December 6, 2013

Retail Liquid Alternatives: The Next Frontier

Equity Research

Exploring growth of Retail Liquid Alternatives ("RLAs")

Retail Liquid Alternatives: an emerging market for Asset Managers

2013 YTD industry organic growth is better, but remains tepid (<2%). Firms are seeking new pockets of growth at attractive fees, while retail investors are re-risking with an eye for sources of uncorrelated returns. At the intersection of these trends sits a growing class of *retail liquid alternative products*. In our view, "RLAs" are in the early stages of a 5-10 year growth trend, generating 15-20% organic growth annually, capable of producing a $2 trillion AuM opportunity--reminiscent of early stage ETF growth.

Supply is multiplying, but demand forming around supply

Asset managers offer ~400 alternative mutual funds and the pace of launches has tripled since 2009. Similar to institutions, which already commit 25% to alternatives, retail investors also seek product for diversification and lower correlations, yet current alternatives allocations are < 5%.

Fees are an issue to resolve, but "barbelling" offers a solution

Less-correlated product is growing 20% organically despite fees 2X "traditional" active funds. Still, fees top the list of advisor concerns. We think as portfolios are structured with cheap beta, a portion of fee savings can help fund allocations to RLAs. Our analysis suggests a shift to 60% passive equity alone could support $10-$20 bn in incremental RLA fees.

The distribution channel knowledge gap needs to be addressed

80% of mutual fund sales are "directed" by advisors. This suggests adequate intermediary education is necessary before RLA adoption accelerates. This is a critical trend to watch as few Asset Managers have made substantial investments in tapping third-party distribution of RLA's. **Wirehouses and RIA's** offer large opportunities. **ETF's** provide a useful case study for the uptake of new product where a knowledge gap exists.

Who's pursuing this growth, and how?

12% of public manager AuM are alternatives (most institutional), but contribution from RLA's are still immaterial to earnings. We expect firms to leverage manufacturing or distribution and a few will succeed at both. We see public alternative firms with diversity and brands as advantaged (notably BX) while traditional managers (BLK, AB, BEN, VRTS, AMG, plus others) are opting to build, buy, sub-advise and/or distribute.

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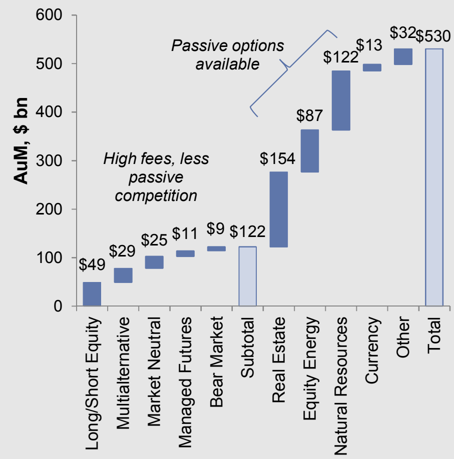
HOW MUCH IN RETAIL LIQUID ALTERNATIVES?



SOURCE: SIMFUND.

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PM Summary: Retail Alternatives – The Next Frontier

An emerging growth market for asset managers

Asset managers are seeking pockets where growth/fees are sustainable in a challenging revenue environment. Investors are re-risking, but with an eye for yield, uncorrelated asset classes, and risk-adjusted returns. The growth of Retail Liquid Alternative products rests at the center of these trends. In our view, the RLA opportunity is both substantial and long-tailed, likely to enhance flows for firms with capabilities and strategies to access this growth. We define RLA's to include long/short equity, multialternatives, currencies, market neutral, managed futures, real estate, energy and commodities. This report examines the asset manager supply and retail demand for alternatives, addresses obstacles, and delves into approaches of firms under coverage to the opportunity. While a "rotation" from cash has helped 2013's flow trends, organic growth is uneven, still modest (+2%) and concentrated in few product niches.

We see this as the **early stage of a 5-10 year trend** of mid-teens average annual organic growth for the category, with some issues still to be resolved.

Top takeaways from this report:

1. Retail liquid alternatives (RLAs) are a ~$2 trillion AuM opportunity for asset managers, capable of generating 15-20% organic growth over the next 5-10 years. We think retail allocations can ultimately move toward institutional levels over time, supporting our forecast. **Alternatives are 4% of US retail AuM, vs. more than 20% of institutional allocations.** Further, as investors reduce fees by moving toward passive we see reinvestment of savings helping solve the cost dilemma that we believe is at least partly holding back adoption. Price sensitivity is low so far: less-correlated mutual fund products are attracting 20%+ organic growth despite fees nearly 2X "traditional" active funds.

2. Supply of RLAs is growing…Industry definitions of the category are broad. Definitions of the space range between **$120 bn** in "core" alternatives mutual fund product (long/short equity, fund of alternative funds—"multi-alternatives", market neutral, managed futures funds) to **$530 bn** including real estate, commodities and natural resources (including ETF's). Either way, the industry has **nearly 400 products currently and 1/3 of those products were launched over the past two years**. **We view "core" alternatives as a faster growth segment (**26% average annual organic growth, +$96 bn cumulative inflows since 2007, +$35 bn YTD) that is less vulnerable to passive and more fee-defensible.

3. …**and demand from financial advisors is rising to meet new supply.** Despite the multitude of recent product launches, we still see demand drivers as sustainable. Of retail investors that own mutual funds outside workplace retirement plans, 82% are purchased via a broker or financial advisor (ICI). Industry surveys (Cerulli) show that financial advisor interest in alternatives is high (over 50% allocate more than 10% to alternatives) though key challenges remain – around fees and product knowledge in particular. Retail investors face similar needs and challenges as institutions: improving diversification, enhancing risk-adjusted returns and building portfolios with less-correlated exposures.

4. Fees are a concern, but "barbelling" can mitigate the issue over time, in our view. Investors are cost-conscious (high fees for alternatives are a concern for a majority of retail and institutional investors), but we think **as low-cost passive penetration increases, it can support the growth of more costly, alternatives**. To illustrate, if passive reaches 60% of equity and 40-60% of fee savings are redirected to grow alternative allocations, we see potential for an incremental **$10-$15 bn revenues and $1-$1.6 trn flows** to retail alternatives over the next 5-10 years (supporting mid-teens annual organic growth).

