



**Will adapting to
today's evolving
demands help
you stand out
tomorrow?**

2016 Global Hedge Fund and
Investor Survey



The better the question. The better the answer. The better the world works.



Building a better
working world

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Executive summary

Shrinking returns and escalating investor demands. Downward pressure on fees and unrelenting requirements to have robust operating models. This year, competing forces came together to culminate in the perfect storm. In a year marked by lackluster performance and rising investor expectations, one inevitably asks: Will the challenges of today pave the way to a more successful tomorrow? That all depends on how you respond. As we look back on the year that has passed and look ahead to 2017, a few points come into sharp focus. Differentiation has become the touchstone of the future, and those funds that strategically embrace change for the right reasons and modify their business model in a way that responds to investor demands will be the ones that prosper going forward. Today, the pace of change is accelerating, and the magnitude of its impact and relevance are amplifying. As you turn the pages of this, our 10th annual Global Hedge Fund and Investor Survey, *Will adapting to today's evolving demands help you stand out tomorrow?*, we hope the observations that have been gleaned help contribute to an ongoing and healthy dialogue that promotes the continued development and advancement of the global hedge fund industry.

First, we would like to extend sincere thanks to those managers and investors who provided viewpoints into the direction and development of this survey, as well as express appreciation to the 100 managers and more than 60 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.

The change continuum

It is important to note that many of the key themes that we are talking about this year are those that have developed over the course of many years, and are now being thrust to the forefront as external pressures and competition for capital mount. The directive for managers has never been clearer: adapt or be left behind.

Key observations

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

The voice of the investor – 2016 has revealed an unprecedented change in the appetite of investors. More so than ever, investors have achieved a level of sophistication that is challenging managers to more thoroughly explain how their offering achieves specific objectives within investors' overall portfolios. Almost half of investors are continuing to actively seek out nontraditional products, and when it comes to investing in hedge funds, their choice is segregated accounts that generally allow for customization that more closely align with their specific needs. In addition, investors are demanding more and paying less. Many investors who have utilized low-cost, passive investment options or those who have reduced their reliance on money managers altogether and are trading on their own behalf are challenging the fee terms of their funds. And while management fees have continued to come down across funds of all sizes, investors are not materially any more satisfied with the fees they are paying relative to past years. Pressure on fees is not likely to let up, which begs the question: How do fund managers achieve scale to maintain profitability?

Differing priorities for different size managers –

Although growth continues to be a priority for funds of all sizes, the smallest managers in particular view growth as an imperative to offset lost fee revenues, as well as mounting expenditures necessary to run the business. The largest managers are most able to weather industry volatility and uncertainty; having largely achieved their growth targets, they increasingly focus on properly supporting their business from an infrastructure and operating model perspective. Meanwhile, midsize managers are placing their bets on talent management, recognizing that their growth agenda and ability to compete with the largest managers can be served by attracting and developing the best and brightest talent.

The path to growth is changing – With asset flows stagnating and investors changing the way they invest, managers are facing the imperative to differentiate not only from one another, but from the growing number of alternative products that are available. We found that in this challenging fundraising environment, managers, particularly midsize and smaller, are emphasizing existing products rather than developing new ones. Amidst a crowded playing field, innovation and responsiveness to customer needs are imperative to standing out. Next generational data analysis is just one example of the methods that certain managers are deploying to enhance their investment strategy and appeal to investors. Additionally, those managers who identify and thoughtfully target the needs of specific client segments are finding themselves best aligned for success.

Large managers are out in front – The over \$10b assets under management managers have the upper hand in today's landscape for a variety of reasons. They have

been most successful at raising capital, and have also been more responsive to changing investor demands – offering both the customization and nontraditional hedge fund products investors are looking for, along with the marketing, messaging and operational infrastructure that caters to evolving investor tastes. Investor desire to co-develop specific vehicles – those that provide the investor everything from unique fees to individual transparency and portfolio exposures – falls squarely in the sweet spot of the largest managers. While just 40% offered funds with customized fees and terms in 2015, 2016 has seen that spike to 63%. Similarly, while only 25% offered funds with customized portfolio exposures in 2015, that has now risen to 41%. In addition, the largest managers have sufficient size and scale to support a broader array of products, and as they add nontraditional products to their offerings, smaller managers that cannot support such launches are retrenching – adding more fuel to the allocation trend toward the largest managers.

The operational imperative – As top-line fee pressures intensify and the costs to run an evolved business model increase, the quest for profitability grows even more challenging. New products and customization being driven by investor preferences, while generally being lower fee generating, only add to operational complexities. And investors have clearly communicated that they will not compromise in their expectations that managers have robust infrastructures to support their business. However, investors are also vocal about their desire to not bear the costs of such enhancements. Inevitably, managers are responding by aggressively refining their infrastructure to eliminate redundancies and excessive costs, as well as cutting management fees. Investments in technology,

including using robotics, are leading to improved automation, and cost reductions across big-ticket support functions in the middle and back office are contributing to declining operating expense ratios, which most managers believe have hit bottom. Conversely, nearly half of investors feel there is still more room to cut. Outsourcing is another way that managers will achieve further operational efficiencies and cost reduction, although there is still a major divide between the high comfort level that investors feel toward outsourcing compared with managers' reluctance to relinquish control.

The changing prime brokerage industry – In last year's survey, we saw the evolving dynamics of the prime brokerage industry take center stage, and this year is no exception. As banks face continued scrutiny and regulatory pressure, managers and their counterparties continue to grapple with the focus on optimization, funding, balance sheet and liquidity. As a result, many managers have fundamentally changed their prime brokerage relationships, entered into new ones, and increased the number of counterparties they do business with. A majority of managers say that their prime brokers have requested significant alterations to their relationship to keep it economically viable, including increased trade allocations, treasury optimization and platform changes. As a result, relationship monitoring and supervision has become more complex, and governance around relationship management has become more imperative than ever – with a need for formalized structures to drive consistent strategy and oversight of the process. Hedge funds managers are addressing these needs by formalizing the treasury function and adding headcount to this area of their business.

The war for talent – Talent management rose to the top of hedge fund managers' and investors' priorities this year as the war for talent has taken on additional complexities. Not only are funds battling each other for tomorrow's star players, they now find themselves in heated competition with Internet giants and tech firms, as well as venture capital and start-up companies across all industries. Managers need to demonstrate to investors that they understand the changing talent market and have implemented programs that will help them secure and retain the talent that will drive their business forward. As borne out in this year's survey findings, talent management now plays a critical role in the competition for institutional assets, with 75% of investors indicating it is a key element in their due diligence process. The focus on talent is sure to continue evolving, as a divide exists between what managers consider paramount versus what future generations of employees believe is critical to attracting them to employers.

Looking forward

As the industry embarks on this next phase in its life cycle, it is clearly fraught with challenges for both managers and investors. The ground rules have changed, and acceptance and adaptation to this dynamic environment are the keys to survival. Changing investor demands are driving a myriad of changes and those firms that listen, understand and strategically embrace change are the firms that will be best positioned to weather the storm. Will adapting to today's evolving demands help you stand out tomorrow?

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



Pace of evolution accelerates subsequent to the financial crisis

Past EY hedge fund and investor survey topics

2010

Restoring the balance

- ▶ Retaining and attracting capital
- ▶ Investment terms, fees and liquidity
- ▶ Increasing demand for transparency

2011

Coming of age

- ▶ Capital raising and due diligence
- ▶ Focus on quality of governance model
- ▶ Negotiation of fund vs. management company expenses
- ▶ Succession planning

2012

Finding common ground

- ▶ Investor reaction to regulatory change
- ▶ Focus on risk management
- ▶ Aligning compensation
- ▶ Considerations regarding changing Eurozone regulations

2013

Exploring pathways to growth

- ▶ Trend toward customized solutions
- ▶ Investors shift to direct investment
- ▶ Battle to maintain margins, as costs outpace revenues
- ▶ Bifurcation between large and small managers increases

2014

Shifting strategies

- ▶ New product development
- ▶ Strategies for expense management
- ▶ Focus on operating models to drive efficiencies and cost savings

2015

Evolving dynamics of the hedge fund industry

- ▶ Growth top priority, but managers increasingly focused on talent management
- ▶ Managers adapting to changing prime brokerage landscape
- ▶ Technology investments becoming more essential
- ▶ Managers expect continued transformation change

2016

Will adapting to today's evolving demands help you stand out tomorrow?

- ▶ Changing investor tastes
- ▶ Operational excellence
- ▶ Continued evolution of prime brokerage relationships
- ▶ Importance of talent management

A close-up photograph of industrial machinery, possibly a conveyor belt or a large pipe, showing signs of wear and rust. The machinery is dark and textured, with some lighter, possibly metallic or plastic, components. A bright yellow rectangular box is overlaid on the top left corner of the image, containing the text 'Pressures on the industry'.

Pressures on the industry



The hedge fund industry continues to be under pressure from several compounding forces. Performance has been pedestrian, with absolute returns challenged by external factors such as unprecedented central bank involvement and relative returns paling in comparison to the historic ongoing equity bull market. Disappointing returns have amplified the discussion among managers and investors as to whether the fees charged are appropriate relative to returns generated. Additionally, investors have become more sophisticated and strategic in developing their portfolios. They have more options than ever within the alternatives universe and are allocating funds to those managers that have a unique offering that is satisfying a specific need of the investor's strategy. Oftentimes, this results in a shifting of assets from those managers who have been slow to react to managers who have been at the forefront of listening to their investors and creating strategic solutions to keep pace with investors' needs.

Competition for capital is turning fundraising to a zero sum game

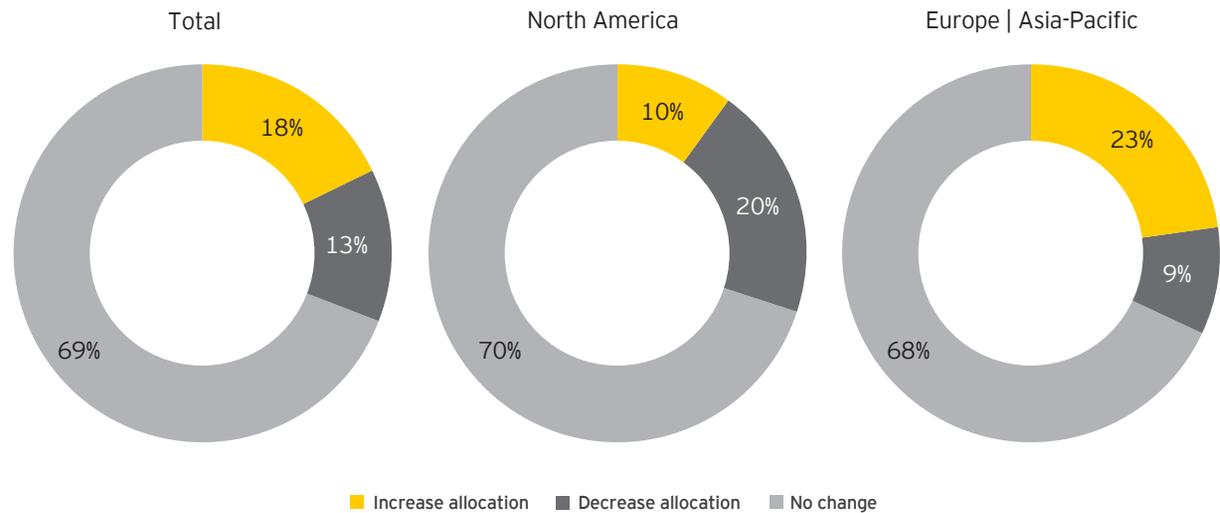
Headlines and news flashes would lead many to think that assets are departing the industry en masse. While there have been certain high-profile outflows, particularly by North American investors, asset levels across the industry remain relatively stable. Institutional investors continue to understand the benefit that hedge funds can provide to their portfolios and remain steadfast in their belief that hedge funds can fill specific needs.

Compared with those forecasting outflows, a larger percentage of investors anticipate increasing their allocation to hedge funds in the coming years. This is particularly evident among European and Asia-Pacific-based investors. The pensions and endowments in these regions tended to have allocated a smaller portion of their portfolio in the past to hedge funds and remain bullish in embracing this asset class as their allocations catch up to those made by North American-based investors.

One in five North American-based investors responded that they are more likely to retrench, the first time that those pulling back have outnumbered those increasing their allocation in the years that we have been polling. North American investors continue to have significant return targets that hedge funds have not been able to deliver, so they are looking for lower fee options in exchange traded funds or other passive investment strategies. Capital flows are rapidly shifting to those managers who have been adapting to the evolving interests of the investor community.

Investors

Do you plan to increase, decrease or maintain your target allocation to hedge funds in the next three years?



However, investors' tastes and specific needs are changing

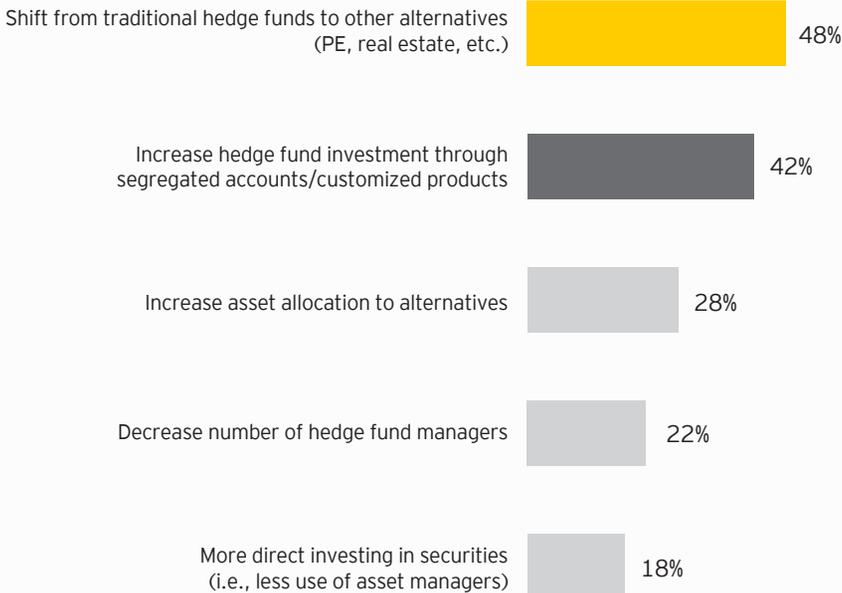
Investor demand continues to evolve in ways that are forcing the industry to adapt. Investors have become more tactical in how hedge fund products fit into the broader construct of their overall portfolio. Where in the past investors used hedge funds to obtain different market exposures, similar exposures can often now be generated by the investor's own direct trading or from lower cost alternatives. This is particularly true given the recent equity bull market. However, when market performance changes, so may the role of traditional hedge funds in investors' portfolios.

Almost 50% of investors expect to continue shifting assets to nontraditional products such as private equity and real assets - strategies that can be harder to replicate elsewhere. As a result, large managers that offer a diverse set of nontraditional hedge fund products are attracting capital and managers that offer solely traditional hedge funds are increasingly challenged.

When it comes to hedge fund investing, investors are seeking specific solutions as part of their broader portfolio and are choosing to invest more through segregated accounts that allow for customization. These vehicles generally give investors more transparency, flexibility and/or terms that are more closely aligned to the investor's specific needs. Customization is the name of the game, the exception being for those managers who have unique, niche strategies.

Investors

What are the biggest changes that you anticipate to your hedge fund investing/investments in the next three to five years?



“ Investors are becoming much more demanding and a lot more specific about what they’re looking to invest in. Secondly, the lack of performance has made investors less inclined to invest in hedge funds.”

(Over \$10b, North America, Fixed Income/Credit)

Management fees continue to be compressed

Lack of performance during a significant bull market and the plethora of lower-cost alternatives, as well as investors' increased comfort in trading on their own behalf, are causing investors to challenge the fee terms of their funds.

Managers are reporting significantly lower management fees year over year. This trend is particularly evident among the largest managers – where management fees declined by 25 basis points on average. For many managers, not only are the days of 2% management fees in the distant past, but investors have pushed below the 1.5% threshold as the average was reported at 1.35%.

