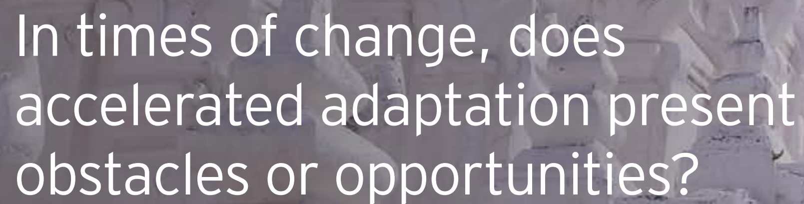
In times of change, does accelerated adaptation present obstacles or opportunities?

The alternative asset management industry faced 2020's challenges and took control of change by remaining resilient, leveraging technology and transforming to drive sustained value creation.

2020 Global Alternative Fund Survey



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EY 2020 Global Alternative Fund Survey contents

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Executive summary

Almost universal agreement can be reached on one issue: 2020 was not business as usual. The year started smoothly in the realm of financial markets and economic indicators. Many asset classes and indices grew from the year's start through mid-February, but in early March the grasp and reality of the COVID-19 pandemic overwhelmed most major cities. Most financial markets screeched to a halt, ending the longest bull market in modern history. In short order, the world swung to the extreme, from record-low unemployment to record highs, from growing GDPs to many that came to an abrupt stop. All of this disrupted the financial markets and global economies and strained and challenged companies' operating models. It quickly became a year that tested – and rewarded – resiliency, and the alternatives industry persevered to overcome obstacles and seize opportunities.

While the market volatility and global uncertainty have clouded the outlook for many, alternative fund performance has shined. Managers largely demonstrated their ability to position portfolios during periods of volatility in a manner that minimized risk while also being opportunistic in taking advantage of temporary market dislocations to drive value for their investors. During the peak market volatility in early 2020, on average, almost all alternative fund strategies significantly exceeded major benchmarks. This performance did not go unnoticed by investors, with the vast majority indicating their alternative managers met or exceeded performance expectations during the period.

Not business as usual took hold and remained. In addition to uncertain market conditions, which resulted in significantly larger trading volumes, the relatively new and forced "work-from-home" concept reshaped how managers conducted business. All aspects of fund management were strained, from portfolio construction among front-office teams used to collaborating in person to investor engagement and due diligence that traditionally relied upon face-to-face meetings and talent acquisition and development at all levels of the organization that were normally facilitated via interaction in the office. By leaning in and accelerating adaptations in technology, automation and outsourcing, alternative fund managers were able to capture consistency in business operations and reporting and move forward with digitalization all while continuing to deliver on the client service needs of their customers – their investors. The strength in operations during this uncertain period has shined a light on future possibilities via enhanced investment and leveraging of data, technology and remote working capabilities, resulting in many managers reimagining the future work environment.

Our 14th annual EY Global Alternative Fund Survey offers a holistic view of alternative fund managers, as well as institutional investors who allocate to these asset classes. In such a trying year for businesses and families, we extend our profound appreciation and gratitude to the many managers and investors who took the time to provide their insights and concerns into the direction and development of this survey. We also extend a hearty "Thank you" to the more than 230 managers and 70 investors who provided sweeping details and pinpoint responses to provide results that will serve to the betterment of all. We believe this instrument will help you and your wider teams with your quest to accelerate toward achieving prosperity and sustainability.

Key observations

The alternative markets' year has been defined by how the industry leaned into and was resilient in the face of a number of disruptions that directly impacted the financial markets, managers' operating model, and every individual who works for or allocates to alternative asset managers. 2020's disruptions, specifically the COVID-19 pandemic, but also societal movements related to race relations and equality and a number of geopolitical events, changed working conditions; created increased market volatility; shined a light on the environmental, social and governance (ESG) considerations of managers and the companies they invest in; and forced managers to pivot strategies and offerings based on expectations of investors. 2020 rewarded those that planned accordingly, embraced technology, delivered outstanding client service and remained resilient. In a year where many industries fell into the shadows of disruption and failed to adjust to market conditions, industry alterations and customer demands, the alternative markets benefited from technology investments and teams that embraced change as a way of reshaping and remaining necessary to preserving and growing their investors' capital.

Allocations and product offerings

While 2020 has been unique for many reasons, the ongoing variation and extension of alternative fund managers' product offerings are on par with years prior with a continuation of convergence and diversification of offerings. Unsurprisingly, all alternative funds are focused on asset growth; somewhat surprisingly, many are optimistic despite the pandemic. Many managers are expanding strategies and structures and leveraging investor enthusiasm for customized products. Commingled offerings continue to represent the largest share of industry assets; however, growth continues to occur in separately managed accounts and newer structures such as co-investment vehicles, special purpose acquisition companies (SPACs) and strategies built around ESG considerations. Investors continue to embrace less liquid strategies, as allocations continue to grow to private equity and private credit. The return profiles of these products continue to be viewed favorably by investors who are willing to commit their capital to products expected to have a longer time horizon and typically less frequent redemption terms compared with traditional liquid hedge funds. The outlook for alternatives remains bullish as their positive performance during the market volatility of 2020 increased investor enthusiasm. In fact, many allocators expect to increase allocations to alternative fund managers as a direct result of how their managers navigated the uncertain markets that this year presented.

ESG

The calls for being better "corporate citizens" from business organizations, shareholders, government agencies, employees and others are growing. The quest to make advancements on ESG concerns, which to date have been slow to gain traction within alternatives, has not been lost on investors or managers. Gaining in importance on a global front, the alternative industry's resiliency to the effects of the COVID-19 pandemic have forwarded their ESG journey: restricted travel and work-from-home mandates have lessened carbon footprints, internal and external views have shaped investment approaches, digitalization is removing bias, and diversity is a broader and expanding part of talent. Investors understand ESG issues within a corporate philosophy, and managers are gaining competitive advantage by strategizing internally with ESG in view and launching ESG-friendly products. With the proportion of investors looking to invest in ESG products projected to nearly double in the next two years, the advantage of leading in this charge can serve as a badge of distinction by drawing and retaining key talent and investors. European investors and managers have regionally embraced ESG ahead of their global peers. But as environmental issues and social justice platforms continue to dominate the front pages, coupled with the fact that good governance practice and risk mitigation have global appeal and prove to positively impact performance, the forward thrust will only continue universally in all regions.

Talent

In any industry that thrives on intelligence and technology, skills evolve and are created anew to realize a need or exploit a trend. The alternative market is a numbers-based, people-needing industry driven by gaining value and outperforming the competition. Therefore, teams need experience, fresh insights and aptitude in what the market demands, which now includes professionals that touch technology, sciences, engineering and automation. In a year that rewarded resourcefulness and accelerated adaptation while testing professional acuity and agility, the industry largely answered the call. In the ever-widening scope of diversity and inclusiveness, the results were upward, albeit still showing significant room for future improvement. While overall organizational success has not diminished via the current work-from-home norms, talent models, in particular, talent development and firm cultural goals, have been strained. Remote working has amplified one benefit – potential boundary-less pools of talent to draw from for talent needs. While this trend is in the early innings of being leveraged by alternative fund managers, firms aren't bound to attracting talent from the traditional major financial markets where they are headquartered. Virtual capabilities are enabling talent that can be pulled from geographically diverse locations that would have been off the radar of alternative fund managers less than a year ago.

Continued focus on data, technology and automation

As the reach of the COVID-19 pandemic became more and more apparent, the need to be resilient accelerated the need to leverage data, technology and automation. Managers have long embraced the merits and profit-enhancing capabilities of the three, but the pandemic fueled the need to advance these tools from pieces in the alternatives industry into game-changers. Hedge funds managers have traditionally led the charge in the deployment of automation and artificial intelligence to combat fee shifts, gain efficiencies and make more informed investment decisions. However, other alternative asset classes are adapting these tools and techniques to their business models and are similarly transforming their operations. The push to free up talent from the mundane, low-value manual tasks to be more value-adding to the operations further exposed the benefits of robotic process automation, blockchain technology or machine learning. The ability to capture more and more data is growing, and the cost of not having a data strategy and governance process only increases. Leveraging data for portfolio construction has become a norm within alternative asset management; forward-looking managers are building teams to analyze data in a fashion that predicts investor behavior and/or analyze their own internal operations to identify efficiencies. Doing more with less, and faster, equals opportunities and profits.

Future outlook

COVID-19 and other disruptions during 2020 impacted the viability of many industries and companies. Alternative fund managers embraced resiliency and largely weathered the storm that this year has brought. This performance, both portfolio returns and operational execution, developed momentum for the industry moving forward that will lift the prospects for many managers. Those who continue to apply some of the lessons learned this year around evolving investor product needs and expectations, data and technology transformation, embracing more diverse talent, and being nimble and willing to embrace new trends will distance themselves from the pack and best position their business for years to come.

Alternative fund managers' resiliency in facing COVID-19

The first six weeks of 2020 got off to a smooth start as far as financial markets and economic indicators were concerned. Many asset classes and indices steadily rose through mid-February despite geopolitical uncertainty and ongoing social unrest. In late February and early March, the explosion of COVID-19 in most major cities disrupted all financial markets and global economies. Operating models were strained as even the best planned disaster recovery strategies did not contemplate a global pandemic. Financial markets experienced significant volatility as everyone attempted to assess the magnitude and duration that COVID-19 would disrupt our lives. As the months have gone by, different geographies and industries have been more impacted than others and are farther along in returning to some sense of normalcy. A retrospective analysis of the global alternative fund industry identifies that managers performed, both operationally and financially on behalf of their partners/shareholders, in an exemplary fashion. Resiliency is just one adjective that can be used to describe how managers and their teams leaned in to working remotely to continue delivering outstanding service to their partners and other constituents. Years of investing in technology and outsourcing permitted operations to continue without missing a beat. Active manager performance was also strong, particularly in late Q1 and early Q2 when market volatility was most extreme, once again demonstrating the value of active management in periods of market dislocations.

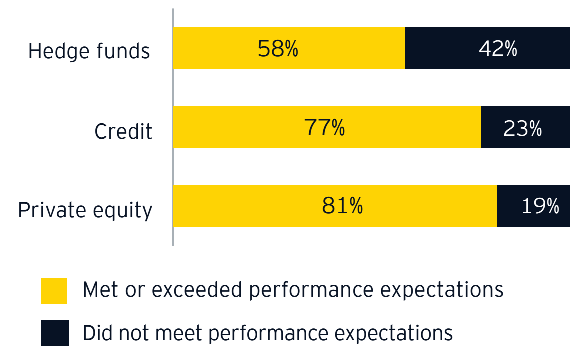
Alternatives outperform relative to expectations during COVID-19

2020 has been like no other time in recent history. The rapid global spread of COVID-19 caused the World Health Organization to declare a global pandemic, causing a massive and sudden shift to remote working and grinding the world economy to a halt. Global markets crashed, ending the longest bull market in modern history, while unemployment skyrocketed with an extremely unclear outlook of what the future would present. Market volatility and uncertainty have persisted, and alternative fund performance has shined.

Investors generally felt that their managers outperformed their performance expectations during COVID-19, especially in private equity, where a ratio of 4:1 felt their managers outperformed expectations. Hedge fund performance varied by strategy, but on average almost all significantly exceeded major benchmarks. When major indices were down 15%–20% in early 2020, many hedge funds were only down low single digits. Funds demonstrated their value in preserving capital in the downturn while opportunistically stepping in to capitalize on market dislocations.

Investors

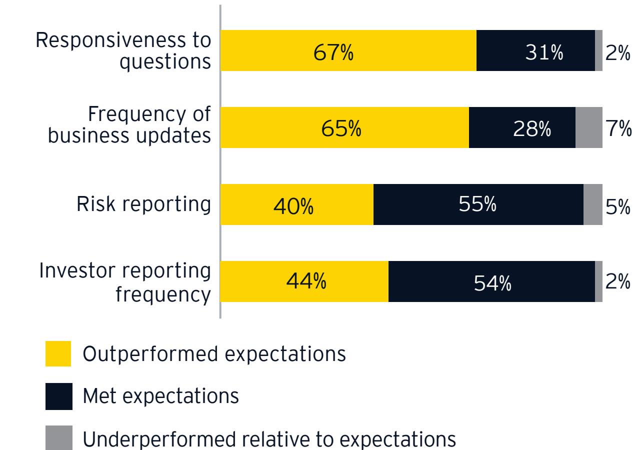
How do you feel each of the following asset classes performed (i.e., rate of return) during the COVID-19 market turmoil?



Client service exceeded investors expectations for the alternatives industry during the COVID-19 market turmoil

Investors

How would you rate your alternative managers on each of the following aspects of client service relative to your expectations during the COVID-19 crisis?



With the extreme levels of market volatility, increased trading volumes and the disruption to society as a whole, including a mostly remote workforce, investors were generally pleased with how alternative fund managers operated their firms during the crisis.

Investors generally felt that managers went above and beyond to be responsive to their questions and provided more frequent updates on the business and performance during the height of the turmoil. In fact, only a small percentage of investors felt their managers did not meet their client service needs during this period.

Managers recognized the need to be proactive with their investors during this period, and those who have been investing in technology, automation and outsourcing were able to leverage various tools to enable consistent business operations and reporting.

In addition to managers being responsive to their clients, service providers also received high marks. Very few managers noticed any disruption to the level of support they received from their service providers.

Remote due diligence and investor engagement managed well, although new relationships presented some challenges

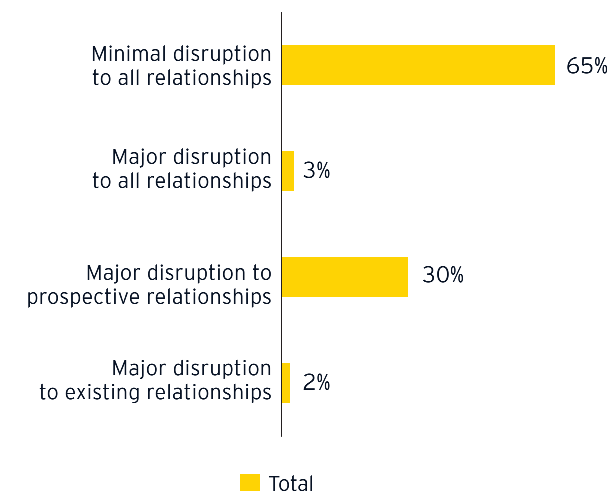
Immediate questions arose as to how fund managers and investors would be impacted by their inability to meet in person to discuss potential allocations and conduct due diligence. Understandably, there were differences in the impact to maintaining existing relationships compared with cultivating new ones.

