

Shifting strategies

Winning investor assets in a competitive landscape

2014 Global Hedge Fund and Investor Survey



EY

Building a better
working world

2014 global hedge fund survey

In this report we seek to understand the ever-changing dynamic between managers and investors and capture how they are responding to new and existing challenges. As the hedge fund industry continues to mature, these insights offer a glimpse into where the industry is headed and the influencers who are directing its path.

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Executive summary

We are pleased to share our eighth annual survey of the global hedge fund industry.

For the last five years, conditions have been volatile, and many in the industry have focused on transparency, cost containment, restructuring operating models and adapting to a heavy regulatory burden. But the focus is shifting to growth. And those in the industry are now looking at how best to address the needs and evolving expectations of stakeholders.

First, we would like to extend sincere thanks to those managers and investors who gave their time and shared their insights and who shaped the direction and development of this survey. Without their input, we would not have such robust results. We believe that it is the combination of the perspectives of these two groups – both their agreements and differences – that drives and shapes our industry.

Our survey found that **growth** is again the focus of managers. But increased competition for assets means that managers are taking a wide range of paths to growth.

The main source of investor capital has shifted – from high-net-worth individuals, to funds of funds, to institutional investors, and now to private wealth platforms.

Investors are increasingly focusing on a targeted strategy and investment philosophy and the ability to tailor fees and terms to fit their needs. And the larger managers are taking a lead in customizing solutions to meet investors' evolving expectations.

Managers with over \$10b of assets under management (AUM) are continually launching new products, such as separately managed accounts, liquid alternatives, and long-only funds.

Investor appetite appears strong for these products. But their impact on managers' margins is noticeable due to their generally lower fee structures. Midsize and smaller managers focus on increasing growth through their current offerings to existing clients and reaching new investors.

Funds of funds (FOFs) are evolving as they battle to keep their share of the market through the use of registered products. Over half of our FOFs respondents offer liquid alternatives – products reliant

upon sub-advisory relationships to be successful. A balance must be struck in these relationships; managers need to view the services as economically feasible given the infrastructure needs and fee structure. If such relationships do not prosper, the liquid alternatives opportunity for FOFs may become extinct.

In order to manage risk and address regulator expectations, it is critical to have the right structure and controls in place for new business initiatives and product development. Managers must beware the herd mentality when considering a new product launch. They may want to look to their peers in the traditional global asset management industry for lessons about what happens when product offerings are expanded too rapidly. In the traditional industry, many managers have evaluated their hasty expansion of products and are now making cuts to their offerings.

At the heart of the industry is the responsibility of managers to act as stewards for their investors. Managers recognize that this obligation – to help investors meet their financial goals and to retain their investors' trust – is the key function of their businesses. Greater alignment of interests between managers and investors is needed, but how this will be achieved is not without debate.

Fund expenses are clearly an area of focus both for managers and investors. Our survey indicates that expense ratios have declined modestly over the past three years. Notably, about three-quarters of investors take no issue with the expense ratios of their funds.

Managers continue to be challenged by the combination of margin pressures and increases in the cost of doing business, particularly as a result of increased regulatory reporting and compliance requirements. Investors are largely sympathetic and have generally been willing to pay for regulatory and compliance-related expenses. But some larger investors have negotiated fee caps. Managers – particularly small and midsize – anticipate pushing more expenses through to their funds.

However, our survey results also indicate that managers are listening to what their investors are saying. Managers are responding to investors' demands by:

- ▶ Improving transparency around expenses
- ▶ Communicating more proactively
- ▶ Establishing a clearer and more sensible sharing of costs

Overall, there appears to be a growing recognition that the relationship between managers and investors is not a battle.

With regard to **manager investments and expenses**, outsourcing and headcount are key trends. Managers are making investments throughout their business in order to support their growth aspirations. Efficiencies and economies of scale appear to be achieved in the back office as headcount in this area has continued to decline. Investors seem comfortable with the reduction in full shadowing performed on third-party administrators, and they support the move to a partial-shadowing model. Investors also seem to accept managers outsourcing additional functions, such as middle-office and marketing, with some level of oversight.

However, managers' responses continue to indicate a concern about service providers' capabilities in these areas. The majority of managers are not aware of third-party providers' capabilities with respect to non-NAV-generating functions. There is a clear need for better education and for development of such solutions. This is an opportunity for both service providers and managers to better understand capabilities and expectations. All parties, including investors, can benefit by advancing this dialogue.

For many in the industry, technology, security and infrastructure – and specifically **cybersecurity and the cloud** – are at the top of the agenda. Breaches and security issues are in the news daily. And global regulators are convening to determine how best to address concerns, raise awareness, and determine sensible governance and oversight.

About half of the managers we surveyed use the cloud. But many of the larger managers do not, citing security concerns as the primary barrier. However, many may be using the cloud without realizing it, because it is likely that some of their vendors are. Managers should be aware of the risks to their data via attacks on their service providers.

When storing data – whether in the cloud or on physical backups – managers need to have in place standardized, well-defined processes, controls and protocols. With appropriate security and controls in place, the cloud can provide an efficient and less expensive way for managers to store data.

Regardless of whether managers use the cloud or not, cybersecurity will be a concern for managers and a focus for regulators.

Only a minority of the investors who responded to our survey are confident in their managers' cybersecurity policies. However, a vast majority of managers intend to make additional investment in this area.

Closing thoughts

Growth is the shared destination, but there are many ways to get there: developing sensible new products; making strategic investments in technology, people and infrastructure; enhancing the brand; and simplifying the business by focusing on what you do best, and how to do it better.

There are many exciting growth opportunities for the industry. But they don't come without challenges.

At a time of heightened competition, managers must cater much more carefully to investor needs and preferences in order to win assets. Managers must be willing to customize their offerings to specific client types. This could involve adjusting fee levels and expense ratios, providing separately managed accounts or supplying registered liquid alternative products.

Simply offering these capabilities will not alone be enough, however. In today's environment, managers must work hard to differentiate themselves from the competition. They must provide a compelling explanation of their investment philosophy and processes.

And to turn these developments into growth, managers need to invest in:

- ▶ Marketing and distribution talent
- ▶ Front-office capabilities to support strategies
- ▶ Infrastructure to support products

At EY we are enthusiastic about the future of the industry. We look forward to continuing our work with you in this robust and meaningful global industry.

Michael Serota

Co-Leader, Global Hedge Fund Services

Arthur Tully

Co-Leader, Global Hedge Fund Services

Growth





Achieving growth remains a primary concern for managers as they are making strategic and innovative decisions in order to meet investor demands. There are some geographic variances in formulating strategy. However it is clear that discovering new avenues for growth remains top of mind for executives.

In this section we explore:

- ▶ Growth strategies
- ▶ Investor allocations
- ▶ New products
- ▶ Manager selection criteria
- ▶ Evolving investor base

Managers are launching new products to increase penetration of existing clients and access new investor bases

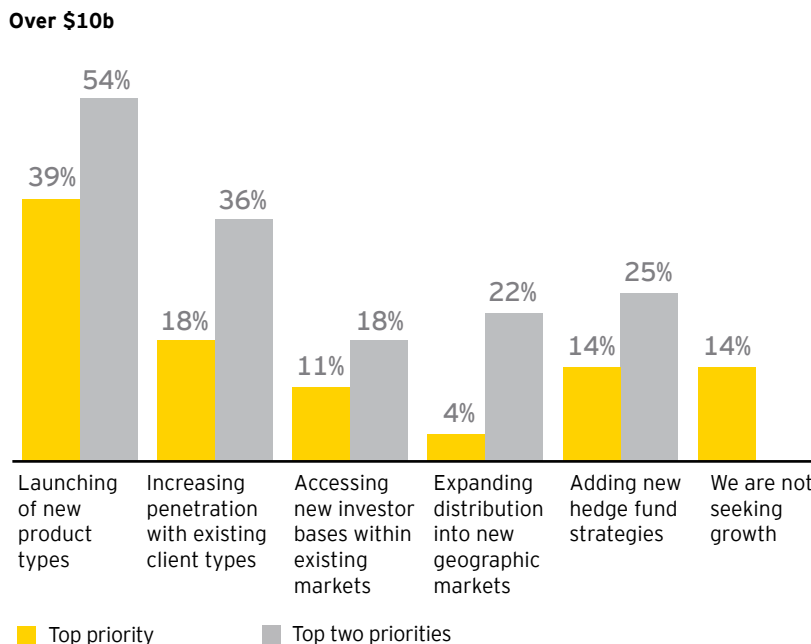
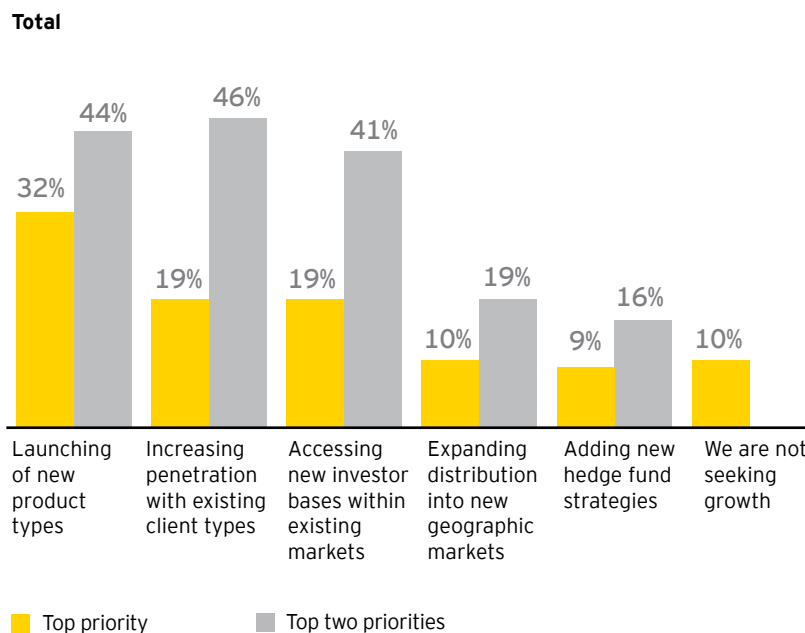
One in three managers says that developing new products to attract capital is a top priority to achieve growth, and the largest managers are the most focused on this strategy. Managers that have been nimble and adapted to the needs of investors – along with a strong brand and established track record – have been most successful in attracting new capital.

New products allow managers to attract more assets from existing investors – by customizing or responding to investor needs – and open up new types of investor bases that may not have historically invested in hedge funds.

At the other end of the spectrum, smaller managers are more likely to pursue capital within the strategies and products they already offer – at least in part because of the infrastructure required to launch new products.

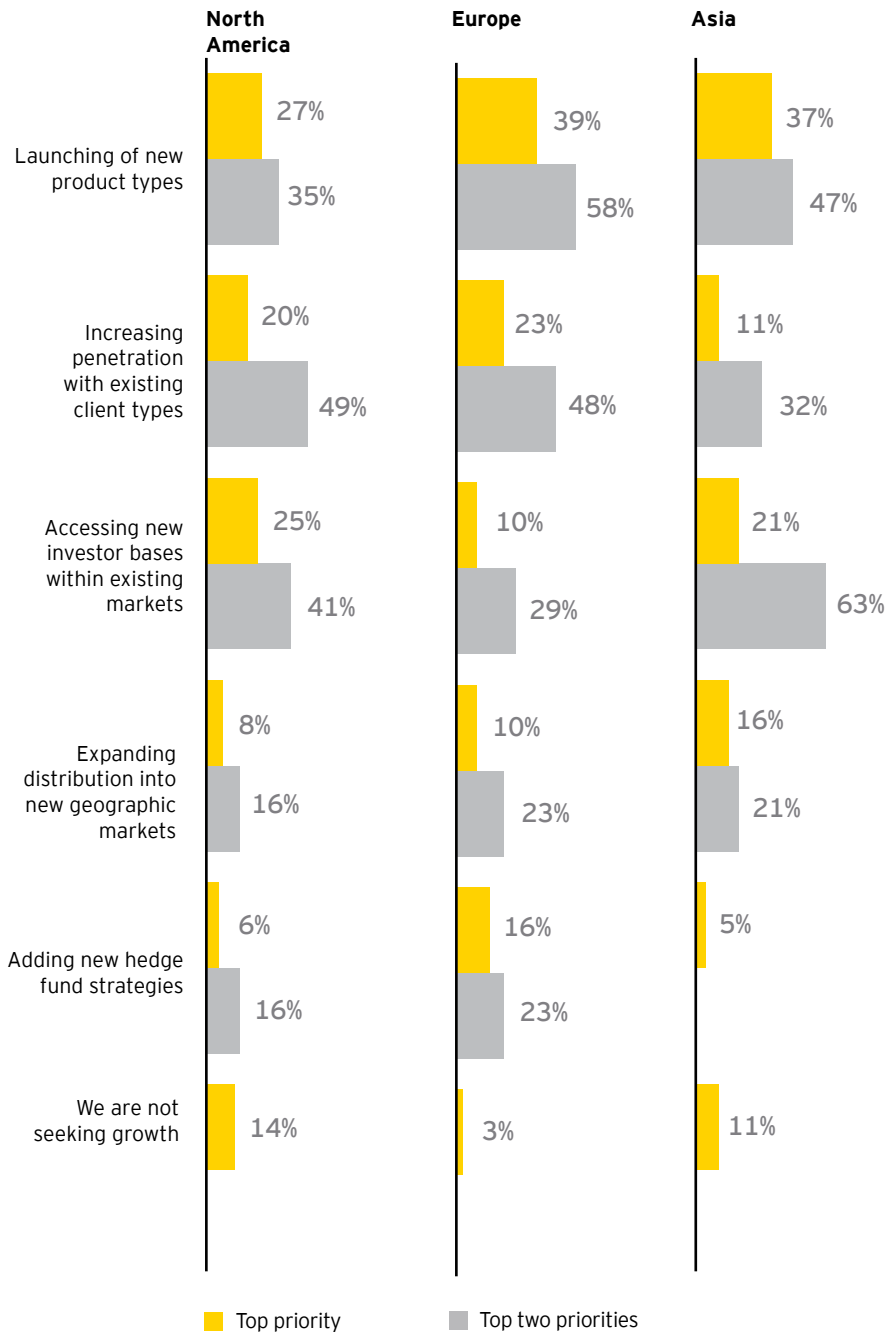
Hedge funds' growth strategies

Please rank the top two approaches your organization is currently pursuing to achieve growth over the next three to five years.



Hedge funds' growth strategies

Please rank the top two approaches your organization is currently pursuing to achieve growth over the next three to five years.



