THE SHAPE OF THE NEW ALTERNATIVE ASSET MANAGER

How Diversifying into New Asset Classes Raises Opportunities and Challenges

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ALTS MANAGERS MUST CONSIDER THEIR CORE STRATEGY IN THE CONTEXT OF ALPHA VERSUS LIQUIDITY, THE SHIFTING INVESTOR LANDSCAPE, AND THE PRACTICAL REALITIES OF EXECUTING THEIR BUSINESS STRATEGY

Succeeding as an alternative asset manager requires agility amid volatile markets in the best of times. In the opening quarter of 2020, the COVID-19 pandemic brought a significant level of market uncertainty. The alternatives fund sector, ever vigilant for non-correlated returns, is adapting to a new market backdrop. Broadly speaking, private funds have had an extended stretch of outperformance, with the valuation impact of COVID-19 slowing deal flow but with performance impact still to be seen. Hedge funds are showing recent signs of strength, with a bias toward equity strategies in recently launched funds.[1]

Even before the economic aftermath of the pandemic, alts managers have been adapting their strategies to shifting market conditions. This has been most prevalent in the move from pure-play hedge funds expanding into closed-end private structures — private equity (PE) being the most predominant, alongside private debt, real estate and infrastructure. There are also instances of PE shops exploring open-ended fund structures, but the inherent imbalance of portfolio versus investor liquidity here is a persistent challenge.

The emergence of these traditional hedge funds into "hybrid" structures has strong implications for their own operating models, as well as for service providers and other stakeholders. Ultimately, alts managers must consider their core strategy in the context of alpha versus liquidity, the shifting investor landscape, and the practical realities of executing their business strategy.

WHAT'S SHAPING THE NEW ALTERNATIVE ASSET MANAGER?

What has brought us here in the first place? Before the negative economic COVID-19 consequences took hold, the appeal of private markets amid struggles in the hedge fund world made up a significant part of the equation. Hedge fund managers have delivered years of lackluster returns, with the market outperforming them for the entire past decade with the exception of 2018, when hedge funds edged out the market with a 4.05% loss versus the S&P 500's 4.38% loss.[2] Further, data shows that investors' money began leaving hedge funds and entering private equity. In 2019, hedge funds made up a third of institutional investors' alternative investments, down seven percentage points from 2018. Meanwhile, private equity grew to 25% of institutional investors' alternative investments, up from 18% the year before.[3]

As a result, many hedge fund managers have followed investors' money and established their own private equity funds. According to EY's 2019 Global Alternative Fund Survey, more than a quarter of hedge fund managers have a private equity or venture capital offering.[4] This offering expansion serves as a hedge on overall returns and access to new capital for hedge funds.

The shifting profile of the investor landscape is also exerting pressure on alts managers, particularly in the private markets. Larger limited partners (LPs) want more options for direct involvement in private equity deals as they gain more experience and confidence in the space. The prospect of new capital from smaller investors through the "democratization of private equity" has managers exploring the use of open-ended structures, an observation also noted by EY. But the trend isn't without controversy. While 57% of North American LPs believe significantly more retail money will be invested in private equity in the next five years, 73% of LPs believe PE investing is not suitable for unsophisticated investors, according to Coller Capital.[5]

25%+

Hedge fund managers that have a private equity or venture capital offering.[4]

As the [COVID-19] fog clears, and managers and investors alike are ready to start making bold moves again, there will be a premium on the speed and robustness of alternative fund responses.

Since hedge fund capital structure is much more liquid, hedge fund managers are not accustomed to the operations and development behind a multi-tier distribution waterfall schedule. Developing such a schedule and committing to following it are big undertakings particularly as PE funds must carry out actions such as increasing the number of LPs and making capital calls and distributions.

ALTERNATIVE ASSET MANAGERS IN A POST-PANDEMIC WORLD

Alternatives funds have witnessed a range of reactions to the COVID-19 pandemic from a surge of redemption requests, dramatic downward valuations in high impact sectors (such as transport and hospitality), and widespread uncertainty across the market.

