

THE RISE OF ALTERNATIVE INVESTMENT VEHICLES
AND ITS IMPACT ON THE TRADITIONAL
BROKERAGE MODEL

by

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ABSTRACT

The context of this study is to examine the evolution of popular investment strategies over the course of recent decades. The goal is to prove how stock market unpredictability has emerged as a key reason as to why investors have been shifting from traditional stock brokerage investments to alternative investment vehicles over the course of the modern era of investing. After providing an extensive overview of the topic, I conduct various statistical analyses to prove the mentioned correlation. The analyses include a comparison of the number of registered firms, investor participation levels, respective industry growth fluctuations, and returns of several indices. Further, I will discuss my findings in a manner that provides insight into the future implications concerning the topic at hand. To conclude, I will summarize legal, legislative, and technologic factors that could potentially cause the newly found trends to continue for the foreseeable future. Linking the downfall of securities brokerage firms to the promising future of alternatives provides a unique view of how investing tactics have evolved since the 1980s.

I. INTRODUCTION AND RESEARCH QUESTION

Throughout the modern era of investing, technological innovation has played a critical role in transforming the financial markets to what they are today. Undesirable market events, such as the Financial Crisis of 2008 and the Dot-Com Bubble, have damaged overall investor confidence. Additionally, unpredictable markets and volatile returns have pushed investors away from traditional, full-service brokerage firms as they seek improved investment vehicles that yield a more desirable return, particularly in times of economic chaos. Subsequently, investors have been more interested in less-traditional investment strategies. Rather than placing day trades with a securities broker, individuals are striving to invest in alternative investments that provide enhanced, risk-adjusted returns at lower levels of volatility. This notion explains why investors have shifted towards newer buy-side opportunities such as hedge funds and private equity firms, among others. As these investment styles proved to be successful, investor demand rose in the mid-2000s. Today, the rising trend of alternative investing is replacing the fundamental dealer-broker model that has served as the backbone of the financial world for the past 40 plus years. With this said, investment in alternatives has been limited due to the expensive minimum outlay norms and high fee structures that typically come with alternative opportunities. In recent years, legislative policy has been enacted in hopes of increasing investment in these non-conventional approaches for the foreseeable future. The question I pose for my thesis statement is: “Has the continued rise of new-age, alternative investing triggered the demise of the traditional stock brokerage model?”

In my research efforts, I have not come across any publications that specifically relate the decline of the securities brokerage industry to the upsurge of alternative investing. I have come across publications that have analyzed the reasons behind why the securities brokerage industry

is facing constant consolidation. Additionally, I have utilized several published articles that highlight the immense growth of the alternative investment industry throughout the 21st century and its upside potential looking forward. With that said, I have not come across any publications that specifically relate these two topics to each other. This correlation sets the premise for my research.

The main gap that lies in my research is the fact that many investors still use the financial advice they receive from their traditional broker. The securities brokerage industry is a large space; thus, financial markets are highly dependent on the buying and selling of conventional securities. This presents another question: “Would a major shift away from public asset investment cause a market meltdown?” Another gap that has come about is whether or not recent legislation, such as the JOBS Act, will interfere with the success of the financial markets. Furthermore, the JOBS Act has only recently been implemented. For example, Title III, one of the main provisions of the legislation, was not enacted until May of 2016. Therefore, there may not be sufficient data available to properly interpret how the Act has impacted various alternative vehicles over the past year. Ultimately, I plan on testing and proving the correlation between alternative investing and traditional investing over the course of the 21st century. From there, I will discuss the future outlook of these types of investment strategies based on the knowledge gained from my research in my literature review and the results found from the statistical analyses conducted in my methodology section.

II. LITERATURE REVIEW

The Unpredictability of Stock Market Investing

As the world progresses, the financial markets have become increasingly complex. Technological advances have allowed individuals to attain an abundance of information quickly.

Although this may be the case, market experts are finding it to be more and more difficult to forecast the correlated movement of a company or industry to the market, even after performing in-depth fundamental and technical analyses. For instance, during the 2016 US Presidential Election, Wall Street analysts were completely uncertain about the financial market's position following Super Tuesday. Surprisingly, the Dow Jones Industrial Average surpassed its prior record high when it closed at 18,613.52 the Wednesday after the election. During unusual occurrences, trading with a stock broker can be a bit of a gamble. Market experts were at a standstill once Trump won the election and no analyst could predict the future of the markets for that coming Wednesday. Essentially, picking stocks can be about as random as playing blackjack at a casino during unusual circumstances. Furthermore, investors have been altering their investment strategies to improve their odds.

In the 1970s, Burton Malkiel, a Princeton economics professor at the time, conducted an original experiment in which he had his students pick fictional stocks every day by flipping a coin. Depending on the outcome, the stocks would either rise by \$0.50 or decrease by \$0.50 each day. In his study, Malkiel promotes the notion that stock prices follow a "random walk". Malkiel's logic is that investing in the stock market is more like gambling, thus, conducting a fundamental or technical stock valuation is a waste of time. This logic applies to day traders looking for quick arbitrage opportunities, rather than long-term investors, who take advantage of the stable ascent of a stock's intrinsic value over an extended period of time. The study questions stock brokers' abilities to actively invest in the stock market successfully in the long-term. In his book titled *A Random Walk Down Wall Street*, Malkiel states "A blindfolded monkey throwing darts at a newspaper's financial pages could select a portfolio that would do just as well as one carefully selected by experts" (Malkiel, 1973). In 2013, Research Affiliates published a study

that tested Malkiel's work. With their findings, Research Affiliates concluded: "Malkiel surmised that his monkey would perform as well as the market; he was too modest. Our simulated monkey appears to be proficient in security selection, adding an average of 160 bps per year. True, the risk (volatility and beta) and tracking error are large, but we still have a respectable Sharpe ratio and an information ratio that looks like skill" (Arnott, Hsu, Kalesnik, Tindall, 2013). A higher Sharpe ratio usually indicates a greater risk-adjusted return.

