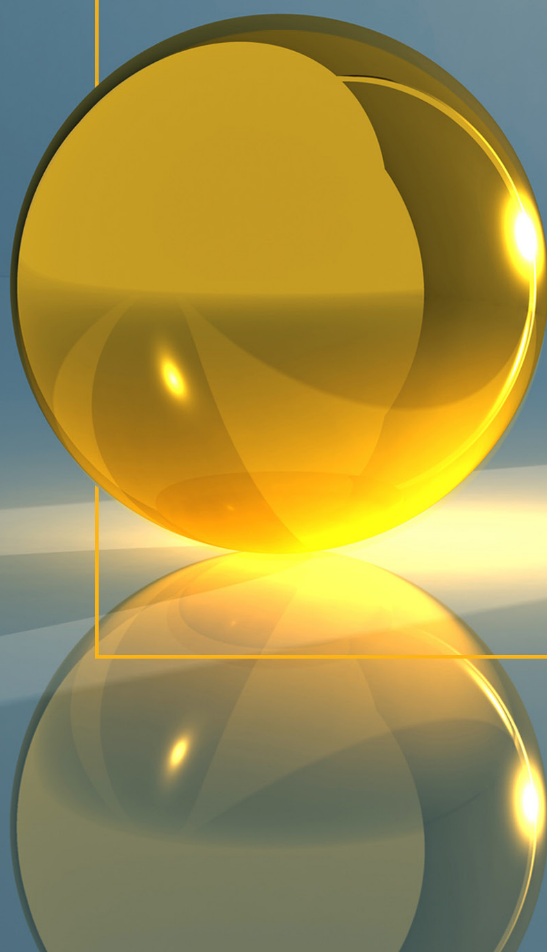
Introduction to alternative mutual funds

FIDELITY INVESTMENTS



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WHAT ARE ALTERNATIVE INVESTMENTS?

Against a backdrop of declining expected returns from traditional investments and increasing investor sophistication, there has been a marked increase in the demand for alternative assets over the past decade as investors look to complement their portfolios and seek better risk-adjusted returns. According to Preqin, an alternative assets data provider, global assets under management (AUM) in the alternative assets industry (defined as private capital and hedge funds) went from $3.1 trillion in 2008 to $10.3 trillion in 2019[1]. Preqin projects this AUM to grow to $14.0 trillion by 2023[2].

Due to their relative complexity and illiquidity, alternative assets are mainly accessible to institutional and high net-worth investors, as opposed to retail investors. Institutional investors may choose to develop in-house alternative investment capabilities, or to outsource the investment due diligence process to specialized fund managers. The following provides a brief overview of the main alternative asset classes.

ASSET CLASS OVERVIEW

Private equity: Direct, typically controlling, equity investments in companies, to which private equity fund managers seek to add value by improving operations or growth. Investments are typically moderately to highly levered.

Private debt: Direct debt investments in companies. Benefits compared with public debt may include an increased scope of opportunities (e.g., investing in smaller enterprises that do not have as easy access to capital markets) and additional flexibility in customizing loan structure and terms.

Infrastructure: Direct debt or equity investments in infrastructure assets such as airports, toll roads, renewable power facilities, etc. Investments can contain various levels of construction risk. These are typically very long-term investments with relatively large investment sizes.

Private real estate: Direct debt or equity investments in residential or commercial real estate across various sectors (e.g., hotel, office, industrial, etc.). In the case of equity investments, returns can come from property capital appreciation as well as rental income.

Hedge funds: Strategies that tend to focus on achieving absolute returns regardless of the performance of the underlying markets. Examples of hedge fund strategies include market neutral, event driven and global macro.

Of the asset classes above, hedge funds are noteworthy in that they are mostly invested in liquid, publicly traded assets, such as stocks and bonds, rather than in illiquid private assets. Additional leverage flexibility, however, allows hedge funds to engage in a broader, more diverse array of strategies beyond traditional long-only investing.

1 *Preqin Future of Alternatives Report* (October 2018); *Preqin Alternatives in 2020 Report.*

2 *Preqin Alternatives in 2020 Report.*

REGULATORY CHANGE OPENS UP RETAIL OPPORTUNITY

In early 2019, the Canadian securities authorities enacted an amendment to National Instrument 81-102 (*Mutual Funds NI 81-102*), the regulation pertaining to mutual funds. The amendment permits the existence of a new class of mutual funds: alternative mutual funds. Alternative mutual funds have significantly more investment and leverage flexibility than their conventional counterparts, allowing them to utilize hedge fund strategies. The updated regulation effectively opened up liquid alternative investments to retail investors in Canada.

BEST OF BOTH WORLDS

Alternative mutual funds combine the advantages of hedge funds and conventional mutual funds. They retain the high liquidity, high accessibility, low minimum investment and strong regulatory oversight of a conventional mutual fund, while gaining access to the broader scope of strategies available to a hedge fund.

FIGURE 1: Alternative mutual funds compared with hedge funds and conventional mutual funds

HEDGE FUNDS		ALTERNATIVE MUTUAL FUNDS		CONVENTIONAL MUTUAL FUNDS
Strategies such as long/short, arbitrage, global macro	→	Strategies such as long/short, arbitrage, global macro		Primarily long-only investments in stocks and bonds
Accredited investors		Retail investors	←	Retail investors
High minimum investment		Low minimum investment	←	Low minimum investment
Low liquidity/redemption frequency		High liquidity/redemption frequency	←	High liquidity/redemption frequency
Offering memorandum		Simplified prospectus	←	Simplified prospectus
Unlimited leverage flexibility (shorts, derivatives, borrowing)	→	Leverage flexibility (shorts, derivatives, borrowing) up to 300% of fund net asset value		Limited leverage flexibility

BENEFITS OF HEDGE FUND STRATEGIES

Adding hedge fund strategies to a portfolio may benefit investors in several ways.

