Investing in funds

Global shift into alternative assets gathers pace

Investors turn to property, infrastructure, private equity and hedge funds

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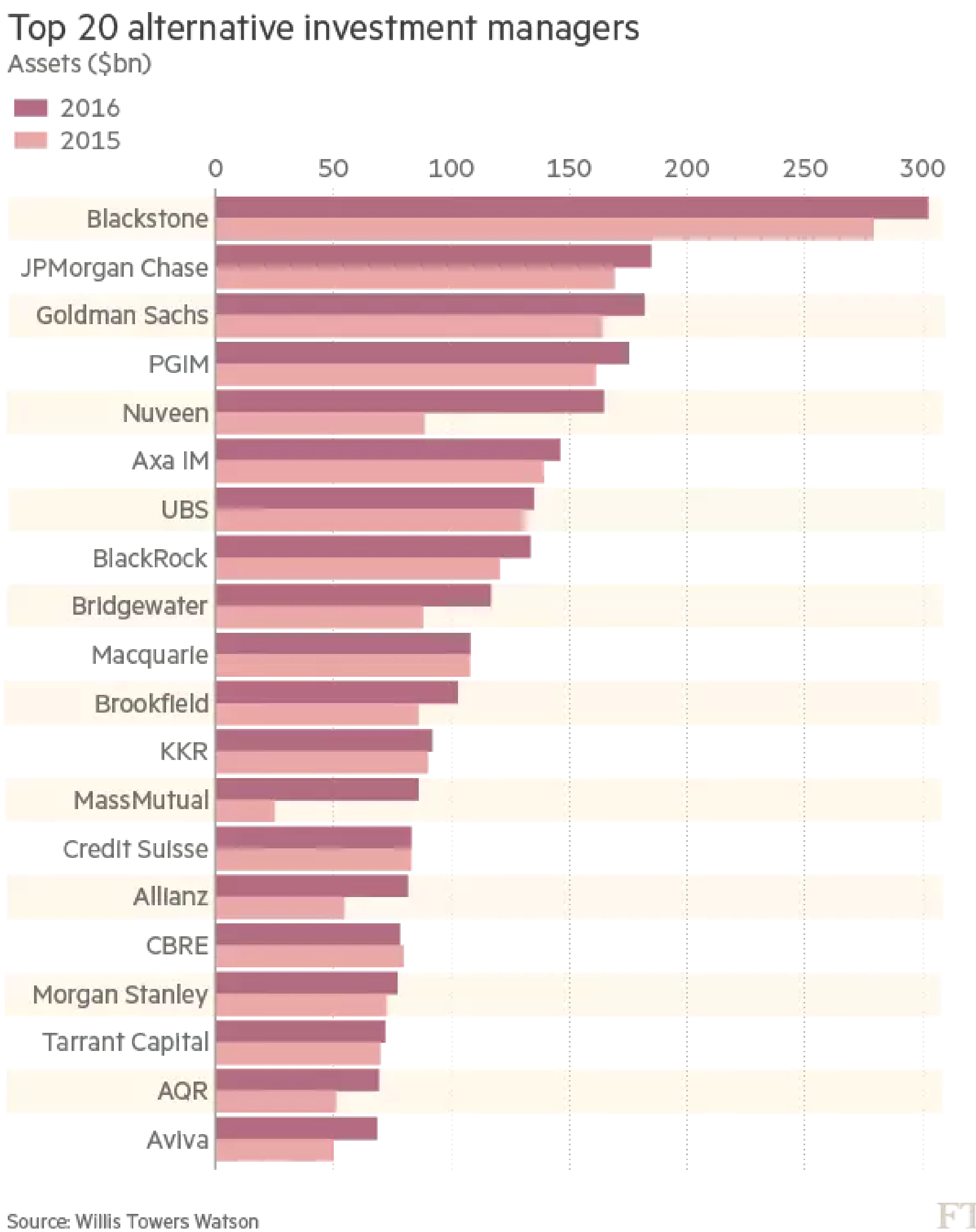
YESTERDAY by: Chris Flood

The worldwide shift into alternative assets gathered pace in 2016 as more institutional investors turned to property, infrastructure, private equity and hedge funds in search of better returns.

Asset purchasing programmes by central banks in response to the 2007-08 financial crisis have led to strong gains and stretched valuations across many publicly traded bond and equity markets, helping to strengthen the attraction of alternatives to large investors.

