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ALTS TRANSPARENCY: FINDING THE RIGHT BALANCE

Despite the dominance of transparency as a discussion topic over the last decade, market practices in alternative investing haven't changed as much as you might think. Even after the 2008 credit crisis illustrated the dangers of having large allocations to opaque, illiquid assets, the industry has struggled to reach accommodation on transparency. The lack of progress is due more to the nature of alternative investments and the very real hurdles to providing and using transparency than an unwillingness to seek common ground.

A survey Northern Trust conducted in 2017 with The Economist Intelligence Unit confirmed that transparency remains a top priority among alternative investors. Yet, in the absence of any standards in market practice, investors continue to work through bilateral agreements, side letters and other arrangements to get what they need. While this ad hoc practice might work for some, a more focused industry-wide approach could have benefits for everyone involved and remove some of the complexity from the process.

So how does the industry move toward more holistic improvements to market practice and transparency? Based on our experience serving both clients that invest in and clients that manage alternative strategies, we believe better market practices start with three things:

1. A more nuanced conversation about transparency.
2. A more strategic approach to managing transparency requirements.
3. A more collaborative partnership between the buy and sell sides.

BETTER TRANSPARENCY PRACTICES START WITH THREE THINGS

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2. A more strategic approach to managing transparency requirements.
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Learn More

To explore the key findings from our 2017 EIU Transparency in Alternatives Investing survey, read our paper, "The Path to Transparency in Alternatives Investing" at **northerntrust.com/path-to-transparency** and view the related infographic at **northerntrust.com/infographic-transparency**.

TAKING A MORE NUANCED VIEW OF TRANSPARENCY

When asked if they'd like more transparency into their alternatives portfolio, the majority of investors will offer a reflexive, "Yes. Of course we want to have a better understanding of our investments." But transparency comes in many flavors, each of which presents different opportunities and challenges depending on the type of investment and the priorities of both investor and manager. If you take the time to dig deeper, you quickly realize that achieving "more transparency" is far from simple.

To start with, "transparency" is a broad term that means many things (see "Evaluating Transparency," on page 3). When you're talking about transparency, what are you really talking about? Insight into holdings? A better understanding of valuations? A good place to start, for both investors and managers, is to evaluate the different types of transparency and how important they are to your organization and your stakeholders.

Next, consider the tradeoffs you're willing to make related to each type of transparency you're seeking. Investors might ask:

- What is transparency worth to you? Will you trade performance for transparency if the cost of being more transparent affects returns? If so, how much?
- Are you getting value from transparency? Do you have the systems and skills to derive meaningful insight from your data?
- Are you willing to pay more for the operational costs associated with transparency?

Managers face similar questions:

- How far will you go to accommodate the requirements of large investors?
- What are the risks of public disclosure of fund data, such as a Freedom of Information Act (FOIA) request that requires public funds to disclose details regarding their investments?
- Are you willing to walk away from a large investor to protect intellectual capital?

These questions are worth considering when weighing the tradeoffs involved.

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EVALUATING TRANSPARENCY

TYPE	INVESTOR RATIONALE	CURRENT INDUSTRY PRACTICE
Holdings	Risk exposure analysis	Hedge funds more problematic than private equity and real estate
Valuations	Need to demonstrate reliability	Hedge fund pricing less problematic than real estate and private equity appraisals
Fees	Ability to quantify and verify fee impacts	Reasonability checks using best available data
Operational	Controls and independent verification vital to due diligence	Controls documents and onsite audits
Liquidity	Cash management and ability to exit	Best guess from available data

Treating Transparency Strategically

Putting time, effort and intellectual capital into developing policies – compliance, liquidity, cash management, valuation practices, data strategy – to govern your business is routine. But do you apply similar discipline to the question of transparency?

