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Financial Services Practice

The Mainstreaming of Alternative Investments

Fueling the Next Wave of Growth in Asset Management

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Introduction

Alternative investments endured a roller coaster ride through the financial crisis. Between 2005 and 2007, global alternative assets under management (AUM) nearly doubled, from $2.9 trillion to $5.7 trillion. Then, during the crisis, market scandals, illiquidity, poor performance and massive redemptions in select categories crippled the alternatives industry. Growth stalled, and some wondered whether the heyday of alternatives had passed.

What a difference a couple of years can make. Year-end 2011 AUM for global alternatives reached record levels of $6.5 trillion, having grown at a five-year rate of over seven times that of traditional asset classes. (In this report, *alternatives* include hedge funds, private equity and investments in real estate, infrastructure and commodities in a variety of vehicles including limited partnerships, fund of funds, managed accounts, and increasingly, mutual funds and undertakings for collective investment in transferable securities, or UCITs.) Growth is expected to continue, fueled by increasing allocations by institutional investors and the movement of alternatives into the retail investment mainstream.

This is a massive opportunity, but to capture it, traditional asset managers will need to embark on a major shift in their operating focus, away from the relative return investment framework and well-defined boundaries (e.g., style boxes, long-only products), toward managing investments to an absolute return target or objective. In addition, they will need to address shortcomings in risk management and reporting and sales capabilities, and resolve the organizational conflicts that will likely arise from the integration of traditional and alternatives work cultures.

To gain perspective on the rapidly evolving global alternatives landscape, McKinsey has undertaken a comprehensive, multiyear global research effort, conducted in part with *Institutional Investor.* Highlights of the findings from this research include:

- *The recent surge in alternative investments is only the beginning of a new wave of growth.* Institutional investors expect, by the end of 2013, to increase their allocations to almost all forms of alternatives – particularly more liquid hedge funds – to a simple average of 25 percent of portfolio assets (17 percent on a weighted-average basis), up from 23 percent in 2011.
- *Investing behavior is bifurcating.* As allocations to alternatives increase, institutional investors are taking divergent paths with regard to investment behavior. On the hedge fund side, for example, smaller, less experienced institutions are continuing to invest in diversified multi-asset class, fund of fund vehicles. Larger and more experienced institutions, meanwhile, are increasingly investing directly in hedge funds or bringing management in-house. Moreover, growth of separate accounts for direct hedge fund investing is most pronounced among the largest institutional investors (AUM greater than $25 billion), which expect to nearly double their use of separate accounts from 2010 to the end of 2013.
- *Alternatives are rapidly moving into the mainstream retail market.* By 2015, retail alternatives are expected to account for one-quarter of retail revenues (even allowing for declining revenue yields) and a majority of revenue growth as retail investors, confronted with volatile financial markets and the underfunding of their own retirements, follow the path blazed by institutional investors. Fueling this trend is a shift in investment frameworks from relative to absolute return and a convergence of traditional and alternative asset classes, investment managers and products.
- *Most traditional asset managers have not yet made the internal changes required to capture opportunities in the mainstreaming of alternatives.* Traditional players fully agree with robust alternative growth projections, but acknowledge being unprepared for the shift. Institutions and advisors also assert that asset managers need to ramp up capabilities in risk management and product expertise. Changes in sales process (e.g., focusing on advisor segments that can sell alternatives), incentives (away from gross flows to revenues) and sales capabilities (e.g., positioning relative return and alternatives solutions side-by-side) are still getting underway. Most

asset managers still need to integrate alternatives into their more traditional work culture.

- *Many specialist alternatives managers are experiencing growing pains* as they seek to tap into the mainstreaming of alternatives. Just as traditional asset managers once went through a challenging transition to more institutionalized capabilities in distribution and governance, specialist players are finding they need to add more customer-centric capabilities to their strength in generating alpha.

The robust growth of alternatives and the blurring of lines between traditional and alternative asset classes are putting a large flow of assets directly within reach of many investment managers. On one side of this flow are alternatives specialists; on the other are traditional asset managers. The actions firms on both sides take now will determine who owns the asset management mainstream.

The Resurgent Demand for Alternative Investments

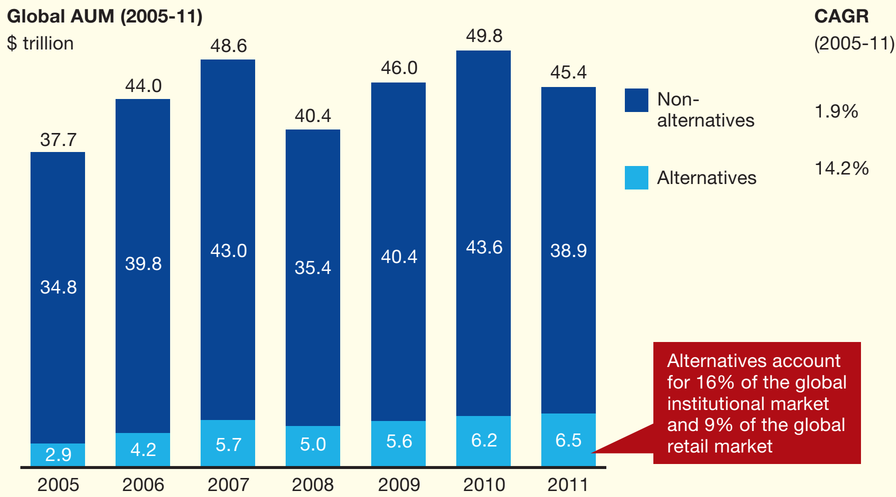
Global alternative investments across retail and institutional segments doubled in AUM between 2005 and 2011, to $6.5 trillion (Exhibit 1, page 6), despite a very public flame-out during the crisis. This represents a compounded annual growth rate of 14 percent over the period, far outstripping the growth of traditional asset classes.