Snapshot of the Modern Era of Investing

Up until the 1980s, brokers and stock exchanges worked side by side. The exchanges had a monopoly on liquidity and, in return, stock brokers had controlled access to the markets, which allowed brokers to earn not only commissions, but also trading fee rebates from the exchanges (Cappon, 2014). Before 1975, all brokerage commission rates were set at a fixed rate. At the start of the modern era of investing, brokerage firms would have to shift their mindset due to the commencement of negotiated commission fees. The negotiated commission fees would give each firm the ability to set their own commission fee structure with their clients. Instead of winning business based on the degree of service and the relationships with their clients, the brokerage industry would now compete based on price (Cappon, 2014). With price being the primary focus, the capital markets encountered major transformations regarding the market's structure and regulation as well as the increased presence of technology. "Electronic trading dramatically increased trading volumes and liquidity and slashed the cost of intermediation and broadened access to markets. Exchange demutualization led to a dilution of the status of exchange member. Access to liquidity was 'democratized'. Liquidity became fragmented among exchanges, alternative trading platforms, lit and dark pools and so on. Exchange 'specialists' (market-makers) disappeared" (Cappon, 2014). Thus, brokers and exchanges now competed against each

other. For example, “brokers may internalize order execution, they may use alternative exchanges or dark pools; established exchanges offer ‘direct market access’ (DMA) and are occupying increasing space in the investment process, both pre-trade and post-trade” (Cappon, 2014).

Beginning in the 1980s, which is considered the start of the modern investment era, it was most common for investors to invest in the stock market with a traditional stock broker. Besides Black Monday in October of 1987, the stock market soared while experiencing tremendous growth throughout the 80s and 90s. Brokerage houses were succeeding just as much as any other financial entity. Conventional, full-service brokerage firms provide the services of equity research and order execution to its clients in addition to delivering a variety of investment recommendations (Cappon, 2014). These traditional firms typically charge a weighty 1-3% fee based on the firm’s assets under management in order to compensate for the brokers’ commissions. Due to the unpredictability of the market and the high management fees involved with traditional brokerage firms, many investors abandoned this strategy and put their wealth into passively managed index and exchange-traded funds that simply provide a low-cost execution order. Passively managed funds were the first types of funds to steal market share from traditional brokerage firms. The passively traded funds were able to do so since they were attaining similar results as the traditional brokers, while charging extremely low commission fees. Therefore, traditional brokerage firms had to decrease their commission fees as a means of survival. “At the beginning of the century, institutional commissions were around 5 cents/share. They are now around 1.5 cents / share, a 70% decline in about a decade” (Cappon, 2014).

As the Dot-Com Bubble came to an end in 2001, many small to medium-sized investors decided to “do it themselves” by leveraging new, online investment tools, such as Scottrade and

TD Ameritrade, while some investors remained committed to their stock broker at a reputable investment bank or brokerage shop. The notion of “Buyer 2.0” refers to new age buyers who research and make their own assessment of a product or service before a salesman gives his or her pitch. With so much information accessible at the consumers’ fingertips today, Buyer 2.0s are “60-90 percent through the decision-making stage of a sale before engaging with a sales professional” (Bourque, 2015). The Buyer 2.0 concept has damaged the traditional stock brokerage model, since individuals feel like they can invest as successfully as registered broker-dealers. Subsequently, the e-commerce revolution has forced institutional brokerage firms to modify its commission structure to a flat-lined fee configuration (D’Costa, 2016). As the 2000’s progressed, the securities brokerage industry became increasingly volatile with no signs of future growth. Buyer 2.0s became increasingly prevalent after the Dot Com Bubble, and even more so after the Financial Crisis of 2008. Thus, the traditional securities industry has faced high levels of consolidation. After the Financial Crisis of 2008, many investors had lost faith in the overall financial system and were seeking investment opportunities that mitigated risk. Hence, these investors began researching several other investment vehicles, including alternatives.

The Emergence of Alternative Forms of Investing

Due to the fickleness and underachieving performance of the public markets, new forms of investment emerged. These alternative approaches include private equity and hedge funds, among others. Instead of participating in the *random walk* of stock market investing, these “new school” strategies attempt to provide higher rates of return, while mitigating the risk involved for a given transaction. “Incorporating alternative investments into a traditional portfolio may help you to reduce overall volatility while increasing portfolio diversification, all with a typically lower correlation to the market movements of traditional investments such as stocks and bonds” (Morgan

Stanley, 2014). By diversifying an individual's portfolio, one could invest in several different markets, strategies, and styles. This increased flexibility provides potential for strong risk-adjusted returns (Morgan Stanley, 2014).

For all intents and purposes, it is crucial to emphasize the robust growth alternative experienced throughout the 21st century up to this point. Although many alternative investment strategies had existed throughout the modern era of investing, rapid activity in this space did not occur until the mid-2000s. Furthermore, "Total assets under management soared from \$1 trillion in 1999 to more than \$7 trillion in 2014...and PWC expects the industry to nearly double again to \$13 trillion by 2022" (World Economic Forum, 2015). During the alternative's peak, which took place between the years of 2005 and 2007, global alternative assets under management (AUM) nearly doubled (McKinsey & Company, 2012). The developing space not only survived the Financial Crisis in 2008, but it grew stronger than it was prior to the recession. Thus, alternative asset investment maintained its rapid growth, unlike its traditional counterparts. The category has now doubled in size since 2005, with global assets under management (AUM) growing at an annualized pace of 10.7 percent—twice the rate of traditional investments" (Baghai, Erzan, Kwek, 2015). The asset class became an increasingly relevant option for investors due to its resilient nature in times of economic turmoil. With private equity buyouts and hedge funds paving the way, alternative investments have proved to have played an integral role in shaping the modern economy.

Description of Chosen Alternative Investment Strategies: Private Equity and Hedge Funds

Although there are several alternative investment strategies, I have chosen two specific strategies that I will ultimately compare against traditional stock market benchmarks. Broadly speaking, the two strategies I have selected to evaluate are private equity and hedge funds. These

alternative investment vehicles are investment styles that could potentially play an active role in company management.

Historically, private equity funds have been comprised of accredited and institutional investors that pool capital to either purchase private companies or to participate in the buyouts of publicly traded companies. From here, the private equity firm attempts to increase the overall financial health of the company by taking an active role in the company's management. Ultimately, the goal of the private equity firm is to increase the private company's inherent value, so they can sell the company or issue an IPO at the conclusion of the holding period, which is approximately five years on average.