5. There is a knowledge gap between product manufacturers (asset managers) and distribution channels, but it is resolvable. 60%+ of advisors cite "asset allocation education" and "better understanding of the actual strategies" as most helpful for increasing alternative allocations. We think educating the third-party distribution channels on RLAs can drive better product uptake, but it will take time. That said, we think it is worth it: in our view, **wirehouses** and **RIA's** offer the largest near-term opportunity and expect alternatives AuM from these two channels to grow by $1 trn between now and 2020. Wirehouses also boast $5.3 trn in total advisor-sold assets and $248 bn already allocated to alternatives. Meanwhile, relatively **centralized decision-making** on portfolio construction and research can help drive acceleration in adoption. **Top-down asset allocation guidelines** can also play a meaningful role in driving change.

6. ETF's provide a useful guide for new product uptake and timing. Retail alternative adoption continues to rise on a similar path as ETF's. Today, there are around the same number of alternative mutual funds as there were ETF's in 2006, and 45% of advisors use alternative mutual funds (the same mix that used ETF's seven years ago). We do not expect product proliferation to be the same and the asset classes are vastly different from many perspectives. The **early adoption of ETF's also took education (which continues today) but eventually took hold.**

7. Public alternative asset managers are in a favorable position – highlight BX. Alternative asset managers with brands and diverse offering are either beginning to subadvise or launch product in the RLA area. Some have also invested in a more comprehensive distribution strategy. However, alternative asset managers (e.g. **BX, KKR, CG**) are only starting to visibly advance distribution efforts within the retail channel.

8. Traditional managers addressing this opportunity have a few paths forward. Firms are building alternative capabilities through new teams, seeding new products and in many cases buying or expanding capabilities via M&A. **BLK** is in the unique position of strong retail distribution access and presence in alternative strategies, which can be combined to launch RLA's on a greater scale in the future. Other examples include **AB, BEN, LM and VRTS**. Sub-advising is also a growing opportunity for "distribution" oriented firms – notably **VRTS** and its JV with Cliffwater have set the stage for more partnerships over time.

9. Key risk #1…Rising market could imply slower adoption, but we have not seen this to date. 2013 market saw the highest Sharpe ratio for the SPX in over 50 years and the S&P 500's 27% gain with active equity fund performance improving. Still, alternative mutual funds have taken in $35 bn of net inflows as of October – demonstrating **sustaining flows even in an improving equity market environment**.

10. Key risk #2…Concern over growing regulatory scrutiny. We believe some firms may take a wait and see approach to the business, while others are going forward with investor education and focusing on managing expectations. That said, the Office of Financial Research specifically noted in October in a report on potential systemic risk in asset management that *"certain hedge fund and private equity managers…introduced mutual funds that are managed using alternative strategies….that can introduce more complex trading…and embedded leverage."*

Defining the scope of this report

Given ~80% of fund sales are advice-driven, this report is primarily focused on third party distribution channels and current supply of products. To be sure, there are additional issues to explore around the broader theme of convergence of alternative and traditional product. This includes possible adoption in multi-asset and target date funds, sustainability of fee structures, as well as adoption within other channels such as defined contribution/401(k) and institutional users of liquid alternatives. Finally, the distribution ecosystem could continue to evolve, driven by factors such as changing regulation (e.g., evolving SEC rules on hedge fund advertising to accredited investors).

Supply of RLAs is multiplying…

$530 bn of retail alternatives AuM; we see "core" categories as the best opportunity

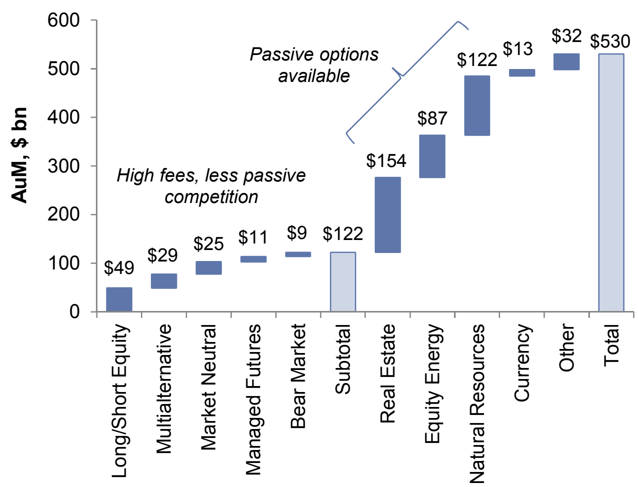
$530 bn alternatives AuM including public RE, energy; 16% organic growth

Most industry sources (including many financial advisors as well as third party research) include public real estate, energy, commodities and currencies under the alternatives umbrella in addition to "core" alternative product (private equity, private real estate, hedge funds, distressed credit). By this definition, there is currently $530 bn in US retail alternative AuM, of which $120 bn is in "core" product (Exhibit 1).

$120 bn "core" alternatives with higher fees, low passive competition, 26% organic growth

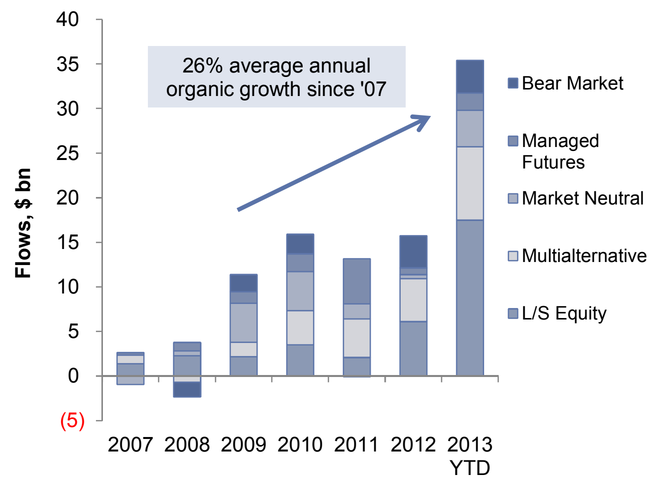
We think long/short equity, multialternative, market neutral, and managed futures funds are most interesting because they have **higher fees**, face **less competition from passive** substitutes, and exhibit **higher growth rates**. Within the $120 bn, the bulk of inflows have come from long/short equity and multialternative products, which have collectively taken in $96 bn since 2007 (26% average annual organic growth). We think this is because these strategies are most amenable to liquidity constraints and can operate with less than 15% in illiquid assets.

Exhibit 1: How much alternative AuM? Depends on what you call "alternative"
By Morningstar category



Source: Simfund.

Exhibit 2: Bulk of flows in "core alternatives" from L/S equity and multialternative funds



Source: Simfund.

