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Global Alternatives Distribution Survey 2018

The right strategy, at the right price

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AIMA
THE ALTERNATIVE INVESTMENT MANAGEMENT ASSOCIATION

Foreword

The alternative funds industry is changing fast. Investors are hyper-sensitive to value for money, and keenly aware of paying predominantly for alpha. They are also increasingly tuned into overall outcomes as opposed to simply raw performance and are demanding better and customised strategies. And they want all this at fee levels that many in the alternative investments industry would not have considered a decade ago.

This has significant distribution implications for alternative fund managers, as they adapt to keep pace with these growing demands, examining all aspects of their business and marketing models and making changes where they can.

But, in other ways, the industry has changed little over the years. Marketing and sales are conducted predominantly by email and telephone, and introductions tend to be face-to-face. The array of new technology used to market and distribute products in other sectors – including in traditional fund management – is virtually non-existent in the alternatives world. This appears at odds with an investment sub-sector which has led the way in mining Big Data and using technology to unearth and implement investment trends.

This report, a collaboration between PwC and the Alternative Investment Management Association (AIMA), examines the two-speed nature of the alternative funds industry and investigates, through a survey and interviews, how alternative fund managers are processing it.

The report is based on a survey in late-2017 of over 140 PwC clients and AIMA members managing alternative fund strategies, with respondents ranging from small to larger managers in alternative fund assets.

The survey was carried out among alternative fund managers in Europe, North America and Asia, many with extensive distribution networks (see Survey Demographics section, below). PwC also interviewed managers at a number of firms on a one-to-one basis to uncover specific detail about their sales practices and add colour to the report. Many of their comments and insights are included in the report.

Jack Inglis
Chief Executive, AIMA

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Executive Summary

In this latest phase in the development of the alternative funds industry, investor demands are rising fast and expectations are sky-high. In terms of reporting, transparency, operational efficiency and, of course, investment returns, investors are demanding near-faultless performance in return for the higher fees sometimes associated with the industry.

There is no suggestion that wholesale change is required to distribution models. But with more capital being allocated to fewer managers, only those who understand that performance, strategy, consistency and reputation must come as a package are likely to attract the size of flows that will allow them to compete going forward.

The outcome is everything

According to the alternative fund managers surveyed, investors see performance as paramount. The difference with the past is that, from the investors' perspective, performance is measured through a broader set of outcomes rather than absolute returns. Outcomes in this context being the delivery of solutions to specific investor needs, as opposed to a more simply defined product, drilling past pure performance to look at how that performance fits with investors' requirements. Whatever the aim, the key for alternative fund managers seeking further allocations is to identify individual needs of clients and then build in the flexibility and skill sets to meet these needs.

To keep their products relevant and meet the growing expectations of their investors, managers proactively monitor investor profiles. Pension plans, endowment, funds of funds and high net worth (HNW) investors are the biggest allocators globally to alternatives. But there are material regional differences.

In continental Europe, funds of funds are the highest allocators to alternatives, and in the UK the largest investor type is pension schemes. In the US, endowments, foundations and charities represent a far larger single investment investor type than in other regions.

Face-to-face access prized above all else

The need to customise their offerings is driving managers' marketing behaviours. As capital is driven to fewer and larger alternative fund managers, other managers know they must articulate their value proposition with vigour and clarity to compete. It is not enough to have a niche strategy and peer-beating performance if those virtues are not reaching the right investors.

Alternative strategies have always depended to a degree on face-to-face communication and firms are prepared to invest considerable sums to get in front of prospective investors. As a large asset manager attests: "It's all about people. Digital distribution doesn't work for alternatives."

The slow adoption of technology by many alternative investment firms for distribution purposes contrasts strongly with the adoption by alternative firms of technology for enhancing investment strategies.

While the uptake of digital distribution will gradually expand, alternative fund managers indicate there are barriers to this expansion. Chief among them is regulation, closely followed by a lack of in-house expertise to operate platforms and also a lack of willingness on the part of some existing investors to engage and transact via a digital platform.

Buyers hold whip hand on fees

With global equities rising more or less consistently since early 2009, not all investors are willing to pay elevated fees for undifferentiated returns that have been available through passive tracker funds. Accordingly, in the current buyers' market, investors can exert considerable pressure on fees. The 2+20 fee structure for hedge funds is rapidly disappearing, with 1+10 more common, and even lower for large tickets or early bird investors.

But the fee adjustment is not completely over: just over a fifth of respondents say they will lower fees, either to attract new investors or retain existing ones. A large fund of hedge funds manager says it has lowered fees for its key "strategic partnerships" in order to retain assets, and plans to lower fees selectively to attract new investors.

Many alternative fund managers have reduced their fees over the course of the equity bull run and some may feel they have cut their margins to the bone. In addition, their operating costs are rising as many invest in new technology and as competition rises for quantifiable investment skill. So, fees are not likely to move much further in the near term. More than three-quarters of respondents are not planning to lower their fees.

Politics unlikely to disrupt buying patterns

The exit of the UK from the EU, due to take place in March 2019, has the potential to impact the alternative fund management industry the world over. Although a transitional period during which little will change until the end of 2020 is being negotiated, managers have already started to plan for change. Still, unless a 'no-deal' scenario materialises, investors and managers will be operating in the same environment for the next two and a half years.

It is too early to speculate on how the UK and EU will develop from the point of view of ease of cross-border distribution of funds. But it is likely that the EU will most likely become marginally more restrictive in the way non-EU funds will be able to be marketed in the EU (it is already difficult today), mainly by lowering barriers within the single market. The UK may become more liberal as was witnessed, for example, by the UK regulatory authorities extending a temporary permission regime to EU firms to ensure the smooth operations of those entities under any potential scenario.

The biggest potential impact on the way EU markets will be accessed by non-EU firms will revolve around any changes to the rules on delegation of portfolio management. Currently, a great number of non-EU firms rely on the ability of their affiliates established in the EU to outsource portfolio management services to entities located outside the EU. If this regime continues without major disruption, difficulties with access to the EU market can be significantly mitigated. Brexit has started a debate on whether and how delegation rules ought to be changed, but significant change is unlikely to materialise in the near future – it is more of a medium-term prospect.

Finally, the industry is still processing the impact of the recently-enacted comprehensive US tax reform. This US tax reform will impact financial markets broadly and may have impacts on specific alternative investment strategies. Some strategies may see a marginal uplift to returns, and some may be able to offer more tax-efficient opportunities to investors.

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1. The outcome is everything

Ever more mindful that alternative funds are a premium investment product often with a premium price attached to them, investors expect considerably more from their alternative fund providers than in the past.

This puts the onus on alternative fund managers to produce strategies which are more tailored to each client and more outcome-orientated. The desired outcomes may be capital preservation, upside opportunities, access to less correlated assets or a wide range of other requirements. As one large US investment firm noted: "Consistency, track record and pedigree are what investors really look for."

What investors want from their alternative assets

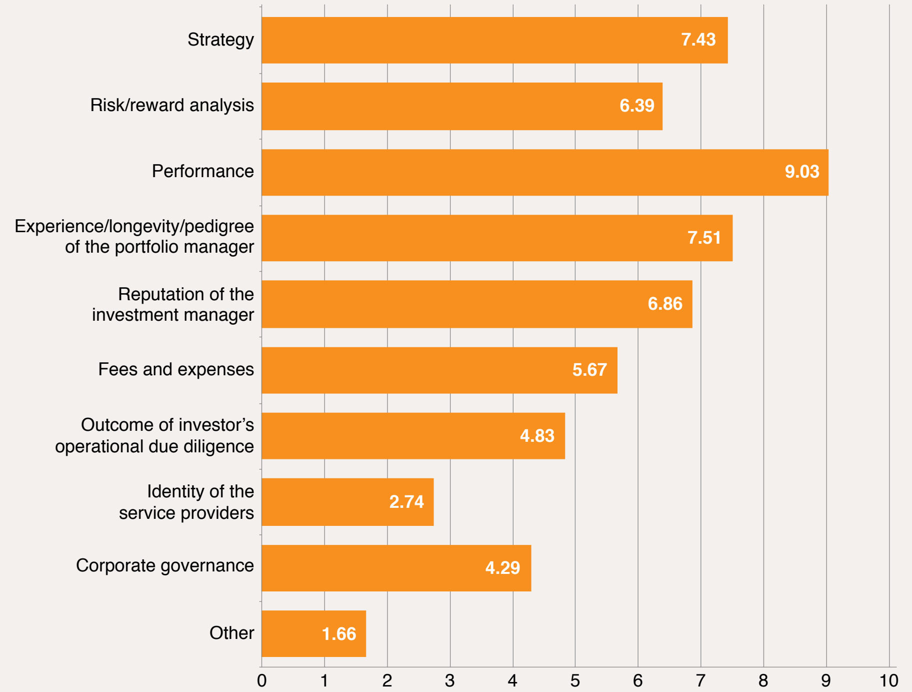
According to the alternative fund managers we surveyed, investors see performance as very significant. The difference with the past is that performance is measured in outcomes rather than just absolute returns.

In fact, performance is viewed as even more important than it was in our previous (2015) survey. In 2015, performance was considered the most important driver for investors when selecting alternative funds. Although performance scored 8.54 in 2015, it scored 9.03 in the current survey.[1]

1 Note: Respondents were asked to rank multiple options. Numbers represent a weighted frequency of rankings awarded to each option.

This bears out our 2015 thesis that investors were starting to expect much more from their alternative managers, including performance that meets mutually-agreed expectations.

Figure 1: Rank the following key drivers for selecting investments in alternative asset funds in the order you think an investor would place them, starting with 1 being the most important.



Note: Respondents were asked to rank multiple options. Numbers represent a weighted frequency of rankings awarded to each option.

Source: PwC/AIMA Global Alternatives Distribution Survey 2018

Amid ultra-low bond yields, performance for many investors means accessing steady returns. Consistency of returns has displaced high-octane performance as the main attraction of alternative funds for investors. As one US-UK placement agent says: "Institutional allocators are yield-hungry. They have to meet targets and need a certain yield. If you can provide that, then you are on to a winner."

> Asian alternative fund manager distributing mainly in the US: "Absolute return on its own is not enough, especially in a year where most managers had good returns."

