Exploring pathways to growth
2013 global hedge fund and investor survey
The hedge fund industry has continued to face unparalleled challenges over the last year. This survey captures the impact of those challenges and how both managers and investors are responding to them. While the survey provides valuable insight into where the hedge fund industry is headed, its findings also present a microcosmic landscape of a maturing industry.
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Once again we approached the execution of this survey with some deliberation, even trepidation, and once again our fears were completely unfounded as the industry responded with alacrity. Managers and investors have participated in record-breaking numbers, giving us coverage of about one-third of the entire industry. Our heartfelt thanks go to all of you who gave up so much of your valuable time to take part in this benchmark survey. We sincerely hope that the results vindicate your patience and prove useful to you as managers and investors.

The survey shows that the industry continues to mature and that those that survived the financial crisis are now beginning to look forward and focus on growth with a resigned acceptance of regulatory and reporting intrusions, however severe and ill-founded. In order to grow, managers are investing heavily in new strategies and new products, developing additional distribution networks, accessing new distribution channels in increasing numbers and, inevitably, seeking out investment and marketing talent. Perhaps unsurprisingly, most of this investment is being made by the largest managers, and the early signs are that it is reaping dividends: they are attracting the bulk of the inflows from both new and existing clients and are clearly claiming the payoffs from the economies of scale they have achieved.

The corruption of the purity of the old hedge fund model is now virtually complete as managers today run a diverse range of products and strategies and look increasingly like mainstream participants in the industry while traditional, long-only managers increasingly launch hedge funds.

With this maturity come the normal tribulations of managing large, diverse businesses: a relentless focus on operational efficiency and costs and a battle to maintain margins. Together these factors are leading to an obvious polarity in the industry, with the largest succeeding...
because of their size and scale and their ability and willingness to invest in the business and the smallest by virtue of simplicity. The middle ground, on the other hand, looks increasingly swampy.

As always in this industry, there are sufficient contrary indicators to disprove the rule. For example, European managers, though many are in that swampy middle ground, appear to have tight control over their costs and anticipate the greatest increase in margins. We may be dealing with a bit of survivor bias in the sample, but nevertheless, the results are remarkable.

Moreover, the optimism of managers about their growth prospects is not necessarily shared by investors. Investors uniformly appear to say that they are unlikely to increase allocations to the sector while managers, particularly smaller managers, remain bullish – both about inflows and the market appreciation of their funds – despite the systemic evidence of correlation between low rates and low returns. Perhaps people are just tired of pessimism?

Managers seem determined to diversify. This is the usual means of attempting to resolve the central dilemma of the asset management industry: satisfying the need to grow one’s business versus growing the assets of one’s customers. Investors are, unsurprisingly, much less interested in buying diverse products from the same manager – they shop around for the best of each type. But this does explain why the data shows that managers attract money from new clients at almost the same rate as they do from existing clients.

Concomitantly, there is a growing demand for customized solutions, and that demand is clearly being met. This may well be another reason why the largest managers appear to be winning – they can offer these solutions at the lowest marginal cost.

As we anticipated in earlier surveys, distribution channels are changing. Direct investment continues to increase and is preferred by managers, with intermediation shifting away from funds of funds to investment consultants. This is another sign of maturity: with returns likely to remain subdued and investors finding access easier, there will remain a focus on the costs of intermediation. Funds of funds are responding by seeking out newer, smaller managers, as well as seeking greater concessions from them, and being able to present smaller institutional investors with a package that is still saleable.

Our study of operational efficiency and costs bears out the advantages accruing to the largest and the smallest (ignoring the fragility of the latter), but what is astounding is not the average or median but the sheer range in the sample. Without studying the particular, which was clearly beyond the scope of the survey, the general observation would suggest an immaturity in the industry that belies the other data – the outliers are some distance from reverting to the mean.

Managers universally face challenges concerning data, its collection, its use and accuracy, and they lack the ability to use collected data for multiple purposes. This is not unique to hedge funds – it is a well heard right across the financial services industry. More particularly, while shadowing has increased and its costs are borne by the managers, there is a noticeable easing of investor expectations about which costs can and cannot be passed onto the funds and, more specifically, recognition that the costs of shadowing could be borne by the funds.

Inevitably, fatigue has set in about regulation and reporting requirements; managers are largely resigned to bearing the costs and dealing with the burden while their investors are still convinced these regulations, promulgated entirely in their name, serve no useful purpose.

We concluded the survey by asking managers and investors about the future. Apart from the usual knee-jerk reaction about regulation and its cost, both investors and managers see a consolidation, both of funds and of managers, although there appears to be little evidence of the industry consolidating so far. Perhaps self-servingly, investors continue to hope for downward pressure on fees.

