In Alternatives We Trust -

The future of alternative listed investment companies

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Alternative investment companies have been the major driver of new issuance in the UK listed investment company market accounting for more than 60% of new share issuance since the financial crisis. In this report we analyse and forecast growth of net assets and new issuance of the listed investment company market until 2020. We expect new issuance of £11.3bn in listed investment companies over the next three years. Two thirds of this new issuance is expected to occur in alternative investments.

Introduction

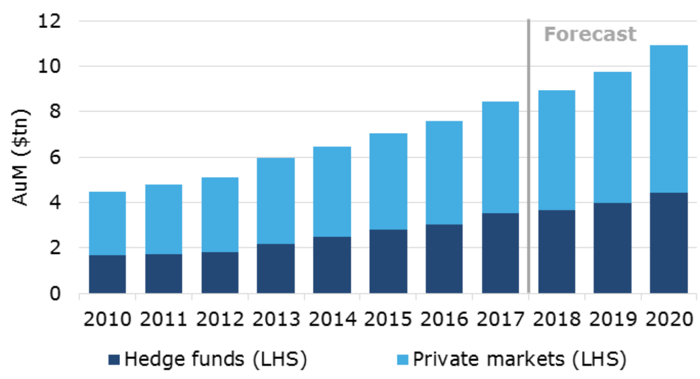
"There is no alternative," pronounced Margaret Thatcher in the 1980s. At the time, she may have had a point regarding portfolio construction – we're sure that's what she meant. However, the proliferation of alternative investment vehicles within a couple of decades has consigned this to history, along with padded shoulders and hair spray.

The rise of private markets has characterised investments so far this century and looks to be a continuing trend. Our report accompanying this one, *The global alternatives market,* detailed the phenomenon and its likely trajectory. This report takes the analysis forward, looking at how the rise of alternatives is manifesting itself through listed investment companies in the UK.

The global alternative market showed that private markets have outstripped the growth of the global investment market over three, five and ten years. As a result, alternative assets have risen from 2.3% of the global investment market in 2000 to 5.2% at the end of 2017. Hedge funds led this trend early on in the millennium and have remained the most popular alternative investment by assets under management. Further growth has come from private equity, particularly either side of the global financial crisis, and private debt and infrastructure in its wake.

The report concluded that we expect the alternatives market to grow in line with broader investment markets over the coming three years, expanding by $2.45tn. Our base case scenario assumes about half of this growth will come from private equity investments, with growth in infrastructure assets also being major contributors. Hedge funds have remained the most popular alternative investment by AUM and could grow faster than almost all other alternative investments over the next three to five years (Fig. 1).

Fig 1: Projected growth in alternative investments globally



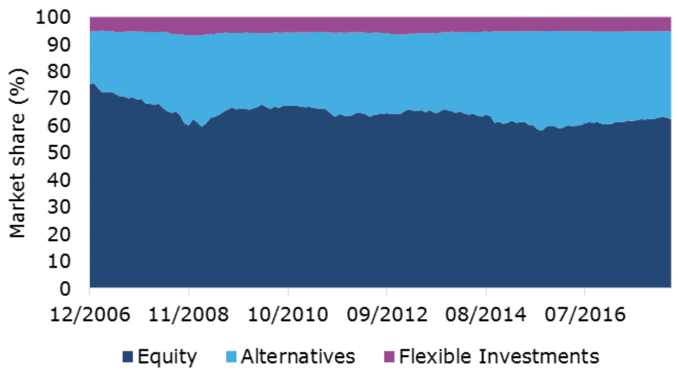
Source: Fidante Capital.

The UK has a diverse and growing range of investment companies through which alternatives can be accessed. Indeed, the boom in alternatives has had an even greater impact on the UK's listed investment companies than it has on the market as a whole. In 1999, 17% of these vehicles invested in alternatives, as compared to now, when 47% do.[1] Below, we take a granular view on how this has occurred, the growth of the various sub sectors, and their likely trajectories in the coming three years.

More than meets the eye

Just from looking at Fig. 2, you might wonder why we're bothering: it seems that alternative investments, as part of the total NAV of listed investment companies in the UK, have not changed much since 2008.

