Embracing Alternatives

Advisors’ interest in alternative investment strategies is growing, but questions remain.
Alternative investments used to be restricted to institutional investors and the most affluent individuals. These large investors typically used hedge funds to access alternatives, which include alternative assets such as commodities as well as non-traditional strategies such as global macro and long/short equity. Today so-called liquid alternatives—alternative assets and strategies provided within mutual funds and investment portfolios—make these types of investments far more accessible.

Assets in liquid alternatives jumped from just under $100 billion in 2009 to nearly $350 billion as of mid-2015. That figure is likely to keep growing: According to a recent Morningstar and Barron’s survey, 63% of advisors plan to allocate more than 11% to alternative mutual funds over the next five years, up from just 39% in 2013.

But many advisors have concerns and questions about the potential benefits of these investments, and how to use them in client portfolios.

Our survey, conducted by Pioneer Investments and WealthManagement.com, received responses from more than 1,100 financial professionals regarding how they evaluate and use alternative investments. When combined with other research conducted by WealthManagement.com, the responses offer insight into advisors’ views on these strategies, and on which types of clients they think could benefit from them.

Understanding alternative strategies
Alternatives can include any investment in asset classes outside of traditional stocks, bonds and cash, such as private equity, commodities, or catastrophe bonds, or any investment in strategies that use leverage, shorting, and nontraditional instruments like futures or options. In the past, they tended to be less liquid, more complex and more lightly regulated than traditional asset classes; most alternative investments were available only through hedge funds and other private vehicles.

These vehicles’ high initial investment requirements—typically $500,000 or more—put alternatives out of reach of most individual investors, as did their tendency to restrict investors’ access to their capital.

According to a recent Investment Trends Monitor Report survey (Figure 1, page 3), more than seven out of every 10 advisors surveyed classified managed futures and long/short equity as alternative strategies. A similar number (71%) categorized private equity as an alternative sector. Direct real estate investments and commodities were the next two sectors most commonly labeled alternative. By comparison, less than a quarter of advisors categorized inflation-focused strategies, unconstrained bonds and other fixed-income strategies as alternatives, and only 19% considered emerging markets debt an alternative sector.
The results from the 2016 Pioneer/WealthManagement.com current survey support the Investment Trend Monitor findings, with REITs (63%), long-short equity (48%) and multi-strategy (43%) cited as the most popular alternative strategies among financial advisors surveyed. Advisors also were most likely to name these strategies as the ones they expect to use in the future.

Different types of advisors offered distinct responses:

- Advisors with over $500M assets under management were more likely to favor relatively sophisticated strategies, including merger arbitrage and non-traditional bonds, than were other advisors. These high-AUM advisors appeared more willing than other advisors to embrace the full range of alternative strategies.
- Wirehouse advisors favored macro- and multi-strategy alternatives.
- Advisors with 10 years or less in the industry reported relatively little interest in alternative credit.
How advisors use alternatives

Advisors seem to agree broadly that alternatives can provide diversification benefits, due to their lower correlation to traditional asset classes. In fact, lower correlation was the most frequently cited quality advisors look for in their evaluations of alternatives, at 63%. This pattern is consistent across industry channels in the survey and is supported by the results of other surveys conducted through WealthManagement.com. For example, more than half (51%) of the advisors surveyed in WealthManagement.com's 2015 RIA Trend Report identified portfolio diversification as a reason to advocate for the use of alternatives in a client portfolio, while the second most commonly cited reason was to lessen volatility, at 39%.

The fact that alternatives are used to increase diversification and lessen volatility means they could be particularly relevant to investors today, when the diversification value of other traditional asset classes like bonds has come at the expense of very low expected returns and potentially disappointing investment results and bond market volatility if interest rates reverse course. Those two main uses suggest that many investors might benefit from at least some exposure to alternatives as a risk-management tool. Again, this notion aligns with the findings of the various surveys cited earlier. Roughly one third of advisors surveyed in the RIA Trend Report (36%) report they recommend some exposure to “many” clients, while another third (33%) report they recommend alts for “some” clients (Figure 2).