Interestingly, while investors have been focused on management fees, managers are not feeling nearly as pressured on incentive fees. The investor sentiment appears to be that the incentive fees at least need to be earned by the manager, whereas investors believe management fees often turn into an automatic profit center for managers.

Despite this downward trend, investors are not materially happier with their funds' expense ratios this year relative to last. Only one in five is currently satisfied with the expense ratios of their funds. Therefore, the fee pressure will likely continue. Responding to the trends in investors' changing preferences increases complexity in operating models and, therefore, puts more of a focus on the need for scale in order to maintain profitability.

“Investors are demanding more and paying less. Adapt or lose out.”

(North America, Pension and Endowment)

Hedge funds

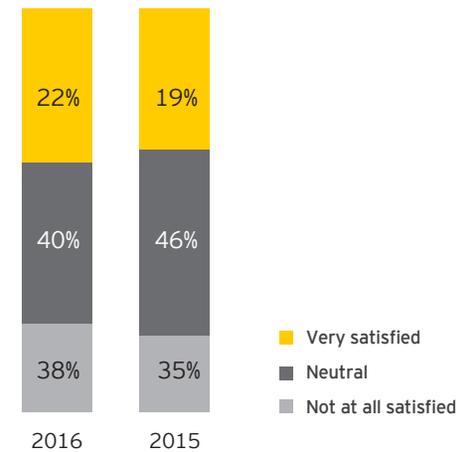
What is your flagship fund's management fee?

Average management fee rate



Investors

How satisfied are you with the expense ratio of the funds in which you invest?



Managers recognize that growth is a necessity to counterbalance industry pressures

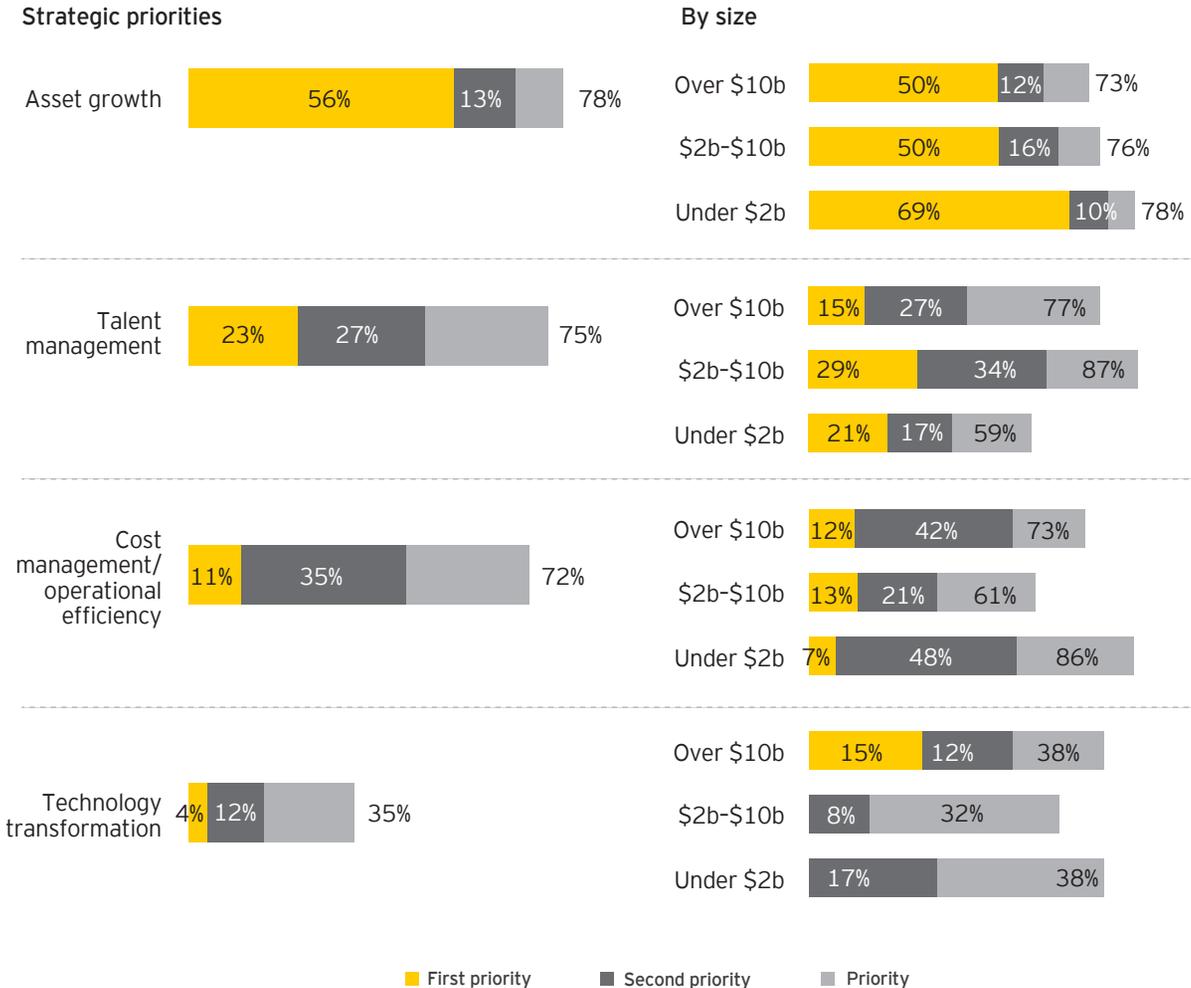
Amid top-line revenue and cost pressures, managers continue to see growth as their top strategic priority. Increased assets under management counter lost revenues occurring as a result of fee reductions while also providing stability to the business in a time when the industry is facing volatility and uncertainty.

Not surprisingly, the smallest managers are most focused on achieving growth – a goal that has become significantly more important, yet increasingly difficult to achieve. The largest managers tend to place a slightly lower priority on growth, as many have achieved their targets and are now pivoting to ensure that their business is properly supported and scalable. They are focused on how to be more efficient and cost-effective from an infrastructure and operating model perspective.

Relative to bigger and smaller organizations, midsize managers are placing a greater focus on talent management. Many are looking to develop and acquire the right talent that will be imperative for them to continue their growth agenda and compete with the largest managers for investor allocations. Regardless of where each priority is ranked, investments in talent, operational infrastructure, and technology are imperative to support the strategic priority of asset growth.

Hedge funds

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



A photograph of a large number of small green seedlings growing in black plastic trays. The seedlings are arranged in a grid pattern. One seedling in the center is highlighted with a bright green glow, making it stand out from the others. The background is dark, and the overall scene is dimly lit, emphasizing the vibrant green of the plants.

Growth



For most managers, growth is a necessity to support the economic realities of today's hedge fund industry. With asset flows stagnating among many of the traditional suppliers of capital to the industry, fundraising is increasingly turning into a zero-sum game. Managers need to be able to differentiate themselves among a crowded universe of not just hedge fund managers, but a growing number of products available within the alternatives marketplace. Investors, those new to the industry as well as those who have supported for many years, are changing the way they invest and looking for different solutions within their portfolios. Their interest in traditional commingled vehicles is waning and desires to have something customized and unique are increasing. Managers who best align their offerings with the desired solutions of the investor community are finding the greatest success in this challenging environment.

Strategies for growth have shifted over the past two years ...

Although growth remains the industry's top priority, managers are changing the methods they are employing to achieve it. Hedge fund managers appear to be coalescing around two key growth strategies: accessing new investor types (68%) and increasing penetration with current client segments (61%). In both cases, they are emphasizing existing product sets over new product development.

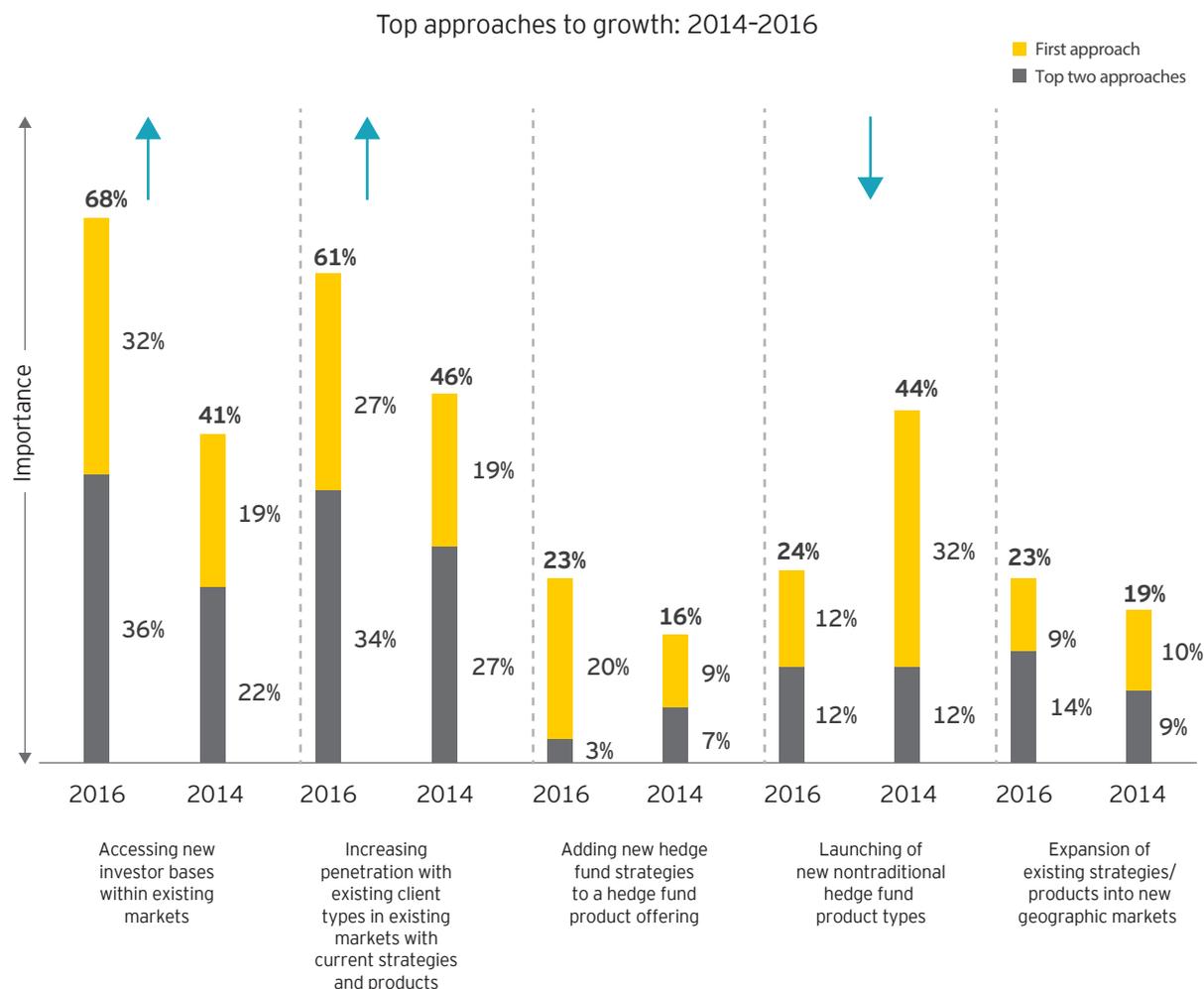
Less than one in four managers identified new product development as a top priority. In the past, managers followed the philosophy; if you build it, investors will come. However, this theory did not hold true as some nontraditional products (e.g., registered liquid alternatives, business development companies) did not gain as much traction with investors as expected. Some managers, though, most notably those over \$10b, continue to find success with new product development as they have leveraged and invested in infrastructure and found robust investor demand in certain products, such as credit, private equity and real assets.

While the largest managers can pursue several growth strategies, smaller managers are more focused. Midsize managers are taking a measured approach – marketing existing offerings to the same kinds of clients they have succeeded with in the past. Smaller managers are seeking to expand into new investor bases within their home markets.

As managers pursue growth in today's challenging environment, it is imperative that they identify the needs of their clients, align product offerings to the demands of target client segments and ensure the appropriate marketing messages are communicated.

Hedge funds

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



... and large managers have the momentum

On a per capita basis, the largest managers have been most successful in raising capital. They have been more adept at adapting to a broader array of investor needs, offering customization and nontraditional hedge fund products and combining all of those with marketing infrastructure and messaging targeted at evolving investor tastes.

The results of the smaller manager represent the continued increase in barriers to entry, as well as long-term success. In fact, two out of three of the smallest managers in the study experienced no growth or net outflows.

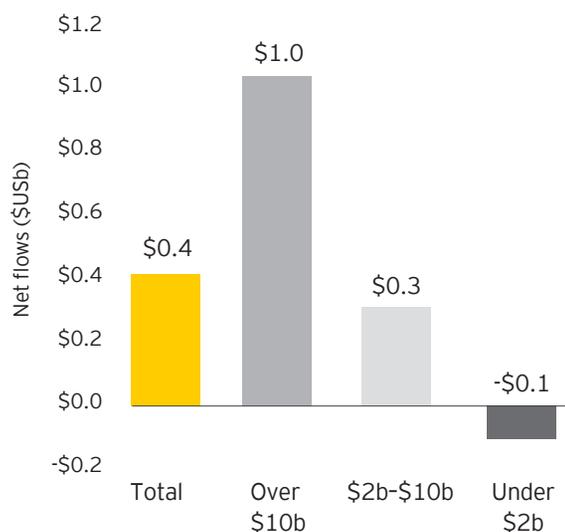
While appetite for emerging managers continues to exist, investors fully expect them to maintain a robust infrastructure. If these managers do not achieve critical capital levels within two or three years, they will struggle to survive.

Some of this trend can be attributable to investors being more comfortable allocating to those largest managers that have a brand name; however, we also see the largest managers taking actions that best align them with their investors, leading to additional allocations.

Hedge funds

What are the amount of asset inflows and outflows across all of your funds?

Net flows per capita



“ Investors are fickle, so you have to be one step ahead of what they are thinking of doing. If you aren’t able to adapt to what investor sentiment is and changing constantly, then you’re going to be left behind.”

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

The largest managers are meeting demand for customization

Investors increasingly are looking to their hedge fund managers to fill specific requirements in their overall investment strategies. As such, demand for customization is growing. Investors have a strong desire to co-develop specific vehicles that provide the investor with everything from unique fees to individual transparency and portfolio exposures.

The largest managers are responding: in 2015, just 40% of the largest managers offered funds with customized fees and terms, and only 25% offered funds with customized portfolio exposures. These shares have increased to 63% and 41%, respectively, in the current year.

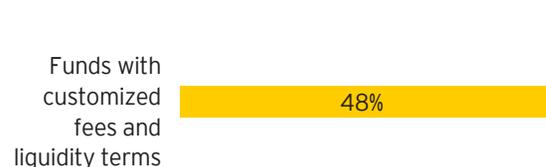
Customized product offerings tend to result in increased costs, while often yielding lower fees. Profitability will be a factor to consider and will be dependent on the size of the mandate and scale of the business to respond to the operational burden of the offering. However, investor appetite shows a strong preference toward moving away from traditional commingled products to customized and nontraditional offerings.

“ We know that the hedge fund industry needs to develop, needs to evolve in response to changing investor preferences. Unless it can evolve quickly, there’s going to be a negative impact on growth expectations. You have to be prepared to evolve with your investors. ”

(\$2b-\$10b, North America, Macro/Global macro)

Investors

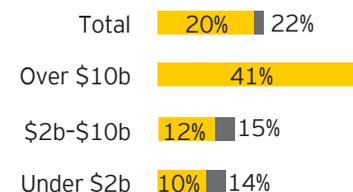
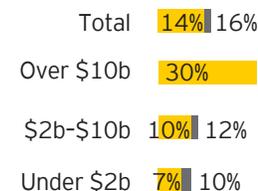
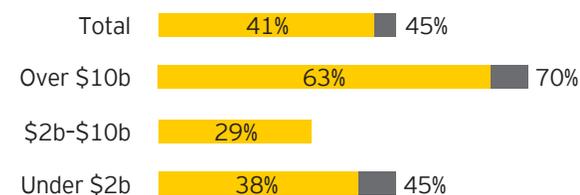
Which product do you currently invest, or plan to invest, through a hedge fund manager?



