



## The 5 New Rules of Hedge Fund IR

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An executive summary of the Privcap thought-leadership series, "The New Rules of Hedge Fund IR"



**Ed Coyne**  
Sprott Asset Management



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# The 5 New Rules of Hedge Fund IR

## Key Findings

1. Increasing investor sophistication is driving transparency
2. The back office must now be front-facing
3. Cyber attacks are a real and growing threat
4. The black box is not a strategy anymore
5. Allocators, not managers, are now the stars

## The Panelists



**Ed Coyne**  
Executive Vice President,  
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**John Hague**  
Partner, National Financial Services  
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President, Head of Business Development,  
AlphaParity

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## Increasing investor sophistication is driving transparency

The hedge fund industry has changed dramatically over the past decade or so, largely as a result of enhanced SEC regulation, but also due to increasing investor sophistication.

“One of the biggest changes is transparency,” says Ed Coyne, executive vice president at Spratt Asset Management. “Clients and investors want to see managers who are willing to open up their books.”

The strongest driver of this trend is not investor sophistication at the institutional level—that has always been there. “Smaller accounts are coming in now and their level of sophistication clearly is higher,” Coyne says. “In fact, almost every client is viewed as an institutional client. It’s not completely new and shocking to the system, but you are hyperaware of it—and your ducks better be in a row. Everyone’s got to take it up a notch and be very organized, because everyone is looking.”

Jeff Silverman, president of AlphaParity, agrees. “The level of sophistication among small and medium investors is much higher and their level of due diligence is far deeper than it ever was. And that has changed the industry. Launching a fund with two guys and a dog in a garage, those days are behind us. They’d need a very large garage for their COO and their compliance officer and all the proper personnel.”

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## The back office must now be front-facing

What goes on in the back office can no longer be shrouded in secrecy, because due diligence is being performed on an ongoing basis, and the responsibility extends well beyond the CFO suite. “Investors are talking to the assistant controllers and the people who are actually pushing the buttons and executing the trades,” says John Hague, a partner and National Financial Services Industry Leader at RSM US LLP.



### Reaching Breakeven Gets Even Harder

**Jeff Silverman**  
AlphaParity

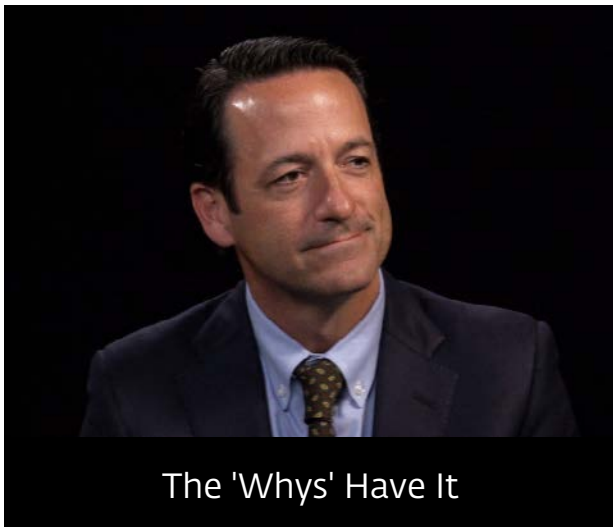
Due to increased regulation and its associated costs, hedge funds need more assets under management (AUM) just to reach breakeven. The days of being small and very profitable are likely over, thanks to the number of compliance layers that funds now need to add to their business.

“There was a study that showed that the breakeven for a hedge fund had shifted higher, from \$100M of AUM to closer to \$250M, and I’m sure that number is even higher today to hit breakeven,” Silverman says. “We’re in an industry where the barrier to entry is still relatively low, but the barrier to success is increasingly getting higher.”

And the runway to reach breakeven keeps getting stretched, he adds, as compliance costs increasingly weigh on the industry. “The hedge fund business was started by folks wanting to be entrepreneurs. They wanted to leave the large institutions, set up on their own and go for their dream, be the entrepreneur,” Silverman says. “That’s really difficult today, unless you have that deep financial wallet or you’re able to team up with a wealthy strategic partner.”

