

ADVISORS AND

ALTERNATIVE INVESTMENTS

Use of alternative investments varies widely depending on the business model of the advisor, but a majority of practitioners share common views on where and why to invest.

Private equity funds and hedge funds represent the largest alternative allocations within the modern wealth management portfolio, but interest in direct deals is projected to be higher than both asset types moving forward.

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KEY FINDINGS

- Private equity (PE) funds are the most commonly used alternative investment, with 77% of advisors maintaining allocations, followed by hedge funds (61%) and private direct deals (15%).
- Almost half (48%) of wirehouse advisors maintain allocations to PE funds of between 5% and 10%, whereas over 70% of registered investment advisors (RIAs) and independent broker-dealers (IBDs), respectively, allocate less than 5% of total client portfolios to PE funds.
- Investment returns are the most cited reason for investing in alternatives across all asset types and advisor business models.
- Finding more appropriate clients is consistently cited as the most important issue impacting advisors' ability to invest in alternatives.
- About half of independent advisors (both RIAs and IBDs) cite ease of access as a continuing issue impacting their ability to invest in PE funds and hedge funds, compared to less than one-in-ten wirehouse advisors.
- The vast majority of advisors (87%) intend to maintain or increase their private equity fund allocations over the coming year.
- While 54% of advisors plan to maintain their hedge fund exposure, 39% plan to invest less, although wirehouse advisors are more bullish on these investment strategies than their independent peers.
- Although participation in direct private deals is proportionately lower than other alternative asset types, advisors are even more enthusiastic about them with 93% looking to maintain or increase exposure over the next 12 months.

Demand for alternative strategies is growing as advisors seek to differentiate in an increasingly competitive market and investors look to maintain returns in a changing environment. Today, the traditional 60/40 portfolio comprised of public equities and fixed income is forecasted to generate about half of what it has historically with significantly more volatility¹, creating a pressing need for new sources of diversification and growth in high-net-worth portfolios.

Simultaneously, alternative investments such as private equity funds, hedge funds and direct private deals are becoming more mainstream. An October 2017 PwC industry report forecasts that alternative investments will surpass \$21 trillion in assets by 2025, more than doubling in size in eight years and reaching 15% of all global assets under management².

Much of this growth has been enabled by the rise of new technologies and platforms that have made it possible to efficiently aggregate thousands of individual high-net-worth investor commitments, thereby opening access to opportunities that previously were only available to large institutions. Advisors are increasingly taking advantage of these choices to offer a diverse range of alternative investments to their clients. However, certain obstacles to high-net-worth investment in alternatives identified in prior iCapital research, such as illiquidity, high minimums and access to high quality offerings, still exist. Varying levels of client wealth and legacy institutional structures also create differences in ease of access to alternative investments across traditional brokerages and independent advisory firms.

What is clear is that all types of advisors are increasingly interested in alternatives and looking for ways to incorporate new exposures and strategies, particularly private equity, into client portfolios. As increasing private wealth and an evolving alternative investment landscape continue to stoke advisor demand for these asset classes, we expect that innovations in technology and product offerings will further democratize alternatives for the high-net-worth market and serve advisors with more accessible solutions.

A 2017 PwC report forecasts that alternative investments will surpass \$21 trillion in assets by 2025, more than doubling in size in eight years and reaching 15% of global assets under management.

¹Can a 60/40 Portfolio Still Produce Solid Returns?, Financial Advisor IQ, July 5, 2017

²Asset & Wealth Management Revolution: Embracing Exponential Change, PwC, October 2017; <https://www.pwc.com/gx/en/asset-management/asset-management-insights/assets/awm-revolution-full-report-final.pdf>

