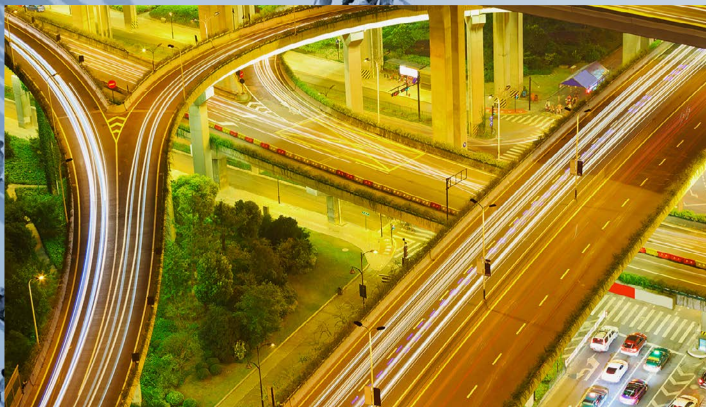


Allianz Global Investors

RiskMonitor

Alternatives
2017

Allianz Global Investors

Understand. Act.

The AllianzGI RiskMonitor assesses the impact of the current market environment on the sentiment, attitudes and behaviour of institutional investors. In the third and last of the 2017 reports we analyse investment in alternatives. These asset classes aim to help institutional investors assert control over portfolios and allocations could increase with improved risk measurement and management.

Contents

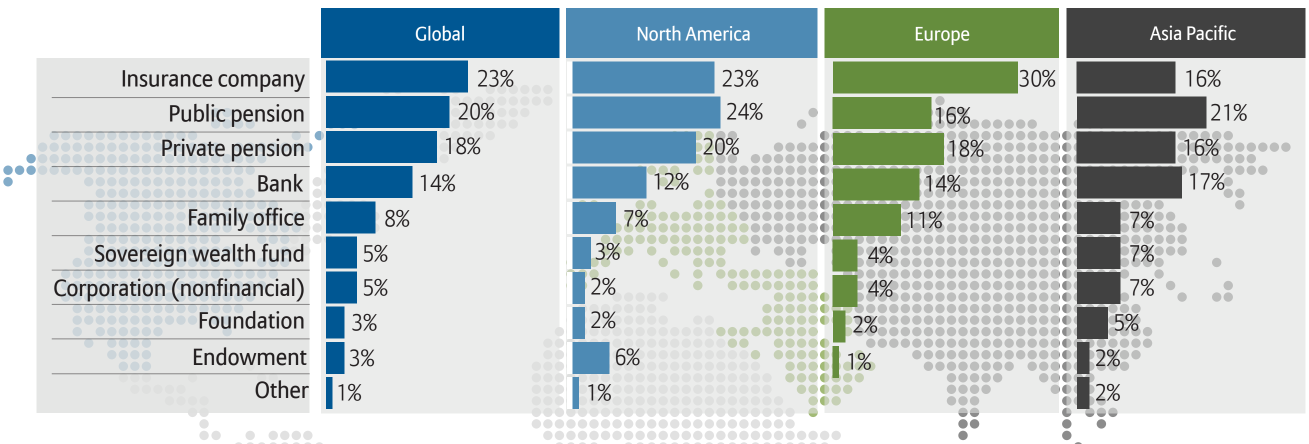
Methodology

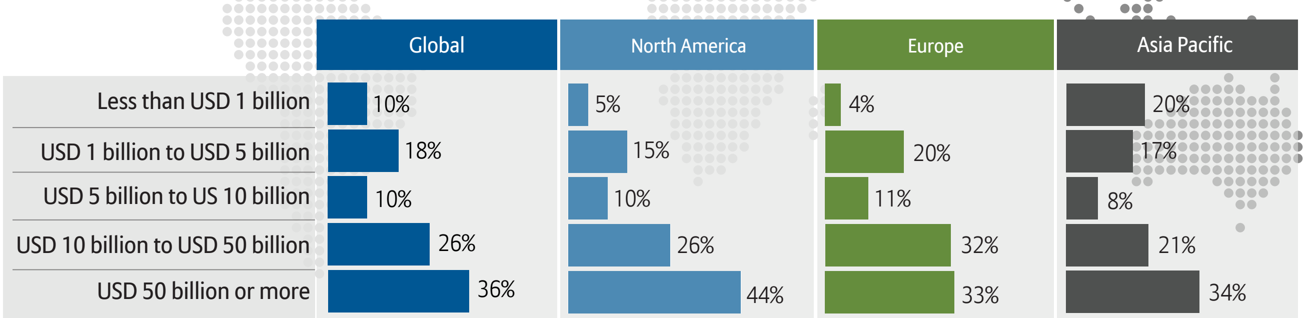
This report represents the fifth annual Allianz Global Investors RiskMonitor study. CoreData Research was commissioned by AllianzGI to conduct this study of institutional investors across North America, Europe and Asia Pacific to better understand attitudes towards risk, portfolio construction and asset allocation.

Respondents were drawn from a variety of 'asset owning' institutions: pension funds, foundations, endowments, sovereign wealth funds, family offices, banks and insurance companies.*

The research was carried out via an extensive global survey during April and May 2017. The 755 institutional investors were split evenly by region: 250 from Europe, 250 from North America and 255 from Asia-Pacific.

