DISTRIBUTION CHANNELS KEY AS EUROPE'S HEDGE FUND REVIVAL CONTINUES

Cerulli White Paper | May 2018

Summary

Across Europe, the recommended allocation of alternative UCITS has risen from 10% to 15% or even higher. With many investors below the recommended level, there is plenty of room for growth. However, rather than upping the number of products, most providers should focus on improving their access to distribution channels. Cerulli expects private banks and wealth managers to continue dominating the alternative UCITS market in 2018, but demand from institutional investors is growing.

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European Hedge Fund Industry Set to Keep On Growing

The outlook is bright for Europe's liquid alternative investment industry, but there will be challenges—such as keeping up with advances in technology. According to Preqin data, Europe-headquartered managers' hedge fund assets under management (AUM) totaled €610 billion (US$728 billion) at the end of last year. Inflows amounted to €27.0 billion in 2017, in sharp contrast to the previous year's outflows of €29.6 billion. The 2017 figure represented around 73% of total global hedge fund inflows. Cerulli believes there is scope for further sizable growth, given that many investors are well below allocators' recommended allocation of 15% or higher.

However, it was not all good news for equity hedge funds. Having seen assets increase significantly in 2015 as rallying equity markets attracted a flood of new investors, supply was ratcheted up. Investor demand over the past two years, however, failed to live up to expectations. Equity hedge fund asset growth between 2015 and 2017 was minimal, while macro and multi-asset strategies both boasted increased AUM in 2017.

Although alternative UCITS credit strategies faltered in 2016, AUM rebounded by 20.9% in 2017 to end the year at €44.4 billion.

Hedge funds have come to realize that launching UCITS versions of their strategies can dramatically increase their standing—globally as well as in Europe—and the past three years have seen many enter the alternative UCITS space with great success. These new entrants, equipped with a wealth of expertise and specialist strategies, have driven up the quality and choice of UCITS funds available to investors.

Key Points

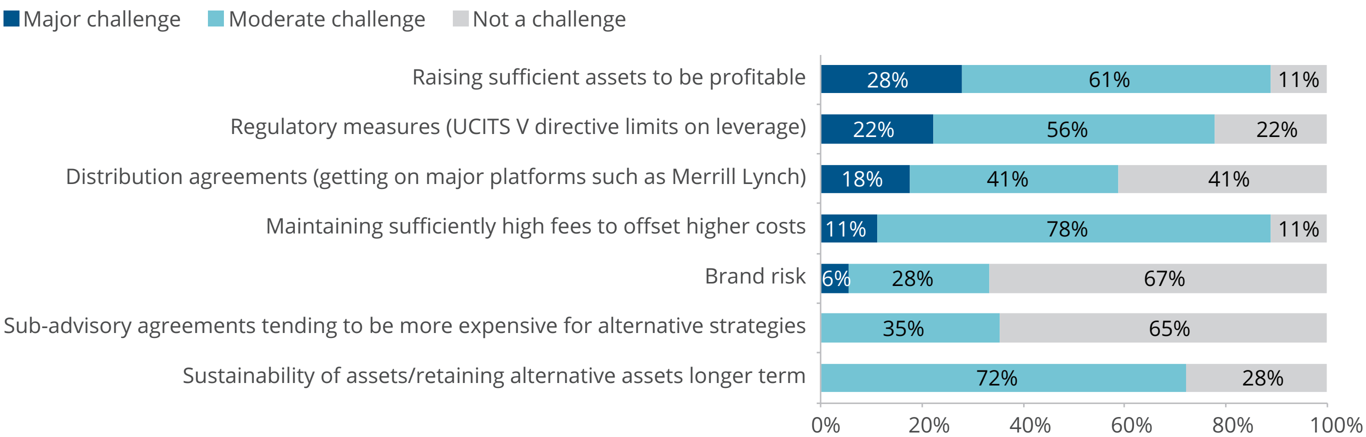
- Private banks and discretionary fund managers are an important distribution channel in Europe. Although it is challenging to build relationships with private banks—which generally prefer to work with a limited number of asset managers as strategic partners—the predicted growth of the subadvisory market should provide opportunities for managers with niche capabilities.
- As Europe's alternative UCITS industry continues to expand, competition will intensify, with US managers now entering the market. Asset managers that can add value by providing custom solutions and diversification or by offering downside protection will continue to thrive.
- The alternative UCITS industry, which kept growing in 2017, now offers investors far more than the diluted version of equity long/short of past years. With fund quality and investor choice on the rise, managers entering this competitive space need to be both inventive and user-friendly.
- The range of alternative risk premia strategies is large and expanding, with new research extending the boundaries of the available strategies. Competition in this space will only heat up, leading to fee pressure and increasing the need to differentiate. The key differentiating factors will be: robust operational risk control; the ability to minimize costs in the implementation of the strategy; good quality of signal; and the ability to provide custom solutions at attractive prices.

