SS&C Intralinks®

2021 LP Survey

Insights on Alternative Investments

Editor's Note

Welcome to the fifth annual *SS&C Intralinks LP Survey* produced in association with Private Equity Wire. The objective of this survey is to gauge how investors are thinking about their general partner (GP) relationships, in addition to highlighting emerging themes that might help inform how investment firms do business over the next 12 months. This year, 196 globally based investors were surveyed to gain their views on what the performance of alternative investment funds will be over the next 12 months and what their future allocation will be.

Certainly, the global impact of COVID-19 has led investors to think carefully about their investment portfolios and the role that alternatives play, as they find ways to protect their long-term capital from market volatility. In that regard, this year's results will hopefully serve as a useful tool for GPs to gauge the current mindset of investors in a period of great uncertainty.

And while they should hopefully be viewed in isolation, the survey findings can serve as a signpost for GPs to tailor their investment products and gain a better understanding of how LPs think about their current portfolios.

Meghan McAlpine

Director, Strategy & Product Marketing, Alternative Investments

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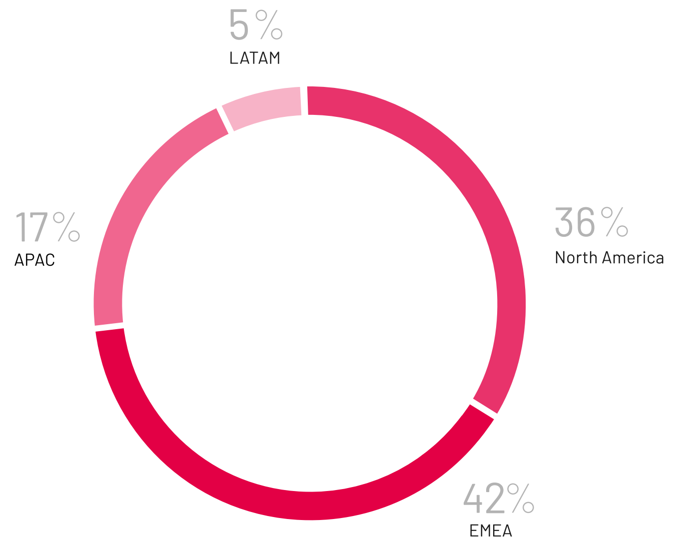
Executive Summary

- Overall, alternatives have hit the mark for LPs over the last 12 months and the economic impact of COVID-19 has perhaps accelerated further demand for alternatives for the year ahead.
- Private equity and private debt strategies are the preferred asset classes but some LPs are not convinced that valuations have come down sufficiently to signal a change in their allocations.
- Hedge funds are still a viable option, but it could be that some LPs will rotate opportunistically out of this asset class to fund additional investments in private markets.
- COVID-19 has impacted the operational due diligence (ODD) process, but investors are using virtual ODD, which is likely to be a long-term structural change in the alternative funds industry, moving forward.
- Environmental, Social and Governance (ESG) reporting is now becoming a key requirement as investors view it in much the same way as they would investment risk. However, half of the respondents rated the level of GP transparency as either 'average' or 'could do better.' Managers who improve their ESG reporting might find they can close the gap on this perceived lack of transparency, as they seek to improve the overall GP/LP relationship.
- Advances in cloud computing have helped to reassure LPs when looking at managers who outsource technology. However, in light of the pandemic and remote working, more than 90 percent of LPs ranked the quality of a GP's outsourced technology capability as either 'important' or 'very important.'
- Data aggregation is a primary need among LPs to help manage their portfolios but this needs GPs to be more willing to provide the requisite amount of transparency.

Survey Methodology

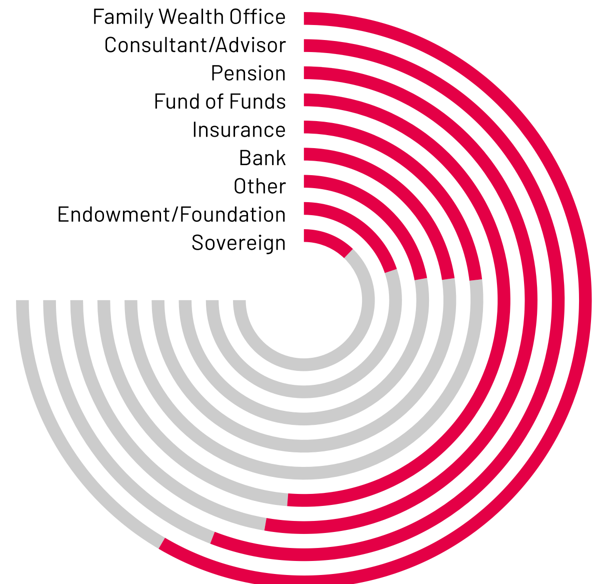
Surveyed investors by geography

This year, the survey canvassed the opinions of 196 LPs.



Types of investors surveyed

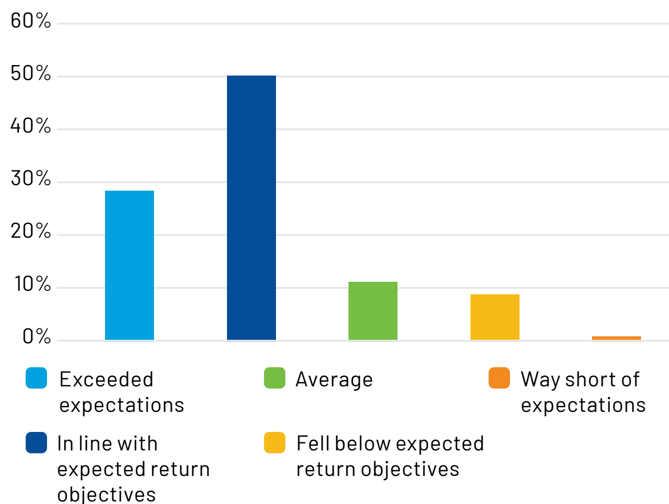
The survey captured the sentiment of a range of professionals who work in the private markets.



Weighing Up Performance

Overall, LPs were satisfied with the performance of their alternative portfolios in 2019. Exactly 50 percent said that performance fell in line with their return objectives, while over one in four investors felt that performance had exceeded expectations. See Figure 1.

Figure 1. How would you assess the performance of your alternatives portfolio for 2019, overall?



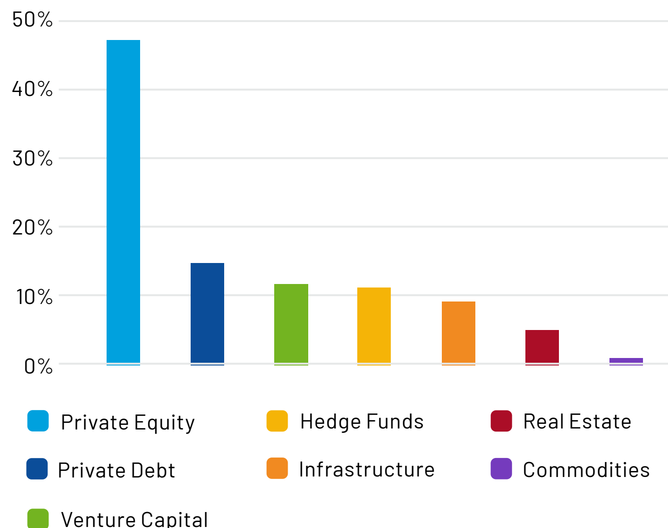
Last year was the best in a decade for hedge funds, during which the HFRI Fund Weighted Composite index[1] returned 10.4 percent, helped by the return of 'risk-on' sentiment among investors.

