2014 Alternative investment outlook championing growth
Finding agility in uneven conditions

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One of the key attributes that has drawn investors to alternative investment managers over the years is their agility. Much like a downhill skier who needs to absorb the terrain to excel, these managers excel by navigating uneven conditions. Over the past few years though, the landscape has leveled out, with the booming stock market temporarily eroding alternative investment funds' historic competitive advantage.

A turning point is already unfolding in 2014. Institutional investors are piling into alternatives despite their recent uneven performance. These investors are attracted to the industry's long-term track record for producing non-correlated, superior risk-adjusted returns. At the same time, they are looking at alternatives through a new lens. Rather than viewing them as a separate asset class, institutional investors are increasingly deconstructing alternatives into risk and attribution themes.

How alternative investment leaders meet these demands, along with those of an ever-shifting regulatory landscape, will be a key theme to watch in 2014 as funds look to stay agile and attract more assets. Given the perennial importance of reputation in this industry, they will also need to ensure their risk management approaches mature to reflect today's increasing complexity.

The past few years have certainly been trying for most alternative investment managers; but in some critical ways, they are now in a better place as a result

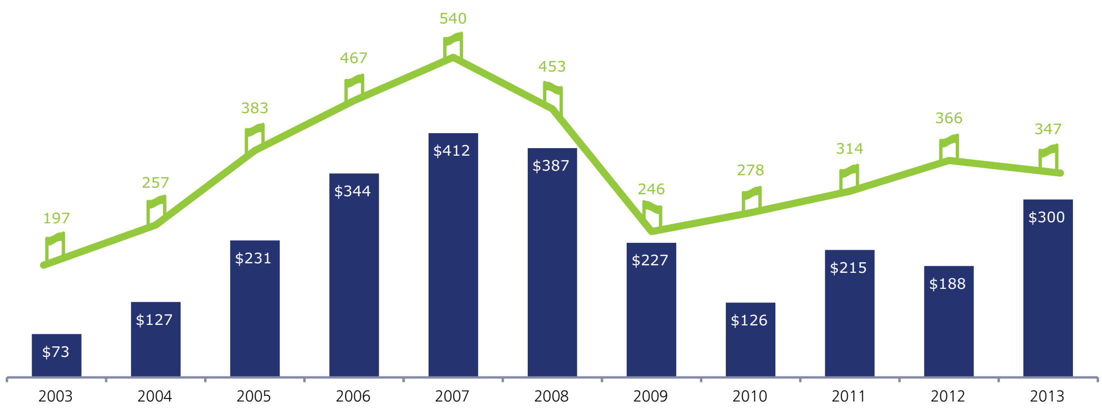
Attracting new assets with scale and differentiating strategies

In spite of a challenging investment environment and increased competition, alternative investment managers continued to raise record sums over the past year. Hedge fund assets under management (AUM) swelled to a record $2.6 trillion in 2013[1]. Not to be outdone, private equity firms staged their own rally, with fundraising reaching the highest levels since 2008 (see Figure 1)[2].

And yet, reviewing these numbers reveals great disparity. The biggest private equity funds continued to garner the most attention, with the remaining funds seeing their average new fund sizes reduced by as much as half that of previous efforts.

It was also a year of uneven performance for hedge funds, against both broader market measures and long-term trends. For the one-year period ending on 31 December 2013, the average hedge fund returned just 11%, falling short of the S&P 500 Index's 30% climb over the same period and even the 17% increase of an average balanced portfolio (60% stocks and 40% bonds) (see Figure 2).

Figure 1: Global private fundraising



Source: PitchBook

1 *Hedge Fund Research 'Hedge Fund Assets Surge to Record to Begin 2014,' press release, 21 January 2014*
2 *PitchBook, '2014 Annual U.S. Private Equity Breakdown Report,' accessed 20 January 2014*

