



**Risk Rating Guidelines for
Alternative Investments in Canada**

January 2019



Table of Contents

EXECUTIVE SUMMARY.....	3
I. Introduction and purpose of this guideline	5
II. Alternative UCITS and U.S. mutual funds risk rating methodologies	5
III. Risk rating scale at investment dealer firms	6
IV. Language in the OM and prospectus	6
V. Alternative mutual funds in Canada	7
VI. Proposed simplified risk rating methodology for alternative mutual funds	7
VII. Alternative fund strategies: Further risk rating metrics considerations	9
VIII. Alternative fund categories	11
IX. Due diligence of alternative funds: Investment manager and strategy	12
X. Summary: Industry innovation and importance of fair rating of alternative investments	12
APPENDIX A - History on Risk Ratings in Canada	14
APPENDIX B - Benchmark Considerations for Alternative Mutual Funds	15
APPENDIX C – About AIMA and the CAIA Association	17

EXECUTIVE SUMMARY

With the recent addition of alternative mutual funds (commonly referred to as ‘liquid alternatives’) to National Instrument 81-102 Investment Funds (‘NI 81-102’),¹ there has been uncertainty around how to treat these new products. Two common questions have arisen: (i) what is the level of overall awareness of liquid alternatives, and (ii) how will these products be risk rated? This paper focuses on the latter—notably the risk rating mandated in the prospectus by the CSA and how it may differ from the risk rating at each distribution channel (i.e., dealers). To assist in the dialogue around alternatives investments and risk ratings, this paper is meant as a **guideline** to foster discussion around these important new products (and their different strategies) and how to view them via a risk ratings lens (i.e., individual risk and how they can reduce an overall portfolio’s risk). For completeness, this paper also discusses risk rating for offerings that are not prospectus-based.

In September 2017, the CSA implemented new risk rating guidelines to which all prospectus-based offerings must adhere. This methodology is based upon standard deviation, which is adequate for most traditional long-only strategies but may understate the risk in alternative investment strategies, which tend to have “fat tail” risk events. For instance, many alternative investment strategies (e.g., market neutral equity and relative value fixed income) have low return volatility, which may result in a low risk rating. This result may cause confusion at distribution channels as money market funds are also rated low risk. To add to the confusion, many distribution channels have only three risk rating categories (low, medium and high), as opposed to the five under the CSA framework (low, low/medium, medium, medium/high, and high).

For simplicity and to encourage the industry discussion on alternative mutual funds, AIMA Canada and the CAIA Association have proposed a system that is less complex, based on the median trailing standard deviation of funds within indices. Note that no alternative mutual funds or no alternative strategies will be rated in the ‘low risk’ category. See Table 1 below.

Table 1 – Proposed risk rating for alternative mutual funds and alternative strategies based on the median trailing standard deviation of funds within indices

Low	Low to Medium	Medium	Medium to High	High
Not applicable to alternative mutual funds and alternative strategies	0% to 7%	6% to 11%	11% to 16%	Over 16%
	Market Neutral Equity	Equity Long-Short	Equity Long-Only	
	Multi-Strategy	Global Macro	Emerging Markets	
	Long-Short Credit	CTA/Futures		
	Relative Value Arbitrage	Event-Driven		

With the CSA’s modernization of NI 81-102 and the creation of alternative mutual funds, the existing methodology at some distribution channels of rating all alternative investments in one category as high risk should also be revisited; hence this guideline document to start the discussion.

Alternative investments are diverse and need to be evaluated individually based on manager and strategy. They play a key role in a balanced portfolio by offering diversification, risk reduction and non-correlated returns to the investor. It is important, especially late in the economic cycle amid a rising rate environment,

¹ NI 81-102 is the National Instrument (via the Canadian Securities Association (CSA)) that regulates Canadian prospectus-based products (i.e., ETFs, closed end funds, commodity pools and mutual funds).

that Canadian investors can access adequately both offering memorandum (private pools) and prospectus (alternative mutual funds) type products.

