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E-BOOK

What Allocators Really Think About the Current State of Hedge Fund Client Servicing

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INTRODUCTION

Last year as COVID was raging across the country, Backstop Solutions organized a panel of allocators to discuss effective versus deficient client servicing they were receiving from external hedge fund managers. This year, Backstop decided to take an even deeper dive into this topic, tracking the experience of leading US and European allocators with respect to client servicing. The purpose? To gain a more in-depth understanding of what's working, where improvement is needed, the impact of the pandemic, and where hedge fund client servicing may be heading.

Here are the 5 most compelling findings of our research:

1. **The quality of client servicing and performance are closely related, reflecting both a manager's character and commitment to process.**
   - While qualitative issues are easy to identify, it's difficult to quantify the negative impacts of deficient client servicing
   - For hedge funds, protracted underperformance along with inadequate client servicing may facilitate redemptions
   - An established record of timely and quality client servicing can help hedge fund managers mitigate redemption risk during bouts of underperformance

2. **Best-in-class servicing is a discipline requiring managers to clearly understand various key issues affecting allocators – to see them through their investors' eyes.**
   - Failure to acknowledge material investment and leadership events in a timely manner can break trust and make future allocations less likely
   - Understanding the respective needs of institutional investors is essential for delivering effective and appropriate client servicing — a large, bureaucratic pension fund, for example, has a long pipeline through which time-sensitive information must flow before it can respond to news
   - This means that, despite what a fund's compliance officer may deem appropriate, managers should keep investors updated about evolving, major developments — not spring critical decisions only when they have been officially announced

3. **Effective communications with clients need to be both proactive and efficient with essential news and ideas clearly communicated early and often.**

4. **Hedge fund client servicing teams have generally met the various, sudden challenges induced by the pandemic with reporting and communication improvements that are here to stay, including greater virtual outreach to managers.**

5. **Client servicing must continually evolve to meet increasing demands for transparency, especially as data management tools advance.**

DEFINING EFFECTIVE CLIENT SERVICING

Delivering quality client servicing is a critical component of successful asset management. Timely and comprehensive accountability to investors is essential for retaining their investments and growing a fund.

At its core, client servicing reflects a manager's understanding of what is happening at a fund. It goes beyond preparation of monthly or quarterly phone calls. Many allocators describe best-in-class servicing as "a discipline that requires managers and their team to clearly understand and articulate a variety of key issues — from explaining why a fund is increasing or losing value, deviating from anticipated volatility, and its near-term outlook, to how a manager is responding to issues ranging from a banking crisis and the collapse of liquidity to a global pandemic."

Effective client servicing is a key responsibility of fund leadership. And allocators agree the largest mistake a fund can make is to discount its importance. As evidenced by our research, top-tier client servicing is both comprehensive and customized to meet specific investor demands.

CLIENT COMMUNICATIONS: A DELICATE BALANCING ACT

During the Backstop panel on client servicing, Elizabeth Eldridge, director of manager research at Glenmede, a $40 billion private asset manager, defined client servicing as the 5th P in understanding a fund — Partnership, along with People, Process, Philosophy, and Performance. Communication and the way information is conveyed is "really important to our relationship with the manager; it's key to understanding what's going on with our investments."

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She assesses the quality of communication based on: how transparent is the relationship; how frequent is the communication; and most important, how strong she senses the relationship is between manager and allocator.

According to Eldridge, two specific qualities distinguish top-tier service providers. The first is being proactive — getting out in front of key developments, from performance to personnel changes. The second is customized efficiency. Not every allocator has the same informational priorities. She wants her managers to know how to filter and deliver information that's most relevant for her firm and client base, helping her to efficiently sift through data and analysis to highlight what's most essential to Glenmede. In other words, to deliver top-flight client servicing, managers must know their allocators.

Her fellow panelist, Jose Soto, chief financial officer at the family office Smith Asset Management, adds, “It’s equally important for managers to know how to avoid excessive communications, as well as the appropriate frequency and quality of communication.”

This makes client servicing a balancing act of sorts.