At EY we remain confident about the continued growth of the industry, and we continue to invest heavily in the sector. Our investment, like yours, is largely in people, and we continue to attract the best people to serve the industry and its multiple stakeholders. We are particularly encouraged by the number of strong younger partners now in the organization, and it is hugely gratifying to note that the next generation is brighter, smarter, hungrier and far better-rounded as individuals than we could ever hope to be. We look forward with optimism to serving you and extend our thanks to all of you, our clients and potential clients, who have made this survey a success and the industry such a vibrant one.

Michael Serota
Co-Leader, Global Hedge Fund Services

Arthur Tully
Co-Leader, Global Hedge Fund Services
The choices that managers and investors are making today will undoubtedly impact their future. Strained resources have produced limited opportunities for growth, causing managers and investors to focus more sharply on preparing for the future. Across individual geographies, preferences varied; however, despite these variables, commonalities emerged.

In this section we look at:

- The most important strategic priorities for managers
- Managers’ most important growth initiatives
- Changes in margins
- Investors’ allocation levels
Hedge fund managers are focused on growth

Almost all managers said growth initiatives were one of their top three priorities – with two-thirds saying growth was their top priority. These managers are pursuing multiple methods to achieve growth. The promise of performance has always attracted capital, so it is not surprising that managers are upgrading front-office talent to improve performance and attract new capital. However, recent market activity shows that managers that are focused on just one strategy are at risk when they do not perform. Therefore, the majority are also focused on adding strategies and products and developing distribution capabilities to diversify their offerings and attract new investors.

Managers in developed markets are more focused on developing additional distribution networks while those in Asia are focused on upgrading talent.

Our results also show that the largest managers (more than US$10b under management) are more focused on adding strategies and products than other managers as they seek growth.

Operational efficiency initiatives are a secondary priority. The majority of chief operating officers are spending most of their time focused on technology investments for middle- and back-office functions, data management solutions, outsourcing and seeking process improvements. These imperatives are critical to achieve economies of scale as the managers grow.

Hedge funds

Which two or three are the most important strategic priorities to your firm?
Hedge funds
Have margins increased, decreased or remained the same over the past year?

Proportion of managers with changes in margin (assuming a 30% initial margin)

- Increased: 56%
- Decreased: 34%
- Unchanged: 10%

But margins are pressured

Though two in three managers reported an increase in revenues over the past year, just half reported improvements in margins. One in three said margins declined and another 10% noted margins remained unchanged as costs increased. Managers attribute the decline in margins to increased costs of regulatory reporting, increasing technology costs and costs related to infrastructure to support new products and strategies.

Managers that fall between US$5b and US$10b under management are disproportionately affected by this compression.

In North America, nearly as many managers noted a decrease in margins as noted an increase. Meanwhile, managers in Europe appear to be more successful at managing costs than their counterparts in other regions. Just one in three European managers notes that costs have increased versus 58% in North America. European managers have been successful in containing costs by outsourcing, refraining from shadowing and by offering less complex strategies.

Although three in four managers in Asia said that costs had increased, they have also been the most successful in raising capital and thereby growing revenue, and margins have improved as a result.

<table>
<thead>
<tr>
<th>Region/Capitalization</th>
<th>Increase in margins</th>
<th>Decrease in margins</th>
</tr>
</thead>
<tbody>
<tr>
<td>North America</td>
<td>49%</td>
<td>-40%</td>
</tr>
<tr>
<td>Europe</td>
<td>60%</td>
<td>-33%</td>
</tr>
<tr>
<td>Asia</td>
<td>71%</td>
<td>-21%</td>
</tr>
<tr>
<td>Less than US$1b</td>
<td>64%</td>
<td>-27%</td>
</tr>
<tr>
<td>US$1b–US$5b</td>
<td>55%</td>
<td>-32%</td>
</tr>
<tr>
<td>US$5b–US$10b</td>
<td>43%</td>
<td>-43%</td>
</tr>
<tr>
<td>More than US$10b</td>
<td>59%</td>
<td>-35%</td>
</tr>
</tbody>
</table>
Most institutional hedge fund investors expect to maintain current allocation levels

The institutional investors that participated in our study reported hedge fund allocations of 14% on average. Those in North America reported marginally higher allocations (16% on average) than those in Europe (12%).

Although a higher proportion of investors responded that they intend to increase (17%) their allocations rather than decrease (11%) them, this proportion has declined from 20% in 2012. The vast majority of study participants say they will maintain their allocations for the next three years. European investors are marginally more likely to increase allocations than their counterparts in North America as they look to exploit opportunities while Europe continues to recover.

Since there are a limited number of institutional investors looking to increase their allocations to hedge funds, managers seeking to grow will do so by offering diversified products and strategies to attract the limited institutional capital, or by using alternative distribution networks in order to attract different types of investors.

Investors
Do you plan to increase, decrease or maintain your current target allocation to hedge funds in the next three years?

