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Morningstar & *Barron's*  
2011 Alternative Investment Survey of  
U.S. Institutions and Financial Advisors

May 2012

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## 2011 Survey Overview

- ▶ Survey aims to capture trends in alternative investing among institutions and advisors.
- ▶ 6<sup>th</sup> annual nationwide survey, conducted in January 2012.
- ▶ 264 institutional investors and 365 advisors participated.
- ▶ Institutional survey included 19 questions; advisor survey had 25.
  - ▶ Five free-response questions tackling new topics like tail-risk hedging and alternative investment process formulation.

# Key Takeaways

- ▶ **Alternatives continue to gain assets, bucking the trend in U.S. equities, but growth and excitement is cooling**
  - ▶ Alternative funds saw inflows of \$23.2 billion in 2011 (\$14.2 billion excluding the nontraditional bond category), while U.S. equity mutual funds bled \$84.7 billion.
  - ▶ However, inflows were lower than prior years. Alternative ETF inflows for 2011 were only \$11.6 billion, the lowest level since 2006. Inflows for alternative mutual funds were \$1.8 billion less than the prior year.
  - ▶ Approximately 65% of advisors and 67% of institutions indicated that alternative investments are as important or more important than traditional investments, down slightly from last year's survey.
  - ▶ From 2008 through 2010, institutions indicated rising interest and investment in alternative investments, but this year's survey saw some retreat. Among the institutions surveyed, 26% indicated they plan to allocate more than a quarter of their portfolios to alternative investments, down from 37% in the last survey.

## Key Takeaways (continued)

- ▶ **Sentiment has cooled to more established equity-based alternatives, but not to non-equity-based strategies like managed futures and currencies, despite poor performance**
  - ▶ Managed futures and currency mutual funds recorded inflows of \$3.6 billion and \$3.4 billion, respectively, in 2011, despite the fact that managed futures lost 6.9% that year, while currency funds lost money every year since 2008.
  - ▶ For the second year in a row, advisors again cited managed futures as the asset to which they were most likely to increase their exposure, while currency funds didn't make their top five.
  - ▶ Institutions flagged managed futures as the third most popular strategy for increased allocation, while long/short equity (or debt) and private equity/venture capital were the top two strategies for increased allocation.
  - ▶ While still positive, flows into market neutral and long/short equity funds—two more well-established categories—saw far lower inflows in 2011 than in 2010.

## Key Takeaways (continued)

- ▶ **Unanimously, advisors and institutions both agreed that diversification was driving alternative investments; high fees and lack of liquidity were holding them back**
  - ▶ Institutions stated lack of liquidity was the greatest impediment, while advisors cited higher fees. Uncertain benefits and lack of transparency were also top detractors.
  - ▶ Over the years, the percent of advisors concerned about lack of liquidity has fallen sharply, from 60% in 2009 to 40% in the most recent survey, coinciding with the launch of many new liquid alternative products.

## Main Topics

- ▶ Alternative Mutual Fund and ETF Growth
- ▶ Institutional and Advisor Survey Participant Profile
- ▶ Defining Alternative Investment Strategies
- ▶ Past Growth and Future Growth—Assumptions
- ▶ Alternative Investment Drivers and Disincentives
- ▶ Hot Topics in 2011: Commodity Investing, Tail-Risk Hedging, Fee Concessions, and the Alternative Investment Process

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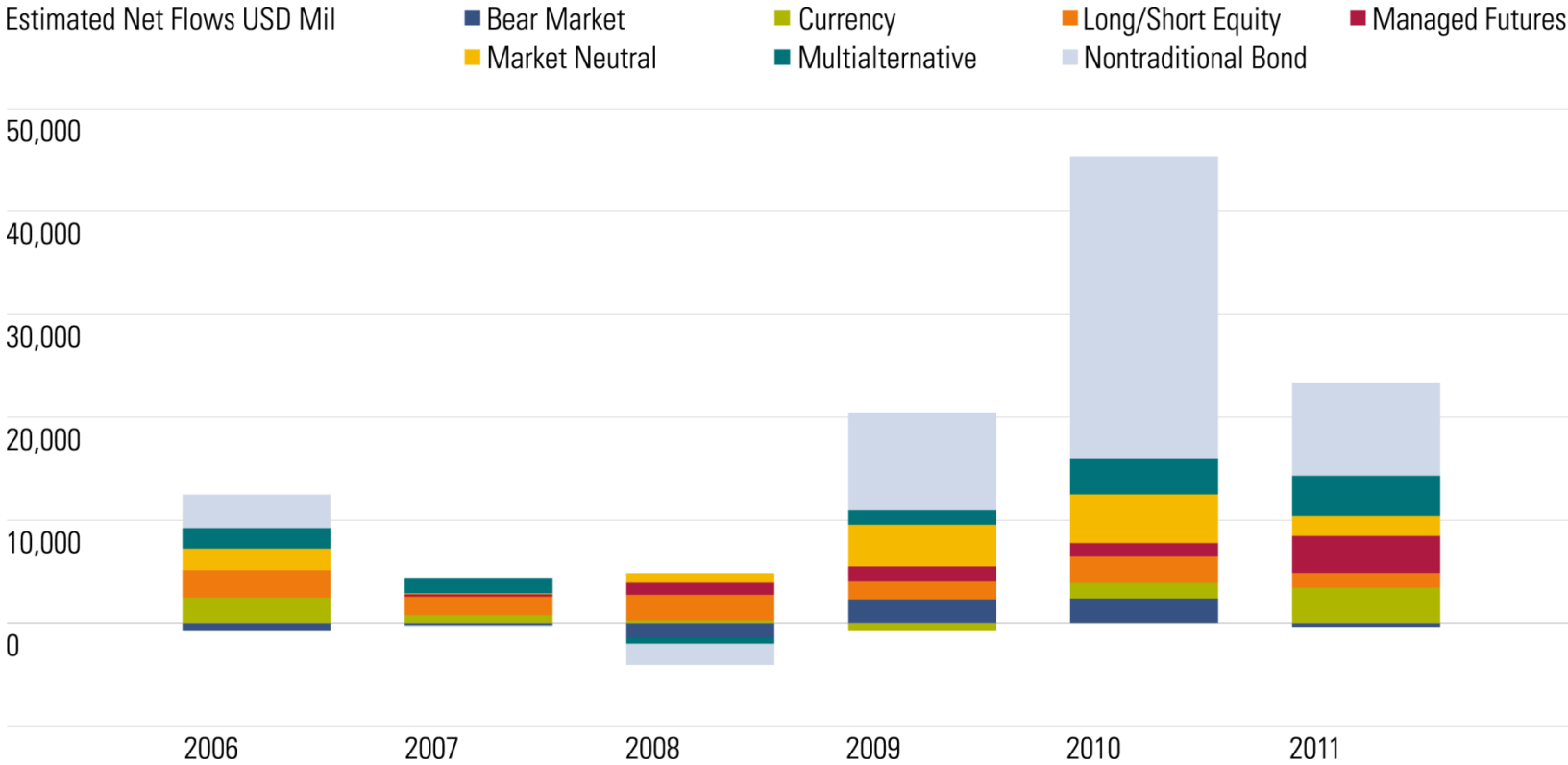
# Alternative Mutual Fund and ETF Growth

## Alternative Mutual Fund and ETF Growth

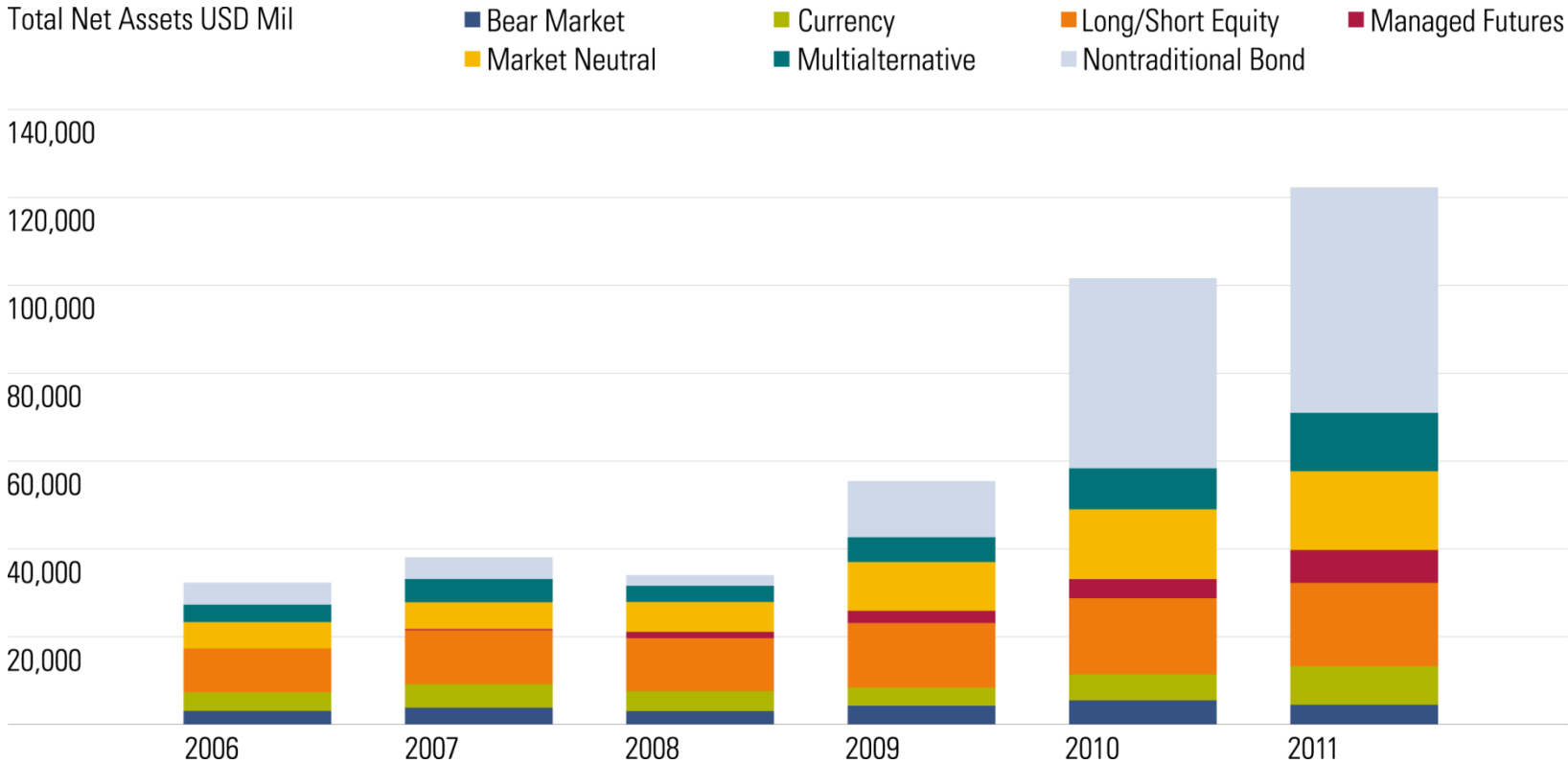
- ▶ All seven Morningstar alternative mutual fund categories have seen tremendous inflows over the past five years.
- ▶ Nontraditional bond mutual funds have gathered the most assets, but managed futures strategies are also gaining steam.
- ▶ The long-short equity and multialternative mutual fund categories jumped in terms of new launches in 2011, adding 17 and 24 new funds, respectively.
- ▶ Alternative ETFs saw net inflows of \$45 billion in 2009.
- ▶ Commodity ETFs are the most popular strategies.
- ▶ Over the last several years, the trading ETF category has seen the most launches.



