Proration

January 2023

The recent growth in SEC-registered alternative funds (private BDCs, private REITs, interval funds, and tender funds) is a direct byproduct of wealth management's efforts to diversify into alternatives. Unlike the limited partnership interests favored by institutions, these alternative funds offer investor protections, administrative convenience, immediate investment, and enhanced liquidity, all things important to individual investors. In a few years, these alternative funds have attracted over $100 billion in investor capital.

Of particular interest to investors is the conditional promise of quarterly liquidity (withdrawal) from the alternative funds. For most funds this means investors can get all their money out in any quarter, if requested withdrawals across all investors does not exceed 5% of net fund assets. When requested withdrawals exceed 5% it triggers an event called "proration" wherein requested withdrawals are cut back proportionately.

The press attention directed at the recent proration experienced by Blackstone's BREIT fund has raised broader questions about the incidence of proration generally. To address potential concerns, Cliffwater conducted a three-year study covering 56 SEC-registered alternative funds. Findings can be summarized as follows:

1. *Proration is a low probability event, occurring at an 8% frequency across all funds and quarters.*
2. *Proration events occurred at a much higher 14% frequency during the four quarters of 2020 when COVID disrupted markets.*
3. *During the aftermath of the 2022 market meltdown, proration events have thus far occurred at a 7% frequency, one-half the proration frequency during COVID.*

Our study suggests that investors in alternative funds should have confidence in the availability of quarterly liquidity without the implementation of proration; with exceptions for either prolonged periods of market stress or fund-specific circumstances such as poor performance.

What is proration?

Proration occurs when investor demand for fund liquidity exceeds specified limits. For example, take a fund that offers quarterly redemptions subject to a 5% fund-level limit, not an investor-level limit. If, collectively, investors redeem 5% or fewer of outstanding shares then all investors that requested liquidity will get all their requested money out of the fund. If investors collectively request more than 5%, say 10%, then a rationing process occurs – aka *proration* – wherein each investor requesting redemption receives the same fractional amount of liquidity, 5/10ths or 50% of requested amount, in our example.

Who sets limits on fund liquidity?

SEC regulations permit registered alternative funds latitude in the frequency (monthly, quarterly, semiannually) and levels (5% to 25%) of liquidity. Fund specific liquidity is set in advance and communicated in the prospectus. Fund management selects redemption frequency and limits to avoid forced selling of less liquid assets to the detriment of long-term investors. Funds that do a good job communicating to investors the full range of fund risks, and specifically why restrictions on fund-level liquidity are necessary, should find proration to be an infrequent occurrence and without investor recrimination.

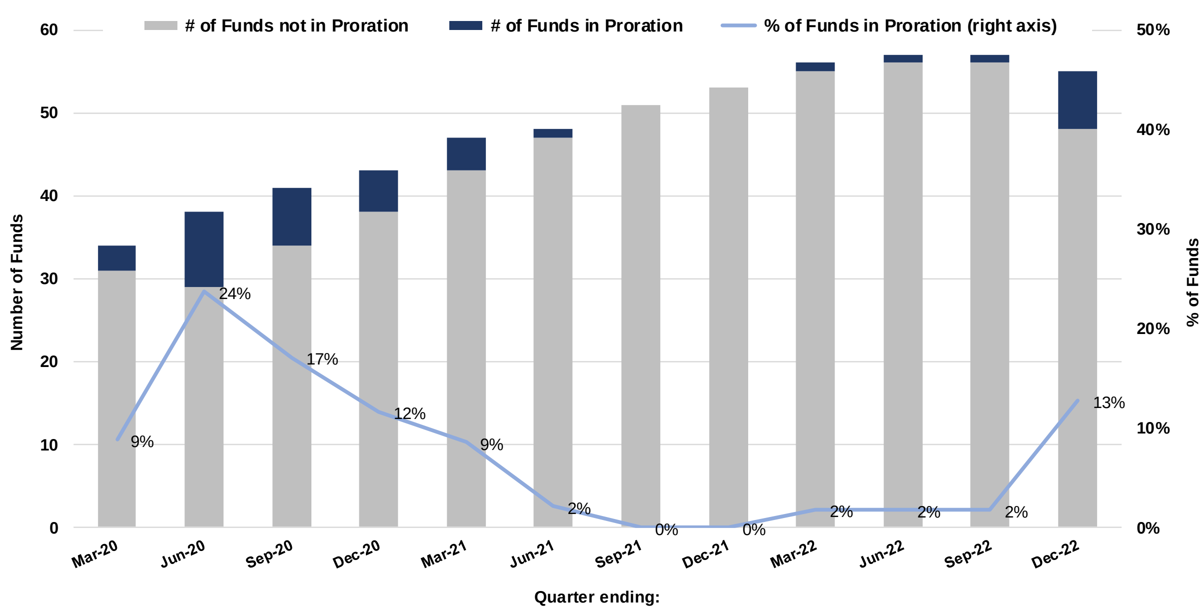
SEC-registered alternative funds that focus on illiquid assets include private BDCs, interval funds, private REITS, and tender funds. Differences exist across these structures but all promise investors discretion over fund purchases and sales (redemptions) unlike private partnerships where the general partner controls cash flows to and from investors. Most registered alternative funds have selected to offer quarterly liquidity subject to a 5% fund-level limit.

