Can the difference of one year move you years ahead?
2021 Global Alternative Fund Survey
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Executive summary

There's no escaping the fact that the effects of the COVID-19 pandemic are still impacting the 2021 investment landscape. The experiences, hardships and requirements of the pandemic continue to prompt alternative asset management firms across the globe to review and adjust their priorities, operations and goals to increase solvency and build prosperity in the face of rapid, ongoing change. If one were to write a story about the alternative fund industry in 2021, it would detail the continuing successful momentum the industry was building in 2020, with alternatives thriving, meeting investor expectations and performing. At the same time, investors, faced with persistent market volatility and business uncertainty, continue to embrace the value of alternative funds to diversify their investment portfolios, mitigate risk and future-proof their returns.

Most of us are familiar with the phrase "the future is now," but what does the expression really mean? In 2021, alternative fund managers are defining the term and applying it by using foresight to envision the future today. They're visualizing how events might unfold toward a particular outcome — in this case, successfully extending their ability to predict and leverage the next wave of investment opportunities — while forecasting and preparing for a future colored by higher investor standards, increased regulatory scrutiny, and workforce and operational challenges.

Alternative fund managers have realized they need to not only address but advance current and future investor priorities, which now extend to retail investors as well, regarding environmental and societal imperatives, while taking the necessary steps to attract, support and retain a diverse and decentralized workforce. They're making critical changes to investment strategies and product mix, including increasing exposure to digital assets, while implementing new talent acquisition and retention policies, employing new digital infrastructures and IT capabilities, and capitalizing on current environmental, societal and marketplace shifts — to help guide their investment direction now and well into the future.

Our 15th annual EY Global Alternative Fund Survey offers a comprehensive "snapshot" of alternative fund managers and the institutional investors who allocate to these asset classes. With the community at large and the business world coming out of a prolonged period of personal and professional disruption, we extend our sincere appreciation and gratitude to the many managers and investors who provided their time and insights into the direction and development of this survey. We also say "Many Thanks" to the 210 managers and 54 investors who provided extensive details and relevant responses highlighting significant trends that will serve both you and your extended teams in accelerating your journey — toward achieving improved sustainability, profits and growth, now and into the future.

Key observations

This year's survey results reflect the sustained popularity and growth of alternative funds as investor perceptions of value for alternative investments have continued to improve. Alternative fund returns were strong when factoring in various uncertainties related to ongoing pandemic recovery efforts, a volatile geopolitical landscape, and compared with stubbornly low-interest rates offered via fixed income alternatives. Flexibility in product and fund structures offered opportunities for investors to take advantage of market disruptions in several areas, including private company investing. In addition, fund managers have shown flexibility in their fees and fee structures, improving the value equation for investors.

It's important to note that while private equity has continued to outperform investor expectations by a wide margin over the past year, hedge funds have posted the biggest improvement over investor expectations. Allocations to hedge funds and private equity are now on par, reversing hedge funds' multiyear downward trend, reflecting improved perceptions of their performance and ability to take advantage of opportunities as they arise. In addition, new flows to private equity are perhaps challenged by the historically large amount of "dry powder" that private equity managers have accumulated from years of successful fundraising.

Evolving investment strategies

The alternative fund industry is continually evolving, with new opportunities emerging on an ongoing basis. From globalization and the onset of digital assets, to the rapidly growing demographic of retail investors and technology innovations — and with investors demanding transparency and investment choices reflective of their values alternative fund managers continue to explore a wide range of asset classes and product mixes to increase sustainability and drive growth. For example, with institutional investor allocations remaining flat, alternative fund managers seeking growth are turning to retail channels, with numerous managers looking to increase capital within this investor base. A growing number of managers are also turning to FinTech platforms that aggregate retail demand and help address challenges that retail channels have historically presented — capital "stickiness," AML/KYC, reporting and other administrative issues associated with servicing many smaller clients.

In addition, investors are increasing their incorporation of ESG risks into investment decisions, to the benefit of managers that prioritize ESG, and to the detriment of those that do not. Institutionalization of the cryptocurrency ecosystem has allowed alternative funds and their investors to begin exploring opportunities in this new and evolving asset class. The industry continues to assess regulatory, business and other risks

associated with cryptocurrencies, but 2021 appears to be an inflection point where this asset class is gaining the attention of all institutional alternative fund managers.

