



# Growing Up: A New Environment for Hedge Funds

2015 KPMG/AIMA/MFA  
Global Hedge Fund Survey

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# Foreword

The hedge fund industry is in the midst of a transformation. The growth environment is constantly changing and, as a result, managers have become more focused than ever on improving operational effectiveness, increasing alignment of interest and delivering value to their investors. New strategies, new investors, new markets and new (and often more customized) products and services are changing the market dynamics.

We see the evidence of change all around us. It is in the growing influence of institutional investors and the rapidly emerging markets. It is in the shift towards customization of products and fee structures. And it is in the macroeconomic trends that continue to buffet our industry.

To better understand how all of these changes are impacting managers around the world, KPMG partnered with the Alternative Investment Management Association (AIMA) and the Managed Funds Association (MFA) to undertake a comprehensive survey, both online and in person, of hedge fund managers.

We believe that – particularly in this time of rapid change – it is critical for our industry to share experiences, insights and leading practices. If we want our industry to grow (both in terms of total assets under management (AUM) and number of managers), we will need to break down barriers and adjust our strategies to continue to thrive.

This year's *Global Hedge Fund Survey* looks at the impact that this change is having on virtually every aspect of hedge fund management, from product mixes and fee structures through to markets and investor types, and provides keen insights gathered from our one-on-one interviews with some of the industry's largest and most successful fund managers.

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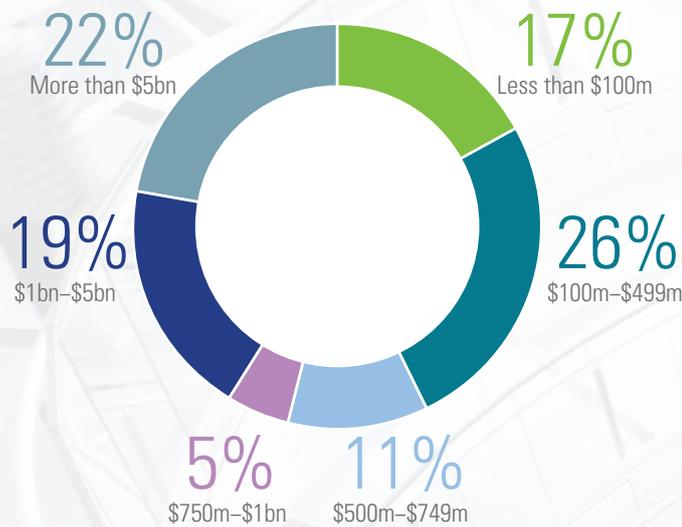
# About the research

With most managers now recognizing that the sector is on the cusp of a significant shift in investors, products and markets, KPMG partnered with AIMA and the MFA to ask hedge fund managers around the world how these changes will impact their strategies, products, models and selection of markets.

This report incorporates the views of more than 100 hedge fund managers representing approximately USD440 billion of assets under management (AUM). Online survey respondents included hedge funds of all sizes, with 43 percent of respondents managing less than USD500 million, 16 percent

managing between USD500 million and USD999 million, and 30 percent managing greater than USD1 billion in assets under management. Eighty-four percent of respondents identified themselves as single fund managers and 16 percent as 'fund of fund' managers.

## Breakdown of respondents by AUM size



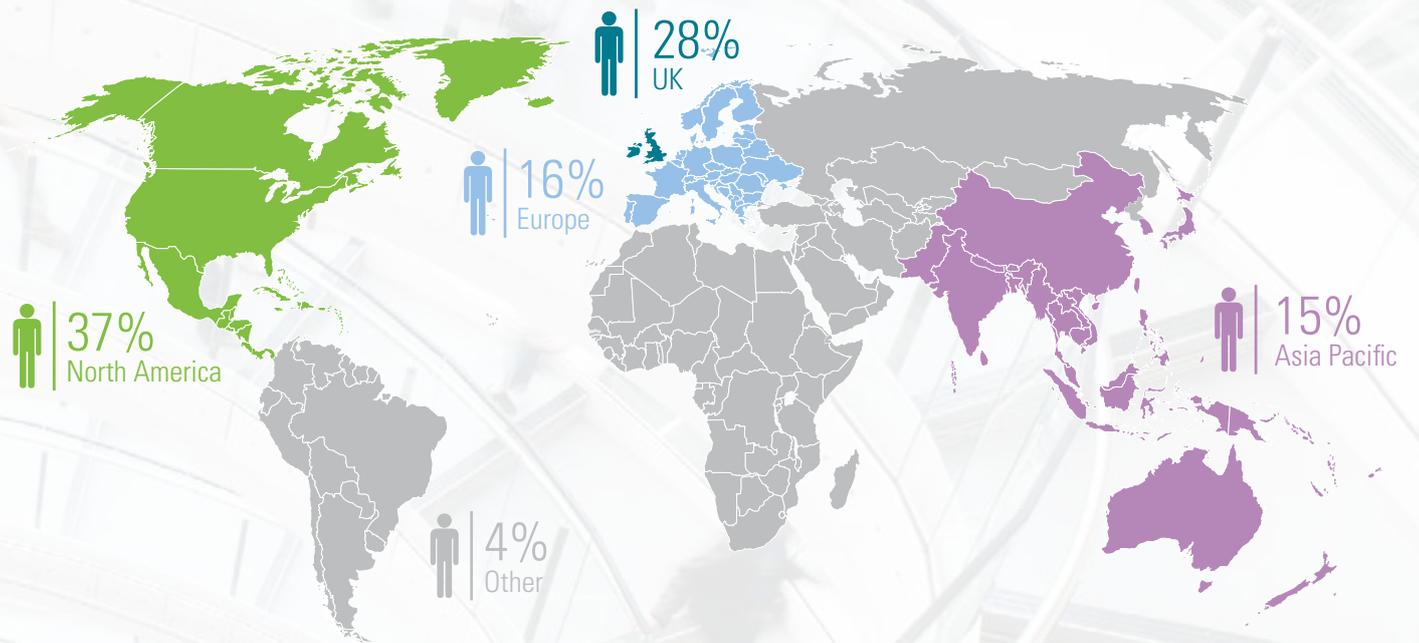
Source: Growing up: A new environment for hedge funds, KPMG International, 2015

Once again this year, the geographic dispersion of our respondents broadly reflects the overall market with more than a third of respondents identifying North America as their headquarters and around a quarter citing the UK. Around a fifth of our respondents reported being headquartered in either (non-UK) Europe or Asia-Pacific.

This report also benefited from a series of structured one-on-one interviews with leading hedge fund managers in major centers around the world who provided deeper insight into the opportunities and strategies they were undertaking to drive growth in this new environment. Surveys were conducted online between September 2014 and October 2014, while the structured interviews were conducted between November 2014 and December 2014.

On behalf of KPMG, AIMA and the MFA, we would like to thank all of those that participated in the survey. In particular, we would like to thank the managers that gave their time to share their views through our structured interviews. The insights and views of all of our participants – online or in person – have been invaluable in helping form this unique and valuable report.

### Location of respondents headquarters



Source: *Growing up: A new environment for hedge funds*, KPMG International, 2015

“ The increasingly rapid shift towards institutional investors, in particular, will catalyze significant changes in the way that managers structure, manage and market their products. ”

# Executive summary

We are living in an era of unprecedented change. But it is not just the world around us that is evolving; so too is the alternative investment industry itself. Indeed, a new environment is now emerging for hedge funds and most managers believe they will grow upwards as a result.

As this report illustrates, the industry, which has seen AUM grow by approximately 10 percent a year since the financial crisis, is positioned to continue along this growth path over the next 5 years. Institutional investors, who already account for roughly two thirds of the total hedge fund capital, will continue to eclipse high net worth individuals as the industry's primary sources of investment. Traditional fee arrangements will erode in the face of more customized models. And new markets will emerge both as investment destinations and as potential customers.

The increasingly rapid shift towards institutional investors, in particular, will catalyze significant changes in the way that managers structure, manage and market their products. The customization of fees and products – a trend already well

underway – is just one strategy that managers are taking to attract institutional investors.

Other growth opportunities are also emerging. Many managers are starting to shift their attention towards new and growing markets. Others are customizing their products – and increasingly their services and strategy – to broaden their appeal. The growing adoption and development of liquid alternative products such as 40-Act and Undertakings for the Collective Investment in Transferable Securities (UCITS) funds shows that demand is shifting.

The impact of new regulation remains a concern. As in the past, managers suggest that the growing regulatory burden is creating significant barriers to growth in most markets. Many say they expect the number of managers to shrink overall as a result.

### An upward growth trajectory

Over the past 5 years, global hedge fund AUM growth has grown at an annualized rate of 10 percent (year-over-year) between 2010 and 2014. With all signs indicating that this trajectory will continue for the foreseeable future, many observers expect global hedge fund AUM to top USD4 trillion by 2020.

### HFAUM annual growth



Source: Hedge Fund Research

### Among our key findings:

- The majority of managers believe that pension funds will be their primary source of capital by 2020; public pension funds and sovereign wealth funds together will account for at least a quarter of capital inflows by then.
- Two thirds of managers think their client demographics will be less concentrated in the next 5 years; only one-in-five say their client demographics will stay the same. Product diversification strategies such as liquid alternatives and customized fees are anticipated to attract additional investors.
- Forty-six percent of respondents expect to either alter their fund strategy or launch new products to attract institutional investors in the next 5 years, while more than two-thirds say they expect to offer specialized fee structures.
- Forty-three percent of respondents said they expect to change the markets in which they invest their capital; 21 percent said they would invest more into developed markets while 30 percent pointed to the emerging markets and 7 percent said frontier markets.
- Managers are moving towards customized product offerings with almost half (47 percent) of all fund managers reporting that they already offer a fund of one or managed account solution and 21 percent saying they plan to offer these solutions within the next 5 years.
- Thirty-eight percent of respondents said that they either had, or were developing, a UCITS fund (making it the second most popular product offering according to our survey); more than a quarter (27 percent) said the same about 40-Act funds (the fourth ranked product).
- Three-quarters of respondents said that they expect the number of hedge fund managers to either decrease or stay the same over the next five years.
- More than three-quarters (77 percent) cited increased regulation as the biggest threat to the industry overall; 84 percent said that their operating costs had increased as a result of compliance obligations.

