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Industry Chapter

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The State of Play for the Alternative Investment Industry in 2022

AIMA

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Tough Times Ahead for the Global Economy

The threat of a global recession looms large as major markets grapple with the highest inflation levels reported in over 40 years, while geo-political tension between Eastern and Western Europe remains on a knife-edge. No, you haven't picked up a copy of this guide from before the turn of the century. The year is 2022 and few investors outside the energy sector (where a barrel of Brent crude oil recently broke $100 for the first time since 2014) are enjoying the experience. The troubles currently facing investments in both public and private markets are well known. Less obvious is the solution. Where should investors be allocating their capital at a time when equity markets are enduring a lengthy and sharp correction, interest rates are back over 1% and several further rate hikes are widely predicted?

A Port in the Storm

While there's a huge amount of dispersion of performance numbers across asset classes and strategies within the alternative investment area, the overall picture demonstrates that alternative investment fund managers are once again fulfilling their role of protecting their investors against downside risk, while providing portfolio diversification and uncorrelated returns. It is unsurprising then that half of US allocators surveyed by With Intelligence and AIMA in the first half of 2022 said they were likely to increase their allocation to hedge funds in the next 12 months.[1] Family offices are the most likely to do so, followed by foundations and endowments. Those that did so in Q1 stood a better chance at weathering the storm that is currently raging across various markets.

H1 2022 – Equities *vs* Hedge Fund Index Comparison

- MSCI World Index is down **21%** YTD (30 June) and **17%** over the past 12 months.
- S&P 500 Index is down **21%** YTD (30 June).
- FTSE 100 Index is down **3%** YTD (16 June) and **0.5%** over the past 12 months.
- HFRI 500 Fund Weighted Composite Index is down **1.4%** YTD (June) for 2022.
- HFRA 500 Equity Hedge Index is down **9.1%**, while the HFRI 500 Macro Index is up **14.2%** over the same timeframe.

While Hedge Fund Research's HFRI 500 Fund Weighted Composite Index is down on the year, a 1% drop-off is a far cry from the more than 20% correction seen across major equity indices, including the MSCI World Index – the most applicable index comparison to hedge funds given they often invest in multiple markets. Strikingly, the HFRI 500 Macro Index is up 14.2%, showing that there is a way to stay in the black or at least offset losses elsewhere in these trying times.

These results align with AIMA's research, including the quarterly Hedge Fund Confidence Index (*HFCI*), which measures the sentiment of global fund managers regarding the economic outlook of their business over the next 12 months on a scale of -50 to +50.

The Q2 2022 edition returned an overall average score of +17.8, a modest uptick from the global average reported in the previous quarter. Global macro and CTA/managed futures were the most confident strategies, scoring +20.5 and +26, respectively. For the second successive quarter, billion-dollar hedge funds (i.e., hedge fund firms managing more than $1 billion) are significantly more confident than their smaller peers, while regionally, fund managers based in the UK are the most bullish.

Hedge funds and the wider alternative investment sector have been rewarded for their performance in recent years with strong inflows that took the global valuation to historical highs. According to *Preqin*, the quarterly valuation for global assets under management for the hedge fund industry peaked in Q4 2021 at just over $4.3 trillion, before dipping fractionally in Q1 this year.

Investors' appetite for alternative investment goes well beyond hedge funds. The H1 Investor Intentions report[2] revealed that private equity was the most in-demand fund type, with 57% of investors likely to increase allocation to this asset class over the coming year. Exposure to real assets (real estate, infrastructure and commodities) and private credit was also shown to be sought after with these asset classes capturing interest from around 40% of investors surveyed. The H2 edition of the Investor Intentions report is due later this year and it will be interesting to see if the latest performance numbers drive interest in alternative investments higher still.

The Macro View

The challenges of COVID-19 may have receded or at least been superseded by more urgent issues but, inevitably, the alternative investment industry now faces the return of more familiar concerns with regulators, particularly in the US, who are in overdrive producing proposals covering everything from definitions of private fund advisors to ESG, digital assets and short selling reporting requirements. The most pertinent of these issues will be discussed in more detail later.

