KNOWL EDGE

Alternative Investments Defined

Reimagine risk reduction with alternatives

At a glance

- The investment landscape today is much more challenging for investors, and traditional approaches to investing may no longer be sufficient to meet the needs of investors faced with three key emerging challenges: higher inflation, equity market volatility and portfolio construction challenges due to rising correlations between asset classes in times of higher market volatility.
- To help meet the evolving needs of investors, TD Asset Management Inc. (TDAM) has introduced the TD Alternative Risk Focused Pool – a solution that combines traditional and alternative investment strategies to complement the traditional balanced portfolio. With an innovative liquid alternatives strategy at its core, it aims to increase diversification and reduce overall volatility.
- Alternative investments, which include asset classes such as real estate, infrastructure and commodities, seek to help investors diversify beyond traditional asset classes such as stocks and bonds, and can help manage risk while increasing the potential for higher returns.

What are alternatives?

Alternatives are investments in assets other than bonds, stocks or cash. These can include investments in real assets, infrastructure, foreign exchange, hedge funds, private equity, commodities, etc., or investment strategies that go beyond traditional ways of investing, such as derivatives strategies, use of leverage and long/short equity.

Alternative investments can often exhibit a low correlation to the performance of traditional assets and may provide additional return upside while maintaining lower levels of portfolio volatility.

Derivatives, leverage and hedging can be effective financial tools that help enable investors to increase their return on investments, improve portfolio diversification, manage downside and risk, and weather market volatility.

Alternative mutual funds (or "Liquid Alternatives") can be mutual funds or **exchange-traded funds (ETFs)**, and are an option for investors looking for exposure to certain investment strategies that other conventional mutual funds are not permitted to engage in.

What sets Liquid Alternatives apart from conventional mutual funds?

Conventional mutual funds are generally composed of a combination of bonds, stocks and money market instruments. They can be actively or passively managed and are built to meet the needs of a wide variety of investor goals and risk tolerances. There are a number of investment restrictions placed on conventional mutual funds that alternative mutual funds are either not subject to or may still be subject to but not to the same degree, which allow alternative mutual funds more flexibility to engage in certain investment strategies. These include, for example, the greater flexibility to invest in other alternative mutual funds, use derivatives for non-hedging purposes, borrow or sell short securities and take more concentrated positions.

Liquid Alternatives usually provide daily pricing and liquidity like conventional mutual funds. They do not have the same net-worth and income requirements that would be required to invest in traditional alternative investments, allowing retail investors to gain exposure to the potential benefits of alternative strategies while maintaining a higher degree of investor protections. Liquid Alternatives provide investors with exposure to more asset classes and investment strategies, and can complement a traditional balanced portfolio as Liquid Alternatives can provide diversification and risk management beyond what traditional assets may offer.

The new **TD Alternative Risk Focused Pool** from TDAM seeks to provide diversification and risk management benefits by incorporating a liquid alternative strategy as part of a multi-asset structure which also features traditional and alternative components. In doing so, the TD Alternative Risk Focused Pool can complement a traditional balanced portfolio and help reduce volatility. For more information about the TD Alternative Risk Focused Pool, **read our brochure >**.