METHODOLOGY: BENCHMARKING ADVISORS AND ALTERNATIVES

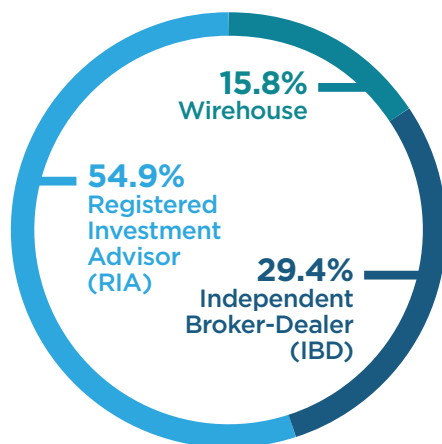
Alternative assets can be complex, spanning multiple structures and strategies while possessing a variety of mechanics and characteristics. At the same time, the high-net-worth market has historically been under-allocated to alternatives, as compared to institutional investors, leaving many individual investors and their closest advisors without a deep or comprehensive knowledge of the various asset types comprising the category. To ensure that we had a sample of knowledgeable respondents, this research initiative was built around advisors who have some experience with alternative investments and have clients to whom they are currently providing these kinds of opportunities.

The study was conducted with more than 450 advisory professionals inquiring about their use of and perspectives on private equity (PE) funds, hedge funds, and direct private deals on behalf of clients. “Direct deals” as used in this report covers investments in small- and mid-size privately held companies, startups, and other private assets such as intellectual property rights and royalties, but excludes private real estate investments.

Of the advisors surveyed, slightly over half (55%) are RIAs, about a third (29%) operate within IBDs and 16% service clients at “wirehouses” (Exhibit 1).

EXHIBIT 1 | Respondents by Business Model

N = 463



More About Business Models

For the purposes of this study, the respondents are categorized as follows. Please note that firm names are provided for illustrative purposes only.

Wirehouses

These respondents include representatives (employees) of large bank brokerages and private banks. These professionals are supported by a centralized home office that helps establish priorities and provide operational infrastructure. They deliver their clients a range of full-service investment, banking and financial services and may collect commissions and/or asset-based fees. Examples of firms: Merrill Lynch, Wells Fargo, JP Morgan.

Independent Broker-Dealers

These respondents operate in a substantially similar way to wirehouse representatives but typically do not have the same degree of home office oversight and direction and may be able to offer a broader range of products and services. Examples of firms: LPL Financial, Kestra Financial, Ameriprise.

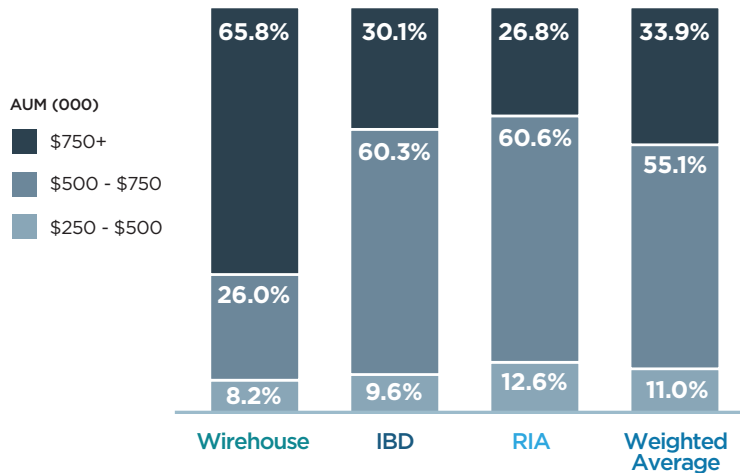
Registered Investment Advisors

These respondents are independent practitioners, unaffiliated with a particular firm and, as such, have no restrictions on the products and services they use but may not have the support infrastructure available through larger firms. RIAs have a fiduciary duty to their clients and are typically compensated through asset-based fees or planning fees. Examples of firms: Ballentine Partners (MA), Wetherby Asset Management (CA), Brownson, Rehmus & Foxworth (IL).

Virtually all (99%) of the advisors surveyed have been in business for at least 10 years, and over 60% have more than 20 years of experience. Fifty-five percent have built practices with \$500 to \$750 million in assets under management, while 34% are managing over \$750 million, with this latter group concentrated among the wirehouse representatives (Exhibit 2).