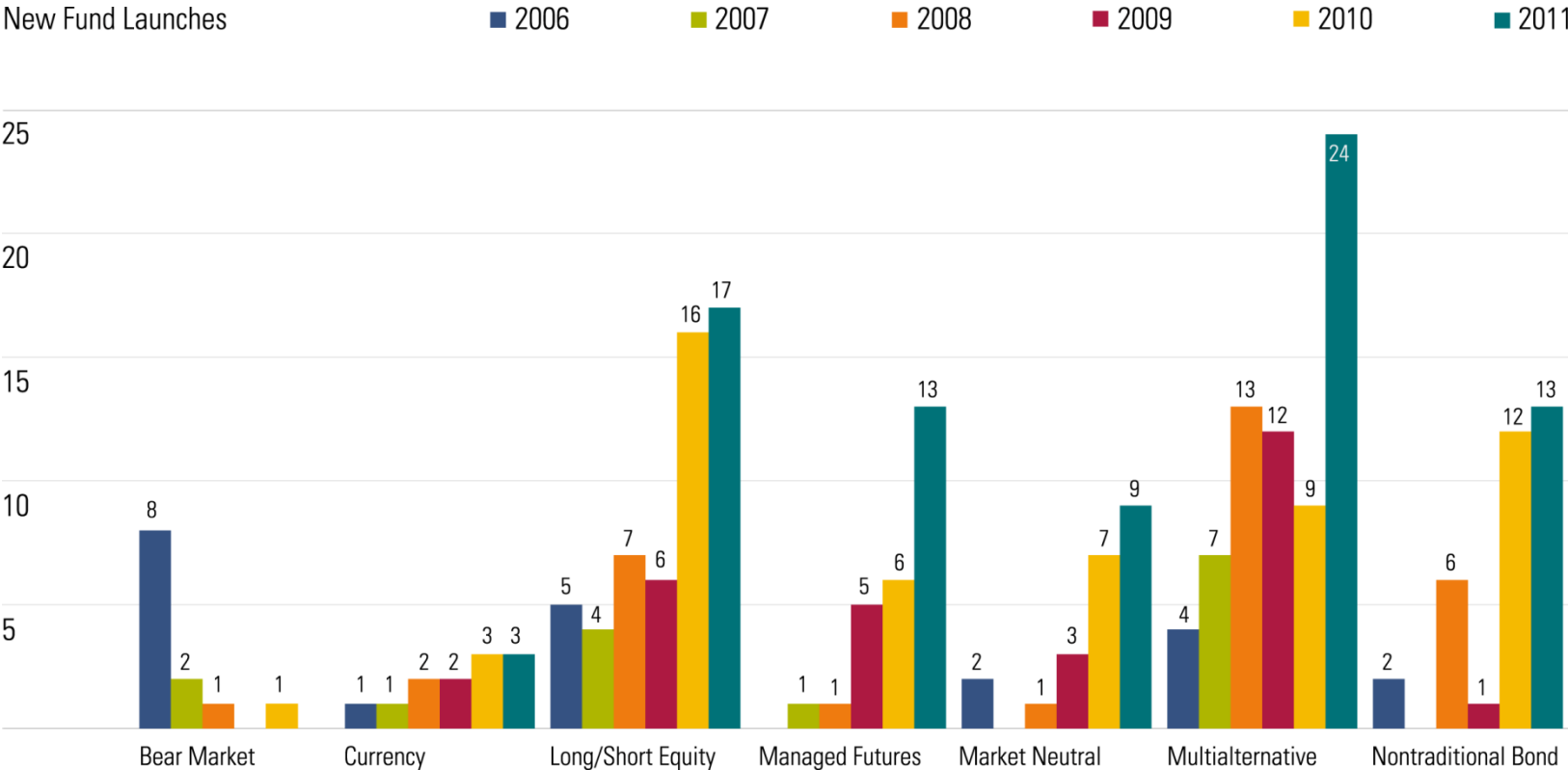
# Alternative Mutual Fund Flows



# Total Assets in Alternative Mutual Funds

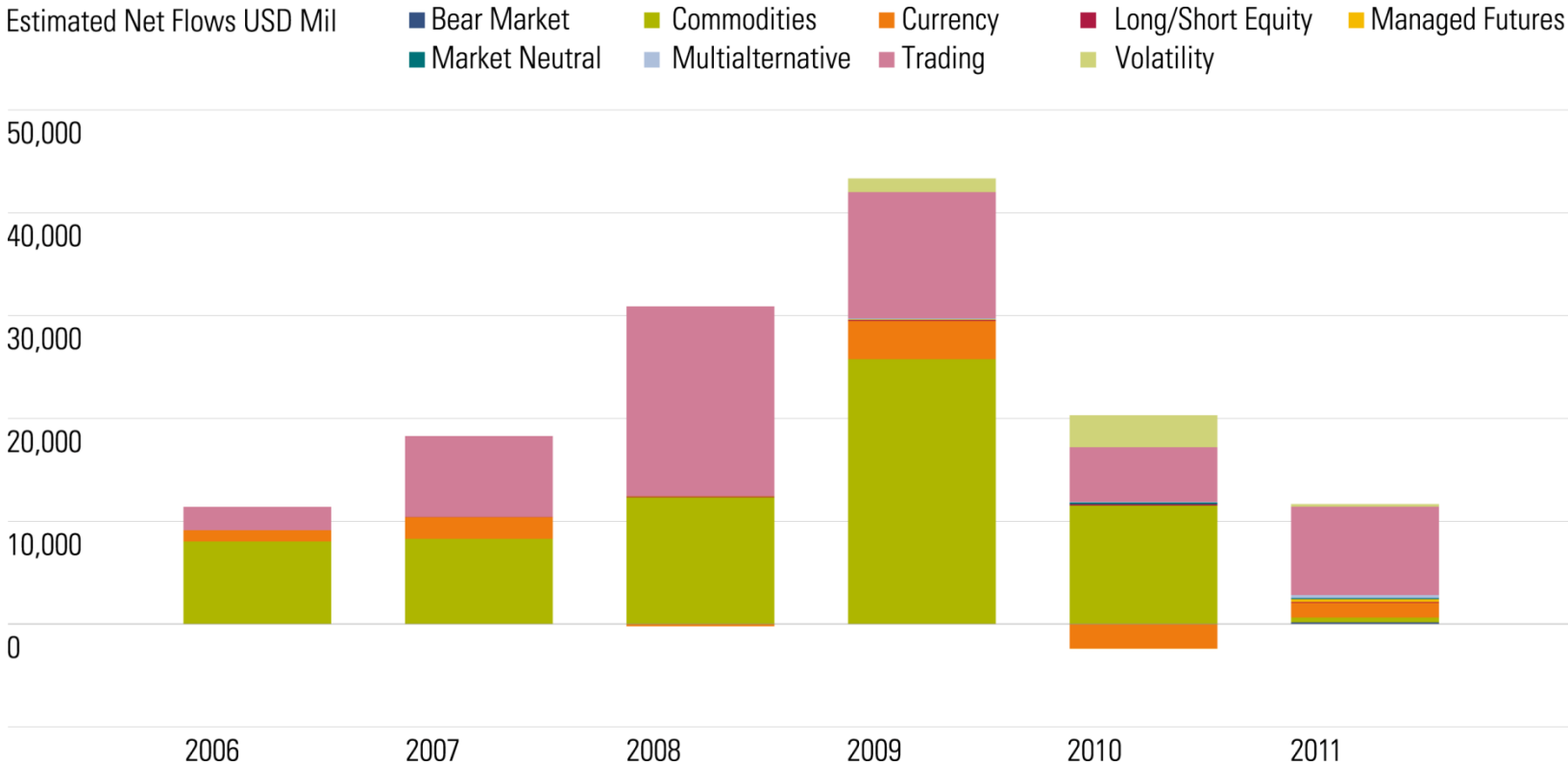


# Annual Alternative Mutual Funds Launches by Category

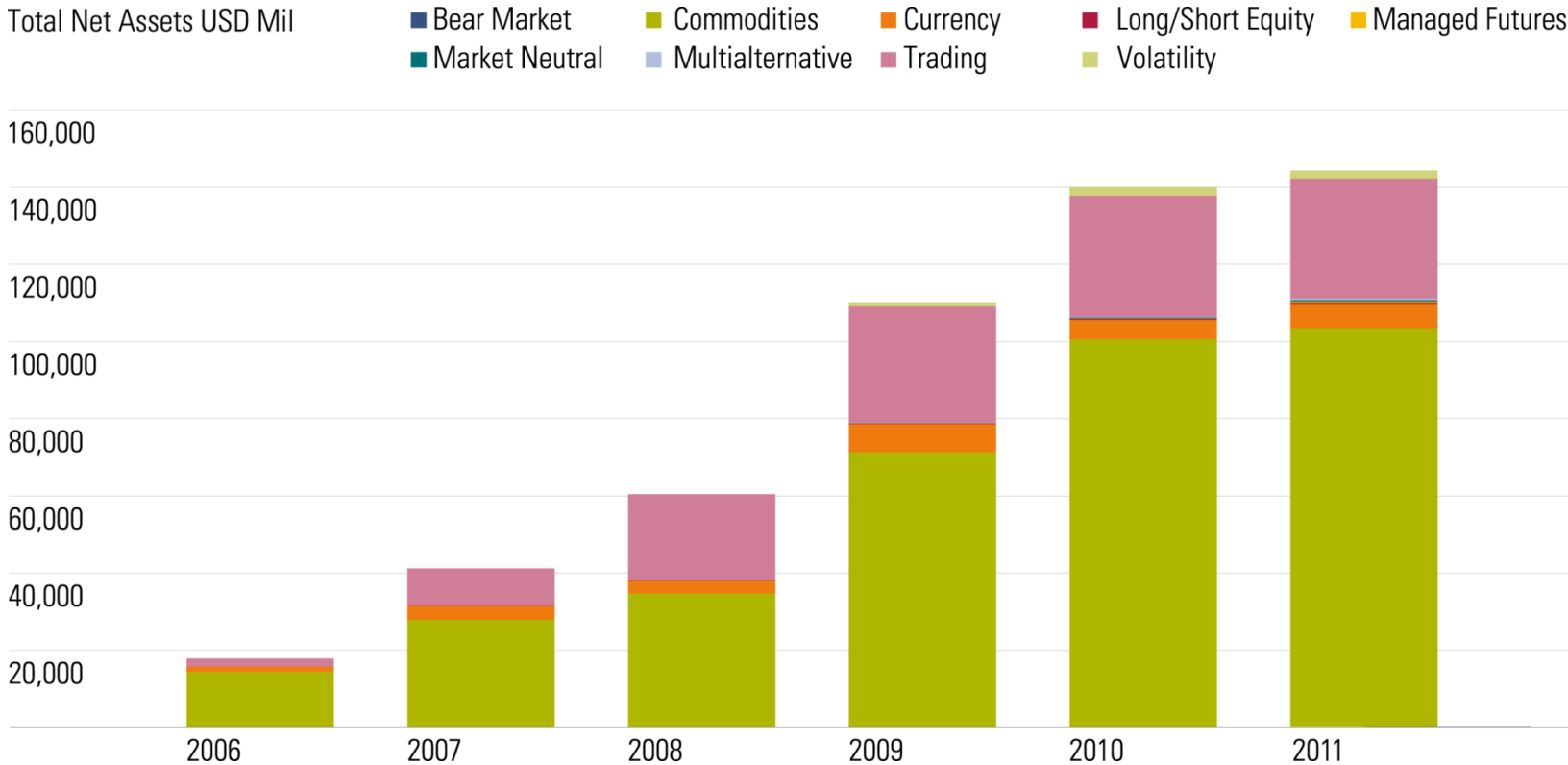


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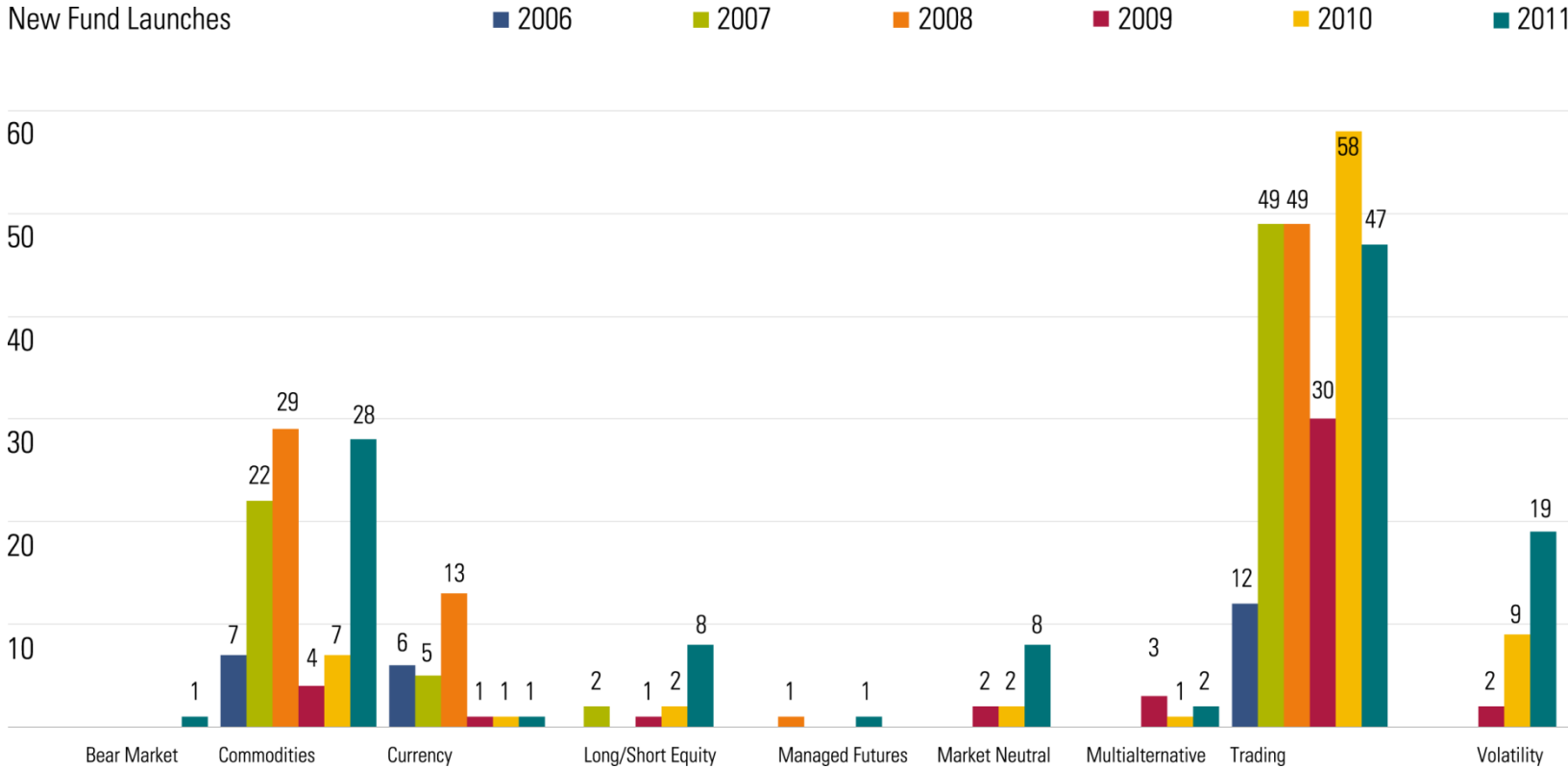
# Alternative ETF Flows



# Alternative ETF Assets



# Alternative ETF Launches by Category

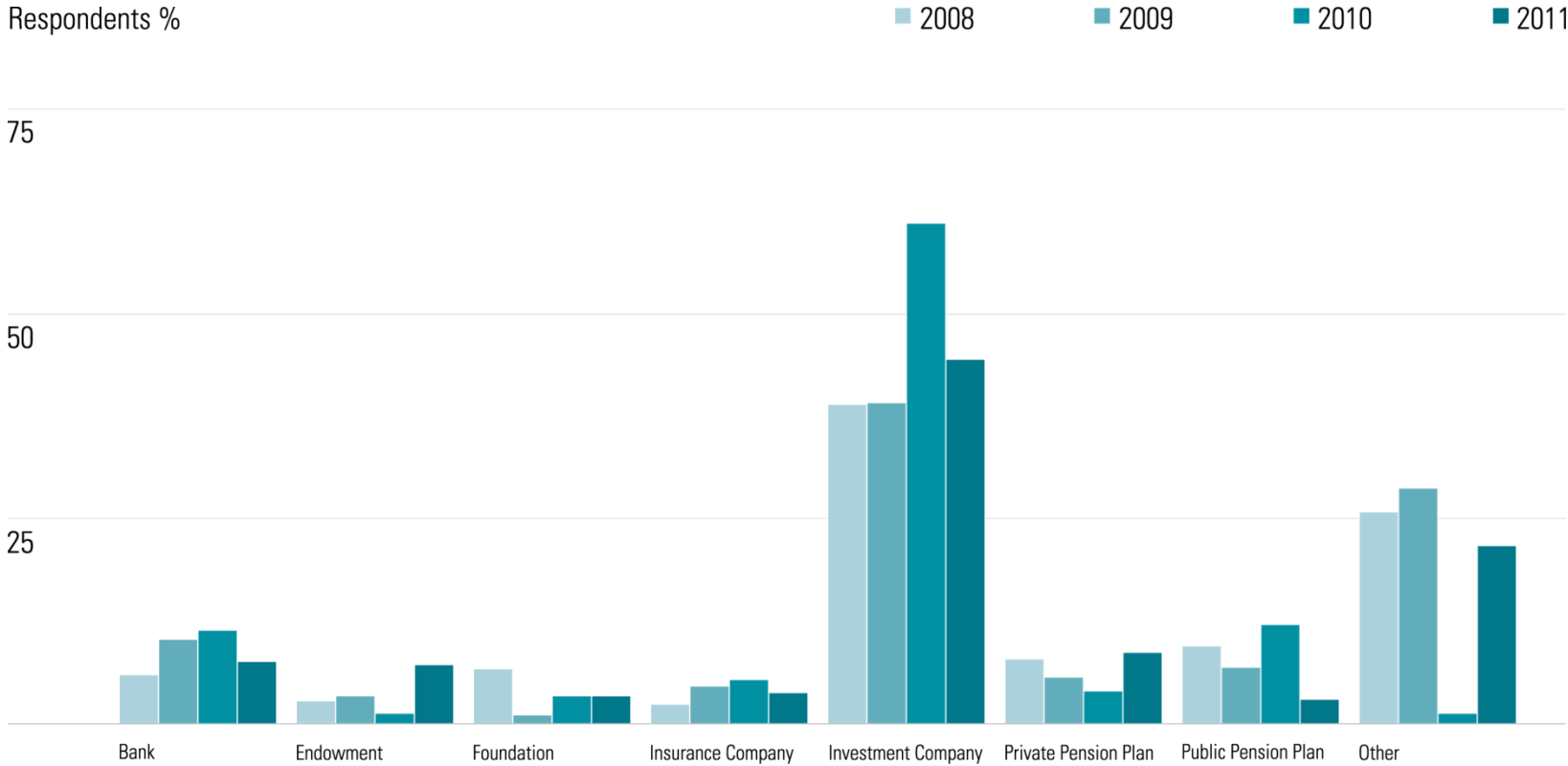


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# 2011 Survey Participation

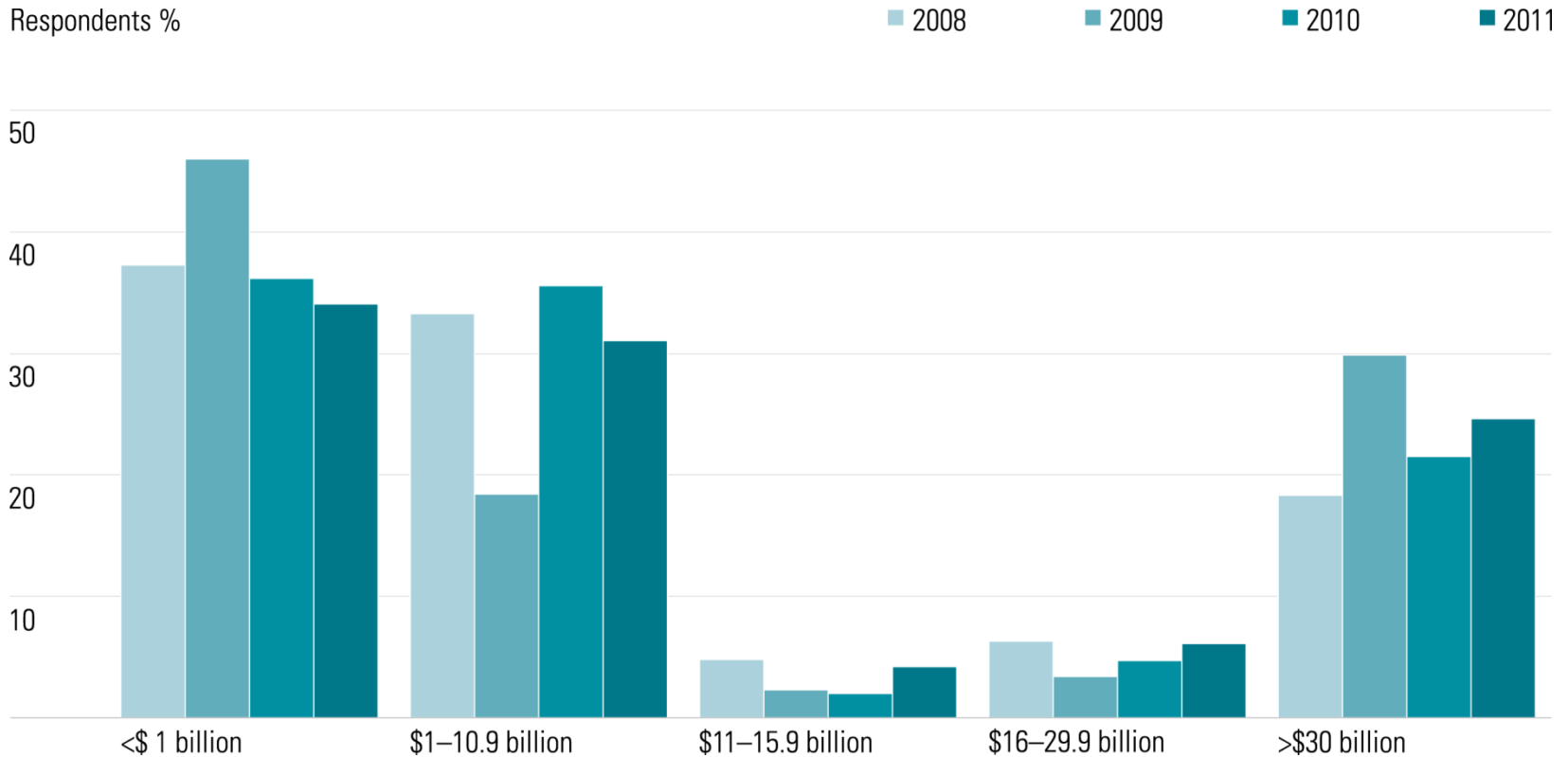
# Institutional Investor 2011 Survey Participation

