



BNY MELLON | **Invested**

# **The Race for Assets**

Alternative Investments  
Surge Ahead

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# Foreword

In our exclusive survey of institutional investors and fund managers, we examine the drivers behind the alternative asset revolution.

The political world is in tumult: Brexit negotiations have stalled in Europe and tensions are rising on the Korean peninsula, among other events. The global economy appears to be weathering such storms. However, it's not all smooth sailing for investors.

Yields remain low on core fixed income and equities are somewhat muted. Meanwhile, low interest rates and quantitative easing programs continue to dampen yields on conventional assets. And this has pushed more institutional investors toward alternatives. Alternative assets under management have reached a record US\$7.7 trillion in 2017.<sup>1</sup>

With this in mind, BNY Mellon in association with FT Remark, the research arm of the *Financial Times*, surveyed institutional investors about their alternative asset allocation. We also interviewed fund managers to see whether the views of the two parties aligned. This follows on from our first survey in 2016, *Split Decisions*,<sup>2</sup> which revealed a ravenous hunger for alternatives.

**Our new report shows that this appetite has only strengthened.**

Investors are largely satisfied with the returns their alternative exposures are generating, and the majority feel that performance has either met or exceeded expectations.

However, while investors are broadly positive about their experience of alternative allocations, they are putting pressure on managers to improve in a number of key areas. Fees remain an item under negotiation, and investors are pushing for greater control and transparency. Fortunately, fund managers recognize the need to meet these demands, through the use of new operational solutions and cutting-edge technology.

This exclusive new survey reveals how a greater understanding between investors and fund managers, enabled by new technologies, will take the industry to a new level and further establish alternative assets as mainstream investments.



# Five key insights on the alternative asset landscape

Our survey reveals five key insights that investors and fund managers need to know.



## **Alternative asset appetite is insatiable. What's driving the hunger?**

Over half of respondents expect allocations to alternatives to increase in the next 12 months, up from 39% in our 2016 study.



## **Asset classes jockey for share. Which ones lead the way?**

Private equity has the highest share of institutions' alternative asset allocations and highest levels of outperformance. But the rising stars are real estate and private debt, whose share of allocation continues to grow.



## **Hedge funds hit back. How will they regain ground?**

After a period of disappointing returns, nearly two-thirds of investors say they are more positive about the prospects for the industry than they were a year ago. Managers are using technology to win back investors.



## **Investors are speaking loudly. Are fund managers listening?**

Institutional investors are becoming more confident in making their own decisions through co-investments, direct investments and the increasing use of managed accounts. Some 98% of fund managers say that investor demands for transparency and lower fees are leading them to focus on how technology infrastructure can help support operational efficiencies.



## **Asset managers are turning to technology. Why?**

From big data to predictive analytics and the use of satellite imagery, technology is set to be the key driving force behind the alternative assets industry in the years to come.

“This year’s BNY Mellon/FT Remark survey shows strong investor appetite for alternatives continues. This next wave of growth brings new challenges to our industry related to harnessing powerful new technology and data science, competing for new types of talent, and giving investors what they want in terms of customization, liquidity and transparency.



**Chandresh Iyer**

CEO, Alternative Investment Services  
BNY Mellon

“Many of the same dynamics we explored in our 2016 study, *Split Decisions*,<sup>2</sup> are still going strong and even accelerating. Alternatives continue to perform at or above investor expectations, driving increased inflows but also higher demands for managers. The pressure on management fees in particular is significantly higher this year, requiring today’s asset managers to adapt and innovate to succeed, whether through new offerings, specializations or operational models.



**Frank La Salla**

CEO, Corporate Trust  
BNY Mellon

# 1 **Alternative asset appetite is insatiable.** What's driving the hunger?

Institutional allocations to alternative investments are rising fast. Assets under management have reached a record US\$7.7 trillion in 2017. And, as our survey shows, the curve is likely to only go up.

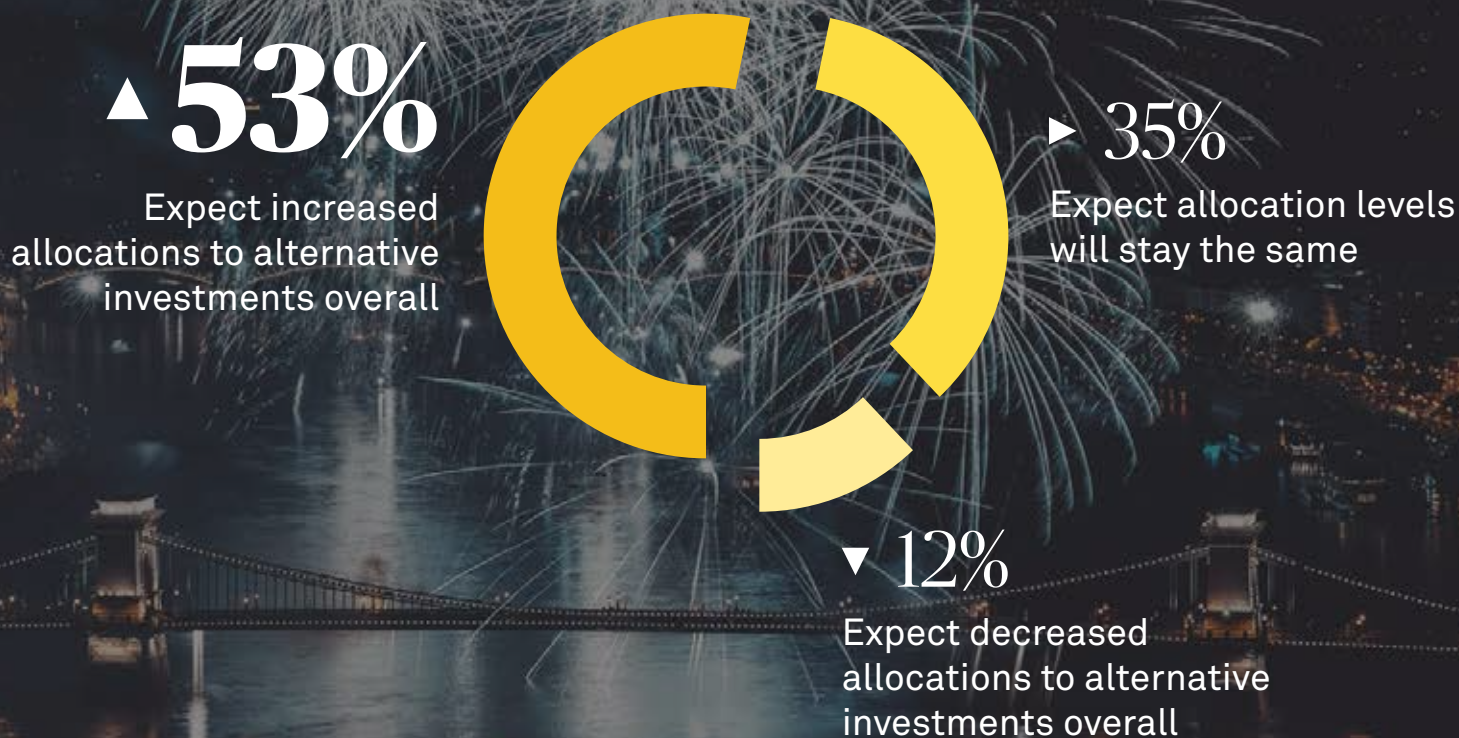
More than half (53%) of respondents expect allocations to alternatives to increase in the next 12 months, up from 39% in our 2016 study. Not surprisingly, one of the main drivers for this is outperformance. As a U.S.-based pension fund investment director notes: “With traditional investment options underperforming, overall asset allocations towards alternatives are going to increase—they are generating very strong returns.”

