SURVEYING THE LANDSCAPE: HYBRID ALTERNATIVE FUND STRUCTURES

In recent years, investor pressure to access wider investment opportunities and earn better returns has led to a growing market in hybrid alternative structures. But it takes a specific skill set to navigate the unique complexity and issues they generate.

WHAT MAKES HYBRID FUNDS POPULAR?

With characteristics of hedge and private equity (PE) funds, several factors make hybrid structures attractive to alternative investment managers and their investors.

• **Predictable liquidity:** Many alternative investment strategies require longer investment periods that restrict exit options, unlike traditional assets. While demand is growing for funds that trade in more illiquid asset types (e.g. bank debt, private debt, direct lending, emerging market assets), investors still want greater liquidity than those investments typically offer. Hybrid funds provide a form of predictable liquidity, although more limited than a typical hedge fund.

• **Credit quality:** The “redemption rush” of the 2008 financial crisis left deep scars. Investors and investment managers alike want to decrease the probability of similar “fire sales” and/or disorderly fund liquidations happening again.

• **Cash flow and portfolio management:** Hybrid funds provide more stable cash flows than other alternative fund structures, which not only can help optimize investment selection, but can also improve the long-term success of a manager’s business.

• **Investor demand for differentiation:** Crowded markets encourage both investors and investment managers to find structures that depart from the “norm” in their search for uncorrelated returns. The balance between liquidity and return has also shifted as investors are more willing to “sacrifice” small amounts of return, for greater liquidity.
WHAT TYPE OF HYBRID?

The term “hybrid” can be used to describe many different types of fund structures, but some more frequently seen characteristics exist.

- Liquid assets with rolling “hard lock” periods. Investors can redeem assets at pre-set periods longer than the typical 18- to 24-month soft locks of most hedge funds.
- Less-liquid assets with a periodic income stream often held to maturity (e.g., bank debt, emerging market debt, real estate debt, etc.).
- Illiquid assets with a periodic income stream distributed to investors on a pre-set interval (e.g., direct lending, peer-to-peer lending).

An investment manager can employ any of these characteristics to provide transparency to investors, as well as align fund performance with manager remuneration.

Before deciding on a structure, it’s best to consider the different processing considerations of each.

Multi-currency commitment/drawdown: Most hedge funds have multi-currency share classes or feeder funds; typical PE funds have commitments based on a single currency. In a hybrid structure that follows a commitment/drawdown methodology and caters to multiple currencies, consider the following:

- **FX rate:** What FX rate should you use to convert the commitment and the drawdown amount? If using prevailing rates, the drawdown amounts in the fund’s base currency could either exceed or fall short of the committed amount.
- **Drawdown calculation basis:** This could be a percentage of the commitment or a numerical value. If the former is used, you run the risk of either falling short or exceeding the commitment amounts. If the latter is used, you run the risk of either falling short or exceeding the commitment amounts if the drawdown amount is based on the fund’s base currency.
- **FX share class hedging:** When cash collateral is held for an FX hedge, some currency share class/feeder fund investors will experience different performance because their full capital isn’t at risk. This would also lead to differing amounts of performance fee/carried interest. Additionally, cash flow management and FX spreads charged by brokers could be affected depending on whether the hedge is executed at the master or feeder fund level.

PE commitment/drawdown: In a fund with an open-ended investment period, a PE commitment/drawdown method usually employs a typical waterfall distribution. The key is to transparently allocate income/expenses to relevant investors on a pre-set allocation ratio, which allows you to track attribution of an investment to invested capital.
Liquid asset performance attribution: Investment accounting methods for liquid assets vs. illiquid assets vary widely. Hybrid structures that lack an integrated process can cause problems for investment managers used to seeing real-time P&L reports, collateral requirements and mark-to-market daily valuations. With the closed-ended nature of the fund, integrated processing of these asset attributes is crucial.

**REMUNERATION CONSIDERATIONS**

Several methods can be used to align hybrid fund performance with investment manager remuneration.

**Hedge fund methods**

The three main hedge fund performance fee methods used to calculate remuneration (equalisation credit, series accounting and partnership accounting) can be used in a hybrid structure. Each poses challenges, though, from system limitations and how "straight-through" the investment accounting vs. the investor accounting processes are.

The most important aspect when considering these methods is how each investment (and therefore their income/expense streams) is tagged to each investor. Consider these tagging structures:

- Setting up a distinct “strategy key” for each investment and expense
- Creating and maintaining a mapping table to ensure performance attributes are correctly and transparently allocated to the relevant investor
- For equalisation credit funds, tag each component of the equalisation credit and contingent redemption to a “strategy key” as well.

**PE methods**

The waterfall distribution method is often the best method to use when calculating remuneration using a PE methodology. As hybrid structures typically hold more investments with open-ended timing, you should also consider tagging investments (and their income/expense streams) using a “strategy key”.

The equalisation credit method is rarely used because of its complexities and inherent lack of transparency.

**Which to choose?**

Hybrid structures often use the PE method of waterfall distribution or the hedge fund method of series accounting, which closely mimics PE-based partnership accounting.
Using series accounting means there is no subsequent close/equalisation required when new investors come into the fund. Plus, the open-investment-period nature of some hybrid funds allows for series accounting to transparently allocate income/expenses to the relevant set of investors.

One of the main outcomes of the different methods is the timing of fees paid to the investment manager; hedge fund methods typically crystallise fees for the general partner in a more predictable and timely manner than the PE methods. This is often with the addition of a clawback, which means the two methods ultimately pay out the same amount of remuneration to the investment manager.

Another outcome to consider is the alignment of the investment lifecycle relative to the fees paid to the investment manager. An increasing number of funds “recycle” their capital when investments are realised; therefore the method used should take that aspect of the fund into account.

DON’T NAVIGATE BLIND

Complexity does not have to be labour-intensive or error-prone. Robust operating models can handle most issues that arise from hybrid structures by offering integrated data flow between the investments, cash, investor allocation and performance fee/waterfall distribution allocation. Call us to discuss the option best-suited to helping you achieve your goals.