Gravitational waves

Hedge funds adapting their business operations in response to changing investor dynamics.

As the convergence between the two worlds of hedge funds and traditional long-only funds continues to draw closer into a unified orbit, one of the challenges that managers will need to embrace is how to interact with investors; especially Millennial investors who have grown up with the internet and communicate almost exclusively using web applications.

Asset managers who are best able to utilise technology to interact, share ideas/solutions and design portfolios for this next wave of investors will likely be tomorrow's winners. "Millennials prefer to find things out for themselves. They are less receptive to old style sales techniques. Observing how the tech giants market to their prospects shows the significant changes that are occurring in sales strategies," said Melissa Hill, Managing Principal, Sabre Fund Management, a London-based quantitative hedge fund manager.

Hill was speaking on a panel hosted by FIS Systems Limited (who recently acquired SunGard) in conjunction with Global Fund Media on Thursday, 17th March at the Reform Club. Entitled *Hedge Fund Insights: How the chemistry between managers and investors is shaping the hedge fund universe*, the panel also consisted of Andrew McCaffery, Global Head of Alternatives, Aberdeen Asset Management; Nick D'Onofrio, CEO, North Asset Management, a global macro hedge fund manager; and Leonard Ng, Partner at Sidley Austin LLP and head of its UK and European regulatory group.

Aberdeen's alternatives platform has grown to more than USD30bn in AUM following the acquisition of leading FoHF manager Arden Asset Management and FLAG Capital Management, a PERE manager, underscoring the extent of the convergence referred to above. McCaffery confirmed that Aberdeen had acquired a platform recently specifically to enhance the way that IFAs can connect with individual investors. "It's about building digital links, and we will be increasing our technology spend, and hiring more technology people, as we build more effective links with intermediaries and investors," said McCaffery.

Andrew McCaffery, Global Head of Alternatives, Aberdeen Asset Management, was one of the speakers on the FIS panel discussion

Increasingly, there are signs that financial institutions recognise the need to evolve their business models to better engage with investors. Robo advisers, which use machine learning software and algorithms to automatically invest into portfolios based on clients' goals and risk thresholds are becoming more prominent.

Just last month, Goldman Sachs acquired Honest Dollar, which maintains retirement accounts managed by Vanguard. More will likely follow. Projections made by consultant A.T. Kearney suggest that robo adviser AUM could reach USD2.2tn in the next five years.

This is one way that technology is being used to adapt to the changing investment habits of investors. If one assumes that technology giants such as Google and Apple have long been at the vanguard of interacting with end users, should they eventually move into financial services it would signal a huge threat to the established fund management community.

Asked whether hedge funds could use machine learning capabilities and predictive analytics to stay ahead of traditional asset managers, the panel said that the main issue was just how expensive it was to put such capabilities in place.

McCaffery pointed out that whilst it would be a significant game changer if the likes of Google did expand into financial services, the one hurdle that is keeping these companies back is regulation. "So long live regulation for a while!" said McCaffery, prompting laughter from the audience, which consisted primarily of senior fund management figures. He added that Aberdeen's focus was on developing more internal technology systems to better cope with data, which Aberdeen must process in abundance to build the best portfolio solutions for its end investors.

"We are looking to establish common systems that support common processes from an investment perspective, and getting the data in place that we can use effectively to support our investors when it comes to developing investment solutions. We are increasingly moving into a digital world and that is changing the way we interact with clients," stressed McCaffery.

The need to evolve one's operational model to remain relevant to investors, both existing and potential, is another aspect of the technology debate as traditional and alternative fund management melds together.

Sabre's Hill said that whilst everybody thinks about investment alpha, 'sales alpha' can be generated by harnessing the power of data to be more strategic about marketing plans. "You need to make systematic decisions about where to compete by product, channel and geography. Being able to analyse the success of plans and refine approaches is the key to effectiveness," commented Hill.

D'Onofrio said that North Asset Management was always looking to improve its systems but admitted that regulation had added a whole new layer of complexity. He made an interesting point, when discussing the convergence trend, by observing that whilst long-only investors have a particular way of seeing things (from a reporting perspective) for their traditional investments, this doesn't necessarily translate over into hedge funds.

"A lot of long-only investors will provide us with a sheet to fill out that isn't relevant to our industry. These are things that we, as an alternatives industry, need to overcome, and efficiently. It's difficult when different long-only investors have different reporting requirements that they must report to their regulator," said D'Onofrio.

One common denominator that all fund managers must grapple with today is market regulation. The industry has become a miasma of global regulations and this has certainly contributed to changing the way that hedge funds in particular interact with their investors. Whereas a decade ago there was little information shared with investors beyond monthly updates and the odd investor letter, today those demands have become demonstrably greater.

