Allianz Global Investors

The Mainstreaming of Alternative Investments

RiskMonitor
2016

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Understand. Act.

The Mainstreaming of Alternative Investments

Infrastructure, private equity and real estate look to grab a greater share of institutional allocations

Once an exotic outlier for adventurous portfolios, alternative investments have gained acceptance to play an indispensable role for many institutional investors. In the ongoing search for growth, yield and diversification opportunities, institutional investors are looking far beyond publicly-traded stocks and bonds and they apparently like what they see. And it's much more than just a hedge fund story, which our latest research shows is losing in popularity among institutional investors. They appear to be turning to even more alternative forms of alternative assets, such as infrastructure, private equity and real estate, to bolster their performance potential.

The recently released 2016 edition of the *RiskMonitor*—our annual survey of institutional investors from around the world, includes an in-depth look into the views, behaviors and attitudes regarding alternative investments. Among our key findings:

- The use of alternative investments is now a global phenomenon as approximately three-fourths of the institutional investors we surveyed around the world invest in alternative assets.
- Diversification was the no. 1 reason institutional investors allocate to alternatives, followed by low correlation to other asset classes and then higher returns vs. conventional equity or debt instruments.
- A large majority of institutional investors responded that they lack the tools to effectively manage alternative investment risk.
- Our survey shows that institutional investors plan to increase allocations to infrastructure and private equity while decreasing allocations to hedge funds and funds of hedge funds.
- In this low-growth, low-rate environment, 67% of institutional investors say illiquid alternative investments can provide attractive risk-adjusted returns.
- When we talk about alternatives moving into the mainstream, our research shows it's really a story of infrastructure, private equity and real estate moving more into the mainstream.

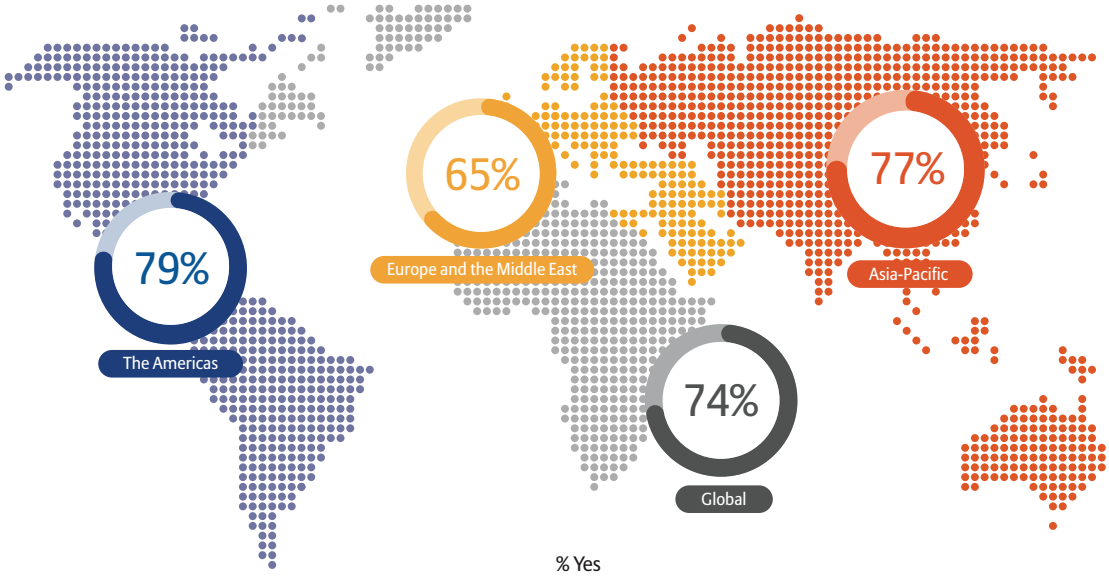
About RiskMonitor

The AllianzGI RiskMonitor highlights the impact the market environment has on the sentiment, attitudes and behavior of institutional investors. This report identifies investors' most pressing concerns, their objectives for the year ahead and analyzes their behavior in the face of the increased volatility. In this fourth rendition of the annual Allianz Global Investors RiskMonitor study, 755 institutional investors across the Americas, Europe and Asia Pacific were interviewed via an extensive global survey during the first quarter of 2016. This included 250 in Europe, 250 in The Americas and 255 in Asia Pacific.