This sentiment is supported by our survey results. The majority of respondents say the various alternative asset classes have performed at or above their expectations. As figure 2 shows, private equity (PE), real estate and private debt are performing particularly well.

Lower fees and a broader range of investment types are also helping to attract more institutional capital to alternatives. “The fees charged by managers have reduced,” comments a CIO at a Scandinavian pension fund. “That is changing the alternatives space, as is the increased complexity of investing in capital markets. More alternative asset investment strategies are developing as a result.”

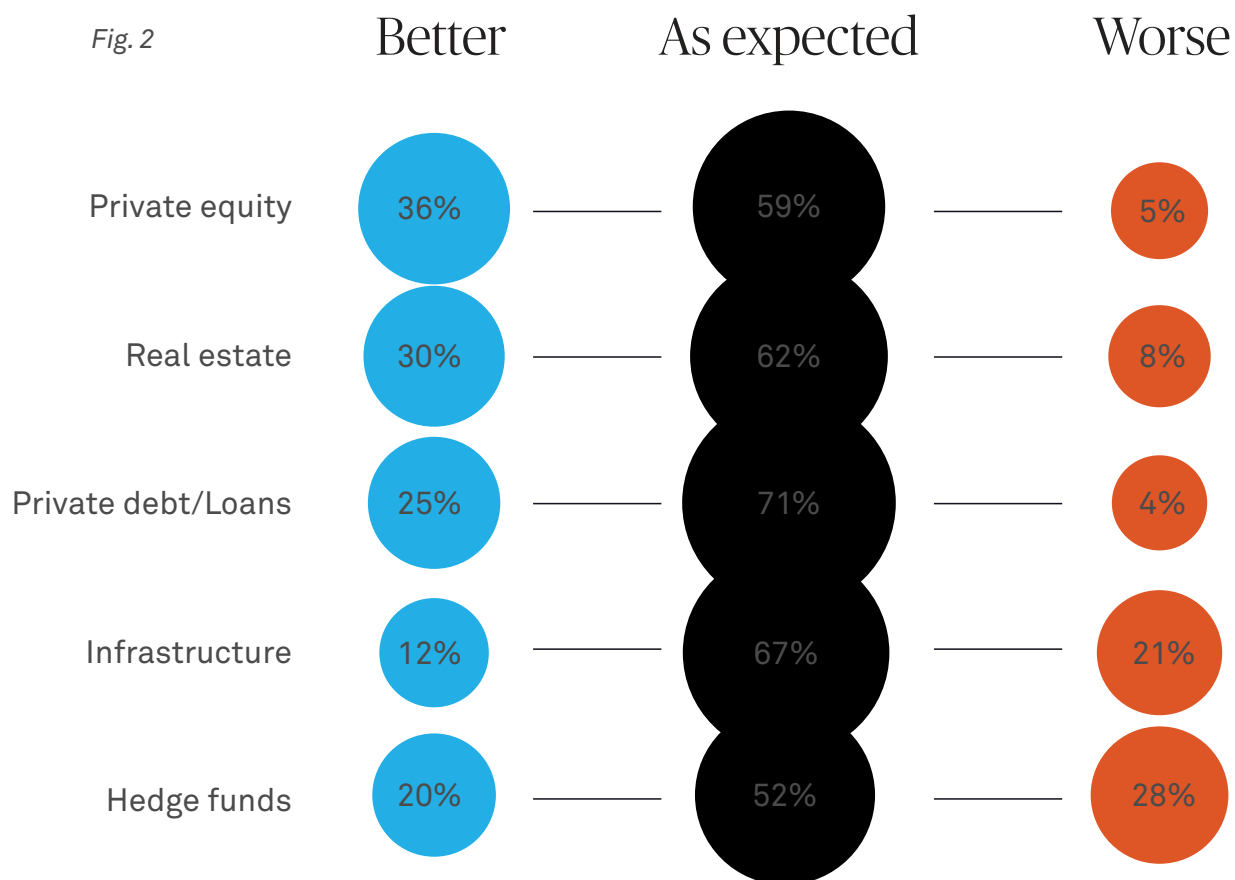
# Institutional investors predict a bright outlook for the alternatives market in the next 12 months