“If we’re seeding an emerging fund,” says Jonathan Feeney, head of tactical strategies at Investcorp-Tages, a multi-national investment firm that manages $7.5 billion in alternative investments, “then continuous and timely communications is expected, especially during the early years.”

But after a fund is well established, he understands excessive claims on a manager’s time by all LPs can be counterproductive. That means it’s incumbent for LPs to be mindful of whether they are part of a group of 10 or 200 institutional investors in understanding how a manager can effectively respond to clients. “We want the management team to be focused foremost on research and investing,” explains Feeney, “while providing clear and timely communication that enables LPs to know contemporaneously what a fund is doing and thinking.”

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INEFFICIENT CLIENT SERVICING: WASTING ALLOCATORS’ TIME

Can allocators quantify the impact of effective versus subpar client servicing on their operations and performance?

“That’s difficult to answer precisely,” says Tilo Wendorff, managing director of absolute returns at the $20 billion German alternative asset manager Prime Capital.

What is certain is problematic client servicing can cost his firm time and distract focus away from investing. “Certainly, we don’t want to have to hunt elsewhere for answers about why a loss occurred or why hedging didn’t work,” Tilo explains. “And the bigger the problem, the greater the search becomes for answers.”

Wendorff puts the matter simply: “If one has difficulties getting clear answers to small problems, it likely doesn’t bode well when larger problems arise.” To help track the quality and timeliness of manager responses, Prime Capital keeps a list of *Cons*, which the group actively discusses internally and will raise periodically with the manager to see how they are responding to these concerns.

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EFFECTIVE CLIENT SERVICING: RETAINING & GROWING THE INVESTOR BASE

Owning up to problems and not trying to dismiss their significance as outliers can put a hedge fund back into investors’ good graces. There may be few better examples of this than the Madrid-based EQMC hedge fund after it suddenly stumbled following years of being a top performer.

Co-fund managers Jacobo Llanza and Francisco de Juan had been delivering 20% annualized returns since they started their European small- and mid-cap benign activist fund in 2010.

After EQMC earned the top spot in Barron’s 2017 annual global hedge fund survey, the managers, with concentrated holdings typically around 15 to 20 companies at a time, saw two seed investments in British companies blow up within one month of each other. The reasons: one was due to financial mismanagement; the other, unexpected irrational action by a founder who then had left the company. Both actions, according to the managers, could not have been anticipated. Until then, only 4 out of the 40 investments made since the fund’s launch lost money.

“We take our missteps very personally,” explains Llanza. “Maintaining our integrity is as critical as our performance; they are inseparable. And investors must be assured this failure was not due to a change in our investment style or process.”

Toward that end, the managers set out on an extensive tour, visiting their major investors across Europe and the US to personally explain what had happened, why it happened, and the additional measures put in place to help minimize the chance of such an event ever occurring again. “Despite the losses these two investments triggered,” recalled Llanza, “most of the investors we visited expressed a genuine gratitude in our efforts to explain and assuage their concerns.”

The result: the fund largely sustained its investor base and its performance has since recovered.

GOOD CLIENT SERVICING DURING CHALLENGING TIMES, CAN ACTUALLY INCREASE ALLOCATION FROM EXISTING INVESTORS…

The above example bears this out. Moreover, because of the extensive due diligence that goes into manager selection, allocators are inclined to ride out perceived short-term underperformance when there has been an established track record of timely and informative reporting and manager access, and when the manager effectively explains why performance is off. “The quality of client servicing and performance are related,” explains Mr. Wendorff, “reflecting a commitment to process in the way things are done at a firm.”

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… BUT DON’T RESERVE YOUR BEST SERVICE FOR JUST THE INVESTORS WHO HAVE MADE LARGE ALLOCATIONS

Managers can also shoot themselves in the foot by not extending the same level of client servicing to investors who have made smaller allocations versus investors who have made larger commitments, explains Jonathan Kanterman, a managing director at the former $1.3 billion NY-based asset-backed lending fund of funds Stillwater Capital. Especially when investors initially venture into specialized strategies, Kanterman observed, even large allocators may initially weigh in cautiously.

If performance proves favorable and investors wish to increase exposure, but they are not receiving timely answers to their questions and regular access to the PM, Kanterman has seen allocators shift their investment to another fund running the same strategy where their larger allocation can command the desired attention.

