



A GUIDE TO ALTERNATIVE INVESTMENTS

Learn the key terms to help you navigate this important segment of the financial services industry



A guide to alternative investments

The alternative investments space is a dynamic and rapidly evolving segment of the financial services industry. While alternative investments in the past have been principally the domain of institutional and accredited investors, this market segment is becoming increasingly available to a wider range of investors, through such vehicles as liquid alternatives.

The landscape can be much easier to navigate once you become familiar with some common terms that are often used within this space. This guide contains explanations of various aspects of alternative investments, so keep it handy whenever you're taking a closer look at different alternative investment strategies to include in an investment portfolio.

What are alternative investments?



Strategies that go beyond traditional investments (such as stocks, bonds or cash)



Alternatives are investments in assets other than stocks, bonds and cash (for example, private equity, hedge funds, real assets, commodities, etc.) or investments using strategies that go beyond traditional ways of investing (such as long/short strategies)



They provide more options for investors to increase their sources of returns, improve portfolio diversification and manage risk



Investors can access alternatives more easily now through a fast-growing market segment known as liquid alternatives: alternative investments in the form of a mutual fund or exchange-traded fund, which offer the additional benefit of daily pricing



Liquid alternatives provide investors with a flexible investment approach through exposure to various asset classes and strategies

A glossary of common terms

Alpha

The excess return an investment achieves over its benchmark is known as alpha. Portfolio managers add value to a portfolio by using their skills to generate alpha. Therefore, alpha can also be considered a measure of portfolio manager skill.

Beta

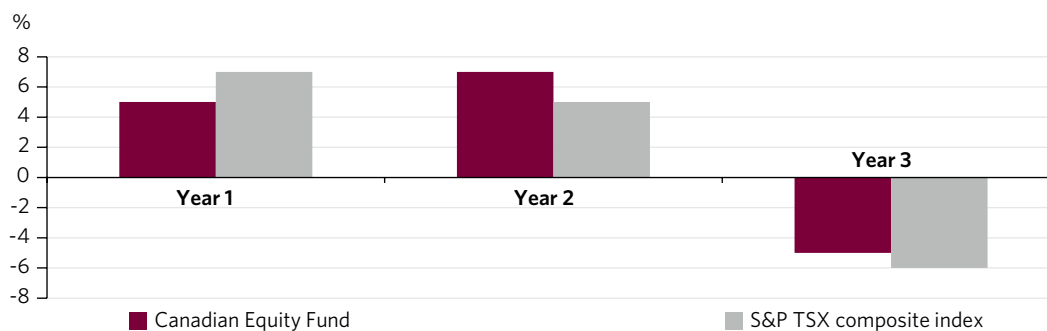
In general terms, the return generated by the benchmark or market is known as beta.

Absolute return

Absolute return represents the total amount an investment has earned over a certain time period. A fund employing an absolute return strategy aims to achieve positive returns in all market conditions – even when the market is volatile, flat or falling. An absolute return strategy typically identifies a target return it aims to achieve over a pre-specified time period. This contrasts with conventional mutual funds that often measure relative returns against a stated benchmark. In this way, absolute return products can be considered “benchmark agnostic.”

For example, consider a Canadian equity fund that seeks to deliver a better return than the S&P/TSX Composite Index. As evident in the following chart, in Year 1, the S&P/TSX Composite Index (the benchmark index) has outperformed the fund. However, in Year 2 and Year 3, the fund has successfully met its objective (despite the negative return in Year 3), as it has outperformed its benchmark index. By contrast, absolute-return investment strategies have an absolute return target that they aim to achieve regardless of the direction of any market.

Canadian equity fund vs. Benchmark index



For illustrative purposes only.

In addition to investments in traditional stocks and bonds, absolute return strategies employ a toolkit of less conventional strategies and instruments to achieve their return objectives, including usage of derivatives, short-selling, the usage of leverage as an investment technique and others.

Derivative

A derivative is a type of financial security whose price or payoff is directly dependent on, or “derived” from, other underlying assets.