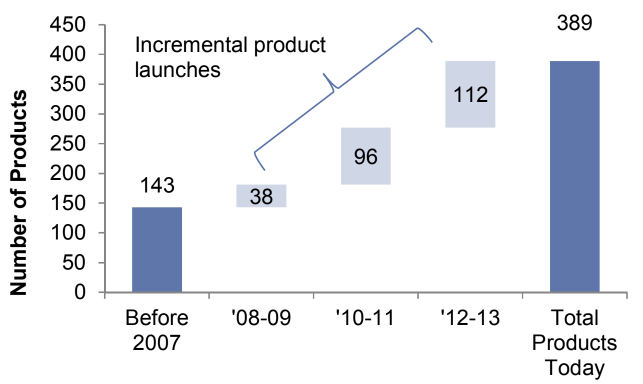
Supply of retail alternatives funds is multiplying, but success varies

55% of YTD alternative mutual fund flows have gone to unrated funds

Competition for shelf space is growing with just under **400 products currently available, 4X the number in 2007** (Exhibit 3). Investors are highly selective with a large dispersion between the most and least successful products. The best performers have captured significant flows: funds with 5 star Morningstar ratings have taken in $1.4 bn per fund, while 4 star funds have taken in $234 mn and 3 star funds $16 mn, on average. For example, Mainstay Marketfield (a long/short equity fund with $17 bn AuM) has accounted for 1/3 of alternative flows this year, and even more in recent months (50% for September and October).

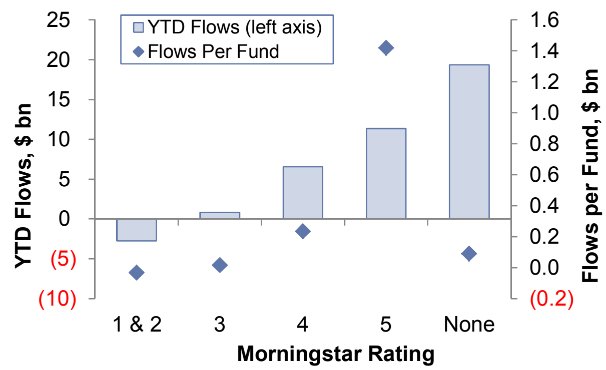
That said, over 50% of alternative products are unrated, likely because they have a limited track record, with 40% of funds launched after 2010 – and there are only 8 five-star "core" alternative mutual funds. Hence, 55% of YTD alternative flows have gone to unrated product, showing capacity constraints of "proven" funds and investor appetite for innovation/new launches.

Exhibit 3: RLA product launches have tripled since 2009



Source: Simfund.

Exhibit 4: 5 star funds capture the most flows, but are scarce



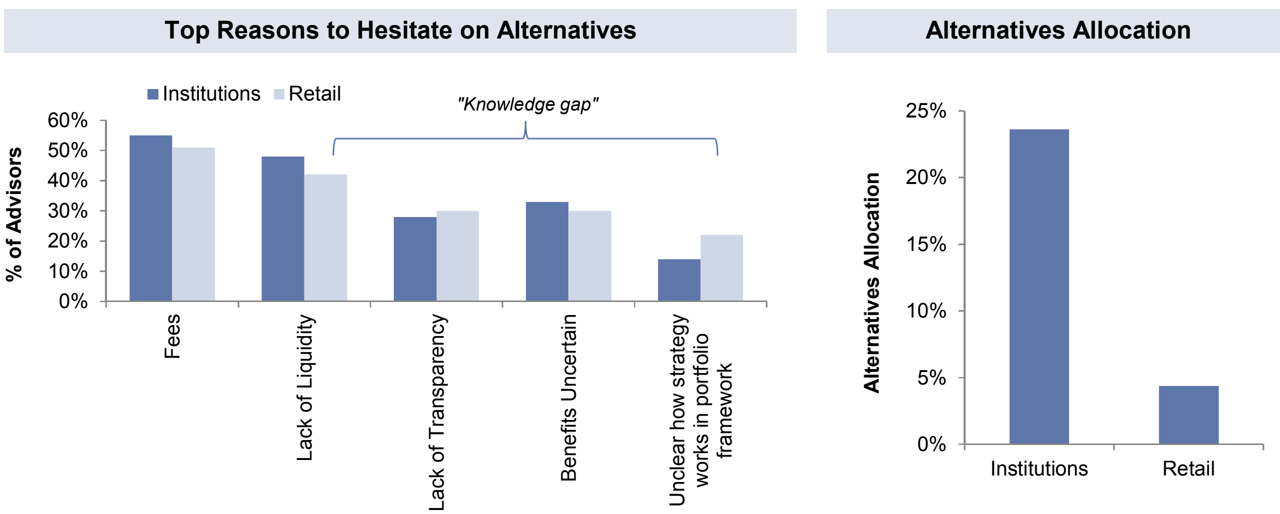
Source: Simfund.

…and underpinnings of demand are sustainable, in our view

Alternatives are currently 4% of US retail AuM, vs. >20% of institutional allocations

Financial advisors (key players in the retail market) show interest in alternatives and over 50% of those surveyed by Morningstar/Barron's indicate they allocate more than 10% to alternatives. Institutional and retail investors have many of the same concerns (fees, illiquidity, lack of transparency). However, the average institutional investor expects allocate 24% of their portfolio to alternatives, vs. alternatives comprising around 4% of US retail portfolios. See Exhibit 5.

Exhibit 5: Institutions and FA's have similar concerns about alternatives, yet institutions have much higher allocations



Source: Morningstar/Barron's, McKinsey, Simfund.

Like institutions, retail investors seek diversification and low correlation

Surveys of financial advisors (Morningstar/Barron's) suggest retail investors are using alternatives for the same key reasons as institutions: approximately 75% of each cite "**diversification/low correlation**" as a top reason to use alternative strategies (Exhibit 6). Indeed, alternative mutual fund categories (particularly managed futures, nontraditional bond) have relatively low correlations to the S&P 500 and Barclays Agg indices (Exhibit 8). That said, retail investors also cite some reasons to invest that are less frequently given by institutions, including "**enhance yield**" and "**poor bond market outlook**" (indicated by 28% and 18% of advisors), suggesting to us that retail alternatives' share gains are also partly driven by **current market conditions**.

Importantly, concerns about **high fees** are the top reason to hesitate on alternatives, cited by over 50% of both institutions and financial advisors. That said, industry data shows that less-correlated strategies with fee rates as much as 2X traditional categories (e.g., managed futures, long/short equity, multialternatives) have shown more than 40% annual organic growth (Exhibit 9). We think this suggests **investors are willing to pay for uncorrelated returns not otherwise available, but the need to economize on expenses could pressure fee rates elsewhere** (particularly where passive substitutes are available). 22% of FA's also indicate lack of clarity about **how alternative strategies fit into their portfolios** (vs. 14% of institutional investors). Demand for new sources of diversification is strong, but without greater **investor education**, retail investors are unlikely to adopt alternatives at the same rate as institutions.

