IQEQ & Proskauer

Guide to Hybrid Funds

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What are hybrid funds?

Hybrid funds are private investment vehicles that have attributes of both hedge and private equity funds. Hybrid funds may combine the illiquid investment strategies associated with closed-ended private equity funds with the liquidity and hedging strategies of open-ended hedge funds, offering investors the diversification that comes with exposure to both public and private investments.

Hybrid funds can provide exposure to a wide variety of liquid and illiquid asset types, including publicly listed, unlisted or over-the-counter (OTC) equities, real estate, infrastructure, derivatives, distressed debt, private credit and collateralised loan obligations (CLOs). Depending on a hybrid fund's structure and terms, it can also offer investors the opportunity to withdraw and add capital on an ongoing basis, or at specified intervals.

Background and history

Hybrid funds offer managers the flexibility to invest in a range of assets and to offer various liquidity structures to their investors. Though not a new phenomenon, hybrid funds gained in popularity after the 2008 financial crisis and are becoming increasingly popular. One trend is hedge fund managers seeking exposure to credit and other instruments, which may be less liquid than equities, and pursuing longer-term, more concentrated strategies to supplement their primary investments. Alongside this shift, private equity and credit managers have continued to look for new sources of capital and a broader investor base through offering open-ended vehicles providing more liquidity than the traditional closed-ended fund.

With the investor landscape becoming increasingly competitive, and with sophisticated investors expecting the liquidity of their fund investments to match the liquidity of the fund's underlying investments, funds are looking for ways to innovate and offer investors more choice, flexibility and returns. To do this, an increasing number are launching hybrid funds, which may offer a more diversified portfolio across asset classes and returns profiles and flexibility for investors around liquidity options, compared to a closed-ended private equity fund or an open-ended hedge fund.

Categories of hybrid funds, and how they differ from other offerings

Hybrid funds can be 'hybrid' in terms of the investments they hold, from an investor perspective, or the withdrawal or liquidity terms they offer investors – or a combination of the two.

With investments, hybrid funds differ from traditional vehicles in that they can hold more than one type of asset; for example, a hedge fund manager may launch a hybrid fund to target high-yielding illiquid distressed debt alongside more traditional listed equities. This offers managers a much greater level of flexibility, and the ability to make investments in two or more asset classes from the same fund. Hybrid funds may also be used by managers focused on a single investment or theme, including seeking to "lock up" capital from investors for a longer period of time in the event of a restructuring, proxy contest, or other activist investment strategy.

The capital commitment and distribution process in hybrid funds can differ from that in both traditional open-ended liquid hedge fund structures and closed-ended fund structures typical of alternative assets. Traditionally, hedge fund managers looking to avoid selling assets at inopportune times or at distressed prices when a large percentage of investors request withdrawals must employ tools such as redemption suspensions, gating and side pockets. Meanwhile, investors in closed-ended alternative funds traditionally only receive distributions once the fund sells its assets towards the end of its lifecycle. Other than selling a stake in the fund on the secondary market, most likely at a discount, there is no mechanism for investors to access early liquidity in these funds.

Hybrid funds can be structured to permit investors to withdraw at regular intervals, on specified dates, or upon the occurrence of specified events, avoiding the liquidity issues listed above by offering investors liquidity options best suited to the assets held in the fund. Managers have a great deal of flexibility when setting redemption options, which can be tailored to the liquidity profile of the underlying assets in the initial stages of a fund's life, and investors can select the most appropriate liquidity option for their needs.

Evergreen funds

In an evergreen fund, returns from realisations are recycled back into the fund to finance new investments rather than distributed to investors, unless an investor elects to become a liquidating investor and receive distributions upon realisation of investments.

Open-ended/semi-open-ended funds

Open-ended hybrid funds also have no closing date, but distribute the capital returned after realising investments to investors. Semi-open-ended funds sit between open- and closed-ended funds, in that they may have a closing date, but also extension periods, and the ability to re-invest and to admit new investors under certain conditions.