Alternatives go global

The use of alternative investments is now a global phenomenon as approximately three-fourths of the institutional investors we surveyed around the world invest in alternative assets. This is especially true in the Americas and Asia-Pacific, where 79% and 77% of our respondents, respectively, invest in alternatives. But less so in the Europe and Middle East, where about 65% of the respondents invest in alternatives, as shown in Exhibit 1.

Exhibit 1: Americas and Asia lead with alternatives
Regional breakdown for investing in alternatives

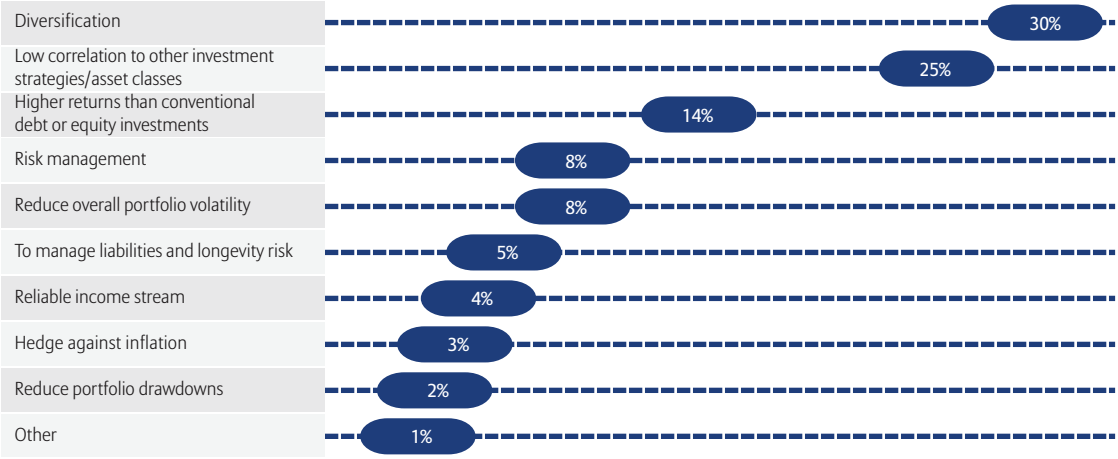


Source: AllianzGI RiskMonitor 2016

Reasons for investing in alternatives

When asked what the most prevalent reason for investing in alternatives was, diversification came out on top with 30% of our respondents pointing to it. The next biggest reason was low correlation to other investment strategies and asset classes, with 25%, and then "higher returns than conventional equity and debt assets," which was listed as the top reason by 14% of our respondents. Next was risk management, which was mentioned by just 8%.

Exhibit 2: Diversification tops performance and risk management
The myriad reasons for investing in alternatives



