Hedge fund managers’ eyes are bigger than customers’ budgets: E&Y

By Kerry Pechter *Thu, Nov 14, 2013*

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Hedge fund managers who survived the financial crisis are focusing on growth beyond their original business models, but investors don’t intend to buy multiple products from one manager, according to Ernst & Young’s 7th annual global hedge fund market survey.

One hundred hedge fund managers who manage a combined US$850 billion and 65 institutional investors with AUM of $715 billion and over US$190 billion allocated to hedge funds participated in the EY survey, called “Exploring Pathways to Growth.”

Strategic priorities for hedge funds, changes in revenues and costs, technology, headcount, outsourcing and shadowing, and the future of the hedge fund industry were topics covered in the survey.

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Besides investing in new strategies and products, hedge fund managers are developing non-traditional distribution networks and channels. Managers with less than US$10 billion under management are budgeting for 15% growth in 2013. But 72% of investors expect to maintain current allocation levels.

Two in three hedge fund managers reported an increase in revenues over the past year as performance improved and assets grew, the survey showed. But only half of managers saw improvements in margins. One in three managers said margins declined and another 10% noted margins remained unchanged. Meanwhile, costs rose.

“European managers appear to have a tight control over their costs and anticipate the greatest increase in margins,” said Julian Young, EY’s Europe, Middle East, India and Africa Hedge Funds Leader. “This is probably because they are managing costs by outsourcing, refraining from shadowing and offering less complex strategies.”

Cost increases were reported by one-third of European managers, 58% of Americans and three out of four Asians. But Asian hedge fund managers have been the most successful in raising capital and thereby growing revenue. Margins have improved as a result.

A majority of hedge fund managers continue to fully “shadow,” and the cost of shadowing is high. Hedge funds fully shadow across a range of functions 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. It is not surprising that the survey highlights that the majority of hedge fund managers continue to fully shadow.

What is surprising is that a growing percent of managers have developed stronger relationships with fund administrators and are paring down full shadows, granting partial oversight to the fund administrator.

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.