Lawson Conner Regulatory Update

The state of the Hedge Fund market

A market snapshot – Is it a great time to raise capital?

Who is affected?

Alternative Investment Fund Managers, Portfolio Managers, Traders

Summary

2017 has seen greater potential for profitability for emerging investment firms, and general investor negativity towards hedge fund fees has declined. This update will look at some of the key reports that have been released over the course of the last couple of months, and focus on assessing the state of the hedge fund market as well as discussing the trends that we could see in 2018.

Key Findings

These findings are drawn from a number of sources, including Bank of America Merrill Lynch, Deloitte and Prequin.

Profitability – Emerging and smaller hedge funds have a much lower breakeven point for profitability than previously thought. Studies over the last couple of years have suggested that hedge funds need assets of several hundred million dollars to breakeven but in the AIMA/GPP Emerging Manager Survey 2017[1], which sampled 135 emerging hedge fund managers, the average breakeven point was $86 million, and a third of the firms surveyed could breakeven with assets of $50 million or less. Outsourcing service functions such as compliance administration, and using smart technology has the potential to make this break-even point even lower. Technology will play a huge part in profitability for hedge fund managers, as artificial intelligence, robotics and big data have a big impact, and hedge funds look to embrace these business-altering innovations. In its 2018, Investment Management Outlook[2], Deloitte predicts that 70% of new hedge fund launches "will likely include investment processes that are supported by computer models, including AI and machine learning algorithms," in contrast with just 47% in 2015. The EY 2017 Global Hedge Fund and Investor Survey[3] also found that 50% of managers said they have implemented or plan to implement something innovative with their tech investments, and 40% said the same for automating manual processes.

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[1] 'Alive & Kicking' -The AIMA/GPP Emerging Manager Survey 2017

[2] Deloitte 2018 Investment Management Outlook

[3] EY 2017 Global Hedge Fund and Investor Survey

A number of specialised services providers are catering to this emerging manager space, for example, we have seen law firms offering fixed pricing on a number of launches and also offering standard fund structures. However, Lawson Conner believe it is critical to develop an institutional product right from the outset to be able to attract institutional and family office money. Emerging managers should not cut corners when it comes to operational due diligence, compliance and regulations as these are core areas of focus for investors, even before the performance of the fund.

Market Outlook – 2017 was mainly positive for hedge funds, with the year on course to deliver the highest return (12.7%) since 2013. In November alone, hedge funds climbed about 6%. According to a survey from Bank of America Merrill Lynch[4], though, the UK continues to be deeply out of consensus among European managers, with 39% of fund managers stating it is the region they would most like to underweight. Despite this, Brexit is not in the top 5 global risks for the BAML respondents – these include monetary policy error and a cash in global bond markets. Towards the end of 2017, Asian markets reached a near decade high as the economy grew at its fastest rate in seven years in the third quarter.

Only 30% of the 140 fund managers surveyed in the Prequin Hedge Fund Manager Outlook H2 2017[5] found the previous year more challenging than the one before; compared to 50% a year ago. A study from eVestment[6] backed up this optimism, showing that November was the thirteenth consecutive positive month and activists and long/short equity strategies are both up an average of 10% over 2017. Despite major political events such as Brexit, and the election of President Trump, the hedge fund market remained buoyant in 2017, with institutional investors remaining the vital source of capital.

Bitcoin (BTC) and other cryptocurrencies also came to the forefront of the hedge fund market last year, with one BTC unit reaching a high of $19,000 before the currency's worth fell away again. Appetite for cryptocurrency could continue to rise through 2018 – 65% of fund managers have seen increased appetite from institutional investors for cryptocurrency products, with 7% actively investing in cryptocurrency and a further 6% intending to do so in 2018.

Investor Attitude – There are mixed views from investors about 2017 and the outlook for hedge funds in the forthcoming year. Ahead of it Prequin Global Hedge Fund Report 2018, Prequin surveyed 200 investors[7], and the outcome was mainly optimistic with 72% expecting hedge funds to either improve in 2018 or

[4] Bank of America Merrill Lynch Global Fund Manager Survey
[5] Prequin Special Report – Hedge Fund Manager Outlook H2 2017
[6] eVestment Hedge Fund Performance Report November 2017
[7] Prequin Investor Outlook Alternative Assets H2 2017

remain level with 2017, and just 28% believing hedge funds will not be able to return to the same high. The Hargreaves Lansdowne Investor Confidence Index[8] recorded a record low for investor confidence across all funds though, with confidence levels at 76 for the year, just one point lower than in 2008 at the height of the financial crisis and of the respondents in the EY survey, 15% said they were likely to decrease their allocations to hedge funds in the next three years, with just 11% expecting to increase allocations.

The EY survey revealed that investors are also looking for more innovation within hedge funds – 30% said that they would like to see hedge funds become more innovative within front office/investing. Only 24% said that the hedge funds that they currently allocate to use next-gen or non-traditional data, but 38% expected that they would within three years.

