a fund where a front-end investor paid commission is an option and a trailer fee is offered by the fund manager.

Other advisors may have “discretion” over their client accounts, giving them the ability to make investment decisions without client consultation for each investment made. These advisors are more likely to have their clients in a “Fee Based” program where fees are charged on assets at the account level. Therefore, they will typically opt for “Class F” of a fund where there is no commission paid by the investor and no trailer fee paid by the fund; in fact, they are prohibited from any type of “double-dipping” in this regard. These discretionary, fee-based advisors often have larger books of business and are more likely to be running a specific core investment model for all their clients, rather than trying to manage each account separately.

This means once the advisor decides to add a fund manager to their core model, it is immediately allocated to all their client accounts, and can be a more lucrative way for a fund manager to gather more assets in a shorter period of time with fewer relationships to maintain.

Getting “On the Shelf”

A fund manager wishing to gain access to the advisor channel will have some work to do. The process is neither simple nor fast but can be easily navigated particularly when using guidance from strong service-provider partners.

The initial step is to generate demand with the advisors, while at the same time reaching out to the product approval contacts or “gatekeepers” at the various IIROC firms to introduce yourself. Firms will typically not review a new fund for setup unless at least one of their advisors has expressed interest, but they are normally willing to talk and explain their firm’s specific processes to you.

The first question the IIROC firms will ask is “Are you on Fundserv?”. Fundserv (which is entirely distinct from and not to be confused with DTCC Fund/SERV in the U.S.) is the Canadian investment fund network which connects dealer systems to fund manager systems. IIROC firms require it as the first condition of approval because it automates all the operational aspects of transacting on funds.

Becoming a Fundserv member and connecting to the network requires complex software offered by your Canadian fund administrator. It also requires that the fund manager be registered with the Canadian Securities Administrators (CSA) as Investment Fund Manager (IFM) or Exempt Market Dealer (EMD); being registered with the British Columbia Financial Institutions Commission (BC FICOM) or the Financial Services Regulatory Authority of Ontario (FSRA ON) is also sufficient.

It is important to note that while any of the above will allow a fund manager to become a Fundserv member, if the IFM registration is not in place, considerable IIROC approval challenges should be expected.

This is because the second question IIROC firms will ask is “Have you signed the Bare Trustee Custodial Agreement with IIROC?”. This agreement is signed between IIROC (the SRO) and the fund manager and is intended to ensure the assets of the fund are held in an “acceptable securities location”.

IIROC will only sign the agreement with a fund manager that is 1) registered with the CSA as an IFM, and 2) where the fund, based on their review of the offering documents, meets their definition of an “investment fund”. If the agreement is not in place, the IIROC member firm would be required to put up capital to cover 100% of their position in the fund, which they will not do, hence this is a requirement of approval.

Once a fund manager has retained a fund administrator to connect them to the Fundserv network and has the Bare Trustee Agreement in place with IIROC, the remaining due diligence relates strictly to the fund manager firm and the funds they are offering. This due diligence varies widely by firm; it may be quick and easy, or it may involve a lengthy DDQ, minimum asset level, multi-year track record, etc. But again, all of this is relative to the level of advisor demand that exists at the firm.

Overview of Additional Retail Channels

Correspondent Brokerage

Many IIROC firms are not “self-clearing”. In other words, they utilize the brokerage services of another IIROC member firm to run their operations. There is also another group of firms such as Investment Counsels or Portfolio Managers (PMs), which most likely run Separately Managed Accounts (SMAs) or may have their own Pooled Funds they manage to simplify their business. Some types of these arrangements may also be referred to as Introducing Broker / Carrying Broker Relationships.

Institutional

This term may be used to describe broadly investors such as Portfolio Managers, Family Offices, Investment Clubs, Pensions, etc. While the type and structure of institutional investors can vary, they will often be using an IIROC firm for various operational services.



Discount Brokerage

This channel appeals to self-directed investors and is generally offered by the major banks and a few other larger IIROC firms. Investors make all investment decisions and execute transactions on their own. No formal advice is offered by the IIROC firm, although research and other value-add do-it-yourself financial planning tools are normally offered.

Robo-Advisors

Unlike discount brokerages which allow investors to buy and trade securities, with a robo-advisor the investor decision making is removed from the equation. Formal advice is not offered; instead the investor completes an online risk tolerance and goals assessment. Based on the result, the invested amount will be put into predetermined assets and then be continually rebalanced to maintain the desired asset mix. Generally, robo-advisors in Canada offer investments strictly in ETFs.

Summary

In general, for a fund manager to succeed in the Canadian retail marketplace:

- Requires the proper registrations with the CSA, most likely as an IFM and EMD
- Will likely require becoming a Fundserv member
- May require meeting the IIROC definition of “investment fund”
- Requires the time and expertise to foster advisor relationships, navigate the head office approval process, and generate demand for the fund

Additional Considerations When Selling To Retail

It can often be a challenge for boutique fund manufacturers and emerging fund managers to distribute alternative investment products to retail investment advisors at broker dealer firms.

Common issues include (i) the overlay of unjustly high internal risk ratings at the dealer, making it hard for advisors to allocate; (ii) a reduced number of fund companies and new funds in general being approved for distribution; (iii) the promotion of internal recommendation list funds and internally-managed model products; and (iii) a lack of interest by advisors to have their clients fill out additional subscription document & risk acknowledgement paperwork. These distribution challenges affect a fund manager’s ability to access pools of capital in Canada and their ability to grow and scale.

Key IIROC firms that tend to use hedge funds and increasingly private product include BMO Nesbitt Burns (BMO Private Wealth), Canaccord, CIBC Wood Gundy, National Bank, Raymond James, RBC Dominion Securities, RGMP, Scotia Wealth (ScotiaMcLeod), TD Wealth, though this list is not exhaustive.

Regulators in Canada are currently considering proficiency requirements that would allow Mutual Fund Dealers Association (MFDA) advisors to purchase alternative mutual funds. MFDA firms are working to grow their operational technology to allow for more widespread access to alternative funds and have better tracking for advisor continuing education.

Advisor Channel Risk Ratings

Additional internal dealer risk rating methods often result in all alternative products being rated as high risk in the retail advisor channel. This limits the number of investors who can access these products. To facilitate risk-reducing portfolio construction and to give retail investors greater access to available alternative investment products, the recent [AIMA & CAIA Risk Rating Guideline Paper](#) advocates that additional Risk Rating systems at the investment dealer should be re-assessed for all alternative fund strategies, including the new alternative mutual funds, to reflect their true risk better. The proposed new risk rating system is based on the median trailing standard deviation of funds within indices (see table below). No alternative mutual funds or alternative strategies will be rated in the 'low risk' category.

Low	Low to Medium	Medium	Medium to High	High
Not applicable to alternative mutual funds or alternative strategies	0% to 7%	6% to 11%	11% to 16%	Over 16%
	Market Neutral Equity	Equity Long-Short	Equity Long-Only	
	Multi-Strategy	Global Macro	Emerging Markets	
	Long-Short Credit	CTA/Futures		
	Relative Value Arbitrage	Event-Driven		

Source: CAIA & AIMA

8

AIMA Canada Investor Survey Results



Summarized by:
Anton Balint
Research Associate, AIMA



Respondent Demographics

To reveal the often private world of alternative investment allocations and preferences, we surveyed investors in Canada. Respondents included wealth / investment advisors (37%), family offices (17%) and pension funds (7%).

Looking at the size of their assets under management (AuM), the respondents manage, in aggregate, about \$76 bn. As a percentage of total respondents, 50% run between \$50 million and \$1 billion, 20% manage more than \$10 billion, 15% run less than \$50 million and the rest 15% manage between \$1 billion and \$10 billion of assets. Perhaps not surprisingly, the investors that manage in excess of \$10 billion are mostly pension funds and some wealth / investment advisors.

Where are you based?



■ Canada - 93%
■ Rest of the world - 7%

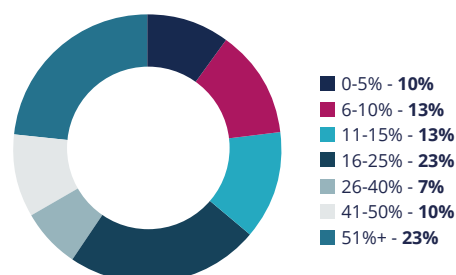
In what, where and how do they invest?

Of all respondents, 23% of them said that they allocate more than 51% to alternative investments, suggesting that about \$39 bn of the total AuM of respondents are invested in alternative strategies.

Only 10% of respondents stated that they only allocate between 0-5% to alternative investments. Meanwhile, 40% of them invest anywhere from 16% to 50% in alternatives. In allocating their capital, only 7% of respondents use consultants extensively and nearly one third of investors surveyed use consultants as part of their investment process only moderately. However, 50% of them do not use consultants at all when investing.

In terms of what alternative markets they invest in, private equity came as the most popular with 73% of respondents saying that they allocate to it, followed by real assets which was chosen by 70% of respondents as an area they invest in and then hedge funds and infrastructure, both strategies were seen as attractive by 67% of investors. Further analysis reveals that the most popular hedge fund strategies are multi-strategy (60% of investors allocate to it), equity long / short (57% of investors allocate to it) and credit long / short (43% of investors allocate to it).

What percentage do you currently allocate to alternative investments?



Also, 70% of them expect their allocation to alternative investments to increase by up to 5% over the next 12 months, 20% want to allocate 6-10% more in alternatives over the coming year, while the remaining 10% are the most optimistic about alternatives and expect to see an increase of more than 11% in terms of capital allocation in this area. While investors will be more cautious about real assets and hedge funds, respondents are most bullish on alternative mutual funds (40% of respondents expect to increase their allocation to these strategies), infrastructure (30% of investors plan to increase their exposure here) and private equity (30% of respondents anticipate allocating more to this market).

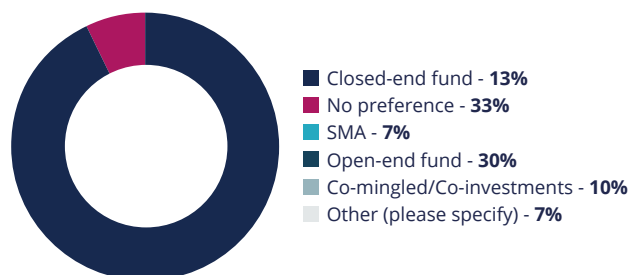
Geographically, the asset allocation mix of respondents seems to favour more developed markets, such as Canada, the United States and Europe (including UK). Almost half of investors surveyed do not allocate to Asia (including Japan) or other Emerging Markets. That said, the survey results show that, overall, investors are well diversified across geographies.

By geography, what does your overall asset allocation mix generally look like?



Interestingly, 33% of respondents have no preference when it comes to fund structure, although 30% of them favour open-ended funds. Only 13% of investors surveyed prefer close-ended funds. In the “other” category seen in the chart below, there is one investor that prefers ETFs and one that looks for fund-of-funds. However, these results may be due to the nature of investors that answered this survey – 23% of them are pension funds and family offices, which have more flexibility than wealth / investment advisors, which make up a bit more than one third of the respondents.

What is your preferred fund structure?



Trends and risks

Despite ESG being everywhere in the news, only 20% of respondents view it as a “very important” factor in their investments, with almost a quarter of them still regarding ESG as “not important”. In our experience, how ESG elements are implemented depends on two things: a) the investment strategy / strategies pursued and b) the scale of the investor as ESG implementation can impose extra costs.

Digital asset allocation has seen growing attention from industry commentators. However, the bulk of the investors we surveyed (77% of them) are not investing in digital assets at the moment – only 10% are. Meanwhile, looking at the risks that investors see on the horizon, cybersecurity, regulatory issues and developing capabilities to efficiently deal with big data were the top three concerns.

9

Planting Your Flag North of the 49th Parallel: Canadian Capital Introduction



Contributions by:
Alana L. Johnston Gould,
CPA, CA

**Director, Prime Services
Capital Introduction**

Alison Marsh

**Associate Director, Prime
Services Capital Introduction**

Scotiabank™

Access a powerful network

With regular outreach to their Canadian investor network, domestic capital introduction professionals have timely knowledge of capital flows, and a deep understanding of open investment mandates and strategy preferences.

This market intelligence helps prime brokers advise funds on the most efficient use of their marketing resources and creates new opportunities in the form of inbound requests from investors for funds that provide specific exposures.

One well-known way to access a prime broker's investor network is by participating in Canadian capital introduction events – educational events for investors that provide a platform to network and raise a manager's profile.

Opportunities range from participating on panels at larger thematic conferences, to smaller round table discussions and one-on-one investor/portfolio manager conversations. Each forum offers differentiated opportunities for managers to demonstrate expertise and thought leadership while showcasing their fund strategy and competitive edge. Increased exposure is important for both emerging and established managers as they build out a Canadian investor base and refine their pitch for new fund launches.

Get the right introductions to the right investors at the right time

Capital introduction teams aim to provide the right introductions – to the right Canadian investors – at the right time in a fund's lifecycle. Intelligent introductions need to be tailored to specific points along a manager's business development journey – such as hunting for seed and/or accelerator funding, creating appetite for new product launches with established managers, or digging for stable long-term investors for mature funds.

The first step is to provide the team with a thorough understanding of a manager's investment strategy, capital raising plan and target investors. When combined with their knowledge of investor mandates and capital flows, teams are best positioned to make a well-timed investor introduction that will increase a manager's success with allocators.

Additionally, capital introduction partners provide useful insights about marketing to distribution networks. In Canada, for example, the investment advisor channel is gaining new prominence with the launch of Alternative Mutual Funds. Capital introduction teams need to be experts in strategic positioning and the risk-assessment methodologies that help managers get their products “on the shelf” at prominent investment dealers.

Crossing the Pond: Helping a European fund manager with the Canadian pensions

Our Canadian capital introduction team often advises hedge funds that are attracted to the large pools of capital at Canadian plans. To illustrate, we've created a composite from recent fund manager engagements to describe how we have worked to facilitate initial forays into the Canadian market.

The fund, in this instance, has a successful 10-year track record and more than US\$1 billion in firm assets, had never marketed in Canada, and sought insight to support their Canadian initiative. As a first step, our team led a call to gain an in-depth understanding of the fund, their investment strategy and target investors. After learning about their niche, sector-specific strategy and preference for long-term capital, we identified certain Canadian institutions and larger family offices that could be interested in the fund.

We recommended Toronto as the client's first port of call, since many of Canada's institutional investors are based in this financial centre. During our next thematic global managers event, we featured one of their senior portfolio managers in front of a receptive audience of representatives from some of the largest names in the pension, fund of funds and family office spaces in Canada. In this forum, they successfully introduced their firm, investment strategy and showcased their knowledge and experience.

Following the event, our team reached out to attendees for feedback on the presentations and to gauge interest in follow-up introductions. These discussions enabled us to identify three investors with good alignment to the fund's investment mandate. We then facilitated introductory calls between each investor and the fund's portfolio manager and business development lead.

As a result of this engagement, this fund made numerous face-to-face contacts to nurture a dialogue and develop an eventual allocation. Further, the manager received invaluable feedback from the event, and we referred them to a Canadian law firm to gain a deeper understanding of structuring in the Canadian market and local regulatory environment. Through our counsel, introductions and support, our client successfully planted their flag in the Canadian market, positioning themselves for a successful market entry.

Leverage industry best practices

Capital introduction teams have a bird's-eye view of business development best practices, including marketing materials, capital raising strategies and pitch books. Local market expertise enables them to coach managers on how to position their pitch for a Canadian audience. It also provides managers with an excellent market research channel. By leveraging a prime broker's feedback, managers can finesse their marketing, sales collateral, and even fund structures, to appeal to a Canadian investor audience.

If more in-depth hedge fund consulting services are required, capital introduction professionals will connect managers with local service providers, including lawyers, and administrators, for Canadian structuring expertise and regulatory information on accessing distribution channels.

When selecting, or adding, a prime broker managers are encouraged to ask pointed questions about Canadian capital introduction capabilities. On-the-ground teams provide valuable services and insights that will deepen the partnership between a manager and their prime for shared growth.

“ Capital introduction partners provide useful insights about marketing to distribution networks. In Canada, for example, the investment advisor channel is gaining new prominence with the launch of Alternative Mutual Funds. **”**

10

Hedge Funds & Canada



By: **Natalie Serebrennik**
Vice-President, Prime Brokerage
Sales, BMO Capital Markets

BMO **Capital Markets**

What is a Hedge Fund?

A hedge fund is a pooled investment structure set up by an asset manager or registered investment advisor. Typically, the manager raises capital from outside investors and then invests it into a strategy. Hedge funds often take speculative positions in derivatives, short sell securities and use leverage to augment return or reduce risk.

What are the Different Types of Hedge Fund Strategies?

There are a variety of popular strategies used by hedge fund managers; some include:

- **Long/Short Equity** – maintain long and short positions in equity and equity derivatives, aiming to generate absolute returns independent of market performance. The fund typically goes long and short in two competing companies in the same industry. The bias tends to lean either long or short.
- **Long/Short Credit** – take long and short positions in a wide variety of global fixed income assets to exploit differences in pricing. The strategy attempts to reduce volatility by hedging out specific risks associated to credit instruments; such as: varying interest rates, issuer default and illiquidity.
- **CTA (Commodity Trading Advisor)** – known as ‘trend followers’. The manager actively takes long and short positions, mainly in futures contracts and options on futures contracts, driven by momentum indicators. This strategy utilizes technical analysis (historical data and market signals) coded into a quantitative system to predict future patterns.

