NORTHERN TRUST

THE PATH TO TRANSPARENCY IN ALTERNATIVES INVESTING

Around the world, many investors are turning to alternative assets to increase yield in the current low — or even negative — interest-rate environment. The Economist Intelligence Unit (EIU), sponsored by Northern Trust, sought to ascertain the importance of various factors to investors' and investment managers' alternative investment decision making. In February 2017, the EIU surveyed 200 senior asset management and institutional investor executives. These executives represented several different types of organizations, ranging from private equity firms and hedge funds to corporations, nonprofits and insurance companies.

The survey explored views on the importance of considerations such as regulations and transparency related to traditional and alternative investments; how these considerations are managed; and the role of data in the management process. Respondents also were asked how investment decision making has changed since the 2008 financial crisis.

Developed by

The Economist Intelligence Unit

ABOUT THE RESEARCH

The 200 executive respondents are engaged in a variety of functional roles. They are dispersed globally, with 60 respondents each from North America, Asia-Pacific and Europe, and the remainder from the Middle East. Half the sample is composed of respondents from organizations with more than $5 billion in global assets under management.

For the purposes of this survey, we defined alternative investments as investment products built on any of the following: debt; hedge funds; infrastructure; natural resources such as land, water or forests; private equity; real estate; or funds of funds of any of the above.

A MATURING ALTERNATIVES ENVIRONMENT

The field of alternative investing has been steadily maturing over the past three decades. If fund managers once perceived alternatives such as private equity and hedge funds as too volatile or risky, that fear has demonstrably dissipated. Today, capital markets, companies and individuals throughout the world embrace these products. One estimate, by the analytics company Preqin, indicates that, globally, the private capital assets under management alone were worth more than $4 trillion in 2015.[1]

The mainstreaming of alternatives has brought to light the differences between them and more traditional asset classes. The EIU survey finds that investment managers and institutional investors apply different considerations when investing in alternative assets than they do for traditional investments. Moreover, investors weigh these considerations differently pre- and post-investment. These considerations and their relative priority have shifted since the 2008 financial crisis. Additionally, the survey finds that most fund managers keep the bulk of their data management related to making investment decisions in-house and that resource-intensive duties like ensuring transparency and complying with regulations tend, they think, to have a net positive impact on performance. For this report, we have defined a successful performance model as one that focuses on sustainable, long-term returns and consistently attracts new investors.

REINFORCED BY THE CRISIS

While the 2008 crisis did represent a setback for the alternatives industry, investing in this asset class not only survived the financial crisis, it "emerged stronger and more important to stakeholders than ever before," according to the World Economic Forum.[2] In fact, alternative assets under management grew at twice the rate of traditional assets between 2005 and 2013.[3] Assets such as hedge funds or private equity are now more accessible as a means of diversifying portfolio risk.

Since the crisis, new business models have surfaced to meet demand across the investing spectrum, including models that bolster alternatives. Publicly traded limited partnerships, for example, have given retail investors access to alternative assets formerly available only to institutional investors. Legislation such as the Dodd-Frank Wall Street Reform and Consumer Protection Act in the United States, and rulings such as the Alternative Investment Fund Managers Directive (AIFMD) in Europe have served to reassure investors about the regulation of alternatives.

Anton Pil, managing partner of JP Morgan Global Alternatives, argues that alternatives are a core part of investing 10 years after the crisis. Investors "see themselves reentering a normal valuation and inflation environment," he says.

To complement the survey, the EIU conducted a series of in-depth interviews with the following experts:

WILLIAM CHYZ
Director, Asset Management and Client Services, Westcourt Capital Corporation

SAMER OJJEH
Principal, EY Wealth & Asset Management

ANTON PIL
Managing Partner, JP Morgan Global Alternatives

"What they're really looking for today is relative value opportunities — things that will help complement traditional fixed income and equity allocations as the markets become re-normalized." Adds Samer Ojjeh, a principal at EY Wealth & Asset Management with deep alternatives expertise: "Many institutional investors are increasing allocation to alternative strategies such as hedge funds, real assets and private equity. Their investment teams are more focused on strengthening their risk management capabilities and introducing their broader portfolio to various strategies."