EXHIBIT 1

Asset Managers' Views on the Challenges Involved in the Development of Profitable Alternative Investments Within Their Firm, 2017

Source: Cerulli Associates

Analyst Note: Asset managers were asked to identify how certain factors affect their firm's potential for developing profitable alternative investments. Asset managers were able to select from "major challenge," "moderate challenge," and "not a challenge."



However, establishing a fund has become more expensive, which has contributed to the polarization of the alternative UCITS industry. While large institutional hedge funds have been able to gather assets, many smaller ones have struggled.

Distribution challenges

The managers Cerulli surveyed for its ***European Alternative Products and Strategies 2018: The Next Steps in Product Development*** report identified the following as key challenges to developing profitable alternative investments: raising sufficient assets; regulatory measures; and distribution agreements. With more managers launching products, raising sufficient assets is becoming ever more difficult. Regulatory hurdles are pushing up operational costs for managers.

A growing number of alternative asset managers are planning to put more emphasis on distributing existing funds rather than developing new products. This shift in focus makes having a strong distribution plan in place even more important. For instance, alternative risk premia managers that have launched risk premia funds over the past few years and now have a three-year track record are looking to scale up their business. Signing distribution agreements with major UCITS platforms and private banks could give them access to a larger client base. Some managers will struggle to achieve such agreements.

Alternative UCITS are being seen as an important revenue driver by more major fund platform providers. Lyxor, for example, has over the past four years moved away from a heavy offshore-commingled-fund bias to a broader offering that includes liquid regulated-UCITS funds.

These platforms remove much of the regulatory and compliance burden for the underlying managers, as well as providing a ready-made marketing and distribution network. Many managers, however, prefer to launch their own UCITS offerings independently as this commission-free route means the managers can offer more competitive fee structures.

One of the largest platform providers in Europe plans to double its UCITS funds to 20 managers over the next 18 months. It has already had discussions with several European and US managers. The platform is looking for alternative risk premia managers, as it plans is to enhance its offering in this arena. It noted, however:

> *"If you look at pure risk premia managers that launched funds three years ago, most do not deliver good returns. So, you need to be very careful when selecting risk premia managers."*

Aware of the fact that there are many ways to do risk premia, the platform provider is aiming to select managers that have exposure to more than one factor or to less-common factors. It is seeking managers that can allocate smartly so as to exclude those factors that fail to perform. Not surprisingly, finding such funds and managers is no easy task.

Being selected by a platform is not a given; platform providers appear to becoming more selective. And although the UCITS framework brings standardization in many respects, funds sold in global jurisdictions may still be subject to additional local regulatory restrictions, which means it cannot be a case of one-size-fits-all.

The alternative UCITS market, now a product category in its own right, is maturing fast. For managers, this means increased pressure to differentiate offerings through innovation, value, and add-on services. For many, particularly those in the increasingly crowded equity long/short space, fees remain a key competitive tool. Those managers with strategies that offer investors something different while striking the right balance of price and complexity will reap the biggest rewards.

Private banks

A trend that Cerulli expects will continue to be a feature of the alternative industry over the coming years is the rise of joint ventures and branding partnerships between specialist alternative managers and private banks. The former are looking to boost assets and the resilience of their business model; the latter are in search of talented fund managers to achieve peer differentiation and to provide niche strategies for high-net-worth individuals and institutional investors.