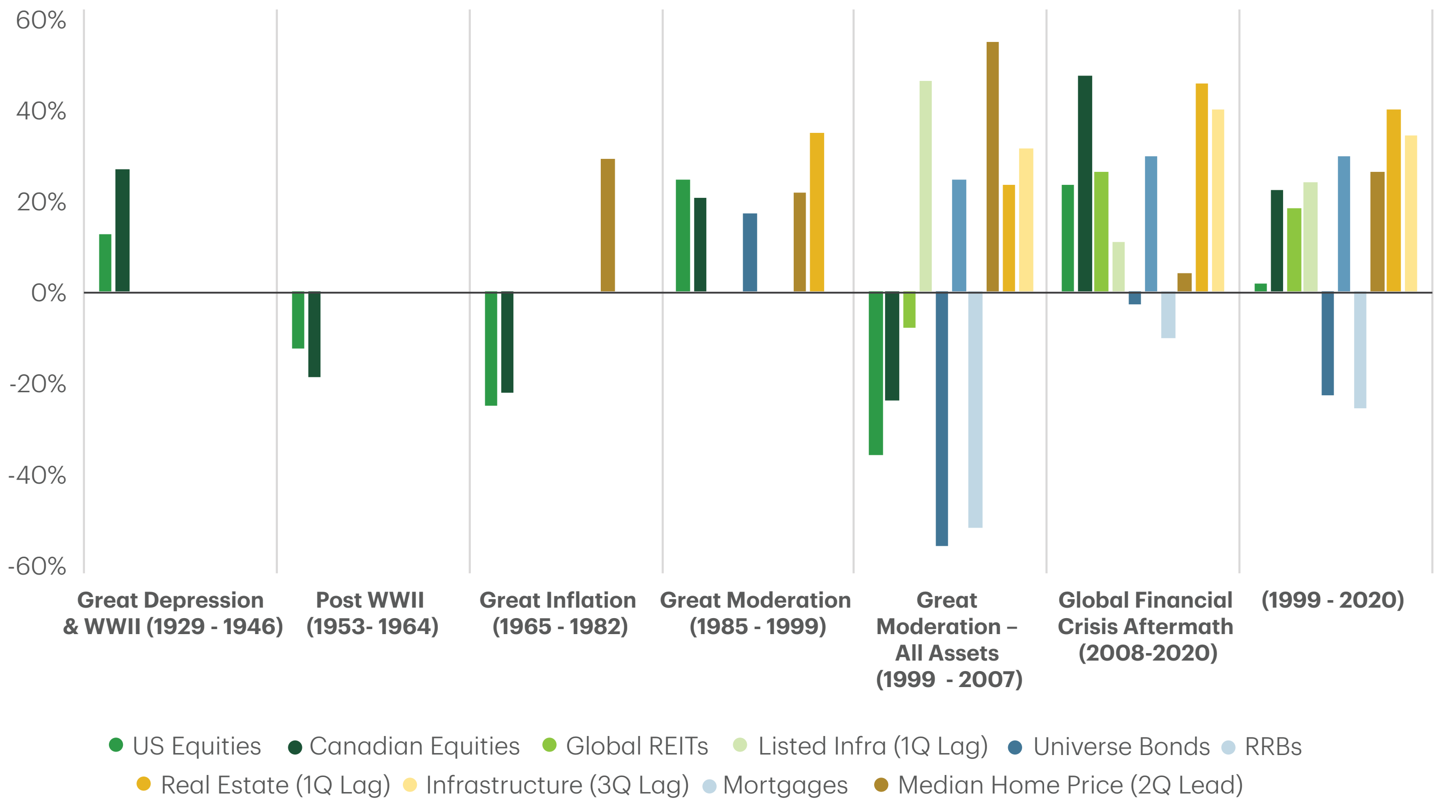
The power of adding alternatives to a portfolio

Conventional mutual funds are usually invested in public equities and bonds which can offer diversification across market sectors; however, they have a high degree of correlation to traditional financial markets. This means that, in times of heightened volatility, we often see a corresponding response to varying degrees depending on the asset allocation within the mutual fund.

Traditional balanced portfolios comprised solely of equity and fixed income served investors well for many years; however, the fundamentals have changed, and we believe an evolution in portfolio construction and asset allocation is warranted.

portfolio

Asset Class Returns in Various Inflation Regimes



Source: Bloomberg Finance L.P., MSCI, Mercer Insight, St. Louis Fed, US Census Bureau, U.S. Department of Housing and Urban Development, TD Asset Management Inc. As of September 30, 2020. Note: Inflation as represented by Canada Headline CPI. Correlation calculated using quarterly returns. Real Estate one quarter lag. Infrastructure three quarter lead. Canadian Equities coincident. Median Home Prices two quarter lead.

Beyond providing exposure to broader asset classes, Liquid Alternatives are also able to engage in certain investment strategies – including short-selling, borrowing, and use of derivatives. These strategies may be utilized to seek to enhance returns, reduce losses from market declines, reduce overall portfolio volatility, or attain a market neutral position.

Main types of alternatives

Public market alternatives

- Foreign exchange strategies
- Options strategies
- Hybrids
- Commodities

Private market alternatives

- Real estate
- Infrastructure
- Mortgages

Public market alternatives

Public market alternatives can add value to a portfolio when utilized within a liquid alternatives framework. Portfolio managers managing liquid alternatives have the ability to utilize these strategies to potentially increase diversification or to enhance returns.

Foreign exchange markets (currencies) are the largest and most liquid markets available. Investors, businesses, governments, and citizens all around the world use currency markets for transactions and trading.

Aside from being a medium of exchange, currencies have different investment properties, which can be used to help diversify a portfolio. For example, the Canadian dollar tends to be highly correlated with commodity prices due to natural resources being an integral part of the Canadian economy.

As a result, a Canadian dollar investor can hedge and diversify their portfolios by holding more defensive foreign currencies such as the U.S Dollar, Japanese Yen or Swiss Franc. Additionally, active foreign exchange management can switch between various currencies based of fundamental and technical factors to generate returns. These strategies can help improve the risk-adjusted returns of a stock and bond portfolio or be used as an overlay to improve returns.

Foreign exchange rates are subject to market fluctuations based on a host of macroeconomic, geopolitical, market and idiosyncratic drivers that could lead to capital loss. Foreign exchange exposure achieved via forward contracts is subject to the operational and financial risks present in derivative instruments.