Fig. 1





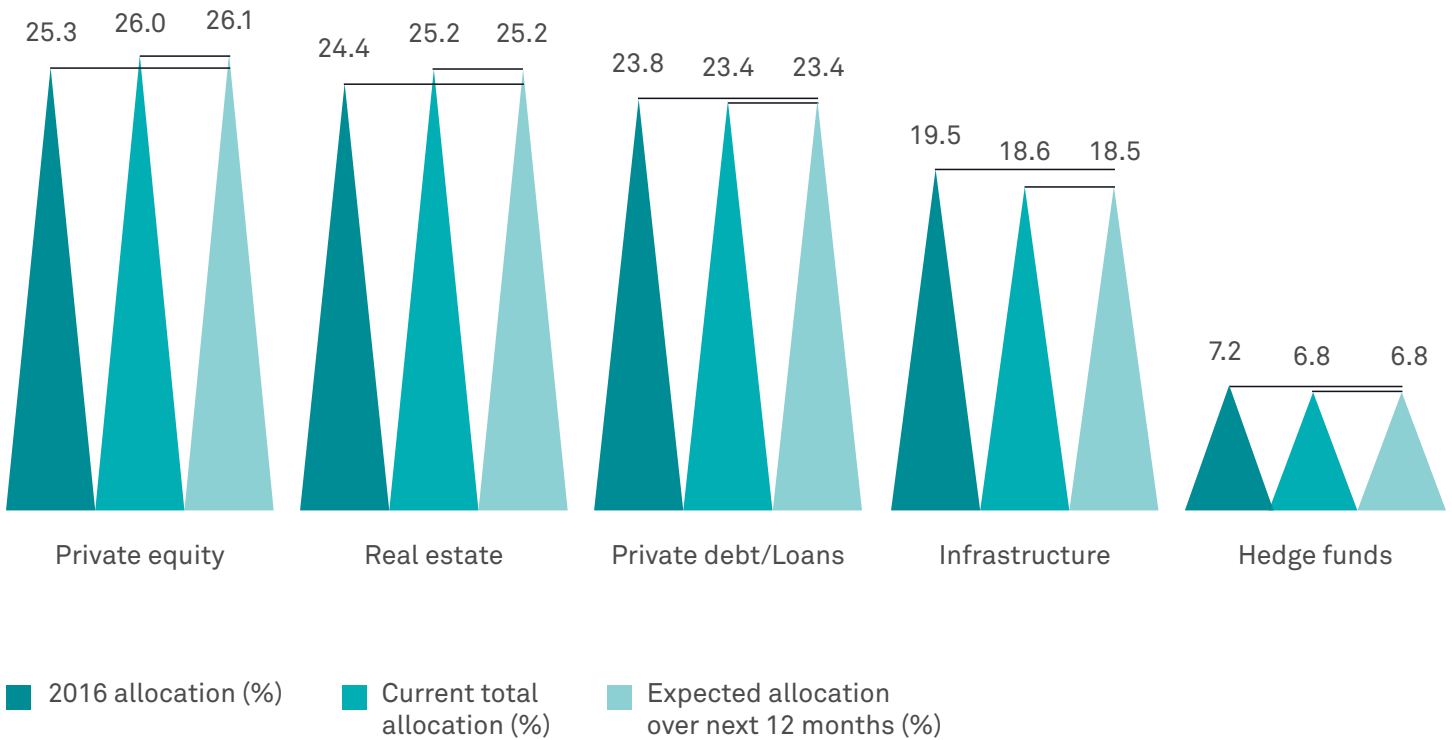
## Alternative asset classes: Performance vs. expectations over the past 12 months





# The average investor's mix of alternative asset classes remains fairly stable looking into next year

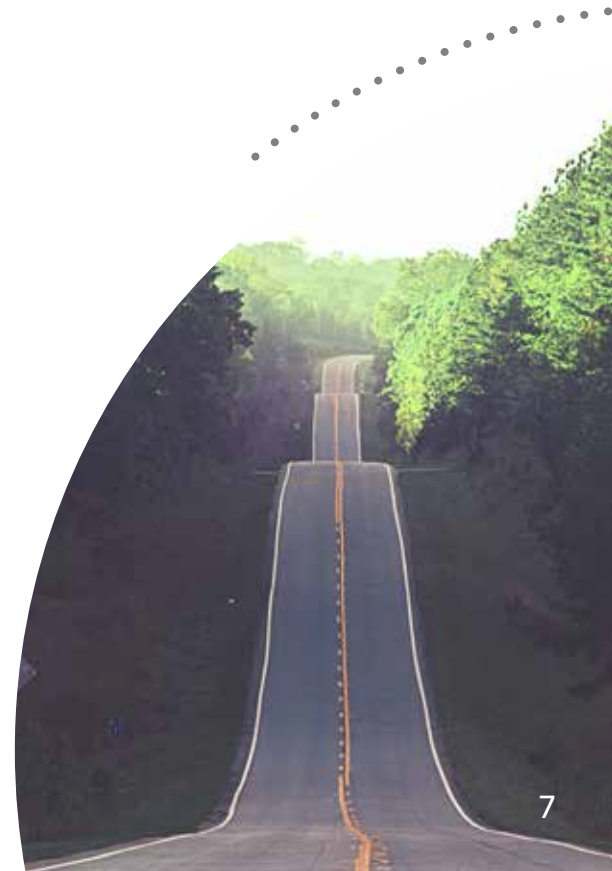
Fig. 3



## Past, present and future allocations

While overall allocations are on the rise, the split between alternative asset classes looks set to remain stable over the next 12 months. This partly reflects the long-term nature of asset allocation decisions, but it also suggests that investors are keen to ensure they have adequate diversification.

Where there is change, it is driven by the performance record of the different investment types. PE remains the most popular alternative investment across all timeframes.



# 2 Asset classes jockey for share: Which ones are leading the way?

Private equity attracts the highest allocations. However, investors are also upping their allocations to real estate and private debt.

PE continues to attract the highest allocations compared to its rivals, taking 26% of the alternatives share. And, according to a January 2017 report from research group Preqin, total AUM for the private equity industry has increased to a record US\$2.5 trillion.<sup>3</sup> The reason is straightforward – outperformance. More than a third (36%) of respondents state that PE has performed beyond expectations. Investors are highly satisfied with the returns they are achieving, and satisfaction is considerably higher for larger investors: of those with assets of US\$51 billion or more, half said PE had exceeded their expectations. But PE returns are not the only factor attracting investors.

PE scored highest of all alternatives on transparency, with 93% saying they were satisfied with this.

As for challenges, fees are in focus—79% of respondents say they will look for lower PE fees and 78% say they will seek out lower management fees. Higher hurdles are also on the agenda, with 74% saying they wanted higher preferred return rates.

