Global hedge fund survey

Weathering the storm

October 2009

Ernst & Young
Quality In Everything We Do

Greenwich Associates

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Methodology

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- The purpose of this study was to record the views and opinions of hedge funds globally to understand how market forces and the changing regulatory landscape are affecting them and what actions they are taking to prepare for the future. Topics covered in the study include: fees and liquidity/redemption terms, custody and prime brokerage, transparency/reporting to investors, US and EU regulation and tax legislation, independent valuation and expectations for the future.
- Greenwich Associates conducted 100 telephone interviews in August and September with hedge funds in the United States, Europe and Asia, representing US$680 billion in assets under management, roughly half of the industry.

Hedge fund profile	100 respondents
Geography	
USA	53
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Executive summary

Executive summary

We have surveyed 100 of the largest hedge funds globally, this year with a notable and deliberate skew to include some smaller funds, particularly in Asia, to solicit their views and to understand how they have withstood the crisis. The 100 funds manage some US$680 billion of equity, roughly half the industry. We are very grateful to those that participated, giving up a not inconsiderable amount of time from their already hard-pressed schedules.

- Funds structures have reacted sharply to the downturn.
  - There is a significant belief that the response forced by the market has been radical, rapid and productive for investors who are benefiting from greater transparency, greater clarity about valuations and the valuation process and fund governance.
  - Increased regulatory oversight on the other hand is felt to be imprecise, slower, of less benefit to investors and expensive.
  - This is not the consistent resistance of the regulated but the unemotional, matter-of-fact view of senior industry executives who are resigned to the fact that there will be significant regulatory oversight and are ready for it.
- Fee structures have responded to investor pressure with clear linkages being established with liquidity and redemption terms.
  - This is set to continue – few respondents felt that there was pressure to simply reduce fees, unlinked to structural changes, and the pressure has been largely on reducing management, rather than incentive, fees.
  - Respondents believe, perhaps naively, that limiting redemptions, imposing gates or suspensions and the like, will have limited impact in the long run.

Executive summary

- Investors are now acutely focused on risk.
  - Performance cannot be the panacea for the entire industry – even those that have performed well through the crisis have suffered redemptions and have been subject to far greater scrutiny on the risks they have been running.
  - Sharing information about risk concentrations, leverage, governance, volatility etc. is near universal and the frequency of demands has increased.
  - Somewhat surprisingly counterparty risk ranks lower than expected: somewhat unsurprisingly, questions about bankruptcy laws in differing jurisdictions and how customer protections operate has been featured more highly post-Lehman.
- There are likely to be very few funds that become tax refugees from the US.
  - Despite endless talk about the redomiciling of fund operations due to impending US tax legislation, few funds are seriously considering doing so.
  - However, nearly a quarter of US and UK respondents say that general partners are considering moving because of tax and other burdens.
  - People, unsurprisingly, remain more fleet-footed than the infrastructure they have set up.
- The draft EU Directive will have a dramatic impact.
  - Many of those affected, particularly in the US, remain uninformed about it.
  - Approximately a sixth of respondents who had considered the draft Directive said they would cease operating in the EU if it was passed in its current form: many more said they would not venture in.
  - Although there is a general belief that it is unlikely that the draft Directive will be approved in its current form there is considerable concern as to its motivation, its directional thrust and a sense of disbelief that business legislation could be so politicized, pushed through with little consultation and appear so restrictive.

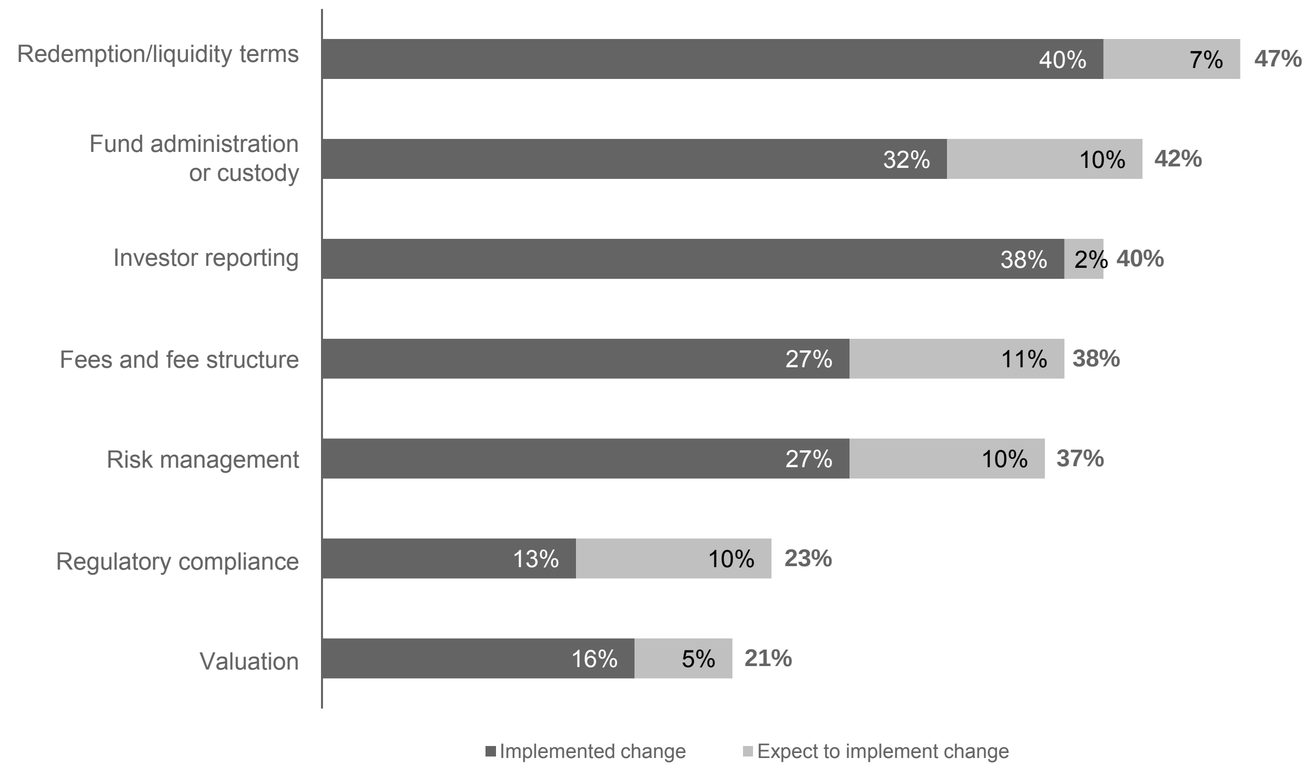
Executive summary

- The push for independence of valuations, demonstrable governance over the process and transparency of reporting to investors are examples of worthwhile initiatives where the benefits clearly outweigh the costs: the opposite is felt to be true of regulation.
- The endgame remains unclear, but changes to the industry have been profound.
  - Funds widely expect the industry to continue to consolidate with increasing costs and greater barriers to entry both playing a part in the process.
  - Start-ups will be fewer and generally smaller than precrisis levels.
  - Despite the obvious structural difficulties for M&A activity in the industry, the inexorable convergence in the asset management industry will take its toll as private equity firms, hedge fund managers and traditional long-only managers inevitably make demands on each others' territory and distinctions become blurred.
  - Fee structures, liquidity and redemption terms and investor demands for transparency and governance will exacerbate the trend.
- In conclusion, the industry has weathered the storm but has not been left unscathed.
  - Some changes have been profound and permanent, others perhaps more ephemeral.
  - There remains more to come, not least from legislators, regulators and tax authorities and although the industry appears resigned to accepting some such impositions there remains a real fear of the authorities overreaching and some of the actions being fundamentally misguided resulting in costs far outweighing any benefits to investors.

Key findings

Fund structures have reacted sharply to the crisis … and managers await further regulatory oversight

Changes made/expected (multiple responses accepted)



Redemption and fees:
56% have either made changes or expect to make changes to redemption terms and/or fees.
29% have made changes to both.

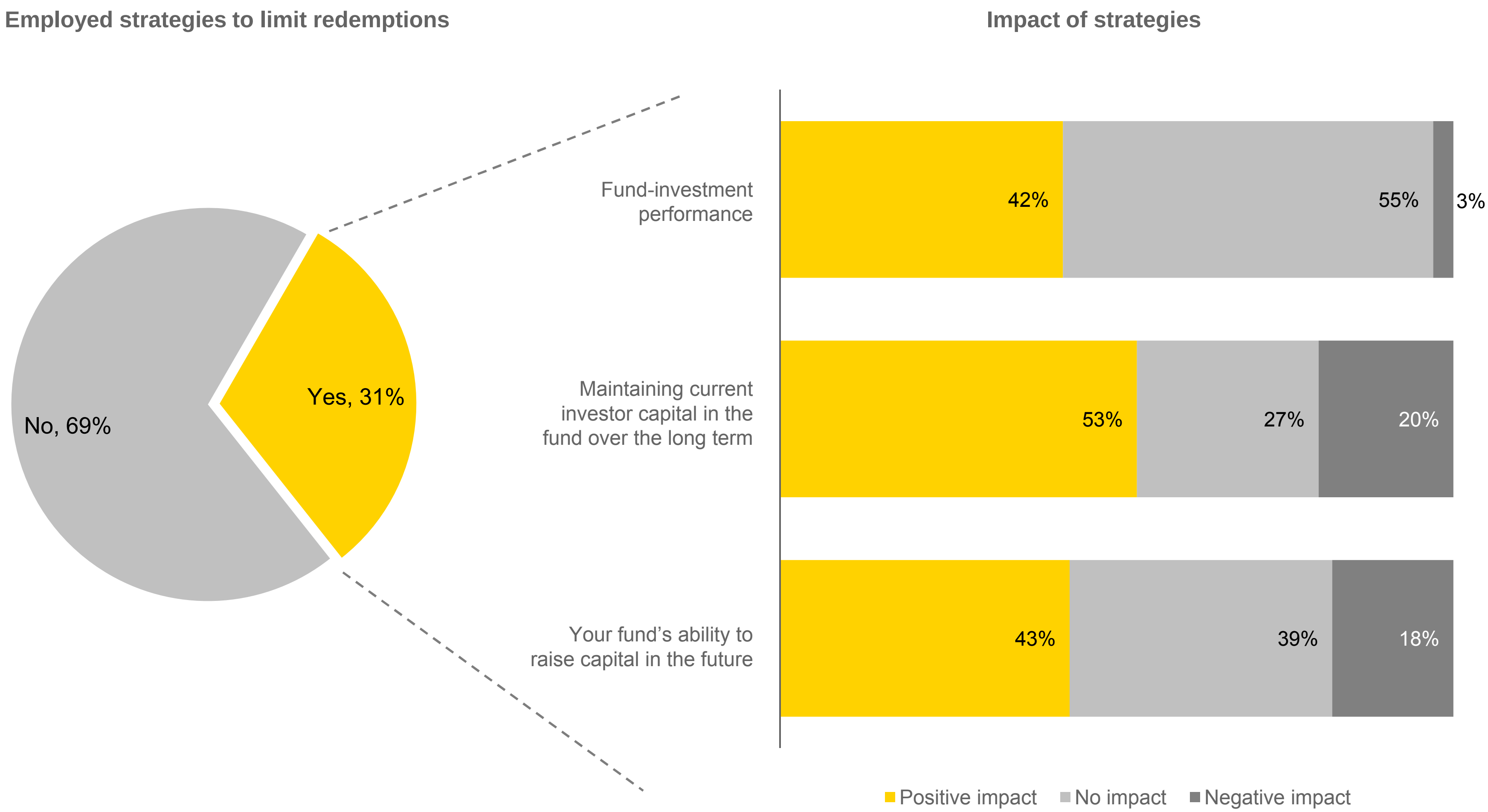
Fund structures have reacted sharply to the crisis… and managers await further regulatory oversight

