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A Make or Break Year Lies Ahead for Hedge Funds

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As an industry, hedge funds are in the midst of an evolution – and those unprepared for the changes risk being left behind. In recent years, market conditions, combined with advancements in low fee products as well as changing investor behaviors have led to headwinds and unfavorable public relations. But, as hedge funds come off a year of continued positive performance, it is clear that headlines tell only half the story.

As inflows continue to gain steam, hedge fund managers are likely looking at another good year in 2018. But winning in this highly competitive environment will require managers to differentiate themselves and build an infrastructure that will help them scale quickly as they grow.

The hedge fund industry added over $30 billion in net inflows in 2017 bringing total industry assets under management (AUM) to a new all-time-high, according to eVestment. A recent BNY Mellon study found that investors' confidence in hedge funds has increased over the past 12 months, with 59 percent of institutional investors rating their confidence in hedge funds as being "more positive."

Yet, at the same time, an increased focus on fees and greater demands by investors continue to force fund managers to rethink their offerings and infrastructure, with two in three managers responding to our survey considering fee reductions. And differentiation in a crowded marketplace where the majority of inflows are going to a minority of funds remains a challenge.

Gaining and maintaining a competitive advantage in a rapidly evolving industry will require staying ahead of investor needs, leveraging the latest technologies to drive increased efficiencies, and putting in place a scalable infrastructure to that will help serve a broader segment of clients.

Deliver on what investors want

Investor demands for lower fees, increased transparency, and greater control have been a catalyst for the development of new products. Senior executives from 350 large institutional investors responding to our survey conducted in late 2017, underscore the importance of these new products, as 98%indicated that new product development is an important factor in their decision making.

Separately managed accounts are proving to be especially attractive to larger investors ($51 billion-plus in assets under management) based on the findings of our research. And registered products, such as mutual fund and UCITS products, are gaining popularity among fund managers given their liquidity and transparency, as well as low associated costs and regulatory oversight.

Investors are asking for more frequent and customized reporting and documentation, as well as greater detail on valuation and operational processes. Increasingly, hedge fund managers are having to explain not only what makes their results repeatable but also what differentiates them from the gains made throughout the current macro environment. These investor demands are naturally putting a squeeze on margins and accentuating the importance of technology in serving a broader set of investors.

Over the last year, we have seen increased adoption of new technologies by fund managers to help address the pressures in the marketplace. Technologies such as artificial intelligence (AI) and predictive analytics are becoming integral to achieving operational efficiencies and enhancing due diligence.

While the majority of the conversation around AI centers on its use in investment strategies, AI, alongside of other technologies, such automation, can also help support financing and trading and streamline back office operations. Technologies such as predictive analytics can help improve investment decisions, while the cloud can help advance operational efficiencies.

Additionally, outsourcing middle office, shadow accounting and reporting functions, as well as other non-core tasks, can not only help reduce costs, but also free up valuable time for client communications and building custom strategies.

Managers looking to differentiate themselves in the marketplace will need to take a close look at their business models and ideal client profile while constantly evaluating and re-evaluating the product set and the technologies they will need to implement so they can achieve their business goals.

Re-evaluate approaches

Developing a customized approach for a broader set of clients is a resource intensive process, which naturally leads to increased costs. Yet, investors are spending more time than ever before evaluating the fees hedge funds charge. The number of hedge funds still charging traditional 2% management and 20% performance fees has been in decline for some time. Further, 68% of fund managers responding to our survey say that they plan to lower fees in the next 12 months.

Managers need to perform an honest assessment of what value their strategy provides in a broader portfolio construction, identify the appropriate investor base that would benefit from the strategy, and create an infrastructure that would support the type of vehicles that best reach that investor base.

Last year was a good year in the industry, but it's too soon to see if 2018 is the year hedge funds truly differentiate themselves. One thing that's for sure is that capitalizing on increasing inflows will require hedge funds to continue to stay ahead of the evolving trends and investor needs. While the industry has done a lot of groundwork over the past years, those who continue to evolve and reinvent themselves will be the ultimate winners.