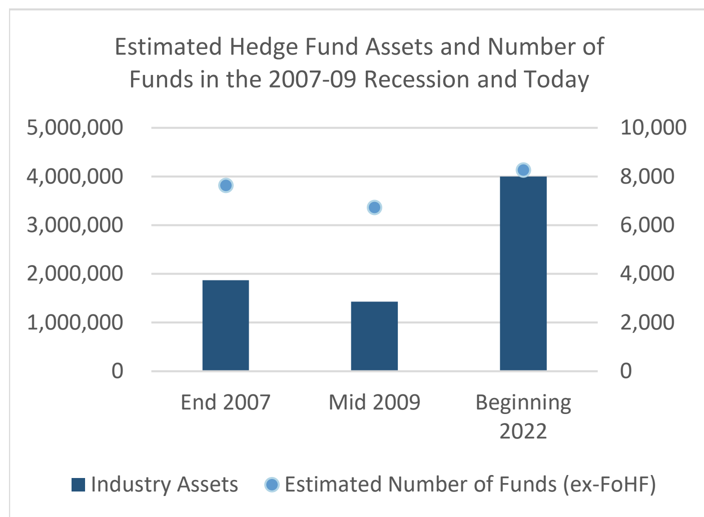
Capital Raising in a Recession:

Attracting Assets In Volatile Environments

For the first time since 2009, managers and decision makers **are planning for a capital raising environment against a potentially recessionary backdrop.** It's been more than a decade since the recession of December 2007 – June 2009, but with many anticipating a recession in the next two years (or sooner!), navigating volatile capital raising waters has become top of mind for many.

History tells us the path to raising and retaining assets in recessions can be a challenging, but not necessarily futile endeavor. Here we explore the experiences of prior recessionary periods, how managers are responding *now*, and how some are planning for the potentially challenging quarters ahead.



Source: HFR

WARDING OFF AN 'ATM EFFECT'

In the 2007-09 recession, funds experienced outflows of nearly **$330 billion**, or nearly one-fifth of total industry assets.

That's a lot of assets.

The majority were redeemed in the third and fourth quarters of 2008 following the collapse of Lehman Brothers before rebounding to positive inflows in the third quarter of 2009, *after* the recession ended in June.

Many of those assets were redeemed by allocators who needed to satisfy other expenses, or from funds of funds – about 400 of which closed between 2007 and the end of 2009.

This time, managers are studying their LP base, revisiting liquidity ladders and stressing scenarios to understand how vulnerable their capital is in any given quarter. They have also worked to pre-empt redemptions by strategically structuring share classes.

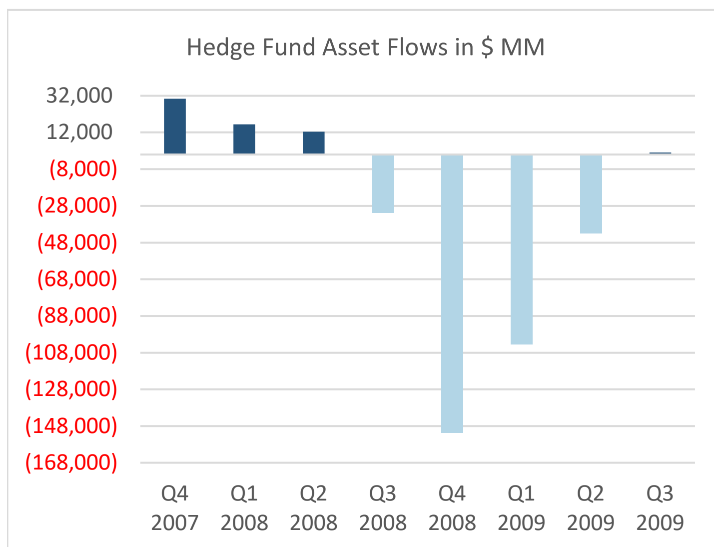
But they are also leading with their front foot – identifying potential partners, revisiting asset pipelines and ensuring dialogue with current LPs is robust, consistent and proactive.

AVOIDING OUTFLOWS: UNDERSTANDING ASSET BASE VULNERABILITIES AND OPPORTUNITIES

The sea of red from 2008-09 below is precisely what decision makers are working to guard against. Even without a catalyst like the Lehman unwind, managers are thinking strategically to learn from history and stave off unnecessary outflows.

