UBS

September 2014

Needs of Institutional Investors in the *New Alternative World*

pwc

Foreword

UBS Fund Services
A new environment has emerged within the alternatives industry, significantly affecting investors and alternative managers alike. In light of this UBS Fund Services, in collaboration with PwC, is delighted to publish this report following a survey among global institutional investors allocating capital within the alternatives space.

During the last number of years and specifically since the financial crisis the investment world has become a myriad of constant change. The aftermath of the financial crisis and the initial fall-out from the subsequent debt crisis has driven a review by governments with respect to financial stability and the prudential management of systemic risk. This has led to a raft of regulation affecting all market participants and it has not been an easy task to adapt. However, it has been an even greater adjustment for alternative managers who have had to grapple with a completely new global regulatory landscape, especially in Europe.

The effect of these changes is still being felt today although the end, of course, is in sight. Many managers are unsure how to deal with the new environment and feel it is an excessively cumbersome and costly process for their businesses, with limited value for investors, however the managers that are willing to adapt, implement solutions for clients and embrace these changes are more likely to succeed in this new world.

UBS Fund Services, as a service provider to both investors and fund managers is at the forefront of supporting our clients to adapt to these changes and I would like to draw your attention to the following key themes which we feel embody the challenges facing the industry today:

- Institutional investors are primarily looking for asset class diversification within their portfolios, e.g. allocations to infrastructure and real assets are expected to increase.
- Seeking double-digit returns from hedge fund managers is no longer the priority; investors are willing to forego returns for lower fees, uncorrelated return streams and transparency.
- There is a clear gap between industrialized managers and boutique managers; this creates opportunities for managers who can capitalize on the new changes and be creative in offering clients solutions rather than products.

We hope you enjoy reading the report and that it can give rise to idea formulation, creative thinking and a better understanding of the alternative asset industry for all participants.

Mark Porter
Head UBS Fund Services

PwC Luxembourg
The financial crisis of 2008 and its aftermath of regulatory change may some day be regarded as the defining hallmark of this era for the financial industry. Government directives are massively changing the playing field and a large range of new players are impacted by these rules. Consequently, financial institutions are rethinking their business strategies in order to find the right balance between compliance and the generation of predictable and uncorrelated returns.

The onslaught of regulations such as AIFMD, UCITS V, PRIPS, BEPS and MiFID II is disruptive for the asset management industry. Furthermore, compliance with stringent regulations does not come cheaply – it is not uncommon for bigger firms to spend significantly to satisfy the new requirements. We could soon begin to see investors shifting asset allocation in favor of less regulated and perhaps cheaper investment vehicles.

But there is a silver lining here for asset managers willing to think outside the box. With change there is also an opportunity for improvement. While the new regulations are burdensome, they also open a window of opportunity for those ready to seize it. This report highlights both the pitfalls and prospects resulting from the ongoing changes, which will affect everybody in the financial world at one point or another. Alternative asset managers who understand how to leverage on this period of transition stand to capture a bigger share of the market and reap genuine benefits.

Hence, in an environment where regulations will drive the development of tailored solutions and where reporting demands will increase the role of technology, successful alternative asset managers of the future have to keep in mind the following three factors:

- Geographical footprint: Managers who don't have the resources and the critical size to establish and promote their brand could very well take a backseat to those who do;
- Investment footprint: The current landscape of asset management companies is evolving, offering a competitive advantage to large asset managers who offer a full range of products and specialized boutiques who have a defined expertise;
- Distribution footprint: Institutional investor solutions can serve as a blue print for retail market products.

Finally, asset managers will need to invest in data management capabilities. Institutional investors are subject to stricter regulatory reporting requirements and internal control standards. Reporting and data will become key differentiation factors reenforcing or, if not managed properly, weakening other key success factors of an asset manager.

We hope that you enjoy reading this report and trust that it will encourage discussion about potential solutions that work for institutional investors in this new alternative world.

Olivier Carré
Partner, PwC

This Survey

To serve clients in the institutional world, it is crucial to understand their needs and plans for the coming months and years. To understand these needs and to elaborate the best services for these clients, UBS Fund Services in collaboration with PwC, have conducted a survey amongst 44 important institutional investors with specific questions regarding their view of the current and coming trends in our industry.[1]

UBS and PwC are convinced that the results of this survey will be of interest to you and are therefore delighted to share the answers and interpretation of the answers gathered with you.

Please note that all forward looking and other statements in this survey solely result from the opinions gathered from the participants and UBS'/PwC's interpretation of them. None of the statements in the report necessarily reflect UBS or PwC's opinion and nothing in this report is meant nor must be understood as investment, legal or business advice.

1 Please refer to the sampling methodology in Appendix 1.

Contents

Executive Summary

Alternative assets add value to investment portfolios

Our study confirms that alternative assets add value to institutional investors' portfolios. Nevertheless, the upcoming regulations are going to impact the use of alternatives by these investors. Thus, alternative asset managers have to adapt in order to develop services that will satisfy client needs as well as comply with new regulation.

During recent years, alternative investments have become an increasingly important component of institutional portfolios in search of alpha, uncorrelated returns and tailored solutions rather than products.

Results from our survey reveal that institutional investors plan to increase their share of alternative investments steadily in the near future due to a growing appetite for infrastructure and real assets in particular.

Many market segments are becoming "institutionalized", i.e. investors are imposing requirements such as reporting, transparency, lower fees and an acceptable compromise between liquidity and returns. A gap in product offering seems to be forming between global asset managers who can offer clients the full spectrum of products and specialized boutiques that develop a particular expertise in specific alternative asset classes.

Evolution of allocation in the next 12–24 months

Asset Class	Evolution of allocation in the next 12 to 24 months
Commodities	↘
Fund of Hedge Funds	→
Hedge Funds	→
Infrastructure	↗
Private Equity	→
Real Assets (shipping, containers, aircraft, etc.)	↗
Real Estate	→

Source: Survey

New regulations are impacting alternatives

The market has quite literally been flooded with regulations, many of which are coming to fruition this year. Interestingly, most of the investors we surveyed perceive the new regulations as neutral with the exception of the Solvency II Directive, which is seen as negative. Because Solvency II will increase governance and data requirements for insurers while demanding greater transparency, it could lead those investors to reduce their allocations to alternative assets. In addition, BEPS (the OECD initiative targeted to avoid Base Erosion and Profit Shifting) may have an impact on the investment structures used by institutional investors. That said, many European asset managers see directives like AIFMD as a cost to their business and, in the case of EU managers, as a competitive advantage against their non-European counterparts for whom the distribution of alternative products will become more difficult once AIFMD is fully enforced. By achieving compliance early, EU managers expect to gain an edge over those facing barriers to entry within the EU market specifically relating to AIFMD. Another side-effect of the new investment environment is that in the wake of new regulations institutional investors are becoming more rigorous in their approach to the selection of alternative asset managers. These investors are increasingly sophisticated and more proficient in the alternative arena, thus, tend to demand more and potentially higher regulatory compliance from their asset managers. In recent years, the range of regulated investment solutions and vehicles available for institutional investors has increased significantly and should continue to evolve as they require more transparency and increased liquidity/predictability for their investments. Furthermore, as institutional assets grow we expect an increase in the use of alternative mandates by institutions such as pension funds and SWFs.

Impact of regulation on institutional investor allocation in alternative investments

Solvency II

	Positive	Negative	Neutral
Europe	15%	**55%**	30%
Americas	12%	25%	67%
Pension Funds	14%	7%	79%
Insurers	14%	**67%**	19%

Source: Survey

% Neutral

AIFMD	66%	IORP II	82%
Basel III	70%	MiFID II	82%
Dodd-Frank	65%	Tax	68%
CRS*	83%	UCITS V	85%
FATCA	73%	UCITS VI	85%
FTT	68%		

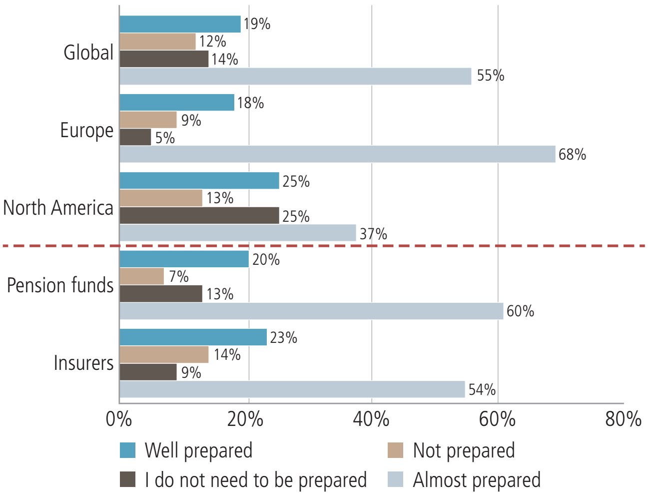
*CRS stands for Common Reporting Standard

Source: Survey

Alternative asset managers in the new world

According to our survey, institutional investors feel that they themselves as well as alternative asset managers are well prepared for the coming regulations. Additionally, they are satisfied with the current level of governance and tailored solutions. Yet, in order for asset managers to thrive in the new alternative world differentiation will be essential. To distinguish themselves from their competitors asset managers will have to offer "solution" oriented investment strategies, as opposed to "asset" oriented ones. Such solutions will require higher levels of sophistication in terms of client servicing and technological acumen. Asset management firms will also have to invest more in human capital that is capable of addressing investors' changing needs. In this vein, asset managers would do well to bear in mind that investors remain dissatisfied with operational technology – they will need to improve their "big data" capabilities in order to sufficiently meet their clients' needs.