264 Responses





# Institutional Investors' AUM Compared to Previous Years

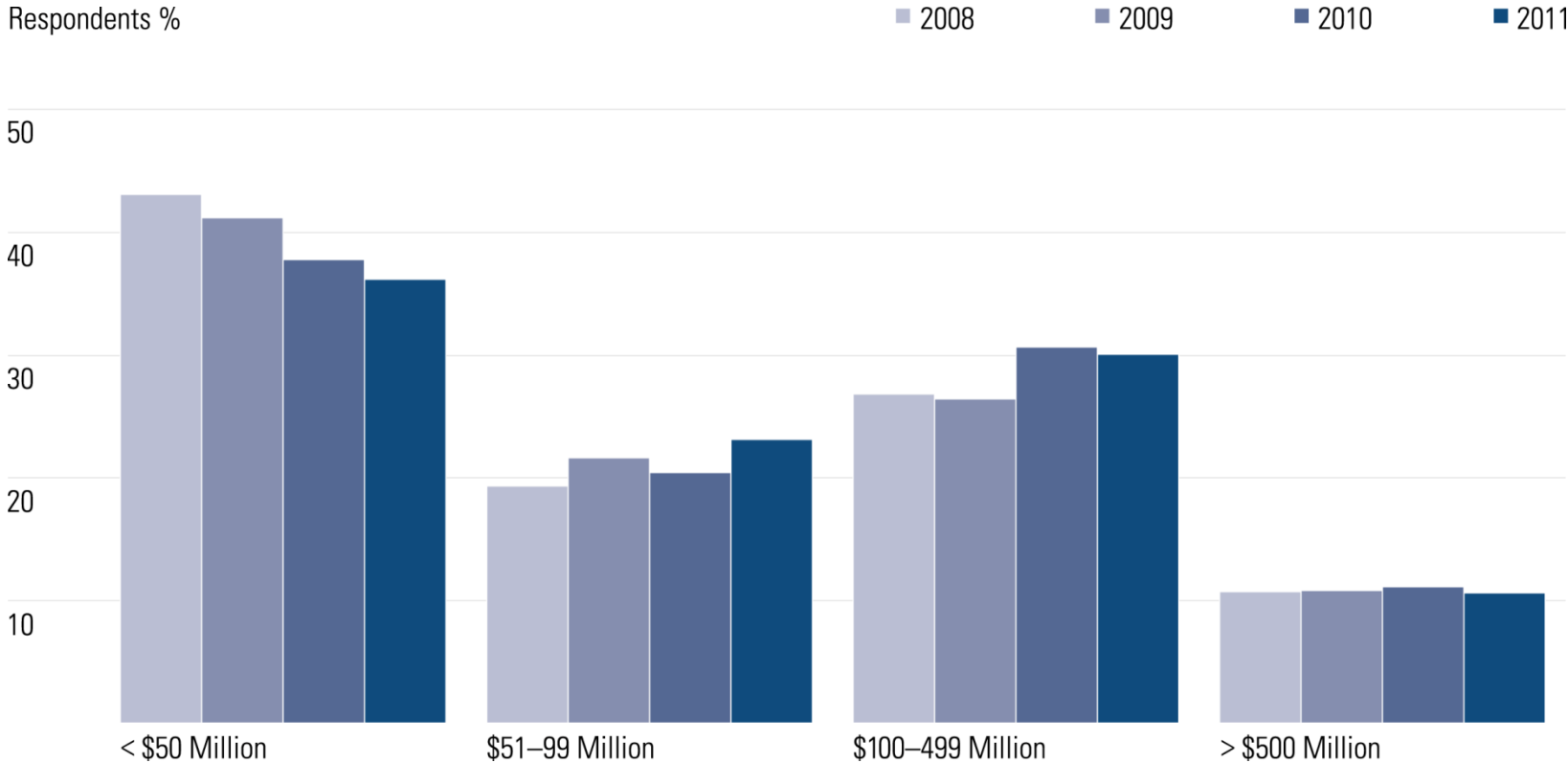


# 365 Advisors Participated in the 2011 Survey

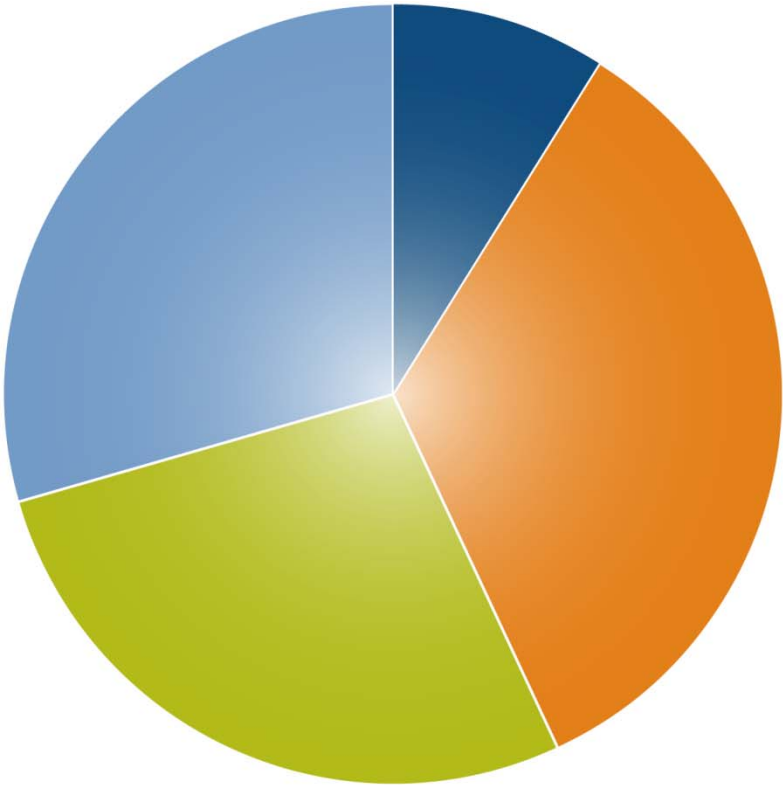


	Respondents %
Broker/Dealer	42.7
■ Wirehouse	9.9
■ Regional	8.0
■ Independent	18.5
■ Insurance	4.4
■ Bank	1.9
■ Financial Planner	9.9
■ RIA—SEC Registered	28.2
■ RIA—State Level	12.2
■ Other	6.9

# Advisors' AUM Compared to Previous Years



# Advisors 2011: Most Serving 100 or More Clients



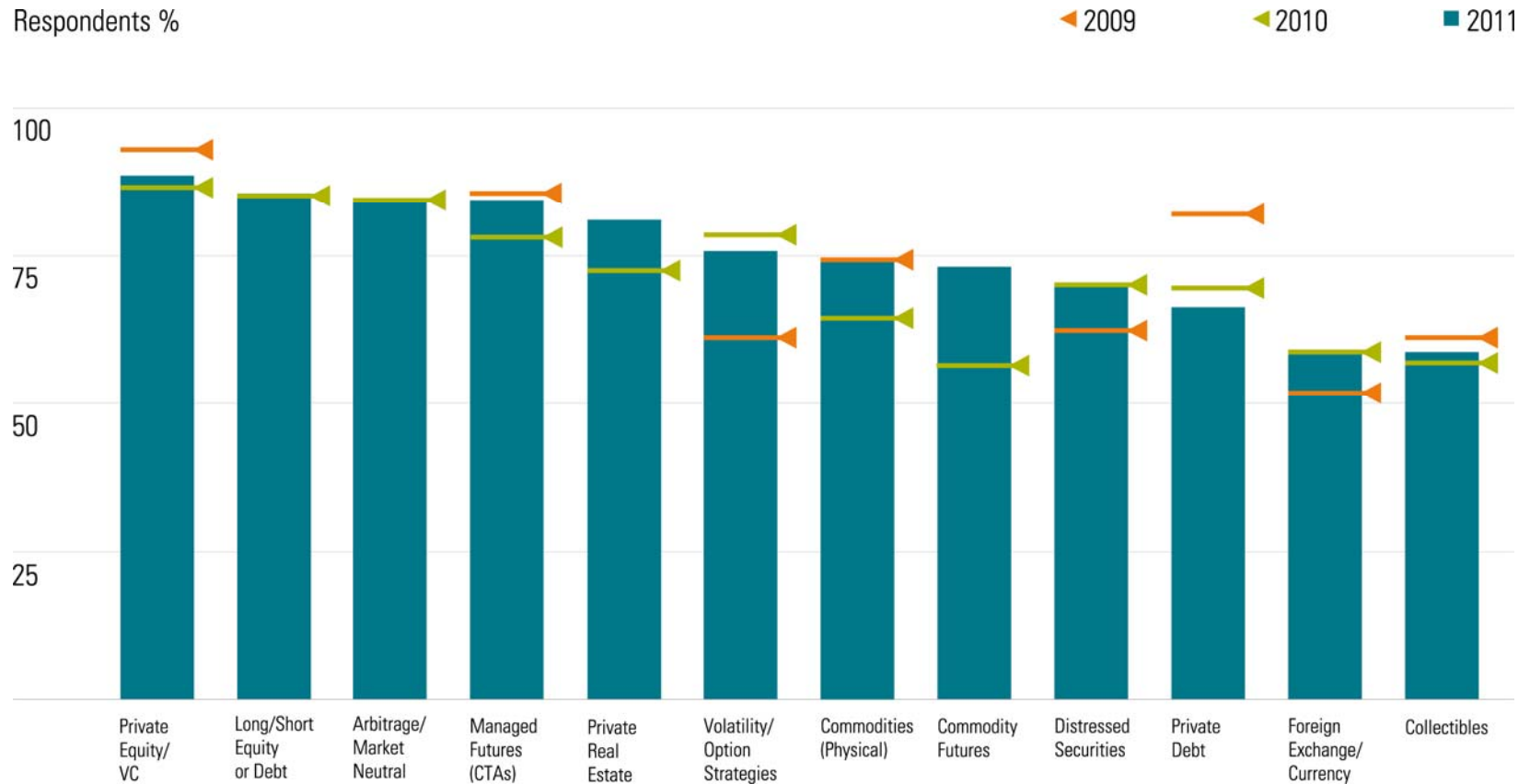
	Respondents %
■ 20 or fewer	9.1
■ 21-99	34.0
■ 100-199	27.6
■ 200 or more	29.3

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# Defining Alternative Strategies—2011

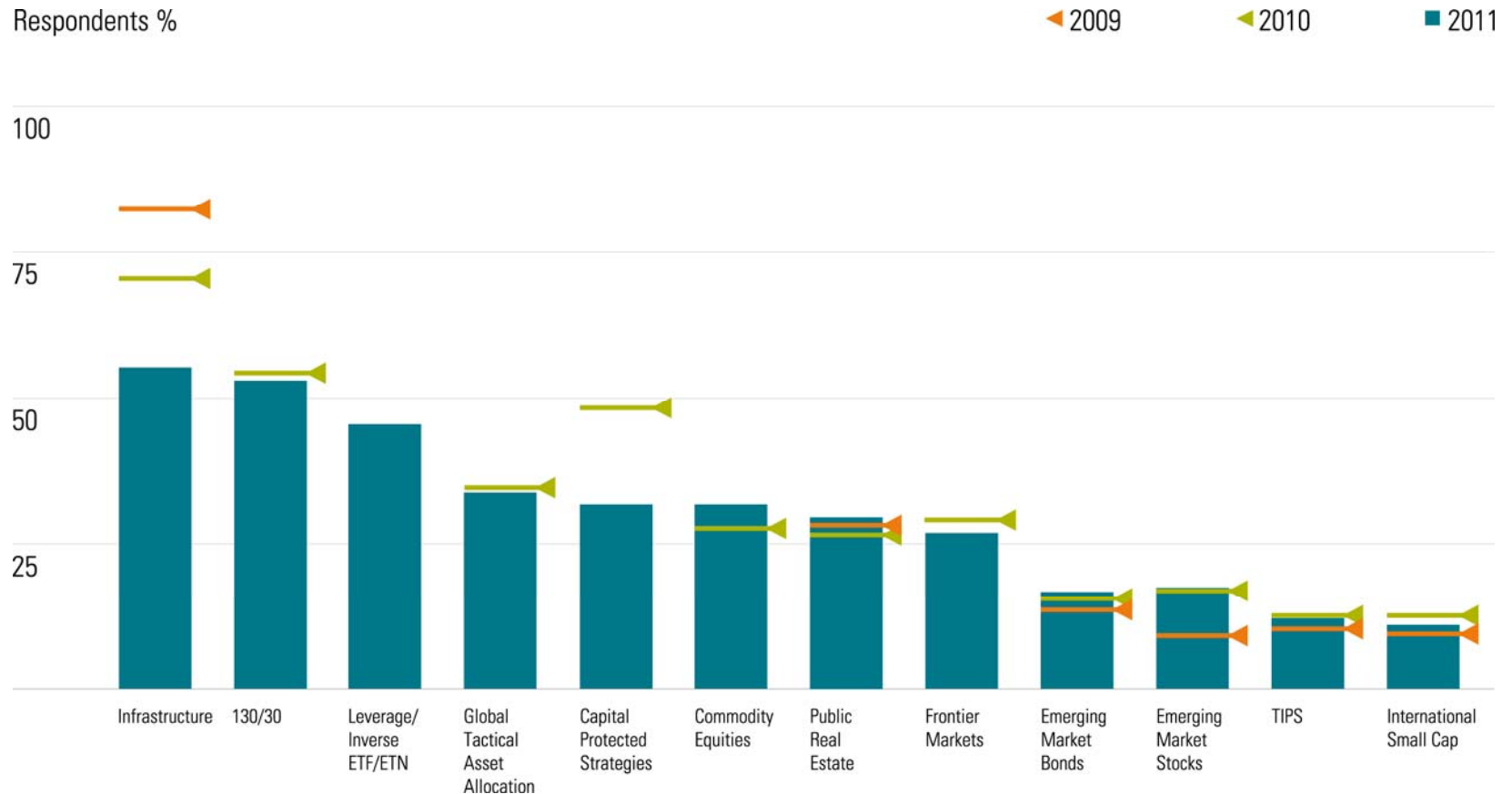
# Institutions: What are Alternative Investment Strategies?

Top 12, ranked by 2011 % agreement



# Institutions: What are Alternative Investment Strategies?

Bottom 12, ranked by 2011 % agreement



## Institutions: Other Alternative Strategies

- ▶ Event-driven, special situations, activism
- ▶ Farmland and timberland
- ▶ Master Limited Partnerships (MLPs)
- ▶ Insurance-linked & catastrophe bonds
- ▶ Funds of hedge funds
  - ▶ Several participants listed this response under “other strategies,” highlighting the confusion between alternative strategies and the vehicles in which they are offered.