Nearly 60% of investors surveyed noted that there were at least minor disruptions to due diligence processes as a result of going remote, although newer relationships were most strained with 30% of managers responding that travel restrictions caused major disruption to prospective limited partners. As some investors are unwilling to invest in a new manager without an on-site visit and other limited partners require extensive vetting of new managers prior to an allocation under normal circumstances, it's not surprising that managers leaned on their existing relationships more heavily during COVID-19 to raise assets. This situation adversely affected managers with a smaller client base compared with larger managers with a well-established investor base as they brought new products to market.

Given the expected longevity of travel restrictions and extended remote working environments, managers have been investing in transforming their investor relations and marketing functions to promote a more remote fundraising environment. All of this has resulted in managers revisiting and accelerating their digitalization plans.

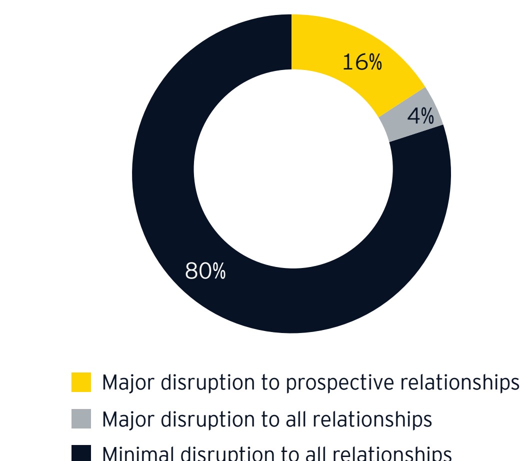
All alternative funds

How has remote working with travel restrictions impacted your ability to engage with investors?



Investors

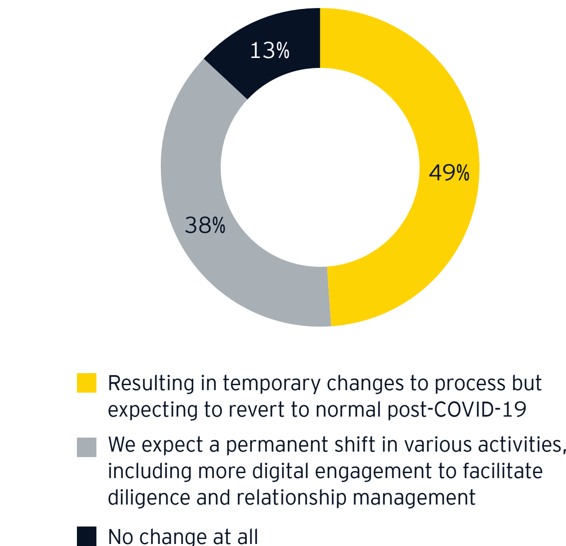
How has the trend towards remote working impacted your relationships and engagement with your existing and prospective alternative managers?



Some managers and allocators optimistic that marketing activities will return to normal, although others are planning for a more digital future

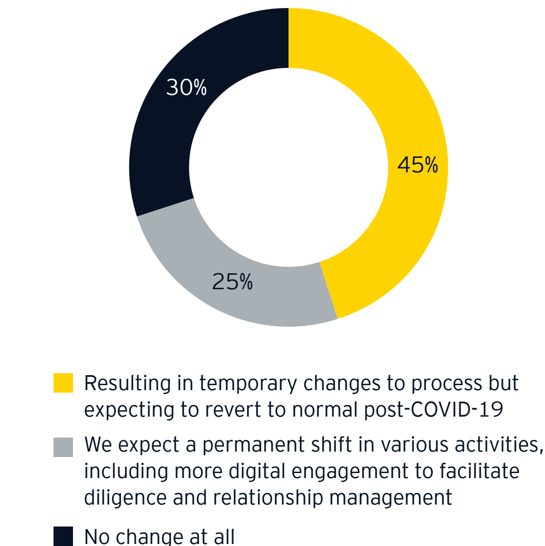
All alternative funds

How have remote working, limited travel and minimal on-site visits impacted your marketing activities?



Investors

How have remote working and travel restrictions impacted your due diligence with prospective managers?



Despite how successful managers were in making immediate changes in response to the crisis, such as embracing electronic document sharing and virtual meetings and walk-throughs, many are hoping for a return to business as usual. In fact, nearly two in three managers and three in four investors responded that the changes made during the COVID-19 turmoil are temporary in nature or they are expecting no changes at all.

This view of investor relations and marketing may be shortsighted. In all industries, remote work and stay-at-home orders have accelerated the digitization trend, with customers becoming more accustomed to these types of experiences. The success of remote work and wide-scale adoption of video conferencing across all generations have challenged the fundamental necessity and the frequency of in-person meetings. In the alternatives industry, a more digitized and virtual investor relations function allows for managers to connect with a larger number of potential allocators in a more cost-effective manner. Without constraints of travel schedules and in-person meetings, this environment is arguably more efficient. Additionally, as managers and investors alike continue on their environmental, social and governance (ESG) journey (which we explore later on in this survey), restricted and limited travel are positive ESG factors that could assist in achieving carbon neutrality.

Marketing and investor relations is the least automated functional area

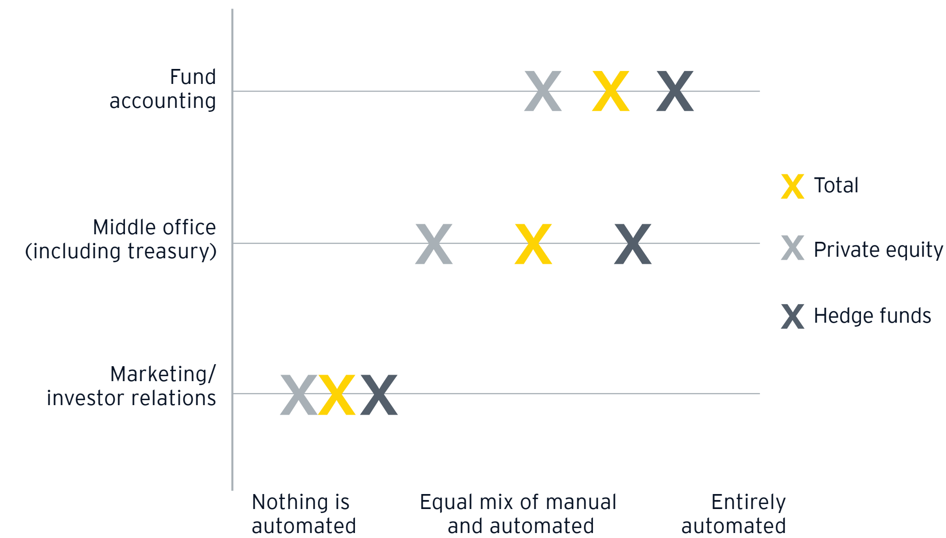
If an increasing digital experience and tailored offerings will be an area where managers can differentiate themselves, the first step is managing data and automating standard processes. In this regard, the industry has a long way to go, specifically in the marketing and investor relations groups.

Managers (particularly private equity managers) admit that most functions involve more manual processes than perhaps are necessary. Fund accounting and middle office are the most advanced functions where for years managers have invested to streamline timely and accurate reporting. However, the marketing and investor relations functions have largely maintained their status quo as a manual-intensive process. Although a high-touch personal experience is needed, that experience can be enhanced by technology and meaningful investor reporting.

Particularly given the challenges this environment has posed with creating new relationships, and the acknowledgment that existing relationships are becoming more bespoke and expecting of an enhanced client experience, managers can not afford to neglect the transformation needed.

All alternative funds

Using the following scale, which of the following best describes the level of automation for processes that are currently conducted in-house in each of the following functional areas?



Alternative managers have the opportunity to invest in technology to better meet their clients' needs

Investors

Using the following scale, how would you describe your typical alternative managers' digital infrastructure to support investors' needs?

Given the lack of automation that managers stated for their marketing and investor relations function, it is not surprising that the majority of investors stated there is a need for increased digital infrastructure from their managers. Nearly two-thirds of investors believe an investment in this area would be beneficial to the future relationship. Investors felt that hedge funds have made better progress, with 39% of investors stating that their digital infrastructure was highly advanced, while only 34% said the same of private equity.

As raising assets continues to be paramount to managers' strategic priorities, increased digitization of investor data to perform targeted marketing and product development is an avenue managers should explore. It's also an area that traditional asset managers have been significantly investing in to attract assets (i.e., think of target date funds and other products aligned based on the demographics of their customers). As alternative managers continue to try and access new limited partner (LP) populations, including retail and newly determined accredited investors, they must manage the changing expectations of investors' expectations of their digital infrastructure.

Allocations and product offering trends

For years we have been seeing both subtle and significant changes in the products that investors are allocating to as well as the development of new offerings from managers looking to capture this sentiment. 2020 has been unique for many reasons, but the continued transformation of alternative fund managers' product offerings is no different than prior years. The industry continues a theme of convergence and diversification of offerings where single strategy offerings are limited to smaller or boutique managers. The largest managers, and those looking to grow, are doing so via an expanded menu of strategies and structures, tapping into continued investor enthusiasm for customized products. A broad theme has been continued interest in less liquid asset classes. Flows to private equity have been robust based on years of outperformance of this asset class. Private credit also continues to pick up steam as many market participants anticipate COVID-19 initiating a credit cycle that will create opportunities for these managers. Many traditional hedge strategies are also in demand, although these managers are also looking to tap the private markets via a number of tools, such as SPACs and increased deployment of side pocket structures.

Asset growth remains the top priority for alternative fund managers

Asset growth, for the third year in a row, continues to be the top priority for both private equity and hedge fund managers. This is unsurprising, as rising costs and fee pressures have made asset growth imperative for managers looking to counteract these forces.

Closely aligned with asset growth is managers' focus on talent management as a key strategic priority. Managers acknowledge the competition for talent continues to be fierce, and key to a successful business is hiring and developing the right people.

Managers are also beginning to recognize the importance of ESG initiatives and offerings. In this area, managers are looking inwards at their operations and outwards by making ESG considerations part of the investment process, and they are launching new products that incorporate ESG into their investing strategy.

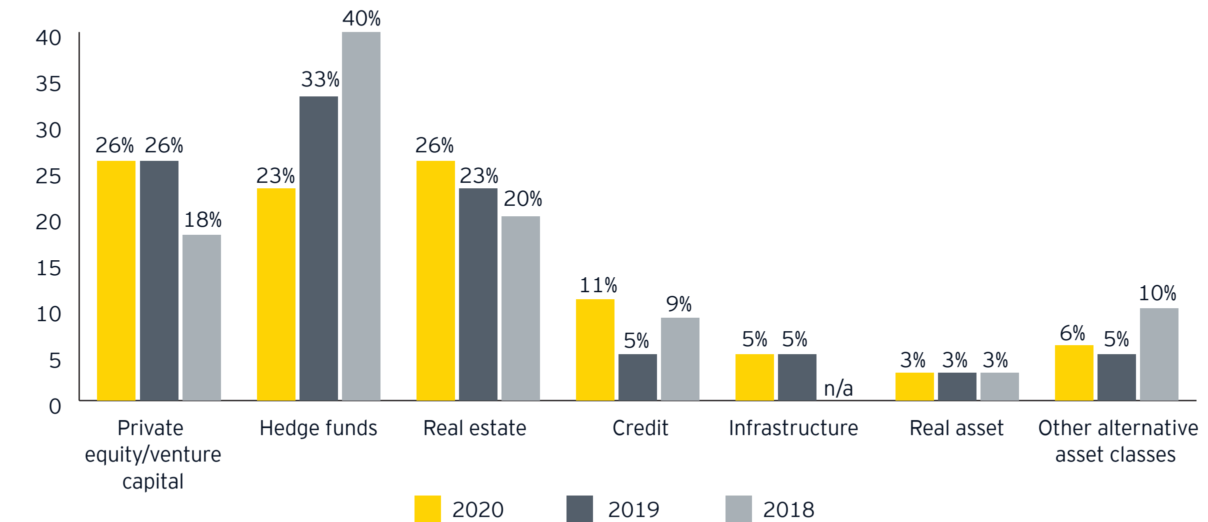
All alternative funds

Please rank the top three strategic priorities for your firm:

Investors maintain large alternatives portfolios, but shifts are occurring within asset classes

Investors

What proportion of your assets under management (AUM) are allocated to alternatives by asset class?



The total allocation by investors to alternatives remains relatively unchanged over the last several years, with between 20% and 25% of their overall portfolios allocated to alternatives. However, the composition of that allocation continues to change.

For the third consecutive year, hedge funds have become a smaller proportion relative to private equity/venture capital, real estate and credit. This is a function of positive flows to these other asset classes compared with hedge funds, which have generally been net flat from a flow perspective. But also, performance of these other asset classes has on average exceeded hedge funds for several years, causing a shift in the composition of each relative to hedge offerings.

Credit managers have continued to capitalize in 2020 as investor appetite for this asset class has grown significantly. Many alternative fund managers have been stepping into lending and middle markets where banks are exiting, creating unique product offerings and value propositions.

