The Dangerous Democratization of Alternatives

Illustration by Jeremy Leung/II

Amateur hour should worry the pros.

By Christopher Schelling
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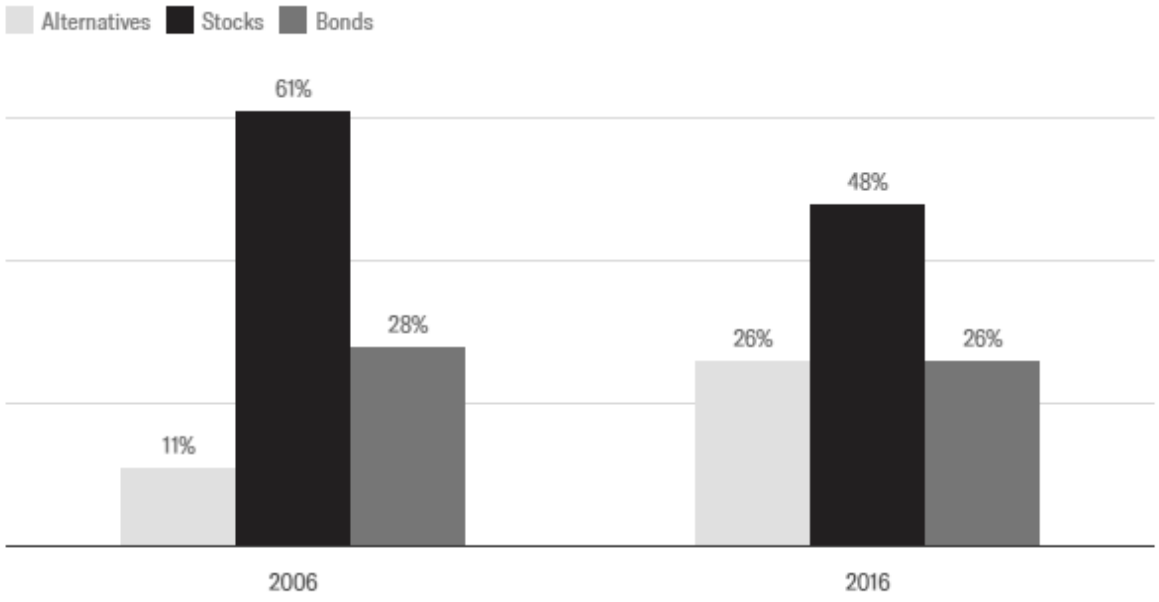
Alternative investments like private equity and hedge funds have long been the near-exclusive purview of ultrarich people and large institutions. Over the past two decades, massive inflows — particularly from big institutional allocators — have powered enormous growth.

Since 2000 private equity, private credit, and hedge funds have surged from just a trillion dollars combined to $8.3 trillion, compounding assets at roughly 11 percent per annum. And by 2023, Preqin forecasts that alternatives will hit $14 trillion in total.

Pensions' average allocation to alternatives has increased from 11 percent in 2006, with 89 percent of the portfolio in traditional assets like stocks and bonds, to 26 percent in private equity and hedge funds a decade later, according to Pew Charitable Trusts data. It's hard to really consider them "alternative" at this point. Borrowing a term from real estate, perhaps "traditional plus" is more appropriate parlance. But given the large allocations already in place, it's unlikely the next decade will see so-called alternatives grow at anything close to the same rate from these investors.

Pension Funds' Evolving Asset Allocation



Source: Pew Charitable Trusts.

Retail investors have been clamoring for a piece of the action. Although stocks and bonds have performed well since the Great Financial Crisis of 2008, hedge funds and private equity still have the allure of the unattainable. People always seem to want what they can't have. These private partnerships have remained exempt from some of the more onerous requirements of the 1940 Investment Company Act by accepting only accredited investors — those above a certain income and net worth. This structural flexibility afforded to pro investors ostensibly gives private partnerships the opportunity to generate their returns, which is a trade-off the managers have been happy to make.

But if Wall Street can be relied on for anything, it's packaging financial products to meet strong investor demand. So-called "liquid alternatives" were one of the investment industry's early attempts at fulfilling latent retail demand for private equity and hedge funds. These products attempt to mimic their institutional brethren, such as merger-arbitrage funds, trend-following commodity strategies, and levered small-capitalization equities. But unlike private partnerships, firms sell liquid alternatives via registered vehicles like mutual funds, closed-end funds, and exchange-traded funds, offering at least daily liquidity at much lower costs. Although 1 to 2 percent management fees (with no profit sharing) are common, liquid alternatives can sometimes be found for just 0.5 percent.

