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Deloitte 2018 Hedge Fund Symposium Executive Summary

Constellation of opportunities | Navigating to true north

Contents

Introduction	**3**
2020 foresight	**4**
Data assets	**7**
Man + machine	**10**
Looking ahead	**13**

Introduction

Ten years ago, we launched the Hedge Fund Symposium for a singular purpose: to provide an update to the industry on matters related to audit and tax. That limited focus didn't last long. At our clients' urging, we started expanding the agenda to make it more business-oriented and cover an increasing list of front-burner issues, from addressing fee pressure and generating alpha in dire markets, to landing and retaining top talent, and making game-changing technology investments.

Over the years, the symposium has transformed into a checkpoint for industry participants looking to either confirm their current course or chart a new one. These days, it can seem like true north is in a hundred different directions, as every star looks like a beacon. We believe that by bringing together some of the industry's smartest people, we can hone our collective vision and spot the trail markers. Deloitte's 10th annual Hedge Fund Symposium was particularly illuminating on a few critical fronts, including the likely track of the economy over the coming 24 months, the future of data in investment decision-making, and changing talent needs in an increasingly competitive marketplace. The following summary report captures some of the insights from those candid conversations, and we hope they prove useful as you seek to find your own path in the coming year.

Sincerely,

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2020 foresight

After years of concern about downside protection, investors finally needed it in 2018 as the bull market for stocks faced its first real hurdle in a long while. February brought the first market decline in 11 months. Then came October, which dealt equity investors their worst month for performance since September 2011. The market's decline was the backdrop for the 10th annual Deloitte Hedge Fund Symposium, and served as both a cautionary note and a source of optimism among the participants.

On the former front, evidence is growing that the boost in growth the economy has enjoyed this year is at least partially due to temporary factors caused by the massive amount of fiscal stimulus injected over the past year. Danny Bachman, US Economic Forecaster for Deloitte Insights and a member of *The Wall Street Journal*'s panel of economists, said that government policy—including the recent tax cut and spending from the budget agreement—has lifted gross domestic product recently, but will likely subtract from growth by late 2019 and into 2020. Add in the prospect of additional Federal Reserve interest rate hikes and a possible chill in investment caused by the ongoing US trade war with China, and the outlook is starting to darken.

"The year 2020 problem is starting to loom large," Bachman said. "Two months ago the probability of recession in the next five years was about 15 percent and now it's up to 25 percent. And the most likely year for it to happen is 2020 because that's when the economy could be at its most vulnerable."

The US midterm elections might not provide much relief. Though prominent legislators have pledged to make some US tax reform temporary provisions permanent, they are unlikely to be fixed in the "lame-duck session" after the November 6 elections and might be challenging even when Congress returns in full in 2019, said Jeff Kummer, managing director for Tax Policy at Deloitte Tax LLP in Washington. "House Republican departures are coming fast and furious," he said. "Midterms always historically have been tough on the President's party. Divided government is a real possibility." As we now know, we will have a divided Congress.

All of this uncertainty continues to make hedge funds a favored outlet for investors' capital. Hedge fund assets climbed to a record $3.24 trillion by the end of June, and the number of hedge fund closures dropped to a level not seen since before the global financial crisis. According to a recent Bank of America Merrill Lynch Fund Manager survey, the increase in market volatility has investors clearly spooked, with the number of investors who are bearish on global growth reaching a 10-year high.

Some of the speakers at this year's event said the investing environment over the next 12 to 24 months is shaping up to be one in which the hedge fund industry has done historically well. "The current environment sets up well for hedge funds," said the CEO of a large aggregator of hedge funds. "There's a lot more volatility as rates go up. And that's going to put pressure on other assets. When the market goes up every year for five, six, seven straight years as it has, people tend to forget that they need risk control and diversification."

But after some high-profile lapses by hedge funds during the market tumult of October, the onus will be on the industry to show it can generate differentiated returns. In recent years, some of the industry's better performers have turned to private credit opportunities as banks bowed out amid increasing liquidity requirements and other regulations. At least one symposium speaker saw the same kind of promise in the blockchain, with its power to disintermediate markets like fine art and collectibles.

The CEO from the fund of funds firm said that offering direct trading resulted from "listening to our clients and giving them what they want." His firm started by co-investing with others but soon began to recruit hedge fund talent so it could generate its own ideas to pitch to direct investing clients, turning it into a $16 billion platform. It also took general partner stakes in alternative managers that appeared on their way to "real institutionalization" and needed help cleaning up their capital structures. "It's really hard to out-trade the market," the CEO said. "We try to think about the market differently."

Increasingly, that kind of thinking is leading industry players to the same destination: alternative data.

Data assets


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Data assets

It's one thing to see data as the great differentiator, and quite another to find what's useful. The markets are awash in data and more information is being created every minute. In fact, 90 percent of the data in the world was generated over the past two years. Hedge funds show a wide degree of separation in turning data into actionable investing strategies. For years, quant funds have led the pack, but the rest of the industry is a "mixed bag," said one hedge fund representative on the symposium's data-focused panel.

"It's too easy to get dazzled by the proliferation of data and forget what you are trying to accomplish," he said. "Most times, it's garbage in and garbage out. You need to always remember the business problem you are trying to solve." He cited weather data as a good example. On its own, it's interesting

but not particularly useful. But when paired with satellite images of parking lots before and after hurricanes, you can get a sense of how retailers are doing.

With everyone turning to data, much of it is quickly becoming table stakes and some of the early gains have already been had. The industry has transitioned from market data pulled directly from trading terminals to market-plus data—think credit card transactions as a proxy for specific categories of sales or Internet searches around unemployment ahead of the monthly jobs figures. And now we're entering the landscape of "truly differentiated data that's not commercially available and is still very difficult to find," said one participant on the panel.

