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Foreword

As the global financial services industry begins to prepare for the post-pandemic world, the hedge fund industry has also been assessing the challenges and opportunities ahead and sharpening its strategies. While the implications of the pandemic will continue to reverberate, much knowledge has been assimilated that resonates with hedge fund organizations about their people, technologies, and cultures. With its investment strategies also well positioned for a strategic place in alternative investment portfolios of investors in the years ahead, the hedge fund industry readies itself for the next chapter.

We last visited the progress of the hedge fund industry in “Agile and Resilient” (a 2020 report also conducted jointly by AIMA and KPMG) during a period of significant market volatility and business uncertainty. That report highlighted how well the industry managed risk and volatility for its investors with above-market returns that were often rewarded with new allocations. The virtual operations of these organizations, in conjunction with the industry’s ecosystem, executed seamlessly in that decentralized environment. Overall, despite the headwinds, it was an exemplary year for the industry.

At the same time, in contemplating the challenges of working in such an environment, the industry began to focus on several critical issues that it perceived as challenges to optimal performance. As the pandemic progressed, the industry expressed concerns about sustaining innovation and fostering collaboration in this virtual setting. Organizations that devoted years to developing a culture for innovation and success knew that maintaining these company values was critical to future growth and attracting and retaining talented people.

The period also crystallized the importance of the industry’s relationship with its investors. As hedge funds pivoted to a virtual capital-allocation world, pre-existing relationships mattered. Despite the advances in virtual data room technology, allocations to new relationships were curtailed. Organizations accelerated investments in hiring investment relations personnel.

To be sure, the recognition of the benefits of technology, both in the front and back office, became increasingly apparent. The cyber risks of a decentralized environment were front and center for all financial services companies. The enabling power of digital technology resounded with the industry.

As the industry enters the next chapter, this new research suggests that the trends observed a year ago have begun to take on additional dimension and importance. Certain new trends have also emerged as strategic imperatives to the future of these organizations.

Foreword (continued)

These issues, as described throughout the study, were top-of-mind of the firms surveyed and interviewed. The questions explored in the report include the following:

How does a firm optimize collaboration in the more complex and challenging hybrid working environment? Who needs to collaborate? How can we continue to also further optimize the virtual structure that is a key component of the model?

Who wins the war for talent? How is that done effectively, yet still embracing the goals of innovation and expanding diversity? What is the frontier for that war - technology? ESG? investor relations?

To what extent does the current virtual capital raising environment sustain itself? What will be the key changes in the ongoing relationship between managers and investors? As investors continue to play a more active role in portfolio construction, to what degree does product complexity and innovation impact the path forward and the business model?

What new investment opportunities emerge from the events of the past two years? Is the industry moving to a product innovation stage that maps toward a new array of portfolio development? Does the growth in private credit and hybrid private equity continue to shape future portfolios?

What is permeating all functions within a hedge fund? Technology is clearly the answer. But what is the correct strategy to embrace the digital, cloud, alternative data, AI, blockchain innovation race that is occurring? How does the industry embrace the ecosystem to achieve scale?

These are a few of the matters covered in this latest in-depth look at the hedge fund industry. How will the hedge fund industry embrace these new challenges? In the summaries that follow, the results are shared from the significant themes impacting the industry. Economic uncertainty abounds but the research suggests the industry is well prepared and poised to take the critical generational steps in the next evolution of the industry.

Tom Kehoe

Managing Director, Global Head
of Research and Communication
AIMA

Steven Menna

Partner, National Hedge Fund
Segment Leader
KPMG in the US

About the research

This survey is part of an ongoing series of research initiatives conducted by KPMG and AIMA since 2012. This year's paper explores how hedge funds have pivoted to the new working environment brought by the onset of the Covid-19 pandemic. The survey was "in field" through Q3 of this year allowing AIMA and KPMG to gather real time data and insights on trends prevalent across the global hedge fund industry.

For this research we surveyed 162 industry professionals accounting for an estimated \$1 trillion in Assets under Management (AUM), representing approximately a quarter of the industry's total asset size.

Responses were divided by order of size. Larger managers (where the firm's assets under management (AUM) exceeded US\$1 billion) accounted for 53 percent of all responses, while smaller managers (where AUM was up to US\$1 billion) accounted for the remainder; 47 percent. From a geographic perspective, over half (54 percent) of all respondents were from North America; 29 percent from EMEA; and 15 percent were headquartered in Asia Pacific.

In addition, KPMG and AIMA professionals canvassed the views of the industry via one-to-one interviews with Hedge Funds, investors and key ecosystem players, including technology companies, prime brokers, fund administrators and law firms to provide additional context to the survey findings. Excerpts from those discussions are included in this report.

Thanks to our participants

On behalf of KPMG and AIMA, we would like to thank everyone that participated in the survey and shared their insights. The views you shared have been vital in helping form this unique and valuable report.



The new hybrid world of work

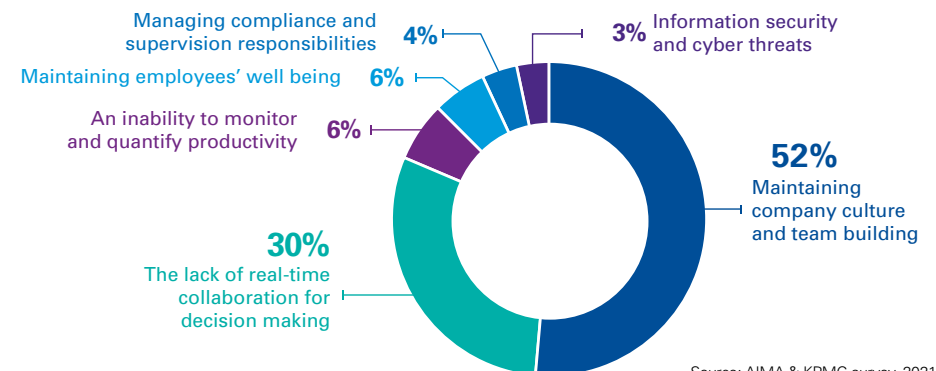
The hedge fund industry is one that thrives during periods of market volatility, because of its ability to adapt and overcome historical and emerging challenges. The new working environment that has emerged from the aftermath of the COVID-19 pandemic is another such opportunity and, as this report demonstrates, hedge funds are once again rising to the occasion.

The constantly evolving market ecosystem serves to ward off complacency and inspire innovation across a firm's investment strategies and internal operations. These pressures were on display during the onset of the COVID-19 pandemic in Q1 2020, when most of the world swapped high-rise offices for dining room tables and spare bedrooms, as city centers shut down almost overnight. Despite the disruption, business had to continue, and teams within hedge funds' trading and operations functions had to maintain normal processes in a fully remote setting, most having to do so for the first time.

The host of operational, technological, and cultural challenges that this radical shift in working practices raised was initially outlined in the 2020 edition Agile and Resilient¹, when many hedge funds were still adjusting to their new reality. The success of the transition to a digital environment was possible, in part, due to the robust ecosystem that hedge funds now inhabit. A greater reliance on outsourcing, particularly by smaller managers, is expected to continue for the long term. It opened many managers' eyes to the possibility that some core functions could be managed more efficiently by service providers.

For this year's study, hedge funds were asked to identify the most significant challenge they had faced after more than a year of operating in a decentralized environment. The main concern is maintaining company culture and team building (52 percent), followed by a lack of real-time collaboration for decision making (30 percent).

After over a year of working in a decentralized environment, which of the following challenges has been the most significant for your firm?



Source: AIMA & KPMG survey, 2021

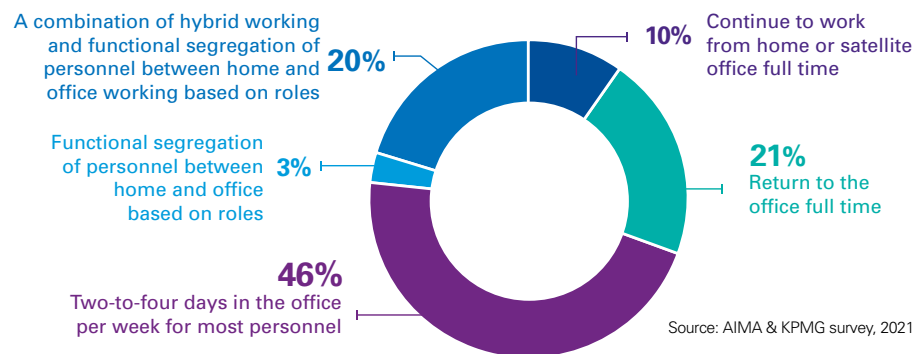
Interviews with hedge funds for this report highlighted that these issues exist at a team and a firm level. Specifically, it was noted that reducing inter-team communications to semi-regular video calls stifled spontaneous innovation. “It’s not practical to ask your team to come up with that light bulb moment at 3 pm on Thursday next week,” one US hedge fund manager quipped, while explaining why he was pushing to get his people back to the office.