Hedge funds provide a revolutionized method of trading. The majority of hedge funds invest in standardized securities, such as stock, bonds, and commodities, just like a day trader at a traditional brokerage firms. What separates hedge fund managers from day traders is their use of sophisticated strategies. These unique strategies allow hedge funds to isolate desired exposures, while mitigating risk simultaneously. Unlike traditional sales and trading, hedge funds tend to be highly illiquid, since an investor's capital is typically locked up by the fund manager for an extended time span. Hedge funds are highly comparable to mutual funds in the sense that they are both professionally managed portfolios that attempt to make returns by investing the pooled capital contributed by various investors. The main difference lies in the fact that hedge funds aggressively manage their portfolios using sophisticated tactics and highly levered positions, whereas mutual funds are passively managed. Although there are many types of hedge funds that exist, activist hedge funds are similar to private equity funds in the way they engage company management to increase shareholder wealth. To do this, a hedge fund manager purchases a number of shares of a publicly traded company to ultimately become one of its board

of directors. To become one of the board of directors, the hedge fund manager purchases enough shares to own at least 5% of the company. The hedge fund manager then can implement changes within the firm to increase its intrinsic value, thus, obtaining a higher return on his investment for investors.

The Wellcome Trust Case Study

As alternative assets proved their reliability in the early 2000s, several investment managers increased their capital allocation into alternatives to provide satisfactory returns for their investors. The Wellcome Trust provides insight regarding how a prominent institutional investor has adapted its investment strategy in a rapidly evolving investment environment. Started in 1936, the Wellcome Trust is a London-based biomedical research charity. The Wellcome Trust is now the largest provider of non-governmental funding for scientific research in the United Kingdom. In the mid-2000s, the firm modified its investment strategy to allocate more capital toward alternative investments. “Overall, allocations to a wide range of alternative investments soared from 15% to 37%, whilst the share of cash and bonds fell to less than 4%” from 2005-2014 (World Economic Forum, 2015). This was primarily done by increasing investment into hedge funds, venture capital funds, and private equity funds. In 2014, The Wellcome Trust allocated 19% towards private equity buyouts, 33% to hedge funds, and 34% to venture capital, according to the firm’s alternative investment breakdown (World Economic Forum, 2015).

By shifting its portfolio towards these alternative strategies, the Wellcome Trust generated \$1,075 million in grants in 2014, which it funded with returns generated by its \$28 billion endowment (World Economic Forum, 2015). Having success with its endowment over past years, the Wellcome Trust’s CIO, Danny Truell, noticed a decrease in total portfolio

volatility, while maintaining excellent returns. “Returns have been strong. At a portfolio level, it generated an average real return of 7.8% over the past decade, far in excess of its target of 4.5%, and better than benchmarks such as the MSCI AC World over the same period. The strong returns have enabled the foundation to grow its asset base by nearly 50% and its cash payments to charities by 60% from 2005-15, a period which included the financial crisis and its aftermath. The new strategy was also able to reduce the volatility of the returns, relative to both the broader markets and historical volatility at the foundation” (World Economic Forum, 2015).

Industry Landscape: Securities Brokerage vs. Alternative Investing

The securities brokerage industry has experienced a 7.6% CAGR from the years 1981-2011 (Cappon, 2014). The explanation behind this CAGR is the fact that the industry was a booming sector in the 1980-90s, but since 2000 the mature industry has been volatile with minimal growth. Competition intensified as “average daily trading volume for US stocks has declined to less than half its peak level in 2000” (D’Costa, 2016). Over the past five years, the securities brokerage industry revenue has grown a trivial annualized rate of 1.8% and over the next five years to 2021, revenue is expected to decrease to a 1.6% annualized rate (D’Costa, 2016). For traditional brokerage firms to survive, the space has endured constant consolidation. “Since 2000, the number of brokerage firms in the US has fallen by almost 25%” (Cappon, 2014).

Traditional brokerage shops are heavily dependent on overall market returns, since their returns are highly correlated with the returns of market indexes historically. Additionally, conventional brokerage houses rarely use leverage to increase returns. Although alternative investment strategies can charge higher fees, they may use leverage to bolster investor returns (Morgan Stanley, 2014). Real estate, hedge funds, managed futures, and private equity are all

examples of alternative asset classes that have performed better than US stocks since 2000. For instance, “Since 1980, stocks have declined more than 10% on six occasions, with an average decline of 28.6% on these occasions. Meanwhile managed futures investments have had an average rate of return of 18.7% during those six periods” (Morgan Stanley, 2014). Commonly used by hedge funds, managed futures are a type of alternative investment approach in which portfolio managers utilize futures contracts to expose themselves to several different markets. Because of this robust growth, alternatives currently make up nearly a quarter of Morgan Stanley’s global investment committee strategic asset allocations (Morgan Stanley, 2014).

Increased demand in the private equity, hedge funds, and investment vehicles industry over the past decade has made industry AUM and revenue soar. “To a lesser extent, high-profile initial public offerings of leading alternative asset management companies, as well as small investors' greater access to the market, have contributed to industry growth” (Gambardella, 2017). Institutional investors seeking retirement solutions and pension plans have been the main contributor to private equity and hedge funds over recent years and demand for retirement is expected to increase in 2017. Over the past five years, industry revenue has grown at an annualized rate of 5.7% and industry revenue is forecasted at an annualized rate of 3.8% from 2017 to 2022. (Gambardella, 2017). “In 2017 alone, IBISWorld expects industry revenue to grow 2.7% as investors continue to seek the relatively lucrative returns offered by private equity funds and hedge funds in an otherwise low-return environment, particularly for fixed-income products” (Gambardella, 2017). Venture capital funds have grown at an annualized growth rate of 6.2% over the past five years as the space has benefitted from increased security prices and M&A activity (Gambardella, 2017). Venture capital funds are forecasted to rise at an annualized rate of 4.7% from 2017 to 2021 as investors will be able to exit their investment through an

acquisition or IPO due to positive nature of the current financial market landscape (Gambardella, 2017).

