ALTERNATIVES IN THE MAINSTREAM

A Potential Growth Opportunity for Advisers

InvestmentNews

Blackstone

Foreword

Recent market strength notwithstanding, the last 15 years have not been easy ones for investors. We've experienced two historic equity market declines and a bond market that has produced gains but meager income.

Today, we face a world of lower growth and increasing uncertainty. In this environment, investors have come to feel that traditional investment choices may be inadequate to meet their needs. As a result, they and their financial advisers have begun to explore the expanding array of strategies and investments known as "alternatives" to complement and diversify traditional stock and bond portfolios.

But alternatives can be confusing. The word itself is over-broad, and means different things to many people. Some investors may turn to them in search of income, or higher returns, some for protection from rising rates and inflation or as a haven from market volatility — and others for some combination of all those. According to this report, **67% of advisers say that a lack of understanding is a key impediment to greater allocations to alternatives.**

The purpose of this Survey, produced in partnership with *InvestmentNews* Research, is to shed light on the growing demand for Alternative Investments, and explore ways that advisers may better deploy them for their clients.

According to this study, portfolio allocations to alternatives among individual investors average less than 10%, compared with about 30% among institutions, and far higher among the largest university endowments.[1]

As this Survey explains, advisers soon may begin to narrow that gap and make better use of alternative investments to potentially improve outcomes for their clients. But that shift in allocation will come only when advisers — and their clients and prospective clients — become more comfortable with and knowledgeable about these non-traditional vehicles and strategies. Simply put, quality education — around the spectrum of strategies that the term "Alternatives" may encompass, and how to incorporate them into a portfolio — is what's missing in the current alternatives landscape.

Blackstone is one of the largest alternative asset managers in the world, with leading businesses in each of the key alternative asset areas (private equity, hedge funds, private credit, and real estate). We began an educational program around alternatives called *Blackstone University* over five years ago, targeting financial advisers, and we've evolved our curriculum of "AI" thought leadership since then, consisting of in-person events, our series of "*Black*" Papers, as well as several *Online Training Modules* offering CE credit. With this foundation of alternatives education in place, we believe we're in a position to partner with investors in an effort to build attractive investment portfolios.

Avi Sharon
Private Wealth Solutions
Blackstone

[1] Source: Global Pension Assets Study 2016, Willis Towers Watson; National Association of College and University Business Officers 2015 Study (Equal-weighted Average); Money Management Institute, "Distribution of Alternative Investments through Wirehouses", 2015.

Introduction

Investment theory and historical performance have shown that alternative investments can provide diversification, risk reduction and, often, enhanced returns. These portfolio-enhancing characteristics are becoming increasingly attractive in today's uncertain world. Yet despite the benefits and growing popularity of alternatives, some advisers and clients remain reluctant to use them.

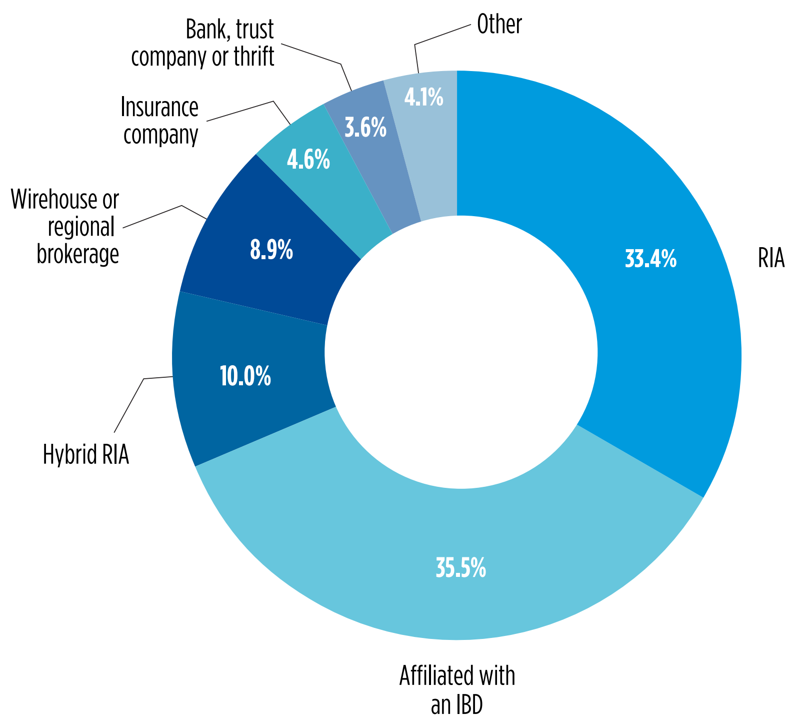
This white paper, drawing on a new study conducted for Blackstone by *InvestmentNews* Research, will reveal findings exploring the extent to which (and the reasons why) alternative investing is expected to grow in the coming years, and several factors that could impede that growth. It also suggests that advisers who develop a real facility in educating clients about alternatives could use that skill as a powerful way to build more valuable client relationships.