Despite these concerns, it is noteworthy that an ability to monitor employees’ productivity was of less concern in late 2021, in contrast to the speculation in the previous year about whether output would suffer, because people were working from home. Most hedge funds interviewed for this report said that their staff adapted well to a decentralized working model, enabled by advanced digital communications and project management tools supported by cloud technology. The increasing influence of technology in the operations of hedge funds is explored further in the next section.

Even as normalcy returns, some form of remote working is expected to become the standard practice for most hedge fund employees. When asked what their new working model would be, respondents’ most frequent answer suggests it is likely to be between two and four days a week in the office (46 percent). The need for front-office portfolio managers to be in close collaboration is one of the leading drivers toward additional in office presence.

Some hedge funds interviewed for this report also stressed the primary importance of effective communication among senior management and C-level executives. Yet again, other firms insisted that collaboration is critical across all functions and all employees, as well as for their culture and communication philosophy.

How do you foresee your post-lockdown working model taking shape for your firm?

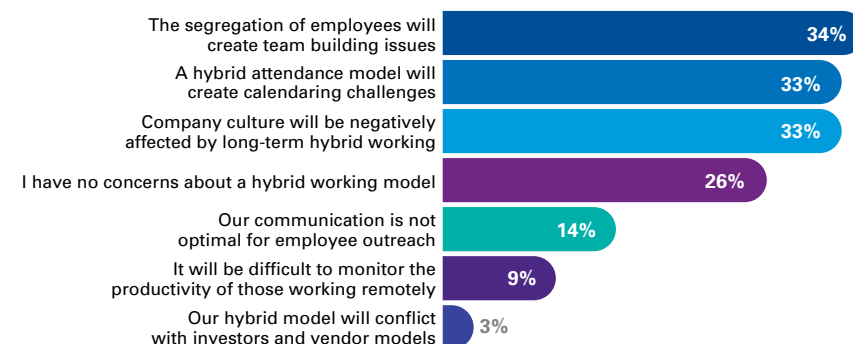


At the extremes, twice as many respondents said they will return to the office full-time as the number that will remain remote full time. Those options, however, were relatively less popular, garnering 21 percent and 10 percent of responses, respectively.

Some view a hybrid working model as the obvious compromise between hedge fund organizations that want their teams in one location and those whose employees enjoy the flexibility of remote working. At the same time, almost three quarters (74 percent) of respondents identified several issues they foresaw arising from the new working environment.

When hedge funds were asked to highlight the biggest possible challenges from those listed, the three most frequently identified were: segregation of employees causing team-building issues (34 percent); hybrid working creating calendaring challenges and crippling spontaneous knowledge sharing (33 percent); and a negative effect on company culture (33 percent).

Which of the following represent your greatest concerns in pursuing a hybrid working model? (select your top two choices)



Source: AIMA & KPMG survey, 2021

As noted above, employee productivity may not be in jeopardy, but a litany of roadblocks to innovation might cause senior management to hesitate over the prospects for a more permanent hybrid work model. So, why embrace it?

According to hedge funds’ HR representatives and executive recruiters, it relates to the war for talent. The risk of talent flight is an evergreen issue in the hedge fund industry. The events of the past two years have exacerbated this further. As a result, there is a new front in the battle to retain top talent, namely whether a firm offers flexible working and an improved work-life balance.

According to industry research by AIMA², which focused on talent management within hedge funds, almost 90 percent of the global hedge fund pool surveyed said they are ‘somewhat’ or ‘very concerned’ about talent retention in the near term.

The COVID-19 pandemic temporarily stifled much of the hiring demand, but that pressure has now been released, meaning the war for talent is now more intense than any time in recent years. As such, competition for talent is fierce in all functions, but there is a particular intensity around technology-focused roles such as quantitative analyst. Other in-demand roles include market researcher and investor relations specialists.

— Tom Kehoe, Global Head of Research and Communications at AIMA

Further details on how the pandemic effected capital raising and the IR function are laid out in section 3.

Subsequent conversations with AIMA’s manager members and industry recruiters repeatedly linked this data point to how firms are approaching the return-to-the-office question. It has proven impossible to address each employee’s individual preferences on how often to be in the office. As a result, many firms increased hiring towards the end of 2021, not only to account for business growth, but also to fill positions vacated by people who had gone to other employers that better suited their needs. Diversity in hiring and retention also factors into these hybrid strategies. As cited in a recent KPMG report entitled “Power or peril?”, women, as an example, may be negatively impacted by certain back to office models.

We see this as an opportunity for asset management firms to transform their work environments to include and support women in the industry. To do this firm leaders need to understand the unique challenges women face in the new reality of work. It’s clear firms are going to need to make changes to keep their top talent. It’s less clear that women who work in certain hybrid environments may be at risk for losing opportunities for advancement.

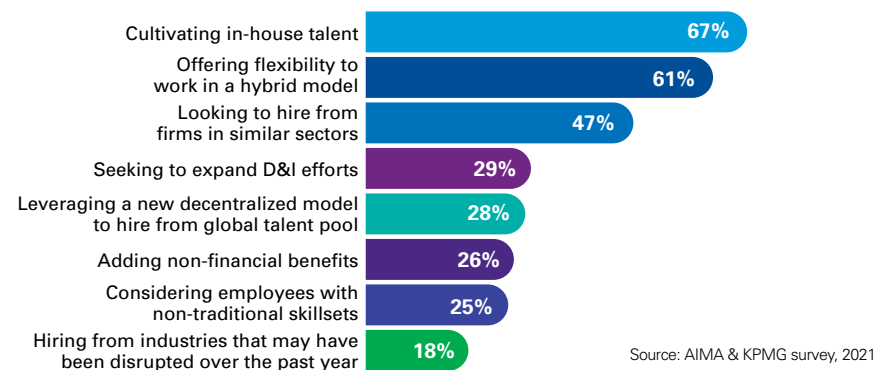
— Camille Asaro, Partner, Audit – Asset Management, KPMG in the US

The initial COVID disruption caused something of a détente in the war for talent, but as many major city centers reopen, hiring pressure has intensified. The new rules of engagement center on what a firm can offer in addition to competitive compensation, including non-financial benefits that improve employees’ wellbeing and work-life balance.

Tom Kehoe, Global Head of Research and Communications at AIMA, said: “Conversations with our manager members have made it clear that the non-financial benefits offered by a firm are more important than ever. An ability to work flexibly and benefit from an improved work-life balance is now a central theme that will decide if a new candidate decides to join your firm or if an existing employee remains with you.”

Asked to select up to three weapons in their arsenal for both retaining and securing top talent, six out of 10 respondents said they are offering flexible working. A further 28 percent aim to use the ability to work remotely to tap into global talent pools they might not have considered previously. This was particularly prevalent in ASPAC, where the hedge fund industry’s talent pool was less developed. Slightly more than a quarter (26 percent) are looking to rely more on offering non-financial benefits more broadly, such as physical and mental health facilities. The most popular option, meanwhile, was cultivating in-house talent (67 percent), which speaks to the importance of maintaining a positive company culture essential to ensuring a low turnover of staff.

Which of the following reflect your firm’s primary incentives and strategies for retaining and securing top talent? (select your top three choices)



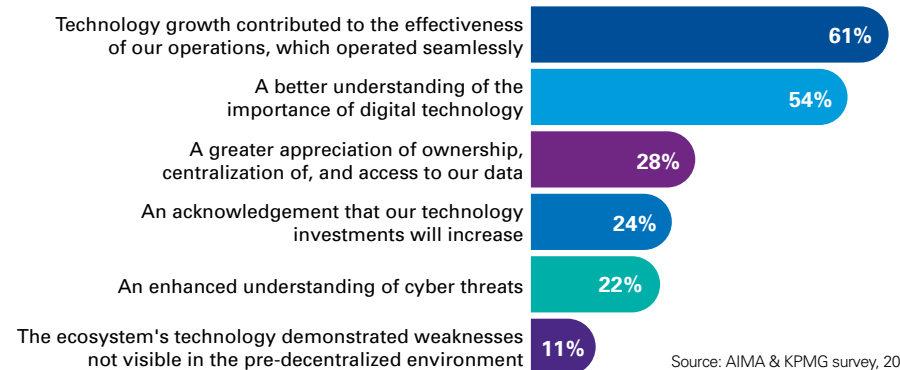
The pandemic brought mass disruption to business operations and global economies, but change also brings opportunities, and few industries are better suited to identifying and capturing them than the hedge fund industry. Firms that are able to adapt to the new working environment will not only survive but thrive. ●



2 Technology, the great enabler

Since early 2020, executives have realized that technology not only enabled adaptation in a decentralized environment, but also created a great opportunity to enhance all functions of the business. Reflecting on 2020's, Agile and Resilient report, there was a clear focus on the new working environment and the ability of hedge funds to continue operating successfully while employees worked remotely. Firms were asked what they had learned from the past year regarding their technology operations.