The most common types of derivatives include futures contracts, forward contracts, options and swaps. The underlying assets for derivatives often include equities, fixed income, commodities and currencies.

The most common uses of derivatives are to hedge, gain or reduce exposure to specific assets or baskets of assets. Derivatives offer flexibility to tailor market views to specific outcomes. From being able to customize specific maturities, to being capital efficient, to providing targeted leverage, when used with sound risk management principles derivatives are a powerful tool to improve investment outcomes.

Hedging

Securities such as derivatives can be used to offset or reduce the risk of investing in an underlying asset; this strategy is known as hedging. For example, an investment manager of a portfolio of U.S. stocks foresees some volatility ahead for the U.S. equity market. In order to moderate potential losses, the manager might take a short position in the S&P 500 Index, perhaps by selling futures contracts. If the U.S. equity market decreases during the term of the contract, the short position can be closed out and the subsequent gain can offset some of the losses in the portfolio's stock holdings. Derivatives are useful in such hedging scenarios because of their known relationship to the underlying assets being hedged. However, in this example, hedging also moderates the positive return the portfolio would generate if U.S. stocks were to actually rise contrary to the manager's expectations.

Leverage

If an investor wishes to increase the magnitude of a potential gain of an investment position (and, by extension, potential loss), the investor can engage in a form of borrowing, known as leverage.

Ways to engage in leverage:

- In **cash borrowing**, an investor borrows cash in order to invest it. The type of cash instruments available to asset managers for borrowing purposes can include cash, loans, credit instruments, bonds and even structured products.
- **Derivatives** allow investors to gain exposure to the price movements of assets without necessarily directly owning them, and their structures often allow investment managers to control large positions with little outlay, or none at all in some cases. The capital needed to take a position in a derivative instrument is usually much less than the capital needed for a more traditional position in stocks or bonds.
- In **physical short selling**, an investor who wants to benefit from the expected decline in a security, often a frequently traded stock, can borrow the shares from a lender, sell them immediately (receiving the proceeds of sale to invest) and profit by repurchasing the shares at a potentially lower future price.

In each of these cases, leverage allows investors to construct a position in an underlying asset without a full cash outlay or direct ownership of that asset. However, as with all forms of borrowing, debts are expected to be repaid. So, while the use of leverage can greatly enhance the potential return of a portfolio, it also introduces some additional risk.

Factor exposure

An investor can allocate portfolio exposure to securities that exhibit certain attributes known as factors. Factors are characteristics of investments that can explain differences in future returns. For example with stocks, investors can tilt exposures towards the “value” factor (stocks that have low prices relative to their intrinsic value), or “momentum” factor (stocks with recent past performance). In instruments that generate a yield such as in fixed income, one can exploit the “carry” factor (holding positions with a high yield against positions with a low yield).

Commodity

A commodity is a basic good that can be traded. Examples of commodities include oil, gas, wheat, gold, soybeans and livestock.

Commodities can be bought and sold using derivatives such as futures and forward contracts. For example, a futures contract is an agreement to buy or sell a commodity at a predetermined future date and price. Commodity futures exchanges create a liquid marketplace to bring producers, hedgers and speculators together by standardizing the quantities and quality of commodities being transacted.

Currency

Currencies can be traded in order to hedge against foreign exchange risk or to add value to a portfolio in other ways based on the expected value of a currency or a basket of currencies.

Ways to trade currency:

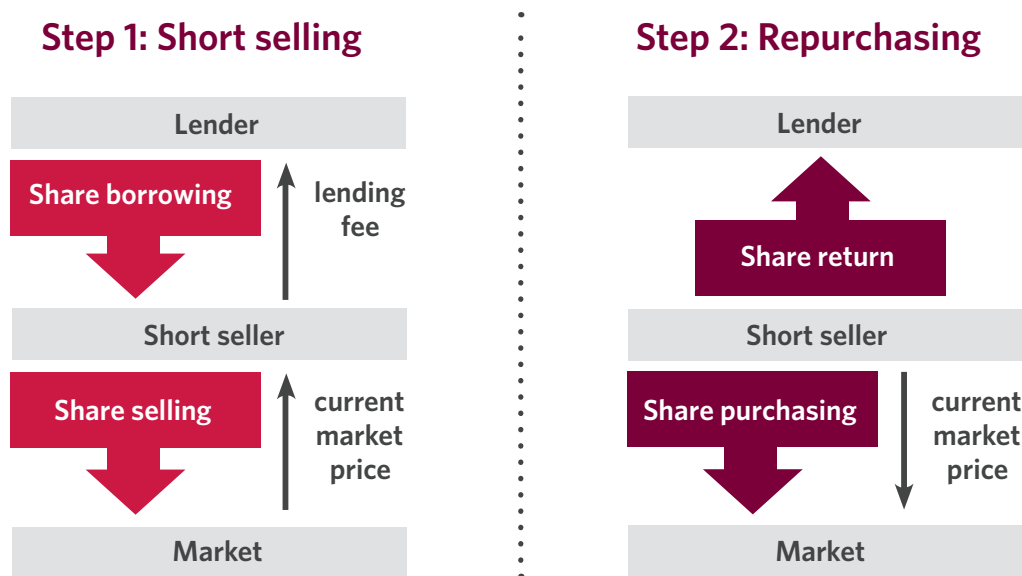
- Currency forwards (forward contracts)
 - Currency futures (also known as exchange rate futures or “FX” futures)
 - Currency options
 - Cash holdings in a given currency
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Long and short positions

A **long position** refers to the purchase of a security with the expectation that it will increase (or rise) in value. A short position involves selling a security with the expectation that it will decline (or fall) in value.

Ways to achieve a short position:

- **Physical short selling** is often used with frequently traded stocks. The typical process involves the short-selling investor borrowing the shares from a lender and immediately selling them. With the short position established, should the share price decline to a level deemed acceptable by the short-seller, the shares can be repurchased at this lower price with the short-seller profiting by closing out the position. Conversely, should the price of the asset unexpectedly rise, the short-seller would experience losses. As with short positions in general, the loss potential for the short-seller is theoretically infinite as share prices can rise indefinitely.



- Through a **derivative investment**, such as selling a forward contract, selling a futures contract, writing a call option or buying a put option. Essentially, the investor is agreeing to sell an asset in the future at a predetermined price, with the expectation that the asset's price will subsequently decline and an investment gain can be made.

Option

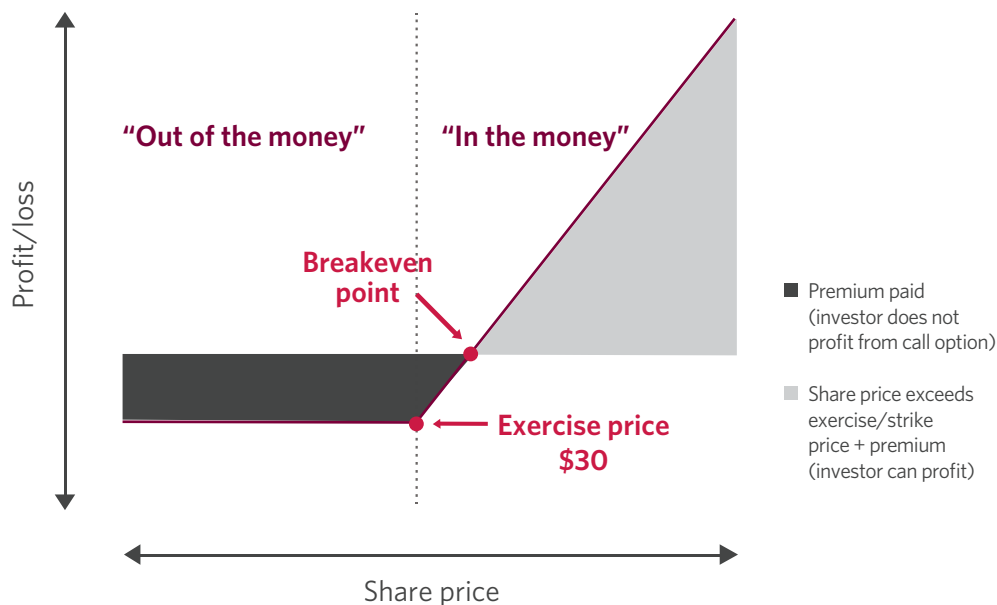
A type of agreement that grants the holder the right but not the obligation to buy or sell an underlying security (see also Call Option and Put Option).

