The ‘Forced’ Institutionalisation of the Hedge Fund Industry

INTRO BY HOST, RICHARD HUGHES:

Thank you for joining us for this podcast on “The Forced Institutionalisation of the Hedge Fund Industry.” Demand in Europe for hedge fund exposure sees no signs of relenting. In 2003, 1 in 5 institutional investors in Europe invested in hedge funds or fund of hedge funds. By 2005, this had increased to 1 in 3 – and the trend shows no signs of abating. With hedge fund stories constantly in the press, this podcast will be of interest to anyone who wants to find out more about the impact of inflows of institutional money on the hedge fund industry. Northern Trust recently sought to explore the consequences that institutionalisation is having on investors and managers alike. In this podcast, Penelope Biggs, head of global business development, Corporate & Institutional Services at Northern Trust, discusses the survey’s findings. Penny, can you tell us how the research was conducted?

PENNY BIGGS:

In late 2005/early 2006, a pan-European cross-section of institutions was interviewed from the following 3 groups of industry participants: investors, hedge funds, and fund of hedge funds. Collectively, they either invested or managed more than 132 billion dollars in hedge fund assets. This represented about 40 percent of the European hedge fund market at the time. Among investors, some of our interviewees included the BBC, Hermes, Stork, and Swiss Life. Some hedge funds interviewed included Arcus, Concordia, Eagle & Dominion, Julius Baer, and Trafalgar Capital. Some fund of hedge funds interviewees were Atlas, Allianz Hedge Fund Partners, EIM, Liongate, and Vontobel Asset Management.

We’d like to thank these interviewees for sharing their unique insight into the European hedge fund industry.

RICHARD HUGHES:

Penny, can you start by telling us what exactly a hedge fund is?

PENNY BIGGS:

Richard, there is no exact definition to the term “hedge fund,” but broadly speaking, their structure and their investment strategies that they trade share some of the following features.

First, hedge funds are collective alternative investment vehicles, often organised as private partnerships or investment companies that generally reside offshore for tax and regulatory purposes. They are characterised by their use of leverage, short selling and use of derivatives, and they measure their performance in terms of absolute returns. A management and performance fee characterises the way in which managers are rewarded for their performance.

Secondly, a fund of hedge funds is a fund that invests in other hedge funds rather than trading assets itself.

RICHARD:

So, what were some of the survey’s key findings?

PENNY:

The survey’s key findings focus on 3 areas: **regulation and standardisation**; **institutional asset allocation**; and **administration**.

One key finding for **regulation and standardisation** is that the potential for the hedge fund industry to split into two distinct sectors is high. These 2 sectors are: first, those focused on the wealth management sector, the traditional source of hedge fund assets; and second, those firms that would have the capabilities to deal with high volume institutional business.

Another finding is that increased regulatory supervision is viewed as inevitable. As a result, the survey suggests that a 2 or 3-tier regulatory environment should be considered for hedge funds and fund of hedge funds managers dependent on their size and target market of investors.

Standardisation is a significant challenge for the industry, with those managers used to operating in a long-only environment best placed to implement change.

In the area of **institutional asset allocation**, the survey found that the popularity of private equity and real estate investments and the perceived lack of transparency are barriers to increased institutional investment in hedge funds.

Also, fund of funds remain the preferred investment vehicle for institutional hedge fund investors. However, the growth of multi-strategy managers threatens the status quo.

The survey found that there is a fear that the growing institutionalisation of the industry is altering the risk/return objectives of hedge funds and leading to a crowding out of opportunities.

Lastly, in the **administration** area, the survey found that outsourcing of custody and fund administration is a given, with the debate now moving to the middle office and services such as performance analysis and risk management. Getting the basics right remains the key priority for fund administrators.

RICHARD:
Thank you. Let’s go deeper into those findings. Penny, can you talk more about the areas of regulation and standardisation?

PENNY:
Certainly. Regarding the regulatory environment, survey participants thought regulation should set standards, but not inhibit managers from being creative. It should not stifle entrepreneurialism and the freedom to perform.

80 percent of all respondents said that they thought the increased participation of institutional investors in the hedge fund market would bring with it additional regulatory and reporting burdens for those managing the assets.

Those that embrace this development in a positive manner will likely be the organisations that prosper. Furthermore, those firms that have moved into the hedge funds space from more traditional asset management routes are better equipped to cope, as they have more established compliance and reporting infrastructure to rely on. Reporting as they do to thousands of retail clients on a weekly basis, they do not believe the hedge funds side of the business will significantly impact their existing reporting and compliance capacity to any large degree.

More specifically, 46 percent of respondents said that the increase in regulatory supervision is a welcome development while 32 percent proclaimed themselves against further regulation.

It remains a divisive and contentious issue in this industry, especially as the Securities and Exchange Commission, the U.S. regulator, is in the process of extending its regulatory remit to non-U.S. managers with American clients.

