The Global Alternative Investment Market

Growth accelerates in private markets

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This report examines the developments in the global alternative investment market. 2018 continued the trend of recent years towards private market investments with strong growth in private equity and private debt, while natural resources and property investments lagged. We provide forecasts for the possible development of these investments in the next three years and show that real assets should accelerate in our view, more than doubling the growth rate of the last three years. We also address why private equity is poised to show strong growth in coming years, in our view.

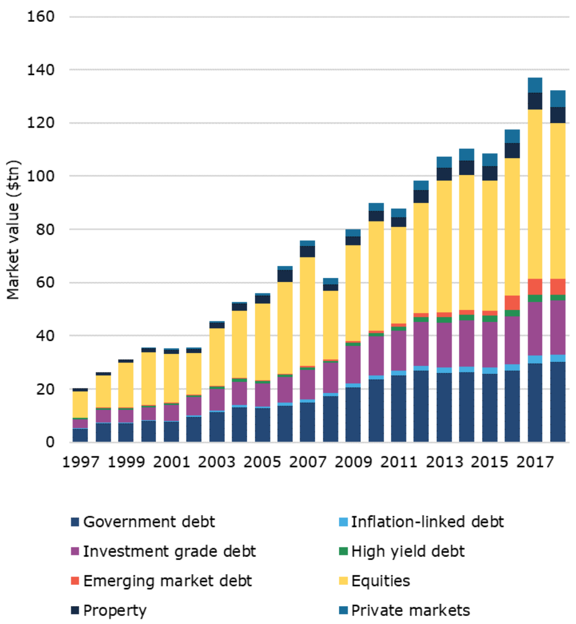
The shift towards private markets continued in 2018

In 2018, the value of the global investment market declined by 3.5% (Fig. 1), the first decline since 2015 and the biggest decline since the Global Financial Crisis (GFC). This setback was driven mostly by equity markets and other risky assets. Global equity markets declined 8.3% in US Dollar terms to $58.4tn, while the value of issued high yield bonds declined 12.3% to $2.3tn. This decline in volatile listed assets is in sharp contrast to private market investments[1], which had another great year, growing assets under management by 11.1% to $6.4tn. Within private markets, each of private equity, private debt and property investments were able to outpace overall private market growth in 2018.

This large difference in growth rates between private markets and the global investment market is the biggest difference we have observed since 2011 and underscores how strong the shift away from listed to unlisted investments is at the moment.

Note that our measurement of the global investment market does not include the world's most popular alternative investment, hedge funds, since these funds invest in other listed or private assets. Hedge fund assets under management (AuM) grew 5.5% in 2018, according to BarclayHedge, with equity market neutral strategies taking the top spot with an annual growth in assets under management of 14.9%.

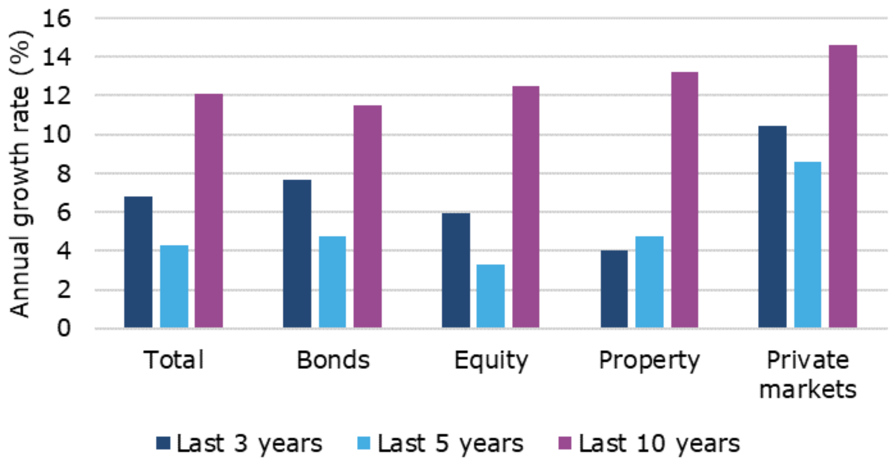
Fig 1: Growth of global investment market



Source: Bloomberg, Preqin, Fidante Partners.