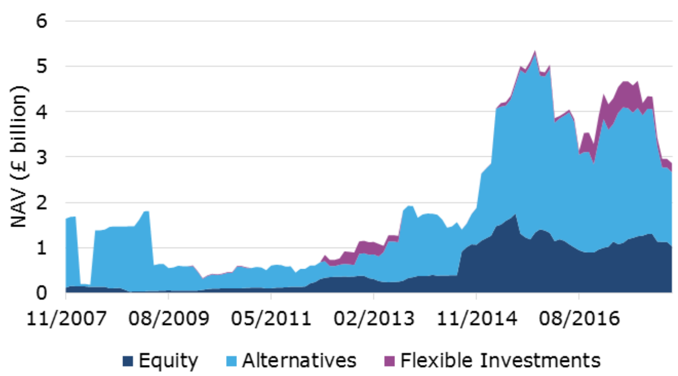
Fig 2: Evolution of the listed investment company market



Source: Fidante Capital.

When we allow for differing asset class growth rates, however, the rise of alternatives in the sector becomes apparent. While net assets of listed investment companies in alternatives has outpaced equities over the past five and ten years, growth has fallen below equity levels in the past three. This seemingly smaller growth of alternative listed investment companies' NAV, however, is merely a reflection of the strong performance of equity markets in recent years, masking a lot of activity in the alternatives space. If we look at new issuance of shares – whether through IPO, tap issuance or other means – then we can see that alternative investment companies account for more than 60% of this since the financial crisis (Fig. 3).

Fig 3: New issuance (rolling 12-month window)



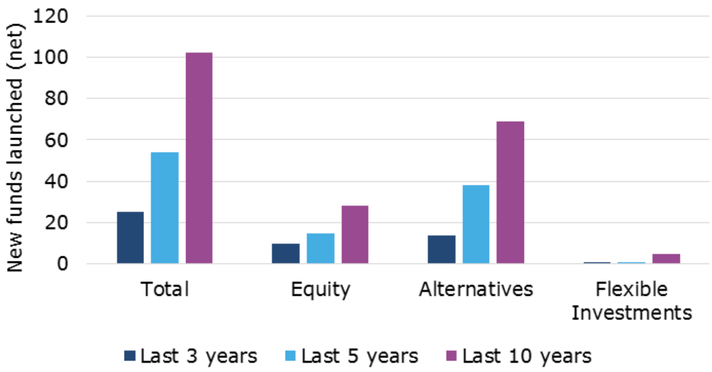
Source: Fidante Capital.

[1] Figures from the AIC.

This pattern is also reflected in the sheer number of new funds launched at the LSE (Fig. 4). The number of alternative investment companies launched in the last five and ten years was more than twice as high as that of equity investment companies. So, while the performance of equities has been strong, the market has clearly been calling out for alternative investments.

Indeed, our accompanying study has shown increasing demand from large investors such as high-net worth individuals and, particularly, pension funds, well ahead of the aggregate market, reflecting their higher level of sophistication.

Fig 4: Investment company net new funds



Source: Fidante Capital.

Infrastructure and renewable energy funds were the main drivers of growth over the past three years, based on new issuance and percentage growth in NAV. The total new issuance in these funds was more than double the second-placed Alternative Credit sector, although the latter was the fastest growing sector by number of funds, with a net 12 new offerings in the past three years.

Nevertheless, in absolute terms, thanks to the strong performance of equity markets in the past three years and the large amount of assets already invested in these sectors, the biggest volume increase was in Equity Global funds, as indicated in column two of Fig. 5. Equity funds focusing on the UK and APAC also grew strongly in terms of NAV.

Fig 5: Leading sectors by growth

Growth last 3 years					
Sector	By issuance (£ million)	Sector	By fund NAV (£ million)	Sector	By fund NAV (%)
Infra / Renewables	3,988.6	Equity Global	5,970.3	Infra / Renewables	56.2
Alternative Credit	1,900.4	Infra / Renewables	4,901.7	Private Equity	55.1
Equity Global	1,286.0	Equity APAC	4,780.9	Equity APAC	49.2
Equity UK	1,052.6	Equity UK	3,273.1	Sector Specialists	45.0
Flexible Investments	871.3	Private Equity	2,980.4	Equity Europe	37.1

Source: Fidante Capital.

Alternative futures

How, then, might this global increase of $2.45tn in alternatives impact on the UK's listed investment companies?

In order to answer this, we adapt the same methodology as in our first report to project growth of such companies in the UK until 2020. Their growth is projected on the basis of three-year future growth rates for each super sector, as defined in Appendix 1. We have estimated the relationship of annual NAV growth between 2006 and 2017 for each of our sectors in a two-stage linear regression. Based on historic relationships, we predict NAV growth until the end of 2020 on an annual basis in the step-by-step process outlined in Fig. 6.

