

ALLOCATOR INSIGHTS AND MARKET INTELLIGENCE

CAPITAL RAISING, FEES, INCENTIVES, STRATEGIES -
WHAT'S NEXT FOR ALTERNATIVE FUNDS

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COHNREZNICK ROUNDTABLE



With financial markets evolving following the unprecedented events of the past 20-plus months, a CohnReznick-hosted discussion examined how the hedge fund industry is adapting to the evolving landscape and the changing nature of investor relationships.

Virtual communications allowed managers to maintain dialogue with allocators throughout lockdown – but the pandemic has left the manager-investor relationship in a state of flux. The discussion saw speakers explore a range of developments across the major themes and topics, including fees, incentives, due diligence, and strategy selection. They also weighed out how industry initiatives, such as the evolving Open Protocol and the growing use of technology, are boosting transparency and disclosure in the sector.

As the COVID-19 pandemic tore through global markets and economies, hedge funds have, on the whole, successfully fulfilled their role in investor portfolios, with the majority of strategy classes notching up positive returns over the last 20-plus months and the industry generating an average return of 12% annually in 2020.



BOOSTING ALLOCATOR INTEREST

That commendable showing has boosted allocator interest in the sector, with hedge funds offering effective downside insulation during the COVID-fueled turmoil and providing the kind of volatility protection that investors look for, according to **Patrick Decker**, a Managing Director at outsourced chief investment officer (CIO) **Verger Capital Management**.

In particular, allocators and investors are increasingly seeking out sector-specific equity long/short strategies which focus predominantly on what **Gaurav Amin**, Partner and Head of Fintech & Implementation at the non-discretionary alternative investment consultant **Albourne Partners**, describes as “COVID-dependent” industries – such as technology and healthcare.

Both Amin and Decker also point to a sharp uptick in interest in

multi-strategy and event-driven strategies where managers can navigate across sector exposures in an active manner.

“We want to own a lot of things that zig when the market is zagging,” said Decker, whose firm manages around \$2.5 billion in assets on a discretionary basis for exclusively non-profit institutions.

“I don’t want to say it’s completely benchmark-agnostic, but what we’re really looking to do is go out and find the best solutions at any particular time for our clients,” he explained, adding that many institutions in the non-profit space often traditionally tie their future to equity market beta.

“We just don’t believe that’s the right situation to be in, particularly when you see equity valuations so high. When people look to fixed income to diversify, my concern is how great of a diversifier is that

when interest rates are basically zero or negative,” Decker said. “Is that really going to provide the protection you need?”

He added that, “with non-profits, there’s an interesting paradox in that they have short-term liabilities that they need to meet but they are the longest of long-term investors – most of these institutions are designed to exist in perpetuity.”

As a result, Verger’s investment approach has less to do with timing (“We are likely always going to have an active allocation to hedge,” he explained) and more to do with the fact that his firm is constantly looking for diversifiers that can complement the overall portfolio composition.

PANDEMIC CHALLENGES



The COVID-19 pandemic – and its attendant remote working and economic lockdowns – has also heralded far-reaching and fundamental changes to the way hedge fund managers and investors operate, ranging from how managers look to assemble their pipelines to the ways investors conduct due diligence on potential allocations.

For Amin, whose firm specializes in investment, operational and quantitative due diligence and risk management across the liquidity spectrum, advising clients investing some \$600 billion in alternatives globally, the elements of due diligence have remained the same – but the process has altered dramatically.

He suggests due diligence is now more accessible and time-efficient, with less need for investors to travel to and from meetings or schedule lengthy four-hour meetings with managers.

“If we didn’t have the level of video conferencing that we had under a COVID environment – if something like this happened say five or ten years ago – then I do feel that there would have been a bigger impact than right now,” Amin observed.

According to **Gary Berger**, Senior Partner at **CohnReznick** in New York and financial services leader for the Northeast region, hedge funds have been able to nimbly adapt their business and operational models to meet their clients’ demands, particularly in the tax and audit sphere.

“They did not skip a beat,” added Berger, who has more than 30 years’ experience in helping launch hedge funds and private equity funds.

However, delving deeper into the capital-raising hurdles, both Berger and Decker point to a sharp contrast in fortunes between emerging and established fund managers.