*Bank and insurance respondents represent a broad mix with concentrations of professional buyers/gatekeepers, fund selectors, fund-of-funds (external manager appointments etc.), heads of research (influence in manager selection), portfolio specialists (those who build model portfolios using external managers). There is no retail participation in this study from financial advisors, or internally focused portfolio managers.





Executive Summary

Our research reveals that institutional investors' primary motive for investing in alternative assets is to achieve diversification. This is particularly important in the current environment, characterized by geopolitical tail risks, disruption, and continued financial repression. The need for diversification is driving institutional investors to look beyond traditional asset classes to alternative investments.

Penetration levels of alternative investments are high, with more than two-thirds of institutional investors investing in these asset classes. However, uptake of alternatives could be increased further as almost half the institutional investors surveyed would consider increasing their allocations if they were better able to measure and manage the risks. This underscores a striking opportunity for the industry to provide further support and education to institutional investors in order to expand the investment options they have available to meet their objectives.

Diversification is the most prevalent motivation for organizations' investment in alternatives. When asked about specific risk management strategies they use across portfolios, diversification both by asset class and geography comes out top. This demonstrates institutional investors' sense of the critical role for alternatives as they manage risk in this environment.

Institutional investors who allocate to alternatives feel more prepared to deal with investment risks compared to those who do not invest in alternatives. However, more education and understanding of alternatives and the role they play can allow for better integration of alternatives in their portfolios.

Looking at the use of specific types of alternative asset classes and strategies, the alternative asset classes with the greatest number of global institutional investors are real estate equity (61%), private corporate equity (48%) and private corporate debt (38%). Infrastructure equity (47%), private corporate equity (47%) and private corporate debt (46%) can expect institutional allocations to increase in the next 12 months, as can relative value/arbitrage (34%) and macro strategies (24%). Institutional investors are also using these different strategies to achieve various goals like diversification and risk management.

Risks loom on the horizon

The current market environment presents significant challenges for institutional investors that we surveyed globally. Against a backdrop of widespread geopolitical uncertainty, institutional investors shared their concerns about the low-yield environment and potential market volatility, and the threat such risks can pose to their investments. Unsurprisingly, given the news flow in recent months, apprehension around geopolitical events tops the list of institutional investors' concerns.

The persistent low-yield environment is the next most prevalent concern. Insurance companies (40%) express significant anxiety about this, compared to the other institutional investor groups under review. Family offices, endowments and foundations are more concerned about market volatility (30%) than other institutional investor types. See table for a full overview of concerns by institutional investor type.

In the first two reports in our RiskMonitor 2017 series, we explored the impact of geopolitics on risk management approaches, and noted how a small sub-group of institutional investors – called "Risk Leaders" – are getting ahead of the game.

In our third report this year, we explore how increasing numbers of institutional investors are using alternative assets to help manage risk and take affirmative action in the face of market uncertainty. Our findings reveal almost half of institutional investors would make a greater commitment to alternatives if they felt they could understand and manage the risks better. With this report, we shed light on the use of alternatives across the industry, with a view to promoting a deeper understanding of these asset classes and strategies.

Institutional investors concerned about geopolitics, low yields and volatility

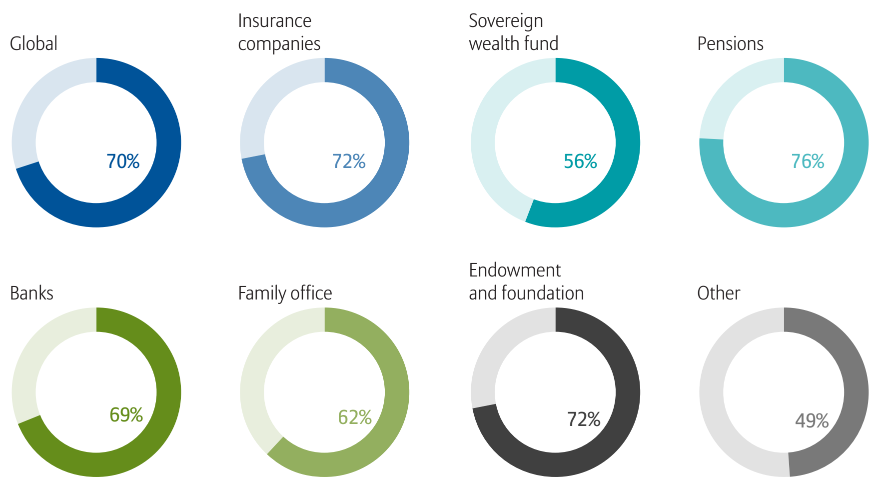
	Global	Insurance companies	Sovereign wealth fund	Pensions	Banks	Family office	Endowment and foundation	Other
Geopolitical events	31%	24%	31%	35%	40%	22%	30%	24%
Low yield environment	21%	40%	22%	12%	20%	16%	13%	10%
Market volatility	20%	13%	22%	24%	9%	30%	30%	25%
Monetary policy	11%	8%	11%	10%	14%	11%	11%	17%
Assets becoming more correlated	10%	9%	8%	11%	9%	14%	9%	17%
Inflation	3%	2%	6%	3%	4%	3%	6%	5%
Currency volatility	3%	3%	0%	3%	3%	2%	0%	2%
Other	1%	1%	0%	2%	1%	2%	1%	0%

Using alternatives

With uncertainty around geopolitical events, the prolonged low-yield environment and potential volatility, institutional investors are looking for new sources of returns and stability. Alternative strategies and asset classes can provide broad diversification and tend to have low correlation with traditional assets. They can also help generate absolute returns and have the potential to improve total portfolio outcomes through arbitrage and hedging strategies.