Level of preparation of institutional investors with regards to the upcoming regulations affecting their business



Source: Survey

Introduction

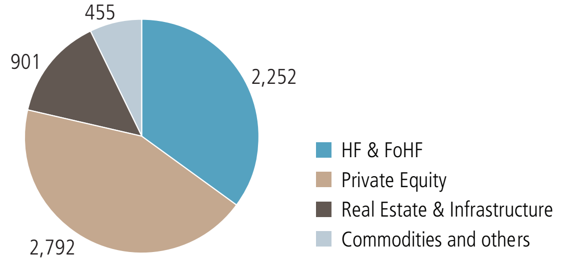
The market for alternative investments

The European Commission's latest Green Paper on long-term financing, published in March 2013, highlighted the fact that insurers and pension funds are well placed to finance long-term investment needs. This is particularly true in a context where banks are undergoing a period of deleveraging and where government policies are constrained by excessive fiscal imbalances.

Unfortunately, the global financial crisis has caused these institutions to rethink how much capital they can devote to long-term investing. The investment pattern is influenced both from the 'buy side', for instance, the Solvency II directive may lead insurers to shift their asset allocation in favour of more liquid assets as well as from the 'sell side', with regulatory constraints put on alternative funds (AIFMD), money-market funds and distribution (MiFID II). The decline of number of workers vis-à-vis retirees has hit pension funds' coverage ratios and as a consequence their liability management has become increasingly complex. Should the Solvency II capital requirements be extended to pension funds, we expect this would accelerate the overall shift away from alternatives in global asset allocation; and more particularly for illiquid assets as a strong demand for liquid alternatives is still observed.

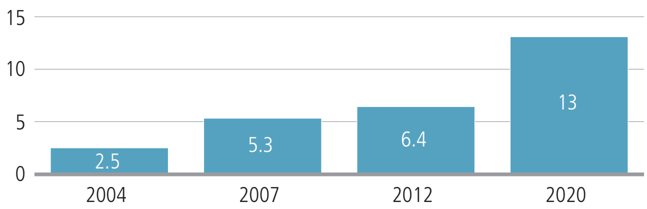
Alternative assets accounted for USD 6.4 trillion of AuM as of year-end 2012, of which USD 2.25 trillion was invested in HF & FoHF, USD 2.8 trillion in Private Equity and USD 901 billion in Real Estate and Infrastructure. A recent PwC report[2] estimates that global alternative assets could reach USD 13 trillion of AuM by 2020. For that to happen, asset managers must be diligent in providing an attractive value proposition for their institutional clients in this new alternative world which has been constrained by regulations.

Chart 1: Breakdown of alternative assets (USD billion)



Source: PwC analysis based on Towers Watson, Preqin, The City UK and HFR

Chart 2: Global alternative assets projection for 2020 (USD trillion)



Source: PwC – Asset Management 2020 – A brave new World

Allocation to alternative investments

With 69% of the European asset management market held by institutional investors[3], they account now for an increasing part of the alternative world as the need for returns in a low yield environment increases. Within the hedge funds industry, the share of institutional investors grew from 56% in 2004 to 80% at year-end 2012. Unsurprisingly, institutional investors hold a vast share of the private equity market with pension funds alone accounting for 17.4% of funds raised in Europe. In today's uncertain economic context, institutional investors are definitely interested in the generation of predictable and uncorrelated returns.

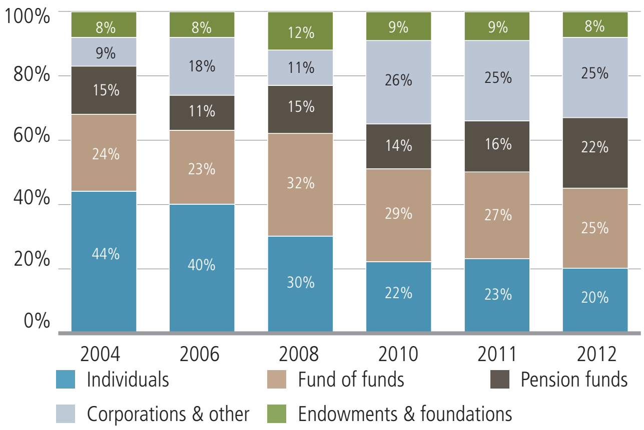
Achieving as well as exceeding the requirements of institutional investors in the new alternative world is consequently an important factor for future growth of the alternative industry. However, the impact of market and regulatory changes on the use of alternatives must be taken into account by asset managers strategizing for the future. Navigating the labyrinth of extensive regulations is costly and time-consuming. Understanding how these changes affect both managers and investors is essential in order to succeed, but knowing how to leverage regulatory changes in order to outpace your competitors is an even greater factor.

2 PwC Asset Management 2020 – A brave new world.
3 Source : EFAMA

The good news is that, while the new directives are burdensome, they also open a window of opportunity for those ready to seize them. Therefore, UBS Fund Services and PwC have launched a survey which seeks to understand the current institutional trend when investing in alternatives and the overall attitude investors convey at present. We also take a look at investors' current appetite for alternatives and the new challenges regulatory directives will introduce for investments in this sector as they become effective this year.

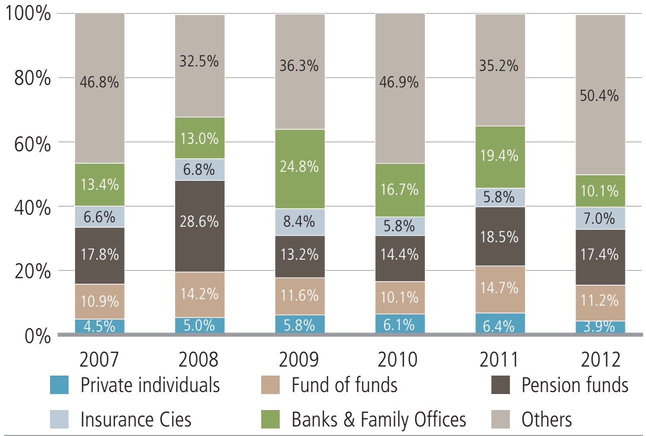
The results of this study will provide not only a benchmark of institutional investor sentiment today, but also a roadmap for alternative asset managers to develop their services in order to better meet their clients' needs in the future.

Chart 3: Global Hedge Funds by source of capital



Source: Hennessee Group LLC

Chart 4: Private Equity funds raised in Europe (investor type)



Source: EVCA

Section 1
Alternative assets are important in institutional portfolios

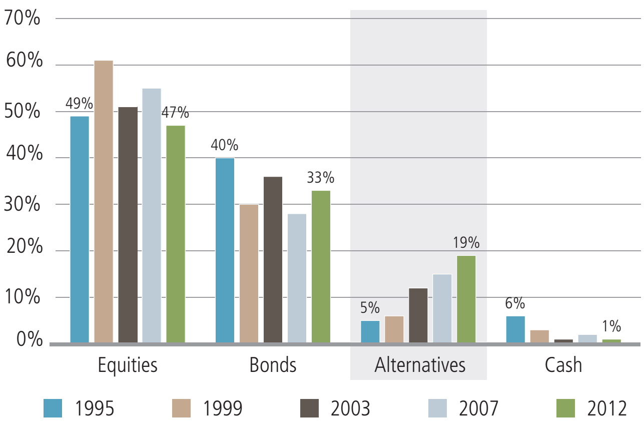
Growth of alternative investments within global asset allocation

Institutional investors today are looking more closely at alternatives as a way to bolster returns. Pension funds, in particular, are adopting this strategy. After a lengthy period of poor performance in a low yield environment pension funds are steadily deploying more assets towards alternative investments, which have emerged as a key driver in the search for alpha and uncorrelated returns. In fact, global pension fund allocation to alternative assets has increased significantly in recent years (from 5% to 19% between 1995 and 2012).

In an effort to maintain effective strategies that cover liabilities, pension funds must achieve a delicate accounting balance. To do this in our post-crisis economic environment, an increasing number are diversifying their portfolios in pursuit of consistent rewards and uncorrelated returns which mitigate risk.

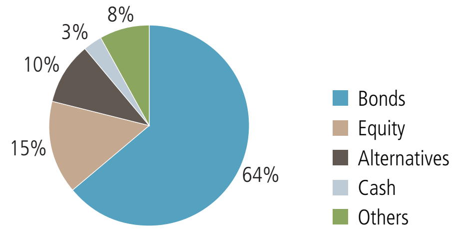
Due to investors' long-term prospects and investment guidelines, pension fund asset allocation is more aggressive than that of insurance companies (European). At year-end 2012 pension funds allocated 47% of their assets to equities, compared with only 15% for insurance companies in Europe. This may be due, in part, to the fact that guarantee of interest for insurance companies has been achieved in the past through fixed income products but today, in a low yield environment, other asset classes like equity or alternative assets are required. Indeed, the contributions to the insurance company's portfolio from fixed income products are influenced by prevailing market conditions – during periods of uncertainty, the composition of the portfolio tends towards fixed income securities. In contrast, during periods of growth, the share of equities within the portfolio increases. That said, European insurers are also showing an appetite for less liquid assets with 10% or more invested in alternatives for decorrelation purposes.

Chart 5: Pension funds' global asset allocation



Source: Towers Watson

Chart 6: European insurers' asset allocation



Source: Economist Intelligence Unit, Insurance Europe, Oliver Wyman analysis

The share of alternative investments is expected to increase slightly

Overall, the survey revealed a 1% projected growth of alternative investments within the portfolios of global institutional investors in the next 12 to 24 months (from 13.4% to 14.4%). However, discrepancies can be observed at a geographic and investor level.

North American investors show greater enthusiasm for alternative investments when compared to their European counterparts. This is not surprising since North America is a prominent hub for alternative assets, accounting for more than half of the world's investors in alternatives. European players, on the other hand, own only one-third of the market while the rest of the world is steadily joining the move to become more visible in this arena[4]. Reasons for North America's dominance are varied as the investment culture in the US is quite different from the European setting.