Growth strategies vary by region

At the surface, it appears that managers in Europe and Asia are more focused on launching new product types than their counterparts in North America. However, the largest managers in North America – over 40% of those with over \$10b in assets under management – say new product development is their top priority in achieving growth, compared to fewer than 20% of managers with less than \$10b in assets under management. These midsize and smaller managers have a limited capital base to fund investments in new products which could challenge their long-term growth.

Managers in Europe have been responding to the Alternative Investment Fund Managers Directive (AIFMD) and have been the most prolific in developing Undertakings for the Collective Investment of Transferable Securities (UCITS) over the past few years. Managers in Asia are more likely to have a globally diverse client base and are seeking to broaden their coverage in these markets – at least in part by developing new products that appeal to a wide investor pool.

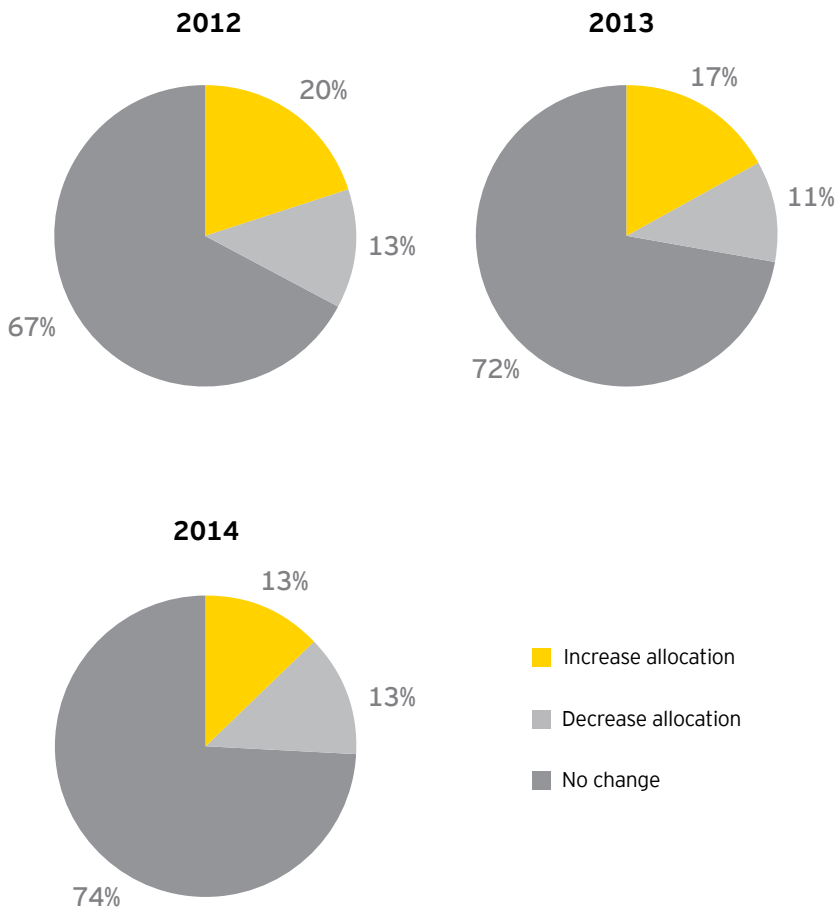


Managers with growth ambitions need to be closer to their investors' needs. This requires more bespoke offerings and not just a flagship solution that is one size fits all.

(Investor, pension/endowment, Europe)

Investors' planned allocation to hedge funds

Do you plan to increase, decrease or maintain your current target allocation to hedge funds in the next three years?



Asset growth in traditional hedge funds slows from their institutional investor base

The proportion of institutional hedge fund investors planning to increase their target allocation continues to fall. Investors that are decreasing allocations say they are de-risking and eliminating high fees. Many who are reducing exposure to traditional hedge funds are investing in other products offered by hedge fund managers that better fit into such investors' investing strategy. Among investors that would like to increase or maintain allocations, 40% say they face obstacles such as allocating too much to a single asset class. These results would suggest that, on a net basis, allocations are not increasing to hedge funds from institutional investors.

Given this backdrop, managers are offering these investors more flexibility via separately managed accounts, developing long-only funds and seeking to cross-sell new products to their traditional investor base. As such, the industry has begun to see inflows from a new investor base – private wealth platforms – and is developing registered products to attract a retail audience.

Managers are offering separately managed accounts, long-only funds and registered products

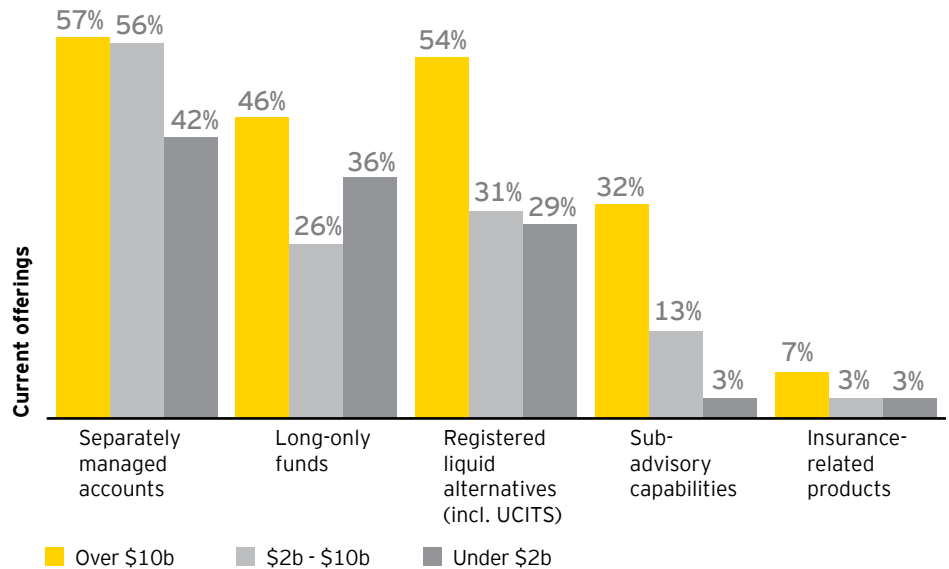
Although separately managed accounts increase operational complexity for a manager, they can help overcome investors' fee objections and allow managers to tailor offerings to meet investor needs.

Managers are also responding to demand for registered liquid alternatives, particularly those in Europe, where more than 60% of managers now offer these products. Liquid alternative funds also open up opportunities with private wealth platforms that have traditionally offered mutual funds to their vast retail client bases. The largest managers with an established brand have a competitive advantage. They can attract these assets and have invested in the necessary infrastructure to ensure that these products are accretive to margins.

In the future, the largest opportunity for hedge fund managers may be in long-only funds. However, they will face stiff competition from the traditional asset managers that have historically operated in this space.

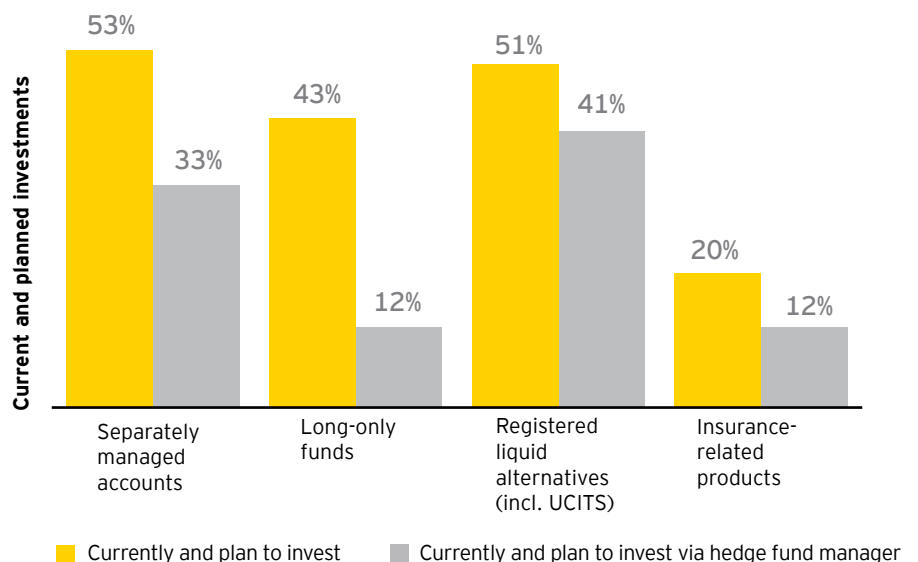
Hedge funds

Which of the following products do you currently offer to clients?



Pensions and endowments

In which of the following do you currently invest, or plan to invest, through a product offered by a hedge fund manager?



The rapidly changing environment in which we operate poses a significant risk and tremendous opportunity, both to us and the industry. Across the board we are seeing a combination of new products, new investor demands, desires for customization and new regulatory mandates. There are increased demands on the business to be nimble. The days of having a comingled, flagship hedge fund where asset accumulation naturally occurs via good performance is really not the way the current environment is working. I think that successful firms are pursuing new channels to acquire investors; they're using new products that are customized to meet investor needs. The winners are being nimble. This is happening because of the maturing of the business. It's no longer a cottage industry with a small number of players. It's expanded now with a number of more mature firms that are starting to look more like traditional asset management firms.

(Manager, North America, \$2b-\$10b)



Managers are continuing to launch new products

The largest managers who have been most prolific in new product development over the past few years are launching more of the same products and are exploring the “new frontier” by developing sub-advisory capabilities and insurance-related products.

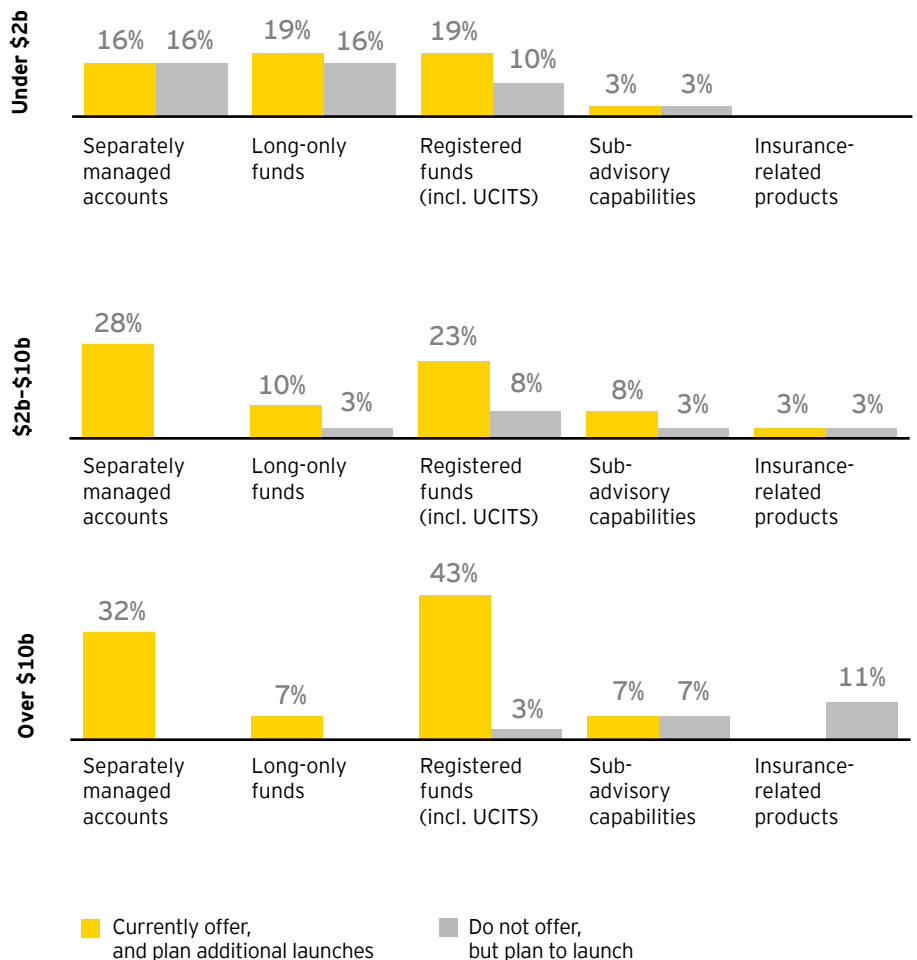
Even managers with less than \$2b under management are seeking to match the offerings that the largest managers developed over the past few years. They view product diversity as a means to win new capital.

Although this strategy has been successful, larger managers seeking to launch new products for the first time should not underestimate the challenges ahead. These challenges can include making significant infrastructure investment which has the potential to have a negative impact on margins.

Hedge funds

Which of the products/offerings are your top three priorities for launching in the next three to five years?

Top priority products to launch in three to five years



The largest hedge fund managers look like full-service investment firms. They have a variety of different products, offered in the different markets and tailored to those clients. Additionally, they have custom separate accounts, customized strategies and so on.

(Manager, North America, \$2b-\$10b)



Funds of funds update their offerings to remain relevant

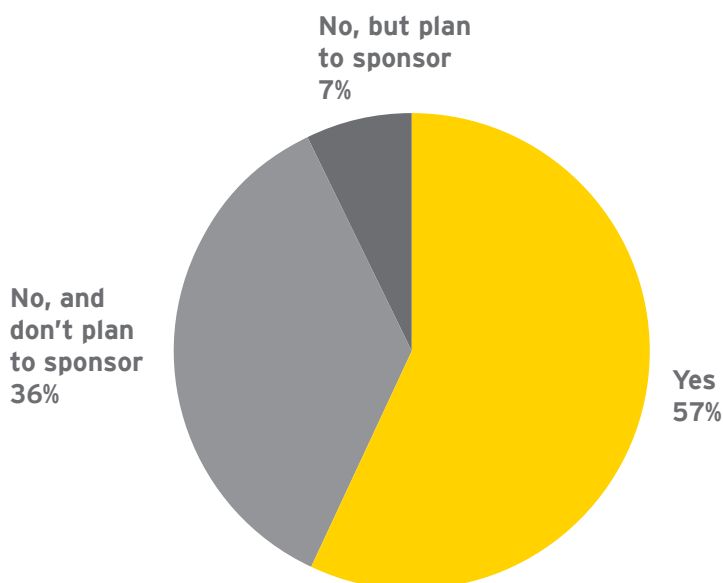
As institutional investors allocate more capital directly with hedge fund managers, funds of funds are changing their strategies so they can remain relevant. They are attracting retail clients by sponsoring registered liquid alternative funds. Additionally, funds of funds are beginning to serve as investment consultants to public pension plans. While this is a revenue-yielding service, this may result in lower fees and force their funds of funds offerings to compete with their consulting services.