A large US asset manager notes: "[Past] performance is important, but not the most important factor." It believes consistency, track record and pedigree are what investors really look for. "It is important to know what gap the investor wants to fill in their portfolio - do they want pure yield, do they want to manage volatility? Many investors are outcome-focused and very mindful of volatility."

Strategy is critical too, managers say. Having a clear and defined strategy and then sticking to it is essential in producing the outcomes desired by investors.

"Strategic fit is important", according to a mid-sized continental European alternatives manager. Investors tend to come to a firm looking for a particular strategy with higher return, but less liquid strategies are in big demand at the moment, it says.

According to alternatives managers, after performance the next most important drivers for selecting assets are experience, longevity and pedigree of the manager.

Offering illiquid and other niche products helps distribution efforts, particularly for smaller alternative fund managers. A UK-based hedge fund manager, for example, says its emerging market debt strategy is a good fit for the large numbers of investors seeking comparatively low volatility while maintaining relatively high yields.

Meanwhile, one of the large US managers in the survey we spoke to sees alternative finance, such as direct lending and peer-to-peer financing, as particularly attractive to investors seeking yield.

High-alpha strategies such as Asian long-short equity funds and highly-concentrated portfolios are also in demand for investors' return-seeking "buckets".

Mixed attitudes towards corporate governance

Reputation is also ranked highly by survey respondents, but corporate governance is ranked low, even lower than it was in 2015. The reasons for this relatively low ranking are unclear, but it is likely that more firms feel they have achieved at least a base level for corporate governance.

In fact, managers most likely still have the same regard for governance, but because of the improvement in governance after the financial crisis and increasingly less flexibility with respect to governance due to mandatory regulatory requirements, investors are no longer struggling with what good governance looks like and most funds are readily able to "tick the box" on this. Accordingly, it is less of a differentiator now and therefore less relevant as a selection factor for investors. An exception to this possibly being the role of a Limited Partner Advisory Committee (LPAC). On occasion, the LPAC can fulfil an important function, allowing the investor to have a seat at the table and in so doing help manage any conflicts.

In their own words: corporate governance

UK alternatives manager: *"Corporate governance is important, but not normally a deal blocker. It can delay the deployment of capital, but normally time is given for issues to be resolved. The only managers who fail the due diligence process are the ones that simply don't want to change."*

Mid-sized Hong Kong manager with mainly US investors: *"Governance seems to be less of an issue with investors – probably because there have been few, if any, recent headlines linked to governance failures in the alternative funds industry."*

Asia-based active currency manager: *"Corporate governance is a given. Poor governance equals no cash."*

Like governance, minimum standards of operational infrastructure have generally been reached. Managers can expect investors to run the rule over every aspect of their operations during the due diligence phase. There is little "operational alpha" these days - firms must simply have at least the minimum standards sought by an investor (for a particular strategy).

A mid-sized Asian manager says: "All investors, or third parties on behalf of investors, conduct robust operational due diligence prior to investing. We take this very seriously and spend a lot of time responding to the interviews."

Indeed, in late 2017, AIMA published a new edition of its flagship due diligence questionnaire (DDQ),[2] 20 years after the first AIMA DDQ helped to standardise the due diligence process for alternative fund managers and investors.

One investment manager interviewed, said that the due diligence process is considerably more robust now than even five years ago.

Who's buying?

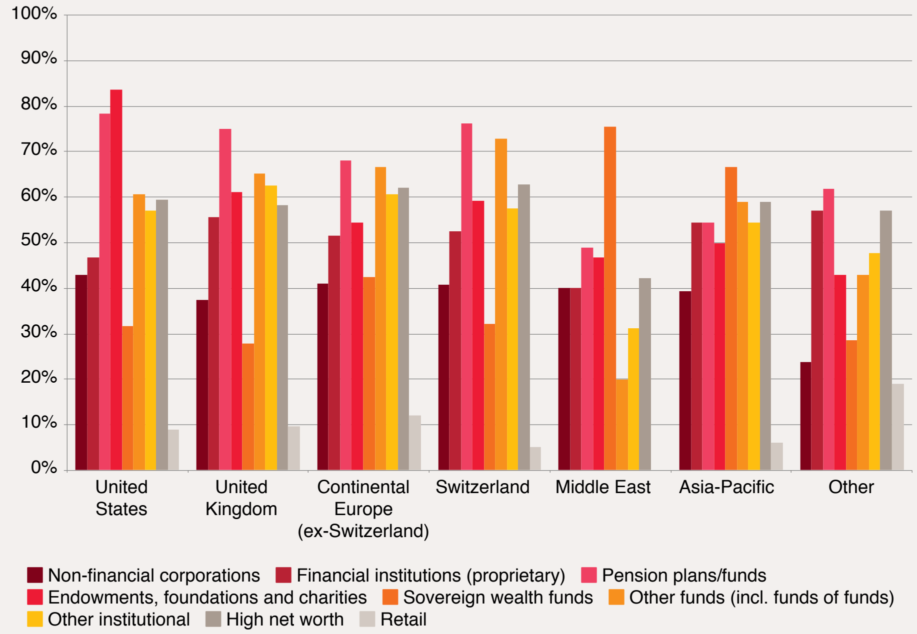
To keep their offerings relevant and meet the growing expectations of their investors, managers must keep abreast of changing buyer profiles.

Historically, pension plans, endowments, funds of funds and HNW investors have been the biggest allocators worldwide to alternatives. But there are considerable regional differences.

Among continental European investors, funds of funds are the highest allocators to alternatives and among UK investors, pension schemes are the biggest allocators.

Irrespective of the quantum of assets available, fund of funds investors are not sought after by all firms. As one mid-sized Asian hedge fund manager told us: "We try not to accept fund of funds investors, given they generally tend to put a lot of pressure on fund managers on fees, given the two-layer investing structure." Obviously, size and scale come into play here, and larger players may well have the muscle to push for reduced fees.

Figure 2: Which types of investors are you currently selling to in each of the following markets?



Source: PwC/AIMA Global Alternatives Distribution Survey 2018

2 www.aima.org/article/aima-launches-new-due-diligence-template.html.

Buyer profiles set to change

In the US, endowments will continue to be the most actively-targeted investor type over the coming three years, as they were in the last survey, with pension plans still expected to be the second-biggest allocator to alternatives.

Only the larger alternative fund managers will be able to access the US pension plan market though. A small investment manager noted the difficulties for smaller players: "Pension plans mainly invest via consultants, so it's difficult for sub-$1 billion funds to break in because you are not on the consultants' radar screen."

HNW individuals will remain just the sixth most targeted investor type in the US. One reason that HNW is only ranked sixth is that this category of investors is rarely targeted individually these days. There are a number of large alternative platforms, mainly set up by large investment banks, which allocate to alternative funds on behalf of large numbers of HNW investors. So it is probable that HNW investors have now become part of the institutional mix from a marketing standpoint, although not necessarily from a regulatory view.

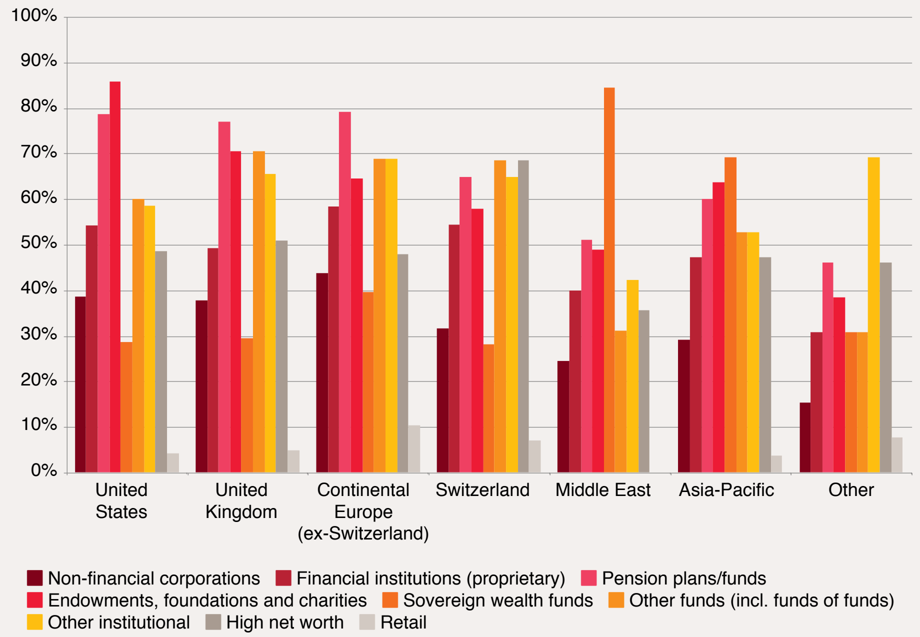
Some firms, however, are convinced that the HNW market holds out great promise and that the only problem is lack of commitment to it from providers. A very large US traditional and alternative fund manager says: "For US accredited investors, there is a lack of good-quality products tailored to their needs. We feel we have the products to fill this gap and are working on our distribution strategy."

In the US, endowments, foundations and charities represent a far larger investment type than in other regions.

In Asia and the Middle East, sovereign wealth funds (SWFs) will continue to be the largest single client segment. In Asia, this is closely followed by endowment funds, which will be attracted to alternative assets as they innovate to seek out new return streams. The HNW segment will still be important in Asia, but relatively less so.

Pension plans in Asia and the Middle East will become much more important sources of capital as middle classes in those regions expand and pension fund assets swell.

Figure 3: Identify the types of investors your fund intends to target in each country or region where you expect to actively market in the period 2018-2021.



Source: PwC/AIMA Global Alternatives Distribution Survey 2018

In continental Europe (excluding Switzerland), and in the UK, pension funds are expected to allocate more strongly to alternatives. However, in Switzerland, the HNW segment will still be a big contributor to assets under management, but matched in the future by funds of funds and, increasingly, pension funds.

The Sovereign Wealth Fund opportunity

The Middle East continues to represent the best market place to source SWF investment, offering a substantial opportunity for alternative fund managers.

SWFs now allocate almost a quarter of their assets under management to alternative funds such as private equity, real estate, gold and infrastructure, according to a 2018 PwC report. The report, *The rising attractiveness of alternative asset classes for Sovereign Wealth Funds,*[3] found that SWFs have responded to adverse conditions since 2014 (essentially falling oil prices), by broadening their investment strategies. In fact, this trend has been observed for about seven years, with the allocation of SWFs to alternatives increasing from 19% to 24% to the end of 2016, according to the PwC report.

