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Deloitte 2017 Hedge Fund Symposium
Look deeper | From obvious to opportunity

Contents

	Introduction	3
	An industry regenerates	4
	Multiple paths to differentiated performance	7
	The emerging role and risks of alternative data	11



Final IMageThink graphic artwork capturing the content of the Symposium.



Deloitte.

HEDGE FUND SYMPOSIUM

ImageThink

Introduction

“As long as the business is growing, you don’t need to change anything.” There is good reason you will not find this quote in the pages of any annual reports or business school tomes.

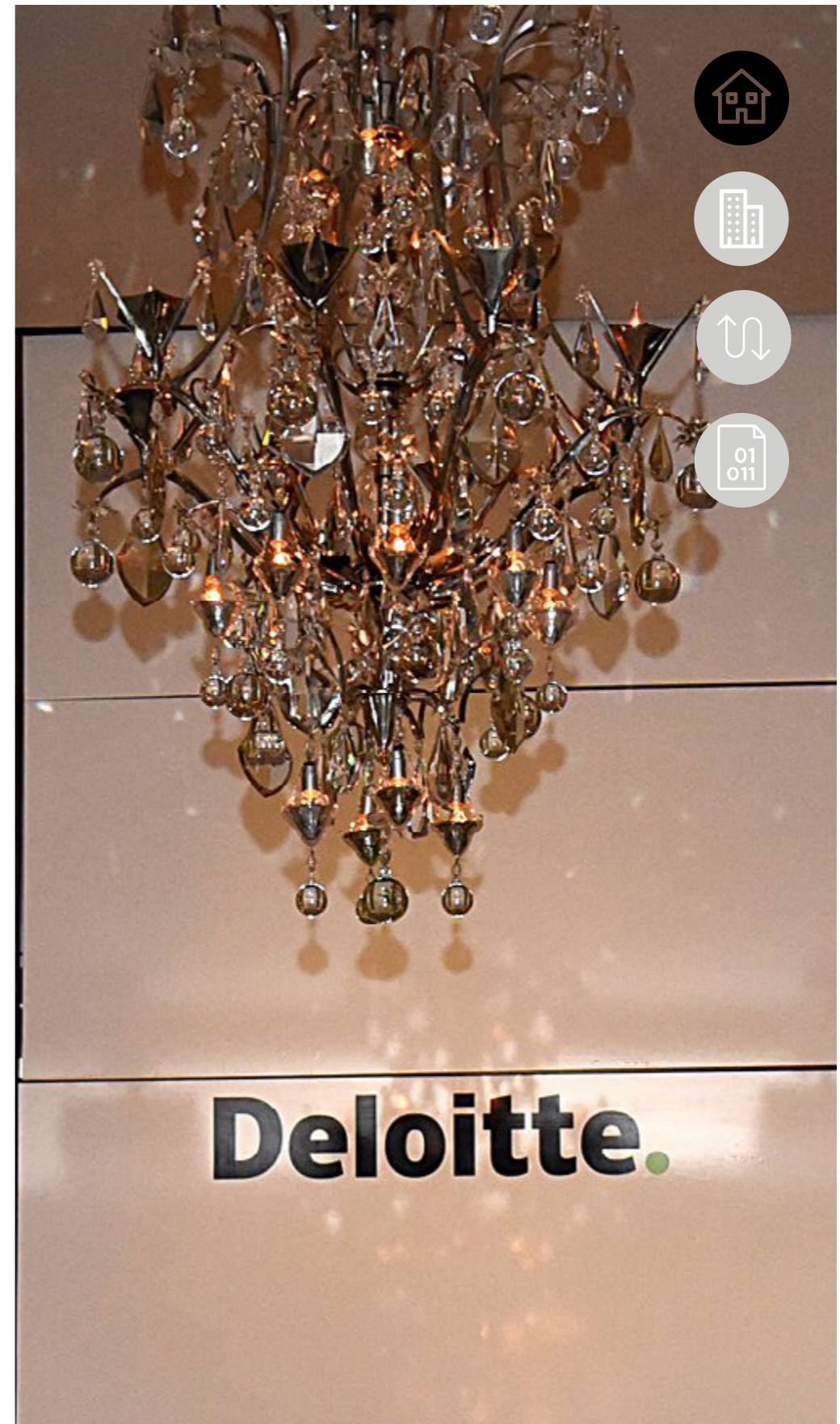
That is because visionary business leaders are constantly thinking about what is coming next—a shift in the market for their goods and services, a new source of competition, or a resource constraint that could derail their plans.

