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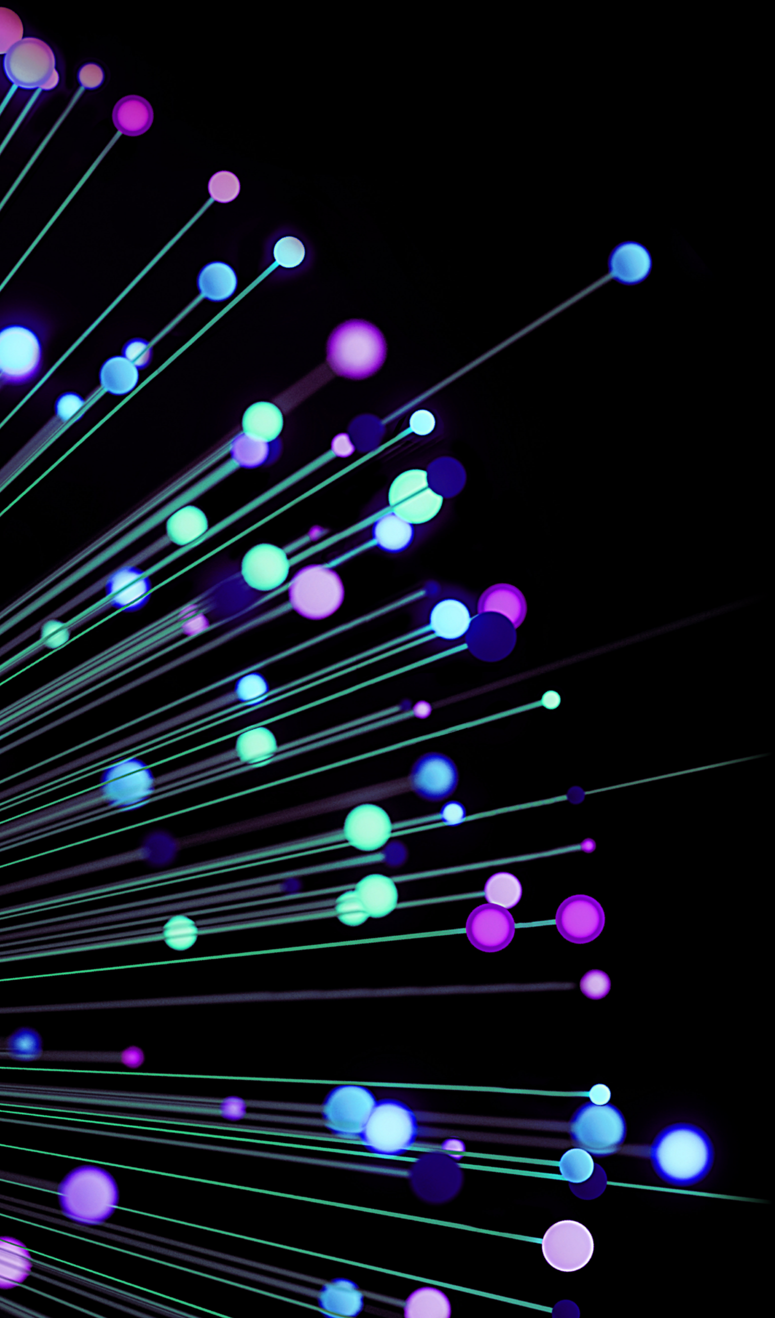
Together makes progress

Unlocking the open-ended alternative fund opportunity: Is industry-wide transformation needed?

Deloitte Private Equity | Firm and Fund series



Preface

Welcome to Deloitte's series exploring key strategic drivers and events influencing the evolution of private capital firms and funds.

I am really excited to bring this series to you which delves into some of the unprecedented challenges and opportunities facing private capital firms right now. What are we seeing firms focusing on at the moment? There is huge focus on liquidity at both the firm and fund levels, a continued focus on growing assets under management in more challenging markets and of course focus on increasing profitability at the firm level. Many firms are also grappling with succession and transition planning. How are firms addressing these goals? Solutions range from one or a combination of expanding into new strategies and geographies, accessing new investor types, establishing continuation vehicles, undertaking general partner stake sales or full consolidation, implementing new and innovative incentive structures, and firm level optimization. Successfully navigating these events requires careful planning and understanding of market practice as well as a relentless focus on the impact on talent, ownership structures, and organizational frameworks.

