MONEY MANAGEMENT INSTITUTE

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Summary: 2015 Edition of *Distribution of Alternative Investments through Wirehouses*

With growth of 19% in 2014, alternative investments – both liquid and traditional – continue to be one of the fastest growing asset classes, and the report analyzes the factors driving wirehouse advisors and their clients to embrace them. It is the only industry study that provides a comprehensive overview of this market segment, one that includes analysis of both traditional and liquid alternative investments. Among its key findings:

Unexpected Growth in the Face of a Continued Bull Market

The increase in wirehouse-associated traditional and liquid alternatives through retail channels from $172 billion at the close of 2013 to $205 billion during 2014 came as somewhat of a surprise to some in the industry because it occurred in the sixth consecutive year of positive returns for equities and amid unexpectedly resilient bond markets. Conventional theory is that strong returns for stocks will cause investors to lose sight of the diversification and downside protection benefits of alternative investments, resulting in slower growth. This surprisingly robust growth – albeit over a small base – is due in large part to advisory solutions sponsor firms and investment managers using alternative investments to achieve specific portfolio outcomes, particularly those that align with goals-based wealth management. The prospects for continued growth appear strong because, at a time when penetration across client portfolios still hovers around 5%, sponsors continue to recommend allocations in the 10% to 20% range.

Continued Growth in Liquid Alternatives

Wirehouse assets in liquid alternative mutual funds and ETFs stood at $102 billion at the close of 2014, an increase of 15% from $88 billion at year-end 2013. This was more than twice the industry growth of 7.3%, an indication of the leading role wirehouses have played in fostering the adoption of liquid alternative investments.

Total Wirehouse Distribution of Alternative Investments through Retail Channels, 2013 – 2014 Assets ($ billions)

Sources: Money Management Institute, Dover Financial Research

Alternative Investments	2013	2014	% of Total	Variance		1-Year Industry Growth	Index Change 2014
				$	%		
Traditional	$83.5	$102.8	50.2%	$19.3	23.1%	8.2%[1]	3.0%[4]
Liquid[2]	$88.3	$101.9	49.8%	$13.6	15.4%	7.3%	13.7%[5]
Totals	**$171.8**	**$204.7**		**$32.9**	**19.2%**	**7.9%[3]**	

1. Represents growth rate for the hedge fund industry. 2. Three wirehouse firms reported liquid alternative ETFs; an estimate was used for the fourth firm. 3. Weighted average growth rate for traditional and liquid alternatives in 2014. 4. HFRI Fund Weighted Composite Index (HFRIFWI) change in 2014. 5. S&P 500 Total Return Index change.

More Granular Terminology Leads to Better Understanding, Utilization

In the past year, advisory solutions sponsor firms have begun to attack the fuzzy product descriptions and classification schemes that made understanding and properly allocating alternatives difficult, and more practical and concrete classifications are now beginning to emerge. One firm breaks alternatives into “diversifiers,” “equity complements” and “fixed-income complements.” Another ranks products from “aggressive” to “conservative” based on the risk/return profile of the fund. These approaches take into account the impact of a strategy on an investor’s net exposure and overall portfolio, a process that goes far beyond traditional “bucket” allocations. Overall, the steps being taken to identify the roles alternatives play within portfolios to achieve specific outcomes dovetail neatly with the trend toward goals-based financial solutions.

Cannibalization or Convergence?

Liquid alternatives have been steadily gaining share from traditional alternatives, increasing from 38% of wirehouse alternative assets in 2011 to 51% in 2013, but this trend stalled in 2014 as the share of liquid alternatives dipped to 50%. While the continuing growth of liquid alternatives has been sometimes characterized as the cannibalization of traditional alternatives, that view now appears, as the statistics suggest, to be an oversimplification because advisors are not reducing allocations to traditional alternatives in order to buy liquid products. Sponsor firm interviews indicate that the migration to alternative strategies in both liquid and traditional structures is at the expense of traditional mutual funds. This is predictive of a changing market in which the competition for advisors' attention is heating up, and it may be more appropriate to frame the trends in the alternatives space in terms of convergence rather than cannibalization. Liquid alternatives are moving up market to high-net-worth clients, and traditional alternatives are moving down market as large alternative managers like Blackstone and KKR look beyond their core institutional base and attempt to expand their footprint in the retail channel by attracting advisors with new hybrid products that appeal to high-net-worth investors. Similarly, mutual fund managers, who continue to face serious competitive challenges, are seeking to develop new strategies to expand product offerings.