# The global economic outlook: At the nexus of aging and alternatives

Two major factors seem set to influence the alternatives funds industry over the coming years: the state of the US economy and the impact of an aging world population. To help explain the impact these trends will have on the industry, we asked **Constance Hunter, Chief Economist with KPMG** and recognized alternatives expert to provide her perspective on what lies at the nexus of these evolving trends.

“ I think that hedge funds will play an increasingly important role in providing better diversification with greater liquidity when compared against other alternative investments... ”

## What is the link between aging and alternatives?

Investors should be interested to know that the average age of the planet's population is increasing by six hours every 90 days or so - simply put, the world population is living longer. And while nobody is about to complain about living longer, the reality is that living longer is not free. In developed economies, it usually means more years in retirement and, as a result, a growing attraction to assets that generate low volatility returns for longer periods of time. This metaphysical aspect of living longer has clear implications for how economies, markets and – in turn – asset allocations will adapt. It is highly likely that hedge funds will play an increasingly important role in providing better diversification with greater liquidity when compared against other alternative investments such as private equity, infrastructure or real estate.

## Do you see US growth continuing?

To understand the US growth picture, one needs to look more globally since much will depend on the global economic

outlook and environment which, in the developed economies, is largely characterized by low bond rates: Japan has 10-year bond rates of just over 0.3 percent<sup>2</sup>; Germany's is 0.5 percent; the UK, 1.6 percent; Italy, 2.9 percent; and the United States, 1.8 percent (which, when one considers that US 10-year rates averaged 6.48 percent over the last 50 years, is remarkable).

At the same time, the October 2014 International Monetary Fund (IMF) report downgraded growth for most economies, developed and developing alike. But the current economic outlook for the US is substantially stronger than the rest of the developed market economies, reflected in the fact that the IMF report also upgraded US growth projections by 50 basis points to 2.2 percent (year over year) in 2014 and 3.1 percent in 2015. In fact, more recent US data shows that growth has actually been stronger than expected and suggests that the US economy will grow between 20-70 basis points more than the IMF's original projections.

## Do you think that the US economy will decouple and lead the world out of its

<sup>1</sup> UN Population Statistics

<sup>2</sup> Bloomberg, December 1, 2014



<sup>3</sup>	Gross domestic product (GDP) Seasonally adjusted annual rate percentage	Consumer Price Index year-over-year percentage change	Purchasing Managers Index	Industry production year-over-year percentage change	Jobless rate	Budget surplus or deficit/GDP	Debt/GDP	Moody's rating
US	2.64%	0.80	53.7	5.14%	5.7	-2.4	122	Aaa
Germany	0.27%	0.09	51.0	-0.27%	6.5	0.1	80	Aaa
Japan	-1.16%	2.38	52.2	-1.00%	3.4	-1.5	237	A1
UK	2.02%	0.01	53.0	2.74%	5.8	-3.7	96	Aa1

**economic malaise, or will the decline in growth in Europe, Japan and select emerging markets be severe enough to derail the US economy's momentum?**

My bets are on decoupling. In part, this is because the US only derives around 12 percent of its GDP from trade, most of it with the North American Free Trade Agreement (NAFTA) and Europe. So the global economy would have to get significantly worse to bring the US growth rate down by more than 20–30 basis points in 2015.

Over the past year, the slowest growth in the world's developed economies has come from Japan and select European economies. Yet clearly the recent mild recession in Europe and scant growth in Japan has not stopped the US economy from gathering steam over the past 2 years. (It should be noted that the current outlook for both Europe and Japan is

for those economies to improve slightly over the next year as a combination of monetary stimulus and structural reforms promote growth in final demand). In the case of Japan, the fall in oil prices will help stimulate greater consumer spending and help the economy's trade balance as Japan imports nearly 100 percent of its oil.)

The last 2 years have also delivered an ever increasing growth rate to the US economy. This is especially evident in the labor market which added 27 percent more jobs in 2014 than it did in 2013. And while the average weekly earnings rose only 2.1 percent in 2014 and the participation rate fell from 63.2 percent in 2013 to 62.9 percent, there are a number of other economic indicators such as capacity utilization, services consumption, and investment figures which grew at levels consistent with an accelerating growth trajectory.

<sup>3</sup>Bloomberg, Markit PMI, Moody's, Individual Country Governments, Data as of the most recent quarter or month as of February 5, 2015

## GDP growth trends



Source: CAO, EUROSTAT, BEA/Haver

Other factors are also suggesting that the US will decouple and continue to grow. Gasoline prices at the pump averaged USD2.48 for the month of December 2014 versus USD3.34 for the year (falling 39 percent from their high in April 2014). Meanwhile, 10-year interest rates have been capped by low global rates and — while rates may have touched 2.99 percent on the first trading day of 2014 — they ended the year at just below 2.0 percent.

Similarly, thirty-year mortgage rates averaged 4.4 percent in 2014 and had fallen to around 4.1 percent at the start of 2015; this has allowed mortgage interest as a percent of wages to fall to its lowest level since that data became available in the early 1950s.

Based on this improved economic outlook and stimulative factors such as low interest rates and low gasoline prices, I think it unlikely that poor growth in other developed economies will bring down US growth by very much. In fact, it is possible that the resultant lower interest rates and gasoline price will more than make up for the drag from potentially lower exports or a stronger dollar. And in turn, this could have a similarly stimulative effect on the US's trading partners' economies, especially those that import a significant percent of their petroleum products.

### If the US seems set to decouple, what of the impact on the rest of the world?

A good way to explore this is to measure the impact of final domestic demand (this is final sales to businesses, consumers and the government) on 'value added' in foreign economies. According to recent research by Wells Fargo economist Jay Bryson<sup>4</sup>, the US has a larger influence than China on Asian economies and a significantly larger impact on the European Union (EU) and the NAFTA region. Its influence in Latin America is only slightly greater than China's as China's recent voracious appetite for commodities has fueled demand from the region's many commodity rich countries such as Brazil, Chile, Bolivia, Ecuador and Mexico. Even so, the US accounts for about 2.6 percent of global value added compared to China's 1.6 percent contribution.

The good news for the global economy is that the US and China are likely to continue posting positive growth in the near future. Even if China's economy slows to the more bearish predictions of a 4.0 percent growth rate from the current 7.3 percent, it will still be making a positive contribution to global final domestic demand. Thus, relatively stronger US growth will likely help stimulate exports for weaker developed economies, thereby also making a positive contribution to their growth.

<sup>4</sup> *Where will Global Growth Come From in 2015?*, November 20, 2014, Wells Fargo, Jay Bryson and Zachary Griffiths

The outlook for the US and the global economy will also be influenced by central bank action with the European Central Bank and Bank of Japan each pledging to proceed with aggressive quantitative easing (QE) programs. If the full USD1.7 trillion of QE planned by these central banks materializes between now and the end of 2015, it will serve to keep global interest rates lower than they would have otherwise been. Ultimately, the relatively higher US rates, in turn, attract fixed income investors from around the world, thereby keeping US rates low despite stronger growth and the Fed exiting QE.

**But what does all of this tell us about the impact of aging demographics?**

I believe that changing demographics will have a significant impact on the asset management industry and hedge funds in particular.

Conventional wisdom suggests that, as investors age, they allocate a greater portion of their portfolio to fixed income assets as, historically, they deliver a more predictable (albeit lower) return stream with much lower volatility than other types of investments such as equities or even real estate.

However, as people start to live longer, they will also start looking for greater return and low volatility. While modern portfolio theory has come under fire since the global financial crisis due to many asset classes becoming highly correlated in times of global systemic stress, it does suggest that diversification of different assets that perform differently from each other can help investors weather minor market storms and can improve compounding by reducing drawdowns in portfolio assets.