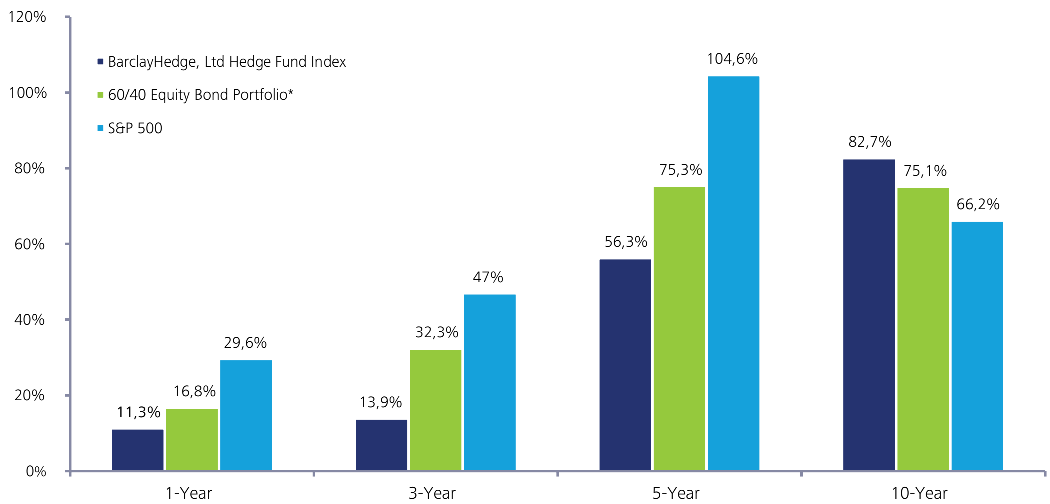
Private equity had a better story to tell after realising an almost 13% increase in capital invested last year, according to Pitchbook[3]. Even so, deal activity fell 14%[4] from 2012 and the question now is whether the industry will be able to put a record amount of dry powder to work.

Institutional investors such as pensions, foundations and endowments have stepped up their participation in hedge and private equity funds, driven by diversification mandates and drawn to the alternative investment industry's long-term track record for delivering uncorrelated, risk-adjusted returns.

Many investors remain satisfied with performance, even over the past year. For instance, 63% of institutional investors interviewed by Preqin stated hedge fund returns had met their expectations last year; another 21% said returns exceeded their expectations[5].

Figure 2: Hedge funds superior long-term performance

Hedge fund returns outperform broad market on long-term basis



Source: Source: BarclayHedge, Ltd., Bloomberg, Deloitte analysis

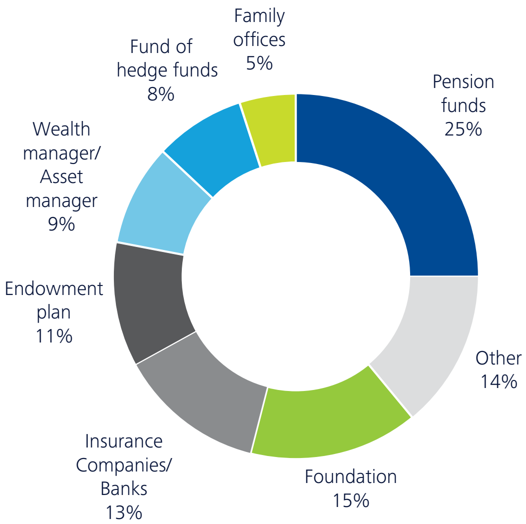
** 60% MSCI U.S. Broad Market Index and 40% Barclays U.S. Aggregate Float Adjusted Index Data as of December 31, 2013*

3 *PitchBook '2014 Annual U.S. Private Equity Breakdown Report,' accessed 20 January 2014, pitchbook.com/2014_Annual_US_PE_Breakdown_Report.html.*

4 *Pitchbook '2014 Private Equity Breakdown Report.'*

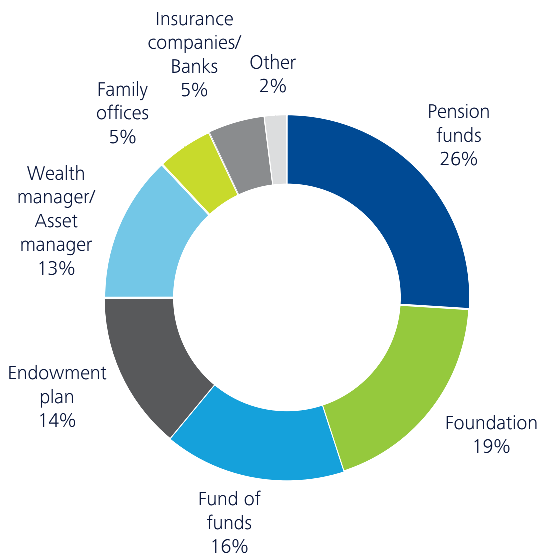
5 *Preqin, 'Preqin Survey: Investor Satisfaction with Hedge Fund Performance Is at Highest Recorded Levels,' press release, 19 December 2013.*