To make these registered liquid alternative funds successful, funds of funds need to recruit hedge fund managers as sub-advisors. One in three of the largest managers currently acts as sub-advisor, and another 7% are planning to launch these capabilities in the next three to five years. These big managers are best suited to handle the operational complexities in reporting and managing multiple third-party service providers. These managers have also established a brand name. This is a prerequisite to participating in these platforms. The success of these products will depend on the ability of funds of funds to continue recruiting quality managers to their platform while offering attractive economics to managers who participate.

Funds of funds

Do you currently sponsor or plan to sponsor a registered liquid alternative fund for your investors?

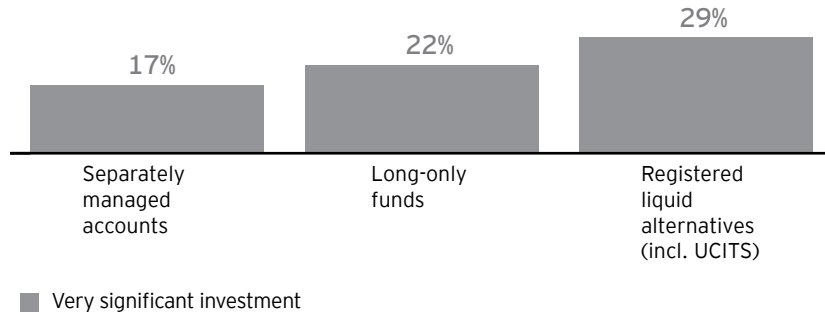
Currently sponsor or plan to sponsor registered liquid alternative fund



Hedge funds

How significant of an investment in infrastructure will your organization need to make to launch those products/offerings?

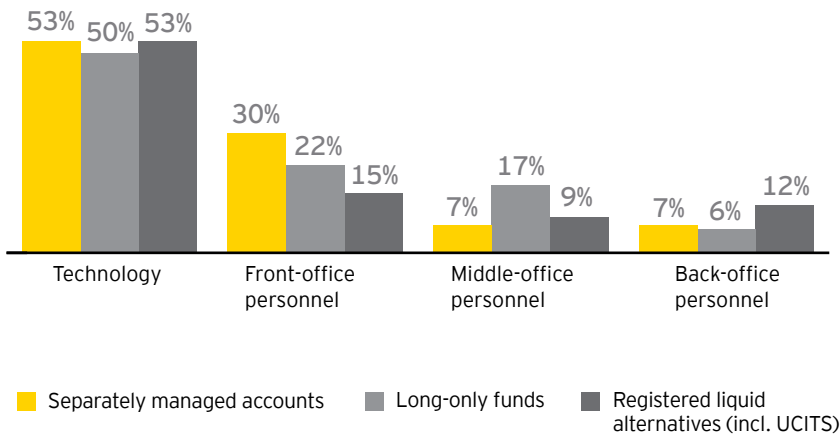
Level of investment needed



Hedge funds

In which of the following areas are you making the most significant investment?

Most significant investments



While an engine for growth, new products often require real investment in infrastructure

Successfully launching a registered liquid alternatives fund requires a more significant investment than launching separately managed accounts or long-only funds due to increased operational complexity in reporting and compliance functions.

As they launch a new product, managers expect their largest investments will be in technology. Managers generally can leverage the same personnel across different product types but need to invest in new risk systems and other middle-office and back-office infrastructure, particularly for regulated products.

Importantly, results of our study suggest that managers who have not yet launched new products often underestimate the investment required to successfully bring a new product to market and do not perform sufficient planning.

Hurdles to new products include infrastructure, capital raising, distribution and others

As the largest managers add new products, they identify developing the required infrastructure and hiring personnel as key challenges.

In contrast, smaller managers see challenges in raising capital. Large managers enjoy the benefit of brand and established client base. But they also have dedicated personnel for product management and marketing to help overcome the capital-raising and distribution challenges.

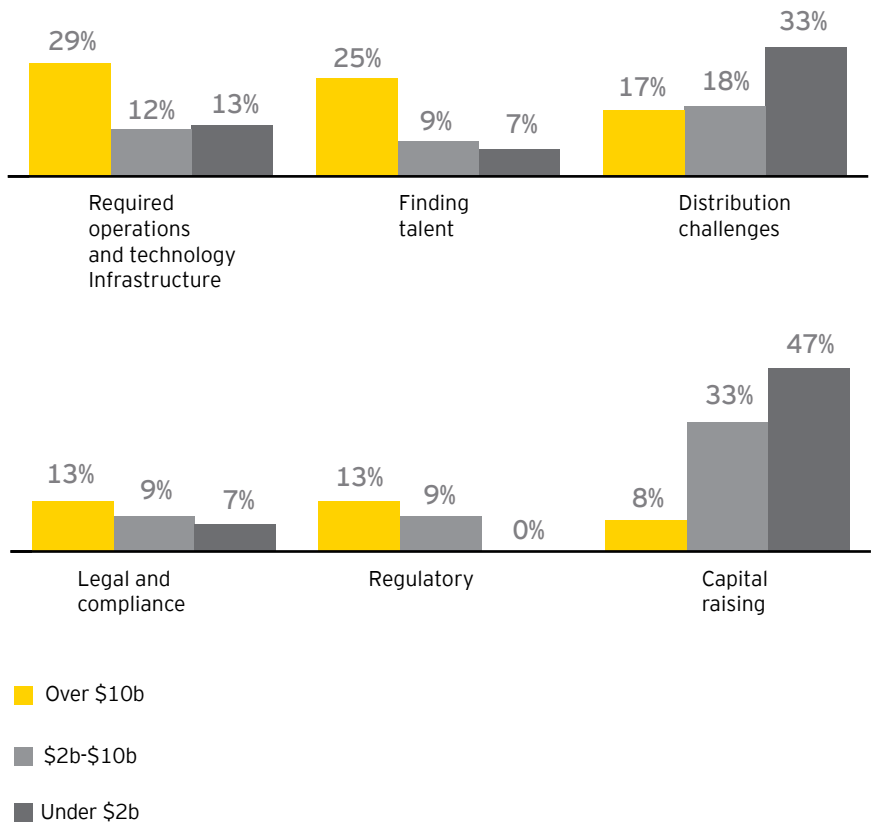
Given the rate at which new products are developed, it is critical that managers who aspire to launch new products differentiate themselves. In the absence of an established track record, they need to clearly articulate their value proposition and investment philosophy.

Addressing infrastructure requirements is an equally important challenge, especially for smaller managers. Managers need to understand investors' needs, spend time educating them about their products and demonstrate how their offerings meet the needs of the investor.

Hedge funds

What were the biggest challenges in adding products/offerings?

Key challenges in adding products





Caution! New products help to raise capital but, for some, have a negative impact on margins

Nearly one in four managers that launched a product in the past three years says the products had a negative impact on margins.

Separately managed accounts often come with fee concessions that impact margins. Those managers with scalable operations are more likely to have seen their margins increase, as a result of their ability to handle the increased reporting volume.

Registered liquid alternatives also are lower-fee products. They require investment in operations infrastructure and more sophisticated governance structures than traditional hedge fund products.

Sub-advisory relationships are low fee payments and may carry with them unique reporting requirements and may require firms to manage a number of unique service provider relationships.

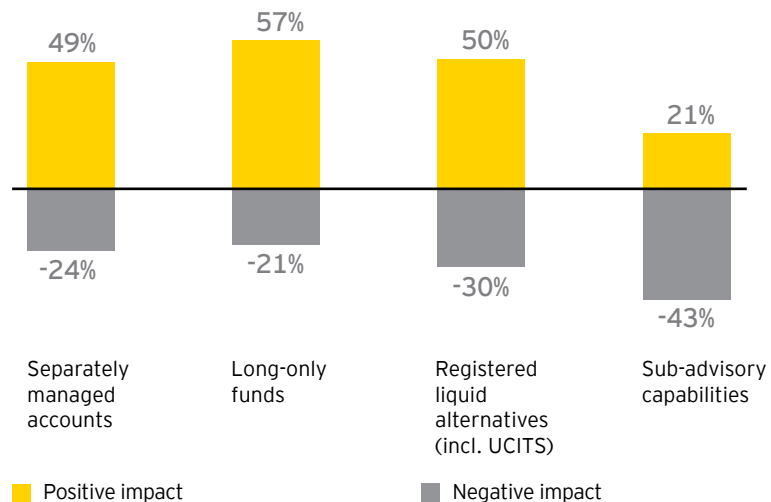
The negative impact on margins is particularly acute in Europe and among the largest managers – two segments that have been at the forefront of product development in registered liquid alternatives and sub-advisory capabilities. In fact, 45% of those who offer UCITS say margins have been hit.

Hedge funds

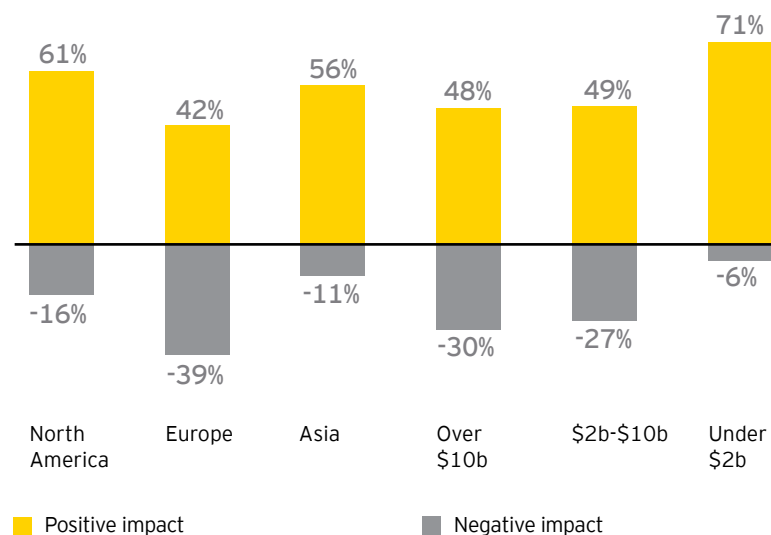
Have the products/offerings you launched in the last two to three years had a positive or negative impact to your overall margins on a percentage basis?

Proportion of managers with changes in margin

By current products offered



By region and size



A trend that is not a flash in the pan is hedge funds getting into mutual funds and other registered products. These 40 Act liquid alternative products are structured somewhat like a hedge fund and provide an opportunity for significant asset growth. Most of our distributors are partnering with funds of funds. We're on one platform now, and we'll be on three more by the end of the year.

(Manager, North America, \$2b-\$10b)



Successful capital raising requires a clear understanding of what investors want to hear

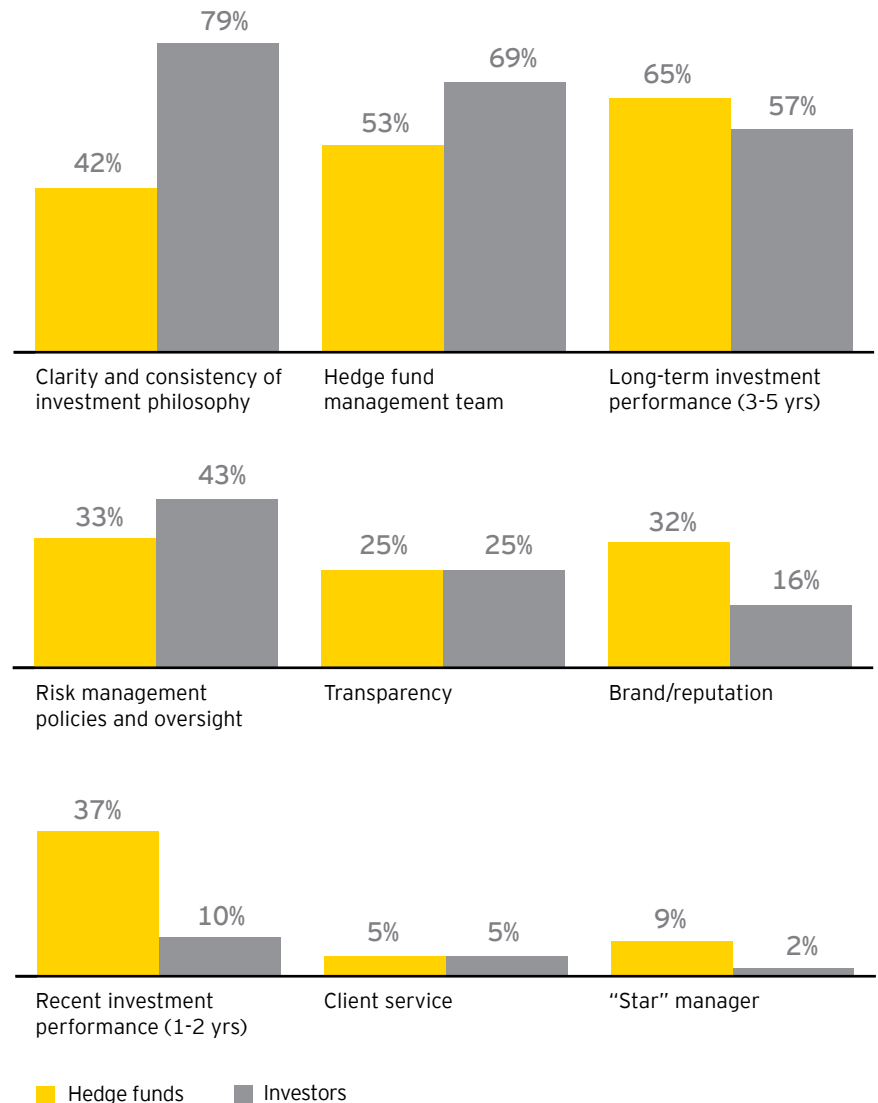
Investors consistently report that, when selecting a manager, they are most focused on understanding a firm's investment philosophy and developing confidence in the management team. Meanwhile, managers believe investors are most focused on historical performance first; however, investors clearly understand that "past performance will not guarantee future success" as they do not place as much weight on past results.

Though the largest managers recognize the importance of communicating their investment philosophy, it tends to be of secondary or tertiary importance. Given the increase of new products, it is more critical than ever that managers convey the right messages in order to give investors confidence in their ability to generate future returns at appropriate risk levels.

Hedge funds and investors

Which of the following are the three most important screening criteria for investors in the initial rounds of manager selection (i.e. prior to comprehensive operational due diligence)?

