The Frontier Line

Accessing private markets through evergreen funds

Issue 229 | December 2024

frontieradvisors.com.au

Frontier Advisors
Forefront Thinking

About us

Frontier Advisors has been at the forefront of institutional investment advice in Australia for thirty years and provides advice on more than $700 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Our purpose is to empower our clients to advance prosperity for their beneficiaries through knowledge sharing, customisation, technology solutions and an alignment and focus unconstrained by product or manager conflict.

Tom Bernard
Consultant

Tom is a Consultant at Frontier Advisors, with over seven years' experience in the finance/investment industry. He joined Frontier in May 2024 as part of the specialist defensives and alternatives research team and has a combination of both research and client consulting responsibilities. He currently provides investment advice to a range of Frontier clients, as well as undertaking manager and investment research as it relates to client portfolios.

Prior to Frontier, Tom spent five years at Zenith Investment Partners where he was a member of the investment committee of several large advisory practices across Australia, presenting macroeconomic research, portfolio analysis, performance attribution and recommendations. He was also involved in internal asset class review process as the designated consulting lead for alternatives, fixed income and private market asset classes, including manager/fund selection, asset allocation decisions and research projects. Tom also has experience as an Investment Officer at CCI Asset Management.

Tom holds a Bachelor of Commerce from the University of Melbourne with majors in Finance and Economics. He is also a CFA Charterholder and a member of the CFA Society of Melbourne.

Frontier Advisors

Introduction

Historically, it has been difficult for certain investors to gain exposure to private markets (such as private debt and private equity), which can offer a number of portfolio benefits including the ability to harvest an ‘illiquidity premia’.

With the advent of evergreen structures, a wider range of investors now have the opportunity to access private market strategies through more efficient structures (rather than via mandates), effectively allowing for the ‘institutionalisation’ of their investment programs.

Evergreen funds, also known as open-end, perpetual capital and semi-liquid funds, offer investors a flexible and efficient means to gain exposure to private assets. Unlike closed-end funds with fixed lifespans, evergreen funds by design continue indefinitely, therein providing investors with a degree of flexibility to both enter and exit these structures.

Much like traditional closed-end funds, evergreen funds pool capital to invest across a diverse portfolio of equity or debt issued by private companies or backed by assets. However, a key advantage of evergreen funds over their closed-end counterparts is that they can offer investors access to their capital on a periodic basis. Their growing prevalence is attempting to bridge a liquidity mismatch – between the underlying assets and investor’s time horizon. In this paper we examine the trade-offs investors should consider before investing in evergreen funds.

Evergreen funds versus closed-end funds

Table 1 highlights some key differences between traditional closed-end funds and their evergreen counterparts.

Table 1: Comparison between traditional closed-end funds and evergreen counterparts

	Closed-end	Open-end
Availability of strategies	Most common, superior range of products.	Limited products but key area of growth.
Return potential	A spectrum of return potential, ability to achieve high return.	Return can be lower than a closed-end fund due to a requirement to hold some liquidity (i.e. cash, liquid credit).
Allocation and implementation	Harder to manage, J-curve effect, takes time to fully deploy.	Ease of management, quicker to deploy (less capital calls), no J-curve effect. For new investors, easy to build and maintain allocation and gain exposure to diversified asset type.
Blind pool risk	Blind pool risk.	Less blind pool risk, ability to diligence assets in established portfolios.
Liquidity	No option to redeem.	Option to redeem, subject to rules and restriction. Liquidity can become highly restricted or illiquid during stressed periods.
Valuation	Occur less frequently, can be quarterly or semi-annually. Interim valuation less important.	Occurs more frequently, can be monthly. Interim valuation is critical. as it affects unit prices and performance calculation.
Fees	Varies from low fee options to higher fee options.	Varies depending on the strategy.
AUD product	AUD unit trust generally not available.	AUD unit trust available.
Minimum investment	Typically $5m.	Can be lower, as low as $20k.

