SURVIVAL OF THE FITTEST

Hedge funds are forcing institutional investors to evolve.

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As institutions enter the hedge fund business, four trends are forcing change in the interaction between the principal participants in the institutional investment space: consultants, plan sponsors and investment managers.

Change in mandates

It will now be possible to clearly separate the provision of alpha from beta. There will be managers willing to provide beta at a low fixed fee and others providing alpha at a higher performance-based fee. This trend has been in place for some time and will become accentuated in the future. The alpha mandates will be less style box agnostic while beta managers will continue to adhere to the traditional classifications.

Demand for quality

Demand for high qualty funds which define and adhere to clearly defined measures of risk and return will increase. Restrictions will include limits on ex ante tracking error, leverage, investment universe and a very clear specification of all sources of tail risk. Sponsors will strongly prefer to have very little tail risk because it has been a consistent source of fund blowups in the past.

Sponsors will also demand a greater degree of transparency in the investment management process and holdings. Strategies based upon complex derivatives that cannot be easily understood will not be viewed favourably, as they constitute a potential source of considerable tail risk.

Complexity for consultants

Successful consultants will be viewed as active participants in the investment process. They will be made responsible for monitoring manager deviations from guidelines—much like the role currently played by fund of funds. Given capacity restrictions and the transitory nature of alpha, manager turnover will be higher and average tenure lower than in the traditional process. Search activity will be continuous and the concept of farm teams will become common so as to ensure a dependable source of new managers. For this extended role, it is likely that consultants will be paid a share of the performance fees in addition to a fixed fee.

Culture change

Investment firms will migrate from a culture of a few senior managers with long tenure presiding over large pools of assets and staff to many investment teams presiding over small pools of assets. There will be less taboo attached to turnover at investment firms as long as it is driven by performance considerations.

This shift to a performance-based culture will lead to investment staff getting a larger share of firm profits. Longevity of managers in the business will signal a presence of skill rather than luck, connections or a desire to signal stability of personnel.

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The rising returns to providers of intellectual capital, combined with performance-based fees, and a more accurate attribution between skill and luck, will lead to better industry dynamics. The better managers—those who are more confident about their skill—will offer their services. Those who are not will find it less profitable to throw darts when it comes to making investment choices. This reduction in moral hazard will lead to a reduction in the total fee paid for managing assets, albeit with a better allocation across the principals and their agents. In this, the asset management industry will follow the time-honoured principles of how industries mature, with the share of profits changing as a function of this natural evolution. ∎