



# Investment Management Review

A Quarterly Update for the Investment Management Industry

# Hedge Fund Trends for 2010 and Beyond:

## Prospering in a Polarized Marketplace

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Institutional money has come to dominate hedge fund inflows over recent years, though until 2008 most hedge funds were still able to dictate terms with their big investors. Not anymore. Investors now call a lot of the shots. The impact of this shift in power is far-reaching.

With a new set of demands and requirements, institutional investors are obliging the hedge fund industry to open its books. They are demanding a ringside seat so they can track what their managers are doing. Transparency is paramount. A more risk-averse investor base is also proving a barrier to entry for newcomers to the hedge fund industry and making life more difficult for smaller players.

At some undocumented moment in the last two years, the terms of trade between hedge funds and their investors changed. The shift was hardly seismic but it is nonetheless apparent to most in the industry. Investors are demanding, and getting, more transparency and liquidity. They are undertaking much more due diligence before investing. Some will now only invest in onshore vehicles. And because the events of 2008 put so many hedge funds on the back foot, the hedge fund industry is, by and large, responding positively to these new demands.

The shift in power reflects a trend that has been under way for much of the past decade: the increasing institutionalization of the hedge fund marketplace. Many in the industry see this leading to an increasing polarization of the marketplace. The bigger hedge fund managers – with institutional-grade infrastructure already in place – are winning an ever-bigger share of the cake. Smaller firms are losing out.

Capital raising has become a major challenge for all but the leading names. Institutional investors are often unwilling to invest until a fund has a 12-month track record. Apart from specialist seeding platforms, most funds of funds are also stepping back until a fund has six months under its belt.

## Hedge Fund Success Factors

So what are the keys to success? What do hedge funds need to prosper in the new world? As already noted, size and scale are important factors – underlined by Man Group's proposed US\$1.6 billion acquisition of GLG Partners to create a company with more than US\$63 billion under management. Economies of scale have become ever more crucial to success. Operational complexity is increasing as managers offer an expanding range of products spanning both offshore and onshore domiciles and managed accounts.

The launch of UCITS funds brings new marketing and other costs and requires the maintenance of distributor relationships. Yet many of the "newcits" launched to date have been only limited successes. Anecdotal evidence suggests hedge fund managers are rethinking their onshore strategy and turning instead to the more liberal non-UCITS structures available in both Luxembourg and Dublin. However, the advent of the Alternative Investment Fund Managers Directive (AIFMD) will reduce some of the flexibility even in these products.

## Transparency Is Core

Meanwhile, institutional investors are clamoring for more disclosures. They want more clearly defined and written policies. And they are conducting more thorough due diligence before investing. As the added regulatory costs implicit in the AIFMD become reality, so they will intensify the need for scale.

But flexibility – and in particular the ability to offer managed accounts – is also becoming critical. In a survey of leading European hedge fund managers conducted by Citi Hedge Fund Services in the spring of this year, institutional demand for managed accounts was keenly highlighted. Most managers said they were happy to provide them in return for a substantial investment. Occasional instances were reported where large investors had redeemed from a main fund investment and asked to be "rehoused" in an individual managed account.

## The Rise of Managed Accounts?

There is mounting evidence, too, that funds of hedge funds are being pressed by their institutional investors to convert as many of their underlying fund holdings to managed accounts as practicable. Funds of funds that have been quick to read the signs have managed to convert around half of their fund holdings into dedicated managed accounts. Clearly, this is only really possible where the managers in question are operating liquid strategies.

Funds of funds that go down this route have to demonstrate to their investors that they are deconstructing the mass of information they receive from each managed account and making good use of it. Some are building out sophisticated management operations to deal with the information they are getting, often using a third-party risk manager. Others are setting up what amounts to a hedge fund front office to interpret the data. Clearly, managed account sponsors are on the line with nowhere to hide if things go wrong.

## Kite-marks

One trend apparent from the survey was increasing acceptance of the need for best practice kite-marking. More and more managers have been signing up to the Hedge Fund Standards Board's best practice standards. These cover 15 key issues in the areas of disclosure, valuation, risk management, governance and shareholder conduct. At the last count, some 58 firms, with a combined US\$215 billion of assets under management, had signed up.

Given the increasing institutional focus on hedge fund managers' internal processes, some managers are also contemplating generating an SAS 70-style report on their internal procedures and related controls in order to provide additional comfort to investors. SAS 70 reporting originated in the U.S. banking industry and involves an external audit of the stated controls either at a particular point in time (a Type I report) or over a set time period (a Type II report). SAS 70 reports are expensive to generate,

but they could become a valuable quality mark in the competition for institutional money.

The ability to match the due diligence expectations of institutional investors is vital. The Citi survey highlighted a new trend. The focus of much due diligence has shifted to funds' operational processes. Due diligence visits now typically involve a "deep dive" into operational and risk management processes. Many investors expect to be walked through specific trades and valuations, taking the process through to the records held by the administrator and prime broker.

## No Substitute for Experience

The entire operations team may be involved as investors analyze every procedural step around trade flow, reconciliation, risk management, portfolio pricing and counterparty exposure management. The external administrator is also now contacted in many cases – sometimes for a face-to-face interview. Many institutional investors have recruited new, experienced people to manage the due diligence function, but specialist consultants are also much in evidence.

Ongoing information disclosure has also assumed new importance. More investors are reportedly requesting access to a full portfolio breakdown – effectively seeking much the same information as they would get from a managed account. Some look for supporting FAS 157-type portfolio classifications. Feeds to consolidated risk reporting tools, as offered by specialist market vendors, are also being requested on a more regular basis.

The ability to deal effectively with these demands is essential if managers are to retain the trust of their institutional investors. One hedge fund manager contacted in the survey reported that the firm had set up an internal transparency committee to cope with the rise in information requests from investors.

All of these pressures reinforce the need for effective and highly automated operational structures and processes that deliver the real-time and customizable data on which internal controls (and by extension portfolio disclosures) rely. There is increasing need for daily trade confirmation, settlement and reconciliation with counterparties, all supported by centralized reporting and delivered in an STP environment that maximizes automation and minimizes human intervention. Cost containment reinforces the case for an integrated, end-to-end solution that spans the complete trade operating life cycle.

As the hedge fund industry increasingly polarizes between big and small players, the winners will be those firms with the scale and operational resources to accommodate the needs of an ever-more-demanding client base – yet do so within an operational environment that is cost-effective and scalable. ■

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