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A down 2022, less impact fund terms more on returns

As inflation, high rates, and war each take their toll on private capital returns, how managers emerge from the cycle will determine their future success

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What impact will current market conditions, which include down equity markets, rising inflation, and rising interest rates, have on alternative assets?
Rising rates will for sure have an impact on the cost of capital while inflation will erode returns. But fee terms will generally remain static, irrespective of interest rates and inflation increases. Instead, terms will continue to be impacted by supply and demand. Fee terms for a particular fund may be negotiable, but this will depend more on a given manager's ability to produce attractive returns compared to competitors. This, however, can shift over time as different investment strategies fall in and out of favor.

How will lower asset valuations affect venture funds?
Depressed valuations have had a negative effect on performance as many players have struggled to keep ahead of higher entry costs. In turn, this could create fundraising challenges for struggling managers down the road. That effect is particularly acute if the fund is between closings. In that situation, new investors will be reluctant to buy into the existing portfolio at cost. Additionally, existing investors may be unhappy about being diluted at discounted prices even if, as is often the case, the general partner has reserved the flexibility to adjust marks to reflect movements in material valuation.

On the other hand, investors generally recognize that markets are cyclical, and pricing dips can create opportunities to invest at attractive prices. This can be advantageous for funds sitting on dry powder. Investors evaluating the performance of a fund sponsor typically look at relative performance against others in the same space. While poor overall sector performance can result in some reduction in allocations, fund sponsors with good relative performance will still attract capital.

Have the events of the past two years, such as COVID-19, geo-political conflicts, and interest rate and inflation volatility, radically changed the hedge fund landscape?
Just as with the Global Financial Crisis, we expect these market events, coupled with the recent rules proposed by the SEC, to generate opportunity for both existing and well-pedigreed emerging managers. High performing managers—whether long/short, market neutral, quant, or macro—will be rewarded, and new managers will be born from performance dislocation. Moreover, it is critical to watch the proposed rules around preferential terms, which could dramatically alter how managers negotiate fee, liquidity, capacity, and transparency terms with sophisticated investors, such as endowments, pensions, and charities.

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