EXHIBIT 2 | Assets Under Management

N = 463



“Investors need their portfolios to weather volatility, compound wealth and fund specific goals. Considering alternatives during the portfolio construction process gives advisors a more complete set of tools as they help their clients navigate a tricky investment landscape.”

— Lawrence Calcano
CEO,
iCapital Network

Among surveyed advisors, private equity funds are the most commonly used alternative investment, followed by hedge funds (Exhibit 3).

EXHIBIT 3 | Alternative Investments Used

N = 463

Alternatives	Industry Weighted Average	By Business Model		
		Wirehouse	IBD	RIA
PE funds	77.3%	87.7%	83.1%	71.3%
Hedge funds	61.1%	58.9%	50.7%	67.3%
Direct deals	14.5%	15.1%	17.6%	12.6%

ADVISORS AND PRIVATE EQUITY FUNDS

The large majority (89%) of advisors surveyed cite attractive returns as the most compelling reason to invest in private equity funds. It's worth noting that proportionately more RIAs also point to diversification and the unique nature of the investment opportunities as reasons to invest, as compared to their peers at wirehouses and IBD firms, which may be related to the historically limited access to PE funds within the independent channel (Exhibit 4).

EXHIBIT 4 | Reasons to Invest in PE Funds

N = 358

		Reasons	Wirehouse	IBD	RIA	
Industry Weighted Average		89.1%	Investment returns	85.9%	89.4%	90.1%
		60.3%	Diversification	32.8%	47.8%	77.9%
		20.1%	Unique opportunities	3.1%	8.8%	28.2%
			By Business Model			

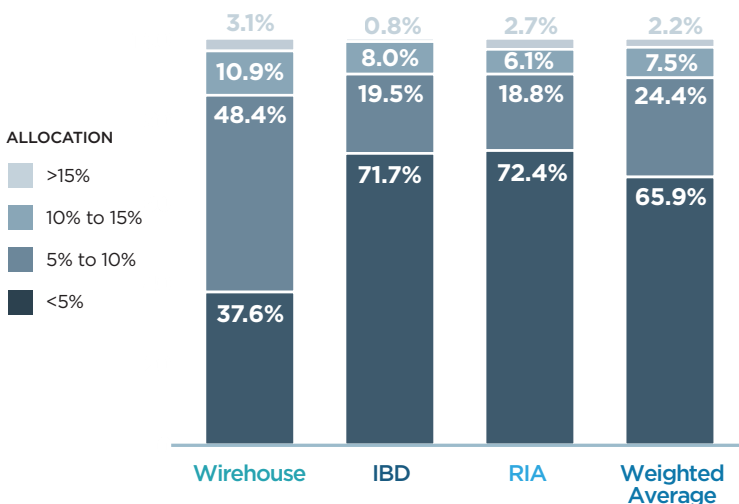
While 66% of advisors have less than 5% of client assets in private equity funds, this is primarily driven by RIAs and IBDs, with over 70% of each cohort allocating at this relatively low level compared to just 38% of wirehouse advisors. Given that platforms facilitating access to private equity funds for the independent advisory community have only emerged over the past few years, this finding is not entirely surprising. Notably, nearly 50% of wirehouse advisors allocate between 5-10% to private equity funds (Exhibit 5).

“A great deal of economic growth today is taking place outside of the public markets. Portfolio exposure to the private marketplace offers diversification and the longer term fundamental growth opportunities that used to be available through investments in traditional stocks and bonds.”

— Nick Veronis
Co-Founder and
Managing Partner,
iCapital Network

EXHIBIT 5 | Allocation to PE Funds

N = 358



The differences in allocation levels by independent advisors and the historical lack of access for these advisors are further highlighted by the distinctions in how advisors access funds. Traditionally, advisors at wirehouses and IBDs mostly rely on their firms to provide access to alternatives, with no wirehouse advisors accessing funds directly from GPs. Whereas 64% of RIA respondents access funds directly from GPs or look for feeder opportunities (39%) to access investments they wouldn't typically be able to access on their own (Exhibit 6).