In a broader sense, ESG and digital assets appear to be jostling for the most attention-grabbing developments this year. The responsible investment space has seen scheduled progress in regulations such as SFDR level 2, which AIMA has published a guide on,[3] overlaid with heated debates around corporate greenwashing, how to deal with short positions in an ESG context, and a growing interest in energy-intensive cryptocurrencies and how this can be squared with E-related policies and standards.

Speaking of digital assets, some hard truths have been learnt recently about how correlated cryptocurrencies are to movements in equities and interest rates, as well as each other. Bitcoin, for example, has slid from all-time highs of $67,000 in November 2021 to trading below $20,000 at the time of writing. The value of the total cryptocurrency market has fallen by about 65% since last autumn, an estimated $2 trillion fall in value. Highly leveraged cryptocurrency funds are experiencing a series of headwinds, while exchanges and other crypto-asset service providers are reducing headcount and mothballing product launches, leading some commentators to predict a new "crypto winter" is upon us. What this means for the space in the longer term is unclear, but there is an opportunity for it to emerge with a greater emphasis on risk management and operational resilience across the ecosystem as well as a greater understanding of the practical use cases of crypto-assets.

Hedge funds have also had to contend with several challenges, not least compliance with the vast swath of economic sanctions against Russia and Russian individuals in the wake of the invasion of Ukraine. In May, the EU banned selling investment funds to Russian or Belarusian persons. To help understand what all this means for alternative investment funds that have exposure to Russia or count Russians among their investors, AIMA has produced a series of guidance in partnership with several law firms to assess this novel issue, which is available at *www.AIMA.org*.

The geo-political tension is not confined to Europe. In Asia Pacific, Hong Kong's rigid approach to security laws and the zero-COVID policy imposed by Mainland China is driving a relocation of talent to other financial hubs across the region.

All this is to say nothing of the positive developments in the operational aspects of running a hedge fund. AIMA, along with its research partners, has observed that fund managers of all sizes are learning the lessons of operating in a decentralised environment, including greater reliance on digital tools and automation offered by service providers, under the auspices of being more efficient and providing greater value for investors.

Regulation

United States

The alternative investments industry faces a bombardment of new rules and rule frameworks across several major jurisdictions, but none more so than in the US. AIMA bolstered its US-based team with two additional senior people at the end of last year as the US SEC began ramping up its activity. By June, our Government and Regulatory Affairs team has responded to over a dozen proposals – and counting – and continues to fully engage with fund managers and investors because these changes too will have enormous ramifications for them as well. Chief among these proposals is the Private Funds Adviser Proposal, which would (i) mandate certain standardised quarterly information reports to investors, (ii) require mandatory annual financial statement audits, (iii) require independent "fairness" opinions on adviser-led secondary transactions, (iv) prohibit all private fund advisers (including those not registered with the SEC) from engaging in otherwise-discretionary practices related to the allocation of certain fees and expenses, conflicts of interest and compensation, and (v) prohibit certain preferential treatment related to redemption rights and transparency that may be deemed to be unfair to others and require disclosure of other types of preferential treatment, irrespective of disclosures and subscription terms. In short, the proposal, if finalised in its current form, would rewrite the rules of business for private fund managers.

More recently, the SEC has proposed to amend the definitions of securities dealer and government securities dealer, changes that would force many hedge funds and private fund advisers to register as such if they are captured by a set of standards that deem them to be routinely providing liquidity in the markets. The financial cost of doing so would be extraordinary. For example (and based on the SEC's conservative estimate), even the smallest firms required to register would face initial costs exceeding $1 million and hundreds of thousands of dollars per annum in compliance costs. Initial costs for larger fund managers could reach $10 million, with annual compliance costs close to $6 million.

The costs associated with dealer registration and ongoing compliance pale in comparison to the proposal's overall impact on securities markets, as well as related futures and derivative markets. Dealer registration entails a number of structural changes, such as the application of capital requirements, which are not suited for off-balance sheet business, the loss of client status and many negative tax implications. These changes could render the hedge fund business model not viable, forcing managers to potentially withdraw from certain investment strategies, leading to a myriad of negative effects on market efficiency and liquidity.

