SEMI-LIQUID PRIVATE MARKETS FUNDS

A RIDDLE, WRAPPED IN A MYSTERY, INSIDE AN ENIGMA?

THE HUBBIS TEAM INVESTIGATES

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INTRODUCTION

The world of private markets is rapidly evolving, ushering in fresh, innovative fund structures tailored for a broader compendium of investor appetites and profiles. Recently, industry titans have rolled out "semi-liquid" offerings – a tantalizing, hybrid private markets offering, combining illiquid long-term asset classes with the allure of liquidity. Nevertheless, they are a puzzle, often leaving even seasoned Asian investors scratching their heads. How can one combine liquidity with an illiquid asset class to provide an effective investment outcome for investors?

In this article, the Hubbis Team takes a look into the world of Private Markets and attempts to decode the allure of these products. Are they the real deal, or just a glimmering mirage, even a Sirens call? Let's find out.

» Private Markets – The Value Proposition

For institutional and high net worth investors, access to private markets has been a pre-requisite of efficient portfolio theory since the asset class gained full recognition under the auspices of David Swensen who created "The Yale Model" which evolved into the "Endowment Model" of asset allocation.

For the investor with a long-term investment horizon, the optimisation of the risk premia to allocate a portion of one's assets to a strategy which can benefit from the term premium (which in itself represents the illiquidity premium) is attractive, and makes sense for investors who have sufficient capital and income to meet their short to medium term needs.

The key therefore to private markets asset allocation is that the investor understands the illiquidity associated with the investment and ensures that the asset allocation to this asset class is in proportion to their overall liquidity needs.

For this reason, the private markets asset class has to date been the purview of institutional and high net worth investors who are able to allocate long-term capital and have sufficient alternative sources of liquidity.

What's the proposition?

The private markets industry is an industry associated with high-margin and thus very profitable products. Arguably this margin is the "cost premium" paid by investors to access the expertise necessary to generate excess returns from the term premium associated with private markets.

Clearly, this cost premium needs to be offset by the term premium for a net positive outcome, in addition to which this needs to outperform more traditional asset classes, such as equity exposure to (say) the MSCI World Index.

The introduction of semi-liquid funds appears to be an attempt to attract investors who wish to have exposure to the term premium upside whilst helping them to manage their liquidity needs and manage the challenge of the capital call structure. This indicates that the funds are trying to attract investment capital from investors who do not have a solid liquidity situation. This of course raises an additional question, such that if a client would conservatively allocate (say) 10% of their investments to private equity, then surely they should have plenty of liquidity elsewhere?

Notwithstanding that, the essence of these funds is that they appear to reflect a product designed to be attractive to a new client segment of investors, and thus a substantial source of additional capital which could be attracted to the asset class. Institutional investors are taken care of, high net worth investors are taken care of, and now the trend is towards the next segment, the mass affluent.

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The basis of the proposition appears to be magnanimous, a democratization of an asset class to allow a broader selection of investors to gain exposure. Sounds good, and conceptually makes sense. The challenge, however, is to translate this concept into a product which can transfer that term premium upside to the investor whilst ostensibly getting involved in the investor's cash management needs – and not least that a relatively unsophisticated mass affluent investor can understand it all. This is where the execution of the concept looks problematic – let's look under the hood and examine the challenges.

The Challenges

With the aim of a semi-liquid private markets fund being just that (i.e. long only access to private markets), how can it provide value to the investor. The following points illustrate the challenge, and are derived from looking "under the hood" of the semi-liquid private equity fund of a leading asset manager with over USD1 billion in assets under management in the fund:

» **1.** Firstly, in order to provide the "semi-liquidity," the product needs to incorporate a liquid component. This liquid component has to incorporate a variety of components in order to provide the desired liquidity to support capital calls as well as funding net liquidity needs of investors. The result is that approximately 75% of the fund's assets are invested in various (private equity focused) limited partnerships, fund structures and certificates, whilst nearly 25% is retained in transferable securities and money market funds in order to provide the desired liquidity (both to fund capital calls as well as potential investor net redemptions).

» **2.** If up to 25% of the fund is invested in transferable securities and money market funds, the chances of the fund providing private equity type returns is almost impossible to achieve. In effect the desire to create an attractive solution to accessing an asset class appears to be destroyed by the method in which it is achieved.

