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Morningstar and Barron's



2014-2015 Alternative Investment  
Survey of U.S. Institutions and  
Financial Advisors

July 2015

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## 2014–2015 Survey Overview

- ▶ Survey aims to capture trends in alternative investing among institutions and advisors.
- ▶ This is the ninth annual nationwide survey.
- ▶ Survey was conducted in the spring of 2015, covering the 2014 calendar year period.
- ▶ 149 institutional investors and 233 advisors participated.
- ▶ Institutional survey included 19 questions; advisor survey had 23.
- ▶ Surveys included four free-response questions tackling new topics, such as the effect of CALPERS' hedge fund exodus, preferences regarding single manager versus multi-manager structures, client characteristics most suitable for alternatives, and attitudes toward nontraded REITS.

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# Key Take-Aways

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## Key Take-Aways

### **Alternative fund flows moderated in 2014, but significant pockets of strength remain.**

- ▶ Alternative mutual fund flows declined in 2014 from record 2013 levels, but organic growth rates in alternatives still exceeded all other asset classes.
- ▶ Alternative outflows were lumpy and not necessarily widespread. PIMCO Unconstrained Bond and Mainstay Marketfield lost a combined \$23.8 billion in 2014, dwarfing the outflows of any other alternative fund. Meanwhile, the multialternative, managed-futures, and long-short equity categories all saw strong positive net inflows overall.
- ▶ Investor behavior with alternative funds nevertheless raises some concerns. Investors have exhibited elements of performance-chasing with particular funds and categories, and the recent moderation in flows suggests that investors may be wavering in their commitment to hedged strategies after a six-year bull run in equities. The flows trends indicate that investors aren't always taking a long-term approach to alternatives, which is critical to using these products properly.

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## Key Take-Aways (continued)

### **Fund launches continue at record clip, despite pullback in flows.**

- ▶ Even as flows have moderated, fund companies continue to launch funds at a record clip. Many of these new funds were launched in the multialternative, long-short equity, and non-traditional-bond categories, each of which saw more than 30 new fund creations. The contrast of increasing fund launches against softening flows suggests that currently supply may be outstripping demand. As companies look to stake a claim in this niche space, assets may not come as easily as expected. Fund companies should also consider carefully the rationale and potential market for new alternative funds.
- ▶ But looking ahead, advisors and institutions expressed continued enthusiasm in the survey for alternative strategies including multistrategy, long-short equity, long-short debt, and managed futures, suggesting that demand may strengthen in the future.

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## Key Take-Aways (continued)

### **Advisors step on the gas, while institutions ease up.**

- ▶ Advisors exhibit increased enthusiasm for alternatives, just as institutions appear to be turning more cautious. Some 63% of advisors believe they will allocate more than 11% to alternatives over the next five years, compared with just 39% who expressed that level of commitment in 2013. However, institutions that expected to allocate more than 25% to alternatives declined from 31% to 22%. A similar pattern emerged in responses to questions about current allocations: As compared with 2013, fewer institutions allocated over 40% to alternatives (9% for 2014, compared with 18% for 2013).
- ▶ Institutions, long at the vanguard of alternative investing, may be tempering their enthusiasm as a result of fees, lockups, and poor transparency in traditional hedge funds, as was the case with CALPERS' announced decision to withdraw from hedge funds. However, respondents to our survey largely denied any influence from the CALPERS decision.
- ▶ A majority of advisors allocate between 6% and 20% to alternatives. While that figure has been largely stable over time, over the past few years more advisors have been increasing their alternative allocations to the 11% to 15% range, moving up from the 6% to 10% range.

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## Key Take-Aways (continued)

### **Multistrategy funds a top pick for both advisors and institutions.**

- ▶ Multistrategy funds were listed as a top current allocation, as well as a top strategy for future allocations, by both advisors and institutions. Multistrategy funds allow advisors to effectively outsource much of the responsibility for selecting and allocating among complex alternative strategies.
- ▶ Long-short equity strategies also garner significant interest from both advisors and institutions, which is consistent with data from prior years.

### **More sophisticated and wealthier clients viewed as optimal candidates for alternatives.**

- ▶ Both advisors and institutions agreed on a “goldilocks” region of suitability characteristics for the ideal alternative investment client. The survey looked at client level of sophistication, distance from retirement, level of assets, required level of return, and level of risk tolerance.
- ▶ Both groups preferred clients to have a higher asset threshold and a higher level of sophistication than average. However, for many other characteristics, respondents agreed that the ideal client for alternatives was right in the middle of many of these suitability ranges.

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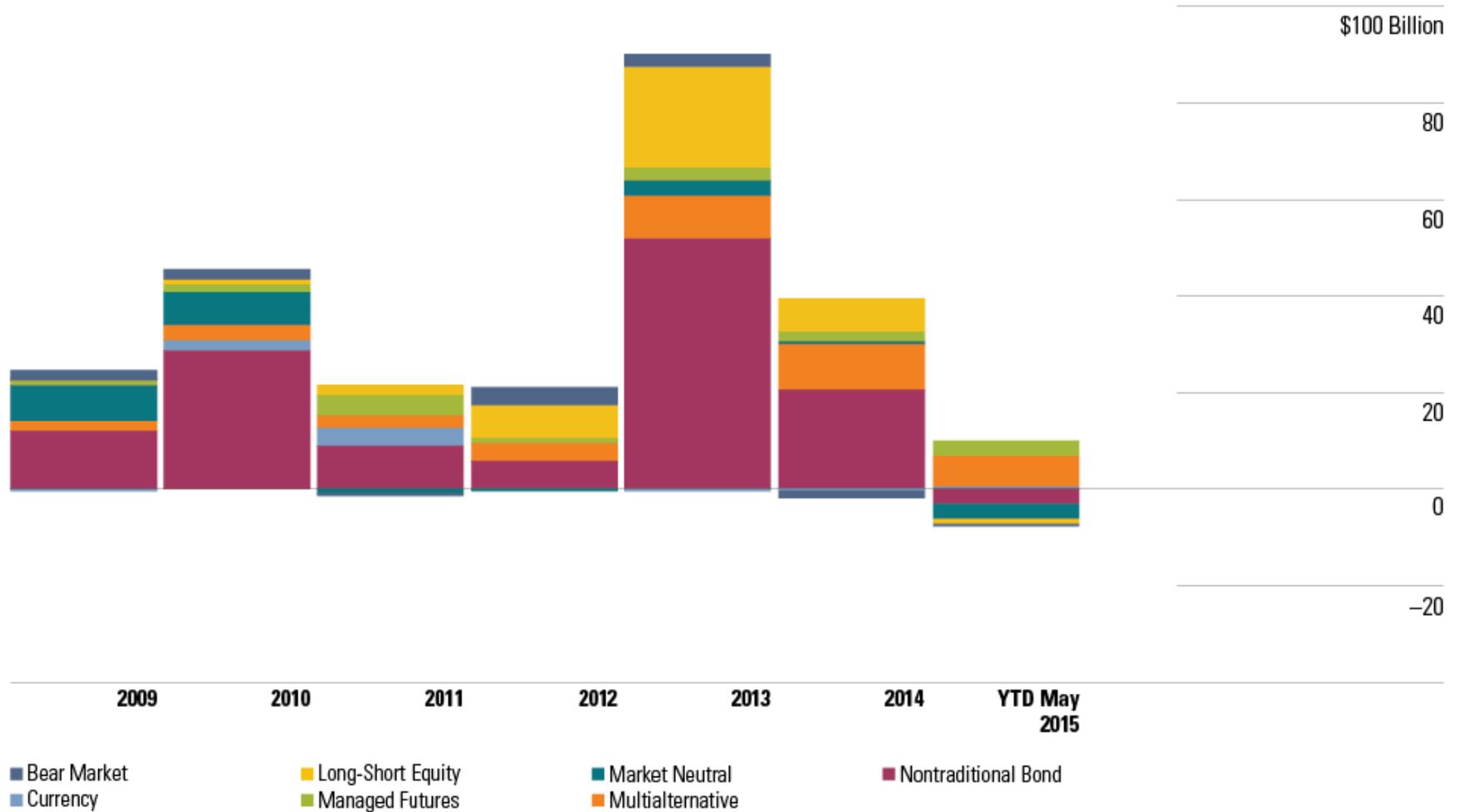
## Main Topics

- ▶ Alternative Mutual Fund and Alternative ETF Growth
- ▶ Past and Future Alternative Investment Growth
- ▶ Alternative Investment Drivers and Deterrents
- ▶ Hot Topics in 2014–2015
- ▶ 2014–2015 Survey Participation

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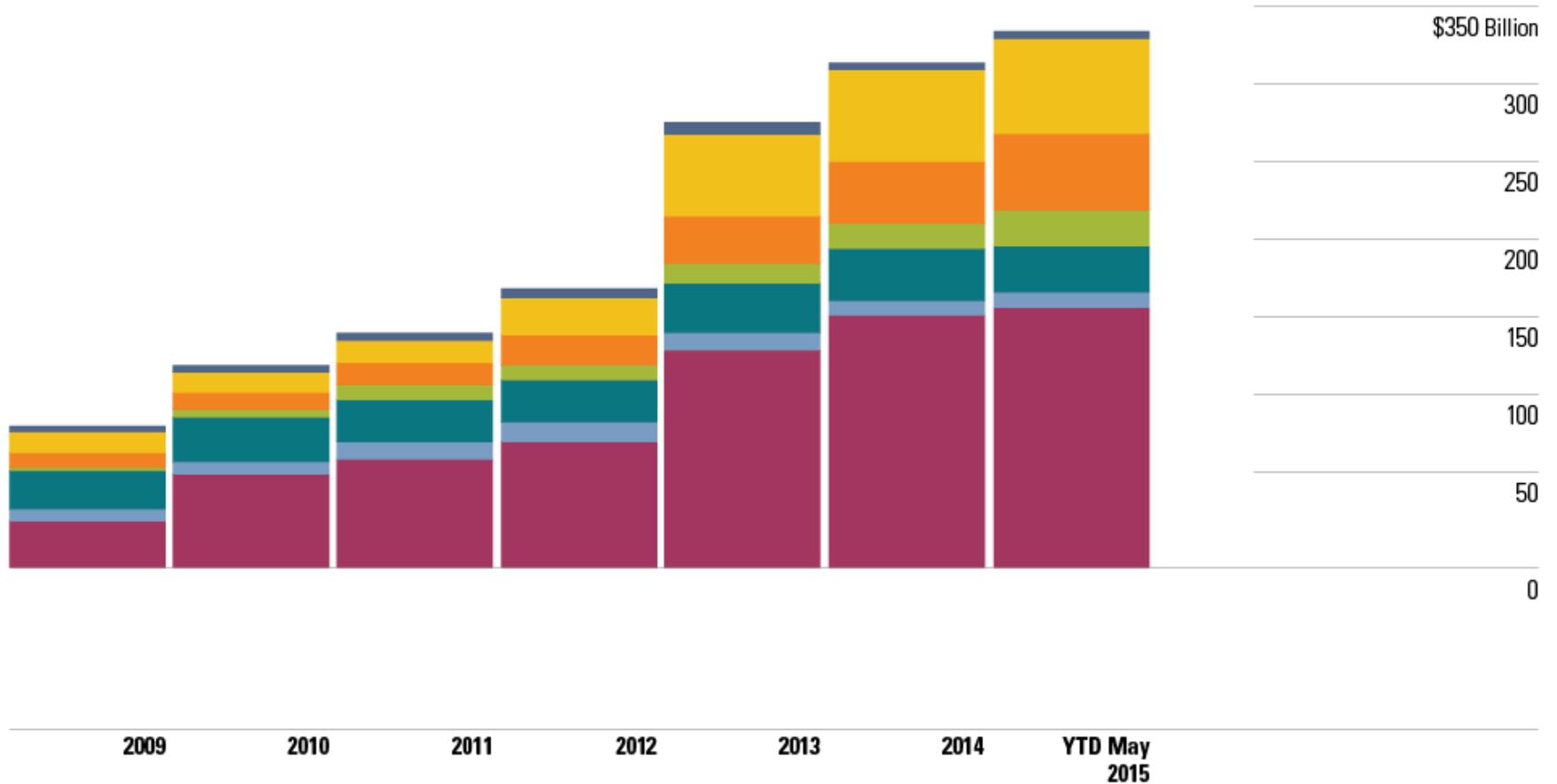
# Alternative Mutual Fund and Alternative ETF Growth

# Alternative Mutual Fund Flows



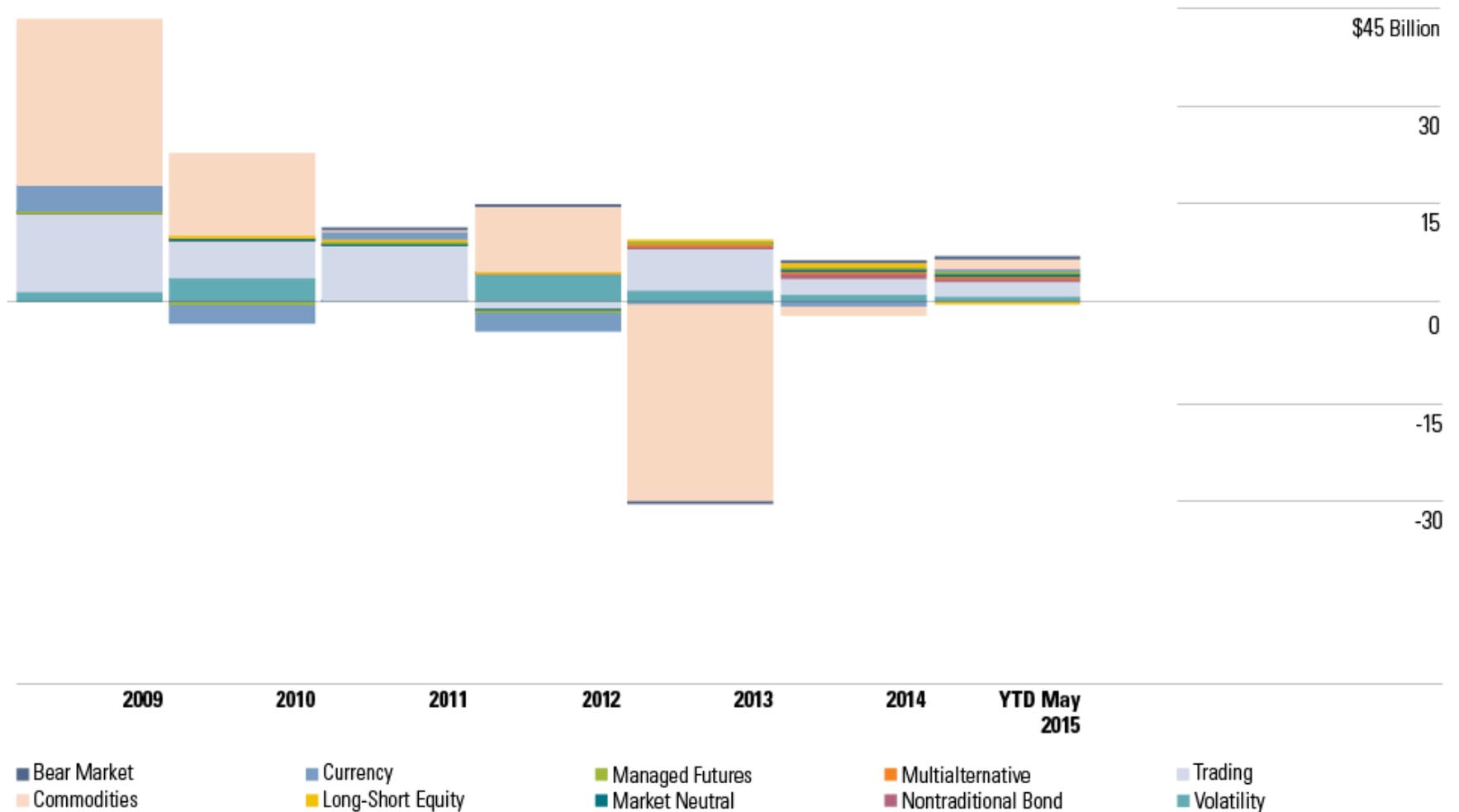
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# Total Net Assets in Alternative Mutual Funds