1. INCREASED OPPORTUNITY SET TO CAPTURE ALTERNATIVE SOURCES OF ALPHA

The additional leverage flexibility granted by the updated regulation allows alternative mutual funds to engage more significantly in short selling and derivatives, as well as borrowing for investment purposes, widening the scope of strategies that can be employed. This results in a broader opportunity set for fund managers as they search for attractive investment opportunities (*see Figure 2*), allowing the capture of alternative sources of alpha.

FIGURE 2: The use of short sales and derivatives increases the scope of potential opportunities.

TRADITIONAL LONG-ONLY INVESTING

+

SHORTING ALLOWS FOR

- Long/short equity and credit
- Market neutral
- Merger arbitrage
- Capital structure arbitrage

DERIVATIVES ALLOW FOR

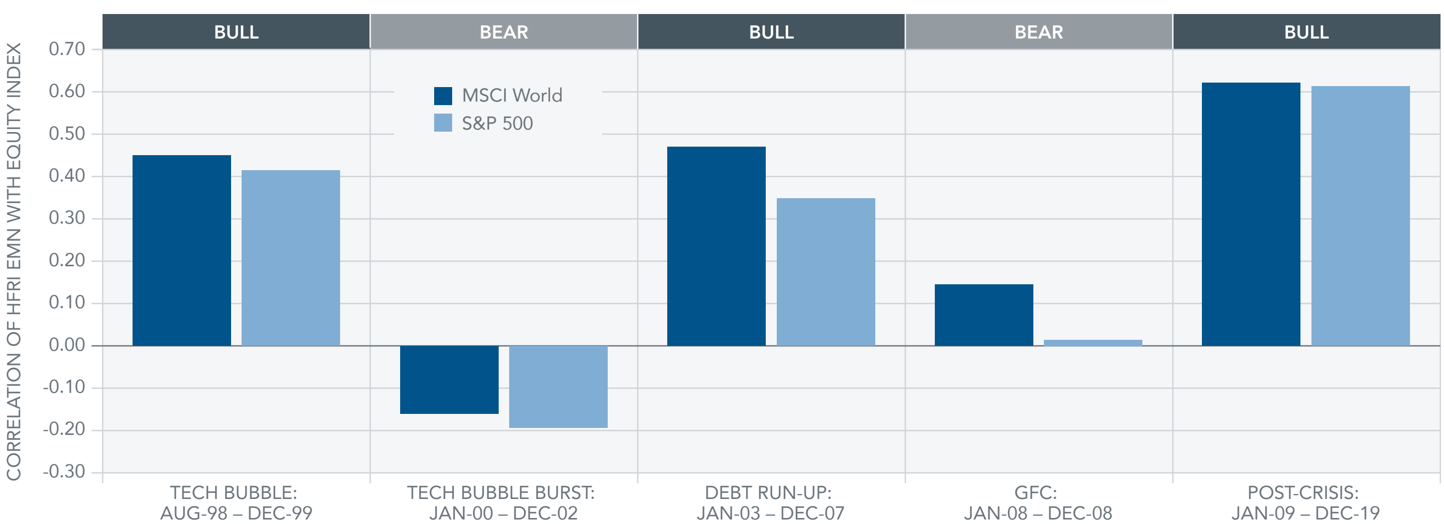
- Options strategies
- Volatility strategies
- Currency strategies
- Global macro

2. PORTFOLIO DIVERSIFICATION

Many hedge fund strategies seek to capture sources of returns with low correlation to the market. Examples include market neutral strategies, which aim to provide positive absolute returns independent of the direction of the underlying market – the resulting portfolios typically have very little exposure to selected forms of risk (notably market risk) – and merger arbitrage strategies, which bet on whether merger deals will successfully close. Low correlation among portfolio allocations leads to diversification benefits, potentially lowering portfolio volatility and improving risk-adjusted returns.

Figure 3 illustrates the correlation of the HFRI Equity Market Neutral Index with the MSCI World and S&P 500 Indexes across major bull and bear markets over the past two decades or so. Over these periods, it seems that the diversification benefits arising from this strategy were even more pronounced in bear markets.

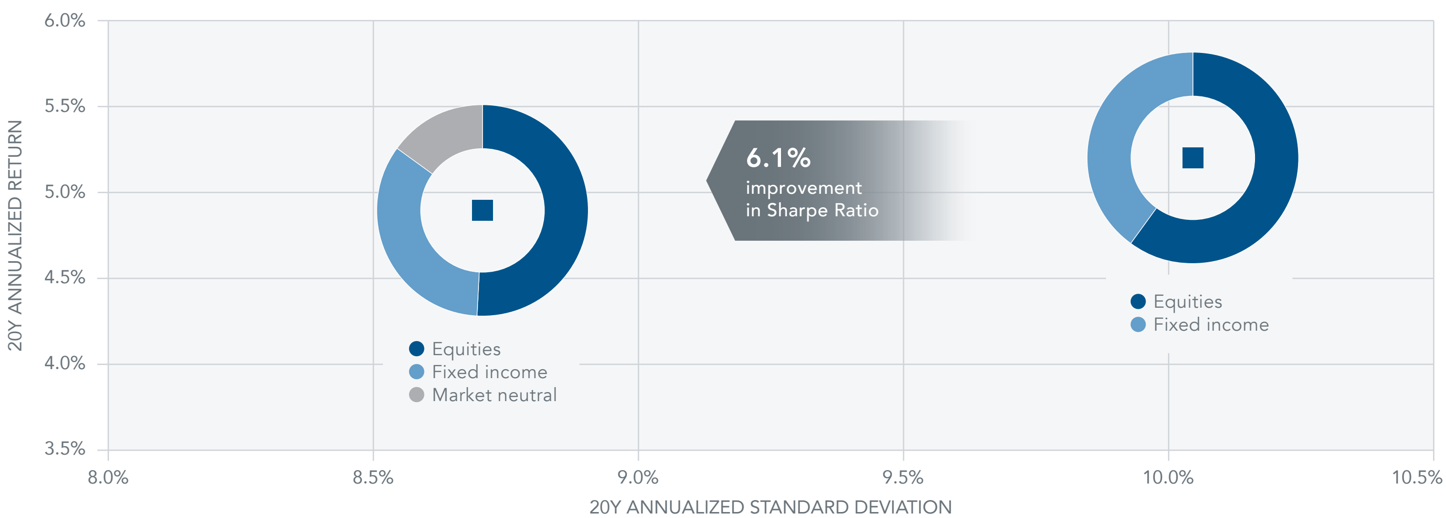
FIGURE 3: Market neutral historical correlation in bull and bear market periods (1998–2019)[3]