The advantages of hybrid funds

Hybrid funds offer several distinct advantages over more traditional investment vehicles, both for investors and managers. First and foremost, managers are offered a great deal of flexibility in structuring a fund tailored to specific investment goals, enabling them to avoid issues that more traditional hedge fund or other alternative investment structures can face.

Search for yield

The prevailing low interest rate environment since the financial crisis has meant that investors searching for yield have had relatively few options. Managers are under pressure to offer access to wider investment opportunities that provide better returns, and hybrid alternative funds are a good way to do this. They offer access to the returns offered by alternative investment strategies, combined with stable cash flows and more predictable liquidity, and so can be very attractive to yield-starved investors. This low-yield environment has also prompted a cultural shift among investors, with many recognising the benefits of committing capital to longer-term vehicles and becoming comfortable with forgoing liquidity in exchange for returns.

Flexibility in Investment holding periods

The liquidity options built into a hybrid fund can offer solutions to complex problems that closed-ended funds face when holding assets at the end of a fund's life. Managers in this situation can either exercise extension periods, typically only two years, or establish a continuation fund to house any remaining assets, which entails significant additional cost and having to balance the needs of current investors that are exiting, those rolling over into the new fund, and new investors. Historically, open-ended funds have also faced challenges when the duration and liquidity of the fund is not closely matched to that of its underlying assets. When this happens, managers can be forced to sell assets at distressed prices or implement indirect solutions such as side pockets and redemption suspensions to avoid a fire sale.

Hybrid funds can be structured to include mechanisms that offer managers flexibility around providing liquidity to investors. Open-ended or evergreen hybrid funds are under no time pressure to sell assets, and, unlike in a private equity fund, investors are free to redeem their capital at any point that the redemption terms of the fund allow. Other liquidity mechanisms in hybrid funds can allow managers to raise further capital for the fund, or to offer the option for investors to redeem capital without the manager having to sell an asset at the wrong time.

Time efficiency

In recent years, private equity managers have looked for ways to expand their options beyond a closed-ended fund, both to avoid having to spend a great deal of their time fundraising every three or four years, and to give themselves more options for dealing with portfolio companies at the end of a fund's life and avoid having decisions to sell assets dictated by the time-limited structure of the fund. Launching a single fund can allow a fund sponsor to save on costs and effort (including organisational and fundraising costs and the onboarding of service providers) involved with launching multiple sequential closed-ended funds.

The flexibility of hybrid funds – for example, structuring a private equity vehicle as an open-ended hybrid fund with new capital commitments from time to time and a lock-up period enabling investors to redeem capital at set intervals – can provide a more permanent source of capital and allow the fund to be marketed on a permanent basis, avoiding the typical process for closed-ended funds of fundraising only when a new fund is being marketed.

The challenges of managing a hybrid fund

The non-standard nature of hybrid funds presents several challenges when it comes to their management. Holding different types of assets, each with different fee structures, adds considerable complexity. The liquidity offered to investors must be matched as best as possible to the cash flow profiles of the underlying assets and managed to ensure that redemptions do not cascade into a run on the fund, which may be difficult. Furthermore, accounting and reporting requirements for hybrid funds place an additional burden on a manager's operations.

Fee calculations

Hybrid funds can tailor fees based on investor preferences, types of structures and underlying assets. A management fee may be charged based on a combination of a percentage of the fund's net asset value (NAV), its invested capital or its committed capital. A hybrid fund may utilise a hedge fund style incentive fee or allocation, typically payable annually as a percentage of both realised and unrealised gains on a "mark-to-market" basis (often subject to a high watermark or a loss carryforward), or a private equity style carried interest, payable upon the realisation of gains and the distributions of net proceeds to investors. Hybrid funds allow a blending of these features.

In addition, it is common for hybrid fund managers to offer a range of fee and liquidity structures, enabling investors to choose the one that best suits their preferences. Examples include a higher management fee with a lower performance fee; a range of hurdle rates structured as either a "hard" hurdle (where the performance fee is collected on only that portion of the return of the portfolio that exceeds the hurdle rate) or, less commonly, a "soft" hurdle (where the performance fee is collected on the entire return of the portfolio as long as the return is greater than the hurdle rate); and lower management fees and/or profit allocation for a longer capital lock-up. In addition to this, managers can offer different share classes that give investors the ability to opt into, avoid, or gain greater exposure to a certain asset class or investment opportunity.

