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Igniting Distribution: Alternative Investment Managers Must Match Attractive Strategies with Liquidity and Performance

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Igniting Distribution

ALTERNATIVE INVESTMENT MANAGERS MUST MATCH ATTRACTIVE STRATEGIES WITH LIQUIDITY AND PERFORMANCE

By Daniil Shapiro, CFA®

Editor's note: This article originally appeared in "U.S. Monthly Product Trends," The Cerulli Edge, April 2021, Issue #124.

KEY FINDINGS

- The volatility associated with the COVID-19 pandemic did not result in a wave of alternative product flows and shook confidence in certain products.
- Product manufacturers can compete on offering low-cost and liquid allocations or unique exposures. The latter will offer an opportunity for a larger set of managers, but efforts should focus on structures that have enhanced liquidity and offer strong return potential.
- Opportunity remains for specialist managers to offer attractively priced products in the non-traded REIT (NTR), interval fund, and non-traded business development companies (BDC) categories. The exchange-traded fund (ETF) vehicle also will offer an opportunity to those that can package strategies in it. Cryptocurrency products—where investors will most need managers' expertise—are on the horizon.

In conversations with Cerulli Associates, alternative investment firm product and distribution executives often reference a return of market volatility as an antidote to advisor allocations to alternatives that are perceived as low. Yet, our latest poll of advisors shows no evident shift into alternative investments because of the volatility associated with the COVID-19 pandemic. Just as many advisors (19 percent) said they decreased allocations in response to the pandemic as said they increased allocations; specific products, such as commodity ETFs, likely fared better. We believe that advisors recognize the diversification, downside protection, and greater income benefits that alternative investment products can offer, but they are struggling to allocate to them due to liquidity requirements, heightened costs, and product complexity.

Cerulli Associates evaluates advisor use of alternative investments in the context

Table 1

ADVISOR-REPORTED ALTERNATIVE INVESTMENT PRODUCT USE, 2021

Advisor-Reported Alternative Investment Product Use, 2021

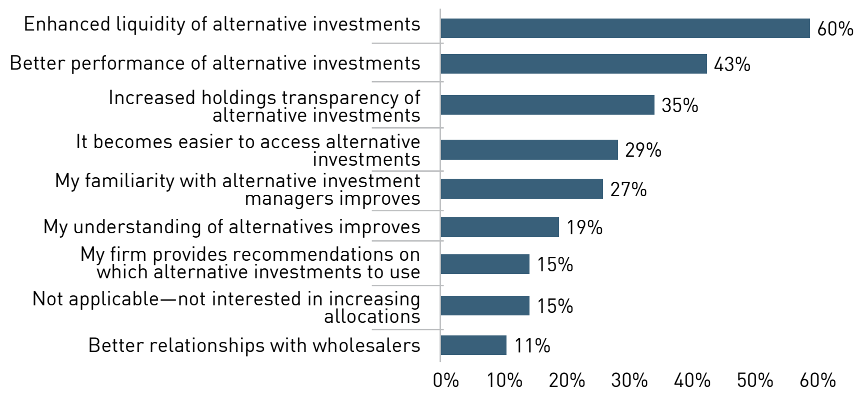
Product	Currently Use	Plan to Start Using	Used Previously but Not Currently	Do Not Use/Have Not Previously Used
Liquid alternative mutual funds (including REIT mutual funds)	66%	5%	6%	23%
Non-traded REITs (NTRs)	60%	3%	24%	13%
Liquid alternative ETFs (including commodities ETFs)	46%	8%	13%	33%
Non-traded business development companies (BDCs)	44%	1%	27%	28%
Private real estate	41%	4%	9%	47%
Private equity	37%	9%	5%	49%
Private debt	36%	3%	8%	54%
Interval funds	32%	14%	9%	46%
Private natural resources	13%	9%	8%	71%
Opportunity zone investments	13%	15%	6%	65%
Hedge funds	11%	8%	11%	70%
Private infrastructure	8%	12%	4%	77%
Special purpose acquisition companies (SPACs)	4%	15%	5%	76%

Sources: Cerulli Associates, in partnership with Blue Vault

Analyst Note: Respondents to this alternatives-focused advisor survey were heavily concentrated in the independent broker-dealer channel, which likely led to greater reported use of specific products (e.g., NTRs, BDCs).