Compared to 2018, the first half of 2019 proved to be a good period for equity long/short and special situation/ activist hedge funds, returning 9.5 percent and 7.8 percent respectively[2].

By year-end, healthcare-focused and activist hedge fund strategies proved to be the top performers, posting strong double-digit returns.

The allure of private equity remains as strong as ever. Nearly half of the survey respondents attributed it to delivering the best risk-adjusted returns for the year. See Figure 2.

Figure 2. Within alternatives, which of the following asset classes generated the best risk-adjusted returns?



Last year, private equity raised USD 555 billion according to *McKinsey's Private Markets Review 2020*[3], while private markets, as a whole, attracted USD 919 billion of net new inflows.

[1] https://www.hedgefundresearch.com/hfri-indices-december-2019-performance-notes

[2] https://www.investmentbank.barclays.com/our-insights/2019-global-hedge-fund-midyear-outlook.html

[3] https://www.mckinsey.com/~/media/mckinsey/industries/private%20equity%20and%20principal%20investors/our%20insights/mckinseys%20 private%20markets%20annual%20review/mckinsey-global-private-markets-review-2020-v4.ashx

"I would say performance in 2019 was in line with expectations," says Marc Rucinski, Asia Pacific head of private equity and real estate at Citi Private Bank. "We're getting late in the cycle but over the last 13 months we have been broadly happy with performance."

Tellingly, even though private equity came out as the top-performing asset class, LPs today are increasingly mindful of the challenges when allocating in a late-stage economic cycle; something that COVID-19 has arguably accelerated.

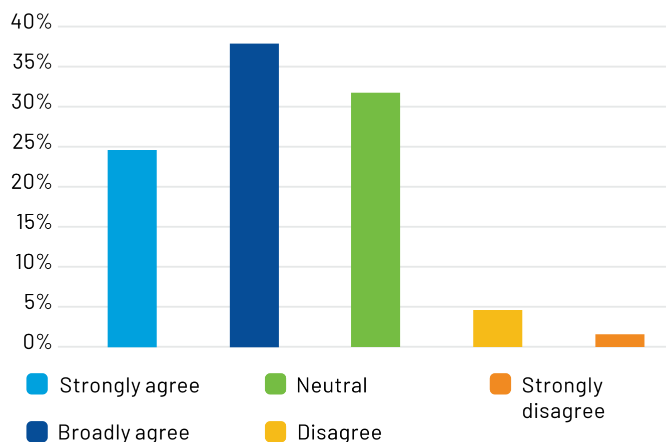
Rucinski remarks: "The private equity space was probably the most difficult in many years, with respect to finding funds we felt were compelling. The reason for this is valuation multiples are very high while company valuations seem priced to perfection.

"What we're trying to do is find a manager who has a real competitive advantage in the market; it could be because of their size, their access (to deals), or a particular specialty focus. If you don't find a manager with an edge, you're effectively just buying the market."

In liquid markets, investors have a greater capacity to interrogate performance as part of their ongoing portfolio management. Hedge fund performance may not have featured too highly in this year's survey results, warped slightly by the gravitational pull of private equity, but there is evidence that LPs remain sanguine for the year ahead.

Michiel Meeuwissen is co-head of alternative strategies at Kempen Capital Management, a leading Dutch asset manager. Commenting on whether he thinks alternatives will help meet investors' liability targets for 2020/21 (see Figure 3) Meeuwissen says: "I would be on the 'agree' end of the spectrum. For a few strategies such as distressed debt, structured credit and relative value hedge fund strategies, the disruption we saw in Q1 and continue to see in the economy, has led to an increased opportunity set.

Figure 3. Do you feel that alternatives will help you meet your liability targets for the next 12 months?



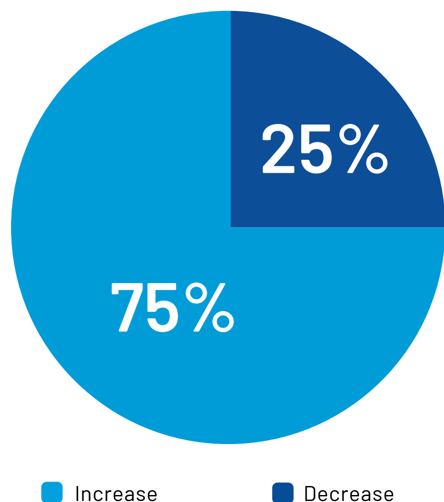
"The amount of PE dry powder is at an all-time record high and as an LP, you have to factor that into your analysis. You can't just look at the fundamentals, you have to recognize the uniqueness of the current market situation: how cheap capital is, how plentiful it is, and how committed central banks are to put more liquidity into the system."

– Asia-Pacific LP

"We think these kinds of strategies can help us achieve the return targets of our clients. I'm more optimistic on the strategic outlook today than I was at the start of the year, prior to COVID-19."

Over the next 12 months, three quarters of LPs confirmed they would be increasing their allocation to alternatives, with one in five LPs aiming to increase it by 10 percent or more; see Figure 4.

Figure 4. Do you expect to increase or decrease your allocation to alternatives over the next 12 months in light of the coronavirus pandemic?



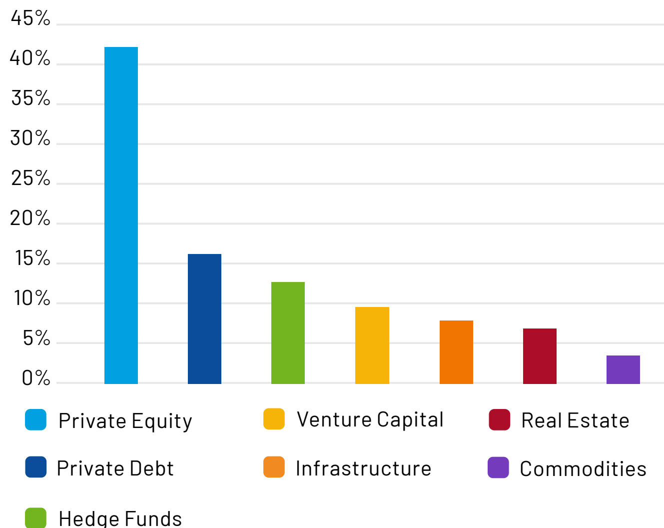
Increase Decrease

Some of the reasons for this include:

- Valuations in early-stage venture to come down/ normalize;
- Dislocation and increased dispersion in the market;
- Lower market prices and potential to access to constrained managers;
- Getting paid more illiquidity premium

Four out of ten LPs said that private equity would be their most overweight allocation over the next 12 months, as illustrated in Figure 5. This was followed by private debt, which LPs said they favor more than hedge funds.