The majority (70%) of institutional investors surveyed say they already invest in alternatives. This figure is consistent across institution type – about seven in 10 insurance, pension fund, bank and endowment and foundation institutional investors use alternatives – although use is less pronounced among sovereign wealth funds (56%) and family offices (62%).

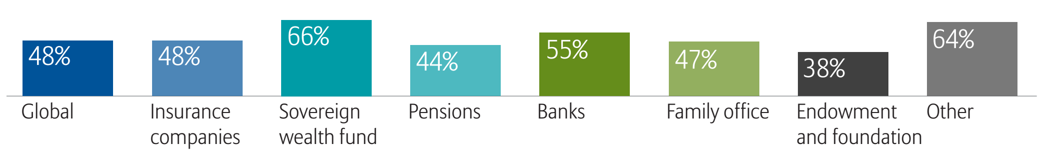
Alternatives usage by institution type



% Yes

Although penetration levels are high, they could be higher. Almost half of institutional investors surveyed (48%) would consider increasing their allocation to alternatives if they were better able to measure and manage the risks. This is particularly relevant for sovereign wealth funds (66%) and banks (55%), compared to pension funds (44%), insurance (48%), family office (47%) and endowment and foundations (38%). In other words, there is a significant opportunity for the industry to drive higher allocations by building greater confidence in alternative strategies and assets.

Better risk management could see alternatives allocations increase



If we were better able to measure and manage the risks, we would consider increasing our allocation to alternatives.

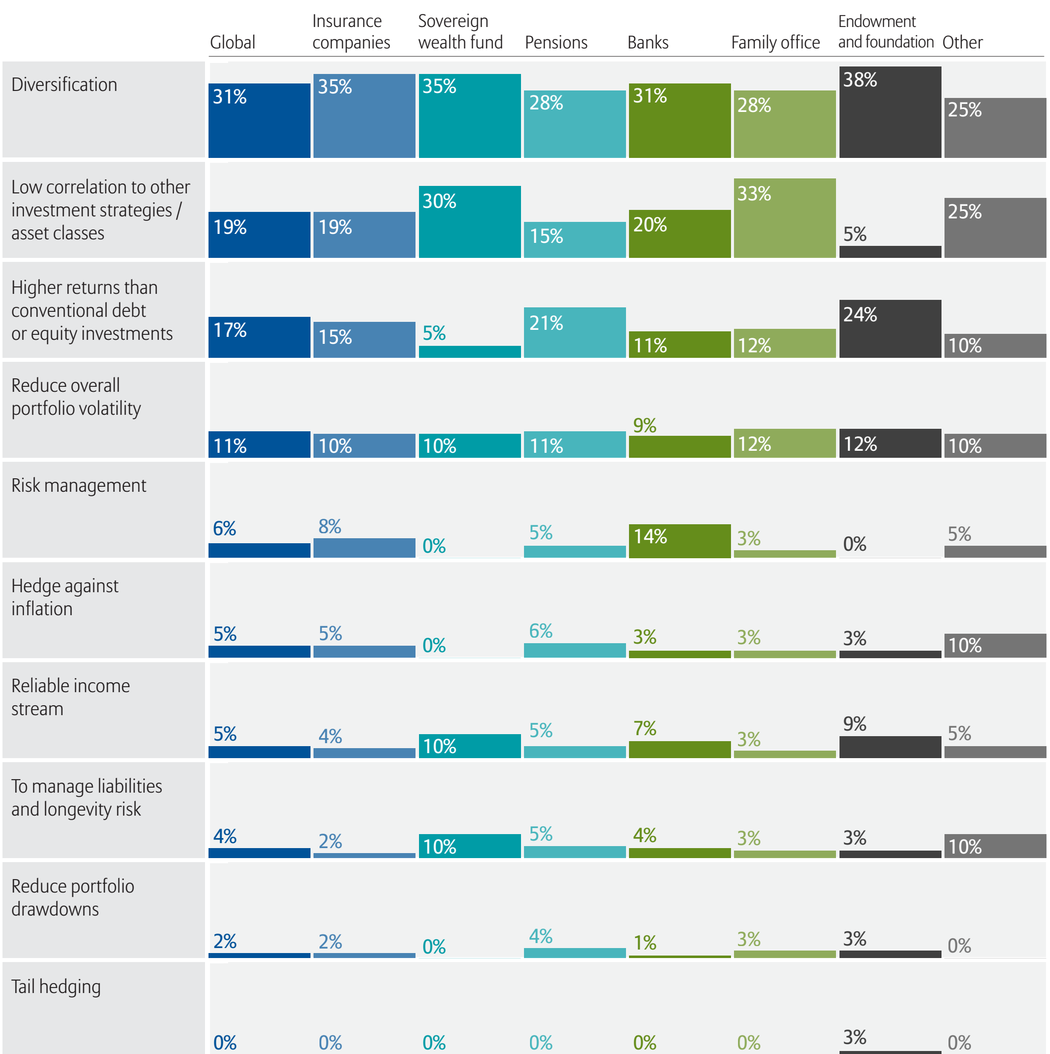
% Agree

The good news is that institutional investors are open to allocating across a broad range of asset classes, including alternative investments, in their efforts to manage the overall risk of their portfolio.