In addition, valuations are a major issue, given the increasingly competitive nature of an industry that has

attracted significant capital flows. In a reversal of historical norms, PE houses are now paying more than strategic buyers for assets, according to a recent BDO report.<sup>4</sup> This is likely to account – at least partly – for the increased popularity of the PE sector specialists among investors. While past performance, alignment of objectives and projected returns all drive PE allocation decisions, the factor that ranks as the most important is sector expertise.

# PE's premium returns

“The ongoing combination of low interest rates and higher levels of uncertainty have continued to fuel allocations to private equity, with investors seeking return premiums associated with longer-term investing.

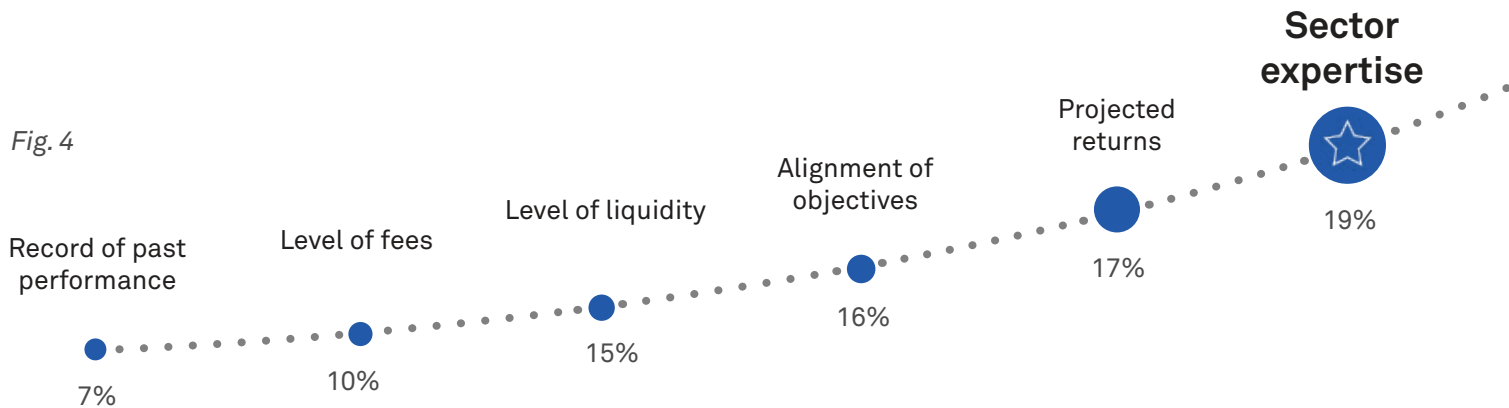


**Alan Flanagan**

Global Head of Private Equity and Real Estate Fund Services  
BNY Mellon

## The six most important factors in investors' private equity allocation decisions

% of respondents ranking that factor as their number-one consideration for private equity allocations



## \$ Debt drivers

Meanwhile, many investors have shifted part of their allocations toward potentially higher return private debt strategies. Once an outsider, private debt is now very much an established part of the alternative asset universe. The growth in total AUM over the last decade has been phenomenal. In 2006, private debt totalled US\$147 billion; by 2016, it had grown to US\$595 billion, according to Preqin<sup>5</sup>.

A large proportion of current private debt capital has been directed toward four main strategies: 78% of respondents have exposure to commercial real estate debt, 73% to direct lending, 71% to syndicated loans and 70% to infrastructure debt.

Looking ahead to the coming 12 months, commercial real estate debt and direct lending allocation are the strategies with greatest appeal (58% plan to increase exposure to the former and 49% to the latter)—but private debt fund of funds jumps to third—place for future exposure, with 46% intending to increase their exposure to these investments.



## Real estate rules

BNY Mellon's 2016 report *Building for the Future*<sup>6</sup> predicted that the demand for real estate would increase over the next 12 months. Our latest survey confirms this. Nine out of 10 respondents believe real estate is an attractive proposition, including 40% who see it as very attractive.

The asset class continues to provide valuable diversification and steady yields. Forty-two percent of respondents said that real estate offered minimized volatility, with a liquidity premium and counter-cyclical of the asset class garnering 29% each. However, the biggest shift in real estate over recent times is in the importance of sustainability funds. Almost all respondents feel it is an important factor—99% of respondents say it is important in their real estate investment decisions.

## Private appeal

“Private equity and private debt have both performed well for investors. The long-term decline in interest rates has led investors to search for yield and these two alternatives have generated good returns. Private equity funds have provided some diversification against the macro environment, while private debt offers cash flow through a floating rate structure that protects against interest rate risk.



### Medita Vucic

Director, Financial Institutions Sales and Relationship Management  
BNY Mellon Corporate Trust

# A real shift .....

“With back offices initially established to meet more traditional needs, today’s investor base demand on liquidity requires real estate managers to reassess operating infrastructures, staff expertise and technology requirements to ensure operational prowess coupled with sufficient transparency.



**Alan Flanagan**

Global Head of Private Equity and  
Real Estate Fund Services  
BNY Mellon

# 3 Hedge funds hit back: How will they regain ground?

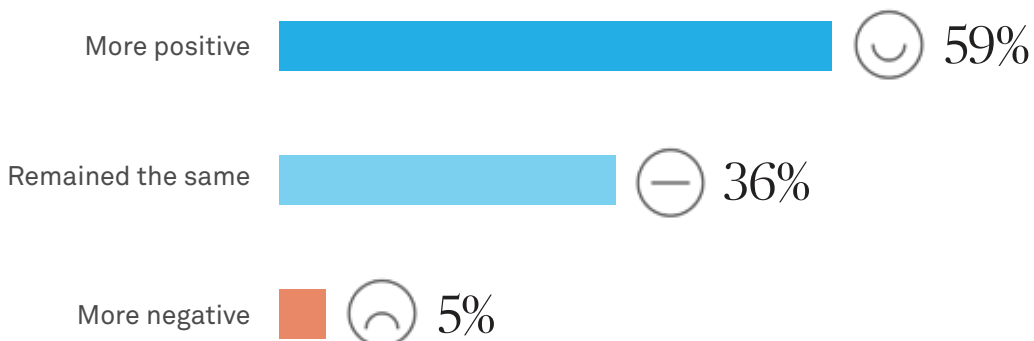
After a couple of difficult years, are hedge funds set for a comeback?