Hedge Fund Insights: How the chemistry between managers and investors is shaping the hedge fund universe – discussion panel

Leonard Ng, Partner at Sidley Austin LLP

In this respect, global asset managers such as Aberdeen have a competitive advantage because they have one precious commodity that most hedge fund managers lack: resources.

With 38 offices globally, platform operations in Luxembourg and Dublin and a huge number of staff to rely on, Aberdeen can better absorb the complexities of marketing funds in different jurisdictions and complying with the necessary reporting obligations. McCaffery stated that rather thinking only about how regulation impacts Aberdeen as a group, much time is spent thinking about how it affect its clients; specifically in relation to Solvency II and Basel III.

"One of the challenges we have is not just reporting but building portfolios around the most efficient way for clients to deploy their capital. That requires having the right systems and human expertise to be able to model scenarios and expected outcomes for investors. For us, our biggest challenge is perhaps less navigating the regulatory landscape and more how we can best bring our expertise to the table to deliver solutions to investors," said McCaffery.

Leonard Ng pointed out that one of Sidley's hedge fund clients now employs four staff whose sole responsibility is to do transaction reporting. "That's how expensive it can potentially become. Annex IV reporting, EMIR transaction reporting, SFTR reporting, reporting on Solvency II; asset managers have to find a way to rationalise that and there are plenty of service providers who have systems to take care of these requirements, but I would advise managers to choose wisely.

"Looking ahead, with respect to MiFID II it is likely to be introduced in January 2018. However, it would be a mistake to stop thinking about this regulation for another year. There are things that managers should be focusing on today such as system builds which take time, so my recommendation is 'don't stop'," advised Ng.

One other important aspect of the hedge fund/investor dynamic – again, as it relates to competition and standing out from a converging funds industry – is the way that managers think about asset raising and designing new products.

With respect to asset raising, North Asset Management has responded to the 'institutionalisation' of the hedge fund industry by focusing on attracting talent and diversifying its portfolio management process; both in terms of people and systems. "We are a discretionary macro fund but we are very focused on quantitative models to help us in our investment process so that we can show investors that there is a repeatable process at work and that there's a fundamental validation of how we run the strategy," explained D'Onofrio.

Hill said that Sabre was building a boutique asset management business, not a hedge fund. The plans for growth include targeting retail and institutional clients via a range of UCITS, offshore funds and bespoke managed accounts. Sabre also has plans to strengthen its distribution partnerships. She said that the key was to have good partners not just to help raise initial seed capital but to help effectively distribute the product.

Hill noted that having built the technology platform to separate out the component parts of their various fund offerings, Sabre had recently launched its first fund of one on behalf of a US institution. HIll also commented that the company had plans to launch another UCITS later in the year. This will be a discretionary market neutral fund, employing a strategy currently operated in a separate managed account.

Regulated funds have become a key weapon for any ambitious hedge fund manager and in many respects the 'liquid alternatives' phenomenon of the last few years is the key battleground for traditional and alternative fund managers. D'Onofrio confirmed that a UCITS version of the North

Melissa Hill, Managing Principal, Sabre Fund Management

MaxQ Macro Fund, which launched on ML Capital's Dublin-domiciled MontLake UCITS Platform two years ago has grown to more than USD350m in AUM.

Over at Aberdeen, McCaffery said that whilst customised portfolios are a key part of its business in terms of raising assets – particularly using managed accounts which give state pension plans and insurers bespoke outcome-driven solutions, and sufficient levels of data that can be plugged in to their wider portfolio – liquid alternatives had become strategically important.

"We've raised USD700m in six months for one of our liquid alternative 'manager of managed account' products, where individual hedge funds come on to our platform and manage a sleeve of capital within the structure. Cost, transparency and the ability for the product to fit into their portfolio: these are themes that we see investors prioritise and we focus on to raise capital," said McCaffery.

As the hedge fund industry continues to evolve, it is becoming increasingly clear that managers are adjusting their business models to accommodate more products and appeal to a wider selection of investors; be they managed accounts, funds-of-one, regulated funds, or straightforward offshore Cayman funds.

This requires, however, a degree of operational flexibility, not to mention an open mindset. One of the clearest manifestations of the changing manager/investor dynamic is the degree of customisation that investors want, not only with products but the way that performance is reported. As a result, managers are having to cope with a wider spectrum of liquidity profiles, fee terms, and levels of reporting granularity.

"The next big challenge for us is can we wrap everything up into a single vehicle for 'Alternatives'; we've got liquid strategies, UCITS, manager of managed accounts, access to illiquid parts of the market. Consultants are talking more about multi-alternative portfolios; combining private equity, real estate and infrastructure strategies with hedge fund strategies.

"To be able to provide that full range of liquidity in a single open-ended vehicle very much remains the Holy Grail at the moment," concluded McCaffery. ■