Options strategies derive their value from the price and performance of an underlying asset. Options give the holder the right, but not the obligation to buy or sell an asset at a particular price at a particular time in the future. Because the pay-off of an option is determined by an uncertain future, a key input to their value is volatility. As a result, options turn volatility into an investible asset class.

There are three key options strategies that can bring diversification to an investment portfolio: tail risk, protected equities and tactical option strategies.

1. **Tail risk strategy –** Options strategies can provide specific and reliable downside protection against equity market downturns. This is because they are linked to the underlying equity market and, in the case of a put option, can provide downside protection if equities fall below a certain price. Tail risk strategies act as insurance and therefore subject the portfolio to premium cost with infrequent and rare payoffs. The portfolio is also subject o operational and financial risks present in derivate instruments.
2. **Protected equity strategy –** A protected equity strategy strives to enable investors to remain invested in the growth potential of equity investments while offering lower volatility and drawdowns. Buying protective options on the downside, while selling call options on the upside, can lessen the cost of protection. This "collar strategy" can help to create a smoother and more stable return stream than outright equities. This strategy seeks to protect the downside by buying protection through put options while offsetting the cost of that premium by selling call options. This subjects the portfolio to a cost drag for running the strategy, and it also limits the potential gains in a strong up market due to sold calls. The portfolio is also subject to operational and financial risks present in derivate instruments.
3. **Tactical option strategies**
   - **Generate yield –** The strategy involves selling options when the implied volatility of the options is elevated to generate income. Tactical options strategies can express a host of discretionary views using single or multi-legged options strategies on both the short and long side. Like any tactical strategy, it may add or detract value from the portfolio. The portfolio is also subject to the risks present in derivative instruments as well as those specific to the use of options strategies.
   - **Capital efficient exposure –** Since options generally only require a small premium outlay, it can be less expensive to gain the desired exposure through options instead of buying or selling the underlying asset outright.

Hybrids consist of several public investments that offer a unique risk and return profile that is a hybrid of equity and fixed income. They tend to offer stable yields and downside protection with the potential for equity participation. Hybrids combine elements of fixed income, equity and options like risk. As a result, hybrids are also subject to the market fluctuations and risk drivers of these major asset classes. Further, these instruments can be subject to illiquidity risk or structuring risk due to their sometimes bespoke nature. There are also elements of operational risk and time risk. Two main hybrids include convertible securities and Special Purpose Acquisition Companies (SPACs).

1. **Convertible securities –** Convertible bonds and Convertible preferred shares offer a steady and stable yield of bond as well as a return of principal invested (assuming no default risk). In addition, they offer the ability to benefit from upside equity participation, beyond a certain stock price, for the company that issued them. Combining stable income and downside protection, with the potential for equity upside participation helps create better risk-adjusted returns than either asset alone.

2. **SPACs –** SPACs are investment vehicles traded on the stock exchange that accept investor capital to seek a private company to merge with and take public. During a SPAC initial public offering, the capital raised is invested safely in short term treasury bills while the SPAC sponsor typically has up to two years to search for an acquisition target. Once an acquisition target is found, investors in the SPAC get to vote on whether they would like their money returned in full or become investors in the new company. SPAC investors therefore get the principal protection of cash prior to the SPAC merger, with the upside potential of private equities. Further, SPACs offer both explicit and implicit income as some management teams offer extra cash or warrants for investing in the SPAC. SPACs can be subject to governance or policy risk.

Commodities (e.g. oil, grains and natural gas) are key inputs to global production and form the building blocks of our society. The commodity futures market allows producers, consumers, and investors to lock in future purchase or selling prices or to speculate on the direction of commodity prices. A few of the key benefits for investors include **inflation protection, diversification, and thematic tailwinds**. Commodities are subject to market fluctuations based on a host of macroeconomic, geopolitical, market and idiosyncratic drivers relevant to the specifics of each commodity market, which could lead to capital loss. Exposure to commodities is typically obtained through the use of derivatives, which subjects the portfolio to the operational and financial risks present in derivative instruments.

Private market alternatives

Private market alternatives (such as private real estate and infrastructure) are a strong portfolio complement, especially in light of ongoing and persistent fixed income challenges. They may offer attractive income streams, portfolio diversification and inflation protection. They also offer exposure to attractive long-term trends such as the green transition, urbanization, and infrastructure upgrades. This is why the investment strategies of the new **TD Alternative Risk Focused Pool** permit it to gain some exposure to these assets.

