

Key challenges for hedge fund managers in 2015

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European hedge fund managers are facing another challenging year with macro uncertainties adding complexity to their primary objective of delivering superior performance. Beyond performance concerns, there are other important trends and challenges facing the industry this year.

Evolving service provider relationships:

New capital and liquidity rules are impacting how prime brokers and custodians view their commercial relationships with hedge funds. With the introduction of Basel III and the Supplementary Leverage Ratio in the US, it is not as attractive for financial institutions to hold significant cash balances on behalf of their hedge fund clients as there are associated capital reserve implications. Accordingly, prime brokers may charge more for financing and/or seek to reduce the amount of leverage that they offer clients. Similarly, custodians are reviewing the balance sheet consumption associated with their alternative clients to ensure that there is an appropriate ratio of fee revenue to cash balances.

Accessing distribution: Post AIFMD, market access has become more complex for European alternative managers. With US investors accounting for the greater proportion of industry inflows, larger European players have choices to make. They can look to acquire a US manager, establish US feeder funds into their existing products or set up new fund products in the US. They can also seek to enter the US in a sub-advisory capacity if their strategy can be accommodated in a 40 Act structure. On the AIFMD front, the desire to access European investors may encourage managers of non-EU funds to establish mirror versions within the EU either on a standalone basis or via an AIFMD managed account platform. Or in the continuation of a 2014 trend, managers may look to establish an alternative UCITS which, while highly regulated, offers the potential to



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access a broader universe of investors via multiple distribution channels. We may also see US and other non-EU managers who stayed out of scope of AIFMD in 2014 reviewing that decision this year in the event that European inflows to alternative products increase.

Industry consolidation: Larger alternative asset managers are purchasing or absorbing smaller players at an accelerating rate. Institutional investors, who account for the majority of hedge fund inflows, prefer investing with larger players making it very difficult for smaller managers to raise capital. Smaller managers struggle to afford the necessary control infrastructure required to pass the due diligence reviews of large asset allocators. The barriers to entry for new managers have reached such a level that it is more likely that new players will seek to launch within an existing larger manager's infrastructure rather than set up their own venture in 2015.

Accelerating convergence: Hedge funds, private equity firms and traditional asset managers who previously would have

operated in what were regarded as distinct markets are increasingly competing for investors. This is to be expected given that the anticipated growth in the alternative market over the next few years is anticipated to exceed the industry overall by a significant proportion. Hedge fund managers are investing in less liquid securities and creating private equity structures to hold them and private equity firms have established more liquid structures to accommodate evolving investor preferences. Retail alternatives look set for exponential growth and many traditional managers are developing new products in the absolute return category to benefit from this trend. Alternative managers are looking to establish liquid alternative products as a means to access a wider universe of investors.

Cost pressures and outsourcing: Various surveys have confirmed that the median management and performance fee levels for the industry have decreased significantly since the financial crisis. Alternative managers continue to look for ways to increase efficiencies in response to this trend which is largely driven by institutional investors who are more actively negotiating fee levels directly than had previously been the case. As a result, many managers are reviewing their operations to identify non-core activities which could be outsourced to another party; typically an administration player. It is likely that there will be an increasing need for regulatory reporting services in 2015. Also, the private equity and real estate industries which historically have performed much of their own administration work in-house may migrate towards a more outsourced model in response to increasing costs and investor preference for independent administration.

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