Diversification is primary driver

Nearly one-third (31%) of global institutional investors say diversification is the primary reason for their organization's investment in alternative assets. This is the highest consideration by some margin when compared to other drivers, including low correlation (19%), potentially higher returns than conventional debt or equity investments (17%) and reducing overall portfolio volatility (11%). The biggest proponents of alternative assets as diversifiers are endowments and foundations (38%), sovereign wealth funds (35%) and insurance investors (35%).

Primary reasons for investing in alternatives

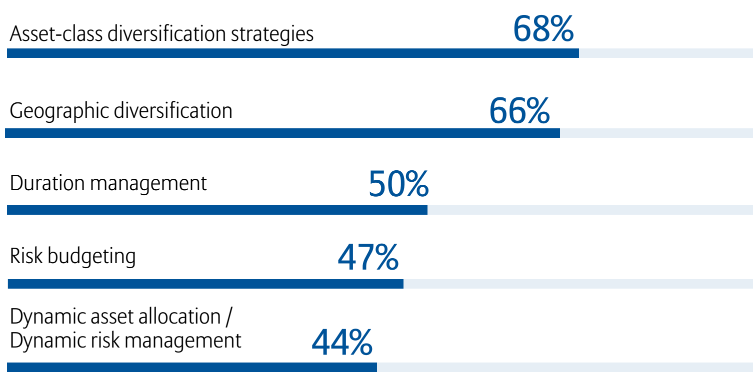


Although diversification is the top reason for investing in alternatives, institutional investors cite other reasons too. Sovereign wealth funds (30%) and family offices (33%) are more likely than other institutional investor groups to allocate to alternatives because of their low correlation to other strategies. Meanwhile, pension fund investors are more likely to be driven to alternatives investment by the potential for higher returns compared to the other groups under review (21%).

The chart examines the different drivers of alternative investments by institutional investor group. Later in this paper we conduct deeper analysis of the specific asset classes institutional investors use to fulfil their goals. This further underscores the versatility and flexibility of alternative assets and strategies.

The use of alternatives as diversifiers is important because diversification across asset classes (68%) and geographies (66%) are the most prevalent risk management strategies used by institutional investors worldwide. This further suggests alternatives play a vital role within institutional investors' approach to managing risk; institutional investors are looking to assert more control over their portfolio by seeking out the broadest range of asset classes available.

Diversification across asset classes and geographies among top risk management strategies



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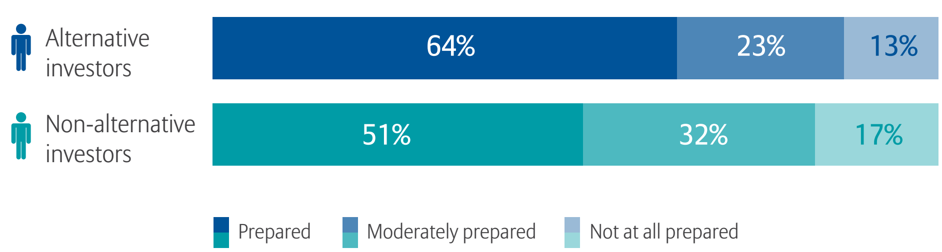
Risk management: alternatives enhance preparedness

Our research shows institutions investing in alternatives think they are better equipped to deal with investment risks. Nearly two-thirds (64%) say their organization is well prepared to deal with investment risks compared to 51% of institutional investors with no alternatives allocations. This could indicate investment in alternatives correlates with a greater confidence in risk management overall.

Alternatives investors better prepared to handle investment risk



Institutional investors (44%) believe alternatives are an important way of protecting their portfolios from tail-risk. While tail-risks are, by definition, unlikely to occur, they are unpredictable and can cause significant damage to a portfolio. Alternatives by virtue of being less correlated with the broad market can help manage overall portfolio volatility and have the potential to reduce extreme losses during these events.

% Agree

Jumping the hurdles

Investing in alternatives comes with its own set of challenges. Only about half (53%) of global institutional investors say they are able to effectively measure the risks posed by alternative assets effectively. This may be because they think they lack the necessary tools: 62% say they need better tools to manage the risks associated with alternatives. This number is higher among insurance and banks (both 66%), endowments and foundations (63%) and pensions (61%). This situation underscores the opportunity for the industry to tackle any shortfall in understanding or tools, and thereby drive greater investment.