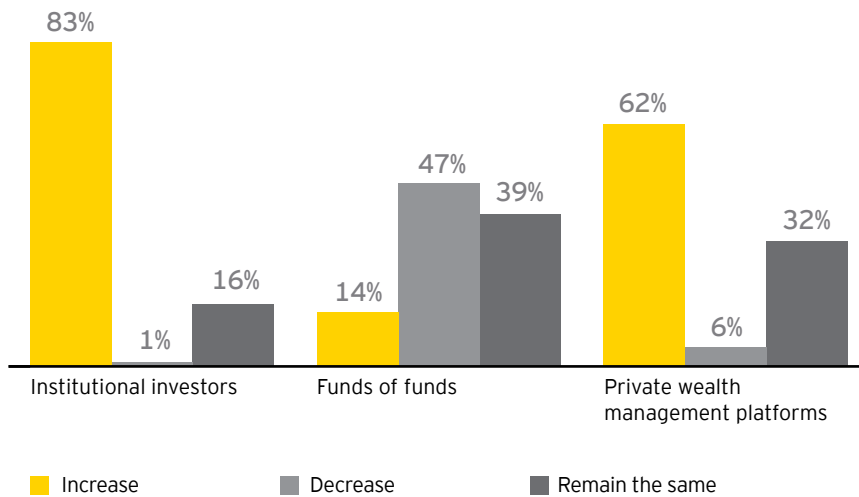
Top selection criteria



Hedge funds

Do you expect the proportion of assets you will source from each of the following channels to increase, decrease or remain the same over the next two years?

Expected changes in source of assets



New product development is aligning with hedge fund managers' evolving investor base

Hedge fund managers expect to source more assets from institutional investors and fewer from funds of funds over the next two years. This trend, which started several years ago, is set to continue as managers prefer clients that invest directly to those that use intermediaries.

The managers in this study source an average of 15% of their AUM via investment consultants. Although more than half the managers expect the share of AUM sourced through consultants to increase in the next two years, that response represents a lower proportion than last year.

Managers also expect to source more from private wealth platforms and view this distribution channel as an additional and growing source of capital.

The results reflect a continued slide in managers' view of funds of funds; however, nearly one in three investors continues to view funds of funds as the most preferred channel of investment, this signals a viable future for these entities.

Fund expenses





Regardless of size or geographic location, the cost of running a business has increased. As such, the discussion on managing expenses continues to be a hot topic for the hedge fund industry as a whole.

In this section we look at:

- ▶ Trends in expense ratios
- ▶ Expenses passed to funds
- ▶ Fee pressure
- ▶ Direct expense caps

Overall, expense ratios have declined modestly as capital bases have increased

Managers with less than \$2b under management report the lowest expense ratios for their flagship fund. There are two key reasons:

1. These managers are three times more likely than the largest managers to offer a long-short equity strategy as their flagship fund. Long-short equity strategies have a relatively modest average expense ratio of 1.77%.
2. In order to attract clients, these managers are more likely to offer fee discounts and less likely to pass through expenses to the funds they manage.

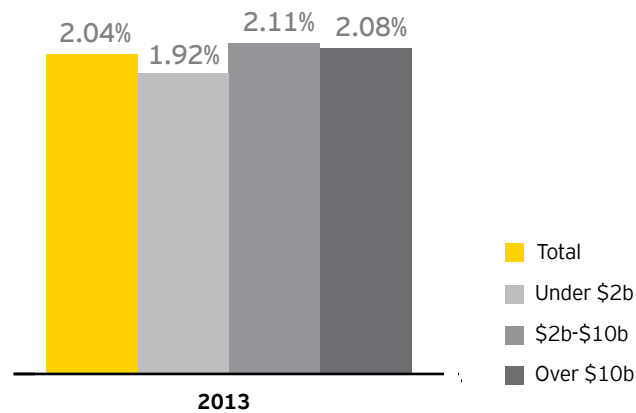
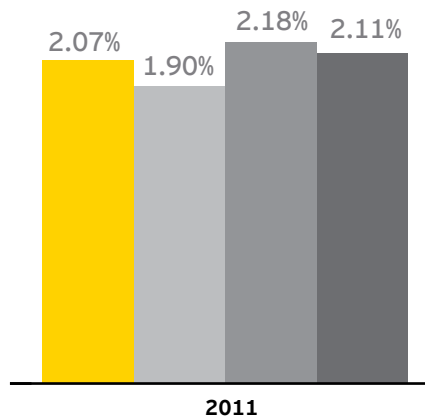
Flagship strategies among larger and midsize managers are more diverse and include credit and distressed strategies. This results in higher average expense ratios. In fact, distressed strategies carry the highest expense ratios – 2.65% on average. This is because the strategy's complexity requires an established infrastructure and additional expenses from service providers.

Nonetheless, expense ratios have been declining for most funds not necessarily because of lower expenses, rather, via spreading expenses over a larger asset base.

Hedge funds

What is the average expense ratio for your flagship fund?

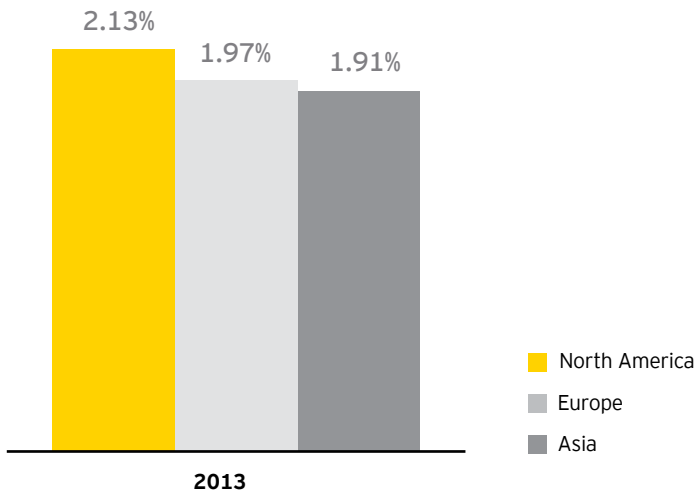
Average expense ratio



Hedge funds

What is the average expense ratio for your flagship fund?

Average expense ratio



European and Asian managers have consistently reported lower expense ratios than managers in North America

For each of the past three years, managers in Europe report lower expense ratios for their flagship funds than managers in North America. This discrepancy cannot be explained by simple differences in strategy. Whereas managers in Asia disproportionately report long-short equity as their flagship strategy, the distribution of strategies of European and North American managers are more similar.

Managers in Europe have historically faced significant scrutiny on fees from investors. They have responded by developing less costly operating models that rely heavily on outsourcing. Furthermore, European managers have been at the forefront of developing UCITS that command lower fees.

Investors generally appear more sanguine about fees as expense ratios have declined

One in three investors says the expense ratio of their largest fund has come down over the past two years, and three in four say they are satisfied or neutral about the expense ratio of the funds in which they invest.

Investors' acceptance of expense ratios is based on their awareness of the increasing cost of regulatory compliance as managers become more transparent about the investments they have been forced to make and the new costs they are bearing.

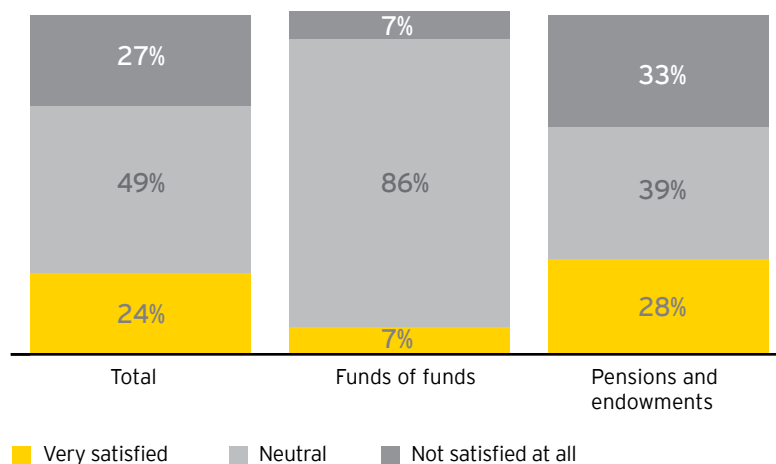
One-fourth say they are not satisfied with the expense ratio of the funds in which they invest. It is incumbent upon managers to work closely with investors that are unhappy about fees, explaining the reasons for the funds' cost base.

Investors have been attempting to protect themselves by negotiating expense caps that are fair to both themselves and the managers. It is not surprising that the largest investors have had the most success at negotiating these caps.

Investors

On a scale of 1 to 5, from 1-not satisfied at all to 5-very satisfied, how satisfied are you with the expense ratio of the funds in which you invest?

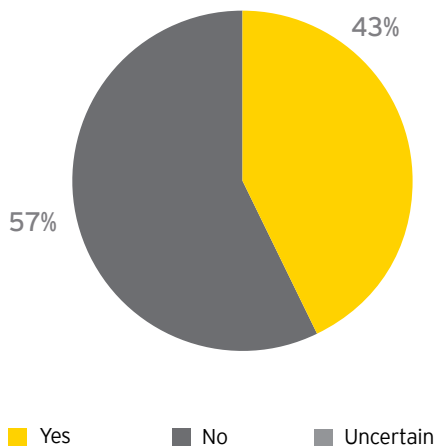
Satisfaction with expense ratio of funds



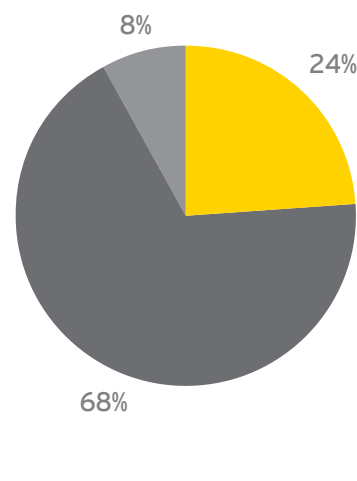
Investors

Have you negotiated a cap on direct expenses with your hedge fund managers?

Funds of funds



Pensions and endowments



The expense ratios of the funds we invest in have been decreasing. We have observed that more managers have been willing to negotiate and we have been making deals with those managers which is more reflective of a partnership between us and them.

(Investor, pension/endowment, Europe)

Our expense ratio has decreased, but only because we have experienced AUM growth. The actual expenses absorbed by our funds have increased, but we have been fortunate to have a larger asset base to spread these costs across.

(Manager, North America, \$2b-\$10b)

We are struggling with the costs of running our business and allocating expenses between our manager and the funds. We have been successful in managing our expense ratio down; however, it is becoming increasingly challenging given the increased expenses we are incurring between regulatory compliance and necessary enhancements to our operational infrastructure.

(Manager, Asia, under \$2b)



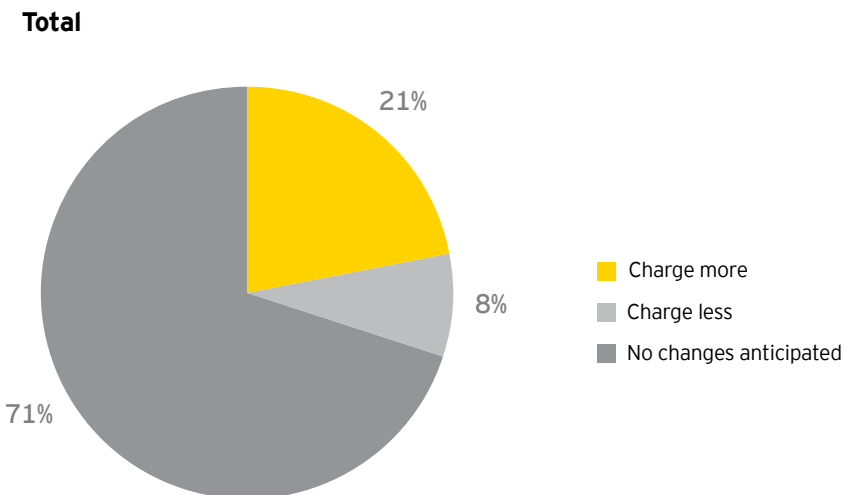
The current environment creates a window of opportunity for smaller managers to pass additional expenses to the funds

Nearly one in four managers anticipates that they will charge more expenses through to the funds in the next year or two. This compares to just 13% last year. It is largely made up of midsize and smaller managers who have lagged behind the largest managers in passing through expenses.

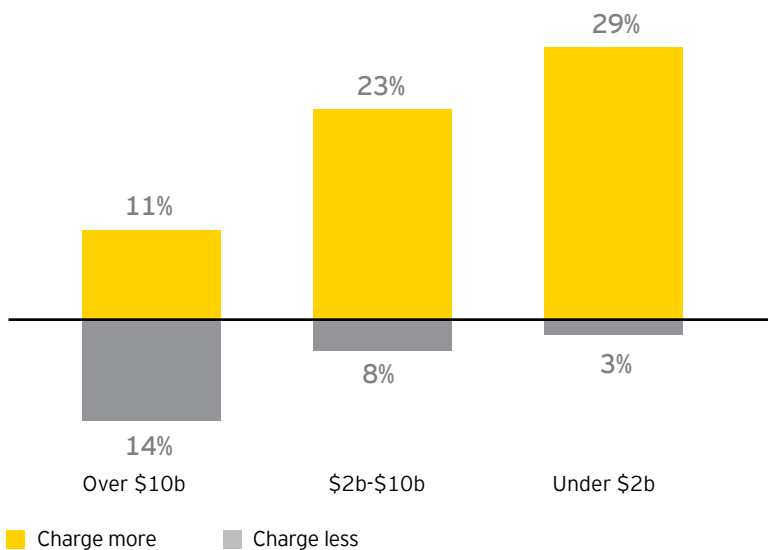
Fifteen percent of investors say their managers have indicated that they will be passing more expenses through to the funds. Managers should continue to be vocal and transparent with investors about the rising cost of running their business as a mutual understanding of this new reality is necessary to ensure investors and managers are appropriately aligned on the issue of expense sharing.

Hedge funds

Do you anticipate charging more or less expenses to the funds than you have previously charged through in the next one to two years?



