Why Investors Are Concerned

By Donna Gilding

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Everywhere you look these days, investors are concerned about market risk. Some of the biggest risks facing investors today are fears about the impact of changes to US monetary policy, the resilience of the Eurozone, the strength of the US equity markets, the lack of potential in the global fixed-income markets and the strength of China's stock market.

The heightened market uncertainty, and the perceived lack of opportunity in the US equity and fixed-income markets, has encouraged investors to funnel vast sums of money to alternative assets. This surge of money into private equity, hedge funds and infrastructure funds has raised questions about the ability of alternative managers to deliver the exceptional returns that many investors are seeking.

According to Towers Watson, the search for safety, diversification and alpha has enabled the 100 largest firms specializing in alternative strategies to increase assets under management by 7% in 2014 after a 6% increase in 2013. Total assets allocated globally to alternatives are now $3.5 trillion. Our managers, along with Towers Watson, expect these assets to continue growing in 2015. As one manager mentioned: "There are many reasons for this trend to continue. Bonds are no longer able to offer the returns, and diversification that they have previously provided to investors have become overly reliant on equities for growth."

BlackRock has said that over half of large institutional investors globally plan to increase their allocation to alternatives, such as property and private equity. One representative of the firm stated that: "Ultimately, any institution that wants to produce high value will have to include higher allocations to alternative asset classes. The ones who are not acting now could be under pressure in the future."

Towers Watson found that among the largest beneficiaries of the shift to alternatives are:

- Macquarie, Australia – the world's largest manager of infrastructure assets
- Bridgewater, US – the largest hedge fund manager
- CBRE Global Investors US – the largest property manager; its assets grew 53% in 2014

Pension funds remain the biggest allocator to alternatives. They account for more than one-third ($1.4 trillion) of the $3.5 trillion managed by the largest 100 alternative managers. The vast majority of the investors, including the sovereign wealth funds, insurance companies, funds-of-funds and wealth managers, increased their alternatives allocation in 2014. The exceptions were the endowments and foundations, which actually reduced their allocation by about 3%. During the global financial crisis, endowments and foundations were forced to sell their most liquid assets to meet capital calls for their alternative investments, which in many cases, exceeded 30% of their overall asset allocation.

Enthusiasm and Caution

There is a great deal of enthusiasm for the continued growth of alternatives, along with record amounts of 'dry powder' (over $1 trillion) available for investment. At the same time, we are also aware of those consultants who believe that some caution may be justified. Investors need to remember that several risk factors still exist:

- Returns have been diluted as money flows into these strategies
- Alternative funds are still relatively illiquid
- Performance can be volatile

Correlation with long-only investments tend to be asymmetric. That means returns are low in the up market and high in the down market. And, these investments "may not offer diversification benefits when most needed."

Cerulli Associates is another firm that is skeptical about the ability of alternative managers to continue delivering significant outperformance. David Walker of Cerulli says that "managers are wise…to cap funds when they feel returns to existing investors may be threatened, rather than hoovering up more subscriptions. It is cheaper to keep existing clients than to constantly hunt for new ones."

Luba Nikulina, head of private equity for Towers Watson, agrees that there are risks, but she remains convinced that the long-term benefits outweigh the risks. She says: "What is the biggest risk? It could be political, or a misstep in a central bank's policies, no one knows. But if you know equities and bonds are expensive and are expecting more volatility, alternatives can help. I expect to see more growth in this asset class."

The Bottom Line

There is no one 'right' answer when it comes to alternatives. Recommendations should be made based on the needs and sophistication of the individual clients and the appropriateness of the strategy. Thorough due diligence is always a prerequisite, especially as it applies to alternatives.

Donna Gilding is an investment consultant with more than 30 years of institutional investment experience.