TRANSPARENCY ASCENDANT

With alternatives becoming more mainstream, transparency — that is, the availability of financial information about the investment vehicle, the underlying assets, co-investors and other stakeholders has become correspondingly more important to investors. In the post-2008 environment, fund managers and investors pay more attention, both before and after investing, to their ability to access financial information.

EY's Ojjeh says reforms were clearly needed within the investment community after the 2008 crisis. "When the crisis hit, institutional investors were caught unprepared," he says. "They couldn't assess, quantify and report on their exposure in a timely fashion. That was a big limitation: it hindered their ability to conduct an orderly exit or retention of alternative investment positions. Clearly, the investment boards for these organizations were not satisfied with such constraints."

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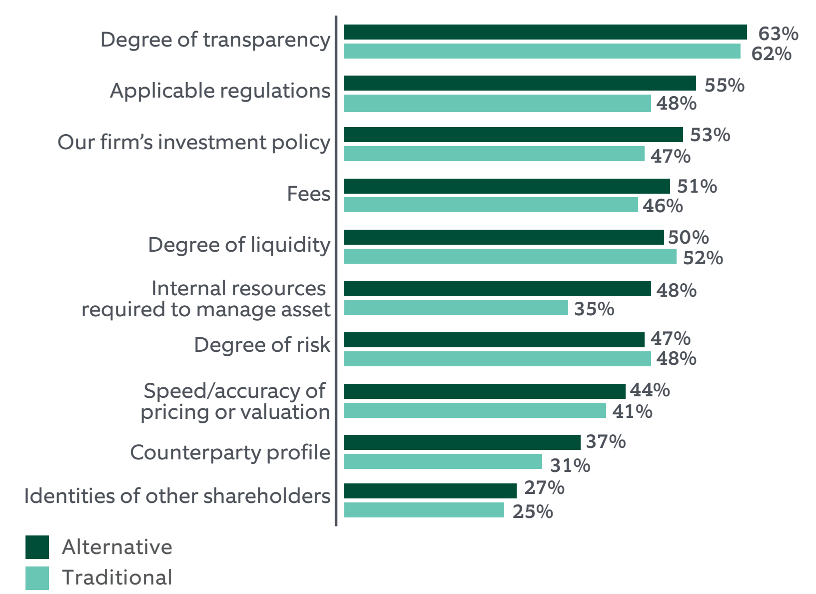
>
> **SAMER OJJEH**
> EY Wealth & Asset Management

EXHIBIT 1: TOP INVESTMENT CONSIDERATIONS
% of respondents selecting "very important"



Source: Northern Trust/EIU Transparency in Alternatives Investing Survey, 2017

Many investment considerations raised by the survey, such as a firm's investment policies, the impact of regulations and the degree of asset liquidity, increased in importance for both traditional and alternative investments post-2008. However, transparency took center stage for a reason, says William Chyz, director, asset management and client services with Westcourt Capital Corporation, an alternative investment advisory firm for high-net-worth investors. He suggests that the growing focus on these considerations is happening because they are all aspects of transparency. "Transparency consists of a number of factors, and, since the crisis, all of them have come into play more than ever," he adds.

Risk management is one of transparency's many components, he says. Also on his list: making evident the degree of liquidity of a product; having sufficient internal resources for managing assets; delivering prompt valuation and pricing on assets; and providing cogent data analysis to investors.

"There's a structural and legal standpoint to transparency, as well," says Chyz. "Of course, people need to understand if the asset is a trust, a limited partnership, who the shareholders are and so on. All those questions, from a due diligence perspective, obviously should be front and center. But it's just as important to have a clear picture of a fund manager's investment strategy. What kind of returns can an investor expect? Are third parties verifying what's going on?"

Transparency calls for a detailed accounting of assets, which may explain why, at the pre-investment stage, it is a principal consideration for both alternative and traditional products. Correspondingly, post-investment, transparency appears almost equally important to investors in both traditional (21% post-investment vs. 11% pre-investment) and alternative (17% vs. 11%) assets.

