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Opinion: Past, Present and Future of Alternative Funds Market

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It's been less than 50 years since the fund of funds model came on the investment scene, and that short history has been anything but dull. Born in the 1970s, American fund of funds took off in the '80s and '90s, and then hit a major stumbling block in 2008, when the widespread financial crisis unearthed deep challenges around liquidity. Today, financial pundits are quick to say that the fund of funds structure is on its way out as an investment model, but the truth is more nuanced. Operations are evolving, and the term itself is used less and less often, but what is really changing are the ways in which multi-fund asset managers must manage their portfolios.

The lessons and lasting impact of 2008

Any firm that invests with alternatives has innate pain points around managing, screening and tracking activity, pricing and performance. Clients who invest with hedge funds or private equity funds agree to lock up their money for a certain period of time. Before 2008, few firms adequately tracked those liquidity terms, and their lack of efficient data management meant that many fund of funds could not accurately predict their future cash flow. They didn't have liquidation scenarios analysis, hypothetical portfolio analysis or stress-testing procedures in place. During the financial crisis in 2008 and through 2009, the deficiencies of these systems came to light.

Since then, increased transparency requirements from regulators and investors alike have required firms to accurately project their future liquidity, including but not limited to when and how much a manager is gating and how much will be available for each eligible period. For fund of funds scrambling to deal with these increased pressures without adequate technology, the process of manually managing multi-manager portfolios has gotten considerably more complicated.

The fund-of-funds landscape today

I recently spoke with a fund manager who said, "If you've seen one fund of funds, you've seen one fund of funds." He was joking, but his subtext was serious. As alternative investment managers try to reinvent themselves and offer more than the traditional co-mingled vehicle, they're facing difficult questions about customization. Investors want tailored portfolios, and a fund of funds with 50 clients today might find itself juggling 50 different trade tickets that reflect 50 different levels of liquidity risk.

That's a huge operational burden that didn't exist in the early days of fund of funds or even five years ago. A firm that carried 10 portfolios in 2008, for example, might easily have 100 today. The investment decisions aren't vastly different, but the operational questions certainly are. When these firms are creating "funds of one" they have to ask themselves:

- What fees are we willing to accept?
- Can we abandon the now-controversial 2-and-20 compensation structure?
- What type of reporting can we do?
- Are those reports enough to satisfy investors?
- Can we accommodate smaller investors?
- What details matter most to today's client?

For years, performance was the only metric that mattered to fund of funds clients. That is no longer the case. Today, sophisticated investors press for information to make sure they're not getting burdened with double fees, and they want evidence that their fund of funds managers are adding value. The fact that so many firms are resistant to this shift accounts for some of the consolidation going on in the market right now.

The fund of funds that do not want to change anything – not their investment strategies, not their fee structures, not their analytics engines, not their reporting mechanisms – are the very same ones that have market watchers predicting the demise of the entire space. These organizations are watching their assets under management (AUM) shrink and their key investors walk away. Among companies that had AUM in the $1 billion to $4 billion range, there have been a significant number of mergers.

The future of alternative multi-funds

Certainly, some of the assets that once kept fund of funds firms flush have moved to managed or customized accounts, where the more stringent transparency requirements assure investors that they can gauge true liquidity. But the multi-fund managers who are embracing more detailed enterprise and performance attribution reporting are retaining their clients.

Surprisingly, many firms still don't know that technology exists specifically for the needs of those dealing with alternative, multi-manager investments. Comprehensive portfolio management solutions not only handle daily trading activity, positions and pricing methodology, but they can also ensure a unified data repository from which managers can analyze exposure, performance and allocation weights.

These systems allow firms to satisfy investor demands for greater transparency while delivering tools for more efficient portfolio and liquidity management. The reality is that when it comes to liquidity, many still grapple with management and reporting within their investment portfolios due to a range of issues, including complex structures, side pocket interests, gating complexities and regulations. Adding a portfolio management solution can ease the liquidity management process and give managers the ability to systematically manage their portfolios while performing complex analytics and reporting.

Fund of funds will continue to exist, but we will see fewer firms identifying themselves this way. Those that survive the ongoing shift in investment preferences will do so because they have learned how to ensure data integrity, deliver customized offerings and facilitate automated reporting. These survivors will help their clients get clearer views of the investments they made yesterday, inform the investments they should make today and reap greater returns tomorrow.

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