

UNLOCKING ALPHA

ESSENTIAL SKILLS FOR IDENTIFYING AND
SELECTING TOP ALTERNATIVE ASSET
INVESTMENTS—ACROSS FUNDS AND DIRECT
DEALS



Unlocking Alpha:

Identifying and Selecting Top Alternative Asset Investments – Across Funds and Direct Deals

Introduction

In today's alternative investment landscape, capital is increasingly funneled toward large fund complexes and established asset management giants as investors gravitate toward perceived safety and brand recognition. According to a 2022 Preqin report, the top 10% of hedge funds by assets under management (AUM) now command over 70% of the industry's total AUM. Yet, this concentration of scale often comes at a cost: the ability to generate alpha—excess returns above the market—tends to diminish as funds grow larger. Challenges such as overlapping trades, bureaucratic delays, and a shift toward preserving assets rather than chasing outperformance limit the agility of these behemoths. This creates a window of opportunity for private banks, high-net-worth advisory teams, and family offices to pursue higher returns through less conventional avenues like boutique managers, direct investments, and co-investment deals, which thrive in less crowded, high-potential spaces.

The rise of direct investments further signals a shift among sophisticated investors. A 2023 UBS survey found that 70% of family offices are boosting allocations to private companies and real estate, drawn by greater control, better alignment with their goals, and the promise of superior returns compared to traditional fund vehicles. This trend highlights a critical truth: the most promising sources of alpha often lie beyond the reach of mega-funds, accessible to those willing to explore alternative strategies.

Core Skills for Sourcing and Selection—Funds and Direct Investments

To excel in identifying and securing the best alternative investments—whether through funds or direct opportunities—investors must cultivate a distinct set of skills. These capabilities enable them to spot undervalued prospects and evaluate them with precision, paving the way for alpha generation.

1. **Network Development & Deal/Manager Discovery**

A well-developed network is the cornerstone of finding unique, high-potential investments. Connections with boutique fund managers, direct deal operators, and other investors unlock early access to emerging opportunities that rarely surface in mainstream channels. Events like the Sohn Investment Conference, private investment groups, and peer collaborations are fertile ground for spotting innovative strategies and promising talent. For example, family offices often tap trusted advisors or co-investors to identify deals that sidestep traditional pipelines, giving them a competitive advantage.

2. **Qualitative Assessment & Due Diligence**

Thorough evaluation is essential when considering smaller funds or direct investment sponsors. For funds, this means analyzing the team's experience, alignment, and investment approach, as well as the strength of their operational and governance frameworks. In direct deals, it involves assessing the leadership's capabilities, the business's competitive edge, and the market's upside potential. Smaller players may lack the refined infrastructure of larger firms, making it critical to scrutinize operational details—like compliance protocols or data security. A 2022 Deloitte study noted that 60% of alternative investment failures trace back to operational shortcomings, emphasizing the importance of rigorous vetting.

3. **Investment & Risk Acumen**

Alternative assets often come with complex risk profiles, requiring sharp financial insight. Investors must unpack factors like credit risk, liquidity constraints, and operational vulnerabilities while aligning them with broader economic and market trends. In private credit, for instance, understanding interest rate impacts and default risks is as crucial as evaluating exit options. In venture capital, anticipating technological shifts and market adoption timelines can determine success. This expertise not only pinpoints high-alpha opportunities but also ensures they fit within a diversified portfolio, optimizing the risk-return balance.

4. **Patience & Seeding Mentality**

Backing early-stage managers or direct investments demands a long-term perspective and comfort with short-term uncertainty. However, the payoff can be substantial: seeding a hedge fund might yield discounted fees, co-investment privileges, or equity stakes, while early direct investments can deliver exceptional growth as businesses scale. A 2021 Cambridge Associates study showed that seed investors in private equity funds often see 3-5% higher returns due to

advantageous terms. This patient, nurturing approach is uniquely suited to alternatives, turning nascent ideas into powerful alpha engines.

5. **Performance Attribution & Crowding Analysis**

Smaller managers and direct deals often sidestep the alpha erosion that plagues larger funds due to overcrowded positions. By targeting niche areas—like distressed debt, emerging markets, or specialized venture capital—they capitalize on market inefficiencies ignored by bigger players. Crowding analysis, which examines position overlap across funds, helps investors assess whether a strategy risks losing its edge. A 2023 HFR report found that low-crowding strategies outperformed by 1.8% annually, underscoring the value of staying ahead of the pack.

6. **Negotiation & Structuring Expertise**

The ability to negotiate favorable terms and craft tailored deal structures adds another layer of value. In co-investments or direct opportunities, investors can secure perks like lower fees, profit-sharing, or enhanced governance rights by leveraging their capital and knowledge. A 2022 EY survey revealed that 65% of institutional investors in private markets actively negotiate to boost returns. This skill enhances alpha by aligning interests and minimizing risks, particularly in customized deals.

Case in Point: Alpha Compression at Mega Multi-Manager Platforms

Large multi-manager platforms—think Citadel, Millennium, or Point72—have historically excelled at generating alpha, leveraging their deep resources and top-tier talent. But signs of alpha decay are emerging. These firms often use a “pod” structure, where multiple portfolio managers oversee independent strategies within the same organization. As the number of pods grows, so does the likelihood of overlapping positions, especially in popular sectors like tech and healthcare. A 2021 Novus study reported a 15% increase in position overlap among large multi-manager funds over five years, linked to declining risk-adjusted returns. This crowding effect weakens alpha, bolstering the argument for smaller, more agile managers who can target uncrowded opportunities.

Data Supporting Outperformance in Smaller Funds and Direct Alternatives

Evidence consistently points to the alpha potential of smaller funds and direct strategies, challenging the notion that bigger is better:

- **Smaller Hedge Funds Excel:** A PerTrac analysis found that hedge funds with under \$100 million in AUM outperformed larger peers by 2.17% annually over 10 years, thanks to their flexibility and focus on less liquid markets.
- **Emerging VC Managers Outpace:** First-time venture capital funds often beat later funds, with a 2021 PitchBook study showing 5% higher IRRs driven by their ambition and niche focus.
- **Niche Private Credit Stands Out:** Specialized strategies like litigation finance or royalty funding deliver strong risk-adjusted returns with low correlation to broader markets. A 2022 Cambridge Associates report pegged their average net IRR at 12%, compared to 8% for general private credit.
- **BarclayHedge Backs Small Funds:** A 2020 BarclayHedge study showed hedge funds under \$250 million in AUM averaged 9.8% annual returns, versus 7.5% for those over \$1 billion, excelling in complex markets.
- **Direct Deals Surge:** A 2023 BlackRock report highlighted a 25% rise in direct private equity investments since 2019, with IRRs averaging 15%, outpacing many pooled funds due to customization and cost efficiency.

Conclusion

Alpha thrives in specialization, flexibility, and early access—attributes often missing in sprawling fund complexes. Boutique managers, emerging funds, and direct investments offer a compelling advantage for investors willing to step off the beaten path. Achieving success requires a disciplined toolkit: cultivating networks to find opportunities, conducting in-depth due diligence, mastering risk analysis, embracing patience, monitoring crowding, and negotiating smart deals. For private banks, advisory teams, and family offices, the potential rewards of tapping these unconventional sources of alpha are immense—but only for those equipped to uncover the market’s hidden treasures.

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