VISION 2025

Perspectives of leading Australian investors in hedge funds

Australia Investor Advisory Group

ABOUT AIMA:

The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with more than 1,900 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than $2 trillion in hedge fund and private credit assets.

AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry.

AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 100 members that manage $350 billion of private credit assets globally.

AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors).

IMPORTANT NOTE:

AIMA MEMBERSHIP

AIMA's Global Reach

Did you know that AIMA members are entitled to a host of benefits?

Committees and Working Groups
Work towards new material on relevant and topical issues

Industry-Standard DDQs
Help with both manager and service provider selection

Events and Networking Opportunities
In 2017, AIMA held over 240 events globally

Access to Experts
One to one with AIMA, to discuss any regulatory queries

Sound Practice Guides
Used to assist implementation of sound policies and processes

Global Regulatory and Affairs
AIMA advocates on behalf of alternative investment managers with over 900 regulatory contacts

Research and Investor Guides
Thought leadership produced to educate and inform about the activities of the alternative investment sector

Communications
Regular updates via e-mail on AIMA's recent activity, to ensure members remain relevant

AIMA Journal
Quarterly online journal of articles exploring updates and issues affecting the alternative investment industry

To learn more about the benefits of AIMA membership,
please contact Michael Gallagher, General Manager, AIMA Australia

E-mail: mgallagher@aima.org

Tel: +61 4 1222 4400

AIMA

Dear Member,

One of AIMA Australia's key goals is to facilitate and develop closer ties to the investment community, both retail and institutional. In order to facilitate this, two years ago, we formed the AIMA Australia Investor Advisory Group (IAG). While this group is not a formal working sub-committee as such, its importance cannot be understated.

The objectives of this group include (but are not limited to) the following:

- Provide guidance on best practice for the local industry.
- Offer insights into product development gleaned from exposure to international firms and trends.
- Conduct a round table session from time to time with local managers on relevant topics.
- Suggest research the local industry might undertake to enable investors to better understand the industry.
- Assist in the planning for the AIMA Australia Annual Forum.

Eighteen months ago, the IAG produced the whitepaper "The Hedge Fund Managers' Guide to Australian Institutional Investors", an open assessment of what the institutional investor expects when considering an investment into hedge funds.

Last and this year the IAG has embarked on a couple of ambitious projects on behalf of you the membership. The first is organising the inaugural AIMA Australia Superannuation Trustees Alternative Funds Education Forum. This forum is where AIMA can help bridge the perceived gap between the Alternative Funds management industry and the Superannuation industry in a neutral non-confronting way with the eventual goal of the two groups having a better understanding of each other and potentially more mutual economic involvement.

The second initiative of the IAG is a flow on from the Hedge Fund Managers Guide and is a virtual roundtable getting into the minds of the IAG members and where they see our industry in 2025. Now while a lot of this paper is conjecture we think it will give a very good insight into what the institutional investor's mind set is and could well be a blue print of sorts for hedge fund firms that are making plans for the future.

Whilst this paper specifically hosts views from the Australian institutional investors community regarding the evolution of the hedge fund industry, it follows a broader initiative being pursued by AIMA to understand what the future holds for the hedge fund industry. Launching this work, AIMA published its seminal paper "Perspectives – industry leaders on the future of the hedge fund industry" The paper has received significant media coverage, and has been highly lauded by hedge fund managers, allocators, academics and policy-makers.

Like the Perspectives paper, we expect the virtual round table discussion from this piece will be thought provoking and, with feedback from you the membership, will provide some key topics that we can look to delve into more detail in the future including further thought pieces, roundtables, forums or general discussion topics.

We would like single out and thank the members of the Investor Advisory Group, who contributed to the virtual round table Chaired by Dr Alistair Rew (AMP Capital), David George (Future Fund), Bobby Pometkov (CSC) and Craig Stanford (Morningstar) and thanks to the other members of the Investor Advisory Group for their ongoing involvement and support.

We hope you enjoy the virtual round table and as usual all feedback is welcome.