Growth is set to continue. McKinsey's 2011 Global Survey on Institutional Investing, conducted in partnership with *Institutional Investor,* reveals that institutional investors expect to increase their allocations to alternatives over the next three years. (Alternatives include hedge funds, private equity, and investments in real estate, infrastructure and commodities in a variety of vehicles including limited partnerships, fund of funds partnerships, and managed accounts, and retail alternatives in mutual funds, ETFs and UCITs.) In particular, those in the U.S. anticipate alternatives will account for a simple average of 28 percent of their total portfolio assets by the end of 2013, up from 26 percent in 2010. European institutional investors have a smaller alternatives allocation (13 percent simple average in 2010), but expect this to increase to 15 percent by 2013. On a weighted average basis, the allocation to alternatives of all institutional investors surveyed will reach 17 percent by the end of 2013, up 1 percentage point from 2010.

Growth will be broad, flowing to almost all alternative asset classes, with the strongest growth expected in hedge funds in the U.S. and in private equity and real estate in Europe (Exhibit 2, page 6). The only alternative asset class expected to shrink is the European hedge fund sector, where some institutional investors remain skeptical following the financial crisis and others, insurers in particular, face increasing capital requirements.

Exhibit 1

Alternative investments have grown faster than non-alternatives over the last 6 years and have surpassed peak 2007 levels

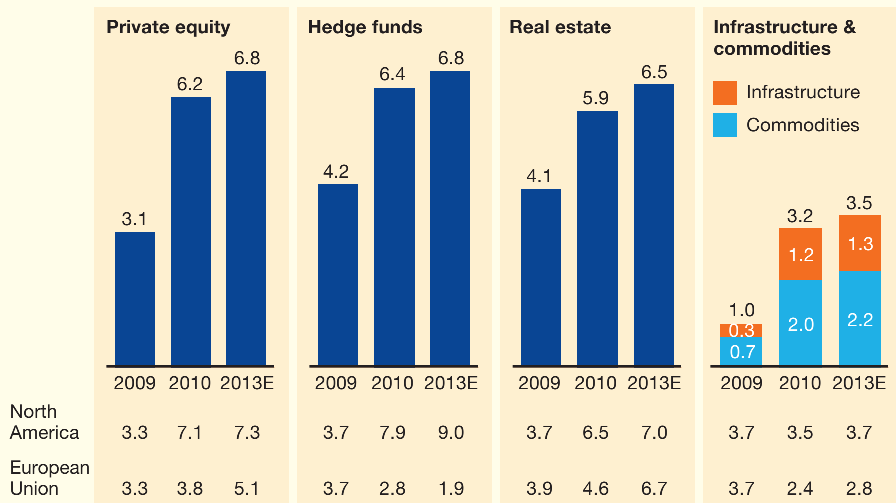


Source: Strategic Insight, McKinsey Global Asset Sizing Database

Exhibit 2

Institutional investors expect to increase allocations to almost all alternative classes

Average percent of total portfolio AUM (simple average calculation)



Source: McKinsey/Institutional Investor Global Survey on Institutional Investing, 2011

In the context of increasing alternatives allocations, smaller institutional investors and their larger peers are taking divergent paths with regard to their investing behavior. On the hedge fund side, newcomers to alternatives and small institutional investors (AUM less than $1 billion) continue to seek diversified multi-asset class, fund of fund vehicles. In contrast, mid-sized institutions are increasingly investing directly in hedge funds. Large-sized institutions (AUM greater than $25 billion) are going a step further – expecting to increase the hedge fund assets they manage internally by 50 percent over the next three years. In addition, institutional investors expect to increasingly invest via separate accounts for their direct hedge fund investing, going from 31 percent of their direct hedge fund assets to 41 percent by the end of 2013. This trend is most pronounced for the largest investors, which expect their use of separate accounts to nearly double.

Mainstreaming Is Fueling the Next Wave of Growth

In the thick of the financial crisis, alternative investments lost much of their positive momentum. Now, investors and managers widely expect a resurgence of this momentum and continuing strong growth. This return to form, however, comes with a new twist. Alternatives are not simply growing; they are becoming part of the investment management mainstream. Three trends are responsible for this development: increasing adoption by retail investors; a shift in investor benchmarks from relative to absolute return; and the convergence of traditional and alternative asset classes, investment managers and products.