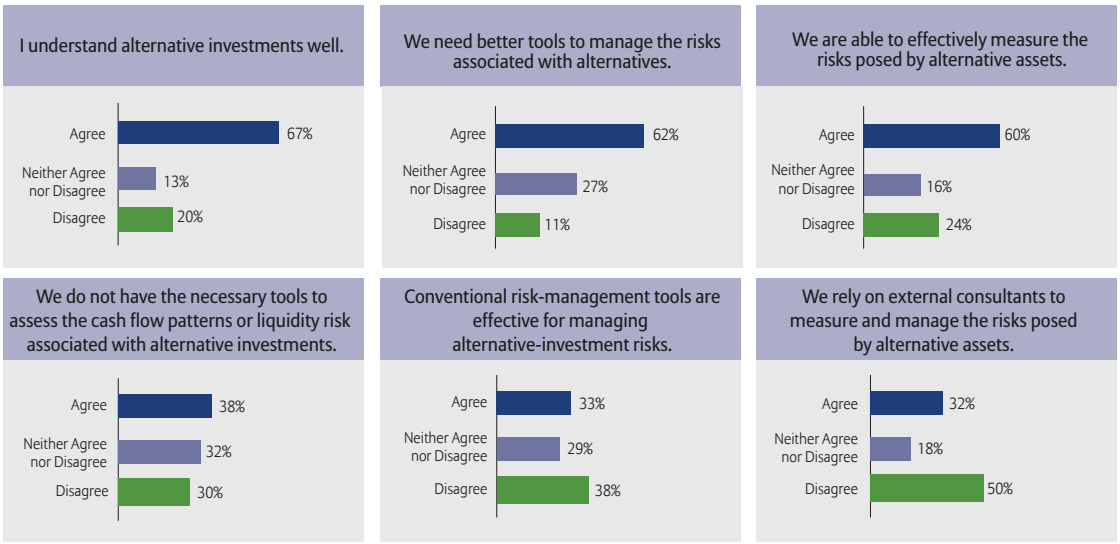
Source: AllianzGI RiskMonitor 2016

Managing risk with alternative investments

While almost three-quarters of our respondents invest in alternatives, just two-thirds of them claim to have a good understanding of alternatives. This disconnect could have serious ramifications for performance and risk whereby institutional investors allocate money into strategies they do not fully understand. The need for better risk management tools was mentioned by 62% of our respondents, which is a significant increase from last year when less than half of the institutional investors surveyed cited the need for better risk management tools.

Exhibit 3: Better risk management tools are needed

The understanding of alternatives exceeds ability to manage their risk



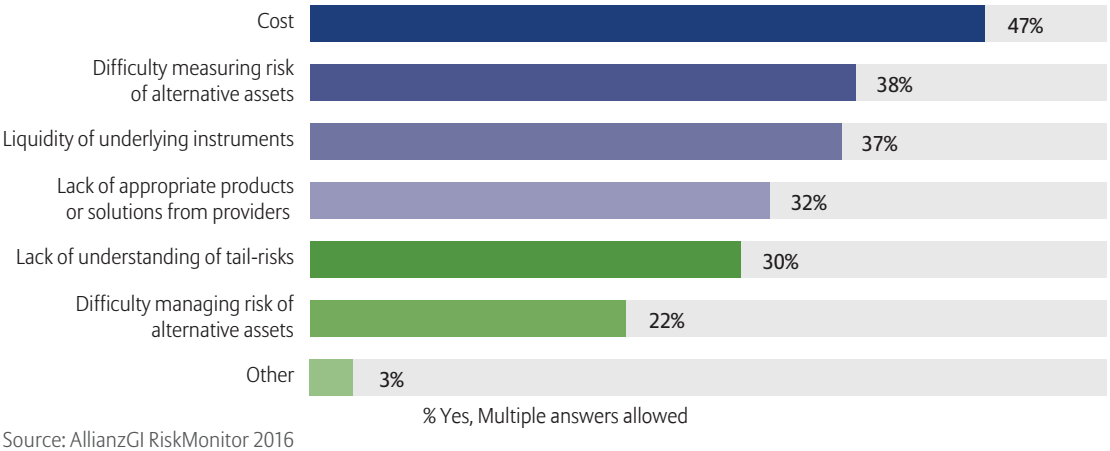
Source: AllianzGI RiskMonitor 2016

Obstacles to more effective risk management

Given the complex nature of many alternative investments, it should come as no surprise that cost is the number one obstacle implementing risk management strategies according to 47% of our respondents. The second biggest reason was "difficulty measuring risk" at 38%. Close behind that as an obstacle to implementing risk management strategies was "liquidity," which was mentioned by 37%. Although institutional investors are sitting on considerable assets, they are nonetheless under pressure to keep costs low—be they government retirement plans or funds with private sponsors.