Against current volatility and elevated uncertainty, all alts managers should be actively assessing their current footing to respond to new information. As the fog clears, and managers and investors alike are ready to start making bold moves again, there will be a premium on the speed and robustness of alternative fund responses. In the deployment of new strategies, there are impacts across the investment lifecycle, from the point of trade through to the investor accounting.

But expanding into new products isn't a move to take lightly. Operations and investor needs can differ vastly between different product types. Deep expertise in the middle- and back-office demands of one product does not necessarily proxy into others, and missteps can be costly. Managers' time is well-spent understanding the practical demands of different solutions that can help them bridge the knowledge and experience gap.

65%

of LPs planned to invest in co-investment opportunities in 2019.[6]

UNDERSTANDING THE DIVIDING LINES OF ALTERNATIVE ASSET CLASSES

As different alternatives classes, particularly hedge funds and private capital, have vastly different strategies for achieving alpha, the needs for the different classes naturally differ greatly. Alts managers must apply significant consideration to the resources they will need to be successful before jumping in. Let's examine the contrasts on different fronts: operations, investors, and cash.

1. OPERATIONAL NEEDS

- **Fund and investment valuation** — In general, hedge funds' assets skew towards exchange-traded equities and derivatives, whose values are public knowledge from minute to minute, making valuation clearer, simpler and less risky than private equity. Valuing a PE fund's investments is less straightforward since the fund's investments deal in the private market. When seeking fund valuation, PE managers turn to valuation specialists to assess the fund's investments. Because investment valuations for PE must be done outside a free marketplace, the value determined is less certain since it is based on many assumptions. Additionally, there can be risk related to the possibility that the valuation specialist is connected to the manager or part of the same group.
- **Accounting and the waterfall schedule** — PE relies heavily on the accounting distribution waterfall model and structure. The model is made up of four tiers encompassing return of capital, preferred return, catch-up tranche and carried interest. Developing a waterfall schedule that appeals to and attracts investors — while still being feasible to carry out during the lifespan of the fund — requires deep experience and knowledge of PE operations. Since hedge fund capital structure is much more liquid, hedge fund managers are not accustomed to the operations and development behind a multi-tier distribution waterfall schedule. Developing such a schedule and committing to following it are big undertakings particularly as PE funds must carry out actions such as increasing the number of LPs and making capital calls and distributions.

Investors who know they bring crucial capital volume to the fund may push for co-investment and other separate account structures so that they can invest directly rather than using the fund as a vehicle for the investment. Doing so provides greater control and lower overall fees.

As managers try their hand at new alternatives strategies, they must have a clear strategy, deploy seasoned expertise and seek out the ideal service providers to assist on their mission.

2. INVESTOR RELATIONS

- **Large investors' terms negotiations** — Within the hedge fund world, investor terms may be easier to predict. Most investors simply seek the most favorable commercials they can get when it comes to management and performance fees, at times through the use of separately managed accounts. In private markets, managers will encounter large LPs pushing for favorable positions beyond fees, including direct or co-investment rights and options for ongoing portfolio company ownership. Investors who know they bring crucial capital volume to the fund may push for co-investment and other separate account structures so that they can invest directly rather than using the fund as a vehicle for the investment. Doing so provides greater control and lower overall fees. Large sophisticated asset allocators have increasingly gravitated toward co-investment over the last several years. Sixty-five percent of LPs planned to invest in co-investment opportunities in 2019.[6]
- **Retail investors' potential debut** — While the largest and most powerful investors push for more sway over the investments, a new breed of investors are trying to break into the bottom of the market. While retail investors have pushed for access to alternative investments for some time, the private market may be on the cusp of admitting their entry, starting with private equity.[7] In the U.S., while retail investors' entry could represent a welcome wave of new capital, the Securities and Exchange Commission (SEC) would need to create a rule change lowering the minimum income requirements for investing in private capital. Under potential future SEC regulations, retail investors could create new costs for private equity managers due to potentially stringent transparency reporting requirements and higher investor volume.

