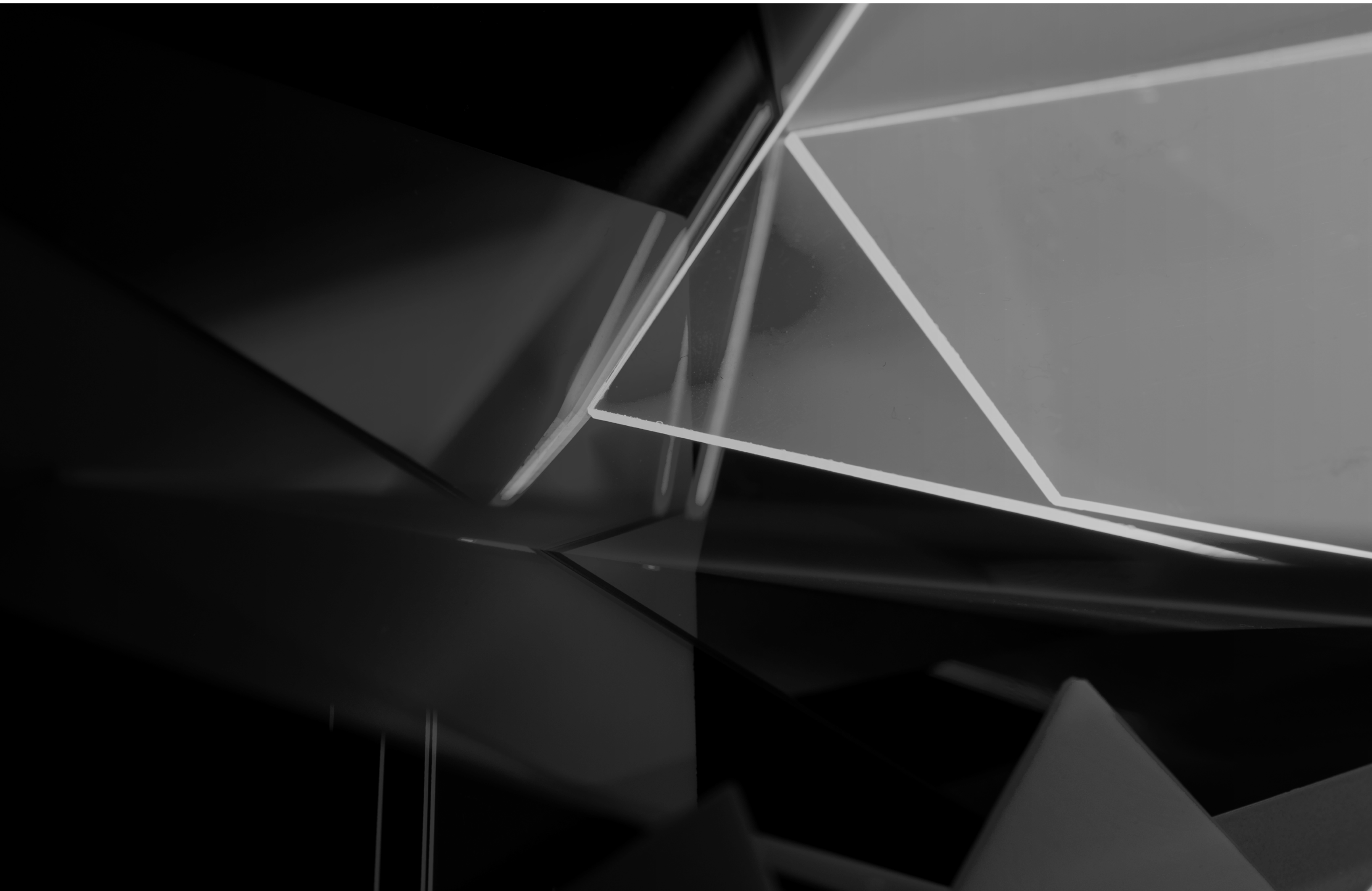
CAPCO

(RE)SET FOR TAKEOFF

ALTERNATIVE INVESTMENTS ARE RESUMING THEIR RISE. CAN BANKS AND SERVICE PROVIDERS KEEP UP?