Exhibit 4: The high cost of risk management

The biggest obstacle to risk management is the sheer cost of it all



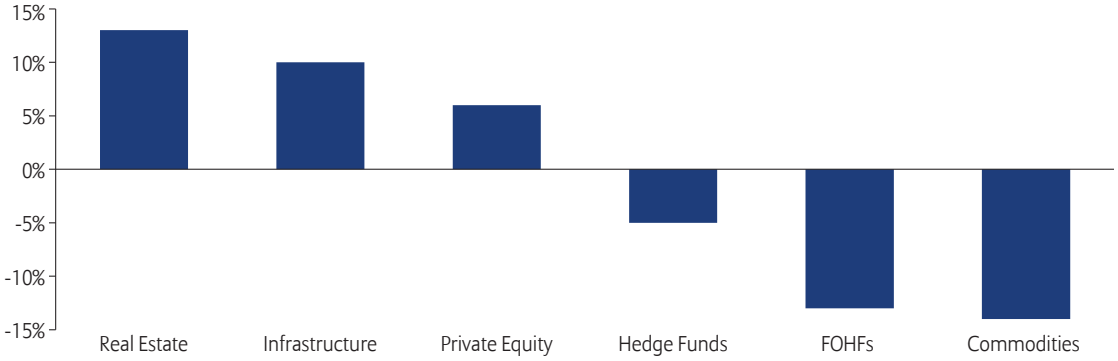
Source: AllianzGI RiskMonitor 2016

Infrastructure becomes a more viable alternative

Despite being associated with the term "alternative investment" perhaps more than any other investment vehicle, hedge funds have lost a lot of their luster as of late. There are the recent underperformance issues, of course, but there appears to be something more profound going on as asset classes such as infrastructure and private equity become more viable as investment options. When we talk about alternatives moving onto the mainstream, it's really a story of asset classes such as private equity, infrastructure and real estate moving into the mainstream.

When asked if they would increase or decrease allocations to certain alternative investments over the next year, real estate came out on top, followed by infrastructure and private equity. Were it not for the sharp drop in commodity prices, hedge funds and especially funds of hedge funds, would likely experience the deepest drop in allocations over the next year, according to our survey.

Exhibit 5: Real estate leads while hedge funds fall behind
Anticipated allocation differentials over the next 12 months*



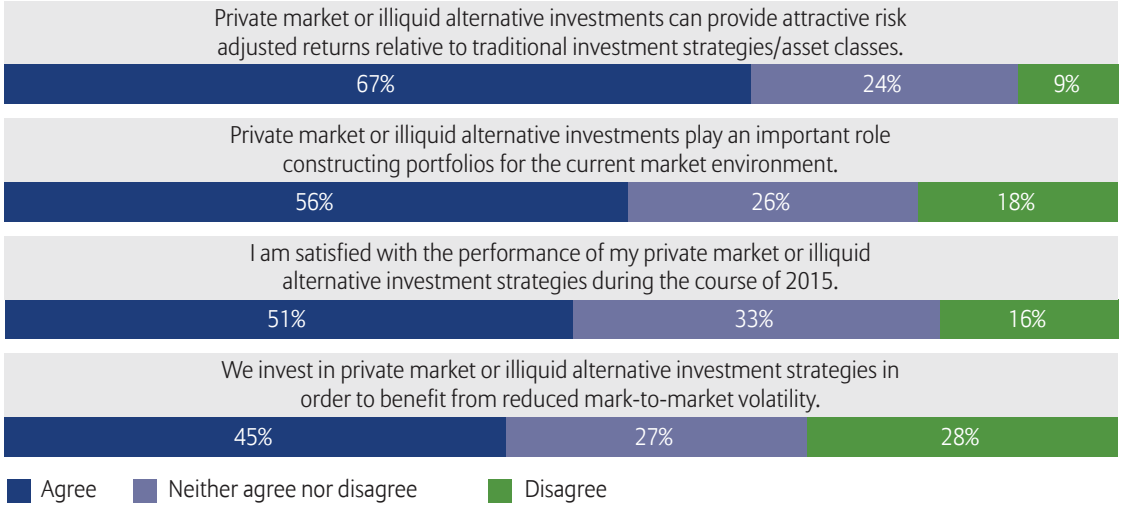
**The difference between instituonal investors increasing or decreasing their allocations to select asset classes over the next 12 months.*

Source: AllianzGI RiskMonitor 2016

The resurgence of illiquid alternatives

With rates at record lows, the search for income has pushed investors toward illiquid assets, which have rebounded strongly after the lows of 2008 with 67% of institutional investors saying illiquid alternative investments can provide attractive risk adjusted returns relative to traditional investment strategies. Over half (56%) also feel these investments are key to building portfolios in the current market environment. In addition to paying out illiquidity premia, illiquid assets also provide diversification opportunities.

