MONEY MATTERS

S'pore's hedge fund industry must evolve to prosper

A range of pressing issues impact the industry's health this year and beyond. BY GORDON RUSSELL

THE development of Singapore's hedge fund industry is often cited as a case study for success in financial services in Asia. The industry today accounts for more than US$29 billion under management at the start of 2015 with around 288 funds operating in Singapore as of March 2014.

Growth over the past decade has been driven in part by supportive government policy, savvy talent and growing appetite among investors for alternative strategies. This will not, however, guarantee future success. There are a range of issues likely to impact the industry's health this year and beyond.

A key factor is differentiation amid increased industry competition. Because institutional investors globally are forecast to inject an additional US$90-US$110 billion into hedge funds in 2015, according to research firm eVestment, there are more managers launching new funds.

Another driver of new funds remains global regulation. As ongoing regulation is restricting the ability for sell-side institutions and pensions to access higher real rates of return, hedge funds are increasingly seen as an option for institutions to balance their investment strategy.

Ongoing scrutiny over the activity of banks has meant that few can rely on proprietary trading activities inside the bank. Most are preferring to exit proprietary trading by spinning out their "prop trading" desks. Talented traders inside banks are also increasingly attracted to starting hedge funds, which can offer less bureaucracy and the potential for higher compensation.

The challenge for new and smaller funds, including those operating in Singapore, is how to attract large amounts of capital and stand out from peers in an increasingly crowded market. Strong performance and solid manager pedigree is often not enough to secure funding.

Today more than ever, institutional investors such as pensions and sovereign wealth funds are demanding true operational excellence, including enterprise-wise, institutional-quality technology, from hedge funds before committing capital.

This includes fund managers having dedicated, real-time systems and processes which promote transparency and reduce risk. Investors need to know, on any given day, the position of their investments and exposure to risk. Monthly or quarterly updates are no longer enough. Real-time reporting is becoming essential. A robust risk platform is no longer a "nice to have". Hedge funds also need to consider cost and be able to strike a balance between technology and operational investment, and profitability. Industry costs are increasing, mostly due to additional reporting requirements in the wake of global regulation.

Fund managers need to ensure that they are highly compliant yet efficient with their spending. Again, technology is allowing managers to upgrade their operational systems which delivers both cost benefits and efficiencies through streamlined processes.

In today's hedge fund ecosystem, Singapore investors need to be aware of three key themes to thrive and develop.

Theme 1: Consolidation to a "Single Solution"

While this is not a new theme in the market, there has been a resurgence of demand for consolidation of systems onto a single solution. Consolidation is now more important than ever, due to two main factors.

The first is cost pressure. As a hedge fund matures and begins to require different and more resources, it is easy for it to wind up building its infrastructure organically. Suddenly, the fund has multiple systems and costs go up due to licensing, support and maintenance of systems.

The second factor is the intangible cost of operational risk when information is transferred from OMS to PMS, or PMS to a risk system. Firms may not be able to manage this internally and safely.

Even organisations that provide services to hedge funds are increasingly looking at reducing operating costs. This drives a review of current systems which will lead to the consolidation of systems and the services they offer to their hedge fund clients.

As a result, hedge fund administrators and brokers continue to ask, how do we consolidate the technology and reduce the hardware footprint within our organisations, and still keep costs down?

Theme 2: Increase of capital inflow into Asian funds

Asian funds are experiencing greater capital inflow than they have seen in a long time and there's no sign of this trend slowing down. In 2014, assets managed by Asian hedge funds increased by US$7.4 billion last year to US$119.75 billion. This is a 6.6 per cent increase from 2013 of US$112.3 billion. Fund longevity and sustainability are key drivers for this capital. Institutional investors are forecast to inject an additional US$90 billion into hedge funds in 2015. Singapore benefited from two clear trends in 2014. A number of funds moved their senior executives to Singapore with a view that as they increased their weighting in Asia assets, they wanted their trusted senior managers or principals closer to the market they are invested in.

There was also a large increase in new funds managed by experienced Japanese managers who have decided to move to Singapore and establish a base. This was driven by their view on the better regulatory environment and the quality of life that Singapore could afford their families.

