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Alternative investments

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**It's time to
pay attention**



Contacts

Boston

Carl Drisko

Partner

+1-617-521-8809

carl.drisko

@strategyand.pwc.com

Chicago

Caitlyn Truong

Partner

+1-773-953-9395

caitlyn.truong

@strategyand.pwc.com

About the authors

Caitlyn Truong is a partner with Strategy& based in Chicago and a member of the firm's digital business and technology team, where she specializes in *Fit for Growth** for capital markets clients. *Fit for Growth* is Strategy&'s proven way forward for companies to grow stronger while strategically managing costs. Truong has differentiated and unique expertise in the overall business model for capital markets companies and deep experience in improving middle- and back-office operations through digital transformation.

Carl Drisko is a partner with Strategy& based in Boston and a member of the firm's IT practice. He leads the firm's financial-services IT architecture team and has 30-plus years of experience in the architecture, design, and implementation of large-scale mission-critical systems in financial services and logistics.

Kimberly Richards is a senior associate with Strategy& based in New York and a member of the firm's financial-services practice, specializing in organizational strategy, market assessment, and operational redesign.

Gbenga Babarinde is a senior associate with Strategy& based in Chicago and a member of the firm's digital business and technology practice. He specializes in *Fit for Growth** and helping capital markets clients with technology strategy and IT effectiveness.

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Executive summary



Alternative investments are growing dramatically, creating a major opportunity for asset managers and servicers. Although many categories of alternative investments offer the prospect of higher fees, they also introduce greater complexity. Taking advantage of the opportunity requires substantial and carefully planned investment in new capabilities.

In our research we've found key requirements and pain points for firms entering the alternative assets space. The range of data and data sources in alternative assets means firms need to invest in technology to deliver real-time data in ways easily accessible to clients. At the same time, alternative assets are burdened with regulatory and reporting requirements that demand investment in systems and expertise.

To participate in this marketplace, firms will have to make a series of important choices. In Strategy&'s experience, those choices start with a realistic assessment of capabilities and proceed to decisions about retail distribution and technology for risk management and portfolio monitoring. Firms should then analyze whether to build those capabilities in-house or bring in outside partners. The players that approach these choices wisely will be well positioned to profit in a marketplace that we expect to grow from US\$10 trillion in assets today to \$18.1 trillion by 2020.

Alternatives go mainstream

It's 1990. A newly affluent investor walks into the wood-paneled office of his financial advisor; he wants to look beyond conventional stocks and bonds. The advisor has an idea. It's a hedge fund with good performance, and it's run by a brilliant college classmate. "We can trust him to make money," the advisor says.

Move forward to 2015. Investors, both sophisticated and "experimental," are looking at alternative investments — vehicles like hedge funds and private equity firms, and asset classes like commodities and real estate — but put less weight in the brilliance of the manager. Instead, they push for analytics that drill into performance, not promises.

Alternative assets used to be a hidden corner of the financial world. Until the financial crisis, many investors thought that sticking to traditional equities and fixed-income investments was just fine. Alternative assets were a black box, expensive to invest in and hard to understand. No longer. But where is some of the strongest asset growth in the world coming from today? Alternative assets. Assets in new categories like liquid alternatives (including exchange-traded alternative funds) are growing at rates as high as 15 percent a year.

By 2020, global assets in alternative investments will grow to US\$18.1 trillion, from \$10 trillion today. That growth is driven by changes in both the *investments* and the *investors*. New, more liquid instruments, including alternative-focused mutual funds from top-tier firms like AQR and Blackstone, have lowered the barrier to entry for investors who might never have considered traditional hedge funds. At the same time, the world's pool of retail investors is growing. Emerging economies have created a new global class with assets to invest. The greatest growth is among the mass affluent (those with \$100,000 to \$1 million in liquid assets). The wealth held by the mass affluent will grow 50 percent faster than assets held by high-net-worth investors (those with more than \$1 million).

Liquid alternatives are growing at rates as high as 15 percent a year.

Greater access means that alternatives are becoming mainstream. The surge of investment in alternative assets has made them a central focus in asset management — a business that itself is stepping out of the banking shadows.