[1] We define private markets as direct investments in private equity, private debt, property, infrastructure and natural resources.

Fig 2: Growth by asset class



Source: Bloomberg, Preqin, Fidante Partners.

Over the last decade since the GFC, growth in alternative investments (defined here as investments in private markets plus hedge funds) has outpaced growth in stocks and bonds. From the end of 2008 to the end of 2018, listed property investments (REITs) grew their assets by 13.2% per year while private market assets grew 14.6% per year. In comparison, equity markets grew by 12.5% per year and bond markets by 11.5% per year. However, growth rates for listed property investments over the last three to five years have declined to levels below those for equities and bonds, while private market assets continued to outpace stocks and bonds by a significant margin (Fig. 2) over this timescale.

> Alternative investments account for 7.2% of the global investment market – a new all-time high.

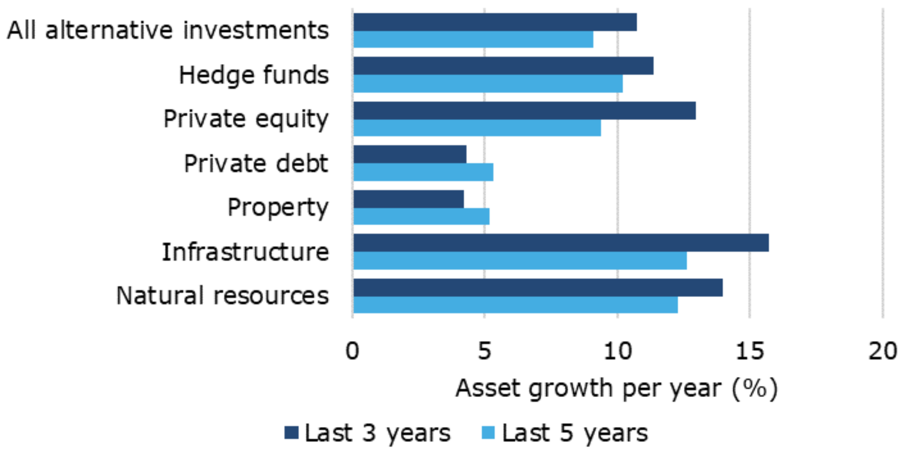
Because of the higher growth in private markets, their share in the global investment portfolio has risen significantly over the last decade from 3.7% at the end of 2008 to 4.9% today. Overall, alternative investments account for 7.2% of the global investment market – a new all-time high and up from 6.1% at the end of 2008.

Growth rates amongst private market assets were similar, ranging from 8.3% growth in AuM for natural resources investments to 12.1% for property investments. This is a welcome change for private debt and property investments, which have seen much lower growth rates in 2016 and 2017 than other private market assets (Fig. 3).

Growth rates for natural resources investments, on the other hand, are on a declining trend. Asset growth in 2018 was 8.3% – the lowest annual growth rate recorded since measurements began in 2011. Natural resources investments saw strong growth due to the shale boom in the US which increased investments in pipelines and other energy infrastructure. These investments are now largely made and with the shale business in the US maturing, growth rates should come down naturally.

If we combine infrastructure, property and natural resources into what is commonly referred to as "real assets", we can see that demand for real assets remains undiminished. The annual growth of real assets in 2018 was 10.2%, virtually identical to 2017 and the highest growth since 2013. However, the true growth may have been higher since many private equity and private debt funds also invest in real assets.

Fig 3: Strong growth in alternative investments



Source: BarclayHedge, Preqin, Fidante Partners.

Two roads to success for hedge funds

Hedge funds continued to grow their assets, albeit at a lower pace than in the past. The funds in the BarclayHedge hedge fund universe grew AuM by 5.5% in 2018, compared to a three-year average of 12.8% between 2015 and 2017. The fastest growing strategies in 2018 were equity market neutral funds, with a growth of 14.9% followed by multi-strategy funds with AuM growth of 12.1%.