Despite a somewhat tumultuous run over the last year plus alternative investments appear to have found their footing. But with renewed investor interest and a changing product landscape comes immense pressure on fund managers to deliver and service providers to support. How can each prepare themselves to capitalize? In the following pages, the Capco Alternatives team provides our perspective on the opportunities – and potential pitfalls – that lay ahead for the alternative investments ecosystem.

OVERVIEW

Following an extended run of year-over-year inflows into alternative investments, the uncertainty and near-shutdown of economic activity in 2020 due to the COVID-19 pandemic served as a brief pause in their upward trajectory. For the first time in 10 years, total assets under management (AUM) dropped from the prior year, from $10.8 trillion to $10.7 trillion.[1] Ultimately, the last five quarters have been a tale of three sentiments of alternative investment activity – continued volume growth in the first quarter, uncertainty and risk-aversion resulting in lower deal volume in the second quarter, and opportunistic activity entering 2021.

With both a shift in the broader economic outlook and a confluence of momentum across multiple fronts (below), we expect alternative investments AUM and activity to regain its footing in the near-term.

1. Asset Managers: A "catch-up" mentality and improved business environment should incentivize managers to put capital to work both de-risking (core real-assets, stable income that has held up through the pandemic; hedge-funds, uncorrelated returns from broader equity market volatility) and adding risk (opportunities to capture dislocations in private credit, private equity)

2. Businesses/Borrowers: Service-oriented industries, eager to put the shutdown behind them, will likely need capital to take advantage of pent-up demand

3. Investors: A broader population of investors gaining access to alternatives through product expansion and regulatory adjustments should swell the pool of capital needed for investment

The result will be greater alternative investment inflows – assets are projected to eclipse $17 trillion by 2025[2] – and deal volume, shining the spotlight back on asset managers, banks, and service providers to enable scale and efficiency in delivering products to end investors and ensuring their LP clients and GP partners operate efficiently.

Capco sees the coming months as a tremendous opportunity for banks, asset managers, and alternative investment service providers. But executing on this opportunity hinges on these firms' ability to support, from an operations, distribution, and technology perspective, what should be renewed highs in deal volume and reset client expectations. Can banks and service providers meet the demand? The answer comes down to three core themes.

1. GETTING MORE ALTERNATIVE

The Expanding Alternatives Landscape

The attractiveness of alternative investments is clear across investor segments – diversification, potential for increased alpha, and a de-correlation to traditional investment products. Broader availability and distribution continues, evidenced by the Department of Labor's June 2020 guidance on allowing private equity investments in defined-contribution plans/employer-sponsored retirement accounts[3], and the SEC's August 2020 amendment to expand the definition of accredited investors[4]. For more, please see the paper by our colleague Michael Daly.

But with technological, behavioral, and regulatory changes, even the more "traditional" alternative investments (hedge funds, private equity, real assets, private credit, liquid alternatives) may not be alternative enough for increased returns, reduced correlations, and alignment to individual principles. There is growing interest in what we refer to as non-traditional alternative investments for forward-thinking investors and managers looking to capitalize on it:

Cryptocurrencies:
There continues to be a surge in the ways retail investors can participate in crypto investments, whether through dedicated platforms, such as Coinbase, Binance and Kraken, or investment platforms, such as Robinhood and SoFi, now offering crypto investment capabilities.[5] Traditional investment managers are increasingly embracing the change, providing cryptocurrencies validation from established investment banks offering investment opportunities aimed at the high-net-worth (HNW) investor.

