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Investments

How do liquid alternatives apply leverage and shorting?

They provide tools for the portfolio manager to create different portfolio outcomes than in a long-only, no-leverage world.

Two important tools in the liquid alternative strategies toolbox are leverage and short selling (known as shorting), as they provide tools for the portfolio manager to create different portfolio outcomes than in a long-only, no-leverage world.

1. Leverage

Leverage is using borrowed money with the goal of enhancing the return on a given investment.

This strategy is valuable but can also entail some risk because, just as exposure to leverage may increase gains, it may also magnify losses if you have leveraged exposure to declining securities. That said, applying leverage to lower-volatility assets (like government bonds) is an example of how leverage can be utilized in a relatively conservative manner seeking to enhance returns.

2. Shorting

Shorting provides the ability to profit when the value of a security declines.

Mutual funds traditionally make gains if their holdings increase in value. However, a liquid alternatives fund can also employ a short-selling strategy where certain securities are borrowed and sold immediately in the market. The desire is for these securities to decline in value, so the fund can repurchase them at a lower price and return them to the lender. If the securities decline in value, the price difference between the original sale and the repurchase represents profit for the fund.