3 Source: Fidelity Investments Canada ULC. HFRI Equity Market Neutral Index, MSCI World Net Index and S&P 500 Index in their respective base currencies. The correlations shown above are used solely to illustrate the historical correlations of the HFRI Equity Market Neutral Index and do not reflect the actual correlations of any particular fund. Hedge fund indexes are based on voluntary self-reported returns that may lead to a positive bias. Market indexes are not adjusted for any investment fees. It is not possible to invest directly in an index. Index performance is not meant to represent that of any Fidelity Fund. Past performance is no guarantee of future results.

Figure 4 further outlines the benefits of portfolio diversifcation, illustrating that adding a modest 15% allocation to market neutral strategies (as represented by the HFRI Equity Market Neutral Index) to a traditional 60/40 equity/bonds portfolio has historically resulted in an improvement in the risk-return tradeoff (as represented by the Sharpe ratio) over the past 20 years.

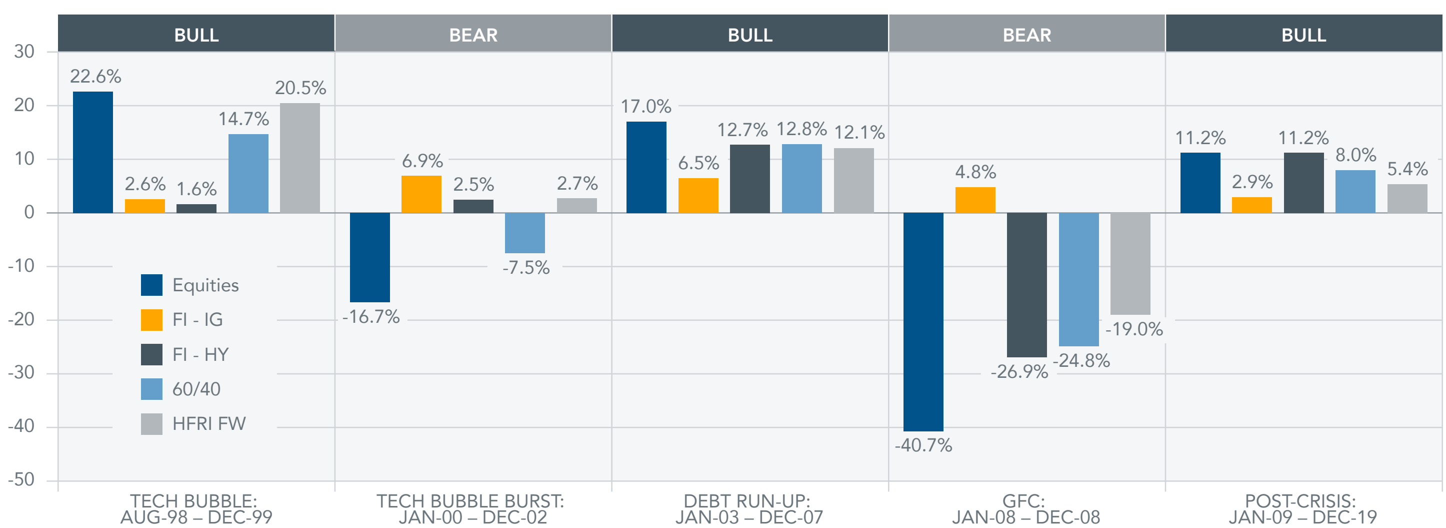
FIGURE 4: Improvement in risk-return tradeoff for a portfolio with a 15% allocation to market neutral[4]



3. DOWNSIDE PROTECTION IN MARKET STRESS

During major bull market periods over the past two decades or so, hedge fund strategies have historically tended to generate positive returns, but have lagged stocks. However, during major bear markets over this period, hedge fund strategies (as represented by the HFRI Fund Weighted Composite Index) have tended to generate better returns relative to stocks (*Figure 5*).

FIGURE 5: Hedge fund strategies in bull and bear markets (1998–2019)[5]

