BNY MELLON

CHAPTER

1

From Alternative *to Mainstream*

Alternatives Ascending

Foreword

The specter of market volatility brought on by large-scale events, such as global pandemic-related lockdowns in early 2020, has had a strong influence on investor approaches to their portfolios. Investors are responding by building resilience into their portfolios to navigate a future with the potential for enormous surprises. Alternative asset managers face a complex mix of opportunities and challenges presented by strong investor appetite for diversification, as well as broader industry pressures.

BNY Mellon, in conjunction with Mergermarket, surveyed 100 institutional investors and 100 alternative asset managers on their perceptions of current trends in the space and on whether the two sides are moving in the same direction. The findings show changing investor and asset manager attitudes and behavior, in some cases contrasting with our 2017 research report, *The Race for Assets.*[1]

In addition to shifting investor needs, highlighted in Chapter 1 of this study, alternative asset managers face structural changes within their organizations. A majority of alternative asset manager respondents cite forces of increased competition and changing economics as top factors driving structural change. They see increased product innovation as another significant structural game-changer. Like their peers in the broader asset management industry,[2] alternative asset managers are deploying digital and data analysis technologies to increase efficiency, overcome regulatory hurdles, promote product innovation and improve reporting.

[1] https://www.bnymellon.com/us/en/insights/content-series/the-race-for-assets.html

[2] https://www.bnymellon.com/us/en/insights/asset-management-transformation-is-already-here/survey-research-series-overview.html

The need for robust data management and analytics is also bringing new complexities to the fore. Alternative asset managers emphasize the challenges of aggregating and managing data across fragmented systems, and point out the obstacles of unstructured data sources, reliability, completeness, and freshness of data.

The structural responses to investor demand and changing internal priorities provide important context for the range of asset classes and allocation trends included in Chapter 1.

The collective perspectives of investors and managers underscore the five outstanding themes outlined on the following page, which we will explore in subsequent chapters. In some cases, our survey uncovered potential disconnects between investors' priorities and those of alternative asset managers. In others, the perceptions and opinions of both investors and managers dovetail strongly.

As alternative investment leaders assess how best to respond and reposition themselves in today's challenging market environment, it is clear that a new approach to future-proof business models, investment strategies and operational processes is needed.

James Slater
Global Head of Client Coverage
BNY Mellon

Based on our findings, we will explore five overarching trends in this and forthcoming chapters.

1. The scramble for scale or specialism:

As market forces pressure managers to increase operational efficiency, the largest will become larger, while specialist managers will attract capital from investors seeking to fine-tune their alternative asset exposure.

2. The case for customization builds:

Investors increasingly seek options that offer greater control than pooled vehicles, as well as lower fees and more transparency.

3. Going digital:

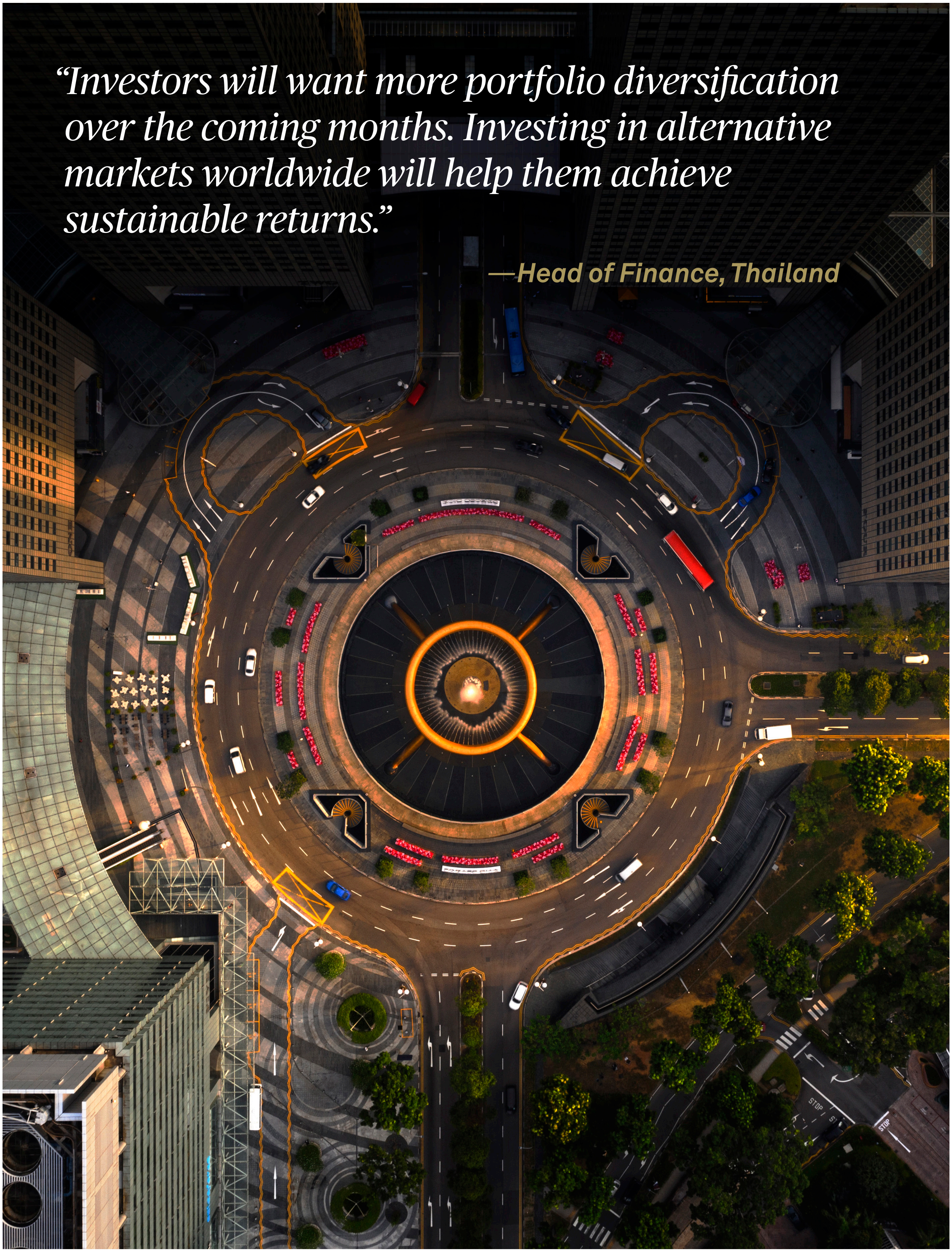
Greater digitization is critical for managers to achieve their objectives for operational efficiency, data management and serving rising market participation of "digitally native" investors.

4. The "retailization" of alternatives:

Managers and service providers will need to work together to solve for the challenges that the retail market poses.

5. ESG will become imperative:

Strong tailwinds already behind ESG, combined with emerging generations of investors and potential regulatory pressure, will drive change through the industry.