Exhibit 6: Retail investors mainly in search of diversification; some demand also driven by low yields
Reasons given by FA's to invest in alternatives

	Top Reasons to Invest	
	Institutions	Advisors
Diversification/Low Correlation	78%	75%
Enhance Risk-Adjusted Profile	55%	47%
Absolute Return	45%	37%
Offer clients investments they won't find on their own	16%	29%
Enhance Yield	13%	28%
Poor Bond Market Outlook	14%	18%

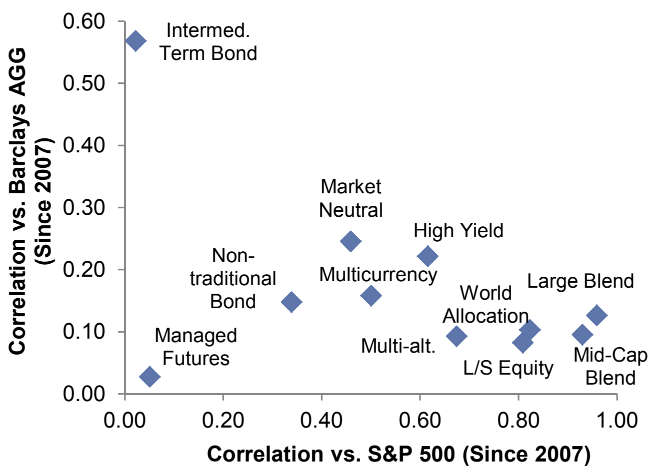
Source: Morningstar/Barron's.

Exhibit 7: Fees a top concern for both retail and institutional investors, followed by lack of liquidity
Reasons given by FA's hesitate on alternatives

	Top Reasons to Hesitate	
	Institutions	Advisors
Fees	55%	51%
Lack of Liquidity	48%	42%
Lack of Transparency	28%	30%
Benefits Uncertain	33%	30%
Unclear how strategy works in portfolio framework	14%	22%

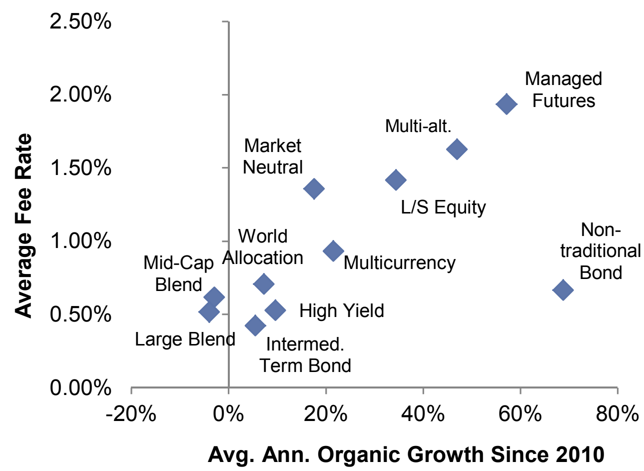
Source: Morningstar/Barron's.

Exhibit 8: Retail investors gravitating toward less correlated strategies



Source: Simfund, FactSet.

Exhibit 9: Many best-flowing categories have the highest fees



Source: Simfund.

Barbelling can solve for fee worries and drive $1-$1.6 trn of inflows

What is the "barbell"?

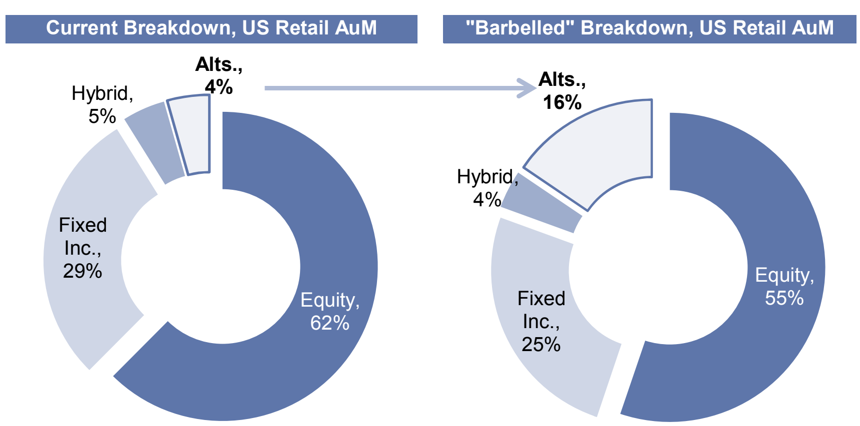
As investors remain focused on expenses and adding diversification to lower volatility, **we think passive penetration will continue to rise with fee savings supporting the growth of alternatives.** Currently, passive penetration of retail equity AuM stands at around 28%, but as we discussed in our November 30, 2012 report, *Where to go when revenue slows*, more mature categories such as Large Cap Blend and Mid Cap Blend are 50-60% passive (Exhibit 12). Investors face the need to economize on fees while also improving risk-adjusted returns, and as discussed in the previous section, surveys indicate high fees for alternative strategies are a reason to hesitate for over half of investors – both retail and institutional. However, the fastest growing active fund categories include managed futures, multialternatives, and long/short equity, which charge **well over 100 bp management fee rates** – suggesting **investors are still ultimately willing to pay higher fees for new sources of alpha**.

Barbelling could shift $10-15 bn fees to alts, $1-$1.6 trn flows

To illustrate, over the next 5-10 years, if passive penetration of equity grows to 60% (from 28%), we see total fee savings of $25 bn, assuming an average active fee rate of 62 bp and passive fee rate of 20 bp. Assuming 40-60% of the fee savings drop to investors' bottom line (i.e., driving higher returns) and an average 100 bp fee rate for alternative products**, we see potential for $10-15 bn of incremental revenue opportunity and $1-1.6 trn incremental flows shifting to alternatives** (see Exhibits 10-11). Note: We assume flat market appreciation and net inflows to risk assets to be conservative. Also, many of the best-flowing RLA's feature near 200 bp+ fee rates, suggesting upside risk.

