Hybrid Funds: An Increasingly Attractive Opportunity for Credit Investors

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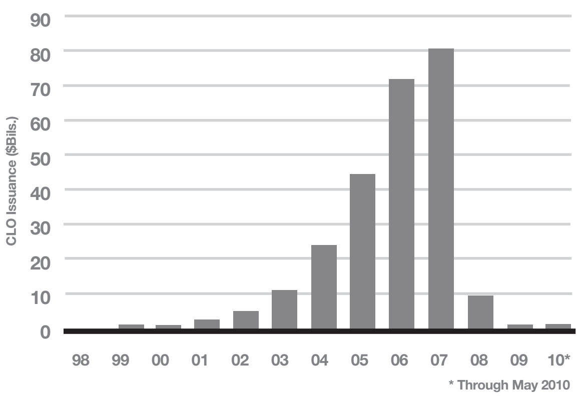
As the alternative investment industry continues to evolve in the wake of the global financial crisis, the use of closed-end fund structures to manage investor liquidity is increasingly prevalent in less liquid trading strategies. These investment vehicles – called hybrid funds – directly address the investor/investment liquidity mismatch by taking advantage of longer capital lock-ups and certain features from a typical private equity fund structure while retaining hedge fund-style trading strategies.

Hybrid funds are optimal to access a variety of illiquid asset types, from fixed income to real estate to private equity. To a great degree, hybrid funds have been concentrating in distressed and intrinsic value strategies where managers have recognized the opportunities to acquire investment assets at prices at attractive levels.

Transformed Landscape

The landscape for credit investors in the global markets has undergone massive change as a result of recent financial events. As evidence of this transformation, the collateralized loan obligation (CLO) market is only now beginning to see signs of life after issuance of CLOs in the U.S. collapsed from nearly $80 billion in 2007 and has remained under $10 billion for the last 2 years. (see accompanying chart). In addition, new legislation and regulation around the world will very likely move credit derivatives to exchanges and risk retention requirements will impact securitization going forward.

U.S. CLO Disclosure



In this altered economic environment, one of the emerging trends is a marked move in the alternative investment industry for credit investors away from traditional hedge funds to a more private-equity-like structure that combines the benefits – and the operational/administrative challenges – of the two structures into a unified entity.

Hybrid Funds: A Definition

Hybrid fund structures are becoming increasingly popular in alternative investment strategies. Because these funds each have specific, individual nuances, they are difficult to define as a group. However, the following is a summary of the three major hybrid classes we see credit managers using today. The partnership accounting complexities created by these structures, coupled with the investment accounting and pricing challenges that bank loans and distressed credit strategies present, have created a new set of operational issues for credit fund operators, administrators and auditors to handle. Hedge Fund managers have been moving into the illiquid distressed credit market by using side pockets. Because most funds limit the use of side pockets to between 10-30 percent of portfolio assets, managers have sought innovative solutions to take advantage of the price and demand displacement in the credit markets. For example, the drive for outsized returns and investment opportunities has led to structures in which lengthy rolling lock-ups of investor capital are employed. In some cases, managers have structured these funds to employ capital commitments in order to manage the inflow of capital for investment as well. At the other end of the spectrum is a more traditional closed-end private equity structure where the hedge fund manager will diversify into more illiquid strategies (for example, bank loans, distressed credit and real estate). In all cases, the manager's primary objective is to match investor liquidity with investment liquidity.

Side Pockets

Hedge fund managers use side pockets to hold illiquid investments because, in many respects, they have similar characteristics to private equity funds. The primary attributes are:

- Investor capital is locked in until a realization event occurs, eliminating the mismatch between investor and investment liquidity.
- The manager's incentive compensation is charged based on realization of investment, which may take several years to occur. Given the longer time horizons needed to deploy these strategies, this type of back-end fee structure aligns the manager's compensation with the strategy.

Capital Lock-Ups

The use of capital lock-ups was a natural progression for managers looking to take advantage of distressed credit prices created by the market events of 2008. Capital lock-ups prevent fund investors from being able to redeem capital for an extended period of time. Prior to 2008, it was common for managers to require an initial one-year lock. Today, the initial lock-up period required by many managers, especially those trading distressed credit strategies, has lengthened to two to three years and sometimes as long as five years. The concept of the rolling lock-up is also becoming more common as well. Here the investors can redeem on their designated redemption date but will remain locked up for an additional period of time should they decide to forfeit their right to redeem.

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The use of capital commitments has also been employed with this capital lock-up structure, giving the manager additional control over capital inflows, which better correlates capital inflows with the manager's ability to make investments. This fund structure looks more like a private equity fund than a traditional hedge fund that uses side pockets but still typically charges a traditional mark-to-market incentive fee.

Closed-End Structure

Closest to the private equity end of the spectrum is the closed-end structure. This type of fund set-up uses investor capital commitments and does not allow for redemption until the fund is wound down, usually after five to seven years. After a defined investment period, managers will typically make capital distributions usually consisting of current income generated and investment realization proceeds. The manager compensation model in a closed-end structure is realized on the back end when investments are realized and is typically subject to an 8 percent preferred return and claw back provisions.

This closed-end fund structure allows credit managers to focus on long-term strategies without having to manage investor liquidity.

Impact on Managers

The combination in a hybrid fund of two very different asset classes with two different economic streams requires a solid infrastructure of people, processes and policies. Managers considering developing a hybrid fund structure should be aware of the following considerations:

- The hybrid structure brings with it new partnership arrangements to manage, support and market.
- The time horizon needed for investing in bank loans and other distressed credit assets is much longer than normal hedge fund investing in equities, bonds and derivatives. The skills required to execute the investments are very different. While hedge funds attract professionals who thrive in a trading environment, private equity attracts people focused on research and analysis.
- The difference in time horizons and types of investments has a major impact on liquidity. Hedge funds are used to providing monthly or quarterly liquidity to their investors, based on a calculation of net asset values. Net asset values are easily determined when the underlying assets are publicly traded securities. However, bank loans and other distressed credit securities are hard-to-price, illiquid assets since there is often no market price for them.
- The two economic models inherent within a hybrid fund also give rise to different tax liabilities coming from the difference between capital gains and trading income, where investors are domiciled and whether investors are taxable or tax exempt. Hybrid credit funds also have to develop a legal structure that accommodates both types of investors and the tax liabilities arising from bank loans, loan origination and other credit assets including foreign investments. The complex structures will include the use of Luxembourg SARLs and Cayman Blocker entities for purchasing certain investments in a tax efficient manner.
- A hedge fund that has a large portion of its assets in credit and illiquid investments will encounter complexities in accounting for those investments and managing the fund's investor liquidity cycle. Accounting for two economic streams can be complex, especially when investments in illiquid and hard-to-price securities become a larger part of the manager's strategy. This trend is pushing managers more and more toward the longer capital lock-ups and closed-end structures.

Impact on Investors

Investors, too, should be cognizant of a new set of considerations when in investing in hybrid funds:

- These credit strategies more typically fall within the hedge fund world, but closed-end structures make hedge fund allocators question whether the product is a hedge fund or private equity fund.
- Investors need to take the time to understand the new hybrid fund structures, especially around manager compensation. It is important for investors to comprehend the manager's ability to side pocket investments, as it will impact their ability to manage their own investment liquidity. In a closed-end fund structure, the manager's compensation will differ from the hedge fund model in that a preferred return is typically used as a hurdle for charging fees, and the investor gets the benefit of a clawback provision should the final fund liquidation not result in a cumulative preferred return for the fund's life.
- Hybrid funds — with different credit investment strategies and complex accounting, legal and tax considerations — are, by definition, complicated. Yet because of investors' demands for increased transparency, they have a clear preference for new investment proposals structured on a simple and transparent basis with offering documents plainly disclosing all investment risks.
- The voluminous and highly complex documentation developed for rated securitization transactions is giving way to the hybrid fund that can be more easily set up and marketed. The slowdown in the securitized transaction market will likely lead to a new group of investors looking to access the alternative investment market. As a result, it is very important for fund managers with private structures to be very clear and transparent with their investors if they want to acquire those allocations from the securitized market.

Going Forward

In our view, hybrid funds, which have become more and more established as investment vehicles in illiquid trading strategies, will be increasingly utilized for the benefit of fund managers and their investors in the credit space. However, managers considering developing these vehicles should recognize the operational and administrative complexities inherent in these vehicles, and look to experienced service providers to deliver the knowledgeable support necessary for them to be successful.