Exhibit 6: Attitudes to private market / illiquid alternatives

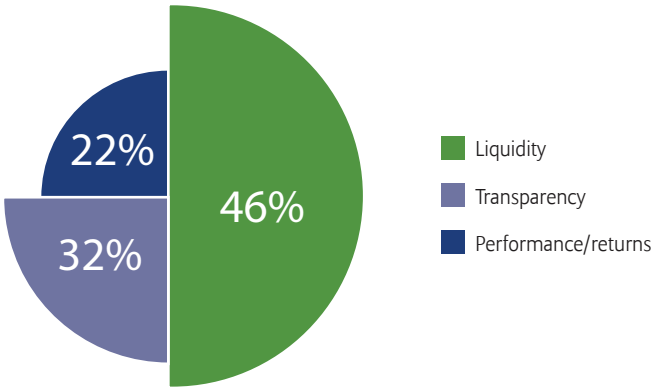


Source: AllianzGI RiskMonitor 2016

The risks of investing in illiquid assets

The risks of investing in illiquid assets resurfaced during the financial crisis as these assets make it very difficult to make short-term tactical decisions or to rebalance portfolios. Their lack of flexibility also leads to a limited ability to meet unanticipated liquidity needs, which our survey shows is the biggest barrier to increased usage. Transparency (32%) is also a concern as illiquid alternatives are notorious for their opacity and complexity. However, although the transparency, or lack thereof, is inhibiting the greater penetration of illiquid alternatives, it is this opaque nature which helps drive the higher returns. In a less transparent, or the more complex a market, mispricings are more likely to exist.

Exhibit 7: Liquidity is the biggest barrier to investing in illiquid alternatives

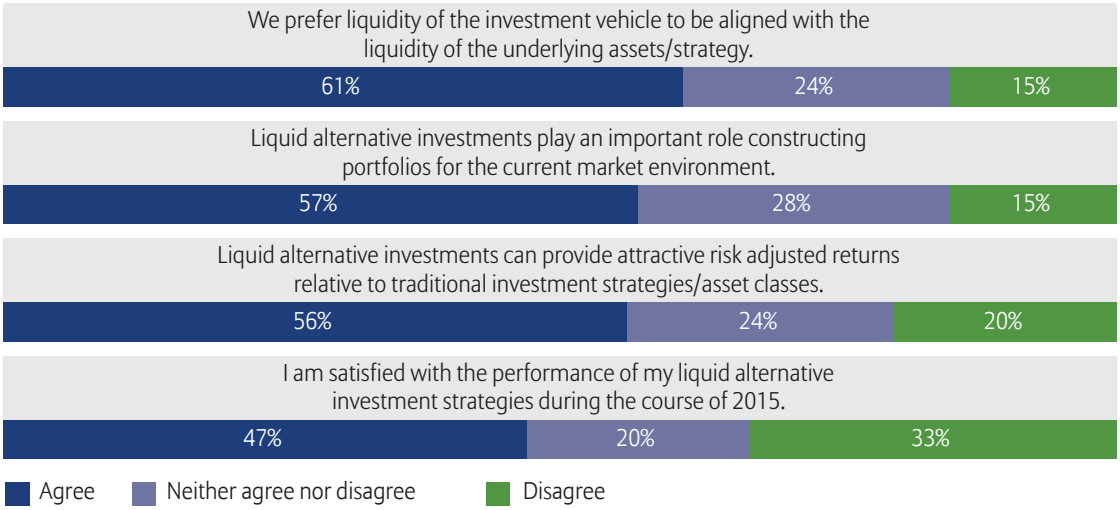


Source: AllianzGI RiskMonitor 2016

Liquid alternatives for uncorrelated returns

Liquid alternatives remain an important asset class that offers the potential to generate uncorrelated returns and decrease volatility while providing greater liquidity. This is not lost on the majority of institutional investors as three in five (57%) believe liquid alternatives have an important role to play in constructing portfolios in the current market environment. The performance of liquid alternatives in 2015, however, has polarized institutional investors with one-third saying they're unsatisfied with performance. However, investors are positive about the role liquid alternatives play in providing attractive risk-adjusted returns relative to traditional investments and asset classes (56% agreed). Three out of five (61%) prefer the liquidity of the investment vehicle to be aligned with that of the underlying assets/strategy.

