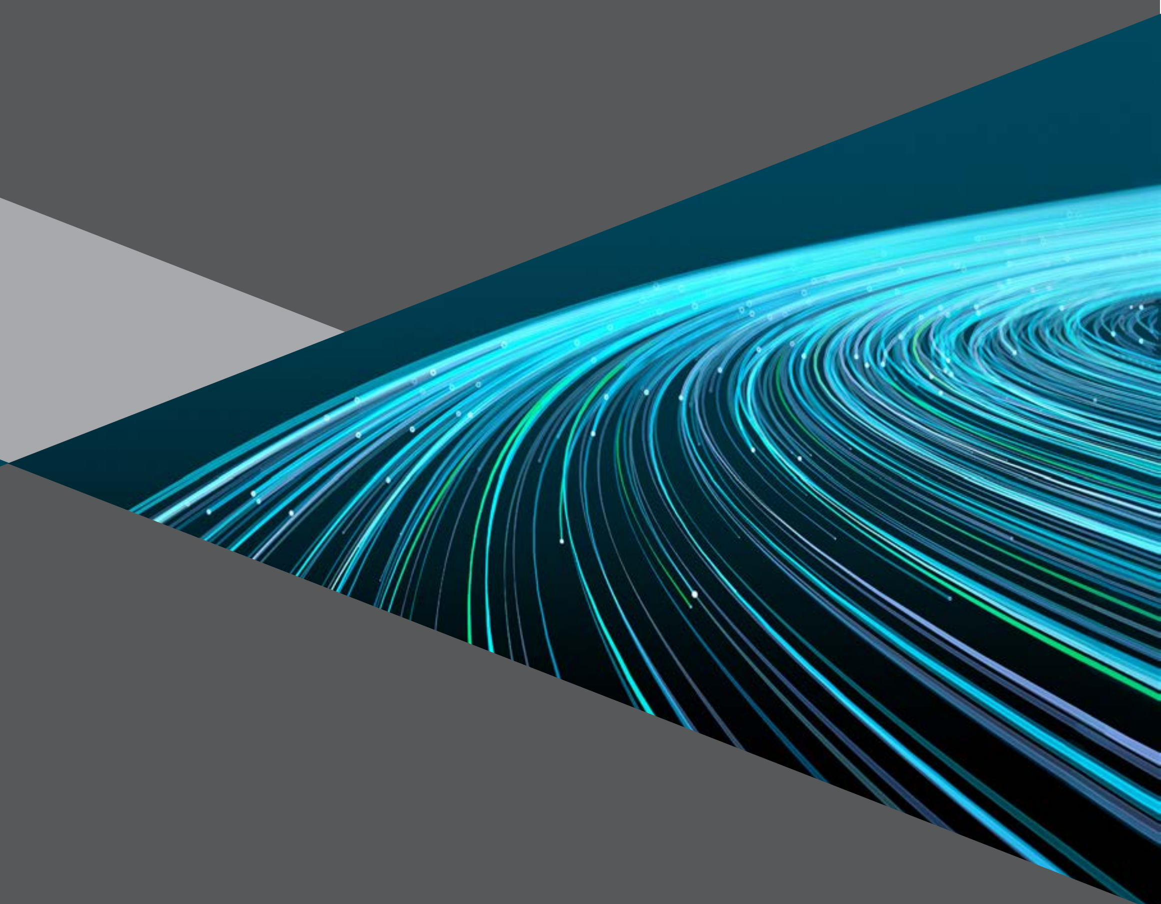
BNY MELLON

CHAPTER

4

From Alternative *to Mainstream*

Looking Towards the Future



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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.[1]

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 previous chapters of *From Alternative to Mainstream*, we provided in-depth data and analysis on alternative asset classes (Chapter 1: *Alternatives Ascending*), asset managers' strategic priorities for pursuing growth (Chapter 2: *Getting Ready for Growth*), and the critical role of data, technology and outsourcing as alternatives move to the mainstream (Chapter 3: *Going and Growing Digital*). In this final chapter, we examine the new products, channels and sources of capital transforming the industry and highlight areas where managers can expect the next big market opportunities.

[1]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 4: *Looking Towards the Future*

New products, new money and new channels are having a transformative effect on alternative asset managers.

After a decade of stellar growth, alternative asset managers stand at the precipice of profound change. Many are looking to build up or refocus their firms' operations to adapt to new market opportunities and manage potential threats.

Structural Change *Intensifies*

The most significant factor driving structural change in managers' organizations is increased competition, mentioned by 50% of respondents as a top-three issue. The concentration of capital among the largest alternative asset managers may help explain this perception. According to Private Equity International, ten of the largest private equity funds raised in the first three quarters of 2021 accounted for 26% of total fundraising.

Many large firms are also becoming multi-asset managers in a bid to provide investors with a one-stop shop for their alternatives exposure. In BNY Mellon's broader industry survey, *"Asset Management: Transformation Is Already Here,"* we found that 72% of asset managers expect to increase their offerings across hedge fund, private equity, private debt, infrastructure, and real estate vehicles.[2] Such firms can use their scale to provide a menu of more bespoke options and maintain blue-chip reputations among investors.

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

Other managers can struggle to compete with these large firms on fees and investment strategies. There is still plenty of room for smaller players specializing in specific niches, but the middle ground looks set to be increasingly tough territory.

Changing industry economics contribute to further pressure for alternative asset managers. Respondents rank that as the third biggest factor driving structural change, placed in the top three by 39% of respondents and garnering the largest share (19%) of most-important votes.

