HSBC Asset Management

Funds
Open and closed-ended vehicles

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Introduction

For many investors allocating towards alternative assets, fund structures may not have been a major consideration in the past. This is primarily because within the alternative assets space, outside of hedge funds, fund vehicles have generally been closed-ended. There are, of course, many examples of open-ended funds within the alternative assets space, but these tend to be focused on yielding assets, such as real estate and infrastructure, with more open-ended private credit funds emerging.

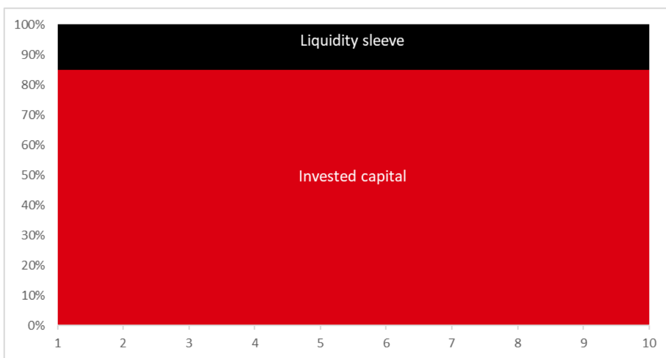
When thinking about private equity, experienced investors are generally more familiar with the traits of closed-ended fund vehicles. They perform due diligence on a range of managers, select their preferred partner and commit capital. They then wait for their committed capital to be called, invested and returns harvested over a period measured in years.

This approach can bring significant benefits, such as an illiquidity premium and greater control, as managers have the ability to nurture and grow both revenues and profits at their portfolio companies before exiting and delivering returns for their investors. These distributions are then often reinvested into new fund vehicles, which can help to provide diversification across vintages. However, in an industry as innovative as alternative assets, it's unsurprising that new approaches to fund investing have evolved.

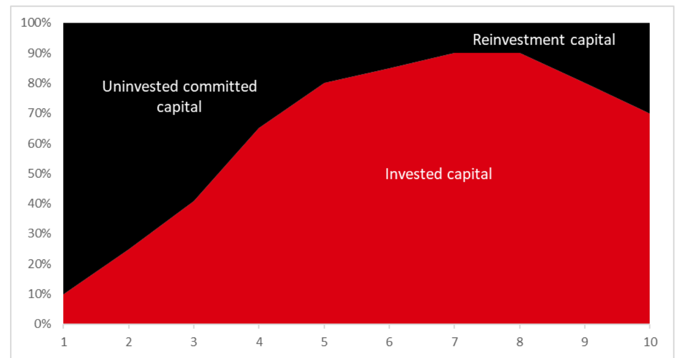
Recently, some managers are now focusing on approaches familiar to investors in public markets and hedge funds, with a move towards launching complimentary open-ended fund vehicles. While these funds can bring benefits for both managers and investors, in reality, they are likely to be considered alongside closed-ended vehicles by some investors. For other investors – particularly those with less private markets experience – they could be a stepping stone towards establishing an alternative investment programme.

Representation of open and closed-end vehicle lifetime structure

Open-ended fund



Single Closed-ended



Source: HSBC AM, as of January 2024
Note: the above does not reflect a focused reinvestment of proceeds into new closed ended funds

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Open-ended funds

Most investors will have a target allocation (across asset classes). This can be considered an essential part of the management of all multi-asset portfolios. When it comes to alternative assets, open-ended funds can help investors to meet their target allocations through rapid deployment. This is because open-ended funds will often be fully invested from day one and investors gain exposure at net asset value (NAV), rather than capital being drawn and invested over a period of time.

What's more, because open-ended funds generally do not have a fixed-term and will continue in perpetuity, an investor can remain invested in a single fund for a time period that suits them. In practice, investors may limit their exposure to a single or limited number of open-ended funds, which does provide exposure to the asset class, but could limit the benefits of manager diversification.

