

A low-angle, upward-looking photograph of several modern skyscrapers with glass facades. The buildings are illuminated from within, creating a warm, golden glow that contrasts with the clear blue sky. The perspective makes the buildings appear to converge towards the top of the frame, creating a sense of height and architectural grandeur.

Deloitte.

2015 Hedge Fund
Symposium Recap

An industry reaching
new heights



Foreword

When the first skyscrapers were imagined in the late 19th century, people scoffed at the idea that we could build such marvels. But one by one, engineering feats altered those perceptions, making it hard today to even imagine a city skyline without them. The same kind of innovation, brilliance, and daring that expanded the vertical bounds of our living and working spaces has extended to the hedge fund industry. The theme of Deloitte's¹ 2015 Hedge Fund Symposium, "An industry reaching new heights", provided insight into the rise of truly differentiated investment offerings that now account for more than \$3 trillion in global assets under management.²

Of course, the higher you rise, the colder it gets. In recent months, high-profile hedge fund managers have received a chilly reception from investors with lofty performance expectations of matching the industry's historically high fees. The market's torrid run over the past six years has refocused investor attention on hedge fund returns, and the late summer swoon in stocks did little to change this for some. Delivering superior risk-adjusted returns in this environment is critical, as is ensuring that investors enjoy greater transparency and tailored solutions.

It's also true that new heights bring new sights. At our 2015 Hedge Fund Symposium, we assembled a group of leaders that enjoys the kind of vantage points that only come from experience. Indeed, much of their success has been achieved by constantly adapting to new realities. It is our hope that the insights shared in this summary of their discussions will help your business address some of your challenges and infuse your strategy with fresh perspectives.

Patrick Henry

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¹"Hedge Fund Industry Sees \$76bn Net Inflow in H1 2015," Press release, Prequin, August 2015.

Focus on performance



The six-year bull market may be struggling to extend itself for at least one more year, but you probably won't find many hedge fund managers troubled over it. After all, the industry has been the subject of countless articles in recent years decrying its inability to match the market's gains, despite the fact that many of these funds are designed to provide risk-adjusted returns that suppress volatility and offer downside protection. In light of this, the market correction in August should have provided a long-awaited salve for underscoring the hedge fund industry's value proposition.

Unfortunately, that wasn't the reality for some. Investor redemptions soared at some high-profile funds after the market rout, forcing a few out of business and others to delay repayment. The founder of one major hedge fund observed that many hedge fund managers weren't hedging much at all by the time the market came under pressure this year. Instead of adding exposure to the short side of their books, they went long instead, hoping to ride the market's ascent even as valuations reached what some considered frothy levels.

"What's interesting to me is that at a time they need it most, people are abandoning one of the aspects that set hedge funds apart: the ability to go short," the hedge fund founder said. "What you end up with, in effect, is a 0.5 correlated fund on the way up and 1.0 correlated fund on the way down." The same speaker's fund, by contrast, is actively looking for the best opportunities to establish short exposure, most recently in the energy and life sciences industries. "We see short-selling as basically being in the insurance business," he said. "A good short seller will make you money in an up market or a down market."

During the course of the day at Deloitte's 2015 Hedge Fund Symposium, other participants depicted fund troubles as episodic exceptions in an industry that delivers diversification benefits and continues to attract fresh assets. Hedge fund assets under management crossed the \$3 trillion threshold early in 2015 as a result of strong

inflows of cash and solid performance. Concerns about equity valuations and tightening correlations between traditional asset classes have in part fueled the demand, but hedge funds have also made themselves more attractive to institutional investors in two ways: 1) reducing or restructuring their fees and 2) offering customized portfolio solutions.

This latter concession was something few in the industry were ready to entertain just a decade ago, when the costs of offering such tailored alternatives outweighed the benefits. In the years since, institutional investors have increased their pressure on hedge funds, to the point that customization is a must-have. "Ten years ago, there was no way we could offer it for clients with less than \$50 million in assets, whereas today we offer it for those with \$20 million," said a managing director from the asset management division of a multinational bank. "There's definitely more pressure on the industry on customizing and less freedom to say no."

Increasingly, those relationships are going the non-discretionary route, with the institutional client looking to take more ownership over investing decisions and turning to the fund manager and its team for differing viewpoints. The hedge fund then becomes vulnerable to the challenge of dealing with lackluster returns, even though they aren't in the driver's seat. Similarly, some investors don't understand the regulations governing hedge fund investments and are sometimes disappointed to learn they cannot execute their vision the way they would like to. Ultimately, customization has granted the industry greater access to investors with \$10 million to \$50 million in assets, a group that has historically been difficult to service and typically appreciative of the extra effort.

"If you go to the trouble and offer a customized solution tailored specifically for your clients, they tend to be a bit more forgiving and give you more time," the bank managing director said. "We find those assets are a bit stickier as a result."

Cost and transparency pressures



Many funds are struggling with the fact that customization comes at a cost. This realization comes as their regulatory burden intensifies and a variety of investors are seeking additional transparency into fund holdings.

Most funds are still working to address increased reporting requirements related to the passage of the Dodd-Frank Wall Street Reform, the Consumer Protection Act of 2010, and the Alternative Investment Fund Managers Directive (AIFMD). Further, new liquidity coverage ratios tied to Basel III are fundamentally altering the industry's short-term funding models. Managing cash, for instance, has transitioned from a fairly straightforward exercise to a significant challenge. Why? Many prime brokers and banks don't want cash to count against their capital reserves.

"No broker or bank wants cash these days because there is no return on it," said one managing director from a prime broker. As a result, "The funding cost structure is dramatically more expensive and everyone needs to get smarter about understanding their collateral."

