Liquid Alternatives Grow and Mature

Stockholm (HedgeNordic) – "The demand for liquid alternatives continues to grow, driven by demand for diversification that decreases market exposure and creates robust portfolios for potentially tougher times ahead," says Andrew Draeneen, Head of Liquid Alternatives strategic capability at Schroders. "The liquid alternatives industry has been growing at approximately 25% per annum over the last ten years in terms of the number of funds and AUM. We are now at US$ 450 billion across 1,100 funds. The market is maturing, and investors now have a great menu of different strategies they can use to build more robust portfolios."

The industry though is still recovering from the fourth quarter of 2018. "Last year was challenging for the liquid alternatives and the hedge fund market. Overall, 80% of the hedge fund and liquid alternative industry was down. The average hedge fund, as measured by HFRI (Hedge Fund Research Index) and Hedge Fund Research UCITS (HFRU) was down 4.6%-4.7%," Draeneen explains. "Schroders had a similar experience to the industry across its different funds," he commented. "We have 34 different strategies, so we inevitably reflect the market. Some strategies did better while others did worse than their peers, but overall we were in line with the market."

According to the head of liquid alternatives, this has led to some adjustments on the part of Schroders's clients. "At the industry level we have seen approximately US$ 9 billion of net redemptions so far in 2019. Previously, the trend was the opposite, with US$ 30 – 50 billion of net subscriptions, on average. At the same time, we have not had to close any of our funds. Most investors decided to focus on the best-performing managers or the ones that can offer fee discounts, rather than divesting. There has been some investor movement, but I think that there are still more clients looking to come on-board this year."

However, market conditions are improving. "The first quarter of 2019 has been the best quarter for hedge funds for many years, and most hedge funds are up about 5%. Q4 2018 and Q1 2019 cancel out." However, new concerns have emerged, according to the Head of Alternative Investments. "Now, investors are worried about valuations and credit spread levels being too tight. The Fed signalling in the US suggests that rates may have peaked at 2.5% and that the next move may be down rather than up. Slowing global growth may also imply tougher times ahead," he explained.

According to Draeneen structural constraints drive the demand in the liquid alternatives market. "Intermediaries, such as wealth management firms, asset managers and financial advisors are the main buyers of liquid alternative strategies. These clients buy these UCITS and daily dealing products for various operational and regulatory reasons. Institutional investors have longer duration assets and do not need the liquidity of a daily dealing UCITS product and may prefer the traditional Cayman hedge funds."

However, the market is not rigidly segmented. "If a liquid alternative strategy has a return stream and pricing comparable to what the flagship Cayman hedge fund offers, then institutional investors might be interested. But the product has to be very attractive. Institutional investors are not going to buy a product that gives them liquidity they do not need in exchange for lower returns at a higher fee."

Investors that go out of their comfort zone, do so for very particular reasons, according to Draeneen. "When institutional investors go into liquid alternatives, it is often to tap the skills and capabilities of a specific team that only does UCITS." There is also a geographical aspect to the demand, according to the Head of Liquid Alternatives. "Of the US$ 21 billion we have in liquid alternatives, approximately 35% comes from institutional investors. They tend to come from markets like Italy, Germany and France where there is an aversion to using Cayman structures or from clients that like a strategy that is only available in the UCITS structure. Nordic investors are fairly experienced and sophisticated, so this bias is not as strong” he says.

“There is a lot of client interest in these types of structures,” Draeneen notes enthusiastically. “Some of the biggest brands of the hedge fund world have now entered the market. Approximately 70% of Europe’s largest hedge fund managers now offer liquid alternatives, and just under 30% of the US’s largest managers offer alternative products as well. Around 100 of the 430 largest hedge fund managers in the world are now offering liquid alternatives,” he explains.

“I think it is a perfect time for investors to embrace liquid alternatives,” he concludes.