SWFs allocate about 7% of their total assets to hedge funds and SWF money represents about 12% of the global hedge fund industry. PwC expects strong growth in SWF alternative portfolios as they diversify away further from traditional asset classes.

Alternatives offer a number of benefits that SWFs seek: increased diversification, principal protection, a hedge against inflation and an increase in portfolio performance. In other words, SWFs seek asset classes which provide very specific outcomes.

3 https://www.pwc.com/gx/en/industries/assets/pwc-world-gold-council-report-january-2018.pdf

Investors take time before committing

One consequence of the more outcome-oriented investor outlook is that decisions to allocate to alternative investment strategies are taken with extreme care. This leads to longer lead times.

Around a quarter (23.5%) of respondents say lead times to investment are three to six months, with 66% citing longer timeframes. In other words, investors will not be rushed. They are aware that this is a buyer's market and are taking their time to choose their strategy and obtain the best conditions.

Alternative fund managers are therefore forced to be patient and accept that they must play a longer game.

Leveraging marketing potential

For the desired investment outcomes to be achieved, alternative fund managers must have sophisticated processes in place to be able to profile their clients.

It is an open question whether alternatives managers have the structures in place to find out exactly what investors really want their investments to achieve. A UK placement agent notes: "Hedge funds assume investors allocate for a reason, without actually asking them what the reason actually is. If they did, the majority would be very surprised by the answer."

Communicating with allocators will be important going forward. As a large US manager says: "Managers and big allocators will be joined at the hip for years to come on big tickets, so all concerned need to ensure it is a good long-term fit."

With the costs of managing alternative investment firms and funds rising, and difficult choices ahead regarding the use of technology, there is growing pressure on marketing teams. These teams are often sparsely populated compared with their counterparts in traditional asset management firms.

Over two-thirds of the alternatives managers in the survey say their in-house sales function consists of between one and five professionals.

This partly reflects the size and maturity of alternatives managers compared with traditional managers. Around 40% of the firms in the survey were established during the last 10 years and nearly three-quarters of the surveyed group have less than $10bn in assets under management.

In addition, just over 10% of fund managers can call on the expertise of more than 10 full-time in-house marketing professionals. The reasons for this are various, but include that marketing can be outsourced to prime brokers and placement agents, or may be carried out by the same staff who manage the investments. One large manager of hedge funds interviewed noted that its 40-strong international sales team was substantially replaced due to a higher reliance on broker-dealers.

It is also possible that some funds simply undervalue the marketing function and allocate insufficient resources to it (or, possibly, were simply not raising capital at the time of the survey).

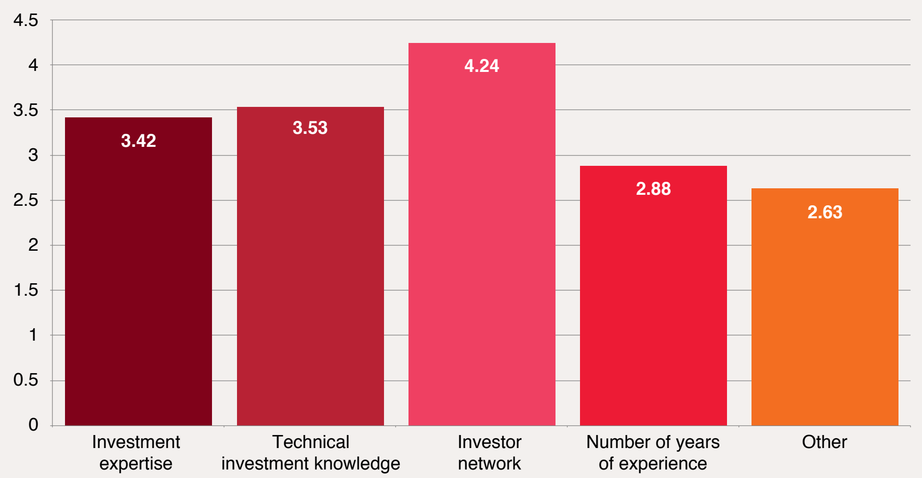
Highly-specific skills required

Despite the apparent lack of resources in the marketing functions of some firms, the same firms are clear about the skills they are looking for when heading to the market to hire marketing professionals.

The primary skill sought is the depth of the candidate's investor network, suggesting there are not typically roles in which marketing professionals from other industries can succeed. This, in turn, suggests the gene pool for marketers in alternative funds is unusually small, engendering intense competition for skilled, experienced marketers.

The other skills demanded reinforce this message: technical investment knowledge, investment expertise and years of experience are all valued above general marketing ability.

Figure 4: Rank the following in order of importance (with 1 being the most important) with respect to hiring internal personnel to market your fund.



Note: Respondents were asked to rank multiple options. Numbers represent a weighted frequency of rankings awarded to each option.

Source: PwC/AIMA Global Alternatives Distribution Survey 2018

2. Face-to-face access prized above all else

The desire to differentiate and tailor their offerings is driving managers' marketing behaviours. As capital heads for ever fewer firms, the survivors know the clarity with which they must articulate their value proposition. It is simply not enough to have a niche strategy and great performance if that message is not reaching investors.

Alternative strategies have always depended to a large degree on face-to-face communication. Just as at a private bank you have a dedicated banker you can meet rather than an outsourced call centre, so it is with alternative funds.

And managers are willing to invest considerable sums to get in the same room as prospective investors. The costs of hiring local teams, travel and translation are all high, but worthwhile in an industry where trust is king and personal contact is at a premium.

As a large US asset manager attests: "It's all about people. Digital distribution doesn't work for alternatives. Institutional allocators talk to each other, a lot, and word of mouth referrals are a big source of new business."

For this reason, the sales function is mutating and charm is no longer sufficient to sell a strategy. Not long ago, the sales team would establish contact with and start to gain the trust of prospective clients to lay the groundwork for the technical side to swoop in and close the deal. Today, the client may only grant you one chance, one meeting, so sales people are required to be subject matter experts on their firm's products.

To get that all-important first (and perhaps only) meeting takes persistence. Networking at conferences and even informally at corporate and private dinners is commonly cited as essential for gaining word-of-mouth momentum. Some larger alternative firms have even set up their own annual conferences, both as an aid to networking and as an adjunct to branding.

"Word of mouth references are important among pension allocators. They all talk," says a mid-sized UK manager. "They will not refer per se, but there are a few leaders in the allocator network and when word gets out that they have allocated to a certain fund, then others get interested."

Premium on direct contact

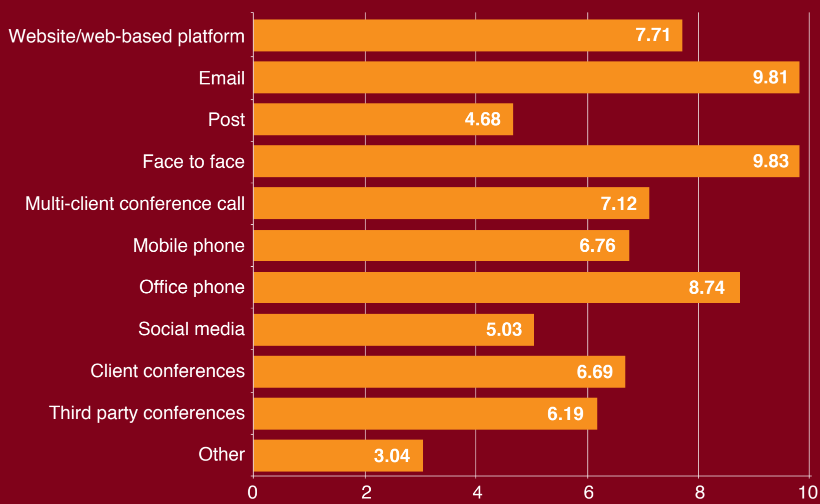
Even amid the current technology explosion, the ability to look a client in the eye is more valuable than any kind of digital engagement, according to many alternative fund managers.

There is a need to explain the complex products and strategies that are a feature of alternative investment strategies, and this is best done within the confines of a face-to-face setting. In addition, direct communication is critical to achieving big ticket sales of alternative strategies to institutional and HNW investors. The trust necessary for such a large transaction to take place necessitates a personal relationship.

While face-to-face meetings are rated the most important communications tool, the second and third most important are good old email and phone call exchanges, to follow up on face-to-face meetings or pave the way for meetings. This was consistent across all regions.

The longevity of these "old-school" tools in the alternative investment sector indicates the sense of permanency and visibility that some investors require. This is particularly true when investors are dealing with alternative investment firms in a different region.

Figure 5: Rank the tools your firm currently uses to communicate with its investors and/or potential investors in order of importance, with 1 being the most important. If you do not use a particular distribution strategy, do not give it a ranking and tick the corresponding N/A box to the right.



Note: Respondents were asked to rank multiple options. Numbers represent a weighted frequency of rankings awarded to each option.

Source: PwC/AIMA Global Alternatives Distribution Survey 2018

The most fruitful distribution channels

As may be expected in an industry where direct contact is at a premium, the most useful distribution channel is judged to be the fund manager's staff reaching out to engage with prospective investors. After that, it's referrals from existing investors. Next comes prime broker capital introductions and recommendations by consultants.

A Hong Kong manager notes: "Referrals from personal contacts and existing investors do crystallise into investments much quicker than referrals through the prime brokers."

The consultant model has been used in the US and the UK for many years and helps position the consultants as gatekeepers to some alternative assets. A large US-based manager said: "You don't just need to be on the consultants' list, you need to be at the top of it. Once you are on the list, then the conversations start and you go from there."

Figure 6: Rank your use of the following distribution channels starting with 1 as the most important. If you do not use a particular distribution strategy, do not give it a ranking and tick the corresponding N/A box to the right.

Note: Respondents were asked to rank multiple options. Numbers represent a weighted frequency of rankings awarded to each option.

Source: PwC/AIMA Global Alternatives Distribution Survey 2018

The consultant model has started to penetrate Asia, where alternative strategies are increasingly in demand for diversification purposes. As an Asia-based hedge fund manager says: "Referrals from consultants have worked very well for us, bringing brand new investors - not just assets from existing investors."