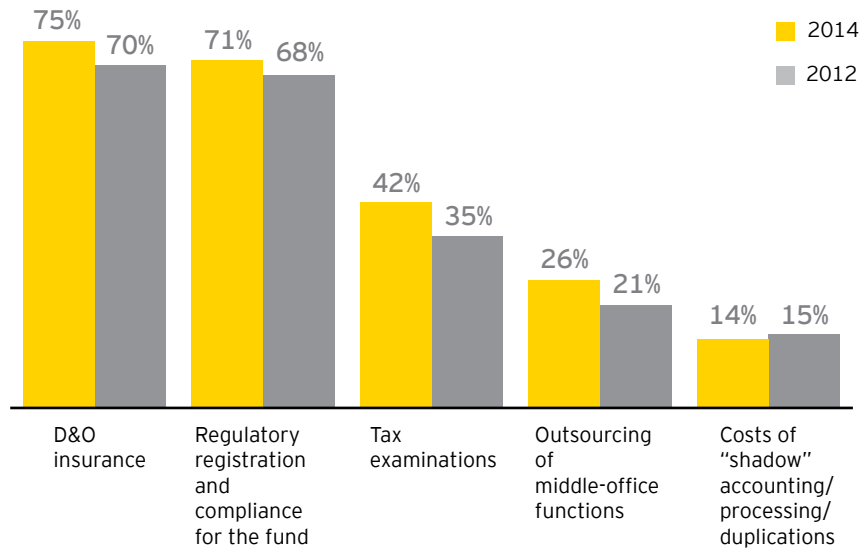
By size



Hedge funds

What type of expenses do you currently pass through to the funds? Please select all that apply.

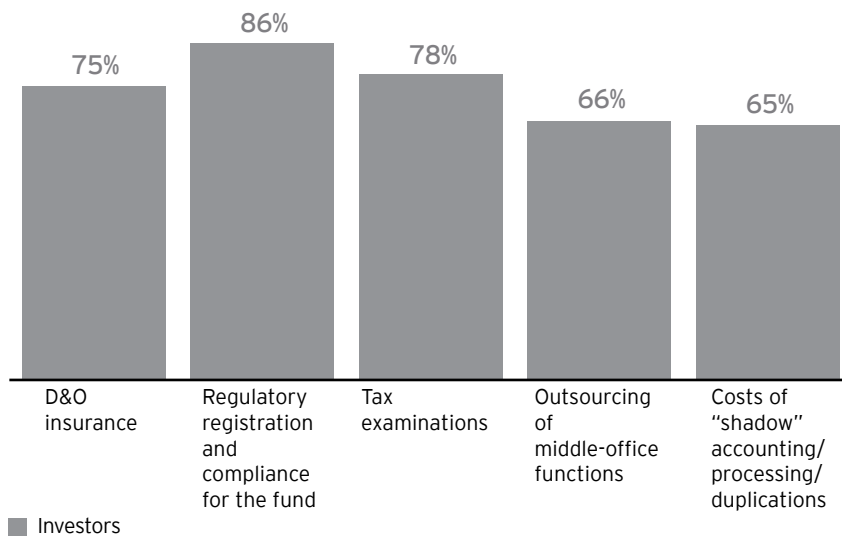
Expenses currently passed through to funds



Investors

What type of expenses would be acceptable to be passed through to the funds? Please select all that apply.

Acceptable expenses to pass through to funds



Investors show greater acceptance for bearing costs of the business

There has been no sea change in the types of expenses that managers pass through to funds. But should there be? As we will find later in the study, investors have a stronger appetite for outsourcing. And, as we see here, they would be willing to cover the cost. Despite investors accepting these expenses, managers continue to bear the costs and do not pass them through to the funds.

Investors recognize the increased burden that compliance managers are facing and appear less resistant to managers charging these costs as fund expenses than in the past.

While focused on individual expense types, investors also examine the overall expense ratio. As long as the expense ratio is within an acceptable level, investors appear willing to compromise on many new or previously challenged costs.

Manager investments and expenses





Managers continue to be relentless in their goal to achieve efficiency. Allocating time and resources to improving the front-, middle- and back-offices has been the trigger to reducing operation costs and minimizing the drag on margins.

In this section we discuss:

- ▶ Where investments are being made
- ▶ Regulatory reporting and technology expenses
- ▶ Achieving efficiencies
- ▶ Outsourcing and shadowing

Investments continue in legal or compliance issues and risk, as managers begin investing across other functions to support growth

Investments in legal and compliance functions do not appear to be abating as managers continue to find ways to streamline reporting functions. Managers have few alternatives to making these investments themselves because there are limited technology or software options. Service providers currently offer regulatory reporting services – an area ripe for outsourcing. However, many managers have not relied on this option due to a lack of trust.

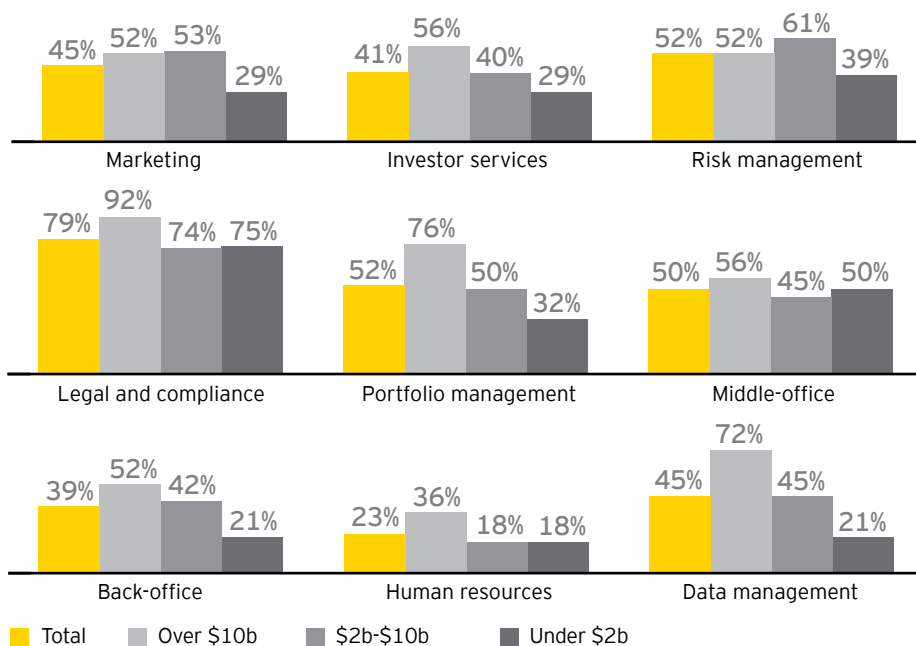
The largest managers are most likely to invest in the front-office and in data management. Front-office investments are critical because these managers develop new strategies and products. Investment in data management supports many stakeholders at the firm. These investments are critical to the task of achieving efficiencies across the middle- and back-office. They support internal controls, risk reporting, portfolio management and effective outsourcing to service providers.

The smallest managers have fewer resources to invest. This is despite their ambitious growth plans and their need to identify opportunities to outsource – particularly in the middle office – to free up investment dollars.

Hedge funds

In which of the following areas have you made investments in the past 12 to 24 months?

Investments in past 12-24 months



Throughout our history, we've always evaluated the buy vs build decision, as strongly in favor of build, not because we felt we had a secret expertise, but because the vendors were still developing the products. But, in the last five years, I think the service providers and software vendors have become more targeted, more focused and have really upped their game in terms of building products that are very customized to this industry. With this development, there's now more availability of off-the-shelf product/solutions so that when you're looking at the buy or build decision now, you'll frequently decide that it's best to buy from an efficiency and cost management perspective. This allows us to reign in our internal spend because we don't need as many people to deal with specialized issues.

(Manager, North America, \$2b-\$10b)

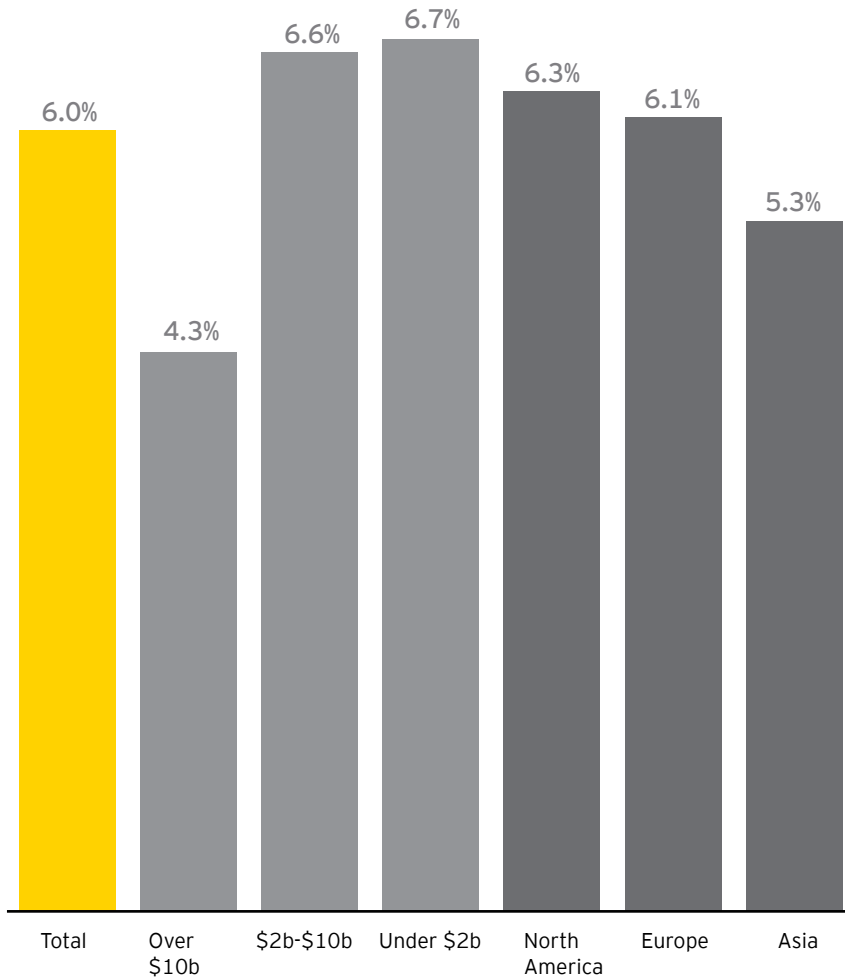




Hedge funds

As a percent of your overall expenses, please provide an estimate of your firm's annual spend attributed directly to regulatory reporting (Form PF, AIFMD, etc.)?

Average drag on margins due to regulatory reporting, assuming 30% margin



Expenses related to regulatory reporting are having a meaningful drag on margin and creating a barrier to entry

Expenses related to regulatory reporting are bearing on margins and creating a barrier to entry.

Regulatory reporting expenses were negligible a few years ago. However, this cost has risen recently, and it is now significantly affecting managers' bottom line. This added cost can translate into an average material drag on margins of 6%, assuming a historical margin of 30%.

Given their lower overall cost base and limited ability to pass through expenses to the funds, the smallest managers are most affected by the added expense. For them, it represents an almost 7% drag on margins. Bearing the cost of regulatory reporting creates a clear barrier to entry for new and emerging funds.

In contrast, large managers are insulated by larger cost bases and have been investing in automated reporting solutions to reduce the burden of regulatory compliance.

Managers in Asia tend to have a lower cost associated with regulatory reporting as these functions have largely been outsourced.

Technology expenses continue to increase

The largest managers are spending the most. They are making strategic capital investments in technology to continue to scale their operations. Investments have moved to two key areas: data management and integrated front-office systems that create efficiencies between the front- and middle-office.

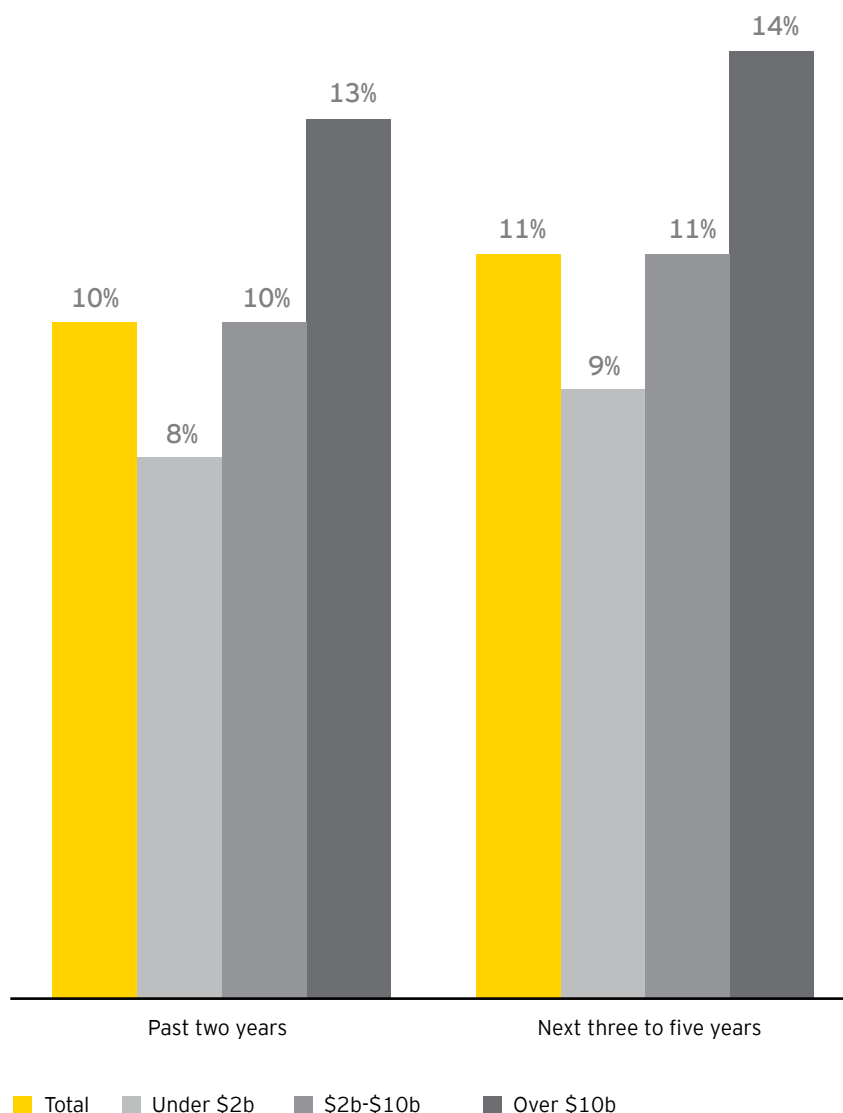
Whereas managers used to integrate disparate best-of-breed technologies, they are now implementing more comprehensive systems that link portfolio management and order management with risk, compliance and accounting systems. A key to making these systems work is data governance and enterprise-wide data management.

History is repeating itself. In the past, managers made material investments in back-office automation, only to outsource those functions to administrators a few years later. As managers seek additional efficiencies, they feel compelled to invest in technology, even as administrators' middle-office capabilities continue to develop. Service providers that succeed in demonstrating proficiency in middle-office processing will have a clear competitive advantage.