“Investors will want more portfolio diversification over the coming months. Investing in alternative markets worldwide will help them achieve sustainable returns.”

—Head of Finance, Thailand

Chapter 1: *Alternatives Ascending*

Investor demand for alternative asset classes is still on the rise.

Alternatives have moved from being a relatively small island in the investment world toward the mainstream in institutional investor exposures. By the end of 2020, alternative assets under management (AUM) reached approximately US$10.7 trillion.[1] Forecasts now estimate the alternatives segment to grow to US$17 trillion in AUM by 2025.[2]

Our survey reflects a similar likelihood, and beyond that, it provides insights into the role that mainstreaming will play in this growth.

Upward Forces

The search for yield in a persistently low interest rate environment has been a significant driver of the rise of alternatives, as we found in both our last alternative asset survey in 2017[3] and in 2021. Alternatives can offer the potential for outperformance versus traditional asset classes.

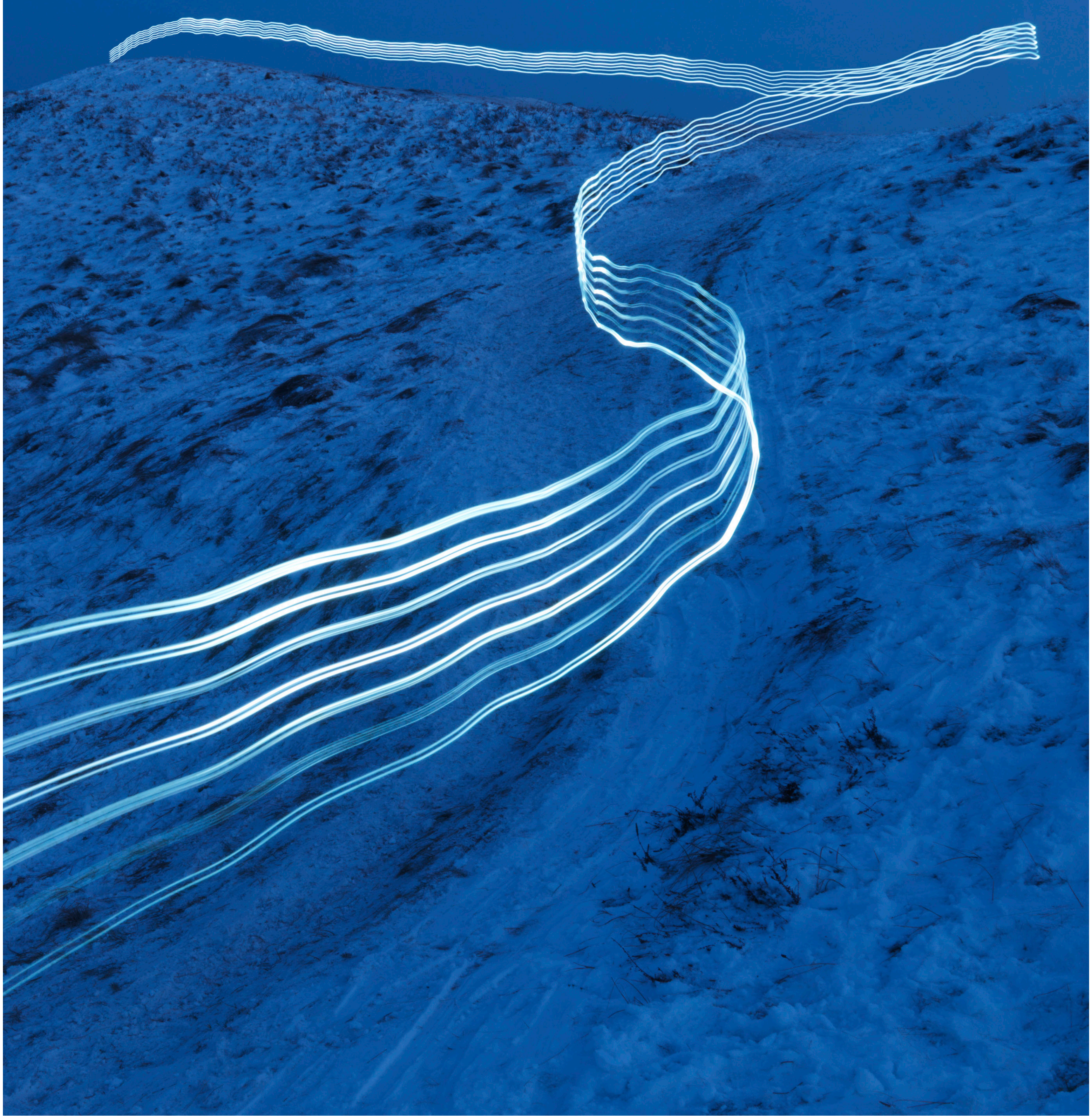
Many alternative asset types, particularly those with illiquid, closed-ended structures, are also at least partly shielded from volatility, an especially attractive reason for diversification in uncertain times.

[1,2] Preqin data: https://www.preqin.com/future

[3] https://www.bnymellon.com/us/en/insights/content-series/the-race-for-assets.html

“As markets are highly volatile, investing in alternatives can help investors target their expected returns.”

—Managing Director, Singapore



Fine-Tuning Allocations

The upheavals of the past couple of years have influenced investors' preferences within the world of alternatives. In many sub-asset classes, however, they have remained consistent with, or even intensified, their previous leanings.

ALLOCATION TRENDS

Institutional investors' past, current and expected alternative asset allocations over the next 12 months.

	2019 allocation (%)	Expected allocation over next 12 months (%)	% increase or decrease
Private equity	24	27	3%
Hedge funds	7	8	1%
Real estate	26	23	-3%
Private debt/loans	24	25	1%
Infrastructure	14	14	No change
Natural resources	5	4	-1%

