The $64 trillion question: Convergence in asset management

Traditional asset managers and alternatives specialists are eagerly contending for an outsize share of a rapidly growing industry.

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The boom in alternative investments presents something of a paradox. On one hand, money has continued to pour into alternatives over the past three years. Assets hit a record high of $7.2 trillion in 2013.[1] The category has now doubled in size since 2005, with global assets under management (AUM) growing at an annualized pace of 10.7 percent—twice the rate of traditional investments (Exhibit 1). New flows into alternatives were 6 percent of total assets in 2013, dwarfing the 1 to 2 percent rate of nonalternatives. Every alternative asset grew, especially direct hedge funds, real assets, and retail alternatives sold through registered vehicles like mutual funds and exchange-traded funds (ETFs). Even private equity, where assets retreated from pre-crisis highs, has bounced back in its new fund-raising.

Curiously, though, alternatives have enjoyed this growth at a time when their returns have generally lagged behind the broader market indexes. The average hedge fund, for instance, produced an 11 percent return in 2013, while the S&P 500 index soared by 30 percent. Skeptics contend that if returns stay sluggish, investor patience will wear thin, and the alternatives boom will run out of steam. However, our new research clearly indicates that the boom is far from over. In fact, it has much more room to run. In late 2013 and early 2014, we surveyed nearly 300 institutional investors managing $2.7 trillion in total assets and conducted more than 50 interviews with a cross section of investors by size and type. The vast majority of institutional investors intend to either maintain or increase their allocations to alternatives over the next three years. Interest is especially keen among large and small pension funds (though not midsize funds) and sovereign-wealth funds. Wealthy individuals are also moving rapidly into the market, as new product vehicles provide unprecedented access to retail investors. Flows from each of these four groups could grow by more than 10 percent annually over the next five years.

In this article, we will first explore the factors driving growth. We then review the two big trends that should shape the strategy of any firm seeking to expand in alternatives: the growing bifurcation of the investor base and some complex shifts in competitive dynamics within the industry.

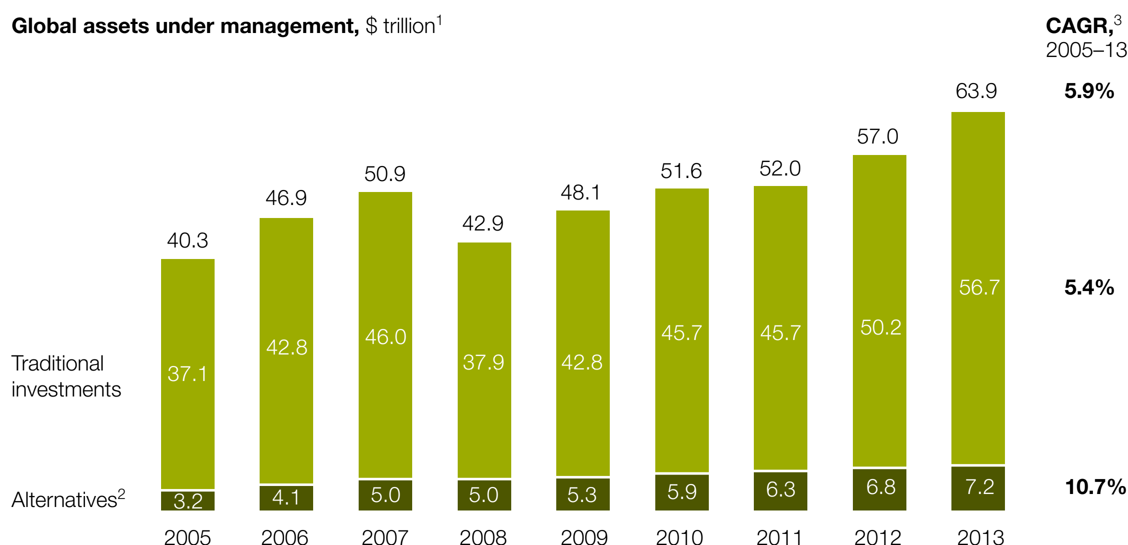
Structural, not cyclical

The rush into alternatives is not a momentum trade. Our interviews with institutional investors suggest that four secular factors are at work:

- Disillusionment with traditional asset classes and products. An increasing number of investors are now using alternatives (particularly hedge funds) as a way to dampen portfolio volatility and generate a steady stream of returns. Demand for alternative credit products has been particularly strong, driven by challenges posed to long-only strategies in the current low (but highly uncertain) rate environment.
- Evolution in state-of-the-art portfolio construction. Many investors seek to complement the low-cost beta achieved through index strategies with the "diversified alpha" and "exotic beta" of alternatives. Further, some 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 (for more, see "From indexes to insights: The rise of thematic investing," on page 51).
- Increased focus on specific investment outcomes. The shift from relative return

Exhibit 1

Alternative investments have grown twice as fast as traditional investments since 2005.