The capital introduction services offered by prime brokers are seen as a less likely source of assets than in the previous survey. A Hong Kong-based manager says that capital introduction teams are "over-rated" and that hedge fund managers should not make prime broker selections based on the capital introduction team.

The news media is no more popular as a marketing channel than it was in the last survey, where it ranked low as a source of finding new clients. Most firms interviewed say they avoid media exposure, except where it occurs as a consequence of speaking at industry events. A common refrain is that there is no way of controlling the message in the media and, worse, the message could be corrupted by factual inaccuracies and misquoting. Furthermore, there are also regulatory issues to contend with, as firms are not usually allowed to publicly market alternative funds.

Direct contact has its price

The obvious problem for an industry relying on direct contact is the elevated cost structure of distribution.

As might be expected in an industry where access and personal contact is at a premium, local marketing team costs and travel are the biggest marketing costs.

The cost of distribution in the EU is deterring some non-EU managers from raising funds within the EU. One Hong Kong manager mainly targeting HNWs and pension plans in US says: "The regulatory environment of US is simpler compared with European countries."

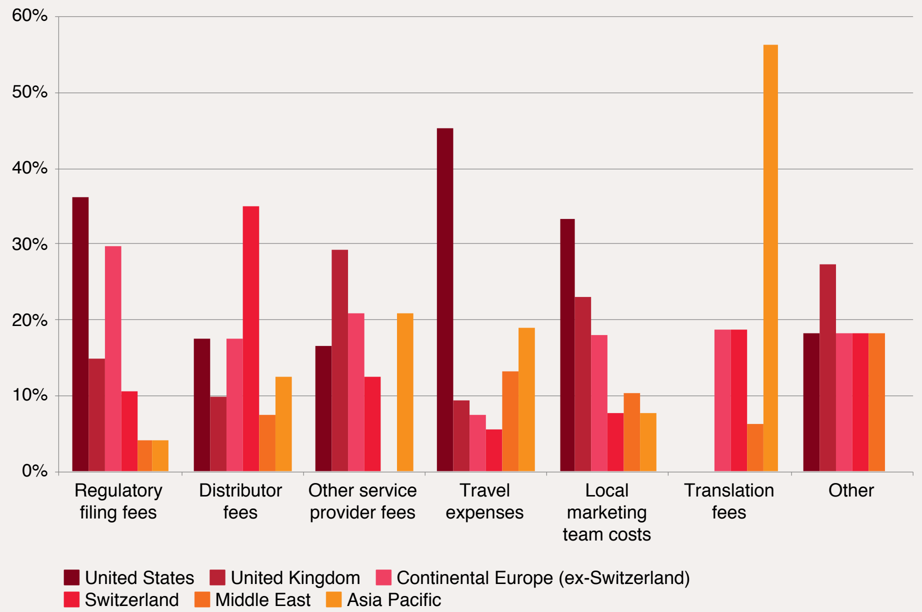
And some EU-based managers find AIFMD not useful when marketing to investors in other member states. The dysfunctional nature of the passport attached to AIFMD means many firms still need to obtain local approval for distribution.

Others have embraced the regulated alternatives fund environment in the EU. A large US asset manager says: "AIFMD is definitely better than the patchwork of private placement regimes. It has created an opportunity for larger managers with sizeable resources."

A mid-sized continental European manager notes that AIFMD is liked by many alternative managers much more than when it was first proposed back in 2009. "A lot of jurisdictions have embraced AIFMD. Many EU investors do not like Cayman funds anymore, leading to the increased pressure to redomicile products."

Overall, alternative fund managers say that Europe (ex-Switzerland and the UK) is the most expensive place to market funds, closely followed by Switzerland. The US is the third most expensive place to market funds.

Figure 7: What is the most expensive aspect of marketing in each of the following countries/regions?

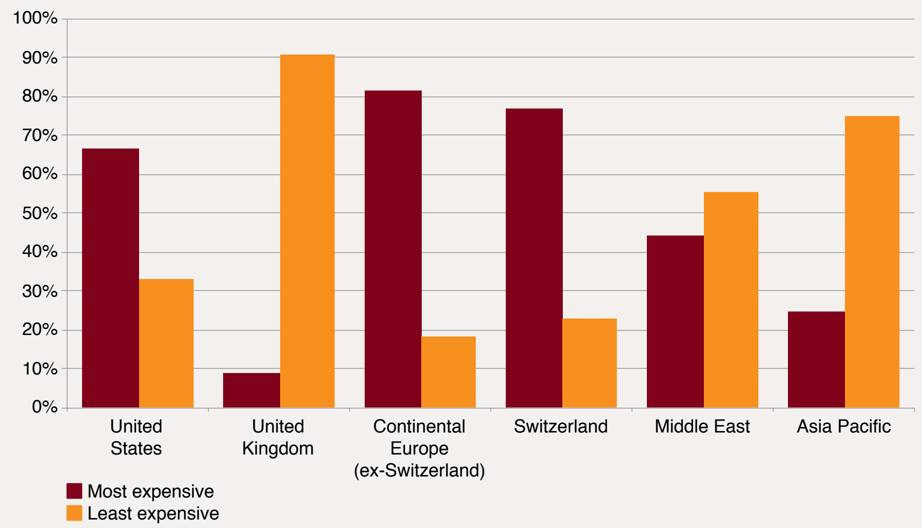


Source: PwC/AIMA Global Alternatives Distribution Survey 2018

In the US and the Middle East, travel is comfortably the most sizeable single cost for alternative asset managers. A large US fund of hedge funds manager says: "Travel and entertainment is not only the most expensive aspect of marketing to clients in all regions, but it is the second-largest expense item after compensation."

Regulatory filing fees are a substantial cost of marketing in the US. This is also an expensive aspect of marketing in Europe, given the variety of countries and the different fees imposed by local regulators. Other notable costs of marketing in Europe are the need for local service providers and translations.

Figure 8: Which country or region is the most expensive to market in? Which country or region is the least expensive to market in? For this purpose, consider all of the types of expenses listed in the prior question other than travel and any other expenses your firm incurs during distribution in each country/region.



Source: PwC/AIMA Global Alternatives Distribution Survey 2018

The least expensive place is the UK, cited by more than 90% of respondents. This finding can be partly attributed to the fact that 30% of respondents have their headquarters in the UK. It also reflects the fact that decision-makers tend to work in a concentrated geographic area. Furthermore, costs for translation are low since staff at all parties speak English. The next cheapest places to market funds are Asia-Pacific and the Middle East.

Technology revolution slow to impact distribution

Technology has the potential to bring down the high costs of distribution in the alternatives industry, but currently only plays a minor role. According to many in the industry, it might never play a big part, given the highly specialist nature of many alternative fund strategies, coupled with an investor base that many feel is resistant to the automation of processes.

A Hong Kong-based manager in the survey, for example, says his firm has "no interest in digital marketing", other than using email to send out monthly newsletters to potential investors.

The low utilisation of technology for distribution contrasts strongly with the adoption of technology for enhancing investment strategies. Hedge funds, in particular, were early adopters of Big Data techniques to uncover market and other trends that could give them an investment edge. Alternative fund managers have also been at the forefront of using technology in their middle offices. But, up until now, technology has not widely penetrated their marketing and distribution strategies.

Another Asia-based manager says there is no digital aspect to the firm's marketing activities "since the target clients are high-end investors who prefer face-to-face tailored services."

That is not to say alternatives funds are not interested in new technology. Notably, some interviewees wondered if their peers were using technology for marketing and distribution. The implication is that they would like to harness technology if possible, but do not currently see how it can aid them.

Rebooting the brand

In fact, technology does have a small, but important, place in the distribution efforts of alternative fund managers. In their branding efforts, most firms build websites in order to bolster their web presence.

While these websites tend to be for information purposes only and are not interactive or transaction-enabled, attention to design and detail are important in the creation of the website. Even firms that do not actively promote their brand tend to have website presence.

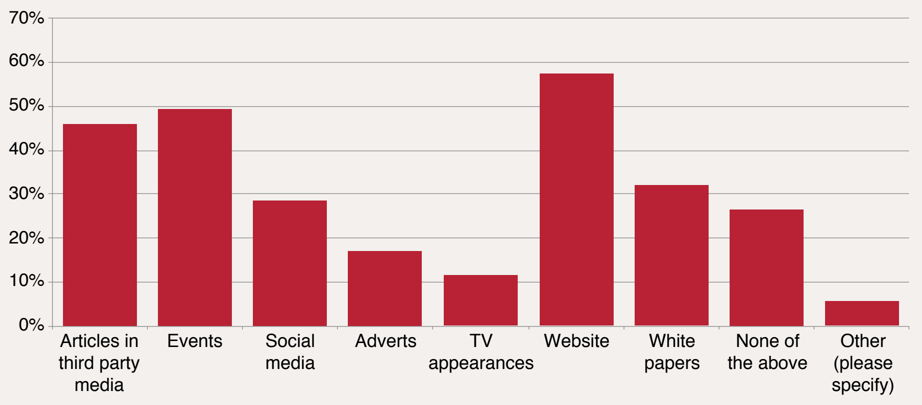
Social media, on the other hand, ranks low as a means of communication, as it did in our last survey. Despite the hype, not everyone wants to communicate by Facebook or be targeted by Twitter and LinkedIn messages. The feedback in our one-to-one interviews even suggests a sales approach leveraging social media might deter some investors.

Nevertheless, while digital marketing is not employed to target the current investor base, this might change as the millennial generation moves up the wealth chain.

Looking ahead five years', some of the many marketing tools employed by alternatives managers will only change at the margins.

The primary means of communication will still be face-to-face and by email. However, there will be an increase in importance of web-based platforms and, to a lesser extent, of social media. Many firms will still use old-fashioned post to communicate with clients and the landline to talk to them.

Figure 9: Which of the channels below does your firm use to promote its brand?