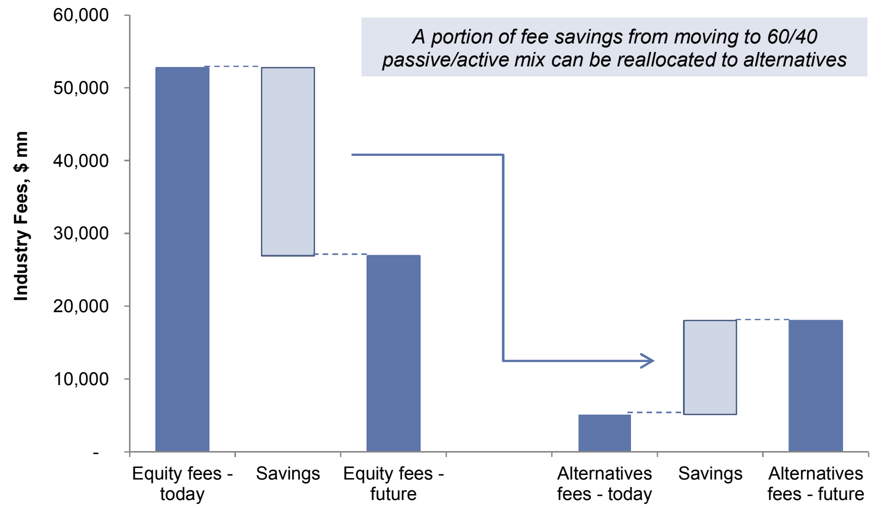
If passive reaches 60% of equity AuM, we see potential for an incremental $10-$15 bn revenues and $1-$1.6 trn flows to retail alternatives

Exhibit 10: An illustration of how barbelling can shift $10-$15 bn fee opportunity to RLA's
AuM breakdown



Source: Goldman Sachs Global Investment Research.

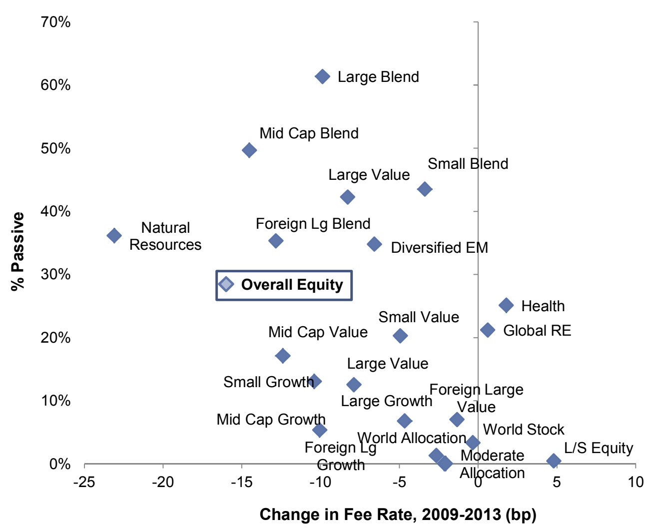
Exhibit 11: Assuming 50% of fee savings from moving to passive are redeployed to alternatives, we see $13 bn incremental revenue opportunity over next 5-10 years



Source: Goldman Sachs Global Investment Research.

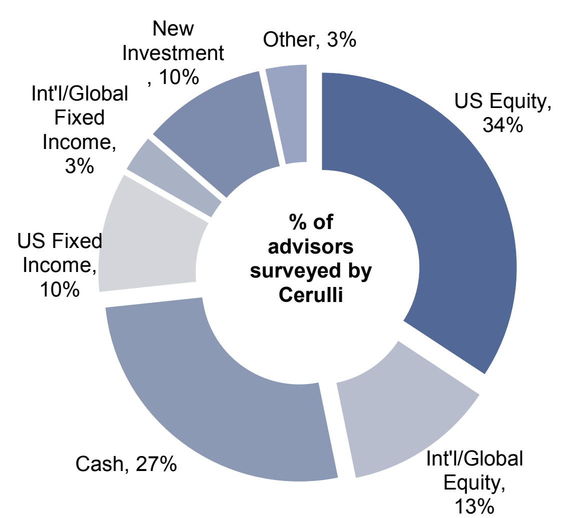
As investors become more asset class-agnostic and seek to diversify across risk factors, we think alternatives can take share of fixed income and hybrid product as well as equities. Surveys show nearly 50% of financial advisors intend to source alternative allocations from US/international equity and 13% intend to source from fixed income, though another 37% intend to allocate from new investments/cash (Exhibit 13).

Exhibit 12: Passive continues to take share of various equity categories, driving fee savings



Source: Simfund.

Exhibit 13: 47% of FA's surveyed by Cerulli expect to fund alternatives from equities
"What is your source of funds for alternatives?"



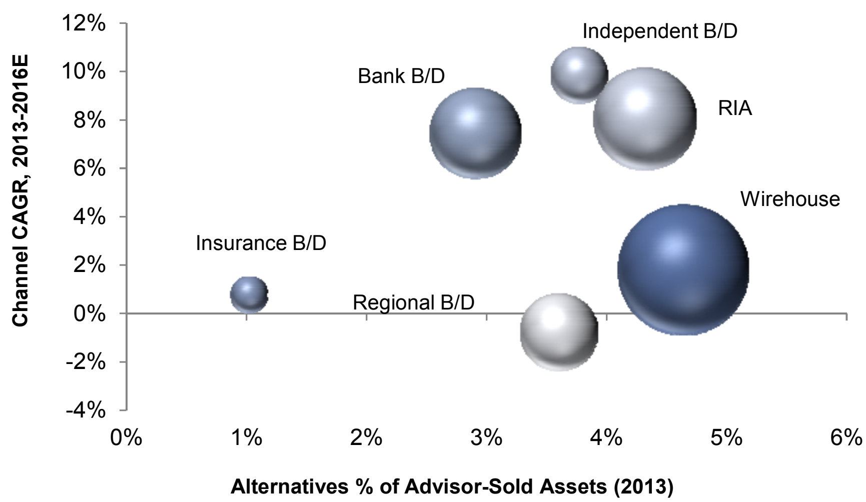
Source: Cerulli Associates.

Addressing the knowledge gap via retail intermediaries

Wirehouses = largest near-term opportunity, though RIA's offer faster growth

Of retail investors that own mutual funds outside workplace retirement plans, 82% are purchased via a broker or financial advisor (ICI). Since most mutual fund sales are directed, we focus on retail intermediaries that can drive greater alternatives adoption. For firms investing in retail alternatives distribution, we think **wirehouses** and **RIA's** offer the largest opportunity over the next 5-10 years. Wirehouses are the largest channel with $5.4 trn in advisor-sold assets, while the registered investment advisor (RIA) channel is smaller at $2.3 trn, but growing at a relatively fast 8% CAGR. Wirehouse assets are expected to grow more slowly (2% CAGR through 2016, according to Cerulli) than RIA's. For wirehouses, more **centralized decision-making** on portfolio construction and research could help quickly push higher adoption of alternatives, in our view. Assuming both channels reach 15% alternatives (current allocation by high net worth investors with moderate risk profiles) by 2020, we see wirehouses and RIAs together driving $1 trn in incremental AuM. See Exhibit 14.

