Alternatives

The Alpha Game

Hedge Funds Step Up Operations to Capture New Growth

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235
hedge fund executives reveal how they see the future of the industry

63%
expect institutional investors will increase their exposure to hedge funds

55%
expect pension funds will increase their exposure to hedge funds

The coming years look strong for the hedge fund industry. Fund managers expect ultra-high-net-worth and institutional investors to increase their allocations to the sector.

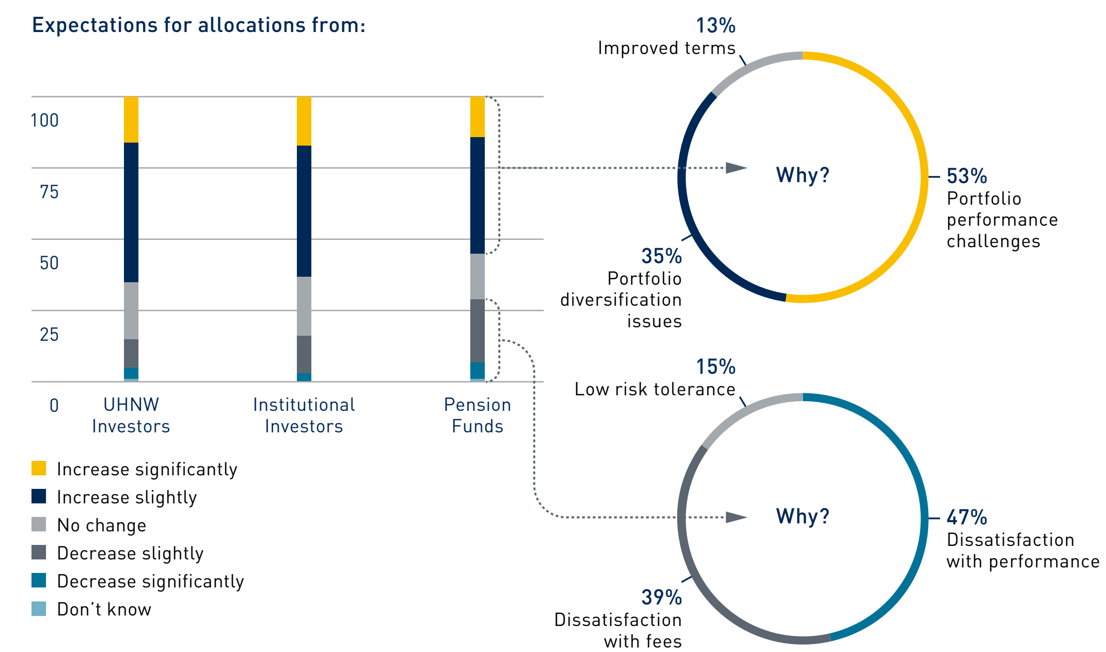
But hedge funds are also operating in a rapidly changing environment. They're catering to the needs of increasingly demanding investors who won't compromise on performance and expect more transparency about where and how they create value. And they're preparing for more complex operations as regulatory demands increase.

We asked 235 hedge fund executives about these trends and their outlook for the future in a new survey conducted by Citigate Dewe Rogerson. The majority of hedge funds see a positive outlook for growth over the next five years. They're also expanding into new markets and product lines. This optimism about the sector's future performance is in line with some of the findings of our recent survey[1] of asset owners, which showed that one in four pension funds plan to invest in hedge funds for the first time. But our hedge fund survey also suggests the industry will require managers to invest in a sophisticated operating model so they can thrive in an environment where costs are scrutinized and stakeholder demands are rising. At the same time, hedge funds will need the right investment talent to drive results.

Capital Flows Support Optimism

Hedge fund managers are expecting strong flows over the next few years. According to our survey, almost two-thirds (65 percent) of hedge fund managers expect ultra-high-net-worth investors will increase their exposure to the industry, and almost as many (63 percent) expect institutional investors will do the same. In addition, more than half (55 percent) of managers think pension funds will increase their allocations to hedge funds as they seek enhanced performance and greater diversification.

Outlook Points to Strong Flows



Source: State Street 2014 Hedge Fund Survey conducted by Citigate Dewe Rogerson.

[1] State Street 2014 Asset Owners Survey, conducted by the Economist Intelligence Unit.

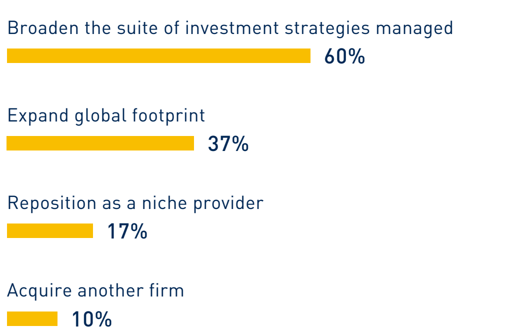
Hedge funds that can deliver upside performance are in demand. Yet our findings follow the recent decisions by CalPERS and others to reduce allocations to hedge funds or withdraw from them completely. And while our research shows strong investor appetite for hedge funds, more than one in four hedge funds (28 percent) expect pension funds to decrease their allocations.

