Alternative Investments – 2023 Review and 2024 Outlook

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2023 Review: 2023 was a strong year for alternative investments despite a backdrop of increased interest rates, high inflation, geopolitical risks, and continued fears of recession, although certain sub-sectors faced headwinds. BCV's Multi-Strategy Alternatives Fund ("the Fund") performed well since its launch in January of 2023. After 10 months (as of November 30th), the Fund returned +6.6%, which is tracking toward the mid-range of the stated 7-9% annual target. This article will focus on the three alternative investment sectors with the largest allocations in the Fund: private credit, private equity, and real estate. Private credit was a bright spot in 2023 with increased interest rates, spreads, and fees generating strong returns for investors. Private equity faced some headwinds largely due to increased interest rates, although this led to great opportunity within "secondary" markets, an area of focus for the Fund in 2023 and described in detail below. Real estate also faced some headwinds due to increased interest rates and lower occupancy in offices as some people continue working from home, however the fundamentals of the multi-family apartment sub-sector remain strong, particularly in Canada. The lion's share of the Fund's real estate holdings are invested in apartments, with less than 1% allocated to office.

2024 Outlook: There are some question marks heading into 2024 as to whether the North American economy will fall into recession. Canadian GDP growth is lagging the United States, and it appears that the Canadian economy may already be in a recession – consumers and businesses are facing the impacts of higher interest rates and Canadian productivity growth lags the United States. Given this backdrop, investors are not expecting the same outsized public equity returns of 2023. Additionally, fixed income returns have been volatile over the last three years so investors are looking for additional sources of diversification. Private alternative investment markets can be an additional source of returns that are uncorrelated to public market returns.

The outlook for private credit is strong as interest rates remain relatively high and banks have pulled back, providing private credit an opportunity to fill the void. After the outsized public equity performance in 2023, there is reason to be optimistic for private equity investments heading into 2024. United States private equity funds launched in periods of high public equity market valuations (like today) tend to outperform public equity investments. In real estate, the long-term outlook remains strong, particularly in the multi-family sub-sector as houses have become unaffordable due to higher interest rates and there is a lack of supply. According to Citi Financial, "alternative investments have the highest next-decade return estimates among all of the asset classes in our proprietary asset allocation methodology."

Private credit: private credit refers to private lending outside of traditional bank lenders or public markets and continues to outgrow these conventional sources of financing. A shift toward private credit has been happening since the global financial crisis ("GFC") led to a change in the regulatory environment with banks unable to provide as much financing to small and medium-sized businesses. Multiple bank failures in 2023 (Silicon Valley Bank, First Republic, Signature Bank) led to a further pullback in traditional lending which continues to create opportunities for private lending to fill the void.

Most private credit investments are floating rate in nature and are benefiting from the higher interest rate environment. As banks pulled back from the market, spreads and fees increased, leading to stronger returns for investors. Deal structures and terms have also improved, with lower leverage and covenants more favourable to lenders. In 2023, private credit was a great sector to be invested in and the Fund had an allocation of 29.6% at the end of November.

BCV's Mult-Strategy Alternatives Fund has a significant allocation to Oaktree's Strategic Credit Trust. Oaktree is a global leader with $121 billion of credit assets under management. The team benefits from scale, a strong track record, and a wide network of deal sourcing opportunities. The strategy primarily invests in private credit but does have the flexibility to invest in discounted public debt in times of market dislocation. As of October 31st, the strategy returned 9.4% year-to-date and 11.2% on a trailing 12-month basis. As of November 30th, 9.5% of the Fund was invested in this strategy.

Private equity: private equity funds acquire stakes in private companies and take an active role in improving operations and profitability before selling at a higher price. Investor capital in private equity funds is committed for a set time frame, that typically ranges from 10 to 12 years.

Since 2009, private equity companies have been using cheap debt to fund acquisitions as interest rates were near historic lows, but a paradigm shift has occurred since central banks began rapidly raising rates. As debt is more expensive, private equity companies can no longer justify the prices they were previously paying to acquire companies. So, the market is at a bit of a standstill as potential sellers are unwilling to accept lower prices. Dealmaking activity has slowed to record lows in 2023, after reaching record highs in 2021. However, the private equity industry needs to exit portfolio companies for funds with finite lives. Traditional exit mechanisms include a sale to a corporate buyer, sale to another private equity buyer, or public listing via initial public offering. Another major option for exits has been developing for many years – "secondary" markets. Secondary private equity funds provide liquidity to private equity investors by purchasing existing investments that are otherwise locked up (without an ability to sell). Secondary investors demand a discount on the purchase in exchange for providing liquidity. Secondary market volumes have tripled over the last six years.

In 2022, private equity markets outperformed public equity markets leading to the "denominator effect" for many large institutional investors (e.g., pension funds, endowments). This occurs when the value of one segment of an investment portfolio performs significantly differently than another, causing portfolio weightings to deviate from targets. Some institutional investors are forced to rebalance their portfolios i.e., reduce private equity allocations, and increase public equity allocations (in this case). Heading into 2023, this phenomenon was foreseeable as demand for liquidity significantly outpaced supply, which led to a widening in discounts for secondary investors. From 2016 to 2021, discounts averaged approximately 10%, but at the end of 2022, this increased to approximately 20%. Said in another way, secondary investors were picking up private equity investments at ~80 cents on the dollar.

BCV's Multi-Strategy Alternatives Fund took advantage of the market conditions by making a commitment to Northleaf's Secondary Partners III (NSP III) strategy. Northleaf is a well-respected Canadian private markets specialist with a 20+ year track record of success. Some very large Canadian pension plans including CPP Investments and CDPQ invest a portion of their assets with Northleaf. Northleaf has executed $3.2 billion of secondary transactions since 2003 (117 transactions). Since then, net returns to investors have exceeded 20% per year and only ~1% of total investments made have experienced a loss. Since inception in 2021, NSP III has generated a total return of approximately 30% for investors. As of November 30th, 7.1% of the Fund was invested in NSP III.

