The evolving dynamics of the hedge fund industry

2015 Global Hedge Fund and Investor Survey

Building a better working world

Contents

Executive summary

Seismic shift. Profound transformation. These are words that have been used to describe the hedge fund industry in recent years. This year has not been without its turbulent moments, but it has also opened the doors to an environment of opportunity. As managers and investors continue to take on new challenges borne from regulatory and cost pressures, new operational considerations and the war on talent, those that consistently innovate and respond to market demands continue to grow. Efficiency is the name of the game, and embracing technology and data optimization is the new imperative. Change is inevitable, and as the standard operating model fades, we've come to realize that the very foundation of the industry is evolving. Challenges will abound, but new avenues will open up as well. From today's vantage point, an industry in its maturity is looking to the future with healthy optimism.

As you turn the pages of this, our ninth annual Global Hedge Fund and Investor Survey, *The evolving dynamics of the hedge fund industry,* we cannot help but reflect on the path that has led the industry to its present state, but more so, we look forward to what the future may bring.

First, we would like to extend sincere thanks to those managers and investors who provided viewpoints into the direction and development of this survey. Additionally, we would like to express our appreciation to the nearly 110 managers and over 55 investors who gave their time and insight to provide such robust results. We believe that this combination of perspectives provides invaluable observations — both commonalities and differences — that continue to drive and shape our industry.

Navigating evolution

The basic economic business model reflects four stages of evolution — start-up, rapid growth, maturity and decline, of which there are two paths, rebirth or demise. The hedge fund industry is in all four stages of this evolution. Start-up funds continue to penetrate the industry. Many funds are experiencing significant growth in their assets under management (AUM). And depending where funds are in the maturity timeline, institutionalization, industrialization or commercialization may be your current state. During this past year, as we have seen for many years, some funds decided to merge with others or close up shop and move on to new ventures. The dynamic nature of this industry has always fostered funds looking at themselves, assessing investors' needs and the effect of external forces, and remaking themselves in order to grow and stay strong.

There has been a multitude of challenges the industry has addressed in all stages of its evolution:

- **Meeting the performance promise:** the challenge to perform through a long-running bull market. Several post-crisis factors such as the prolonged low interest rate environment and other government intervention subsidizing traditional economic reality, as well as regulatory changes to managers and service providers have all impacted managers' operating and investment approaches.
- **Escalating stakeholder demands:** Investor and regulator demand for enhanced transparency, pressure on fees, and enhanced alignment of interests have amplified to levels not previously experienced.
- **The impact of regulatory change:** The magnitude of focus and change since the global financial crisis at local, national and global levels has placed a significant burden on people, operating models and technology capabilities.
- **Squeeze on operating margins:** Partially driven by stakeholder and regulatory considerations, the costs of running a business have escalated dramatically, creating increased barriers to entry for new participants while also straining the economics of even the largest managers.
- **Reputational:** Negative press from the one-off bad actors who fail to act in accordance with laws, as fiduciaries to their investors or with a lack of general business ethics. Conduct risk and responsibilities as a fiduciary underpin the focus on trust.

2015 stands in sharp contrast to the last decade; today, the concept or definition of a pure "hedge fund" has even been challenged. The blurring of activities and convergence with other segments within the asset management, and more broadly, financial services industry, have made it a significant challenge for hedge funds to brand themselves, and their benefits, clearly in the marketplace. Brand has never been more important as new money flows have been consistently going to the largest, well-known managers, not only in hedge funds but broader asset managers. Yet, start-up hedge funds are experiencing robust investor demand. The investor base has changed dramatically. Just a decade ago, investors were two-thirds high net worth and one-third institutional. Today, the reverse is true. How hedge funds are sold or distributed has changed as well, and the impact of digital and social media will only accelerate further change. The focus on the investor and the "client experience" has never been greater and is clearly in the cross hairs of regulators, globally.

Key observations

This year, our survey focused on a variety of interesting themes, a few of which are briefly highlighted here.

Growth remains managers' top priority as most see it as the critical success factor in a lower margin environment. While universally highlighted by managers of all sizes, growth is occurring differently depending on where each manager is in its life cycle. Smaller and mid-size managers who are in their infancy tend to be looking to grow their client list and penetrate more investors with their core offerings. The largest managers who have achieved brand recognition within the industry continue to seek to expand their offerings; however, where in years past this meant launching of new alternative products (i.e. registered funds), there has been a shift in focus as managers have prioritized offering new strategies within traditional hedge fund vehicles. This is partially a result of the mixed operational and financial results of launching new products, but also a reflection on changing investor demands by market participants who are more sophisticated and want tailored exposures that align with their unique investment goals.

Managers are feeling the effects of recent bank regulations as they begin to impact their **prime brokerage relationships.** Various bank regulations, particularly those as a result of Basel III and Dodd-Frank, have kicked off a cycle in which we are only in the early innings; managers are experiencing re-pricing in addition to trade financing constraints with many of their counterparties. This has caused managers to evaluate the manner in which they obtain financing and, in some cases, make changes to their strategy. As managers and prime brokers continue to discuss their relationships we suspect this issue will continue to evolve and grow in significance in the coming years.

Additionally, in light of some of the challenges that managers are facing as a result of increasing costs, **technology and outsourcing** continue to be tools that managers are utilizing in an attempt to develop a more efficient and cost effective operating model. Data management and investments in technology remain as critical as ever in response to increasingly complex fund operations, heightened focus and scrutiny around cyber security as well as the ever growing number of regulatory and investor mandated reporting requirements. A well designed front to back office infrastructure not only yields efficiencies but, in the long run, will result in cost benefits.

With back office outsourcing at a saturation point, managers have begun to embrace more robust middle office solutions that have been introduced to the market in the last several years. These advanced offerings are allowing managers to scale their model as they grow in a cost efficient manner while permitting their internal resources to focus on more critical core activities. Many have commented as to the benefits obtained from pursuing this new frontier and anticipate the overall industry to move in this direction; this is no different than how the industry migrated to back office outsourcing earlier in its life cycle.

Looking forward

As the industry embarks on this next phase in its life cycle, one thing is abundantly clear. The road ahead will be fraught with twist and turns. The ground rules have changed, and acceptance and adaptation to this dynamic environment are the keys to survival. Changing investor demographics, convergence of products and strategies within asset management and other industries, and market reform in both emerging markets and developed markets alike are all providing the opportunity for disruptive innovation to drive growth.

At EY, we are enthusiastic about the future of the global hedge fund industry. We look forward to continuing to invest alongside the industry and support its efforts to enhance financial well-being for investors worldwide.

Strategic priorities — achieving growth

During 2015, the hedge fund industry continued its evolution, where common goals are not only maintaining, but growing market share in the face of a number of different challenges. Growth ambitions are certainly nothing new; however, we are finding that managers increasingly view growth as a necessity to counter many headwinds that are disrupting their traditional business model. The level of AUM necessary to thrive is not only higher than what would have been necessary in the past, but the timeline to achieve these critical thresholds is shorter than ever. Additionally, the need to attract and retain top talent is paramount to success. The good news is that asset flows to the industry remain healthy; however, competition for these assets is stronger than ever as managers compete to satisfy investor expectations for products, exposures and outcome-based solutions.

Strategic priorities of an evolving industry

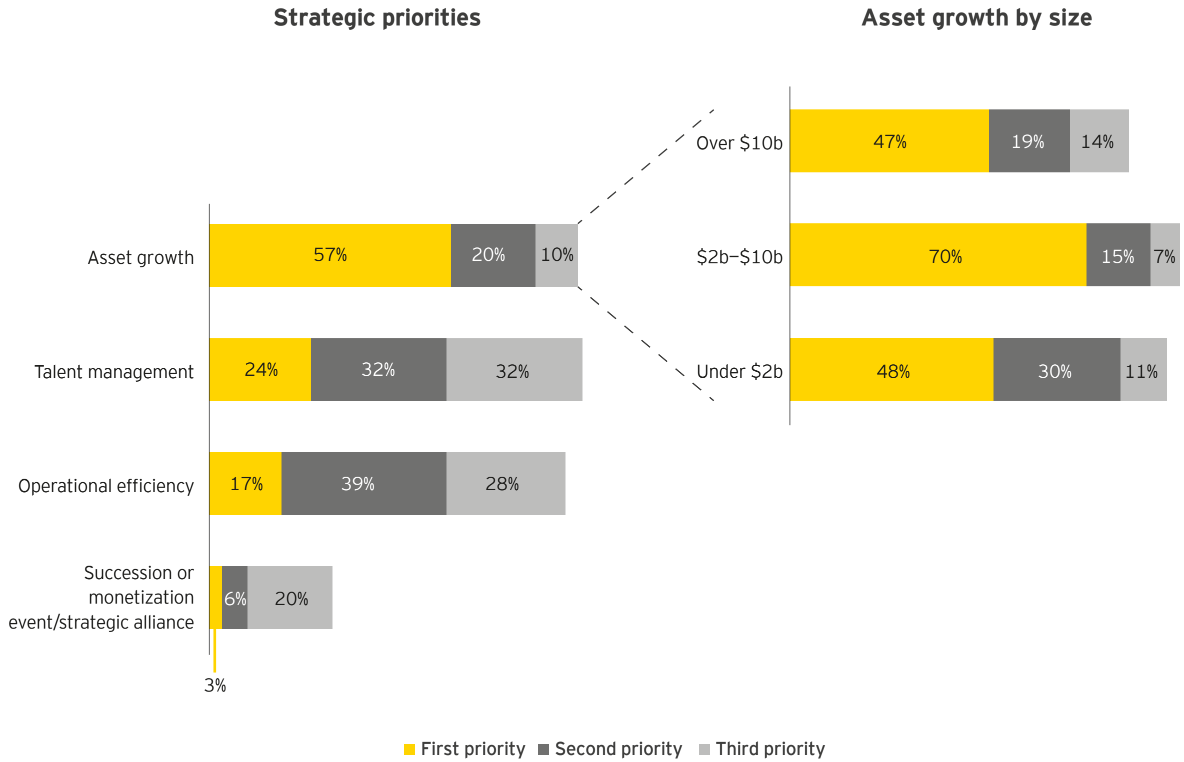
A majority of managers remain focused on asset growth as a strategic priority; however, those citing it as the top priority dropped significantly compared to 2013 when three out of four managers reported asset growth as the top priority. This reduction is partially driven by the success of the largest managers having implemented their growth strategies, whereas those mid-size managers with $2 billion to $10 billion of assets under management are still playing catch-up. Achieving growth remains a complicated proposition on account of increased competition, evolving investor demands and operating model constraints/margin considerations.

With their asset growth goals within reach, a higher proportion of the largest managers – one in three – noted that talent management is their new top strategic priority. They are seeking ways to attract and retain the best talent, not only in the front office where the pursuit of top investment talent remains paramount, but also in the back and middle office functions. This trend mirrors other industries (i.e., technology) where major firms differentiate themselves in their ability to identify, train and maintain top talent.

> "In order to continue our growth, we need to retain and continue to hire top talent. We're not looking for people with experience but rather people with potential. We are all competing for the top talent so it boils down to: do they join you or do they join them?"
>
> **(Over $10b, North America, Multi-strategy)**

Hedge funds' strategic priorities

Please rank the following in order of strategic priority to the firm.



Divergence in approaches to achieving growth

Growth can be achieved in a variety of fashions, and we find that managers tend to take different approaches based on their current size and point in their life cycle.