Paul Chadwick
Managing Director,
Nanuk Asset Management
Chair, AIMA Australia

Michael Gallagher,
General Manager,
AIMA Australia

The paper can be downloaded for free at
https://www.aima.org/educate/aima-research/perspectives-research.html

CONTRIBUTORS

Dr Alistair Rew

IAG Chair, AIMA Australia
Head of Alpha Strategies, AMP Capital

Dr Alistair Rew is the chair of the AIMA Investor Advisory Group, which aims to bring the experiences and insights of large institutional investors to domestic and global alternative asset managers. Alistair has over 20 years global experience across the alternative investment management industry, including investment team building, coaching and development, the development of investment processes and decision frameworks, hedge fund and private equity investing, integrated portfolio and risk management, and the application of investment-focussed data, technology, analytics and visualisations in complementing and enhancing the performance of investment teams.

Alistair started his career in London on the trading floors of Kleinwort Benson and Barclays Capital before joining XL Capital Investment Partners in New York, where he was charged with heading up and building a highly regarded global hedge fund program and investment team.

Alistair currently works at AMP Capital as head of alpha strategies, focussed on the development of absolute risk and return, long only and long-short investment teams, capabilities and strategies across AMP Capital. As part of this, Alistair established and leads Cortex, a people, team, data and technology-centric strategy focussed on partnering and integrating with investment teams to deliver superior investment performance to the Firm's clients. Key elements of the strategy include leveraging data and technology to enhance portfolio and risk management decision making. Alistair leads a diverse multi-discipline team, bringing together complementary technical and human skills, including data science, technology, software development, research, visualisation, risk and portfolio management, and behavioural finance professionals.

Alistair has a PhD in Econometrics, an MSc in Finance and a BSc in Economics and Finance.

Bobby Pometkov

Senior Investment Manager,
Commonwealth Superannuation Corporation

Bobby Pometkov is a Senior Investment Manager at Commonwealth Superannuation Corporation (CSC). CSC is managing a number of retirement schemes for the Australian Government employees and members of the Australian Defence Force. CSC assets under management at present are approximately AUD 37 billion. Bobby is responsible for the absolute returns strategies of the firm and has been with with CSC since 2005. Prior to that he worked for Charlemagne Capital (IOM) Limited - Hebros Bank Jsc in the position of Manager of Product Management Department from 2002 until 2004. He holds a Masters Degree in International Management and from Maastricht University and a Masters Degree in Economics from UNSS Bobby also holds Grad. Diplomas in Finance and Psychology from ANU.

CONTRIBUTORS

Craig Stanford

Head of Alternative Investments,
Morningstar Investment Management

Craig is responsible for overseeing the group's alternative investments, including investment research and selection, as well as portfolio construction and portfolio management for the Ibbotson Alpha Strategies, Global Trading Strategies and Diversified Alternatives Trusts. Craig is also responsible for research projects into opportunistic investments, and is a member of Ibbotson's Asset Allocation and Risk & Portfolio Construction Committees. Craig has worked for Ellerston Capital in Sydney, ABN Amro in London., London & Capital as well as Notz, Stucki & Cie. He started his career in investment management in South Africa in 1996. Craig is the current Chair of AIMA Australia's Education committee.

David George

Deputy Chief Investment Officer, Public Markets,
Future Fund

David George is Deputy Chief Investment Officer, Public Markets, of Australia's Sovereign Wealth Fund, the Future Fund, valued at A$165.8 billion on 31 December 2017. The organisation is also responsible for the investment of the building Australia Fund, Education Investment Fund, Health and Hospitals Fund and the DisabilityCare Australia Fund. At 31 December 2017 these funds had a combined value of A$25.1 billion.

David joined the Future Fund in April 2008 and from 2013 has had responsibility for investments across the debt, cash and public market alternative investment programs. In March 2018 David took on the newly created role of Deputy Chief Investment Officer, Public Markets, which has oversight of the listed equity, debt, cash, hedge fund and derivative overlay investment activities.

Prior to joining the Future Fund, David was a Principal at Mercer Investment Consulting in Sydney and previously has held management and analytical roles at Mercer in Toronto, the Royal Bank of Canada and Integra Capital Management. David sits on the Board of the CAIA Association and is a Trustee of the Standards Board for Alternative Investments (SBAI). David earned a BA in Economics from Western University and is a CFA and CAIA charter holder.