Advisors appear to believe that alternatives have a role to play for a broad range of investor types. Few advisors believe that liquid alternatives are appropriate for investors with short time horizons (17%)—not surprising, given the limited liquidity of most alternative investments. But advisors think clients with longer time horizons (30%) and even a medium tolerance for risk (36%) may still be good candidates for this type of alternative investment, according to our survey.

FIGURE 2: Reasons to advocate using alternatives in client portfolios (2015)

<table>
<thead>
<tr>
<th>Reason</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>As a portfolio diversifier</td>
<td>51%</td>
</tr>
<tr>
<td>To lessen volatility</td>
<td>39%</td>
</tr>
<tr>
<td>As a risk management tool</td>
<td>36%</td>
</tr>
<tr>
<td>Superior return opportunities</td>
<td>13%</td>
</tr>
<tr>
<td>Client request</td>
<td>7%</td>
</tr>
<tr>
<td>I don’t use alternatives</td>
<td>27%</td>
</tr>
</tbody>
</table>

Advisors have tended to use satellite positions in alternatives to seek better portfolio diversification. The 2015 RIA Trend Report found that two thirds (64%) of advisors surveyed use alternatives as a satellite position in client portfolios, compared to just 28% who reported using alternatives as a core holding. The 2015 RIA Trend Report also identified a modest increase since 2014 in the percentage of advisors using alternatives in a satellite capacity, with much of that gain appearing to come from advisors who previously used alternatives as a core holding.

The qualities advisors look for when evaluating alternatives reflect advisors’ use of them to manage risk. As mentioned earlier, advisors in the 2016 Pioneer/WealthManagement.com survey were most likely to cite low correlation as an important quality. They also were far more likely to cite liquidity (62%) and downside protection (62%) than historical performance (40%) as important qualities in their evaluation process. We believe a desire for liquidity may indicate that advisors are reluctant to invest their clients in alternatives such as venture capital, private equity or infrastructure investments, which may tie up investors’ capital for years at a time. Instead, advisors may look more favorably on alternatives that give clients more access to their investments. (Figure 3)

Interestingly, larger advisors (by AUM) were more interested in access to portfolio managers than are other advisors. Some 17% of top advisors—see page 8 for top advisor definition—said they value access to managers, versus just 5% for all other advisors. A desire for access to portfolio managers could indicate that top advisors want to understand the details of the processes used by the manager, which would be critical in using this asset class as a risk management tool.

FIGURE 3: Top three most important qualities when evaluating alternative investments

<table>
<thead>
<tr>
<th>Quality</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low correlation with other assets classes</td>
<td>63%</td>
</tr>
<tr>
<td>Liquidity</td>
<td>62%</td>
</tr>
<tr>
<td>Downside protection</td>
<td>62%</td>
</tr>
<tr>
<td>Transparency of the strategy</td>
<td>43%</td>
</tr>
<tr>
<td>Historical performance</td>
<td>40%</td>
</tr>
<tr>
<td>Historical Volatility</td>
<td>18%</td>
</tr>
<tr>
<td>Access to fund manager</td>
<td>7%</td>
</tr>
</tbody>
</table>

Source: Pioneer/WealthManagement.com 2016 survey on alternatives
Strategies for investing in alternatives

We believe alternatives are likely to continue to play an important role in client portfolios in the coming years. Almost four in every 10 advisors surveyed in the 2015 RIA Trend Report expect to increase their use of alternative investments in the next three years, and slightly more than half of the advisors surveyed expect to maintain current usage levels. Yet the survey shows that many advisors continue to grapple with questions about not only what types of alternative strategies they should incorporate into client portfolios, but how they should achieve that exposure. The industry is responding to this trend by creating vehicles that invest in alternatives that seek to bring investors diversification value while preserving liquidity. This industry response is still in its infancy, but growing fast both in the size and diversity of offerings. (Figure 4)

