Your ESG partner

We are at the cutting edge of sustainable investing and ESG regulation for hedge fund managers.

Our team of specialists deliver strategic advice to the world's largest managers.

Contact Lucian Firth or Nick Colston to find out what you need to do ahead of the **10 March 2021** deadline.

lucian.firth@simmons-simmons.com
nicholas.colston@simmons-simmons.com

simmons-simmons.com

THE FUTURE OF HEDGE FUNDS

Sarah Crabb
Partner
Simmons & Simmons LLP

Devarshi Saksena
Partner
Simmons & Simmons LLP

Lucian Firth
Partner
Simmons & Simmons LLP

Leading the market for the past thirty years, the hedge funds team at Simmons & Simmons is perfectly placed to advise the market on navigating the opportunities and challenges for hedge funds over the next five years.

The Simmons & Simmons hedge funds team in London is led by Richard Perry, Iain Cullen, Dev Saksena, Lucian Firth and Sarah Crabb. The team sets out its five key predictions for the future of hedge funds over the next five years below.

1. Greater fund customisation

In an extremely competitive landscape for raising capital, managers are under pressure to tailor offerings to the specific needs of potential investors. We see no indication that the trend for greater customisation will slow down over the next five years.

Allocators have increased bargaining power, as evidenced in recent years by fee rate compression, and managers offering bespoke fee deals in exchange for large tickets will inevitably continue.

Increased desire for investor control and oversight will likely prevail. Managers willing to consider setting up managed accounts and funds of one to accommodate the wishes of strategic investors will continue to rise, regardless of the operational complexities and conflicts of interest that can occur when managed alongside commingled funds. Similarly the recent trend for hedge fund co-investments, which are typically associated with the illiquid end of the investment spectrum, is expected to continue. Co-investments provide investors with the right to co-invest alongside the manager's fund, into which the investor may or may not have themselves invested.

Co-investments usually arise where the allocation to the fund is too large or where the fund is limited by investment restrictions such that the fund can only accept a portion of the proposed allocation (if at all).

Previously choice of fund structure and domicile was largely investor driven. Fund structures are now increasingly fragmented and there is no longer a "one size fits all" approach. Regulation, tax and macro-politics influence the choice of structure far more than ever before.

For example, if a fund invests in credit or a manager wants to access European investors then structuring an onshore fund in Europe might be preferred but if a fund has a non-credit strategy or a manager wants to structure "out" of Brexit then an offshore Cayman Islands' launch may make sense.

2. Renewed importance of the seed investor

In recent years, we have seen fewer but higher calibre start-up managers. Two to three years ago, managers were mainly launching autonomously.

Barriers to entry such as increased regulatory burden, compliance costs and the impact of Covid-19 on investor appetite to allocate to new managers, means we are now seeing more demand for seed deals in start-up conversations.

Our prediction is that emerging managers are likely to require committed seed capital prior to pressing ahead with the cost and expense of launching a fund independently which may or may not be successful in attracting external capital.

If seed capital is not a given, portfolio managers might be more encouraged to join a platform or an established manager to manage a particular fund or strategy with a remuneration package that is directly linked to the profits of the fund or strategy.

We also predict a prevalence in seeders investing in more distressed funds managed by mature managers.

These so-called stabilisation investments can make sense for seeders as they choose to invest in funds managed by a manager with a proven track record and existing infrastructure in return for a slice of the manager's economic returns.

3. Emphasis on responsible investment and ESG

A big talking point in the industry in 2020 has been responsible investment and environmental, social and governance (ESG) and how these apply to hedge funds.

Reports of better risk-adjusted returns and increased net flows into sustainable funds, coupled with increased investor expectations from both large and next-generation investors around consideration of ESG factors lead to our prediction that many managers will incorporate ESG principles into their investment philosophies over the next five years.

This is supported by increased ESG focus from global regulators, including the introduction of EU ESG legislation - the EU Sustainable Finance Disclosure Regulation being the first to apply from Q1 2021.

As a result of continued focus from investors and regulators, we expect managers to embed processes to consider governance, culture and diversity much more readily in their own firm structures.

4. Diversification of asset classes

As managers seek to optimise returns, we predict a renewed focus on diversification of asset classes and investment strategies over the next five years with managers looking to non-traditional asset classes.

As part of this diversification, we note that both established and emerging managers are incorporating digital assets and gold into their investment universe.

Although historically volatile, Bitcoin has demonstrated a meaningful diversification effect for portfolios in recent times and certain managers have looked to digital assets and gold as a hedge against inflationary risks.

Employing derivatives within a portfolio can be a way to obtain exposure to the upside without encountering some of the complexities of investing directly in assets such as cryptocurrencies and gold.

5. Consolidation within the asset management sector

Our final prediction for the next five years is further consolidation within the sector. Movement of portfolio management teams will likely increase as established managers seek to acquire capabilities rather than invest time and capital in organic growth.

Increased competitive pressure and rising compliance costs, together with continued downward pressure on fees, will likely lead to accelerated consolidation amongst managers.

Our specialist asset management M&A team is seeing increased activity in this area and expects a wave of further activity as smaller managers navigate the aftermath of COVID-19.

This repeats a trend for increased M&A activity in the sector that was seen following the turbulence of the 2008-2009 financial crisis.

Final word

Hedge funds have evolved considerably over the past three decades and will continue to do so over the next five years to continue to attract investment and meet investor needs.