Real Estate: 2023 was a challenging year for some private real estate investments, but there is reason to be optimistic moving forward. According to J.P. Morgan, their "work suggests that stress is relatively constrained". COVID has had

a long-lasting impact on the office sub-sector. Shrinking office demand due to a permanent move (in many cases) to hybrid work combined with higher interest rates have impacted office real estate portfolios in a negative way. Valuations in U.S. office properties have declined by approximately one third since their peak, and delinquency rates on office properties were 6.1% in November 2023, however the Fund has very little exposure i.e. <1%. In 2023, real estate transaction activity slowed, but is expected to pick up in 2024, which is positive for the sector. Net operating income continued to grow in 2023 across all real estate sub-sectors, which is also a positive sign moving forward.

The Fund's real estate holdings are largely comprised of multi-family apartments in Canada and the U.S. The long-term prospects for multi-family investments remain strong. The rise in interest rates has made mortgages unaffordable for many people, pushing them into the rental market. The outlook is particularly positive in Canada taking into consideration a lack of supply and such a strong pace of immigration. The Fund has a significant investment in Avenue Living's Core Trust strategy (9.6% of the Fund as of November 30th). Avenue Living is a vertically integrated North American real estate owner and operator with over $4.9 billion of assets under management and owns ~17,000 multi-family units. The prairie provinces are expected to see more positive housing developments than other regions due to high interprovincial migration, ownership affordability, and a stronger economic outlook. Over half of Avenue Living's units are in Edmonton, Calgary, Regina, and Saskatoon. As of November 30th, the strategy returned 12.3% year-to-date and 12.9% on a trailing 12-month basis.

Conclusion: Alternative investments are expected to continue providing numerous benefits to an investment portfolio including diversification, low volatility, inflation protection, and potential for higher returns. 2023 was a strong year for alternative investments and for BCV's Multi-Strategy Alternatives Fund. All things considered; we believe the outlook for 2024 is even stronger.

Central Banks Are Not Yield Curves – Part Deux

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This time last year, in an article titled "Central Banks Are Not Yield Curves", I wrote the following:

1) *Central banks only directly control short-term rates, and increases/decreases to the Bank of Canada's ("BoC") policy rate need not necessarily portend a respective move in longer-term yields.*

One year on, while the BoC's policy rate increased from 4.25% to 5.00% as at time of writing, the 5- and 10-year Canada bond yields are unchanged over the same period (though with some large fluctuations in the interim). Some market participants suggest the decline in longer-term yields is due to central bank commentary and the signaling of policy rate cuts as the cause, which overlooks declining inflation, weaker growth expectations, and more as the fundamental causes. I reiterate the point – Central Banks Are Not Yield Curves.

2) *Historically, while the yield curve is inverted, <u>and particularly when central banks are still in their tightening cycles</u>, equity markets tend not to bottom.*

Indeed, the S&P/TSX traded sideways throughout most of 2023. It was not until the yield curve began to normalize AND central banks signaled the end to their hiking campaigns and the beginning of rate cut deliberations that the S&P/TSX rallied in October from its YTD low.

3) *Economic data may have further room to surprise to the downside, including labour data (which is a notoriously lagging indicator).*

Call this one half-correct. Economic data certainly deteriorated as the year progressed. Look no further than Canada's GDP which has flatlined all year and indeed turned negative on a per-capita basis. Even the U.S. economy, despite its admitted robustness, experienced a large decline excess labour demand, and its manufacturing sector has been contracting for 14 successive months. Not to mention the challenges facing the European and Chinese economies.

What has been wrong, or at least not yet correct? Payrolls and the consumer. The former, although incredibly resilient, has undergone a large shock that is still being resolved and is exhibiting some signs of weakness (particularly in Canada), whereas the latter is supporting itself largely with debt and a reduction in savings.

4) *Gradual moves towards curve normalization (i.e., a return to an upward slope) should be monitored as a sign of improving financial market tone.*

The 2-year 10-year yield spread reached peak inversion mid-year in 2023 and has been gradually normalizing. In the last few months, and AFTER the yield curve began to move towards normalization, we've seen some stability in non-labour economic data, a rally inequity markets, and tightening in bond credit spreads.

What yield curve signals can we glean today for 2024?

For starters, it remains inverted – remember that this is abnormal, despite the inversion longevity. Additionally, the move towards yield curve normalization appears somewhat stalled and remains at the same level of inversion as between mid-2022 to mid-2023. This suggests that, despite all central bank and media commentary, financial markets continue to grapple with where inflation will ultimately land longer-term (notwithstanding very good progress in 2023). All exacerbated by government and consumer sensitivity to any level of interest rates above that of the historically abnormal, and near-zero, levels throughout the 2010s.

If you're a believer, as I am, that longer-term interest rates move independently from what central banks do, then it is worth asking why bond buyers drove 10-year and longer yields down 60-100bps from October to now. Had that not happened, the yield curve today would be nearly normalized. Is this asset rebalancing from sovereign funds, hedge fund, large institutions, etc? Are they preparing for potential weak growth and/or further deterioration in economic data? Or simply taking advantage of relatively high yields? Perhaps, all the above.

BCV's intention is "buy on" as the yield curve continues to normalize. Particularly since, despite the equity rally in the last few months, some compelling long-term deals remain (many good quality dividend-paying names remain below their 2022 high, e.g. banks, utilities, etc.). However, it will pay to be mindful of not just curve normalization, but also the relative changes in short and long-term yields which will hopefully be a mix of declining short-term yields and stable if not moderately rising long-term yields.