One of the key benefits of open-ended funds is a level of liquidity offered through limited redemption mechanisms. In order to achieve this, the funds generally price their underlying investments on a monthly basis – although this is not always the case. Given the need to balance pricing for both sellers and buyers, it could be argued that marking valuations to market is vitally important for open-ended funds. That said, some underlying investments, if they are held in closed-ended underlying funds, may not be as regularly valued. In these examples, open-ended funds could be simply a fundraising wrapper, providing exposure to underlying funds which certain types of investors may not have had access to. In such circumstances, there could be the perception of false liquidity at the open-ended fund level, that may not exist at the underlying investment level. This liquidity can be revoked by the fund manager under certain situations, for example if there is a raft of redemptions which the manager cannot satiate from the liquidity sleeve. One point to note is that while the liquidity sleeve is there for a specific purpose, it will also act as a drag to performance, as the fund will not be fully invested. Furthermore, given the lower IRR on offer in many open-ended structures, the counter argument to the nominal liquidity on offer is that an investor actually needs to remain in an open-ended vehicle for a longer period to create commensurate returns to a repeated closed-ended fund investment cycle.

In contrast, given that investments within closed-ended funds are not readily tradeable, there is arguably less of an incentive or need to aggressively mark to market. Investors in closed-ended funds generally take the liquidity hit in exchange for an illiquidity premium.

A further difference in the two types of fund structure is how performance is measured. Open-ended funds typically use time-weighted returns (TWRs) which shows a compound rate of growth and excludes the impact of cash flows. This approach is generally appropriate for open-end funds, as it can accurately measure the performance of a manager, irrespective of the pacing of invested capital over time. This contrasts with the use of internal rate of return (IRRs) as a standard performance metric for closed-ended funds, which is a dollar-weighted metric that takes into account the timing of cash flows.

Open-ended fund composition

As with any investment, it is important to understand the portfolio constituents of any fund. This should be a part of any robust due diligence (DD) process. Often, an open-ended fund might invest in other (open or closed-ended) funds managed by the same provider. In some cases, open-ended funds will take a slice of every deal done across all the strategies a manager operates. While this approach provides direct exposure to portfolio companies, it can reduce the ability for investors to be selective with the strategies they believe a single manager may be strongest in. Other open-ended funds may invest into one or several underlying funds run by the manager, in effect, creating a multi-fund structure. Investors may be agnostic about these approaches, but, on the whole, investors must make themselves comfortable with each of these considerations, so their commitment to an open-ended fund is an informed one.

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Limitations to liquidity

Given markets can often reprice relatively quickly, some open-ended funds may not necessarily be able to provide liquidity in these circumstances. In addition, should redemption requests outweigh the liquidity available, an open-ended fund may close. This can cause further issues around the potential disposal of the fund's best quality assets, which might be the easiest and fastest to sell, leaving those remaining invested with the (relatively speaking) poorer quality assets.

Take-aways on open-ended funds

Regardless of the positive and negative characteristics, these fund structures may become more common in the alternative assets space. Particularly as they are likely to benefit from greater recognition over time – despite the inherent risks. Managers will likely be keen to see their acceptance widen, as these structures can broaden their offering, particularly to emerging client types (for alternative assets), such as non-institutional high net worth and ultra-high net worth individuals. These investor types are viewed as increasingly important across the alternative assets industry, as some institutional investors reach or exceed their target allocations towards alternative assets.