FAST FACTS ABOUT ALTERNATIVES

- **83%** of clients are interested in alternatives.
- Average allocations to alternatives should rise from **10% to 14% of client portfolios** within three years.
- That shift would represent nearly **$150 billion in net flows to alternatives** among independent advisers.
- Yet **67%** of advisers say that clients' **"lack of understanding is a key impediment"** to alternatives allocation.
- **51%** cited "the need for more insight into **portfolio construction with alternatives**".

About the survey:

InvestmentNews conducted the survey underpinning this research between November 8, 2016 and November 29, 2016. The resulting data were collected, checked and analyzed by the *InvestmentNews* Research team; in total, 392 advisers participated in the survey. Reflecting the *InvestmentNews* audience, independent advisers comprise a majority of the sample. The findings of this survey may be accepted as accurate at a 95 percent confidence level, within a sampling tolerance of approximately plus or minus 4.9 percent.



The Current Environment

Several current indicators point to potentially greater use of alternative investments over the next three years: Historically rich valuations for equities, a possible bottoming out of interest rates if not a change in their direction, as well as investor willingness to explore new investment approaches.

Perhaps most important, say advisers, is that investors — often unprompted by advisers — are expressing more interest in alternatives. According to findings from recent research conducted by *InvestmentNews*, **83% of clients have expressed some level of interest in alternative investments.**

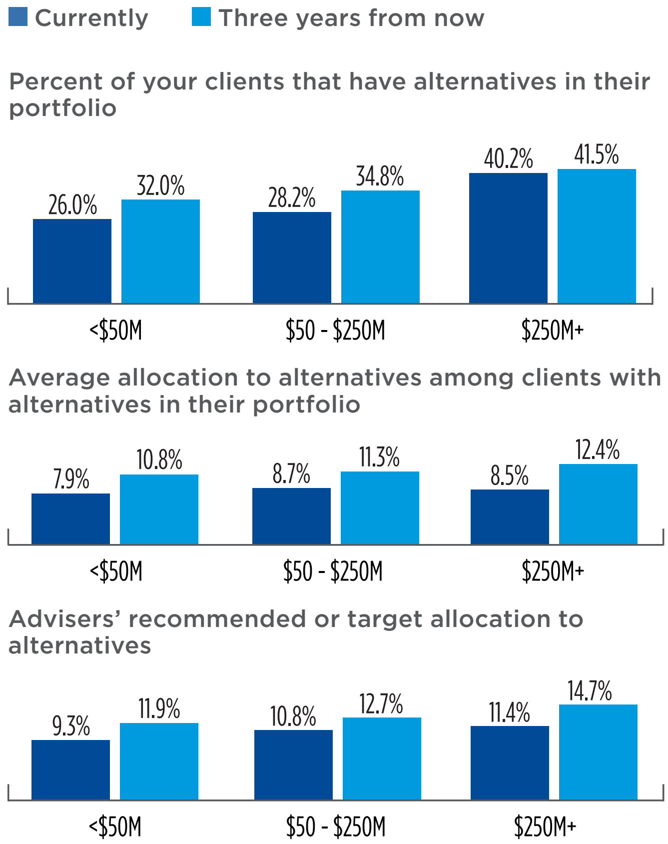
The Rise of Alternatives in Client Allocations

Because of this increase in client interest, advisers believe that the use of alternative investments will increase over the medium term. Advisers who manage up to $250 million in assets say that the percentage of clients who have alternatives in their portfolios will increase from roughly a quarter to about a third over the next three years.

