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2014 Alternative Investment Outlook
Championing growth
Finding agility in uneven conditions

Deloitte Center *for* Financial Services

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Foreword

Dear colleagues:
"It was the best of times; it was the worst of times…" So begins Charles Dickens' *A Tale of Two Cities*. In many ways, this describes the environment that the financial services industry is facing as we start 2014. The economy is showing some signs of life, balance sheets are stabilizing, and investors' confidence is trending toward the positive. That said, this year likely will be one of continued challenges for industry executives to realign business models, adjust to increasing regulation, and attempt to innovate for growth.

The investment management industry certainly is seeking to balance opportunity and challenge. Many parts of the business have seen growth in assets under management and profitability. We also note a renewed investor tolerance for risk-based returns, and firms are responding in a number of ways, including the launch of new products and by exploring global expansion. At the same time, these new forays are confronting industry participants with a more complex array of risks, and they will need to account for these as they react to regulators who are enforcing rules with renewed vigor. Nevertheless, many investment managers are poised to take advantage of increased opportunities for growth in 2014.

We are pleased to share with you this outlook for 2014, based on original research combined with the insights and first-hand experience of many of Deloitte's leading investment management practitioners. We hope you find this report insightful and informative as you consider your strategic decisions this year.

Regards,

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Overview

One of the key attributes that has drawn investors to alternative investment managers over the years is their agility. Much like a downhill skier who needs to absorb the terrain to excel, these managers excel by navigating uneven conditions. Over the past few years though, the landscape has leveled out, with the booming stock market temporarily eroding alternative investment funds' historic competitive advantage.

A turning point is already unfolding in 2014. Institutional investors are piling into alternatives despite their recent uneven performance. These investors are attracted to the industry's long-term track record for producing non-correlated, superior risk-adjusted returns. At the same time, they are looking at alternatives through a new lens. Rather than viewing them as a separate asset class, institutional investors are increasingly deconstructing alternatives into risk and attribution themes.

How alternative investment leaders meet these demands, along with those of an ever-shifting regulatory landscape, will be a key theme to watch in 2014 as funds look to stay agile and attract more assets. Given the perennial importance of reputation in this industry, they will also need to ensure their risk management approaches mature to reflect today's increasing complexity.

Attracting new assets with scale and differentiating strategies

In spite of a challenging investment environment and increased competition, alternative investment managers continued to raise record sums over the past year. Hedge fund assets under management (AUM) swelled to a record $2.6 trillion in 2013.[1] Not to be outdone, private equity firms staged their own rally, with fundraising reaching the highest levels since 2008 (see Figure 1).[2]

And yet, reviewing these numbers reveals great disparity. The biggest private equity funds continued to garner the most attention, with the remaining funds seeing their average new fund sizes reduced by as much as half that of previous efforts.

It was also a year of uneven performance for hedge funds, against both broader market measures and long-term trends. For the one-year period ending on December 31, 2013, the average hedge fund returned just 11 percent, falling short of the S&P 500 Index's 30 percent climb over the same period and even the 17 percent increase of an average balanced portfolio (60 percent stocks and 40 percent bonds) (see Figure 2).

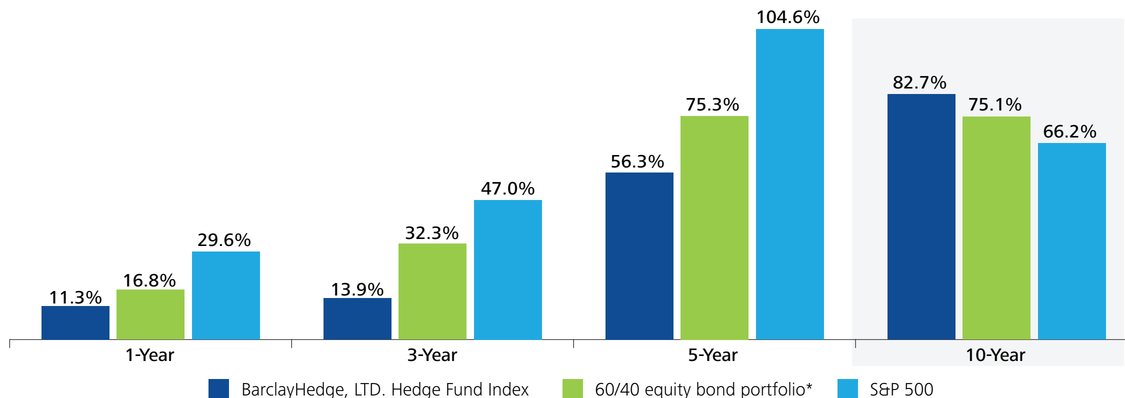
Figure 1. Global private equity fundraising