By growing at an overall 14.2% CAGR from 2005-2011, the overarching alternatives industry could capture approximately 16% of the global institutional market (McKinsey & Company, 2012). Due to continued success, these strategies are becoming increasingly more prevalent as the unpredictable public markets continue to disappoint investor expectations. Today, “Institutional investors currently have about \$24 trillion under management globally” (McKinsey & Company, 2012). Subsequently, the alternative investments space is becoming a larger portion of the U.S. GDP as they encourage increased competition between industries.

III. METHODS & RESULTS SECTION

To properly test my thesis, it is imperative that I perform statistical analyses that compare the securities brokerage industry against the alternative investment industry. The goal is to use historical data that conveys how the rise of alternative investment vehicles, specifically hedge funds and private equity funds, is causing traditional brokerage firms to suffer. I intend to provide information that confirms the industry-wide trend of consolidation among traditional brokerage houses. Further, I will present additional statistics that show attractive movements for alternative investments. These trends will provide a logical explanation as to why firm consolidation is a major movement for the current landscape of the securities brokerage industry. From there, I will determine the superior alternative investment vehicle.

Data Trend #1: The Number of Firms

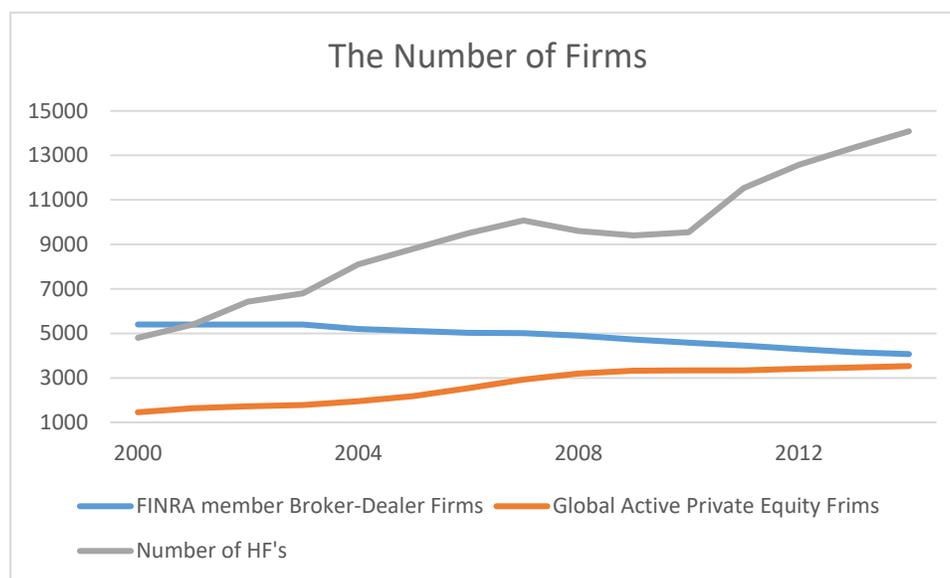
As alternative investment styles became increasingly popular throughout the mid-2000s, less and less broker-dealer firms survived over the years. To prove this trend, I researched the number of member broker-dealer firms for each of the past 17 years. I collected pre-2007 data

from NASD's (The National Association of Securities Dealers) annual reports. In the summer of 2007, the SEC approved and enacted the merger between NASD and the NYSE Regulation, Inc., which formed FINRA (The Financial Industry Regulatory Authority) (FINRA News Release, 2007). Due to the outcome of the merger, I then compiled the data regarding the number of FINRA member broker-dealers from 2007 to present day.

After amassing a substantial list, it became evident that the number of broker-dealer member firms were decreasing every year. My intention was to provide further evidence to back up the Forbes article I previously mentioned that stated, "Since 2000, the number of brokerage firms in the US has fallen by almost 25%" (Cappon, 2014). Since the article was published in 2014, I calculated the industry's declining growth rate up until that point. Since there were approximately 5,400 member firms in 2000 and 4,068 member firms in 2014, the declining growth rate was an estimated -25% (NASD and FINRA Year in Reviews and Annual Financial Reports, 2000-2014). Next, I calculated the declining growth rate once more using 2016 data. As of 2016, there are 3,835 FINRA registered broker-dealer firms, so the declining growth rate from 2000-2016 is approximately -30% (FINRA Statistics, 2016) The industry-wide trend of consolidation looms as time goes on and I do not see this trend ending anytime in the foreseeable future.

To portray the rise in alternative investing, I gathered data regarding the number of hedge funds and private equity shops worldwide. The number of global active private equity firms grew from 1,453 shops in 2000 to 3,530 firms in 2014, which represents a 143% increase in the number of firms. An active private equity firm is "defined as either having raised a fund in the prior five years or have completed a deal in the prior three years" (Pitchbook, 2015). In a similar manner, I calculated a 203% growth rate when analyzing the increase in the number of global

hedge funds from 4,800 in 2000 to 14,553 in 2016 (The City UK, Prequin Global Hedge Fund Report, 2017). The figure below depicts the passing of the torch in terms of investment approaches. Not only has the number of broker-dealer firms declined, but registered investment advisors who manage alternative investment vehicles have also become increasingly widespread throughout the course of the 21st century.