Hedge funds

On average, approximately what percent of total expenses were allocated to technology expenditures over the past two years? And over the next three to five years?

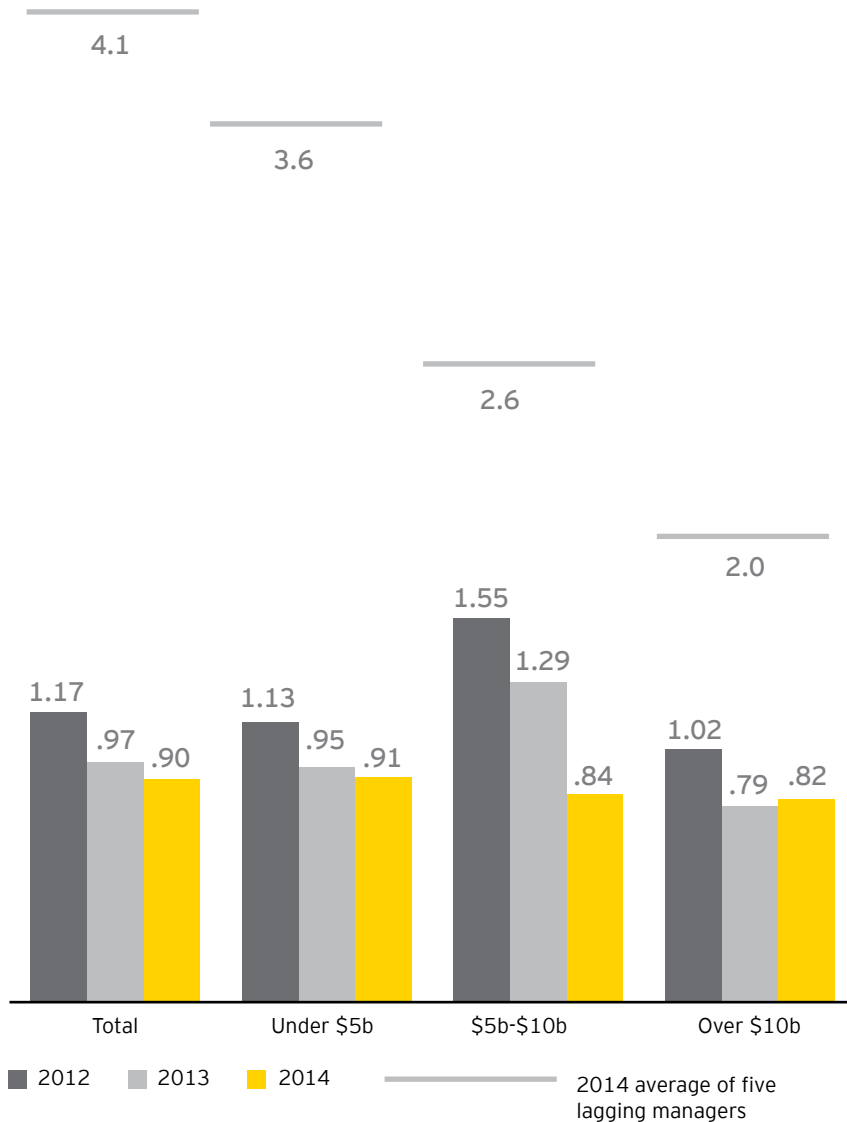
Past and future average technology expenditures



Hedge funds

Please detail your firm's resourcing for the following functions on a full-time equivalent (FTE) basis.

Average ratio of back-office FTEs per \$1b in AUM to front-office FTEs per \$1b in AUM



Technology investments, combined with outsourcing, are resulting in headcount efficiencies in the back-office

Over the last few years, investments in automation, effective outsourcing and a concurrent reduction in shadowing or replication have helped managers to achieve efficiencies in the back-office. Midsize managers have realized the most efficiencies in the past several years. They are now achieving ratios of support personnel to front-office headcount in line with those of the largest managers.

Although leading managers appear to be approaching the achievable limits of headcount reductions, the industry can secure additional efficiencies from middle-office outsourcing and continued investment in technology. In addition, there remain managers of all sizes that have clear opportunities to realize efficiency from technology, outsourcing, and a reduction in shadowing and replication for outsourced functions. Reduction in the average ratio of back-office FTEs to front-office FTEs will continue to diminish for larger managers unless these managers take a holistic assessment of their operating models.

There is meaningful differentiation by strategy. Managers that offer distressed and credit strategies are considerably less efficient than managers that offer only long-short equity. Back-office processes – including valuation – for these strategies are complex, and outsourcing solutions remain less reliable.

Back-office functions are largely outsourced, but middle-office remains in-house

To no one's surprise, back office functions related to net asset value (NAV) and financial statement generation continue to be predominantly outsourced. The only funds holding out on these functions are those with complex structures and/or trading strategies and those funds that have developed what they believe to be superior technology and internal processes compared to those offered by administrators.

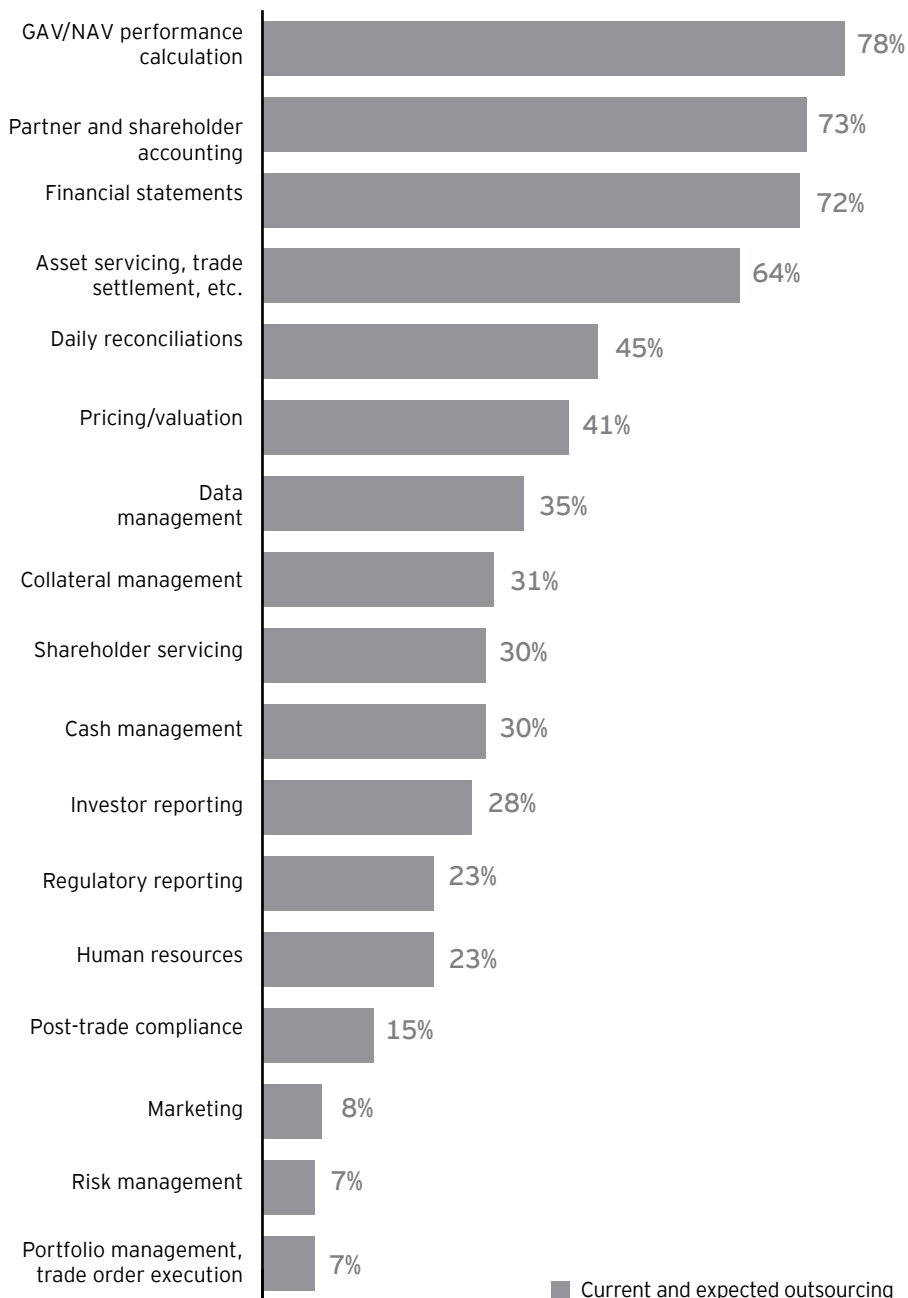
Outsourcing for middle-office functions is much less common and is an area ripe for consideration for managers looking to reduce the workload and cost of their internal infrastructure performing these tasks. Fewer than half of managers currently outsource middle-office functions despite advances made by third-party providers in these areas, in addition to growing investor comfort with managers' relinquishing control of these responsibilities.

Historically, managers in Europe have been more keen to outsource than peers in other regions. Since the financial crisis and the Madoff investment scandal, managers in North America have closed the gap noticeably. This is a result of investor demand for independent oversight and a need to improve cost structures.

Hedge funds

Do you currently outsource any aspect of the following functions to a third party (including consultants)? In which categories do you expect to outsource more of the function in the next two years?

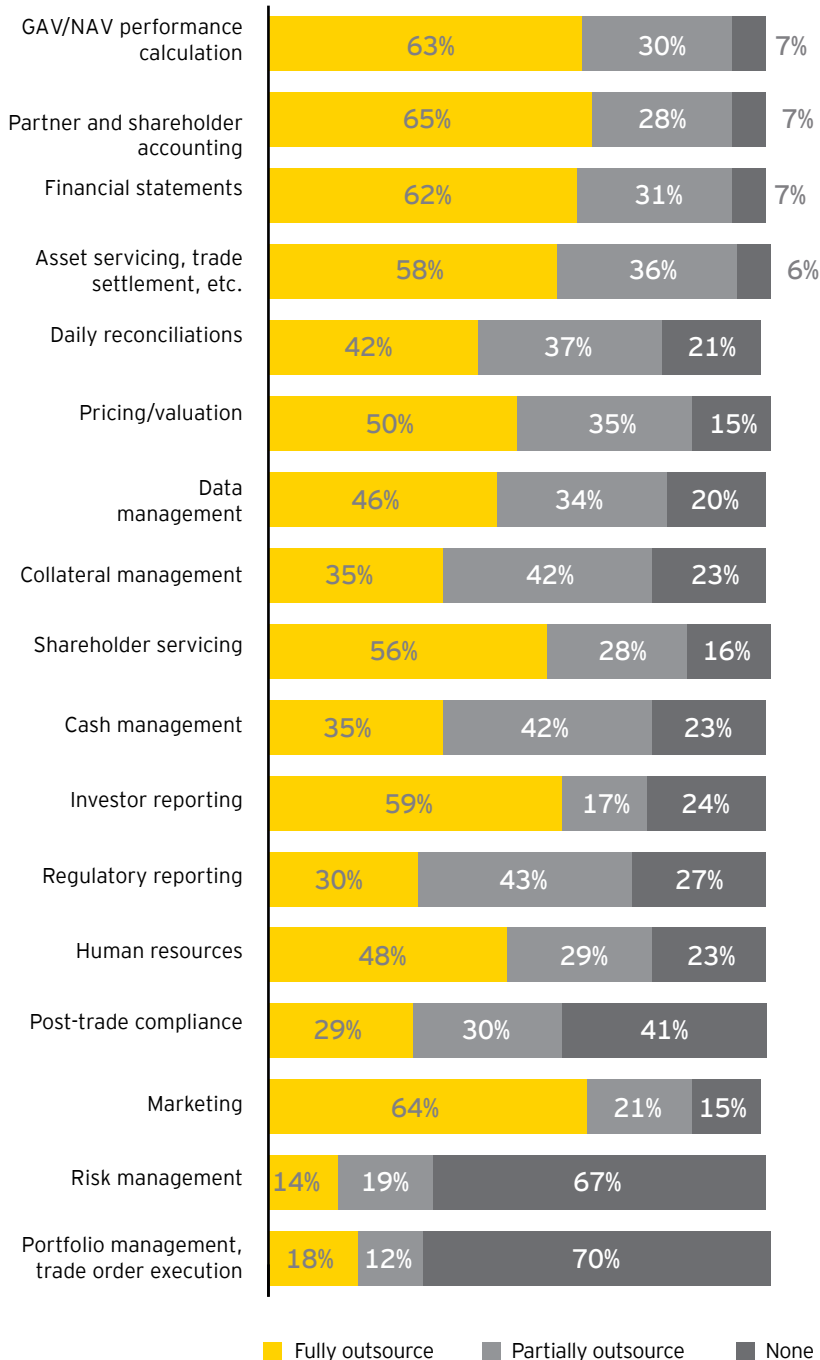
Current and expected outsourcing



Investors

For each of the following activities and functions, what is acceptable for your hedge fund managers to fully outsource, partially outsource or not outsource at all to a third-party?

Acceptable functions to outsource



Investors are increasingly comfortable with outsourced operations

The last page highlighted that fund managers continue to resist outsourcing functions outside of the core back-office. This is despite the fact that investor responses once again show an increased level of comfort with managers leveraging the solutions offered by various third-party vendors for almost all middle- and back-office tasks. Investors are overwhelmingly tolerant of managers outsourcing everything from daily reconciliations and pricing to collateral management and shareholder reporting. In fact, risk and portfolio management are the only two functions identified by investors as not permissible for outsourcing.

Given this current state, managers should be exploring the solutions provided by third-party vendors and understanding where they can leverage opportunities to scale back the functions currently performed in house. Whereas in the past an expectation may have resided that investors wanted greater manager involvement in these areas, the climate has certainly changed presenting a window of opportunity for managers to re-evaluate and enhance existing business models.



Hedge funds

On a scale of 1 to 5, from 1-not developed at all to 5-highly developed, how developed are third-party service provider offerings in the following areas?

Maturity of third-party service providers



Middle-office outsourcing represents the new frontier for additional cost savings

Managers do not yet see middle-office outsourcing as a viable alternative. As a result they continue to make significant investments in middle-office infrastructure.

Many managers see these functions as too closely tied to the front office. They believe that the required coordination between the middle-office, investment professionals and risk management would be impeded if middle-office functions are outsourced. Furthermore, they do not perceive the capabilities of third-party service providers for these functions to be as mature as those for back-office processing.