When it comes to those who run hedge funds today, the worry list is both exhaustive and expanding. A broad-based investor shift away from active management to low-cost passive alternatives, a prolonged period of underperformance, a proliferation

of alternative data that offers both risks and rewards, a looming succession crisis at many legacy funds—these are just a smattering of the issues the industry is trying to get ahead of these days, even as assets under management (AUM) continue to climb to new heights.

Deloitte’s Ninth Annual Hedge Fund Symposium gave attendees the opportunity to discuss these pressure points and share some antidotes that are bringing relief. As in years past, the discussion spanned many dimensions of operating success, from product differentiation and distribution strategies to technology advances and talent acquisition. As usual, the candid conversations revealed triumphs worth emulating and missteps to avoid. This summary report is our annual effort to encapsulate some of the greatest insights from the Symposium. It is our hope the event and the insights it brings spark some proactive and provocative interactions inside your own firms—and ultimately helps the industry own its future as well as its past.

The 2017 Hedge Fund Symposium was held once again at The Rainbow Room—an iconic venue overlooking the Manhattan skyline.



An industry regenerates

Joseph Fisher, Deloitte's US Investment Management Audit leader, provides insights to the hedge fund industry leaders in attendance. ✓



In a year that was chock-full of headlines, the hedge fund industry's rebound did not get much ink.

Managers who survived 2016—marked by the closure of more than 1,000 funds—were charged in 2017 with stemming the tide of investor outflows. These outflows were brought on by both a persistent bull market that made alpha scarce, as well as a broad investor shift into low-cost passive funds that put further pressure on margins. Indeed, the tide started to turn early in the year as the resumption of positive returns helped attract new capital. By the third quarter of 2017, industry AUM had topped \$3.6 trillion, and the pace of fund closures had slowed.

As Deloitte's 2017 Hedge Fund Symposium got underway, attendees were for the most part cautiously optimistic about the near-term outlook. Responding to a live online poll shared through the Symposium's event app, more than a third of the attendees said they were bullish about the outlook for 2018, expecting continued asset growth with new emerging managers entering the industry. Another 40 percent said they expected the industry to hold the line on AUM in the coming year, even as pressures persisted.



An industry regenerates

One trend working in the industry's favor is the combination of higher interest rates and central bank deleveraging, said the CEO of a multibillion-dollar fund-of-funds investment management firm. Near-zero rates in the wake of the global recession created distortions across assets and forced investors to chase yield wherever they could get it. "It was a huge hit for the hedge fund world, but now that's starting to reverse," he said. "It's not an overnight process, but rates are starting to go up, the central banks are deleveraging, and that's a great opportunity for hedge funds."

"The fact that the industry proved so resilient during this difficult time and still reached peak assets is very exciting."

CEO of a multibillion-dollar fund-of-funds investment management firm

Economic and marketplace forces are creating an environment conducive for the rejuvenation of the hedge fund industry. ➤



An industry regenerates

Not all in the room shared such positive sentiments. Nearly a quarter of those responding to the first polling question characterized the outlook as bearish, with larger managers losing assets to other sectors and smaller firms continuing to shut their doors. To be sure, downward pressure on fees continues to squeeze most industry participants. A Casey Quirk by Deloitte analysis of hedge fund managers released earlier in 2017 found that 64 percent of those surveyed reported a decline in their fees over the past three years, with only 32 percent saying fees have remained constant and 5 percent citing an increase. The same study projected that investment management operating margins would shrink from 31 percent to 20 percent over the next five years, if recent historical trends hold.

Better performance will clearly help funds combat such trends: The Casey Quirk by Deloitte study found that the top quartile

of performers has been less susceptible to fee erosion. But in the midst of a broad and prolonged slump of underperformance across the industry, some hedge funds are experimenting with different ways to break from the industry's traditional 2-and-20 model, with some going as far as zero percent performance fees. "Either the fees have to come down or everyone's expectations have to come down," said the president of a New York-based credit hedge fund. "Realistically, the number of hedge funds will continue to shrink."

Some in attendance expressed a belief that such a shakeout would create a healthier environment for those who survive. They pointed to the fact that, even during its recent woes, the industry was still able to attract more capital. If that is going to continue, then investors need to see the industry responding not just to their fee demands, but also to digging deeper to deliver on their unique needs.