# Advisors: What are Alternative Investment Strategies?

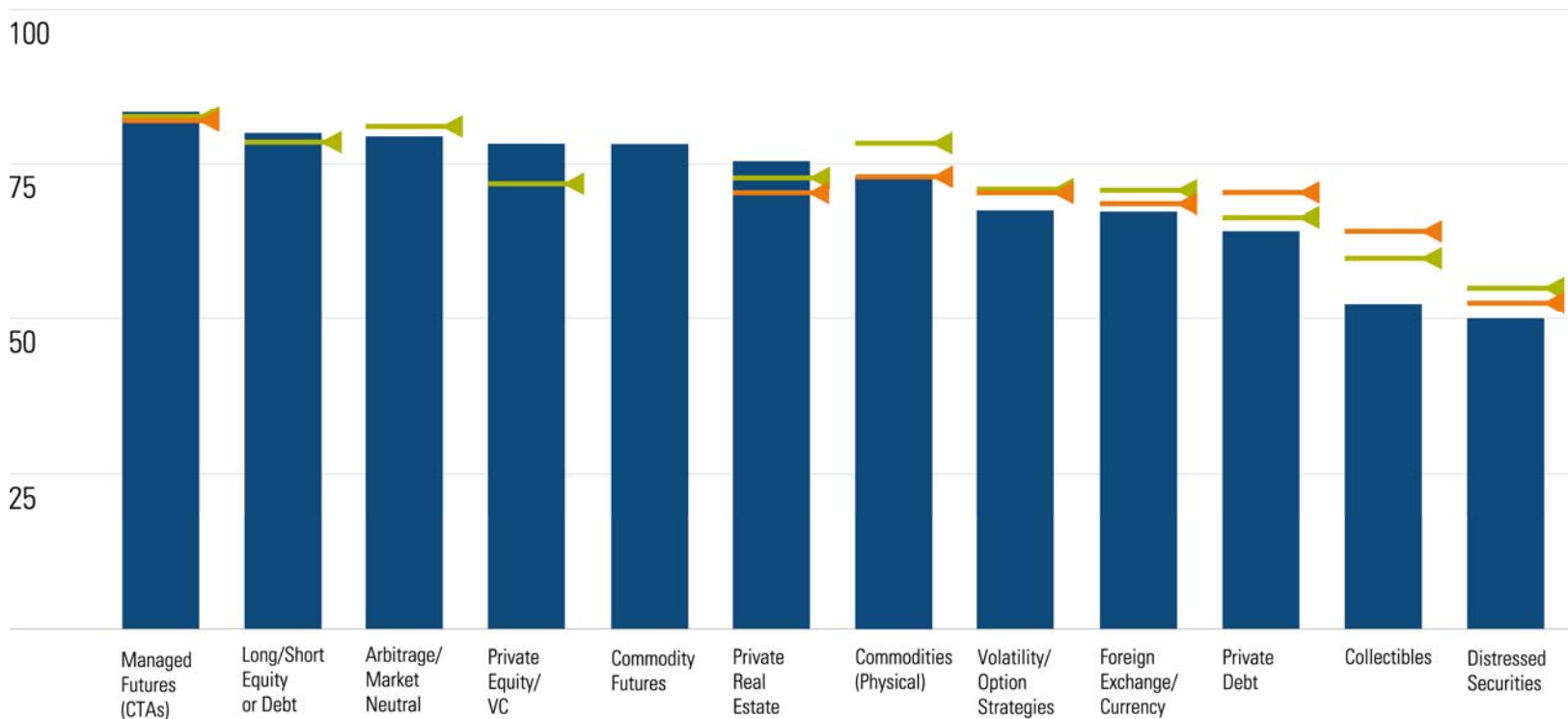
Top 12, ranked by 2011 % agreement

Respondents %

◀ 2009

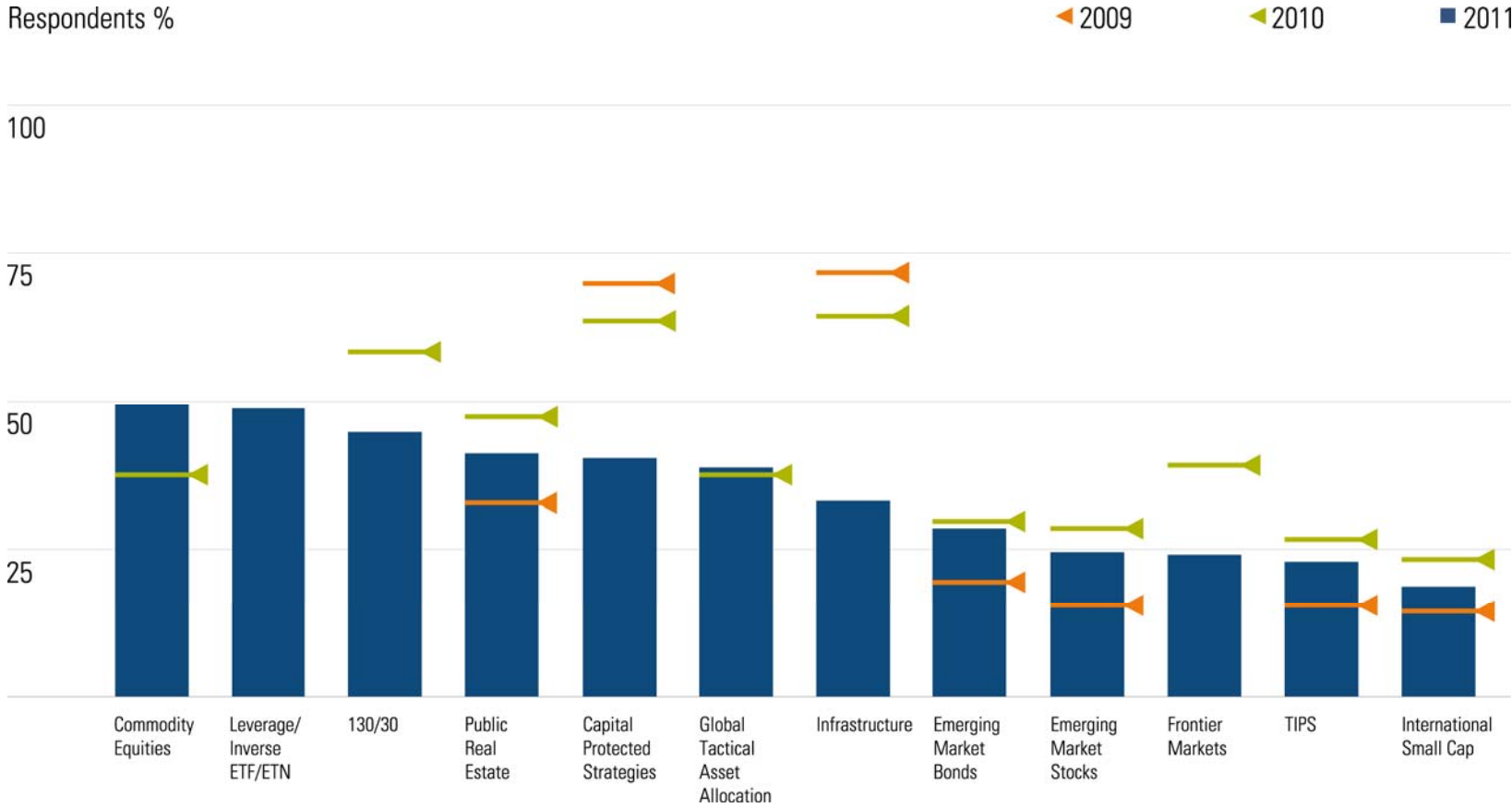
◀ 2010

■ 2011



# Advisors: What are Alternative Investment Strategies?

Bottom 12, ranked by 2011 % agreement



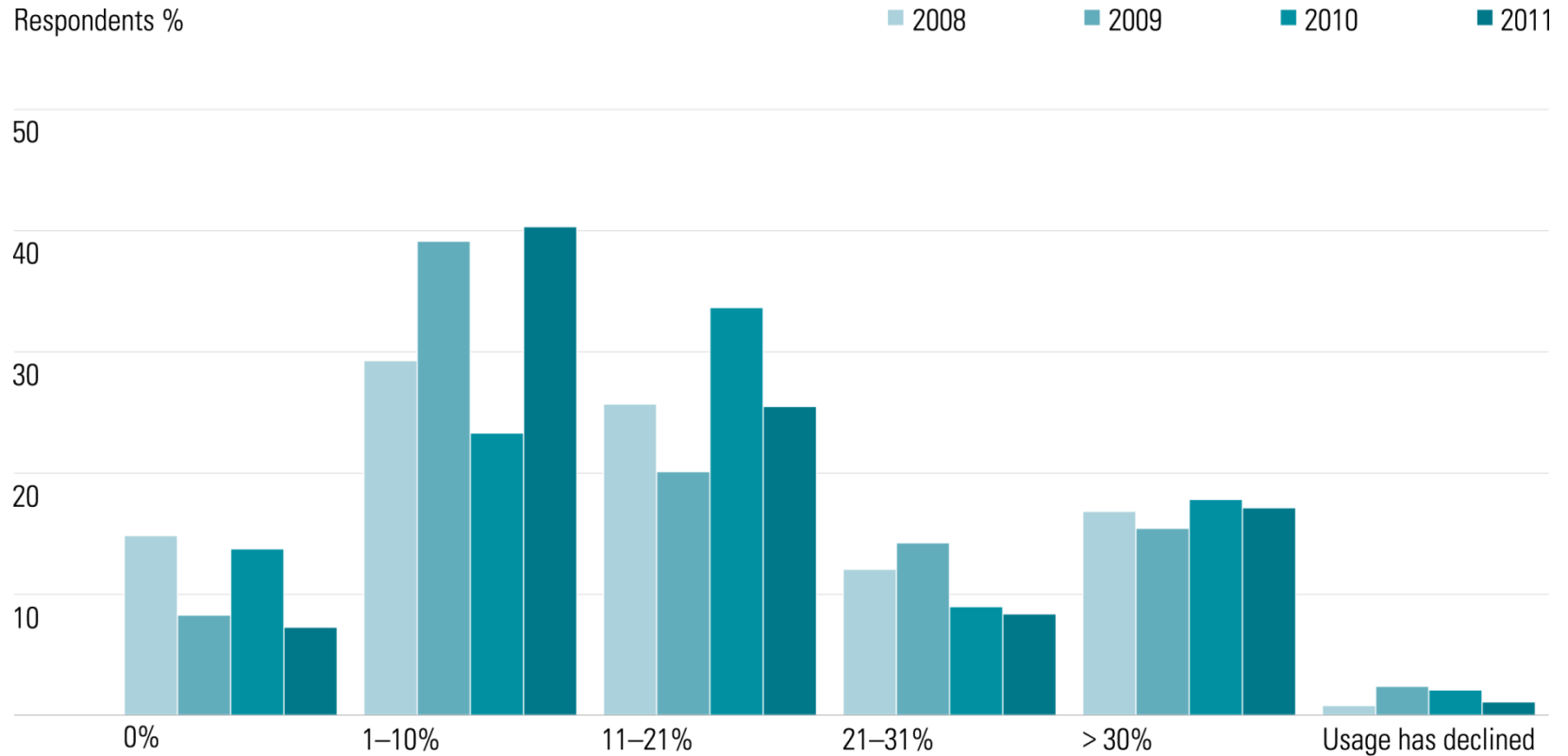
## Advisors: Other Alternative Strategies

- ▶ Asset-backed lending
- ▶ Merger arbitrage/event-driven
- ▶ Timberland, farmland
- ▶ MLPs, oil & gas

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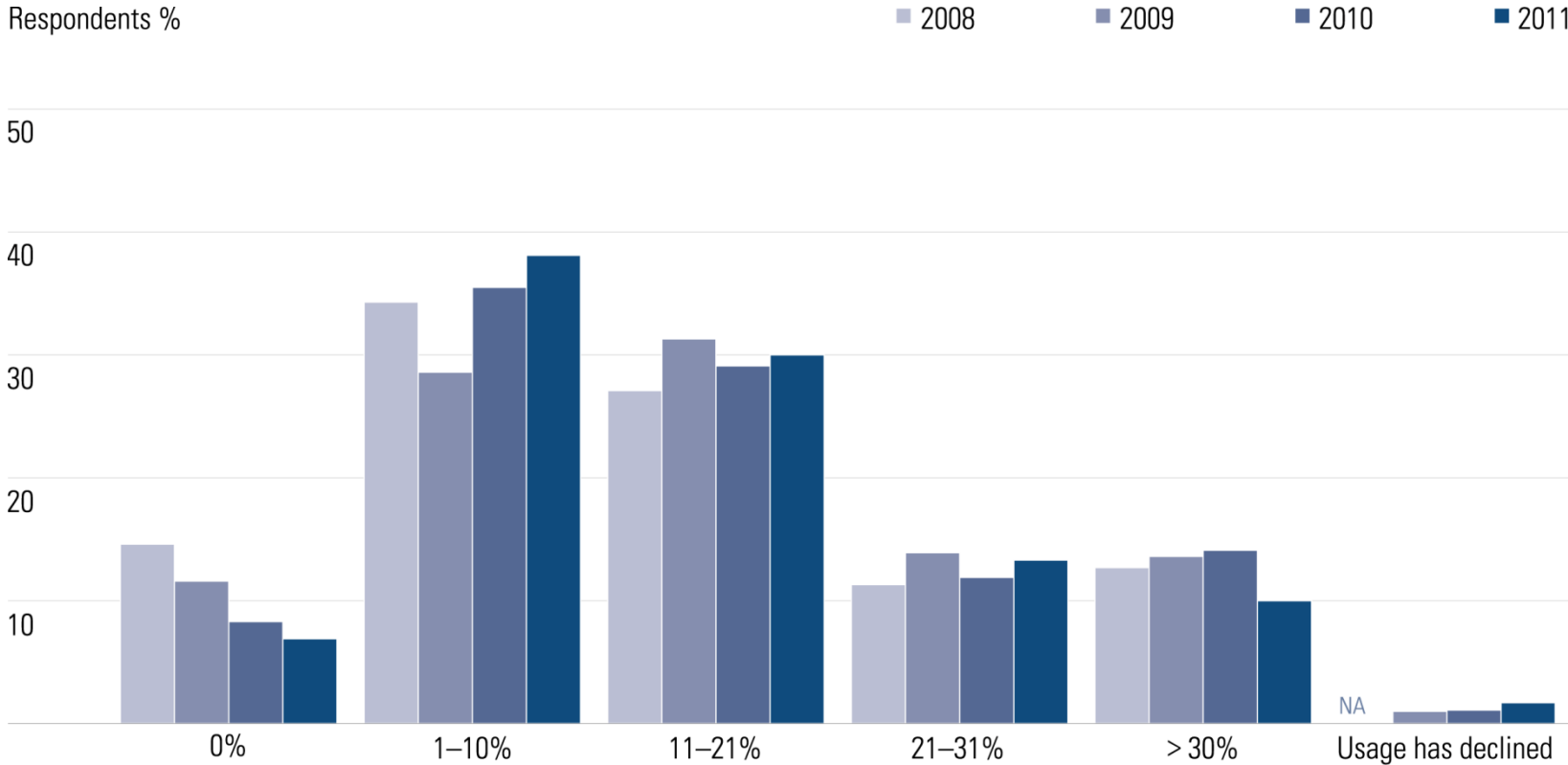
# Past and Future Alternatives Growth

# Institutions: Average Annual Growth in Alternative AUM Over Past Five Years



**What has been your estimated average annual growth in alternative assets under management over the last five years?**

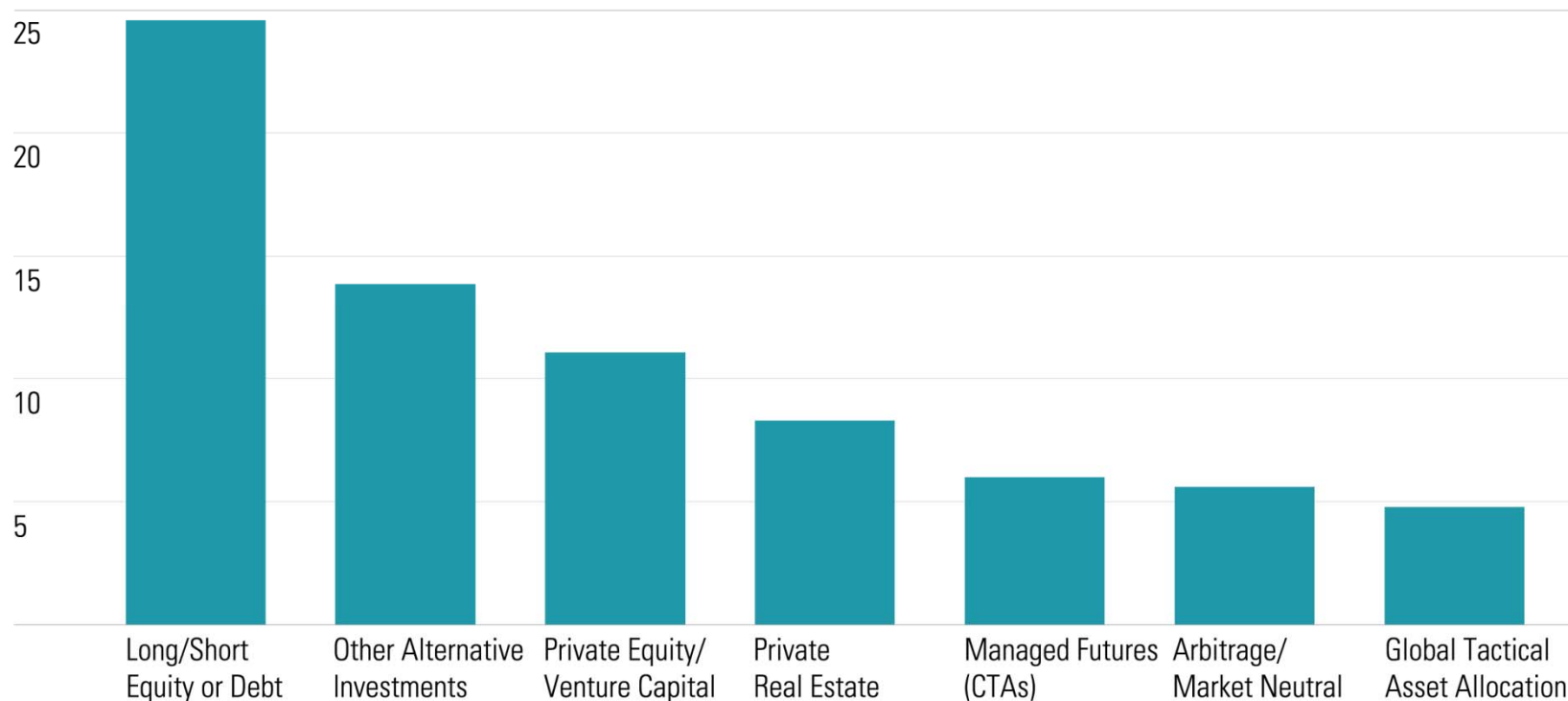
# Advisors: Estimated Average Annual Growth in Alternative AUM Over Last Five Years



**What has been your estimated average annual growth in alternative assets under management over the last five years?**

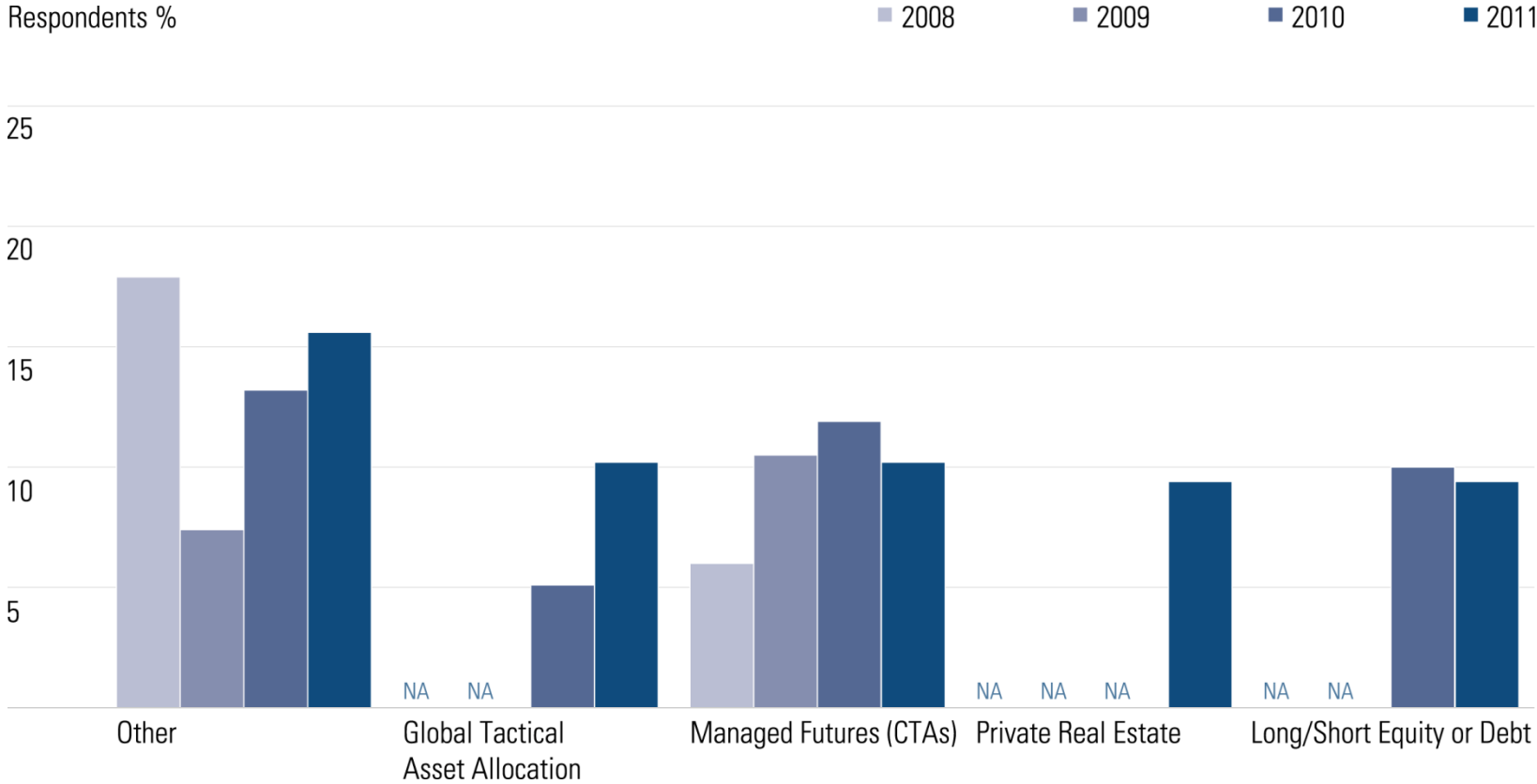
# Institutions: Strategies Representing Largest Alternative Allocation Over Last Five Years

Respondents %



**Over the last five years, which ONE alternative STRATEGY has come to represent the largest (%) allocation of your investment portfolio?**

