

THE ALTERNATIVE ASSET INVESTMENT PUZZLE

HOW EUROPEAN-BASED ASSET OWNERS ARE SOLVING THEIR ALTERNATIVE INVESTMENT CHALLENGES

As asset owners increasingly look to alternatives to help both grow and diversify their portfolios, they are drawing on a variety of approaches to boost their exposure. Today, the conventional fund-of-funds approach is complemented by an array of solutions as numerous as the asset sectors themselves. Some of Europe's largest asset owners are even venturing beyond the investor role by entering the realm of the manager and setting up their own investment vehicles.

However, changing roles from investor to fund manager requires careful consideration. The potential to gain full control over a portfolio's objectives needs to be balanced against the complexity of running a direct investment fund – from investment decision making and deal access to regulatory and operational considerations.

In this paper Northern Trust examines considerations from the perspective of a European-based asset owner investing in alternatives across private equity and debt, real estate and infrastructure (loosely termed private market assets) as we review:

- Drivers and challenges of alternative asset investing
- Changing relationships between asset owners and investment managers
- Factors to consider for external and internal models

GROWING IN POPULARITY

Market data suggests that asset owners are boosting their exposure to alternatives. Private equity alone is projected to account for US\$10.2T in global assets under management by 2025.¹ Likewise, a recent EY survey found a third of investors expect to increase their allocations to private equity in the next three years.³ As alternatives make up a growing portion of portfolios, it is understandable that asset owners are looking for opportunities to exercise greater control and influence.

Northern Trust's recent webcast, which discussed evolving approaches to alternative investment in Europe, saw more than a third of respondents to a live poll predict growth in active engagement between general partners (GPs) and limited partners (LPs) over the next five years.² Similarly, the EY study found 38% of investors anticipated increasing involvement in key investment or operating decisions as active limited partners over the next two years.³

\$21.1T

GLOBAL ALTERNATIVE ASSETS
AUM BY 2025¹

\$10.2T

PRIVATE EQUITY AUM BY 2025¹

THE CHALLENGE

A third of respondents to a Northern Trust survey predicted growth in active engagement between GPs and LPs over the next five years.²

THE CHALLENGE

Alternatives come with their own set of challenges and complexities compared to traditional assets. During its webcast, Northern Trust asked viewers, comprised of both industry stakeholders and asset owners, to choose their main challenge with alternatives investing from among five options. Close to half the respondents said accessing the best assets was most challenging. The deal access result comes at a time when some industry findings suggest as much as US\$1.8T in capital is awaiting investment.⁴ There is also the fact that alternative asset deals often do not happen quickly. They can take between six months and two years to come to fruition, sometimes longer. For mid to small asset owners, many opportunities are simply not available to them due to the amount of available capital.

The second greatest challenge was transparency reporting, which highlights a desire on the part of investors for more granular and comparable data at a fund level, from performance data to strategy and risk analytics. But the lack of global industry standards and resulting inconsistency can create friction between managers and investors who are seeking similar informational efficiency they experience in public markets.

The third greatest challenge was liquidity requirements. Due to the long-term nature of alternative investments, liquidity can pose a challenge, depending on the type of scheme. Asset owners need to understand liquidity constraints to manage cash flows and meet obligations as well as plan for market volatility.

Similarly, fees were referenced as a challenge, which underlines their complexity. Even standard industry practices for alternative investment fees can lead to confusion and misunderstanding. The way asset owners address these challenges is influencing how they build out their alternative asset allocation.

THE ALTERNATIVE INVESTMENT CONTINUUM

Asset owners are accessing alternatives in many ways, but most fall within the spectrum shown in Figure 1. Some are coming to the asset sector with limited experience and accessing alternatives via the fund of funds route.