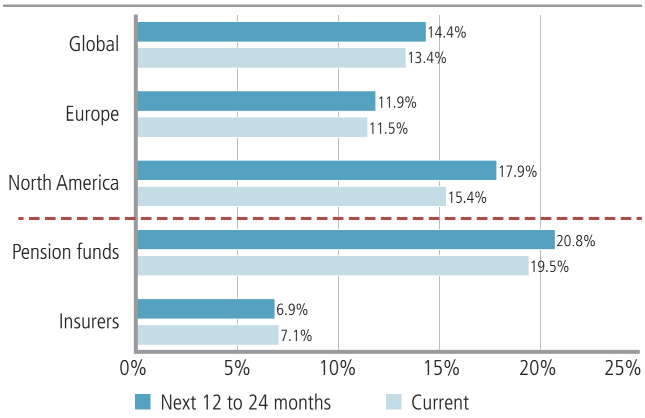
North America's appetite for alternative products is more robust than that of European investors. Part of this stems from the fact that Europe has consistently lagged behind the US in the alternative space. For instance, regarding the private equity market, North American investors began to massively invest at the beginning of the 1980s but Europe's private equity market did not mature until the mid-1990s. Additionally, the regulatory environment in the US is less stringent than it is in Europe allowing investors freedom and opportunities they don't see on the other side of the Atlantic.

The strong development of the pension fund industry in the US is another reason for North America's prevalence in the alternative space. At year-end 2012, the level of pension assets held in the US was more than twice the amount in Europe. In an era of low interest rates, North American pension funds are looking to reduce reliance on publically traded stocks and bonds in order to meet the demands of millions of affiliates. Faced with an ageing population amid shrinking returns, many US public pensions have raised their exposure to alternatives to record levels. As of June 2012, public plans with more than USD 1 billion had a median of 15% in alternatives, the highest ever.[5]

Pension funds represent the most significant source of capital for investment managers of alternative assets, particularly in private equity and hedge funds. Our survey reveals that their average allocation to alternative investments is about 19% and is expected to grow to 21% in the next 12 to 24 months, in line with data disclosed previously (see Chart 5). More recently, pension funds started allocating to infrastructure and commodities for diversification and alpha generation purposes.

Insurers have also been increasing their focus on alternatives over the last few years, given the low yield environment. However, our study shows an average level of allocation below the one observed in the market (7.1% vs. 10%). A status-quo in their allocation to alternatives is anticipated in the next 12 to 24 months due to Solvency II requirements that may restrict their allocation to less liquid assets.

Chart 7: Share of alternative investments from total AuM



Source: Survey

4 Preqin
5 Reuters, Forgoine, Sam, Cash-strapped US pension funds ditch stocks for alternatives, Aug 20, 2012

A decrease of interest in commodities while allocation to Real Estate remains stable

Amid increased appetite for infrastructure and real assets, investor sentiment towards commodities has declined. The end of the super cycle for commodities, resulting in a sharp market decline since 2008, has led investors to stay away from this asset class. Our survey confirmed this status as well as the fact that institutional investors plan to decrease their allocations to commodities in the coming years.

While Real Estate performs well on a risk-adjusted basis relative to other asset classes due to low volatility and healthy average returns, our sample of investors is not likely to make new commitments to the asset class despite its satisfactory performance. On the one hand, Real Estate is delivering attractive rewards – from Q1 1978 to Q4 2012 the NCREIF Property Index (NPI) reported an average return between those of equities and fixed income, but with the lowest volatility of the three. Therefore allocation to Real Estate, despite attractive features, is expected to remain steady over the next 12 to 24 months. This outcome is explained by the fact that our interviewees already had an overweighting in their allocation to Real Estate and that they are looking for more diversification within their portfolios of alternative assets.

Stable allocation in Private Equity, HF & FoHF

The bright spot in the markets is private equity. Institutional investors report the highest level of satisfaction with this asset class in terms of performance, and this is expected to continue for the next 12 to 24 months. Since year-end 2000 the performance of private equity funds has outpaced the S&P 500 index 2:1 and 2013 was a particularly good year for the industry, which raised USD 431 billion, a record since 2008.[6] Nevertheless, our survey highlights the notion that institutional investors would do well to maintain their current allocation to private equity. A major reason for this status-quo was articulated by one of our survey participants, who said, *"The long tail of Private Equity funds causes a proliferation of managers in the portfolio, which becomes very difficult to administer. We decided, then, not to increase our allocation in that area."*

Hedge Funds and Fund of Hedge Funds allocations are also expected to remain static. Despite the fact that nearly half of pension funds and insurance companies had plans to increase their allocations to Hedge Funds in 2013 by more than USD 100 million on average[7], institutional investors are taking a more moderate approach for the future. With favourable performance no longer expected, our survey shows that institutional investors plan to stabilize their investments. Only 39% of the participants are currently satisfied with their Hedge Funds' performance, and only one-quarter expect Hedge Funds to deliver a satisfying level of performance in the next 12 to 24 months. This trend is confirmed by a Deutsche Bank survey which noted that, *"in three years, the percentage of respondents targeting double digit returns for their hedge fund portfolios has dropped from 52% to 32%."*[8]

However, amid the institutionalization of the alternative space, investors' expectations are changing. Where double-digit returns were once the primary driver in the hedge fund market, investors today are willing to sacrifice potentially higher returns for lower management fees, lower correlation with financial markets, increased transparency from fund managers, and more liquidity as confirmed by the great success of liquid alternatives over the past number of years.

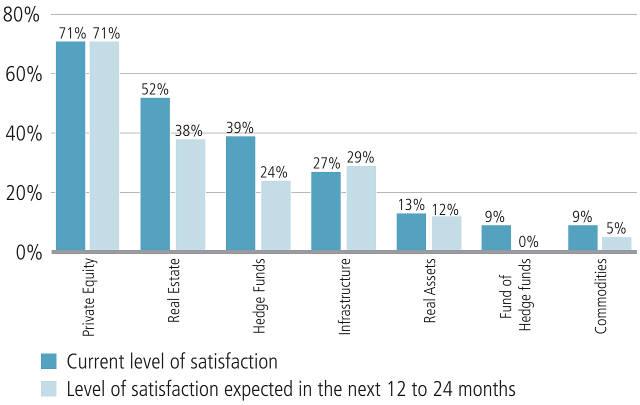
Table 1: Evolution of allocation in the next 12–24 months

Asset Class	Evolution of allocation in the next 12 to 24 months
Commodities	↘
Fund of Hedge Funds	→
Hedge Funds	→
Infrastructure	↗
Private Equity	→
Real Assets (Investments in shipping, containers, aircraft, etc.)	↗
Real Estate	→

Source: Survey

6 Preqin
7 2013 Deutsche Bank Alternative Investment Survey
8 ibid

Chart 8: Current level of satisfaction with the performance of alternative asset classes and expected best performers



Source: Survey

Growing appetite for Infrastructure and Real Assets

The landscape of our world is changing in significant ways that will have a distinct impact on asset management in the near future. The global urban population is expected to increase to 6.3 billion by 2050 (almost twice what it was in 2010). Furthermore, the number of megacities (urban centers with a population in excess of 10 million) will reach 37 by 2025, a 60% increase.[9] Twelve of these will be in emerging markets, facilitating the necessity for massive infrastructure. According to the OECD, USD 40 trillion will be needed to keep pace with the growth of the global economy through 2030 and infrastructure investing will most probably be disproportionately invested in emerging markets.[10]

The importance of adequate infrastructure and real asset investments in any economy cannot be overemphasized. Both deliver collective benefits and are crucial for promoting sustainable economic growth. Infrastructure assets like utilities, airports, roads and electric grids are essential to the life of developed and emerging societies. The OECD has made building and maintaining new infrastructure a high priority for the coming years.

Infrastructure and Real Assets are long-life investments characterized by steady cash flows derived from tangible assets, low volatility and inflation-linkage. According to our survey these attractive features mitigate their expected low yields and appeal to institutional investors, who intend to increase their allocations to these assets in the next 12 to 24 months.

According to the OECD[11] pension funds with the largest allocations to infrastructure are investing directly in infrastructure, often co-investing along with infrastructure funds but also taking leading roles in consortia, thereby competing with other funds and financial sponsors when bidding for projects. These large pension funds over the years have been able to acquire the knowledge, expertise and resources to invest directly in infrastructure. Nevertheless, if the pension fund is not large enough it would normally invest through infrastructure funds. In addition, pension funds prefer to invest in large and mature operating assets that already generate cash flow although they will evaluate and participate in Greenfield projects on an opportunistic basis. Therefore, for small/medium sized pension funds and the financing of Greenfield projects, asset managers need to propose adequate solutions.

Public investment is insufficient to cope with the colossal demand for essential infrastructure. To support mass urbanization, additional capital may be sourced from pension funds and other institutional investors. Asset managers, therefore, will face the challenge of managing various forms of public/private partnerships in order to provide their clients with viable investment frameworks. Vehicles that strike an appropriate balance between public and private interests will be attractive to institutional investors.

Funds with this profile are currently being offered by several countries hoping to garner financing for infrastructure. In Europe, for example, regulated ELTIFs[12] (European Long Term Investment Funds) will be designed to meet the needs of institutional and private investors who are prepared to see their money tied into long-term assets, such as building projects, in return for steady rewards. This vehicle may be an answer for pension funds and insurance companies who want to commit to finance long-term infrastructure projects.

Despite the challenges of devising investment structures that can effectively navigate the dynamic arena of alternative markets, asset managers should remain committed to infrastructure and real assets which could drive up total assets under management in these two asset classes. This new generation of alternative investments is expected to address the increasing asset and liability constraints of institutional investors and satisfy their preeminent objective of a decorrelation to more traditional asset classes.