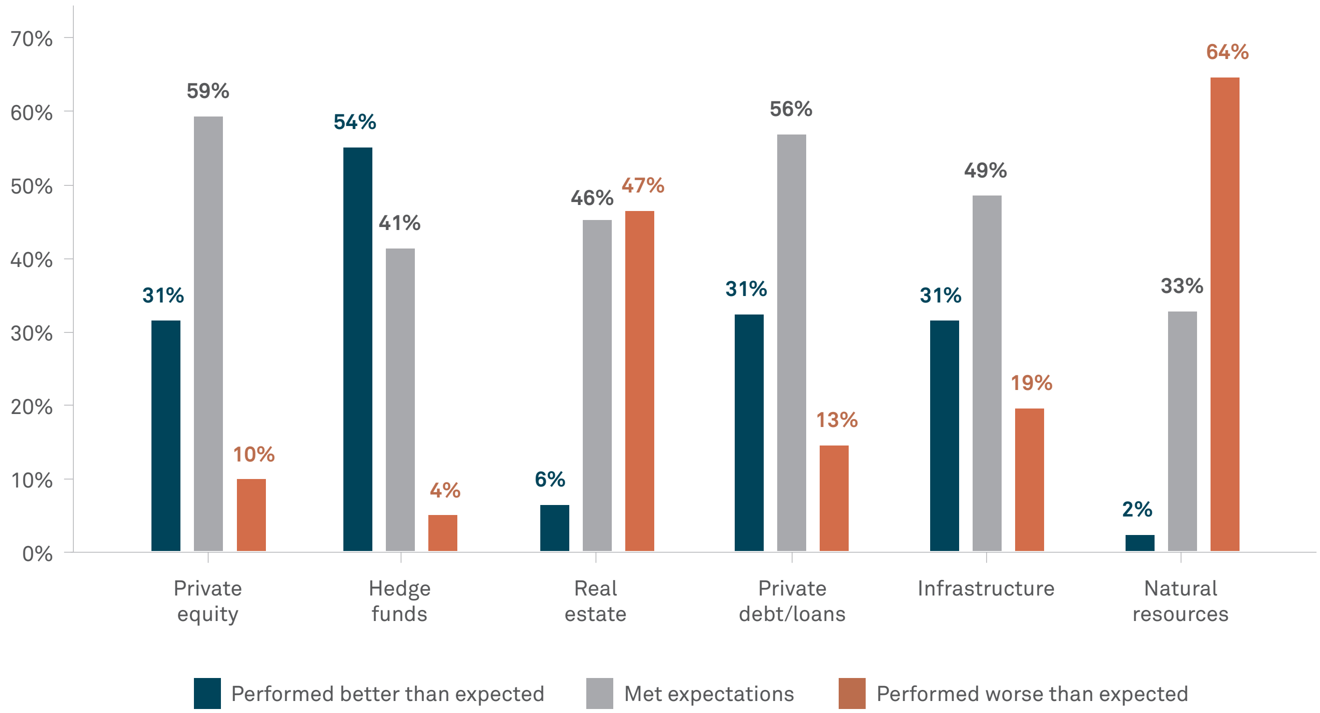
Institutional investors appear largely satisfied with their current allocation levels across alternative asset types, with proportions remaining broadly stable. However, there are some subtle shifts. The performance of each sub-asset class over the past 12 months offers clues as to why investors are making these allocation decisions.

Hedge funds, which fell out of favor among some investors in the years leading up to the pandemic, have largely performed well since the outbreak of the crisis. Private debt, private equity and infrastructure have also done relatively well over the past 12 months.

Perhaps unsurprisingly, given the pandemic-related disruption to property segments such as city center offices and retail, nearly half of investors say real estate has performed below expectations. Worse still has been natural resources, reflecting lower demand through 2020 as lockdowns reduced consumption and curtailed economic activity.

PANDEMIC PERFORMANCE

Institutional investors shared how the alternative assets in which they are invested performed over the last 12 months amid COVID-19.

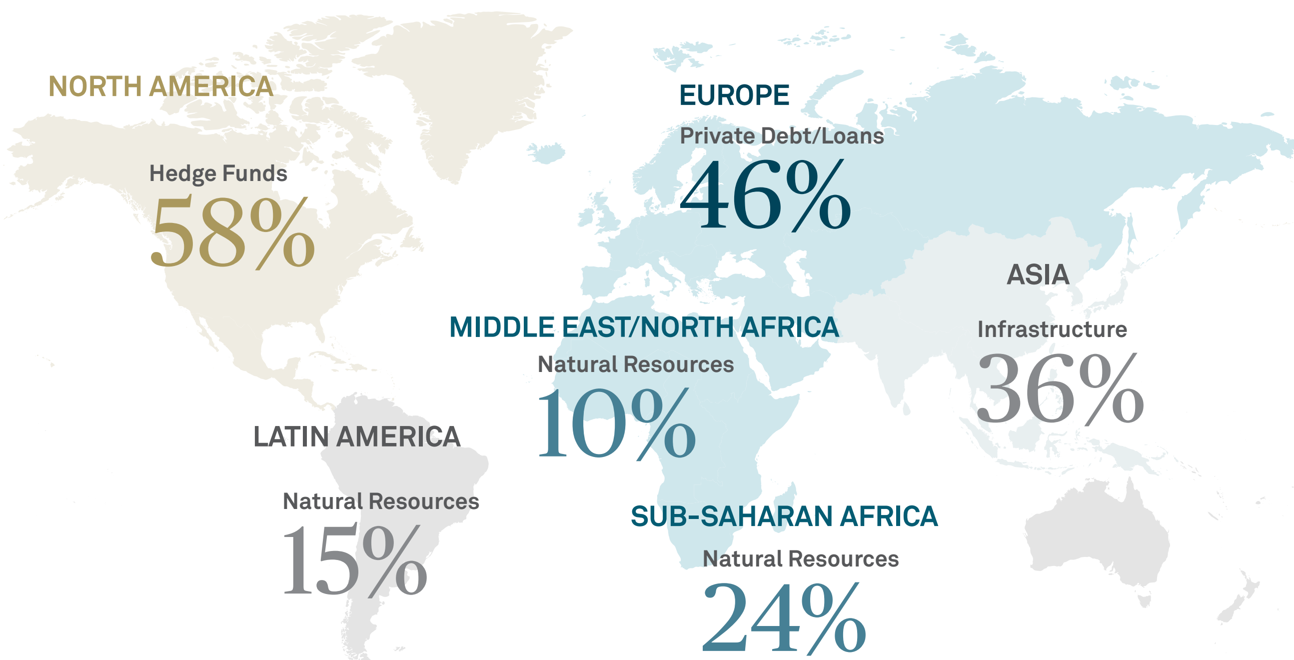


Regional Potential

Institutional investor perceptions differ by region, based on local macroeconomic factors. Those same factors add further nuance around which sub-asset classes they describe as attractive within each region.

HOTSPOTS FOR GROWTH

The map below shows the percentage of institutional investors who said they are most interested in increasing allocations in specific region and asset class combinations, as indicated.



"North America offers the best long-term growth opportunities, reflecting the rate of technology advancement and availability of talent in the region."

—Partner (Hedge Fund), Sweden

Private Equity *Retains the Crown*

As in our previous studies, private equity remains the most popular alternative asset type among institutional investors.