Those advisers also noted that portfolio allocations to alternatives should rise to roughly 12% from about 9%, while advisers who personally manage more than $250 million in assets say that client allocations to alternatives should rise slightly more. This is in line with targets for alternative allocations being set by advisers, who **plan to increase their portfolio allocations by about three percentage points over the next three years.**

FIGURE 1:

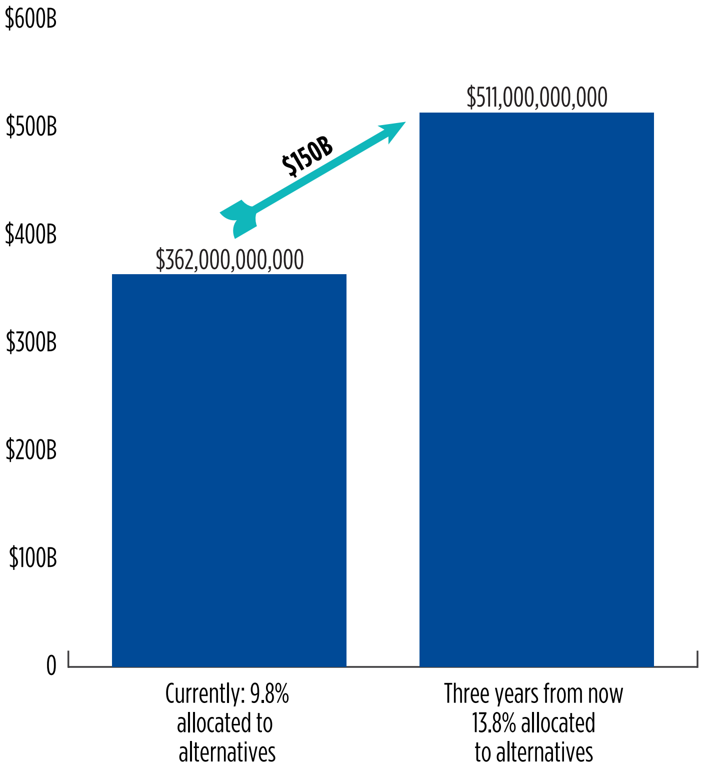
ALLOCATING TO ALTERNATIVE INVESTMENTS BY ADVISER AUM



Trying to take the measure of this expected shift to alternatives, we looked at the dollar impact. The typical firm in our survey manages $130M in assets and allocates approximately 9.8% of a typical client portfolio to alternatives. On average, **the typical adviser anticipates that allocation will rise to 13.8% in three years**. Assuming that our sample of independent firms is a reasonable proxy for the population of independent advisers, **that four percentage point expansion represents a $149 billion projected increase in alternative investments** in the independent advisory channel over the next three years.

FIGURE 2:

A $150B OPPORTUNITY?
Projected Increase in Allocation to Alternatives Across the Entire Independent Advisory Channel