Which of the following best reflect your firm's key takeaways from operating in the remote working environment? (select your top three choices)

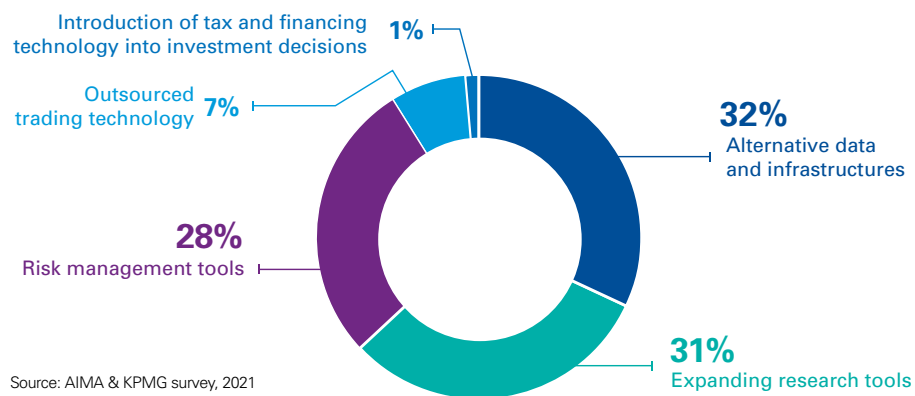


Remote and hybrid work environments have challenged the information technology functions of hedge funds. The trend shifted this year to the many benefits available through alternative data, cloud computing and digital technology, access to APIs, enterprise data management, expanded research tools and cybersecurity. Technological innovation and the increased adoption of these tools will continue to reshape the hedge fund operating model.

With the complexity of regulatory requirements and in-house fund operation costs, the reliance on outsourced technology platforms has created a proven and effective operations model for hedge funds around the globe.

— Paul Pisani, Senior Director, Alternative Investments
KPMG in the US

As part of your firm's investment in front-office technology, which option from the below list is your top priority?



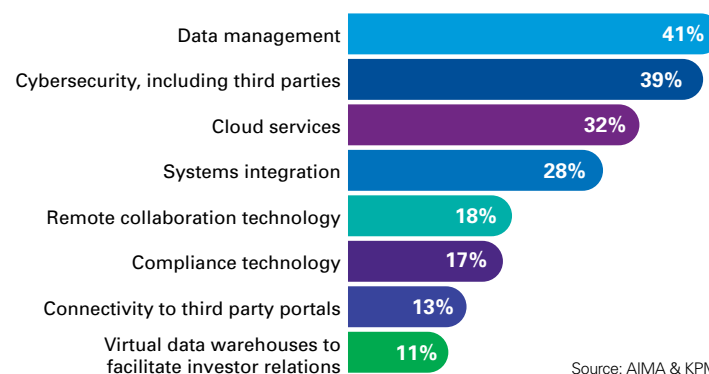
Source: AIMA & KPMG survey, 2021

Hedge funds' front office operations are prioritizing technology in the forms of alternative data and infrastructures (32 percent) and are expanding research tools (31 percent). Leveraging non-traditional data sources in the form of artificial intelligence, satellite imagery, credit card transactions, weather patterns, app usage, social media posts, and so on, have provided an opportunity for many funds to differentiate their investment strategies.

Financial firms are doubling down on their investments in intelligent automation as they emerge from the pandemic. This trend is intensifying, with strong tailwinds driven by worker scarcity, regulatory scrutiny, shareholder demands for profitability, and competitive pressures. Intelligent Automation is front and center for every C-level executive; so firms that can both define clear data and process automation strategies, and are able to execute, will emerge as winners of this new arms race.

— Bikram Singh, Founder and CEO of EZOPS
an AI firm focused on data and process automation

Regarding investment in the back and middle office functions, what are your firm's top two priorities?



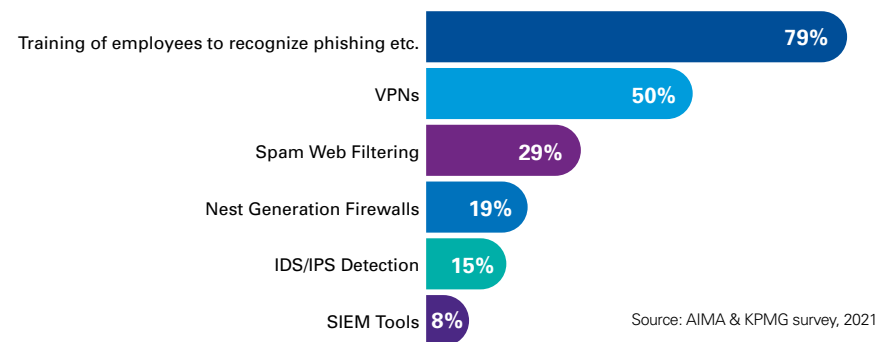
Source: AIMA & KPMG survey, 2021

In the middle- and back-office, the focus is on data management (41 percent) and cybersecurity (39 percent). While enterprise data management systems had been part of development plans for many firms, the pandemic brought new urgency to the matter. With so many sources of data and the constant shifting of data and personnel locations, Enterprise data management systems have now become a strategic necessity. Many difficulties arise with the need to stabilize data and personal information in an ever-shifting work environment.

"Moving to a hybrid work environment challenges the way we once thought about securing our edge. Suddenly we had to think about our data living everywhere, all of the time. This challenged us to build new endpoint-centric security measures to prevent data loss," said Jonathan Brucato, Director of Technology Services at Eze Castle Integration.

As the industry continues to see an uptick in cyberattacks, it is no surprise that cybersecurity investment is by far the top priority for firms with less than US\$1 billion under management (53 percent).

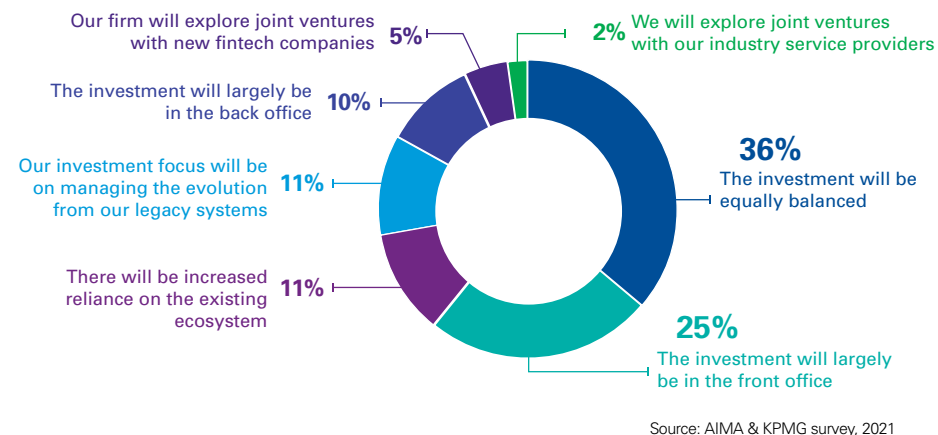
What specific tools are you using to bolster your cybersecurity capabilities? (please select your top two choices)



Simon Eyre, Chief Information Security Officer at Drawbridge Partners, echoed the study's findings. "It's highly encouraging to see the results of the survey reflect the fact that funds have moved to a higher standard of cybersecurity awareness as we approach 2022, with both investors and regulators pushing for advances. These improvements in confidentiality are combined with efforts in digital transformation to enhance the integrity of a business' data, another side of cyber that often doesn't receive the same level of attention."

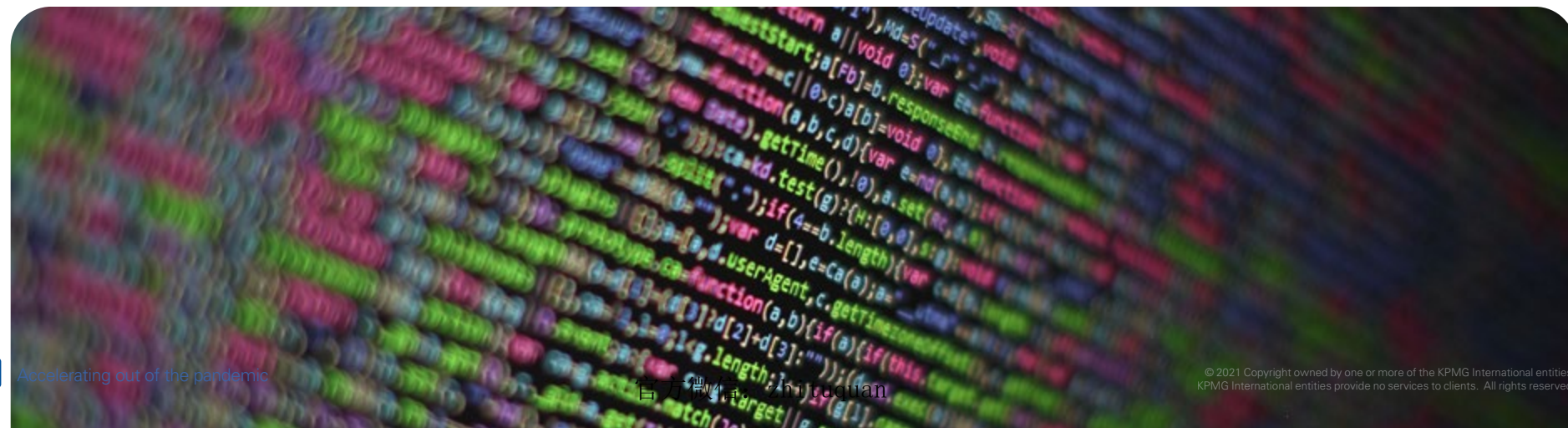
Other constituents have also moved cyber security concerns to the top of their agendas as well. Investor due diligence teams have added a series of inquiries around cyber threats and processes to curtail them. Regulators throughout the

What most accurately describes the investment focus of your firm over the next 12 months.



global community have routinely begun to define proper practices and safeguards that hedge fund organizations should adhere to.