Source: PwC/AIMA Global Alternatives Distribution Survey 2018

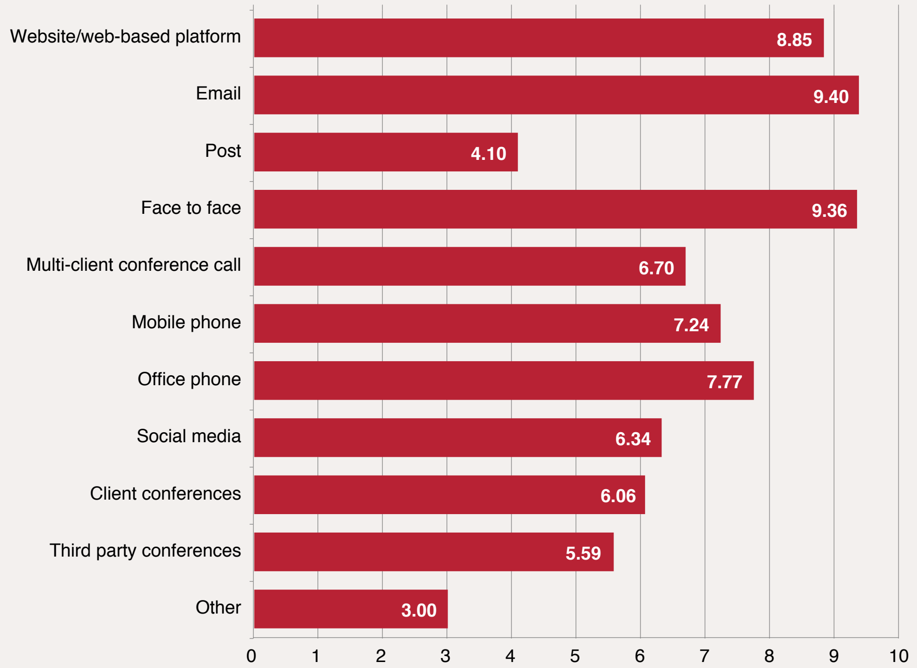
Obstacles to digital

While the usage of digital distribution platforms will gradually expand to accommodate millennials, respondents to the survey indicated there are barriers to this expansion. Chief among them is regulation, closely followed by a lack of in-house expertise to operate platforms and also a lack of willingness on the part of existing investors to engage and transact via a digital platform.

"Regulation is definitely a barrier," says a mid-sized UK hedge fund manager, "but once you have the scale to invest in the infrastructure it can be managed."

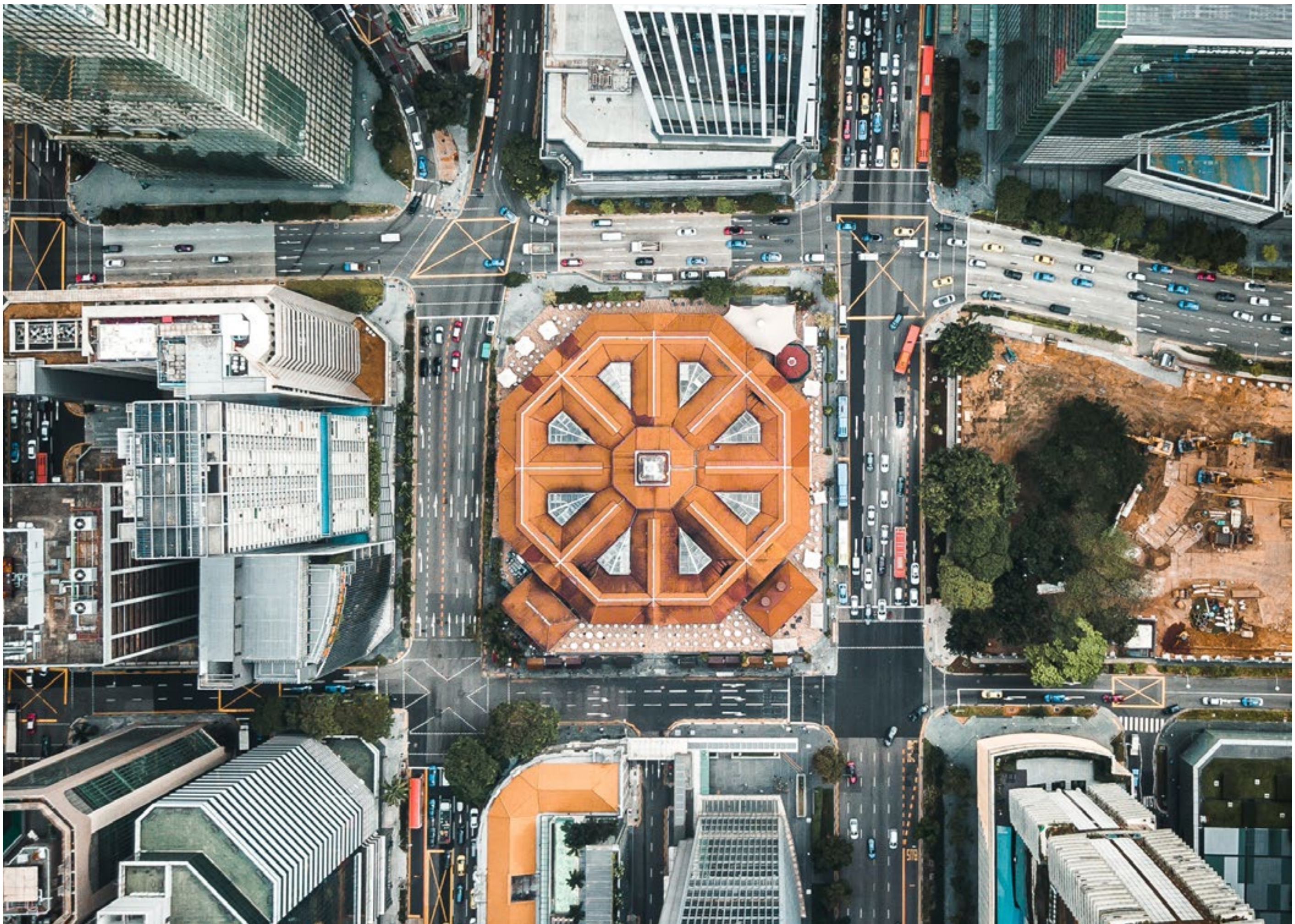
A Hong Kong manager cites privacy regulation as a key challenge: "In terms of digital distribution, the General Data Protection Regulation (GDPR) is a big deal. Separately, although not a regulation per se, cybersecurity issues are also potentially disruptive to digital distribution."

Figure 10: Rank the tools your firm uses to communicate with its investors and/or potential investors in order of the importance you think they will have in 5 years' time, with 1 being the most important.



Note: Respondents were asked to rank multiple options. Numbers represent a weighted frequency of rankings awarded to each option.

Source: PwC/AIMA Global Alternatives Distribution Survey 2018



3. Buyers hold the whip hand on fees

In a buyer's market, investors can exert considerable pressure on issues such as fees and transparency. By common consent, the 2+20 fee structure for hedge funds is quickly becoming a relic, with 1+10 more prevalent and even sometimes lower for very large tickets.

With global equities having risen consistently since early 2009, investors are balking at paying high management fees, particularly in an environment where returns have been available through simple passive funds with much lower fees.

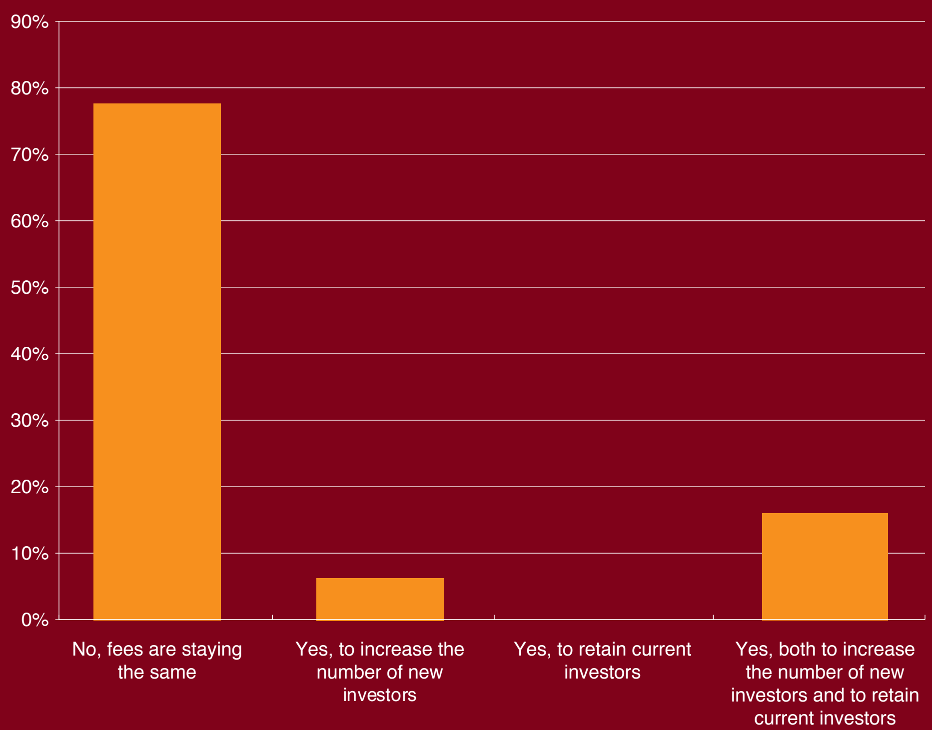
Fees may have reached their low point

Alternative fund managers have reduced their fees over the course of the equity bull run and some may feel they have given enough ground. This is particularly the case for managers who are seeing their costs rising through investment in new technology and demand continuing to rise for proven investment skill.

So, fees are not likely to move much further in the near term. More than three-quarters of the survey respondents say their firms are not planning to lower their fees.

A large US asset manager says fees are now far less sensitive in its alternative range than in the traditional business.

Figure 11: Are you planning to lower the fees offered in your fee structures?



Source: PwC/AIMA Global Alternatives Distribution Survey 2018

Meanwhile, an Asia-based manager believes the multi-year track record of its capacity-constrained, non-correlated strategy is sufficiently impressive not to have to lower fees. It has suffered no negative years and says it is "not interested" in talking to investors that seek to negotiate on fees.

But the fee adjustment is not completely over: just over a fifth of responding managers say they will lower fees, either to attract new investors or retain existing ones. A large fund of hedge funds manager says it has lowered fees for its key "strategic partnerships" in order to retain assets, and also plans to lower fees selectively to increase the number of new investors.

Other managers have been willing to adopt innovative fee models, agreed in advance with investors. Some managers, for instance, receive no management fee, but a higher performance fee for any alpha generated. Indeed, there has been a growing interest in the 1+30 concept, where managers are primarily rewarded for true performance, with a minimal management fee to cover base level running costs.