- Morgan Stanley[6]
    - Was the first to announce they will be offering a means to invest in Bitcoin through three funds: two of which are from Galaxy Digital and the third is a joint effort fund between FS investments and NYDIG.
    - Access to these funds will be granted to investors with a suitable risk tolerance and over $2 million invested at the bank
- Goldman Sachs[7]
    - Taking steps to offer the full spectrum of Bitcoin investment offerings "physical Bitcoin, derivatives or traditional investments"[8]
    - Investments in these offerings will be reserved for HNW individuals, with an account minimum of $5 million

Non-financial Assets:
Despite the inevitable eye-rolls or indifferent shrugs from the old guard, non-financial assets (which we define as assets whose value is prescribed not by contractual claims (stocks, bonds, fund commitments) but rather by physical (precious metals) or implied (art, digital assets) worth), will play an increasingly larger role as investors seek to further diversify and better align their holdings to their interests and passions, and asset managers look for new channels for sourcing capital and capturing return.

- Non-Fungible Tokens (NFT) Assets
    - Cryptographic assets with a unique identification code on blockchain to establish ownership and distinguish it from other similar items, NFTs offer the ability to buy, sell, and trade items online, such as artwork or digital real estate[9]
    - NFTs have become popularized lately though the introduction and adoption of NBA Top Shot, which allows customers to purchase moments in NBA history in the

    - form of highlight videos and digital artwork. As of late February, the platform had generated over $230 million in gross sales and a single Lebron James Highlight sold for slightly over $200,000[10]
    - NFTs have been adopted by the art world, with Christies Auction house's recent sale of *Everydays: The First 5000 days* created by Beeple for $69.3 million[11]
- Precious Metals
    - Often viewed as a safe-haven in volatile times, low-yield environments, or as a hedge against inflation (from stimulus packages), precious metals, such as gold, have provided strong returns over the course of the pandemic
    - Palladium – the material used frequently in catalytic converters throughout the automotive industry – saw an 18% rise in price throughout 2020, given the increase in demand and a decrease in supply from the pandemic[12]

From Open-Sourced to Closed-End?

Not all product innovation requires innovative tech savvy. While broader asset management trends indicate mutual funds giving way to ETFs and direct or custom indexing, traditional closed-end funds (CEFs) are being utilized as vehicles to provide access to more illiquid alternative investment products generally not available to a broader set of investors within other vehicles. The structure, issuing a fixed number of shares which are not redeemable from the fund, allows the fund managers to invest in illiquid products and pursue a longer-term strategy without the risk of having to deal with withdrawals or outflows.

CEFs allow investment managers to take on more risk than an open-ended fund, as managers can:

- Invest 15% of portfolios in illiquid securities
- Lever their capital up to 33% under SEC regulations[13]
- Allocate capital to investment types potentially outside of traditional guardrails (i.e., direct lending or a unitranche fund to complement a bank's leveraged finance group – more below)

These CEFs appeal to end-investors as they provide the opportunity for both appreciation and income, and investors receive a significant portion of their returns in the form of distributions, making CEF's a more attractive option than traditional bond investments.[14]