The survey suggests that an increased emphasis on rigorous risk management has been instrumental in transparency's rise: when asked why transparency had become more significant for either traditional or alternative investments, nearly three-quarters of respondents (73%) cited portfolio risk management as the most important element. That was followed by regulatory requirements (53%) and competitive considerations (43%).

For respondents in Europe, in fact, portfolio risk management is the single biggest factor influencing their view of transparency (83%), followed by regulatory requirements (67%). The latter is particularly notable since only 28% of North American respondents agree that regulatory requirements are a major consideration, pointing instead to fee calculations (53%) and competitive considerations (52%). Europe's stringent and complex new rules regarding alternatives may account for this disparity.

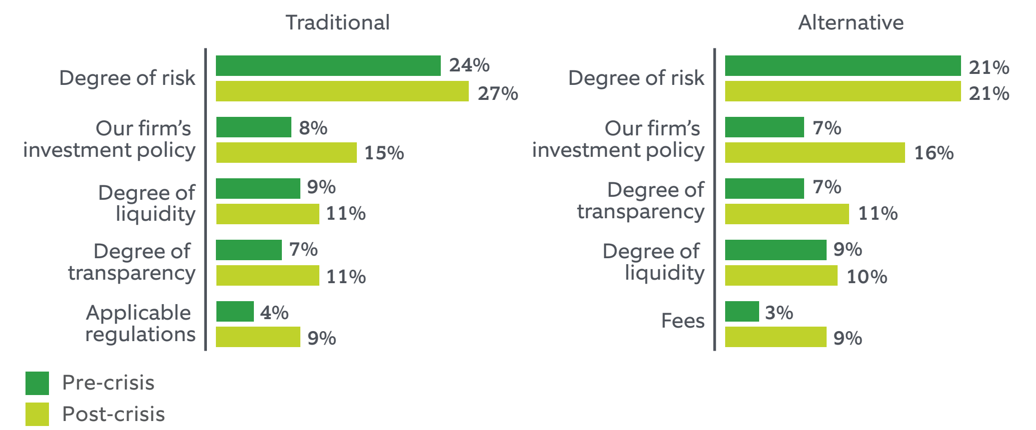
21%

RATE TRANSPARENCY MOST IMPORTANT CONSIDERATION AFTER INVESTING FOR TRADITIONAL ASSETS, UP FROM 9%

17%

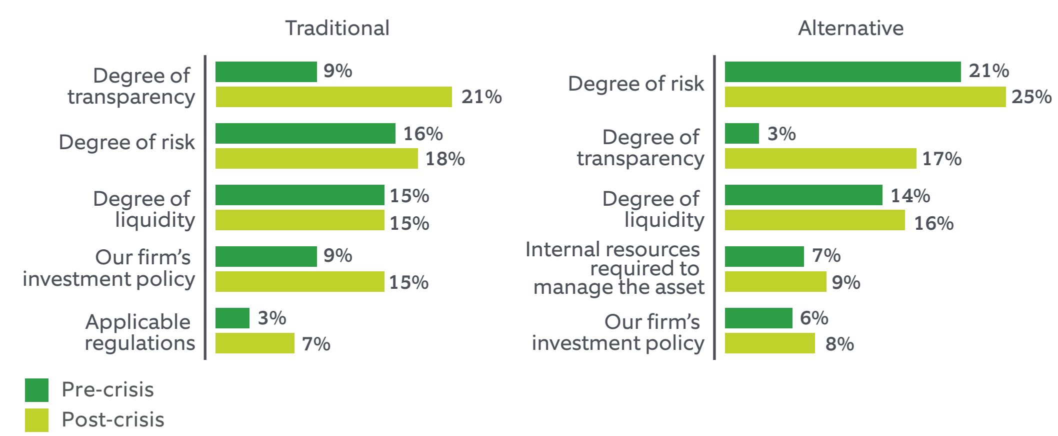
RATE TRANSPARENCY MOST IMPORTANT FACTOR AFTER INVESTING FOR ALTERNATIVE ASSETS, UP FROM 3%

EXHIBIT 2: MOST IMPORTANT PRE-INVESTMENT CONSIDERATIONS



Source: Northern Trust/EIU Transparency in Alternatives Investing Survey, 2017

EXHIBIT 3: MOST IMPORTANT POST-INVESTMENT CONSIDERATIONS



Source: Northern Trust/EIU Transparency in Alternatives Investing Survey, 2017

THE AVAILABILITY OF DATA

The survey reveals no large differences in the information sources that firms routinely use to gather intelligence about traditional and alternative investments. Most rely heavily on specialist databases, market data feeds and reports from analysts and the media, as well as on administrator or custodial data. The biggest difference between asset types is that specialist databases are used somewhat less frequently in seeking information about alternative investments (50% vs. 57%).