Call option

A call option is a type of option contract where the holder has the right but not the obligation to buy an underlying asset within a certain period at a specified price called the exercise or “strike” price. Investors purchase call options on an underlying asset if they believe it will rise above the strike price – at which point their option rises in value (otherwise known as being “in the money”) and they would profit.

For example, Stock A is currently trading at \$30, and the investor believes the price of Stock A will increase. The investor purchases a call option with a strike price of \$30 and pays a premium of \$2 to purchase the option, which amounts to \$200 as each option contract represents 100 shares. The call option purchased has an expiration of one month. This means that the investor has the option to buy 100 shares of Stock A at the strike price of \$30 until the option expires.

An investor's profit or loss from purchasing a call option



Note that the owner of a call will generally only exercise their option if the share price has gone up, allowing the buyer to acquire the shares at the lower strike price in the call contract. If the share price falls, the option owner will not exercise it and the seller will keep their shares and the premium.

Selling a call option: The seller of a call option takes the opposite side to the option contract from the holder. The seller has the obligation to deliver the underlying asset at the strike price to the holder of the call option if the holder decides to exercise the option. In return, the seller of the call option receives the premium paid by the holder of the call option as compensation for taking the risk that the holder will exercise the option. Selling a call option is similar to insurance, the holder buys protection (pays a premium) they can choose to exercise, and if exercised the seller must deliver (pay the holder) on the obligation. The seller of a call option can only earn the premium, but faces theoretically unlimited losses as markets rise.

Put option

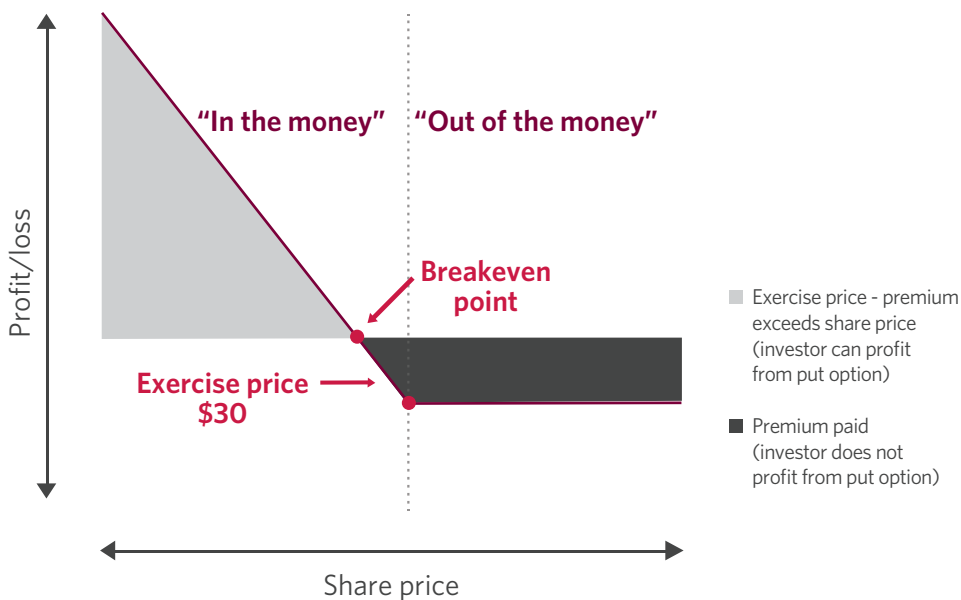
A put option is a type of option contract that gives the holder the right but not the obligation to sell a specified amount of an underlying asset at a set price within a specified period. An investor who purchases a put believes that the price of the underlying asset will drop below a pre-set “strike” price before the option expires.