Increasing adoption by U.S. retail investors

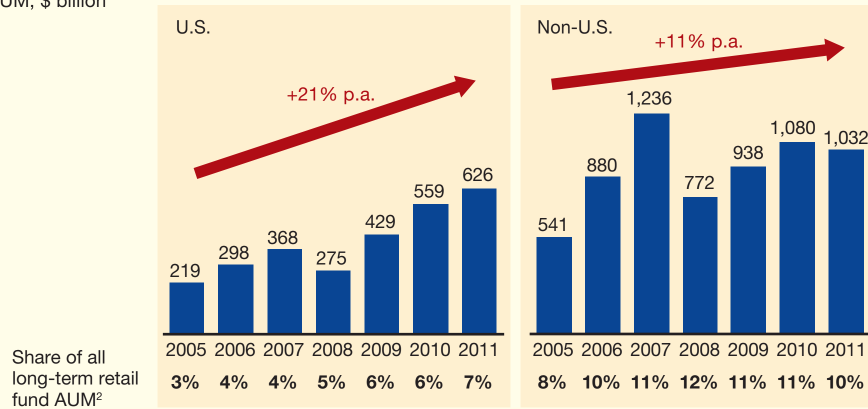
Long the preserve of institutional and high-net-worth (HNW) investors, alternatives are moving into the U.S. retail mainstream as individuals, confronted with volatile financial markets and retirement savings gaps, seek wider options. Investment managers are enabling this trend by making products more accessible, packaging alternative investment strategies into regulated mutual funds and ETFs (and UCITs in Europe), and selling them through traditional retail distribution channels. As a result, retail alternative assets and alternative-like strategies such as commodities, long-short products and market-neutral strategies have grown by 21 percent annually since 2005, and now stand at roughly $700 billion, or approximately 6 percent of total

Exhibit 3

Alternatives are experiencing strong growth in the retail market, particularly in U.S. mutual funds

Retail alternative funds asset growth[1]

AUM, $ billion



[1] Alternatives includes absolute return, commodities, currency trading, dedicated short bias, equity energy, leveraged strategies (both long and inverse), managed futures, market neutral, multi-strategy alternatives, natural resources, options arbitrage, precious metals, real estate and volatility strategies; excludes distressed debt.

[2] Includes mutual funds, closed-end funds, ETFs and UCITs structures, and excludes limited partnerships and separately managed accounts

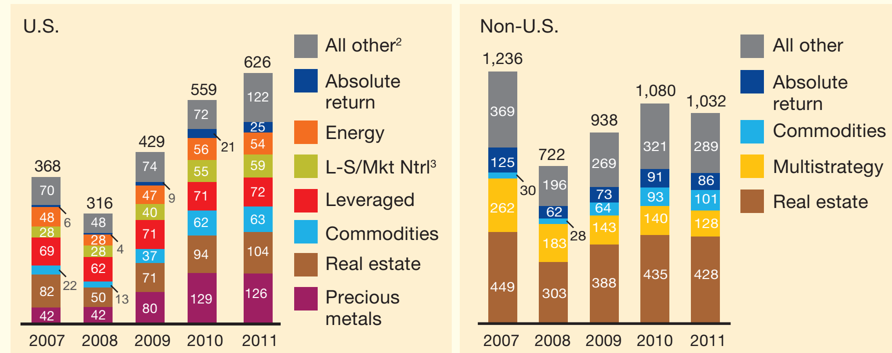
Source: McKinsey/Institutional Investor Global Survey on Institutional Investing, 2011

Exhibit 4

The most popular retail alternatives in the U.S. are gold and real estate funds; in Europe and elsewhere, real estate and multistrategy funds lead the way

Largest retail alternative strategies[1]

AUM, $ billion



[1] Includes mutual funds, closed-end funds, ETFs and UCITs structures, and excludes limited partnerships and separately managed accounts

[2] Includes volatility, options arb, natural resources, multi-strategy, managed futures, short bias (bear funds) and F/X strategies

[3] Long-short, market neutral and active extension (130/30) strategies

Note: Many funds use a combination of strategies (e.g., a leveraged inverse commodity fund) making consistent classification difficult.

Source: McKinsey/Institutional Investor Global Survey on Institutional Investing, 2011

U.S. long-term '40 Act retail assets. In contrast, retail alternatives in Europe, which also experienced rapid growth in the years leading up to the crisis, remain stuck at 1 percentage point below their peak market share level in 2007 (Exhibits 3 and 4).

Retail investors will continue to adopt alternatives; by 2015 they will account for an estimated one-quarter of long-term retail fund revenues in the U.S. and a majority of retail revenue growth (Exhibit 5, page 12).

Shifting investor benchmarks

The second major factor driving higher allocations to alternatives is the gradual shift to an absolute return type of investment framework (characterized by more market-neutral and benchmark-agnostic strategies) as institutional investors across the spectrum redefine how they measure performance in order to better align outcomes with objectives. While managing investments to an absolute return target is now more standard in the institutional segment, even retail investors and advisors long accustomed to a Morningstar-based relative return investment framework have joined the trend. McKinsey research has found, for example, that nearly half of retail registered independent advisors (RIAs) surveyed are already managing their client portfolios against an absolute return benchmark and using alternative and alternative-like solutions to help clients achieve their objectives.