Stocks of dry powder have accumulated for such investments, capitalizing the industry with copious amounts of funding. The industry remains well-capitalized, despite a travel-ban-inflicted decline in fundraising in 2020 (down 19% by value and 20% by volume versus 2019, according to Private Equity International).[3] Private equity firms globally had at least US$1.48 trillion of dry powder available at the end of Q2 2020, per Preqin figures.[4]

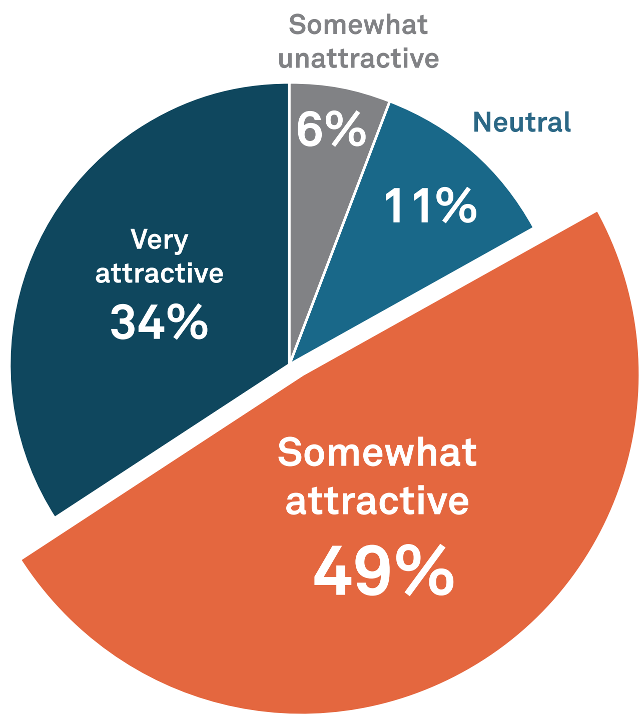
"The amount of dry powder has grown. That allows for radical decisions and cross-border transactions. Private equity firms are able to respond quickly to opportunities when they are identified because of the capital at their disposal."

—Investment Director, Netherlands

[3] https://infogram.com/1pe3960rlgkwepfmpekmvdqn2wtlrl0x9ld?live

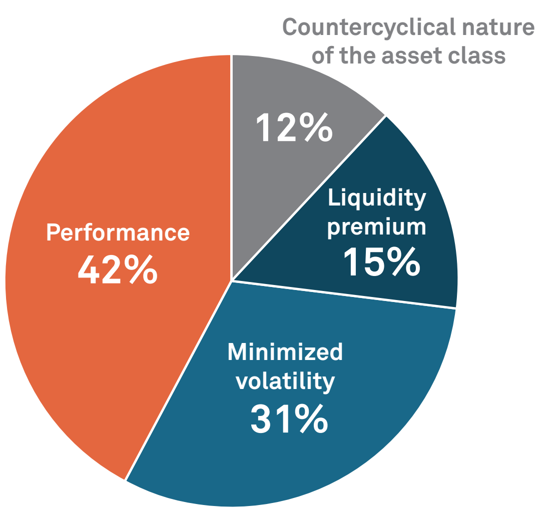
[4] https://www.preqin.com/Portals/0/Documents/About/press-release/2020/July/PEVC-Q2-2020.pdf?ver=2020-07-08-154129-593

How attractive will private equity investment be in the coming 12 months?

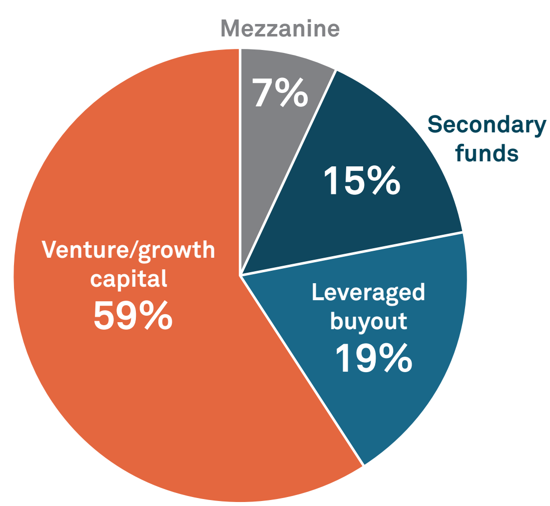


Strong performance and minimized volatility are the main points of attraction for investors, not to mention private equity's reliability through the vagaries of the pandemic crisis. Within the category itself, venture capital and growth funds have flourished, likely fueled by COVID-related technology valuations.

What is the main attraction of private equity that would encourage you to increase your allocation?

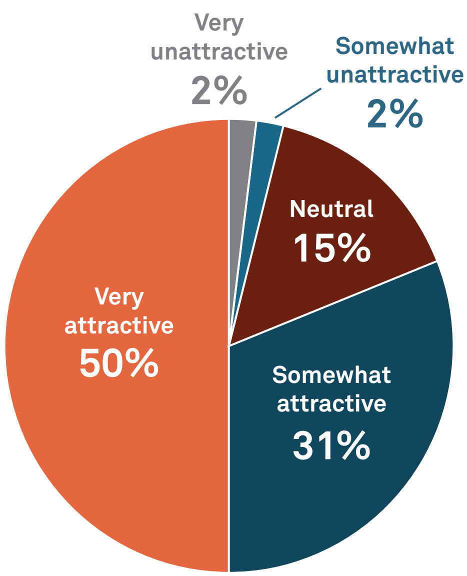


Which private equity fund type is your top choice to provide the best returns over the next 12 months or longer?