Fig 6: Forecast methodology

Forecasting the future of NAV growth	
Stage 1	Estimate future returns of the FTSE 100 index based on its relationship with return last year, 3-month and 10-year interest rates at the beginning of each year, as well as real GDP growth and CPI during the year. Predictions for interest rates, GDP and CPI are consensus forecasts from Bloomberg.
Stage 2	For each of our sectors, we estimate annual NAV growth based on its past relationship with FTSE 100 returns, 3-month and 10-year interest rates at the beginning of each year, as well as real GDP growth and CPI during the year. Predictions for interest rates, GDP and CPI are consensus forecasts for Bloomberg.
Forecasting NAV growth	Based on the forecast growth rates for each sector we calculate growth of NAV. NAV growth for each sector is then aggregated to our three super sectors.

Source: Fidante Capital.

Alternative directions: case by case

Our base case assumes that current consensus forecasts for UK GDP growth, UK CPI and UK interest rates (3-month and 10-year) are correct. This implies slower economic growth, inflation of around 2% and a gradual normalisation of interest rates. Here, the growth rate of NAV in alternative investments would decline from the 10% average of the past 10 years to about 7% while equity investment growth would accelerate towards 11% from the 6% of the previous ten years. Despite the higher growth of equities, most of the new issuance would still be in alternative investments. Out of the £11.3bn expected new issuance, about two thirds would go to alternatives.

Fig 7: Base case scenario

Estimated growth next 3 years			
	Issuance (£ bn)	NAV growth (£ bn)	NAV growth (% p.a.)
Total	11.3	43.9	9.6
Equity	4.4	32.2	11.1
Alternatives	7.3	10.1	7.1
Flexible Investments	0.0	1.6	6.9

Source: Fidante Capital.

Our optimistic scenario assumes UK GDP growth accelerating to 2%, inflation remaining at 2%, no more Monetary Policy Committee rate hikes and a slow rise in 10-year gilts towards 2% by 2020. In this scenario we expect much faster growth in alternative investment NAVs, due to their better performance. New issuance, on the other hand, would increase only moderately and remain largely the same as in our base case scenario.

Fig 8: Optimistic case

	Estimated growth next 3 years		
	Issuance (£ bn)	NAV growth (£ bn)	NAV growth (% p.a.)
Total	12.1	59.2	12.6
Equity	4.2	37.0	12.5
Alternatives	7.8	20.1	13.4
Flexible Investments	0.1	2.0	8.7

Source: Fidante Capital.

Our pessimistic scenario is based on a hard Brexit where the UK crashes out of the EU in 2019, sterling declines dramatically, inflation spikes to 3.5% and the Bank of England (BOE) is forced to hike interest rates to 2% in 2019, thus triggering a recession. In this scenario, growth in alternative investments would plummet. While new issuance holds up reasonably well, the mix is likely going to be very different than in the base case, probably tilting much more towards defensive investments and less in private equity, which is correlated more with the economic cycle.

Fig 9: Pessimistic case

	Estimated growth next 3 years		
	Issuance (£ bn)	NAV growth (£ bn)	NAV growth (% p.a.)
Total	9.0	9.7	2.3
Equity	3.8	15.9	5.8
Alternatives	5.0	-6.7	-5.4
Flexible Investments	0.1	0.5	2.4

Source: Fidante Capital.

Getting granular on the base case

If we take a deeper dive into our base case scenario, we see a number of trends emerging (Fig. 10).

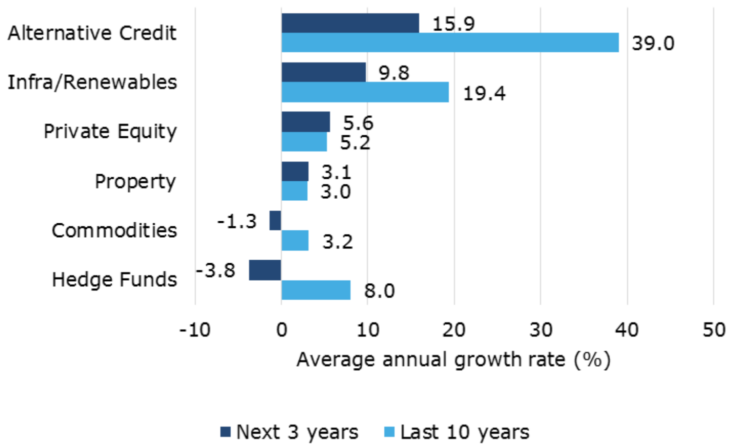
In alternatives investments, we expect the fastest growth in Alternative Credit and Infrastructure, as the investor thirst for yield continues. Over the past decade, Alternative Credit has been driven by corporate borrower demand, as banks have withdrawn from serving much of this – particularly SMEs, complex or cross-border deals – and income-seeking investors' requirement for higher yields than are achievable in public fixed income markets. This is still a young market with ample opportunity for growth, and this should be reflected among listed investment companies. Although Figure 9 shows a slowing from the previous decade, it should be noted that this is off a low absolute base of assets. Infrastructure investments carry the additional advantage of a measure of inflation protection, which should be attractive in this scenario.

