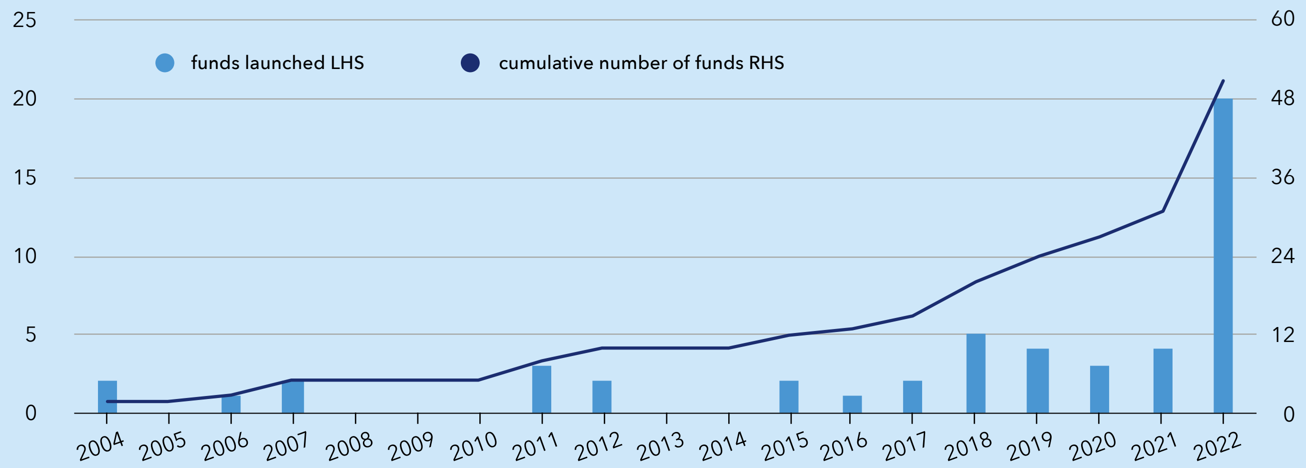
Article

EVERGREEN FUNDS: A NEW PARADIGM FOR INVESTMENT IN PRIVATE MARKETS

Recent years have witnessed the fast growth of the open-ended or evergreen fund structures in private markets. According to an analysis published by Bfinance[1], more open-ended funds were launched in 2022 than in the preceding five years combined.

FIGURE 1: **EVERGREEN FUNDS LAUNCHED**



LHS: left hand side RHS: right hand side Source: BFinance

Evergreen funds: a flexible investment tool

Evergreen funds are gaining traction among limited partners (LPs), as these vehicles provide a higher degree of flexibility compared to closed-ended structures. As open-ended funds are constantly raising capital, investors can choose to add to their position over time. In the same spirit, investors can also adjust positions, if needed, as part of a more dynamic asset allocation, in private markets.

Open-ended structures allow LPs to hold well-performing assets for a considerably longer period than is generally possible with closed-end funds, which have a finite life. Furthermore, given that an evergreen fund has no terminal date, the risk of the fund having to make a future sale of all holdings at a discounted valuation is minimised. However, open-ended funds carry the risk that certain assets may have to be sold for liquidity provision during the lifetime of the funds, especially when holding concentrated portfolios, which is a key concern to investors.

1 BFinance. (2022). The explosive growth of open end funds. [Online]. www.infrastructureinvestor.com. Available at: https://www.infrastructureinvestor.com/the-explosive-growth-of-open-end-funds/ [Accessed 28 February 2023].

What has driven the debate versus closed-ended funds?

Historically return realisation, liquidity availability, and transaction costs, have driven the debate between open and closed-ended designs. All of these points, however, in my view can be reduced and even outweighed by substantial benefits

Returns realisation

While closed-ended funds need to liquidate their investments towards the end of their lifespan, open-ended funds can hold their assets in perpetuity, making more challenging for LPs to predict when they would realise returns on their investments. However, definite fund terms can offer investors an efficient balance between reinvested capital and shareholder remuneration (i.e. distribution of ordinary and extraordinary dividends).