“ At Auspice we believe that, non-correlated alternative investments should be a core holding in all portfolios, regardless of investor size or sophistication. Alternatives should not be viewed as risky, but as conservative and prudent, given the measurable value to investment portfolios. Investors need to recognize that while most asset classes and traditional alternatives provide the constant gratification of a convergent return stream, they are highly correlated to equities, have negative skew, and most do not protect the portfolio at critical times.

It is worth noting, that many of the risks and opportunities, in the market, are not continuous, but episodic. To manage these events requires discipline and that is best executed through rules-based strategy, risk and capital management. This is the domain of CTAs and quant managers. CTA investments are one of few strategies that provide positive skew and returns at critical times that are accretive to most portfolios. Additionally, CTAs can provide this exposure in a cash-efficient manner using the leverage and liquidity of futures contracts providing the investor another edge in better use of their investment capital. CTAs are not new, and their strategies have been around for decades used by many of the most sophisticated investors, but they have yet to achieve the type of widespread adoption that we believe is warranted. ”

– **Tim Pickering, Founder, President, CIO, Auspice Capital**

- **Global Macro** – aim to make profit from large economic and political changes in various countries. Analyzes how these macroeconomic trends will affect interest rates, currencies, commodities, and/or equities around the world and can invest in these asset classes to support the overall investment objective.

“ Investors in Canada benefit from two things: First, asset managers are subject to intense regulatory scrutiny from their inception. This means greater protection for investors, and the assurance that their money is in trustworthy hands. Second, investors benefit from a financial and capital markets framework that is among the most sophisticated – and safe – in the world. This environment has fostered the growth of a community of experienced and qualified managers with a unique international focus and perspective. A core tenet of our approach at IBV Capital is what we call “suggestivism” -- a distinctly Canadian approach to actively investing in companies. This approach is built on exceptional due diligence, disciplined capital allocation, and collaboration with the companies we invest in. We work alongside management teams to implement positive changes within a company to help extract and realize value over time. ”

– Talbot Babineau, CEO & Co-Founder, IBV Capital

- **Market Neutral** – target zero market volatility by simultaneously going long securities that are likely outperform and short securities that may underperform the market.
- **Arbitrage** – take advantage of price inefficiencies between closely related securities. These strategies tend to rely heavily on leverage. Unexpected market shifts can cause losses.

- **Fixed Income** – invest in securities which generate stable and predictable returns. These securities are often categorized as low risk and pay a fixed rate of interest.

“ The days of earning five or six percent from fixed income or GICs are well behind us. Active portfolio management is needed to beat inflation, especially once taxes are accounted for. At Algonquin Capital, we help investors and their advisors to overcome the challenges of the low and potentially volatile interest rate environment. Our investment strategy enables us to be proactive and agile in changing market conditions to take advantage of a broad scope of market inefficiencies and opportunities. Our approach is to split a corporate bond into its credit and interest rate exposures, and to manage actively each independently. In doing so we can hedge unwanted risk and isolate the value in fixed income products. This positions us to generate returns in all interest rate environments. ”

– Hasnat Mahmood, Chief Compliance Officer & Chief Financial Officer, Algonquin Capital

- **Event Driven** – exploit pricing inefficiencies occurring in response to specific corporate events that lead to capital structure changes (for example: mergers and takeovers, liquidations and reorganizations).
- **Quantitative** – rely on quantitative analysis to make investment decisions, using algorithmic modelling to achieve desired investment goals
- **Multi-Strategy** – use a variety of investment strategies with an overall low risk profile to achieve consistent positive returns.



“ From the very first days of Polar, in November of 1991, we made a conscious decision to have as broad a portfolio as possible. Back then, we were invested only in Canada. Although we believe that exploitable inefficiencies routinely exist within the Canadian market, we also knew that being an investor solely in Canadian convert arbitrage, merger arbitrage, or distressed debt strategies would expose us to the times when one or more of our strategies wasn't working. That's why we needed as many buckets of optionality as we could logically manage.

Today, we employ a multi-strategy, arbitrage-oriented approach to capital markets and seek to extract returns from a diversified set of opportunities while maintaining a well-defined and rigorous risk management framework. Adding strategies, people and technologies to the portfolio process affords us a greater chance to achieve our objective with low volatility and a focus on preservation of capital. ”

– Paul Sabourin, Chairman & Chief Investment Officer, Polar Asset Management Partners

What is the Most Common Fee Structure?

Fee structures are often made up of a management and incentive/performance fee. Over the last few years, Canadian fund managers have felt pressure to lower fees to better align themselves to their counterparts in the U.S. The standard '2 and 20' fee model is transitioning into more of a bespoke arrangement between the fund manager and end client. While funds with 2% management fees and 20% performance fees are not uncommon in Canada, fee pressures from both institutional and retail channels are lowering the averages. The management fee is paid to the manager regardless of how the fund performs. The '2% fee' is based on the fund's net asset value (NAV). The incentive fee is paid out if the fund profits. There are a few ways a manager can charge this type of fee.

1. The performance fee can be calculated as a direct result of the fund's increase in NAV. $20\% \times \text{net increase in NAV}$.

2. Similarly, the fee can be a direct result of the fund's increase in NAV, adjusting for the management fee. $20\% \times (\text{net increase in NAV} - 2\% \text{ management fee})$.
3. Hedge funds often feature a “high water mark” provision in their fee structure to provide assurances to investors in the event the fund declines in value. If the fund is losing money, the manager must improve returns above this mark before receiving their incentive bonus. The fund must exceed the highest NAV it has previously achieved. Essentially this provision gives the investor the confidence that that performance fees are not paid on the profits that were just used to offset the losses from the prior year.
4. Hurdle rates serve a similar purpose. A manager can only collect his/her performance fee when returns are higher than this established amount.

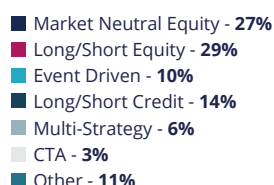
Who Can Invest in Hedge Funds?

Most hedge funds are not widely available to the public. The minimum investment can be quite considerable, as low as \$100,000 and in some cases as high as \$1,000,000. By default, a large portion of the investable community doesn't qualify. Investors are typically classified as accredited and/or sophisticated. They are comfortable with riskier strategies employing derivatives and shorting in order to maximize profit potential. Hedge funds, like other private placement transactions, are often exempt from full registration requirements. An offering memorandum is the standard document accessible to all investors, which showcases the offering terms and risks associated with the investment.

Canadian Demographic

Asset concentration in Canada is well-diversified. Recent Preqin data values the Canadian hedge fund industry at approximately \$40-60B in AUM, with only a handful of firms in the \$1B+ in assets category. Many of the managers would be in the emerging category of sub-\$250M and even sub-\$100M. The average fund size in Canada is \$45M*. Long/short equity, equity market neutral and long/short credit remain the most popular strategies, though event-driven and multi-strategy follow closely behind:

Assets By Strategy¹

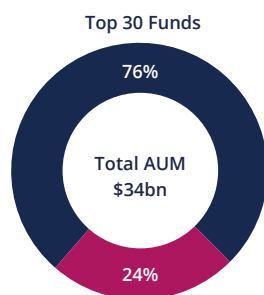


Median Fund Size: \$41 Million

1. Source: Prequin, RBC Global Asset Management

2. Based on AUM of reporting funds as of February 28, 2018

Asset Concentration²



Bottom 169 Funds
Average AUM ~\$50mn

“ Besides ensuring a high level of service and care, quality Service Providers are key to a Hedge Fund’s success. HGC views our Service Providers as partners in the broader sense and, as such, we look to enter into long standing relationships with them. This ensures familiarity and comfort for both the fund manager and the investor. While these high-quality partners can be somewhat cost prohibitive to funds just launching, our approach has been to try to ensure that your operations are as strong as your track record. This approach can allow managers to access more institutional level investors and bank platforms who have the ability to allocate meaningfully over the course of time. ”

– Brett Lindros, Executive Vice-President,
HGC Investment Management

“ It is hard to believe that AIMA Canada is now over 16 years old. Back then, alternative funds – particularly “hedge funds”- were in their infancy in terms of managers, allocations and service providers in this country. Since 2003 however, the Canadian industry has matured in all respects but it has not always been an easy road. Like other jurisdictions, we had our share of issues including fund mis-sellings, bad actors and frauds. Since the Global Financial Crisis, our industry has responded positively by promoting better safeguards for all participants in the industry. Regulators, service providers, investors and managers have started constructive dialogue, promoting and enforcing best practices in an effort to improve all aspects of our industry.

Arrow Capital has structured its business strategy to be focused on the burgeoning liquid alternatives market. After spending over 10 years in the funds of hedge funds market, we are now almost exclusively focused on in-house alternative investment management. The experience of following hundreds of managers, some very successful, has helped shape how we manage our business.

We expect the focus on the retail hedge fund industry in Canada over the next 5-10 years to be on the liquid alternatives market, mirroring the growth of the UCITS market in Europe. This market should be very good for managers providing access to long/short equity, credit and global macro strategies. Today, all of AIMA Canada’s hard work has created a vibrant industry with a better framework and experienced practitioners. I am very much looking forward to the future and AIMA Canada’s continued role in the development of the alternative industry. ”

– Jim McGovern, Managing Director
& CEO, Arrow Capital Management Inc.

Sector Allocation and Asset Mix in Canadian Hedge Funds



By: Reid Baker
Director, Analytics & Data,
Fundata Canada Inc.



A common international myth about Canadian hedge funds is that they are concentrated solely on oil and gas. A look at the sector allocation and asset mix within the alternative fund categories (aggregating all offering memorandum and prospectus product) shows differently:

Alternative Equity focused			
Sector		Asset	
Energy	20.87%	Canadian Equity	43.02%
Financial Services	14.13%	US Equity	27.86%
Fixed Income	13.78%	International Equity	19.16%
Exchange Traded Fund	13.52%	Domestic Bonds	14.56%
Consumer Services	10.43%	Foreign Bonds	6.54%
Technology	8.81%	Cash and Equivalents	6.46%
Basic Materials	8.50%	Income Trust Units	4.82%
Industrial Services	8.43%	Other	3.92%
Mutual Fund	7.06%		
Cash and Cash Equivalent	6.72%		
Consumer Goods	5.45%		
Industrial Goods	4.87%		
Healthcare	4.60%		
Other	4.47%		
Real Estate	3.39%		
Utilities	2.55%		
Telecommunications	2.42%		

Source: Fundata, as at Aug 8 2019.

Alternative Credit focused			
Sector		Asset	
Fixed Income	72.84%	Domestic Bonds	48.83%
Cash and Cash Equivalent	15.82%	Foreign Bonds	36.75%
Financial Services	6.33%	Canadian Equity	16.22%
Utilities	5.37%	Cash and Equivalents	15.82%
Energy	4.23%	International Equity	6.13%
Real Estate	3.31%	Income Trust Units	2.61%
Telecommunications	2.83%	Other	2.39%
Technology	2.26%	US Equity	2.35%
Mutual Fund	1.62%		
Basic Materials	0.98%		
Consumer Services	0.84%		
Healthcare	0.65%		
Industrial Goods	0.53%		
Other	0.44%		
Consumer Goods	0.16%		
Industrial Services	0.05%		

Source: Fundata, as at Aug 8 2019.

Alternative Market Neutral			
Sector		Asset	
Cash and Cash Equivalent	83.36%	Cash and Equivalents	83.36%
Other	9.36%	US Equity	10.43%
Industrial Services	5.39%	Other	8.95%
Consumer Services	4.20%	Canadian Equity	7.86%
Energy	3.00%	International Equity	3.15%
Technology	2.46%	Domestic Bonds	1.84%
Healthcare	2.12%	Income Trust Units	0.96%
Basic Materials	1.90%	Foreign Bonds	-1.00%
Financial Services	0.87%		
Fixed Income	0.56%		
Real Estate	0.24%		
Mutual Fund	-0.01%		
Utilities	-0.36%		
Telecommunications	-0.41%		
Consumer Goods	-0.67%		
Industrial Goods	-1.65%		

Source: Fundata, as at Aug 8 2019.

Alternative Multi-Strategy			
Sector		Asset	
Fixed Income	50.18%	Foreign Bonds	48.66%
Mutual Fund	43.76%	Other	38.53%
Cash and Cash Equivalent	17.98%	US Equity	18.31%
Financial Services	16.35%	Cash and Equivalents	18.04%
Other	7.72%	International Equity	11.31%
Technology	2.58%	Domestic Bonds	5.91%
Real Estate	2.52%	Canadian Equity	3.62%
Healthcare	2.29%	Income Trust Units	1.32%
Industrial Services	1.73%		
Consumer Services	1.68%		
Utilities	1.54%		
Exchange Traded Fund	1.52%		
Basic Materials	1.49%		
Energy	1.34%		
Consumer Goods	1.14%		
Telecommunications	1.05%		
Industrial Goods	0.68%		

Source: Fundata, as at Aug 8 2019.

Alternative Other			
Sector		Asset	
Cash and Cash Equivalent	33.29%	Foreign Bonds	47.40%
Fixed Income	27.49%	US Equity	34.08%
Real Estate	25.87%	Cash and Equivalents	33.29%
Technology	21.63%	Canadian Equity	25.34%
Mutual Fund	19.74%	Income Trust Units	24.71%
Financial Services	19.17%	International Equity	18.64%
Utilities	17.79%	Other	14.73%
Industrial Services	14.95%	Domestic Bonds	3.04%
Consumer Services	10.24%		
Healthcare	4.98%		
Other	4.37%		
Basic Materials	3.94%		
Consumer Goods	3.27%		
Energy	3.13%		
Industrial Goods	2.65%		

Source: Fundata, as at Aug 8 2019.



“ With the influx of talent into the hedge fund industry, along with the growth of data availability and quantitative methods, skilled practitioners have harvested the knowledge of pioneers and academics to codify and implement various hedge fund strategies.

Given the systemization of most of the classic hedge fund strategies, manager returns will cluster around strategy-specific risk-return profiles and return dispersion will narrow, leaving fees as a key differentiating factor.

Analogous to historical technological advances, the financial innovation driving the acceptance of alternative investments has spread from early adopters to sophisticated investors, with the general populous to follow.

Accordingly, access to these hedge fund strategies is opening up to all investors, leading to the democratization of alpha. ”

**– Julian Klymochko, Founder & CEO,
Accelerate Financial Technologies**

“ Canadian investors are leaders in alternatives. They're savvy, experienced and innovative. We take a consultative approach to helping investors build alternatives portfolios, and we believe Canada is a good place to learn as well as contribute to the local community as we leverage our experience to innovate for the benefit of our global clients. ”

**– Charbel Cheaib, CPA, CA
Director, Institutional Client Business, BlackRock**

“ While Hedge Funds employ a vast number of strategies here in Canada, HGC believes that within those strategies hedge funds should have narrow mandates for investor clarity, produce uncorrelated returns to the market, have a low level of volatility and a high degree of liquidity. Our belief is that a narrow mandate allows the Portfolio Managers to focus on core competencies and avoid style drift, while ensuring that the underlying investors have a greater understanding of where a respective fund may fit into their overall portfolio and allocate with that certainty in mind. ”

**– Brett Lindros, Executive Vice-President,
HGC Investment Management**

AIMA MEMBERSHIP

AIMA's Global Reach



Did you know that AIMA members are entitled to a host of benefits?

Committees and Working Groups

Working with peers to shape the industry and share expertise

Industry-Standard DDQs

Streamlines manager and service provider selection

Events and Networking Opportunities

Connect and network with peers at over 275 events held globally

Access to Experts

One-to-one contact with AIMA to discuss regulatory queries

Sound Practice Guides

Used to assist implementation of sound policies and processes in an increasingly complex operating environment

Government and Regulatory Affairs

Benefit from AIMA's advocacy work on a global scale

Research and Investor Guides

Shaping the industry narrative to promote a better understanding of the alternative investment sector

Communications

Keep up-to-date on AIMA's recent activity, industry news and regulatory change

AIMA Journal

Share your thought leadership with the global industry via our quarterly publication

To learn more about the benefits of AIMA membership, please visit www.aima.org

AIMA

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NI 81-102: Liquid Alternatives in Canada

On January 3, 2019, [NI 81-102](#) was officially revised to allow for liquid alternative funds in Canada (officially named alternative mutual funds, though alternative ETFs and closed end funds are also permitted under these rules). This has been an exciting and impactful change for the industry on all sides as a true convergence between boutique and traditional asset managers has and continues to ensue. With over 60 new product offerings and over \$3.5B in AUM by August 2019, the true winner is the retail investor, who deserves to have better access to the diversification, risk reduction and non-correlated returns that alternative investments provide. To better educate the market on these rule changes, AIMA Canada & Scotiabank published in December 2018 a [Launching Alternative Mutual Funds Handbook](#) with a [webinar](#) on the same subject. AIMA Canada also released a shortened retail-focused DDQ and a [1-page investment advisor DDQ](#) to assist with product due diligence at both head office and advisor levels.

This legislative innovation is creating a convergence of boutique hedge funds and traditional asset managers in Canada, many of whom are looking to enhance their distribution capabilities and product offerings, including through sub-advised relationships. Early predictions anticipate the Canadian alternative mutual fund market could grow to C\$20B to \$100B in the next five years.

Some highlights on NI 81-102 are below, though the regulators have been open to exemptive relief applications where a specific strategy may require more flexibility. Exemptive relief permitting rehypothecation, multiple custodians and more flexibility for long/short credit and market neutral strategies has already been granted as of October 2019. These amendments reflect many years of AIMA Canada guidance and regulatory advocacy from our Board and Legal, Finance and Compliance Committee volunteers. With the CSA focused on Regulatory Burden Reduction, we expect further changes to be announced as this part of the industry develops organically.