<table>
<thead>
<tr>
<th></th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase</td>
<td>20%</td>
<td>17%</td>
</tr>
<tr>
<td>Decrease</td>
<td>13%</td>
<td>11%</td>
</tr>
<tr>
<td>Unchanged</td>
<td>67%</td>
<td>72%</td>
</tr>
</tbody>
</table>
We've added a senior business development professional to develop new distribution networks. In the product category, we're looking at European distribution and registered US products.

– Manager, North America, under US$10b

We have increased our marketing efforts to attract more institutional investors and are adding and developing products to attract their interest, ensuring the retention of our people by matching remuneration to their skill sets and upgrading technology to meet compliance requirements.

– Manager, Asia, under US$10b
Few words have resonated as strongly with managers and investors across the industry as “growth.” In the wake of regulatory changes, shrinking margins and technological advances, managers have remained cognizant of the need to develop long-term growth solutions. Regardless of their size or geographic location, achieving sustainable growth has been the pressing issue for most managers.

In this section we explore:

- Net asset flows
- Obstacles to allocation
- Products offered by managers
- Customized solutions
- Channels of investment
Most managers report net inflows

Two in three managers reported net inflows in 2012. Managers in Asia and Europe were most successful in raising capital – growing by 25% and 10%, respectively. Investors have begun to reinvest in Europe after an exodus during the past couple of years, and they appear to be interested in growth markets, such as Asia, as well.

In North America, although 60% of managers reported inflows, those inflows were negligible when compared to the total assets of the region. This, combined with a finding that nearly half of inflows are being sourced from new clients, suggests that there is no net new investment in managers in North America, but rather a reallocation among managers as the competition for capital intensifies.

Hedge funds

Please detail asset inflows across all of your funds in 2012.

Percentage of managers reporting net inflows

<table>
<thead>
<tr>
<th>Region</th>
<th>63%</th>
<th>60%</th>
<th>67%</th>
<th>67%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>North America</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Europe</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Asia</td>
<td></td>
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</tr>
</tbody>
</table>

Total net flows as a percentage of assets

<table>
<thead>
<tr>
<th>Region</th>
<th>5%</th>
<th>1%</th>
<th>10%</th>
<th>25%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>North America</td>
<td></td>
<td></td>
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<tr>
<td>Europe</td>
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<td></td>
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</tr>
<tr>
<td>Asia</td>
<td></td>
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</tbody>
</table>
Hedge funds
Please detail the amount of asset inflows and outflows (US$) across all your funds in 2012.

Net flows (US$b)

Almost 90% of net inflows were to managers with more than US$10b under management in 2012. Roughly three-quarters of managers with more than US$5b under management reported net inflows whereas just 55% of those with less than US$5b did.

Net flows to the smallest hedge funds managers were negative, but there was significantly greater variance in reported flows – with a small majority reporting nearly 100% growth or more. This is the result of increased barriers to entry for the smaller funds. Smaller funds that do not grow their asset base quickly will have difficulty surviving in the current environment given infrastructure and regulatory demands.

Meanwhile, the larger funds continue to attract capital as they diversify their product offerings and offer customized solutions for investors.

Managers are bullish about their prospects for future growth. The largest managers are budgeting 10% growth – which is roughly in line with their recent experience. It is surprising, however, that managers with less than US$10b under management are budgeting for 15% growth in 2013. This outlook may reflect the growth levels needed for these managers to sustain their business models as costs continue to increase.
But obstacles remain

Fees and performance continue to be the largest obstacles for institutional investors, followed by risk tolerance. Although performance has improved, investors cannot ignore the lackluster performance of previous years, particularly since the industry built itself on the promise of performance.

Managers are being compelled to redefine themselves and the promise they offer to investors of a well-diversified portfolio. They need to market themselves in such a way that investors understand the value they bring and how they fit into the investors’ asset allocation.

Additionally, managers are compelled to identify and exploit new opportunities for growth — whether it be new geographies or new client segments within their geography — and are focusing on developing their distribution capabilities as a result.

Investors

What is the single biggest obstacle to allocating a greater proportion of assets to hedge funds?

- Fees: 30% (2013), 25% (2012)
- Performance: 30% (2013), 19% (2012)
- Risk tolerance: 17% (2013), 17% (2012)
- Regulations: 10% (2013), 11% (2012)
- Liquidity needs: 20% (2013), 11% (2012)
- Transparency: n/a (2013), 11% (2012)
- Complexity: 7% (2013), 6% (2012)

* Multiple responses were allowed in 2012
Hedge funds
Which of the following products do you currently offer to clients?

Managers believe that new strategies and products will attract investors

Hedge fund managers around the globe have begun to offer non-traditional hedge fund products to attract capital. Larger managers have been more prolific in product creation as they seek to attract capital, and the strategy appears to have been successful.

These managers can better afford to add strategies and products than smaller managers can – they have the scale to bear the costs of managing multiple products. Smaller managers that have not reached strategy are taking additional risk.