Hybrid fund managers must address how any side pocket or co-investment fees are balanced to make sure all investors in the fund feel that the fees they are charged are equitable, and ensure that underlying fees, such as administration and brokerage fees, are allocated fairly across investors if they only apply to a subset of assets in the fund.

When considering liquidity options for a hybrid fund, managers must consider the need for equalisation of shares for new or exiting investors, as there is the potential for large discrepancies between early and later investors when additional capital is raised after the fund has been operating for several years. The net effect of offering such flexibility of fees to investors is that the fee calculation for each investor in the fund may be unique, and the waterfall calculation may become very complex.

Flexibility on fees presents increasing challenges when it comes to administrating the fund. Much of this work for hedge funds holding liquid assets is automated, whereas for illiquid assets, capital calls, valuations and other administrative tasks are typically performed manually. A fund housing both requires an administrator to be able to reconcile the two quickly and efficiently.

Gating and lock-ups

Funds with fewer liquid assets need to incorporate mechanisms to ensure that the liquidity of the fund matches as closely as possible the liquidity of the underlying assets and that the manager is not left with insufficient funds to invest should investors choose to withdraw their capital.

One method of doing this is with lock-up periods, which are common in open-ended vehicles and consist of set periods of time during which investors are unable to withdraw capital. The length of these generally depends on the liquidity of the underlying assets and investment strategy, and it is not uncommon to see different classes being set up with different fee arrangements, so investors opting for the longer lock-up period receive a higher fee discount than those choosing the option to redeem sooner. A "hard" lock-up provides that an investor's capital may not be redeemed for a set period of time (often between six months and two years), and a "soft" lock-up permits redemptions during the lock-up period, subject to a redemption fee, typically 2-5% of the amount redeemed.

Another way for managers to structure these is as rolling lock-up periods, where if investors choose not to redeem at the end of a lock-up, they are automatically rolled into a new period.

Another tool that enables the manager to control fund outflows is the use of gates, which limit redemptions from a fund, usually by reference to either the NAV of the fund, a fund-level gate, or the NAV of an investor's holding in the fund, an investor-level gate. Typically, a gate would prevent an investor from withdrawing more than 25% of either the fund's NAV (in the case of a fund-level gate) or the NAV of their investment in the fund (in the event of an investor-level gate) on any given dealing day. Gates are used to avoid a situation in which the fund is forced to sell a significant portion of its assets below their intrinsic value, to the detriment of all its investors, should a large investor opt for liquidity that the manager can only provide by selling assets at the time of the request. They also help avoid concentration issues, where non-redeeming investors are left holding less-liquid assets after more liquid ones have been realised to meet redemption requests.

Investor-level gates are more common, as they align investor behaviour with the long-term nature of the fund's investment strategy. They also avoid the pitfalls of fund-level gating; during the 2008 financial crisis, fund-level gates encouraged investors to submit standing redemption requests to avoid being the last investors left in the fund and holding its least liquid assets. Where these deferred redemption requests were given priority to new ones, it encouraged a run on the funds in question.

Reporting requirements

Housing liquid and illiquid assets in the same fund can create a significant reporting burden for managers as investors want access to transparent, timely and customised information, often mandated by regulatory requirements. The mixing of publicly listed assets and private, hard-to-value securities requires complex accounting techniques and significant back office infrastructure in order to calculate accurate NAVs on a regular basis, as well as tracking distributions and allocations, for example.

Hedge fund or private equity fund managers launching hybrid funds that will house assets outside their traditional space must be aware of the additional regulatory requirements that this entails, and ensure they have support in place to meet these.