Frontier Advisors

There are several misconceptions associated with evergreen funds that need reconciling, some of which include:

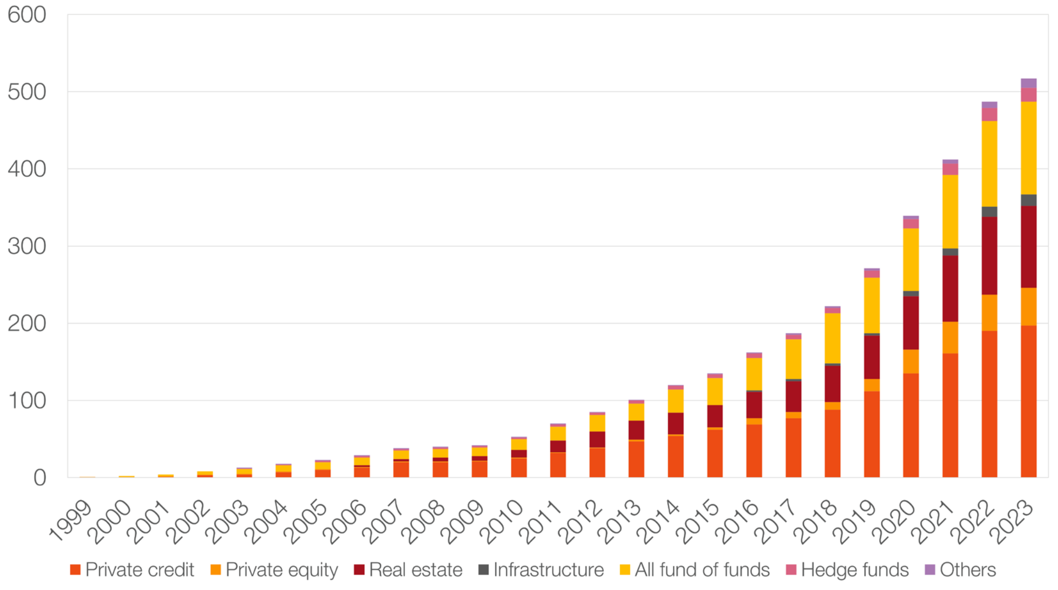
- The structures are little more than simple adaptations of closed-end strategies.
- The quality of assets in evergreen funds are inferior to those of closed-end or mandates held by superannuation funds.
- Valuation principles differ or are inferior in evergreen vehicles to their closed-end counterparts.
- The liquidity provided in an evergreen fund significantly detracts from their ability to provide returns commensurate with closed-end funds.
- Fees are higher in evergreen funds relative to closed-end funds since they are tailored more toward 'retail' investors.

Our analysis will look to address these views and highlight that each structure will come with its own specific requirements and considerations.

Ever-growth

Chart 1 illustrates the significant growth in private market products launched through an evergreen structure.

Chart 1: Number of evergreen funds launched globally



Source: Preqin

Preqin estimates the evergreen market segment (including private equity, private credit, property and infrastructure) is valued at US$350 billion globally, as at March 2024. Preqin counts 520 evergreen funds globally, which is approximately double the number from five years earlier. This positive trend is projected to continue in response to the strong demand by investors to increase their exposure to private market assets.

Locally, a common access point we have observed is via an Australian 'feeder' fund, whereby assets raised are aggregated alongside global investors, into an established, scaled, 'master' fund. Applications and redemptions are commonly netted off at the local fund level before seeking liquidity from the master fund (i.e. Luxembourg-based, SICAV, Cayman, BDC).

Key features of fund design

The key challenge for private market asset classes is the ability to manage the mismatch between the longer-dated nature of private assets and offering investors periodical (e.g. monthly/quarterly) liquidity.