Biggest Trends in Traditional Alternatives

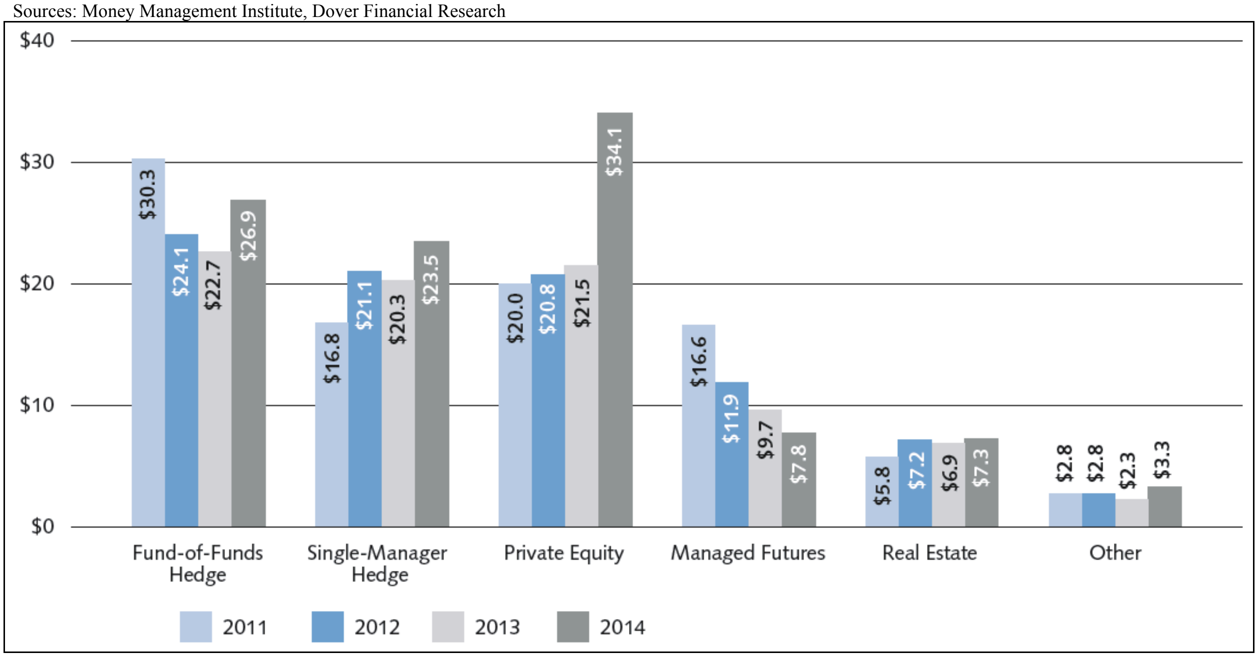
- **Private Equity –** Within traditional alternative investments at the wirehouses, the biggest single change in 2014 was the 59% jump in private equity assets to $34 billion, reflecting growth in leveraged buyouts, mezzanine financing and other credit-related forms of private equity. Private equity investments accounted for 33% of wirehouse traditional alternative assets at the end of 2014, up from 26% in the prior year – a sizeable increase. The growth in private equity, the principal reason why traditional alternative investments grew faster than liquid alternatives in 2014, gives every appearance of continuing given the substantial size of the market and the strong demand from high-net-worth investors seeking to move out of traditional fixed-income funds in a quest for new sources of yield through credit strategies. Private equity's allure is the opportunity for enhanced income, potential alpha and uncorrelated returns, which make it suitable for a wide range of investor goals. Wirehouses and private equity firms are responding by developing credit-oriented products which are more liquid in comparison to the typical 10-15 year buyout. The growing popularity of these new products is indicative of an emerging trend.

