

Weathering the storm

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The global hedge fund survey «Weathering the storm» published by Ernst & Young in November 2009 reveals that the global downturn forced hedge fund managers to respond swiftly and radically to the demands of investors. Increases in transparency and governance brought on by the crisis represent dramatic improvements for investors. Significant changes to the governance, fund administration, and investor reporting have all enhanced investor confidence without significant additional cost. This rapid transformation has also shown that the industry can effec-

tively respond to the needs of investors. In stark contrast to this is the increased regulatory oversight, which has been viewed as imprecise, of less utility to investors, and even overly expensive.

The global hedge fund survey

The survey was conducted by international research concentrated consulting firm Greenwich Associates for Ernst & Young, and polled 100 of the largest hedge funds globally, representing USD680b in assets under management (roughly half the industry), and this time with a notable and deliberate skew to include some smaller funds, particularly in Asia. The objective was to solicit the views of hedge fund managers and to understand how

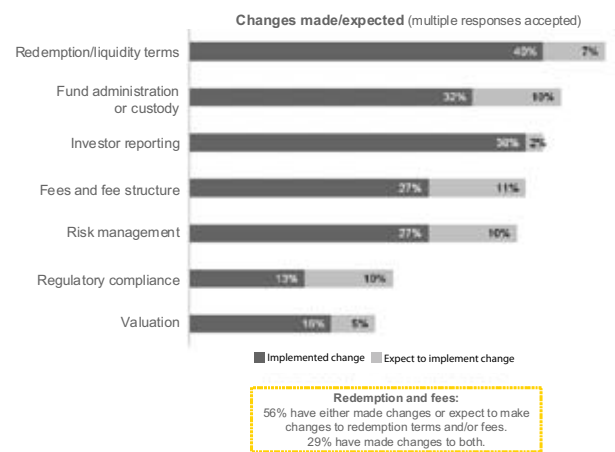
they have withstood the crisis as well as how they have been preparing for a more certain future in light of market forces, and the changing regulatory landscape. Survey participants were asked to comment on fees and liquidity/redemption terms, custody and prime brokerage, transparency and reporting to investors, US and EU regulation and tax legislation, regulatory reporting, independent valuation and expectations for the future of the industry.

Profound structural changes for hedge funds

The survey tells several stories. The financial crisis has forced dramatic changes to the hedge fund industry with 27% of the managers interviewed changing fee structures, 40% changing liquidity terms, 38% changing investor reporting, 32% changing fund administration or custody, and 27% changing risk management since the beginning of last year. The key changes are shown in Graph 1.

An important message is that fund 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 valuation processes, and fund governance. Survey participants even saw this rapid transformation as proof that the industry effectively can respond to the needs of investors. Increased regulatory oversight on the other hand was felt by the hedge fund managers to be imprecise, slower, of less benefit to investors, and even overly expensive. This is not the consistent resistance of

Graph 1 | Hedge fund structures have reacted sharply to the crisis and managers await further regulatory oversight



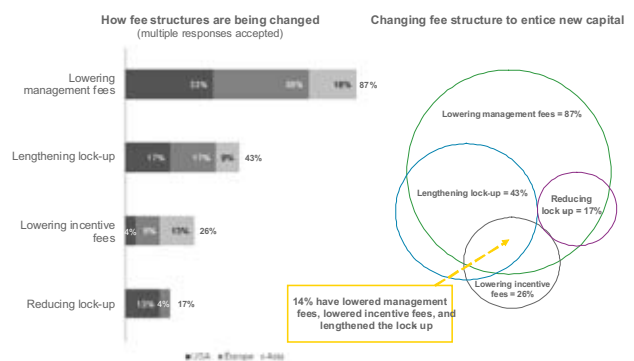
Source: Global hedge fund survey: weathering the storm, Ernst & Young, October 2009

the regulated hedge fund managers but rather the unemotional, matter-of-fact view of senior industry managers 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 between 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 fees, rather than incentive fees. Respondents believed that limiting redemptions, imposing gates or suspensions and the like, will have limited impact in the long run.