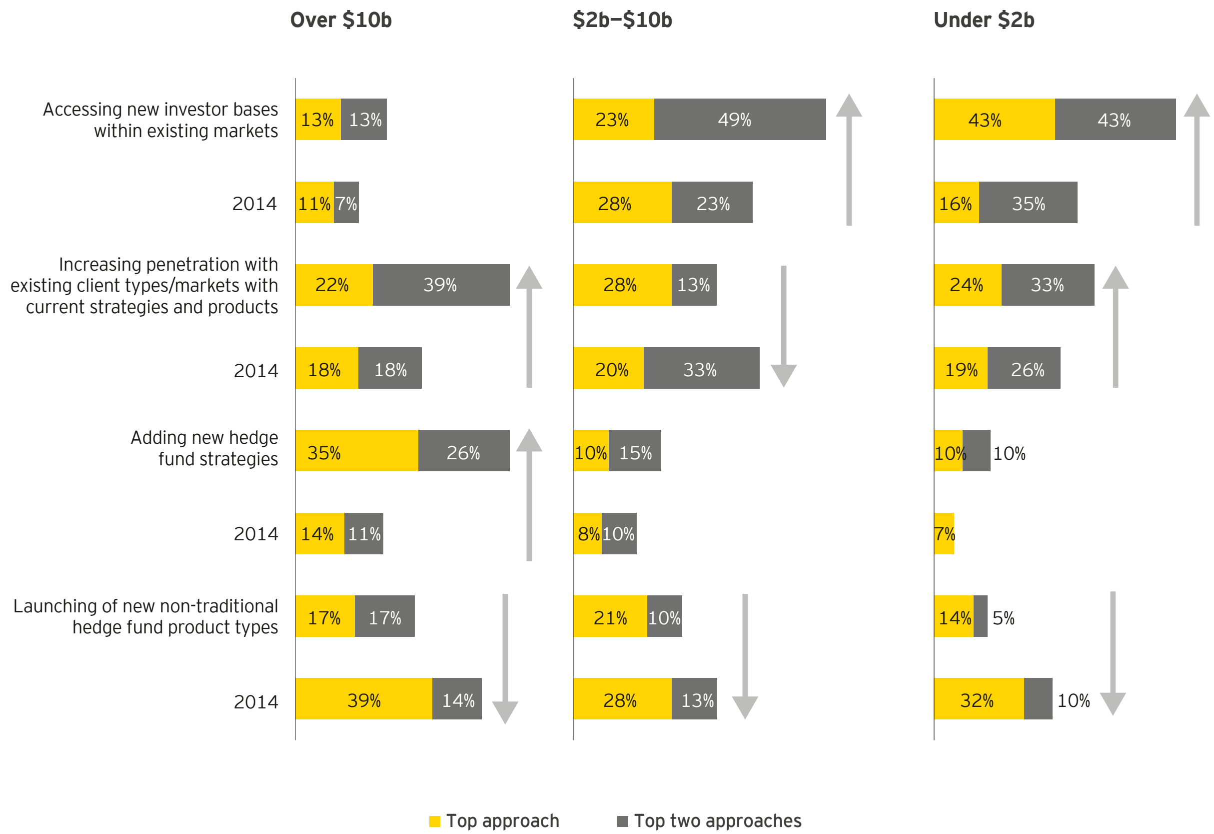
The smallest and mid-size managers are increasing their focus on accessing new investor bases. They are looking to expand their appeal beyond their core traditional hedge fund investors who generally have supported them from their launch date.

The largest managers, already having established a large clientele and brand in the market, are now focused on cross-selling products and becoming a "one stop shop" for investor needs. In prior years, this meant launching non-traditional hedge fund products. It appears that there may be less of an appetite to offer these non-traditional products as all participants highlighted a significant drop in new product launches. The largest managers are shifting their focus to offering new strategies. To execute this plan, they are not only hiring top talent to focus on offering new strategies, they are also driving consolidation of smaller managers.

Hedge funds

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

Top approaches to growth



Investor appetite for alternative products exists; however, traditional hedge fund managers are challenged by other market participants

In past years, managers identified new product development as the pathway to reaching new investors and growing AUM. Many hedge fund managers are finding challenges in this space as investors appear to use other asset managers to obtain these products.

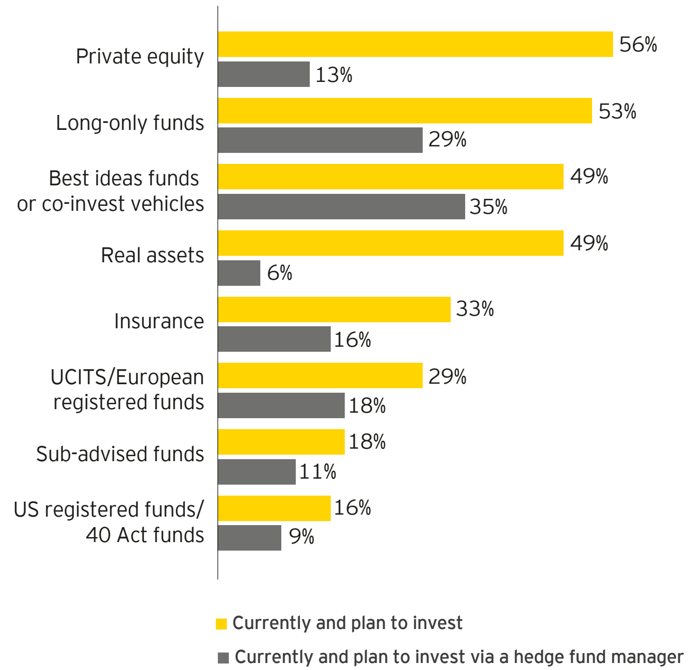
Certain of the products investors are most keen in having exposure to are not traditionally offered by hedge fund managers (i.e., private equity, real assets). Managers need to determine whether they are willing and able to compete with these alternative managers by making the required investments, including acquiring talent and building their brand. Alternatively, managers can solely focus where investors have demand for hedge fund products.

Additionally, a majority of investors remain committed to emerging managers. These new managers continue to receive a healthy proportion of new capital as they are viewed as nimble and able to deliver alpha by focusing on a core strategy.

As investors become more focused on actively managing their portfolio risk, there will be increased demand for customized solutions. Managers are at a crossroad and need to ask themselves whom they want to be. Should they choose to continue down this path, they will need to invest in people, infrastructure and brand. The investors will continue to evaluate whether managers can compete and meet their evolving requirements.

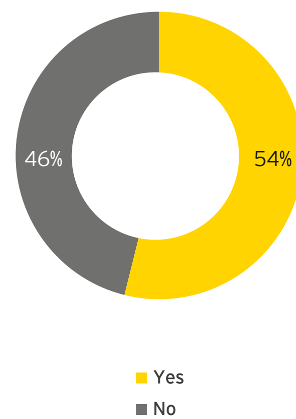
Investors

In which of the following non-traditional hedge fund products do you currently invest or plan to invest, through a hedge fund manager?



Investors

Do you currently invest in or have you considered investing in an emerging hedge fund manager?



"We'll certainly be doing customized solutions. We'll certainly be doing separately managed accounts. Whether we're doing insurance, a full range of alternative products or whether we're doing private equity that's yet to be seen. If you want AUM growth, you need products to meet client needs."

($2b–$10b, Europe, Fixed Income/Credit)

Product diversification helped managers commercialize, but it did not come without challenges

The largest managers were at the forefront of new product development. This has fueled their ability to transform from a standard hedge fund to a broader asset manager. However, they are now dealing with the ramifications of this expansion.

While offering new products was positive for investor interest and brand recognition, managers underestimated the bottom-line impact as there is a significant drop-off in margin satisfaction and an even heavier toll on the managers' talent. This may be a reason for the decline in new product development.

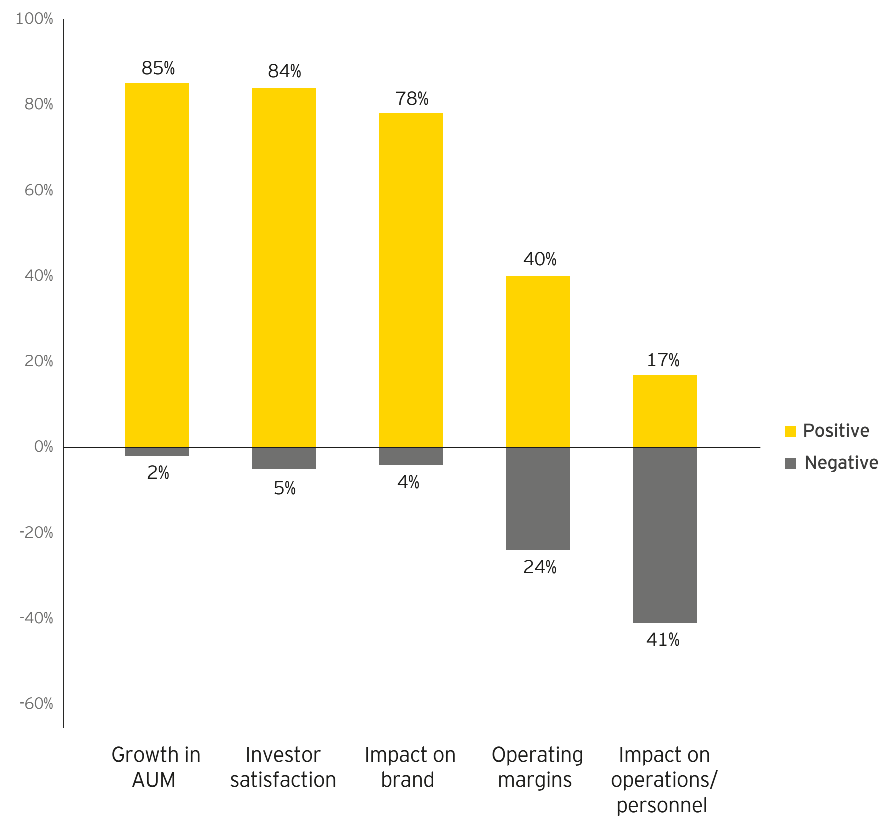
Thus, managers need to find a balance when launching new products — they may be successful in increasing AUM, but have questionable financial implications and strain the team supporting the products. This conundrum is challenging managers to question their current operating model and the investments needed in key areas, such as technology, in order to have successful product launches.

New products are hardly the only area contributing to margin compression ...

Hedge funds

If you have launched any products in the past two years, what has been the impact in the following areas?

Impacts of new product launch



Management fees continue to be under pressure, particularly for the smallest managers

… management fees also continue to be squeezed. Average management fees are over 50 basis points lower than the historical 2% as respondents reported an average rate of 1.45% for their flagship vehicle. The smallest managers who often lack the negotiating leverage of the larger managers and must make fee concessions for initial capital reported a lower average rate of 1.33%.

At the heart of the issue is a more sophisticated investor base and the competition for capital being at an all-time high, which has forced managers to negotiate the terms of investment more than ever. Management fees are the most preferred area to negotiate among managers and investors, and 60% of managers say they have already offered reduced management fees for large mandates.

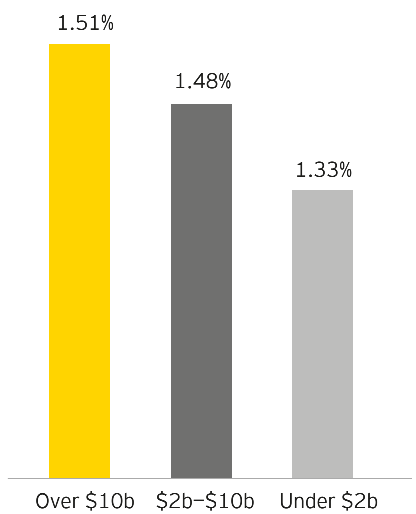
Though managers do not prefer to negotiate incentive fees, 70% report that they would entertain concessions to the incentive such as imposing minimum hurdle rates, tiering of incentive rates, reinvestment of incentives and/or crystallization periods longer than a year.