COVID-19 provides boost in interest in active management

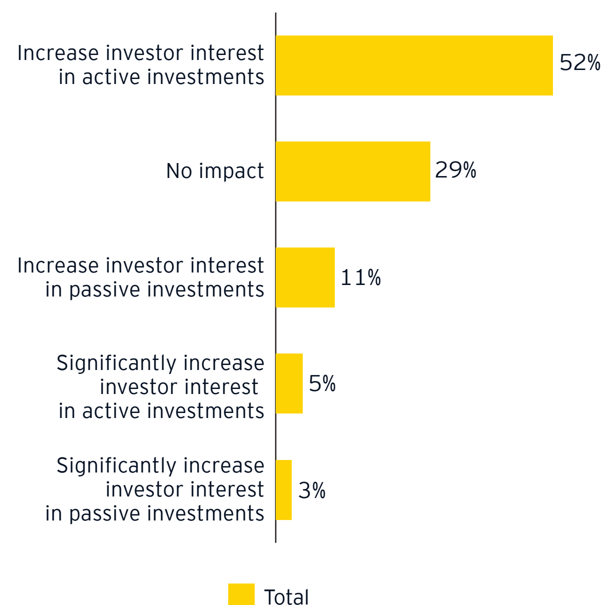
A shift in alternative products is not the only change we are seeing play out. Hedge fund managers expect that COVID-19 market volatility will drive a significant increased interest in active management. Over half of hedge fund managers surveyed believe the impact of COVID-19 and the related market volatility will increase investor interest in active management. This trend is more pronounced with the largest hedge fund managers, those with over US $10 billion in AUM, where over 75% responded that COVID-19 will increase interest in active management.

The level of optimism was slightly less from investors, but nonetheless, allocators tended to agree, as 30% anticipate having an increased interest in active management, while only 15% anticipate having an increased interest in passive investments.

The sentiment from both is buoyed by the initial performance returns from alternative fund managers where volatility created opportunities to outperform benchmarks and other passive offerings.

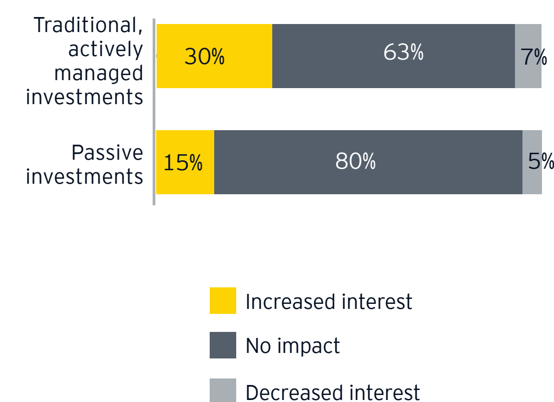
Hedge funds

How do you think the COVID-19-related market turmoil will impact investor interest in passive versus active investments over the next two to three years?



Investors

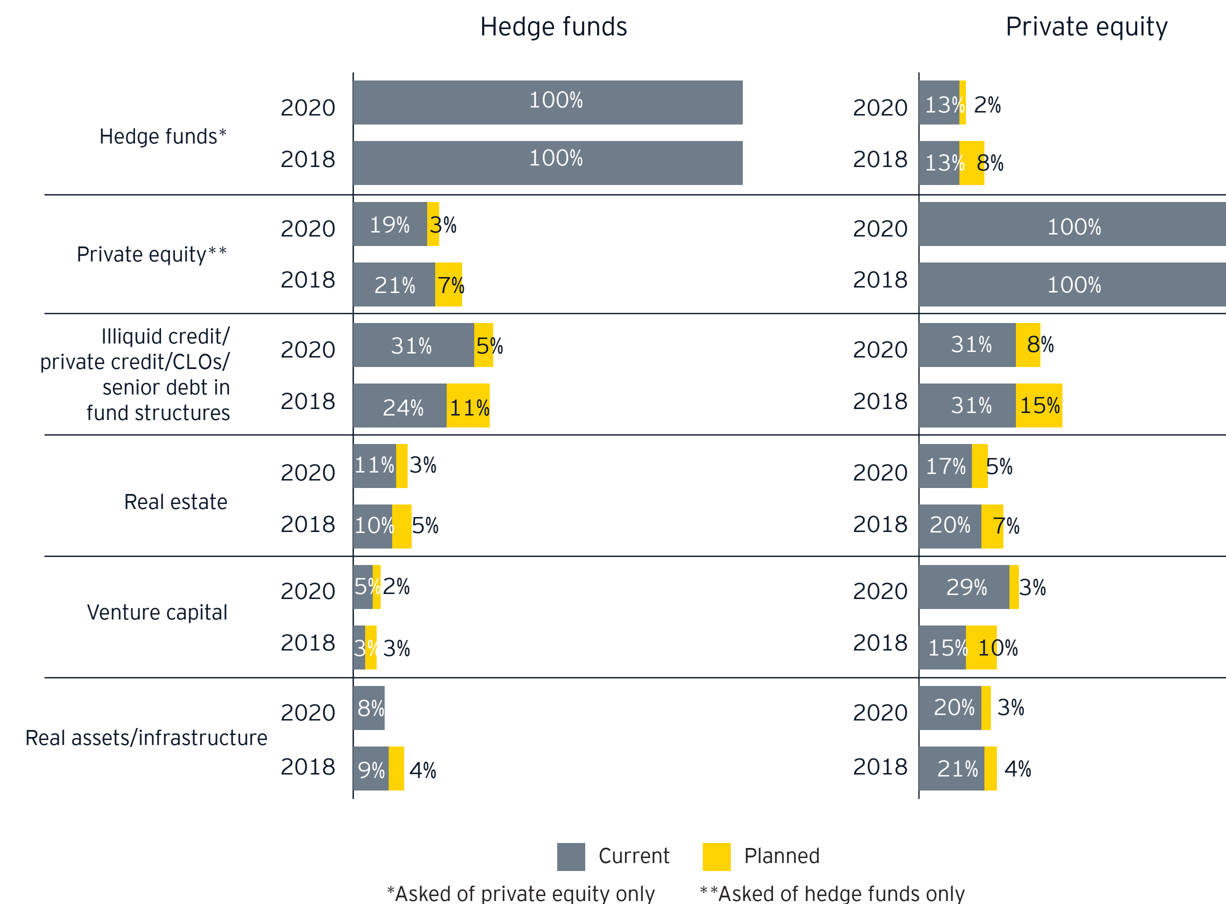
How has the COVID-19-related market turmoil impacted your interest in the following versus actively managed alternative investments in the next two to three years?



Alternative managers continue to offer a variety of products

All alternative funds

Which of the following products do you currently offer/plan to offer to clients in the next two years?



*Asked of private equity only **Asked of hedge funds only

Our previous survey results have indicated ambitions for managers to expand their offerings outside of their core areas of expertise. 2020 reflects consistent results, where we continue to see the blurring of lines differentiating hedge and private equity managers.

Credit offerings continue to be the most overlapping strategy between various fund managers with nearly a third of traditional hedge fund and private equity managers having an illiquid or private credit strategy.

COVID-19 created challenges and opportunities to launch new products – opportunity, in that volatility created attractive market dislocations for certain assets. Around 15% of managers, generally the largest fund managers, launched new products during the immediate aftermath of COVID-19 to take advantage of these conditions. The challenges, however, of moving quickly to attract capital in a remote environment stymied some managers' ambitions. In fact, managers looking to raise new assets went from 82% pre-COVID-19 to 77% post-COVID-19.

Hedge funds are deploying various alternative structures

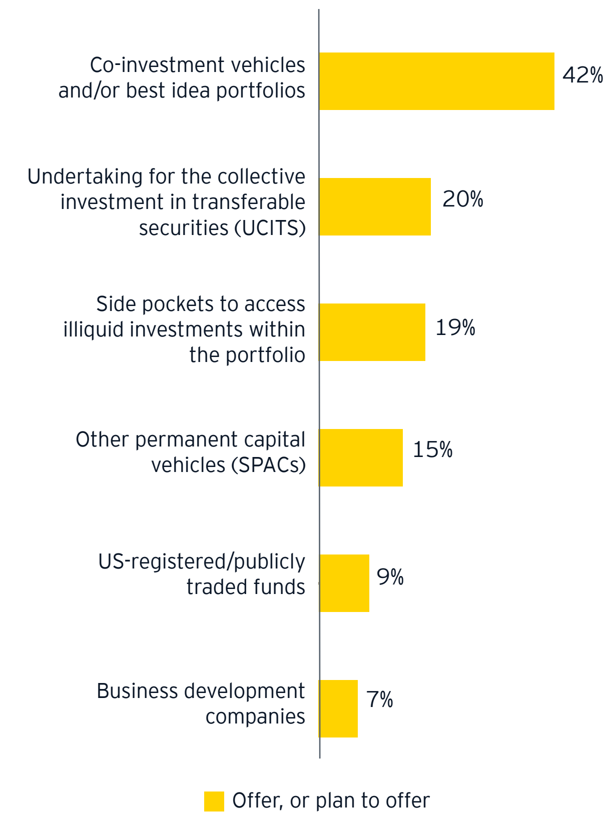
Hedge funds have been expanding their offerings, or tapping new markets, private asset classes in particular, via a variety of unique structures.

More than 40% of hedge fund managers are currently offering co-investment vehicles or best idea portfolios. Additionally, almost 20% of managers are creating side pockets, which allow investors an election to participate in illiquid investments within a broader portfolio. These structures allow managers greater latitude to concentrating investments in high-conviction ideas and/or expanding into less liquid investments that may not fit within the traditional commingled portfolio.

Another area of explosive growth is SPACs. At the time of this writing, there has been almost a threefold increase in the amount raised in SPACs compared with 2019. Managers have found these types of permanent capital structures to be an attractive way to raise capital, acquire companies and fast-track them towards the public markets. Traditionally, the promote earned from these deals has also been lucrative to managers. Target companies have also found these deals attractive as a way to access liquidity, while still retaining a stake in the business. While a number of managers are sponsoring these deals, traditional activist managers have been particularly represented in these transactions.

Hedge funds

Which of the following structures/vehicles do you currently offer/plan to offer to clients in the next two years?

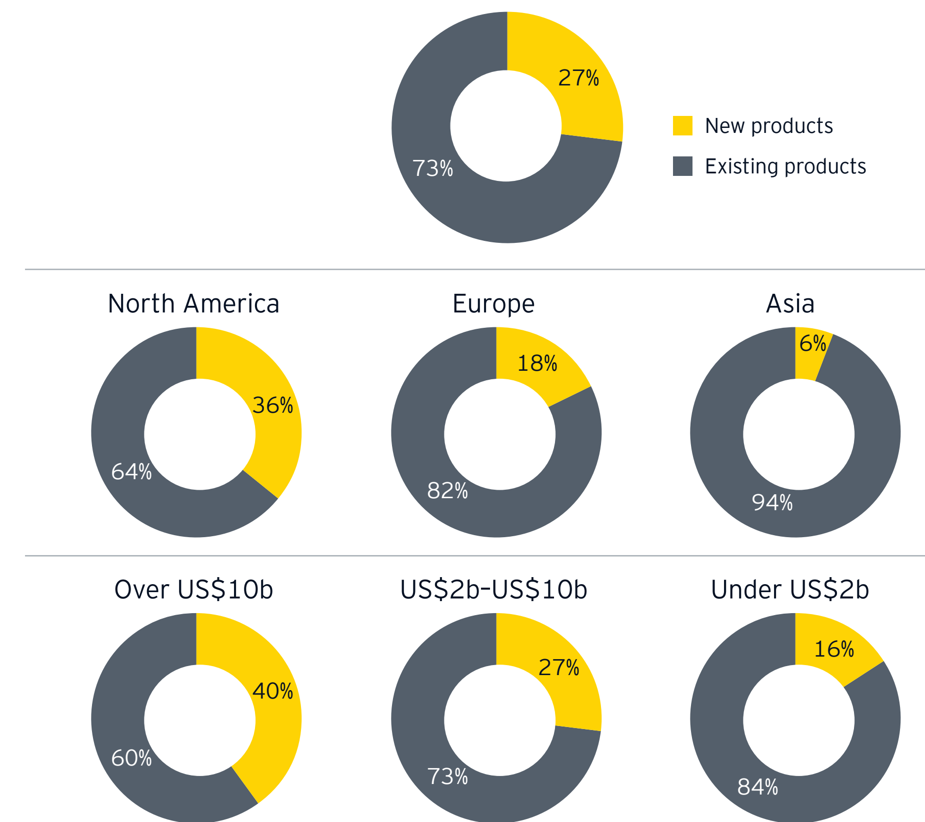


> Managers that are offering 'best-in-class' service are offering affordable co-investment funds and performance fees with a hurdle that matches the managers' assumed rate of return.
>
> – Endowment, North America

27% of new assets raised are going to new products

Hedge funds

Over the past 12 months, what proportion of new flows have been in new products versus existing products?



The result of increased products and structures has been accretive to managers' business, as 27% of hedge fund managers' capital inflows have come to new products.

From a geographic perspective, managers in North America have been most successful in attracting new flows to new products. Part of this is explained via the concentration of the largest managers in North America. Managers in Asia tend to be smaller organizations that focus on a core strategy so may only have one flagship fund, and while European managers tend to have similar characteristics as managers in North America, various regulatory considerations appear to be diluting their appetite for significant new product development.

These largest managers have been particularly aggressive in attracting assets into their new offerings, as 40% of all new funds are into these new products, compared with just 16% among the smallest managers. Larger managers have the benefit of brand, scale and infrastructure to support the talent, reporting and IR considerations related to these offerings.

Managers remain bullish on SMAs

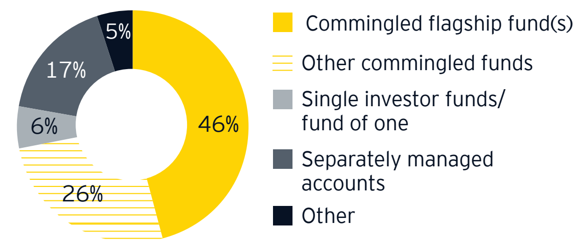
New flows also continued to be directed toward SMAs and fund of ones, which represented 22% of all new flows. Investors remain interested in the customization that SMAs and funds of one offer. Compared with 2017, SMAs make up a larger percentage of investors' portfolios, increasing from 24% to 32%. The result of this trend is that managers offering SMAs report that nearly a quarter of their firm assets are in these accounts.

Managers expect this trend to continue, with 44% expecting SMA assets to increase in the next two years, while only 13% expect a decrease. Investors are more muted, with just 1 in 10 investors expecting allocations to SMAs/funds of one to increase in the next three years.