# Advisors: Alternative Strategy That Provided Greatest Growth to Business Over Last Five Years



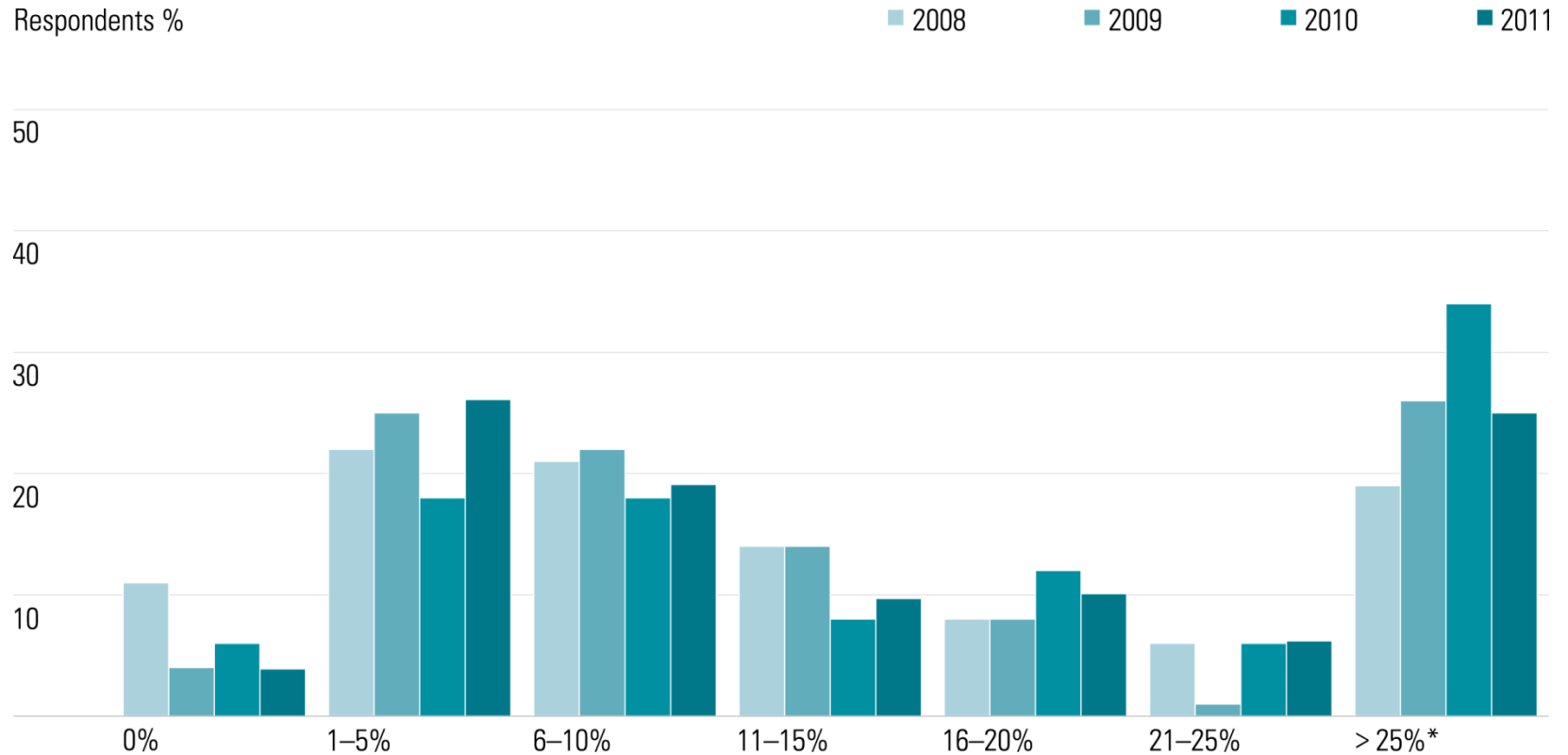
**Over the last five years, which ONE alternative STRATEGY has provided the greatest growth to your business/your book of business?**



## Advisors: “Other” Growth-Driving Alternative Strategies

- ▶ MLPs
- ▶ Senior secured notes
- ▶ Structured products
- ▶ Commodity ETFs
- ▶ Microcap long-only
- ▶ Hedge funds and funds of hedge funds
  - ▶ Again, this highlights participant confusion between alternative strategies and investment vehicles

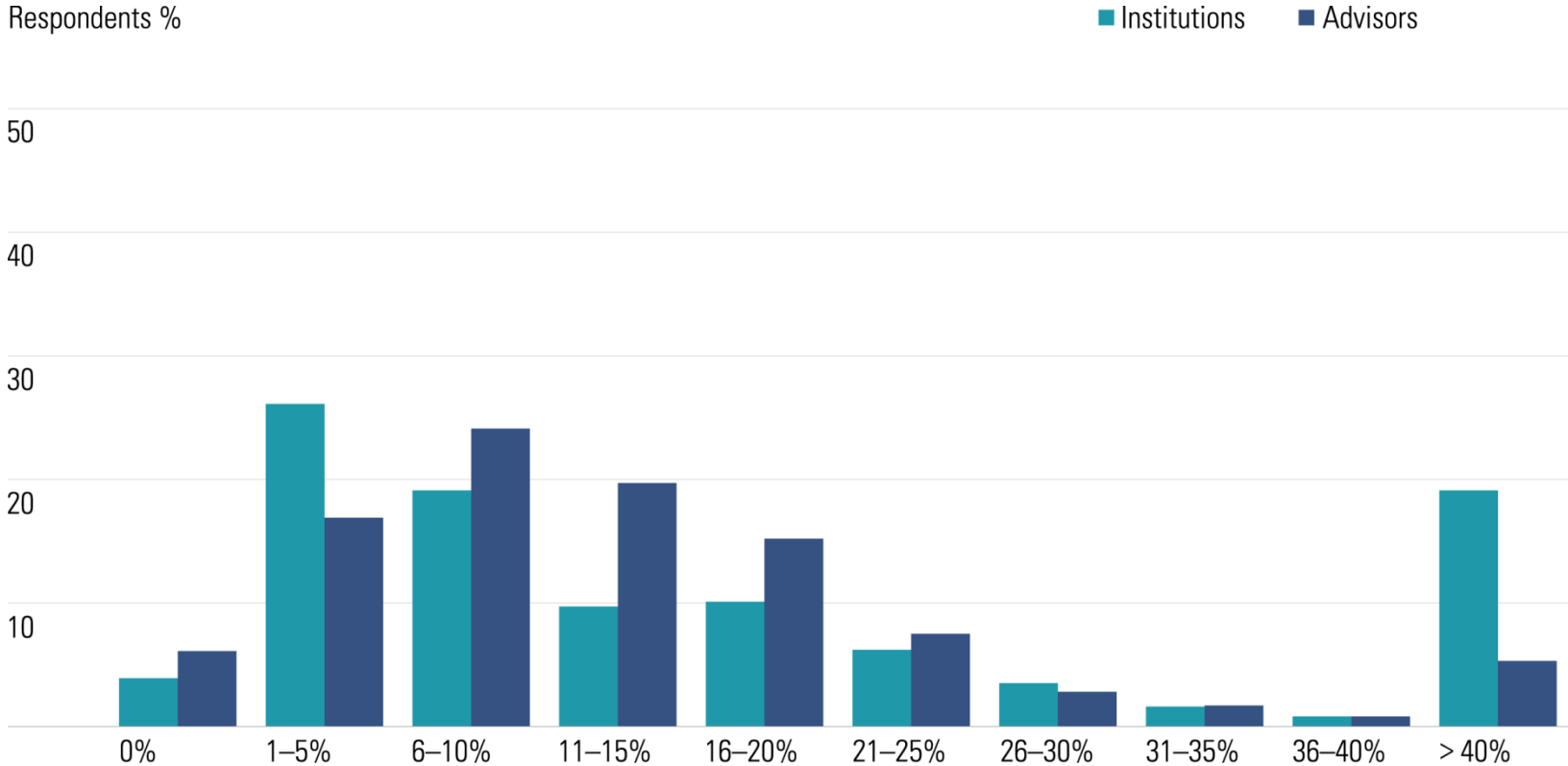
# Institutions: Allocation to Alternative Investments Over Time



**What was the average percent allocated to alternative investments?**

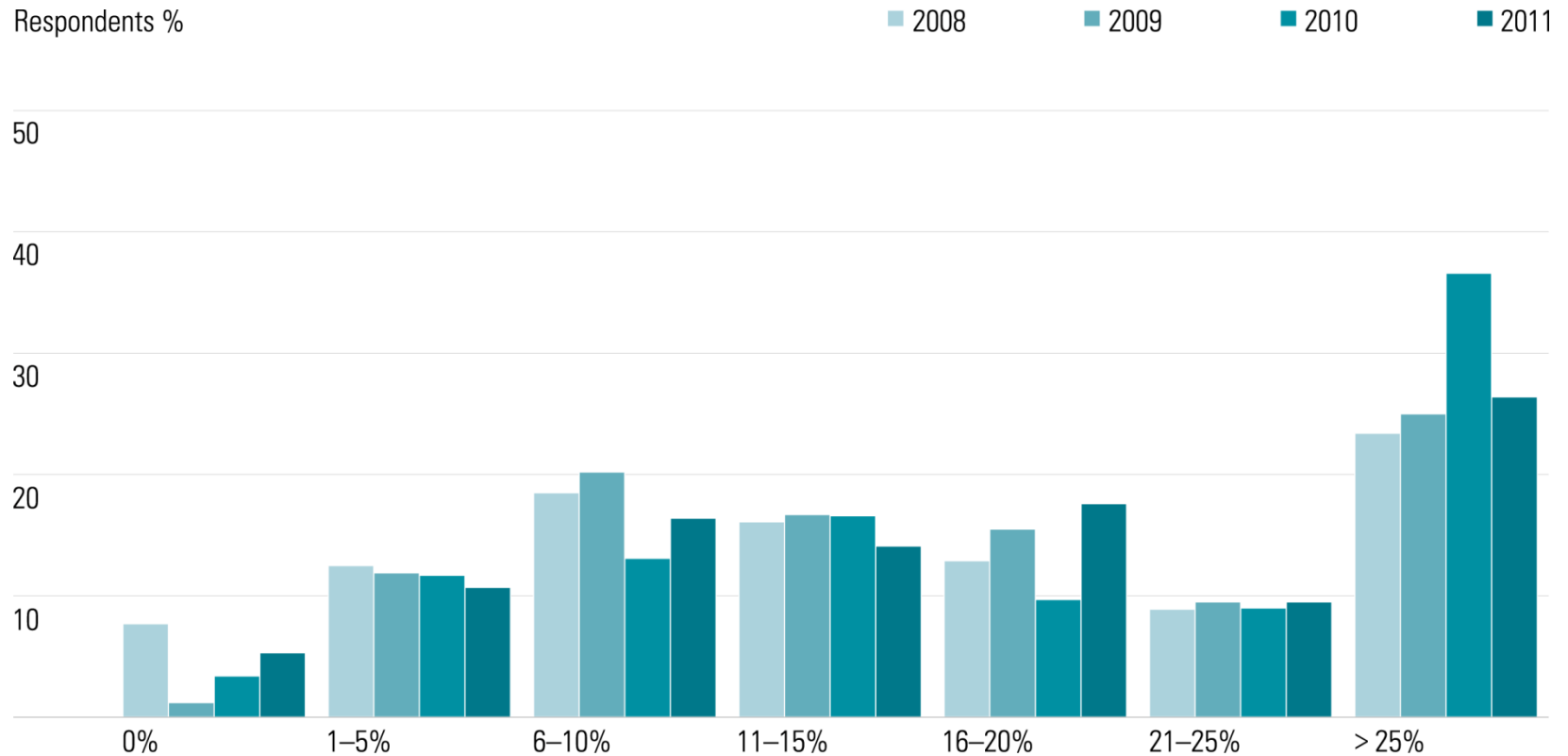
\*19% said alternatives make up 40% of holdings

# Institutions and Advisors: Allocation to Alternative Investments in 2011



**What percent of your clients are currently using alternative investments?**

# Institutions: Allocation to Alternatives Over the Next Five Years



**What is your anticipated OVERALL allocation to alternative assets over the next five years (until 2016)?**

# Institutions: Top Alternative Strategies for Increased Allocation

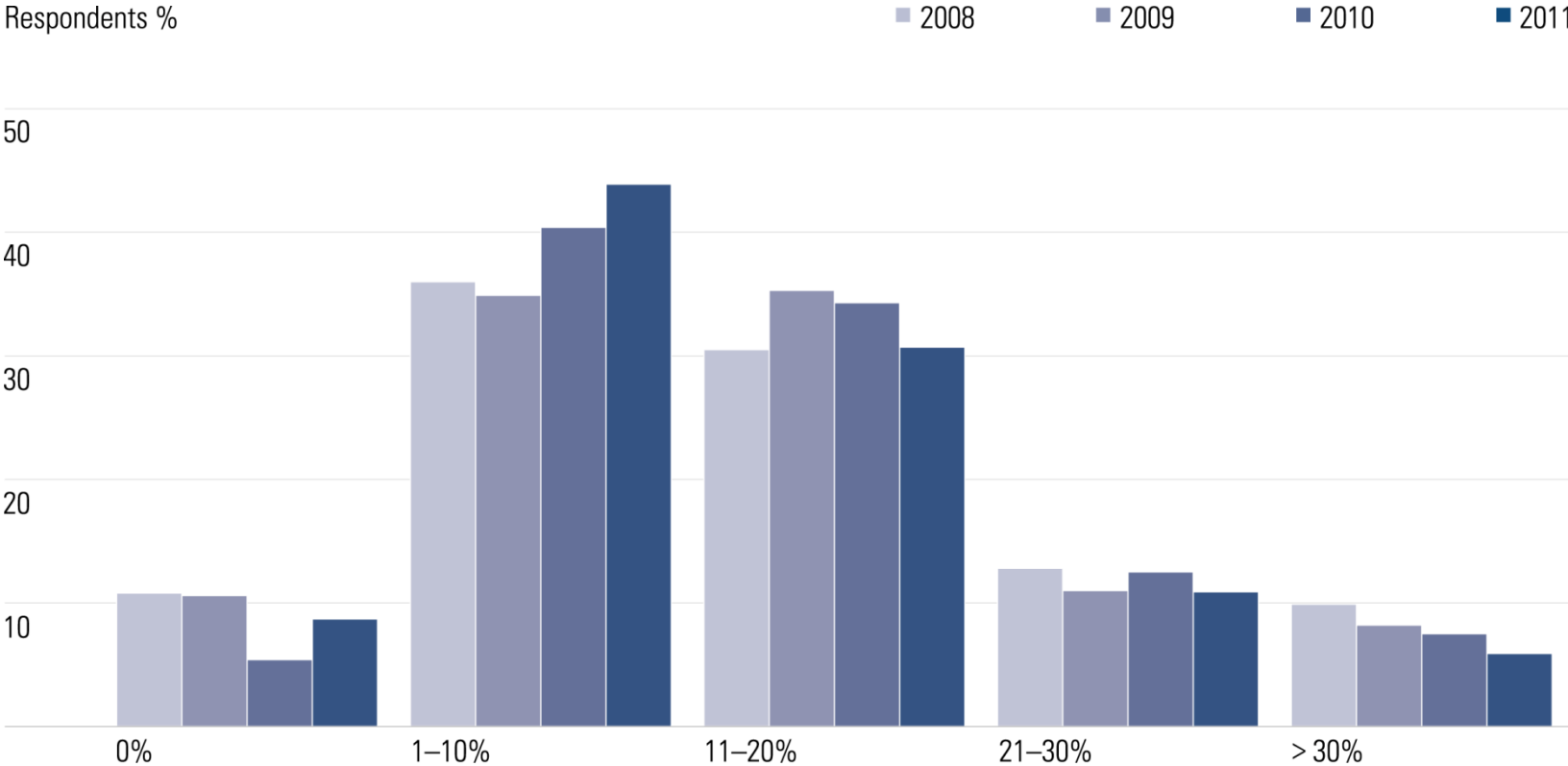
Respondents %

■ 2011 Responses



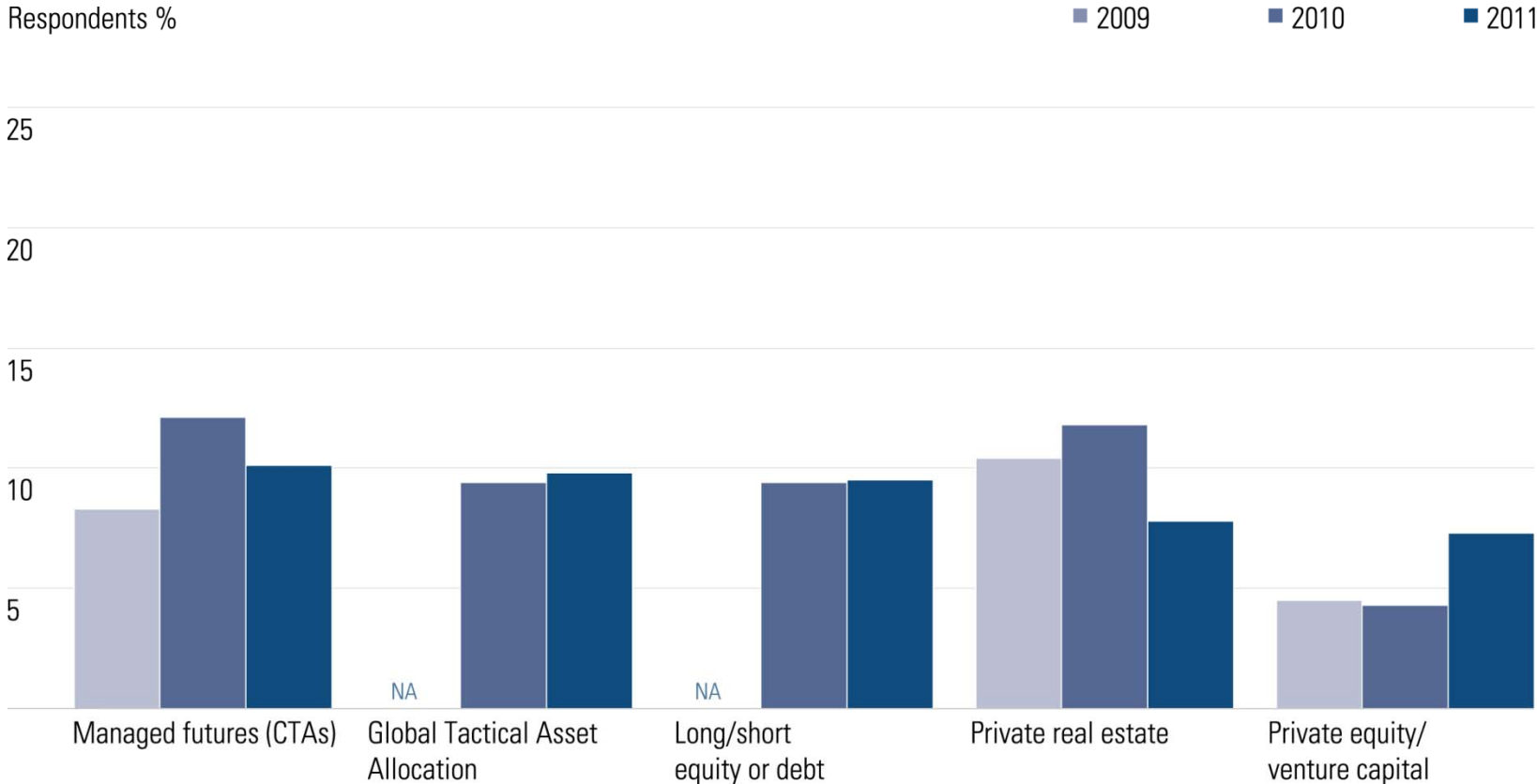
**Which alternative investment strategy will you examine most closely for an increased allocation over the next five years?**

# Advisors: Anticipated Annual Growth in Alternative AUM



**Over the next five years, what is your anticipated average annual growth in alternative assets under management in your practice?**