Investment Restrictions & Obligations	Alternative Mutual Funds, ETFs & Closed-End Funds
Eligible Investors	Available to the mass market via prospectus (IIROC only, MFDA pending)
NAV Calculation	Daily
Redemption Rights	Daily (most common), weekly & monthly could apply as well
Initial Holding Period	Maximum 6-month (at option of manager)
Redemption Proceeds	T+2
Performance Fees	Permitted
Borrowing (cash and / or securities)	Limited to 50% of NAV (Borrowing + Short Selling cannot exceed 50% of NAV)
Short-selling	Limited to 50% of NAV, no cash cover required
Leverage	Maximum of 3X leverage defined as (total short securities + short cash + notional size of derivatives*)/ NAV *excludes derivatives used for hedging
Concentration Limit – issuer level	20% of NAV, subject to carve-outs
Illiquid Assets	10% of NAV at initial investments, 15% hard-cap
Disclosure requirements	Publicly-filed financial statements Top 25 holdings disclosed quarterly Leverage disclosure in annual and interim financial reports

“ As a technology, data analytics and service provider to alternative fund managers in Canada and globally, Linedata’s Global Asset Management Survey (2019) *, revealed these top 3 challenges:

1. Delivering investment performance

Pursuing the right investment strategy is clearly a decisive factor in the hunt for performance (the top challenge for 44% of respondents); with effective portfolio management critical to achieving this end. Access to real-time insights and actionable intelligence throughout the investment process – from execution management to position tracking and reporting – can help Canadian managers identify and capitalize on new opportunities, providing a competitive advantage. Moreover, optimized portfolio management operations enable diversification into new asset classes and strategies such as Liquid Alternatives.

2. Maintaining agile and efficient operations

In the wake of the financial crisis and more recent regulatory pressures, many asset managers find it difficult to prioritize upgrading their IT infrastructure, finding themselves simply patching and replacing parts when necessary. In the Canadian hedge fund space, many shops have grown up on spreadsheets. This means the industry is now rife with outdated and fragmented systems – with custom solutions often built over time and through acquisition – that are plagued with issues, drastically inefficient and are at breaking point. Furthermore, with intense competition, fee compression and the resulting need for differentiation, firms of all sizes seek improvements to operational efficiency - from decision support and trade execution through to back-office reconciliation - to better serve their own as well as their investor’s needs. Good performance is up to the managers and their investment teams, but on the operations side, it is important to be a real partner in finding the right operating model, whatever the strategy.

3. Transforming the business to better serve investors

This is really the ‘new’ battleground both in terms of the managers and their key service providers. Everyone wants better service – better data, faster, cheaper, more easily accessible. Immediate access to information about risk, return, potential additional products and services which may be there for them. We can all learn from how consumer tech has exploded in the last decade. It’s important for firms to deliver not just good investment products, but good technology and a great experience for their users. Many of our clients are looking closely at leveraging the public cloud, for agility, cost management and scalability. Others are looking at leveraging their own data to manage non-financial risk. For example, firms are focusing on operational data and looking for patterns that can identify problems before they happen, such as breaking trades, operational losses, valuation problems, compliance issues. Even starting with the real basics – looking at core systems, the data that flows through them and whether firms are getting the best value from what they have already today. This is often an excellent place to start, considering good analysis begins with good data. Those who successfully navigate their technology stack and streamline operations stand to gain a distinct competitive advantage. Furthermore, as the industry becomes ever more complex, digitalized and real-time, adopting the right technology and systems – as well as partnering with a vendor that can advise on the best solutions – will be vital to helping Canadian managers traverse this changing landscape.”

– **Stephanie Orloff, Head of Business Development – Canada, Linedata**

*[Linedata’s 9th Global Asset Management Survey](#)

12

Canadian Hedge Fund Categories, Directories, Indices and Performance

Hedge Fund Categories in Canada:

AIMA Canada was made a non-voting member of [CIFSC](#) in 2018. AIMA worked with the CIFSC to lead the development of categories that recognise the diversity of alternative investment products in the market and allow meaningful comparison of performance between investment fund strategies. The categories reflect the alternative investment strategies most widely used in Canada and currently include:

Investment Restrictions & Obligations	Offering Memorandum	Prospectus
Alternative Equity Focused	85	21
Alternative Credit Focused	23	8
Alternative Multi – Strategy	27	17
Alternative Market Neutral	16	4
Alternative Other	49	12

As at Aug 8 2019. Source: Fundata

Hedge Fund and Alternative Mutual Funds Directories

With the support of Fundata, AIMA Canada posts these hedge fund and alternative mutual fund directories on our website. [Alternative IQ](#) also hosts an annual Canadian hedge fund awards based on quantitative measure.

For additional reference, [SEDAR](#) is an official site that provides access to most public securities documents and information filed by issuers with the thirteen provincial and territorial securities regulatory authorities (“Canadian Securities Administrators” or “CSA”) in the SEDAR filing system.

Hedge Fund and Alternative Mutual Funds Indices

The [Scotiabank Canadian Hedge Fund Index](#) (SCHF Index) offers both an equal weighting and an asset weighted calculation. The SCHF Index includes both open and closed funds with AUM greater than C\$15 million and at least a 12-month track record of returns, managed by Canadian-domiciled hedge fund managers.

The [Scotiabank Alternative Mutual Fund Index](#) tracks the performance of the Canadian Alternative Mutual Fund universe. Returns are calculated monthly on an equal-weighted basis. Index constituents are limited to funds that are classified as Alternative Mutual Funds, as defined in National Instrument 81-102. Given the emerging nature of liquid alternatives, there is no minimum track record, or AUM, required for inclusion in the Index at this time.

Hedge Fund Performance

[Canadian Hedge Watch](#) publishes monthly performance for hedge funds in Canada. It also offers data from its own indices.

Key Themes in Alternative investments in Canada



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ESG & RESPONSIBLE INVESTING

Although still in its early stages in Canada, environmental, social and governance (ESG) issues are making their way into the investment process for alternative fund managers. Demand for these products is coming from across investor types, from high net worth individuals to institutional investors. For some of these investors, they see ESG as a part of their fiduciary duty to deliver returns and be a responsible investor. In Canada, many of the largest institutional investors have signed the UN Principals of Responsible Investments (PRI) and have committed to incorporating ESG factors into their allocation process. Increasingly, an investment manager's willingness and ability to address ESG factors is one of the criteria investors are using in their selection process.

Fundamental investment managers are well positioned to unleash the potential for capital to be allocated to corporations that are making meaningful progress toward ESG initiatives. Investment managers that also employ shorting have an even greater potential impact by selling short companies which score poorly (or have a negative ESG score) and increasing their cost of capital.

A major challenge has been the lack of quality ESG data. Third party scores are often static and backward looking, relying on voluntary company disclosure and artificial intelligence. Fundamental primary research has an important

role to play in sifting through and analyzing the often conflicting data. Investment managers are introducing their own leading edge-scoring methodologies to combat the lack of rigorous data and to analyze the "ESG friendly" corporate narratives that are bombarding investors with potential greenwashing. Fund managers developing ESG methodologies are adding value by actively considering ESG in analysis and investment decisions through investment research, proprietary scoring and real-time ESG performance monitoring.

The latest research by investment banks confirms this. In a recent report, J.P. Morgan states that ESG factors can affect markets more than previous analysis suggested, such as the Volkswagen AG 2015 emissions scandal and depressed water levels on the Germany Rhine River, which hurt the industrial and tourism sectors late 2018. J.P. Morgan strategist John Normand wrote that the environmental measure appears to have a positive influence on market performance, while equities seem to exhibit the strongest and more consistent sensitivity to ESG factors.⁴ Currently, 68% of Canadians say sustainable investing has become more important to them in the past five years, with millennials having the strongest feeling about sustainable investing.⁵ As a result, multi-family office advisors are actively speaking to their clients about values-based investing.



Ultimately, investment managers can achieve meaningful impact as well as meaningful financial returns over the long-term by integrating environmental, social, and governance (ESG) considerations into fundamental investment analysis and portfolio construction. Profitability and corporate responsibility are not mutually exclusive ideas. The pace and scale of change is unprecedented. Dedicated focus on understanding sustainability will create a greater opportunity to enhance value while achieving attractive risk-adjusted returns, generating measurable impact, reducing inadvertent and direct ESG-related risk and identifying new ESG-related investment ideas.

Increasingly, Canadian firms are also becoming signatories of the United Nations Principles for Responsible Investment (UN PRI) as well. Many of Canada's largest pensions have a public policy for Responsible Investing and/or ESG. Some, including CDPQ and OTPP, have also created specific investment strategies and approaches for addressing climate change. These represent opportunities for managers globally who cater to these important investment goals.

As a further leading example from a prominent endowment, the University of Toronto Asset Management Corporation (UTAM) has a formal [UTAM Responsible Investing Policy](#) is integrated at all investment decisions and applicable to all assets under their management.

For further reference:

- [CPPIB Sustainable Investing](#)
- [CDPQ Climate Change](#)
- [OTPP Climate Change](#)
- [CSA Guidance on Climate Change-related Disclosure](#)

“ Thematic research on the electrification of transportation and battery technology led us to discover that by applying an ESG lens we could not only identify incremental high quality investment ideas, but we could also identify, measure and manage a whole group of new direct and indirect risks. After more than a year of research and development we launched one of North America's first equity long short ESG strategies, which integrates' our bottom up company stock specific analysis and our existing factor management with ESG analysis and a proprietary ESG scoring methodology. Unique to our strategy is that we can go both long and short: rewarding companies with good ESG practices and scores while shorting those with negative attributes. ”

– Blair Levinsky, President & CEO,
Waratah Capital Advisors

“ Over our 20 years as family office advisors, our role has been to facilitate conversations about family values and the purpose of wealth within family enterprises. Historically, there has been a gap between these two. As we witness the largest transfer of wealth in North American history, millennial successors are coming into wealth ownership with a whole new set of demands which are fundamentally changing the conversation about the purpose of wealth. Family offices are in a unique position to facilitate the transfer of both wealth and values in a sustainable way. As ESG frameworks have proven to be viable investment tools for portfolio managers, we are now able to naturally connect the values we know our families have with the investment returns we know they need – there no longer needs to be a gap. ”

– Shayne Stephens, President & Co-Founder,
Landmark Family Office.

DIVERSITY AND INCLUSION

Diversity and Inclusion (D&I) is also a key theme for Canadian investors, asset management firms, and service providers. Focused D&I due diligence questionnaires are becoming more common, and many of Canada's largest firms and pensions have dedicated professionals and teams concentrated entirely on the initiative.

AIMA Canada partners each year for events and programming with Women in [Capital Markets \(WCM\)](#), whose sole mission is to accelerate gender diversity across Canada's financial industry. [The Canadian Centre for Diversity and Inclusion \(CCDI\)](#) is a social organization designed to help employers, diversity and inclusion/human rights/equity, and human resources practitioners effectively address the full picture of diversity, equity and inclusion within the workplace. [100 Women in Finance \(100WF\)](#) also has a strong presence in Toronto.

AIMA is a proud supporter of diversity & inclusion with more initiatives forthcoming.

ALIGNMENT OF INTERESTS: FEES, CO-INVESTMENTS AND CUSTOMIZATION

AIMA recently published a research report, [In Harmony](#) – how hedge funds and investors continue to strike the right note in aligning their interests. It examines how hedge funds and investors are aligning interests that best meet their mutual needs. The analysis reveals that investors and managers are exploring new approaches to negotiate fees and fund terms, and that hurdle rates are more widespread. The prevalent use of the '2 and 20' compensation model is now consigned to the past and we have observed increased use of 'tiered fees' for investors. A new equilibrium in the alignment of interests is on the horizon.

Customisation and co-investing mean hedge-fund managers can now deliver solutions that meet their investors' specific risk and return goals. This trend has been accompanied by a recognition of the value of accurate and informed communication between investor and manager, allowing for a productive exchange of knowledge between both parties and an increased understanding of investment strategies by investors.

These themes are certainly prevalent and widely practiced by Canada's leading institutions, and there is also a trickle-down effect on lower fees in retail product offerings as well. This is driven both by institutional trends and a main street investing focus on passive ETFs given the decade-long bull run, along with CRM2 legislation increasing disclosures on fees and the cost of professional investment advice. Many retail managers have lowered their management and performance fees to better compete versus these long-only strategies.

From a Canadian perspective, stats on such fee trends are highlighted below:

Redemption Liquidity	Number of OM products	Number of Prospectus Products
Daily	9	104
Weekly	32	1
Bi-Weekly	1	0
Monthly	91	1
Quarterly	5	0

Source: Fundata, Aug 21 2019

Current fee trends	OM Funds	Prospectus Funds
Average Management Fees	1.74%	1.36%
Average Performance Fee	15.87%	7.60%
Average Short-term Trading Fee	2.51%	0.86%
Use of performance fees	60.49%	44.34%
Use of Hurdle rates	25.85%	26.42%

Source: Fundata, Aug 21 2019

⁴ Joanna Ossinger, "JPMorgan Says This \$720 Area is Only Getting Started"

<https://www.bloomberg.com/news/articles/2019-05-30/jpmorgan-says-this-720-billion-space-is-only-getting-started>

⁵ Doug Watt, "Invest your conscience" <https://www.moneysense.ca/save/investing/sustainability-no-longer-an-obscure-investment-consideration-study/>

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The World of Private Debt



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EVOLUTION OF PRIVATE CREDIT

In the wake of the global financial crisis (“GFC”) banks tightened lending activity under stricter capital rules leaving a funding gap in the upper middle market. This gave private debt the catalyst to evolve from a niche industry to a mainstream global financing option for borrowers. The private credit asset class experienced explosive growth in the last decade with an annual growth rate of 20.5% and assets tripling in size – it is on track to reach the \$1 trillion mark by 2020. North America accounts for more than half of the world’s private debt assets. Private debt has surpassed infrastructure and natural resources combined and is set to exceed real estate as an asset class size by 2020.

Private debt funds in the U.S. continue to lead in market share over banks by being able to offer borrowers bespoke credit terms and faster execution. The private lending sector in the U.S. is significantly larger than the Canadian market. The aftermath of the GFC did not have the same effect on the Canadian banking system as it did in the U.S. Banks in Canada continue to play a dominant role controlling close to 80% of lending, making the Canadian credit market more highly concentrated and narrow. The Canadian non-bank private credit market is still nascent and lacks the deep high yield and leverage lending markets seen in the U.S. This is changing, bond issuance by Canadian non-financial firms to the non-financial corporate sector has doubled since 2008.

Borrowers

The universe of borrowers is expanding from mainly mid-market firms to companies at all stages of development that either cannot access conventional lending or want tailored flexible financing solutions which traditional bank lenders, constrained by more conservative risk appetites and frameworks, are unable to provide. Private credit managers are also increasingly lending outside of the mid-market with almost a quarter of companies in the U.S. having an EBITDA over \$75 million and 40% of companies with EBITDAs lower than \$25 million. This broadening of the borrower base has made private credit an integral part of the real economy – a source of financing but also a potential risk to financial and economic stability.

Market Environment

Private credit is on the cusp of a new era of growth. The sheer volume of dry powder promises further expansion of the sector. In this late stage of the market cycle, growth will be fueled by the rate environment and volatility of the equity markets. Macro-economic concerns, trade tensions, and monetary policy will motivate investors to look for alternative investment solutions and bring into sharper focus the benefits of private credit. Investors will seek shelter in a defensive asset class that can provide both capital preservation and non-correlated returns.

Popularity of the private asset class will gain traction as investors in search of yield find a compelling investment case in private debt with its attractive risk-adjusted returns, low volatility and income potential. Demand for private credit will be stimulated by the thirst for yield. Private credit outperformed other asset classes with short and long-term returns superior to fixed income and public equity. Private credit has the potential to generate private equity-like returns with a better risk-return profile and lower volatility. Returns are expected to be in the high single to low double digits – more than 200 basis points above fixed income return estimates. Also, the historical loss rate of private debt is lower than that of high yield bonds.

Post-financial crisis, investors' inability to rely on historical bond rates due to the low rate environment and the fall of government and corporate bond yields precipitated private credit becoming an alternative to fixed income allocations.

Compelling returns relative to fixed income spurred record levels of capital raising, which is expected to continue as more investors re-allocate monies traditionally earmarked for fixed income or private equity buckets.

Institutional Investors

Institutional investors are driving growth with 70% of capital coming from pension funds, insurers, and sovereign wealth funds. Canadian pension funds are global leaders in the alternative space, as demonstrated by CPPIB's 11% allocation to private debt in 2018. The appealing risk return profile of private credit has led to its emergence as one of the most rapidly growing institutional investment asset classes.

Private credit is becoming an increasingly prevalent part of investor portfolios, with more than half of existing investors expected to increase allocations. There is a lot more market share to be captured with only 30% of institutions invested in private debt today. There is also a wide opportunity set for allocations from new investors.

Family offices and high-net worth individuals have the advantage of not being constrained by concentration limits. Family offices now comprise 5% of total AUM – demonstrating the broadening of the investor base. Private credit in Canada remains considerably under-invested signaling a need to promote widespread awareness of the asset class.

The World Economic Forum predicts that by 2050 there will be a \$400 trillion pension funding gap, underscoring the magnitude of challenges facing pensions globally. Against a backdrop of demand for yield, pension plans are the probable contender to lead the charge on capital committed to private credit. The growing influence of institutional investors will have profound implications for the entire alternatives industry as investors become more sophisticated and targeted in their allocations. Investors are now exerting greater control over capital they commit and are expecting higher yields in return for their investment. The industry is catering to an ever-expanding list of requirements as investors demand better reporting and greater transparency. Managers should expect greater scrutiny of their due diligence and operational processes, succession plan and investment team skill set.