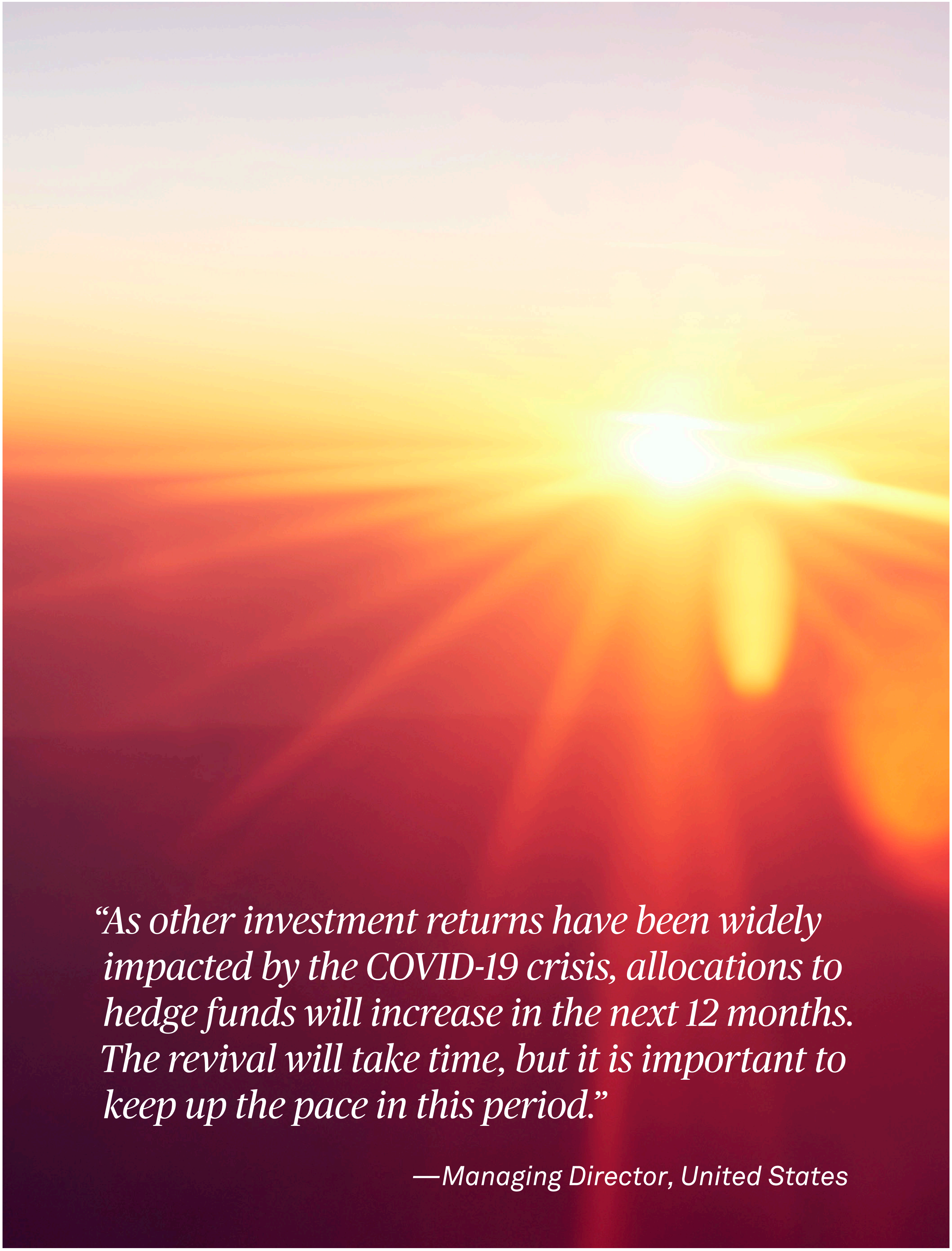
Hedge Funds *Burn Bright*

Among alternative sub-classes, our study found how far hedge funds' performance has exceeded investors' expectations. The recent strong performance of hedge funds will likely put this sub-class in good stead over the coming 12 months, with 81% ranking hedge fund investment as very or somewhat attractive. This ranking is up significantly from our 2017 survey, when 59% said they felt positive about the industry's prospects.



How attractive will hedge fund investment be in the coming 12 months?

The results reflect wider industry trends. As noted earlier in this chapter, 54% of investors say hedge funds' performance has exceeded expectations, the highest proportion of all alternative asset classes.


"As other investment returns have been widely impacted by the COVID-19 crisis, allocations to hedge funds will increase in the next 12 months. The revival will take time, but it is important to keep up the pace in this period."
—Managing Director, United States

Special Situations Rebound

The economic disruption and uncertainty stemming from the pandemic have also shifted investor views around hedge fund strategies. Investors are particularly interested in special situations, with 50% ranking it in the top three hedge fund strategies by attractiveness, followed by market neutral with 40% and distressed with 27%.

Conversely, in our 2017 survey, investors viewed distressed and long-short strategies as most attractive, while special situations ranked fifth and market neutral garnered just 3% of respondents' first-place votes.

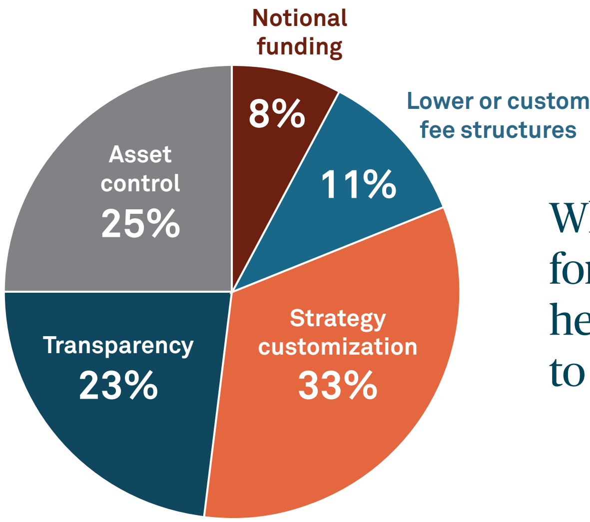
Investor Ranking	2017	2020
1	Distressed	Special situations
2	Long-short equity	Market neutral
3	Global macro	Distressed

Bespoke Demand Galvanizes Managed Accounts

Investors' demand for more bespoke exposure and terms also plays a significant role in current views and future prospects for hedge funds. Our survey results reflect this trend as investors continue to increase allocations to managed accounts, at the expense of standard funds and funds of hedge funds.

	2017 proportion	2020 proportion	Expected proportion over next 12 months
Managed accounts	17%	23%	**29%**
Fund of hedge fund	68%	33%	**32%**
Standard fund	15%	44%	**39%**

High demand for bespoke arrangements is also apparent in how investors ranked the factors driving their decisions to increase managed account allocations.



What is the main driver for increasing your hedge fund allocation to managed accounts?

"The value of dedicated managed accounts – which afford investors more control over assets, as well as greater transparency and customization – has been clearly reaffirmed during the COVID-19 crisis, and there's every reason to expect this trend to continue."

***—Josh Kestler,** Global Head of HedgeMark,[5] BNY Mellon*

[5] BNY Mellon's HedgeMark® specializes in supporting institutional investors in the development and operation of their own private dedicated managed account platform.

Private Debt *Stands in the Gap*

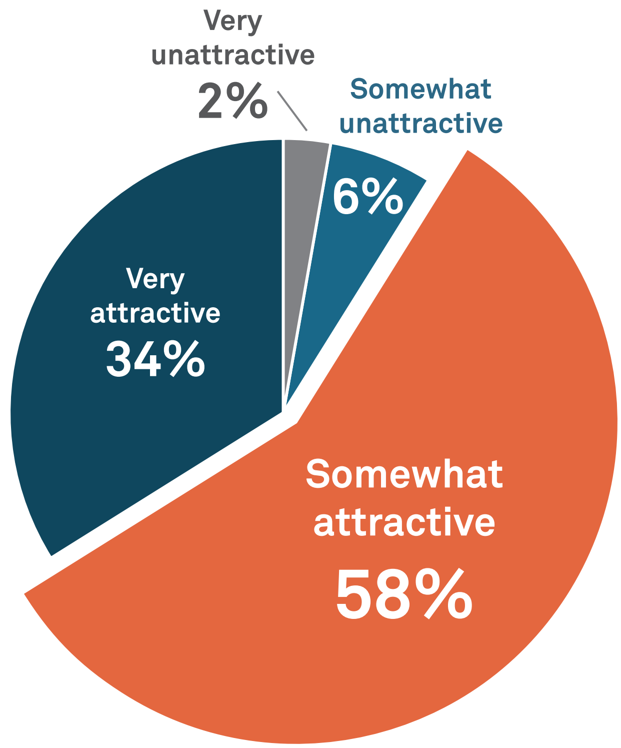
The private debt market has grown rapidly over the past 10 years. Private funds have stepped into the gap left by traditional lenders in the wake of the 2008 financial crisis. As our survey shows, this sub-asset class makes up around one-quarter of institutional investor alternatives allocations.