Over the next 12 months hedge funds are anticipating technology investments to be equally balanced (36 percent) with a slight focus in the front office (25 percent). Hedge funds continue to seek ways to set themselves apart to generate alpha and raise capital; they are relying on front-office technology in the form of expanded research and risk management tools and are analyzing alternative data to do so. The current and future investments made in technological innovation are evident throughout the survey and this trend is expected to continue. ●



Capital raising, it's about the investor

Successful investment managers have adapted their operating models to appropriately accommodate the needs and evolving requirements of investors for effective due diligence in the virtual world.

— Joseph Fisher, Senior Lead Partner, Alternative Investments,
KPMG in the US

In 2021, investor demand for hedge funds continued to rise in response to the industry's success in managing volatility and risk. Total assets under management broke new records, on the back of continued good fund performance and the investment of additional capital. In September, BarclayHedge reported the seventh straight month of hedge fund inflows, a period during which the industry has attracted \$154 billion in new assets.³

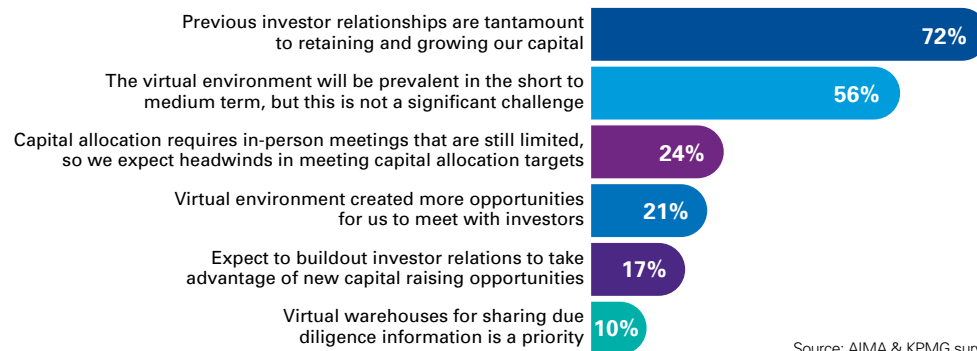
During the pandemic, one of hedge funds' most vital functions has been Investor Relations (IR). The decentralized environment has heightened the uncertainty for investors, as their ability to perform on-site investor due diligence has diminished. The benefits of meeting face-to-face with the portfolio manager and observing first-hand a firm's culture cannot be discounted. In addition, as investors are requiring customized products and investments in new financial products, industry experience and the power of existing IR relationships have been crucial to the continued success of the larger hedge funds.

Among the lessons of the previous year's disruption: 72 percent of respondents stated that previous relationships with investors are vital for retaining and growing the firm's capital. Larger established managers have benefited the most through continued increases in allocations from existing relationships with investors, with an emphasis on private credit and hybrid allocations. This speaks to the continued bifurcation of the larger and smaller managers.

The importance of pre-existing relationships between managers and investors is further underlined, as the remainder of new capital raised outside of larger firms is handled by second-generation hedge fund managers. Start-up emerging managers have faced increased fundraising challenges and have focused on building their track records with "Friends and Family" capital.

That being said, some larger managers are now returning capital to investors, as they move to longer-term arrangements, while others are closing their fund to new investments. This may be the catalyst to allow the remainder of the hedge fund industry to attract new capital. So, many emerging managers believe they are also well positioned for growth, thanks to these favorable market opportunities as well as their performance to date.

Given the past year's disruption of IR operations, what conclusions have you drawn regarding the current and future capital raising strategy at your firm? (select your top two choices)

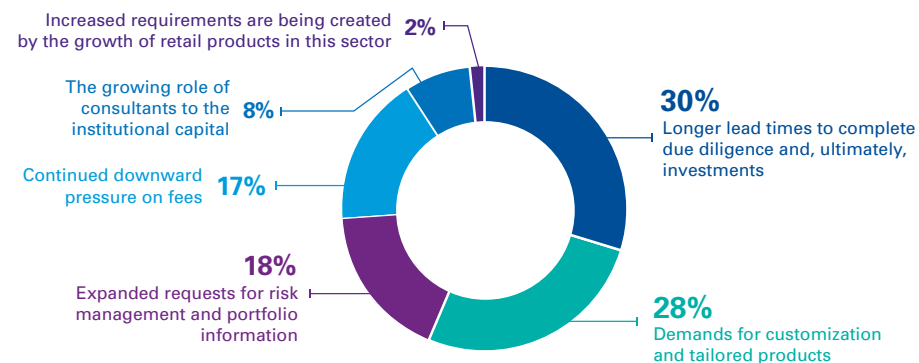


Source: AIMA & KPMG survey, 2021

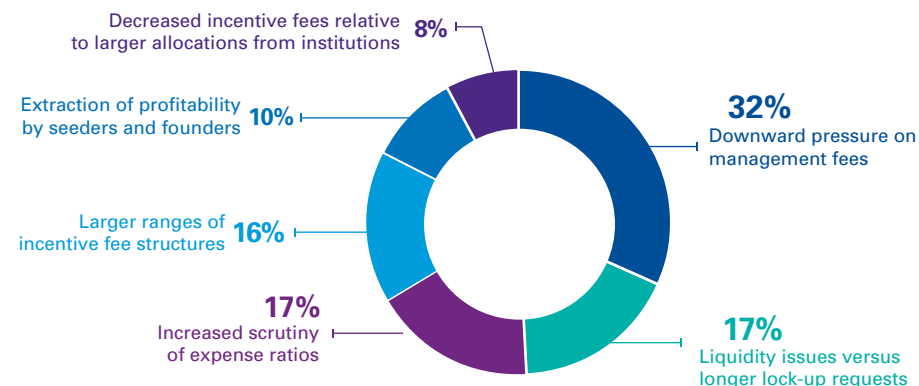
Whether from the perspective of existing funds or emerging managers, skilled IR professionals with extensive investor relationships are therefore in high demand. The evolution and optimization of digital tools, such as video conferencing and data sharing rooms, have further enabled IR teams to succeed in the virtual environment. In fact, 56 percent of respondents expect most of the work of investor relations will

continue to take place in a virtual environment in the short-to-medium term. In the future, investment managers and investors will need to find the right balance between the efficiencies of remote and digital technologies and the need for face-to-face interactions.

Which of the following investor-related issues does your firm consider the most pressing today?



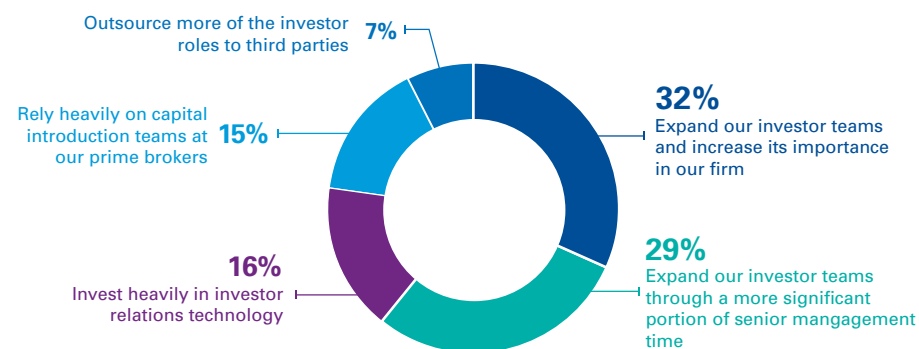
Regarding your firm's fee structure, which of the choices from the list below does your firm perceive to be the most challenging over the next 12 months?



Source: AIMA & KPMG survey, 2021

In addition, when asked about which pressure on their fee structure firms perceive to be the most challenging over the next 12 months, 32 percent of the respondents noted downward pressure on management fees. That said, overall concerns around maintaining fees relative to other macro issues are relatively low. However, there was also much discussion on the growing alignment of interests between hedge funds and investors, as customization and transparency are enhanced.

Given the changes in the relationships and interactions with investors, how would you best categorize your new strategy for capital raising and investor relations?



Source: AIMA & KPMG survey, 2021

Given the change in relationships and their more-remote interactions with investors, hedge funds were asked to describe their new strategy for capital raising and IR. Thirty-two percent of the respondents said they intend to expand their investor teams and heighten the influence of IR in the firm. The expansion of the investor relations team will need to be carefully managed, given the limited availability of the IR professionals in the current hiring environment.

To be sure, the IR function will be critical to the success of future operating models. One solution to the scarcity of IR talent is to do more with other people at the firm. Twenty-nine percent of respondents intend to increase the proportion of senior management time spent raising capital. Indeed, it has become a top priority for all functions to address investor requirements. This ability will be augmented by the continued hiring and development of top IR professionals.