That challenge has prompted some in the industry to bring in experts specifically focused on managing counterparty risk and collateral. In today's climate, treasurers need to understand the location of all assets, determine which are best suited for each broker, and incorporate controls around that process. Reducing transaction and financing

costs through better counterparty management has the obvious impact of improving performance, and fund managers that have embraced the treasury function are generally being rewarded for it.

"Functions, utilities, software and information that helps bridge those gaps is going to be one of the next big waves that's going to happen in our business to help the treasurer be a lot smarter," stated the prime broker executive. "A lot of what we are seeing is still in the early innings. Three years from now, I think we'll be saying, 'Wow, I can't believe we weren't talking about these structures or tools then.'"

As hedge funds seek to improve their internal transparency, institutional investors and wealthy individuals are pushing for greater clarity into holdings and investment decisions, even as they bring a new degree of scrutiny to fund fees. The result is "a lot more handholding" between hedge funds and their clients, one hedge fund of fund leader said. She said that some of her fund's investors are now asking to tag along on due diligence meetings with the underlying managers so they can put their own questions to those being considered for investment.

While manager selection is fundamentally the same as it was five years ago, how funds interact with managers has dramatically shifted. One fund of hedge funds now negotiates a global rate with its underlying managers and prime brokers when establishing new business. In return, the firm gives the managers a power of attorney to trade the account.

"We want them to take a lot of the investment risk to produce the investment return," said the firm's chief executive officer. "But we want the risk budget to come out of what they're actually being paid to do and not to pay for back office support, which is where our scale is very helpful."



Chris Farkas, director in Deloitte UK's audit practice, poses a question to a panelist.

Governance and risk management regimes



Hedge funds cannot offload all of the risks they face on a regular basis. With so much at stake from a reputational standpoint, they can't afford to let key risks—including regulatory compliance, counterparty, operational, fiduciary and cyber risks—go undetected.

"You can't outsource your responsibility," said the head of internal audit and risk at one global asset manager. "In the end, you have to answer to your investors."

Over the past 15 years, the hedge fund industry's risk management practices have matured, mainly in response to events such as the Sept. 11 terror attacks, insider trading controversies, and cybersecurity lapses. Many risk challenges were therefore dealt with "on the fly" and not in a proactive, holistic way. That's beginning to change, several participants in the symposium's risk panel offered. For instance, it's more common now for new hedge funds to be staffed to manage risk from day one, including having a full-time, in-house general counsel.

"Awareness is the first step," said the managing director at a global investment management practice. He advised fund companies each to undertake a risk assessment that helps differentiate performance risks from others. Examinations by the US Securities and Exchange Commission (SEC) point to the need for funds to have ready a risk matrix that details the process for identifying

and responding to all manner of risks, from more predictable, low-frequency tail events to more common, high-frequency lapses such as employees plugging peripherals into desktop computers. Funds should be less concerned about handing a "roadmap for helping examiners identify weaknesses" than missing out in identifying the risks themselves.

What is one area the SEC has identified as an exam priority? Cyber risk. Given this, one panelist stated that funds would be wise to ensure their chief technology officer has experience managing a cyberattack and conducting "hack testing" to spot for deficiencies both inside and outside the organization.

With hedge funds increasingly outsourcing back-office support functions, it's becoming increasingly important for funds to cover third-party providers in their risk assessments. Before signing any service agreement, fund leaders should conduct thorough due diligence on the external provider. Key performance metrics for the provider should also be established to ensure they are taking agreed-upon steps and needed controls seriously. "There's a tendency in the industry to focus on misses or near-misses by looking at the control environment," the managing director said. "Enterprise risk management is about looking at inherent risks in the system and then laying the controls over them."

One critical way hedge funds have laid the foundation for effective enterprise risk management regimes is by bringing in independent directors. Boards are now regularly taking on pressing governance issues, such as talent, and recognizing that a diversity of viewpoints is important to break free from moribund thinking.

"How hedge funds are finding new talent is a much more robust discussion than it used to be," said the chief executive officer of a fund cofounded by several women managers. "We're in a world now where it's no longer just the manager's fund, and that is going to be hard for some of the older firms and founders in the industry."



Ted Dougherty, Deloitte's US hedge fund leader (left), and Ramona Heine, deputy-head of products for UBS Asset Management (right), consider pressures placed on hedge funds during an executive spotlight session.

Conclusion



Hedge fund leaders are not strangers to scaling new heights, and by all accounts most will look back on this pivotal time in the markets as a time for reflection. At the same time, it is growing increasingly clear that hedge funds are being held to higher standards than they have ever before. Investors are demanding the kinds of concessions once deemed undoable, while exerting downward pressure on management fees. At the same time, regulators are driving up operational costs with new capital and reporting requirements.

This elevated level of complexity is challenging hedge funds in new ways; however, the discussions at this year's symposium reveal that the industry's leaders are hard at work in solving this myriad of challenges. Along the way, they are discovering that the further they go in meeting client and regulator demands, the more leeway they have to manage assets for superior, long-term growth. When all is said and done, it may very well be that this turn in the industry's evolution is one of the most transformative, laying the foundation for a permanent place in investor portfolios.



Jim Chanos, president and founder of Kynikos Associates (left) and Joe Fisher, Deloitte's US investment management audit leader (right), discuss opportunities for hedge funds in an executive spotlight session.

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Patrick Henry, US investment management leader, welcomes guests to the symposium.



John Jaramillo of Constellation Advisers LLC (left) and Roger Arrieux, partner at Deloitte & Touche LLP (right), have a chance to catch up at the reception following the day's program.