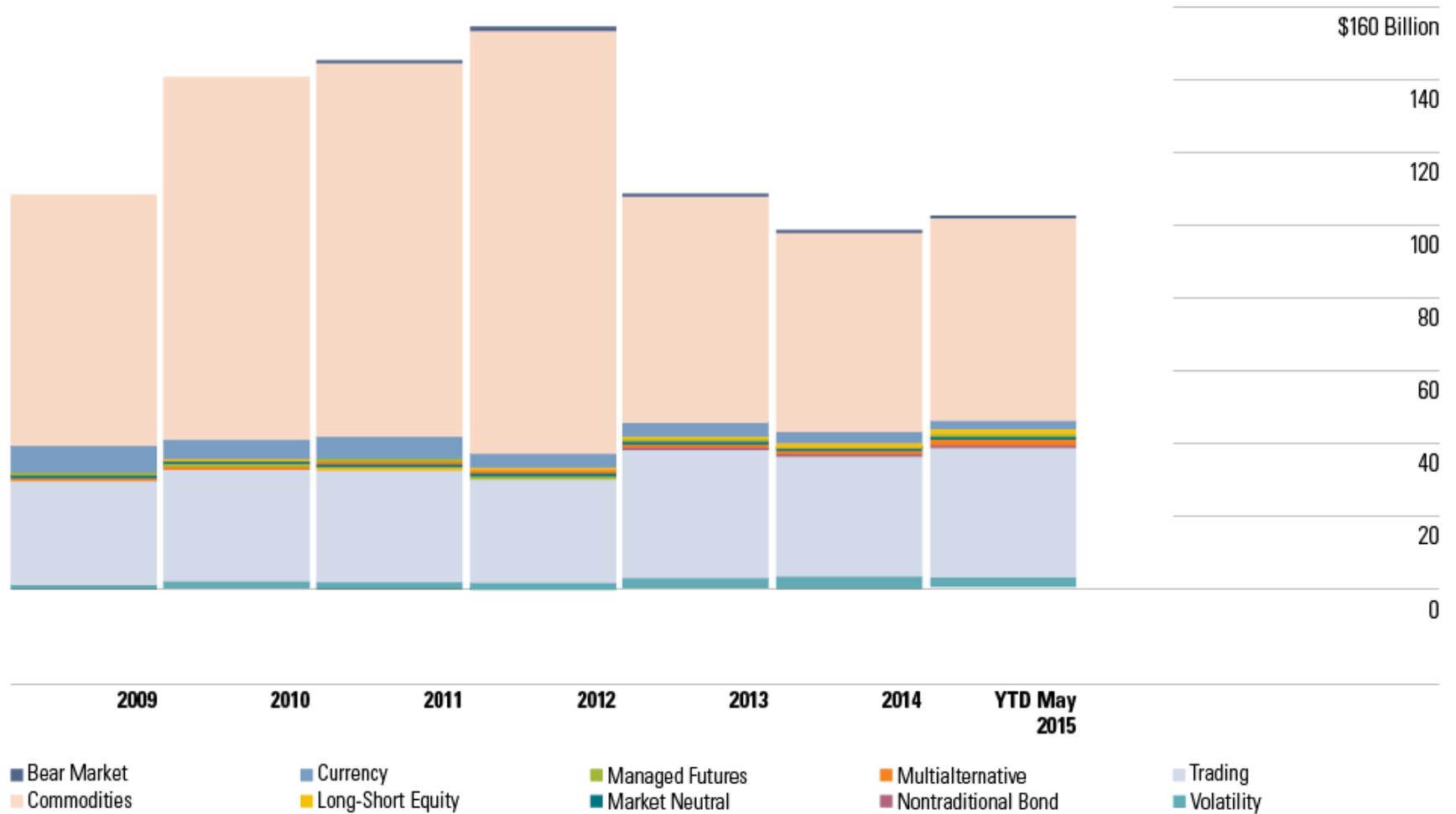
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# Alternative ETF Flows



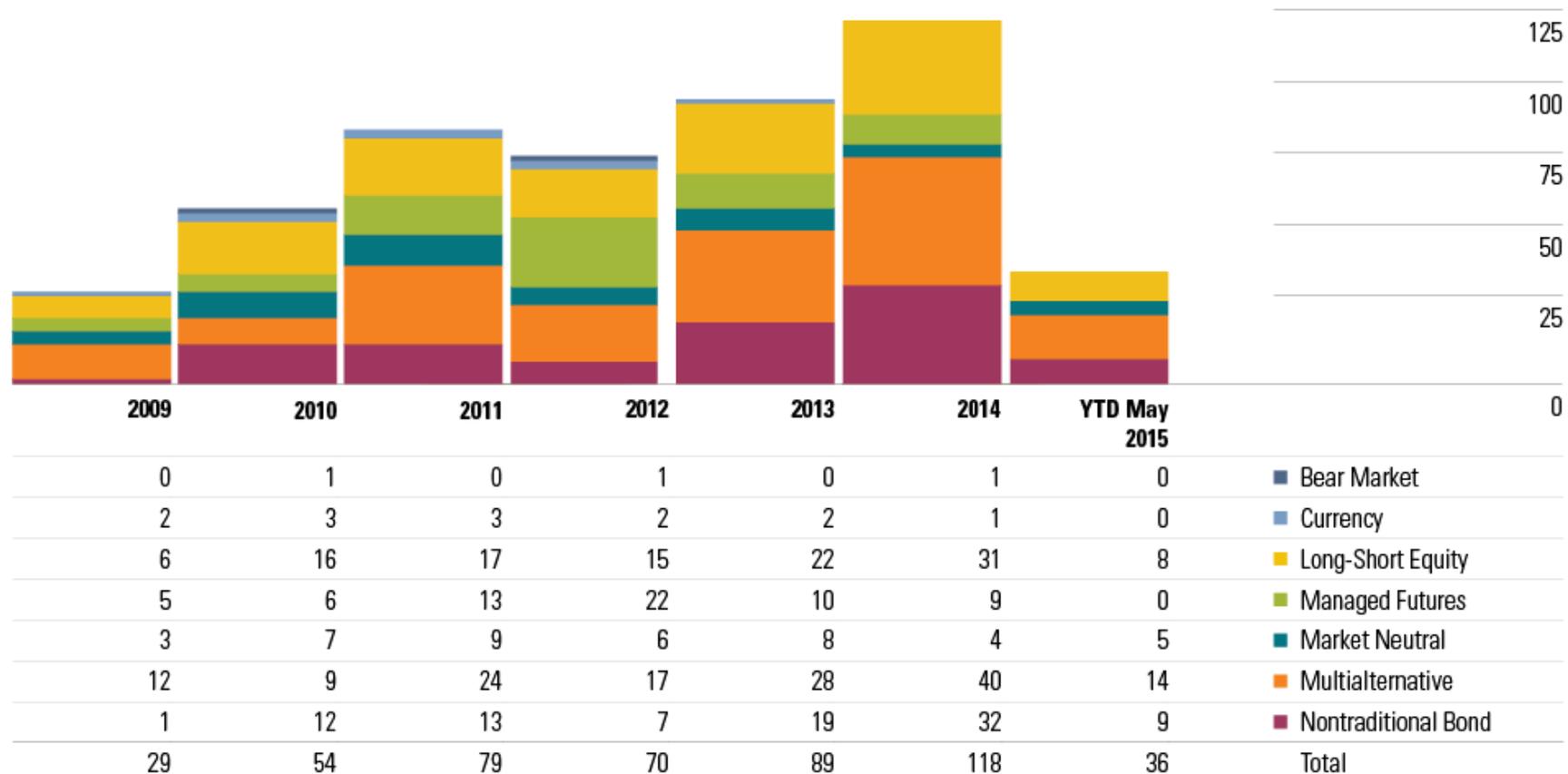
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# Total Net Assets in Alternative ETFs



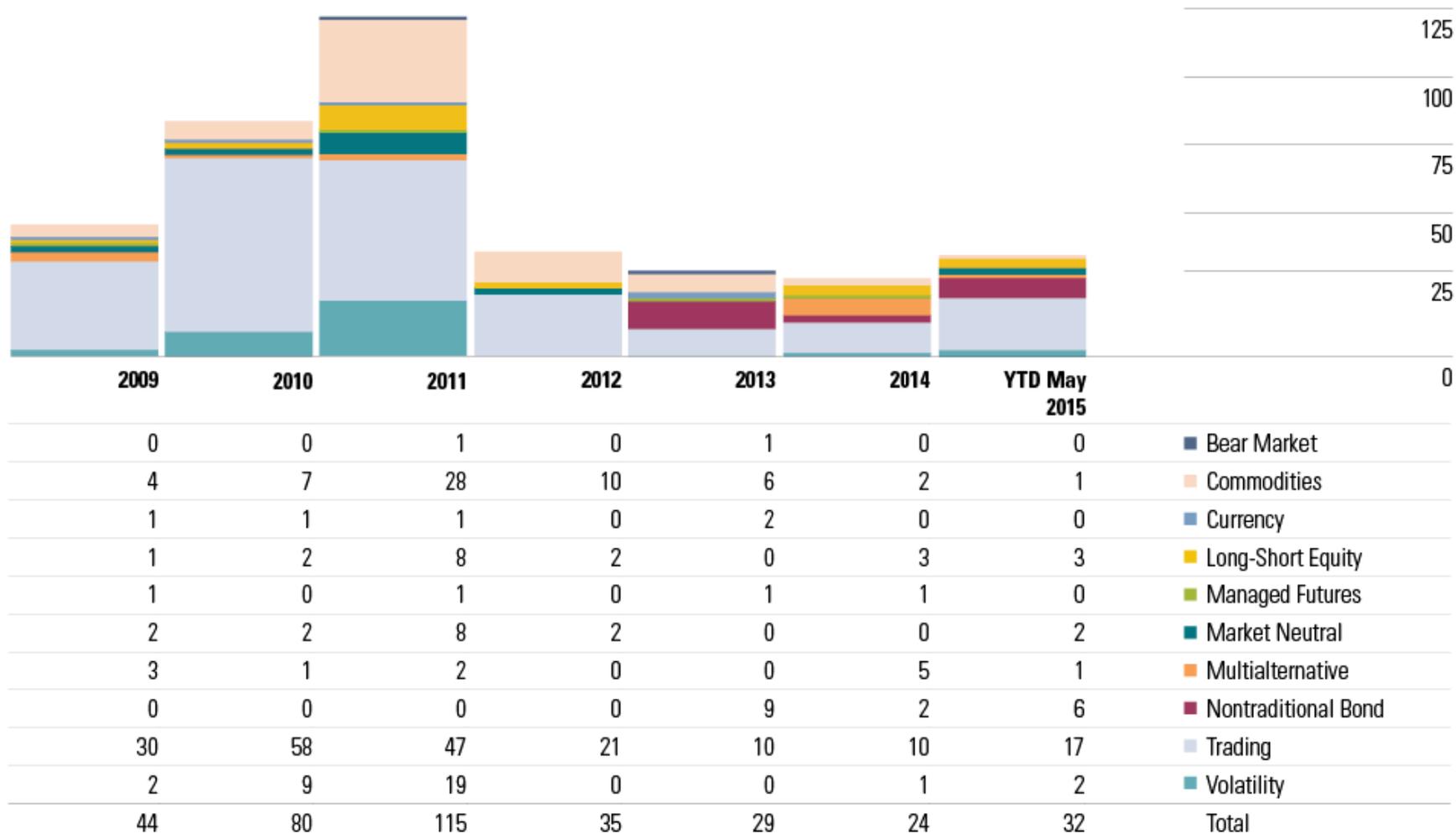
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# Alternative Mutual Fund Launches by Category



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# ETF Launches by Category



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## Alternative Flows and Launches

- ▶ **Growth rates for alternative funds have slowed but still remain the fastest compared with any other Morningstar Category.**
  - ▶ Organic growth rates for alts slowed in 2014 to 12.3%, from 42.2% for 2013. While this sudden deceleration is significant, alts still grew at the fastest clip relative to all other asset classes.
  - ▶ Alternative fund launches also reached their highest level in 2014, as more companies are seeking a claim to this fast-growing niche. However, this may not be sustainable given the slowdown in flows. Either flows need to increase over the next couple of years, or smaller funds may be forced to close.
  - ▶ In 2014, alternative fund flows were hampered by large outflows from mammoth funds in the space, such as PIMCO Unconstrained Bond and Mainstay Marketfield, which together accounted for about \$23.7 billion in outflows. However, those outliers masked some otherwise positive trends. In the first five months of 2015, managed futures and multialternative funds gained in assets, while non-traditional-bond funds and market neutral strategies receded.
  - ▶ Not surprisingly, commodity mutual funds and ETFs exhibited net outflows in 2014, as the mutual fund commodity broad basket category fell 18.0% in 2014.

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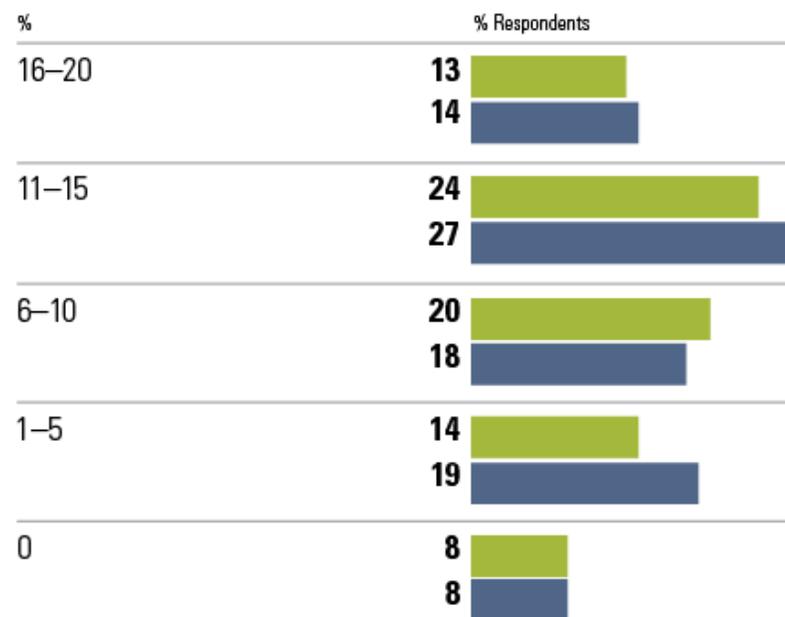
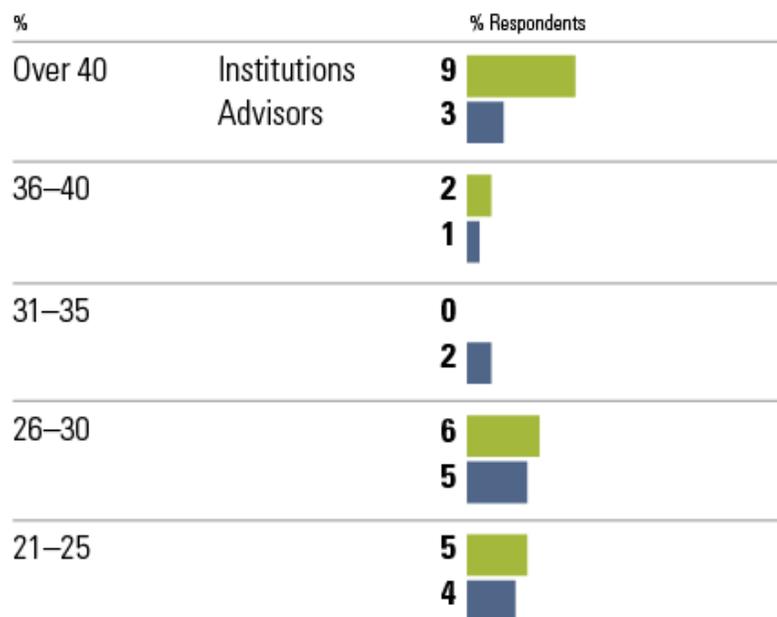
# Past and Future Alternative Investment Growth

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## Past and Future Alternative Investment Growth

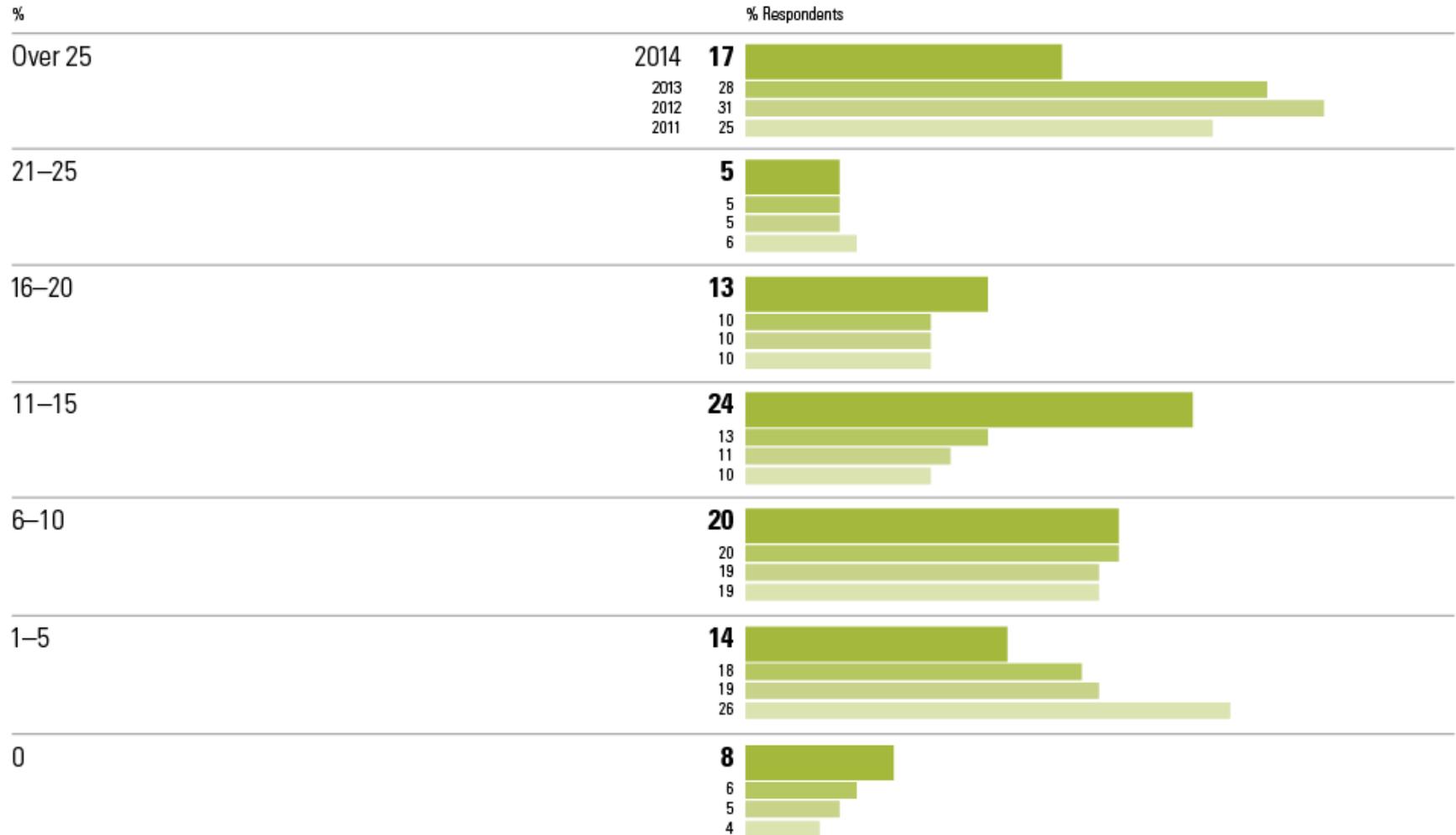
- ▶ 59% of advisors say they allocate between 6% and 20% to alternatives, while 58% of institutions allocate to that level. Compared with 2013, fewer institutions allocated over 40% to alternatives (9% for 2014, compared with 18% for 2013). Institutional enthusiasm for alternatives may be moderating.
- ▶ In terms of future allocations, both institutions and advisors are looking to grow their long-short equity allocations, while institutions are especially focused on increasing their multialternative allocation.
- ▶ The number of advisors and institutions who exhibited no growth in alternative assets under management over the past few years is on the rise, corresponding with the moderation of alternative growth seen in other aspects of the survey.
- ▶ Multistrategy funds are a top growth strategy for both institutions and advisors, as more options are launching as 1940-Act mutual funds, while hedge-fund-of-fund assets are dwindling. Advisors also cited master limited partnerships (MLPs) as their fastest-growing alternative strategy over the past five years. Business development corporations (BDCs) and private real estate have also garnered increased attention over the past five years.