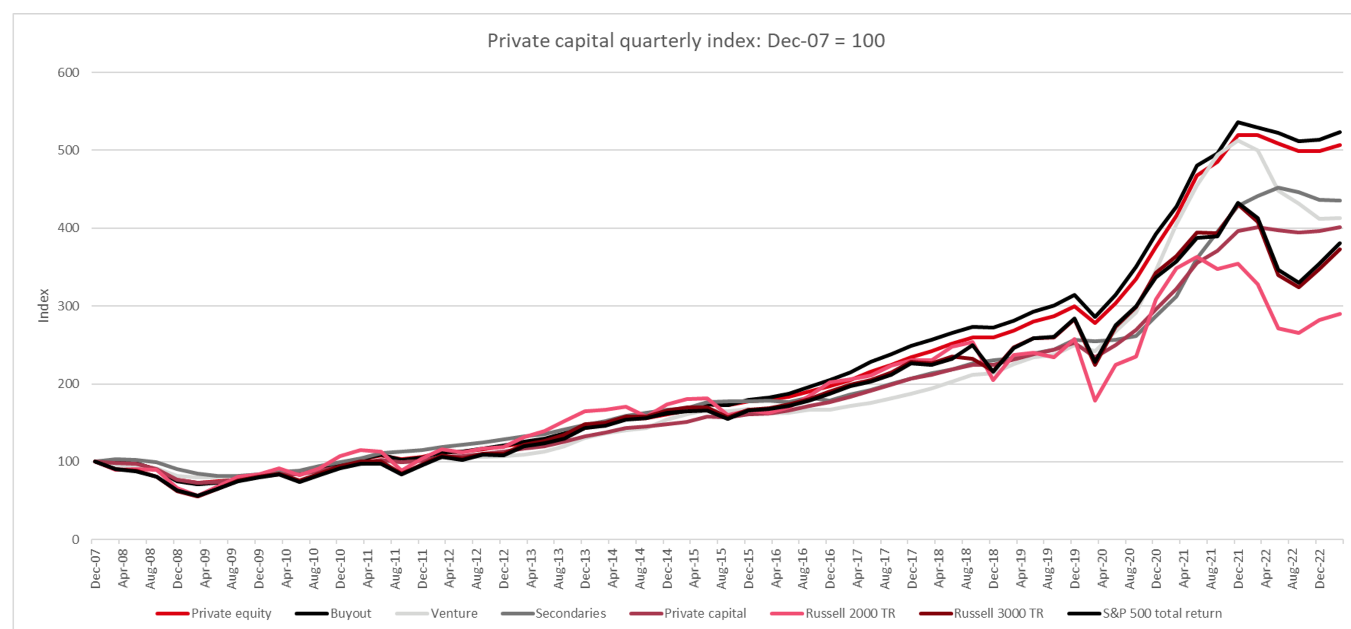
Anything that can be done to increase the attractiveness and availability of alternative assets could be a driver of future industry growth. Open-ended funds are likely to be a good starting point for many investors in their alternative asset investment programme. As they gain experience, they could then look to develop a more sophisticated investment programme, utilising closed-ended funds, which are structured very differently.

Closed-ended funds:

Institutional investors are generally familiar with the closed-ended nature of pooled investment vehicles. That they are different in structure to open-ended funds is often a prized characteristic for many investors.

While there is an inherent lack of liquidity, traditionally, investors have benefited from an illiquidity premium from their alternative assets. Data suggests that over the long-term, private equity and venture capital funds have outperformed public markets in the US – by a relatively wide margin for some parts of the market.

Private capital quarterly index: Dec-07 = 100



Source: Preqin, data as of October 2023

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While open-ended funds can provide a liquidity backstop if needed (depending upon the fund structure and any entry / exit limitations), when it comes to closed-ended fund structures, investors need to be aware that they will have to manage their liquidity, with uncertain timing of future capital calls. This may make managing a programme of closed-ended fund commitments more admin-heavy, with a need for some liquidity within the broader portfolio.

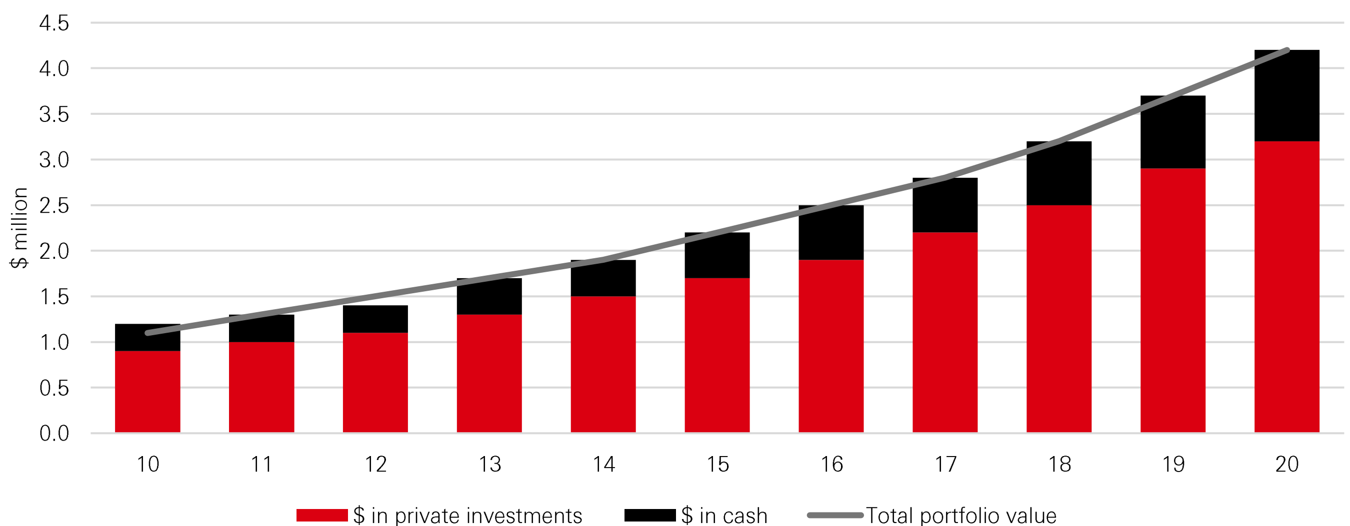
Those undertaking a programme of closed-ended alternatives fund investments, utilising a multi-vintage programme (diversification across vintages) can enhance net returns while reducing risk. Invested capital grows, with distributions reinvested into the next generation of funds, delivering similar compounding effects as witnessed with some open-ended funds[1]. A private investment program entails committing to new private funds each year to maintain an allocation to private investments in perpetuity. By diversifying across multiple vintage years, J-curve effects are mitigated as distributions from more mature funds tend to outpace capital calls of new funds. Capital calls for new investments are then mainly funded through recycling of capital, while a portion of cash tends to be generated providing a buffer for environments when calls may outpace distributions.