EXHIBIT 6 | Accessing PE Funds








N = 358

		Access	Wirehouse	IBD	RIA
Industry Weighted Average	62.6%	From firm	100.0%	89.4%	32.6%
	36.9%	Direct from GP	0.0%	14.2%	64.1%
	26.8%	Feeder funds	12.5%	15.0%	39.2%
	16.8%	Fund-of-funds	7.8%	9.7%	24.3%
			By Business Model		

Overall, 61% of advisors point to high minimums as the biggest obstacle to greater investment in PE funds, while 53% point to illiquidity (which is consistent with prior iCapital research). However, the relatively low penetration of private equity within the independent advisory space is evidenced by 54% of advisors at IBDs and 49% of RIAs citing ease of access as an obstacle, compared to only 6% of wirehouse advisors. Additionally, while an overwhelming majority of advisors (86%) view finding more appropriate clients as an obstacle to greater investment, this issue was most pronounced amongst RIAs (Exhibit 7).

EXHIBIT 7 | Issues Impacting Ability to Invest in PE Funds

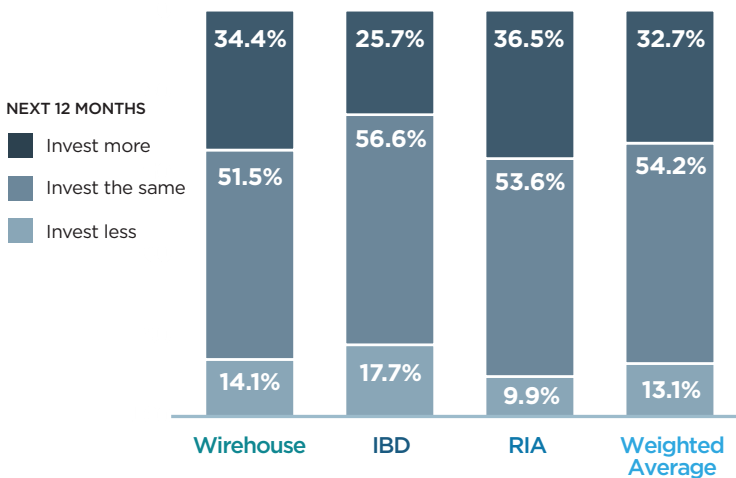
N = 358

			Issues	Wirehouse	IBD	RIA
	66.8%	Past performance	60.9%	72.6%	65.2%	
	42.7%	Ease of access	6.3%	54.0%	48.6%	
	60.9%	High minimums	51.6%	74.3%	55.8%	
	10.6%	Explaining the investment to clients	9.4%	12.4%	9.9%	
	5.3%	Competing investments	4.7%	8.0%	3.9%	
	52.8%	Illiquidity	17.2%	61.1%	60.2%	
	86.3%	Finding more appropriate clients	79.7%	83.2%	90.6%	
Industry Weighted Average			By Business Model			

The vast majority of participating advisors (87%) intend on maintaining or increasing their private equity fund allocations over the coming year, seeking to take advantage of the historical performance premium associated with the asset class and the diversification potential (Exhibit 8).

EXHIBIT 8 | Future Actions re: PE Funds

N = 358



Key Takeaways

- Regardless of business model, almost all (89%) advisors allocating to alternatives cite investment returns as a reason to invest in private equity.
- On average, wirehouse advisors allocate between 5% and 10% to private equity, compared with most independent advisors who allocate less than 5%.
- Advisors at wirehouses and IBDs rely on their firms to provide access to private equity funds, while most (64%) RIAs access funds directly from GPs.
- Most advisors point to finding more appropriate clients (86%), high minimums (61%) and illiquidity (53%) as obstacles to greater investment in PE funds, with independent advisors at BD firms (54%) and RIAs (49%) also citing ease of access.

ADVISORS AND HEDGE FUNDS

Similarly to private equity funds, a majority of advisors invest in hedge funds for higher returns, followed by diversification. Also in line with sentiment around private equity, RIA respondents are slightly more likely than their peers to point to diversification as a reason to invest (Exhibit 9).