Hedge funds have been through a tough time in recent years. In 2016, they returned an average of 5.6%, according to Hedge Fund Research (HFR),<sup>7,8</sup> far short of the 11% generated by the S&P 500. This is further reflected in the 11% of respondents who say hedge funds failed to live up to performance expectations.

However, with 59% of respondents saying they are positive about the industry's prospects for the next 12 months, the asset class looks set to rise again. This optimism is supported by robust industry trends. On the back of improved performance numbers in 2017, hedge fund AUM reached a record US\$3.15 trillion by the end of Q3, according to HFR.<sup>9,10</sup>

## How has your confidence in the hedge fund industry changed in the past 12 months?

Fig. 5



# The top six factors shaping hedge fund allocation decisions

Fig. 6

- 
- #1** Regulatory changes
  - #2** Industry reputation
  - #3** Macroeconomic factors
  - #4** New products
  - #5** Communication with the funds
  - #6** Fee structure

## Industry changes are reviving hedge fund investments.

Industry changes are reviving hedge fund investments. Key among these is reductions in fees, which have become increasingly flexible for investors. Average management fees were 1.4% in Q1:2017, with performance fees averaging 17.1%, according to HFR<sup>11</sup>, well below the previous industry norm of “2 and 20.” In our survey, 82% of respondents believe that management fees will come down further in the next 12-18 months.



The development of new products is one of the main factors behind an increase in allocations. According to our survey, 98% of respondents cited this as important in their decision making. And technology is helping to hasten the evolution of these new products. Quant strategies, driven by increased automation and improved data capture, are one of the fastest-growing areas: quant funds are managing a record US\$500 billion of assets in 2017, according to Barclays figures<sup>12</sup>.

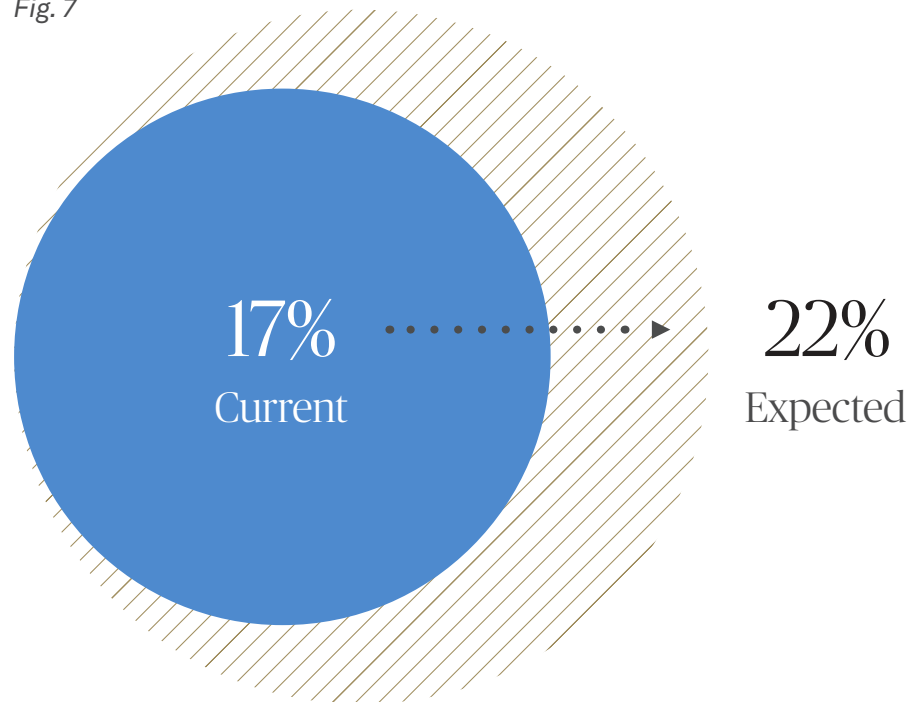
With further adoption of technologies to improve investment decisions and outcomes—for example, the use of satellite imagery to detect infrastructure patterns globally and support investment decisions or the increased use of big data and analytics—hedge funds look set to capture more investor allocations in the future. Technology-enabled services are also part of the reason for the increase in expected allocations to managed accounts, which are anticipated to rise from 17% of hedge fund allocations to 22% in the next 12 months according to our survey respondents. Managed accounts are especially attractive to larger investors (US\$51 billion+ in AUM) and to investment managers and fund of funds managers, who plan to increase their allocations significantly (anticipated increases of 21% and 32%, respectively).





## Investors plan to shift more of their hedge fund allocations into managed accounts

Fig. 7



## Momentum behind managed accounts

“Investors are showing an increased appetite to invest through managed accounts and, as a result, hedge fund managers have been increasingly looking at how to offer that to their investors. We are seeing growth in the technology and services that enable such accounts.”



**Peter Salvage**

Global Head of Hedge Fund Services  
BNY Mellon

# 4 Investors are speaking loudly: Are fund managers listening?

Can investors and managers reach a compromise on fees, transparency and control? And how can technology help deliver this accord?

As alternative allocations have risen, so have investors' voices. And managers are taking notice. The overwhelming majority (98%) of fund managers we surveyed say that investor demands have raised the need for new operational solutions.

This investor-friendly approach is apparent in the new products they are developing such as liquid alternatives and managed accounts. In addition, the majority of managers are seeking to outsource middle office, shadow accounting and reporting functions to reduce costs.



