Allocator demand in 2019

Will Broadway, of SS&C Advent, reflects on the shifting demand of allocators and its impact on hedge fund operations

Hedge funds' almost mythical status is under threat. The industry's reputation for superior investment nous has been tarnished by a run of lacklustre performance, raising questions about funds' ability to generate returns in bull and bear markets, and the fee levels they charge. With investors examining, and in some cases reconsidering their allocations, hedge funds' operational capabilities will play an ever more important role in attracting and retaining capital.

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Will Broadway works with SS&C Advent's suite of products for hedge funds, private markets funds, family offices, prime brokers and fund administrators within the Emea region. For the last five years, he has been offering solutions comprised of software, services and data to teams in the front, middle and back office, across investments and operations, at both fund managers and the full spectrum of asset owners globally.

Hedge fund shine is fading

In the aftermath of the financial crisis, the hedge fund industry seemed to be on a one-way road to growth, as global allocations – especially from institutional investors – surged. But while the US stock market enjoyed the longest bull run in history, hedge fund performance since 2014 has been widely accepted as underwhelming.

The last 18 months of heightened market volatility should have provided opportunities for funds to demonstrate their value. Instead, on aggregate the industry ended 2018 down 4.9% for the year, according to the latest eVestment data, with many funds failing to beat or even get close to their benchmarks.

Investor sentiment has shifted in response. At the height of their powers and mystique, investors eagerly swallowed the '2&20' (and sometimes higher) fees for the chance to invest in the most prestigious funds. Now many are reassessing their positions.

Family office allocations to hedge funds have been falling since at least 2015, with a 3.2 percentage point decline this year, according to the Campden Wealth/UBS 2018 Global Family Office Report. Hedge funds now make up just 5.7% of the average family office portfolio. And while few institutional investors have followed the California Public Employees' Retirement System's (Calpers) example and divested from the hedge fund sector completely, many are questioning the money they pay and what they get for it.

Increasingly, what allocators want to see is better service in a number of key areas – and that is having a significant impact on hedge fund managers' operations.

Fee flexibility

The old 2&20 fee model is not quite dead, but it is endangered, with just 30% of hedge funds now charging these levels, according to Hedge Fund Research data. Allocators, particularly large institutional investors with the greatest purchasing power, are negotiating down the fees they pay, even with the hedge fund titans. HFR data shows average management fees have slipped to 1.4%, while performance fees stand at 17.1%.

More flexible fee structures, incorporating complex high-water marks or different crystallisation and liquidity periods, are also gaining ground. For example, in the '1 or 30 model' pioneered by the Teacher Retirement System of Texas, investors pay a 1% management fee if the fund is below its benchmark, but a 30% performance fee if it rises above.

Operationally, tracking and managing a variety of more bespoke fee models is challenging for funds. Any calculation errors could result in the fund administrator telling the hedge fund to undercharge their investors.

Having a sophisticated and reliable shadow fund accounting system that allows a hedge fund to monitor and check the fee calculations guards against that risk. In addition, it allows hedge funds to see how fees impact their revenues and profits at any given time.

Liquidity profiles

An investor base with a wider variety of liquidity profiles poses additional operational challenges. Hedge funds will need to accurately forecast future cashflows and understand how redemptions could affect their portfolios. For hybrid, alternative investment vehicles with both open-ended and closed-ended funds, it will be particularly important to understand what impact a redemption in one part of the business will have on another part.

Alternative fund structures

The range of fund types, strategies and structures is also changing as hedge fund managers seek new ways to attract capital.

Previously, funds typically had one or just a handful of strategies, and a less complex master-feeder structure. Today, they need to be open to doing business in more jurisdictions and in different flavours. Pursuing multiple investment strategies has become more commonplace. Funds may also have significant capital in separately managed accounts, which pose different operational challenges. Growing numbers offer some form of liquid alternative, such as a Ucits-compliant or '40 Act fund, to maximise their assets under management, and thus the management and performance fees.

But the more strategies, structures and fund types a manager has – with the expanded network of external custodians and fund administrators that brings – the more complex the business is to manage. Which is why a robust portfolio management and accounting system is essential.

For example, Geneva by SS&C Advent provides fully automated support for all currencies, instruments, transaction types and global strategies, along with investor accounting and servicing for onshore and offshore funds all within one system. This results in huge efficiency and client service advantages.

Improved information quality, quantity and transparency

Investors now want more information, on a faster and more regular basis. Quicker NAV turnaround is one factor. Even where a fund trades complex asset classes, investors expect the NAV to be signed off shortly after month-end.

A daily estimate of returns, up-to-date lists of positions and holdings, and granular data on exposures to different countries, sectors and asset classes on the long and short sides are another prerequisite. Shadowing equips managers with the data they need to create and send these reports without having to wait for the official books and records from their fund administrator.

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For instance, the Open Protocol Enabling Risk Aggregation (Opera) filings have become an industry standardised way for hedge funds to collect, collate and communicate market risk and exposure data. A system like Geneva that can generate Opera filings as a standard report is therefore a key benefit.

Allocators may also want ad hoc analysis of events in the market. That might entail seeing their sector and country exposures to certain stock holdings (such as tech stocks), the risk associated with those, the return attribution and the fund's investment strategy. Prospective investors may ask for similar analysis during the investment due diligence process. A tool that enables the fund manager to quickly and easily draw up empirical evidence to show how the portfolio moved, and create a narrative of how the fund reacted to and handled market events in an easy-to-use, organised fashion can be a powerful competitive differentiator.

Operational due diligence

Operational due diligence processes have become significantly more rigorous, with just one missed checkbox on the due diligence report enough for allocators to veto investing into that fund. Allocation processes can take years, and competition is intense, so firms need the right fundamentals in place if they are to stand out.

The ability to shadow account, especially as a fund attracts more institutional money or trades in complex asset classes, will be a crucial element. Using a proven systems infrastructure from a big brand vendor, and partnering with a reputable prime broker and fund administrator shows the fund has devoted the necessary resources to its operational infrastructure, and has the right set up to handle that allocator's money.

How Geneva helps

No system demonstrates a hedge fund's professionalism and focus on meeting allocators' demands better than Geneva. It is the industry's leading fund accounting platform, used by 300 funds across the globe, as well as administering 68% of the AuA held by the world's top 10 fund admins (as of Q2 2018).

Industry participants trust Geneva because it gives allocators the security they seek, while delivering all the functionality and data outputs a hedge fund needs to run an efficient, scalable business, without the attendant operational headaches. And at SS&C Advent, we are constantly updating the system with enhanced functionality and new modules to ensure that will always be the case.

Thanks to the option of our cloud-based software and services delivery model, Geneva users can also benefit from fast and easy implementations, seamless maintenance and version updates, and full system support handled by our highly trained experts.

With a true shadow accounting capability, at a significantly reduced total cost of ownership, hedge funds of all strategies and sizes will be well-positioned to satisfy allocators' growing demands, and attract and retain capital in this competitive environment. HFM