- **Trend toward Single-Manager Funds Provides Greater Choice for Clients –** The steadily rising share of assets in single-manager funds, which reached 47% of wirehouse hedge fund assets in 2014, reflects a strategic shift in emphasis by wirehouses towards alternative investments. The adoption of single-manager funds represents an intense effort by wirehouses to support more granular allocations to hedge funds, adding value by helping clients select specific-purpose hedge funds and giving them access to premier fund managers. That, in turn, is requiring the allocation of significant resources to research, education, operations, and back office support. While the expanded coverage of due diligence teams is partly a defensive risk management measure, firms increasingly see that research as a way to identify attractive opportunities for clients.

- **Funds-of-Funds –** While there has been an ongoing shift from funds-of-funds (FOFs) towards single-manager structures for several years, the outlook for the fund-of-funds structure – both in the industry and at the wirehouses – was reinvigorated in 2014. FOF assets at wirehouses had dropped 25% between 2011 and 2013, but assets rebounded from $23 billion in 2013 to $27 billion in 2014. Generally, wirehouses use a higher proportion of funds-of-funds than the overall industry because they offer one-stop diversification with a smaller initial investment and are fairly simple to explain and monitor. The 2014 uptick may be attributed to hedge funds countering the downtrend by reallocating capital across a wider range of strategies, which allows managers to be more opportunistic. FOFs have also received a boost from customized funds which wirehouses are offering to their largest clients.

Wirehouse Traditional Alternative Investment Assets by Product Type, 2011 – 2014 ($ billions)

Sources: Money Management Institute, Dover Financial Research



Biggest Trends in Liquid Alternatives

- **Nontraditional Bonds –** Among the nine major categories of wirehouse liquid alternative investments, investors seeking enhanced yield or lifetime income solutions have made nontraditional bond funds the most popular alternative mutual fund strategy by a wide margin with a 52% share of assets and an 86% share of net sales in 2014 compared to 27% in 2011. With strong demand for active management of duration and credit risk and for unconstrained approaches to fixed income, nontraditional bonds have become a core solution and a widely used defensive play in a rising rate environment. The less constrained nontraditional bond funds are engaging in opportunistic "go-anywhere" searches for attractive yields across sectors, geographies and variations in credit quality.

- **Hybrids –** Demand for greater liquidity and for opportunistic forays into niche asset classes has spurred the creation of hybrid products that are neither traditional nor daily liquid alternatives. One example is interval funds, closed-end '40 Act products that have emerged as a novel way to provide periodic liquidity for private equity investments, a potentially large opportunity given the size of the private equity market. Hybrids are often designed to complement traditional portfolios – they may be customized for the client or created in response to advisor demand for a niche asset such as mineral rights or infrastructure.

- **Managed Futures –** Prior to mid-2014, managed futures strategies had five straight years of low returns in both traditional and liquid structures. Recently, these strategies got a boost from a strong U.S. dollar and weak energy prices, and the improved performance has sparked a revival in demand as investors began to rediscover that managed futures are one of the few strategies genuinely uncorrelated with major asset classes, making them an ideal portfolio diversifier.

- **Managed Solutions and Liquid Alternatives: An Excellent Fit –** Managed solutions programs, used by advisors to create holistic, outcome-oriented financial solutions for clients, are ideally suited for alternative investments. Thus, it comes as no surprise that, while liquid alternative products account for 16% of wirehouse mutual fund and ETF flows, 70% of those liquid product flows are linked to fee-based programs. While liquid alternatives can be introduced without totally taking away an advisor's freedom to add value through portfolio construction and investment selection, they enable centralized control of investment risk and compliance oversight and capitalize on economies of scale in research, trading and operations. All of these characteristics provide a good fit for the use of alternative investments in advisory programs.