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2016 Hedge Fund Symposium

Opportunity amidst uncertainty

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We've all been prone to generalization at times. That's why when we look back over the hedge fund industry's recent run of underperformance, we can take the widely reported benchmarks in stride. The industry benchmarks simply are proxies that cloud a much wider range of outcomes. The fact is there are still leading funds in this space that are delivering for their investors, and they're accomplishing this feat in an environment that has given so many investors false confidence.

We recognize that there are real and difficult consequences from negative headlines. Deloitte's Eighth Annual Hedge Fund symposium gave attendees the chance to grapple with some of the acute pressures facing the industry as we explored the theme of "opportunity amidst uncertainty." Active management is under assault, and hedge funds are a popular target. Redemptions are on the rise, and, increasingly, institutional investors are questioning the industry's value proposition. At the same time, competition for talent is making it harder to replace seasoned managers who contributed to the industry's robust growth in assets in recent years.

In some critical ways, the formula for success today is the same it's always been; exercise good judgment and make timely and informed decisions, and you're bound to attract attention. But it's going to take more for hedge funds to differentiate themselves in an increasingly crowded market. The group of leaders we assembled for this year's symposium shared some of the solutions they're exploring to help their firms stand out across a number of dimensions, from performance and talent development to compliance and fee structures. We hope this summary inspires your business to build on these innovations and sets the stage for the next phase of the industry's growth.

Where do we go from here?

The backdrop for Deloitte's Eighth Annual Hedge Fund Symposium was decidedly more downbeat than when it was held a year ago. In addition to continued underperformance—the hedge fund industry's 4 percent year-to-date return as of mid-October fell short of the S&P 500's return[1]—the industry is facing a range of related ripple effects that are threatening to slow, if not fully arrest, the rising growth trajectory in assets under management (AUM) it has enjoyed for decades:

- **Rise in redemptions:** In 2016, hedge funds were hit by the biggest tide of redemption requests since the global financial crisis in 2009.[2]
- **Shift in allocations:** Driven by unrelenting media coverage of industry underperformance and expense ratios, the number of public pension funds exiting or reducing their hedge fund exposure climbed.[3]
- **Talent woes:** In this challenging environment, many longtime hedge fund managers have called it quits and hiring the next generation of talent has become more difficult.

Many symposium attendees were quick to point out that the industry is ensnared in a larger war on active management in general. Clearly, the rise of passive investments—graduating in recent years from one-fifth of long-only assets to one-third by the end of 2015—has taken a toll on all active managers, not just hedge funds. The now-eight-year bull market has no doubt played a pivotal role in prompting investors to question their expenses at a time when all boats are rising with the tide.[4]

Many participants characterized the bout of weakness as a short-term phenomenon. Several speakers pointed out that there remains enormous diversity among results within the hedge fund community, with the top fifth of hedge funds still delivering on their stated goals. Another positive indicator is that emerging managers, or those with less than $1 billion in assets, have experienced net inflows this year.

"It's unfair to use too small a period of time to evaluate what's not an asset class, but rather a number of strategies using broader underlying asset classes across markets," said one featured industry luminary representing a global long/short credit manager. "It's not a surprise to anyone in this room that hedge funds would underperform markets that have all gone up."

Many agreed that global central banks have distorted financial markets, with massive bond-buying programs putting them in competition with large money managers. "The size of the credit space has doubled over the past five years, and we'll likely need another shakeout like we had in January 2016" to bring institutional investors back in, one speaker stated. More generally speaking, a handoff from monetary policy stimulus to fiscal spending in 2017 could very well pave the way for more differentiated returns and for more hedge funds to prove their value once again.

"I'd much rather be here than back in 2008," said one participant who advises hedge fund clients. "Hedge funds are simply going through the kind of disruption that challenged other industries like autos."

The temporary disruption may have a permanent impact on the industry's traditional 2-and-20 fee structure. Fee pressures are not hitting all firms equally—those who have delivered for clients have been able to maintain their fees or avoid significant discounting. The average firm, however, is feeling significant and accelerating fee pressure, and startups and entrenched hedge fund firms have begun investigating alternative structures. Some have adopted expense pass-through models that spread the costs incurred by the firm and refuse to pay the owners a profit until those expenses are all recouped. One extreme approach is to reward investors who stayed on during periods of bad performance by eliminating fees altogether for some period of time.