Figure 3: Breakdown of private equity investors



Source: Prequin

Figure 4: Breakdown of hedge fund investors



Source: Prequin

Institutional investors now represent more than half of the total capital being managed by hedge funds (see Figure 3&4),[6] and they appear poised to allocate an even higher percentage of their portfolio to alternatives going forward[7]. Sovereign wealth funds, led by Abu Dhabi and China, now occupy three of the top five slots among hedge fund investors, and four of the top ten[8]. An exciting new investor base is opening up with hedge funds poised to tap the domestic Chinese market for the first time. Recently announced in Shanghai, the Qualified Limited Domestic Partner Programme will soon allow several foreign hedge funds to raise money from institutions within China for investing overseas.

While increasing allocations by institutional investors is a more recent phenomenon for hedge funds, institutional investors have dominated private equity investing for some time; pension funds, foundations, and endowments still lead the way.

As institutional investors account for a growing share of the pie, the big alternative funds will likely continue to get bigger. Given that these investors' fiduciary responsibility makes them particularly sensitive to headline risk, they are naturally drawn to larger, well-established funds with impressive operational and compliance infrastructures.

The silver lining here is that while institutional investors allocate a majority of their assets to the largest funds, they still look to diversify a portion of their holdings in search of the occasional home run that emerging fund managers can provide. For the smaller and emerging players, the recent period of industry underperformance is turning up the heat to generate better returns and presenting windows of opportunity in a challenging fund-raising environment. According to Preqin, 81% of the largest institutional investors have invested in emerging managers, compared with 43% of all other institutional investors[9].

6 Preqin, 'Hedge Fund Spotlight,' June 2013
7 Credit Suisse Capital Services, 'Mid-Year Survey of Hedge Fund Investor Sentiment,' July 2013
8 Hedge Fund Alert, 'Top 20 Investors Contribute Mightily to Funds,' 20 November 2013
9 Preqin, 'Hedge Fund Spotlight,' May 2013

Adding more staff and manual processes to conduct such tasks is not a cost-effective, long-term solution.

'The challenges for alternative investment managers have never been greater, but the appetite for investors has never been greater either, so fund managers are feeding off that investor buzz,' said Cary Stier, head of Deloitte's Global Investment Management practice[10]

Meanwhile, smaller private equity firms continue to create a distinct value proposition for themselves by developing expertise in sector- or theme-focused investing strategies. Specific niches within healthcare, energy, technology and real estate attracted such funds' interest last year, and we suspect these areas as well as other emerging opportunities will help narrow managers' sights even more this year.

Finally, 2014 will likely see additional efforts by alternative fund managers to re-engage the retail investor base by taking their alternative investment strategies mainstream in a variety of more liquid products offered through '40 Act funds and UCIT products. AUM in liquid alternative products climbed to $279 billion as of 30 September 2013, up from $68 billion in 2008[11].

Still, it is unclear how far the industry will go in pursuit of retail clients. Many fund managers remain wary of new alternative mutual fund products fearing they will disadvantage existing investors and put their brand at risk. The costs to set up a retail platform and operations can be prohibitive, particularly when it comes to ensuring compliance with '40 Act regulations and meeting liquidity requirements. With that said, a recent Deloitte Dbriefs webcast polled industry participants and 45% indicated that they were interested in launching a mutual fund/registered product in the near future.[12]

Creating a competitive advantage through better data

As regulators and investors continue to press for earlier and more substantial reporting, the ability to leverage data quickly and in an accurate manner is becoming a competitive differentiator in the industry. Institutional investors, in particular, are no longer looking at alternative investments as a separate asset class, but instead are deconstructing them into risk and attribution themes — strategy, geography and liquidity for example — as the basis for making allocations to hedge funds and private equity funds.

