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Hedge Funds Must Sharpen Approach to Crack the RIA Market

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Access. Everyone wants it. In all aspects of life, people want access to top-tier products and services, from the hotels the stars stay at to the hedge fund managers who manage billions of dollars for high-net-worth investors. The latter has been a challenge over time, but in recent years, the market has seen extensive efforts to bring hedge fund strategies to the masses.

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But providing independent registered investment advisors (RIAs) and their clients with access to hedge funds has proven to not be an easy task. One of the main challenges has been the general lack of information and understanding in the market about what hedge funds do and the types of products they offer. Another challenge has been adopting an appropriate vehicle, and then picking – and sticking to – the right distribution approach. While entering a new market requires a cost-benefit analysis, given the rapid growth of the RIA segment – especially the rise of billion-dollar RIAs – alts managers would be well-served to give these decisions serious thought in order to identify new venues of growth.

For years, alternative strategies had only been readily available to institutions and qualified purchaser investors, and they – for the most part – reaped the benefits when those strategies delivered higher returns. Historically, defined benefit plans – like state pensions – outperformed defined contribution plans, such as 401ks, in part due to their access to alternatives. Over time, the desire for access to these products has moved across the investor scale from institutions to individuals. The biggest challenge is bringing those two groups together.

Bridging the gap between alts managers and RIAs is an important exercise. Hedge funds primarily are meant to provide downside protection, uncorrelated returns, and alpha generation – three elements of any complete asset allocation. So, while news on hedge funds has been mixed recently as the broad markets have enjoyed an extended bull run, the end result still should be a much broader implementation of alternative strategies.

But the question still remains: How do alts managers get their products in front of the right interested investors and how do RIAs learn more about the strategies and managers?

For hedge fund managers looking to market their products to RIAs, the biggest issues are how to create attractive products and structures and how to reach and connect with an investor group that is much more diverse in both its make-up and goals than hedge funds' traditional institutional client base.

Efforts have focused on evolving alternative strategies into structures like open end mutual funds, business development company (BDC) vehicles and – most recently – interval funds, among other legal entities. While some strategies have moved into these structures seamlessly, others have faced more challenges within the constraints of the Investment Company Act of 1940. This is in part due to limitations on leverage, liquidity, and redemption cycles. Additionally, alts managers often have to manage overlap between their private funds and these new legal structures. Results for these products have been varied.

A recent Morningstar study, which highlights the proliferation and then the rapid sell-off of liquid alternatives in recent years, underscores how investment sentiment for these products can shift rapidly. For liquid alts, quick asset gathering earlier this decade was followed by underperformance and outflows. Strong performance by the broad-based markets and the ability to get exposure to traditional asset classes via low cost products, such as indexes, have also been headwinds for alternatives.

RIAs looking to move toward larger allocations to alternatives also have faced challenges in sourcing and vetting alts managers, dealing with subscription documents, and the tax implications of investing in a hedge fund issuing a Schedule K-1 federal tax form versus a public fund issuing a 1099 form.

There have been solutions that attempt to solve some of these issues. Platforms or feeder programs like iCapital Network and others have been created to help with identifying alts managers, performing due diligence on them, and providing a streamlined subscription process for investors. This gives alts managers an opportunity to have funds they can manage for a larger number of smaller investors without stressing out over internal operational processes or increasing costs for administration of the fund.

Other hedge fund managers have created tailored products they believe will have broader demand and have looked to the large wirehouses and wealth managers to get on their platforms. The problem with this model has been the intense competition for shelf space and hedge fund managers' reliance on other firms to help them promote their products. As such, success with this model has been varied.

It is important for alts managers to strategically choose the model and sales approach that's best for them and put resources behind it. But even then, one of the biggest issues preventing advisors and alts managers from working more closely is education.

In addressing that issue, some larger alternative asset managers have taken to targeting independent advisors directly – by signing on as sponsors for conferences and events organized by large RIA clearing firms – to establish direct contact with RIAs and better understand their operational and business goals. These are all steps in the right direction to help bridge the gap between RIAs and alts managers and this approach seems to be paving the way for the future.

Still, there is a lot of confusion in the marketplace about what hedge fund managers do, what the purpose of their strategies are, and how to best access them, creating a general skepticism about alternatives. The best way to address this is through wider education efforts. More alts managers spending more time putting out thought leadership pieces, holding events, and having meetings directly with advisors will slowly break down the barriers and bring both groups together to bring downside protection and alpha generation to every portfolio.