# Institutions and Advisors: Allocation to Alternative Investments in 2014



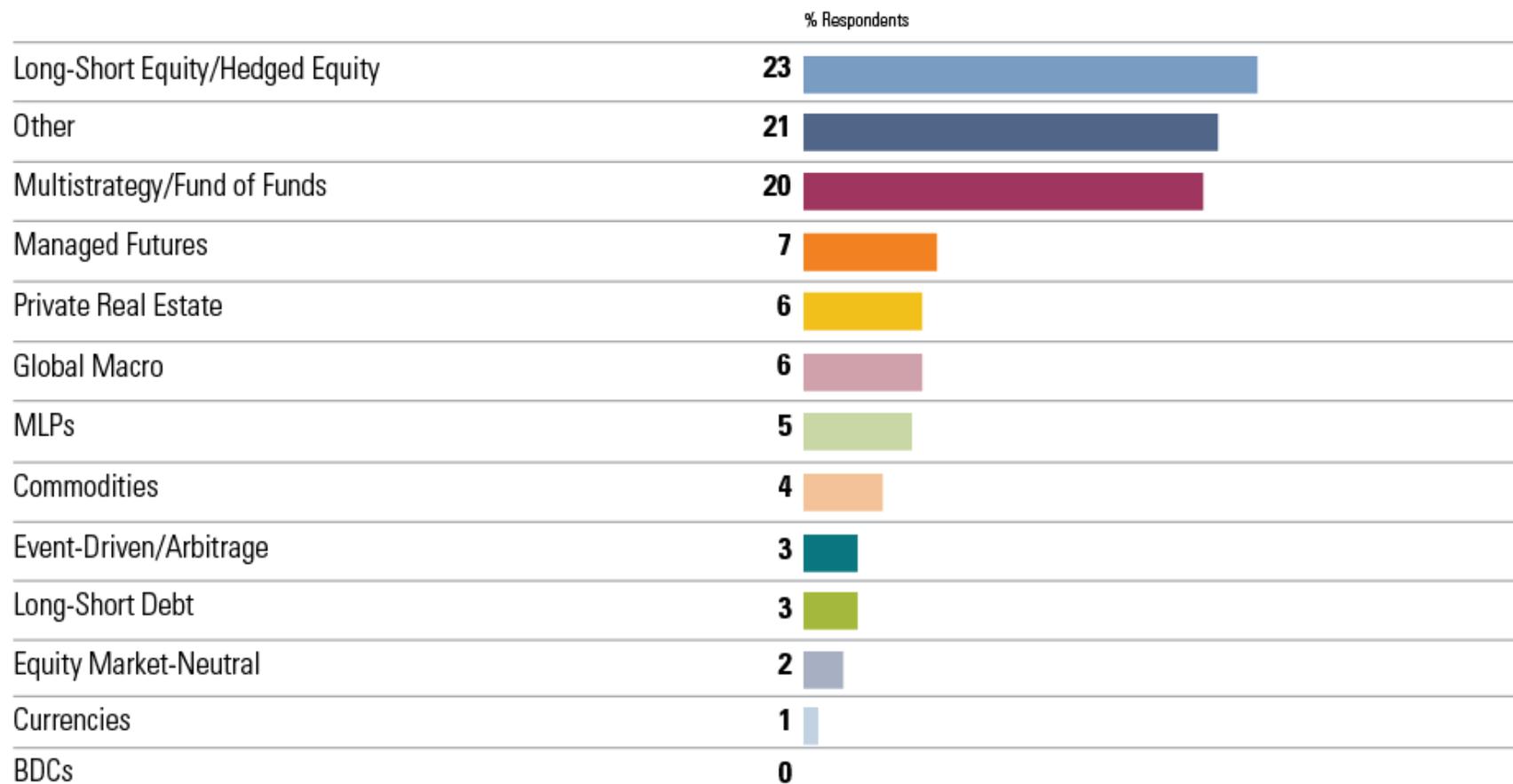
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# Institutions: Allocation to Alternative Investments Over Time



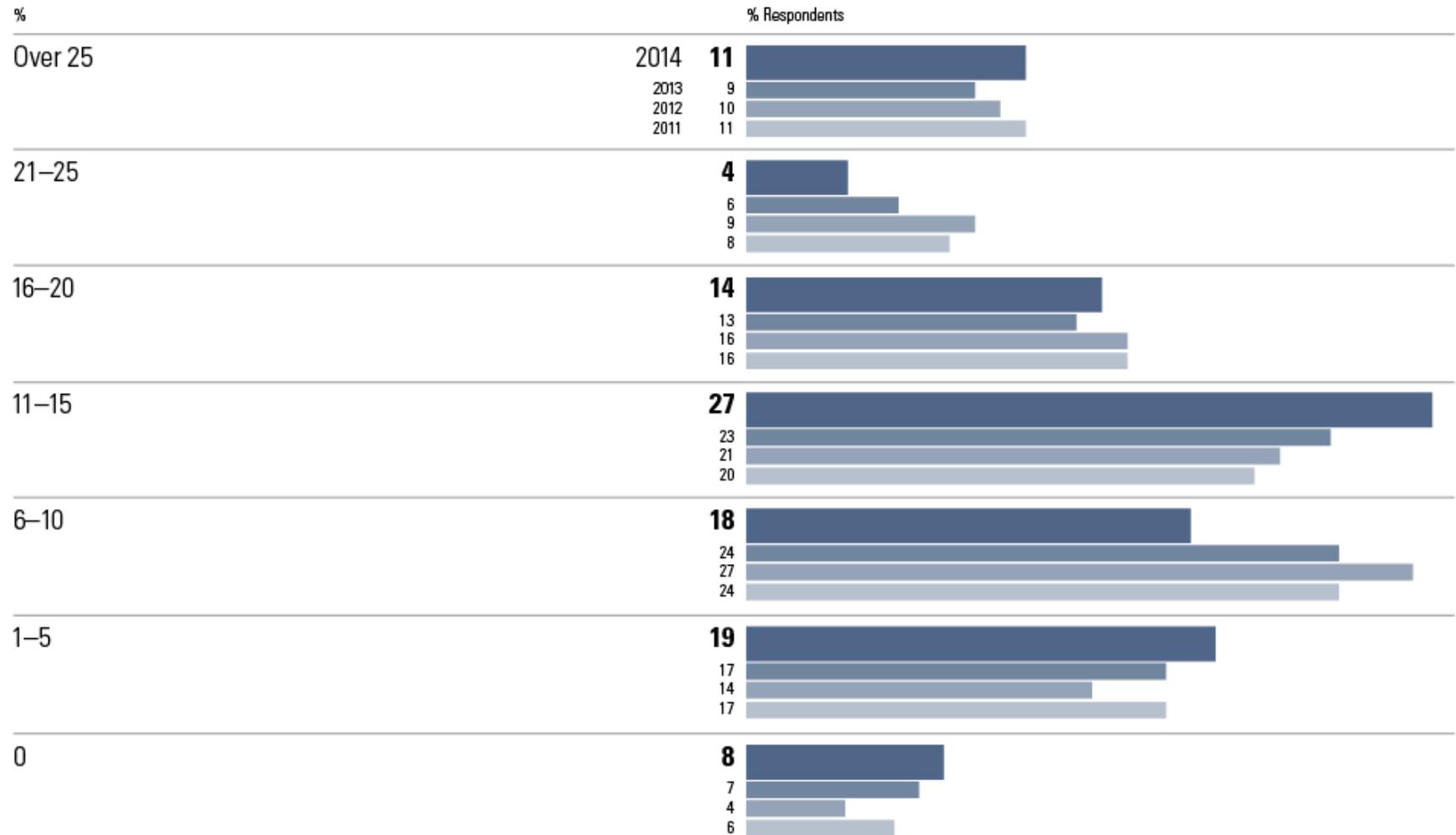
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# Institutions: Current Largest Alternative Investment Strategy



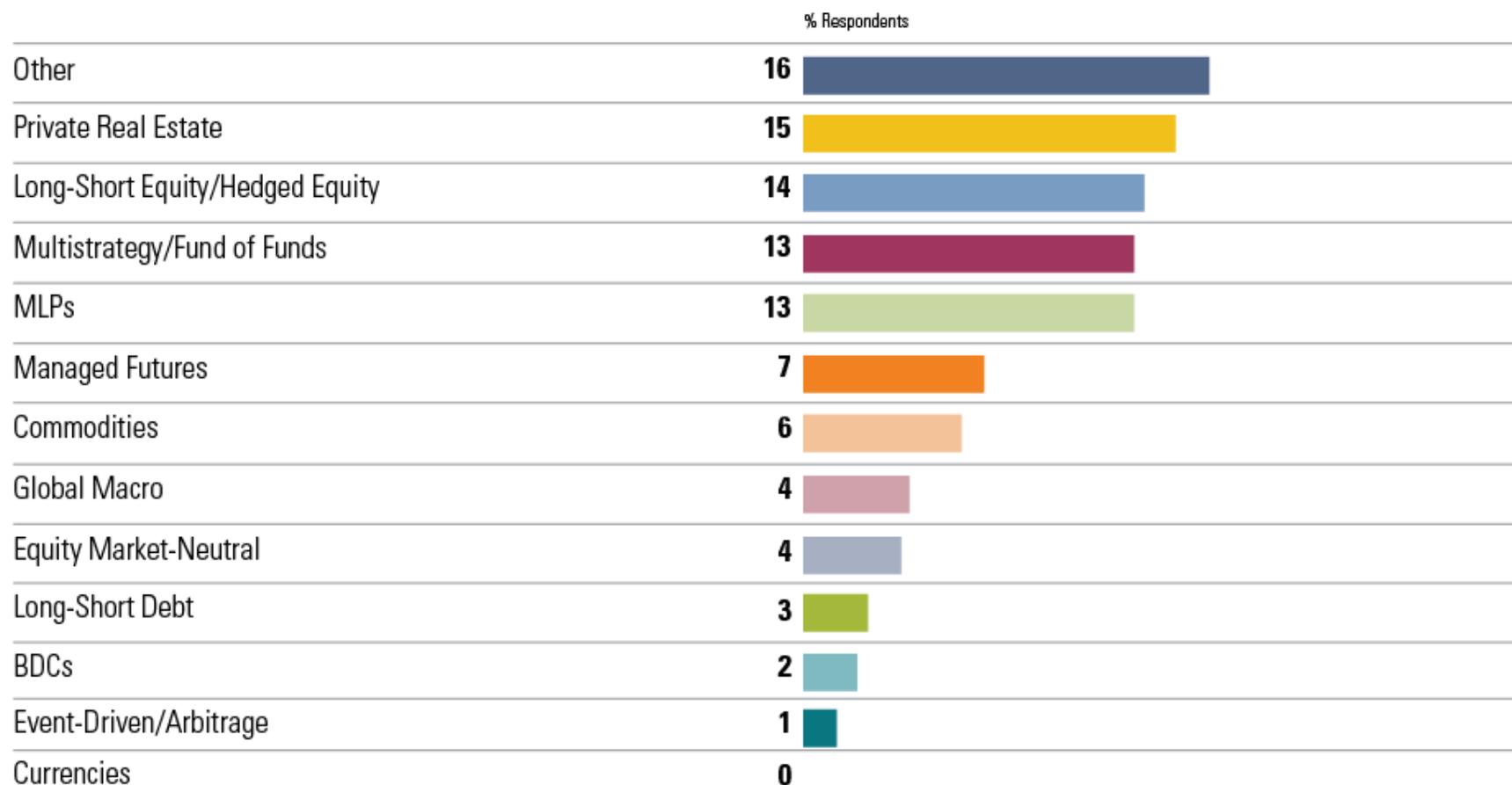
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# Advisors: Allocation to Alternative Investments Over Time



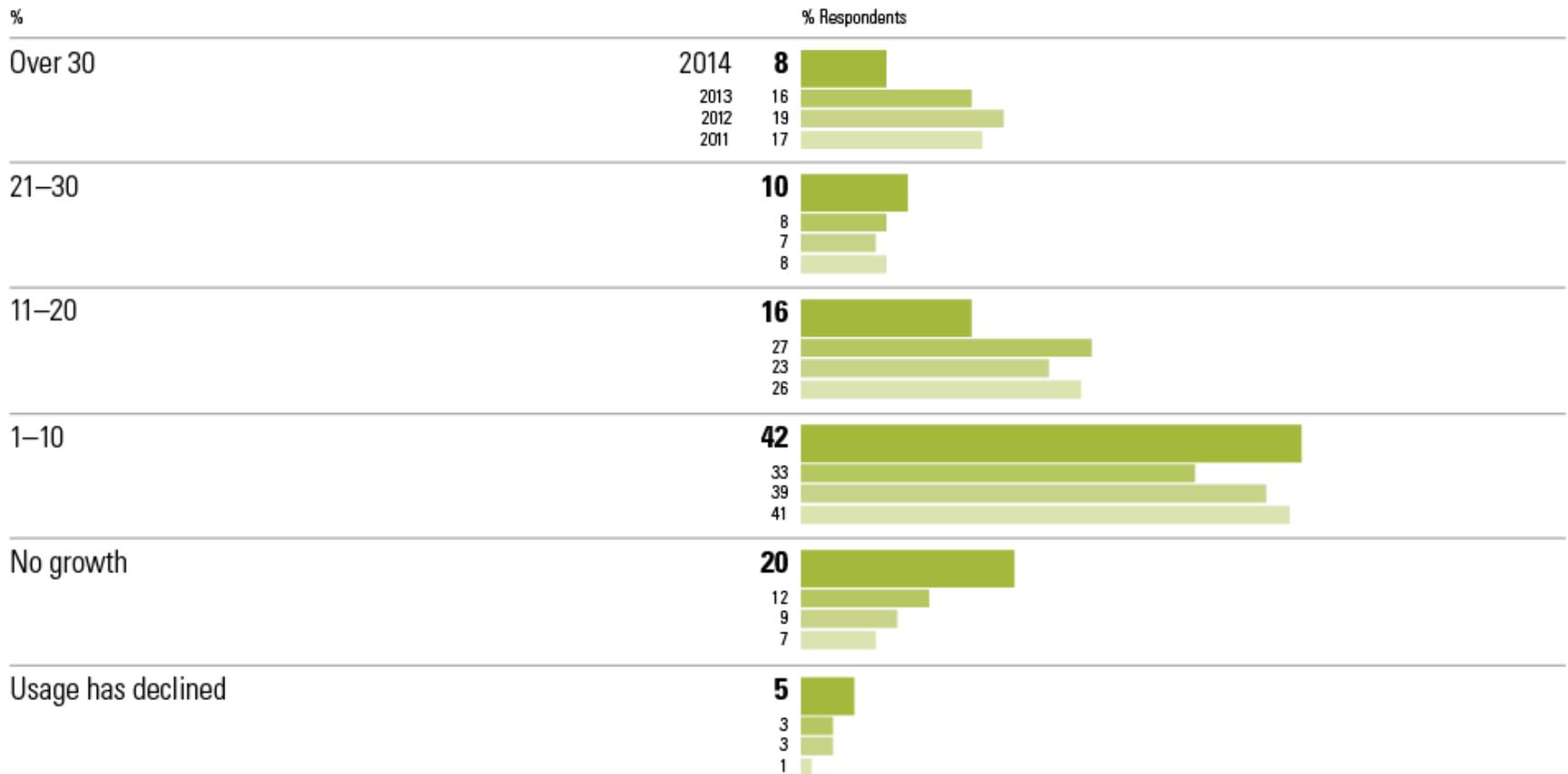
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## Advisors: Current Largest Alternative Investment Strategy