The possible reasons: a lack of available databases at a reasonable cost and a shortage of talent to mine them.

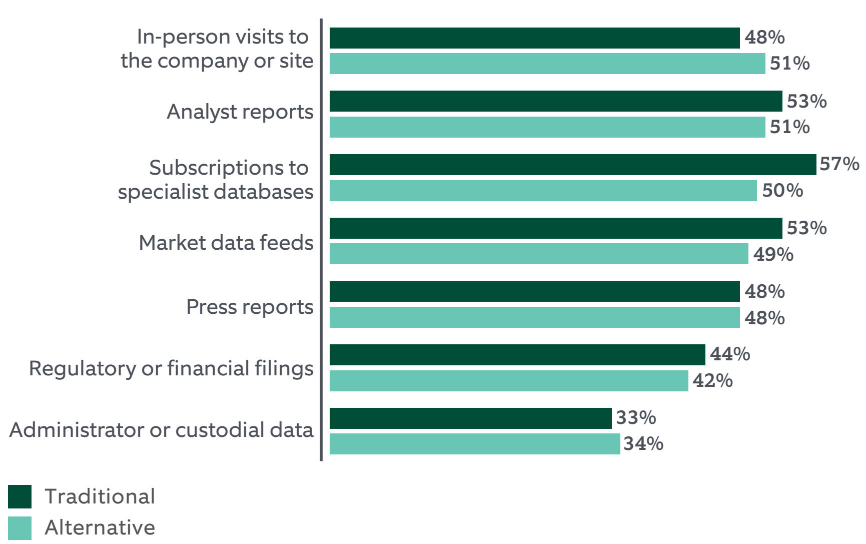
"Alternatives asset managers produce a large volume of information," says EY's Ojjeh. "Having transparency and responding to regulatory demand is amplifying the need for specialized resources, such as talent and infrastructure. The different strategy and data models that managers are dealing with prove to be very challenging for institutional investors to analyze when it comes to making investment decisions."

In addition, there are some notable regional differences in the most frequently used sources. While the three major regions employ in-person visits and administrator/custodial data to roughly the same degree, firms based in Asia-Pacific refer to press and analyst reports, market data feeds and regulatory or financial filings far more often.

> Firms use specialist databases less often to get information about alternative assets, perhaps because of a lack of available databases at a reasonable cost and a shortage of talent to mine them.

EXHIBIT 4: WHAT INFORMATION SOURCES DOES YOUR FIRM USE ROUTINELY?