Specific changes made …

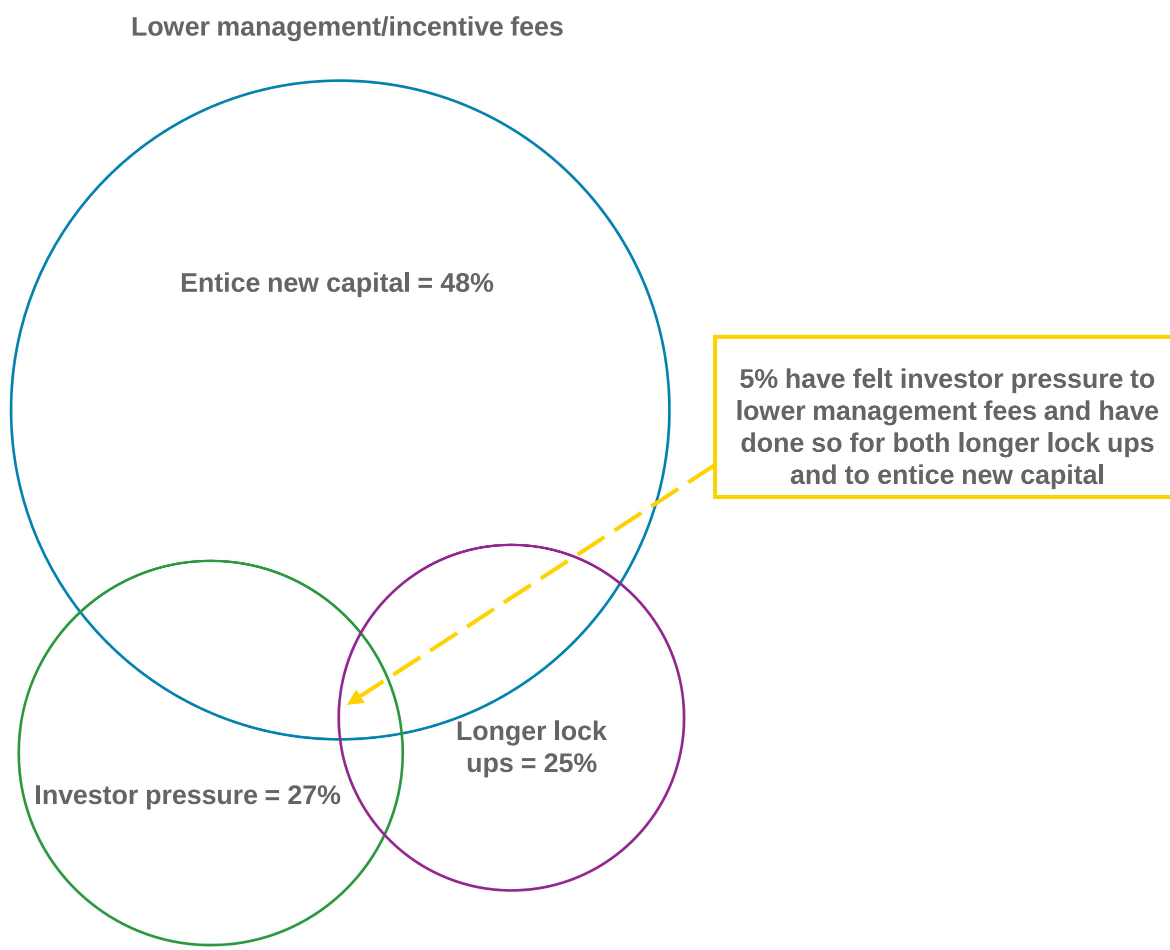
- *"We have hired [an accounting firm] to [review] our valuation methodology and have input to the illiquid valuation. As the prime broker starts having their custody solutions, I'm sure we will start changing. Regulatory changes are coming down the line all the time, we will react as they come. For fees, we launched two new share classes with lower fees and we changed the liquidity terms on the funds [making them] more liquid."*
- *"We had two hedge funds converted to full time administration in response to Madoff."*
- *"We are not currently registered but will be… For fees, we may introduce break points for asset size and will perhaps change the management fee. We are constantly refining our reports… In Europe, we have looked at a split prime brokerage/custody model away from a pure prime brokerage model. We plan SEC regulation for our US entity, and I'm sure we are going to have to respond to the European directive once that becomes more cemented."*
- *"We have added side pockets, expanded independent valuation, and given more transparency of portfolio demographics and risk metrics. We've changed custodians and quarterly valuation will be moved to monthly on [all] funds."*
- *"We have provided an extensive amount of transparency. We have reevaluated risk and increased our internal reporting."*
- *"We have changed our fund administrator. We have moved to more transparent reporting of our monthly newsletter to investors more focused on risk nature of investments."*

Source: Select quotes from survey participants

Tumultuous action taken to limit redemptions but few managers believe it to be damaging in the long run

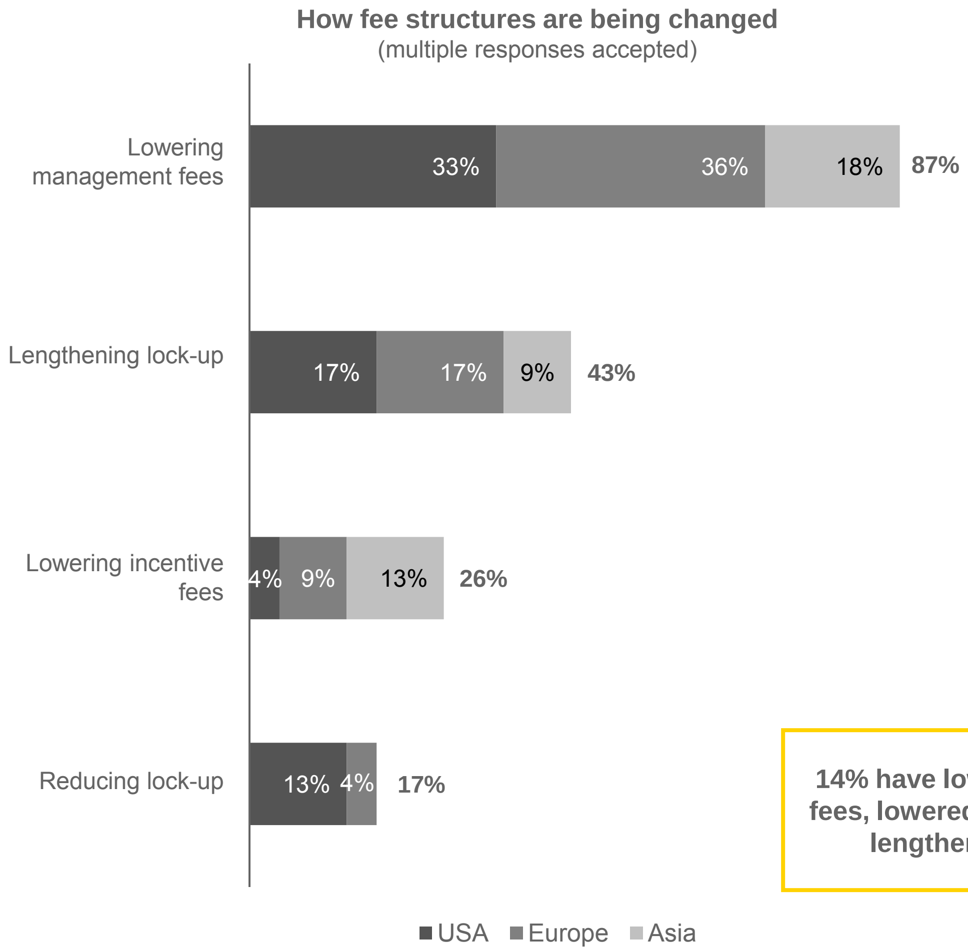


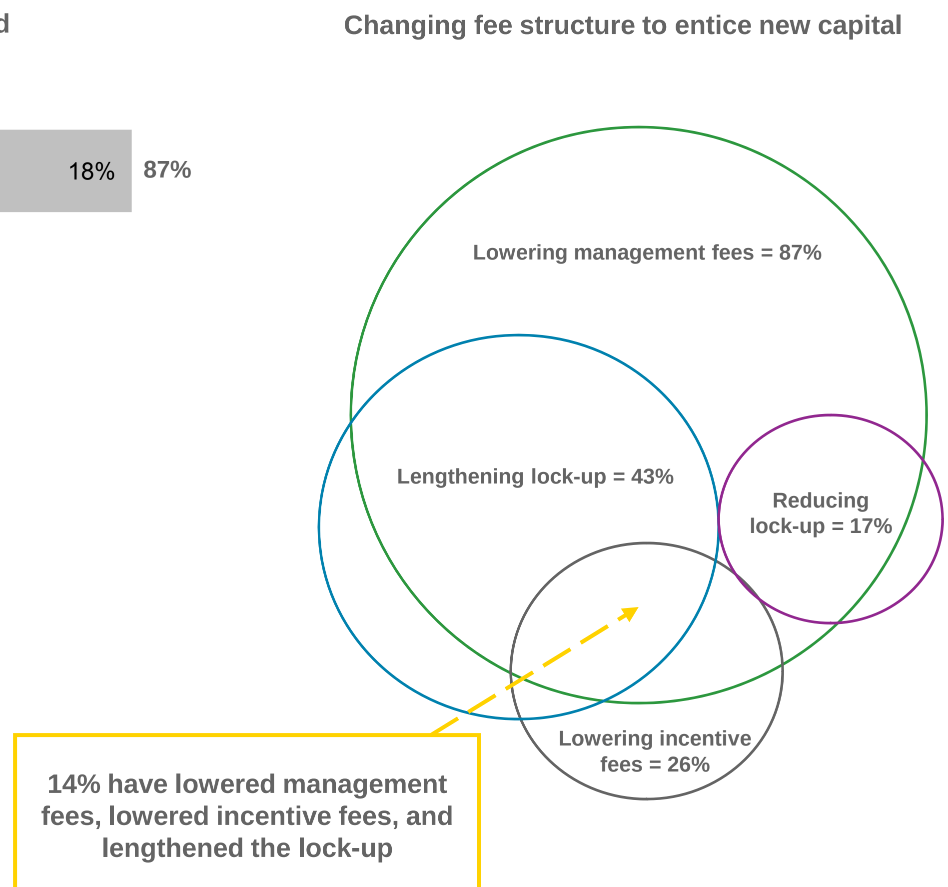
Fees have been driven downwards by structural changes, not because of any absolute pressure to reduce …