Though there is clearly institutional investor demand for a subset of these products – registered alternative funds, long-only funds, UCITs (in Europe), private equity and structured products – future potential appears to be more limited for others among the institutions responding to our survey. Relatively few of the investors that don’t already invest in these non-traditional products say they want to invest via a hedge fund manager.

It is important to note, however, that a number of these alternative products are designed to attract a more diversified investor base and extend hedge funds’ reach to new sources of capital.
Demand for customized solutions is robust

Nearly two-thirds of investors either already invest, or would like to invest, in a customized solution. Demand is most robust among funds of funds – nearly 70% of funds of funds already invest in a customized solution and another 15% say they would like to.

Managers in North America are responding fastest – 75% of managers in North America offer customized solutions or plan to whereas just 50% of their European counterparts currently do or plan to in the future.

Hedge fund managers should heed lessons learned by traditional managers in recent years. Customization can be unwieldy, and traditional managers are now rationalizing and seeking to simplify. Hedge fund managers need to be strategic and optimize their cost structure in delivering customized solutions. They should determine the asset level and fees at which a customized solution makes sense for their firm.

**Hedge funds**
Do you offer customized solutions to your investors?

- Yes: 51%
- No, and don't plan to: 34%
- Not currently, but plan to in the future: 15%

**Investors**
Do you currently invest in customized solutions/products offered by a hedge fund manager?

- Yes: 51%
- No, and don't plan to: 36%
- No, but would like to: 13%
Our biggest obstacle is our ability to get into the top-performing funds. A lot of them are closed. One faces the situation where if you’re not in the top 10% or 20% of all hedge funds, the investment returns drop off pretty dramatically.

– Investor, North America

I think there is a place for hedge funds in the portfolio as there are a variety of things you can get in terms of diversity, but the investment committee is very hung up at the moment on fee costs.

– Investor, Europe
One in three managers requires a minimum investment of over US$100 million for a customized solution

The results suggest a big disconnect among managers in different geographies with respect to minimum commitments – particularly in North America, where managers require a larger minimum commitment for a customized solution. By contrast, Asian managers are clearly seeking to attract capital with lower minimum commitments.

Managers and investors are largely aligned as they negotiate fees – managers are most flexible on management fees where investors are looking for concessions. The largest hedge fund managers appear most willing to negotiate. Funds of funds are more flexible than pension funds and endowments when it comes to negotiating performance fees, but are far more demanding when it comes to lock-ups.
Hedge funds

Has the proportion of assets you have sourced from each of the following channels increased, decreased or remained the same over the past few years?

Direct investment from management platforms
- Increased: 39%
- Decreased: 24%
- Remained the same: 37%

Direct investment from institutional investors
- Increased: 74%
- Decreased: 8%
- Remained the same: 18%

Funds of funds
- Increased: 66%
- Decreased: 21%
- Remained the same: 13%

Investment consultants
- Increased: 54%
- Decreased: 12%
- Remained the same: 34%

Investors

Has the proportion of assets you have invested through each of the following channels increased, decreased or remained the same over the past few years?

Direct investment
- Increased: 44%
- Decreased: 9%
- Remained the same: 47%

Funds of funds
- Increased: 37%
- Decreased: 13%
- Remained the same: 50%

Investment consultants
- Increased: 29%
- Decreased: 13%
- Remained the same: 58%

Direct investment is increasing

Large institutional investors are investing more in hedge funds directly – often with the assistance of investment consultants – as funds of funds continue to lose traction because of cost pressures.

The trend is most pronounced in North America, where two in three investors say they have decreased the proportion of assets they invest via funds of funds and increased direct investment. As a result, managers in North America are most bearish on sourcing investments from funds of funds in the future.

More than 75% of hedge fund managers in Europe and North America say that direct investment has increased and most expect this trend to continue. As that happens, an increasing proportion of managers expect that they will work with investment consultants in the coming years. This has meaningful implications for managers’ marketing strategies and service models.
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2013 global hedge fund and investor survey

Managers clearly prefer direct investment over funds of funds

This year, an increasing proportion of large investors prefer direct investment versus investing via funds of funds. The trend is most pronounced in North America, where 60% of investors say they prefer direct investment. For these investors, the cost of intermediation has become too expensive at today’s rates of return. These firms are well positioned to internalize due diligence, given their sophistication, and the trend is accelerating as the industry becomes more transparent.

It’s not surprising that managers prefer direct investment — capital invested directly tends to be stickier and the size of the investment tends to be larger. However, marketing directly to institutional investors requires sales and service infrastructure akin to those of traditional money managers that sell to the institutional market.

Despite this trend, there will always be a role for funds of funds and investment consultants. Funds of funds are responding by focusing on smaller institutional investors and the retail market and investing in smaller hedge funds. For these investors, funds of funds provide diversification of manager exposure with better concessions on fee and liquidity terms. For smaller managers seeking growth, funds of funds provide access to a highly fragmented investor base.

