SS&C Intralinks®

2020 LP Survey

Insights on Alternative Investments

produced in partnership with privateequitywire

Introduction

2019 marks the third year that Intralinks has produced its global limited partner (LP) survey, in partnership with Private Equity Wire, to gauge how they view alternative investments over the next 12 months.

This year, the survey canvassed the opinions of 182 LPs, of whom 40 percent had more than USD 5 billion in AUM and 25 percent had more than USD 1 billion in AUM.

In last year's survey, one of the strongest areas of allocation interest among investors was mid-market private equity. Some 58 percent of LPs said they planned on doing direct investments throughout 2018/19, with six out of 10 specifically choosing to focus on the mid-market private equity space. One in four said they would focus on core real estate and regional infrastructure.

Fast-forward, and this year's survey findings show an even clearer preference for mid-market private equity, with 61 percent of LPs favoring direct investment into this asset class, while only one in six saying they would focus on core real estate and regional infrastructure investment opportunities.

As well as assessing LP appetite for different alternative asset classes and the profile of manager they will be favoring over the next 12 months, this year's survey also introduces a set of questions on technology considerations in addition to how LPs think about emerging managers.

The goal of the survey is to give general partners (GPs) fresh insights into how investors think about their alternative allocation programs, from performance expectations to transparency and reporting, from manager AUM size to investment vehicle preferences.

Although they should only be viewed in isolation, these findings can, to some extent, serve as a signpost for GPs to tailor their investment products and gain a better understanding of how LPs think about their current portfolios.

In turn, it's hoped that this report can improve the channels of communication and strengthen GP-LP relationships across the alternative fund industry.

1.0 Asset Class Performance & Outlook Review

Broadly speaking, five out of 10 investors felt that returns from their alternative allocation programs over the past 12 months were in line with their objectives, as figure 1 illustrates. Only one in five LPs felt they had exceeded expectations – which mirrors investor sentiment in last year's survey – but this does not paint the full picture.

Drilling down specifically into individual asset classes, it becomes evident as to which GPs generated the best risk-adjusted returns.

Private equity, in keeping with its market-wide appeal, came out as the clear winner, cited by 45 percent of survey respondents (see figure 2).

Commenting on the performance of private equity, a spokesperson from a leading U.S. public pension fund says, "With respect to the 10-year economic expansion we've witnessed in the U.S., purchase price multiples have been going up, public equities have been going up and it all helps to drive valuations and deal activity. Private equity has performed very well as a result of this. It's hard to be disappointed."

The question LPs have to ask is: Is the PE growth story sustainable?

With market valuations still soaring, to what extent are they factoring in the threat of a market downturn, which could irrevocably reverse the fortunes of some PE-backed companies ill equipped to handle a recession?

For now, the momentum remains. According to a report by Bain & Company[1], total buyout value in 2018 jumped 10 percent to USD 582 billion (including add-on deals), "capping the strongest five-year run in the industry's history."

Hedge funds still on a rocky road?

One of the most notable differences from last year's survey is a manifest lower degree of confidence in hedge funds. In last year's survey, 26 percent of respondents said the asset class they were "most happy" with was hedge funds. This year, it fell to 12 percent.

It's been a rollercoaster ride for hedge fund investors in recent years. In 2017, performance was a "slam dunk" with hedge funds, on average, posting positive gains for each of the 12 calendar months and generating a respectable 11.41 percent.[2]

Having attracted net inflows of USD 49.5 billion through November 2017, the hedge fund industry's foundations suffered a wobble last year, in large part because of the market volatility that ensued in Q4. Average returns, according to the Preqin All-Strategies Hedge Fund benchmark[3] were -3.42 percent – the worst year's performance in a decade.

Some LPs believe that hedge funds as an asset class can still work, provided they have access to the best managers and have good relationships in the market. "The best hedge fund managers don't need to offer discounts because they are in high demand. If you have access to the best hedge funds, you're going to be doing well and making money in this volatile market. Problem is, they are all closed," says a U.S.-based allocator.

The CIO of a U.S.-based family office believes that sustained performance within the top decile is more achievable within VC, over time. "If you're a top VC fund," he says, "entrepreneurs will come to

> "We invest across all asset classes, long-only as well as PE, RE and hedge funds. Recently we've been meeting more PE/RE managers because we are actually moving all of our investments onshore and as we do so, we will have to shift our assets in order to become more tax efficient. Hedge funds, at that point, will not be tax efficient."
>
> – U.S.-based family office investment advisor

Figure 1: How would you assess the performance of your alternatives portfolio for the last 12 months, overall?

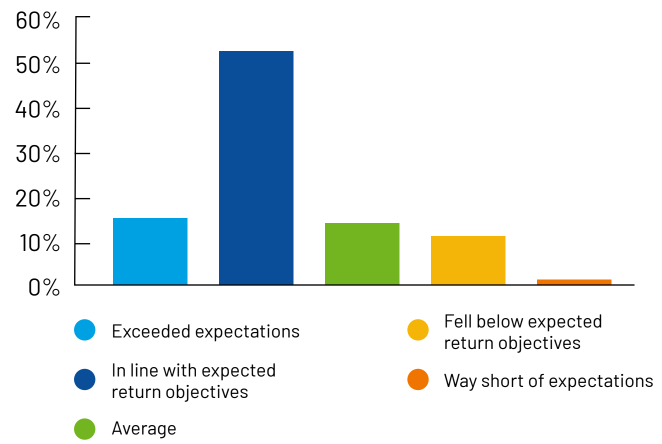
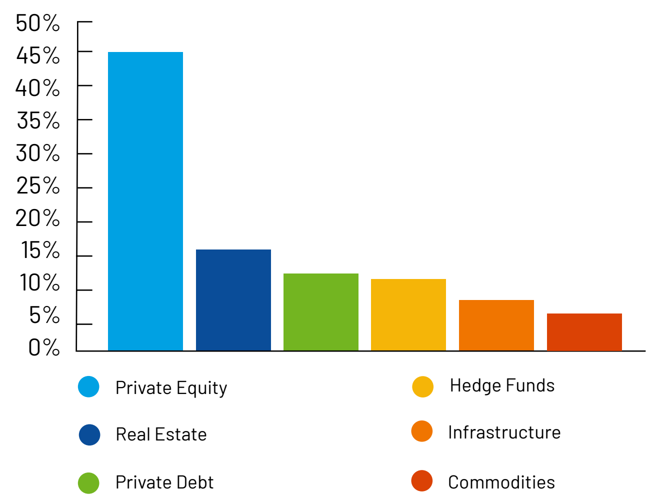


Figure 2: Within alternatives, which of the following asset classes generated the best risk-adjusted returns?



you first because it makes them look good by having a high-quality VC fund invest in them. As a result, the top VC managers get access to the best deal flow. I think it's harder for PE managers and hedge funds to sustain performance in the top decile but they still do it."