By taking a deeper look at hedge funds' expectations, we get a clearer picture on what may be driving investor behavior. They believe pension funds' primary driver for reducing exposure to hedge funds will be disappointment with returns — almost half (47 percent) expect this to be their primary concern. This highlights the sharp focus on hedge funds' ability to deliver value and align with institutional needs.

More than half of managers (53 percent) think the primary reason why pension funds will invest more in hedge funds is to drive portfolio performance. And 35 percent think pension funds are mostly looking to improve portfolio diversification. As pension funds aim to reduce deficits, many see hedge funds forming a core part of their strategy to fill the gap. Hedge funds that are able to demonstrate consistent performance and the right mix of products will be able to translate these client needs into growth.

Expansion on the Horizon

Will you make any of the following changes to your business strategy over the next five years?



Source: State Street 2014 Hedge Fund Survey conducted by Citigate Dewe Rogerson.

Growing the Product Mix

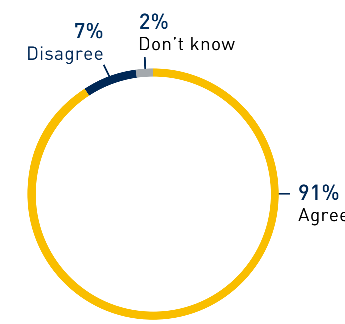
How are hedge funds responding to the opportunities of increased institutional interest? Our survey shows they plan some significant changes to their business strategy over the next five years. Almost two-thirds (60 percent) are looking to broaden the range of investment strategies they offer. This partly reflects demand from institutional investors for a wider choice of investment strategies to tailor to their long-term objectives.

While a broader range of investment strategies can help hedge funds accelerate growth, it also brings challenges. Product portfolios with multiple investment strategies also require expanded capabilities and expertise. Hedge funds moving from a single commodity approach to a global macro strategy, for example, may need new talent to expand their internal capability for trading these strategies capabilities.

In addition, more than one-third (37 percent) of hedge funds are looking to increase their global footprint to tap into growth opportunities in overseas markets. This also puts a strong focus on investing in the talent required to support an increasingly global operation.

New Standard to Attract Capital

Hedge funds will be required to more clearly demonstrate their value to prospective investors to attract new capital.



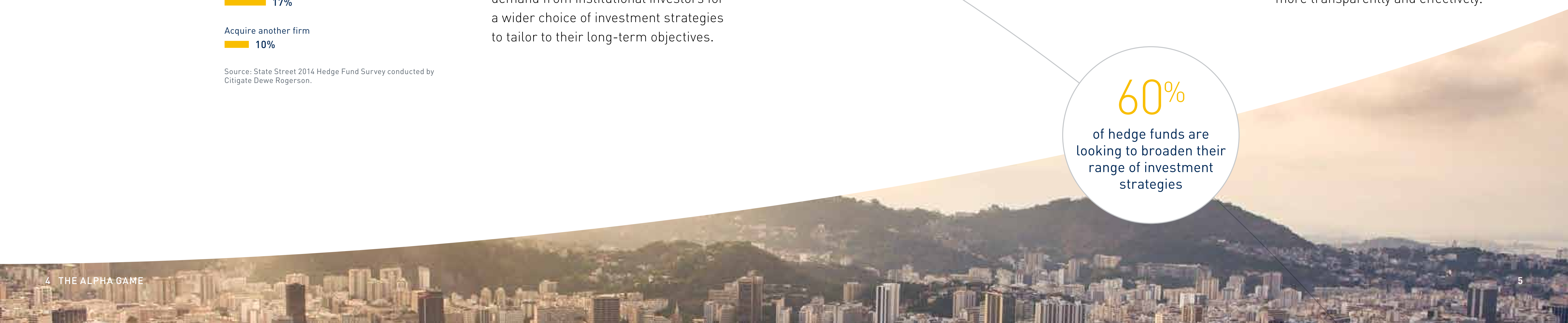
Showing Value to Win Market Share

Hedge funds are optimistic about their clients' appetite for their products. But most believe they'll be required to better demonstrate their value to prospective investors — a sentiment shared by more than 9 in 10 (91 percent) in our survey.

Not only do hedge funds need to deliver better risk-adjusted performance — they're also expected to communicate more effectively about how they achieve their goals. This requires investment in technology and employees with the right skills to deliver new efficiencies, greater agility and higher-quality reporting. Risk and performance analytics will also play a more important role in helping hedge funds manage their clients' portfolios more transparently and effectively.