For example, hedge funds largely said goodbye to the traditional "two and twenty" fee model long ago, with management fees at an average of 1.37% and performance fees at 16.36% at the end of Q3 2020, according to HFR[3].

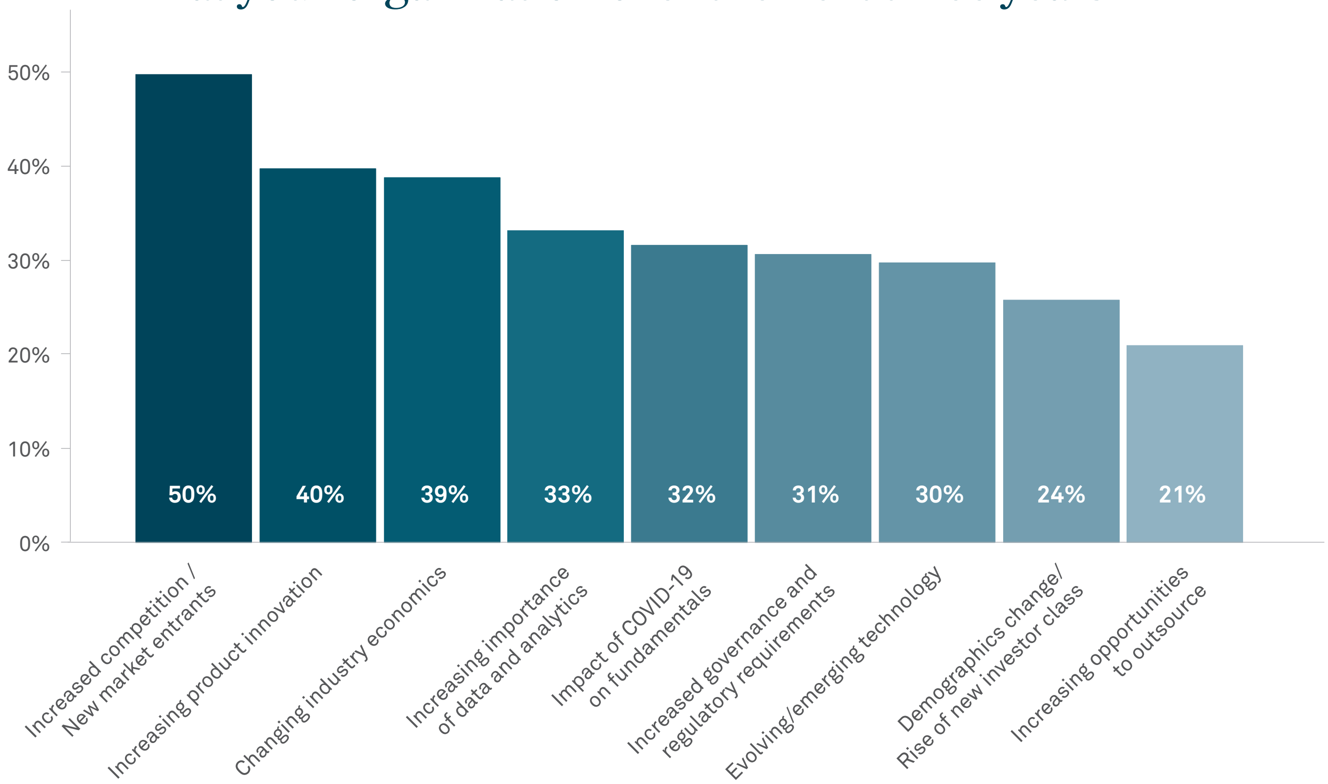
Other alternatives have not been immune to fee pressure either. The trend towards co-investments in private equity, for example, is in part an attempt by investors to decrease the average cost of investing since management fees and carried interest are either lower or not levied on such investments.

Increasing product innovation is also a crucial factor behind structural changes at alternative asset management firms, with 40% placing it in the top three. This ranking is perhaps unsurprising in a market that identifies competition and changing industry economics as major factors. Product innovation can help asset managers address both these points.

[3] https://www.hfr.com/news/hedge-fund-launches-rise-as-industry-positions-for-growth-in-2021

Other factors driving innovation include the adoption of digital technologies, demographic shifts (younger investors have very different expectations from their predecessors), and the rise of new investor classes, including retail.

What factors will most likely drive structural changes at your organization over the next three years?