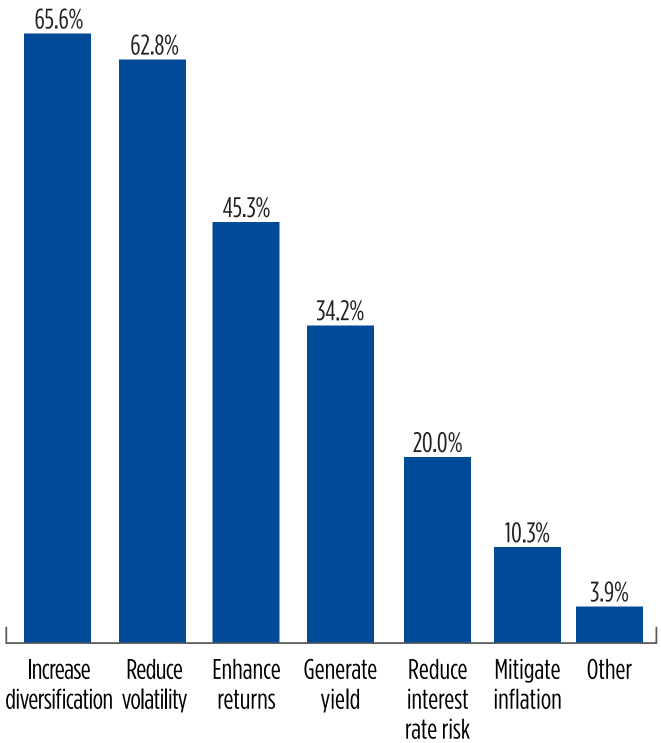
Source: Cerulli Edge Advisor Edition
Note: The median AUM for survey participants is $130,000,000

Motivations Driving Product Allocations

The motives behind the shift to a greater allocation to alternatives are varied. The **primary driver appears to be a desire for increased diversification** (expressed by 66% of advisers in the survey), and reduced volatility (63%). Additional benefits advisers are seeking include enhanced returns (45%), greater yields (34%), reduced interest-rate risk (20%) and a desire to mitigate the effects of inflation (10%).

FIGURE 3:

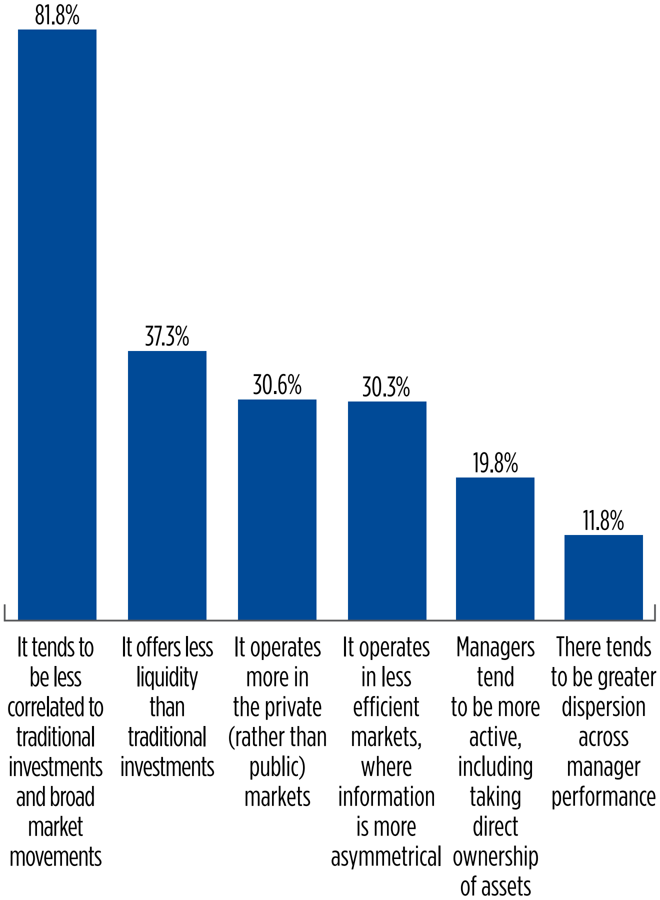
MOTIVATIONS FOR INCREASES TO ALLOCATION TO ALTERNATIVE INVESTMENTS



Underlining the interest in portfolio diversification, **the defining characteristic of alternatives, say most advisers, is their lack of correlation to traditional investments and broad market movements** (82%). In a world where investors increasingly are allocated passively to “the market” through either index funds or ETFs, advisers may see a growing need to diversify away from that tidal movement. Additionally, alternatives are viewed as distinct from liquid, public market investment options, with corresponding benefits (“managers tend to be more active”—20%) as well as liabilities (“offers less liquidity than traditional investments”—37%).

