Advance with Alternative Investments
Diversification when you need it
All charts are for illustrative purposes and not intended to be representative of any specific investment vehicle. Please refer to the Appendix on back cover for definitions of benchmarks displayed. Past performance is not indicative of future results. This information is not intended to be used as the primary basis of investment decisions. Because of individual client requirements, the information should not be construed as advice designed to meet the particular investment needs of any investor.
Expand your investment toolkit

Of all the lessons learned from the 2008 market dislocation, one of the most lasting realizations is that our tolerance for risk may actually be lower than we previously imagined. Yet as markets have recovered through the years that have followed, we may have also learned that some risk may be required to achieve the returns we seek. Therefore, taking steps to accept risk — and consequently manage it — may be a priority for you.

Portfolio diversification is one way to hedge against risks associated with individual securities. For example, equity and fixed income investors spread risk by owning stocks from diverse sectors and geographies, and by purchasing bonds from different issuers with different credit ratings and maturities. But when broad price swings remain commonplace for stocks, and bonds and cash seem stuck in a low interest rate environment, alternative investments may offer a solution to protect against these types of systemic risks.

RBC Wealth Management defines alternative investments simply as any investment outside of publicly traded, long-only, stocks, bonds, or cash. Though alternative investments are commonly perceived to carry an undue amount of risk, alternative investments may actually lower certain types of risk exposure by taking advantage of what are often called “non-correlated asset classes.” This term is used for alternative investments because their performance is less likely to correlate with the performance of the broader stock, bond, and cash markets. As non-correlated assets, alternative investments can help portfolio volatility attributable to equity markets as well as help improve overall returns. By losing less value compared to a volatile benchmark, an investment can both recover faster and grow quicker. Conversely, non-correlated assets may not perform as well as the broader equity market during extended bull markets, where they may only capture a portion of the equity market upside.

It is certainly true that alternative investments come with important considerations to understand before investing. For example, not all strategies are alike or serve the same purpose. Some strategies may use leverage or other complex financial structures that involve risk, some may be more illiquid and/or difficult to value, and some may have limited regulatory oversight.

Which solution is right for your goals?

Alternative investments come in several shapes and sizes. Depending on your specific needs and financial circumstances, one may be more appropriate than another. The purpose of this brochure is to provide a brief overview of some of the most common types of alternative investments and those that are offered at RBC Wealth Management: hedge funds, private equity, and real assets.

### Alternative investment strategies

<table>
<thead>
<tr>
<th>Hedge Funds</th>
<th>Private Equity</th>
<th>Real Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Convertible Arbitrage</td>
<td>Buyout</td>
<td>Commodities</td>
</tr>
<tr>
<td>Distressed</td>
<td>Direct Lending</td>
<td>Energy</td>
</tr>
<tr>
<td>Equity Long/Short</td>
<td>Mezzanine</td>
<td>Infrastructure</td>
</tr>
<tr>
<td>Fixed Income Arbitrage</td>
<td>Venture Capital</td>
<td>Real Estate</td>
</tr>
<tr>
<td>Global Macro</td>
<td>Venture Capital</td>
<td>Timber</td>
</tr>
<tr>
<td>Managed Futures</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Market Neutral</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Merger Arbitrage</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

This chart provides examples of investment strategies employed by alternative asset managers.
Hedge funds

Potential to diversify beyond traditional long-only investing

**Definition**

We define hedge funds as investment strategies that have access to a broader mandate than just equities, bonds, and cash. Some examples of the types of strategies available to hedge fund managers include shorting, the use of leverage, the use of derivative securities, and the ability to invest in instruments that do not offer daily liquidity. This broader approach provides hedge fund managers the opportunity to generate differentiated sources of return, increased portfolio diversification, and enhanced risk-adjusted returns.

**Features and benefits**

**Differentiated sources of return**

Hedge funds include differentiated sources of return, allowing for reduced volatility which has resulted in returns that have been historically more consistent than the S&P 500 over time.

From 1990 to 2015, hedge funds were able to provide more consistent returns than equity markets, as represented by the S&P 500, by capturing 50% of the equity market upside and 25% of its downside. By limiting the downside market participation, hedge funds not only provided notable outperformance over equities, but did so with much less volatility. This performance result is possible because most hedge funds have access to strategies that can hedge their market exposure — although it is important to note that not all hedge funds hedge. It is also important to note that in strong equity market environments, hedge fund strategies are likely to underperform on a relative basis. For example in 2013, the S&P 500 was up 32% while hedge funds, as represented by the HFRI Fund Weighted Composite Index, were up just 9%.
Hedge funds can provide diversification benefits through reduced correlation.