Even amongst those in favour of increased regulation, there is an industry- wide recognition that the burden will fall more heavily on some parts of the industry than others, and there could be negative long-term consequences. For example, increased regulation and regulatory reporting could stifle creativity on the part of the portfolio managers, and add to compliance and infrastructure overheads that smaller, boutique firms find challenging. This in itself could also discourage fund managers from setting up new hedge fund firms, compounding fears over a lack of available capacity in the industry going forward.

Those that are in favour of more regulation made the point that increased regulation is all part of the improvement in professional standards in the industry, which in turn will help to create the conditions for more investors to diversify into hedge funds. As a result, institutional investors, their advisors, and fund of funds managers specifically targeting the institutional market were most in favour of more regulation.

However, single strategy managers and fund of funds serving high net worth investors were, on the whole, against the increase in regulation. The prospect of a ‘one size fits all’ regulatory model was questioned particularly by those without a large in-house support infrastructure.

In short, the development of the regulatory environment is likely to have the single biggest influence over the future of the industry.

RICHARD:
And what about standardisation?

PENNY:
The survey found that institutionalisation forces hedge funds that want to play in that space to raise their game.

The average worldwide size of a hedge fund is 105 million dollars, for example relatively small, and many firms remain boutique operations with fewer than 25 employees.

As a result, it has been very difficult for investors to impose commonly accepted standards on what has been an eclectic range of investment management operations. Such standards could include common asset identifiers, reporting frequency, accounting treatments, pricing, fees, etc.

There was wide disagreement amongst firms interviewed for this study on the topic of standardisation, ranging from those who view it as an inevitability, to those who believe institutions will find it impossible to place commonly recognised criteria on such a wide range of investment approaches as currently prevail in the industry.

76 percent of those interviewed that either count institutions as the majority of their client base or see them as the future of their business say they have already embraced or are embracing a high level of standardisation. This was particularly true of those groups which also maintain an established and recognised long-only business, and can transport many operational standards over to their hedge funds division.

Ultimately, much will depend on where firms see their primary source of business. Those that believe they will continue to source the bulk of their business from private individuals will be less inclined to implement changes, again further supporting the possibility of a split in the industry.

RICHARD:
Penny, can you expand on the survey's findings regarding asset allocation?

PENNY:
91 percent of all respondents to the survey said that the main driver for investing in hedge funds was to achieve portfolio diversification and non-correlated absolute returns (outside the mainstream investment areas such as equities, debts and cash instruments).

When asked to provide us with their level of exposure to alternative investments, perhaps surprisingly, the overall average percentage of their portfolios invested in hedge funds assets was just 2.1 percent with real estate and private equity having higher allocations.

It appears that many institutional investors still do not consider hedge funds to have a significant role to play in their portfolios vis a vis other alternative asset classes. This is something for hedge funds to be mindful of as ultimately they often compete for the same alternative investment dollar as private equity and real estate funds.

That said, as the boundaries and definitions surrounding hedge funds and private equity become more blurred this could lead to investors being able to gain exposure to both asset classes through ‘blended’ alternative vehicles.

RICHARD:
What did the survey conclude regarding the perceived lack of transparency of hedge funds?

PENNY:
Media often portray the hedge fund industry as opaque and secretive, so understanding if our sample institutional investors feel the same way is key to explaining why their allocation to hedge funds appears to be relatively low.

Transparency in a fund manager’s operations, which is necessary to prevent fraud and malpractice, was one area of concern. 100 percent of respondents agreed that there will need to be further operational transparency in the future. The degree of transparency in the underlying portfolio in terms of underlying securities or funds, accuracy and timeliness of pricing and valuation was also an area that many felt the industry needed to address with more clarity. 69 percent of respondents felt that failure to do so would hinder the growth of the sector.

The granularity sought by institutional investors is not something all managers crave and does suggest that they will have to make a conscious decision about whether their primary objective is to attract either institutional or private investors.

RICHARD:
Regarding a single manager versus fund of hedge funds, what did the survey conclude?

PENNY:

After making the decision to allocate a proportion of a portfolio to hedge funds, the next decision for investors is to choose the appropriate vehicle: single manager or fund of funds.

77 percent of our institutional investor respondents allocate through the fund of hedge funds route. This gives them access to products that offer them a range of different strategies for diversification purposes. 40 percent also stated that the lack of resources to monitor and review funds coupled with lack of experience due to the complexity of their underlying strategies were reasons for allocating through fund of hedge funds rather than direct.

68 percent of institutional investors using fund of hedge funds relayed that while they are currently content to use the fund of fund structure, they are concerned about the additional layer of fees these investment vehicles present.

This concern is already leading to the emergence in Europe of “supra” alternative asset managers offering in-house multi-strategy, multi-structure product offerings allowing investors to gain diversification without the additional fees.

This trend will likely fuel competition and fee pressure on the fund of hedge funds managers and single strategy managers and could lead to consolidation of the latter.

Could this in part explain the slowdown of new start-up operations in 2006, as star managers were attracted to boutique firms offering multistrategy, multi-structure platforms with a built-in infrastructure to accommodate their talent?

RICHARD:
Penny, what did the survey find regarding hedge fund capacity?