Thus, it stands to reason that an aging population experiencing greater and greater longevity will — by increasing its allocation to bonds — push down yields, thus reducing returns which thereby creates demand for a wider variety of assets to help diversify portfolios in an

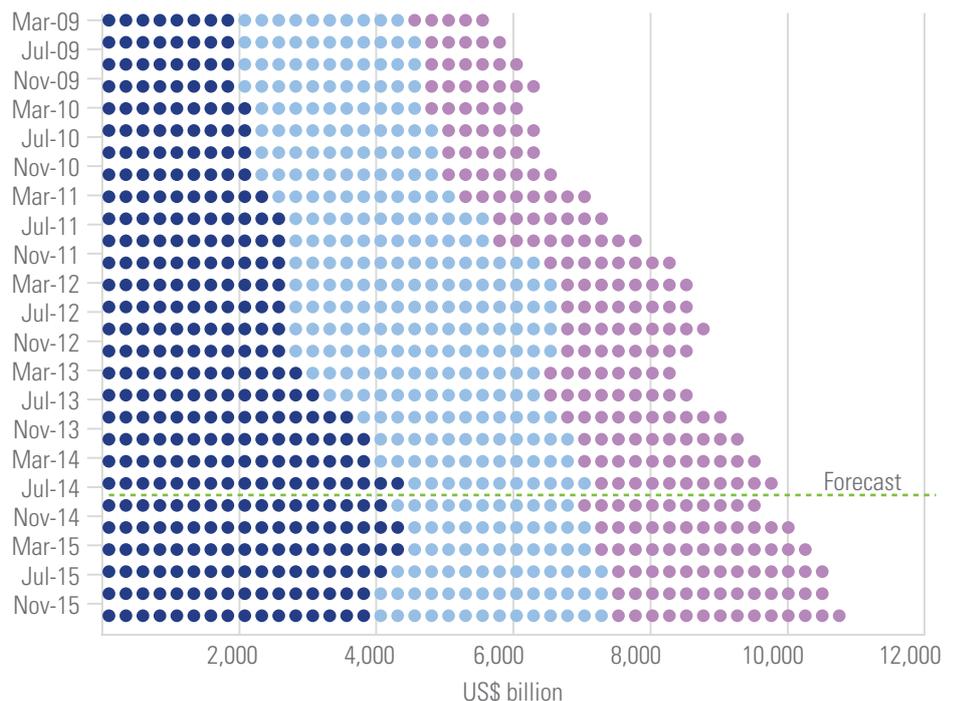
attempt to reduce volatility and improve compounded returns.

This need for diversification is likely to continue to drive allocations to alternative investments and hedge funds are an important part of that alternatives universe. They can be used to increase allocations to fixed income without taking duration risk; they can be used to gain exposure to commodities that are not constrained by the near contract rolls that exchange-traded funds (ETFs) are subject to; and they can provide almost every stripe of exposure to equities on both the long and short side.

In a recent study by Cerulli, 72 percent of respondents cited the need to optimize risk adjusted returns as the primary reason for increasing their allocation to alternative assets. Given the current global economic outlook and the trend towards increased longevity, it seems clear that diversifying portfolio allocation still has more time to run its course and hedge funds will be a primary beneficiary.

**Central bank action on quantitative easing**

● Fed ● ECB ● BOJ



Source: TBC

# New investors change the dynamics

While high net worth individuals were once the ‘bread and butter’ of the alternative investment sector, our survey demonstrates that most managers are expecting that institutional investors will drive their long-term growth. At the same time, the demographics of investors are also shifting and diversifying. Clearly, the dynamics of the market are about to change.

“ Indeed, most managers responding to our survey told us that – by 2020 – pension funds (both corporate and public) would be their primary sources of capital. ”



The fact that investor demographics and types are changing should come as no surprise to managers around the world. Indeed, according to our survey, most managers are expecting a significant shift in their primary sources of capital over the next five years.

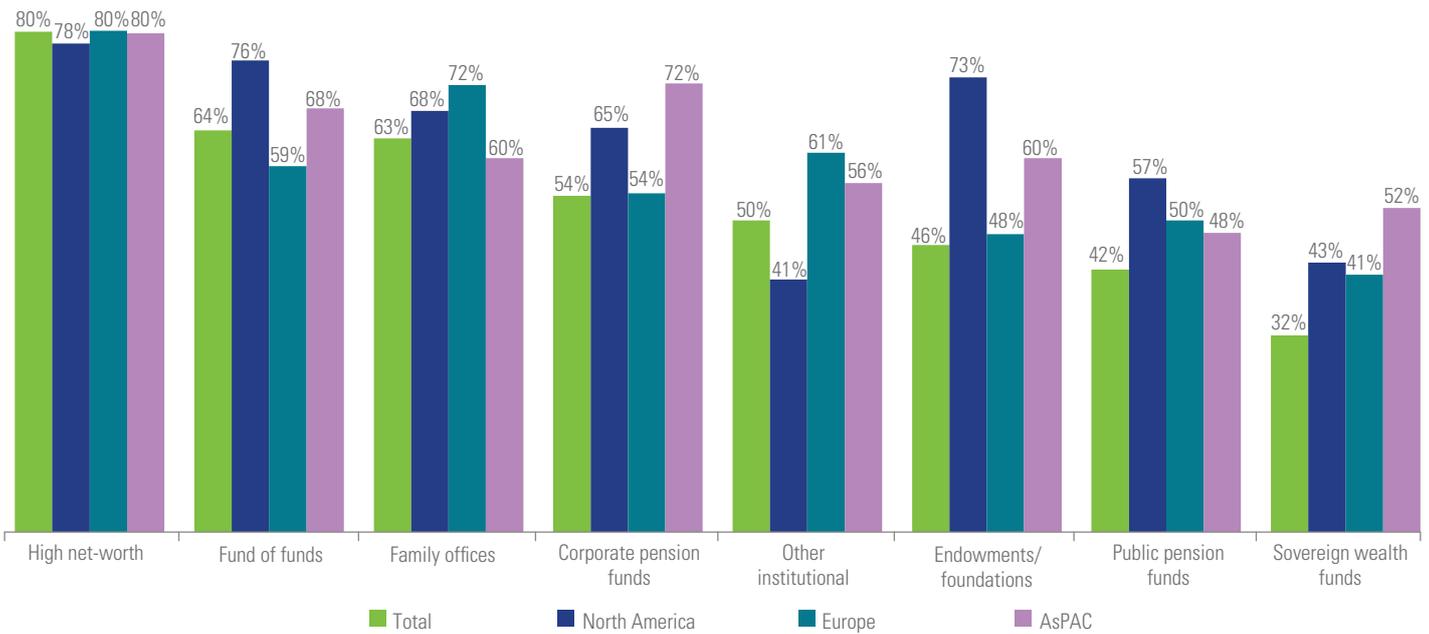
Today, the vast majority (80 percent) of managers say that their funds include some capital from high net worth investors; almost two-thirds (63 percent) include capital from family offices which, arguably, operate similarly to the high net worth category. Barely half (54 percent) say they already manage capital for corporate pension funds while

42 percent boast investment from public pension funds.

Interestingly, funds in Asia-Pacific seem to have been the most successful in attracting institutional investors to date: almost three-quarters (72 percent) say they manage capital for corporate pension funds and more than half (52 percent) count sovereign wealth funds amongst their clients.

Perhaps not surprisingly given the sheer quantum of capital these institutional players are looking to invest, larger fund managers tend to have been more successful than medium or smaller

### Percentage of HFs with any investment by investor type

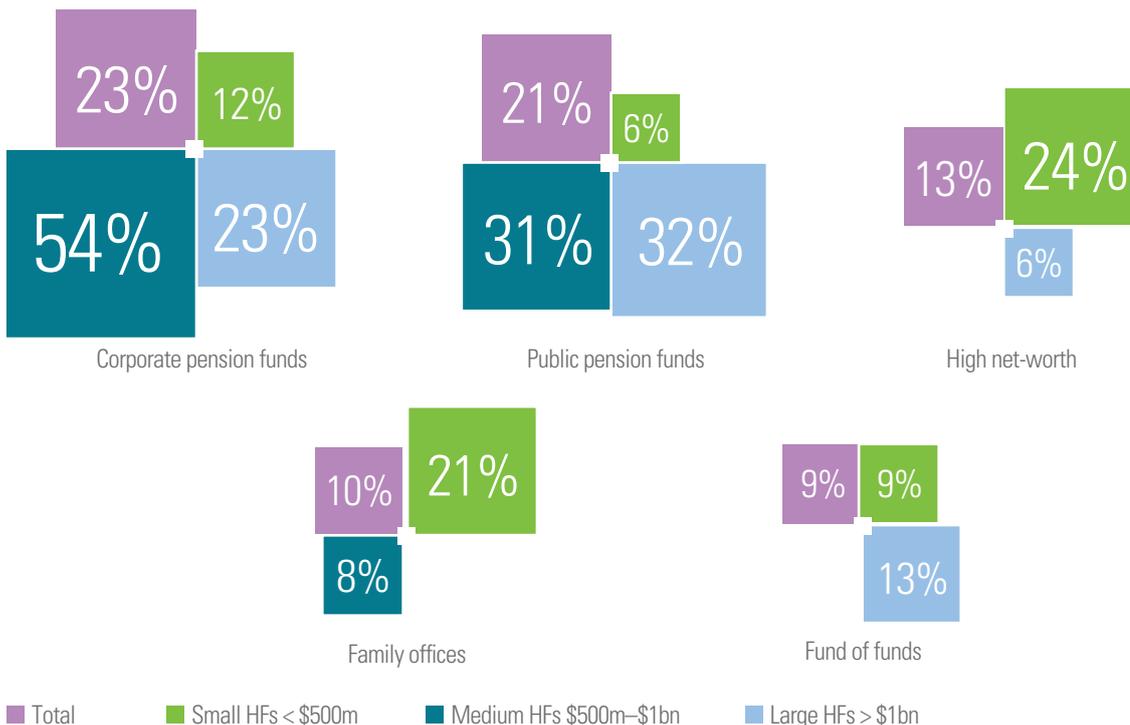


Source: Growing up: A new environment for hedge funds, KPMG International, 2015

fund managers in attracting capital from institutional investors. “The average pension fund manager absolutely loves hedge fund managers that perform and there have always been people who are spectacular performers,” noted the founder of one UK-based fund manager.

