The industry embraces disruption and innovation in investor relationships, strategies and operations

Disruptive technology. Customized products and changing fee structures. Strategic outsourcing.

All of these and more are putting both veteran and start-up alternative fund managers to the test as they continue to navigate the cross-currents, all the while seeking operational efficiencies and generating alpha.

“The industry has never been afraid to redefine itself. It is predicated on the notion that entrepreneurial spirit and the need to evolve will drive managers to find more customized, innovative solutions for their investors - thereby embracing rather than ignoring the disruption around them,” said Jeff Short, head of the Wealth & Asset Management Sector in the EY Financial Services region of Bahamas, Bermuda, British Virgin Islands and Cayman Islands.

Recently more than 250 alternative fund managers, directors, administrators, lawyers and regulators gathered to discuss these and related issues at EY’s 10th Annual Alternative Funds Symposium in the Cayman Islands. After hearing the results of the 2017 EY Global Hedge Fund and Investor Survey, and the Private Equity Survey, attendees observed spirited panel discussions on relevant topics. Below we highlight the top six trends revealed during the panels.

1. Digital disruption bears watching

Blockchain is quickly emerging with the potential to revolutionize the way many traditional processes are managed, some panelists pointed out. The shared-ledger technology can reduce the number of reconciliations, decrease human intervention and lower overall costs. “The automation you can apply in this context is pretty amazing,” said David Byrd, Blockchain Assurance Research Lead at Ernst & Young LLP. “When you have a shared ledger where data is more transparent and trusted, then the analytics you can perform over that data become better.”

Emerging digital asset classes such as crypto-currencies are causing both disruption and creating opportunities to generate alpha. Their popularity is growing, with funds investing directly in crypto-currencies and indirectly in infrastructure providers. A flash poll on crypto showed most audience members taking a cautious approach.

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<tr>
<th>Crypto-currency: what is your sentiment toward this new asset class?</th>
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<tbody>
<tr>
<td><strong>50%</strong> It’s only a matter of time before the bubble bursts</td>
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<tr>
<td><strong>32%</strong> I’d like to see a regulator define what it is first</td>
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<tr>
<td><strong>14%</strong> Seems interesting, I’ve already started mining for it</td>
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<tr>
<td><strong>4%</strong> An investment I can rely on to put my kids through college!</td>
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Panelists also discussed the many issues raised by trading crypto-currencies and other digital assets, expressing an eagerness to have a voice in the future of this asset class. AML and KYC regulations may need to be updated to address these advancements. A globally accepted digital identification protocol might emerge to fill this need, one panelist suggested.
**Demand increases for tailored strategies**

Many institutional investors are considering some type of customized product or “fund of one,” according to Richard Gannalo, US CFO and US COO, Cross Ocean Partners; the industry is responding with increased flexibility. An event flash poll showed just how important it is for managers to be willing to create bespoke strategies or fee structures.

As critical as this factor may be to their success, panelists warned managers to be judicious balancing the benefits of offering tailored strategies with the potential for onerous costs. Each custom product can require its own portfolio, internal management, and valuation and reporting processes, which can quickly inflate overall costs. “You have to be really thoughtful as you grow,” Gannalo added. “You gain momentum for these types of products, but as your margins are shrinking and the demand increases for building out your operational side ... The cost just may not be worthwhile.”

**Technology driving operational efficiency**

Technology continues to grow in importance for fund managers, as emerging solutions—such as robotic process automation, artificial intelligence, analytics and blockchain—are driving improvements in operational efficiency. A flash poll at the event underscored this trend, with nearly 90% of attendees citing either significant investments underway or interest in such solutions.

Again, panelists cautioned that investments in technology demand careful consideration. Managers must be fully cognizant of their information needs and flow both internally and externally before making a purchasing decision. Managers seeking automation to reduce headcount and decrease costs also have to keep in mind that some systems may require expensive talent to implement and maintain, which could cancel out savings in other functions.

That said, managers must consider how a fund will evolve over time when evaluating new solutions to reduce the odds they will outpace their technology investments. “Understand the technology you are putting in place today will grow with you and scale up if you are fortunate enough to scale,” Gannalo advised.

**Flexible fee structures gain traction**

It appears the days of the ubiquitous 2/20 fee structure are permanently behind us. A flash poll conducted at the event showed a multiplicity of fee structures present in today’s industry. With investors heavily focused on performance, innovative models are emerging that emphasize alpha generation. Attendees indicated the most prevalent structure today calls for a performance fee only if a specific benchmark is reached.

There has also been a rise in tiered models that scale fees down as an investor’s AUM increases. Ernst & Young LLP (EY) Partner Seda Livian said that investors are still willing to pay funds’ fixed costs, but added that funds are “really going to have to earn [their] overall fee.”

Livian also pointed out that this trend can be especially challenging for start-up funds that need cash flow to pay for infrastructure. These managers are negotiating flexible fee structures that provide them cash up front in exchange for fees that decrease over time.
The human element remains critical

Despite a clear surge in new technology, including robotics and intelligent automation, a number of panelists stressed the importance of the human touch to the continued growth of the industry. The need for talented and experienced professionals abounds, whether it be getting to know portfolio company CEOs personally and spending time with their management teams or overseeing relationships with third-party service providers.

Barbara Ann Bernard, Founder and CIO, Wincrest Capital Ltd., pointed to event-driven scenarios as one area that still requires shrewd human insight. An unexpected crisis such as Brexit that impacts leaders and organizations in so many different ways is one example of “macro-volatility that creates micro-opportunities,” she said. “The reality is technology does a lousy job of understanding human psychology.”

Outsourcing even more strategic

Given the continuing pressure on fees and heightened regulatory and investor demands, managers are leveraging outsourcing more strategically. Fund structures depend more heavily on their administrators, while on the operational side managers look to service providers to perform additional business functions, from tax to regulatory compliance.

With outsourcing increasingly critical, fund managers also are giving up more control, panelists pointed out. This requires them to have in place the proper talent to oversee third parties performing vital functions.

Managers are also looking to their administrators and service providers to embrace cutting-edge technology – e.g., robotics, intelligent automation and analytics – that makes them more efficient, panelists suggested. “Everybody wants more quality at a lower price ... and technology forces that to happen,” said Rishi Ganti, partner at Orthogon Partners. “We absolutely pick our service providers based on that. Peek under the hood, and they’re deploying technology.”

Final thoughts

Based on these discussions at EY’s 10th Annual Global Alternative Funds Symposium, one thing seems clear: adaptability is the watchword for today’s savvy alternative fund managers. There are so many changes coming so quickly in digital technology, investor demand for custom products and new fee arrangements, and the capabilities of administrators and service providers. In response, managers must remain nimble when it comes to marshaling their people, processes and systems. Fortunately, there is every reason to believe that the industry recognizes the challenges it faces in this dynamic environment. By continuing to discuss this new normal and bring innovations to the table to meet emerging needs, alternative managers can stay steps ahead of the onrushing disruptions.
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