Taking the retail alts plunge?

Considerations before launching a retail alternative investment fund

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What every private fund manager needs to know before taking the plunge

The past several years have seen tremendous growth in the retail alternative funds market (retail alt funds), with annual growth of 23 percent since 2008.[1] And total assets held by retail alt funds have jumped to nearly $450 billion from less than $50 billion in 2008, with growth expected to continue.[2]

Private hedge fund managers clearly see this a potentially lucrative opportunity, with 42 percent offering retail alt funds and another 34 percent considering doing so.[3] But, as you will learn in this report, there are a number of potential risks and other key factors that should be considered before launching a fund.

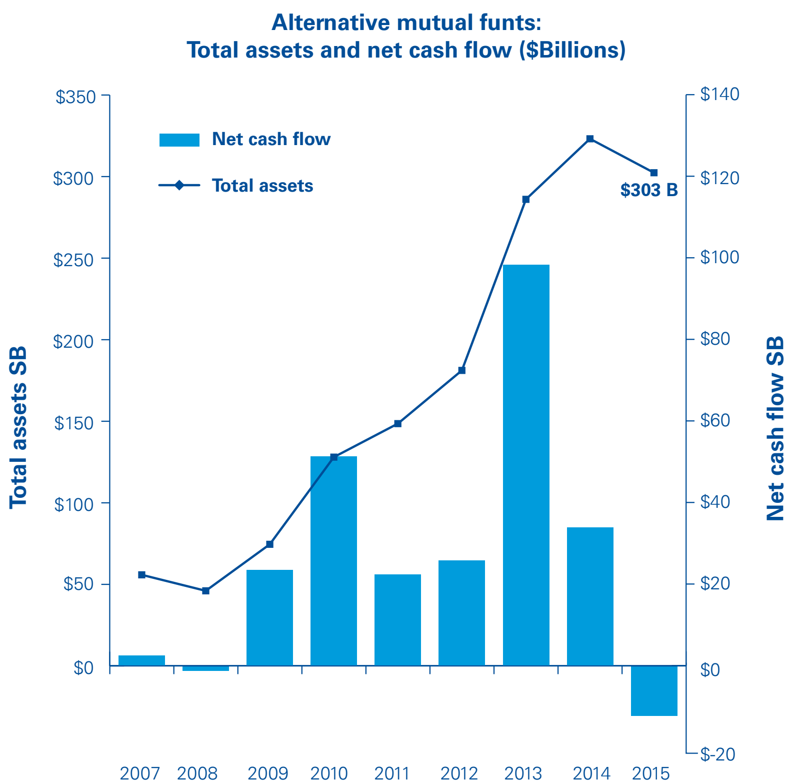
1 Source: Strategic Insight Simfund
2 Source: Strategic Insight Simfund
3 "From Alternatives to Mainstream (Part Two)," Deutsche Bank, September 2014

Entering the retail alt funds space

Hedge fund managers typically take their hedge fund style and strategy and try to replicate it in a '40 Act investment company.[4] They enter the retail alt funds space in a variety of ways, including:

- Creating their own platform
- Using a shared platform
- Managing a sleeve of multimanager funds (e.g., acting as a subadviser to a retail platform).

Figure 1:
Retail alt funds: Strong growth postcrisis



Note: Includes mutual funds only, excludes ETFs; alts universe above includes Morningstar® alternative categories and nontraditional bond

Source: Strategic Insight Simfund

4 This refers to investment vehicles (e.g., mutual funds, exchange traded funds [ETFs], etc.) regulated by the Investment Company Act of 1940.

The retail alt funds attraction

Fund managers' interest in retail alt funds has grown, in large part, as they have come to realize that retail investors have an appetite for such products.