UNDERSTANDING WHAT'S IMPORTANT FOR EACH ALLOCATOR

Managers can develop a triage approach in initially identifying ideal communications for various types of allocators, while also being mindful that specific investors may require more customized attention.

And on specific matters, funds can cause irreparable damage by not being upfront about essential matters to allocators, such as key-man risk. This tends to affect smaller shops that run less than several billion dollars and are not backstopped by several top-level managers that can step in if the PM departs or has fallen seriously ill.

> **If you're going to deliver sensitive or bad news, treat it like a defensive driver where the allocator is a passenger. Give the allocator as much warning as possible and avoid it being like a hit-and-run scenario.**

One allocator on the Backstop panel recalled that his firm first heard — through a Google news alert — that a key man was leaving a fund in which they were invested. That soon put an end to the relationship.

Even more egregious, Kanterman remembers an instance when a fund sat on the news of its PM's passing for three weeks before he heard about it. "While there was a co-manager capable of sustaining operations," recalled Kanterman, "trust was broken."

Fernando Vinzons, chief financial officer and director of investments at the $13 billion Cook County Pension Fund, puts the matter plainly. "If you're going to deliver sensitive or bad news, treat it like a defensive driver where the allocator is a passenger. Give the allocator as much warning as possible and avoid it being like a hit-and-run scenario."

Falling in the category of knowing a client's specific needs, Vinzons explains "managers must realize that public pension funds require longer time to respond to news than other allocators where a CIO may be able to respond on the spot."[1]

"I found it challenging when a manager acknowledges some major changes are happening but refuses to provide updates during the process," explains Jose Soto. He has been told by a manager, "We don't do that until we know exactly what we have to tell our clients."

Soto also recalled when his firm was hit with a large tax bill involving the transfer of a partnership asset to the fund's custodian. "This was only an administrative move with ownership of the asset not going to change, it was just an assignment," explains Soto, "but the manager, without asking us (or understanding the possible ramifications), treated this as a redemption and reinvestment, which made it a very large taxable event." This underscores the importance of knowing an allocator's needs.

[1] Vinzons also found that when a consultant gets directly involved, it can get managers to communicate more clearly. And this frequently translates in getting a manager to put his comments in writing.

HOW TO BURN BRIDGES

Glenmede's Elizabeth Eldridge says the biggest mistake she has heard is silence when the markets or specific strategies turn volatile. "I've had some asset managers go dark as I'm getting questions from my CIO or my clients about what's happening to our investments," Eldridge recalls. "Being told 'we're extremely busy,' doesn't cut it. It's essential for managers to be timely and responsive, especially during such times." She points out there's a good chance during this time that their peers, i.e., other hedge funds, *are* communicating, "and that can make a manager stick out in an unbecoming way."

Prime Capital's Wendorff shares two experiences with which some allocators may be familiar. "A manager once chided us for asking too many questions," recalls Wendorff, "and in another instance after having travelled to a fund's office to speak with the PM, we were stuck with an investor relations person for nearly the entire visit. The PM gave us just five minutes."

Wendorff also remembers being personally harangued by a manager when he explained his redemption was only due to a decision to shift exposure. "I like to keep our opportunities open after leaving a fund that has performed well," explains Wendorff, "but this manager's behavior made that unlikely."