Risk / Return Spectrum

Private credit can offer a wide spectrum of risk return profiles. Over the last five years average returns were 8.7% across private debt strategies. Risk return decisions will dictate where to go in the borrower's capital structure. Senior secured debt is the safest investment in a restructuring scenario delivering low-risk moderate returns in the range of 6-8%, and if levered can garner an extra 2-4%. Returns can be augmented through equity tranche, structured debt investing or uni-tranche debt. Riskier strategies of unsecured, leveraged, mezzanine and distressed debt can deliver even stronger returns, but with higher risks.



Future of Returns

The next chapter in the private credit story will be marked by a move from unparalleled alpha to more muted beta-type performance returns. Excess capital has had the unintended consequence of propelling prices upwards and pushing returns down. While there has been some stabilization of this trend with managers expressing an unwillingness to compromise on yields, pricing pressures applied by borrowers coupled with a flight to safety could reduce returns further. A downturn in the market will further decrease the differential of performance spreads between top and median quartile funds – ultimately creating more homogenous beta-like investment returns. Competition will intensify as lenders try to counteract these factors and attempt to deliver the type of yields investors are accustomed to.

However, structural growth drivers persist, foretelling continued strength of the private credit market. That said, the industry cannot be complacent to the impacts of the impending end of the credit cycle and the competitive market dynamics that are putting pressure on deal terms and pricing, causing leverage levels to rise.

MARKET TRENDS – DRIVERS OF CHANGE

Private credit market fundamentals have undergone a seismic shift since the GFC. Dry powder is at an astounding level competing for a limited supply of deals - instigating intense competition. The combination of the 14% corporate tax rate in the U.S. and accelerated depreciation provisions acted as stimulus for M&A activity, adding further liquidity to the market. All of this has led to a new normal – a borrower-friendly environment. We are also witnessing a proliferation of lenders, new entrants and new strategies. An emergence of market trends is unfolding from bigger deal sizes, to the rise of niche strategies and a move to non-sponsored deals.

The New Normal – Borrower Friendly World Covenant-Lite

The influx of capital has led to the dawn of the borrower-friendly era with an erosion of covenants and yield compression. Borrowers have more choice of lenders and are now in the driver's seat when it comes to negotiating loan covenants and pricing. Traditional mid-market discipline has been compromised with managers pressured to sacrifice standards to win deals.

There is a marked erosion of credit documentation resulting in weaker financial covenant protection, exposing investors to greater credit risk. Where funds offer liquidity, stress conditions could prompt quick sell-off by investors making firms more vulnerable to risk re-pricing. Leveraged loan markets are particularly susceptible to shocks from changing investor sentiment. Covenant-lite deals ("cov-lite") are flourishing with as many as 85% of leveraged loans now considered to be cov-lite. The prevailing cov-lite phenomenon heightens the probability of defaults and losses thereby adding a fragility to the market that we have not seen before. Market conditions for borrower-friendly loan covenants are anticipated to continue.

In the U.S. the saturated upper mid-market (\$50 million to \$100 million EBITDA range) is feeling the brunt. Lender protections are better in the mid-market and lower-end of the market where there is less liquidity, making the lower mid-market more attractive than the large cap space in terms of risk return profile and downside protection. Syndicated deals are seeing the least amount of maintenance covenants. Variations in EBITDA definitions are becoming progressively concerning with debt repayment being impacted. There is less pressure on covenants in direct lending deals with at least between one and three maintenance tests being maintained.

Canadian private debt lenders have been fortunate as they have not had to face the same level of cov-lite pressure as the U.S. market. There is a ripple-effect however, as Canadian borrowers are increasingly looking to get better deal rates and terms. Canadian borrowers across industry segments, especially those with lower credit ratings, are increasingly turning to the U.S. leveraged loan market for financing. The amount of leveraged loans to Canadian companies has more than doubled in the past four years and cov-lite deals have jumped from one in five to one in three deals. U.S. private lenders are also starting to enter the Canadian marketplace. However, a cultural bias toward lenders with local presence and ongoing long-term interest in Canadian businesses is expected to keep the bulk of Canadian borrowers relying on home-grown lenders. Foreign ownership restrictions in certain industries will also keep foreign lenders away.

Pricing Pressures

Record capital is empowering borrowers to exert fee pressures. Borrowers are insisting on lower arrangement fees and loan coupon rates. Borrowers are no longer picking up the full tab of origination fees, they are being split or paid by funds. In closed end funds, while fees on invested capital has long been the hallmark in the U.S., in Canada fees have historically been charged on committed capital. Canadian managers are now experiencing the fee pressure as investors are pushing managers to accept management fees on invested capital which is resulting in a perverse incentive to put out capital for fee generation – elevating the risk of lower quality debt.

More Leverage

Leverage levels are at their highest since the GFC, even within investment grade corporate debt. In an environment of fee and loan coupon compression, private credit managers are turning to leverage to continue to deliver target returns in the senior capital structure. Total leverage multiples for U.S. middle-market loans was at an all-time high at the end of 2018.

Faster Deal Turnaround

Competition is shrinking due diligence timelines with financing being arranged on accelerated timeframes. Sellers are expediting processes and private equity sponsors are originating single standard term sheets instead of engaging in extensive negotiations with multiple lenders. The private equity community has come to expect this level of speed and efficiency. This trend toward faster deal turnaround has led to a bifurcation in the market with a sub-set of lenders resisting succumbing to this pressure.

Style Drift

Yet another unintended consequence of the new normal is strategy style drift by private credit managers to areas that extend beyond the core strategy. Investors will need to stay astute and assure themselves that they are invested in the type of loans and strategy that they intended and that the goalposts have not shifted beyond their expectations. Over half of investors have witnessed some level of style drift by managers.

Upsized Deals

Demand for private credit has led to fund sizes ballooning, managers with more capital to deploy seeking larger deals, and larger mid-market managers raising capital in record time. Lenders able to meet hold size demands that were in the small mid-market space are now scaling up to the larger mid-market space. This leaves room for niche and smaller managers to fulfill smaller ticket sizes.

The syndicated market has been disrupted with upper mid-market alternative lenders able to take up the whole deal, moving the traditional passive buyer model to the margin. Single mid-market private debt lenders are writing ticket sizes of upwards of \$100 million whereas pre-financial crisis, such a hold size required borrowers to seek out multiple lenders. Single deal sizes are even reaching levels between \$300 million and \$500 million, predominantly in the U.S. Borrowers are electing the benefits of proceeding with a single lender to avoid multiple due diligence processes and inter-creditor issues.

The ability to take down an entire deal allows lenders to build stronger relationships with portfolio companies and add value to their business model through their greater involvement. This is becoming a key advantage that borrowers expect from experienced private lenders, who in turn are able to extract an execution premium for this intangible bonus. Private equity firms are also reaping the benefit of this increased lender engagement as it lightens their oversight burden.

The largest funds have been the main benefactors of the influx of capital and bigger deal sizes. Mega-funds were born when the top 10 firms got 1/3 of the new capital while hundreds of other funds had to share the balance. Institutional investor concentration restrictions are also forcing the rise of the mega-fund. The desire for multi-strategy is driving rampant consolidation resulting in a change in the industry players. Further consolidation is a likely effect of a downturn, which will serve to stem the intense level of competition in the marketplace. Markets are less regional as global firms are increasing their multi-jurisdiction market share.



Experienced vs Novice

Increased competition from newer funds is creating a bifurcation of private debt managers into experienced versus novice managers, each with contrasting approaches:

Experienced lenders lend on fundamentals to withstand changes in the credit cycle and take a patient, long-term approach focused on capital. The investment process typically involves disciplined risk management, careful screening and extensive due diligence and is often relationship-based. In a bull market, experienced lenders take a cautious, more selective strategic view in exiting loans and will look for borrowers with scale.

Novice lenders are more likely to be volume-centric with a disproportionate emphasis on loan expansion which can lead to more aggressive risk-taking or risk complacency and an insufficient focus on credit quality and exit strategies. The result is a quicker capital deployment process and more lax lending standards with first time lenders being more susceptible to pressure from borrowers. Deals are more transaction-based as building a relationship-based pipeline requires time in the market. The effects of the competitive environment are felt more deeply by newer lenders.

The Deal Pipeline

Deal sourcing is a critical component to success in the current environment. While sponsor and intermediation models are still the primary source of origination in upper and mid-markets in the U.S. things are rapidly changing. Non-sponsored lending is becoming the holy grail – which has long been the primary model in Canada for non-bank private lenders. Sourcing in the small to mid-market in Canada presents challenges as companies continue to be closely-held and information tends to be more opaque.

Managers motivated by the desire to insulate against reliance on externally driven deals and private equity M&A activity are building in-house origination capabilities. The less populated non-sponsored market is highly attractive as it can deliver opportunities for better pricing and returns. Lenders don't have to contend with facing off with competing lenders sponsors bring to the auction. These features make direct lending a preferred origination pathway for sophisticated investors. Investors should assure themselves that managers have

a healthy and diverse sourcing pipeline of compelling investment opportunities that provide the ability to deploy capital at a steady pace across broad sectors.

There is a growing trend toward cultivating direct relationships with borrowers and nurturing these relationships to garner repeat business. Dealing with proven performers with whom they have established strong, trusting relationships lowers the risk for lenders and helps them defend against aggressive competitors trying to entice good borrowers with low rates and lazy terms.

Origination of non-sponsored deals requires investment by managers in the right mix of expertise and skillsets in-house to not only originate deals but to conduct the level of due diligence and monitoring needed to finance companies who typically have less governance and operational safeguards in place.

The sponsored market is also becoming narrower as sponsors take a critical look at their universe of lenders and hone relationships with key lenders. Private equity firms are driving this change because they want the assurance of dealing with reputable experienced private credit firms who won't put the business at risk. Private credit managers willing to trade-off less appealing lender terms for the comfort of a well-vetted company are partnering with private equity firms.

MARKET OPPORTUNITIES

Allocation Expectations

Allocations are expected across all sectors of the private credit market, with a focus on small mid-market, mid-market, distressed debt and asset-based lending. Driven by investor appetite, a greater portion of lending activity is in less conventional lending strategies like asset-backed finance, trade finance, receivables, real estate and distressed debt.

Market Segments

All segments of the lending market in Canada continue to be largely the domain of the Canadian banks with private lenders seeking opportunities outside of the bank sphere of comfort or capability. There may be emerging valuable opportunities for Canadian private lenders to refinance loans held in bank portfolios as a result of rising loss provisions if banks respond by reducing exposure to non-performing loans.

South of the border, the senior credit market segment is quickly becoming saturated with multiple players including: banks, direct lenders, investment banks, and high-yield investors – making returns harder to achieve. Mid-market lending is the largest segment of the private debt asset class, with almost 90% of middle market loans in the U.S. held by private lenders. The face of the mid-market has changed drastically, making it harder to define. The mid-market has morphed from a largely homogenous market providing similar size loans to specific borrowers to a complex and stratified market. There are now different sub-sectors within the broader mid-market strategy with each offering different risk-returns profiles.

The move to larger deal sizes and growth of the upper and mid-market has stimulated opportunities in other market segments where borrowers are struggling to access financing. These small-cap borrowers are incentivized to work with private lenders over private equity companies who expect a controlling stake. The risk philosophy and long-term view of the private lender also aligns better with the financing needs of mid-market and small-cap borrowers than banks. Direct lenders and other players that offer smaller companies an alternative to giving up control to private equity firms are being rewarded with higher spreads.

Lenders are turning to the less crowded, lower-end of the mid-market to generate higher returns and secure better deal terms and lender protections. Less competition makes the yields more attractive and there is extra alpha upside to compensate for greater risk of default and distinctive risks associated with smaller firms and key man risks. Lenders may also benefit from illiquidity and complexity premiums and yield for providing flexible financing. With less competition, the lower mid-market allows managers to be more selective and diversify their holdings.

The Differentiating Edge

The niche market is expanding as managers seek to secure their spot in a less competitive game. Lenders striving to differentiate themselves are developing specialized unique skills in targeted strategies that set them apart from generalist private debt lenders focused on broader market opportunities. Niche lenders specialize in specific industries or smaller more capacity

constrained strategies, such as: specialty finance asset-backed lending (eg. equipment leasing, aviation finance, art finance), venture capital /growth equity (eg. technology), distress debt, and trade finance. Direct lenders are also looking to non-conventional royalty streams. The flip side is that niche lenders may be shutting themselves out of broader deals.

Investors are looking to complement their core portfolio with unique investment strategies that fit their needs and offer a real value proposition. As the industry matures mandates are becoming more diverse and sophisticated. Being able to accommodate responsible investing mandates with ESG criteria can provide managers with a competitive edge.

The growing specialty market in the U.S. is a good predictor of this trend spreading to other jurisdictions. The size of these strategies is now making them a viable option for institutional investors. Returns in specialized sectors should be higher as these lenders will not be as susceptible to pressure to conform to cov-lite structures.

THE CLOSED-END WORLD – TOP ASKS OF LIMITED PARTNERS

More Investor Protections

Increased competition has shifted the balance of negotiating power to investors. Limited partners (“LPs”) now scrutinize management teams and fund terms in greater detail, consolidate their investments with a smaller number of managers, and are engaged in a general flight to quality.

Fund terms have become more favourable to investors since the GFC. LPs ask for a panoply of investor protection kick-out and termination rights including: no fault manager removal mechanisms, termination of investment period triggers, key person event clauses, and no-fault dissolution of funds.

LPs are seeking the right to restrict manager activities and expanding the definition of cause and disabling conduct to cover breach of manager fiduciary duty and standard of care. LPs are also demanding greater transparency of indemnification expenses, greater powers, and mobilization of the LP advisory committee.

Co-Investment Opportunities

There has been massive growth in the use of co-investment opportunities ("CIO") - doubling over the last 20 years. Investors making allocations across the full spectrum of asset classes are requesting access to CIO as a matter of course and this is set to continue. According to a 2018 LP Survey, more than half of LPs plan on engaging in direct investing over the next year.

As investors have become more sophisticated, managers and investors have sought to gain from the mutual benefits that participating in CIOs can yield. CIO are a popular tool for institutional investors to hedge their portfolio exposure to different market segments and to reduce the impact of fees and carry. CIO generally deliver better investment returns at a reduced or fee-free basis. LPs are increasingly looking to make direct investments to exert greater control and influence over design and construction of their investment portfolio and to maximize efficiency. It allows them to add concentration to their investment program and not be fully governed by manager choices. Investors want priority access and more private equity style protections such as consultation and veto rights over structure and key terms. Back-ended carry structure is also a common ask.

Managers offer CIO as part of a competitive package of fund terms to encourage investment and build relationships with investors. Offering of CIO affords managers deal access where they would otherwise be constrained by concentration restrictions and enables them to maintain fee levels. Managers should adopt investor allocation methodologies to determine whether large investors get first participation rights or whether all LPs can gain access on a pro-rata basis and to address the speed at which co-investors can act on opportunities, as speed is usually of the essence.

The most common strategies pursued in CIO are sector opportunities, activist, distress debt and concentrated versions of existing strategies. Investments in a main fund and CIO may not be possible because of restrictions around liquidity and concentration. For concurrent investments, deal entry and exit will require conflict of interest assessments and any related party transactions would necessitate proper disclosures and processes. Differing liquidity terms, investment periods, restrictions on follow-on investments and tax considerations could result in differing exit strategies.

Side Letters

Demand by sophisticated investors has led to side letters becoming commonplace in closed-end private credit funds where they seek enhanced rights due to the long-term nature of their investment and the complexity of funds. Initial cornerstone LPs have come to expect a Most-Favoured Nations Clause ("MFN") clause as a matter of course.

There are commercial, practical and regulatory considerations when entering into side letters. Conceding to side letter requests may be a more viable option than including terms in fund documents. There are standard commercially reasonable terms that are commonly found in side letters, such as: carve-outs rights granted to seed investors, accommodations for investors to reflect their specific legal, regulatory or tax concerns, and notification of event clauses (e.g. key person disabling conduct; material changes in valuation). Side letters are also used to provide a seat on the advisory committee and set out expressly negotiated fee terms.

The most common, and potentially most problematic, is the MFN clause which has wide-ranging implications and can markedly expand obligations owed by the fund or manager. MFN clauses can apply to all side letter terms or simply relate to certain terms (e.g. fees) and can apply to all investors or those with equal or lower capital commitments. Issues can become exacerbated where an MFN clause has the effect of expounding the application of problematic terms to multiple investors.

Excusal rights should be carefully circumscribed to avoid cherry-picking of deals and to lower the risk of being unable to call capital needed to fund a deal. Blanket consent should not be provided for transfer rights, as managers should be assured that a transferee meets relevant criteria. Caution should be exercised where the credit facility could be put in jeopardy.

The key is for private credit managers to be vigilant and not simply accede to investor requests. Managers need to balance competing interests of investors with principles of not allowing preferential treatment that could harm other investors, otherwise they could risk running afoul of their fiduciary duties. Managers also need to be mindful of legal and practical perils associated with ongoing monitoring of compliance and entering into conflicting side letters.

ON THE HORIZON – BRACING FOR A DOWNTURN

The industry is bracing itself to be tested when the credit cycle ends bringing greater challenges and risks. The decade-long private credit growth masked the importance of experience in default scenarios. The greatest test will be for first-time entrants unfamiliar with navigating through complexities of choppy waters. The performance of novice private debt managers during credit bull markets is substantially similar or slightly better than that of their more experienced counterparts, making it difficult for investors to discriminate based on returns alone. Lenders who engaged in lax underwriting will also have to face the consequences in a recessionary climate. To ensure resilience, lenders need to remain focused on staying true to lending standards and not unduly make compromises in the hunt for capital.