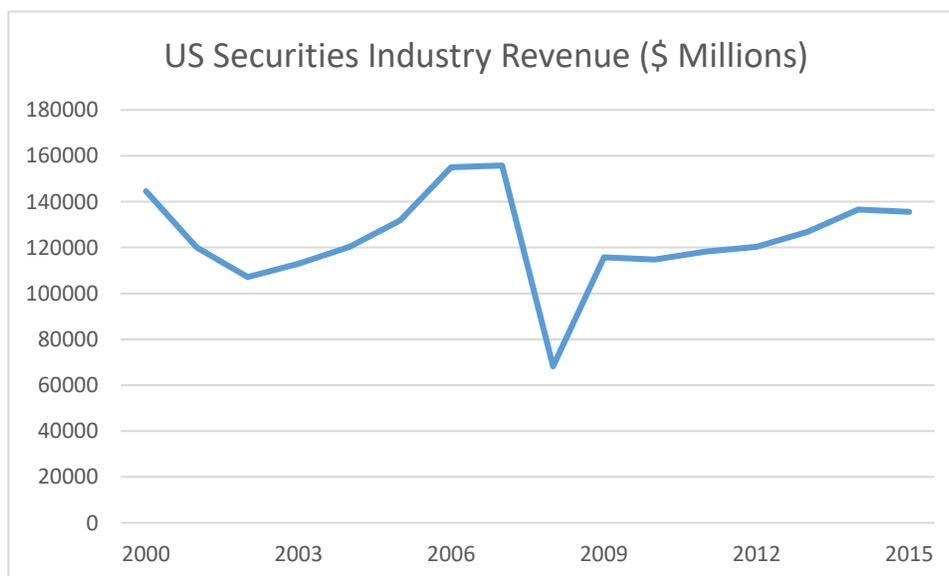
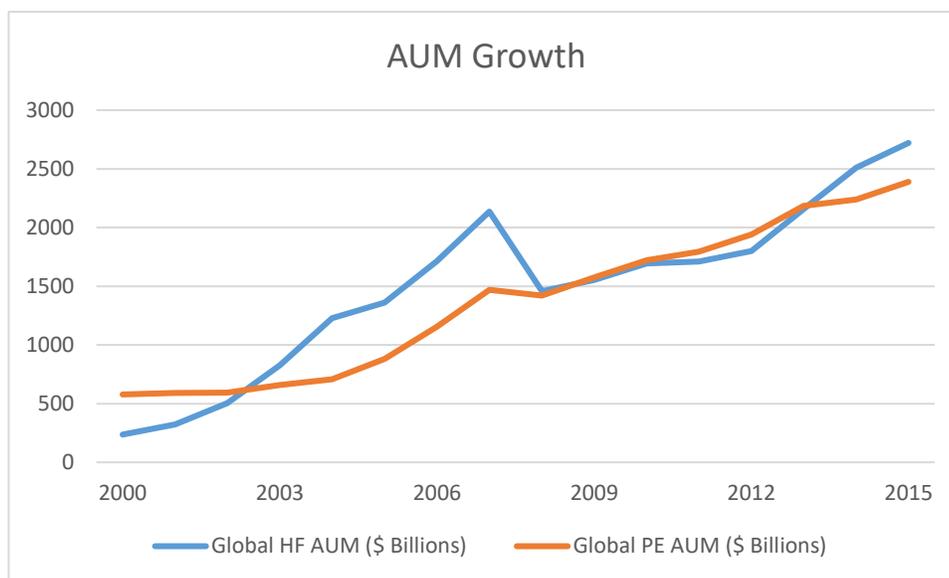
Data Trend #2: Investor Participation

Assets under management (AUM) serves as a strong proxy for measuring investor participation in alternatives, since AUM is the market value of the assets fund managers invest on the behalf of their clients. AUM increasing from year to year signals that the fund is growing as it continues to provide superior results to its investors. Furthermore, registered investment advisors that manage AUM do so in a fashion that incentives them to avoid risk, while capitalizing on lucrative returns. Traditionally, alternative investment analysts are compensated with a percentage of AUM for transacting a deal.

According to Barclay Hedge, the value of AUM for hedge funds globally has grown from roughly \$236 billion in 2000 to \$3.01 trillion in 2016. This increase signifies a 16.13% CAGR. “From 2015 to 2016, the hedge fund industry’s AUM has increased by \$70 billion to \$3.22 trillion, but the North American region was the only region to experience net growth” (Preqin Global Hedge Fund Report, 2017). Preqin’s 2017 Global Private Equity & Venture Capital Report notes that the value of AUM for private capital has increased at an 8.96% CAGR as the AUM value has grown from \$578 billion in 2000 to \$2.49 trillion today. Since AUM in the private equity space has experienced growth for eight straight years, the current \$2.49 trillion in AUM is more than double the size of the private equity industry’s AUM in 2006 (Preqin Global Private Equity & Venture Capital Report, 2017). It is critical to note that a private equity firm’s AUM is comprised of dry powder and the unrealized value of the portfolio’s assets. Dry powder is industry jargon for highly liquid marketable securities or cash reserves that can be used to perform a transaction. “Private equity fund managers have an all-time high level of dry power today with \$820 billion” (Preqin Global Private Equity & Venture Capital Report, 2017). The unrealized value of the portfolio’s assets refers to the position in which a fund manager resides before exiting a private equity deal. Upon exiting the transaction, the fund manager can finally realize the market value of the investment and ultimately increase profits.

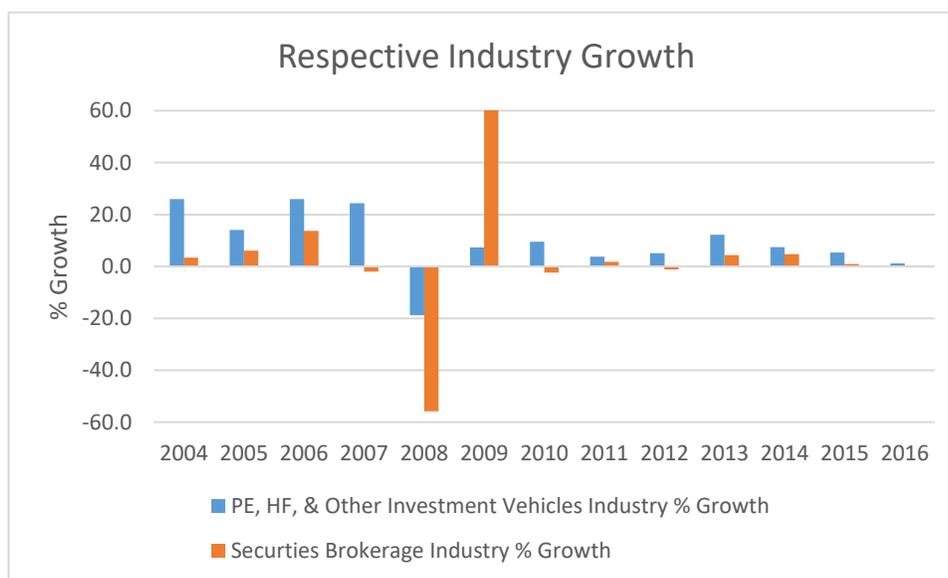
The truest way to measure investor participation for a traditional brokerage house is to recognize the amount of revenue the firm has on an annual basis. I say this because these investment vehicles are primarily commission-based, unlike alternatives. After experiencing tremendous growth for the last two decades of the 20th century, total revenue has been relatively stationary for the securities brokerage industry. According to the US Census Bureau, revenues have only grown from \$144,631 million in 2000 to 135,640 million in 2016, representing a -

0.40% CAGR (US Federal Reserve, 2017). Although both securities brokers and alternative fund managers invest on the behalf of others, alternative fund managers are working with much more capital than securities brokerage firms now. Additionally, a negative CAGR in regards to an industry's revenue is not ideal and this serves yet as another reason the securities brokerage industry is losing its investors base to alternatives.