Aside from performance and access to the best managers being sticking points, one of the other key challenges LPs face is how to pick out top talent in an overly crowded marketplace. There are over 15,000 hedge funds, although last year did witness more liquidations than fund launches – 746 versus 609 according to Preqin[4] – which might indicate the first sign of consolidation.

"Approximately 80 percent of allocations are going to multi-billion dollar hedge funds that, generally speaking, have been underperforming because they find themselves in a very crowded space; they are all investing in the FAANGs (Facebook, Amazon, Apple, Netflix and Alphabet's Google) and other popular large-cap stocks," comments an advisor to a group of U.S. and Canadian family offices.

"You have to go downstream to managers that are generally managing less than USD 500 million to find interesting, unique strategies. However, these tend to be capacity constrained strategies, and the managers are harder to find.

Figure 3: Do you expect to increase your allocation to alternatives over the next 12 months?

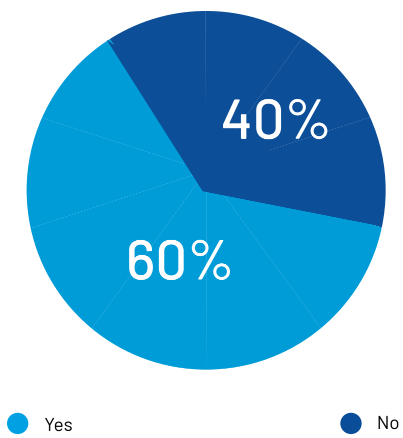
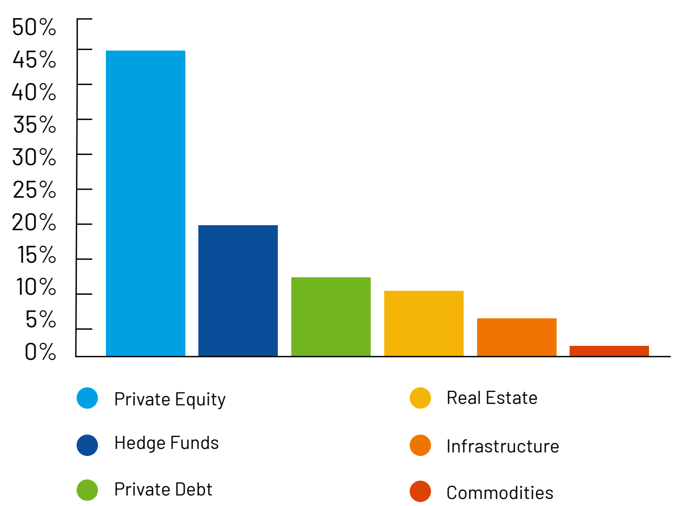


Figure 4: Which asset class do you expect to be most overweight, on an absolute basis, in alternatives?



"I've built out a list of 30 or so unique managers – some are in the private debt/direct lending space, some are focused on the cannabis industry. No one wants to hear about long/short equity or pure credit. That's partly why, as this survey finding shows, private equity has been so popular with LPs.

"It's time for LPs to get their hedge fund allocations back to around 10 or 11 percent, and some are beginning to recognize this."

> "Conversationally, I think people are more optimistic about hedge funds over the near term, on the expectation there will be some sort of liquidity crisis or sociopolitical crisis. Hedge funds perform best when interest rates are higher but also when there are periods of strong market uncertainty. Based on conversations I've had with other family offices, people are more optimistic about hedge funds for the next 10 years than they were in regard to the last 10 years."
>
> – U.S.-based family office investment advisor

Weighing up the options

The quote above on increasing allocation levels to hedge funds is interesting, insomuch as last year's LP survey failed to reflect this. Rather, it once again underscored that LPs are training their sights on private equity.

Some 60 percent of LPs confirmed that they would be increasing their allocation to alternatives during 2019/2020, with four out of 10 LPs suggesting this would be a 1 to 3 percent increase (see figure 3).

Overwhelmingly, the majority of LPs said that private equity would be their biggest overweight allocation, suggesting that they remain enthralled by the asset class (see figure 4). Commodities and infrastructure do not appear to be high on LPs' wish list for the next 12 months.

Part of this, at least in respect to commodities, is doubtless linked to a slowdown in global GDP, and more specifically China's slowing economy. Last quarter, it fell to 6.2 percent, which is the lowest quarterly growth rate since 1992.

Perhaps in anticipation of choppier waters ahead, against a backdrop of ongoing geopolitical tensions and a slowing global economy, hedge funds were cited as the second highest overweight asset class.

Anthony Gordon is principal of the eponymous Gordon Family Office. He confirms that the general sentiment is that the family office will likely look to increase its hedge fund exposure by approximately 10 percent over the next 12 months, and that its overall exposure to alternatives will also rise by that amount.

"The majority of that 10 percent increase will be on the hedge fund side, as well as some direct ventures we'll be looking at," says Gordon.

When asked what he thinks of LPs being overtly overweight on private equity, he believes that one of the reasons for this is because a lot of LPs think that it is uncorrelated to public equity markets and credit markets, which he disagrees with.

"If you're a smart hedge fund investor, however, and you're getting mid-teen returns with quarterly or monthly liquidity, why go into seven- or 10-year PE funds, with possible extensions, to maybe get 12 to 15 percent? On the high end, some exceptional LPs are getting 20-plus percent returns, and on the low end they might be getting 5 to 9 percent, but they've got a massive illiquidity component to consider.

"I'm not expecting to get market-like returns on hedge funds, I'm expecting exceptional returns," says Gordon.

One intriguing development is investors moving directly into venture capital. According to PitchBook,[5] VC fundraising in the U.S. reached USD 55.5 billion across 256 vehicles last year and was the largest annual raise in at least a decade.

At the vanguard of this is SoftBank, which seemingly overnight has become one of the world's largest technology investors. Its USD 100 billion Vision Fund is targeting disruptive companies and has already deployed USD 80 billion.

With more money being pumped into technology companies, in the hope that the next unicorn will emerge, this could lead to higher valuations in the lower- and mid-market PE space over the next few years.

Several venture growth funds have underlying companies with little to no profits, only scorching loses, says Gordon, who adds, "How sustainable is PE growth going to be? A lot of companies are receiving capital, yet they aren't making a profit. When are we going to see profits coming from Uber, for example?

"The PE market is expensive. If credit markets fracture and everything gets restructured across the board, including global equities, there could be serious consequences.