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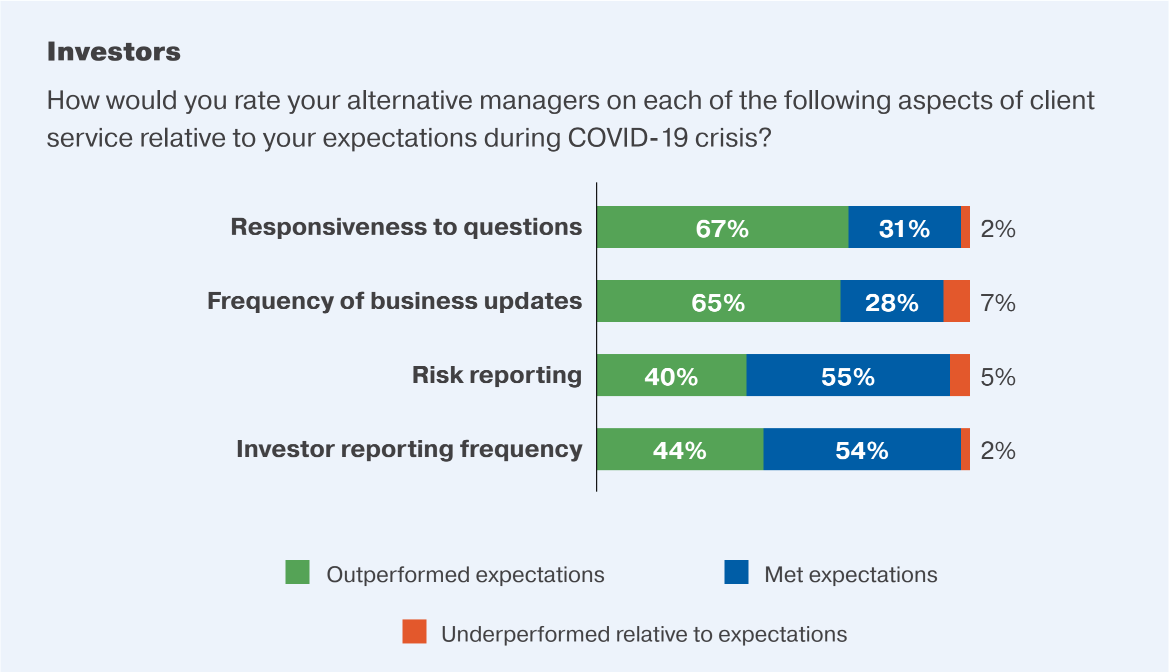
CLIENT SERVICING DURING THE PANDEMIC

When COVID-19 struck global markets in early 2020, it triggered a perfect storm that stressed client servicing: a dramatic collapse in value across virtually all asset classes, grave concerns about how long it would take shuttered economies to recover, and sudden restrictions on face-to-face meetings to better discern what managers were thinking, doing, and planning.

In its 2020 annual report on the alternative asset management industry, the global financial consultancy EY found two-thirds of the several hundred investors surveyed thought managers outperformed their expectations when it came to responsiveness to questions and frequency of business updates. And over 95% found risk reporting and frequency of investor reporting also exceeded or met expectations.

“With extreme levels of market volatility, increased trading volumes, and disruption to society as a whole,” EY found “managers recognized the need to be proactive with their investors during this period, and those who have been investing in technology, automation and outsourcing were able to leverage various tools to enable consistent business operations and reporting.” [2]



CLIENT SERVICING POST-PANDEMIC: PERMANENT IMPROVEMENTS

A silver lining of the pandemic, according to many allocators, is that it may be hard for managers to walk back many of the client servicing improvements that have evolved over the past year.

Cedric Dingens, head of investment solutions and alternative investments at the CHF 10 billion Geneva-based independent asset manager Notz Stucki, observed, “COVID-19 brought more interaction between LPs and managers, more in depth reporting and better communications.” Many managers anticipated this increased demand for transparency and have responded to the challenge. “And now that we have this,” Dingens believes, “it will be less likely that managers will pull back from this greater transparent reporting and communication once travel is possible. I believe we are seeing permanent improvements.”

[2] EY, “2020 Global Alternative Fund Survey,” November 2020, p. 5.

While visiting new funds has largely been restricted for more than a year, Dingens also sees allocators being “the beneficiaries of far more virtual cap-intro meetings than ever before. This is giving us a chance to meet far more managers.”

Elizabeth Eldridge and Jose Soto agree with these observations. And while they believe there will be a return to in-person meetings by late 2021, they expect a significant portion of virtual communication to remain in place. Soto doesn’t feel “this can replace actual visits to a manager’s office where you meet various team members, get a sense of their candor and interaction, and the working environment.”