Figure 5. Which asset class do you expect to be most overweight on, on an absolute basis, in alternatives?



Private Equity, Private Debt, Hedge Funds, Venture Capital, Infrastructure, Real Estate, Commodities

This could relate to the wider interest in distressed credit as investors look to back GPs who are well placed to support companies being impacted by the global pandemic. Compared to hedge funds, illiquid private markets appear to be the preferred choice as LPs deploy capital over the next 12 months.

There remains, however, a degree of caution.

"Due to market uncertainty, the investment community has set a higher bar for extending duration in private equity and private debt," comments a U.S.-based outsourced

investment office. "While inflows into both of those asset classes have been very strong in the preceding few years, my expectation is that inflows will continue to be healthy but relatively more measured."

This sentiment is echoed by Citi Private Bank's Rucinski. "As much as there's been disruption, public markets have moved back up and there's no indication to us that private markets have had any significant price adjustment," he says. "While there are some exceptions in our portfolio, it has been much more muted than expected given the economic outlook.

"If one was to look at private equity (PE) pricing, without any other context as to what is going on in the world, you would have no clue we are dealing with a global health pandemic.

"We'll make the adjustments, but we have to see valuations move first. There is no reason for us to jump into traditional PE buyout funds right now as valuations have been relatively unchanged. Deal volumes might be lower but many valuation multiples are still as high as they were pre-COVID."

That LPs still appear to be favoring private equity so strongly is even more surprising when one considers the sheer amount of capital that has flooded into the asset class over the last few years.

This brings up an obvious question: Where are LPs finding this additional capital to further increase their exposure to private equity?

Sara Rejal is head of liquid diversifying manager research at Willis Towers Watson, a leading global investment consultant and fund of hedge funds manager.

Rejal was surprised by Figure 5. In her view, investors already seem to be quite full on their private equity and private credit allocations.

"Private credit has been a very popular strategy in the last five years so it's surprising that people feel they still have a significant illiquidity budget with more cash to fund those types of investments," she comments.

It could be that LPs will look to fund additional exposure to private markets by liquidating their hedge fund positions.

"There does seem to be some tactical positioning taking place, with investors taking capital from some of their hedge funds that have performed well, without wishing to touch their pure long-only equity portfolios that might have taken a hit," explains Rejal.

Not that hedge funds are a busted flush. If anything, today's volatile environment is one in which hedge funds should thrive, although based on LP feedback from the survey, distressed and opportunistic credit would appear to be preferred strategies.

"A lot of the conversations we have with our pension fund clients focus on the need to have diversification in their portfolio to avoid the risk of being overly exposed. Clients who had exposure to tail risk hedge funds, for example, were really pleased by the protection benefits they provided earlier this year."

- U.K.-based investment consultant

Mark Roberts is the chief investment officer for Ironsides Asset Advisors, a U.S.-based investment advisor that manages USD 678 million in AUM. He confirms that Ironsides has just invested in a TMT-focused equity long/short manager who spun out of Steve Cohen's family office three and a half years ago.

"Last year, a lot of TMT managers had a difficult fourth quarter but these guys managed through that period pretty well," confirms Roberts. "We were extremely pleased to watch how they responded during February and March 2020, when markets were volatile, and it was another empirical rather than qualitative point for us to assess what they were doing. This manager is now part of our volatility-controlled portfolio."

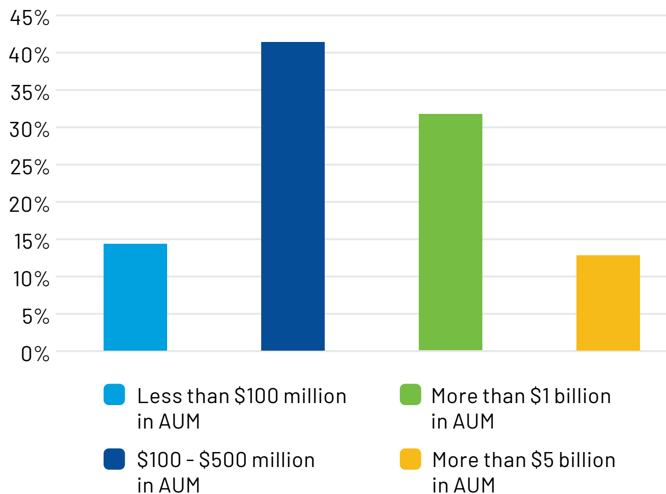
"Now we feel like we've really got a conversation starter, compared to previous years when talking to clients about hedge funds was difficult because they didn't meet their expectations. Now, we've got a strong story that they need to be part of their portfolio."

- Sara Rejal, Willis Towers Watson

GP Selection Insights

From a GP size perspective, investors have mixed AUM preferences, both for 2020 and the next 12 months. While the majority of LPs still seem to be favoring mid-sized managers, operating with between USD 100 million and USD 500 million in assets, there remains a consistent focus on those running north of USD 1 billion as shown in Figure 6.

Figure 6. What fund manager AUM size did you strongly favor in 2019?



Whereas last year 53 percent of LPs said they favored mid-sized managers up to USD 500 million in AUM (see Figure 7a), this year that figure has fallen to 41 percent (see Figure 7b).

Instead, it would appear LPs are looking to increase their portfolio weighting toward GPs with USD 5 billion or more in AUM. Over the last 12 months, the number of investors who said they would be favoring managers of this size has increased from 5 percent to 15 percent.

Figure 7a. What fund manager AUM size will you be favoring in 2019?

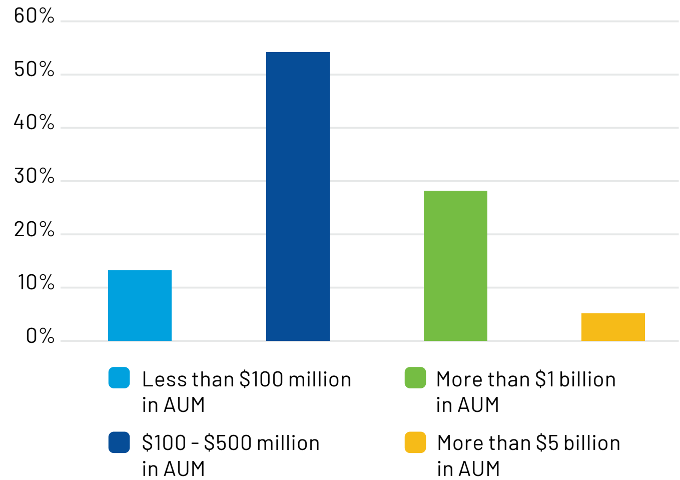
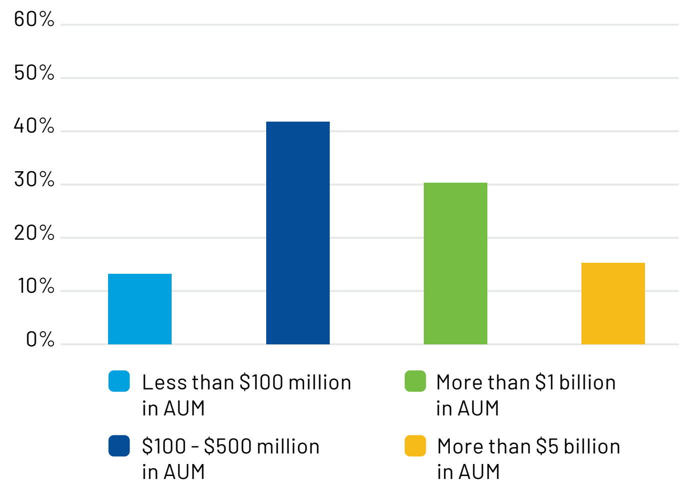