Source: PitchBook

Private equity had a better story to tell after realizing an almost 13 percent increase in capital invested last year, according to Pitchbook.[3] Even so, deal activity fell 14 percent[4] from 2012 and the question now is whether the industry will be able to put a record amount of dry powder to work.

Figure 2. Hedge funds superior long-term performance

Hedge fund returns outperform broad market on long-term basis



Source: BarclayHedge, Ltd., Bloomberg, Deloitte analysis

*60 percent MSCI U.S. Broad Market Index and 40 percent Barclays U.S. Aggregate Float Adjusted Index data as of December 31, 2013

[1] Hedge Fund Research "Hedge Fund Assets Surge to Record to Begin 2014," press release, January 21, 2014.
[2] PitchBook, "2014 Annual U.S. Private Equity Breakdown Report," accessed January 20, 2014.
[3] PitchBook "2014 Annual U.S. Private Equity Breakdown Report," accessed January 20, 2014, pitchbook.com/2014_Annual_US_PE_Breakdown_Report.html.
[4] Pitchbook "2014 Private Equity Breakdown Report."

Institutional investors such as pensions, foundations, and endowments have stepped up their participation in hedge and private equity funds, driven by diversification mandates and drawn to the alternative investment industry's long-term track record for delivering uncorrelated, risk-adjusted returns. Many investors remain satisfied with performance, even over the past year.

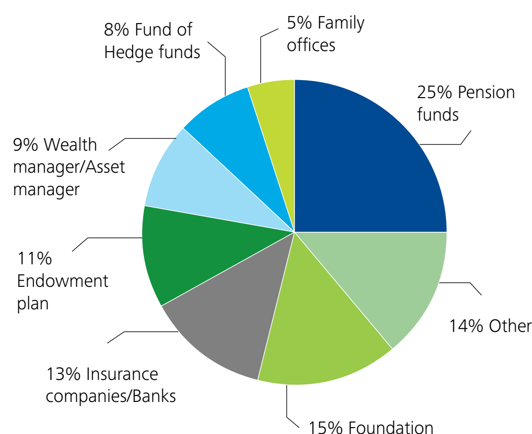
For instance, 63 percent of institutional investors interviewed by Preqin stated hedge fund returns had met their expectations last year; another 21 percent said returns exceeded their expectations.[5]

Institutional investors now represent more than half of the total capital being managed by hedge funds (see Figure 3),[6] and they appear poised to allocate an even higher percentage of their portfolio to alternatives going forward.[7] Sovereign wealth funds, led by Abu Dhabi and China, now occupy three of the top five slots among hedge fund investors, and four of the top ten.[8] An exciting new investor base is opening up with hedge funds poised to tap the domestic Chinese market for the first time. Recently announced in Shanghai, the Qualified Limited Domestic Partner Program will soon allow several foreign hedge funds to raise money from institutions within China for investing overseas. While increasing allocations by institutional investors is a more recent phenomenon for hedge funds, institutional investors have dominated private equity investing for some time; pension funds, foundations, and endowments still lead the way.

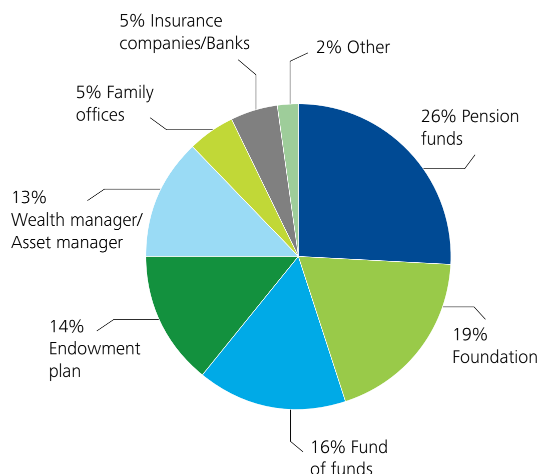
As institutional investors account for a growing share of the pie, the big alternative funds will likely continue to get bigger. Given that these investors' fiduciary responsibility makes them particularly sensitive to headline risk, they are naturally drawn to larger, well-established funds with impressive operational and compliance infrastructures.