But the huge scale of new cash inflows into alternatives in recent years has also driven up valuations across these illiquid assets and raised concerns that investors may be disappointed by future returns that are widely expected to be lower than those achieved historically.

Many investors, however, feel they have little choice but to embed illiquid alternatives ever more deeply into their portfolios due to the uninspiring returns on offer from mainstream asset classes after a bull run that has lasted for eight years for equities and almost three decades for government bonds.



Total assets managed by the 100 largest alternative investment managers rose to a little more than $4tn at the end of 2016, up a tenth on the previous year, according to the latest annual Willis Towers Watson/FTfm Global Alternatives Survey, which covers 10 asset classes and seven investor types.

“There was a significant rise in alternative assets last year, markedly stronger than the 3 per cent increase registered in 2015,” says Luba Nikulina, global head of manager research at Willis Towers Watson, the world’s largest adviser to institutional investors.

Blackstone retained its position as the world’s largest manager of alternative assets in 2016. Helped by inflows into its real estate and fund of hedge funds businesses, Blackstone’s alternative assets rose 8.3 per cent last year to $302bn.

JPMorgan held on to second place in the ranking with an increase of 8.9 per cent in its alternative assets to $185bn.

Anton Pil, global co-head of alternatives at JPMorgan Asset Management, says reductions in expected returns for publicly traded stocks and bonds means that investors seeking to boost returns will have to increasingly consider alternative assets along new avenues of diversification and, most importantly, a genuinely active approach to asset allocation.

“The wide dispersion in manager returns is a characteristic of all alternative strategies. This makes effective manager selection critical for success,” says Mr Pil.

Taimur Hyat, chief strategy officer at PGIM, the investment arm of US insurer Prudential, says that some alternative investment strategies have been exposed as little more than levered [debt financed] plays on public markets.

Assets under management by alternative investment managers

End 2016 ($bn)

	Top 100 pension funds assets under management	Top 25 wealth managers AUM	Top 25 sovereign wealth funds AUM	Top 100 institutions AUM
Real estate	665.7	245.1	56.2	1427.7
Private equity	113.3	16.1	26.8	695
Funds of PE funds	293.1	16.8	6.1	492.1
Hedge funds	187.5	106.4	39.1	674.6
Fund of hedge funds	79.0	24.4	28.7	227.7
Infrastructure	125.7	28.8	15.9	161.2
Illiquid credit	122.8	12.2	7.4	359.9

Source: Willis Towers Watson

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"Investors are having to think more carefully about which alternative investment strategies offer real diversification benefits from their traditional holdings of stocks and bonds," says Mr Hyat.

The study shows that money has continued to pour into real estate, which accounts for a little more than a third ($1.4tn) of the assets managed by the top 100 managers. Property remains the most popular asset class for institutional investors, even though returns in the UK and US real estate markets slowed in 2016.

Total alternative assets under management globally stood at $6.5tn spread across 562 managers.

"US and UK property markets are at high points in their real estate cycles. Investors need to be cautious when choosing higher risk strategies, particularly those using higher levels of debt," said Ms Nikulina.