On a rolling three-year basis, trends are easier to be spotted and we can identify two types of hedge fund strategies that were successfully able to grow their asset base. The most successful strategies over the last three years were low volatility/defensive strategies that aim to protect against drawdowns in equity markets, should the bull market come to an end. Merger arbitrage funds (rolling three-year volatility of 2.6%) saw strong growth in assets in 2016 and 2017, before petering out in 2018. The rolling three-year growth rate in AuM of 34.5% remains by far the highest growth of any hedge fund strategy. Other strategies with strong asset growth over the last three years were equity market neutral strategies (rolling three-year volatility of 2.1%) and multi-strategy funds (2.6%).

More volatile hedge fund strategies continue to struggle, particularly when they cannot offer an attractive track record over the last couple of years. Convertible arbitrage strategies and global macro strategies saw AuM decline by 3.8% per year and 2.1% per year over the last three years, respectively. Even worse hit were distressed securities strategies (-9.6% per year in AuM) and event-driven strategies (-10.0% per year in AuM).

There is, however, one high volatility strategy that managed to increase its AuM substantially over the last three years: equity long-biased strategies. Despite a 2018 performance of -8.7%, this strategy managed to grow its AuM by 9.2% in 2018 after a jump of 68.6% in 2017. No doubt the strong performance of the strategy in 2017 (+14.0%) attracted investors who wanted to gain equity exposure with the option of reduced drawdowns should the bull market end.[2]

The example of equity hedge funds shows that while low volatility and defensive strategies are the main drivers of asset growth in the hedge fund universe, high volatility funds can still attract assets if the performance is attractive. Funds that are stuck in the "murky middle", with a volatility

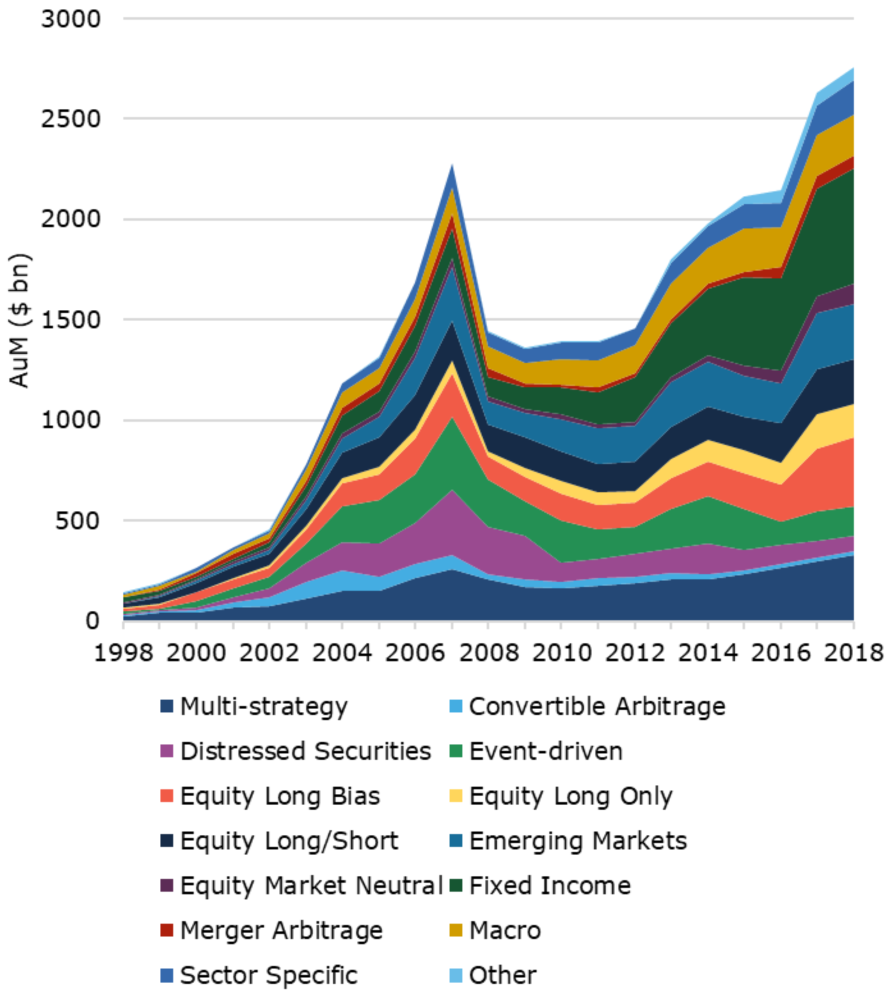
[2] Past performance is not a reliable indicator of future outcomes.

