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The Battle Of Alternatives: The Special Cases Of Hedge Funds, Private Debt And Private Equity

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Moving further into a challenging 2016, investors remain apprehensive about the global financial outlook and they are in the process of accepting the new state of markets, which is the low-returns in equities and fixed income. Extensive QE and negative interest rates inflate the markets and constitute the main reasons for the low-yielding scenery and for the rise of alternative investment allocations. Institutions like insurance companies and banks find themselves amid a difficult situation making alternative income-producing strategies appealing. Political issues add uncertainty to the ever-changing status of markets, such as the ongoing Greek debt and the upcoming Brexit referendum and concurrent U.S. elections. Even earnings in big corporations are lowering, signaling the need for rebalancing portfolios and shifting to alternative investments.

Alternative investments constitute a broad category, but this perspective focuses on three asset classes: hedge funds, private equity and private debt. Hedge funds constitute the most debated and controversial asset class gathering the lights of publicity for numerous reasons. With over $3.23tn of assets under management according to BarclayHedge and over 5 thousand institutional investors, hedge funds are considered to be the elite of money managers charging the infamous 2/20 structure to their investors. There is a lot of discussion since the beginning of 2016 regarding high fees and bad performance indicating the upcoming reshaping of the industry following the divesting of major pension funds. Despite, the exodus of big names in the institutional spectrum, more and more pensions are attracted to hedge funds according to Preqin research, which contrasts the recent assaults on the asset class.

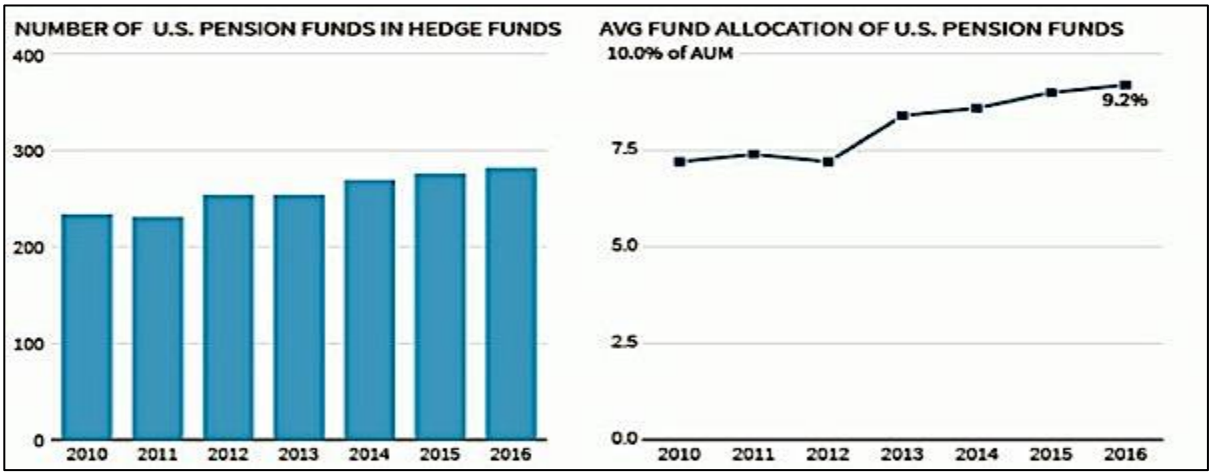

Figure 1. U.S. Pension Fund investments in Hedge Funds, Source: Preqin Investor Profile

However, this pressure is likely to be sustained and resulted already in lowering of fees from some managers. But is it fair for some managers to take lower fees while they are delivering robust outperforming returns and while the costs for running a hedge fund are enormous? Recent regulatory changes and the need for alluring talent into the space gives rise to costs, which smaller managers have to charge their investors. The 'war on hedge funds' is based on the bad performance the asset class is exhibiting the last two years and this is merely explained by the overcrowding of managers. Hedge Fund Research database contains over 7,300 investment products, which manifests the over-competition in the space and attenuates the returns from α-focused strategies, making the pursuit of niche and unique strategies trivial. Hedge fund managers need to become creative and offer novel opportunities to the investors via exotic products and robust investment processes. Technology is the breakthrough the space is waiting for and new algorithmic and blockchain related strategies eye opportunities in a new unexplored investment arena.

Private equity, on the other side, is probably the biggest player in the “allocation battlefield” with assets under management exceeding $4.2tn and with investor appetite for the well-established asset class. Private equity constitutes the biggest enemy of hedges funds in attracting capital and identifying investment opportunities. Private equity seems to be more appealing to long-term investors due to the illiquidity offered, which allows to realise higher returns than their peers in the hedge fund space.