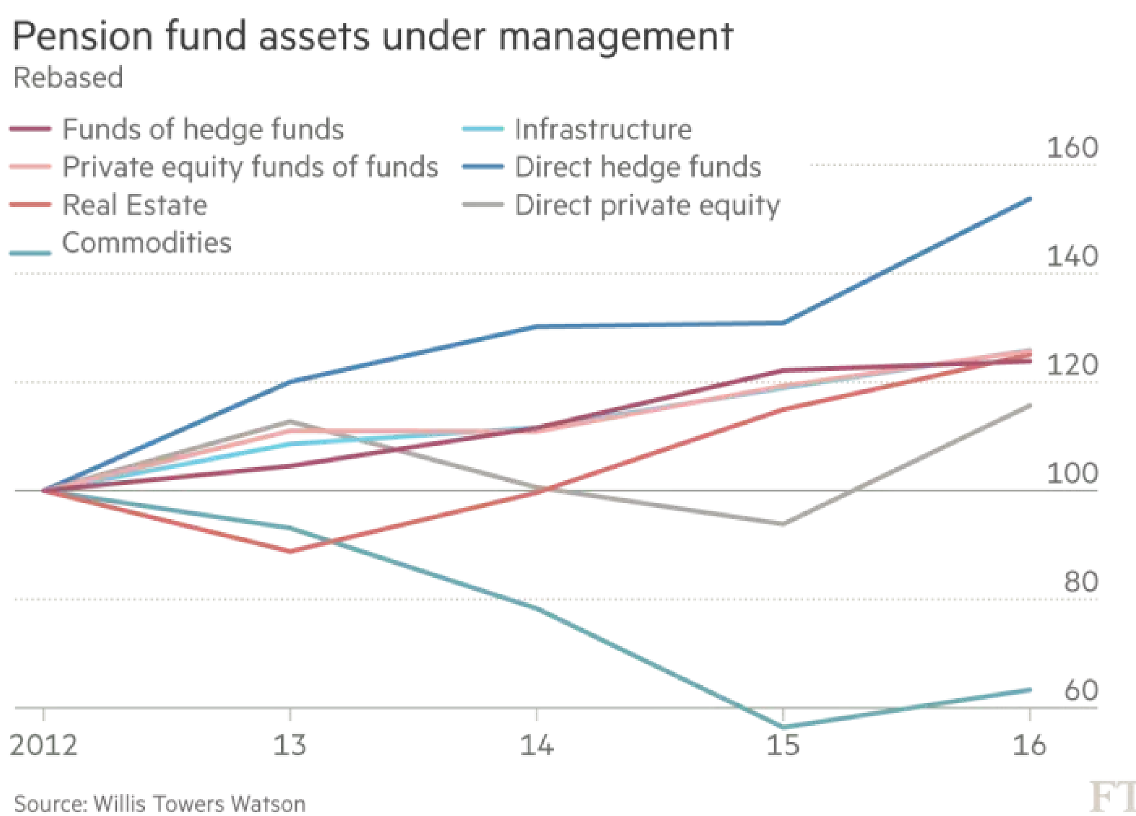
But Germany, France and the Netherlands all registered an increase in real estate returns in 2016.

Ms Nikulina added: “The continental European market appears further away from its peak and real estate looks reasonably well supported by low interest rates, despite the region’s economic challenges.”

Mr Hyat says PGIM’s real estate portfolio managers and investors have become “increasingly cautious” about valuations and “a much more granular approach” is now required to identify pockets of value in cities and property sectors which can have distinct supply and demand drivers.

Private equity managers attracted inflows of $325bn last year, an increase of 18.5 per cent on 2015, according to Preqin, the data provider.

Fundraising has been boosted by investors recycling money from private equity funds that have matured into new vehicles. But fierce competition among private equity managers to win desirable assets has pushed the price of investment deals towards new highs.



At the same time, dry powder — money promised by investors that private equity managers have not yet spent — has climbed to a record $1.5tn, suggesting that suitably priced deals have become more difficult to find.

“Pricing is incredibly rich. There are too many deals that have been priced and leveraged to perfection to withstand a downturn,” warned Ms Nikulina.

In contrast, fundraising for hedge fund managers proved much more challenging. Investors withdrew $70bn from hedge funds in 2016, according to the data provider HFR. Three-quarters of large investors were disappointed by the performance of their hedge fund portfolios in 2016, marking the highest level of dissatisfaction in at least four years. However, some of the top managers surveyed by Willis Towers Watson bucked the weakness.

Bridgewater, the money manager founded by Ray Dalio, retained its grip on the top slot for hedge funds with assets up by a third to just less than $117bn.

AQR, the hedge fund co-founded by Cliff Asness, registered a 35.6 per cent increase in assets, helping it to snatch second place in the rankings from London-listed Man Group where assets rose by a more modest 6.3 per cent.

Ms Nikulina expects more capital will be withdrawn from hedge fund managers, due to concerns about performance and also due to rising competition from low-cost smart beta strategies — a halfway house between active and passive management.

“This is providing opportunities for remaining hedge fund investors to renegotiate lower fees. The probability of a downturn in public markets becomes more likely with every year that passes and so investors need to diversify away from traditional equity and credit exposures is also continuing to provide support for hedge funds,” says Ms Nikulina.

The ranking of infrastructure managers compiled by Willis Towers Watson shows Australia’s Macquarie retaining its long held top spot, but Brookfield of Canada registered a significant increase in assets after closing the world’s largest infrastructure fund in 2016.

Almost all institutional investors are below their target infrastructure allocation or have yet to invest, in spite of growing efforts by governments worldwide to encourage pension funds and asset managers to invest in roads, bridges, electricity and water supply facilities.

Ms Nikulina says that although it has become more difficult to find deals with attractive valuations as asset prices have risen, “the reality is that the requirement for infrastructure is immense in all geographic regions”.