Note: Based on the 56% of funds that have made changes or expect to make changes to redemptions and/or fees

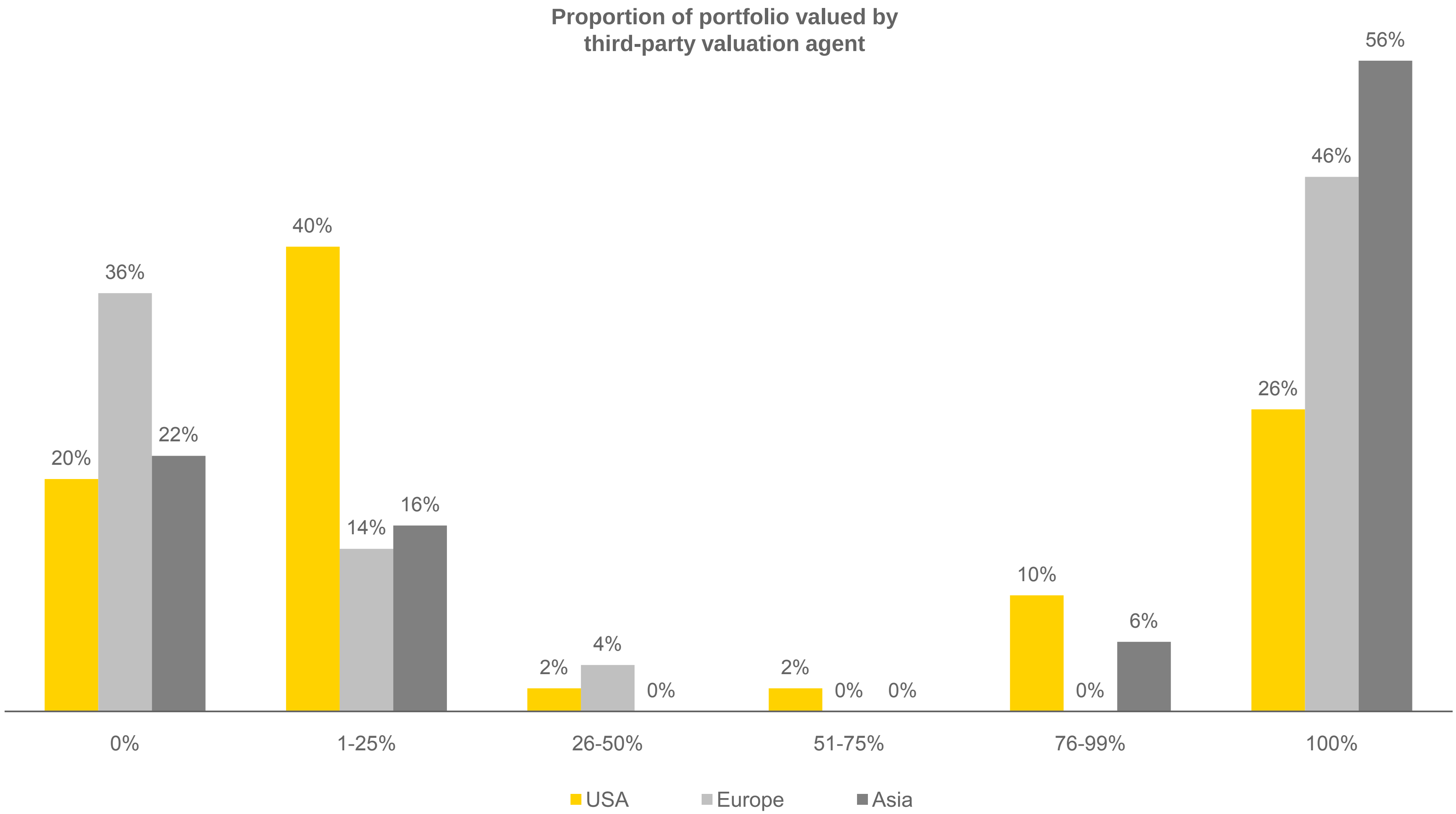
… And to entice new capital – the pressure is most marked on management rather than incentive fees





Note: Based on the 48% of funds that have made changes to fees and fee structure to entice new capital

Polarized views on use of third-party valuation agents with differing interpretations in the US vs. Europe/Asia



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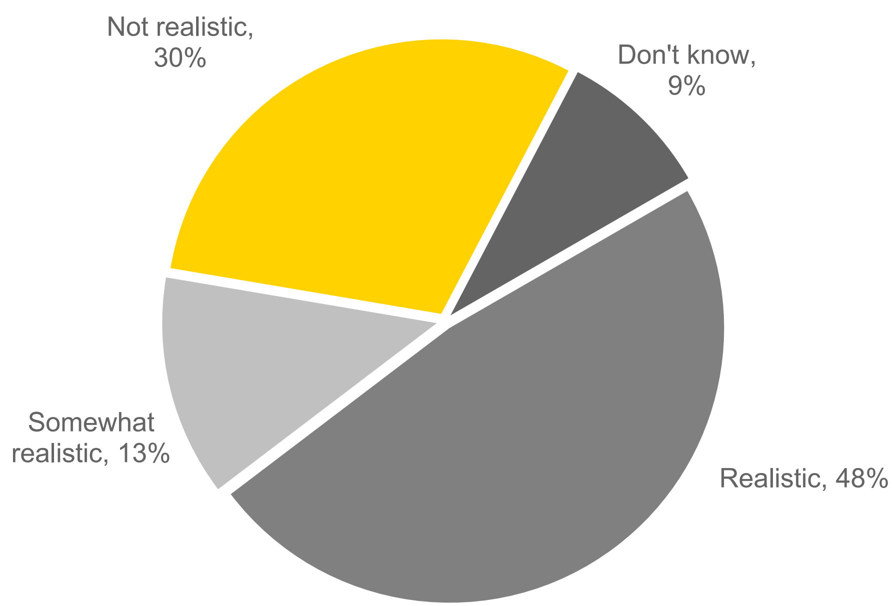
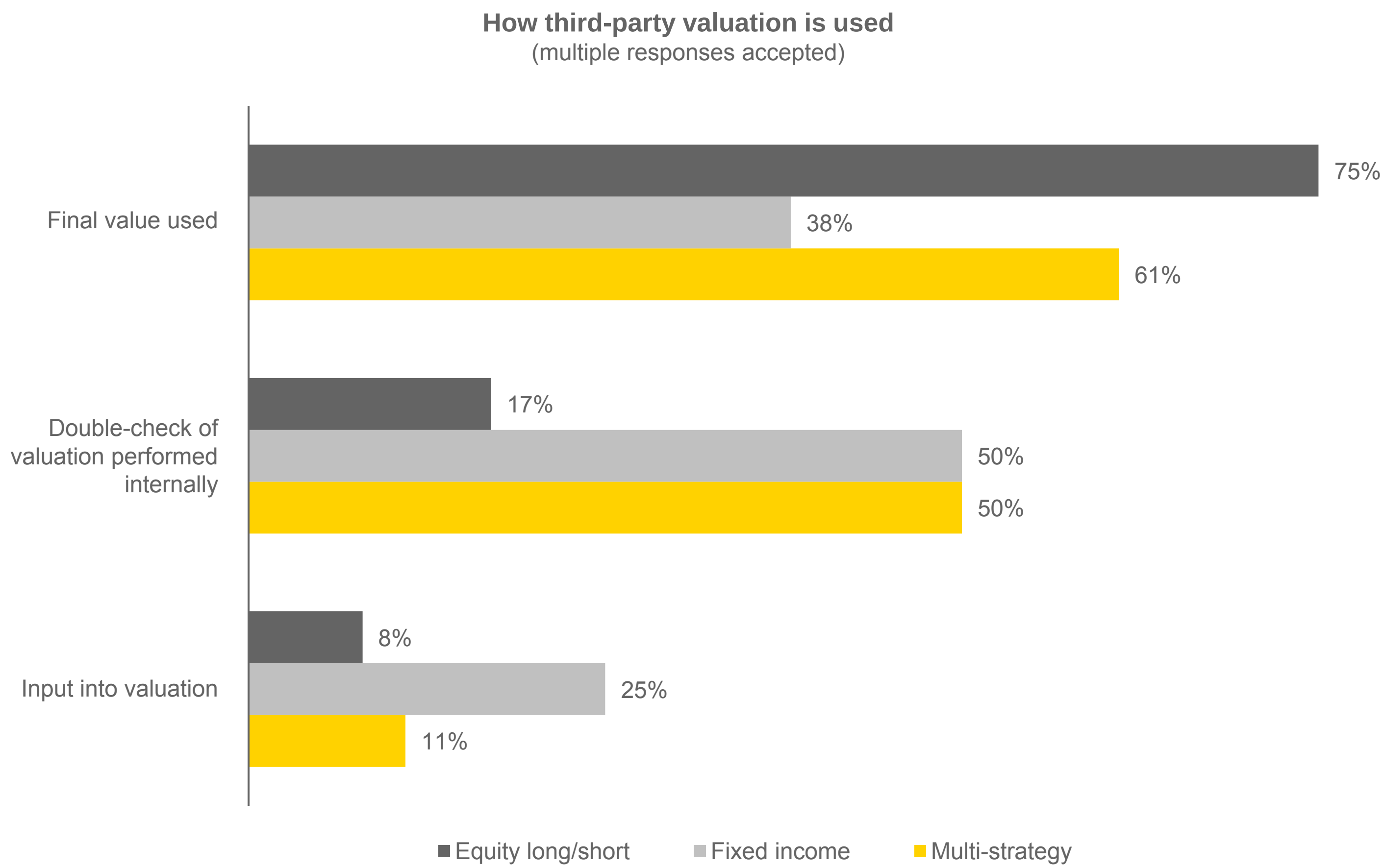
Much skepticism about the knowledge and capabilities of third-party valuation agents, particularly for illiquid investments.

Ability of third-party valuation agent to value portfolio of illiquid investments



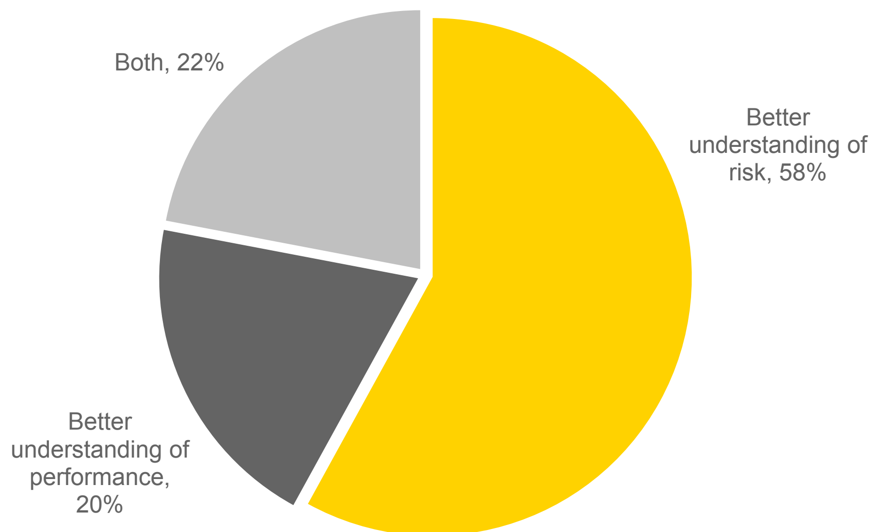
A significant number of funds don't think it is realistic to have third-parties value illiquid investments

Third-party valuation is not the solution to less transparent markets.