Exhibit 14: Wirehouses and RIAs can drive $1 trn increase in retail alts AuM by 2020
Assumes all channels reach 15% alternatives by 2020



Bubble size = 2020E alternatives AuM

Channel	Channel AuM		Alternatives		Alts Allocation		Channel Exp CAGR
	Current	2020E	Current	2020E	Current	2020E	
Wirehouse	5,360	5,962	248	894	4.6%	15.0%	2%
RIA	2,302	3,663	99	549	4.3%	15.0%	8%
Regional B/Ds	1,867	2,873	54	431	2.9%	15.0%	7%
Independent B/Ds	2,169	2,069	78	310	3.6%	15.0%	-1%
Bank B/Ds	629	1,106	24	166	3.8%	15.0%	10%
Insurance B/Ds	435	455	4	68	1.0%	15.0%	1%
Total	**12,762**	**16,128**	**508**	**2,419**	**4.0%**	**15.0%**	

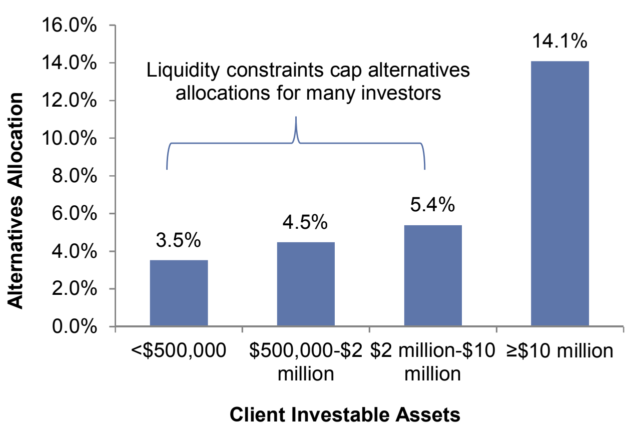
Source: Cerulli Associates, Goldman Sachs Global Investment Research.

Key issues to resolve: Knowledge gap, liquidity concerns

When surveyed by Morningstar/Barron's, 22% of advisors indicate "lack of clarity on how alternatives fit into their portfolios" as a top reason to hesitate on alternatives. We think **top-down asset allocation guidelines** will play a meaningful role in driving change – particularly for "mass affluent" clients with alternative allocations below 5%. Addressing investors' **liquidity concerns** can be a catalyst to drive the next leg of retail alternatives adoption, as over 40% of advisors surveyed list "lack of liquidity" as a top reason not to invest in alternatives. Clients with more than $10 mn in investable assets (and a higher tolerance for illiquidity) already have significantly higher alternatives allocations, at 14% even for investors with "moderate risk" profiles. If alternative mutual funds can be shown to solve liquidity issues, we expect moderate risk portfolios for clients with $500k-$10 mn in assets (currently 4-5%) can also approach 15% (Exhibit 15). Meanwhile, Morgan Stanley Wealth Management's recommended "aggressive" allocation is 25% alternatives - the same as institutional target allocations. See Exhibit 16.

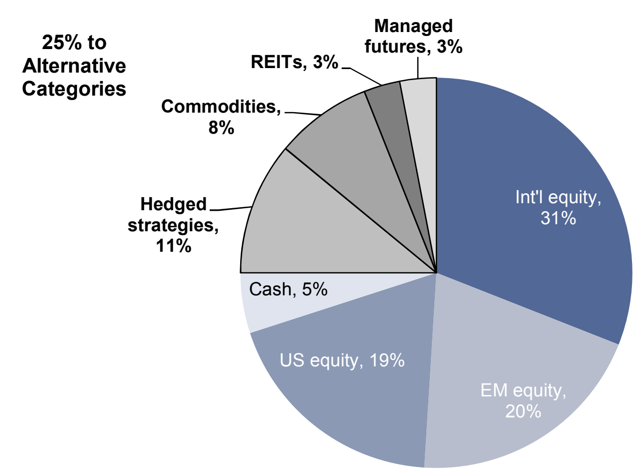
We think educating advisors on product offerings is an important way alternative managers can collaborate with research departments and drive higher advisor implementation. Broker-dealers also play a key role in speeding adoption of target allocations via manager selection and due diligence support. As per Cerulli, 20% of advisors think "due diligence support from B/D" is the most helpful factor for adding alternatives. That said, **investor education is even more important with over 60% of advisors citing "asset allocation education" and "better understanding of the actual strategies" as most helpful**.

Exhibit 15: HNW clients have higher alts allocations, likely due to higher illiquidity tolerance
Moderate risk alternatives allocation



Source: Cerulli Associates.

Exhibit 16: MSWM's recommended "aggressive" asset allocation to alternatives is 25% - in line with institutions

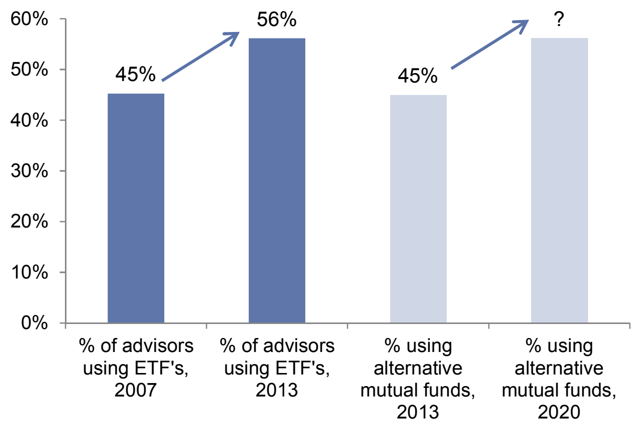


Source: Cerulli Associates.

ETF case study for closing of a knowledge gap (uptake, timing)

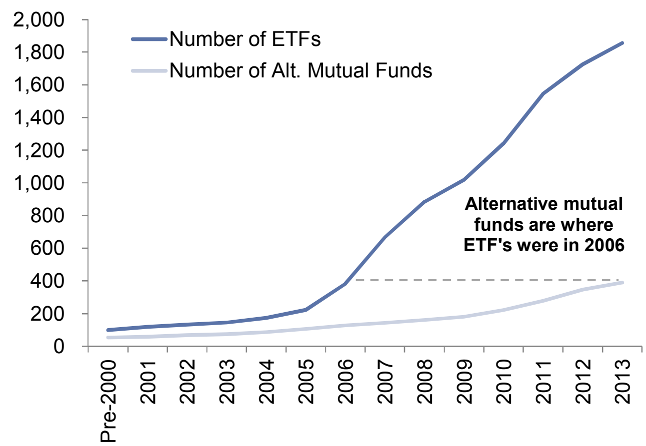
We think the growing adoption of ETF's over the past several years can serve as a case study for how a new asset management product can grow as retail intermediaries are educated on potential uses, benefits and risks. In 2006, US ETF assets stood at $420 bn across just under 400 product offerings, and as investor education and advisor comfort with the product has developed, ETF's have grown to $1.6 trn of assets across 1,900 products (22% AuM CAGR). 56% of advisors now use ETF's, vs. 45% in 2007, and we believe the growth story is not yet over as more than 50% of advisors expect to raise their allocation to ETF's (18% of FA's by more than 10%).

