The future of growth and the asset management industry:
Disruptive forces rewrite the solution for hedge fund success

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Introduction

Investors demand that hedge fund managers find alpha that exceeds market performance, an increasingly challenging hurdle during an eight-year bull market. “Low-fee” and “low-cost” work as long as a rising tide lifts all boats.

But all bets are not off yet for the hedge fund industry. Political and economic surprises create heightened volatility, and we are most certainly living in unpredictable times. The industry attracts the best and the brightest talent who can build the most sophisticated risk, liquidity and return models that investors expect. Scope and scale matter; the one category of funds that experienced net asset inflows in 2016 were funds over $1 billion in assets under management.¹ As the industry consolidates for scope and scale, the breadth and depth of investment offerings will increase. Investors will continue to look to diversify risks for their overall portfolios, and hedge fund leaders will be there to serve.

Surviving in a period of disruption

A changing industry landscape
The hedge fund industry is changing norms around risk, return, liquidity and fees. New competitors are developing creative alternatives to the traditional 2/20 fee model, linking performance fees to key market metrics. Leaders in the hedge fund industry are responding with market-correlated performance fees while exploring hybrid models that include passive investments as well as private equity and other illiquid asset classes.

Large investors like pension plans and endowments appear willing to trade liquidity for lower fees and more stable returns. Hedge funds are responding by stretching 90-day liquidity norms with offers of discounted fees for more permanent capital. In some cases, hedge funds are bringing in strategic investors. In addition to capital, these investors present other benefits like expanded asset class offerings.

A changing business model
Hedge funds are moving to a more scalable business model that allows the operational end of their businesses to grow (or scale back) based on the size of their portfolios. This adaptable business model encourages the search for functions that can be outsourced and for efficiencies in both front- and back-office operations, such as investments in fintech tools that automate processes and reduce costs.

Hedge funds are one of the most effective ways to diversify risk in an investment portfolio, but they are, by design, extremely difficult for the average investor to access. The industry looks to open new pathways for the “nearly wealthy,” investors with less than $1 million in net worth. Investors are becoming younger, more diverse and more frequently not from the United States.

Continued regulatory uncertainty
The Trump administration and Congress seem to be in harmony when it comes to softening regulatory structures developed over the Obama era. But as hedge funds grow through consolidation, they also enter new global markets that have their own regulatory and tax regimes. Hedge funds are finding that expanding investor access requires a clearer, more transparent view of risk and return, providing investors and counterparties with greater confidence in the industry. Risk and regulatory expenses, as well as escalating cybersecurity costs, are pressuring margins for hedge funds.

Funds need to be prepared to redefine the way they approach risk and return, liquidity, and fees to broaden their appeal to investors.
A friendlier regulatory environment in the US?

In the recently published white paper *The best defense is always a strong offense*, Grant Thornton LLP asset management leaders discuss potential implications of the Trump administration.

The Department of Labor’s (DoL’s) fiduciary rule, a 2016 regulation that requires all brokers and advisers to act in the best interests of their clients, was scheduled to become effective in April 2017, but on Feb. 3 President Trump issued an executive order asking the DoL to re-examine the rule and consider revising or rescinding it.

John Stomper, a Grant Thornton Audit Services partner specializing in financial services, said: “While it may well be delayed and the rule could lose some of its teeth, some form of enhanced protection for the small investor appears likely. Asset managers would be well-advised to lay the groundwork for compliance now at whatever level is ultimately required.”

Among the changes that Stomper recommends are updating technology platforms to manage increased compliance obligations, making sure wrap fee programs meet fiduciary standards and carrying out thorough training to ensure that employees understand appropriate behaviors under the new rules.

Elsewhere on the regulatory front, asset managers can expect continued attention from the SEC. According to Michael Rose, Grant Thornton Advisory Services partner, SEC attention for asset managers is relatively new.

“It’s only been the past few years that the SEC has focused on asset management,” Rose commented. “We don’t expect that attention to relent under the new administration.”

According to Rose, most of the SEC’s regulatory action is expected to involve investment advisory agreements, ensuring that the actions of asset managers match the promises they make in those agreements. Along those lines, he sees failure to fully or accurately disclose fees as a prime target, including fee and expense disclosures and fair-trade allocations to all the funds.