Exhibit 8: Liquid alternatives can play a vital role in portfolio construction
Attitudes toward liquid alternatives

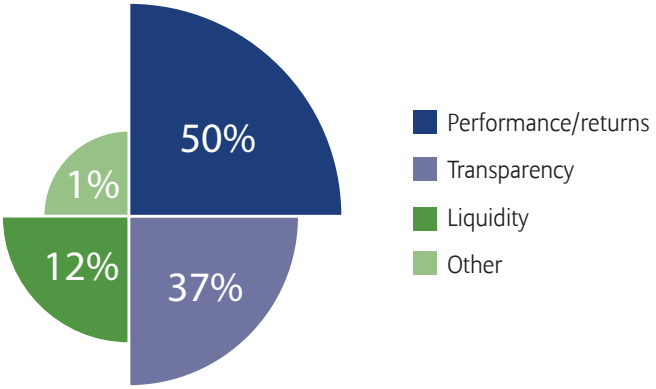


Source: AllianzGI RiskMonitor 2016

Liquid alternatives: Performance and transparency issues

The past year was uneven for liquid alternatives with a few fund closures and a fairly broad dispersion in performance. The primary reason inhibiting institutional investment in liquid alternatives is the performance/returns (50%) of these instruments, followed by transparency (37%), and then liquidity (12%).

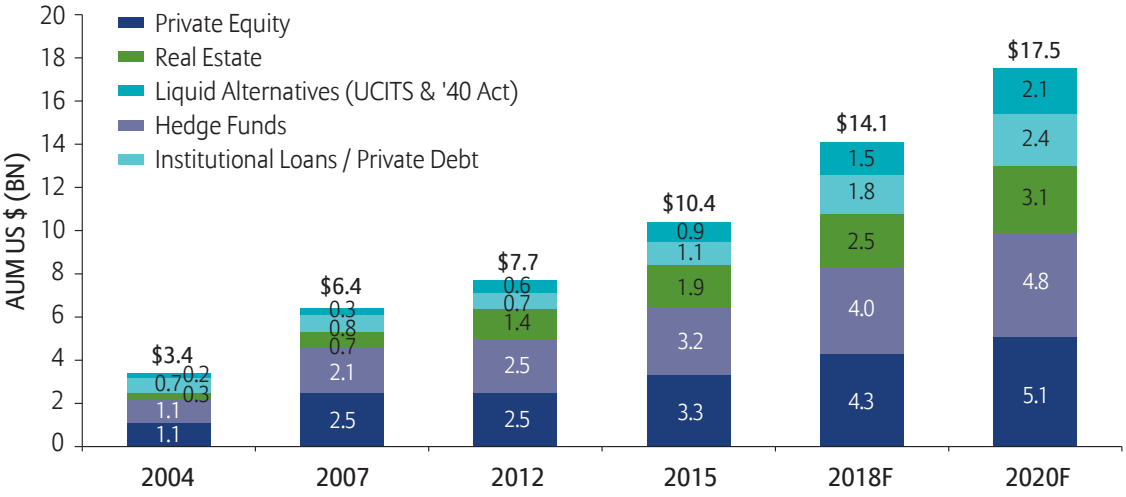
Exhibit 9: Performance is the biggest barrier to investing in liquid alternatives



Source: AllianzGI RiskMonitor 2016

Onward and Upward with Alternatives

Exhibit 10: Growth of alternatives AUM over time



Source: AllianzGI; PWC

Appendix

Shifting allocations in alternative assets

For both liquid and illiquid alternative investments, respondents weighed in on their top reasons for shifting their allocations, as shown in the tables below.

Reasons for increasing allocations

	Real estate	Private equity	Infrastructure	Commodities	Private debt	Hedge funds	FOHFs	Dynamic/ Multi-asset/ Tactical AA
High return potential	✓	✓		✓		✓	✓	✓
Low risk								
Downside protection					✓	✓	✓	
Low correlation diversification	✓	✓	✓			✓	✓	✓
Hedge against inflation								
Hedge agaginst interest rate rise								
Currency hedge								
High liquidity								
Income potential	✓		✓		✓			
Valuation (cheap)				✓				

Reasons for decreasing allocations

	Real estate	Private equity	Infrastructure	Commodities	Private debt	Hedge funds	FOHFs	Dynamic/ Multi-asset/ Tactical AA
Little upside potential	✓	✓		✓		✓	✓	✓
Lack of liquidity		✓			✓			
High downside risk				✓		✓		
Highly correlated								✓
High inflation risk								
High interest rate risk								
High currency risk								
High credit risk			✓		✓			
Valuation (expensive)	✓		✓				✓	

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