> "When we are deciding which manager to allocate to, we look for the type of portfolio they can put forward for us, how it can be tailored to our needs, governance, transparency and the returns they expect to generate."
>
> **(Pension Plan, Europe)**

Hedge funds

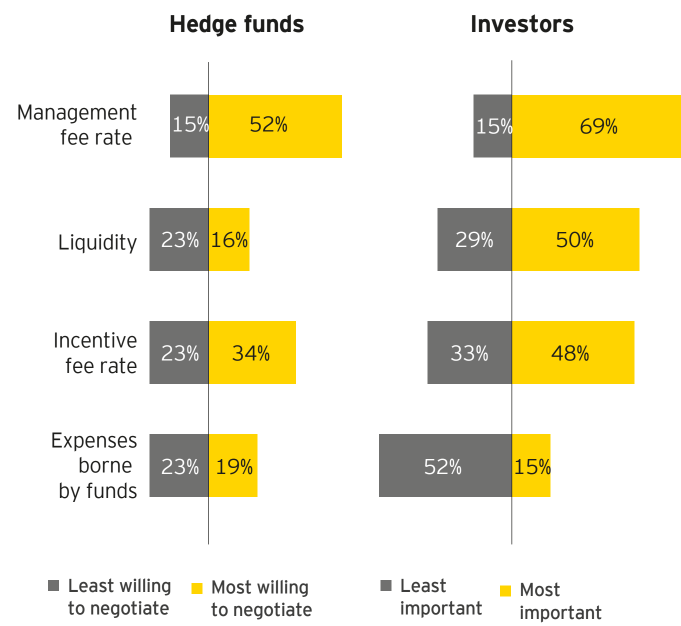
Based on pre- and post-operating ratios, what is your flagship fund's average management fee?

Average management fee rate



Hedge funds and investors

Which terms are you most willing to negotiate with investors? Which of the following terms do managers need to be most willing to negotiate?



Passing expenses through to the funds has reached its limit

In the past, a lever managers could pull in response to increasing expenses was to pass through certain costs to the funds. However, few managers expect to pass through more expenses to the funds going forward. This is partially in response to regulatory scrutiny, but more directly related to the fact that investors have been laser focused on individual types of expenses they are bearing in addition to the overall expense ratios of their funds.

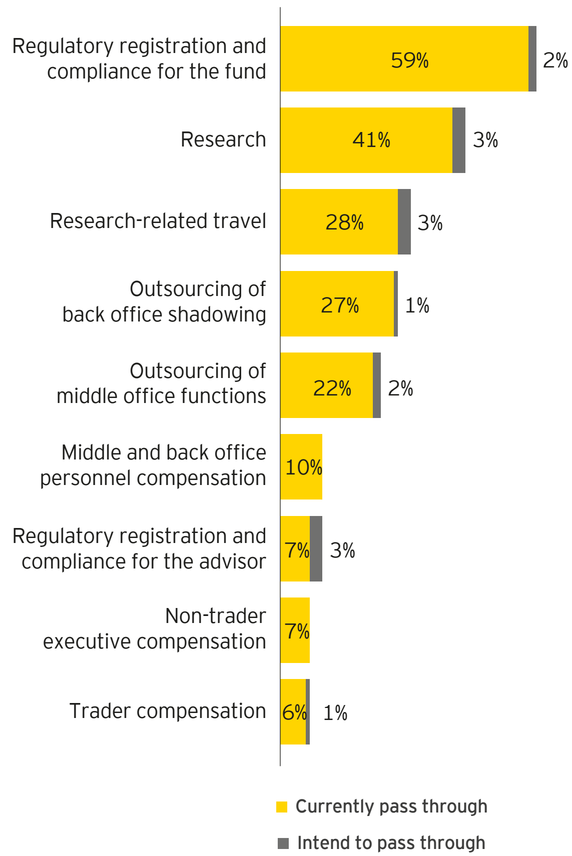
Not surprisingly, the smallest managers have fewer pass-through options and in almost all categories were bearing a substantially greater portion of the expenses as compared to their mid-size and larger peers. This cycle exacerbates the struggles that new managers have in successfully launching their businesses.

As further evidence of how far this dynamic has swung, nearly 30% of managers have negotiated caps on expense ratios and a further 17% say they would be willing to. This negotiation allows investors to fix the amount of expenses they will incur at an acceptable threshold while forcing the managers to further focus on managing their costs.

While the costs highlighted here are certainly not new, or surprising, for any manager or investor, the regulatory environment continues to prompt a number of new direct and indirect costs to the industry.

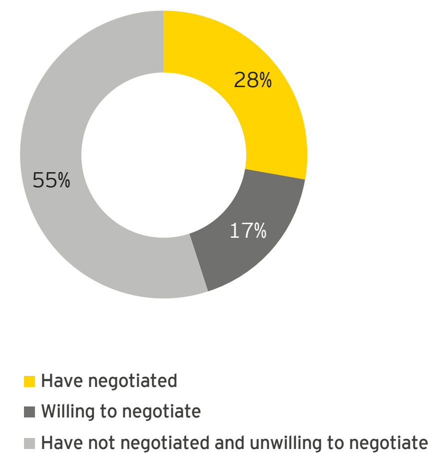
Hedge funds

Which types of expenses do you currently pass or intend to pass through to your flagship fund?



Hedge funds

For any of your offerings, have you negotiated a cap on expense ratios with any of your investors? If not, are you willing to negotiate a cap on expense ratios?



Evolving prime brokerage relationships

Regulations enacted subsequent to the financial crisis intended to reduce market risk are directly impacting the manner in which prime brokers service the hedge fund industry. These regulations put in place as a result of the Dodd-Frank Act and Basel III have changed the basic ability of prime brokers to offer financing and maintain hedge fund assets. Increased focus on optimization, capital liquidity, funding and the balance sheet have impacted banks' capacity and economics, resulting in an evolution in how prime brokers view hedge fund relationships. Prime brokers have increased focus on balance sheet and collateral management, and are re-pricing clients when necessary. Relative to other challenges highlighted in this study that have been playing out for many years now, the evolving prime brokerage environment is in the growth phase of its life cycle. It will be a long time before we understand the full effects of the changes, though we do know the impact will be felt across the board — from prime brokers, to investment managers, to investors.

Managers face new pressures as prime brokerage fees increase

Our study identified that nearly 30% of managers have reported experiencing price increases from their prime brokers, with an almost equal number indicating that they anticipate price increases to occur in the next year.

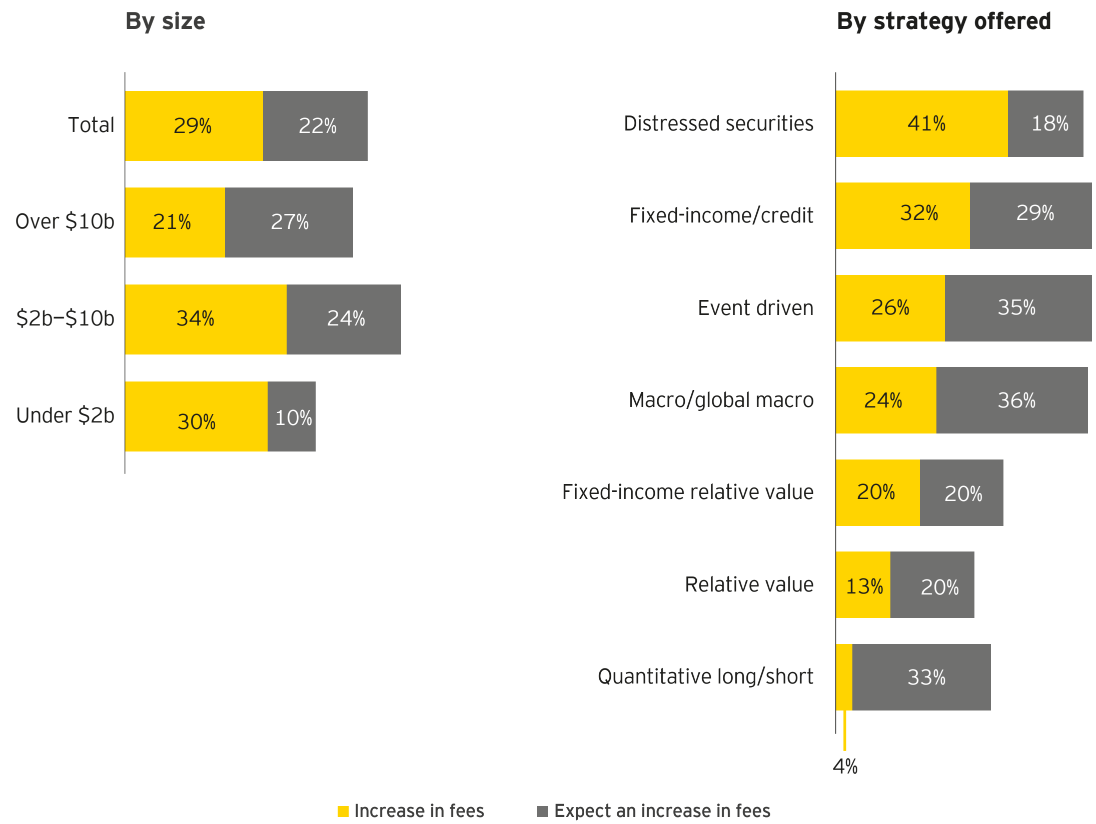
A variety of factors will impact when and where in the re-pricing cycle managers will begin to feel these increases, but it is clear that this issue will impact a majority of managers regardless of size or strategy.

Those first reporting increases are managers who have a combination of balance sheet intensive strategies and trading in products that are traditionally not as profitable for prime brokers. On the opposite end of the spectrum, quantitative and equity long/short strategies appear to have been spared in this initial re-pricing as they tend to trade higher volume, high-quality liquid assets that result in lower net balance sheet exposure and/or greater internalization/optimization for the prime brokers. That said, these strategies are still anticipating price increases in the future as the cost of servicing all clients has risen and thus the current return on these assets is not optimal for the prime brokers.

> "Regulation is generally an issue — not only directly on hedge fund managers, but on the banks that they deal with. So getting access to financing and leverage is a risk facing hedge fund managers."
>
> **(Pension, Europe)**

Hedge funds

For each strategy you offer, have your prime brokers increased pricing in the past 12 months? For each strategy you offer, do you expect your prime brokers to increase pricing in the next 12 months?



Financing cost increases are substantial, directly impacting trade economics

The magnitude of trade financing price increases will vary depending on each manager's unique facts and circumstances, in particular, the types of assets the manager trades. However, what is clear is that all forms of financing are becoming more expensive — in some cases, being at or above 25%. These costs have a direct impact on overall trade economics and will cause managers to evaluate the feasibility of certain trades given these increased costs.

It is worth pointing out that the actual price increases reported by those managers initially impacted tend to be larger than those expected in the future by those managers spared from re-pricing initially. While this is partially driven by the prime brokers taking first action with those managers whose financing economics required the most improvement and, thus required larger increases, this expectation gap of more muted price increases is likely not going to be the reality.

Hedge funds

For each strategy you offer, have your prime brokers increased pricing in the past 12 months?

For each strategy you offer, do you expect your prime brokers to increase pricing in the next 12 months?

	Average % increase in prime broker pricing over past 12 months				Average % increase in prime broker pricing expected over next 12 months			
	Margin financing	Securities lending for "hard to borrows"	Repurchase agreements	Swaps clearing	Margin financing	Securities lending for "hard to borrows"	Repurchase agreements	Swaps clearing
Distressed securities	20%	15%	13%	25%	12%	8%	10%	8%
Fixed-income/ credit	31%	46%	21%	25%	9%	20%	10%	9%
Event driven	12%	12%	NA	NA	10%	9%	9%	5%
Macro/global macro	10%	5%	7%	5%	7%	5%	8%	7%
Fixed-income relative value	30%	NA	7%	13%	8%	13%	11%	11%
Equity long/ short	12%	25%	5%	5%	9%	10%	11%	7%
Quantitative long/short	NA	NA	NA	NA	6%	7%	5%	6%

NA — not applicable for the relevant strategy or insufficient response rates to be statistically meaningful.