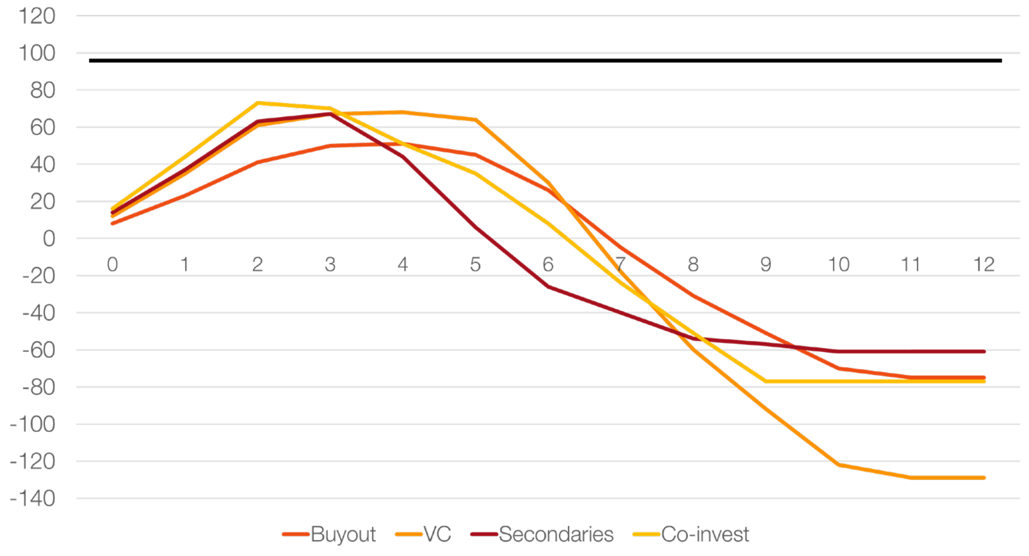
In our opinion, the management of longer dated private assets and the provision of controlled liquidity (i.e. through interest payments and maturity of loans as is the case for private credit) requires an additional skillset. Included amongst these are expertise in balancing portfolio exposures; the use of liquidity management tools (including liquidity forecasting); valuation frameworks; and awareness of operational and structural nuances.

Typically, when evergreen funds are launched, we have commonly observed managers investing with an established 'seed portfolio', moved over at cost (i.e. existing assets which have been incubated/seasoned on balance sheet of the manager). This allows funds to avoid the typical J-curve and blind pool limitations associated with closed-end funds, instead investing in a diversified portfolio from day one. From there, funds generally originate new deals directly (often through pro-rata participation of deals sourced across the respective platform) or via inheriting mature portfolios.

When investing in a recently established evergreen fund, investors should avoid funds where the vehicle is inheriting a mature portfolio with a large allocation to certain deal types. We believe asset diversification is critical, particularly for smaller investors with resource constraints to both build and monitor a private markets program that comprises multiple line items. With a program that consists solely of closed-end funds, investors are required to be constantly in search of new funds to allocate to. Furthermore, there are lower legal costs for investors as they are not required to re-up into every vintage. The use of evergreen funds is also more flexible for cash management than closed-end funds.

Allocations in closed-end funds require a structured commitment strategy. Careful planning of commitment levels is required as committed capital may be drawn down by managers at a variable pace. For an investor with a target invested allocation of $100 million, a commitment of this size may not result in the investor achieving a full allocation. In the case of private equity investment via a closed-end fund, the invested amount (net of distributions received) could be as low as $60-70 million, as shown in Chart 2.

Chart 2: Illustrative estimated investment pace with $100 million commitment for closed-end fund