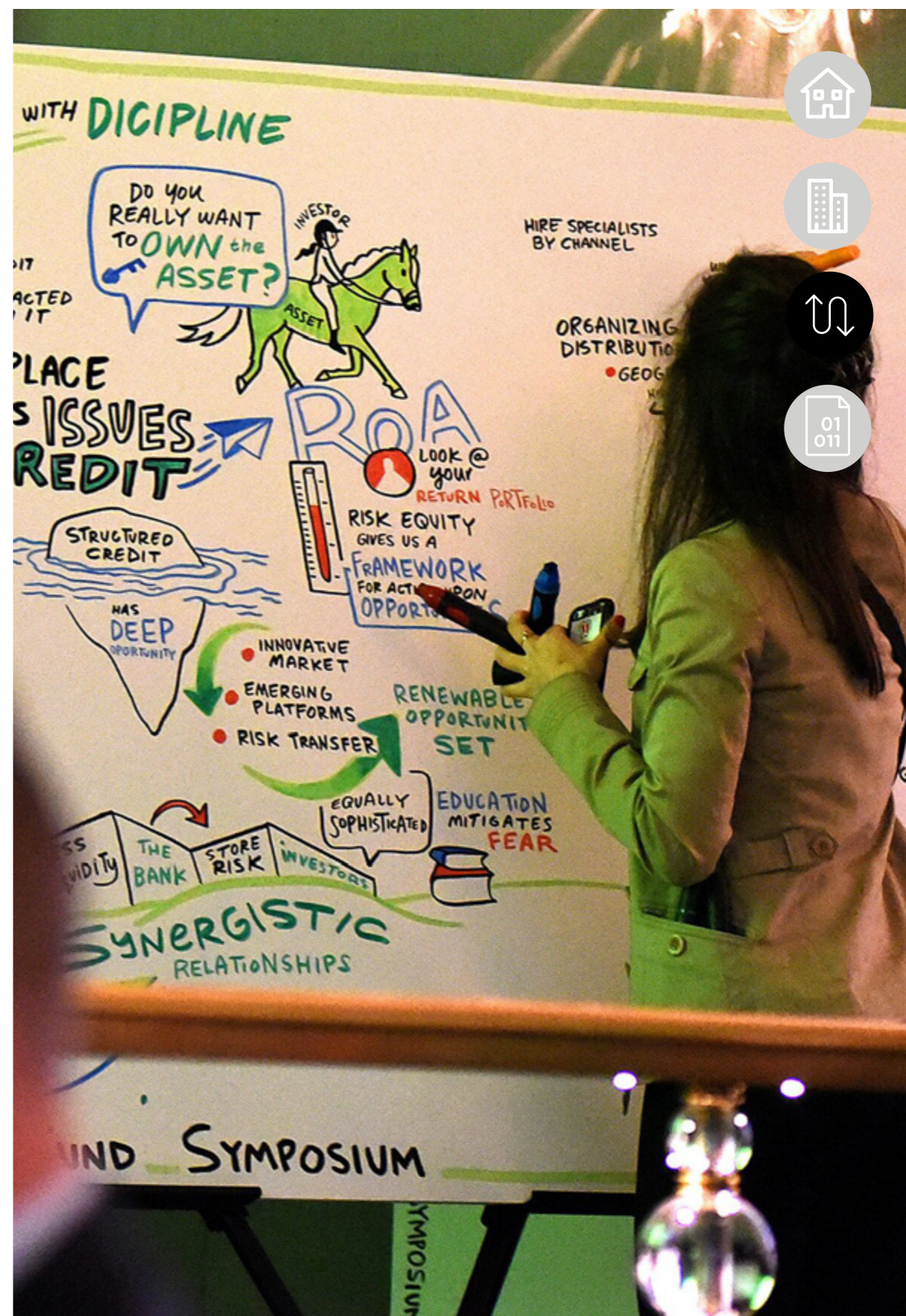
"More and more of the underperforming hedge funds are closing, and it's really shaking up the industry, but other firms are going to be in a great position to take advantage," said one senior vice president with a multibillion-dollar investment management firm.



Multiple paths to differentiated performance

So how best to take advantage? One tack may be geographic. As traditional hedge fund products fall out of favor in the United States and Europe, rapid wealth creation in Asia and Latin America may provide new sources of capital. But many speakers iterated over the course of the Symposium that hedge funds need to embrace innovation and differentiation unless they want a return to the outflows experienced during 2016. "It's an atmosphere that rewards innovation and differentiation," said Joe Fisher, investment management leader of Deloitte's Audit and Assurance practice.