One in five managers expects pricing increases to change the way they trade

When faced with price increases, managers can either bite the bullet and incur the cost or they can search for ways to shift their trading strategy. It is interesting to note that one in five managers embraced the latter resort and actually reported changing the way they execute their trading strategy.

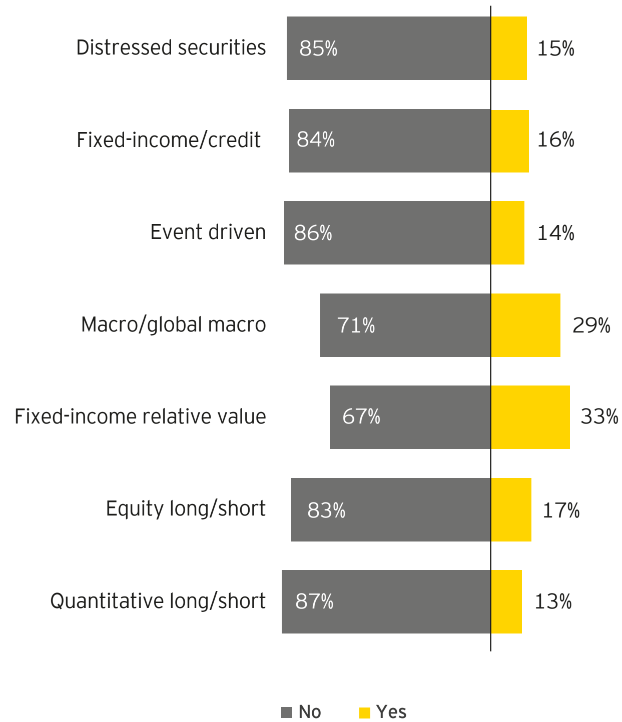
In an industry geared toward supporting the trading behaviors and preferences of the front office, we are starting to see a clear shift in mindset. Managers, particularly fixed-income/credit and global macro, are responding that they have materially adjusted their operations so that trading is responsive to the new reality.

Whether it be moving toward swap-based trade execution, reducing repo financing or an overall reduction of leverage, managers of all strategies are having to make hard decisions about whether certain trades make sense given the associated costs.

> "The impact of regulatory changes in the US and European Union will continue to impair the prime brokers, the availability of leverage and the liquidity of some of the capital markets."
>
> **(Over $10b, North America, Global Macro)**

Hedge funds

Has the pricing increase or expected pricing increase caused you to change the way you trade?



In addition to outright re-pricing, prime brokers have suggested other changes in their relationships with funds

In addition to outright price increases, prime brokers have been having conversations about how to alter relationships so that managers better fit within their evolving business model.

The prime brokers' preference is for managers to concentrate more business with them to maximize cross-selling revenues. However, managers are taking the opposite approach by continuing to add relationships. New entrants to the market have provided managers additional options to complement their existing relationships. While a third of all managers have increased their relationships, 60% of those managers impacted by re-pricing have expanded. This expansion is driven by the fact that managers are larger and more complex than ever with increased financing needs. As many prime brokers have less capacity to offer, the primary solution for managers is to increase relationships.

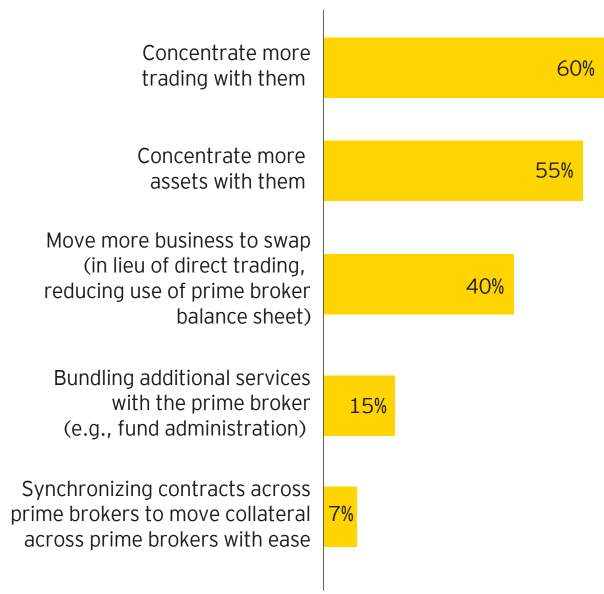
Whereas after the 2008 crisis we witnessed an expansion of the number of prime broker relationships as managers wanted to mitigate counterparty credit risk, now we are seeing an expansion of relationships to mitigate counterparty capacity risk.

> "There seems to be less willingness on the part of the prime brokers to provide services and to focus only on their major clients."
>
> **($2b–$10b, North America, Multi-strategy)**

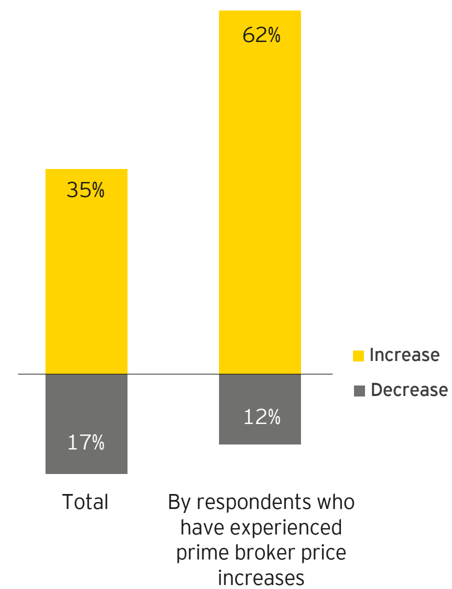
Hedge funds

Which actions have prime brokers requested you take? Did you or are you planning to increase, decrease or keep constant the number of prime brokers you worked with over the past 12 months?

Prime broker suggested actions to alter relationship



Past and expected changes in number of prime brokers



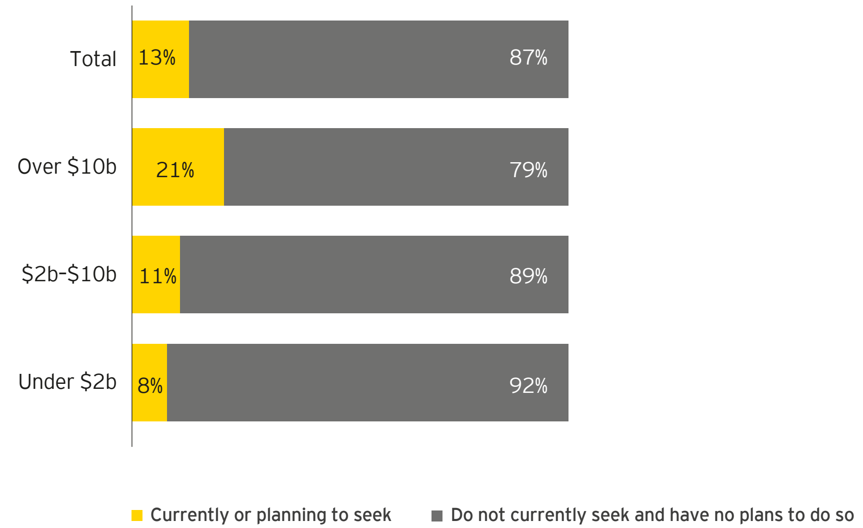
One in five of the largest managers is seeking financing from non-traditional sources

In addition to the new boutique prime brokers entering the industry, we are beginning to see an appetite from managers to seek financing from other non-traditional sources, whether it be from institutional investors and sovereign wealth funds, custodians or even other hedge funds. While the percentages are not large, going back two to three years, these financing means likely would have been non-existent.

The biggest managers tend to be on the leading edge of many of the industry's innovations, so the fact that just under a quarter responded "yes" could be an indication that this trend is only beginning and that we will continue to see managers seek fresh and inventive ways to finance their operations. Whether this holds true will depend equally on whether there is sufficient supply from these alternative counterparties in addition to whether managers will provide the demand. This trend creates both risk and opportunity. The lack of traditional financing options could continue to cause liquidity constraints and hinder managers' ability to finance their strategies in a cost-efficient manner. New entrants will view this as an opportunity to enter an industry once dominated by global investment banks and capture market share by providing the industry's financing needs.

Hedge funds

Are you currently seeking or do you plan to seek financing from non-traditional sources in the next two years?



"A shift in providers in the counterparty space may happen in the next 2+ years if things don't improve for the banks. We are not sure that banks, on an ongoing basis, are going to be overly interested in doing business in prime brokerage if it continues to be a low return business due to the regulatory environment. But prime brokerage is needed, so there may be other, new possibilities popping up: independents from the banks, some counter-parties get larger, some consolidation; all leading to higher costs and probably fewer people in the business."

(Over $10b, North America, Equity Long/Short)

Cash is not king (for the prime brokers) requiring action by managers

A final complexity that managers need to address is that many prime brokers are reluctant to hold cash as a result of how such balances are classified toward the banks' capital reserves.

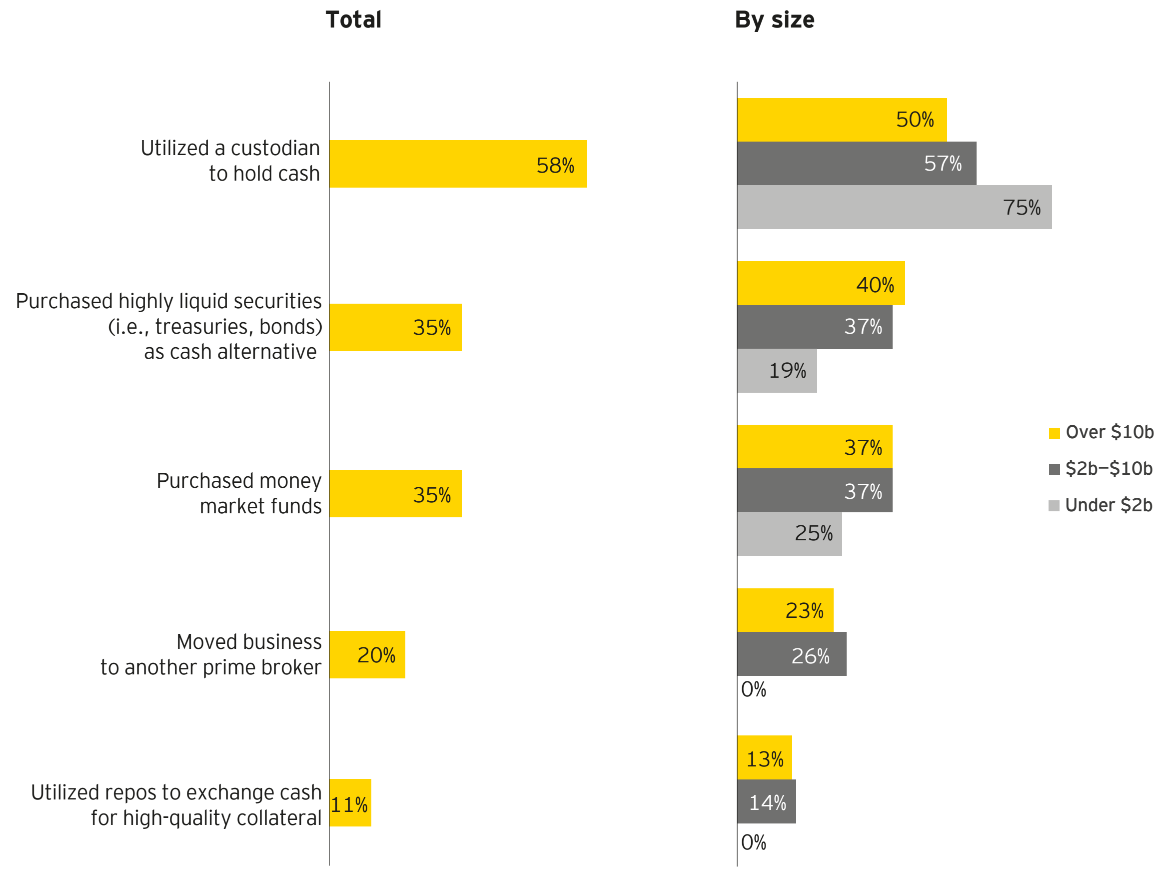
A majority of managers have responded by moving cash to custodians while a third have reported purchasing cash equivalents such as treasuries or money market funds.

