Executive Summary—2017 Retail Distribution of Alternative Investments

Background

In 2011, the Money Management Institute (MMI) and Dover Financial Research began this series to evaluate the alternative investment trends across retail distribution channels. This exclusive report analyzes proprietary data on both traditional and liquid alternative investments, making it unique within the industry.

The report has historically focused on wirehouse firms. To provide members with a more comprehensive view of the industry, MMI expanded its coverage this year to include alternative investment data from other major retail intermediaries. The inclusion of these firms expanded the data set from $196 billion to $320 billion in assets. See page 9.

Market Overview—Reinvention Is on the Horizon

During the last several years, cyclical and secular trends have converged, and alternative investment players have had to navigate against this perfect storm. These unrelenting forces, such as fee pressure and an eight-year bull market, have caused core segments of the industry to decline, creating an inflection point. Alternative investment distributors and manufacturers are now being forced to press the reset button and reevaluate their positioning, infrastructures, and product development efforts. Reinvention is on the horizon. See pages 9–13 and page 28.

Hedge funds and liquid alternatives have been hit the hardest by recent trends. Both products have underperformed major equity benchmarks over the last one-, three-, five- and 10-year periods. This has resulted in industry outflows of $70 billion for hedge funds and $20 billion for mutual fund liquid alternatives. Both hedge fund and liquid alternative assets experienced single-digit growth in 2016. See pages 20–25.

In 2016, the number of ETF and mutual fund liquid alternative products declined for the first time since 1993. Liquidations outpaced launches for most of the major Morningstar alternative categories. Going forward, industry consolidation will continue to occur, benefiting large-scale product manufacturers. See pages 47–51.

Executive Summary—2017 Retail Distribution of Alternative Investments

Retail Traditional Alternative Investments

Hedge Funds

Within the retail universe, the lion's share of traditional alternative investments (83%) is associated with wirehouse firms. Wirehouses have a greater proportion of high-net-worth clients who can meet the high minimums needed to invest in these products. Wirehouses also have master feeder structures, which facilitate retail distribution. See page 9.

At wirehouses, the total share of hedge fund (single manager hedge funds and fund-of-funds hedge funds) assets to total traditional alternative assets declined from 49% to 40% at the end of 2016 due to fee and performance pressures. Hedge fund assets continued to shift toward single-manager funds, which grew 24% from 2013 to 2016. See pages 41 and 43.

There is no doubt that the hedge fund industry has faced a series of challenges over the last several years. In particular, the trend in investor preferences toward returns over non-correlation has heavily impacted this industry. However, wirehouses continue to cite pockets of opportunity for all types of hedge fund products. The biggest opportunities include custom funds and established, renowned single-manager funds. Other retail firms cite funds-of-funds as an opportunity for their clientele.

Private Equity

The quest for higher returns and enhanced yield has favored private equity. In 2016, global private equity firms raised $347 billion. The popularity of private equity is also evident at wirehouse firms, where private equity assets have more than doubled from 2013 to 2016. Private credit accounts for the bulk of assets and deals in the private equity segment. See pages 35–41.

In 2017, private equity is set to dominate the mix with more emphasis on returns. This change will influence the role of alternatives in client portfolios, and distributors will have to adapt their due diligence and risk management practices accordingly. A bear market will test the discipline of investors and the risk management processes at intermediary firms.

Executive Summary—2017 Retail Distribution of Alternative Investments

Retail Liquid Alternative Investments

Liquid alternative asset levels at wirehouses declined faster than the overall industry, dropping by 25% (from $102 billion in 2014 to $77 billion in 2016). In comparison, the liquid alternatives industry declined by only 5% in the same period. Wirehouses often lead the industry. Is this an indication of future trends? See page 61.

At wirehouse firms, core liquid alternative Morningstar categories, such as non-traditional bond, equity long/short and even multialternative, realized outflows due to market cycles, performance and high-profile failures. Managed futures remain a bright spot, with modest performance and very low correlation to equities. See page 63.

Other intermediaries were also impacted by industry trends, experiencing outflows associated with mutual fund alternative investments. These firms report low usage levels of liquid alternative investments, ranging from 1% to 8%. Some firms are extremely risk averse and do not offer hedge strategies to investors. Others do not incorporate liquid alternatives into home office models. See pages 66–67.

Reinvention and New Opportunities

The alternative investments industry is at turning point. Investment managers must work with distributors to reinvent products, redefine the category and expand the market. This report cites potential product opportunities, such as option writing, microfinancing, peer-to-peer lending, and managed futures among other opportunities.

Finally, the industry must also redefine success. It is tempting to use the 20% to 25% portfolio allocation as a measure of market potential and success. But, this metric has proven to be unrealistic given the complex nature of this industry. See pages 71–76.

If you have questions about the report, please contact:

Hilary Fiorella	Money Management Institute	(646) 868-8515	hfiorella@mminst.org
Jean Sullivan	Dover Financial Research	(781) 461-0922	jean_s@doverfr.com