For example, Stock A is currently trading at \$30, but the investor believes there is volatility ahead. The investor purchases a put option with a strike price of \$30 and pays a premium of \$2 to purchase the option, which amounted to \$200 as each option contract represents 100 shares. The put option purchased has an expiration of one month. This means that the investor has the option to sell 100 shares of Stock A at the strike price of \$30 until the option expires.

Assuming there is market weakness during this period, shares of Stock A decline to \$25. At that point, the investor exercises the option whereby the shares are sold to the option writer for the strike price of \$30.

The investor would make \$500 on the put option – the difference between the strike price and the market price multiplied by the number of shares or $(\$30 - \$25) \times 100$. However, the investor actually earns \$300 after taking the premiums (what was paid for the put options) into consideration $(\$500 - \$200)$. The maximum loss on the trade is the premium of \$200, which would happen if the stock either rose or didn't fall below the strike price. And of course, the maximum profit would occur if the stock dropped to \$0.

An investor's profit or loss from purchasing a put option



Selling a put option: The seller of a put option takes the opposite side to the option contract from the holder. The seller has the obligation to purchase the underlying asset at the strike price from the holder of the put option if the holder decides to exercise the option. In return, the seller of the put option receives the premium paid by the holder of the put option as compensation for taking the risk that the holder will exercise the option. The seller of a put option can only earn the premium and they are limited to the loss they can experience if the stock price were to drop to zero.

Notional value

Notional value represents the total dollar amount of an underlying asset controlled by the derivative contract.

Notional value is calculated as follows: Multiplying the units of an investment by its spot price (the immediate price a security trades at in the market).

Let's look at an example using MSCI World Index futures.

The value of these futures is 50 x MSCI World Index, as one MSCI World futures contract represents 50 units of the index. If someone buys an MSCI World futures contract at \$2,000, the notional value of the contract is \$100,000 (50 x \$2,000). By contrast, the market value of one unit of the MSCI World Index is \$2,000.

Forward contracts

A forward contract is a customized agreement between two counterparties to buy or sell an asset at a fixed time in the future at a price that is predetermined. For example, a farmer can sell forward contracts as a way of hedging against falling commodity prices.

A forward contract is one of the most basic derivative products. It gives its holder the obligation to conduct a transaction involving the underlying asset – which can be a security, currency or commodity – at a predetermined future date and price. The two parties involved are: 1) the eventual buyer (or long position) who pays the contract price and receives the underlying asset and 2) the eventual seller (or short position) who delivers the security for the fixed price.

When the spot price (the current price an asset can be bought or sold at for immediate delivery) is lower than the forward contract price, the seller or short position will receive the benefit or payoff from the long position. The opposite is true when the spot price is higher than the contract price – the long position gains.

Let's consider an example. There's a farmer with three million bushels of wheat to sell six months from now. The farmer is concerned about a potential decline in the price of wheat. As a result, the farmer (seller) enters into a forward contract with an institution (buyer) to sell three million bushels of wheat at a price of \$4.50 per bushel in six months to be settled on a cash basis.