In addition, diversification across vintages within closed-ended funds can mean exposure to various investments is gained across all phases of the economic cycle, avoiding the need to aim for perfect timing upon entry and exit. This can help to boost returns, with Burgiss research suggesting that an investment programme recycling distributions could deliver an annual return of 14%, after being established and in a steady-state. This represents a 4.2 multiple on committed capital and is a relatively high hurdle rate for an open-ended fund to emulate. Burgiss research suggests that they “would expect a perpetual capital [open-ended] fund to potentially produce a return at a slight discount to a closed-ended private investment program.”

Note:

1. UBS Research, as of November 2023: Post | Feed | LinkedIn

Growth of USD 1mn commitment in a multiple vintage year private equity program funded from recycling and cash



Source: Burgiss, UBS, as of November 2023
Note: Commitments to a multiple vintage year private equity program funded from cash earning 3.5% per annum and recycling of distributions from previous vintage years. Analysis is on steady state years 10–20. Private equity is assumed to have an IRR of 17%.

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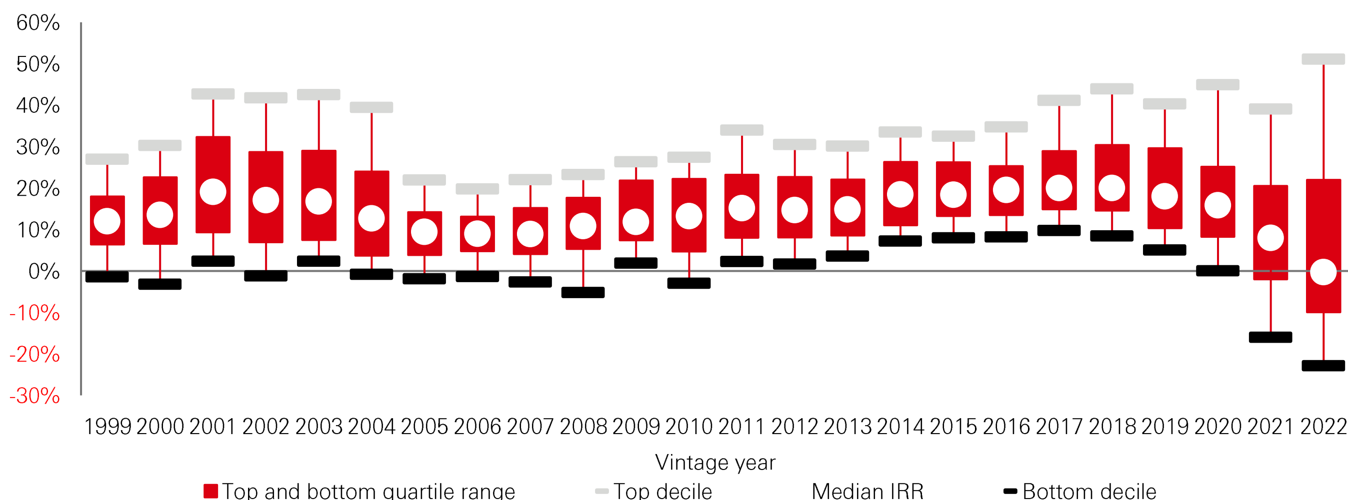
Closed-end funds often report performance using an internal rate of return (IRR). While IRR is a relevant measure by which to track performance, many others are used too. It is not the purpose of this paper to describe each approach in detail, but we would be remiss to ignore the variety of return measures available.