This series explores these key events and trends shaping the private capital landscape. Our aim is to bring the breadth of our global expertise and experience to support your firm in understanding the art of the possible, planning out the roadmap to an event and supporting in the design and execution of the chosen solutions.

I hope you find our insights valuable.

Olivia Biggs
Global and UK Private Equity Firm and Fund Services Leader

To the point

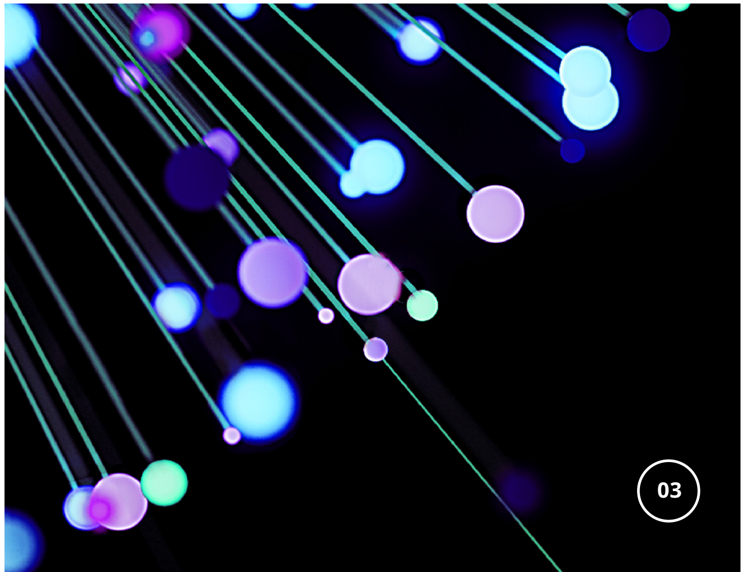
Demand for open-ended Alternative Investment Funds (AIFs) is growing among High-Net-Worth Individuals (HNWIs) and family offices.

General Partners (GPs) have strategically prioritized offering these products to secure perpetual capital.

Open-ended funds offer GPs and Limited Partners (LPs) advantages such as continuous capital inflows and diversified investment options.

Operational challenges include liquidity management, asset valuation, regulatory compliance and investor and staff education.

Effective distributor management is crucial for the successful marketing and distribution of these funds.