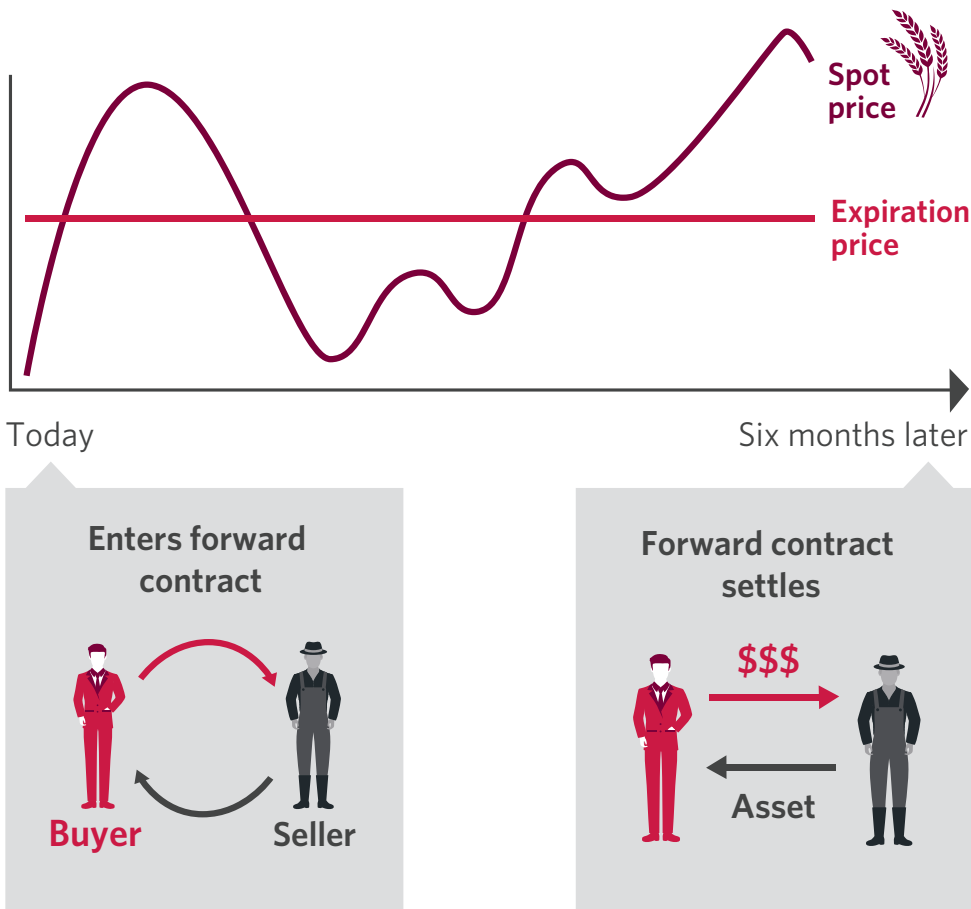
In six months' time, there are three potential scenarios:

- Spot price remains the same. If wheat remains at \$4.50 per bushel, no money is exchanged and the contract expires.
- Spot price is higher than contract price. If the spot rises to \$5.00, the farmer owes the institution \$1.5 million: $(\$4.50 - \$5.00) \times 3$ million. That represents the difference between the current spot price of \$5.00 and the contract rate of \$4.50.
- Spot price is lower than contract price. If the price of wheat declines to \$3.00 per bushel, the financial institution (buyer) owes the farmer (the seller) \$4.5 million: $(\$4.50 - \$3.00) \times 3$ million. That represents the difference between the contracted rate of \$4.50 and the current spot price of \$3.00.

Forward contracts *continued*

In each of these scenarios, the farmer has effectively locked in a price of \$4.50 per bushel, hedging out the risk of price fluctuations. In the first scenario, the farmer is financially unaffected. In the second scenario, the farmer pays the institution \$0.50 for each of the bushels that can be sold for \$5.00 on the open market. In the third scenario, the farmer gets paid \$1.50 per bushel that can only be sold for \$3.00.

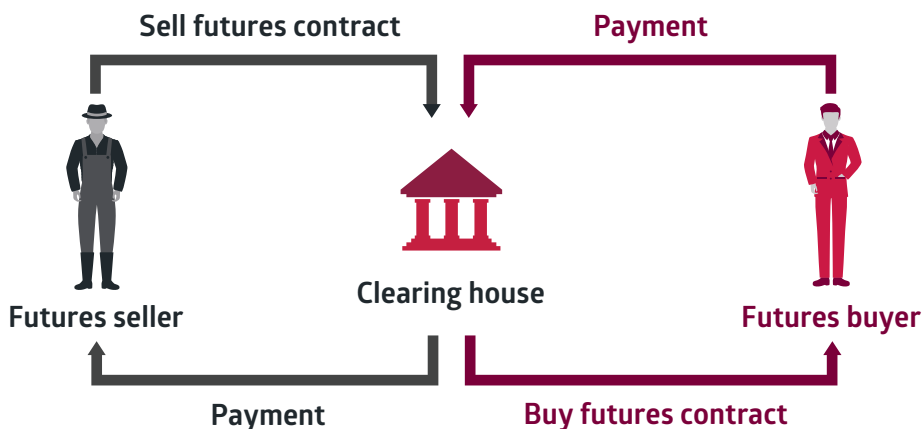
Note that the seller of the contract, in the short forward position, has the potential for unlimited loss. The buyer, in the long forward position, has the potential for unlimited gain. Conversely, the loss potential for the buyer (and the gain potential for the seller) is limited because the price of the underlying security cannot fall below zero.