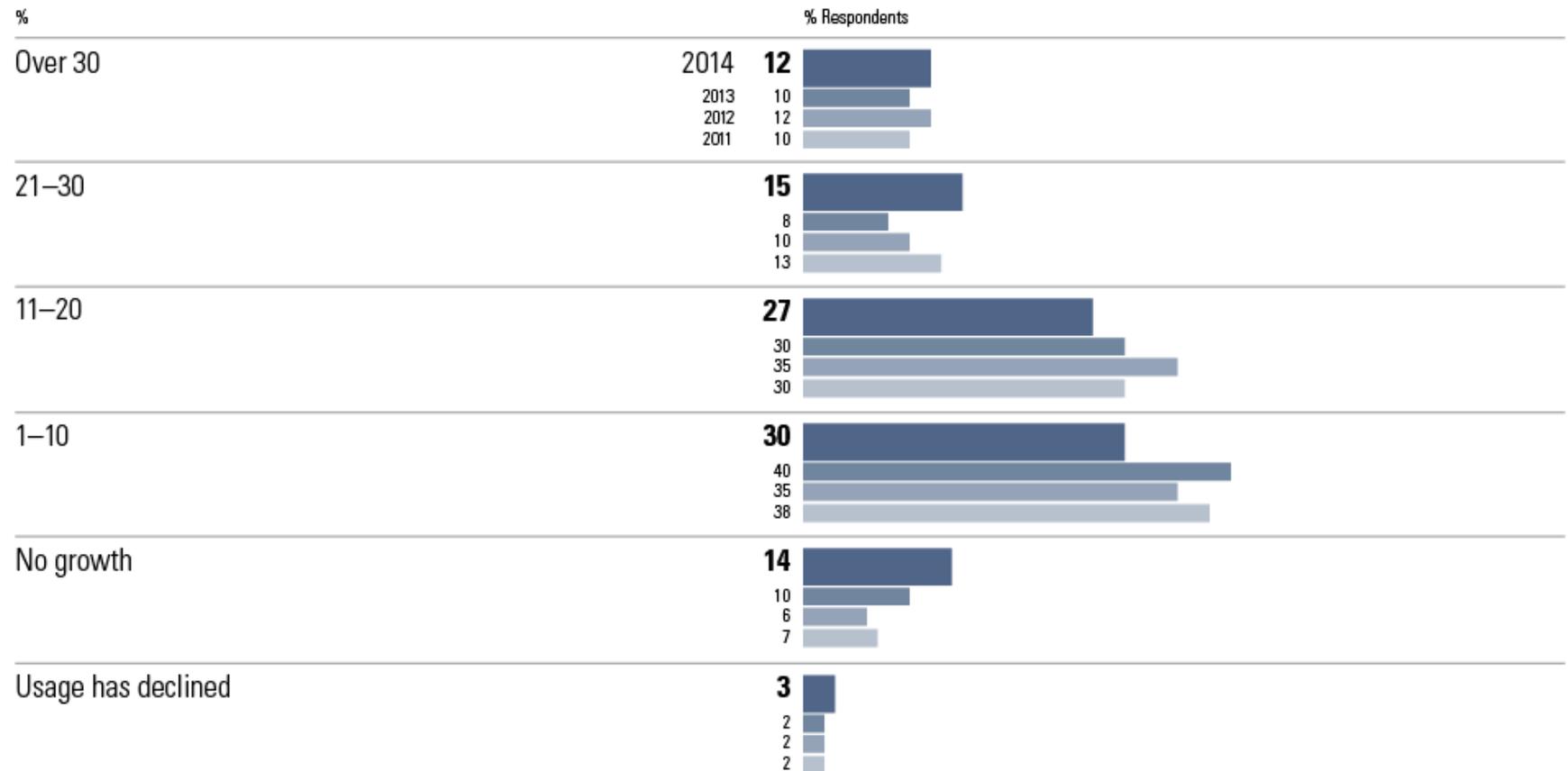
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# Institutions: Estimated Average Annual Increase in Alternative Allocation Over the Past Five Years



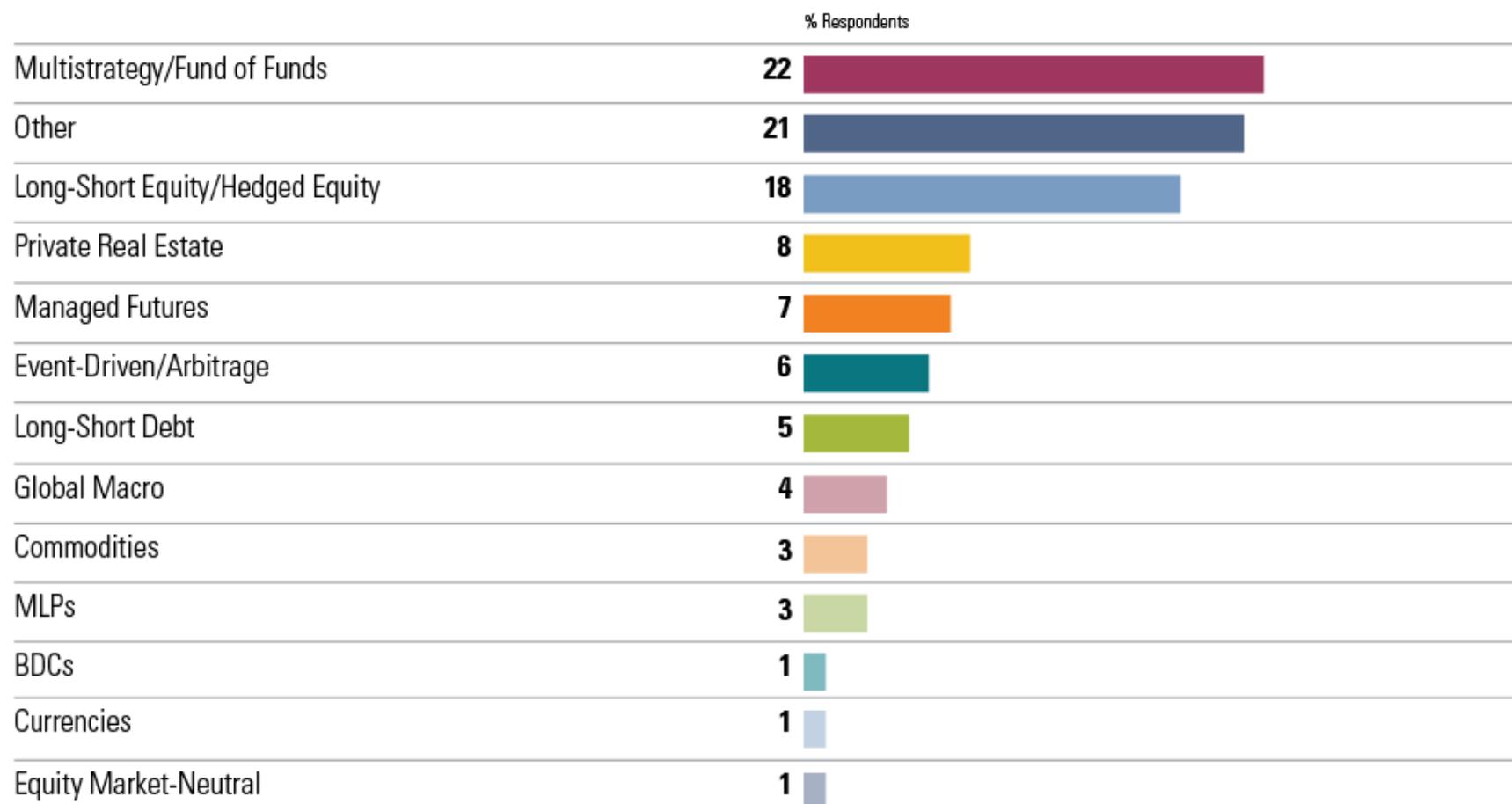
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# Advisors: Estimated Average Annual Increase in Alternative Allocation Over the Past Five Years



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## Institutions: Strategies Growing the Fastest as a Percentage of Alternative Allocation Over the Past Five Years



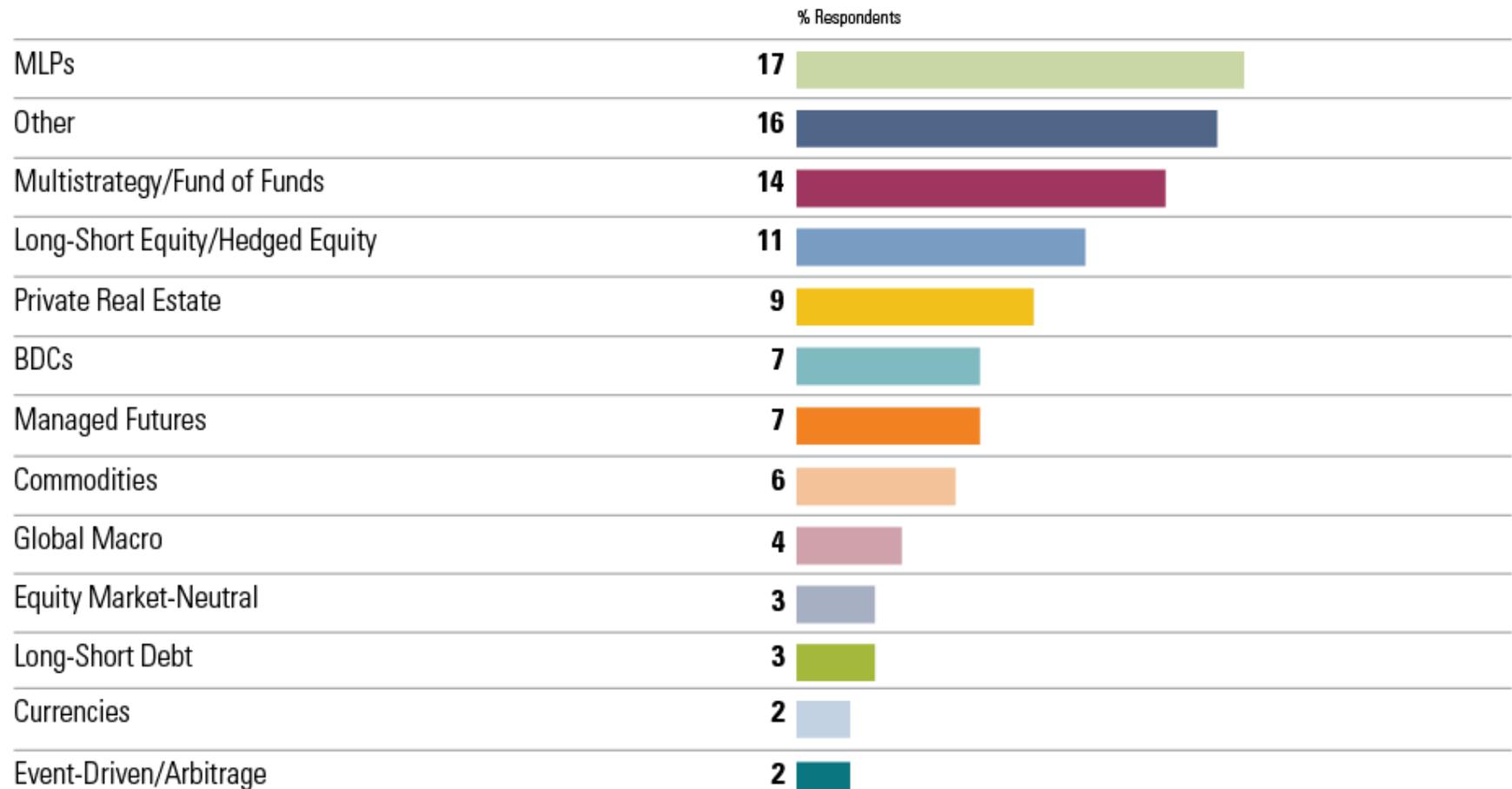
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## Institutions: Other Alternative Investment Strategies

- ▶ Other responses include:
  - ▶ Private Equity Lending
  - ▶ Direct Private Equity
  - ▶ Managed Volatility
  - ▶ REITs/Real Estate
  - ▶ Opportunistic Credit

## Advisors: Alternative Strategies Growing the Fastest as a Percentage of Alternative Allocation Over the Past Five Years



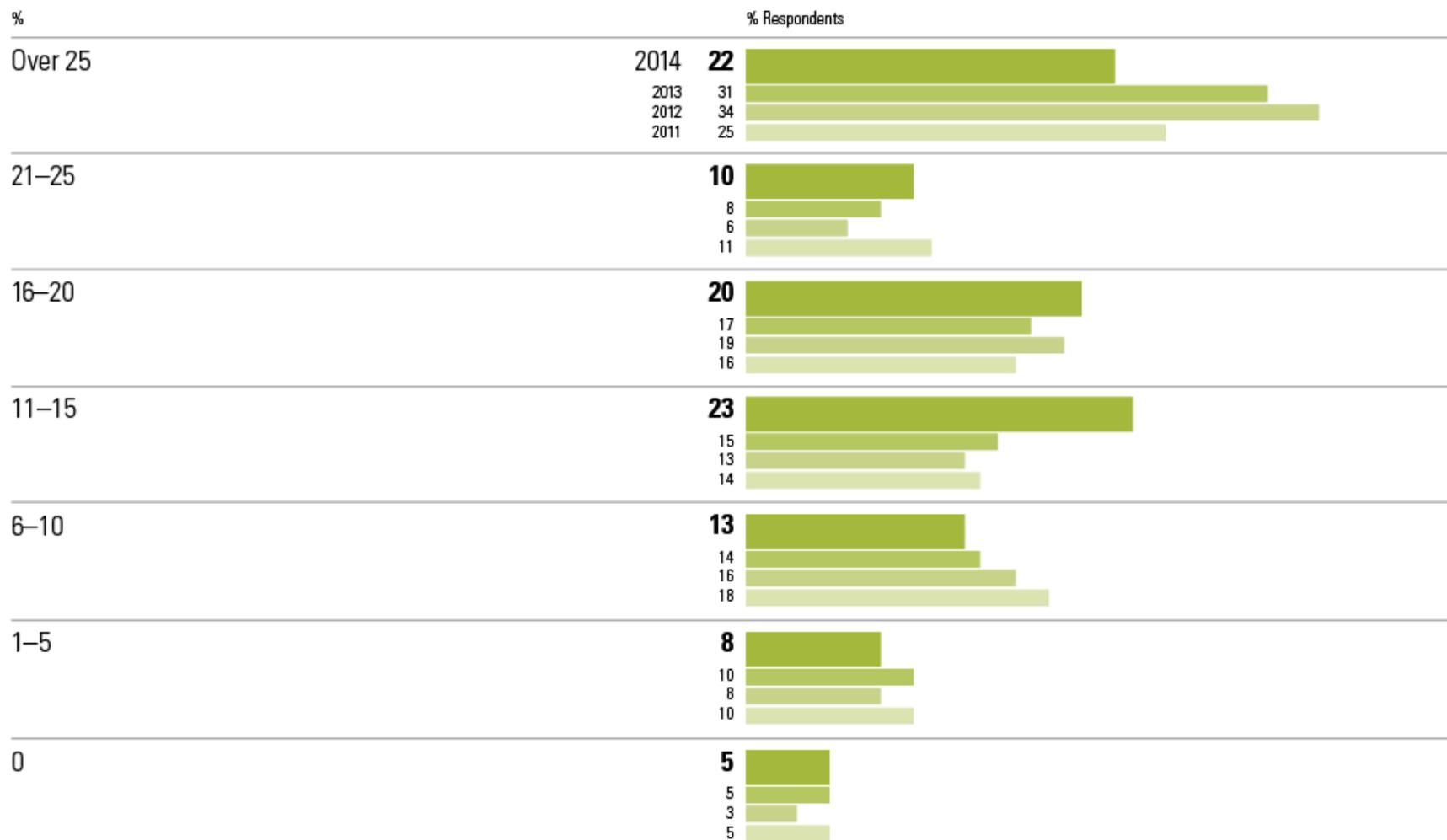
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## Advisors: Other Alternative Investment Strategies