Risk measurement and management is a challenge

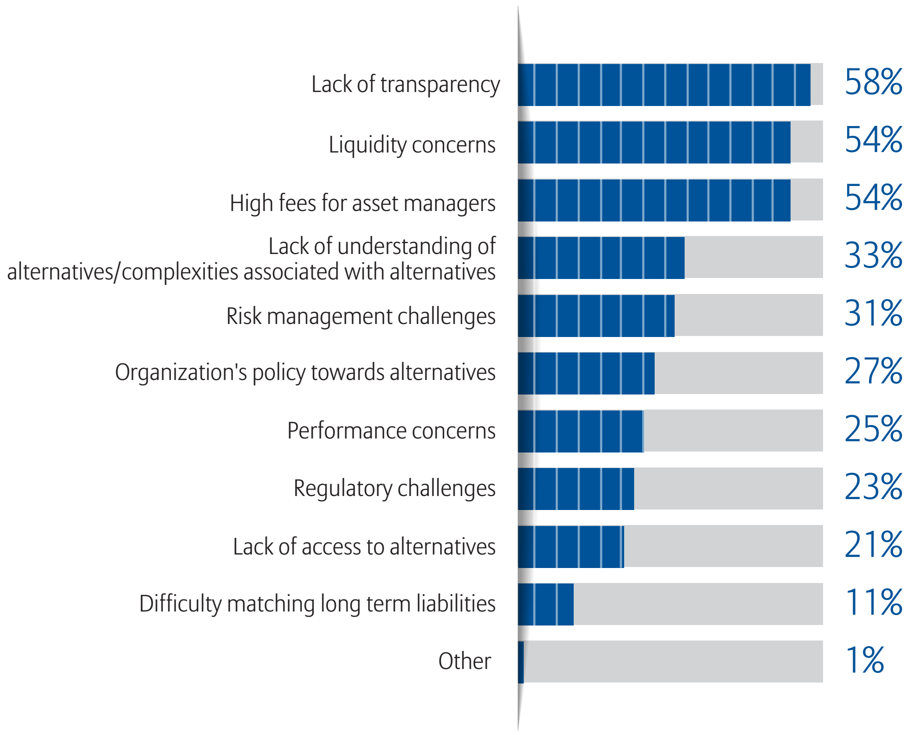
We need better tools to manage the risks associated with alternatives as conventional tools are ineffective.

We are able to effectively measure the risks posed by alternative assets.

% Agree

We know that an improved understanding of alternative assets and the risk they carry would help boost investment. But what are the other factors standing in the way of additional flows into alternatives? Topping the list (see chart below) is a perceived lack of transparency, followed by liquidity concerns. The sense that alternatives come with a higher cost also features in the top three challenges.

Challenges to investing in alternatives



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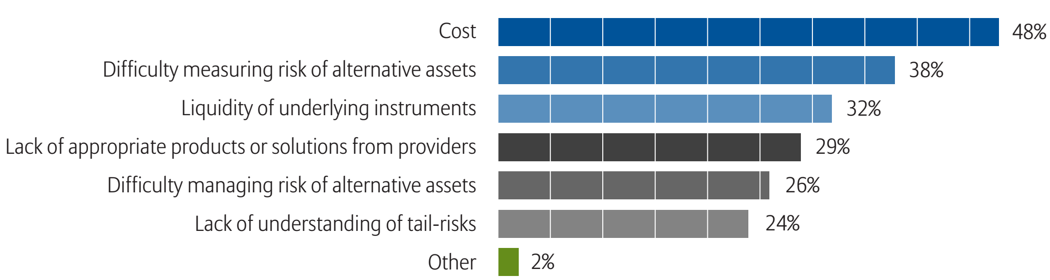
We also asked institutional investors about the obstacles they face when implementing risk management strategies. Half (48%) pointed to cost as the main hurdle. For more than a third of institutional investors (38%), the difficulty of measuring the risk of alternative assets is an obstacle to implementing their chosen risk management strategies. Around a quarter (26%) cite the challenges in managing the risks.

These difficulties are also prevalent when the data is considered by institution type. Around four in 10 pension funds (42%) and insurance investors (38%) say measuring the risk is a challenge and a third of all other groups under review echo this sentiment. Approximately a quarter of all groups, apart from sovereign wealth funds, feel the same way about managing risks alternatives present when implementing a risk management strategy.

Therefore, improving the ability for institutional investors to better assess the risks posed by alternatives can not only help improve penetration of these asset types but can also help develop stronger risk frameworks across institutions.

Obstacles to implementing risk management strategies



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Institutional investment in alternatives

We wanted to gain deeper insight into the alternative investment strategies implemented by institutional investors. There is a wide variety of strategies to choose from within the broader spectrum of liquid and illiquid alternatives. Institutional investors also shared the strategies they are using to achieve particular goals.

