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INVESTMENT MANAGEMENT

The Rise of Hedge Fund Co-Investments

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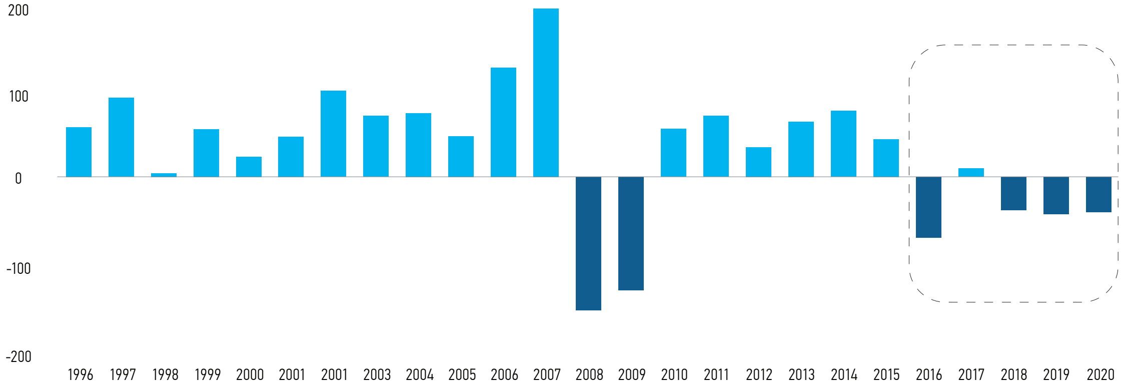
While co-investing has been a feature of the private equity industry for many years, it is a more recent and growing trend in the hedge fund industry. We believe that hedge fund co-investments are an important tool to increase the total return of portfolios, while limiting correlation to traditional asset classes and core hedge fund strategies. Co-investments can also be used to respond more rapidly to dislocations in markets, such as those presented in many markets in 2020.

Why are we seeing growth in hedge fund co-investment opportunities?

Prior to the global financial crisis the hedge fund industry experienced strong inflows. Many hedge funds enjoyed relative freedom to pursue niche opportunities and put less liquid

Net Outflows in Hedge Funds Drives Opportunity

Net Asset Flows in $ Billions



Source: HFR® Global Hedge Fund Industry Report – Fourth Quarter 2020 as of January 2021 investments into side pockets. In recent years, industry inflows have been more limited and investors have been more restrictive on permissible investments, particularly less liquid situations. *(Display 1)*

As a result, hedge funds, outside of mainstream liquid strategies such as equity long/short and global macro, have had less discretionary capital available to deploy. This has coincided with regulatory changes that have decreased bank and insurance company willingness to invest in non-traditional asset classes, creating more opportunity for alternative forms of capital to fill that void. The end result has been an increase in established hedge funds seeking co-investment capital for discrete opportunities that do not meet the liquidity, concentration or asset class guidelines of their main funds.

From the investor's perspective, fees, transparency and correlation are key focal points when it comes to hedge fund allocations. In our view, co-investments have the potential to provide improvement on all three fronts. Furthermore, they can provide a way for investors to target specific exposures and risk/return profiles that meet their investment objectives.

In short, we believe co-investments offer a clear and self-sustaining value proposition to hedge fund managers and investors. For managers, co-investments represent a new form of capital that enables them to participate in high-conviction opportunities that, absent co-investment capital, they would not be able to pursue. For investors, co-investments offer a means of direct access to differentiated sources of return with potentially bespoke risk/return profiles as well as attractive fees, transparency and control rights.

How do hedge fund co-investments differ from private equity co-investments?

The primary difference is the universe of managers from which co-investments are sourced. Co-investing is a mature concept for private equity firms. Indeed, many private equity managers have established and often contractual processes for how co-investments are allocated among existing clients. Co-investing is a newer concept for hedge funds. Most hedge fund managers do not have a long list of existing investors with whom they have traditionally partnered on such investment opportunities. At the same time, most hedge fund allocators are not equipped to make decisions about co-investments. As a result, these opportunities tend not to be as heavily trafficked as private equity co-investments and there tends to be greater potential for tailoring implementation strategies.

