The Rise of Alternatives

Game Changers
Future Trends in Securities Services

An in-depth look at the rise of alternative investments, with a focus on its drivers, its effects and the opportunities and risks it poses for investors, asset managers and asset servicers.
The rise of alternative assets has been one of the major investment themes of recent years, as investors diversify their search for yield and asset managers seek to help them achieve their goals. But with some investors concerned about a possible end to the bull market in bonds\(^1\), many in the industry are asking whether the rise of alternatives will continue and, if so, what implications it will have\(^2\).

In this paper we take a fresh look at the rise of alternatives, with a particular focus on its drivers, its effects, and the opportunities and risks it poses for investors, asset managers and asset servicers. Briefly summarised, our views are that:

- The economic and structural factors encouraging investors to increase their allocations to alternative assets look set to continue. An enhanced role for alternatives could become a permanent feature of many investment strategies.
- The rise of alternatives provides both mainstream and alternative asset managers with an opportunity to counter the rise of passive investment. Alternatives markets will to continue to grow in size and sophistication, with a corresponding impact on asset managers’ and asset servicers’ strategies.
- However, mainstream asset managers seeking greater alternative scale may find that obstacles to success are greater – and faster growing – than expected. We think effective outsourcing of middle and back office operations will become an increasingly important component of success.
- The rise of alternatives is shaking up specialised asset servicing, especially in Europe. Firms that can invest heavily in their platforms could prosper, but those without scale advantages or technical excellence may find it increasingly hard to compete.
- Innovation is central to alternatives markets. Investors, asset managers and asset servicers must be alert to unexpected opportunities – and threats. Disruption could come from inside or outside the industry.
- Alternative investments are not new, but are being adopted by a wider range of investors than ever\(^3\). The market has also changed significantly since the last major downturn. Education, information sharing and co-operation are vital to ensuring that alternatives create long-term value for investors.

\(^1\) Global Research Quarterly Q3 2017, HSBC Global Research, 22.06.17
\(^2\) Hunt for yield pushes investors into riskier assets, Financial Times, 29.11.16
\(^3\) Global Alternatives Survey 2017, Willis Towers Watson, 17.07.17
We expect the rise of alternatives to continue, exerting growing influence on the investment industry and investor outcomes. Products and strategies will become more complex and innovative. Within the industry itself, competition and convergence seem likely to accelerate.

Asset managers and asset servicers need to understand how these changes could impact their business models. They need to adapt their strategies in response, and make the changes and investments required to achieve lasting success.

The rise of alternatives creates significant opportunities, but not every firm will be able to grasp them. Individual organisations – and the industry as a whole – must act now to ensure that investors derive long-term value from the rise of alternatives.

Introduction
Investors’ search for yield¹ has been a defining feature of the post-crisis years. The resulting shift towards less liquid, alternative assets continues to gain momentum. It is reshaping the investment industry, as investors look for yield in unconventional places, and asset managers and service providers work to help them.

The rise of alternatives is driving convergence between investment categories, and between different segments of the investment industry. Some observers see this as evidence of the industry’s adaptability. Others believe it reveals the weakness of traditional business models at a time when many asset managers are threatened by fee pressure and the growth of passive investment – factors highlighted by Standard Life’s merger with Aberdeen Asset Management⁵.

This paper is the second in our Game Changers series, examining key developments impacting the Securities Services industry. The paper considers six aspects of the rise of alternatives, including investor demand, the opportunities and threats for asset managers and asset servicers, possible sources of further disruption and the wider implications for the industry.

We hope that this paper and others in the series will give readers a fresh perspective on industry developments, helping them to reach better decisions about their own strategic plans.

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¹ In this paper we mainly use the term ‘yield’ to refer to a regular income distribution. But we recognise that some investors include gains that allow them to drawdown capital in their definition of ‘yield’

² Standard Life buys rival Aberdeen for £3.8bn, Financial Times, 06.03.17
Key Areas of Debate

1. Will the rise of alternatives continue?

Recent years have seen institutional investors searching the financial world for new sources of return. Low bond yields have been the leading driver, but the aftershocks of the financial crisis have also encouraged investors to diversify in search of income. One approach has been to increase allocations to defensive, high yielding equities. But with key indices reaching record highs, many investors are concerned about the valuation of equities and their potential correlation with bonds.