■ Currently invest and plan to invest

Hedge funds

Which of the following products do you currently offer or plan to offer in the next two years?



■ Current offerings ■ Planned offerings

Investor appetite for a diverse array of products results in opportunities

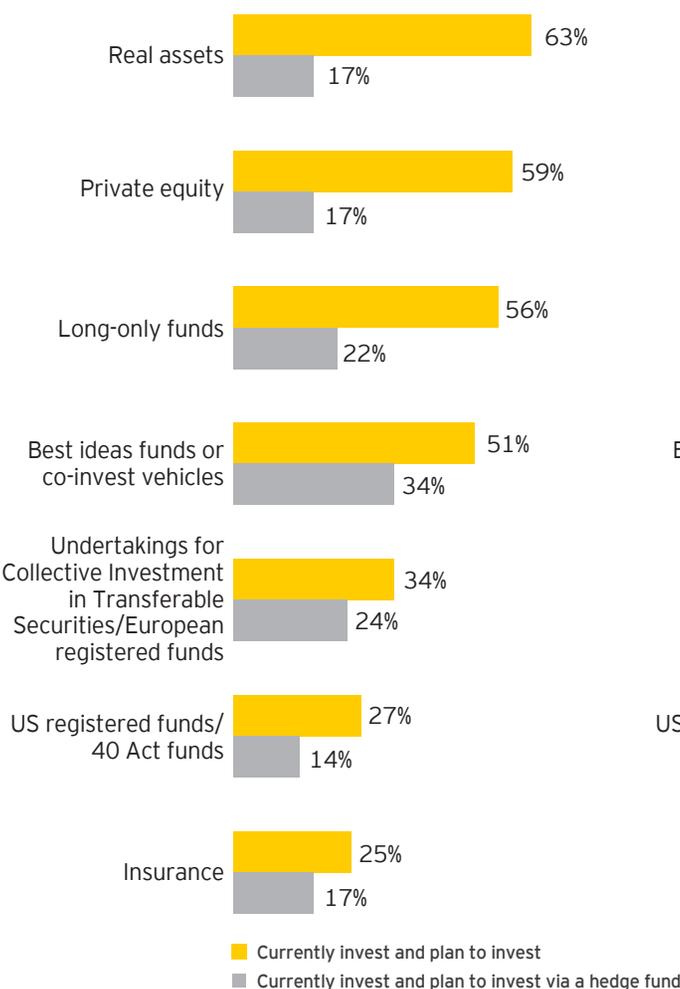
As investors' product demands expand, assets are flowing to the largest managers that offer a wide array of nontraditional hedge fund products. One in three of the largest managers offers private equity, real asset strategies and best ideas vehicles – compared to single-digit percentages for smaller managers. Compared with 2015, smaller and midsize managers have retrenched and are offering fewer new products; however, larger managers have continued to maintain their market share for certain new products, while increasing it for others.

Many investors do not see any but the largest hedge fund managers as solution providers for mandates that extend beyond traditional core competencies. This likely reflects a perceived lack of availability and presents a clear opportunity for managers with capabilities.

Those managers who are able to demonstrate a competency and deliver a compelling offering in these nontraditional products are finding ample investor interest and a less crowded marketplace. In fact, the 2016 investor responses indicated increased demand levels of investments in all categories, except for insurance-related products, as compared to 2015.

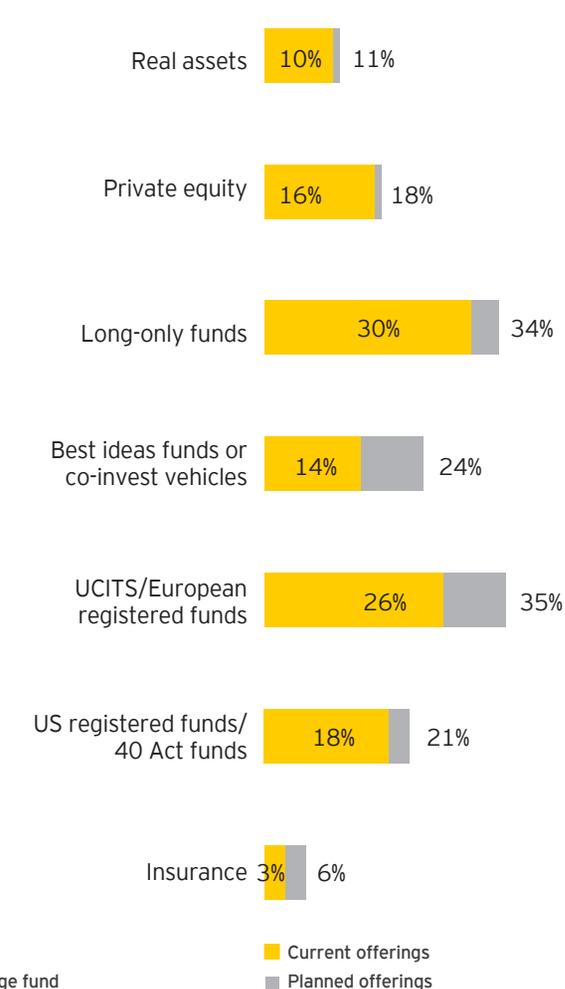
Investors

Which products do you currently invest, or plan to invest, through a hedge fund manager?



Hedge funds

Which products do you currently offer or plan to offer in the next two years?



The largest managers have sufficient scale to support a broader array of products, while others are rationalizing

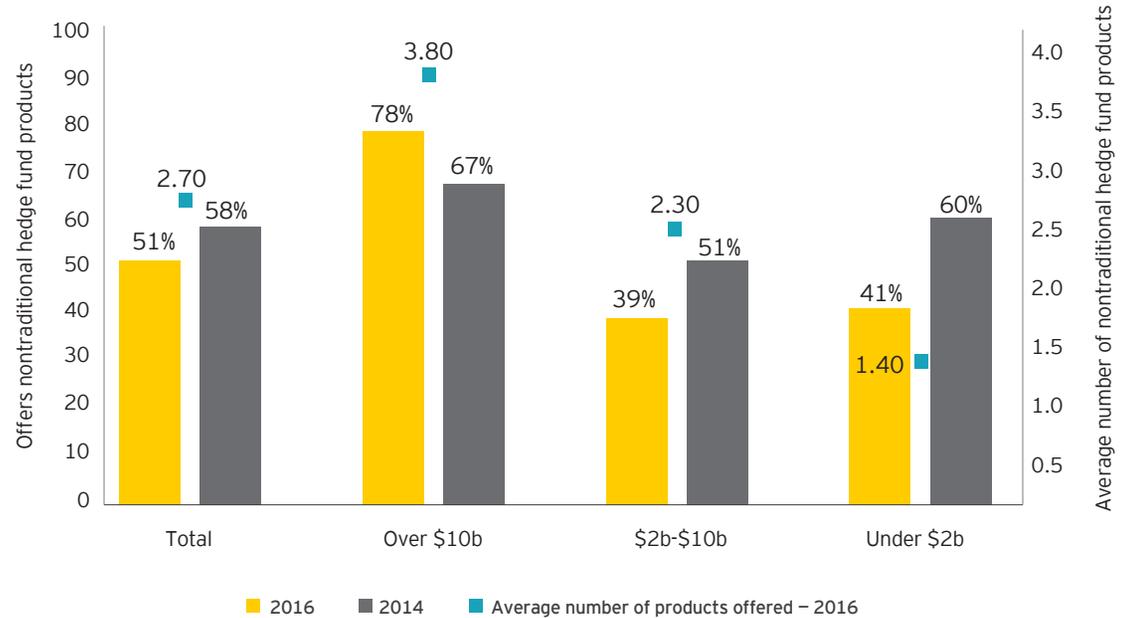
While the largest managers are adding nontraditional products to their offerings, smaller firms are cutting back. This adds more fuel to the allocation trends, resulting in the big managers getting bigger at the expense of their smaller peers.

While most managers offering nontraditional products indicate that they offer more than one of such offerings, new products create operational challenges. Few managers – just two in five – say they achieved significant efficiencies in subsequent product launches from investments made to support prior efforts. Based on the nature of these vehicles, each generally requires its own individual investment and support, yet many of them are being offered with reduced fees. Given the current environment of cutting costs, these nontraditional products need to be carefully evaluated.

It is not surprising to see retrenchment by managers that have not reached sufficient scale to support the investment necessary to support a new product launch.

Hedge funds

Do you offer nontraditional hedge fund products?



Managers of all sizes are elevating marketing efforts

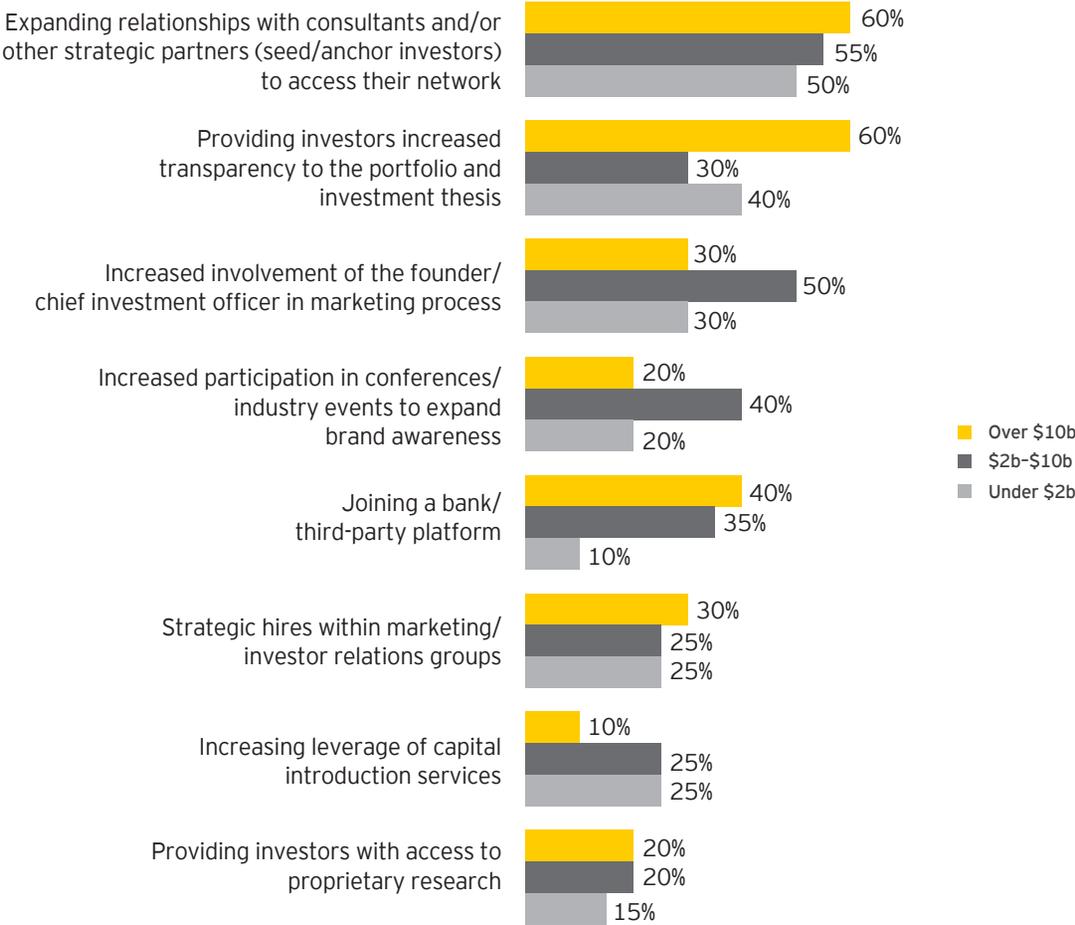
As managers seek to better market their funds, they are expanding relationships with investment consultants and strategic partners, while also taking a number of different approaches in an attempt to reach new investors.

The largest managers uniquely favor providing increased transparency into their investment process and portfolio. As a result, the largest managers have been able to showcase their competitive advantages in an effort to differentiate themselves from the competition. This appeals to investors who have a desire and need to understand how the investment strategy aligns with the goals of their broader portfolio.

Regardless of the medium that managers use to market their offerings, it is imperative that they effectively present their value proposition and factors that differentiate themselves from other managers. Managers need to understand investors' needs and to be able to articulate how their strategy or offerings could help investors meet their objectives. Those managers who do this most effectively are most successful at obtaining multiple mandates from existing investors.

Hedge funds

What strategies are you employing to better market your funds?



Reasons that investors invest in hedge funds

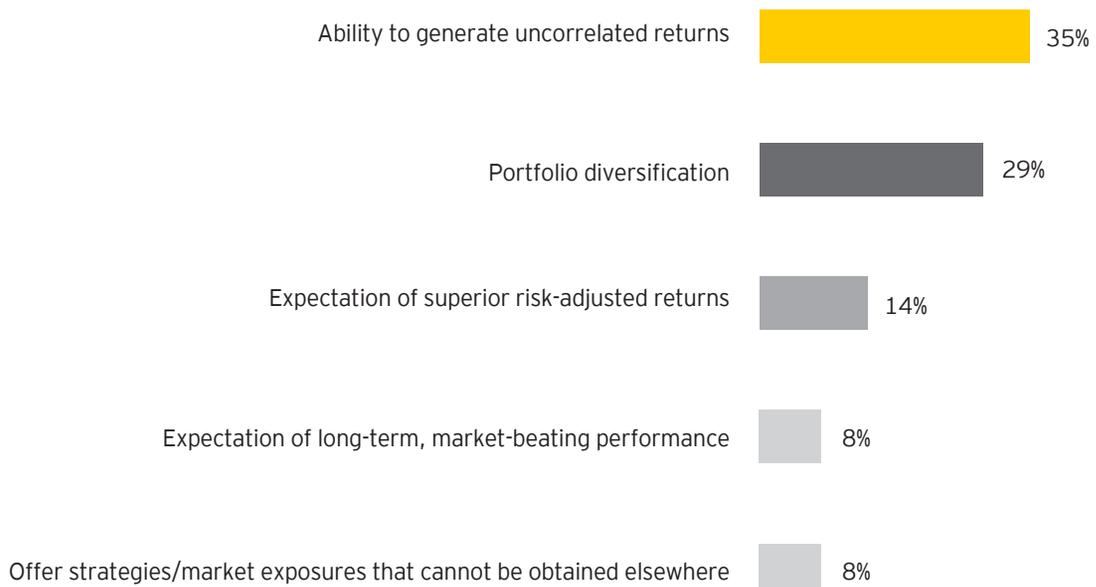
Investors choose hedge funds for a myriad of reasons. Key among them is generating uncorrelated returns and diversifying their portfolio. Given these top two responses, it is not surprising that investor sentiment has been somewhat sour on the industry recently, as returns for many managers have been increasingly correlated, if not underperforming to standard benchmarks, resulting in less diversification.

What should come as a surprise, if not a warning to managers, is that only 8% of investors indicated they are investing because they are getting one-of-a-kind market exposures through hedge funds that cannot be obtained elsewhere. This gives an indication of the competition in the market and the investors' perception that many hedge fund strategies can be replicated through other channels.

For managers looking to achieve growth, smart strategic steps, like matching product offerings to evolving investor demand and investing in distribution channels, will fall short if marketing messages do not align with investors' core motivations for investing in hedge funds. Further, managers should recognize that offering an innovative product that cannot be easily replicated will help them stand out in a crowded alternatives universe.

Investors

What is the primary reason you invest in hedge funds?



Next generational data being utilized by more than just the quants

Product and marketing alone will not solve the growth challenge. Managers need to seek every advantage in achieving performance and in offering differentiation.

Quantitative managers have been leveraging big data and nontraditional data sources to generate returns for years. Fundamental managers now also are looking to leverage big data to create opportunities for alpha generation.

More than half of managers either currently or expect to use nontraditional data in their investment process. The smallest managers lead the pack, with nearly 60% utilizing this information. Many managers are using artificial intelligence programs to model and analyze large amounts of data. If used appropriately, nontraditional data can both aid in identifying investment opportunities, as well as providing an innovative and differentiating aspect to a manager's investment program that could appeal to investors. However, it is critical that managers understand the data that is being obtained, what it represents and how to use it. A misunderstanding or misinterpretation can have severe negative impacts on the trading strategy.