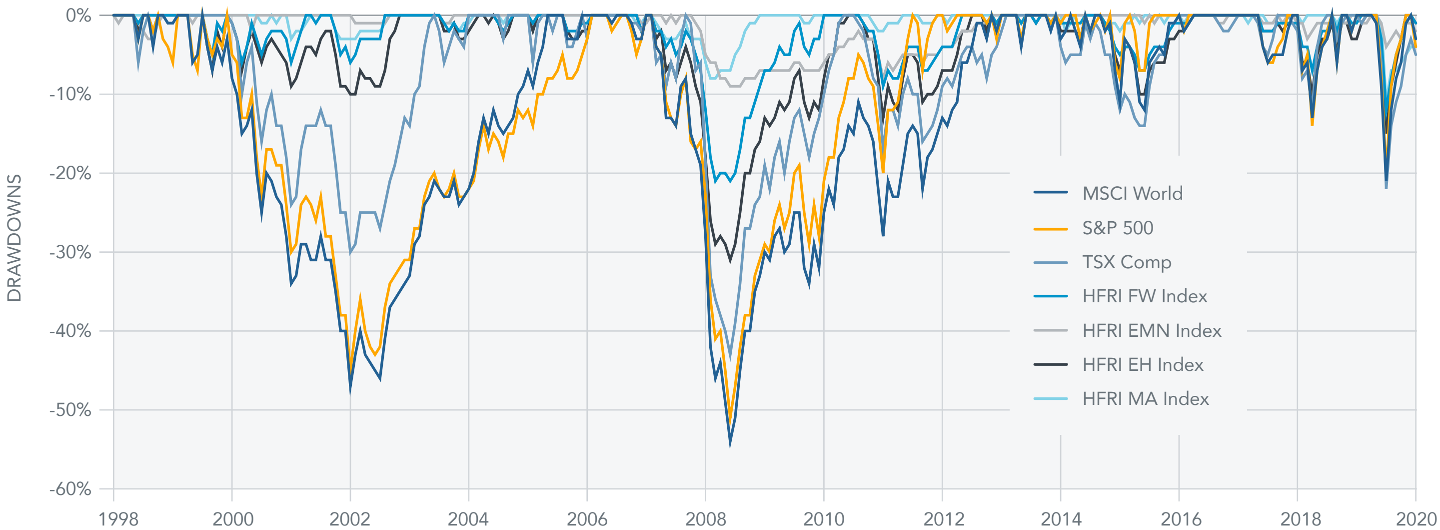


4 Source: Fidelity Investments Canada ULC, as at September 30, 2020. HFRI Equity Market Neutral Index, MSCI World Net Index and BBG Barclays Global Agg Index in their respective base currencies. The performance shown above is used solely to illustrate the historical performance of the HFRI Equity Market Neutral Index and does not reflect the actual performance of any particular fund. Hedge fund indexes are based on voluntary self-reported returns that may lead to a positive bias. Market indexes are not adjusted for any investment fees. It is not possible to invest directly in an index. Index performance is not meant to represent that of any Fidelity Fund. Past performance is no guarantee of future results. Sharpe ratio calculated based on the three-month U.S. T-Bill return in base currency as the risk-free return.

5 Source: Fidelity Investments Canada ULC. HFRI Fund Weighted Composite Index, MSCI World Net Index, BBG Barclays Global Agg Index, BBG Barclays Global HY Index. 60/40 portfolio is represented by 60% MSCI World, 40% BBG Barclays Global Agg. All indexes are in their respective base currencies. Returns shown are annualized over the denoted period. Hedge fund indexes are based on voluntary self-reported returns that may lead to a positive bias. Market indexes are not adjusted for any investment fees. It is not possible to invest directly in an index. Index performance is not meant to represent that of any Fidelity Fund. Past performance is no guarantee of future results.

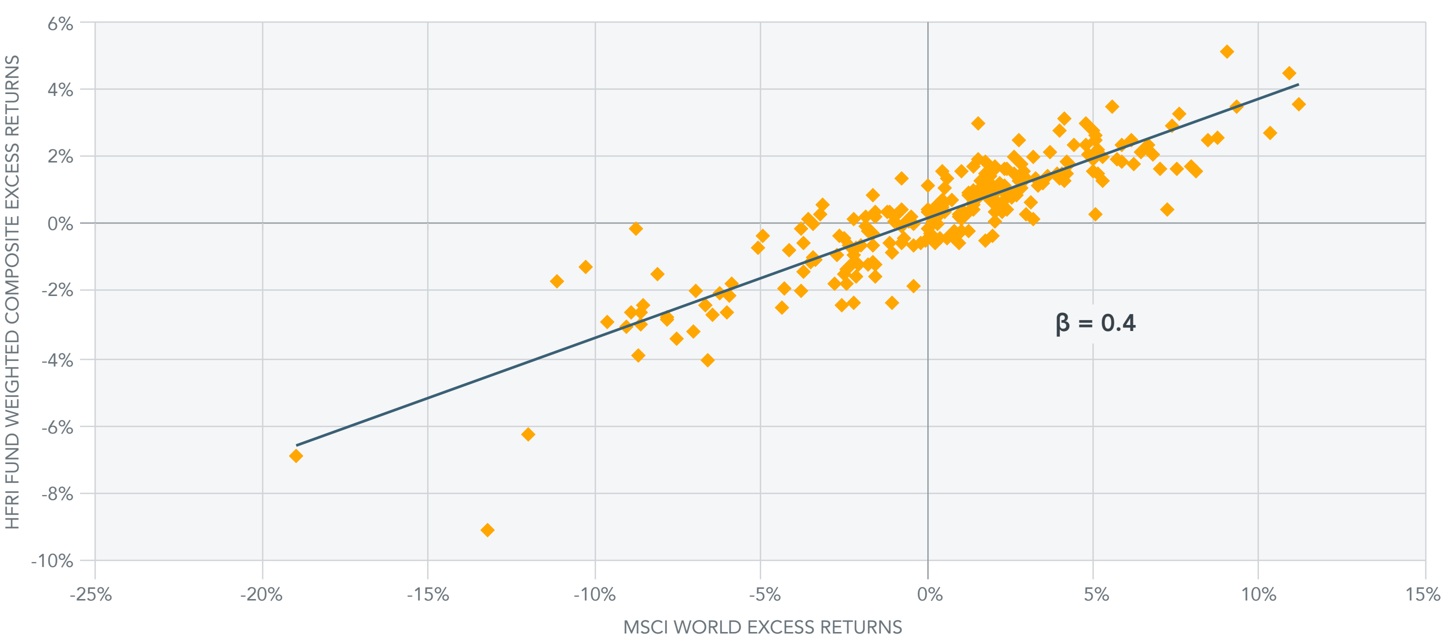
In addition, hedge fund strategies have historically demonstrated less severe drawdowns than equity markets during times of market stress. *Figure 6* illustrates the cumulative drawdowns of the HFRI Fund Weighted Composite Index, the HFRI Equity Market Neutral Index, the HFRI Equity Hedge Index and the HFRI Merger Arbitrage Index compared with those of various broad equity indexes.

FIGURE 6: Historical drawdowns of hedge fund strategies compared with equity indexes[6]



The lower drawdowns are driven in part by the lower market exposure, or beta, of hedge fund strategies on average. *Figure 7* illustrates the historical 20-year market beta of the HFRI Fund Weighted Composite Index.