I. Introduction and purpose of this guideline

Within the retail investment channel, dealer firms have long overlaid additional risk rating policies over and above the CSA's requirement of using standard deviation alone to classify into risk categories. While the reasons for this are many, all too often this unfairly results in all alternative funds being unfairly rated as high risk, thereby limiting the number of investors who can access these products. History clearly shows that alternative funds offer diversification, risk reduction and non-correlated returns throughout the market cycle, especially amid a rising interest rate environment. For more AIMA/CAIA research on the benefits of alternative investments, see [Trustee papers](#).

To facilitate risk-reducing portfolio construction, better support emerging fund manager businesses and give retail investors fair access to available products, it is imperative to lower if not remove the high risk rating barrier to investing in both alternative mutual funds and alternative fund strategies.

AIMA advocates that:

1. Additional risk ratings systems at investment dealers be revisited for alternative mutual funds.
 - a. If this is not possible, we recommend increasing the risk category by one level above the standard deviation-designated category according to the CSA risk rating methodology.
2. Additional risk rating systems at investment dealers are reviewed for alternative fund strategies.
 - a. Risk ratings must more fairly align with the true risk of an alternative fund strategy, which can often reduce risk and dampen volatility in a balanced portfolio.
 - b. Alternative fund strategies should not be rated automatically high risk due to their ability to use short-selling, leverage, etc.
3. Any risk rating scale at the investment dealer or the fund manufacturer should include five categories of risk rather than only three to ensure greater flexibility and consistency with prospectus risk ratings.
 - a. Those five categories should be: low, low-medium, medium, medium-high and high.
4. Fund categories should be separated for alternative fund strategies and alternative mutual funds, and then also expanded with sub-categories so that products can be evaluated adequately against their peers.

If investment dealers continue to believe that standard deviation is not sufficient as a sole metric to properly evaluate risk, perhaps a further standardized risk rating process mandated by the CSA to ensure a uniform, transparent risk rating approach among dealers is worth exploring.

Specific rationale and considerations on these are outlined below.

II. Alternative UCITS and U.S. mutual funds risk rating methodologies

The inclusion of robust risk ratings in Canada is unique and not closely replicated in other large global markets.

For U.S. alternative mutual funds, each distributor has its own internal process with respect to determining suitability, but there is no national system for risk ratings.

In Europe, alternative UCITS use the value at risk method² and the commitment method for measuring global exposure. The commitment method is a standardized approach to calculating the gross notional exposure and global exposure (net leverage/gearing) arising from a portfolio's derivatives.

While risk ratings have likely served the Canadian investor and the financial services sector well, it is imperative to give investors the ability to access the diversification, risk reduction and non-correlated returns that alternative investments provide, and not block the inclusion of these in broad portfolios.

Table 2 – Nomenclature

<i>Alternative funds</i>	Both alternative fund strategies and alternative mutual funds inclusively
<i>Alternative fund strategies</i>	Alternative funds offered by offering memorandum (OM) in retail channel
<i>Alternative mutual funds</i>	Alternative mutual funds as outlined in NI 81-102 offered by prospectus in retail channel
<i>Risk rating category/scale</i>	Scale usually including low, low-medium, medium, medium-high, high
<i>Fund category</i>	Canadian Investment Funds Standards Committee (CIFSC) category
<i>Liquid alternatives</i>	Including alternative mutual funds, U.S. alternative mutual funds and alternative UCITS, in general

III. Risk rating scale at investment dealer firms

Investment dealers today are not required to adopt the risk rating outlined in manufacturer prospectuses (as per the CSA). However, most have a separate internal risk rating scale. Often, this is a three-tiered scale (low, medium and high) or a five-tier scale (low, low/medium, medium, medium/high and high). While we appreciate that neither we nor the CSA can enforce a risk methodology among the dealer community, we recommend dealers at least use the more flexible five-tiered scale of risk categories. This is to allow greater flexibility and promote improved accuracy when placing a fund in any one category, while also providing consistency with CSA's prospectus risk ratings.