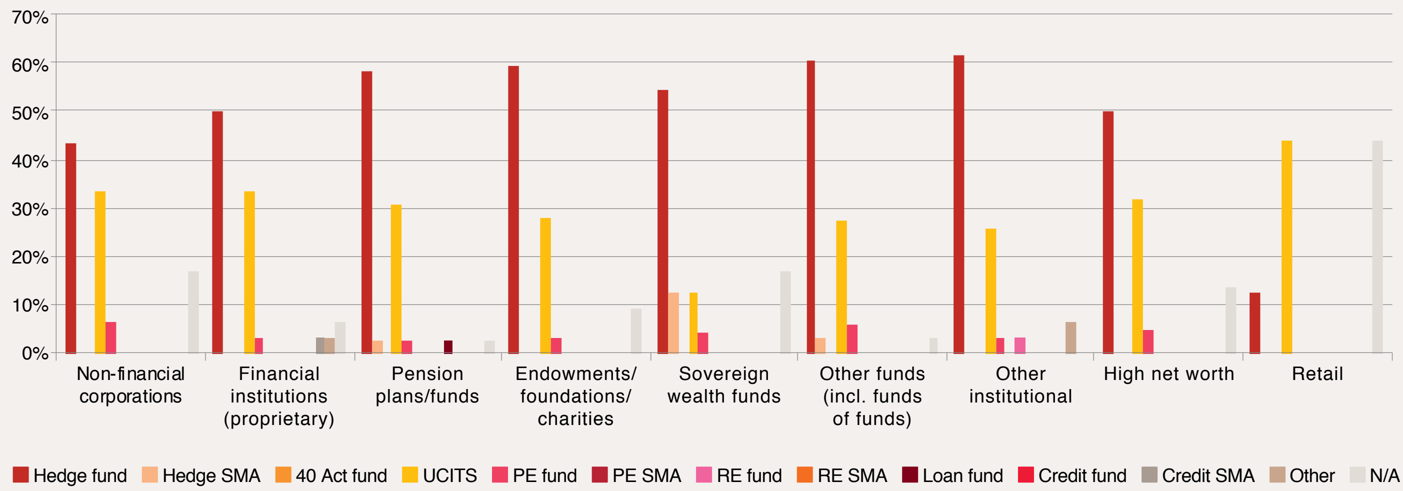
Which products will see future demand?

The fees and outcomes story is accompanied by another shift: to liquid alternatives (in certain regions).

According to the survey findings, liquid alternatives funds are expected to be popular with endowments, pension schemes and funds of funds across all regions. A full third of all HNWs investing in alternatives are expected to do so through UCITS funds and 44% of retail investors are expected to do so. In continental Europe, excluding the UK and Switzerland, UCITS are expected to be an even bigger part of the mix across all investor types, with the exception of SWFs.

In Asia, the commingled structure will be strong. There is also predicted to be some use of UCITS across all client segments, as the UCITS brand continues to hold the trust of Asian investors.

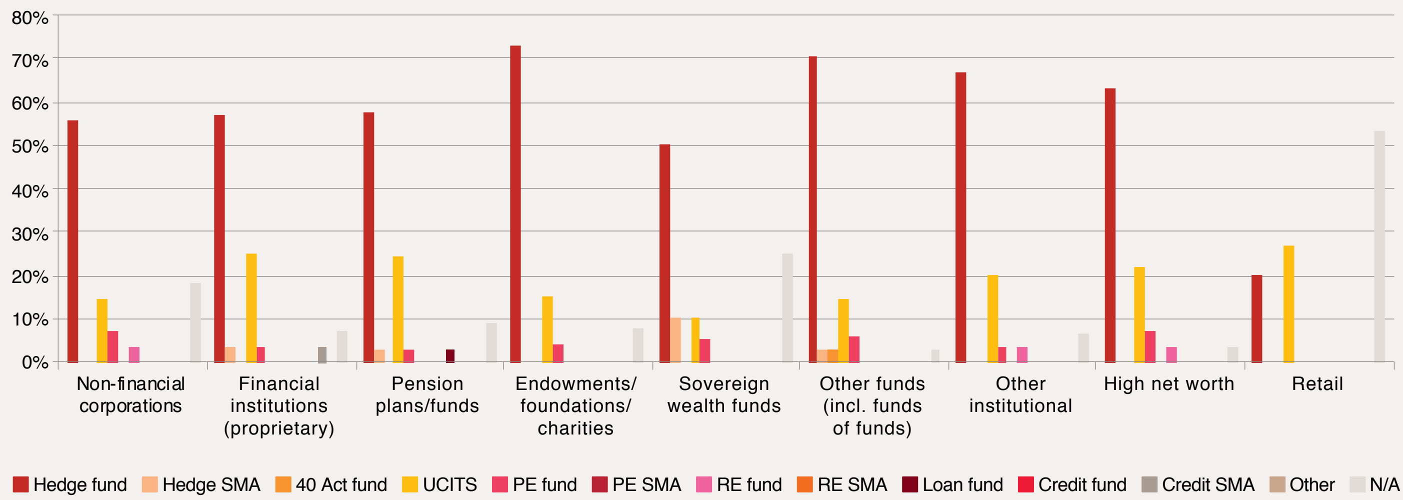
Figure 12: Continental Europe (ex-Switzerland)



Source: PwC/AIMA Global Alternatives Distribution Survey 2018

In Switzerland, traditional commingled alternative fund structures, as in the US, will continue to dominate. But there too, UCITS will be well represented in investors' portfolios, particularly among financial institutions, and in the HNW and retail segments.

Figure 13: Switzerland



Source: PwC/AIMA Global Alternatives Distribution Survey 2018

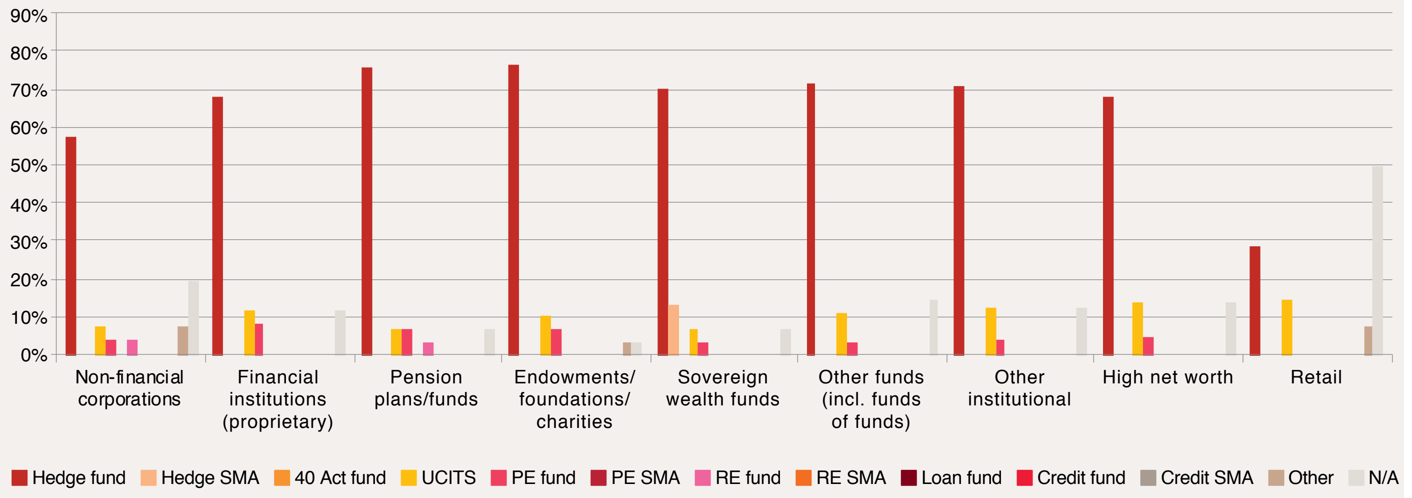
More alternatives managers are looking to break into the liquid alternatives space, to which they are typically under-exposed. A continental European hedge fund manager says: "Liquid alternatives are a big growth area for us. Lots of our alternative products are being structured into UCITS in particular, and all are taking in large flows."

The UCITS structure may also be a way for alternative fund managers to position themselves to access millennials in the future, possibly via digital marketing and trading. It may also help overcome restrictions, particularly in parts of Europe, on using offshore funds.

The exception to the widespread enthusiasm for liquid alternatives is in the US, where the established commingled hedge fund structure is expected to remain the most popular for all investor types.

In the Middle East, again the commingled alternatives fund structure will dominate. SWFs are expected to use separate accounts. UCITS will also be used to some extent.

Figure 14: Asia Pacific



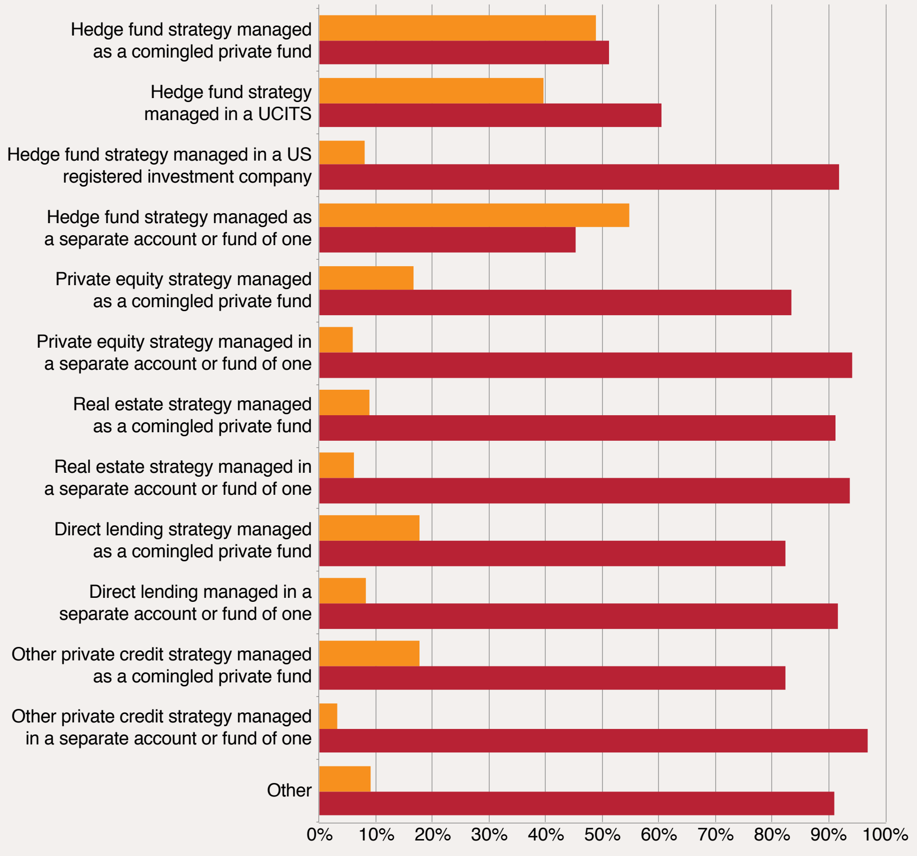
Source: PwC/AIMA Global Alternatives Distribution Survey 2018

Managed accounts to dominate new business

According to alternatives managers, deploying alternative investment strategies within a managed account have become more popular – 55% of firms plan to offer at least one managed account solution to investors.