FIGURE 4:

ADVISERS' DEFINING CHARACTERISTICS OF ALTERNATIVES

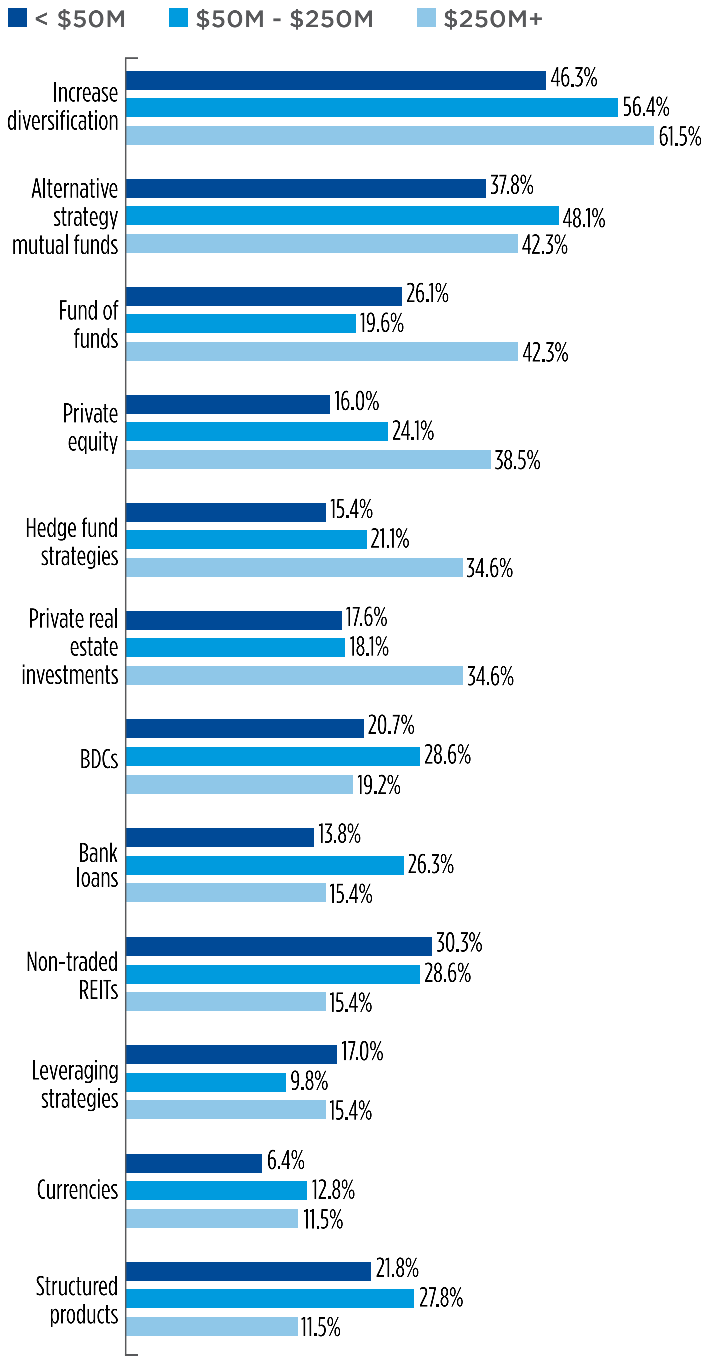


Finally, the types of alternative products used by clients vary significantly depending on the adviser's asset base. Among advisers managing more than $250 million, use of fund of funds, private equity, hedge fund strategies and private real estate investments was much more prevalent than among advisers managing fewer assets.

Among advisers managing between $50 million and $250 million in assets, alternative strategy mutual funds, business development companies, bank loans and currencies were included in a greater percentage of portfolios than in those managed by advisers with either lower or higher AUMs. Inclusion of non-traded real estate investment trusts and leveraging strategies was greatest in portfolios managed by advisers with $50 million or less in assets under management.