Our survey demonstrates that a shift towards a larger focus on institutional investors is now underway. Indeed, most managers responding to our survey told us that – by 2020 – pension funds (both corporate and public) would be their primary sources of capital. Slightly less

### Top box response, when asked to rank what will be the primary source of capital over the next 5 years.



Source: Growing up: A new environment for hedge funds, KPMG International, 2015

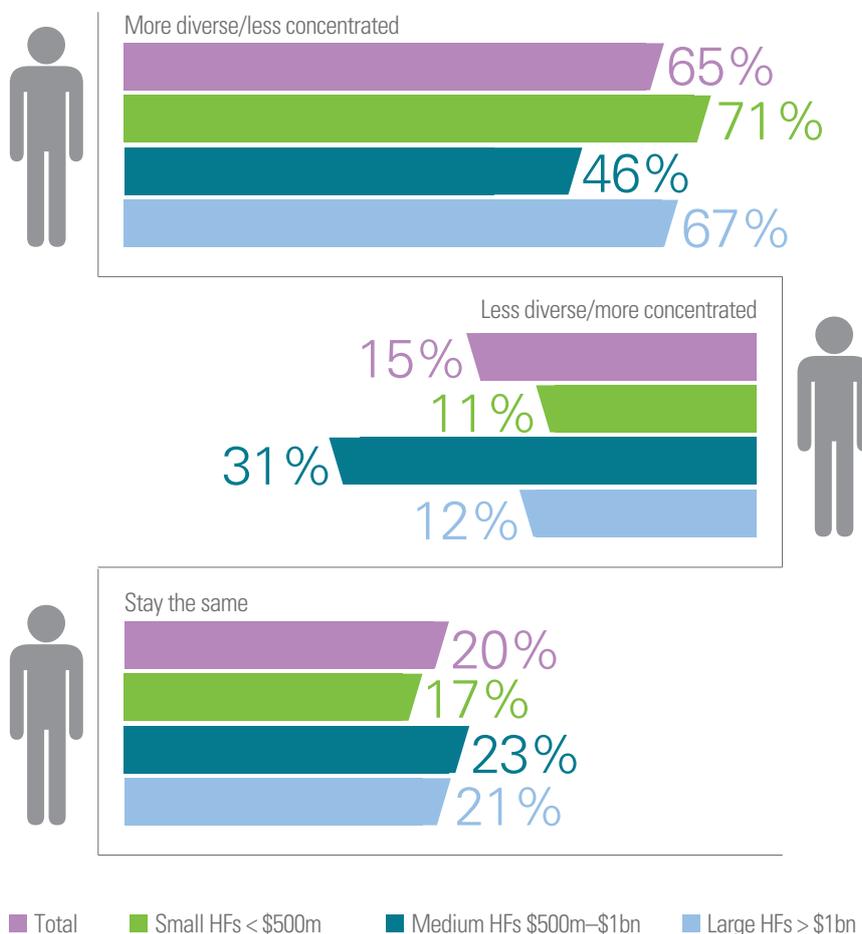
than a quarter of respondents said that they expected corporate pension funds and public pension funds (23 percent and 21 percent respectively) to be their primary source of capital in 5 years' time while only 13 percent pointed to high net worth investors and just 10 percent pointed to family offices as their primary source of capital in the future.

"Part of what we are seeing here is the result of continued pressure on the fund of funds approach as a point of entry for pension and institutional investors," suggested the founder of one large North American fund manager. "As a result, we're seeing more pension funds move towards direct investing where they can have more control over their investments."

Our survey suggests that medium-sized fund managers are the most optimistic about their ability to attract institutional investors in the future. More than half (54 percent) of all fund managers with AUMs of between USD500 million and USD1 billion said that they expect corporate pension funds to be their primary source of capital by 2020 (versus just 23 percent of their larger competitors).

As managers attract greater allocations from institutional investors, transparency is becoming increasingly important – and increasingly time consuming." Investors — particularly institutional investors — are demanding more detailed reports from their fund managers, arguing that they should have access to the same level of granular data that regulators

### Over the next 5 years, how do you expect your client demographics will change?



Source: *Growing up: A new environment for hedge funds*, KPMG International, 2015



### Insights on investors

Pension funds anticipated to drive growth over next 5 years

- 65 percent expect their client demographics will be more diverse
- 21 percent expect public pensions to be their primary future source of capital
- 23 percent identified corporate pension funds to be their primary future source of capital

enjoy,” pointed out the General Counsel of one multi-strategy fund manager based in Hong Kong. “For smaller houses, this will likely mean adding dedicated resources just to manage the increased demand for reporting.”

Perhaps recognizing this, most small firms seem pleased to focus on filling the gap as their larger peers shift to institutional investors. Smaller funds were twice as likely to say that high net worth investors and family offices would be their primary source of capital in the future versus pension funds of any type. But many smaller fund managers continue to attract some institutional capital.

“I don’t think small fund managers are locked out of the institutional side necessarily,” noted the COO of one large Hong-Kong based fund manager. “Big investors will continue to invest with

the top small fund managers to diversify their risk. The challenge is in showing you are committed to best practices, have a strong track record, the right mind-set and an ability to diversify risk and allocate money wisely.”

Almost two-thirds of managers said that — over the next 5 years — they expect that the demographics of their clients will change to become much more diverse; only 20 percent said that their client demographics would likely remain the same.

“There’s still enough smart capital out there to support the growth of the industry and recent reports suggest that capital flow allocations have increased to small and medium-sized fund managers recently, so I wouldn’t suggest that the market is skewed towards larger players at this point,” argued a North American manager.

# Fund strategies shift to attract new capital

The transition from high net worth and family offices to institutional investors is leading many managers to review their fund strategies in order to attract new investor types and demographics. But as customized fee structures, funds of one and more ‘service-oriented’ managed solutions become more commonplace, many within the sector are starting to consider how they might alter their fees to meet the unique demands of these new investors.

“At the end of the day, we all recognize that we need to be more innovative in the way we structure new solutions to suit clients in the alternatives space.”

According to our survey, almost half of all managers now believe that they will need to change their fund strategies in order to attract new investors and institutional capital. Forty-six percent of respondents said that – over the next 5 years – they would either alter their fund strategy or launch new products into the market to attract investment capital from pension funds and the aging demographic.

Medium-sized fund managers seem set to see the greatest change as they

increasingly attract institutional investors. Larger fund managers were the least likely to say they would alter their strategy (likely due to the fact that most already focus on institutional investors), with smaller fund managers only slightly more likely to suggest a change (reflecting a continued focus on high net worth and family office investors). Forty-nine percent of medium-sized fund managers said they would make a change.

## In the next 5 years, do you expect to alter your strategy or launch new vehicles to attract investments from pension funds and the aging population?

Yes



Source: *Growing up: A new environment for hedge funds*, KPMG International, 2015

For closed funds, the focus has shifted onto performance, noted the General Counsel of one large UK-based fund manager. "It's all about achieving organic growth through improved performance, not increased assets – I think that's the way the industry is heading." As another UK-based manager put it, "It's performance that's going to drive the European market going forward."

Interestingly, when asked what growth strategies they expected to use in order to attract increased investment, more than two-thirds pointed to some sort of specialized fee structures with respect to either incentive fees or management fees. Only around a third of respondents said they would use seed deals or increased liquidity options in order to drive growth.

Management fees, in particular, are coming under pressure. "We've seen pressure on management fees but not performance fees," noted one global multi-strategy asset manager. "At the end of the day, we all recognize that we need to be more innovative in the way we structure new solutions to suit clients in the alternatives space."

Many suggest that the pressure to develop more customized solutions is already heating up. Almost two-thirds (64 percent) of respondents said they were already witnessing increased demand for 'solutions' such as managed accounts and funds of one from their investors. Forty-four percent say they already offer customized solutions to their investors with a further 22 percent saying that they are preparing to do so.

Our survey also shows that managers are increasingly willing to adjust their fee structures to better align to new investor requirements. "There's no doubt in my mind that fee structures are changing from '2 and 20'"; stated one UK-based manager.

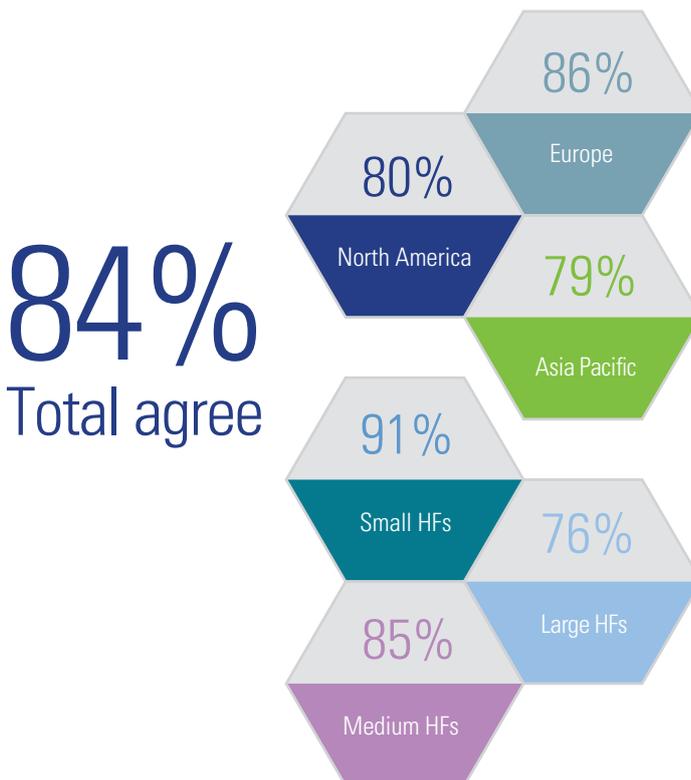
Clearly, the traditional '2 and 20' approach to fees will likely continue to be the standard for those with more commoditized fund structures, but our interviews and our data suggest that

managers are starting to play with fees as part of their approach to customizing solutions. Indeed, the vast majority (84 percent) of respondents to our survey said that they expected investors and managers to compromise on fee arrangement over the next 5 years.