Both in our market research and in advising our global clients, Strategy& has found that being a leader in this space has significant upside — and requires strategic planning and smart execution.

Why is growth happening?

Investing in alternatives has experienced dramatic growth in the past several years — the market has seen an 11 percent compounded annual growth rate (CAGR) over the last decade. As PwC’s “Asset Management 2020” report outlined, there are several reasons for overall growth in global assets. Developing economies (such as many in Asia-Pacific, Latin America, Middle East, and Africa) are shifting from saving to investing behaviors. The global middle class will grow to more than 1 billion consumers by 2020. Sovereign wealth funds are taking a more active role in global capital markets. Since the financial crisis, diversifying out of long-only equity funds and fixed-income investments has become critical for many investors. Additionally, as fixed-income instruments offer meager earnings due to depressed interest rates, strategies to achieve greater returns have been top-of-mind for investors.

Alternative asset managers have responded to interest from retail investors by rolling out newly accessible investment instruments. Alternative investments used to offer little transparency and few options for retail investors. That has changed. We have seen dramatic growth in alternatives packaged in retail structures like mutual funds, Undertakings for Collective Investment in Transferable Securities (UCITS), liquid alternative funds from asset managers (Pimco, Neuberger Berman), and even publicly traded shares in alternatives institutions themselves (Blackstone). Not only do retail investors now have more access to alternatives, but financial advisors have been allocating more of their clients’ portfolios to alternatives — the 2014 RIA Database survey reported that 43 percent of advisors expect to increase their client allocations to alternatives within the next 12 months, and 78 percent of advisors agree or strongly agree that alternatives are a critical and important part of asset allocation.

This growth in alternatives has implications across the value chain.

For investors, alternatives offer different risk and return characteristics than traditional assets, and often the opportunity for higher yields.

Alternative assets used to offer little transparency and few options. That has changed.

For asset managers, as well as firms that support them (e.g., global custodians), alternatives are an attractive play; the variety and complexity of these assets command a higher service fee. Average management fees for hedge funds launched in 2013 are approximately 140 basis points, according to Hedge Fund Research figures cited by the *Economist*. According to Preqin, four out of 10 hedge fund firms still charge a management fee of 200 basis points. By contrast, the Investment Company Institute's 2014 Fact Book notes that the average expenses for equity mutual funds and fixed-income mutual funds are 74 basis points and 61 basis points, respectively.

With alternative assets, **asset servicers** can earn fees two to six times those paid on traditional equity or fixed-income investments. The potential to earn higher fees with alternatives provides incentive for asset managers to innovate and continue product development — for example, it has led to the creation of liquid alternative funds and alternative investment strategies offered through traditional investment vehicles such as mutual funds and UCITS. Our research also shows that firms showcasing robust alternatives capabilities have the opportunity to win market share from investors looking to combine a range of asset classes in one portfolio.

Where is growth happening?

We expect growth in alternatives to continue at least through 2020. Total assets will grow at an average of 11 percent a year, from \$10 trillion to \$18.1 trillion, with several distinctions by asset class type, sector, and region.

Growth by asset class type: Private equity and hedge funds are expected to remain the largest sub-asset class types through 2020 at \$10 trillion in assets. Hedge funds, private equity, and real estate investments will make up nearly 75 percent of overall assets. However, we expect several smaller subcategories — liquid alternatives, commodities, and institutional loans — to grow at a faster rate. Liquid alternatives, which will provide a '40 Act vehicle — i.e., a fund that complies with the mandates of the Investment Company Act of 1940 — to invest in alternatives strategies (and reach a wider retail base in the process), are expected to grow at a CAGR of 18 percent from now until 2020. We expect institutional loans, the asset class type that includes leveraged loans, syndicated loans, and collateralized debt obligations, to grow at a CAGR of 17 percent from now until 2020. This growth will be fueled by growth in private equity funds and business development companies in the middle-market lending space, both of which use this financing structure, as well as by the need for alternative financing structures to meet Europe's overall funding gap as a result of new banking regulations (*see Exhibit 1, next page*).

