When One Size Doesn’t Fit All: Hybrid Fund Solutions for Alternative Asset Managers

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Hybrid fund structures, which can combine elements of both open-ended hedge funds and closed-end private equity funds, have become increasingly common in the current market environment. Their more flexible terms as to subscriptions, redemptions and fees can make them more suitable for vehicles investing in less liquid assets, such as private credit, distressed debt, direct lending and other credit-oriented strategies. They can also be used by fund sponsors and managers seeking to lock up investor capital for a longer period of time in connection with a restructuring, proxy contest, or other activist investment strategy, often in a hybrid vehicle focused on only a single underlying investment.

This article describes the principal features that are common in hybrid funds, and explores some of the advantages and disadvantages of such structures, as well as some of the tools available to fund sponsors and managers to deal with the challenges in launching and operating a hybrid fund.

What is a Hybrid Fund, and what are they good for?

Simply stated, a hybrid fund is a private investment vehicle that has attributes typical of both hedge and private equity funds. Most notably, a hybrid fund can permit investors to withdraw capital at specified intervals, and can permit new or existing investors to add capital on an ongoing basis at specified intervals, both of which are prohibited in a typical closed-end fund structure.

Hybrid structures can offer significant advantages for sponsors of investment vehicles who want the flexibility to raise capital on a “permanent” basis, and/or who want to offer investors some amount of liquidity. The structure can also be attractive to sophisticated investors who increasingly expect a fund’s liquidity profile to be specifically tailored to the liquidity of the underlying investments. We have also seen hybrid vehicles used increasingly frequently for funds focused on a single investment or theme, often where capital is raised on a “club” basis from investors interested in the specific investment thesis.

Pros and Cons of Hybrid Funds

Hybrid funds can permit fund managers to customize their product in order to better align the terms of a fund with the fund’s underlying investments.

Hybrid funds can be structured to permit new capital contributions from time to time based on the mark-to-market value of the underlying investment portfolio. A fund sponsor can therefore market the fund on a permanent basis, rather than going through alternating periods of fundraising followed by periods of inactivity before the launch of the next fund, as is typical for sponsors of closed-ended funds.

Launching only a single fund, rather than a series of similar investment vehicles, can also allow a fund sponsor to save on the costs and upfront effort (including organizational costs and work associated with fundraising and onboarding administrators, prime brokers, custodians, and other service providers) that might otherwise be incurred launching multiple closed-ended funds sequentially.

Hybrid structures can, however, pose significant challenges, including, in particular, matching the cash flows from subscriptions and redemptions with the underlying cash flows from investments and the identification of new investment opportunities. However, those challenges can be managed by incorporating one or more of a number of available customized terms into the hybrid fund’s governing documents, as discussed below.

Typical Hybrid Fund Terms

Additional Capital Contributions

Hybrid funds can permit new capital contributions on an ongoing basis, rather than limiting investment to a specified fundraising period (typically twelve months from the first closing). New capital contributions can either be accepted in full as of the subscription date, or drawn down over time from irrevocable capital commitments by investors on an as-needed basis, or some combination of the two.

As is the case with closed-end funds, the fund sponsor can use a line of credit tied to the fund’s capital commitments to make investments before subscription monies are received from investors. This can permit a fund to participate in investment opportunities without having to worry about possible lags after drawdown notices are sent out, or waiting until the next subscription date to receive funds.

Hybrid funds can be structured to address a key problem that arises in typical closed-end fund structures if the fair market value of the fund’s underlying portfolio investments changes materially after the initial closing with investors but before the final closing. In the typical closed-end fund structure, investors admitted after the first closing are treated as if they invested as of the first closing, participating in all of the fund’s investments, but paying interest to the fund on the percentage of capital commitments previously contributed to the fund by investors admitted at earlier closings. As such, later investors benefit from a “last-look”, participating in unrealized gains on portfolio investments made prior to their commitment to the fund.

