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Global Hedge Fund Distribution Survey 2015

Distribution Disrupted – Spotlight on Alternatives

This report is a collaboration between PwC and the Alternative Investment Management Association (AIMA).
It examines the disruption of distribution trends in the hedge fund sector and looks at how firms are dealing with and driving the resulting challenges and opportunities.

December 2015

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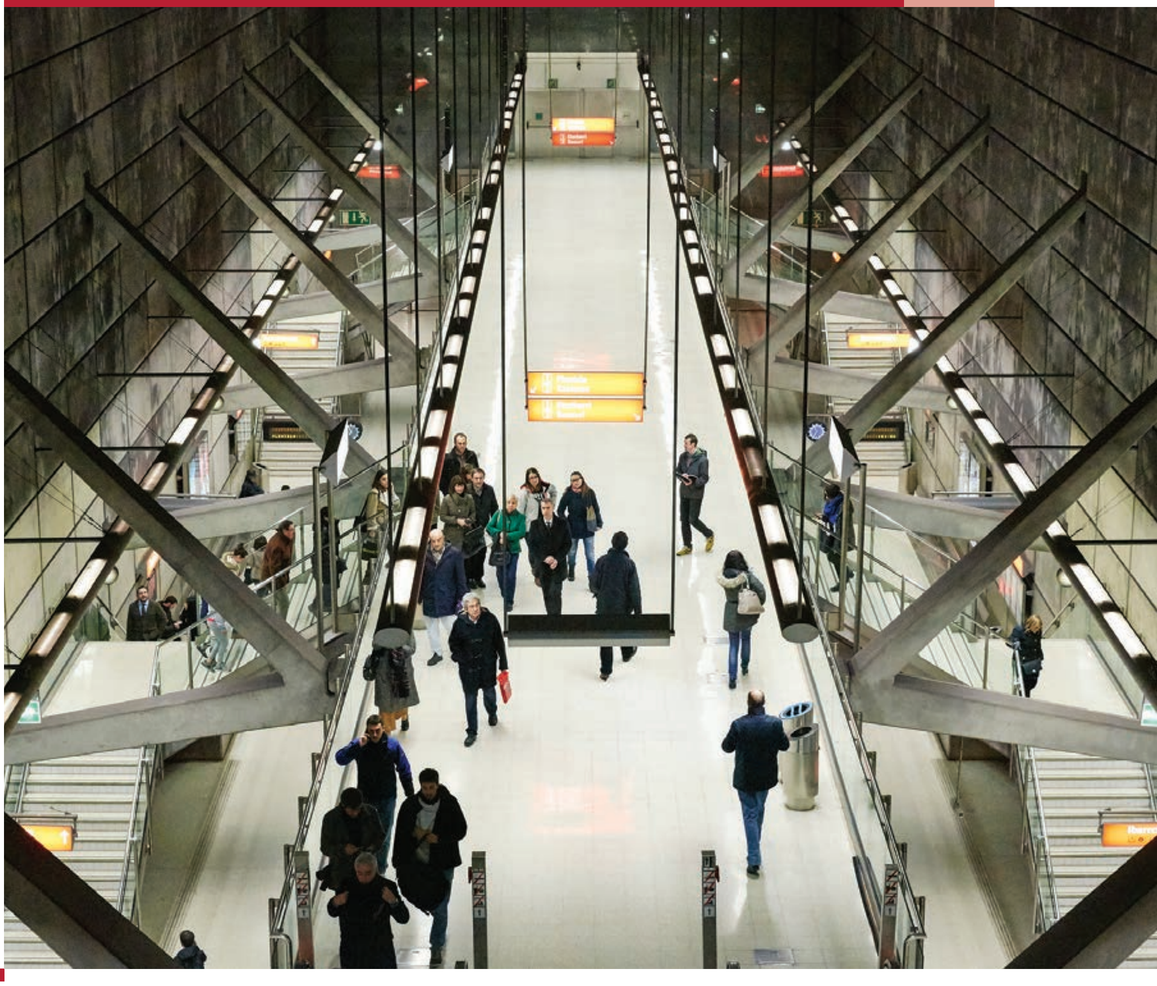
Alternative Investment Management Association



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Foreword

The rapid changes across the global economic landscape due to the financial crisis have generated tremendous change in the asset management industry as it has assumed centre stage. The need for increased and sustainable long-term investment returns has increased investor appetite for alternative asset classes in particular.

The alternatives industry, having slowly begun the process of institutionalisation prior to the crisis, is now maturing more rapidly in order to manage a variety of distribution opportunities, which is a priority for firms continuing to seek growth. More traditional distribution approaches, significantly, have been disrupted by regulation and by a more vocal and influential investor base.

This report, a collaboration between PwC and the Alternative Investment Management Association (AIMA), examines this disruption of distribution trends in the hedge fund sector and explores how firms are dealing with and driving the resulting challenges and opportunities.

The report is based on a survey in mid-2015 of 146 AIMA members which manage traditional hedge funds, or liquid alternative funds, or both. The respondents to the survey manage around $550 billion in hedge fund assets[1], or close to 20% of the global industry, which manages around US$2.9 trillion in assets.[2]

The survey population includes leading hedge fund firms in Europe, North America and Asia, many with extensive distribution networks (see Survey Demographics section, below). More than half of the firms surveyed manage more than US$1bn in Assets Under Management (AuM), and a quarter over US$10bn. In North America and the UK, more than a third of firms surveyed had AuM of over US$10bn.

PwC also interviewed managers at a number of these firms on a one-to-one basis to delve into greater detail on their distribution approaches and the opportunities and challenges they encounter in the marketplace. Their comments and insights are reflected in the report. It is clear that most firms are aware of the changing landscape and the growing opportunity, and are now actively developing and refining their distribution strategies accordingly.

The report is accompanied by 'Viewpoints', which seek to analyse the report's findings and project the implications of those findings into the future. In this sense, the report is aligned with PwC's Asset Management 2020 and Alternative Asset Management 2020 reports[3], which forecast the shape and needs of the asset management industry in the coming years.

We hope you find the report insightful and helpful.

Jack Inglis
Chief Executive, AIMA

Olwyn Alexander
EMEA Alternatives Leader, PwC

1 Source: HedgeFund Intelligence, AIMA.
2 Source: Centre for Hedge Fund Research.
3 www.pwc.com/assetmanagement

Executive Summary

Regulation sparks distribution awareness. A rapidly evolving regulatory environment has focused minds in the hedge fund industry. Systematically identifying and targeting sales channels and targets used to be an opportunistic rather than strategic activity at many hedge funds. But in the wake of new regulation, many firms are developing sophisticated processes to decide which investor channel or channels, and which markets to target and, consequently, which regulatory regimes they are prepared to address.

Regulation is opening up the opportunities for hedge funds distributing in Europe, the US and Asia. For example, the Chinese currency is slowly opening up to internationalisation and Beijing is reducing investment barriers. Such changes bring investment opportunities. Even the EU's Alternative Investment Fund Managers Directive (AIFMD) represents an opportunity for firms which may wish to avail themselves of some of the private placement regimes in more liberal Member States, or choose to fully comply and thereby gain a passport to sell funds across the EU.

AIFMD has changed the distribution game for hedge funds. It has been a catalyst for firms to reconsider their distribution strategies – more than three-quarters of managers in the survey say they have changed where or how they market non-EU Alternative Investment Funds (AIFs) to EU investors in the wake of AIFMD. If the AIFMD passport is extended to allow EU Alternative Investment Fund Managers (AIFMs) to market non-EU AIFs to professional investors across the EU, many EU AIFMs say they would apply for a passport. In the meantime, a good number of non-EU fund managers that are marketing in the EU have decided to create their own EU AIFMs or become sub-advisers for EU AIFMs instead of opting to use a non-EU AIFM.

It is clear that scale provides cost advantages that enable investment in meeting regulatory requirements, and this deepens the divide between the large and small managers. Larger managers can attract more flows through more complex and costly distribution opportunities whereas the small tend to stay localised, with more limited distribution focus.

Increasing Sophistication of Investors
The hedge fund industry has experienced strong growth since its inception and this growth shows little sign of slowing. However, this growth is accompanied by an increasingly demanding, sophisticated and influential investor base.

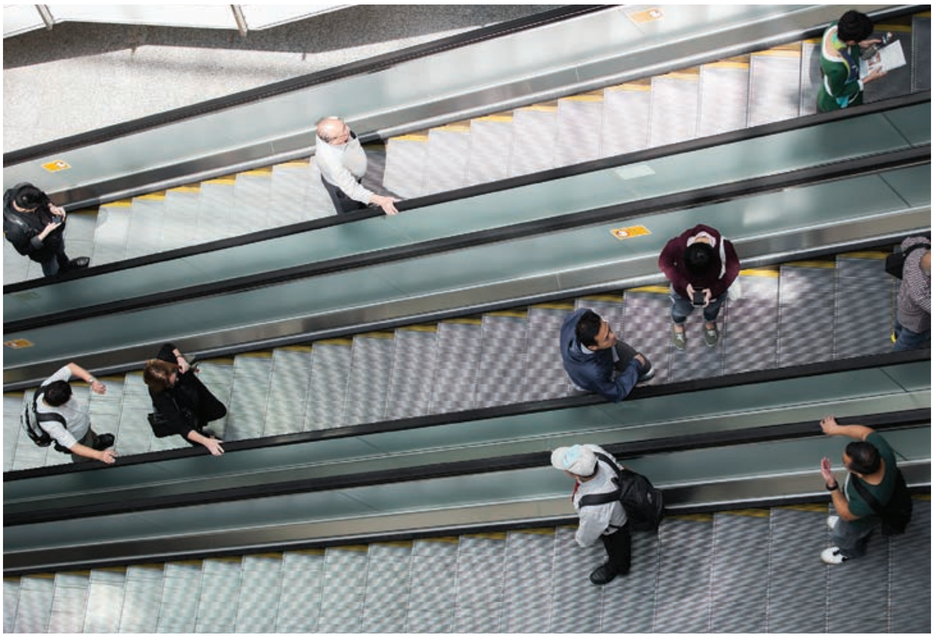
Growth in the industry is strongly supported by the survey: well over half of hedge fund managers (61%) report that assets are rising. The trend is even stronger among larger managers – two-thirds of mid-sized firms report rising assets and all of the large firms surveyed say assets are on the increase.