# Advisors: Top Alternative Strategies for Growth of Business



**Over the next five years, which alternative investment strategy offers you the greatest business growth potential?**

## Alternative Investment Growth: Conclusions

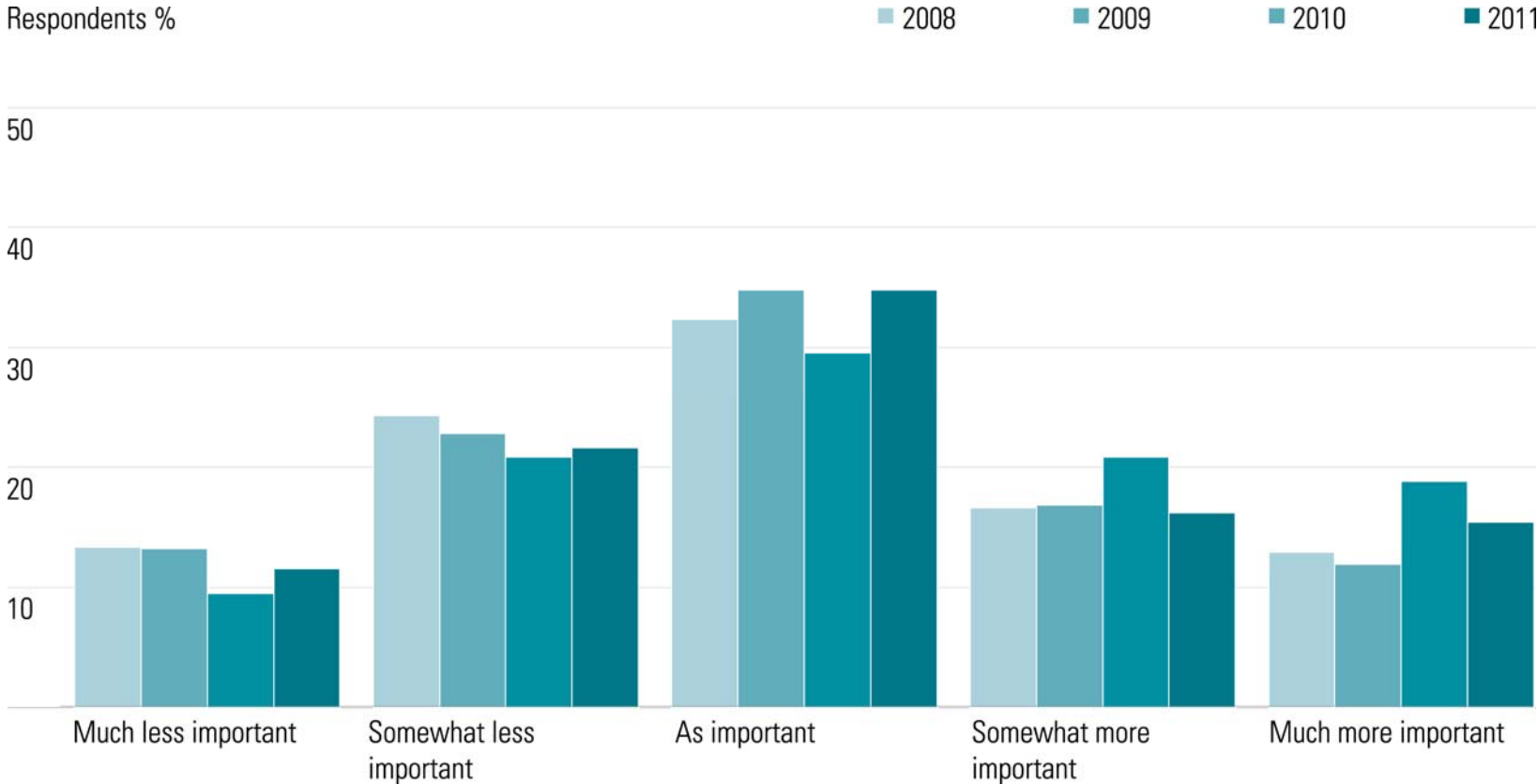
- ▶ Advisors are less comfortable with alternatives than institutions, as 23% of institutions and 30% of advisors allocated 5% or less to alternative investments in 2011.
- ▶ But, 19% of institutions and 5% of advisors allocated more than 40% to alternatives, indicating that there are more sophisticated investors in both groups.
- ▶ Managed futures, GTAA, and long-short strategies are most important to advisors, while long-short, private-equity, and managed futures strategies are most important to institutions.



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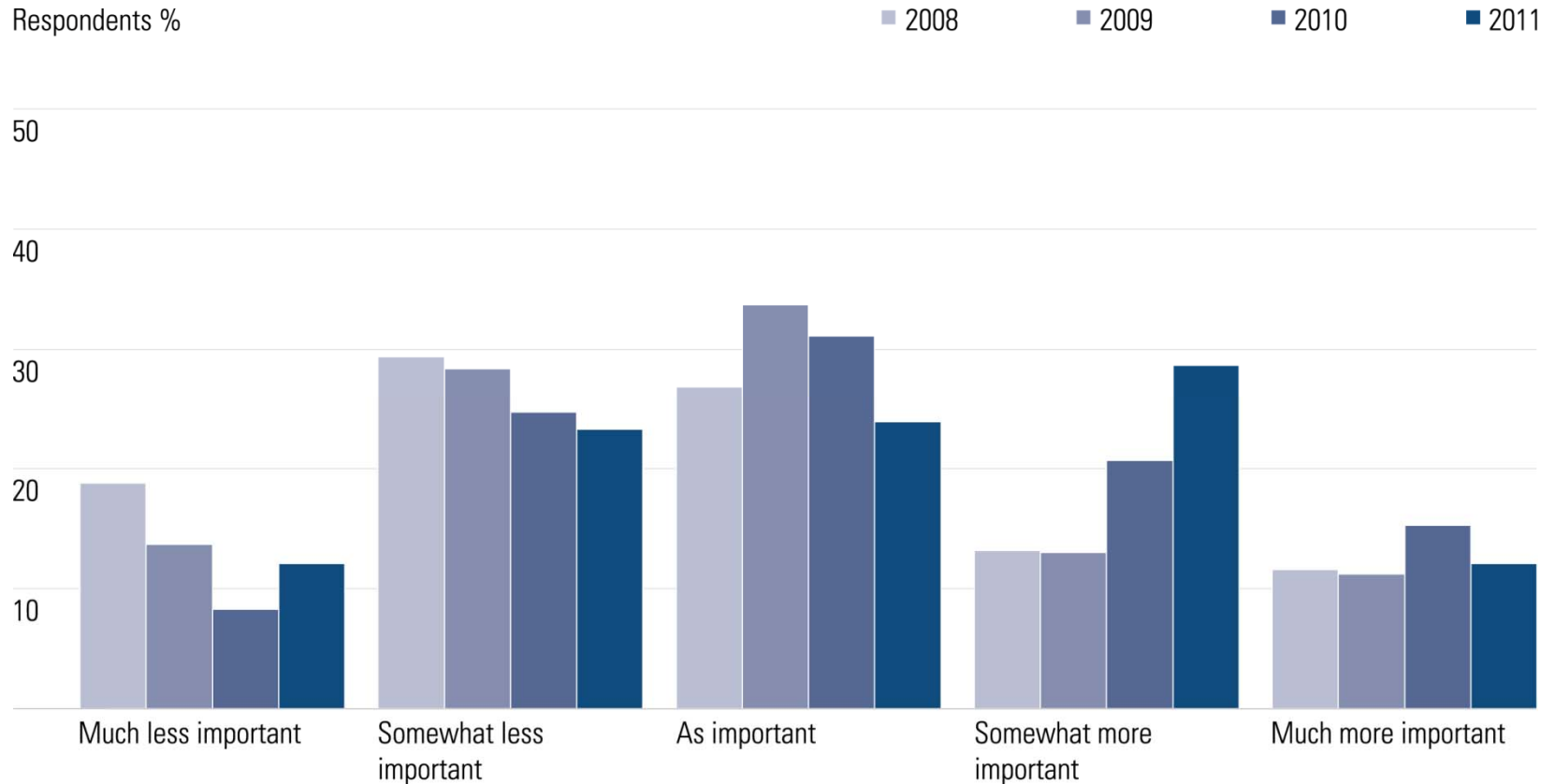
# Alternative Investment Drivers and Disincentives

# Institutions: Importance of Alternative Investments Relative to Traditional Investments



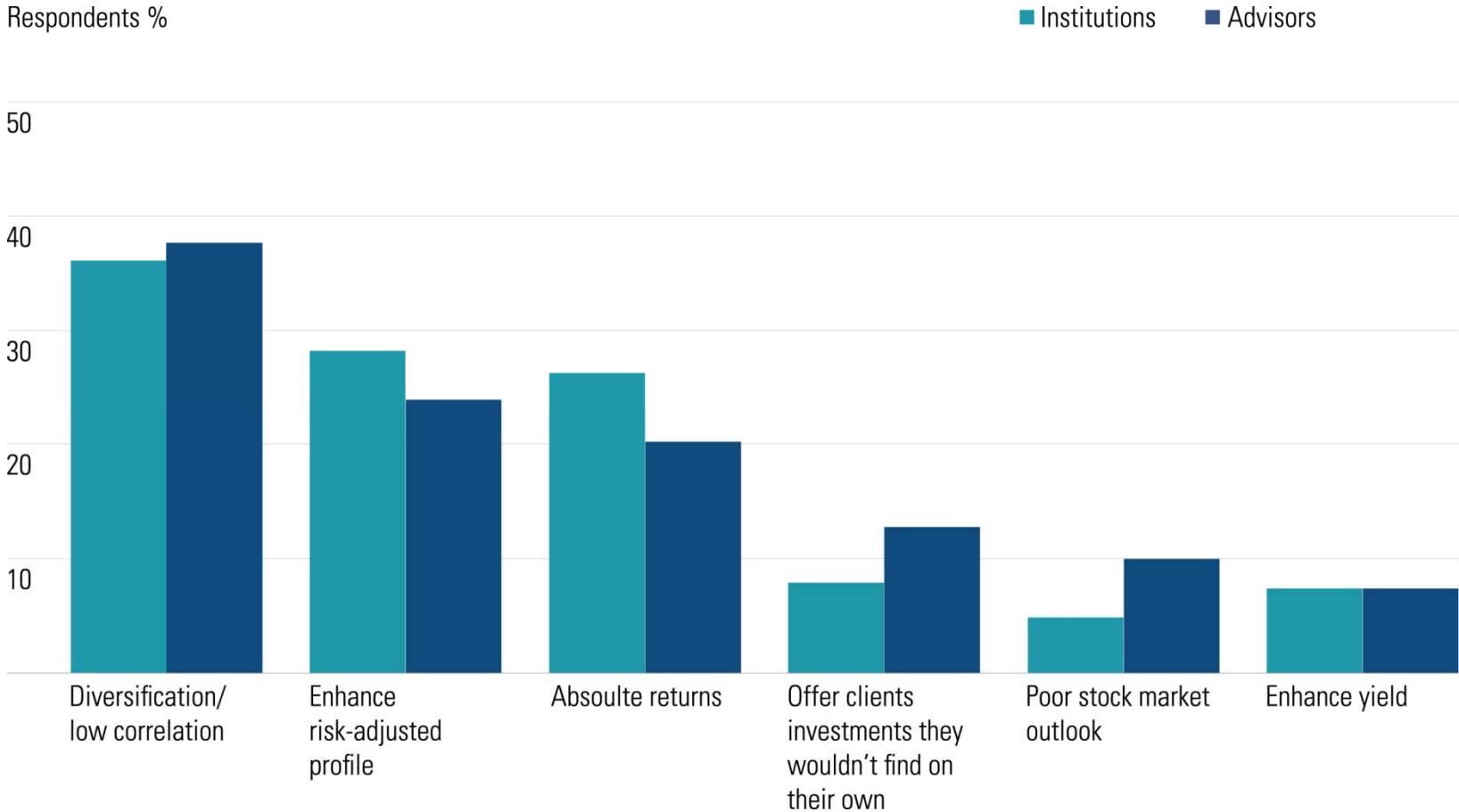
**To what extent do you think alternative investments will become as, or more, important as traditional investments (stocks, bonds, etc.) over the next five years?**

# Advisors: Importance of Alternative Investments Relative to Traditional Investments



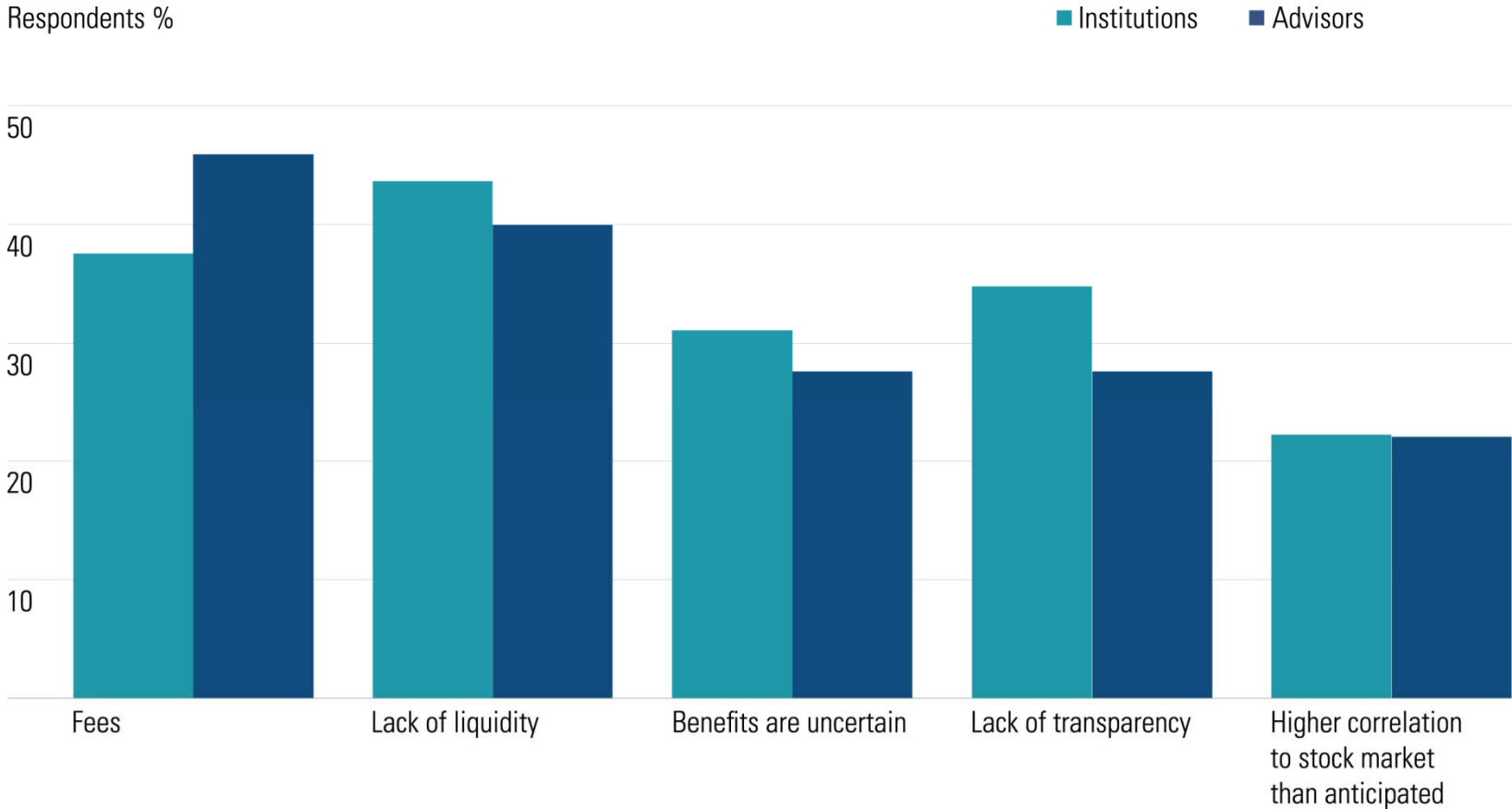
**To what extent do you think alternative investments will become as, or more, important as traditional investments (stocks, bonds, etc.) over the next five years?**

# Institutions and Advisors: Top Drivers of Investments in Alternatives



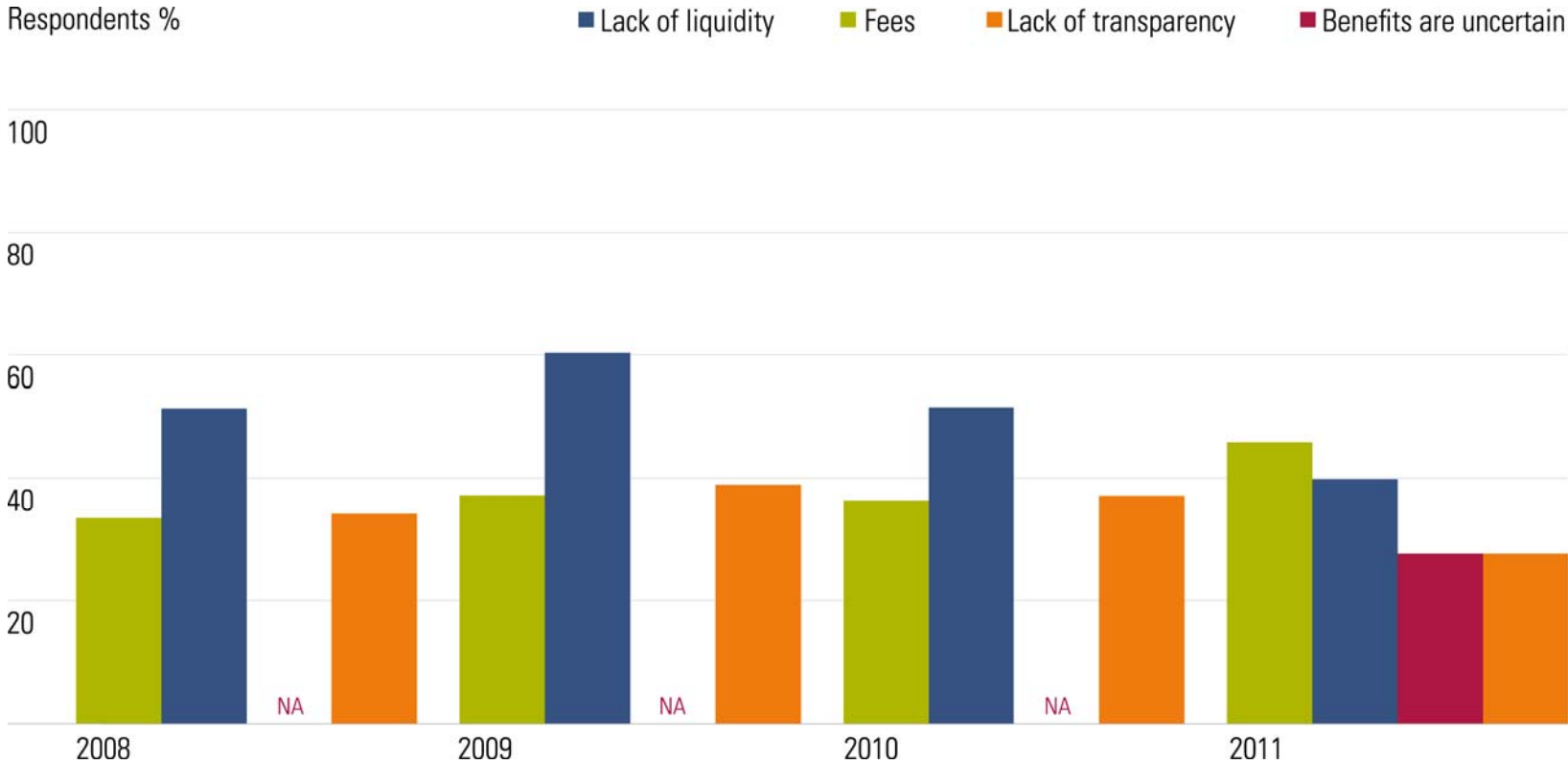
**What have been the top THREE drivers of alternative investment demand at your firm?**