FIGURE 7: Historical market beta of hedge fund strategies[7]

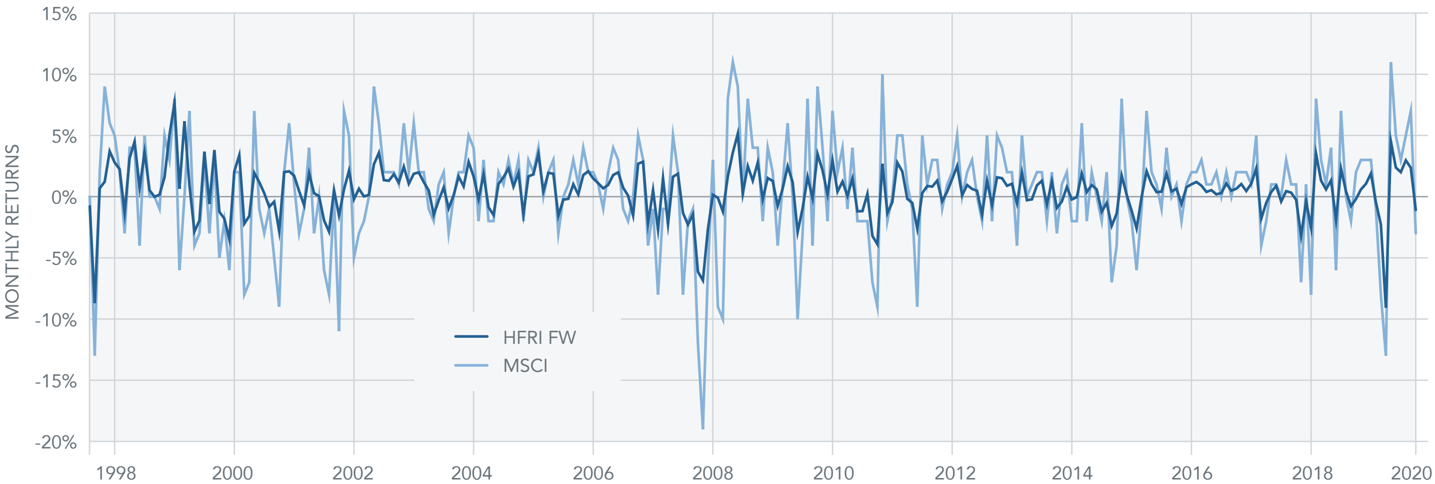


6 Source: Fidelity Investments Canada ULC, as at September 30, 2020. HFRI Fund Weighted Composite Index, HFRI Equity Market Neutral Index, HFRI Equity Hedge Index, HFRI Merger Arbitrage Index, MSCI World Net Index, S&P 500 Index, S&P/TSX Capped Composite Index. All indexes are in their respective base currencies. Hedge fund indexes are based on voluntary self-reported returns that may lead to a positive bias. Market indexes are not adjusted for any investment fees. It is not possible to invest directly in an index. Index performance is not meant to represent that of any Fidelity Fund. Past performance is no guarantee of future results.

7 Source: Fidelity Investments Canada ULC, as at September 30, 2020. Beta based on a regression performed using monthly return data in base currencies starting back from September 30, 2020, for 20 years. Risk-free rate taken as the three-month U.S. T-Bill return.

In addition, hedge fund strategies tend to generate less performance volatility overall. *Figure 8* illustrates the monthly performance over the past 20 years of the MSCI World Index and the HFRI Fund Weighted Composite Index.

FIGURE 8: HFRI Fund Weighted Composite vs. MSCI World monthly returns[8]



INVESTMENT CONSIDERATIONS

Alternative mutual funds may offer benefits to investors who wish to complement their existing portfolios. The optimal portfolio allocation to alternatives depends on the nature of the investor's existing portfolio, investment objectives, risk tolerance and specific investment circumstances.

When considering investments in alternative mutual funds, it is important to remember that there exists significant variation in these products with regard to risk appetite and return objectives. Funds can range from those that focus on seeking low volatility, low correlation with the market and absolute returns regardless of market performance to those that seek to capitalize on the increased leverage limit to take scaled-up speculative bets on certain assets.

Liquid alternatives introduce new risks to a portfolio that traditional long-only investing does not typically encompass, including risks associated with short selling and derivatives. For example, short selling may result in positions with a potentially unlimited downside. Some sources of derivatives risk include counterparty risk and risks associated with any margin requirements. Depending on the extent and the purpose of using alternative mutual funds, the degree of risks associated with short sales and derivatives can vary. Investors should discuss the specific risks of a given fund with their financial advisor in advance of purchase.

8 Source: Fidelity Investments Canada ULC, as at September 30, 2020. MSCI World Index and HFRI Fund Weighted Composite index, in their respective base currencies; monthly returns.

Appendix

KEY TOOLS IN ALTERNATIVE MUTUAL FUNDS

SHORT SELLING

Portfolio managers engage in short selling if they expect that the price of a security will decline. Physical short selling involves selling borrowed securities in the open market. Then at a later date, the securities are bought back and returned to the broker. The profit is the difference between the proceeds from selling the securities at a higher price and the cost of rebuying them at a (hopefully) lower price, less borrowing and transaction costs.