In many ways, redemptions are unavoidable. Allocators may redeem for reasons as diverse as harvesting some of the gains they've earned, a broader portfolio review and realignment, the need for liquidity, or underperformance of a manager, among others.

Thoughtful managers often have a general plan or approach to minimizing or replacing redemptions. In more volatile times – these strategies take on even greater importance.



Source: HFR

What is clear is the importance of a diverse LP base **must come into play *during*** asset raising and replacement stages, not after.

With assets clustered in **nearly the same number of managers, but across twice as many assets is if similar patterns ever repeat (~17% of industry assets in outflows), the pain would be more concentrated than 2008-09 and result in up to $*680 billion in potential outflows.***

So – what's important in *this* era?

Key Considerations from Allocators Writing Tickets in 2H2022

The Jefferies Capital Intelligence team surveyed nearly 80 global allocators who intend to put pen to paper and write tickets in the second half of 2022. While we don't know when – or even *if* – the U.S. economy will head into a recession, we wanted to check the pulse of those who are actively writing tickets in a year with headlines reflecting challenges in nearly all corners of the market.

We spoke with funds of funds, family offices, pensions, endowments and foundations, bank platforms and RIAs. While there is little unanimity around the drivers of and strategies behind these allocations, some common threads do appear.

1. **Your Next Dollar May Come From the Same Place As Your Last Dollar.** Many allocators who are writing tickets in the second half of the year are reunderwriting managers already in their portfolio – especially in dislocated markets like healthcare or biotech. Are your current LPs looking to deploy more capital with managers they already know and trust? It's worth asking the question.
2. **Co-investments and SPVs May Be Attractive to Some in Highly Volatile Markets**. Market volatility has meant gross exposures have ticked down towards decade lows. On the one hand, this has allowed a number of managers to protect on the downside. On the other, it has posed a tricky conundrum for allocators – if some of the most successful managers in this market have achieved this by going to cash…why write an incremental allocation if your assets will sit in cash, but be charged a management fee? By contrast, SPVs and co-investments can offer an attractive option for allocators wanting to act nimbly, but only have fees charged off of the called capital. However, many co-invests are long only, which as we note later, are less popular with some allocators after years of inflows.
3. **Funds of Funds, Bank Platforms and RIAs as Potential Partners and Sources of Capital in Redeeming Markets**. In times of heightened redemptions, new capital either comes from current LPs who want to add exposure - or new partners. At the top of the *new* partner list should be allocators whose entire portfolio is comprised of alternatives funds (funds of funds), or those whose business model thrives on offering new and differentiated products to end clients (platforms or RIAs).
4. **After A Period of Considerable Demand, Long Only Funds Are Now Hit…or Miss**. Of the nearly 80 allocators we surveyed, fewer than five said they were planning on allocating to a long only fund. Each of these allocations is going to a different *type* of long only strategy. *But*, this is often as a result of allocations in the last few years and prior rotation/allocations into long only products.
5. **ESG Demand is Currently Muted**. Only one of the allocators surveyed is preparing to write a ticket to an ESG or sustainability fund, and this will be a closely watched space after the fervor of the last few years. This doesn't mean appetite has entirely evaporated; rather, we anticipate those writing tickets to ESG/sustainable managers may be taking additional time around due diligence and reference checking given heightened regulatory scrutiny.
6. **Hard Closed Means Soft Closed and Soft Closed Means Open**. Funds' pipelines have taken on new relevance. Review your pipeline with the same strategic lens as you do your current LP base. Are there some potential partners who are more vulnerable to inflation and rising rates? Could your products become *more* relevant to some portfolios…or less?
7. **A Matrix of Share Class Options Could Make It Easier for Potential Partners to Invest.** There are two themes that are converging – one is that a number of allocators have spent the last decade not *truly* understanding what they own and what the liquidity profile of their broad portfolio is. The second is a growing willingness of managers to offer multiple share classes to better align the product offering with their partners' needs. This greater optionality allows the allocator community more choices in accessing products that could be a fit for their needs.
8. **Marketing Is Not Just Generating New Relationships – It's Further Monetizing Current Ones.** Especially given the next incremental dollar could be coming from a current LP, the cost of *getting* that dollar could be less than earning a new one.
9. **Customization Remains Key**. Given expectations around potential heightened volatility in the coming quarters, LPs are increasingly looking to funds to help provide solutions to them for various challenges in their portfolios, whether a cash management tool, hedged exposure to a specific market, or others.