Specifically, over half of the hedge funds (56%) surveyed had made or planned to make changes to redemptions terms and/or fees. One in four had lowered fees because of investor pressure, with nearly half having done so in order to attract new capital (graph 2 shows the expectations regarding fee structures). More controversially, almost a third of the managers opted to impose gates or suspensions on redemptions during the crisis, but they remained optimistic that their actions will not have a negative impact on their ability to maintain or raise capital. Some 53% believed that this would help maintain current investor capital in the fund over the long term.

Graph 2 | Expectations regarding fees structures (to attract 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

Source: Global hedge fund survey: weathering the storm, Ernst & Young, October 2009

On the topic of relocation, there are likely to be very few hedge funds that become tax refugees from the US. Despite endless talk about the re-domiciling of fund operations due to impending US tax legislation, few hedge fund managers are seriously considering doing so. However, nearly a quarter of US and UK respon-

dents said that general partners were considering moving because of tax and other burdens. People, unsurprisingly, relocate faster than the infrastructure they have set up. Investors have become more acutely focused on risk. Performance cannot be the panacea for the entire industry – even the managers that have performed well through the crisis have suffered redemptions and have been subject to far greater scrutiny by clients and investors 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 ranked lower than expected; and unsurprisingly, questions about bankruptcy laws in differing jurisdictions, and how customer protections operate had been featured more highly post-Lehman.

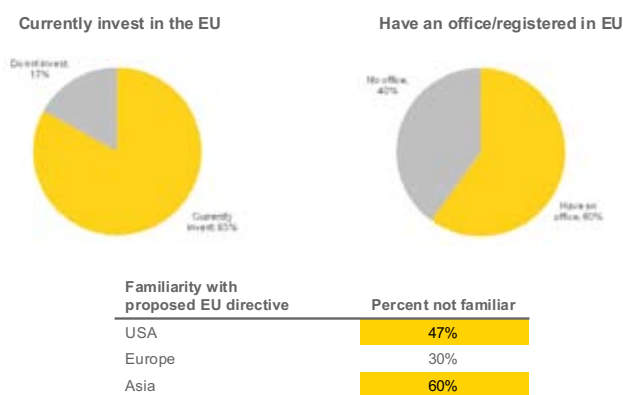
When it comes to the figures, approximately 80% of the hedge fund managers indicated that the primary area of focus for increased disclosure has been a better understanding of risk and performance. It is noteworthy that by a three to one margin, investors are now more focused on better understanding risk rather than performance. The most significant increases in risk management information shared related to risk concentration (95%) and leverage (71%). Nearly all respondents share this information on a monthly basis. These actions were welcomed by the industry as worthwhile initiatives, in which the benefits clearly outweigh the costs. However, almost half of the respondents admitted that some information is shared only with those who ask for it.

Proposed EU Directive - dramatic impact for hedge funds

Outside Europe, particularly in the US and Asia, there is limited awareness of the draft European Commission Directive on Alternative Investment Fund Managers (AIFM). Approximately a sixth of the respondents who had considered the draft directive said they would cease operating in the EU altogether if it was passed in its current form. Many more (30%) said they would not venture in or set up an office there.

Over four fifths of European fund managers believed that the AIFM Directive would increase costs, while 28% believed it would improve investor confidence, and 26% thought it would slow down reporting. Although there is a general belief that it is unlikely that the draft Directive will be approved in its current form, there is concern as to its

Graph 3 | Independent valuation (much skepticism about the knowledge and capabilities of third party agents, particularly for illiquid investments)



Source: Global hedge fund survey: weathering the storm, Ernst & Young, October 2009

motivation, its directional thrust, and a sense of disbelief that business legislation could be so politicized, be promulgated with lack of consultation, and appear so restrictive.

How the future unfolds for hedge funds

The hedge fund managers interviewed were not opposed to new regulation. To the contrary, they understood that there will be stricter regulatory oversight and they are preparing for it. They were concerned, however, about the alignment between regulatory bodies in the US, the EU, and elsewhere, and the cost of compliance relative to any positive benefit to investors.