The industry was in its early stages during the last global recession and fared better than most markets. However, history may not be a good predictor of how private credit does in the next downturn because of the fundamental changes the asset class has undergone in the last decade. The private credit industry will be forced back to basics. Lenders that maintain discipline on covenant protections, have skilled re-structuring expertise, adapt their investment strategies, and employ risk management techniques to improve detection and monitoring of problems will not only survive but will thrive in challenging market conditions. Long-term success is dependent on lenders holding fast to their core underwriting standards.

Default and Recovery Rates

Default conditions continue to hover around immaterial levels of 2% but that is not expected to last with predictions calling for default rates higher than the historical average of 3.1% by 2021. There are already negative indicators appearing in the healthcare, energy and retail sectors. Canadian debt markets have become more vulnerable to a major credit incident with record levels of indebtedness – a meaningful predictor of recession severity. For the first time ever, the Bank of Canada, in its June 2019 review of the Canadian financial system, introduced non-financial corporate indebtedness as a key vulnerability to financial stability. History has shown that middle-market default rates are lower than the upper market and broadly syndicated loans.

Direct lenders are in a buy-and-hold model as quick exits are not a viable option. Lenders who create alignments with borrowers and take a vested interest in supporting outcomes for borrowers will be solution-oriented and not prematurely demand liquidity that would harm borrowers, and ultimately investors, where other options exist. Recovery enhancement and lowering default rates hinges on being able to take a patient and thoughtful approach to issues with longer-term value creation in mind. These relationship-based characteristics attributable to the mid-market lead to higher recovery rates, despite the more durable companies in the upper market.

Experience Matters

Investors will need to be more judicious in their choice of managers and investments as economic conditions worsen and default rates rise. The focus will shift from pure alpha and outperforming funds to funds that can provide steady returns and a differentiated strategy. In a bear market, experienced lenders are opportunistic and look for forced sellers and deep value. Novice lenders may adopt a shorter-term strategy that allows them to exit prior to the credit cycle turning again. Without experience through credit cycles, they could be more prone to panic and denial and may look for bids at any price to exit problem loans. Sponsors and investors will seek out lenders with demonstrated experience through multiple credit cycles and expertise in challenging work-out scenarios. Lenders with the bandwidth to deal with multiple troubled assets will have a further advantage. Lenders that have experience in value recapture under distressed or default conditions and who can capitalize on the mistakes of others will prosper - resulting in the performance gap between novice and experienced managers to widen. Experienced lenders will enjoy a leading edge and will be better able to maintain investor and borrower confidence.

Strategies for Investing

Lenders are already starting to plan for deteriorating credit conditions. Those that weather the storm will actively employ distinctive strategies to manage risks and take advantage of opportunities by lending higher in the capital structure, moving away from cyclical sectors or adopting niche lending strategies.



Cyclical Buffer Industries

Placing deliberate emphasis on backing incumbent borrowers and targeting larger more durable companies that can withstand an economic downturn is key. Managers will need to be more selective in their choice of borrower and pivot away from highly cyclical industries to more resilient sectors. Firms seeking more stable returns will start to focus on defensive industries that demonstrate less sensitivity to economic conditions, like technology, media, telecom, healthcare and business services. Prudent managers will steer clear of industries that did not fare well in past recessions, but they must be alert to the possibility that what worked in the past may not work in the future. A broad diverse portfolio of borrowers will also serve to hedge against concentration risks. This may be somewhat more challenging in Canada given that a significant portion of the economy is focused on energy and mining. Lenders must also deal with the cyclicity inherent in these sectors.

Capital Structure

Lending at higher positions in the capital structure with prudently valued collateral and exit plans acts as a defense to rising default rates. Institutional investors will seek the protection of being invested in securely collateralized loan obligations. There may also be rationale for structuring part of the debt in a manner that allows for loan coupons to be put on pause to provide borrowers cashflow options to assist them in remaining afloat while the right exit strategy is sought.

Multi-Strategy Approach

Firms taking a multi-strategy approach may find themselves in a better position to weather market cycles as the diversity of fee streams and strategies can lessen volatility and smooth out returns. Managers are expanding their offering to a more diverse range of loan strategies including senior and subordinated debt.

Opportunistic Strategies

Distressed debt opportunities will become more available as the market turns. Rescue lenders can take advantage of a market downturn by taking large equity stakes and picking up debt at significantly discounted prices.

Model the Downside

Prudent risk mitigation calls for downside case modelling in cycle and stress scenarios for company and industry specifics. This is a necessary component in building a solid loan portfolio. Modelling for downside scenarios will become even more crucial in late stages of the market cycle. It will enable lenders to ensure structuring of transactions to meet different scenarios with inclusion of adequate loan to value ratios and the right mix of other considerations. Careful modelling provides the underwriting team with the ability to identify areas of sensitivities and sustainability of the borrower's business model and assess their ability to meet obligations.

Downside modelling should include how the borrower and its revenue and business model will be impacted by: market cycle changes; loss of stakeholder or key customer relationships; operational infrastructure; industry dynamics such as competitive and disruption landscape; customer trends; capital requirements and cash flow; cost pressures; regulatory changes; and technological advancements. A deep dive to validate information and all assumptions is integral to strong underwriting skills. Extensive and critical assessment of qualitative and quantitative factors related to the company and the competitive industry, in both growth and downturn scenarios, is key to long-term success.

Due Diligence and Risk Management

Steadfast commitment to robust underwriting diligence and skillful structuring maintained through all market cycles and stress scenarios is imperative. The ability to apply superior diligence and credit risk assessment to prospective loans tiers lenders into different categories. All loans carry a certain amount of risk. Managing private credit is more art than science. The spectrum of rigor of due diligence and monitoring can differ drastically between managers. Investors must gain comfort with a manager's approach to evaluating borrowers and have a good understanding of how processes and transactions are structured to protect against key risks. Equally important will be operational infrastructure that supports rigorous post-close monitoring and reporting. To succeed firms will need to have excellent risk management and operational capabilities with transparent governance structures that address conflict of interest and valuation issues.

Discipline in modelling and structuring coupled with strong diligence and monitoring should act to reduce default rates and lower volatility.

Lender Liability

The size of the private credit market and its potential impact on the real economy will put alternative lenders conduct under a microscope. Lenders risk being accused of putting borrowers in distress by pursuing their interests to be repaid ahead of interests of borrowers and other stakeholders. Where excessive control is exerted by lenders their well-intentioned actions to mitigate losses could have the unintended consequence of affecting the nature of the duties owed to borrowers. Lenders that take active control of the business and operations of borrowers and interfere with their economic relationships – even in accordance with contractual rights - will fear being sued and held liable. Risks are heightened when a lender deviates from rights and remedies found in contractual agreements. Borrowers unable to re-pay their debts may unfairly attempt to cast blame on lenders by alleging misconduct. Lenders should structure loan documentation to be as iron-clad as possible in allowing active control and other rights to protect against potential liability risks.

Several prominent U.S. bank lenders have faced class actions that alleged lender liability for acting on tenuous defaults and halting the advancing of funds thereby causing or worsening their insolvency woes. Lenders have been found liable for damages for abuse of control of a borrower's operations causing harm. Bank lenders in Canada have not faced similar litigation. The Canadian experience and courts have been more favorable to lenders. However, private lenders should be keenly aware of the risks as they may not be spared from such actions if the market turns.

LOOKING AHEAD – WAVE OF THE FUTURE

While growth drivers for the private debt asset class remain strong, the industry is facing headwinds from intensifying competition and the impending correction in the markets. A sustainable future for the private credit asset class will be dependent on how the industry performs during a downturn. Maintaining good financial discipline centered around sound business models and engaging in transparent communication with all stakeholders and the broader public will be of paramount importance.

The next recession will shape the future of the asset by shaking out private credit firms and loans that will not weather the storm – we will likely see the bar rising once again on loan protections. Although Canada is in a better position than the U.S. it could feel the economic effects of a decline in funding in the U.S.

The strong forces of disruption of technology and ESG will force the investment industry into action. To compete in the new normal firms will need to leverage the transformative potential of technology. The future of the industry will be marked by a wave of innovation that will see investment firms harnessing the power of machine learning and data analytics for everything from finding investment opportunities to credit quality evaluation, loan monitoring and investor reporting. The full benefits of artificial intelligence and machine learning can only be felt in the private credit arena when quality and quantity of data is available.

The shifting market dynamics will surface questions that only time will provide the answers to. Questions of where managers will find opportunities, how they adapt to changes, how they survive and thrive, how they adapt to the digital transformation, how they set themselves apart, how they respond to the ESG wave and investor demands, what type of strategies take the lead, and how all the players play in the sand-box.

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Private Credit Vendors



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harmonic

The recent growth in private credit lending has been swift and exciting. Within a relatively short period of time, a significant portion of the corporate loan market has been fundamentally restructured such that alternative credit is helping finance a significant portion of Canadian, American and European economies.

As this market continues to grow in complexity and size, so too do the operational, administrative and reporting responsibilities of private credit managers. With spreadsheets no longer considered to be a particularly efficient platform for loan tracking and administration, private credit managers are increasingly looking to service providers to increase efficiency and reduce operational risk. In the following discussion, we'll look at some of the challenges currently facing managers and also take a high-level view of what service providers can offer in response.

Common Challenges

As highlighted in the ACC's 2017 research paper, Enhancing the Loan Administration Function, the top three most common challenges cited by private credit managers are as follows:

- 1) Reporting requirements (to investors or regulators)
- 2) Technology limitations to effectively track a loan through its lifecycle
- 3) A manager's limited prior knowledge with administering a loan

While these are common challenges irrespective of a fund's size, these become more and more problematic as a manager's volume and/or complexity of loans increases. That is, legacy systems may not be able to effectively manage the new demands being placed on them, and thus may not be able to offer the clear and comprehensive reporting that a growing manager needs for internal decision making, regulatory reporting, and investor reporting.

Moreover, many managers and investors have stressed the importance of more timely and robust requirements. This is particularly the case with increasingly demanding institutional investors – clearly an important class of investors for the industry as it grows.

Service Providers

Whether big or small manager, a private credit vendor can be advantageous in a number of ways for handling both standard and non-standard loans. In one fell swoop, a good provider can partner with a manager and effectively address all of the above plus quite a few other administrative headaches. A good administrator will understand not only a manager's fund structures, but also the manager's own organization. This will allow them to offer the best possible service, as well as minimise any operational risk in the handling of the manager's loan portfolio allowing managers to concentrate on their portfolios.

What are the basic vendor service operating models?

As with any service offering, delivery models can differ between vendors. For ease of illustration purposes, we've broken things out into what are essentially 3 different services. Firms can generally cherry pick from the below, customize one or more of each, or take the entire lot. Below we've briefly outlined each category:

Fund Administration

- The essentials of a fund administrator's offering include fund accounting, NAV and performance calculations, investor services and reporting, and management of capital calls and distributions.

Back and Middle Office Support

- Service providers can effectively act as a manager's back and middle office, providing services tracking of a loan book and performing any or all of a fund's back or middle office's functions.
- Parameters can vary widely per client engagement and can be as bespoke as required; basics would include daily, weekly or quarterly reconciliations with counterparties, including banks, daily P&L and/or GL reporting.

Loan Administration or Agency

- The loan administrator or agent is generally hired by the lender and can act as an independent facilitator of a deal throughout its entire lifecycle.
- This facility generally sits between lender and borrower and takes over the responsibilities of deal setups and maintenance, lifecycle transactions, collateral and collateral tracking, and of course, the generation and distribution of notices to all parties, as well as managing and settling cash activity.

The relationship between these service types and our three key challenges - reporting, technology and expertise - depend significantly upon a manager's business model. For example, one fund with a high volume operation, technology could be quite advantageous to limit volume sensitivity and labour costs. Alternatively, a smaller manager with lower capacity but more complex deals, technology could be less relevant however a knowledgeable service provider could be extremely valuable by providing insight into best practice procedures, AML/KYC outsourcing or simplifying investor or borrower reporting.

Whatever the scenario, as the private credit industry continues to grow in Canada and elsewhere, managers from the smallest to the largest, will face the challenge of upgrading infrastructure to keep pace with their growing businesses. Whether kept in-house or delegated to a service provider, a robust loan administration function enables private credit managers to focus on their core skills: meeting the needs of their investors and providing credit to borrowers in need of tailored solutions. This, in turn, allows them to continue providing financing to the real economy, helping create jobs, nurture new industries, and drive economic growth.

Alternative Credit Council (ACC): Financing the Economy

The [ACC](#) has published our annual [Financing the Economy](#) research since 2015. This research is now established as a key source of data on the market and widely cited by industry, investors and policymakers. When this research commenced, private credit was a growing but misunderstood part of the alternatives industry. Today, private credit is now recognised as an asset class with the sector on track to reach a size \$1tn AUM by 2020. Our research has helped shape perceptions of that growth and supported investors and policymakers understanding of the benefits of private credit.

To mark the 5th anniversary of this research the ACC has interviewed 25 leading figures from within the industry. Taken as a whole, these individuals represent the full breadth of the asset class and the different strategies that this encompasses. The paper will showcase their views on the key trends that will shape the future of the asset class. Our findings will demonstrate that the outlook for private credit remains bright with the sector better placed than many assume to weather the challenges that lie in wait for the asset class. This research includes some unique Canadian perspectives, alongside those from across the globe, that ensure the opportunities for private credit in Canada are more widely understood.

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Private Equity, Real Assets, Infrastructure, and more in Canada

Private equity, real assets, real estate and infrastructure investments continue to rise in popularity in Canada. This is reflected by strong investor asset allocation. Historical problems with liquidity and access are slowing being overcome as offerings in these asset classes are structured for retail. For example, RBC Global Asset Management announced a \$7B real estate fund partnership with pension British Columbia Investment Management Corporation and QuadReal Property Group. TD Asset Management acquired Greystone Capital to further diversify their private market solutions, and Brookfield continues to be a prominent player in infrastructure and real estate funds. Real estate investment trusts continue to be a popular solution amongst retail advisors as well.

“ Investors such as pension plans and sovereign wealth funds have increased their allocations to buyout strategies and become more aware of their structural constraints. They want private equity to give them ongoing exposure to high-quality businesses, but unfortunately, the traditional buyout model hasn’t evolved much since the 1980s: the model still requires selling companies after a few years and taking fees each time. Why not pursue an approach that enables you to really target and then hold best-in-class companies without artificial time constraints?

There are a lot of strong, growing companies that want to work with an investment firm who can provide active, longer duration capital. For example, many family-owned companies do not want to sell to a buyout fund and face the likelihood of being sold all over again in a few years. They would prefer to work with a firm that can add meaningful industrial value and help them create true long-term value.

The bigger picture is the changing landscape in corporate ownership. We’re seeing fewer public companies and a maturation of the traditional buyout model. We think there’s a need for a new model that builds on the lessons learned in buyouts—particularly the importance of active ownership and value creation—while creating better alignment among the general partner, limited partners, and our companies. That is what we’ve achieved with Long Term Private Capital. ”

– André Bourbonnais, Managing Director, Global Head of Long Term Private Capital, BlackRock

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Canadian Regulatory Landscape



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Blakes

CANADIAN REGULATORY LANDSCAPE

In Canada, securities regulation is a matter of provincial and territorial jurisdiction meaning that each of Canada's 10 provinces and three territories has its own legislative scheme for regulating the securities market with each being administered by a local securities regulatory authority.

As a general principle, the laws of the jurisdiction (province or territory) in which a Canadian purchaser of securities resides will govern any trade in securities to that purchaser.

Notwithstanding the fact that provinces and territories have tried to harmonize securities rules through national instruments and have succeeded in various areas (including certain registration matters), there are still differences across the jurisdictions (including as it relates to investment fund manager (IFM) registration) and, as a result, local legislation must be considered.

The Ontario Securities Commission (OSC) has jurisdiction over securities matters in Ontario, Canada's most populous province with Toronto generally being viewed as Canada's financial centre. Due to the size of the province, the OSC has the biggest investment fund branch in the country and typically is the principal regulator on various matters due to investors' location, alongside the Autorité des marchés financiers (AMF). The AMF is the organisation responsible for financial regulation in the province of Québec, with Montreal representing Canada's second largest financial centre. Out West, the British Columbia Securities Commission (BCSC) & Alberta Securities Commission (ASC) represent additional key regulatory bodies.

LAUNCHING AND SELLING A FUND IN CANADA

Investment Fund Checklist

Is the Issuer an Investment Fund?

Various requirements under Canadian securities law are triggered based on the characterization of the investment vehicle. For example, a vehicle which is an "investment fund" for purposes of Canadian securities law will be subject to different registration requirements and filing obligations with respect to its activities in Canada than a typical "corporate issuer". As a result, it is important to determine if an issuer is an "investment fund" as a starting point of any inquiry.

An "investment fund" is defined under Canadian securities legislation as a "mutual fund" or a "non-redeemable investment fund".

- Mutual Fund:

- primary purpose is to invest money provided by its securityholders;
- issues securities which are redeemable on demand; and
- redemption price computed by reference to the value of a proportionate interest in the whole or in part of the net assets of the issuer (i.e., net asset value of the issuer).



- Non-Redeemable Investment Fund:

- primary purpose is to invest money provided by its securityholders;
- does not invest:
 - for the purpose of exercising or seeking to exercise control of an issuer; or
 - for the purpose of being actively involved in the management of any issuer in which it invests;

other than an issuer that is a mutual fund or a non-redeemable investment fund; and

- is not a mutual fund

Additional guidance regarding the definition of “non-redeemable investment fund” has been provided by Canadian regulators and it requires a careful consideration of the characteristics and investment strategy of an entity as part of such determination.