IRR as a measure is important, as it considers cash inflows and outflows. This approach is more appropriate for closed-ended funds given the greater level of control that managers have over the timing and magnitude of a fund's cash flows[2]. To bridge the gap, many investors also compare net multiples on invested capital (MOICs) over similar time horizons. MOICs are the ending value of investments (including any asset sales or distributions), relative to how much was invested over the time period, and provide another solid measure of a fund's performance.

All these things considered, execution is critical. It is for this reason why manager selection skills are so important – particularly now (the data in the example below provides a snapshot of performance, with later vintage funds likely to see IRR dispersion narrow, given these funds are in their relative infancy). **With greater dispersion between winning and losing** funds , selecting the 'right' manager can lead to outsize returns, compared to peers. But DD and fund selection is not simply focused on managers alone; selecting investments across strategies can increase diversification and limit single-manager exposure. Investors with a multi-vintage investment programme are not only able to diversify across managers, but they can also choose to reinvest with winning managers after they have been identified and relationships established. However, as not all managers can repeat investment performance across every fund they launch, it is important that the DD processes continues, to increase the likelihood of identifying strong performing managers over the long-term.

Note:
2 Alternative asset returns – Apples, Oranges and Best Practices | J.P. Morgan Asset Management (jpmorgan.com)

Private equity – IRRs by vintage



Source: Pitchbook, data as of October 2023

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Conclusion

Just because something is difficult, doesn't mean it should be avoided. Open-ended funds can offer sensible trade-offs, such as lower minimum investments, no administrative burden for capital calls, no J-curve effect and a fast route to private market exposure. As a result, these investments can be an ideal source of exposure for those beginning their alternative investment programme. They could then gradually introduce exposure to closed-ended funds over time as they maximise returns.

Research shows that a long-term programme of commitments to closed-ended vehicles, with distributions recycled into new funds, is likely to offer the potential for greater returns. While selecting the 'right' managers might not be the easiest of tasks, it pays dividends when it comes to performance. Committing to a well thought out and researched programme of closed-end fund commitments, over an extended period of time, is likely to be most beneficial for long-term investors looking to maximise returns.

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Key Risks

Risk Considerations. There is no assurance that a portfolio will achieve its investment objective or will work under all market conditions. The value of investments may go down as well as up and you may not get back the amount originally invested. Portfolios may besubject to certain additional risks, which should be considered carefully along with their investment objectives and fees.

- **Illiquidity:** An investment in the Fund is a long term illiquid investment. By their nature, the Fund's investments will not generally be exchange traded. These investments will be illiquid.
- **Long term horizon:** Investors should expect to be locked-in for the full term of the investment
- **Economic conditions:** The economic cycle and prevailing interest rates will impact the attractiveness of the underlying investments. Economic activity and sentiment also impacts the performance of underlying companies and will have a direct bearing on the ability of companies to keep up with interest and principal repayments.
- **Loans to private companies:** The Fund will invest in loans to medium sized privately owned companies. There are specific risks associated with lending to such companies, including that they may have limited financial resources, access to capital and higher funding costs. They may also be more vulnerable to market, key-man and other risks and their accounts are not typically published.
- **Valuation:** These investments may have no or a limited liquid market, and other investments including those in respect of loans and securities of private companies, may be based on estimates which cannot be marked to market until sale. The valuation of the underlying investments is therefore inherently opaque.
- **Fund Risk:** Investments into this Fund may, among other risks, be negatively affected by adverse regulatory developments or reform, credit risk and counterparty risk. The credit market bears idiosyncratic risks such as borrower fraud, borrower bankruptcy, prepayment risk, security enforceability risk, subordination risk and lender liability risk.
- **Investor's Capital At Risk:** Investors may lose the entirety of invested capital

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