# Institutions and Advisors: Top Reasons to Hesitate Investing in Alternatives



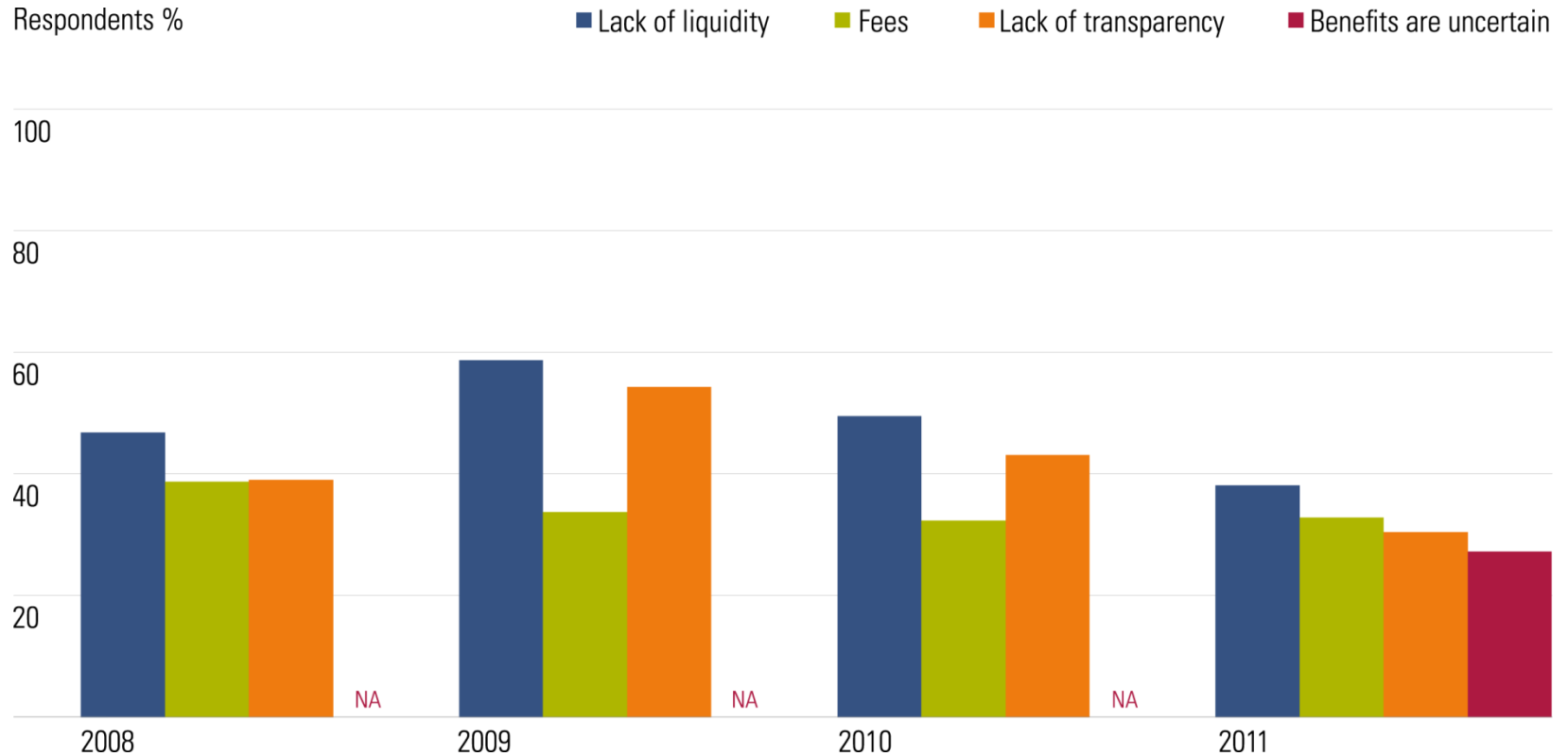
**Please select the top THREE reasons you hesitate to invest in alternative investments or not use alternative investments at all.**

# Advisors: Top Reasons to Hesitate Investing in Alternatives



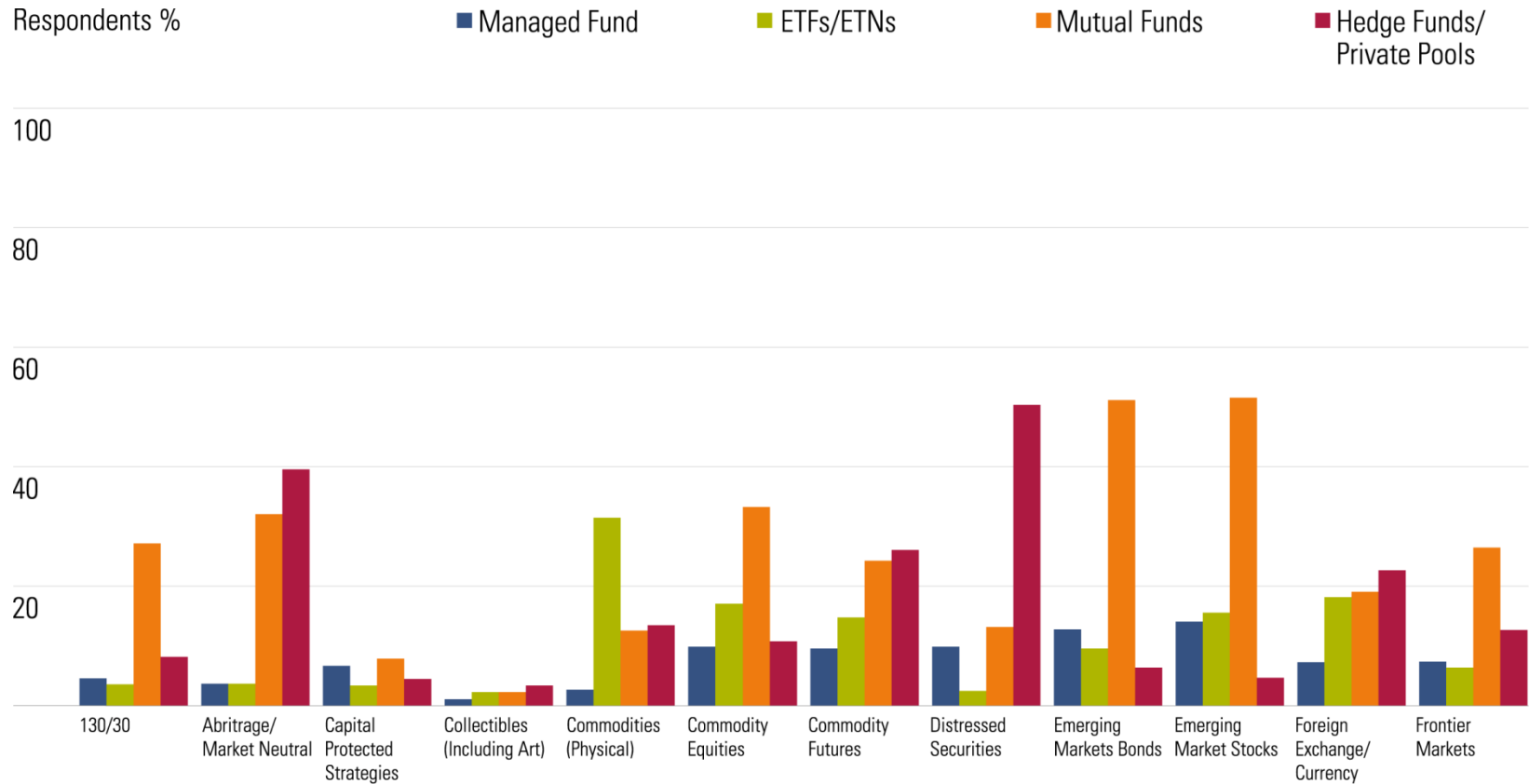
**Please select the top THREE reasons you hesitate to invest in alternative investments or not use alternative investments at all.**

# Institutions: Top Reasons to Hesitate Investing in Alternatives



**Please select the top THREE reasons you hesitate to invest in alternative investments or not use alternative investments at all.**

# Institutions: Investment Vehicles Used to Access Alternative Strategies

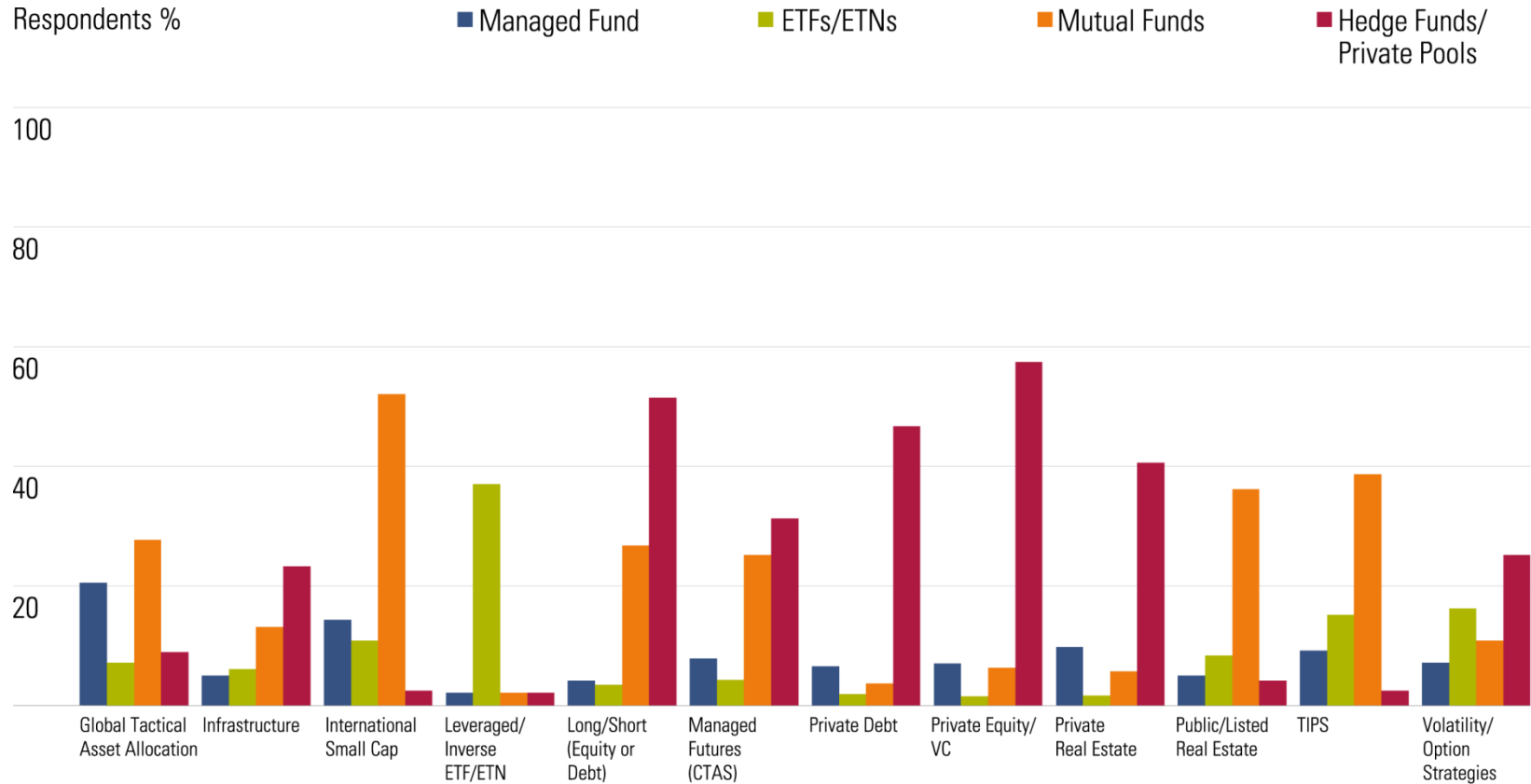


**What is the primary vehicle you use to access the following alternative investments?**



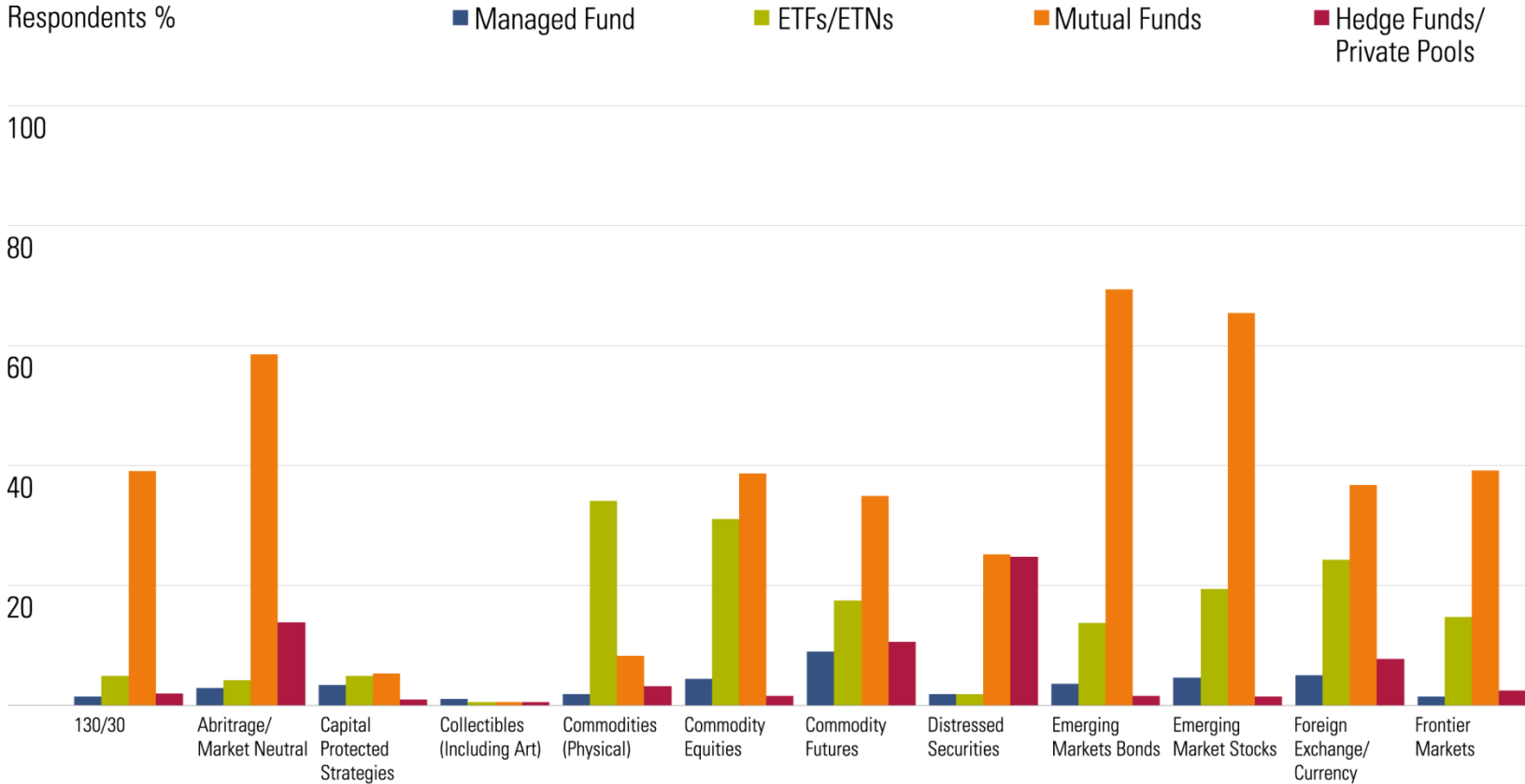
# Institutions: Investment Vehicles Used to Access Alternative Strategies

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**What is the primary vehicle you use to access the following alternative investments?**

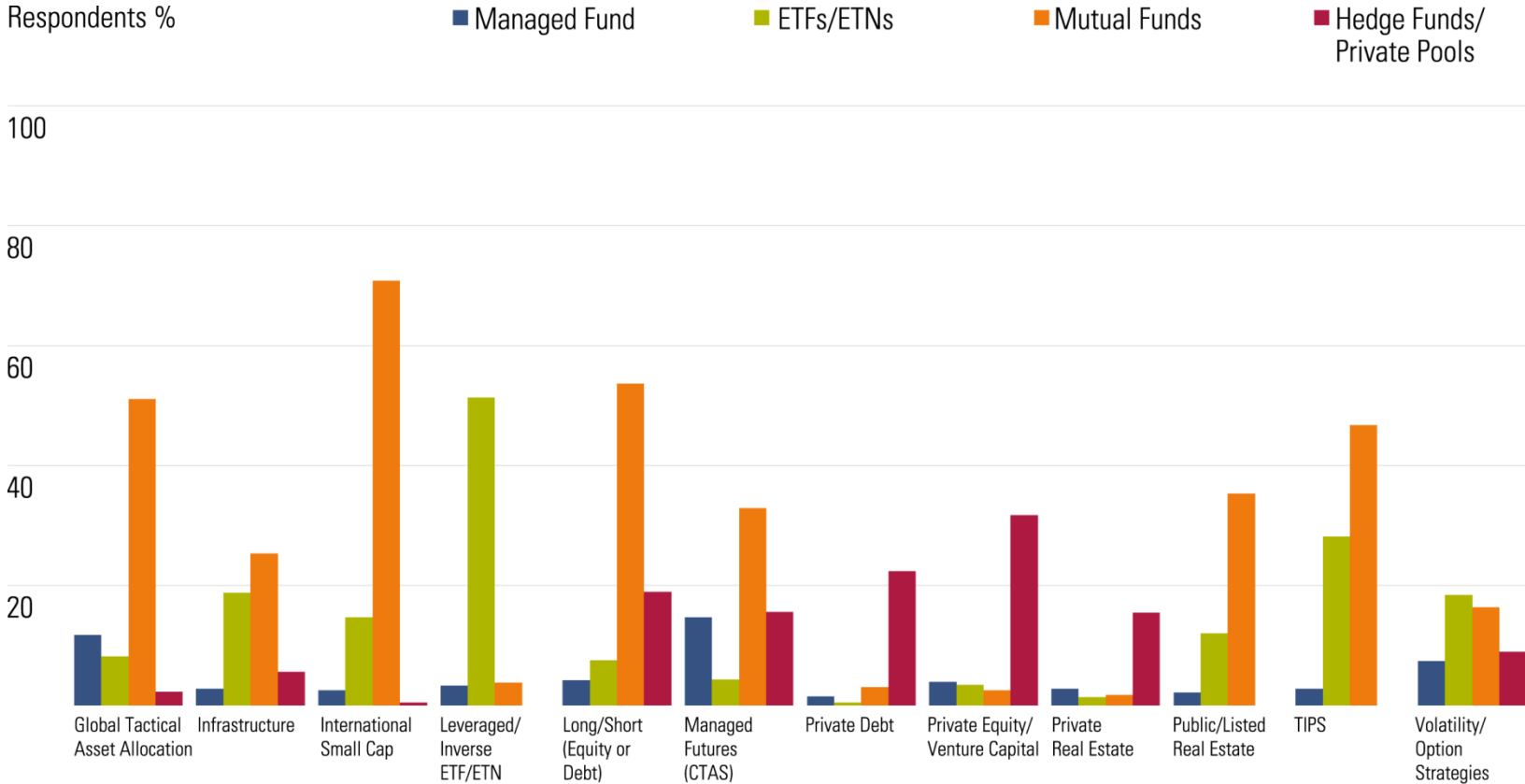
# Advisors: Investment Vehicles Used to Access Alternative Strategies



What is the primary vehicle you use to access the following alternative investments?