"I think things are overdone in PE and RE and look too expensive in established markets. I am looking at PE investments that are outside of the big tier cities, more in emerging markets where you have more Wild West characteristics but where the potential upside is massive if you partner with the right manager. I think you'll see some ballistic winners in emerging markets, including China and India."

Sector preferences

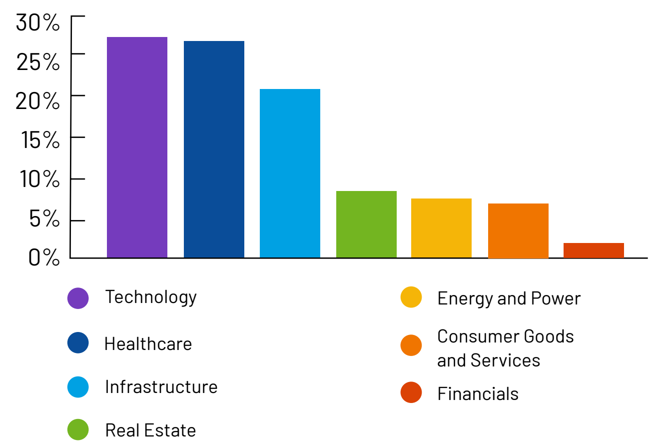
As to where LPs would like alternative fund managers to focus their investment activities, there were two clear market sectors that stood out: Technology and Healthcare (see figure 5).

Kieran Cavanna is the co-founder of Old Farm Partners, a New York-based FoHF manager that focuses specifically on small and mid-sized managers. Cavanna previously managed the hedge fund selection team at Soros Fund Management. He says that the portfolio, which consists of 17 hedge funds, currently holds three specialist Healthcare funds and two Technology-focused funds, all five of which made positive gains last year.

"I think Healthcare is the best sector for equity long/short strategies – there is such a wide range of things going on in that sector from regulatory changes to scientific advances, as well as great short opportunities coming from drugs that lack strong commercial potential. Technology has similar dynamics. Those two sectors are our biggest allocations and will continue to be," comments Cavanna.

Sector specialist funds are appealing to investors because research suggests they outperform generalist funds. In private equity, for example, the average IRR on investments made by single sector funds between 2001 and 2014 was 22.6 percent, compared with 17.9 percent for investments made by generalist private equity funds, according to research by Cambridge Associates.[6]

Figure 5: Which one of the following sectors do you most want to see your GPs invest in?



Moreover, Healthcare-focused funds have proven to excel over the above time period, generating an average IRR of 34.4 percent compared with 19.2 percent by generalist funds.

It is unsurprising that this sector is a key area of focus for LPs, given the vast array of mid-market opportunities in Europe, where valuations remain more competitively priced than the U.S.

The same applies equally to Technology, with Europe offering a diverse landscape of opportunities as London, Dublin, Luxembourg

> "Once you've committed to a PE fund you're basically in passive mode; there's nothing you can really do other than sell your LP interests in the secondary market. There's no intellectual work required, as there is when managing an active equity and/or credit portfolio. Picking the right story in PE is extremely difficult."
>
> – U.S.-based family office investment advisor

and Berlin all seek to become world-leading Technology markets. In Switzerland, the canton of Zug, referred to as Crypto Valley, is at the vanguard of blockchain and crypto technology innovation.

"I would agree with the survey findings. There are many secular tailwinds in both the Technology and Healthcare sectors," says a U.S. public pension fund spokesperson.

He goes on to explain that in the event of a recession, which will happen at some point, the current approach is to lean more toward value-oriented strategies and reduce exposure to PE managers running growth strategies.

"Some of our PE growth managers have done well and generated good multiples, but how sustainable is that? When we look at our portfolio, we still want exposure to high-conviction managers who over the last decade have executed a 'good to great' strategy, but we're also leaning more into value-oriented strategies over the next 12 to 24 months," he says.

> "I'm agnostic on whether the GP is a generalist or sector specialist, and I'm also sector agnostic. I'm presently not that interested in Utilities and Energy, but one of the managers we invest with is astounding in that space. I'm only interested in finding exceptional managers that could be doing anything, anywhere. But I do think fintech, and in particular card payments, is a very hot sector right now. U.S. Infrastructure could also be very interesting over the coming years."
>
> – Anthony Gordon, Gordon Family Office

2.0 GP Selection Criteria

In 2018, more than half of LPs said that their preferred fund manager size was in the USD 100 to USD 500 million AUM range, as figure 6 reveals. This sentiment remains intact for 2019/2020. Based on figure 7, one might infer that a "barbell" approach to manager selection will continue, with LPs allocating to managers of USD 100 to USD 500 million on the one hand, and managers of USD 1 billion-plus on the other hand.

This shows that diversification remains a key priority and that LPs are willing to take more risk by investing in smaller managers, provided they are confident more attractive risk-returns can be achieved. In this respect, manager selection in the middle market is crucial, across all alternatives.

Figure 6: What size of GP will be favoring in 2018/9?

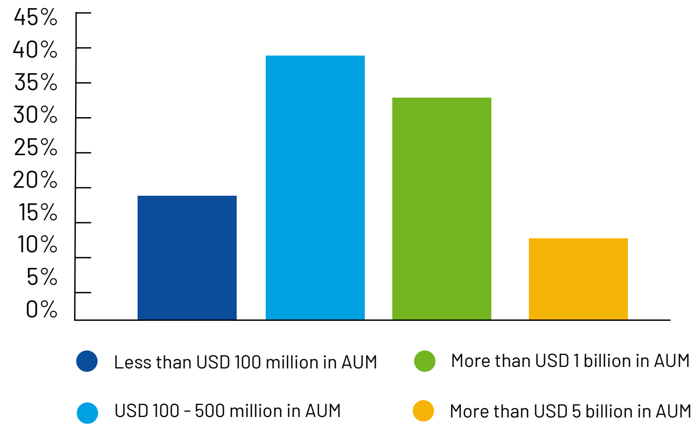
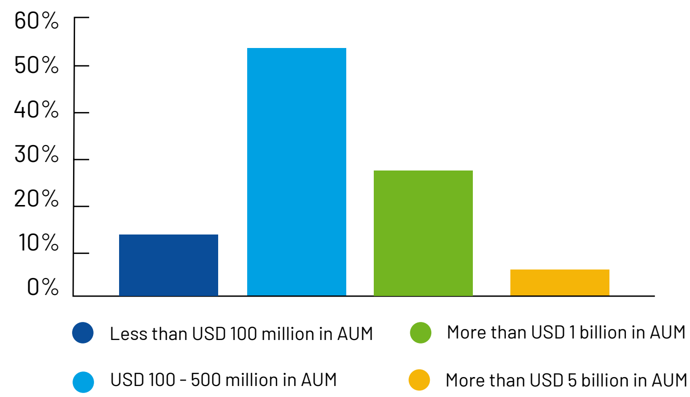


Figure 7: What fund manager AUM size will you be favoring in 2019?