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For example, many hedge funds make longer-term, illiquid investments that are difficult to value. Investors are not satisfied with being told that the fund has a fair value methodology. “They’re asking what the details of that methodology are,” Hague says. “They’re asking if you have a valuation committee or any oversight as it relates to the independence of that function. They’re getting into the details. They could care less if you’ve got a cash flow model. They want to know what the variables are and how you get the completeness and accuracy of the variables.”



The 'Whys' Have It

**Ed Coyne**  
Sprott Asset Management

Increasingly, savvy investors are demanding greater transparency from hedge funds. They are no longer content to hand over their money and hope for the best. They want to know what a hedge fund is investing in—and why.

“I think the big thing is the ‘why,’” Coyne says. “‘Why do you own this? Why are you shorting this? Why are you taking this position?’ Understanding the reasoning behind why you’re taking a position is probably at the forefront now in a way that it’s never been before.”

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## Cyber attacks are a real and growing threat

A cyber attack can happen to any organization—a major medical center in L.A. or the local police department in Idaho Falls. Hedge funds are a lucrative target. Hackers might go after a fund’s portfolio information, or they might steal details of investor accounts.

“There are stories out there about hacks of fast-trading firms,” Hague says. “There’s a rumor that a cybersecurity breach is actually getting ahead of some of these orders before they even hit the exchange floor and taking advantage of that. It hasn’t been confirmed but there’s a good theory out there, authored by the FBI, that this is happening. So you’ve got the investment side and you also have the confidentiality of the investors’ information.”

The damage a trading hack can do is significant particularly with thinly traded securities. “Having instantaneous access to that information is a huge advantage from a trading standpoint, when these stocks can move multiple points off a single trade order,” Coyne says. “That’s a real concern, obviously, as you open up your books, if the people who see what you own are people getting ahead of your trades, whether it’s through fraud or just through looking at your balance sheet.

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## The black box is not a strategy anymore

Hedge funds have traditionally kept their proprietary trading strategies secret—and investors have traditionally not complained. In fact, the more impenetrable the strategy, the more investors tended to be attracted to it. A very mysterious black box methodology suggested managers with privileged access to the dark arts of investing.

That was then. Now, with hedge funds underperforming equities and bonds and regulators armed with crowbars and their flashlights, the door is being thrust open.

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So is the black-box fund model a thing of the past? Yes, more or less. “The black box, even the star manager phenomenon that we had 10 or 15 years ago, has largely fallen by the wayside,” Coyne says.

Investors simply won’t tolerate it. “The black-box mentality directly conflicts with today’s need for transparency in the investor universe,” Silverman says. “Investors need to understand the process. They need to understand the risk-management process, the decision process, the sizing of positions. It is just not palatable to the investor to sit across the table from someone who might have some very splashy midterm profile but hides behind the black box.”

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## Allocators, not managers, are now the stars

Another tectonic shift in the hedge fund industry is the move away from star managers. It’s no longer enough to show up to a pitch meeting with a big investor and introduce the new star manager: “This guy is going to be on our team. How much would you like to invest?”

“Pre-crisis, we lived in a world where it was about star managers,” Silverman said. “The allocator would pull together a collection of star managers in filling each bucket and he’d think he had a diversified portfolio. But the crisis taught us that the portfolio often wasn’t diversified — many of these star managers had a great deal of overlap. Now it’s about the star allocator. The allocator has the mandate from his investment committee to go build a truly diversified portfolio.”

Another shift has been a return to fundamentals, to more collegial relationships with clients. This is another part of the trend toward transparency. “Your ability to reach out to the client with good news or bad is very important—really accepting the idea that they do need that transparency,” Coyne says. “That client-service role has become elevated substantially over—it’s over and above, ‘Hey, we can deliver the numbers.’” ■