“In terms of emerging managers, if they were pretty much done with the process, and were on the one-yard line going into the end zone, then they maybe got the allocation,” said Berger. “But if the process had just started when the pandemic hit, and their allocation process and capital-raising hit a major snag, a lot of them had to resort to friends and family money.”

Building on this point, Berger continued: “It changed the whole

dynamic for a lot of emerging managers, and it’s become a much longer haul unfortunately. Hopefully, in the post-pandemic period, they are able to get these allocations that they were hoping to get.”

In contrast, for larger hedge fund firms, having stable and established relationships with allocators in place prior to COVID-19 made it easier for investors to either allocate additional capital or new capital to a manager.

Decker acknowledged the challenges of not being able to conduct in-person meetings and actively allocate to new managers over the last two years. But he revealed there have been a number of instances where his firm has allocated capital to managers they had not yet met in person.

“Do I expect that to be the norm going forward? Absolutely not – it was a necessity at the time. We do believe still that face-to-face meetings will happen, but I think this has really increased efficiency and accelerated the due diligence process as well,” Decker added.



ALIGNING INTERESTS

The question of fees has often proved to be a thorny topic at the heart of the hedge fund manager and investor dynamic. Lukewarm returns in the years following the Global Financial Crisis have led to considerable downward pressure on fees, and the classic “two and twenty” hedge fund fee model is now “pretty much long gone,” particularly for emerging and start-up fund managers, according to Berger.

However, innovations around fee flexibility and alignments of interest have evolved the conversation and shaped the direction of travel when it comes to investor-manager relationships.

Fees could be better structured and shaped in order to better reflect the difference between alpha and beta returns, according to Amin. “When the manager is giving you beta returns, they should not be charging you high levels of fees,” he noted. “You want to pay the hedge fund fees for alpha, and so you need to structure the terms in a way that allows you to make it fair beforehand.”

Decker said that, “when we think about incentive fees and performance fees, for us that just means better alignment with our clients. At the end of the day, our job is not to reduce our clients’ fees to the lowest point possible, our job is to provide them with the

highest performance, net of fees. And we’re happy to pay those – that means the manager has done exactly what they said they were going to do. That means they’re doing a great job for our clients.”

Decker also points to other mechanisms that can further align interests between hedge funds and investors.

“One of the things we’d like to see, particularly among emerging newer managers regardless of what their background may have been before starting a particular strategy or company, is being able to have preferred terms when it comes to things like capacity,” he said.



HEIGHTENED TRANSPARENCY

In recent years, the rise of ESG investing among managers and investors, and the development of new EU regulations impacting hedge fund firms that have a global presence, have increasingly nudged transparency, reporting, and risk disclosure matters toward the top of the industry's agenda.

Transparency is a hot topic within the hedge fund space, according to Berger.

"Every conference you go to, every session, talks about transparency at the manager level. But one thing that's important is that you have to be careful what information you give one investor versus another," he cautioned. "If you provide certain transparency to one investor, the question is whether you advantage that investor if you haven't made that information available to all investors."

One major initiative that looks to address reporting consistency has been the Open Protocol template, led by co-chairs Albourne and the SBAI, which aims to standardize and streamline the reporting of risk information among hedge funds and other investment managers. Following its introduction 10 years ago, more than 50% of assets in the hedge fund space are now reporting in the Open Protocol format, notes Amin.

"Open Protocol is very dear to me," he said. "It is a completely industry-led initiative, with no commercial agenda whatsoever – Albourne has spent resources and efforts to put it together, but effectively we are giving it to the industry; there's no proprietary data here."

Amin added that, "that has increased the level of transparency and the efficiency of data processing, so you no longer need to go and fill in individual templates for different clients or investors, you can just fill in this one template and give it to everybody."

The Open Protocol template has seen several updates made over the past decade, and two new key additions this year driven largely by current market demand and involving ESG and digital assets.

The addition of a digital assets tab – focused on cryptocurrencies and related blockchain infrastructure – comes as cryptos form an increasingly larger part of hedge funds' overall investments. It allows investors to get a better handle on what exposures they may have. The addition of an ESG reporting tab, meanwhile, looks to address a lot of the "noise" generated by different players in the market, Amin said. "Each one has their own agenda, their own template, their own way of doing things, and it is effectively increasing the cost of monitoring ESG risk."