Figure 3.

Breakdown of private equity investors



Breakdown of hedge fund investors



Source: Prequin

[5] Preqin, "Preqin Survey: Investor Satisfaction with Hedge Fund Performance Is at Highest Recorded Levels," press release, December 19, 2013.
[6] Preqin, "Hedge Fund Spotlight," June 2013.
[7] Credit Suisse Capital Services, "Mid-Year Survey of Hedge Fund Investor Sentiment," July 2013.
[8] Hedge Fund Alert, "Top 20 Investors Contribute Mightily to Funds," November 20, 2013.

The silver lining here is that while institutional investors allocate a majority of their assets to the largest funds, they still look to diversify a portion of their holdings in search of the occasional home run that emerging fund managers can provide. For the smaller and emerging players, the recent period of industry underperformance is turning up the heat to generate better returns and presenting windows of opportunity in a challenging fund-raising environment. According to Preqin, 81 percent of the largest institutional investors have invested in emerging managers, compared with 43 percent of all other institutional investors.[9]

Meanwhile, smaller private equity firms continue to create a distinct value proposition for themselves by developing expertise in sector- or theme-focused investing strategies. Specific niches within healthcare, energy, technology, and real estate attracted such funds' interest last year, and we suspect these areas and other emerging opportunities will help narrow managers' sights even more this year.

Finally, 2014 will likely see additional efforts by alternative fund managers to re-engage the retail investor base by taking their alternative investment strategies mainstream in a variety of more liquid products offered through '40 Act funds and UCIT products. AUM in liquid alternative products climbed to $279 billion as of September 30, 2013, up from $68 billion in 2008.[10]

"The challenges for alternative investment managers have never been greater, but the appetite for investors has never been greater either, so fund managers are feeding off that investor buzz," said Cary Stier, head of Deloitte's Global Investment Management practice."[11]

Still, it's unclear how far the industry will go in pursuit of retail clients. Many fund managers remain wary of new alternative mutual fund products fearing they will disadvantage existing investors and put their brand at risk. The costs to set up a retail platform and operations can be prohibitive, particularly when it comes to ensuring compliance with '40 Act regulations and meeting liquidity requirements. With that said, a recent Deloitte Dbriefs webcast polled industry participants and 45 percent indicated that they were interested in launching a mutual fund/registered product in the near future.[12]

The bottom line

The ongoing shift in expectations and stipulations will likely buy established alternative investment managers more time to find their footing from a return perspective as institutional investors favor downside protection over higher near-term performance. This migration will continue to favor the biggest funds whose reputation and robust infrastructures offer a high degree of comfort for pensions, endowments, and sovereign wealth funds. Those outside the industry's top tier will need to develop specialized investment strategies that allow them to use their flexibility to capitalize on inefficiencies in niche markets and help institutional investors round out their portfolio exposure.

[9] Preqin, "Hedge Fund Spotlight," May 2013.
[10] Shelly K. Schwartz, "Seeking Safe Havens? Analysts, Advisors Point to Liquid Alternative Funds," CNBC.com, November 24, 2013.
[11] Stephen Foley, "Hedge Funds Drop Fees to Win Big Investors," The Financial Times, December 12, 2013, http://www.ft.com/home/us.
[12] Deloitte Dbriefs webcast "Blurring the Lines: When Retail and Alternative Investment Worlds Collide," August 15, 2013.

Creating a competitive advantage through better data

As regulators and investors continue to press for earlier and more substantial reporting, the ability to leverage data quickly and in an accurate manner is becoming a competitive differentiator in the industry. Institutional investors, in particular, are no longer looking at alternative investments as a separate asset class, but instead are deconstructing them into risk and attribution themes — strategy, geography, and liquidity for example — as the basis for making allocations to hedge funds and private equity funds.

