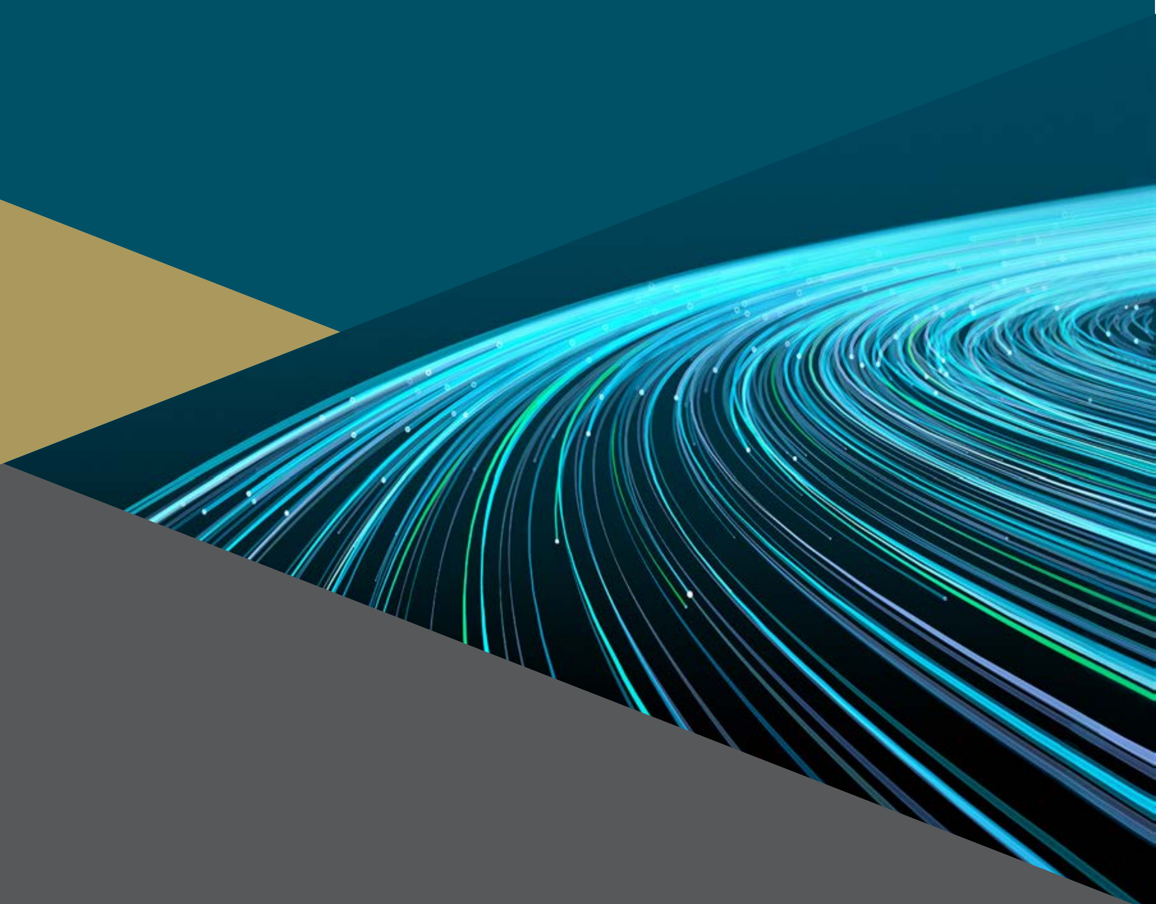
BNY MELLON

CHAPTER

2

From Alternative *to Mainstream*

Getting Ready for Growth



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Foreword

Earlier in 2021, BNY Mellon surveyed 100 institutional investors and 100 alternative asset managers about their current and future alternative asset allocations and their views on various sub-asset classes. We conducted this research in conjunction with Mergermarket. We also interviewed alternative asset managers on their current and future priorities to provide a perspective on whether the two sides are moving in the same direction.*

The resulting report, *From Alternative to Mainstream,* reveals alternatives as an increasing component of investors' efforts to diversify their portfolios, minimize volatility and seek out resilience and increased returns.

In the first chapter of *From Alternative to Mainstream,* we provided in-depth data and analysis on alternative asset classes and allocation trends. In this next chapter, we compare the factors driving investor demand with the perspectives of alternative asset managers on-demand and strategic priorities.

*Note: This report is the latest study on alternative investments from BNY Mellon. The first was in 2016, Split Decisions and the second, Race for Assets, was conducted in 2017. These studies portray an investor base clamoring for alternatives as a means of generating strong returns at a time of continued low interest rates and yield.

Chapter 2: *Getting Ready for Growth*

Many alternative asset managers will have to adjust course to capitalize on greater investor demand, emphasizing bespoke solutions, compelling strategies and greater transparency.