LIVE POLL QUESTION 1

What is your main challenge with alternatives investing?²

43%

ACCESSING THE BEST ASSETS

30%

TRANSPARENT REPORTING

16%

LIQUIDITY REQUIREMENTS

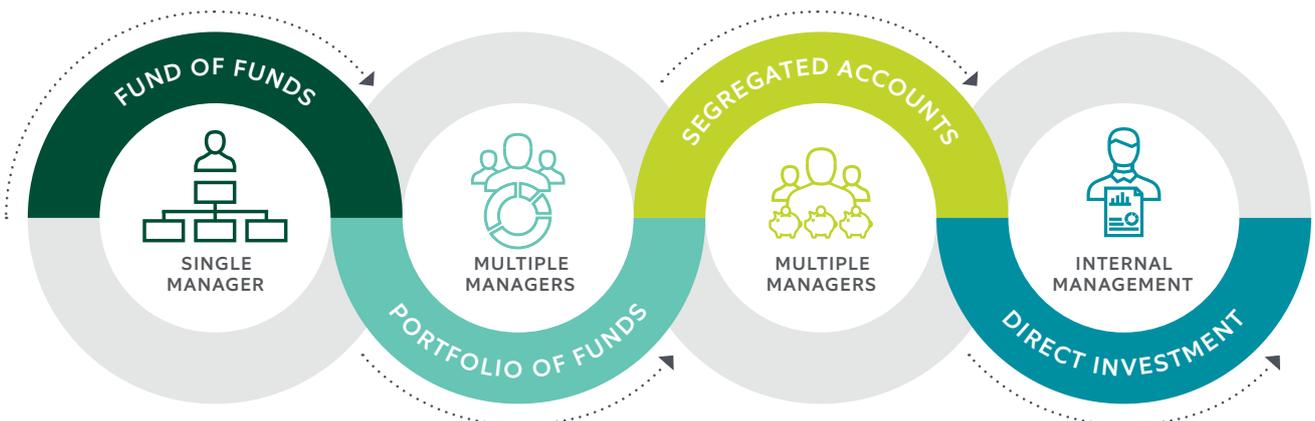
9%

FEE MODELS

2%

OTHER

FIGURE 1: THE CONTINUUM



Others are looking to get more involved with their external managers via segregated accounts. At the far end of the spectrum are asset owners who have built a deep in-house understanding of alternatives; they have well defined systems and processes in place to make direct investments without using external managers. It should be noted that, in practice, this is often not an either/or scenario. Many asset owners will deploy a multi-faceted approach incorporating different elements of the alternative investment continuum to meet various portfolio objectives.

SINGLE MANAGER/FUND OF FUNDS

All active investment decisions are taken by a third-party manager

The conventional entry to alternatives is to gain exposure through a fund-of-funds structure without playing an active role in portfolio construction. The asset owner will appoint a single manager to make selections on the investor’s behalf. This enables investors to leverage the manager’s expertise, the existing fund range and any newly planned fund launches. By choosing this approach investors tap into an established market offering that is scalable and diversified across different managers and funds. It’s a ready-made solution that requires less management time.

These schemes can be particularly suitable for smaller asset owner investors who are looking for broad exposure and lack the resources for a more hands-on approach. However, they can feature multiple management fee structures that need to be factored in over the longer term. They also may be less aligned with asset owners’ specific requirements and generally involve some compromises. Single manager fund of funds were nominated by only 7% of Northern Trust’s webcast poll respondents as their largest alternative asset pool.²

LIVE POLL QUESTION 2

What model best describes your largest alternative asset pool?²

64%

MULTIPLE MANAGERS:
PORTFOLIO OF FUNDS

17%

IN-HOUSE: DIRECT INVESTMENT

12%

MULTIPLE MANAGERS:
SEGREGATED ACCOUNTS

7%

SINGLE MANAGER: FUND OF FUNDS

FIGURE 2: QUESTIONS, STRENGTHS AND WEAKNESSES TO CONSIDER WHEN CONTEMPLATING USING A SINGLE MANAGER/FUND OF FUNDS



QUESTIONS



STRENGTHS



WEAKNESSES

How large is your portfolio?	Expertise and deal pipeline of a specialist manager	Higher management fees and expenses
What are your specific investment objectives?	Fund universe independently screened and assessed	More onerous regulation and reporting obligations
Are there suitable products in the market?	Access to existing fund ranges and future launches	Assets less aligned to specific investor requirements
What performance/risk reporting is required?	Spread risk across different managers and funds	Less transparency of cash flows and risk metrics
Is the manager’s ESG framework consistent with yours?	Scalability giving flexibility on size and duration	Inconsistent reporting: timing, content and measurement
Can you access and use data in a consistent and granular way?	Minimal administration and management time	Risk of manager low performance and/or staff turnover