ImageThink's graphic artist creates visual notes throughout the day from the Symposium conversations. ▶



Multiple paths to differentiated performance

Varying options to drive growth in a challenging market environment were discussed at the Symposium. ✓



Casey Quirk by Deloitte Managing Principal Yariv Itah said there are three main factors that will set apart the hedge funds of the future: new capabilities, robust distribution, and/or business leadership and alignment. “The places where the clients are—where the growth is—have changed,” Itah said.

“Buyers are increasingly seeking alternatives to traditional hedge fund products, and tomorrow’s winners must retool to succeed.”

New capabilities include product development and innovation, but also superior product management—including the ability to be disciplined and close a product that is not working. Some stressed the need for scale to offer a broad menu of options for investors. Others highlighted successes that managers of new funds realized in getting off the ground quickly by tapping their track records and existing clients to launch funds with different strategies, such as distressed credit. Another example was provided in the form of drawdown vehicles, which some funds are using to set cash aside and deploy it for new opportunities in the future.

“The most successful fundamental managers out there today are the ones

that are diversifying their business,” said a longtime hedge fund leader focused on investor relations.

They are also increasingly working with a broader array of partners to identify new opportunities. The CEO of the multibillion-dollar fund-of-funds firm said he regularly works with outside managers to identify the best ideas for co-investment in “supersized funds of one.” “It’s a way to create higher alpha at a lower fee,” he said.

Hedge funds have always been good at taking advantage of large dislocations in the financial markets, and some said they see the industry doing the same now with regulatory changes that are challenging many in the financial services business.



Multiple paths to differentiated performance

Technology and talent were focus areas for several panelists while discussing investments hedge funds are making for the future. ✓



Banks now are beholden to stricter capital and liquidity controls, creating “compelling opportunities across the capital structure,” one panelist said. Credit funds, which “didn’t really exist pre-crisis,” according to one such fund manager, are filling the void. “Now it’s one of the more established alternative asset classes,” he said.

“Banks were forced into the moving business, so now we’re in the storage business,” said the chief investment officer of a credit-focused hedge fund. “Investors started realizing this was a differentiated, scalable, and repeatable strategy with a constantly renewable opportunity set.”

When it comes to distribution, more hedge funds are investing behind their brand after years of purposefully staying out of the spotlight, according to several panelists focused on business development. Many are finding this is easier said than done, given that different groups of investors require varying levels of sophistication in terms of communications. From a resource perspective, they need both senior people who know how to talk to seasoned buyers, as well as younger team members who can be developed into client service experts over time.

Technology is also increasingly playing a role on the sales side. “Sometimes, if you’re tackling the registered investment

advisor (RIA) space, it means going after a technology solution provider to do more marketing,” said the industry consultant. “And sometimes it means actually hiring a few folks internally to go after those channels.”

Finally, business leadership and alignment was a focus of a dedicated panel on talent-related issues. Hedge fund leaders are cognizant of the generational shift they will need to engender as many industry luminaries approach retirement age. Many investors flock to hedge funds because of the people who lead them—it is a point of differentiation that is unique to each fund and one that can be lost if investors do not see the same qualities in their successors.