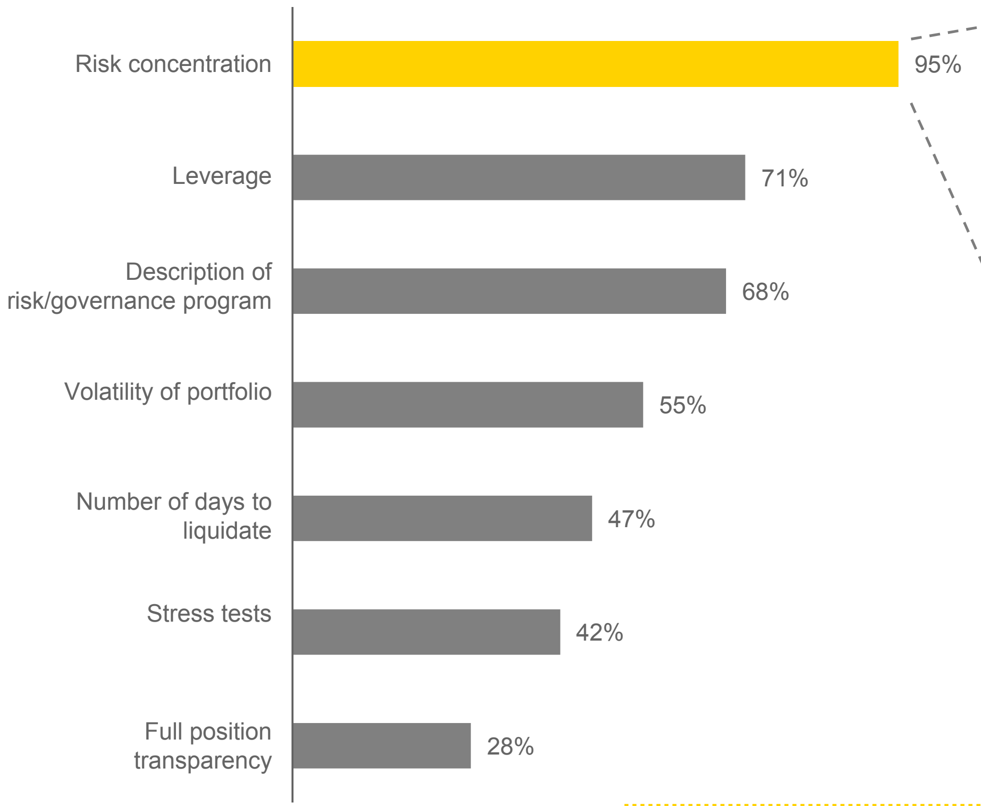
Massive investor focus on risk… as the performance panacea fades

Primary area of focus for increased disclosure

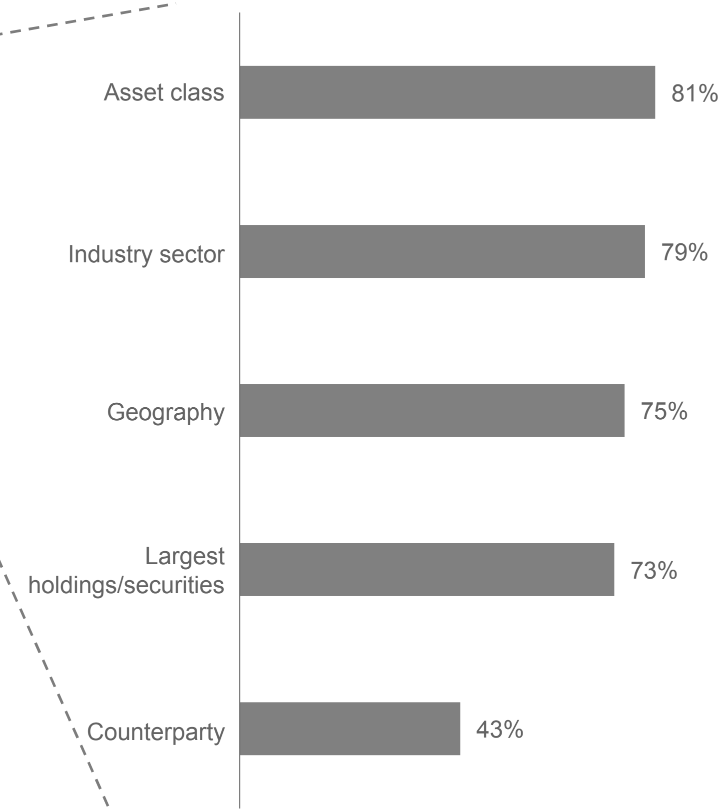


Information to investors on risks has risen markedly – surprisingly counterparty risk ranks lowest

Risk management information shared with investors
(multiple responses accepted)



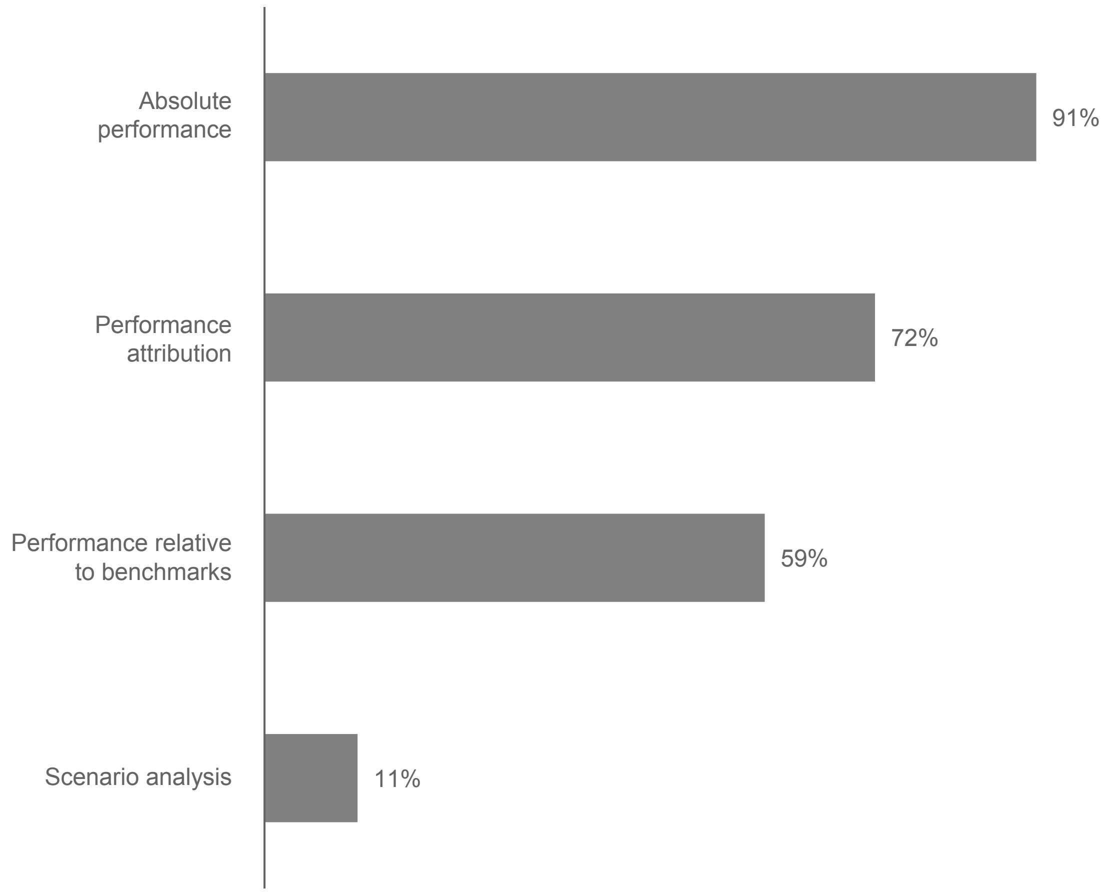
Risk concentration by:
(multiple responses accepted)



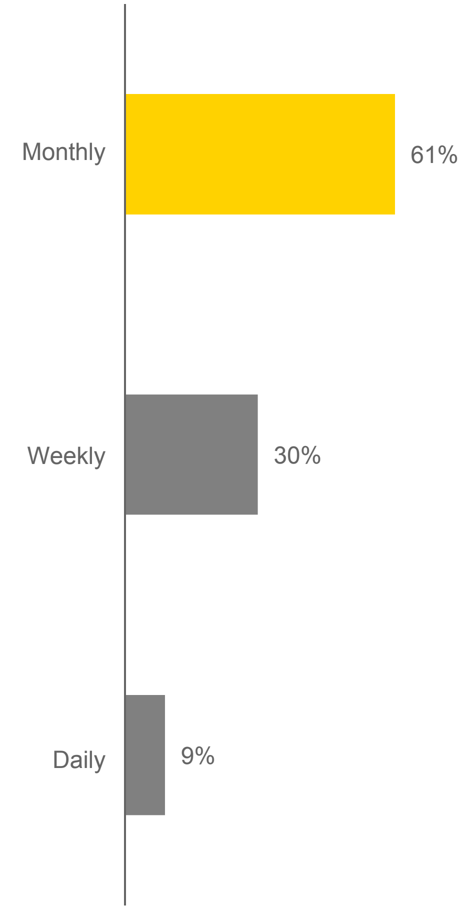
Nearly all respondents share information on a monthly basis

Performance data provided monthly – virtually across the industry

Performance information shared with investors
(multiple responses accepted)

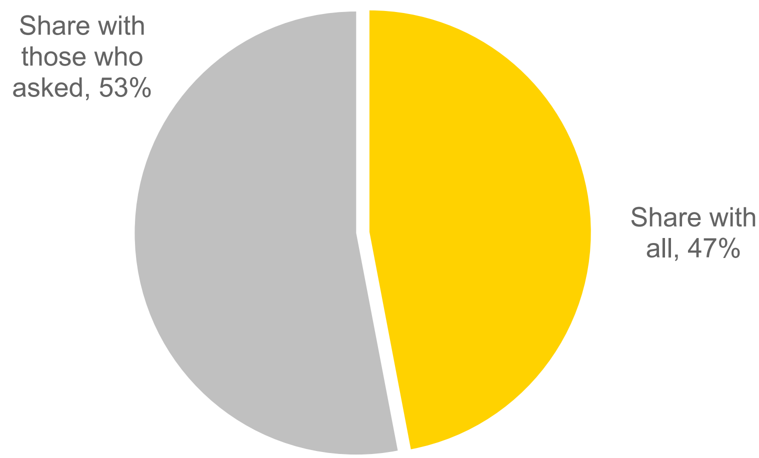


Frequency shared



Disciplines about information sharing with investors is still embryonic compared to public markets

