



NORTHERN  
TRUST

# FROM PRESSURE COMES DIAMONDS

How industry forces will give way to a new level  
of maturity for alternative assets





When a diamond is formed, carbon atoms come under high temperatures and crushing pressure, fall into efficient alignment, and ultimately give way to a valuable gemstone and one of the hardest naturally occurring substances.

In some ways, the alternative fund industry is going through a similar process. Capital continues to flow in from a wider array of sources, increasing pressure on how managers realize returns and meet the demands of their investors.

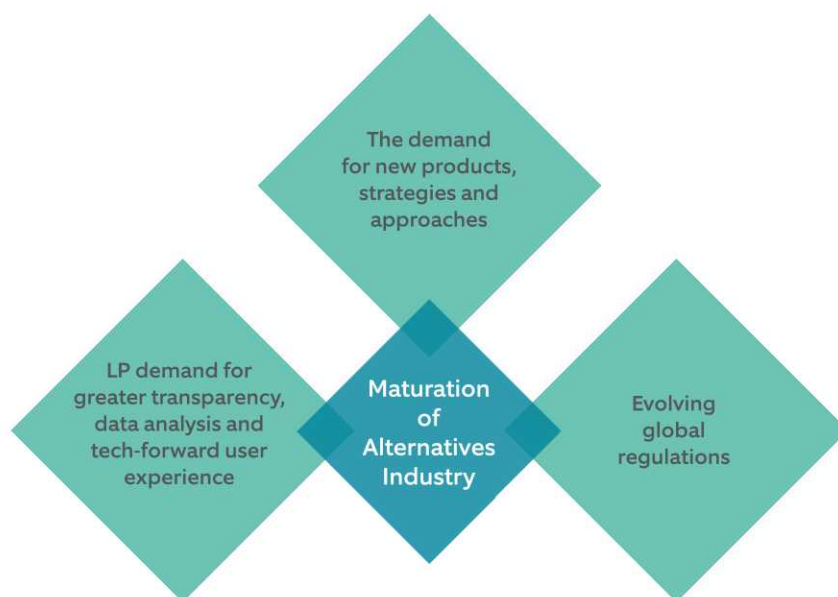
The industry itself has already come a long way in a relatively short period of time. In earlier days, specialist fund managers leaned into distributing their products to a small group of sophisticated investors prepared to make a modest fixed term investment. Fast forward to today, and projections indicate that the alternative asset industry will grow from \$10.7 trillion to some \$17 trillion by 2025<sup>1</sup>, despite a temporary slowdown caused by COVID-19, with private capital (primarily private equity and private debt strategies) expected to lead the way. Asia-Pacific is predicted to grow particularly fast, with a forecasted compound annual growth ratio (CAGR) of 25.5% over the next four years – more than twice the forecasted global rate of 9.8%.<sup>2</sup>

It's important to remember that these investment tailwinds come with the expectation of returns, and from a more diverse population of limited partners. The premium on capturing alpha is going up, with a two-sided cost impact of spending capital to support new strategies, and a rising cost of providing investors a compelling and transparent experience. Alternative asset managers' response to these forces will determine when and how the industry evolves. Will they rise to the challenge of these pressures? And will we see a shinier, more aligned, more mature alternatives sector emerge on the other side?

## UNDERSTANDING ALTERNATIVES' CURRENT FORMATIVE PRESSURES

Growing capital inflows and a larger, more diverse investor base create the needed conditions for the alternatives industry to mature. As discussed, demand for alternative assets is growing – institutional investors' allocations to alternatives sit between 20% to 25% with private capital receiving a greater share.<sup>3</sup>

But more than just experiencing the right conditions, managers must feel the push to follow through in their practices to actually realize industry maturation. Regulators, a broadening alternative asset investor base, and the increasing congestion of the manager landscape are all applying different categories of pressure.



### 1. New products, strategies and distribution opportunities

Cash is flowing into alternative investments at a record rate, and the field is becoming increasingly crowded with new private fund launches and opportunities. From 2010 to 2020, the number of private equity funds roughly doubled.<sup>4</sup> Though hedge funds had a shakeout in 2020 as the first-quarter market drop was the fatal blow to many already-underperforming funds, the sector has seen healthy performance since, and the conditions should be improved for hedge fund startups this year.

<sup>3</sup> EY, Global Alternative Fund Survey 2020, [https://assets.ey.com/content/dam/ey-sites/ey-com/en\\_gl/topics/wealth-and-asset-management/ey-in-times-of-change-does-accelerated-adaptation-present-obstacles-or-opportunities-v2.pdf?download](https://assets.ey.com/content/dam/ey-sites/ey-com/en_gl/topics/wealth-and-asset-management/ey-in-times-of-change-does-accelerated-adaptation-present-obstacles-or-opportunities-v2.pdf?download)

<sup>4</sup> McKinsey & Company, "A new decade for private markets", 2020, <https://www.mckinsey.com/~media/McKinsey/Industries/Private%20Equity%20and%20Principal%20Investors/Our%20Insights/McKinseys%20Private%20Markets%20Annual%20Review/McKinsey-Global-Private-Markets-Review-2020-v4.pdf>



To cut through the clutter and stand out to limited partners (LPs), general partners (GPs) are turning to emerging investment and distribution strategies. But the quest to set oneself apart comes with its own challenges surrounding one's existing investor base. If managers choose to engage with any of these alternative investing trends, they'll have to be prepared to communicate with their original investors about their plans – assuring them that new products, funds, or distribution strategies won't take away attention and resources from their original approaches.

## THE EMERGING TRENDS SHAPING MANAGERS' PRODUCTS, STRATEGIES AND DISTRIBUTION DECISIONS

### TRANSITIONS TO HYBRID ALTERNATIVE STRATEGIES

As some alternative asset managers encounter the pressure of an increasingly crowded market, many have eyed a hybrid approach as a way to differentiate themselves to investors.

Many pure-play hedge funds have expanded into closed-end private structures – private equity being the most predominant, alongside private debt, real estate and infrastructure. For many hedge fund managers, this serves as a hedge against the performance of the hedge fund industry itself, which has been outperformed by the S&P 500 for the vast majority of the past decade. Meanwhile, institutional investors' allocations to private equity have grown to 26% in 2019 and 2020, up from 18% in 2018.<sup>5</sup> On the pure-play private equity side, some shops are exploring open-ended fund structures, but the inherent imbalance of portfolio versus investor liquidity is a persistent challenge.

The journey to a new alternative investment strategy is neither quick nor simple. As managers try their hand at new alternatives strategies in order to stand out from the pack, they must have a clear path forward, the right expertise, and a plan to transparently communicate the change with their existing investors.

### THE RISE OF SPACS

Special purpose acquisition companies, or SPACs, are blank check companies that exist solely to raise capital from investors. These publicly listed SPACs sell shares and hold investors' money over the course of two years, during which they must acquire another company or return the capital at the end of the period. As their use has trended upward recently, they've begun to compete for GPs' time and resources, while also adding to their exit options for investments.

SPACs originated in the 1990s but skyrocketed in popularity in 2020. In 2016, SPAC IPOs raised \$3.5 billion, while in 2020 SPAC IPOs raised \$66 billion – making up nearly half of the U.S.'s 2020 IPO activity.<sup>6</sup> This SPAC boom was brought on by pandemic-fueled volatility in public markets. GPs saw opportunity in opening SPACs and merging with companies while markets were down, knowing that if the acquired company can make it through the pandemic, they'd see impressive returns over time.

However, this investment vehicle poses key risks and concerns for managers and their investors. If a long-time private equity manager decides to foray into the SPAC space, it could encounter a learning curve when it comes to shareholder relations if it's accustomed to communicating only with experienced institutional investors on the private market side.

Managers who choose to build out a SPAC offering while maintaining their traditional alternative assets will also have to consider how to provide transparency to their investors about the returns and benefits of the SPAC's operations, as well as the manager's time and priorities. If they fail to keep their alternative asset investors in the loop with their new SPAC ventures, they may risk losing goodwill or alienating their broader investor base.

<sup>5</sup> EY, "2020 Global Alternative Fund Survey", [https://www.ey.com/en\\_gl/wealth-asset-management/does-accelerating-adaptation-present-obstacles-or-increase-opportunities](https://www.ey.com/en_gl/wealth-asset-management/does-accelerating-adaptation-present-obstacles-or-increase-opportunities).

<sup>6</sup> SPAC Analytics, 2020, <https://www.spacanalytics.com/>

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## A GROWING EMBRACE OF SECONDARY MARKET TRANSACTIONS

With more and more capital injected into the private capital sector leading to a greater number of deals occurring, the secondary market will continue to see increased activity. This is further egged on by GPs' and LPs' growing motivation to actively manage their alternative investment portfolios, making the secondary market more attractive and inviting to more investors, as well as by spikes in demand for liquidity brought on by managers seeking additional exit options during the pandemic.

As the secondary market becomes more active simply due to a broader shift toward private capital investing and a desire to actively manage their illiquid portfolios, the industry has seen an embrace of specialist secondary fund strategies, as well as an absence of exits occurring at significant discounts.

To a smaller yet still significant degree, managers' desire for longer holding periods while needing to give original investors liquidity within the fund's legal life also drives secondary market activity. This gives way to more special purpose acquisition secondary transactions where GPs will team up with large LPs and purchase a holding out of its original fund and offer existing fund investors the choice of liquidity or rolling their investment over into the new vehicle.

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## EXPANDED DISTRIBUTION WITH U.S. DEFINED CONTRIBUTION PLANS

In June 2020, the U.S. Department of Labor issued a communication clarifying the use of private equity assets in DC plans. The DOL concluded that a "plan fiduciary would not, in the view of the Department, violate the fiduciary's duties under section 403 and 404 of ERISA solely because the fiduciary offers a professionally managed asset allocation fund with a private equity component as a designated investment alternative for an ERISA covered individual account plan in the manner described in this letter."<sup>7</sup>

Outside of the U.S., other countries have long embraced the addition of alternative assets in retirement plans. Australia, for instance, has widely embraced alternatives for superannuation plans, particularly for large sponsors with a high employee count, offering risk tolerance needed for illiquid assets. And on both of the core challenges of alternatives in DC plans – frequent valuation and liquidity – Australian superannuation plans have found a way to work with alternative asset managers.

However, until now, the U.S. had not received clear direction on including alternative assets in DC plans, and the DOL's communication could open alternatives to a new market of investors. It is important to note this will be a slow and steady journey – not an opening of the floodgates. Building new and complex investment options into DC plans often falls to HR professionals, unlike DB plans which are almost solely overseen by experienced investment professionals. With this new kind of target audience, managers will have to finetune their strategy, partners, sales approaches and communication style if they want to be involved in this market.

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<sup>7</sup> U.S. Department of Labor, "U.S. Department of Labor Issues Information Letter on Private Equity Investments", June 3 2020, <https://www.dol.gov/newsroom/releases/ebsa/ebsa20200603-0>



As investor allocations to private capital increase so do LPs' appetites to gain greater insight and visibility into their GPs' investment processes and operations.

## 2. Elevated expectations for the LP experience

As investor allocations to private capital increase so do LPs' appetites to gain greater insight and visibility into their GPs' investment processes and operations.

This trend has been led by larger LPs who have requested customized processes and specific accommodations. In turn, this has resulted in more segregated mandates, carve outs and side pockets, parallel investments, side letters with different terms, and joint ventures for large LPs, along with more complexity for GP operations. As large investors seek greater customization, GPs are often managing LP relations approaches as they go, creating multiple service models, varying expectations, and increasing difficulty in tracking and reporting systemically.

The industry is also still figuring out how to meet LPs' transparency expectations. Due to a lack of well-defined standard reporting and analytics practices within the private capital industry, data portability and asset class comparability within their portfolios can become a significant challenge for LPs. Fintech vendors have identified this opportunity and are developing solutions that lean on artificial intelligence (AI) and machine learning to help LPs pull transparency data from GP statements. While this removes the pressure from GPs to some degree, it also highlights the opportunity they face to better anticipate their LPs' needs.

Ultimately, investors are seeking the kind of investment experience we're all accustomed to as consumers – rather than relying on quarterly or monthly statements per individual fund, they want to be able to log in to a digital platform and quickly see a real-time view of their portfolio of alternative investments, as well as perform their own analysis within the same tool. In addition, they seek more standardized, consumable and combinable reporting to help them paint a clearer picture of their entire portfolios, liquid and alternative investments alike. As a result, managers face the opportunity to anticipate these LP needs and equip their back-office operations with robust investor-facing technology that meets these needs.

## 3. Regulatory evolution

At the same time, increasing regulation, as well as greater scrutiny as the industry grows, means more attention and focus must go to governance and compliance. Managers need good resources to help with objectives such as:

- Going global (opening funds in different domiciles or regions, with the attendant regulation that follows).
- Adapting to new strategies as they expand their investments to incorporate opportunities like private debt or distressed assets.
- Complying with privacy, anti-money laundering/know your client, registration and other laws in their chosen domiciles.
- Staying current with new and existing local and regional regulations that are increasingly applied to the alternatives industry.

Financial centers are actively developing their legal and regulatory framework to build competitive advantage while adopting international best practices.

Recent global developments indicate a growing focus on private capital and a drive to build a flexible but well-governed regulatory framework which gives managers and investors the requisite information and protection. This is no longer a niche market for a few sophisticated participants – it is realigning to a much broader community of investors and a deeper product set.

ASIA PACIFIC	EUROPE	NORTH AMERICA
<ul style="list-style-type: none"> <li>Variable Capital Companies framework was introduced in Singapore at the beginning of 2020 which is already starting to be used by private capital managers.</li> <li>The Hong Kong Limited Partnership Fund bill – which is attractive as a flexible private fund structure and offers a competitive alternative to other locations – was passed in July 2020 and took effect August 2020.</li> <li>The region is actively exploring passporting whereby funds based in one jurisdiction can be actively promoted in other participating countries similar to that in place in the EU.</li> </ul>	<ul style="list-style-type: none"> <li>Luxembourg has seen significant success from the flexible Reserved Alternative Investment Fund regulation for private capital managers which was launched in 2016 and is now well established for private capital funds.</li> <li>Ireland has enacted the Investment Limited Partnerships (Amendment) Bill 2020 which paves the way for significant growth across Ireland's private equity infrastructure, renewables and real estate offerings.</li> <li>The UK regulator has introduced new rules governing funds which invest in inherently illiquid assets ("FIILAs") designed to reassure investors and aligned to private capital and real estate.</li> <li>Guernsey's Private Investment Fund (PIF) regime introduced in 2016 offers an expedited route to market for eligible funds and is set to be enhanced with two new models, removing the requirement for manager involvement.</li> </ul>	<ul style="list-style-type: none"> <li>U.S. defined contribution plans take a step toward welcoming alternative investments thanks to a Department of Labor communication. While it will still be a slow and steady journey, managers interested in making their funds available to retail investors through DC plans will have to plot out their transparency measures carefully to comply with standards necessary in DC plans.</li> <li>Cayman introduced a dedicated private funds law which requires new registration and ongoing oversight obligations which include asset verification and cash monitoring.</li> </ul>



As investors push for greater and more frequent insight into the performance of their investments, holistic data management is a crucial dimension that managers have the opportunity to master.

## NAVIGATING THE EVOLVING WORLD OF ALTERNATIVES

While industry pressures, such as launching new strategies, improving transparency and complying with evolving regulations have the potential to bring alternatives to the next level as an asset class, managers must rise to the occasion if they want to reap the rewards. Doing so requires a unique approach for each exerted force.

As alternative asset managers continue to navigate their rapidly changing industry, they can look to these fronts in honing the best strategy for their own firm:

- **Technology**

As investors push for greater and more frequent insight into the performance of their investments, holistic data management is a crucial dimension that managers have the opportunity to master. They should focus on extending the lens beyond just portfolios and deals to also report on treasury, financing, portfolio management, and balance sheet and cash optimization activities – making an effort to include exposures across countries, sectors, and even financing counterparties. Capturing and utilizing this kind of data equips them to make more educated investment and operational decisions, ultimately increasing fund performance.

Organization, management and communication of this data also helps to keep LPs in the know as they seek a more complete picture of how the GP manages their capital, and how that fits in with their larger portfolio and investment strategy. Blockchain and distributed ledger technology (DLT) presents rich opportunity for managers to achieve the levels of transparency and data insight that LPs increasingly seek. Maintaining a single interface that is updated in real time can create an eased investor experience for a highly manual asset class. Northern Trust has already entered the blockchain waters by developing a private equity-targeted blockchain solution to guide certain fund administration elements, such as the capital call process.<sup>8</sup>

To achieve this standard of data management and the investor experience, managers may choose to seek a technology partner with cloud-based capabilities, making way for a smooth onboarding compared to the experience of building a custom tool. Technology should be flexible and comprehensive, covering not only the investments, but the entire process of managing a fund, such as cash and securities movement from several source banks and communications with the investors. An effective and accessible API library will form an important part of this framework, allowing managers to easily move data from one source to another with little or no bespoke programming.