Exhibit 17: Adoption by more advisors to contribute to growth over next 5-10 years – similar to ETF's



Source: Cerulli Associates.

Exhibit 18: ~400 alternative mutual funds in market today – same as ETF's in 2006; expect similar growth trajectory



Source: Simfund.

We expect retail alternative adoption will continue to rise, following a similar investor education path as ETF's. Today, there are around the same number of alternative mutual funds as there were ETF's in 2006, and 45% of advisors use alternative mutual funds (the same mix that used ETF's seven years ago). Though we do not expect product proliferation will necessarily be the same, Cerulli survey data suggests 18% of advisors surveyed intend to increase their use of alternative mutual funds by up to 10% and another 9% of advisors by more than 10%.

How are companies under coverage executing on the opportunity?

Retail alternatives build-out still in the early stages

While many managers have strong retail presence and alternative specialists have strong name recognition and track record in institutional strategies, no managers have a fully built-out suite of retail alternative product offerings. In our view, the best approach varies with a given manager's existing core competencies. For example, building out comprehensive retail distribution may make sense for managers that already have or are developing a broad suite of alternative product. For managers focused on one or two key areas of alternatives, accessing retail via subadvisory relationships may make more sense given the extensive investment required for full distribution build-out.

Exhibit 19: Potential retail alternatives strategies
Examples from our coverage

		Length of Payback Period	
		Less than 3 Years	3-5 Years
Amount of Investment	Low	Subadvise retail products AQR (AMG)	
	High	Buy/expand alternative capabilities via M&A BEN, LM, CG, KKR	• Invest in comprehensive retail distribution BX, KKR, AB • Build alternatives capability organically AB, APAM

Source: Goldman Sachs Global Investment Research.

- **Building alternatives capability organically**: Managers with limited alternative product can build it organically by hiring new teams and seeding product from their balance sheet. Examples: AB hired a team from Caxton Associates, a hedge fund, in 2011 and has begun to launch mutual fund strategies advised by the team, such as Long/Short Equity (now $800 mn AuM). APAM intends to add an alternatives team, though no hires have been announced yet. VRTS also intends to seed new retail-oriented funds subadvised by Cliffwater (manager of $52 bn in existing alternative product for institutions).

  Pros: New products more integrated into existing firm/infrastructure.

  Cons: Returns on investment likely take 3-5 years to materialize (time required to establish a performance track record and begin to gain significant inflows), difficult to compete with existing industry leaders known for alternatives expertise.

- **Buying/expanding capabilities via M&A**: Some managers (e.g., BEN, LM) have sought access to existing alternative product with track records via M&A (purchase of hedge fund of funds managers K2, Permal). Alternative specialists are seeking to broaden their platforms and position themselves to offer multi alternatives. Examples include CG's recent acquisitions of stakes in firms such as Claren Road (credit HF), Emerging Sovereign Group (EM HF), Vermillion (commodities), Metropolitan (RE FoF) and Diversified Global Asset Management (fund of hedge funds) and KKR's acquisition of Nephila (insurance-linked securities and catastrophe bonds).

Pros: Quick access to products with track records/name recognition, access to niche strategies.

Cons: May be difficult to integrate with existing strategies given questions over compensation and potential equity dilution, less control over performance.

- **Subadvisory relationships**: We think subadvising a retail product distributed by another manager could be a more profitable approach for firms with a few core alternative competencies for which significant investment in distribution, compliance/ reporting infrastructure, etc. may not be realistic. Example: AQR (AMG affiliate) subadvises for the Principal Global Multi-Strategy fund ($1.2 bn AuM).

  Pros: Access to retail distribution with limited investment spend and high returns.

  Cons: Risk of manager replacement, more limited branding, lower fees.

- **Invest in comprehensive retail distribution strategy**: Some alternatives specialists (BX, KKR, CG) are making significant investments in launching alternative mutual funds based on existing capabilities. Managers work with retail intermediaries at wirehouses, regional brokers and private banks to design product while also investing in investor education. Examples include AB's marketing campaign and BX's "Blackstone University" for advisors.

  Pros: Helps build brand name as a leader in the space, directly addresses roadblocks to retail adoption.

  Cons: Requires substantial investment (often multiple years).

Exhibit 20: Few managers have both built-out retail distribution and a track record managing alternative product
X-axis reflects extent of current institutional and retail alternative product

Level of Retail Distribution Build-Out \ Level of Alternative Product Build-Out	Limited Alternative Product	Some Products/Seeding Strategies	Real Estate/Commodities (incl. public securities, ETF's)	"Core" Products with Track Record
Strong Retail Distribution	WDR TROW FII JNS	AB VRTS EV CLMS BEN	IVZ CNS	BLK
Some Access to Retail *(e.g. as a subadviser or a handful of products)*	APAM PZN	LM		AMG BX KKR CG OAK
Limited Retail				APO FIG OZM

Source: Company data, Goldman Sachs Global Investment Research.