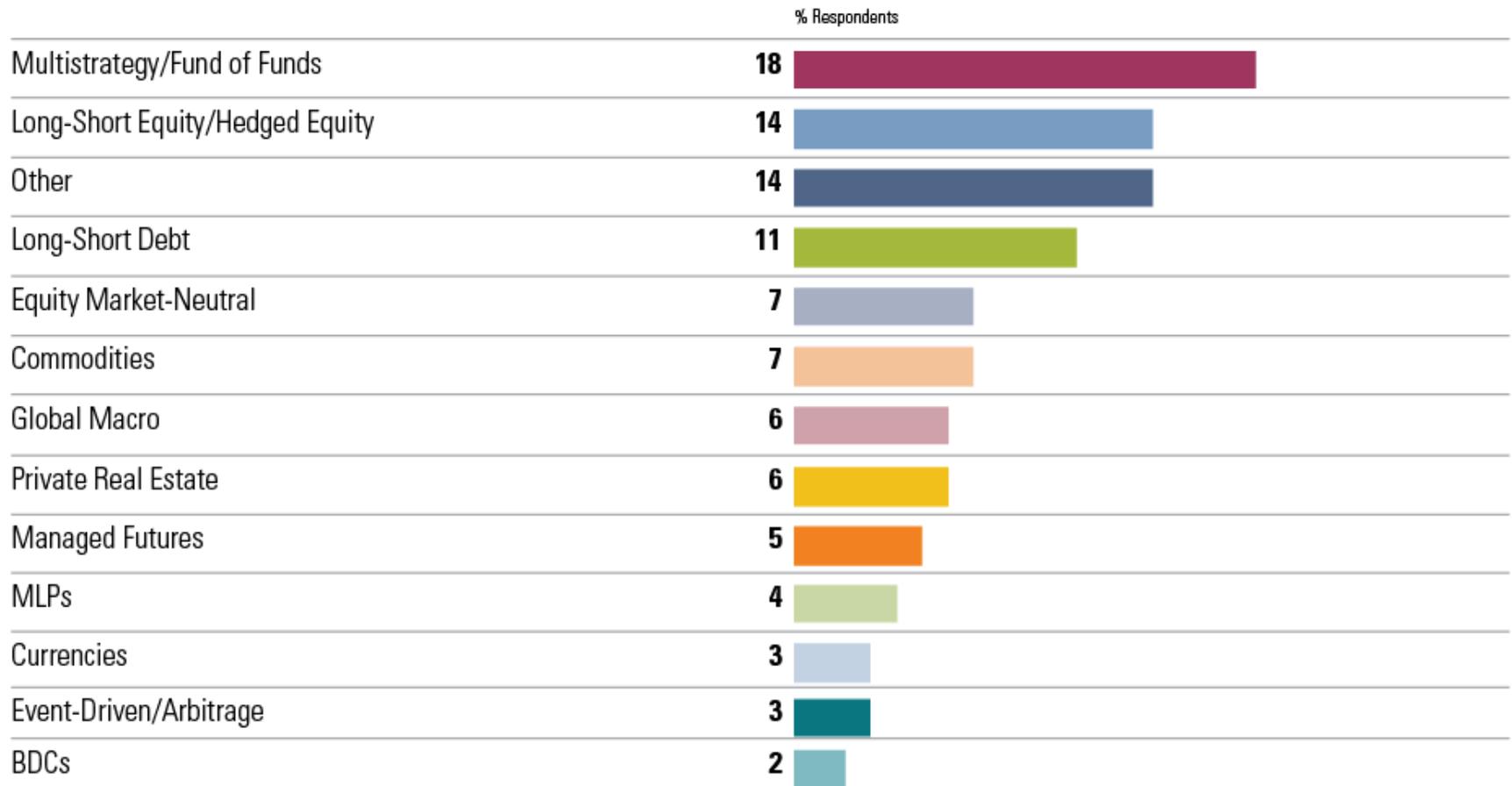
- ▶ Other responses include:
  - ▶ Nontraded REITs/Public REITs
  - ▶ Global Tactical Asset Allocation
  - ▶ Reinsurance Products
  - ▶ Private Equity/Venture Capital
  - ▶ Options-Based Strategies

# Institutions: Anticipated Allocation to Alternatives Five Years From Now



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# Institutions: Top Alternative Strategies for Increased Allocation



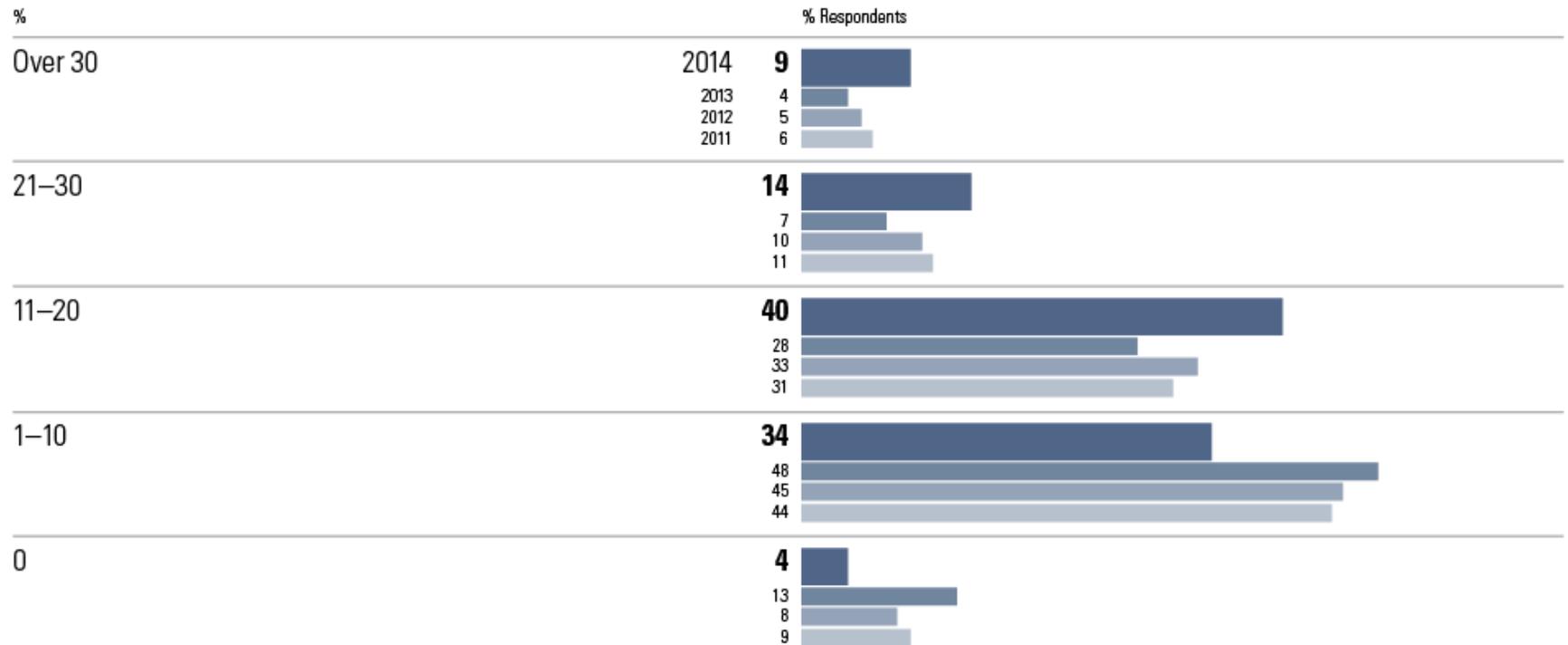
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## Institutions: Other Top Alternative Strategies for Increased Allocation

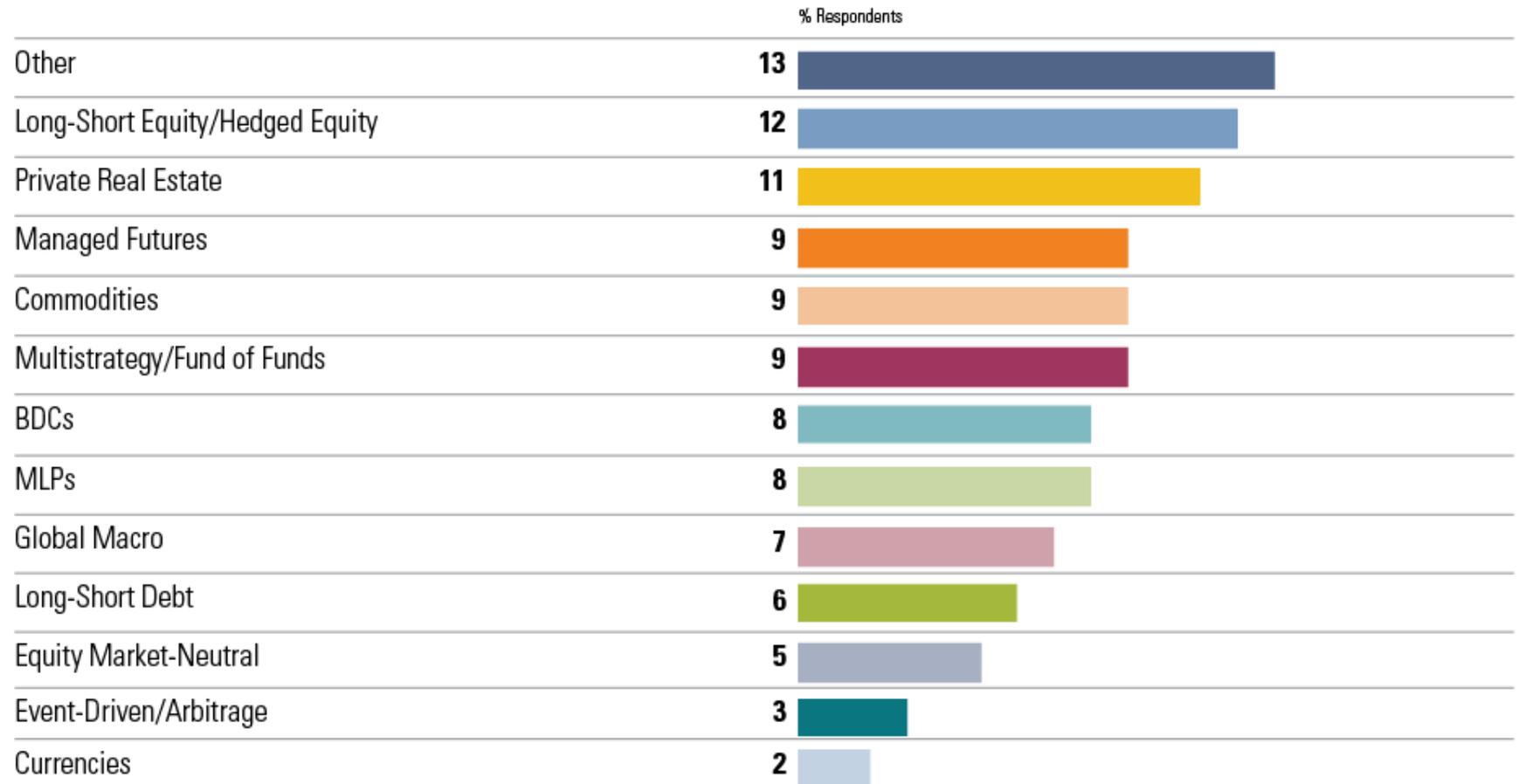
- ▶ Other responses include:
  - ▶ Managed Volatility
  - ▶ REITs/Real Estate
  - ▶ Private Equity
  - ▶ Hedge Fund Replication
  - ▶ Options-Based Strategies

# Advisors: Anticipated Allocation to Alternatives Five Years From Now



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## Advisors: Top Alternative Strategies for Increased Allocation



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## Advisors: Other Top Alternative Strategies for Increased Allocation

- ▶ Other responses include:
  - ▶ Options-Based Strategies
  - ▶ Venture Capital/Private Equity
  - ▶ Publicly Traded Private Equity
  - ▶ REITs/Real Estate
  - ▶ Global Tactical Asset Allocation

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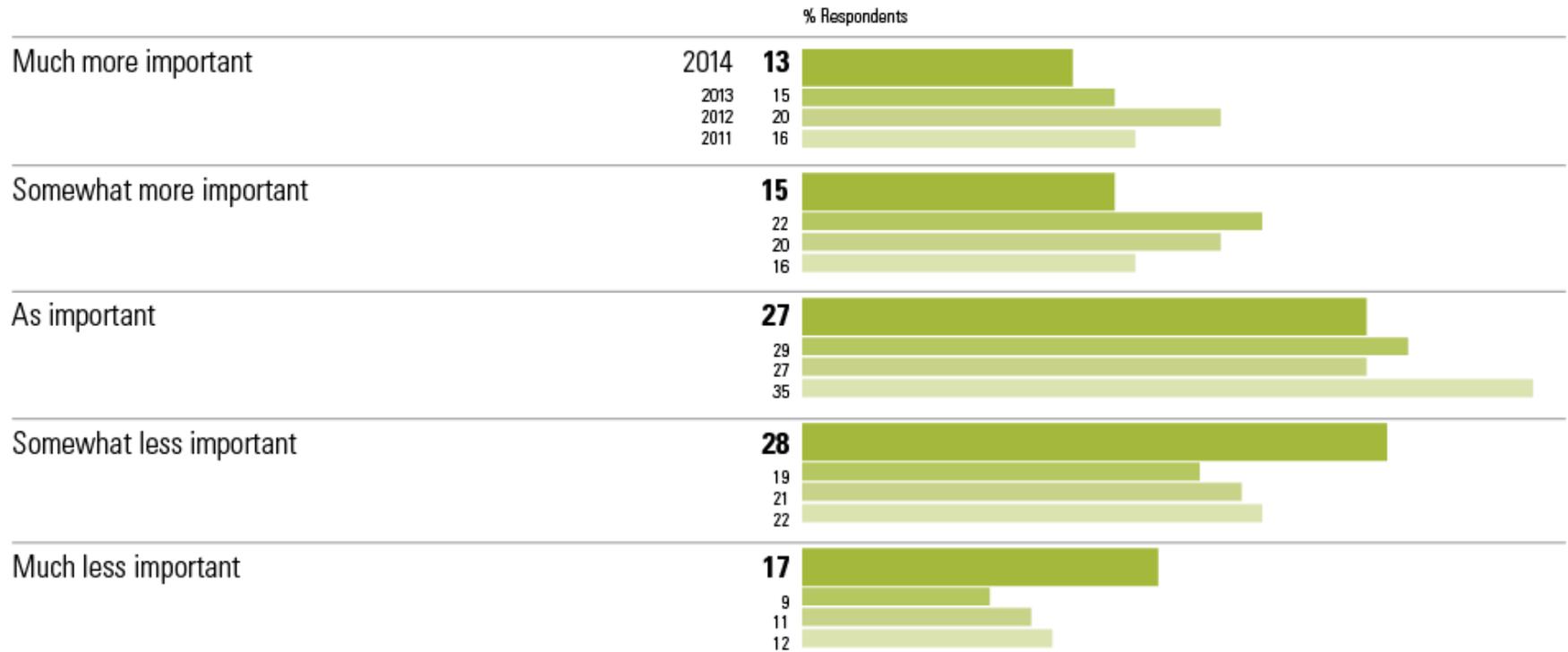
# Alternative Investment Drivers and Deterrents

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## Drivers and Deterrents

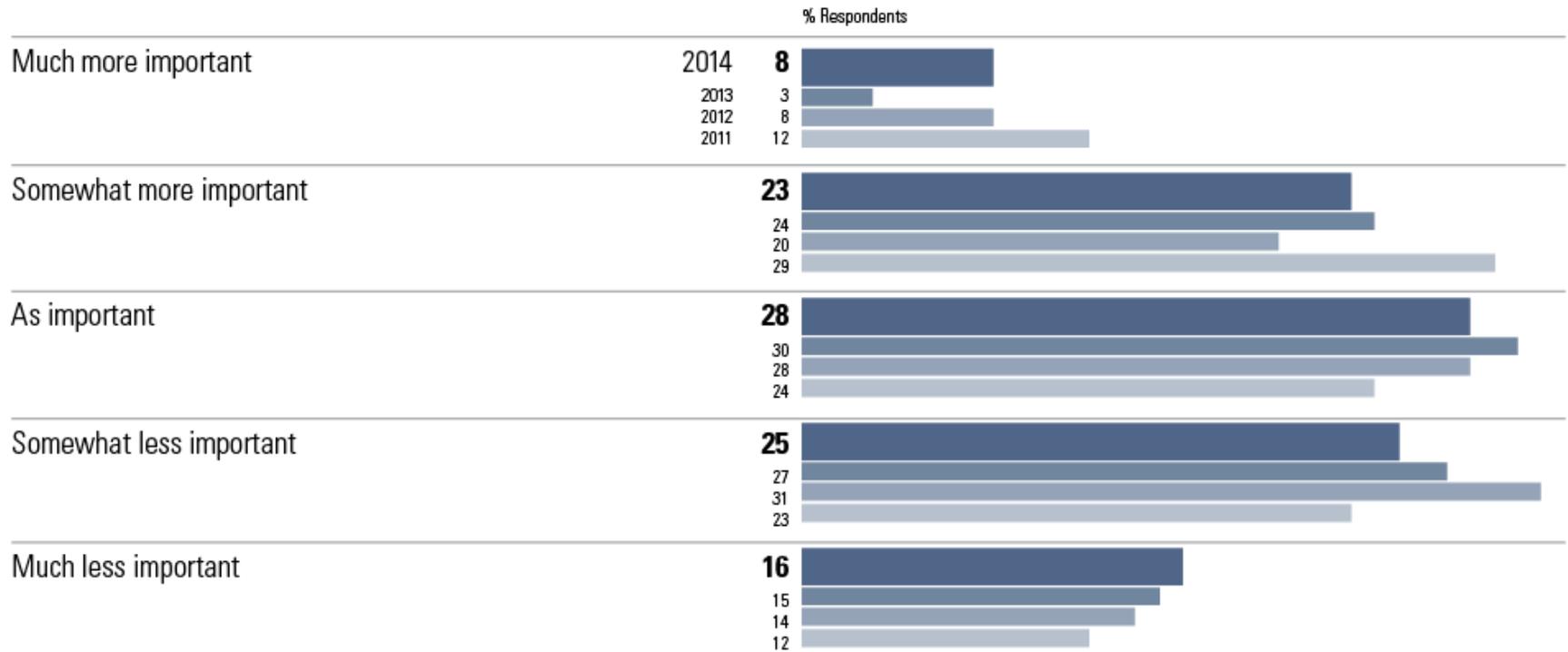
- ▶ Interestingly, a higher percentage of institutions stated that alternatives were “somewhat less important” or “much less important” than traditional investments, as compared with the previous year. Advisors appeared to hold similar convictions as last year.
- ▶ Once again, diversification/low correlation remains the top driver for investing in alternatives. The poor bond market outlook was also a top reason to invest in alternatives, as both advisors and institutions look to seek cover from rising interest rates and low yields.
- ▶ Compared with last year, investors more often cited “higher correlation to the stock market than anticipated” as a top reason to hesitate investing in alternatives. Respondents also cited “difficulty to perform due diligence” as a top impediment. Alternative asset managers should emphasize true differentiation of their strategies as well as improved transparency.
- ▶ High fees remained the top impediment to investing for both advisors and institutions, with half or more of each group citing fees as a top reason to hesitate.