A large US based manager, indicated "There is a ratcheting down of management fees as AUM grows. We see overall asset inflows compensating for fee decreases, although it doesn't make sense to go below one and a quarter percent."

What is clear from our survey is that the new reality is much more intricate as managers start to embrace more complex customization models that reflect the shift in the investor base and demands. This really underlines the evolution in strategy from managers as providers of products to providers of customized solutions."

**Over the next 5 years, expect customized fee structures will be more prevalent**



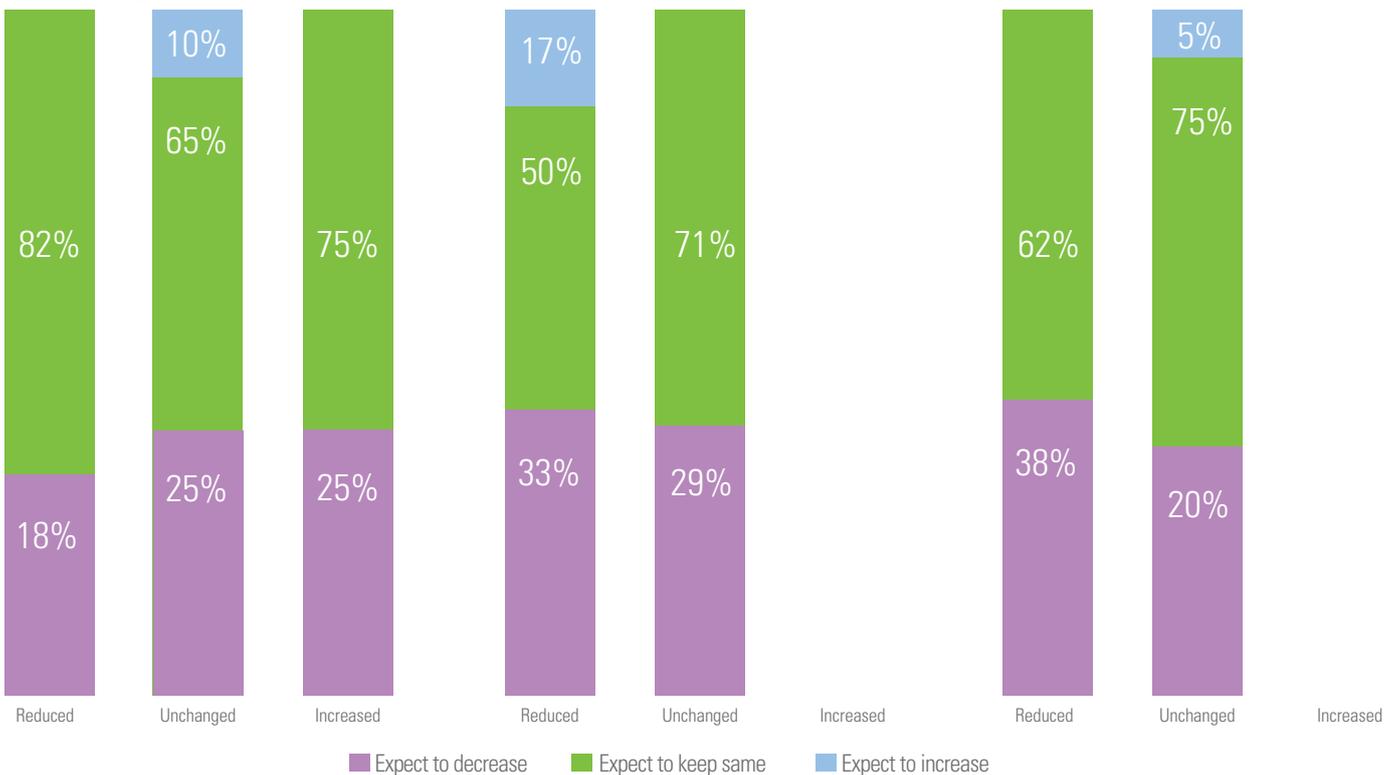
Source: *Growing up: A new environment for hedge funds*, KPMG International, 2015

## Changes to management fees by firm size

Past changes



Expected changes



Source: Growing up: A new environment for hedge funds, KPMG International, 2015

### Insights on fund strategies

Customized fees anticipated to be a key growth strategy over next 5 years

- 46 percent expect to alter their strategy or launch new vehicles
- 31 percent expect to change their fees
- 84 percent anticipate customized fees will be more prevalent

Many managers suggest that they have already started to customize their fee structures. According to our survey, 42 percent of managers have experienced some change in their fees since 2008. However, almost nine-in-ten of those that have seen changes in the past report that they have been downward. Medium-sized fund managers, in particular, report experiencing higher levels of change and more downward pressure on fees than smaller and larger peers.

“Some pension funds and institutional investors often put too much focus on fees in an effort to be as cost effective as possible, but ultimately this will impact performance and I’m not sure anyone wins in that scenario,” noted a European-based manager with a large global investment bank.

For many, however, the traditional fee structures will remain steady over the next 5 years. Just 31 percent said they expected to change their fees in the future; although 84 percent of these still expect the pressure to remain downward. Once again, medium-sized firms seem to expect the most volatility in their fee structures, likely reflecting their shift towards customized solutions to attract new institutional investors.

“If you want increased assets then you need to focus on performance. At the end of the day, if you treat your customers right in terms of performance versus reward, assets will almost certainly follow,” advised a UK-based manager.



# New markets come into focus

As the majority of fund managers start to plan for a change in investor demographics over the next 5 years, a growing number are also starting to explore new markets for growth. Our survey suggests that — increasingly — managers are looking to the emerging and frontier markets as their next big investment opportunity.

This year's survey suggests that fund managers are standing on the cusp of a major shift in focus from West to East as new investors emerge and new markets come into view.

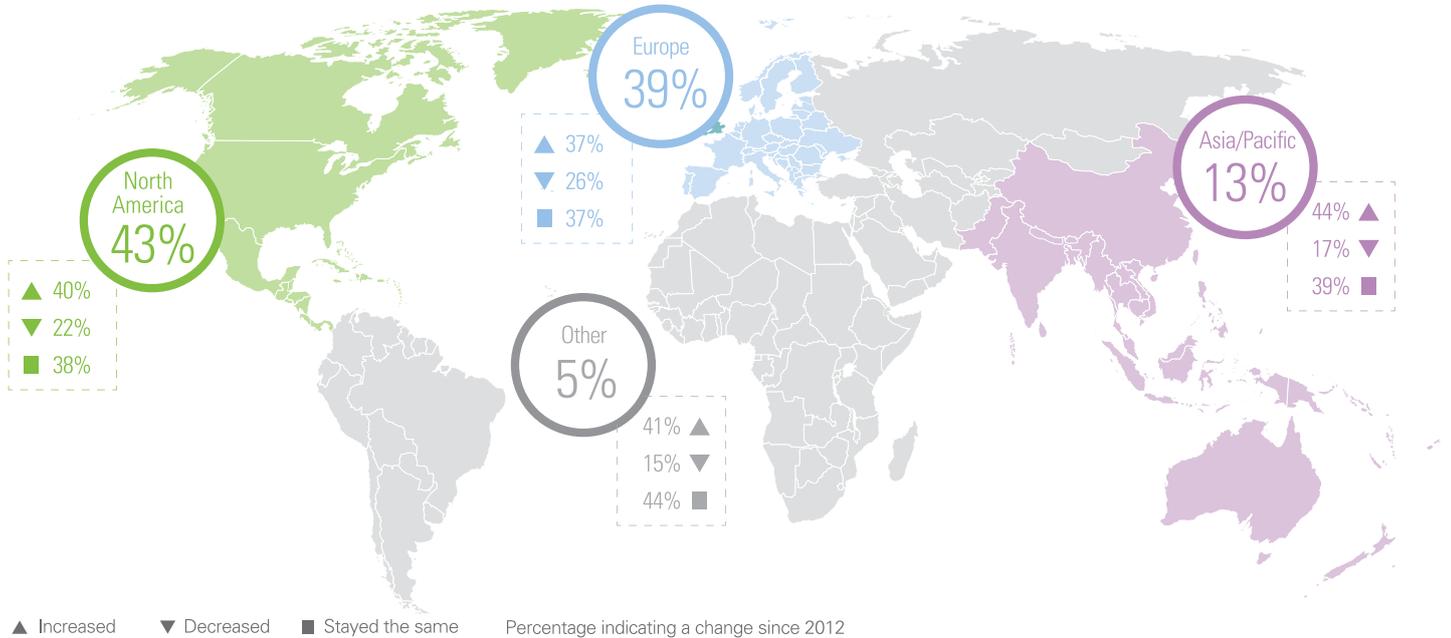
Today, most capital invested in hedge funds still comes from North America and Europe. North America accounts for around 43 percent of investors, followed by Europe (excluding the UK and Switzerland) who make up 17 percent of investor capital, the UK (13 percent) Asia-Pacific (also 13 percent) and Switzerland (9 percent). Brazil, Russia, India and China (BRIC), emerging and frontier markets account for just 5 percent of investors.

However, the data suggests that some of the greatest inflow increases in purely percentage terms over the past two years have come from developing and emerging markets. Forty-four percent of those with investors in Asia-Pacific say they have seen an increase in investor activity from this region while 17 percent cited a decrease; 41 percent of those with investors in the Middle East and Africa (albeit only a small number) say that they have seen activity increase (versus just 9 percent who said it decreased).