Futures contracts

Similar to a forward contract, a futures contract is a type of derivative that describes a legal agreement to buy or sell an underlying asset at a specified price at a specified future date. In contrast to a forward contract, futures contracts are highly standardized and are traded on an exchange, but similarly allow an investor to gain exposure to a given underlying asset or hedge against its price volatility.

Each futures exchange uses its own clearing house to take the opposite position of a given trade, acting as intermediaries for each investor wishing to buy or sell a futures contract.



Forwards vs. futures

Forward contract	Futures contract
Usually customized and privately negotiated between two parties	Highly standardized terms and conditions
Trade over-the-counter	Trade on an exchange
Only settled at time of delivery; counterparty risk (the risk of one side not fulfilling the terms of the contract) is present	Settled daily via clearing house. The clearing house of the futures exchange acts as counterparty to both parties in the contract, helping eliminate counterparty risk
No margins required	Margins required to be posted and maintained to help eliminate counterparty risk
Mostly used by parties who wish to hedge against the volatility of the price of the underlying asset	Frequently used by speculators to gain exposure to the direction of the underlying asset

Commodity futures

For investors wishing to gain exposure to raw materials, or hedge against their price volatility, these types of futures contracts focus specifically on basic commodities such as oil, metals or various agricultural products.

Index futures

If an investor wants to gain or hedge exposure to a particular market, index futures are an extremely useful and common means of doing so. Index futures are futures contracts where the underlying asset is an equity market or another financial index. For example, an investor who believes U.S. stocks in general are going to rise might want to take a long position and purchase an S&P 500 futures contract. This is an efficient way of getting exposure to the U.S. market rather than having to directly purchase U.S. stocks or an index fund. Conversely, an investor who believes U.S. stocks will decline might take a short position and sell an S&P 500 futures contract, to either benefit from a decline in share prices or to hedge against potential losses in an existing portfolio of U.S. stocks.

Equity futures

A futures contract that allows an investor to benefit from the movements of an equity index or even a specific stock.

Bond futures

A bond futures contract allows an investor to benefit from the movements of a bond index or even individual bonds.

Swaps

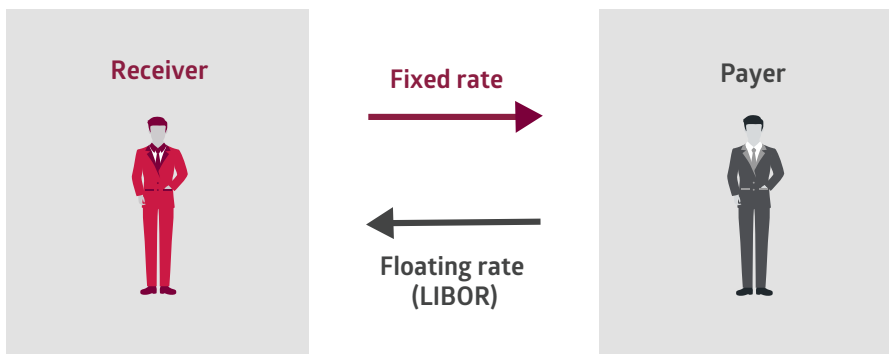
Another type of derivative that can be used to gain exposure to (or hedge against) changes in financial markets is a swap. As the name suggests, this means two parties exchange financial instruments. In practice, however, this usually means two parties exchanging the cash flows of their respective financial instruments but not the instruments themselves.

Interest rate swaps

An interest rate swap is a contractual agreement whereby one party exchanges a stream of interest payments for another party's payments.