And much of it is proprietary. Consumer companies have led the data revolution and readily shared it in attempts to win more advertising dollars. But industrials, health care providers, and others in the value chain are now trying to wrap their heads around the challenge and opportunity. The global director of content and technology solutions for a large financial data provider talks to a lot of corporate clients who are thinking about monetizing their data to create new streams of revenue. With the number of connected devices exploding thanks to the Internet of Things, this new wave of data is "going to make the readily available standardized subscription products look like table stakes," he said.

The head of proprietary research at a large hedge fund manager predicted that in 10 years' time data will start being actively traded on exchanges like stocks. "There are people in this industry who are actually seriously talking about it and thinking about data as a distinct asset class," he said.

One big question that is emerging is around the quality and authentication of data. The industry has always performed extensive due diligence and had rigid requirements on other firms and providers it partners with. But many data providers are fairly new and founded by entrepreneurs without much of a track record. One product manager for a large Wall Street bank said investment firms that are serious about capitalizing data have to protect themselves. "If you don't have standards for the data assets you buy then you are destined to fail," he said.

The panelists agreed that firms can perform initial screens by asking two questions: "Do they own the data and are they allowed to sell it?" The director from the financial data firm said his company has turned the vetting of data providers into a service that it provides to corporate clients. "We require institutional quality," he said. "Some prove not to be ready."

Another challenge, particularly for custodial banks, is finding the right infrastructure for analyzing the data. Advances in cloud computing have enabled companies to turn to outsourced data centers that grant access to 100 CPUs just one day out of every month. "The processing power you have available to you today through the cloud is staggering," said one panelist. But privacy concerns loom large. "It's an industry mind-set and it's probably going to lead to a hybrid solution for the mega banks."

Man + machine

In some ways, alternative data are just the latest evolution in investment research. Instead of having someone sit in a chain eatery to see how much traffic has been hurt by an e-coli scare, fund teams can now employ credit card transactions and geolocation data to be more precise about it. But no matter how good your data are, you still need the right capabilities in-house to turn them into alpha.

"We talk a lot about data, but it's just research using data as an input, right?" asked one speaker from the industry. "We're believers that this movement will be about man plus machine. We don't think this will be a fully automated process. That means you still need to have the right process and people to make sense of it, and there are big challenges inherent with that."

For starters, this next chapter in the industry's evolution requires a new breed of talent. Data science is becoming a key job requirement, along with the ability to program and be creative. "You still have to have a finance orientation, but you can learn that," said the representative of the market data firm. "With data, the big limitation is talent that has data science capabilities." Indeed, few occupations in the economy are in such hot demand. Job postings for data scientists rose as much as 75 percent between 2015 and 2018 at some job-search sites, and data science PhDs now command starting salaries of $300,000 or more. That means hedge funds and other investment managers are increasingly battling for top talent with some of the nation's biggest technology players.

"Amazon and Google have a big presence here in New York," said the CEO of a large asset manager based in Manhattan. "We don't classify them as competitors but at some point they could be." In response, his company has tried new approaches, such as recruiting at schools they didn't consider before. And to help retain talent, they're thinking of new ways to compensate and incentivize star employees with the right skills, he said.

Using cognitive computing analysis from a recent survey of 16,700 data scientists, Deloitte found other steps—such as shielding data scientists from office politics, keeping their compensation on an upward trajectory, and providing access to their field's latest tools and techniques—also proved successful in keeping them from bolting for other employers.

Industry participants are also waking up to the reality that they need help in the C-suite for dealing with the intersection of technology and talent. Even some large asset managers are just now adding their first chief technology officers to help direct their growing stable of programmers and ensure they are asking the right questions when it comes to technology solutions. "Our ability to build great technology and to use information in a constructive way is an untapped, nascent advantage that's going to be really important for us over the next five years," said the CEO of a large asset manager that just hired a CTO.

As one generation makes room for the next, leadership succession is also finally starting to get the attention it deserves, said Joe Fisher, a partner at Deloitte & Touche LLP and the Audit leader of its US Investment Management practice. "Roughly 25 percent of alternative asset management founders are over the age of 65, and approximately 42 percent are between the ages of 55 and 65," Fisher said. "This has propelled many large alternative asset managers to unveil their succession plan."

One CEO who recently took the helm of his asset management company said his transition was five to seven years in the making. When it comes to eventually helping to name his successor, he said he would be looking for candidates with broad exposure to the business and the client base. "They need to have a good feel for how everything works," he said. He said he's also benefiting from having continued access to the firm founder he replaced.

"The last thing you want to do is surprise your LPs or your employees," he said. "Succession isn't a big-bang event. It's a multi-year process, at least if you really want to do it right."

Looking ahead

Looking ahead

No matter what the economy or financial markets bring in the coming year, hedge fund leaders will need to continue to prove their worth. The symposium series has taught us that value resides not just in the strong performance the industry has historically generated, but also meeting the widely expanding needs of an increasingly heterogeneous class of investors. With those pressures unlikely to alleviate anytime soon, hedge fund firms will need to pick their paths carefully. The integration of technology and talent will likely play a preeminent role in addressing those challenges, and firms both established and emerging will need to find the right balance.

The industry faces many challenges which will require the ability to adapt, but we believe the best days are ahead. Those leading the charge these days share a rare blend of resources, intellect, and curiosity. That's a powerful combination for managing this unprecedented period of change, and we have no doubt it will propel our industry forward.

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