

# **Institutional investors - should class matter?**

## **Applying the same standards to alternatives.**

Anyone who has walked onto a forecourt with the intention of buying a car knows it is a minefield. Not only do you have to dodge the more aggressive elements of the pack of dealers loitering around the vehicles, but you have to be able to see past the marketing speak of those who are actively trying to rid themselves of the occasional albatross of a car that can't be shifted from the garage. Effectively you're a buyer in a market where full knowledge is desirable, but probably not achievable. The same applies to buying a house - the most expensive thing someone is likely to buy, but will only spend a couple of hours in it before investing!

You'd, therefore, think an investment in a quoted share on a reputable market should be the gold standard within the portfolio of an institutional investor. Data should be easily accumulated as the listed shares are ultimately transparent, readily available through a simple internet search. Not only is individual data on listed entities in the public domain, but a clear method of being able to compare similar investments is also available, as their listed peers, eager for institutional funding, are subject to the same rules of listing and, therefore, transparency of performance.

## **Seeing the wood from the trees - intelligent reporting**

Investing in an alternative investment fund, however, swings again towards the opaque, this time through the medium of individual fund manager's preferred reporting framework. Whether the fund in question invests in private equity, venture capital, real estate, infrastructure or debt, the quarterly reporting schemes used to filter information through to investors have no statutory framework or consistent method of presentation across the industry. So an investor relying on listed markets to accurately value their investments holds no such faith when tracking value within a fund investment.

Does reporting excellence remain a myth then? Investors can still rely on audited accounts being issued, but these are only approved as true and fair under accounting rules. Thanks to the very flexibility of limited partnership agreements used in the industry, there is no guarantee of consistency in the treatment of transactions. Some ground, however, has been made up by those managers selecting an accounting framework such as IFRS or US GAAP.

Great strides towards comparability have been made by the bodies that are responsible for setting standards, with IFRS finding itself moving towards US GAAP treatment via the investment entities provisions, so the illogical consolidation requirement for investments has been removed. Listing rules force public companies to follow IFRS for their reporting, which provides to investors consistency of presentation and treatment, which allow for comparison advantages, whereas fund managers still have the luxury of choice and ultimately the ability to bypass some accounting disclosure should they wish.

While there can be some comfort in seeing your fund managers adopting, frankly, sometimes difficult accounting frameworks, disclosed fair value in those statements is ultimately built on valuation techniques that are assessed by auditors only for reasonableness, so purely a means of estimation. Under IFRS, investments will be categorised as Level 3, meaning the figure presented is based on a calculation methodology, and subject to wild differences once a sale stage is reached, when cash will begin to drive the numbers, with certainty finally achieved. Moreover, capital accounts are more frequently being presented to investors as single page documents, largely the US standard, being specific to the investor, which adds further murkiness to recipients given that the treatment of other investors in that fund is lost.

## **Through the looking glass**

Transparency, then, is crucial. A closed-ended fund investment tends to have three elements in its life: buy, hold and sell. More so than any other investment type held in an institution's portfolio, cash payment and receipt will be the only real method of finding performance. Without direct cash flows to rely on, fair value indicates progress in the portfolio, but is only a loose guide through the jungle of returns. How a manager goes about valuing its portfolio therefore becomes fundamental to an investor's expected return calculations, and this should be ultimately tempered, knowing the numbers are supplied by a party with

a vested interest, not wanting to ever overstate value, so exits are, as much as possible, good news stories.

So, true comparison for investors to rate funds remains tantalisingly out of reach. ILPA and EVCA have attempted to build standard templates to be used in fund reporting, elements of which are being requested by investors more frequently, but while adoption remains sporadic, that bullseye is being missed. Fund managers still control the information flow and their desire for less disclosure remains a barrier to ILPA being the complete solution.

This isn't to say the listed route is perfect - as the latest accounting scandals in the media have demonstrated, regulation is not a fool-proof solution. And if there isn't a regulatory safety net, then what regulation of reporting does the alternatives sector need? In reality, returns will always drive markets and historically, the sector outperforms market norms. But this outperformance maybe masks that the industry has been guilty of a black box approach to communication with investors in the past, providing enough information to maintain investor buy-in, without full transparency. As we move into an age where information flows freely and expectations will be that data is readily available, investor confidence will shift towards those managers that share, ensuring a compliance culture of testing and intelligent interrogation of data supplied by funds will be standard.

## **So, who will watch the watchman?**

Any successful fund manager with a solid history will likely not have to live with the same level of scrutiny experienced by a new fund launch or a manager delivering reduced returns, but why should that be? The solution offered by the Aztec Group is the creation of an independent route to tracking performance, intelligent interrogation of quarterly reporting, resulting in the creation of an investor's 'market' for their fund investments, analysing returns by metrics such as fund manager, vintage, geography, sector, and others. Aztec Group develops this by looking through all structures, not only at one 'cash' level, but, crucially, through revolutionary dashboard technology overlaying our system, at a portfolio level too.

To find out more about how we work with institutional investors click [here](#).