[1]Figures may not sum, because of rounding.
[2]Does not include retail alternatives (ie, exchange-traded funds, mutual funds, and registered closed-end funds).
[3]Compound annual growth rate.

Source: Hedge Fund Research; Preqin; McKinsey analysis

benchmarks to concrete outcomes tied to specific investor needs has created a new tailwind for alternatives. Alternative strategies are seen as more precise tools—for example, real estate and infrastructure can provide inflation-protected income, and hedge funds can help manage volatility.

- A hard-to-close gap. Some defined-benefit pension plans have persistent asset-liability gaps and are assuming unrealistic rates of return in the range of 7 to 8 percent. Many of these plan sponsors are placing their faith in higher-yielding alternatives.

Other McKinsey research finds that the retail segment will be a primary driver of alternatives growth, particularly in the United States. High-net-worth individuals and the mass affluent are increasingly looking to hedge downside risk, protect principal, manage volatility, and generate income. Access to alternative 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 offerings structured as so-called '40 Act funds[2] have experienced particularly robust growth, as investors seek to balance their desire for new alternatives exposures with the need for liquidity.

The upshot is that alternatives now account for a disproportionate share of industry revenues, a state of affairs that we expect 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.

Moreover, alternatives' fees are holding up better than many expected—a sharp contrast to traditional actively managed products, which face the growing threat of commoditization and margin compression. Eighty percent of institutional investors we surveyed expect the management fees they pay hedge funds over the next three years will either remain at current levels or, in a small number of cases, increase. And few expect performance fees to fall, though about half expect to see structural changes to improve incentive alignment between managers and their investors. For example, many expect 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.

A wide range of needs

As they assess the opportunity, asset managers must recognize the diversity of investment priorities and needs among client segments. Larger investors and their smaller peers are interested in adding hedge funds but otherwise have divergent product preferences (Exhibit 2).

Institutions managing more than $2 billion are moving down the liquidity spectrum to embrace more specialized private-market exposures, especially to real assets. Two-thirds of these investors report that they plan to increase allocations

Exhibit 2

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

[1]Figures may not sum, because of rounding.
[2]Vehicles providing nonaccredited investors with exposure to alternative strategies via registered vehicles: closed-end funds, exchange-traded funds, and mutual funds.
[3]Compound annual growth rate.

Source: Hedge Fund Research; Preqin; McKinsey analysis

to agriculture, energy, infrastructure, real estate, and timber; they seek to move beyond relative investment performance toward more defined investment outcomes and extract liquidity premiums while gaining exposure to hard-to-access forms of beta. More specifically, large public pensions have come to see alternatives as critical "outcome oriented" building blocks for their portfolio (for example, as infrastructure for long-dated income, and private equity to extract illiquidity premiums). Smaller investors (those with less than $2 billion in AUM, invested by small teams of generalists) say they seek the enhanced performance and diversification that alternatives can potentially deliver (for example, 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). Investors are also diverging in their

investment priorities and manager preferences (Exhibit 3). Large investors that we surveyed indicated a desire to take greater control over their alternative investing activities. These institutions prioritize the sourcing of coinvestments and often seek to consolidate their relationships with investment managers into a smaller and more strategic set; often, they also seek assistance in building capabilities. These large, sophisticated institutions are becoming more differentiated, frequently leaning toward specialist boutiques (rather than large, generalist 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 report that their highest priority is to secure access to quality investments and managers. Alternatives add a level of complexity to the investment and risk-management processes, driving these institutions' appetite for outsourced services and solutions with embedded advice, including multialternative products, funds of funds, and managed account platforms. In contrast to their larger peers, smaller investors are drawn to large managers because of their established brands, ability to deliver across a broad range of alternative asset classes, and their robust operational and compliance infrastructures.

Exhibit 3

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

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

Source: McKinsey analysis

When worlds collide

The competitive landscape in alternatives is still largely unformed. In stark contrast to traditional asset management, the alternatives market remains highly fragmented, with ample room for new category leaders to emerge (Exhibit 4). 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.

