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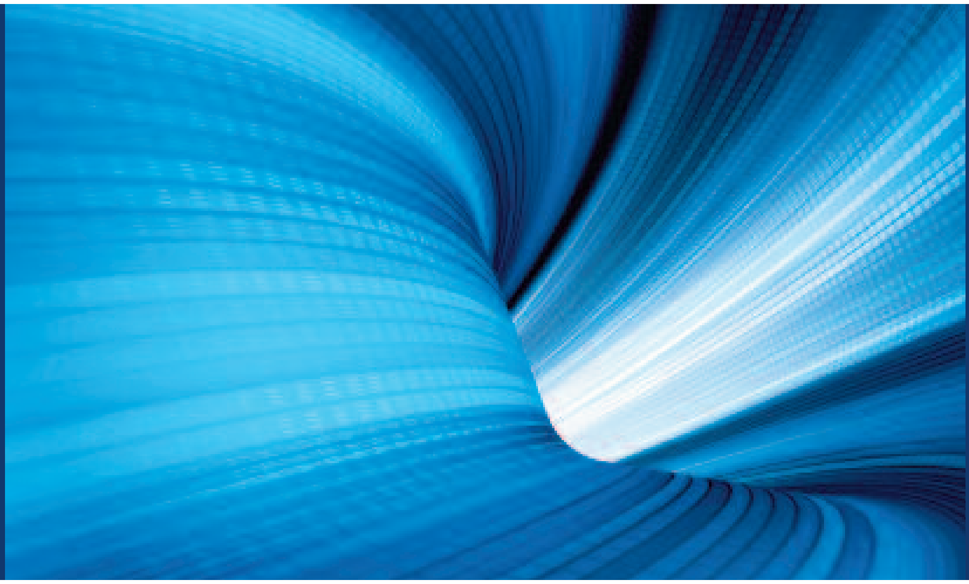

The Trillion-Dollar Convergence: Capturing the Next Wave of Growth in Alternative Investments

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Contents

Executive Summary

Investment trends come and go, so it may be tempting to think of the current rush to alternatives as a passing fad. On the one hand, money has continued to pour into the category—which McKinsey defines to include hedge funds, funds of funds, private equity, real estate, commodities and infrastructure—over the past three years, with global assets hitting an all-time high of $7.2 trillion in 2013. And with their premium fees, alternatives now account for almost 30 percent of total industry revenues, while comprising only 12 percent of industry assets. Yet returns for many alternatives products have lagged the sharp gains of broader market indices in recent years, leading skeptics to contend that investor patience is wearing thin—and that the alternatives boom is about to run out of steam.

To the contrary, McKinsey research clearly indicates that the boom is far from over. In fact, it has much more room to run, as alternatives become increasingly entrenched in investor portfolios. Institutional investors—who control approximately 60 percent of the money flowing into alternatives—have not only upped their allocations to alternatives over the past few years, but the vast majority intend to either maintain or increase them over the next three years. Retail investors, meanwhile, are moving rapidly into the market, as new product vehicles provide unprecedented access to a broad range of alternatives managers and strategies. Structural, rather than cyclical, forces are accelerating the adoption of alternatives, chief among them the linking of alternatives to critical investment outcomes—a phenomenon that takes the value of alternatives strategies "beyond alpha." Gone are the days when the sole attraction of alternatives was the prospect of high-octane performance. The market meltdown caused by the global financial crisis, coupled with the extended period of volatility and macroeconomic uncertainty that followed, have left their marks, and investors are now turning to alternatives for consistent, risk-adjusted returns that are uncorrelated to the market. They are also increasingly looking to alternatives to deliver on other crucial outcomes like inflation protection and income generation.

For asset managers, the continued rise of alternatives represents one of the largest growth opportunities of the next five years. And in stark contrast to traditional asset management, the alternatives market remains highly fragmented, with ample room for new category leaders to emerge.

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Within the hedge fund and private equity asset classes, for instance, the top five firms by global assets collectively captured less than 10 percent market share in 2012—a far cry from the 50 percent share enjoyed by the top five firms competing in traditional fixed-income and large-cap equity. The competitive landscape is also rapidly evolving. The mainstreaming of alternatives is now driving a "trillion-dollar convergence" of traditional and alternative asset management. Leading hedge funds, private equity firms and traditional asset managers—which to date have occupied distinct niches in the investment management landscape—will increasingly battle for an overlapping set of client and product opportunities in the growing alternatives market.

This report draws on the findings of McKinsey's 2013-2014 Alternative Investment Survey, which polled nearly 300 institutional investors managing $2.7 trillion in total assets and included more than 50 interviews with a cross section of investors by size and type. It also builds on McKinsey's ongoing research into the growth of the retail alternatives market and the insights published in our 2012 report, *The Mainstreaming of Alternative Investments*. Key findings from our most recent research include the following:

- Over the next five years, net flows in the global alternatives market are expected to grow at an average annual pace of 5 percent, dwarfing the 1 to 2 percent expected annual pace for industry as a whole. By 2020, alternatives could comprise about 15 percent of global industry assets and produce up to 40 percent of industry revenues.
- The next wave of growth in alternatives will be driven disproportionately by a "barbell" comprised of large, sophisticated investors who are experienced alternatives investors and smaller investors who are "first-time buyers." Specifically, flows to alternatives from four segments of investors—large public pensions and sovereign wealth funds, smaller institutions and high-net-worth/retail investors—could grow by more than 10 percent annually over the next five years.
- Growth in alternatives is playing out as "a tale of two cities," with divergent investment priorities and manager preferences emerging across different investor segments. Larger, more sophisticated investors (e.g., institutions with more than $10 billion in assets under management [AUM]) reveal a clear bias towards specialist investment managers and alternatives boutiques that offer unique insights and market exposures. At the other end of the spectrum, smaller, less established investors (e.g., those with under $2 billion in AUM and core retail channels) have a strong preference for the breadth and stability of larger managers and the comfort of established brands.
- Liquidity preferences are evolving and reshaping product priorities. Hedge funds and other liquid alternatives will continue to experience robust demand from virtually all investor types. But larger, more sophisticated investors will invest further down the liquidity spectrum, with the vast majority planning to increase their allocations to more specialized private-market asset classes—real estate, infrastructure, and other real assets such as agriculture and timber—over the next three years.
- Retail alternatives will be one of the most significant drivers of U.S. retail asset management growth over the next five years, accounting for up to 50 percent of net new retail revenues. In addition to growth in institutional alternative strategies and vehicles, McKinsey expects absolute return, long/short and multi-alternative strategies in mutual fund formats to grow disproportionately over the next two to three years. New product development and smart distribution will remain critical to capturing growth opportunities and market share in the retail alternatives market.

- Traditional and alternative asset management will continue to dovetail, leading to a "trillion-dollar convergence." Four successful alternatives manager archetypes will emerge in this environment, each with a distinct value proposition: *diversified asset managers, multi-alternative mega firms, specialist alternatives platforms* and *single-strategy boutiques*. While specialist firms will continue to play a significant role in the alternatives industry, McKinsey expects ongoing share gains by larger, at-scale managers, as the industry continues to mature.

The ongoing integration of alternatives into the core of both retail and institutional portfolios will represent one of the most attractive growth opportunities for asset managers in the coming five years. It is an opportunity that will change the competitive dynamics of the industry as the business models and strategies of traditional and alternatives managers converge. For the many asset managers who are dabbling in alternatives, or for alternatives managers who compete only in a narrow market niche, the time has come to decide whether to commit and invest in a well-defined strategy. As the convergence accelerates, successful firms will make deliberate choices about how to position themselves favorably against a new set of tailwinds that are driving growth.

