

Increasing transparency has helped to unmask the operational risks in the alternative investment arena.

Alternative Investments Adapt: Four Trends Reshaping the Industry

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After years of volatile asset valuations and intense investor scrutiny, the alternative investment industry is well on the road to recovery. But while investment returns are more robust, the industry is experiencing a profound transformation as four key trends play out in the alternatives space. How funds respond to these trends will help determine their success in the years to come.

1) Increased Transparency

The lack of transparency in the alternative investment industry was once viewed as a competitive advantage. Limited transparency protected proprietary investment strategies from becoming public knowledge. That same lack of transparency, however, also masked the market and operational risks undertaken by funds in the alternative sphere. Risks that didn't become fully known until the financial crises hit, and by then, it was already too late for some investors.

Investors want and need to know where their cash is being allocated and how they can maximize liquidity when the need arises. Transparency in these situations centers on better fund compliance, rigorous internal controls and greater accuracy in reporting — all of which can be used to provide a strong level of assurance to clients. But a strong commitment to transparency can benefit everyone — investors, counterparties and even alternative investment funds themselves.



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Until recently, alternative investors primarily consisted of high-net-worth individuals with rather limited capabilities to conduct a thorough review of a fund. Now that institutional investors such as pension funds are the dominant investors, fund managers are being subjected to more rigorous due diligence into their investment decisions, operational procedures and fund governance. The stakes for transparency are higher than ever and alternative managers have to adapt or risk losing their institutional clientele to a more transparent competitor.

2) More Regulations

To prevent a repeat of the 2008 financial crises, industry regulators from around the world have passed a series of new laws designed to protect investors, maximize transparency and ensure liquidity in capital markets. Alternative funds came under particularly close scrutiny during regulatory hearings and are subject to some of the strictest new provisions.

In the US, the most sweeping changes to financial regulations since Great Depression were signed into law in July 2010 with the Dodd-Frank Bill. This bill affects every aspect of the US financial industry, with special provisions for alternative funds, many of whom must now meet the same SEC requirements as traditional registered investment advisers.

This means that alternative investment managers with over \$150 million in assets under management will have to register with the SEC and be subjected to new reporting requirements. Specifically, SEC registered alternative investment managers will have to report on a wide range of business activities including assets under management, use of leverage, counterparty credit risk exposure, and trading and investment positions.

In November 2010, the European Commission passed the Directive on Alternative Investment Fund Managers (AIFM). AIFM, which came into force early 2011 with full implementation required by 2013, provides an EU-wide regulatory framework that enables alternative managers to market their funds in any (or all) member EU countries. Much like Dodd Frank in the US, the Directive includes enhanced disclosure requirements and provisions on capital investment.

Also coming in Europe, UCITS IV (Undertaking for Collective Investments in Transferable Securities) is scheduled to take effect on July 1, 2011. Many alternative managers are refashioning funds to fit the UCITS framework. Key provisions include limits on the use of leverage, concentration limits in individual securities and restrictions on direct investments in commodities, which have been deemed too volatile for UCITS funds.

3) Outsourcing

In keeping with their often secretive investment processes, alternative funds have traditionally preferred to keep most of their operations in-house. Fund accounting, reporting and reconciliation were all handled by a fund's back office, which was not typically at the forefront of alternative manager concerns.

This all changed during the financial crises when it became clear that many portfolio managers underestimated the operational capacity needed to run an alternative fund. As a result, back office operations shifted from being viewed as a purely

administrative role to one that is integral to an alternative fund's success.

Alternative managers are increasingly turning to their operations for improved efficiency, increased transparency and greater accuracy to manage risk and enhance performance. These funds, however, often lack the dedicated expertise and appropriate technology platform to maximize their operational procedures. This is where outsourcing to a capable third-party provider can help customize and integrate back-office processes such as custody, banking and cash management into one, complete operational solution.

Outsourcing, however, does involve a new degree of counterparty risk where the location of assets at any given time is of utmost concern. To mitigate such risks, new business models are emerging for the safekeeping of cash and securities whereby alternative managers are turning away from prime brokers and moving toward custody banks. Such financial institutions have the demonstrated scale and scope to meet operational needs, ensure liquidity and facilitate transparency for alternative investment funds.

