Direct investment strategies: risk and legal issues

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The pursuit of multiple investment goals has always been a balancing act for investors. They have had balance competing considerations such as the value of minimising risk or maximising yield, while also taking into account other factors such as when deciding whether to invest with an asset manager based on its reputation or its past performance; all at the same time trying to keep fees and costs down.

There is little wonder why investors frequently choose to use third-party managed funds rather than taking it upon themselves to directly invest in companies or other assets, without the benefit of a third-party fund or asset manager. There is however a growing trend among investors who have displayed a growing appetite for direct investment and co-investment.

This increasing interest can be attributed to a number of factors including the need to recover portfolio values in the light of COVID-19. It must not be forgotten that this trend has started well before the pandemic. Prevailing market conditions meant that investors began to look for greater flexibility and control in their investments, as well as a means to reduce fees paid to third-party managers. This article will look at the benefits of investing directly, what barriers compliance teams at financial and professional services firms face in doing so, and what they can do to minimize these.

Attraction of direct investing

Heads of investment are increasingly keen to explore direct investment opportunities; sometimes as a standalone strategy and sometimes through co-investment i.e., alongside third-party managed funds to boost portfolio performance – a strategy dubbed as "dual investment".

As mentioned above, the increasing interest in direct investment began before the pandemic. However, there is no denying that the pressures of COVD-19 and its effect on the global economy have increased the pressure on investors to bolster returns. After all, investment markets and asset classes have all felt the financial impact of the pandemic, during which time many third-party managed funds adopted defensive postures. Third party funds often focussed on recession-proofing their portfolios, still bruised from the financial crash of 2008 no doubt, and were reluctant to exit investments or move aggressively to take advantage of pricing dislocations.

The benefits of a direct investment strategy for investors, or to at least having a strategy that includes some level of direct investment, are clear. Investors can sometimes deploy capital faster, take advantage of market opportunities, adjust their portfolios to suit their unique positions and objectives and balance risk and performance more effectively. Despite certain risks and complexities discussed below, making direct investments can help maximise yields, and diversify and fine-tune portfolios. While an investor who invests directly will not benefit from the expertise of an experienced fund manager; they gain greater control of both the portfolio and risk management, which for some investors is a clear benefit.

Some of the most significant barriers to adopting direct investment strategies include capacity, as well as regulatory, legal and tax issues. Going it alone forces investors to source the investment opportunities themselves, adopt the performance risk involved in both the execution and the management of the investment, and manage the legal regulatory and tax burden, all of which a third party would usually bear.

Managing risk and legal obligations

If investors were better able to address the concerns arising from investing directly, they would increase their use of direct investments. After all, by doing so they gain more flexibility and control as they look to successfully navigate the pandemic-affected market.

There are a number of important steps that can be taken in order, which will help investors effectively manage the performance risks and legal obligations involved in investing directly. These include:

1. *Sourcing and terms*: ensuring there is a pipeline of potential investment opportunities is critical, which can be done in-house teams as well as teaming up with other investment partners (ie co-investment). Of course, investments which may seem to be attractive at first will need to be made on terms that work.
2. *Execution and diligence*: investors will want to develop or enhance their capacity to execute and monitor investments, including managing legal, regulatory and tax risks. It is particularly important to be able to conduct appropriate commercial and legal due diligence – no investment is devoid of risk and there will in all probability be some potential deal-blockers that arise. This can be a daunting time for investors who are not used to going direct. A judgement-based framework is essential at this stage to ensure the

right decisions are taken when faced with legal considerations. The due diligence process should unearth any problems that could affect the investment's value including regulatory enforcement, a patent issue, or a current or impending lawsuit.

3. *Protecting the deal*: once the structuring and execution hurdles have been overcome, investors should turn their attention to mechanisms which safeguard the economics of the deal. This includes being mindful of measures to mitigate potential losses of value, future capital commitments and restrictions on making other investments.

Closing thoughts

While the COVID-19 pandemic was not the only catalyst to the rise of interest in direct investment and co-investment strategies, it has certainly accelerated their adoption. Third-party fund managers have and can serve essential functions by assisting investors allocate and deploy capital, however, direct investment will likely continue to be an attractive alternative to many institutional investors due to the cost savings and greater flexibility and control afforded to investors. There is likely to be an increase in the use of direct investment and co-investment strategies in the near to medium term.

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