Private banks and discretionary fund managers are key distribution channels in Europe, particularly in Switzerland, France, and the UK. Demand from these channels for more complex strategies such as macro, managed futures, and alternative risk premia has risen noticeably. However, despite an increased recommended allocation of up to 20% to alternatives in advisory mandates, most still hold 5% or less.

Cerulli's survey of private banks found that 28% of their clients with moderate risk tolerance allocate between 1% and 5% to liquid alternative mutual funds. Some 32% of the private banks we surveyed said that the typical allocation to liquid alternatives of clients with moderate risk tolerance is between 6% and 10%. Another 20% said that the typical allocation to liquid alternatives is above 10%.

Cerulli believes that there is still plenty of room for further growth among these retail channels. Around one-third of private banks expect their clients' typical allocation to alternative investments, as well as alternative UCITS, to increase over the next 12 to 24 months.

EXHIBIT 2

Asset Managers' Most Important Distribution Channels for Alternative Investments Over the Next 12–24 Months, 2017

Source: Cerulli Associates

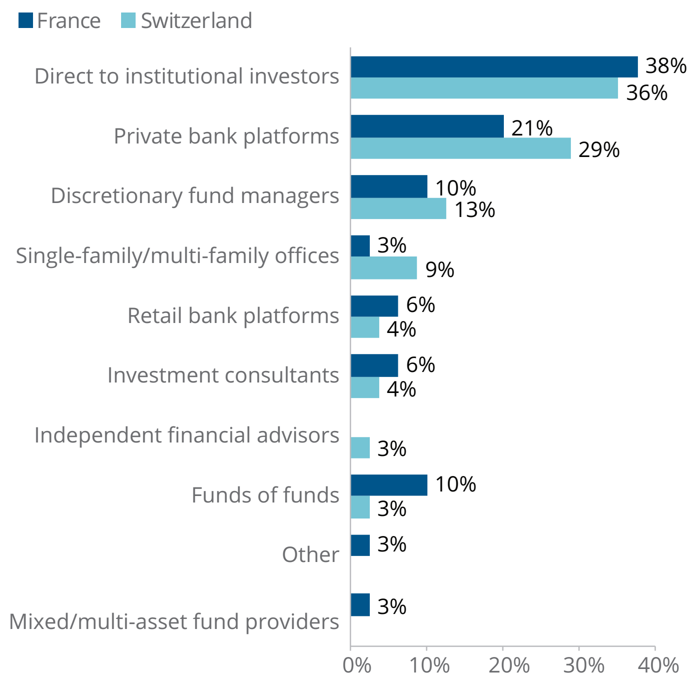
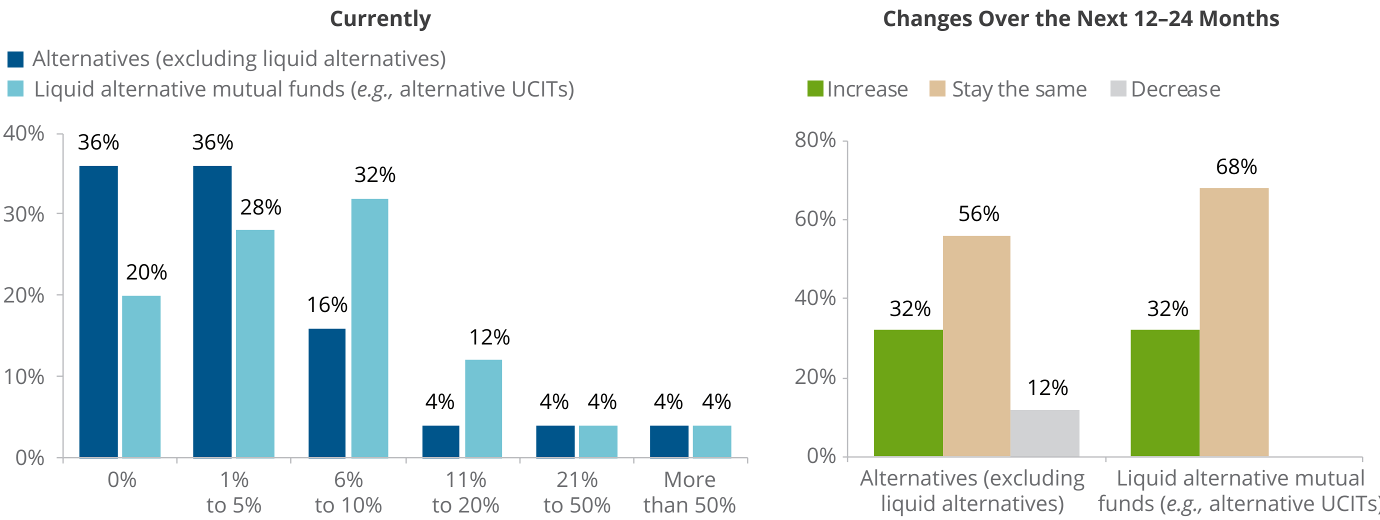