Multiple paths to differentiated performance

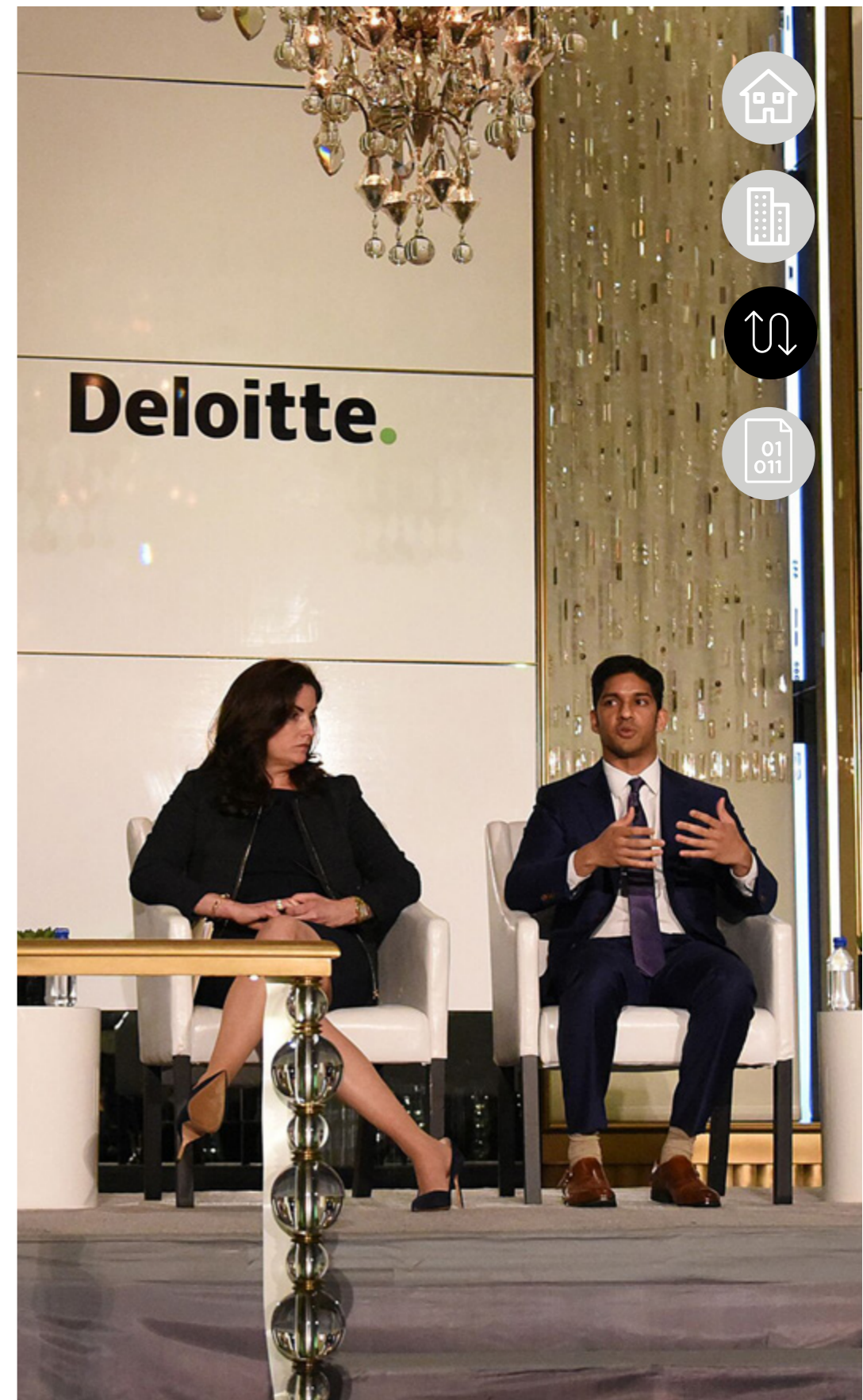
One hedge fund leader said her company is “spending a lot of time thinking about culture, and making sure younger employees are invested for long-term success.”

Issuing equity to the upcoming generation may be a viable option for more established firms, but one consultant to the industry cautioned that such an inducement can be difficult to pull off because up-and-comers typically want “a very big piece of the pie.” Instead, firm leaders might consider giving prized talent responsibilities that go beyond portfolio management and including them in the decision-making process.

The partner of a large executive recruiting firm said she worries hedge funds are not doing enough to lay a solid foundation for the future. Last year, some high-profile funds designed to promote successors closed when the star manager decided to walk away. “We keep waiting for the year that succession planning is going to be a big driver in the consulting and hedge fund space, and every year it doesn’t happen,” she said.

One hedge fund leader went so far as to predict that generational transfer problems will explain why 80 to 90 percent of today’s hedge funds will not survive. “Generational transfer is very hard,” he said. “Many of these founders have big personalities and will have a hard time passing the reins. Investors aren’t particularly accepting when the big shot leaves.” This more than suggests that hedge funds that manage this leadership transition effectively, and prove so to investors, stand to have a competitive advantage in the years ahead.

Symposium panelists discussed the incredible impact that generational transfer and transition leadership has in determining which hedge fund survive long term. ➤



Alternative data is currently being used in the war for talent at many hedge funds. ✓



The emerging role and risks of alternative data

Data has long been a valuable resource to hedge funds, particularly quant shops, but many firms are now digging deeper to mine alternative data to fuel performance and win the war for talent. In a separate live poll conducted during the Symposium, the majority of the attendees said they are already using alternative data or actively pursuing it as an opportunity.