In response, many institutional investors are increasing the role of alternative assets in their portfolios. In this paper, we use the term ‘alternatives’ to include ‘liquid alternatives’ such as high yield bonds as well as less liquid assets such as private equity, private debt, commodities and real estate. Pension funds in Australia, Canada, Germany, Japan, South Korea, Switzerland and the UK now have an average allocation of more than 30% to alternative assets.

Different investors take different views about the role of alternatives in their portfolios. Many high net worth and endowment investors have long embraced the ‘Yale model’, blending listed securities with alternatives. In contrast, most insurers and pension funds have only recently taken a significant interest in alternatives. This group are increasingly drawn to credit backed by real assets such as property, infrastructure, renewables and even aircraft. These investments are marketed as combining stable long-term income with comparatively low capital risk and, hopefully, low correlation with mainstream assets. Of course, investors typically give up liquidity in exchange for yield (see Debate 6).

But are some investors arriving late at the party? After all, the Federal Reserve is gradually tightening its monetary policy, although the ECB seems unlikely to follow in the near future. We see few signs that investor appetite for alternatives will be reversed in the medium term. First, global bond yields are expected to remain ‘lower for longer’ over the next few years. Second, demographic ageing could contribute to permanently subdued levels of growth, inflation and yields. Third, geo-political instability may continue to make some investors wary of increasing their exposure to listed equities.

Finally, many investors continue to believe in the value of active asset management, and alternatives are an increasingly important element of many active strategies. Far from being reversed, demand for alternative investments could be poised to move to the next level. Asset managers and servicers – especially those that view the alternatives boom as a fad – should take notice.

In summary

Bond yields are far from returning to pre-crisis levels. The structural factors driving investors to pursue yield enhancement also look set to continue. An enhanced role for alternative assets seems likely to become a permanent feature of many investment strategies.

2. How is the rise of alternatives reshaping the investment industry?

The search for higher yields is putting alternative asset management at the forefront of changes reshaping the global investment industry.

The most obvious change is that mainstream investment managers such as Allianz Global Investors, BlueBay, M&G, Hermes and Schroders are diversifying into alternative assets. This reflects a desire to meet investor demand, build on existing expertise and limit outflows to specialist rivals. Above all, it represents a way for traditional active managers to fight back against the rise of passive investing.

A second change is that alternative managers are crossing over between activities that were previously separated. For example, a number of private equity (PE) houses are moving into real estate and credit, and some leading hedge fund managers are developing private market platforms.

The scale of change is illustrated by the boom in private markets. Private equity is thriving, especially in the US where more than 100 unlisted companies are valued at more than US$1bn. Private debt markets are also enjoying stellar growth, particularly in Europe. ‘Shadow banking’ assets in the region have more than tripled since 2003 to over €40tn as debt funds take up the slack from banks’ shrinking balance sheets.

Other current indicators of innovation in private markets and other alternative assets include:

- Emergence of new structures. Banks and asset managers are developing innovative new structures to deliver yield enhancement. One example comes in the shape of credit-linked notes that enhance yields by giving investors synthetic exposure to sovereign, corporate or indexed default risks.

- Rapid expansion by debt funds. Many asset managers are setting up private debt funds. These range from broad-spectrum funds that make and buy loans, to specialised funds focusing on specific niches. Institutions such as DC pension providers are attracted to the promise of higher yields within a structure providing a degree of liquidity.
• Loan origination by credit investors. European asset managers are hiring credit analysts to help extend new SME lending20. Luxembourg and Ireland now offer regulated fund structures designed to allow for loan origination. Some large investors also show a growing interest in direct lending (see Debate 5).

• The evolution of private market infrastructure. NASDAQ is developing private market liquidity platforms, and has acquired a private stock dealer21. Other signs of growing maturity include the emergence of specialised research into private companies at the start-up, secondary and pre-IPO stages of development.

We expect growth in alternative investments to continue, and market developments to accelerate. Without making definitive predictions, we expect the next 12-18 months to see:

• The continued emergence of new asset classes and investment strategies. Sustainable, uncorrelated returns will be the main focus of development, but adventurous investors could also be tempted by novel areas such as trade receivables.

• Asset managers pushing for scale at fund level to improve efficiency and attract larger investors. Fund labels will likely evolve as investors become less wedded to specific asset classes. For example, real estate and infrastructure funds could be combined and rebadged as real asset funds.