While these alternatives are available to all, the results show that the smaller managers tend to primarily utilize custodians rather than other mechanisms. This suggests that smaller managers have made the determination that these other tools are not an effective solution (whether from a cost or operational perspective).

The increasing complexity of financing and cash management activities and managing a growing number of relationships with prime brokers comes at an increased cost of building out an infrastructure and personnel to handle these responsibilities.

Hedge funds

As prime brokers increasingly refuse to accept cash deposits, how have you responded?



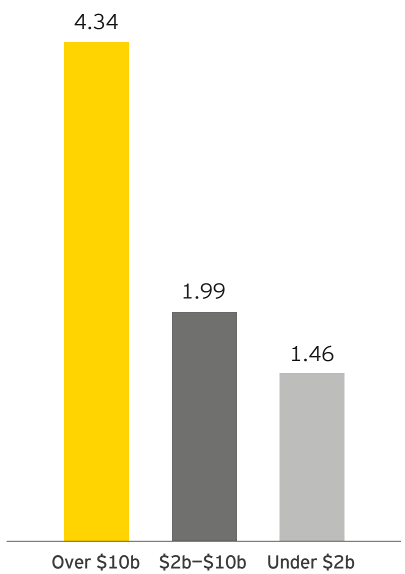
Centralized treasury has become an integral process in managing the overall business

As a result of the changing prime broker landscape, the need to better manage counterparty risk and collateral, as well as other treasury functions, has become an increasingly critical component of a manager's operations. Managers have responded by having individuals dedicated to this function to help optimize their activities and conduct business in the most economically sound way possible. The largest managers, due to necessity and the means to implement, have responded the most quickly and have built out groups that can focus on these efforts.

Though it is not surprising that the smallest managers have not yet developed these groups — they are less complex and/or focused on growing their businesses — mid-sized managers could benefit from the support of a more robust treasury team. It does seem noteworthy that half of all managers do not currently have a central treasury function. Given the evolving environment we have been describing, we believe this will be a critical area of focus to build out in the immediate future.

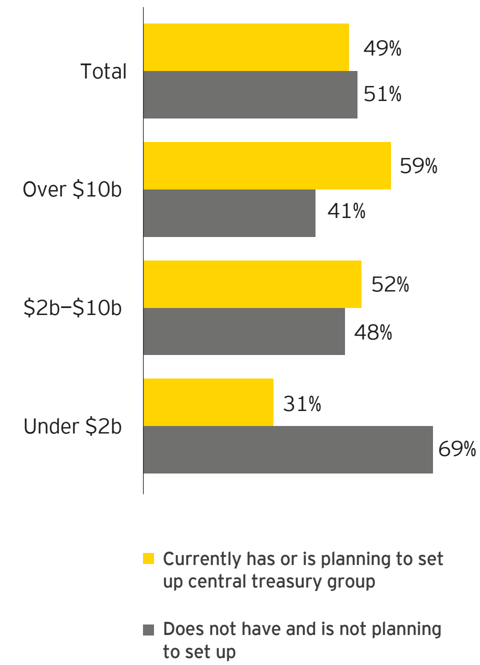
Hedge funds

How many full-time equivalents are dedicated to managing financing and collateral?



Average number of full time equivalents

Does your firm have a central treasury group?
If not, is your firm planning to set up a central treasury group?



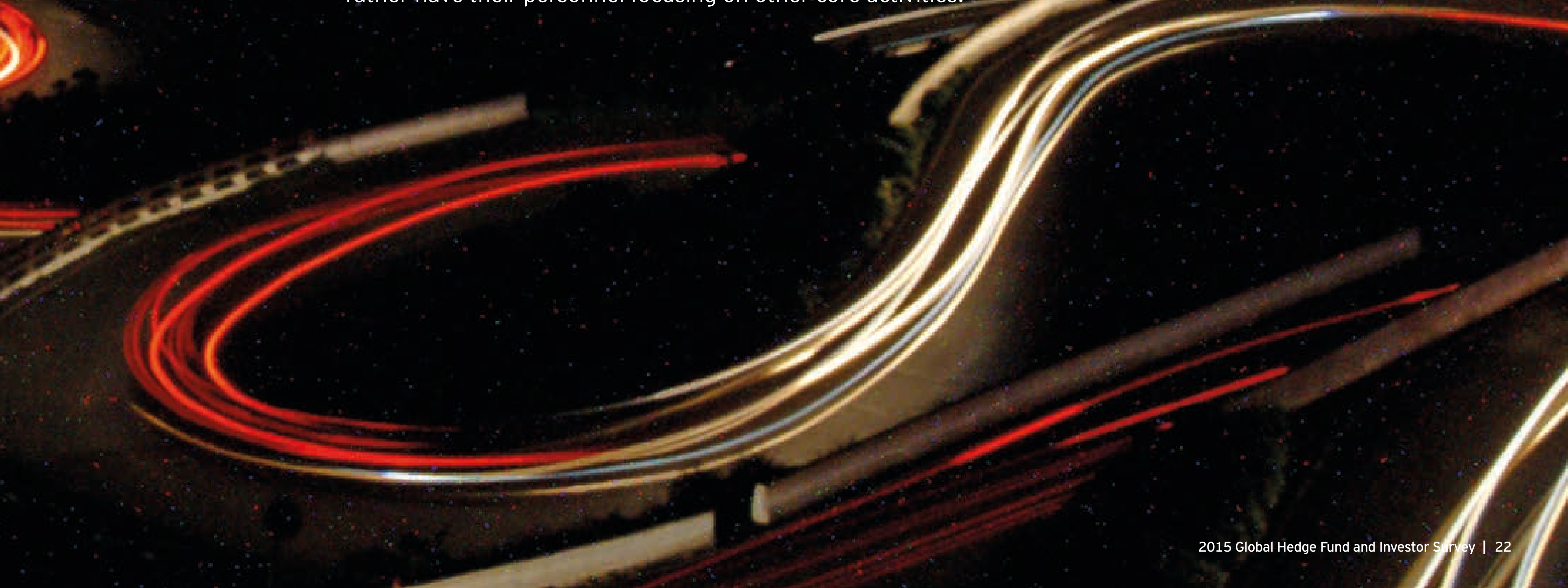
Technology investments and middle office outsourcing

Top-line revenues remain under attack in the form of fee concessions and a permanent departure from the "2 and 20" industry model. Further, trade economics are being pinched in the form of increased financing costs, taking a further bite out of the revenues of a manager. Last, the costs of the business are certainly not declining, creating a dramatic squeeze on the margins that a manager yields.

This has caused the AUM break-even point to exponentially increase compared to earlier days in the hedge fund industry's life cycle. In 2015, an asset base of $500 million is often a minimum amount required to support the costs to run an increasingly complex business. So what does it take to be successful and profitable?

Managers need to be more focused than ever on the financial considerations of running an effective business. That means understanding the implications of a lower revenue environment while being cognizant of ways in which the operating infrastructure can be optimized to gain efficiencies and also the impact that successful investments, particularly in technology, can have on the business.

Investments in technology can help integrate front to back office reporting capabilities, leading to more timely and less manually intensive exercises. Additionally, while back office outsourcing is near a saturation point, the middle office offerings from various participants have become quite robust and customized to the asset management community. Leveraging these solutions is a cost-effective alternative for managers who would rather have their personnel focusing on other core activities.



Technology investment expenditures continue to steadily rise

As a proportion of a manager's overall expense budget, technology expenses have increased dramatically over the past several years. This trend is partly a function of many managers not properly investing historically and having to play catch-up. It is also fueled by the fact that today's technology environment and the impact it has on the business is rapidly evolving.

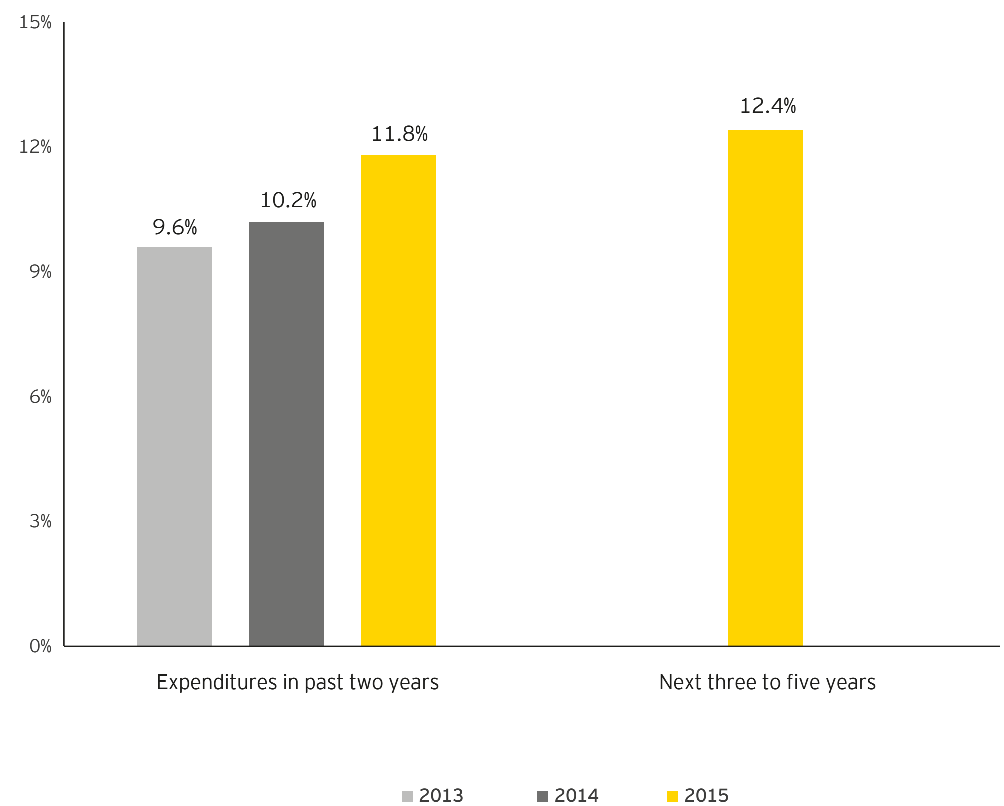
In today's environment, managers must scale their operations. This is challenging as the industry moves to more bespoke products and challenging regulatory demands.

The proposition of continued expansion of technology related costs is daunting; however, it is a reality of operating in a maturing industry. Whether it be driven by goals of developing tools that allow for more timely and customized investor necessitated reporting, regulatory reporting, risk management capabilities or being responsive to ever-present cybersecurity concerns, it is imperative that all organizations provide the appropriate attention to building out this area of the business.

> "We are looking for more customized accounts from our managers, which will really increase the need for improvement in their technology to adapt to the operational and reporting considerations."
>
> **(Fund of Funds, North America)**

Hedge funds

What percentage of your overall expense budget was allocated to major technology expenditures over the past two years? What percentage of your overall expense budget do you expect to allocate to major technology expenditures in the next three to five years?



Managers are investing in technology to support a variety of business functions

Though the overall pace of investment in technology is anticipated to slow slightly in the future — 70% of managers expect to make major investments in the next two years, compared to over 80% who invested in the past two years — the magnitude of the spend is forecasted to increase. This is a result of greater business transformation projects, which result in larger front to back office efficiencies.