Figures above from last year's *SS&C Intralinks LP Survey*

> "We allocate across the full spectrum of PE managers, but agree that the USD 100 to USD 500 million AUM range is particularly attractive given the very high levels of dry powder (and pricing) being seen in the large and mega cap space. Recently, we won three mandates looking for managers with funds under EUR 1.5 billion. Although we aren't looking specifically at the USD 100 to USD 500 million, the principal is the same – to target smaller European managers."
>
> – Merrick McKay, head of Europe – private equity, Aberdeen Standard Investments

Adi Divgi oversees investment activities for his family office, EA Global, in New York. He confirms that PE managers in the USD 100 to USD 500 million AUM range are a sweet spot, providing an example to illustrate.

"We invested in WM Partners Fund I, a health and wellness fund with around USD 300 million in AUM, in 2017. It was our best-performing investment last year. It was a one-line item fund with one operating company that acquired vitamin mineral supplement providers. WM Partners sold to Clorox at a meaningful revenue multiple at the end of 2018, and we made 2.1X (net)," confirms Divgi.

The mid-sized manager arena offers plenty of opportunities for larger institutions to adopt a PE mindset and buy equity interests in managers. This has been quite prevalent in the hedge fund space, as LPs build platforms to invest in a range of smaller managers to best put their capital to work, in a way that limits concentration risk. One family office spokesperson confirms that four years ago they created a private equity venture to target hedge fund managers in the USD 250 to USD 500 million AUM range with at least a three-year track record "because in our view, we felt that was where the best returns were and where the best growth opportunities were."

This exercise of acquiring GP stakes in hedge funds or giving managers LP capital in return for taking a top-line revenue share in the management company is a real growth area for family offices and public pensions.

However, even though smaller managers have, historically, generated better returns, the challenges of getting in front of investors are incredibly difficult.

"There are 15,000-plus hedge funds, investors are receiving 300 emails a day and I think the marketing capabilities of a lot of smaller and emerging managers are really not very good," confirms the investment advisor to U.S. and Canadian family offices.

"I think you'll see a move toward much better marketing capabilities over the next few years, where managers start using video and other social media channels to better present themselves and catch the attention of LPs."

Emerging managers have gravitational pull

Emerging managers would appear to have a gravitational pull at present, based on this year's survey findings: by definition, these are managers who are running less than USD 500 million in AUM.

At Aberdeen Standard Investments, Merrick McKay, who heads up the firm's European Private Equity business, says that these will typically be managers with a regional focus and are probably going to be more generalist with some sector specialization. "We think there is a greater market opportunity for managers of this size. It's a vibrant ecosystem and we have a strong track record identifying alpha generators and top quartile performers in this area," comments McKay.

Emerging managers operate in what is now a highly bifurcated marketplace. In both the hedge fund and PE industries, very few new managers launch with significant capital. There have been some big hedge fund launches this year such as Crake, Candlestick Capital and Woodline Partners, all of which were oversubscribed USD 1 billion-plus launches. This follows the success of D1 Capital Partners and ExodusPoint – two of the biggest new funds in 2018. But whether it's PE or hedge, the vast majority of managers struggle to raise assets while the big-name global brands attract the bulk of assets.

Some of the most famous managers continued to shine in 2018, such as Ray Dalio's Bridgewater Associates, whose flagship Pure Alpha strategy generated 14.6 percent net of fees. D.E. Shaw Group produced similar returns for its Composite Fund, returning 11.2 percent, while another titan of the industry, Renaissance Technologies generated 8.5 percent for its Renaissance Institutional Equities Fund.[7]

These managers are the apex predators, accessible to only the largest institutional investors and as such represent a tiny percentage of the overall industry.

Beware of return dispersion

Nevertheless, despite the challenges of competing in this bifurcating market, LPs are willing to invest in emerging managers with PE once again the preferred asset class as figure 8 shows.

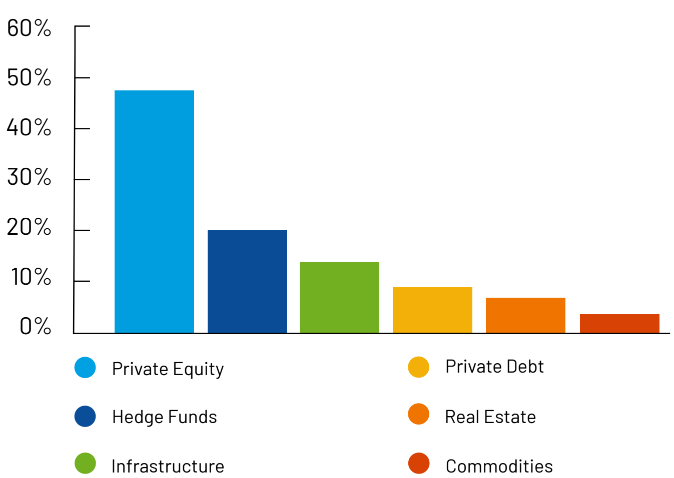
The U.S. public pension fund investor explains that the appeal of emerging managers is the attractive return potential they offer.

As figure 9 shows, this was cited as the most important consideration by 37 percent of LPs. Managers operating in Europe's lower and middle market are of particular interest, says the pension fund, although they admit that there is a far greater dispersion of returns within mid-market PE funds.

"When you allocate to large funds run by established managers you tend to see low double-digit net returns. But when you go to funds in the lower middle market, historically you could achieve a broader range: mid-20 percent IRRs all the way to single digit IRRs.

"A lot of LPs are playing in the mid-market, as the survey suggests, but because of the dispersion of returns manager selection becomes even more important," says a pension fund LP.

Figure 8: In which asset classes will you be favoring emerging managers in the next 12 months?