Hedge funds
Which would you most prefer as a source for new funds?

Investors
Which channel do you most prefer for investing in hedge funds?
Direct investments from institutional investors are preferred because they are more stable and it gives us a direct and permanent relationship with the source of capital. There are also fewer fees to intermediaries.

— Manager, North America, under US$10b

We have the size to go direct, so it’s more efficient for us and we can tailor the products to our needs.

— Investor, Europe
As the industry continues to leverage technological advances, managers have redefined efficiency. Once considered a by-product of regulatory change, increased efficiency is now a significant investor demand. Although managers have traditionally sought to reduce costs through lowering headcount, they have begun to employ innovative tactics in their front-end and back-end offices.

In this section we look at:

▶ Where headcount changes are being made
▶ What the top challenges related to data and data management are
▶ Where managers are making capital expenditure in technology
▶ Whether investors and managers are in agreement on outsourcing and shadowing strategies
▶ The use of a second, third-party administrator for shadowing
Managers continue to increase headcount to support growth – though hiring appears to be slowing

Generally, fewer managers than last year say they plan on adding headcount across front- and back-office functions this year – a sign that the pace of hiring is slowing.

The largest managers continue to add headcount at a faster rate than the overall market in virtually every function, including marketing, investment operations, risk management and legal/compliance, to ensure their operating models are adequate and scalable to support growth and meet the expectations of investors and consultants. Ironically, the only function not reflecting a higher pace of hiring is portfolio management, though this can be attributed to higher rates of hiring last year by larger managers.

Obviously, as headcount increases, so do costs. It is critical that managers find efficiencies in scale – particularly in support functions – in order to control costs and protect margin. Though outsourcing has promise for some, no one solution fits all.

Hedge funds

For each of the following functions, do you expect headcount to increase, decrease or remain the same in the next two years?

Total funds

<table>
<thead>
<tr>
<th>Function</th>
<th>Increase – 2012</th>
<th>Increase – 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Technology and data management</td>
<td>27%</td>
<td>10%</td>
</tr>
<tr>
<td>Human resources</td>
<td>23%</td>
<td>29%</td>
</tr>
<tr>
<td>Investor relations</td>
<td>46%</td>
<td>66%</td>
</tr>
<tr>
<td>Marketing</td>
<td>35%</td>
<td>42%</td>
</tr>
<tr>
<td>Portfolio management</td>
<td>31%</td>
<td>45%</td>
</tr>
<tr>
<td>Middle office</td>
<td>19%</td>
<td>37%</td>
</tr>
<tr>
<td>Back office</td>
<td>37%</td>
<td>45%</td>
</tr>
<tr>
<td>Risk management</td>
<td>27%</td>
<td>45%</td>
</tr>
<tr>
<td>Legal and compliance</td>
<td>29%</td>
<td>45%</td>
</tr>
</tbody>
</table>

Greater than US$10b in assets under management

<table>
<thead>
<tr>
<th>Function</th>
<th>Increase – 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Technology and data management</td>
<td>29%</td>
</tr>
<tr>
<td>Human resources</td>
<td>19%</td>
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<tr>
<td>Investor relations</td>
<td>35%</td>
</tr>
<tr>
<td>Marketing</td>
<td>29%</td>
</tr>
<tr>
<td>Portfolio management</td>
<td>45%</td>
</tr>
<tr>
<td>Middle office</td>
<td>43%</td>
</tr>
<tr>
<td>Back office</td>
<td>43%</td>
</tr>
<tr>
<td>Risk management</td>
<td>29%</td>
</tr>
<tr>
<td>Legal and compliance</td>
<td>38%</td>
</tr>
</tbody>
</table>

* Only a subset of the above headcount categories were asked of hedge fund managers in 2012.
**Hedge funds**

Please detail your firm’s resourcing as of 30 June 2013 on a full-time equivalent (FTE) basis.

Average ratio of back-office FTEs to front-office FTEs per US$1b in assets under management

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The largest managers have sufficient scale to leverage their existing platforms and invest in technology to achieve the greatest level of efficiency. The smallest managers cannot afford not to be efficient – they have been slower to add complexity and have been forced to outsource to remain competitive.

By contrast, managers with US$5b to US$10b under management are adding infrastructure for new products and strategies in order to grow, but have not yet achieved the scale necessary to support them. Although they have realized some efficiencies year on year, they remain the most challenged.
Managers have also reduced middle-office headcount by outsourcing and investing in technology.

There is a paradigm shift taking place as managers are no longer relying on increased headcount to achieve growth. Instead, they are looking at infrastructure improvements as a means to optimize their growth models. Hedge fund managers are achieving scale through a better integration of front, middle and back office, supported by good data management practices and the use of best-in-class technology. As a result, functions in the middle office are subject to an increasing amount of outsourcing and automation.