While there is diversity in the areas of investment, it is clear that managers broadly recognize the need to evolve their current capabilities and is noteworthy that only 16% have not made an investment in the past, and less than a third have no expectations for further expenditures.

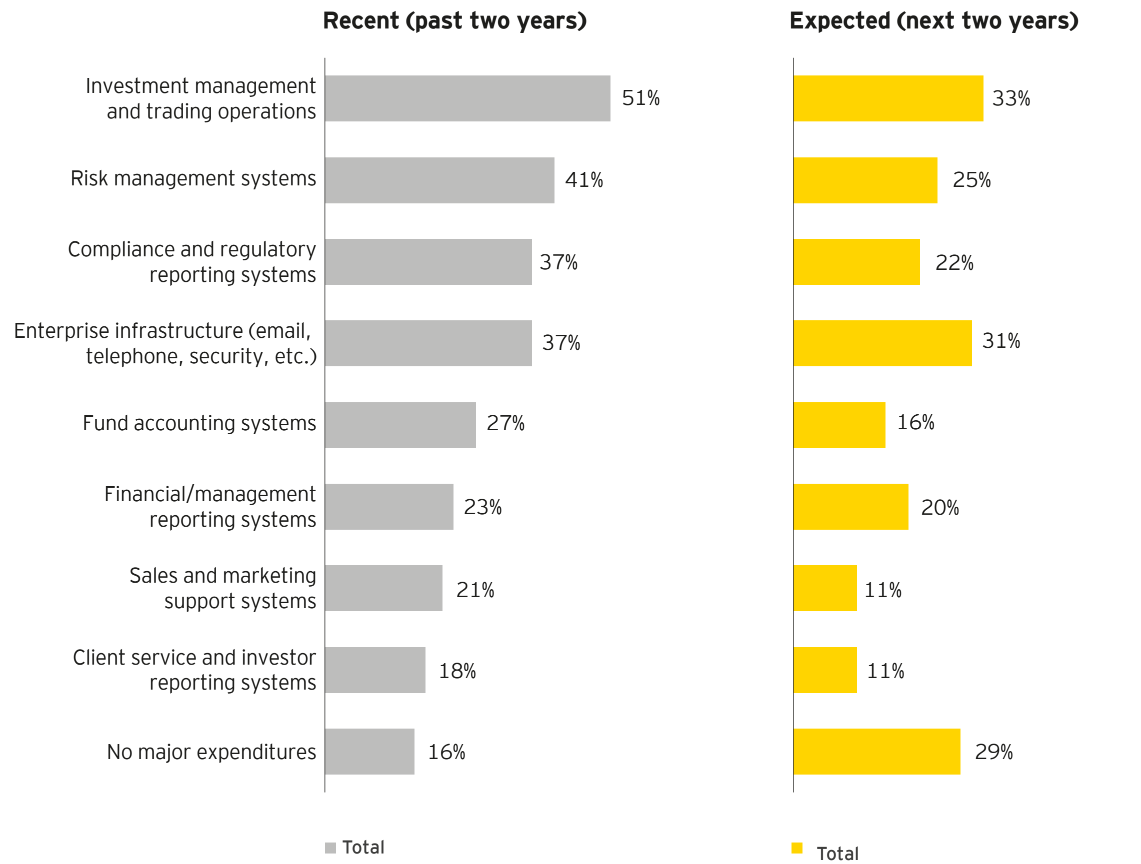
Mid-size managers are outpacing both larger and smaller managers materially in expenditures in most business processes as they invest in infrastructure to support their growth ambitions.

> "We continue to build our infrastructure to scale and consider our outsourcing model. Your ultimate goal could be growth, but you cannot underestimate building the infrastructure and further enhancing your operational capabilities to achieve that."
>
> **($2b–$10b, North America, Global Macro)**

Hedge funds

In which of the following have you recently made (past two years) major expenditures in technology?

In which of the following do you expect to make major expenditures in technology in the next two years?



Data management and technology need to be advanced to provide seamless operations and to reduce reporting risk

Investment in data management and advanced reporting are vitally important for managers as they continue to grow. Data needs to flow seamlessly from manager to vendor and counterparties and back, to close any gaps between trading, risk and reporting.

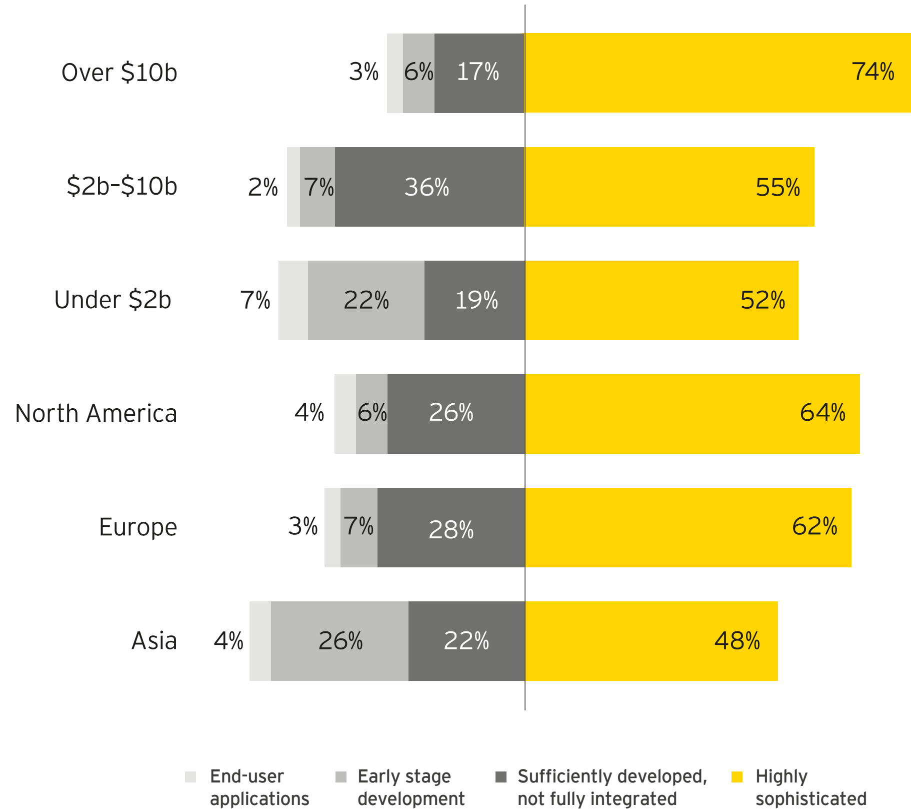
Given their recent investment, few managers would characterize their technology environment for data and reporting as in early stage development or leveraging end-user applications; over half of managers with less than $10 billion under management believe there is room for improvement. The most common issues these managers face is a lack of an integrated set of technologies in which data is easily managed.

As outsourcing becomes more prevalent and critical, an appropriate data and technology environment is a greater necessity.

Hedge funds

Along the following continuum, which of the following best describes your technology environment as it relates to data and reporting?

State of technology environment: data and reporting



Middle office outsourcing is an additional tool to optimize the operating model

In the face of increased costs and demands as a result of managers' ever-growing and complex businesses, middle office outsourcing remains an area that 6 in 10 managers have embraced.

Middle office outsourcing continues to evolve with service offerings from new entrants – spin-outs from managers, banks and technology companies – with offerings that have provided serious competition to incumbent providers that continue to invest in this space.

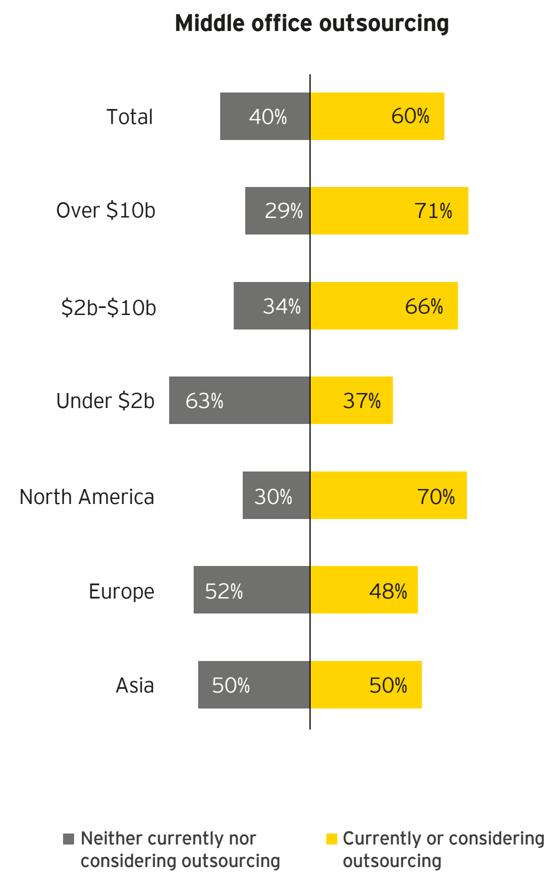
Though smaller managers are likely to have less complex needs, they should evaluate whether the available solutions offer much-needed cost efficiencies, thus reducing their break-even point. For the two-thirds of smaller managers who have not looked to outsource, this could be a tool that helps reduce the operational and cost burden so they can focus on core capabilities.

" We are going to continue to outsource more and spend in technology infrastructure."

(Under $2b, Asia, Equity Long/Short)

Hedge funds

Are you currently outsourcing or considering outsourcing any of the following middle office functions?



Investor comfort with outsourcing far outpaces manager willingness to relinquish control

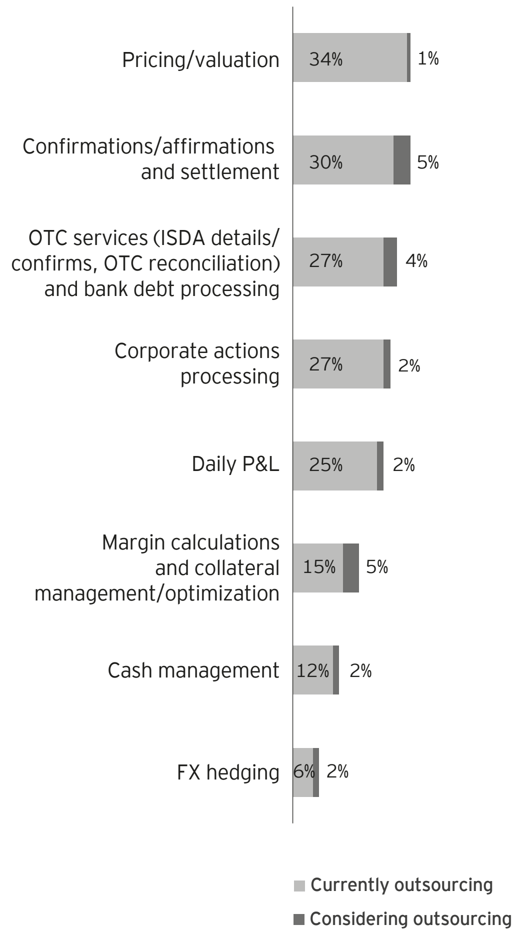
While the previous results indicate that a majority of managers are comfortable outsourcing areas of the middle office, these results show a greater reluctance among specific types of activities. Part of this inconsistency can be attributed to current outsource providers choosing to focus on niche areas of expertise while lacking quality full-service middle office offerings. Managers who are considering outsourcing middle office functions would be wise to put a holistic transition strategy in place even if they expect to make the move in stages. The interdependencies between functions — and the front office — should not be underestimated.

Broadly speaking, investors are accepting of outsourcing all of these functions. They show the most resistance to cash management and hedging, but even those are supported by 60% of investors. Managers should not resist outsourcing on the mistaken belief that investors are not comfortable with it. Investors are satisfied with the benefits that managers have reaped from using third parties to perform a majority of back office functions and are now encouraging their managers to be opportunistic in expanding to utilize specialists in performing as much of the middle office as possible.