However, average allocations to hedge funds across business models are lower than to private equity funds, with 73% of respondents investing less than 5% of their assets (Exhibit 10).

EXHIBIT 9 | Reasons to Invest in Hedge Funds

N = 283

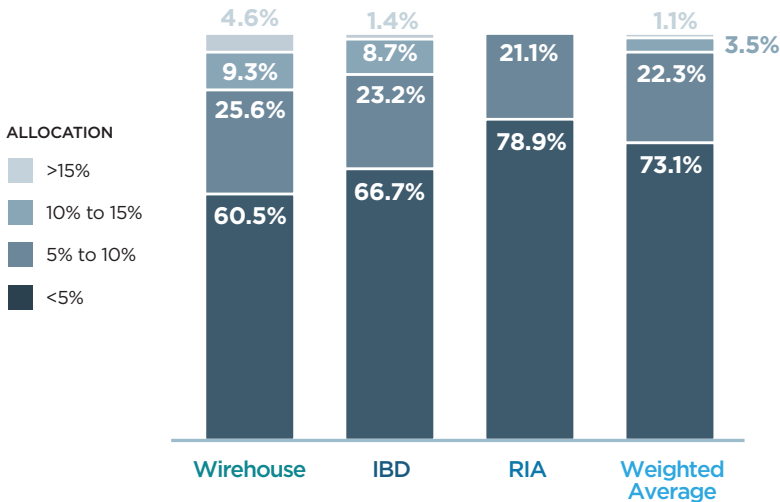
Reasons		Wirehouse	IBD	RIA
78.1%	Investment returns	90.7%	79.7%	74.3%
40.6%	Diversification	37.2%	30.4%	45.6%
5.7%	Unique opportunities	0.0%	5.8%	7.0%

Industry Weighted Average

By Business Model

EXHIBIT 10 | Allocation to Hedge Funds

N = 283







“A majority of advisors cite lagging performance as an impediment, but many hedge funds have continued to outperform their benchmarks and certain strategies can provide meaningful downside protection to a portfolio in volatile markets.”

— Eileen Duff
Head of Independent Wealth Solutions,
iCapital Network

In accessing hedge funds, IBDs and wirehouses function more similarly than RIAs. Eighty-three percent of RIA respondents gain access to hedge funds directly from GPs, although 14% also employ feeder funds to facilitate access. Notably, the RIAs surveyed completely steer clear of hedge fund-of-funds, consistent with the overall trend in industry assets under management over the past few years. Advisors at wirehouses and IBDs continue to use both feeders and fund-of-funds, perhaps due to legacy programs in place at their home offices (Exhibit 11).

EXHIBIT 11 | Accessing Hedge Funds

N = 283

			Access	Wirehouse	IBD	RIA
		54.1%	From firm	100.0%	88.4%	28.7%
		53.7%	Direct from GP	0.0%	15.9%	82.5%
		15.9%	Feeder funds	14.0%	23.2%	13.5%
		4.6%	Fund-of-funds	9.3%	13.0%	0.0%

Industry Weighted Average

By Business Model

Advisors who invest in alternatives are largely dissatisfied with hedge fund investment performance, which has been widely reported over recent years. Interestingly, over a quarter of advisors across business models cite competing investments as an issue impacting their ability to invest in hedge funds, likely a reference to increasingly sophisticated liquid alternative strategies that have been widely available after the financial crisis at seemingly competitive fee structures. The issues cited by wirehouse advisors tracks with private equity in that far fewer have trouble accessing hedge funds, compared with their independent peers. Furthermore, clients of wirehouse advisors appear to be more comfortable with illiquidity, perhaps a reference to overall higher levels of client wealth (Exhibit 12).

While 54% of advisors plan to maintain their hedge fund exposure, 39% plan to invest less, although wirehouse advisors are more bullish on the asset class than their independent peers (Exhibit 13).