IV. Language in the OM and prospectus

Fund managers/manufacturers should include volatility band language in both the OM for private pools and the prospectus for alternative mutual funds to ensure best guidance to dealer firms on suggested risk rating. This will ensure that investment dealers have a fair metric with which to commence their due diligence and review of the product.

² The value at risk method is discussed further below.

V. Alternative mutual funds in Canada

While alternative mutual funds are new to Canada and regulations require that these funds publish no track record, there are other markets to refer to in order to estimate the risk of alternative mutual funds. The global hedge fund universes are proxied by the Center for International Securities and Derivatives Markets (CISDM) or another provider of hedge fund indexes. For U.S. alternative mutual funds, the Morningstar series of indices are also used as relevant comparisons. For alternative UCITS funds in Europe, relevant comparison indices are published by alternativeUCITS.com.

Table 3 – Three-year trailing risk statistics for hedge funds and equity indices

3-Year Risk Measure	CISDM Fund of Funds	CISDM Commodity Trading Adviser CTA	CISDM Equity Long-Short	CISDM Fixed Income Arbitrage	S&P TSX Composite
Standard Deviation	2.7%	7.4%	4.2%	2.3%	7.4%
Maximum Drawdown	-5.5%	-7.2%	-6.6%	-4.1%	-15.8%
Skewness	-0.82	0.34	-0.78	0.08	-0.08
Sharpe Ratio	0.59	0.39	1.13	0.46	0.58

Source: CAIA Association, CISDM, S&P

With the more complex portfolio construction of alternative funds, standard deviation alone is not a complete measure of risk. Notice that the skewness of funds of funds and equity long-short funds in the table above is much larger and more negative than that of the S&P TSX composite. That is, alternative mutual funds are more likely to have larger negative returns than is suggested by their standard deviation alone.

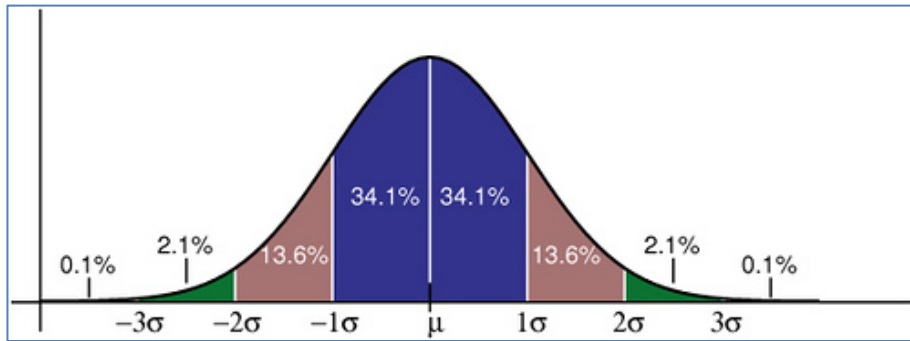
In order to avoid confusion between the risk ratings of long-only and alternative mutual funds, it is important to interpret the risk of alternative mutual funds using the same framework that the CSA presents for long-only funds. However, due to the more complex risks of alternative mutual funds, standard deviation cannot be used as a stand-alone risk measure. For example, including funds of funds and fixed income arbitrage in the low risk category may be inappropriate, despite their historical standard deviation below 3%, as these funds clearly have higher risks than experienced by the money market and short-term fixed income funds that dominate the low risk category of long-only funds.

VI. Proposed simplified risk rating methodology for alternative mutual funds

STANDARD DEVIATION PLUS ONE CATEGORY HIGHER

Standard deviation is the most widely accepted and easily understood measure of volatility risk. By measuring the amount that a fund's returns deviate from its mean return, standard deviation gives the investor an idea of the range in value that can be expected for their investment. Standard deviation is a risk measure that allows for easy, relevant comparisons across peer groups.