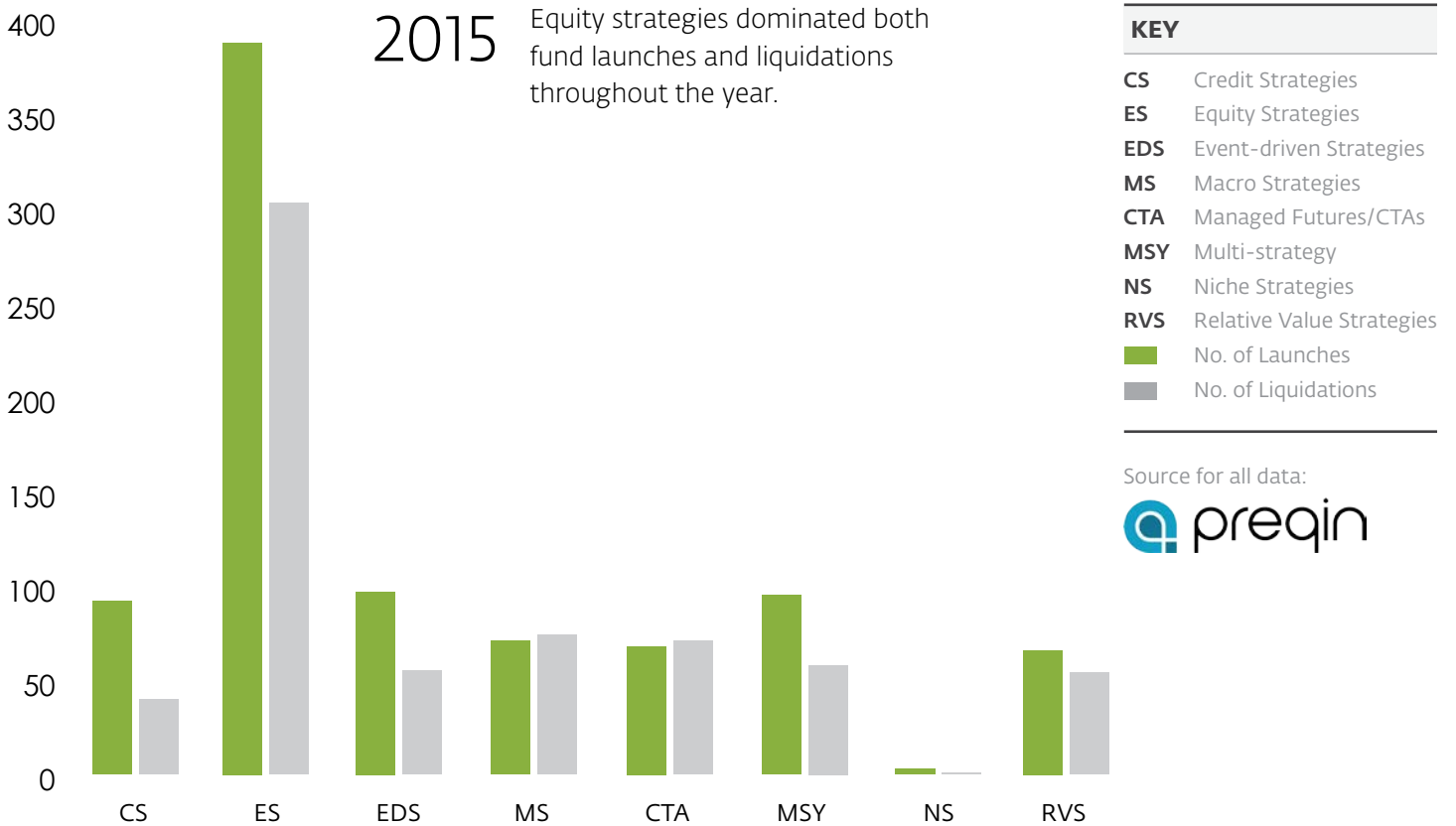
### Transparency Has a Bright Side

John Hague  
RSM US LLP

Increased transparency isn’t just good for investors—in the long run it’s good for the industry. When all hedge fund managers are put under the hot light, the real professionals will shine and those who are less than professional will be shunned.

“It’s been a rapid change,” says Hague. “I spoke at a conference 10 or 12 years ago in Bermuda and in one of the sessions managers were saying they weren’t going to allow any transparency whatsoever. And now the only way you get ahead is by offering transparency. Everything has changed radically and that’s driven by regulations, best practices and demands of the investors.”