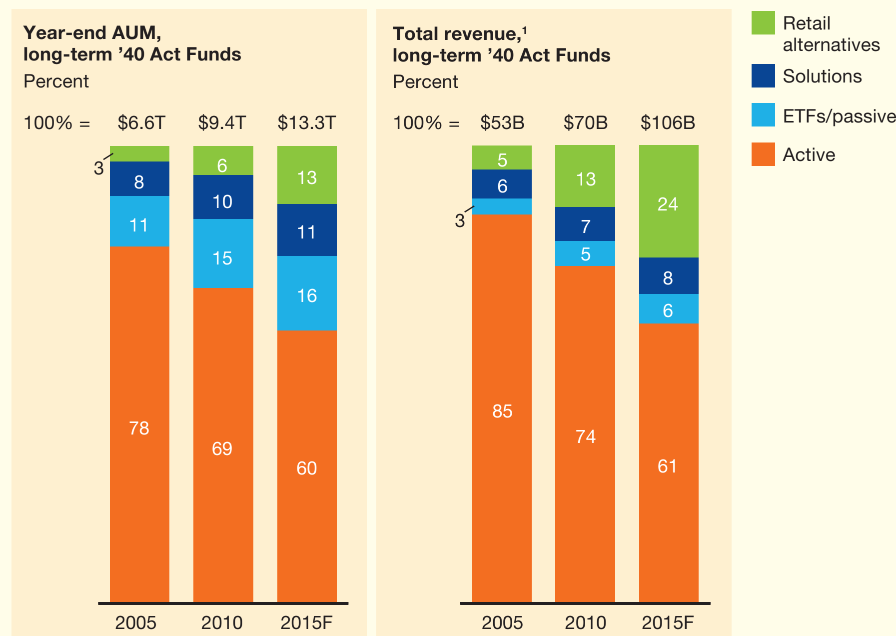
Investment managers and products converging

Further fueling the mainstreaming of alternatives is the convergence of traditional and alternative investment managers and products. This convergence is reflected in the way investors allocate money for investments and in the resulting blurring of once distinct lines between specialist alternatives managers and traditional asset managers, as both gear up to offer alternatives and alternative-like strategies to the mainstream market.

In line with their shifting investment framework, institutional investors are increasingly changing how they categorize and operationalize their use of alternative investments. While the design of institutional investors' investment strategy remains oriented by asset class (e.g., with investment policies designed – and risk budgets set – by asset class), a growing number of institutions are grouping their hedge fund investments under the much larger public equities umbrella as opposed to treating them as part of a stand-alone alternatives bucket that includes illiquid assets like direct investments in real es-

Exhibit 5

By 2015, retail alternatives will likely account for 13% of U.S. retail fund assets and approximately one-quarter of revenues



[1] Defined as expense ratio times average annual assets. Expense ratio includes management fees, distribution and marketing/12b-1 fees and administrative and group operating fees; excludes commissions

Source: Strategic Insight; McKinsey estimates

tate, private equity and infrastructure. According to McKinsey research, over 20 percent of institutional investors expect to integrate their hedge fund allocations with underlying asset classes by the end of 2013, up 5 percentage points from 2010. This is a dramatic increase in the potential revenue pool for hedge fund players and asset managers alike and has important implications for investment managers' product design, sale and distribution process, and client reporting.

The integration of liquid, "public markets" alternatives with traditional asset classes is eroding the distinctions between firms that offer or advise on traditional versus alternative strategies. This is also leading to the convergence of products. Witness the recent rise of mega-alternatives specialists, the diversification of monoline traditional players into a broader range of asset classes as well as into the business of providing "solutions," and the incursion of alternatives players into the long-only product arena. Convergence can also be

seen in the increasing number of new products that make alternatives available to a wider investor audience. For example, assets in alternative '40 Act funds grew by 32 percent in 2010 compared to 16 percent for the broader long-term fund industry. Absolute return funds in particular, which capitalize on the investor mindset shift away from relative return performance, have rapidly gained share from traditional relative return products on both the institutional and retail side.

Asset Managers Are Making Alternatives a Priority

Asset managers are extremely bullish on the growth potential for alternatives. Fully 100 percent of U.S. participants in McKinsey's research, and 70 percent of those from Europe, expect alternatives will grow faster than traditional asset management products. The higher revenue yields and resulting faster-paced revenue growth make the opportunity particularly attractive for asset managers. Alternatives generated over $18 billion in performance and management fee revenues for the top five publically listed specialist alternatives firms in the U.S. alone in 2010, and accounted for more than one-third of traditional asset managers' institutional revenues at the peak of the market in 2007. Even with downward pressure likely over the next few years, revenue yields for institutional alternative products should remain well above the 35 bps average earned on today's traditional institutional products.

For instance, institutional investors expect the management fees they pay hedge funds – traditionally characterized by a 2 and 20 structure – will begin to decline only slightly: half expect to pay fees in the 1 to 1.5 percent range in 2013, down from a 1.5 to 2 percent range in 2010. Few expect any changes to performance fee levels, although 40 percent of institutions do expect to see a move from simple high level marks to greater use of clawbacks. Interestingly, only a third of asset managers expect to see declines in hedge fund management fees over the next three years (and 20 percent expect declines in performance fees), but slightly more than half expect changes in fee structures, such as a greater use of clawbacks as well as a general shift in pricing for investment management products from relative to absolute return.

