FORESIGHT IS 20:20

The hedge fund landscape remains as dynamic as ever as firms adapt to the changing demands of clients. Leanne Golding and Kevin Huys of Harbour examine some of the key trends likely to shape the industry in 2020 and beyond.

The growth and maturation of the hedge fund industry is well documented and has been examined in many articles over the years. As we approach the next decade, it is useful to consider the topics and trends that are likely to have a significant impact on the industry in 2020 and beyond.

Savvy firms are already focused on many of these topics. Whether it is investment managers changing tack to attract new capital or to improve efficiency, or investors seeking to be responsible corporate citizens, these initiatives will form part of the continued evolution of the industry in the years to come.

ESG investing

The term ESG—environmental, social and governance—has been used extensively in recent years in the context of impact investing. The environmental aspect focuses on the impact of operations on the natural environment. The social aspect focuses on a firm’s corporate culture and how it handles its personnel, including such areas as diversity and pay equity. Included with social practices are considerations of how the firm interacts with its community.

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For governance, investors evaluate the management structure and policies for transparency, conflicts of interest, and independence.

More investors are beginning to expand their focus to traditional hedge funds and demand that their investment managers and their service providers have ESG practices in place. A May 2018 survey of 80 hedge fund managers by the Alternative Investment Management Association (AIMA) found that more than 10 percent of the surveyed investment managers had committed to an ESG strategy.

The same survey found that in the preceding 12 months, the investment managers had seen a 50 percent increase in demand for ESG strategies from current and prospective investors.

Everyone in the industry is well acquainted with operational due diligence (ODD) reviews of hedge funds and their service providers. Going forward, it is expected that more and more ODD teams will be asking about ESG practices as part of their reviews, or even conducting separate ESG assessments. To be prepared, managers should consider the following:

Policies: does your firm have established policies in relation to diversity, and have you undertaken a review of compensation packages to ensure are they are equitable and in line with your policies on diversity and equality?

Infrastructure: have you chosen to operate from a Leadership in Energy and Environmental Design-approved building or to use an alternative energy source? What is your firm's environmental impact?

Vendors: are you choosing to partner with vendors who are also committed to ESG and asking them the same questions that investors are asking you?

Community involvement: does your firm support local community initiatives and charities? Do you encourage and provide opportunities for staff to give back to the community?

Governance: does your firm have appropriate policies in place to govern its operations? Do your service providers have equivalent policies? Are the policies well known to your staff, has adequate training been provided, and are there appropriate systems for grievances to be heard?

Implementing ESG practices should not require wholesale change. Not only will it make you more investible, but it is likely to make your firm a more desirable place to work and improve staff morale and productivity. You may also get a warm feeling inside for making the world a better place.

Outsourcing

The practice of outsourcing has been building for many years in the hedge fund industry. For emerging managers it is often an important component of their operations and an effective strategy for managing costs in their initial years.

Large, established managers are also re-evaluating their operations and looking to outsource functions as an option to increase efficiencies. In January 2019, Bridgewater Associates announced they will outsource significant parts of their human resources, recruiting and finance processes, and we expect this trend to continue to grow.

Whereas in the past most outsourced functions were eventually brought in-house, some emerging managers today may be reluctant to graduate from their outsourced structures, as the benefits of

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allowing some of that operational infrastructure to remain outside the investment manager’s direct operations often outweigh any perceived inconvenience or risk.

As investment managers and their funds grow, determining when to shift to new outsourcing service providers or when to bring components of their operations back in-house will become crucial business decisions.

While the practice of outsourcing has become widely accepted, a high level of oversight by the manager and fund directors is still required. In most instances, although the tasks have been delegated, the ultimate responsibility remains with the manager or the directors—those charged with governance cannot delegate away their responsibility.

Frequent and robust reporting from the outsourced providers is required to ensure that appropriate oversight is maintained. Managers and directors should also carefully consider whether within their delegation they are also placing a reliance on the outsourced provider to fulfil the requirements of a law or regulation. If that is the case, they must document the regulatory status and complete periodic reviews to confirm continued compliance.

Service agreements must also be clear on the tasks and roles that are being outsourced.

Fee flexibility and creativity

Attracting and retaining capital has become more challenging in recent years. This has placed downward pressure on fees, and resulted in greater creativity with fee offerings. The Ernst & Young 2018 Global Alternative Fund Survey found that 50 percent of the hedge fund managers surveyed were offering customised fees and liquidity terms to investors through special classes or managed accounts, up from 41 percent in 2016.

This trend will continue and result in a broad range of fee structures that are designed to cater to a diverse and demanding investor population. The possible options are limited only by the human imagination, but managers should ensure that fee arrangements result in a proper alignment of interest, and that they are easily understood and calculable to reduce the likelihood of causing a net asset value (NAV) misstatement.

It is important to consider a fee structure’s commercial appeal, the equality of fees across similarly placed investors, and the ability of the fund administrator to account for it properly.

Transparency and reporting

Customisation and creativity go beyond fund structures and their related fees. Investors today expect to be provided with thorough and informative reporting on a timely basis, and often to their precise specifications. The details of many of these specific requests are typically set out in the reporting section of a letter agreement or side letter.

Other investors prefer a separate managed account so that they have full transparency of the portfolio. When entering into reporting or transparency arrangements, managers need to consider the feasibility of what is being requested, whether they have the data points available to provide the information to investors in an accurate and timely manner, and whether such information should also be provided to other investors.

As the sophistication of investors’ data management capabilities continues to grow, managers and service providers should be evaluating and investing in technology, or seeking out third-party providers, to ensure that they are keeping pace. In the future, the inability to provide a high degree of customised reporting will cost you dearly.

Data privacy

The introduction of Europe’s General Data Protection Regulation in 2018 was a big step forward for data protection, and the trend will continue as other jurisdictions bring their data privacy laws in line.

The Cayman Islands will bring its Data Protection Law online later this year. Firms will need to carefully navigate these regulations not just in relation to investor data, but also how they obtain, store, share, and utilise all data in their daily operations. ‘Big data’ offers great potential to change the way we all do business, but with great power comes great responsibility.

Evolution of audit

The ‘big four’ audit firms have made significant investments in technology that are changing the way they conduct their audits. Firms are performing real-time testing of NAVs throughout the year which will reduce timelines at year-end, and are also automating the exchange of data with administrators.

They are also using technology to review trends or anomalies in the data, to help them focus their reviews. These technological advances will not only allow for more efficient and timely audits, but will also allow the audit firms to compile significant amounts of data from their clients. They will now be able to analyse the data outside the audit process which will allow them to identify industry trends and best practices and significantly expand the industry insights they can provide to clients.

Be prepared

These changes will affect us all in some way. Everyone needs to be prepared to look ahead, anticipate, evolve, and innovate. The critical topics we are discussing today could be replaced in six months or a year with a new set of issues and concerns. The key is to remain nimble and keep your eyes forward—as the title suggests, foresight is 20:20. ■

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