Figure 1

ADVISOR-REPORTED FACTORS THAT WOULD DRIVE INCREASED ALTERNATIVES ALLOCATIONS, 2021



Sources: Cerulli Associates, in partnership with Blue Vault

of the democratization of alternatives theme. Increasingly, advisors have access to higher-caliber alternative investments previously accessible only to institutions. However, this trend has not played out as expected. The most-liquid products (liquid alternatives) have stagnated in asset growth—often from being too watered-down from institutional peers.

At the same time, convergence zone products (e.g., NTRs, interval funds, non-traded BDCs), although undergoing innovation and growing in assets, have been dominated by a small stable of managers with successful strategies that increasingly offer enhanced liquidity. The Blackstone Real Estate Income Trust (BREIT) product, which uses a perpetual net asset value (NAV) REIT structure and provides the opportunity for monthly redemptions, is now a $37-billion product and is being joined in leaderboards by a BDC counterpart, Blackstone Private Credit Fund, which also has been successful at fundraising. A broader product pool, however, has continued to struggle with performance, fees, and unique liquidity challenges. Some broker-dealers paused NTR redemptions during the COVID-19 drawdown due to NAV uncertainty, and some more-complex interval funds faced severe withdrawal pressure amid investor concerns about portfolio composition and liquidity.

We perceive two key modes of competition for alternative investment allocations—low-cost and liquid, e.g., successful liquid alts strategies, and unique exposures that often back into brand-name manager skill but also offer the possibility for strong performance. Sixty percent of polled advisors report that enhanced liquidity would drive them to allocate more to alternative investments, and 43 percent reported that the same or better performance could lure them (see figure 1). Currently, the largest interval fund, the $13-billion ACAP Strategic Fund, is an aggressive innovation-focused equity strategy that has delivered attractive returns. Similarly, a key strength of the BREIT product is its well-timed investment in warehouses supporting e-commerce.

Cerulli Associates believes that managers will continue to have tremendous opportunity to offer alterative exposures to advisors, but it may be different from the road map devised earlier. The lion's share of liquid alternative product flows likely will continue to go to a select few simple and low-cost strategies such as JPMorgan Hedged Equity and BlackRock's Multi-Strategy funds, which gathered $6.4 billion and $2.9 billion in 2020, respectively. Meanwhile, advisors will continue to cautiously view a wider range of products.

The ETF vehicle is fertile ground for alternative allocations; advisors allocate more to it than to mutual funds. The success of defined outcome ETFs underscores that advisors will allocate to options-based products with specific return profiles and that they seek downside protection. Similarly, the launch of several special purpose acquisition company ETFs reflects the ability of managers to use the vehicle to offer exposures to newer market segments that clients may have difficulty navigating on their own.

Cerulli Associates expects that cryptocurrency products will, over time, also make their way into advisor portfolios. Where advisors already allocate heftily to gold and other commodities perceived as diversifiers—all while incurring storage costs—it wouldn't be surprising to see cryptocurrency and other digital asset allocations muscle in over the long term. Only a sliver of advisors currently report investing in cryptocurrency on their own accord (as opposed to by client request), but almost one-third expect to do so during a longer period.

With multiple Bitcoin ETFs expected to gain approval this year, we expect to see increased maturity of cryptocurrency investing. Although it's not imminent, Cerulli expects managers to eventually offer dedicated digital asset strategies that help investors navigate a complex landscape. This is cutting-edge but also a return to basics for alternatives manufacturers. These firms would be offering a unique exposure where investors are dependent on the access offered and the manager's intellectual capital.

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