Is proration common?

No, a three-year Cliffwater study of all SEC-registered alternative funds investing in real estate, credit, and private equity using private BDC, interval fund, private REITS, and tender fund structures with net assets greater than $100 million finds that proration has been uncommon.

Exhibit 1 reports numbers of alternative funds both in and not in proration by quarter over the past three years. The number of funds in proration is also shown as a percentage of all SEC-registered alternative funds, referencing the right-hand scale.

Exhibit 1: Proration Frequency for SEC-Registered Alternative Funds, Q1 2020 to Q4 2022

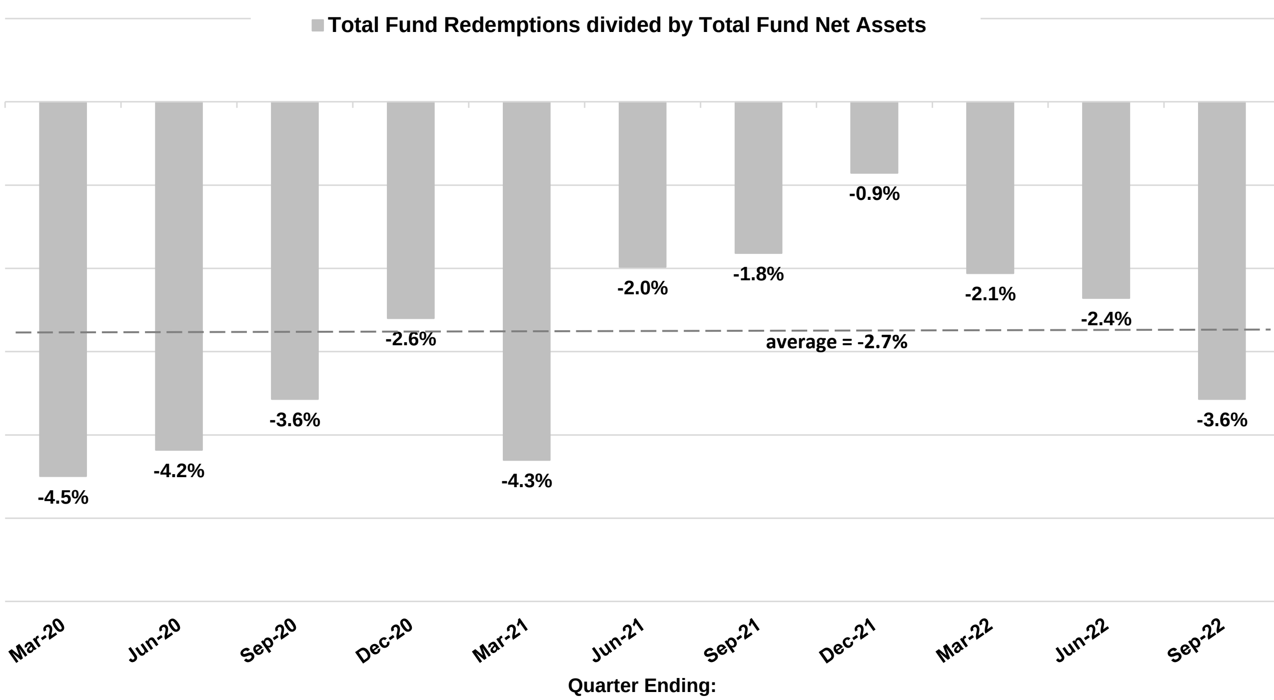


	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22
# of Funds in Proration	3	9	7	5	4	1	0	0	1	1	1	7
# of Funds <u>not</u> in Proration	31	29	34	38	43	47	51	53	55	56	56	48
% of Funds in Proration (right axis)	9%	24%	17%	12%	9%	2%	0%	0%	2%	2%	2%	13%

Most funds (92%) do not experience proration in any quarter. When proration occurs, it is more likely to happen during periods of market stress such as 2020 and 2022. Importantly, the 2020 period covering COVID showed the greatest rate of proration, almost double the frequency measured by the last two quarters of 2022.