The investment management industry has always highlighted the importance of portfolio diversification. Over time, the definition of “portfolio diversifiers” has evolved. Over the past few decades, diversifying by region, sector, market cap, maturity, and coupon has largely been sufficient for equities and bonds. However, over time, this has proven not to be enough for some investors. As a result, alternative strategies have been considered as an option to help achieve those same intended diversification objectives.

Portfolio diversification from 1990-2015

Using HFRI Fund Weighted Composite Index as a proxy for hedge funds and the S&P 500 for equity markets, the above chart shows the potential for hedge funds to outperform equity markets on a cumulative basis. (Source: Zephyr Analytics)

Using the HFRI Fund Weighted Composite Index as a proxy for hedge funds, the S&P 500 as a proxy for equity markets, the Barclays US Aggregate as a proxy for bonds, the Cambridge Private Equity Index as a proxy for private equity, and the National Association of Real Estate Investment Trusts (NAREIT) All Equity Index for real estate, the above chart shows that allocating a portion of your portfolio to alternative investments may help reduce the overall volatility of your portfolio and create the potential for greater wealth creation and preservation over time. (Source: Zephyr Analytics)
Enhanced risk adjusted returns
Historically, hedge funds have preserved value relatively well in down markets when compared to traditional equities.

Hedge funds have typically shown over time that they can mitigate downside participation during market dislocations, including the bursting tech bubble in the early 2000’s and again in the recent financial crisis of 2008. In 2008 for example, equity markets, as represented by the S&P 500, were down 37% while hedge funds, represented by the HFRI Fund Weighted Composite Index, were down 19%. Likewise from April to December 2001, the S&P 500 was down 15%, while hedge funds, represented by the HFRI Fund Weighted Composite Index, were up about 5%.

Downside protection during market dislocations

Using the HFRI Fund Weighted Composite Index as a proxy for hedge funds, and the S&P500 as a proxy for equity markets, the above charts shows that hedge funds have tended to decline less than the equity markets in periods of severe equity market stress. By providing downside protection, hedge funds may reduce the recovery time from drawdowns and may provide portfolio growth opportunities more quickly. (Source: Zephyr Analytics)

Fund of Hedge Funds
Fund of hedge funds provide a vehicle for investing in multiple hedge fund strategies and managers, and provide investors with an additional layer of due diligence, monitoring, and risk management. While there are diversification benefits of this structure, an additional layer of fees is often charged.
Private Equity

Potential to enhance returns through an illiquidity premium

Definition

Private equity funds attempt to achieve enhanced risk-adjusted returns relative to public stock markets. Private equity funds utilize strategies such as acquiring private companies and adding value by improving operational efficiency to enhance margins, or by adjusting corporate strategy to drive growth. Since private equity funds take a long-term view on their investments, they are less liquid investments; however, they have demonstrated the ability to capture an illiquidity premium because of this long-term investment view. The typical holding period for private equity is 10 years or more. As a result, understanding the life cycle of a private equity fund is very important.

Private equity fund life cycle

Above is an example of the J-Curve life cycle for a private equity fund.
During the “Fundraising Period” (years one through three), the fund manager collects commitments, or the amount of money an investor wants to invest. The entire commitment amount is generally not collected up front; instead, an investor’s commitment amount is gradually “called” by the private equity fund through a series of capital calls. The timing of the capital calls will vary based on a private equity fund’s identification of underlying portfolio investments during the “Investment Period” (years one through five). Throughout the “Harvesting Period” (years four through eight) of a private equity fund’s life, portfolio companies are restructured or continue to grow as the private equity manager begins to position the underlying companies for re-sale. During the “Distribution Period” (years eight and forward) of a fund’s life, investments are realized through the sale of the portfolio companies, and proceeds are returned to private equity investors in the form of distributions. Note that each period of the private equity life cycle may overlap and may vary depending on the fund.

**Features and benefits**

Private equity fund investing is a strategy that rewards patient investors by capturing the illiquidity premium inherent in private investments. Private equity companies utilize this premium afforded to investors with long-term investment horizons, by allocating capital to strategies that can provide above-market risk-adjusted returns. According to Venture Economics, private equity funds have historically had excess returns over public markets of three to four percent annually over trailing five- and ten-year periods.