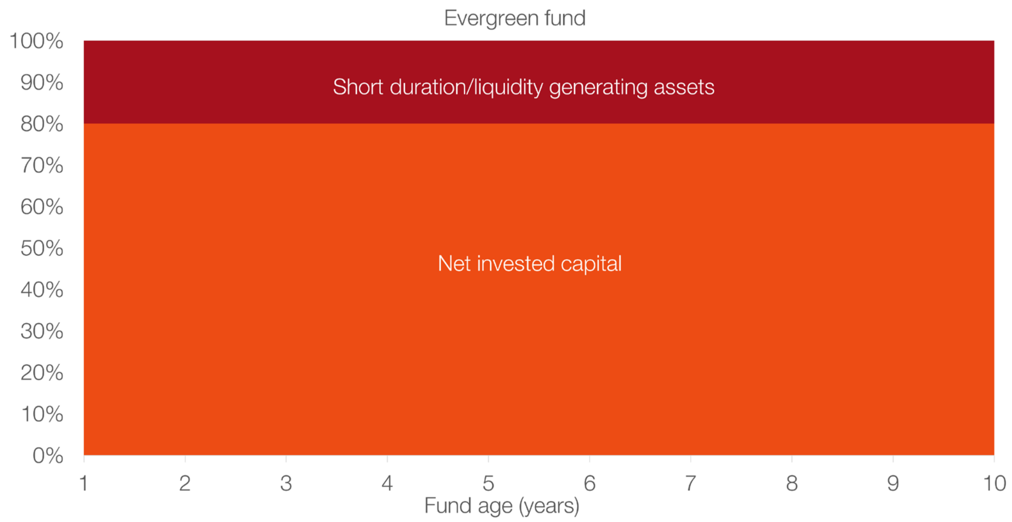
Source: Frontier Advisors

Frontier Advisors

Within a closed-ended fund, there is a gradual draw down during the investment period, which can normally span between three to five years. Depending on the fund/strategy, a general partner (GP) may not draw down 100% of capital during the investment period, preferring to keep some dry powder for future capital needs and various other reasons. Also, some level of distribution can be expected from earlier investments, typically from year three onward and assets can also be sold within this timeframe. Distribution profiles will vary depending on strategies and vintages.

In contrast, Chart 3 illustrates the benefits of instant deployment, which is created through investing in a full ramped evergreen portfolio.

Chart 3: Illustrative investment for evergreen fund



Source: Frontier Advisors

Frontier Advisors

Not all evergreen structures are the same

Frontier has observed disparate structures in evergreen products designed for larger institutional clients relative to those targeting smaller institutional or private wealth groups.

The type of structure designed is also an outworking of the natural liquidity of the underlying assets. To help illustrate this, Table 2 showcases the spectrum of asset types' duration within the private credit universe. Since credit returns are primarily a story of coupon/income, this supports the use of evergreen structures as our preferred method of implementation for many illiquid credit strategies.

Table 2: Spectrum of asset types' duration within the private credit universe

Strategy	Typical asset duration	Preferred implementation
Diversified/asset-based lending	Three to five years typically	Open-end
Global direct lending	Up to seven years typically	Open-end
Australian direct lending	Up to seven years	Open-end
Opportunistic credit/ distressed credit	Variable (long-term)	Closed-end
Real estate construction	Two to four years	Open-end or closed-end
Infrastructure debt	Five to fifteen years	Open-end or closed-end

Source: Frontier Advisors

The bulk of evergreen assets under management today is still in income-producing strategies such as those shown in Table 2. This differs from private asset classes like private equity and venture capital, which are less liquid and have historically been less represented by evergreen products. However, this is gradually changing as opportunities such as secondaries and co-investment strategies within private equity mature, offering managers more flexible ways to enhance liquidity without relying heavily on dedicated liquidity sleeves.

When designing evergreen products for smaller institutional clients, fund managers are increasingly working with key stakeholders such as wrap platforms, managed account providers and asset allocators to ensure these can be managed efficiently alongside daily priced funds.

This results in differing evergreen structures, with some offering more frequent liquidity (e.g. monthly) relative to others that are less accommodating (e.g. with initial lock up periods of circa one/two years, less frequent redemption windows and the payment of redemption requests over several quarters rather than in a single payment). Shorter liquidity timelines in evergreen structures are particularly evident for those offered under a product disclosure statement (PDS) structure in Australia, where the underlying investor base is largely comprised of private wealth, family office and other smaller institutional client types.

Frontier Advisors

How do funds remain open for investment

Based on our observation, evergreen vehicles offering liquidity generally limit redemptions to 5% of net asset value (NAV) on a quarterly basis.

In addition to this, both pro-rata provisions and various 'gating' restrictions are common.

Market conditions, natural liquidity of asset realisations and investor demand can also impact liquidity, such as heightened demand for redemptions in unfavourable market conditions. Overall, the interplay of these factors will determine the optimal level of liquidity exposure held across varying funds.

There is a growing prevalence in the use of dedicated liquidity sleeves by funds (typically up to 20% of a fund's NAV), affording the manager additional flexibility to manage inflows and limit the return drag. This can be achieved via a range of strategies, as discussed in more detail in this paper. Notwithstanding this, these funds are not designed to withstand extreme liquidity events, rather are designed to afford greater flexibility through the cycle to manage cash flows.