# Institutions: Importance of Alternative Investments Relative to Traditional Investments



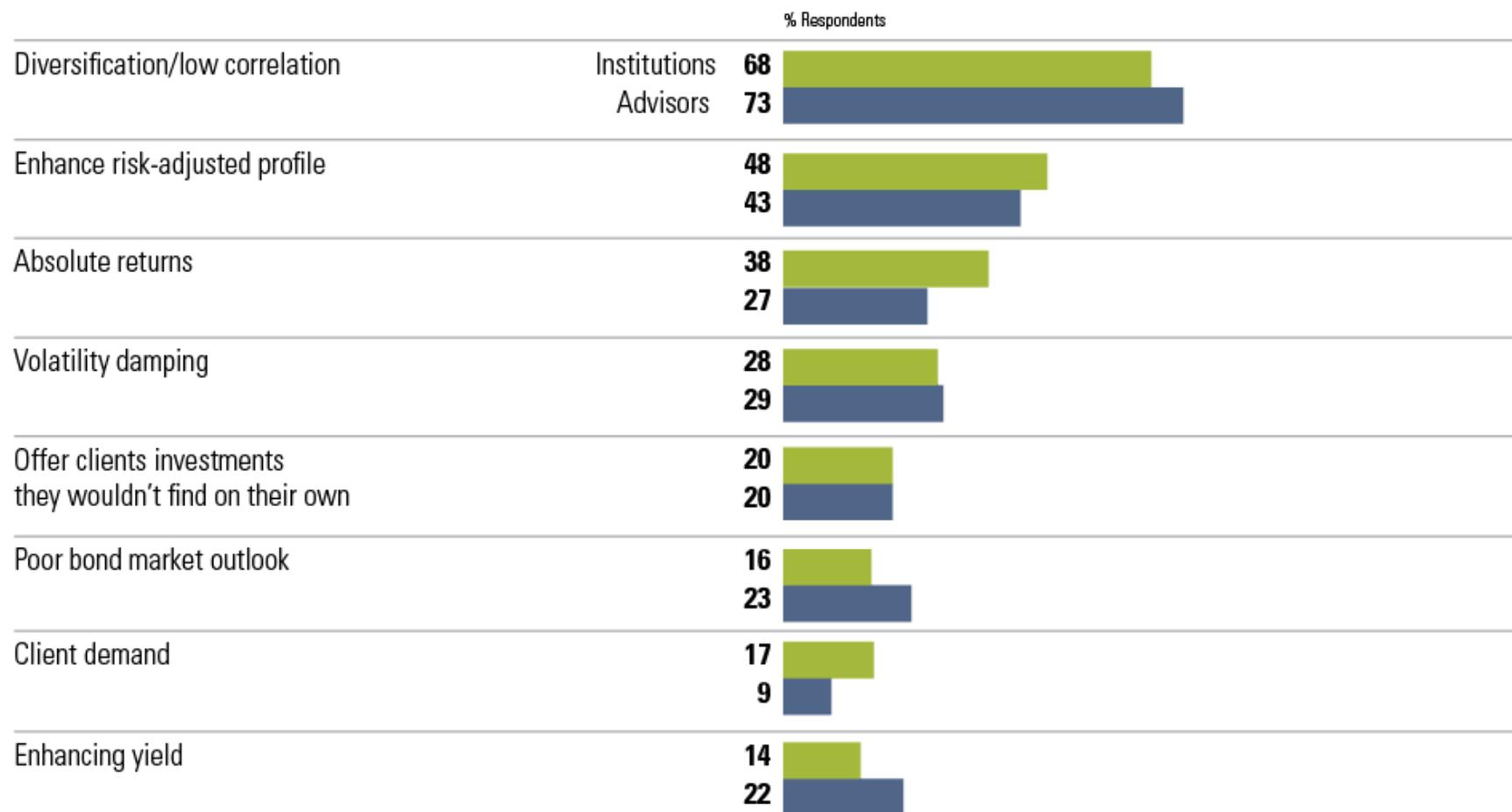
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# Advisors: Importance of Alternative Investments Relative to Traditional Investments



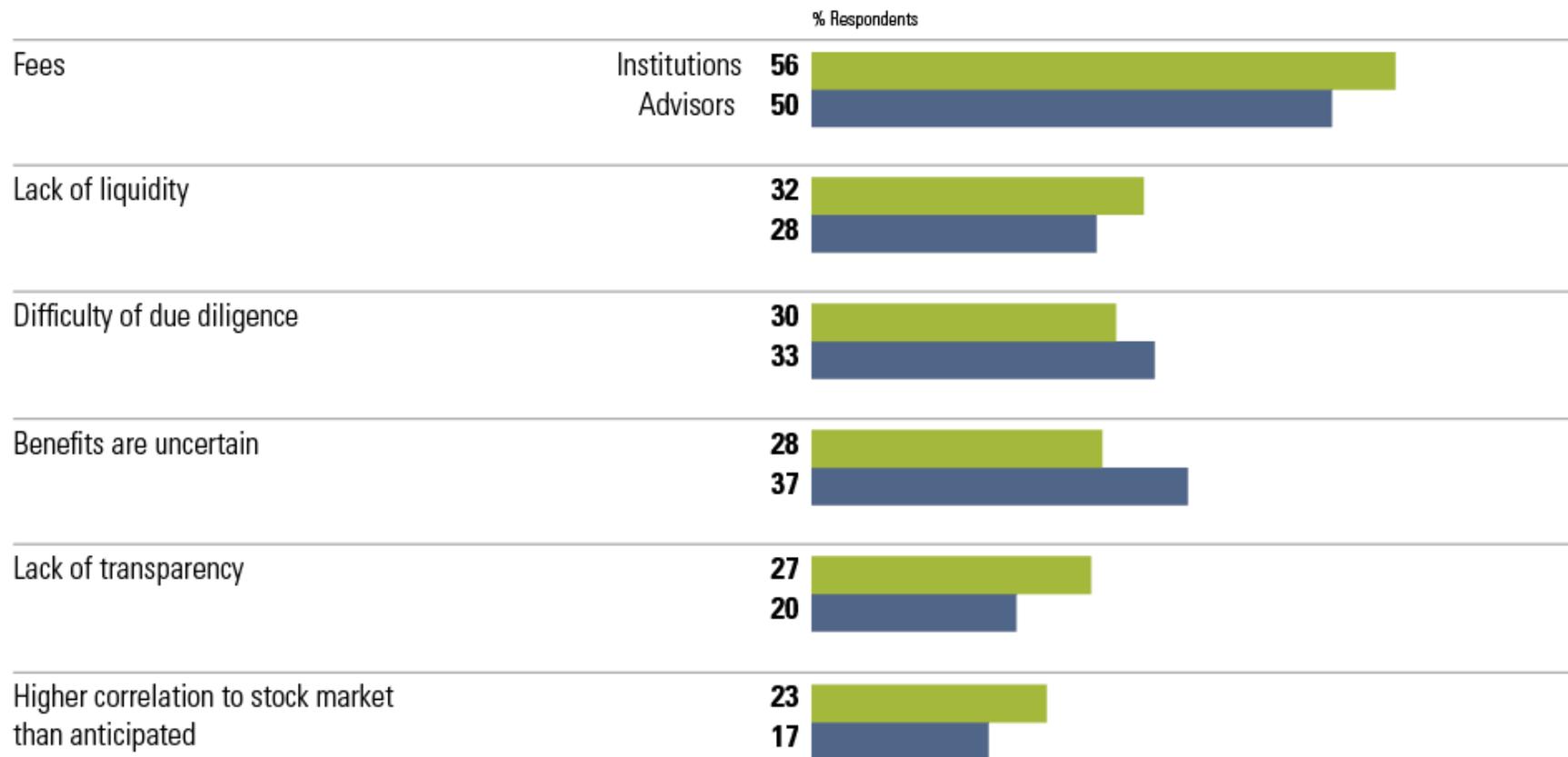
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# Institutions and Advisors: Top Drivers of Investments in Alternatives (Up to Three Responses Selected)



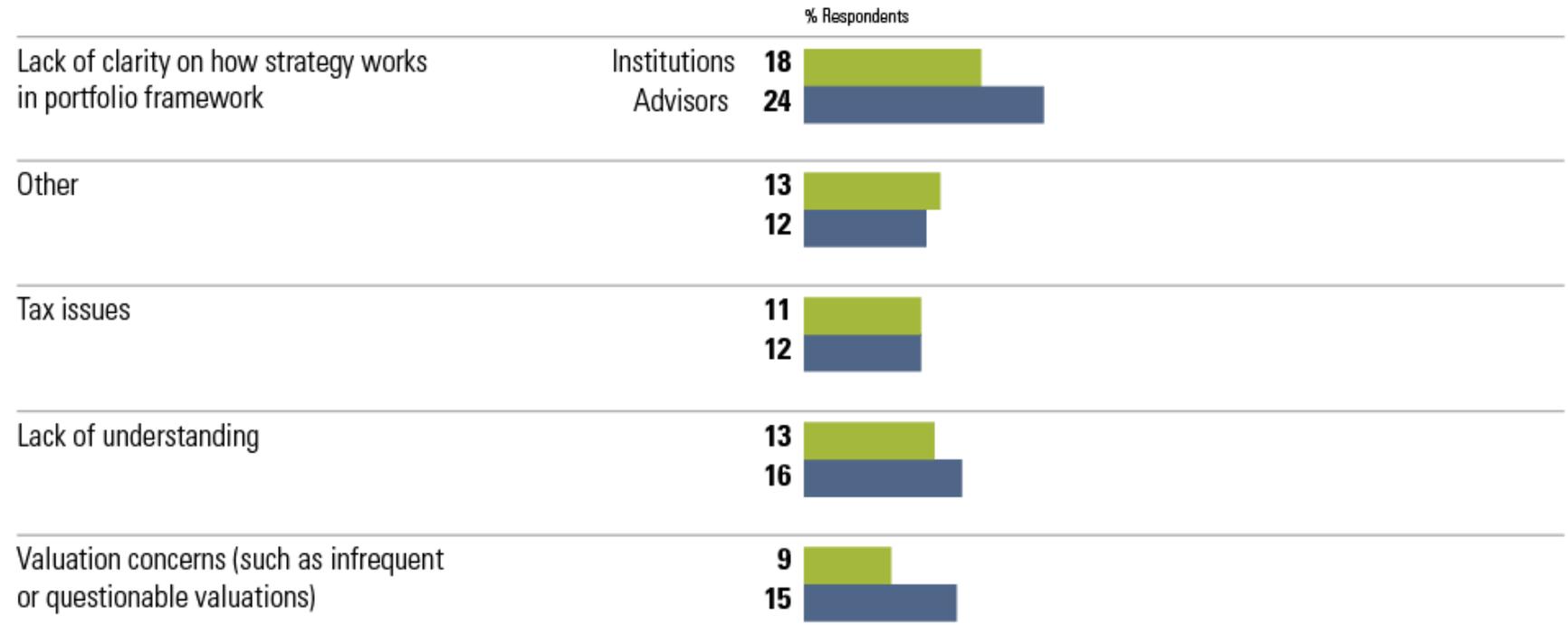
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# Institutions and Advisors: Top Reasons to Hesitate Investing in Alternatives (Up to Three Responses Selected)



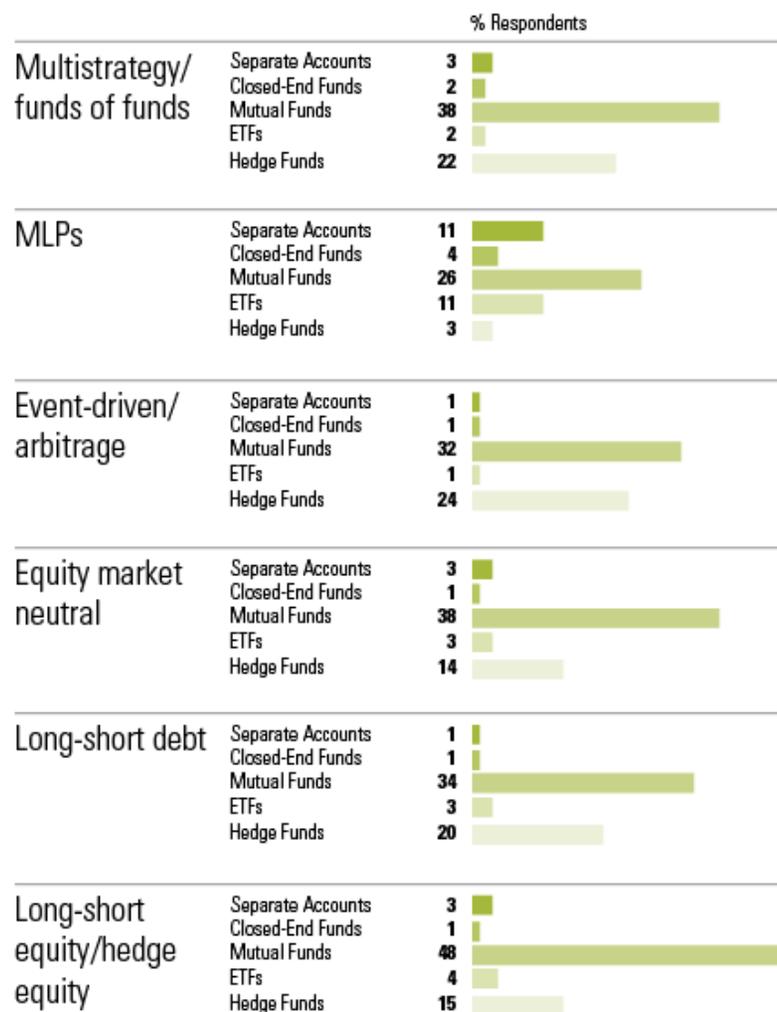
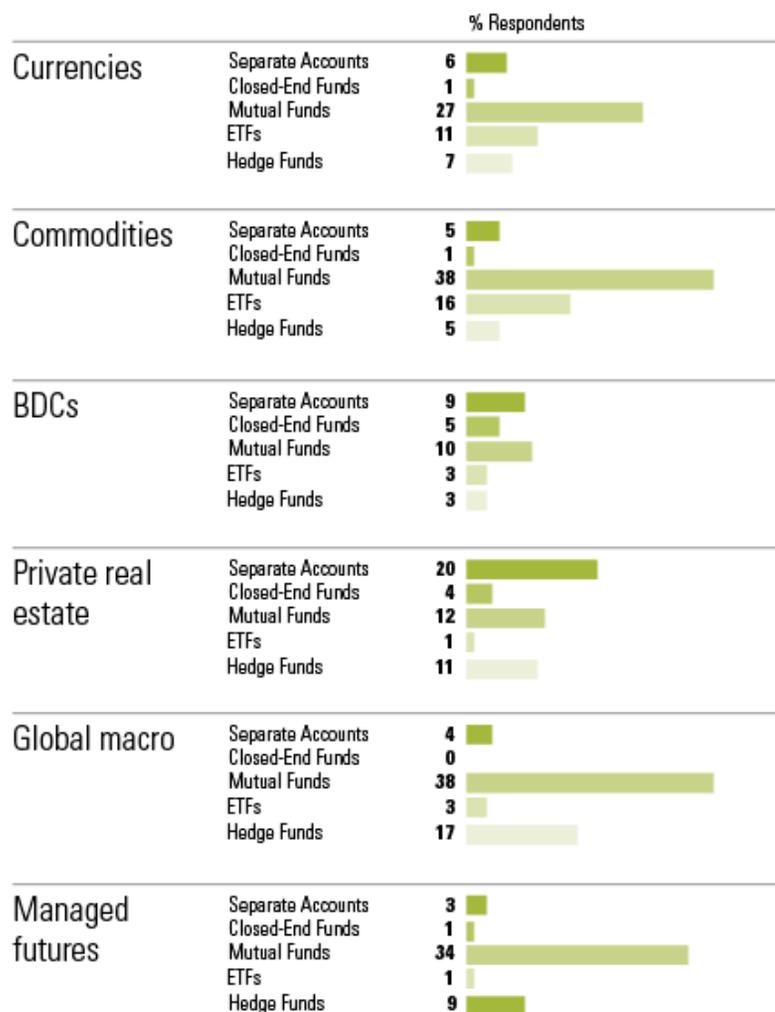
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# Institutions and Advisors: Top Reasons to Hesitate Investing in Alternatives (cont.)