Shared information with investors

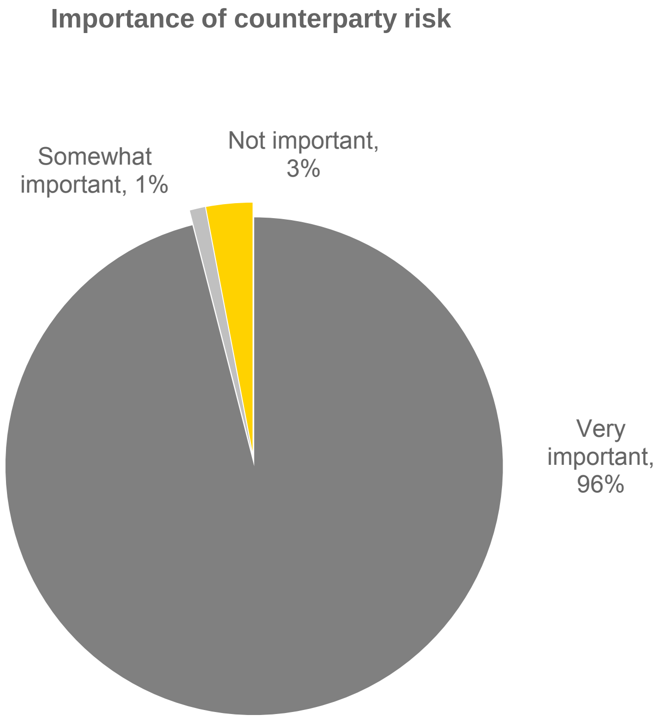


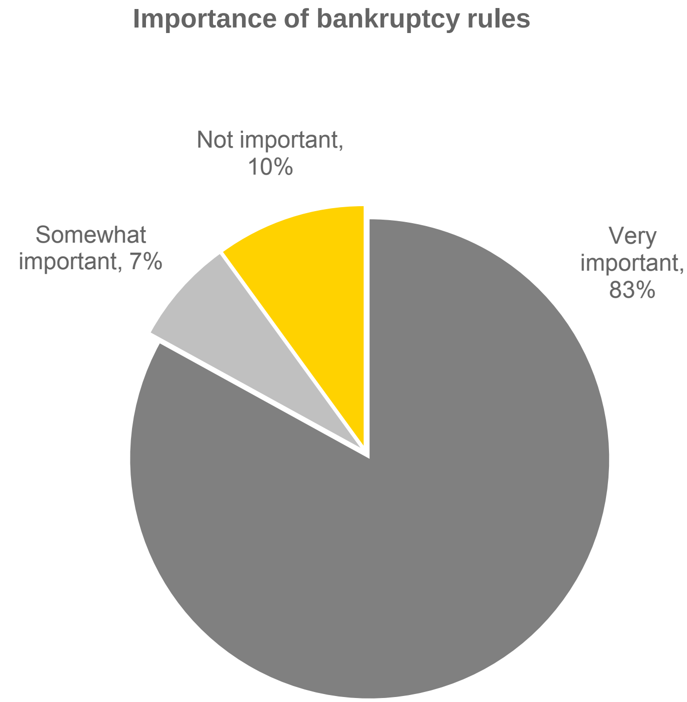
Sharing of information

- "It is almost always discussed at length with the legal department. We are conscious of the obligation to treat [investors] equally."
- "You have to understand the transparency rules. Transparency means position reporting, leverage, volatility, etc. Of course we give all these numbers. If someone prior to investing wants to see the portfolio once, then the directors have the right to show that to them so long as it doesn't disadvantage in any way the current investors… We would not provide position information on an ongoing basis to one investor and not provide it to [another]."
- "We don't like to cherry pick for particular investors, but if you have a managed account there is a lot of disclosure that as a consequence you get to see everything, but as a fund investor you get to see less."
- "It depends on the information. If it's a clarification, we share it. We make the same responses to everyone. We have so many due diligence meetings that we don't send out special correspondence."

Source: Select quotes from survey participants

Counterparty risk considerations vital in choosing a custodian or prime broker… post-Lehman, bankruptcy rules feature strongly

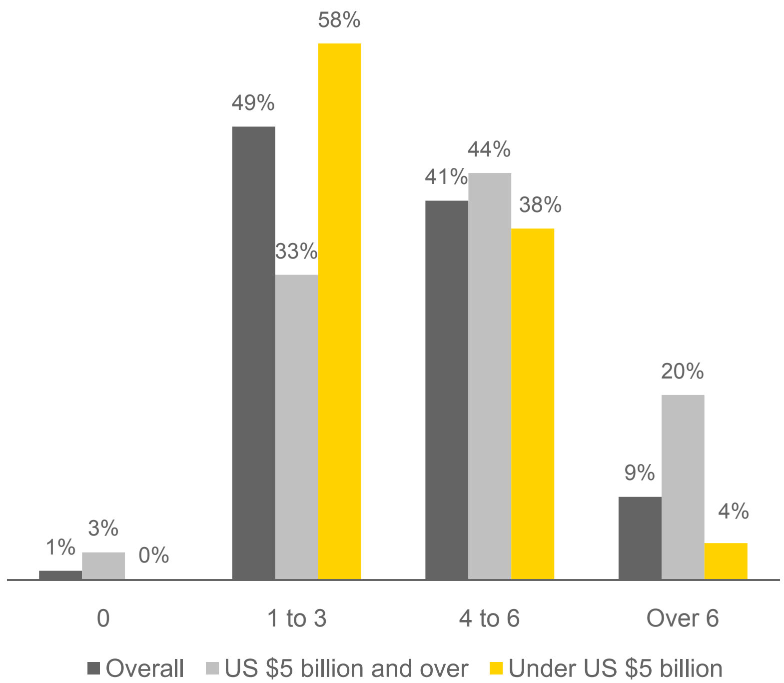




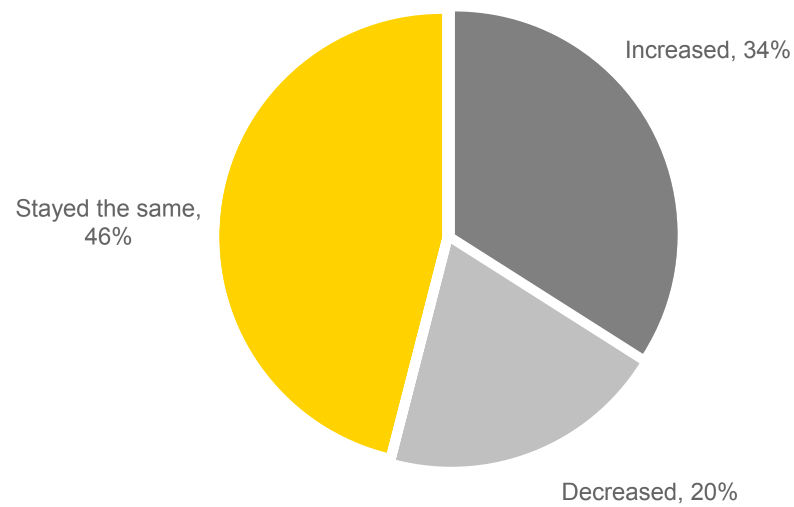
	Counterparty risk (very important)	Bankruptcy rules (very important)
USA	92%	92%
Europe	100%	69%
Asia	100%	83%

One in three funds added PB relationships – one in five reduced… finding an equilibrium post-Lehman?

Number of prime brokers used
Average number of prime brokers used = 4



Change in number of prime brokers



The costs of doing business and the focus on risk management has increased

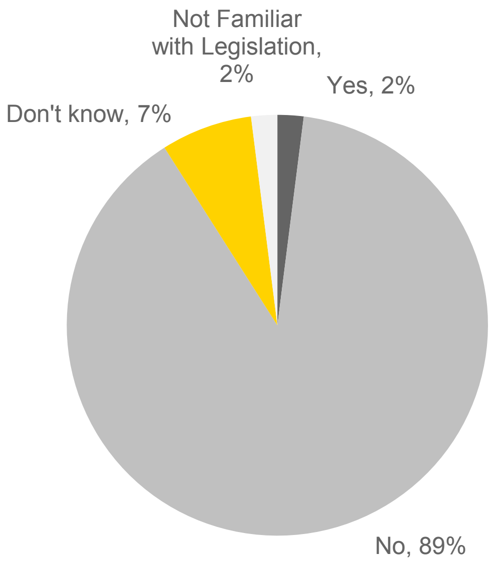
Relationships with prime brokers

- "It's more difficult to negotiate terms …The prime broker has changed margin requirements and wants up front collateral."
- "Obviously it is getting more expensive, that is without question. So they are definitely charging more for the same financing capabilities. In terms of what we are requiring of them, I would say it has become more difficult to negotiate with them. Their requirements have gotten more difficult and stringent."
- "Prime brokers are asking more from us, including imposing restrictions on leverage."
- "There has been a bit of change on both sides. We have focused a huge amount of time and attention in terms of trying to optimize margin rights and optimize capital use. We have seen definitely a move to more conservative margin techniques by prime brokers …We've had discussions around bankruptcy protection, bankruptcy remote structures, separation of custodianship, all of those things."
- "There has been more diversification, more monitoring and more risk management."

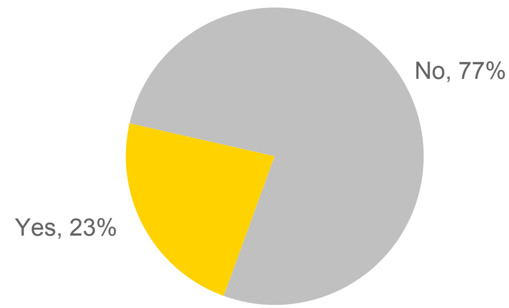
Source: Select quotes from survey participants

Is tax legislation driving funds offshore? All talk, no action.