Fig. 8

98%

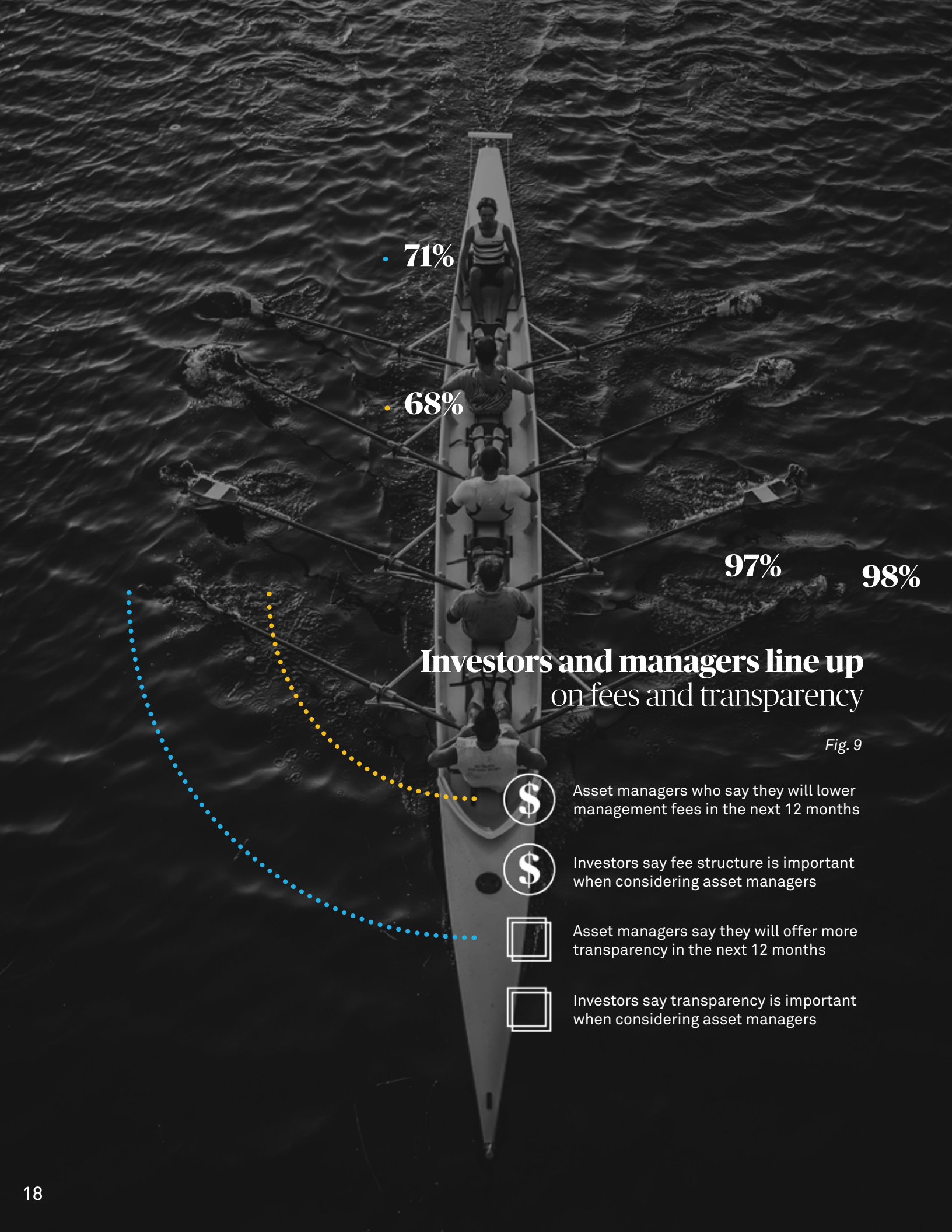
of fund managers say that investor demands have raised the need for new operational solutions

And reduce costs they must, as fee structure is hugely important to investors when considering whether to invest, cited by 97%. With that in mind, 68% of fund managers say that they will look to lower fees in the next 12 months.

The picture on transparency is determined by asset class. Investors are happy with the level of transparency provided by PE, private debt and real estate. However, hedge funds have some way to go—nearly half (45%) of investors say they are dissatisfied. More specifically, the majority of dissatisfied investors (83%) are looking for more information on the

underlying assets in a fund. Again, managers are listening—71% plan to offer greater transparency over the coming 12 months as seen in figure 9.

And this need to focus on transparency and lower fees means that asset managers have put technology infrastructure spend high on their agenda. An effective technology strategy enables managers to scale up while keeping costs low. They are seeking platforms that will provide timely, detailed and accurate data to manage their businesses and report to investors effectively.



• 71%

• 68%

97%

98%

## Investors and managers line up on fees and transparency

Fig. 9



Asset managers who say they will lower management fees in the next 12 months



Investors say fee structure is important when considering asset managers



Asset managers say they will offer more transparency in the next 12 months



Investors say transparency is important when considering asset managers

In addition, institutional investors' exposure to alternatives has become increasingly sophisticated over the last decade. They are seeking more co-investment and direct investment opportunities.

In our survey, 55% say they will expand their direct investment activity while 36% of investors intend to increase co-investment over the next 12-24 months. Fortunately, 71% of fund managers currently offer co-investments. While co-investing may be welcomed by managers as it can provide additional firepower for investments, managers are likely to be less sanguine about the competition that will result from greater direct investing.

## What do managers expect to offer in the next 12 months?

Fig. 10

- #1 More transparency
- #2 Lower management fees
- #3 More warranties

## Clear focus on transparency

“As the private debt investor base continues to deepen, transparency requirements continue to evolve with respect to underlying portfolio information, risk and performance attribution and regulatory reporting needs. Flexible solutions from administrators and specialist providers are key to asset managers to solve for such requirements in a cost-effective manner.



**Rob Wagstaff**

EMEA Head of Sales and Relationship Management  
Corporate Trust BNY Mellon

# 5 Asset managers are turning to technology. Why?

No sector is immune from technology's transformative effects. And fund managers need to become disruptors if they are going to thrive.

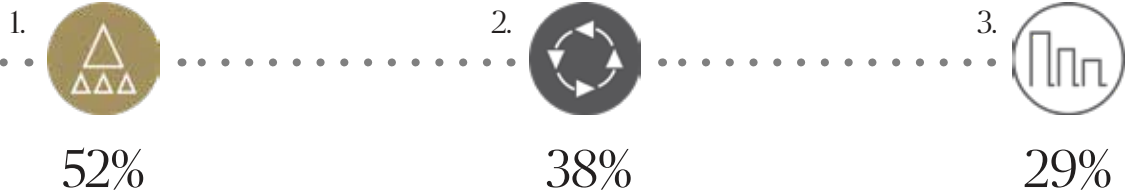
As noted above, technology is playing a major role in facilitating operational improvements and reducing costs that, in turn, produce savings for investors. With the arrival of automation, new analytical tools and even artificial intelligence, the cost of running many functions in a typical firm—from front through to back office - can be brought down.