<sup>8</sup> Wall Street Journal, "Northern Trust Deploys Blockchain for Private Equity", February 23 2017, <https://www.wsj.com/articles/BL-CIOB-11538>



- **Effective governance**

Compliance with legal and regulatory obligations continues to be an essential requirement which needs to be carefully discharged by suitably qualified individuals. Stakeholder management and oversight is an ongoing challenge to ensure all parties are aligned, and that decision makers are equipped with accurate and timely data to manage both risk and performance.

Tying back to the theme of technology, emerging regtech tools will make their mark on managers' governance efforts. AI tools on the market can do the tedious work – which previously fell to human teams – of sifting through unstructured data such as regulatory text, flagging instances to human teams when a compliance action may be needed. AI also has the potential to monitor the cash movements of a fund and flag suspicious requests or activity that could be fraudulent.

Demand for environmental, social and corporate governance (ESG) information and metrics covering sustainable investing is set to grow with Europe taking a lead. Regulators are rolling out new disclosure requirements with detail about how to classify and measure different sustainability criteria such as climate change, pollution and biodiversity. This will impact the alternative asset investment community and drive a need for governance models to embrace not just financial performance and risk, but broader considerations of impact on social and environmental ecosystems.

The right partners should be able to assist with effective governance in multiple domiciles, as well as complementary products and services, including the European requirement for Depositary services or governance support services, to manage the shifting regulatory landscape for an expanding firm.



- **Expert guidance**

The pressures managers face warrant big operational and strategy decisions, and left to navigate them on their own, managers risk losing sight of their original strategy and alpha-generating opportunities promised to their core investors by focusing on non-alpha generating activities.

A third-party asset service firm with a bird's eye view of all factors making up the private capital space – market trends, regulations, emerging tech and more – can be a crucial strategic partner. As a valuable team member, administrators can help provide key insights and guidance as managers make their decisions, including whether to offer a new class of products, how to inform and educate investors on their alternative investing options, and how to go about investing in technology to support their systems. The technology front in particular is expensive and time consuming and has benefits of scale when done by an administrator rather than individual firms.

Ideally, the right partner can offer bundled services, allowing the manager to liaise with only one or a few teams that have the full picture of their operations, providing the benefit of increased communication efficiencies and more holistic guidance. When a partner knows all facets of a manager's business, they're better able to anticipate client needs.





## MAPPING THE FUTURE OF ALTERNATIVES

The alternatives industry is at an inflection point. Demand is growing, and the alternative space has never been so attractive to investors – or to managers. As money continues to pour into the industry, managers are running into stiff competition in an increasingly saturated GP field. Regulation continues to adapt to police the potential risks to investors. Data poses challenges since alpha is premised on the protection of sensitive information, and technology is beginning to drive its own change agenda with blockchain architecture leading a rethink of the digital financial services landscape.

If alternative asset managers want to rise above the noise in attracting investors, they should focus not only on returns. When embarking on a new strategy, such as opening a SPAC or making their funds available to DC plan participants, investor communication is particularly important. Managers will need to be open and transparent about their investment strategy and plans, and will need systems and processes in place to communicate that to their core clients. Top-tier reporting and data has grown in importance to investors, and managers need to be equipped to meet these data needs with their technology, expertise and governance abilities.

This trifecta of returns, reporting and communication is more in demand than ever as investors seek out their target returns and the context to make educated investment decisions. Some managers will choose to implement their own homegrown solutions to achieve this trifecta, but for those who don't have the resources, time, and expertise – or who prefer to avoid such an investment – outsourcing these needs to industry partners is an appealing path.

As Thomas Carlyle, the 19th century historian and philosopher, once noted, “No pressure, no diamonds.” These forces will continue to change the shape of the alternatives industry, creating challenges, tough strategic decisions, and moments of doubt for managers. But as they rise to the occasion and create the optimal alternative investing experience that investors seek, they will push the industry into a new level of maturity to all parties' benefit.



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