EXHIBIT 3

Private Banks: Typical Allocation to Alternative Investments of Clients with Moderate Risk Tolerance Currently and Anticipated Changes, 2018

Source: Cerulli Associates

Analyst Note: Private banks were asked to estimate the typical asset allocation to alternative investments of their clients with a moderate risk tolerance and how they expect this to change over the next 12 to 24 months.



As Exhibit 3 shows, significant numbers of private banks expect to increase their allocation to market-neutral strategies and equity long/short strategies over the next 12 to 24 months. Around one-third expect to increase their allocation to risk premia and multi-strategy alternatives. Although 48% of the banks surveyed already have an alternative risk premia offering, others remain sceptical of this approach: 32% of the private banks we surveyed do not currently invest in alternative risk premia and have no plans to do so.

For instance, private banks in Switzerland use alternative risk premia strategies in conjunction with hedge funds or as add-ons to hedge fund portfolios. These banks realize that replacing a discretionary fund manager with a systematic risk premia manager can improve diversification because an increase in angles and different trading times. Private banks and fund-of-funds managers such as Pictet Alternative Advisors look for managers that have some form of proprietary process in the quantitative space and can create new signals for alpha generation.

More than half of the private banks Cerulli surveyed (66.7%) listed diversification as a reason for investing in alternative risk premia strategies. Some 41.7% identified superior risk-adjusted returns and the fact that alternative risk premia strategies have lower fees than traditional hedge funds as key factors.

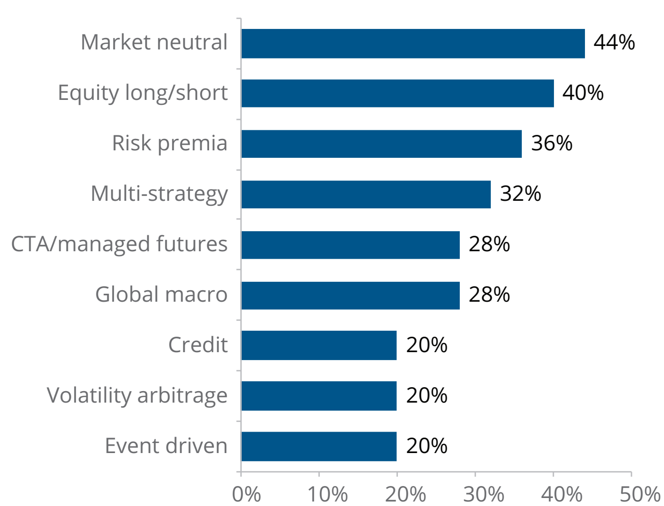
Although these strategies provide diversification benefits, some private banks believe that their performance is not strong enough.

EXHIBIT 4

Private Banks: Anticipated Allocation Increase in Liquid Alternative Strategies Over the Next 12–24 Months, 2018

Source: Cerulli Associates

Analyst Note: Private banks were asked to indicate in which of the following liquid alternative (alternative UCITS) strategies they have plans to increase their allocation over the next 12 to 24 months.



With some private bank platforms looking to reduce provider numbers, getting listed is becoming more difficult. However, for those managers that already have an existing fund on a platform, the chances of getting another one listed are significantly higher. Asset managers without existing listed funds will need to be able to offer highly differentiated products.