60%

of hedge funds are looking to broaden their range of investment strategies



Liquid alternatives give investors diversification while helping them access strategies that have historically only been available through hedge funds.

The Impact of Liquid Alternatives

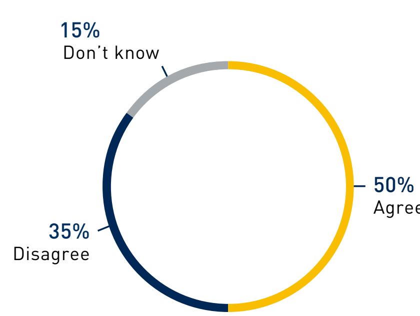
Institutional investors are increasingly attracted to liquid alternatives as they look to reduce volatility and drive up returns. Liquid alternatives share some of the characteristics and upside potential associated with hedge fund strategies — but they're packaged within a mutual fund vehicle that offers greater liquidity to investors. They also follow the reporting and compliance standards of 40 Act funds in the US and Undertakings for Collective Investment in Transferable Securities (UCITS) in Europe.

William Kinlaw, head of Portfolio and Risk Management Research for State Street Global Exchange, says liquid alternatives give investors diversification while helping them access strategies that have historically only been available through hedge funds. Mr. Kinlaw explains, "The analogy I like to use is that, if the stock market is like a car, these products are like a bike. There's no way a bike is going to outrun a car on the open road, but when you get into traffic, the bike can weave through and be more consistent in its speed."

The growth in liquid alternative products has been rapid. In 2013, according to a survey[2] by Barclays Prime Services Capital Solutions, alternative mutual funds raised as much as two-thirds of the total raised by hedge funds, despite the latter industry having 18 times the assets. This trend also comes through in our survey:
50 percent of hedge fund managers expect liquid alternatives to take market share from traditional hedge fund strategies over the next five years. However, 35 percent disagree and another
15 percent say they don't know if these funds will take share from traditional hedge strategies. So while the scale of the threat to traditional hedge funds remains uncertain, many industry players will launch their own liquid alternative products to capture growing demand in this area.

Unknown Impact of Liquid Alternatives

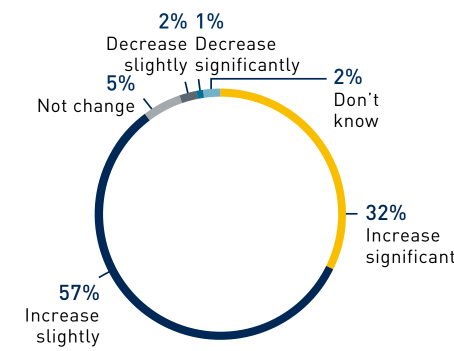
Over the next five years, alternative mutual funds will seize share from traditional hedge fund strategies.



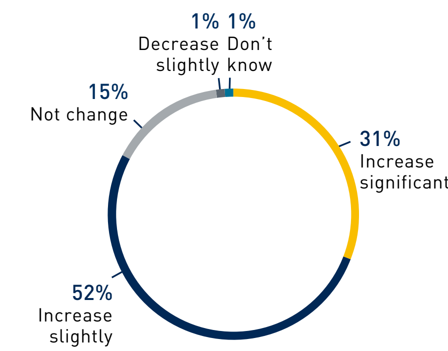
[2] Going Mainstream: Developments and Opportunities for Hedge Fund Managers in the '40 Act Space, Barclays Prime Services Capital Solutions, February 2014.

Increased Operational and Regulatory Burden

Operational complexity
in the hedge fund industry will:



Regulatory scrutiny
of the hedge fund industry will:



Source: State Street 2014 Hedge Fund Survey conducted by Citigate Dewe Rogerson.

The Compliance Challenge

Regulatory pressures are increasing. Hedge funds must meet multiple requirements arising under the Alternative Investment Fund Managers Directive (AIFMD), the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Foreign Account Tax Compliance Act (FATCA) and a number of other regulations. In our survey, more than 8 out of 10 hedge fund managers (83 percent) expect regulatory scrutiny of their industry to increase over the next five years.

Complying with regulatory requirements in multiple jurisdictions is costly and time consuming. A survey of hedge funds conducted in 2013 indicated that the average compliance cost for a medium-sized hedge fund is $6 million, a figure that rises to $14 million for the largest hedge funds.[3] Investment at this scale becomes challenging to sustain unless hedge funds can develop processes and tools to ease the regulatory burden. As a result, many of them are investing in advanced reporting tools that make it easier to collect and deliver the kind of granular data regulators around the world increasingly require.

With the recent global financial crisis still front of mind, investors will favor hedge funds that can demonstrate the highest levels of risk control and regulatory compliance. If funds can provide attractive products that also have the right regulatory "wrapper," they'll find it easier to attract investment. Compliance can therefore help funds grow market share — provided their infrastructure can keep up with a rapidly evolving regulatory landscape.