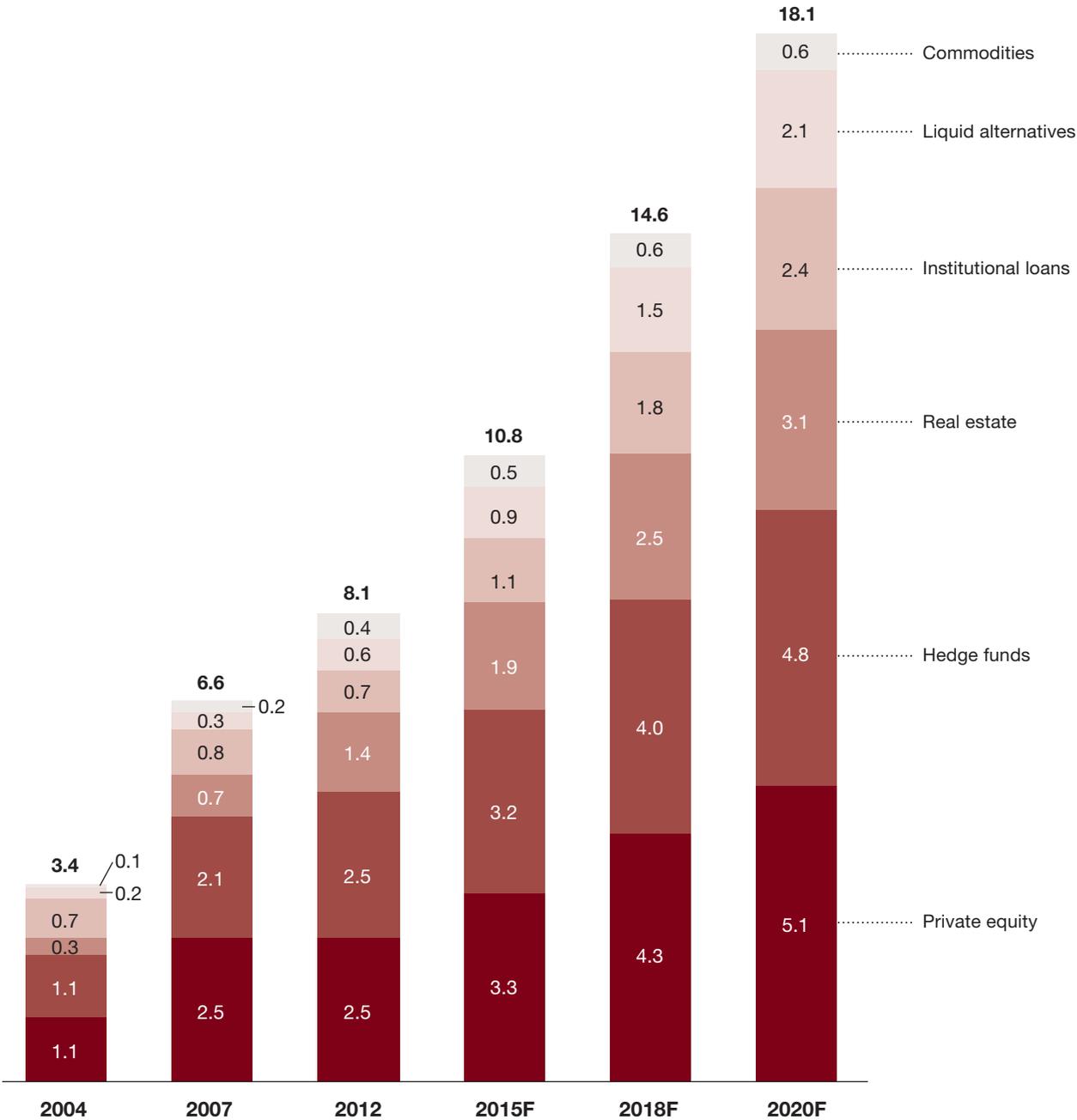
Growth by sector: We expect that more than half (\$10 trillion) of alternative assets in 2020 will remain held by institutional clients. Even so, mass affluent and high-net-worth investors are expected to be larger drivers of growth, with a 13 percent CAGR from 2015 to 2020 compared with a 9 percent CAGR for institutional investors (*see Exhibit 2, page 11*).