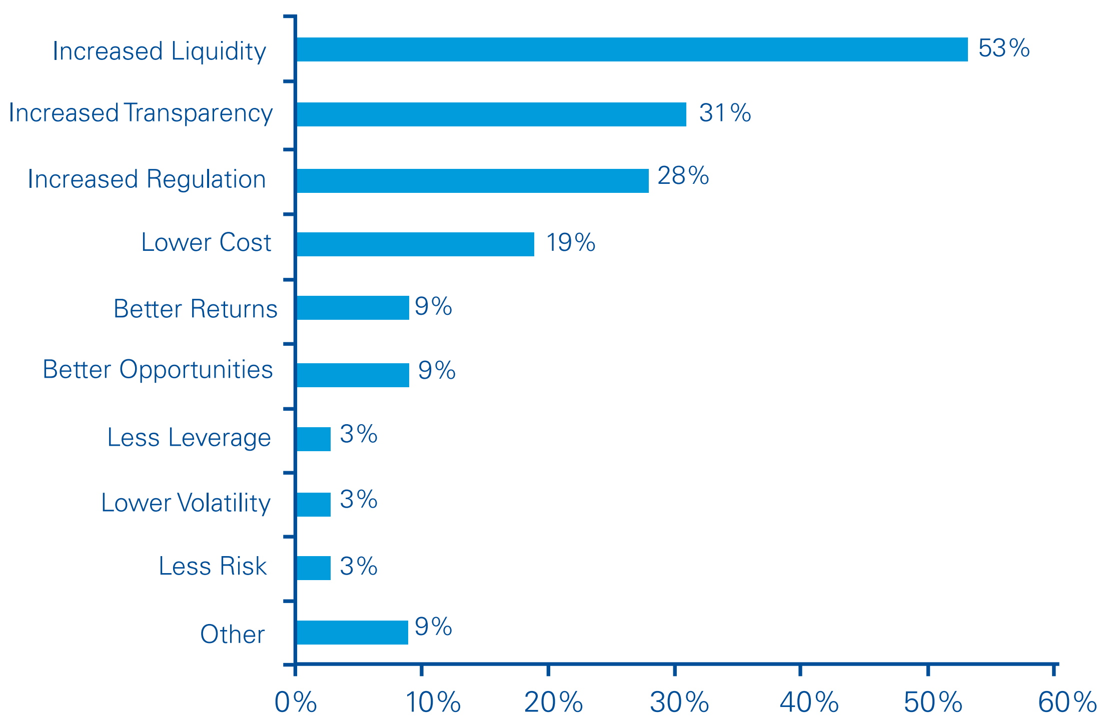
From an investor's perspective (see Figure 2), retail alt funds generally offer:

- Increased liquidity
- Increased transparency
- Increased regulaton
- Lower costs
- Simplified tax reporting: Retail alt funds investors receive Form 1099 for dividend income or capital gains instead of Form Schedule K-1.
  - » Hedge funds generally issue K1s, which can be more complicated and may involve state filings.
- Tax advantages:
  - » Tax is only imposed on distributions actually paid to investors.
    - Retail alt funds can also "pay" a deemed capital gain dividend where no cash is received by investors; instead, it is reinvested in the fund, net of taxes.
  - » Investors in hedge funds are subject to tax on their share of net income generated or realized by the fund, whether or not it is paid to them.

From the fund manager's perspective, retail alt funds generally offer:

- Access to a wider potential retail/consumer audience (since access is not limited to "accredited" investors[5] as it is with hedge funds)
- Wider range of distribution channels
- Greater industry exposure.

Figure 2:
Investors' Reasons for Investing in Liquid Alternatives



Source: Preqin Investor Interviews, November 2014

5 Defined by the SEC as individuals whose annual income exceeds $200,000 or whose net worth exceeds $1 million, excluding their primary residence

Key regulatory and tax limitations on retail alt funds

There are several limitations imposed by the U.S Securities and Exchange Commission (SEC) and the Internal Revenue Code (IRC) that you need to be aware of when setting up a retail alt fund[6]. While these requirements may appear onerous, they may also have the effect of helping you avoid potential cannibalization issues.

In order to comply with SEC and IRC regulations, you may have to change your retail alt funds strategy sufficiently from your existing hedge fund strategy that you end up targeting a different investment audience. Here is an overview of these requirements:

Liquidity requirement: One of the requirements of a registered '40 Act fund is that the fund cannot invest more than 15 percent of its assets in illiquid investments.

Now, to be considered a liquid investment, you must be able to sell the investment within seven business days at a price that is close to its fair value. This significantly limits the types of assets in which you may invest.