[3] 2013 KPMG/AIMA/MFA Global Hedge Fund Survey.

Operational Complexity

As hedge funds look to benefit from stronger flows, they'll find their operations under the spotlight. Almost 9 in 10 (89 percent) hedge funds in our survey expect increased operational complexity over the next five years. This is inevitable as they support a broader range of investment strategies while meeting heightened regulatory pressure and responding to investors' growing demands for transparency.

Such complexity is a considerable burden. It requires hedge funds to invest in state-of-the-art systems to support new investment strategies and reporting requirements. But operational excellence is also an area where hedge funds can differentiate their offerings and attract funding.

So the role of the chief operating officer (COO) is becoming more important in determining the success of the overall business model. As investors focus on due diligence, they spend a great deal of time looking at the operations team. The COO therefore plays a pivotal role in attracting investment while making sure the front office has the tools required to deliver performance.

This suggests that hedge funds of the future will focus on their operations as a source of competitive advantage. They'll roll out advanced and highly integrated data architectures. They'll need operational systems that can cope with a broader range of stresses and risks, and an infrastructure that links front, middle and back office functions seamlessly. Ultimately, hedge funds will need to bring in leadership and talent to make sure their operations have the same standards of innovation and excellence typically found in their front office investment teams.

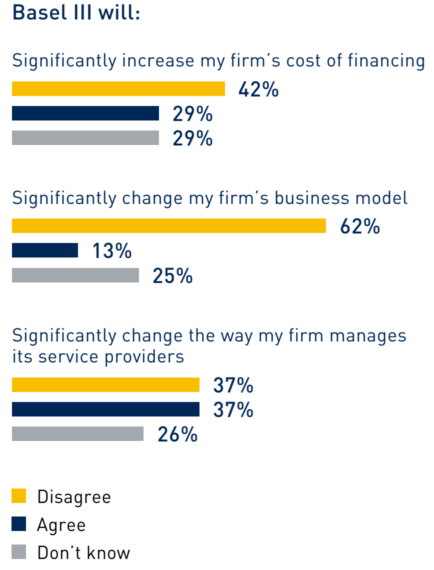
89%

Almost 9 in 10 hedge funds expect increased operational complexity over the next five years.

The Basel III Effect

The impact of Basel III — the impending global regulatory standard around capital adequacy and market liquidity risk — has been debated in the past year. For now, our survey suggests many hedge funds are uncertain about the regulation's potential implications.

Unknown Impact of Basel III



Only 29 percent agree Basel III will significantly increase their cost of financing. A further 29 percent say they don't know what the effects will be. And while only 13 percent see a significant change to their business model, one in four say that, at this stage, they don't know if, or what, changes will be necessary.

However, more hedge funds say Basel III will change their relationships with external partners. Thirty-seven percent say they expect significant changes to the way their firm manages its service providers, including prime brokers. Even so, the uncertainty persists — 26 percent say they don't know if they'll make changes to these relationships. The most forward-looking funds will start to look at these questions now to prepare for potential impacts.

Conclusion

We believe the next five years will see a period of radical change in the hedge fund industry. Our survey reveals that hedge funds expect greater interest from institutional investors and high-net-worth individuals. Many in the industry expect to increase the scale of their operations to meet that rising demand.

Competition will be intense, however. Hedge funds need to work hard to differentiate their proposition. They will continue their focus on product innovation and excellence in the front office. But, increasingly, the leading hedge funds will combine their unique investment ideas with a strong operating model. They must consistently outperform the competition, while constantly adapting to new demands from clients and industry regulators.

The leading hedge funds of 2020 will:

- Create innovative investment strategies to meet investor demands for high returns and greater value.
- Introduce new talent with the experience and knowledge to trade these strategies on a global scale.
- Broaden the range of the product mix to capture new areas of growth.
- Develop a strong data capability with valuable insight on all new and emerging analytics products.
- Invest in the technology and skills required to provide greater transparency around risk and performance.
- Meet heightened regulatory scrutiny as well as investor demand for the right regulatory "wrapper".
- Balance innovation in the front office with a solid operational core across the back office.

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About the Research

This report is based on the findings of a State Street survey of 235 hedge fund executives conducted in October 2014 by Citigate Dewe Rogerson. The survey asked respondents to make a set of five-year predictions for the industry regarding business strategies, expected flows, operations and regulation. Just more than half (57 percent) of the respondents were based in North America, a third (32 percent) came from Europe and the remainder (11 percent) were from the Asia-Pacific region. Just under three-quarters of the respondents (72 percent) represented funds with assets of up to $1 billion, a fifth (19 percent) of respondents were at funds with between $1 billion and $10 billion, and 8 percent came from funds with more than $10 billion of assets.

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