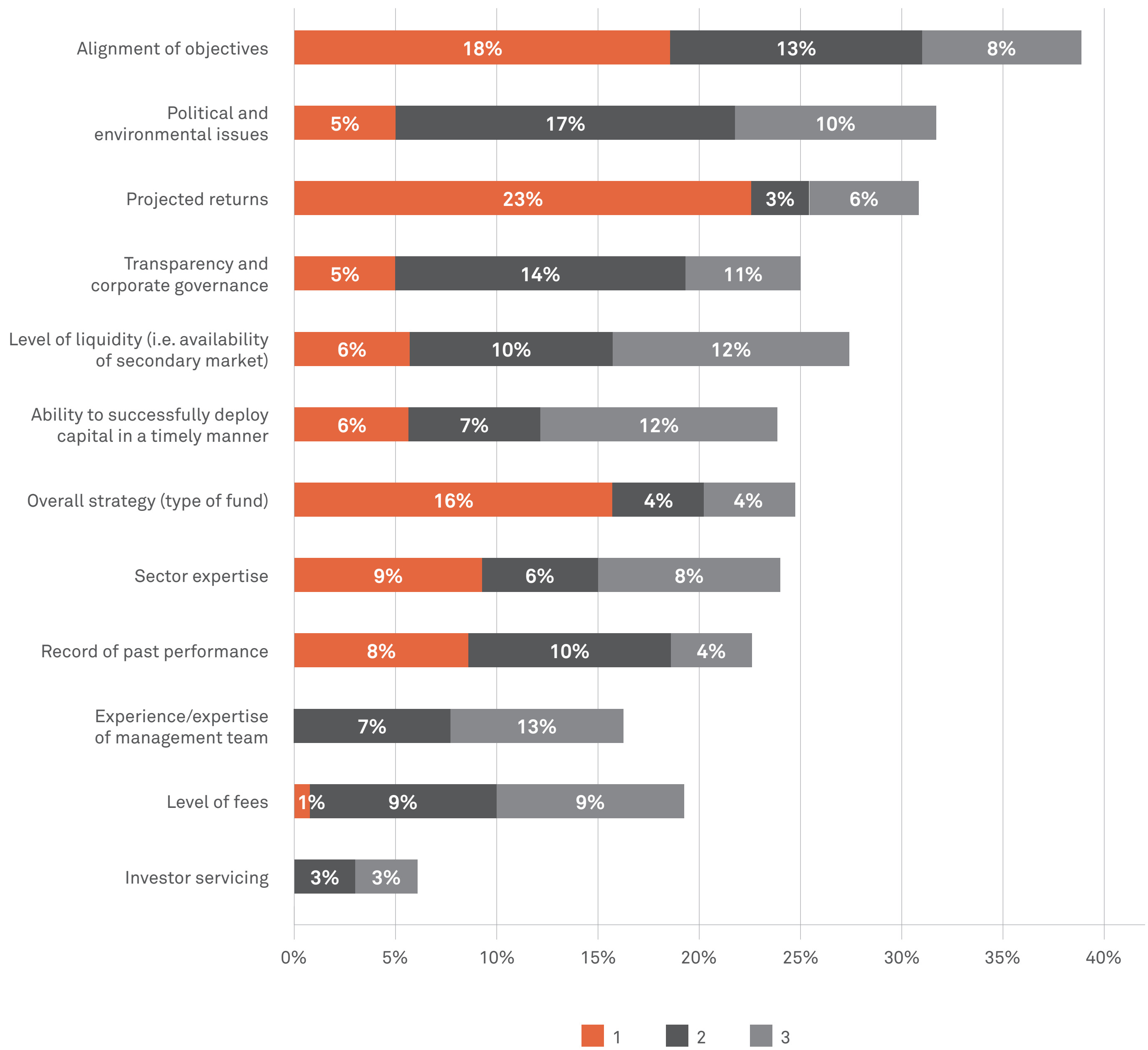
Strategy and Competition

The majority of alternative asset manager respondents expect increased allocations to alternative assets in 2021. These expectations are consistent with investor respondents' allocation trends outlined in chapter 1 of this series, which found that alternatives have moved towards the mainstream in institutional investor exposure after being a relatively small island in the investment world.[1] Managers rank investment performance as their topmost concern (*i.e.*, ranked as 1). Alignment of objectives with investors comes in second, followed by overall strategy.

However, the relative ranking shifts when considering factors that appear anywhere among the top three competitive factors (*i.e.*, ranked as 1,2 or 3). Alignment of objectives rises in managers' top three, followed by political and environmental issues. These rankings shed light on the potential future role of ESG in alternative investments, which will be explored in chapter 4 of this series.

[1] https://www.bnymellon.com/us/en/insights/from-alternative-to-mainstream/chapter-one-alternatives-ascending.html

What do you feel are the most important factors to make you competitive in the market? (Select top three.)



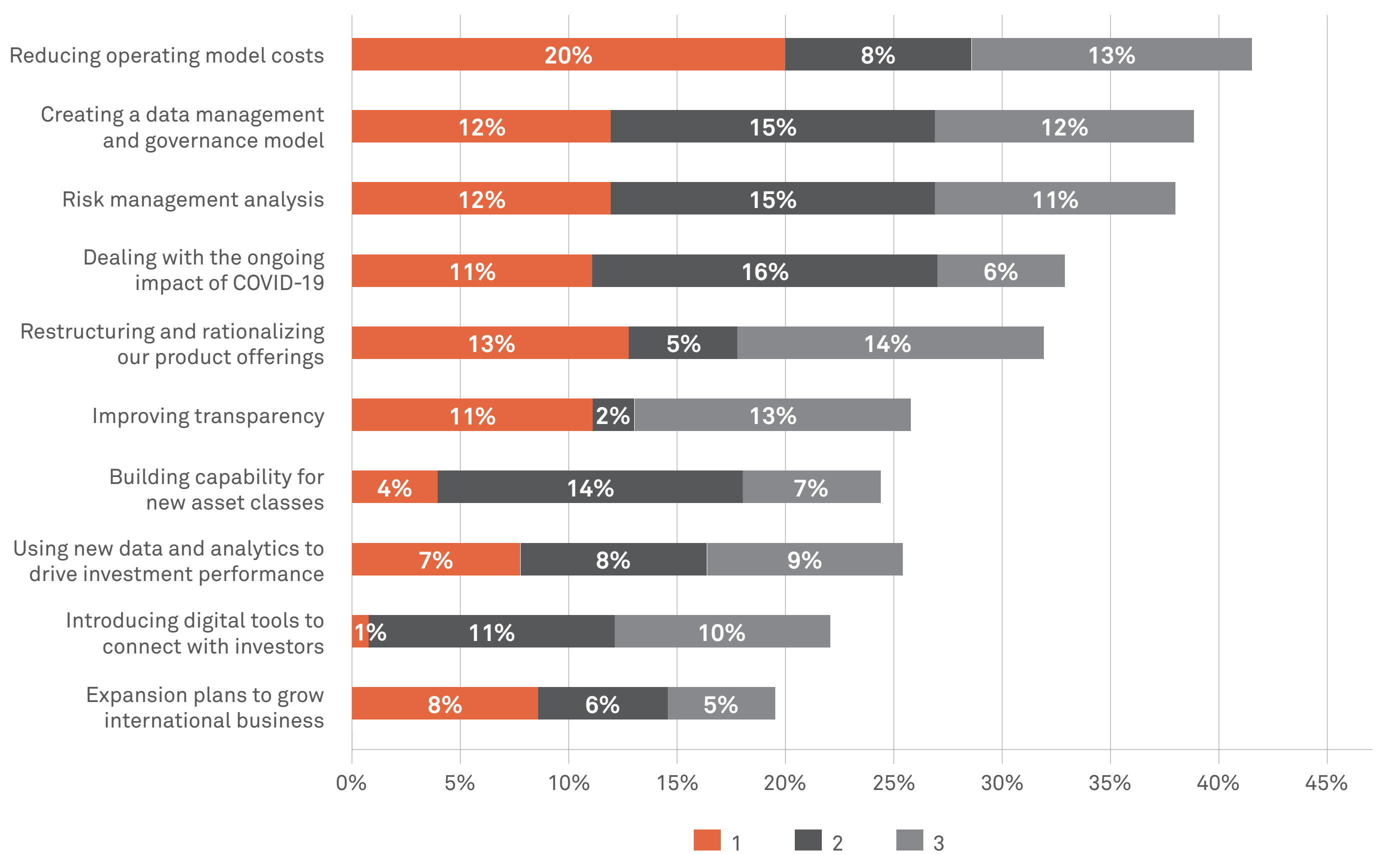
Transparency: *The View Depends on Where You Stand*

Strategic priorities for alternative asset managers show some divergence from investor views, especially when it comes to transparency.