Asset managers across the U.S. and Europe expect to shift their AUM mix, with alternatives and alternative-like products increasing from 15 percent of total portfolio AUM in 2010 to 20 percent by 2013.

Higher revenue yields also characterize retail alternatives and alternative-like products, which can generate two to three times greater revenues than traditional mutual funds. Moreover, compared with the two other major product growth opportunities in asset management, ETFs and target-date funds, alternatives command a significantly higher revenue margin – 2.3 times greater than target-date funds and 4.2 times greater than ETFs.

Asset managers are equally attracted by the diversification benefits of alternatives, citing "diversify revenues/reduce revenue volatility" as one of the top three reasons to offer alternatives. As a group, asset managers also see alternatives as a major growth opportunity with greater competitive whitespace in the short- to medium-term.

Expectations for strong growth and attractive revenues have prompted traditional asset managers to respond. Two-thirds have made alternatives a top-three growth priority, with U.S. firms showing a stronger bent than their European counterparts. Asset managers across the U.S. and Europe expect to shift their AUM mix, with alternatives and alternative-like products increasing from 15 percent of total portfolio AUM in 2010 to 20 percent by 2013. The primary focus is on product development, with over 90 percent of asset managers planning to launch alternative-like/absolute return products (in a variety of vehicle formats) over the next three years. Roughly 70 percent plan to launch hedge funds and commodity funds – nearly twice the level of activity found in 2010.

These significant projected portfolio shifts are evidence that traditional asset managers see the value and the opportunity in the growth and mainstreaming of alternative asset classes. It remains to be seen whether they will focus as intently on the capability improvements that will make the move into alternatives a profitable and sustainable one.

The Challenge for Asset Managers

Traditional asset managers are convinced of the growth potential for alternative investments, and are gearing up to provide them to their clients, but they are also realistic about their ability to succeed in the alternatives space (Exhibit 6, page 20). In Europe and the U.S., slightly more than one-third of the traditional asset managers surveyed consider themselves well- or best-positioned to win in alternatives. In contrast, over 75 percent rate niche (specialized) alternatives players as well- or best-positioned to win, and 70 percent see the large diversified alternatives players as well- or best-positioned to win.

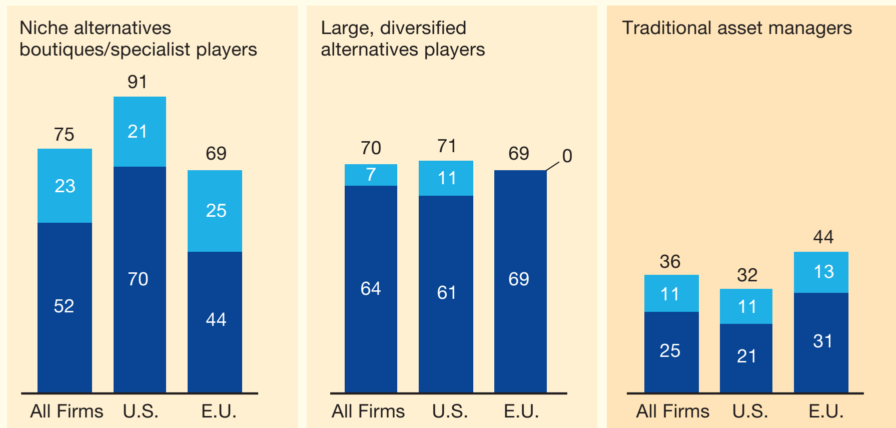
Investors share – at least in part – this view of traditional managers' ability to win their alternatives business. On the capabilities that drive investor satisfaction (beyond pure investment performance), institutional investors rate specialist alternatives managers more highly than traditional managers in two crucial areas: *risk management* and *technical product expertise* of the sales force. However, they rate both traditional and specialist managers poorly on overall understanding of client needs (Exhibit 7, page 20). On the retail side, where traditional asset managers have established relationships with retail distributors, over 60 percent of the RIAs surveyed primarily use specialist managers for their alternatives products. In addition to calling for better pricing, RIAs believe traditional asset managers need to clarify product and strategy

Exhibit 6

Many traditional asset managers have a cautious outlook on their ability to win in alternatives

Question: On a scale of 1-5, how well-positioned do you believe the following types of firms are to win in alternatives?

Percent of firms

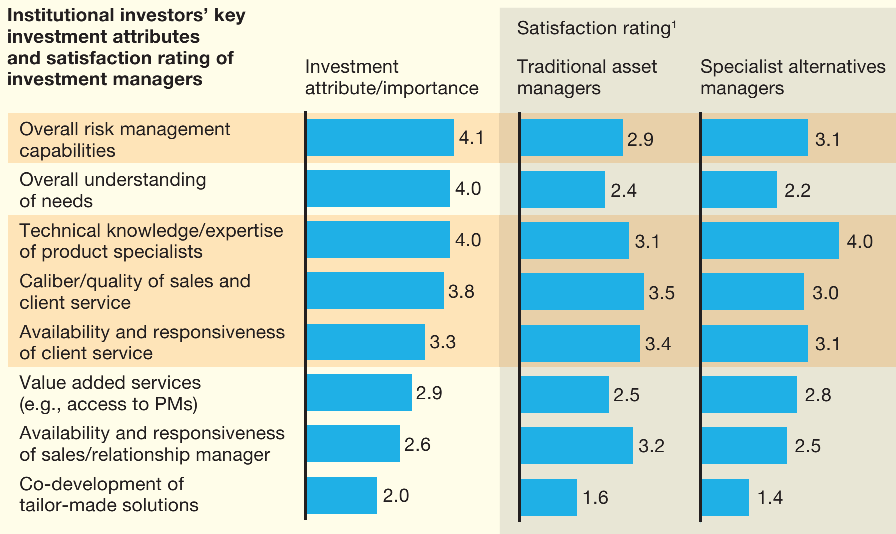


Source: U.S. Institute Asset Manager Survey of Alternative Investments

Exhibit 7

Institutional investors rank traditional asset managers below alternatives specialists on technical knowledge and risk capabilities