In a promising sign for hedge fund managers, last year as many managers expected assets in their flagship commingled fund to decrease as those that expected it to increase. This year, however, managers seem much more bullish on the future prospects for their flagship funds, with 33% expecting an increase and only 19% expecting a decrease. If their view holds true, this is good news as their flagship funds often serve as a bellwether for the business.

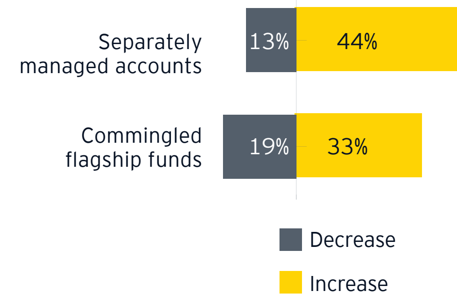
Hedge funds

What proportion of your organizations' AUM are in each of the following?



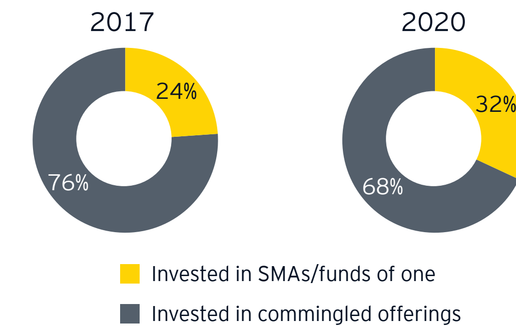
Hedge funds

For the following structures, do you expect the proportion to increase, decrease or remain the same in the next two years?



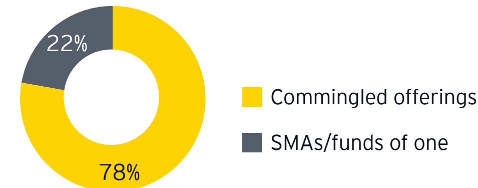
Investors

What proportion of your organizations' investment in hedge funds that are externally managed is invested in SMAs and/or funds of one?



Hedge funds

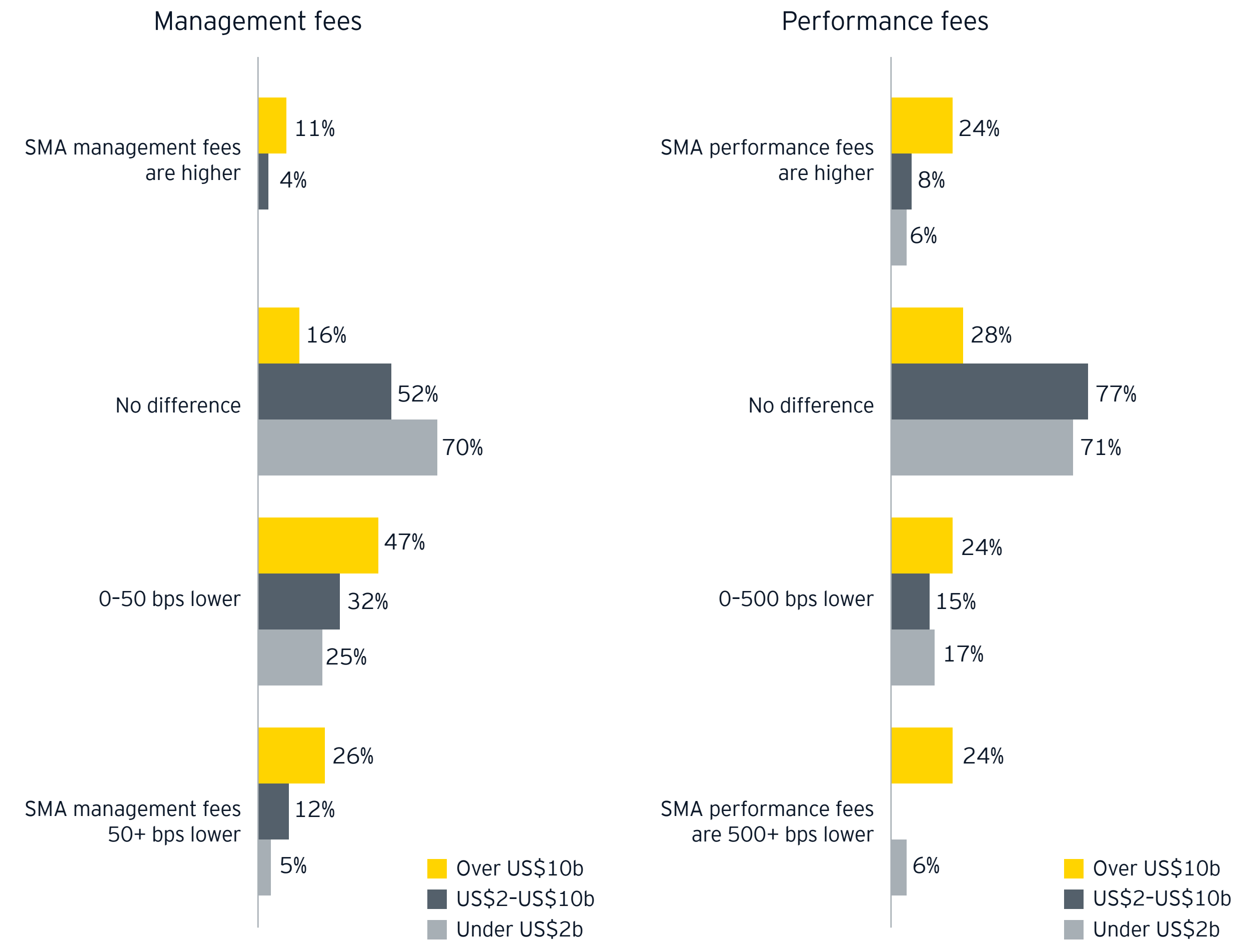
Over the past 12 months, what proportion of new flows have been in commingled offerings vs. separately management accounts/funds of one?



Fee considerations for SMAs

Hedge funds

On average, by how much do your management fees and performance fees differ in your SMAs versus your traditional commingled offerings?



As almost a quarter of capital inflows are going to SMAs, the fee structures of these products have a meaningful impact on managers' bottom lines. Perhaps interesting is that most managers are not differentiating fees between their SMAs and more traditional commingled offerings. Smaller managers and startup entities often rely on managed accounts to cover the cost of operations while they are ramping up fundraising for their flagship funds and have been most successful in negotiating with investors on no meaningful fee reductions

The over US $10b managers, who have better infrastructure to support SMAs, are often attracting the largest mandates from investors where there may be a greater expectation and ability to offer concessions.

Where fee concessions are being made, it is more frequent on the management fee, which aligns with investor sentiment around willingness to pay for performance but not wanting management fees to be a profit center.

For managers in the US, nontraditional fee structures are becoming the norm

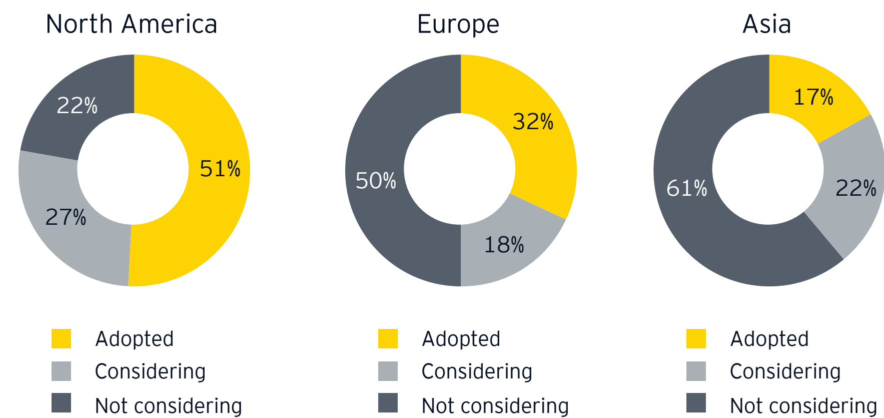
As investor dissatisfaction around traditional fee structures is showing no signs of abating, managers partly have responded by continuing to offer nontraditional alternatives. North American managers appear more progressive on this point compared with their global peers.

Nearly 80% of managers in the US are currently offering clients more customized fee structures. However, this trend does not yet seem to be taking hold nearly as much outside of the US, where fewer than one-third of managers are currently offering nontraditional fee arrangements (and 20% are considering doing so).

Managers are generally more open to offering nontraditional fee structures for their commingled offerings than they are for their SMAs/funds of one. In fact, more than half of managers stated their management fees were lower in these types of fund structures. The lower fees are often the result of managers' willingness to take a reduced fee for a larger ticket amount or money they deem more "sticky," as many investors are likely to stay invested longer after spending the time and money to create these separate structures.

Hedge funds

Have you adopted any nontraditional alternative fee structures (i.e., not fixed management and performance fee)?



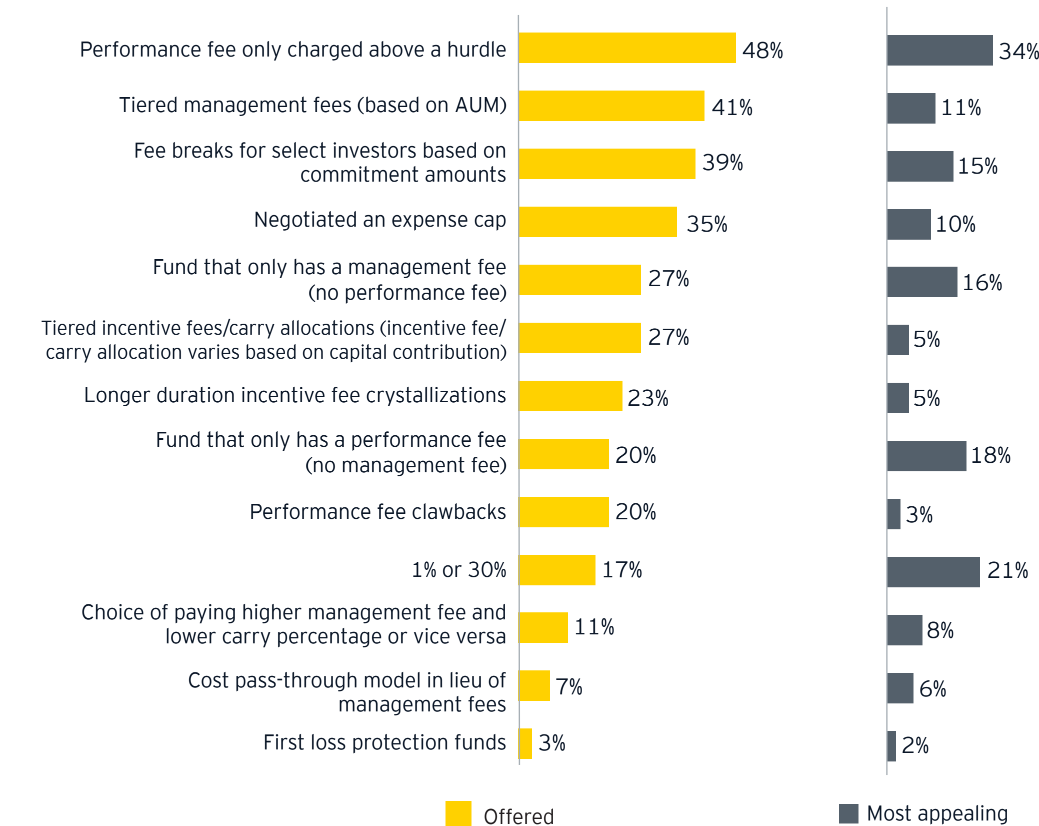
Managers are offering a wide variety of nontraditional fee alternatives

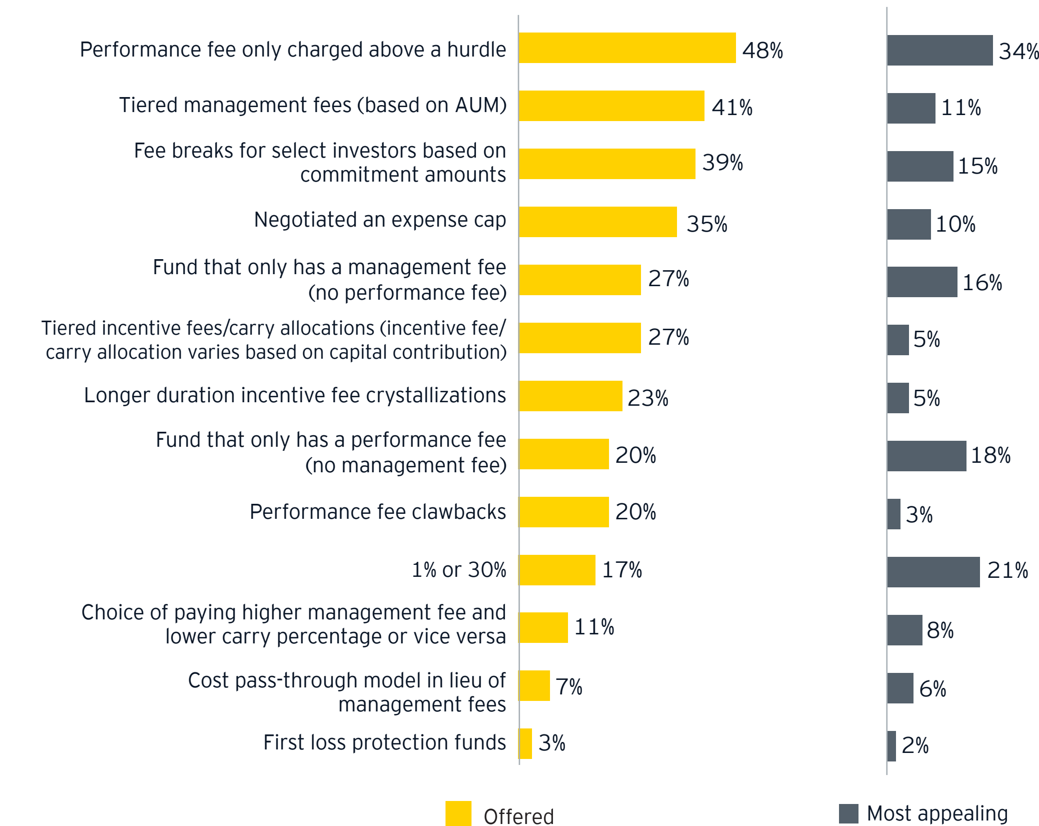
Hedge funds

Which of the following nontraditional fee alternatives do you offer?