For asset managers, the emphasis is on inward-looking factors, ranking reduced operating model costs first. Restructuring and rationalizing product offerings is next in line, followed by risk management analysis and creating a data management and governance model to support growth.

Specifically, the priority of risk management analysis may reflect a desire to understand how investments might perform in a changed economic environment. Significant shifts in business and consumer behavior have occurred in the wake of COVID-19. Such capabilities can present new opportunities and uncover previously unforeseen risks and challenges due to major geopolitical or economic developments.

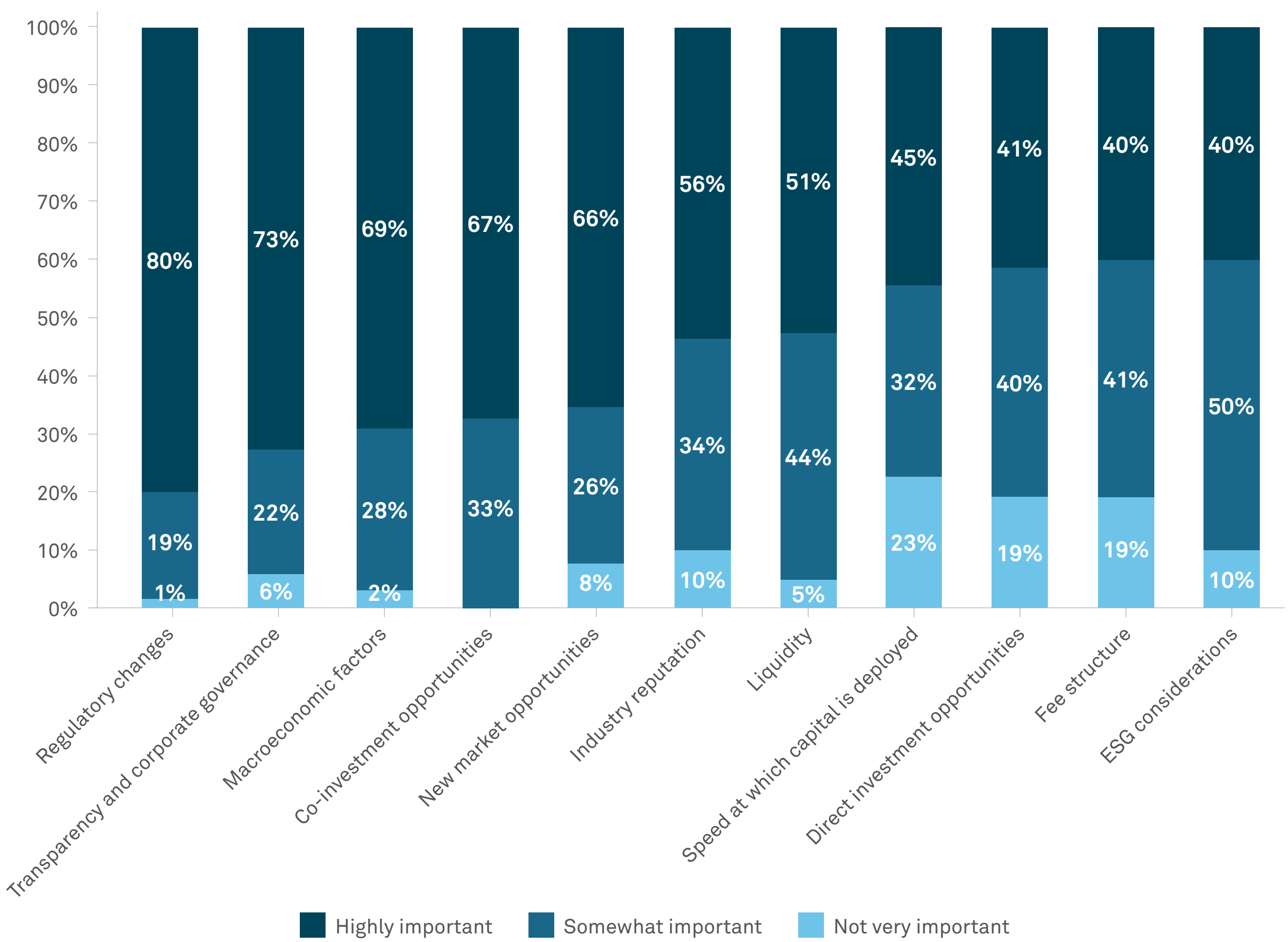
What are your strategic priorities? (Select top three.)



By comparison, one factor that matters greatly to investors places lower on asset managers' agendas. Improving transparency fell below 30% in our 2021 research, a marked shift from our 2017 study when 71% of asset managers surveyed said they would "offer more transparency in the next 12 months" to investors.[2]

However, even in 2021, investors name transparency as one of the main barriers to investment in some alternatives. It is second to macroeconomic factors for private debt and at the top of the list for hedge funds. For private equity, 73% of investors describe transparency and corporate governance as highly important when deciding to maintain or increase their allocations.

How important are the following factors when deciding whether to maintain or increase your PE allocations?



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

It may not be a total divergence in priorities, however. By prioritizing data management, managers could already be taking steps towards providing the transparency investors crave.

For example, in private markets, information often comes in an unstructured format, with data difficult to extract and report in an easily digestible way. The significant differences between the requirements of investors compound this difficulty. Providing transparency at scale to a wide variety of investors may require alternative asset managers to direct significant resources toward creating manageable data pools before they can extract the right information.