Investors are increasingly aware that the sheer volume of assets they are pumping into hedge funds gives them considerable influence over how those assets are managed. As PwC identified in the paper *Alternative Asset Management in 2020*, assets will only flow to the most compelling strategies and the most professionally managed firms. Investors will expect more from their hedge fund providers – more tailored, outcome-based hedge fund products which provide capital preservation and upside opportunities.

What sells?
It is clear from the survey that performance remains the key sales factor. However, performance must go hand-in-hand with a strong brand, appropriate fee structures and a focus on good service and tax issues.

Excellence in all these areas must be accompanied by sound sales strategies and it is clear from the survey that direct engagement is the best medium for this. However, sales lead times can be long – nearly a quarter of survey respondents report that lead times are over a year. Such long lead times are likely to have a disproportionately large impact on small and start-up funds, which depend on rapid asset growth to survive.

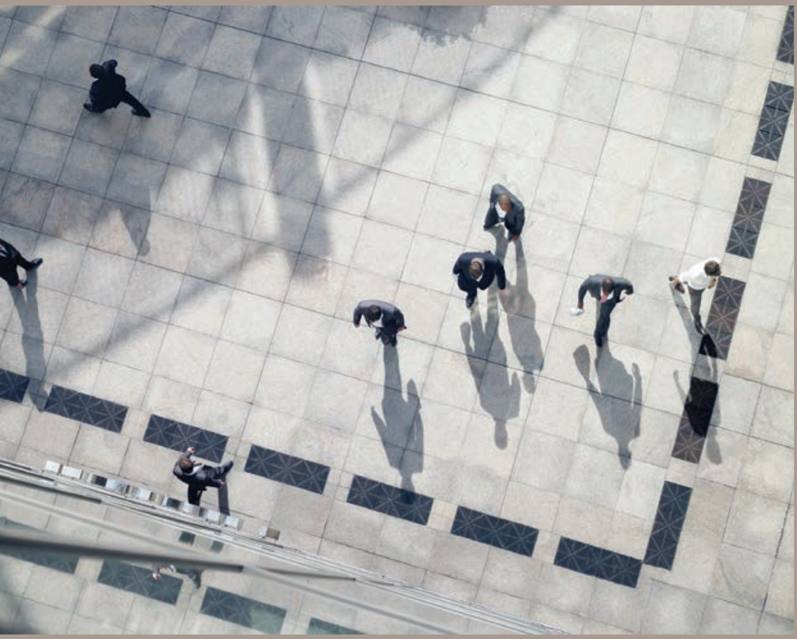
Going forward, considerable thought will be applied to each and every fund launch. Nearly half of the managers in this survey anticipate launching a hedge fund in 2015-16. As investors become more demanding and require greater customisation, the research and business development activity before a fund launch will intensify. Every product must be thoroughly vetted – for potential performance, for attractiveness to the market and for potential profitability.



Liquid alternatives: a rising tide?
The growth in liquid alternatives – primarily UCITS funds in Europe and mutual funds registered under the Investment Company Act of 1940 in the US, known as '40 Act funds – has been prolific. With greater transparency, a strong regulatory environment, appealing liquidity terms, often lower fees and the ability to access a range of alternative strategies, growth in liquid alternatives is unsurprising. The survey bears this out, with 81% of firms that manage UCITS funds reporting rising assets under management (AuM). Meanwhile, some 87% of US managers of liquid alternative funds in the survey say AuM is rising in these strategies.

There are likely to be many more liquid alternative funds, with half of survey respondents in the UK planning to launch one in 2015-16. Nearly a third of the US firms are planning a liquid alternatives launch. However, just 14% of the continental European firms plan to launch a liquid alternatives fund in 2015-16.

Liquid alternatives operate in a densely regulated environment, which is more restrictive than the traditional hedge fund environment. Investment managers may need to alter their investment strategies to make sure that their investment portfolios are managed in compliance with regulations, and they will need appropriate infrastructure. In addition, liquid alternatives may have to be tailored for fund supermarket ranges, distribution platforms and other distribution channels, which involves significant negotiation between investment manager and distributor. This can result in a compromised alternatives distribution strategy.



Regulation sparks distribution awareness

1

What a difference ten years makes. A decade ago, hedge funds could target and sell to qualified or professional investors virtually anywhere in the world with relatively few constraints. While some regulations existed in certain jurisdictions, they were not highly prescriptive and focused primarily on qualifications of investors.

The situation is radically different in the post-financial crisis era, and most hedge fund firms worldwide are faced with significant regulation which has increased their compliance and reporting workloads, added to their cost bases and, in many instances, restricted their ability to sell their funds.

At the same time, the aftermath of the financial crisis has also led to policy-making which has opened up opportunities to fill some of the funding gap that has emerged.

In addition, regulation has been enacted which aims to support the growth of the asset management sector and, particularly, alternatives. This is manifest in Asia, where policy-making is attempting to drive asset growth. In Singapore, the Enhanced Fund Manager Regime has brought alternative funds under the same regulatory umbrella as traditional funds, increasing their distribution scope. Meanwhile, Korea has expanded the profile of investors eligible to invest in hedge funds and lowered the minimum investment. India introduced an Alternative Investment Funds regime, while Thailand is currently undertaking a public consultation to introduce regulation for alternative investment funds.

In the US we have seen measures such as the Jumpstart Our Business StartUps Act (JOBS Act). Since the financial crisis, the US and the EU have also encouraged infrastructure investment and other investment aimed at stimulating economic and corporate growth.

The European Commission's Capital Markets Union (CMU) initiative is likely to channel further assets into alternatives. For example, the European Alternative Investment Fund (ELTIF) vehicle is to be operational as of the end of this year and is likely to get favourable regulatory treatment. After a long and difficult process of negotiation and implementation, the AIFMD should now start bringing some rewards by allowing EU-domiciled managers and funds to sell across the whole of the EU and soon, potentially, extending that benefit to non-EU funds.

Focusing marketing efforts

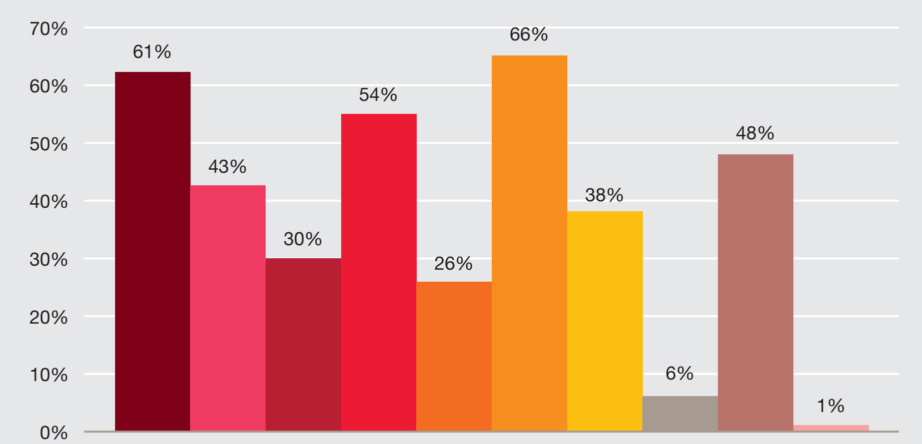
It is against this regulatory disruption that hedge fund managers have developed a conscious awareness of the need for a targeted distribution strategy, which was not so necessary in the past. We see evidence of this increase in distribution awareness in our survey results. There is now a cost and a regulatory burden to selling in a number of countries. So hedge fund managers need to be more considered about where they want to sell and to which investor types – institutional, high-net-worth (HNW) individuals, endowments, sovereign wealth funds and so on.

Few people would be surprised to learn that the biggest marketing efforts by hedge fund firms are focused on the US and are likely to be so for some time to come. It is simply the deepest, most sophisticated investment market in the world.

Firms are currently marketing to investors in (in order of stated priority):

1. US
2. UK
3. Switzerland
4. Asia-Pacific
5. Continental Europe

Figure 1: Hedgefund managers actively marketing funds to professional/qualified investors



UK · Continental Europe excluding Switzerland and Scandinavia · Scandinavia · Switzerland · Middle East · US · Canada · Brazil · AsiaPac · Other

Source: PwC/AIMA Global Hedge Fund Distribution Survey 2015

As a UK hedge fund manager says: "The US market is a very big pool and is currently more open to alternative products, and so it is our focus. The UK is relatively small, but growth is being driven by changes in pension mind-sets."