Our experience has been that few organizations treat transparency strategically. But instilling the same discipline to your transparency efforts as you do to other aspects of your business will reap dividends. To do this, consider developing a transparency "tool kit" to facilitate decision-making and consistency across your organization. The tool kit should consist of agreed standards, processes and controls to govern how you assess transparency and how you use the information once you receive it.

While your tool kit should reflect your unique requirements, the overall process of developing it typically would include the following steps:

1. Identify Stakeholders

While transparency is critical for risk management, decisions around transparency practices actually affect a much broader swath of an organization, as you can see in Exhibit 1.

As the chief financial officer (CFO) from a large fund-of-funds manager pointed out, investors "want to make sure they are good stewards to their end investors and that they can rely on us to help them fulfill that obligation." Taking a broader view and incorporating appropriate stakeholders will help you build a better and more flexible tool kit.

EXHIBIT 1: BEYOND RISK MANAGEMENT – STAKEHOLDERS IN TRANSPARENCY PRACTICES

MANAGERS

FRONT OFFICE

Understanding what information will be disclosed and/or made public may affect how the front office designs and executes investment strategy.

SALES, DISTRIBUTION AND INVESTOR RELATIONS

Can provide context and competitive intelligence on what investors are requesting; helps refine messaging to investors and prospects.

BOTH

EXECUTIVE LEADERSHIP

Needs to understand tradeoffs between transparency, performance and value creation to align practices with organizational strategy.

OPERATIONS TEAMS

Need to understand what kinds of data should be delivered and analyzed to derive value from transparency.

INVESTORS

INVESTMENT DECISION MAKERS

Understanding leadership's view on how to handle tradeoffs between transparency and other matters will affect the investment selection processes.

TRUSTEES/FIDUCIARIES

Understanding transparency standards and needs is critical for properly ensuring that beneficiaries' interests are protected.

2. Prioritize Types of Transparency

As we discussed earlier, there are many types of transparency. It's important to weigh your needs as they relate to the various types so that you have a clear understanding of what's important to your organization. As a manager, providing some types of transparency may be an important part of your strategy (as may be the case for funds focused on environmental, social and governance [ESG] strategies). Providing other types might constrain your potential returns (as in the case of valuations for a private equity fund).

As an investor, regulation dictates some of your transparency needs. Other types of transparency may have higher and lower priority. Knowing which are crucial, and what you're willing to exchange for that transparency, will make the conversations more effective. As Kathleen Olin, chief compliance officer at Indus Capital Partners, explained, "The most productive conversations we have about transparency are those where investors are crystal clear about their ultimate aims and goals."

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>
> **KATHLEEN OLIN**
> Chief Compliance Officer
> Indus Capital Partners

3. Rank Key Questions and Build Your Tool kit

Once you've identified stakeholders and prioritized the types of transparency you need, you're ready to begin actually developing your tool kit. As with all strategies, your plan should revolve around what you want to achieve. The insight you gain by refining what you mean by "transparency" and what tradeoffs you're willing to make to achieve it can help you specify your transparency-related goals.

From here, a list of strategic questions emerges. The specific questions on your list will depend in large part on what you want to achieve related to transparency. Some questions that may be more universal include:

For Managers

- What "industry standard" levels of transparency do our peers provide?
- What regulatory requirements might apply to us or to our investors?
- What types and depth of transparency are we willing to provide out of the box vs. value added?
- What guidelines should we follow when negotiating transparency in exchange for other concessions, such as longer lockups, minimum investment size or higher management fees? Who has final say on negotiations?
- How will we communicate with investors who are asking for transparency we cannot or will not provide? What can or will we share with them to explain our reasoning?
- What are our operational processes for compiling/delivering transparency data to investors?

For Investors

- What's the minimum acceptable level of transparency in an investment?
- Who certifies that an investment meets transparency standards?
- What's the process for exempting an investment from transparency standards?
- Who negotiates transparency with managers, and what are our standards around side letters, separate accounts and other transparency mechanisms?
- How do pre- and post-investment assessments of transparency differ?
- What processes, controls and/or systems need to be in place to make use of the transparency we receive?