HEDGE FUND INVESTING IN 2025 VERSUS TODAY

AIMA

How will investors approach hedge fund investing differently in 2025 versus today? What do you think the underlying drivers of these changes will be?

Bobby Pometkov

The institutionalization of the hedge fund industry will continue and the gap between hedge fund and traditional asset managers will close, especially for the big names. Investors will be more engaged and will seek customization and IP exchange bringing the investment process into their in-house investment process.

Craig Stanford

I hope that time, technology and education will help investors to better understand the real drivers of investment performance and how much of that is due to manager skill rather than exposure to a previously unidentified beta – this won't be unique to hedge funds, but will be seen across the investment landscape.

Not to say that exposure to some betas doesn't add value (especially where the end investor is unable to do so themselves) but the ability to isolate that will be an important component of calculating the managers true added value .

This will cause more fragmentation in the investment universe, between those managers that can demonstrate skill and those that can't, which will allow investors to make a more informed decision about how much that skill is worth to them.

This will impact fees, which will impact the business model and for many it will not be possible for them to continue as is – some will have to drop their fees and downsize, and others will have to leave the business.
As investors realize that the pool of alpha is more finite than the pool of managers you might find allocations to alternative beta and other diversifying assets become more interesting.

David George

Luckily 2025 is near enough that a few current trends are likely to remain in place. The first is that there will be less talk of 'investing in hedge funds' as an activity, as hedge fund strategies will continue to be divided into their building blocks (active management, alternative premia or factors). Further, those strategies will likely increasingly play a role across a wider segment of the institutional portfolio, versus being a discrete sector of their own.

No prizes for guessing the underlying driver, although fee efficiency does not necessarily mean less fees.
Investors will want to pay very low fees for markets they can buy in an index, low fees for factors or harvestable premia that can be systematically implemented, but will pay well for the error term beyond these, as that alpha is both scarce and likely to play an increasingly important role in meeting their long term objectives.

Dr Alistair Rew

I agree with the comments made by each of you and would go one step further – the notion of 'hedge funds' vs, for want of a better term, 'non-hedge funds' should disappear by 2025. We have seen these two ends of the investment management spectrum converge significantly over the last decade and I personally think that the term 'hedge fund' is no more than an outdated label, referring to some sort of different legal structure, usually accompanied by a higher fee structure.

As a result, and in combination with a number of other key industry trends, the more traditional asset class approach to portfolio and risk management and construction, where the portfolio is described as distinct buckets of equities, fixed income, credit, hedge funds, private equity, property and infrastructure, or similar naming conventions, will be far better integrated by 2025.

I expect that we will see a significant trend towards a more integrated, holistic, one-portfolio approach to investing and many of the traditional asset class silos will disappear. This should have a broad range of benefits for investors, ranging from the potential for superior portfolio construction, allocation and optimisation, to greater realisation of the diversification benefits inherent in a portfolio, to more effective use of fees in generating the best potential risk-return profile required by the investor's unique circumstances.

AIMA

In which ways do you think the hedge fund industry will be different in 2025 versus today? What are the core drivers of these changes?

Craig Stanford

It will be a lot less profitable for most managers, and I suspect there will be fewer investors. Hedge fund returns over cash (in aggregate), have been too low for too many years and I think many investors will grow tired of hearing the excuses. Perhaps institutions will continue to show support, but I think the aggregate level of returns is too low to retain everyone's interest.

In order to survive, some funds will become less protective of their 'IP', and align themselves to smaller pools of investors that are able to supply substantial amounts of capital, albeit at a lower fee. Perhaps these managers are brought 'in house'.

David George

In all likelihood the industry will be larger in terms of assets, but smaller by number of managers. There are a few drivers to this view. The first mainly comes from the smaller end, as the already escalating costs of regulation, compliance and reporting raise the breakeven size for many firms. The second is that supplementing the regulatory burden will be the competitive costs of alpha production, which I think will increasingly require investment in broader quantitative techniques and data acquisition. Finally, the institutional investor trend to manage fewer, broader and deeper investment manager relationships will continue to reward an ability to provide breadth, scale capacity and outstanding service.

