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Alternative Mutual Funds

Dechert Partners Aisha Hunt and Richard Horowitz Discuss Strategies and Challenges for Hedge Fund Managers Wishing to Enter the Alternative Mutual Fund Space

By Jennifer Banzaca

For hedge fund managers, entering the alternative mutual fund space can be attractive for various reasons, including expanded distribution, diversification of product lines, permanent or at least more resilient capital and economies of scale in investment analysis (i.e., getting more mileage out of similar investment ideas). However, hedge fund managers entering the alternative mutual fund space must confront challenges with which they often have little or no experience – challenges relating to regulation, operations, distribution, marketing, fees, personnel, industry structure and related topics. We recently explored the opportunities and challenges of the alternative mutual fund space in a two-part series. See "How Can Hedge Fund Managers Organize and Operate Alternative Mutual Funds to Access Retail Capital? (Part One of Two)," The Hedge Fund Law Report, Vol. 6, No. 5 (Feb. 1, 2013); and Part Two of Two, The Hedge Fund Law Report, Vol. 6, No. 6 (Feb. 7, 2013). Fortunately for hedge fund managers wishing to access the alternative mutual fund opportunity, there are a number of ports of entry into the space – different structuring tactics, different strategies and different levels of required resource commitment. To explore the range of the opportunity and the various ways of accessing it, The Hedge Fund Law Report recently spoke with Aisha Hunt and Richard Horowitz, both partners at Dechert LLP focusing on structuring and advising alternative mutual funds. Among other things, our interview with Hunt and Horowitz covered: the benefits and costs of offering advisory services through a series trust versus a stand-alone alternative mutual fund; the time and resources necessary to launch alternative mutual funds; open-end versus closed-end funds; trends in the use of fulcrum fees; offering commodity strategies through alternative mutual funds; cannibalization considerations; and the role to be played by 401(k) plans in the future of alternative mutual funds.

HFLR: Can you describe the series trust model through which hedge fund managers can offer their alternative investment strategies to retail investors without going through the process and incurring the expense of organizing their own alternative mutual funds?

Hunt: I know most managers who have really done their due diligence are aware of the series trust option, and I think that may be a fit for some managers. Series trusts are sponsored by administrators and by some advisers. They offer what they are framing as a one-stop shop for launching a fund so that a manager does not have to go out and negotiate various agreements and does not have to identify appropriate board members.

HFLR: What is the division of responsibilities among a hedge fund manager and the various service providers when the hedge fund manager offers its strategies through a stand-alone vehicle it organizes versus an existing series trust?

Hunt: Ultimately, a mutual fund does not have any employees. If each service provider is responsible for providing certain services, the sponsoring hedge fund manager will obviously have a heavier project management

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role, but the administrator will ultimately be managing the project. The trust is only looking to the adviser to provide advisory services and the requisite oversight of any subadvisers. I do not think the marginal additional burden on a manager after a fund is launched through a series trust is that much different than the same responsibility the manager has in a standalone context.

Horowitz: For some of the larger managers, if they decide they want to be in the mutual fund business, it has to make sense for them, and they have to raise a lot of money. Then the question is: what is their strategy for raising a lot of money for their mutual fund? Presumably they are going to hire their own internal distribution people to help, whether it's wholesalers or people from mutual fund groups that they have taken into their own organization who have experience dealing with the Charles Schwabs of the world. So, there is certainly a cost of bringing these people on and building up your distribution team to give you access to different platforms. If you are a small hedge fund manager and you have an interesting strategy that does fit within a mutual fund, you are going to have one series in the series trust.

HFLR: What are some of the considerations a hedge fund manager should evaluate in determining whether to offer its advisory services through an existing series trust or whether to organize its own stand-alone alternative mutual fund? How do the costs and time to market compare?

Hunt: With respect to the series trust, I think the biggest potential cost is the long term effect of a series trust not fitting, meaning you are stuck in a long-term relationship with an administrator you are not satisfied with or you are not satisfied with the package that has been put together or you do not feel like the board composition is such that it has the requisite collective expertise to really understand alternative strategies. If you are just given a suite of service providers and it really does not work that well or is not a fit for your product, once you launch, you are looking at potentially doing a reorganization of that series trust that can be extremely costly – far more costly than the actual fund launch.