Figure 7b. What fund manager AUM size will you be favoring in 2020?



This echoes the earlier survey findings on LPs plans to increase their alternatives allocations over the coming year. This is easier to achieve by investing in large-cap managers raising billions of dollars for new funds than it is by focusing on smaller and mid-sized managers.

Furthermore, it suggests that LPs are looking to back the most trusted names in the industry to guard against reputation risk; as well as appease investment committees who might be cautiously minded in the current market. Another factor could be that large-cap managers are more likely to have experienced a market downturn, such as in '08, and considered a safe pair of hands.

"We believe there is a minimum size needed for any manager we build relationships with, in terms of their institutional infrastructure, the prime brokers they work with, compliance and risk controls, and so on. There's no hard and fast rule but if the manager's AUM is USD 250 million, that would probably be the minimum threshold we would consider," confirms Meeuwissen.

Some LPs remain size agnostic, although one LP states that while large managers are more preferable because of the depth of resources they can apply to investing, research, deal sourcing and risk management, "I think the marketplace has become overly focused on size."

"This needs to be taken into context based on the opportunity and what one is trying to achieve from a risk/return perspective in the alternatives space," they say.

Thomas McComb, portfolio manager, private equity group, J.P. Morgan Asset Management, says that the bank's approach is opportunistic and doesn't involve favoring a particular AUM range.

"On the buyout side, we typically prefer GPs in the lower and mid-market," states McComb. "That said, as some groups scale, where we are confident they will continue to be able to successfully execute their strategy, we may scale with them."

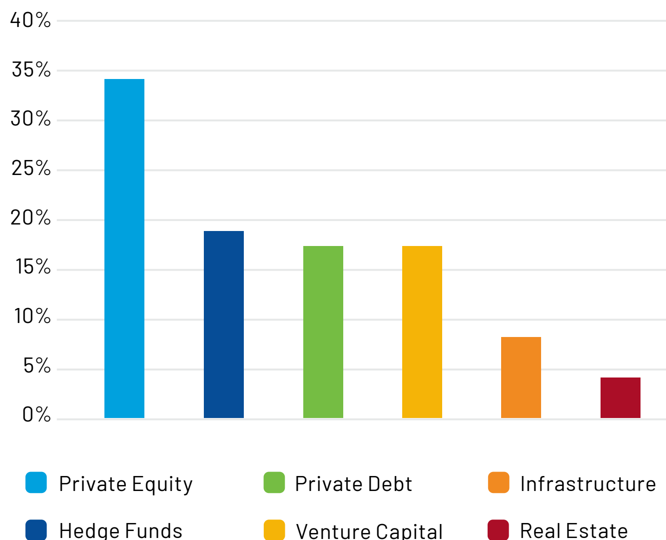
Over at Citi Private Bank, Rucinski confirms that the team tries where possible to consider managers who fall into the USD 100 million to USD 600 million AUM range.

"For example, there is a first-time fund manager we are working with right now," comments Rucinski. "They've done a number of one-off deals and we are working with them to create a fund from scratch where we will constitute the bulk of the AUM and the manager will look to bring in some additional investors. We think their strategy and positioning in the market are unique and worth the time and energy."

Backing first-time funds

Private equity is the preferred asset class as LPs look to diversify their allocation programs over the next 12 months by backing emerging managers, although hedge funds, private debt and venture capital are also areas of focus. See Figure 8.

Figure 8. In which asset classes will you be favoring emerging managers over the next 12 months?



"Normally, the in-person meeting is a pre-requisite for us. However, in the past, the availability and willingness of managers to do video calls was not as prevalent. The ability to virtually walk around the office does provide a lot more comfort and is a good substitute for a lack of physical meeting."

– Marc de Kloe, Theta Capital Management

Marc de Kloe is partner – strategy, investments & operations at Theta Capital Management, a Netherlands-based hedge fund specialist that builds fund-of-fund vehicles for institutional investors.

The global lockdown has not stopped Theta Capital performing manager due diligence, with de Kloe confirming they recently invested in a manager with a shorter track record "as his references were second to none."

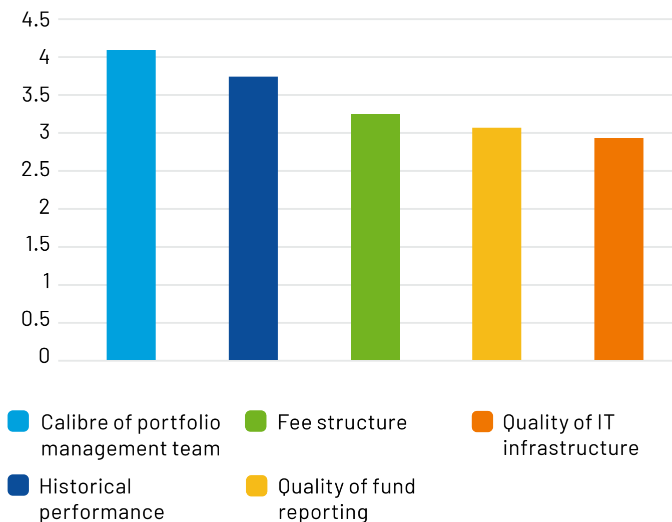
"These references (former employers and current investors) were an important part of the decision process, which allowed us to allocate without having been on site – which was a first for us," he says.

The opportunity to tap into attractive returns remains a key driver behind LPs' interest in emerging managers. The quicker investors can invest the better, as managers of first-time funds will typically be highly motivated to impress.

A report by the BVCA[4] finds that 82 percent of investors said they would consider investing in Fund I, when considering emerging managers. Moreover, nearly 90 percent said they would get comfortable investing with an emerging manager having known them for less than two years.

When it comes to screening managers of all sizes — not just emerging managers — the majority of LPs still regard the calibre of the management team as the single most important criterion. See Figure 9.

Figure 9. How would you rank the following when selecting a manager, with 1 being least important and 5 being most important?