This increasing demand for risk and performance attribution information is challenging investor relations teams to create tailored reports that pull data from various systems not originally designed for that purpose. In fact, investor demand for greater transparency in risk and performance was ranked among the top three drivers of change in the industry by more than half of the respondents in a State Street survey of alternative fund managers.[13] Some large investors are already making their capital commitments conditional on a fund's ability to generate this type of customised reporting as part of their due diligence on a quarterly and sometimes monthly basis going forward.

10 Stephen Foley, 'Hedge Funds Drop Fees to Win Big Investors,' The Financial Times, 12 December 2013, http://www.ft.com/home/us
11 Shelly K. Schwartz, 'Seeking Safe Havens? Analysts, Advisors Point to Liquid Alternative Funds,' CNBC.com, 24 November 2013
12 Deloitte Dbriefs webcast 'Blurring the Lines: When Retail and Alternative Investment Worlds Collide,' 15 August 2013
13 State Street Corporation 'The Next Alternative: Thriving in a New Fund Environment,' July 2013

These emerging investor requirements come at a time when alternative funds are already being pressured to respond to a litany of information requests from regulators. The key regulations affecting alternative investment managers — the Alternative Investment Fund Managers Directive, the Foreign Account Tax Compliance Act, Form PF and Form PQR — all require data-centric solutions. Looking ahead, over-the-counter derivatives reform and new limits imposed by Dodd-Frank on bank proprietary trading and sponsorship of hedge funds and private equity funds will likely have significant implications for data collection and reporting.

In meeting these diverse demands, fund leaders are discovering that extracting and integrating existing data into the required format is time-consuming and fraught with regulatory and operational risk. One key sticking point is that not all of the information required to meet these compliance demands comes from internal sources. Much of it will need to be provided by fund administrators, prime brokers, or other third-party vendors and that data will need to be retrieved and normalised. Adding more staff and manual processes to conduct such tasks is not a cost-effective, long-term solution.

Instead, leading fund managers have proactively spent the past few years investing in a comprehensive data strategy that wraps in data warehousing and advanced data modeling, with some making room for a chief data officer in the C-Suite to set and run the technology agenda. The potential rewards from harmonising this information into a single data platform are significant, not just in using it to grant greater transparency, but also to be a solution provider by creating customised client solutions. Leading alternative investment managers are already reverse-engineering investment offerings based on their clients' unique obligations to their own investors, and more managers will likely follow suit in 2014, making customisation a major theme.

'Data is the hottest topic by far,' said Ellen Schubert, a senior advisor in Deloitte's Hedge Fund practice. *'Every meeting I go into right now is about data — the amount of data that hedge funds have to retain, manage, manipulate and massage for their portfolio managers, their investors, their regulators and the entire company.'*[14]

14 Hedge Fund Alert, 'Survey: No End in Sight for Industry Growth,' 8 January 2014

In the year ahead, effective data management will be just as important for identifying new return opportunities as it will be for keeping investors and regulators happy. Leading private equity firms are already employing technology solutions to help track their portfolio companies on a real-time basis in a single place. Greater visibility into portfolio companies' operations is helping managers identify ways to help run the companies more efficiently, maximise the amount of cash they generate, and increase their exit value.

Meanwhile, hedge fund managers are increasingly relying on real-time data to make trading decisions. In fact, the fastest growing hedge fund strategy over the past five years has been 'quantitative' trading, including market-neutral, statistical arbitrage as well as high-frequency strategies. But there are also opportunities for more traditional managers to crunch data to improve their performance.

Managing external relationships and reputational risks

As investors and regulators increase their focus on risk management, alternative investment managers are working harder to gain a more holistic view of risk. With so much at stake from a reputational standpoint, they cannot afford to let key risks go undetected. As a group, the global financial services industry clearly understands this —a full 94% of industry respondents in a global risk management survey Deloitte conducted last summer[15] said their executive management teams are spending more time on the oversight of risk compared to five years ago.

Given the fee pressure that continues to reign over the industry, we expect to see hedge fund and private equity leaders being more strategic about identifying and weighing risks when deciding where to allocate resources. Risk-based resourcing models, which measure an organisation's exposure to a wide range of risks and identify the optimal resources for managing those risks, are being used by more firms as they investigate new product offerings and geographies.