STRATEGIC REVIEW OF CAPITAL RAISING AND RETENTION EFFORTS

In times of heightened volatility, it is important for managers to review their workflow and processes for raising and retaining assets.

Review your current LP base and your pipeline. This serves multiple purposes, among them:

- In the current environment, who is most likely to redeem, and who is most likely to add?
- Which partners are sensitive to inflationary environments and rising rates?
- Are we overconcentrated in one allocator vertical?

Review and enhance your communication efforts. Much has changed in the last six months, and in periods of transition and volatility, nothing beats regular and transparent communication with all partners and potential partners. Is it worth engaging with a third party to better understand your performance and what's happening in broader markets? Should you ramp up meetings, calls, videos or podcasts? How can you ensure your firm stays front and center to talk through not just *your* book, but what may be happening in the market more broadly? Is this an opportunity for your firm to be seen as a thought leader?

Consider a new share class. Would giving potential LPs (or those adding!) additional liquidity or pricing options allow more flexibility to allocate? In a transition environment, products that were priced a certain way or had specific liquidity profiles may be less relevant.

Think about incubating new products. Volatile or recessionary periods are sometimes regarded as a *better* time to launch a company than in high flying economic years. Would now be a good time to incubate a new internal strategy to take advantage of dislocations? Could the market's transition be a good thing for a differentiated investment strategy?

Lead from the front foot. This is the one of the first transitionary periods for most asset classes in more than a decade. As investors endeavor to grasp what is happening in the broader market and position accordingly, there are considerable opportunities to shore up support from partners, identify new partners, and build out the firm's asset ecosystem in general.

Know how your fund is perceived in the market. Perceptions change, people change, markets change. It is important for funds to check the temperature in different environments and over time to ensure perception in the market aligns with funds' performance, culture and success.

BASIC ASSUMPTIONS HAVE CHANGED

The competitive landscape has fundamentally changed, leading managers to rethink their approaches to developing and sustaining their partners.

Among the shifts:

- **Third party data solutions are becoming more common** as firms look for ways to better decompose performance, understand which analysts and PMs are truly outperforming, and communicate these facts to LPs and potential LPs.
- **Transparency is not just best practice anymore – it is standard.** After decades of operating largely in obscurity, managers need to respond to demands for transparency from LPs, regulators and counterparties. Those who are less transparent can have a harder time raising and retaining assets. Allocators cite lack of transparency as a driver of redemptions – not just performance.
- **The competitive landscape is being shaped by shifts in communication norms.** Improved reporting tools, enhanced data and analytics and new mediums of communication are all converging to elevate how managers dialogue with LPs. Audio, video and data visualization tools are all being leveraged to keep partners abreast of changes in the portfolio or views on market moves.
- **New skills in demand are enhancing IR/marketing teams.** As managers work to stay ahead of competitors and attract and retain new assets, content specialists, former journalists and data visualization experts are all increasingly sought to round out next generation marketing and IR efforts.
- **LPs have gotten more sophisticated, with more complex needs, and the marketing/IR function has responded.** Funds need to understand their strategy's performance and statistics and where it fits into various portfolios. This has happened as marketers and investor relations professionals have worked to improve their return on time across the fundraising lifecycle.

How Jefferies Can Help

The Jefferies Capital Intelligence team has recently done studies on capital allocation for the second half of 2022, strategic share class construction, developing alternatives platforms in recessionary environments, and deep dives on multiple allocator verticals.

This research allows a unique vantage point for understanding the nexus between allocators and investors during a time of global economic transition. The trends of the last decade or more are shifting, leading to new best practices and opportunities for firms to solidify and expand their partnership base.

A similar number of funds are today managing nearly twice the assets they were in 2007. This has fundamentally reshaped the competitive landscape and strongly factors into how firms are strategically thinking about how to take their firms into the coming years.

If we can advise on any of the following topics, we welcome your inquiries and opportunities for collaboration:

- Allocator appetite in 2022 and beyond
- Strategic reviews of allocator base by timing, size and vertical
- Revisiting communication models and opportunities for expanding your messaging
- Understanding strategic share class construction

We look forward to working with you.

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