Investors

Which of the following nontraditional fee alternatives are most appealing?





For those managers that offer nontraditional fee alternatives, there are many different iterations and models. The most common approach is implementing a hurdle rate before charging a performance fee. Investors, too, prefer this model as one in three note it is the most appealing nontraditional fee structure

Of managers surveyed, 41% offer tiered management fee structures, which was a response to pressure from investors that did want management fees to be a profit center for the manager. Managers also continue to be willing to offer fee concessions for larger ticket sizes or cap the amount of expenses an investor pays.

Although relatively few managers offer these structures, funds that have no management fees (performance only) and funds that have clawback provisions are some of investors' most preferred fee models. These findings reflect that investors are willing to reward managers for performance.

Manager operating expense ratios

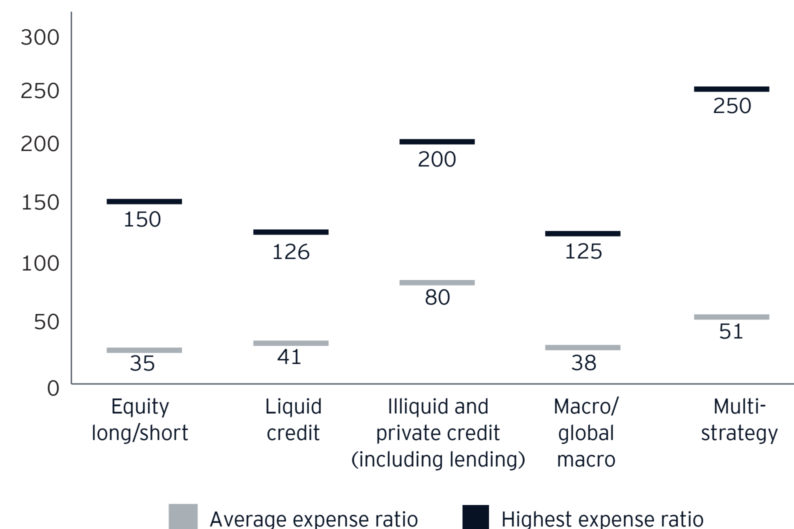
For some managers and investors alike, the use of nontraditional fee models has been a useful tool to address the continuing tension regarding the costs of investing in alternative product offerings. While investors remain laser focused on the headline costs represented by management and incentive fees, we continue to see healthy dialogue around the operating expenses passed through to investors

Equity long/short funds reported the lowest average operating expense ratios. This is not surprising given the types of products these funds are trading and less complex operations necessary to support. Multi-strategy and private credit reported the highest average ratio, which speaks to the complexity of operations (multi-strategy) and portfolio composition (private credit) causing these strategies to being more expensive.

These data points are largely consistent from 2018, when we last explored this question. The focus on this issue partially explains why managers remain so focused on asset growth. As costs continue to raise, AUM growth is the manner in which managers are maintaining or driving these ratios lower.

Hedge funds

For each of the following strategies you offer, what is your largest (AUM) commingled fund's operating expense ratio, excluding any incentive or management fees and trading-related expenses such as interest and dividends?



> I'd like to see managers strategically focus on ensuring that their investments are maximized and that realizations are executed in the most cost-effective way possible.
>
> –North America, Endowment

ESG

If not for the global pandemic, it's possible that 2020 would have been remembered as the year that ESG dominated headlines within the business and economic environment. On a global basis, all industries and companies have been assessing how their activities and operations align with a heightened focus by individuals, shareholders, governments and other constituents on addressing various environmental, social and governance considerations. Alternative asset managers find themselves square in the middle of this conversation from two different perspectives. From a product offering and strategy perspective, alternative fund managers and their investors want to understand how investment philosophies align with ESG considerations. Also, as a business organization, shareholders, employees and others want to better understand how their asset managers are embracing ESG as a corporate philosophy. While the primary objective of asset managers is to preserve and grow investor capital, managers are increasingly being asked by all constituents to do more as corporate citizens.

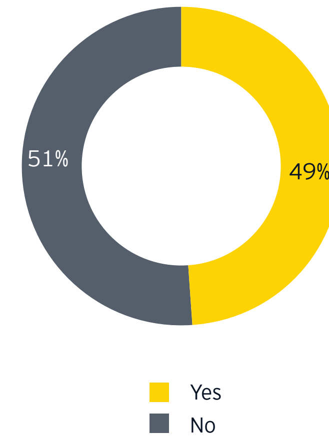
Alternative managers are not keeping pace with demand for ESG products

Socially responsible investing continues to prove to be a promising avenue for growth. Almost half of investors are currently investing in ESG products, which is almost double the number of investors including ESG products in their portfolios in 2019. Investors are placing a significant emphasis on managers' ESG policies when deciding whether to invest with a manager. Nearly all investors (88%) ask managers how ESG is incorporated into their investment decision-making.

Although socially responsible investing is top of mind for investors, the proportion of investors desiring exposure to ESG products well outpaces the number of alternative managers that offer them. In fact, only one in five managers offers ESG products, which remains unchanged from 2019, and a little less than half of managers have been able to systematically include ESG risk factors into their investment process. Managers that are able to mobilize and launch products in the ESG space will be met with increasing demand.

Investors

Do you invest in ESG products?



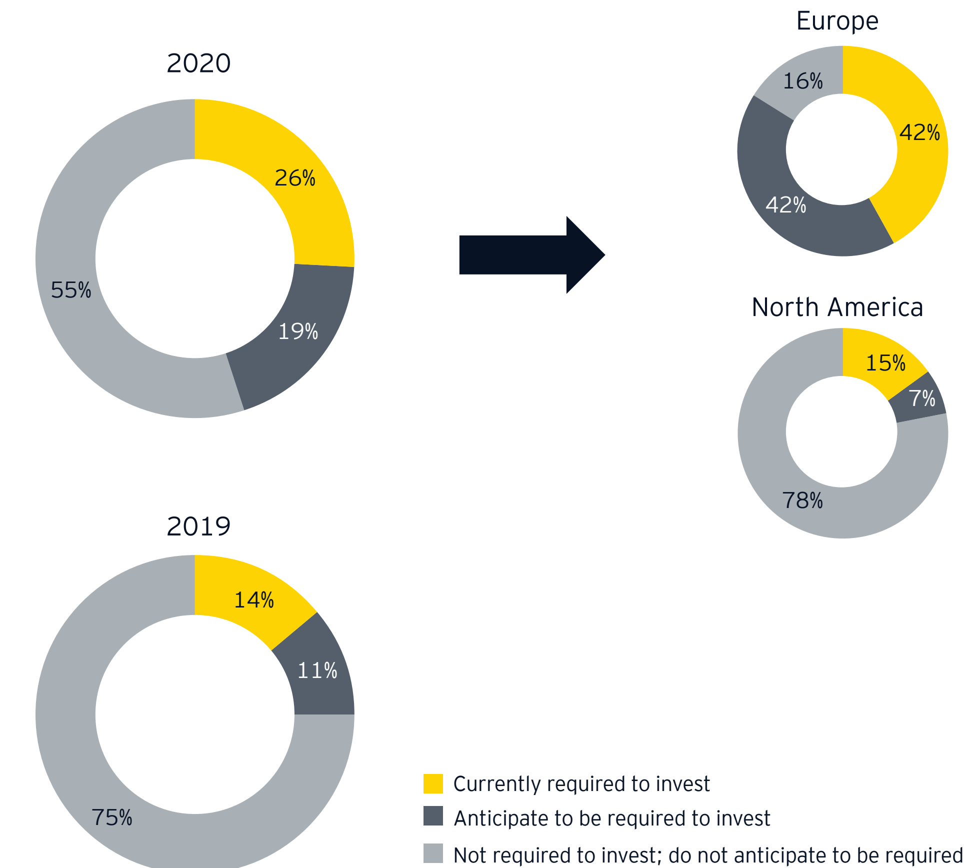
All alternative funds

Do you offer or plan to offer ESG products?

More investors are being required to invest in ESG products

Investors

Is your organization required to invest in socially responsible products, or do you anticipate being required to invest in socially responsible products in the next two years?



Over the past year, the percentage of investors required to invest in ESG products has nearly doubled, and that figure is expected to nearly double again in the next two years.

As expected, much of this trend is being driven by investors outside of the US. In Europe, 84% of all investors either are currently or expect to be required to invest in ESG products in the next two years. Conversely, only 15% of US investors are currently required to invest in ESG products, though that figure is expected to grow to nearly a quarter in the next two years.

European investors have been the first to the table, which is stemming from their individual stakeholder demands, as well as principles for socially responsible investing being incorporated into many European countries regulatory requirements. However, given the COVID-19 environment and spotlight on social justice, we anticipate that investors from all over the globe are rethinking their priorities when selecting investment allocations.

The combination of these factors demonstrates that these products are not only appealing for their good governance practice and risk mitigation, but there have been multiple studies that prove that incorporating ESG risks into investment decision-making can have a positive impact on performance. Therefore, we anticipate ESG mandates will continue for the foreseeable future.

Investors expect an increase in the amount of ESG investing they do

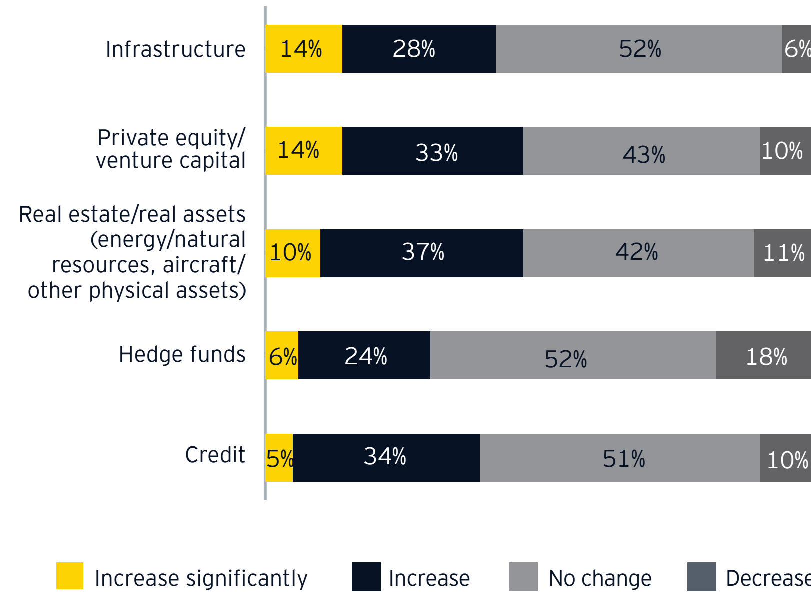
As investors determine where they plan to allocate their capital, infrastructure, real estate and private equity ESG products prove to be more popular than hedge funds and credit funds. Almost half of all investors expect the amount of ESG investing in infrastructure, private equity and real estate to increase in the next two to three years. This is largely a result of such firms having significant influence or controlling stakes in these assets, which allows managers to influence their portfolio companies' daily operations and management.

However, less than a third of investors expect their ESG investing in hedge funds to increase in the next two to three years. Among the hurdles hedge fund managers may have to cross to gain traction in the ESG space are (1) the fact that they may not be able to influence the companies they invest in based on their ownership percentage and (2) limited access to ESG metrics and quality concerns for underlying companies that do publish ESG metrics, so it is more challenging to be impactful from an ESG perspective.

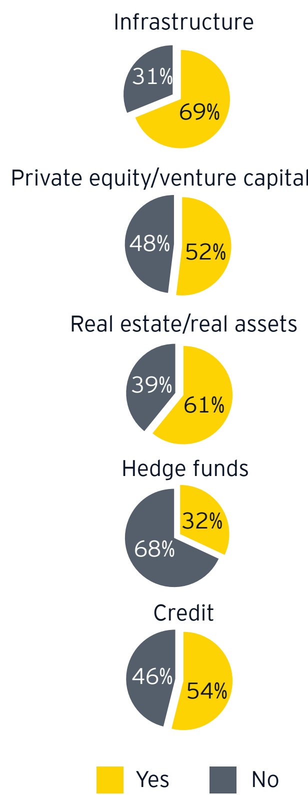
Most investors generally feel that there are sufficient ESG offerings in infrastructure and real estate/real assets, and more than half feel the same about private equity. On the other hand, just 30% of investors are confident that hedge fund managers will be able to meet the demand for ESG products. Currently, most hedge fund ESG investing involves negative screening, which does not give investors confidence ESG risks are thoroughly evaluated. However, with the emergence of ESG frameworks and scoring, as well as broader inclusion of ESG risks into the investing process, there are opportunities for hedge funds to prove they are capable of providing investors with products that meet their needs.

Investors

How do you expect the amount of ESG investing you do via the following alternative asset classes to change in the next two to three years?



Do you feel there are enough ESG offerings in each of these asset classes to meet your needs in the next two to three years?



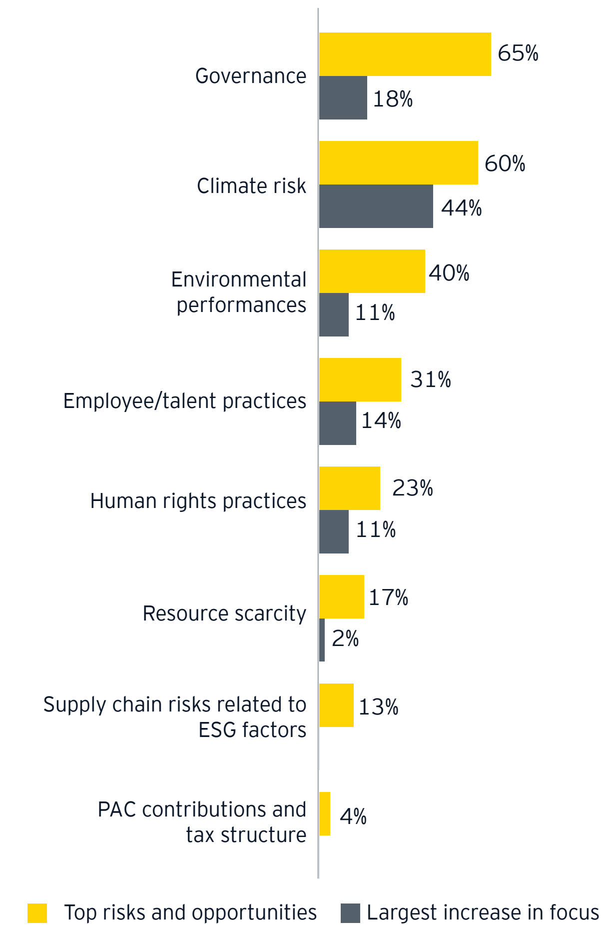
Governance tops the list of ESG risks and opportunities

All alternative funds

What are the top ESG risks and opportunities you include in your decision-making?