Answering such questions will lead you to a set of practices that can help you consistently manage transparency demands in concert with your broader organizational strategy and goals. Having executive sponsorship when sharing these new practices across your organization can help create awareness and promote compliance with the new policies.

CREATIVE THINKING CAN BRIDGE THE GAP

Be aware of assumptions you make when building your transparency tool kit. Just because you've always done something one way, doesn't mean it's the only possible solution. A willingness to consider different ways to accomplish your goals might make it easier to find common ground.

As an example, it's natural to assume that transparency means the data is delivered to the investor's offices and housed on the investor's servers. But in some circumstances, the manager may not feel comfortable sending data because it no longer has control over how that data is used.

Jane Buchan, chief executive officer at PAAMCO, says they have found a way to allow investors access to the data they want without giving up control by challenging the assumption that data must be delivered to investors to be useful.

"We allow our investors to come on site to our offices and inspect almost anything within reason," Buchan says. "We feel there's no reason why an investor shouldn't be able to see – or even conduct tests on – a portfolio while they're here. It satisfies the investor's need without the managers worrying about the data getting into the wrong hands."

This is just one example of how what could be a barrier to transparency can be overcome with creative thinking. By being aware of and deliberately challenging certain assumptions, you may be able to identify creative solutions to other transparency issues you're facing.

4. Establish Practices for Review

Today's solutions can quickly become tomorrow's challenges if you're not deliberate about taking stock and adjusting your strategy. You should regularly review your transparency tool kit – at least annually. This allows you to assess changes in market practice, review organizational strategy, and test and confirm controls and procedures. In particular, you'll want to be sure to account for:

- Trends in capital structure and fund design and their effect on transparency;
- Evolving investor expectations and needs in response to market volatility, regulatory demands, thought leaders and other factors; and
- Fintech innovation and how to properly address the opportunities and challenges created by disruptive technologies such as blockchain and artificial intelligence.

Regardless of how you design your process, deliberate review and adjustment are essential to making sure your actions remain aligned with your long-term strategic goals.

FORGING A PARTNERSHIP BETWEEN INVESTORS AND MANAGERS

Alternatives are different from other asset classes. Traditional equity and fixed income assets are transactional and can be bought or sold more or less on demand. Alternative investments, on the other hand, are complex long-term commitments, and both investor and manager enter into a relationship more akin to a joint venture than a transactional investment. If the parties understand one another and have complementary objectives, the fund is more likely to succeed. If both parties think about their relationship in a different light and approach their interactions as a partnership, finding consensus on transparency may be easier.

THE CHALLENGES OF STANDARDIZATION

Many organizations have attempted to create standardization around transparency in alternatives investing, especially in the wake of the liquidity crisis in 2009:

- The buy-side advocacy firm, Institutional Limited Partners Association (ILPA) advocated for the standardization of capital call, distribution and valuation information as far back as 2005.
- Open Protocol Enabling Risk Aggregation (OPERA) advocates for standards for the hedge fund industry, aimed at standardizing data and formats for providing risk and exposure data to investors.
- The National Council of Real Estate Investment Fiduciaries (NCREIF), National Association of Real Estate Investment Trusts (NAREIT) and the International Property Databank (MSCI IPD) have all issued similar calls for the real estate sector.
- The International Private Equity and Venture (IPEV) Capital Standards Group put forth a principle-based approach for completeness of statements rather than rule-based standardized templates.
- The Standards Board for Alternative Investments (SBAI) advocates for a framework of transparency, integrity and good governance to improve the alternative investment industry.

"There's a lot of variance in terms of mission and scope across groups," says PAAMCO's Jane Buchan. "Some are very narrowly focused on one or two issues, while others are taking a broader perspective." Given how numerous and how varied industry groups are, investors and managers both should evaluate their priorities and focus their time, money and efforts coordinating with groups that best represent their long-range goals.