"Demands for greater transparency have raised concerns about how much information provision is ideal."

—Head of Investments (Private Equity Fund), China

It is also important to point out that alternative asset managers have already expended considerable resources on improving investor reporting. Part of the reason for the apparent disconnect around transparency may stem from a divergence between the reporting alternative asset managers need for their own purposes and the varying requirements of different investor types.

> *"Even if the asset manager is providing full and timely transparency on the dimensions that make sense for their particular strategy, an asset owner will have significant data challenges in mapping their own risks and exposures across strategies."*
>
> ***—Frances Barney,*** *CFA, Head of Global Risk Solutions, BNY Mellon*

For example, in private equity, the Institutional Limited Partners Association (ILPA) has led several initiatives to encourage improved reporting over the past five years, including a reporting template for fees, carried interest and expenses and a portfolio company metrics template. Initiatives such as these have aimed to foster best practices and bring standardization to the market.

The pandemic has also had a more recent impact by raising the bar on what investors expect from their alternative asset managers. In the early stages of lockdown, many managers provided investors with detailed fund- and asset-level information to help them understand the impact of COVID-19 on their portfolios. Nearly two-thirds of private markets fund managers (63%) surveyed recently by IHS Markit said they had perceived a change in the depth and breadth of reporting required by stakeholders.[3]

[3] https://ihsmarkit.com/research-analysis/under-pressure-are-private-equity-firms-prepared-for-the-data-.html, April 30, 2021

Fees Remain a Point of Contention

Fees remain a negotiation point for investors. Still, fee pressure falls strikingly far down the list of challenges identified in our survey.

Only 4% of alternative asset managers say fee pressure is the most important challenge they face in the near term, the smallest share of any answer option. Just 13% describe it as a top-three issue. In terms of competitiveness in the market, a mere 1% of alternative asset managers surveyed say that fees are the single most important factor.

For investors, talk about fees depends on the type of alternative asset. They direct most of their attention to fees at private equity and hedge funds. As mentioned earlier in this report, 31% of investors surveyed (the largest share) identify lower or custom fee structures as a major secondary concern for increasing their hedge fund allocation to managed accounts. When deciding whether to maintain or increase their PE allocations, 81% of investors identify fee structure as either highly or somewhat important. By contrast, in 2017, 97% of investors said fee structure is important when considering asset managers.[4]

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

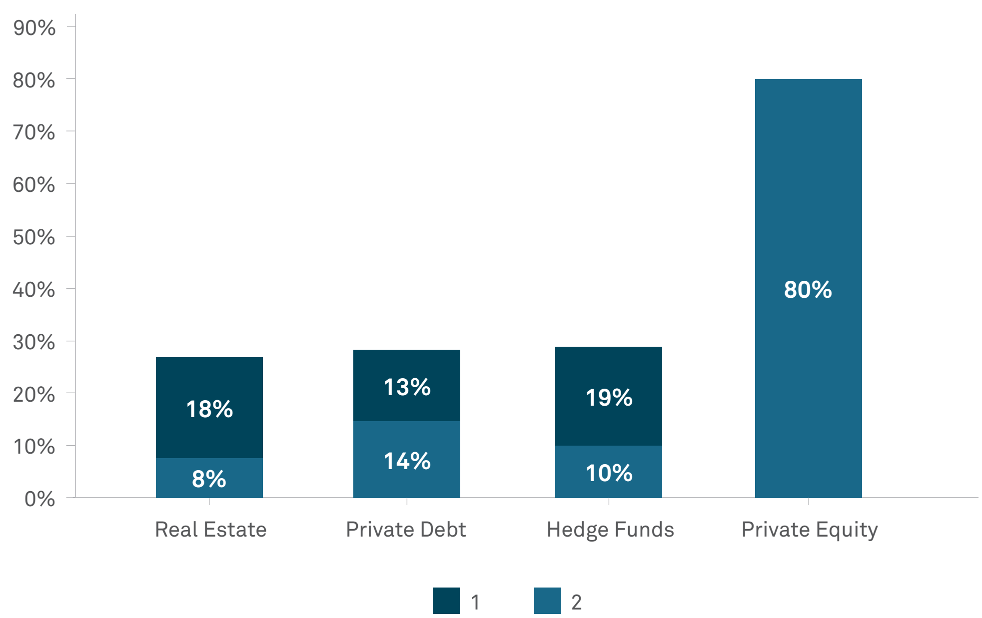
> *"There is increased pressure to reduce fees. Clients are making comparisons, without necessarily appreciating the impact on the quality of performance and returns."*
>
> ***—Managing Director (Hedge Fund), United States***

Regulatory Challenges Pose Obstacles, *Real and Perceived*

Among institutional investors, 80% consider regulatory changes as highly important in their allocation decisions for private equity. This is the highest response for the question, mirroring the responses of our 2017 survey.