Registration Requirements

At a high level, entities will be required to register under Canadian securities law if they are:

- in the business of, or holding themselves out as being in the business of, trading securities;
- in the business of, or holding themselves out as being in the business of, advising in respect of the buying and selling of securities; or
- acting as an investment fund manager.

As a result, issuers, managers, and those distributing securities (specifically securities of investment funds) may be subject to registration requirements under Canadian securities law.

Therefore, it is important to consider the activity being undertaken in Canada or with respect to Canadian investors as well as the factors above related to the definition of “investment fund” as these factors will determine the rules and registration requirements applicable to an offering as well as any ongoing obligations.

	IFM Registration	Adviser Registration	Dealer Registration
Investment Fund	Yes	Yes	Yes
Private Equity Fund	No	No	Typically, yes
REITs	No	No	Typically, yes
Mortgage Investment Entities	No	No	Typically, yes
Lending Vehicles	No	No	Typically, yes
Managed Account	No	Yes	No

Note: The terms Private Equity Fund, REITs, Mortgage Investment Entities, Lending Vehicles and Managed Account are not defined under Canadian securities legislation and its use in the chart above is for informational purposes only and the actual characteristics of such entity and its activity will determine the applicable registration requirements.

Dealer Registration

In Canada, any person “engaged in the business of trading” in securities (including pre-marketing and marketing activities done in furtherance of the sale) must be registered as a dealer and/or a dealer representative acting on behalf of a registered dealer (“Dealer Registration Requirement”). This means that an issuer or its manager is generally not permitted to contact and deal directly with prospective clients in Canada as every sale of securities of an “investment fund” to an investor in Canada must be typically made using a registered dealer or a dealer eligible to rely upon an exemption from the Dealer Registration Requirement.

The most common exemption from the Dealer Registration Requirement is the international dealer exemption which allows a non-Canadian dealer registered or licensed in its home jurisdiction and which has satisfied certain requirements, made a filing with the Canadian regulator and appointed an agent for service in such Canadian jurisdiction, to engage in trading activities with “permitted clients” in respect of “foreign securities” and primary offerings of Canadian debt securities.

“Permitted clients” are a sub-set of the “accredited investors” exemption but it is important to note that the “permitted client” definition is more restrictive than the “accredited investor” exemption specifically with respect to individuals.

Canadian asset managers are typically registered as exempt market dealers (EMDs) in order to satisfy the Dealer Registration Requirement without relying on a third party. An EMD is permitted to trade in securities being distributed under a prospectus exemption and may also be used by foreign issuers.

Since the terms “trading” and “securities” are broadly defined under Canadian securities law for purposes of the Dealer Registration Requirement, it is imperative that managers and issuers obtain legal advice prior to any contact with prospective Canadian clients. However, Canadian regulators have provided some guidance and developed certain basic principles to assist in the interpretation of these terms and as a result certain activity might be exempt from registration.

Investment Fund Manager Registration

A person or company that directs the business, operations or affairs of an investment fund is required to register as an investment fund manager (“IFM Registration”) with the Canadian regulator in which its head office is located. The IFM Registration is only applicable to “investment funds” meaning that the determination whether an entity is an “investment fund” for purposes of Canadian securities legislation again becomes essential.

Ontario, Quebec and Newfoundland and Labrador also require non-resident IFMs to register if the investment fund an IFM manages has securityholders that are resident in those jurisdictions and the IFM or a fund the IFM manages has actively solicited local residents to purchase securities of a fund after September 27, 2012. There is an exemption from the IFM Registration if, among other things, the securities of the investment fund are distributed only to “permitted clients” and certain filings are made with the applicable securities regulators. In addition, an IFM relying on the non-resident exemption has on-going filing obligations with respect to its activity in these jurisdictions including payment of a participation fee in Ontario.

The IFM Registration requirement does not apply to an IFM in the other Canadian jurisdictions unless fund management activities are conducted on the ground in the local jurisdiction. As a result, soliciting investors or distributing securities of a foreign investment fund in those provinces or territories or having holders of securities of a foreign investment fund being resident in those provinces or territories does not typically trigger the IFM Registration in those jurisdictions.



Adviser Registration Requirement

Unless an exemption is available, any person engaged, or holding itself out as engaging, in the business of advising anyone in Canada with respect to buying or selling securities is required to be registered and abide by the requirements for registered advisers (the “Adviser Registration Requirement”). The Adviser Registration Requirement is generally applicable to advisers who manage a portfolio of a person or company that is resident or otherwise located in Canada (including a Canadian fund) but a portfolio adviser to a foreign fund which is distributed to Canadian investors would generally not be required to be registered as an adviser in Canada.

The most common exemption from the Adviser Registration Requirement is the international adviser exemption which allows non-Canadian advisers which have satisfied certain requirements, made a filing with the Canadian regulator and appointed an agent for service to provide advice to “permitted clients” as long as such advice does not involve securities of Canadian issuers, unless providing advice regarding securities of Canadian issuers is incidental to providing advice on a foreign security. An adviser who relies on the international adviser exemption will be subject to on-going obligations including monthly reports related to Canada’s anti-money laundering regime and payment of an annual fee.

The Canadian legislation also provides an international sub-adviser exemption from the Adviser Registration Requirement which allows the foreign adviser to provide advice on securities of Canadian issuers but places greater responsibilities and risks on the Canadian registrant.

Prospectus Requirement

Asset managers offering securities of their investment funds to Canadian investors must do so on the basis of a prospectus or in reliance on a prospectus exemption.

The exemption most frequently used among capital raising exemptions in Canada is the accredited investor exemption which allows an issuer to distribute its securities to qualified entities and individuals without a prospectus. The threshold is relatively low as an individual may qualify as an accredited investor if he or she, alone or with a spouse, own financial assets having an aggregate net realizable value over C\$1 million; has net assets of at least C\$5 million; or has net income before taxes in excess of C\$200,000 alone or C\$300,000 together with his or her spouse. There are other exemptions which are also available and may be relied on by an issuer. A prospectus exempt offering does not require a written document describing the business or investment strategy of the issuer; however, if a document is used certain prescribed disclosure may be required including description of the rights of action for damages or rescission where such document contains a misrepresentation.

Securities issued pursuant to a prospectus exemption are subject to resale restrictions and hold periods. If an issuer, such as a private fund, distributes securities under a prospectus exemption and does not become a reporting issuer in Canada thereafter, such securities will never be freely tradeable in the Canadian market. Recent amendments provide an exemption to allow Canadian purchasers of a foreign security under a prospectus exemption to sell such securities over an exchange if the issuer is listed on a foreign exchange.

A private placement of securities under certain prospectus exemptions, including the accredited investor exemption, will trigger a reporting requirement where an issuer must file a report within 10 days of the distribution or, in the case of an investment fund, within 30 days of the end of the calendar year with respect to distributions during such year.

A prospectus offering (which requires filing of a prospectus and other materials which are reviewed by and must be signed off by Canadian securities regulators) provides the asset manager access to retail investors but is much more costly and time consuming and will result in on-going public disclosure obligations.

INVESTMENT FUNDS		
	Retail Products	Exempt Products
Target Investors	Retail investors Registered Accounts	Exempt individuals (accredited investors) Pension funds Family offices Registered Accounts
Offering Document	Prospectus	Typically an offering memorandum but one is not required
Regulatory Oversight	Prospectus and other materials reviewed by securities regulators	Offering document not reviewed
Financial Statements	Required in the Prospectus	Generally not required
On-going Reporting Requirements	Semi-annual disclosure and filing requirements including financial statements	No regulatory requirement other than annual and interim financial statements which are exempt from filing requirements As set out in constating documents and agreed to with investors
Investment Strategy / Investment Restrictions	Mutual funds (including alternative funds) and non-redeemable investment funds limited through legislation including with respect to leverage, liquidity and types of investments	No regulatory restrictions Limited by constating documents and as agreed to with investors

ADDITIONAL LEGAL & REGULATORY CONSIDERATIONS

As part of [AIMA's Navigating Private Placement Series](#) 2017, please see here for a further summary of Canadian securities legislation and key considerations for registration requirements, exemptions, fees and filing requirements.

Further Links To Key Canadian Securities Law & Resources

AIMA Canada regularly engages with regulators both formally and informally on several items. Recent regulatory initiatives of note with subsequent comment letters can be found on the AIMA Canada website at aima.org.

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Fintech & Innovation in Canada



By: Jennifer Tkachuk-Tremblay
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FinForum



Canada's financial system has a reputation for being stable, secure, conservative, mature, and overwhelmingly supported by the five major banks. While we have this safe and steady foundation, it is important to mention the incredible growth in the financial technology and innovation space, including but not limited to the retail investing, institutional, corporate finance, infrastructure, and regulatory environment that is causing substantial disruption. Canada's tech scene is not one to be ignored. Specifically, in 2018, Toronto, was named North America's fastest growing tech market by CBRE for the second year in a row.

Today, fintech companies often see themselves as strategic allies to established financial institutions. This is a stark change from the earlier fintech days where the

mindset was one of new school vs. old school. Today, partnerships between both sides exist and flourish as fintechs bring new, more efficient technology to the forefront, automate work streams, improve customer experiences, drive cost savings, and quicken turnaround times for due diligence processes or deal cycles. On the other hand, institutions provide the environment in which emerging firms can grow, and many provide capital, mentorship and partnership to the young companies. A PwC 2017 Global FinTech Report claimed that 62% of Canadian financial institutions were actively involved in partnerships with fintech companies and 88% claimed to increase this going forward.

From a fintech infrastructure standpoint, Canada is in a strong position given the rise of accelerators, innovation labs and incubators. These environments, ecosystems or communities are often driven and backed by large corporations, banks and educational institutions. In all of these ecosystems, fintech companies have the opportunity to partner with other start-ups and established institutions, whilst being introduced to capital providers and the venture community. Some of the prominent collaborative and catalytic environments include MaRS Discovery District, the Creative Destruction Lab, Communitech, bank-owned digital innovation or venture arms, the DMZ, or the recently launched OTPP-BCG Digital Ventures incubator, Koru.

There are even some niche-focused innovation hubs, such as Decentral that focus exclusively on disruptive and decentralized technologies, including blockchain and cryptocurrency. According to a publication by Salesforce, as of May 2019, "Canada's top 20 accelerators and incubators have attracted more than \$1.7 billion in follow-on investments and contributed to the creation of over 10,000 new jobs. A number of large [Canadian VCs] have poured hundreds of millions of dollars into Canadian startups, and the Canadian venture capital market and incubator and accelerator scenes will only continue to grow."

The USA and the UK have long been viewed as Fintech leaders, creating encouraging and collaborative environments for entrepreneurs, including regulatory sandboxes, and tax exemption benefits. Similarly, Canada is holding its own, but we have the privilege of boasting more favorable immigration policies than our neighbors to the south, as well as more political and economic stability than our allies across the pond due to Brexit. Structurally speaking, Canada is well-positioned to continue to attract talent from around the globe. To name a couple Canadian regulatory programs, the OSC Launchpad and Fintech Sandbox create easier avenues for emerging fintech companies - particularly those faced with some level of regulatory obligations, to navigate the bureaucratic and fiduciary necessities of the industry more efficiently. Mature financial institutions specializing

in financing and supporting early and mid-stage companies like Silicon Valley Bank, as well as emerging financial institutions in support of early-stage companies and entrepreneurs, such as Clearbanc, are seeing tremendous success in the Canadian venture and start-up market. These firms help finance and bank emerging companies, bold entrepreneurs, and in SVB's case, even the VC firms themselves at times. Notable innovative developments include Clearbanc's launch of the "20 minute term sheet" for entrepreneurs to more easily and quickly secure financing, thus removing some of the red tape and hurdles in the start-up financing space. Further supporting their mandate to bank entrepreneurs, they announced in early 2019 that they plan to lend \$1 billion in non-dilutive financing to start-ups in 2019. Globally, Silicon Valley Bank has supported over 30,000 tech companies since opening its doors in California 35 years ago. In March 2019 the company formally announced that its Canadian headquarters, in Toronto, were open for business. This constituted a sure sign of significant tech demand in Canada and that SVB was enticed to no longer just support Canadian firms like Drop, Shopify and Vanedge Capital from Santa Clara. Among other things, SVB specializes in lending to scale-up technology companies, private equity and venture capital firms.

The global fintech sector is rapidly growing and evolving, with several sub-categories emerging. Some of these fintech subsectors include capital markets and trading, wealth management, blockchain and cryptocurrency, lending and credit, insurance, payments and money transfer, infrastructure services, security and identity, crowdfunding, banking and personal finance. Most of these are backed by some application of artificial intelligence, machine learning and/or natural language processing (NLP) technology. And in case you need a hand, as far as resourcing or talent, companies like Element AI exist to integrate AI tools into existing businesses. Given the plethora of subsectors, and the myriad of investment opportunities within these spaces, there have been a growing number of venture capital firms participating in the sector. Prominent Canadian fintech investors include Omers Ventures, RBC Ventures, TD Ventures, Georgian Ventures, BDC Ventures, Panache Ventures, PowerCorp and its affiliates like Diagram and Port3ge, as well as Golden Ventures, Real Ventures and Information Venture Partners. According to the MoneyTree Canada report by PwC Canada and CB Insights, venture capital funding in Canada hit an all-time high in 2018, with over USD\$3.5 billion invested across 471 deals.

Focusing specifically on capital markets and trading, wealth management as well as the adjacent tech sector - Reg Tech (regulatory tech), we see a range of applications that can be complementary to traditional or mature financial institutions and investment managers.

In the capital markets and trading realm, we see technology-driven companies emerging at all points in the value chain. Companies like Agreement Express are streamlining and expediting the onboarding process for wealth management firms and insurance companies. Then you have more mature companies like Overbond, which provides predictive analytics to the bond market. Q4 is another mature fintech company in Canada lead by a seasoned and successful management team. Q4, among other areas, is disrupting investment banking and broker-dealer cash equities desks as they provide software driven investor relations and corporate access solutions directly to issuers and corporations. Easily integrated and API-driven custody and broker solutions like Apex Clearing, Drive Wealth, Gatsby and Tradier, albeit not Canadian, are also quickly growing in popularity as alternatives to larger institutions who may be less nimble or tech savvy. Another Canadian fintech success is Quandl - acquired by NASDAQ in late 2018. Quandl aggregates and delivers, via API, all sorts of financial, economic, and alternative datasets that serve investment professionals. Of course, it's also worth noting that "alternative data" is becoming increasingly popular amidst the hedge fund and asset management community given the constant and insatiable need to continually seek new sources of alpha.

Digital banking is quickly evolving into ecosystem banking. Ecosystem banking will enable true end-to-end customer journeys where Fintech companies and banks can seamlessly co-exist. Open banking is another sector to watch - where financial institutions follow an open API infrastructure. Open APIs allow third-party developers to build applications and services around the infrastructure of the financial institution.

Additionally, Canada is home to disruptive companies like Equibit Group which is a blockchain based securities trading platform that enables a peer-to-peer equity and debt marketplace to raise capital for investors. Furthering the partnership-mentality, companies like Paycase have teamed-up with well-established institutions like the TMX to build a blockchain-enabled network that merges traditional and crypto finance, capturing numerous facets including exchange, remittance, and compliance.



Wealth Management is another ever-shifting component of finance, and therefore fintech. Here, you can see the rise of robo-advisor platforms like Wealthsimple, Wealthbar, Modern Advisor, and Nest Wealth; to integrated solutions that incorporate insurance and other forms of employer-sponsored compensation like LINK Investment Management, League and Invisor. Other novel offerings include Mylo, which invests its clients 'spare change,' and Delphia Inc.. Delphia, is a Toronto-based Y-Combinator and venture-backed company that is democratizing quantitative strategies previously unavailable to retail investors, at a fraction of the cost of traditional hedge funds. They do this by leveraging proprietary and evergreen data (analyzed anonymously and in aggregate to protect personally identifiable information) collected from self-declaring and consenting members of their social app community. They even allow their members to invest in financial products just by using their data.

An overarching theme amidst all fintech players, is the importance of data. If data is now being viewed as possibly the most valuable commodity on the planet, then it's easy to see how data related topics such as monetization, privacy, sharing or connectivity are becoming increasingly popular, necessary and sensitive subjects. While technology has enabled exponential opportunities to share and exchange information, it has also led to instances where information has been misused. The data-movement has thus allowed for an additional suite of fintech companies to emerge. As such, a handful of Canadian start-ups are developing frameworks for innovation in a future where trust is paramount, and these firms are rooting themselves in principles of privacy, inclusivity, authenticity and irrefutability. Previously mentioned venture capital firm, Georgian Partners, has taken a very forward, thought-leadership, role in "trust" given its publication of the "11 Principles of Trust". The premise of this framework is that in a technology-driven world it is critical that all parties (clients, regulators and partners) trust how their information is protected. And as such, Georgian has provided multiple levels and steps on best practices for 'building trust' whether you're a new company or a mature one.

As we begin to tie up this brief overview of the Canadian fintech climate, we need to take a step back and ask ourselves a question: how does Canada stack up, in fintech, versus the globe? The answer: good - but there's

of course room for improvement. The general challenge with tech - particularly with new ideas - is the new technology is often born before its application is ready. I.e. the rail care is built before tracks. It's no surprise then that the EY Fintech Adoption Index shows that we (Canada) lag in adoption and usage, as well as practical application. Whether it's consumers or companies being unaware of partnership opportunities, supporting infrastructure not being phased in appropriately, or an overall need for greater understanding about how technologies work at an individual level, or a lack of trust or hesitation in new technology-driven approaches, we do have some room - as individuals and corporations, to develop.

