Article

An investment evolution:
Navigating the strategic pivot to alternative funds

Alternative investments are becoming a mainstream asset class. Explore what's driving their market growth and how technology advancements are shaping their future.

After the 2008-09 global financial crisis pushed developed market interest rates to zero – at times even lower – investors were faced with a new challenge: building yield-producing portfolios. To do so, they sought out alternative strategies, investing in hedge funds, private equity, real estate and infrastructure. However, the complexity of these approaches, often combined with a lack of transparency and liquidity, typically restricted them to being merely tactical additions to portfolios.

Nevertheless, and even after the past two years of interest-rate tightening by the U.S. Federal Reserve (Fed) and European Central Bank, along with overall valuation gains by securities traded on public exchanges (e.g., NYSE), alternative investment funds steadily became a more significant asset class. Having more than quadrupled in size over the past 20 years to $22 trillion – representing around 15% of global assets under management (AUM)[1] – they are now often considered a strategic asset allocation. In this article, we'll examine the factors influencing this rapid growth over the past few years, how technology affects this asset class, and how asset managers and investors can adapt to growing complexity.

1 https://caia.org/content/january-2024-next-20-trillion-alternative-investments

Going mainstream

Another consequence of the financial crisis was that the performance of traditional asset classes, such as equities and bonds, became uncomfortably highly correlated in a 'risk-on, risk-off' trading environment. Alternative investment funds proved a useful diversification product to reduce volatility in portfolios. That extra benefit was important in onboarding investors to take exposure to these less liquid assets that largely operated outside the regulatory norms of the mutual fund industry.

"This private market continues to present yield opportunities that clients view as disproportionately better than what's available in the public market space," says **Grant Irwin, Head of Institutional Trust and Custody at U.S. Bank.**

The new regulatory environment also helped bring these vehicles toward the mainstream. In 2013, the EU set up the Alternative Investment Fund Managers Directive (AIFMD) to protect investors and mitigate systemic risk. It introduced stricter compliance around information related to liquidity, plus a requirement for the independent valuation of assets to enhance transparency. These, in turn, opened up the funds to a wider customer base, bringing in institutional money, such as pension and insurance funds, as well as high net worth individuals.

The final step is to expand that access to capture the retail market. Legislation around investor protection will be tightened another notch, especially with regard to the more complex securities and structures that hedge funds typically employ. Most retail investors are only familiar with 'plain vanilla' mutual funds invested in the traditional asset class vehicles, which can be valued – and more importantly, exited – on a daily basis.

"Daily valuations of most alternative products are challenging and often not possible, so that is an adjustment in itself," says **Amanda Karshna, Head of Relationship Management – Alternative Investments for Global Fund Services at U.S. Bank.** "The alternative fund administrator has made great progress in being able to produce operational efficiencies that allow for a more frequent NAV [net asset value] on alternative investments, which is really what's required by the retail investor."

Technology is driving growth.

Advances in the technology that creates and services these funds are driving their adoption. Automation of repetitive functions lowers the costs of alternative investment funds that are typically more expensive than a mutual fund or an index-tracker exchange-traded fund (ETF). In addition, automation has streamlined regulatory reporting processes, allowing real-time portfolio monitoring and quicker performance analysis, strengthening compliance and risk management, and enabling a faster response to investors. Technology can also help track regulatory changes and ensure compliance.

All these benefits have also opened up new investment areas for new investment areas for alternatives. Investors considering areas such as big data, cryptocurrencies and AI are heavily dependent on the latest technology to decipher, analyze and implement investable opportunities. While diversification and risk reduction help promote the appeal of alternative investments, there remains the need to produce a sufficiently robust track record to compensate for their intrinsic drawbacks.

"Technology advances are creating more fund data feeds and access to information between fund issuers and the investing public. This translates into investor confidence that additional yield opportunities and returns are available in the private market," Irwin notes. "That's what continues to drive the growth in the segment."

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Operational challenges are just as complex.

Nevertheless, from an operational standpoint, that growth comes with a price tag. The complexity of alternative investment structures creates just as many challenges from accounting, valuation and customer service perspectives.

That is complicated by differing rules depending on where a fund is being launched. In the U.S., risk modeling and compliance infrastructure are presented to investors on a discretionary basis, whereas in Europe, both investment profiles and risk management processes are more standardized and regulated by legislation.

“In Europe, fund structures will require that local investment management companies be the official managers of funds,” says **Ken Somerville, Head of Fund Services for U.S. Bank Global Fund Services – Ireland**. “The funds must also have a form of Europe-based trustee within the depository, who acts as an independent overseer. And some fund structures will have prescribed levels of investment, diversity and liquidity.”

Alternative funds globally require more frequent financial statements and an equally sophisticated supporting infrastructure to manage all this inbound data. Achieving this will require interconnectivity between processing tools so that asset managers can centralize, analyze, value and report on their AUM. Naturally, funds will need to find the human capital to manage it all.

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Head of Fund Services
U.S. Bank Global Fund Services – Ireland

"There is a huge range of skills, technology and people solutions required to support the alternative space," **Somerville** says. "Transparency, risk reporting and liquidity are now hard-wired into funds. That's a challenge for the manager."

Some financial firms simply don't have that support infrastructure, while most only have a part of it, and they often can't move fast enough to support access to a new opportunity. It takes time to build the required skills and money to acquire the necessary technology, with the added risk that the opportunity may prove to be short-lived and the resources subsequently rarely used.

Global custodians and service providers can bridge the gap between what a firm has and what it needs. They have gained experience across most tradable markets, with the added benefit of being able to access local knowledge and expertise. Custodians are well versed in the challenges of monitoring and valuing private assets that they don't actually hold, instead creating an asset on the trust accounting system that represents that investment.

"It's about taking assets that aren't connected to the general universe of security servicing and turning those into a desirable experience for your client base," says **Irwin**. "Asset owners are going to need to look at custodial shops that have solutions tailored specifically to holding and servicing the alternative investments that they invest in and wish to have reporting on."

Investment evolution

Importantly, having that servicing support will allow investment firms to concentrate on strong performance to attract and retain new funds. That means having the ability to react quickly to new opportunities while ensuring timely compliance. That combination is key to making alternative asset classes appeal to a broader range of investors and sealing their transformation into a mainstream product offering. The Fed's signal that interest rates may start to fall could lend renewed momentum to the search for alternative sources of yield and income.

"Private capital, private credit – I think that's going to be the fad for quite some time," confirms **Karshna**. "We went from simple structured hedge funds with limited legal entities to incredibly complex, structured closed-ended funds with numerous legal entities. The alternative asset manager is always evolving."

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Amanda Karshna
Head of Relationship Management – Alternative Investments
U.S. Bank Global Fund Services

Disclosures

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