Structures and domicile

Structuring considerations

Capital commitments and contributions

In a typical closed-ended fund, investments may only be made in a specified fundraising period (typically, 12 months from the first closing), where investors pay the cost of investments and an interest charge when they make their commitment. Hybrid funds, however, may permit new capital contributions on an ongoing basis. New capital commitments may be accepted in full or drawn down over time in a private equity style "capital commitment" structure. A hybrid fund may use a line of credit tied to the fund's capital commitments to make investments if subscription monies have not yet been received. As such, a fund may participate in investment opportunities when they arise, rather than waiting for investors to make capital contributions pursuant to a drawdown notice or waiting until a later subscription date.

A hybrid fund may be structured to address a material change in the fair market value of the fund's underlying portfolio investments after the initial closing but before the final closing. Instead of treating later-admitted investors as if they invested at the first closing, which may raise "last look" fairness issues for those earlier investors, a hybrid fund may adjust the capital account balances of existing investors to reflect the fair value of the fund's underlying assets as of any later closing date on which new capital contributions are accepted. A hybrid fund may also be structured to limit investors in later closings so that they only participate in new investments made at or after the time of their investment.

Withdrawals

A hybrid fund may be structured to give investors different withdrawal options at different times. Those withdrawal options may be achieved using any combination of slow pay provisions, withdrawal capital accounts, in-kind distributions, side pockets and suspensions.

A hybrid fund manager may use a "slow pay" provision to segregate a withdrawing investor's proportionate share of an illiquid investment and, rather than being forced to sell the asset prematurely, wait to realise the illiquid investment over time as it sees fit and distribute the net proceeds afterwards. A slow pay provision locks in the withdrawing investor's percentage share of the illiquid investment as of the withdrawal date. The provision is only invoked upon a redemption and only affects the withdrawing investor.

A hybrid fund may instead use a "withdrawal capital account", which is similar to a slow pay provision and allows a fund manager to segregate a withdrawing investor's "vertical slice" proportionate interest in each of the fund's underlying investments as of the withdrawal date. A hybrid fund manager may pay some redemption proceeds in cash as of the redemption date and segregate the remaining investments in a withdrawal capital account. In both the slow pay and withdrawal capital account scenarios, the investor bears the risk of

future performance of the investments in the withdrawal capital account until they are realised.

A hybrid fund may distribute illiquid investments in kind to satisfy a withdrawal request. If an investor does not want to receive distributions in kind, the fund may offer to sell the investment on the investor's behalf and to distribute proceeds to the investor. Alternatively, a manager may use a liquidating special purpose vehicle (SPV) to satisfy a withdrawal request, in which case an investor would be distributed shares in the SPV and only receive cash once the assets are sold.

A hybrid fund may utilise "side pockets", which segregate certain illiquid investments from the fund's liquid portfolio. An investor invested in a side pocket will have its participation percentage "frozen" with respect to the side-pocketed investment as of the date it is side-pocketed. An investor may not redeem its interest in a side-pocketed investment; upon realisation of the investment, the net proceeds are paid out and distributed to the investors investing in the side pocket. Side pockets provide flexibility, as a manager may side pocket an investment at any time for all or certain investors, including before a redemption date to segregate illiquid assets that the manager does not believe can or should be sold to satisfy redemptions.

Side pockets are becoming a more popular option again after falling out of favour in hedge funds for several years. It is not uncommon for side pocket participation to have either a fund-level or investor-level cap and/or to be at the option of the investor (such election to be made at the time the investor makes a capital contribution). Neither the cap nor the option to participate, however, would typically apply to an investment that was not initially side-pocketed but was subsequently designated a side pocket (i.e. because it became illiquid). Each investor in the fund at the time the investment is designated a side pocket typically would be required to participate in the investment, regardless of whether the fund-level or investor-level cap were exceeded or the investor had opted out of participating in side pockets.

Upon certain events (including an exchange closure, difficulty in determining an underlying investment's valuation, or if the disposition of investments might not be practical), a hybrid fund can permit the fund manager to temporarily suspend the right of investors to withdraw capital. A manager will generally suspend withdrawals only as a last resort.