The very size of the US market attracts a great many competitors, however, and some firms are reluctant to commit resources. While many Hong Kong-based funds, for instance, target the US market, not all are willing to commit the marketing resources necessary. One very large Asian firm comments: "In the hedge fund space, the US is a crowded market and it takes significant and prolonged investment to carve out a name. We view the US as quite a closed economy/investment market. It is very hard to raise capital unless you have built out a distribution team with distribution people." The sentiment is echoed by other non-US managers in the survey.

This explains why some managers are looking to expand through M&A. As discussed in PwC's Asset Management M&A trends paper[4], deal flow in the alternatives market in the US is not solely domestic, but involves non-US buyers looking outside their home territories for attractive acquisition targets. By acquiring US firms, non-US firms can solve some of their distribution challenges overnight.

New asset raising that firms anticipate from each country/region in 2015/2016 is: (by ranking):

1. US
2. UK
3. Continental Europe
4. Switzerland
5. Asia-Pacific

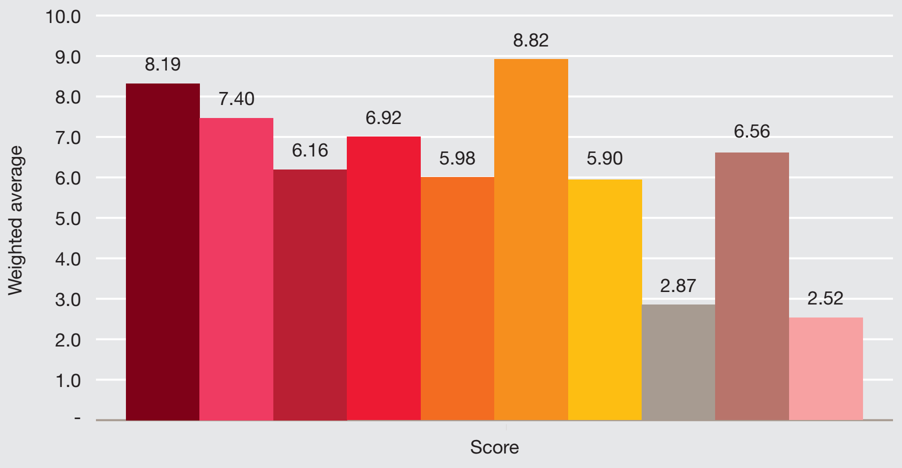
Although many funds are marketing to investors in Asia-Pacific, it is not currently viewed as the most fertile hunting ground. However, pockets of capital are viewed as attractive, as one Asian hedge fund manager notes: "Japan is one of the biggest allocators to hedge funds in Asia and there is significant potential as the Japanese shrink their allocation to Japanese Government Bonds (JGBs) and increase allocations to alternatives, long-only products and offshore bonds."

However, the ranking of countries and regions that provide the best new investment opportunities is likely to look a little different by 2020. With private wealth growth in emerging markets outpacing developed markets, wealth management will become an area of explicit focus and differentiation for hedge fund managers.

The internationalisation of the Chinese currency and Beijing's ongoing reduction of investment barriers could provide opportunities for investment professionals. Among changes likely to have significance for both the Chinese and Hong Kong markets by 2020, several are already in evidence:

- The launch of the first yuan-denominated Qualified Domestic Limited Partnership (QDLP) hedge fund
- The establishment of Shanghai-Hong Kong Stock Connect
- Confirmation of the Shenzhen-Hong Kong Stock Connect is due in early 2016
- The launch of duty-free zones by two Chinese provinces to encourage the establishment of financial services firms across the respective provinces.

Figure 2: Anticipated new investments by region 2015/2016



Source: PwC/AIMA Global Hedge Fund Distribution Survey 2015
Note: Respondents were asked to rank multiple options. Numbers represent a weighted frequency of rankings awarded to each option

"Japan is one of the biggest allocators to hedge funds in Asia and there is significant potential as the Japanese shrink their allocation to Japanese Government Bonds (JGBs) and increase allocations to alternatives, long-only products and offshore bonds."

As Latin American (LatAm) countries look for alternative investments to domestic bonds, hedge fund asset managers have an opportunity to create new products that can attract high-net-worth individuals and sovereign investors. In LatAm, distribution channels are concentrated among a few firms and are likely to be controlled by the biggest banks well beyond 2020. In addition, the asset management industry is concentrated among a few big firms with the top ten asset managers in Brazil, for instance, responsible for 88% of AuM.[5] To enhance the distribution of hedge fund products within the region, asset managers will consider alliances with local asset managers and distributors.

5 Source: Associação Brasileira das Entidades dos Mercados Financeiro e de Capitais (ANBIMA)

In the Middle East, sovereign wealth funds (SWFs) will be the main focus. The assets managed by SWFs are set to grow strongly, notwithstanding the oil price slump in 2015. By 2020, sovereign investor assets are projected to grow by 6.2% to hit US$15.3tn.

What investor types are buying?

In the US and UK, the main targets for marketing efforts are currently, defined benefit and defined contribution (DB/DC) plans and other financial institutions. In continental Europe, there is more emphasis on insurance companies and banks. The focus on insurance remains despite the effect of Solvency II requirements, which impose a risk charge on insurers for holding hedge fund assets, depending on the strategy. In Asia, marketing is fairly evenly spread between the different types of investor.

The targets are changing though. Hedge funds are signalling that their future distribution efforts will have to be refocused to take account of shifting investor bases. They expect, for instance, that most new investment sourced in the UK in 2015/16 will be from fund of funds. In continental Europe, the focus is expected to shift towards high-net-worth (HNW) individuals.

In the Middle East, SWFs will be the main focus. The assets managed by SWFs are set to grow strongly, notwithstanding the oil price slump in 2015. By 2020, sovereign investor assets are projected to grow by 6.2% to hit US$15.3tn. In addition, the emergence of 21 new sovereign investors is expected, taking the total number of SWFs from 125 today to 146 by 2020.[6]

While in the US, defined benefit pension plans will continue to be a focus for hedge fund markets in 2015/16, defined contribution plans will become a more fertile market as they continue their rapid growth and defined benefit continues its decline. In Canada, non-Canadian managers tend to target the defined benefit segment, whereas local Canadian managers are more focused on HNW investors.

Figure 3: Highest amount of anticipated new investment 2015/2016

Location	Investor type
UK	Fund of funds
Continental Europe ex S&S	HNW individuals
Scandinavia	Other financial institutions
Switzerland	Other financial institutions
Middle East	Sovereign wealth funds
United States	Defined benefit pension plans
Canada	Defined benefit pension plans
AsiaPac	All of the above

Source: PwC/AIMA Global Hedge Fund Distribution Survey 2015

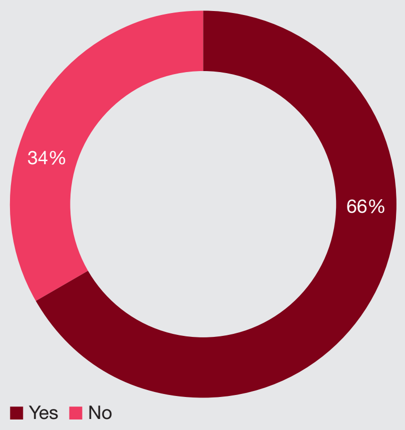
AIFMD poses distribution challenges

European regulation relating to the hedge fund sector has been notably more stringent than elsewhere. AIFMD was a revolutionary piece of regulation with global impact once it was fully implemented in 2014. Many firms feared that the costs of compliance and reporting would damage their businesses, and that their ability to raise capital in Europe would be restricted. Some hedge fund firms indicated they might choose to locate offshore and target non-EU investors, while others signalled they might use the established and successful UCITS vehicle for their hedge fund strategies.

AIFMD has been a catalyst for hedge fund firms to focus on distribution – many of them for the first time. Indeed, according to the firms surveyed, the biggest challenges to distribution in the EU since AIFMD came into effect are complying with marketing rules and transparency requirements. This is

6 Source: Fast Forward to Centre Stage – Alternative Asset Management in 2020 – PwC, June 2015

Figure 4: Is your firm, or does your firm operate, an EU AIFM?



Source: PwC/AIMA Global Hedge Fund Distribution Survey 2015

followed by increased compliance/costs, relying on reverse solicitation and lack of consistency across member states.

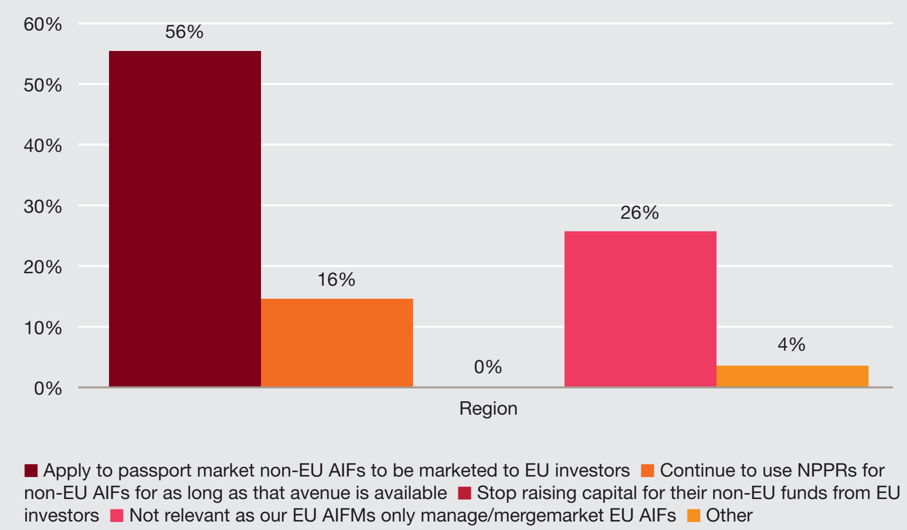
Nevertheless, many hedge fund firms have accepted the constraints of AIFMD. Two-thirds of the firms surveyed which said they were managing or marketing AIFs in the EU have an AIFM in the EU. Small firms surveyed see the most benefit in using the new Directive, perhaps because they are most likely to be actively fundraising. However, some of the mid-sized and large firms in the US are less convinced, which may reflect the fact that US firms are less drawn to the AIFMD because it does not yet offer them a passport to distribute right across the EU and because their circumstances are such that they are able to rely on reverse solicitation. In other words, the regulatory challenges of complying with AIFMD are not necessarily matched by the potential rewards on offer.