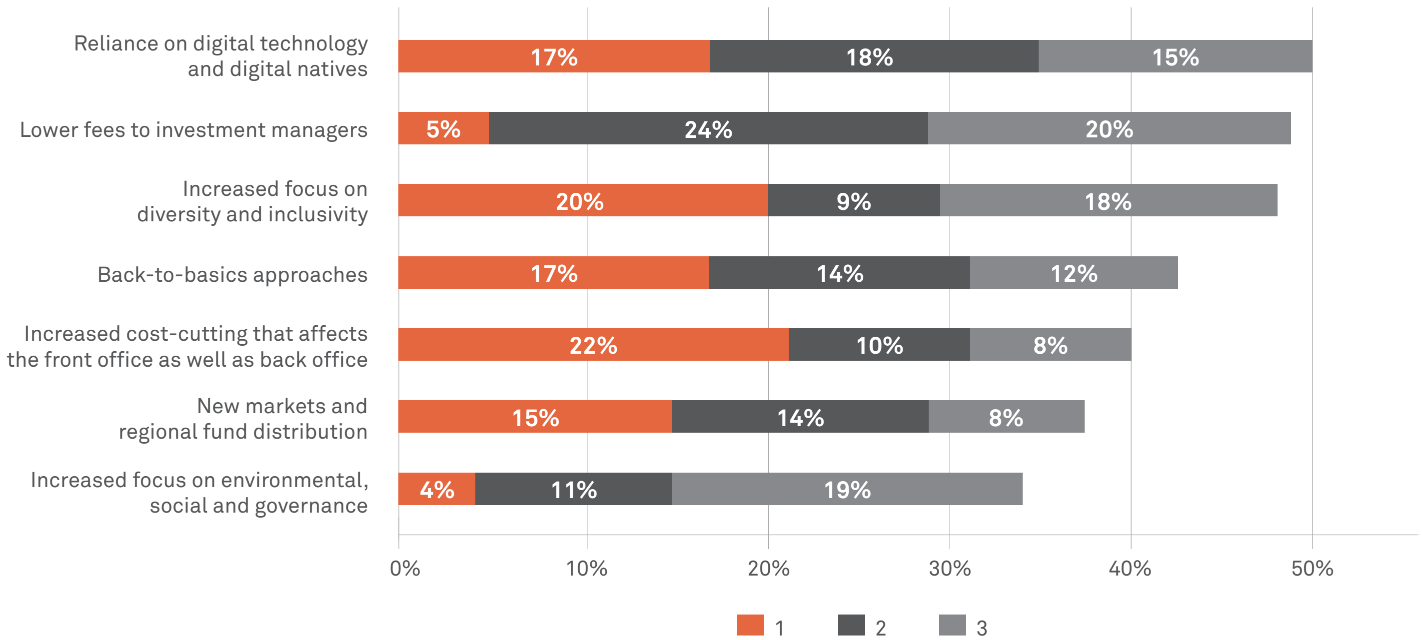
All of these factors are apparent in the most significant trends that managers identify for the alternative investing space over the next 12 months.

> *"There is more competition from global players, and new entrants to alternatives assets have been doing well. They are offering lower management fees to their clients, which has attracted our attention."*

—Partner (Hedge Fund), United Kingdom

Reliance on digital technology and digital natives is the most commonly cited factor overall. However, with 22% of first-place votes, the number-one trend is increased cost-cutting that affects both front and back offices.

What do you predict will be the most significant trends in the alternative asset investing space over the next 12 months?



"Investors are raising the bar on their investment organizations; they want to allocate to organizations that promote and embrace people with a range of gender, experience and cultural backgrounds to enhance decision-making and improve investment outcomes."

—Kenny King, Head of Alternatives, *Asset Servicing, BNY Mellon*

In second place is an increased focus on diversity and inclusivity. Attention paid to surging social and racial inequalities has left a mark on the alternative investment industry. Our survey suggests there is now a greater understanding that diversity can improve decision-making within the industry.

Investors and industry associations are helping promote the diversity and inclusion agenda as well. In summer 2020, the Alternative Investment Management Association (AIMA) teamed up with Albourne Partners to develop a new diversity and inclusion questionnaire for hedge funds. At the end of 2020, the Institutional Limited Partners Association (ILPA) launched its Diversity in Action initiative to make the private equity industry more diverse and inclusive.

"Product innovation is important because of the demographic changes. Clients expect portfolio management tools and real-time information. Innovation can take time, but we have to be patient."

—Head of Investments (Private Equity Fund), China

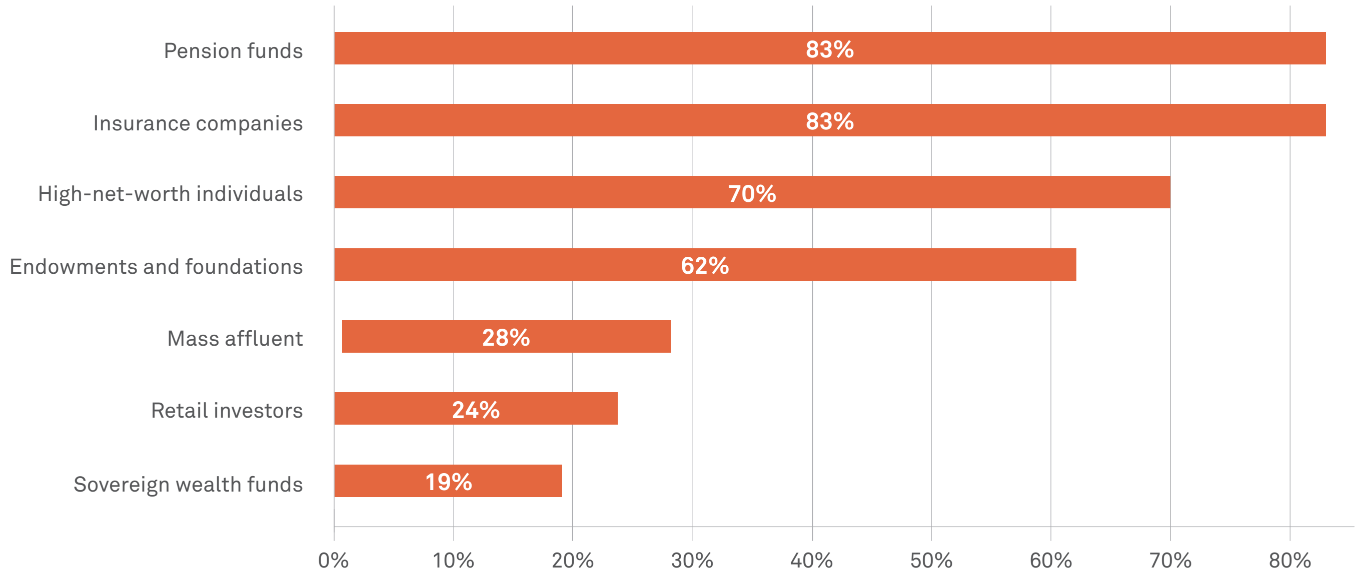
Sources of *New Money*

When it comes to the sources of future capital for alternative assets, 83% of managers are anticipating growth in commitments from their existing insurance company and pension fund investors, with endowments and foundations coming in second.