FIGURE 5:

STRATEGIES CURRENTLY USED IN RETAIL PORTFOLIOS



The current landscape for alternative investments and strategies, therefore, is broad and promising. Still, the research has found several factors that, if not addressed, are likely to impede more robust growth of alternatives. Below, we outline these "gaps" in the current alternatives landscape and offer suggestions for addressing them.

The Need for a Clearer Definition of Alternatives

While investors and advisers alike are expressing greater interest in alternatives and increasing their use of these investments in portfolios, considerable confusion remains about the specific nature of alternatives. **Our research found that 67% of advisers say that their clients' lack of understanding is a key impediment to an alternatives allocation among clients** — more than the rather common objections surrounding illiquidity (55%) and fees (56%).

This confusion is evident in questions like the following: Do alternatives constitute a new, distinct asset class or are they extensions of traditional asset categories? Is it an alternative's structure that distinguishes it from a traditional investment product?

In itself, there is little harm in having a broad, rather than narrow, definition of alternatives. The problem arises when the definition of alternatives is so all-encompassing and vague that neither adviser nor client is clear about the role of a specific alternative investment in a portfolio.

Traditionally, of course, "alternatives" meant assets and asset classes that had negative or very low correlations to the traditional asset classes of equities, fixed-income securities and cash. In simple terms, when traditional stocks and bonds zigged, alternatives were understood to zag. But there has to be more to it than that.

Commodities and real estate, for example, traditionally have been considered alternative investments because of their historically low correlation to equities. But if an office building is part of a real estate investment trust whose shares are traded publicly — with correspondingly high correlation to small-cap equities — does that make the public REIT an alternative or more akin to a traditional equity investment?

Hedge funds, to take another example, are generally (and properly) understood as "alternatives"— but mostly due to their structural characteristics. The ability to invest in a way that could generate gains from declining asset prices provides a true alternative to investors, who largely have been limited to long-only investments. But the hedge fund universe encompasses at least a dozen specialized 'alternative' strategies — some of which concentrate on public stocks, others in credit, hard assets or interest rates, and so on. They all provide uncorrelated returns, but they may be more sensibly understood as extensions of the underlying asset in which they invest more than generic "alternatives."

Illiquidity is another quality that sometimes characterizes alternatives. Private equity funds, non-traded REITs and non-traded business development companies often are considered alternative investments because they don't provide the ready liquidity of stocks, bonds and mutual funds. Instead, they offer compensating trade-offs that can include stronger yields or higher total returns.

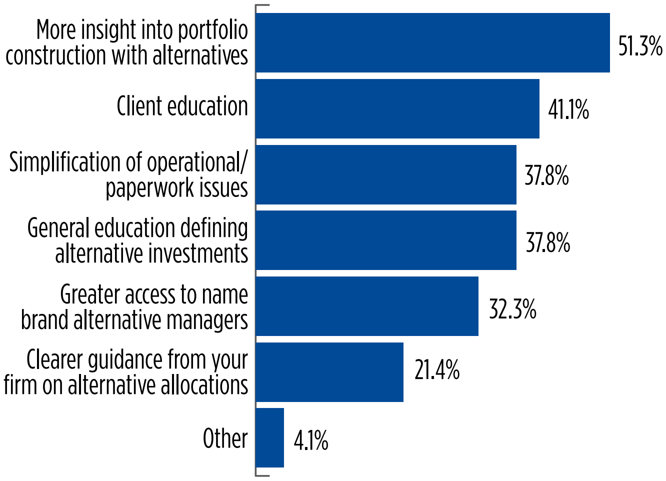
Asset Allocation with Alternatives

Apart from the problem of definition, there is an equally problematic area of confusion with alternatives — portfolio construction. It seems that many advisers simply are not comfortable building alternatives into their clients' portfolios. When asked which factor would help them better utilize alternatives, **51% of advisers cited the need for more insight into portfolio construction incorporating these products and strategies.**

Simply put, many advisers don't know where alternatives may best fit, what current investments alternatives would replace or complement, and what task the alternative investments selected would be responsible for accomplishing in a diversified portfolio.