Additional industry data support this finding. Private debt AUM grew from US$315 billion in 2010 to US$848 billion in 2020 and is projected to reach nearly US$1.5 trillion by 2025.[6]

Forward-looking investor optimism about private debt prospects continues unabated. Nearly all of respondents see private credit and loans as attractive over the next 12 months.

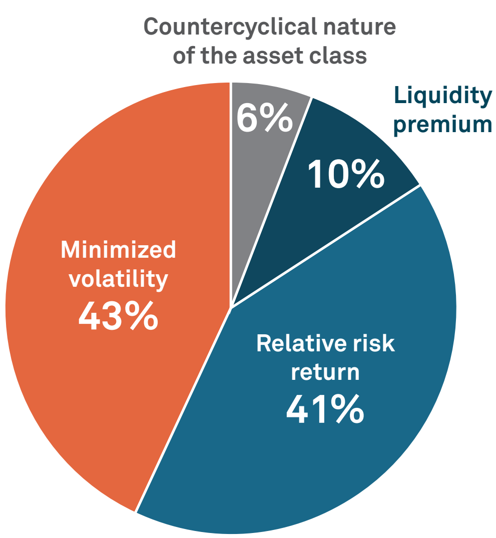
> *"We have to think about the present market conditions when determining the most attractive asset classes. Minimized volatility is an attractive feature, and private credit's long- and short-term potential has been vital to our portfolio management and diversification strategies."*
>
> ***—Investment Director, Netherlands***

[6] https://www.preqin.com/future



How attractive will private credit/loan investments be in the coming 12 months?

Investors are particularly drawn to private debt's capacity to minimize volatility and relative risk return.



What is the main attraction of private credit/loans as an asset class that would encourage you to increase your allocation?

One of the benefits of private debt highlighted by respondents is the choice of strategies available. Among these, syndicated loans, direct lending and private debt funds of funds are the most popular for investors currently.

Investors plan to increase their exposure primarily to direct lending, mezzanine and CLOs. They also see promise in European private credit, reflecting the increasing number of options available in the region, pushing North American private debt out of its top position from our 2017 study.

Conversely, investors say they are looking to decrease their allocations to commercial real estate debt and to distressed debt/special situations. Ongoing uncertainty surrounding working and consumer patterns and the longer-term financial impacts to company balance sheets due to the pandemic are likely causes of this intent to decrease.

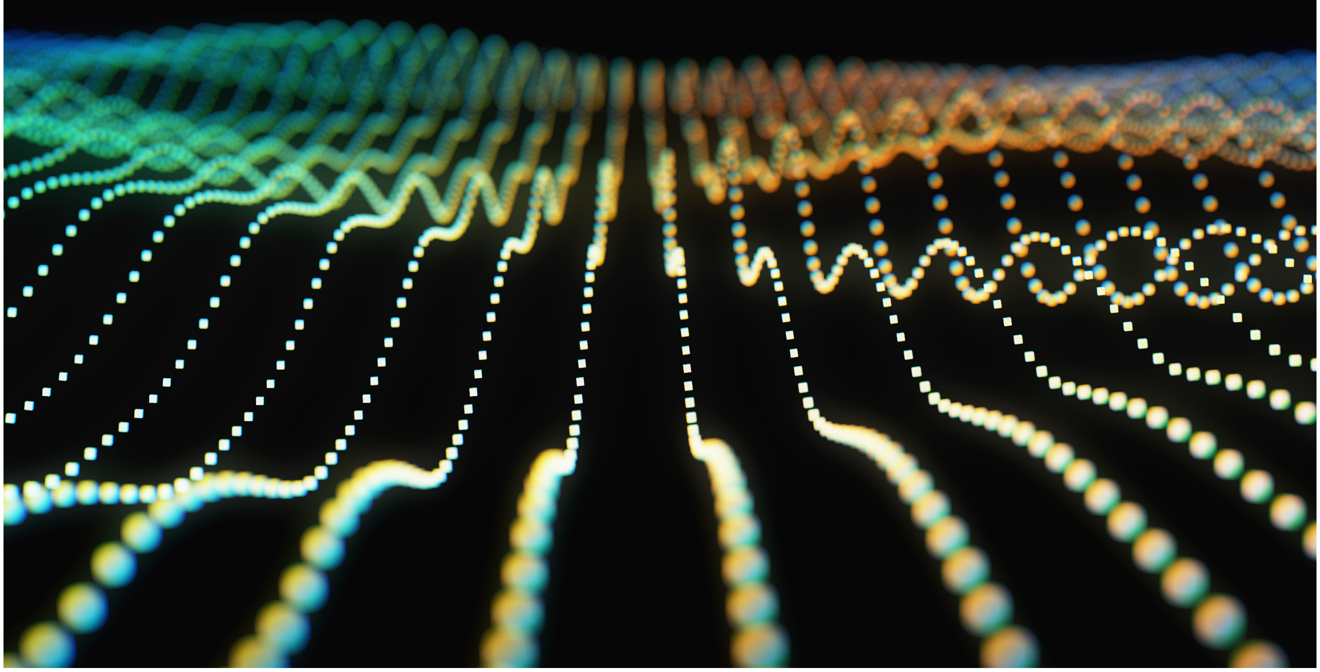
Choice of strategies

Institutional investors shared their plans to increase, decrease or make no change to their private credit/loan exposure in the next 12 months.

	Decrease (%)	No change (%)	Increase (%)
CLOs	5	28	68
Commercial real estate	39	39	23
Direct lending	3	18	80
Distressed debt/ special situations	23	30	48
Infrastructure debt	13	55	33
Mezzanine	6	23	71
Private debt fund of funds	19	24	58
Senior debt	23	38	40
SME debt	8	58	35

“Private credit offers investors options through the cycle. When things are going well, and people are paying their loans, credit funds offer strong cash flows to pass on to investors via distributions. During more difficult times, strategies such as distressed debt can provide a natural hedge for the portfolio.”

*—**Megan Gentilesco,** Head of Private Equity and Credit Fund Services, BNY Mellon*



Mixed Sentiments *for Real Estate*

With nearly half of investors reporting that real estate fell below expectations in 2020, it is unsurprising that many of them reported bearish attitudes about its prospects for the coming 12 months.

40%
of respondents believe real estate will be unattractive through 2021.