We also have a need for more capital - entrepreneurs continually look south of the border once local capital providers have been exhausted. In short - the pace of our new companies, and new ideas, is outgrowing the rate at which capital is flowing into the space. Many things, however, are working very well for us. We are certainly attracting and retaining talent better than the earliest days of the start-up tech boom when Canada was continually suffering from 'brain drain.' We're also an undeniable world leader in core technologies such as artificial intelligence, blockchain and machine learning - which are industry-agnostic global tech underpinnings. Specifically, we are home to world-renowned AI visionaries, thought-leaders and academics: Geoffrey Hinton, Yoshua Bengio and Richard Sutton.

In closing, AIMA is playing a pivotal role in ensuring its members and the investment community is increasingly aware of what is happening in the fintech space as well. Whether it's through events and thought-leadership sessions for its members, or the production and co-authorship of white papers on emerging technologies, markets or asset classes such as Digital Assets, AIMA is clearly a proponent of innovation and change. With over 850 incorporated fintech companies in Canada across numerous niches - some of which were highlighted here, coupled with the fact that we have one of the most stable, trusted and robust banking systems in the world, a supportive suite of accelerators and innovation catalysts, and a mindset built around collaboration and partnership, Canada certainly has the potential to assert itself as a world-leader in fintech.

A world beyond paper processes



By: **Greg Fenlon**

Head of Alternative Investor Services

Citco Fund Services (USA) Inc.

CITCO

Traditional paper-based approaches are inefficient and risky, but new approaches are emerging

Onboarding investors has traditionally been an arduous and unwieldy process. Lengthy physical documents - sometimes over 70 pages long - are exchanged between investors, institutions and fund administrators. This process has become increasingly impractical, inefficient and unsecure.

However, the road to a paperless system is in sight. The industry demands that such an environment is created, and it is time for platforms to catch up and deliver it.

The current challenge

We face the challenge of moving out of an unsophisticated and labour-intensive landscape. At present, many investors are still operating in a paper-heavy world, filling in lengthy documents that have to be scanned, faxed, emailed or even posted back to fund managers and administrators. This creates real operational risk as these files can be lost in transit, misdirected or mislabelled. This can result in investors missing their trade and potentially sully a strong relationship with a client overnight.

Upon receipt of these paper documents, there is still plenty of work left to do. The investor-processing team will have to decipher an investor's handwriting and go through the document page by page, working through any strikeouts or incomplete sections. Challenges are also encountered with the absence of standardization across documentation. Investor misinterpretation is commonplace and can result in incorrect categorizations or administrative back-and-forth. An enhanced investor experience delivered through a holistic, digital interaction is a much-desired prospect for market participants.

Sharing data digitally

Any form of digital transformation has to accommodate both new and existing investors – two different groups that have different requirements. Existing investors can more easily transact in funds, having already completed all due diligence and documentary requirements. Driving this population to an online experience is a more seamless proposition.

For new investors, given this is the commencement of their relationship with any fund, they will have more onerous responsibilities as part of their onboarding. In addition to completing fund application forms, they will need to comply with all relevant AML/KYC checks, which also requires the provision of further documentary support.

To meet this need, there has to be an appropriate forum to allow the various parties to interact: the manager interaction with the investors during the prospecting phase, and the investor with the administrator during the acquisition phase. This can be readily achieved by utilising a fully-functioning “data room” - established for the two parties to share the relevant documents securely over a digital platform. The manager will also be able to glean metrics to ascertain how investors are using the documents they share.

CitcoConnect™ is a digital solution that automates and simplifies the process of managing prospective investors. The platform offers a capital raising and fund reporting data room, digitized subscription forms, a subscription wizard and an investment manager control. Born out of a drive for investor-friendly efficient and streamlined onboarding process for all market participants, this enhancement pays heed to the importance of cybersecurity as well as the physical fraud threats that exist today.

A key feature of CitcoConnect™ is that subscription agreements required by the fund at the time of investment can also now be digitalized. Instead of manually completing long and arduous documents by hand, a new investor can simply fill out a smart document online and execute it by generating a secure electronic signature. This document can then be saved in its entirety as a PDF and be submitted to the administrator along with required KYC and tax documents, negating the use of fax, email or “snail mail”. It will land digitally, directly into an automated electronic workflow and the whole process of investing has begun without, in most cases, using a single piece of paper.

By challenging the status quo and long-held industry norms, we can strive for a truly streamlined and modern investor experience in the alternatives space, creating a new approach that delivers better standards across all processes as well as the quality of service that clients deserve.

Meeting the Growing Needs of Infrastructure



By: Cesar Estrada

**Senior Vice President
Head of Product Management
for Private Equity and Real
Assets fund services
State Street Corporation**



What do a high-speed rail line, a toll road in Ontario and emerging renewable power technology have in common? All have garnered billions of dollars from institutions investing in infrastructure.

Proponents of infrastructure assets note that the class, by and large, boasts yields high enough to be attractive in a low-interest rate environment, while also providing exposure to stable, predictable cash flows. This hasn't escaped the notice of fund managers as well as institutional investors, who have been making generous infrastructure allocations.

Canadian financial institutions have a long history of funding infrastructure. Pension funds, insurance companies and asset managers put money into direct investments to give them control over their investments and avoid unnecessary fees.

According to Preqin and Infrastructure Canada:

- 67% of Canadian institutions allocate to infrastructure¹
- 141 infrastructure transactions took place in Canada in 2018²
- 22 billion USD was allocated to infrastructure in 2018 — the highest allocation to infrastructure in the past five years²

The buzz around infrastructure assets may stem in part from the widespread understanding that Canadian infrastructure needs are intensifying, as infrastructure

reaches the end of its useful life and needs repair or replacement. Canada's long-term infrastructure investment plan amounts to \$180 billion over the next 12 years.³ The launch of the Canada Infrastructure Bank in 2018 aims to attract private investors to fund that investment.

"The significant growth we've experienced in our Infrastructure Fund Services business is coming from both specialist firms getting bigger and from new entrants, from funds in both ends of the risk/reward spectrum – e.g. core and opportunistic," explains Cesar.

Of course, need isn't enough to justify investment in any infrastructure asset. Funds only consider assets that are expected to meet targeted rates of return and many may not pass muster. This risk is particularly significant for infrastructure assets because they're mostly illiquid; a toll road can't just be traded away. Yet the assets' illiquidity is something institutional investors like pension funds are often willing to bear for the sake of long-term exposures that match their long-term liabilities. The lack of liquidity may also present opportunities for the largest infrastructure-focused funds, which can afford to take on bigger projects than smaller investors, especially when they form joint ventures with other investors. It's a valuable advantage, as investors today often must compete with one another for stakes in the most promising infrastructure assets.



Partnering with an experienced third-party service provider that understands infrastructure allows fund managers more time to focus on finding those promising infrastructure assets. Industry expertise and a dedicated fund administration practice combined with technology and reporting capabilities that support the diverse nature of infrastructure investments, will only enhance investor interest and support continued growth of the asset class at both the fund manager and the industry level.

1. Preqin. "Canadian Infrastructure – February 2015"
2. Preqin. "Canada_Preqin_Infra_DealsExits_Annually"
3. Infrastructure Canada

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The Impact of Increased Operational Complexity on Launching a New Private Equity Fund

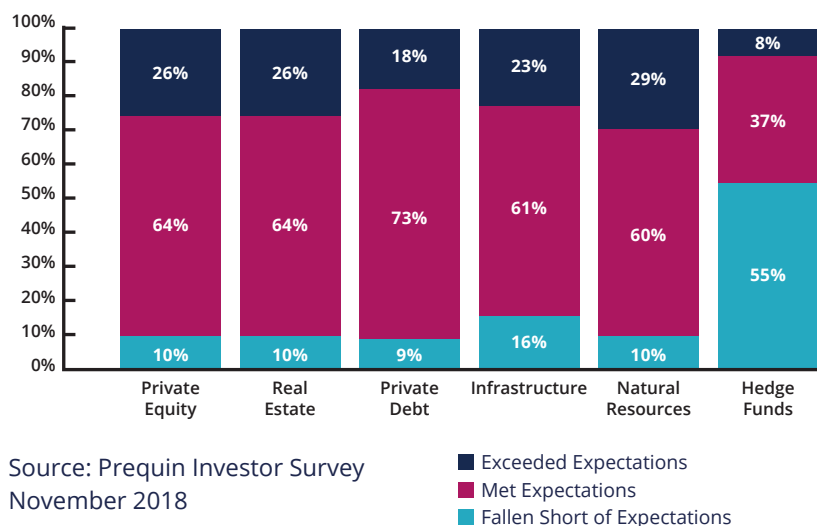


By: **Mark Weir**
Regional Head of Fund Services
Benoit Sansoucy
Vice President, Fiduciary Services

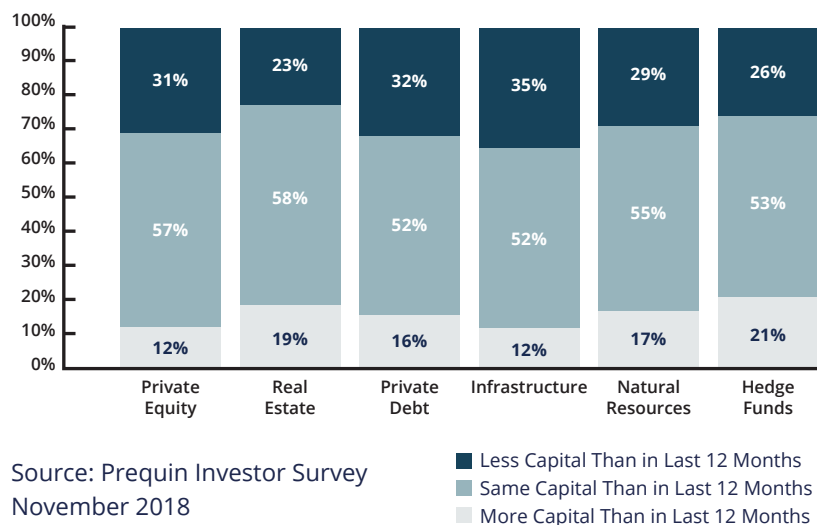


Over the last decade, private equity has generated strong returns, outperforming benchmarks and generally meeting or exceeding expectations. As a result, investors are optimistic and plan to increase target allocations to this asset class over the next 12 months. It is expected that this trend will result in investments being made in both developed and developing markets around the globe.

Investor View on Portfolio Performance Over 12 Months Relative to Expectations

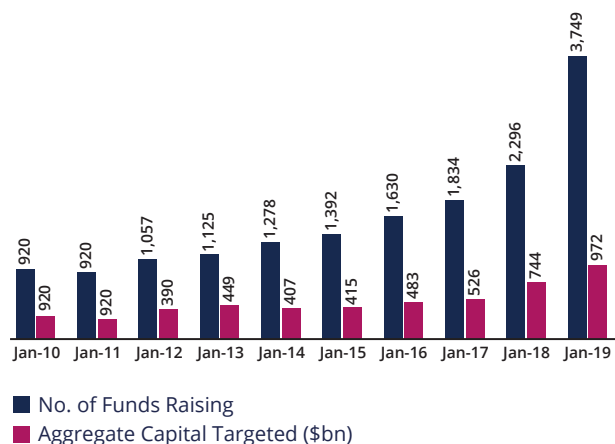


Investor View on Portfolio Performance Over 12 Months Relative to Expectations



With more capital flowing to private equity, a number of established General Partners (“GPs”) are looking to launch new funds. In addition, there has been a steady stream of entrepreneurial investment managers who are confident about opportunities in the space and are eager to set up first-time funds. However, doing so can be an intimidating prospect and new challenges are emerging. Due to a rapidly evolving compliance landscape and growing regulatory scrutiny, coupled with increasing Limited Partner (“LP”) demands, traditional practices for launching and operating a private equity fund may no longer apply, resulting in longer lead times, delayed launches, a need for larger operations teams or additional outsourcing partners.

Private Equity Funds in Market Over Time, 2010 - 2019



Source: Preqin 2019 Global PE&VC Report

Significant time and resources are allocated to defining and implementing the investment strategy, ensuring the right teams are in place, developing a plan for fundraising, establishing the appropriate legal structure and undergoing investor due-diligence. While these steps are necessary to lay the foundational elements for bringing a new fund to market, an equally important but often overlooked element of this process is creating a robust operational infrastructure. This is the linchpin of the fund’s operations and ensures not only a successful launch but ongoing effectiveness of the fund throughout its multi-year lifecycle including the end of life phase.

Key elements of this process include:

1. Establishment of Robust LP On-boarding

Processes: With the continuing evolution of Anti-Money Laundering (“AML”) regulations and Know Your Customer (“KYC”) requirements globally, including recently enacted requirements for Cayman Islands domiciled closed-ended investment vehicles to comply with requisite AML regulations, there is a need to ensure mechanisms are in place for the management of the fund’s legal obligations. This includes the collection of information and performance of AML/KYC in accordance with applicable jurisdictional legislation. Implementing a robust LP on-boarding process ensures adherence to regulations upfront, so that compliance risks are mitigated and time-consuming remediation is not required after capital is called.

2. Establishment of a Strong Governance Framework:

As LP’s continue to become more sophisticated, the need for enhanced governance oversight continues to increase. Governance is essential whether a fund is being established as part of a managed account platform, a standalone commingled fund, or a co-investment opportunity which can introduce additional complexities when it comes to compliance practices. Given the long-term nature of a private equity fund, this oversight can help to preserve LP value through activities such as negotiating beneficial service provider terms, establishing consistency in valuation methodologies, encouraging increased communication and effectively managing end of fund life scenarios. Furthermore, the development and execution of appropriate policies and procedures can help mitigate risk and potential reputational harm. Governance solutions can be implemented through the use of a GP entity that is independent of the investment manager or by way of an advisory or governance committee to the GP which has been established with specific rights and discretions with respect to exercising certain GP powers.

3. Establishment of Best of Breed Partnership

Accounting Practices: Accounting for private equity investments requires a deep understanding of the fund's governing documents, such as limited partnership agreements and private placement memoranda. This can become more complicated as structures evolve to include co-investments and side agreements such as managed custody accounts. Funds can reduce operational risk and add value for LPs by leveraging third party resources that bring independence to the maintenance of books and records, including ensuring that valuations and expenses are applied in adherence to the terms agreed between GPs and LPs. In addition, these resources bring specialised knowledge and expertise in complex allocations and incentive calculations, as well as experience monitoring the events that trigger waterfalls throughout the life cycle of each fund. Studies of SEC filings have noted that funds that utilise a third party administrator are also less likely to receive SEC sanctions or a qualified audit.

4. Establish Regulatory Reporting and LP Screening

Processes: Ongoing risk management and regulatory compliance have become key priorities for private equity funds and their investment managers with regulators demanding greater transparency, enhanced reporting and investor oversight. Private equity GPs may be required to submit, maintain and produce a series of regulatory reports including Form PF and Annex IV filings on the firm's assets, reconciliations and audit reports to demonstrate compliance with SEC custody requirements, and FATCA and CRS filings. Co-investment opportunities may demand increased reporting for co-investing LP's. In addition, funds must manage various other compliance and due diligence requirements including ongoing KYC/AML verification and the appointment of AML compliance officers in certain jurisdictions. Access to specialists in these areas can help ensure the required support for ensuring that the fund consistently discharges all of its regulatory obligations.

5. Establish a Strong Infrastructure around

LP Relations: LPs have become increasingly sophisticated and are demanding greater transparency into their investments. GPs require solutions to facilitate connectivity and ongoing communication with LPs, ensuring they have access to current and historical information including capital statements, call and distribution notices, quarterly and annual financial statements, performance history, market updates and newsletters. In addition, as LP requirements continually evolve, there may be a need for custom reports that GPs should be equipped to provide.

An ever evolving regulatory and investor landscape is putting more pressure than ever before on private equity GPs of all sizes to optimise their operational processes. GPs are grappling with how to effectively meet these increasingly onerous and rapidly changing requirements. While they have a number of factors to consider in how best to achieve this, access to expertise is key. Having access to experienced and professional governance service providers and outsourcing certain business processes to an external service provider that has an established track record of operational excellence, innovative technology and seasoned professionals can yield significant benefits. Not only does outsourcing provide economies of scale, it can also significantly enhance credibility among LPs who are demanding more independence in fund operations and governance. As a result, establishing sound governance and operational practices will create access to larger pools of institutional capital.

Retail Alternative Investment Funds in Canada



By: **Derek Hatoum**
Partner, PwC



After years of consultation and dialogue, the Alternative Investment Fund (AIF) for retail investors became a reality in late 2018 as part of the modernization of investment funds initiative of the Canadian Securities Administrators.

The regime

Previously, firms that wished to offer retail investors a mutual fund product that engaged in otherwise prohibited activities, such as short selling, holding commodities, borrowing, and using derivatives other than specific ones, had to seek exemptive relief to do so. Others had offered commodity pools under National Instrument (NI) 81-104 that provided some flexibility with investment restrictions, but this did not effectively provide an ability to offer retail customers a broader suite of alternative products.

This new AIF is a type of mutual fund that is permitted expanded investment flexibility versus a conventional mutual fund and many of the forms of relief previously granted are now built right into the amended regulations.

The recent launch of the AIF has been effected through amendments to various existing regulations, including NI 81-101/102/104/106/107 and NI 41-101. In addition to creating expanded investment flexibility, other aspects of the amendments have been designed to facilitate the conditions under which an AIF can be sold in the retail space, set what continuous disclosure obligations

apply, and address how certain conflicts are dealt with, to name just a few.