We have observed a clear trend whereby hedge funds have been assessing the set-up of a part or all of their business in Switzerland. The higher tax rate in London has been clearly a driver of this trend.

Planning for future growth - a critical element of business strategy for investment management and especially hedge fund firms also encourages hedge funds to seriously determine whether or not to move operations from the UK. If foreign states continue pressuring the hedge fund industry by pushing taxes and regulatory burden up, then Switzerland is a good turf for setting up hedge funds and acquiring new assets. Considering that hedge funds are highly mobile, they have been the first to hit the exodus wave and cause a capital and know-how drain towards jurisdictions like Switzerland.

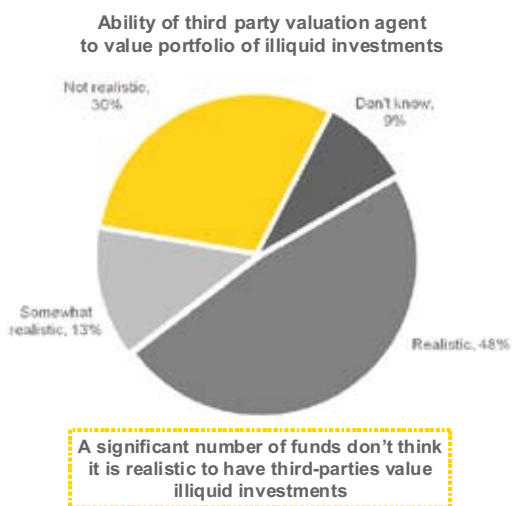
The service providers to the hedge fund industry have also been strengthening their presence in Switzerland and elsewhere, to follow the trend of their clients. The current discussions around the AIFM Directive at the European

level, in particular regarding the relationships to non-EU countries and delegation of services to non-EU countries, will continue to be interesting to follow and should definitely have an impact.

Is the US, the EU, or Switzerland the main place to be for hedge funds? On the North American continent, the US Congress has been actively promoting reform of the investment industry and the US government has placed restrictions on firms that have taken a lot of government aid. Given its increasing economic power, Asia could become more important as a financial hub. Hong Kong and Singapore have proved that they can attract international fund managers and bankers. Kuala Lumpur aspires to become a Mecca for Islamic finance, Seoul and Tokyo want to become regional financial centers, and Mumbai and Shanghai global ones.

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. However, only 48% of the managers interviewed believe that third party valuation agents are able to value portfolios of illiquid investments which show the limits of such independent valuations (as revealed in Graph 4).

Graph 4 | EU Directive – many remain uninformed, especially in the US and Asia



Source: Global hedge fund survey: weathering the storm, Ernst & Young, October 2009

Although the endgame remains unclear, Graph 5 shows that changes to the industry have been profound. Hedge fund managers widely predicted that the hedge fund industry will see continued consolidation as a result of recent events and expected regulation. Increasing costs and greater barriers to entry will both play a part in the process and further signify

that start-ups will be fewer and generally smaller than prior to the crisis. Despite the obvious structural difficulties for M&A activities in the industry, the inexorable convergence in the investment 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. Last but not least, fee structures, liquidity and redemption terms as well as investor demands for transparency and governance are also expected to exacerbate the trend.

Graph 5 | Profound changes in the industry



Source: Global hedge fund survey: weathering the storm, Ernst & Young, October 2009

Conclusion

In summary, the global hedge fund industry has weathered the storm, but has not been left unscathed. The survey results indicated that some changes have been profound and permanent, others perhaps more ephemeral. Although the industry appears resigned to accepting legislation, regulation and tax changes, 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.

With respect to the post-crisis legislative and regulatory changes, we believe it is important that re-regulation be applied in a non-discriminatory manner and in a manner that ensures a level playing field for all. It will be interesting to follow how the legislators will continue to push forward and how the hedge fund sector will in turn continue to respond to the challenge.