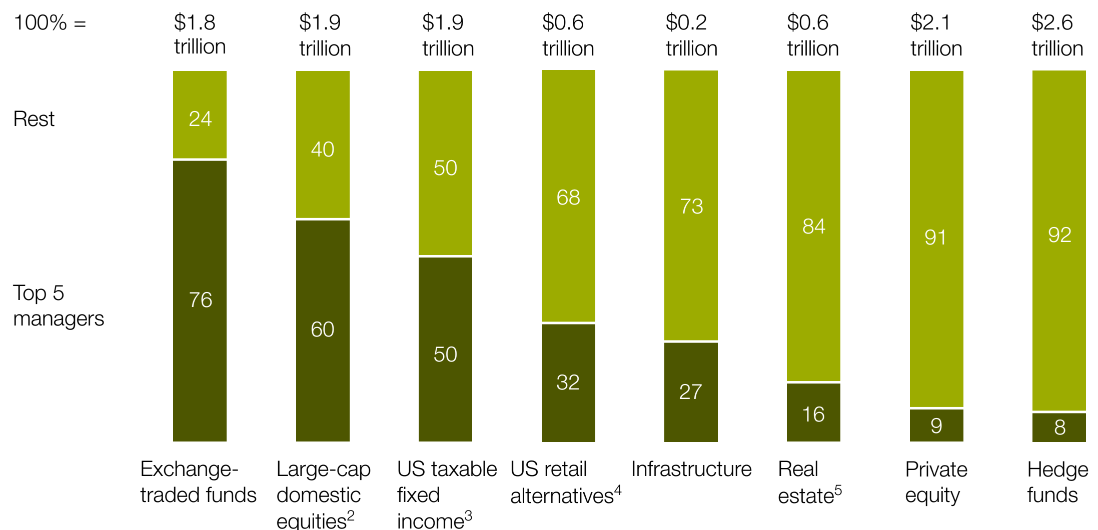
To be sure, the alternatives market will likely remain highly competitive and support a greater diversity of players than the traditional asset-management market, given some of the natural constraints on firm size (for example, the capacity limitations of certain alternative investment strategies) and the common preference for specialist boutiques. Nonetheless, some consolidation is likely as firms joust for a disproportionate share of flows.

Increasingly, that competition will not take place simply between classic rivals. The mainstreaming

Exhibit 4

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

Concentration of alternative assets under management by top 5 managers,[1]
2013, total global assets, %



[1]Based on manager assets under management.
[2]Includes large-cap value, growth, and blend categories.
[3]Includes short-term, intermediate-term, long-term, multisector, high-yield, bank-loan, and retirement-income categories.
[4]Alternatives investment strategies in Investment Company Act of 1940 funds; excluding real-estate-investment-trust and precious-metal funds.
[5]Real-estate funds in private equity–style structures.

Source: *Institutional Investor*; Morningstar; Preqin; Strategic Insight; McKinsey analysis

of alternatives is now driving a convergence of traditional and alternative asset management—two big players in the $64 trillion wealth-management industry. The two sides will increasingly battle for an overlapping set of client and product opportunities in the growing alternatives market.

Traditional asset managers 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. Alternatives specialists are also moving swiftly. A few publicly listed megafirms have broken away from the pack with an aggressive expansion of their investment platforms to offer a broad and comprehensive alternatives menu across all asset classes, geographies, and strategies, including a push into retail. And some private-equity firms are acquiring market-driven, trading-related investment capabilities.

With the stakes so high, 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, institutional 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.

As firms consider how best to establish an advantaged position in this burgeoning industry, they need to make deliberate choices about their business model. Its design must be shaped by a clear view of the specific kinds of clients they want to serve. Several skills will increasingly be at a premium: innovation in solution-based products (such as multialternative funds), distribution (for example, liquid alternatives in defined contribution), marketing (retail advisor education on alternatives "use cases" is one example) and thought leadership (such as alternatives-oriented model portfolios). As firms get larger, their organizational challenges will naturally grow; listed companies will also have to negotiate the tricky balances between the needs of shareholders and clients. And the growth of alternatives will only exacerbate the industry's need to attract and retain top-flight talent. o

[1] We include assets held by hedge funds, private-equity firms, and real assets (in agriculture, commodities, energy, infrastructure, and real estate) held by financial investors.
[2] The Investment Company Act of 1940.

The authors wish to thank Kevin Cho, Céline Dufétel, Sacha Ghai, Aly Jeddy, Owen Jones, Bryce Klempner, Carrie McCabe, Gary Pinkus, and Nancy Szmolyan for their contributions to this article.

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