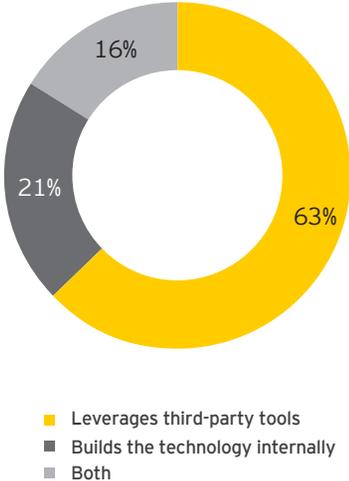
The vast majority of managers currently in this space are buying rather than building the tools necessary to aggregate and analyze this data. The availability of this data could result in the convergence of the fundamental and quantitative strategies. Overtime, as more managers pursue this strategy, the data could become commoditized. Differentiation will be driven by technological sophistication in using models and artificial intelligence in order to facilitate unique investing opportunities and speed to market.

Hedge funds

Do you use nontraditional or next-generation data and big data analytics to support your investment process?



Are you leveraging third-party tools for next-generation or big data analytics or building technology internally?



Emerging managers continue to play a role in investors' portfolios

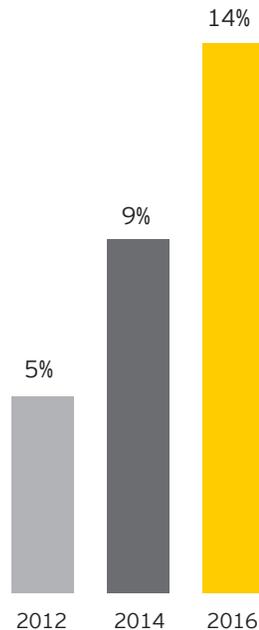
While the largest managers enjoy a number of advantages, there continues to be a robust appetite among investors for start-ups.

Emerging managers represent 14% of investors' overall allocation to hedge funds, and fund of funds are driving this trend. As the broader investment community is fairly aware of and has access to invest in the largest managers, fund of funds have positioned themselves to research and identify emerging managers who may not be on the radar of other institutional investors. In fact, almost 70% of pensions and endowments indicated they had restrictions on day 1 investing in start-ups, compared with only 28% of fund of funds reporting such restrictions.

Two-thirds of investors choose emerging funds in a search for alpha – either for their nimbleness or to invest early with future “stars.” Others like the negotiating leverage they can achieve with new managers who tend to be more flexible on terms with initial investors. We also see that the newest managers are tailoring their operations to incorporate some of the new and innovative technology and tools to aide with their investment strategy.

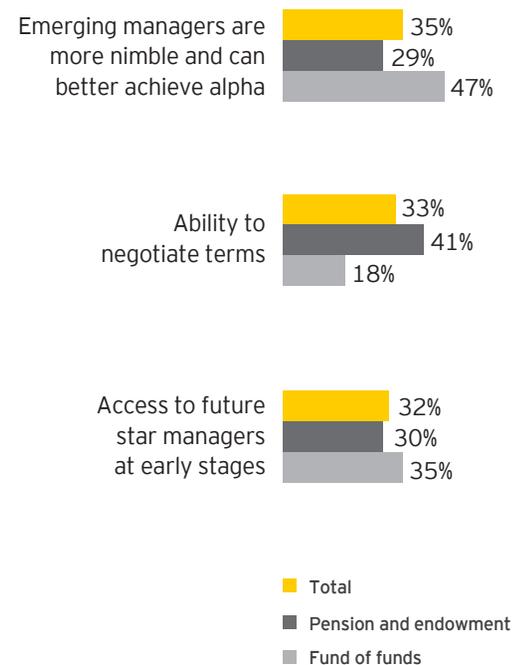
Investors

What percentage of your allocation to hedge funds is to emerging managers (new launches in last three years)?



Investors

What is the most important benefit of investing with an emerging manager?







Operational efficiency

Growth remains imperative for a variety of reasons, one of the key drivers being that it offsets the squeeze on margins that managers are facing. Top-line fee pressure, combined with increased costs to run an evolved business model that includes nontraditional products and customized solutions, continues to hamper managers' ability to maintain profitability targets. Knowing full well that margin compression will not abate on its own anytime soon, managers continue to use creative solutions in developing an operating model that meets the needs of their internal and external stakeholders, while also eliminating redundancies and excessive costs. Investments in technology are leading to improved automation, while strategic decisions with service providers are resulting in collaborative partnerships that leverage the capabilities and expertise of various third parties, while allowing managers to maintain an optimal level of ownership and responsibility over critical functions.

Investors continue to expect a robust operating model ...

Industry pressures have prompted managers to increase their focus on operational efficiency as a means of enhancing, or at least preserving, profitability. Operational efficiency becomes more important when performance is challenged and margins are being compressed.

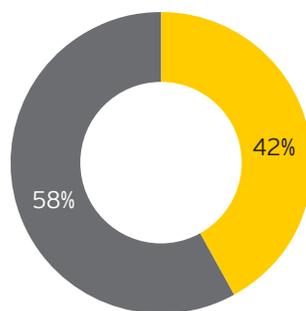
Operational excellence also remains a key to winning institutional mandates, and the bar to clear investor approval continues to be raised.

A majority of investors reported having separate and distinct investment and operational due diligence teams. Four in five investors say operational due diligence can eliminate a manager from consideration regardless of the investment team analysis, and two-thirds of investors have said their operational due diligence team has used this veto power.

While investors have a desire to search far and wide for alpha, innovative offerings and other solutions that best fit within their portfolios, the message remains clear that they will not compromise in their expectations that managers must have robust infrastructures to support the business.

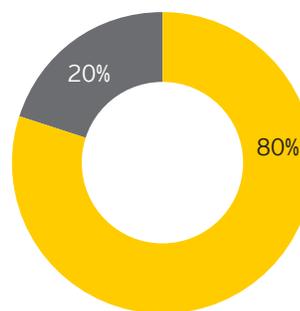
Investors

Which of the following best describes your structure as it relates to hedge fund due diligence?



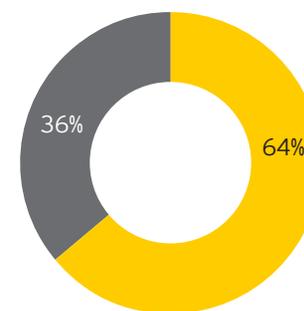
- One due diligence team that conducts both investment due diligence and operational due diligence
- Two distinct teams: one that conducts investment due diligence and another responsible for operational due diligence

Can an operational due diligence veto eliminate the manager from consideration for investment?



- Yes
- No

In recent years, has operational due diligence prevented an investment?



- Yes
- No

“Some of the changing investor preferences include the need for customization, which can be operationally challenging. But that’s certainly the way it’s going – more individual accounts, more customized accounts with different mandates. Your operations need to be able to support that intense client and investor demand.”

(\$2b-\$10b, North America, Macro/Global macro)

... while pushing for the funds to bear less of the cost of such infrastructure

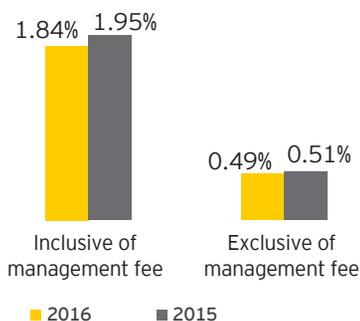
While investors are unwavering on their expectation of institutional quality operating models, they also continue to challenge expense ratios, which restricts managers' ability to push through certain of their costs to the funds. Managers have reacted by both cutting management fees and working aggressively to make operations more efficient, which results in declining operating expense ratios.

Fewer managers expect expense ratios to continue to decline relative to last year – a sign that managers expect the pace of change to slow and that they are reaching the limit of cost efficiencies that can be gained. However, a significant plurality of investors expect that expense ratios have more room to decline. Less than 1 in 10 expect increases in expense ratios in the coming years, with the remaining population split among those who believe the ratios need to come down further and those who would be content if the ratios held constant.

By strategy, the quantitative managers have been most effective at holding their management fee constant at 2%. This reflects an understanding by investors that this strategy and supporting infrastructure can be expensive to develop and maintain. Additionally, quantitative managers at the moment have been performing relatively well and are in vogue among the investor community. Oftentimes, positive performance trumps other considerations and is able to put matters such as expense ratios on the back burner. Investors see the value in a strategy that cannot be easily replicated elsewhere.

Hedge funds

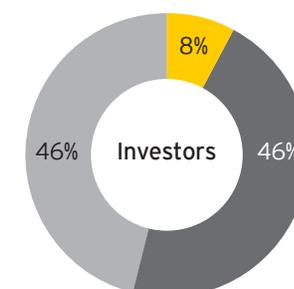
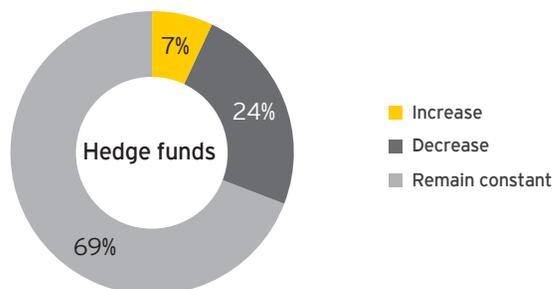
What is your flagship fund's operating expense ratio inclusive of the management fee, but excluding any incentive fees and trading-related expenses such as interest and dividends?



	Average operating expense ratio	
	Inclusive of management fee	Exclusive of management fee
By size		
Over \$10b	1.80%	0.52%
\$2b-\$10b	1.88%	0.45%
Under \$2b	1.81%	0.51%
By strategy		
Equity long/short	1.70%	0.49%
Fixed income/credit	1.93%	0.44%
Macro/global macro	1.73%	0.58%
Quantitative	2.30%	0.30%
Multi-strategy	1.95%	0.55%

Hedge funds and investors

Do you anticipate these ratios to increase, decrease or remain constant in the next one to two years?



Efficiencies being gained in the back and middle office

Managers are focused on opportunities for cost reductions across “big-ticket” support functions. Nearly half have reported actual or expected cost reductions in the middle and back office and nearly 40% reported savings in technology and data management.

Managing headcount is a component of this; however, many are actually adding to their roster as they are investing in senior-level professionals to not only help them identify tactical opportunities, but to design and implement efficient best-of-breed operating models.

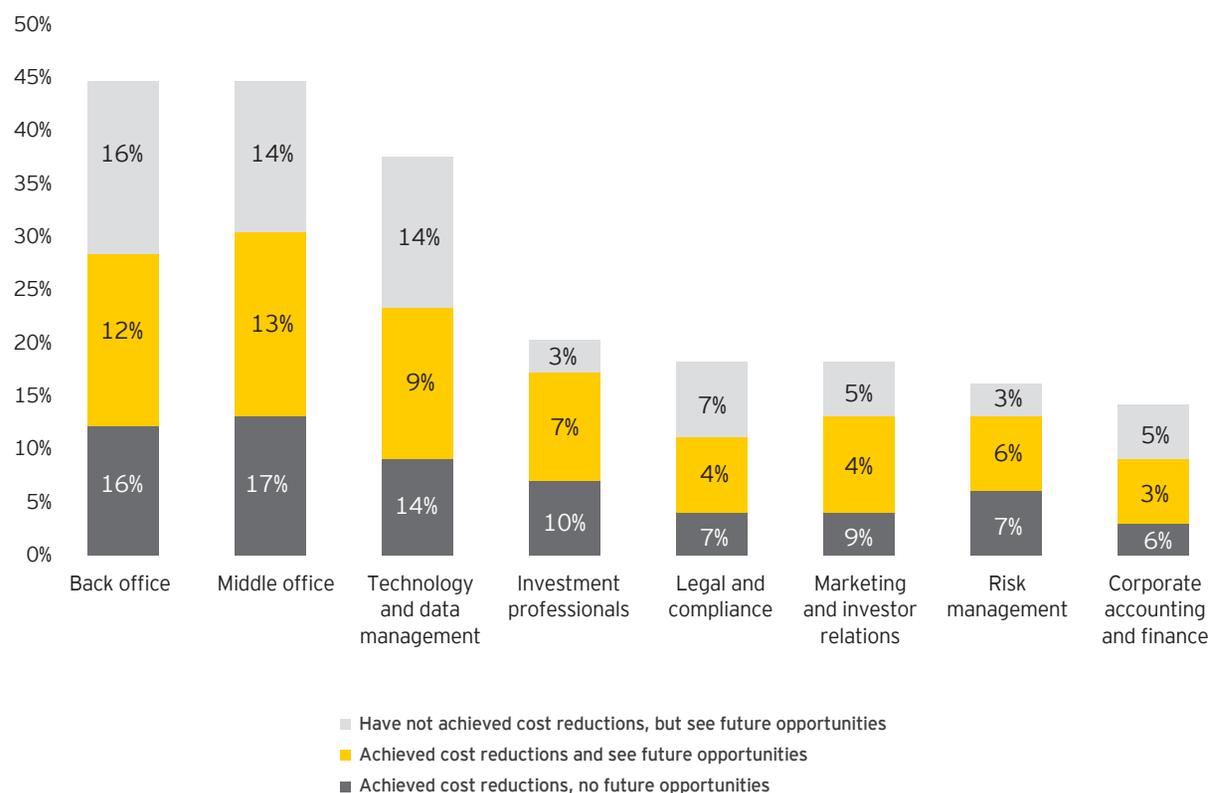
While actual efficiencies have already been obtained by many across all organizational groups, managers see larger opportunities for future cost reductions in all areas. This is due in part to managers reaping the benefits of new technology and leveraging of sophisticated service offerings from third-party service providers.

“Both our technology and overall operating model have completed a transformation to deal with increasing business and investor needs. Some examples – we built a data warehouse, established the role of a dedicated data manager, etc. Our goal is to achieve the full benefits of these investments that we made in data management.”

(Over \$10b, North America, Equity long/short)

Hedge funds

In which of these functions have you achieved cost reductions over the past one to two years?
In which of these functions do you see the greatest opportunity to reduce costs in the future?



Managers are achieving cost reductions by investing in technology and outsourcing to reduce headcount

Most of the largest hedge fund managers have been successful at reducing costs with new investments in technology and automation. Further, most large and midsize funds see continued savings coming in the future via strategic deployment of technology. An example of which is robotics in the back and middle office, which continue to reduce the need for manual involvement in various routine operations, minimize risks of human error and streamline efficiencies in data processing.

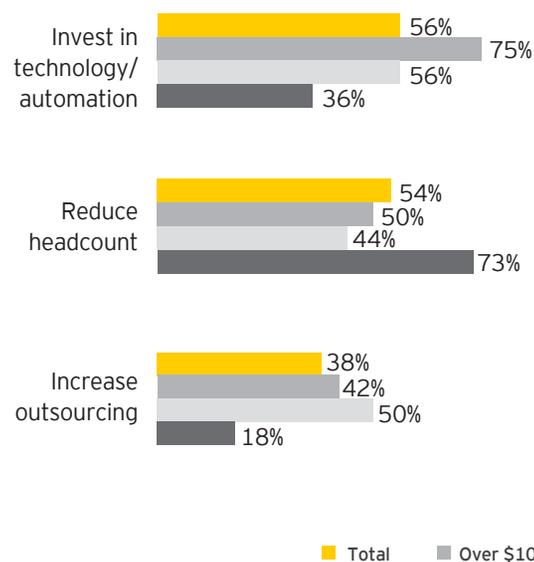
By contrast, smaller funds that found cost savings relied more heavily on headcount reductions. These smaller managers likely do not have the resources yet to be making significant investments in technology and instead rely more heavily on outsourcing.

Targeted headcount reductions do not always necessarily equate to overall headcount declines. Often, managers responded that they were able to redeploy individuals from one area where automation and other efficiencies resulted in less manual involvement to other areas of the business where growth and complexity required additional resources.