9 PwC, Asset Management 2020, 2014
10 ibid
11 OECD – Annual Survey of Large Pension Funds and Public Pension Reserve Funds – October 2013
12 ELTIFs: Proposal for a regulation by the European parliament and of the council on European Long-Term Investment Funds – COM/2013/0462 final – 2013/0214 (COD)

Size of alternative asset managers used by institutional investors
Institutional investors are focused on critical mass, brand and expertise for the alternative asset managers they have selected, but also strive for a reasonably diversified portfolio of managers within their mandates. The panel of institutional investors we observed work mainly with large and medium-sized asset managers. However, they rely on the expertise of small boutiques for specific asset classes in the private equity space or for Real Assets.

Depending on their size, alternative asset managers have to adapt their strategy in order to gather assets from both institutional investors and retail investors. Three main features characterize their strategy.

Geographical footprint: Large asset managers have the capacity to reach a broad swath of investors all over the world. Additionally, they have the capabilities to target specific demographics and deliver messages and products suited to diverse audiences. For instance, with the current context of the liberalization of the Chinese currency, Renminbi denominated products will increasingly flood the market offering asset managers the opportunity to attract a new type of investor by diversifying their product range. Marketing plays a big role in the strategies of large asset managers who are strongly focused on branding in order to more effectively penetrate distribution networks and institutional investors in every region of the world. Brand awareness is very important for certain demographics, in particular for Asian investors. Hence, the continued growth of emerging markets forces asset managers to expand their global footprint. Most emerging markets jurisdictions want to involve asset managers from the West provided they set up structures "on the ground". Managers who don't have the resources and the critical size to establish and promote a brand could very well take a back seat to those who do.

Investment footprint: The current landscape of asset management companies is evolving, offering a competitive advantage to large asset managers and specialized boutiques. Large asset managers seem to be engaged in a fierce competition to offer the full range of solutions to their institutional clients, whereas boutiques are, by definition, focusing on specialization.

Distribution footprint: The retail market is gaining momentum because it offers private fund managers a chance to diversify their revenue streams and earn more consistent fees. Nevertheless, distribution to retail investors is a completely different game from that to institutional distribution. The former targets a mass audience and is based heavily on marketing, whereas the latter requires face-to-face interactions and focuses on individual relationship building. However, institutional investor solutions can serve as a blue print for retail market products. The proliferation of "Alternative UCITS" in Europe or "Alternative Mutual Funds (40' Act mutual funds)" in the United States is a good example of new investment strategies initially tailored for institutional investors that have subsequently been deployed to retail clients.

Therefore, in order to diversify their client-base, alternative managers are launching more and more retail products that accommodate the investment strategies employed by private hedge funds packaged as '40 Act Mutual Funds in the US or Alternative UCITS in Europe. But to succeed in this arena, managers will need to develop specialized distribution expertise and operational infrastructure, not necessarily affordable to small/boutique asset managers.

Geographic reach, investment range and distribution capabilities are key success factors investment firms have to deal with in the alternative space – hence a gap is forming in the industry. Global asset managers can offer clients the full spectrum of products and solutions through developing an international presence in marketing, distribution and client targeting. Boutique managers are much more restricted in terms of reach, so they tend to operate at the regional level where they can offer particular expertise in specific alternative asset classes. But the mid-sized/small firms fall somewhere between these two scenarios, thus, are facing difficulties establishing a clear position in the market.

Table 2: Size of alternative asset managers used by institutional investors

	Large	Medium	Small	Boutique
Real Estate	33%	**77%**	3%	10%
Private Equity	**61%**	16%	–	21%
Hedge Funds	**77%**	31%	23%	12%
Funds of Hedge Funds	**56%**	37%	22%	14%
Infrastructure	47%	**53%**	12%	12%
Commodities	**42%**	33%	33%	8%
Real Assets	13%	**75%**	25%	13%

Large (> USD 2 bn AuM)
Medium-sized (Between USD 500 million and USD 2 bn AuM)
Small (Between USD 50 million and USD 500 million AuM)
Boutique (< USD 50 million AuM)

Source: Survey

Section 2
The impact of market and regulatory changes on the use of alternatives

Alternative investments are a cornerstone within institutional investors' portfolios – their role and importance no longer must be demonstrated. Therefore, we have endeavored to ascertain the impact imminent regulations will have on institutional investors' behavior where their use of alternative assets is concerned. To that end we have asked investors to assess the impact of the main regulations on their investment behavior. In general, most have indicated that they perceive new regulations as quite neutral, with the exception of the Solvency II Directive.

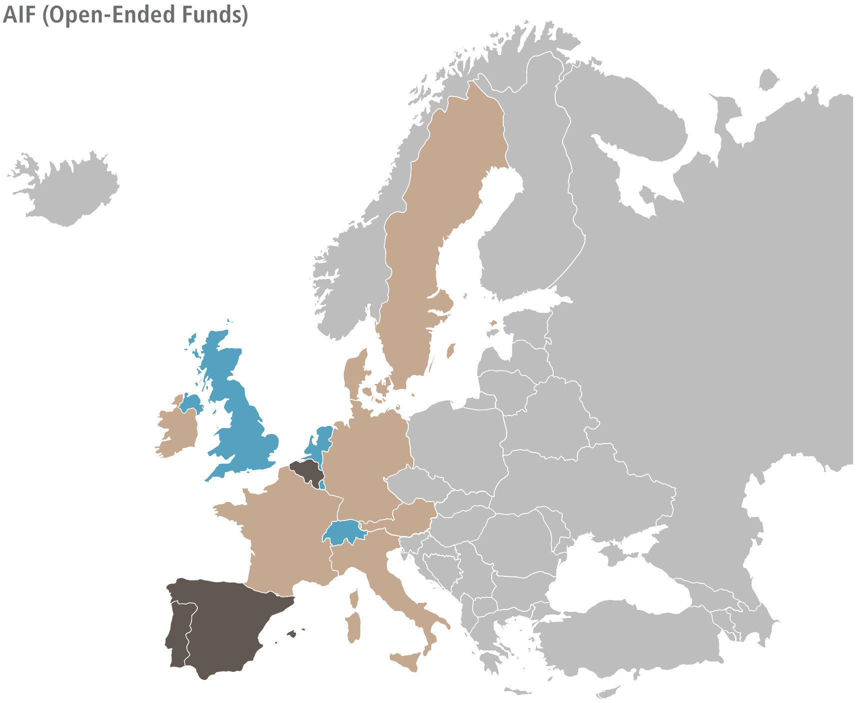
AIFMD: A neutral impact for institutional investors; a window of opportunity for European asset managers?

Interestingly, regulations like AIFMD, Dodd-Frank, Wall Street Reform and the Consumer Protection Act, or UCITS V, are perceived as neutral even though they will likely strengthen investor protection. In addition, only one-quarter of those surveyed took a negative view of regulations like AIFMD[13] and the Financial Transaction Tax (FTT)[14] which will indirectly affect the level of fees that may be passed on to investors. This low level of negative outlook towards the FTT in our survey can be explained by the fact that pension funds might not be included in the scope of the FTT.

That said if AIFMD is causing less concern or interest than expected among institutional investors, with two-thirds of them considering its impact as neutral, it is clearly perceived as a potential competitive advantage for European asset managers. With the commencement of the Directive, European asset managers expect to have a leading edge in the European market over US players for whom the distribution of alternative products will be restricted as significant EU Member States abandon their Private Placement Regimes in the coming months.

Hence when only AIFMD-compliant AIFMs are able to access European markets, European asset managers may leverage on a window of opportunity to grab market share away from their US competitors who will need more time to adapt their structures and organizations to meet AIFMD requirements.

Figure 1: Private placement map for NON-EU AIF (Open-Ended Funds) managed by NON-EU AIFM – with AIFMD



- Private placement very restrictive, or became stricter, or not defined after July 2014
- Private placement not allowed (registration required for any type of active solicitation) – excluding Reverse Solicitation
- Wait for AIFMD implementation

Source: PwC

13 According to BNY Mellon, the average cost of AIFMD compliance for investment firms is estimated to be USD 300,000, with one-off risk and compliance costs expected to reach at least USD 100,000

14 According to EFAMA (March 2013), the total impact of the FTT would have reached EUR 13 billion assuming that the FTT had been applied at the start of 2011, all other things being equal.

Solvency II: The worst impact for institutional investors

Solvency II will increase the governance and data requirements for insurers and substantially strengthen their need for transparency in these investments. Consequently, the directive is leading many of them to review their current investment strategies, which could result in reduced allocations to alternative assets.

Indeed, under Solvency II, the most punitive capital treatment is reserved for private equity and hedge funds, which are classified as "other equities" and subjected to a 49% capital charge. In addition, Solvency II rules penalize portfolios that do not have a clear "look through" to the underlying assets; and in the absence of detailed information about portfolio holdings, a 100% capital charge can apply. This is especially the case for hedge fund sub-strategies that use a proprietary algorithmic trading model most commonly referred to as "black boxes". The transparency requirements of the Solvency II Directive send a clear message to insurance companies: those who utilise black boxes as part of their portfolio construction will pay a steep price for doing so.

The demanding regulatory framework of Solvency II towards alternative investments and uncertainty regarding its entry into force cause a lot of concern for European insurance companies; 67% of them feel this regulation has negative ramifications. As a result, 70% of European insurers within our sample are less willing to invest in alternative assets. "The complicated look-through process and the new capital charges under Solvency II will probably decrease our alternative investment allocations," said an insurance company we interviewed for our study.

Some insurance companies are dealing with the regulation by changing the way they gain exposure to alternative strategies. For instance, in order to continue investing in Real Estate and lower their capital charge, they replace their "fund" structures with "direct investments" as part of a joint venture with real estate funds. Regulations like Solvency II have an impact on the use of alternative investments by institutional investors, which can affect the number of asset managers they work with as well as the structures they employ to achieve the requisite exposure to alternative strategies.