This increasing demand for risk and performance attribution information is challenging investor relations teams to create tailored reports that pull data from various systems not originally designed for that purpose. In fact, investor demand for greater transparency in risk and performance was ranked among the top three drivers of change in the industry by more than half of the respondents in a State Street survey of alternative fund managers.[12] Some large investors are already making their capital commitments conditional on a fund's ability to generate this type of customized reporting as part of their due diligence on a quarterly and sometimes monthly basis going forward.

"Data is the hottest topic by far," said Ellen Schubert, a senior advisor in Deloitte's Hedge Fund practice. "Every meeting I go into right now is about data — the amount of data that hedge funds have to retain, manage, manipulate, and massage for their portfolio managers, their investors, their regulators, and the entire company."[13]

These emerging investor requirements come at a time when alternative funds are already being pressured to respond to a litany of information requests from regulators. The key regulations affecting alternative investment managers — the Alternative Investment Fund Managers Directive, the Foreign Account Tax Compliance Act, Form PF, and Form PQR — all require data-centric solutions. Looking ahead, over-the-counter derivatives reform and new limits imposed by Dodd-Frank on bank proprietary trading and sponsorship of hedge funds and private equity funds will likely have significant implications for data collection and reporting.

In meeting these diverse demands, fund leaders are discovering that extracting and integrating existing data into the required format is time-consuming and fraught with regulatory and operational risk. One key sticking point is that not all of the information required to meet these compliance demands comes from internal sources. Much of it will need to be provided by fund administrators, prime brokers, or other third-party vendors and that data will need to be retrieved and normalized. Adding more staff and manual processes to conduct such tasks is not a cost-effective, long-term solution.

Instead, leading fund managers have proactively spent the past few years investing in a comprehensive data strategy that wraps in data warehousing and advanced data modeling, with some making room for a chief data officer in the C-Suite to set and run the technology agenda. The potential rewards from harmonizing this information into a single data platform are significant, not just in using it to grant greater transparency, but also to be a solution provider by creating customized client solutions. Leading alternative investment managers are already reverse-engineering investment offerings based on their clients' unique obligations to their own investors, and more managers will likely follow suit in 2014, making customization a major theme.

[12] State Street Corporation "The Next Alternative: Thriving in a New Fund Environment," July 2013.
[13] Hedge Fund Alert, "Survey: No End in Sight for Industry Growth," January 8, 2014.

In the year ahead, effective data management will be just as important for identifying new return opportunities as it will be for keeping investors and regulators happy. Leading private equity firms are already employing technology solutions to help track their portfolio companies on a real-time basis in a single place. Greater visibility into portfolio companies' operations is helping managers identify ways to help run the companies more efficiently, maximize the amount of cash they generate, and increase their exit value.

Meanwhile, hedge fund managers are increasingly relying on real-time data to make trading decisions. In fact, the fastest growing hedge fund strategy over the past five years has been "quantitative" trading, including market-neutral, statistical arbitrage, and high-frequency strategies. But there are also opportunities for more traditional managers to crunch data to improve their performance.

The bottom line

More alternative investment managers are recognizing the importance of having flexible and automated data systems to support front office decision-making, create custom reports, and answer information requests from regulators and investors alike. The technology investments alternative investment managers are making not only help them to be more responsive to portfolio managers, traders, investors, and regulators, but also put them in a better position to take control of their data from a performance perspective. Those firms that have fallen behind on the data side will need to pay closer attention to their technology strategy lest they cede an opportunity to create a competitive edge.

Managing external relationships and reputational risks

As investors and regulators increase their focus on risk management, alternative investment managers are working harder to gain a more holistic view of risk. With so much at stake from a reputational standpoint, they cannot afford to let key risks go undetected. As a group, the global financial services industry clearly understands this —a full 94 percent of industry respondents in a global risk management survey Deloitte conducted last summer[14] said their executive management teams are spending more time on the oversight of risk compared to five years ago.

Given the fee pressure that continues to reign over the industry, we expect to see hedge fund and private equity leaders being more strategic about identifying and weighing risks when deciding where to allocate resources. Risk-based resourcing models, which measure an organization's exposure to a wide range of risks and identify the optimal resources for managing those risks, are being used by more firms as they investigate new product offerings and geographies. These increasingly sophisticated approaches for balancing growth with risk and control will be particularly useful as alternative investment leaders explore new distribution avenues, such as more liquid products targeting retail investors.