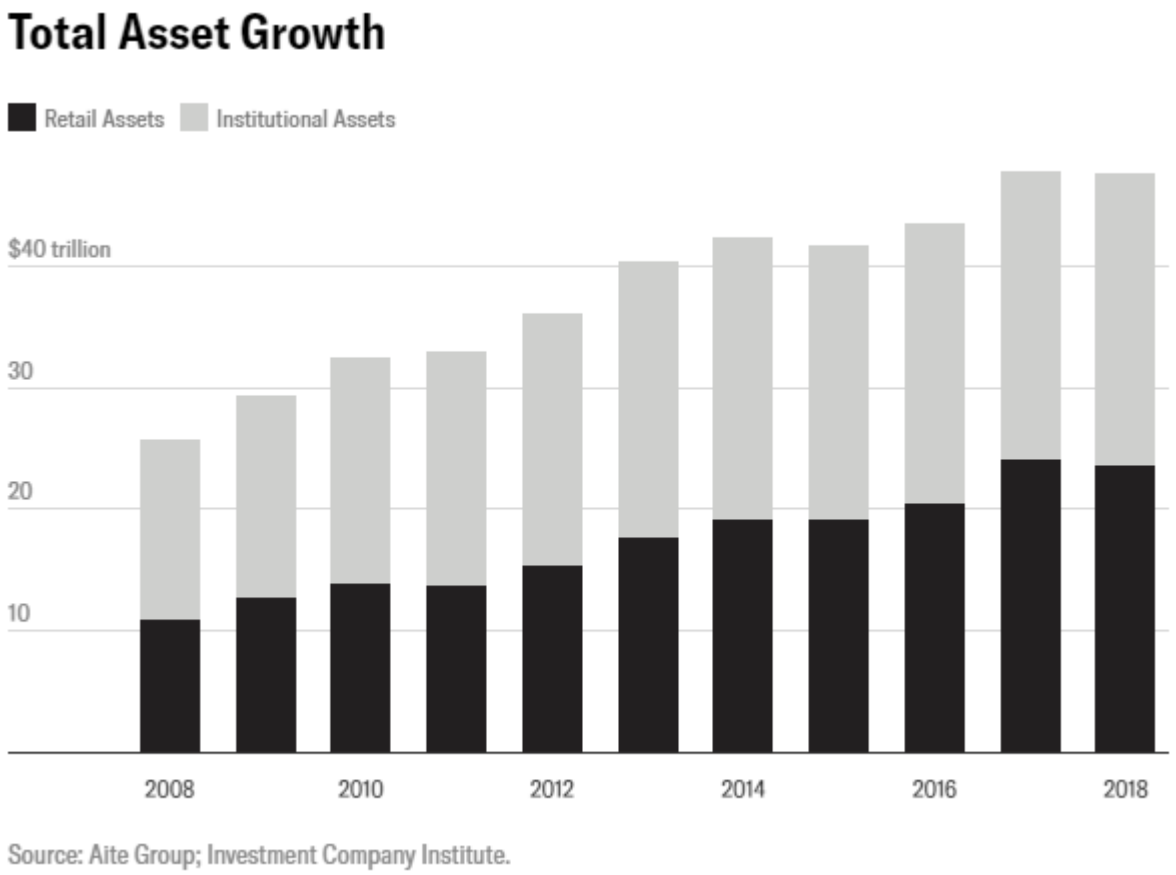
Interest in these strategies has skyrocketed. Googling "liquid alternatives" yields 119 million results in half a second. Assets in these vehicles have also risen sharply, growing from just under $14 billion in 2003 to nearly $300 billion as of the start of 2019 — a growth rate of 21 percent per year — according to data from consulting firm RVK and financial research firm Morningstar. But investment returns from these products, constrained as those products are by the regulatory requirements of their structures, have largely disappointed. Liquid alts typically underperform hedge fund and private equity indexes by a significant net basis despite their lower costs.

Consulting firm Wilshire Associates' liquid alternatives index returned 6.7 percent in 2019 — pretty underwhelming next to the 31.5 percent the S&P 500 delivered. Though stocks may be an unfair comparison, Wilshire estimated that the liquid alts sector experienced $25 billion in total redemptions in 2019, its first real year of negative flows, as retail investors left disappointed. True access to the desired underlying return streams for non-accredited investors continues to remain elusive.