Our model also predicts a decline in NAV for listed hedge funds. This is largely a reflection of the recent trend away from closed-end fund vehicles for the asset class, towards UCITS and other platforms, despite our expectation in *The global alternatives market* report that hedge funds overall should grow strongly over the coming period.

If we compare the projected growth rate for listed investment companies in the coming three years with the average growth rate of the last 10 years we see the following additional trends (Fig. 10):

- Growth rates for Alternative Credit and Infrastructure are highest, but falling from the explosive growth seen in the past ten years.
- Growth rates for private equity and property are expected to remain at the levels seen in the previous decade.
- Commodities and hedge funds are the biggest losers. The drivers for this are different, as we expect hedge fund demand to remain robust but directed elsewhere, as explained above, whereas commodities will continue to be victims of waning demand irrespective of investment wrapper.

Fig 10: Investment company net new funds



Source: Fidante Capital.

Summary

As with the swan, the steady-as-she-goes appearance given by an alternative assets NAV that has remained fairly constant over recent years conceals frenetic below-the-waterline activity. In terms of total assets, UK-listed investment companies are dominated by equities, which are in an on-going bull market.

In contrast, alternative investment companies account for more than 60% of new shares issued since the financial crisis. What's more, the number of alternative listed investment companies launched in the past five and ten years more than doubled the number of equity company launches.

Infrastructure and renewable energy funds were the main beneficiaries of this growth, in terms of new issuance – more than double the second-placed Alternative Credit sector, which nevertheless leads by the fastest increase in fund numbers.

Applying the same methodology as our broad alternatives study, our base case predicts a fall in the alternatives' NAV growth rate from the 10% average of the past 10 years to about 7%, with equity growth continuing to outstrip it. Despite equities' stronger growth, most of the new issuance would still be in alternatives: about two thirds of the expected £11.3bn new issuance, with Alternative Credit and Infrastructure being the main beneficiaries of this.

Appendix: Gathering and sorting

We have built a database of 713 investment companies, both current and defunct, listed on the London Stock Exchange and the Amsterdam stock exchange between January 2007 and March 2018.[2] We have based our classification on the Association of Investment Companies sectors but simplified it in order to be able to discover general trends per asset class.

As with any market data, some provisos need to be made: first, while delisted and defunct companies are included in the database whenever there was share and NAV data available, not all of them have such data. This means that our data has survivorship bias and may overstate the growth of investment company assets under management in the past. Second, while private equity trusts are part of the database, venture capital trusts are not.

Fig 11: Our sector classifications

Supersector	Sector	AIC sector included
Equities	Equity Global	Global
		Global Equity Income
		Global Growth
		Global Growth & Income
		Global High Income
		Global Smaller Companies
		Split Capital Trusts
	Equity North America	North America
		North American Smaller Companies
	Equity Europe	Europe
		European Smaller Companies
	Equity APAC	Asia Pacific – excluding Japan
		Asia Pacific – including Japan
		Japan
		Japanese Smaller Companies
	Equity UK	UK All Companies
		UK Equity & Bond Income
		UK Equity Income
		UK Growth
		UK Growth & Income
		UK Smaller companies
	Sector Specialists	Sector Specialist: Environmental
		Sector Specialist: Biotechnology/Life Sciences

[2] The data is based on the monthly publication of the listed investment companies on the LSE by the Association of Investment Companies.

		Sector Specialist: Financials
		Sector Specialist: Small Media Comms & IT
		Sector Specialist: Tech, Media & Telecom
		Sector Specialist: Utilities
Alternatives	Alternative Credit	Sector Specialist: Debt
		Sector Specialist: Liquidity Funds
		Sector Specialist: Securitised Debt
		Sector Specialist: Leasing
		Sector Specialist: Litigation
		Sector Specialist: Zero Dividend
	Property	Property
		Property Direct – Asia Pacific
		Property Direct – Europe
		Property Direct – UK
		Property Securities
	Infra/Renewables	Sector Specialist: Infrastructure
		Sector Specialist: Renewable Energy
	Commodities	Sector Specialist: Commodities & Natural Resources
		Sector Specialist: Forestry & Timber
	Hedge Funds	Hedge Funds
	Private Equity	Private Equity
Flexible Investments	Flexible Investments	Flexible Investments

Source: Fidante Capital.

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