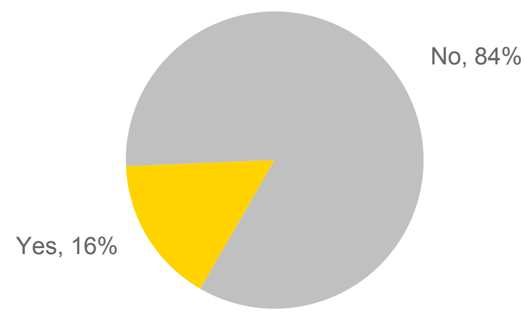
Considering redomiciling US offshore operations due to proposed US tax legislation



Considering redomiciling because of individual tax rates (US/UK)

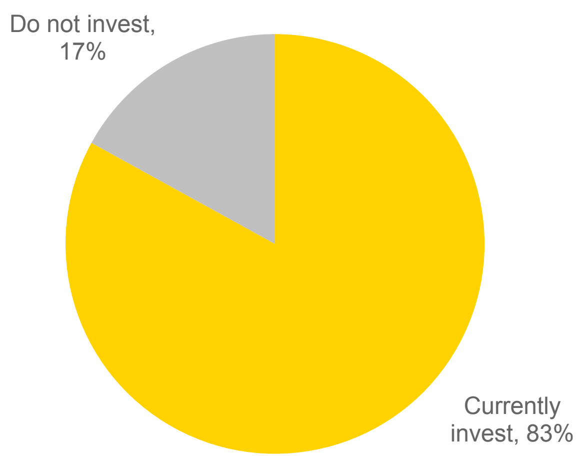


Considering redomiciling because of individual tax rates in New York/California/New Jersey

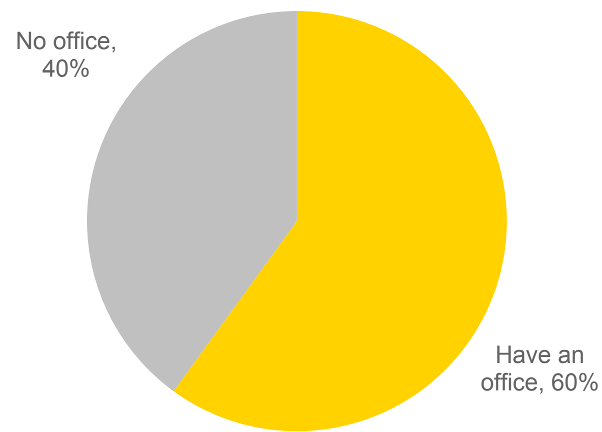


EU Directive – many remain uninformed, particularly in the US and Asia but …

Currently invest in the EU



Have an office/registered in EU



Familiarity with proposed EU directive	Percent not familiar
USA	47%
Europe	30%
Asia	60%

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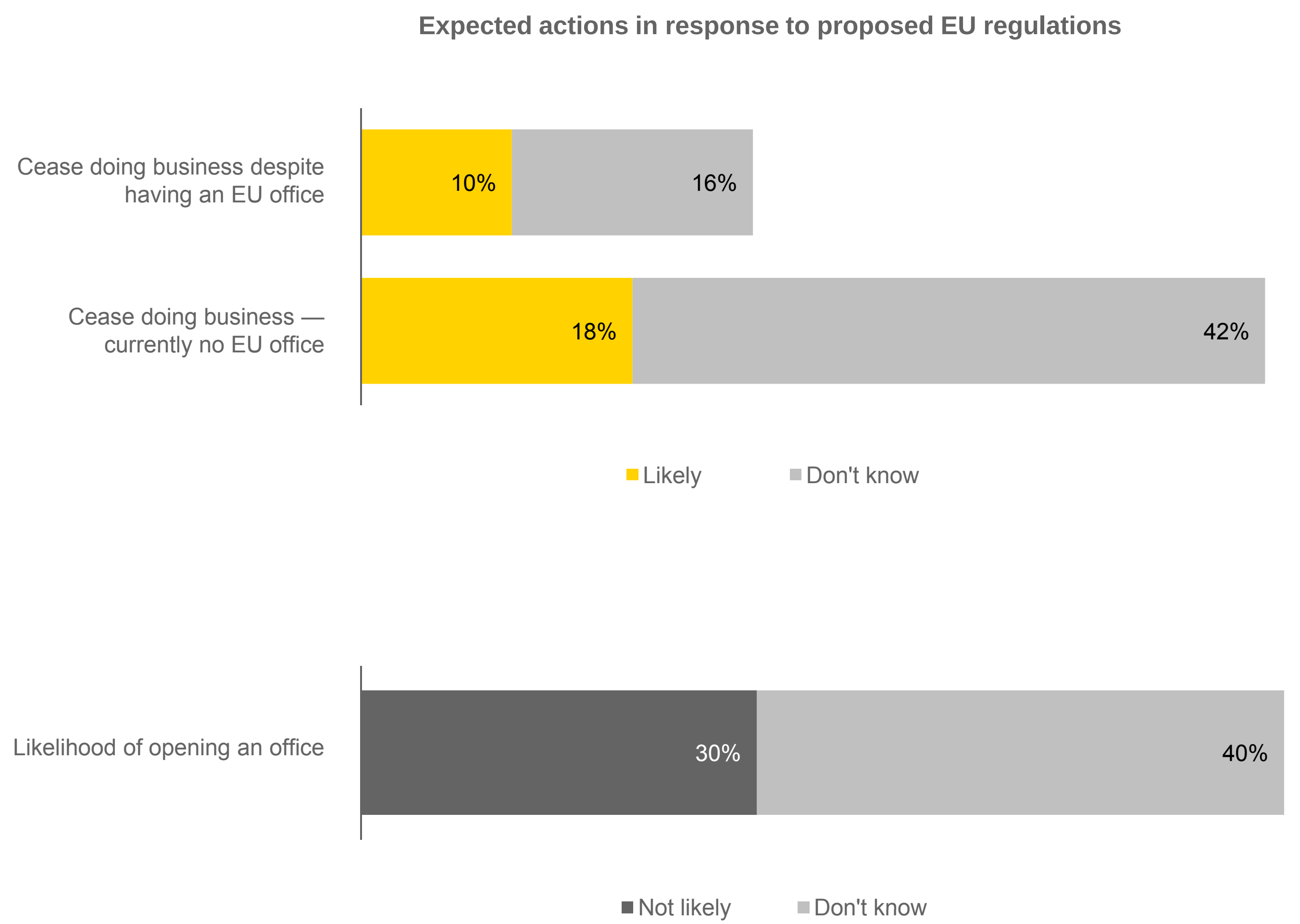
… those that are aware suggest its effect is dramatic – existing funds will cease doing business and many more will not venture in



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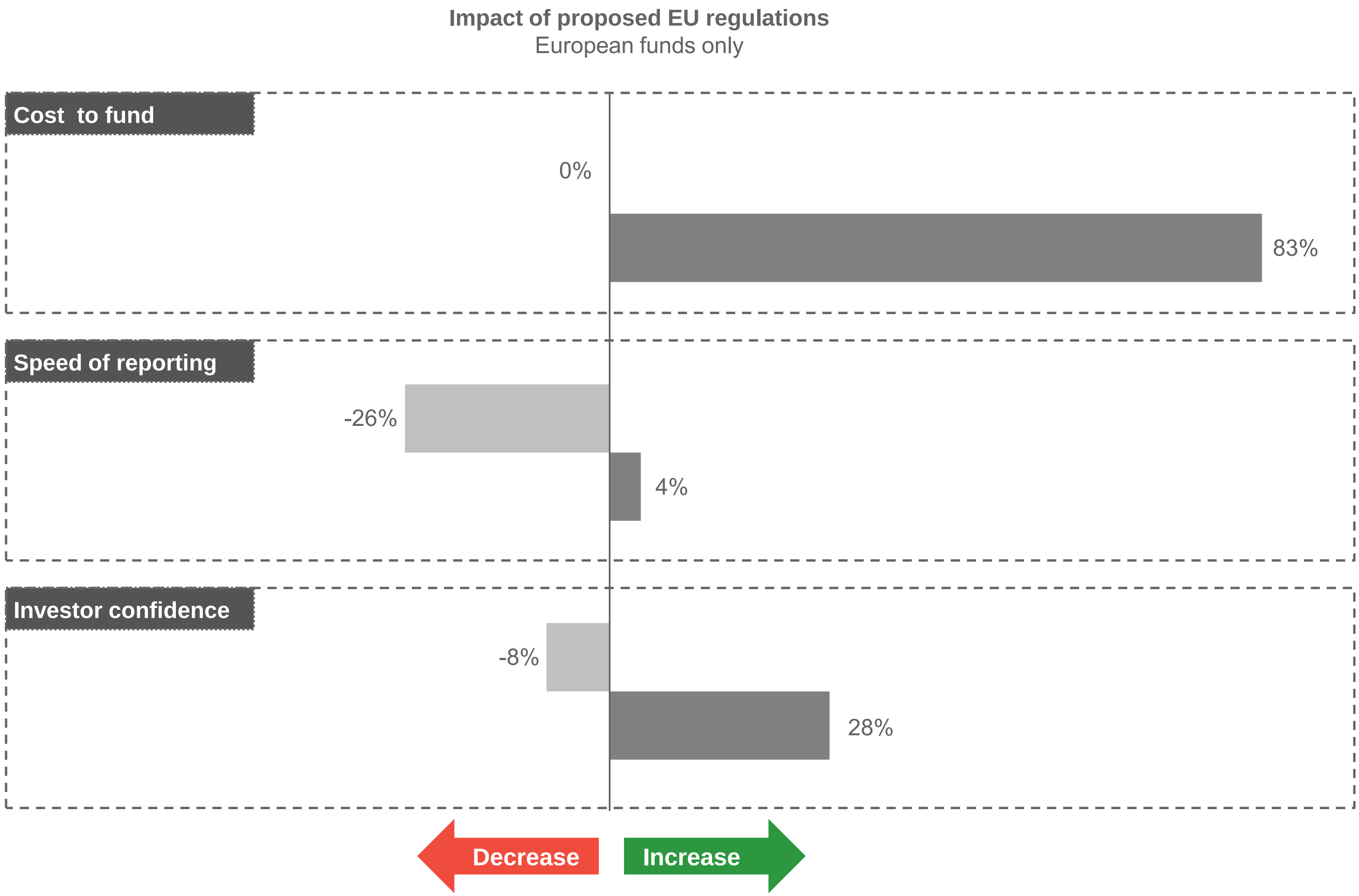
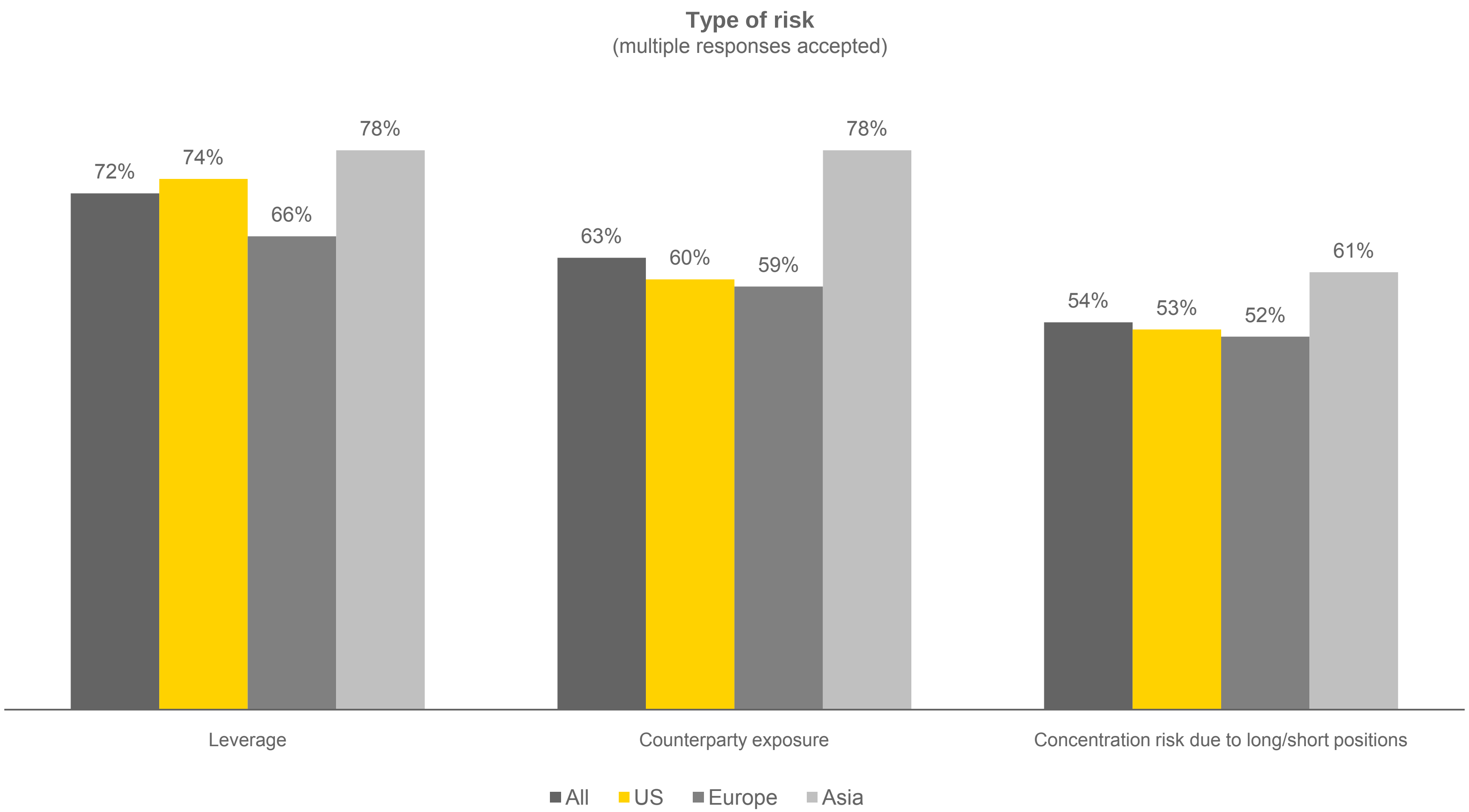
And costs are expected to dramatically outweigh benefits