The Securities and Exchange Commission might change that. Chairman Jay Clayton has said he's eyeing an overhaul of all regulations around private placements, with the

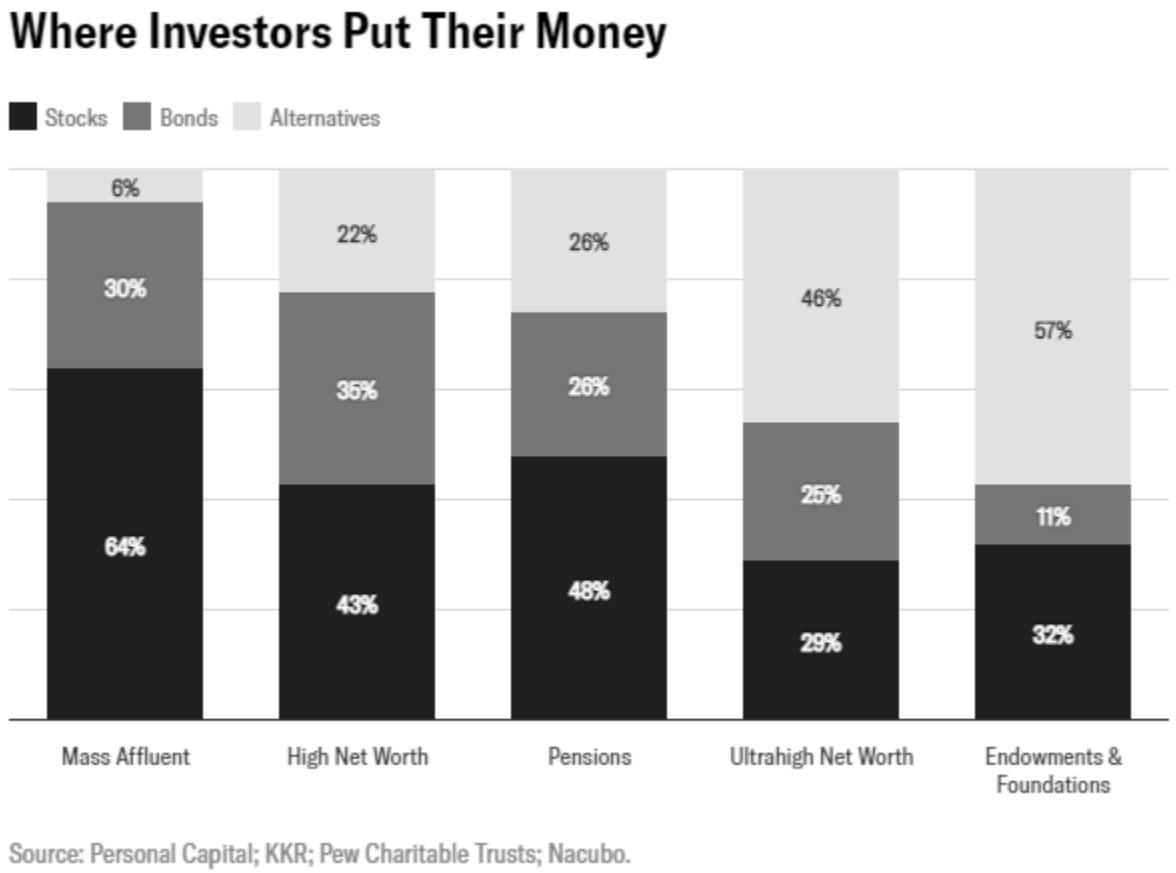
intent of making them more accessible to individual investors. It appears the democratization of alternatives is an SEC priority. In fact, in a December press release, the regulator proposed loosening accreditation requirements, making it easier for more people to qualify.

I'm certain asset managers — particularly established alternatives shops like KKR and Blackstone — do appreciate the chance to get their products in front of a wider audience. Liquid alts may have stalled, but sales of true private alternative partnerships through investment advisers surged 149 percent last year, to $19.2 billion, largely from non-traded real estate investment trusts, interval funds, and private direct-lending vehicles like business development companies.



It is no wonder that these large investment firms have been keen to peddle their wares to the individual investor market. Retail assets under management hit roughly $24 trillion at the end of 2018, close to matching institutional assets and growing nearly twice as fast.