3. CASH MANAGEMENT

- **Fund structure** — Managers who consider expansion to fund families supporting both open- and closed-end structures must be mindful of new levels of cash management complexity. For open funds, the day-by-day cash management of public markets, against the shifting and multi-dimensional landscape of portfolio financing options, collateral requirements, and FX exposure is already an area ripe for advanced optimization solutions. Cash management for closed-end funds is more of a timing play centered around the uncertainty of LP capital calls being met and potential demands for the GP to lean on short-term credit facilities. Each of these fund structures individually demands attention to minimize finance costs and the administration burden for LPs in cash management. The conceptual melding of the two compounds the complexity of achieving optimal results, and alts managers should approach this prospect with care.

- **Pandemic effects** — Irrespective of fund structure, the COVID-19 ripple effects are showing alts managers firsthand the importance of understanding their investor profile. Institutional investors who can deliver large portions of capital are more likely to be bound by their own investment charters, with fixed percentage caps to the alternatives sector. These same investors are thus subject to the volatility of the public markets and the secondary impacts to their longer-term alts allocations. Alternatively, some alts investors may see the recent events as an opportunity to buy in further at a discount. Regardless of the directionality and horizon, alts managers must be mindful of the sensitivities of their investors and the prospect of early redemptions and possibility of failed capital calls.

TAKING ON A NEW ASSET CLASS IN THE RIGHT WAY

Because the worlds between separate alternative asset classes can differ so much, alts managers need to consider the factors behind their motivation to expand and their ability to meet the operational needs behind their new targeted asset class or classes. For those who seriously consider a multi-strategy approach, they should contemplate the following questions:

- **Why am I doing this?** Is this part of my overall business strategy? Is it just a hedge on returns? Or is it because I feel like I've developed the expertise to compete against more established players in these new areas? For example, a credit strategy hedge fund may develop a complimentary closed-end private debt fund while a multi-strategy hedge fund relegated to chasing beta may consider a hard turn to add pure private markets strategies as a diversification play.
- **Is this a "bolt-on" or a holistic implementation?** What synergies do I hope to realize in operations, investor relations, technology, etc.? Are there informational arbitrage opportunities by broadening my investment strategy? A manager should be able to realize efficiencies in operations through the expansion, rather than having to buy a full stack of independent capabilities to support the new strategy.
- **What is my positioning to my current and prospective investors?** How do I ensure my current investors are not concerned about the viability of the original strategy they've invested in and the potential distraction/dilutive factor of my new strategy? Strategically aligned, synergistic expansions are easier to position and rationalize to investors than diversification-driven, bolt-on efforts.

Not only can the right provider fill all operational needs — they also serve as a guide as the manager defines the strategy in a new territory.

- **Am I operationally ready?** Do I have service providers who are not only able to support this, but are already positioned to implement and advise me, including offering adjunct services that can lower my costs and risks?

The right outsourcing partner can be invaluable in helping to navigate the unique needs of a new asset class. When expanding from pure-play asset class territory into a new class, there are countless differences and needs, as discussed. Left to navigate them all on their own, alts managers could struggle to maintain their original strategy and alpha-generating opportunities while finding their way when setting up a new fund.

A partner can bridge the gap and consult on the new fund's strategy and needs so that the manager can keep all operations afloat and successful, even when finding their way in a new asset class. Not only can the right provider fill all operational needs — they also serve as a guide as the manager defines the strategy in a new territory.

Seek out the following in the ideal provider:

The experience to anticipate a client's needs as they set their sights beyond a pure-play strategy.	An administrative partner should be well-versed in the breadth of fund structures, the associated requirements, the regulations, and the challenges they'll face. Knowing their administrator is ready and able to support future changes gives a manager assurance that they can execute their strategy.
The ability to bundle services.	Ideally, a chosen partner has the ability to provide all services needed when expanding to a new asset class. This allows the client to benefit from a "one-stop shop" for all their service needs as they become familiar with the operations of a new fund structure.
Access to aligned and tight-knit client engagement.	If an alts manager is engaging an administrator for multiple asset strategy needs, each solution team within the administrator should be able to work together and communicate with the client cohesively, rather than provide several fragmented fronts. In this scenario, the alts manager would benefit from guidance that provides the full picture of their needs and operations.