Combined with a rebound in industry performance, fee restructuring will likely help the industry weather the recent bout of redemptions and stay relevant for the foreseeable future, although there will likely be some more short-term pain. "This space is going to contract but it's not going to go away," said one industry veteran who now advises hedge funds on a range of strategic challenges. "There's plenty of room left to run but a lot of the growth will likely come from strategies that don't exist today. We're quite bullish that there's going to be demand for what I would call these 'new active' managers, or those who are best-equipped to go beyond the benchmarks."

The industry executive predicted there will be a divergence between broad asset managers who offer low fees to bring in more investors and emerging hedge fund managers exploring more liquid strategies. Their value proposition won't just be generating alpha, he said, but doing so while exhibiting business proficiency and exceptional risk management. The discussions over the course of the day revealed one ingredient many believe will likely help firms realize all three ambitions: talent.

Talent as a differentiator

The hedge fund industry isn't alone in trying to stay abreast of sweeping changes in the market for standout talent. Deloitte's most recent annual study of the worldwide workforce, ***Global human capital trends 2016***, noted that a combination of factors are driving transformational change in the workforce, including the rise of millennials, the proliferation of digital technology, and a new social contract between employers and employees.

But, in some critical ways, the talent challenges the industry faces are unique, as several talent experts discussed during a dedicated panel at this year's symposium. Skilled talent has historically been the driving force behind the hedge fund industry's ability to deliver superior returns. For more than 30 years, the financial services industry in general, and hedge funds in particular, has found it easy to attract the best and the brightest to their firms. But now, in an environment where hedge funds are facing heightened pressure to prove their value to investors, the search for the next generation of industry leaders has taken on new meaning.

"If you want to drive differentiated returns, you need differentiated talent," said a human resources executive from a large family office. But what exactly makes talent differentiated? The global long/short credit manager said his firm looks for three traits among manager candidates: integrity, intelligence, and ethos. "There is no substitute for good judgment," he said. "It's important to be self-aware and actively spot for weaknesses." His point was echoed by several other participants, who said it's just as important that new hires bring a volume of good ideas and quality of analysis to the table. In addition, new talent has to be able to fit in with the firm's culture and help preserve it as the organization grows.

In addition to these soft skills, the industry is increasingly on the hunt for those with the technology skills to sift through a flood of new information. Data scientists are in hot demand among asset managers, which may have lagged behind other industries in recruiting such skills but are now actively seeking to close the gap. A representative from one energy-focused hedge fund said a dearth of industry specialists has led it to leverage outside firms to analyze topographical data and identify areas where carbon resources may be more abundant.

But there are growing obstacles in the industry's efforts to land top talent. The performance problems of recent years have made it more difficult to compete. The investment banks that once served as fertile ground for new hires have downsized in recent years, shrinking the pool of available talent at a time when private equity firms are stepping up their efforts to pluck young and promising professionals.[5]

Some of the bigger industry participants in attendance said they're turning to unique programs to get ahead of the talent crunch. One large family office introduced a new initiative in recent years that teaches recent college graduates to master financial analysis and research skills needed to contribute to investment recommendations. Others are targeting the talent pipeline earlier in the development process by conducting candidate interviews as early as sophomore year of college and casting a wider net by broadening their network of go-to universities.

Because smaller firms have fewer resources to train new hires, they have turned to cultivating a wider range of backgrounds and bringing on generalists capable of "doing everyone else's job." In this light, many speakers saw workforce diversity as an opportunity to develop their unique approach versus following the well-worn path.

"There's an emerging investment performance case for diversity," said the family office talent manager. "This year we've seen some of the perils of the level of crowding that goes on in the industry, as well as from generating consensus views on the market. Finding people that have a differentiated process and contrarian point of view and don't necessarily drive their investment ideas the same way is increasingly attractive."

Making an impact

A growing number of hedge funds are seeking to differentiate themselves further by addressing the social and environmental goals of their investor base. A dedicated panel at the symposium explored opportunities around the rising popularity of impact investing in the institutional investor community. The universe of such investments—which provide a way for investors to make a measurable social or environmental impact while still producing a financial return—is rapidly growing, driven by changing investor sentiment on key fronts.

