CAPCO

OPPORTUNITY IN UNCERTAINTY:

MUST-WIN BATTLES FOR ALTERNATIVE INVESTMENT BUSINESSES

INTRODUCTION

2019 proved to be a milestone year for alternative investments, with assets under management exceeding $10.3 trillion. Amidst the extended bull-run in traditional markets, investors continued to look to alternative strategies to supplement their portfolios and provide uncorrelated gains. While specific asset classes saw net-outflows, overall investor capital allocated to alternatives increased over $675 billion, more than seven percent[1].

2020? Off to an ominous start. In the grips of an unprecedented health crisis, coupled with macro and geopolitical uncertainties, all asset classes are likely in for a reset and reevaluation. And while the first half of this year may ultimately prove to be a lost few months, there will be a tremendous opportunity for alternative investment managers as things begin to normalize. In the same way passive investment strategies proliferated in the wake of the 2008 financial crisis, we believe with investors currently reeling from the volatility of public markets and a mixed performance for robo-advisors and automated allocation platforms that alternative investments and private markets are well-positioned for when investors become comfortable re-allocating capital. We highlight four themes for the ongoing changes we think will characterize the alternative investments space as the dust settles on the current environment:

- Expanding access for investors.
- Investments in technology and innovation.
- Mounting pressure on fund administrators and service providers.
- The resurgence of the hedge fund allocations.

1. EXPANDING ACCESS FOR INVESTORS

With the convergence of increasing investor demand for alternative investments exposure and technological and operational enhancements for distribution, Capco believes the trend of increasing investor accessibility to alternative investments will continue its rise in 2020:

SEC proposal for Amending Investor Restrictions

Oft-debated restrictions for broader access to alternative investments are the accredited investor (Rule 501 of Regulation D) and the qualified institutional buyer threshold (Rule 144A of the Securities Act of 1933), which limited access to specific investment types based on subjective measures (net worth, income) and arguably objective measures (sophistication).

On December 19 of last year, the SEC proposed amendments to the definition of an accredited investor (AI) and qualified institutional buyer (QIB) with the 60-day public comment window closing on March 16.

The proposal's highlights[2]:

- Adds new categories permitting natural persons to qualify as accredited investors based on professional certifications or designations (i.e., FINRA Series 7 license).
- Add a category for investments into a private fund based on a persons status as a 'knowledgeable employee' of the fund.
- Add LLCs that meet certain criteria, registered investment advisors (RIAs) and rural business investment companies (RBICs) as entities that may qualify.
- Add a category for entities owning investments as defined in rule 2a51-1(b) of the Investment Company Act more than $5 million that was not formed for the specific purposed of investing in the securities offered.
- Add 'family offices' with at least $5 million in assets under management (AUM) and their family clients.
- Add the term 'spousal equivalent' to the accredited investor definition to allow spouses/spousal equivalents to pool their finances to qualify.

Approximately 9.86 percent of the individuals in the US meet the accredited investor requirements[3]. The remaining population is estimated to hold over $20 trillion of the private net worth in the country. Loosening the qualification requirements would theoretically allow this population to participate directly in private market investments, opening a new segment to alternative managers. The challenge, however, will be the practicality of these investors identifying these alternative investment opportunities. Given this, we believe the more significant impact of relaxed accredited investor and QIB requirements would be expanded distribution by wealth and asset management firms to their retail clients. This would provide an opportunity to grow existing wallet share through a diversified product set and offer access to new investor segments – mass, mass-affluent.

To do so in the current environment often means the arduous process to offer those that do not meet the requirement via separate or nominee accounts. Facilitating broader distribution will require operational changes for asset management firms - from client onboarding through investment policy, compliance and suitability controls.

Segregated Accounts and Investment Vehicle Structures

The SEC proposed changes to the AI/QIB rules notwithstanding, asset management firms and alternative platforms have been leveraging ways to provide broader access to investments through account types and pooled assets. While there are challenges, we believe the appeal of these for investors and the use by managers will continue to grow in 2020.

Separately Managed Accounts (SMAs) for Hedge Funds

Hedge fund investors are increasingly seeking more customized, specialized strategies via separately managed accounts (SMAs), and managers are beginning to embrace the shift, with an increasing number currently offering or planning to offer the strategy.

- **The Benefits:** Separate accounts provide a channel for meeting investor demand for hedge fund strategies and personalized offerings with greater holdings transparency and customized fee structures.

- **The Challenges:** SMAs structures typically come with lower fees, shorter lock-up periods/greater liquidity (i.e., more frequent redemptions), and additional reporting costs. They also pose a risk of cannibalization and/or fee compression to the traditional commingled structure, which generates higher fees with less overhead.

Nominee/Omnibus Accounts: Account type in which an entity legally owns the investment assets, though for the investors' beneficial ownership. The investors have all rights of ownership over the assets.

- **The Benefits:** Allows asset management firms to pool assets of multiple investors, increasing the array of investors who can gain exposure to alternative investments. End investors can benefit from a lower cost structure.

- **The Challenges:** Admin/custodian reconciliation to managers, the granularity of tax-lot tracking, redemption processing issues, etc. Regulatory considerations, limit to fund administrators that can support.

Public Real Estate Investment Trusts (REITs): Vehicles for real estate exposure available to general investors, as opposed to a private REITs typically limited to institutional investors

- Blackstone's Real Estate Income Trust (BREIT), the firm's institutional caliber private real-estate investment trust is a prominent example. The non-traded offering is targeted to income-focused individuals and carries a minimum investment of $2,500 after meeting some suitability standards - net worth of $250,000 or gross annual income of $70,000 and a net worth of $70 thousand[4], a lower hurdle than typically required for commercial real estate exposure.

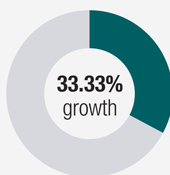
Alternative Investment Platforms

Alternative investment platforms, which provide alternative asset managers a channel to distribute products to qualified retail investors, have become increasingly more accessible and have been rapidly attracting capital. As the technologies mature – with a focus not only on client experience but on streamlining administrative, manual tasks such as onboarding, sub-doc population, client reporting – the adoption of platforms by investors seeking exposure to private investments will continue. Managers will follow the money, and antiquated concerns around exclusivity, aura, and increased transparency should dissipate as investor capital becomes available more quickly and in a more cost-effective manner. The opportunity remains large as only a small population of alternative managers has accepted capital via platforms:

The established alternative investment platforms continue to see growth, paving the way for more innovation among products and new entrants into the space.

Invested Capital

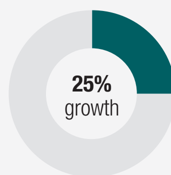
2018 2019



CAIS[1]

$8 billion plus

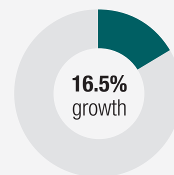
$6 billion plus



CADRE

$2.5 billion

$2 billion



iCapital[2]

$46.6 billion

$40 billion

AUA/invested capital increases

2. FROM LOW TECH TO CUTTING EDGE: INVESTMENTS IN TECHNOLOGY AND INNOVATION

Alternative investment managers have traditionally been low tech, both personnel and infrastructure. Unsurprisingly, the adoption of more advanced technologies and the boosts to both capital and performance for some of the larger alternative managers have made the benefits of embracing novel technologies clear to industry participants.

Artificial intelligence and machine learning (AI/ML)

For alternative managers, the adoption of AI/ML is driven by two critical factors. First, the increasing administrative and regulatory requirements put tremendous operational pressure on the traditionally tech-lite managers. Investments in technologies that streamline the data gathering, and investor, performance, and regulatory reporting will represent strong ROI cases. Reducing the manual process of private investments allows managers to more efficiently manage their assets and provides a path to the reduced fees for limited partners (LPs).

More valuable to managers, however, may be the use of AI/ML to improve risk modeling and diligence techniques, ultimately boost returns. Funds leveraging AI/ML have outperformed the broader ecosystem of hedge fund managers and basic systematically traded hedge funds on a three- and five-year annualized basis. Approximately 23% of systematic hedge funds launched in 2019 use AI/ML, nearly double the rate of fund launches in 2016.[5]

Applying Data

Alternative managers have come to the realization that the ability to efficiently and accurately process data has shifted from a competitive advantage to a basic requirement.

Collating and analyzing both structured and unstructured sets of data will continue to increase in importance for Alternatives Managers, in our opinion, for two use cases:

- Investment diligence: Leveraging data to more efficiently identify private investment opportunities in both novel ways (Will the management of company X or company Y be more receptive to a buy-out?) and by applying the traditional risk and return forecasting done in more liquid investments today.

- Operational efficiency/data-driven operational insights: How to harness data to improve the performance of existing investments and portfolio companies.

Forward-thinking firms are attempting to bring quantitative approaches proven successful in the public markets to private investments.

- Private equity firms are in the early stages of trying to adopt public market-type data science, a massive set of untouched data, and an opportunity to apply novel techniques. Sightway

Capital, the private equity fund of quant-hedge-fund pioneer Two Sigma, has raised $1.2B for its inaugural fund.[6] This investment shows both its general partners and its investors are placing a bet on the applicability of data-driven decisions in private markets. It's just a matter of accumulating the data.

- Blackstone has built a team of dedicated data scientists collaborating with individual business units to leverage advanced analytics and statistical modeling during the investment process and for ongoing operational improvements.[7]

The challenges are considerable – lack of available data, higher transaction costs, ambiguity in the best way to apply data. But ultimately, it is all about collecting data points, iterating on the uses. The applications will not materialize overnight. The big players have tremendous advantages in this – highly capitalized, greater leverage in structuring data access contracts – and in a field in which efficacy correlates to volume, the first movers who have already begun collecting the data points will only extend their advantage.

3. MOUNTING PRESSURE ON FUND ADMINISTRATORS AND SERVICE PROVIDERS

While the value of tech investments is clear, certain functions and tasks may prove best suited for outsourcing. And often, these managers are going to look to their existing fund administrators and third-party service providers, who bring both the understanding of the alternative products, the technology expertise, and the ability to reduce "time to market."

Unfortunately, the reality for alternative fund administrators is that they have become more of a necessary evil than a value-add partner. Twenty-five percent of alternative asset fund managers changed service providers in 2019. Twenty-three percent of changes were fund admins, 56 percent of those that changed fund administrators did so due to dissatisfaction with the quality of service, 33 percent due to costs.[8]

Fund admins will become an increasingly important participant in the data supply chain for alternative managers. And as the technology and data requirements for alternative managers continue to mature, the ability of admins to consume, manage, process and revert data to managers, and the ability to support more streamlined administrative processes such as reading and digesting legal documents and partnership agreements, credit facility covenants, investors notices in a more timely manner.

In light of newer, more nimble administrator firms such as Carta and Aduro Advisors attracting assets, we expect to see the larger incumbents be more acquisitive – think to State Street's purchase of Charles River in 2018[9], the recent partnership with iCapital[10] and SS&C'S acquisition of Algorithmics[11] – to provide a broader, more streamlined set of services to their asset management clients.

4. THE RESURGENCE OF THE HEDGE FUND ALLOCATIONS

2019 was a down year for hedge fund allocations, with $98 billion in net outflows[12]. Given the current market environment, a period of slow activity on the fund-raising front is likely. But despite both headwinds, as both the broader market and investors find their footing, the need for diversification and alpha supports the value proposition for hedge fund managers.

- Despite investors pulling capital from hedge funds, total assets under management rose about four percent to $3.3 trillion, as performance offset some of the redemption pressure.[13]

- Thirty percent of the funds raised in 2019 were for emerging managers (first-time funds). Performance, demand for alpha should continue to drive capital to these emerging managers.

- Investors will be seeking a defensive strategy. Seventy-nine percent of investors surveyed said they would allocate the same or more to hedge funds.[14] Relative value funds made up 14% of new fund launches,[15] and given the volatility in traditional investments and resulting dislocation between market prices and fundamentals the strategy should attract more assets.

    - As the extended bull market in equities loses steam and global uncertainty continues, investors will look to hedge fund exposure for a source of both alpha and non-correlation to traditional investments.

    - Private equity firms are sitting on nearly $1.5 trillion of dry powder[16], which has two implications – more competition for deals, driving valuations up, and potentially resulting in disappointing returns for investors. But near-term, this may cap the amount of capital private equity managers will seek to raise in 2020, which we anticipate will drive the unallocated assets to hedge fund strategies. The outcome of the 2020 presidential election – and the emergence of candidates with less than enthusiastic view towards the tax treatment of private equity general partners – may also result in exit activity and return of LP money.

Looking beyond 2020, we believe the traditional fund-raising process for hedge fund managers is primed for a technology solution. The common channels – investment consultants, third-party marketing firms, cap intro arms of banks – is time-consuming, expensive, and underserves emerging managers or those with less than $2 billion in AUM. There is a gap in the market for a streamlined, technology-oriented solution that connects asset allocators to fund managers more efficiently, and we expect that gap to be filled by innovative fintech providers.

IN SUMMARY

Capco anticipates 2020 and beyond to be a period of both growth and complex change for asset managers and alternative investments. Despite continued capital inflows and an increasing manager count, there will be clear winners and losers among managers, banks, fund administrators and service providers. The ability to evolve will not come without challenges, but the firms that identify opportunities and effectively execute their approach will benefit disproportionately.

REFERENCES

1. Preqin. Dry Powder & AUM - Assets Under Management Breakdown
   https://pro.preqin.com/analysis/dryPowderAUMBreakdown
2. U.S. Securities & Exchange Commission. Press Release 2019-265, "SEC Proposes to Update Accredited Investor Definition to Increase Access to Investments"
   https://www.sec.gov/news/press-release/2019-265#
3. https://dqydj.com/accredited-investors-in-america/
4. Blackstone Real Estate Income Trust, Inc. Supplement No. 4 Dated March 20, 2020 to the Prospectus Dated January 4, 2019
   1 https://www.caisgroup.com/about/fast-facts/
   2 https://www.icapitalnetwork.com/newsroom/press-releases/icapital-network-platform-assets-experience-expansive-growth-in-2019/
5. Preqin. Alternatives in 2020
   https://docs.preqin.com/reports/Preqin-Alternatives-in-2020-Report.pdf
6. https://www.prnewswire.com/news-releases/two-sigmas-private-equity-business-closes-on-1-2-billion-in-commitments-300963426.html
7. Sarah Butcher, eFinancial Careers. How Blackstone Uses Data Scientists to Win Deals. February 2020.
   https://news.efinancialcareers.com/us-en/3003126/data-science-jobs-private-equity
8. Preqin. Prequin Special Report: Service Providors in Alternative Assets. December 2019
   https://docs.preqin.com/reports/Preqin-Special-Report-Service-Providers-in-Alternative-Assets-December-2019.pdf
9. https://newsroom.statestreet.com/press-release/corporate/state-street-acquire-charles-river-development-26-billion
10. https://newsroom.statestreet.com/press-release/state-street-announces-new-partnership-icapital-network
11. https://investor.ssctech.com/investor-relations/press-releases/press-release-details/2019/SSC-Completes-Acquisition-of-Algorithmics/default.aspx
12. eVestment. December/Year-End 2019 eVestment Hedge Fund Asset Flows Report
13. eVestment. December/Year-End 2019 eVestment Hedge Fund Asset Flows Report
14. Preqin. Alternatives in 2020
    https://docs.preqin.com/reports/Preqin-Alternatives-in-2020-Report.pdf
15. Preqin. Alternatives in 2020
    https://docs.preqin.com/reports/Preqin-Alternatives-in-2020-Report.pdf
16. Preqin. Dry Powder & AUM - Assets Under Management Breakdown
    https://pro.preqin.com/analysis/dryPowderAUMBreakdown

AUTHOR

Max Mauro, Principal Consultant

ABOUT CAPCO

Capco is a global technology and management consultancy dedicated to the financial services industry. Our professionals combine innovative thinking with unrivalled industry knowledge to offer our clients consulting expertise, complex technology and package integration, transformation delivery, and managed services, to move their organizations forward.

Through our collaborative and efficient approach, we help our clients successfully innovate, increase revenue, manage risk and regulatory change, reduce costs, and enhance controls. We specialize primarily in banking, capital markets, wealth and asset management and insurance. We also have an energy consulting practice in the US. We serve our clients from offices in leading financial centers across the Americas, Europe, and Asia Pacific.

To learn more, visit our web site at **www.capco.com**, or follow us on Twitter, Facebook, YouTube, LinkedIn and Instagram.

WORLDWIDE OFFICES

APAC
Bangalore
Bangkok
Hong Kong
Kuala Lumpur
Pune
Singapore

EUROPE
Bratislava
Brussels
Dusseldorf
Edinburgh
Frankfurt
Geneva
London
Paris
Vienna
Warsaw
Zurich

NORTH AMERICA
Charlotte
Chicago
Dallas
Houston
New York
Orlando
Toronto
Tysons Corner
Washington, DC

SOUTH AMERICA
São Paulo

WWW.CAPCO.COM

© 2020 The Capital Markets Company. All rights reserved.

CAPCO
THE FUTURE. NOW.