Figure 1 – Standard deviation of a normally-distributed return series



Source: CAIA Association

Effective September 1, 2017, Canadian mutual fund managers were required to adopt a new prescribed risk classification methodology to determine the investment risk levels of publicly offered mutual funds (including exchange-traded funds (ETFs)) they manage. The new risk classification methodology requires managers to determine the investment risk level of their funds using 10-year standard deviation and to disclose that risk level in the Fund Facts document (‘Fund Facts’) and in the ETF Facts document (‘ETF Facts’), as applicable, using a prescribed five-category risk level scale. The standard deviation ranges and investment risk levels are as follows:

Table 4 – Standard deviation to risk rating

Standard Deviation Range	Investment Risk Level
0 to less than 7	Low
6 to less than 11	Low to Medium
11 to less than 16	Medium
16 to less than 20	Medium to High
20 or greater	High

Source: Investment Funds Institute of Canada

From a sound practice perspective, risk ratings for alternative mutual funds should be:

- Calculated using the methodology outlined in Appendix F of NI 81-102;
- Calculated annually in conjunction with the filing of disclosure documents. Ideally, the calculations would be made not more than 60 days prior to the date of the applicable Fund Facts, ETF Facts, prospectus renewal or amendment; and
- Reviewed by the investment dealer’s product area, legal and compliance areas with final approvals and any supporting documentation and/or rationale well-documented and stored in a secure location.

Although a system for rating funds that has a complex calculation across multiple risk factors could be devised, AIMA Canada and the CAIA Association have designed a system that is less complex, using the existing Investment Funds Institute of Canada (IFIC) framework (see Appendix A) with a risk rating one

category higher than is used for long-only funds. Note that no alternative mutual funds will be rated in the low risk category.

Table 5 – Proposed risk rating for alternative mutual funds and alternative strategies based on the median trailing standard deviation of funds within indices

Low	Low to Medium	Medium	Medium to High	High
Not applicable to alternative mutual funds and alternative strategies	0% to 7%	6% to 11%	11% to 16%	Over 16%
	Market Neutral Equity	Equity Long-Short	Equity Long-Only	
	Multi-Strategy	Global Macro	Emerging Markets	
	Long-Short Credit	CTA/Futures		
	Relative Value Arbitrage	Event-Driven		

Source: CAIA Association

New alternative mutual funds will have no track record and will be benchmarked relative to a global hedge fund or liquid alternatives index. Once the individual funds have a sufficient track record of their own returns, such as three to five years, the risk rating will transition from being based on an external index to being based on the fund's own results.

The chart above is based on the performance of individual funds, not fund indices. Note that the standard deviation of hedge fund indices is calculated by taking the average of all funds within a given month and then taking the standard deviation of that average over time. The assumption is that investors are accomplishing diversification within each given strategy, which would require investing in a number of funds. Table 5 is based on the median standard deviation of funds within indices, which will more likely approximate the experience of investing in a single fund or a small number of funds within each strategy group. For example, while the standard deviation of a managed futures index might be 7.4%, the standard deviation of the median fund in that index may be closer to 11%.