MULTIPLE MANAGERS/PORTFOLIO OF FUNDS

More strategic control via investments with a number of alternative managers into sector-specific funds

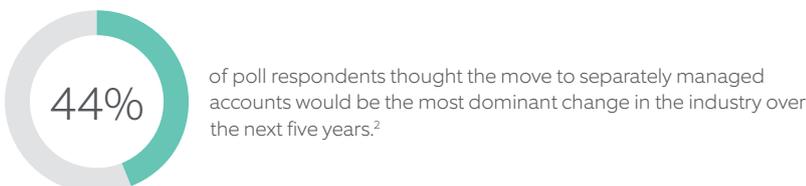
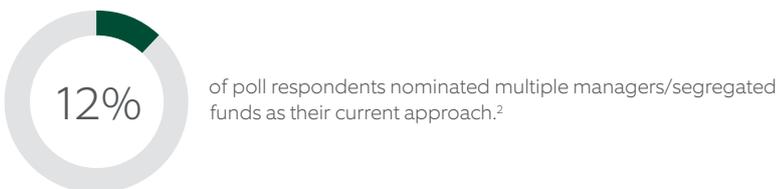
‘Within our client base we are seeing asset owners who want to have a lot more say into which funds are being selected. So they will bring people in-house to oversee the selection programme’, comments Stuart Lawson, Northern Trust’s senior product manager, Alternative Fund Services. ‘This internal investment team will work with external managers and, typically, appointed consultants to arrive at a portfolio of funds. Compared to the fund-of-funds approach they will generally have greater control in terms of strategy and approach, which include joining advisory boards and seeking direct involvement in key decisions’. In Northern Trust’s webcast this was the most favoured model, nominated by about two-thirds of respondents.²

MULTIPLE MANAGERS/SEGREGATED PORTFOLIOS

Portfolio serviced by dedicated managers to construct a unique, customised portfolio to meet specialist needs

Moving along the investment continuum, the drive for a more bespoke approach is driving managers to respond by developing segregated accounts for larger asset owners. Under this structure investment managers develop a customised portfolio on behalf of their asset owner clients to meet their specific needs. This goes further to helping meet particular investment objectives by focusing on, for example, Fintech, health care or certain environmental, social and governance criteria. The approach also supports the drive for increased transparency and more tailored liquidity and fee solutions.

However, this approach may stop short of fully aligning with the goals and control some asset owners seek. While this was nominated by 12% of poll respondents as their current approach, 44% thought this would be the most dominant change in the industry over the next five years, which further underscores the trend of more active engagement and control by asset owners.² It also poses an operational and commercial challenge to managers who find their operating model becoming fragmented in response to the particular requirements of segregated accounts.



INTERNAL MANAGEMENT/DIRECT INVESTMENT

Asset owners set up a proprietary investment vehicle and enter the world of the asset manager

Some of the larger asset owners establish their own internal management framework and take full control via direct investment into alternative assets. This increasing blurring of lines between the investor and manager is part of a global trend where many high-profile pension schemes and sovereign wealth funds have decided to go it alone. While the trend is more prevalent outside Europe (Canada, Australia and the United States in particular), Northern Trust has noted a growing interest from European-based asset owners.

Northern Trust's Head of UK Institutional Investor Group, Mark Austin, observes that 'An important driver for pension schemes is the obligation to match their liabilities with their assets. A lot of alternative investments, particularly direct real estate and infrastructure, have great characteristics in terms of matching long-term liabilities, generating income and being inflation linked. There is a good financial case for bringing some of this in-house'.

