NORTHERN TRUST

REFRAMING THE CONVERSATION

FOUR AREAS WHERE ALTERNATIVES INVESTORS AND MANAGERS CAN SEEK COMMON GROUND

Investors are seeking more transparency into their alternative investments to try to mitigate the inherent risks, but the lack of data standards and conflicting perspectives can create friction between investors and managers. A more constructive dialogue between the buy and sell sides could help everyone strike a better balance.

Alternative fund investments are more than mere transactions. For such investments to be successful, investors and managers must engage in a collaborative relationship that achieves an alignment of the parties' differing long-term goals. Successful long-term relationships are usually marked by give and take, mutual understanding, and compromise. We believe the meaningful evolution of the alternatives industry to meet the needs of both managers and investors requires a similar approach.

As an administrator and service provider to both the buy and sell sides, Northern Trust believes the following are areas where more collaboration between manager and investor could yield results.

MORE WAYS TO IMPROVE TRANSPARENCY

In our recent paper: *Alts Transparency: Finding the Right Balance,* we outlined three key areas where managers and investors can collaboratively drive better practices around alternatives transparency. The paper also explored how managers and investors can benefit from developing a transparency strategy.

1. REGULATION

Regulations affect investors and managers alike, and by their nature regulations are ever-changing. Many of the regulations introduced since 2008 – notably Dodd-Frank in the United States, the Alternative Investment Fund Managers Directive (AIFMD) in the European Union and the Australian Securities & Investments Commission Regulatory Guide 97 (ASIC RG 97) – have been at least partially concerned with transparency and the disclosure of certain information to regulators and to the general public. More recently, we're seeing regulatory changes that could alter how alternative funds are structured, domiciled, managed, distributed and taxed.

WHAT
Regulation – At proposal stage

HOW
Industry group to industry group

BENEFIT
Joint focus on areas of mutual concern could increase the likelihood of lobbying success.

Discussion about regulation can be divided into two separate areas: addressing regulation before it becomes law and discussions about how much of the information gathered to meet regulatory requirements should be disclosed to investors or the general public.

The traditional path of addressing new potential regulation involves buy-side and sell-side organizations independently lobbying regulators. But approaching new regulation collaboratively in areas where both sides have reached consensus could better serve the interests of all parties – investors, managers, regulators and, most importantly, end investors or beneficiaries. Here are some potential areas where common ground might exist:

- Do the new regulations create confusing overlap with existing regulatory requirements? Working together to raise these concerns and get them addressed prior to implementation could save both sides time and money.
- Is it possible to better align a new regulatory requirement with other regulations, either from a different jurisdiction or domicile?
- Do the proposed timelines offer both sides enough time to implement systems needed to meet the new requirements?
- Are there potential "knock on" implications to either side that regulators/legislators have overlooked?

Monitoring and assessing the potential impact of proposed regulation is time consuming and complicated. Pooling industry resources to monitor and analyze potential changes can help mitigate unintended negative effects and makes a stronger case for change in areas where both sides agree.

After regulation becomes law, a new issue arises: how much of the information managers are gathering and presenting to regulators should also be shared with investors? Investors often feel that since the managers have gathered it, sharing it shouldn't pose a problem. Many managers, on the other hand, feel that the data regulators require doesn't accurately reflect risk. Finding a compromise or at least a common understanding about what information might accurately reflect a fund's real risk exposure could minimize frustration on both sides.

WHAT

Regulation – After implementation

HOW

Discussions between individual managers and investors

BENEFIT

Discussions about whether information provided to regulators will be helpful or misleading to investors can minimize frustration on both sides.

LOCAL REGULATIONS COMPLICATE SITUATION IN UNITED STATES

While the U.S. federal government is discussing loosening regulation, some states are stepping up to fill the void. Several states have either passed or are considering legislation that would place new requirements on public funds, which are often major investors in alternative strategies. If these laws limit or curtail alternative investing, managers stand to lose a key source of capital, while public funds will need to find other ways of generating returns to meet their liabilities to retirees. State-level regulatory changes also open the door to a form of "regulatory arbitrage," with managers shifting funds, domiciles or distribution strategies to obtain more favorable taxation and regulatory terms.

2. USE OF CREDIT

Sustained low interest rates have led some managers, particularly in the United States, to become more creative with their use of credit. In most cases, using credit may offer meaningful benefits for both managers and investors. But some extended or complex credit arrangements can have unforeseen consequences for investors, which has led to some concerns about nonstandard credit arrangements. These concerns particularly focus on the consequences, such as tax implications, liquidity surprises from "jumbo sized" capital calls, accounting challenges where funds are invested, divested and distributed before capital is ever called, and how to account for them in their risk assessments.

When managers more clearly define how they are using credit, investors' anxiety levels decrease because they feel more confident that they have a handle on the risks. This can be accomplished in a variety of ways. In Europe, for instance, regulators already require that managers conduct scenario testing and disclose solvency issues. If managers were to discuss these results with investors, it could provide more insight into the risks, and increase investors' comfort. In other markets, managers might find it worth the time to explain in advance to investors how they are planning to use credit and the benefits they expect from that use. This could allow investors to become comfortable with the credit-related risks or to raise potential consequences they see arising.