Indeed, managers of large funds are least likely to be AIFMs themselves or to have set up an AIFM. It is intuitive that managers from the US and Asia have not proceeded under the AIFMD banner, because if they do not already have a presence or substance, the cost of establishing the relevant infrastructure is high.

Nevertheless, a good number of non-EU fund managers that are marketing in the EU have decided to create their own EU AIFMs or become sub-advisers for EU AIFMs instead of opting to use a non-EU AIFM. Some non-EU managers have decided not to wait for the outcome of the third-country passporting debate and have gone down the EU AIFM route early. Fund managers in this category may have been persuaded by clients and/or consultants that they need to have a presence on the ground in Europe.

European funds, on the other hand, have little choice but to comply and appoint an AIFM for non-UCITS products, unless they wish to relocate outside the EU and opt out of selling in the EU. Indeed, it is interesting to see that some EU managers surveyed have decided to create non-EU AIFMs.

Figure 5: What approach would your EU AIFM take, if the AIFMD passport is extended to allow EU AIFMs to market non-EU AIFs to professional investors across the EU?



Source: PwC/AIMA Global Hedge Fund Distribution Survey 2015

Among survey respondents, the most popular jurisdiction for EU AIFMs is the UK, followed by Ireland, France and Luxembourg. The UK is clearly attractive as an AIFM jurisdiction, but the survey results may be skewed by the dominance of UK-based firms in the survey universe.

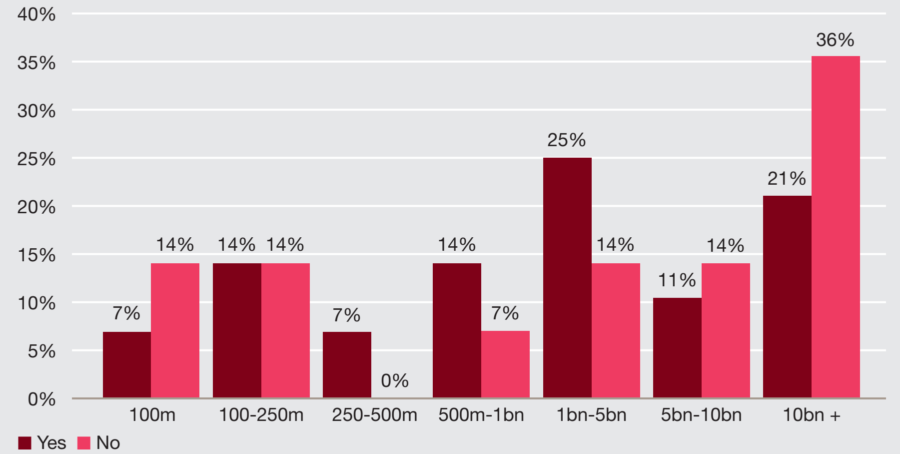
EU AIFs are most actively marketed in the UK, followed by Sweden, Ireland, Finland and the Netherlands. Germany is only the sixth highest target for marketers despite being Europe's biggest and most populous economy. In Germany, although there is clear guidance on requirements, there are additional requirements that many firms find burdensome and time-consuming. These include additional disclaimers, marketing guidelines, clear evidence of the procedures to avoid marketing to retail investors and higher registration costs.

Non-EU AIFs waiting for green light to passport funds in EU

Some 78% of firms surveyed say they have changed where or how they market non-EU AIFs to EU investors in the wake of AIFMD. The impact is greatest on firms operating outside the EU, particularly in the US and Australia.

About 40% of survey respondents that are marketing AIFs in the EU say they operate a non-EU AIFM. US and Asian hedge fund firms are most likely to have one, but they are operated by European firms too. The most popular locations for non-EU AIFMs among survey respondents are the US, followed by the Cayman Islands and Switzerland.

Figure 6: Is your firm, or does your firm operate an EU AIFM? (Responses by size of managers US$)



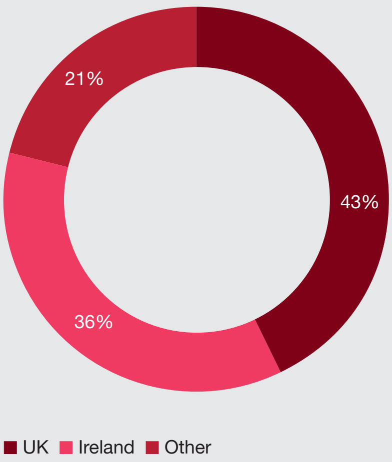
Source: PwC/AIMA Global Hedge Fund Distribution Survey 2015

If the AIFMD passport is extended to allow EU AIFMs to market non-EU AIFs to professional investors across the EU, most EU AIFMs say they would apply for a passport. However, a quarter of respondents said any change to the passporting rules would not be relevant as their EU AIFMs only manage or market EU AIFs.

The issue of third-country passporting is moving ahead, but at a pace which is unlikely to excite hedge fund marketers. The European Commission in October 2015 agreed to follow the European Securities and Markets Authority's (ESMA's) advice to delay a decision on extending the passport to third-country AIFMs until a larger number of countries has been assessed.

It is expected that any extension of the AIFMD passport to non-EU jurisdictions will not result in the automatic withdrawal of the national private placement regimes (NPPRs) at the end of the three-year transitional period. Indeed, if the AIFMD passport is extended to allow non-EU AIFMs to become authorised to market AIFs to professional investors across the EU, non-EU AIFMs would predominantly still continue to use the NPPRs for as long as the option is available. However, 37% of non-EU AIFMs currently marketing AIFs in the EU under the NPPRs say they will apply to become authorised in a Member State of Reference and seek to passport any AIFs being marketed to EU investors. Of these firms, many would apply in the UK, followed by Ireland. The UK is also the preferred place for non-EU AIFMs to market, followed by Sweden, Finland and Germany.

Figure 7: If your non-EU AIFM were seeking to become authorised, which Member State of Reference would they likely seek to apply in?



Source: PwC/AIMA Global Hedge Fund Distribution Survey 2015

Figure 8: In which EU countries would non-EU AIFMs likely choose to market AIFs to professional investors via the passport, if made available?

1. UK
2. Sweden
3. Finland
4. Germany
5. Denmark
6. Ireland
7. Luxembourg
8. France
9. Italy
10. Austria

Source: PwC/AIMA Global Hedge Fund Distribution Survey 2015

Viewpoint

Increased regulation has helped focus minds in the hedge fund industry. Identifying and targeting sales channels and targets was not systematic at many hedge funds until recently. Today, many have sophisticated processes to decide which investor channel or channels, and which markets and regulatory regimes, they want to target.

While some of the big US endowment funds have decided to modestly reduce their hedge fund allocations, the US is the most advanced market in terms of its willingness to invest in hedge funds and is still seen as the place of most opportunity for hedge fund marketers.

Looking ahead, new markets and untapped investor types will open up. The shift in global economic power from developed to developing regions will drive focus on sovereign investors (including Public Pension Reserve Funds), fast-growing institutions and the emerging middle classes in new markets. These groups of investors will increasingly seek branded multi-capability firms.

Regulation can also bring additional burdens, and AIFMD certainly provides its share of them. It employs a strict approach to marketing, an area in which there were previously no set procedures. Compliance costs associated with infrastructure requirements, additional reporting, constraints on depositary banks and so on, amount to considerable expense.

Firms outside the EU hoping for an AIFMD passport will have to be patient. ESMA is not yet close to a final decision on the matter and countries that would have benefited following the first review – Guernsey, Jersey and Switzerland – will have to wait until a larger number of countries has been assessed. These include, in the first instance, the US, Hong Kong and Singapore, followed by a new wave of countries including Australia, Canada, Japan, the Cayman Islands, the Isle of Man and Bermuda.

In addition, latest discussions on the NPPRs indicate that there will not be automatic disbanding of the NPPRs, even once the respective third country has been granted a passport. The fact that these would co-exist for a three-year period is a bone of contention, since it would allow, for example, US managers to accept assets under NPPR without having to comply with the full AIFMD requirements. By contrast, EU-based funds have to fully comply. As a result, a good number of non-EU firms have indicated they will not apply for a passport and will instead use the NPPRs for as long as possible.

However, the AIFMD also offers distribution opportunities, particularly for firms with global operations, firms already accustomed to managing regulated products and firms that are willing to step up to the challenge of the increased requirements. These firms will manage the extra costs and burdens, and turn them into competitive advantages.

Increasing sophistication of investors

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Aside from a dip post-financial crisis, the hedge fund industry has experienced consistent growth since its inception, and this growth shows no sign of slowing. With this growth has come an increasingly demanding, sophisticated and influential investor base. Investors are now clearly more proactive in discussing the outcomes they need, their domicile and structure preferences and are more likely to negotiate on fees. This has disrupted traditional distribution approaches as well as product construction, tax set-ups and fee structures.