Data Trend #3: Respective Industry Revenue Increases/ Decreases

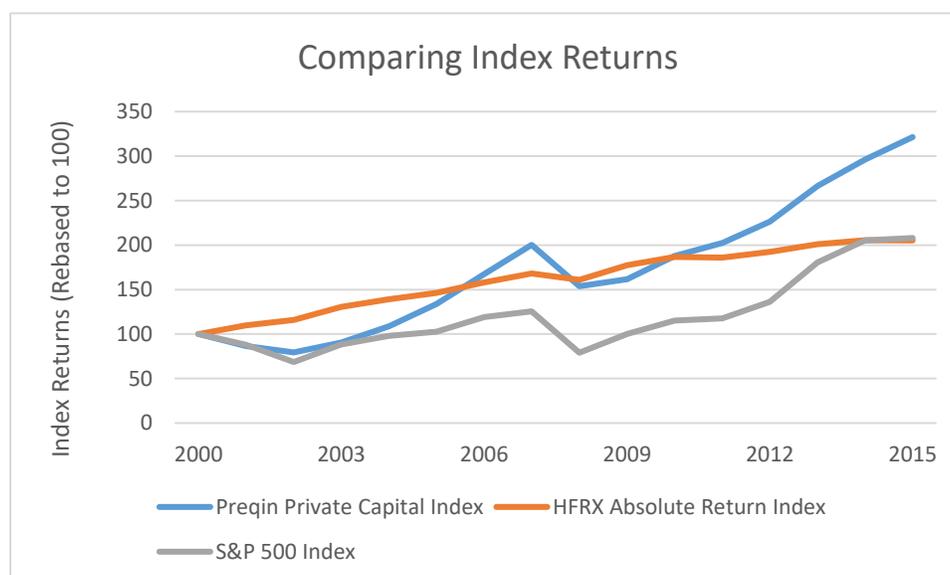
Gauging industry growth in terms of revenue for both the alternative investments space as well as the securities brokerage sector will help reinforce ongoing investment trends. As a whole, the private equity, hedge fund, and other investment vehicles industry has been in the growth stage of the business life cycle, whereas the securities brokerage industry remains mature. As you can see from the figure shown below, alternatives have proven to be the more resilient investment choice when compared to securities brokerage. During the Financial Crisis in 2008, the alternative investment industry had a -18.8% growth rate from its performance in 2007 (Gambardella, 2017). Since the securities brokerage industry is largely correlated to the returns of the market, securities brokerage suffered nearly three times as much when its growth rate declined to -55.8% from 2007 (D'Costa, 2016). The lowered volatility of alternatives during times of economic havoc, specifically in 2008, has only increased the sector's relevance.



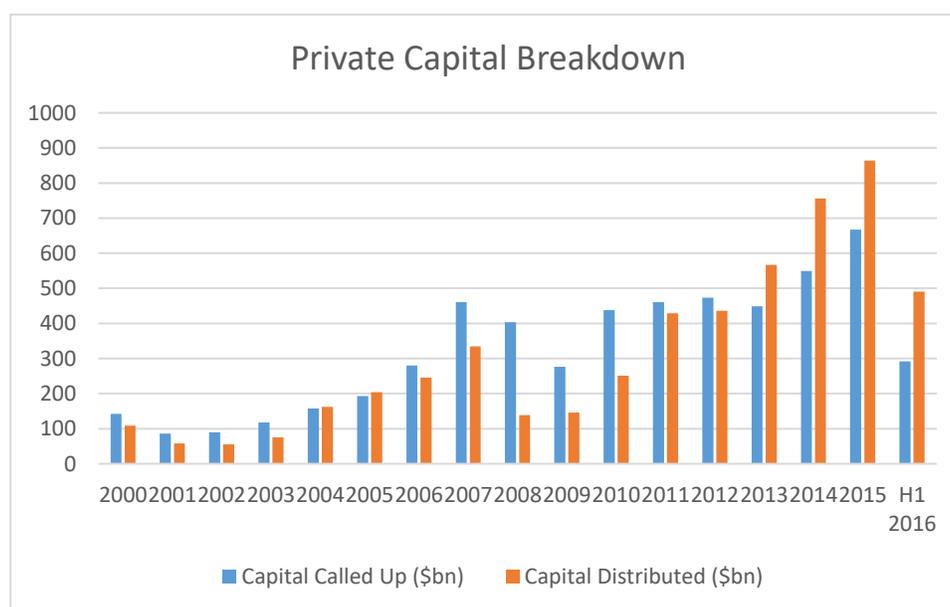
Data Trend #4: Comparing Index Returns and Private Equity Breakdown

The enhanced returns alternatives have experienced to date over the 21st century serves as another reason investors are shifting towards these new-age investment approaches. As shown in

the figure below, total returns from broad private equity and hedge fund indices have typically beaten the S&P 500 Index since 2000. The Preqin Private Capital Index “uses net-to-LP performance data for over 6,200 private equity partnerships -- with capitalization of over \$3.3 trillion – to capture the average returns earned by investors within their private equity portfolios based on the actual amount of money invested in private equity partnerships” (Preqin Global Private Equity & Venture Capital Report, 2017). The HFRX Absolute Return Index measures the overall return of hedge funds and it is representative of all hedge fund strategies that are commonplace today (HFI, 2017). Preqin’s Private Capital Index has experienced a 7.57% CAGR from 2000 to 2015, while the HFRX Absolute Return Index had a CAGR of 4.61% during this time frame. During this span of time, the S&P 500’s index returns grew at a 4.68% (Preqin Global Private Equity & Venture Capital Report, 2017). As you can see from the figure shown below, the HFRX Absolute Return Index was least impacted index during the financial crisis in 2008 as it steadily increased its index returns over the years. I chose to compare the two indices against the S&P 500, since the S&P 500 measures the performance of 500 large-cap, US stocks. The S&P 500 typically shows the average return of the market. Since investors are experiencing superior returns at lower levels of volatility, there is a large movement away from conventional US stocks.