However, the strong showing of high-net-worth individuals as sources of future capital is worth noting. Much of this capital is likely to be directed at alternatives through family offices, an investor class that has expanded significantly over the past few years.

Global Family Office Report 2019 from UBS and in partnership with Campden Wealth Research found that the number of single-family offices had risen by 38% over the preceding two years to 7,300. According to the same annual report in 2021, family offices' institutional approach to asset allocation, with approximately 40% dedicated to alternative investments, generated solid returns in 2020. Based on the year's average global strategic asset allocation, in U.S. dollars, a notional portfolio would have yielded a return of 8.1%, with a downside risk of 11.9%.

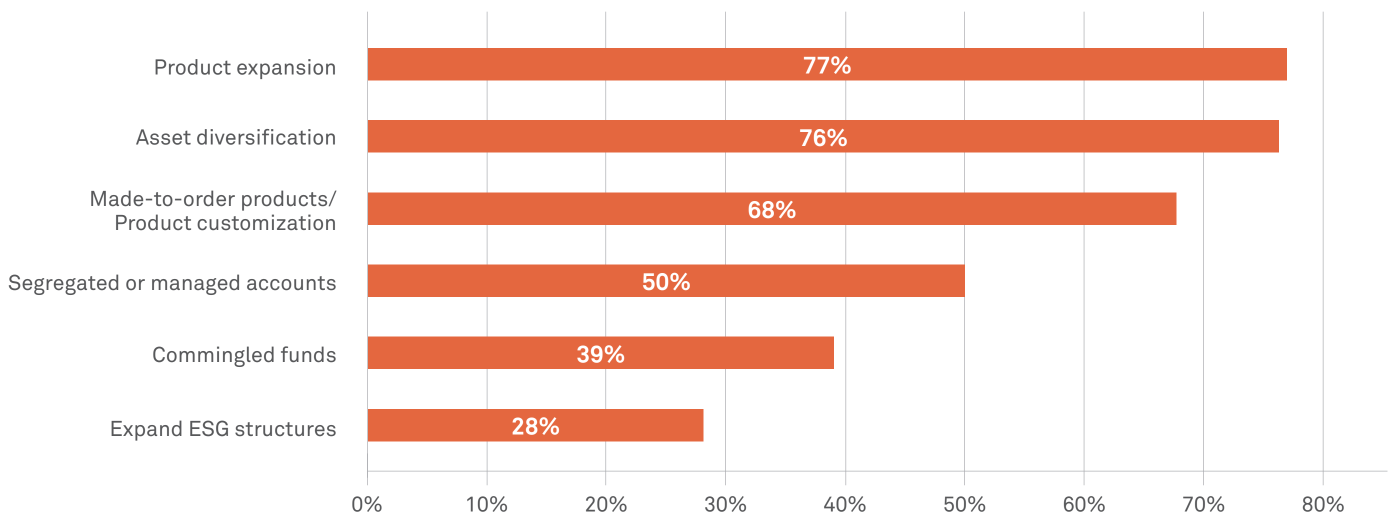
Within your customer base, in which of the following investor classes do you expect to see growth in levels of investment over the next three years?



Alternative asset managers are looking to adopt numerous strategies to target the investor classes they see as offering the most growth potential. Over three-quarters are expanding their product offering and diversifying assets.

However, the most critical strategy, echoing some of the survey's other findings around co-investments, is building made-to-measure or customized products as a means of growing assets under management (AUM). Asset managers must also pay attention to their ability to attract up-and-coming investors, including segments at greater scale.

Which strategies are you employing to target the investor class where you expect to see the most growth?



"New investor classes are driving change in engagement and fundraising practices. It is a continuous process, and we are looking at the most functional way to work on the planned structural changes."

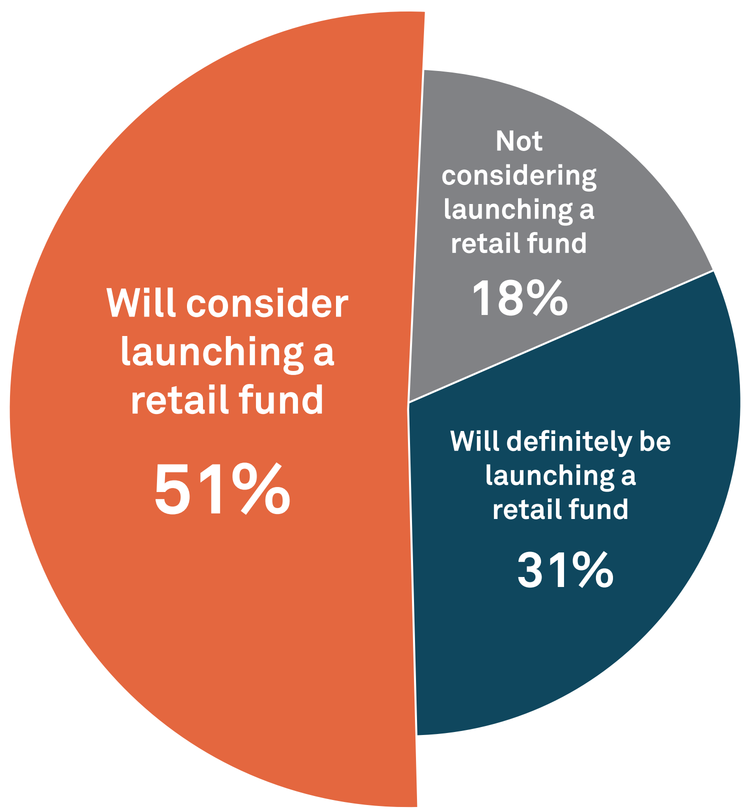
—Managing Director (Private Equity Fund), United States