Institutional investors' key investment attributes and satisfaction rating of investment managers



[1] Satisfaction rating: 1 = Low, 5 = High

Source: McKinsey/Institutional Investor Global Survey on Institutional Investing, 2011

details and improve risk management and compliance for alternative investing (Exhibit 8).

Overcoming these challenges and perceptions will demand immediate management attention from traditional managers, but they are not the only hurdles they face in their efforts to thrive in the alternatives mainstream. Traditional asset managers must also resolve broader organizational and cultural issues.

For their part, specialist alternatives managers – which excel at producing alpha – must overcome the organizational and governance-related growing pains that inevitably arise with the transition to a more client-centric business model.

Improving investment capabilities

For investors considering awarding alternatives mandates to traditional asset managers, lack of track record and credibility are primary concerns. Half of the respondents to the institutional investor survey, for example, say they are

Exhibit 8

Retail RIAs echo need for asset managers to improve technical product knowledge and risk capabilities

Percent of firms

Source: U.S. Institute Survey of Independent Advisors' Use of Alternative Investments

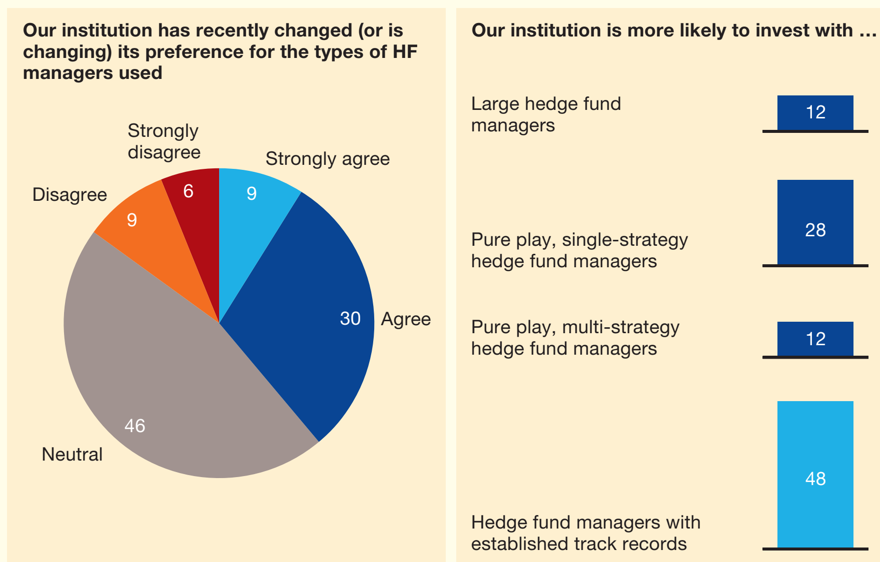
more likely to invest with hedge fund managers with established records (Exhibit 9) (three years is typically considered the minimum). Track records are equally crucial on the retail side. More than 70 percent of RIAs surveyed consider historical fund performance the most important factor influencing their selection of an investment manager for alternatives.

Traditional asset managers looking to gain quick traction often turn to acquisitions or team lift-outs, but acquisition failures far outnumber success stories in the alternatives space. Other firms have established strategic partnerships or minority investments in alternatives boutiques to stress test strategic fit before making an acquisition; but unless the partnership is structured so that the asset manager receives a significant piece of the revenue in the short term and the option to acquire the boutique later on, the asset manager can end up serving as a lucrative distribution arm for the boutique with little benefit to itself. Finally, asset managers with a longer-term view can build organically or leverage existing capabilities. However, this is a long, hard road, particularly in the institutional space where consultants have a strong bias for specialist alternatives managers with established track records.

Exhibit 9

Institutions favor hedge fund managers with established track records

Percent of firms that agree/strongly agree



Source: McKinsey/Institutional Investor Global Survey on Institutional Investing, 2011

Enhancing risk management and reporting

The risk management bar is high for asset managers seeking inroads in alternative assets. Investors are strictly enforcing risk limits and penalizing managers that are out of tolerance, either through mandate terminations or fee clawbacks. Investors are also pressing for improvements in performance reporting and higher degrees of customization.

To meet these investor demands (and to manage their growing exposure to derivatives) asset managers must step up their approach to risk measurement, management and governance. For many this means establishing a truly independent chief risk officer role and giving this executive a voice and decision-making authority on investment committees. This will be a dramatic shift, from portfolio managers governing themselves to out-of-tolerance portfolios being examined and collectively adjusted on a frequent basis.