It is not surprising that there is an increase in headcount in legal and compliance and the back office, as these are the areas most responsible for implementing mandates from new regulatory and reporting requirements, including AIFMD and Form PF.

### Hedge funds

Please detail your firm’s resourcing as of 30 June 2013 for the following functions on a full-time equivalent (FTE) basis.

FTEs for each category as a percentage of total FTE:

<table>
<thead>
<tr>
<th>Category</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk management</td>
<td>4%</td>
<td>5%</td>
</tr>
<tr>
<td>Legal and compliance</td>
<td>6%</td>
<td>9%</td>
</tr>
<tr>
<td>Portfolio management</td>
<td>48%</td>
<td>52%</td>
</tr>
<tr>
<td>Middle office</td>
<td>22%</td>
<td>15%</td>
</tr>
<tr>
<td>Back office</td>
<td>18%</td>
<td>19%</td>
</tr>
</tbody>
</table>
As managers seek efficiencies from technology and outsourcing, they will need to address data challenges.

Although 70% of managers said that their data management and governance practices were highly effective, just 5% said they did not face data challenges, suggesting that “highly effective” might be an overstatement. Challenges ranged from availability of data (e.g., disparate systems), data accuracy (e.g., manual processes) and timeliness to complying with changing regulatory demands (e.g., Form PF, CPO-PQR).

Data governance and management are a problem facing the broader financial services industry. Firms recognize that “good” data is key for effective risk management and for achieving operational efficiency, allowing higher levels of integration between systems and outsourcing partners and the ability to leverage technology.

As such, it has become a key strategic priority that attracts senior management attention.

### Hedge funds

What are your top two or three challenges related to data and data management?

<table>
<thead>
<tr>
<th>Challenge</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increased regulatory demands</td>
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<tr>
<td>Availability of data</td>
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<tr>
<td>Accuracy of data</td>
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<td>Timelines</td>
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<tr>
<td>Changing business requirements</td>
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<tr>
<td>Data governance (procedures, policies and ownership)</td>
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</tr>
<tr>
<td>Duplication</td>
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<tr>
<td>Data granularity</td>
<td>3%</td>
</tr>
<tr>
<td>Uncertain</td>
<td>3%</td>
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</table>
Managers continue to invest in technology even though fewer are making large capital expenditures

Even though fewer managers are making capital expenditures, regulatory compliance continues to be a major driver of investment. One manager noted, “The biggest driver for us is compliance, namely the increased regulatory burden and the increase in the number of filings.” The slowdown in capital expenditure is likely a sign that infrastructure investments made over the past two years have paid dividends as these investments have been scalable and flexible enough to support growth and diversification strategies.

Managers continue to make investments to upgrade legacy trading systems, enterprise infrastructure and risk management. These are viewed as strategic investments driven by the pursuit of performance and efficiency.

Investments in risk management are driven by both internal and external demands. Many investors remain less than satisfied by risk management reporting by their managers.

Managers expect modest increases in technology expenditures over the next two years relative to the past few years to support these investments, including the increased headcount needed to manage new technologies.

Hedge funds

In which of the following have you recently (past 12 months) made capital expenditures in technology?

- Compliance and regulatory reporting
- Investment management and trading systems
- Risk management
- Enterprise infrastructure*
- Client service and investor reporting
- Fund accounting and financial reporting*
- Sales and marketing support systems, including website

* These categories were not part of the 2011 data
Most managers are outsourcing what they can

Having already largely outsourced back-office functions, hedge fund managers are seeking additional operational efficiencies by outsourcing other non-core activities—particularly technology, legal and compliance, and middle-office functions.

Best-in-class outsourcing providers offer data storage capabilities for the middle office and portfolio management, as well as collateral management capabilities. These solutions allow for a more timely and accurate picture of the managers’ portfolio.

In addition to service providers, hosted solutions continue to evolve and attract managers. They not only improve data processing, but also provide servicing hardware, while processing managers’ data within secure facilities (including cloud technology). As a result, hosted solutions have been increasingly adopted by hedge fund managers.

Investors are accepting of managers’ outsourcing, and European investors are generally more accepting of outsourcing than North American investors are.
Managers continue to fully shadow, but there is a growing trend to pare down shadowing

It is not surprising that the majority of managers fully shadow. Interestingly, a growing number of managers have developed stronger relationships with fund administrators and are paring down full shadows in favor of partial oversight falling on the administrator.

The cost of shadowing is significant. Hedge funds fully shadow to mitigate the risk of error, and indirectly to provide a contingency plan, if needed. They shadow more in the front office, where sensitivities to error are greatest and timely resolution of errors is critical to avert adverse consequence and reputational risk.

Investors agree that the front office is most important, but are more discriminating than managers in what they deem important to shadow. Trade reconciliation and investment valuation are most important, while a number of back-office functions, including partner/shareholder accounting and investor reporting are not. Yet nearly half of hedge funds fully shadow these latter functions.