A hybrid fund structure can address this issue by adjusting the capital account balances (or share balances) of existing investors, as in a hedge fund structure, in order to reflect the current fair market value of the fund’s underlying assets as of any later closing date on which new capital contributions are accepted from investors. Alternatively, investors admitted at later closings can be limited so that they only participate in new investments made at or after the time of their investment.

Liquidity

Hybrid funds can be structured to permit investors to withdraw capital, either at regular intervals, on specified dates, or upon the occurrence of specified events, such as the realization of an investment or completion of a restructuring, or on some combination (for example, upon the realization of underlying investments, but in any event not later than a specified period after the initial closing). Hybrid funds can also be structured to give investors a variety of liquidity options to choose among at different points in time, permitting different investors to elect different liquidity results.

Withdrawals from hybrid funds can be permitted monthly, quarterly, bi-annually, annually, or even less frequently. Managers of hybrid funds also have a number of tools at their disposal to manage the potential mismatch in timing of redemption payment obligations and the underlying cash flows from the fund’s investments, as described below.

Slow-Pay

A “slow-pay” provision gives a fund manager the option to segregate a withdrawing investor’s proportionate share of an illiquid investment and distribute the net proceeds of the investment after the realization of the investment, rather than being forced to sell the investment prematurely, possibly at a less advantageous price, or before an anticipated event has occurred. The fund manager can then sell the segregated investment over time, as it sees fit, and pay the net proceeds of the ultimate realization to the investor as the segregated investment is sold and proceeds are realized.

Slow-pay provisions “lock in” the withdrawing investor’s percentage share of the illiquid investment as of the redemption date. The withdrawing investor remains exposed to the risk of the investment’s performance until the fund sells or otherwise disposes of the position on the investor’s behalf. Unlike a side pocket (discussed below), a slow-pay provision is only invoked upon a redemption, and only affects the redeeming investor; the remaining portion of the illiquid asset (that is not attributable to the redeeming investor) remains part of the fund’s investment portfolio for the benefit of all remaining investors, including any new investors subsequently admitted to the fund.

Lock-Ups and Gates

Lock-ups and gates are liquidity management tools that are common in open-ended vehicles. A hard lock-up provides that an investor's capital cannot be redeemed for a set period of time (typically, between 6 months and 2 years) following the date of the original investment. A soft lock-up permits redemptions during that the lock-up period, but subject to a redemption fee (typically 2-5% of the amount redeemed).

A redemption gate restricts the amount that can be redeemed by investors as of any redemption date. "Fund-level" gates limit the total redemptions as of any specific redemption date to a specified percentage (typically 5-25%) of the total value of the fund. This can prevent a "run" on the fund and limits the amount of assets that the fund would need to sell in order to meet redemption requests. Alternatively, an "investor-level" gate limits the amount that any investor can redeem as of any redemption date to a specified percentage of the investor's current investment in the fund (typically 25%). Both of these tools can be effective in managing liquidity and redemptions.

Withdrawal Capital Account

A withdrawal capital account, similar to a slow-pay provision, permits a fund manager to segregate a redeeming investor's proportionate interest in each of the fund's underlying investments (sometimes referred to as a "vertical slice" of the fund's portfolio) as of the redemption date. Depending on the liquidity of the underlying investments, the fund manager may determine to pay some redemption proceeds in cash as of the redemption date, and to segregate the remaining investments into a withdrawal capital account. As with a slow-pay provision, the investor bears the risk of the future performance of the investments in the withdrawal capital account after the redemption date until the investments are realized.

In-Kind Distributions

A fund can also distribute illiquid investments in-kind to investors in order to satisfy a redemption request, in lieu of selling the investment and paying cash. Certain investors are hesitant to receive distributions in kind, and often negotiate to be given the option to require the fund sell the investment on the investor's behalf, and to distribute the proceeds (less all costs related to the sale) to the investor. A hybrid fund can also be structured to give investors different redemption options at different times, so that different investors can elect to have portfolio investments liquidated for their account, distributed to them in kind, retained in the fund, or some combination of the three.