Despite these challenges, many in the industry see a broader benefit in efforts to increase transparency into alternative investments. As the fund-of-funds CFO we spoke with pointed out, "To gain widespread adoptions, these organizations need to ensure that the volume of information requested is commensurate with its use. In other words, do the majority of users require the information? Managers are generally willing to provide additional information, but having to provide massive amounts of quarterly information in multiple formats is not sustainable for many small to mid-sized managers."

This underscores the need for a broader cross-functional discussion between the buy and sell sides to arrive at mutually agreeable and supportable practices if the industry hopes to define a workable standard.

Because we support both investors and managers around the globe, we see the complexity and subtlety on both sides of the transparency discussion. While we don't presume to know the best way to solve these issues, we do believe that the path forward involves reframing the conversation. Rather than talking about transparency within silos (managers with other managers; investors with other investors), we need to have industry dialogue that reaches across these barriers and involves all parties in an industry-neutral setting. And it's important that these conversations include the people involved in generating or using the data, who may have a more intimate understanding of the complexities involved than their firms' executives likely do.

Starting the conversation with a more nuanced view of transparency, and a clear understanding both of your own and the other party's needs can help managers and investors align objectives. Armed with a deeper understanding of the challenges faced by your "partner" in the investment relationship can help you reach a solution that is palatable to you both.

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Many of the professionals we spoke to, on both the buy side and the sell side, spoke to the benefits they see to this cooperative approach. The CFO of a large private equity firm explained that in his experience, deeper conversations are important. "Having a conversation to understand the basis of a request allows us to provide the most useful information to the investor."

The existence of these legitimate barriers to transparency is one of the main barriers to reaching an industry consensus today. For example, managers may face challenges in providing the requested transparency because of the complexity of the data needed, or the potential damage providing the information might cause them. These issues are not easily overcome and can make delivering transparency more costly than either party may want.

CONVERGENCE AS A DRIVER OF COMPLEXITY

Transparency isn't the only trend shaping the alternatives landscape. For several years we've seen a trend towards convergence among alternative managers, including:

- Managers diversifying products to include a combination of hedge, private equity, real estate, and infrastructure strategies.
- Strategies that include tangible assets alongside listed securities, derivatives, currencies, etc.
- The adoption of more complex capital structures.

While a separate trend, convergence has an impact on transparency discussions. The inclusion of more varied strategies, structures, and underlying securities in alternative funds make it more important for investors to understand their exposures. At the same time, more complex holdings make it more difficult for managers to systematically pull, consolidate and deliver transparency data.

	Investors Say	PE, RE, Infrastructure GPs Say	Hedge Funds Say
Holdings	• I can't have "black holes" in my portfolio. I need to understand exposures and allocations for risk and stress testing.	• We provide complete information on underlying holdings in our statements. • Our investments don't lend themselves to traditional risk and exposure analytics.	• Sharing my positions compromises my IP • Regulatory reporting already strains my ops teams, I can't provide this in every investor's requested format too. • Investors who want holdings transparency can set up a separately managed account.
Valuations	• I need confidence in valuation practices to satisfy audit requirements. • I need to understand valuations to support ASC 820/ IFRS 13 reporting. • I can't assess risk unless I have holdings AND valuations.	• Public disclosure of valuations and methodologies may cap the maximum sale value of our assets. • If valuation calculations are public, it could hurt an eventual IPO.	• We share our pricing policy with investors as standard practice. • We're open to discussing valuation practices, but valuing specific assets leads to holdings, and we need to protect our intellectual property.
Fees	• I need detail to confirm that assessed fees match legal documents. • Fee detail is essential for assessing value creation.	• The complexity of fee rebates makes investor-level disclosures a challenge. • We need to choose the best providers; I can't do that if I have investors who are primarily concerned with costs. • If fees are made public via FOIA request, it opens us up to reputational risk and regulatory scrutiny.	• Gross vs. net returns are listed on investor statements. • Providing detailed fee calculations for every investor is an operational challenge.
Operational	• I need to demonstrate that I've done my due diligence on controls. • I need to be able to see and understand a manager's processes to be comfortable with an investment.	• Our business is different; it's not "apples to apples" with other fund types, and so investors may not understand that our controls are adequate. • We issue an annual SOC1-type report; on-site due diligence places a lot of strain on our team and impedes focus.	• Due diligence visits are a standard process; we work with our administrator to make sure investors have what they need.
Liquidity	• I need to understand liquidity details to manage cash flows and meet obligations. • I have to be able to forecast market liquidity to plan for volatility or unforeseen events.	• We provide information on capital calls as fast as possible, but sometimes investment opportunities arise quickly. • We have a lot of bi-lateral agreements with individual investors; providing detail to each one is a logistical challenge.	• Lockups are essential for our strategy; shorter lockups can affect performance. • Terms and conditions are detailed in the subscription documentation and in agreed side letters.