Managers of all sizes, but the largest and midsize in particular, have benefited from increases in outsourcing; however, the current levels of outsourcing indicate that managers are not fully leveraging the solutions offered by third parties and, as such, will continue to be an opportunity to derive further savings in the future.

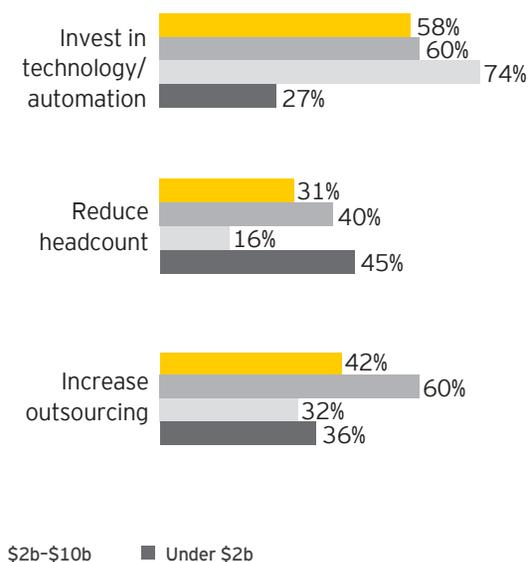
Hedge funds

How did you achieve cost reductions?



Hedge funds

How do you plan to achieve cost reductions in the functions for which you have set targets?



Investor comfort with outsourcing functions not matched by managers' reluctance to give up control

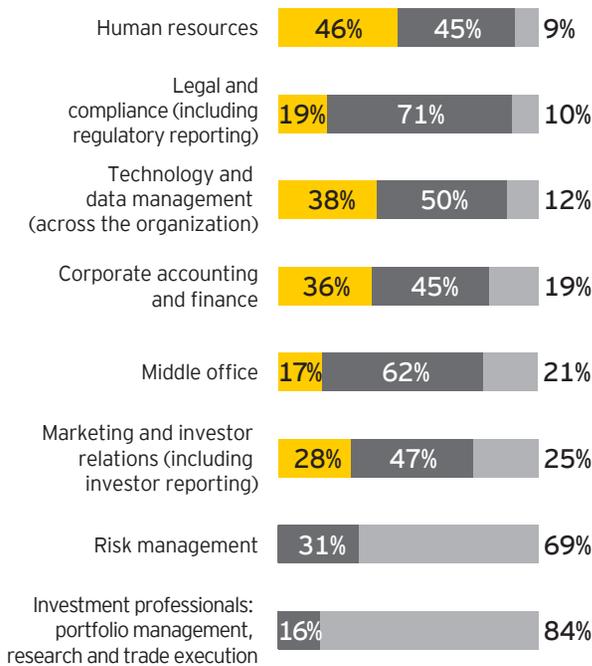
Managers should be exploring outsourcing opportunities for activities that do not represent a clear competitive advantage to be performed in-house. There appears to be no investor resistance, as very few object that support functions be outsourced, assuming the proper internal oversight exists.

The largest managers are already outsourcing more aggressively than smaller managers across almost every category, but opportunities exist for managers to do more and to consider reducing the amount of replication they perform of key support functions.

Interestingly, the middle office is one area that managers have universally identified as prime to achieve cost reductions, yet, less than one in five is currently outsourcing. Third-party solutions that are increasingly tailored to the industry will significantly contribute to the future efficiencies that are expected to be gained in the middle office.

Investors

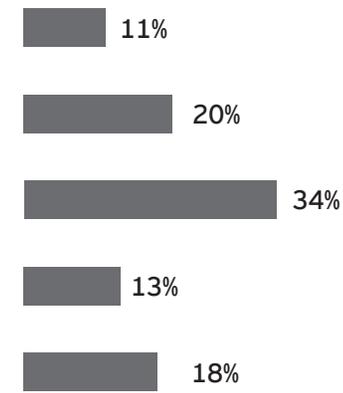
Which function is acceptable for your hedge fund managers to outsource to a third party?



■ Fully outsource ■ Partially outsource ■ No outsourcing

Hedge funds

Which of these functions do you currently outsource or plan to outsource any aspect of the function to a third party (including consultants)?



Note: Middle office includes treasury and liquidity management, trade support, valuation and performance, asset servicing, derivatives management and daily reconciliations.

Investors increasingly averse to bearing various pass-through expenses

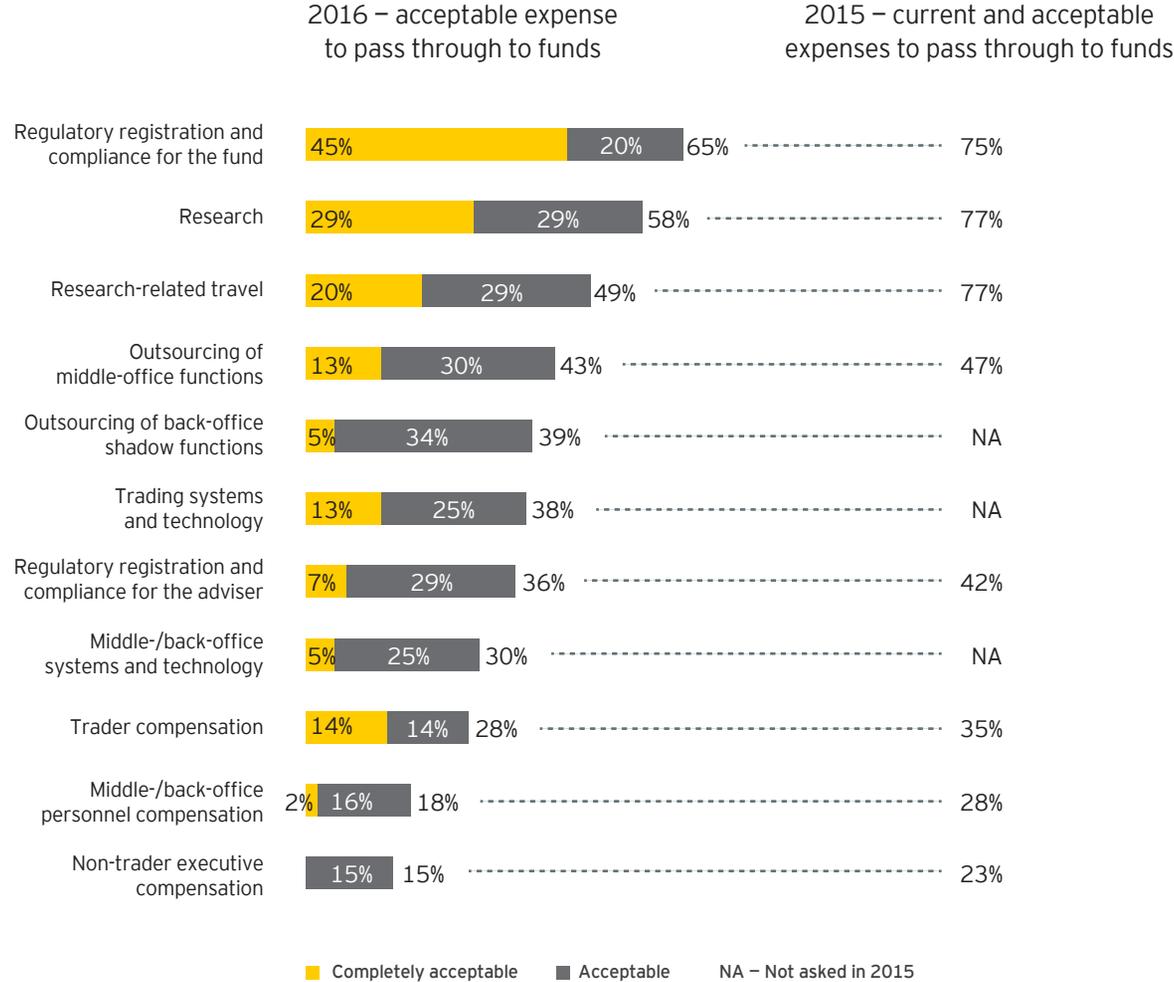
Investors are more averse to additional expense pass through to funds than past years – particularly in the areas of research and research-related travel. This comes as no surprise, given the overall pressures that investors have been putting on management fees and expense ratios.

Investors’ aversion to new pass-through expenses means managers need be even more focused on operational efficiency to maintain profits. They need to extend their competencies beyond investing and develop (or hire) talented business and operations managers who can better manage profitability, revisit outsourcing arrangements, extent of shadowing and spending across all functions.

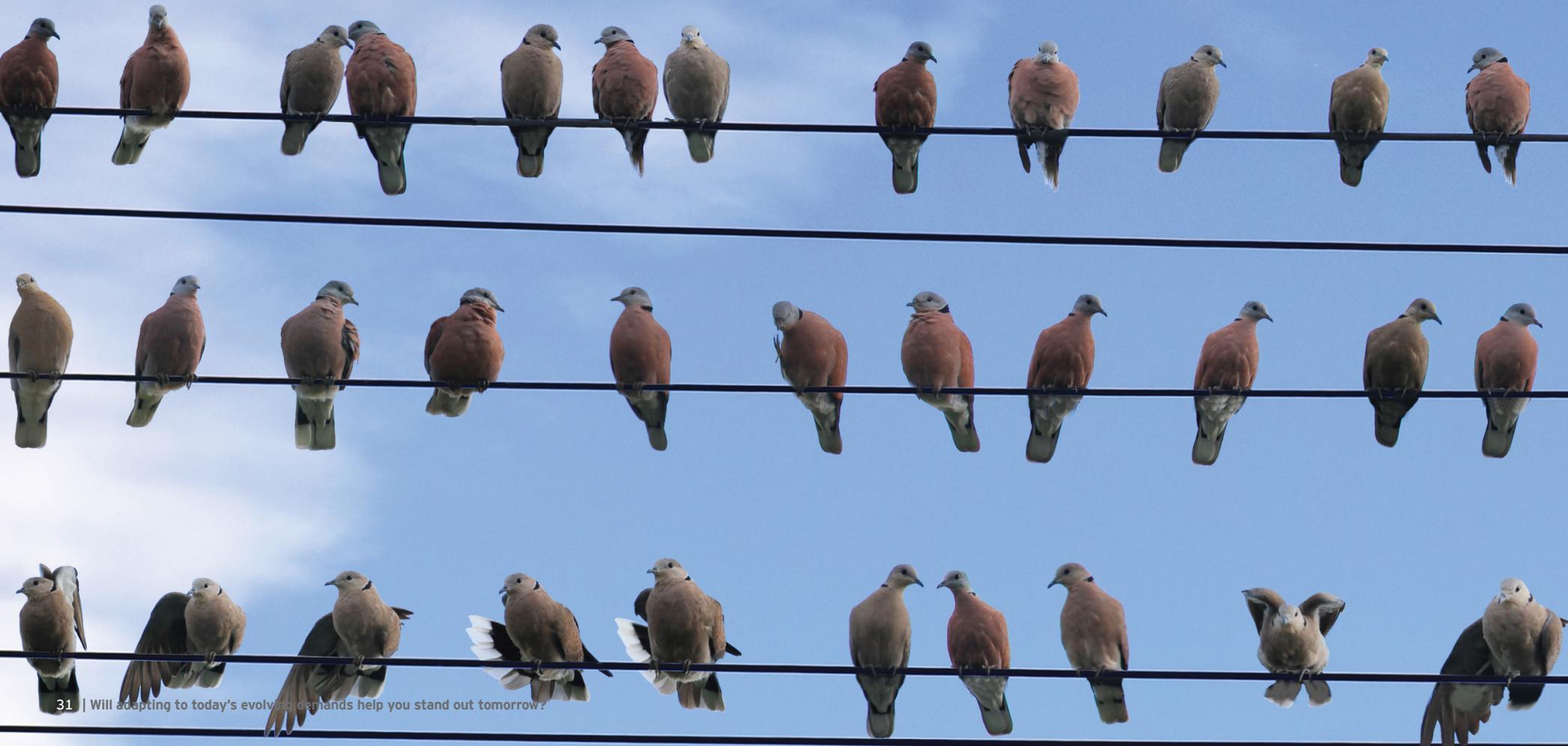
In response to the pressures on management fees and expense pass-through, many managers have evaluated scrapping the traditional management fee in lieu of a full expense pass through model in an attempt to be more transparent and better align the expenses of running the business with what investors will bear. However, 95% of investors say they prefer a traditional management fee with no pass-through expenses. So while the current model prevalently used by the industry has its challenges, it is clearly favored among the investor community.

Investors

How acceptable is it for your managers to pass through the following expenses to the funds in which you invest?



**Managing through
a changing prime
brokerage industry**





During 2016, there has been no reduction in the scrutiny faced by the banks nor the regulations under which they must comply. The trickle-down impact to the prime brokerage business continues to be felt, as managers and their counterparties continue the dialogue of the past several years as to how they can best partner together in light of the focus on optimization, funding, balance sheet and liquidity. This often has resulted in managers changing the way they engage with their prime brokers and often entering into new (and usually more) relationships. Managing these activities in a way that maximizes the economic benefits to the fund, while minimizing risk and operational inefficiency, requires a more formal process and the integration of all aspects of the business. Investors have started to take note; however, it is fair to say that many could still use further education of the issues and their impact on their fund managers.



Continued evolution of prime brokerage and hedge fund relationships

Regulations enacted subsequent to the financial crisis continue to filter through the banking industry and are impacting how prime brokers service the hedge fund industry. Prime brokers are requiring managers to alter their relationships, which impact how funds conduct their core trading and financing processes.

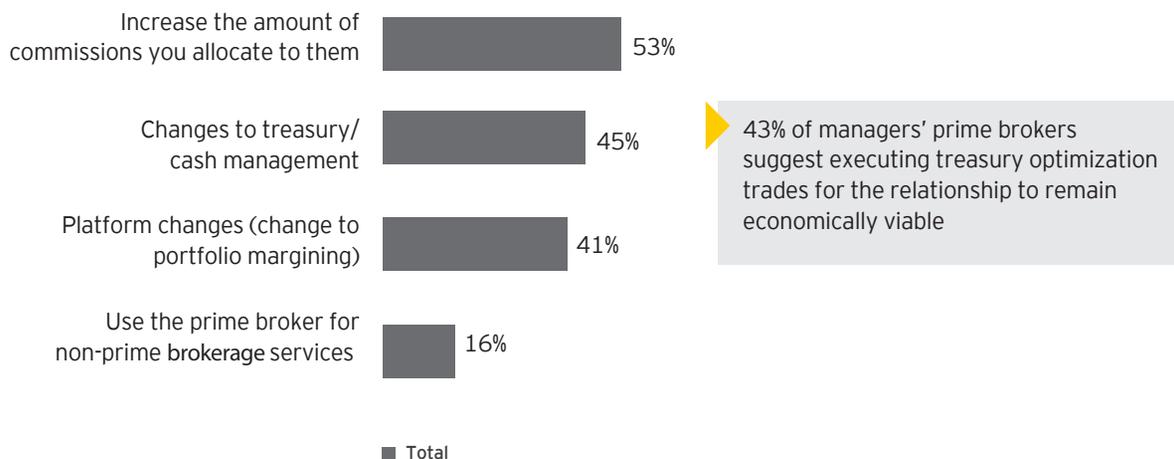
Almost 60% of managers say their prime brokers have requested fundamental alterations to their relationship to keep it economically viable (the most common suggestion being increased trade allocations, resulting in larger commissions for the prime broker). Other popular changes, such as treasury optimization and platform changes, potentially add new complications to a manager's infrastructure and require additional oversight and monitoring.

While pricing was a key consideration in 2015, during which time 3 in 10 managers experienced broad price increases, this trend has subsided slightly. In 2016, less than 2 in 10 managers reported instances of their prime brokers re-pricing their services.

Generally the prime brokers were able to address their most troubling economic relationships in 2015, which meant less of a need for pricing discussions in 2016. Also, certain prime brokers are finding themselves with capacity that they did not anticipate, which is causing them to be more flexible in dealing with pricing discussions with clients.

Hedge funds

Which ways have your prime brokers suggested altering your relationship to remain economically viable to the prime broker?