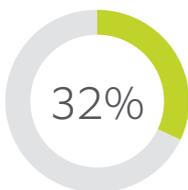
Potential cost savings on external manager fees are also a consideration when adopting the direct investment model. Austin adds that 'What's brought this into focus is the fact that pension schemes are increasingly using pooled or index type approaches to their equity/fixed income exposure, which is throwing the cost of alternatives into sharp relief'.

The associated costs of setting up a direct scheme would normally be quite preventative for smaller asset owners; however, some are grouping assets to achieve scale and purchasing power. In the UK, for example, the local authority pension funds of England and Wales have combined their assets into eight separate pools to achieve greater investment economies of scale, collective negotiating power and access to resources.

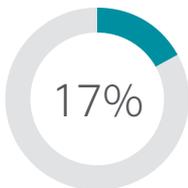


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MARK AUSTIN
HEAD OF UK INSTITUTIONAL INVESTOR GROUP, NORTHERN TRUST



A global survey conducted by EY, found 32% of investors expect to increase their direct in-house investments over the next two years.³



Northern Trust's webcast survey, with a greater focus on Europe, suggested 17% were following a direct in-house investment approach.²

Some pools have already outlined plans to build in-house investment teams for their private equity, private debt and infrastructure investments. Many are building multi-billion-pound private market portfolios, giving them more capital to access attractive investment deals to achieve their goals.

The move toward direct investment is already established in the Netherlands and gaining traction in the Nordic regions. According to Austin, ‘The Dutch market in particular is well evolved in terms of having the size and scale to turn up to deals with enough firepower at the table and enough people with the skills to make that happen. In the Nordics, there is a lot of interest in increasing allocation to alternatives and making a difference with those investments, such as investment in infrastructure and environmentally sustainable projects’.

Figure 3 illustrates how asset owners seeking this option are looking to access a number of advantages over the indirect investment models. Northern Trust’s Stuart Lawson observes that ‘At the top of these is the potential ability to achieve the optimum investment return objectives by gaining full control over investment decisions and portfolio construction’. These may be closely matching investment characteristics with the liability profile of a pension fund or promoting sustainable economic development for charities or local government. According to Lawson, ‘It also represents an opportunity to meet softer ESG or impact investment considerations by investing in assets such as renewable energy or recycling capability with long-term benefits for stakeholders. There could also be cost savings by not having to pay external manager fees and flexibility over the appropriate legal and regulatory regime’. In tune with the trend for greater investor control, Northern Trust’s webcast survey found 13% of respondents expected this model to increase over the next five years.²

FIGURE 3: QUESTIONS, STRENGTHS AND WEAKNESSES TO CONSIDER WHEN CONTEMPLATING DIRECT INVESTMENT

 QUESTIONS	 STRENGTHS	 WEAKNESSES
Do you have the investment and operational expertise?	Full alignment to risk, reward, ESG and time horizon	Requires specialist in-house expertise/management
Can you recruit/retain talent?	Control of investment selection and portfolio construction	Replaces variable cost with largely fixed cost base
Have you considered legal, regulatory, and capital obligations?	Involvement over the management process and fees	Less flexibility to future change/market disruption
Do you have the requisite access to source/win deals?	Greater choice over the legal and regulatory regime	Ongoing investment into technology/regulatory change
Is your technology/data strategy defined and fit for purpose?	Opportunities to collaborate with other asset owners	Potential asset concentration risk
Are there trusted providers to provide operational support?	Scope to support targeted innovation/impact investing	Sourcing/monitoring external service providers

LIVE POLL QUESTION 3

What will be the most dominant change in the next five years?²

44%

GROWTH IN SEPARATELY MANAGED ACCOUNTS

36%

GROWTH IN ACTIVE ENGAGEMENT BETWEEN GPs AND LPs

13%

GROWING SHIFT TO INTERNAL MANAGEMENT

7%

NO MATERIAL CHANGE

But going it alone brings its own challenges, including operational specialist structures considerations like risk and compliance management and how to recruit and retain key talent. Foremost is the need to ensure the right level of in-house expertise to meet both the investment and operational demands of running a successful fund. Austin explains that ‘When using an established fund manager, asset owners are able to address these issues via their established due diligence processes. If going alone, they will need to ensure their trustees/fiduciaries have the ability to oversee these arrangements directly’.