An Alternatives Boom Built to Last

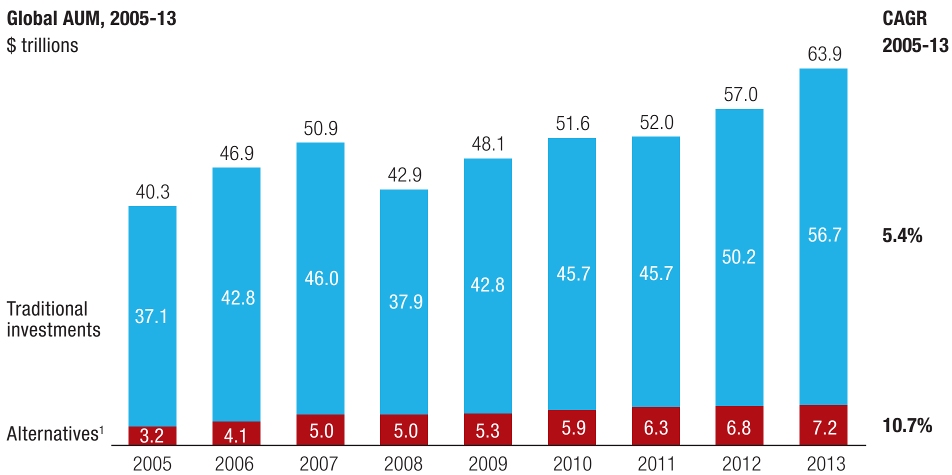
Viewed through the narrow lens of short-term relative returns, the alternatives boom presents somewhat of a paradox. Money has continued to pour into alternatives over the past three years, with assets hitting a record high of $7.2 trillion in 2013.[1] The category has now doubled in size since 2005, with global AUM growing at an annualized pace of 10.7 percent—twice the growth rate of traditional investments (Exhibit 1). New flows into alternatives, as a percentage of total assets, were 6 percent in 2013, dwarfing the 1 to 2 percent rate for non-alternatives. Yet, recent returns for alternatives products have generally lagged the broader market indices. The average hedge fund, for instance, produced an 11 percent return in 2013, while the S&P 500 Index soared by 30 percent.

But the demand for alternatives is not a short-term phenomenon. Indeed, just as impressive as the absolute

[1] Excludes $0.9 trillion of fund of fund assets and ~$2 trillion of retail alternatives. See appendix for detailed definitions of alternative investments used in this paper.

Exhibit 1

Alternative investments have grown twice as fast as non-alternatives since 2005



[1] Does not include retail alternatives (i.e., mutual funds, ETFs, and registered closed end funds).
Source: McKinsey Global Asset Management Growth Cube; Preqin; HFR

growth of alternative assets is the degree to which they are now entrenched as a standard component of almost every investment portfolio. Among institutional investors—who control about 60 percent of the category's assets—alternatives comprised approximately one-quarter of total portfolio assets in 2013, a proportion that has steadily increased. And while they were once an exclusive preserve of sophisticated investors like large pension funds and endowments, alternatives increasingly feature as the core engines of alpha and drivers of diversification for a range of smaller institutions and retail investors. Growth has taken place across every alternative asset class, but has been particularly robust in direct hedge funds, real assets and retail alternative sold through registered vehicles like mutual funds and ETFs (Exhibit 2, page 8). Even private equity, where assets retreated from pre-crisis highs, has bounced back in its new fund-raising.

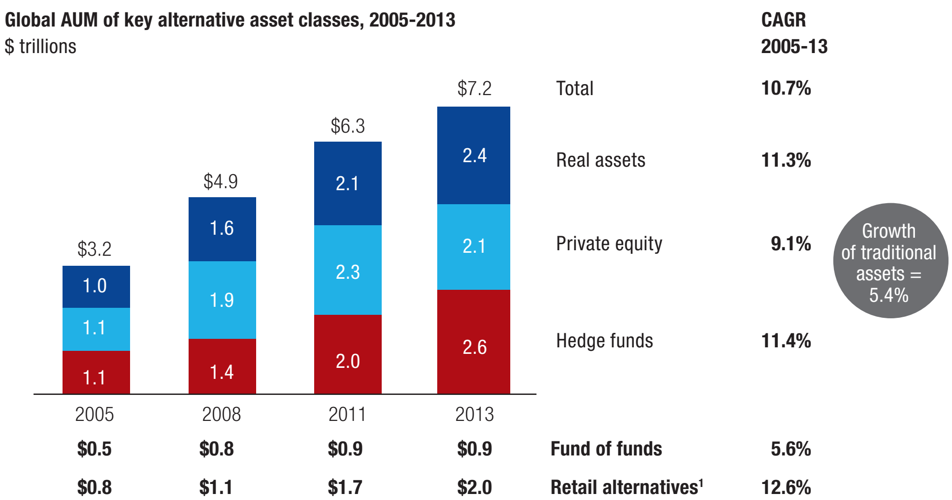
Four structural trends are driving alternatives' growth

McKinsey research indicates that the rapid growth of alternatives is not simply the result of investors chasing returns. Powerful structural forces are accelerating the adoption of alternatives, chief among them the matching of alternatives with critical investment outcomes—transforming the value of these strategies "beyond alpha." Gone are the days when the primary attraction of hedge funds was the prospect of high-octane performance, often achieved through concentrated, high-stakes investments. Shaken by the global financial crisis and the extended period of market volatility and macroeconomic uncertainty that followed, investors are now

Exhibit 2

Growth has been broad-based across alternative asset classes, with direct hedge funds and retail alternatives accelerating fastest

Global AUM of key alternative asset classes, 2005-2013
$ trillions



[1] Vehicles providing non-accredited investors with exposure to alternatives strategies via registered vehicles: mutual funds, closed-end funds and ETFs.

Source: McKinsey Global Asset Management Growth Cube; Preqin; HFR

seeking consistent, risk-adjusted returns that are uncorrelated to the market. They are also looking for solutions to needs they see on the horizon, including interest rate risk mitigation, inflation protection, income generation and tail risk protection.

Specifically, a set of four structural trends are driving increased allocations to alternative asset classes:

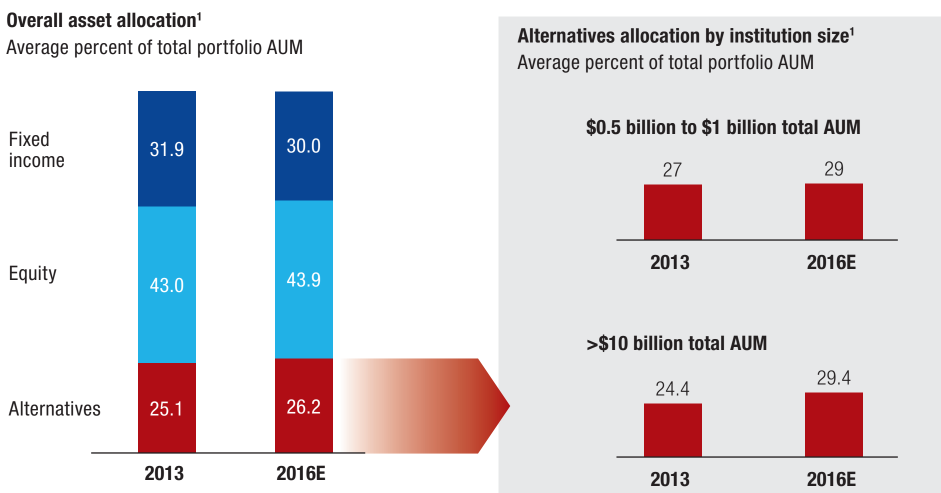
1. Disillusionment with traditional asset classes and products in an era of increased volatility and macroeconomic uncertainty. An increasing number of investors are now using alternatives (particularly hedge funds) as an "insurance policy" to dampen portfolio volatility and generate a steady stream of returns. Demand for alternative credit products has also been strong, driven by challenges posed to long-only strategies in the current low (but highly uncertain) rate environment.

2. Evolution in state-of-the-art portfolio construction. A growing pool of investors is gravitating towards the notion of "bar-belling" in their investment portfolios; that is, complementing the low-cost beta achieved through index strategies with the "diversified alpha" and "exotic beta" of alternatives. Many of the most sophisticated institutions are beginning to abandon traditional asset-class definitions and embrace risk-factor-based methodologies, a trend that repositions alternatives from a niche allocation to a central part of the portfolio. Hedge funds, for instance, are now considered by a growing number of these investors to be part of a larger pool of equity and fixed-income allocations.

3. Increased focus on specific investment "outcomes." The shift from relative-return benchmarks to concrete outcomes

Exhibit 3

Over the next three years, demand for alternative investments will remain robust, with large and small institutions alike boosting allocations



[1] Survey results exclude institutions with less than 10% of portfolio invested in alternative assets.
Source: 2013/14 McKinsey Alternative Investments Survey

tied to specific investor needs has created a new tailwind for alternatives. Alternative strategies are seen as more precise tools that can deliver a range of "solutions"—for example, real estate and infrastructure as sources of inflation-protected income, or hedge funds as a tool to manage volatility—that investors are demanding.