"We've seen a lot of growth in the Middle East with sovereign wealth funds and, today, they are right up there

“...the data suggests that some of the greatest inflow increases over the past two years have come from the developing and emerging markets.”

## Changes to regional breakdown of investors since 2012



Source: *Growing up: A new environment for hedge funds*, KPMG International, 2015

with US pension funds as our biggest allocation areas,” said a large US-based asset manager. “We definitely see a huge opportunity in China and expect increased asset flows from East Asia within the next 5 to 10 years.”

In comparison, respondents seem to indicate that growth in the developed market is flattening. So while 37 percent said they had seen activity in Europe increase, 26 percent said it had decreased. Those with investors in Switzerland and the UK were almost just as likely to say that activity in those markets had increased as they were to say it had decreased.

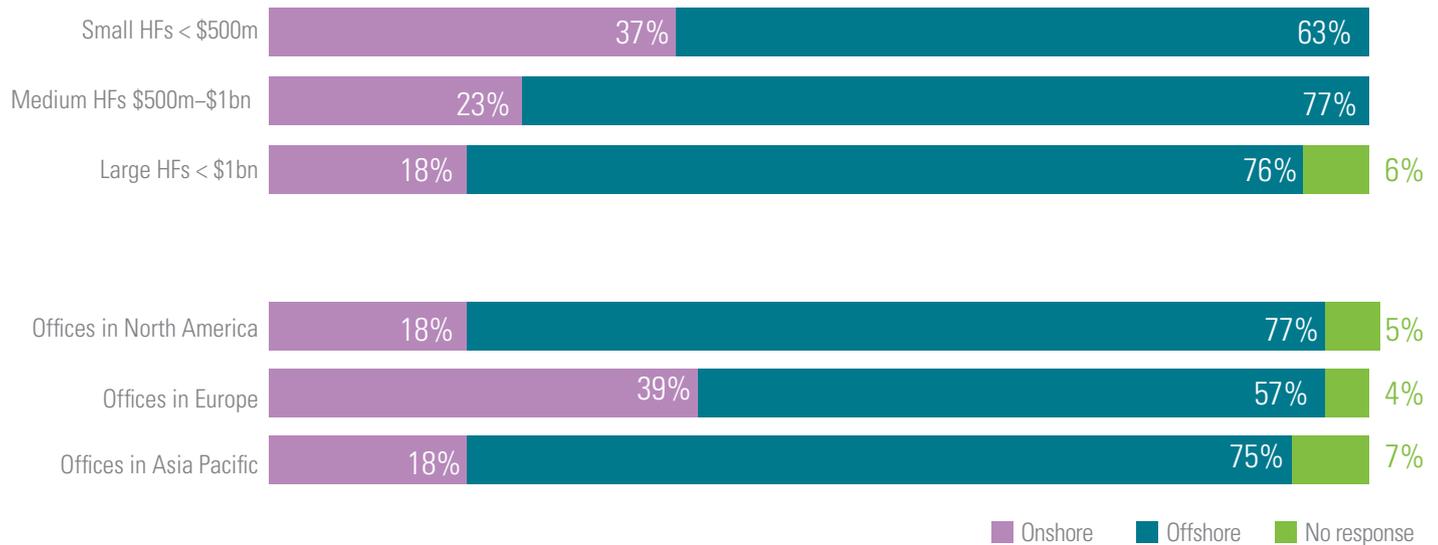
Likely as a result of the shift in investor demographics and markets, the

majority of managers say that — if they were to set up a new fund in the next 5 years — they would most likely domicile their master fund offshore. Not surprisingly, the Cayman Islands seemed the most likely destination with 63 percent of managers identifying that country. Other domiciles identified by managers included the US (12 percent), Ireland (11 percent), Luxembourg (8 percent), Switzerland (3 percent) and Malta (3 percent).

Our survey suggests that managers are increasingly looking to the developed and emerging markets not just for new investors but also as a destination for investment capital. “In my opinion, managers should be placing about a quarter of their investment portfolio

## If you were to set up a new fund in the next 5 years, where would it be domiciled?

70% | selected offshore



Source: *Growing up: A new environment for hedge funds*, KPMG International, 2015

into the emerging markets,” argued a manager for a US-based fund manager focused on the emerging markets. “That is what people should do, but people usually don’t do what they ‘should’ do.”

More than four-in-ten (43 percent) said they expect to change the markets in which they invest their capital. But interestingly, only 21 percent said they would invest more into developed markets while 30 percent pointed to the emerging markets and 7 percent said frontier markets. Perhaps not surprisingly, those with existing offices in Asia-Pacific indicated a higher focus on the emerging and frontier markets.

“Our China strategy is more of a 10 to 20-year strategy; it may be somewhat

irrelevant now except as a distribution channel, but down the road it will be increasingly important,” added the manager of one global fund manager based in the UK. “We’re absolutely looking at the frontier markets, particularly Africa, for future growth.”

### Insights on markets

Asia Pacific is becoming an important hedge fund market

- 46 percent of funds have seen growth in Asia Pacific investors in past 2 years
- 54 percent of managers with offices in Asia Pacific have seen growth of investors from within the region in past 2 years

# Changing the product mix

While our survey finds that managers are seeing an increased demand for customized products – such as funds of one and managed accounts – there are indications that ‘liquid alternatives’ such as UCITS and 40-Act funds are continuing to gain traction.

“... liquid alternative funds such as UCITS and 40-Act funds are continuing to gain traction.”

Throughout this survey, respondents have indicated that they are moving towards greater customization of fund structures and fee arrangements; our data suggests they are also customizing their product offerings.

The trend towards customized product offerings is clear. Almost half (47 percent) of all fund managers report that they already offer a fund of one or managed account solution. Twenty-one percent say they plan to offer these solutions within the next 5 years.

“When I talk to my marketing folks, they see fund of one and customized products as the big growth area,” said one large US-based investment advisor. “We’re still pushing our comingled products, but it’s become a much harder sell recently.”

Not surprisingly, large-sized fund managers were more than twice as likely as their smaller counterparts to say they already offered funds of one. But smaller fund managers seem keen to catch up: 50 percent of respondents from smaller funds said they plan to offer a fund of one solution in the next 5 years (half of those say they will offer the product within the next 12 months).



As we reported in our previous *Global Hedge Fund Survey*, liquid alternative funds such as UCITS and 40-Act funds are continuing to gain traction. As one manager of an off-shore fund candidly noted, “Investors are definitely looking for more liquid products with shorter

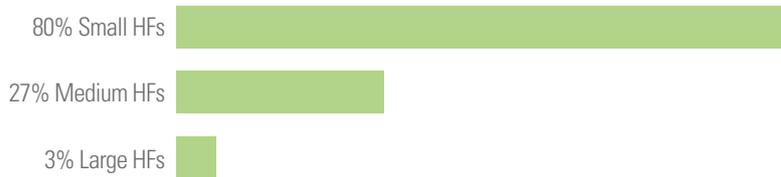
## Who is utilizing or expects to offer fund of one in next 5 years

**70%** | of respondents currently utilize or expect to offer a fund of one

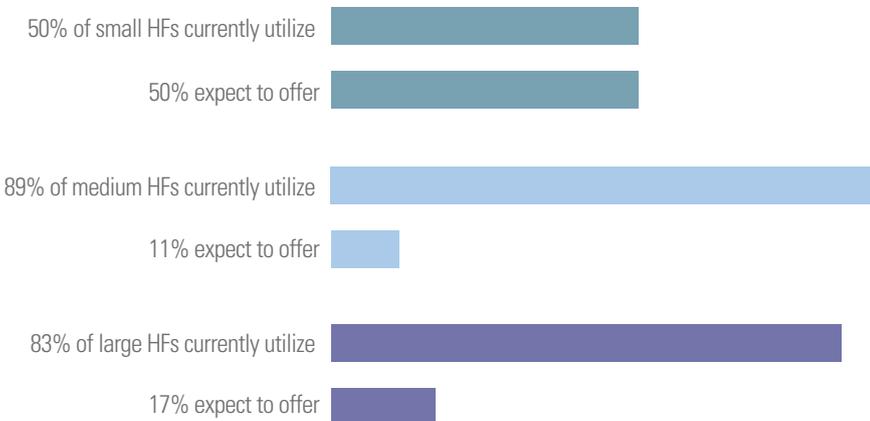
### Of the 67% that currently utilize:



### Of the 33% that expect to offer:



### Utilization vs expect to offer varies by size of HFs



Source: *Growing up: A new environment for hedge funds*, KPMG International, 2015

redemption notice periods – investors want to have their cake and eat it too.”

Indeed, 38 percent of respondents said that they either had, or were developing, a UCITS fund (making it the second most popular product offering according to our survey). More than a quarter (27 percent) said the same about 40-Act funds (the fourth ranked product).

“It’s become a matter of ‘why not’ as opposed to ‘why’;” noted one London-based fund manager who is

currently launching their first UCITS fund. “Launching a UCITS fund aligns nicely with our strategy of liquid macro fixed income, but I also believe that the UCITS platform will be more attractive to European pension funds and investors that don’t want to put their money into a Cayman fund.”

