Broadening investments in the chase for yield

Global AM Perspectives – Podcast transcript

Podcast with Hans Volckens, Partner and Head of Asset Management and Real Estate, KPMG in Germany, and Tom Kehoe, Managing Director, Global Head of Research and Communications, Alternative Investment Management Association (AIMA)

Musical intro

Announcer:

Hello, and welcome to “Global AM Perspectives”, a new KPMG podcast series for asset managers, fund managers and investors around the world.

Through discussions with leaders from KPMG and major market players, this series will include short episodes that look at some of the most pressing issues, emerging trends and market opportunities within the asset management, real estate and private equity industries.

In our second episode, Hans Volkert Volckens, Partner and Head of Asset Management and Real Estate, KPMG in Germany, and Tom Kehoe, Managing Director, Global Head of Research & Communications at the Alternative Investment Management Association (AIMA) will discuss the megatrends of the hedge fund industry, the influence of ESG regulation on hedge funds, and how hedge funds react in markets of inflated prices for equities, bonds and real estate.

With that, let’s turn to Hans and Tom.

Hans:

Tom, let me start by asking what are, from the hedge fund industry's view, what are the mega trends you're reacting to?

Tom:

Not surprisingly, these are the same mega trends that are impacting across wider society as well. These being the influence that technology has across the alternative investment management sector and the rise of responsible investment and ESG.

To take the first of these, we believe that technology will wield an even greater influence on the hedge fund industry. Artificial intelligence and machine learning will become a lot more important for hedge fund firms, forcing them to re-evaluate how they operate and invest. We see examples of machine learning being used with the recent pandemic. It's been a great testing ground to understand the usefulness of collecting these vast amounts of data. An often-quoted statistic that I like to mention as well, is that 90percent of the world's data of today has only become available in the last two years.

So, you have this force as well as the technological advances being made, which is really pushing the industry and society at large down this technological route. We would expect that the use of technology will become a lot more prominent across the industry. And, it won't just be the systematic and quantitative funds that will use this type of technology, but it will also feed right through to discretionary funds as well.

The events of the past year has further demonstrated how technology and the various roles of technology have been extremely effective in managing businesses, so we would expect to see an acceleration of the digitization trend across the hedge fund industry more globally.

Hans:

That's very interesting, as you say, because at KPMG we totally believe that technology will drive the industry in every aspect our clients are active in. And on the other side, it will also drive how we will have to deliver, how we will have to shape our services today, and ten years will look different than today. So investing in technology is something that is decisive. And one of the core elements to stay competitive for the clients, but also for KPMG.

But there is, of course, one other major trend we definitely have to discuss here in this podcast, which is ESG sustainable finance. And, of course, this is something where we see regulation coming up across the globe and a taxonomy develop in order to determine what is actually a sustainable product. What is a sustainable finance opportunity? And how are hedge funds dealing with the ESG debate across the globe?

Tom:

Environmental issues and social justice movements continue to dominate the news, so we would expect that this year, efforts will be ramped up to integrate ESG and responsible investment across investment products universally. Conversations are ongoing between managers and investors as to how managers can meet the requirements set by their investors to incorporate ESG factors into the various products that they offer now, and also any solutions being worked on so that every stakeholder in the industry, whether it's the asset manager, whether it's the investors, whether it's shareholders, whether it's the employees of the firm; they're all making ESG a pre-requisite.

I may remind listeners about a paper that we did with KPMG — this time last year we published it, which examines the rise of sustainable investing across the alternative asset management industry. Our research surveyed managers and investors across the AIMA membership, but also the KPMG client base — almost every hedge fund manager that we spoke to have made improvements to their ESG programs or had started an ESG program.

But, of course, ESG has been, and forms of ES and G, have been practiced by the hedge fund industry for many years already. The pandemic is going to have investors be more concerned about finding socially responsible and resilient businesses and we would expect there to be a doubling down on sustainable social issues and climate change.

Regarding the regulatory angle to all of this, it's really interesting what is happening globally in terms of attitudes towards ESG. What we are seeing now is that a lot of the impetus is still contractual ESG with investors, they being the ones who are driving the push for ESG and responsible investment globally. We do expect things to shift with the onset of regulation. Yet, there is this dichotomy of views from policy makers globally, as to what is the best action to take when it comes to implementing ESG and responsible investment.