4. Allocations out of "desperation rather than desire." A portion of incremental institutional demand is being driven by persistent asset-liability gaps at defined benefit pension plans, where funding ratios continue to hover around 75 percent. With many of these plans assuming, for actuarial and financial reporting purposes, rates of return in the range of 7 to 8 percent—well above actual return expectations for a typical portfolio of traditional equity and fixed-income assets—an increasing number of plan sponsors are being forced to place their faith in higher-yielding alternatives.

Alternatives allocations will continue to increase, across all investor types

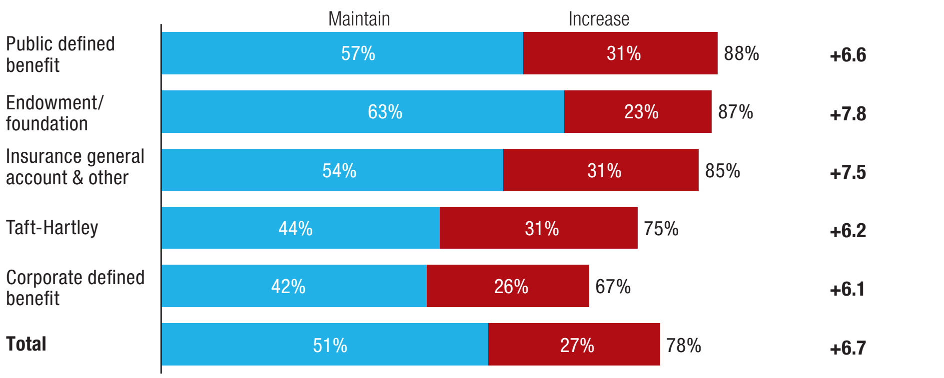
Taken together, these four structural trends will translate into continued robust demand for alternatives. McKinsey research reveals that large and small institutional investors alike expect to increase their allocations to alternatives over the next three years. In the aggregate, the investors McKinsey surveyed expect alternatives to account for an average of 26.2 percent of their total portfolio assets by the end of 2016, up from 25.1 percent in 2013 (Exhibit 3). Institutions with at least $10 billion in AUM expect their alternatives allocations to top 29 percent by 2016, a full 5 percentage points above 2013 levels.

Exhibit 4

Three-quarters of investors expect to maintain or increase their alternatives allocations over the next three years

Institutions expecting to maintain or increase alternatives allocations over the next three years
Percent of institutions by type

Expected change through 2016[1]
Percentage points



[1] Among institutions expecting to increase alternative allocations over the next 3 years.
Source: 2013/14 McKinsey Alternative Investments Survey

The ongoing shift towards alternatives will not be confined to any one type of investor. Across all classes of institutional investors—including public pensions, corporate pensions, endowments, foundations and insurance companies—interest in alternatives will remain at all-time highs, with more than 75 percent of these investors expecting to maintain or make meaningful additions to their alternatives portfolios over the next three years (Exhibit 4). Among institutions expecting to increase alternatives allocations over the next three years, the expected average increase will be almost 7 percentage points.[2]

Alternatives are now a crucial source of industry flows and revenues

In stark contrast to traditional asset management—where market appreciation has been the primary source of asset growth in recent years—growth in alternatives has been driven primarily by new flows. McKinsey estimates that net flows in the global alternatives market will continue to grow at an average annual pace of 5 percent over the next five years, dwarfing the 1 to 2 percent expected annual pace for the industry as a whole.

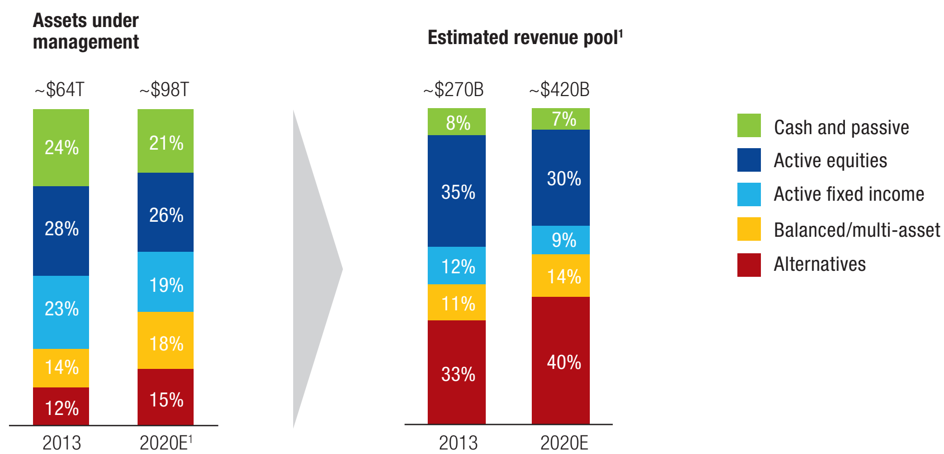
More importantly, alternatives are now a crucial source of revenue growth in an industry where traditional actively managed products face the constant threat of commoditization and margin compression. As managers face unrelenting fee pressures for most traditional products, pricing for alternatives is holding relatively firm. For instance, 80 percent of institutional investors McKinsey surveyed expect the management fees they pay hedge funds over the next three years will either remain

[2] Corporate pension funds were one notable exception among the group surveyed, with a significant minority – generally those who were considering pension risk transfer or liability-driven investing programs – indicating some possibility of scaling back their alternatives allocations.

Exhibit 5

By 2020, alternatives could account for about 40% of revenues in the global asset management industry

Global asset management market (externally managed assets)



[1] Excludes performance fees (i.e., carried interest).
Source: McKinsey Global Asset Management Growth Cube

at current levels or, in a small number of cases, increase. And few expect any changes to performance fee levels, although almost half do expect to see structural changes to improve incentive alignment between managers and their investors—for example, a move from simple high-water marks to a greater use of clawbacks. Healthy revenue yields have also held up in the retail segment. Compared with the two other major product growth opportunities in retail asset management, ETFs and target-date funds, alternatives command a significantly higher revenue margin—more than two times greater than target-date funds and four times greater than ETFs.

The upshot is that alternatives now account for a disproportionate share of industry revenues, a state of affairs that McKinsey expects will continue. In 2013, alternatives accounted for about 12 percent of global industry assets but generated one-third of revenues. By 2020, alternatives will comprise about 15 percent of global industry assets and produce up to 40 percent of industry revenues, as the category continues to siphon flows from traditional products (Exhibit 5).

The imperative for sound stewardship

How this growth scenario plays out will be highly contingent on the sound stewardship of industry leaders. The relative richness of fee levels puts the onus on asset managers to demonstrate why alternatives exist and how they benefit investors—not just investment managers. This will require a fiduciary mind-set, the disciplined pursuit of differentiated strategies that add clear value, thoughtfulness in the alignment of incentives and a commitment to high standards of investor education, product transparency and regulatory compliance.

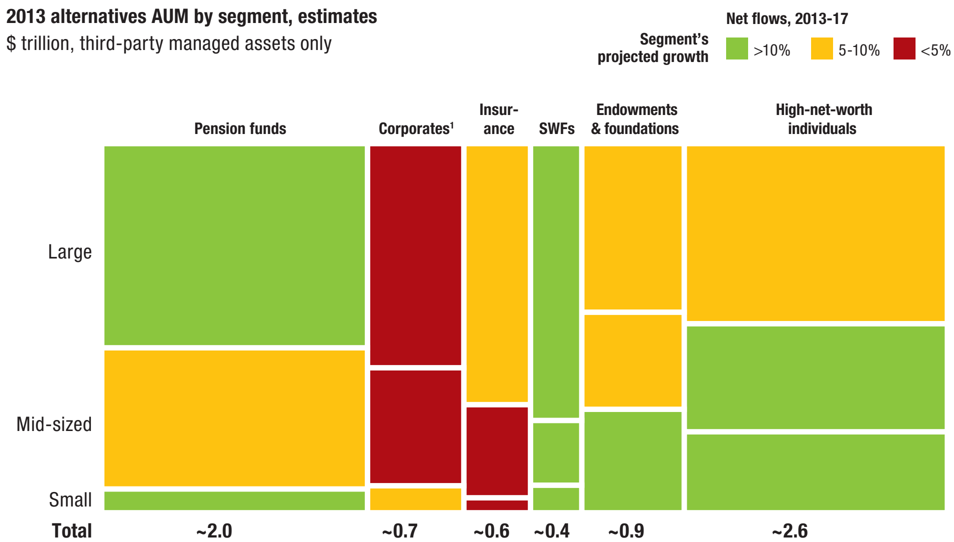
In short, asset managers that are active in the alternatives market need to ensure that they are delivering quality investment solutions that meet investor needs. The growth of the alternatives market and the extension of alternative strategies to smaller investors (e.g., retail segments) has already attracted some regulatory scrutiny. Failure on the part of the alternatives industry to retain the confidence of its key stakeholders could result in the disruption of some of the positive growth trends described above.