Table 3: Impact of regulation on institutional investor allocation in alternative investments

Solvency II	Positive	Negative	Neutral
Europe	15%	**55%**	30%
Americas	12%	25%	67%
Pension Funds	14%	7%	79%
Insurers	14%	**67%**	19%

Source: Survey

% Neutral			
AIFMD	66%	IORP II	82%
Basel III	70%	MiFID II	82%
Dodd-Frank	65%	Tax	68%
CRS	83%	UCITS V	85%
FATCA	73%	UCITS VI	85%
FTT	68%		

Source: Survey

A more rigorous selection of alternative asset managers

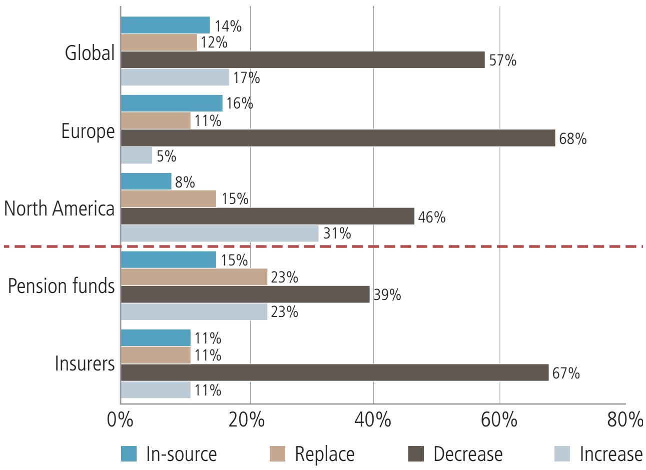
Institutional investors looking for more predictable and uncorrelated returns in an evolving regulatory environment (which may have a negative impact on their asset allocation) must optimise the way they leverage the expertise of their alternative asset managers. Part of our survey, therefore, seeks to measure the impact of regulatory changes on the number of alternative asset managers institutional investors choose to work with.

The result is clear: overall, 57% of the institutional investors we interviewed plan to decrease their number of alternative asset managers. This is especially true for European insurers, of which 68% plan to do so. In addition to new regulations, the increased level of sophistication on the part of investors is another factor impacting the number of asset managers within alternative portfolios. A decade of market uncertainties characterized by increased volatility has generated an increased awareness and expertise among investors. A few years ago, most institutional investors started building their alternative portfolios by allocating small amounts to several different asset managers. But now, having gained experience, they feel comfortable enough to narrow down the number of managers they work with. Institutional investors will continue seeking greater knowledge of alternative asset manager's activities in order to clearly understand how performance is achieved and how risks are managed. Hence, it is reasonable to assume there will be an increase in the due diligence requirements when recruiting alternative asset managers.

A higher degree of institutional money in alternative asset classes is also creating a more rigorous selection of managers. Institutional investors, who are dominating the alternative space (as demonstrated in our introduction), require more transparency, regulated entities and increased liquidity. Therefore, alternative asset managers who do not bring these attributes to the table will be supplanted by those who do. Additionally, alternative asset managers that cannot offset the lack of liquidity/flexibility inherent to alternative investments by delivering high returns will be out of the game. This is particularly difficult given the high costs associated with this investment class.

New regulations, increased investor confidence, a higher ratio of institutional money and poor returns are all factors influencing the management selection process. As a consequence, the quantitative process initially used for the selection of alternative asset managers will be steadily replaced by a more qualitative approach. By decreasing the number of managers with whom they work, institutional investors will be more able to generate economies of scale in terms of analysis and investigation as well as to strengthen their relationships with the managers they retain. As one of our participants said, *"By focusing on fewer key relationships, we expect that the portfolio will be more efficient to manage and monitor."*

Chart 9: Regulatory impact on the number of alternative asset managers with whom institutional investors work

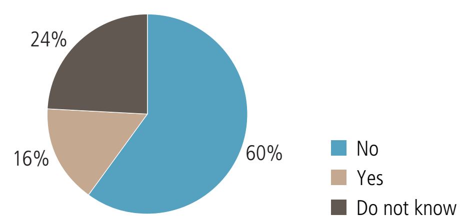


Source: Survey

Sophistication of investor infrastructure

With the heightened proficiency of institutional investors in the asset management arena, more and more are setting up their own middle office functions in order to monitor investments and service providers' activities. Our survey reveals that institutional investors want to maintain control of their administrative tasks since 60% do not plan to outsource additional administrative requirements to third-party providers. These middle office (or investment office) functions allow investors to cluster investment managers and mandates in a more structured manner. To do this, however, they must have highly developed monitoring and reporting capacities as well as proprietary technology, which make additional outsourcing of administrative functions obsolete. That said, while institutional investors are increasingly taking control over their own middle offices, newly acquired expertise in conjunction with new regulations may lead them to reduce the number of alternative asset managers they are going to work with in the future.

Chart 10: Potential outsourcing of administrative requirements to third-party providers



Institutional investors: no major changes expected regarding vehicles or domicile of alternative assets

Although new regulations will bring much disruption the vehicles and domiciles used to invest in alternative investments will not change in the next two years, according to our respondents. However, we estimate that institutional investors have not yet anticipated the shift the alternative industry is likely to make. As Olwyn Alexander, PwC Partner, said, "In five years' time, the hedge fund industry as we know it will be almost unrecognizable. Given the tsunami of regulation managers are facing, together with investors' increasing demands, we are going to see a fundamental change in the way managers operate, the way funds are structured and the way service providers along the value chain operate their businesses."

Change in vehicles

Despite the general outlook of participants in our survey, who do not foresee a change in vehicles, we anticipate an adjustment in this area. Indeed, the range of regulated investment solutions and vehicles available for institutional investors has increased significantly in recent years and should continue to evolve.

It has already been demonstrated that over the past year, the alternative investment fund industry had to adapt to its clients' needs. For instance, hedge fund managers commented that a few years ago they preferred providing portfolio transparency as opposed to providing a managed account because the cost of running a managed account was higher. However, managed accounts have gained in popularity among institutional investors since the crisis and have provided them with a broad range of investment choices, customized asset allocation, competitive fees and transparency.

PwC estimates that we will see a growth in alternative mandates by institutional investors, specifically pension funds. EFAMA statistics on the European asset management market have confirmed this trend; the share of assets held in overall European mandates (mainstream and alternatives) grew from 49% in 2007 to 53% in 2011.

In Europe, "Structured UCITS" have been the most popular type of new fund structure to emerge since the onset of the crisis. Hedge fund managers have launched large numbers of UCITS funds in recent years, tapping into demand from sophisticated institutional investors who are seeking both hedge fund-type returns and the protection of a defined regulatory structure[15]. However, the use of such UCITS vehicles for transparency and compliance reasons may be rebalanced in the near future by the arrival of AIFMD-compliant structures. The various requirements of the directive should result in greater transparency for institutional investors.

In addition, BEPS (Base Erosion and Profit Shifting) may also have an impact on investment structures. In late 2012 the G20 meeting of finance ministers announced a coordinated drive to modernize the current framework of tax treaties and set national anti-tax avoidance laws, the underlying principle being that taxable profits must be aligned to where the real value-added functions of the business are carried out. Real Estate investors will potentially be more likely to use REITs that provide certain tax benefits as these regimes are out of the scope of BEPS.

Evolution of domiciles

The AIFM Directive is a huge opportunity for countries such as Ireland and Luxembourg to replicate their success on the UCITS stage[16] and they have been very prompt to ensure the effective and timely implementation of legislation in this area which has greatly supported the industry.

In May 2013, Ireland was the first European regulator to accept applications for the authorisation of AIFMs and adapted its QIF to QIAIF (Qualifying Investor Alternative Investment Fund) in order to specifically target professional investors. On 20 December 2013, Ireland published the General Scheme of the Irish Collective Asset-management Vehicle (ICAV) Bill. The ICAV is designed for Irish investment funds and will provide a tailor-made corporate fund vehicle for both UCITS and alternative investment funds. In July 2013, the Luxembourg Parliament voted to implement the AIFM Directive. About two hundred applications have already been received by the CSSF. In addition to implementation the Luxembourg law includes modernization of the sector laws governing various Luxembourg investment vehicles, the creation of a new partnership form (Société en Commandite Spéciale) and the introduction of a special tax regime for carried interest schemes.

Following the implementation of AIFMD, we expect that there will be a bifurcation of the alternative investment fund industry depending on the localization and the investor base of AIFMs. On the one hand, Non-European AIFs having a large European client base will have to develop local AIFMD expertise in Europe as it will be difficult for them to track and comply with AIFMD requirements without a local presence. On the other hand, non-European AIFs having a low proportion of European investors may have to exit the European market altogether as the AIFMD cost of compliance will damage their profitability. For the latter, they will mainly utilize "offshore" vehicles (i.e. Cayman/Delaware etc.).

While this will obviously lead to increased costs and inefficiencies in managing pools of money, it does allow managers to allocate the costs to those investors whose jurisdictions are mandating differing levels of regulatory requirements. We anticipate that Luxembourg and Irish domiciled funds will become more dominant while offshore funds become less visible.

15 A similar phenomenon is observed in the US. However, it is mostly retail investors that are accessing hedge fund strategies thanks to the US version of 'Structured UCITS' (Alternative Mutual Funds, registered under the Investment Company Act of 1940).