Let's take the example of what's happening in Europe first, which is very much leading the way on sustainable investment. The European Commission's stated ambition is to integrate sustainability considerations into its financial policy framework, to mobilize finance for sustainable growth, and this entails new rules and changes via the EU sustainable finance action plan. And the regulatory pressure then, on environmental, social and governance issues, is strong and growing even stronger, from new rules around reporting on data and integrating it into investment decisions to the required disclosure around ESG risk analysis. And at that stage, asset managers are going to have to be public regarding what they are doing in terms of incorporating sustainability factors into their investment decisions. So, while some managers are already doing that behind the scenes, they are not particularly public about it. This is a game changer, because at that stage, they'll be forced to have to show their cards to everybody.

Hans:

And it's so important, I mean, when you, look at the European initiative, that we do have a level playing field, because otherwise we would have different KPIs, country by country, and thereby more intransparency than transparency. So, this is really a push towards a harmonized way of valuing sustainable financing.

Tom:

Exactly.

Hans:

And I think even beyond that we need to even cross continents in order to have a true global level field here in order to bring the necessary transparency to the table.

Tom:

Exactly. And I think there is -- well, certainly as part of this, we will see that move towards, as you've alluded to, this harmonization around reporting of risk, but also measures on how to collect that to, you know, definitions around all of these things now need to be put in place. It's a step in the right direction. However, we're not quite there yet and it will require the industry working with policy makers to get this reconciled.

Hans:

Yeah. Let's stay optimistic on that issue. You talked about the flow of capital, Tom, and let's take a look at the scenery we currently have, due to the low interest environment and the inflated prices. If you look at the equity side of the bonds side, definitely in the real estate side, almost across the globe. And we see traditional asset managers looking and evaluating whether it makes sense to take further products on board in order to create alpha. Listening to you, it seems that the hedge fund industry has enough opportunities to invest into transforming industries, or is there a similar situation that you've got to seek for new and further asset classes due to the fact that the low interest environment has led to prices and level of prices that become more and more unattractive?

Tom:

The past 18 months or so, and particularly in the last year, have offered a few signs that there are reasons to believe that the current financial cycle may be coming to an end. There have been several forecasts suggesting that that classic investor portfolio which would be made of equities and bonds, (the 60/40 portfolio), will return low single digits over the coming years. If so that would then halve the returns that they made in over the last 10 years.

And so given that outlook, diversifying investment strategies is more important than ever now, for investors that would be faced with managing portfolio risk, and also looking to identify solutions, as you've suggested, that would generate enough portfolio returns to support liabilities that they might have. Investors should then look beyond that classic portfolio of investment. And I would argue that those who believe that markets will exhibit increasing uncertainty and dispersion should then consider making an allocation to hedge funds and, and unconstrained strategies delivered by hedge funds.

And notably, we did some research about this at the end of last year, thinking about how hedge funds did in the first quarter of last year when the average hedge fund lost about 5-6 percent and equity markets were down 20 plus percent. Hedge funds did exactly what investors asked them to do, which is preserve capital, manage the draw downs, and historically they've been the best at doing that. Investors see the value from hedge funds and being able to manage risk.

Investment in infrastructure funds can offer investors access to investments with time spans that outlast equity and bond cycles. And then, on the credit side, many private credit hedge fund managers offer their investors exposure to a different part of the corporate world, like access to a liquidity premium, the excess returns gained by investing capital, patient capital, over the long term, while providing essential funding to a crucial pillar of the global economy. All of this, is really necessary as the global economy looks to recover from the COVID-19 pandemic.

Hans:

And that is so interesting, listening to you. I mean, when you take a look at the typical perception on the street, hedge funds are seen as the dark forces of the financial industry and especially in the last weeks, creating a lot of noise in the media. On the other side, I mean, they are an important part of the future balanced portfolio, as you said. They are financing the digital transformation of the global industry and they are trying to invest ESG compliant. So, hedge funds, it seems, the transformation of the global industry would not happen at that speed and that dimension, so they fulfil a very important function.