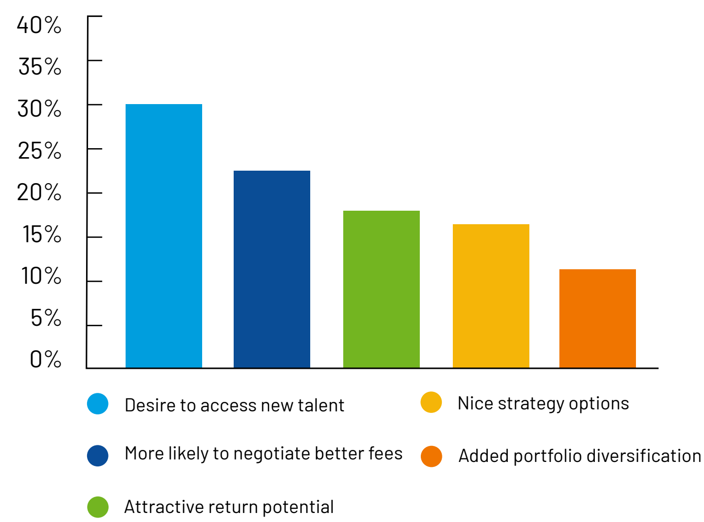
GP pre-selection criteria

Relationships are still the most important aspect for LPs, underpinned by the quality of the portfolio management team, at the pre-selection stage. Nearly two-thirds of LPs cited this factor, and perhaps in anticipation of a market downturn, the second most important factor was evidence of historical performance (see figure 10).

This survey finding was revealing in that LPs assigned the lowest importance to the quality of the manager's IT infrastructure. If, as this survey suggests, LPs are interested in allocating to managers in the USD 100 to USD 500 million AUM range over the next 12 months, one might expect them to pay more attention to this aspect.

"I think this is a collision of two things: investment due diligence and operational due diligence," comments Richard Tomlinson, deputy chief investment officer at the Local Pensions Partnership, which manages GBP 16 billion in several U.K. pension schemes.

Figure 9: What is the main driver behind allocating to emerging managers?

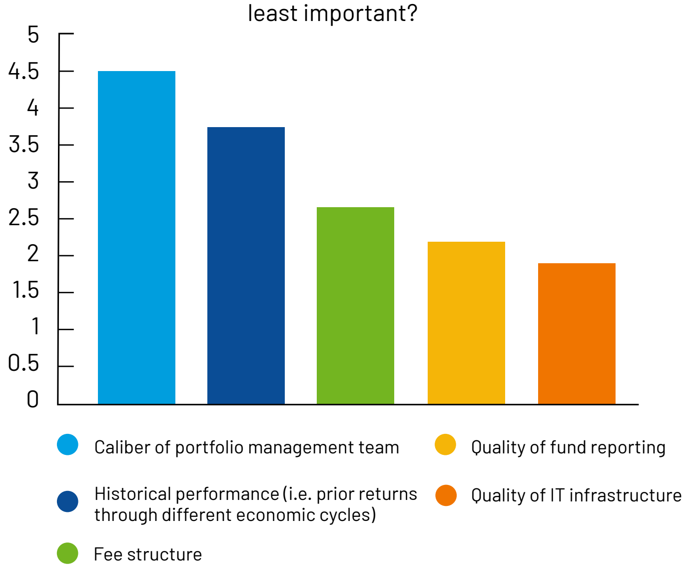


> "At Old Farm Partners, we look for proven managers running USD 100 million to USD 1.5 billion. There is a huge opportunity for managers in that AUM range. They can react and move to the market. If you're a lot bigger than this range – running several billion dollars – that's not possible, especially on the short side. They just can't change course quickly enough, the way smaller managers can. The smaller managers can really move with the opportunity set faster, and in a world where everything is moving a lot faster this is critical to good risk-adjusted performance."
>
> – Kieran Cavanna, CIO & co-founder, Old Farm Partners

"From an IDD perspective I understand why LPs are looking at smaller niche managers, given that the bigger managers are flooded with capital, but they're not going to measure up from an ODD perspective. LPs will ask, 'Where's your chief risk officer?' 'Where's your segregation of duties?' They don't have any because they are too small.

"What this says to me is if you want to invest in a newer, younger manager you just cannot demand the level of infrastructure that you would expect with a larger established manager. Within PE

Figure 10: How would you rank the following when selecting a manager, with 1 being the most important and 5 being the least important?



we currently have a preference for more niche, idiosyncratic-type investment activities."

"Those emerging managers that do have a solid IT infrastructure in place and technology solutions that add value to their business could benefit," says Meghan McAlpine, director, strategy & product marketing, alternative investments at SS&C Intralinks. "It may be seen as a competitive advantage to sophisticated LPs, giving the emerging manager a leg up on their competitors who may have more of a nascent infrastructure."

It could also be indicative of a wider level of acceptance in the alternatives industry toward GPs using outsourced IT and managed service solutions, as a way to reduce costs.

One LP was surprised by the finding: "If you are going after managers in the USD 100 to USD 500 million AUM range, you would think the quality of IT infrastructure would be a key consideration. It's amazing that it ended up being ranked lower than the quality of fund reporting."

Reduced blind pool risk

LPs take macro tailwinds into account at the pre-allocation stage. Oftentimes, GPs who secure allocations tend to be those offering the right kind of strategy at the right time. Other factors, according to Divgi, include: "Reduced blind pool risk, the manager's ability to underwrite assets, evidence that the management teams generated realized returns in their prior funds and partnering with a proven entrepreneur.

"I have, in the past, said 'No' to GPs I had previously allocated capital to. One of the reasons was that a GP was launching a new fund double the size of their previous fund. Also, one manager was doing a 100 percent blind pool commitment at final close for their latest fund, whereas in their previous fund they were 25 percent committed to various deals, so my blind pool risk was lower."

Fee issues

The issue of fees remains among LPs but it's perhaps not as dominant as in years past. As figure 10 shows, it was cited as the third most important factor for GP selection.

Hedge fund managers have done a lot to reduce fee structures over the years, but this is not being seen in private equity.

MJ Hudson, a leading legal and asset management consultancy, recently reported in the fifth edition of its *Private Equity Fund Terms Research* report[8] that only 18 percent of funds surveyed this year offer LPs discounted management fees, compared with 24 percent in 2018. The report also finds that a lower proportion of capital is commanding a management fee of 1.5 percent or less: 52 percent compared with 79.5 percent in 2018.

In Tomlinson's view, private equity is going through the same maturation cycle as we saw with hedge funds "and the returns of yesteryear… I cannot see how they can be repeated going forward."

"Companies are staying private for longer, and there is a huge wave of capital chasing PE opportunities," says Tomlinson. "If I'm going to pay for these 2/20 high-cost investment structures I want a granular definition of how much of that fee the manager is taking as value-add and how much they are leaving over for investors.

"In private equity, the fees are still material, and you could argue whether there's enough value-add for those fee levels. The question I ask myself is, 'Given fees have fallen in all other areas of alternatives, will PE fees be the last shoe to drop?' I don't believe the aggregate universe is good enough to justify the aggregate fee level."