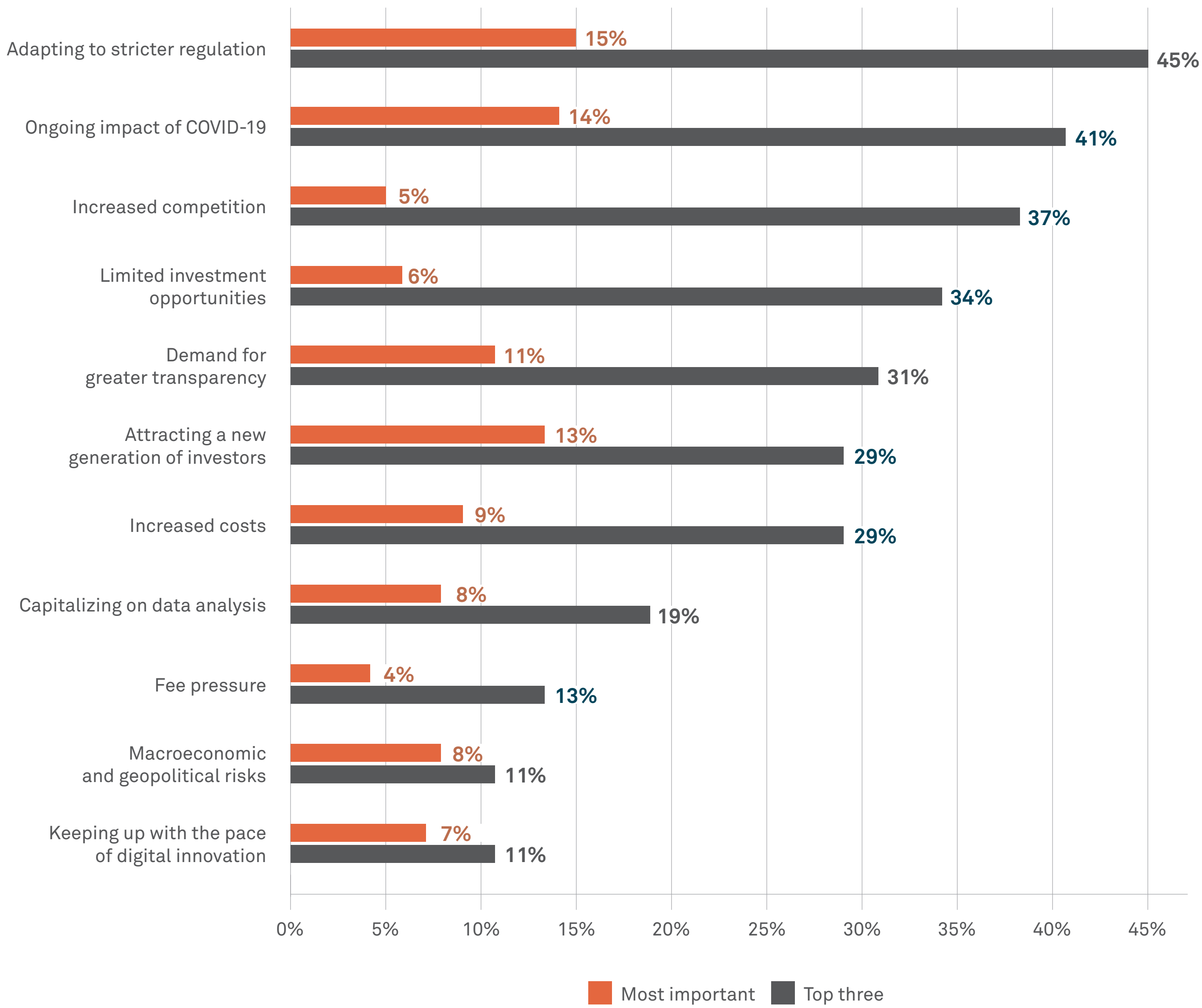
Regulatory changes are also high up the list of obstacles investors face when deciding whether to allocate more towards private debt and real estate, where this is the third biggest barrier.

Investor Perceptions of Regulatory Change as #1 or #2 Obstacle to Allocation



These responses align closely with those of alternative asset managers, for whom adapting to stricter regulation is the biggest short-term challenge.

What are the main near-term challenges facing your organization?



"The pandemic has seen a flight to data. There is a lot of detail in real estate and, while reporting may have been pretty good in many parts of the industry already, COVID-19 saw increasing information requests, some of which may become standard."

—**Neal Armstrong,** *Head of U.S. Real Estate Services, BNY Mellon*

Alternative investments have contended with increasing regulation for some time—an inevitable consequence of their growing significance in the economy and investors' portfolios. Managers also face an increasingly complicated web of regulation when expanding into new products and geographies.

A handful of regulatory initiatives stand out for their significance to alternative as well as traditional asset managers.

- Alternative Investment Fund Managers Directive (EU)
- Uncleared margin rules for OTC derivatives (U.S.)
- Prudential rules for private fund managers (U.K.)
- Private Funds Act, revisions to Anti-Money Laundering (AML) regulations, and revisions to the Cayman Islands Monetary Authority's (CIMA) administrative fines regime (Cayman Islands)
- LIBOR cessation (global)
- ESG-related regulation (U.S. and EU):
  - Considerations for the Advisers Act, the Investment Company Act, and ERISA, as well as stated examination priorities issued by the SEC's Office of Compliance Inspections and Examinations ("OCIE") and the formation of the ESG Subcommittee of the SEC's Asset Management Advisory Committee ("AMAC")[5]
  - New EU regulations such as the Sustainable Finance Disclosure Regulation (SFDR) and other ESG-related legislative activity

As a result, some alternative asset managers may concentrate on regions where regulation has a lighter touch. However, another view is that increasing regulation will allow alternative asset managers to attract new pools of currently-constrained capital. As regulatory frameworks for alternatives become more aligned to those in mainstream investments, the case builds for unlocking sources of capital from investors under regulation that currently prevents them from investing in this part of the market.

[5] https://www.dechert.com/content/dam/dechert%20files/knowledge/publication/2021/3/Environmental-Social-And-Governance-Investing-Considerations-US-And-EU.pdf

“With regulations becoming stricter, we will have to involve more consultants and advisory firms as we consider new market entry positions. It’s a risk, but we cannot postpone plans because of regulatory pressures.”

—Investment Director (Multi-Asset Fund), United States

“For long-term growth opportunities, Asia-Pacific markets are ideal, followed by Sub-Saharan Africa. The main reason is the ease of investing in these regions–regulations are not as strict as in Europe or the Americas.”

—Private Equity Fund Manager, Australia

Macro Concerns Vary *by Asset Class*

Investors cited macroeconomic factors as a substantial obstacle to allocating more capital to hedge funds (second most popular answer, with 34% identifying this as a top-two hurdle) and in real estate and private debt (top answer for both, with 31% and 39%, respectively). However, for alternative asset managers, macroeconomic and geopolitical risks are second from the bottom in their list of near-term challenges.

This difference of opinion may reflect the fact that many managers, while dealing with some difficult situations in their existing portfolios, perceive longer-term opportunities in a period of dislocation. Many private credit funds, for example, have relatively broad mandates, enabling them to target opportunities appropriate to different stages of the cycle.

In addition, as discussed in Chapter 1 of *From Alternative to Mainstream,* many investors view real estate as a solid countercyclical option despite the challenges faced by the segments most affected by COVID-19. Given its high levels of dry powder, private equity may also be in a good position to generate strong returns through a downturn.

> *"In the long term, there are opportunities as industries look to consolidate and private equity funds can capitalize on lower valuations."*
>
> ***—Investment Director (Multi-Asset Fund), United States***

Competitive Questions, *Bespoke Answers*

Alternative asset managers see increased competition as the third biggest near-term challenge to their organization, with 37% selecting it as a top-three issue.