As managers try their hand at new alternatives strategies, they must have a clear strategy, deploy seasoned expertise and seek out the ideal service providers to assist on their mission.

A NEW BREED OF ALTERNATIVE ASSET MANAGERS

As the lines between alternative asset classes blur and managers branch from pure-play firms into custom strategy firms with collections of fund families, they will require appropriate guidance and services to help generate alpha. The drive to diversify alternative investment strategies will pick up steam and the balance will tip in favor of these non-traditional funds, making a transition seem even more appealing. But the move into new asset classes isn't a simple or quick journey. As managers try their hand at new alternatives strategies, they must have a clear strategy, deploy seasoned expertise and seek out the ideal service providers to assist on their mission. This will underpin new investment options to investors, diversify their alpha-generation strategies, and ultimately change their stripes to navigate through current economic uncertainty and outperform the market and their competitors.

SUMMARY: TABLE OF CONSIDERATIONS BY FUND STRUCTURE

FUND TYPE	OPERATIONAL	INVESTOR RELATIONS	CASH MANAGEMENT
Hedge	24-hour cycles of trade processing, reconciliations, valuation, profit and loss. Emphasis on agility and minimized latency.	Investor-controlled capital flows (subscriptions/redemptions), typically on a monthly basis. Prospect of SMAs and/or side-pockets from large investors.	Strong external influences from portfolio lifecycle events (corporate actions, settlements, collateral, investor activity), with portfolio financing considerations for leverage. Premium on immediacy of cash/FX data and execution capability.
Private	Monitoring of portfolio holdings, complexity of limited partner agreements, waterfall calculations and performance.	General partner-controlled capital flows (calls/distributions), timed to portfolio deal transactions. Large LPs may demand co-invest/direct-invest, and/or ongoing ownership options.	Deal-driven cash flow timing; large, short-term credit line availability is key to mitigating late/failed calls.
Bottom line	Inherent differences in operational cadences, fund and investor accounting methodologies. Do not over assume synergies.	Investors in both structures will have different sensitivities along the lines of their own shape (asset owners, fund of funds, family offices, etc.). Larger investors will bring special demands for favored terms.	Strong banking relationships are key for credit and financing. Complex fund structures lend themselves to advanced cash optimization solutions.

About Northern Trust

A proven partner to some of the world's most successful and innovative investment managers, Northern Trust has over 30 years' experience administering the full spectrum of investment strategies for clients around the globe. We help facilitate improved speed-to-market, operational efficiency, business focus and distribution for our clients' traditional and alternative funds. Our solutions include fund administration, global custody, investment risk analytics, back-and-middle office investment operations outsourcing, institutional brokerage and solutions to support regulatory change.

ENDNOTES

1 Seward &Kissel LLP "New Hedge Fund Study 2019 Edition" https://www.sewkis.com/wp-content/uploads/STUDY-New-Hedge-Fund-Study-2019.pdf

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3 EY "2019 Global Alternative Fund Survey" https://vaioe.at/wp-content/uploads/2019/11/2019_Global-Alts-Fund-Survey_FINAL.pdf

4 Ibid. https://vaioe.at/wp-content/uploads/2019/11/2019_Global-Alts-Fund-Survey_FINAL.pdf

5 Coller Capital "Global Private Equity Barometer Winter 2019-20" https://www.collercapital.com/sites/default/files/Coller%20Capital%20Global%20Private%20Equity%20Barometer%20Winter%202019-20.pdf

6 Private Equity International "Co-investment growth leads to uncertainty over terms" December 5 2018 https://www.privateequityinternational.com/co-investment-growth-leads-uncertainty-terms/

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