VII. Alternative fund strategies: Further risk rating metrics considerations

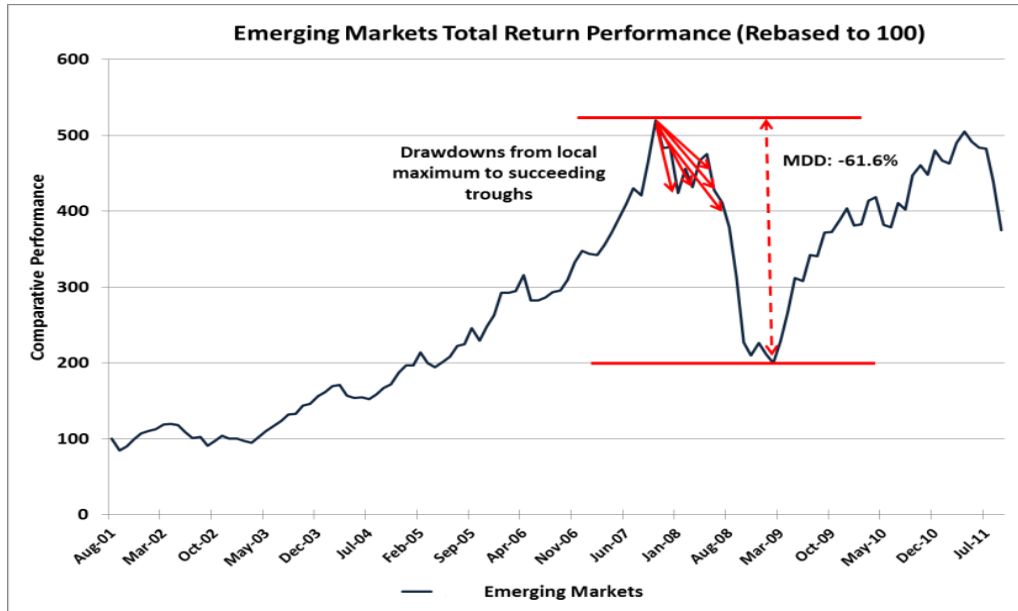
Historically, alternative fund strategies have been proven to reduce risk and dampen volatility in an investor portfolio, while producing non-correlated returns and diversification benefits. It is counter-intuitive, then, that these products be rated automatically high risk. This does a disservice to the investors who should be able to access these benefits. However, if an investment dealer requires a more advanced process of risk ratings for alternative fund strategies than standard deviation alone, we recommend reviewing the following risk metrics and developing a fair framework that includes some of these outlined below.

1. Maximum drawdown

Drawdown measures the percentage lost from the peak of an investment's value to the trough or the low point of the investment's value during any given time frame. The maximum drawdown ('MDD') is the largest percentage peak-to-trough decline during the time frame. MDD is a good representation of how a fund reacted to previous market declines. It can be used as a relative measure against its peers and

provides some insight into the effectiveness of the manager's risk mitigation techniques and loss prevention strategies. Note that, for a given group of investments, risk as measured by MDD may differ substantially from risk as ranked by standard deviation.

Figure 2 - Illustration of maximum drawdown



Source: FundData

2. Sharpe ratio

The Sharpe ratio is the average return earned in excess of the risk-free rate per unit of volatility or total risk. The Sharpe ratio is a measure of risk-adjusted return comparing an investment's excess return over the risk-free rate to its standard deviation of returns. Generally, the greater the value of the Sharpe ratio, the more attractive the risk-adjusted return. The Sharpe ratio has shortcomings, it reprimands upside and downside volatility. Because the Sharpe ratio assumes that investment returns are normally distributed, it does not capture non-symmetric distributions and may not fully reflect tails in return distributions.

3. Up/Down capture

"Up capture" indicates how well a fund performed when the market was up. If the up capture is greater than 1, it means that the fund outperformed the market when the market was up. Conversely, "down capture" measures how well the fund performed when the market was down. A down capture greater than 1 means that the fund has underperformed the market during periods when the market was down. Up/Down capture is a good indication of how the fund manager captures profits to the greatest extent possible while implementing effective risk mitigation techniques.

4. Sortino ratio

The Sortino ratio is a popular downside measure used as an alternative to the Sharpe ratio. The Sortino ratio improves upon the Sharpe ratio by isolating downside volatility from total volatility by dividing excess

return by the downside deviation. The Sortino ratio is a variation of the Sharpe ratio that differentiates harmful volatility from total overall volatility by using the asset's standard deviation of negative asset returns, called downside deviation. The Sortino ratio replaces, in the denominator, the standard deviation of returns that are below the target return. The Sortino ratio takes the asset's return and subtracts the risk-free rate, and then divides that amount by the asset's downside deviation. Just like the Sharpe ratio, a higher Sortino ratio is better.

5. Batting average

“Batting average” is a quantitative measure that shows how frequently the fund manager produces a positive return. A batting average greater than 50% means that the manager has produced a return greater than zero in more than half the performance periods. When considered with compound returns, the batting average indicates whether or not the fund manager is consistent with performance (high batting average and high returns) or if positive returns are the result of just one or two periods of excellent return (low batting average with high returns).

6. Value at Risk ('VaR') and Conditional VaR ('CVaR')

VaR and CVaR are risk measures used to assess the tail risk of an investment fund. VaR is a measure of the risk of loss for investments. It estimates how much a set of investments might lose (with a given probability), given normal market conditions, in a set time period.