We have seen other impactful proposals aimed at shortening the settlement cycle, accelerating beneficial ownership reporting, requiring the reporting of short position data and the reporting of securities lending information, and enhancing recent event reporting of Form PF. I can only allude to these proposals here, but each are substantial in their own right.

European Union

The Alternative Investment Fund Managers Directive (AIFMD) was critical to the development of the global hedge fund industry over the past decade. The global industry has reconciled itself with the new rules and spent the last few years highlighting the value of stability as policymakers in Europe assess how the current framework can support capital formation in the EU.

As part of the review of AIFMD, AIMA's calls to "fix only what is broken" have broadly been heeded (with the notable exception of loan funds) and many of the reforms proposed by the EU Commission in November 2021 are iterative rather than transformative. The most material of the EC's proposed reforms relates to liquidity management, delegation, and loan funds.

In all instances AIMA has been a leading interlocutor between the alternative investments sector and the EU institutions. This has resulted in some marked improvements in the General Approach agreed by the EU Council in June and in the draft report for the EU Parliament prepared by the Rapporteur. The second half of the year will see the EU Parliament finalise its position as trilogue negotiations begin. The outcome of this negotiation will shape the future of the investment funds sector in Europe and AIMA will continue to safeguard our members' interests through the legislative process.

The reforms being introduced to the European Long-Term Investment Fund (ELTIF) have not garnered the same level of attention as the AIFMD but have the potential to be as influential on the development of the European market as AIFMD was many years ago. The proposed reforms expand the assets in which ELTIFs can invest, provide ELTIF managers with more investment flexibility and streamline retail distribution. Taken together, this package of reforms turbocharges the ELTIF as an investment vehicle and put it on the path of becoming an EU version of the $223 billion[4] US Business Development Company market. AIMA has been advocating these reforms to the ELTIF for several years, and welcomes seeing our proposals translated into legislation.

Readers are encouraged to visit *www.AIMA.org* for a more detailed breakdown of the implications of the proposals and more details regarding what AIMA is doing on behalf of its global members.

APAC

For APAC, the COVID factor is still dictating market trends to a greater extent than in other regions. Asian financial hubs, most notably Hong Kong, have been much slower to re-open to the world, and this cautious approach may lead to long-term consequences regarding the flow of industry talent across the region. In Hong Kong, a steady stream of financial market participants including hedge fund firms appear to be reconsidering whether they are currently located in the best place for managing their business, or if other centres in APAC or even the Middle East might be more accommodating to their businesses. For hedge funds specifically, there has been a dearth of new fund launches in Hong Kong, while losses to the talent pool are driving up salaries and competition.

There are green shoots across the region, however. AIMA's Q2 HFCI marked the first up-tick in the confidence of APAC-based fund managers after three quarters of consecutive declines.

In Singapore, the Variable Capital Company (VCC) investment fund structure was launched in January 2020 and has been widely hailed as a success in making Singapore more competitive as a fund domicile. There is an opportunity for Singapore to capture a strong flow of capital and the VCC structure aims to make sure it stays there, as opposed to the Cayman Islands or Hong Kong. AIMA, and its members, worked closely with the Monetary Authority of Singapore in the development of the VCC structure and continues to coordinate with regulators on the enhancement of the VCC framework, dubbed VCC 2.0, to consider regulatory safeguards to allow non-regulated entities such as single-family offices to use VCC and to provide feedback on the usage of a price other than NAV in certain circumstances to facilitate operations of illiquid assets.

Elsewhere, a series of billion-dollar plus fund launches in 2022 highlighted the growth potential of the private credit market in APAC. The gap between businesses' capital needs and local banks' ability to provide finance is much starker in APAC than in other regions. With private equity firms also growing their footprint in the region, private credit is likely to play a key role in financing growth in local economies across the region.

