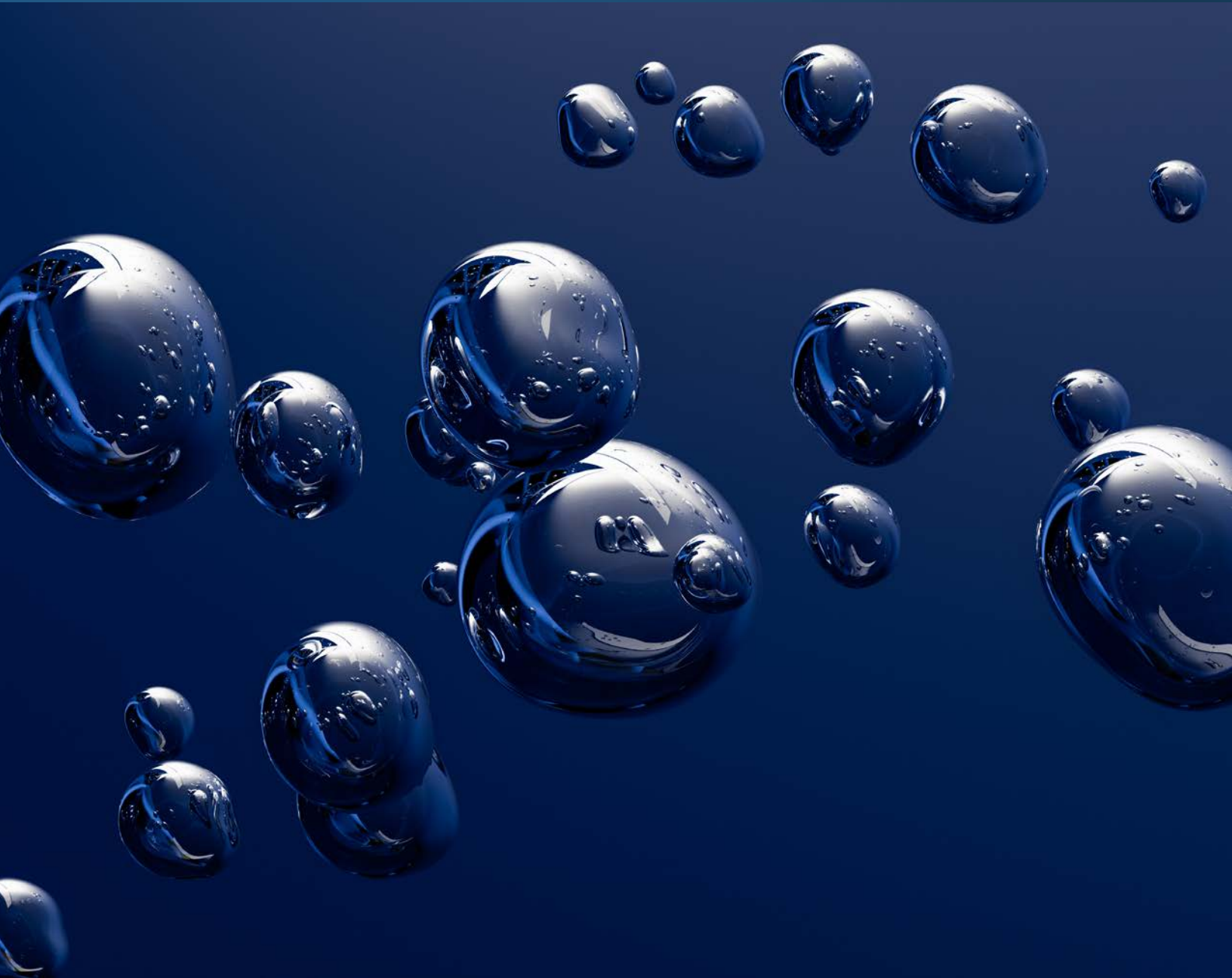




# Alternative credit explained: Everything you need to know about liquid alternative credit strategies

A practical guide to fixed income and alternative investment concepts



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## What is liquid alternative credit?

There is a lot of confusing “lingo” that exists in fixed income investing (for example – bonds, debt, credit, loans etc.). Despite what the critics may say, for the average investor, most of these terms can be used interchangeably. In reality, there are some technical differences in these descriptions, but this paper is not meant to be overly technical. With that in-mind, and in attempt to simplify this category of investments, liquid alternative credit is just a *flexible approach to investing in fixed income securities*. Some of the common instruments found in the fixed income market include:

- Government bonds (also known as treasuries or sovereign debt)
- Corporate bonds (debt or bonds that are issued by a corporation)
- Money market instruments (short-term debt, like treasury bills and commercial paper)
- High-yield bonds (corporate bonds that are rated below investment-grade)
- Securitized loans (such as asset-backed and mortgage-backed securities)

The key difference between liquid alternative credit and what many refer to as “traditional fixed income” is that the former invests in these markets by using a broader set of techniques such as short selling, leverage, and derivatives; while continuing to maintain **daily liquidity and transparency for investors**.