Asset managers need to manage the integration of the alternative and traditional work cultures.

In addition to meeting high standards in risk management, reporting, liquidity and transparency, asset managers must provide investors with cross-portfolio views and comparisons that include asset classes and product strategies managed externally. Investors made it clear in the survey that they expect to increase outsourcing of performance measurement and reporting and risk management, increasingly requiring asset managers to compete with consultants to take their relationships to the next level.

Improving sales capabilities

To capture a greater share of the alternatives market, traditional managers must also revamp their distribution strategy. Certainly, they will need to leverage their existing client relationships and distribution strengths to gain momentum. In the long term, however, their challenge will be to address the distribution-related shortcomings that investors point out in the survey. While they grade traditional managers highly on responsiveness, investors are less impressed with their technical expertise and value-added services, compared to alternatives specialists.

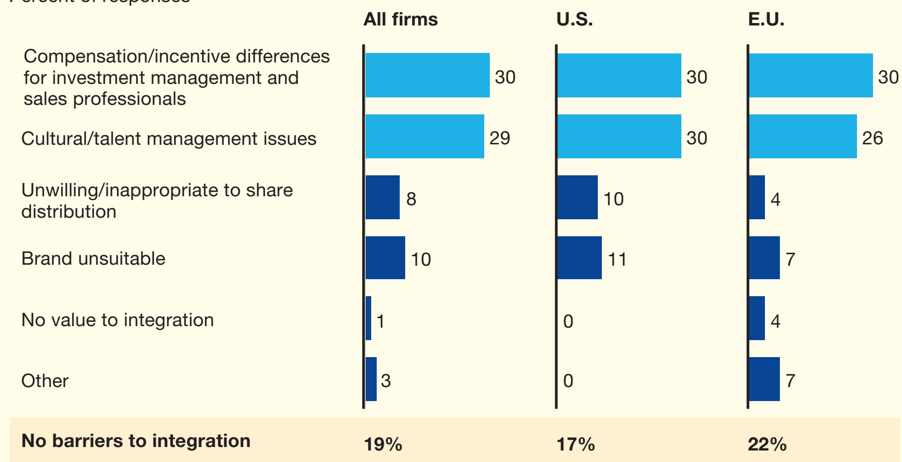
Reversing these shortcomings will require significant changes to sales processes (e.g., focusing on sub-segments of advisors that can sell alternatives), incentives (away from gross flows to revenues) and capabilities (e.g., building the expertise to position relative return and alternative products side

Exhibit 10

Asset managers face organizational challenges in integrating alternatives

Question: What does your firm see as the main barriers to integrating alternatives into your asset management organization?

Percent of responses



Source: U.S. Institute Asset Manager Survey of Alternative Investments

by side). Initially, traditional firms will need to decide on the right sales model for both retail and institutional. For example, should they use client portfolio managers or product experts, or dedicate sales specialists from each alternative asset class to liaise with more traditional sales professionals? They must also design effective sales training and product communications materials, particularly on the retail side. Finally, while most investors say they need help with performance measurement and reporting, portfolio construction, and risk and liquidity management, asset managers should also work with clients to understand the specific services and support they value, and weigh the investments needed to deliver them.

Resolving organizational conflicts

While building the skills and capabilities to compete with alternative specialists, asset managers also need to manage the integration of the alternatives and traditional work cultures. Two-thirds of the firms we surveyed expect to fully integrate alternatives into their existing asset management factory or product suite over the next three years, but also seem well aware of the barriers they will need to overcome in the process. The most worrisome is-

sues identified by asset managers are compensation/incentive differences for investment management and sales professionals and cultural and talent management (Exhibit 10).

Growing pains for specialists

Specialist alternatives managers outperform at generating alpha. But it would be a mistake to think that this strength will translate into an automatic advantage as alternatives go mainstream. Specialist firms are undergoing their own set of growing pains:

- *The transition from an institutional and investment strategy-oriented culture to a client-centric model.* Historically, specialists have focused on building and running the alpha engine. Now, they will need skills in identifying, converting and servicing key target clients and building up retail distribution partnerships.
- *Evolving core management processes.* As they move into the alternatives mainstream, specialists will encounter the escalating complexity that results from needing to manage multiple client segments, distribution channels and a more diverse talent pool. They will need to focus on previously non-core issues such as performance management and incentives and capital funding to make a successful transition.
- *Creating the right operating model for scaling the business.* The move to a more client-centric alternatives model calls for a more robust front- to middle/back-office integration to handle much larger volume at lower ticket sizes, as well as a support infrastructure to ensure the right controls.

Winning in the New Mainstream: Strategic Imperatives for Traditional Asset Managers

Market transitions inevitably present risk and opportunity for the players involved. For traditional asset managers, the resurgence and mainstreaming of alternatives will demand a shoring up of their historical strengths and a self-assessment and strategy for reversing their shortcomings. To help shape the management discussion on these issues, we present the following imperatives and relevant questions for firm leadership to debate and discuss.