Real assets are the physical assets required for a properly functioning economy and societal quality of life. These are the assets that provide services such as power for electricity, water or waste management, transportation of people and goods, or simply a place to live and work. Privately held assets tend to offer lower correlations with other asset classes, and exposure to private real assets in a portfolio can enhance risk-adjusted returns for investors. The majority of return from real assets is typically generated from recurring, contracted income or cash flow rather than capital appreciation. Some of the most common real assets include the following:

1. **Infrastructure –** Sectors within infrastructure can include transportation, renewable energy, utilities and telecommunications, among others. Infrastructure can provide reliable cash flows due to the stability of its revenue model. There is a wide variety of sectors available within infrastructure as well, which allows for flexible portfolio diversification.
2. **Real estate –** Real estate is an attractive long-term holding due to its low correlation to stocks and bonds. It may also offer some level of inflation protection and is a well-diversified sector: there are investment opportunities in a variety of sectors (office, retail, industrial and multi-unit residential) and stages in its life cycle, from a stabilized, income-producing property to a parcel of land for future development providing exposure to varying risk and return profiles.
3. **Commercial mortgages –** Investing in direct commercial mortgages can add value in a rising interest rate environment, and can provide capital preservation and the opportunity to increase returns across sectors. A commercial mortgage is a mortgage on a property other than a single-family residence. It includes loans secured by office, retail, industrial and multi-unit residential properties. The underlying real estate for a given loan can be at various stages in its life cycle. These different types of commercial mortgages have varying risk and return profiles.

The TDAM Advantage

With over 30 years of experience in alternative investment solutions, TD Asset Management Inc. (TDAM) has built a strong reputation in the alternatives space and has a proven track record of innovation in this ever-changing investment environment. Our alternative investment strategies have been refined over decades, with a focus on robust portfolio management and diversification. The Alternatives team works closely with the Fixed Income and Public Equities teams as part of our collaborative approach to our investments that capitalizes on the full breadth of expertise of our organization.

The increased market volatility experienced in recent years continues to demonstrate the key role that alternative investments can play in a diversified portfolio.

We believe that the quality and depth of our alternative offerings will help continue to deliver stable income and capital growth and lower correlated performance to public market asset classes.

TDAM was among the first to introduce asset allocation portfolios, pioneering the integration of alternative investments alongside equities and fixed income. Our approach combines three decades of asset allocation experience with new thinking and innovation that can help improve investment outcomes for you.

Collectively, the Asset Allocation Team is comprised of 29 people, who collaborate every day to manage over $98 billion[1] in assets on behalf of investors.

Let's talk

For more information, please contact your **investment professional**.

Connect with TD Asset Management

[1] Aggregate statistics as of June 30, 2022 for TD Asset Management Inc. and Epoch Investment Partners, Inc. TD Asset Management Inc. operates in Canada and Epoch Investment Partners, Inc. operates in the United States. Both entities are affiliates and are wholly-owned subsidiaries of The Toronto-Dominion Bank. The information contained herein has been provided by TD Asset Management Inc. and is for information purposes only. The information has been drawn from sources believed to be reliable. Graphs and charts are used for illustrative purposes only and do not reflect future values or future performance of any investment. The information does not provide financial, legal, tax or investment advice. Particular investment, tax, or trading strategies should be evaluated relative to each individual's objectives and risk tolerance. Certain statements in this document may contain forward-looking statements ("FLS") that are predictive in nature and may include words such as "expects", "anticipates", "intends", "believes", "estimates" and similar forward-looking expressions or negative versions thereof. FLS are based on current expectations and projections about future general economic, political and relevant market factors, such as interest and foreign exchange rates, equity and capital markets, the general business environment, assuming no changes to tax or other laws or government regulation or catastrophic events. Expectations and projections about future events are inherently subject to risks and uncertainties, which may be unforeseeable. Such expectations and projections may be incorrect in the future. FLS are not guarantees of future performance. Actual events could differ materially from those expressed or implied in any FLS. A number of important factors including those factors set out above can contribute to these digressions. You should avoid placing any reliance on FLS. Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the fund facts and prospectus, which contain detailed investment information, before investing. Mutual funds are not guaranteed or insured, their values change frequently and past performance may not be repeated. Mutual fund strategies and current holdings are subject to change. TD Alternative Risk Focused Pool (the "Pool") is an alternative mutual fund. It has the ability to invest in asset classes or use investment strategies that are not permitted for a conventional mutual fund. The specific strategies that differentiate this Pool from a conventional mutual fund may include the increased use of derivatives for hedging and non-hedging purposes, the increased ability to sell securities short and the ability to borrow cash to use for investment purposes. If undertaken, these strategies will be used in accordance with the Pool's objectives and strategies, and during certain market conditions, may accelerate the pace at which the Pool decreases in value. TD Mutual Funds are managed by TD Asset Management Inc., a wholly-owned subsidiary of The Toronto-Dominion Bank and are available through authorized dealers.

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