

# Hedge Fund Trends for 2010 and Beyond

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# Introduction

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Citi's Hedge Fund Services team undertook interviews with leading European hedge fund managers in spring 2010. The interviews gathered managers' views of likely trends in the industry through 2010 and beyond.

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- Composition of hedge fund managers interviewed ranged between London based managers with average assets under management (AUM) of US\$5 billion and continental European managers with average AUM of US\$3 billion
- The interviews gathered managers' views of likely trends in the industry through 2010 and beyond, focusing on a number of key issues;
  - Industry regulation
  - Fund domiciles and structures
  - Marketing and fund raising
  - Management and incentive fees
  - The demands of investors
  - Fund valuation and governance models
- The findings point to changing times ahead for the industry

## INDUSTRY CHANGE

- Asset Manager Consolidation
- Traditional/Alternative Convergence
- Investor Transparency
- Institutionalisation
- Scalability/Efficiency
- UCITS Growth

## REGULATORY CHANGE

- AIFMD
- UCITS IV
- Retail Distribution Review
- Anti Money Laundering – Third Directive
- CESR Consultations
- Solvency II

DRIVERS OF CHANGE IN THE EUROPEAN INVESTMENT MANAGEMENT INDUSTRY

# Executive Summary

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In early 2010, as the European hedge fund industry emerged from a prolonged period of turbulence, two things were clear to most market participants: confidence was finally returning and major changes lay ahead.

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## Factors driving transformation of the industry

- Draft AIFMD proposed significant changes to how hedge funds currently do business introducing custody model, leverage limitations, marketing restrictions, remuneration guidelines and more
- Convergence of traditional long only and hedge industries with crossover of domicile, structure and investor base
- Industry institutionalisation with investors demanding greater transparency, enhanced liquidity and engaging in extensive due diligence processes before investing

## Key findings from manager interviews

- “Prepare and wait” on AIFMD outcome
- Cayman remains the leading domicile
- Institutional pressures and increased complexity for managers
- Investment in marketing stepped up
- Intense focus on due diligence and transparency from investors
- Liquidity terms need to better match liquidity of underlying portfolio
- Talk of fee pressure overblown
- Asset protection models continue to be reviewed
- Robust board of directors increasingly important

# Regulation

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The cost of complying with the AIFMD is widely seen as a drag on performance. As yet, there is little sign that hedge fund managers are making widespread changes to their current business structures.

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- **AIFMD**

- Managers not persuaded that its provisions will reduce the systematic risk that hedge funds supposedly pose or will increase investor protection
- Preference for regulation that focuses on processes and procedures (risk management, portfolio valuation, role of the Board of Directors, use of external administrators and auditors)

## AIFMD Contentious Areas

- Custody model
- Liability provisions for depositories
- Constraints on function delegation
- Third-country marketing rules
- Role of Board of Directors
- Impact on non-EU jurisdictions

## Manager Concerns

- Ignores overwhelming use of prime brokerage
- Increased operating costs for fund, concentration among providers
- Asset, risk and liquidity management responsibilities
- Many hedge funds sell to investors via private placement throughout Europe
- Role of Board of Directors in managing fund is not acknowledged
- Jurisdictions, such as Cayman, have served hedge industry well

- **Compliance**

- Compliance costs seen as having direct impact on fund performance
- Preparation difficult due to multiple drafts and re-drafts of directive to date
- Lack of synchronisation on hedge fund regulation between US and Europe
- Review current business model and consider potential outcomes

# Fund Domiciles and Structures

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Hedge fund managers see no pressing need to bring their offshore fund ranges onshore in the immediate future — though the AIFMD could change that.

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- **Redomiciliation**

- Little pressure from existing investors for managers to move to EU domiciles such as Luxembourg and Ireland and away from the most commonly used offshore domicile, Cayman Islands
- While offshore locations have suffered some credibility issues through the media, they are still seen as a key location by hedge fund managers with new offshore product continuing to be launched
- AIFMD seen as a major consideration in driving any future large-scale redomiciliation of existing offshore products. For now, however, offshore domiciles are still carrying the majority of hedge fund assets
- Fin 48 concerns around uncertain tax liabilities are also increasingly becoming a factor for consideration

- **UCITS Vs QIFs and SIFs**

- Any future redomiciliation activity may not be into UCITS products, which do not play to all hedge fund strategies. Irish QIF or Luxembourg SIF seen as more flexible if large-scale redomiciliation is required
- Recent onshore hedge fund launches have been in the form of UCITS or “Newcits”, driven by the desire to attract a new range of potential investors (retail, institutions, pension funds etc)
- There is positive investor disposition to the transparency, liquidity profile and regulatory framework offered by UCITS

- **Challenge for Smaller Managers**

- Cost barrier to establishing UCITS product versus traditional Cayman product
- Many larger managers launching absolute return UCITS are also established brand names on the long-only UCITS side and can leverage their existing distributor relationships

- **Demand for Managed Accounts**

- Ongoing interest from larger institutions, particularly pension funds as product provides transparency and liquidity
- Investment size is crucial, managers are happy to accommodate SMAs for a substantial investment

# Marketing and Fund Raising

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In a difficult market, hedge funds are beefing up their marketing teams and diversifying their investor base. Larger firms look best placed to manage the challenges in both the institutional and the retail markets.