Alternative assets held by high-net-worth individuals (those with more than \$1 million in investable assets) will grow at a CAGR of about 10 percent, as this sector also continues to allocate more of its portfolio to alternative investments. The fastest growth will come from the group of investors we think of as “mass affluent,” or individuals with \$100,000 to \$1 million in liquid financial assets. This group will show an

The fastest growth will come from the “mass affluent.”

Exhibit 1

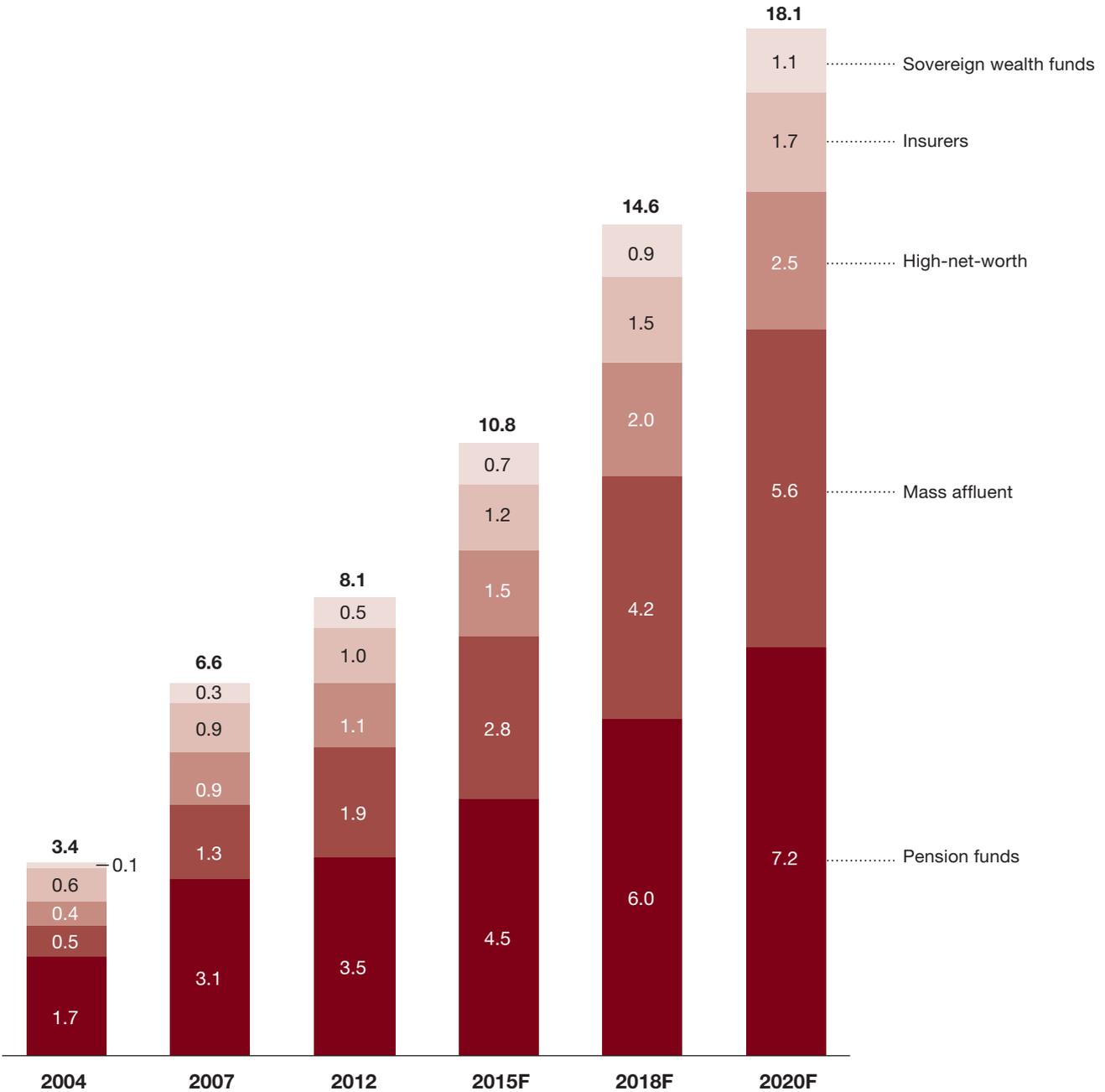
Global alternative assets (US\$ in trillions) by asset class type



Note: Totals may not equal sums due to rounding.