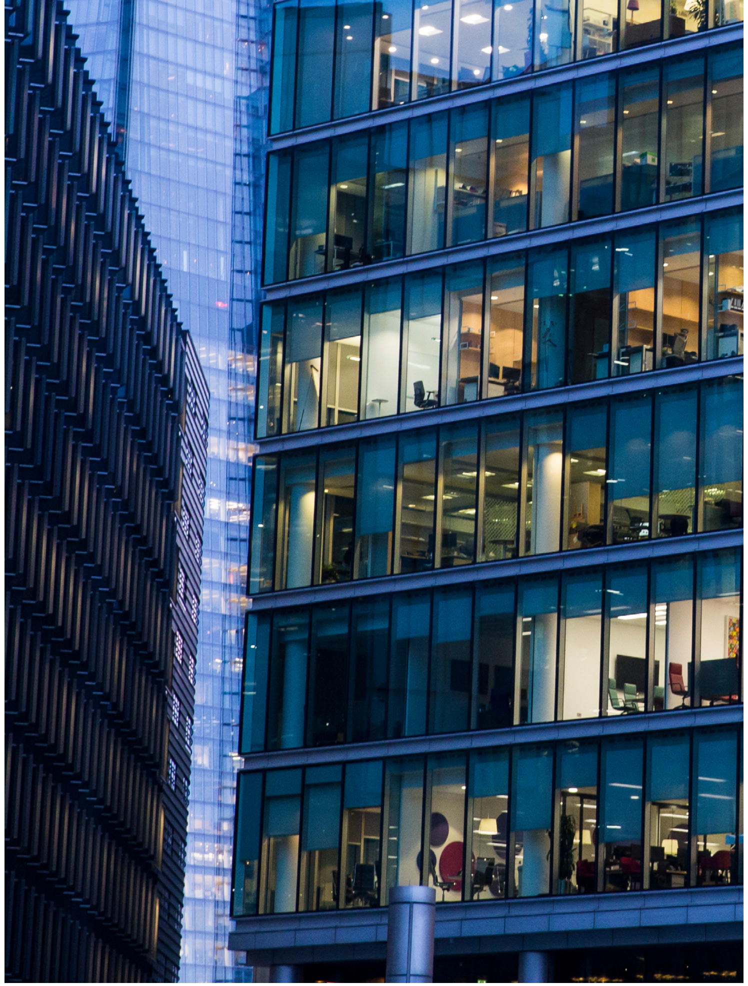


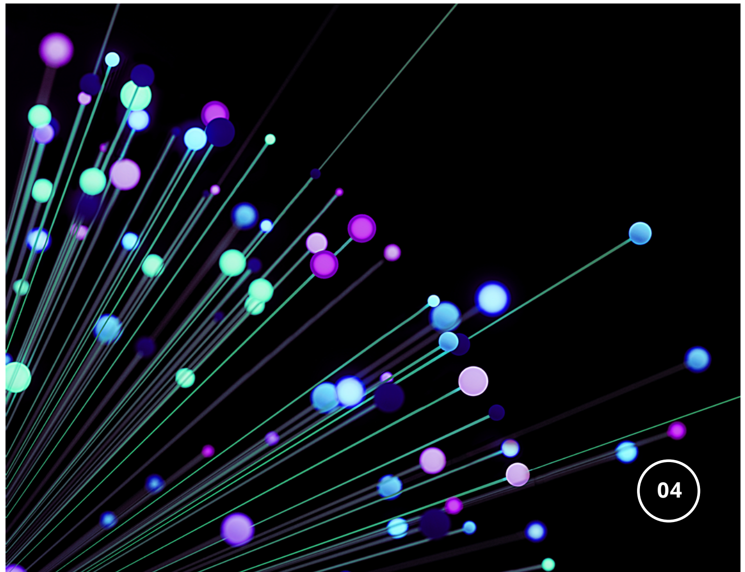
Introduction

Over the past decade, global private capital firms fundraising experienced steady growth, supported by a tailwind of favorable economic and market conditions. However, this trend reversed over the last two years, with fundraising declining to pre-pandemic levels amid macroeconomic challenges and turbulent geopolitical tensions. Institutional investors, cautious of market volatility, started slowing their allocation to alternative assets, amid portfolio rebalancing and slowdown in return of capital.

In contrast, private investors have defied this trend, demonstrating unwavering confidence in alternative assets, investing increasing amounts in asset classes once considered accessible only by Ultra-High-Net-Worth individuals (UHNWIs) and institutions.

An emerging offering of semi-liquid funds has accompanied this trend for private individual investors seeking greater investment flexibility compared to usual closed-ended funds. However, from educating and handling distributors to managing liquidity or reporting on financials, managing (dynamic) open-ended products has proven to raise new challenges for managers of (static) closed-ended alternative funds, driving a transformational wave in the industry. This article explores the drivers behind this growing demand, the strategic responses from GPs, and the operational challenges and some of the solutions to unlock the open-ended alternative fund opportunity.





The surge in demand for open-ended alternative investments

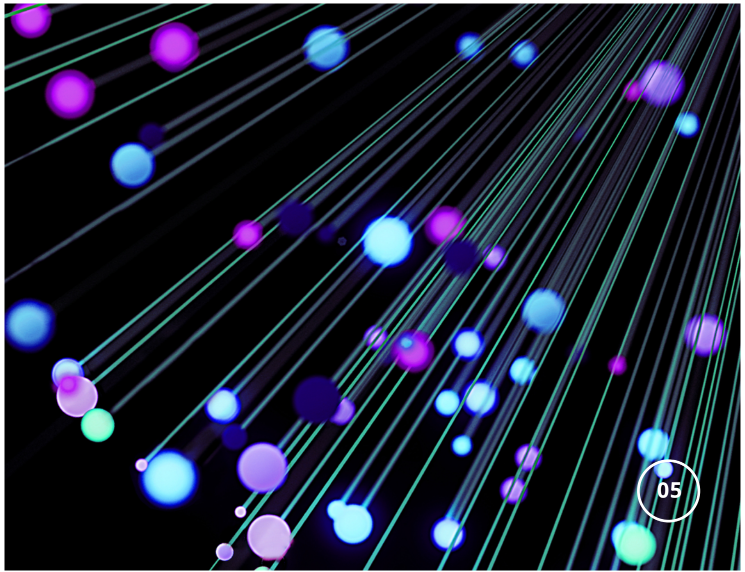
In recent years, private individuals, and their wealth managers have outpaced institutional investors in their growing appetite for investments. Between 2018 and 2021, private individuals and family offices boosted their share in global private equity fundraising by over 5%. Despite 2022's economic uncertainties and a dip in their PE fundraising share, these investors still contributed around EUR 22 bn[1], matching the previous year's figures.