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- **Difficult Capital Raising Climate**

- Investors are conducting extensive front-to-back due diligence process over a much longer timeframe before they make commitment
- Investors looking for proven track record and clear investment process and philosophy
- Hedge Funds are beefing up their marketing team as they attempt to diversify their investor base

- **Reducing Reliance on High Net Worth Individuals**

- Investor base widened to include institutional investors such as endowments, universities, pension funds etc
- As institutional investors carry higher demands there is a perception that these demands can best be met by larger managers rather than boutique style managers or start-ups. This may lead to a two-tier industry in the future

- **UCITS: Distribution is Key**

- Managers entering distribution relationships with banks and intermediaries in order to sell UCITS
- Others are reviewing platforms which provide distributor relationships
- Costs associated with selling through intermediaries – trailer fees and commissions, in-country registration, local paying agents
- Clear strategy required as to which distributors and countries to target

# Key Areas of Investor Focus

Investors are carrying out exhaustive checks to understand every facet of firms' daily operating procedures and demanding new levels of transparency and asset security.

- **Due Diligence – Operational Focus**
  - Many institutional investors have added experienced professionals to their in-house teams
  - Greater focus on operational functions of the manager, administrator and counterparties
  - “Day in the life” walkthroughs are common incorporating visits to service providers
- **Demands for Information Disclosure**
  - Transparency demands taking different forms from full portfolio breakdowns, as in the norm for SMAs, to FAS 157 classifications and feeds to external risk reporting tools
- **Controls Infrastructure Audits**
  - SAS 70 type reporting being looked at by some managers as a means to provide investors with greater comfort
- **New Asset-Holding Models**
  - Managers spreading counterparty risk by utilising multiple prime broker relationships
  - Otherwise prime custody and bankruptcy remote Vehicles are two steps most actively considered
- **Liquidity**

## Investor Focus



# Fees

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Downward pressure on fees exists, but it is mainly targeted at management fees. Our leading question to all interviewees on this topic was “2 and 20 — is this fee model outdated?”

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- Investors are willing to pay fees for performance
- Downward pressure mainly focused on management fees. 1% felt as too low a fee by many hedge fund managers
- Several managers are prepared to negotiate fees if an investment is of sufficient size to warrant it
- In some cases there is a trade off between liquidity and fees. Less frequent liquidity could entail a lower management fee however management fees could also increase where greater liquidity is required
- Consensus that investors are willing to pay traditional 20% incentive fee in return for performance
- Incentive fee arrangements should crystallise in a similar manner to the assets of the underlying portfolio or in line with lockup arrangement if they are in place

# Fund Valuation & Governance Models

Debate continues over the role of administrators, the fund Board and expert valuers when it comes to hard-to-value securities. Importance of the role of the fund's Board of Directors continues.

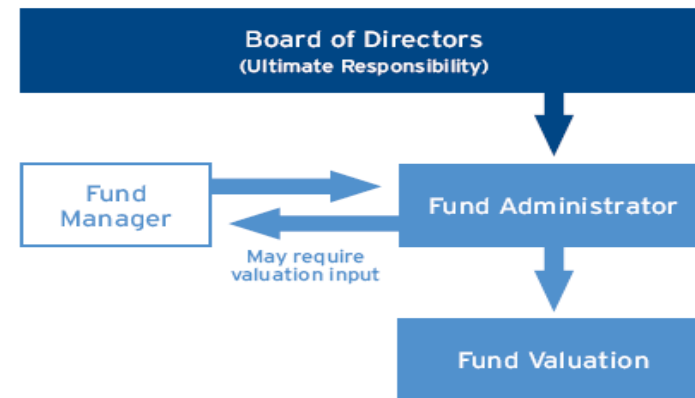
- Fund Valuation - Responsibility

- Managers agree the administrator is responsible for the overall calculation of the fund valuation
- The Board of Directors, however, has ultimate responsibility and must satisfy itself as to the valuation processes and procedures adopted
- Several managers express view that administrator should stand over all pricing and not involve the Board. Others believe the administrator is not suited to price unlisted, illiquid or esoteric instruments
- Potential solution is for administrators to appoint independent expert valuers, however, this is an expensive option for the fund
- Most workable solution, perhaps, which is common today, is where the administrator manages the valuation process and any exceptions are taken to the Board or valuation committee