Dr Alistair Rew

In most cases and on balance, I think the hedge fund industry is unlikely to be seen as a distinct component of the investment management industry. Instead, 'hedge fund' strategies are likely to be managed by teams that are increasingly part of global, multi-discipline, institutional, investment management firms. I expect such firms would offer access to a broad set of building blocks and solutions across all risk-return, fee, liquidity combinations and spectrums to satisfy the demands of their clients.

It's likely there will be a small group of managers, who I suspect will run much higher risk profiles than most other managers, perhaps more akin to the industry in its infancy, who may still fall into a distinct group; perhaps we continue to call these hedge funds? However, I suspect that such managers will withdraw from the mainstream client base and focus on more niche investors; perhaps high net worth clients, friends and families.

Given this, I would expect further consolidation across the industry. Capacity constrained strategies and teams may merge and form multi-manager platforms. Other more scalable strategies and teams may join large investment management firms. Smaller firms are likely to have a very difficult time staying in business.
As I see it, industry change is being driven by a confluence of factors which are converging at the same time: material advances in data & technology; the changing nature of the knowledge, skills, education and academic research across the investment management industry; the greater attention to fees and costs; greater regulation and the desire to have more flexible solutions and tailoring of portfolios to individual client needs. The run into 2025 is going to be really exciting as all these factors interact and reshape the industry.

Bobby Pometkov

There will be a lot of small managers struggling to raise money and a few household names will also struggle going forward. Hedge fund strategies will be challenged not so by the passive and ETF investments but by the IT and quant based strategies, especially as computing capabilities increase exponentially. Price discovery will become much faster – therefore challenging some strategies, specifically arbitrage and relative value strategies.

IMPACT OF TECHNOLOGY

How do you think technology will impact the way hedge funds evolve and implement their investment strategies in 2025?

David George

It would be hard to understate the impact technology will have, in a variety of ways. Data is the primary culprit, as the explosion of available data creates a necessity for managers to determine what to do with it. Ignoring developments is unlikely to pay, while the choices to be made about what data, and what to do with it, will require increasing comfort with quantitative techniques within the investment process. As a positive, it is likely that an ecosystem of vendors and service providers will enable adoption by managers willing to invest smartly. The most difficult part of this may be separating the hyperbole from valuable insight applied to the investment process.

Dr Alistair Rew

Technology and data should be one of the main areas that all investment firms are focussed on today and going forward. While the benefits of lower costs and more efficient processes attributable to technology are clearly understood by most investment management firms, there exists only a small proportion of the industry who have truly integrated technology into the operating model of their investment process. Those firms who have established a culture of data, technology and quantitative decision making are the new industry leaders and will continue to invest in these areas which are fundamental components of their DNA. However, those firms and strategies that have historically been more qualitative in their approach should look to build out an integrated data, technology, portfolio and risk management strategy and ensure that this becomes core to what they do.

The significant advances in technology, computing power, data storage, data sets, the internet of things, artificial intelligence and machine learning should lead to some unique opportunities across the industry. At the most basic level technology must be used to improve all we do today, from security selection, to risk and portfolio management through to how we engage and share with clients.

Bobby Pometkov

Managers will have to adapt their process and risk management in particular to be able to navigate the challenges into the future. I also think that high turnover and short term focused strategies will be challenged.

Craig Stanford

There are a few levels to consider here. In terms of cybersecurity, it will be more important for everyone.

In terms of the strategy itself, it will come down to specifics (how much the strategy depends on new/unique datasets, fast identification of imbalances, execution speed etc.) so for some it will be a threat but it will be an opportunity for others.

I would suspect that the pace of innovation will continue to climb, and that parts of the industry will change faster than we can imagine.

What do you think a hedge fund managers investment team will look like in 2025, what are the key differences versus today and why will these changes happen?

Dr Alistair Rew

I'd expect significantly more technology, data and visualisation specialists embedded in, and integrated with, investment teams with the aim to complement and enhance decision making across all aspects of the investment process. Simultaneously I would not be surprised to see a growing use of behavioural finance experts, performance coaches, psychologists and the like to further analyse and enhance decision making by both individuals and teams. An increase in the breadth of skills, personality types, learning and problem solving abilities will become increasingly crucial for investment teams to succeed.