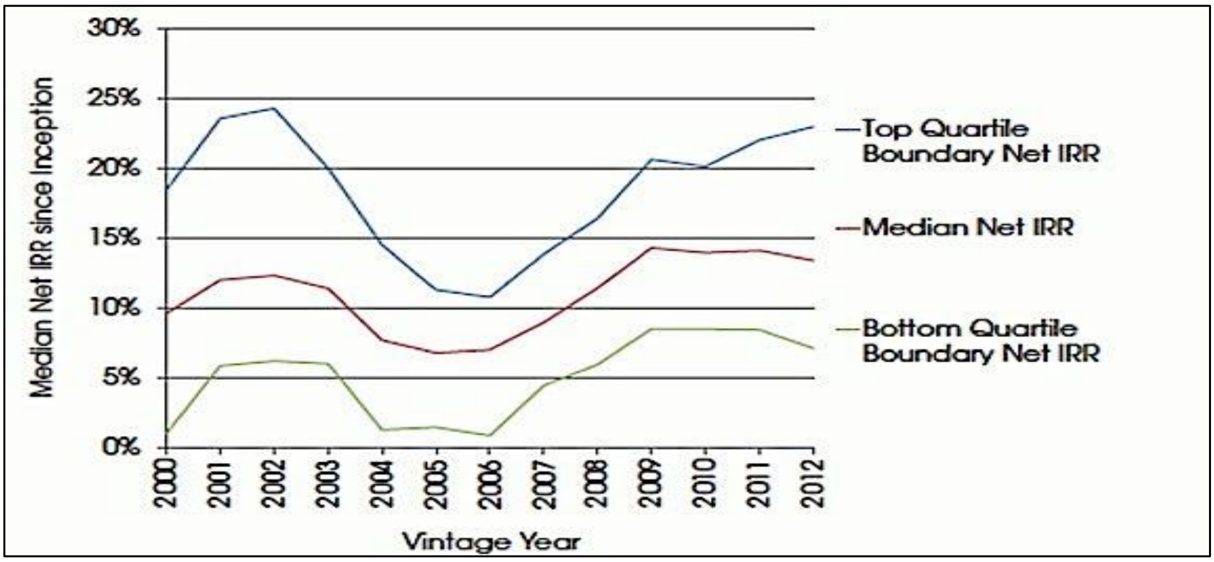

Figure 2. Private Equity Returns, Source: Preqin Private Equity Report 2016

Investors appreciate the clawback provisions that PE managers offer them and prohibit managers from receiving fees when losses are experienced. The turbulent and volatile global markets add more uncertainty to the investments alongside the valuation challenges, which make the identification of the right investment opportunities hard and this will impact the long-term return of the funds. European PE is having another predicament to overcome, which is the AIFMD, a compliance burden that PE managers are not familiar with and makes them struggle. AIFMD will introduce depository and risk management processes to private equity funds. The next years are going to be challenging and constitute a period of adjustment to the new regulatory area.

The last case is private debt, which is a nearly $500bn asset class and one of the most intriguing in the investment arena. Private debt is looking to capitalise new opportunites created by the global economic outlook and offers investors an amazing tool for diversification and downside protection as it is collateralised by real assets. Due to the nature of business, investors know what to expect in terms of returns and the asset class is growing steadily alongside the investor appetite as seen below.