Another area where alternative investment leaders will need to be vigilant is the added risk associated with extending the organization to a wider range of external service providers, from fund administrators to third-party solutions accessed through the "cloud." Even when sufficient resources are available, some fund leaders will still prefer to turn to capable service providers so they can focus on their core competency of generating investment returns.

To date, hedge funds have been more likely adopters of outsourcing, mainly due to the fact that the use of independent administrators was all but mandated in the wake of the financial crisis. However, private equity managers are increasingly adopters of outsourcing as the cost and complexity of their internal infrastructure is forcing chief financial officers to look to third-party capabilities as an option. As it is no longer acceptable for general partners to calculate their fund net asset value in-house, private equity firms are continuing to explore the optimal level of control over their books and records through different shadow accounting techniques.

Outsourcing regulatory compliance is still a touchy subject for many funds given the loss of control and increased risk that it brings without the ability to discharge the ultimate responsibility. However, outsourcing certain components of regulatory compliance, such as regulatory reporting, annual compliance reviews, and personal trading, can help funds achieve capabilities within the industry that prevent them from becoming an outlier, an important consideration when regulatory requirements are in a constant state of flux.

By nature, these extended relationships are exposing fund managers to new or increased risks. These threats include potential business disruption, regulatory breaches, counterparty credit risk, service failure, and the theft or inadvertent dissemination of personal identification information or intellectual property. Given the reputational harm and financial impact that can be inflicted when these risks turn into full-blown crises, it will be critical for fund managers to continue to fine-tune their risk management approaches and stay on top of emerging threats.

[14] Deloitte, "Global Risk Management Survey, Eighth Edition," July, 2013.

A critical component of these risk reviews pertains to cyber preparedness. Alternative investment funds have in recent years increased their focus on protecting against internal threats and building safeguards around IT infrastructure, and these efforts are paying off. With that said, there is still room for improvement, as alternative investment managers should understand that the hacker community is smart, big, and nimble and usually a step ahead of risk prevention efforts.

At the same time, the extension of the enterprise to outside partners requires that fund managers expand the scope of these efforts and recognize that cybersecurity is not just an IT issue, but an enterprise risk issue that extends to its vendor relationships. As hedge funds and private equity funds expand their network of third-party providers, cyber risk should be a key component of supplier risk reviews. This goes not just for the obvious candidates such as plan administrators and prime brokers, but for technology, research, sales, and marketing partners as well. Industry leaders should be sure to review that each vendor has adequate security controls in place and maintains an internal incident response team whose mitigation plans account for third-party cyber breaches.

"Cyber education can start with simple questions, such as who would want your information, and why do they want it, said Mary Galligan, a director with Deloitte & Touche LLP's Security & Privacy practice and former FBI special agent in charge of cyber and special operations. "It's important for alternative investment managers to start with a clear understanding of their vulnerabilities to make risk management and mitigation more informed."[15]

The bottom line

A historically private industry is looking outside its walls for help. Given the scale advantages that continue to bring new assets to the biggest funds, smaller competitors are having a difficult time convincing investors that they have the means to meet their demands, no less those of regulators. This pressure is prompting more fund managers to lean on outsourcing solutions for a wider array of support functions. While external service providers are clearly becoming more sophisticated, these expanding relationships are not without risk. Effectively managing these risks will be just as important for keeping regulators at bay as it will to protecting both a fund's reputation and its ability to win more assets down the road.

[15] Mary Galligan, "Deloitte's Alternative Investment Symposium" (panel discussion, The New York Public Library, New York, NY, November 21, 2013).

Conclusion

The past few years have certainly been trying for most alternative investment managers; but in some critical ways, they are now in a better place as a result. The increasing regulatory burden may have been a distraction, but the infrastructure investments made by firms to manage regulations have strengthened their organizations to become more efficient and better able to respond to investor demands. Private equity funds finally appear poised to put more of their dry powder to work, even if they have to set their sights on smaller deals. Hedge funds are embracing change in different ways by testing new strategies, geographies, and distribution channels. The overarching story is no longer one of capitulation — but of growth. And that's a story we believe leading and emerging fund managers will enjoy telling this time next year.

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