The disruptive power of new technologies are front of mind for most fund managers, with predictive analytics, cloud and big data anticipated to have the most significant impact on their business. Predictive technologies are largely viewed as important for improving investment decisions, while the cloud is seen as enabling greater operational efficiency. "Technologies such as big data, blockchain, cloud and predictive analysis are certainly going to shape our business," says a U.S. hedge fund managing director. "Cloud is important for running the business and overcoming the hassles of back-end work. Analytics is most critical considering the significant uncertainty we have now."



# The top three trends investors predict will shape the alternative asset landscape in the next 12 months

Fig. 11



Increased indexing

More cash flows from financial advisors and HNW individuals

Lower fees for investment managers



Meanwhile, the two top trends revealed in our survey—increased indexing and more capital flowing from financial advisors and high net worth individuals (HNWI)—show how technology is set to be the driving force in the industry for the foreseeable future.

In many ways, these trends are two sides of the same coin. Most indexing products for alternatives are structured as exchange-traded funds (ETFs) or available through mutual funds and as such are available to individual investors and institutions alike. They offer the potential for exposure to a diversified set of alternative investment opportunities, plus greater liquidity than closed-ended alternative fund vehicles. Larger alternatives managers are also offering index-type alternatives exposure specifically

targeted at individual investors in a bid to broaden their investor bases and capture growing HNWI capital. The ability of managers to capture this expanding market is enabled by increasingly sophisticated technologies and the rise of robo-advisors, but it does increase regulatory hurdles in the case of retail investors.

Some institutional investors also fear the effect on returns if this new pool of capital is directed largely toward alternatives. While global pension fund assets total US\$36.4 trillion in 2017 with a five-year CAGR of 5.8%, the figure for HNWIs is far higher, at US\$60 trillion, having increased at a CAGR of 7.4% over five years, according to the latest Willis Towers Watson *Global Pension Assets Study*.

## The technology impact

“The impact of technology on both front and back office is accelerating and the biggest gains are still to come. Data science is maturing and becoming relevant and accessible to managers beyond just the power quant shops. Machine learning is speeding up NAV production and will drastically lower the costs of running an alternative investment manager.



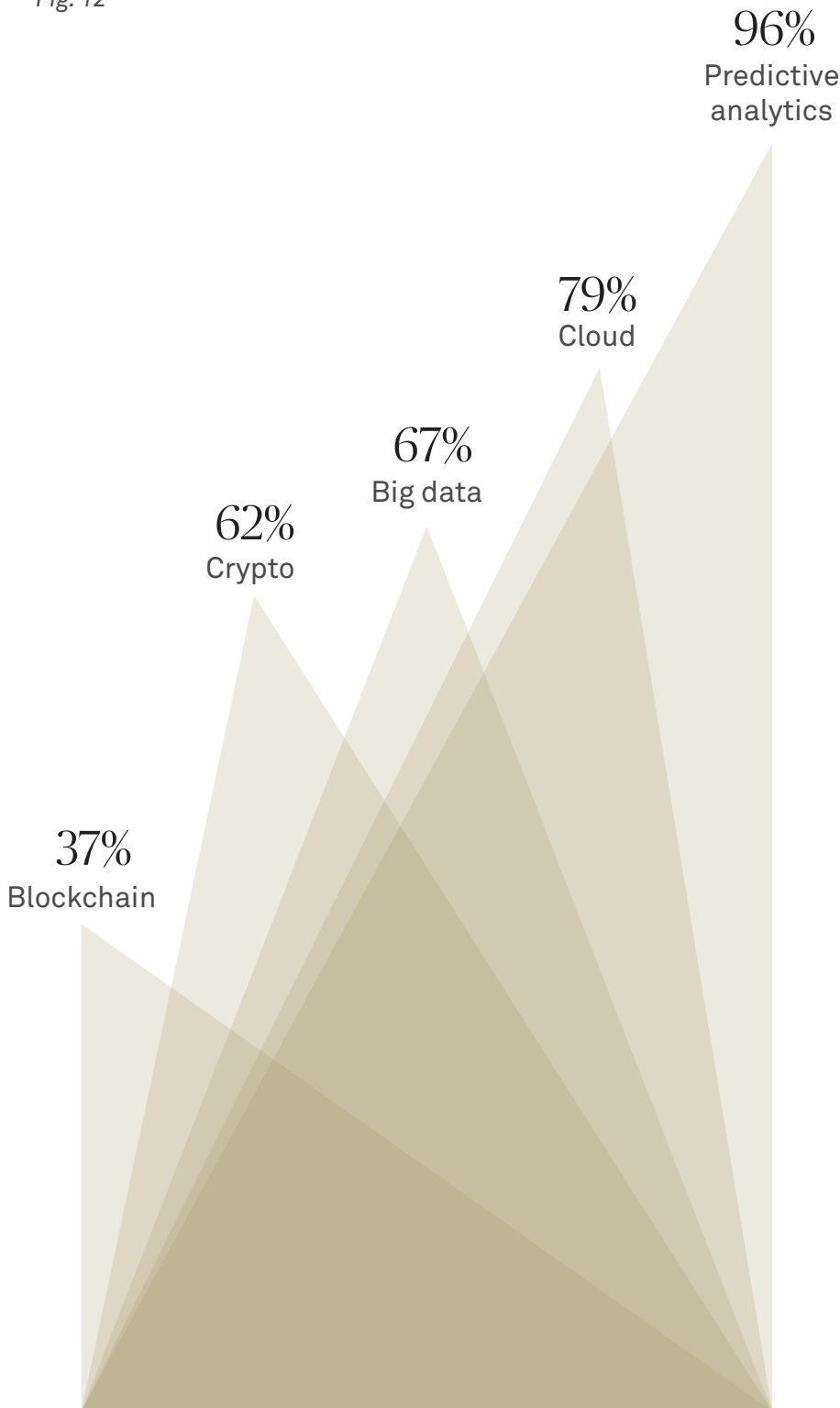
**Peter Salvage**

Global Head of Hedge Fund Services  
BNY Mellon



# The five technologies fund managers predict will most significantly impact the alternatives industry

Fig. 12



## A bright future

The investment strategies and dynamics revealed by our research present an optimistic outlook for alternative asset classes.

