CHESTNUT ADVISORY GROUP
Grow Your Edge With Investors

Taking Investors' Temperature

Market Insights For Asset Managers

September 2015

Upcoming Appearances

Alpha Hedge West
September 27–29
San Francisco, CA

Chestnut CEO Amanda Tepper is moderating a panel on Hedge Fund Branding Best Practices

PAICR Annual Conference
November 16–17
New York NY

Amanda Tepper is hosting a presentation on "How To Grow Your Edge With Investors"

Client Servicing for Institutional Asset Managers
November 30–
December 1
Boston, MA

Amanda Tepper is speaking on two panels

Trust, but Verify: Best Practices for Communicating about Operating Risk

Although building investors' trust is crucial to a successful asset management business, it is not easy to do, particularly when it comes to verifying and monitoring the status of asset managers' operations. New tools providing investors a live database of key operating risk factors are an excellent solution, and we expect early asset manager adopters of these systems will gain market share as a result.

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The Biggest Hedge Funds Continue To Eat Their Competitors' Lunch

As we have often noted, the largest asset managers are continuing to gain market share at the expense of smaller managers. The hedge fund segment of the industry also mirrors this trend, which accelerated markedly in the first half of this year. In the six months ended July 2015 the largest hedge funds received a whopping 71% of all new capital inflows.

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Trust, but Verify: Best Practices for Communicating About Operating Risk

Our research shows that highly trusted asset managers raise more assets more quickly, and retain their assets longer, than other managers.[1] Building and maintaining that trust, however, is not easy. When it comes to verifying and monitoring the status of asset managers' operations, the due diligence process is becoming increasingly onerous for everyone involved. New tools providing investors a live database of key operating risk factors are an excellent solution, and we expect early asset manager adopters of these systems to gain market share as a result.

Understanding Operating Risk is Important to Investors…

In a recent Chestnut survey of asset allocators, over 50% of respondents told us that operating risk was a top concern when hiring asset managers.[2] In research we conducted for our white paper last year, 82% of allocators ranked a strong understanding of an asset manager's risk management policy as highly important in their hiring process.[3]

…Although the Process to Gain That Understanding is Painful

One major issue with operating due diligence as it stands today is that there are no widely accepted standards for measuring and monitoring this risk. As a result, each consulting firm and institutional pension plan has their own custom DDQ and due diligence process. This means that asset managers and their key service providers must answer slightly different versions of mostly similar questions over and over. This inefficient system is becoming an increasingly onerous tax on asset managers.

…And Not Particularly Helpful or Forward-Looking

Katina Stefanova, an expert on asset manager operating risk, shared her views on – and some potential solutions to – this vexing issue with us. Ms. Stefanova served as a key leader building Bridgewater's critical business functions as that firm grew from $15 to $150bn. Currently Ms. Stefanova is launching two new firms: Marto Capital, a multistrategy asset manager, and AcordIQ, a portfolio governance solution firm.

First on Ms. Stefanova's list of items to fix in the current approach to managing operating risk is that most investors and consultants focus primarily on lagging indicators. Unfortunately this method is highly ineffective, since by the time lagging indicators raise red flags, it is usually too late to lessen the blow. For example, two key items most commonly monitored for operating risk include employee turnover (too late; the key people have already left), and careful monitoring of past investment performance (too late; the performance has already crumbled or strayed from the stated style).

> "Any asset manager can build investor trust through three important steps: being credible, reliable, and transparent."
>
> — Katina Stefanova,

Transparency Around Governance is a Better Approach

We asked Ms. Stefanova, "What does it mean to create trust between LPs and asset managers, and how do you achieve that?" She told us, "any asset manager can build investor trust through three important steps: being credible, reliable, and transparent." Assuming most asset managers are indeed setting realistic goals for themselves (credible) and are already doing exactly what they say they will do (reliable), the real pain point in the operating due diligence conundrum – and area for improvement - is transparency.