These tools allow managers to pursue differentiated goals for investors, such as:

- Reduced volatility
- Additional income
- Greater returns

Many liquid alternative credit strategies exist; a few examples include:

- Long/short credit or long/short fixed income (the names are generally synonymous, which is explained later)
- Absolute return credit (strives to achieve a positive return, regardless of the market environment)
- Fixed income arbitrage or market-neutral (small differences between similar fixed income securities)
- Enhanced or alternative income funds (aim for a higher yield than what you would receive in traditional fixed income)
- Leveraged credit strategies (borrowing additional money with the intention of increasing returns)





## Why are investors looking beyond traditional fixed income or bonds?

Traditional fixed income strategies are typically long-only, meaning they purchase securities expecting they will increase in value or, at minimum, return the initial investment plus income (the coupon). Returns are largely driven by income (or yield), and changes in interest rates and credit spreads. Credit spreads refer to the yield difference between a risk-free bond and a corporate bond with a similar maturity, which we simplify and explain further later.

Traditional fixed income investing can become more challenging when:



Interest rates are volatile (particularly when they're moving up)



Inflation picks up



Credit conditions shift quickly (which may mean more risk)

In addition to this, some of these events may mean that your traditional fixed income behaves more similarly to your equities or stocks, which makes diversification tricky.

Liquid alternative credit may introduce a **broader opportunity set** to navigate some of these challenging environments, which could help alongside your other investments.



## What drives returns in fixed income investing?

Broadly speaking, fixed income returns are primarily driven by two key factors:

### Interest rates

Changes in interest rates typically impact fixed income prices (to varying degrees):

- The relationship is often inverse.
  - As **interest rates rise**, prices tend to **fall**.
  - As **interest rates fall**, prices tend to **rise**.

Fixed income managers often describe a portfolio's sensitivity to interest rate moves using duration.

**Duration** measures how sensitive a bond's price is to changes in interest rates:

- **Higher duration** typically means **greater sensitivity** to rate movements.
- **Lower duration** typically means **less sensitivity** to rate movements.

This can work for or against you in terms of returns, depending on the environment.

### Credit spreads

A **credit spread** is the additional yield investors demand when lending to a borrower with a higher risk of not being able to repay their debt. In plain English: if you lend to a government (e.g., Canada or the U.S.) versus a company struggling to pay the bills, and both loans mature on the same date, you would likely demand a higher return from the riskier borrower.

While a spread is specific to each security, credit spreads are often discussed as an average. They reflect market perceptions of issuer strength and broader economic conditions (which vary over time):

- Spreads widen → prices typically fall
- Spreads tighten → prices typically rise



## How do long/short fixed income strategies differ?

Traditional fixed income funds select securities while managing duration and credit exposure within a long-only framework.

While those principles also apply to liquid alternative credit strategies, they can take a more flexible approach using tools such as short selling, leverage and a broader use of derivatives, particularly when the environment for traditional fixed income is more challenging.

- Long-only returns rely on owning the right securities at the right times.
- Long/short strategies can access a broader tool set to seek returns and/or reduce volatility in tougher environments.

### Short selling

We won't get into all of the mechanics of short selling. For simplicity's sake, short selling can be understood as taking an opposing view: instead of investing in something you believe will go up in price, you're investing with the thought that it will go down. While that may sound counterintuitive, it can be useful in certain scenarios:

- When prices of a security (or market prices more broadly) fall
- To reduce the risk or volatility of an overall portfolio

Short selling can be executed in a number of different ways, and it doesn't come without risk. But if used properly, it can be an effective tool for liquid alternative credit managers.



## Key takeaways

Liquid alternative credit can be as simple or as complicated as you want it to be.

To sum things up:

- It's a more flexible form of investing in the world of fixed income.
- Managers use a wider array of techniques than traditional fixed income to help generate returns or reduce volatility.
- In many cases, it's not a question of one versus the other.
- For most investors, liquid alternative credit and traditional fixed income can be complementary, creating added diversification on the road to your financial goals.

To learn more, visit [fidelity.ca/alternatives](https://fidelity.ca/alternatives)



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