"The increasing regulatory pressure on our main counterparties has created growing uncertainty for the business. Potential changes in capital adequacy or proscriptive policies that may limit what types of securities banks may invest in could have a huge effect on our business."

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

Number of prime brokerage relationships continues to increase

We continue to witness a trend of prime brokers re-evaluating the types of business they do and the managers with whom they are willing to do business.

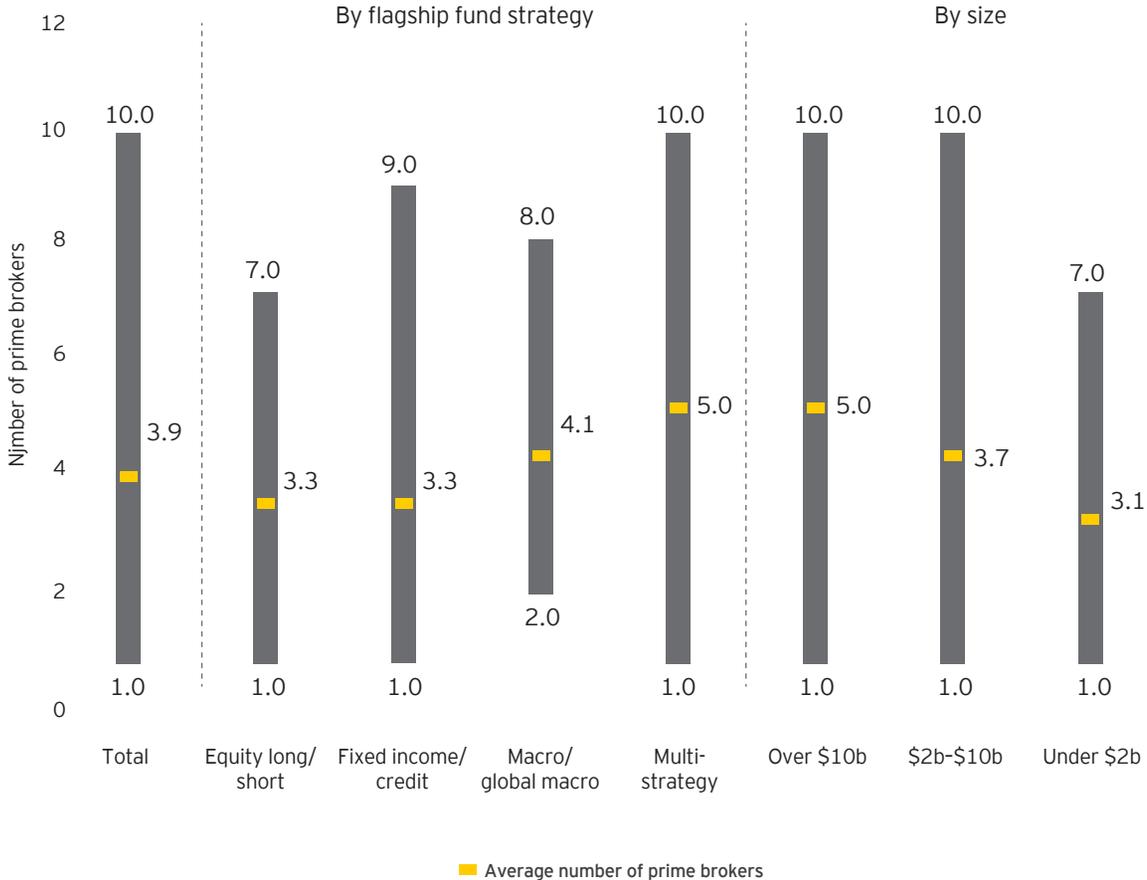
Managers have responded by engaging with an increased number of financing relationships. No longer are managers comfortable with only having a limited number of relationships available to them. Managers have increased relationships to new entrants to the prime space for concern of facing capacity constraints when attempting to put on a trade.

Not surprisingly, the more strategies a manager offers and the larger a manager is, the more prime brokerage relationships a manager maintains. Multi-strategy firms and the over \$10b managers both report an average of five prime brokerage relationships. The smaller, long/short equity managers are most likely to only have two or three prime brokerage relationships.

Increased diversification is effective in mitigating both counterparty exposure and yielding more financing options. However, it certainly adds complexities with regards to relationship monitoring and supervision.

Hedge funds

How many prime brokers do you currently use?



Opportunity for managers to educate investors on prime brokerage relationships

As a number of the global primes retrench, managers looking to increase their financing relationships are finding new strategic partnerships with emerging and niche prime brokers. While these relationships can be born out of necessity, many are driven by the emerging or niche prime broker's ability to provide a value-added service or benefit that fills a gap within the managers' existing relationships. One in four managers sees opportunity in shifting business to a niche prime broker with the perceived benefits ranging from new capabilities to reduced costs.

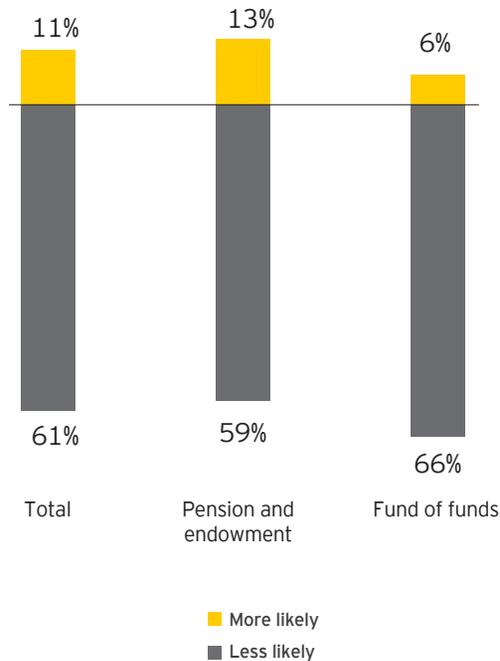
Managers and investors alike acknowledge that institutional investors are becoming more knowledgeable with regards to trade financing and how relationships with counterparties impact the business; however, additional education is still needed in certain areas. For example, investors expressed concern about risks associated with using an emerging or niche prime broker – largely related to their lack of experience and understanding of such institutions' ability to service the hedge fund industry.

Managers working with niche prime brokers – or considering doing so – should actively engage with their clients and prospects to allay concerns and educate them about the benefits of working with such prime brokers.

Additionally, just two in five investors feel they are fully aware of regulatory changes and requirements as they relate to prime brokerage. Pensions and endowments expressed a larger degree of uncertainty with respect to such matters. Given the importance that prime brokers play to a manager's operations, as well as the significance that investors place on this selection when they consider managers for investment, this presents an opportunity for engagement with investors.

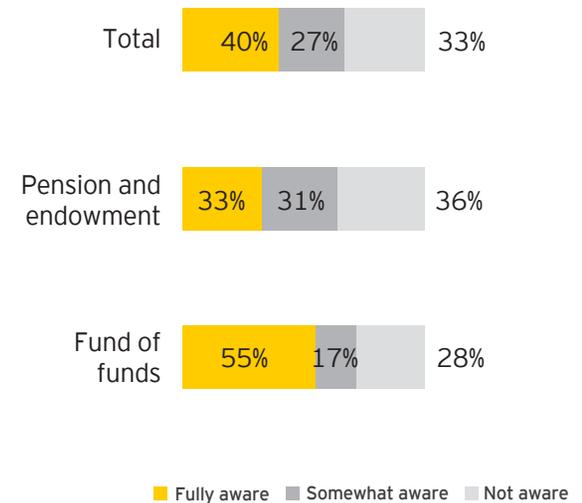
Investors

In comparing two identical funds, are you more or less likely to invest in the fund that uses a niche prime broker as opposed to an established top tier prime broker?



Investors

How knowledgeable are you about the impact of regulatory changes impacting the prime brokerage industry?



Governance and structure are critical to manage the growing number of relationships

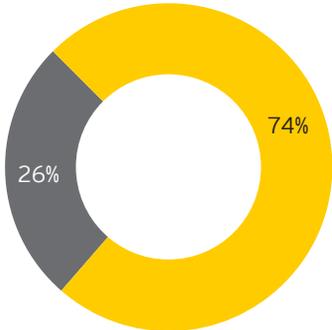
As managers increase the number of prime brokers they utilize, they are compelled to improve governance and structure around relationship management.

Three of four managers – and 85% of the largest managers – have formal review processes in place to evaluate their prime brokerage relationships.

Formalizing the review process allows managers to better monitor their relationships and extract the maximum value from their partners. Committees with dedicated resources, power and responsibility can provide permanent mechanisms to drive a consistent strategy and oversight of the process. Many hedge fund managers are accomplishing the same goals without the formality of a designated committee.

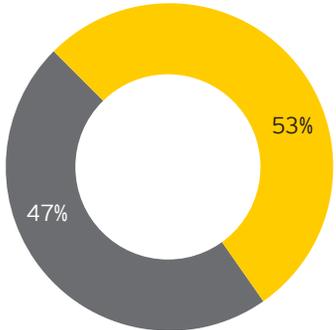
Hedge funds

Do you have a formal review process to evaluate your prime broker's performance?



■ Yes
■ No

Do you have a counterparty management committee?



■ Yes
■ No

“ Our financing is extremely important to us and we employ different means of financing to manage our positions, which are constantly under pressure from banks as their balance sheets shrink, and that can certainly have a detrimental effect on our liquidity. We have expanded our financing arrangements with different counterparties, so if one goes away, we have back-ups available. Negotiating lock-ups has been increasingly critical as well.”

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

Managers are becoming more formalized in managing the treasury function

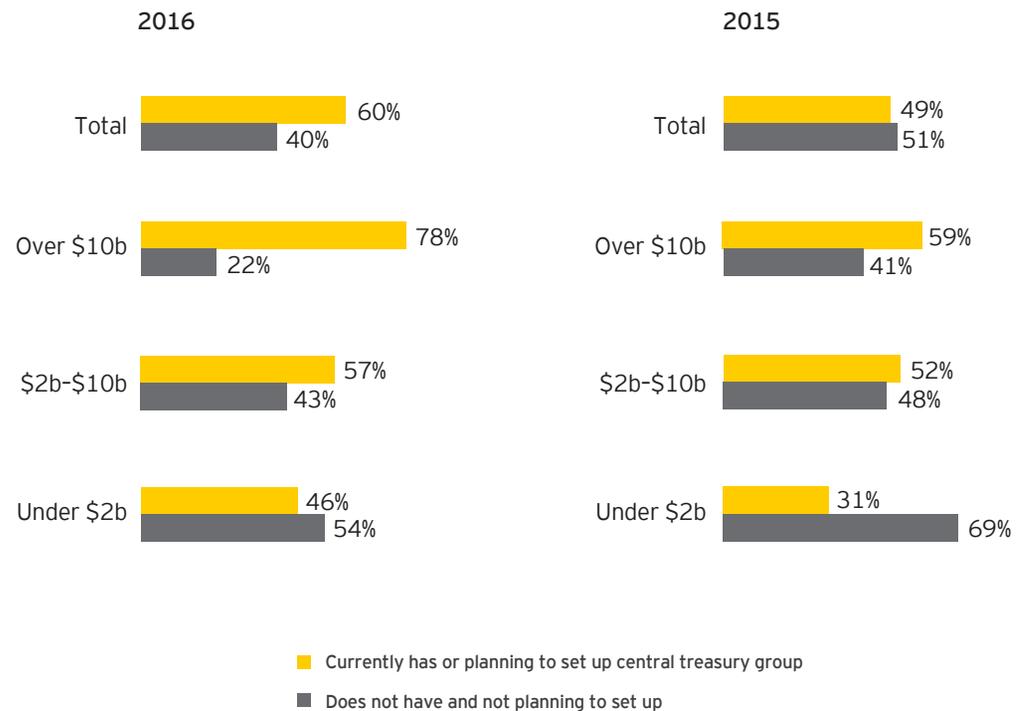
As financing, cash and collateral management becomes more complex, managers are increasingly setting up a central treasury function. The largest managers have been the pioneers in this space out of necessity based on the number of relationships they oversee, but also recognize the opportunity and benefits that treasury can drive if properly planned.

Year over year, managers of all sizes have reacted and created a central treasury group. Eight out of ten of the largest managers have such a group, and half of the midsize and smallest managers have created the function.

Those reaping benefits are managers developing treasury groups that intersect the finance, operations, risk and portfolio management aspects of the business. Having an appreciation for how all processes fit together can facilitate strategic financing activities that contribute to the profitability of the firm.

Hedge funds

Does your firm have a central treasury group that manages financing and collateral?



Increasing headcount dedicated to managing financing and collateral

Size and composition of a treasury team will be dictated based on the size and strategy of the manager, in addition to the processes, duties and objectives of the function. Compared to 2015, almost all managers have increased their headcount in this area. The largest managers have been most proactive by adding more than 1.5 full-time equivalents, growing their total coverage to more than 5.5 full-time equivalents.

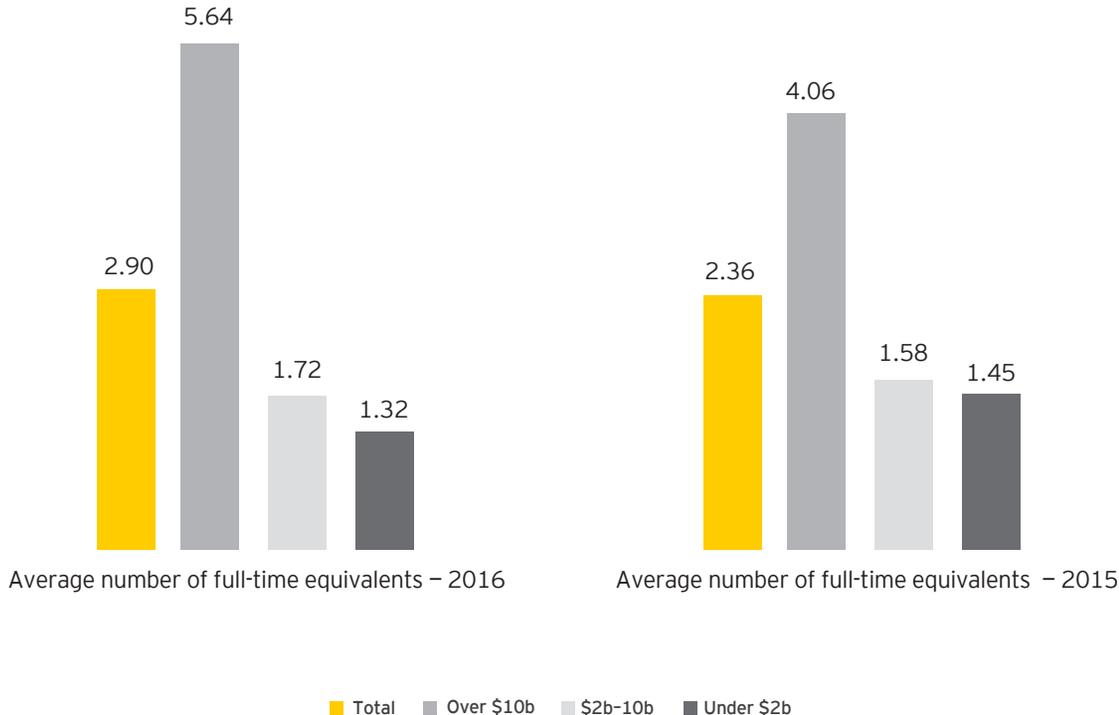
Identifying the right individuals to fill these roles is critical, as they often need to be multifaceted and understand how their decisions impact all areas of the business, including financing, risk and operations.

The largest managers continue to add headcount to their teams. Their businesses are becoming larger and more complex, and they recognize the importance of having sufficient coverage in this area.

Identifying talent in the treasury group is increasingly cited as one of the bigger challenges that managers have in staffing their firms. As these roles have not typically been in abundance at funds, there is a relatively low number of individuals who have the right skillset that coincides with the responsibilities managers now need covered.