The emerging role and risks of alternative data

One technology area that is showing much promise in this respect is natural language processing, which is allowing funds to sift for keywords among millions of websites, Twitter feeds, analyst presentations, and other digital sources. According to some estimates, the business of selling alternative data to hedge funds is booming, garnering \$200 million in investments from the industry in 2016, and on its way to doubling that figure by 2020.

Fund managers can use social information to identify which stores are gaining in popularity to adjust their holdings and get ahead of consumer sentiment. Credit card data is seeing a similar maturation, from being used to predict quarterly results to helping analyze competitive dynamics between retailers, such as inventory churn rates and consumer trends. One speaker on a panel dedicated to alternative data said he sees a “barbell approach” taking root, in which new startup funds are branding

themselves around big data and marketing their funds that way, while big traditional players are seeking out alternative data and trying to incorporate it into their existing investment process.

Advanced data analytics is also increasingly viewed by industry participants as a way to attract a new generation of talent. “There’s a tremendous war for talent, just as there’s a tremendous war for capital,” said one representative of a large investment bank. “Alternative data is helping funds differentiate themselves by showing how innovative they can be.”

But new technologies are not just a recruiting tool, they are helping to fill internal talent gaps. Typically, efforts to marshal alternative data are led by a senior analyst who is data savvy but not particularly well versed in making sense of massive amounts of information. Some hedge funds should consider “going all in” by building a data

insights project that works in conjunction with the investment team, the investment banker said. But the data scientists who serve as the backbone of such efforts are in hot demand, and in some cases it might make more sense to outsource alternative data analysis instead.

No matter which path they take, hedge fund leaders need to have their eyes wide open to the risks involved with deploying more and more data, several of the data panelists said. Such threats include the inadvertent use of nonpublic information, dissemination of personally identifiable information, making investment decisions based on fake data, and cyberattacks. The Pentagon’s research arm, the Defense Advanced Research Projects Agency (DARPA), said recently that it is working with dozens of high-speed traders, quant fund managers, and others in the financial services arena to better understand how hackers could manipulate the financial system with erroneous data.



The emerging role and risks of alternative data

Symposium attendees explore the emerging role of alternative data and the risks associated with relying on it. ✓



“You really need to investigate how you’re accessing the data, whether the entities behind it have been vetted, and how defensible it is in general,” said Prakash Santhana, a fraud and risk leader with Deloitte Advisory. “Because, at the end of the day, you will be liable.”

Some of the speakers shared their view that the technology to absorb data is developing faster than the protocols to

govern its usage. A law firm partner who has represented investment firms shared an example in which a fund trades on nonpublic information without realizing it. “The worst-case scenario for me is about the jewel in the rough that people find because they ‘met a guy and he has this data set,’” she said. “Those are the kinds of things that make me the most uneasy.”

All of this means hedge funds need to be certain they have adequate controls and procedures in place to better understand the data they are using and how they will respond in the event of an incident. Those in charge of the technology agenda also need to have checkups of the data sets their firm uses on a periodic basis because of the constantly changing nature of the quality and vulnerabilities associated with alternative data.



Look forward

With traditional asset classes appearing more and more stretched, today's market environment should be ripe for alternative investments to prosper. And yet investors are increasingly expanding their definition of "alternative" and seeking different answers than they have in the past. That means the pace of change in the hedge fund industry is only going to accelerate.

Rather than let market conditions continue to shape the competitive landscape, hedge fund leaders need to act now to properly position their firms to withstand the kinds of seismic shifts our Symposium attendees covered and continue to track. Innovation is often used strictly in a technology sense, and technology may be the answer for many. But for the industry to take ownership of its present challenges, it is going to have to embrace innovation in many forms—with new products and capabilities, distribution strategies, compensation structures, talent management, and co-investment opportunities all up for discussion. By looking deeper, it is quite possible the industry's best days are still ahead.

Data defined

Big data: High-volume, high-velocity, and/or high-variety information assets that demand cost-effective, innovative forms of information processing to enable enhanced insights, decision making, and process automation.

Alternative data: A subset of big data—typically unstructured and from a variety of sources (e.g., text, imagery, video)—used to generate alpha or inform investment decisions.

Traditional data: Regularly reported information—such as financial statements and price and volume data—that has long been used by the industry to support investment decisions.



Save the date

Deloitte's Tenth Annual Hedge Fund Symposium

October 24, 2018

New York City

Details forthcoming

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