**Historically, private equity has outperformed broad-based public equity indices**

<table>
<thead>
<tr>
<th>Jan 1990 – Dec 2015</th>
<th>Annualized return</th>
<th>Standard deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cambridge PE Index</td>
<td>14.27%</td>
<td>11.43%</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>9.29%</td>
<td>14.57%</td>
</tr>
</tbody>
</table>

**Growth of $1MM, 1990-2015**

Using the Cambridge Private Equity Index as a proxy for private equity performance, and the S&P 500 as a proxy for equities, the above chart shows that allocating a portion of your portfolio to private equity may help you enhance the overall return on your investment capital. (Source: Zephyr Analytics)
Real Assets

Potential to hedge against inflation

**Definition**

It is important to be aware that a variety of real asset strategies exist, including real estate, commodities, timber, and energy, to name a few. Real assets can be viewed as tangible assets that are differentiated from traditional financial assets. Real asset funds aim to enhance risk-adjusted returns by capitalizing on investment mandates to achieve opportunistic growth, inflation protection, and/or income generation goals.

**Features and benefits**

Using real estate as an example, various strategies can be employed based on investment objective. The real estate market segments are generally described as Core, Core Plus, Valued Added, and Opportunistic. The risk return profile of these segments increases as one moves from Core to Opportunistic. For example, strategies in the Core segment might purchase properties that are generally fully leased, have readily available information, and have efficient markets. These properties are generally held to produce secure income. On the other side of the spectrum is the Opportunistic segment. Opportunistic strategies often employ the “buy it, fix it, sell it” strategy. Often times, these are properties that are in the development process and have higher return potential. However, this increased return potential may also result in higher risk potential as these strategies may use greater leverage. More specifically, leverage can enhance returns in a favorable market, but can exacerbate losses in an unfavorable market. Indices measuring real estate performance, such as the National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index, have tracked real estate returns of nearly 8% annually since 1990, with just one-third of the volatility of the S&P 500 during the same time.
Using the NCREIF Property Index as a proxy for real estate investments, and the S&P 500 as a proxy for equity markets, the above chart illustrates that allocating a portion of your portfolio to real assets may generate returns at a fraction of the volatility of broader-based stocks. (Source: Zephyr Analytics. NCREIF Property Index measures investment performance of a large pool of individual commercial real estate properties acquired in the private market for investment purposes only.)
Mutual Funds, Interval Funds, Private Investment Companies

<table>
<thead>
<tr>
<th>Liquid Alternatives</th>
<th>Private Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alternative Investment Strategy ‘40 Act Funds</td>
<td>Interval Fund</td>
</tr>
<tr>
<td>Registered w/SEC</td>
<td>Registered w/SEC</td>
</tr>
<tr>
<td>Limited</td>
<td>Limited</td>
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<tr>
<td>No minimum investor requirements</td>
<td>Accredited Investor</td>
</tr>
<tr>
<td>Accredited Investor or Qualified Purchaser</td>
<td></td>
</tr>
<tr>
<td>Asset-Based</td>
<td>Performance &amp; Asset-Based</td>
</tr>
<tr>
<td>Performance &amp; Asset-Based</td>
<td>Performance &amp; Asset-Based</td>
</tr>
<tr>
<td>Daily</td>
<td>Quarterly</td>
</tr>
<tr>
<td>Low</td>
<td>Monthly to 12 yrs.</td>
</tr>
<tr>
<td>Medium</td>
<td>High</td>
</tr>
</tbody>
</table>

**Mutual Funds**

Traditionally investor access to alternative investments was limited to private investment companies; however, alternative strategies have expanded into the mutual funds space as well, as more investors are looking for strategies that may help them diversify their portfolios above and beyond traditional stocks and bonds. Mutual funds have restrictions regarding use of leverage, illiquidity features, and minimum diversification, among other considerations.

**Interval Funds**

A growing structure used by alternative investment managers are interval funds. Interval funds are registered with the SEC under the Investment Company Act of 1940, and may require minimum investor qualifications. Interval funds typically provide liquidity, but may have lock-up periods. An important feature of interval funds is that the board of directors has discretion to offer liquidity, but is not required to do so.

**Private Investment Companies**

Private investment vehicles are not registered with the SEC under the Investment Company Act of 1940, and often require minimum investor qualifications. Private investment companies file exemptions and are thus not subject to the same restrictions as mutual funds and interval funds with regards to leverage, liquidity, and portfolio diversification. These private structures may have the ability to capture an illiquidity premium afforded to longer-term investment opportunities.
Risk management

As with any investment, alternative investments come with their share of risks. It is very important to understand the risks you are taking when you add alternative investments to your portfolio.

The following list summarizes some key risk characteristics often associated with alternative investments. Additional notes on these risks are provided below. Please note that risks related to specific investments may be found in the offering documents for each product. The client and advisor should read and understand these documents prior to investing.