16 As of end 2013, 86% of authorisations for cross-border distribution came from Luxembourg and Irish domiciled funds.

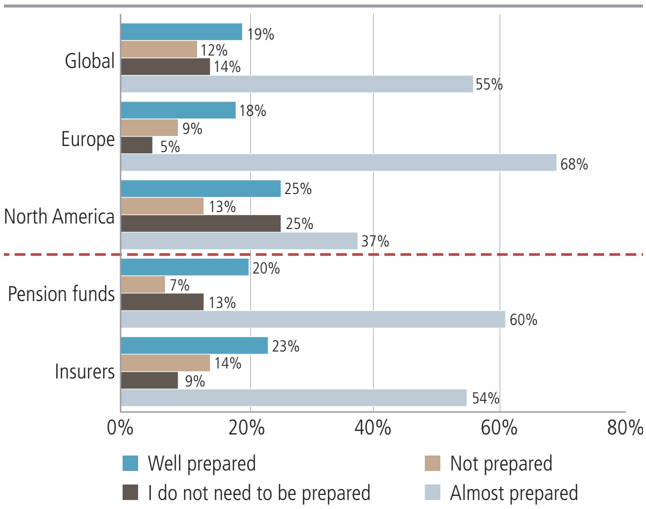
Investors and their alternative asset managers are prepared for upcoming regulations

The impending regulations are likely to affect institutional investors' business. For instance, Solvency II will increase the governance and data requirements for insurers and IORP II will impose new requirements on pension funds in Europe regarding corporate governance, transparency and reporting of portfolio investments. Therefore, asking them to assess their level of preparation with regards to these upcoming regulations has been a fruitful exercise.

Overall, 69% of institutional investors feel well prepared or almost prepared, especially pension funds in Europe. However, this statistic can be mitigated as most institutional investors are not yet fully aware of the on-going regulatory changes coming in at both their level and the product level. As shown previously, there is still a lot of uncertainty for insurers regarding Solvency II which is perceived as the regulation with the worst impact (67% of insurance companies expect a negative impact). We have observed that few insurers on the market are prepared in this area.

On the asset managers' side, they need to analyze how new regulations will affect their clients' businesses regarding capital requirements and investment strategies. They should be thinking about how to adapt in order to increase profitability in this new alternative world where financial regulation is leading to opportunities to launch new investment products and services that better meet investors' needs. When we asked institutional investors to rate their asset managers' level of preparation with respect to pending regulations, they ascribed an average of 6/9, meaning that alternative asset managers are perceived as quite well prepared to meet institutional investor's expectations.

Chart 11: Level of preparation of institutional investors with regards to the upcoming regulations affecting their business



Source: Survey

Section 3
What works and what doesn't work with Alternative Asset Managers

Satisfaction gap with alternative asset managers

There is no doubt that investors in alternatives will have to reconsider their asset allocation in order to comply with new regulations, the question is how? Sweeping changes in the industry present new challenges for asset managers, who will have to make understanding their clients' needs a chief priority in order to succeed.

Additionally, the price tag for bringing firms into compliance is currently reaching into the hundreds of millions for big managers, and many smaller companies lack the necessary resources to meet these demands effectively. In the asset management world, this means the challenge of compliance is also creating genuine opportunities.

In our survey, we asked institutional investors to rate their level of satisfaction with asset managers in various areas. The results indicated that most investors are happy with tailored solutions and governance, but are less satisfied with operational technology, reporting, fee structures and transparency. Asset managers will need to pay close attention to these areas when developing their strategies in the future.

What works

Governance

We are witnessing unprecedented change in the governance world: new perspectives on boardroom composition, higher levels of stakeholder engagement, more emphasis on emerging risks and strategies, and the increasing velocity of change in the digital world. These factors, coupled with calls for enhanced transparency, are all driving the governance evolution.

Asset managers currently face significant challenges within the context of transparency and fair investor treatment. New regulations have created a litany of hoops they have to jump through. Dodd-Frank, for example, delivered the most significant financial regulation reforms since the Great Depression. Designed to promote financial stability, protect the consumers and increase transparency, the Act, by one law firm's count, requires that regulators create 243 rules, conduct 67 studies and issue 22 periodic reports.[17]

The continuing avalanche of regulations, direct and indirect, is a key challenge for firms, and in order to comply, most will have to reconsider their long-term business plans. The AIFM Directive requires the implementation of sound risk management processes and disclosure, MiFID II reform applies strict transparency rules to ensure fair price formation and UCITS V focuses strongly on protection of investors and product regulation. Improper conduct in capital markets has created the necessity for extensive oversight, resulting in new regulations that put a strain on firms struggling to meet the rigorous terms of compliance. Nevertheless, these controls have been implemented with the intent of correcting a wayward industry and, if that happens, everybody wins. Recent examples of such regulations are the changes in Cayman Island governance rules where on March 21, 2014, the Cayman Islands government announced a bill establishing a registration and licensing regime for directors of funds regulated or licensed in the Cayman Islands. This newly-adopted CIMA guidance and registration sets forth a new framework of board duties and a system of regulatory oversight of fund directors. This framework emphasizes the importance of the board exercising hands-on oversight of the investment manager with regard to the fund's operations.

Despite the challenges these regulations present, most investors appreciate their necessity. Good governance plays a key role in addressing trust issues, both in how fund boards perform their duties and also in how they influence the actions of others. Respondents to our survey mentioned that there is growing recognition of the important role played by independent boards which re-enforce the trust and reliability with respect the activities of investment vehicles.

A costly segregation of functions

That said extensive governance, while necessary, is not without substantial cost. Under AIFMD, AIFMs must demonstrate that safeguards against conflicts of interest allow for the independent performance of risk management activities and that the risk management process is functionally and hierarchically separate from the operating units, including portfolio management. Hence, AIFMs are now required to implement systems that identify, measure, manage and monitor all risks relevant to each AIF.

17 Davis Polk, "Summary of the Dodd-Frank Wall Street Reform", July 2010.

Insurance and reinsurance undertakings subject to Solvency II must now establish effective systems of governance which provide for sound and prudent business management. At a minimum, these systems must include an adequate transparent organizational structure with a clear allocation and appropriate segregation of responsibilities as well as an effective system for ensuring the transmission of information.

Aside from the obvious expenses of hiring more personnel, firms will also have to look at internal restructuring. For institutional investors, improving the way they handle data is imperative. The viability of new segregated functions will depend on input data and added value output for investors. In addition, firms must face the fact that reporting requirements set new standards for systems and data management, as well as raising the barriers to entry.

That said, plenty of managers are convinced these efforts, although costly, will strengthen their competitive position. For example, firms engaged in derivatives trading stand to benefit significantly from Dodd-Frank's push to establish open and transparent derivatives exchanges. Other firms could see the upside, as well, in the areas of strategic restructuring, streamlining core businesses and establishing enhanced risk controls.[18]

Tailored / Oriented solutions

For institutional investors, the emergence of Liability Driven Investments (LDI)-based funding strategies may be considered one of the most significant developments during the last ten years. Of course, other types of risk hedging and return enhancing tools like portable alpha, leverage, shorting and derivatives for hedging unrewarded risks have been developed by asset management companies to better satisfy institutional investors growing needs. But today, the new challenge for alternative asset managers is to continue creating investment strategies that comply with institutional investor's new regulatory requirements.

Solvency II increases the data and governance demands on insurers and requires them to review (and possibly rethink) their investment paradigms. Regulatory capital considerations may encourage some insurers to increase investment in assets with relatively low capital requirements, such as highly-rated sovereign bonds, at the expense of corporate bonds, equities, property or hedge funds. But insurers clearly won't want to turn their back on these riskier asset classes altogether, as they need the potentially higher returns to make their portfolios competitive.

Creation of solutions tailored to new regulations is essential

If there is sufficient transparency in the underlying investments, it may also be possible for them to alter hedge funds structures in order to reduce the global equity charge that will be applied. In the United States, for instance, recent figures indicated that US institutional investors are turning to alternative mutual funds and away from hedge funds – alternative mutual funds showed inflows of USD19.7 billion in 2012, while USD7.6 billion flowed out of single-strategy hedge funds in that same year.[19]

A new playing field for alternative asset managers

Stringent regulations in the aftermath of the financial crisis have shifted the playing field for alternative asset managers: disintermediation will require a better understanding of clients' constraints, regulations will drive the development of tailored products and solutions and reporting demands will increase the role of technology. The way firms deal with this new alternative world will determine whether these changes become challenges or opportunities.

In an environment where asset managers interface directly with institutional investors, acquiring staff with a solid understanding of institutional clients' needs is strategically advantageous. In addition to managing portfolios, the requisite skill-set for investment managers will now include an in-depth understanding of institutional clients' constraints.

Additionally, faced with new barriers resulting from regulations, firms may look to specialisation. Those that find innovative solutions or tailor their products to deal with regulations will no doubt surpass those that don't. An added benefit of this strategy will be the ability to cater to niche markets. Valuable opportunities are abound for asset managers who lead the way in developing products, fund structures, investment strategies and other financial risk mitigation techniques that allow institutional investors to curb their capital requirements while continuing to deliver favorable returns.

Finally, technology will play a differentiating role, as reporting and portfolio management will have to become more sophisticated to comply with regulatory requirements. Firms that can scale the hurdles created by regulations can leverage on the transitional environment, but this could be harder for those without the resources to do so. As indicated previously, there is a notable gap between large and small players.

18 Steve Culp, Financial Institutions Start to See Some Upside in Dodd-Frank, Forbes, March 2013
19 Morningstar and Barron's – 2013 alternative investment survey

What doesn't work

Operational technology and reporting
Investments in technology and data management are vital in order to cope with the rigors of regulations and reporting. Under Solvency II or IORP II, institutional investors will have to demonstrate to their supervisors that the data they use is sufficiently complete, accurate and appropriate for their specific needs. Pressure from boards will increase in order to make sure that the information they use in decision making and reporting is based on reliable external data, including information from asset managers, and meets the same standards of quality, detail and verification as internally sourced information.

The "Big data" challenge

However, while many industries today make understanding their customers' behavior and attitudes high priority, the asset management industry is antiquated in the way it handles information about its clients. If asset managers want to remain competitive in an increasingly aggressive environment with demanding regulations, they should consider implementing data gathering and analysis mechanisms that managers in comparative industries have been using for years. These mechanisms are better known as "Big Data".

Leveraging on Big Data opens the door to a new way of doing business and is already transforming industry processes all over the world. Today, highly successful companies are driven by data-based decision-making and data-enriched products and services by efficiently exploiting the internal reservoir of information available. By applying Big Data processes to pressing financial services issues, asset management companies can reshape their operations and accelerate their results.