Source: Strategy& and PWC

Exhibit 2
Global alternative assets (US\$ in trillions) by sector



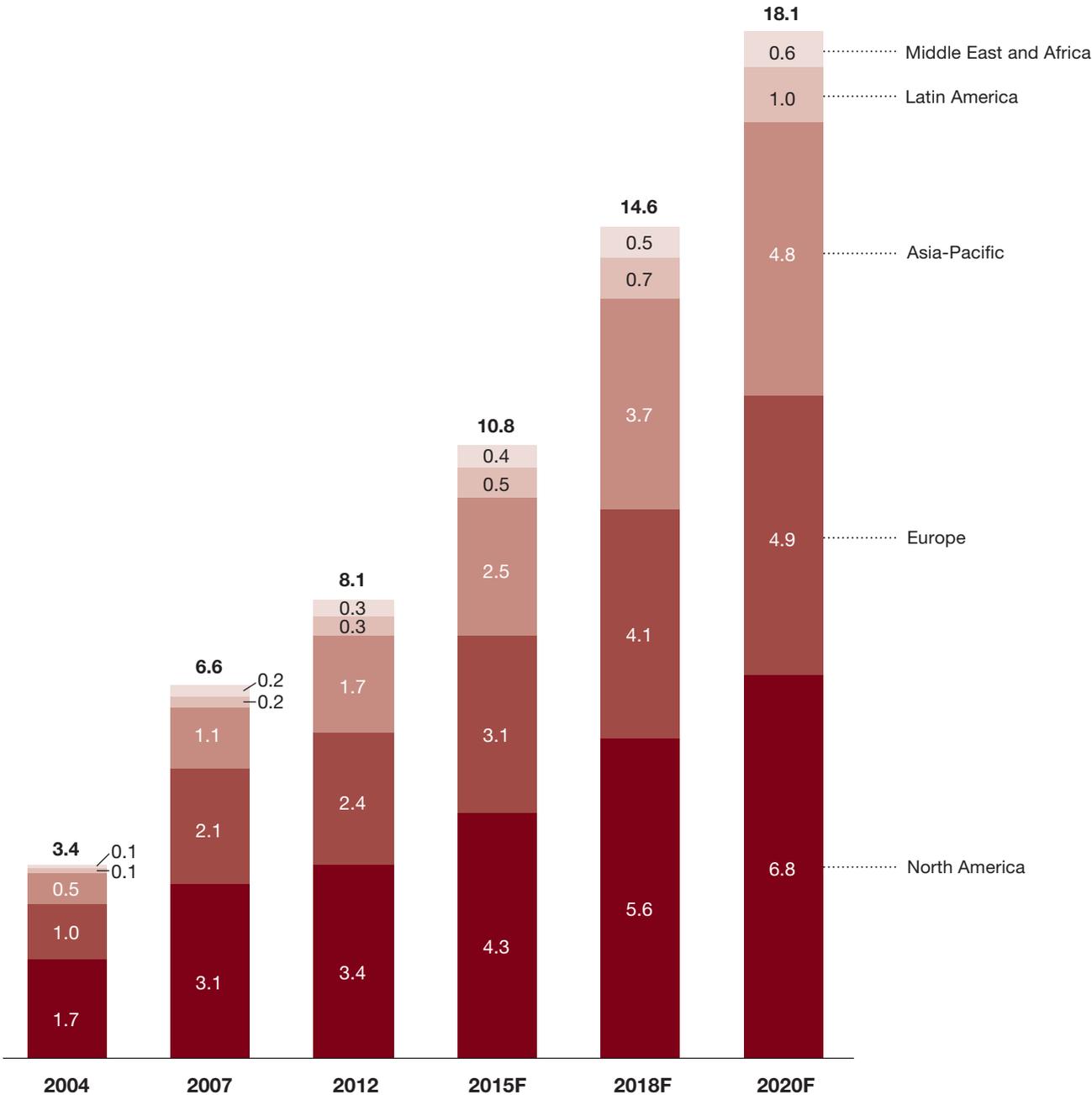
Note: Totals may not equal sums due to rounding.