ESG

Europe remains at the forefront of ESG and responsible investing, particularly when it comes to regulation. The EU SFDR seeks to establish a harmonised approach in respect of sustainability-related disclosures to investors within the EU's financial services sector based on the type of financial products that are being marketed. The level 2 regulatory technical standards for SFDR and the Taxonomy Regulation are due to come into force on 1 January 2023. AIMA and Maples Group have published a guide to the new SFDR requirements.[5]

In June AIMA and the ACC responded to the call for evidence on the UK's Green Finance Strategy. In our response, we encourage the government to continue to develop the strategy in a way that supports the ability of the investment management sector to drive change in the area of green finance and meet the evolving needs of investors. In the private credit space, ESG and responsible investing are important areas of focus for our members. Research from the ACC's 'Financing the Economy 2021'[6] report shows that ESG integration is an integral part of most private credit managers' lending strategies, with 74% noting that ESG is considered for all investments.

Across the pond, the SEC turned its attention once again to ESG, proposing two new rules in May. The first would require advisers, registered investment companies and BDCs to provide additional disclosure requirements regarding ESG strategies in fund documents. The second would amend the 'Names Rule' and expand the current requirement for certain funds to adopt a policy to invest at least 80% of their assets in accordance with the investment focus the fund's name suggests.

Private Credit

The investment case for private credit continues to evolve with investors weighing the respective value of long-term structural drivers supporting the asset class's growth against current and upcoming macroeconomic challenges. Significant inflows of institutional capital into direct lending strategies during recent years has seen yield compression in some markets and led to allocators paying more attention to a smaller premium for taking on illiquidity risk. This has seen some investors and managers seek more exposure to either niche forms of direct lending or other more specialised private credit strategies. At the same time private credit continues to be attractive on a relative basis amid the bear market conditions in equities and higher inflation affecting the value of some fixed income assets.

Interest in private credit from retail and semi-professional investors continues to grow. While many in the industry welcome this development, access to deep liquidity pools of retail capital also poses challenges. Adapting tailored, illiquid private credit products towards retail-friendly products poses important operational and regulatory challenges, particularly the ability to deploy capital in sufficient volumes to satisfy the liquidity needs of this investor base. The work of AIMA's private credit affiliate, the Alternative Credit Council, on the UK Long Term Asset Fund and European Long Term Investment Fund means that alternative asset managers have more options when it comes to funds that can address the needs of retail and semi-professional investors.

Endnotes

1. https://www.aima.org/educate/aima-research/us-investor-intentions-h1-2022.html.
2. *Id.*
3. https://www.aima.org/resource/guide-to-the-eu-sustainable-finance-disclosure-regulation-regulatory-technical-standards.html.
4. As of 31 March 2022 https://cliffwater.com/files/cdli/docs/CDLI%20Fact%20Page_%20Q1'22_%20Final.pdf.
5. https://www.aima.org/resource/guide-to-the-eu-sustainable-finance-disclosure-regulation-regulatory-technical-standards.html.
6. https://acc.aima.org/research/financing-the-economy-2021.html.

Jack Inglis, chief executive officer of AIMA, has been in the financial services industry and closely involved with hedge funds for over 30 years. He has held senior management positions at both Morgan Stanley, where he served for 16 years, and Barclays, where he was prior to joining AIMA. From 2007 to 2010 he was CEO of London-based hedge fund manager Ferox Capital Management. He served as a non-executive director of London Capital Group plc from 2007 to 2010 and currently sits on the board of the Chartered Alternative Investment Analyst Association (CAIA). He began his career in 1983 at UK stockbrokers James Capel (which was subsequently acquired by HSBC) and has extensive experience in origination, distribution, financing and trading across the fixed income and equity capital markets. He holds a Master of Arts in Economics from Cambridge University.

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The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with around 2,100 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than $2.5 trillion in hedge fund and private credit assets.

AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry.

AIMA set up the Alternative Credit Council (ACC) to help firms focused on the private credit and direct lending space. The ACC currently represents over 250 members that manage $600 billion of private credit assets globally.

AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors).

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