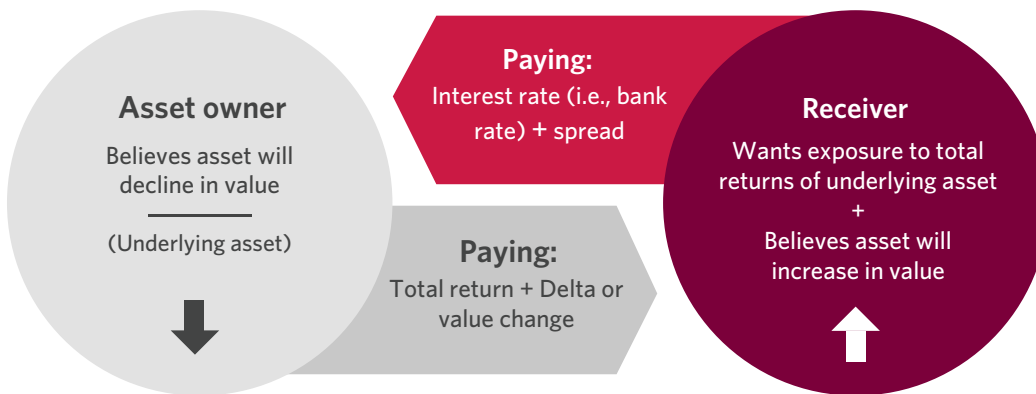
Interest rate swaps commonly exchange fixed-rate payments for floating-rate payments based on a notional amount of principal. The floating rate is pegged to a reference rate, typically LIBOR. The market value of a swap at inception is typically set to zero, meaning no cash flows get exchanged at inception.

Interest rate swaps can be used by corporations to optimize their financing profile with respect to variable or fixed interest rates, and can be used by investors to speculate on interest rates.



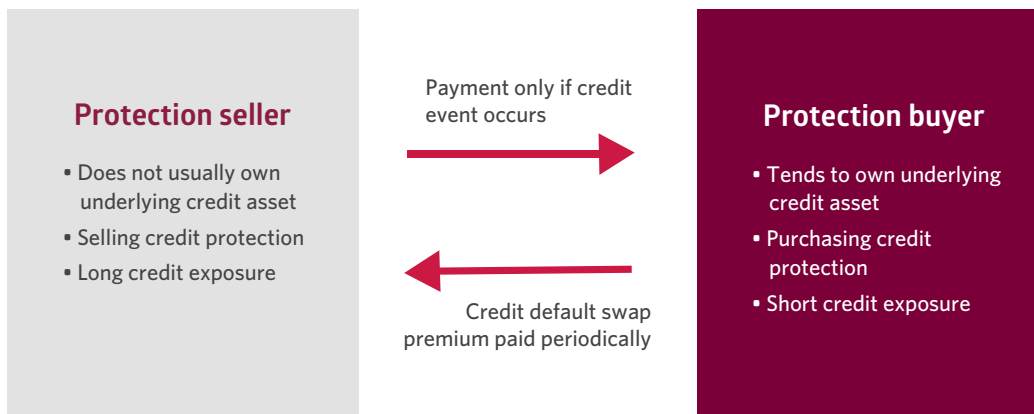
Total return swaps

Swaps can be used by parties who wish to gain the total return benefits of a given underlying asset (such as a bond, equity or loan). In a total return swap, one party pays a set rate (fixed or variable) to the owner of an underlying asset, in exchange for payments equivalent to the asset's total return (which includes both income and capital gains).



Credit default swaps

Swaps can be used to transfer credit risk from a party who wants protection from risk to a party that's willing to take it on for a premium. The buyer of a credit default swap is often the holder of the underlying credit asset, known as the "reference asset," and makes payments to the swap's seller for the duration of the contract. However, the seller agrees that in the event of a default or, in some cases, another type of credit event (such as a credit downgrade), that the seller will pay to the buyer the reference asset's principal and any interest payments that would be paid from the time of the event to the maturity date of the reference asset.



**To learn more about liquid alternatives and the role they can play in an investor's portfolio,
contact your wholesaler.**

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