Talent management

Employers were experiencing high turnover rates before the shutdowns triggered by the pandemic. Still, in 2021, "the war on talent," or the ability to attract and retain workers, may be one of the greatest challenges facing the alternative fund industry yet. Employees who worked remotely during the pandemic experienced an improved work-life balance and other benefits associated with working from home, are literally "in the driver's seat" in having the upper hand when it comes to choosing who they will work for and how, when and where they will work. But the alternative fund industry has an advantage over traditional employers. The industry flourished during the pandemic using a decentralized operating model without geographical or workplace flexibility limitations. This operating model also created opportunities for managers to reach out beyond their traditional locations to expand their talent pipeline, to search for and recruit diverse talent.

And in their pursuit and retention of top talent, alternative investment firms recognize that they need to create an attractive, flexible, inclusive and diverse working environment that maximizes employee productivity, with hybrid work plans offering some of the flexibility that working from home offered.

In 2020 and 2021, racial injustice and the protests that followed were inflection points highlighting deeply rooted disparities that exist throughout society and the business world. Long overdue, alternative fund managers and investors recognized that incorporating diversity, equity and inclusion (DEI) policies and programs into corporate governance and investment strategies is a core business imperative. By understanding that facilitating the inclusion of diverse talent reflects their corporate culture, their communities, and the companies they invest in — with growing data indicating that diverse teams are higher performing — managers have realized that diversity in the workplace is a "need to have."

As such, they're committing to inclusion initiatives, such as unconscious bias training and hiring practices, and establishing DEI committees as a starting point to promote inclusivity, attract and retain top talent, and satisfy investor demands. It's important to note that embedding DEI policies into corporate governance and investment strategies are considered top investor priorities. With investor scrutiny increasing, managers who operationalize and take DEI to the next level can attain increased investor interest and growth.

Environmental, Social and Governance (ESG)

In 2021, with environmental and social justice issues dominating the news cycle, the ESG movement has taken "center stage," with managers formalizing their ESG policies at both the management company level and in their investment strategies to satisfy investor demands. These demands include investing in companies that actively incorporate sustainable practices into their corporate strategy planning and disclosure efforts and investing in companies that offer sustainable products. In response, alternative fund managers are incorporating focused ESG strategies that include integrating ESG into their own sustainability risk profiles while embedding ESG risks and considerations into their investment decisions and product mix.

But managers need to be aware that the most important driver of investor interest in sustainable funds is the environmental impact they could have. And with investors becoming aligned to the idea of a more sustainable world, they expect their fund managers to provide investment choices that reflect their increased awareness and values. Although a lack of data standards around ESG remains at the heart of many managers' challenges with adoption, managers who have not yet increased integration of ESG risks and sustainable investments across their corporate policies and product mix are at risk of losing investor interest and capital.

What does the future look like?

During the pandemic and throughout 2021, alternative fund returns were strong, and in the future institutional investors will continue to realize the value of alternative funds for diversification, risk mitigation and returns. Alternative fund managers can successfully adapt and take advantage of the rapidly changing market by understanding and acting on the reality that their future success depends not only on their ability to predict and secure new investment opportunities but on their ability to predict, prepare for and meet higher investor standards — requirements that include increased integration of ESG and sustainable products into their investment strategies, taking necessary actions to attract and retain talent, promoting a diverse, equitable, inclusive, and flexible work environment, and providing enhanced investor reporting to increase the transparency of their financial and nonfinancial performance.

In addition, investments in cryptocurrencies and expansion into retail markets to increase capital flows are growing, while continuing regulatory scrutiny and operational challenges can stymie future growth. But alternative investment firms, by prioritizing investments in digital infrastructures and IT capabilities and outsourcing parts of their operational processes, can address cybersecurity, facilitate data analysis and enhance investor reporting — leading to future investor confidence and growth.

Background and methodology

The purpose of this study is to record the views and opinions of alternative fund managers and institutional investors globally. Managers and investors were asked to comment on their future and strategies for the decade ahead. Specific topics included industry trends, talent management and diversity, environment, social and governance (ESG) risks and investments, investment strategies, and future views on the industry.