4) Hybrid Investment Structures

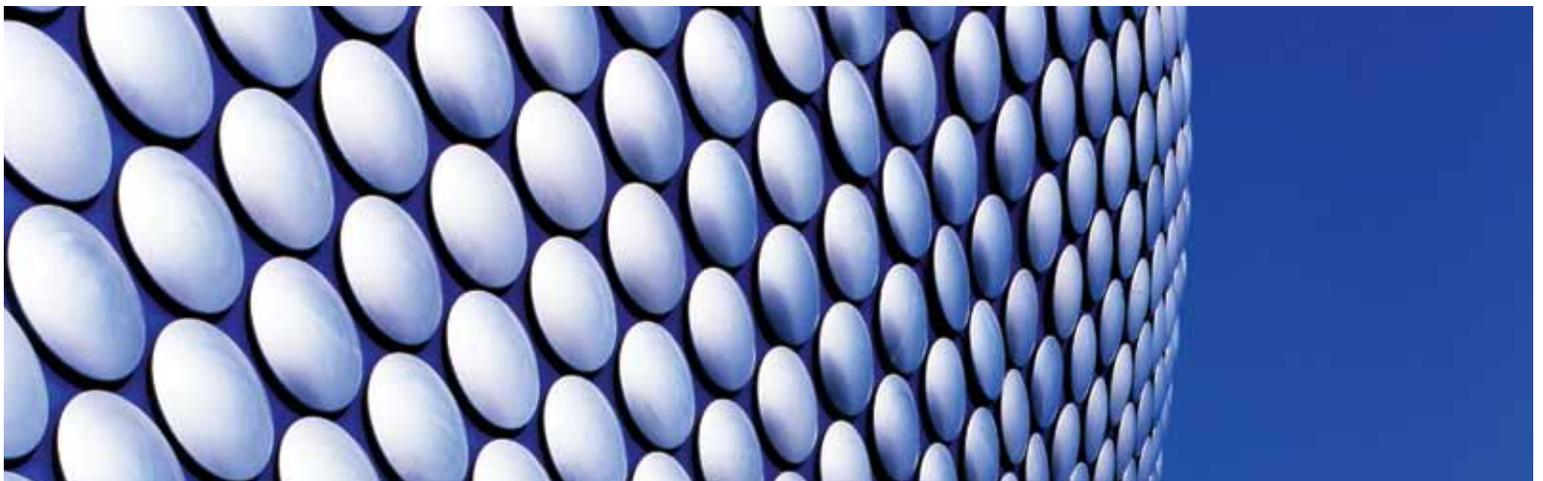
Historically, hedge funds and private equity firms have been distinct: hedge funds created wealth primarily from publicly traded securities and private equity firms created wealth from private, illiquid equity investments. In addition, the time horizon of private equity investing is much longer than in hedge fund investing, and the skills required to execute the investments can be very different. Now, however, some major hedge funds are investing in illiquid assets and some private equity firms are investing in liquid assets. This new hybrid model of investing is rapidly converging the space between hedge funds and private equity.

Mixing asset classes and investment strategies creates new operational and regulatory ramifications for alternative funds and their investors. Traditional hedge fund and private equity investments each have their own set of rules regarding disclosure, reporting obligations, and taxation. Combining hedge fund investments with private equity investments in one fund greatly increases the regulatory, accounting and reporting complexity in which an alternative fund must comply.

The potential benefits, however, may outweigh the potential pitfalls in a hybrid alternative structure. Hybrid funds are a great vehicle for alternative asset managers seeking the best available investment opportunities no matter the market. In addition, by integrating two distinct investment vehicles into one fund, an alternative manager may be better able to meet the investment needs and return requirements of increasingly demanding institutional investors.

Once viewed purely as an administrative tool, back office operations are now being viewed as an integral part of an alternative fund's success.

By integrating two distinct investment strategies, an alternative fund may be better able to meet the return requirements of increasingly demanding institutional investors.



Who's Helping You?

For more information on current trends reshaping the alternative investment industry, please contact:

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