Investors

What are the top ESG risks and opportunities you include in your decision-making? Which of these considerations/opportunities have received the largest increase in your focus during 2020?



When it comes to creating high-quality ESG products, the focus on governance tops the list for both managers and investors. Approximately two-thirds of both investors and managers stated that governance is a top risk.

Additionally, 60% of investors said that climate risk was an area of risk. In the 2020 EY Climate Change and Sustainability Services Global Institutional Investor Survey, it was found that many companies do not consider their current strategy's resilience against climate-related risk and lack a structured approach to identifying climate-related opportunities.

Almost half of investors surveyed stated that climate risk would have the largest increase in focus during 2020. Investors are focused on climate change as they seek to understand how this specific risk could adversely impact their long-term returns if it results in a systemic shock to the economy.

Approximately one in three managers prioritized humans rights practices when assessing ESG risks, while only one in five investors thought of human rights practices as a top ESG risk. Human rights practices continue to be a focus for managers, as their brand and reputation could be imminently tarnished if there are issues at companies they manage, particularly given the enhanced spotlight on social justice.

Investors are placing much more emphasis on managers' internal ESG policies

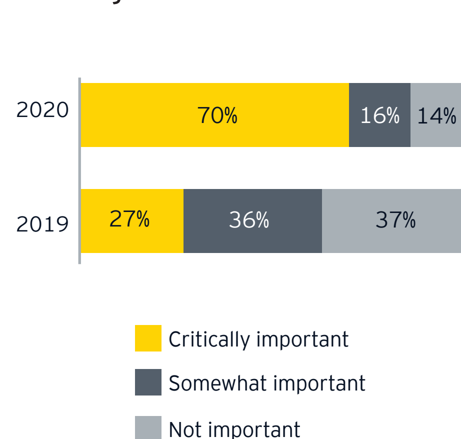
Besides the demand for ESG products, over the past 12 months, there has been a significant increase in investors' focus on their managers' internal ESG policies when conducting their due diligence process. The number of investors that said that a manager's internal ESG policy is important when deciding to make an investment more than doubled from 2019 to 2020. These results would suggest that is no longer a differentiator to just have an ESG policy, but an expectation of investors.

When asked how important it was for a manager to have a policy, 70% of investors noted that it had a significant impact on their decision to invest. Similarly, in the 2020 EY Climate Change and Sustainability Services Global Institutional Investor Survey, 72% of investors say they usually conduct a structured and formal review of ESG disclosures, which is up more than double from the number of investors that formally reviewed ESG disclosures in 2018.

For nearly half of alternative managers that do not have a policy, the need to develop one is proving to be more important by the day if they want to attract asset allocations. Private equity funds are further along than their hedge fund peers, as almost two out of three private equity managers currently have an ESG policy, while only half of hedge fund managers have an ESG policy.

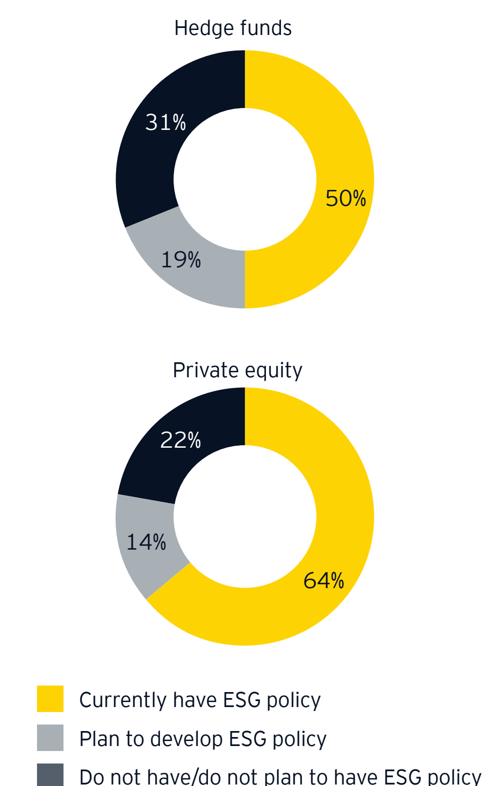
Investors

How important is an alternative manager's internal ESG policy (a policy that guides the management company's policies/procedures) when deciding whether to make an investment?



All alternative funds

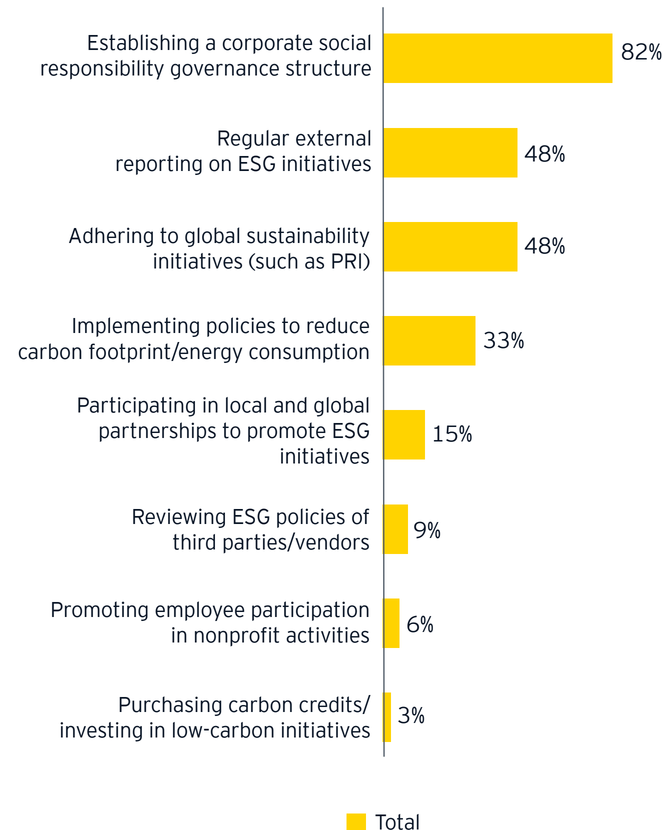
Does your organization have, or plan to develop, an ESG policy?



Once a governance structure is in place, investors would like to see their managers join global sustainability initiatives and reporting on their ESG activities

Investors

Which of the following do you feel are the most important components of an alternative manager's internal ESG policy?



All alternative funds

Which of the following components are part of your organization's ESG policies and procedures?

Investors are not only reviewing ESG policies, but they are expecting managers to have a policy with a robust governance structure designed to oversee ESG initiatives across the entire organization. However, the alternatives industry is proving to be behind the curve, as just one in three managers have established this type of a corporate social responsibility governance structure.

Half of investors would like to see regular reporting on their managers' ESG initiatives, and only 20% of managers have regular external reporting in place. Additionally, investors would like to see more managers join PRI or other global sustainability initiatives, and only 20% of managers are currently adhering to these types of global sustainability initiatives.

However, for those managers that have put the necessary ESG policies in place, they need pivot their attention to communication. Nearly 40% of managers do not regularly engage with any of their clients about ESG topics. Without a regular cadence, they may miss out on an opportunity to showcase for investors their progress in becoming a good corporate citizen. Besides the investors, managers are also finding that their employees have a vested interest in being associated with an ESG-friendly organization.

Talent

Talent priorities have always been front and center for alternative fund managers, but the conversation was specific to how could managers attract and retain the best-in-class finance professionals. Today's alternative fund managers require skill sets that go beyond traditional finance, pressuring them to pivot strategies to compete in different talent pools such as technology, sciences and others. The focus on equality in other areas of society has also continued to shine the spotlight on the diversity and inclusiveness (D&I) policies of alternative fund managers. Like so many other industries, the alternatives industry has taken steps forward in improving its diversity and inclusiveness, although more meaningful and material changes will hopefully continue in future years.

Hedge fund and private equity managers are taking very different approaches to talent management

Despite facing many of the same issues when it comes to hiring and retaining top talent, hedge fund and private equity managers are taking vastly different approaches to their talent management strategies.

More than half of all private equity managers surveyed said that increasing gender and ethnic minority representation is a top priority. For hedge fund managers, improving employee productivity continues to be a top priority in 2020.

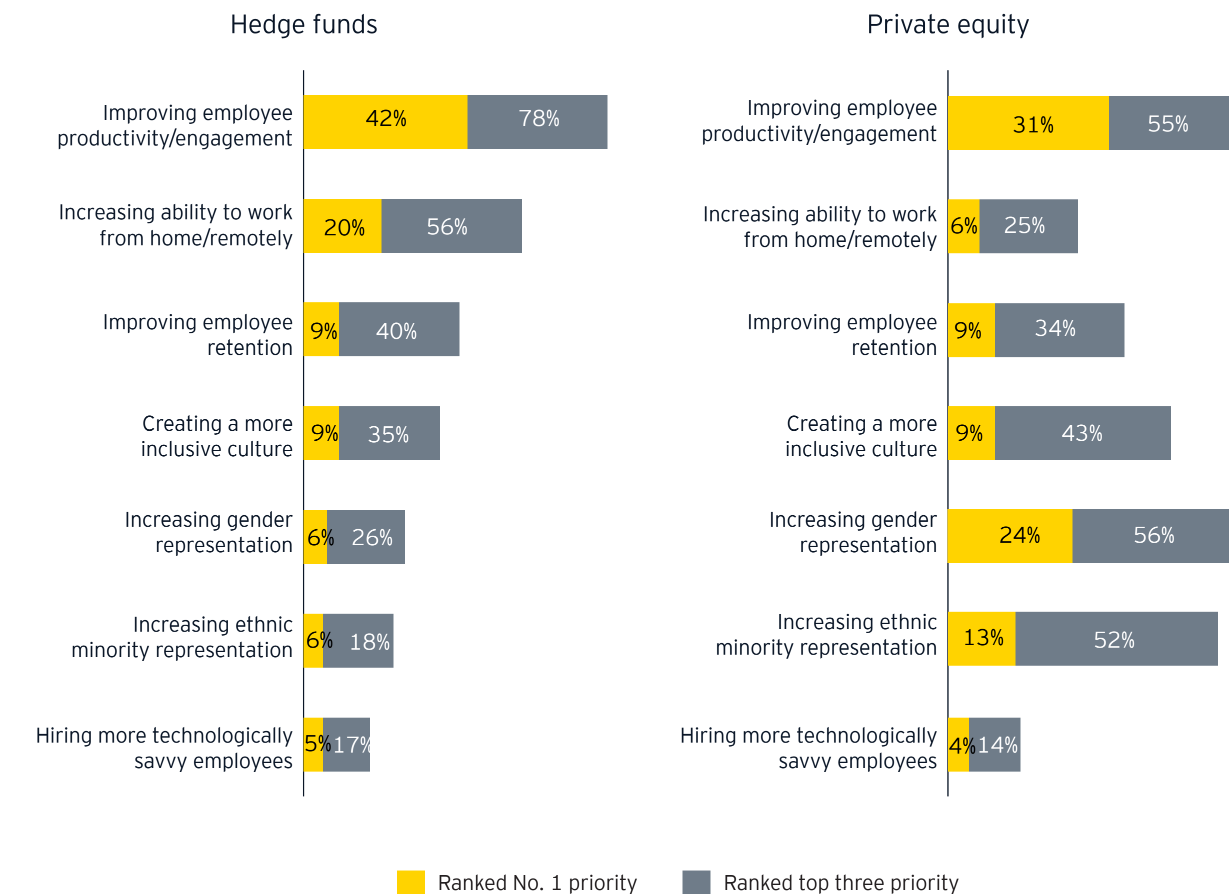
Despite hedge fund managers traditionally reporting less diversity among their ranks compared with private equity peers, implementing strategies to increase gender and ethnic diversity ranks much lower on hedge fund managers' list of priorities. This may only cause the gap to widen between hedge fund and private equity managers' success in building diverse teams.

The contrast between private equity and hedge fund managers can partially be attributable to the differences in business models. Private equity managers are focused on diversity, as their investment philosophy requires analysis and idea generation, whereas hedge fund managers are more focused on technology and alternative data to gain a competitive advantage.

Despite this difference, it remains surprising, given the broader global conversation around D&I, that hedge funds rank it lower on their list of priorities. However, both sets of managers are equally focused on creating a more inclusive culture, which is one of the ways managers are trying to address the topic of D&I at their organizations.

All alternative funds

Please rank the top three talent management priorities for your firm:



Partial remote working is expected to become the new normal

All alternative funds

On average, what percent of time do you expect these business units will work remotely after conditions normalize post-COVID-19?

What are you doing to enable and manage a more remote workforce?

Organizations have seen that their employees can be productive without being in office, which has opened up many possibilities for remote working to become more permanent.

Alternative fund managers expect approximately one-third of employees to work remotely even after conditions normalize post-COVID-19. Many managers cited that they are reducing their office space and plan on having a dedicated workforce to be on a permanent work-from-home schedule, while others determined they will be implementing a permanent rotating schedule for employees. Given this new dynamic, managers need to invest in infrastructure to support their workforce who are and will be working remotely.

Perhaps surprising is that there is no real difference in expectation between remote working plans between front- and back-office personnel, as each group is viewed as being able to work nearly a third of the time out of the office. This speaks not only to the efficiency and resiliency that each has demonstrated during this COVID-19 environment but also the evolving expectations of all employees that they can have more flexibility in their work locations.