• Further convergence and concentration among alternative investment managers, as mainstream and specialised firms use acquisitions and targeted hires to develop their scale in new areas.

• Blurring between different classes of capital as investors become willing to hold a wider range of instruments. For instance, real estate investors that were once limited to senior debt are showing greater interest in subordinated loans, project finance, mezzanine finance and preference shares.

• Increasing demand for long-term private investments from pension funds, sovereign funds and endowments. Several PE firms have recently launched funds blending equity, real estate and infrastructure to deliver stable returns over 10, 12 or even 14 years. One recent study shows that half of institutional investors plan to increase exposure to long-term private equity22.

These developments will have profound implications for the investment industry. In particular, asset managers and asset servicers are likely to see competition intensify – something we explore in the next two areas of debate.

In summary

The rise of alternatives is reshaping the investment industry, as mainstream and alternative asset managers seek to diversify their offering and develop strategies that cannot be replicated by passive vehicles. We expect alternatives markets to continue to grow in size, sophistication and complexity. That will have a major impact on the operating environment of asset managers and asset servicers alike.

20 Banking & Asset Management Survey 2017, Page Executive, 27.02.17
21 More companies are choosing a sale over an IPO, Wall Street Journal, 01.08.16
22 Private equity funds take a longer view of lower returns, Financial Times, 31.10.16
3. What are the prospects for mainstream firms seeking alternative scale?

The rise of alternatives presents mainstream asset managers with a valuable opportunity to diversify into growing, high margin income streams. It also provides a chance to deepen existing client relationships. Developing a new source of return is a sure way to start a conversation with investors and consultants.

However, the prospects for those entering alternative management for the first time are far from certain. On one hand, mainstream managers have some potential advantages. They can leverage existing relationships with major investors, and larger funds are attractive to institutions worried about ownership restrictions. On the other hand, they face many potential obstacles:

- **Technical challenges.** Illiquid assets pose technical challenges in every area of operations. These include price discovery and portfolio management in the front office; valuation, risk management and client reporting in the middle office; and administration, corporate actions and regulatory compliance in the back office. This means that effective outsourcing is arguably more important than in any other area of asset management (see Debate 4).

- **Knowledge and skills.** Moving into alternative asset management requires the development of distinct expertise. One example is the need to manage large, unpredictable cash balances. Another is handling redemptions when investing in a mixture of liquid and illiquid assets. A third is managing unpredictability – such as receiving physical inventory when a distressed company is liquidated.

- **Operating models.** The requirements of alternative asset management make it hard to build out operating models quickly. Firms need experienced staff, appropriate technology and processes, and a supportive governance framework. New entrants are often unsure what their target operating model should be, or how to achieve it. Key individuals such as COOs or CTOs may also struggle to oversee outsourced activities. To address this, at least one major asset management group has recruited a new CEO with significant alternatives experience.

- **Competition for targets.** New entrants often look to M&A to develop the capabilities they require. Deals can provide instant scale, but are not without risk. It is very hard for an acquirer to be sure they are buying the right talent, or that the target will continue to perform well under new ownership.

- **Talent management.** Attracting and retaining talented, specialised staff is challenging. Top talent tends to gravitate towards firms that offer decision-making discretion, capital to manage and generous rewards. Mainstream firms can struggle to match the freedom and remuneration offered by limited partnerships. It can also be hard to justify alternatives fees to clients, shareholders and other portfolio managers.

- **Culture and governance.** Large asset managers that acquire smaller rivals have to strike a difficult balance between giving them sufficient independence and maintaining appropriate control. Some buyers may struggle to ‘hold their nerve’ if subsidiaries record significant losses or outflows.

In short, new entrants often find alternative asset management more competitive than expected. Recent years have seen a significant ‘thinning out’ of firms, as alternatives markets have become more mature. Returns and profitability could be eroded further as more firms crowd in, competition pushes up staffing costs and larger investors exert pressure on fees. These challenges point to the need for managers to maintain a flexible cost base. Once again, that underlines the vital importance of effective outsourcing of middle and back office operations.

**In summary**

The rise of alternatives will continue to create strategic opportunities for mainstream asset managers. But the low hanging fruit may already have been picked. Obstacles to success are significant, and are only likely to grow as alternative investment markets become more competitive and ‘institutionalised’. Effective outsourcing is an increasingly vital component of success.