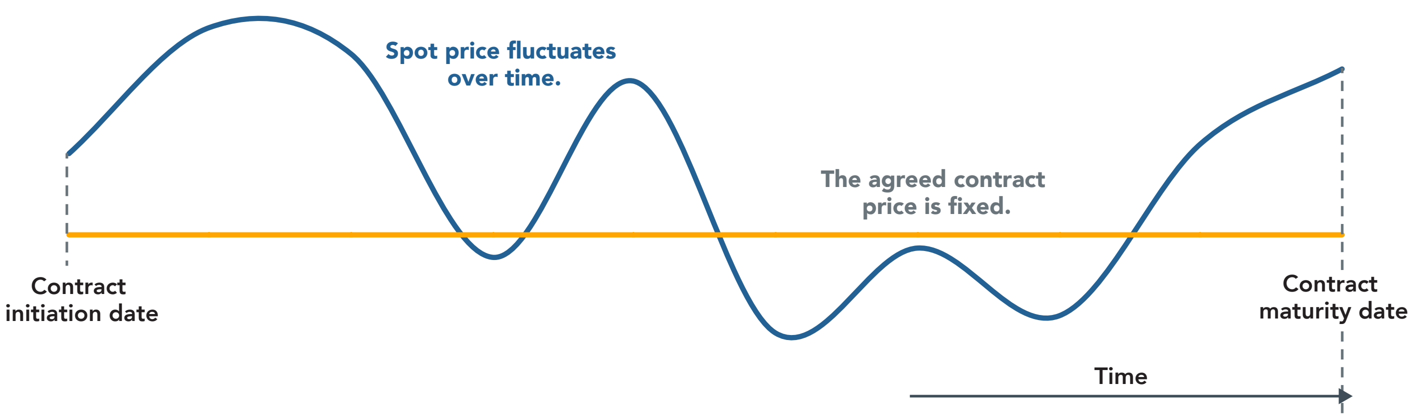
DERIVATIVES

A derivative instrument is broadly defined as any instrument whose value is derived from some underlying security or basket of underlying securities. Derivatives can be used for hedging purposes to reduce portfolio risk, or for speculative purposes to implement a certain investment view. Derivatives allow for more tailored exposures and payoff profiles. The main types of derivatives include futures contracts, forward contracts, options and swaps.

Futures/forwards

Forward and futures contracts allow speculation on the price of an underlying security in the future. Taking a long position on a forward/futures contract means agreeing to buy the underlying security at some future date, while shorting a forward/futures contract means agreeing to sell the underlying security at some future date.

At contract initiation, the long and short parties agree on a price at which the underlying security will be exchanged at some future date. At contract maturity, the long party buys the underlying security from the short party at the price agreed upon at contract initiation. In the below example, the long party benefits, because the spot price at maturity is higher than the agreed price paid for the underlying security.



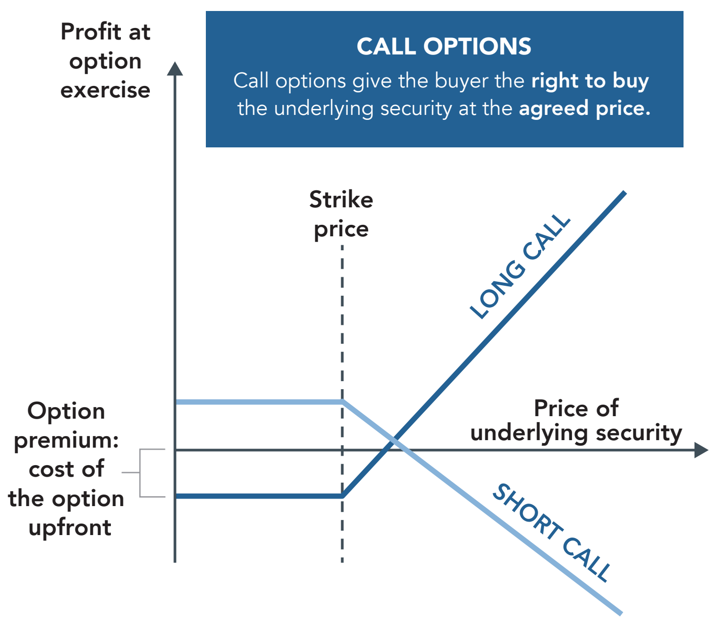
Options

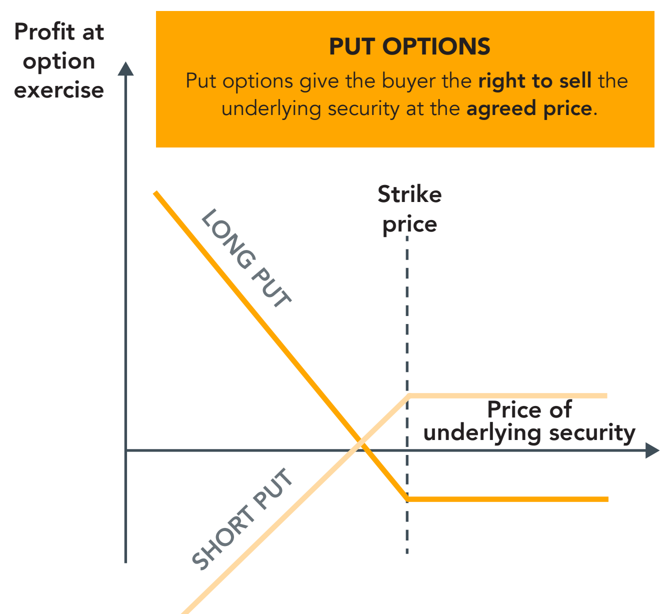
Option contracts give the buyer (long position) the right, but not the obligation, to buy or sell an underlying security at a pre-agreed price (called the strike price) within a specified period of time, or at option contract maturity.

Call options give the buyer the right to buy the underlying security at the strike price, meaning that call option buyers would exercise their right to buy when the price of the underlying security at the time of option exercise is higher than the strike price.

Put options give the buyer the right to sell the underlying security at the strike price, meaning that put option buyers would exercise their right to sell when the price of the underlying security at the time of option exercise is lower than the strike price.

The charts below illustrate the profit of long and short positions on call and put options at the exercise date, as a function of the price of the underlying security. Note that the profit of short positions is equal in magnitude to, but of the opposite sign of, the profit of corresponding long positions.



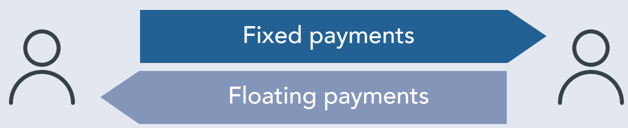


Swaps

A swap is an agreement between counterparties in which one stream of payments is exchanged for another stream of payments, based on some notional amount. Swaps can be used to change from one kind of exposure to another.