When asked what conditions are needed to reduce shadowing, some managers cited a higher level of integration with their administrators. Others admit that they would need agreement among all their investors that they could stop.

Hedge funds
For functions you outsource, which do you fully shadow, perform oversight or do nothing?

Investors
Which are the two most important functions for your hedge fund managers to shadow? Which two of the following functions are the least important for your hedge fund managers to shadow?
**Hedge funds**

Do you anticipate charging more expenses to the funds than you have previously charged through?

- **Yes**: 13%
- **No**: 87%

**Investors**

Have any of your hedge fund managers signaled that they will charge more expenses through to the fund than they previously did?

- **Yes**: 16%
- **No**: 84%

**Investors**

What type of expenses would be unacceptable to be passed through to the funds?

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<thead>
<tr>
<th>Expense</th>
<th>2013</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Marketing expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trader compensation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Regulatory registration and compliance for fund</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of administrator(s)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>D&amp;O insurance</td>
<td></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Expense</th>
<th>2013</th>
<th>2011</th>
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</thead>
<tbody>
<tr>
<td>Research-related travel</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Regulatory examinations</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Outsourcing of middle-office functions</td>
<td></td>
<td>no data</td>
</tr>
<tr>
<td>Costs of shadow accounting/processing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax examinations</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other research expenses/soft dollars</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Few managers expect to pass more costs to the funds, but investors are increasingly accepting.

Few managers see an opportunity to pass more expenses through to their funds.

Conversely, fewer investors actively object to passing through expenses than even a few years ago – in particular, expenses related to shadowing, regulatory registration and compliance for the funds and research expenses are clearly seen as less objectionable than in years past.

It is likely that improved performance has shifted investor focus away from cost. But it is also true that managers have actively engaged investors in discussions about costs as the cost of regulatory greater controls, transparency and shadowing have become more burdensome.

Investors continue to object to some expenses being passed onto the funds: marketing and trader compensation remain least acceptable to investors.
Most hedge fund managers have not considered using a second administrator for shadowing

Only a small minority of managers say that they are considering engaging a second third-party administrator to shadow. Most are reluctant to cede control for oversight and shadowing and recognize that the likely headcount reduction is not large enough to warrant the additional costs.

Half of investors believe that using a second administrator for oversight and shadowing is an acceptable solution. The question is who will pay — if it adds additional cost to the funds, it is unlikely that investors would remain as supportive.

---

**Hedge funds**

Have you started using, or are you considering using, a second third-party administrator for shadowing?

- Total: 96% Yes, 4% No
- North America: 98% Yes, 2% No
- Europe: 86% Yes, 14% No
- Asia: 100% Yes, 0% No

**Investors**

Is it acceptable for the hedge funds in which you are invested to use a second third-party administrator to shadow instead of the investment manager of the fund?

- Total: 60% Yes, 40% No
- North America: 55% Yes, 45% No
- Europe: 68% Yes, 32% No
The increase in the cost of running the business was due to growth and regulatory compliance, resulting in added headcount, systems and office space.

– Manager, North America, over US$10b

We are constantly looking at our architecture design to try to improve how we capture data and how we distribute it. It’s really about data warehouse architecture and process flow – where we get it from, how it gets routed along to the user path and where it gets held.

– Manager, North America, under US$10b
The new regulatory landscape encompasses an increasing amount of legislation whose purpose and scope inherently contain significant cross-border implications. The costs from regulatory reforms aimed at fostering harmonization and stability have created new challenges for the hedge fund industry. More than ever, the broad application of regulatory and compliance requirements has led managers to find ways of striking a balance between achieving growth and minimizing costs.

In this section we explore:

- The views of managers and investors on the benefits of industry regulations
- The benefits of globally harmonizing regulations
- The impact of extraterritorial regulations, such as AIFMD
The results show that industry perceptions of regulatory change have not changed over the last few years.

To date, regulations have primarily served to add costs to the system — costs that are being borne by investors and managers, but have provided minimal benefit to the due diligence process or to minimize any concerns of systemic risk.

In fact, over two-thirds of investors say that regulations on hedge fund reporting have had no beneficial impact on their due diligence process.

Half of the managers and investors recognize that global harmonization of regulations would be beneficial.

**Hedge funds and investors**
Using a scale of “1=not at all beneficial” to “5=extremely beneficial,” to what extent do you believe the hedge fund regulation(s) will benefit investors in the long term?

<table>
<thead>
<tr>
<th></th>
<th>Hedge funds</th>
<th>Investors</th>
</tr>
</thead>
<tbody>
<tr>
<td>5/4 beneficial</td>
<td>11%</td>
<td>13%</td>
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<tr>
<td>3 neutral</td>
<td>41%</td>
<td>31%</td>
</tr>
<tr>
<td>2/1 not beneficial</td>
<td>48%</td>
<td>56%</td>
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</table>

**Hedge funds and investors**
Using a scale of “1=not at all beneficial” to “5=extremely beneficial,” to what extent do you believe that hedge fund investors would benefit from greater global harmonization of regulations?