# Hedge Fund Launches & Liquidations, by Strategy

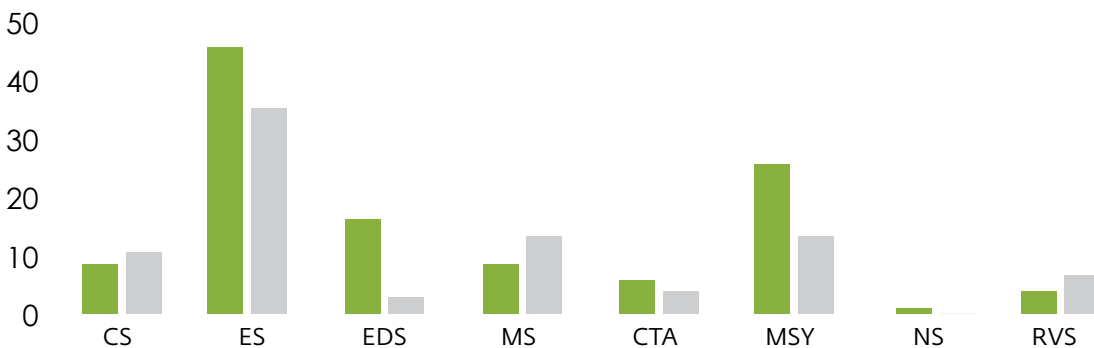


KEY	
CS	Credit Strategies
ES	Equity Strategies
EDS	Event-driven Strategies
MS	Macro Strategies
CTA	Managed Futures/CTAs
MSY	Multi-strategy
NS	Niche Strategies
RVS	Relative Value Strategies
	No. of Launches
	No. of Liquidations

Source for all data:  
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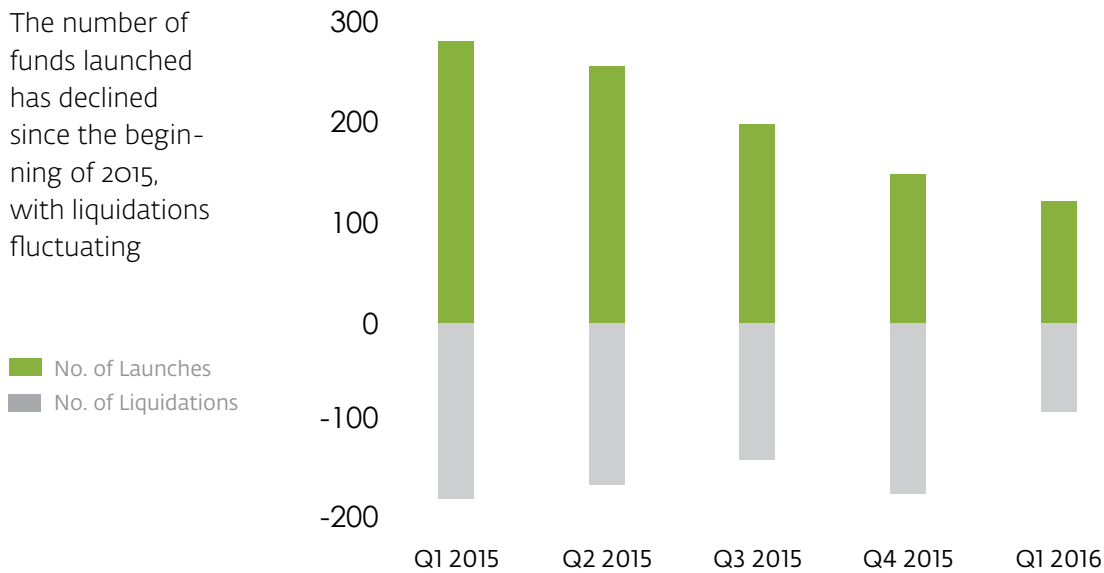
## Q1 2016

Once again, funds with equity strategies were more active than other categories, with multi-strategy launches coming in strong