By contrast, a hedge fund may be able to put 100 percent or more of its assets into illiquid investments. So managers with a significant amount of illiquid investments in their portfolio who wish to launch a '40 Act fund can elect to open a closed-end fund, where there are no limitations on illiquid investments.

Leverage requirement: There also are limits on how much leverage you can use in your portfolio. Under Section 18 of the Investment Company Act of 1940, an open-end fund is subject to a 300 percent asset coverage requirement.

Example: A retail alt fund has $100 million in assets. It can borrow $50 million. That is, $50 million in leverage and $150 million in total assets.

With a hedge fund, on the other hand, there is no such mandated limit.

Additionally, retail alt funds, like any other type of '40 Act fund, are limited to borrowing from a bank. (A mutual fund may not issue debt.)

Diversification requirement: In order to be eligible to avoid tax at the entity level, a retail alt fund must comply with a quarterly 50 percent asset diversification test:

– The fund must maintain at least 50 percent of its total assets in cash and cash items, government securities, other retail alt funds, and other securities on a quarterly basis.

– The amount of other securities of any one issuer cannot exceed 5 percent of the fair value of the fund's total assets or 10 percent of the outstanding voting securities of the issuer. Any investment that exceeds these thresholds would not qualify in the 50 percent determination.

There are several other requirements a retail alt fund must also satisfy in order to be eligible to avoid tax at the entity level. Note: The 50 percent asset diversification test and other concentration limits may be a problem for a retail alt fund, depending on its strategy.

6 For purposes of this discussion, we are assuming that the retail alt fund is taxed as a "regulated investment company" (RIC) under Subchapter M of the Internal Revenue Code.

The retail alt funds challenge

However, as discussed earlier, launching a retail fund is not without potential pitfalls and challenges. Below are some of the issues you may encounter and potential strategies to address them.

Q. Will a retail fund "cannibalize" my existing hedge fund?

Hedge fund managers may consider offering a retail alt fund with the same or similar investment strategy (where permitted by regulation) as their current hedge fund. Most likely, that is where their area of expertise lies and what they are comfortable with.

- The potential drawback of this strategy is that the fees are typically lower in a retail alt fund, and the management/advisory fees are lower as well (see Figure 3). As a result, investors may opt to leave the manager's hedge fund and invest in the retail alt fund if the investment strategies are identical.
- So while fund managers may build up assets on the retail side, they may lose hedge fund investors who opt for the lower fee fund; thus, there is no real net gain

That is the essence of cannibalization.

Figure 3:
Mean Terms & Conditions for Liquid Alternative Funds vs. Hedge Funds

Terms & conditions	Alternative Mutual Funds	Hedge Funds
Minimum Investment ($000s)	232	1,993
Management Fees	1.06%	1.58%
Redemptions Frequency (Days)	1	30

Source: Preqin Hedge Fund Analyst

Example: Fund manager operates a $200-million private fund and receives a management fee of 1.5 percent plus a 20 percent incentive fee. He launches a retail alt fund with a similar strategy, where he receives a 2 percent management fee (generally subject to an expense cap) and no incentive fee.

Because it is less costly for investors to go the retail alt funds route with the same potential earnings/risk profile, the fund manager may find investors leaving the hedge fund in favor of the retail alt fund and also unable to attract new hedge fund investors.

Potential solution: Consider structuring the retail alt funds strategy in a manner that is sufficiently different than the hedge fund strategy. You may need to do this in any case in order to comply with certain '40 Act requirements (see sidebar). In this way, you may be able to minimize this potential cannibalization issue, as the differentiated fund will have different characteristics and will likely attract a different audience.

By properly structuring your retail alt fund, you should be able to avoid the cannibalization issue. Conversely, the hedge fund strategy might take advantage of certain mechanisms that the retail alt fund is prohibited to utilize. For example, the fund manager can:

- Increase the use of leverage
- Create a more concentrated portfolio
- Allocate a significant portion of the portfolio to illiquid investments
- Customize the hedge fund to be more attractive to certain types of investors.

When it comes to the cannibalization quandary, it is important to understand who your investors are and what their risk/reward profile is. There are three primary investor audiences for hedge funds and retail alt funds:

- General pubic/retail investors
- High-net-worth individuals and family offices
- Institutions (e.g., pension plans, endowments, and foundations).