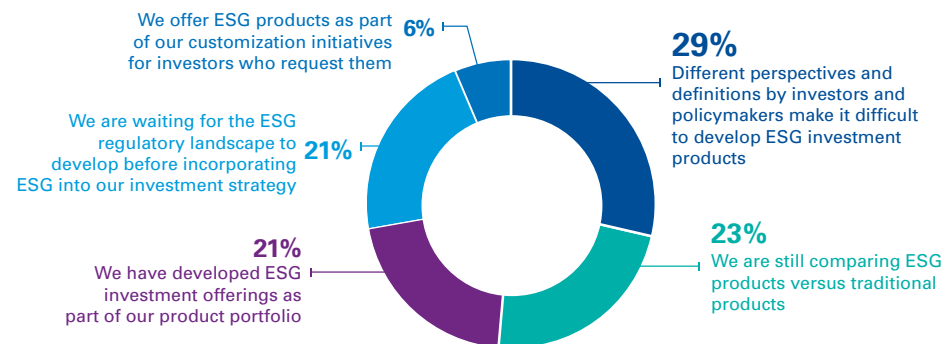
Regarding digital assets, 38 percent of respondents said that, before investing will occur, they were awaiting clarity from regulators on compliance and tax treatment, as well as further improvements to the supporting infrastructure. Interestingly, nearly 29 percent of respondents stated that their contractual obligations with investors and financing agents restrict the firm from investing in digital currencies at this time.

Investors are not only looking for a wider array of assets, but they are also insisting increasingly that ESG criteria should be included in hedge funds' investment strategy. Even though ESG investing is not new, hedge funds are taking an incremental approach, given the disharmony over ESG investing rules in different jurisdictions, as well as a lack of consistent data and the expertise to interpret it.

2021 has been a year of acceptance of digital assets by the Hedge Fund Industry. Many large hedge fund patriarchs went on record with a view that digital assets represent a legitimate asset class for investing. That said, while a handful of hedge funds have started investing in and launching funds dedicated to digital assets, the industry, as a whole, is still in the early phases of that transition. This remains a period of research and enablement for investing in digital assets, so it is likely that 2022 may see a significant move into digital assets by the more established hedge funds. At the same time, crypto asset managers are experiencing tremendous growth as institutional investors move into the asset class.

— Mikael Johnson, Senior Audit Partner,
Alternative Investment Practice, KPMG in the US

Which of the following choices represents your firm's current investment approach to ESG?



Source: AIMA & KPMG survey, 2021

A reason for this is the lack of a commonly accepted standard for measuring ESG criteria. Twenty-nine percent, the highest share, agree that “it is difficult to develop ESG investment products owing to the different perspectives and definitions by investors and policymakers.” In addition, 23 percent, the next largest segment, say they are still researching the comparative performance of ESG-focused versus traditional products. Some managers interviewed noted that investor sentiment varies around ESG scores or sustainability factors and that it is challenging to develop products until there is more specific clarity from the regulators on requirements.

The evolving investment landscape presents managers with many new challenges. Success may be defined by a manager's ability to evolve their business models and transform their operating model to meet, or exceed, the increasing demands of their sophisticated investor base. ●

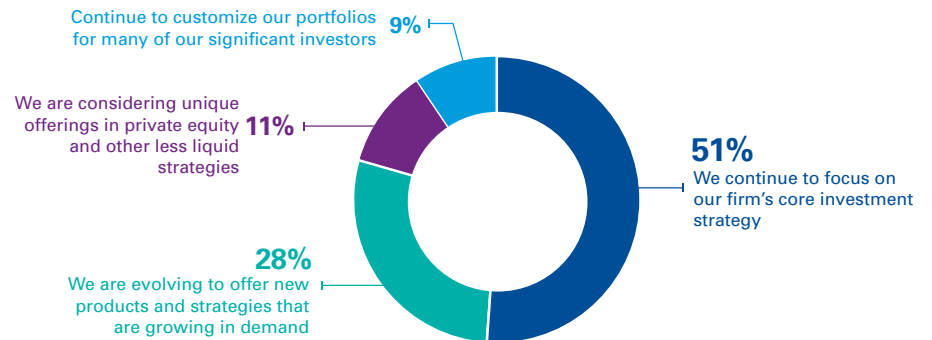
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Product innovation, the differentiator

The acceleration out of the pandemic has resulted in many fund managers evolving their investment products and strategies to align with their investor demands in the current environment.

— Ed Hollywood, Managing Director, Alternative Investment Practice, KPMG in the US

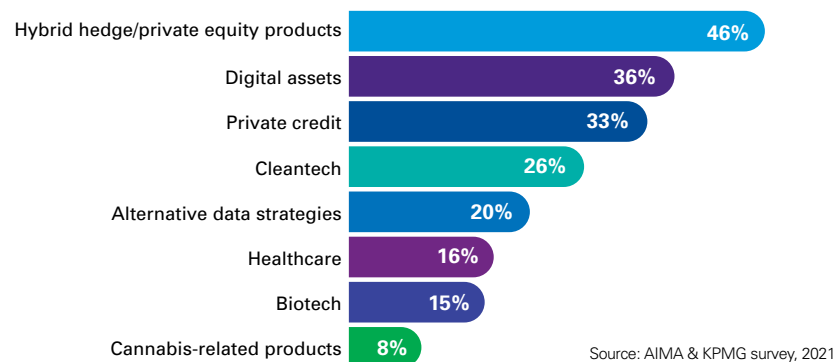
Which of the following best describes the evolution of your firm's investment product over the past 12 months?



Source: AIMA & KPMG survey, 2021

While approximately half (51 percent) of investment managers said they would continue to focus on their core investment strategy, 49 percent of managers have complemented their traditional investments in the public markets with investment opportunities in private markets or in other new products or strategies. These hedge fund managers have adapted to recent investor demand for private credit and hybrid strategies in private markets to augment their traditional hedge fund strategies. Therefore, investor allocations have begun to shift in part to managers with investment capabilities in both arenas. According to research by AIMA's Alternative Credit Council and with Intelligence's Private Credit offering (formally Private Credit Fund Intelligence) just over a third of LPs plan to commit further capital to private credit in the second half of the 2021.⁴

Which top two strategies do you believe will grow the most in popularity over the coming 12 months?



Survey respondents and interviewees noted that, during the pandemic, investors have taken a more granular approach to their portfolios by demanding new hybrid products that accomplish specific portfolio objectives. When asked to choose the two most popular investment strategies (where there is a significant uptick in interest and a belief that there will be continued future growth in the next 12 months), the top responses were: hybrid hedge/private equity products (46 percent), digital asset (36 percent), and private credit (33 percent). Of course, the operating model, in turn, has to consider the implications of these new products and to create tax-efficient structures for them. Firms must also consider the liquidity of the portfolio, as well as the impact on administration, compliance and financial accounting.

The volume of start up enterprises for emerging managers has been steady over the past year in comparison to 2020, most of which are focusing on equities. Niche areas, such as biotech or technology, are particularly popular. Another popular area is where managers are focusing on both public and private equities. Managers are either providing access to their best private equity ideas in a co-investment vehicle or creating a hybrid structure which includes 'side pocket' functionality.

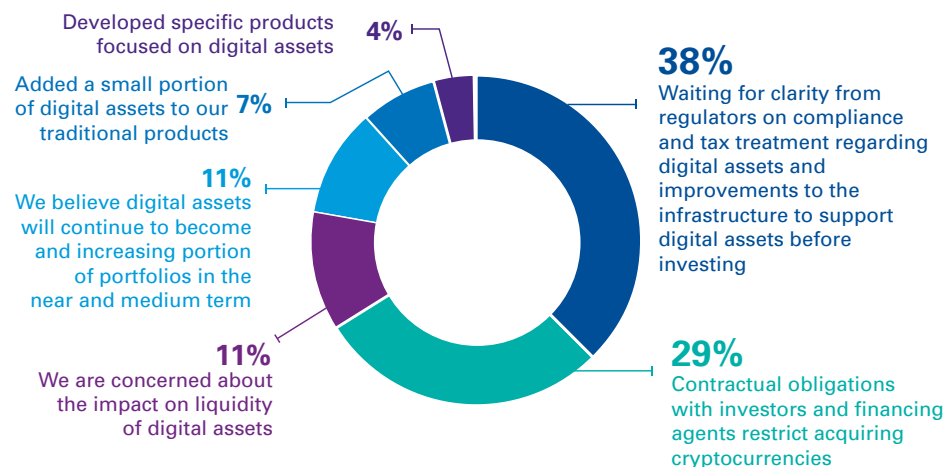
— Christopher Mears, Audit Partner and National Emerging Manager
Audit Practice Leader, KPMG in the US

There are so many nuances to consider, including whether to invest in their existing marketable bucket or through a side pocket. In addition, managers need to balance the existing percentage of private investments allowed to be acquired, based on their governing documents. Investment managers need to fully comprehend the accounting and tax matters in order to be successful.