Private banks often have their own investment strategists to devise specific investment themes. Asset manager with products that match the investment team's needs have a better chance of being approved. Success, however, does not depend solely on the attractiveness of the fund—having a good relationship with private banks in multiple distribution areas is also a key factor. As one manager told us:

> *"Private banks focus on a limited number of partners. For boutiques like us it is definitely tough. But we have been selected because what we propose is different from the competition. We have been referenced as a provider for European and Japanese equities so now we can bring in other products. You have to differentiate yourself."*

When choosing partners, private banks and fund platforms often prefer niche alternative managers that are experts in their field as this enables them to enhance their product offering. They therefore often seek smaller managers rather than well-known names for some investment strategies.

Although it is challenging to build relationships with banks, it is especially important for small and mid-sized managers to do so. Banks can help them to wrap products into different vehicles and offer client-centric solutions.

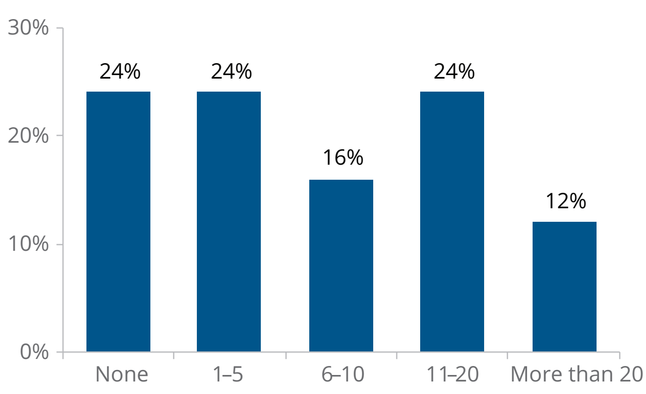
The Swiss market is dominated by banks, with most looking to increase their passives offering. In a bid to be different from the competition, these banks home in on the best active managers. As one manager told Cerulli, "If you are one of 25 platforms out there, then you must be different."

EXHIBIT 5

Private Banks: Total Number of Direct Single Hedge Fund Managers Private Banks Are Invested With Currently and Anticipated Changes Over the Next 12–24 Months, 2018

Source: Cerulli Associates

Number of Direct Single Hedge Funds Currently



Anticipated Changes Over the Next 12–24 Months

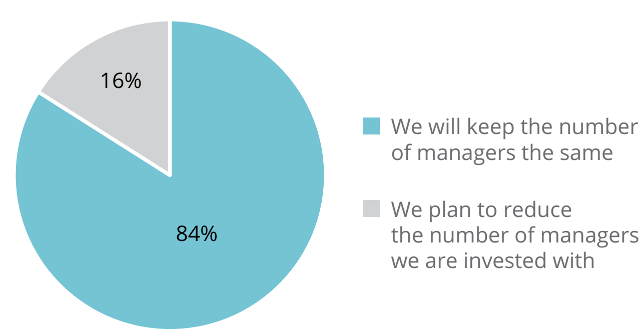
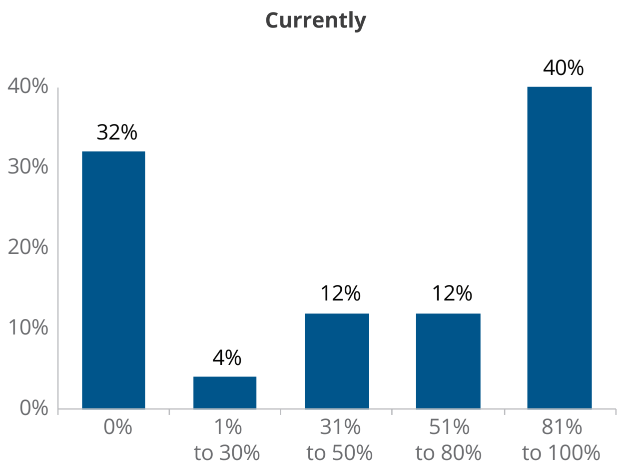
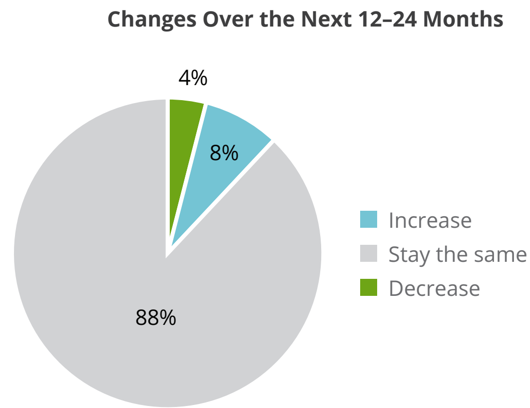