The most common action managers have taken to better equip their employees working from home is by providing enhanced technological capabilities at home – 7 out of 10 managers provided their employees with better technology, and over half of managers are allowing their teams to work flexible hours.

Majority of managers have informal, or no, D&I policies

Managers have heard their investors and are taking action to try to improve the diversity of their workforce. However, given the difficulty that managers have had in affecting change from a diversity and inclusiveness perspective, one must ask whether they are focused on the right areas.

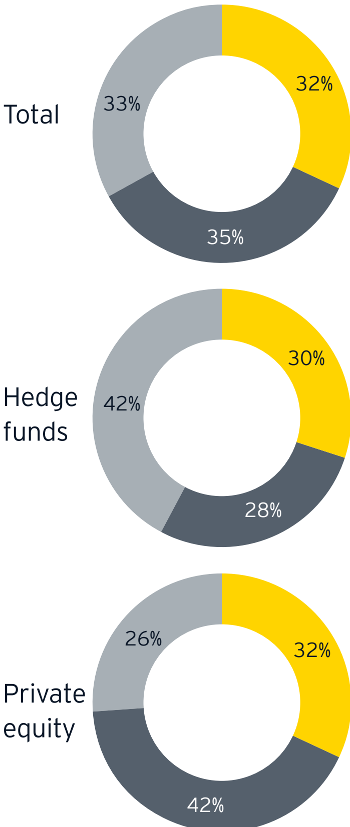
Only a third of managers have formally documented D&I initiatives, with another group of managers saying their strategy in this area is informal. The components of these strategies are scattered.

Almost two out of three managers promote awareness and provide training on bias and inclusion as part of their D&I initiatives. From there, there are large drop-offs as a minority of managers reported sponsoring diversity groups, interview training, setting diversity targets and other initiatives.

In order to move the needle and significantly improve the amount of diversity, managers will need to look at ways to improve the diversity of applicants and evolve the recruiting and hiring process. Managers also likely need to consider alternative talent pools from where they traditionally may have recruited to find skilled candidates who were not identified from prior talent attraction techniques.

All alternative funds

Which of the following best describes your current D&I initiatives?

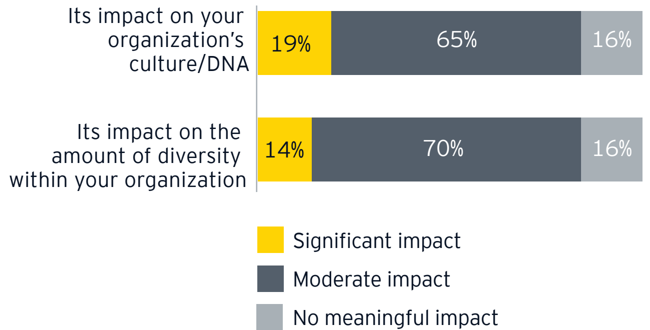


Which of the following are components of your current D&I initiatives?

Managers have yet to see their D&I policies have a significant impact on their organization

All alternative funds

How would you rate the effectiveness of your organization's D&I initiatives along the following dimensions?



> "Firms that have the most innovative talent management strategies are careful about both the diversity of the team and more importantly the inclusion of the team. Firms don't benefit from diversity if the diversity is not included.
>
> —Fund of funds, North America

Even though most alternative managers would acknowledge that they have a significant opportunity to increase the amount of diversity within their organization, few have seen their D&I initiatives make a significant impact to date.

For those managers that have D&I policies, only 19% have seen their policies have a significantly positive impact on their organization's culture. And just 14% of managers cite that their D&I initiatives have had a significant impact on the amount of diversity in their organization.

This could be driven by the fact that the D&I initiatives implemented have been rudimentary and, therefore, the implementation of those initiatives have not been able to enact significant change in the organization. Managers' challenge is to find the right mix of activities that will have a sustainable, positive impact on their people and business.

Managers still have a significant opportunity to improve gender diversity, particularly in the front office

In terms of actual employee diversity, there are different stories among hedge fund and private equity managers and between front- and back-office roles. With regards to gender representation, it is clear that the front-office roles have a significant lack of diversity. More than half of hedge fund managers and more than a third of private equity firms have less than 10% of women in front-office positions, which is almost entirely unchanged from 2019.

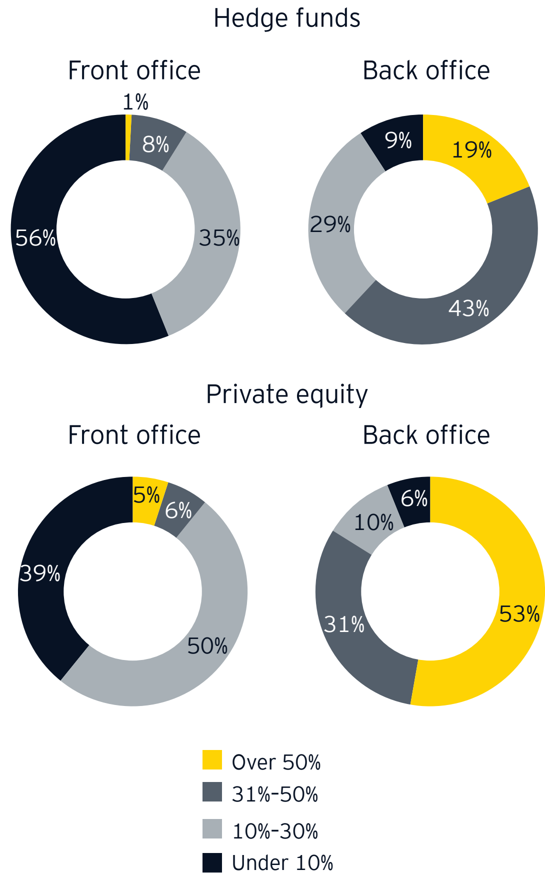
However, managers have made improvements in the back office. The number of hedge fund managers and private equity managers that have more than half of the back office as women is up significantly year over year.

When looking at gender diversity, private equity managers continue to be further along than their hedge fund peers in both the front office and back office.

More than half of alternative managers expect to increase their front-office headcount in the next two years, which serves as good opportunity for these managers to implement their diversity practices when undertaking hiring efforts.

All alternative funds

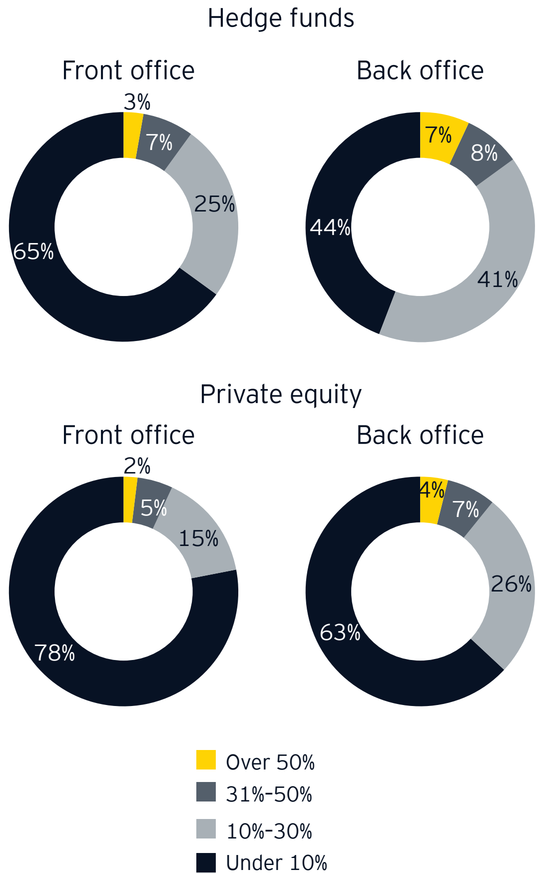
Approximately what proportion of employees in your front office, as well as outside the front office, are women?



Relatively few roles in the front or back office are filled by underrepresented minorities

All alternative funds

Approximately what proportion of employees in your front office, as well as outside the front office, are underrepresented minorities (e.g., Black and Latinx)?



Not only is gender representation important, but having an ethnically diverse organization is also critical to an organization's success and an area of focus of many constituents. Compared with gender diversity, underrepresented minorities make up an even smaller percentage of alternative fund managers' workforces.

Two-thirds of hedge fund managers and more than three out of four private equity firms reported less than 10% of front-office employees that are underrepresented minorities.

The back office proves to be slightly further along than the front office for both hedge fund and private equity managers, but the vast majority of managers indicated they have back-office teams with 30% or less minority representation.

There are a number of reasons that diversity at alternative fund managers is critical, but investor behavior and expectations is near the top of the list. Most investors feel that their organizations are more diverse than their fund managers, and 96% of investors want to allocate more to female- and minority-led firms.

Investors are increasingly sensitive to their managers' D&I

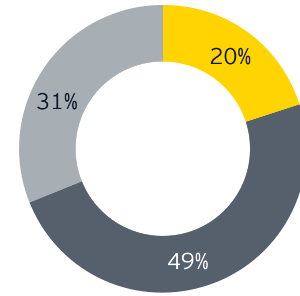
It is critical that managers focus on diversity, as nearly all investors note that a manager's D&I policies play a role in their decision to invest. This is particularly important to attract capital from outside the US, as nearly all investors outside the US note that D&I policies play a critical role in the investment decision.

Investors do not only see D&I initiatives as a societal and good governance behavior. They also report a belief that diversity drives positive investment performance. Nearly 70% of allocators believe their more diverse managers deliver stronger returns.

The due diligence process for investors is becoming more involved and requires a deeper dive into the hiring practices of their managers. More than half of investors surveyed (57%) reported reviewing the D&I composition of managers evaluated for a potential allocation. Failing to consider diversity and inclusiveness will cost asset managers capital and hurt their recruitment efforts as top talent increasingly wants to be part of a diverse team. Managers need to take the opportunity now to make the necessary changes to their policies and practices.

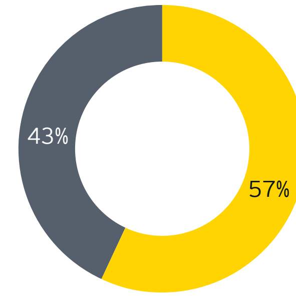
Investors

What do you feel is the impact of having significant diversity in the front office (gender and underrepresented minorities) on managers' returns?



- Significantly positive impact
- Moderately positive impact
- No impact

Do you review the actual D&I composition of your managers (e.g., proportion of women and underrepresented minorities)?



- Yes
- No

> "Of the various disruptors of 2020, increased attention to diversity and inclusiveness has had a positive impact and will be permanently adopted.
>
> – Private equity, North America

Continued focus on data, technology and automation

Alternative fund managers' attention on embracing advanced data and technology is not new; however, the events of 2020 have caused many managers to accelerate their transformation efforts. Digital solutions have been imperative for managers and investors that have needed to operate during 2020 in a largely virtual environment. Managers that have successfully navigated 2020 point to investments in their infrastructure that have been paying dividends; however, this year has identified opportunities to further accelerate digital agendas. Furthermore, harnessing the power of data continues to be a competitive advantage. This is true both in the context of utilizing data to make superior investment decisions in the portfolio and, increasingly, of leveraging data to make more informed operational decisions as well as helping managers better understand their LPs' preferences and product development expectations. The future success of alternative fund managers depends on their ability to successfully embrace data and technology to support their partners' investment needs but also to run efficient businesses.

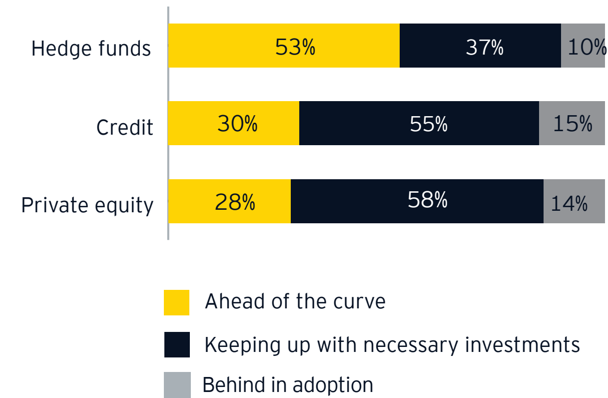
Investors see hedge funds as more technologically proficient

As technology continues to evolve and has become even more critical in a COVID-19 environment, investors are reasonably satisfied with their managers' efforts to embrace technology and data. Hedge funds in particular were reviewed favorably, as more than half of investors surveyed felt that the hedge fund industry was ahead of the curve from a technology perspective relative to other financial services. This reflects hedge funds' prompt adoption of data and technology, largely to support portfolio activities but more recently as mechanisms to evaluate their overall business operations and engagement with allocators.

While a majority of credit and private equity manager received satisfactory responses from allocators, they have more work to do in keeping up with the ever-evolving data and technology landscape. Those who are not investing and focused on this as a strategic priority are at risk very quickly of being passed over by the competition.

Investors

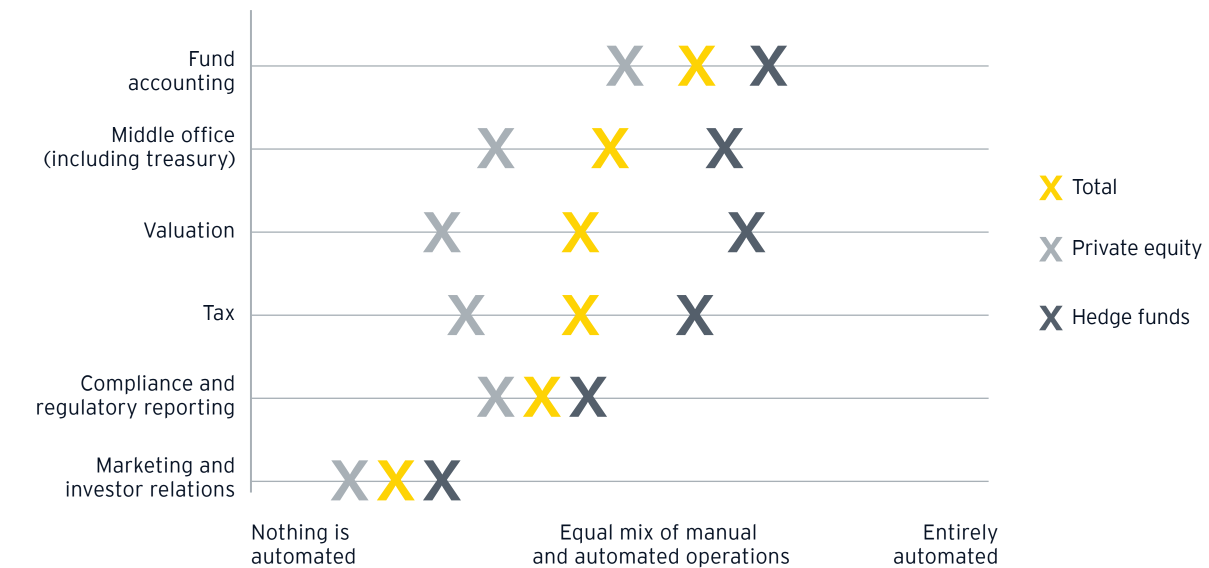
How would you describe the sophistication of your average alternative manager in embracing technology and data relative to the overall financial services industry?