> "After the recent tax reforms in the U.S., investors can't deduct management fees from investment firms – as opposed to trading firms – anymore. We might achieve 10 percent gross, but after management and incentive fees we might be down to 6 percent net. However, because we can't deduct the management fee, we actually pay tax on 8 percent. So on an after-tax basis, we might only end up with 3 percent, which is terrible. Perhaps management fees need to change to account for this."
>
> – U.S. East Coast-based LP

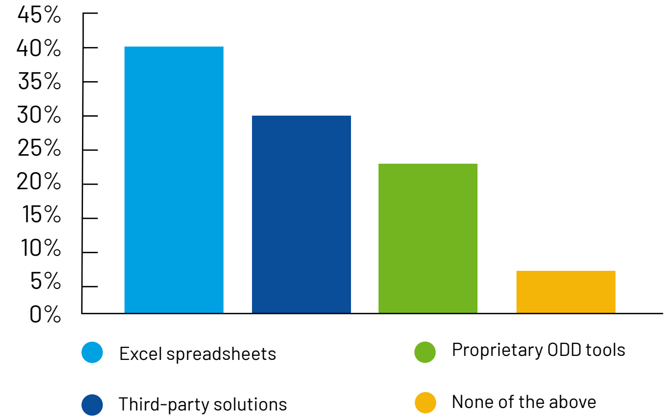
3.0 Technology Considerations

If, as this survey suggests, LPs continue to increase their allocations to alternative assets over the next 12 months, monitoring investments at the portfolio level will require good technology tools.

New technology can improve how LPs manage their investments as they look to become more tactical in how they build exposure to different sectors and industries, as well as interrogate the amount of alpha GPs are purportedly generating. But there is still a long way to go. As figure 11 shows, the majority of investors still rely on Excel spreadsheets when assessing GPs at the due diligence stage, with less than one in four choosing to use proprietary ODD tools.

Less surprising is that, once an allocation to a manager has been made, portfolio and risk analytics tools are viewed as the most important solutions, as cited by 33 percent of survey respondents (see figure 12).

Figure 11: What technology solutions do you use when perfoming due diligence on managers?



> "From a technology perspective it is important to know: Where is your cash? Who is the prime broker? Many hedge funds have no cash because they are levered, and those that do have cash are pretty straightforward about it. I'm always able to see clearly into what the fund's cash position is. I don't find this is obscured or unreported on."
>
> – U.S.-based LP

"If you have a portfolio of 50 GPs, it's important to have the ability to look through the fund structure and be able to answer the question, 'What is my exposure to Financial Services, or to Energy?' If you don't have an understanding of the industries and business models you are exposed to in the portfolio, I think it's hard to gain a really clear understanding of the portfolio's risk profile," says a U.S. pension plan spokesperson.

Increasingly, managers are using alternative data sets to generate research ideas. This has led to an explosion in the volume of data, and LPs are sensitive to this, with 27 percent of survey respondents regarding data aggregation tools for enhanced reporting as the second most important technology tool.

This shows that LPs expect managers to up their game and simplify how they present data in their monthly or quarterly reports. Some investors have thousands of line items in their portfolios and don't require insights on each and every one; they expect good, clear reporting that summarizes the key points, to get a good handle on how the manager is running the investment strategy.

As one LP comments: "Position-level performance tracking at the scale we are and the complexity of our portfolio is difficult. We only have position-level transparency in a few areas. If you're not careful the data can become too unmanageable."

At the start of 2019, Intralinks published a blog[9] post which suggested that as LPs continue to set the bar higher on the level of transparency and enhanced reporting capabilities provided by GPs, experts anticipate that "fund managers will implement growing technological advancements such as artificial intelligence to institutionalize their operations and attract more LPs."

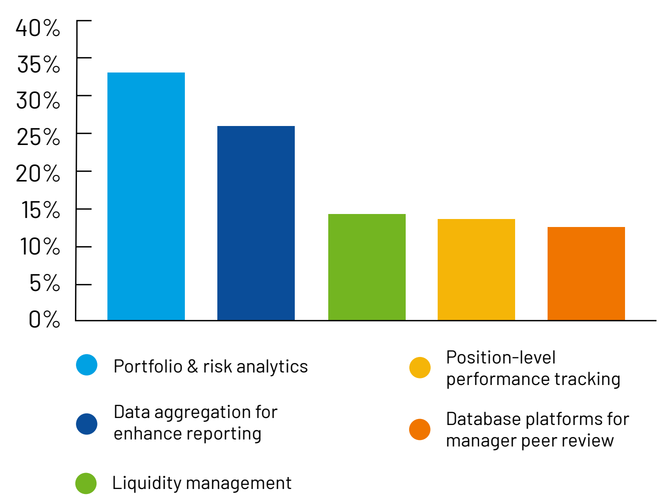
False sense of security

"Real assets" – PE, RE, Infrastructure – are immensely complex multi-year investments. LPs don't expect to receive the same level of granularity compared to actively managed global macro or credit long/short hedge funds, for example, but as more LP capital rotates into these long-term assets, the more important liquidity management will become.

For now, it seems, liquidity management is not a priority based on how LPs responded to the survey; only one in 10 said they regarded it as their most important technology need. Is this indicative of a false sense of security? As investors pile in to private markets, are the lessons of the financial crash being overlooked? It is hard to say.

"Currently we are late in a cycle," says a family office CIO. "We can't time markets because we don't know when they will turn to go into

Figure 12: What would you currently regard as your most important technology need?



cash or short equities. Hedging throughputs is also a directional bet that markets will fall soon, and if they don't, you are wrong on your view.

"One thing to do late in a cycle is avoid short volatility or skewed strategies, short liquidity strategies, leverage and strategies with an asset liability mismatch. These strategies do not earn enough return relative to the risk late in a cycle, but at the bottom of a cycle, you do get rewarded well."

Tomlinson is "amazed" at how few investors cited liquidity management.

Liquidity is becoming one of the unintended consequences of well-meaning monetary policy, and you're now seeing liquidity issues biting at multiple levels, according to Tomlinson.

"As people have moved more capital into private market portfolios, are they keeping up with their liquidity management at the portfolio level and paying attention to their outgoings – meeting their pension liabilities – relative to the rate of distributions versus capital calls?

"If you are faced with a liquidity squeeze, where are you going to raise cash from in the portfolio? It may mean having to sell listed equities but do you really want to do that in a stressed market?

"We are very conscious of liquidity management, and I think it's becoming more of an issue," asserts Tomlinson.

4.0 Investment Allocation Trends

When asked their preferred investment allocation method, alongside traditional LP stakes in commingled funds, 34 percent of survey respondents said it would be direct investment vehicles (see figure 13).