4. How will the rise of alternatives impact asset servicing?

The growth of alternative investing creates a valuable opportunity for asset servicers to upscale their services and build closer relationships with investors and asset managers. Set against that, developing new capabilities in the alternatives space may prompt some asset managers to rationalise existing outsourcing relationships.

What effects will this potential shake-up have on the servicing sector? After all, few asset servicers – global or specialised – can meet every need for every class of alternative asset. This is particularly true in Europe where, despite the harmonising effects of AIFMD, there are still around two thousand specialised servicers.

At one end of the spectrum there is scope for large international servicers to act as one-stop-shops, handling both mainstream and alternative assets. But in reality, achieving this is likely to prove challenging – even for the largest custody banks. Most major platforms are not designed to deliver the specialisation that low volume, illiquid alternatives require. Many already struggle to handle private equity or real estate funds. Practical challenges include obscure asset data; non-standard legal documents; complex valuations; and the need for credit expertise. Regulatory reporting is particularly demanding, especially under Solvency II. In short, it is hard to combine the reach of an international platform with tailored alternatives services. A robust global model supplemented with niche platforms may be the most realistic option for many large custody banks. It also enables servicers to respond to future changes, such as the emergence of alternative ETFs (see Debate 5).
At the other end of the spectrum, specialised providers face their own challenges. As investors diversify, many alternatives servicers are seeking to move beyond their existing niche. But firms with experience in one asset class often find it hard to thrive in new areas. This is not just about the right talent and technology. In many cases, business models also need to be adapted to the economics of different asset classes.

In our view, any service provider that makes the right technology investment – whether built or bought – has an opportunity to build valuable, lasting relationships with alternatives managers. However, firms that fall short run the risk of losing high margin business to specialised competitors. Asset servicers of all sizes need to develop clear strategies, based on an informed view about the rise of alternatives.

In summary
The rise of alternatives promises to shake up the specialised asset servicing industry, especially in Europe where the market is highly fragmented. Firms that can invest heavily in their platforms could reap the rewards, but they cannot afford to take a half-hearted approach. In contrast, mid-sized providers without scale advantages or technical excellence may find it increasingly difficult to compete.

5. What might disrupt current developments in alternative investing?

As asset managers and service providers adapt their business models to the rise of alternatives, what external factors should they keep an eye on? Apart from macro-economic conditions, we see potential for some emerging themes to push the rise of alternatives in unforeseen directions.

One of the most obvious is the growth of direct investment. Canadian, Australian, European and Asian retirement schemes are among the institutions investing directly in private debt and equity without the advice of an asset manager26. Some are even acquiring buyout lenders27. Sovereign wealth funds are also drawn to direct investment; the Abu Dhabi Investment Authority now manages a third of its assets in house28.

At present, only the biggest institutions have the expertise to invest directly in illiquid assets. But their size – 1% of Norway’s Oil Fund is worth more than US$9bn27 – means that even small changes will have a tangible market impact. In time, this could encourage smaller institutions to question the value that asset managers contribute. For now, smaller institutions often prefer to co-invest alongside buyout firms, giving managers a chance to develop close relationships. But this could change as investors gain experience and third party research into alternatives becomes more readily available.

A less obvious source of disruption could come from international tax harmonisation. Returns from alternative assets often have complex tax profiles. For investments backed by physical assets this can include a combination of interest, dividends and capital gains. The OECD’s BEPS28 Action Plan is encouraging tax authorities to make changes that could have a negative impact on the appeal of alternative assets. One example comes from the US, where ‘dividend equivalents’ paid by equity derivatives are now taxed like cash dividends. Although its full impact may not be felt for years, BEPS could have a significant effect over the life of long-term, illiquid investments. For instance, increased tax leakage could make it hard for some real estate funds to maintain current levels of return.

Looking further ahead, a completely different driver of change could come from exchange traded funds. At first glance this seems unlikely. After all, ETFs typically offer a low cost way to track liquid underlying assets – the polar opposite of alternative investment management. But ETF developments could have unexpected effects on alternatives markets. Multi-asset ETFs blending equity, fixed income and alternative returns are already common. ‘Smart beta’ ETFs that track customised equity indices are also growing strongly, attracting net inflows of $24bn in the first quarter of 201729. Smart beta is not a direct substitute for alternative investment, but many investors use it for yield enhancement. Other recent innovations include ETFs that track hedge fund indices. If investors come to view ETFs as a source of ‘uncorrelated’ returns, they could pose a challenge to some alternative asset managers.