As an alternative to investment, managers should consider working closely with their service providers to advance their capabilities. Service providers should see this as a call to action and continue to invest.

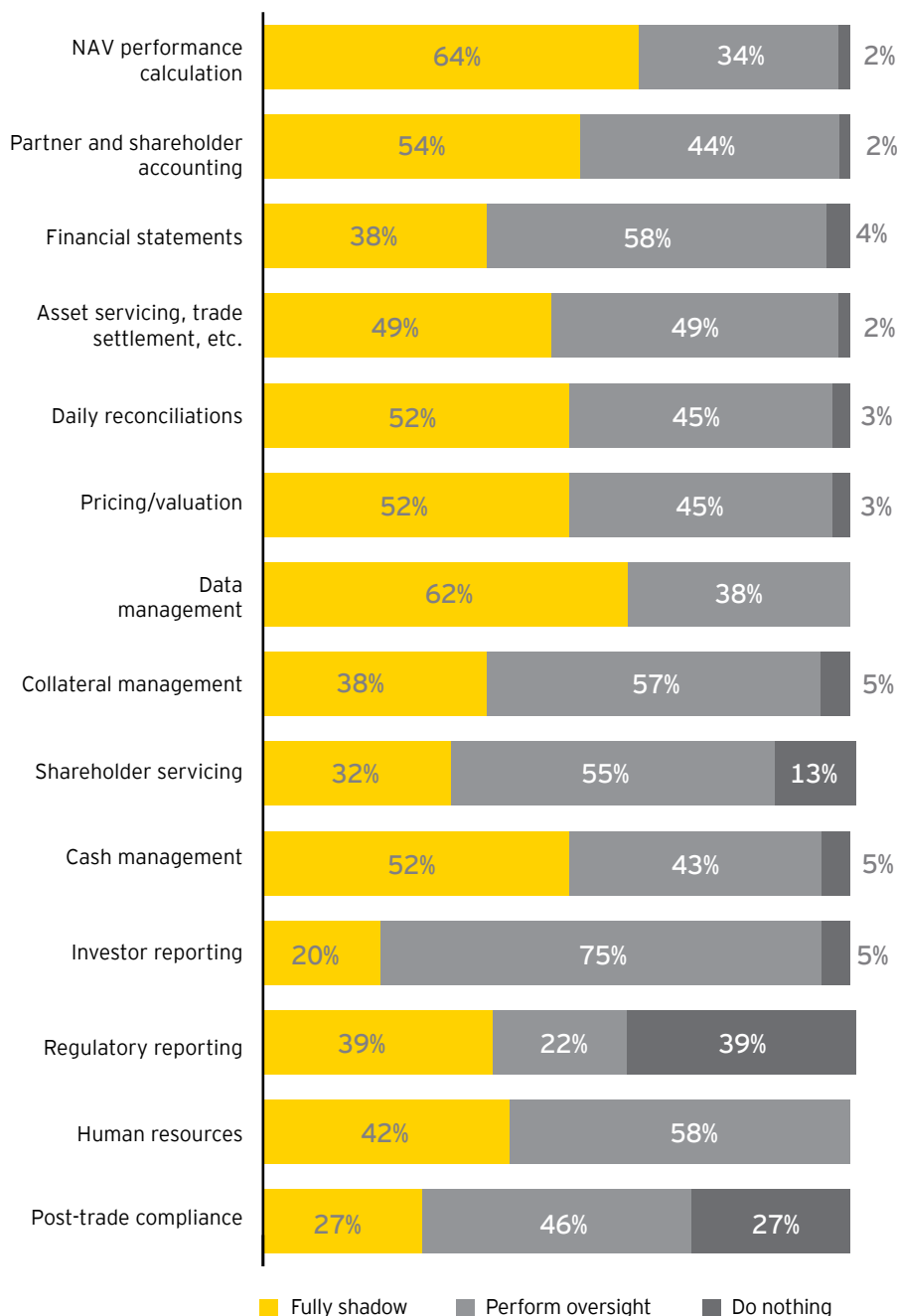
Reduced replication of outsourced functions can improve efficiencies

Fully replicating outsourced functions negates the cost savings that a manager could realize from outsourcing. Yet, judging by the pervasiveness of full shadowing, it would appear that many managers are unwilling to eliminate this duplication of effort. This reticence is explained by the need to ensure that they have appropriate checks and balances on their administrators and to mitigate risks of business continuity and disaster.

It is to be expected that when managers move to outsource certain processes for the first time, they will fully shadow until comfortable that their service provider is sufficiently processing these new responsibilities. It is surprising that functions with a track record of successful outsourcing, such as NAV calculation, continue to receive full shadow treatment from a majority of managers.

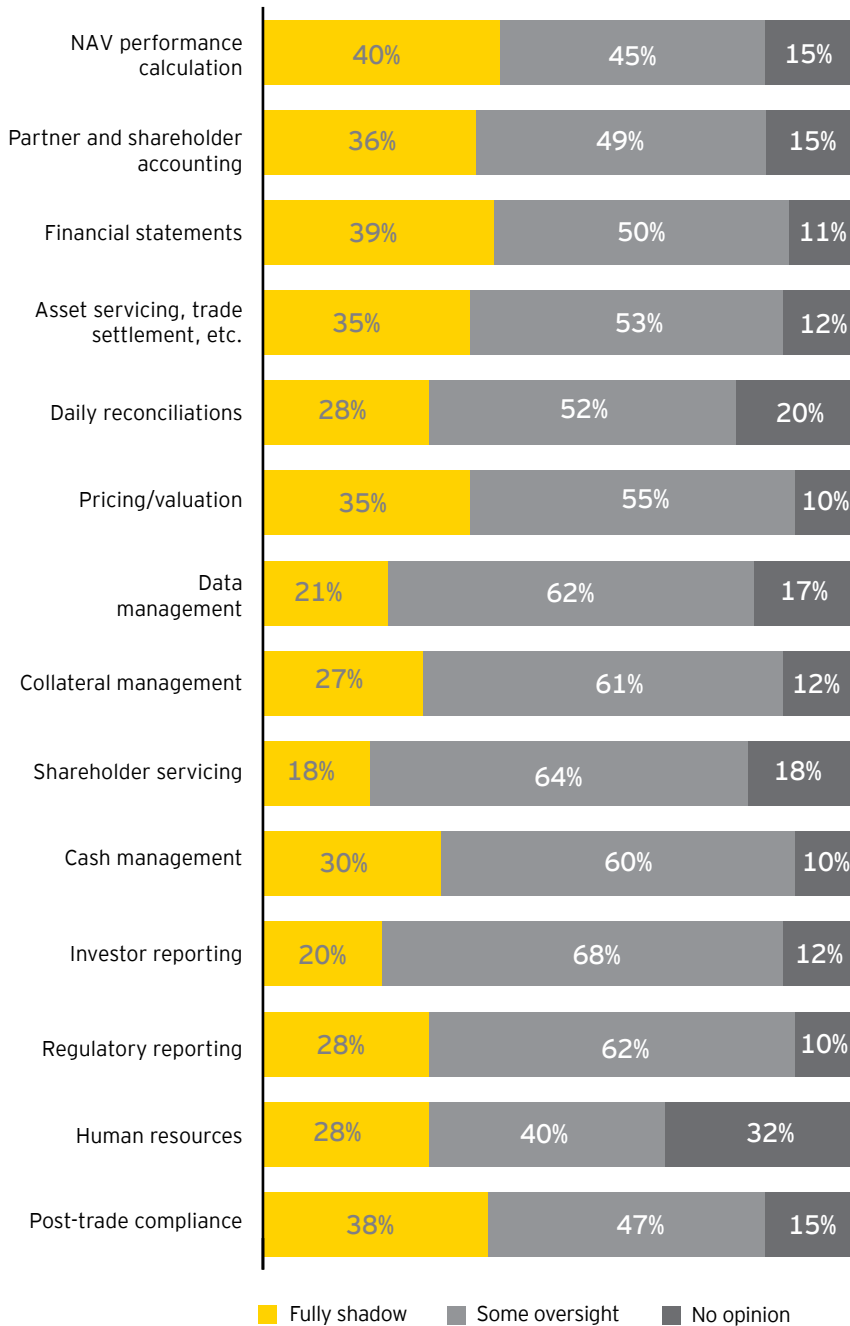
Hedge funds

For the functions you outsource, which do you fully shadow, perform oversight, or do nothing?



Investors

For each of the following functions that would be acceptable to outsource to an administrator, would you prefer that the hedge funds in which you are invested fully shadow or perform oversight?



Investors prefer moderate oversight

Administrators should see this as an opportunity. Managers will always do some replication, but administrators can raise comfort levels with their processes. They can prove to managers that they have adequate controls in place to prevent costly errors, that they are sufficiently capitalized and committed to the business, and that they have disaster recovery plans in place. Investors by no means are saying they expect no involvement from managers; however, an overwhelming response across all functions indicates they are comfortable moving away from the costly and time consuming, intensive full shadow model that many managers use.

Investors are clearly more tolerant of oversight than are managers. They recognize that the redundancy increases the cost structure of their managers and impedes further reductions in management fees.

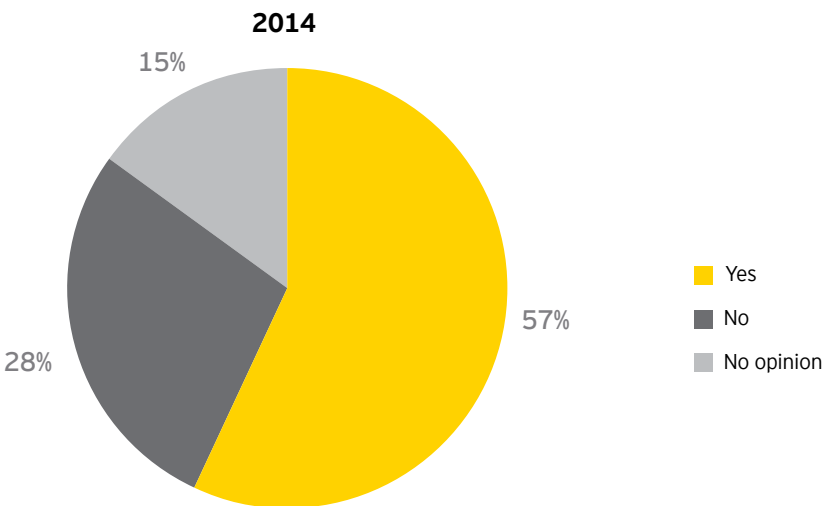
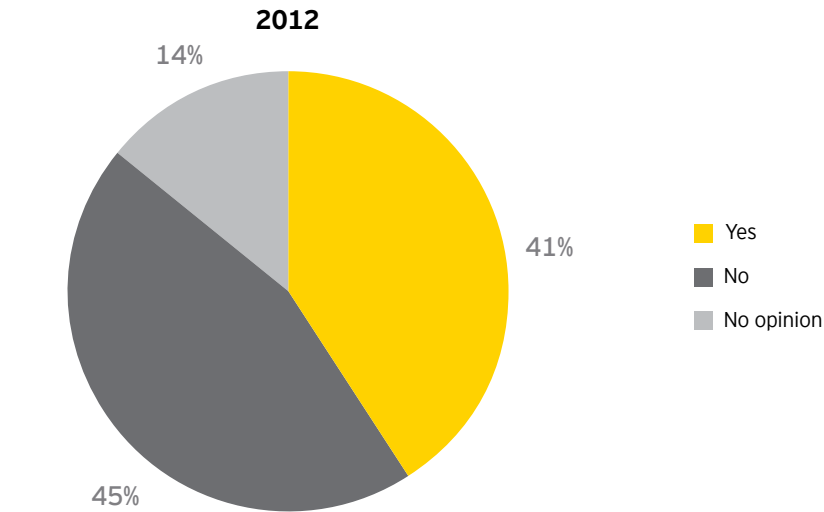


For the next year or two people will be struggling to keep pace with the regulatory change. To keep up, good firms will not have a problem attracting talent to get over this obstacle. However, this will raise the bar to getting into this industry, and smaller firms will have a problem keeping up with the same regulatory demands on larger firms. Larger firms have a lot more resources and tend to have more robust processes and infrastructure in place to address these issues without disrupting their business.

(Manager, North America, over \$10b)

Investors

Is it acceptable for the hedge funds in which you are invested to use a second administrator to shadow (in lieu of the manager shadowing)?



Investors are increasingly comfortable with a second “shadow” administrator, but will not want to bear the cost

Although investors appear increasingly tolerant of using a second administrator to shadow, they will rarely be prepared to bear the cost if passed onto the funds.

Furthermore, it is unlikely that most managers would be willing to give up control and oversight of key processes. This puts even more impetus on managers to identify the right balance between oversight and full replication.

While there have been a few high-profile examples of managers using a second administrator, the movement has not yet gained widespread appeal.

Cloud computing and cybersecurity





Across the hedge fund industry, cloud computing and cybersecurity have become acute concerns of investors and regulators. As a result, how to protect a firm from cyber attacks is at the forefront of discussions across the hedge fund industry.

In this section we explore:

- ▶ Use of cloud computing
- ▶ Cybersecurity investments
- ▶ Steps to improve cybersecurity
- ▶ Investor confidence

Most managers do not use the cloud, citing security concerns

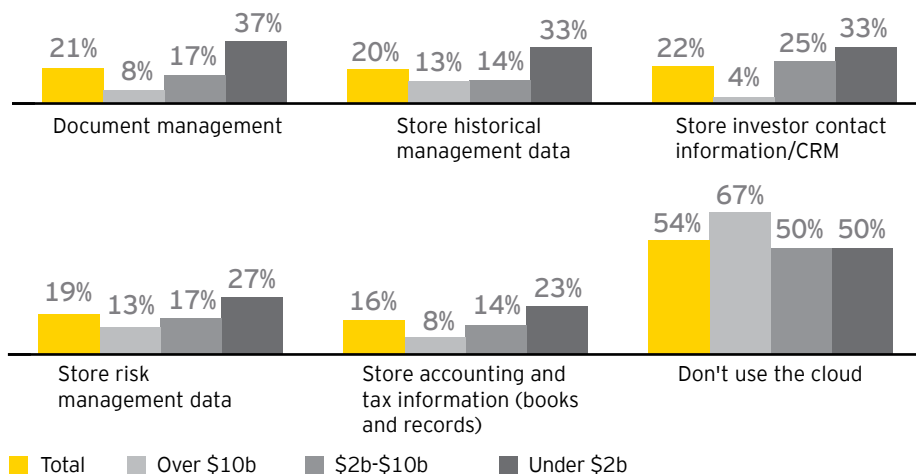
Managers point to security concerns as a key impediment to using the cloud. Although some security concerns are legitimate, they are not as acute as many managers believe. The lack of accepted security standards fuels fears as well as recent well-publicized breaches. However these types of targeted attacks could happen with most security systems that managers have in place.