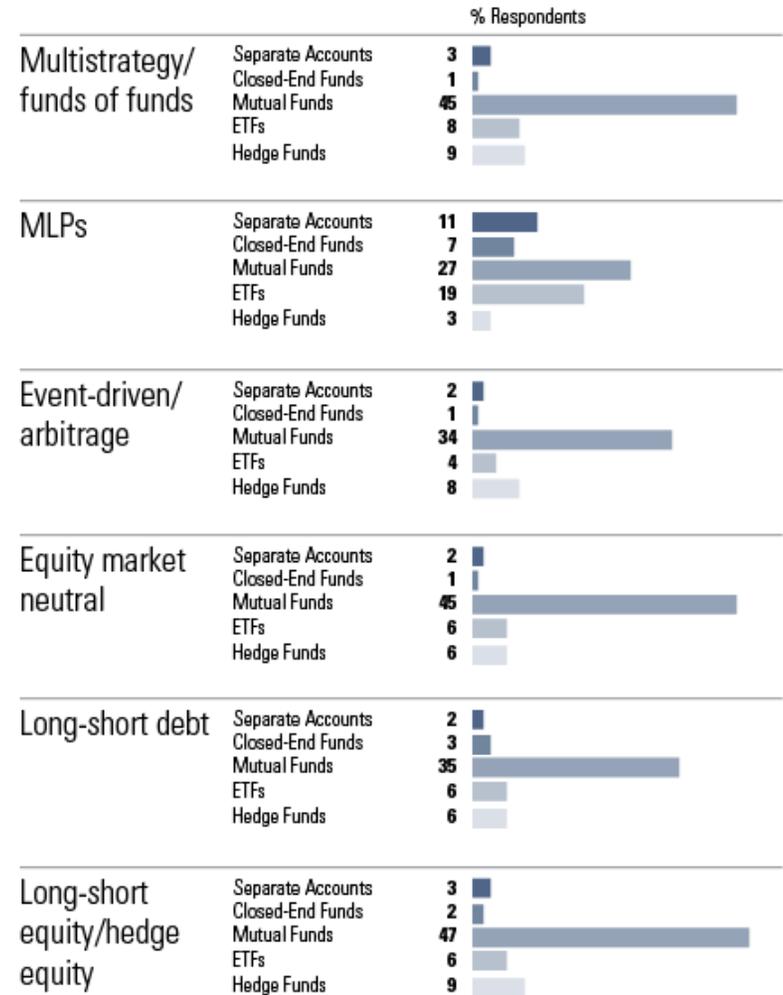
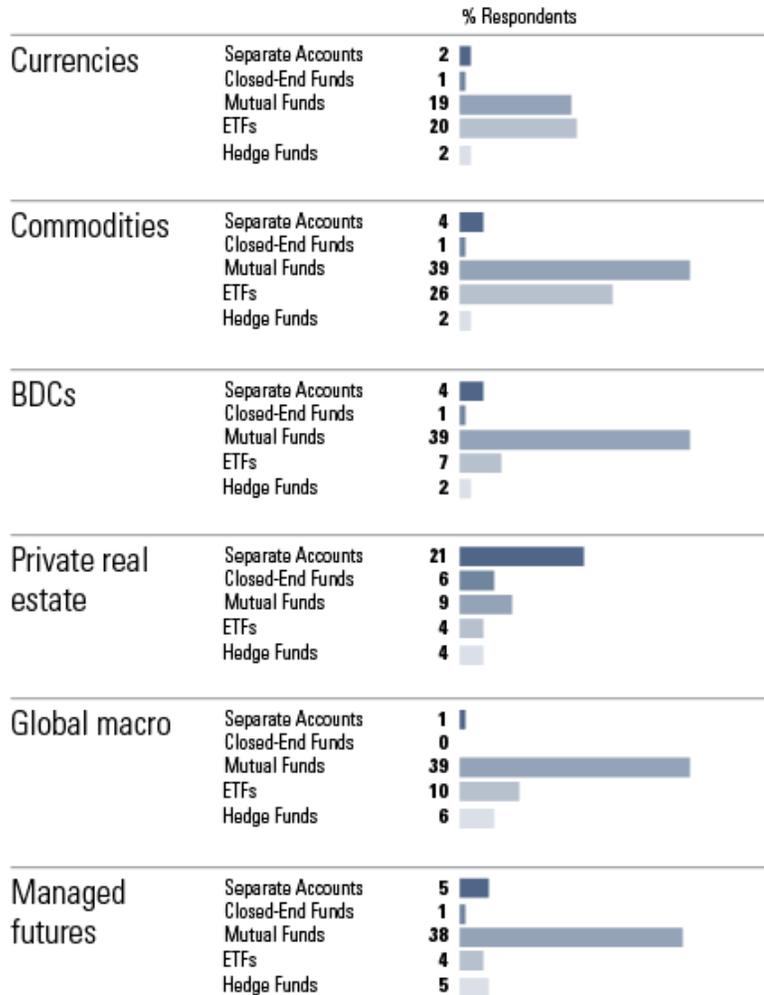
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# Institutions: Investment Vehicles Used to Gain Access to Alternative Strategies



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# Advisors: Investment Vehicles Used to Gain Access to Alternative Strategies



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## Hot Topics in 2014-2015

- ▶ CALPERS' hedge fund exodus
- ▶ Single manager vs. multimanager structures
- ▶ Client characteristics most suitable for alternatives
- ▶ Appeal of nontraded REITS

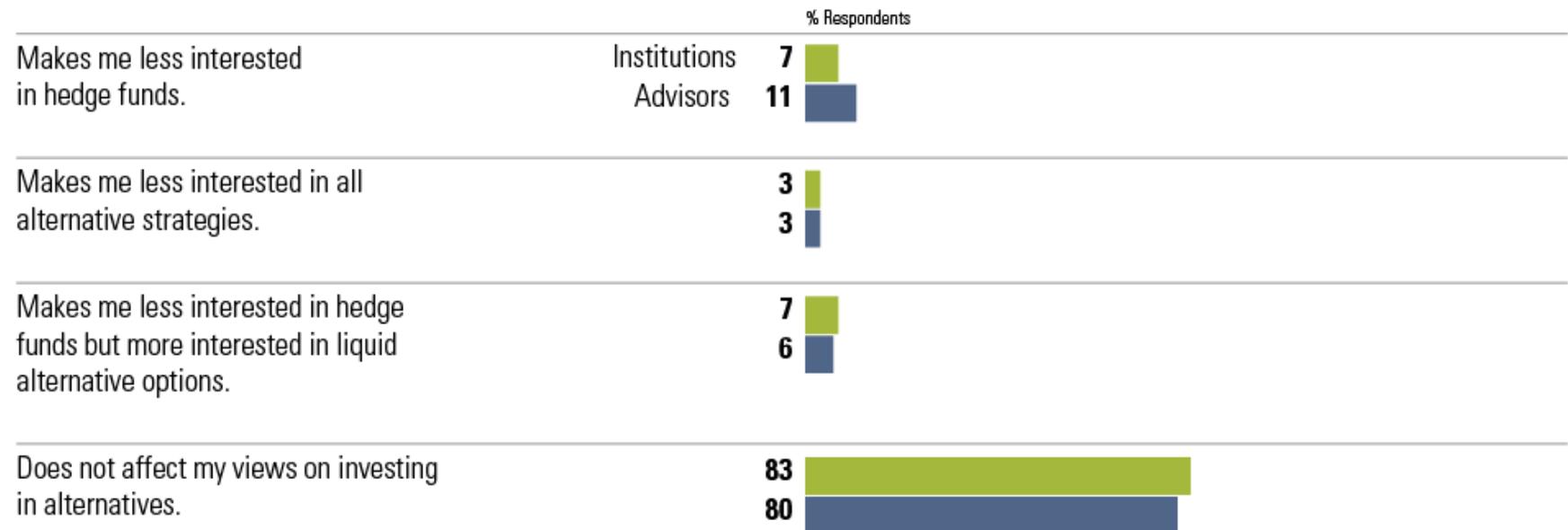
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## Hot Topics in 2014-2015

- ▶ CALPERS' decision to divest its hedge fund business seems not to have had an impact on respondents' sentiment regarding hedge funds. The news buzz around this story may have been greater than its practical impact on the investment world.
- ▶ Most advisors are agnostic between single and multimanager alternative strategies, suggesting that fund companies should continue to develop both types of products.
- ▶ Respondents believed that alternatives were more suited for clients with above-average sophistication and a higher level of assets. Meanwhile, advisors and institutions agreed that alternatives are least suitable for clients near retirement and also not suitable for clients requiring a high degree of risk.
- ▶ Many advisors and institutions expressed unfavorable or skeptical attitudes toward nontraded REITS, which may put a ceiling on the growth of this asset class.

## Hot Topics: CALPERS' Hedge Fund Exodus

Does CALPERS' decision in 2014 to divest its hedge fund investment arm influence your views on investing in hedge funds or liquid alternatives?

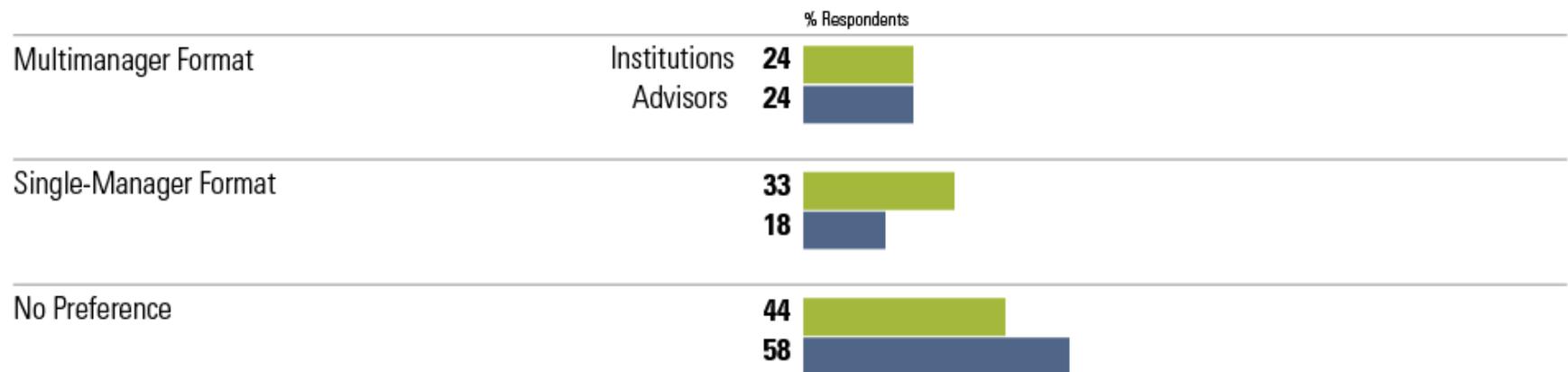


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## Hot Topics: Single Manager vs. Multimanager

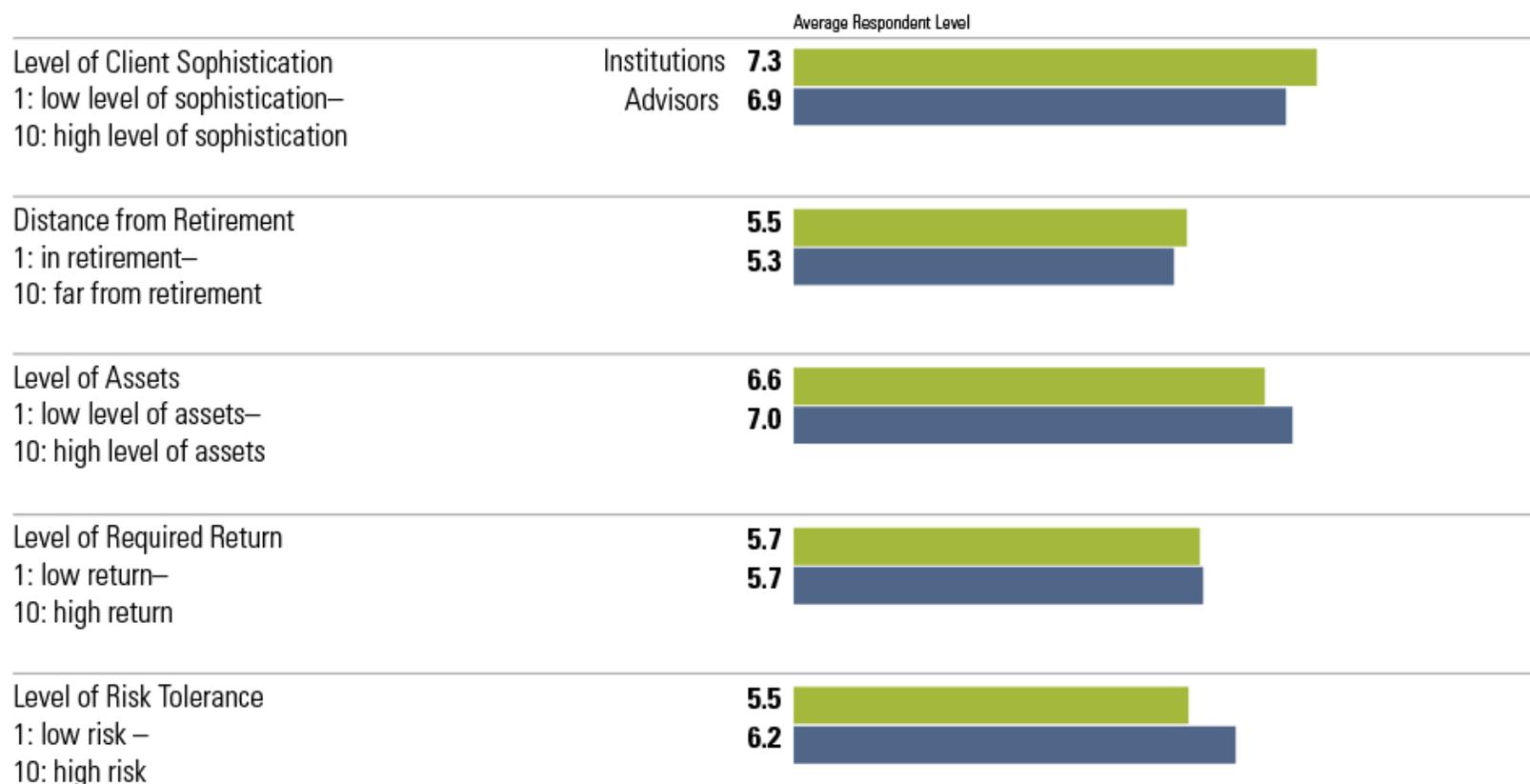
Do you have a preference regarding the manager structure of alternative funds?



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## Hot Topics: Client Characteristics Most Suitable for Alternatives

What client characteristics do you believe are the most optimal for alternatives?



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## Hot Topics: Favorability of Nontraded REITS

What is your attitude toward and/or investment use of nontraded REITS?

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Favorable: I currently use nontraded REITS in client portfolios and believe they are a reasonable investment.



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Neutral: I am considering investing in nontraded REITS but have not yet invested in them.



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Skeptical: I do not currently invest in nontraded REITS but would consider researching them further.



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Unfavorable: I do not intend to invest in nontraded REITS.