For managers, Open Protocol is a "first step in that journey" to better ESG disclosure, Amin adds. "At no additional commercial cost to you, you can see what your exposures are to different industries, to different sectors. Then you can apply a framework on top of that and understand your ESG exposure risk across your portfolios and across your investments. You can then think about how you want to manage it going forward."

So what types of information are investors looking for now? And are managers able to easily provide it? For Berger, whose client base comprises many emerging and start-up funds, managers are increasingly being pressed for more portfolio detail, as opposed to information about their broader investment strategies.

"Separate and distinct from profitability, there are many more requests for portfolio data," Berger explained. "For an emerging manager these requests can be burdensome as new managers are usually thinly staffed with most infrastructure outsourced. Ultimately, these requests will be directed to the manager's fund administrator."

For Amin, this is where Open Protocol templates can play a beneficial role.

"It covers multiple angles: It covers your leverage risk, your liquidity risk, your market risk, your concentration risk, your tail risk. It covers multiple aspects of the risk that you want to convey information for," he added.

Similarly, Decker sees a push for more transparency among managers and allocators alike, against a broader landscape characterized by the accelerated digitization in areas such as due diligence and reporting.

"That's a very positive thing," Decker said. "We need to be focused on what really matters for us. What are the exposures we have? What are the factors in the portfolio? Those are the types of things that are more important than a line-by-line look at what the holdings are."

He concedes that there are always going to be certain managers that will be more opaque and push back on requests. However, he stressed that these typically are not emerging managers; rather it will be those larger, established managers which are less dependent on new capital.

"I think there's always going to be that push and pull between investors and the funds themselves," Decker said. "It really goes back to what you need to know, what is important to you, and what is important for your clients."

LOOKING TO THE FUTURE

As talk turns to what lies ahead for hedge funds following an eventful 20-plus months, the continued blurring of the lines between hedge funds and private equity is expected to be a key industry theme.

“We are seeing private equity managers behaving more like hedge funds, and hedge fund managers behaving more like private equity managers. That kind of transition, that narrowing of the divide between those two spaces is something that we are noticing a lot,” Amin observed.

He also points to the ongoing digitization of information, with technology and AI at the heart of the process, along with more efficient due diligence, underpinned by ongoing monitoring and dialogue. “Investors won’t just see a manager once a year,” he added.

Decker is meanwhile keen to highlight a shift in hedge fund managers’ approaches to pitching opportunities, and sees manager-

investor relationships evolving more toward partnerships and less like transactions.

“What we’re really seeing an increase of, and what we’re really encouraged by, are managers coming to us not trying to fill a hole in a portfolio, or solve a problem, but rather coming to us with what their best ideas are,” Decker said.

Expanding further, he said: “What we’ve seen a lot of through the pandemic is an increase in managers coming to us and saying, ‘Hey, you’ve invested in this with us in the past, you actively participated in this portfolio, we’re going to redeem that because we think that opportunity set has shrunk but here’s our next best idea; here’s this high conviction idea that we have.’ ”

“That’s what we love to see,” Decker added. “We don’t want them to look at us as a transaction, we want this to be a partnership.”

Berger sees “a new world” in which virtual communications are at

the heart of client relationships.

“If you look at some of the larger hedge funds and emerging managers, they’re spread out throughout the country and they’re basically going to either not go back to the office full-time or go back on a limited basis, maybe one or two days a week at most,” he explained.

“Everyone has learned that they could do business virtually. Everyone was very concerned about it when the pandemic hit; we didn’t know what was going to happen, we didn’t know if hedge funds would survive, or do what they’re supposed to do,” he said. “We all learned that not only did hedge funds survive, they did a lot better than we thought they were going to do. I think they will continue to flourish in this virtual environment.”

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Patrick Decker is focused on engaging the non-profit community and regularly interacts with institutions, their constituents, consultants, and industry experts. Through this outreach, Patrick seeks to communicate Verger's ability to support mission-based non-profits and expand the number of institutions the company serves.

Prior to joining Verger, Patrick spent 13 years at Hirtle, Callaghan & Co. Most recently, he served the firm as an Investment Officer and was primarily responsible for developing and managing client relationships. Prior to joining Hirtle, Callaghan & Co., Patrick held various client-facing positions at The Vanguard Group and ING Direct (now Capital One).





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