Treat alternatives as a business, not an asset class or product set

Traditional asset managers that have successfully developed alternatives businesses have generally taken a long-term view and made substantial investments. There is no silver-bullet structure – successful models range from stand-alone entities to integrated businesses, often depending on a firm's size and ownership structure. However, debate on the following questions can help orient asset managers in the right direction:

- What is our alternatives strategy? Is it consistent with our overall objectives? What are the potential branding and market perception issues?
- What leaders are responsible and accountable for the success of the alternatives business?
- Are we investing sufficiently to close operational gaps and to build strong investment management and product development capabilities,

a holistic distribution strategy and improved risk management, reporting and governance?

Pick bets for growth

With more than 10 main asset classes and hundreds of sub-asset class strategies, and an increasing diversity of distribution channels, the alternatives market offers many options for traditional asset managers. Firms need to consider where they can be distinctive.

- What skills and capabilities do we have for building short-term credibility in the alternatives space, and for setting the foundation for expansion?
- In which asset classes or investment strategies are we best positioned to succeed? For example, can we turn our expertise in high-yield fixed income into the core component of a hedge fund? Do we have the skills and reach to develop "go anywhere" alternatives products that leverage our global asset allocation skills?
- What channels and client segments match our existing and future capabilities?
- What are the right product vehicles to prioritize for distribution in each channel?
- What is the potential to grow organically, with asset class or product extensions that closely align with existing capabilities and brand promise?

Decide how to scale investment capabilities

Investors considering awarding alternatives mandates to traditional asset managers are concerned about their lack of track record and credibility. Firms need to objectively evaluate the gaps in their investment skills and determine whether to "buy" these capabilities, or partner and build them.

- What is the potential for building capabilities organically? What investment skills and track records can be leveraged? Is there a development path by which talent can move from traditional to alternative investments?
- What is the role of acquisitions or team lift-outs? What role will the acquisition play in our overall alternatives business? Will the acquisition serve as the sole engine providing alternatives capabilities, or will we combine it with existing capabilities to provide products in an integrated manner?

- What is the potential for strategic partnerships or minority investments in alternatives boutiques as a substitute for, or precursor to, making an acquisition? What are the challenges?

Leverage distribution strength and client service capabilities

While investors rate traditional asset managers highly on distribution and client service capabilities, firms should build on these strengths to maximize their impact.

- How do the distribution models for retail and institutional clients differ?
- Which distribution and educational support model for retail will best ensure scalability and profitability?
- How do we provide the best distribution and product experts to our clients? Given the complexities of the products, should we be employing product specialists to work directly with institutional clients and gatekeepers at retail partners?
- How should client service be handled for alternatives products? For instance, should it be centralized or team-based?

Address organizational and cultural challenges

Organizational and cultural differences between traditional and alternatives asset managers has often led to underperformance in alternatives. Firms need to make mindful choices to mitigate these organizational risks.

- Should the alternatives complex be integrated with the traditional asset management business or managed as a stand-alone entity?
- If integrated, should the alternatives investment team be merged into the traditional portfolio management team or have a separate reporting structure? Should portfolio managers be allowed to manage both traditional and alternatives portfolios?
- Should investment research be shared across traditional and alternatives managers?
- How do we compensate and reward alternatives portfolio managers?

Improve risk management and client reporting

Strong risk management capabilities in alternatives are highly valued by institutional investors. Given their lack of experience managing alternatives strate-

gies and using leverage and derivatives, the bar for traditional asset managers is particularly high here. They need to overinvest in building risk management and client reporting processes and systems that will help them overcome investor perceptions.

- What should our overarching risk management governance and framework look like?
- Who should be responsible for overseeing risk management? Should this individual or team report to the CEO or to the investment management organization?
- What should the risk budget be overall and at the fund level? How should we handle out-of-tolerance risk positions?
- How should investment positions and performance (e.g., attribution) be reported to clients (e.g., customized by client)?

* * *

Almost given up for dead in the middle of the financial crisis, alternative investments have recovered, and are expected to far outpace the growth of traditional assets over the next few years. Meanwhile, evolving investor frameworks on both the institutional and retail side and a shifting manager landscape are leading to a convergence among manufacturers and products. To succeed in the transition to this new mainstream of asset management, traditional managers need to address critical shortcomings in their investment and risk management capabilities, leverage their existing strengths in distribution, and integrate the alternatives organizational culture with their current culture.

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The authors would like to acknowledge the contributions of Owen Jones and Robert Palter to this report.

About the McKinsey research behind this report

This report is based in part on a multiyear research effort on alternatives conducted by McKinsey in partnership with *Institutional Investor* and the U.S. Institute, covering both the investor and manufacturer landscape. The research includes the following:

- A global survey of over 70 institutional investors from the U.S., Europe and Asia (managing a total of more than $2 trillion in assets).
- A survey of 50 U.S. registered independent retail advisors regarding their alternatives usage and practices.
- A survey of 30 defined contribution (DC) plan sponsors concerning their preferences and buying behavior for alternative assets, as well as conference polling of over 100 DC plan sponsors on alternatives.
- A global survey of 45 asset managers (managing over $10 trillion in AUM) on their alternatives strategies.
- Over 20 interviews with senior executives at leading traditional asset management firms and specialist alternatives managers.
- McKinsey client work and proprietary research on the alternatives industry.

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To learn more about McKinsey & Company's specialized expertise and capabilities related to the asset management industry, or for additional information about this report, please contact:

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