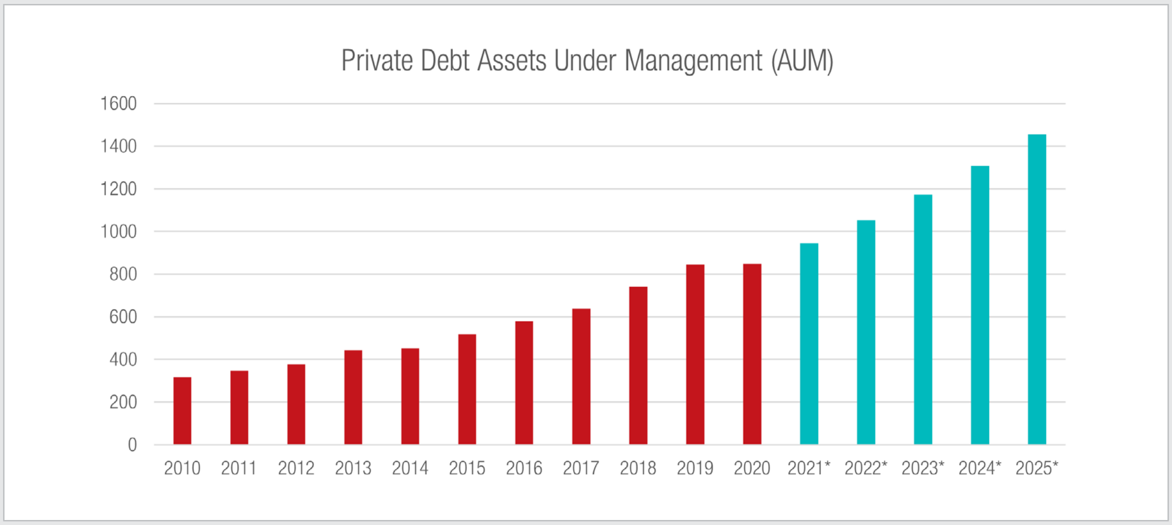
Non-traditional, digital, and non-financial assets will continue playing a larger role for alternative mangers. The challenge for both managers and service providers will be in developing and investing in operational support, distribution, and sales strategies mature enough to efficiently meet the current demand and flexible enough to support future innovations and applications.

PRODUCT HIGHLIGHT

Private Credit & Direct Lending

More novel alternative investment products are not the only ones experiencing change. Private credit, specifically direct lending, is experiencing a market shift and growing interest in.

Paltry yields in public debt, coupled with a population of investors searching for yield and shifting to risk-on mode with both institutional and individual investors has driven massive growth in private credit, one we believe will only accelerate in the coming months and years. An asset class that was already one of the fastest growing alternatives pre-pandemic, private credit/private debt is expected to re-ignite, growing 73%, an estimated 11.4% CAGR, through 2025 according to Preqin.[15]

