Understanding the Rise of Liquid Alternatives in the United States

Over the past several years the hedge fund community has realized important changes to the investor base from a range of end investors. Today we see an intense interest in liquid alternatives that will have a profound impact on the industry for years to come. Institutional investors have continued a steady pace of allocations to traditional privately offered hedge fund vehicles throughout 2014. When we look across the investor spectrum, investment channels aligned to retail investors have now begun what is anticipated as a substantial wave of new allocations to publically offered alternative mutual funds, commonly referred to as 'liquid alternatives'. The recent rapid growth of these products has garnered a vast amount of attention by industry participants as these vehicles have doubled in assets in just a three year period, and currently total 1/3 of a trillion dollars. These products are being launched and managed by a variety of traditional 'Long Only' Asset Managers as well as franchise and boutique Hedge Fund managers that have built their businesses primarily through privately offered vehicles. This article will provide a commentary on the current status of liquid alternatives.

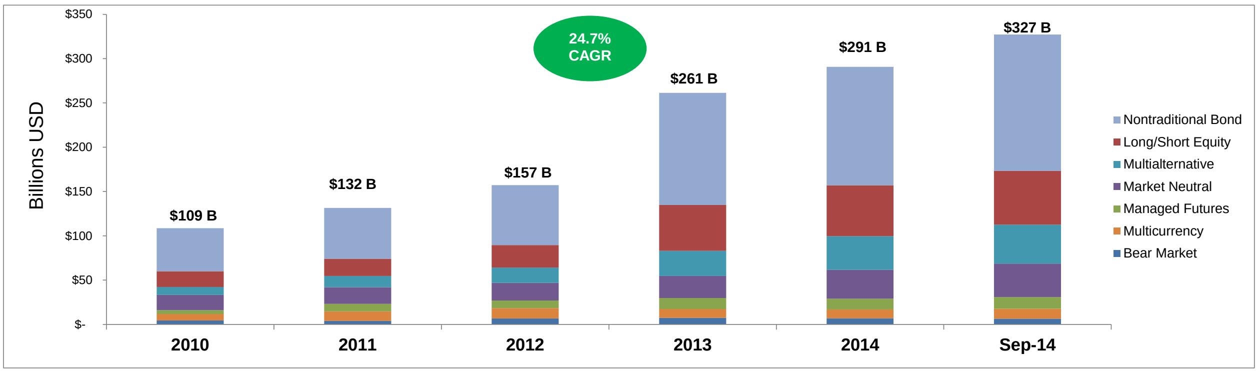
While several industry studies have pointed to the significant potential for the growth of alternative mutual funds from US based money management firms on behalf of a retail audience, little study and analysis has been undertaken to ascertain what strategies and firms are best positioned to capture a portion of the nearly $10 Trillion US retirement market. By taking a closer look at the recent product trends in these early days of the liquid alternatives phenomena, we can better understand how firms are positioning their offerings to build lasting franchises in this market.

For more information and insight on the evolving story of the rise of liquid alternatives in the US market please contact prime.advisory@citi.com and we would be happy to share our research.

Strategy Growth and Product Landscape

To gain a better understanding of the product development trends for these funds, a review of the rapid growth of these products is imperative. Since Morningstar, the leading independent mutual fund research company started closely monitoring and categorizing alternative mutual funds in 2003, nearly 450 funds have been launched in the US market. Through September 2014, these funds total nearly $330 Billion in Assets under Management ('AUM') across the following seven key alternative strategies: Multi-Alternative, Equity Long/Short, Equity Market Neutral, Nontraditional Bond, Managed Futures, Multi-Currency and Bear Market. The total asset growth trends for these fund strategies are highlighted in Chart 1.

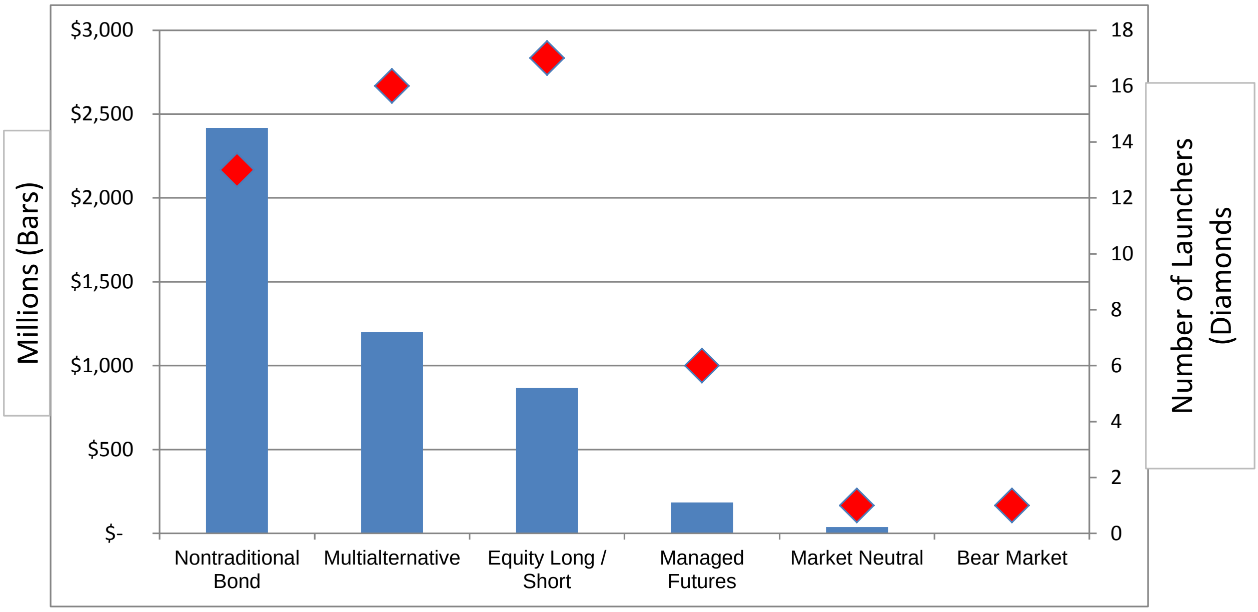
Chart 1: Assets Managed by Alternative '40 Act Mutual Funds 2010 – 3rd Quarter 2014