HNWIs are drawn to investments offering long-term capital appreciation, intergenerational wealth preservation, and positive social and environmental impacts. Additionally, private investors enjoy the entrepreneurial approach of these investments, on top of various other benefits that this article will describe further. Steffen Pauls, Founder and CEO at Moonfare, noted, "We see a strong demand for open-ended structures as a number of factors coalesce. Demand is partially driven by increasing interest in liquidity. But other factors, including investor familiarity, supply trends, deal availability and regulatory developments are also important to consider."

Over the past 15 years, HNWI's allocation to alternative investments has doubled from 7% to 14% and is expected to keep rising, reflecting the growing adoption of these asset classes.

The motivation to invest in open-ended alternatives includes access to a diverse range of asset classes, such as real estate, private equity, and private debt, with customized liquidity windows. Laura Warren, Global Head of Tax and Structuring at Hamilton Lane, explains, "Evergreen Funds are a relatively new way for retail/high-net-worth investors to diversify their portfolios and obtain exposure to the private equity market, historically reserved to institutional investors."

Vivian Sze, Principal, Global Product Strategy, at Apollo Global Management, adds "Such products extend the range of possible risk/return allocations for such investors, making this trend very powerful!"



[1] Invest Europe, "Annual Activity Statistics," accessed 14 November 2024.

Strategic response by General Partners

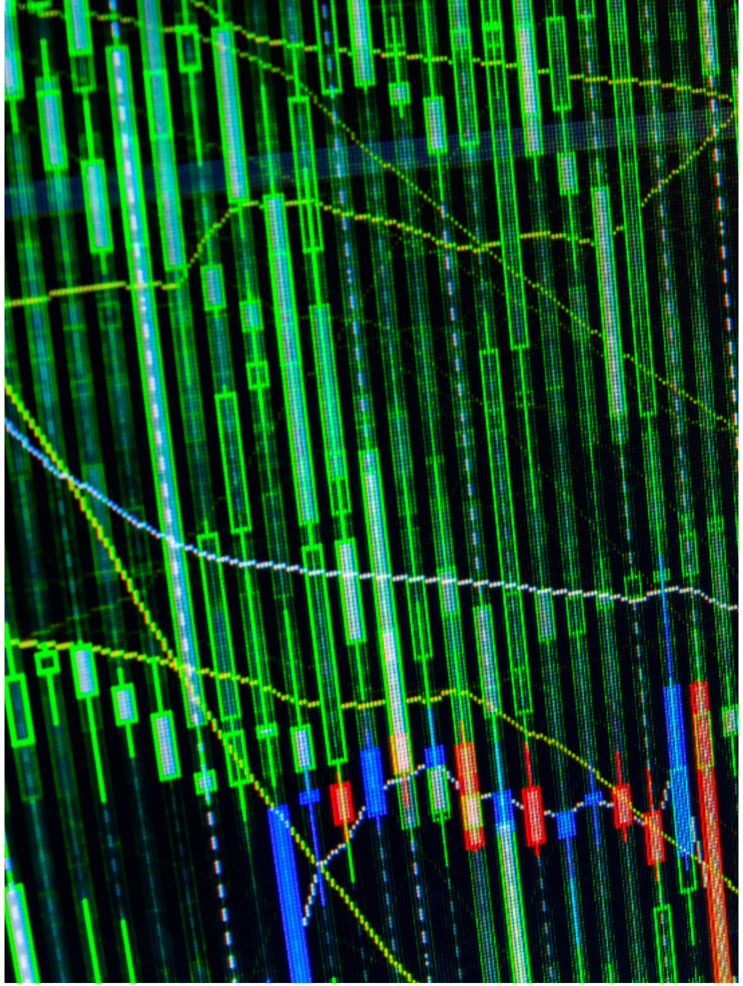
In response to this burgeoning demand, leading GPs have made private individuals and introducing open-ended alternative investment products a strategic priority. Blackstone's Stephen A. Schwarzman confirmed this on LinkedIn in May 2024, stating: "In the first quarter [of 2024], Blackstone's fundraising in private wealth accelerated meaningfully to US$8 billion, and we now manage over US$240 billion from the channel—representing the largest platform in our industry." This shift caters to the evolving preferences of semi-professional investors while securing perpetual capital.