[4] https://indd.adobe.com/view/a84c9bd5-9bb4-4070-959d-c1a6991ec6ef

In isolation, this result is not surprising but the reality is LPs need to consider a raft of factors before allocating, and these will differ depending on the size and nature of the investor.

At Citi Private Bank they typically spend six months performing due diligence.

As Rucinski explains: "We conduct a full review of the manager including operational, investment and legal due diligence. For example, we review every historical deal and the attribution of the historical performance to the current team. It's great if the organization has a good track record but if the team that did deals in the past is no longer at the firm, we factor that in. We want to ensure the team we are backing stays there and is properly motivated.

"We manage around 120 funds and over the years we've seen the good, the bad and the ugly. We spend considerable time on and know how to structure LPAs, side letters, PPMs, subscription docs and so on."

In Rejal's experience, the theoretical allure of higher return expectations compared to reality, are sometimes quite different. In her view, emerging managers can be quite conservative in the early years.

"To tackle this we tend to be explicit with emerging managers by telling them to take as much investment risk as the strategy allows. It helps to have managed accounts to do this because it means the manager isn't worried about their flagship fund suffering a drawdown. It's human nature; no-one wants to suffer a huge drawdown in their first year," says Rejal.

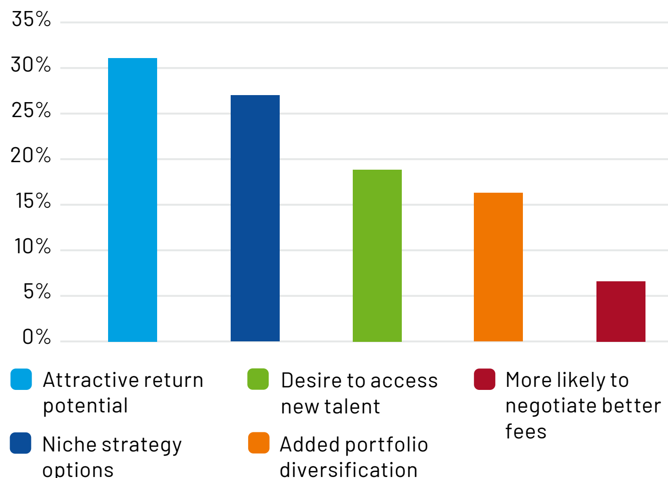
Investors less likely to negotiate emerging manager fees

Figure 10 shows that few LPs cited the ability to negotiate lower fees as a reason for investing in emerging managers. It suggests that investors realize squeezing too hard on management fees in the early years is detrimental to long-term business success and, ultimately, self-defeating.

Some investment firms remain highly focused on the issues of fees, however.

"We go through every cost and revenue within the GP to try to understand whether they need more of the management fee in the early stage of the investment, or not. If they do, we would look to scale down the fee over time, as the manager grows," comments Rejal.

Figure 10. What is the main driver behind allocating to emerging managers?

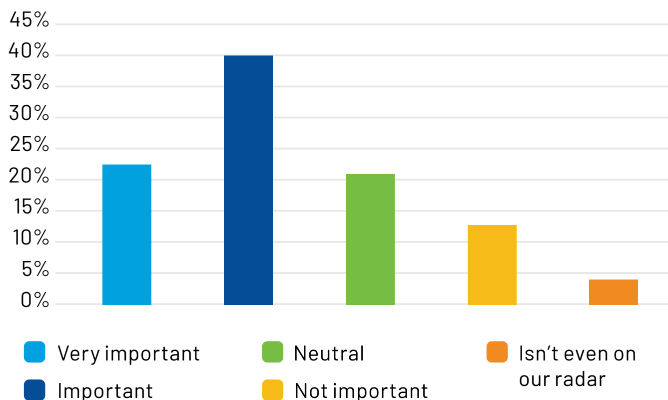


Transparency & Reporting

ESG is now a key risk metric

In this year's survey, LPs were specifically asked how they viewed the importance of ESG reporting over the next 12 months. The findings were quite clear: 62 percent said they regarded it as being either 'important' or 'very important.' See Figure 11.

Figure 11. How important do you view ESG reporting from your underlying managers over the next 12 months?



This sends a strong message to GPs, who can no longer afford to take a blasé approach to ESG. Arguably, there are going to be geographical variations, with European investors more focused on sustainability risk in their portfolios, but overall ESG is likely to be a long-term structural shift in the global alternatives arena.

Indeed, GPs might need to start thinking about sustainability risk in much the same way as market risk, when reporting to LPs.

Rejal confirms that at Willis Towers Watson, providing ESG solutions is a core objective this year.

"Ultimately we want to see ESG data on a monthly basis. For example, we want to see it in monthly fact sheets to assess the constituents of our clients' portfolios and what their ESG risk exposures are.

"We are still some way away from achieving that with managers, however. It's difficult when every LP wants something different. There are still teething issues before we get something that everyone is going to be happy with."

ESG reporting is part of a wider issue for GPs still needing to improve their overall level of transparency. In this year's

"We are very strict on transparency, especially as it relates to fees. We have a team that works with GPs to supply us with fee transparency and if they fail to play ball, we have a direct conversation with the management team and ask them not to be difficult. That often leads to progress. We ultimately want to know that the fees they are reporting on line up with the LPA."

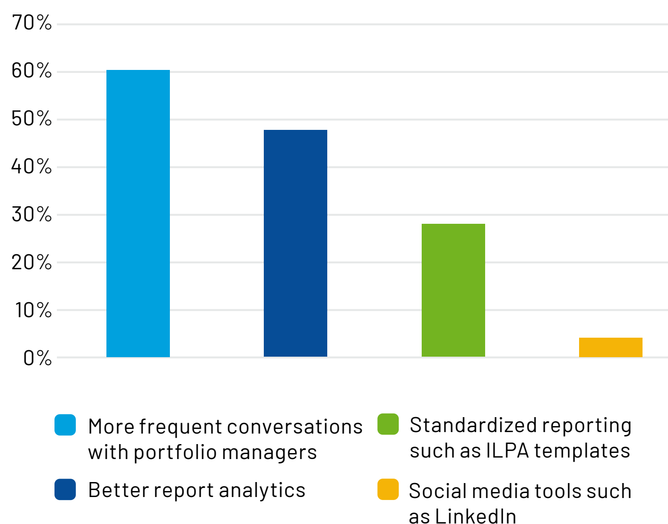
– Richard Tomlinson, Local Pensions Partnership

survey, half of the respondents rated the level of GP transparency as either 'average' or 'could do better.'

Managers who make strides to improve their ESG reporting could go some way toward addressing this perceived lack of transparency, as they seek to improve the overall GP/LP relationship. And in these uncertain times, even just engaging in more frequent conversations with LPs could make a difference.

As Figure 12 shows, 60 percent of LPs felt that this would further bolster the relationship and by default, improve the optics of transparency.

Figure 12. What would help improve your relationship with GPs (choose one ore more options below)?