The Granularity of Growth in the Alternatives Market

As the powerful structural trends described in the previous chapter continue to play out, McKinsey expects flows to alternative assets to remain robust across all major client segments in the coming years. That said, our research suggests that the next wave of growth in alternatives will be disproportionately driven by a "barbell" comprised of large, sophisticated investors that are already significant alternatives users, and smaller investors who are relatively unfamiliar with the asset class. Four segments of investors are likely to account for a disproportionate share of alternatives growth over the next five years (Exhibit 6, page 14).

Exhibit 6

Over the next five years, a "barbell" of large/sophisticated and small/newer investors will account for a disproportionate share of alternatives flows



[1] Includes corporate defined contribution plans as well as assets held on balance sheets of non-pension corporate entities.

Source: Prequin; SWF Institute; National Association of College and University Business Officers; The Foundation Center; McKinsey Global Asset Management Growth Cube

- **Large public pensions** are struggling to generate required returns with the conventional policy portfolios dominated by stocks and bonds in the current low-yield, high valuation environment. These investors are increasing in sophistication and have come to see alternatives as critical "outcome-oriented" portfolio building blocks (e.g., infrastructure for long-dated income, private equity to extract illiquidity premiums). Growth will accelerate as more of these investors integrate alternatives within traditional asset class allocations.

- **Sovereign wealth funds** are typically on the receiving end of capital infusions resulting from commodity and energy-related national wealth as well as steadily growing foreign exchange reserves. These investors—who are concentrated in Asia and the Middle East—are fueling demand for high-conviction/opportunistic strategies (e.g., hedge funds) and embracing alternatives managers that offer not just alpha but also opportunities for learning, capability-building and co-investments. A growing appreciation for the unique "permanent" nature of the sovereign capital base is also driving an increased willingness to take on illiquid assets (e.g., private equity, real estate and infrastructure).

- **Small pension funds and endowments** are increasingly entering the market as "first-time buyers" as they recognize the limitations of traditional asset classes and seek out the enhanced performance and diversification that alternatives potentially deliver (e.g.,

Exhibit 7

There is a distinct and divergent set of needs emerging among large and small investor segments

	Large (and sophisticated) institutions	Smaller institutions
Investment priorities	Co-investments and capability building as a favored source of value add	Access to broad range of quality managers with sound risk management practices
Insourcing versus outsourcing	Targeted build-up of in-house investment capabilities and openness to strategic partnerships	Outsourced services valued as a supplement to internal capabilities (e.g., outsourced chief investment officer and fund-of-funds models)
Investment vehicles	Separate accounts and customized structures (e.g., "fund of one") preferred	Comingled and "retail" vehicles (mutual funds and ETFs) under active consideration
Manager preferences	Some degree of bias towards specialist managers for unique abilities and exposures	Large managers viewed positively given product breadth and perception of stability

Source: McKinsey Global Wealth & Asset Management Practice

unconstrained bond strategies as a replacement for core fixed-income holdings). Smaller pension plans are contemplating a shift to the "endowment model" of more aggressive and direct allocations to alternatives (versus the historic emphasis on traditional asset classes or allocations via funds of funds). Many of these investors have nascent alternatives programs, and their low base of allocations in the segment (typically 0 to 5 percent) leaves significant room for growth.

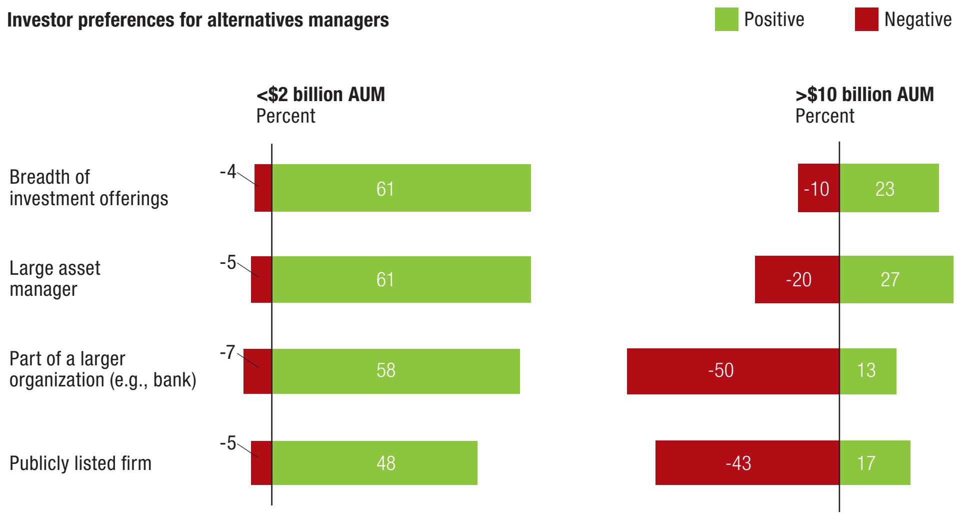
- **Retail and high-net-worth investors** are fueling a new wave of demand now that they have access to a broad array of alternatives strategies through the proliferation of liquid retail funds. Categories where greatest demand is anticipated include absolute return, multi-strategy and alternative credit strategies. This growing interest in alternatives is compounded by a positive overall flow dynamic—retail flows are expected to be three to four times those of institutional flows. Demand has been strongest in the U.S. market (private banks, family offices and registered investment advisors [RIAs]) as well as in more global ultra-high-net-worth channels (e.g., private banks and multi-family offices).

Divergent priorities across institutional segments

Within the institutional investor universe, growth in alternatives is now playing out as "a tale of two cities," with a divergent set of investment priorities and preferences emerging across investor segments (Exhibit 7).

Exhibit 8

Small investors strongly favor large, established alternatives managers with broad offerings – attributes that are less important to large investors



Source: 2013/14 McKinsey Alternative Investment Survey

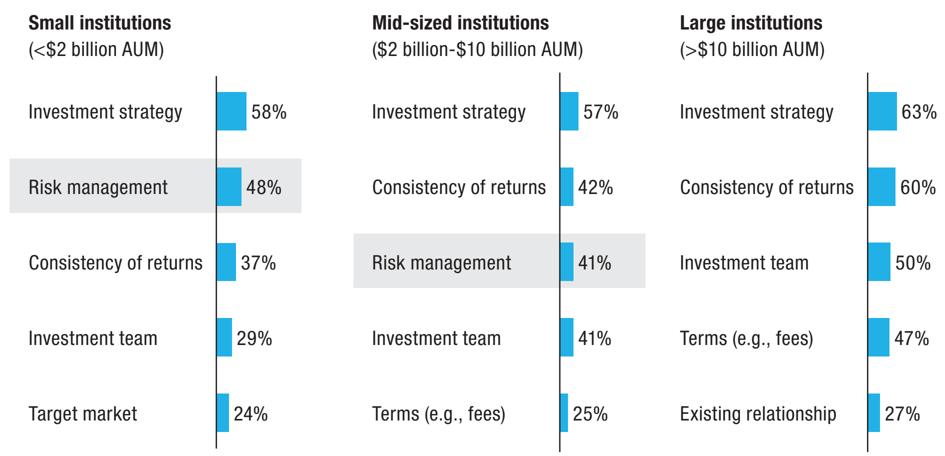
McKinsey's survey of institutional investors reveals that large, more sophisticated investors (typically those with more than $10 billion in AUM and possessing dedicated in-house alternatives expertise) intend to take more control over their alternatives investing activities. A segment of institutions has been steadily increasing direct investment activities in targeted areas that favor the long-term capital they can provide. These institutions prioritize the sourcing of co-investments and often seek to consolidate their existing relationships with investment managers into a smaller, but more strategic, set that often includes an element of capability building. These large, sophisticated institutions are also raising the bar on differentiation, frequently leaning toward specialist boutiques (rather than large, generalist asset managers) for their ability to deliver unique capabilities and customized exposures, often in the form of separate accounts.