If you are planning to enter the retail space as an alternative fund manager for the first time, there are some important considerations to address. Connecting with qualified counsel, accounting and tax professionals is also recommended.

Your registration status

When offering retail funds, you will need to make sure your firm has the right registrations in place. NI 31-103 has several categories of registration in place, and firms that offer mutual fund product generally must be registered as an "Investment Fund Manager". Changing your category of registration requires an application to your provincial regulator, and brings with it differing ongoing obligations. One of those ongoing obligations may be an increase to the minimal working capital that you must maintain month to month. Others are quarterly reporting, such as summarized investment portfolios and NAV error reporting, as well as annual reporting on compliance with Parts 9, 10 and 11 of NI 81-102. These are just a few of the things that may change for you. Understanding how these apply to you to not only ensures you will be permitted to offer such products, but outlines the impact to your firm on the additional time and costs associated with doing so.

Prospectuses and new fund launches

You are likely used to issuing confidential offering documents, such as private placement memorandum and term sheets. To offer an AIF to the public you will need to file a prospectus and related annual information form. NI 81-101, which covers mutual fund prospectus disclosure, now incorporates the requirements for an AIF and is broken out into two parts: Part A covers general information about investing in a mutual fund while Part B provides specific information about each fund offered. Unlike a confidential offering document, NI 81-101 is far more prescriptive as to form and content of a mutual fund prospectus.

Your principal provincial regulator will review your pro forma prospectus and provide comments that you must address before the final prospectus is filed and a regulatory receipt is granted.

When forming a new fund, you (or your affiliates) will need to make a seed capital investment of at least \$150,000 worth of the new fund's units, and these units cannot be redeemed until unaffiliated investors have subscribed for at least \$500,000 of units. The prospectus will incorporate, by reference, an audited opening statement of financial position that shows this seed investment.

You'll need to coordinate this with your auditor in advance of filing the prospectus. They will need to review the prospectus and provide consent on the incorporation by reference in the prospectus of their opinion on the seed capital financial statements before the regulator will grant you a receipt.

Once up and running, this prospectus requires an annual refresh, along with the filing of required continuous disclosure documents, including semi-annual and annual financial statements, management reports of fund performance and fund facts.

Reading and understanding these prospectus requirements before launching a fund ensures your resource time needs and budgeted costs are adequately estimated, and enables you to bring your great ideas to market with the least friction.

Know your capabilities

A key success factor in entering the retail space is knowing your firm's capabilities. If you are not accustomed to the additional demands of a retail fund, there may be experience gaps to identify and address.

Frequent NAV computation, expanded reporting to investors (e.g. fund facts, management reports of fund performance) and the formation of an independent review committee to address potential conflicts of interest between the firm and the fund, are just a few things that could be new to you.

- Will the more stringent requirements over custodianship, concentration limits, short selling/ derivative/commodity/liquidity significantly impact the investment style of your team?
- Have you considered your marketing strategy? Will you seek access to dealer platforms, self-market to investors, or sub-advise to established mutual fund managers? Are you familiar with the advertising standards for a mutual fund manager? And, do you understand the sales practices regime of NI 81-105?
- What about the costs of launching an AIF under the new regime, including the ongoing costs for your business?

Carrying out a thoughtful analysis of your strategy and the potential market appetite for your product, together with an assessment of your current capabilities and financial condition will help you manage your business and operational requirements in order to set you up for a successful foray into this brave new retail world!

How you can truly be digital instead of just doing digital?



By: **Anthony Rjeily**
 Partner, National Leader, Digital
 Transformation and Innovation, EY



Although the alternative investment community may have been somehow immune to digital disruption given its “alternative” nature, compared to the more traditional B2B or B2B industries, each one of us at a minimum has heard or has been exposed to new digital technologies in our everyday life. With the advent of new technologies such as artificial intelligence, blockchain, robotic process automation and quantum computing, one should expect that all industries, including alternative investment firms, will be impacted in one way or another by digital. The question is, how do you prepare for this transformation and how can you leverage it as an opportunity to create value?

Either you’re a hedge fund, a VC, a PE firm or a derivatives trader, your business will be impacted by these technology changes and you need to start planning on how to become a digital organization and not just apply digital technologies in an uncoordinated manner.

Here’s how to get set your digital transformation journey for success

Most organizations are undergoing some form of digital transformation or are planning to pursue it soon. While that shouldn’t surprise anyone, it is concerning that businesses that have already poured considerable sums into such transformations are unclear on the value they’re creating, how their investments align with the overall business strategy and how to sustain changes in the long-run. Executive teams know they need to start or continue investing in digital transformation, but more leaders need to focus on an evolution that escapes hype and embraces impact.

The problem we at EY see most often in the work we do with our clients is when digital transformation is limited to just upgrading front-end customer experiences without connecting the front office to the middle and to the back. Examples of such initiatives include digital apps for a smooth client on-boarding process, the ability to generate reports with just one click or submit a support request using your mobile device.

While the focus on experience that we've observed for years now is understandable and necessary in order to acquire new customers and retain existing ones. But to truly transform a business to be relevant to ever changing customer expectations, the middle- and back-office functions can't be ignored. Digital only truly works if it's connected across the organization in three main ways: improving customer interactions, enhancing enterprise capabilities and employee experience, and spurring applied and scalable innovation.

In banking, applying for a mortgage, as an example, may start out as a great digital experience – a simple website, attractive design and a quick application process. But once you hit the apply button, the experience can often quickly deteriorate as the manual, inefficient middle- and back-office processes kick in. Similar situations can exist in the alternative investment industry. The reality is that most business processes, that are required to support customer experience haven't been transformed, optimized and aligned to the outcomes businesses are trying to achieve. More often than not, this could result in delays, additional manual touchpoints and what we refer to as non-optimized experiences. In the mortgage application example, an employee calls you to tell you they need you to complete five other steps to actually submit that mortgage application. This isn't pleasant for employees either and hinders their ability to be brand ambassadors who deliver exceptional customer service we all expect. Thinking of the customer experience from all angles – end-to-end and connected front, middle and back – will enable true transformation and drive the enablement of profitable and optimized customer experiences.

While transforming the front, middle and back-offices is the immediate imperative, a true digitally connected business will sustain its success by continuing to curate new innovations. This includes understanding customer preferences on an individual basis, harnessing the power of new technologies at the right time, such as Blockchain, Artificial Intelligence and IoT, seeking new types of ecosystem partnerships and exploring new business models for the next source of value. This is where true differentiation lies and positions an organization to deliver the outcomes its business seeks to achieve.

None of this is possible, however, without going back to the basics. Leaders need to set transformation goals that are measurable, traceable and most of all – realizable. The question is not how to integrate the latest cool gadget into the business, but what outcomes does the business want to achieve and how? Then choose the enabling tools, technologies and ways of working that will help you get there. This way you'll be much more likely to succeed not only in execution but also in benefit delivery. What we recommend to our clients, and practice ourselves, is tune out the digital noise out there and think holistically, while innovating in an applied and scalable way. That's how you can truly be digital instead of just doing digital.

The Growth of Private Credit



By: **Brendan Sibeth**
Business Development,
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Gabriel Vinizki
Business Development,
SS&C Technologies, Inc.



Fund managers diversify their strategies to reduce risk and to deliver new and reliable sources of returns for end clients. As more institutional and alternative asset managers acknowledge the difficulties presented by today's market conditions, such as continued low interest rates and increased volatility, some are making the transition into new asset classes.

Many managers are actively moving to private debt and direct lending, issuing loans to underfunded small-to-medium-sized enterprises (SMEs) that are excluded from traditional bank financing.

This deviation from conventional investment brings both opportunities and challenges. These new investment avenues may offer reasonable returns and have tacit regulatory endorsement, but for firms who have historically made their clients' profits through traditional asset and derivative investments, the swing to such complex debt products cannot be made without major adjustment to their processes.

Why the change in course? For several years, active managers have struggled to outperform benchmarks, with one in three large cap managers failing to beat the S&P 500 in 2016.¹ While performance improved the following year, it remained relatively low with just 43 percent outperforming passive peers.² Although volatility helped active firms in 2018, they are still facing

pressure from relatively less expensive passive managers, some of whom have even launched zero-fee products.³

This is forcing active managers to scope out new strategies beyond conventional stock-picking. Similarly, hedge fund performance following the financial crisis has yet to reach its pre-2008 zenith, and while 2017 was the industry's best year return-wise since 2013,⁴ the results in 2018 appear to be more mixed.⁵ This is partly because assets in the \$3.23 trillion industry⁶ have ballooned and managers who were once able to pinpoint interesting investment opportunities are now being crowded out of those trades. Returns are falling, and benchmark targets are not being met. Firms are working hard to cultivate existing clients and win new mandates, often through generous fee discounting. Despite this, hedge funds – just as traditional long-only managers – face competition from lower-cost smart beta, index trackers and hedge fund replicator strategies (i.e. products that track hedge funds). This is forcing firms to seek out new sources of alpha.

For the \$2.83 trillion private equity industry, performance – which has consistently exceeded that of public markets and other asset classes – is currently not a problem. Client satisfaction in private equity is phenomenally high, with 93 percent of investors telling data provider Preqin that returns in 2018 had met or exceeded their expectations. More than half said they would grow

their allocations in the asset class in the long term.⁷ The principal dilemma facing the private equity market is the risk of overheating⁸ fueled by sizeable deal multiples, large leverage ratios and extraordinarily high dry powder volumes.⁹ With too many private equity firms chasing after too few deals,¹⁰ buyouts are routinely concluding at double-digit multiples of EBITDA, valuations which many feel cannot be propped up indefinitely. Conscious of this, more private equity firms are edging away from buyouts and are investing in different asset classes.

Fund managers embrace loan origination

Loan origination and direct lending to SMEs is a growing strategy across the asset management industry. A record \$129bn in aggregate capital was raised in 2017, followed by a still-impressive \$110bn secured in 2018¹¹. While returns have dropped recently¹², internal rate of return (IRR) is still hovering between five and 10 percent as the average margins on loans stands at around 600bps to 1500bps.¹³ Performance advantages are not the only driver of increased flows into loan origination products. Low rates have made banks reluctant to provide loans, and regulators – both intentionally and unintentionally – have had a material impact. Basel III assigns SME loans a higher risk rating, forcing banks to hold more capital on their balance sheets when providing financing to such companies. This has led to a deprivation of bank financing which has prompted SMEs to explore other funding channels, and asset managers have proven to be willing backers.

Canadian Perspective

In Canada alone, private debt under management has totalled a staggering \$10.4 Billion USD in June, and in 2019 alone, more than \$600 Million USD has already been raised. Renewable energy projects, housing, grocery store, mortgages, and bridge loans, distressed debt, short duration, venture debt, are among the most popular investments.¹⁵

Many Canadian pension and endowment funds have embraced private credit investments due to their equity like returns without the volatility of a traditional equity investment. Recently, the Canadian Pension Plan Investment Board (CPPIB), stated that it is extending a push into private credit to help fill a need for yield made scarce by low interest rates. To help illustrate this growth, in 2011 CPPIB had \$5.1 Billion in private debt investments. Fast-forward to March of 2019, that figure is sitting at \$32.7 Billion shown in their most recent report.¹⁶

As global yields continue to plunge, and economic slowdown worries loom, it has become increasingly urgent for portfolio managers to find alternative return sources. Further growth within the private credit market is anticipated to continue in Canada and abroad due to higher yields compared to traditional fixed income, shorter loan durations, low correlation with public markets, and diversification of sources of risk and return just to name a few. Private credit and its various forms have proven to be a legitimate form of fixed income investing, satisfying a wide range of risk appetites. Of course, with any investment strategy, one must take the time to fully understand how private credit works, and where it fits within a portfolio.

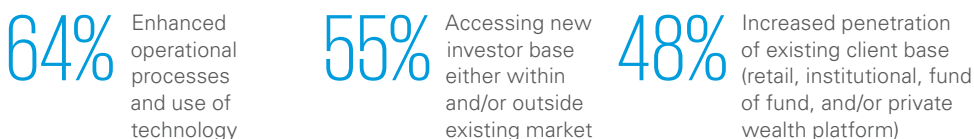
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- 2 Mercer Capital (2018) Value Focus: Asset Management Industry
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- 15 Paula Sambo (May 14 2019) Toronto Star: Burgeoning alternative credit market sparks Canada's first Fund of Funds
- 16 Paula Sambo (September 9, 2019 Bloomberg News: Canada Pension Giant CPPIB is Expanding its private credit wager

It's decision time

Highlights from the 2019 Canadian asset management opportunities and risks report

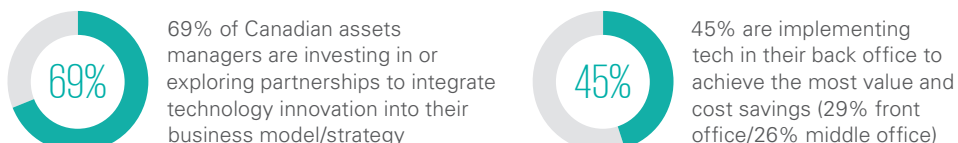
Top organizational opportunities



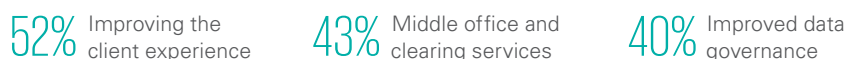
Top organizational risks



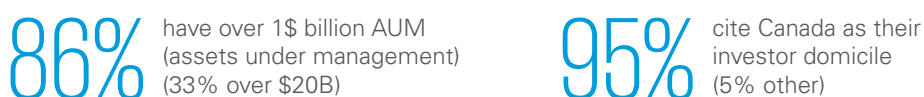
Technology top of mind



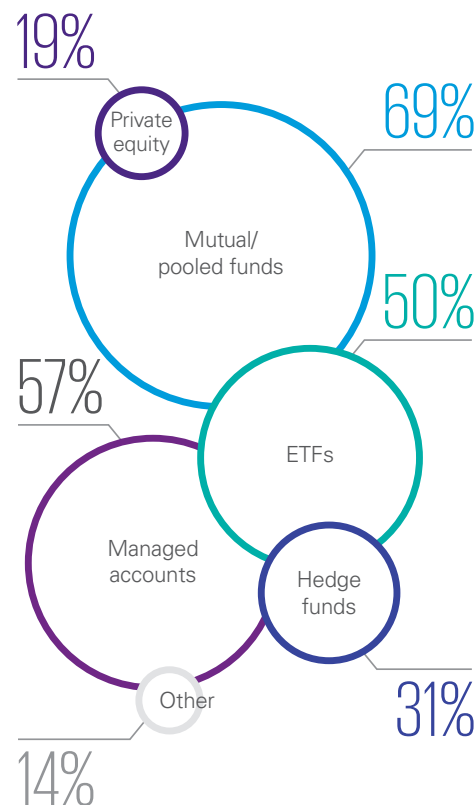
Top anticipated benefits from technology investments



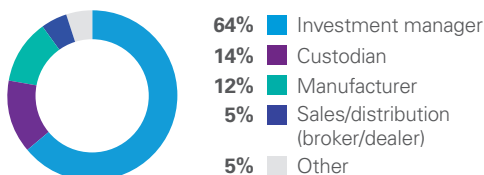
Respondent breakdown



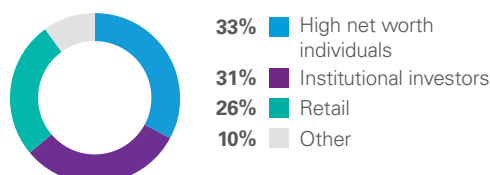
Product types



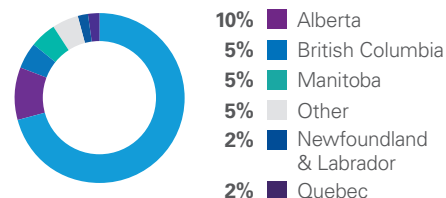
Sector



Investor base



Headquarters



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- a. [Indices: Hedge Funds & Alternative Mutual Funds](#)
- b. [Fund Directories: Hedge Funds & Alternative Mutual Funds](#)

2. AIMA Canada Public Resources

- a. Investment Advisor DDQ
- b. Infographic
- c. Canada Hedge Fund Primer
- d. Long/Short Equity Strategy – AIMA Canada
- e. Launching Alternative Mutual Funds Handbook
- i. Plus, recorded webinar with CE Credits
- f. CE Credit Presentation: Introduction to Alternative Investments and Benefits of Adding to your Portfolio

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- b. L'autorité des marchés financiers – Quebec ([AMF](#))
- c. BC Securities Commission ([BCSC](#))
- d. Alberta Securities Commission ([ASC](#))
- e. Investment Industry Regulatory Organization of Canada ([IIROC](#))
- f. Mutual Fund Dealers Association ([MFDA](#))
- g. Investment Funds Institute of Canada ([IFIC](#))
- h. Canadian Investment Funds Standards Committee ([CIFSC](#))
- i. [Sedar](#)

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- d. Conseil des Gestionnaires en Émergence Quebec / Emerging Managers Board Ontario ([CGE-EMB](#))
- e. Alternative IQ Hedge Fund Awards ([AiQ](#))
- f. Canadian Venture Capital & Private Equity Association ([CVCA](#))
- g. Portfolio Management Association of Canada ([PMAC](#))
- h. [CAIA Chapters](#) in Montreal, Toronto and Vancouver
- i. Private Capital Markets Association ([PCMA](#))

5. AIMA Global Research and Resource Highlights

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 - 1 [The Way Ahead](#)
 - 2 [Portfolio Transformers](#)
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 - 4 [Efficient Flows & Liquidity](#)
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