

## Press release

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### Investors want greater board responsibility and accountability in key areas, 5<sup>th</sup> annual EY global hedge fund survey finds

**Perceptions among investors and managers differ on some key aspects related to governance, fund expenses, administration, succession and capital raising.**

**Luxembourg, 22 November 2011** – Global hedge fund managers and investors agree on key industry issues, but disagreement still exists in some important areas, according to Ernst & Young's fifth annual survey of the global hedge fund market.

The report, which juxtaposes the views of managers and investors, indicates that the two groups differ on some important matters such as governance, fund expenses, administration, succession and capital raising.

- **Governance.** Only 45 percent of investors said that their funds' Boards of Directors are very effective at carrying out their duties to funds, while almost 70 percent of managers feel the board is very effective.
- **Fund expenses.** Seventy-six percent of investors want shadow accounting, but only 35 percent are willing to pay for it.
- **Administration.** Three-quarters of investors said it is important that a hedge fund completely outsources valuation to an administrator, but 71 percent of managers perceive risks in this.
- **Succession.** Two-thirds of investors feel that having a well-articulated succession plan is important to their investment decisions, while only 38 percent of managers agree.
- **Capital raising.** There appears to be a lack of clarity between investors and managers about the loss of mandates. Almost 40% of managers say they do not really know why they lost a mandate. Investors point to concerns about risk management policies, inconsistency of information presented and lack of independent Board or administration.

The findings in the report, *Coming of Age*, were compiled by consulting firm Greenwich Associates for Ernst & Young. This year's study polled 92 hedge fund managers who manage some US\$600 billion, and 42 institutional investors with over US\$130 billion allocated to hedge funds.

“Despite the recent market volatility, the hedge fund industry has recovered significantly since the dark days of 2008. However further to several on-going regulatory initiatives and the recent Weaving case in the Cayman Islands, investors are getting increasingly focused on board governance and oversight. In this respect there are significant gaps between the views of hedge fund managers and investors where there is a very strong view among investors that boards are more aligned to the interests of the managers than to those of the investors.” says Michael Ferguson, EMEIA Regulated Funds Leader and Asset Management Leader at Ernst & Young, Luxembourg. “

Despite several opinion gaps, investors and hedge fund managers agree on several issues, including their top concern: the impact of regulation, which is cited as the chief worry of 48 percent of hedge fund managers and 36 percent of investors.

Some key findings from the report are as follows:

### **Governance**

Although managers and investors agree that independence is important for good governance, investors remain wary of boards' effectiveness. Sixty-eight percent of managers say the board of directors is effective in carrying out its duties, but only 45 percent of investors agree. Three-quarters of managers say the board is accountable to investors, but only 38 percent of investors say the same.

Investors want greater board accountability; they desire board responsibility for investment guideline compliance (36%), reviewing and approving NAVs (29%), resolving disputes over valuations (19%) and setting risk policies and thresholds (38%). However, most managers (69%) say that they, rather than the board, currently have responsibility and accountability for compliance with investment guidelines, and 72 percent say they establish overall risk policy and thresholds.

“Investors are of the strong view, that Boards are primarily interested in serving the interests of the managers and very rarely challenging them on the real issues that really matter to investors such as valuations, risk, remuneration policies and style drift. I guess this can be traced back to who really appoints the Board, in legal terms, the investors do, but in reality with significant influence from the managers, ie it is generally the managers or their representatives that interviews the potential board members not those of the investors. It also of course depends on the quality and experience of the Board, do they have the competencies to challenge the managers on the real issues. There needs to be a better balance struck here, where directors proactively engage and challenge the managers on the real issues” says Ferguson.

### **Fund expenses**

Higher costs for compliance, regulatory reporting and other infrastructure items coupled with the increased trend of outsourcing and extensive shadowing have resulted in margin compression across the industry. Hedge funds are increasingly evaluating how expenses should be shared between the investment manager and the fund. However, managers and investors differ on what costs should be passed through. While the majority of investors agree that it is important to perform shadow accounting, almost two-thirds of investors object to passing on the cost of shadow accounting; yet, more than one-quarter of managers said that they currently pass on these costs.

Fee and margin pressures are also causing more managers to offer graduated fees in return for larger mandates. More than twice as many hedge funds as last year say they have offered graduated fees for larger mandates.

“The survey results a definite call to action for hedge fund managers to align fund expenses to what investors expect and are willing to pay,” says Ferguson.

### **Administrators**

Nearly all managers use administrators in some capacity, and nearly two-thirds of both groups agree that administrators have a positive impact on investor confidence. However, a majority of investors (74%) said it is important that managers completely outsource valuation to an administrator, but most managers (71%) perceive risks in fully outsourcing this function. Despite this, just one in four managers or investors is confident that administrators can accurately value Level 3 assets.

Shadowing is prevalent, and is often deemed to be a necessity - 76 percent of investors cite it as important. However, in many cases shadowing results in a replication of the work that administrators are performing, which then requires reconciliation between the fund's and the administrator's systems.

"The findings highlight a significant duplication of efforts and a business model that is both expensive and very unique to the hedge fund industry. Over the long term, hedge funds are likely to reflect on this model and to move to a model that builds on the administrator's strengths while at the same time building in additional controls to address any shortcomings at the administrator on such critical areas as valuation," notes Ferguson.

### **Succession planning**

Managers underestimate the importance to investors of a clear succession strategy. Nearly two-thirds of investors said having a well-articulated succession plan is important to their comfort level. However, only 38 percent of managers said they thought a well-articulated plan is important to retaining investors. Only 39 percent of managers said they have a well-developed succession strategy, while 50 percent of investors said they are confident with their hedge funds' succession strategies.

Hedge funds and investors also view loyalty differently. Over half of managers believe investor loyalty lies with the founding principals. However, 55 percent of investors say their primary loyalty is to individual portfolio managers.

Investors also are more likely than hedge fund managers to want founding principals to increase their equity stakes. Eighty-three percent of investors say they want founding principals to have "skin in the game" and leave significant assets with the fund upon transition. However, only 60 percent of managers say the same, instead focusing on positioning certain professionals as the face of the firm, which is important to only 17% of investors.

### **Capital raising/due diligence**

Due diligence processes have changed. While long-term investment performance remains a priority, investors say they are more concerned with operational due diligence and internal controls. Nearly two-thirds of investors say that the most important criterion when selecting a manager is the portfolio management team. Yet only half of managers feel the same. Managers instead identify long-term performance as one of the most important criteria (72%), but only 43 percent of investors agree.

“It is interesting to note the very different views of the managers and investors on what is the key priority, long term performance verses operational due diligence and internal controls. As a result, of this there is a significant opportunity to improve communications between managers and investors so managers can better provide investors with what they need to make good decisions.”

For the full report, please visit <http://www.ey.com/LU/en/Industries/Financial-Services/Asset-Management>.

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### **About the survey**

Greenwich Associates interviewed 92 hedge funds representing nearly US\$600 billion in assets under management, and the views of 42 institutional investors representing US\$1 trillion in assets under management. The objective of the study was to record the views and opinions of hedge funds and hedge fund investors globally, measure the views of each on the same topics and examine the two groups together. Hedge funds and hedge fund investors were asked to comment on succession planning, governance, administration, fees and expenses, capital raising, due diligence and the future landscape.

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