Here, managers across BNY Mellon Investment Management boutiques explore the alternatives sector’s growing appeal, future prospects and assess some key market risks.

Alternative investments — assets which lie beyond conventional mainstream investments such as equities, bonds and cash — offer a broad array of opportunity for investors. Infrastructure, property, emerging markets, private equity, commodities, loan structures and structured products, farmland investments and renewable energy are just some asset classes offering distinctive risk and return profiles.

**Fund Managers’ Views on Whether the Assets Under Management of the Industry Will Be 50% Higher in 2020 Than at Present**

In turn, strategies such as absolute return and multi-asset can help investors diversify alternatives exposures in order to minimize risk and maximize returns in often volatile global markets.

A 2016 BNY Mellon/FT Remark study¹ of 400 large institutional investors found alternative investments had generated strong returns over a 12-month period, with 93% of respondents saying they had met or exceeded expectations.

A wide range of external factors is driving growth in this market. Static or dwindling government bond yields, inflation driven by unconventional monetary policy and volatile equity markets are just some trends encouraging investors to gain exposure to higher-yielding and higher risk assets.
The alternative investment universe is not without its challenges. Concerns over fee levels, illiquidity, obscure benchmarks and doubts on the overall transparency, risk and effective performance measurement inherent within the alternatives sector remain live industry issues.

However, despite this, a separate 2016 report by BNY Mellon and alternative investment data provider Preqin suggests the alternatives industry now faces a historic opportunity to grow. The report argues a backdrop of profound global macroeconomic, demographic and environmental change is driving unprecedented new demand for “real” assets such as commodities and infrastructure across both developed and emerging markets.

Institutional Investors in Alternative Assets by Target Allocation to Each Asset Class (as a Percentage of AUM)

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Proportion of Respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private Equity</td>
<td>60% 70% 80% 90% 100%</td>
</tr>
<tr>
<td>Hedge Funds</td>
<td>5%-9.9% 10%-14.99% 20% or More</td>
</tr>
<tr>
<td>Real Estate</td>
<td>5%-9.9% 10%-14.99% 20% or More</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>5%-9.9% 10%-14.99% 20% or More</td>
</tr>
<tr>
<td>Private Debt</td>
<td>5%-9.9% 10%-14.99% 20% or More</td>
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<tr>
<td>Natural Resources</td>
<td>5%-9.9% 10%-14.99% 20% or More</td>
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GROWING SCALE

From a scale perspective, the alternative investment industry is large and growing fast. According to recent research by global advisory, broking and solutions company Willis Towers Watson, the total global alternative assets under management (AUM) is now US$6.2 trillion, exponentially higher than the US$1 trillion AUM the sector recorded in 1999. In turn, global consultancy PwC predicts AUM within the industry could reach US$13 trillion by 2020.

BNY Mellon/FT Remark’s study found emerging markets now make up 31% of institutions’ alternative investment exposure, although further growth looks limited — the report found investors were planning to allocate 34% of alternative investment to emerging markets.

Beyond renewables, infrastructure, property and rental investment are other alternative asset classes offering a range of direct and indirect access routes to investors. According to data from market analyst Morningstar, open-ended European property funds saw their highest inflows in four years in 2016. In the U.S., sectors such as municipal bonds and the burgeoning single-family rental market also offer diverse and growing opportunities.

Pension funds are among some of the largest investors in alternatives but other institutions, including sovereign wealth funds and insurance companies, retain a healthy appetite for these investments that seek to generate efficient returns to match their long-term liabilities. While retail investors can gain limited access to alternative assets via some fund structures, their
typically higher risk profile means they often have greater appeal for institutions and smaller sophisticated investors such as high net worth and family office investors.

The complexity of alternative investment is underscored by the numerous strategies employed within the universe they represent. Absolute return funds, which can use a range of more unconventional assets and techniques including employing leverage, short selling and the use of derivatives (see box on derivatives on page 7), and arbitrage, have been popular with investors seeking positive absolute returns in a post-financial crisis environment. In turn, the evolution of absolute return has also piqued interest in broader-based multi-asset funds, which can invest in a range of both conventional and unconventional assets.