that is low enough such that it limits the upside potential but still sufficiently high so that other, lower volatility strategies provide better downside protection, have struggled in recent years – and it seems unlikely that this trend will change.

One other factor that is driving hedge fund AuM is the continued pressure on fees. If we compare hedge fund of funds with multi-strategy funds, we observe that the AuM of fund of funds declined by 7.3% per year during the last three years. In comparison, AuM of multi-strategy funds continue to grow at a rapid pace of 12.1% in 2018 and 12.3% on a rolling three-year basis.

But multi-strategy funds have similar volatility to fund of funds and produce similar returns, once the additional fee layer of fund of funds is accounted for. Thus, the difference in AuM growth seems to be due to fees rather than a reluctance by investors to invest in diversified hedge funds that offer a one-stop access to a multitude of strategies that can be plugged into an existing multi-asset portfolio.

Fig 4: Growth of hedge fund strategies



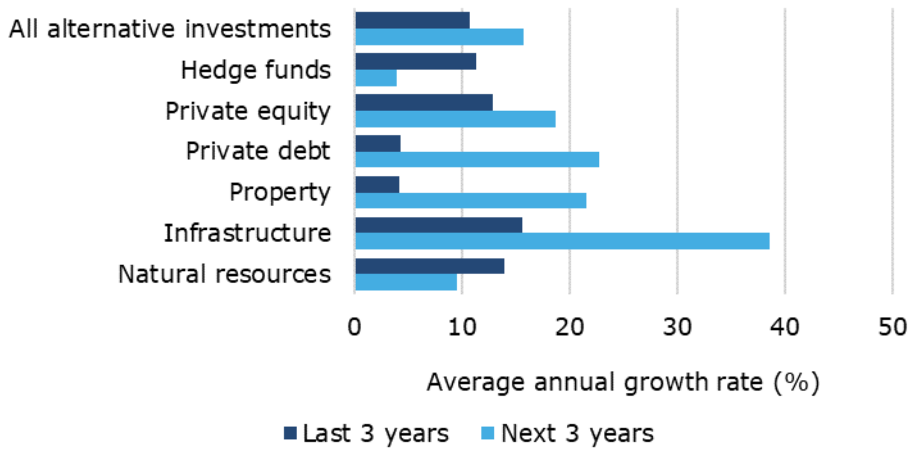
Source: BarclayHedge, Fidante Partners.

Strong growth, particularly for real assets

At the beginning of 2019, fears about declining global growth, from the US to Europe to China, are dominating the debate amongst investors. At the same time, interest rates have risen in the US, creating repricing pressure for fixed income investments, property markets and commodities.

We use a macroeconomic-driven forecasting model to predict growth in different asset classes for the next three years until 2022.[3] In our base case scenario, we use OECD forecasts for global GDP growth and inflation until 2021 and Bloomberg consensus forecasts for 3-month and 10-year US Treasury yields. Based on the historic relationship between these variables and asset growth in the different asset classes, we predict three-year growth rates in assets. Currently, this base case scenario is essentially a steady state, with the OECD predicting both world growth and world inflation to remain stable until 2021. 3-month interest rates in the US are also expected to remain virtually unchanged going forward, while consensus forecasts for the 10-year US Treasury yield are for an 0.1 percentage point increase.

Fig 5: Strong growth expected for most alternative asset classes



Source: BarclayHedge, Preqin, Fidante Partners. Forecasts are subject to estimation errors and may deviate significantly from the performance shown.