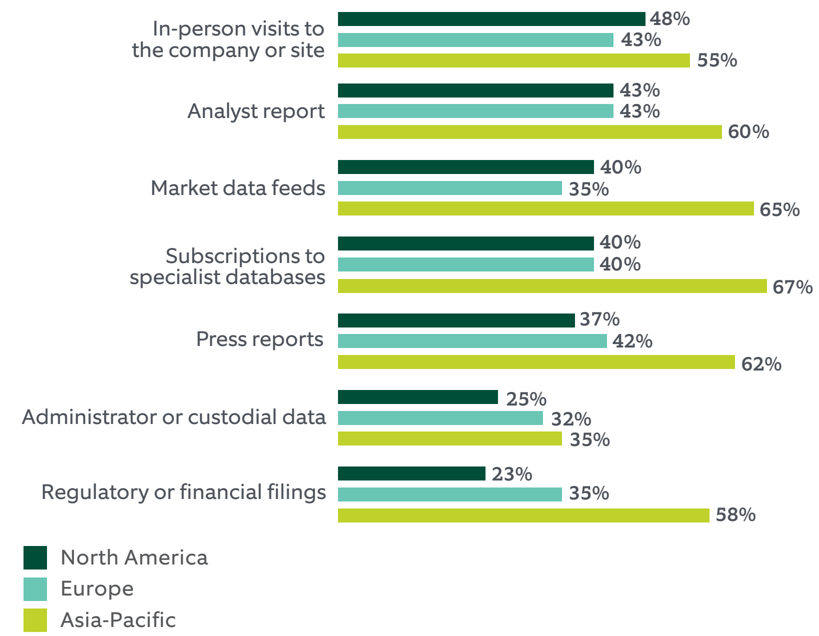
% of respondents



Source: Northern Trust/EIU Transparency in Alternatives Investing Survey, 2017

EXHIBIT 5: SOURCES USED TO ACQUIRE INFORMATION ABOUT ALTERNATIVE INVESTMENTS

% of respondents by region



Source: Northern Trust/EIU Transparency in Alternatives Investing Survey, 2017

Ojjeh surmises that, despite the importance that firms place on transparency post-investment, their measures may fail because of the opacity of the data alternative investments generate compared with traditional investments — and because firms may fear exposure if they fail to act on the data, however complex it may be.

"Having the data sets the bar higher for those institutional investors," Ojjeh says. "Making the data available also creates the expectation that institutional investors will be analyzing the data and using it to manage exposure. So institutional investors run the risk of having data that signals a clear exit action but that also shows they did not identify the signal or act on it."

THE CHALLENGES FACING SMALLER FIRMS

From an asset management standpoint, compared with large firms, smaller firms (those with less than $5 billion in global assets under management) more often base investment decisions on a greater number of factors. Such factors include the degrees of transparency, risk and liquidity presented by an asset as well as applicable regulations. These considerations shape smaller firms' investment decisions for both traditional and alternatives assets.

"In the last decade boutique firms have given way to larger, more established players who have [significant] resources," says Pil of JP Morgan. "Keeping up is getting harder and harder to do in a smaller setting. All these businesses are becoming more resource-intensive in today's environment."

Outsourcing is one solution that can keep smaller firms competitive, Pil suggests. Heightened transparency and improved reporting measures are putting pressure on these firms to find a means of delivering on promises as effectively as their larger counterparts. In addition, clients have become more sophisticated since 2008, and they now insist on receiving all relevant information relating to their assets in a timely manner. Many smaller firms simply do not have people on-site who can handle the demand. Partnering with service providers can be one answer to this dilemma.

THE ANALYTICS IMPERATIVE

Regardless of company size and despite using a variety of data sources and types, survey respondents who consider both types of investments are nearly unanimous about how they analyze the information they amass. Four in five rely "entirely" or "mostly" on internal data management and analytical capabilities to evaluate asset-related concerns. Only 6% outsource the function entirely.

Given the complexities of information management for alternative products, however, an increase in outsourcing in that realm may be inevitable, suggests Pil, with the understanding that many factors should come into play before firms decide whether that option can be a workable solution. With due diligence, they must, for example, question whether devoting on-site personnel to data management is the best use of their resources. They must do a cost analysis. And they need to assess the credibility and independence of prospective service providers, as well as their expertise in the field.

Given the complexities of information management for alternative products, however, an increase in outsourcing in that realm may be inevitable, suggests Anton Pil, Managing Partner, JP Morgan Global Alternatives.

WHO'S IN CHARGE?

The survey found that there is no industry-wide standard for transparency oversight. The day-to-day work of ensuring that existing and potential investments are adequately transparent generally falls to the investment management (52%) or risk and compliance (49%) functions. But when asked who gets the final say on how much transparency is needed before proceeding with an investment, one-third of respondents point to the investment committee collectively, while about half point to different members of the C-suite. No single individual or group emerges as the go-to authority.

This lack of overriding consensus cuts across every type of organization, though some notable differences are evident. For example, asset managers of alternatives (such as hedge funds or real estate) are twice as likely (61% vs. 31%) to task the investment management function with the day-to-day work of ensuring investment transparency as those at benefit funds (which include health, welfare or pension funds); in turn, benefit funds more often look to their risk or compliance staff (67% vs. 33%). But some types of managers, such as development agencies, wealth funds and insurance companies, express no clear preference for either function — they are about evenly split. No clear pattern emerges overall, indicating a lack of agreed-on best practices in the industry.