"The increase in competition is one of the main considerations because we have to invest in constant growth and look for inorganic expansion measures."

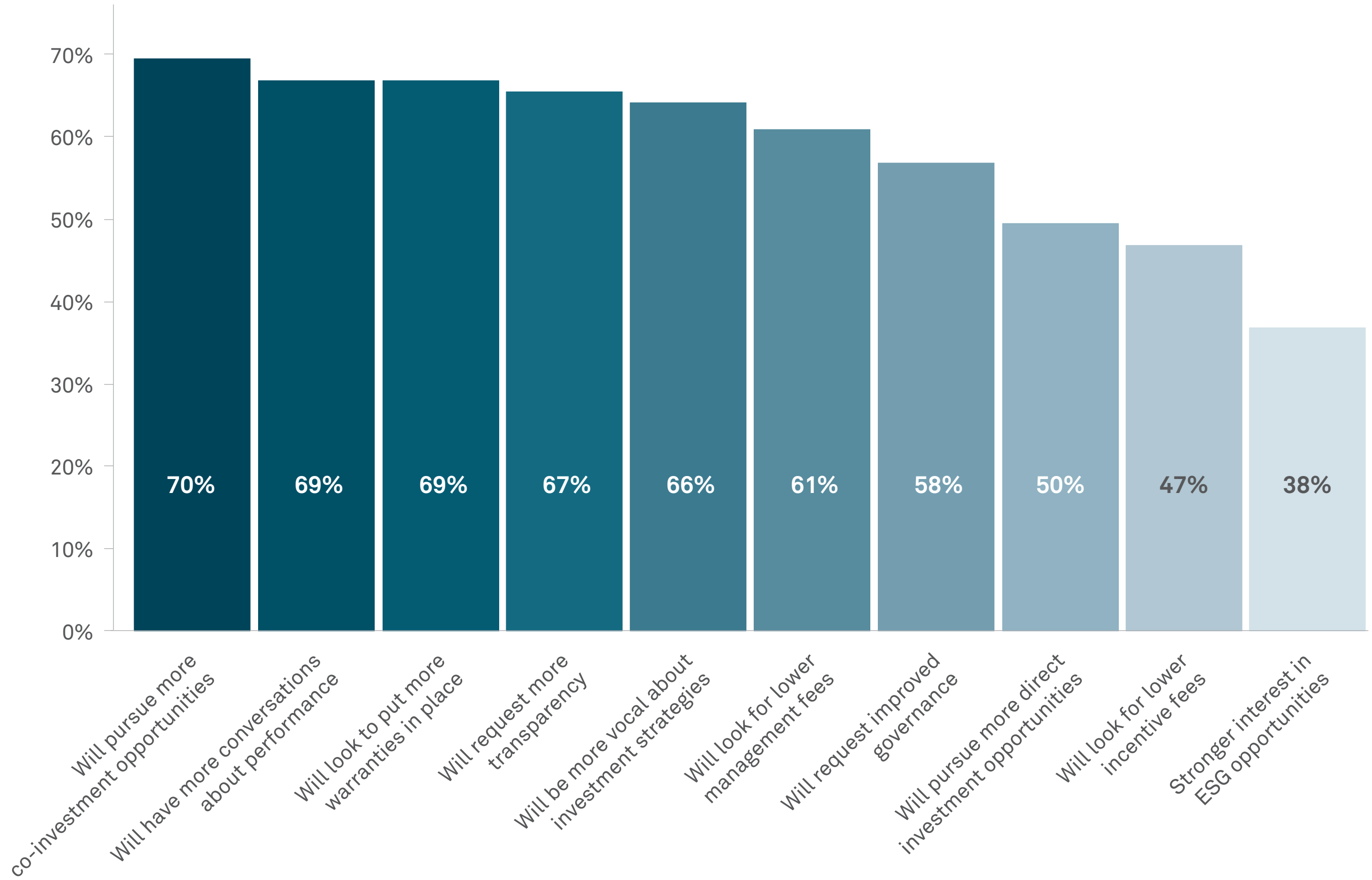
—Managing Director (private debt fund), United States

One response is to offer bespoke solutions across a variety of strategies and access points to meet differing investor needs. Providing investors more control and exposure at a granular level while also potentially reducing fees and growing assets under management (AUM) can be an attractive competitive proposition. The rise of co-investments in private equity, managed accounts in hedge funds and separate accounts in private debt are part of this move towards customization.

Investor appetite for these strategies is especially apparent in private equity. Our survey shows investors will increasingly look for co-investment opportunities from their private equity managers as they seek exposure to investments with low-to-no management fees. As shown above, a full 100% of survey respondents say that the opportunity to co-invest is highly or somewhat important.

Demand for co-investments is evident in responses to how investors expect to change their approach to investing in private equity over the next 12 months as well. Here, the top answer is pursuing more co-investment opportunities. Pursuing co-investment is even slightly ahead of conversations about performance and requesting more transparency. At 100%, it is also a significant jump from our 2017 survey when only 17% of respondents said they would look for co-investments.

In which ways do you expect your approach to investing in PE to change in the next 12 months?



Co-investment values and volumes—already on the rise—look set to swell over the next year. Figures for this part of the market are difficult to collate since deals and their details are rarely made public, but estimates by advisory firm Triago suggest that 2019 saw co-investments worth US$66 billion, up from US$55 billion a year earlier.[6]

[6] https://www.privateequityinternational.com/pei-300-through-co-investment-lps-share-the-dealmaking-burden/

“We’ve seen a lot of activity in separate accounts in private debt since the pandemic as large managers seek single investors to target specific opportunities.”