EXHIBIT 12 | Issues Impacting Ability to Invest in Hedge Funds

N = 283

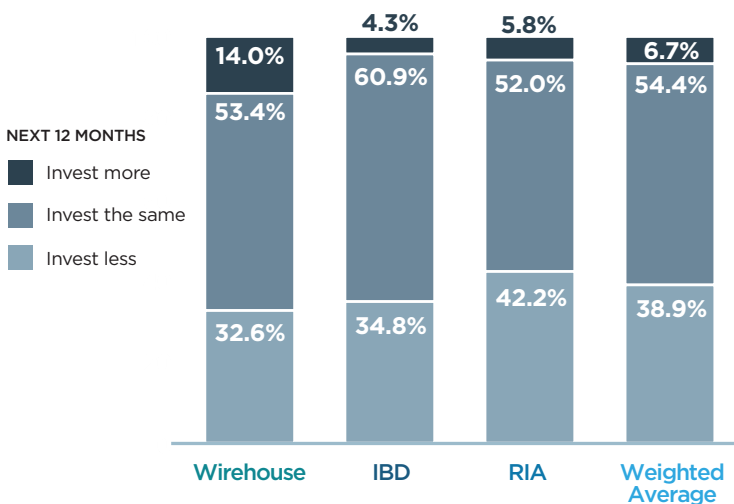
		Issues			
		Wirehouse	IBD	RIA	
Industry Weighted Average	88.0%	Past performance	90.7%	82.6%	89.5%
	39.9%	Ease of access	11.6%	46.4%	44.4%
	49.5%	High minimums	37.2%	55.1%	50.3%
	9.5%	Explaining the investment to clients	9.3%	13.0%	8.2%
	26.5%	Competing investments	18.6%	26.1%	28.7%
	50.2%	Illiquidity	30.2%	56.5%	52.6%
	89.8%	Finding more appropriate clients	88.4%	89.9%	90.1%

Industry Weighted Average

By Business Model

EXHIBIT 13 | Future Actions re: Hedge Funds

N = 283



Key Takeaways

- RIAs access hedge funds in different ways than their peers at IBDs and wirehouses, leaning heavily on direct access from GPs and notably steering clear of hedge fund-of-funds, while advisors at wirehouses and IBDs continue to use both feeders and fund-of-funds and rely on access from their firms.
- Wirehouse advisors are less likely to cite ease of access and illiquidity as issues impacting their ability to invest in hedge funds, pointing to the differences in business model characteristics like net worth and infrastructure between advisor models.
- Despite negative sentiment around hedge fund performance, most (54%) advisors plan to maintain their hedge fund exposure.

ADVISORS AND PRIVATE DIRECT DEALS

All advisor types, regardless of which business model they work in, are interested in private direct investments based on the returns they can offer. However, they also believe that these are ‘unique opportunities’, likely due at least in part to the relative scarcity of high quality deals that are available to them. Unlike private investments via funds, wirehouse advisors are most likely of all advisor types to invest in private direct investments for their diversification benefits (Exhibit 14).

EXHIBIT 14 | Reasons to Invest in Private Direct Deals

N = 67

		Reasons	Wirehouse	IBD	RIA
Industry Weighted Average	88.1%	Investment returns	81.8%	91.7%	87.5%
	32.8%	Diversification	45.5%	33.3%	28.1%
	56.7%	Unique opportunities	63.6%	54.2%	56.3%
			By Business Model		

Advisors are rarely able to invest directly alongside private equity fund managers and rely primarily on their networks of lawyers, accountants and other professionals as well as friends and family for direct deal flow. Additional meaningful sources of deal flow, particularly for RIAs, include angel groups of wealthy individual investors and syndicate situations involving an intermediary who gathers capital from a variety of sources. Most of these origination channels simply provide introductions to investment opportunities and leave the onus on advisors to conduct due diligence (Exhibit 15).

“The appeal of direct investments has accelerated in recent years for two key reasons – access to unique opportunities that aren’t available elsewhere and the potential for enhanced returns – but limited deal flow continues to be an obstacle for ready capital.”