**Risks**
- May have limited regulatory oversight
- May have limited transparency
- May have more illiquid terms relative to traditional stock and bond portfolios
- May have higher fees relative to traditional stock and bond portfolios

**Investment details**
- Minimum investments vary among offerings
- Many require minimum investor qualifications such as net worth and investment experience
- Liquidity (redemptions) can vary with potential lock-ups and advanced notice
- Tax reporting could be K-1s (typically requires multiple extensions) or 1099s.

**Manager selection**
Manager dispersion is significant within alternative investments, so it is important that any investment strategy has been thoroughly evaluated and is well understood. For example, hedge fund strategies in 2014 fluctuated significantly from top performing managers to bottom performing managers. For example, the return dispersion in the long/short equity space in 2014 was nearly 40% (-19% to 20%) while the dispersion of the U.S. Equity returns was a mere 9% (9% to 18%), accounting for four times the greater dispersion during the same time period. Though the following example refers to hedge funds, manager dispersion affects all alternative strategies, including hedge funds, private equity, and real assets.
Using data reported from the Dow Jones Credit Suisse Hedge Fund Indices (HFN Indices), returns reflected above are the top 5% and bottom 5% of reporting funds. U.S. Equity represents U.S. Large Cap Core Equity funds in the eVestment database for 2014. U.S. Fixed Income represents U.S. Core Fixed Income funds in the eVestment database. Returns reflected are the top 5% of funds and bottom 5% of reporting funds in the data set. (Source: Decagon, Investor Strategy Expectations 2015.)

**Liquidity risk**

Liquidity can vary from daily to more than 10 years, depending on fund terms. The divergence is based on underlying investments. Investment companies that invest in liquid securities such as publicly traded stocks and bonds have more liquidity, whereas investment companies that invest in private securities such as private equity and real asset funds are expected to be less liquid. Liquidity risk applies to all alternative investment strategies, though it may be more prevalent for private equity, where the holding period may be longer than 10 years.

**Valuation risk**

Valuation risk refers to the risk of reported value of an investment potentially being overvalued /undervalued due to inadequate sources of reliable valuation available for an investment. To evaluate valuation risk, it is important to understand that security valuation is primarily broken into three levels of pricing. Level 1 securities have observable inputs, quoted prices, and active markets, and have minimal risk associated with these securities. Level 2 securities have observable input and quoted prices, but trade in non-active markets. Level 3 securities carry the most risk, as these are typically private securities whose prices are not determined on an exchange. These securities have no observable inputs, no quoted prices, and no active markets. With Level 3 securities, the prices that are reported by the fund have the potential to vary significantly from the price the fund could actually get for the asset if it were to be sold that day. Hedge fund, private equity, and real asset managers will have varying degrees of exposure to level 1, level 2, and level 3 securities. As a result valuation risk will vary depending on the allocation to the different pricing levels.
Leverage risk
Leverage risk occurs when the market exposure of an investment is in excess of investor capital. For example, if $1 of investor capital is used to capture $5 of investment exposure, the leverage used in this example is $4. Leverage can benefit or hurt an investment as it can enhance returns, but on the same note magnify investment losses. As the leverage being employed goes up, so does the potential risk of loss in the investment. The use of leverage is not uniform across a particular strategy. Rather, different hedge fund, private equity, and real asset managers will employ varying levels of leverage.

Due diligence
The Greenwich Roundtable (“GR”) is a non-profit research and educational organization for investors who allocate capital to alternative investments. GR conducted a study in which they reviewed 22 cases where hedge funds were shut down either due to fraud or poor performance, and identified the various risk management oversights that were lacking in each case. They identified that in cases of fraud, a proper review of service providers, identifying back office problems, and avoiding funds with unreasonable volatility would potentially have helped detect problems with a firm — although there is no assurance fraud would have been discovered. In other cases, it was determined the negative performance was aided by excessive leverage, liquidity problems, and inadequate risk management. RBC conducts extensive due diligence in an attempt to mitigate exposure to high risk situations. However, there is no guarantee such a situation would be detected or prevented regardless of strategy.

Contractual risk
Contractual risk refers to rights available to the investor as per the offering documents. Contractual risk will vary depending on the structure of the fund. Funds offered through a private placement may have a higher level of contractual risk relative to mutual funds. Conversely, private investment companies have greater flexibility to change the terms of the offering without investor consent. Private equity, hedge funds, and real assets are all offered in different structures, as shown in the “Structures” table above.
Your RBC Wealth Management financial advisor can provide more information and detailed explanations of the benefits and drawbacks associated with the options available to you. He or she can also help you select alternative investments to help you potentially improve the risk and return of your well-diversified portfolio. Speak with him or her about your individual goals today.