> "We need to be able to implement the necessary controls and procedures to be able to handle the growth we have achieved via new products, including a number of different multi-strategy products. We need to invest in technology and reconsider which functions we outsource."
>
> **(Over $10b, North America, Equity Long/Short)**

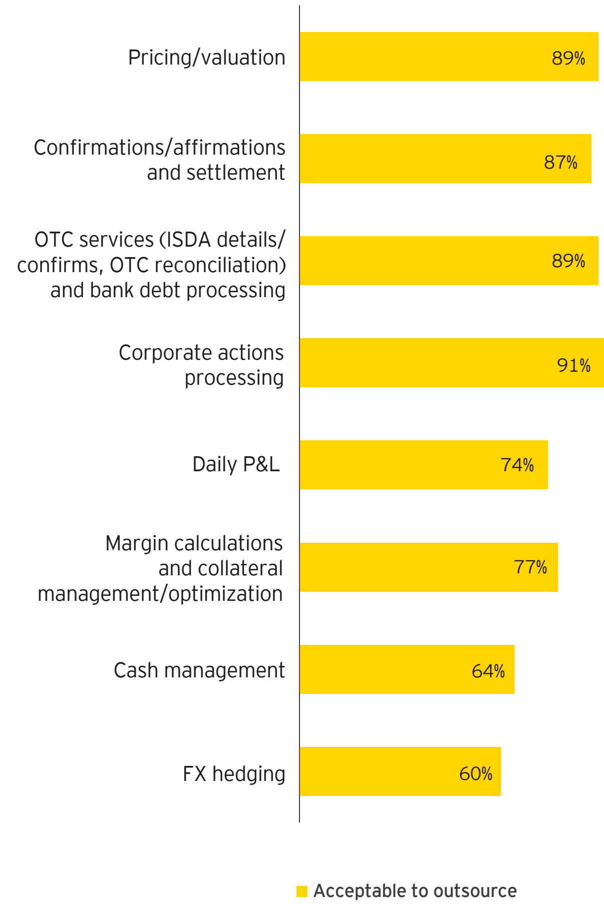
Hedge funds

Are you currently or considering outsourcing any of the following middle office functions?



Investors

Which of the following middle office functions are acceptable for your hedge fund managers to outsource to a third party?



Cost savings is a key driver, but other factors are also providing impetus to outsource

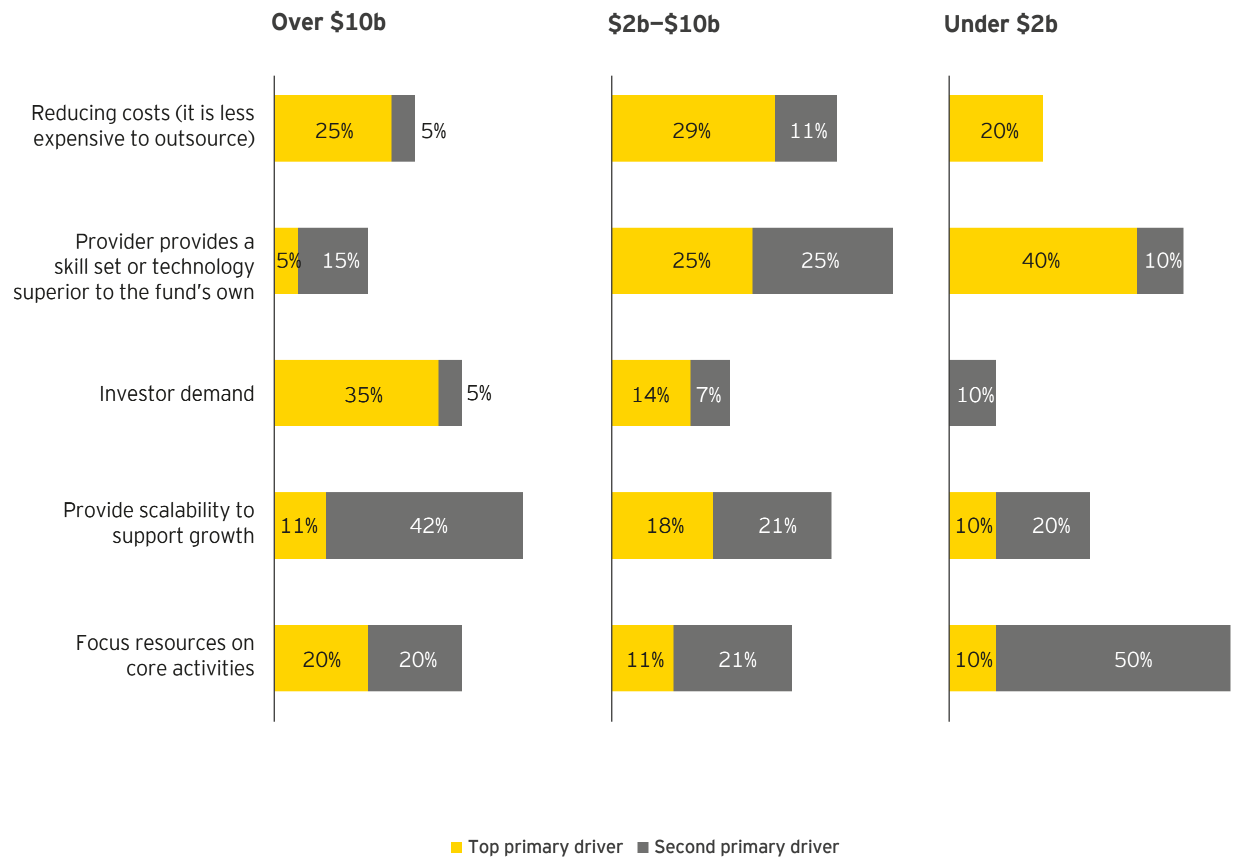
All managers recognize the cost benefit associated with outsourcing as a key driver; however, it is interesting that other deciding factors tend to vary by size of the manager.

The largest managers point to investor demand and scalability as key drivers of outsourcing decisions. They likely recognize that investors are supportive of outsourcing as a means of separation of duties and independent oversight in addition to the size and scale of their business requiring external servicing. The technology solutions tend not to be a consideration for the large managers as these entities often have already made significant investment in their infrastructure and have the necessary tools to perform these functions.

Conversely, smaller and mid-size managers are motivated by the lure of skill sets and technology that is best in class. These managers need to move rapidly but have not yet built out their own systems or teams in these areas and can benefit from utilizing the services of a provider who has the requisite expertise.

Hedge funds

What are the top two primary drivers for outsourcing in rank order of importance?



Future landscape

“We will see a diversification of hedge funds with some managers moving back to the traditional concept of hedge funds while others become global, institutionalized, asset managers. At the moment, it’s a mixture of the two where a number of firms are trying to be all things to all people. It’s a question of how successful some of those firms will become.”

(Pension Plan, Europe)

“Talent management will continue to be a major differentiator amongst firms. We will increasingly be competing not just amongst ourselves, but with the technology businesses in Silicon Valley. Attracting top talent will be difficult when you have the Googles, Facebooks and other start-up firms playing in the same talent pool.”

(Over $10b, North America, Multi-strategy)

“We will continue to see a trend towards more multi-strategy offerings with increasing operational complexity. To stay relevant, managers will need to offer customized solutions to fit investors’ evolving needs.”

($2b-$10b, North America, Multi-strategy)

"Hedge funds are no longer a niche. Everything becomes mainstream, and I think opportunity is then greatly diminished. There are too many talented investors pursuing similar strategies. There is not sufficient innovation."

(Pension Plan, North America)

"The biggest trend is institutional managers are becoming retail and retail managers are becoming more institutional; the lines of what is hedge, mutual funds or retail, are blurring. Everyone is going into other peoples' areas so to speak. I think the lines of what's a hedge fund versus a mutual fund and how that is defined will become blurry."

(Over $10b, North America, Multi-strategy)

"There will be continued focus on the larger multi-product firms. Those are the guys who have survived the various cycles. Firms will continue to be taken out because they're not diversified and have only a focused product. The way the industry is developing, anyone who is that small and only focused on one product doesn't have the resilience to survive any downturn in their product. They can be very good at their product and it may be a very profitable product at any point in time. But, when there is that downturn and everyone pulls out of it, they can't continue to manage."

($2b–$10b, Europe, Fixed Income/Credit)

Transformational change expected as managers are not content with their status quo

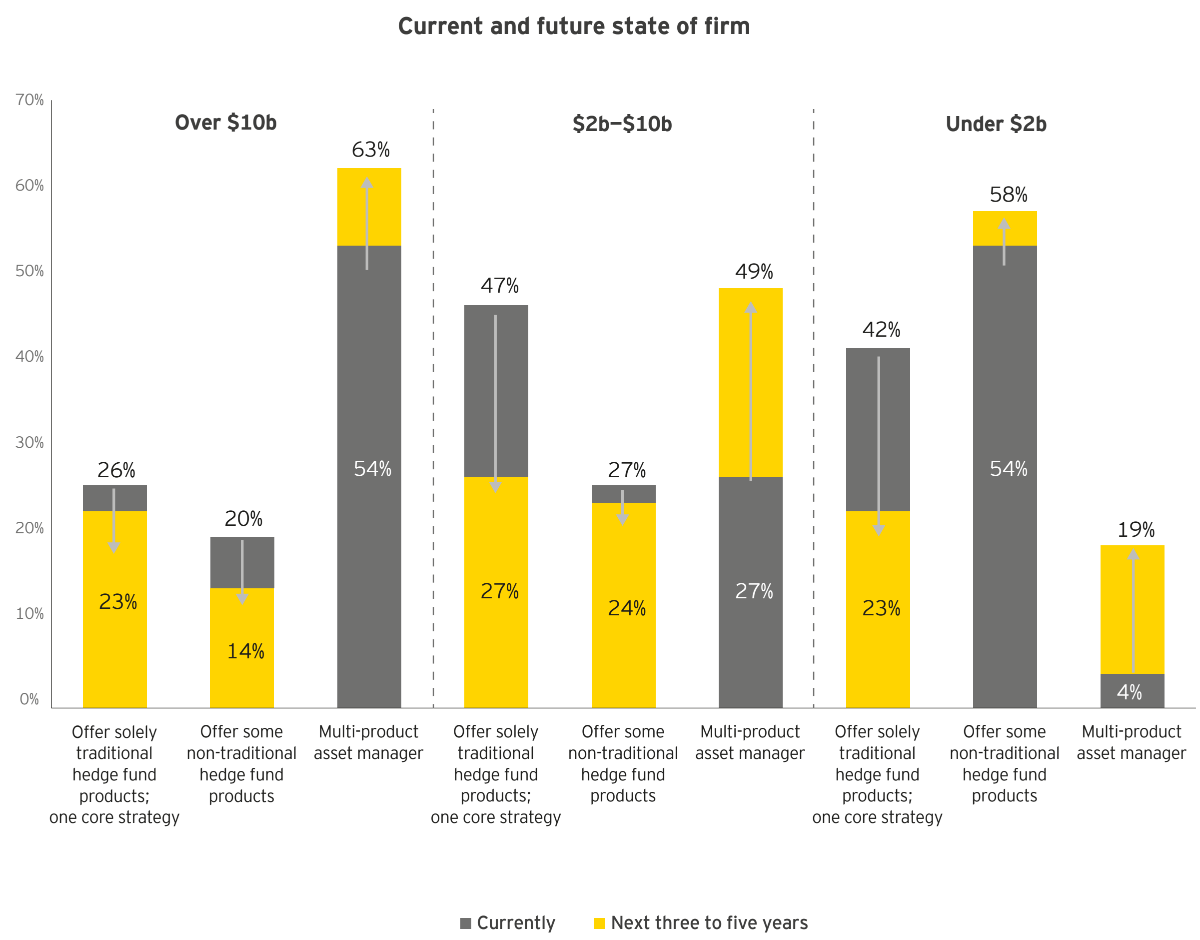
The largest managers now view themselves as alternative asset managers, offering multiple product types and strategies to meet all investor needs. Currently almost half of the mid-size managers are only offering a single strategy traditional hedge fund product, however, they realize taking the leap to a multi-product asset manager is the path forward in a maturing industry and half hope to emulate their larger peers and offer more products to appeal to a larger and more diverse investor base.