—Dermot Finnegan,
Global Head of Private Markets
Fund Administration, BNY Mellon

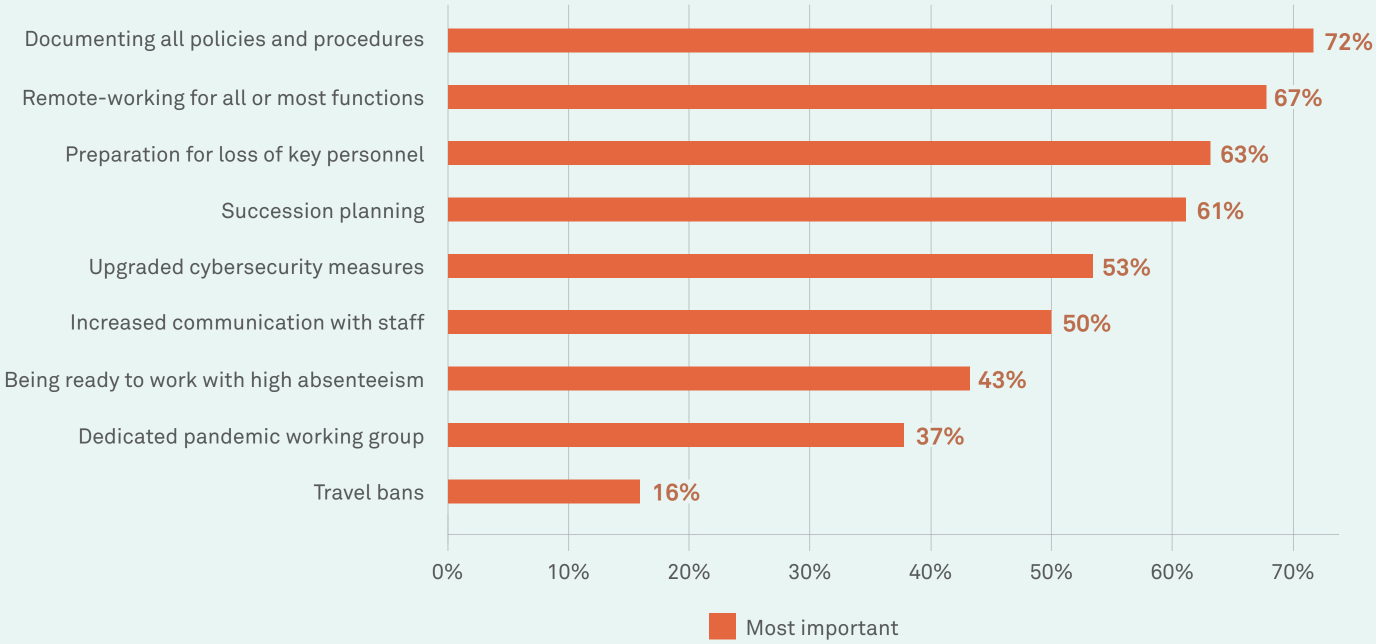
COVID-19 Challenges Continue

The ongoing impact of COVID-19 represents alternative asset managers' second-biggest near-term organizational challenge, with 41% mentioning it in their top three. COVID-19 also adds to the challenge of limited investment opportunities, with more than one-third (34%) naming this factor a top-three challenge. *(See chart p. 13)*

Alternative asset managers are working through these challenges on several fronts. The greatest business continuity priority is documenting all policies and procedures, followed by work-from-home for all or most functions, preparation for the loss of key personnel and succession planning.

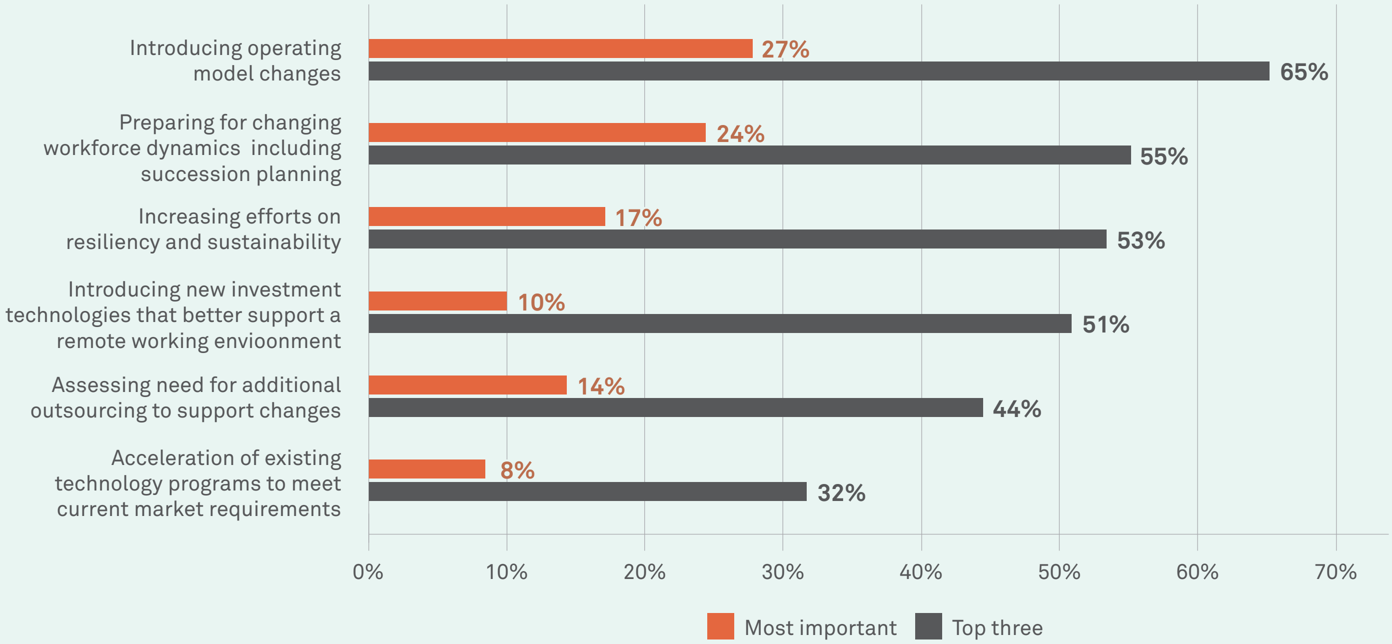
Upgrading cybersecurity measures sits in the middle of the pack. Presumably, cybersecurity has been an ongoing workstream for many years now, but it may be that some alternative asset managers are in danger of complacency. Reports of cyber-attacks on managers have increased substantially since the start of the pandemic and there have been some successful high-profile malware attacks.

What plans have you put in place to maintain business continuity during the COVID-19 crisis?



The pandemic has also led to a shift in priorities for alternative asset managers. Nearly two-thirds say they are introducing operating model changes, which will likely increase efficiency and enable the fourth-ranked priority of supporting remote working through increased technology adoption. They also have their eye on succession and changing workforce dynamics, again reflecting a move towards more remote working patterns. Increasing efforts on resilience and scalability come in a close third. Nearly half are assessing the need for additional outsourcing to support changes.