Because they do not have in-house IT expertise and cannot invest in the hardware they need, smaller managers are more likely than the largest managers to use the cloud. But even the largest managers are likely to use third-party service providers that leverage the cloud. Managers who are evaluating the cloud, or have vendors that use it, can allay security concerns by conducting proper due diligence on vendors and hosts.

Should managers overcome their security concerns, they still need to evaluate the costs and benefits. Although using the cloud may reduce costs, this will have to be traded off with the lengthy and detailed due diligence that managers would need to perform.

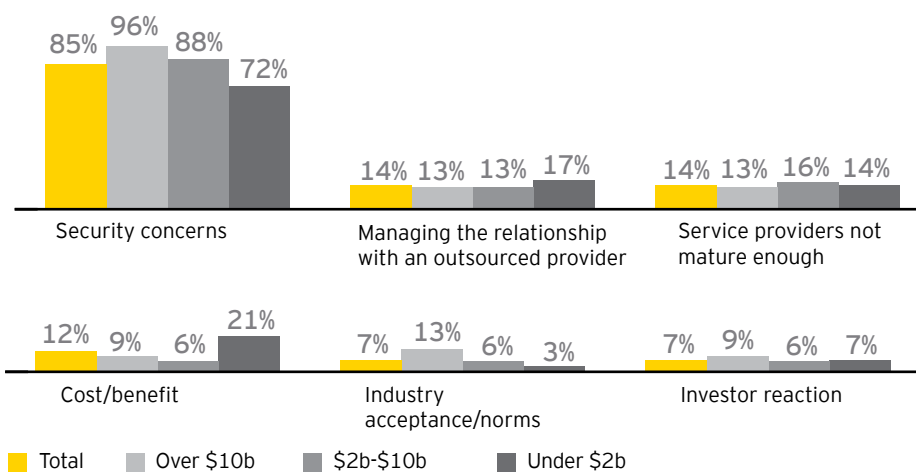
Hedge funds

For what purposes does your firm use the cloud?



Hedge funds

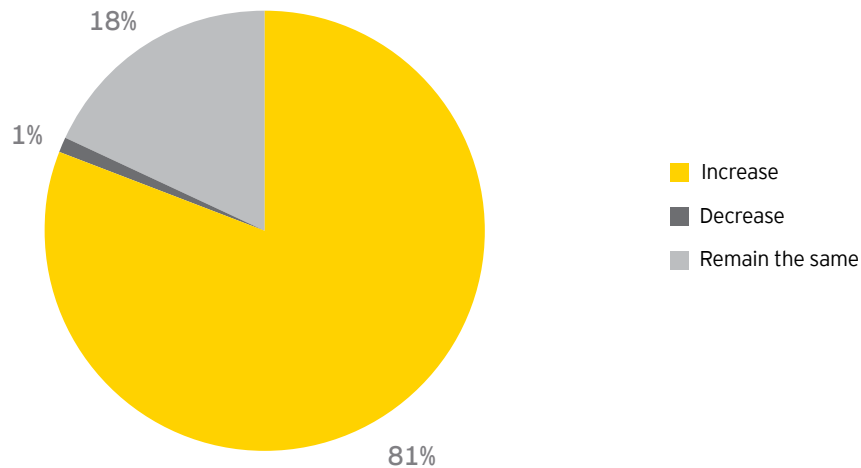
What are the main impediments and concerns about using the cloud?



Hedge funds

Do you expect your spend on cybersecurity to increase, decrease or remain the same over the next two years?

Expected spend on cybersecurity



Managers expect to increase spending on cybersecurity, but few have made investments

Although most managers are planning to spend more on cybersecurity, investments to date have been modest and superficial.

Leaders are taking proper steps to secure not only their organization but their entire “ecosystem.” This includes vendors, business partners, service providers and even underlying portfolio companies.

Cybersecurity has been a topic of priority concern for regulators. Given this, and managers’ aspirations to target retail investors, investments in this area will become more critical.

Managers are planning to take a number of steps to improve cybersecurity but will need to do more

To date, managers have been focused on detecting intrusion, preventing external penetration attacks and monitoring email. They recognize the need for vendor oversight but many struggle with what it truly means.

Managers that have not already done so should consider four key steps:

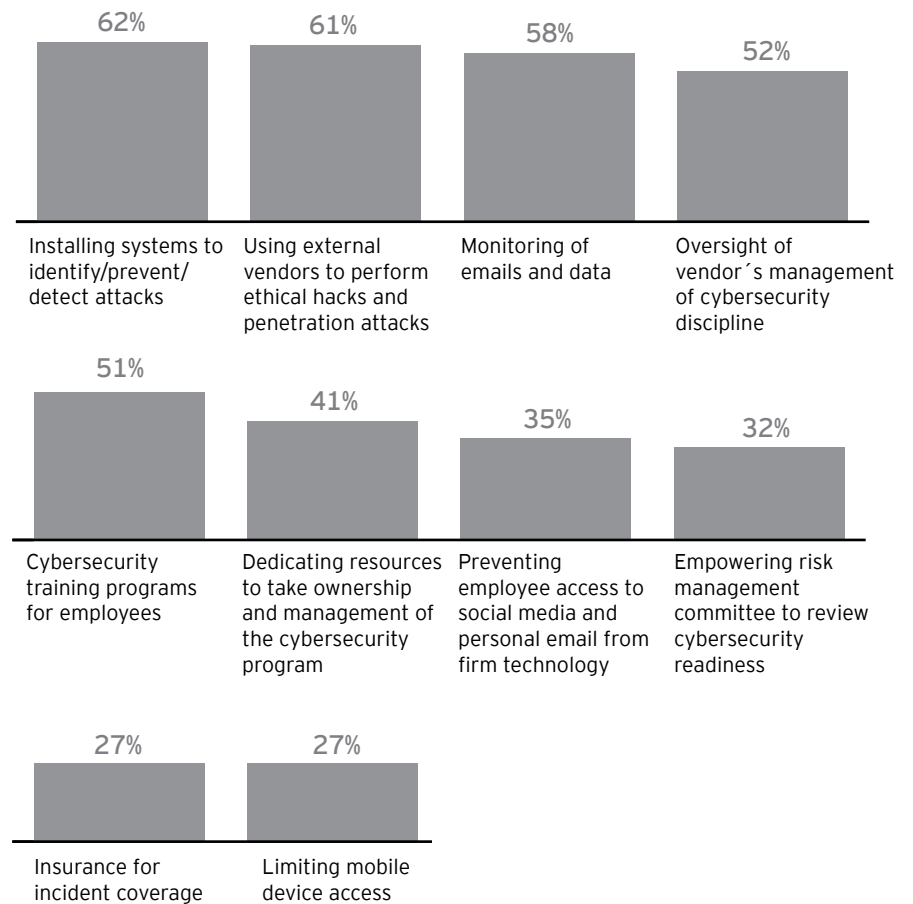
1. C-level sponsorship to review and approve policies and facilitate cybersecurity programs
2. Employee training about threats and the appropriate response
3. Third-party oversight that extends beyond due diligence when retaining a service provider to ongoing oversight
4. Developing a formulated and codified response to attacks, including appropriate disclosures that comply with regulations

Although it is available, insurance for incident coverage may not be an attractive option. It is expensive, has many caveats and claims will force disclosure of a breach.

Hedge funds

What steps are you taking to improve your firm's cybersecurity?

Steps to improving cybersecurity



Cybersecurity is on the radar of our top leadership. Our risk management committee has been evaluating our cybersecurity readiness while utilizing external vendors to perform various attacks on our systems. Any breaches of our internal or client data would be a damaging blow to our credibility and would certainly impair our ability to retain capital, let alone go to market to raise new funds.

(Manager, Asia, under \$2b)



Fewer than one in three investors are confident in their managers' cybersecurity policies

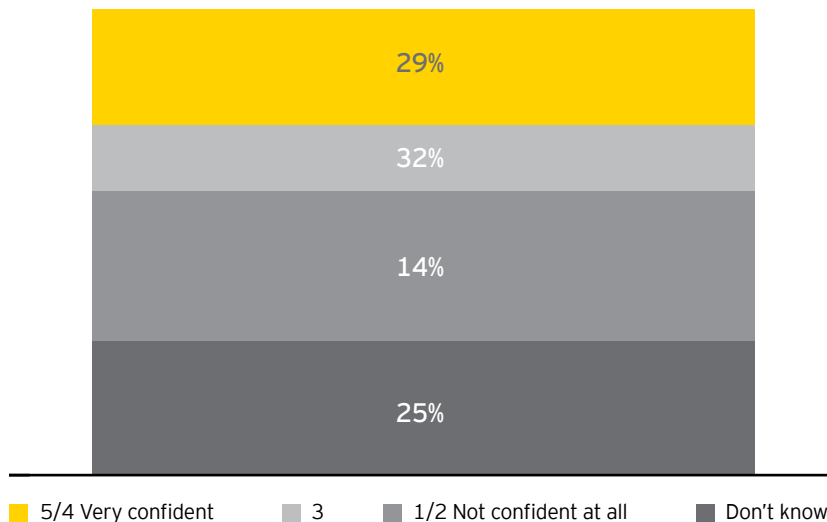
It is not surprising that, among investors, the majority is not very confident in their managers' cybersecurity policies or cannot offer a view. Most managers do not yet have fully formulated policies, and there is no standard methodology for performing due diligence on cybersecurity.

It is incumbent upon investors to learn more about cybersecurity and ask their managers to demonstrate how they are addressing it.

Investors

On a scale of 1 to 5, from 1-not confident at all to 5-very confident, how confident are you of your managers' cybersecurity policies and procedures?

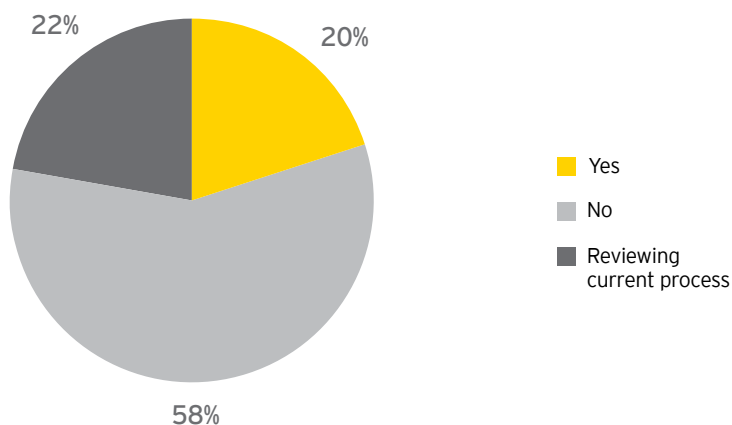
Confidence in managers' cybersecurity policies



Investors

Have you changed your due diligence process as it relates to cybersecurity?

Cybersecurity due diligence



Cybersecurity is absolutely the number one risk facing our business and the entire industry. As a result, we are incurring significant expenditures in our people, processes and technology in order to gain and retain investor confidence.

(Manager, Europe, over \$10b)



Final thoughts



Historically, hedge fund managers could be confident that, as long as they delivered on investment performance, they would attract investors and assets at fee levels sufficient enough to guarantee attractive margins.

Today, the situation is much changed and much more challenging. At a time of heightened competition for assets, a strong investment function is a must. Winning assets in the future will require managers to cater much more carefully to investors' needs and preferences. Managers will have to tailor their offerings to specific client types. They must be willing to adjust fee levels or expense ratios, provide separately managed accounts, and supply registered liquid alternative products. These are just some of the ways in which managers can customize their services to meet investors' needs.

Of course, simply offering these capabilities is not enough. In today's market, managers must work just as hard to sell themselves to investors by distinguishing themselves from the competition. That requires a compelling presentation that clearly communicates investment philosophy and process. Delivering on these counts will require new investments in marketing and distribution talent, front-office capabilities to support strategies, and infrastructure to support products.

Respondent profile

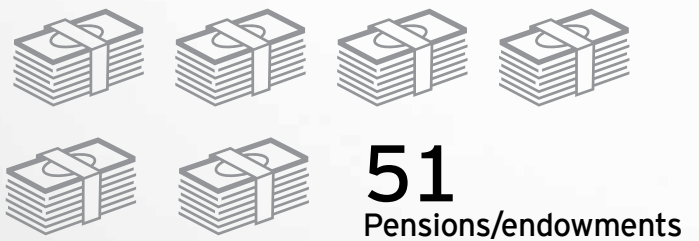
Background and methodology

The purpose of this study is to record the views and opinions of hedge fund managers and investors globally. Topics include managers' strategies to achieve growth and the infrastructure investments required to implement those strategies, expenses and cybersecurity.

From June to August 2014, Greenwich Associates conducted:

- ▶ 100 telephone interviews with hedge funds representing \$956b in assets under management (AUM)
- ▶ 65 telephone interviews with institutional investors (fund of funds, pension funds, endowments including foundations) representing \$1.3t in assets, with \$220b allocated to hedge funds

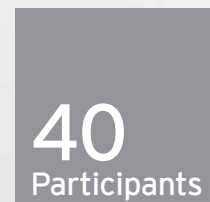
Investors



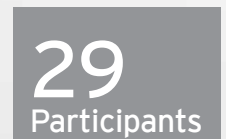
Hedge funds



Under \$2b
AUM



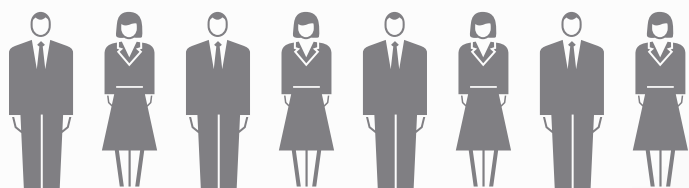
\$2b - \$10b
AUM



Over \$10b
AUM



North America



50
hedge funds



39
investors

Europe



31
hedge funds



22
investors

Asia



19
hedge funds



4
investors



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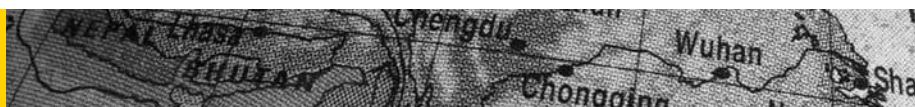
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