When you understand who your primary audience is, then you can develop products that meet their specific needs

Q. How do I explain the benefits of retail alt funds?

It is critical to be able to **communicate** the goals and investment strategies of your retail alt funds to your investor audience. Whether you refer to it as a value proposition, elevator pitch, or investing strategy, you need to be able to tell your potential investors in a clear, succinct manner:

- Who you are
- How you will generate alpha
- How you will minimize risk.

Investment managers should have a "story" that is appropriate for each audience. For example, using complex equations and formulas describing your investment and/or risk minimization strategies may sound impressive but will not be as helpful to a general public/retail investor as a clear, basic explanation of how your retail fund differs from your hedge fund.

If your investors do not understand your investment strategy, they may not invest. Additionally, if those enlisted to distribute your product cannot properly articulate your strategy, you may not be successful in growing your retail alt fund.

This is especially the case if you are dealing with individuals or a less sophisticated group of investors. Even if you are addressing an institution's investment or due diligence committee, a higher-level, more detailed explanation may be appropriate.

Two of the key features that many retail alt funds generally provide to investors are:

- Low market correlation – offering downside protection
- Absolute return – offering steady growth.

Simply put, retail alt funds may underperform in an upmarket and may outperform in a down-market.

What's more, many retail alt funds are designed not to correlate to the market (e.g., the Standard & Poor's [S&P] 500 index). In light of the diversification strategies that most retail investors pursue, retail alt funds present a strong opportunity to introduce uncorrelated strategies into their portfolios.

Many investors think that retail alt funds potentially present additional risks. However, retail alt funds may give them a hedge to their existing strategies so there is an overall risk reduction.

Slow but steady growth: When the market is growing like it has been since 2013, slow but steady retail alt funds growth may not seem compelling. However, if the market takes a downturn similar to 2008, or even if it becomes flat, retail alt funds may be a more suitable option.

For example, trading strategies used by hedge funds generally fared significantly better in 2008 than many mutual funds and the S&P 500 index, illustrating the benefits of such strategies.[7]

This is a key reason that many investors, pension plans in particular, put allocations into alternative strategies (see sidebar below). They want to hedge against another stock market crisis and try to protect their downside by investing in these uncorrelated strategies.

7 Hedge Funds Took a Serious Hit in 2008, CBS News, January 12, 2009

Why pension plans may favor retail alt funds

We have already reviewed why retail investors are so interested in retail alt funds. But what about institutional investors, like pension and 401(k) plans?

Pension plan allocations to alternative investments (private and public) have soared in recent years.[8] But there are a number of reasons why retail alt funds may be the preferred option over private alternative funds for pension plans to gain access to alternative investment strategies.

For example:

- Retail alt funds avoid unrelated business taxable income (UBTI) issues. Distributions from retail alt funds generally avoid potential UBTI issues, which can crop up for tax-exempt investors in hedge funds.
- There are no Employee Retirement Income Security Act of 1974 (ERISA) implications. Retail alt funds do not have to limit the amount a pension plan can invest before triggering ERISA requirements.
- Some older pension plan charters prohibit investing in private funds; this prohibition does not apply to retail alt funds.
- Retail alt funds generally offer pension plans more liquidity than private hedge funds.
- Retail alt funds are subject to strict transparency requirements and regulatory oversight, so pension plans face less overall scrutiny over their investment choice.

Q. Can I use my hedge fund track record to promote my retail alt fund?

Investors, regardless of type, typically look to a fund's track record before making investments. This is particularly true when it comes to pension plans, as they are held to higher fiduciary standards in order to protect participants.

When you launch a new retail alt fund, you typically **cannot** use the track record you may have established when you ran a hedge fund. However, there may be some exceptions to this rule:

- You may be able to use the hedge fund track record if the retail alt fund uses **exactly** the same investment strategy.
  - You need to check with legal counsel to make sure that this is permitted under the regulations.
  - Keep in mind that by doing this, you then run the risk of cannibalization, as discussed earlier.
- You may be able to convert an existing hedge fund into a registered retail alt fund and use the same investment strategy. In that case, you may be able to use the hedge fund track record to market the retail alt fund—but you will no longer be running the hedge fund.