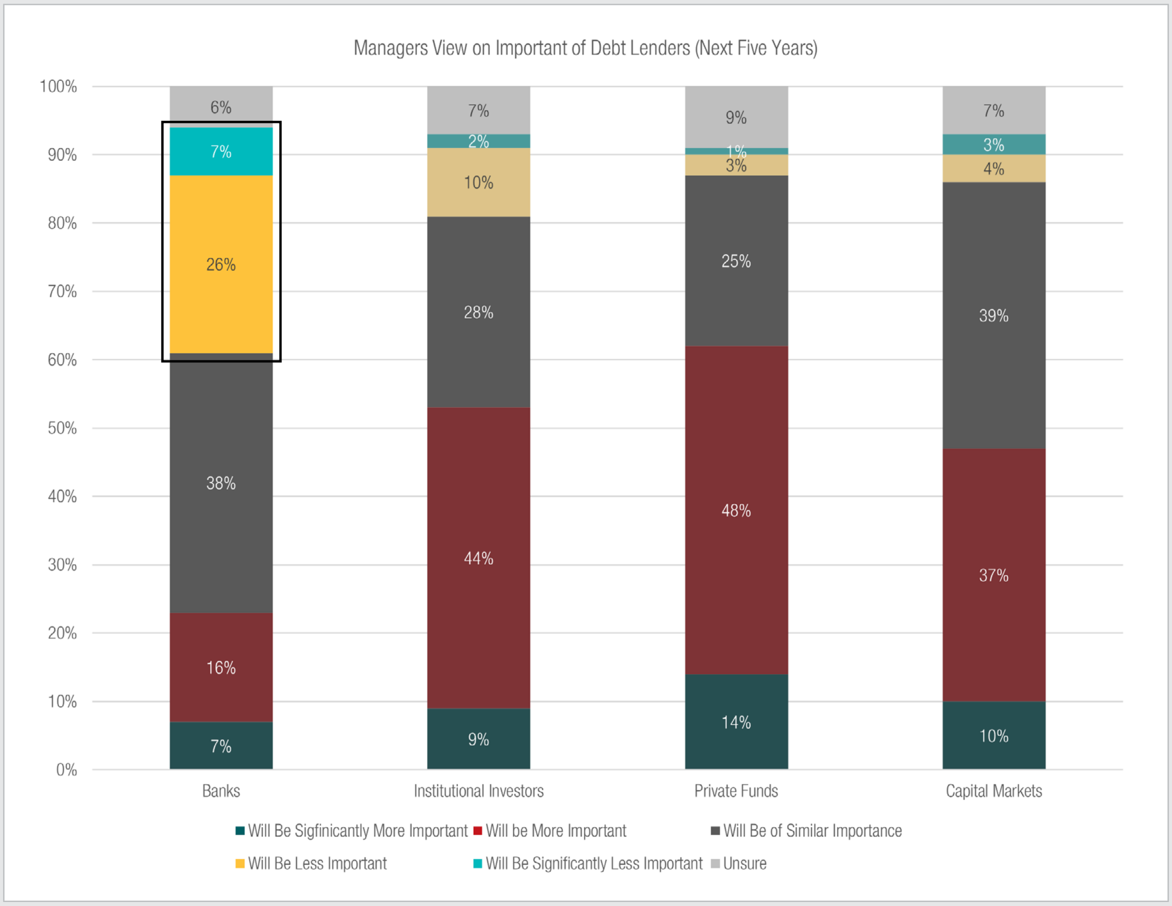


Of that growth, Capco anticipates a large percentage to be focused on direct lending. Direct lending (non-bank lending) is not a novel concept and has made up the largest proportion of total private debt AUM in recent years (38% as of December 2019).[16] Perhaps a silver lining of the COVID-19 halt for capital markets was the avoidance of a potential direct lending bubble as many lenders understandably stepped out of the market for much of the year. The underlying drivers for the growth, if anything, are more pronounced and participants are easing their way back into a more amenable market:

- Borrower-Driven:
  - Restriction-effected middle-market businesses are once again performing
  - Growing demand for access to less-onerous, low-execution-risk private credit
  - Middle-market borrowers (middle-market), underserved by commercial banks and leveraged finance groups, are seeking injections of capital with little to no time to waste on traditional source (syndication risk, time to execution)

- Lender/Investor-Driven:
    - More attractive opportunities for lending as performing businesses seek capital
    - Better positioned for better terms, stronger covenants, and lower leverage
    - Pressure on traditional bank lending groups being intermediated by private equity firms and direct lenders
    - Increasing demand to exposure to private credit from a risk/return profile from institutional investors

With risk restrictions put on banks following the financial crisis, more and more dedicated directlending funds and larger financial sponsor firms are entering the space every year, filling the need for middle-market borrowers and taking market share from traditional bank lenders. A recent survey by Preqin shows the perception of banks and traditional lenders becoming less and less important.[17]



Banks and traditional lenders are being intermediated – doing the analysis and deal-sourcing work for financial sponsor or leveraged finance clients, only to lose the deal to direct lenders. For traditional lenders to remain competitive in the middle market, it is imperative to understand not only the strategic opportunities but also their institutional limitations for pursuing a direct lending offering.

2. ACCELERATING INNOVATION THROUGH COLLABORATION

Alternative Investment Technology

Alternative investment managers are scrambling to digitize and incorporate well thought-out data and analytics strategies to both their investment and operational decision-making processes. Both the benefits of adopting cutting-edge technologies AND the constraints managers face to do so organically are abundantly clear. Capco expects the increased pressure to innovate and the operational constraints of doing so to push more asset manages to look externally for solutions, relying on their fund administrators and new FinTech partnerships.

Looking External: FinTech Partnerships

FinTech companies understand they are nimbler and can offer best-in-class technologies to alternative investment managers. To capitalize on this, FinTechs are creating an integrated network of alternative investment partnerships, including offerings of new data and analytics providers, management solutions built on modern technology, and user-experience focused online platforms with access to investments and managers.