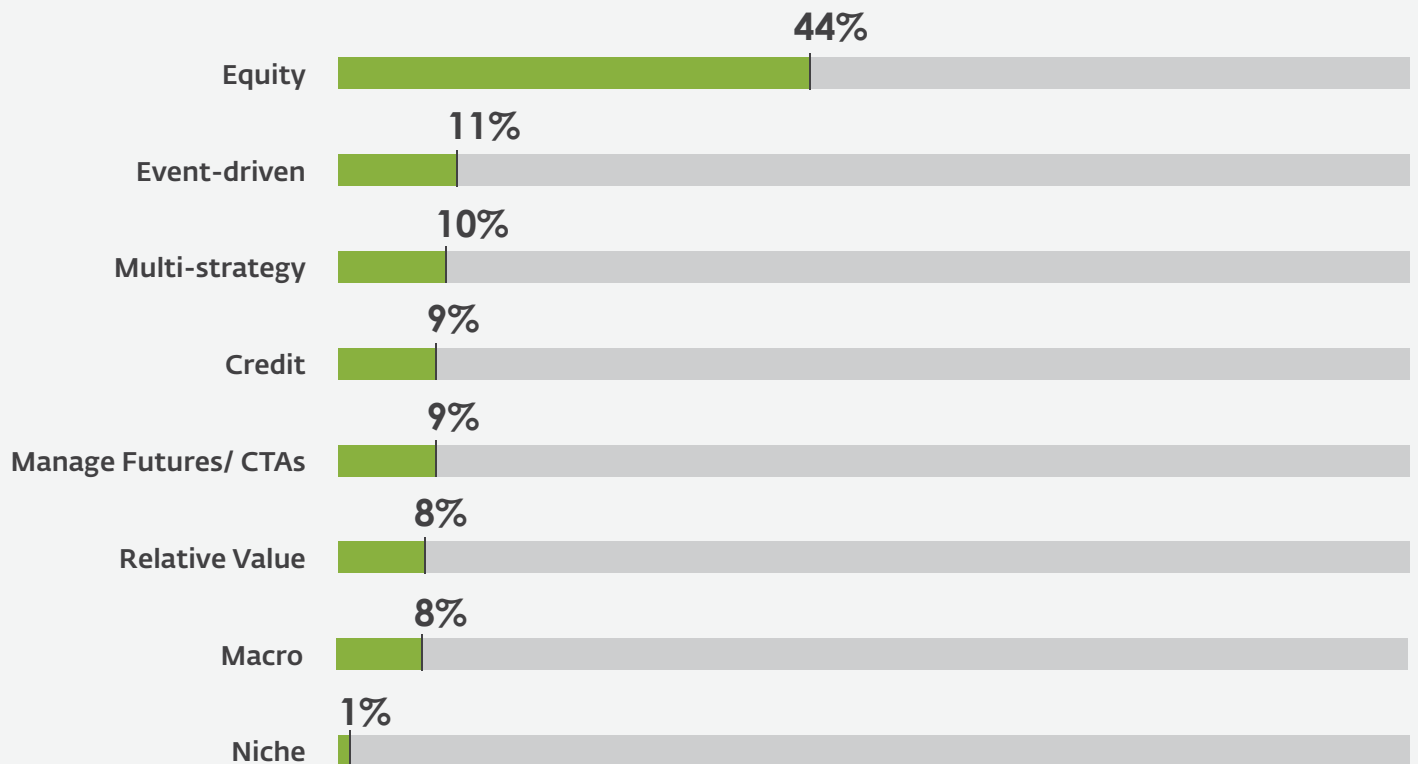


# Overall, by Quarter 2015-present

The number of funds launched has declined since the beginning of 2015, with liquidations fluctuating



## Active Hedge Funds by Strategy, % of total



# Expert Q&A

With John Hague  
Partner, National Financial Services  
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## Privcap: How does RSM work with hedge funds?

We service clients in around 80 cities and about 110 countries worldwide. We focus on investment companies of trading any strategy whatsoever—so private equity, commodity pools, short-term, long-term, anything. And we also focus on the brokerage and trading aspect of the industry with proprietary trading firms, futures commission merchants, broker dealers, investment advisors, etc.

### What are some services that you would provide to a hedge fund client that perhaps they'd be surprised to hear about?

Well, in addition to the standard audit and tax work that all CPA firms are known for, we feel very comfortable in sitting down with our clients and hearing about the issues that they're facing as it relates to corporate structure, transactional services, cybersecurity, anti-money laundering, regulatory compliance, etc. So we've got a full basket of services that the marketplace needs. ■





## About Privcap Media

Privcap is a digital media company that produces events and thought-leadership content for the global private capital markets. Privcap Media offers communications services to market participants.

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