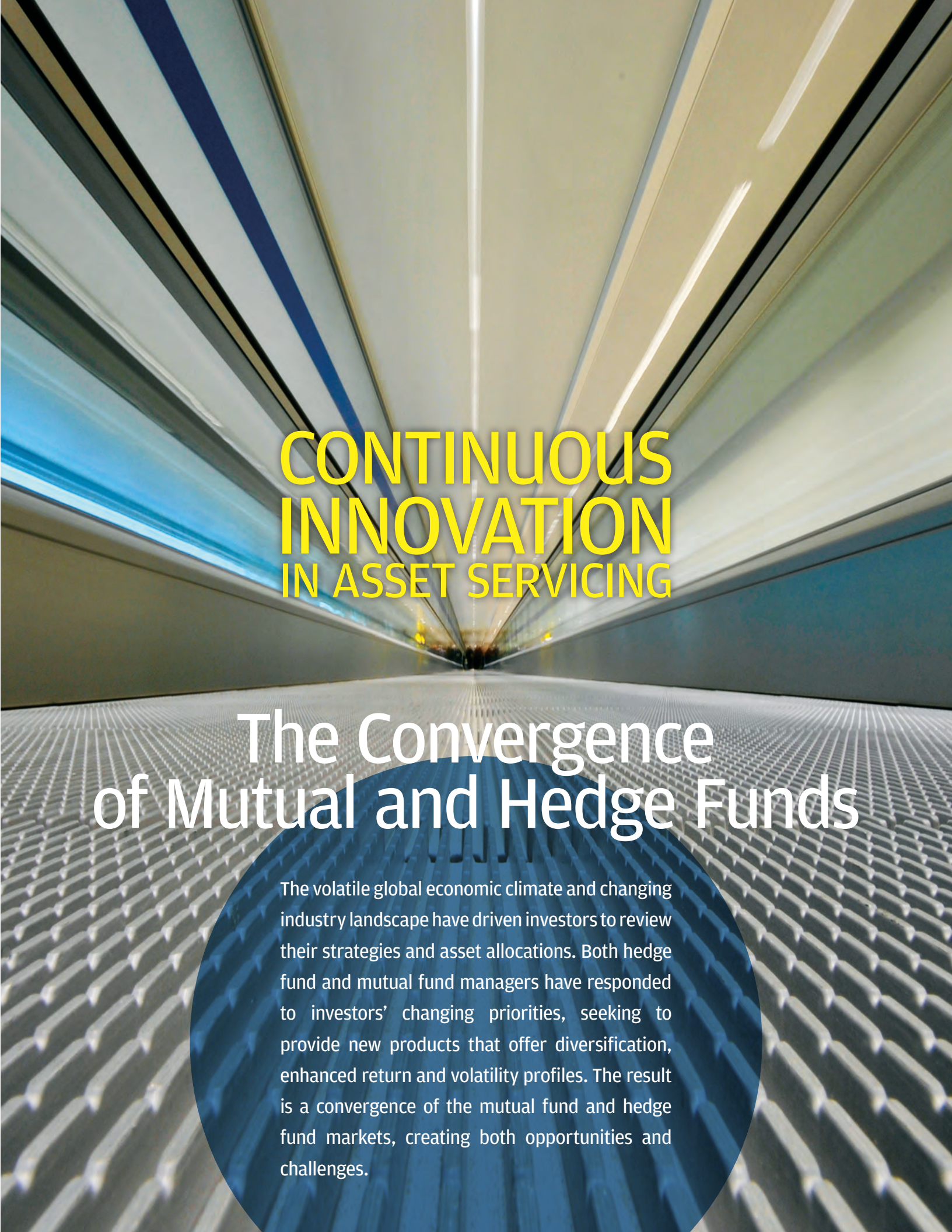

CONTINUOUS INNOVATION IN ASSET SERVICING

The Convergence of Mutual and Hedge Funds

The volatile global economic climate and changing industry landscape have driven investors to review their strategies and asset allocations. Both hedge fund and mutual fund managers have responded to investors' changing priorities, seeking to provide new products that offer diversification, enhanced return and volatility profiles. The result is a convergence of the mutual fund and hedge fund markets, creating both opportunities and challenges.