With these forecasts, our model predicts continued strong growth in alternative investments of 15.7% per year (Fig. 5). Total alternative investments (hedge funds and private markets) are predicted to grow by $5.2tn until 2022. Most of the growth ($4.8tn) is forecast to occur in private markets, with infrastructure investments and private debt investments showing annual growth rates of 38.6% and 22.8%, respectively, and property investments not far behind. Hedge funds and natural resources investments in private markets are expected to be the laggards over the coming three years. Hedge funds are still expected to grow AuM by $382bn over the next three years in our base case scenario, but at a growth rate of 4.0%, growth is expected to slow down significantly from recent levels. The outlook for investments in natural resources is somewhat better with growth in AuM of $211bn, roughly matching the growth in assets over the last three years in US Dollar terms (Fig. 6). If we combine property, infrastructure and natural resources into the group of real assets, our forecasts show expected growth of $1.8tn in the next three years for an annual growth rate of 22.9% – a strong acceleration from the 9.6% annual growth experienced over the last three years.

[3] See appendix for details.

Fig 6: Base case scenario

	Cumulative growth ($ bn)	
	Last 3 years	Next 3 years
All alternative investments	2,495	5,206
Hedge funds	846	382
Private equity	1,044	2,298
Private debt	108	772
Property	106	725
Infrastructure	174	818
Natural resources	217	211

Source: BarclayHedge, Preqin, Fidante Partners. Forecasts are subject to estimation errors and may deviate significantly from the performance shown.

In order to assess the sensitivity of our forecasts to different economic developments, we calculate forecasts for an optimistic scenario and a pessimistic scenario as well. The results are shown in Fig. 7 and Fig. 8.

Our optimistic scenario assumes an acceleration of global growth from current levels of 3.6% to 4.5% in 2021. At the same time, inflation is expected to decline towards central bank targets of 2%, while US interest rates increase slightly. In this scenario of strong growth and contained inflation, we expect hedge fund asset growth to accelerate dramatically from $382bn under the base case to $1.1tn. This would equate to an annual growth rate of 10.5%, which is still low compared to the 20% growth rates projected for private equity and private debt in this scenario and the 44% growth rate for infrastructure investments.

Fig 7: Optimistic case

	Cumulative growth ($ bn)	
	Last 3 years	Next 3 years
All alternative investments	2,495	6,443
Hedge funds	846	1,070
Private equity	1,044	2,537
Private debt	108	675
Property	106	899
Infrastructure	174	984
Natural resources	217	278

Source: BarclayHedge, Preqin, Fidante Partners. Forecasts are subject to estimation errors and may deviate significantly from the performance shown.

In contrast, our pessimistic scenario assumes a global growth slowdown to 3.0% in 2021, joined by a decline in inflation towards 2.0% and a decline in 3-month US Treasury rates to 2.0% and 10-year Treasury yields to 2.5%. This would be a reaction to lower central bank interest rates as the Fed and other central banks around the world try to stimulate the global economy through lower rates.

Interestingly, growth rates for private equity are expected to decline only slightly in this scenario and growth in private equity, private debt, and natural resources investments should hold up relatively well in this scenario. Hedge funds, on the other hand, are forecast to experience bigger declines in growth in this scenario, though growth would remain positive (Fig. 8).

Fig 8: Pessimistic case

	Cumulative growth ($ bn)	
	Last 3 years	Next 3 years
All alternative investments	2,495	3,549
Hedge funds	846	68
Private equity	1,044	1,930
Private debt	108	484
Property	106	422
Infrastructure	174	447
Natural resources	217	199