- **iCapital Network:** The financial technology company partners with State Street Corporation, to provide fund managers accelerated fund raising and product launch, scaled distribution, and a database of investor documents by combining State Street's core transfer agency and private market fund administration capabilities with iCapital's platform technology and distribution network

- **Allvue:** Allvue provides a broad set of alternative investment solutions to managers and banks and was formed by the combination of two established alternatives technology providers – Black Mountain Systems and its expertise in data aggregation, reporting, and process management and AltaReturn's solutions for fund managers, administrators, and family offices.

Alternative investment market trends, along with asset manager and investor demand, are leading the drive toward the change in custodial services. An increase in regulatory pressure is intensifying scrutiny on alternative investment custodian's transparency and accountability. These operations teams are struggling under the pressure, so they need specialized providers to step in. Independent, specialized custodians are partnering with FinTech companies to develop technology solutions to meet the needs of alternative investment managers.

Administrator and Custodian Solutions 2.0

Fund administrators are under incredible pressure. A 2020 survey indicated that 26% of private capital fund managers changed admins in 2020, 53% of those due to dissatisfaction with the quality of service.[18] Alternative investment administrators and custodians are becoming misnomers in the traditional sense. Forward-thinking service providers have transformed into technology companies which happen to provide custodial and admin services, with robust data transmission and analytics tools and automated product offerings to meet the demands of alternative investment fund managers.

These firms are heavily investing in technology and automation tools to provide seamless and elevated services to their customers. With market shifts and demand from managers, the top priorities for the immediate future are:

- Big data and analytics for investment and operational decision-making

- Mobile and cloud technology for scale and efficiency

- CRM solutions to manage communications across investment lifecycles

- Investor relationship services to provide secure access to account and fund data
- Portfolio management solutions to centralize data on a single platform
- Account solutions to managed pooled investment

SS&C Technologies is one of the larger alternative-fund administrators pushing change in the level of service provided to alternative investment managers and investing to position themselves as market leaders. Targeting fund manager solutions with the goal to modernize their operations load and increase overall efficiency, SS&C saw significant increase in adoption for their alternative asset solutions in 2020, with growth private equity, private debt, and illiquid strategies.[19] SS&C also caters to the end investor, enhancing the end-client experience and improved time frames for reporting and transparency.

The industry-wide push for, and continued investment in, technology to support increased activity and provide best-in-class services will bring alternative investment management closer to the automation it needs in order to continue its growth and will position the administrators and custodians who think strategically to gain immense market share.

3. PUSHED TO THE LIMIT

Next-Gen Operational Efficiency

Pressure continues to mount on Asset Managers to justify their fees to investors, and banks and service providers to justify the cost of their services to their partners. Higher transaction volumes, product expansion, and increasing investor sophistication continue to up the pressure on financial institutions, and managers are increasingly looking to partner with outside service and technology providers and administrators to keep up with the needed back-end upgrades and the concerns below, while allowing the managers to focus on investment opportunities and returns, their core competency.

- Regulatory and compliance concerns, forcing firms to take further actions to ensure quality and regulatory assurance
- Increasing investor demand for more transparency in alternative investment strategies and operation
- Increasing investor sophistication, seeking upgraded services, real-time data and reporting, and reduced fees

Most firms are not set up to support the day-to-day activity in parallel with proactively investing in uplifting antiquated, manual workflows, and legacy infrastructure. Inefficient outsourced operating models can make it hard to react quickly, and technical debt in application estates can make it hard to automate. Fund managers are concerned about operational abilities to keep up with industry trends and investor demand. Fund managers are concerned with pressure on operating budgets, noting increasingly larger portions of budgets being devoted to technology-based operational efficiencies.[20]