Access to real-time data will become the norm

Providing real-time data access to their institutional clients is one of the first applications of Big Data that asset managers will have to deal with in order to satisfy the expectations of institutional clients who are dealing with increasing regulatory pressures. Therefore, new regulations are expected to accelerate the use of real-time data tools. Access to portfolio-level real-time data will become the norm as institutional investors increasingly use portfolio-level data to manage their own risk levels.

Furthermore, when applied to reporting, these technologies can enable institutional investors to gather up-to-date data required for reporting to their home state regulator. The need for greater portfolio transparency started with European insurers under Solvency II, but will soon spread worldwide. For instance, in Mexico, the Pension Fund Regulator (CONSAR) requires a daily access to the investment portfolio of local pension funds.

Because real-time data is becoming more pervasive in the asset management world, solutions that can track asset performance and monitor portfolios in real-time will give asset managers a leg up over their competitors.

It is important for institutional investors to receive reporting from independent sources

As part of our survey, we asked institutional investors how important it is for them to receive reporting from an independent source: 74% stated it is important. Thus, both insurers and asset managers may look to fund administrators to provide the industrialized approach needed to produce reports in an efficient and cost-effective way. Hence, for service providers, the competitive landscape will become more and more challenging. Only those with the best technology offerings and with the scale to continue investing in the development of new offerings will survive.

Technology is a necessary cost that should, in turn, reduce overall asset management costs for firms, particularly when they use outsourced technology solutions. With the increase in global access, there will be pressure on technology systems to provide accurate and timely information while meeting security and privacy needs. Technology should have the flexibility and breadth to enable investor reporting as well as disclosure accuracy and completeness for investors, regulators and tax authorities. This will facilitate compliance with the plethora of overlapping tax and regulatory reporting requirements emerging over the next few years.

Fee structure

Asset managers will be under continued pressure, amid the ongoing push for greater transparency and comparability from investors as well as scrutiny from policymakers and regulators, to disclose the fees they earn. In the UCITS space, EFAMA has recently set up a working group in order to foster a common approach to the use of performance fees in Europe as national regulators still take different approaches. Under AIFMD, alternative asset managers will have to adopt specific remuneration policies which are closely aligned with the recent EU Capital Requirements Directive for the financial services industry.

The current industry trend is seeing a major shift in power characterized by lower fees and lower performance, but better transparency and governance (e.g. Hedge Funds). For individual investors, lower fees and greater transparency are materialized by the abolishment of trailer fees, which is a game-changer for many distributors that will need to assume the role of consultants. For institutional investors, this issue is less relevant since "no load" or "institutional" share classes are already free from intermediary remuneration. Nevertheless, high fees have to be justified by attractive performance along with adequate transparency regarding their structure.

A new study from Preqin finds that hedge funds charging more than the industry-standard of 20% for performance have been the best performers over the past six years. Such funds have the highest net-returns on both a three and five year annualised return basis and posted the best risk-adjusted returns. However, despite attractive performance, fees remain the biggest concern for institutional investors looking for further detailed information about the fund's terms and conditions.

Investors are chasing hidden fees

Indeed, investors in alternatives are often charged more when it comes to management and performance fees. Hence, to discover and limit hidden fees, investors must review offering documents prior to investing, and conduct robust negotiations in order to ensure that excessive and inappropriate charges are not being added elsewhere by the manager.

In the alternative space, fee levels have declined, but not uniformly. They are still high compared to traditional strategies. According to Deutsche Bank, the percentage of investors negotiating fees for alternatives has increased 40% year on year, from 51% in 2012 to 71% in 2013.[20]

Asset managers should propose innovative fee structure

The disclosure of performance fees is currently a hot topic in the industry in an attempt by regulators to align interests of managers and investors.

Opportunities for asset managers lie in proposing innovative fee structures, like the ones mentioned below, to their institutional clients in order to fairly align themselves with stakeholders' interests and gain their trust.

- Sliding scale fees that decline as assets under management increase;
- Longer measurement periods for performance fees, which last up to three years instead of only 1 year;
- Hurdle rates measured over a multi-year lock-up period rather than being reset annually.

20 2013 Deutsche Bank Alternative Investment Survey

Transparency

According to Russell, EMEA investors are transparency conscious, with 70% saying the relative lack of transparency is a barrier to investing (vs. 50% globally)[21]. However, in the aftermath of the financial crisis transparency has been slowly increasing based on investor and regulatory requirements. The development of managed accounts over the last ten years brings a clear increase in transparency and liquidity, but investors are still demanding and expect to get more from their alternative providers.

Risk Management

The new capital charges defined by the Solvency II Directive will heighten insurers' focus on the balance of risk and reward within their investment portfolios. Insurers will gravitate to asset managers that can help them assess their investment risks and risk-adjusted returns more effectively. This includes being able to provide them with more detailed risk information and more extensive scenario analysis. Successful asset managers will be those better able to provide their institutional investors with sophisticated risk analytics in order to make their risk management more effective.

Liquidity

Liquidity is also a key consideration. Insurers and pension funds will have to demonstrate the liquidity of their investment portfolios, which will influence their choice of assets. Asset managers, therefore, will be expected to provide adequate information to allow them to sufficiently analyse liquidity.

Holdings

Solvency II and IOPS also introduces a "look through" approach to the valuation of funds, under which the prime investments are treated as direct holdings. If this information is not available, these funds will be treated as other equities, thereby attracting the highest capital charge.

Remuneration

In February 2013, the European Securities and Markets Authority (ESMA) published its final guidelines on remuneration of AIFMs (hedge funds, private equity funds and real estate funds) in order to promote prudent risk-taking by fund managers and help align the interests of both fund managers and investors.

Transparency over investment activity and products will have to exist at all levels (risk, liquidity, holdings, remuneration) and there will be nowhere for non-compliant managers to hide as the regulatory authority's reciprocal rights concerning tax and other information extend across the globe.

Roadmap for alternative investors to develop their services

Key areas	Recommendations to alternative asset managers
Governance	An appropriate segregation of responsibilities as well as an effective system for ensuring the transmission of information is required by new regulations. However, the viability of new segregated functions will depend on input data and added value output for investors.
Tailored solutions	The requisite skill-set for investment managers will now include an in-depth understanding of institutional clients' constraints in the new alternative world. Valuable opportunities are abound for asset managers who lead the way in developing products, fund structures, investment strategies and other financial risk mitigation techniques that allow institutional investors to curb their capital requirements while continuing to deliver favourable returns.
Operational technology & reporting	Providing real-time data access to their institutional clients is one of the first applications of Big Data that asset managers will have to deal with in order to satisfy the expectations of institutional clients who are dealing with increasing regulatory pressures. Technology should have the flexibility and breadth to enable investor reporting as well as disclosure accuracy and completeness for investors, regulators and tax authorities.
Fee structure	Opportunities for asset managers lie in proposing innovative fee structures to their institutional clients in order to fairly align themselves with stakeholders' interests and gain their trust.
Transparency	Alternative asset managers have to provide their institutional clients with: • Risk Management solutions • Adequate information to allow them to sufficiently analyse liquidity • Detailed information related to holdings in the "look through approach" context • More transparency on fund managers remuneration policies

21 Source: Russell Investments' 2012 Global Survey on Alternative Investing

Conclusion
Asset Managers: Meeting the Needs of Institutional Investors

Institutional investors have needs

New types of alternative assets
Our study reveals that the share of alternative investments is expected to increase steadily over the next few years due to an increased interest from institutional investors who are looking for diversification and uncorrelated returns in a highly regulated climate. The market has spent the last decade in recovery mode and is now transitioning into a post-crisis environment where regulations are changing the way asset managers do business. Our survey demonstrates the confirmed emergence of new types of alternative assets such as infrastructure and real assets as part of institutional investor portfolio construction. However, allocation to traditional alternative asset classes (private equity, hedge funds and funds of hedge funds) are expected to remain stable. This new interest from institutional investors in alternative assets does change the dynamics of this market segment. Pension funds and insurance companies are putting more importance on transparency (i.e. reporting), liquidity (i.e. redeemable investments), cost (i.e. lower fees) and more balanced risk-return profiles.

Deeper relationships with alternative asset managers
New regulations are already beginning to have a tremendous impact on the behavior of institutional investors, specifically in their selection of alternative asset managers. In this new highly-regulated environment investors tend to work with fewer managers, but are increasing the quality of interactions with those they retain. To satisfy their clients' needs in the newly regulated investment world, asset managers will have to understand the investors they work for and provide them with genuine solutions suited to their unique circumstances. When asked what managers could improve, the institutional investors we surveyed identified the following as areas of concern: sound governance, tailored solutions, operational technology and reporting, transparency and fee structures. Our study suggests, therefore, that asset managers wanting to succeed in the coming years will have to focus on these areas while taking into account institutional clients' constraints.

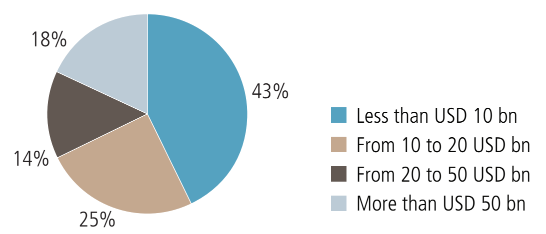
Asset managers can provide solutions

Leveraging on regulations
For asset managers who are savvy and determined, the onslaught of new regulations can be a blessing in disguise. Leveraging these rules, though, will require an in-depth understanding of institutional clients' constraints. Clients who are skeptical should be provided with greater transparency. Managers should engage with clients to offer fee structures that align with stakeholders' interests and to offer clients the right technological solutions for their business. For instance, flexibility around operational technology could enable instant reporting and disclosure for investors, regulators and tax authorities. In short, asset managers who create strategies tailored to the new regulations and investors' needs will lead the way in the alternative space.