# Advisors: Investment Vehicles Used to Access Alternative Strategies

(continued from previous slide)



What is the primary vehicle you use to access the following alternative investments?

## Drivers and Disincentives: Conclusions

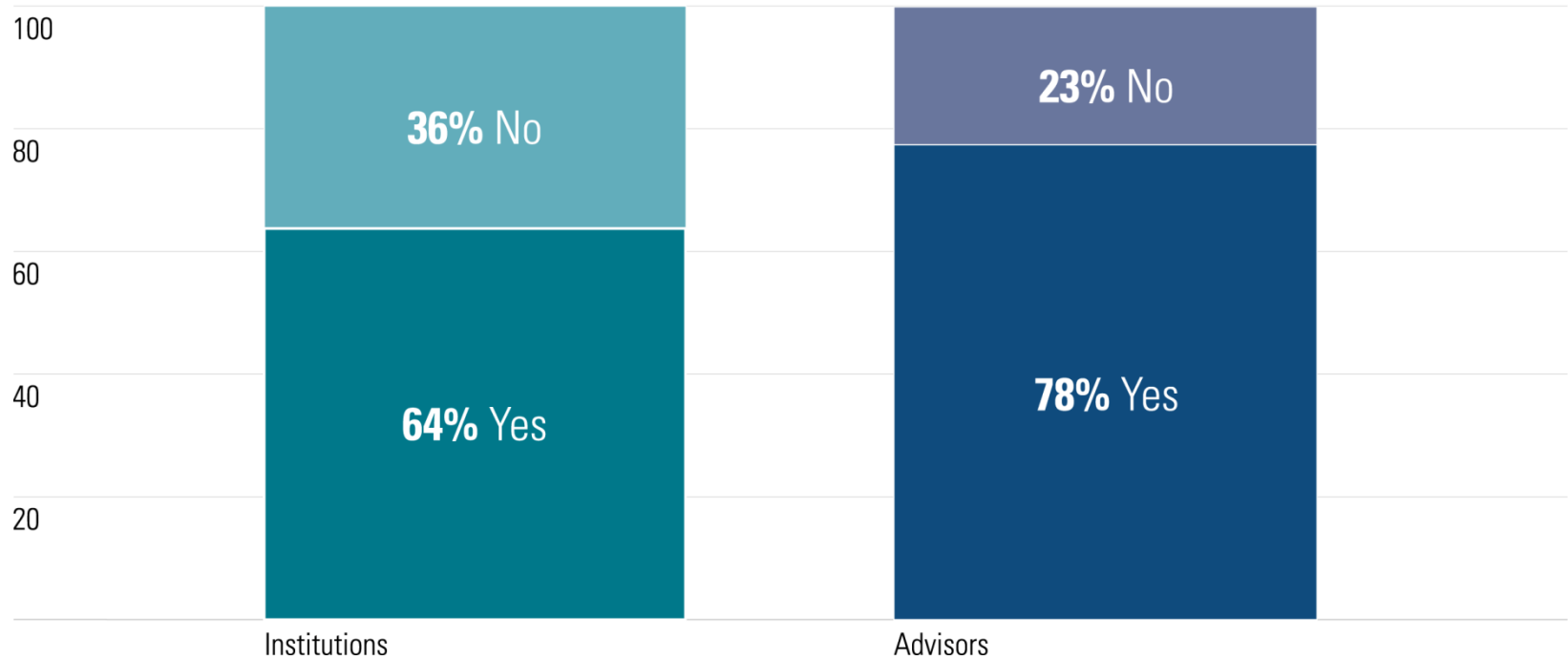
- ▶ More and more advisors (41% in 2011) believe that alternative investments are more important than traditional investments.
- ▶ Both advisors and institutions are investing in alternatives for the right reasons—primarily to diversify and enhance risk-adjusted returns. But more institutions are seeking absolute returns.
- ▶ Advisors are more concerned with the fees charged by alternative investments, while institutions are deterred more by lack of liquidity. This indicates that institutions have not yet embraced liquid alternative vehicles.
- ▶ Advisors are using mutual funds and ETFs to invest in most alternative investment strategies, while institutions are using more private pools or hedge funds.

# Hot Topics in 2011

- ▶ Are Commodities Alternative?
- ▶ Tail-Risk Hedging
- ▶ Institutional Fee Concessions
- ▶ The Alternative Investment Process

# Hot Topic: Are Commodities Alternative?

Respondents %



**Do you consider commodities to be part of your alternative allocation?**

# Are Commodities Alternative?

- ▶ Institutional Response
  - ▶ The majority of institutional respondents considered commodities alternative.
  - ▶ Those that didn't primarily responded that commodities are just part of a traditional asset allocation.
  - ▶ The most common vehicles for accessing commodities exposure was ETFs followed by CTAs/hedge funds.
- ▶ Advisor Response
  - ▶ Most advisors consider commodities, including commodity-related equities, to be part of an alternative allocation.
  - ▶ Many advisors who didn't believe that commodities are alternative investments were simply not investing in commodities at all.
  - ▶ Advisors are gaining exposure to commodities through ETFs, mutual funds, and managed futures CTAs/hedge funds.

# Are Commodities Alternative?

## Institutional Comments

“We use a managed futures, daily rebalanced ETF strategy that is equally weighted across 17 commodities.”

“Exposure both through ETFs that hold futures and mutual funds that hold equities of commodity (natural resource) companies.”

“Mostly through passive mutual funds and ETFs, but going forward I see more exposure through active mutual funds that employ managed futures.”



# Are Commodities Alternative?

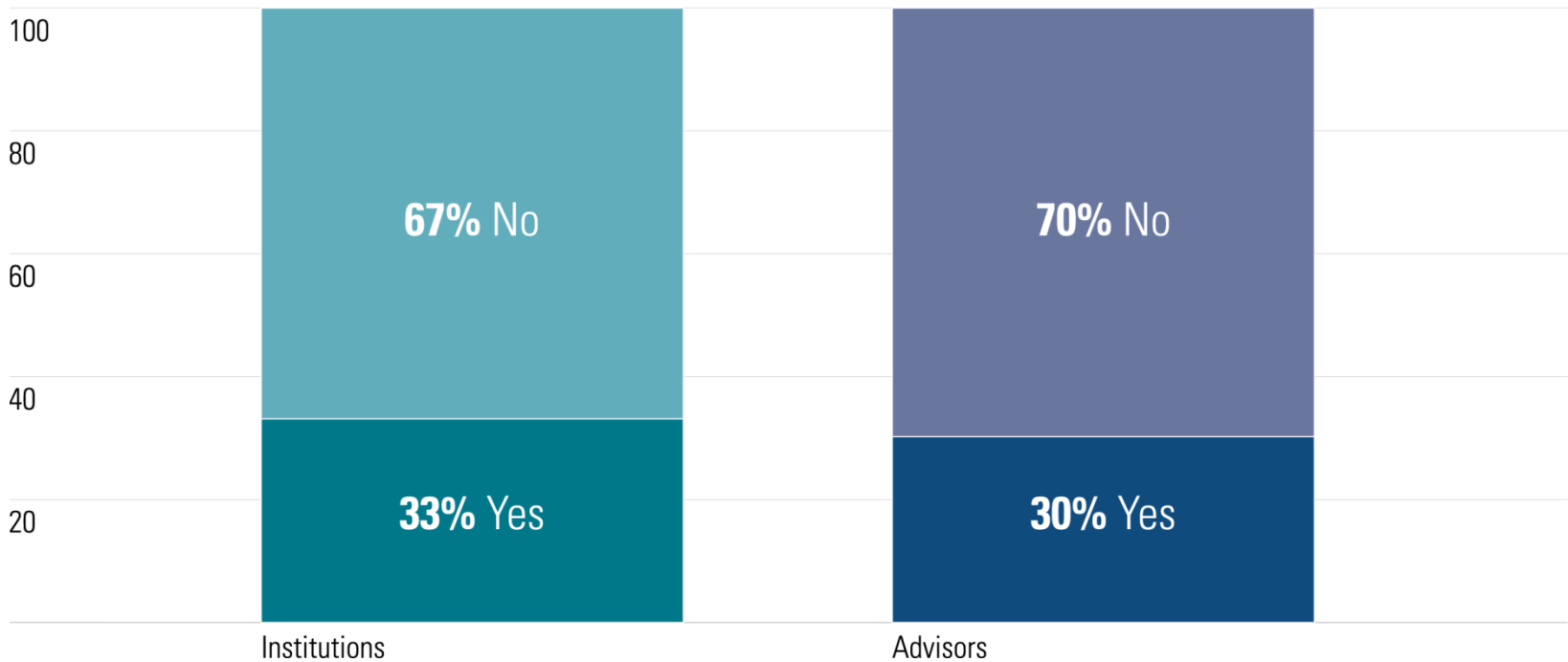
## Advisor Comments

“In general commodities are considered an alternative asset class, however, investment in commodity ETFs, mutual funds, or related securities are not considered alternative strategies at our firm, but rather an important aspect of a well-diversified portfolio.”

“Commodities are simply the latest hot thing and are already proving questionable as an effective diversifier. We do not necessarily accept them as an actual asset class and their investment characteristics have changed markedly in recent years, as investors and investment advisors alike, have flocked to them.”

# Hot Topic: Use of Tail-Risk Hedging

Respondents %



**Does your firm utilize tail-risk hedging (strategies designed to hedge extreme losses) in its portfolio management process?**

# Use of Tail-Risk Hedging

- ▶ Institutional Response
  - ▶ Most respondents stated that they did not use tail-risk hedging per se because it was too costly to be beneficial.
  - ▶ Alternately, many institutions used options strategies or held cash as a way to hedge extreme losses.
  - ▶ Many believed that by diversifying, their portfolios should not experience extreme downturns.
- ▶ Advisor Response
  - ▶ Many advisors believed that employing active management and proper portfolio diversification, and to a lesser extent, holding cash precluded the need for tail-risk hedging.
  - ▶ PIMCO funds were popular vehicles for hedging.

## Use of Tail-Risk Hedging: Institutional Comments

“If you actually do the math, you'll see that such strategies are too expensive. It is far better to merely reduce risk than maintain risk levels but buy expensive insurance.”

“In our alternative strategy, our primary hedging tool is options (or cash). When we don't hold much cash, we will often hold out-of-the-money puts to protect from an unforeseen decline.”

“We recommend strategies such as managed futures, which can exhibit long volatility characteristics.”

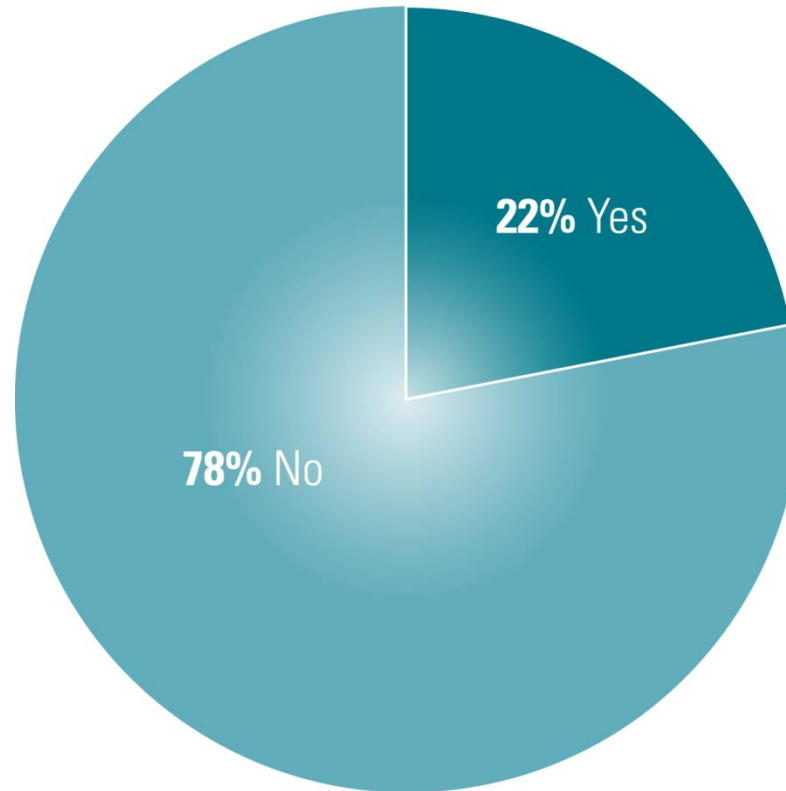
“We choose to use volatility ETNs in order to hedge our equity allocations. In particular we use XIV and TVIX in a combined strategy.”

## Use of Tail-Risk Hedging: Advisor Comments

“Our clients generally have a long time horizon and can withstand a temporary severe decline in the value of their portfolios...We allocate their portfolios between stocks, bonds, and cash. This has historically proven to be a cost-effective way to hedge against extreme losses.”

“I invest with truly active managers (mutual funds). They have the ability to build up as much cash as they like.”

## Hot Topic: Fee Concessions



**Over the past year has your institution obtained fee concessions when investing in alternative strategies?**

# Institutional Fee Concessions

- ▶ The majority of respondents had not received fee concessions.
  - ▶ Those that had received fee concessions stated that they were small in size.
  - ▶ Some institutions received more favorable liquidity terms instead.
- ▶ Comments:
  - ▶ “We have been able to negotiate much better fees over the past year and really three years. Rationale can vary but typically due to size of investment or liquidity trade offs. We have also negotiated separate accounts with many managers, which helps lower fees.”
  - ▶ “I have assembled a portfolio of 15 hedge fund managers that normally charge 2-and-20 with redemption notices and lock-ups to agree to a flat fee in an SMA with no incentive fee with daily liquidity and real-time transparency. The average cost of the 15 managers is 94 basis points.”

# The Alternative Investment Process: Free Response Question

- ▶ Please describe your process for investing in alternative strategies. How do you choose which areas to invest in? What's your research process? Once you've settled on a particular strategy, how do you choose a product? And, of course, how do you implement a new strategy and measure its success?.



# The Alternative Investment Process

- ▶ Summary of Institutions' Responses:
  - ▶ Institutions started with a top-down or macro-economic research process.
  - ▶ Most respondents use a committee to research and also analyze the success of a strategy.
  - ▶ When choosing a specific product the manager of the vehicle often was the catalyst for the final decision.
- ▶ Summary of Advisors' Responses:
  - ▶ Varied depending on advisors' level of independence. For example, several advisors stated their home office dictates their selections, while others stated that they analyze larger market and economic trends
  - ▶ Some advisors mentioned teams of individuals or consultants while others were independently conducting the research process and evaluating the success themselves.
  - ▶ Advisors valued the manager's and the fund's past success and the client's asset allocation needs when selecting a vehicle.

## The Alternative Investment Process: Institutions' Comments

"We look across the entire landscape for attractive areas to invest in terms of risk-reward and then comb through the universe."

"From this group we select the manager(s) with the greatest 'edge' or ability to generate out performance in the future based on their ability to adapt their approach to handle the inevitable deterioration of their edge over time."

"Our process is intensive, beginning with identification of necessary investment strategies, such as market neutral, managed futures, long/short equity. Once we identify a need for our platform, we will actively search for multiple access points, including mutual funds and direct hedge funds. The research process is highly intensive and includes onsite visits with investment professionals, regular conference calls, and a review of fund documentation. Success is measured by the ability of the investment to realize its stated investment objectives without style drift."

## The Alternative Investment Process: Advisors' Comments

“Since I am an hourly fee-only advisor, I use mutual funds. For clients who have specific concerns—low risk, inflation protection, etc.—I research mutual funds with a track record and risk and return objectives that match my clients’ investment objectives. Most of those fall into a moderate or conservative asset allocation strategy that includes GTAA. Strategies include using asset classes for natural resources, TIPS, commodities and other real-return strategies in addition to global stock and bond asset classes. Plus stock “shorting” strategies to reduce volatility and limit investment losses.”

“We have used a product that is a fund of funds product from our broker dealer. We have also used long/short funds, and managed futures funds in the mutual fund area for smaller clients. We used our back office, Lipper, and Morningstar to identify product and looked for non-correlating strategies.”

“Based on market outlook and a combination of quantitative and qualitative factors, such as phone calls and in person visits, asking people we trust, mining connections.”

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# Credits

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