In summary
The rise of alternatives is a major driver of innovation in investment management. But innovation rarely proceeds in a straight line. Investors, asset managers and asset servicers should be alert to the potential upsides – and downsides – of unexpected developments. Catalysts for disruption could come from within the industry, but also from external factors such as technology and politics.

26 Pension schemes pour money into European direct lending, Reuters, 23.03.17
27 British Columbia Investment Management acquires majority stake in Hayfin, Pension & Investments, 31.01.17
29 Base Erosion and Profit Shifting
30 2,000% rise in money allocated to smart beta, Financial Times, 14.05.17
6. Are markets ready for risks arising from the rise of alternatives?

Recent history shows that risks can often go unnoticed or overlooked when the investment industry is focused on growth. So it is worth asking whether investors – and asset managers – have identified the risks that the rise of alternatives could trigger.

We do not suggest that investors fail to understand that enhanced, uncorrelated returns may come with elevated levels of risk. But the rapid development of alternative assets means that many structures and investments have yet to be tested in a severe downturn. For example:

- **Liquidity risk.** The tendency of liquidity to evaporate when it is most needed makes it hard to manage – even in public markets. Investors may find that less liquid investments become unmarketable in stressed conditions. That could compel them to sell more liquid assets that are underwater.

- **Credit risk.** Historic through-the-cycle loss data is largely absent for many alternative forms of debt. That could make it hard to detect mispricing. Institutions with relatively little experience of investing in public debt are likely to have an imperfect grasp of credit risk in private markets.

- **Operational risk.** The complex structures of many alternative investments – and the potential of some, such as convertibles, to change risk-return profiles – could pose unforeseen operational risks.

With boundaries between asset classes becoming blurred, individual aspects of risk could be blended in unpredictable ways. For example, a combination of unconstrained, multi-asset and absolute return funds could create hidden concentrations of risk that leave investors vulnerable to macro events.

Unexpected losses or contagion attributed to alternative investments might also create the conditions for a regulatory backlash. Supervisors in many markets are already concerned about the potential for a liquidity crunch arising from asset managers’ growing involvement in debt markets. The IMF has described open-ended credit funds as one of the greatest sources of liquidity risk, and the SEC is also looking at this area.³⁰

But for asset managers and asset servicers, the greatest risks arising from the rise of alternatives could be reputational. Alternatives present an opportunity for active managers to combat the rise of passive investment. But firms must ensure that investors, such as pension trustees, are completely clear about the expected behaviour of alternative asset classes, in good times and bad. In our view, aligning expectations across the value chain is essential to ensuring that the rise of alternatives brings lasting success to investors and the wider industry. Investor education, open dialogue and close working relationships are vital.

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³⁰ US regulators ease rules on fund redemptions, Financial Times, 13.10.16

**In summary**

Alternative investments are not new, but growing demand from a wide range of investors poses risks as well as opportunities. The market has seen significant product innovation since the last major downturn. Market participants should do all they can to ensure that they continue to create long term value for investors, and the industry as a whole.
Conclusion

The rise of alternatives is an increasingly important feature of the investment landscape. But this is not a single theme, or a simple one. It is having tangible, complex effects in many different areas of the investment industry.

We expect investors to continue to diversify their sources of return. That will stimulate further innovation and growth in alternatives markets – as well as increasing signs of ‘institutionalisation’. It will also drive greater convergence between mainstream and alternative investment management.

Asset managers and asset servicers need to understand the implications of these changes on their business models, and adapt their strategic planning accordingly. For many asset managers, the rise of alternatives provides an opportunity to fight back against the growing popularity of passive investment. But it poses potential threats for firms that are unable to take advantage. Asset servicers also have a new opportunity to create value for clients, provided they can make the right investments and develop the right capabilities.

Overall, we expect competitive forces to intensify. Winners will enjoy stronger relationships and revenues, but many firms will struggle to overcome growing obstacles. And there is the possibility for high-profile missteps to harm individual firms, or even the sector as a whole.

Ultimately, the search for yield poses the same challenge to asset managers and asset servicers – can they create value in a changing world? More specifically, can they help investors to increase their yields while managing the associated risks? It is up to individual firms to ensure that they can answer with an emphatic “yes”.