Glossary of terms

**Buyout**
A private equity strategy that uses investor capital to acquire businesses, which are publicly-traded or privately-held companies. Buyout transactions often involve the use of debt financing (leverage).

**Commodity**
A physical substance, such as oil, timber, or metals. Investors can buy or sell commodities directly or through futures contracts.

**Leverage**
The use of financial instruments or borrowed funds, such as margin, that results in an investment amount greater than the dollars actually employed. Leverage magnifies returns, both positive and negative.

**Long investing**
Buying a security in the hopes that its price will rise so that it can be sold later at a higher price, creating profit.

**Short investing**
Borrowing a security and selling it in the hopes that its price will fall so that it can be bought back later at a lower price and returned to its owner (lender of the security), creating a profit for the borrower.

**Venture Capital**
A private equity strategy that provides capital to new or emerging companies that are in need of funding in order to grow or expand.
The Standard and Poor’s 500 index is an unmanaged, capitalization weighted benchmark that tracks broad-based changes in the U.S. stock market. This index of 500 common stocks is comprised of 20 industrial, 20 transportation, 40 utility, and 40 financial companies representing major U.S. industry sectors. The index is calculated on a total return basis with dividends reinvested and is not available for direct investment.

The Barclays Aggregate Bond Capital index is composed of securities from the Lehman Government/Corporate Bond Index, Mortgage-Backed Securities Index, and the Asset-Backed Securities Index.

The MSCI World Index is a free-float weighted equity index. It was developed with a base value of 100 as of December 31, 1969. MXWO includes developed world markets, and does not include emerging markets. MXWD includes both emerging and developed markets.

The HFRI Fund Weighted Composite Index is an equal-weighted index comprised of more than 2,000 single-manager funds. These funds must have at least $50 million under management or have been actively trading for at least twelve (12) months to qualify. All funds report assets in USD and all funds report net of all fees returns on a monthly basis.

The Cambridge Associates LLC U.S. Private Equity Index® is based on returns data compiled on funds representing over 70% of the total dollars raised by U.S. leveraged buyout, subordinated debt and special situation managers between 1986 and 2007. Cambridge Associates LLC calculates the pooled net time-weighted return by quarter from March 31, 1986 through the most recent quarter. The pooled means represent the time-weighted rates of return calculated on the aggregate of all cash flows and market values as reported by the General Partners to Cambridge Associates LLC in their quarterly and annual audited financial reports. Net returns exclude all management fees, expenses and performance fees that take the form of a carried interest.

The Barclay CTA Index contains a universe of Commodity Trading Advisors (CTAs) regardless of size that have at least four years of performance history. There are over 400 programs included in the Calculation, which is unweighted and rebalanced annually.

The NCREIF Property Index is a quarterly time series composite total rate of return measure of investment performance of a very large pool of individual commercial real estate properties acquired in the private market for investment purposes only. All properties in the index have been acquired, at least in part, on behalf of tax-exempt institutional investors – the great majority being pension funds.

Mutual fund and exchange traded fund investors should consider the investment objectives, risks, and charges and expenses of a fund carefully before investing. Prospectuses containing this and other information about the fund are available by contacting your RBC Wealth Management Financial Advisor. Please read the prospectus carefully before investing to make sure that the fund is appropriate for your goals and risk tolerance. Historical fund performance does not guarantee the same results in the future. Principal value, share prices and investment returns fluctuate with market conditions. Your investment may be worth more or less than your original cost when you redeem your shares.

This material is not intended to replace the advice of a qualified tax advisor, attorney, and accountant or insurance advisor. Consultation with the appropriate professional should be done before any financial commitments regarding the issues related to the situation are made.

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Investing in alternative investments is speculative, not suitable for all clients, and intended for experienced and sophisticated investors who are willing to bear the high economic risks of the investment. Investors should seriously consider whether such investments are suitable in light of their individual financial situation. The valuation of these investments may fluctuate, and as a result, may lose more than the original investment. Past performance is no guarantee of future results. Prior to investing, investors must obtain and carefully read the alternative investment offering materials, including the offering memorandum or prospectus, which will contain the information needed to evaluate the potential investment and provide important disclosures regarding risks, fees and expenses.

In order to be eligible to invest in certain alternative investments, investors must be an Accredited Investor, as defined by Rule 501 of Regulation D of the Securities Act of 1933 or a Qualified Eligible Person, as defined by CFTC Regulation 4.7. For certain investments, investors must also be a Qualified Client, as defined by Rule 205-3 of the Investment Advisers Act of 1940, as amended, or a Qualified Purchaser, as defined by Section 2(a)(51) of the Investment Company Act of 1940.