Horowitz: It really depends on the amount of control the adviser wants to have as the product and strategy proceed. If you are really going to have one or two series in a series trust, you may have one or two service providers do the heavy lifting for your two funds. If you want to control setting up the fund complex and the board members, and if you want this branded as your fund, this could be the way to go.

HFLR: Can you comment on the amount of time and expenses that a hedge fund manager must allocate to organize and bring an alternative mutual fund to market?

Hunt: As service providers are becoming more aggressive in positioning themselves to support an inflow of alternative mutual funds in the market, we are seeing opportunities for managers who are in a rush to get a product to market. We are seeing an appetite among service providers to allow new and emerging mutual fund managers to bring a product to market cost-effectively. The cost can be comparable to a series trust if the manager is willing to solicit bids from service providers. It's really just project management. If you allocate four to six months to get to market and you are willing to allocate project management resources to soliciting bids from service providers, you might be able to negotiate a pretty great deal on your own with service providers that you feel are a great fit for bringing your product to market. I think the standalone barriers to entry are definitely much lower because service providers are becoming much more competitive as the liquid alternatives space has heated up. [See also "SEI Report Describes the Growth Opportunity for Hedge Fund

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Managers in Regulated Alternative Funds," The Hedge Fund Law Report, Vol. 4, No. 44 (Dec. 8, 2012).]

HFLR: What alternative investment strategies are best suited to be offered through open-end mutual funds versus closed-end funds?

Horowitz: First, you have to clarify what you mean when you say "alternatives strategies." Some of the strategies are certainly more liquid strategies that fit within the context and requirements of a mutual fund. Some are more complex. So, we first need to discuss what strategies fit into a mutual fund and what it means to be an adviser to a mutual fund versus being an adviser to a closed-end fund if your strategy is more illiquid. I think a lot of people are focusing on closed-end funds as well, whether it's an exchange-traded closed-end fund that is traded on the New York Stock Exchange or an unlisted, continuously offered closed-end fund. Some managers' strategies really do not work well in a mutual fund, and they have to compromise certain key parts of their strategies if they want to manage a mutual fund. So, you have to consider whether the manager is launching a fund that is really in the best interest of shareholders and if they are giving shareholders the best parts of their investment strategy. So, maybe a closed-end fund makes more sense.

HFLR: Can you identify the types of strategies that hedge fund managers have offered through closed-end funds?

Horowitz: Certainly funds of hedge funds, funds of private equity funds and manager-focused closed-end funds. I think that is an interesting idea. Then you tend to see more liquid fixed income strategies and credit opportunity-type strategies.

Hunt: Specialized real estate funds.

HFLR: What are some considerations that hedge fund managers should evaluate in determining whether to organize open-end mutual funds versus closed-end funds?

Hunt: The threshold question is: How liquid is the strategy? To the extent your strategy entails in investing more than 15 percent of the portfolio in illiquid securities, then your strategy is not a candidate for a mutual fund structure. We are talking to clients about the appropriate legal structure, focusing on core strategies and thinking about the best way to optimize distribution of those strategies. Legal structures are tantamount to distribution channels, and the goal is to try to get managers to understand all their options.

The next thing to look at is how much liquidity a manager wants to provide to investors. How frequently are you going to allow your investors to redeem? In the traditional closed-end fund, I think people who really understand them often mention "permanent capital."

Horowitz: A lot of our larger clients certainly have some concerns about managing a daily net asset value (NAV) mutual fund product. You have to calculate NAV every day and you have to be confident you will not have any valuation issues. People will say they would love to be able to offer their mutual fund on various platforms and open it up to a true retail offering, and that could be an advantage. When it comes to a closed-end fund and an exchanged-traded closed-end fund, you have to have an underwriting syndicate that is confident in your abilities and your brand in order to raise enough money. So, you have to question whether you will be able to pull off a successful underwriting. We have spoken to managers who have that kind of brand power and can do an exchange-listed closed-end fund.