The low frequency of proration suggests that the common 5% quarterly redemption limit meets the collective needs of fund investors. Exhibit 2 shows aggregate redemption rates across all alternative funds by quarter.

Exhibit 2: Aggregate Alternative Fund Redemption Rates by Quarter, Q1 2020 to Q3 2022



Quarterly fund redemptions, in aggregate, range between 1% and 4% over the measurement period with an average redemption rate equal to 2.7%. Higher redemption levels, like proration occurrences, are associated with general market stress, but together with regular cash dividends paid separately to investors, investor liquidity needs appear to have been fully satisfied in most instances by the 5% fund-level redemption limit.

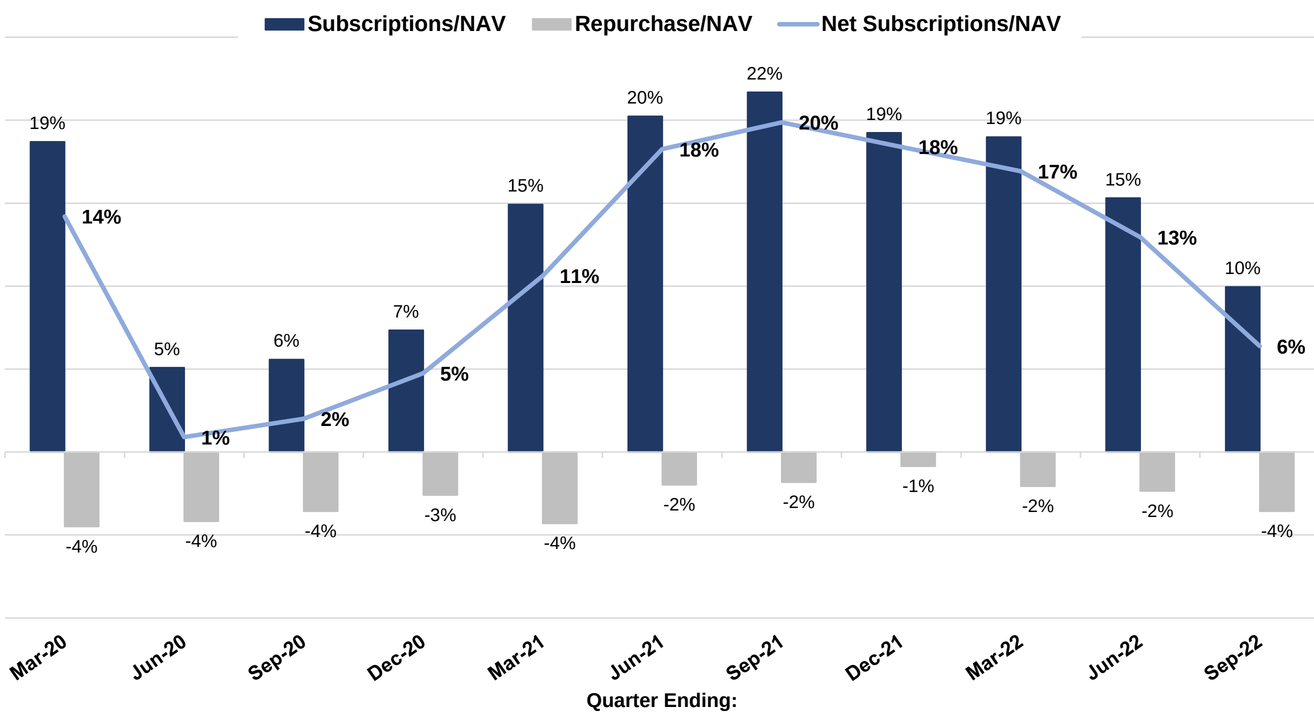
What causes proration?

The data show that proration is an unusual event under most circumstances because average investor redemption demand sits at about one-half of fund limits. But there are conditions that can turn proration more systemic. Some of these are fund specific, like poor performance, a changing portfolio profile, or a management change that reduces investor confidence. Others can be macroeconomic, like a prolonged recession causing investors to seek safety in cash. Still others can be investor-related, such as a change in circumstance, particularly when the investor base is concentrated. Also, fundraising prowess is a factor for fund strategies that rely on maintaining commitments over time, needing fresh capital to maintain vintage diversification. Well-informed investors know these conditions/risks are manageable and potentially come with attractive risk-adjusted returns. At the same time those investors remain watchful for events that might trigger something more systemic for a fund.