Assets Under Management by Alternative Asset Managers

Mellon Capital’s head of investment strategy, Sinead Colton, adds: “Many investors became interested in multi-asset investing when we were clearly in a low-growth, low-interest-rate environment over the past number of years but it is just as relevant in today’s environment where growth is improving. The power of an allocation to multi-asset strategies is in their ability to bring a more tactical element to portfolios which can complement the other strategic allocations they might have.”

TRENDING AREAS

From an alternative asset perspective, growing economies of scale in the renewable energy sector and concern about climate change and sustainability are making renewable energy developments an increasingly sought-after asset class.

According to Paul Flood, lead manager of Newton’s multi-asset income strategy, renewables can offer attractive diversification potential and similar qualities to some more mainstream infrastructure assets. He believes both can play a useful role in investment portfolios in the current low-yielding environment.

“When you are looking to provide stable and attractive returns consistently over time it can help to find assets that have low sensitivity to the economic cycle. Equities, corporate bonds, high yield and emerging market bonds, all have tended to be more sensitive to the economic backdrop, which is why infrastructure and renewables — with their availability-based cash flows — look increasingly attractive,” Flood says.
“Often these assets can benefit from fixed inflation-linked cash flows, which cover significant portions of their revenue streams, providing a business model which may allow investors the potential for steady and attractive returns.”

Flood adds that the wider impacts of global quantitative easing (QE) programs and the apparent return of inflationary pressures in markets such as the UK are increasing the attractiveness of renewables, infrastructure and even more esoteric income-generating areas such as aviation finance.

“If policymakers are successful in reviving inflation, then it will likely be beneficial for investors to have exposure to assets that have a degree of inflation protection. Infrastructure, renewables and some other alternative assets do have the potential to offer a degree of direct inflation protection, which mainstream equities and bonds often don’t,” he says.

Against a backdrop of financial regulatory change, the loans sector has also attracted many new professional investors over the past 18 months, attracted to their returns. According to Alcentra Chief Investment Officer Paul Hatfield, sectoral default risk remains low and the current interest-rate environment is particularly favorable to investors in syndicated loans, which offer floating-rate returns.

Commenting on the wider loans picture in Europe and the U.S., he adds: “As with all asset classes, valuations are currently stretched and we think this will be a coupon-clipping year, with the potential for European and U.S. loans delivering attractive returns. The technicals there are also strong but there is some new issuance expected to meet demand in light of predicted U.S. interest rate rises this year.”

Ulrich Gerhard, senior portfolio manager for short-dated high yield bonds at Insight Investment, has also noted recent inflows to the loans sector but believes the current market outlook also merits exposure to short-dated high yield bonds.

“The overall outlook for high yield bonds appears to be broadly positive. Default rates remain low and economic data is encouraging. However, the fortunes of the U.S. and European markets are diverging, suggesting investors might consider a targeted approach rather than broad exposure to the asset class.

“In the U.S., uncertainty over how many interest-rate hikes are to come is leading companies to refinance and issue debt at an accelerating rate, leading to weakness in secondary markets. There have also been significant inflows into the loan market, as they typically have historically not been as affected by the negative impact of rising interest rates. We believe these trends have opened up some opportunities for short-dated high yield investors, especially after a period in which it has been difficult to find investments at reasonable levels,” Gerhard says.

**GEOPOLITICAL FACTORS**

After a period of seismic political change in 2016 — with the election of Donald Trump as U.S. president and the UK’s vote to leave the European Union (EU) — markets are braced for more uncertainty this year. While the French elections are now over, the prospect of upcoming European elections in markets such as Germany and Italy and growing concern over events in Syria and North Korea continue to spook markets. According to Gerhard, this environment calls for a nimble investment approach.

At a more prosaic level, the UK’s protracted withdrawal from the EU under Brexit looks set to impact European investment regulation and may have unintended consequences for investment in alternatives. Already, UK-authorized management companies under the Alternative Investment Fund Managers Directive/AIFMD regulations and AIFMs of EU funds face questions over the future of the existing EU management passport facility, which currently allows them unhindered access to the EU market.
In the U.S., the Trump administration has also hinted at tax and regulatory change which could have significant impacts on alternative markets. Anticipated reform concerns the so-called Dodd-Frank financial and consumer legislation, introduced following the global financial crisis.