At the other end of the spectrum, smaller, less established investors (typically those with less than $2 billion in AUM, with small teams of investment generalists) report that their single-largest priority is to secure access to quality investments and managers. Alternatives add a level of complexity to the investment and risk management process, driving these institutions' appetite for outsourced services and solutions with embedded advice, including multi-alternative products, funds of funds, outsourced CIO solutions and managed account platforms. In contrast to their institutional counterparts, smaller investors are drawn to large managers because of their established brands, ability to deliver across a broad range of al-

Exhibit 9

Small investors view risk management as a top-three requirement for alternatives firms; large investors focus much more on investment team

Top five criteria for selecting alternatives managers



Source: 2013/14 McKinsey Alternative Investments Survey

ternatives asset classes and their robust operational and compliance infrastructures (Exhibit 8).

McKinsey's survey also reveals that smaller institutions are twice as likely to select risk management/mitigation as a top-three criteria when it comes to selecting an alternative manager. This is due in large part to their lower degree of familiarity with alternatives and lack of large, dedicated investment teams to support due diligence and ongoing risk monitoring. Larger institutions, by contrast, have a greater focus on consistency of returns, investment team and fees than smaller institutions (Exhibit 9).

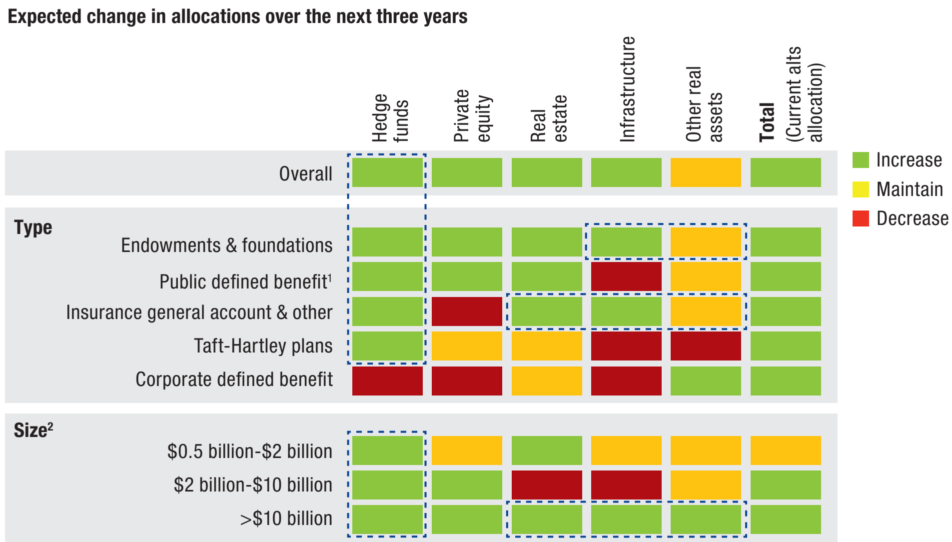
Product preferences are diverging for small and large institutions

Recognizing the diversity of investment priorities and needs among client segments is an important first step for asset managers seeking success in alternatives, but it is hardly sufficient. Understanding how those segments map onto product demand is critical for deciding where to play in the market. And as they continue to increase their alternatives allocations, smaller institutional investors and their larger peers are exhibiting divergent product preferences (Exhibit 10, page 18).

To be sure, hedge funds are experiencing robust demand from virtually all investor types, given their flexibility and liquidity in delivering a broad range of alternatives exposures. But this is where the similarities end. Larger, more sophisticated investors are moving further down the liquidity spectrum to embrace more specialized private market exposures (especially to real assets). Smaller, less established investors, by contrast, are

Exhibit 10

Over the next three years, hedge fund demand will be strong across the board, but large investors will venture much further down the liquidity spectrum



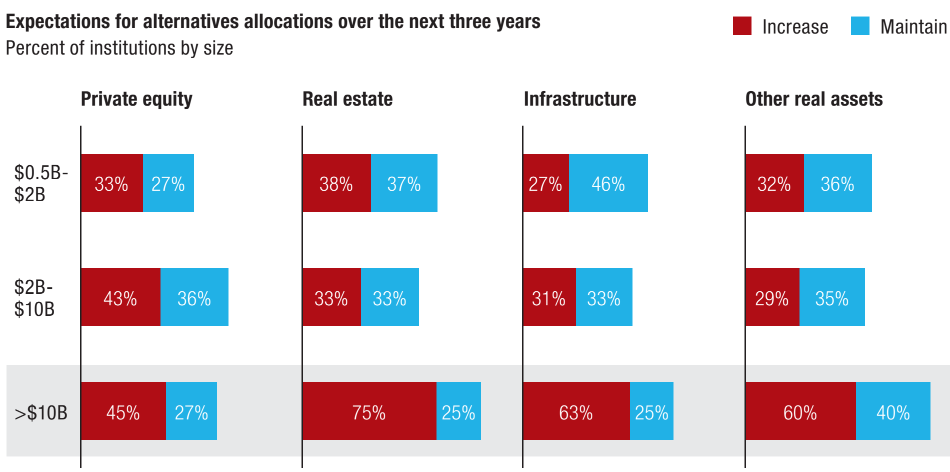
[1] Includes public defined benefit and public institutions (e.g., SWF).

[2] Trends by size exclude corporate defined benefit.

Source: 2013/14 McKinsey Alternative Investments Survey

Exhibit 11

Two-thirds of large investors will increase allocations to private-market assets over the next three years, but small investors will be far more tentative[1]



[1] Excluding corporate defined benefit plans.

Source: 2013/14 McKinsey Alternative Investments Survey seeking to fill alternatives allocations primarily through hedge funds and other liquid alternatives.

Among larger, more sophisticated investors, real assets—including real estate infrastructure, agriculture, timber and energy—are emerging as the next frontier in private investing, as these institutions look beyond relative investment performance toward more defined investment outcomes and seek to extract liquidity premiums while gaining exposure to hard-to-access forms of beta. Indeed, more than two-thirds of large investors plan to increase their allocations to real estate, infrastructure and real assets over the next three years (Exhibit 11). Large endowments and insurers have been early movers in real assets, citing benefits such as diversification, inflation protection, enhanced returns and long-term income streams.

At the far end of the barbell of alternatives investors, the retail segment is reasserting itself as the primary driver of growth.

Smaller institutions, too, have been expressing increased interest in real assets, but have yet to make meaningful allocations beyond commodities and real estate funds. One reason for this tentative approach is a lack of market depth and limited track records among managers in more specialized categories. Real assets also have unique and complex risk exposures (e.g., commodity valuation, weather risk, currency risk, political risk) which many small investors are not currently prepared to address.

Retail demand is fuelling growth in liquid alternatives

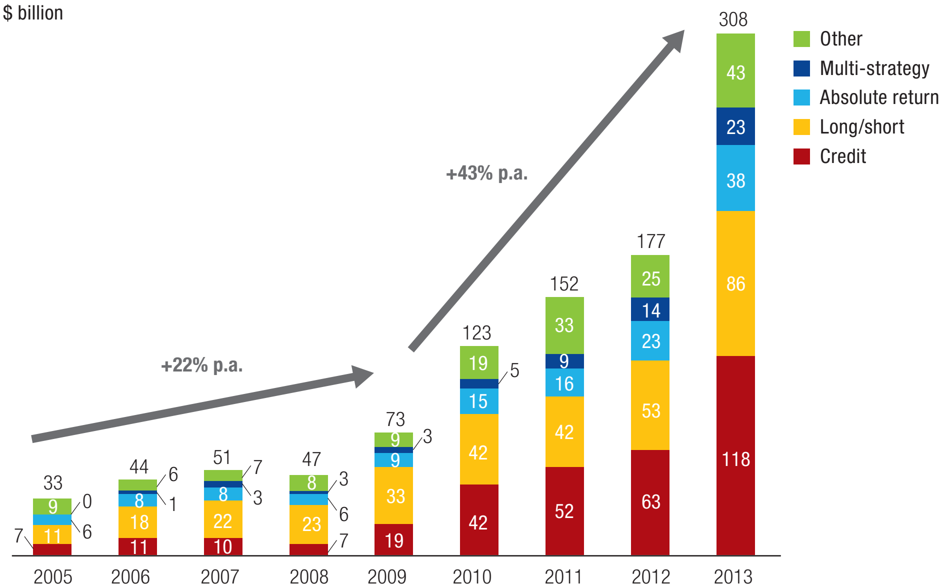
At the far end of the barbell of alternatives investors, the retail segment is reasserting itself as the primary driver of growth. This is particularly the case in the U.S., as retail alternatives continue to move into the mainstream, driven by a new wave of demand from both high-net-worth individuals and mass-affluent investors. These investors are increasingly looking to hedge downside risk and seeking out solutions such as principal protection, volatility management and income generation in a low-rate environment. Access to alternatives strategies is being democratized through product and packaging innovations within regulated mutual funds and ETFs. As a result, the broad category of retail alternatives assets—which includes alternative-like strategies such as commodities, long-short products and market-neutral strategies in mutual fund, closed-end fund and ETF formats—has grown by 16 percent annually since 2005, and now stands at almost $900 billion.