Only 15 percent of LPs said they were 'very satisfied' with the technology capabilities of their GPs, with respect to reporting. This is something investor relations teams might look to consider, not only to improve existing LP relationships but to better present themselves to prospective LPs who want to see high-quality reporting.

Rejal further confirms that part of the reporting expectations they want to see from hedge fund managers relates to trading expenses. The aim, she says, is to better understand how much frictional cost there is, relative to the amount of alpha being generated, "especially in systematic strategies where the trade volume is high.

"In some cases, we are asking managers to slow down the rate of trading; how much additional return are they really making? If it's not guaranteed to make alpha, then don't do it."

Part of the trust and verify process that LPs use to assess the quality of GPs is now increasingly extending to how investment firms think about data security and governance. COVID-19 has led to a spike in cybersecurity attacks and data breaches, which are becoming increasingly sophisticated.

At Kempen Capital Management, Meeuwissen says data governance has become a more important topic, "especially for data-driven systematic strategies. There are of course strategies where the frequency of data is less important, but even there we see data governance becoming a more important topic of discussion at the pre-investment stage."

In this year's survey, 70 percent of LPs said they were only 'moderately satisfied' with data governance measures.

Still, it is not just the manager but also the quality of their service providers. At Theta Capital, de Kloe refers to a recent case where a very large fund administrator had a data breach.

"I believe they took the right actions to provide data protection services to affected users and ideally you would not want this to happen. However, data breaches seem to be a part of day-to-day business.

"It is a topic we take up with our GPs and we would want to see modern infrastructure in place as well as an action plan in case of a breach."

Technology & Outsourcing

Concerning technology capabilities, beyond reporting and data governance institutional investors are becoming more receptive to the concept of outsourcing, which should come as a relief to smaller and mid-sized managers. After all, combined with ongoing regulatory and compliance costs, alternative fund managers can ill afford to spend significant capital on technology outlays.

Thanks to advances in cloud computing, and the ability to partner with trusted third-party vendors, GPs have greater latitude to limit their technology spend while still remaining operationally resilient.

Business resilience has come under scrutiny in 2020 as the entire funds industry has found itself working remotely.

Figure 13 shows that more than 90 percent of LPs ranked the quality of a GP's outsourced technology capability as either 'important' or 'very important.' In that respect, COVID-19 has proven to be a litmus test for how well managers have continued to do business as usual, amid such disruption. Still, Roberts cautions: "While I do feel good about how managers have adapted and worked remotely this year, my real concern is 12 or 24 months out from now, can the manager maintain the firm's internal culture? How will they mentor and train junior associates and staff?"

To assuage investors, GPs will need to focus on maintaining a solid culture while they continue with remote working practices.

As for their own technology needs, investors believe that portfolio and risk analytics, as well as data aggregation tools, are the two most important areas as they look to gain deeper insights into how their portfolios are performing. See Figure 14.

Figure 13. How important is it that GPs have good outsourcing technology capabilities to work remotely and continue to do business as usual in light of COVID-19?

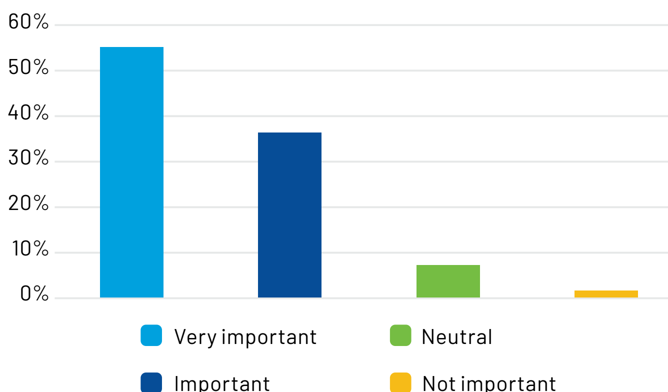
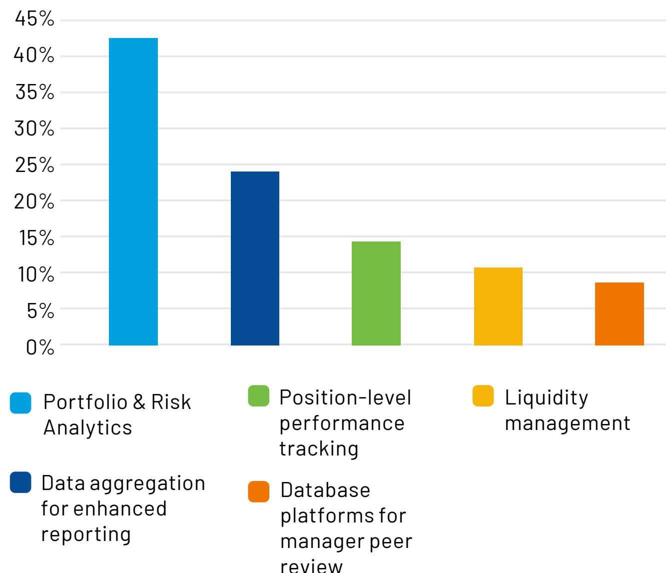


Figure 14. What would you currently regard as your most important technology need?



Two of the main reasons for needing data aggregation capabilities are enhanced reporting and increased transparency across their portfolios.

Richard Tomlinson is chief investment officer at the Local Pensions Partnership, which manages GBP 16 billion in several U.K. pension schemes; approximately half of which is invested in alternative assets. He says that data aggregation only works if GPs are willing to share sufficient data on their funds.

"We are working with third-party partners to build data aggregation tools to increase transparency and enable us to better analyze the portfolio but to do that, we need transparency from the GPs on the underlying assets in their funds. It's an ongoing conversation we are having with them," explains Tomlinson.

LPs want to use better portfolio and analytics technology to augment their investment experience, part of which is to better understand how their underlying managers are performing and where they are generating true value (i.e. alpha) for the fees they pay.

At Ironsides, one example of this has been to run factor assessments across all managers in the portfolio.

"It's not that we are trying to create a better, more optimized portfolio but rather to make sure our managers don't have overlapping factor risk," says Roberts.

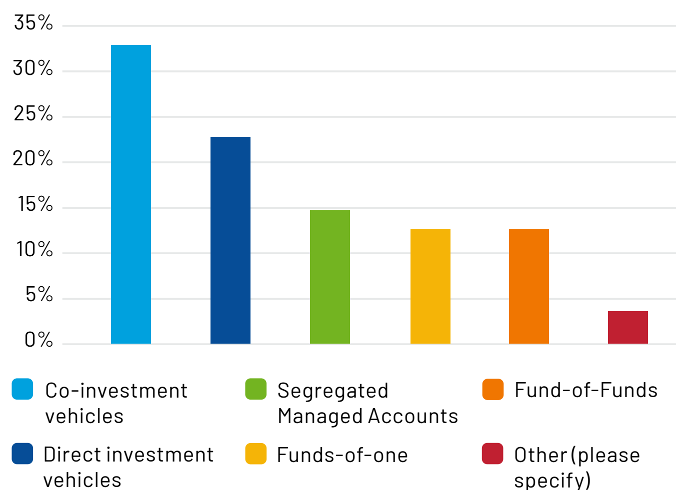
"One of the reasons for investing in the TMT manager I referenced earlier was because their factor exposure was very different from our manager set. We like diversification across factors, especially when the fund is part of a volatility-controlled portfolio."