Systemic risk – regulators need information about leverage



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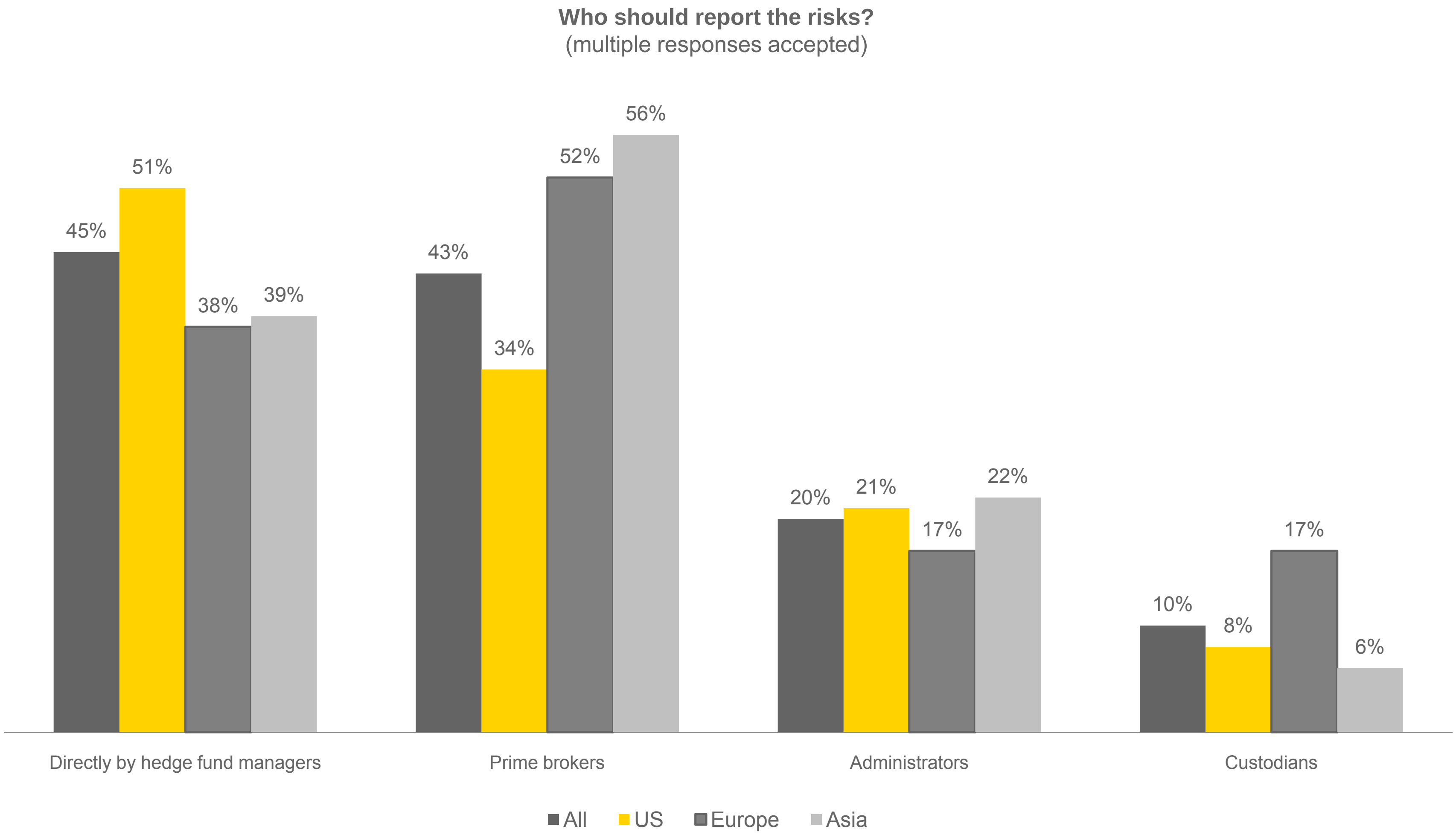
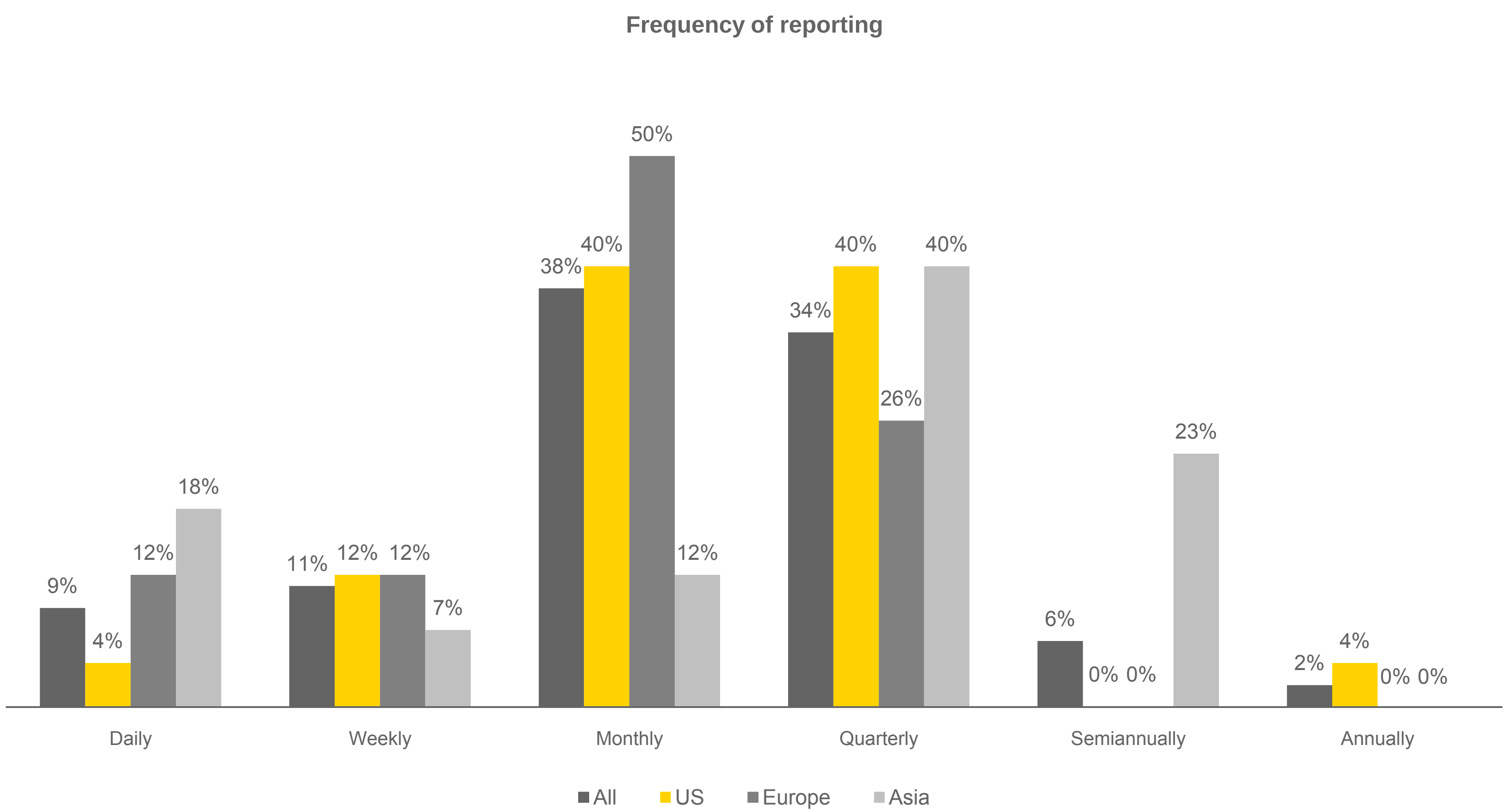
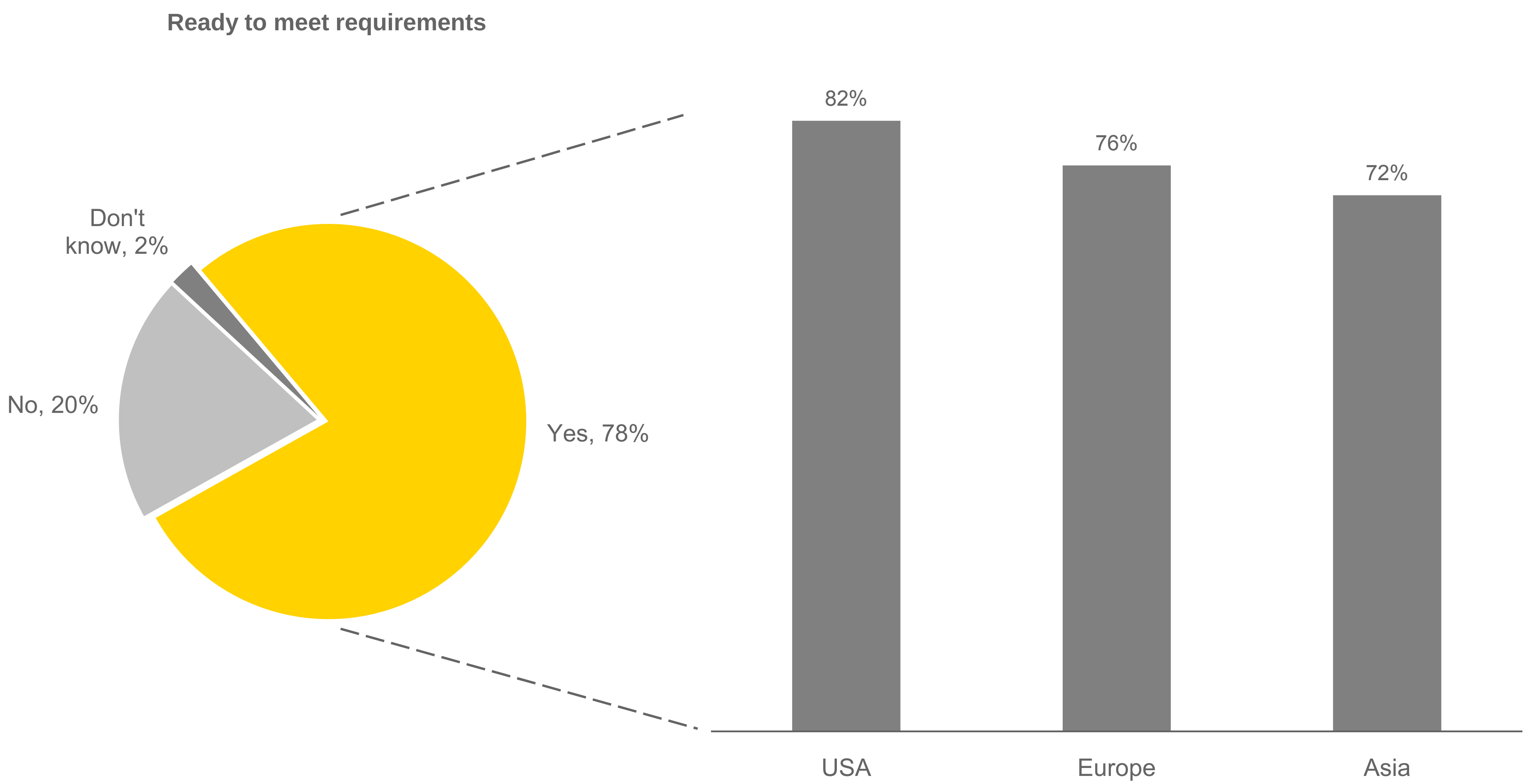
Self-help in the US, dependency on others elsewhere …