Beyond a dedicated liquidity sleeve, we have observed additional layers of defence present in evergreen fund terms, to protect against 'gating' in periods of stress. These include:

- Lines of credit – e.g. up to circa 20-25% of the gross value of the fund.
- Redemption fees – that are charged on early redemptions, e.g. in the first 12-months of investment.
- Sell cost – introducing a buy/sell spread in periods of elevated volatility.
- Gating the fund – if a manager has observed consecutive quarters of reaching their indicative redemption limits, or if there is a material redemption request in any given quarter.

Given the recent introduction of many of these structures, most funds are yet to be tested by a historic precedent of prolonged market stress.

How the peer group is providing liquidity

To enable periodic redemption windows, funds implement a range of liquidity mechanisms.

These may include allocations to liquid asset classes such as cash and short-term credit exposure, broadly syndicated loans (BSLs), exchange traded funds (ETFs), listed private equity (LPE), synthetic exposures or the use of external leverage/financing facilities. Ultimately, it is important for investors to understand how these may detract from the 'purity' of the private markets exposure.

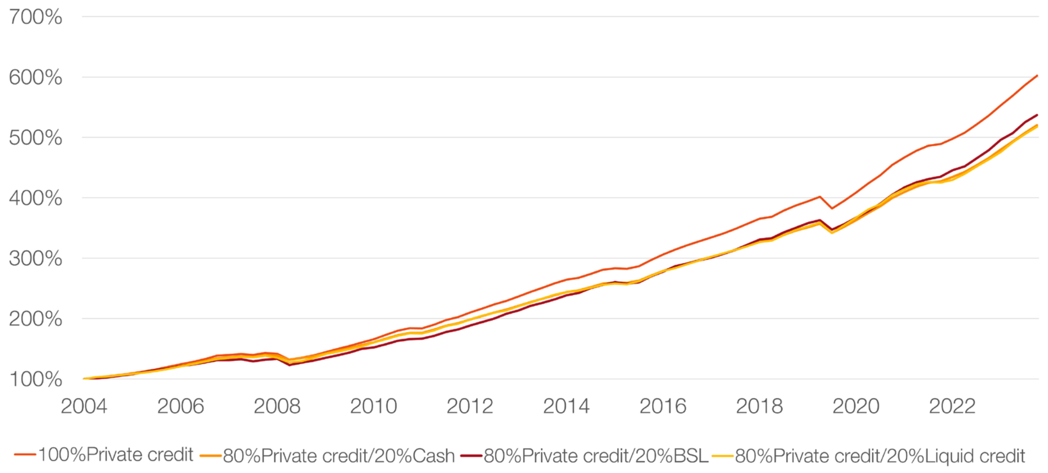
Across the peer group, it is common for managers to rely on internal capabilities such as cash management, liquid credit and BSL's to provide liquidity exposure.

Does liquidity come at a cost?

Based on our analysis, the key detractor of returns in an evergreen fund structure relative to their closed-end counterparts is primarily attributable to the portfolio holding residual assets used to create liquidity, rather than any discrepancy in asset quality.

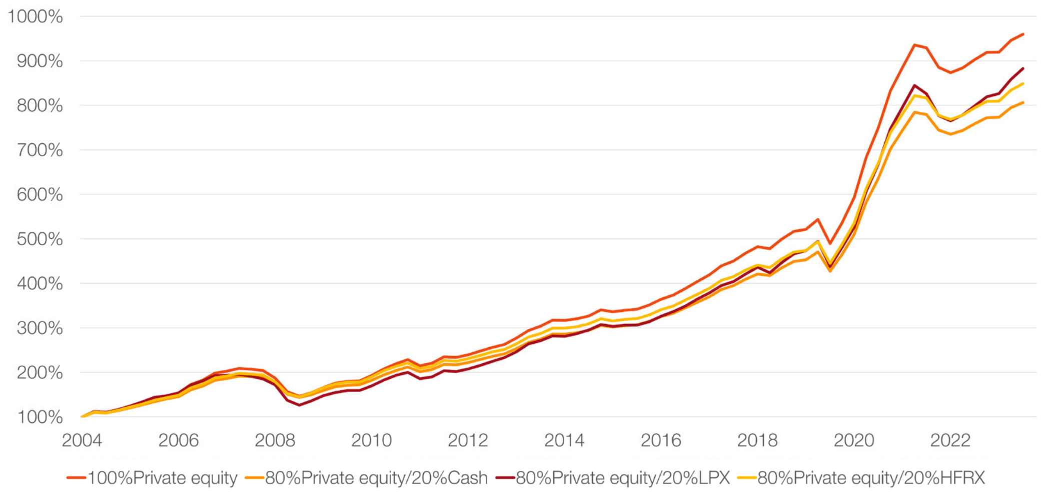
This return differential is demonstrated in Chart 4 and Chart 5, which show 20-year performance outcomes across strategies retaining a dedicated liquidity sleeve relative to a closed-end fund.