Hedge fund-like strategies offered through ’40 Act funds have experienced particularly robust growth, as investors seek to balance their desire for new alternatives exposures with the need for liquidity. Since 2005, mutual fund AUM in hedge fund strategies have grown ten-fold, with

Exhibit 12

Retail hedge fund strategies have grown tenfold since 2005, with a sharp acceleration since the financial crisis

Open-ended mutual fund AUM in hedge fund strategies, 2005-2014
$ billion



Source: Strategic Insight; McKinsey analysis

a sharp acceleration in the years following the financial crisis (Exhibit 12). This impressive momentum has been sustained despite the significant run-up in equity markets over the past two years. Looking ahead, retail alternatives will be the most significant driver of U.S. retail asset management growth, accounting for up to 40 to 50 percent of net new retail revenues over the next five years. McKinsey expects absolute return, long/short and multi-alternative strategies to grow disproportionately over the next two to three years.

The growth of retail alternatives is being driven by a set of structural trends similar to those driving institutional demand. Retail investors and their advisors are turning away from the confines of traditional "style-box" investing to embrace investment outcomes. More retail assets are flowing to RIAs, and McKinsey research has found that nearly half of these advisors are already managing their client portfolios against an absolute-return benchmark and using alternatives and alternatives-like solutions to help clients achieve their objectives. Meanwhile, there is significant headroom for retail alternatives expansion in the largest intermediary channels (wirehouses), as the typical 5 percent or below alternatives allocation within current investor portfolios greatly lags the average 20 percent allocation that some home offices are implementing in their asset allocation models.

New product development remains critical to capturing growth opportunities and market share within the retail alternatives market. Indeed, retail investors and advisors are showing unprecedented openness to new products, with more than 40 percent of new flows currently going into unrated funds (that is, those without a three-year track record) buoyed by a combination of brand recognition and strong institutional track records. As a result, a number of leading alternatives funds have been able to gather assets rapidly, as alternatives move into the mainstream for this group of smaller, more dispersed investors.

A Rapidly Evolving Competitive Landscape, With Room for New Leaders

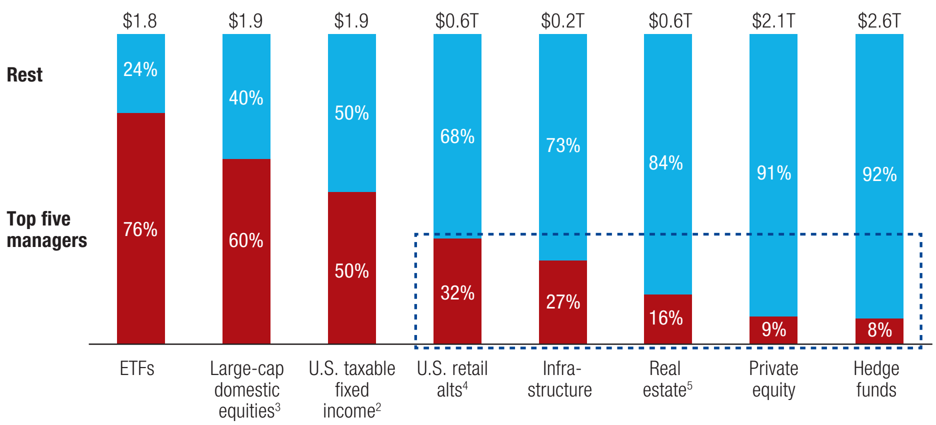
In stark contrast to the traditional world of asset management, no true “category leaders” have yet emerged in the alternatives market. The primary axis for competition remains performance within a narrowly defined set of product silos, and the market share of top firms remains exceptionally low relative to other asset classes. Among hedge funds and private equity asset classes globally, the top five managers by assets collectively captured less than 10 percent market share in 2012—a far cry from the 50 percent share enjoyed by the top five firms in traditional fixed income and large-cap equities and the 75 percent share of top ETF firms (Exhibit 13). The top five real estate managers captured only 16 percent market share. Infrastructure and retail alternatives vehicles are somewhat more concentrated, with the top five managers maintaining a 25 to 35 percent market share.

Exhibit 13

The alternatives market remains highly fragmented, with ample room for new category leaders to emerge

Alternative AUM concentration by top 5 managers[1]

Total global assets (2013)



[1] Based on manager assets under management.

[2] Includes short term, intermediate term, long-term, multi-sector, high yield, bank loan, and retirement income categories.

[3] Includes large cap value, growth, and blend categories.

[4] Alternatives investment strategies in '40 Act funds; excluding REIT and precious metal funds.

[5] Real estate funds in private equity style structures

Source: McKinsey Global Asset Management Growth Cube; Morningstar; Strategic Insight; Preqin; Institutional Investor

While alternatives, by their nature, lend themselves to a more dispersed competitive set, the degree of fragmentation in the market suggests that a subset of firms—be they traditional asset managers or alternatives specialists—could capture a disproportionate share of flows in multiple products and multiple client segments. Firms seeking to thrive in this new world of alternatives will require excellence beyond investment performance, with a high premium placed on innovation in solution-based products (e.g., multi-alternative funds), distribution (e.g., liquid alternatives in defined contribution), marketing (e.g., retail advisor education on alternatives "use cases") and thought leadership (e.g., alternatives-oriented model portfolios).

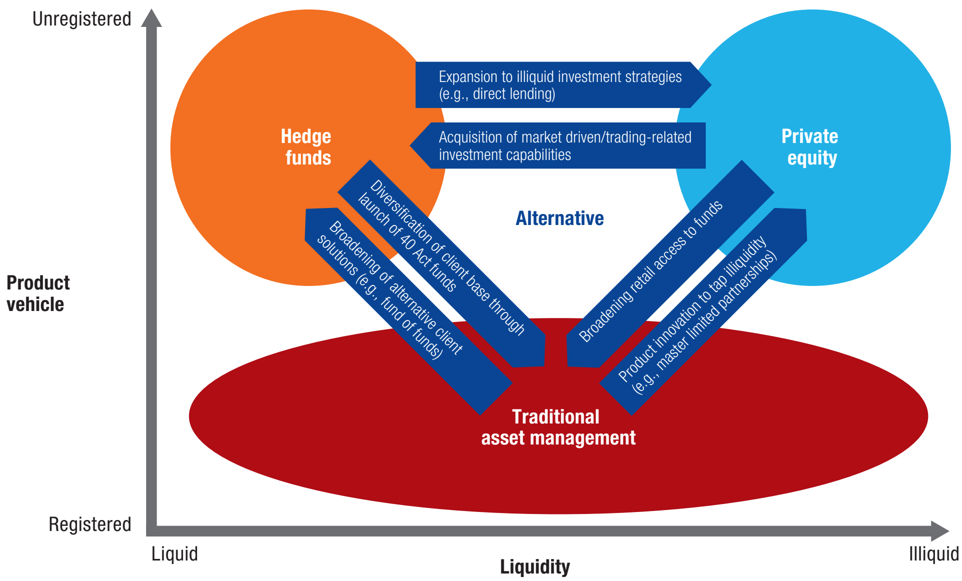
To be sure, the alternatives market will continue to be highly competitive and support a greater diversity of players than the traditional asset management market, given some of the natural constraints on firm size (e.g, the capacity limitations of certain alternative investment strategies) and the common preference for specialist boutiques. Nevertheless, leading hedge funds, private equity firms and traditional asset managers—which to date have occupied niches in the investment management landscape—will increasingly pursue an overlapping set of growth opportunities in the fragmented alternatives market.