Alternatives are no longer available only to investors willing to assume the risks associated with illiquid assets. Although many investors continue to invest in alternatives through hedge funds and other vehicles with limited liquidity and high investment minimums, newer options, including liquid alternatives, present opportunities to gain exposure to the low correlations and increased diversification opportunities of alternatives, with lower minimum investment requirements and greater liquidity. What’s more, the range of strategies considered to be “alternative” by at least some advisors surveyed demonstrates the breadth of this asset class. Advisors seeking to add diversification to their clients’ portfolios now have a large toolkit to choose from—even if they have typically used those tools as supporting players in portfolios built around traditional asset classes.

For instance, in the 2016 Pioneer/WealthManagement.com survey, advisors on average report a 7% allocation to non-liquid alternative investments, with a majority of advisors (57%) reporting allocations of 5% or less. This allocation remained relatively consistent across industry channels. Top advisors averaged a slightly higher allocation than other advisors, and were almost twice as likely as all other advisors to hold an allocation of 10% or more in non-liquid alternatives.
For their part, liquid alternatives received only a slightly higher average allocation (11%) among advisors surveyed. Top advisors appeared to favor liquid alts more than all other advisors, however. On average they hold a 15% allocation to liquid alternatives, while all other advisors average just under 11%. Moreover, nearly a third of top advisors (29%) reported allocations of 10% or more. We believe it’s possible that top advisors are already more comfortable with the concept of adding exposure to alternatives in general, and specifically to liquid alternatives, than are advisors generally.

Putting alternatives to work for clients
The 2016 Pioneer/WealthManagement.com survey found that advisors’ and clients’ concerns about liquid alternatives tend to be aligned: For instance, most advisors and their clients are concerned with fees (64% and 73%, respectively) and strategy complexity (55% and 67%), according to advisors in our survey.

There were also slight differences among advisor groups with respect to the advisors’ concerns. Smaller advisors (by AUM) and independent broker/dealers typically were more worried about the evolving regulatory environment than other advisor groups, perhaps due to the difficulties these advisors can have.

Most advisors and their clients were concerned with fees (64% and 73%, respectively) and strategy complexity (55% and 67%), according to advisors in our survey.
navigating an increasingly complex compliance environment. Top advisors shared the same primary concerns with their peers, but they were more likely than all other advisors to be concerned about the lack of access to the manager in liquid alternatives (12% vs. 7%), and less likely to be concerned about the strategy complexity (41% vs. 57%). Perhaps mirroring their advisors’ concerns, the clients of top advisors are also slightly less likely than all others to be concerned about strategy complexity (57% vs. 68%, according to advisor perception), although, based on advisors’ responses, top advisors’ clients seemed to be more likely to hold on to concerns about the relative newness of liquid alternatives as an investment type than were the clients of all other advisors (50% vs. 39%).

Before advisors can appropriately incorporate alternative investments into their clients’ portfolios—whether through traditional, less-liquid investments or newer liquid alternative portfolios—they must be able to explain their rationales to clients who may have justified concerns and questions about this asset class. To explain their alternatives strategy with the necessary degree of clarity and conviction, advisors themselves must understand how the alternatives work and what role they can play in a client portfolio.

The 2016 Pioneer/WealthManagement.com survey, along with data from other WealthManagement.com surveys, shows that there is strong interest by advisors in bringing alternatives to a larger cross-section of investors, but that even top advisors continue to express a degree of uncertainty about the asset class and how to use it. That said, there is evidence that top advisors are adopting a more sophisticated and mature view of alternatives as risk-management tools, potentially offering a path for other advisors to follow.

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Who are the Top Advisors?

Of the more than 1,100 respondents in the Pioneer Investments/WealthManagement.com Alternatives Study, roughly 10% were identified as top advisors based on the top 10% of assets under management (more than $500 million). The goal of this differentiation was to provide a group that represents experienced, successful advisors who can offer a model for how alternatives can be incorporated into client portfolios. Responses from top advisors were then compared against other advisors where applicable.