Hedge fund assets are expected to grow from US$2.9tn in 2013 to US$4.9tn in 2020, a compound annual growth rate of 7.9%, according to a report published by PwC in June 2015.[7]

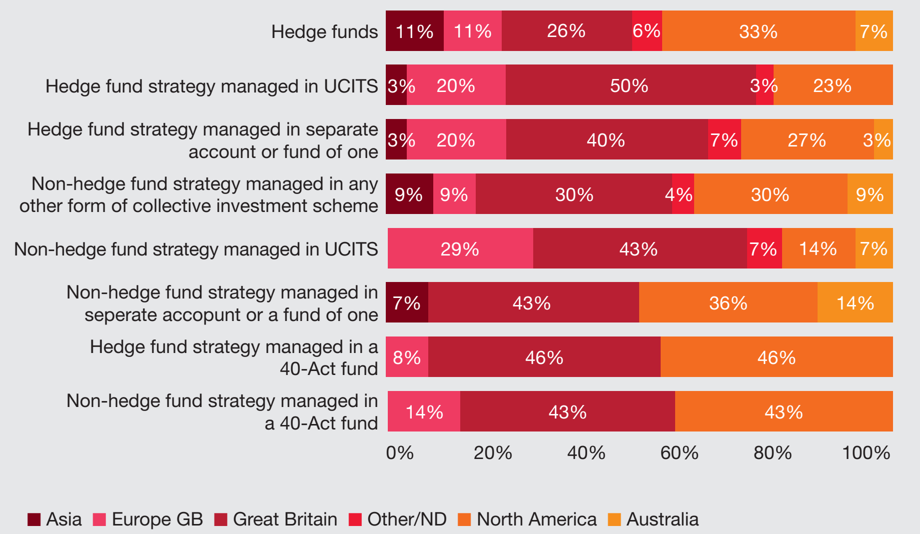
This growth trend is strongly supported by the findings of the PwC/AIMA Distribution Survey 2015: well over half of hedge fund managers (61%) report that assets are rising. The trend is even stronger among larger managers – two-thirds of mid-sized firms report rising assets and all of the large firms surveyed say assets are on the increase.[8]

The ambition and expectations of hedge fund firms are typified by this comment from the manager of a mid-sized North American hedge fund firm: "We plan to add US$1bn to our AuM in the next two-year period from our three pillars of distribution of institutional, fund of funds and retail."

7 Source: Fast Forward to Centre Stage – Alternative Asset Management in 2020 – PwC, June 2015

8 Throughout the report we refer to 'small', 'mid-sized' and 'large' hedge fund firms. We define small as firms with AuM of <US$5bn, mid-sized as firms with AuM of US$5bn-$10bn, and large as firms with AuM of >US$10bn

Figure 9: Proportion of managers who cited increase in AUM by product and region



Source: PwC/AIMA Global Hedge Fund Distribution Survey 2015

However, the rising tide of assets will not float all boats. Investors, aware of their growing power and influence over the funds they invest in, will increasingly seek outcome-based investment solutions that seek to deliver target returns or pre-defined cash flows.

The financial crisis, and a number of well-publicised cases of fraud, gave impetus to a significant expansion and enhancement of investor due diligence. This has driven the institutional side of the industry to accept regulation, improve governance standards and enhance transparency. In turn, armed with much greater knowledge and insight, investors are now increasingly more sophisticated and realise their power and influence.

The most sophisticated institutional investors have more complex structures and objectives and demand increasingly customised solutions. Hedge fund firms will adapt their investment capabilities, organisations, infrastructure and investor relations to the needs of investors. Furthermore, alignment of new and existing products with global tax rules will be a major consideration given the increasing cross-border nature of investors and investments.

Sources of rising assets

The sources of rising assets are varied. But the biggest investors in the strategies managed by the firms surveyed are, by ranking:

1. Funds of funds (including manager of manager investments arranged by consultants)
2. High-net-worth individuals
3. Defined benefit pension schemes
4. Other financial institutions (mainly insurers and banks)
5. Endowments/foundations/charities

While some may view it as surprising that funds of funds rank number one among investors in hedge fund strategies, it is a reflection of the fact that alternatives are now a mandatory asset allocation for many small and medium-sized institutions. Because these smaller institutions do not have direct access to managers, due to limitations on the size of their asset allocation, funds of funds provide a convenient way to achieve asset class exposure.

Multi-strategy investment has proliferated since the financial crisis of 2008/2009, as investors acknowledge the need for dynamic asset allocation in an extended low-yielding and volatile environment. A large UK traditional and hedge fund manager says some of its liquid alternative funds are creaking under the strain of demand from funds of funds: “We have taken in a huge amount of money from UCITS funds of funds and we are reaching capacity in some of our strategies.”

A further reason for the prevalence of funds of funds as sources of investment could be that the survey was taken by a sizeable proportion of investors based in Europe, where funds of funds are more commonly used compared with North America. In North America, endowments and foundations are more prominent investor types, which use funds of funds to gain experience and then directly invest with the underlying managers. Consultants dominate distribution in the North American and UK markets. “Consultants are our most important channel,” says a small UK hedge fund firm. “If you hit the consultants’ sweet spot, you will get inflows.”

> “The money that we really want is from US endowments. They are more sophisticated and likely long term.”
>
> Manager of large North American hedge fund

Lastly, it should be noted that the sources of investment are fairly evenly distributed so funds of funds and HNW investors do not disproportionately dominate.

Figure 10: Most important investor types

Location	Most important	Second most important
UK	Fund of funds	HNW individuals
Continental Europe ex S&S	Fund of funds	Defined benefit pension plans
Scandinavia	Fund of funds	Other financial institutions
Switzerland	HNW individuals	Fund of funds
Middle East	Sovereign wealth funds	HNW individuals
United States	Endowments/foundations	Fund of funds
Canada	Defined benefit pension plans	Endowments/foundations
AsiaPac	Defined benefit pension plans	Other financial institutions

Source: PwC/AIMA Global Hedge Fund Distribution Survey 2015

"Funds of funds are first movers and are most likely to invest early in our funds. They can deploy large amounts of assets, and quickly."

Funds of funds are sought after as clients, even though the money they provide is often not 'sticky'. As one very large European fund manager says: "Funds of funds are first movers and are most likely to invest early in our funds. They can deploy large amounts of assets, and quickly."

In addition, as more pension plan investors gravitate towards hedge funds in their search for alpha they frequently implement their views through funds of funds as a safe way to gain asset class exposure.

In geographical terms, the single biggest source of flows into hedge funds is US-based investors. Emerging markets – particularly Asia-Pacific – are expected to become a stronger source of growth for the hedge fund industry going forward. In 2012, high-net-worth individuals based in the Asia-Pacific region accounted for assets of less than US$13tn. It is expected that Asia-Pacific's share of high-net-worth assets will increase to some US$22.6tn by 2020,[9] with much of that increase in China.

Latin American and Asian investors, and especially institutional and high-net-worth investors in China, represent a sizeable, and largely untapped, opportunity for hedge fund managers. Asian markets in general will present opportunities, but none more so than China, given its explosion of high-net-worth individuals.

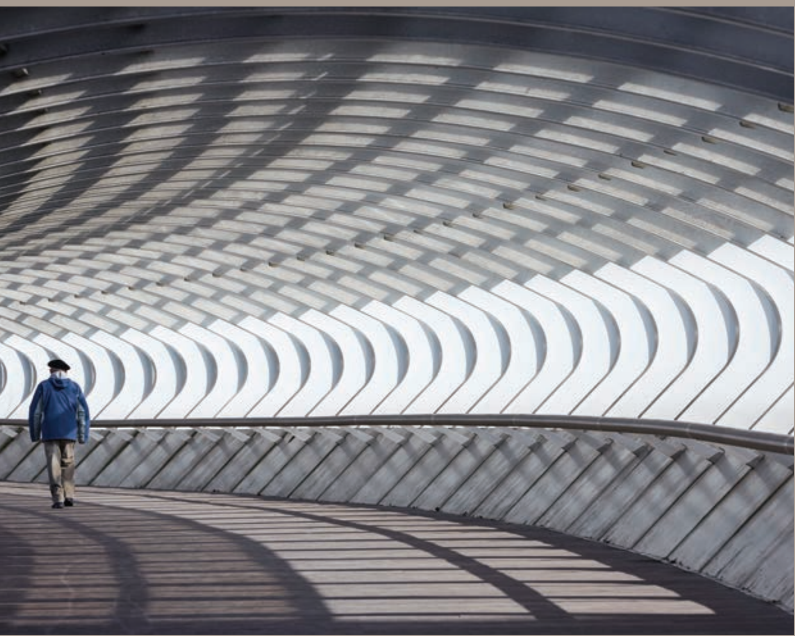
9 PwC Market Research Centre analysis, with past data based on Credit Suisse's Global Wealth Report

Viewpoint

Firms in this survey report strong growth of new assets into their hedge fund products. We see growth in hedge fund strategies going forward as being driven by three key trends: a government-incentivised shift to individual retirement plans; the increase of high-net-worth individuals from emerging populations; and the growth of sovereign investors.

These three investor types (and others besides) are gaining awareness that the sheer volume of assets they are pumping into hedge funds gives them considerable influence over how those assets are managed.