The alternatives trajectory

In 2008 and 2009, after a decade of exponential growth, hedge funds suffered two years of negative capital flows, but fund assets have since rebounded. From 2010 forward, Hedge Fund Research (HFR) estimates that hedge funds have attracted more than $125 billion in new net global flows.[1]

In addition, a recent study by PERTRAC observes that the average age of an alternatives UCITS fund is 3.5 years,[2] indicating that these funds are typically new to the industry. In January 2009, alternatives UCITS assets dropped to €38 billion across 200+ funds before following a generally upward trajectory to reach €150 billion in October 2011 across approximately 900 funds.

The opportunity

Some registered fund managers have capitalized on this growing interest in hedge fund strategies by offering innovative products within a registered fund framework. Mutual fund managers may find that the competition is crowding their space, making it increasingly challenging to differentiate themselves and outperform. As such, they may seek to expand their investment tool kit. For example, a manager who wants to express a view that some investments will underperform may seek to launch an extended fund, often referred to as "130/30," where the manager has 130% long exposure and 30% short exposure for a net exposure of 100%. A manager may incubate this new investment approach by launching a new alternatives fund, using it as a proof of concept while it gains momentum and client investments.

Another reason mutual fund managers are offering alternatives strategies is to retain key talent. As the hedge fund market has expanded over the past decade, talented portfolio managers seeking to employ cutting-edge investment strategies have been hired away from more traditional investment shops to smaller, more entrepreneurial hedge fund firms. Some of the traditional asset management firms have found that allowing these key performers to manage alternatives' products has not only served to increase job satisfaction but also to provide revenue diversification for the firm.

Concurrently, some hedge fund managers are finding attractive opportunities within the registered fund market. According to the ICI, 90.2 million individuals own mutual funds in the U.S., representing 44% of all U.S. households. For those households, the median investment in mutual funds is $100,000 and represents $230 billion in aggregate. Non-financial institutions in fact represent the largest ownership of mutual funds in the U.S., with $730 billion as of 12/31/2010, and financial institutions such as credit unions, insurance companies and banks own $544 billion.[3] Making inroads into these markets could offer a significant revenue opportunity to hedge fund managers wanting to diversify their revenue/investor base. Mutual fund investors have responded with enthusiasm, as this allows them to access alternative strategies for which they may not have otherwise qualified.

The challenges

As noted above, managers have compelling reasons to launch alternatives' funds. However, these opportunities are coupled with some significant complexities and challenges.

Cannibalization of existing clients: Hedge fund managers who launch registered funds may face cannibalization of their existing client base. Their clients may feel that they are better served by investing in the lower-priced registered fund. In addition, the exclusivity associated

with being a hedge fund investor might be somewhat diminished if the same strategy is available to all investors. As such, this could potentially dilute margins of the existing hedge fund business.

Impact of convergence on fees: Alternatives managers have found that they are able to charge premium fees relative to those charged for traditional long-only funds, as they typically offer a more flexible investment approach with different risk/return profiles and correlations. However, the entry of new players could result in lower fees across the alternatives' funds market.

Experienced hedge fund managers may command a higher fee schedule, as they have more knowledge of leverage, shorting and other derivatives tools to express their market views. New entrants may need to consider if their prior success in the mutual fund segment warrants the higher returns charged by others. In addition, investors in the registered fund space are accustomed to more clarity in fee disclosure and may expect either simple asset-based or simple performance-based fees prevalent in their investment universe.

Asset servicing considerations

These new strategies represent an increase in complexity and require a higher degree of asset servicing and customized client support. In the context of this new convergence model, hedge and mutual fund managers should ask:

- ***What types of global services will I need?***

  When contemplating entry into new markets, asset managers may require guidance. Hedge fund managers may need education on market requirements and regulatory schemes as they develop a local presence or new distribution channels. There are additional complexities to launching a registered fund, including shorting and associated complexities of funding, posting and movement of collateral, regulatory requirements, the establishment of trusts and Boards of Directors, the creation of a prospectus, and SEC listing and ongoing filings. The answer is a global service provider that can provide advice, experience and ability to guide you through execution of your strategy across the multiple requirements for these products.