The widescale prevalence of managed accounts would seem to support the earlier finding that many alternative fund managers are increasingly being asked to tailor their offerings to match the objectives and target outcomes of specific investors.

Figure 15: Are you planning to launch this type of fund?



Source: PwC/AIMA Global Alternatives Distribution Survey 2018

In their own words: managed accounts

A mid-sized UK manager: *"In the core business, we are doing more and more one-off mandates, responding to the tailored needs of investors."*

Active currency manager: *"The managed account can be a variation on an existing strategy or very client-tailored. The client typically wants something close to the commingled strategy but with a bit more flexibility, such as adding or reducing leverage when they feel more positive or negative about the strategy."*

Meanwhile, 49% of managers across all regions surveyed planned to launch a commingled alternative investment fund and some 40% planned to launch an alternative investment strategy within a UCITS structure. Those who are not launching UCITS funds tend to have very niche or illiquid strategies, or say UCITS funds may cannabalise sales of the less liquid fund structures.

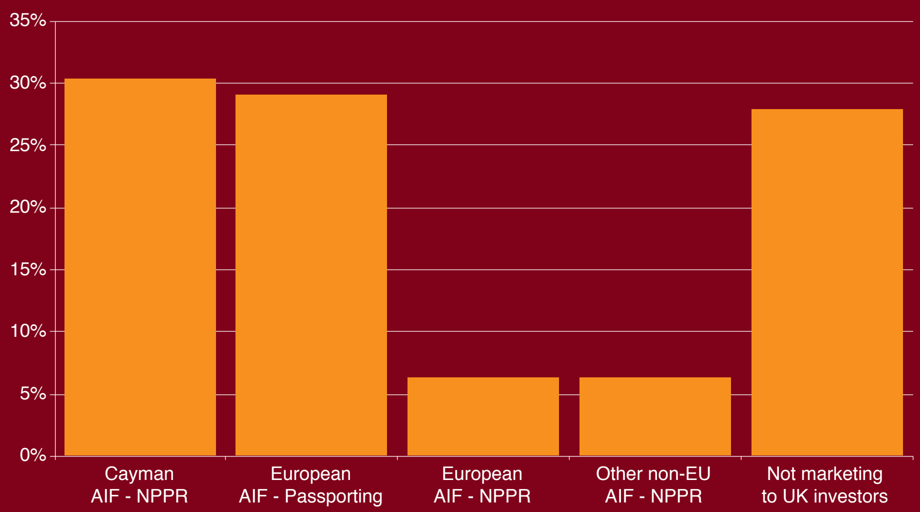
Disintermediation of core banking activities is still taking place – 18% of managers said they would launch a direct lending strategy managed as a commingled fund. Meanwhile, 17% were planning to launch a private equity commingled fund.

4. Politics unlikely to disrupt buying patterns

The exit of the UK from the EU, provisioned for March 2019, has a number of potential impacts on the fund management industry, some of which will be felt the world over, but most of which are unlikely to generate significant change in the next two years unless there is complete break-down in negotiations.

On the face of it, the UK alternative investment industry could face the greatest challenge as a result of Brexit. A US-UK placement agent says: "The AIFMD has a good framework and we think Europe will take London's financial prominence away over time. The industry will have to adapt."

Figure 16: My firm is currently accessing the UK market primarily through:



Source: PwC/AIMA Global Alternatives Distribution Survey 2018

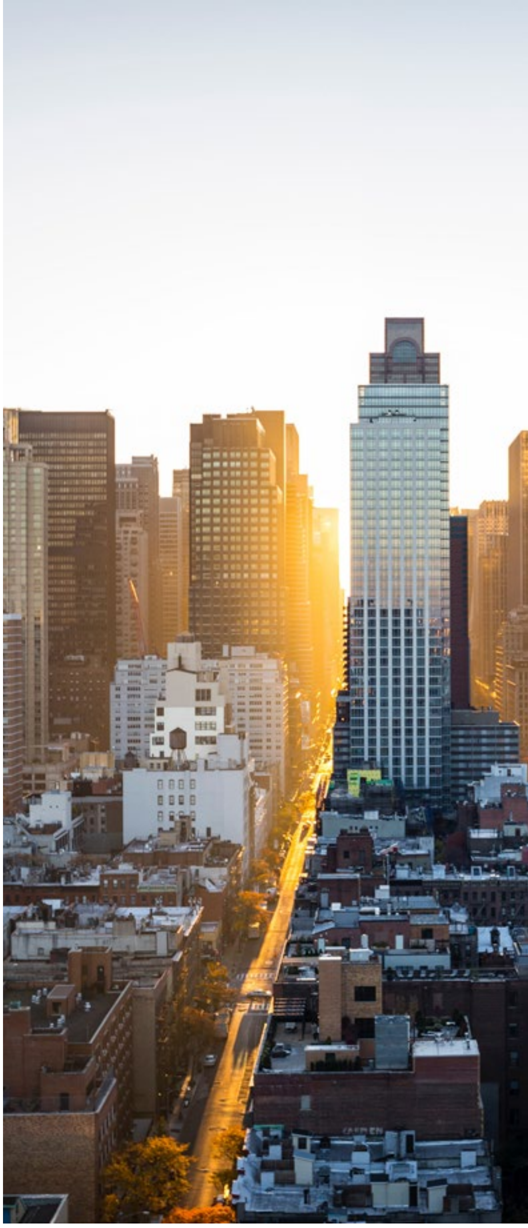
In the survey, 29% of alternative managers surveyed say they use European funds and the AIFMD passport as a means to access investors in the UK.

Assuming the UK withdraws from the EU single market, the UK will become a "third country" under various EU rules, including the UCITS Directive and the AIFMD. This will require UK alternative fund managers to change the way they do business with EU investors and clients. UK AIFMs marketing European AIFs will no longer qualify for the marketing passport under AIFMD and will be treated as non-EU AIFMs (similar to the way that non-EU currently operate in the EU).

However, the vast majority of EU AIFs managed by UK AIFMs are not in the UK. In addition, many UK managers already have AIFM structures or UCITS management company structures in the jurisdictions where their EU AIFs are established. Those which do not are looking to understand whether it is better to create new licensed entities or whether to appoint existing AIFMs and/or UCITS management companies that specialise in providing a range of platform services while delegating portfolio management to non-EU entities.

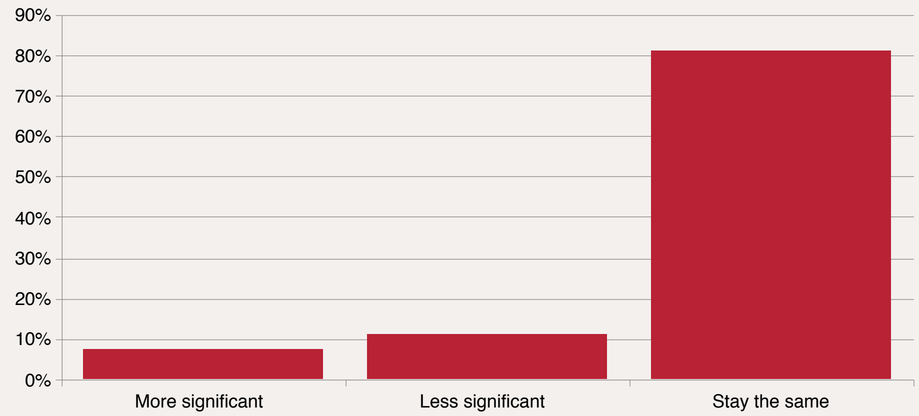
Depending on whether and how the UK adjusts its rules in the face of leaving the EU single market, Brexit could also impact on the way that EU alternative fund managers distribute to UK investors.

The UCITS Directive does not contain provisions relating to third countries. As a result, UK-domiciled UCITS and UK-domiciled UCITS management companies will be considered to be non-EU AIFs and non-EU AIFMs, respectively, after Brexit. But because the vast majority of alternative UCITS are not domiciled in the UK, the main issue will be to what extent UK managers will be able to provide portfolio management services to the EU entities on an outsourced basis.



EU-27 domiciled UCITS distributed into the UK will also be impacted by the loss of passporting into the UK, but they will still be able to distribute to professional investors in the UK. Firms which are active in the retail market may be disrupted more severely. In December 2017, the UK Government provided some welcome clarity on what this means for EU firms passporting into the UK by announcing a plan to legislate for a temporary permission regime which would enable relevant passporting firms and funds to operate as they do today until a replacement regime is implemented in the UK.

Figure 17: How important will the UK be as a fund raising destination for your firm post Brexit?



Source: PwC/AIMA Global Alternatives Distribution Survey 2018

Despite the uncertainty, some 81% of respondents say that after Brexit they will fundraise in the UK as much as they have done in the past. Only 11% said the UK will be a less significant destination for sourcing assets. Some 7% even said the UK would be a more attractive place to raise assets in the future, possibly because investment firms believe the UK may be able to operate outside the AIFMD regime after Brexit. It is far from certain this will be the case, however.

A mid-sized UK hedge fund firm says it is "very bullish about Brexit". Even if the going is tough in the immediate post-Brexit period, the firm says it is confident it can deal with any issues that arise.