Some examples of different types of swaps include the following:

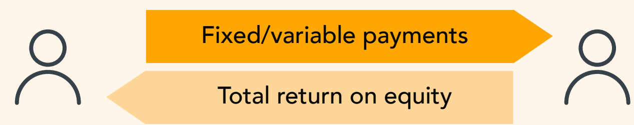
INTEREST RATE SWAP



- Person on left is paying fixed and receiving floating payments
- Plain vanilla IRS are based on LIBOR[1] rates
- Payment frequencies can vary (e.g. semi-annual, quarterly)

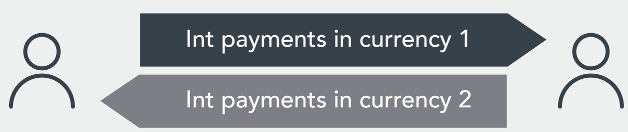
1 Rate that banks with high credit quality charge each other for ST financing.

EQUITY SWAP



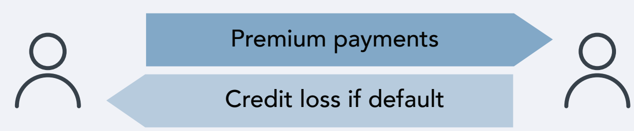
- One party's payments are based on the returns of some equity or index, while the other party pays a fixed series, a floating series, or a series based on the returns of another equity

CURRENCY SWAP



- Two counterparties agree to exchange future interest payments in different currencies
- Can be fixed-for-fixed, floating-for-fixed, or floating-for-floating

CREDIT DEFAULT SWAP



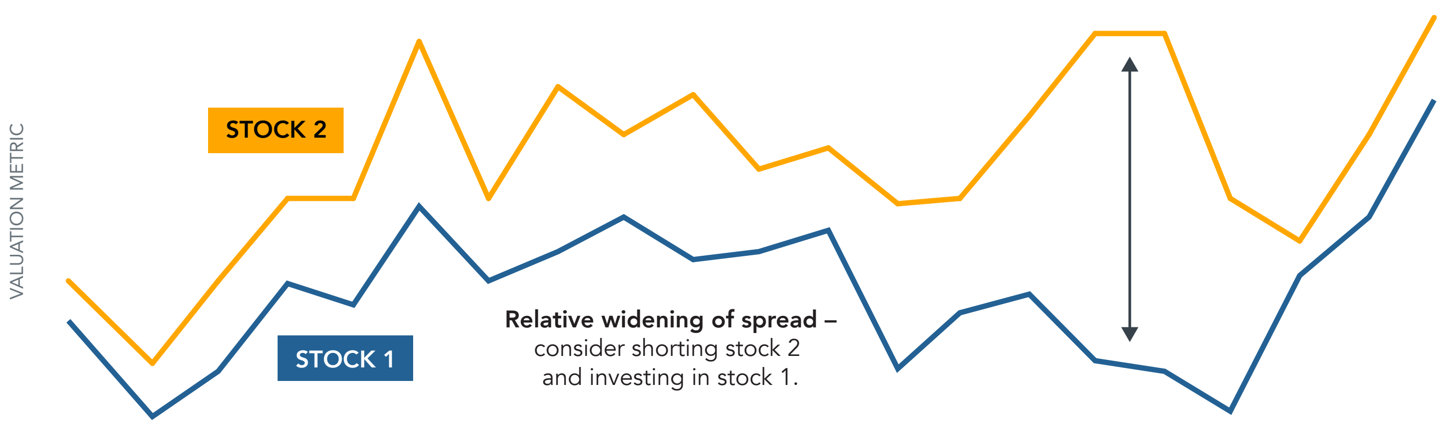
- One party, the protection buyer, pays a fixed premium to the other party, who agrees to cover any principal loss in case of default of the underlying bond

KEY STRATEGIES IN ALTERNATIVE MUTUAL FUNDS

LONG/SHORT

A long/short strategy consists of buying an undervalued security (e.g., a stock) and shorting an overvalued security. Ideally, the long position will increase in value, and the short position will decline in value. The relative amount of long and short positions can vary; for instance, in a "130/30 fund," for every $30 in short positions, the fund has $130 in long positions.

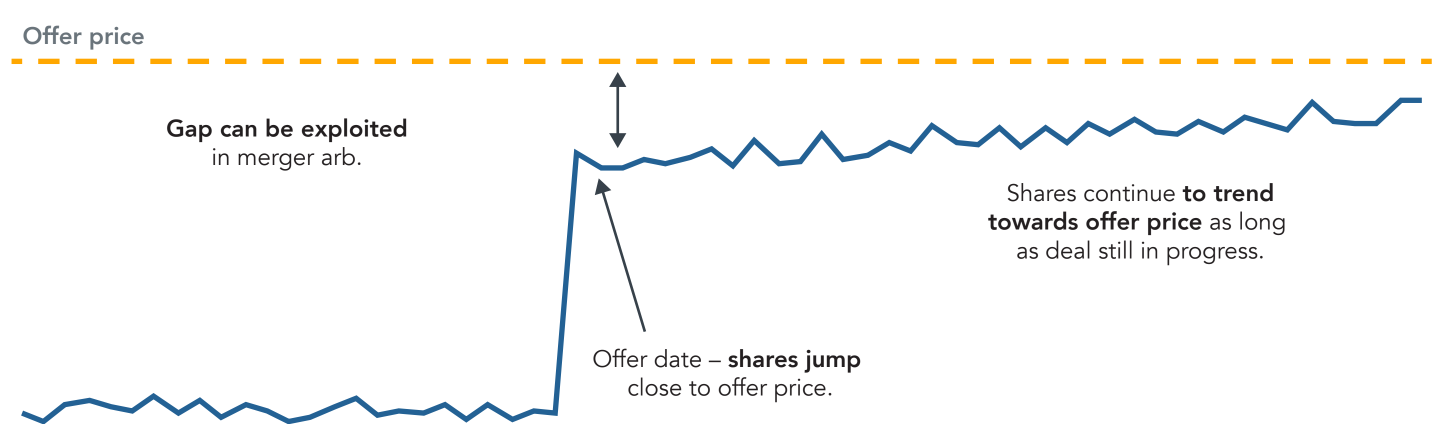
Long/short strategies can attempt to extract relative value, which means benefiting from a relative mispricing between two securities (see chart). The two securities can be chosen such that they have similar exposure to the market (e.g., similar betas), such that the net overall position has a low market beta, allowing the investor to focus on idiosyncratic returns.