— Hannah Shaw Grove
Managing Director and
Chief Marketing Officer,
iCapital Network

EXHIBIT 15 | Accessing Direct Deals

N = 67

		Access	Wirehouse	IBD	RIA
	1.5%	Co-invest with PE funds	0.0%	0.0%	3.1%
	58.2%	Network	72.7%	54.2%	56.3%
	20.9%	Angel group	9.1%	16.7%	28.1%
	17.9%	Syndicate	18.2%	8.3%	25.0%
	41.8%	Family & friends	36.4%	50.0%	37.5%
	9.0%	Online	9.1%	12.5%	6.3%

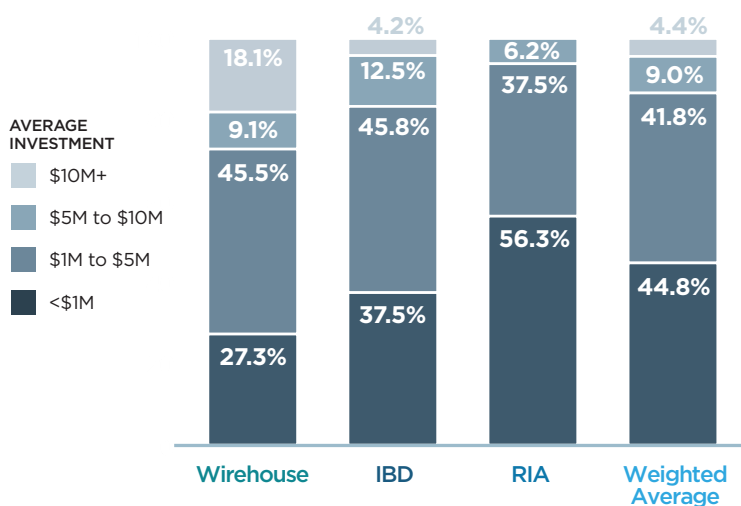
Industry Weighted Average

By Business Model

The average check size into private direct investments from wirehouse and IBD advisors falls between \$1 and \$5 million, while over half of RIAs cite less than \$1 million as their average investment per deal. Almost a fifth (18%) of wirehouse advisors typically invest over \$10 million per deal (Exhibit 16).

EXHIBIT 16 | Average Investment Per Deal





N = 67



Unsurprisingly, limited deal flow and finding more appropriate clients are the top cited obstacles to direct investing for all advisor types. Sixty-nine percent of RIAs also specify illiquidity as a problem, which may explain the smaller average check sizes per deal in this channel in that many RIA clients may not be able to afford large illiquid allocations, particularly those with concentrated risk (Exhibit 17).

EXHIBIT 17 | Issues Impacting Ability to Invest in Direct Deals

N = 67

		Issues	Wirehouse	IBD	RIA
Industry Weighted Average		Limited deal flow	72.7%	70.8%	75.0%
		Due diligence problems	0.0%	4.2%	3.1%
		Illiquidity	54.5%	54.5%	68.8%
		Finding more appropriate clients	81.8%	91.7%	71.9%

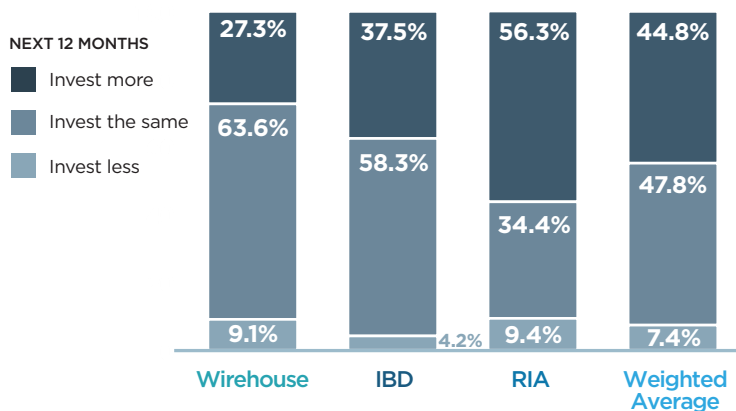
Industry Weighted Average

By Business Model

The majority of advisors plan to either increase their allocations to direct investments (45%) or to invest the same amount (48%) over the next 12 months, with only 7% planning to invest less. RIAs have the strongest interest in increasing exposure going forward, which could present an opportunity for aggregation platforms offering high quality deals and due diligence to these advisors (Exhibit 18).