As we first identified in our paper *Alternative Asset Management in 2020*, assets will only flow to the most compelling strategies and the most professionally managed firms. Investors will expect more from their hedge fund providers: more tailored, outcome-based hedge fund products which provide capital preservation and upside opportunities. The focus for many firms will shift to creating a broader asset class and product mix and opening new distribution channels.



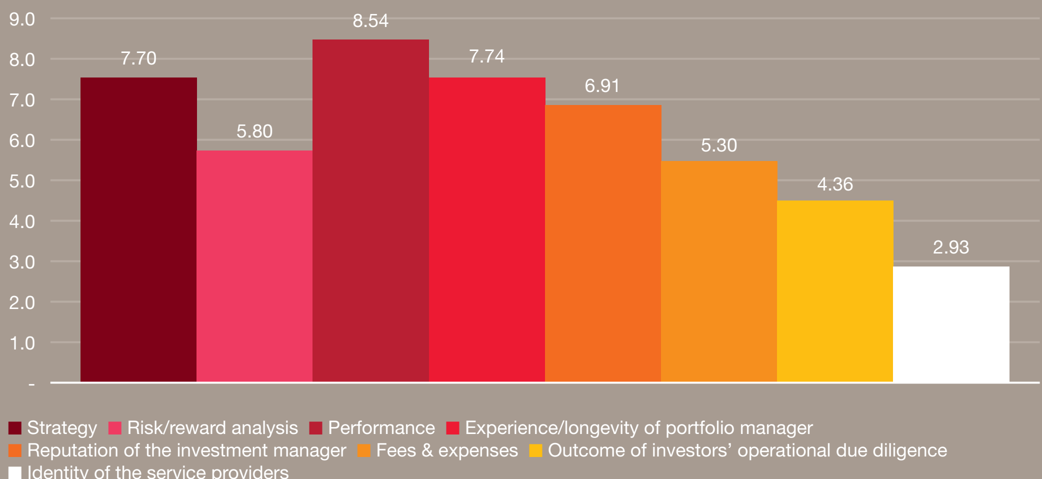
What sells?

3

As hedge fund managers face a more challenging distribution environment, with investors becoming even more powerful and influential, how can they differentiate themselves? What will sell?

The ingredients required to make a compelling hedge fund strategy are numerous and vary according to the type of fund and its target investors.

Figure 11: Key drivers for investors when selecting hedge fund investments



Source: PwC/AIMA Global Hedge Fund Distribution Survey 2015
Note: Respondents were asked to rank multiple options. Numbers represent a weighted frequency of rankings awarded to each option

The key ingredient, according to survey respondents, is – not surprisingly – performance. The top three factors that managers believe investors consider when they invest in hedge funds are:

1. Performance
2. Experience/longevity/pedigree of the portfolio manager
3. Strategy

This finding is consistent with the priorities of investors themselves. It is clear from research over a number of years that investors have gravitated towards the larger hedge funds with strong performance, deep resources, recognised brands and longevity.

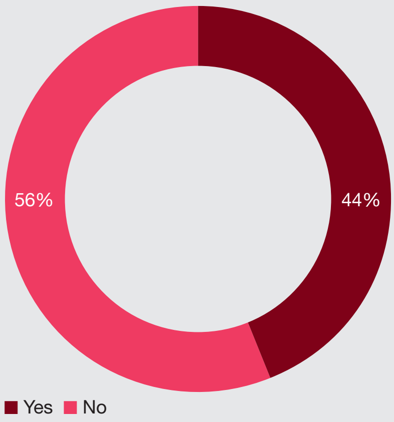
As a US hedge fund manager notes: “We have found throughout the past year of operations that more than anything it is experience and reputation that means the most. We struggled at the beginning of operations in attracting investors when the marketing material was firmly based around performance. The focus is now about showing the expertise and that we can be trusted by investors. Additionally, given the maturity of the fund, we need to be able to prove to investors that we will be around in 12 months.”

It is possible that the importance that managers attach to the issue of performance may reflect reported dissatisfaction by investors about their hedge fund returns. Investor disappointment with the performance of hedge funds over the last 12 months is at its highest since 2008.[10] In this context, the emphasis by managers in this survey on performance is understandable.

“Our investors judge performance over a three-year time horizon. We don’t appeal so much to high-net-worth investors or family offices whose outlook is more short term and opportunistic.”

Manager at UK hedge fund

Figure 12: Do you anticipate launching a new hedge fund in 2015/2016?



Source: PwC/AIMA Global Hedge Fund Distribution Survey 2015

Fees are not regarded by survey respondents as one of the top factors influencing hedge fund selection. As a mid-sized North American hedge fund manager says: "We use the same fee schedule as we have from Day 1 and although it may be a little higher than average, our investors know they will get the right performance."

It is possible that the perception of managers is not aligned with that of their underlying investors. The decline in both management and performance fees across the hedge fund industry in recent years has been driven by investors. Even more recently, regulators have focused on the issue of fees, particularly in the pensions and private equity arena, putting further downward pressure on fees.

A further factor that investment managers brought up in our interviews was tax. Investors expect robust and efficient tax infrastructure and have minimal tolerance of tax uncertainty or tax adjustments. A large UK traditional and hedge fund manager asserted that tax is now a core component for successful sales: "Structuring of tax is now a key consideration to make a fund attractive for new investors."

> "We deconstruct historical performance and try to project gross rates of real alpha, discarding bulk beta."
>
> Global pension fund consultant

Investors overall tend to have sophisticated methods of evaluating potential hedge fund investment. These methods are often driven by, or implemented by, consultants. One global consultant outlines its '3P' analysis – people, process, performance.

People analysis includes the background and tradition of the manager, its key talent, compensation and turnover.

Process evaluation includes how the manager values assets and includes them in the portfolio, the sustainability of the process and strategy and how managers cope with change and setbacks.

In terms of performance, the key is to understand where performance comes from. Alpha is scarce but, where it exists, clients are naturally keen not to overpay for it.

Nearly half of all hedge fund managers plan to launch a fund in 2015/16

A rapidly expanding industry with ever-more demanding clients naturally needs to adapt and refine its product offerings. As a result, new launches are high, with 44% of firms expecting to launch a new hedge fund in 2015/16. Firms in the UK and the US are considerably more likely to launch new hedge funds than firms in continental Europe and Asia-Pacific. However, in interviews with UK and US firms, it is clear that interest in hedge funds from EU institutions is starting to heat up, particularly in Italy and Germany. This could lead to more funds being launched within the EU itself.

Firms with more than US$500m in AuM are more likely to launch a new offering than firms with less than US$500m in AuM. Larger firms clearly have the resources and skills to expand their product ranges and maintain – or extend – market share.

Nearly half of the new funds to be launched are expected to be established in the Cayman Islands, with nearly a quarter in Ireland, 12% in Luxembourg and 10% in the US. The relatively lower proportion of funds to be established in the US reflects the fact that over three-quarters of US-managed hedge funds are domiciled in the Cayman Islands.

The biggest obstacles to a successful hedge fund launch, according to the survey responses, are investor appetite for the strategy and the regulatory burden. The regulatory burden of AIFMD has been and continues to be significant. Specific concerns around remuneration disclosure and the burden of reporting (so-called Annex IV reporting) have slowed take-up of the AIFMD licence.

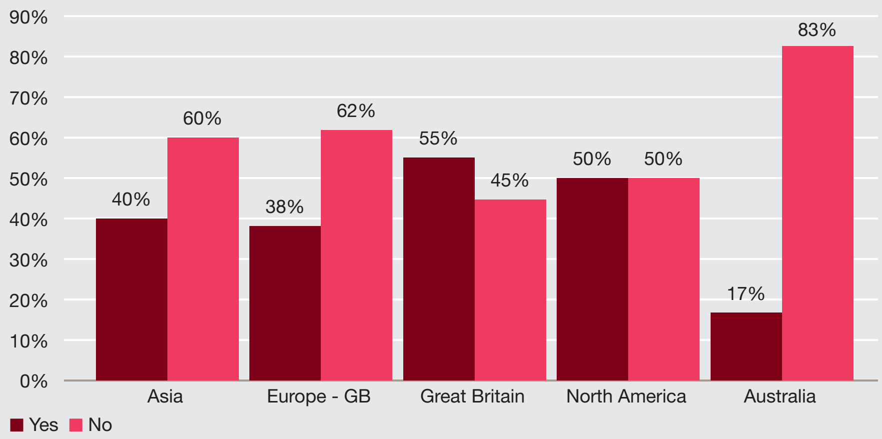
To a lesser extent, firms are worried about market trends, investor appetite for hedge funds in general and the ability for the fund to generate fees which exceed its costs. Appetite is currently strong, but as one hedge fund manager which distributes its products globally notes: "Returns from hedge funds are not as sexy as many other types of funds at the moment, so the strategy has got to be right."

The threat of regulation concerns firms in the UK most, followed by those in North America.

"Hedge funds are entrepreneurial by nature. They are often behind the curve when it comes to having a formal distribution strategy. New product launches are often dictated by the principal of the firm."