The Coming *Retail Revolution*

While retail investors currently account for a small proportion of alternative asset managers' pools of capital, the next few years could see some significant changes. The industry has discussed this trend for many years as savings products such as retirement plans become increasingly individualized and as defined benefit schemes are phased out.

Nearly one-third of managers in our survey say they will definitely launch an alternative investment fund aimed at the retail market, with even more saying they will consider doing so.

What are your plans for setting up an alternative investment fund for retail investors in the next 12 months?



"We will see more individual investors looking to access alternative investments. While this raises questions around liquidity, we will see asset managers create wrappers that enable individuals to invest smaller ticket sizes, most likely via intermediaries."

—**Daniel Tennant,** *Managing Director, Global Client Management, Alternatives, BNY Mellon*

Meanwhile, public markets investments have become increasingly concentrated in large companies in sectors like technology, reducing investors' options and their ability to build in diversification. By December 2021, Apple, Microsoft, Amazon, Tesla and Google accounted for 24% of the S&P 500 Index market capitalization.[4]

In response to this ongoing trend, the U.S. Securities and Exchange Commission issued regulatory guidance in 2020 that could expand retail investor access to alternatives. While precise proposals are not yet in place, this guidance may even allow private markets investments such as private equity in 401(k) pension plans. Any move on this front could precipitate an avalanche of retail capital into alternatives.

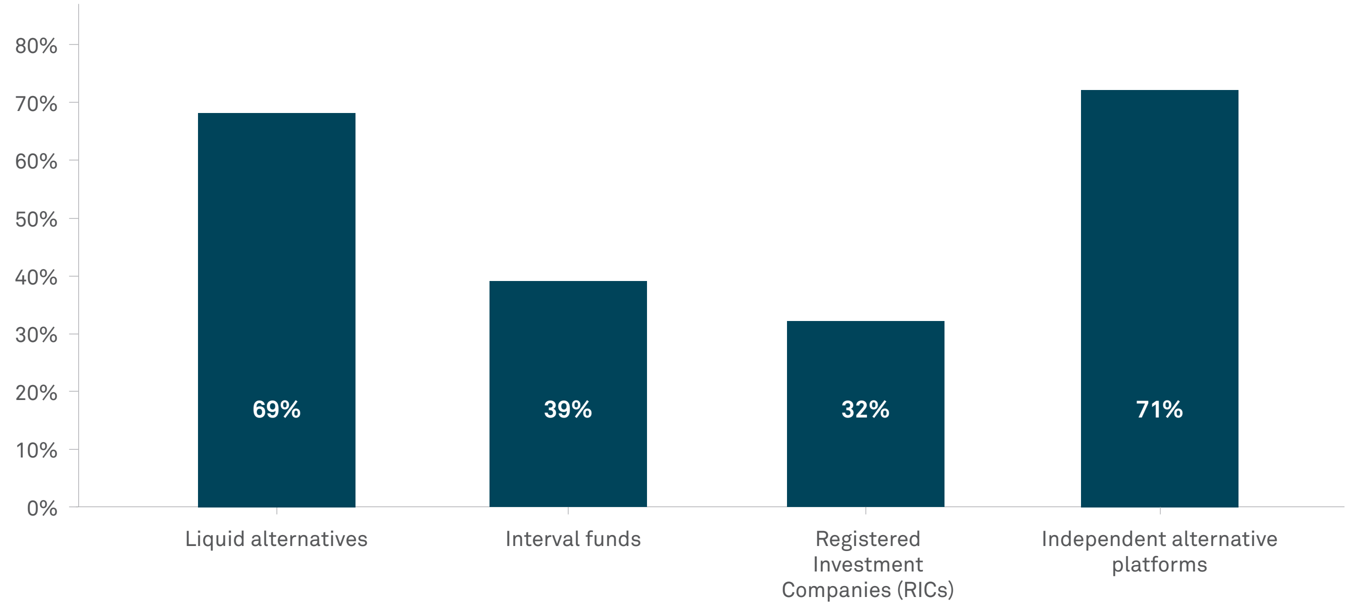
To attract retail capital, alternative asset managers will need to put significant effort into designing the right products with liquidity appropriate for the retail space, as well as building effective distribution channels. Many will be quite unfamiliar with these areas.

As a way to tap into the retail market, respondents' flag independent alternative platforms and liquid alternatives funds as the preferred options over Registered Investment Companies (RICs). This sentiment implies more of an appetite for direct exposure to alternatives rather than through intermediaries.