It is clear that the positive performance of the hedge fund industry in 2017 has at least maintained investor appetite but Lawson Connor believe to maintain this momentum in 2018, fund managers will need to make increasing efforts to innovate and harness new technology.

Fees – Most investors are looking for more favourable fees from hedge fund managers and there has been a backlash against the common 2 and 20 fee structure, which prolific US investor, Warren Buffet, described it as 'obscene' last August. The 2 and 20 fee structure seems to be less common with the emerging fund managers surveyed by AIMA, with firms with a sub-$500 million AUM charging a management fee of 1.25% on average. Only 14% of fund managers in this survey were charging a 2% management fee. The BarclayHedge[9] July Fund Manager survey illustrated how the fee structure in the hedge industry is evolving, with 36.6% of the 134 of the fund managers surveyed, saying that they offered reduced fee or no fee alternatives to investors. An article in Institutional Investor[10], in August, suggests that many funds are moving towards a sliding scale fee, where the management fee decreases as the assets under management increase, with law firm Seward & Kissel estimating that 20-25% of hedge fund launches are offering this structure.

We believe that the industry sentiment will continue to edge towards more favourable fees as investor pressure increases, and fund managers will need to find a way to make fee structures more attractive. This is backed up by the EY study, which found that 66% of hedge fund managers have adopted or are considering non-traditional fee structures to attract investors.

[8] The Hargreaves Landsdowne Investor Confidence Index December
[9] BarclayHedge FundManager Survey 2017
[10] Institutional Investor, 'No 2 and 20 – no problem' 25th August 2017

Compliance – 89% of respondents in the AIMA survey say that they are spending at least 20% of management company expenses on compliance and regulatory costs, and most of the fund managers surveyed expect this proportion to increase now that MiFID II has been implemented. It is no surprise that MiFID is expected to have such an impact on compliance costs – two major hedge fund firms, Bevan Howard and Tudor, dropped their MiFID licenses last year, switching to Alternative Fund Investment Management Licenses instead. Another challenge for hedge fund managers is how to pay for research, as the MiFID directive which came into force on January 3rd states that costs can no longer be bundled up with trading commission. A separate AIMA study[11] found that 34 per cent of alternative asset managers remained undecided about how to pay for research in June, just six months before MiFID implementation.

Deloitte predicts that 2018 will see a shift towards cloud computing from small and medium sized investment firms, and that there will be an accelerated adoption of outsourced functions, both front and back office, in a 'complex and disruptive environment'. This is backed up by the EY Global Hedge Fund and Investor Survey, which found that 57% of hedge fund managers are innovating to improve their operational efficiency in response to market disruptions. At Lawson Conner, we agree that as compliance becomes more demanding and fund managers grapple with the intricacies of MiFID II, along with investor demands for technological advancement, we will see a further shift towards outsourcing as a way of increasing profitability.

In its report, Regtech Strategies for Financial Services 2017-2022, research firm Juniper found that Regtech spending, as a percentage of regulatory spending, will increase dramatically, from 4.8% in 2017 to 34.4% by 2022. This represents a vast opportunity for Regtech vendors, who can capitalise on banks seeking efficiency in meeting regulatory compliance requirements. With multinational financial institutions such as Citi having as many as 30,000 compliance staff, just three bank compliance departments could fill London's Wembley Stadium. Automation has huge potential to reduce this.

This level of staffing means that a 50% reduction could save a single large bank $1.2 billion per annum, based on average wages. The research also found that AI automation of KYC (Know Your Customer) checks will reduce time required by 90%, generating time savings of 5.4 million hours annually by 2022.[12]

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[11] AIMA MiFID survey, June 2017

[12] https://www.juniperresearch.com/press/press-releases/regtech-spending-to-exceed-$76bn-by-2022

Performance and Growth – 2017 looked set to deliver the highest annual return for hedge funds, of 12.73%, since 2013. The Prequin All-Strategies Hedge Fund benchmark also generated incremental gains in November of 0.40%, making it the thirteenth consecutive month of positive returns. It has been a year of milestones for the hedge fund industry. Total industry capital reached a record high of USD 3.16 trillion in Q3 2017. At Lawson Conner, we expect this growth to continue despite continued political uncertainty. The success of Asian and Emerging markets and the increased appetite for cryptocurrencies such as Bitcoin and Blockchain could lead to accelerated growth in Q1 of 2018.

How we can help?

Lawson Conner has worked extensively with our clients to assess the impact of regulatory change. We would be delighted to discuss how we can help support the Fund & Wealth Managers in your organisation to meet these new challenges. Lawson Conner's team of compliance professionals can assist you at every stage as you seek to comply with the new regulatory obligations.

About Lawson Conner

Lawson Conner is a leading provider of compliance and regulatory infrastructure.

Lawson Conner offers customised solutions in the areas of Fund Structuring, Compliance Advisory, Global Regulatory Infrastructure, Fund Distribution, Regulatory Hosting, Appointed Representative Services and ManCo Services.

As a reliable and trusted partner, we create long term value by working with passion, expertise and unparalleled commitment to the industry and our clients.




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