In addition to redemptions, an important metric signaling investor confidence is fund subscriptions which represent cash inflows. Strong inflows go together with low redemption rates and vice versa. Strong inflows also buffer overall fund liquidity and mitigate any potential need for asset sales to meet redemption requests.

Exhibit 3 reports both aggregate alternative fund subscriptions as a percent of net assets together with redemptions from Exhibit 2. Net subscriptions, the difference between subscriptions and redemptions, is shown in the line.

Exhibit 3: Alternative Fund Subscriptions, Redemptions, and Net Subscriptions, Q1 2020 to Q3 2022



In aggregate, alternative funds have been cash flow positive over the study period with quarterly subscriptions averaging well above redemptions. At the same time, subscriptions appear cyclical and negatively correlated with redemptions. Overall, the alternative fund industry appears to have good external liquidity characteristics that assists in managing alternative portfolios for long-term investors.

These overall industry dynamics may not apply to individual funds that may suffer from poor performance, high redemption rates, proration, and low subscriptions, all of which can be reinforcing. A few alternative funds within this sample exhibit some of these characteristics which is why investors need to monitor funds regularly.

What is the future for registered alternative funds?

Expect the $100 billion registered alternative fund universe to grow and over the next five years with new entrants backed by quality asset management firms and a wider range of alternative asset choices. Also look for investors to get more access to private equity in registered vehicles to provide a complement to current private debt and private real estate offerings. Unfortunately, proration will never go away but hopefully investors understand that for the most part it exists to protect them.

Additional Information

This report provides historical repurchase and subscription information regarding various investment vehicles that span multiple alternative asset strategies, including private credit, real assets (principally real estate), and private equity. Inclusion is based on SEC-registered alternative funds using private BDC, private REIT, interval fund, and tender fund structures with net assets greater than $100 million. Furthermore, Cliffwater has selected for inclusion in this report Alternative Funds that utilize the relevant strategy and are representative of the relevant strategy. Data on repurchase and subscription amounts was collected on a quarterly basis using SEC filing reports, including Monthly Portfolio Investments Report ('NPORT-P') and Certified Shareholder Reports (Semi-Annual and Annual), all of which were obtained from the SEC database.

For the fourth quarter of 2022, Cliffwater contacted the investment managers within Cliffwater's SEC-Registered Alternative Funds Universe to ask whether their fund experienced proration during the quarter. Cliffwater was able to obtain responses from 55 alternative funds, of which, seven were stated to be in proration. In addition, approximately five alternative fund managers declined to comment on their funds' current proration status and as a result, were excluded from the Alternative Funds Universe for that quarter. Total fund population equaled 56 on December 31, 2022, of which 32, 20, and 8 were categorized as credit, real asset, and private equity, respectively.

The Alternative Funds in this report are grouped into three major categories: (i) Credit Funds; (ii) Real Asset Funds; and (iii) Private Equity Funds.

- Credit Funds: Includes Interval Funds, private BDCs, and Tender Funds that invest across a broad range of credit strategies (domestic and global), including corporate, mortgage, consumer, emerging market and municipal credit markets, and utilizes a flexible asset allocation strategy among both public and private credit sectors within the credit markets, which may include corporate debt, mortgage-related and other consumer-related instruments, collateralized debt obligations, including CLOs, government and sovereign debt, municipal bonds and other fixed, variable, and floating-rate income producing securities of U.S. and foreign issues.
- Real Assets Funds: Includes Interval Funds, private REITs, and Tender Funds that invest across a broad range of real asset strategies, including real estate, infrastructure, timberland, and agriculture/farmland. Real Assets Funds will also invest in both domestic and international public and private securities such as common equities, preferred shares and debt investments associated with real assets. In addition, funds will invest in institutional investment funds as well as certain closed-end institutional real asset funds that have targeted capital raises, investment lock-up periods and expected fund life terms. Real Asset Funds invest primarily in real estate.
- Private Equity Funds: Includes Interval Funds and Tender Funds that invest primarily in any of private equity investments of any type, including primary and secondary investments in private equity and other private assets funds and investments in companies that are typically made alongside one or more investment funds (e.g., co-investments). In addition, Private Equity Funds can invest in exchange-traded funds ("ETFs") designed to track equity indexes, as well as cash, cash equivalent and other short-term investments. Typically, Private Equity Funds will invest across a broad spectrum of strategies, including buyout, growth capital, special situations, and other private assets funds, determined by a diverse selection of geographies and vintage years.