> *"As traditional pension funds give way to more individually administered savings plans, asset managers will need to tap new sources of capital. The move to attracting retail investors will drive innovation in fund structures, distribution and investor choice.*
>
> ***—Megan Gentilesco,** Director, Alternative Investment Services, BNY Mellon*

[4] As of market close December 2, 2021

What type of alternative investment fund or strategy are you considering to engage retail investors?



ESG:
A Changing World

Environmental, social and governance (ESG) considerations have continued to rise on the investment agenda. Many investors now view sustainability as a key part of their stewardship role in managing long-term capital.

In the alternative asset investment sphere, 61% of the 400 LPs polled by Preqin in 2020 believe that ESG will become an integral part of the industry over the next three years.[5] As of October 2021, Preqin estimates there are US$3.10 trillion of private capital assets under management (AUM) managed by firms that are committed to ESG investing, representing 36% of total private capital AUM ($8.52 trillion).

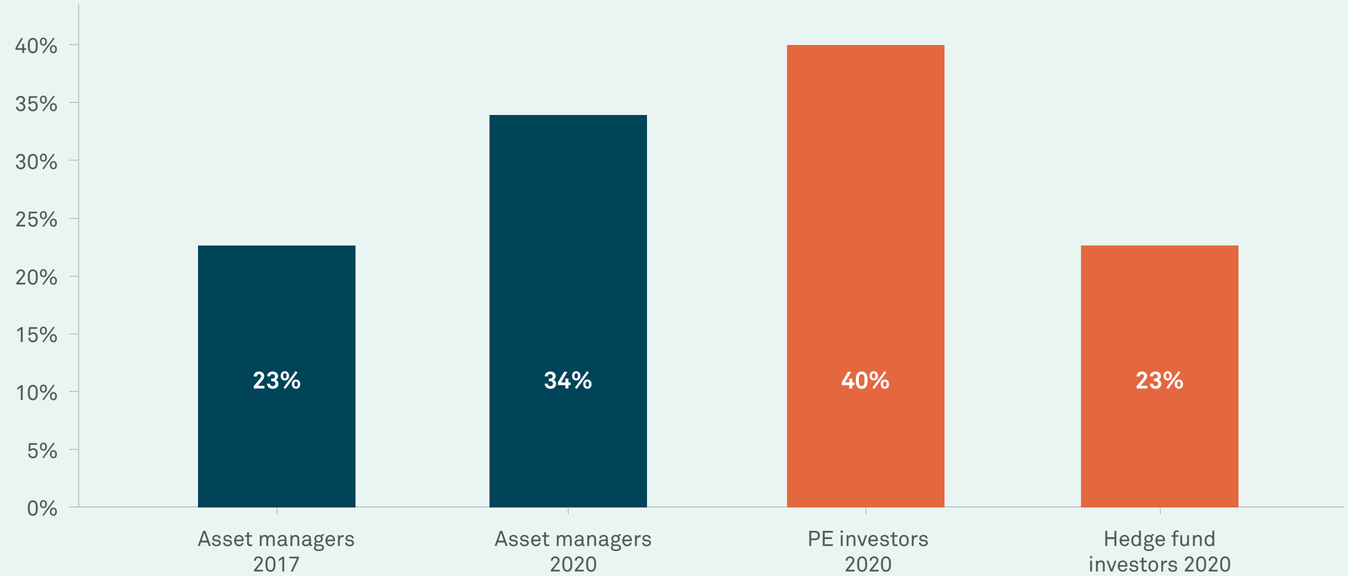
The views of alternative asset manager participants in our survey show that ESG is a significant trend in the space, even as they focus on other trends such as cost-cutting or diversity and inclusion. Overall, increased focus on ESG garnered 34% of top-three responses on significant trends in the space, up from 23% in 2017.

While ESG does appear on the radar, however, just 4% identify ESG as the most significant trend for the next 12 months.

This view of ESG supports the results from our broader asset management study, in which 50% of respondents say they are looking to increase ESG strategies overall. Even with a greater focus on ESG considerations among institutional investors, this study finds that only 40% of investors view ESG as highly important in their private equity allocation decisions. The number declines to 23% with hedge funds.

[5] www.preqin.com/insights/research/reports/esg-in-alternatives-navigating-the-climate-crisis

Importance of ESG



While ESG appears to be less of a priority in alternatives than other factors, it does remain on investors' radars. As noted in chapter 2, alignment of objectives rises to 39% in managers' top three, followed by political and environmental issues at 32% each.[6] It may be a question of relative priority in the current market climate, where greater transparency dominates attention for investors and competitive pressures for asset managers.

Some of this reluctance may also be attributable to the difficulty of monitoring and reporting ESG performance. A wide range of metrics and tools in the market for measuring and communicating ESG progress could be overwhelming. It may also reflect the current focus on diversity and inclusion (part of the ESG spectrum) among managers, which is easier to measure.

"New ESG perceptions have emerged, and there is more precedence given to responsible investing and green initiatives than there was before."