Fund managers headquartered in Europe were, as would be expected, most likely to say they either had, or were developing, a UCITS fund while North American managers were most likely

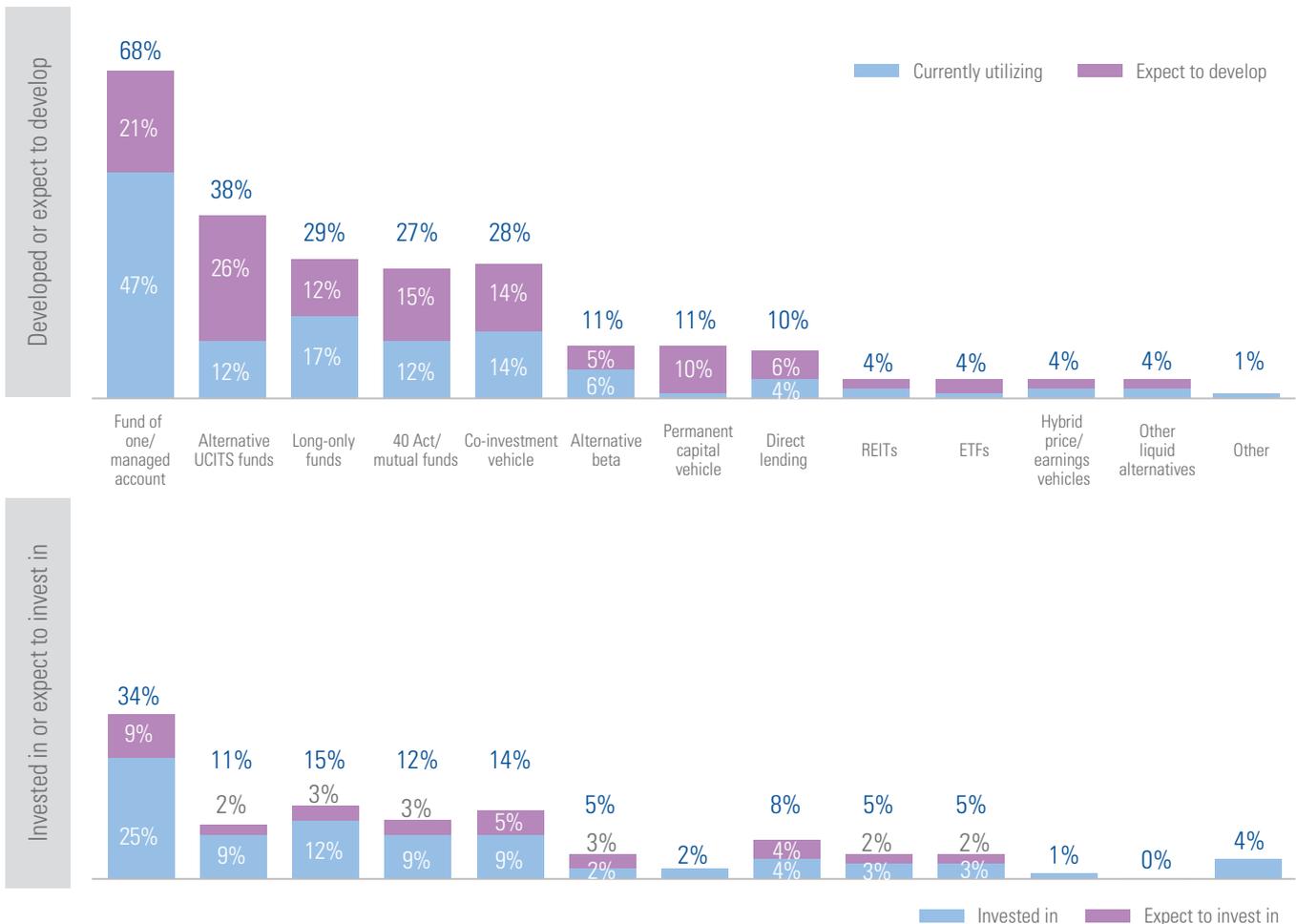
to point to an existing or planned 40-Act fund. Interestingly, however, fund managers headquartered in Europe demonstrated a high preference for both UCITS and 40-Act funds.

Many managers also suggest that they are waiting to see how existing products in the market perform. “Banks and larger asset managers will eventually be all over liquid alternatives, but not until they’ve had time to prove their performance,” added a Canadian-based investment manager.

Some, however, suggest that the shift towards attracting institutional investors may dampen the appeal of launching new liquid alternative products for larger managers. “We want allocations from pension funds with longer-term strategies so we have no interest in providing daily liquidity products,” said a UK-based manager.

Others worry about the longer-term impact of moving towards more liquid alternative strategies. “With UCITS funds and alternative investment funds (AIFs) there are differing approaches to the business that are being adopted

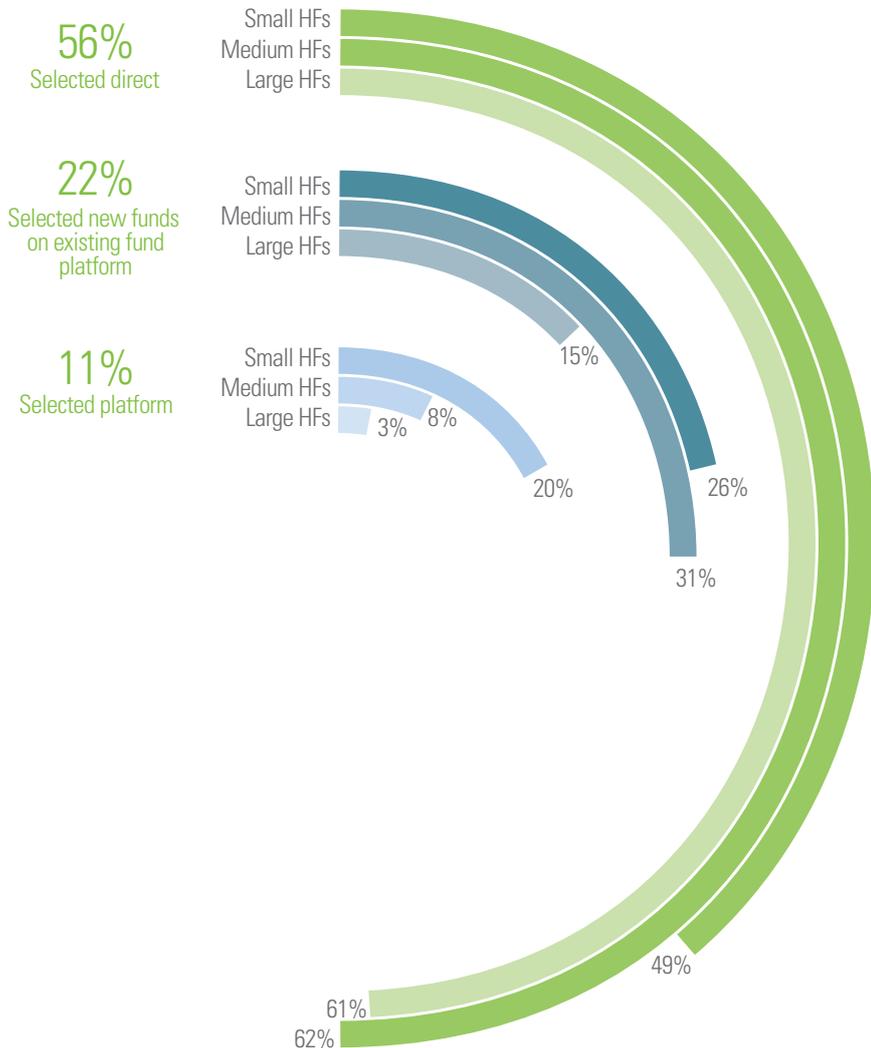
### Over the next 5 years, what products are fund managers considering?



Source: Growing up: A new environment for hedge funds, KPMG International, 2015

## Preferred method for launching a fund

89% | have a preferred method



Source: *Growing up: A new environment for hedge funds*, KPMG International, 2015

in light of new and altering compliance requirements,” noted one UK-based manager. “The downside to this is that some marketplaces are being missed.”

Likely as a measure to retain control during a time of transition, the majority of managers (58 percent) said they would expect to use more direct methods when launching new products and funds into the market. Around a quarter (22 percent) said they would likely launch new funds on top of their existing funds business.

However, one in five respondents from smaller-sized fund managers said they would likely use platforms to launch new products, presumably in order to reduce operating costs and complexity. “Smaller managers are joining our platform because we take away the headache of operating infrastructure which means our managers can just focus on trading — it’s what they like and what they’re good at,” added one large European hedge fund manager and platform provider.

### Insights on product mix

Liquid alternatives are gaining traction

- 12 percent of fund managers have developed alternative UCITS funds and 26 percent expect to develop in the next 5 years
- 12 percent have developed 40-Act funds and 15 percent expect to develop in the next 5 years

# Barriers to growth emerge

With several factors now contributing to a higher barrier of entry for the hedge fund industry, our survey suggests that managers expect competition to level out. As incumbents, many expect this to have a positive effect on the industry. Yet many challenges still remain — the cost and complexity of regulation chief among them.



The fact that running a hedge fund management firm is becoming more complex and challenging — particularly for new entrants — is clear. According to our survey, managers expect competition to decrease somewhat as a result of higher barriers to entry. Three-quarters of respondents said that they expect the number of hedge fund managers to either decrease or stay the same over the next five years. Only 24 percent said they expected numbers to increase (driven

largely by respondents headquartered in North America).