Creativity can be a good thing, and can provide a competitive edge to managers and investors alike. But no one likes surprises, which is where candor between investors and managers can help ensure clarity so that all parties know what to expect. Some discussion around this has already happened, and investors are less worried now than when these practices first arose. But we believe further conversation still would be beneficial.

WHAT
Use of Credit

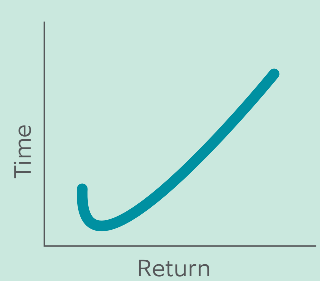
HOW
Discussions between individual managers and investors

BENEFIT
Being clear on planned use of credit facilities and potential implications can avoid frustration and potential consequences down the road.

MANAGING THE J-CURVE EFFECT

Private equity funds typically display asymmetric performance over their investment horizon, commonly known as the "J-curve," showing a "dip" in the early years before the returns begin to grow. Why? Because the investment process is time consuming, holding periods are typically 10 or more years, and the early years often involve costs associated with restructuring or realigning a target company. Today, many managers are seeking to manage this effect by using credit in the early stages of a fund's life to avoid negative drag on investors' capital and to present a more symmetrical return profile. This is particularly true of EMEA-based managers involved in new launches.

ILLUSTRATION OF TYPICAL PRIVATE EQUITY FUND RETURNS OVER TIME



3. FEES

Fees for alternative investments are complex, and even standard industry practices can lead to confusion and misunderstanding. If managers took the time to educate investors about fee and expense matters while hearing what investors feel are appropriate levels of accountability and transparency in expense management, this dialogue could help quell many of the most hotly contested issues.

- **Offsets:** The standard 2 and 20 fee structure is a straightforward calculation, but when managers apply offsets from consulting and other fees earned from underlying portfolio companies (a popular practice among private equity, real estate and infrastructure funds), both calculation and verification become more complex. There is evidence the management community is strengthening language around fees in agreements and is being increasingly responsive to requests for fee details. However, this increased disclosure is not easily assembled and is not without operational cost. Reasonable standardization could benefit both managers and investors.
- **Gross vs. Net Fees:** In our experience, fund returns are best stated on the industry standard net-to-investor basis. When investors attempt to "gross up" returns to compare net vs. gross, the numbers may not match, leading them to assume the manager made calculation errors. Discussions about how the manager is calculating returns, especially about the treatment of fee and capital call credit use, could alleviate some of this confusion.
- **Carried Interest:** Paradoxically, the one area where investors and managers are in near-complete agreement is also where some of the trickiest problems occur. Misunderstandings about carried interest have led to the public and the press decrying "fee hikes" without realizing those charges represent a coordinated effort to reward performance. This is an area where managers and investors working together to clarify and educate beneficiaries and others could have a benefit for everyone involved.
- **Business Decisions:** In a perfect world, managers should make expense decisions based on value, choosing the specialists and providers that will help them generate the best overall return. When investors are privy to the manager's every decision, some may pressure the manager to lower expenses or choose lower-cost providers. Managers that succumb to this pressure may then make decisions on political considerations and short-term thinking rather than on what will drive the best long-term results. Engaging in dialogue around these decisions can help investors understand the longer-term value rather than just focusing on the short-term cost.

WHAT
Fees

HOW
Discussions between individual managers and investors

BENEFIT
Clearing up misunderstandings about common industry practices can allow managers to focus on creating long-term value and give investors a clearer understanding of what they're paying.

4. OPERATIONS

Due diligence and operational controls have been considered industry standard for hedge funds for decades. The Madoff scandal quickly made intensive due diligence a non-negotiable requirement among large investors, and questionnaires, audit reviews, on-site visits and other mechanisms are now considered business as usual. However, this has been less true of other alternative strategies. Private equity firms in particular have been less comfortable with due diligence, in part because of fears that investors might not accurately assess the efficacy of controls, or that they may demand certain practices that add complexity and overhead expense.

But operational due diligence is the new normal where alternative assets are concerned. Investors will rightly expect to understand controls as a means of assessing risk, and regulators increasingly are following suit. Managers will be better served to educate investors about controls they fear will be misunderstood than by trying to avoid the conversation altogether. Regardless of whether and how often investors push for operational transparency, we believe that managers who embrace investor due diligence stand to benefit from "right sizing" their control framework in collaboration with investors.

WHAT
Operations

HOW
Discussions between individual managers and investors

BENEFIT
Managers and investors both stand to benefit from collaboration to better understand the controls that are in place, and to right size the control framework to meet both parties' needs.

SETTING THE STAGE FOR TOMORROW

Not only can creating a mutual understanding between managers and investors help with today's issues, it also can create a framework for more productive relationships in the future. In an age where technology and innovation are reshaping every aspect of the financial services industry, the only certainty is that things will continue to change. Open dialogue between investors and managers can help them adapt to changing investment strategies and technology more quickly and smoothly.

Dialogue may not be a cure-all; differences of opinion and needs will always exist. But reframing the conversation between managers and investors holds the potential to measurably improve industry-wide transparency practices.

LEARN MORE

Are you interested in ways you can work to reframe conversations about transparency with your managers or investors? We would be happy to discuss these ideas and the insights we've gained from our ongoing research.

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