For example, a leading convertible arbitrage fund moved its key investment team to Singapore including the CIO. Two managers left large, well-established Japanese funds to move to Singapore and start Japan-focused long-short equity funds.

How do these trends impact the ecosystem? Smaller funds in Hong Kong and Singapore are seeing more capital, which will establish certain managers in the region.

At the same time, however, new startups will struggle with their first seeding, particularly given that megafunds in Asia (approximately US$4 billion and up) are taking advantage of this new capital by starting new funds.

Theme 3: Hedge funds converting into family offices

We are seeing an increasing trend of hedge funds changing their business models into family offices, tapping into the Asian private wealth space. The model is becoming more cost-efficient and also helps cater to high net worth individuals (HNWI). Converting into a family office structure can simplify the process and can be more cost-efficient than operating a hedge fund business, plus that structure also faces less regulatory scrutiny than a typical hedge fund.

To take a step back, a large proportion of Asian funds are seeded by private wealth – funds that are currently US$50 million to US$200 million are primarily seeded by private net wealth. Increased regulatory requirements, a desire for institutional infrastructure and a need to keep costs low have all become catalysts for hedge funds converting into family offices. This converted structure will still need a consolidated solution and reporting package which meets HNWI needs. Many of these new models are using an out-of-the-box reporting. For example, one leading Singapore family office seeded a spin-off fund of US$100 million as a way to diversify their portfolio and as a way to provide access and opportunity to an increased rate of return.

With an increased need for improved investment yields, more family offices are looking to do the same as they become more comfortable with hedge fund operations and the transparency they can have over the investment strategy.

Undoubtedly, hedge funds operating in Asia will be seeing unprecedented growth this year, and it will certainly be a year of opportunity for Singapore investors in this space. Still, there are several factors that may be potential impediments to new or smaller hedge funds. As the landscape continues to evolve, it is critical for funds to understand the nuances in the market and to ensure its technology and risk management.

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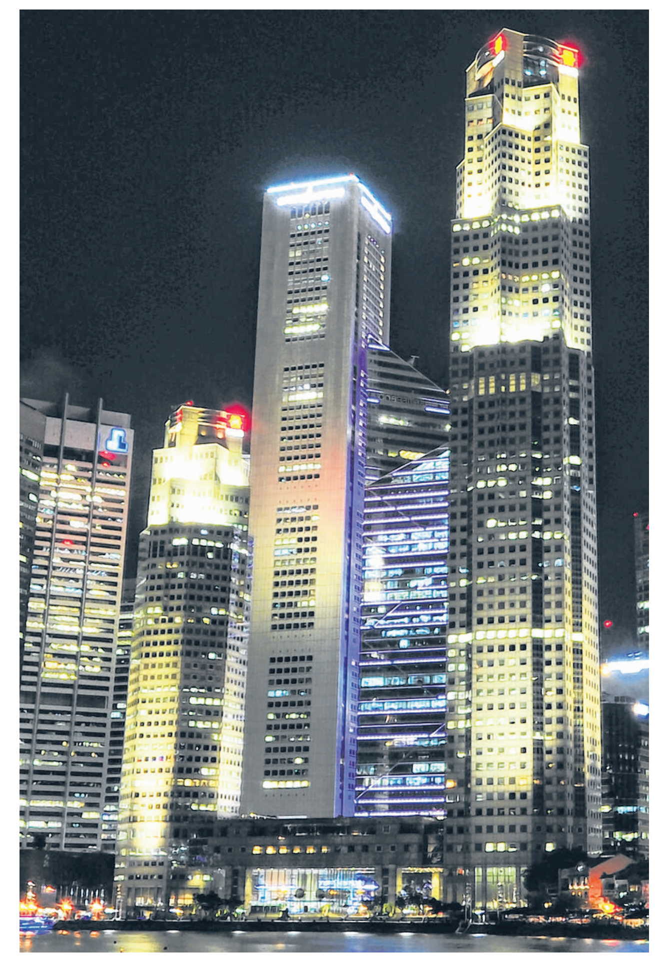

The challenge for new and smaller funds, including those operating in Singapore, is how to attract large amounts of capital and stand out from peers in an increasingly crowded market. FILE PHOTO: