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MARKET INSIGHT

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Liquid Alternative Investment Solutions

The recent development of liquid alternative funds is a positive for investors who want to benefit from hedge fund returns while maintaining the option of quickly accessing capital.

Following the widespread gating, suspension, and funds under liquidation during and after the 2008 credit crunch, investors in hedge funds expressed a strong need for favorable liquidity terms. For an increasing number of investors, the return benefit of holding illiquid assets is often outpaced by the need of quickly accessing capital during periods of uncertainty. While in the US, and especially for institutional investors, quarterly redemption frequency for hedge funds is generally accepted, European investors are more selective and focus on the fact that redemption terms offered by any particular hedge fund are in line with the liquidity of the underlying assets.

For many years hedge funds have been marketed on their ability to protect capital and deliver uncorrelated returns to broad market indices, especially by operating trading strategies in less liquid markets which tend to return more than plain vanilla liquid assets. Considering various surveys and depending on the strategy followed, returns of liquid alternative funds are estimated to be ranging from 0% to 3% lower than those of traditional hedge fund vehicles. Given that the world is now going through a period of zero interest rate policy globally and that market direction is still dictated by interventions from political and monetary authorities, investors are more willing to accept a slight performance discount in exchange of a better liquidity profile for their investment that is a closer match to their preferences. In this configuration, a number of alternative risk premium such as the ones extracted from holding or trading illiquid assets might not be available anymore. However, the universe of trading strategies in a liquid format remains extremely diversified and attractive. Also, talented hedge fund managers will always have the ability to extract alpha in liquid markets through sophisticated trading strategies.

Initially, the demand for liquid alternatives has been driven by private banks as they were significantly impacted in the aftermath of the 2008 crisis and consequently they were looking for a different way to implement their hedge fund allocation. As of today, private banks and asset managers are still the largest participants in this field but we are seeing an increasing number of institutions that are in need to have the option of making allocation shifts swiftly.

Market analysis

« The number of tools available to create bespoke liquid alternatives is constantly increasing and liquid alternatives are now a viable long-term option »

Hasan Aslan
Co-manager of the Reyl Resurgence fund & co-head of alternative funds investment research, selection and advisory at REYL & CIE.

One of the reasons is that accommodative monetary policies across the globe have dramatically reduced yields on risky assets and a number of large institutions and pensions are currently struggling to meet their obligations. In this context, hedge funds as an asset class represent a valid value proposition and the liquid format of hedge funds has become more attractive.

From a regulatory standpoint, the advent of Newcits, AIFMD in Europe and the 40 Act in the United States, has created a framework that will continue to drive the instutionalization of alternative investment vehicles to broaden their distribution channels. We believe this is a clear inflection point toward the harmonization of the offering that will obviously benefit both retail and institutional investors. This trend to harmonize alternative investments has also a strong impact on the liquidity offered. Managers who want to tap into this new source of capital are taking the opportunity to adjust the liquidity of their funds in order to increase their distribution channels and reach a larger audience.

Banks and large asset managers have quickly understood that there was an opportunity in fulfilling this demand for liquid alternatives. Since 2009, we have seen an increasing number of players in the managed account platform field, replication products, and Newcits providers answering the liquidity issue. The number of tools available to create bespoke liquid alternatives is constantly increasing and liquid alternatives are now a viable long-term option.

The UCITS universe combined with the managed account platforms has considerably increased in size, both in terms of number of funds and assets under management. Therefore, it has become realistic today to offer a diversified liquid fund of hedge funds as opposed to the pre-crisis period. Except for a number of strategies such as distressed investing, structured credit, and infrastructure investing, all other strategies are well represented within the liquid hedge fund space. We estimate the number of alternative UCITS funds and managed accounts to be over 1,000 today. Moreover, investors could also benefit from the use of replication products in order to beef up the allocation to a specific strategy.

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Nicolas Roth
Co-manager of the Reyl Resurgence fund & co-head of alternative funds investment research, selection and advisory at REYL & CIE.

Despite the strong growth experienced recently, alternative UCITS funds still represent a small portion of the hedge fund industry, estimated between 7% and 10% of the universe. In the coming years, we expect this figure to further increase as UCITS-compliant hedge funds are gaining traction, not only in Europe but in other regions of the world as well. The regulated, liquid, and transparent characteristics of UCITS funds are well suited for retail investors. It is worth noting that traditional hedge fund allocators have also started to pay attention to it. For investors such as pension funds, the issue remains the size of alternative UCITS funds universe and particularly the absence of certain strategies in this format.

For the same reasons, in the aftermath of the financial crisis, managed accounts went through a surge in interest from institutional investors. Practically, investors are placing a large ticket with a hedge fund and asking the manager to run a separate account pari passu with the pooled investment vehicle in exchange of lower management and performance fees. As the hedge fund manager is not constrained to apply an additional layer of operational oversight on the separate account, the manager is often accepting a reduction in the level of fees.

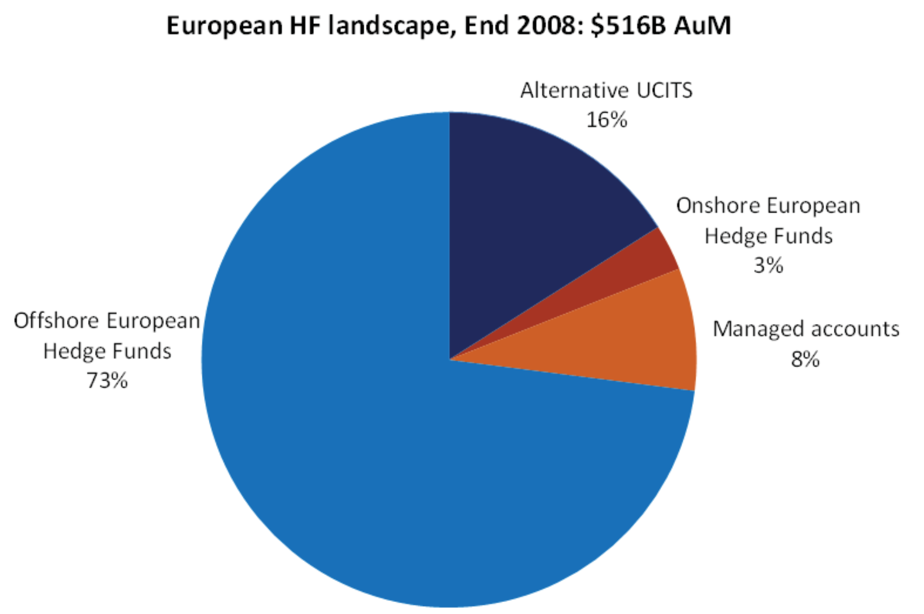
A number of significant factors need to be taken into account before diving into the offering of liquid alternatives in order to secure success. Firstly, a robust operational setup as well as long standing relationships with all service providers will be determinant in the management of liquid alternative vehicles. Secondly, liquid alternatives may give the dangerous impression of commoditized investments. Investing in hedge funds, being an offshore structure or a fund available on a managed account platform, require a tremendous amount of due diligence and a rigorous analysis on all aspects of the investment, from the operations to a deep understanding of the trading strategy. Furthermore, when an investment is made via a managed account platform, one cannot neglect the due diligence to be performed on the provider of the account in order to fully assess all operational risks.

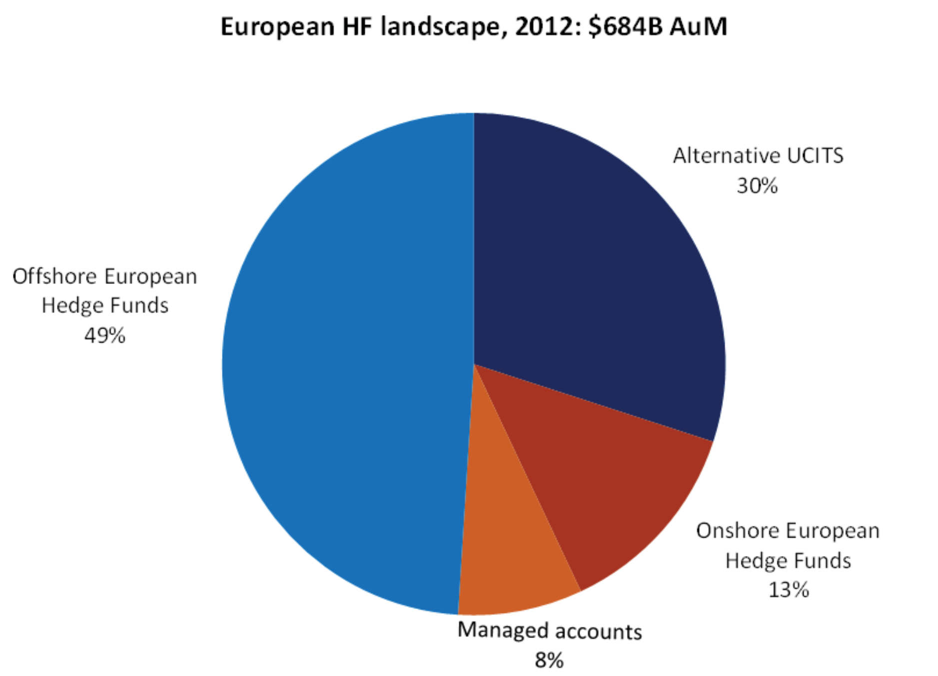
Market analysis

« Despite being long-term investors by definition, a number of pension funds have started to hold liquid alternative funds in order to be flexible »

Employing a thorough and proven due diligence process, leveraging knowledge, and ultimately having the ability to construct portfolios suited to navigate the current market conditions will be the most relevant factors to build a successful franchise in the liquid alternative space.

In summary, the institutionalization of hedge funds is bringing a number of positive elements to the table and, via the advent of alternative UCITS funds and managed account platforms, solving the liquidity puzzle of investors. Obviously, some strategies of the alternative investment space such as distressed investing or infrastructure investing in the private equity form are hardly suited to be replicated in a liquid format and will remain available for investors able to deal with longer lock-up periods. As of today, the means of gaining access to hedge fund returns has increased and besides traditional funds of hedge funds, we believe that the tools are now available to create liquid alternative investment funds that meet the highest standards in terms of operational setup, risk management, transparency, and liquidity. We continue to believe that traditional alternative investments and liquid alternative investments are not meant to cannibalize each other but are rather designed to live next to each other, answering the different liquidity preferences and giving investors access to different sources of risk premium.





Source: Citi Prime Finance analysis based on HFI Eurohedge, HFM Week, Strategic Insight data

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