Out of the three investment strategies mentioned, private equity has emerged as the leading investment strategy over the past 16 years. Since the private equity space has consistently produced positive results, there has been an increase in investor interest. This has caused capital calls to rise. The private equity space is raising record levels of capital, so these funds can produce even greater returns. With greater returns, comes greater capital distributions back to the investors. As you can see from the visual shown below, capital distributed has exceeded capital called up in recent years. For example, the private equity space called up approximately \$667 billion of capital, while distributing roughly \$864 billion in 2015 (Preqin Global Private Equity & Venture Capital Report, 2017). This type of track record is only going to cause the private equity space to grow exponentially in future years.



IV. DISCUSSION

Synopsis of Findings

With my findings, I reinforced the notion that correlates the rise of alternative investment strategies with the demise of the traditional brokerage model. By conducting an analysis for data

trend #1, I provided substantial evidence that confirms how conventional broker-dealer firms are consolidating, and emphasized how this trend will continue. Additionally, I showed the continued rise in the number of alternative investment platforms, specifically by highlighting the increase in the number of hedge funds and private equity firms globally. Data trend #2 provides evidence that proves how investor participation in alternatives has skyrocketed over the past 16 years in terms of AUM. Also, I confirmed how investors are losing interest in broker-dealers by calculating a negative CAGR for the industry's revenue from 2000 to present-day. I made the assumption that the best way to measure investor participation for alternatives is by using AUM and that the most accurate way to measure investor participation with broker-dealers is to use industry revenue as my proxy due to the inherent nature of each industry's compensation structure. Data Trend #3 helped prove the thought that alternative investments are more resilient and consistent than traditional securities brokerage, particularly in times of macroeconomic distress. Data Trend #4 was vital to portraying how private equity total returns have outperformed the market since 2000. I was shocked that the HFRX Absolute Return Index had a lower CAGR than the S&P 500 from 2000-2015. Although this may be the case from 2000-2015, the "Prequin all-strategies hedge fund benchmark returned 7.40% in 2016, up from 2.03% in 2015", while increasing industry AUM by \$70 billion (Prequin Global Hedeg Fund Report, 2017).

Reasoning

After conducting data trend #4, I decided to further investigate the high returns of the Prequin private capital index, since it was the highest performing investment strategy in this study. The high returns of private capital investment became even more evident after showing how capital distributions have exceeded the capital called in recent years. "The three-year annualized

net IRR for private equity funds for June 2016 is 16.4%” and the “top-quartile private equity funds since vintage 2010 have generated median net IRRs of 20.6%, nearly eight percentage points above the median benchmark” (Preqin Global Private Equity & Venture Capital Report, 2017). For this reason, I concluded that investing in private equity is the most advantageous investment strategy for an investor to participate in today.

I have identified performance and fees as the two primary hurdles for hedge fund managers in their current industry landscape. “Although 56% of hedge funds reported positive returns in 2016, 66% of investors and 41% of fund managers believed performance objectives were not met in 2016” (Preqin Global Hedge Fund Report, 2017). This result instigates a popular debate between active and passive investing. Investors may not see the point in paying high management fees to hedge fund managers if they can’t outperform the market. “The mean management fee by active single-manager hedge funds is 1.56%, while the mean performance fee is 19.30%” (Preqin Global Hedge Fund Report, 2017). The hedge fund space must address their performance and fee structures to maintain satisfactory fundraising levels from institutional investors in the future. Subsequently, investors may decide to leave hedge funds to invest with passively managed funds that attain total returns equal to or greater than that of the S&P 500. “Investors withdrew a net \$102 billion from hedge funds and 47% of investors issued a hedge fund redemption request in 2016” (Preqin Global Hedge Fund Report, 2017). With that said, “28% of investors and 47% of fund managers believe that hedge fund industry performance will perform better in 2017 than it did in 2016” (Preqin Global Hedge Fund Report, 2017).

V. IMPLICATIONS

RIA’s vs. Broker-Dealers

Before investing with a financial advisor, it is crucial to identify the legitimacy of the advisor's certification and their degree of competency. Although traditional, full-service brokerage houses and alternative investment shops both provide financial advice to clients, it is important to note the difference between a broker-dealer and a registered investment advisor (RIA). "A broker is defined as someone who conducts transactions in securities on behalf of others; a dealer is defined as someone who buys and sells securities for his or her own accounts; and an investment adviser is defined as someone who provides advice to others regarding securities" (SEC, 2008). If an investor is unable to differentiate between a broker-dealer and a RIA, he or she is putting themselves at a disadvantage as they seek financial advice. One reason that would logically explain the shift from traditional securities brokerage to alternatives is increased investor knowledge.

The primary differences between the two financial professions lies in the regulations and the fiduciary duties each must follow. Broker-dealers can't engage in the selling of securities without registering with the SEC, since the SEC has right to suspend a broker if the he or she is guilty of violating federal laws. In 2007, the SEC delegated the responsibilities of regulating broker-dealers to the self-regulatory agency known as FINRA (SEC, 2008). Today, a broker-dealer must register to become a member of FINRA before engaging in any business activities. Due to the Securities Exchange Act of 1940, broker-dealers can't sell securities to their customers unless the investments are appropriate for the client's needs (SEC, 2008). The broker-dealer is required to reveal any pending conflicts of interest for a given transaction. RIA's must register with the SEC to assist institutional or high net worth clients with managing their assets. Regulated investment advisors must do so according to the Federal Investment Act of 1940 (SEC, 2008). Much like broker-dealers, RIA's have a fiduciary duty to act in the best interest of

his or her clients. The distinguishable facet that makes RIA's unique is the fact that they cannot trade on the behalf of the investor unless the broker-dealer explains the details of the investment and the investor gives his or her consent to trade the security.