From July to September 2021, Greenwich Associates conducted:

- One-hundred and seven interviews with hedge funds representing over US$1.2t in AUM and 103 interviews with private equity firms representing nearly US$2.7t in AUM
- Fifty-four interviews with institutional investors (funds of funds, pension funds, endowments and foundations) representing approximately US$1t in AUM

Manager respondent profile	
Total	**210**
By segment	**Total participants**
Hedge fund	107
Private equity	103
By geography	**Total participants**
North America	138
Europe	45
Asia	27
By AUM	**Total participants**
Over US$10b	63
US$2b-$10b	70
Under US$2b	77

Investor respondent profile	
Total	**54**

Hedge fund managers	
By geography	**Total participants**
North America	53
Europe	33
Asia	21
By AUM	**Total participants**
Over US$10b	28
US$2b-$10b	37
Under US$2b	42

Private equity managers	
By geography	**Total participants**
North America	85
Europe	12
Asia	6
By AUM	**Total participants**
Over US$10b	35
US$2b-$10b	33
Under US$2b	35

Industry trends

Alternatives continue to perform and deliver. Throughout 2021 the alternative funds industry has proven its ability to weather economic volatility and manage risk while producing returns that met or exceed investor expectations. And this performance has not been ignored. With more than half of investors surveyed saying that the value provided by alternative fund managers has improved relative to a few years ago, investors continue to embrace alternatives for diversification, risk mitigation, and returns. Private equity has continued to outpace investor expectations by a wide margin. At the same time, hedge funds' actively managed strategies proved attractive to investors, helping them end their several years of mixed performance and outperform investor expectations. In addition, flexibility in product and fund structures has offered opportunities for investors to take advantage of market disruptions in several areas, including private investing. Although institutional allocators indicate their total investments in alternatives are at capacity and do not represent a significant capital raising growth engine for funds, managers seeking growth are turning to "retail," family office and high-net-worth individuals to increase capital. And with investor scrutiny increasing on alternative fund managers' financial and nonfinancial performance, managers recognize the need to advance investor priorities regarding ESG and sustainability, talent management and DEI policies, as well as managing costs. In addition, fund managers have shown flexibility in their fees and fee structures, improving the value equation for investors.

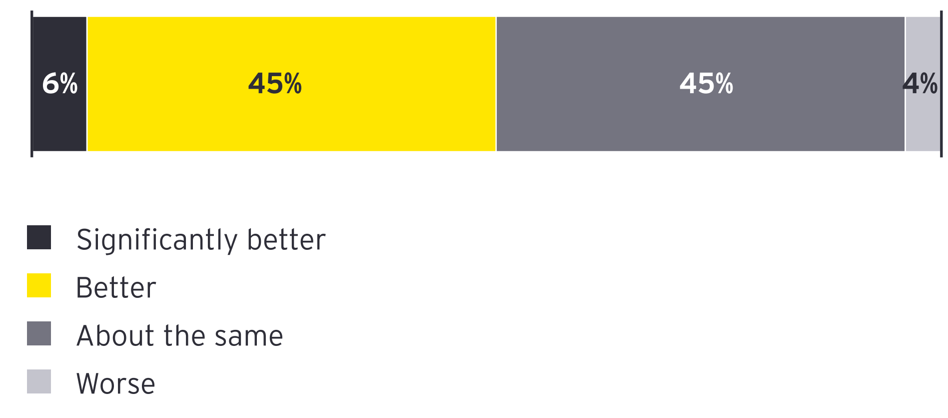
Investor perceptions of value for alternative investments have continued to improve

The record-breaking market volatility of 2020 caused long-term investors to look for opportunities that would provide value, increase diversification of their portfolios and mitigate risk — even when the market turned sideways. They found it through alternative investments. As the market rebounded into 2021, alternative investments carried their positive momentum forward, with their performance continuing to drive inflows of capital and perceived value for all segments.

More than half of institutional investors surveyed reported that the value provided by their alternative managers had improved relative to a few years ago, a direct correlation to improved performance, as managers achieved strong returns during the market turbulence of the past few years.

In addition, flexibility in product and fund structures offered opportunities for investors to take advantage of market disruptions in several areas, including private investments, while fund managers' demonstrating increased flexibility in fees and fee structures have added additional investor value.

Q. Investors: based on recent and expected future performance and the absolute fees associated with investing in alternative funds, how does the value provided by alternative fund managers compare to two to three years ago?