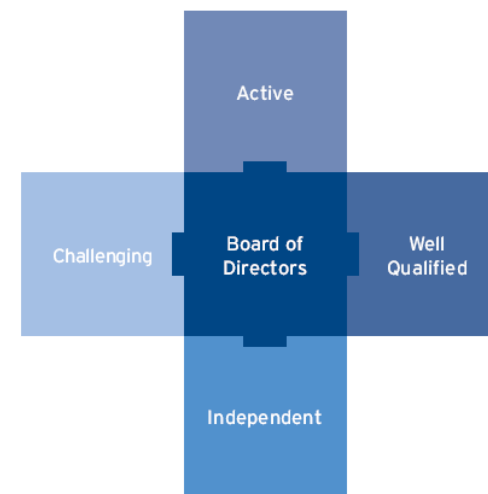
- Governance

- Investors expect to see Boards in place that are active, independent, well qualified and challenging
- Supply of high-quality independent directors with specific hedge fund experience is limited with many directors sitting on a number of Boards

## Fund Valuations



## Governance Model



# Conclusion

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The events of the past year have shifted investors' priorities and lifted the bar on standards of regulation, transparency and risk management.

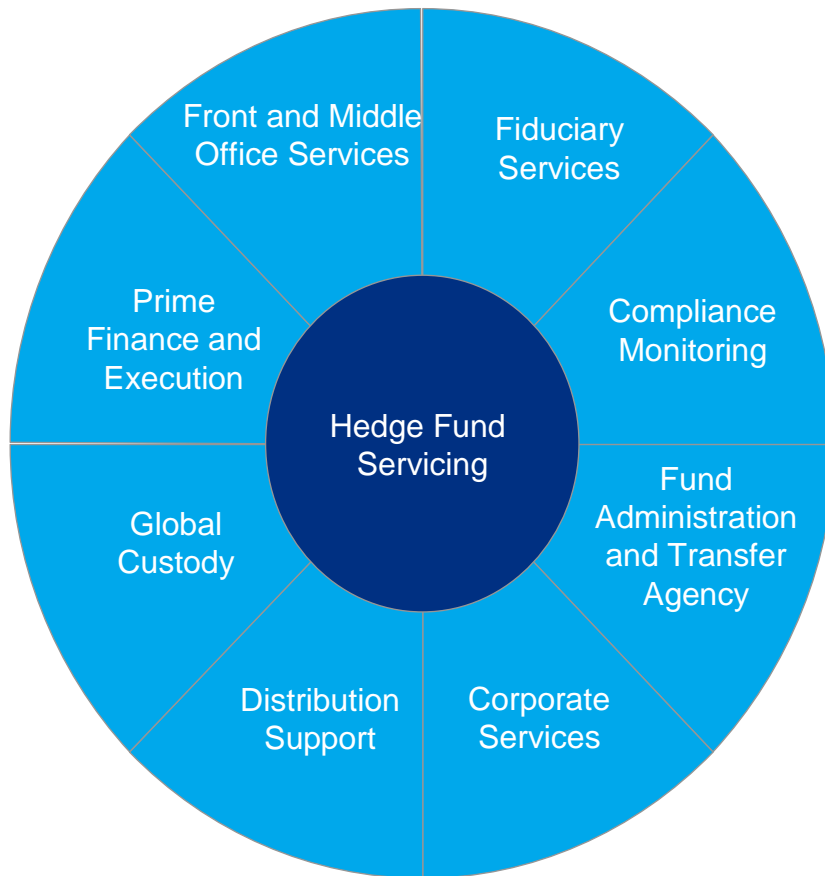
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- Institutional acceptance of the investment case for hedge funds remains as strong as ever.
- However investors now demand the comfort of external administration, the protection that comes from ring-fencing assets and improved liquidity
- Hedge fund managers need to respond to the changed circumstances with more than knee-jerk cost-cutting. They need to reassess the entire business model and ask themselves a series of questions:
  - Is the product portfolio atuned to the times?
  - Can we rationalise the range of funds to focus on key competencies and deliver better performance and client service
  - Do we have the scale to succeed in today's world? If so, are we optimally structured to exploit that scale – or positioned properly to make the most of our market niche?
  - Have we responded adequately to investor demands for asset protection and transparency?
- Hedge fund managers need to review their operational approach. Is in-house administration still viable or desirable? What is core and what is not? Is there merit in moving from a fixed to a variable cost base?
- Hedge funds that succeed in years to come will be those that stand up to intensified due diligence by exhibiting institutional quality, providing more transparency and delivering consistent, non-correlated returns over time

# Hedge Fund Servicing Requirements

Citi offers an end-to-end solution for investment managers across all products and key jurisdictions.

## UCITS and Non-UCITS Offering Mix



## Manager Requirement Mix

- Trustee/custodian to assume fiduciary responsibilities
- Compliance monitoring of investment and other restrictions
- Fund administration capabilities for complex and vanilla instruments and also frequency of NAV calculations
- Transfer agency capabilities for retail and non-retail investors, performance and distribution fee calculations
- Distribution support for new distribution arrangements
- Corporate secretarial services for Irish and Luxembourg vehicles
- Global Custody for safekeeping, clearing and spreading of counterparty risk
- Trade execution, clearing and prime finance
- Middle office services for pre and post trade activity, collateral management, risk and performance metrics and also P&L reporting

# Contacts

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