… Most markedly in Asia where managers say “report often, but make sure somebody else does it for you”



Nearly everybody feels ready to meet regulatory requirements … without necessarily knowing what they are?



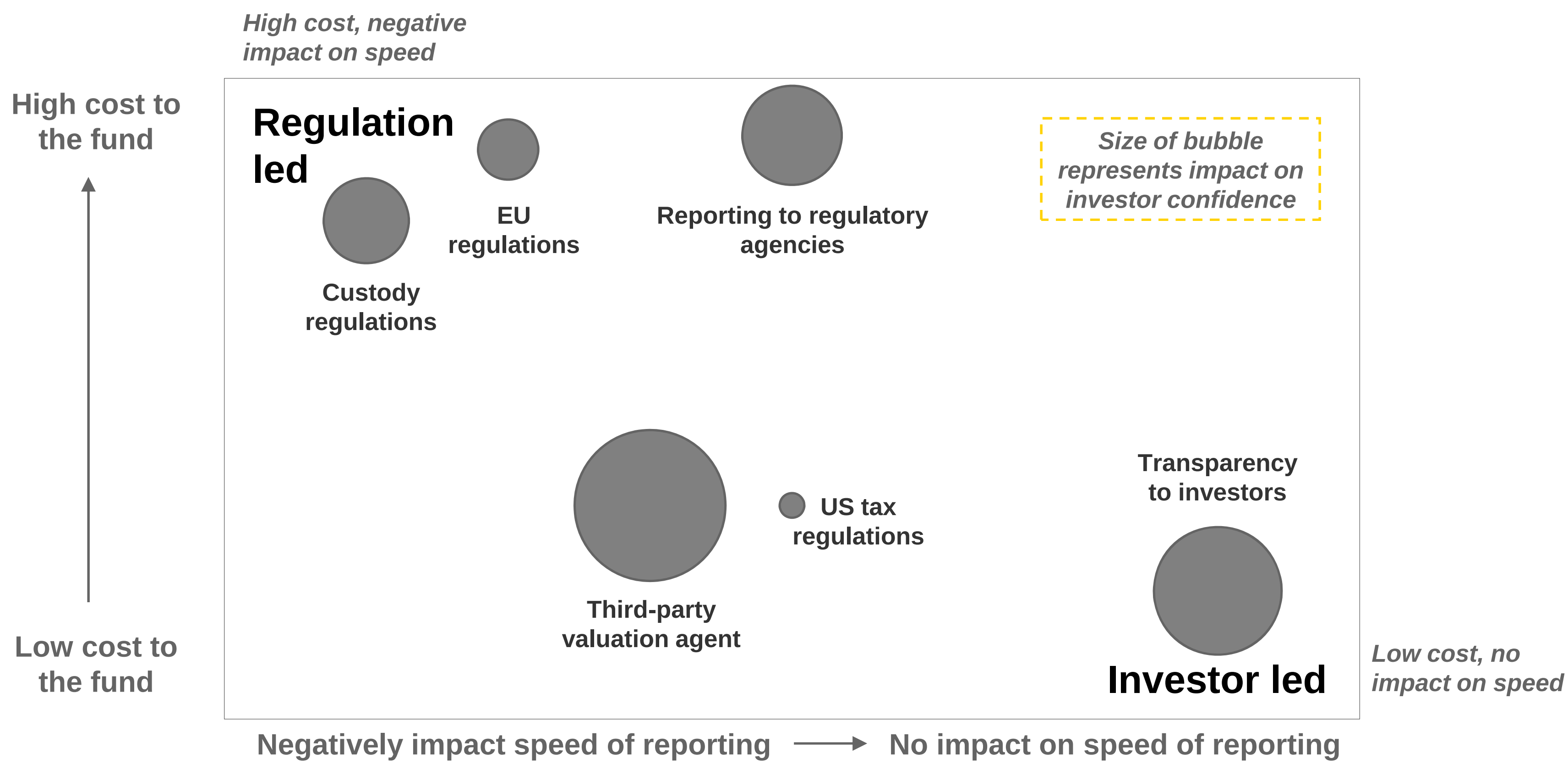
Challenges in complying with impending regulation …

- "The biggest challenge is being completely in the know about what is expected. The increased reporting will have a mild increase in the cost of the fund because more work means more systems and taking the time to develop the reporting."
- "Global leverage caps will be a challenge. With the EU side, if the regulations are implemented the way they are currently drafted, then it could have a very large impact on the cost side. I suspect it will be slightly watered down."
- "I think we will be ready. The biggest challenge will be the regulatory audits, if that is what happens. Also, beefing up the internal control environment to make sure it meets the standard they are looking for will be another challenge."
- "The biggest challenges will be to ensure the accuracy of data that is required to be reported. There will be a lack of unity and common consensus with various regulatory bodies. The issue is defining what specific reporting requirements are mandatory and the need to readjust our office management requirements to suit and match those extra regulatory conditions. We are a Swiss-based fund manager and not part of the EU. We believe the Swiss government will support increased regulator monitoring and therefore we will be required to adapt to any change. We will comply."

Source: Select quotes from survey participants

Investor driven change is the most productive at the least cost: regulation is believed to be forced, less far reaching and expensive

Impact of changes on hedge funds



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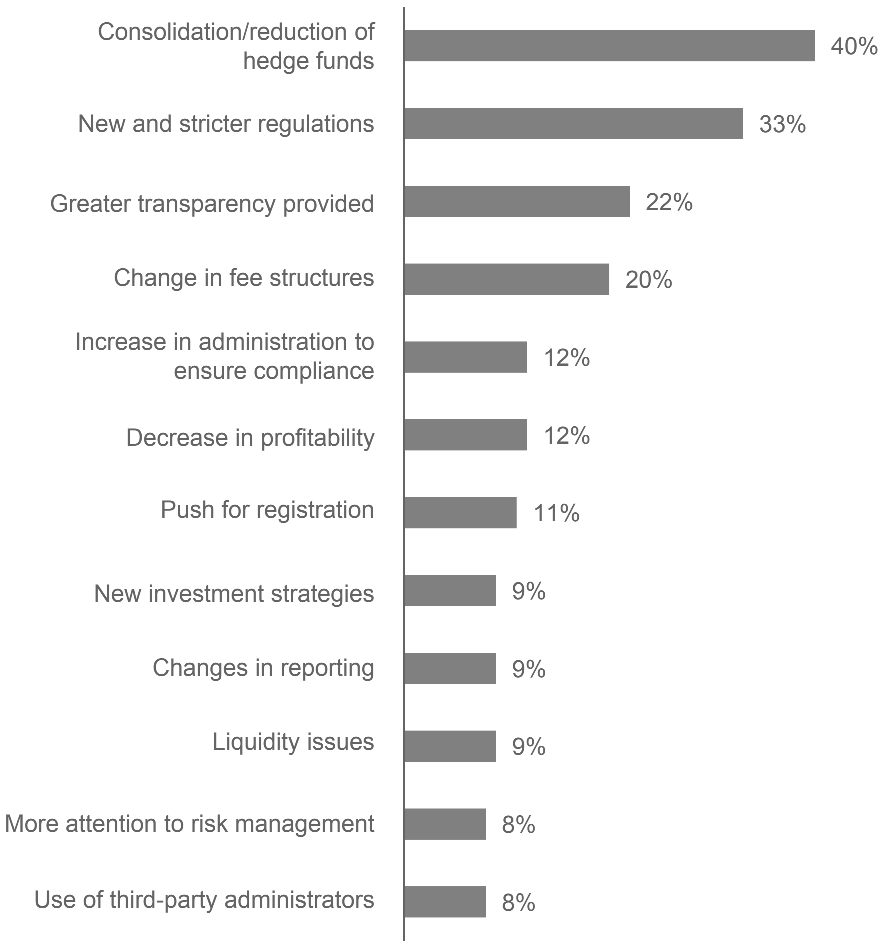
Profound changes in the industry that have been initiated are likely to continue – the endgame is not yet in sight

Biggest changes (top 12 issues)
(multiple responses accepted)



Future change to hedge fund industry

- "Regulation will increase. The entry barriers for hedge funds will increase. For smaller hedge funds, it will be difficult to survive."
- "The number of funds will be smaller. The regulatory landscape … will be unfavorable to fund managers and investors as well as some providers. All stakeholders will be negatively affected."
- "The oversight regulation is going to impede the entrepreneurial nature of the hedge fund industry and its ability to generate returns … I wish there was going to be a greater uniformity between regulators … At the end of the day, this will not help investors … navigating through the rulebook is going to be impossible."
- "There will be more consolidation and more institutional clients. There will be a loss of funds and it will be more difficult to start up new funds. There will be more pressure to reduce management and incentive fees."
- "It is becoming more and more difficult for new entrants with the higher barrier to entry. If the regulators create a new framework, there will be new arbitrage opportunities."
- "Evolution of investment strategies will continue to evolve as the market changes."

Source: Select quotes from survey participants

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