PENNY:

Well, over half of the respondents said they were concerned about hedge fund capacity constraints and the impact this would have on future performance. Technological advances, systematic trading and new managers chasing similar inefficiencies were all offered as reasons for potential reduced returns. Indeed, recent performance numbers for the industry indicate that maybe there are already too many managers chasing too few opportunities. Again, perhaps this concern is also borne out in higher allocations to private equity and real estate amongst our sample group.

One part of the industry that appeared to be less concerned about capacity was fund of hedge funds, particularly those prepared to consider new strategies, or those who were making substantial allocations to very liquid areas of the market. 57 percent of those interviewed said that some strategies are in long-term decline while the remaining 43 percent thought that the decline in returns was just cyclical and that if there are significant difficulties in one area, investors will simply gravitate to new ones. One respondent stated, “People are permanently finding new ways to exploit anomalies”. Perhaps as evidence of this, 96 percent of the firms interviewed dedicate significant resources to following developments in all emerging strategies such as environmental i.e., carbon emission, commodities and emerging credit.

RICHARD:
Can you tell us what the survey’s key findings were regarding administration?

PENNY:
The survey found that the purest form of alpha is cost control. Recent estimates indicate that institutional cash flows accounted for over 40 percent of new inflows to the hedge fund industry in 2005. As a result, there has also been increased scrutiny for providers of back-office services to hedge funds, like fund administrators and custodians.

A desire to offer clients a ‘one-stop shop’ has tempted many banks into the market, but at the same time, some managers have complained that new entrants are not sufficiently ‘up to speed' with the more sophisticated strategies and instruments and volumes that they trade.

As a result, much more emphasis is being placed on operational due diligence of the administrator by both asset managers and investors. This is a trend that is set to continue as institutional assets flow into the industry.

Accuracy and responsiveness seem to be the most important factors in administrator selection. More simply put, "doing the basics reliably and on time is what matters most." Access to accurate pricing and speed of valuation were also cited as key criteria for administrators. Independence, the quality of staff, transparency, reputation and proximity also emerged as secondary considerations.

99 percent of those surveyed outsource their core custody and fund administration services to independent third-party providers in Europe. Other areas that are outsourced include FX hedging, cash management, risk management, middle office and performance analysis.

A hot topic for the industry at the moment is the pricing of over the counter derivatives. Surprisingly, 84 percent of those surveyed thought that the administrator is best qualified to price over the counter securities.

Conversely, as an administrator, we believe that the counterparty to the trade is best qualified to price over the counter securities as they will ultimately close out the position.

One of the core functions of the administrator is the timely production of a net asset value in an agreed timeframe. With the increased use of OTC derivatives in portfolios, we always agree a robust pricing and valuation procedure prior to the fund launch.

If there is a difference in price that falls outside pre-agreed parameters between the counterparty price and the agreed pricing mechanism at a valuation point, then an escalation procedure is initiated. Ultimately any pricing dispute is resolved by the board of directors of the fund.

RICHARD:
In conclusion, can you summarise for us the survey's findings please Penny?

PENNY:
There is a division emerging between those managers with a business model firmly founded on servicing the assets of private, wealthy individuals and their advisors, and those firms focused on the increasing institutional share of hedge fund assets.

The firms seeking to develop business with institutional investors believe improved regulation will help them in this effort. The managers concentrating on the high net worth market feel the opposite.

In the case of big fund management houses, with large in-house compliance and legal teams, much of the necessary infrastructure and personnel is already in place to cope with new regulatory requirements, whereas for many boutique managers it is not.
The survey suggests that a 2 or 3-tier regulatory environment should be considered for hedge funds and fund of hedge funds managers dependent on their size and target market of investors. It also suggests that the criteria for regulatory compliance and reporting should be dictated by the distribution channel, profile and quantity of investors that the fund discloses in its prospectus.

It also seems very probable that funds which accept institutional investment, or deal with large funds of funds that represent predominantly institutional cash, will find that they will have to comply with a much heavier operational burden than has been the case to date.

It is entirely likely that small, boutique managers may find that the costs associated with the institutional dollar (euro) are simply too high for them to participate. The managers that find this challenge too great may well be content to remain embedded in the private money space, fulfilling the prophecy that institutional participation will indeed force a division in the future model of the hedge fund industry.

Should that be the case, the hedge fund industry needs to take note of the likely increased asset allocation to private equity and real estate funds. While all three asset classes serve very different purposes, on the whole they remain regarded by the investor as ‘alternative’ investments and as such are all, to some extent, in competition with each other.

Finally, further institutional investment is likely to place greater emphasis and scrutiny on the fund administrator. Those companies like Northern Trust who are already geared up for operating in this stringent environment are likely to be the biggest beneficiaries as are their clients.

RICHARD:
Thank you, Penny. For more information on hedge funds and to read the full white paper on this subject, please visit Northerntrust.com/europe. And if you’d like to hear future podcasts from Northern Trust, please visit NorthernTrust.com/podcasts to subscribe.