In recent months, for example, high-profile pension funds have enacted changes to their investment mandates to account for environmental and social objectives, in response to a recent US Department of Labor notice that allows ERISA plan fiduciaries to take such factors into account. Meanwhile, more engaged millennial investors, who stand to inherit and create a significant amount of wealth in the coming years, are putting pressure on institutional investors to follow suit.

While hedge funds have barely scratched the surface in the area of impact investing, we expect there to be an increasing demand to source and measure impact investing opportunities on behalf of their clients. The symposium discussion included the entire range of investment possibilities, from traditional profit-only motivation to full-on philanthropy. But the bulk of the time was spent on sustainable impact investing (in which both sustainability and financial returns drive investment selection) and thematic impact investing (in which investments are directed by targeted themes such as climate change or water scarcity) in combination with financial return objectives.

Technology is emerging as a key enabler in this respect, providing more transparency into investments, as well as a basis for measuring the social and environmental impacts of investments in areas such as affordable housing, microfinance, and sustainable development. "Hedge funds seeking to remain relevant are looking to gather AUM in new ways, and impact investing represents an awesome opportunity," said one executive from a broker-dealer that matches institutional investors with impact investment prospects.

At the same time, hedge funds should be able to produce differentiated returns by analyzing companies for their adoption of impactful business practices.

Finally, impact investing may emerge as a key selling point for hiring the millennials at the crux of the human capital discussion. Impact investment managers will likely find it easier to source the best talent among millennials who consider environmental and social objectives as part of their core values.

Agenda items for 2017

The coming year will likely bring a number of other pressing issues for hedge funds.

For starters, the US presidential election result will likely usher in changes to the hedge fund industry, but exactly what those changes are remain unclear. While running for office, President Trump stated he was in favor of ending carried interest, yet his other tax proposals position him as firmly pro-business, and simple tax-rate reductions may make the end of carried interest moot.[6] It's also the case that only some hedge funds would likely be impacted if the tax treatment was changed; only a small portion of them accumulate a meaningful amount of long-term gains and are therefore more insulated from a change than private equity firms. A former US representative who addressed the election during the symposium said the bigger threat to the industry would have been a Democratic majority in the US Senate and the appointment of a chair to the Financial Services Committee who was "no fan of financial services firms."

A more pressing concern for the industry will be complying with the Foreign Corrupt Practices Act (FCPA). The US Department of Justice and the Securities and Exchange Commission have concluded FCPA actions at a notably higher rate in 2016 compared to 2015, and hedge funds have been put on notice that their foreign dealings will be heavily scrutinized.[7]

The hedge fund FCPA settlement is a "huge red flag" for the industry, one panelist observed. Potential ramifications from running afoul of the law could be legal exposure for employees, reputational harm from indictments or convictions, exodus of investor assets, or portfolio companies passing on potential transactions, in addition to hefty fines. The partner of a prominent law firm serving the industry advised that hedge funds need to demonstrate strong conviction at the top in staying compliant with FCPA, as well as maintaining substantial due diligence programs with overseas partners. Internally, hedge funds need to understand the scope of their risk and ways to attack it, elevating the importance of regular risk assessments that include an FCPA component.

In the short space of time between the date of our symposium and the issuance of this report, the US Supreme Court issued a unanimous decision in a case that will likely impact hedge funds' governance agendas in 2017. In *Salman v. United States*, the Court ruled that a person sharing inside information need not receive any benefit from related transactions tied to such information. Given that the decision effectively broadens the ability of the government to prosecute suspected insider trading, hedge funds will have to become even more diligent to ensure their employees are in compliance.

At the end of the day, the discussions at Deloitte's Eighth Annual Hedge Fund Symposium revealed that plenty of opportunities still exist to sustain the hedge fund industry's prominent role in institutional investor allocations. At a time when some are questioning the industry's value proposition and willingness to change, the far-reaching nature of the innovations and initiatives discussed showcase the dynamism and responsiveness that those inside the industry have long cultivated.

Industries don't grow ten-fold in the span of two decades without being deliberate and adjusting to new realities. While it's true that hedge funds face challenges that are different and more pressing than those of the past, the industry's natural tendency for innovation and evolution will contribute mightily to firms' ability to adapt. Hedge funds of the future might differ in some key respects from those leading the field today, but we are confident of the industry's ability to protect its legacy as a true alternative to the status quo.

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