— Seth Factor, Tax Partner and National Emerging Manager
Tax Practice Leader, KPMG in the US

With their investments in private markets, investment managers need to balance their potential returns versus the liquidity considerations of the portfolio. Conversations with various industry leaders suggest there has been a significant increase in separately managed accounts, co-investment opportunities, “best ideas” funds and side pockets, to allow hedge fund managers to satisfy investors’ demand for greater exposure to them, while continuing to maintain the liquidity terms of the hedge fund vehicle. The structural complexities that accompany product innovation can be daunting and difficult to scale. ●

Which of the following choices best represents your firm’s current approach to digital assets?



Source: AIMA & KPMG survey, 2021

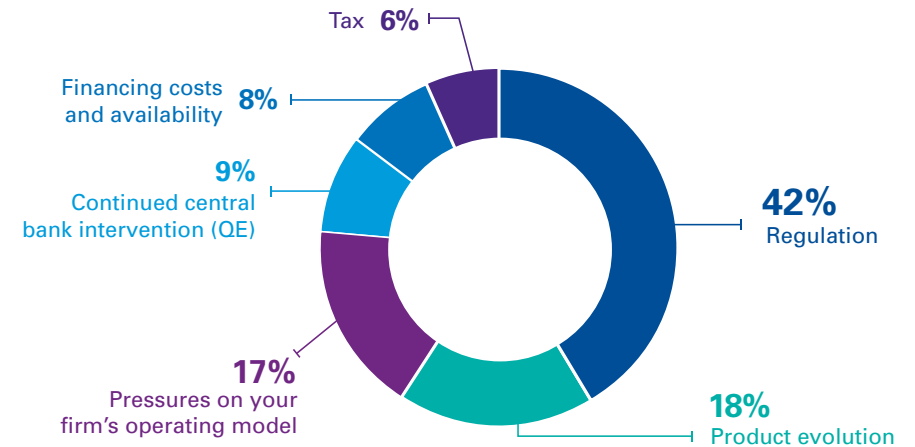


5
Compliance headwinds, the next challenge

Since the 2008 global financial crisis, a wave of new regulatory scrutiny has emerged around the world to create greater transparency and oversight of well-established business practices, from trading history and collateral to emerging trends, such as the promotion of ESG products. Although global regulatory bodies are attempting to provide high-level guidance to promote continuity, both subtle and substantial variations are emerging across the various markets. These fault lines have been exacerbated further in recent years, as new investment products were introduced, global tax regimes were developed, or by events such as Brexit or other jurisdictional changes.

These concerns are reflected in survey responses. When firms were asked what challenges they predict will be their chief concern over the next 12 months, regulation attracted the largest share of the vote with 42 percent. This was followed by product evolution (18 percent) and pressures on the operating model (17 percent). These last two concerns are discussed in greater detail in sections 4 and 6.

Which of the following challenges do you expect to be among your firm's chief concerns for the next 12 months?

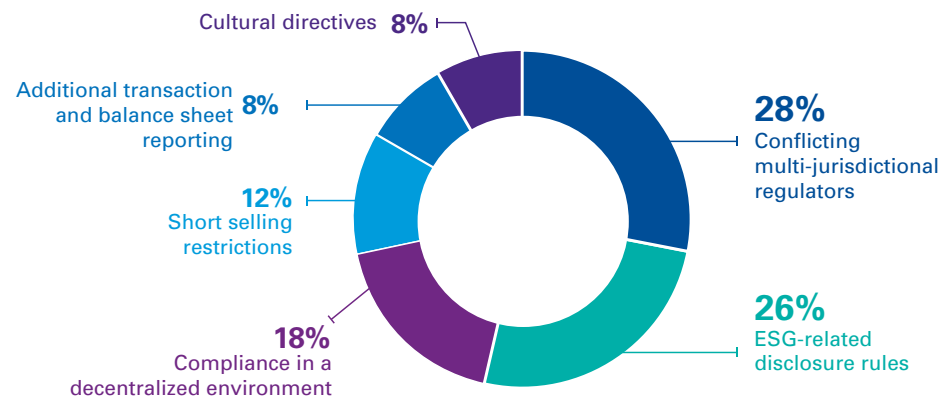


Source: AIMA & KPMG survey, 2021

Hedge funds were then asked to identify which regulatory hurdle was keeping them awake at night. The aforementioned issue around conflicting multi-jurisdictional rules frameworks narrowly took the top spot, with 28 percent. ESG-related disclosure rules were the second most popular option (26 percent), followed by compliance in a decentralized environment (18 percent). Notably, one in 10 reported concerns around a tightening of short-selling restrictions, following a year of regional short-selling bans

in Europe and ASPAC, and events in the US around the GameStop short squeeze and ‘meme stock’ phenomenon. Currently, there are a host of Compliance areas that are drawing the focus of the hedge fund industry; these are just a sample of the ones most cited by managers.

Which of the various regulatory concerns present today will pose the most significant challenge to your firm over the next 12 months?



Source: AIMA & KPMG survey, 2021

Cross-border Rules

As discussed in section 4, the search for alpha has driven many firms to expand their product range and enter new markets/regions. This leads to increased compliance and operational burdens. The opportunities of investing in China, emerging markets, or other areas are often slowed by the regulatory challenges.

AIFMD

More regulatory uncertainty comes in the form of a review of the EU’s AIFMD, for which the European Commission has published a legislative proposal in November 2021. The proposal focuses the following specific areas: delegation, liquidity risk management, loan origination funds, fees and charges disclosure, depositaries and the introduction of references to the EU list on non-cooperative jurisdictions for tax purposes or the EU “high-risk” third-country AML blacklist.

In general, AIMA and others are advocating that the current terms of the regulatory framework be left largely unchanged. The requirements have so far proved effective and the need for regulatory stability and certainty is paramount.

The publication of the proposal starts the inter-institutional negotiations process in Brussels which can last from a few months to a year. AIMA and the ACC are engaging with EU policy-makers to adjust the amendments on all matters, to ensure that the framework remains as open and fit for purpose as possible, notably regarding the matters of delegation, liquidity management tools and loan funds.

SEC

The SEC has identified certain areas in the private funds sector that may be reviewed. They include: transparency around fees and expenses to investors; the practice of Side Letters; the benefits of certain additional performance metrics; conflicts of interest; additional and more timely information regarding the current Form Private Fund Disclosures. As noted below, the commission continues to look at digital currencies and ESG rules and regulations.

MiFID

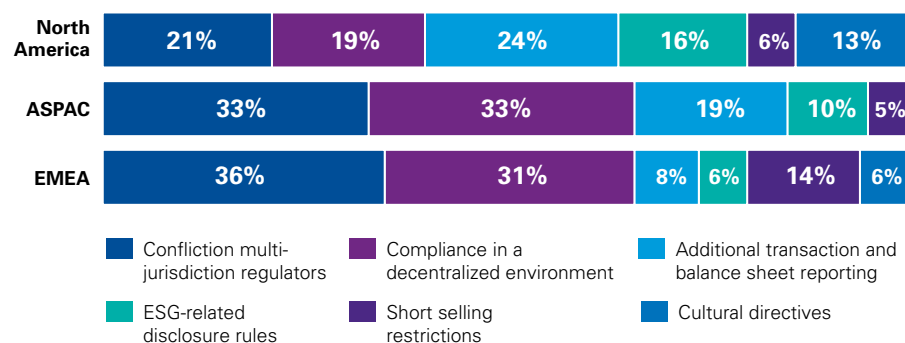
The European Commission has now published proposals that would amend existing MiFIR requirements on pre and post-trade transparency, and the UK is undertaking a wholesale markets review which is likely to result in substantial changes to many MiFID obligations that have been on shored into UK law.



ESG

Responsible investing is undoubtedly a global trend, but the penetration of ESG into the agenda of various regulators and, by consequence, the activities of hedge funds, varies significantly. Likewise, although ESG-related reporting is the second most significant regulatory challenge, according to the survey overall, this obscures regional differences. When broken down by region, North American respondents have progressed somewhat less far, with regard to ESG products, than their peers in ASPAC and EMEA. The latter has taken a leading position in adopting regulation around sustainable investing. However, the SEC in the US recently created the Climate and ESG Task Force to study the issues surrounding this evolving investment area, so this may change as clarity occurs.

What regulatory concerns will pose the most significant challenge to your firm over the next 12 months?



Source: AIMA & KPMG survey, 2021

In the EU, the Sustainable Finance Disclosure Regulation (SFDR) is the centerpiece of the trading bloc's focus on sustainability and has made it a global leader in the race to tackle greenwashing and steer capital towards greener investments. It had a phase-one implementation in March 2021 and phase two will come into force in 2022, bringing additional requirements to boost transparency about the sustainability of the products that firms distribute. Moreover, its impact is being felt globally, given the fact that SFDR's disclosure requirements capture not only firms based in the EU but also those who service EU investors. Regulators in ASPAC's financial centers, such as Tokyo, Singapore and Hong Kong (SAR), China are also pursuing green agendas.