Potential external management fee savings also need to be weighed against the considerable cost of establishing and maintaining an in-house platform and teams, which can be preventative for smaller asset owners. As highlighted earlier in the paper, deal access is also a potential challenge as asset owners will most likely be competing with asset managers with deep industry connections to source and secure deals.

As investment portfolios grow in complexity, so does the specialist skill set required to meet day-to-day administration, regulatory and reporting obligations. Some asset owners will choose to build their own support teams whereas others will look to appoint a third party to meet administration and middle-office requirements. Under this arrangement the existing asset servicer may extend the traditional custodial and indirect portfolio monitoring service with an end-to-end administration role. This may span everything from fund launch support, lifecycle event processing, NAV production, compliance and regulatory reporting services to depositary, banking and treasury. This helps provide access to operational expertise as well as offset the costs of making long-term investments in technology and staffing.

LOOKING TO THE FUTURE

Asset owners are navigating these markets in different ways. It is rarely a case of just selecting one model but rather a mix and match of options within a strengthened organisational focus on alternative assets.

According to Lawson, ‘Asset owners are at various stages in their journeys with alternatives, but whatever model the asset owner deploys there is a drive to have a closer relationship with the fund manager. Many investors are not only looking for more information, but also more active control and a dynamic interface with their managers’. This is evidenced in Northern Trust’s webcast findings, which forecast continued growth for separately managed accounts and active engagement between investors and managers.

The ability to access these options can be supported via teaming up with an asset servicing provider who is able to provide an operational platform that has been developed for both an asset manager and asset owner.



Asset owners are at various stages in their journeys with alternatives, but whatever model the asset owner deploys there is a drive to have a closer relationship with the fund manager.

STUART LAWSON
SENIOR PRODUCT MANAGER,
ALTERNATIVE FUND SERVICES,
NORTHERN TRUST

ACCESSING ALTERNATIVES: APPROACHES IN ACTION

See how three Northern Trust clients access alternatives using a variety of approaches along the alternative investment continuum.

DIRECT INVESTMENT DIVERSIFYING TO EXTERNAL MANAGERS TO EXPAND JURISDICTIONAL REACH

Frank Eizinga, chief investment officer of Dela Corporation explores Dela's outlook on their alternative investments. Dela is an insurance company based in the Netherlands, Belgium and Germany with approximately four million members.

Dela Corporation is looking to grow its alternatives asset allocation to 40% of total investments by 2022 as it expands beyond Dutch-focused real estate and infrastructure investments. This represents a near doubling of its allocation to real assets. Currently Dela has direct investments in Netherlands-based retail and residential properties and more recently added investments in two infrastructure funds. Most of its real estate is invested through Dela's own real estate management company. Dela's liquid investments and fund investments are held via a Dutch FGR (Fonds voor Gemene Rekening) vehicle, which is a tax-transparent fund for joint account.

Real assets currently comprise around 24% of Dela's €5.6 billion investment portfolio, which it projects to rise to €7 billion by 2022.

'As we look to increase our exposure to real assets in the real estate and infrastructure sectors we are widening our playing field to achieve more diversification in terms of risk management, growth, inflation protection and high yield', Eizinga explains.

This will involve moving/converting a proportion of their directly owned real estate into more indirect fund investments using the FGR vehicle to consolidate their entire investment universe. Dela is looking for opportunities managed by external managers outside of the Netherlands. The broad aim is to meet long-term growth targets and diversify into other jurisdictions, initially targeting Europe and later expanding to Asia and the US.

Eizinga explains that while investing via managers is arguably more expensive in terms of fees and offers less control, this is counterbalanced by the flexibility to reach a wider universe of opportunities in country-specific locations and the ability to upscale more efficiently.

Northern Trust is a strategic business partner to Dela and plays a central role as independent data and analytical services provider. Support for Dela includes a wide range of asset services, such as fund administration and transfer agency for the FGRs and Solvency II reporting.



As we look to increase our exposure to real assets in the real estate and infrastructure sectors we are widening our playing field to achieve more diversification in terms of risk management, growth, inflation protection and high yield.