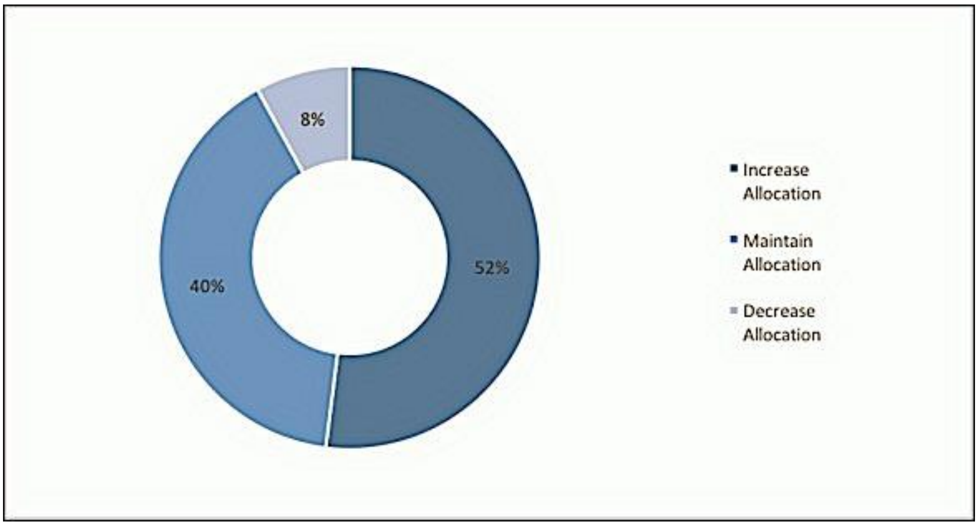

Figure 3. Long-term Investors' Intentions For Their Private Debt Allocations, Source: Preqin Private Debt 2016

What comes as big surprise is the appetite in Europe for private debt products and the regulation which is changing in favour of private debt managers in some countries, facilitating the loan origination from funds. The growing demand for private debt and especially direct lending funds has a solid rationale behind it and this is Basel III for banks and Solvency II for insurance companies. Despite the incentives from EU politicians to boost banking lending, corporations appear to seek alternative financing highlighting the decreased need for bank loans. Under regulatory capital considerations, like RWA for banks and solvency capital for insurers, lending to SME and lower middle market is prohibitive due to increased capital requirements.

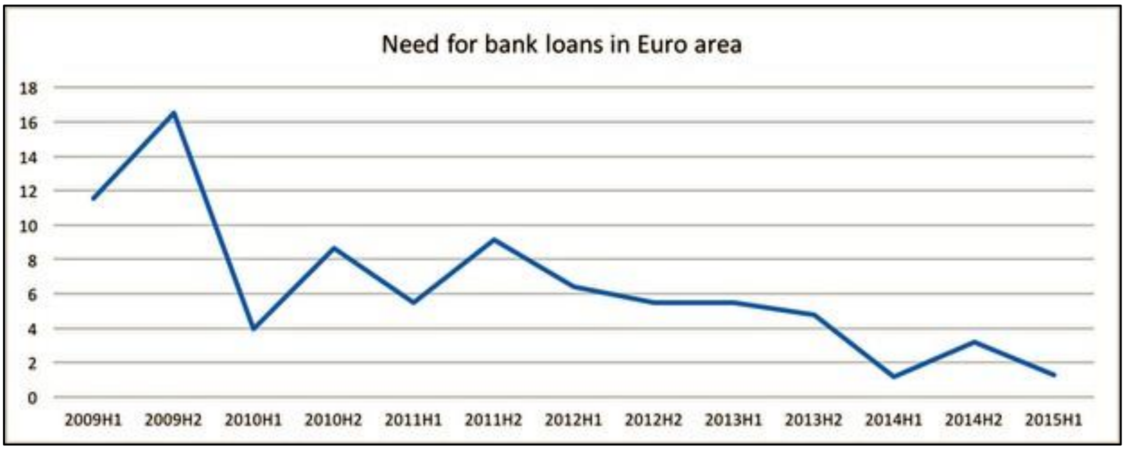

Figure 4. Need For Bank Loans In The Euro Area From 2009 To 2015H1, Source: ECB Data Warehouse

The above figure indicates the change of landscape in corporate financing in the Euro area and welcomes the rise of direct lending funds, which appear to be extremely successful in fundraising as seen below.