Another important difference is the breadth of investment strategies accessible through each of the two categories. Private equity co-investments typically involve control private equity positions that are subject to the same factors that influence valuation of public equities. Hedge fund co-investments represent a diverse array of asset classes, liquidity profiles and risk. They can be "risk-on" or "risk-off" and everything in between. They can range from publicly traded equity and debt to non-traded investments, such as litigation finance and reinsurance, which have no correlation to traditional assets classes. For this reason, we would generally expect that hedge fund co-investments would have lower correlation to global equities than private equity co-investments. Hedge fund co-investments also tend to have shorter holding periods than private equity co-investments.

How are hedge fund co-investments sourced?

Today, sourcing is entirely dependent upon having access to a robust network of idea-generators. The most obvious sourcing channel comes from hedge fund managers with whom an investor has existing primary fund investments. However, it is increasingly common for hedge fund managers to solicit co-investment capital directly from allocators with whom no primary fund relationship exists. This is happening because few hedge fund managers have existing investors with active co-investment programs and managers recognize co-investments as an opportunity to broaden their client base and support future business growth.

What are the key barriers to entry?

While we believe there are many potential benefits to making co-investments, there are challenges as well. Broadly speaking, we see four key barriers to entry:

1. **SOURCING:** Having a wide network of existing hedge funds—idea generators—and a pipeline for new ones is critical. The greatest advantage in this space comes from the luxury of choice, having access to a wide range of potential opportunities and being selective.
2. **ANALYSIS:** Co-investing requires integrating a hedge fund manager due diligence framework with asset-specific underwriting. Many hedge fund investors are not structured or resourced to support this two-pronged approach.
3. **EXECUTION:** Co-investing requires efficient decision making, often over the course of mere days. In addition, legal documentation and vehicle structuring must be accomplished far more rapidly than is required in traditional fund investing.
4. **CAPITAL FLEXIBILITY:** Co-investments are often presented because the hedge fund manager has constraints on size and/or liquidity that prevent inclusion of these ideas in a main fund. Investors must have the mandate and appetite to be flexible around these parameters in order to maximize their opportunity set.

How is alignment typically achieved with the hedge fund manager?

Generally speaking, alignment is achieved in two ways. It can come from assurance that a manager has "skin in the game", investing personal capital alongside that of external investors. And it can come through fee structures that are akin to "sweat equity". There are a wide range of fee structures (including no fees), but structures are typically skewed toward realization-based incentives over a performance hurdle whereby a manager is only compensated if the investment achieves the investor's objectives.

What is the role of co-investments in client portfolios? What are the trade-offs?

We believe the primary role of hedge fund co-investments in client portfolios is to potentially increase expected return. Secondary benefits may include improving transparency, reducing average fees and introducing targeted exposures that are not correlated to existing allocations.

The trade-offs are that co-investments are resource-intensive and require quick response times. In addition, they can have higher risk and wider distributions of outcomes than traditional fund investments. Finally, co-investments may require more onerous contractual liquidity.

Conclusion

In our view, hedge fund co-investments have a distinct role to play in well-balanced portfolios, offering important diversification benefits to traditional asset classes as well as hedge funds and opportunistic investments. We believe that hedge fund co-investing will reach the level of adoption currently found in private equity, leaving significant runway for growth in the years ahead.

DEFINITIONS

Correlation: Statistical measure of the degree to which the movements of two variables are related.

Dispersion: A term used in statistics that refers to the location of a set of values relative to a mean or average level. In finance, dispersion is used to measure the volatility of different types of investment strategies. Returns that have wide dispersions are generally seen as more risky because they have a higher probability of closing dramatically lower than the mean. In practice, standard deviation is the tool that is generally used to measure the dispersion of returns.

Equity Long Short: A group of strategies that tend to focus on buying equities that are expected to increase in value and selling short equities that are expected to decrease in value.

Global Macro: A group of strategies that tend to incorporate directional trading in relatively liquid investment instruments. Global Macro strategies tend to attempt to anticipate global macroeconomic events, generally using all markets and instruments to generate returns, and generally undertaking fundamental analysis.

Risk-On and Risk-Off: Terms refer to investor tendency to seek or shun assets they perceive to have greater than normal market risk.

Volatility: A statistical measure of the tendency of a market or security to rise or fall sharply within a period of time – usually measured by standard deviation.

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