Matching liquidity

Historically, the nature of the underlying assets determined the choice of fund vehicle, with open-ended structures being the choice for liquid assets and close-ended structure typically being the preferred vehicle for illiquid portfolios. However, there are various mechanisms that an open-ended fund can incorporate to provide a managed liquidity profile matching the illiquidity of the underlying portfolio such as initial lock-up for portfolio ramp-up , adequate redemption notice periods, gateing mechanism (restrictions to redemptions from a fund), matching outflows and inflows, as well as deferring redemptions.

Transaction cost efficiency

An additional concern relates to the transaction costs borne by long-term investors when fresh capital is drawn into the fund. A study performed by Willis Tower Watson (WTW) showed that acquisition costs payable by long-term investors in open-ended, unlisted real estate funds using the amortisation method, could be more than double compared with vehicles using the offer-spread method[2].

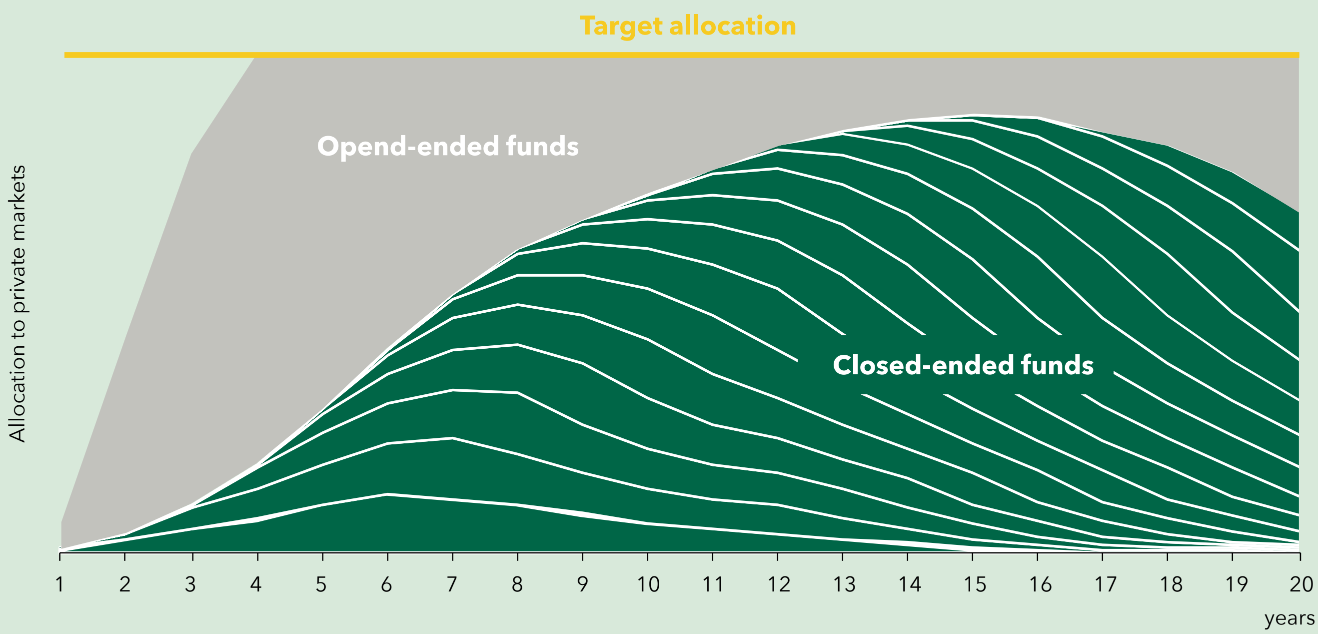
The difference between the two methods is that the offer-spread method applies the costs of investing new capital only to the investor whose new capital is being invested. On the other hand, the amortisation approach distributes the expenses of investing fresh capital proportionally among all investors. Technicality aside costs discrepancies can be alleviated with equalisation, or catch-up mechanisms. The amortisation technique, on the other hand, divides the costs of investing new capital proportionately across all investors.