DON’T JUST COMMUNICATE – LISTEN

Client servicing is a two-way street. It’s not just a matter of managers explaining their actions to their investors, but also listening to allocators’ thoughts and suggestions. Investcorp-Tages’ Jonathan Feeney explains, “a number of our emerging managers appreciate hearing what we believe an LP needs, from the specific details and report formatting to the frequency of such communication. We’ve also helped emerging managers deal with consultant interviews to help ensure a positive outcome.”

While allocators select managers because they have faith in their investment skills, on occasion they may also offer suggestions about how to ramp up performance. In one instance, Feeney recalls an Equity Market Neutral manager generating significant Alpha, but felt its performance was being held back by having zero Beta. “So we suggested to modestly edge up Beta from zero to 0.2 to 0.3,” explains Feeney. This was accomplished through relaxation of industry and sector constraints, and the manager subsequently opened a new share class that could run with higher volatility through the application of 1.5 times leverage.

Prime Capital’s Wendorff shared a similar experience. He suggested an Equity Market Neutral fund push up gross leverage, saying it wouldn’t materially change the fund’s Beta and would increase its Alpha. It agreed to do so, which ended up boosting returns without adding substantial risk. That said, Wendorff has no problems if managers decide not to follow his team’s recommendations, so long as they explain their thinking.

WHAT INVESTOR RELATIONS TEAMS NEED TO DELIVER

Investcorp-Tages' Feeney expects his managers "to establish a communication process and schedule and stick with it." This includes:

- Timely, meaningful access, especially during times of stress;
- Refined, detailed reporting on performance and attribution, risk reporting, and careful, considered forward-looking views about the portfolio and markets;
- A consistent reporting schedule of weekly estimates, monthly reporting, follow-up PM calls; and
- Pleasant and knowledgeable personnel that understand what we need to know.

When they're not speaking directly with PMs, allocators expect investor relations personnel to have a firm technical grasp of the strategy so they can ask the right questions and then in turn communicate a coherent, clear and accurate message. Mr. Feeney has found "top-tier personnel may be ex-traders or allocators or sell-side sales people who have a very good sense for what is required."

HOW CLIENT SERVICING DIFFERS ACCORDING TO SIZE, AGE, AND STRATEGY OF A FUND

While the bulk of allocations are made into funds with proven track records of performance and client servicing, seeding new managers has become more common — a chance to gain access to a manager with an established pedigree at a previous firm at cheaper fees.

When they seed investors, allocators typically receive top client servicing—from customized reports to regular access to the PM. But Feeney cautions, "even when managers come from a well-run organization, one can't always assume they will replicate the same level of client support once they set up their own shop."

Cedric Dingens of Notz Stucki hasn't found significant differences between high-octane versus more consistent managers, and doesn't note significant differences in servicing due to where a manager is based. "Most managers competing for investors at a global level," observes Mr. Dingens, "realize meeting established standards of client servicing is key to securing allocations and keeping them."

Differences in client servicing is most clearly observable by distinct hedge fund strategies. For example, the greatest transparency is often seen in straight forward strategies, including hedged equity, credit, and event-driven. There tends to be greater opacity with strategies relying on proprietary technology, including intricately managed CTAs and equity quant funds. The reason? Feeney observes, "There's a higher level of secrecy surrounding a select number of top-tier Quant funds."

While this is contrary to best-in class-client servicing, Feeney understands there is clearly intellectual property at stake in “a furiously competitive environment, where Alpha is being fought over between firms with very deep pockets, huge data requirements and the pervasive commoditization of quant factors and signals.” In some sense, he admits one may actually want these firms to maintain a high level of secrecy to protect their IP and retain their performance edge, preventing competitors from reverse-engineering their way into understanding it. So when investing in such a fund, an allocator makes a conscious trade-off: significant transparency for access.

Feeney’s colleague at Investcorp-Tages, Vincent Beerthelemy, cross-asset strategist and portfolio manager, admits even when one gets significant data, it’s not always possible to identify drivers of underperformance of Quant Equity, Statistical Arbitrage, and short-term CTA funds because of the complexity of models and the sheer number of trades being made on a regular basis with.

He says the case for machine-learning strategies can be compelling. “Their weakness,” he says, “is clearly knowing in a timely manner when they’ve missed their mark and why.” But he would expect forensic accounting to eventually identify weaknesses.