Source: Citi Investor Services Analysis based on Morningstar data

In reviewing trends in new fund launches for this year, we see continued demand for products from the Equity Long/Short, Multi-Alternative and Nontraditional Bond categories. Recently we have observed a resurgence of new launches in the Equity Long / Short category. In total, the industry has witnessed 17 new Equity Long / Short funds launched this year (one third of all launches) accounting for $870 million in new assets. This stand in comparison to only eight such funds launched in all of 2013. The number of launches and total assets by strategy through September 2013 are detailed in Chart 2.

Chart 2: 2014 New Alternative '40 Act Mutual Fund Launches and Assets Raised



Source: Citi Investor Services Analysis based on Morningstar data

It's important to review the role that 'Multi-Alternative' funds (sometimes referred to by industry commentators as 'Multi-Alts') have played in these early days of US liquid alternative growth. As of the end of September 2014, there are 118 'Multi-Alt' funds representing the third largest category in alternative mutual funds. Over the course of the last 24 months we have seen a progression of launches from this sector of the industry, offering diversified access to a range of strong pedigree boutique hedge funds who are exploring the retail market. Many of the sub-advisers to these funds have been using the Multi-Alt experience to refine their liquid alternative products and get comfortable with operating a fund within the constraints of the 40 Act. They have also begun to consider the possible impacts to organizational structure and compensation models if they decide to develop a full retail product set.

The growth in the Multi-Alt products may now be reaching a plateau with industry commentators detecting potential category saturation at some point in 2015. In the course of our conversations with industry participants throughout the past year, we sense that appetite for 'shelf space' within the retail wealth management industry for ~15 funds of greater than $1 Billion AUM. We may now have reached a point of maturity in the US liquid alternative market where those pedigree Hedge Fund managers who have been acting as sub-advisors are now ready to launch their own single-strategy mutual funds.

The Emergence of High Pedigree Single Strategy Liquid Alternative Mutual funds

We believe that there is both a demand and supply side set of conditions that are signifying a transition into more single-strategy liquid alternatives.

On the demand side, the US wealth management industry dominated by independent financial advisers, is continuing to educate themselves about the benefits of Equity, Fixed Income, and Macro alternative strategies and how they can be an important part of their client's portfolio. The explosion of conferences and educational tools around liquid alternatives has dominated the dialogue in 2014 and influenced the more nuanced approach Financial Advisors are using in assessing and building alternatives into their client's portfolios. In assessing market factors, one only has to look to the equity market becoming more volatile in Q4 2014, and an impending interest rate rise coming at some point in 2015 or beyond to appreciate that the time is now to allocate a greater percentage of the portfolio to specific strategies that can help with dampening volatility and preserving capital.

In looking at the supply side, the Hedge Fund managers who have been exploring the retail market through their Multi-Alt relationships have now seen the true size of the opportunity to provide investment solutions to the vast wealth management and retirement industry. Their product development has proven that they can generate risk-adjusted returns within the constraints of the '40 Act and that by differentiating the product from their private funds, they do not risk a 'cannibalization' of their traditional business. Separate teams and organizational boundaries are being constructed to oversee the retail portion of their business, and investment is taking place on branding and positioning. In the 4th Quarter we have seen a number of single-strategy Equity Long/Short and Non-Traditional Bond strategies file with the Securities and Exchange Commission and we expect to see more before the end of the year.

The managers launching these single strategy products are recognized Hedge Fund names bringing their expanded asset management skills to the universe of funds offered from traditional asset managers that dominated the early period of product creation. These portfolio managers are Hedge Fund veterans who have significant personal investments in their private funds and appear to be self-seeding this new breed of funds. The emergence of the single-strategy product range is just beginning, but we can see its first forays into the market begin to take shape.

Looking forward to 2015, there are a multitude of factors that could either slow down or accelerate the rise of single-strategy liquid alternative funds in the US, however we feel the broad adoption of alternative mutual funds over the past several years creates a significant opportunity for blue chip hedge funds to now enter the market . As markets return to historically normal levels of volatility, we see the financial adviser community more focused on such products. The Multi-Alts performance for 2014 will be closely scrutinized for correlation to equity and bond markets, and the promise of diversification will be assessed. The supply of new products will increase and the range of educational forums, conferences, and seminars will rapidly expand as market participants realize the opportunity unfolding.