Valuations

Hybrid fund structures with ongoing subscriptions and withdrawals must determine the fund's NAV as of any subscription or withdrawal date. For any assets that are difficult to value on any such date, a fund may permit valuations based on formulaic ("mark-to-model") valuations or on periodic third-party valuations, which typically occur semi-annually or annually. A manager should be aware that a hybrid fund structure may not be viable if it is too difficult to value a significant portion of the fund's investment portfolio on a regular basis.

Domicile

Hybrid funds also bring with them unique challenges when it comes to choosing where they should be domiciled, and managers must carefully consider the pros and cons of each jurisdiction when choosing a suitable domicile. Central to these concerns is the requirement of investors for jurisdictions that are well regulated, politically stable and which offer tax-efficient structures – and the fact that this is a decision with long-term consequences.

The U.S.
Based on long-standing custom, hybrid funds domiciled in the U.S. are typically structured as Delaware limited partnerships, mainly due to the tax efficiencies offered by a "pass-through" entity, the quality and business expertise of Delaware judges, and the relatively well-established legal framework created by Delaware's limited partnership law, which provides fund managers with certain structural and operational advantages.

Cayman Islands
Despite recently heightened regulation of private funds in the Cayman Islands, the Cayman Islands remains the preferred hybrid fund domicile for Asia-based hybrid fund managers, either in the form of an exempted limited partnership or exempted limited company (i.e. a corporation). This is due to manager/investor familiarity with the common law jurisdiction, the well-established legal framework for private funds, which provides certain structural and operational advantages relative to other jurisdictions, and certain tax efficiencies.

Parallel or other vehicles may need to be established in order to accommodate investors from other jurisdictions or for other tax, regulatory or legal reasons.

Europe and the U.K.
Most of the commonly used European and U.K. fund domiciles can be, and are, home to hybrid funds. Common fund structures include the Luxembourg special partnership (SCSp) – with or without a Reserved Alternative Investment Fund (RAIF) wrapper – as well as the English, Jersey or Guernsey limited partnership, the Jersey or Guernsey protected cell company, and the Irish Collective Asset-management Vehicle (ICAV).

The choice of fund domicile will depend on the factors common to private funds of all kinds, such as the compatibility of the local tax regime with that of the fund's target countries, the ease (or otherwise) of the local regulatory climate, and investor familiarity and sentiment. Equally, the Alternative Investment Fund Managers Directive (AIFMD)'s marketing regulations and the equivalent U.K. regulations do not distinguish between hybrid funds, whether fully or semi-open-ended, and standard closed-ended funds.

Considerations for running a hybrid fund

The complexities involved give rise to several considerations when it comes to the set-up and day-to-day running of a hybrid fund. Chief among these is the need for an ecosystem of support service providers with the skills and experience to tailor their services to the specifics of a manager's hybrid fund structure.

Legal

Lawyers supporting hybrid fund managers need to ensure that the fund mechanisms, share classes and capital allocations are detailed appropriately in the fund's documentation, and that potential regulatory, fiduciary and compliance issues, as well as any conflicts of interest, are mitigated and managed appropriately.

Accounting and administration

Hybrid fund accountants must be flexible enough to adapt to the requirements of liquid and illiquid assets, and to deal with the complexity of accounting records that this entails. Multiple valuation periods, non-standard cash flows and allocation rules across the structure can add considerable further complexity to fund accounting.

Fund administration expertise is also crucial when it comes to hybrid funds. Managers need administrators to provide knowledgeable and thorough guidance when setting up a fund, and ongoing accounting, NAV and fee calculations, regulatory reporting and investor servicing. The ability and experience to combine both traditional closed-ended private equity administration with open-ended liquid funds is critical in ensuring investors are treated fairly and the objectives of the fund are fully understood.

Find out more

Whether you are a debt fund manager, a family or corporate office restructuring international investments, or a private equity firm looking to expand your investment opportunities, IQ-EQ's Global Private Debt and Credit Desk can help with our experience, technology and global reach.

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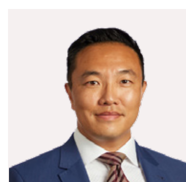

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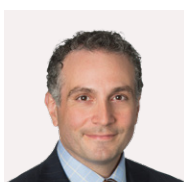

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