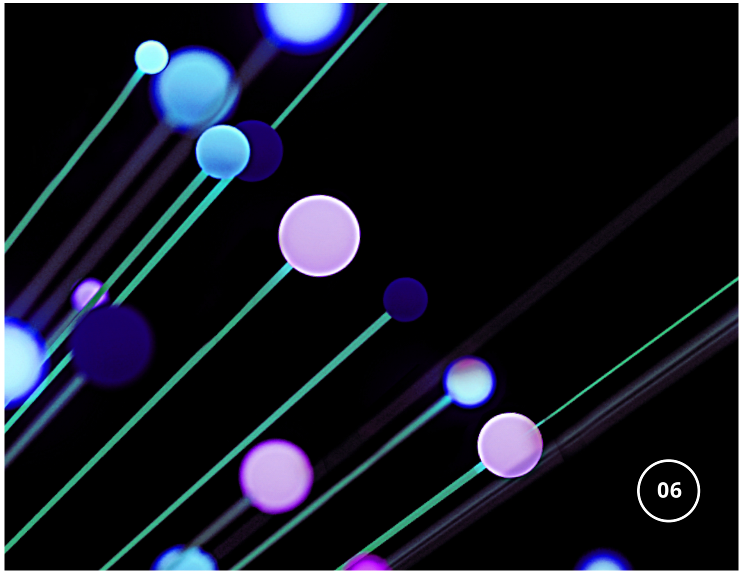
GPs are transitioning from managing illiquid, closed-ended funds with 8 to 12-year durations to evergreen structures, allowing constant inflows and outflows of investors throughout the investment lifecycle. This transformation creates more accessible, diversified strategies for a broader range of investors. While the market refers to the "retailization" of alternative asset management, GPs primarily cater to mass affluent and HNWIs, with net wealth typically ranging from €1 million to €100 million. These new fund structures are designed to meet the distinct requirements and product preferences, time horizons, and risk tolerances of these investors, offering greater flexibility and access.

For GPs, launching open-ended alternative funds offers key advantages: access to a new and unexploited investor universe, continuous capital inflows, diversified offerings, and the ability to address liquidity demands. It opens access to a previously untapped source of capital from semi-retail investors, who until recently had limited to no exposure to alternative assets.

"Once we have made an effort to be committed in that space, it is a journey which unlocks a very large market, approximately 10 times larger than the UHNWI population globally."

Vivian Sze · Principal, Global Product Strategy
Apollo Global Management

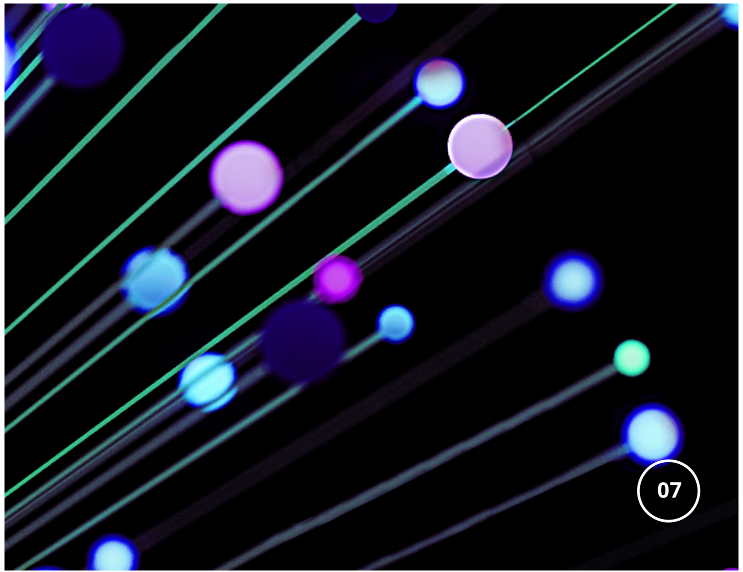




Discovering a new world of distribution channels

Most GPs currently lack in-house capabilities to reach their new investor population. Moving from institutional investor relationships to distribution channels, such as banks and distribution platforms, entails a significant shift in distribution methods. Not only must fund managers establish core strategic relationships with global (private) banks and regional champions to ensure the successful marketing and distribution of their products, but they must also engage in extensive discussions with distributors to align on key fund lifecycle events and distributor-specific constraints to smoothly operate subscriptions, redemptions, and reporting processes. When it comes to lock-up (soft or hard) for instance, distributors may handle them differently, with some tracking internally and others relying on external transfer agents.