There are other managers who want to think more about the unlisted, continuously offered closed-end fund where it looks, in some ways, like a mutual fund in that you have a continuous offering. The fund calculates its NAV on a monthly basis and you provide some liquidity to investors on a quarterly basis. So, that is another distribution strategy.

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There are also closed-end funds of hedge funds. Those are unlisted, continuously offered closed-end funds and they are distributed by the Morgan Stanleys and Smith Barneys of the world, as well as the Charles Schwab platforms of the world. It's a product that is offered to accredited investors. So, it's not a true retail fund. But it is still an interesting diversification strategy where you can get your name out there and build your distribution momentum over time. It's not daily liquidity but quarterly liquidity. That said, you are able to offer more illiquid strategies to people and you are charging a higher management fee than a mutual fund would charge.

HFLR: How does distribution differ in closed-end fund versus open-end funds?

Hunt: Traditional mutual funds are typically distributed through registered investment advisers and wirehouses. You really do need a distribution plan, whether you are partnering with an adviser that has a large wholesaling team that you can leverage, or whether you will hire internal or external wholesalers.

In the same way hedge fund managers have to hire a CCO, if they are moving into the Investment Company Act space, unless they are partnering with someone who has distribution, they really need to think about the entirety of the distribution plan and potentially the head count of the wholesaling team dedicated to that.

In continuously offered funds, those funds are primarily distributed through large financial institutions that have significant wealth management groups.

Horowitz: There are some managers that we have spoken with who really are not yet comfortable being in the mutual fund business. It's a big undertaking to develop a distribution network and you have to be out there constantly promoting your funds and making sure you are on the platforms. If you can do an exchange-listed closed-end fund and line up the likes of Credit Suisse, Morgan Stanley and Goldman Sachs to distribute your closed-end funds to their clients, you should do that. That is a simple strategy if you can pull it off. The larger managers we represent would love to have permanent capital and the fund is closed. You do not have to worry about redemptions and you go about your business.

If you do not think you can pull that off, the other option is the unlisted closed-end fund. You still have the ongoing distribution responsibility, but your marketing position is that the strategies are more illiquid and are not subject to the 85 percent liquidity requirement of a mutual fund, so the manager is arguably giving investors the best he has to offer.

Hunt: It's really about product diversification and asking what products are a good fit for your core strategies. I think the biggest opportunity is really in the mutual fund space, but it's a harder road. Once you get over the hump of a certain asset level for certain strategies, it's usually not a problem to continue to raise assets if that fund continues to perform.

What I think is interesting about the open-end opportunities is that, and this is only for managers with liquid strategies, you can launch a similar strategy through a variable trust fund and access insurance companies. There really is a strong demand among insurance companies for managers with good track records. If you are launching a mutual fund and you can launch a strategy that is similar through a variable trust to get access to those variable insurance investors, that is a huge opportunity where you only need one insurance company interested to access a significant distribution channel. [Cf. "Investments by Family Offices in Hedge Funds through Variable Insurance Policies: Tax-Advantaged Structures,

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Diversification and Investor Control Rules and Restructuring Strategies (Part Two of Two)," The Hedge Fund Law Report, Vol. 4, No. 12 (Apr. 11, 2011).]

In a perfect world, you would have your mutual fund, a traditional or continuously offered closed-end fund, a variable trust fund and a UCITS, and you'd be distributing your core strategies globally to various investor demographics. That is the way to maximize distribution.

HFLR: Can you describe any trends you are seeing in the use of fulcrum fees by hedge fund managers offering their strategies through registered products?

Hunt: The fulcrum fee is actually being revisited by hedge fund managers. The fulcrum fee has been generally out of favor for a number of years and as hedge fund managers are rediscovering how the Investment Company Act works, they are approaching fulcrum fees with creativity. It's a little more within their comfort zone, but it does create some significant impediments to distribution with RIAs and wirehouses understanding how those fees would work. You still have managers who have launched or are in the process of launching with fulcrum fees. As part of the overall educational effort to teach registered investment advisers and wirehouses about alternatives strategies, there are going to be some big managers that start to make headway on educating that same audience on fulcrum fees.