FIGURE 6:

UTILIZING ALTERNATIVE INVESTMENTS



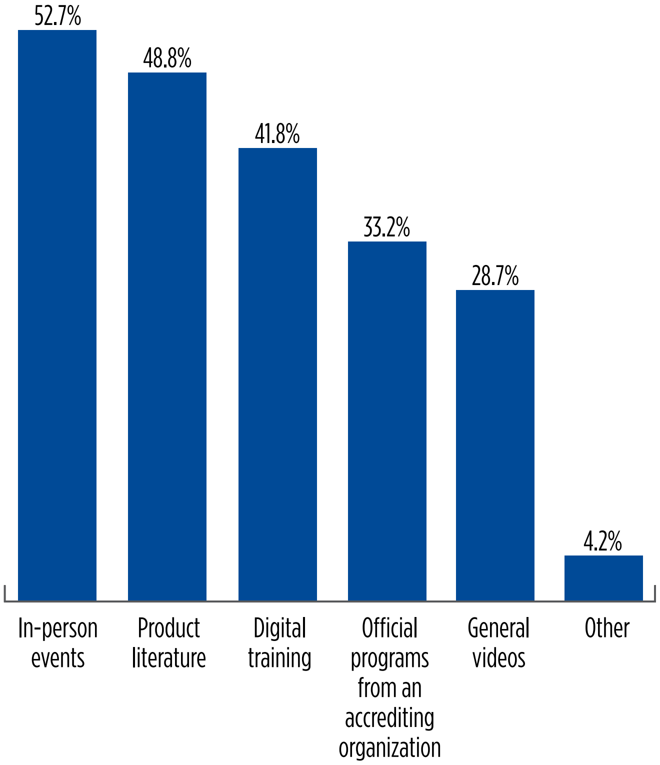
For regulatory and compliance reasons, the providers of alternative products and strategies generally have been reluctant to offer specific portfolio construction advice that incorporates their offerings. In some way, however, providers must be able to provide this advice to advisers in order for them to use alternatives most effectively for their clients.

A Learning Moment for Alternatives

The confusion among advisers highlighted above is a sign that **many are insufficiently familiar with alternatives and require more education to better serve clients.** The question is what sort of education works best and how advisers can most effectively acquire the educational support they need to raise their level of expertise.

FIGURE 7:

MOST BENEFICIAL EDUCATION PROGRAMS



In-person events and digital training seem helpful means to get the word out. And to become more educated, advisers at all levels of AUM strongly believe that better product literature from alternatives providers would be beneficial for them and their clients.

Advisers with less than $250 million in assets under management, see value in educational videos about alternatives. Advisers with more than $250 million in AUM tend to be less enthusiastic about online and video programming.

Advisers at all levels of AUM also believe that formal educational programs about alternatives from an accrediting organization would be helpful.

Conclusions and Key Takeaways

It is clear that financial advisers at firms of all sizes are likely to increase their use of alternatives significantly over the next three years. Primarily motivated by the need to diversify portfolios, source higher yield and decrease volatility, advisers at larger firms are likely to rely on more sophisticated alternative products and strategies for their wealthy clients, while advisers serving less wealthy clients will turn to less bespoke solutions.

The key to wider acceptance of alternatives among investors will be education. Advisers who develop a real specialty in alternatives and are able to give better advice as a result of this knowledge may be in a position to build stronger, more valuable relationships with clients. The best advisers will strive for expertise in portfolio construction using alternatives. They also will excel in an ability to communicate the value of alternatives to clients and prospective clients.

In bullet form, here are the takeaways:

- **Average allocations to alternatives should rise from 10% to 14% of client portfolios within three years.**
- **That shift would represent nearly $150 billion in net flows to alternatives among independent advisers.**
- Despite growing acceptance, confusion about alternative products and strategies remains an impediment to growth. **More than half of advisers survey want "more insight into portfolio construction with alternatives.**"
- Advisers should develop greater familiarity with alternatives and their use in portfolio construction in order to better serve clients.
- **Advisers can become more valuable resources to clients by educating them about alternatives** and the role of these investments and strategies in a portfolio.