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<thead>
<tr>
<th></th>
<th>Hedge funds</th>
<th>Investors</th>
</tr>
</thead>
<tbody>
<tr>
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<td>54%</td>
<td>54%</td>
</tr>
<tr>
<td>3 neutral</td>
<td>23%</td>
<td>25%</td>
</tr>
<tr>
<td>2/1 not beneficial</td>
<td>23%</td>
<td>21%</td>
</tr>
</tbody>
</table>
AIFMD will affect my selection of managers and my allocations to hedge funds because I will have fewer funds to select from and fewer options overall.

— Investor, Europe

Current regulations will not benefit investors. Regulators go in with a lot of good intentions. Mix in politics and the aim gets watered down. Regulations are rarely forward-looking nor do they succeed in protecting investors from the next crisis.

— Investor, North America
Respondents are increasingly concerned regarding the extraterritorial nature of regulations – for example, the AIFMD or FATCA. This pressure is most keenly felt in Europe, where over half of the managers expect that extraterritorial regulations will adversely affect them. The concerns stem from the compliance and reporting burdens of Form PF and FATCA, as well as the marketing restrictions imposed by the AIFMD.

We are already seeing certain EU countries, such as France and Germany, gold-plate their private placement regimes, making it harder for funds to raise money there. Many managers will seek to gain minimum compliance with the AIFMD and rely upon reverse solicitation from European investors. Time will tell if “AIFMD compliance” becomes a brand in the same way that UCITs has.

**Hedge funds**

Do you anticipate that extraterritorial regulations, such as AIFMD, will prevent you from marketing, investing or otherwise operating in those territories?
From my perspective, it is like the authorities are trying to fight the “last war” rather than focusing on what the “next war” will be. Hedge fund regulation requirements have had a real effect on the increased movement for “costs” on hedge funds, which you expect will be passed onto investors. Are investors winning out of that action?

— Manager, Asia under US$10b

In general, regulations are good for investors. They promote good behavior and oversight. I don’t believe the regulations as they have been created and set up will be that impactful. The market will govern.

— Manager, North America, over US$10b
The predictions of managers and investors for the future, while not completely synchronized, are showing signs of convergence as the hedge fund industry matures. Moreover, their visions of the future reveal that managers and investors both foresee a future industry where some can overcome the myriad of new challenges and others will falter.

This section looks at:

- The biggest industry trends over the next one to two years
Managers continue to see increasing costs from regulatory compliance and consolidation in the industry

Investors and managers are more aligned than in the past in their expectations for the future. Both see increasing regulatory intrusion and accompanying costs.

While managers expect consolidation, we expect fragmentation will continue as there appears to be little evidence of the industry consolidating so far. There are more hedge fund managers now than there were pre-crisis. Managers will continue to come and go – the largest will likely get larger, some mid-tier managers will grow and others will fail. But there will continue to be a proliferation of new start-ups with lofty aspirations to grow.

Hedge funds
What will be the two biggest trends or developments in the hedge fund industry over the next one to two years?

- Increased regulatory/compliance oversight and costs: 39% (2012), 28% (2013)
- Consolidation of funds/managers: 43% (2012), 24% (2013)
- Downward pressure on fees: 13% (2012), 5% (2013)
- Greater transparency: 8% (2012), 1% (2013)

Investors
What will be the two biggest trends or developments in the hedge fund industry over the next one to two years?

- Increased regulatory/compliance oversight and costs: 14% (2012), 23% (2013)
- Consolidation of funds/managers: 28% (2012), 15% (2013)
- Downward pressure on fees: 28% (2012), 15% (2013)
- Greater transparency: 16% (2012), 6% (2013)
We will see continued institutionalization from an operational perspective. How the business is being run – bigger firms will get bigger, smaller firms will struggle. This is a product of rising costs that the bigger firms have the scale to absorb while smaller firms will have a tough time competing.

– Manager, North America, over US$10b

I think consolidation is the biggest trend. The hedge fund industry will become a smaller universe of bigger players. It’s an inefficient and expensive way to invest now, and it is getting worse with the expense of compliance.

– Manager, North America, under US$10b
Methodology
The purpose of this study is to record the views and opinions of hedge funds and investors globally. Topics covered in the study include strategic priorities, changes in revenues and costs, technology, headcount, outsourcing and shadowing, regulation and compliance, and the future of the hedge fund industry.

Greenwich Associates conducted:

- 100 telephone interviews from July to August 2013 with hedge funds representing nearly US$850b in assets under management
- 65 telephone interviews with institutional investors (funds of funds, pension funds, endowments and foundations) representing more than US$715b in assets, with over US$190b allocated to hedge funds
Europe

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<td>Pensions/endowments</td>
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Asia

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Type of investor

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