EY's Ojjeh says some companies are addressing this issue of transparency responsibility with fresh hires in the compliance department. "Many private equity firms have brought in permanent chief compliance officers to ensure their people and their investment activities adhere to firm policies and regulatory requirements," he says. "We've seen this trend in both the United States and Europe, where new regulations have underscored the need for professionals focusing on compliance issues."

No single individual or group emerges as the go-to authority on how much transparency is needed before proceeding with an investment.

EXHIBIT 6: WHO HAS THE FINAL SAY ABOUT TRANSPARENCY REQUIREMENTS?

% of respondents

Source: Northern Trust/EIU Transparency in Alternatives Investing Survey, 2017

IN A GLOBAL ENVIRONMENT, REGULATIONS CAN COMPLICATE TRANSPARENCY

Globalization is also affecting transparency to varying degrees. Four out of five European respondents say that the degree of transparency is "very important" to their decision-making. By contrast, fewer than three in five of North American respondents and less than half of respondents from Asia-Pacific agree. Ojjeh says that as firms expand around the world and face new regulatory issues, they often must work through a morass of nation-specific regulations. As a result, investors may feel hampered in their ability to understand how these firms conduct their business.

"Getting into new geographies is creating pressure because many of these organizations are not familiar with the new regulatory requirements of some of the geographies that they are expanding into," he says.

BECOMING MORE TRANSPARENT

Alternative investing has become a substantial and increasing part of portfolios across the globe. This new reality can be ascribed, to some degree, to new measures that firms have taken to ensure transparency regarding these assets, says Westcourt Capital's Chyz.

"Can there be more done on the transparency front? I believe it's always wise to make information more accessible," he says. "At the same time, alternatives investing will never be 100% transparent, just as it will never be for traditional investing. Ultimately you have to trust the person you're investing with. But the emphasis on transparency has certainly helped alternatives become more mainstream."

Other experts who were interviewed for the study concurred that, while transparency has a positive impact on performance, it may be hindered by such factors as opaque data, a scarcity of resources and talent, no stewardship of transparency, and complex new regulations that firms must deal with as they globalize.

While transparency has a positive impact on performance, it may be hindered by opaque data, a scarcity of resources and talent, no stewardship of transparency, and complex new regulations that firms must deal with as they globalize.

Firms can address these issues in a variety of ways:

- Develop transparency policies and formally assign ownership to support the data management necessary for transparent portfolio management. Risk and compliance officers are the most popular option among market leaders.
- If internal resources are limited, firms can outsource more aggressively to find service providers that can aggregate data from a variety of sources and provide expertise in analyzing, interpreting and presenting data.
- Support and adopt standards and conventions developed by industry bodies across various alternative asset classes. This will help to provide investors with consistent and comparable data.

Companies that respond with authority and vigor can take advantage of a field that is growing at an impressive rate.

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EXPLORE FURTHER THE PATH TO TRANSPARENCY

A Northern Trust Perspective

If you would like to explore further the role transparency is playing in alternatives investing, you can download our infographic at www.northerntrust.com/AltsGraphic.

END NOTES

1 "Alternatives Assets Industry Grows to Record $7.4tn in 2015: Private capital funds reach $4.2tn in combined AUM, while hedge fund industry grows to almost $3.2tn" (Preqin press release, January 26, 2016). Preqin includes in its definition of private capital: private equity, venture capital, private debt, real estate, infrastructure and natural resources.

2 Alternative Assets 2020: The future of Alternative Investments (*World Economic Forum 2016*)

3 Baghai, Pooneh, Onur Erzan and Ju-Hon Kwek, "The $64 trillion question: Convergence in asset management", McKinsey, 1 February 2015, http://www.mckinsey.com/insights/financial_services/the_64_trillion_question.

Unless otherwise stated, all data has been sourced from the Economist Intelligence Unit survey, February 2017.

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