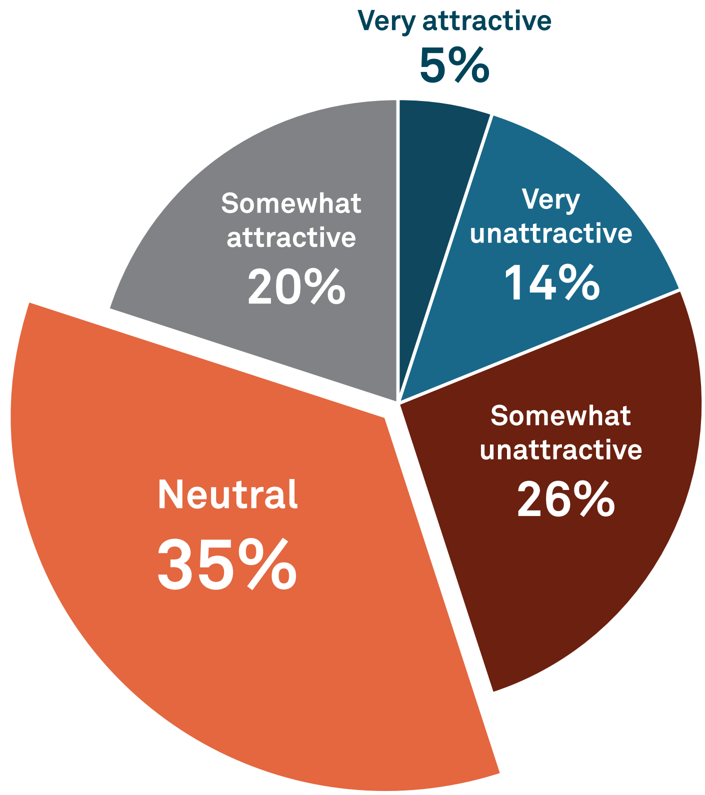
Remote working patterns could affect demand for city-center office and hospitality space, while the shift to online shopping could impact physical retail stores. Retail property prices in the US at the end of 2020, for example, were down 4.3% from 2019, according to Real Capital Analytics, while office space registered a 1.5% increase.[7]

This uncertainty could persist to some degree well beyond the pandemic. However, based on our survey findings, it has not translated into significant plans to decrease allocations. Respondents only expect a percentage point decline in allocations to real estate. Further analysis shows that they do not view real estate as a monolith. They view this asset class with a fair degree of nuance.

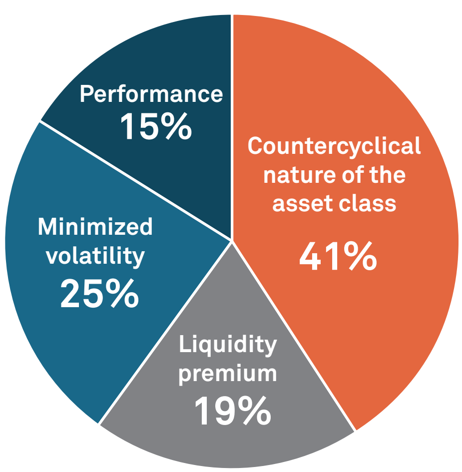
> *"Real estate assets are far more stable than liquid assets. Investors are aware that they are making long-term commitments and that growth rates will trend higher again. Post-pandemic, there will be more opportunities to consider domestically and in overseas markets."*
>
> ***—Head of Investments, South Africa***

[7] https://www.rcanalytics.com/us-prices-dec-2020-rcacppi/

How attractive will real estate investment be in the coming 12 months?



Furthermore, a sizable proportion of investors see promise in the countercyclical qualities inherent in many parts of the real estate sector. Apartment and industrial prices posted annual growth of 8.3% and 8.8%, respectively, in 2020.[8]

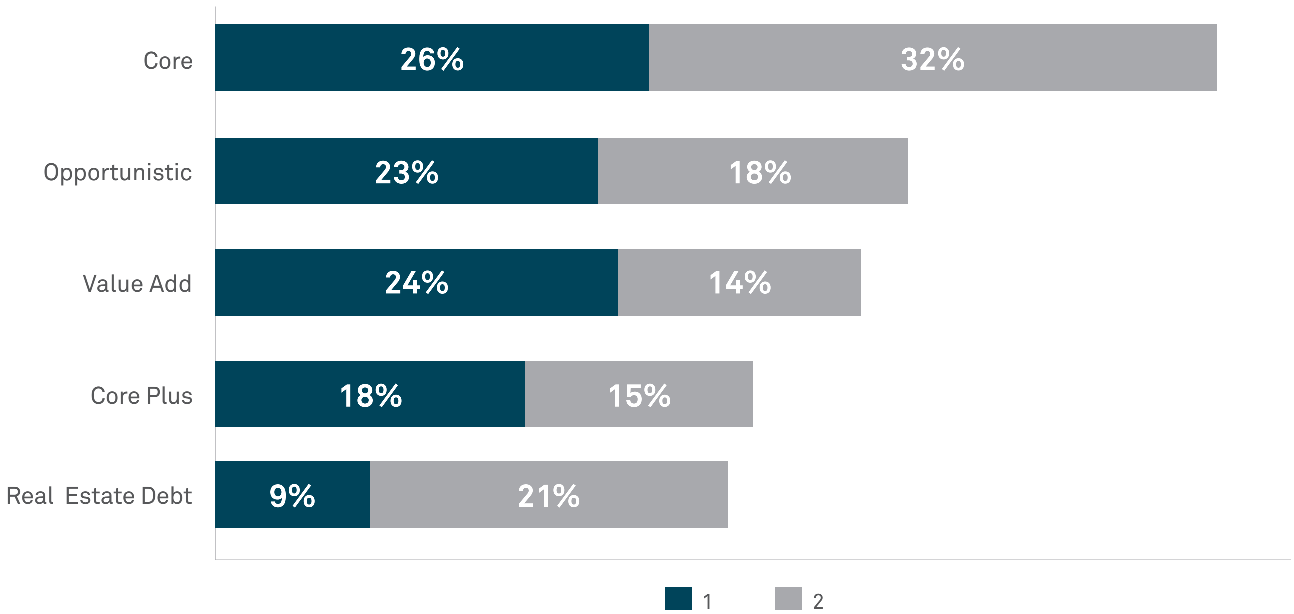


What is the main attraction of real estate as an asset class that would encourage you to increase your allocation?

[8] https://www.rcanalytics.com/us-prices-dec-2020-rcacppi/

In addition, many respondents are clear about the need for a long-term perspective when investing in property assets, including minimized volatility and the potential to acquire high-quality assets at lower cost in a more challenging market. These factors influence their preferences among types of real estate funds, such as for core funds.

Which types of real estate investment funds do you expect will provide the best returns over the next 12 months? (Select top two and rank them 1 and 2, where 1 is the type you expect to provide the best returns.)



"COVID-19 has slowed purchasing down in real estate in 2020 and 2021, but as we move through the year, there will be greater clarity by asset type, and an increased focus on debt, leading to an expectation of a strong fund launch year and positive vintage for 2021. We may also see some shift in the types of asset targeted, with value-add strategies coming to the fore in 2021 as pricing has lowered."

—***Dermot Finnegan,*** *Head of Private Markets, BNY Mellon*

Conclusion

As with our prior studies, the relative attractiveness of each asset class shifts over time. In aggregate, investor demand shapes the priorities that alternative asset managers will need to consider in competing for institutional capital.