Investors, conversely, have legitimate data needs for risk management, stress testing and due diligence, but the variance in data formats and the systems and talent requirements needed to normalize and get value out of the data present their own layer of expense and complexity.

To help facilitate a better understanding of the challenges each group faces related to transparency, we have outlined some of the key issues in the illustration on page 9.

BARRIERS TO TRANSPARENCY: SOME HIGH, SOME LOW

Sometimes investors and managers can easily find common ground on transparency because the barriers to providing the requested information are low, and the benefits for both sides are higher. For example, investors focused on ESG criteria are likely to have a strong desire for transparency into a fund's underlying holdings. Managers of ESG strategies often recognize that offering that holdings transparency is a compelling product feature and are more likely to do so.

In other situations, the balance may be harder to achieve. It's easy to understand why an investor would want transparency into valuation practices, and many managers have made an effort to provide them with the relevant valuations for their funds. But some investors still are looking for more – often information about the methods used to generate those valuations or some type of independent verification that the valuations are sound. But what if disclosing details about valuations (and making those valuations subject to FOIA requests) effectively puts a cap on the asset price, limiting the manager's ability to sell assets at a higher price? What if disclosure affects the price of an initial public offering (IPO)? In these scenarios, transparency may work against both the manager's and the investor's long-term interests.

As the CFO of a fund-of-funds manager told us, "We believe managers have a duty to provide investors with as much transparency as possible. But we also understand that this can cause material impacts to their operations if information, such as the manager's valuation of a company, becomes public. In our experience, most managers are able to strike a balance so that we have the information we need and their sensitive information is not compromised."

Moving Toward Consensus and Better Practice

No "magic bullet" exists that fully meets the needs and objectives of all parties at all times. Especially when it comes to transparency, compromise between individual investors and their managers will remain important. However, when we look at the issue of transparency in its entirety, we do believe it's possible for the industry to move toward better practices and consensus around key issues.

The first step involves taking a more deliberate and nuanced approach to transparency discussions among all parties. It may require both sides to better define what transparency means to them specifically, and what tradeoffs they're willing to make in exchange for achieving it. Taking a more strategic approach to transparency may also help provide a better framework for making these decisions, and ensuring that the information received or provided is as logistically manageable as it is strategically valuable. And finally, it involves moving the relationship between investors and managers toward more of a partnership approach, in which the partners gain a better understanding of the needs and challenges of their fellows.

As the chief operating officer of a large corporation said, summing up their experience on getting the transparency they need, "If you know what you need, can have a knowledgeable staff member articulate it to the manager clearly, and show some patience and empathy, you will get what is needed."

When it comes to transparency, compromise between individual investors and their managers will remain important. However, we do believe it's possible for the industry to move toward better practices and consensus around key issues.

LEARN MORE

Are you interested in exploring the idea of finding a balance on alternatives transparency or how a transparency tool kit can benefit you? We would be happy to discuss these ideas and the insights we've gained from our ongoing research.

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