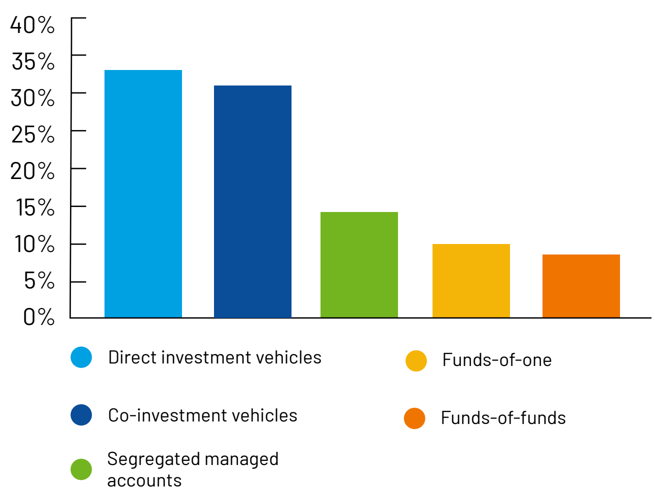
This underscores a growing level of confidence in how they approach the world of alternative assets, as some larger institutions build their own in-house investment teams to improve returns and reduce fees.

The same is true of co-investing as LPs look to build closer partnerships with their GPs to invest side-by-side in buyout deals. In this year's survey, it was cited by 30 percent of investors.

As reported by *Pensions & Investments*,[10] the likes of the USD 226.5 billion CalSTRS and USD 44 billion University of Texas/Texas A&M Investment Management Co. are making changes to their private equity investment approaches to evolve beyond commingled funds.

"Family offices specifically are very interested in co-investment opportunities," says a family office investment advisor. "A private equity manager operating a commingled fund will see deal opportunities, and what they will tend to do is say to investors, 'If you give us another USD 20 million we could co-invest on this deal for a modest 50 basis point fee.' There is definitely growing interest in this."

Figure 13: Aside from commingled funds, what will be your preferred investment method in 2019?

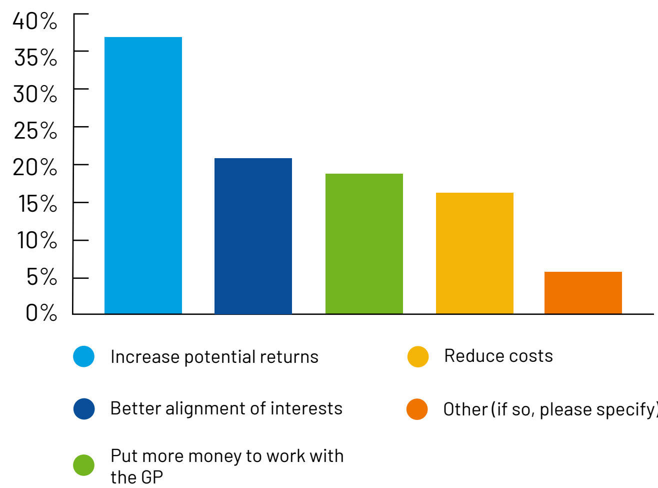


One of the main drivers for co-investing is that LPs feel they offer increased potential returns (see figure 14). One in five LPs believes that doing so can lead to better alignment of interests.

Standing shoulder to shoulder

As Private Equity Wire[11] reports, research by Unigestion Private Equity shows limited partner co-investment deal value has increased threefold since 2013. Commenting on its newly inked partnership with GCM Grosvenor, chief investment officer of the USD 31 billion South Carolina Retirement System Investment Commission Geoffrey Berg said he believed the program would allow the pension "to efficiently and seamlessly execute co-investments and become one of the premier co-investment partners to private equity sponsors."

Figure 14: If yes, what is the main reason for doing so?



Commenting on the survey findings, the U.S. public pension plan spokesperson confirmed that they were still in the process of studying the PE market opportunity for co-investing: "Our goal is to put a program proposal together for our investment board. It is one of our highest priorities.

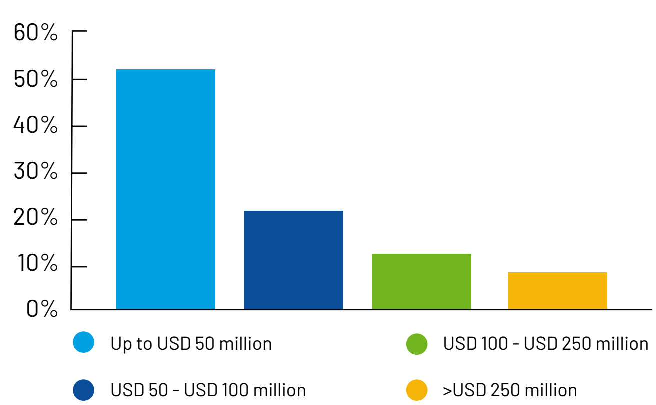
"Co-invest underwriting allows you to stand shoulder to shoulder with GPs. However, it's different if you're getting a post-close equity syndication where you have to make a decision in six weeks or less based on a PowerPoint deck the manager gives you, versus co-underwriting a deal where you are involved in early stages of the transaction. You might still get incremental insight into how the manager works in a syndication process, but there are varying degrees of engagement."

Naturally it depends on the size of the investor as to how much co-invest capital they wish to deploy. It also depends on their existing GP relationships and the number of co-invest deals being offered. For now, co-invest targets, on average, appear modest. Half of LPs said their target would be up to USD 50 million, while 25 percent said their target would be up to USD 100 million (see figure 15).

Straight to the source of the deal

Direct investing is a step further from co-investing, requiring the investor to have sufficient expertise and talent in-house to execute on deals without any GP partnership. As mentioned earlier in this

Figure 15: What is your co-investment deployment target?



report, one of the highest profile technology investors today is SoftBank with its USD 100 billion Vision Fund.

Interestingly, those LPs surveyed who said they would be direct investing over the next 12 months overwhelmingly pointed to mid-market private equity as their main target.

This is somewhat surprising, given the risks to buying companies that need transformation, or restructuring, to improve their fortunes. It's a very different beast to VC investing, as investors look for the next Tesla or Uber, cognizant of the fact that they might need to back 10 or more companies to strike gold with one.

At the LPP, Tomlinson confirms that they will outsource some investment activities and keep some in-house, "but in those instances there has to be a strong rationale for doing so."

In private markets, he says they invest directly into infrastructure assets where they can provide proper governance and stewardship, "but one area where we would be resistant is mid-market private equity."