Other potential areas for scrutiny include improper valuation of illiquid assets, use of valuation methods that differ from fund agreements, failure to disclose investment risks and inadequate disclosure of conflicts of interest.

Even if it’s not easy, the path to preparation for asset managers is clear. Rose suggests that his clients review and document their allocations processes, compare them to investment advisory agreements to ensure consistency, and employ technology and analytics systems to provide accurate allocations. “Get ready now for questions from the SEC,” he concluded. “They’re coming, so be ready to respond.”
Shaping the hedge fund of the future, today

After years of growth, the hedge fund industry faces new competitors, changing client needs and expectations, and changing regulatory requirements.

With additional scrutiny on fees and more low-fee alternatives, hedge fund managers are under heightened pressure to demonstrate value.

What actions can leaders in the industry take today to shape their businesses for the challenges and opportunities of tomorrow?

Is it time to sell?

"There's a squeeze in the middle for hedge fund M&A," says John Cristiano, a Grant Thornton Transaction Advisory Services managing director. "Funds in the middle are too small to be dominant and too large to position themselves for a distinct market niche. Fund managers need to ask themselves whether now is the right time to seek impartial advice about monetizing their value by taking advantage of high valuations and selling their businesses to one of the larger funds."

Consolidate for scale and scope

Consolidation will create numerous choices for incumbents. For some, this means acquiring other funds to scale up; others will evaluate if this is the time to sell. Larger funds are also expanding their scope by acquiring advisers in other asset classes, such as private equity and real estate funds.

This year has already seen an impressive roll call of M&A deals. In January, Skybridge Capital announced a definitive agreement for RON Transatlantic EG and Seward & Kissel client HNA Capital (U.S.) Holding to acquire a majority stake in Skybridge, according to Hedge Fund M&A. And in February, KKR announced a strategic partnership with Pacific Alternative Asset Management Company to create a new liquid alternatives investment firm. In February, Japan’s SoftBank Group purchased Fortress Investment Group for nearly $3.3 billion.

In addition to gaining scope and scale through consolidation, larger hedge funds are also expanding internationally. They face the classic "build-or-buy" decision and, in the current environment, that decision is frequently "buy."

Some smaller boutique funds have maintained a foothold in their niche and been rewarded with handsome performance fees. But those with less-than-stellar fee incomes can’t keep the lights on with only management fees, let alone make the substantial investment in innovative fintech tools that automate processes, reduce costs and expand investor access.
The disruptive effects of passive investment fee structures have been a wake-up call for all active managers — hedge fund managers included. Gone are the days of the traditional active management fee model of a 2% management fee and a 20% performance/incentive fee.

Hedge fund data shows a clear trend of fee compression. Management fees for 2016-vintage hedge funds dropped to 1.33% from 1.60% for funds launched in 2015, and the average incentive fee for funds launched in 2016 fell by four basis points to 17.71% compared with 2015 funds. Credit Suisse’s ninth annual Hedge Fund Investor Survey revealed in February 2017 that 61% of investors reported that they had at least one manager in their portfolio with a hurdle rate; 57%, meanwhile, said their management fees had been lowered in the previous 12-month period.

Michael Patanella, Grant Thornton Audit Services partner and national Asset Management sector leader advises the following:

- Drive efficiency in the back office. When margins contract, reducing expenses is vital to maintaining or improving them.
- Embrace technology, especially as it opens new avenues for distribution. Don’t dismiss automation and robo-advising technologies; examine how they could fit into your business model.
- Tighten internal controls. Not only will they help drive efficiency, but they’ll also make responding to eventual SEC or DoL inquiries faster and less costly.

Fintech for hedge funds

The burgeoning fintech industry is both an enabler and a disrupter within the financial services industry. Fintech solutions support and enable not only the back-end functions of financial institutions, but also their customer interface and experience. Goldman Sachs estimates that fintech firms could capture nearly $660 billion in revenue from traditional financial services players involved in payments, crowdfunding, wealth management and lending. The investment landscape within fintech is also very positive. According to Forbes, $18.9 billion in funding poured into fintech startups during the first nine months of 2016.