Chart 4: Cliffwater Direct Lending Index – Cumulative return (September 2004 to June 2024)



Source: Frontier Advisors

Chart 5: State Street Private Equity Index – Cumulative return (September 2004 to June 2024)



Source: Frontier Advisors

As is demonstrated in the charts, performance outcomes are generally superior among private asset pure plays, which corresponds with the concept of harvesting an illiquidity premium over the longer-term and having less mark-to-market risk. That said, investors may effectively be transposing the cash-drag (or equivalent exposure to liquid assets) from outside their private markets program to inside the evergreen fund.

Frontier Advisors

Similar assets but different performance outcomes

In addition to liquidity factors, the peer group of managers assessed as part of this analysis commonly cited the following reasons for performance dispersion between evergreen and closed-end funds with comparable assets:

- Warehouse/ramped assets - each underlying company transferred into the portfolio (e.g. from the balance sheet or via another vehicle), often at cost price, has progressed through the value-creation cycle to varying degrees, resulting in improved diversification benefits and lower volatility.
- Fees – there is often a discrepancy between funds that charge fees on committed capital versus invested capital. Many evergreen funds also charge performance fees on individual assets. Furthermore, some funds set performance fees and hurdles lower for evergreen funds where liquid assets are present.
- Compounding of returns – in evergreen structures, asset realisations are automatically reinvested in the underlying portfolio, providing the benefits of long-term compounding.

The final word

Based on our analysis, private market allocations offer a number of portfolio benefits, including the potential for higher returns and reduced volatility, ultimately translating into more efficient portfolio outcomes.

There is a variety of options for investors to access private markets, albeit each will come with its own specific requirements and considerations. What option to use depends on investors' preferences and circumstances. It can often be appropriate to use a combination of options.

We view evergreen structures as more suited to private wealth and smaller institutional investors, and/or those with less developed allocations to private markets or investors preferring simple implementation. For the larger and more sophisticated investor types, who can handle additional complexity, the appeal is less clear.

Notwithstanding the semi-liquid status, we believe investors should consider open-end funds as illiquid investments that offer a level of capital management flexibility. Investors should approach their usage with a long-term timeframe in the context of achieving their ultimate goal - an ongoing and stable private markets investment program.

Learn more

If you would like to discuss this paper in more detail or explore how we can assist with your portfolio, please reach out to your client team or a member of our Defensive Assets and Private Markets Team.

Frontier Advisors

Frontier Advisors

Level 17, 130 Lonsdale Street, Melbourne, Victoria 3000

Tel +61 3 8648 4300

Frontier Advisors is one of Australia's leading asset consultants. We offer a range of services and solutions to some of the nation's largest institutional investors including superannuation funds, charities, government / sovereign wealth funds and universities. Our services range from asset allocation and portfolio configuration advice, through to fund manager research and rating, investment auditing and assurance, quantitative modelling and analysis and general investment consulting advice. We have been providing investment advice to clients since 1994. Our advice is fully independent of product, manager, or broker conflicts which means our focus is firmly on tailoring optimal solutions and opportunities for our clients.

Frontier Advisors does not warrant the accuracy of any information or projections in this paper and does not undertake to publish any new information that may become available. Investors should seek individual advice prior to taking any action on any issues raised in this paper. While this information is believed to be reliable, no responsibility for errors or omissions is accepted by Frontier or any director or employee of the company.

Frontier Advisors Pty Ltd ABN 21 074 287 406 AFS Licence No. 241266

---

frontieradvisors.com.au

Frontier Advisors