Another key aspect that differentiates broker-dealers and RIA's is the way in which each professional is compensated for a given transaction. Broker-dealers are usually compensated through the firm's transaction-based compensation plan. Furthermore, broker-dealers will also make a profit off trade commissions. Investors can be in a more advantageous position when investing with RIA's, since they are more incentivized to perform their fiduciary duties due to the nature of their compensation structure. RIA's are typically compensated by earning a portion of assets under management for a given transaction (SEC, 2008). This means the alternative fund manager is also financially tied to the performance of the transaction, unlike a dealer-broker who earns based on commission. The RIA compensation structure could serve as a potential explanation for the enhanced returns and the low volatility levels investors experience with alternative investment vehicles. Many insist that more investors are shifting towards alternative investment strategies for this very reason.

Legislative Influence: The Future Impact of the JOBS Act

Federal legislation heavily influences an individual's investment, since government intervention has produced both negative and positive consequences for the financial markets in the past. Regulators expect that investment in the mentioned alternative methods will increase in coming years, partly due to the Jumpstart Our Business Startups (JOBS) Act, which was approved by Congress in 2012. The JOBS Act was designed to encourage funding in small entrepreneurial businesses across the US, which has been weak ever since 2008. By alleviating

previous securities regulations, the legislation provides investment firms with the opportunity of expanding their respective investor bases.

Title III of this legislation, which commenced in May of 2016, allows non-accredited investors to engage in equity crowdfunding in addition to accredited investors, thus, promoting overall entrepreneurship in the US. Sites such as Crowd Funder and Kickstarter will allow everyday individuals to invest in promising startups early from a remote location. Ultimately, this will result in an altered venture capital business model. “A hybrid model will emerge where VC’s and Angels will lead and set the terms at which they want to invest, and then leverage equity crowdfunding platforms for distribution to a much larger set of investors” (Barnett, 2014).

Additionally, Title II, which was implemented in September of 2013, permits companies to engage in general solicitation to market securities offerings. Hedge funds and private equity firms can now broadly advertise their funds, which could potentially lead to a larger number of investors and an increased AUM. By marketing their fund against industry peers, more individuals will have the opportunity to invest in these funds that have been semi-exclusive in the past. In particular, smaller funds have a unique opportunity to expand their fund in a shorter period of time by taking advantage of the legislation. With that said, “77% of private equity fund managers and 63% of hedge fund managers” claimed that they do not plan to market under the JOBS Act at this time (Preqin Special Report: JOBS Act, 2017). The reasoning behind their current ambivalence toward the legislation is attributed to additional costs, regulatory scrutiny, and the negative perception that comes with marketing their fund towards unknown investors (Preqin Special Report: JOBS Act, 2017). Additionally, fund managers may not want to start utilizing the Act until they have seen a pattern of funds successfully benefiting from the legislation. The passing of the JOBS Act serves as evidence that investors are shifting away from

traditional stock market investing and gravitating towards alternative assets. This legislation will cause the alternative investment space to swell in coming years. Because of this, I expect private equity and hedge fund managers will utilize the benefits of the JOBS Act as they compete for market share.

V. CONCLUSION

Today, the global AUM for alternative assets has hit an all-time high at \$7.7 trillion. Hedge funds currently lead all alternative asset classes with \$3.2 trillion in AUM, while private equity is in second with \$2.49 trillion (Preqin Global Private Equity & Venture Capital Report, 2017). Real estate, private debt, infrastructure, and natural resources make up the remaining \$2 trillion of AUM in alternatives. As investors continue to mitigate potential risk, more individuals and institutional investors are investing in multiple alternative asset classes to diversify their portfolios. Although hedge funds lead all alternatives in AUM, I have been able to identify private equity as the premier alternative investment strategy over the course of the 21st century. Investors are satisfied with private equity performance due to the fact that “84% of investors have a positive perception of private equity, the greatest proportion among alternative asset classes”, and “48% of investors plan to increase their allocation to private equity over the longer term, compared with only 6% that plan to decrease it” (Preqin Global Private Equity & Venture Capital Report, 2017). Additionally, “95% of investors believe that their private equity portfolios have met or exceeded performance expectations over the past 12 months, up from 81% in December 2011” (Preqin Global Private Equity & Venture Capital Report, 2017).

Technological innovation has played a vital role in the progression of investing over the years. As mentioned in my literature review, technological advancements have been a contributing factor towards the downfall of the stock brokerage model. In the coming years,

technology will continue to play an even larger role within the financial services industry as brokerage houses maintain their consolidation trends. In March, Blackrock Inc. strategically decided to lay off more than 30 of their stock picking analysts as the public corporation transitions to artificial intelligence to make market predictions. The New York-based “firm has become the world’s largest asset manager, with \$5.1 trillion in total assets, in large part because of its dominant position in low-cost, passive investment such as exchange-traded funds.” (Krouse, 2017). With that said, Blackrock invests on behalf of its clients in a variety of ways, including investment in actively-managed equities. Although Blackrock has become the world’s largest asset manager, the firm’s actively-managed stock business unit has struggled as its clients have taken out their investments in three of the past four years (Krouse, 2017). BlackRock had “\$275.1 billion in active stock assets under management at the end of December, down from \$317.3 billion three years earlier” (Krouse, 2017). After experiencing lackluster performances when compared to its industry peers, Blackrock has accepted the perception that it is difficult for humans to beat the market when investing in traditional stocks. “The funds’ annual average return is 4 percent and 7.3 percent over three and five years, according to data from Morningstar Inc. This compares with the industry average of 5.3 percent and 8.8 percent” (Willmer, 2017). By transitioning to predictive quant funds, the firm can utilize artificial intelligence to minimize future costs and rebound from the losses attributed to actively managed stocks in recent years.

Less investors are aiming to actively beat the public market, thus, there has been increased investor participation in low-cost quantitative funds and promising alternative investment vehicles. Through my findings, I have discovered that traditional securities brokerage houses are facing constant consolidation due to the rise of alternative investment firms. Artificial intelligence poses another major threat to the survival of the securities brokerage industry. The

traditional securities brokerage space may soon be over as we know it. As the use of artificial intelligence within the investment space picks up speed, traditional broker-dealers can't help but to look over their shoulder as their occupation potentially becomes obsolete.

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