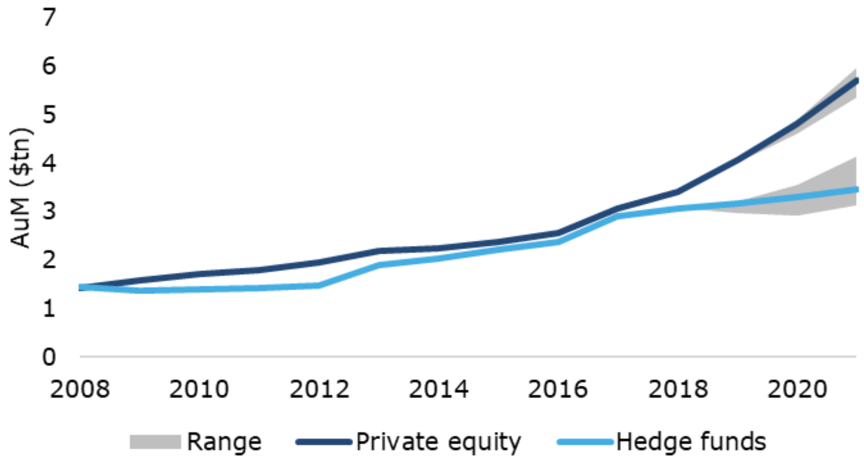
Source: BarclayHedge, Preqin, Fidante Partners. Forecasts are subject to estimation errors and may deviate significantly from the performance shown.

Private equity as a late cycle phenomenon

One of the surprising outcomes of our forecasts is the big discrepancy between private equity and hedge fund AuM. As Fig. 9 shows, the AuM of these two asset classes has grown along similar lines between 2008 and 2017, but in 2018, private equity AuM jumped 11.5%, while hedge fund AuM grew 5.5%. In our forecasts for the next three years, the uncertainty around hedge fund AuM is also much bigger (as can be seen by the wider grey cone in Fig. 9) than for private equity.

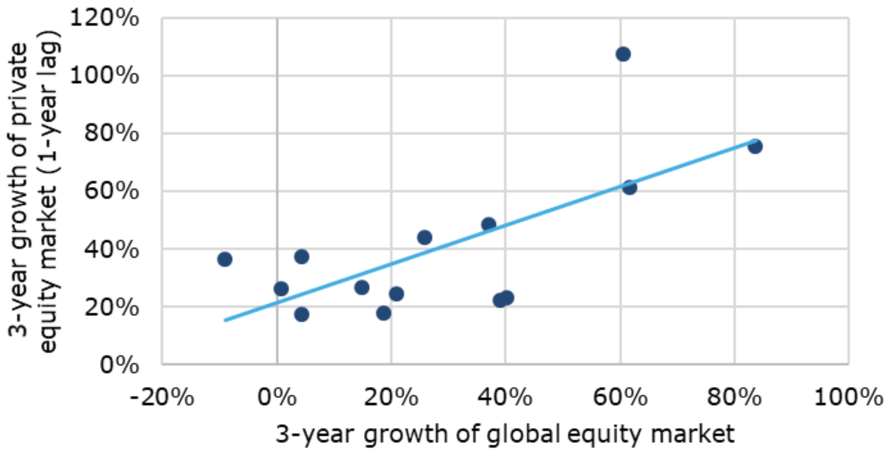
As media reports of high valuations in private equity deals continue to mount and worries about a potential end of the equity bull market of 2009 to 2018 increase, investors rightfully worry if private equity investments can grow at such a fast pace going forward.

Fig 9: Private equity taking off



Source: BarclayHedge, Preqin, Fidante Partners. The grey areas show the difference between optimistic and pessimistic scenario forecasts. Forecasts are subject to estimation errors and may deviate significantly from the performance shown.

Fig 10: Strong equity markets driving private equity growth



Source: Bloomberg, Preqin, Fidante Partners.

Fig. 10 provides a clue as to why our model predicts such strong growth in private equity AuM going forward. Historically, private equity booms have been a late cycle phenomenon which have accelerated as equity market cycles matured and monetary policy became more restrictive.

In Fig. 10 we show the relationship between private equity AuM growth and listed equity AuM growth. The chart shows three-year rolling AuM growth for both asset classes, with private equity growth lagged by one year. The chart shows that in order to see strong growth in private equity AuM one needs to see strong listed equity market growth in the one to three years prior. Investors seem to take their clue about private equity markets from past performance in listed equites.

Additionally, there is a second effect at work. As equity bull markets mature and equity market volatility increases, investors are looking for alternative sources of high return that can substitute or diversify part of the existing equity market exposure. Private equity investments are often the beneficiary of these shifts in asset preferences.