At times, these priorities can differ from, or even contradict, the internal priorities of firms that manage alternative assets. Furthermore, mainstream investors are gaining greater access to investing in alternative assets through retirement plans and, increasingly, direct-to-consumer products. Both of the above are themes we will cover in future chapters of *From Alternative to Mainstream.*

Alternative asset managers have an opportunity to respond to that investor demand if they are ready to heed the underlying signals of investor needs and preferences, and engage with service providers who can help them achieve operational transformation and future-proof their businesses.

Coming Attractions

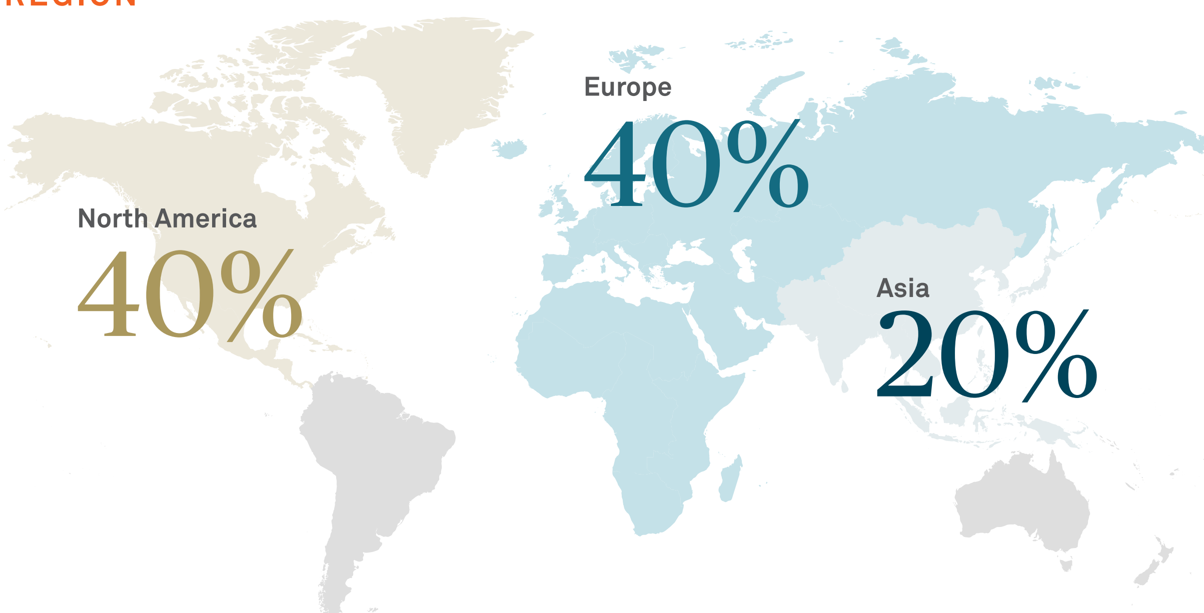
Over the coming months, BNY Mellon will release the detailed findings from this wide-ranging alternative investments study. Each chapter offers deeper insights and strategies to help you thrive as the industry evolves and adapts, and alternative investments move toward the mainstream.

- **Getting Ready for Growth —** Explores the bespoke solutions, compelling strategies and levels of transparency that will create the greatest competitive advantages.
- **Going and Growing Digital —** Highlights how data, technology and outsourcing are the future of asset management, while mastering digital technologies is essential to managers' priorities.
- **Looking Toward the Future —** Examines the new products, channels and sources of capital transforming the industry, and highlights areas where managers expect the next big market opportunities.

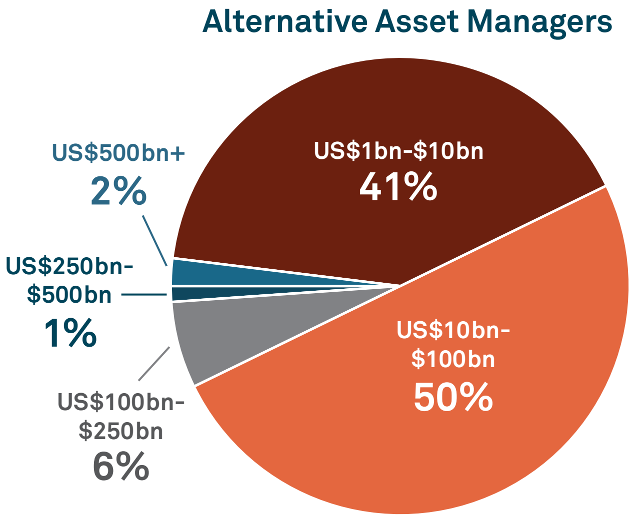
Appendix: *Methodology*

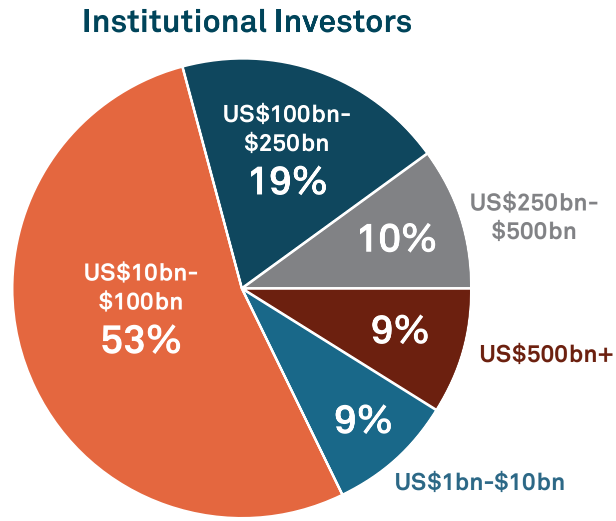
In Q3 and early Q4 of 2020, Mergermarket surveyed 100 alternative asset managers and 100 institutional investors from the US, EMEA and Asia-Pacific regions to gain insights into key trends in the alternative assets space. C-level and senior executives (job titles: Chief Executive Officer, Chief Investment Officer, Managing Partner, Partner, Managing Director and Investment Director) from alternative asset managers with AUM from US$1 billion to US$500 billion participated in the survey. C-level and senior executives (job titles: Chief Financial Officer, Chief Investment Officer, Managing Partner, Partner, Managing Director, Finance Director, Investment Director and Head of Investment) from institutional investors with AUM of US$1 billion to US$500 billion participated in the survey. All responses are anonymous. Data is presented in aggregate.

REGION



ASSETS UNDER MANAGEMENT





ASSET MANAGER BREAKDOWN

Hedge fund	25%
Private equity fund	25%
Credit/private debt fund	20%
Real estate fund	20%
Multi-asset fund	10%

INSTITUTIONAL INVESTOR BREAKDOWN

Investment manager/ Fund-of-fund manager	30%
Pension fund/ Trustee	30%
Insurance company	20%
Endowment/ Foundation	10%
Sovereign wealth fund	10%

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