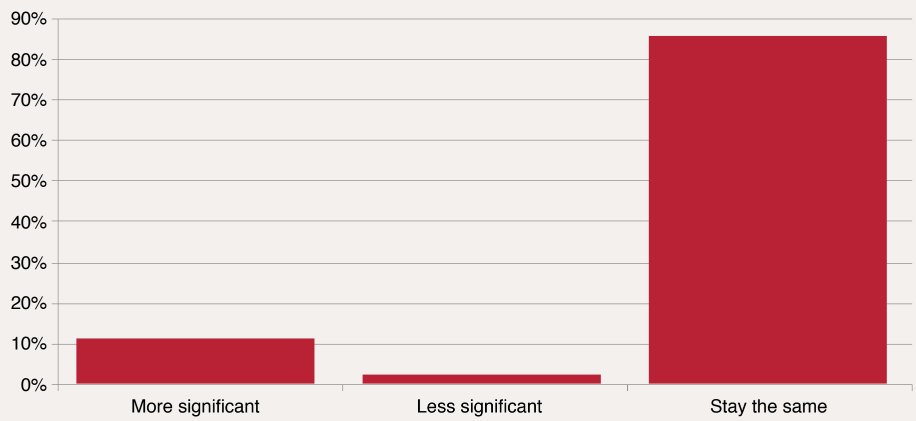
The view of continental European managers interviewed as part of the survey is that UK firms contain much of the available talent in Europe, so a workable structure will be found. "People will figure out a way to get flows to the most talented managers," one alternative fund manager says. So just as UK managers will need to find ways to source EU-based capital after Brexit, so EU-based investors face challenges in accessing the wealth of talent and strategies that reside within the UK.

Views of Brexit from outside Europe are mixed, which is not surprising given the many uncertainties over Brexit that still exist. One Asian manager said the UK would be "more rational and flexible" after Brexit, so it would be a more natural place to source assets."

However, another Asia-based manager is considerably less positive on the UK as a source of funds: "We were hoping to use the UK as a stepping stone to go into Europe by using passporting. Now we will focus our efforts more on America."

This last comment is intriguing in that it suggests that the EU is not a natural second choice if the UK is a less promising source of fundraising. Indeed, 86% of respondents said the EU 27 would be no more and no less attractive post-Brexit.

Figure 18: How important will the EU-27 be as a fund raising destination for your firm post Brexit?



Source: PwC/AIMA Global Alternatives Distribution Survey 2018

Just over 10% said the EU 27 would become a more fruitful destination, while 2.5% said it would be a worse place to raise funds.

Funds more wary of post-regulated Europe than post-Brexit Europe

Post-crisis regulation enacted across Europe appears to have more of an impact than Brexit considerations. With many non-EU alternative managers are frustrated that they are still unable to seek authorisation to use the AIFMD passport - a full two years after the EU authorities pledged to make it available to managers domiciled in "equivalent" regulatory regimes broad interest in the third country passport is dropping. Interviewees for the survey talked of "very stringent" regulation in Europe. One said: "Luxembourg will never allow the use of non-EU AIFs. It is easier to sell elsewhere and avoid Europe."

In their own words: European regulation

Asia-based manager: *"Passporting is great in theory, but not workable in practice. It will realistically only be available to $10 billion-plus managers."*

US placement agent: *"AIFMD effectively tells European institutional allocators what they cannot invest in. Why? At the end of the day managers are entrepreneurs, but the regulation penalises them and prevents growth."*

Hong Kong hedge fund firm: *"Asian investors are more sophisticated now and can move more quickly than in Europe. We prefer to stick to the Asia region now."*

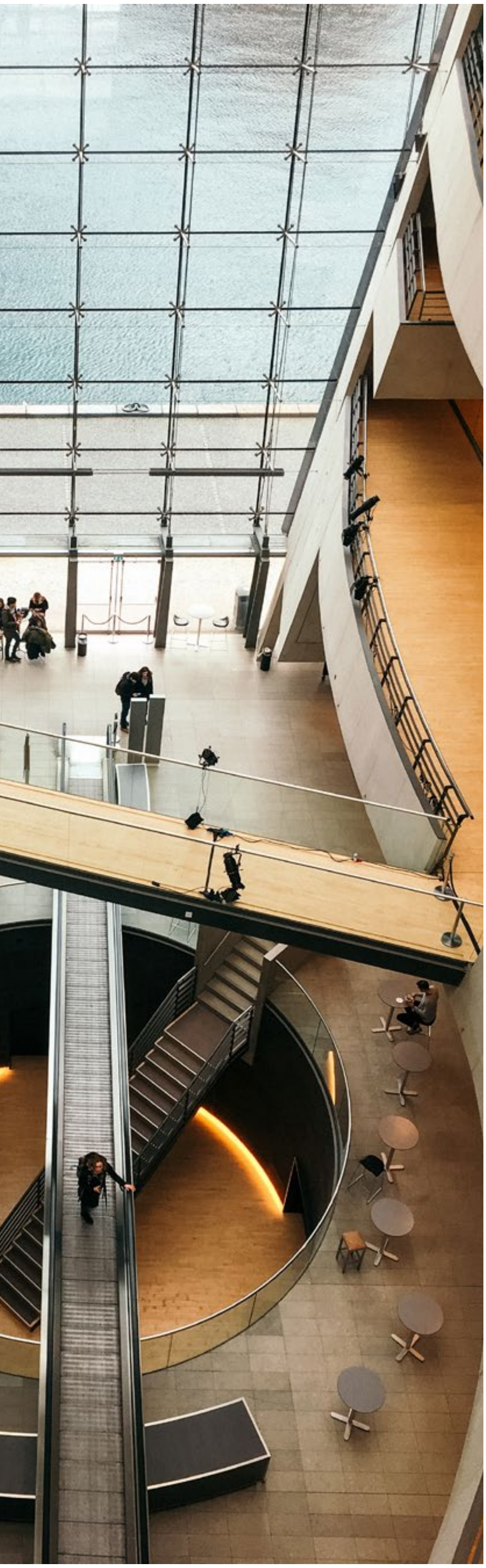
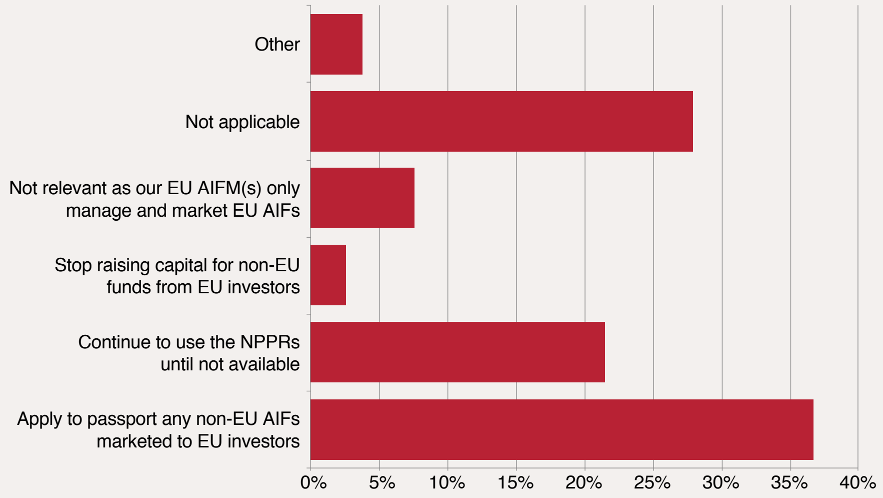


Figure 19: If the AIFMD passport is extended to allow EU AIFMs to market non-EU AIFs to professional investors across the EU and to allow non-EU AIFMs to elect to become authorised and take advantage of the ability to market AIFs to professional investors across the EU, what approach would your AIFM(s) take with regard to non-EU AIFs?



Source: PwC/AIMA Global Alternatives Distribution Survey 2018

Just 37% of respondents to the survey say they will apply to market their funds to EU investors using the AIFMD regime. For alternative fund managers based in the US and Asia who would consider the EU, this option was cited as the most popular. However, it was down from 56% in our previous survey.

Conversely, around a fifth say they will continue to use national private placement regimes until they are no longer available. That is an increase on the 16% in the last survey.

Shake-up of US tax shakes up alternatives

On December 22, 2017, President Donald Trump signed the Tax Cuts and Jobs Act (the “Act”), which enacts the most significant US tax reform since 1986. The Act lowers business and individual tax rates, modernises US international tax rules and makes many other changes.

This US tax reform impacts financial markets and may boost certain alternative investment strategies. The Act is expected to positively impact long-short equity strategies. Event-driven strategies, including merger arbitrage, may also see a benefit from tax reform, as companies are expected to be active in deal making and capital reorganization in 2018. Tax reform may also result in increased opportunities for distressed debt funds over time as the universe of distressed securities expands.

In addition to potentially enhancing returns for certain investment strategies, tax reform impacts various investment vehicles. Individual investors that hold, directly or through a fund, interests in real estate investment trusts or publicly traded partnerships (e.g., master limited partnerships) may see a boost in their after-tax income, as qualified income from these entities are in many cases eligible for a new 20% deduction (effectively reducing the associated federal income tax rate).

It remains to be seen what the long-term implications will be for alternatives and whether or not the Act alters the appetite or approach of investors in alternatives in the US.

Conclusion

The way alternative products are distributed has changed little since the products first appeared on investors' radar. But the world around alternative fund managers is changing fast: investors want a lot more from their alternative funds and demand lower fees at the same time. Many investors are also looking for more accessible alternatives via mutual fund structures, such as UCITS. Meanwhile, geopolitics is a perennial disruptor to distribution channels.

Alternative fund managers are responding but, in some cases, too slowly. Compared with their sophisticated investment strategies, the distribution activities of many alternative fund managers seem relatively clunky. The direct contact paradigm is a slow and expensive means of communications, which is decidedly dated.

Shorn of technology options and the accompanying economies of scale, costs for alternative managers are likely to rise in line with assets, making it hard to increase margins. And yet assets managed by alternative funds keep rising, so they must be doing something right.

Far be it for us to suggest there should be wholesale change in the industry. We do not. But we do think that with more capital being allocated to fewer managers, only the savviest – those who understand that performance, strategy, consistency, and reputation must come as a package – will adapt and attract the size of flows that will allow them to compete going forward.

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