**FRANK EIZINGA
CHIEF INVESTMENT OFFICER,
DELA CORPORATION**

DIRECT INVESTMENT AND SELECT EXTERNAL MANAGERS

The Nationwide Pension Fund, which has approximately £6 billion in assets under custody at Northern Trust, has been investing in alternatives for more than 10 years. Mark Hedges, chief investment officer of Nationwide Pension Fund, provides insights into the scheme's approach to its alternative asset allocation, including its direct property investment strategy.

Alternatives play a prominent role in the Nationwide Pension Fund. With a combination of direct investment in real estate and allocation via specialist managers across multiple alternative asset sectors, the scheme is illustrative of the diverse approaches pension schemes are engaging with. In Nationwide's case alternatives play a key role in both the liability-matching and return-seeking components. The trustees have targeted a 30% allocation to alternatives overall, of which 10% is focused on liability matching and 20% designated to generating growth.

The liability-matching portfolio includes direct property investment in a mix of commercial and residential UK properties, mainly ground rents and long-lease properties. The ground rent investments have been set up in a general partner/limited partner structure. Meanwhile, the value creating portfolio is invested via specialist external managers across private equity, real estate, private debt and infrastructure.

Hedges explains that 'For our direct ground rent investment strategy, we draw on our long expertise in the UK real estate sector as a building society. By going direct we save on fees as well as have full control of our portfolio. Property in the UK is intrinsic to our business'.

Moreover, the way the investment has been structured means it could be opened up to other investors if Nationwide wanted to diversify more and add additional scale. Nationwide uses a property agent to manage day-to-day maintenance of the properties and rent collections, where relevant.

Hedges advises that pension schemes considering making a direct investment need to ensure they have the depth of expertise, scale, resources and infrastructure to ensure they can run these successfully. 'Another consideration for direct investment is that it does take time to originate opportunities and they can be quite competitive to secure', he adds.

For the 20% of value creating alternative investments, Nationwide favours managers with a direct investment approach rather than the funds-of-funds model, which entails an additional layer of cost. This allocation is across the spectrum of private equity, real estate, private debt and infrastructure in the more traditional investment manager approach.

'We are looking to find managers who have a unique selling point in their space and are able to source deals which offer something slightly different to give an edge in adding value. To us, it's about the people, track record and ability to deliver what they say they can in a differentiated way', Hedges says.

Northern Trust is custodian to the Nationwide Pension Fund, providing valuation and performance services across the portfolio, including alternative asset allocation as well as supporting its general ledger.



For our direct ground rent investment strategy, we draw on our long expertise in the UK real estate sector as a building society. By going direct, we save on fees as well as having full control of our portfolio.

MARK HEDGES
CHIEF INVESTMENT OFFICER,
NATIONWIDE PENSION FUND

EXTERNAL MANAGERS WORKING CLOSELY WITH IN-HOUSE TEAM

A large sophisticated global asset owner with more than US\$50B in AUM invests in alternatives to secure returns consistent with their long-term objectives whilst diversifying risk away from traditional allocations. The asset owner invests in a broad spectrum of alternative assets, such as private equity, real estate and infrastructure, in diverse sectors like airports, water and communications. The investments are made by a select number of external managers who work closely with the in-house investment management team to ensure they are aligned with investment goals.

Northern Trust is the asset owner's custodian and provides services for both traditional and alternative investments, including daily accounting and the associated transactions and valuations necessary for each investment on the asset owner's books.

FOR MORE INFORMATION

Northern Trust provides asset servicing solutions to leading institutional investors such as pension schemes, corporate and financial companies, insurance companies and fiduciary managers.

To learn more about how we can support your evolving needs in the alternatives sector, please contact your relationship manager or:

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END NOTES

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3. EY, *At the Tipping Point: Disruption and Pace of Change in the Alternative Asset Management Industry – 2018 Global Alternative Fund Survey*, 2018
4. McKinsey & Company, *The Rise and Rise of Private markets: McKinsey Global Private Markets Review*, 2018

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