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

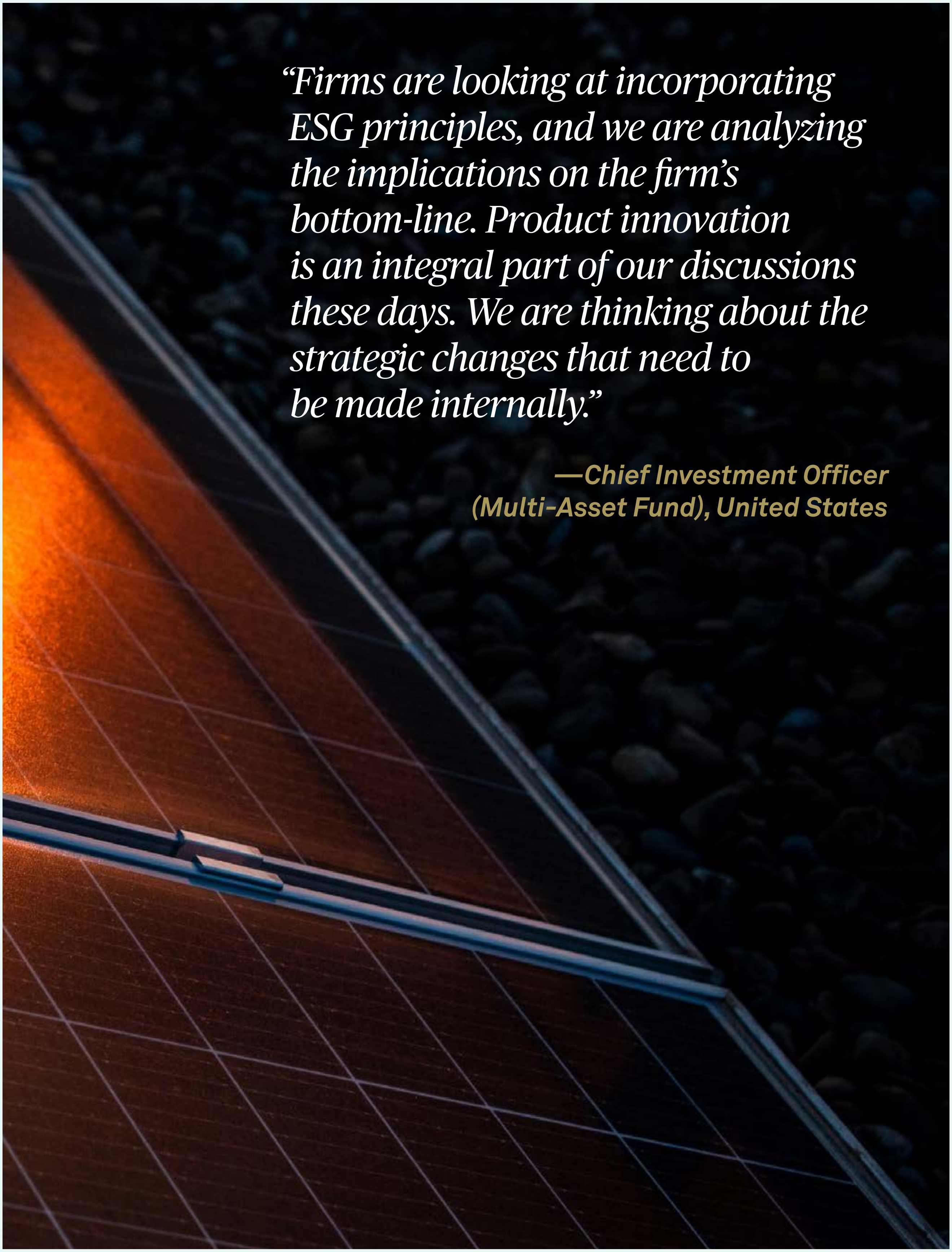
[6] https://www.bnymellon.com/us/en/insights/from-alternative-to-mainstream/chapter-two-getting-ready-for-growth.html

Greater urgency may also emerge in response to regulatory pressure. From March 2021, the European Union has required EU-based alternative asset managers to implement ESG policies and report on how ESG factors are being integrated into decision-making under the Sustainability-Related Disclosure Regulation. The U.K. is taking similar steps on sustainability reporting.

Furthermore, by choosing a lesser-focus on ESG matters, alternative asset managers may be missing both potential risks and returns. BlackRock founder and CEO Larry Fink outlined this risk in his 2021 letter to CEOs: "We know that climate risk is investment risk. But we also believe the climate transition presents a historic investment opportunity."

Finally, alternative asset managers with a strong ESG track record may find it easier to attract capital from younger generations, who care more deeply about sustainability. A recent survey of high net worth families by Barclays Private Bank in October 2020, *Smarter Succession: The Challenges and Opportunities of Intergenerational Wealth Transfer,* found that 68% of those aged 60 or older say their children have taken the lead on ethical and social investment matters for the family. AUM growth opportunities exist as well for firms that intentionally create a positive impact through their investments alongside generating returns. In 2020, analysis by the Global Impact Investing Network last updated in 2020 put the size of the impact investment market at US$715 billion, surging from an estimated US$4 billion in 2010.[7]

[7] https://thegiin.org/research/publication/impinv-survey-2020



"Firms are looking at incorporating ESG principles, and we are analyzing the implications on the firm's bottom-line. Product innovation is an integral part of our discussions these days. We are thinking about the strategic changes that need to be made internally."

—Chief Investment Officer (Multi-Asset Fund), United States

Conclusion

Institutional investors continue to clamor for alternative investment exposure. New investor classes are getting in on the act. As the industry further extends its reach, it could even shed its "alternative" label. To summarize what alternative asset managers in our study are thinking about this future, the following forces are reshaping the industry, nudging it ever closer to the world of mainstream asset management:

- Product innovation can support investment strategies.
- Diversity can improve decision-making within the industry.
- High-net-worth individuals will serve as important sources of capital.
- Alternative asset managers will increasingly attract retail clients as a new segment.
- Asset managers with a strong ESG track record may find it easier to attract capital from younger generations.
- ESG is less of a priority than other factors but is playing a key role in private equity decisions.