The lack of a track record has been a major obstacle to persuading pension and 401(k) plans to invest in retail alt fund or to offer them as an investment option. The well-respected Morningstar will not rate a fund unless it has at least a three-year track record.

Many retail alt funds have not been around for very long, so they have not been tracked by Morningstar. However, once they have been around for three to five years, where they can have a Morningstar rating, we may potentially see a lot more of them on pension and 401(k) platforms.

Q. What are the current popular strategies for retail alt funds?

As with alternative funds in general, there are a host of investment strategies being employed by retail alt funds. Among the most popular are:

Long-short strategy: Long-short strategies use leverage, derivatives, and short positions in an attempt to maximize total returns, regardless of market conditions. They invest primarily in stocks.

Events-driven strategy: Events-driven strategies take advantage of transaction announcements and other one-time events. One example is merger arbitrage, which is used in the event of an acquisition announcement. Another example is "distressed securities," which involve investing in companies that are reorganizing or may be selling below their fundamentals.

8 "Alternative Investments 2020: The Future of Alternative Investments," World Economic Forum, October 2015

Global macro strategy: This strategy bases its holdings, such as positions in various equity, fixed income, currency, and futures markets, primarily on overall economic and political views of various countries (macroeconomic principles).

For example, if a manager believes that Japan's economy is about to surge, he might take long positions on stock in major Japanese companies or buy futures contracts on major Japanese indexes or the yen.

Multistrategy funds (multistrat): A multistrat is where several hedge fund managers manage a sleeve of assets in a fund, which in turn roll up into a return of a single retail alt fund. Multistrats typically offer the benefits of:

– Fund diversification

– Investor access to some of the more well-known hedge fund managers in the industry

– Potential tax breaks due to netting of gains across asset sleeves.

Current yield strategy: Because banks are paying virtually no interest, a current yield strategy is designed to generate cash, which is then distributed to investors. It is not designed to be a long-term investment strategy where earnings are retained and the principal investment grows (which may also create phantom income issues[9])

Closing thoughts

While the retail alt funds market holds much promise for managers of existing hedge funds, there are a host of regulatory requirements and strategic considerations that need to be addressed before you decide to launch one.

We have discussed a number of these issues in this article, including the possibility of cannibalizing an existing hedge fund and the increased regulation on retail funds. Stay tuned for additional articles on retail alt funds, where we will explore a variety of important subjects, including platform choices, distribution and transparency issues, as well as the special mind-set it takes to run a retail fund as opposed to a hedge fund.

9 With phantom income, investors may be taxed on earnings even though they are not actually distributed to or received by them. This is something most investors seek to avoid.

How KPMG can help

KPMG is a leading provider to the financial services industry, serving more than more than 70 percent of FORTUNE 1000 companies in the United States. Our U.S. asset management services are delivered through 2,900-plus professionals, including 315 partners, part of a global network of member firms whose financial services presence of more than 35,000 partners and professionals spans 115 jurisdictions covering the world's most prominent financial centers.

In addition, KPMG provides professional services to:

- More than 75 percent of the top 50 U.S. stock-based mutual funds
- More than 70 percent of the top 50 alternative assets managers in the United States
- 95 percent of the top 20 public money managers and their funds.

We also deliver audit, tax, and advisory services to a broad range of industry players—from start-ups to FORTUNE 50 diversified financial service firms—enhancing financial and operational structures and helping our clients proactively take advantage of change rather than merely reacting to it.

We offer:

- Deep experience in the alternative investments space: Regardless of where your firm is in its evolution—from launch to globalization to exit—our professionals have the passion and experience to help you deal with the issues and challenges that impact you today, as well as prepare you for what lies ahead.
- Global strength and capabilities: Professionals located in all of the world's major commercial hubs, working through our global network of member firms, serve our clients wherever they do business.
- Outstanding team leadership by senior professionals: Our engagement teams, led by senior partners and professionals, work shoulder-to-shoulder with you to offer practical, customized, and appropriate insight and guidance and deliver tangible results.
- Leading technology and innovation: We supplement our hands-on approach with industry-leading technology and innovative approaches that allow you to operate and leverage your resources—people, vendors, legacy platforms, and equipment—more efficiently.

Contact us

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