A "trillion-dollar convergence" is well underway

The mainstreaming of alternatives, combined with the highly fragmented nature of

Exhibit 14

The convergence of traditional and alternative asset management is well underway



Source: McKinsey Global Wealth & Asset Management Practice

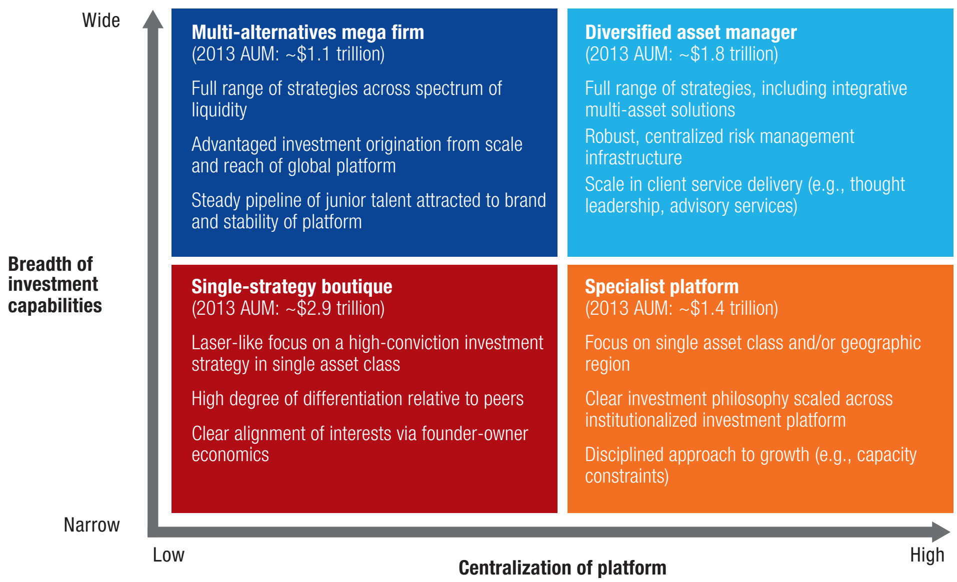
the market, is driving a "trillion-dollar convergence" of traditional and alternatives asset management—a convergence that McKinsey first identified in 2012[3] and that is now rapidly accelerating (Exhibit 14). Players on both ends of the spectrum are competing on new battlegrounds to increase their relevance to a broader set of clients and their alternatives needs. Traditional asset managers have moved quickly to stake their claim to the liquid alternatives space. They have used their distribution reach to achieve a first-mover advantage in the market for alternatives mutual funds and ETFs. Indeed, 18 of the 20 largest retail alternatives funds in 2013 were run by traditional asset managers. Traditional managers with experience structuring undertakings for the collective investment of transferable securities (UCITs) funds have had an upper hand in the European and Asian retail markets. A number of these traditional firms have built credible in-house alternatives boutiques (e.g., hedge funds) and are seeking to adapt their multi-asset capabilities to innovate in solutions delivery in the core institutional space.

Alternatives specialists are also moving swiftly. A small number of publicly listed mega firms have broken away from the pack with an aggressive build-out of their investment platforms to offer a broad and comprehensive alternatives menu across all asset classes, geographies and strategies. No longer content with simply capturing the top tier of institutional flows, these firms have been making forays into the retail space through innovations with retail-friendly products (e.g., private equity funds with low minimums or '40 Act alternatives mutual funds), the launch of "tra-

[3] *The Mainstreaming of Alternatives: Fueling the Next Wave of Growth in Asset Management*, McKinsey & Company, 2012.

Exhibit 15

Four successful business models are emerging within the alternatives industry, each with a unique value proposition



Source: McKinsey Global Wealth & Asset Management Practice

ditional" asset management subsidiaries, and the development of retail distribution forces. Hedge funds are expanding to illiquid investment strategies, such as direct lending and distressed investing, and increasingly moving into retail products. And private equity firms are acquiring market-driven, trading-related investment capabilities. These firms have also been rapidly expanding their global footprints, with a particular focus on building an emerging markets presence.

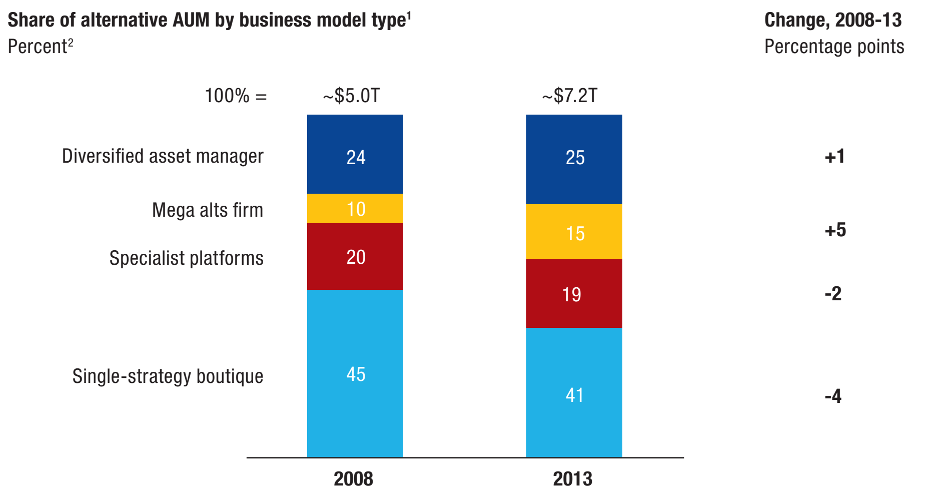
In this era of convergence, competition between traditional managers and alternatives specialists will only intensify. As alternative investments continue to make their way into retail distribution channels through vehicles such as liquid-alternatives funds, asset managers are likely to increase the pace of acquisitions and lift-outs to add that capability. Likewise, in the institutional space, managers are acquiring capabilities in asset classes like real estate, credit and hedge funds. A wave of partnerships or joint ventures between traditional and alternatives firms (including funds of funds) is also possible, as smaller managers lacking scale and distribution heft seek to establish relevance in alternatives.

Successful business models in an era of convergence

The rapid convergence in the competitive focus of traditional asset managers and alternatives specialists is leading to the emergence of a new alternatives ecosystem. As this ecosystem takes shape, which firms will lead the way? McKinsey research suggests that four successful business models are emerging, each with a distinct value proposition tailored to a targeted set of clients (Exhibit 15).

Exhibit 16

Specialist boutiques are losing share to more scalable business models, as the alternatives industry matures and "institutionalizes"



[1] Excludes retail alternatives and funds of funds.

[2] Percentages may not total 100 due to rounding.

Source: Institutional Investor; Towers Watson; company websites; McKinsey analysis

- **Single-strategy boutiques** are the nimble and highly-focused firms that have thus far been the mainstay of the alternatives industry. They will continue to be a channel for innovation and talent incubation and a source of high-conviction strategies for investors seeking a performance edge.

- **Specialist alternatives platforms** possess a unique investment philosophy and a sharp focus on delivering investment excellence in a single asset class or strategy through an institutionalized platform. Leading firms in this group typically take a highly disciplined approach to growth that is sensitive to capacity constraints and brand dilution.

- **Multi-alternative mega firms** offer a breadth of "industrial strength" alternative investment capabilities across a range of strategies, asset classes and geographies. These firms leverage their strong brands, synergies across investment engines (e.g., risk management and investment origination) and an increasing ability to offer a set of tailored alternatives solutions.

- **Diversified asset managers** offer a "one-stop shop" for a full set of client investment needs. Unique strengths of firms pursuing this model include the ability to integrate alternative investments into a set of broader investment solutions and services (often in concert with traditional asset classes) and at-scale distribution capabilities that can reach a broad range of client segments.

As the industry matures, more scalable business models are capturing share

As the alternatives industry matures, it is also evolving in the direction of greater institutionalization. In the process, the more scalable business models—diversified asset managers and multi-alternative mega firms—are capturing market share from single-strategy boutiques (Exhibit 16). Specialist alternatives platforms will continue to play an important role in the industry, but will be more constrained in their growth by their narrower focus on single asset classes.