Across these forces, deeper structural changes to the industry and shifting investor expectations are prompting alternative asset managers to scale up, reduce costs and innovate in order to stay ahead of the game in an increasingly competitive market. The more that institutional investors and retail investors engage, the more growth opportunities there may be. It comes down to alternative asset managers' choice to follow this evolution or, instead, specialize further.

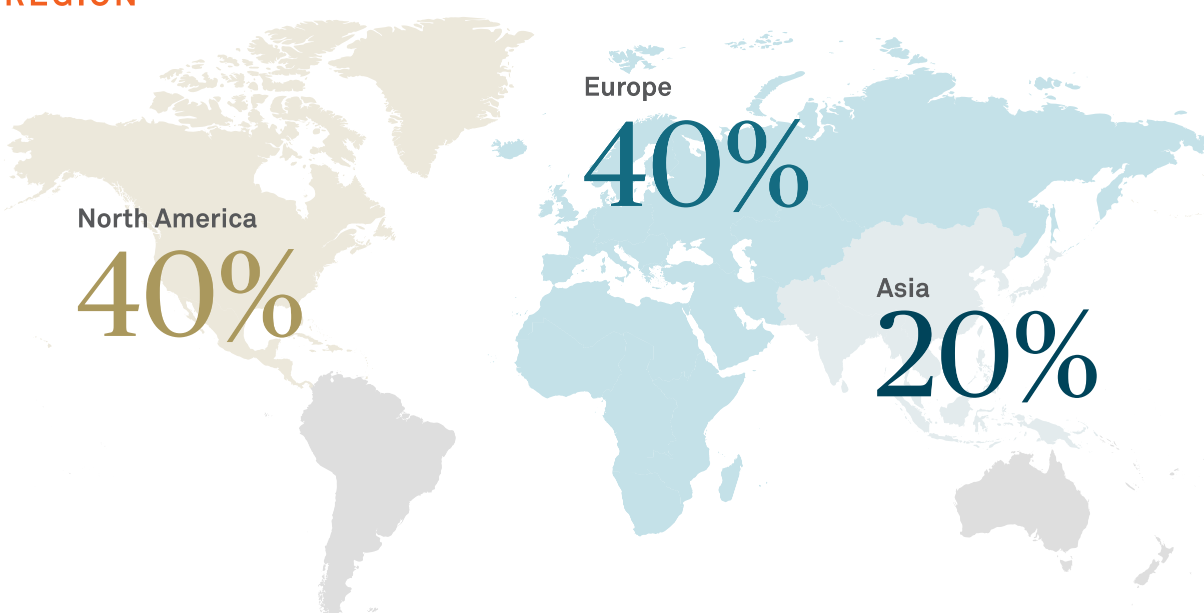
For More Findings

In previous chapters of *From Alternative to Mainstream*, we provide background and insights on the trends that feed into the deeper structural changes addressed in this chapter. For further analysis, we invite readers to consult previous chapters of this report.

Appendix: *Methodology*

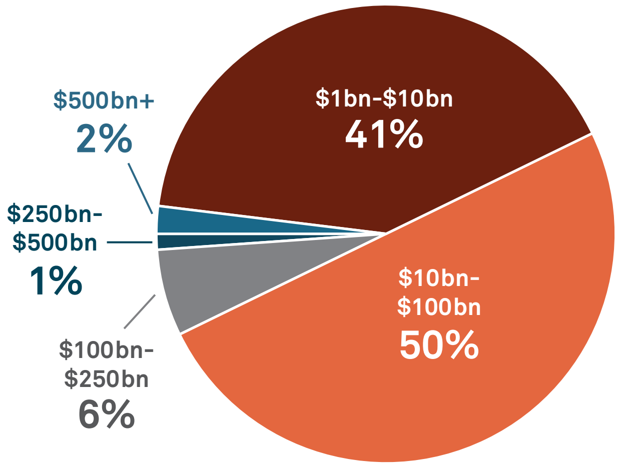
In Q3 and early Q4 of 2020, Mergermarket surveyed 100 alternative asset managers and 100 institutional investors from the U.S., EMEA and Asia-Pacific regions to gain insights into key trends in the alternative assets space. C-level and senior executives (job titles: Chief Executive Officer, Chief Investment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

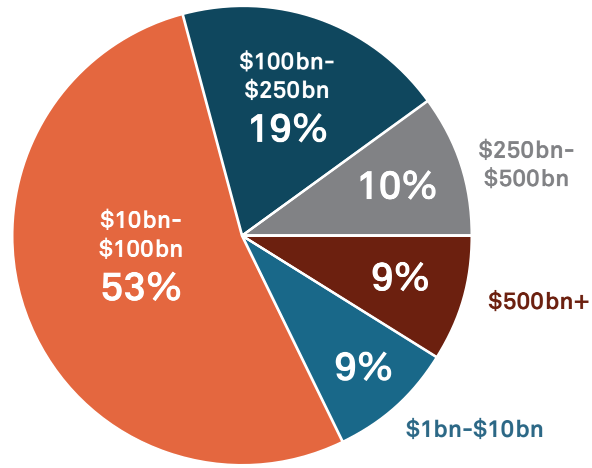


ASSETS UNDER MANAGEMENT*

Alternative Asset Managers



Institutional Investors



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%

*All figures are in USD

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