Appendix 1
Survey sample

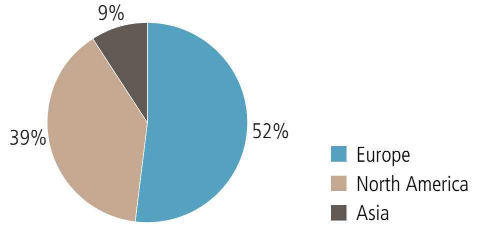
- This online survey was conducted during the last quarter of 2013. All graphs in the document referring to the survey will be sourced as "Survey".
- Our sample includes the responses of 44 Institutional investors representing 1.9 USD trillion in AUM.
- The geographical spread of participants is well balanced between Europe (52%) and North America (39%). Asian investors account for only 9% of participants and as a consequence, their results will not be isolated in the analysis.
- Our respondents are mainly insurers (50%), followed by pension funds (39%). More than half of our participants (57%) manage more than USD 10 billion of assets. Sovereign Wealth funds did not want to participate for confidentiality reasons.

Chart 12: Participants by size



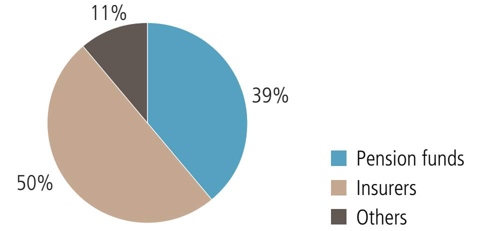
Source: Survey

Chart 13: Geographic breakdown



Source: Survey

Chart 14: Participants by type of institution



Source: Survey

Appendix 2
Objectives and achievements

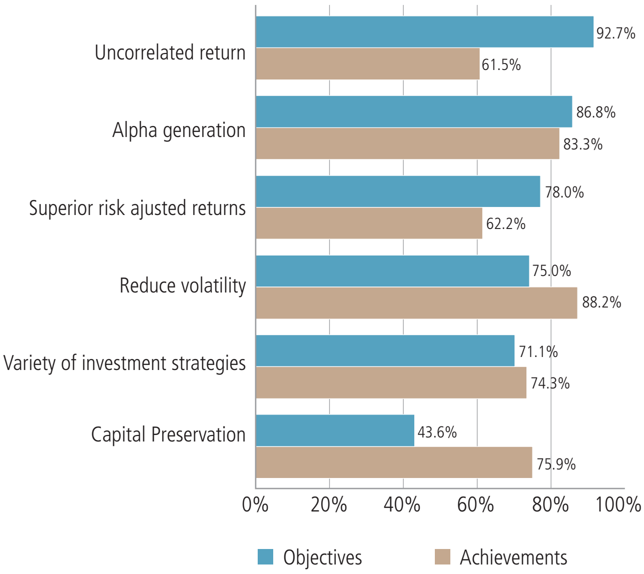
Uncorrelated returns: the most important objective is not achieved

Institutional investors are turning to alternative assets not only to see higher returns, but for the more important objective of diversifying their portfolios with uncorrelated returns. Although alpha generation is largely achieved, as demonstrated here, the objective of achieving uncorrelated returns is not currently being satisfied, especially given the constraints investors face with respect to liquidity, flexibility and higher fees.

Nevertheless, although statistical studies tend to demonstrate that alternative investments are generally decorrelated from traditional financial markets, there is still an indirect correlation between the value of a portfolio and the broader economic environment. This is particularly true for private equity portfolios where the value of the companies they hold may partially reflect fluctuations in the economy thereby creating a misperception among institutional investors regarding their ability to generate a satisfactory level of decorrelation.

That said, there is a higher-than-expected reduction in perceived volatility for alternative assets which has helped to mitigate risk and satisfy liability management constraints. In addition, alternative strategies (like numerous hedge fund substrategies (i.e. equity long/short strategies)) are being successfully marketed as vehicles that offer capital preservation during market downturns[22]. According to our sample, alternative investments have surpassed the objective of reduced volatility that investors set for them.

Chart 15: Objectives and achievements when using alternative investments



Source: Survey

22 According to HFR, the HFRI Equity Hedge (Total) Index delivered an annualized performance of 9.2% over the last 5 years.

Appendix 3
Regulations affecting institutional investors

Basel III Proposal (Banks)

Five main objectives: raise the quality, quantity, consistency and transparency of the capital base to ensure that banks are in a better position to absorb losses; strengthen risk coverage of the capital framework by strengthening the capital requirements for counterparty credit risk exposures; introduce a leverage ratio; introduce a series of measures to promote the build-up of capital buffers to face periods of stress and set a global minimum liquidity standard for internationally active banks.

Solvency II (Insurance Companies)

Solvency II will increase the governance and data requirements for insurers and is leading them to review their current investment strategies, which will have a significant impact on asset managers and fund administrators. The main challenges for asset managers and fund administrators are the following: quality and availability of data, timely reporting, revisiting investment strategies and cost efficiency.

IORP II (Pension Funds)

The impact of the Solvency II directive will be broadened as IORP is introduced for pension schemes. Looking further out, the effect is likely to be even more far-reaching. The regulation may help accelerate the demise of traditional retirement products. Unit-linked life products, defined contribution pension schemes and other new products will increase their dominance as more primitive species face extinction.

Alternative Investment Fund Managers Directive (AIFMD)

The AIFMD aims to regulate AIFMs of AIFs. AIFs can be defined as all non-UCITS funds, thereby covering hedge and private equity funds as well as real estate structures and 'plain vanilla' long only non-UCITS funds. With at least 48 subsidiary pieces of technical guidelines, rule-making and reviews to follow, many more details on how AIFMD will apply in practice will emerge. There are a number of challenges to be addressed by the AIFMs (i.e. depository, operating conditions, risk management, valuation, remuneration, reporting & disclosure…).

Dodd-Frank Wall Street Reform and Consumer Protection Act

President Obama signed the Act on July 21, 2010. The Act contained 16 titles, more than 500 rules, 1,500 sections and 2,300 pages dealing with various financial services industry matters and other industries. Its goals are to: restore public confidence in the financial system following the 2008 financial crisis, put measures in place to prevent another financial crisis and allow regulators to identify failures in the system before another crisis can occur. Many of the provisions have an extraterritorial effect.

FATCA

FATCA is a US law that aims to detect US tax evasion. The requirements imposed by the regulation are extensive. In particular, the following aspects are relevant: new benchmark in terms of account holder identification and documentation; comprehensive fulfilment and evidence of due diligence procedures; publication of FATCA relevant data in the market; annual reporting of selected information to the US tax authorities ('IRS').In case of non-compliance with FATCA, remittance of a 30% withholding tax on US sourced income applies for non-IGA countries and for NPPI and recalcitrants in IGA countries.

FTT

In September 2011, the European Commission proposed a draft directive introducing an EU-wide financial transaction tax. The draft tax covers a wide range of financial transactions including stocks, bonds and derivatives and provides for a tax applicable to all financial transactions, on condition that at least one party to the transaction is established in an EU Member State and that a financial institution established in the territory of a Member State is party to the transaction. The tax rate applicable would be set by each member state.

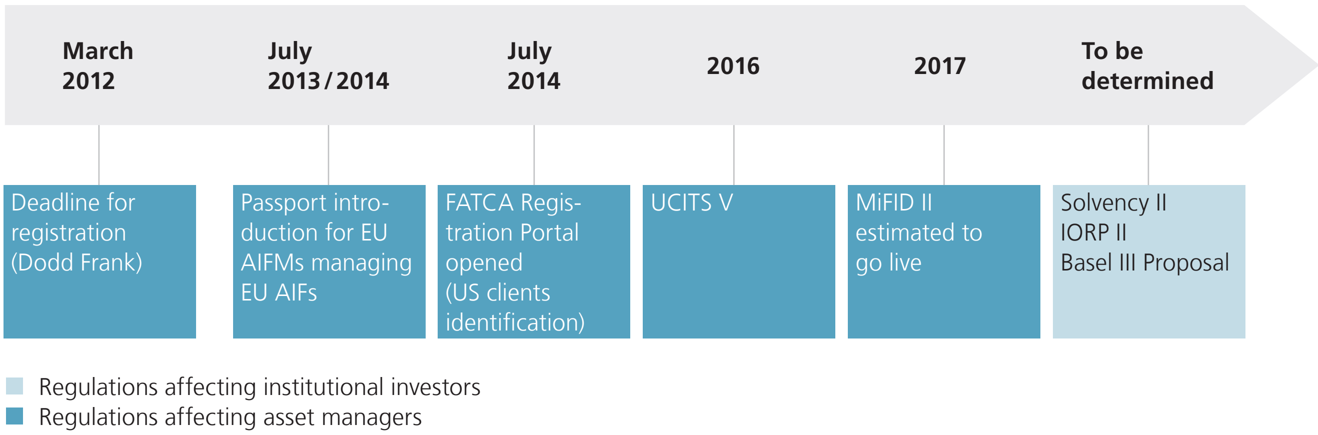
MiFID II

The new Markets in Financial Instruments Directive ("MiFID II") proposed by the European Commission and published on 20 October 2011, will significantly impact investment firms and the structure of the European securities market. The MiFID II proposal intends to reinforce transaction reporting requirements, to enlarge scope of regulation to a wider range of assets, and to confirm willingness to further protect investors.

UCITS V/UCITS VI

UCITS V will bring clarifications with respect to the UCITS Depositary legal framework, in line with the requirements specified for AIFs under AIFMD. The proposal also harmonises the remuneration policies of UCITS at the management company level and sets a common regime for sanctions to ensure investor protection is enforced. The European Commission published a consultation document on UCITS VI on July 26th, 2012 regarding product rules, liquidity management, depositary, money market funds and long term investments.

Appendix 4
Timeline of upcoming regulations



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