Standardization and Automation:
There is little standardization across alternative investments service providers. Administrators, in order to support varying client demands, offer a plethora of different structures and registrations, making it difficult to streamline workflows and processes across different clients. Asset managers and the asset management arms of banks, often have multiple service providers and administrator

relationships, which creates nuanced workflows on both sides. Other headwinds:

- There is no single, best-in-class platform which allows operations teams to manage all required data in a single place

- Data is often sourced from physical documents (subscription and redemption docs) and manually re-keyed in data storage applications

- Exchanges between stakeholders is often conducted via email, rather than systematic data feeds or APIs

The result is reduced efficiency and transparency, higher processing costs, and an increased risk for input errors, information breaches, and compliance issues, and a high turnover rate due to capacity constrained resources. Commonly, a lack of formal documentation and specific operational processes, nuances, and institutional knowledge residing exclusively in the heads of individual employees, creating unnecessary "key-person" risk.

Broadly for asset managers and service providers the greatest risk is the risk of lost opportunity – deal execution for GPs, traction for increased assets under administration for service providers. The alternative investments ecosystem needs to establish industry standards in order to reduce manual workflows and streamline data transfer and reporting processes. The managers, banks, and service providers that do so will set the standard and capitalize on a tremendous opportunity. Those that do not will continue fall behind.

SUMMARY

As the broader economy continues toward a sense of renewed normalcy, we expect the demand for exposure to alternative investments, the pressure on performance for asset managers, and the operational constraints on banks and service providers to increase exponentially. Developing a deep understanding of the expanding product needs, investing in next-generation operations, and developing innovative technology solutions and partnerships will be paramount for success in the space. The coming months will present an enormous opportunity for alternative investment participants who embrace this challenge and position themselves strategically to capitalize on it.