Bobby Pometkov

More compliance and more IT (either for investment strategy and risk or just to manage the increased information flows and risks/cybersecurity) staff will be needed.

Craig Stanford

I think that there will be a real hollowing out of the industry, and that fees will be much more closely related to value added. In such an environment, only the fittest will thrive.

David George

Following on from the answer above, the proportion of front office personnel bringing quantitative application to data gathering, analysis and portfolio construction will grow. This is not to say that discretionary and qualitative approaches to selection and research will go away, but there will be more attempts to combine these with quantitative tools for better outcomes.

FEES, REVENUES AND COSTS IN 2025

Given changing client needs and demands, the impact of technology and data, regulatory change, how do you think this will impact fees / revenues and costs? What are the implications of this on managers and the industry?

Bobby Pometkov

Alpha will be smaller, faster to arbitrage and identify. Therefore returns would be lower (if alpha only) and that will put pressure on fees, but the Hedge funds that still have an edge, competitive advantage or high barriers to entry or are just popular from AA point of view will still be able to charge higher fees. Supply and demand rules will still work.

Craig Stanford

I doubt regulation will decrease, but perhaps technology can be leveraged to improve implementation so that costs to comply don't increase as fast, or actually fall.

David George

To the extent this hasn't already happened, the 2/20 model will be increasingly consigned to history.
Better technology in terms of techniques for evaluating performance track records already provides a clearer view of beta, factor and alpha elements. Aligning fees to each will bring more variety to fee schedules, but also bring more investors to the sector as the ability to demonstrate value becomes clearer. As a final note, that variety will be on both sides of 2/20, as where alpha exists in quantity and with consistency the model will trend toward an alpha share concept.

Dr Alistair Rew

On average fees are likely to be lower than they are today and the focus will be on paying for alpha, with zero fee for betas or risk premiums. However, those teams that can demonstrate consistent alpha should be able to distinguish themselves from those that don't and I suspect that the fee-for-alpha they can charge will actually increase. By 2025 it would be nice to have a solid rationale for what the share of alpha should be between the client and the manager.

The cost side is interesting. I feel that there are many areas for efficiency gains across the industry; technology and data should allow for more of this to be realised. In the near term greater demands from all stakeholders will result in more investment and greater cost but hopefully this can be materially offset in the medium term by efficiency gains from the application of improved technology and operating models.

Perhaps by 2025 the use of spreadsheets will be significantly lower than today – now that would be a big win from a perspective of simplification and reduction in costs, risks and inefficiency!

AIMA

What do you think managers should be doing to position themselves now for what the industry will look like in 5-10 years time?

Craig Stanford

Start generating actual alpha, or start pricing your beta accordingly.

David George

Two things stand out for me. In the first I would encourage managers to think deeply about their value proposition to investors, clarifying where their competitive strengths are and how that is being delivered in the context of a marketplace that is increasingly parsing beta, alpha, and other alternative factors. Does their strategy speak to one or a blend of those, and is their pricing likely to seem appropriate? The second area relates to those choices to be made around data and technology. These should be embraced as opportunities to improve the investment process and client service.

Dr Alistair Rew

Firstly, I'd suggest that managers embrace, rather than fight, the ongoing changes that are influencing the industry, and in this context rethink what their overall value proposition is to their end investor base. Secondly, regardless of background or strategy, embrace and invest in investment technology, data and expert resources – make this central to all stages of the investment process to enhance investment decision making in the pursuit of superior investment outcomes for clients.

Bobby Pometkov

Managers should adapt to changing environment and not be stubborn and blame the environment. Managers are generally stingy, but they should invest in resources to address the ever-changing changing environment (either from IT point or regulatory of view) Managers should also look for business stability, either through diversification or having strategic relationships. I think this will become more important and managers will have to be more nimble and innovative in the way they align their and the investors interests.

AIMA AUSTRALIA
Tel: +61 412 224 400
Email: apac@aima.org