MERGER ARBITRAGE

Merger arbitrage speculates on the successful completion of mergers and acquisitions, and is a type of event-driven investing. Typically, when a target company receives a takeover offer from an acquirer, its stock price does not fully converge with the offer price: this reflects the probability that the merger/acquisition might not end up closing.

If the acquirer offers to purchase the target with cash, the portfolio manager can buy the target's stock, making a profit if it becomes increasingly likely that the deal will occur. If the acquirer offers to purchase the target with its own shares, the portfolio manager can buy the target's stock and short the acquirer's stock. This creates exposure solely to the spread between the stocks, making a profit when the spread narrows if the deal closes.



CAPITAL STRUCTURE ARBITRAGE

Capital structure arbitrage seeks to profit from the differential pricing of various instruments issued by one entity. For example, if portfolio managers think that a company's senior debt is underpriced relative to its junior debt (debt that has lower priority to claims in case of bankruptcy), they may buy the senior debt and short the junior debt. Since yield and price are inversely related, this position will profit if the difference in the yields of these two securities widens.

GLOBAL MACRO

Global macro is based on the prediction of large-scale events related to national economies and international relations, and can be systematic or fundamentals-based. This strategy typically employs forecasts and analysis of interest rates, currency exchange rates, commodities, international trade, government policies and other broad systematic factors. Common examples of global macro trading include betting on the relative values of currencies, commodities or interest rates on sovereign debt.

VOLATILITY STRATEGIES

Volatility strategies speculate on the frequency and magnitude of future movements in various asset markets. There are various ways in which volatility strategies may be implemented, including taking relevant positions in options and swaps.

CONVERTIBLE ARBITRAGE

Convertible arbitrage typically involves taking a long position in a convertible security, usually a bond that can be converted to common stock at the investor's discretion, and a short position in the underlying common stock. The strategy seeks to profit from the relative mispricing of the convertible security.

MULTI-STRATEGY

The term "multi-strategy" applies to funds that implement a variety of strategies.

Index descriptions

MSCI WORLD NET INDEX

Captures large- and mid-cap representation across 23 developed market countries. With 1,651 constituents, the Index covers approximately 85% of the free float-adjusted market capitalization in each country.

S&P 500 INDEX

A float-adjusted, market capitalization-weighted index that includes 500 leading companies and captures approximately 80% of the available market capitalization in the U.S.

S&P/TSX CAPPED COMPOSITE INDEX

The S&P/TSX Capped Composite imposes capped weights of 10% on all of the constituents included in the S&P/TSX Composite. The S&P/TSX Composite covers approximately 95% of the Canadian equities market.

BLOOMBERG BARCLAYS GLOBAL AGGREGATE INDEX

A flagship measure of global investment-grade debt from 24 local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed rate bonds from both developed and emerging market issuers.

BLOOMBERG BARCLAYS GLOBAL HIGH YIELD INDEX

A multi-currency flagship measure of the global high-yield debt market. The Index represents the union of the U.S. High Yield, the Pan-European High Yield and Emerging Markets (EM) Hard Currency High Yield Indexes.

HFRI FUND WEIGHTED COMPOSITE INDEX

A global, equal-weighted index of over 1,400 single-manager hedge funds that report to HFR Database. Constituent funds report monthly net of all fees performance in U.S. dollars and have a minimum of $50 million under management or a 12-month track record of active performance. The HFRI Fund Weighted Composite Index does not include funds of hedge funds.

HFRI EQUITY MARKET NEUTRAL INDEX

A global, equal-weighted index in U.S. dollars. Returns included are net of all fees. Excludes funds of hedge funds. If a fund in an index liquidates or closes, that fund's performance will be included in the HFRI up to the fund's last reported performance update. Tracks hedge funds that typically maintain characteristic net equity market exposure no greater than 10% long or short.

HFRI EQUITY HEDGE INDEX

A global, equal-weighted index in U.S. dollars. Returns included are net of all fees. Excludes funds of hedge funds. If a fund in an index liquidates or closes, that fund's performance will be included in the HFRI up to the fund's last reported performance update. Tracks hedge funds that maintain both long and short positions, primarily in equity and equity derivative securities.

HFRI MERGER ARBITRAGE INDEX

A global, equal-weighted index in U.S. dollars. Returns included are net of all fees. Excludes funds of hedge funds. If a fund in an index liquidates or closes, that fund's performance will be included in the HFRI up to the fund's last reported performance update. Tracks hedge funds that employ an investment process primarily focused on opportunities in equity and equity-related instruments of companies that are currently engaged in a corporate transaction.

For more information, speak to your financial advisor today, or visit fidelity.ca/**Alternatives**

Throughout the document, the term "hedge fund" is used to mean an exempt-market fund that is not required to offer its shares or units pursuant to a prospectus.

Commissions, trailing commissions, management fees, brokerage fees and expenses may be associated with investments in alternative mutual funds and ETFs. Please read the alternative mutual fund's or ETF's prospectus, which contains detailed investment information, before investing. Alternative mutual funds and ETFs are not guaranteed. Their values change frequently, and investors may experience a gain or a loss. Past performance may not be repeated.

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A fund's volatility is determined using a statistical measure called "standard deviation." Standard deviation is a statistical measure of how much a return varies over an extended period of time. The more variable the returns, the larger the standard deviation. Investors may examine historical standard deviation in conjunction with historical returns to decide whether an investment's volatility would have been acceptable given the returns it would have produced. A higher standard deviation indicates a wider dispersion of past returns and thus greater historical volatility. Standard deviation does not indicate how an investment actually performed, but it does indicate the volatility of its returns over time. Standard deviation is annualized. The returns used for this calculation are not load-adjusted. Standard deviation does not predict the future volatility of a fund.

The Sharpe ratio is a measure of risk-adjusted returns and is calculated as the ratio between a portfolio's excess return over a risk-free rate and its standard deviation.

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