In the UK, the Financial Conduct Authority, the Bank of England and the Prudential Regulation Authority published a discussion paper this year focused on diversity, equity and inclusion (DE&I), addressing everything from policy and practice through to targets and reporting. This has broadly been taken by the hedge fund industry as a statement of intent that DE&I will be an area of growing interest for UK regulators and a consultation paper is expected in Q1 2022 that will lay out more detailed proposals.

Short Selling

Short sellers continue to draw the attention of policy makers and regulators. The initial equity market shock in Q1 2020 inspired a spate of sometimes prolonged short selling bans across Europe and ASPAC, although not in the US or the UK. Then, in Q1 2021, the US meme stock saga saw a surge in retail investors combining their collective buying power with that of institutional investors to create a short squeeze on several high street brand names. This brought additional attention of regulators to this investment practice.

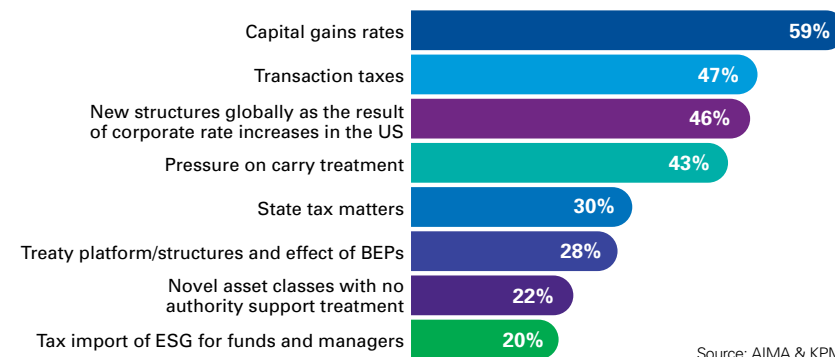
Managers did less planning around tax rate increases this year than they had in previous years of new legislation. This was probably due to the uncertainty as to the ultimate outcome of the US proposed tax legislation. As we approach year-end and the analysis of the legislation begins to take more shape, we would expect a flurry of activity around gain recognition and income acceleration.

— Jay Freedman, Global Head of Hedge Fund Tax Practice, KPMG in the US

Taxing Concerns

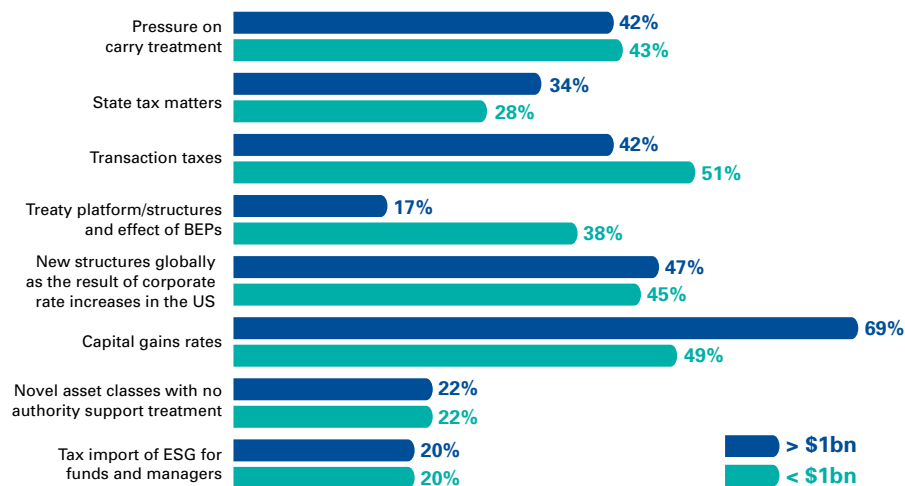
In the hierarchy of evergreen challenges facing hedge funds, regulation is subordinated to taxes. When asked to select the three greatest tax concerns that they will face over the next 12 months, survey respondents pointed to capital gains rates, transaction taxes, and new structures globally, driven by increasing tax rates in the US. Capital gains rates are a prominent concern for smaller firms (those with less than US\$1 billion AUM), with a 22-percentage point lead on the second most significant tax concern for that group. By comparison, larger firms reported that transaction taxes are a slightly bigger concern (51 percent) than capital gains tax rates (49 percent). Capital gains rates were also the main tax concern for North American firms (76 percent), compared to levels reported by EMEA (33 percent) or ASPAC (48 percent).

What are the three greatest tax concerns your firm will face over the next 12 months?

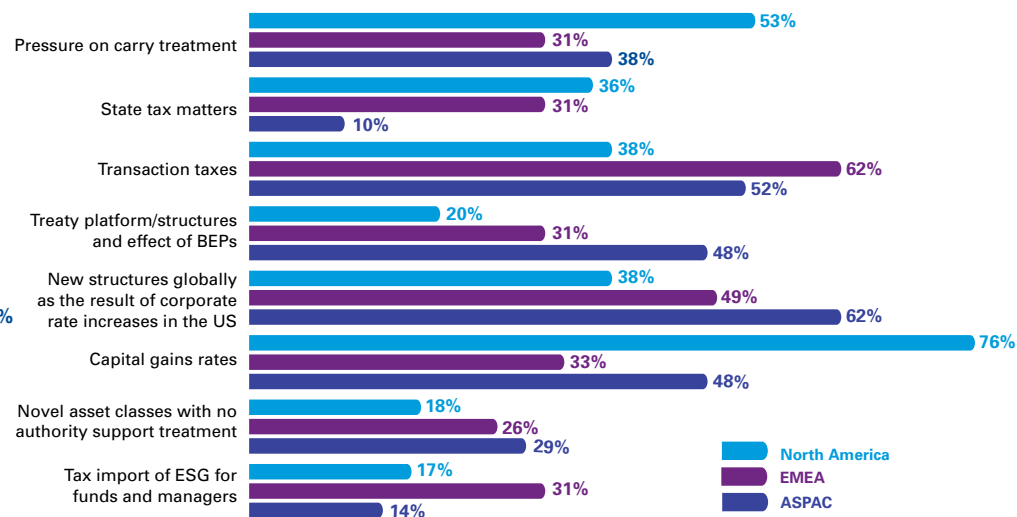


Source: AIMA & KPMG survey, 2021

What are the three greatest tax concerns your firm will face over the next 12 months? By firm size



What are the three greatest tax concerns your firm will face over the next 12 months? By firm location



Source: AIMA & KPMG survey, 2021

6

The business operating model, the next evolution

The hedge fund industry was thrust, in March 2020, into executing disaster plans in an environment that many architects of such had not completely envisioned, with employees across all sectors and roles working from home in a completely decentralized setting. Firms had to adjust to the new environment in a time of record trading volatility and volume. Yet they expanded their communication channels, utilized technology in an ever-increasing fashion and reworked normal operating patterns to adapt to the circumstances. This required creative leadership to be open to the challenge, with a recognition that the normal working comfort zones had been disrupted.

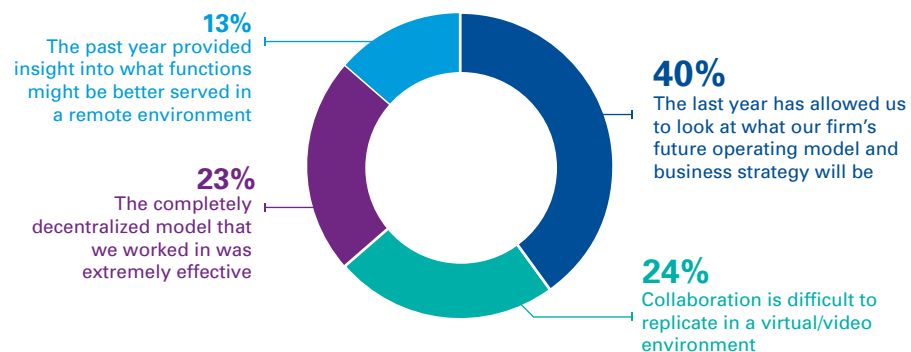
— Jim Suglia, National Sector Leader,
Investment Management, KPMG in the US

When the issue of hedge funds' operating model was visited in "Agile and Resilient" in late summer of 2020, 20 percent of the industry at that time stated that "they believe this is a chance to redefine the business model, combining innovative technology within a decentralized environment to transform."

The subject has been revisited again in this year's survey. Certainly, the previous sections that spoke to the issues of a hybrid working environment, the influence of new technologies, the evolving capital allocation environment, the brave new world of product innovation, and the compliance headwinds collectively and unanimously suggest that the world is different and the existing business plan may need some modifications. Let's explore this scenario.

The idea to reflect on a possible change was consistent with the response from the industry as follows.