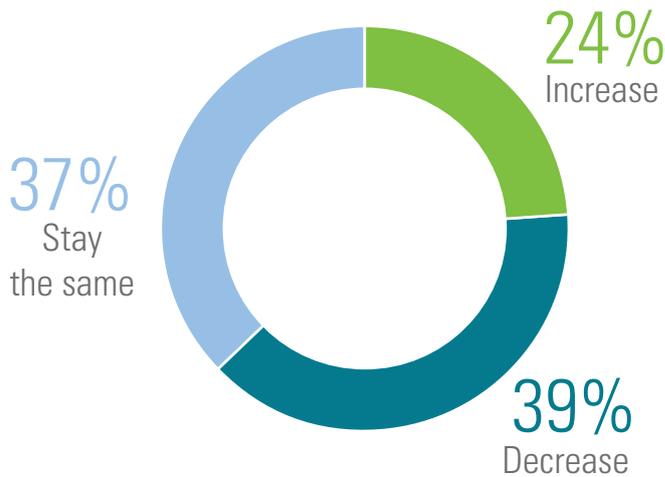
“The barriers for small start-ups are so much higher today,” noted the CEO of one large UK-based fund manager. “I’m surprised more start-ups aren’t banding together to consolidate their infrastructure and technology — not full-scale mergers... cultures are too different... but some form of consolidation that allows them to share costs.”

As we noted in our previous *Global Hedge Fund Survey*, regulation continues to pose serious challenges to growth for the vast majority of managers. Indeed, when asked what factors they believed to pose the largest threat to the growth of the industry over the next 5 years, more than three-quarters (77 percent) cited increased regulation.

“It’s pretty clear that regulators aren’t thinking about the industry when they make changes,” noted one UK-based manager. “The workload created certainly doesn’t help investors and does nothing to improve the business.”

Interestingly, funds headquartered in Europe and Asia-Pacific were more likely than those in North America to cite regulation as a potential limiting factor

**Over the next 5 years, the number of HF managers are expected to:**



Source: *Growing up: A new environment for hedge funds*, KPMG International, 2015

“... when asked what factors they believed to pose the largest threat to the growth of the industry over the next 5 years, 77 percent cited increased regulation.”

to growth (81 percent and 83 percent respectively, versus 67 percent for North America).

However, some managers clearly believe that their regulatory costs will flatten out in the near future. As one UK-based manager noted, “Once the first cycle is completed and everybody understands what the requirements are, it will be much less of a burden.”

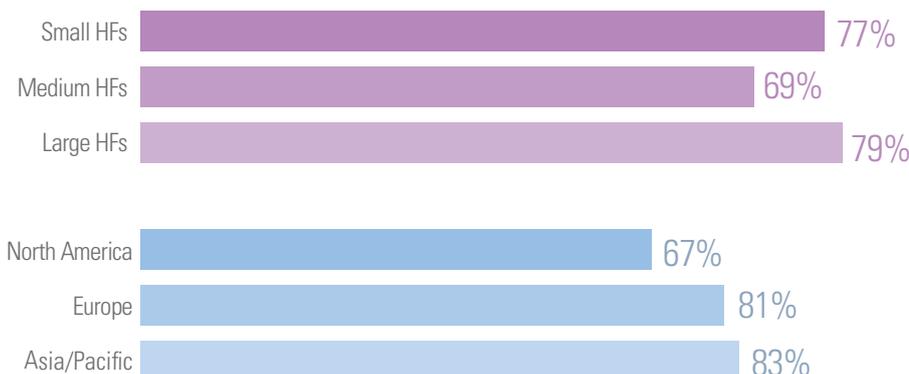
Smaller and larger-sized firms also reported higher levels of concern about regulation than their medium-sized peers, likely reflecting a lack of capabilities on the part of smaller funds and significant complexity for larger (and

likely more global) funds. “We have a dedicated compliance and regulatory structure that allows our managers to focus on growing the business; that may not be the case for smaller funds with fewer resources,” added the UK-based manager.

In particular, the increasing cost of compliance seems to be driving up costs for most managers. Eighty-four percent of respondents said that their operating costs had increased as a result of compliance obligations. The remainder said that costs had stayed the same (nobody suggested that their costs had decreased).

**Over the next 5 years, regulation identified as the largest threat to the growth of the HF industry**

77% | overall selected regulation



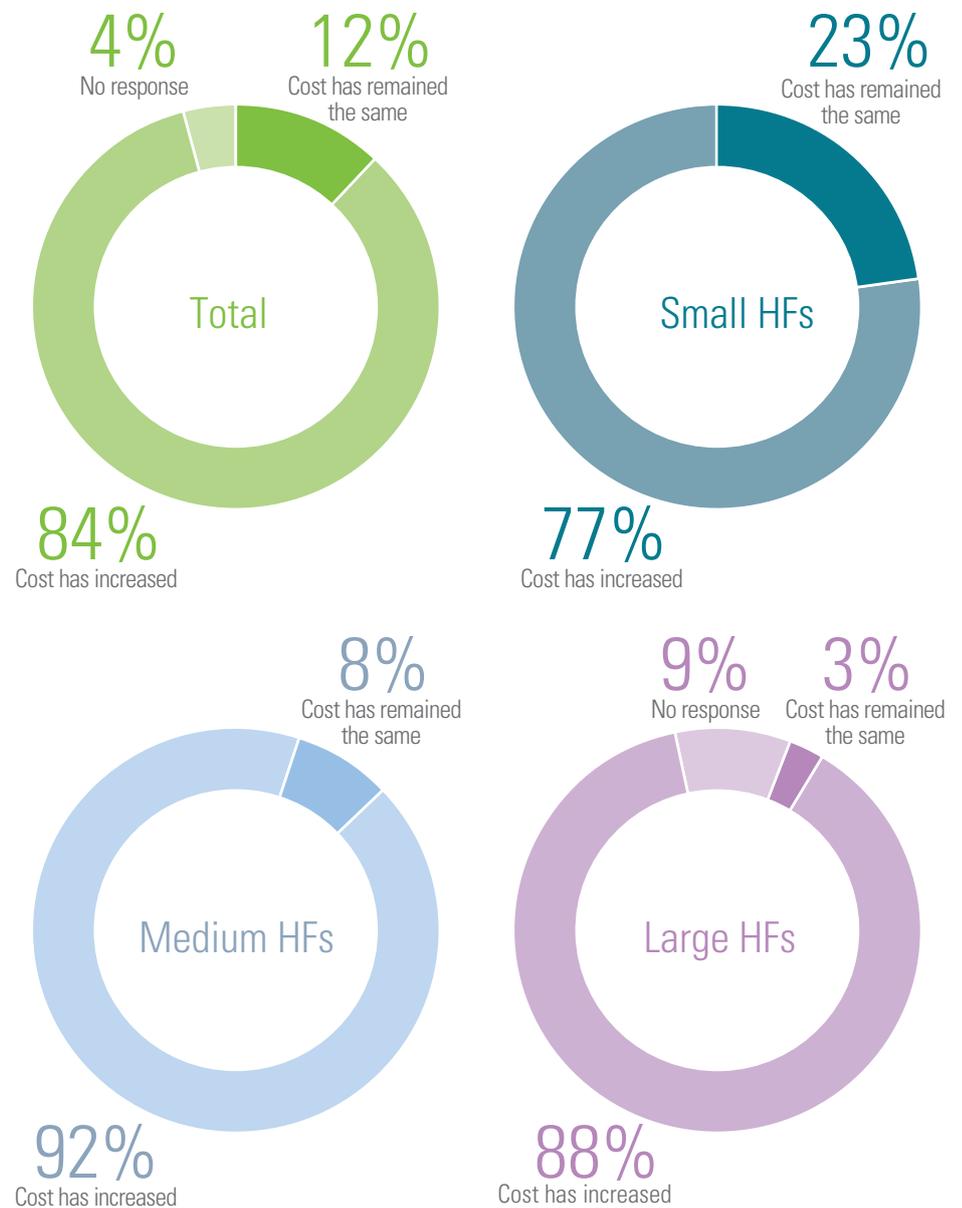
Source: *Growing up: A new environment for hedge funds*, KPMG International, 2015

“We have added considerably to the compliance function and spend, and more of our other functions — finance and operations in particular — are now spending more time on compliance-related tasks,” added another UK-based manager. “With the cost of doing business in a more

regulated environment so much higher, we see even more value in growing our business.”

Other than regulation, respondents also identified a number of other potential challenges to growth over the next 5 years. Almost half (46 percent) said they recognized that if they underperformed,

**The impact of the increased level of compliance on the estimated total operational cost on HFs over the past 3 years.**



Source: *Growing up: A new environment for hedge funds*, KPMG International, 2015

**Over the next 5 years, which factors will be the largest threat to the growth of the HF industry?**



Source: *Growing up: A new environment for hedge funds*, KPMG International, 2015

they might see a loss of assets while four-in-ten said they saw pricing pressures as a significant barrier to future growth. Access to capital and potential reductions in dealer balance sheets and risk capacities were also cited as top five challenges facing the industry.

**Insights on barriers to growth**

Regulation continues to be seen as a barrier to growth

- 74 percent anticipate the number of managers are expected to remain the same or decrease in the next 5 years
- Regulation is the largest barrier, with 77 percent of respondents identifying regulation as a large threat to growth

“ Eighty-four percent of respondents said that their operating costs had increased as a result of compliance obligations. ”

# What you should take from this report

## Key take-aways for managers

- The industry, which has grown by approximately 10 percent a year since the financial crisis, is positioned to continue along this growth path over the next 5 years.
- A large share of the new growth will come from public-sector investors such as public pension plans and sovereign wealth funds.

## Key take-aways for regulators

- Managers have added considerably to their compliance functions since the crisis.
- Many managers continue to find that increased regulation is raising barriers to entry and driving increased consolidation.



## Key take-aways for investors

- As customized fee and fund structures become commonplace, managers will increasingly position themselves as solution providers.
- Thanks to advances in liquid alternatives such as UCITS and 40-Act funds, a true retail client base will increasingly emerge.

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