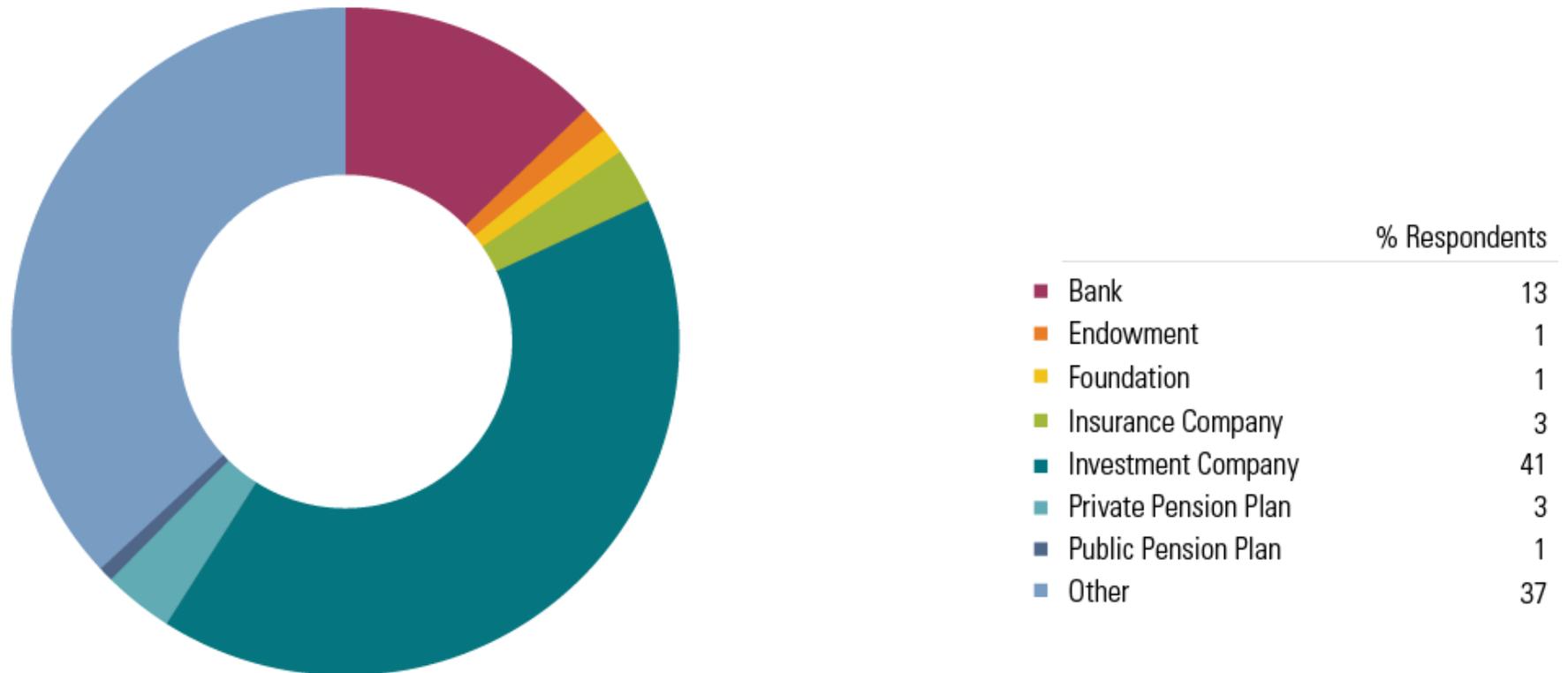
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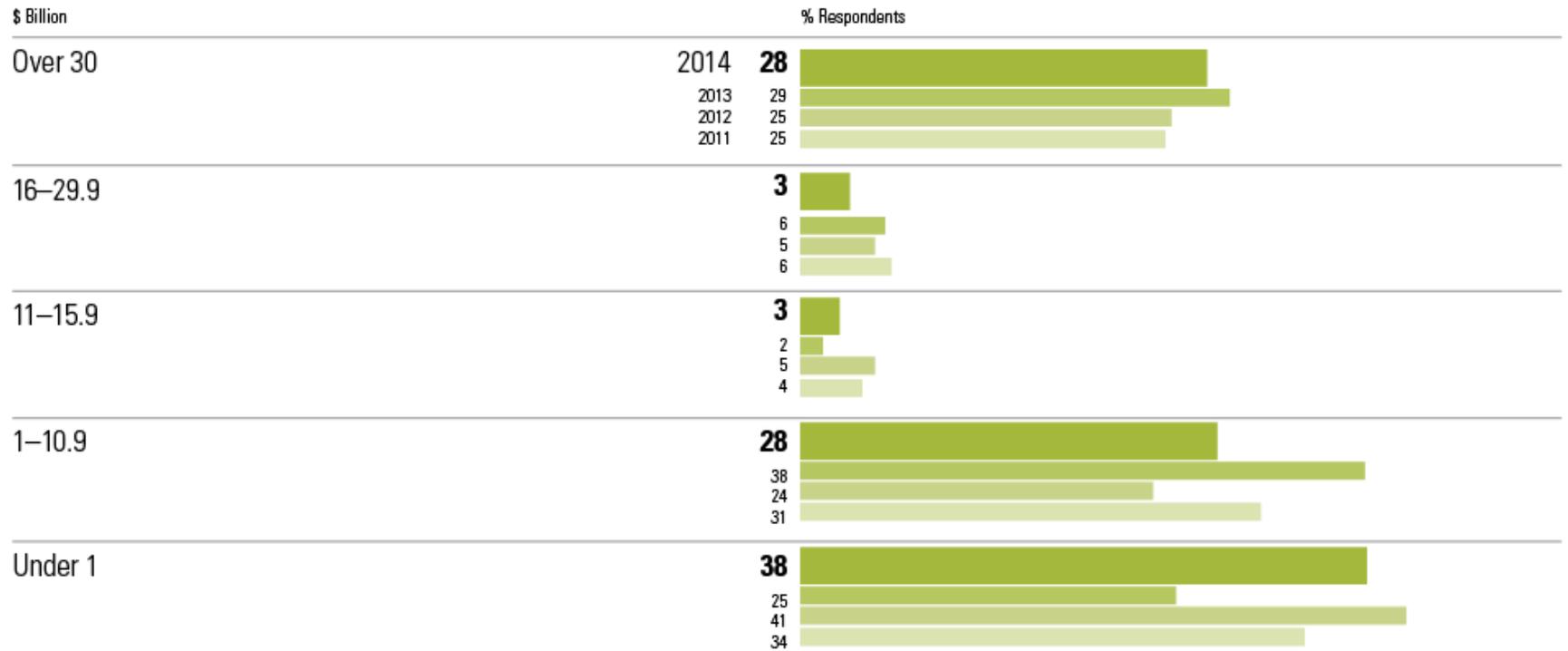
# 2014–2015 Survey Participation

## Institutions' 2014-2015 Survey Participation: 149 Responses



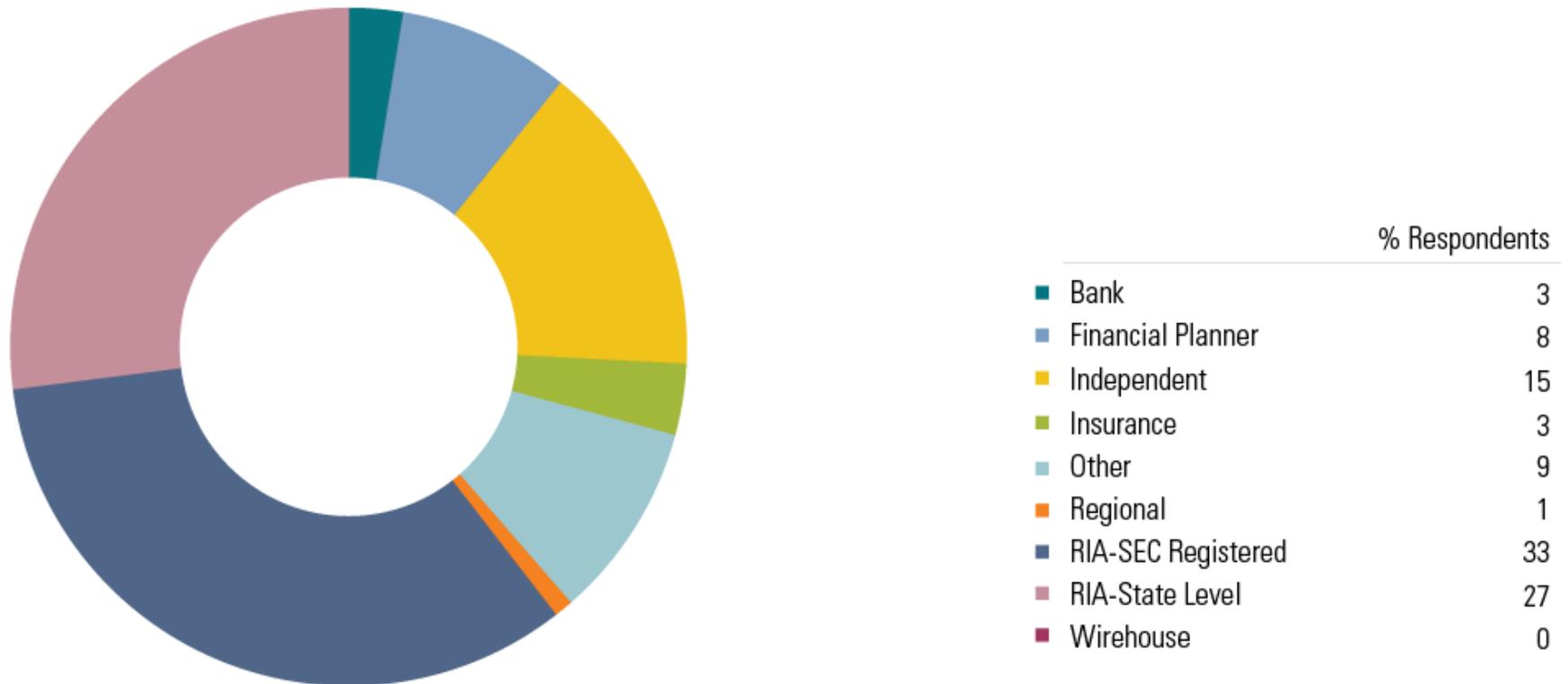
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# Institutions' Assets Under Management Compared With Previous Years



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## Advisors 2014-2015 Survey Participation: 233 Responses



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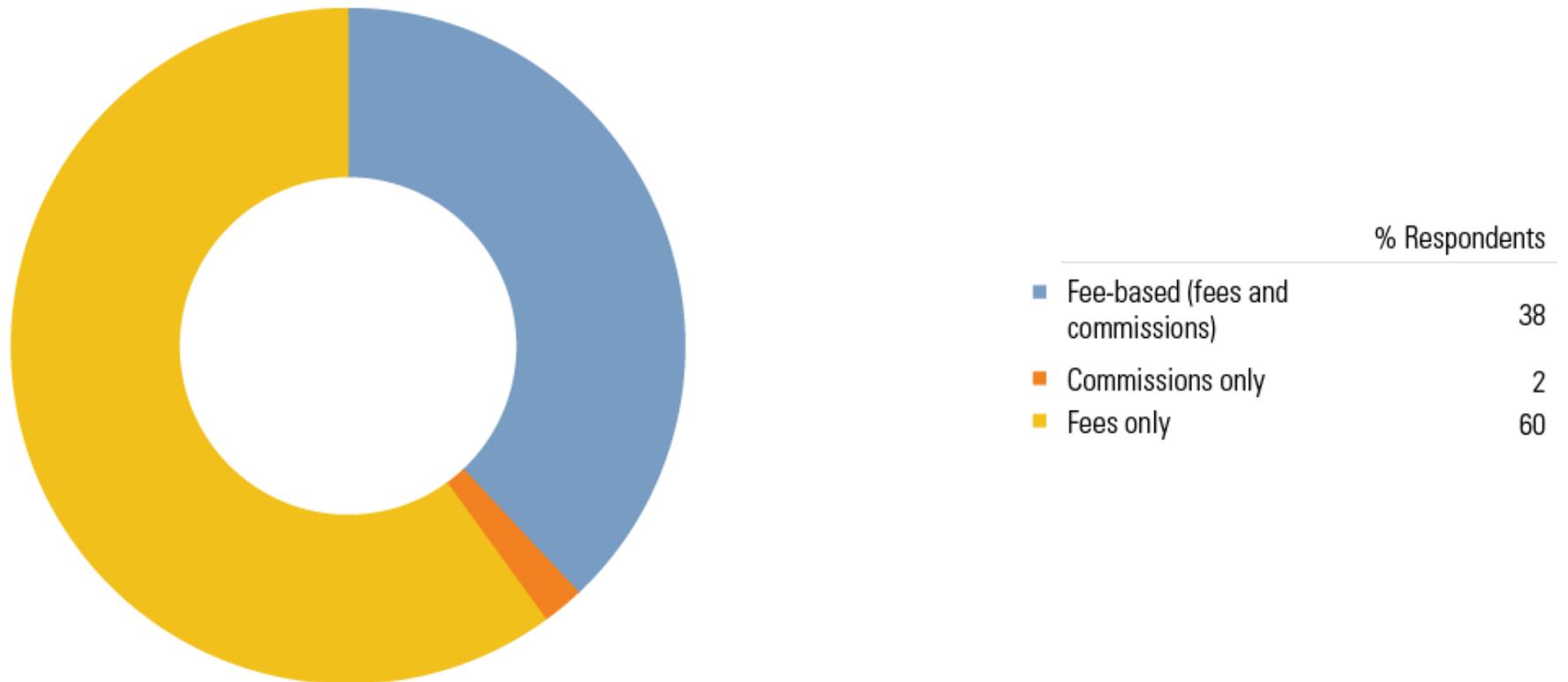
## Advisors Client Breakdown: 2014-2015



	% Respondents
■ Investors <\$1 million in net worth	39
■ Affluent investors \$1 million–\$5 million in net worth	30
■ High-net-worth investors >\$5 million in net worth	15
■ Institutional Investors—pension plans, foundations, endowments, and so on	15

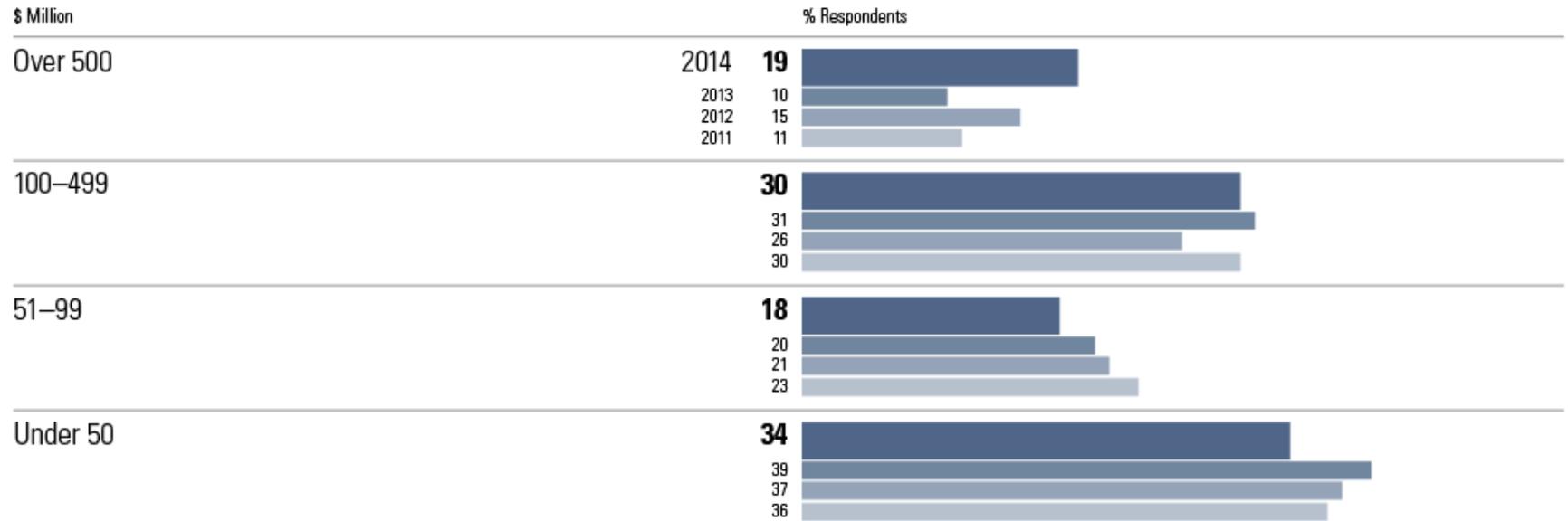
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## Advisors Compensation Breakdown: 2014-2015



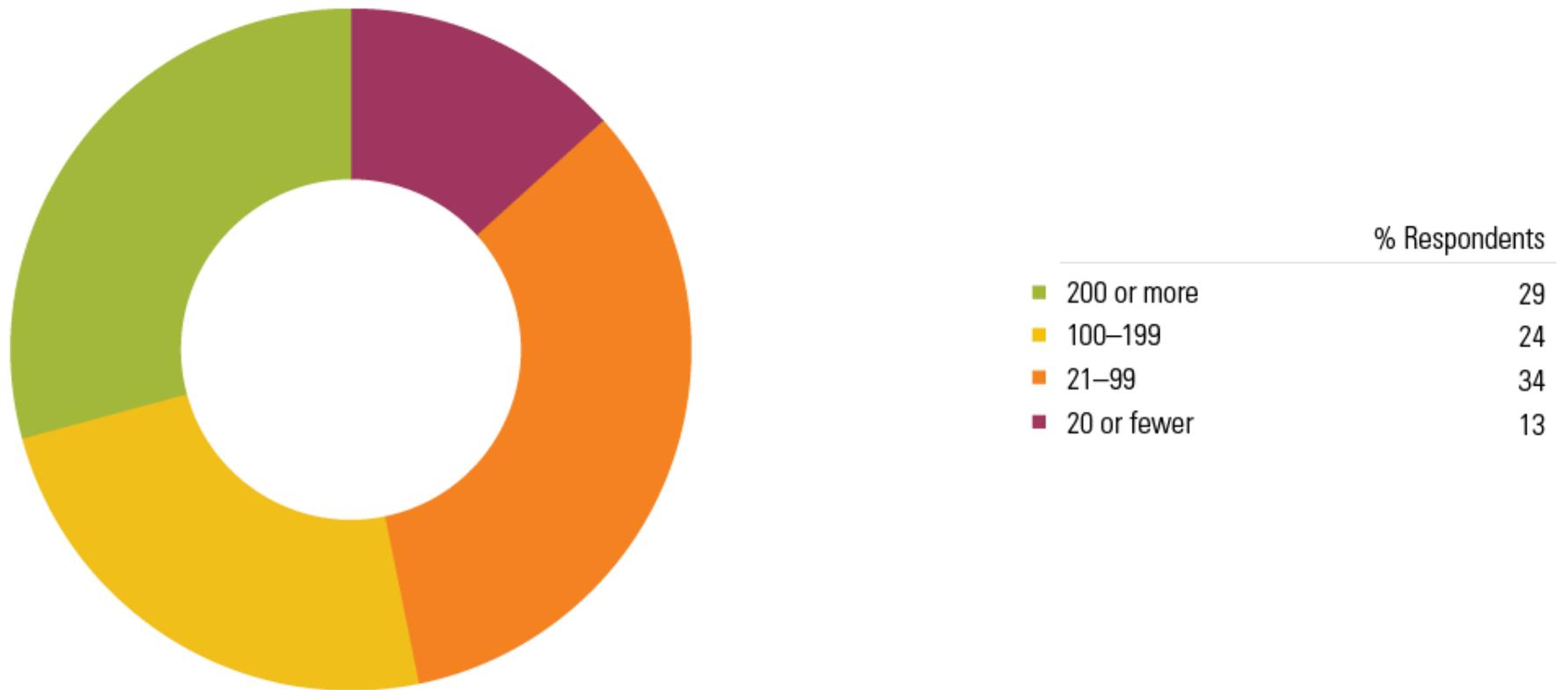
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# Advisors' Assets Under Management Compared With Previous Years



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## Advisors 2014-2015: Distribution by Number of Clients



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Alternative Strategies

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