He confirms that the family office has designed everything in-house to perform this factor analysis: "From a philosophical perspective, doing this kind of work educates us more on the portfolio. We think there's a benefit to working through data issues, modeling issues, etc., to better understand the overall portfolio."

Investment Allocation Preferences

Interest in direct investing has slightly waned year-on-year. Whereas last year, it was cited by 34 percent of LPs, this year that number fell to 23 percent, with co-investing still the preferred option beyond the usual commingled fund approach. See Figure 15.

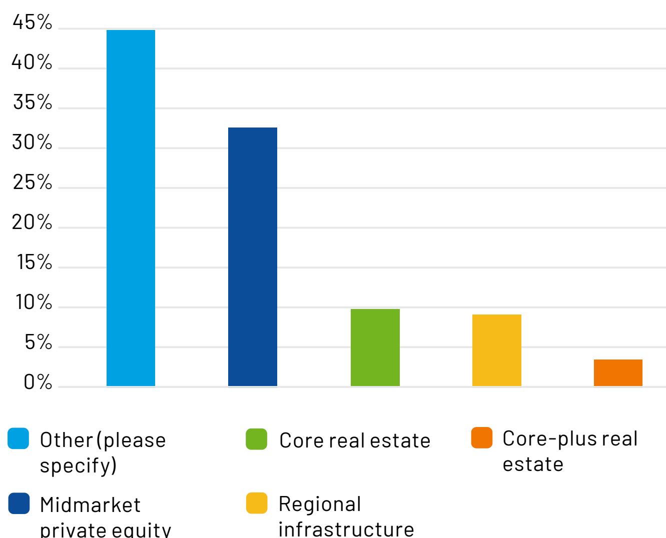
Figure 15. Aside from commingled funds, what will be your preferred investment method over the next 12 month?



For those who do plan on pursuing direct investments, the types of asset classes are variable.

As Figure 16 shows, mid-market private equity remains popular but interestingly 'other' was the highest response among 45 percent of LPs. Areas of interest include: forestry, emerging-market SMEs, natural resources and opportunistic (as opposed to core) real estate. The allure of direct investing, especially among entrepreneurial-focused family offices, is that it allows them to be hands-on and assert a greater level of control. However, this requires significant resources and can be hugely challenging and time-consuming. It could be that the aftershocks of COVID-19 have caused LPs this year to pull back, slightly, on direct deals.

Figure 16. Do you plan to do direct investments this year? If yes, which assets will you be focusing on?



Still, some remain committed to exploring mid-market private equity.

As UBS wrote in its *Global Family Office Report 2019*[5], 54 percent of investments within the average private equity

[5] https://www.ubs.com/global/en/wealth-management/uhnw/global-family-office-report/global-family-office-report-2019.html

portfolio were direct, with technology being the most popular sector.

At Ironsides, Roberts confirms that the family office monetized one direct investment last year and currently holds two late state venture capital/growth equity-type investments in the portfolio.

"One of the companies operates in the biotech space, the other is a technology group. Almost always, there is a family connection with the company and/or the board," states Roberts.

At LPP, Tomlinson says they have a larger exposure to real assets such as real estate and infrastructure, as opposed to private equity.

"We have two co-investment advisory relationships in private equity and we run equities in-house. In credit, we have a couple of fund-of-ones so we are, in many ways, structure agnostic," he says. "The main reason for (direct) investing in real assets is to hold them over a longer period of time as opposed to buying companies as part of a buy-and-build strategy. That is too hands-on and we don't have the resources or governance."

Asked why he thought only one in ten LPs cited direct infrastructure deals, compared to one in three for private equity, Tomlinson thinks this is likely to be a function of size.

"Direct investing in infrastructure requires you to write cheques of hundreds of millions of dollars, whereas, in mid-market PE, the size of deals is going to be much smaller, on average," he adds.

Co-investing fees...will this be a trend?

The chance to tap into more attractive return streams remains the most important reason for co-investing.

Whether this is more aspirational than practical is open to interpretation. To some extent, GPs might view Figure 15 with some skepticism because saying they want co-invests, and acting on them, are two quite different things.

One LP says that almost every family office claims they want to do co-investing in private equity "but so few can pull the trigger and do it in the timeframe required. I see more lip service when it comes to co-investing than actual execution on deals."

"We would consider co-investing should attractive investment opportunities present themselves, as we seek return enhancements for our clients within clearly defined risk parameters."

– Thomas McComb,
portfolio manager, private equity group,
J.P. Morgan Asset Management

Roberts explains that given the size of the family office they have to be very tactical and targeted when it comes to considering co-investments.

"We have a couple of co-investments in the portfolio and we are considering a deal right now. Those managers we've done deals with are typically less than USD 500 million in AUM," he says.

This year, the survey asked LPs whether they would consider paying fees to continue to access co-invest deals. As Figure 17 shows, zone-third of LPs said 'possibly,' which is too ambiguous to exact any real interpretation. More tellingly, only five percent said they would pay fees.

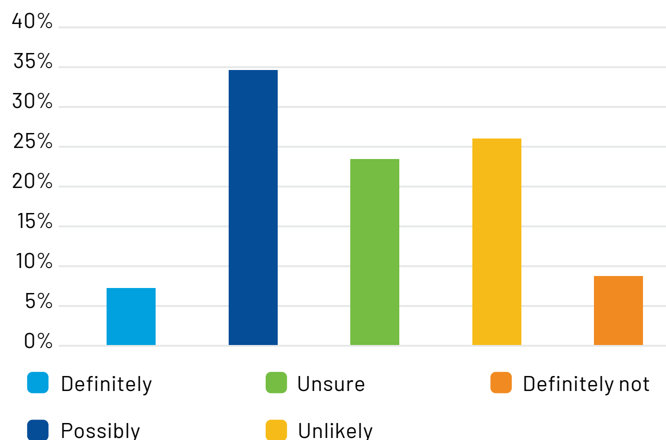
How should GPs interpret this?

Some might feel that if the deal is compelling enough, and there is enough interest among their investors, they could feel justified in charging fees. But generally speaking, GPs who are thinking of going down this path might want to reconsider as there is no clear evidence that LPs are open to the idea.

For now, it is unlikely that co-investment fees will emerge as a viable trend.

"There are plenty of fees already been charged by GPs. If a GP is doing a co-invest because it's too big for the portfolio (in terms of available assets) and they think it is going to really add value then I don't think the GP should be charging fees," opines Roberts.

Figure 17. To what degree would you be prepared to pay fees to a GP to continue co-investing activities?