As a result of the pandemic, how do you envisage your priorities shifting?



"Short-term returns have slumped because of COVID-19. Sourcing new opportunities has been difficult because of physical restrictions."

—Managing Director (Private Equity Fund), South Korea

Conclusion

Given the factors that investors prioritize, we believe alternative asset managers will look to bespoke solutions, compelling strategies and levels of transparency as significant sources of their greatest competitive advantages. Performance conversations and warranties may also come under consideration. With these conditions and the broader picture of investor demand in mind, alternative investment managers will have to adjust course to thrive by meeting demand with flexibility.

We summarize these efforts with the following six observations:

- Performance is paramount.
- Risk management analysis attempts to relate performance to the changing investment environment.
- Alternative asset managers need to create manageable data pools to extract the right information.
- There is ongoing and increased pressure to reduce fees.
- Increasing regulation may offer a silver lining by letting alternative asset managers unlock new pools of currently constrained capital.
- Investors are looking to co-investment opportunities to reduce management fees.

Despite the risks and challenges generated by the COVID-19 downturn, many alternative asset managers perceive longer-term opportunities in a period of dislocation. Those able to react with agility may be positioned to outperform their competitors.

Coming Attractions

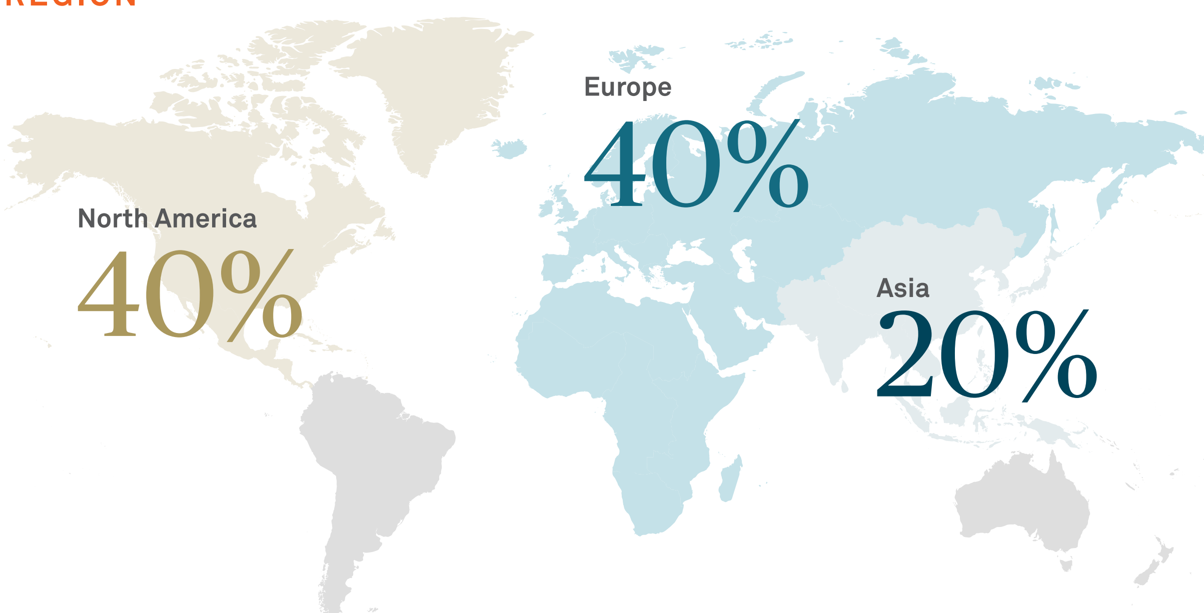
Over the coming months, BNY Mellon will release the detailed findings from this wide-ranging alternative investments study. The next two chapters will focus on how asset managers will shift as the industry evolves and adapts and as alternative investments move towards the mainstream.

- **Going and Growing Digital —** Highlights how data, technology and outsourcing are the future of alternative 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.

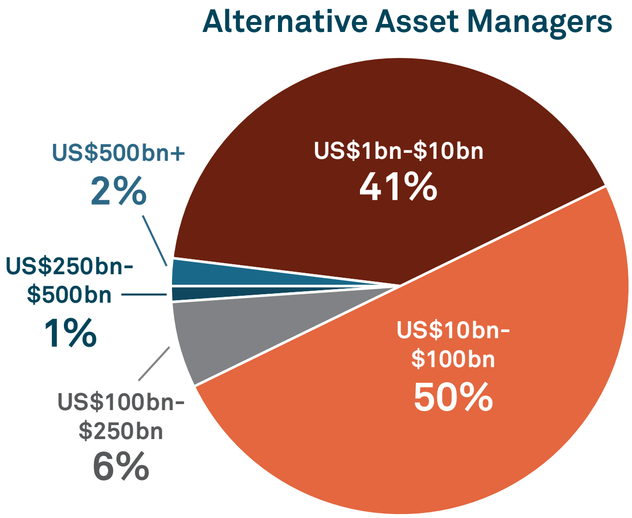
Appendix: *Methodology*

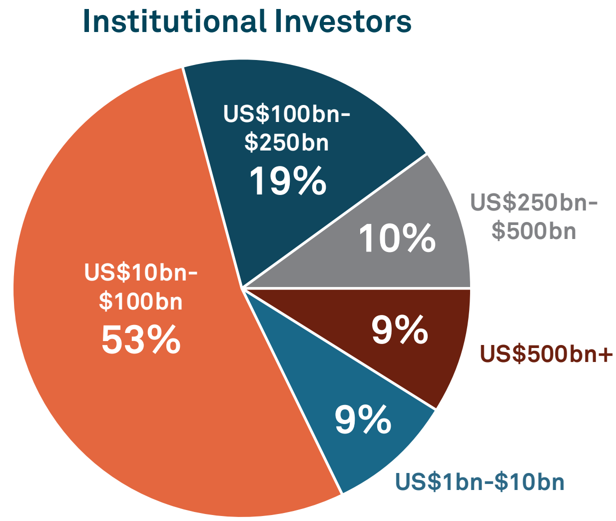
In Q3 and early Q4 of 2020, Mergermarket surveyed 100 alternative asset managers and 100 institutional investors from the US, EMEA and Asia-Pacific regions to gain insights into key trends in the alternative assets space. C-level and senior executives (job titles: Chief Executive Officer, Chief Investment 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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