Source: Strategy& and PWC

impressive growth rate of approximately 15 percent CAGR as the global middle class expands, particularly in Asia, and more investors enter alternatives for the first time.

Growth by region: Alternative assets are expected to remain predominantly based in North America and Europe, with those two geographies accounting for a combined \$11.7 trillion of a total \$18.1 trillion in assets in 2020. However, growth in other regions is expected to be higher. In both Asia and Latin America, alternative assets are expected to grow at a 14 percent CAGR from 2015 to 2020 (*see Exhibit 3, next page*).

Exhibit 3
Global alternative assets (US\$ in trillions) by region



Note: Totals may not equal sums due to rounding.

Source: Strategy& and PWC

What does this mean for technology and operations?

Operational and technology support will need to continue to improve for asset owners, managers, and fund servicers to effectively manage growth in the alternatives asset class. In the cases where an asset manager or owner is just starting to develop alternatives capabilities, the required changes will be notable.

Risk management processes need to evolve for alternatives, which frequently have less transparency than other asset classes. For example, hedge and private equity funds may report information only quarterly. For derivatives like commodities contracts, the lack of mark-to-market valuations creates pricing ambiguity.

New regulatory compliance standards (including reporting) for relevant alternatives regulations (e.g., Europe's Alternative Investment Fund Managers Directive, the U.S.'s Foreign Account Tax Compliance Act) will also need to be understood and adhered to. This is a pain point for existing alternatives managers, who voted "managing regulatory compliance" as their largest challenge at the PwC 2014 Alternative Investments Seminar. Additionally, depending on the geographies that a manager chooses to invest in, differing legislation by country can be another complicating factor.

Retail-specific processes will need to be established for asset managers entering the retail market with alternative offerings. For example, for new liquid alternative funds, retail platforms and daily processes (including distribution) must be set up to meet the '40 Act regulations and liquidity needs. These costs can be high, and for an alternatives manager stepping into the mutual fund/UCITS arena, the learning curve is very steep.

In addition, asset managers or those managing their own assets will find that they need to enhance some of their existing capabilities.

Client service for asset managers will need to be enhanced. Investors in alternatives require higher touch, with more interaction and education, than mutual investors due to the

complexity. Additionally, entry into retail alternatives will require setup of effective distribution, including marketing strategies designed to sell complex products, listing in industry databases, and a dedicated sales force.

Data integration/aggregation will be required in order to enable automated and flexible processes such as reporting — especially given that alternatives have typically had a separate and distinct set of technology platforms. This is particularly true when aggregate portfolio reporting with dissimilar asset class or sub-asset class types is of interest (such as in multi-asset class strategies). It becomes an especially intense pain point when clients desire nonstandard reporting on such investments. Asset managers need the ability to “drill down” on the performance of specific strategies in a granular way — e.g., private equity firm holdings and sometimes even the underlying assets in a complex security.

Real-time portfolio information will be required for alternative holdings where available, as this information enables front-office decision making and supports processes such as risk management.

All this means that firms entering the alternatives space will need to enhance supporting technology and operations. Specifically, they should focus on the following.

Technology needs to deliver accurate and real-time enabled information — particularly for the risk and portfolio reporting that is needed for real-time decision making. This requires capabilities to pull disparate data sets quickly and accurately from multiple sources. Enterprise data management becomes a critical part of the technology solution, putting greater stress on enterprise data architecture, comprehensive data model and data warehouse, and data integration capabilities.