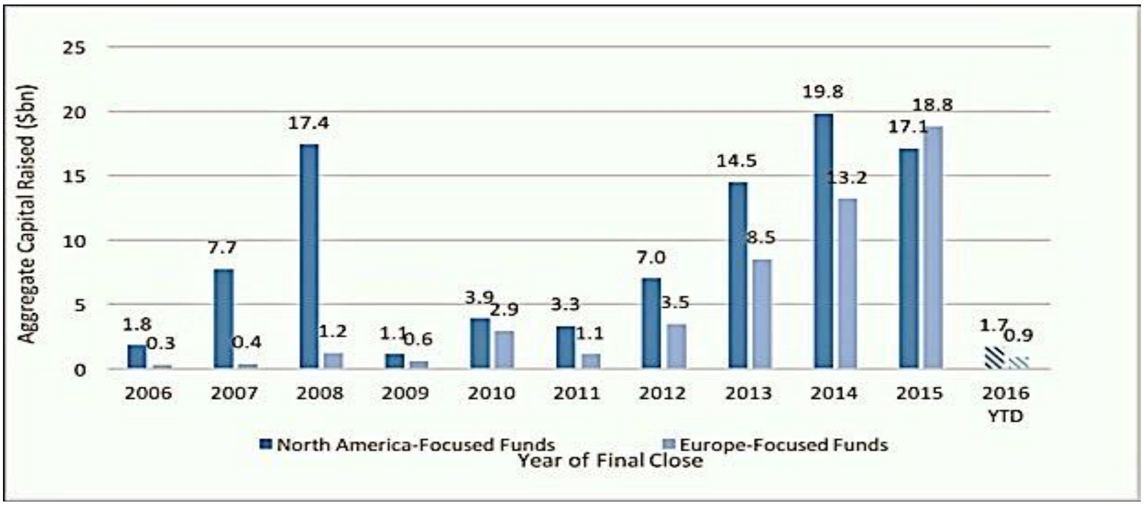

Figure 5. Direct Lending Fundraising: North America vs. Europe Funds, 2006 - 2016 April, Source: Preqin Private Debt Report 2016

Potential comeback from banks regarding lending especially in the SMEs area could only prove beneficial for the direct lending arena, because it will help the asset class become bigger, more competitive and sustainable. Apart from banks and insurers, pension funds could find a great fit for their asset liability matching portfolios due to the illiquidity of several private debt funds, which is a crucial consideration due to the risky nature of this business. The Dodd-Frank Act and AIFMD provide investors with confidence when it comes to investing in such funds due to the stringent compliance and risk management rules.

Private debt is positioned strategically somewhere in the middle field between the battling alternative asset classes of hedge funds on one side, with mostly up to monthly liquidity for single managers and up to quarterly for fund of hedge funds, and illiquid private equity on the other side, with typical 5, 7 and 10 year terms plus potential yearly extensions e.g. in real estate. The fee model is lower than the 2/20 in hedge funds and private equity and more tight to the long only fixed income fund space with performance fees. In general, we recognise a melting pot of alternatives and particularly private debt and direct lending strategies demonstrate how hedge funds and private equity are growing together. Mostly long only, un-levered and with low volatility, those strategies seem to assist family offices, fund of funds and slowly as well institutionals like pensions, insurers and sovereign wealth in the search for yield. Most of the largest GPs in PE have long opened private debt strategies and various credit and high yield related hedge funds started direct lending into corporates, specialty finance, trade finance, consumer credit and real estate. Extensive due diligence is required in analysing direct lending strategies, as not only the underlying lending activity to individual, firm or transaction, but as well the level of debt as LTV and the seat in the capital structure from senior secured, mezzanine, convertible, unitranche or preferred equity requires dedicated credit experience and structuring capabilities combined with extensive risk management, credit scoring, restructuring and workout experience. Plenty of direct lenders do not possess a credit scoring mechanism, are unregulated as no formal registration is yet required and particularly in the online peer-to-peer (P2P) and marketplace lending space follow 'no cherry picking' policies from senior management down to the credit analysts. Those policies combined very low decline rates of loan applications - meaning almost every applicant gets a loan - lead to volume based lending practices, in part comparable with pre-crisis 'originate-to-distribute' subprime mortgage lending, but now from non-bank lenders in the shadow banking system. Certain direct lending strategies provide liquidity like hedge funds and face an underlying asset and liability mismatch in their portfolios. In stressed markets, investors will want to redeem their investments according to liquidity provision in the fund prospectus, but will likely have to queue with their peers until GP's have liquidity available. The direct lending market has risen 100-150% p.a. since 2009 on both sides of the Atlantic and a recent resurrection of bank senior loan provision to lending funds combined with the securitisation of marketplace and P2P loans in the US and Europe for funding purposes, with the engagement of tier 1 rating agencies, seems like a recipe for upcoming stress in this industry. From an investor perspective, private debt and direct lending are welcome sectors with high yielding and low volatility strategies. Extensive investment and operational due diligence is required in order to survive periods with stressed solvency levels during the next credit cycle turn, as the direct lending space has not yet been tested in a downward credit market.

This perspective aims at analysing three of the major asset classes inside the alternative investment space, which provide investors with options for diversification and return enhancement amid a changing and low-yielding economic environment. This analysis will be different if the upcoming political scenery changes with specific mentioning of a potential Brexit.

This perspective is neither an offer to sell nor a solicitation of an offer to buy an interest in any investment or advisory service by Stone Mountain Capital LTD. For queries please contact Alexandros Kyparissis under email: alexandros.kyparissis@stonemountain-capital.com and Tel.: +44 7843 144007. For further information around our research and advisory services please contact Oliver Fochler under email: oliver.fochler@stonemountain-capital.com and Tel.: +44 7922 436360.

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