Horowitz: Certainly business development companies can charge a full-blown performance fee. They have basically charged a performance fee on income and on capital gains. Recently we filed a registration statement for a client that wants to set up a closed-end fund that will charge a performance fee based on income, which you are allowed to do. The prohibition is on charging a performance fee based on capital gains. That is an interesting concept, to have a management fee and a performance fee based on income with a hurdle.

Hunt: People do not understand and appreciate the performance fee prohibition. For those fund managers that are running managed futures strategies with a very similar risk/return and income profile of a bond fund, it would be a very attractive option to be able to charge the performance-based fee on income.

HFLR: Can you describe the challenges of offering commodities strategies through alternative mutual funds and how hedge fund managers can offer such strategies through registered funds?

Hunt: There are a number of commodity pool operators and commodity trading advisors (CTAs) that are interested in offering managed futures strategies to the retail public. What's interesting is the legal structure of the managed futures funds because mutual funds cannot have investments that generate more than 90 percent in bad income and commodities, and managed futures generate bad income. Basically, managed futures funds are structured to have a controlled foreign corporation (CFC) subsidiary that will hold that bad income and convert it to good income, and allow the managed futures fund to receive pass through tax treatment. The IRS has issued over 70 private letter rulings blessing this structure but there has been a moratorium placed on those private letter rulings. Now managers are obtaining legal opinions or otherwise getting comfortable with the advice of legal counsel to structure these funds.

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Some managed futures funds are single strategy funds that have one manager that manages the fund and the portfolio. Some have multi-strategy managed futures funds with multiple CTAs that provide subadvisory services.
There are a lot of different interpretations among people in the industry about how to utilize CTAs, how the funds use derivatives to get exposure to CTAs and whether to allow CTAs to charge performance-based fees that normally could not be charged directly to the fund.

The use of derivatives is designed primarily to not have CTAs directly managing the assets in the CFC. What managers are doing is setting up a reference portfolio with a financial institution that allows them to have CTAs manage that reference portfolio. That reference portfolio is then utilized in a total return swap, so the regulatory landscape is uncertain. The SEC has not taken a formal position on this structure.

HFLR: What are some of the key issues that you believe hedge fund managers must understand before entering the registered fund space?

Horowitz: There has been a lot of discussion about cannibalization and whether a manager is shooting himself in the foot by offering a similar fund with lower fees. It needs to be discussed.

Compliance is another issue. The SEC has said its exam priorities for 2013 include alternative investment companies. There will be more inspections of these vehicles and SEC focus on valuation procedures and related issues. [See "SEC's National Examination Program Publishes Official List of Priorities for 2013 Examinations of Hedge Fund Managers and Other Regulated Entities," The Hedge Fund Law Report, Vol. 6, No. 9 (Feb. 28, 2013).]

Managers also need to consider the education challenges. Investors need to understand what these funds are supposed to do in the portfolio and what they are not supposed to do. They need to understand the performance characteristics and what the purpose of investing in these funds is. It's certainly increasing their diversification, serving a risk reduction strategy for their portfolio and I think most people know there will be bumps in the road. These funds have a really important role to play, but investors need to understand that these are long-term portfolio diversification strategies. So, there's some educating that needs to occur. If you expect these funds to outperform the long-only strategy when the S&P is up 12 percent in a year, you are going to be underwhelmed. When the S&P is down 15 percent in a year, chances are these funds will prove their worth.

HFLR: What trends do you anticipate seeing in the future with respect to the offering of alternative mutual funds by hedge fund managers?

Hunt: One of the predictions I have is that over the next 10 years you are going to start to see some of these products as 401(k) plan options. When some of these larger, well-known alternative mutual fund families are able to get access to 401(k) funds, that is definitely going to change the incentive for managers to move into this space. [See "401(k) Plans Offer a Powerful Distribution Channel for Hedge Fund Managers Willing to Tackle ERISA, Liquidity and Non-Discrimination Concerns," The Hedge Fund Law Report, Vol. 2, No. 19 (May 13, 2009).]