» **3.** The costs involved in the structure then has to be assessed and how this drag is likely to affect the total return. As with most fund of funds the picture is not encouraging. Total expenses of the fund (at the fund level) amount to approximately 175 basis points for the last year, and this on a USD1 billion fund. This expense then of course is allocated differently, dependent on the share class, with the mass affluent focused share classes illustrating a total expense ratio of just under 250 basis points, with the opportunity for an up to 3% up front charge as well. In addition, investors will need to consider the additional layer of costs associated with the underlying LLPs, funds and certificates, and without doing a dive into the next level there will almost certainly be further layers. So, if one incorporates the underlying fund fees (which will incorporate management fees, custody and administration fees and carried interest costs etc.), the cost drag starts to accelerate rapidly, particularly for the mass affluent investor who appears to be the target of the fund.

» **4.** In conjunction with the drag on performance with costs, if a share class is incurring up to 250 basis points in costs, and approximately 25% of the fund is invested in transferable securities and money market funds, then that is a very expensive way to hold liquidity.

» **5.** Pricing - A semi-liquid fund has to be an open-ended fund by default. The problem of course with an open-ended fund is the challenge of arriving at a net asset value calculation in order to price the shares/units in the fund. When the underlying assets are exchange traded with daily pricing, that is not a problem, but when your underlying asset is a portfolio of illiquid private markets funds, then it is impossible to get a true statement of the value. With a closed ended fund this is not a problem, but with an open-ended fund the pricing of the NAV will be a fiction based on the asset manager and custodian agreeing a valuation methodology which simply cannot be accurate, and in which there is a potential conflict of interest to adopt a methodology which favors the upside of the fund which provides a benefit to both the asset manager and custodian.

» **6.** Finally, the age-old problem of attracting what may be short-term liquidity to a long-term investment, creates its own challenges. As we have seen with open-ended fund structures accessing illiquid investments, if investors all want to exit at the same time, there is a danger of the fund being gated. Perhaps this is why the fund has such a high allocation to its liquidity component, but nevertheless the risk is there, and this high allocation changes the entire dynamics of the investment and asset class exposure.

Fitting a Square Peg into a Round Hole

As a wealth manager, advisor or fiduciary, the duty to one's client is to assess the risk and reward of an investment product and how that product can complement a client's strategic asset allocation objectives and long-term investment outcome.

Whilst it is generally accepted that private markets as an asset class can provide the opportunity for superior risk adjusted returns for investors over time, the question that must be asked is when does a round peg become a square peg i.e. when is an asset class so manipulated that it is no longer representative of the asset class?

For institutional and high net worth investors who have the resources and ability to invest directly into institutionally priced vehicles or directly, then the private markets asset class can provide a compelling choice for some assets. However, it is arguable given the above factors, that if one does not have this ability or resource, then the attempt to create a semi-liquid product out of an illiquid asset class turns the Prince into a frog, and does not provide the exposure intended or sort.

The Benefits in Private Markets (PM)

1. A key feature for the asset class is the diversification benefits when constructing an investor's strategic asset allocation (SAA) which reflects an investor's target return and volatility tolerance. The trade-off in liquidity is matched by higher expected return targets after fees and the non-listed PM funds contribute key diversification benefits to the total portfolio.

2. Performance fees (PF) are standard for this asset class and tend to be a share of excess return. This tends to be around 15-20% of the excess return which aligns the investment manager and the investor (the manager is incentivized to produce excess returns for the investor).

3. The non-listed PM sector is sensitive to the economic cycle, but due to the illiquid nature of the asset class, short-term volatility is often avoided due to the long-term commitment of investors. Therefore, a quality and well-established PM manager is well placed to deliver excess returns for investors over the long term and help to diversify their risk.

The Final Word

The professionalisation of the asset allocation process in Asia continues to accelerate as more investors are drawn to a disciplined approach to strategic and tactical asset allocation, combined with a focus on re-balancing portfolios systematically in order to take advantage of inefficiencies and fluctuations in the markets.

The choice of product to achieve outcomes needs to take into account many factors, but the driving force in achieving good investment returns is the asset allocation involved. In this process efficient and cost-effective product needs to be utilized to reduce cost drag and must have as close a correlation as possible to the asset class return characteristics being sort.

The challenge in accessing private markets on a long-only basis is to access competent asset managers who can provide an edge and a cost-effective vehicle to achieve asset class exposure. Furthermore, the challenge for the investor is to ensure they can allocate capital with a long-term view and have the necessary resources elsewhere to meet short to medium-term liquidity needs.

There are of course private markets funds which are providing liquidity whilst not presenting themselves as trying to provide long-only returns i.e., they are actively managing the liquidity basket to reflect an investment view on the cyclical nature of private markets. This is of course fine, provided that the investment methodology is clearly stipulated, and investors are not led to believe that they are buying a long-only product.

Nevertheless, after a brief look under the "hood" of a semi-liquid (long-only marketed) private markets fund, one can understand why Asian investors may continue to scratch their heads – these funds do appear to be a riddle, wrapped in a mystery, inside an enigma.

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