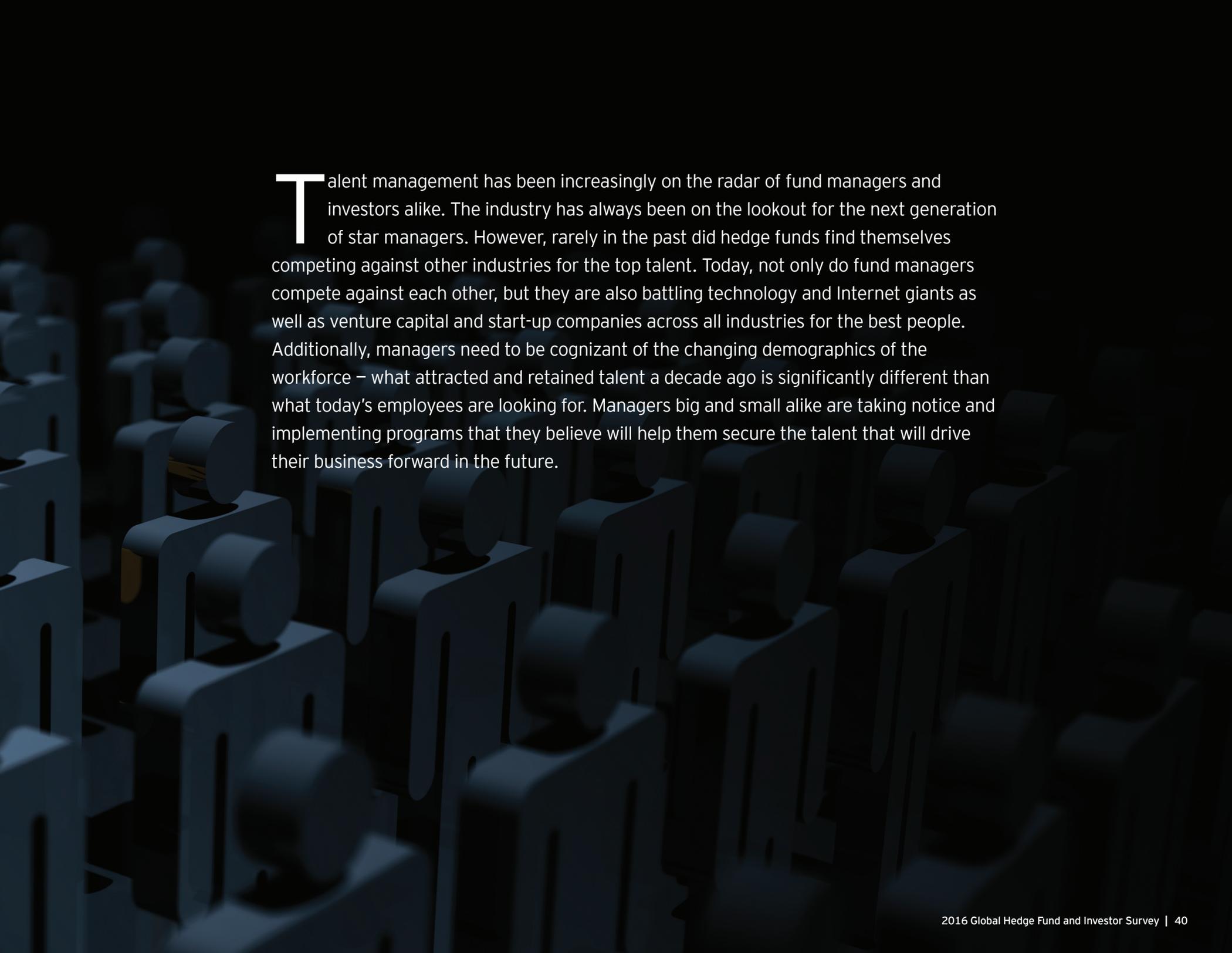
Hedge funds

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



Talent management





Talent management has been increasingly on the radar of fund managers and investors alike. The industry has always been on the lookout for the next generation of star managers. However, rarely in the past did hedge funds find themselves competing against other industries for the top talent. Today, not only do fund managers compete against each other, but they are also battling technology and Internet giants as well as venture capital and start-up companies across all industries for the best people. Additionally, managers need to be cognizant of the changing demographics of the workforce – what attracted and retained talent a decade ago is significantly different than what today’s employees are looking for. Managers big and small alike are taking notice and implementing programs that they believe will help them secure the talent that will drive their business forward in the future.

Talent management programs are evolving, as managers focus on attracting and retaining talent

After growth, talent management is viewed as the top priority of hedge fund managers. In many ways, the two objectives – growth and talent – are aligned. A manager requires the right employees to execute on their growth objectives.

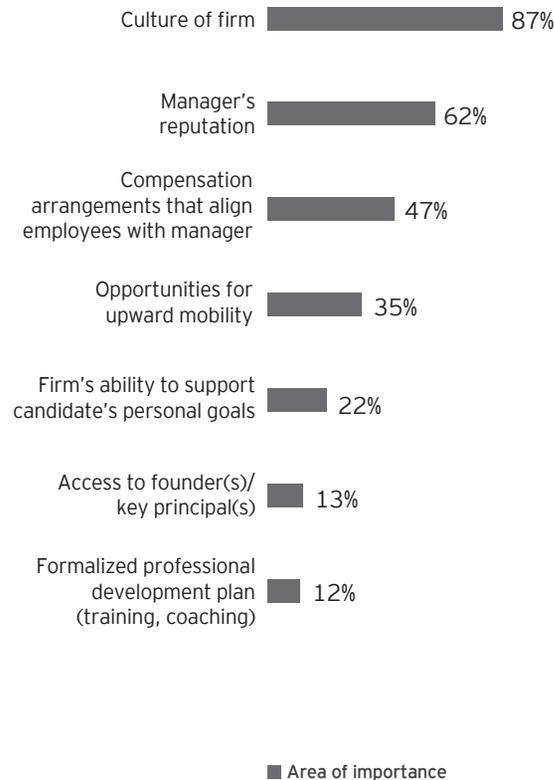
The skillset of today's talent and what will be needed in the future also continues to evolve. As managers increase their reliance on automation and outsourcing, employees are less often involved with performing routine tasks. Today's talent and that of the future need to be prepared to handle complex tasks that cross-functional groups. Individuals with a deep understanding of the business will be of the upmost value to managers.

Aside from all-in compensation, managers see culture and reputation as keys to attracting and motivating talent. Larger managers also say that opportunities for advancement are essential.

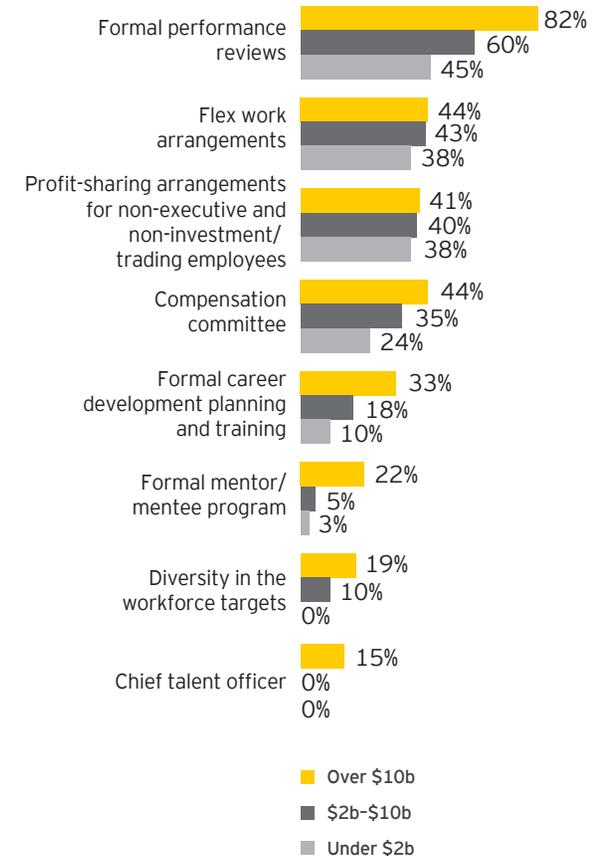
As the industry has matured and many areas of managers' operations have become more institutionalized, one area that has lacked attention is the talent management programs. Managers should continue to formalize their talent and career development programs and focus on areas such as generational needs and diversity and inclusiveness programs. The millennial generation recently became the largest percentage of the overall workforce. Just like Gen Xers differed significantly from the Boomers prior to them, Millennials have significantly different desires and need to be incentivized. Millennials place a high emphasis on compensation, but almost equally important to them are jobs that promote upward mobility and ability to support personal goals, two considerations that fund managers do not currently think are the most important to their talent programs relative to other factors.

Hedge funds

Aside from the amount of all-in compensation, what is the most important factor in attracting and motivating talent?



Which of the following do you have in place as part of your talent management program?



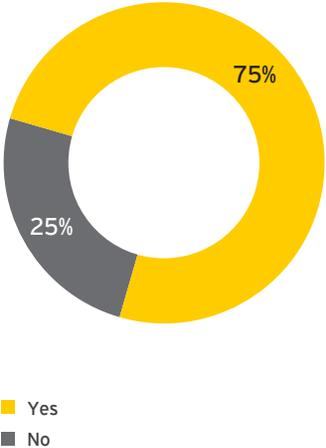
Three-quarters of investors request information about a manager's talent management program during due diligence

Talent management also plays a critical role in the competition for institutional assets. Investors are increasingly requesting details on managers' talent management programs as part of their due diligence. 75% of investors indicated that this was a key consideration of their due diligence process.

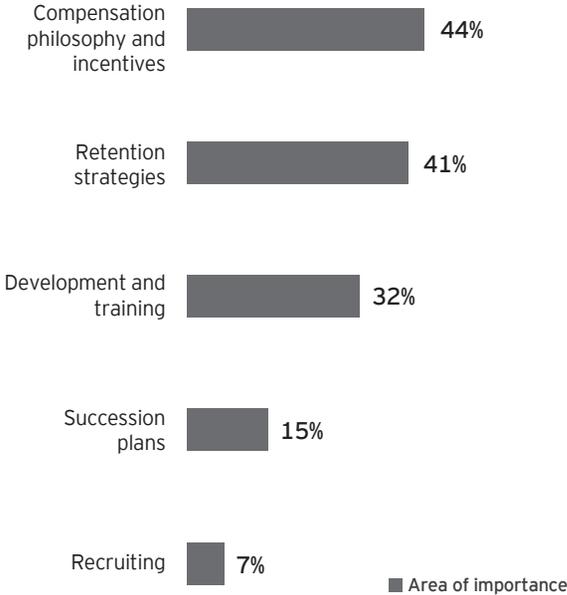
Compensation and retention strategies were the two most critical considerations. Investors want to ensure that their managers attract and retain the right talent and that incentives are aligned with their interests. One in three investors are also interested in how managers are developing and training their personnel. Investors want to understand the efforts being taken to enhance skillsets of other personnel, so they are relevant and keeping pace with the rapid evolution of the industry.

Investors

During the due diligence process, do you request information about a firm's talent management program?



Which information about a manager's talent management program is most important to you?



"Lack of growth and talent are related. If organizations aren't really growing, it's tough to attract talented people. People naturally want to go where the business is growing and where there are personal growth opportunities. As an investor, we are focused on our managers' ability to grow, as it will have a direct relation to their ability to employ the best people."

(Europe, Pension and Endowment)

Investor loyalty – a disconnect between manager perception and reality

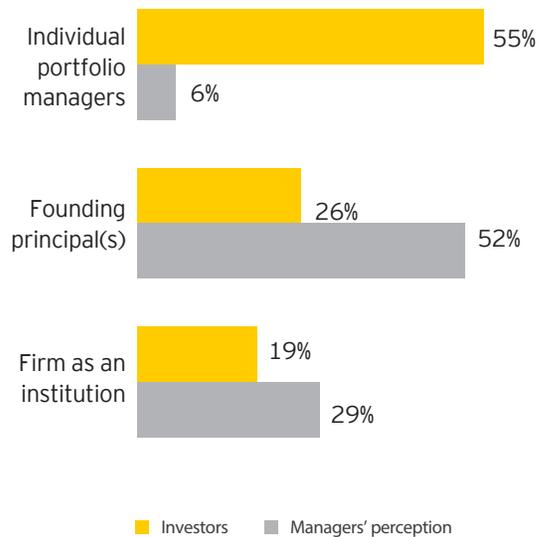
Although managers are confident that client loyalty is rooted in strong relationships with the firm's founding principals, investors state clearly that their primary allegiance is to their portfolio managers. In periods such as this where attracting and retaining capital is so critical and challenging, managers would be wise to recognize that 55% of investors say they are most loyal to individual portfolio managers, and not necessarily the founder or firm as an institution.

This suggests that managers should be focused on ensuring their talent program is appropriate to grow and retain talented investment professionals. Succession plans should be put in place for their portfolio managers to give investors confidence in the institution's ability to generate returns if a "star" leaves.

However, few managers are planning for the succession of their critical front-office personnel. There have been various high-profile examples of effective succession planning, where investors were comfortable remaining with an institution long after its original founders and/or key portfolio managers stepped away from leading the organization. As managers increasingly view themselves as franchise institutions, adopting more formal succession plans will be critical.

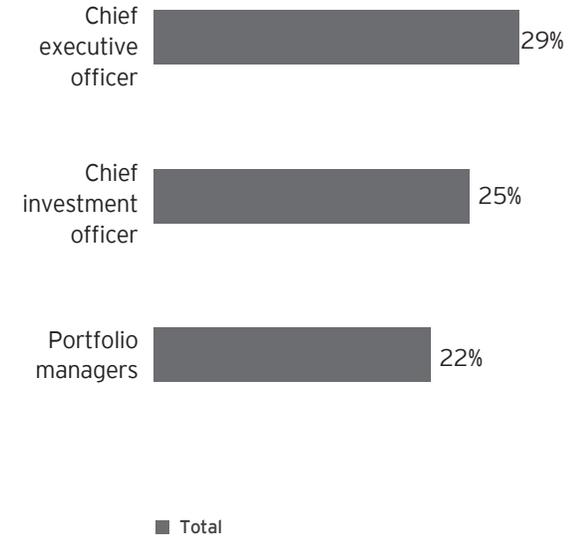
Hedge funds and investors

Where is your loyalty most rooted, and thus any changes would most significantly and immediately cause you to reevaluate your decision to remain invested in a fund/manager?



Hedge funds

For which officers do you have a clearly articulated, documented succession plan?



Investors also focused on the non-trading executives

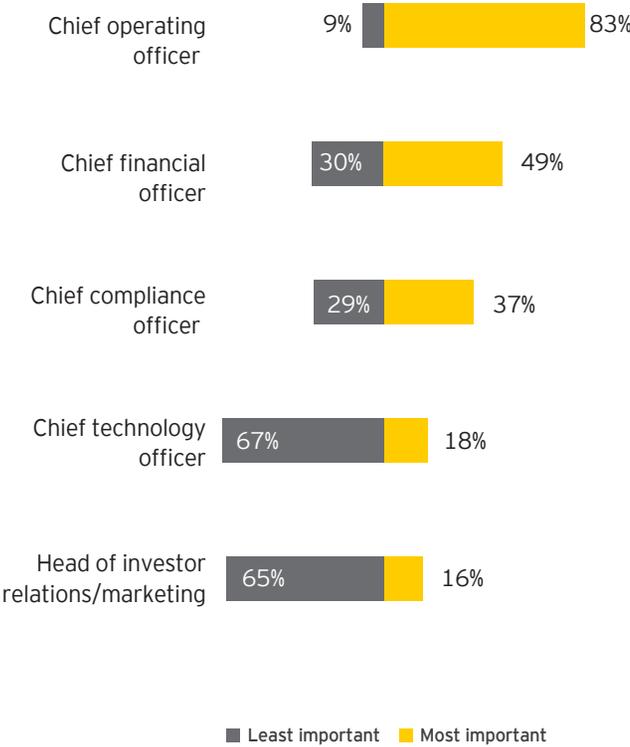
Due diligence on talent is not limited to the front office. Most investors believe that vetting the chief operating officer is critically important. A high proportion of them also vet a firm's chief financial officer and value the role of an empowered chief compliance officer.

Roughly half of managers have documented succession plans for certain positions, but relatively few have plans for critical operational roles. Across all of the key non-investment executive roles, less than 2 in 10 managers have documented succession plans.