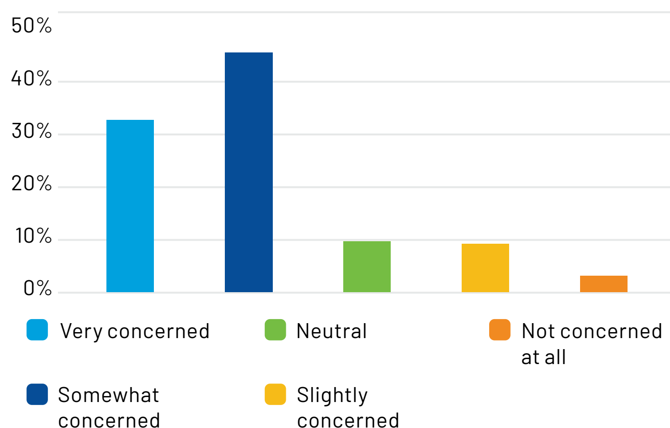
Sector & Market Outlook

The next 12 months are likely to remain fairly volatile, which will require LPs to pay close attention to how their alternative allocations are faring. Economic uncertainty will undoubtedly present ongoing attractive entry points for private equity, private debt and distressed credit managers.

And with ongoing geopolitical events on the horizon – namely the U.S. presidential elections in November this year and the unresolved U.S.-China trade dispute – active managers, especially hedge funds, could be well placed to exploit price inefficiencies in various market sectors.

The impact of COVID-19 has, however, made LPs a little apprehensive. When asked how concerned they were by the impact of the pandemic on global markets, 45 percent responded 'somewhat concerned.' See Figure 18.

Figure 18. How concerned are you by the current geopolitical landscape, ahead of the upcoming US and Germany presidential elections, and the impact of COVID-19 on global markets?



"I would differentiate between market correction and economic correction," remarks LPP's Tomlinson, when asked if he felt GPs were well prepared for a long-term market correction.

"A lot of businesses in portfolios are exposed to various economic factors — look at what is happening to restaurant chains in the U.K. for example — but from a market perspective, they seem to be quite buoyant. If there is another market correction, the key factor will be timing when to exit equity positions, but for me, the bigger worry is an economic downturn.

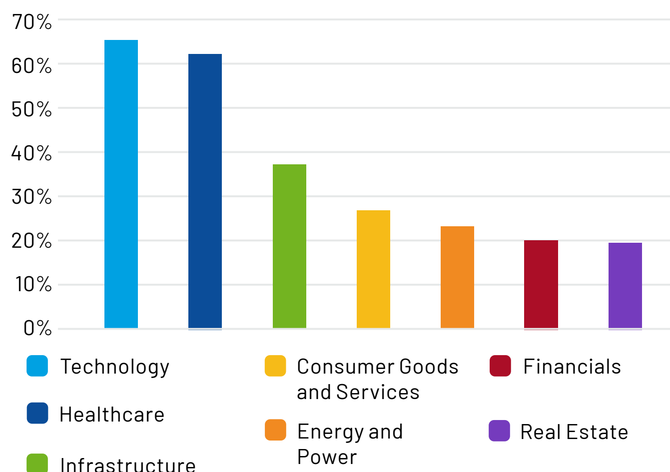
"In a couple of years, it is not inconceivable that asset prices will be higher thanks to monetary support and the economy will get through the crisis as a result of fiscal stimulus; it's hard to predict what will happen but we have to be aware there will be some significant downside risk scenarios on the table."

"It could be a good time for hedge funds, especially those managers who focus on uncorrelated sources of returns such as relative value arbitrage managers. With respect to equity long/short, compared to long-only equities I think there are more chances now for active managers to make money on both sides of the book."

– Michiel Meeuwissen,
Kempen Capital Management

Technology and healthcare are still regarded as the most attractive sectors of investment among LPs, as seen in Figure 19, but as the U.S.-based outsourced investment office cautions: "While we do think those sectors appear to be the most immune to the current macro environment the question is, has the pendulum swung too far? There may be some really interesting opportunities beyond those two sectors, which over the past four to five months have certainly risen in price."

Figure 19. Which ones of the following sectors do you most want to see managers invest in?



The overall consensus among LPs surveyed this year is to continue to back private market GPs who are operational experts, with the ability to acquire assets and transform their cash flows. This desire for managers to demonstrate operational value-add has always been imperative, but perhaps it has taken on added significance given the exceptional circumstances this year.

At Citi Private Bank, Rucinski explains that when it comes to sector preferences, the key is not to look for managers who can do multiple expansion within a certain time but rather finding those who can truly transform businesses "which is the best way to generate consistent returns."

"There's a group we are working with, for example, who specializes in hospitality. You might think that is a suspect time to be investing in hospitality but we think it's exactly the right time.

"This particular investment group has made compelling returns in good times as well as bad times, regardless of the market cycle. They know how to go in and increase the net operating income (NOI) on a hotel asset by cutting costs, driving revenue, working with the brand, etc., to maximize the operational value.

"We think this will be the key to the current cycle for managing a hotel in an eventual post-COVID-19 rebound. In hospitality, we expect there to be significant distress in the next few years," outlines Rucinski. He adds that the team is aiming to do five PE/RE deals in the second half of 2020.

Operational productivity is another investment theme among LPs over the next 12 months.

"This theme of productivity could apply to technology, to healthcare; we even invest with one GP who is excellent at bringing operational productivity to the energy sector. We want to keep pushing on that going forward," asserts Roberts. He says the family office is likely to remain light on real estate over the next 18 months. "We're just not sure how this all plays out, as a result of COVID-19. We are long data centers and cell tower companies in public equities, which is a proxy play on infrastructure."

Conclusion

Over the last 12 months, the LPs we surveyed have been satisfied with the performance of their alternative investment portfolios. Looking ahead into 2021, private equity and private debt are the two preferred areas of capital allocation. Some LPs we surveyed remain cautious, however, and want to see valuation multiples fall within private equity.

In the current climate, LPs are increasingly looking to back fund managers who can demonstrate a clear operational edge within private markets. This is likely to favor experienced GPs with a track record of improving the fortunes of companies during tough economic times as well as good. The need for this expertise has led to a reduction in direct investment appetite, although co-investing remains a key priority for a lot of investors.

This has also influenced GP size considerations, with a notable year-on-year increase among LPs choosing to invest with GPs running USD 5 billion or more in AUM. Encouragingly, however, LPs are still willing to back emerging managers and are less likely to try and negotiate lower fees.

Across the alternatives industry, ESG is now a key focus among LPs and represents the latest stage of transparency growth. LPs still want more frequent communication with their managers, and those who embrace technology to improve reporting (and other functions) might find they can improve the LP relationship.

While choosing to outsource technology is no longer frowned upon by investors, the global pandemic has meant that LPs want clear assurances that GPs' outsourced technology capabilities are resilient.

Investors remain faithful in their commitments to alternatives, including relative value credit-focused hedge funds and sector-specific equity long/short funds. But looking ahead into 2021, it would appear private equity GPs will continue to attract institutional dollars over and above other alternative asset classes.

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