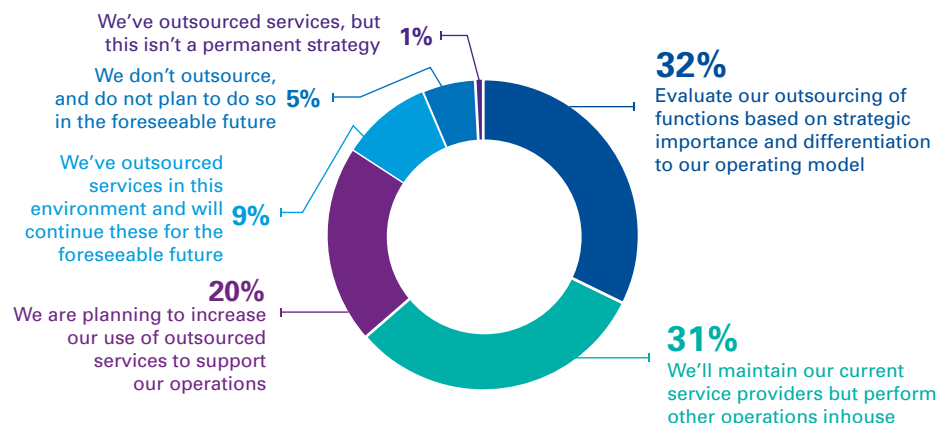
Considering lessons from changes made to your firm's business model this past year, which statements best summarizes your findings?



Source: AIMA & KPMG survey, 2021

While viewing themselves as largely successful in a decentralized environment, about 75 percent of the respondents indicated that the events of the past year gave them reason to take a fresh look at their operating model and what functions might be better served going forward in that remote environment.

Regarding your firms use of outsourced services, which statement best reflects your firm's operating strategy?



Source: AIMA & KPMG survey, 2021

Many firms that we spoke to attested that they have been outsourcing or co-sourcing non-core functions for many years preceding the pandemic. But a sizable portion of the industry indicated that the pandemic provided a reason to pause to assess what worked well virtually. This, also, may be an opportunity to continue those outsourced relationships.

Many firms had already moved to a robust outsourced model and will continue along that path (33 percent); another 40 percent were intending to evaluate the strategic importance to the firm and reach conclusions, much akin to the results at the top left.

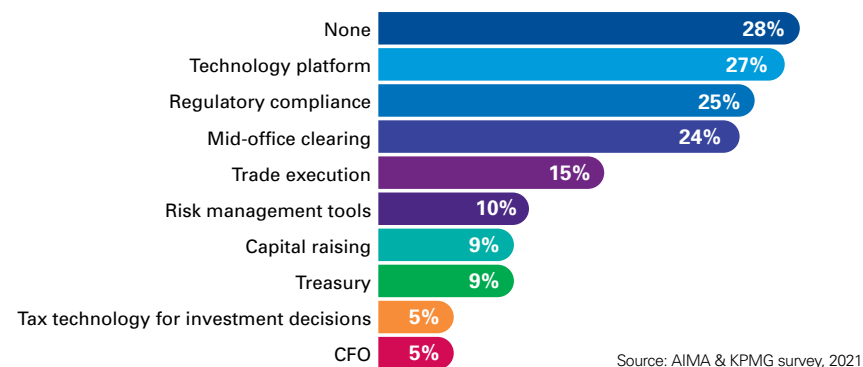
When evaluating functionality in a firm, rarely have we observed firms completely outsource or rely on everything internally. Usually, these determinations are made relative to a specific organization's makeup and its strengths or needs. Firms have a wide-ranging view of which functions they believe deserve assistance.

The compounding challenges posed by the pandemic, in part due to lockdown measures and the rapid deployment of work-from-home arrangements by firms, have forced hedge fund managers to further question their existing operating models. We have observed a marked increase in the number of managers searching not only for better ways of digitally operating in the 'new normal,' but also for the longer-term optimization of key functions currently conducted in house.

Managers also benefit from accessing the fund administrators' global talent pool and collective knowledge base, so that they can focus on core investment activities, reduce headcount related costs, take advantage of industry best practice processes, and reduce technology spend on back and middle offices, thus enabling more investments in front office technology.

— Declan Quilligan, Head of Hedge Fund Services, Citco Fund Services (Ireland) Limited

If your firm was to outsource part of its operations, which options would be the top priority?

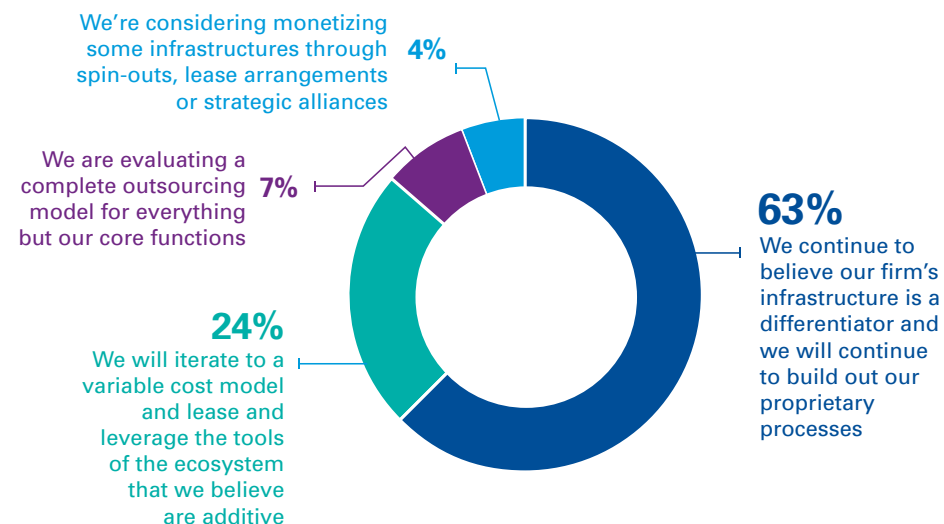


The functions for firms of all sizes most likely to be outsourced were the technology platform (section 2) and regulatory compliance (section 5). For smaller firms, the outsourced CFO function and outsourced trading was prominent, while the larger firms with potentially more complex operations began to look for solutions in mid-office clearing. This is consistent with the interviews and observations from AIMA and KPMG professionals, as industry leaders. Clearly, emerging managers have the most virtual approach to their operating model.

When describing the outlook for the firm's business model, coming off the successful performance of the last two years, many firms (60 percent) looked at this as a differentiator to their business. Yet, at this moment, the remainder were aiming to iterate to a more favorable variable-cost environment that would combine the options of direct outsourcing and other strategic joint venturing with the ecosystem.

Firms have gone through a period of introspection that would probably not have taken place without the pandemic. Much has been learned and much will be carried forward. Some of the results suggest a deep-breath response as to how well their operating models held up during arguably the most difficult operating environment in our recollections. That is well earned. These organizations are presently absorbed with migrating to the hybrid model, which is a managerial challenge. Yet we are in an environment where management fees continue to trend lower. We understood from analysis in the war for talent that we are augmenting new roles in the organization in a

Which of the following statements best describes the outlook for your firm's business model?



variety of functions. We recognize that the regulatory and tax landscape in the coming years will be more difficult and more expensive. We witness every day the operational difficulties of transitioning to a new array of products and operational and structural complexity. We believe technology offers solutions, but at a cost. The manner in which it is deployed in a collaborative manner with the ecosystem will be the strategic differentiator.

With margins compressing and complexity and costs rising, something must give. hedge fund organizations, once settled in the hybrid world, will begin to embrace the challenges of an operating model that will allow them to thrive in that next generational chapter. By all accounts, the industry continues to succeed at each of these milestones. ●

Industry outlook and key takeaways

The hedge fund industry embraced the hybrid working environment, accentuating the key values of both environments:

- Maintaining culture
- Optimizing collaboration
- Creatively attracting and retaining its talented professionals.

It evolved its product set to respond to the customization demands of its investors:

- Multi strategy firms may be best positioned from an operational perspective.
- Market opportunities continue to prevail out of the pandemic; private credit and hybrid hedge/private equity strategies lead product innovation.
- Institutional investors are poised to balance their investment holdings with alternative investments, as a growing component of their portfolios; but they continue to demand specialized structures.
- ESG features will add to the complexity of products in the near to medium term.

Clearly, the hedge fund industry has continued its agile and resilient journey as it emerges from the decentralized environment of the last 18 months. The resilience demonstrated by hedge funds during the early days of the pandemic has now transformed into innovation in both its investment strategies as well as its business operating model. As the industry accelerates out of the pandemic, it's once again poised for its next chapter of growth.

— Steve Menna, Senior Director, Alternative Investments, KPMG in the US

The industry enhanced its transparency and communication with investors. Digital data sharing facilities and virtual due diligence advances have enhanced the allocation process.

- It has begun to moderate its business operating models to allow for the changing inflexion to the new strategic imperatives, while narrowing margins force decisions on other non-core portions of the business.
- The ecosystem will continue to become a strategic operational partner as the Hedge Fund industry looks to scale its investment opportunities.
- Emerging managers continue to be an important segment of the industry growth, but the bifurcation with the more established managers continues to grow.
- Technology continues to drive all aspects of the evolution. Digital strategies and the growing role of data analytics are at the forefront in the automation of processes across the firm.

We trust you find the information from this report helpful to you as you reflect on impact of these events on your organization.

If your firm is interested in having a more detailed discussion concerning strategic changes to your business operating model or exploring benchmarking analyses relative to similar competitors to your strategy, size and geography, please contact your KPMG representative or those outlined in this Contacts section of this report.

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About AIMA

The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with approximately 2,100 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than US\$2 trillion in hedge fund and private credit assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 200 members that manage US\$450 billion of private credit assets globally. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors).

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