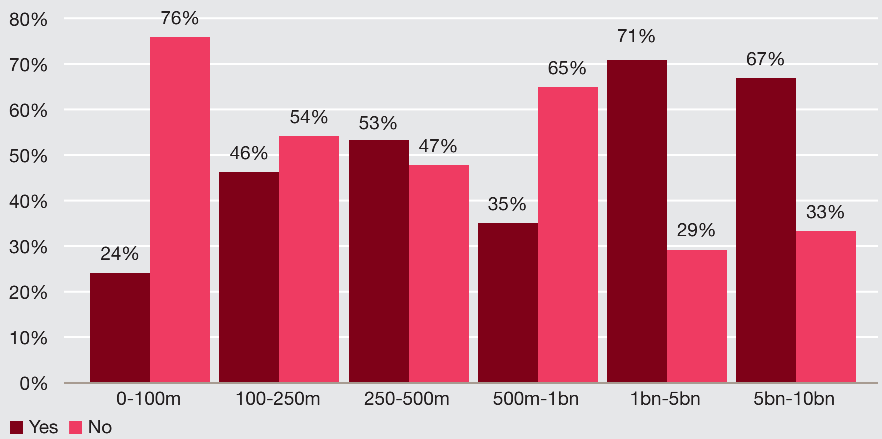
Large European hedge fund manager

Figure 13: Do you anticipate launching a new Hedge Fund in 2015/2016? (response by geography)



Source: PwC/AIMA Global Hedge Fund Distribution Survey 2015

Figure 14: Do you anticipate launching a new Hedge Fund in 2015/2016? (response by size of manager US$)



Source: PwC/AIMA Global Hedge Fund Distribution Survey 2015

Direct engagement is the most successful sales channel

The most important distribution channels for hedge funds identified by survey participants are:

1. Hedge fund internal staff engaging investors
2. Fund directors (principals or partners) marketing the fund
3. A US-registered broker dealer has been engaged to distribute the funds
4. A non-US placement agent or distributor has been engaged to distribute the funds

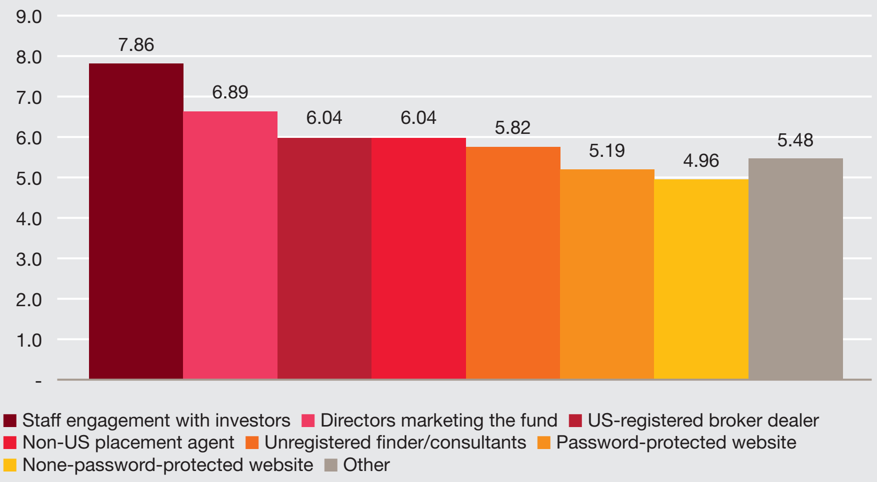
"Years ago distribution was relationship driven. Today it's all about the cap intro teams, but they all have the same lists."

Manager of very large European hedge fund

It is often a prolonged process from the initial contact with an investor to receiving a commitment to invest in a hedge fund. The most common length of time is six to 12 months.

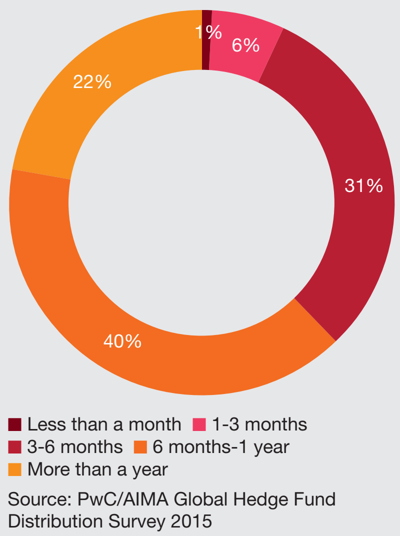
But nearly a quarter of respondents reported that lead times are over a year. This makes it particularly hard for young funds and start-ups to make headway given that managing cashflow in the early period of a fund or firm's existence – due to significant regulatory, compliance and legal costs – is challenging.

Figure 15: Ranking distribution channel in order of importance



Source: PwC/AIMA Global Hedge Fund Distribution Survey 2015
Note: Respondents were asked to rank multiple options. Numbers represent a weighted frequency of rankings awarded to each option.

Figure 16: How long does it take for an investor to make an investment from firm's initial contact with the investor?

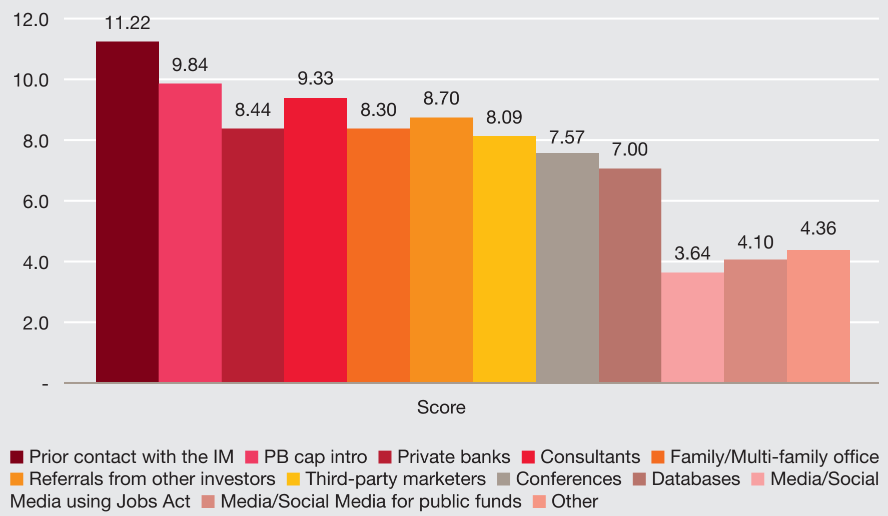


Source: PwC/AIMA Global Hedge Fund Distribution Survey 2015

Asked what are the main sources for new contact with investors, respondents say existing relationships are key. New contact sources by ranking are:

- Prior contacts of investment manager personnel
- Capital introduction teams at prime brokers
- Consultants
- Referrals from other investors
- Referrals from private banks

Figure 17: Ranking sources of new clients in order of importance



Source: PwC/AIMA Global Hedge Fund Distribution Survey 2015

Viewpoint

The factors that enable one fund to attract more assets than others are complex. But it is clear that performance is, as ever, key. However, performance must be allied to a solid reputation, sensible pricing and a focus on good service.

Brand is also a major differentiator. Since the 2008/2009 financial crisis, investors have become extremely sensitive to counterparty risk and this is unlikely to change, with investors continuing to be attracted by strong track records and evidence of longevity.

Tax, too, is important both for launching new funds and distributing existing ones. As we forecast in *Alternative Asset Management in 2020*, performance evaluation and attribution will increasingly focus on post-tax yields in years to come. Prospective investors are likely to ask about tax compliance before they consider investing in a fund. As a result, the tax function will play a key role in some hedge fund firms.

But it is not enough to excel in all these areas; they must be communicated too. And it is clear from the survey that direct engagement is still the best medium for this.

Going forward, considerable thought will be applied to each and every fund launch. As investors become more demanding and require greater customisation, the research and business development activity before a fund launch is intensifying. Every product must be thoroughly vetted, not just for potential performance, but also for attractiveness to the market and – not least – potential profitability. In addition, regulators are focused more than ever on the suitability of products for their target investors.

Equally, managers of liquid alternatives will develop their offerings to take advantage of the growth opportunities stemming from new pools of capital. Some of these new pools, particularly the institutional investor channel, may already invest in hedge funds. Others, such as retail investors, are new to hedge fund strategies. Traditional asset managers with their strong distribution capabilities and trusted brands may well dominate the second wave of liquid alternatives, but a number of hedge fund managers will also develop successful retail capabilities.

Liquid alternatives: a rising tide?

4

The growth in liquid alternatives, whether UCITS or '40 Act funds, has been prolific, and has truly disrupted the hedge fund industry. Investors find there is a lot to like about liquid alternatives. With a strong regulatory environment and product restrictions, more appealing liquidity terms, often lower fees and the ability to access a range of alternative strategies, their growth is unsurprising. The survey results bear this out with 81% of firms in the survey that manage UCITS funds reporting rising AuM. Meanwhile, some 87% of US managers of liquid alternative funds in the survey say AuM is rising in these strategies.

The liquid alternatives momentum was particularly strong in 2015, with the Lipper Fund Flows report for August 2015 reporting that alternative UCITS were the best-selling product type in Europe during the month, attracting inflows of €3.4bn. This is particularly impressive given that European investors withdrew a net €36.5bn over the month from UCITS.

There are a number of compelling reasons for investors and investment firms alike to seize the opportunity offered by liquid alternatives:

- Traditional firms that already have UCITS and '40 Act structures are looking for additional strategies and asset classes to add to their range
- As investors seek new areas of return, they are increasingly turning to hedge fund and other alternative strategies, thereby increasing demand
- Liquid alternatives can be suitable for both retail and institutional channels, so a broader range of potential investors can be targeted
- Some firms are looking for ways of bringing their hedge fund strategies to the broader market, but are put off by the burden of AIFMD, and therefore concentrate their energies on UCITS platforms, which have broader investor appeal and wider recognition as a regulated product.