These increasingly sophisticated approaches for balancing growth with risk and control will be particularly useful as alternative investment leaders explore new distribution avenues, such as more liquid products targeting retail investors. Another area where alternative investment leaders will need to be vigilant is the added risk associated with extending the organisation to a wider range of external service providers, from fund administrators to third-party solutions accessed through the 'cloud'. Even when sufficient resources are available, some fund leaders will still prefer to turn to capable service providers so they can focus on their core competency of generating investment returns.

To date, hedge funds have been more likely adopters of outsourcing, mainly due to the fact that the use of independent administrators was all but mandated in the wake of the financial crisis. However, private equity managers are increasingly adopters of outsourcing as the cost and complexity of their internal infrastructure is forcing chief financial officers to look to third-party capabilities as an option. As it is no longer acceptable for general partners to calculate their fund net asset value in-house, private equity firms are continuing to explore the optimal level of control over their books and records through different shadow accounting techniques.

15 Deloitte, 'Global Risk Management Survey, Eighth Edition,' July, 2013

'Cyber education can start with simple questions, such as who would want your information and why do they want it,' said Mary Galligan, a director with Deloitte & Touche LLP's Security & Privacy practice and former FBI special agent in charge of cyber and special operations. *'It's important for alternative investment managers to start with a clear understanding of their vulnerabilities to make risk management and mitigation more informed.'*[16]

Outsourcing regulatory compliance is still a touchy subject for many funds given the loss of control and increased risk that it brings without the ability to discharge the ultimate responsibility. However, outsourcing certain components of regulatory compliance, such as regulatory reporting, annual compliance reviews and personal trading, can help funds achieve capabilities within the industry that prevent them from becoming an outlier, an important consideration when regulatory requirements are in a constant state of flux.

By nature, these extended relationships are exposing fund managers to new or increased risks. These threats include potential business disruption, regulatory breaches, counterparty credit risk, service failure and the theft or inadvertent dissemination of personal identification information or intellectual property. Given the reputational harm and financial impact that can be inflicted when these risks turn into full-blown crises, it will be critical for fund managers to continue to fine-tune their risk management approaches and stay on top of emerging threats.

A critical component of these risk reviews pertains to cyber preparedness. Alternative investment funds have in recent years increased their focus on protecting against internal threats and building safeguards around IT infrastructure, and these efforts are paying off. With that said, there is still room for improvement, as alternative investment managers should understand that the hacker community is smart, big, nimble and usually a step ahead of risk prevention efforts.

At the same time, the extension of the enterprise to outside partners requires that fund managers expand the scope of these efforts and recognise that cybersecurity is not just an IT issue, but an enterprise risk issue that extends to its vendor relationships. As hedge funds and private equity funds expand their network of third-party providers, cyber risk should be a key component of supplier risk reviews. This goes not just for the obvious candidates such as plan administrators and prime brokers, but for technology, research, sales and marketing partners as well. Industry leaders should be sure to review that each vendor has adequate security controls in place and maintains an internal incident response team whose mitigation plans account for third-party cyber breaches.

16 Mary Galligan, 'Deloitte's Alternative Investment Symposium' (panel discussion, The New York Public Library, New York, NY, 21 November 2013)

Conclusion

The past few years have certainly been trying for most alternative investment managers; but in some critical ways, they are now in a better place as a result. The increasing regulatory burden may have been a distraction, but the infrastructure investments made by firms to manage regulations have strengthened their organisations to become more efficient and better able to respond to investor demands. Private equity funds finally appear poised to put more of their dry powder to work, even if they have to set their sights on smaller deals. Hedge funds are embracing change in different ways by testing new strategies, geographies and distribution channels. The overarching story is no longer one of capitulation — but of growth. And that's a story we believe leading and emerging fund managers will enjoy telling this time next year.

To the **point**:

- Institutional investors are likely to allocate a higher percentage of their portfolio to alternative investments going forward
- More alternative investment funds will likely go mainstream to pursue retail clients through '40 Act funds and UCITS
- Alternative investment funds are looking to harmonise information into a single data platform to create greater transparency and customised client solutions
- More alternative investment funds will invest in a comprehensive data strategy that wraps in data warehousing and advanced data modeling
- More alternative investment funds are establishing service provider oversight frameworks to better manage their extended enterprise
- Alternative investment managers will take a more vigilant approach to cyber preparedness and establish an incident response team for cyber breaches