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THE HEDGE FUND INDUSTRY

## Institutional Investors' Expectations as a Catalyst to the Hedge Fund Industry

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Despite hedge funds' growing appeal as an alternative investment proposition, investors can pay a high price as a result of inefficiencies pervading the industry. These include scarcity and cost of information, frictions in the workflows and limited standards of practice. Fundamentally, lack of transparency, constrained liquidity, and restricted access to capacity remain issues of concern to investors. The picture is improving, though, as institutional investors' sophistication and rigor act as a strong catalyst for change, ushering in new intermediaries to redefine business models, customized technology solutions and talk of best practice.

### **Traditional and New Players respond to Institutional Investors**

Because of their unique dual role as intermediary and advisor to both investors and managers, Funds of Funds (FoFs) have developed a driving role in the industry. As performance fees can induce successful managers to limit fund size, competition for top-ranked funds remains intense. While access to capacity is often provided by FoFs who act as gatekeepers for existing funds, their role is also increasingly to help launch new funds. As such, they vet new managers, provide seed capital and ultimately decide who survives. Due diligence and ongoing monitoring responsibility then rest on their shoulders instead of investors'. Once FoFs reach

scale, they may find greater opportunities to provide fund managers with additional services, such as infrastructure to aggregate and process data, analytical or compliance tools. Clearly all this comes at an additional cost, but to most investors—and managers, for that matter—the FoFs value proposition is typically more compelling than working independently.

While fund managers focus on trading and growing their assets, establishing a robust infrastructure, streamlining operational processes or providing transparency services to investors are equally important elements to the fund's long term success. Until now, fund managers had to pick among a value network of service providers (e.g., prime brokers, fund administrators) often with limited visibility regarding the level of services they were getting and opaque pricing. Only the bigger funds were typically in a position to negotiate effectively. Outsourcing of these services in an integrated, cost-effective way through services aggregation platforms is now available to small and mid-size funds as well. Even if the savings incurred by managers are not always passed on to investors, the derived efficiencies benefit them indirectly in the form of better services. Convergence between FoFs and aggregation platforms appears to be an emerging trend and related business models are tackling inherent conflicts of interest in creative ways.

In response to the current investment climate and resultant pressure on investment management firms, the appeal of absolute return strategies and superior sources of alpha generation have translated into a growing interest in hedge funds by traditional financial institutions. An increasing number of acquisitions of hedge funds or FoFs by banks or investment firms has taken place against a backdrop of intense consolidation in the asset management industry. Economies of scale are expected to spill over into the bank-affiliated funds along with a transfer of some of the best practice already present in these institutions. Some financial institutions are even going the extra mile and building hedge fund proprietary platforms while leveraging their prime brokerage capabilities.

### **Enter Best Practice**

Best practice is entering the fray for independent funds, as well. While portfolio risk management is a long-recognized competitive differentiator among hedge funds, the absence of clear risk management guidelines and investment transparency can leave investors uncertain about their actual exposure. Frameworks and methodologies largely adapted from the buy-side are being modified and enhanced to accommodate the different level of complexity of risks specific to hedge funds. By the same token, providing risk transparency without compro-

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mising proprietary investment strategies is not only do-able but necessary as sophisticated investors reject the black-box approach of yesteryears. FoFs, service providers and other intermediaries are all tackling this issue.

On a related note, performance measurement is another topic dear to investors and non-standard practices in this area are believed to have taken a toll on accuracy. Indeed, accurate performance measurement has been complicated by survivor bias, pricing of illiquid securities and non-systematic reporting. Performance fee structure also seems quite volatile as funds drift from the traditional 1-2/20 fee (i.e. 1-2 percent of AUM and 20 percent of the profits generated by the fund) to accommodate specific situations. Some funds keep a larger share of the profits because of their stellar performance while others who are less successful instead increase their management fees. An interesting industry initiative aiming at standardizing practices in this area is the Global Investment Performance Standards (GIPS) by AIMR (Association for Investment Management and Research). AIMR is encouraging investment management firms (and hedge funds in particular) to adopt GIPS and thus alleviate the need for intervention by government regulators. Whether hedge funds embrace GIPS or other standards remains to be seen but the push towards performance standardization looks unavoidable.

A recent survey by Capco, a Belgian consulting firm, indicates that almost 50 percent of hedge fund failures are caused by poor operational risk controls, particularly in the areas of trade processing, accounting, administration, valuation and reporting. With the exception

of investments in established funds with proven track records, investors in hedge funds are, de facto, also investing in very entrepreneurial firms. And unlike strongly capitalized asset managers, they may not be here tomorrow if something goes wrong. Clearly, due diligence and monitoring of funds by institutional investors have to focus also on the operational side. The good news is that by adopting bank-like best practice in the area of operational risk, funds can mitigate investors' concerns. Who will provide this? Again, outsourcing is the common route and FoFs, service aggregation platforms and other providers are preparing for this.

**Innovation at Play**

Finally, in order to increase transparency, liquidity and offer more appealing products to investors, more financial infrastructure has to be developed that will augment capital flows from institutional investors to hedge funds. Financial engineering, in the form of securitization, can create the necessary market infrastructure to reduce the inefficiencies in the market, thereby creating a more complete and efficient financial market. In fact, securitization of hedge funds in the form of Collateralized Fund Obligations (CFO's) first hit the market last year with Man Group's issuance of collateralized equity fund obligations. More liquidity will result from a developed secondary market of hedge fund securities, possibly by-passing the traditional lock-up period for hedge fund investments. Likewise, the process of securitization through the rating and monitoring of tranches by ratings agencies will improve transparency.

**What do all these changes mean for investors?**

Clearly, good things in terms of more transparency, improved liquidity, customized fees, access to capacity, reduced cost of due diligence, access to new products, better risk and control procedures and more reliable metrics.

As to hedge funds, a key achievement will be to maintain the entrepreneurial nature of their business while embracing institutional investors.

**TERMS & EXPRESSIONS**

**Alpha:** A coefficient measuring the risk-adjusted performance, considering the risk due to the specific security, rather than the overall market. A large alpha indicates that the stock or fund has performed better than would be predicted given its beta (volatility).

**Buy-side:** The part of the financial markets that purchase and sell securities for money management purposes, rather than for underwriting purposes.

**Fund administrator:** A third party who provides accounting and administration services (including books and record maintenance, investor reporting), often along with back and middle-office services.

**Fund of funds:** Fund comprised of hedge funds. Most funds of funds are diversified, i.e. investors' assets are allocated across various strategies.

**Lock-up period:** An interval during which an investment may not be redeemed. Hedge funds and funds of funds typically have a lock-up period of one year followed by redemption opportunities on a quarterly or monthly basis.

**Prime broker:** Broker who acts as settlement agent, provides custody for assets, provides financing for leverage, and prepares daily account statements for its clients (money managers, hedge funds, market makers, arbitrageurs, specialists and other professional investors).

**Securitization:** Process of aggregating similar instruments, such as loans, mortgages or funds into a negotiable security.

**Survivor bias:** The tendency for failed funds to be excluded from performance studies due to the fact that they no longer exist. Hedge fund performance may be affected due to survivor bias if fund managers tend to merge or discontinue underperforming funds.