- ***Would I benefit from integrated asset servicing?***

  Managers of alternatives' strategies should consider the potential benefits derived from partnering with a single asset servicing provider that offers financing, securities lending, prime custody and derivatives servicing on an integrated, consolidated platform. Managers who employ hedge fund-like and portable alpha strategies inclusive of shorting and derivatives may find they also require the enhanced services provided by a global firm

Fee Models

Hedge fund managers have been able to command a premium for their products given, among other things, absolute return profiles, flexibility in range of investment tools and the ability to generate alpha. It is typical for such managers to charge investors a management-based fee plus a performance-based fee.

As mutual fund managers begin to offer these products, some are utilizing a different fee model. Specifically, they are using straightforward asset-based management fees, although they tend to be higher than those charged for traditional long-only mutual funds.

There is a divergence of opinion on the future state of alternative funds' fees. In a 2011 survey conducted by Morningstar and Barron's,[4] some participants responded that managers with fund of funds' structures experienced fee concessions to investors, acknowledging that seed investors and large investors were able to achieve fee concessions for alternatives investments. However, the majority of respondents did not experience pricing compression, indicating that they utilized "40 Act vehicles" and that fees were "included under [a] standard asset-based fee schedule." Alternatively, a paper published by KPMG[5] purports that the industry convention of "2 and 20" (2% management fee and 20% performance fee or "carried interest") is likely to diminish as the primary fee structure in favor of performance-based fees where managers get paid only when their investors outperform a benchmark or hurdle rate.

Convergence – The Broad View

OPPORTUNITIES	CHALLENGES
Demand for alternatives from mutual fund investors	Registered funds have strict disclosure, valuation and reporting requirements
Revenue diversification for asset management firms	Increased competition is likely to bring down industry fees
Demand higher fees than for traditional long-only mutual funds	Entering the alternative space may cannibalize existing profitable businesses
Allows managers more tools in their investment toolkit	Alternative strategies are more complex and require specialized knowledge and increased oversight

across prime brokerage, execution services, custody, financing, securities lending, futures and options, derivatives, collateral management and other market-related services. In addition, the investment flexibility of derivatives makes them inherently more complex and costly to service, allowing a provider with an integrated platform to streamline the process for you and reduce the risk associated with multiple service provider solutions.

▶ ***Do I require a new level of valuation services?***

The daily valuation standards for mutual funds can seem quite rigorous to hedge fund managers new to the space. Because mutual funds must publish a daily price, the fund companies must be able to produce a daily fund valuation, or Net Asset Value (NAV). As these funds often engage in derivatives-based strategies, valuation becomes much more complex and may be outside existing service levels. Asset managers should seek a service provider with a range of pricing sources and in-house expertise to ensure valuations are performed with timeliness and accuracy.

To be successful, alternatives asset managers need to understand and mitigate the risks inherent to new vehicles and markets. These strategies require a new level of servicing and can take both time and resources as the firm comes up the learning curve. Choosing an asset servicing partner who offers the best fit of services can facilitate the development of a robust oversight model, allowing managers to focus on their core competency of asset management.

The expanding investor and product landscape

As professional investors evolve the industry will continue to see new vehicles, instrument types and portfolio structures. With these expanded strategies come different opportunities and challenges. To capitalize on these strategies, managers need to consider both investment and consequent operational changes to their businesses. This is part of the analysis that all managers should undertake in looking to expand their offerings across the traditional and alternatives fund space.

J.P. Morgan is a global provider for end-to-end asset servicing with industry-leading expertise across all fund types and structures. The firm's spectrum of services, global footprint and deep experience ensure customized, full-service support. ■

Russell Warren
Product Executive, Investor Services

[1] HFR, "HFR Global Hedge Fund Industry Report," Third Quarter 2011; from 1/1/2010 to 9/30/2011, hedge funds attracted $126,187 billion in net asset flows globally; www.hedgefundresearch.com

[2] PERTRAC, "The Coming of Age of Alternatives UCITS Funds," January 2012; www.pertrac.com

[3] ICI, "2011 Investment Company Factbook;" www.ici.org/pdf/2011_factbook.pdf

[4] Morningstar and Barron's, "2010 Alternative Investment Survey of U.S. Institutions and Financial Advisors," January 17, 2011; www.morningstar.com

[5] KPMG, "Transformation, The Future of Alternative Investments," 2010; www.kpmg.com

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