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## EXECUTIVE SUMMARY

### QUARTER IV, 2008: ALTERNATIVE INVESTMENTS

By Bing Waldert, Associate Director, Cerulli Associates

*Editor's note: This article focuses on survey results relating to alternative investments from registered investment advisors, broker-dealers, and institutional consultants. Methodology: In July 2008 IMCA distributed a survey link to more than 6,800 U.S. members. The respondents included 169 broker-dealer reps, 25 registered independent advisors, and 32 institutional consultants who completed the survey instrument using Cerulli Associates' online survey engine. Wholesaler representatives and other professionals who did not work with clients were encouraged to NOT complete the survey, making the effective response rate 5 percent.*

**A**lternative investments have been a topic of increasing interest for investment advisors, broker-dealers, and product manufacturers in recent years. Institutions, generally seen as bellwethers of portfolio construction techniques, have increased their allocations to these products. Likewise, academic research has ably demonstrated the value of using alternative investments to construct a portfolio. Finally, retail product development of these vehicles has accelerated, making them more easily available to advisors and their clients.

We will look closer at these trends, but first, we must consider what an alternative investment is. Cerulli believes three factors must be taken into consideration when determining whether a product is an alternative or not. The first criterion is structure of the product. This definition, however, might include exchange-traded funds (ETFs), which could be used as the core of a portfolio. The second criterion is asset class. One might consider anything outside of traditional long equities and bonds an alternative. Ultimately, Cerulli considers correlation and use in portfolio construction to be the strongest test for whether a product can be considered an alternative. If a product exhibits low correlation to traditional equity and bond investments and is used to diversify a portfolio, it is exhibiting characteristics of an alternative.

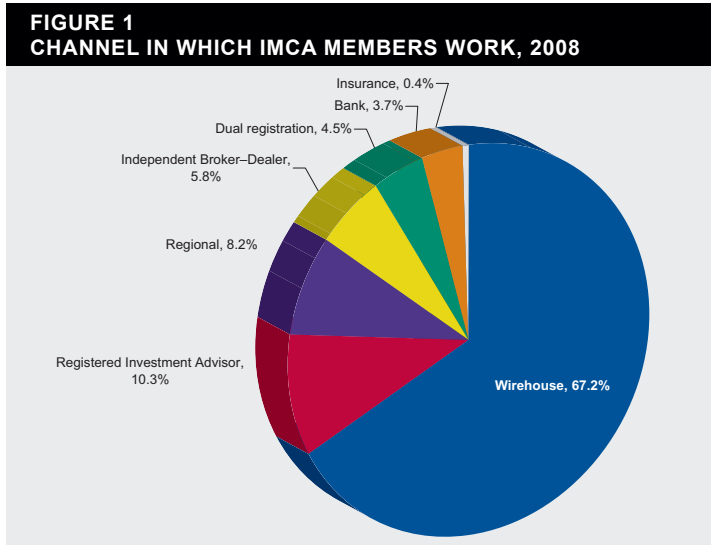
Institutional adoption of alternatives has been a key factor in the introduction of these products to the retail world. In fact, two-thirds of IMCA members who responded to the survey agreed that institutional investing and academic research has influenced their decisions to use alternative investments. When looking at institutional portfolio construction trends one sees interesting applications to the retail world. For example, endowments have a predictable set of expenses, such as faculty salaries, that they must meet every year. Likewise, liability-driven investing (LDI) has gained popularity in the defined benefit world as pensions match their investments to explicit future liabilities. As such, one easily can see the application of these portfolio construction techniques

to baby-boomer investors who are seeking to generate streams of retirement income.

Interest in these products also has been driven by recent difficult market conditions. Some broker-dealers have reported to Cerulli that recent sales in alternatives may be influenced more by performance rather than the overall benefit they can bring to a portfolio, given the recent poor performance in traditional stock and bond markets. However, as we examine the data collected from IMCA members, we see that portfolio diversification and risk management are key elements in alternative use. Indeed, when IMCA members were asked about their reasons for using specific alternative strategies, the most commonly cited reasons were portfolio diversification and stabilized returns.

Cerulli expects alternative use to increase in the retail world in coming years. Just 12 percent of IMCA members who responded said they believed that alternative investments were inappropriate for their clients. In addition, more than half of the IMCA respondents said they believed that the use of alternative investments differentiated their practices. Cerulli has observed advisors beginning to move alternatives down-market to less-wealthy and accumulation-oriented investors as a means of differentiating their practices. Perhaps most tellingly, more than half of IMCA members who responded reported that they plan to increase their allocations to alternative investments in coming years.

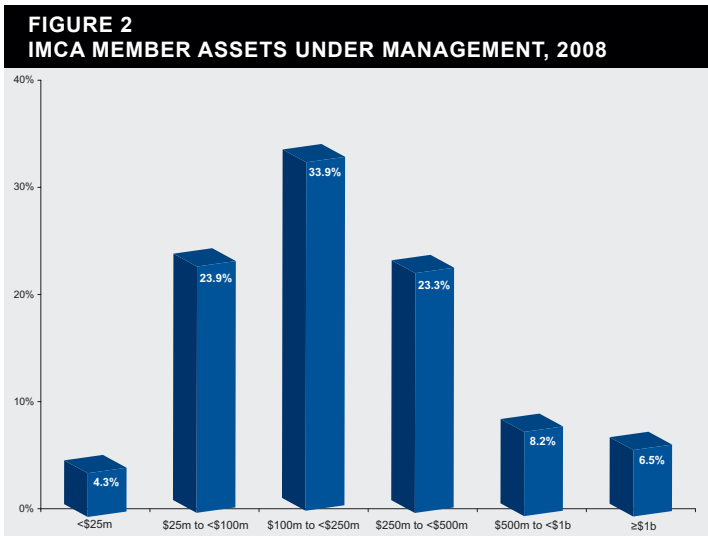
However, the onus is on broker-dealers, product manufacturers, and other service providers to facilitate the increased adoption of alternative investments. As we have discussed, alternative investments frequently fall outside traditional stock and bond investments. Advisors are seeking assistance on how to prudently incorporate these vehicles into client portfolios. Those providers who can help advisors better use these products stand to benefit from the increased adoption of alternative products.



Sources: Cerulli Associates, Cerulli Associates–Investment Management Consultants Association Advisor Surveys

**FIGURE 1:** Respondents to the second IMCA survey of 2008 work primarily in the wirehouses. Independent registered investment advisor (RIA) was the second most-often-checked option, with more than 10 percent of respondents. Despite recent regulatory and merger activity, Cerulli still expects to consider wirehouses a stand-alone channel in 2009. The five firms that encompassed the wirehouse channel (Merrill Lynch, Smith Barney, UBS, Morgan Stanley, and Wachovia) are likely to continue to figure similar characteristics to their legacies—massive scale, national presence, large branch offices, and an investment focus with clients. These firms were acquired for the strengths they offer and Cerulli does not expect widespread changes to their business model.

**FIGURE 2:** The largest segment (34 percent) of IMCA members who responded to the survey manage between \$100 million and \$250 million in assets. Twenty-four percent of members responding said they manage between \$25 million and \$100 million and 23 percent said they manage between \$250 million and \$500 million.



Sources: Cerulli Associates, Cerulli Associates–Investment Management Consultants Association Advisor Surveys

The full results of the Cerulli Associates–IMCA survey on alternative investments are available to IMCA members as an exclusive member benefit. IMCA members receive four quarterly research reports and six issues of *Investments & Wealth Monitor* each year. For a \$395 annual membership fee, you can continue to receive cutting-edge investment consulting and wealth management content.