Side Pockets

A fund manager can "side pocket" an investment that the fund manager considers illiquid or difficult to value. The effect of a side pocket is to "freeze" the participation percentages of all investors with respect to the side-pocketed investment as of the date the investment is side-pocketed. No investors may redeem their interest in an investment that has been side pocketed. Instead, the net proceeds of realization of the investment will be paid out to investors only after the investment is realized.

While side pockets have been somewhat out of favor in hedge funds for many years, they are becoming more common again, especially when the fund manager provides investors with an opportunity to make an election to opt-in or opt-out of participating in side pockets.

Side pockets differ from slow-pay and withdrawal capital account provisions in that the fund manager can typically side pocket an investment at any time, not just as a result of a redemption request. Also, the side-pocketed investment is typically side-pocketed for all investors, not just for redeeming investors, thereby freezing the participation percentages of all investors with respect to the investment at the time the investment is side-pocketed, not just the participation percentages of the redeeming investors.

Suspension

As a last resort, a hybrid fund can permit the fund manager to temporarily suspend the right of investors to redeem or withdraw capital. The fund manager's right to suspend redemptions is typically included in open-ended fund documents, but is very rarely used. Typically, the fund manager can suspend redemption rights when an exchange on which the fund's underlying investments trade is closed, when prices for the underlying investments cannot reasonably or practically be determined, or when the disposition of investments might not be practical or might harm the fund or its investors.

Valuations

Perhaps the most important issue affecting the structure and viability of a hybrid fund is the ability to value the fund's investment portfolio. Hybrid fund structures that permit ongoing subscriptions and redemptions must be able to make a determination of the fund's net asset value as of any date on which subscriptions are accepted or redemptions are permitted.

If market quotations are not available for non-traded assets, mechanisms can be included in hybrid fund documents to permit valuations based upon formulaic ("mark-to-model") valuations or (more likely) based upon periodic (typically semi-annual or annual) third party valuations. However, if ultimately it is either not possible or too difficult to value the fund's investment portfolio, then a hybrid fund structure likely will not be practical, and a more typical closed-end fund structure is more likely to be used.

Fees and Allocations

Management fees and performance-based compensation in hybrid funds can be structured to more closely resemble either an open-ended hedge fund incentive fee or allocation or a closed-end fund carried interest, or some variation of either, depending on the nature and liquidity of the underlying investments.

A management fee can be charged based on a percentage of the fund's net asset value, or a percentage of invested capital or committed capital, or some combination of the two.

Performance-based compensation can be structured more like a hedge fund incentive fee or incentive allocation, typically payable annually as a percentage of both realized and unrealized gains on a "mark-to-market" basis, and typically subject to a "high water mark", or "loss-carryforward," that ensures that any loss must be recouped before the fund manager receives any incentive compensation.

Alternatively, incentive compensation can be structured more like a typical private equity fund carried interest, payable only upon the ultimate realization of any gains and distribution of the net proceeds to investors, often subject to a hurdle or preferred return to investors and a clawback to prevent the fund manager from receiving excess distributions.

Hybrid structures can combine many of these features. For example, in a hybrid fund structure, an annual incentive allocation may be payable only on net realized (not unrealized) gains, or only after investors are given an opportunity to realize liquidity with respect to all or part of their investment (e.g., after the expiration of any lock-up).

As a general principle, the more significant the restrictions on withdrawals of capital, and the longer the period of any lock-up, the more likely investors are to push for deferred incentive compensation structures that are payable to the fund manager only upon the ultimate realization of the underlying investments and distribution of proceeds to investors.

Conclusion

The flexibility and customization possible in hybrid fund structures make them a useful tool for sponsors and managers launching funds focused on investments that may be less liquid than traditional hedge fund investments, but more liquid than traditional closed-end fund investments. By taking advantage of the variety of terms offered, a fund manager can launch a hybrid fund that provides all of the necessary tools to manage the fund while meeting the needs and expectations of investors.

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