"These are either growth businesses, or businesses that need a turnaround. It requires knowing who you think will be tomorrow's winners, knowing when to buy and sell, change management teams, write business plans, etc.," says Tomlinson.

Over at Gordon Family Office, they engage in both direct investing and co-investing across real estate and venture capital.

"One of the big advantages is that you end up doing more work on the underlying investments, which in my view makes you smarter and less lazy. There's the potential for a big payoff if you go in early, maybe in a Series A or Series B funding round," says Gordon.

By going "all in" with a direct investment, an LP stands to gain much more.[11]

Gordon confirms that the family office invested in a fund that contained Baidu, for example, on day one.

> "You can't play around in the mid-market PE space without having the specialist skills in-house. That LPs are willing to directly invest... For me that feels exuberant and a bit of a warning sign. As Warren Buffett once said, 'It's only when the tide goes out that you know who's been swimming naked.'"
>
> – London-based LP

"By the end of the investment, it made something like an 18 percent return, annualized over 10 years, which sounds great but Baidu was only a small part of the fund and there were also a lot of duds in the fund. Whereas if we'd invested directly in Baidu, we would have made far greater outsized returns," he remarks.

It is that desire to optimize returns that appears to be molding how sophisticated investors think about private markets. And this could be a signal of further growth as LPs rebalance their exposure to commingled investment programs versus co-invest and direct investment programs.

At EA Global, Divgi confirms that they have made several direct investments, including Series B and Series C fund rounds with a digital education company, "and I'm currently doing a Series D investment with an enterprise-flexible workspace company focused on specific cities in Africa.

"Another direct investment is with a next-generation solution provider for reducing food waste in the U.S.

"Direct investing is a way for us to diversify the family office's portfolio, and also it's a way for us to invest in opportunities we are passionate about," concludes Divgi.

Conclusion

Demand for alternative investment funds among the institutional LP community remains robust. However, there are signs that investors are starting to become more confident and sophisticated in their allocation methodology. That co-investment and direct investment approaches featured prominently in this year's survey is in some ways a shot across the bow for GPs and particularly those running closed-ended funds. Not only must they keep investors happy by offering co-investment deals, they must also appreciate that LPs are making the deal landscape more competitive – pushing asset valuations higher – by doing their own direct investments. As such, GPs will need to be even more judicious and creative when completing on deals, if this desire for direct investing continues.

LPs are clearly open to investing with emerging managers as they seek out attractive risk-adjusted returns in their hedge fund and PE/RE fund allocations. Those managers who are able to really focus on polishing their marketing and presentation efforts to stand out from their peers could be well placed to benefit. But as the industry continues to be awash with new fund launches, making a good first impression while established managers continue to attract a large percentage of net new assets will be far from easy.

Perhaps one other interesting takeaway from this year's survey is the relatively low weighting that LPs place on the quality of a GP's IT infrastructure and fund reporting. Admittedly, in respect to hedge funds, managers have a plethora of high quality managed IT and outsourced service providers to choose from to lower their operational costs.

But in the closed-ended fund space, one might think that the quality of reporting would feature more prominently; especially if we are heading to the end of a decade-long period of economic expansion. Knowing what one's exposure is to illiquid investments during a down cycle is going to be vital. PE/RE managers who are taking their IT/technology responsibilities seriously are likely going to be well-equipped to reassure LPs and maintain a good level of transparency in the event of a market shakedown. This is further reinforced by the lack of focus among those LPs surveyed this year on liquidity management.

Key Takeaways

- Year-on-year, the number of LPs who said hedge funds produced the best risk-adjusted returns fell from 24 percent to 12 percent.
- Interest in private equity shows no sign of abating. Not only was it cited as the biggest overweight preference by 40 percent of LPs, it was also the primary target for direct investing activity, with mid-market PE earmarked by 60 percent of LPs.
- Overall, 34 percent of LPs plan to use direct investment vehicles alongside commingled funds, suggesting a growing level of sophistication and confidence in alternative assets.
- Management fees in private equity might need to be reduced – something the hedge fund industry has increasingly opted to do in recent years.
- Mid-market PE, infrastructure and real estate managers could face stiffer competition on deals going forward as LPs develop in-house investment teams.
- Emerging managers have a huge opportunity to win over LPs, especially those in the USD 100 to USD 500 million AUM range, as investors look for specialist funds to generate outperformance ahead of expected market volatility.
- Healthcare and Technology are key investment themes for LPs over the next 12 months.
- LPs do not consider IT infrastructure to be a key factor in assessing managers, suggesting that they are becoming more comfortable with the outsourcing and IT managed services model.
- Liquidity management is not a high-priority technology consideration despite LPs investing more into illiquid asset classes.
- GPs who offer co-invest opportunities are likely going to be favored by LPs. It is something they will need to be aware of as attitudes toward fees and returns evolve over the coming years.

About SS&C Intralinks

SS&C Intralinks is the pioneer of the virtual data room, enabling and securing the flow of information by facilitating M&A, capital raising and investor reporting. SS&C Intralinks has earned the trust and business of more than 99 percent of the Fortune 1000 and has executed over USD 34.7 trillion worth of financial transactions on its platform.

About Private Equity Wire

Launched in 2007, Private Equity Wire publishes PE news and features for LPs and GPs as well as their service providers, issuing daily news over its website as well as features, reports, research, awards and events for the global PE industry.

[1] https://www.bain.com/contentassets/875a49e26e9c4775942ec5b86084df0a/bain_report_private_equity_report_2019.pdf

[2] https://docs.preqin.com/samples/2018-Preqin-Global-Hedge-Fund-Report-Sample-Pages.pdf

[3] https://docs.preqin.com/press/HFs-in-2018.pdf

[4] https://docs.preqin.com/press/HFs-in-2018.pdf

[5] https://files.pitchbook.com/website/files/pdf/4Q_2018_PitchBook_NVCA_Venture_Monitor.pdf

[6] https://www.privateequitywire.co.uk/2019/06/18/276608/sector-focused-pe-funds-outperform-generalist-pe-funds-almost-5-cent

[7] https://uk.reuters.com/article/us-hedgefunds-deshaw/hedge-fund-d-e-shaws-flagship-fund-posts-double-digit-returns-idUKKCN1P123Y

[8] https://www.mjhudson.com/download/fund-terms-5th-edition-part-1/

[9] https://www.intralinks.com/blog/2019/01/3-predictions-alternative-investments-industry-2019

[10] https://www.pionline.com/article/20190401/PRINT/190409988/calpers-not-alone-on-private-equity-shift

[11] https://www.privateequitywire.co.uk/premium/lp-co-investment-deal-value-sees-three-fold-increase-2013

intralinks.com/alts