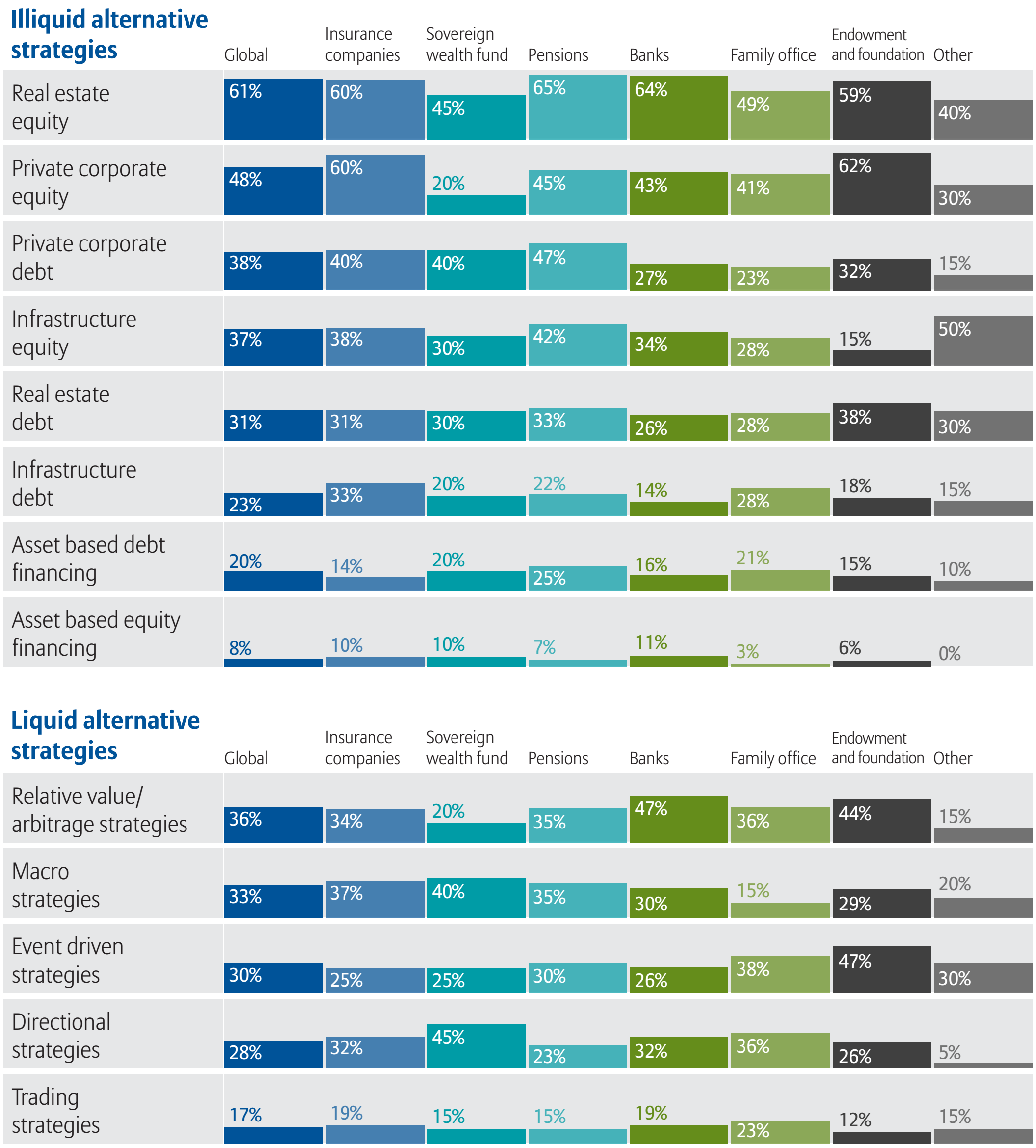
Current allocations

Based on our survey, the alternative asset classes used by the greatest number of institutional investors are: real estate equity (61%), private corporate equity (48%) and private corporate debt (38%). As the table below indicates, the adoption levels differ by institution type.

In line with global figures, the top three strategies used by insurance and pension fund investors within illiquid alternative asset classes are real estate equity, private corporate equity and private corporate debt. Across illiquid asset classes, insurance companies allocate more to private corporate equity (60%) as do endowments and foundations (62%). A slightly higher proportion of pensions allocate to private corporate debt (47%) than the average institutional investor.

Within the liquid arena, banks allocate more to relative value/arbitrage strategies (47%) than the average institutional investor. More sovereign wealth funds favor directional strategies (45%) while endowments are more likely to allocate to event-driven strategies (47%). Family offices are less likely to invest in almost all types of alternatives compared to the average institutional investor – the only two asset classes they are substantially more likely to invest in are event-driven strategies (38%) and directional strategies (36%).