Data management systems will need to support accurate, up-to-date information and data integrity for many kinds of data types. This is critical when alternatives are integrated with other asset classes, or when alternatives capabilities are captured through partnerships with different data formats and systems requirements. Otherwise, institutions might find themselves faced with ad hoc back-end data modifications, such as manually manipulating alternatives accounting entries to feed into overarching accounting systems.

Streamlining and outsourcing are the keys to ensuring low cost and effectiveness. Each approach has costs and benefits. Outsourcing arrangements will require strong risk management. If managers are looking to move into liquid alternatives, they can consider partnering

Firms entering the alternatives space will need to enhance supporting technology and operations.

with custodians (who have expertise in the '40 Act) to accelerate the launch and improve operations.

Creating capabilities in-house requires talent acquisition of operating personnel, as well as client-facing staffers experienced with alternatives, who will respond to queries and manage the client relationship.

How do institutions take advantage of growth?

Given the rise of alternatives, asset managers and owners looking to expand their presence in this space should follow five steps.

First, institutions need to assess their present capabilities. The process starts with baselining key processes — risk, compliance, any retail/institutional market processes, reporting, and client service — as well as documenting strengths and shortcomings. Doing so will let firms make a realistic appraisal of additional capabilities they will need, and will allow them to make decisions on questions like keeping management in-house versus outsourcing or adding additional geographic capabilities. In our experience, a formal study is essential: In the 2014 PwC Alternative Investments survey, the respondents, by a large margin, picked the need for formal processes, procedures, and controls as the top operational priority for alternatives managers.

Second, institutions have to consider whether they will participate in the retail market for alternative investments. Those that plan to do so need to establish the right fund structure and distribution, and provide client support teams with the right training. Regulators are beginning to pay close attention to whether alternatives strategy advisors have detailed knowledge of the complex products sold to retail investors to ensure that FINRA's suitability rule is met. As a result, asset managers are introducing training on alternatives and some are requiring advisors to undergo certification programs such as the newly launched Fundamentals of Alternative Investments Certificate Program by the Chartered Alternative Investment Analyst Association.

Third, they need to understand the tools that deliver effective risk, portfolio monitoring, and data management. This requirement is supported by the 2014 PwC Alternative Investments survey, in which respondents picked greater use of data, analytics, and advanced technologies as the second top operational priority for alternatives managers.

Fourth, they should consider whether they will build capabilities in-house or gain them through external partnerships. In building

capabilities, institutions should use leading tools for routine operational activities, mostly in the back office. They should consider building or customizing tools that will let them differentiate their products with analytics, dynamic reporting, and other client-facing activities. Partnerships, on the other hand, allow for quicker market entry and the possibility of forming minority investments with small alternative funds to test strategies. Keep in mind, however, that a smaller portion of the lucrative higher alternatives fees will be captured in-house through this arrangement. The main benefit of partnership is to quickly confirm strategic fit for alternatives. If the scale and usage of alternative offerings turn out to be substantial, the institution can then either fully acquire alternative funds or develop a similar fund in-house.

If this route is chosen, there are major considerations for selecting the right external partner and ensuring that the asset manager/owner maintains a differentiated strategy and stays relevant.

Finally, institutions should recognize that they need time. Any organization expanding into the alternatives space should recognize that it will need some time to gain performance data and understand whether the alternatives strategy is truly working. Furthermore, typical operating costs in alternatives are higher than in other investment spheres. Management fees are notably higher than in traditional asset classes, but so are the costs — if the fees are any indication, then asset managers in the alternatives space should be prepared for costs as much as six times those of fixed income or equities.

Conclusion

Alternative investments hold out a bright prospect for members of a growing new international investor class willing to pay higher fees to expand their investment options. Those investors, however, are expecting a high level of service and transparency. Profiting from the growth in alternatives means devoting time and resources to deliver that efficiently.

Strategy& is a global team of practical strategists committed to helping you seize essential advantage.

We do that by working alongside you to solve your toughest problems and helping you capture your greatest opportunities.

These are complex and high-stakes undertakings — often game-changing transformations. We bring 100 years of strategy consulting experience and the unrivaled industry and functional capabilities of the PwC network to the task. Whether you're

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