For hedge funds, common areas of focus include the following:

Blockchain: The Depository Trust & Clearing Corporation (DTCC) is partnering with IBM and two startups to create a blockchain solution for credit default swaps. According to Steven Goldberg, a director in Grant Thornton’s Risk Advisory Services practice, the DTCC could be just the tip of the iceberg. “As early as 2018, we could see blockchain applied to stock trading,” Goldberg said. “We could go from several days for trade settlements to real-time settlement.”

Artificial intelligence (AI): AI means that machines learn from the ground up (from real-time data and trial and error) as well as from the top down (through a programmed set of rules). Fintech tools with AI act more like the human brain. They are able to work through situations where bits of information are missing, and can discern patterns in data even when there is ambiguity. By learning ways to improve performance or discovering data from other machines, interconnected machines can change course without human intervention.

While the first applications have related to robo-advisers, AI is beginning to be adopted by analysts in order to better understand commodity patterns and trends, particularly in alternate asset management. Some hedge funds are expanding the role of AI to include strategic decision-making. Bridgewater Associates is looking to build the algorithms to handle employee ratings with a goal of eliminating bias and emotion in the process.

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Improve global compliance while managing costs
Consolidation, growth and increased compliance are interlinked. With few exceptions, hedge funds with more than $150 million of assets under management must register with the SEC, which is now scrutinizing allowable fund expenses for proper cost allocation. Certain states set thresholds at $100 million. As hedge funds grow through consolidation, they also enter new global markets that have their own regulatory and tax regimes.

Global markets, layered regulatory frameworks
Niamh Meenan, Grant Thornton global head of Asset Management, sees the allure and challenges for hedge funds expanding beyond the United States. “There are very few aspects of this industry now that are purely domestic, whether it’s your investors, investments or structures,” Meenan said. “Each market is so important that hedge fund managers can’t exclude a market even if the regulatory environment is robust. As a result, hedge fund managers face a layered and complex regulatory environment.”

Even President Trump’s promise of more relaxed regulation presents challenges. “I would caution that while investors want to make money, they also want to know that where they are putting their money is safe,” Meenan said. “For regulators, the key is to create a framework that meets statutory and regulatory demands for robustness, but remains practical enough to allow a vibrant commercial operation.”

Given their access to deal and investor information, hedge fund managers are ready targets of cyberthreats. Breaches at the fund level can shake investor confidence and affect a firm’s ability to raise funds. Hedge funds are expected to make cybersecurity an ongoing process that is part of their business strategy and risk management policies, even weaving it into the diligence process.

SSAE 18
Kristina Vieni, Grant Thornton Advisory Services managing director specializing in technology for financial services companies, reminds her clients that the Statement on Standards for Attestation Engagements (SSAE) No. 18 goes into effect May 2017, replacing SSAE 16. These updated standards require asset managers to have greater vigilance regarding risk assessment of third-party technology providers.

“Virtually all asset managers are leveraging outsourced technology providers to help manage noncore capabilities,” she said. “Asset managers are responsible for the oversight of these external providers, which include prime brokerage and administrators of the books and records. They need to insist on Service Organization Controls 1 and 2 reports from these providers, and assess the risks that may impact them.”
Conclusion

As lower fees reshape the industry, each hedge fund will have to decide how it fits into the consolidation story: Will it acquire and grow, or be acquired and realize its accrued value? Funds that opt for the status quo will need to assess their unique value proposition in the changing landscape.

Those funds that survive in the new era will have to offer hybrid models that combine the best of traditional and alternative investment management. Those that succeed will shape products that will appeal to growing investor bases worldwide.

The leading funds will have to be selective in deciding which companies to acquire as they expand nonorganically at home and abroad. They will also need to address their cost bases, and partner effectively with service providers and fintech specialists. When they have created all these positive circumstances for their businesses, they will have more time and resources to service global clients of all shapes and sizes. Finally, as they venture into new markets they will need to factor in compliance and containing the growing threat of cybercrime, while also being diligent about costs.

With the right internal processes and systems in place, hedge funds that present new and existing investors with a transparent and credible new fund proposition will have every chance of leading the charge into this exciting new era for the industry.
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