Alternatives currently invested in



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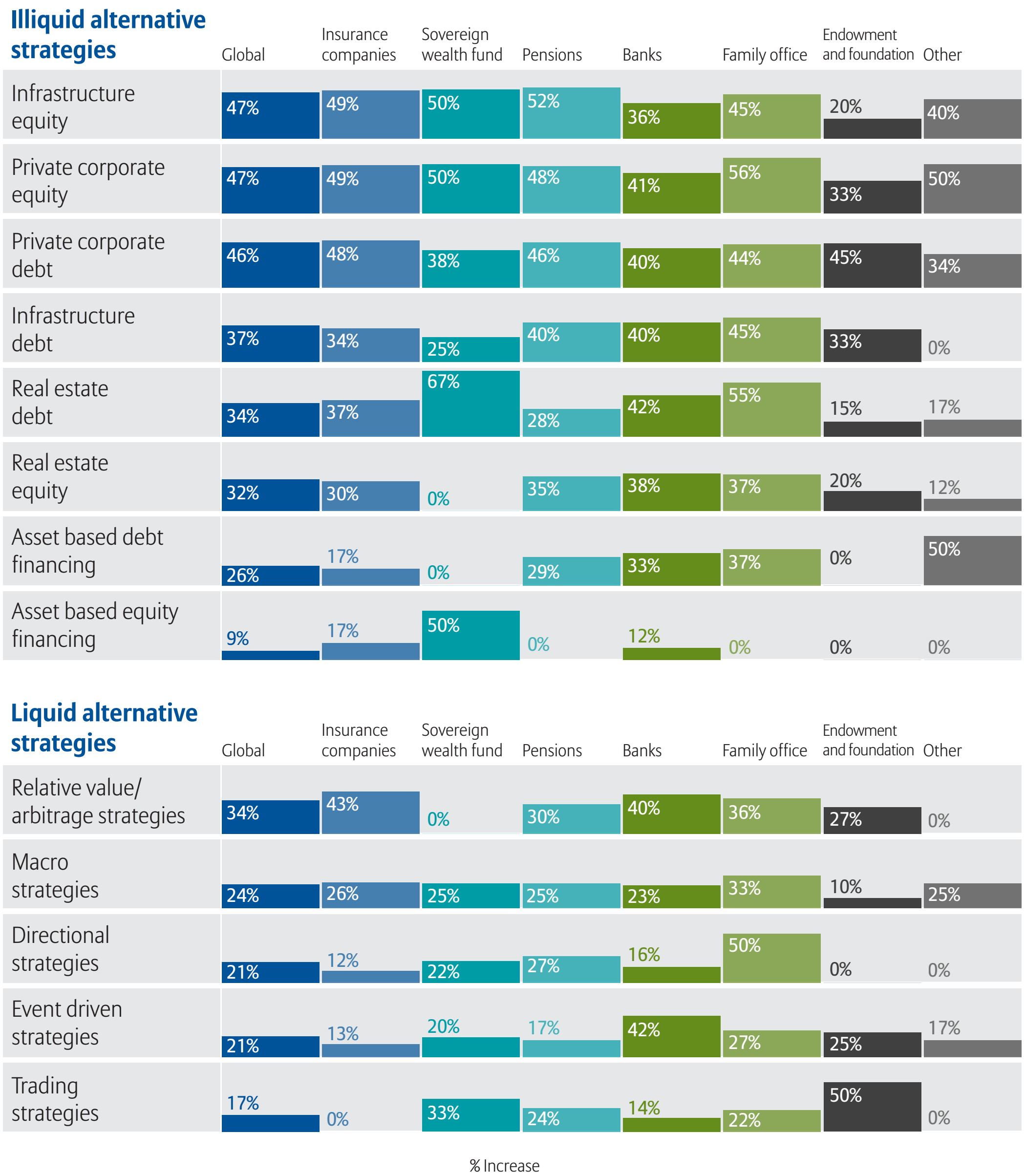
Increasing allocation to alternatives

These institutional investors also provided a snapshot of their anticipated allocations to the different alternative strategies under review in the next year. The illiquid alternatives asset classes pegged for increases within institutional portfolios in the next 12 months are: infrastructure equity (47%), private corporate equity (47%) and private corporate debt (46%). In terms of liquid strategies, relative value/arbitrage (34%) and macro strategies (24%) are expected to see allocations increase.

Institutional investors who plan to increase allocation in the next 12 months



The three illiquid asset classes preferred globally are the same as those favored by insurance investors who also plan to increase allocations to infrastructure equity (49%), private corporate equity (49%) and private corporate debt (48%). The top three for bank investors are real estate debt (42%), private corporate equity (41%) and private corporate debt/infrastructure debt (40%). Pensions investors peg infrastructure equity (52%), private corporate equity (48%) and private corporate debt (46%) for increased exposure. Sovereign wealth funds differ in their preferences with real estate debt (67%) gaining the most favor among this institutional investor type.

When it comes to liquid alternative strategies, family offices are more likely than other institutional investors to increase allocation to directional strategies (50%) and macro strategies (33%). More endowments (50%) and sovereign wealth funds (33%) plan to increase allocation to trading strategies compared to their peers in other institutional investor groups. Insurance institutional investors are more likely to increase investment in relative value/arbitrage strategies (43%) compared to global institutional investors.

Using alternatives to help achieve investment goals

Earlier in this paper we identified diversification as a key motivation for investing in alternatives. The following section details the variety of applications of specific alternatives. The chart below isolates the alternative strategies to consider the appeal and target of the use of different alternative asset classes. Institutional investors were asked which alternative strategy they believe should be employed to meet a particular investment objective. The colored boxes in the chart represent the different investment goals while the list of strategies they could choose from are displayed along the vertical axis.