REFERENCES

1. Preqin. The Future of Alternatives 2025 (https://www.preqin.com/future)
2. Preqin. The Future of Alternatives 2025 (https://www.preqin.com/future)
3. U.S. Department of Labor. News Release 20-1160-NAT. June 3, 2020, "U.S. Department of Labor Issues Information Letter on Private Equity Investments" (https://www.dol.gov/newsroom/releases/ebsa/ebsa20200603-0)
4. U.S. Securities & Exchange Commission. Press Release 2020-191, "SEC Modernizes the Accredited Investor Definition" (https://www.sec.gov/news/press-release/2020-191)
5. Jacobi, Luke. Best Cryptocurrency Brokers. Benzinga.com, April 17, 2021 (https://www.benzinga.com/money/best-brokers-cryptocurrencies/)
6. Son, Hugh. Morgan Stanley becomes the first big U.S. bank to offer its wealthy clients access to bitcoin funds. CNBC.com, March 17, 2021 (https://www.cnbc.com/2021/03/17/bitcoin-morgan-stanley-is-the-first-big-us-bank-to-offer-wealthy-clients-access-to-bitcoin-funds.html)
7. Son, Hugh. Goldman Sachs is close to offering bitcoin and other digital assets to its wealth management clients. CNBC.com, March 31, 2021 (https://www.cnbc.com/2021/03/31/bitcoin-goldman-is-close-to-offering-bitcoin-to-its-richest-clients.html)
8. Casperson, Nicole. Goldman Sachs is getting into Bitcoin — who's next?. Investment News, April 1, 2021 (https://www.investmentnews.com/goldman-sachs-is-getting-into-bitcoin-whos-next-204692)
9. Hackl, Cathy. Five Things Brands Need To Know About NFTs (Non-Fungible Tokens). Forbes, Forbes.com, March 4, 2021. (https://www.forbes.com/sites/cathyhackl/2021/03/04/four-things-brands-need-to-know-about-nfts-non-fungible-tokens/?sh=3d65b1ac222f)
10. Young, Jabari. People have spent more than $230 million buying and trading digital collectibles of NBA highlights. CNBC.com, February 28, 2021 (https://www.cnbc.com/2021/02/28/230-million-dollars-spent-on-nba-top-shot.html)
11. Chow, Andrew R. NFTs Are Shaking Up the Art World—But They Could Change So Much More. Time, Time.com, March 22, 2021 (https://time.com/5947720/nft-art/)
12. Williams, Georgia. Palladium Outlook 2021: Supply Constraints a Tailwind for Higher Value. Investing News, January 12, 2021. (https://investingnews.com/daily/resource-investing/precious-metals-investing/palladium-investing/palladium-outlook/)
13. Hoops, Thomas. Closed-end funds can offer opportunities, but they come with risks. Investment News, January 27, 2015. (https://www.investmentnews.com/closed-end-funds-can-offer-opportunities-but-they-come-with-risks-60288)
14. Foster, Michael. The 10 Best Closed-End Funds (CEFs) for 2021. Kiplinger's, January 28, 2021 (https://www.kiplinger.com/investing/cefs/602170/the-10-best-closed-end-funds-cefs-for-2021)
15. Chauhan, Ashish. Future of Alternatives 2025: Private Debt's Spectacular Rise Will Continue. Preqin, November 4, 2020 (https://www.preqin.com/insights/research/blogs/future-of-alternatives-2025-private-debts-spectacular-rise-will-continue)
16. Chauhan, Ashish. Future of Alternatives 2025: Private Debt's Spectacular Rise Will Continue. Preqin, November 4, 2020 (https://www.preqin.com/insights/research/blogs/future-of-alternatives-2025-private-debts-spectacular-rise-will-continue)
17. Preqin Fund Manager Survey, August 2020 (Future of Alternatives 2025: Private Debt's Spectacular Rise Will Continue (preqin.com)
18. Preqin. Preqin Special Report: Service Provides in Alternative Assets. September 2020 (f15f3a12-1b36-49ac-96ac-fb1a7408f2ef-Preqin-Special-Report-Service-Providers-in-Alternative-Assets-September-2020.pdf)
19. SS&C Technologies Holdings, Inc.: 2020 Annual Report. February 25, 2021 (https://s22.q4cdn.com/211474323/files/doc_financials/2020/annual/2021-SSC-10-K-2020-Bookmarked-(FILED).pdf)
20. Scharfman, Jason. (2020) Alternative Investment Operations: Hedge Funds, Private Equity, and Fund of Funds. Palgrave Macmillan

AUTHORS

Max Mauro, Principal Consultant, Alternative Investments Lead
max.mauro@capco.com

Elizabeth Dunigan, Consultant
lizzie.dunigan@capco.com

ABOUT CAPCO

Capco is a global technology and management consultancy dedicated to the financial services industry. Our professionals combine innovative thinking with unrivalled industry knowledge to offer our clients consulting expertise, complex technology and package integration, transformation delivery, and managed services, to move their organizations forward.

Through our collaborative and efficient approach, we help our clients successfully innovate, increase revenue, manage risk and regulatory change, reduce costs, and enhance controls. We specialize primarily in banking, capital markets, wealth and asset management and insurance. We also have an energy consulting practice in the US. We serve our clients from offices in leading financial centers across the Americas, Europe, and Asia Pacific.

To learn more, visit our web site at **www.capco.com**, or follow us on Twitter, Facebook, YouTube, LinkedIn and Instagram.

WORLDWIDE OFFICES

APAC
Bangalore
Bangkok
Gurgaon
Hong Kong
Kuala Lumpur
Mumbai
Pune
Singapore

EUROPE
Berlin
Bratislava
Brussels
Dusseldorf
Edinburgh
Frankfurt
Geneva
London
Munich
Paris
Vienna
Warsaw
Zurich

NORTH AMERICA
Charlotte
Chicago
Dallas
Hartford
Houston
New York
Orlando
Toronto
Tysons Corner
Washington, DC

SOUTH AMERICA
São Paulo

WWW.CAPCO.COM

CAPCO

JN_3222