As most concerns can be alleviated, investors should focus on the compelling advantages

While, most of the aforementioned concerns may be relieved with specific fund terms, open-ended structure do provide investors with compelling advantages, including, but not limited to, better liquidity terms, higher visibility of the underlying portfolio, and better cost alignment.

2 Marketscreener (2016) Available at: https://www.marketscreener.com/quote/stock/WILLIS-TOWERS-WATSON-PUBL-25623167/news/Willis-Towers-Watson-Investors-in-real-estate-unlisted-funds-paying-over-double-what-they-should-b-21904772/ (Accessed: March 1, 2023).

FIGURE 2:
COMBINATION OF CLOSED AND OPEN-ENDED FUNDS CAN ALLOW INVESTORS TO REACH DESIRED PORTFOLIO ALLOCATION TO PRIVATE MARKETS



Highly liquid

Limited partners who invest in closed-ended funds are generally barred from withdrawing their money from the fund until the end of the term with some exceptions such as transfers or secondary trades (that have been authorised). On the other hand, with an evergreen structure the fund manager can raise funds in perpetuity and allow investors to inject or redeem capital, subject to customary notice periods and liquidity management mechanisms (i.e. initial lock-up period, redemption/withdrawal notice, gate mechanism preventing forced sales). Despite some limitations, these better liquidity terms facilitate an LPs ability to reach desired portfolio allocations through increases or reductions in their fund commitments.

Clear visibility

Traditional closed funds may have a 10-year term (with the possibility of extension option), and for the initial 12-18 months, the fund manager will raise new capital for the fund. If structured as a blind-pool (without a seed portfolio), investors' commitments will be put into work only when a new investment opportunity arises, which could take up to several years. Conversely, investors buying into existing evergreen funds are immediately exposed to a diversified portfolio of assets with, arguably, a quicker capital deployment, avoiding blind pool risk.

Cost alignment ...

Closed-ended funds typically charge management fees on committed capital in the beginning and on invested capital later on. In contrast, open-ended funds generally charge management fees on NAV, in other words, only when investors' money is put to work.

...while escaping J-curve

Moreover, by investing in a yielding portfolio, investors can escape the so-called J-curve, prevalent in closed-ended structures. This phenomenon occurs because close-ended funds often generate negative returns in the early stages of their investment periods, partially because they charge management fees on unfilled commitments and partially because they do not, yet, contain mature assets yielding positive returns. This benefit of open-ended structures allows lower volatility in the return profiles of investors.

Long term investors can hold onto valuable assets

An evergreen fund's indefinite lifespan allows long-term investors to hold onto valuable assets. This is particularly crucial when investing in long-maturity, income-generating assets like infrastructure and real estate.

Arguably, income-oriented strategies are a natural match for open-ended structures, as they allow investors to have greater flexibility in tailoring the timing of their investments (acquisitions and disposals) based on market circumstances or their own investment needs. More importantly, investors will avoid forced asset sales at the fund's fixed terminal date, which, in adverse market conditions, could negatively impact fund returns.

As versatile instrument to investors should keep on gaining traction

Overall, an open-ended structure provides investors with a versatile and complementary investing instrument. Investors may gain compelling benefits such as reaching and maintaining a targeted allocation owing to improved liquidity conditions, lowering blind-pool risk, and enhancing cost alignment with J-curve reduction, among others.

Open-ended funds, in particular for income-oriented investment strategies such as infrastructure and real estate, provide for the retention of the most valuable assets while timing market opportunities. As a result, we should expect that the evergreen structure will continue to gain traction among LPs and will eventually establish a new paradigm for private market investments.

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