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Allocators have sometimes seen the quality and clarity of client servicing diminish as a manager excels and runs a great deal more capital. Feeney has seen that after a fund’s assets reaches several billion dollars, “the focus on client servicing changes.” And he has sensed subtle shifts in the tenor of the relationship.

How is this manifested? Feeney has seen reduced transparency (less than what may have been previously agreed upon) and more limited access to key decision makers as bureaucratic layers get built up between the PM and the LP, including investor relations staff, product specialists, and senior personnel.

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NEW INVESTMENT VEHICLES SPELL AN EVEN GREATER NEED FOR TRANSPARENCY

Whether dealing with Bitcoin, SPACs or complex derivatives, the investment universe is constantly changing and with this will come an ever greater need to better understand these evolving assets.

Managers have explained the rising institutional demand for crypto currencies to Cedric Dingens as a reflation trade in response to fears that the massive government spending in response to COVID-19 may be undermining the value of the world's major currencies. "Managers involved in cryptos can help us understand crypto market dynamics," explains Dingens, "by tracking net flows into the space, institutional activity, along with new options and futures and the ability to arbitrage." Notz Stucki's exposure to crypto is very low because it recognizes that, despite what managers are saying, this is a pure demand play right now.

"At the end of the day, the asset management world is small," says Glenmede's Elizabeth Eldridge, "and the truth always comes out. So it's always better for managers to be honest about things—even when it's a difficult topic.

Client servicing can help explain a manager's exposure to SPACs — pre-investment or post acquisition, industry targets, and whether or not it's taking an activist role after allocation. Notz Stucki has little exposure to managers who have a material allocation to SPACs and only on a very selective basis.

Alexandre Louchtchay, chief risk officer at the Geneva-based Iteram Capital, observed three-month volatility of a US emerging Equity Long-Short manager had risen from a norm of 10% to 14%. He found through fund communication that the manager was boosting its exposure to SPACs. Discovering the fund was investing more than Iteram had expected into these vehicles raised a red flag because the allocator has a 10% limit on its total exposure to these vehicles.

That said, the basics of client servicing don't change. "At the end of the day, the asset management world is small," says Glenmede's Elizabeth Eldridge, "and the truth always comes out. So it's always better for managers to be honest about things—even when it's a difficult topic."

Eldridge believes the need for transparency will only become greater. "Being overwhelmed by too much data is a pain," she quips. But well-organized summaries of data can address this problem.

As data management technology evolves, it will help further refine understanding of what's driving returns and risk. Fernando Vinzons says, "when a manager can show new ways of cutting and presenting data, that could be a real plus when I'm considering whom I want to bring on board."

THE NET-NET

The world's leading allocators believe fund performance and client servicing are inseparable, reflecting a manager's character and commitment to process. The ability to explain one's actions to others clearly and consistently over time reveals one's fundamental way of thinking and acting. Too often, failure is not clearly addressed or even well understood by managers who are struggling, as they believe that it's "just a matter of time" before things turn around.

A shrewd hedge fund manager will not maintain a position in a company's stock if they lack confidence in their ability to receive all pertinent information about the company on a timely basis. Hedge fund managers need to realize top allocators feel the exact same way about their fund.

Further, client servicing is not a static function — it evolves with changing demands, the availability of technology, and the use of more complex investment methodologies that demand clear explanation of their opportunities and risk. Managers need to live ahead of this curve and evolve with the times.

Failure to deliver top-tier client servicing can be costly, not only in losing potential add-on investments, but also the clients themselves when they feel trust has been compromised. There are simply too many hedge funds out there for any allocator to feel compelled to stay with a fund that's not delivering adequate client servicing.

***Eric Uhlfelder** has been covering capital markets from New York over the past 30 years. His work has appeared in major publications, including The Financial Times, The Wall Street Journal, Pensions & Investments, The Economist, BusinessWeek, Institutional Investor, and The New York Times. His last book, "Investing in the New Europe," was published by Bloomberg Press. He recently completed his 18th annual global hedge fund survey, which appears on the Backstop BarclayHedge website. And he has earned a National Press Club award for excellence in writing.*

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