Tom:

It's interesting that you describe it as the dark forces of the investment industry. And, I've been in the industry long enough to recall certain policymakers calling them the locusts of society. These labels, particularly the dark forces of the investment industry are perpetuated by public perception, of course...

Hans:

Yes.

Tom:

...and accentuated by the popular media through Wall Street and the movies like Wall Street and The Big Short and The Billions Show.

Hans:

And even some politicians.

Tom:

Oh yeah, exactly. Don't get me wrong. I love these shows. They're great entertainment. But all of these portray hedge funds as being highly risky and highly secretive and highly speculative in their nature. The reality is that nothing could be further from the truth. You know, in terms of highly risky, yes, they lever, but the hedge fund on average would lever no more than the type of leverage you would take out if you were to purchase a house.

If you think about hedge funds over the longer term, going back 20 or 30 years, their risk is actually as low, and in some cases, some strategies are lower than what you would get from investing in a bond. So, you know, the opposite is quite the case. Actually, the risk from investing in the S&P 500 would be significantly more than you would get from investing in hedge funds. Are they highly secretive? Absolutely not. For years hedge funds have been regulated, having to report their positions to both regulators and investors.

One topic epitomizes the popular view regarding hedge funds more than anything else, and that is short selling. Going after short sellers is a recurring historic theme. As you've mentioned, with policymakers and some business leaders describing it as being anti-patriotic, and some people think its actions amount to betting on a company's failure, and that it’s somehow mean spirited to short sell. And why would you then look to have, or take a shot at a company that's trying to make a profit for its employees and shareholders? Why would you want to take it down? Like why is short selling so useful? And, you know, there have been big calls for it, over time, to be removed entirely. But all of this misses the essential point around short selling.

For most asset managers, it is an essential risk management tool. It's a tool that investment managers use to protect their investor's money and limit the risk of losses. It gives investors flexibility. It diversifies their income streams and is a smart way for them to express a sentiment other than saying everything is going up. And the reality is, as you know Hans, is that markets are inefficient and sometimes securities are mis-priced. And that's precisely why investors look to the hedge fund industry and asset managers to root out these kinds of inefficiencies and translate them into gains. If their analysis is right, they make a gain for the investor. If they call it wrong, they lose out. And doing it right, though, takes skill, expertise, a lot of sweat equity, and is fundamental to a healthy financial market.

Hans:

For me, looking from the other side, it is also a very important tool to force companies to transform into a better future; may it be on the digital road, may it be ESG compliant, may it be with competitive products. Short selling is the instrument where managers are forced to react, and therefore I think it is very important to keep it and have it as a tool in order to force the companies to change. And therefore, hedge funds use this tool actually over time in the best manner for the overall global industry.

Tom:

Precisely. The reality is that the hedge fund industry is full of people who are actually producing something. They’re producing cheaper capital for every company in the world by making markets more efficient. And in doing this, they are also producing excess returns or managing risk or both, that end-up being able to help the pensions of emergency workers, like nurses or fire officers or teachers, as well as supporting the endowments of universities, and supporting state pension plans. And all of these plans need investment returns, and hedge funds are there every day, looking to help them to do so.

Hans:

And they are not acting behind the curtain. They are acting in front. They are acting on the stage because most of the time, when they go into and invest and they make it public, they write to the local management, they force changes, they force reactions, and therefore, from my perspective, it is one of the most transparent ways of investing because you connect that with a direct link, a direct communication with local management.

Tom:

Could not agree more.

Hans:

Tom, thank you very much for your time and the very, very interesting insights you gave.

Tom:

Pleasure, thank you.

Announcer:

I am sure you will agree it was really interesting to hear from Tom and Hans, and on behalf of the listeners I would like to thank them both for taking the time to take part in this podcast.

To let us know what you think about this episode, or if you have any ideas for future episodes, please email us at assetmanagement@kpmg.com. And remember, you can find our latest publications, articles and other material on kpmg.com/assetmanagement.

Join us again next time as we'll continue to explore other top of mind issues within the asset management, real estate and private equity industries so stay tuned.

Thanks for listening.