Firms in all four of these models will need to focus their management agendas on a number of themes to capitalize on their strengths and capture share in the alternatives market:

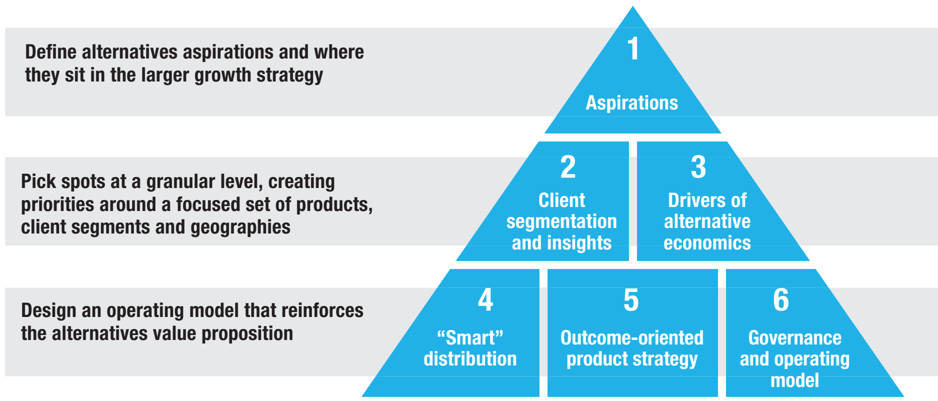
- *For diversified asset managers,* the main imperative will be to extend their advantage in product development and solutions innovation and to stake out a claim to segments where scale provides an advantage. The core challenge they face is to create a convincing value proposition to attract and retain top alternative investment talent, while adapting their operating models to accommodate alternatives teams with a highly independent bent.
- *For multi-alternatives mega firms,* the key to success lies in developing a robust governance model that weaves together a significantly expanded array of investment teams across multiple asset classes into a coherent firm that is more than the sum of its parts. The core challenge that these firms (the majority of which have recently gone public) will need to manage is to balance the demands of their shareholders, who value growth and diversification, with those of their investors, who value investment focus and performance.
- *For specialist platforms,* ongoing discipline in business expansion (e.g., new geographical markets) and the management of capacity constraints will be the key to maintaining investor loyalty. The core challenge that this group will seek to mitigate is in talent attraction and retention against both the larger and more diversified firms who have deeper pockets (and in many cases, public currency) as well as the smaller boutiques, which offer a more entrepreneurial economic environment.
- *For single-strategy boutiques,* alpha generation on a consistent basis will continue to be the primary driver of success. However, the institutionalization of investment platforms and processes and the professionalization of risk management functions will be increasingly important as boutiques seek to access larger pools of capital, as will talent retention and succession as individual firms mature. These firms will also need to find creative solutions (e.g., partnerships) to address opportunities in retail, given the distribution scale required in that segment.

Thriving in the Converging Alternatives Market: Six Imperatives for Management

Asset managers with a meaningful alternatives franchise—and those seeking to build one—will need to make deliberate choices about where to play and how to position themselves in a rapidly evolving competitive landscape. Six sets of actions are critical to defining and executing a successful strategy in alternatives (Exhibit 17).

Exhibit 17

Six building blocks of a successful alternatives strategy



Source: McKinsey Global Wealth & Asset Management Practice

1. **Be clear about aspirations in alternatives** and how they fit into the broader growth strategy. For instance, is the goal to be a top-three player in a narrowly focused set of asset classes or is it simply to have an at-par offering across a diverse range of alternatives strategies to be responsive to client demands? What are the firm's relative—and realistic—aspirations in investment performance, growth in assets under management, and mind-share with sophisticated investors? What is the right balance to strike among these objectives? What metrics should be used to judge success?

2. **Pick target client segments at a granular level** and ensure that product and distribution teams have deep insight into the underlying needs and investment challenges that clients are seeking to solve with alternatives. This choice of where to play is not simply a matter of deciding between the broad categories of institutional and retail; it is about making a commitment to serve a specific set of needs for a targeted set of sub-client segments (e.g., alternative credit exposures for sovereign wealth funds). The result is a focused set of priorities and resource allocations for a limited number of products, client segments and geographies.

3. **Develop a nuanced understanding of the business economics of alternatives** to enable disciplined trade-offs for different fee models (relative certainty of management versus performance fees), scale characteristics of product vehicles (high margins of hedge funds versus operating leverage of mutual funds), and flow characteristics of client segments (e.g., "stickiness" of retirement assets versus "hot money" in core retail), as well as to create the right metrics for guiding performance management for the alternatives franchise.

4. **Build a smart distribution model** that combines specialized alternatives know-how (e.g., via product specialists

that support a generalist sales force) and operating leverage (e.g., potentially via partnerships) and that makes targeted investments in client marketing/education that link specific alternatives capabilities to investment "use cases." Successful alternatives managers will invest in building the ability to deliver advice on the entire client portfolio—a capability that will grow in importance with the proliferation of alternatives products. The complexity of the sales challenge will be amplified as managers face both the greater sophistication of larger investors and the proliferation of smaller alternatives buyers. Distribution and client service will increasingly be critical for alternatives franchises seeking growth.

5. **Define an outcome-oriented product strategy** that clearly aligns investment capabilities and strategies across the enterprise toward priority client investment outcomes. For example, how does the current product set and near-term pipeline map against the core investor priorities of growth, volatility management, inflation protection, income generation and interest-rate risk mitigation? What role do alternatives play in the delivery of a broader set of multi-asset investment solutions?

6. **Create a robust governance and operating model** that balances the independence of alternatives investment teams with the opportunities to build synergies across investment and distribution platforms. This effort should include designing the right mechanisms for coordination across investment engines, defining appropriate levels of centralization for key product and distribution capabilities (e.g., whether to build an integrated alternatives business versus a federation of boutiques), and developing a set of processes to attract and retain alternatives talent and incentivize it appropriately.

▪ ▪ ▪

The alternatives market will unquestionably represent one of the most attractive growth opportunities for investment management firms in the coming five years. Firms of all stripes—whether they are traditional asset managers that are dabbling in alternatives or specialized alternatives boutiques seeking to grow beyond the narrow cores—must commit and invest in a strategy that defines where to play and how to capture share in the rapidly converging world of traditional and alternative asset management.

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The authors would like to acknowledge the contributions of Kevin Cho, Sacha Ghai, Aly Jeddy, Owen Jones, Bryce Klempner, Carrie McCabe, Gary Pinkus and Nancy Szmolyan to this report.

APPENDIX

Defining *Alternative Investments*

Definitions of alternative investments vary considerably because of the relative youth of the category and the dynamic nature of the industry. For the purposes of this paper, alternative investments are defined as a class of investments that offer return streams with a fundamentally different set of correlations and/or risk-return profiles than traditional asset classes such as stocks, bonds and cash.

Exhibit A

Defining alternative investments

The alternative investments universe

Hedge funds (~$2.6 trillion global AUM)
- Long/short equity
- Relative value
- Event-driven
- Global macro
- Multi-strategy

Private equity (~$2.1 trillion)
- Leveraged buyouts
- Growth investing
- Venture capital
- Mezzanine capital
- Distressed

Real assets (~$2.4 trillion)
- Real estate
- Infrastructure
- Agricuture
- Energy
- Commodities

Fund of funds (~$0.9 trillion)

Retail alternatives (~$2 trillion)

Vechicles providing non-accredited investors with exposure to the above stragegies via registered vehicles: mutual funds, closed end funds and ETFs

Source: McKinsey Global Wealth & Asset Management Practice

At the core of alternatives sit three broad categories of investments. These are sometimes referred to as "institutional quality" alternatives, because they are typical of what would be held by sophisticated institutional investors, such as pension funds or endowments.

- **Hedge Funds:** A wide-ranging set of private investment vehicles that invest in the public markets, typically employing strategies that involve leverage and the use of derivatives. Key hedge fund categories include equity long-short, relative value, event driven, global macro and multi-strategy
- **Private equity:** A set of closed-end investment vehicles with fixed lock-up periods that invest in both equity and debt that are not publicly-traded. Key categories are leveraged buy-outs, growth equity, venture capital, mezzanine financing and distressed investing.

- **Real assets:** A category of investments that focuses on ownership of non-financial assets through a variety of closed- and open-ended fund vehicles. Key categories include real estate, infrastructure, agriculture, timberland and energy. Commodities – which are sometimes classified as a distinct asset class – are included in this category as well.

Beyond these individual asset classes, there is an additional layer of "funds of funds" – investment vehicles that provide broad exposure to a wide range of alternatives investment managers and strategies. The bulk of these vehicles are focused on hedge funds, although there are meaningful fund of fund assets in private equity (and to a lesser extent real assets). Multi-asset fund of funds that deliver broad-based exposure across alternative asset classes are a small but emerging category.

The final category is "retail alternatives." This refers to a broad array of strategies that are designed to deliver alternatives exposure via registered retail vehicles, including mutual funds, closed-end funds and exchange-traded funds. These registered retail vehicles create restrictions on the underlying investment strategies that can be employed (e.g., liquidity requirements and restrictions on the use of derivatives and leverage), but provide managers with access to a broad base of retail investors.

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