However, there is a growing demand for B2B fund platforms, which private banks and family offices increasingly leverage to streamline distribution. Platforms, such as iCapital, Allfunds, FundsNetwork and Fund Channel are key players in this space. Meanwhile, emerging B2C platforms such as Moonfare enable fund managers to directly reach end-investors while simplifying administrative complexities tied to traditional distribution methods. Such platforms support industry trends by offering end-investors a familiar reporting environment, similar to those used with mutual funds and undertakings for collective investments (UCITS) products.



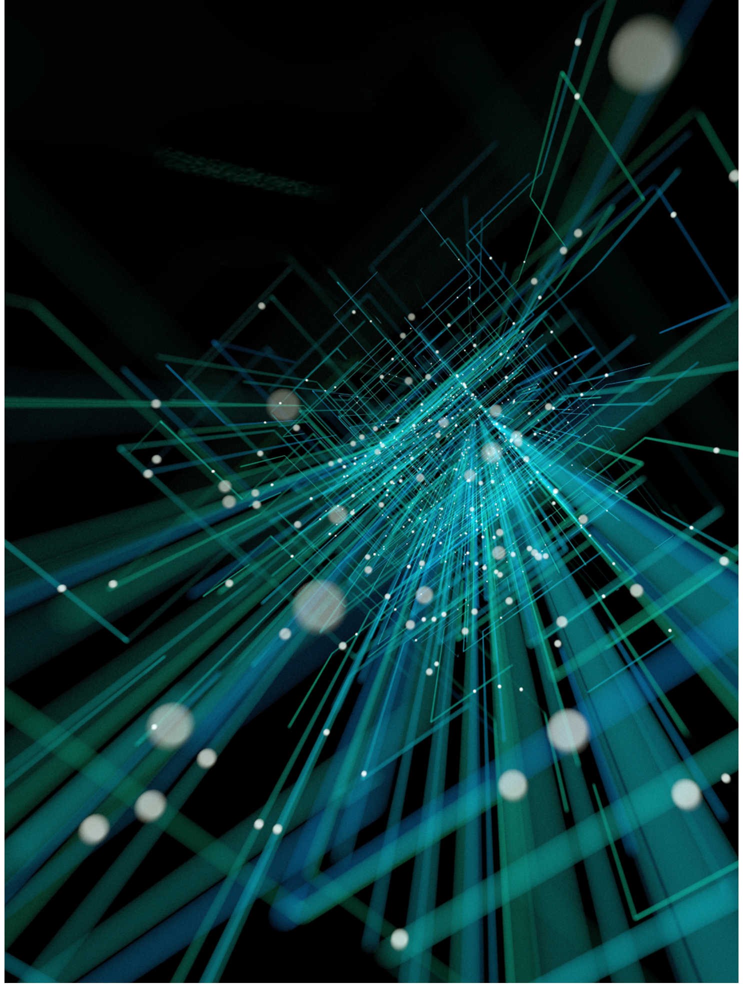
New products with relatively consistent terms and features

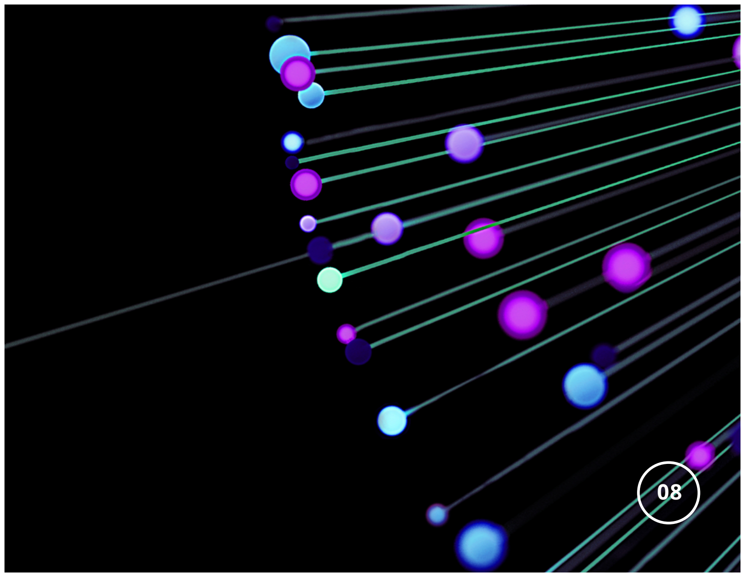
The evolution from traditional to open-ended structures has transformed the investment landscape, introducing multi-asset investment strategies, varying investment horizons and ticket sizes, distinct product features like gating mechanisms, as well as liquidity windows and different lock-up periods based on share classes.