Just how far the growth story of alternative investments can go remains an open question. However, strong performance across many alternative asset classes and the rise of supportive strategies, such as absolute return and multi-asset, augur well for a sector that has made significant strides in widening its audience, tightening regulation and demonstrating its value.

**EXPERTISE NEEDED**

Either way, despite strong demand for these assets, robust risk management is crucial and most market commentators agree specialist investment and market expertise is advisable for investors new to these markets. According to Flood, the sheer range of alternative investments now available demands a cautious and considered approach to asset allocation.

“With a vast range of asset classes to consider, investors need to be careful how they allocate their investments and make sure that they are not exposed to overvalued assets. It is very important both managers and clients know what they own, how particular sets of assets interact with the rest of any given portfolio and have a clear understanding of what their underlying exposures are,” he concludes.

**TRADING PLACES: DERIVATIVES IN ACTION**

Derivatives — financial contracts whose value is derived from a stock, commodity, interest rate, currency or market index — can play a useful role in portfolio management across both mainstream and alternative asset classes. Futures, swaps and options are among the most commonly used instruments. It's important to note there can be additional risks with derivative investments including higher volatility and lack of correlation with the underlying instruments.

Despite their many useful applications, we believe derivatives require expert management and tight risk management to avoid potential losses.

Commonly traded over the counter (OTC), derivatives can be used as a speculative tool, a hedging instrument or to seek to protect assets against changes in value. Portfolio managers can use instruments such as futures and options to lower trading costs, generate extra returns and manage risk within portfolios across sectors as diverse as equities, fixed income and foreign exchange.

Derivatives usage continues to grow as portfolio managers and investors become more familiar and comfortable with their use. A 2016 capital markets survey conducted by valuation and risk analytics provider FINCAD found 92% of financial institutions’ derivatives usage would either increase or stay the same in 2017. (FINCAD surveyed more than 230 buy- and sell-side institutions across the world.)

Last year, a separate Bank for International Settlements Central Bank Triennial Survey of close to 1,300 global financial institutions also found the daily average turnover of foreign-exchange and interest-rate derivatives traded worldwide — on exchanges and OTC — rose from US$10.5 trillion in April 2013 to US$11.3 trillion in April 2016.
RISKS

All investments involve risk including loss of principal. Certain investments involve greater or unique risks that should be considered along with the objectives, fees, and expenses before investing. Alternative strategies (including hedge funds and private equity) may involve a high degree of risk and prospective investors are advised that these strategies are suitable only for persons of adequate financial means who have no need for liquidity with respect to their investment and who can bear the economic risk, including the possible complete loss, of their investment. The strategies will not be subject to the same regulatory requirements as registered investment vehicles. The strategies may be leveraged and may engage in speculative investment practices that may increase the risk of investment loss. Investors should consult their investment professional prior to making an investment decision. Bonds are subject to interest rate, credit, liquidity, call and market risks, to varying degrees. Generally, all other factors being equal, bond prices are inversely related to interest-rate changes and rate increases can cause price declines. Commodities contain heightened risk including market, political, regulatory, and natural conditions, and may not be suitable for all investors. Derivatives and commodity-linked derivatives involve risks different from, or possibly greater than, the risks associated with investing directly in the underlying assets. Derivatives can be highly volatile, illiquid, and difficult to value and there is the risk that changes in the value of a derivative held by the portfolio will not correlate with the underlying instruments or the portfolio’s other investments. Commodity-linked derivative instruments may involve additional costs and risks such as commodity index volatility or factors affecting a particular industry or commodity, such as drought, floods, weather, livestock disease, embargoes, tariffs and international economic, political and regulatory developments. Equities are subject to market, market sector, market liquidity, issuer, and investment style risks to varying degrees. Investing in foreign denominated and/or domiciled securities involves special risks, including changes in currency exchange rates, political, economic, and social instability, limited company information, differing auditing and legal standards, and less market liquidity. These risks generally are greater with emerging market countries.

An absolute return strategy is an unconstrained investment approach and performance is measured against a goal that reflects portfolio construction focused on risk management and is designed to deliver positive returns in changing market environments. Traditional “relative return” funds are managed to and measured against broad-based benchmark indices, rather than against “absolute” measures of principal risk. Absolute return portfolios may not fully participate in strong positive market rallies.

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