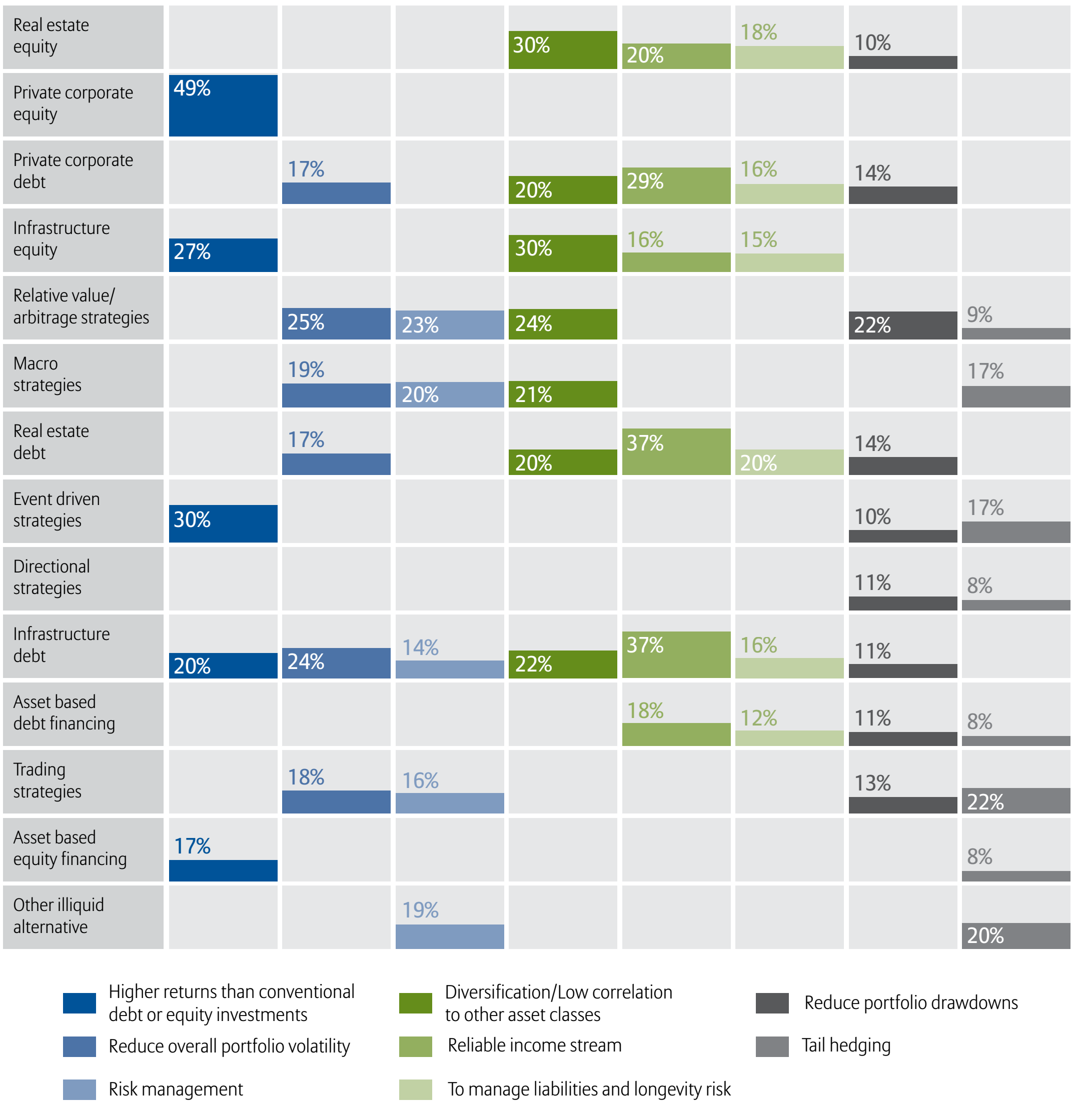
Real estate equity (30%), infrastructure equity (30%) and relative value/arbitrage strategies (24%) among others seem to be the most popular strategies for institutional investors when they are looking to diversify or invest in strategies that have low correlation to traditional asset classes.

Private corporate equity (49%) is used to generate higher returns along with event-driven strategies (30%) and infrastructure equity (27%) while real estate and infrastructure debt (37%) are considered to provide a reliable income stream.

For risk management, 23% use relative value/arbitrage strategies, 20% macro strategies, 16% trading strategies and 14% infrastructure debt. A further 19% use other illiquid alternatives in their efforts to manage risk. Meanwhile liquid alternative strategies – trading strategies (22%), macro strategies (17%), event-driven strategies (17%) - seem more popular when it comes to tail hedging.

The chart below demonstrates the versatility of the different alternative strategies available. It shows these asset classes are able to support institutional investors in their efforts to meet the myriad of investment objectives they have to juggle.

Alternative strategies best suited to particular investment goals



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Across institution types, endowments and foundations are more likely to use private corporate equity (62%) for higher returns than conventional debt or equity investments compared to other groups. More banks use real estate debt (43%) to provide a reliable income stream. Endowments and foundations are most likely to use relative value/arbitrage strategies (44%) for managing risks while a higher proportion of insurance investors use infrastructure debt (21%) for the goal of managing risk compared to global institutional investors.

In summary

The penetration of alternative asset classes has made giant strides and they are now a fixture in the majority of institutional investor portfolios. However, there is a significant opportunity to encourage greater engagement, understanding and investment in alternatives. Institutional investors say they are willing to increase their allocations if they are better able to manage and measure the risks alternative assets bring to their portfolio. This can be considered an outstretched hand on behalf of institutional investors asking the industry for improved support when it comes to alternatives and risk.

Alternatives are now one of the lynchpins of investment as institutions turn to the broadest set of asset classes available in their efforts to find risk management tools and higher returns in a world challenged by market risks and persistent low yields. Institutional investors say alternatives play a vital role in the overall risk management of their portfolios as diversification is the biggest motivation behind investing in alternatives. Almost equally important, institutional investors are seeking higher returns and utilizing alternatives to do this.

Today's institutional investors are juggling a multitude of investment objectives and alternatives are proving to be a valuable part of their toolkit in reaching their goals. Although lack of transparency, liquidity concerns and the cost of implementing risk management strategies are points of concern, 70% of institutional investors are committed to their investment in alternatives. Throughout this paper we have shown the value in these strategies as they are versatile and are being employed to meet a variety of specific goals.

However, there is still progress to be made when it comes to understanding and education on alternative investments. Half of institutional investors (48%) we surveyed said they would invest more in alternatives if they could better measure and manage the risks associated with them.

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