Most products' first wave were indirect alternative funds, with a core portfolio comprising secondaries and additional co-investments. Newer products launched by managers of varying sizes consist of wrappers that invest in the manager's existing products, essentially making them single-manager, multi-product feeder funds.

Minimum ticket sizes for semi-retail investors range from €10,000 to €50,000, depending on the share class. While redemption windows vary, our research shows that 74% of the 23 largest products offer quarterly redemption, with Vivian Sze noting, "The market has quickly moved toward quarterly liquidity." The effort and operational complexities that come with more frequent redemption windows are generally not considered worthwhile. Some managers may also impose a soft lock-up period with a redemption fee of up to 5% or early withdrawals within three to five years. Finally, the data we hold shows an average management fee of around 1.4%, with performance fees structured based on the underlying asset type.

The focus on innovative solutions for deal sourcing, portfolio construction, and risk management has also become critical. High-level product regimes, such as the European Long-Term Investment Fund (ELTIF) have proven successful in this domain, primarily due to their flexibility and direct distribution capabilities to retail clients. However, private investors vary greatly in their knowledge and capabilities regarding alternative assets, prompting the development of different fund types and product features tailored to cater to these diverse investor profiles.





New products require long-lasting transformation in the alternative industry

GPs accustomed to managing traditional closed-ended AIFs need to review their operational model and processes to manage open-ended alternative funds.

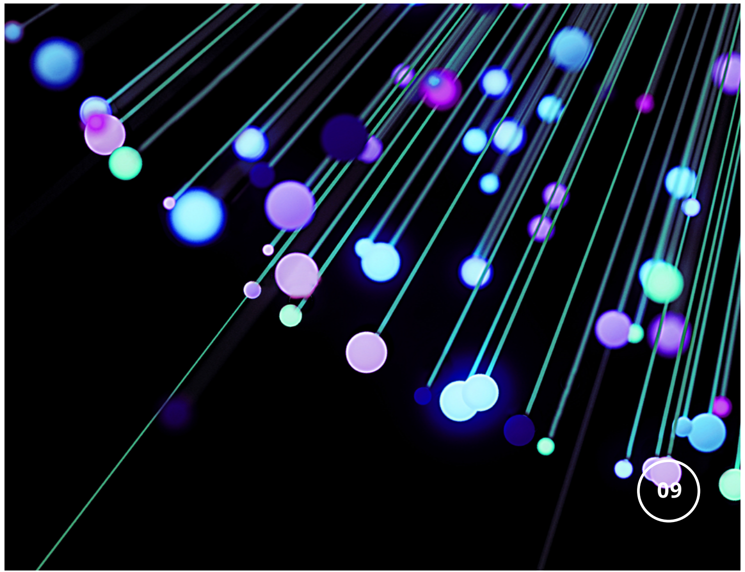
As observed by Laura Warren, "Offering private equity in a semi-liquid format creates significant reporting and management requirements not needed in typical private equity partnership funds. To comply with these requirements, managers need to build the right internal infrastructure and find the best service partners to operate effectively and create a good investor experience."

The investor-traded nature of such products calls for sounder valuation, NAV calculation and operational processes. To meet these requirements, Alternative managers are strengthening their valuation governance, enhancing fund finance functions, introducing real-time expense recognition, and deploying necessary technology. Liquidity management is another example of a new challenge, where managers need to carefully balance capital inflow and outflow to meet redemptions, without compromising the fund's overall investment strategy and returns or activating gating mechanisms.

Managing liquidity risk involves stress testing, a liquid asset pocket, and continuous monitoring.

To substantiate the aforementioned challenges, recent market observations have indicated valuation concerns in some related legacy vehicles, such as open-ended real estate funds. These concerns have led to significant valuation adjustments and a liquidity crunch as redemptions increase. Operational gaps can promptly lead to investor uncertainty and hamper market dynamics. However, Laura Warren added, "When those issues occur across the industry, while at first they cause friction, it often results in gained efficiencies for the manager."