EXHIBIT 18 | Future Actions re: Direct Deals

N = 67



Key Takeaways

- Advisors across business models view private direct deals as the most unique alternative investment opportunity, and wirehouses also seek direct deals for diversification.
- Although wirehouse advisors do not view ease of access as an obstacle to investing in private equity or hedge funds, this did not hold for private direct investments, with wirehouse advisors citing 'limited deal flow' as an obstacle in comparable numbers to their IBD and RIA peers.
- Of all asset types, advisors are most enthusiastic about private direct deals, with a full 93% looking to maintain or increase their exposure over the coming year.

IMPLICATIONS

Advisors are continually under pressure to enhance performance returns and, as a result, many are turning to the private markets and other alternative strategies to satisfy these pressures. Across all advisor business models, it is evident that alternatives have a key role to play in client portfolios, but a number of challenges persist:

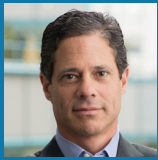
- Importantly, the characteristics cited by advisors as impacting their ability to invest in alternatives include finding more appropriate clients, illiquidity and high minimums, suggesting that advisors need wealthier clients with the risk tolerance for alternative investments and sufficient assets to meet fund minimums without sacrificing portfolio diversification.
- While platforms that provide access to alternatives at lower entry points may mitigate advisors' concerns about high minimums, comparatively long hold periods and limited secondary liquidity will persist as characteristic attributes of many alternative asset types, making asset allocation and portfolio construction expertise indispensable for advisors seeking to reap the potentially higher returns of these exposures and strategies.
- Across business models and all three forms of alternative investments, advisors are remarkably confident in their due diligence expertise, with over 70% rating themselves as "excellent" and relatively few citing "due diligence problems" and "explaining the investment to clients" as issues. While this may indicate increasing comfort levels with alternatives across the industry, it could also reflect a potential overestimation of capabilities among advisors, especially with respect to direct deals.
- With private equity managers increasingly turning their attention to the high-net-worth market as a source of capital, a growing number of independent advisory firms are capitalizing on their direct relationships to create custom multi-manager private equity programs for their clients. Building out their in-house manager selection expertise and developing these proprietary products helps firms differentiate in a competitive advisory market, and with the advent of technologies and services that facilitate the efficient bundling of small individual commitments, is very feasible today for firms with the requisite scale.

"There is growing interest among advisors in delivering a broader range of alternative investments to their high-net-worth clients, and they need solutions to help them address historical challenges like high investment minimums, limited product choices, illiquidity and cumbersome operational processes."

— Tom Fortin
Managing Partner and
Chief Operating Officer,
iCapital Network

- Average direct investment sizes remain relatively small compared to traditional institutional co-investors, but given that many of these entities are increasingly competing with GPs for deals rather than co-investing alongside them, alternative asset managers may want to consider new ways of accessing high-net-worth capital in the co-investment context.
- Recognizing the market opportunity for alternatives in the high-net-worth community as well as the complexity of effectively evaluating alternative investments, alternative asset managers and distribution platforms need to remain aware of the importance of education and complements such as portfolio construction and risk management tools as they expand their presence in this market. Advisors also need to ensure they understand the complexities, where private investments fit within portfolios, and how they are expected to perform in different market conditions.

CONTRIBUTORS



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iCapital Network is the financial technology platform democratizing alternative investments with complete tech-based solutions for investors, advisors and asset managers. The firm's flagship platform offers high-net-worth investors and independent wealth advisors a curated menu of private equity and hedge funds at lower minimums with a full suite of due diligence and administrative support in a secure digital environment. Banks and asset managers leverage iCapital's tech-enabled services to streamline and scale their private investments operational infrastructure. iCapital was included in the 2018 Forbes FinTech 50 and as of March 31, 2018, serviced more than \$5.2 billion in invested capital across more than 12,000 underlying accounts.

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