It is no wonder that major private equity firms like KKR or Apollo all had their IPO at the end of the last equity bull market between 2006 and 2008. Similarly, private equity AuM grew 24.5% in 2005, 31.0% in 2006 and 27.2% in 2007. And despite the massive dislocations during the GFC, the illiquidity of the asset class led to a mere 3.2% decline in AuM in private equity in 2008, according to data compiled by Preqin.

Readers should compare these late cycle growth rates for private equity AuM with the early cycle growth rates of 2003 (10.8%) and 2004 (7.6%) in the previous cycle, or the early cycle growth rates in the current cycle, when private equity AuM grew by 10.7% in 2009, 9.4% in 2010, and 4.2% in 2011. If the last cycle is any guide, then we should expect private equity asset growth to pick up in 2019 and 2020.

Summary

2018 brought the first decline in the global investment market since 2015 and the biggest decline since the GFC. However, this decline in the size of the global investment market was mostly driven by listed investments. Private market investments, together with hedge funds, continued to grow, sending the share of alternative investments in the global investment market to an all-time high of 7.2% at the end of 2018.

We observe several trends in alternative investments over recent years:

- Investors are increasingly looking for opportunities in private market investments while growth in hedge fund AuM remained moderate.
- Within private market investments, private equity and infrastructure investments had the highest growth rates in recent years but after a couple of years of low growth, property and private debt investments are seemingly catching up.
- Within hedge funds, low volatility strategies, such as equity market neutral or merger arbitrage, were able to garner the most assets while more volatile strategies like global macro, event-driven or distressed securities have faced a declining asset base.

We expect several of these trends to continue over the next three years until 2022. Based on our model projections, we expect the following major trends within alternative investments:

- We expect the annual growth rate of alternative investments to average 15.7% over the next three years, increasing the asset base by $5.2tn in total.
- We expect private market investments to outpace hedge funds by a wide margin, with the highest growth rates in infrastructure investments. Overall, we expect growth in real assets (infrastructure, property and natural resources) to more than double from the average over the last three years and for real assets to grow by $1.8tn by 2022.
- The largest expected growth in assets under management over the next three years ($2.3tn) is projected for private equity investments. This is based on the historical acceleration of private equity asset growth towards the late stages of a cycle.

Appendix: Methodology

Global investment market

We have used the sources below to calculate the total value, and relative weights, of the global investment market, using the methodology outlined by Doeswijk et al.[4] This is "the invested market portfolio, which contains all assets in which financial investors have actually invested. So, for example, we excluded durable consumption goods, human capital, private housing and family businesses. The presence of an asset in the benchmark of leading index providers is generally an important criterion…we included publicly available financial assets only." We complement these calculations of listed asset markets with data from Preqin and their estimates for the assets under management in different private markets.

Private markets comprise direct investments in private equity, private debt, property, infrastructure and natural resources.

We emphasise that private equity and private debt investments are catch-all asset classes that may include investments in property, infrastructure and natural resources as well. Thus, the growth rate in real assets (i.e. infrastructure, property and natural resource) is likely understated in the data.

Also, our definition of alternative investments equals private markets plus hedge funds and like Doeswijk et al. we do not include cash, private homes and family businesses in the global investment market.

Category	Source
Listed capital markets	Bloomberg
Size of private markets	Preqin
Size of hedge fund industry	BarclayHedge

Growth projections

We have estimated future growth of alternatives on the basis of three-year future growth rates for each sector. The sum total of these asset growth forecasts enables us to estimate future growth of the global investment market.

The estimated future growth of each asset class is based on its relationship with USD 3-month and USD 10-year interest rates at the beginning of each year, as well as real GDP growth for the world and CPI for the world (both based on OECD data) during the year. Predictions for interest rates are from Bloomberg, and for GDP and CPI from the OECD Global Economic Outlook.

[4] Ronald Doeswijk, Trevin Lam, CFA, and Laurens Swinkels (2012). "The Global Multi-Asset Market Portfolio, 1959–2012" *Financial Analysts Journal*, vol. 70 (2), p. 26-41.

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