The smallest managers continue to fill a niche, and have more tempered expectations about where their organization will be in the near future. They remain focused on incremental growth while recognizing the efforts needed to succeed in this more expensive and challenging environment.

Delivering on transformation change goals requires the efforts and attention of the entire organization and will require commitments to operational, technology and personnel investments, all while not losing sight of delivering on client expectations.

Hedge funds

How would you characterize your firm currently? Where do you see your firm in the next three to five years?



Final thoughts

Mahatma Gandhi is credited with the phrase "The future depends on what you do today." While it is almost certain that he did not have hedge funds in mind, the concept is relevant nonetheless. Our industry has evolved dramatically and in no way represents the days of a generation earlier. Many of the hedge fund pioneers and larger managers have matured such that they have operations and brand recognition that more closely resemble global financial institutions. Investor expectations for the size, infrastructure and business model of emerging and mid-size managers are only slightly less modest; with institutional investors contributing a majority of the assets to the industry, these participants are demanding more robust and well-developed investments in the operational infrastructure of their managers. This transition did not take place overnight; however, those looking to achieve growth in the future need to embrace the new dynamics of the hedge fund environment by properly planning today to reap benefits down the road.

Managers must be willing to continue to understand the needs of a diverse investing universe, a universe for which the population has many distinct groups that each have different needs and desires. While offering products that appeal to their targeted investor base is a start, managers also need to understand the shifting economic landscape whereby they are generally earning less to manage these products but are also incurring more costs to operate. While issues such as fee compression have played out over several years, new battles can and will continue to arise. Changes coming through as a result of the shifting prime brokerage landscape are the latest challenges that managers are faced with addressing.

This altered landscape makes the present an interesting and exciting time in the industry. Many managers are embracing the evolving business and developing innovative solutions to position their firms to succeed while simultaneously creating a blueprint that others can follow. Legacy managers have been on the forefront of new product introductions as well as designing infrastructures that have the scale and sophistication to support the most complex and challenging of business environments. The next generation of managers continue to push forward with ingenious approaches to capturing market share and building businesses that will create their own legacy. The future will bring new challenges and threats, but the outlook by all is upbeat in anticipation of ongoing growth, fueled by investor demand.

Background and methodology

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, investor demand, changes in the prime brokerage relationship, middle office outsourcing, technology investments and the future landscape of the hedge fund industry.

From June to September 2015, Greenwich Associates conducted:

- 109 telephone interviews with hedge funds representing just over $1.4 trillion in assets under management
- 57 telephone interviews with institutional investors (fund of funds, pension funds, endowments and foundations) representing nearly $1.83 trillion in assets, with roughly $413 billion allocated to alternative investments

Hedge fund respondent profile	
Total	109
By geography	# of participants
North America	55
Europe	31
Asia	23
By AUM	# of participants
Over $10b	36
$2b-$10b	46
Under $2b	27

Investor respondent profile	
Total	57
By geography	# of participants
North America	30
Europe	24
Asia	3

Contacts

Global

Michael D. Lee
michael.lee@ey.com
+1 212 773 8940

Michael Serota
michael.serota@ey.com
+1 212 773 0378

Americas

Bahamas

Tiffany Norris-Pilcher
tiffany.norris@bs.ey.com
+1 242 502 6044

Bermuda

Jessel Mendes
jessel.mendes@bm.ey.com
+1 441 294 5571

Brazil

Flavio Serpejante Peppe
flavio.s.peppe@br.ey.com
+55 11 2573 3290

Pedro Miguel Ferreira Custódio
pedro.custodio@br.ey.com
+55 11 2573 3035

British Virgin Islands

Rohan Small
rohan.small@ky.ey.com
+1 345 814 9002

Mike Mannisto
mike.mannisto@ky.ey.com
+1 345 814 9003

Canada

Joseph Micallef
joseph.n.micallef@ca.ey.com
+1 416 943 3494

Fraser T. Whale
fraser.t.whale@ca.ey.com
+1 416 943 3353

Cayman Islands

Dan Scott
dan.scott@ky.ey.com
+1 345 814 9000

Jeffrey Short
jeffrey.short@ky.ey.com
+1 345 814 9004

Curaçao

Fatima de Windt-Ferreira
fatima.de-windt-ferreira@an.ey.com
+599 9 430 5020

Bryan Irausquin
bryan.irausquin@an.ey.com
+599 9 430 5075

US (Boston)

Robert Glassman
robert.glassman@ey.com
+1 617 375 2382

Shaun Real
shaun.real@ey.com
+1 617 375 3733

Alex Johnson
alex.johnson1@ey.com
+1 617 585 1930

US (Chicago)

Anthony Rentz
anthony.rentz@ey.com
+1 312 879 3957

Matthew Koenig
matthew.koenig@ey.com
+1 312 879 3535

US (Dallas)

Adrienne Main
adrienne.main@ey.com
+1 214 754 3226

Christine Jha
christine.jha@ey.com
+1 214 969 0702

US (Houston)

Brenda Betts
brenda.betts@ey.com
+1 713 750 5913

US (Los Angeles)

Scott Odahl
scott.odahl@ey.com
+1 612 371 6840

Michael O'Donnell
michael.odonnell@ey.com
+1 213 977 5858

Mark Gutierrez
mark.gutierrez@ey.com
+1 213 240 7490

US (Minneapolis)

Brian Mcilhinney
brian.mcilhinney@ey.com
+1 212 773 7208

Michele Walker
michele.walker@ey.com
+1 612 371 8539

US (New York)

Joseph Bianco
joseph.bianco@ey.com
+1 212 773 3807

Natalie Deak Jaros
natalie.deak@ey.com
+1 212 773 2829

Samer Ojjeh
samer.ojjeh@ey.com
+1 212 773 6486

David Racich
dave.racich@ey.com
+1 212 773 2656

US (Philadelphia)

Robert Mulhall
robert.mulhall@ey.com
+1 215 448 5614

US (San Francisco)

Michel Kapulica
michel.kapulica@ey.com
+1 415 894 8605

Paul Kangail
paul.kangail@ey.com
+1 415 894 8056

US (Stamford)

Jackie DeRosa
jacqueline.bloom@ey.com
+1 212 773 1872

Michael Estock
michael.estock@ey.com
+1 203 674 3137

Europe, Africa and Middle East

Bahrain
Ashwani Siotia
ashwani.siotia@bh.ey.com
+973 1751 4708

Jersey
David Moore
dmoore@uk.ey.com
+44 1534 288697

Dubai
Anthony O'Sullivan
anthony.osullivan@ae.ey.com
+971 4 312 9120

Michelle Kotze
michelle.kotze@ae.ey.com
+971 4701 0100

France
Hermin Hologan
hermin.hologan@fr.ey.com
+33 1 4693 8693

Matthieu Dautriat
matthieu.dautriat@ey-avocats.com
+33 1 5561 1190

Germany
Oliver Heist
oliver.heist@de.ey.com
+49 6196 996 27505

Rosheen Dries
rosheen.dries@de.ey.com
+49 6196 996 26163

Guernsey
Mike Bane
mbane@uk.ey.com
+44 1481 717435

Ireland
Fergus McNally
fergus.mcnally@ie.ey.com
+353 1 221 2599

Donal O'Sullivan
donal.osullivan@ie.ey.com
+353 1 221 2455

Isle of Man
Paul Duffy
pduffy@im.ey.com
+44 1624 691818

Angus Gilmore
aegilmore@im.ey.com
+44 1624 691803

Italy
Mauro Iacobucci
mauro.iacobucci@it.ey.com
+39 02 72212471

Stefano Cattaneo
stefano.cattaneo@it.ey.com
+39 02 72212452

Paolo Zucca
paolo.zucca@it.ey.com
+39 02 8514938

Luxembourg
Michael Ferguson
michael.ferguson@lu.ey.com
+352 42 124 8714

Adam Miller
adam.miller@lu.ey.com
+352 42 124 7147

Malta
Ronald Attard
ronald.attard@mt.ey.com
+356 2134 2134

Karl Mercieca
karl.mercieca@mt.ey.com
+356 2134 2134

Mauritius
Daryl Csizmadia
daryl.csizmadia@mu.ey.com
+230 403 4707

Ryaad Owodally
ryaad.owodally@mu.ey.com
+230 403 4717

Netherlands
Remco Bleijs
remco.bleijs@nl.ey.com
+31 88 407 3935

Ton Daniels
ton.daniels@nl.ey.com
+31 88 407 1253

Russia
Marchello Gelashvili
marchello.gelashvili@ru.ey.com
+7 495 755 9813

Petr Avramenko
petr.avramenko@ru.ey.com
+7 495 755 9700

South Africa
Anthony Cadman
anthony.cadman@za.ey.com
+27 21 443 0664

Spain
Roberto Diez Cerrato
roberto.diezcerrato@es.ey.com
+34 933 663 842

Monserrat Turrado Alonso
monserrat.turradoalonso@es.ey.com
+91 572 72 15

Nordics
Peter Franks
peter.franks@se.ey.com
+46 8 5205 8973

Fredrik Stigerud
fredrik.stigerud@se.ey.com
+46 8 5205 9853

Helena Noren
helena.noren@se.ey.com
+46 8 5205 9687

Switzerland
Christian Soguel
christian.soguel@ch.ey.com
+41 58 286 4104

UK
Robin Aitchison
raitchison@uk.ey.com
+44 20 7951 1083

Julian Young
jyoung2@uk.ey.com
+44 20 7951 2295

Russell Morgan
rmorgan1@uk.ey.com
+44 20 7951 6906

Matt Price
mprice1@uk.ey.com
+44 20 7951 2223

Fiona Carpenter
fcarpenter@uk.ey.com
+44 20 7951 9373

Asia-Pacific

Australia
Jon Pye
jon.pye@au.ey.com
+61 28295 6972

Antoinette Elias
antoinette.elias@au.ey.com
+61 2 8295 6251

Rohit Khanna
rohit.khanna@au.ey.com
+61 2 9248 5560

China (Hong Kong)
George Saffayeh
george.saffayeh@hk.ey.com
+852 2849 9290

Paul Ho
paul.ho@hk.ey.com
+852 2849 9564

China (Shanghai)
AJ Lim
aj.lim@cn.ey.com
+86 21 22282929

Yeeckle Zhou
yeeckle.zhou@cn.ey.com
+86 21 2228 2833

Gavin Tang
gavin.tang@cn.ey.com
+86 21 2228 3023

India
Viren H. Mehta
viren.mehta@in.ey.com
+91 22 6192 0350

Sameer Gupta
Sameer.gupta@in.ey.com
+91 22 6192 0480

Japan
Kazuhiro Ebina
kazuhiro.ebina@jp.ey.com
+81 3 3506 2411

New Zealand
Graeme Bennett
graeme.bennett@nz.ey.com
+64 9 300 8191

Matthew Hanley
matthew.hanley@nz.ey.com
+64 9 300 8008

Singapore
Brian Thung
brian.thung@sg.ey.com
+65 6309 6227

Amy Ang
amy.ang@sg.ey.com
+65 6309 8347

South Korea
Jeong Hun You
jeong-hun.you@kr.ey.com
+82 2 3770 0972

Jong-Yeol Park
jong-yeol.park@kr.ey.com
+82 2 3770 0904

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