Varying degrees of automation within operations

All alternative funds

Which of the following best describes the level of automation for processes that are currently conducted in-house in each of the following functional areas (e.g., excluding any automation by your service providers)?



While investors may be satisfied with their managers' implementation of technology, there is certainly room for improvement when it comes to the automation of various functions. Investors and other constituents expect that manual processes can and should be phased out. Advancements in technology offerings, whether internally developed or from service providers, have made it possible for managers of all strategies to automate all areas of their business. This will result in more efficient and timely processing and reporting while demonstrating the appropriate commitment to a digital infrastructure that investors are coming to expect.

Once again, hedge fund managers are leading the way in all key functions. They were early adopters of outsourcing and continue to leverage various tools to advance their journey to a leading, technology-driven infrastructure. We continue to see hedge fund managers pushing next-generation tools such as machine learning, robotics and blockchain technology to keep up with their evolving, complex business operations.

Private equity managers in the past several years have been making a noticeable effort to follow in the footsteps of their hedge fund peers as they look to move away from manually intensive, spreadsheet-driven reporting. In fairness, they do have more headwinds to overcome then their hedge fund peers since the nature of their transactions do not lend themselves to automation as easily, for example, automating a valuation model of a private deal is a tougher challenge. However, as these results indicate, their operations have room to make up relative to hedge funds.

Managers are in the early stages of leveraging advanced data to better understand their clients and their business operations

With the amount of data at a manager's disposal growing exponentially with each passing day, the cost of not having a data strategy and governance process only increases. Despite the investments that managers are making in data and data governance, the use of advanced analytics based on that data is still in its infancy.

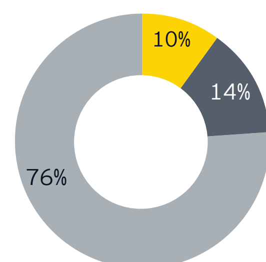
A quarter of hedge fund managers are using, or plan to use, advanced data to predict investor behavior, and a third are doing so to analyze their own internal operations. The largest managers are much further along, particularly on using advanced data to assess business performance and efficiency, as 60% are either already doing so or plan to. As businesses are becoming larger and more complex, those that are making investments in these areas have a significant advantage in understanding how to effectively engage with prospective allocators and what investments should be prioritized to maximize "operational alpha" via efficient operations.

As 58% of hedge fund managers either have a chief data officer or plan to hire one in the next two years, we expect to see rapid growth in how organizations leverage data. These individuals and groups are being viewed as critical components of not just the front office's data consumption but also helping business executives to develop strategy for the broader organization.

Hedge funds

Are you using advanced data to analyze the following?

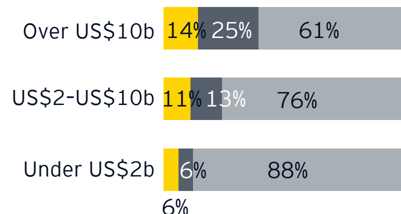
Investor behaviors and predict future servicing/product develop needs



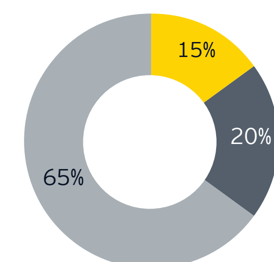
Yes

No, but have plans to

No, and do not plan to



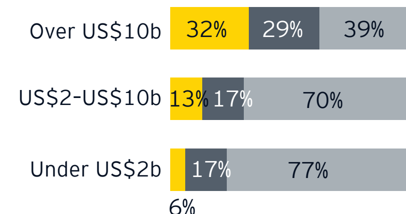
Business operations (not trading results) to assess performance and efficiency



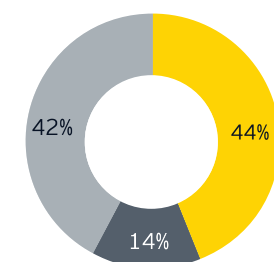
Yes

No, but have plans to

No, and do not plan to



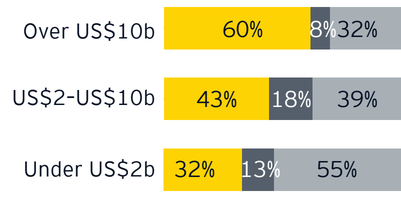
Do you have a person (e.g., chief data officer) or team of people whose primary responsibility is obtaining and analyzing data (including front-office data and non-investment data)?



Yes

No, but have plans to

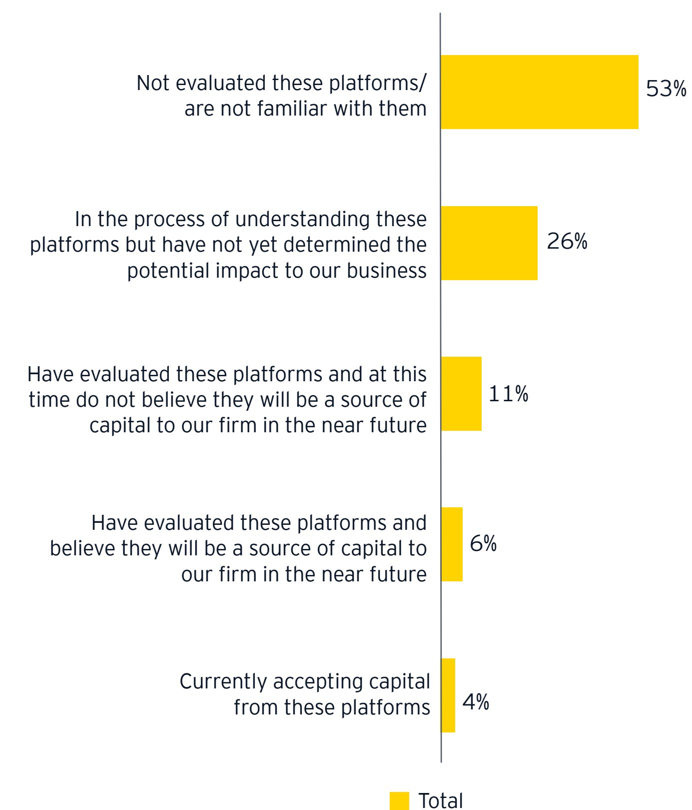
No, and do not plan to



FinTech platforms continue to be a largely untapped source of potential assets

Hedge funds

How would you describe your firm's efforts in understanding and engaging with FinTech platforms that aggregate capital and/or streamline manager due diligence/research for individual investors that may not have previously qualified to invest in alternative products?



Total

As the investor relations function will likely evolve over the coming years, so too must the way that managers source capital. The number and sophistication of FinTech platforms that promote allocator engagement and evaluation of alternative fund managers have been growing substantially over the past few years, yet many managers have still not explored these platforms.

In fact, more than half of hedge fund managers are not familiar with or have not evaluated these providers' ability to complement the manager's fundraising activities.

While many of these platforms are currently targeted towards giving retail and higher-net-worth individuals access to alternatives, their client and asset base continues to expand. As managers continue to seek out additional sources of capital, these platforms could be an attractive option for many. The growth of FinTech platforms over the past few years leads us to believe these are not a passing trend but are here to stay.

As we plan for a post-COVID-19 world, financial services will need to harness the power of technology such as FinTech to transform and grow at scale and speed, while meeting the growing expectations of the customer of the future.

Future landscape

"We expect a higher focus on D&I in hiring practices and advancement.

– Endowment, North America

"I envision the industry growing significantly with more need for deep analysis to determine outperformers.

– Pension, North America

"I think going forward we will see more frequent use of AI technology. What would the impact of more AI technology look like? I think it could analyze data quicker, which might even cause a reduction in the natural human workforce.

– Endowment, North America

"I anticipate alternative fund investing to increase over the next few years so that investors can gain some upside from losses incurred during this current market crisis.

– Pension, North America

"I foresee going forward there is less in person contact, which may strain some relationships, but with time savings of Zoom meetings, etc. New relationships can potentially expand and location may not be as important anymore.

– Fund of funds, North America

"Going forward, conventional investment management approaches and models will be less effective in a rapidly changing landscape due to the advances in technology for businesses and consumers.

– Pension, North America

Demographics and methodology

Background and methodology

Manager respondent profile	
Total	237
By segment	Number of participants
Hedge fund	110
Private equity	127
By geography	Number of participants
North America	167
Europe	40
Asia	30
By AUM	Number of participants
Over US$10b	72
US$2b-US$10b	92
Under US$2b	73

Investor respondent profile	
Total	73
By geography	Number of participants
North America	44
Europe	26
Asia	3

Hedge fund managers	
By geography	Number of participants
North America	64
Europe	28
Asia	18
By AUM	Number of participants
Over US$10b	28
US$2b-US$10b	45
Under US$2b	37

Private equity managers	
By geography	Number of participants
North America	103
Europe	12
Asia	12
By AUM	Number of participants
Over US$10b	44
US$2b-US$10b	47
Under US$2b	36

The purpose of this study is to record the views and opinions of alternative fund managers and institutional investors globally.

Managers and investors were asked to comment on their future and strategies for the decade ahead. Specific topics included strategic priorities; allocation trends, the growth agenda, data and technology investments; talent management and diversity; and future views on the industry.

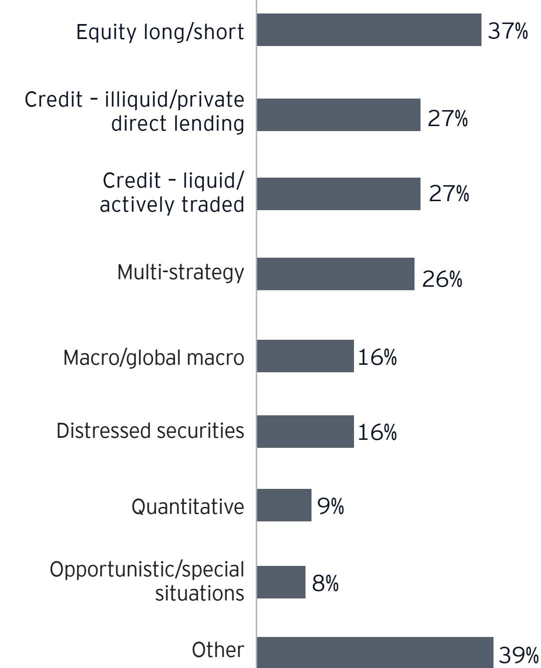
From July to September 2020, Greenwich Associates conducted:

- 110 interviews with hedge funds representing over US$1.8t in AUM and 127 interviews with private equity firms representing nearly US$2.7t in AUM
- 73 interviews with institutional investors (funds of funds, pension funds, endowments and foundations) representing more than US$1.4t in AUM

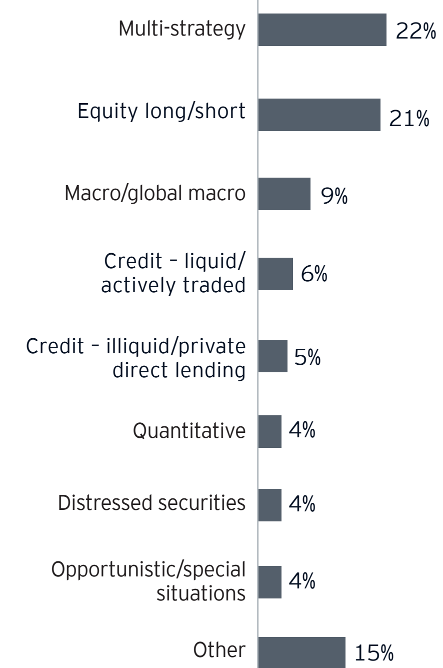
Hedge fund strategies: demographics

Hedge funds

Which of the following fund strategies does your firm offer to clients?



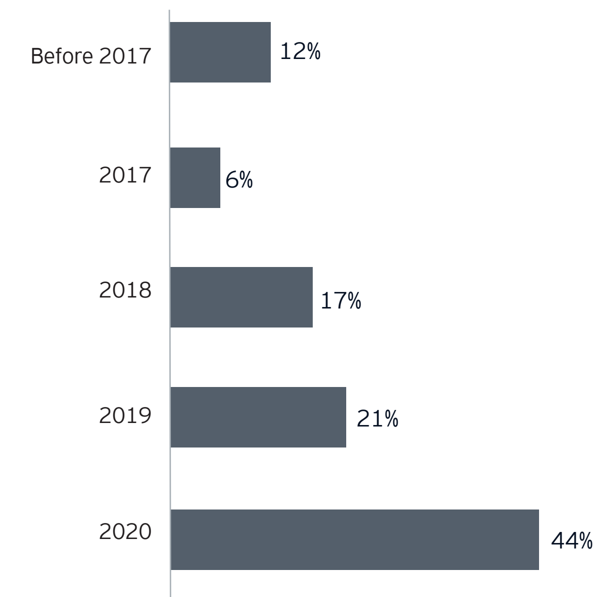
If you have more than one fund, which of these best describes the strategy of your "flagship" fund?



Private equity respondent demographics

Private equity

In what year did your firm's most recent fund close?



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