As assets under management among alternative managers continue to rise (they reached a record US$7.7 trillion in 2017, according to Preqin\(^1\)), institutional investors are becoming more confident in their allocations to the various asset classes.

Yet they are also becoming more vocal about what they expect from fund managers, with fees and transparency high on their list of areas for change.

While our survey, *The Race for Assets*\(^2\), showed that over half of investors expect allocations to alternatives to grow through the first half of 2018, it also demonstrated that this increased appetite is far from unconditional.

Fees were mentioned by 97% of investors as a factor when considering whether to invest in a fund, with nearly four out of five saying they planned to seek out lower fees. Meanwhile, nearly half (45%) want to see more transparency among hedge funds, and the majority of these (83%) are seeking more information on the underlying assets in a fund.

Evidently, fund managers are listening to these appeals. *The Race for Assets* reveals that the majority of managers are planning to raise transparency and lower fees in the next 12 months. There is also evidence, particularly among hedge funds, of a shift toward a higher performance element and lower management fees in a move that should align the interests of fund managers and their investors more closely.

Simply reducing management fees is not enough, however. It’s clear that the adoption of new operational models and solutions is essential if fund managers are to achieve the twin goals of increasing transparency and reducing costs.
Managed accounts on the rise

For larger investors (those with around US$200M+ in AUM to deploy), part of the answer lies in hedge funds’ managed accounts. A small but fast-growing option, managed accounts represent 17% of hedge fund allocations today but are expected to rise to 22% over the coming year, according to our survey.

These not only provide investors with a greater level of control over their hedge fund exposure, they also offer the opportunity for lower management fees and reporting on all aspects of their investments at a granular level.

While this is a growing trend, not all hedge fund managers currently offer this type of structure. But as investor appetite for managed accounts continues to grow, more managers are likely to expand their offerings.

Real-time reporting

Given that investors seek lower management fees and greater transparency, regardless of their size, fund managers need to take a close look at their reporting practices.

Risk is a key issue: investors are requesting more information on how much of a book is priced by the fund manager and how much by an independent third party, and they want data on individual holdings.

Those at the forefront of the alternative fund management space are offering investors an experience akin to retail banking. Using online portals or apps, investors can interact with live data in a format that allows them to see headline figures and more. They can understand where and how value in the portfolio has changed, and whether the called capital has been received and invested. They can also track performance attribution.

Overall, this presents a more timely and user-friendly solution to reporting. It is replacing the more traditional forms of communication, such as email reporting, and removing the need for time-intensive and error-prone manual processing of data on both the portfolio and investor reporting.

For managers used to maintaining tight control over the form and content of communication, the prospect of providing more information in such a format is likely to be more than a little daunting and contrary to the firm’s culture. However, if well managed, online portals can be tailored to provide the information investors require while also protecting commercially sensitive information.

New tools for a new age

The key to improving transparency is reporting enough information in a form that investors can use, while at the same time avoiding data overload. Investors with managed accounts, who have access to data on all their underlying positions, may need to ensure they have the right technology and resources available to them to analyze and interpret vast amounts of information on a live basis.

Yet not all investors need this level of granularity—or be set up to cope with it. And it may not always be helpful, or even desirable, for managers to expose daily risk views to clients. New tools can provide monthly performance and attribution reports. They also can drill down further into more detailed information on individual positions as an option, with managers’ consent—and only if investors require it.

“We need knowledge of any risks the investments may face. Without this, it’s very hard for us to make investment decisions.”

European pension fund CIO

Harnessing technological solutions

With the increased prevalence of managed accounts in the hedge fund space, treasury optimization moves center stage. Automation is an important trend here, with tools now available that move money at the end of the trading day to the safest and highest-returning overnight spot.

Programs can be coded to follow specific rules and optimize Treasury line-by-line, removing the potential for human error while also reducing the need for manual transfers.

Investing in technology infrastructure will ultimately keep operating costs lower, and enable fund managers to report to investors in a timely, detailed and accurate fashion.

Managers need to invest in new capabilities, such as online subscriptions and redemptions that will improve efficiency, reduce cost and improve accuracy, all while supporting investors as they migrate to new systems.

Co-investments on the rise

As investors seek more control over their investment exposure, lower fees and greater transparency, there is growing appetite for co-investments and joint ventures. Our survey showed that while just 19% of investors currently take up the opportunity of co-investing, well over a third (36%) intend to increase their activity over the next two years.

Aside from the embedded transparency in co-investments, this type of investment usually attracts lower management fees and carried interest than those made solely via funds. In some cases, investors can access these opportunities without a management fee. This can boost overall returns while also mitigating the risk of redemptions from, and increased subscriptions to, a funds’ pooled capital. In addition, investors have more control and influence through co-investments than through a fund vehicle.

For managers, the benefits are clear. Offering co-investment rights can help attract investors, differentiate managers from competitors and enable the fund to invest more in situations where the manager has a particular edge and therefore higher return potential.

There is also a side-benefit for both parties. By working together on investment opportunities, the relationship between fund manager and investor can be strengthened through better understanding, more trust and closer alignment.

However, co-investments will mean a change in the relationship between investor and manager. Investors leveraging co-investment opportunities will want a more intimate view into the investment level activity and an understanding of the allocations and fees methodologies to ensure that the interests are aligned. The ability to delve to this depth may require a retooling of capability at the investor level also.

Yet our survey points to a gap between the extent to which managers are offering co-investments (71% currently do) and investor take-up (which is low but growing). This is partially due to the speed with which investors need to act when co-investment opportunities arise.

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Words of wisdom
Three steps on the road to success

1. **Realize that future developments are happening now.** Despite being a nascent technology, blockchain (a digital ledger that disintermediates transactions) is being adopted by numerous funds. Asset managers are using the technology to enhance administrative processes and compliance. This creates cost efficiencies, improved data security, and greater transparency—the factors which are most important to investors.

2. **Get ready for more standardized and automated reporting.** This will become the norm. In particular, investors will increasingly seek information from alternative fund managers that can be integrated into their overall investment portfolios, to better understand their exposure, manage risk and gain a holistic view of their performance across all asset classes.

3. **Get the balance right between transparency and protection of sensitive information.** Key investor requests are disclosure on the underlying portfolio and information on the proportion of assets valued by the fund and by third parties. Fund managers need to decide what and how much they are willing or able to disclose to investors and recognize that a refusal to provide certain information may hamper investor relationships and future fundraising efforts, particularly if performance dips.

For the latest content in this series, please visit bnymellon.com/raceforassets.

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