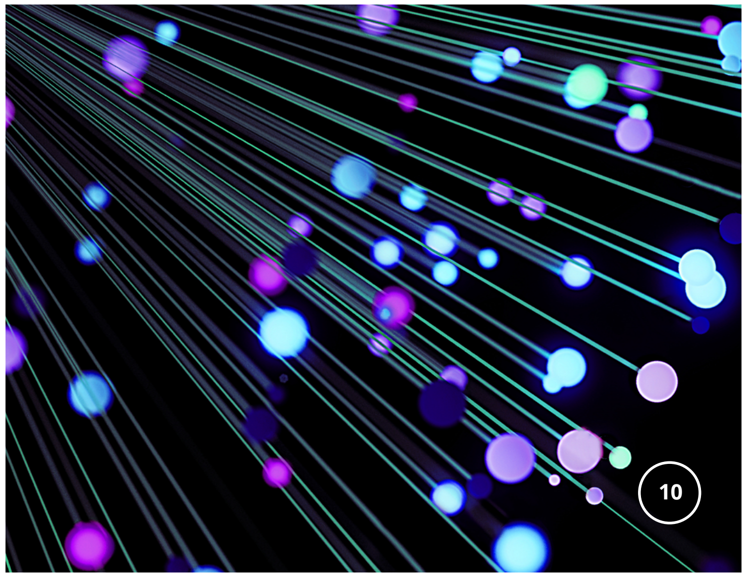
Additionally, the entire investor journey needs to be revamped, as fund managers now face additional investor reporting requirements (e.g., Packaged Retail Investment and Insurance-based Products), with a level of detail mandated by local authorities to safeguard these new investors' interests. One main risk with semi-liquid products is mis-selling to investors. "Individual investors often do not hear the 'semi' part of the phrase 'semi-liquid,' and without education could react in shock if redemption requests were to go unanswered in challenging markets," says Steffen Pauls. Vivian Sze emphasizes that "a lot of education has happened and still needs to happen, both toward distributors and toward end-investors."



New products require long-lasting transformation in the alternative industry

Regulatory challenges also play a significant role, as these funds face increased scrutiny from regulators to protect non-institutional investors. Open-ended funds, just like traditional funds, are also subject to Alternative Investment Fund Manager supervision but necessitate stricter compliance and oversight. The European AIFMD passport facilitates the cross-border distribution of funds within the EU but permits active marketing only to professional investors. Distribution to semi-professional or retail investors (within a regulatory meaning, i.e., non-professional investors) is at the discretion of each country's local authorities. The new ELTIF regime, benefiting from the EU passport for retail investors, is increasingly being used.

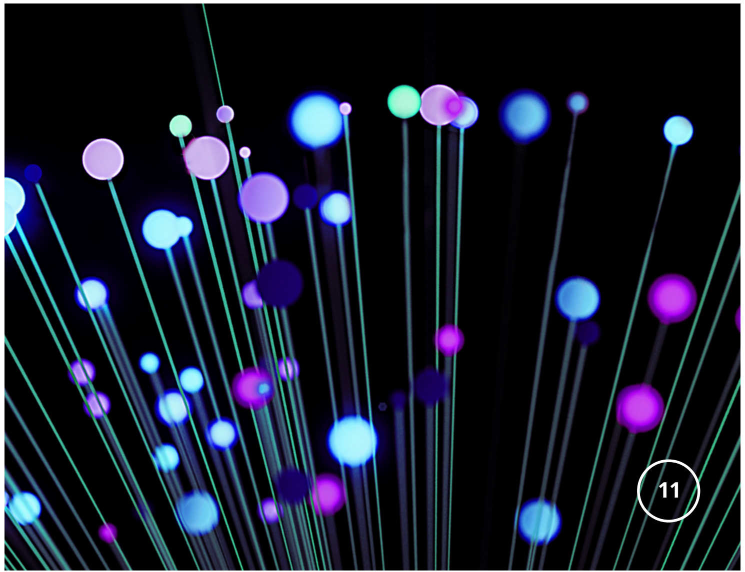
However, certain national requirements hinder progress, as some European jurisdictions require local products to be established (e.g., France for investor-product wrapped investments) or specific share class listings (e.g., Sweden). This means a GP venturing into this new market must carefully consider its target markets from both business and regulatory perspectives, weighing fundraising potential against the additional complexities of operating in such markets. Extensive coordination and a robust understanding of varying legal requirements across jurisdictions are essential to navigate these regulatory complexities effectively.



Conclusion

The rising demand for open-ended AIFs reflects a significant shift in investment strategies among HNWIs and family offices. Leading GPs have responded to this demand by offering a range of flexible, diversified products that meet the nuanced needs of these sophisticated investors. While the benefits are clear, the operational, regulatory, and distribution challenges require careful navigation to succeed in this evolving landscape.

The future of alternative investments will likely see further innovations, driven by the desire of both GPs and LPs to maximize returns while managing risks effectively. By addressing the current challenges and leveraging strategic opportunities, the industry can anticipate sustained growth in open-ended alternative investment products.



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