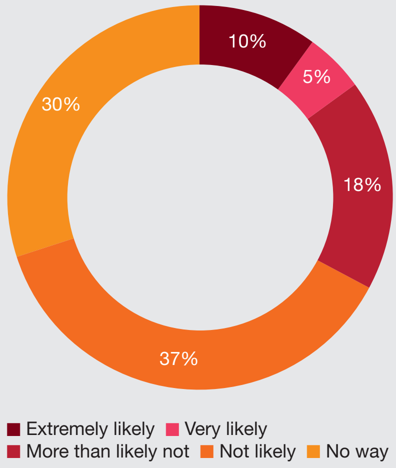
Over the longer term, PwC estimates demand for liquid alternative funds worldwide will rise from US$260bn at the end of 2013 to US$664bn by 2020.[11] This rise can be explained by the coming evolution in liquid alternatives. Whereas the first wave of liquid alternatives has focused largely on institutions, the second wave will target the retail and mass affluent markets, including the rapidly expanding defined contribution pensions fund market.

Hedge fund firms enter the market for liquid alternative assets with their eyes wide open, however. One very large European hedge fund manager noted: "UCITS are massive pools and the German market looks attractive. But we are talking about pretty flighty investors in these kinds of funds."

For hedge fund firms outside of the EU and US, the burgeoning liquid alternatives sector provides another route into these regions. Some Asian hedge fund managers, for instance, struggle to gain profile and sales traction among US investors. Those firms that are able to gain access to retail and mass affluent distribution platforms in the US may be able to gather assets without having to substantially increase marketing resources. In this sense, the liquid alternatives evolution could be a leveller in geographical terms.

There are likely to be many more liquid alternative funds, with half of survey respondents in the UK planning to launch one in 2015/16. Nearly a third of the US firms are planning a liquid alternatives launch. But just 14% of the continental European firms plan to launch a liquid alternatives fund in 2015/16.

Figure 18: Likelihood of launching new liquid alternative find (UCITS/40 Act fund)



Source: PwC/AIMA Global Hedge Fund Distribution Survey 2015

11 Source: Fast Forward to Centre Stage – Alternative Asset Management in 2020 – PwC, June 2015

First, 'millennials' (people who reached adulthood around the year 2000) are changing client demographics, behaviours and investment expectations. Millennials represent 25% of the workforce in the US and account for over half of the population in India.

The ways that liquid alternatives are distributed are changing and are likely to mutate further and faster as established retail distribution trends are disrupted by new technology.

First, 'millennials' (people who reached adulthood around the year 2000) are changing client demographics, behaviours and investment expectations. Millennials represent 25% of the workforce in the US and account for over half of the population in India. By 2020, millennials and Generation X will represent 60% of the global workforce.[12] They have grown up with broadband, smartphones, tablets, laptops and social media, so creating online, mobile and social media channels to promote products, brand awareness and trust is becoming mainstream in the retail asset management industry.

Technological developments have enabled the creation of information-rich mobile apps that are used to promote and sell products to clients while providing them with market insights and educational materials. Although mobile apps in the asset management industry are at an early stage compared to other markets, this trend is going to further evolve as the mobile channel becomes a powerful tool for marketing initiatives.

Second, Big Data is empowering market analytics, facilitating insights from structured and unstructured sources into marketing efforts and product development initiatives. Big Data can harness demographic and psychographic information about consumers derived from product reviews, commentaries, blogs, content on social media sites, and data streamed 24/7 from mobile devices, sensors and other technical devices. Building the capacity to use Big Data to get the right information to identify the right markets and customers at the right time will enable investment companies to make the right decisions about products and sales channels.

Third, a new breed of online technology-driven investment advisory firms, often referred to as 'robo-advisors', are adopting fully delegated, assisted or self-service advisory models to help consumers build and manage investment portfolios based on their age, risk aversion, income requirements, investment timeframe, income, savings and assets.

12 Reshaping Retail Fund Distribution – PwC/Caceis Investor Services, June 2015

Viewpoint

Liquid alternatives will not be embraced by every investor, but their sustained growth over recent years suggests they will play a bigger role in retail and institutional portfolios in the future. Many investment managers see the potential size of inflows as more than offsetting the loss in fees incurred through potential cannibalisation of their traditional hedge funds. Indeed, in many cases, a complementary product range encompassing traditional hedge funds and liquid alternatives can develop. In addition, investment firms should be able to achieve better diversification among their investor base through liquid alternative offerings, reducing over-reliance on a particular investor channel.

However, liquid alternatives operate in a regulated environment, which is more restrictive than the traditional hedge fund environment. Investment managers may need to alter their investment strategies to make sure that their investment portfolios are managed in compliance with regulations, and they will need appropriate infrastructure. In addition, liquid alternatives may have to fit into fund supermarket ranges, distribution platforms and other distribution channels, which may involve significant negotiation between the investment manager and the distributor.

The intersection of retail asset management and technology in the coming years is likely to redefine distribution for liquid alternatives and, possibly, for the whole hedge fund industry. Creating online, mobile and social media channels to promote products, brand awareness and trust is already becoming mainstream in retail asset management. Could this spread to the hedge fund industry? It is possible: at least two large European banks have already launched global digital private banking platforms for clients in the Asia-Pacific region.[13] The digital platforms represent a new private banking service delivery model and empower clients with 24/7 access to comprehensive information about accounts, market insights, personalised intelligence and trading tools. It surely will not take a great leap of imagination – or technology – for this model to become part of the institutional investor landscape.

13 Reshaping Retail Fund Distribution – PwC/Caceis Investor Services, June 2015

Conclusion

The hedge fund industry is well placed to take advantage of a number of global investment trends. These include rapid growth in emerging markets and of HNW investors, allied to increasing demand from institutional investors worldwide for non-correlated assets. This strong baseline of growth and demand is supported by regulatory changes which will enable well-governed and compliant hedge fund managers to distribute their strategies globally.

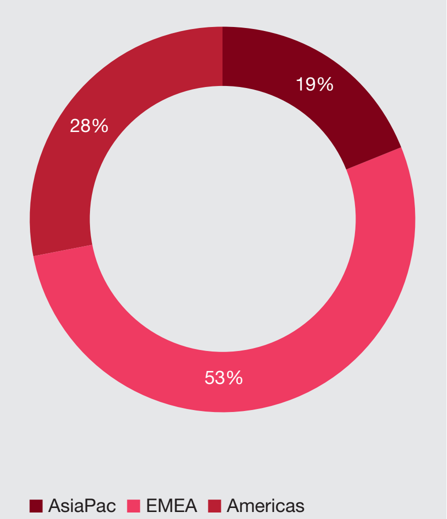
To succeed in raising AuM in existing funds and to successfully launch new funds, the onus is on hedge fund managers to keep firmly on top of regulatory and investor-related developments and to hone their distribution strategies. In addition, investors will demand performance that matches expectations and service levels which exceed them.

Hedge fund managers will need to be agile, continually monitoring the ever-changing distribution landscape.

Great opportunity exists. But it must be seized!

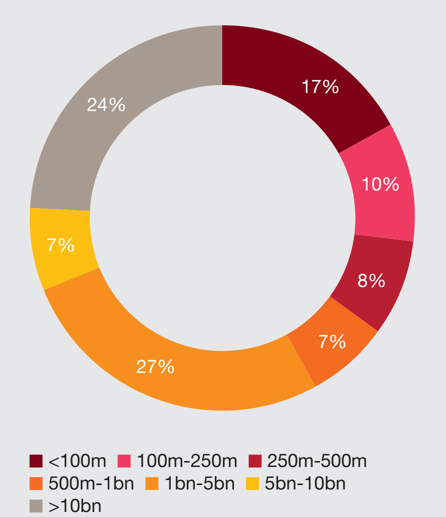
Survey Demographics

Figure 19: Where are your firms headquarters located?



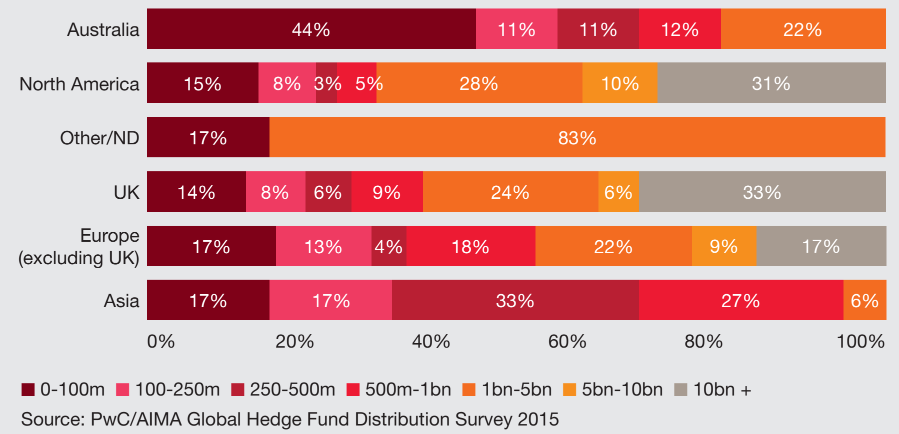
Source: PwC/AIMA Global Hedge Fund Distribution Survey 2015

Figure 20: What was your firm's aggregate AuM (US$) at 31 December 2014?



Source: PwC/AIMA Global Hedge Fund Distribution Survey 2015

Figure 21: What was your firm's aggregate AuM in US$ at 31 December 2014 by region?



Source: PwC/AIMA Global Hedge Fund Distribution Survey 2015

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