Imagine the size of the alternatives industry a decade from now if the average mom-and-pop investors' allocation approaches that of the pension community, let alone the typical alts-heavy ultrahigh-net-worth or endowment and foundation portfolios. Preqin's call for $14 trillion may well prove conservative.



Such growth would likely come at a cost.

Hedge funds and private equity returns have diminished to varying degrees with the influx of institutional capital over the past two decades. Likewise, another doubling of assets could seriously erode whatever excess return opportunity still exists, negating the whole reason for the allocation. (The asset managers will still be fine, of course.)

And in this changing landscape, a new business model has arisen: the independent alternatives platform. Like the big investment bank platforms, these offer a roster of third-party private equity funds and hedge funds to investors that join their client base. Unlike the banks, they do not have investment advisory businesses of their own. By

subscribing to a platform — sometimes by paying a membership fee and a management fee on assets — investors get easy access to a ready-made lineup of managers they would otherwise have to find on their own, and can outsource cumbersome subscription paperwork and capital calls to electronic processes. Platforms can be true one-stop shops.

I call this business model "Retail Alts 1.0." Selling access scales well, and is profitable for those involved. But there are a few reasons to worry that these platforms will fall short of providing the outcomes that investors are hoping for.

First, manager selection in alternatives really matters. Unlike in public equities, where the difference between top- and bottom-quartile managers in any one year averages about 2.5 percent, in private equities that spread approaches 20 percent. Picking the right or wrong manager matters hugely. Most of these platforms have robust due diligence processes in place, which they've typically outsourced to third-party vendors. And there's the rub.

Research on due diligence should give investors pause. Looking at 13 years' worth of manager research recommendations from several leading investment consultants, an article in *The Journal of Finance* in 2015 compared the performance of the approved managers with those not recommended, and the results did not flatter consultants. Recommended managers subsequently underperformed their unendorsed counterparts by 1 percent per annum, the study found. Notably, among the approved managers, consultants were even worse at conviction-based prioritization. Top picks returned an average of 6.8 percent, whereas lower-rated managers generated 8.6 percent a year. I suspect clients think their consultant fees buy more skill than that.

Other work backs this up. A paper published in the journal *European Financial Management* in 2016 compared the effects of internal versus external due diligence on private equity portfolio returns of multiple institutional limited partners. Again, greater internal due diligence correlated to higher returns across multiple metrics, such as internal rate of return (maligned as it may be) and multiples on invested capital, whereas external due diligence had no discernable effect. Still more research shows strong evidence that in private equity manager selection, some limited partners consistently outperform and others lag time and again. One standard-deviation increase in in-house skill for manager selection led to a three-percentage-point boost in returns. Picking managers as an aligned principal fiduciary, not as an agent, is key to successful outcomes, especially in alternatives, where dispersion is widest.

There's another simpler, practical problem. The client still has to pick the actual managers and construct the portfolio. The beleaguered fund-of-funds model solved for this by relieving the end client of the paradox of choice. As sponsors of 401(k)s have come to realize, simply dropping a massive menu of investment options in front of individuals creates analysis paralysis. Unable to come to grips with sorting through dozens of products, investors often simply do nothing. And when they do roll up their sleeves to figure it out, their picks underperform on average.

The institutional appetite for funds of funds has long since abated, but I think this may have more to do with disappointing returns and the added layer of fees than the actual structure. Focusing on specific outcomes may be the solution. Indeed, 401(k) plan sponsors already know this. Most have significantly streamlined their offerings, and in many cases default members into a target-date fund — a fund of mutual funds mixed according to members' projected retirement dates. These one-stop-shop products change allocations as members age, often for one transparent all-in management fee. In the defined-contribution world, reducing options, focusing on outcomes, and unburdening individuals has substantially increased participation rates and, more important, average client balances.

No investor needs hedge funds or private equity per se. The entire exercise is about curating the exposure to generate a desired return profile, either superior capital appreciation or higher income than is possible via traditional markets, thanks to differentiated and less liquid risks. I'll call this "Retail Alts 2.0": owning the management of the portfolio, ensuring outcomes meet expectations, and getting paid on that basis. Sourcing, diligencing, selecting (or perhaps more accurately, declining over and over and over until finally finding something worthwhile), structuring, and monitoring will matter more than mere access. But that model probably won't scale so well.

The rules of the game are quite literally changing as we go. Yet one remains constant: Alpha and scale are invariably antithetical to one another. Which business model will you choose?

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