In the current low-interest environment where returns are hard to come by, yield-hungry institutional investors are expanding their allocations to the five asset classes. However, this shouldn't breed complacency among fund managers. Performance, in all aspects—including returns, fees and transparency—is paramount and investors' demands are growing.

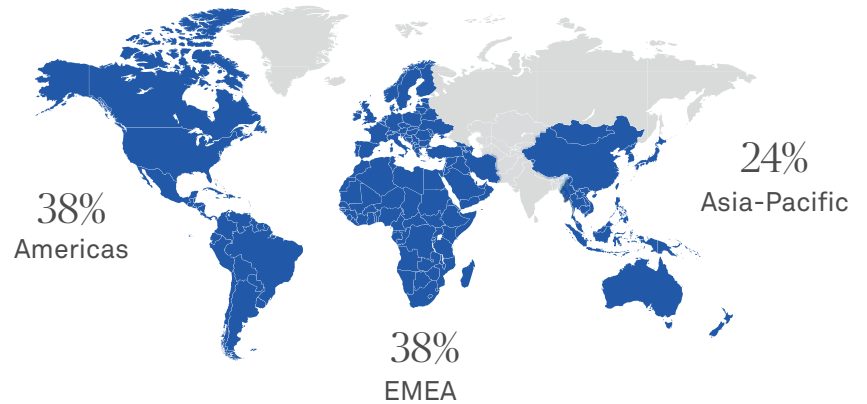
Fortunately, it would appear that fund managers are taking this on board—indeed, 98% say that investor demands are raising the need for new operational solutions. And as our survey shows, a mixture of cutting-edge technology, intelligent efficiency savings and a greater focus on customer needs will help them meet these demands.

# Methodology

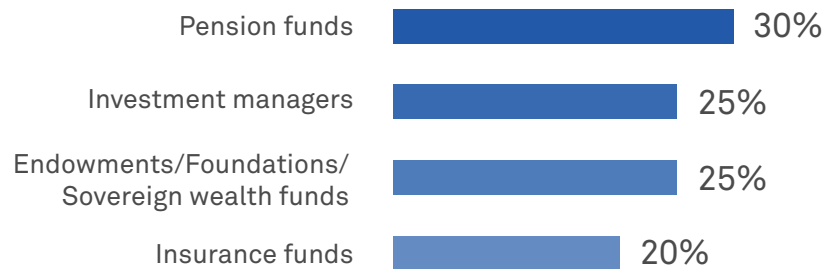
In the third quarter of 2017, FT Remark interviewed senior executives from 350 large institutional investors to understand their strategy for allocating funds to alternative investments (defined as private equity, hedge funds, real estate, infrastructure and private debt/loans).

At the same time, FT Remark interviewed 100 alternative fund managers, to understand how they are reacting to a changing regulatory landscape and increasing demands from their institutional investor client base.

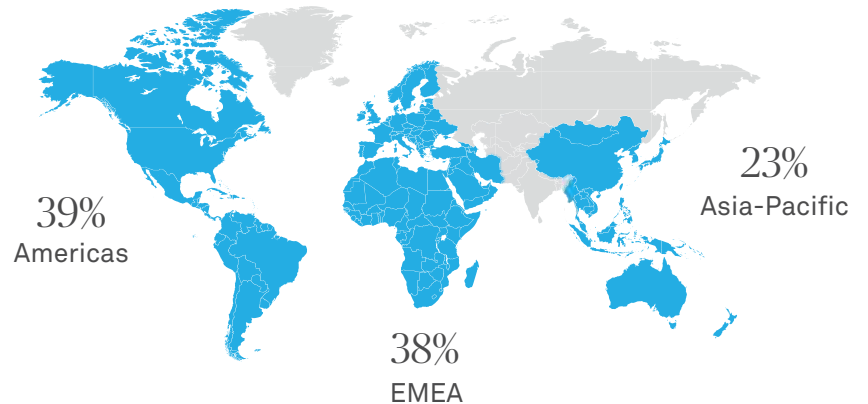
Senior executives geographic splits:



Senior executives respondent splits:



Alternative fund managers geographic splits:



# Coming attractions

In the coming months, BNY Mellon will expand its coverage of the alternative assets landscape and delve deeper into the key dynamics revealing additional insights that can help investors and fund managers thrive. Future content will include:



Deeper dives into the topics explored in this report



Additional segmentation by region, institution type and AUM



Additional commentary with BNY Mellon subject matter experts and clients



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## About BNY Mellon

BNY Mellon is a global investments company dedicated to helping its clients manage and service their financial assets throughout the investment lifecycle. Whether providing financial services for institutions, corporations or individual investors, BNY Mellon delivers informed investment management and investment services in 35 countries and more than 100 markets. As of Sept. 30, 2017, BNY Mellon had \$32.2 trillion in assets under custody and/or administration, and \$1.8 trillion in assets under management. BNY Mellon can act as a single point of contact for clients looking to create, trade, hold, manage, service, distribute or restructure investments. BNY Mellon is the corporate brand of The Bank of New York Mellon Corporation (NYSE: BK). Additional information is available on [www.bnymellon.com](http://www.bnymellon.com). Follow us on Twitter @BNYMellon or visit our newsroom at [www.bnymellon.com/newsroom](http://www.bnymellon.com/newsroom) for the latest company news.

**FT Remark**

Research from the Financial Times Group

## About FT Remark

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- 1 <https://www.preqin.com/docs/reports/Preqin-Investor-Outlook-Alternative-Assets-H1-2017.pdf>
- 2 <https://www.bnymellon.com/us/en/our-thinking/investment-in-alternative-assets-split-decisions.jsp>
- 3 <https://www.preqin.com/docs/press/GPER-Launch-2017.pdf>
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- 7 <https://www.hedgefundresearch.com/hfri-indices-december-2016-performance-notes>
- 8 <https://www.ft.com/content/4b727f0a-f2dd-11e6-95ee-f14e55513608>
- 9 <http://www.pionline.com/article/20171019/ONLINE/171019775/hfr-hedge-fund-industry-aum-reaches-fifth-consecutive-quarterly-peak?newsletter=editors-picks&issue=20171019>
- 10 <https://www.hedgefundresearch.com/news/steady-hfri-gains-drive-industry-assets-to-record>
- 11 <https://www.hedgefundresearch.com/news/q2-2017-hfr-market-microstructure-report-published>
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