Ms. Stefanova believes it is particularly important for asset managers to provide transparency around governance, such as making it clear to allocators on an ongoing basis that managers are following their own risk guidelines. Asset managers that can convincingly address this issue should be lavishly rewarded by investors; investors have told us in our recent research that the single biggest risk they are concerned with when hiring an asset manager is whether they will stick to their own risk guidelines.[4]

Focus on Leading Indicators of Operating Risk

The most effective way to provide investors with convincing evidence that operating risk is well under control, according to Ms. Stefanova, is by proactively shifting the focus of risk management from lagging to leading indicators. For example, it is generally accepted that an asset managers' ability to attract, retain, and cultivate talented individuals is an important indicator of potential operating risk. Rather than monitoring employee turnover, however, Ms. Stefanova suggests a focus on more forward-looking talent retention and development efforts, such as whether or not there is sufficient (or any) succession planning, especially of founders; employee happiness/engagement survey results; and recruitment data. By demonstrating a solid culture and infrastructure around talent, asset managers can build trust with investors.

Other forward-looking areas in which managers can help allay investors' operating risk concerns center around the asset managers' values, culture, and technology. The maturity of a firm's technology systems, the internal tech pipeline as currently used in the investment process, and the reliability of their tech designs are excellent but often overlooked indicators of potential operating risk.

Reducing the Operating Due Diligence "Tax" on Asset Managers

Once established, these customizable databases make critical information readily accessible to managers and their investors without reliance on error-prone human processes or sifting through mountains of unnecessary data. While such governance platforms will not preclude investors and consultants from asking for other operating data that is not in the asset manager's standard setup, it should substantially reduce the ongoing operating due diligence burden on the asset manager.

Once Again, the Biggest Hedge Funds Continue to Get Bigger

As we have often noted, just as with the rest of the asset management industry, the hedge fund industry is also rapidly consolidating, all through market share shifts. The big are getting bigger every year, while smaller funds are finding it more and more difficult to attract and retain clients. In 2014 hedge funds with $5bn or more of AUM received 51% of all net asset flows. This trend accelerated markedly in the first half of this year, with the largest hedge funds receiving a whopping 71% of all new asset allocations through July 2015.

Hedge Fund Asset Flows by AUM Size, 2014–2015YTD

Hedge Fund AUM	Jan–June 2015 $ bn	Jan–June 2015 %	2014 $ bn	2014 %
Over $5bn	$29.0	71%	$38.7	50.7%
$1–5bn	$5.3	13.4%	$27.6	36.2%
Less than $1bn	$6.0	15.1%	$10.0	13.1%
Total	$39.7	100%	$76.3	100%

Source: HFR

The hedge fund industry's largest funds now control 69% of the total assets, although these firms represent only 6% of all hedge fund firms, according to HFR. What is driving this continued market dominance?

Hedge Funds With the Strongest Brands Continue to Raise the Bar

In order to effectively build the necessary trust to commit their capital, investors have told Chestnut that they want to receive a steady stream of deep and relevant investment substance from their asset managers, delivered in a clear, concise and consistent manner.

For example, one Top 10 hedge fund recently told us that they have a 21-person team making a large, sustained effort to continually reinforce the perception of their firm as smart and world class. One way they do this is by ensuring they send a thoughtful newsletter to their investors every time there is a big move in the markets.

This is consistent with the results of Chestnut's research into what investors want from their asset managers. In one of our recent surveys, sixty-nine percent of respondents said the timeliness and quality of an asset manager's headline event communications is important when making a decision to hire or fire a manager.

Interestingly, we also learned that more institutional investors turn to their asset managers for insight about the potential impact of a headline event on their portfolio than to any other source, including consultants, media and peers. We believe that the outstanding efforts of the largest asset managers have set the bar high, so that other asset managers who do not reach out to investors with any insight after a substantial market move look poor in comparison.

Brand-Building Investment Is Paying Off

Investor marketing spending by hedge funds increases dramatically with hedge fund size. For example, funds averaging $1.5bn in size spent $1.3mm annually on their client efforts in 2013. In contrast, funds averaging $10bn in size spent $7.8mm annually on their investor base, and the largest funds, averaging $36bn in size, invested an average $15.3mm annually on investor marketing. Clearly these funds are seeing a good return on their investor brand-building investment and setting a high standard for the rest of the industry.

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[1] *Your Performance Doesn't Really Matter,* Chestnut Advisory Group, 2014
[2] *Risk is a Four-Letter Word,* Institutional Investors' Edge, June 2015
[3] *Your Performance Doesn't Really Matter,* Chestnut Advisory Group, 2014
[4] *Risk is a Four-Letter Word,* Institutional Investors' Edge, June 2015

For a full copy of our white paper "Your Performance Doesn't Really Matter: What Successful Asset Managers Do Differently", please visit our website, www.chestnutadvisory.com, or contact us directly: info@chestnutadvisory.com