An extension to VaR, the CVaR measure is more sensitive to events that happen in the tail end of a distribution. While VaR represents a worst-case loss associated with a probability and a time horizon, CVaR is the expected loss if that worst-case threshold is ever crossed. CVaR, in other words, quantifies the expected losses that occur beyond the VaR breakpoint.

VIII. Alternative fund categories

Alternative strategies are as diverse as mutual fund strategies. They deserve to be categorized more accurately so that performance can be better judged relative to true peers. Today, all alternatives are included in one category. We recommend expanding this to include the following categories:

Table 6 – Categories of alternative funds

Simplified Categories	Advanced Categories
Equity-focused	Equity long-only
Credit-focused	Equity long/short
Market neutral	Global macro
Multi-strategy/Other	Relative value arbitrage
	CTA/Managed futures
	Event-driven
	Multi-strategy
	Market neutral equity
	Long/short credit
	Emerging markets

Source: AIMA Canada

IX. Due diligence of alternative funds: Investment manager and strategy

In the initial phase of risk rating qualitative due diligence on the fund manager and their proposed product is essential. Before using the proposed risk framework, one should determine whether the new fund is likely to track closely one or more of the benchmark indices. For example, the average equity long-short fund may have a beta to underlying equity markets between 0.4 and 0.7 resulting from 100% long and 50% short positions. Alternative mutual funds with similar beta as well as gross and net long-short exposures can be appropriately benchmarked to a long-short equity index. However, products such as a 150-50 fund with a beta of 1.0 and 150% long and 50% short exposures are more similar to the risk of a long-only equity index than to a long-short equity hedge fund or liquid alternatives index. Benchmarking 150-50 funds to a long-short equity index is inappropriate, as the long-short equity index would underestimate the risk of the 150-50 funds.

The due diligence process should also consider manager specific factors before investors make an investment or risk rating decision. Investors should consider the experience of the manager, including how long the team has been managing investments and how closely their historical experience matches that of the proposed strategy. For example, managers with a track record of managing long-only funds may not necessarily have experience transferrable to the management of long-short funds. Retail advisors and investors should also perform operational due diligence to evaluate the quality of the fund's trading and risk management systems, internal controls, and the quality of service providers such as accounting, legal, custody and prime brokerage.

See [AIMA Due Diligence Considerations for Retail Advisors](#). AIMA member DDQ resources, including an AIMA Illustrative Questionnaire for the Due Diligence of Liquid Alternative Funds, can be accessed through www.aima.org.

X. Summary: Industry innovation and importance of fair rating of alternative investments

With the CSA's modernization of NI 81-102 with the creation of a new category - alternative mutual funds - the antiquated methodology of rating all alternative investments in one category as high risk must also be disrupted.

Alternative investments are diverse, and play a key role in a balanced portfolio, offering diversification, risk reduction and non-correlated returns to the investor. It is important, especially late in the economic cycle amid a rising rate environment that Canadian investors can adequately access both OM and alternative mutual funds products.

CONTRIBUTORS

AIMA Canada Risk Rating Guideline Working Group, led by:

Claire Van Wyk-Allan, AIMA Canada

Keith Black, CAIA Association

Rob Lemon, CIBC Capital Markets

Racheal Wason, BMO Capital Markets

January 2019

DISCLAIMER

This publication should not be considered as constituting legal or investment advice or as a substitute for seeking legal or investment counsel. It is provided as a general informational service. To the extent permitted by law, neither AIMA or the CAIA Association, nor any of its members, employees, agents, service providers or professional advisers assumes any liability or responsibility for, or owes any duty of care in respect of, any consequences of any person accessing any of the information contained in this publication. The information contained in this report is for general informational purposes for readers of this publication only.

Appendix A – History on Risk Ratings in Canada

CSA guidelines

In December 2016, the CSA made amendments to mandate a CSA risk classification methodology for use by fund managers to determine the investment risk level of conventional mutual funds and ETFs for use in the Fund Facts and in the ETF Facts, respectively. A mandated standardized risk classification methodology could provide greater transparency and consistency than was available, which allowed investors to more readily compare the investment risk levels of different mutual funds. The amendments outlined the use of standard deviation as the sole risk indicator to determine a mutual fund's investment risk level on the risk scale in the Fund Facts and the ETF Facts.

It also requires a mutual fund that does not have the sufficient 10-year performance history to use the past performance of another mutual fund as proxy for the missing performance history: (i) when the mutual fund is a clone fund as defined under NI 81-102 and the underlying fund has 10 years of performance history; or (ii) when there is another mutual fund with 10 years of performance history, that is subject to NI 81-102 and that has the same fund manager, portfolio manager, investment objectives and investment strategies as the mutual fund.

In selecting an appropriate reference index, a mutual fund must consider each of the factors listed in Instruction (2) of Item 5 of Appendix F to NI 81-102 when selecting and monitoring the reasonableness of a reference index. Other factors may also be considered in selecting and monitoring the reasonableness of a reference index if such factors are relevant to the specific characteristics of the mutual fund.

IFIC Guidelines

The CSA adheres to the use of standard deviation as the key measure to define risk rating categories for all types of funds covered by NI 81-102, including alternative mutual funds and commodity pools. More information on this can be read [here](#).

In June 2017 IFIC published its "[Voluntary Guidelines for Fund Managers Regarding Fund Volatility Risk Classification](#)" (IFIC Classification Guidelines). In this document, IFIC sorts long-only investment funds into categories of risk based on the three- and five-year trailing standard deviation of historical returns. The IFIC guidelines classify the volatility of funds in the following categories, though IFIC guidelines did not have fixed ranges - ranges were determined annually by reference index returns. While IFIC maintained guidelines for many years, IFIC guidelines have no current effect now that there is mandatory risk rating methodology that does have fixed ranges.

Table 7 – IFIC risk ratings for long-only funds based on standard deviation

Low	Low to Medium	Medium	Medium to High	High
0% to 7%	6% to 11%	11% to 16%	16% to 20%	Over 20%

Source: IFIC Classification Guidelines

As a result of the update of NI 81-102, alternative mutual funds and commodity pools will need to be assigned risk classifications. These funds may hold up to 15% of capital in illiquid securities, as well as have borrowings and short selling up to 50% of the fund's net asset value. Up to 20% of the net asset value of the fund can be concentrated in a single security. Given these expanded investment guidelines, alternative mutual funds have a more complex risk profile than long-only, unlevered funds.

Appendix B - Benchmark Considerations for Alternative Mutual Funds

Under the CSA mutual fund risk classification methodology, alternative mutual funds with less than 10 years of performance history are required to use a reference index to complete the remainder of the 10-year period used to determine performance history (standard deviation), which informs their risk rating. Such a reference index can be a composite of several indices. If a reference index is used, its appropriateness must be monitored on an annual basis.

During the comment period following the 2016 release of the CSA's proposed alternative funds framework, many investment fund managers commented that traditional reference indices do not align with alternative mutual funds as they do with traditional mutual funds under NI 81-102. As such, we consider three sample options for the reference index of an alternative mutual fund: (i) traditional indices, (ii) Hedge Fund Research Indices ('HFRI'), and (iii) Hedge Fund Research Indices Performance Tables ('HFRX'), describing the pros and cons of each option. Brief notes on other popular benchmark options (BarclayHedge and Scotiabank) are also included below, as the reasons for selecting various benchmarks can be diverse and should be primarily for reasons to best align with the investment strategy.

Traditional indices

To use a traditional index as a reference, it should reasonably approximate, or be expected to reasonably approximate, the standard deviation of the mutual fund. Traditional reference indices have limited applicability to alternative mutual funds because they do not include performance history (standard deviation) of alternative strategies such as leverage and shorting securities, which are typically used by alternative mutual funds. As such, traditional indices do not accurately represent alternative mutual funds' risk and returns.

HFRI and HFRX

The HFRI and HFRX indices are maintained by Hedge Fund Research (HFR), the established global leader in the indexation, analysis and research within the hedge fund industry. Its indices are considered the industry standard benchmarks for hedge fund performance.

(a) HFRI:

According to HFR, HFRI® Indices are designed to capture the breadth of hedge fund industry performance trends across all strategies and regions. The constituent universe of each HFRI index is submitted to HFR by hedge fund managers on a voluntary basis. Most HFRI Indices are equally-weighted (annual rebalance) while the constituent funds of the HFRI Asset Weighted indices are weighted according to the assets under management reported by each fund for the prior month.

(b) HFRX:

HFR utilizes a UCITS-compliant methodology to construct the HFRX® Hedge Fund Indices. This methodology includes robust classification, cluster analysis, correlation analysis, advanced optimization and Monte Carlo simulations.

Production of the HFRX methodology results in a model output which selects funds that, when aggregated and weighted, have the highest statistical likelihood of producing a return series that is most representative of the reference universe of strategies. In addition, the HFRX methodology defines certain

qualitative characteristics, such as: whether the fund is open to transparent fund investment and the satisfaction of the index manager's due diligence requirements.

The main difference between HFRI and HFRX is that most HFRI indices are equally-weighted, while HFRX is asset-weighted. This varies by index.

Table 8 – HFRI and HFRX Indices pros and cons

	Pros	Cons
Traditional Reference Indices	<ul style="list-style-type: none"> Well-established and understood Reported by third party 	<ul style="list-style-type: none"> Misaligned with most alternative strategies
HFRI	<ul style="list-style-type: none"> Applicability to alternative investments Actual performance history 	<ul style="list-style-type: none"> Returns are “self-reported” Constituents are funds that may not comply with NI 81-102
HFRX	<ul style="list-style-type: none"> Applicability to alternative investments Simulated performance history 	<ul style="list-style-type: none"> Returns are “self-reported” Constituents are funds that may not comply with NI 81-102

Source: Mackenzie

Other indices

While HFR focuses on hedge funds without limits on investment strategy, the liquid alternative indices follow funds compliant with the UCITS Directive or the U.S. Investment Company Act of 1940, as amended, that are closer in spirit to the proposed rules for alternative mutual funds.

Other common industry indices include BarclayHedge and Scotiabank.

BarclayHedge Fund Indices: BarclayHedge produces industry leading benchmarks covering more than 30 indices on hedge funds, managed futures/CTAs, UCITS, foreign exchange and commodities funds sourcing data directly from managers. The Barclay Hedge Fund indices are recalculated and updated real-time as monthly returns for the underlying funds.

Scotiabank Canadian Hedge Fund Index: The aim is to provide a comprehensive overview of the Canadian hedge fund universe. To achieve this, index returns are calculated using both an equal weighting and an asset-based weighting of the funds. The index includes both open-end and closed-end funds with a minimum asset under management of C\$15 million and at least a 12-month track record of returns, managed by Canadian-domiciled hedge fund managers.

Appendix C – About AIMA and the CAIA Association



The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with more than 2,000 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than \$2 trillion in hedge fund or private credit assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programs and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 100 members that manage \$350 billion of private credit assets globally. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialized educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors). For further information, please visit AIMA's website, www.aima.org.



The CAIA Association, a non-profit organization founded in 2002, is the world leader and authority in alternative investment education. The CAIA Association is best known for the CAIA Charter®, an internationally recognized credential granted upon successful completion of a rigorous two-level exam series, combined with relevant work experience. Earning the CAIA Charter is the gateway to becoming a member of the CAIA Association, a global network of over 10,000 alternative investment leaders located in 80+ countries, who have demonstrated a deep and thorough understanding of alternative investing. Having grown rapidly, the CAIA Association now supports vibrant chapters located in financial centres around the world and sponsors more than 200 educational and networking events each year. The CAIA Association also offers a continuing education program, where trustees can learn the Fundamentals of Alternative Investments in a 20-hour, video-based program. For more information, please visit www.caia.org.