EXHIBIT 6

Private Banks: Proportion of Alternative Assets Under Administration Outsourced to Third-Party Managers Currently and Anticipated Changes Over the Next 12–24 Months, 2018

Source: Cerulli Associates





Although Cerulli's survey results show that most private banks plan to keep the same number of direct single hedge fund managers they are invested with over the next 12–24 months, securing partnerships with banks remains a challenge for asset managers. Some 16% of the private banks that responded to our survey plan to reduce the number of managers they are invested with, while others will be very selective in the future. Nonetheless, Cerulli believes that good opportunities are available in UCITS for high-caliber managers with unique propositions.

Our survey of private banks shows that performance is the most important factor when it comes to conducting due diligence on third-party alternative asset managers. Risk controls and fees and expenses are the second- and third-most-important factors respectively.

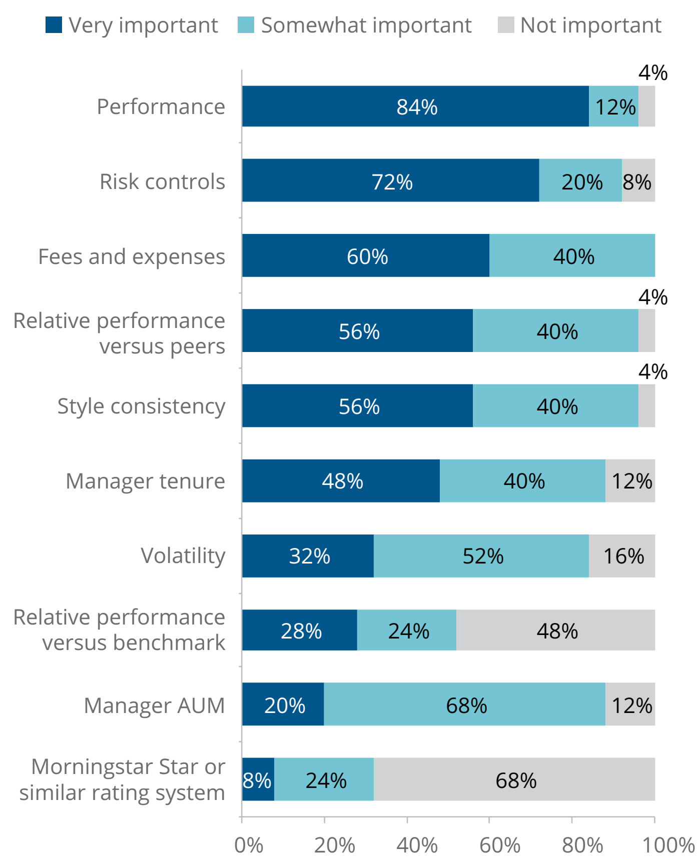
Although private banks ranked style consistency as the fourth-most-important factor when performing due diligence on alternative asset managers, they said that a change in investment style (style drift) is the most crucial driver for terminating relationships or mandates with alternative asset managers.

Some 72% of private banks reported that performance is among the top factors when deciding to remove managers from their lists. In contrast, Cerulli's conversations with pension funds suggest that some are willing to tolerate underperformance for a few years. Private banks identified manager tenure/change and capacity (both 48%) as the joint third-most-important factors when terminating relationships or mandates with alternative asset managers.

EXHIBIT 7

Private Banks: Most Important Factors When Conducting Due Diligence on Third-Party Alternative Asset Managers, 2018

Source: Cerulli Associates



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- Technology's impact on hedge fund industry
- Growing importance of subadvisory agreements in Europe
- Solvency capital-efficient solutions
- Solvency II and search for yield impact on outsourcing in Europe
- Increasing ESG integration not only in traditional, but also in alternative investment products

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