Given the importance investors place on the individuals fulfilling the chief operating officer and chief financial officer responsibilities, we would expect more managers to prepare contingency plans and succession plans for these roles to avoid investor concern and disruption to the operations of the firm in a period of transition.

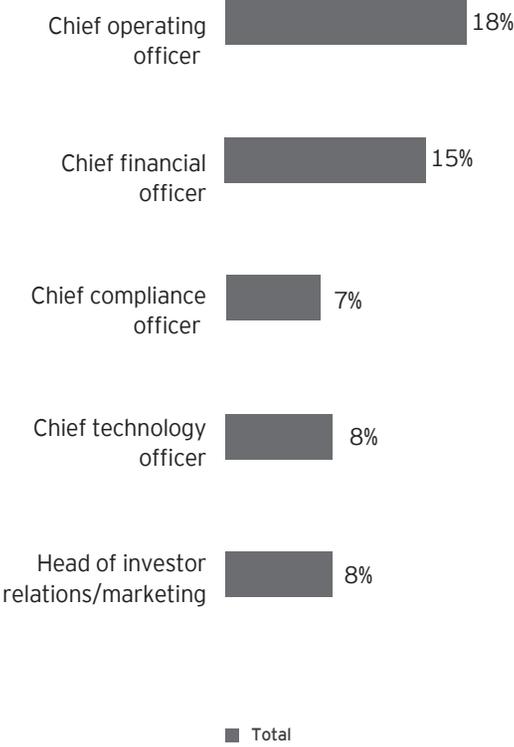
Investors

As part of your due diligence of a manager, which functional role is the most important to vet?



Hedge funds

For which of the following officers do you have a clearly articulated, documented succession plan?



Future risks and opportunities

“ When you’re a firm as large as ours, you don’t know what everyone is doing. Mistakes, honest mistakes, can happen and they affect you whether they are intentional or not.”

(Under \$2b, Europe, Multi-strategy)

“ Our industry is based on having investors. If investors choose not to be in hedge funds, which they have been actually doing, then that’s a risk for us. For example, there’s been more than one endowment or big investor base that’s decided 100% to pull out of hedge funds. We need to be better at understanding what investors need.”

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

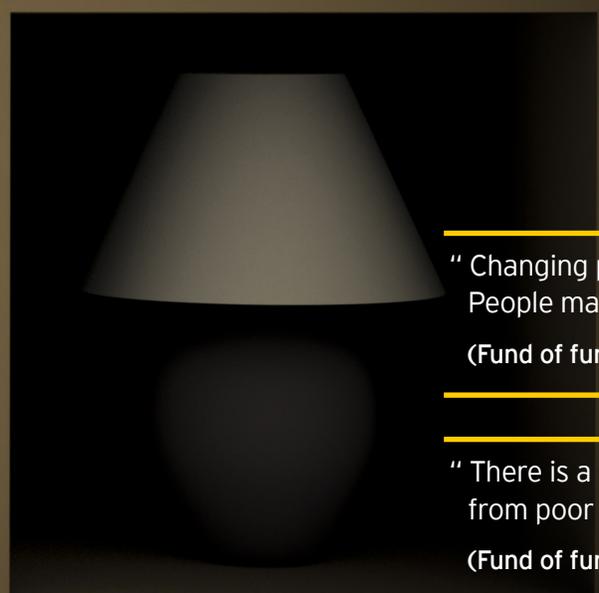
“ The barrier to entry continues to grow for smaller hedge funds. If the regulatory burden continues to increase then it becomes harder for smaller firms to get into the market to begin with.”

(More than \$10b, North America, Equity long/short)



“ You have to grow to make sure you can maintain an institutional infrastructure and meet the needs of investors. Those needs are changing as we move forward, as many of our institutional investors have needs for returns and investment performance to help manage their cash flow.”

(Under \$2b, Asia-Pacific, Multi-strategy)



“ Some of these banks may not be as strong as they seem from the outside. Regulators may do some destructive things to the markets, in the name of helping them, that will ultimately reduce liquidity of certain assets.”

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

“ Changing preferences is that a hedge fund’s product offerings is not meeting their clients’ needs. People may say, ‘you’re a great manager, but I don’t like your space.’”

(Fund of fund, North America)

“ There is a general investor level of dissatisfaction with hedge funds currently. The problem comes from poor performance.”

(Fund of fund, Europe)



“ As we are a maturing industry, finding and developing talent is a growing challenge. Banks were once a natural breeding ground for people and are no longer a viable talent source for us. We have to learn to train people ourselves and be patient enough to do that.”

(Under \$2b, Asia-Pacific, Multi-strategy)

Greatest risks facing hedge fund managers

Hedge fund managers and investors agree that changing investor preferences represents the top risk for managers going forward. Managers that are able to adapt to the changes in demand will be most likely to succeed in the future. Interestingly, this risk is most prevalently identified by the largest managers. The survey has shown that these managers have been most proactive at insulating themselves from the risk by diversifying their offerings to investors.

Regulatory and reputational risk often go hand in hand and likely will always be top of mind given the low tolerance for errors and the significant price to pay when such an issue arises.

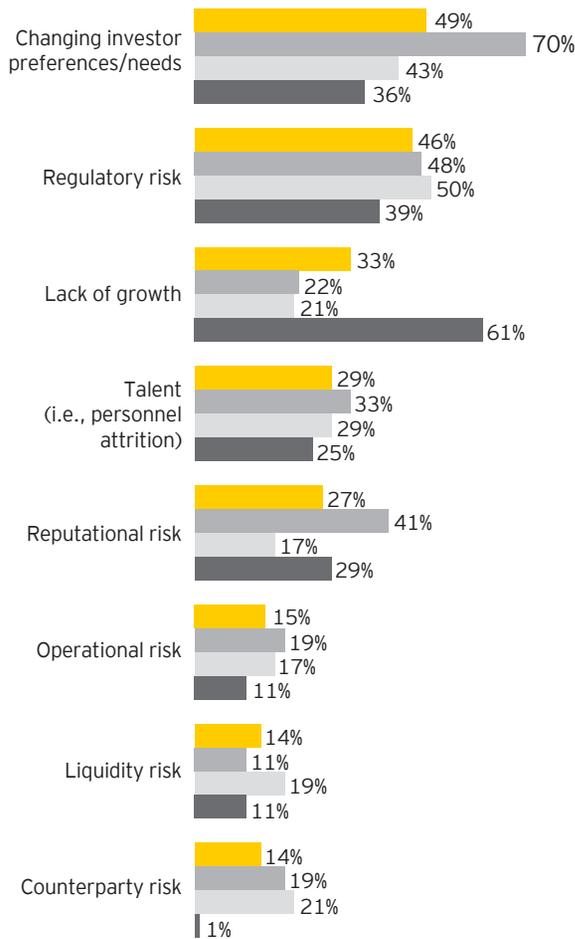
Lack of growth remains a constant threat but is viewed as a significantly larger issue for the smallest managers. These managers struggle with the increased barriers to entry. With costs on the rise, smaller managers need growth to survive, as well as facilitate their future business goals. At 61%, this was, by far, the top risk noted by the smallest managers.

Subsequent to the financial crisis, managers have become very proficient at addressing operational, liquidity and counterparty risk. While each represents a significant risk, managers and investors appear relatively comfortable with the measures in place to mitigate such matters.

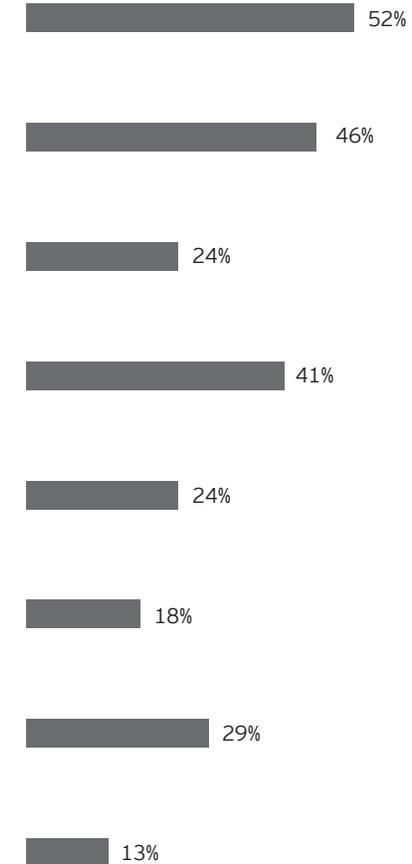
Hedge funds and investors

What do you believe are the greatest risks (excluding performance) facing the hedge fund industry?

Hedge funds



Investors



■ Total ■ \$2b-\$10b
■ Over \$10b ■ Under \$2b

The largest hedge fund managers are advanced in the transition to becoming diversified alternative asset management platforms

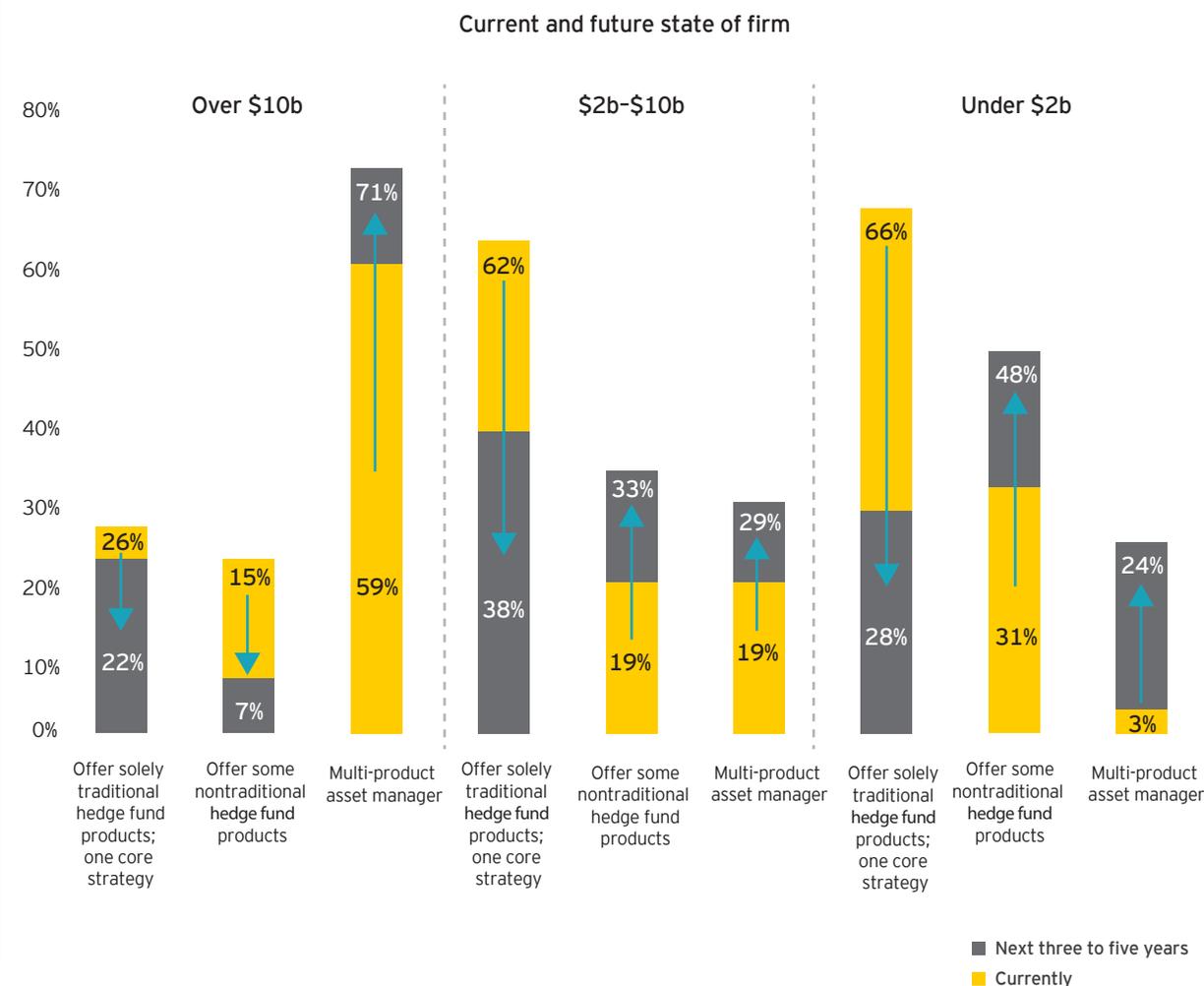
Managers today continue to hold steadfast to their goal of growing into larger, diversified asset managers. Seventy-one percent of the largest managers describe themselves as multi-product asset managers, and a significant percentage of midsize and smaller managers expect to move from offering solely one core strategy in a hedge fund product to a greater diversification of offerings.

We saw this trend last year and continue to see hedge funds expecting to have bigger ambitions about their future state than how they currently describe their business. The largest managers are well along this path, and the number of managers that focus solely on core hedge fund strategies continues to decline. Managers that have not reached the same scale show ambitions of moving in this direction also, but need to be aware of the operational challenges that come with customization and product proliferation and prepare accordingly.

These transformational changes cannot occur without the leadership and support of the entire organization. Hitting these goals requires the alignment of the business – front to back – alongside strategic and thoughtful collaboration with counterparties and third-party service providers so that the manager can package an optimal offering to best partner with its investors.

Hedge funds

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



Conclusion

“In the struggle for survival, the fittest win out at the expense of their rivals because they succeed in adapting themselves best to their environment.”

Charles Darwin

Today's hedge fund industry is rapidly evolving – managers run businesses and operations that more closely resemble institutional financial franchises and investors are more sophisticated and tactical in analyzing their investment portfolios broadly and how hedge funds specifically fit into the mix. On account of modest hedge fund performance, as well as a plethora of investment opportunities in the alternatives universe, leverage has swung significantly to the side of investors who are demanding more from managers – both with regards to terms that are more aligned with investor interests, but also for product offerings that are catered to their specific needs and identified objectives. Many managers have been quick to adapt and are having success operating on this new playing field. Others who have been slow to react or who have dug in their heels in resistance to change are finding it very difficult to attract, and retain, investor capital.

The issues and dynamics unfolding today show no signs of abating in the future. So what does this foretell for the industry? Managers who take all measures to best partner with their investors will find success. This means recognizing that each investor is different and one-size-fits-all solutions likely will not appeal to the masses.

Innovation will be front and center – both in utilizing a variety of ways to differentiate from an investment strategy perspective, as well as for purposes of designing a best-of-breed operating model. Next-generational data analysis is increasingly being utilized by managers of all strategies to identify alpha. In the back office, robotics and other automation are creating efficiencies and driving savings necessary to counteract margin compression. The financial barriers to entry are not scaling back and the reality is that it will make the path to prosperity more onerous for smaller and midsize managers. Like other mature industries, one has to think that consolidation will be a trend to monitor. Larger managers have the scale and infrastructure to be opportunistic in acquiring teams or entire fund groups from smaller managers, where such acquisitions give larger managers the ability to further diversify their business.

Periods of change, while often difficult to manage, always result in opportunities. Those managers who are embracing this new environment, taking stock of their capabilities and identifying the threats posed by competitors and other forces, are positioning themselves to surge ahead and not just survive, but thrive in the future.

Background and methodology

The purpose of this study is to record the views and opinions of hedge fund managers and institutional investors globally.

Topics include managers' strategic priorities and product demand, cost management, evolving prime brokerage relationships, talent management and the future landscape of the hedge fund industry.

From June to September 2016, Greenwich Associates conducted:

- ▶ 100 telephone interviews with hedge funds, representing nearly \$1.1 trillion in assets under management (AUM).
- ▶ 63 telephone interviews with institutional investors (fund of funds, pension funds, endowments and foundations) representing more than \$1.5 trillion in assets under management, with roughly \$280 billion allocated to hedge funds.

Hedge fund respondent profile	
Total	100
By geography	
North America	52
Europe	26
Asia	22
By AUM	
Over \$10b	28
\$2b-\$10b	43
Under \$2b	29

Investor respondent profile	
Total	63
By investor type	
Pension and endowment	45
Fund of funds	18

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