Exhibit 21: Alternatives and retail distribution across coverage
Total alternatives AuM includes institutional and retail strategies. Mutual fund AuM as of October 31

	Total			Type of Alternative					Notes on Retail Alternative Product
	Firm AuM, $ bn	Alts AuM, $ bn	% Alts	Private Equity	Hedge Fund	Real Estate	Alt. Credit	Other	Sample Mutual Funds
BX	248	248	100%	63	53	69	63		•Alternative Multi Manager ($1 bn)
CG	191	191	100%	136	21	13	21		--
APO	157	157	100%	43		9	105		--
AMG	508	121	24%	24	90		7		•AQR Managed Futures ($5 bn) •AQR Diversified Arbitrage ($3 bn) •AQR Multi-Strategy Alt ($1.5 bn)
BLK	4,096	103	3%	31	28	13		31	•Global Long/Short Credit ($4 bn) •Emerging Market L/S Equity ($700 mn) •Global L/S Equity ($200 mn)
KKR	90	90	100%	60	10	1	20		•KKR Income Opportunities ($300 mn) •KKR Alternative High Yield ($117 mn)
IVZ	746	85	11%			50	20	15	•Invesco Global Markets Strategy ($120 mn)
OAK	80	49	62%		4		45		--
OZM	39	39	100%		32	1	6		--
FIG	58	34	59%	15	7		13		--
CNS	46	33	71%			33			•Cohen & Steers Realty ($5.4 bn) •Infrastructure ($2.7 bn) •Institional Realty ($2.6 bn)
LM	656	20	3%		20				Expect future launches with Permal
BEN	845	17	2%	8	9				Franklin K2 Alternative Strategies Fund
EV	281	16	6%		16				•Global Macro Absolute Return ($6 bn) •Diversified Currency Income ($800 mn) •Tax Advantaged Bond/Option Strategy ($200 mn)
AB	445	13	3%		11	2			•L/S Equity ($800 mn) •Market Neutral ($35 mn)
VRTS	55	6	11%					6	•Virtus Dynamic AlphaSector ($2 bn) •Cliffwater (not yet launched): Alternative Total Solution, Alternative Income Solution, Alternative Real Assets Solution
CLMS	27	3	12%		3				•Market Neutral Income ($3 bn) •Long/Short Equity ($43 mn)

Note: Commodities (incl. ETF's) listed in "other". AuM is pro forma for recently announced acquisitions.
Hedge fund includes long/short mutual funds and fund of hedge funds; PE includes private equity FoF.

Source: Company data, Simfund, Goldman Sachs Global Investment Research.

What are the risks to the retail alternatives story?

In 2013, alternative mutual funds have gained $35 bn of flows despite strong equity performance

We see several key risks to retail alternatives' growth story:

- **Slow adoption**: If traditional active equity benefits from higher equity markets and better excess returns, industry players may see less urgency to invest in and develop alternative product. That said, we see potential for a "reverse denominator" effect: if equity markets rise, retail investors may be even more under-allocated to alternatives than previously thought. Moreover, in 2013 to date, the S&P 500 is up 27% and active equity fund performance is improving, and yet alternative mutual funds have taken in $35 bn of net inflows as of October – suggesting to us that **share gains of retail alternatives can be sustained even as traditional equity performs better**.

  Secondly, as higher equity markets drive strong performance fee realization, robust fundraising, and +14% build in dry powder this year, alternatives specialists may feel less of a need to focus on a long-dated opportunity.

- **Capacity concerns**: Similar to other active strategies, managers may need to scale successful strategies to match the availability of investment opportunities in order to protect performance – therefore capping AuM growth.

- **Investor education and expectations management**: Clear explanation of a product's investment strategy, how it fits into a retail investor's portfolio and expectations management are key to a manager's long-term success (as well as sustainable growth of the industry).

- **Heightened regulatory scrutiny**: The Office of Financial Research's October study on potential systemic risks in asset management cited retail alternatives as an area that may merit additional study:

  "Another way that…risks could surface is by investors herding into certain new products, particularly if the products are relatively illiquid and investors fail to fully appreciate their risks under different market conditions….certain hedge fund and private equity managers have introduced mutual funds that are managed using alternative strategies. Such funds can introduce more complex trading strategies and embedded leverage."

  Greater regulatory scrutiny may lead to more reporting requirements and restrictions around what can be held in an alternative mutual fund, slowing product launches and/or muting potential returns.

Exhibit 22: APPENDIX: Alternative mutual fund flow leader board

Fund Name	Ticker	Mstar Category	Mgmt Fee	AuM (10/31)	YTD Flows	YTD Perf.	Start Yr	Mstar Rating
MainStay Marketfield	MFLDX	Long/Short Equity	1.40	17,009	11,447	13%	2007	5
PIMCO StocksPLUS AR Sht Strtgy	PSTIX	Bear Market	0.75	7,223	3,709	-23%	2003	
PIMCO WrldWd Fdmntl Advtg AR Strat	PWWIX	Market Neutral	1.10	3,010	2,491	-1%	2012	
AQR Managed Futures Strategy	AQMIX	Managed Futures	1.05	5,130	2,421	5%	2010	4
JHF II Glbl Absolute Rtn Strategies	JHAAX	Multialternative	1.26	4,146	2,355	3%	2011	
Robeco BostonPrtnr L/S Rsrch	BPIRX	Long/Short Equity	1.25	2,416	1,783	14%	2010	4
NB Long Short	NLSIX	Long/Short Equity	1.42	1,648	1,379	12%	2011	
Virtus Dynamic Alphasector	EMNAX	Long/Short Equity	1.89	1,895	1,292	30%	1998	3
Blackstone Alternative MultiMgr	BXMMX	Multialternative	1.95	1,078	1,041	N/A	2013	
ASG Global Alternatives	GAFAX	Multialternative	1.15	2,188	841	10%	2008	2
Principal Glbl Multi-Strategy	PMSAX	Multialternative	1.60	1,208	673	3%	2011	
Eaton Vance Diversified Currency Income	EAIIX	Multicurrency	0.63	796	668	-6%	2007	1
Calamos Market Neutral Income	CVSIX	Market Neutral	0.68	3,227	643	4%	1990	4
AQR Multi-Strategy Alternative	ASAIX	Multialternative	1.85	1,467	603	3%	2011	
Wasatch Long/Short	FMLSX	Long/Short Equity	1.10	2,426	535	18%	2003	4
Gateway	GATEX	Long/Short Equity	0.64	7,880	413	6%	1977	3
Merger Fund	MERFX	Market Neutral	1.00	4,896	348	3%	1982	4
PIMCO EqS Long/Short	PMHIX	Long/Short Equity	1.57	693	319	31%	2012	
Gabelli ABC	GABCX	Market Neutral	0.50	954	308	5%	1993	4
Touchstone Merger Arbitrage	TMGAX	Market Neutral	1.05	698	274	4%	2011	
Arden Alternative Strategies	ARDNX	Multialternative	1.85	1,034	261	5%	2012	
Litman Gregory Masters Alternative Str	MASFX	Multialternative	1.40	672	243	4%	2011	
CBRE Clarion Long/Short	CLSIX	Long/Short Equity	1.25	619	238	-1%	2012	
AQR Diversified Arbitrage	ADAIX	Market Neutral	1.00	2,777	218	2%	2009	3
BlackRock EmgMkt Long/Short Eq	BLSIX	Market Neutral	1.50	680	212	0%	2011	

Source: Simfund, FactSet.

Disclosure Appendix

Reg AC

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