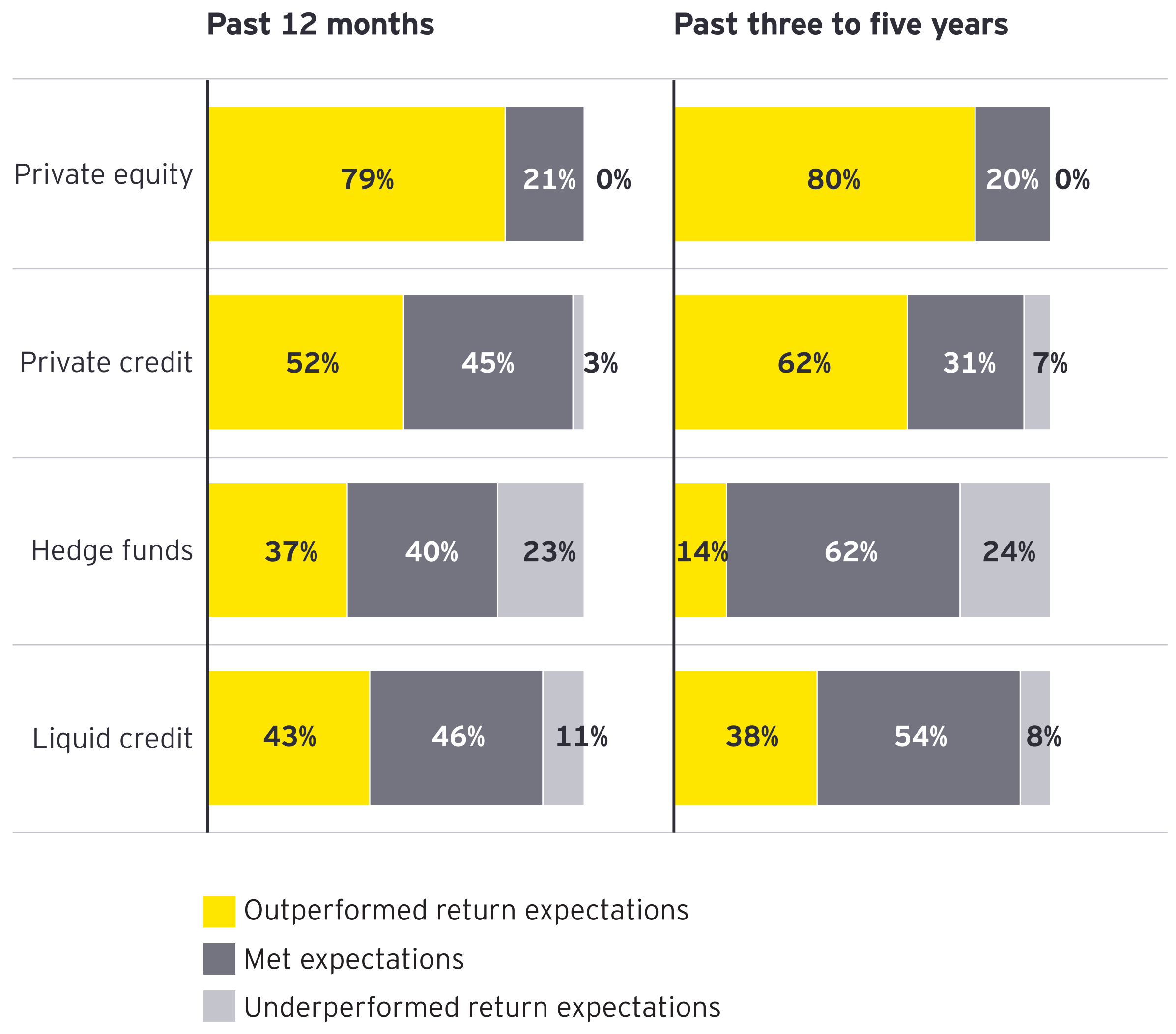


Hedge fund performance improved, and private equity continued to outperform

Hedge funds' actively managed strategies proved attractive to investors, with hedge funds posting the largest improvement over investor expectations – with the proportion of investors surveyed stating that hedge funds outperformed over the past 12 months nearly tripling, compared with the past three to five years.

Private equity funds continue to flourish as deal activity remains robust with increasing valuations occurring in private transactions and IPOs. Providing support for this trend is the amount of special purpose acquisition companies (SPACs) actively seeking targets to take public. This increased performance may be attributed to the fact that private credit can remain steady when facing market uncertainty, such as long-term and short-term inflation, and the possibility of rising interest rates. The exit or retrenchment of traditional lenders of private credit has created a void that alternative fund managers have successfully filled. Private credit returns have continued to be attractive compared with other fixed income alternatives where yields have been depressed.

Q. Investors: how did each of the following asset classes perform relative to your expectations over the last 12 months and over the last three to five years?



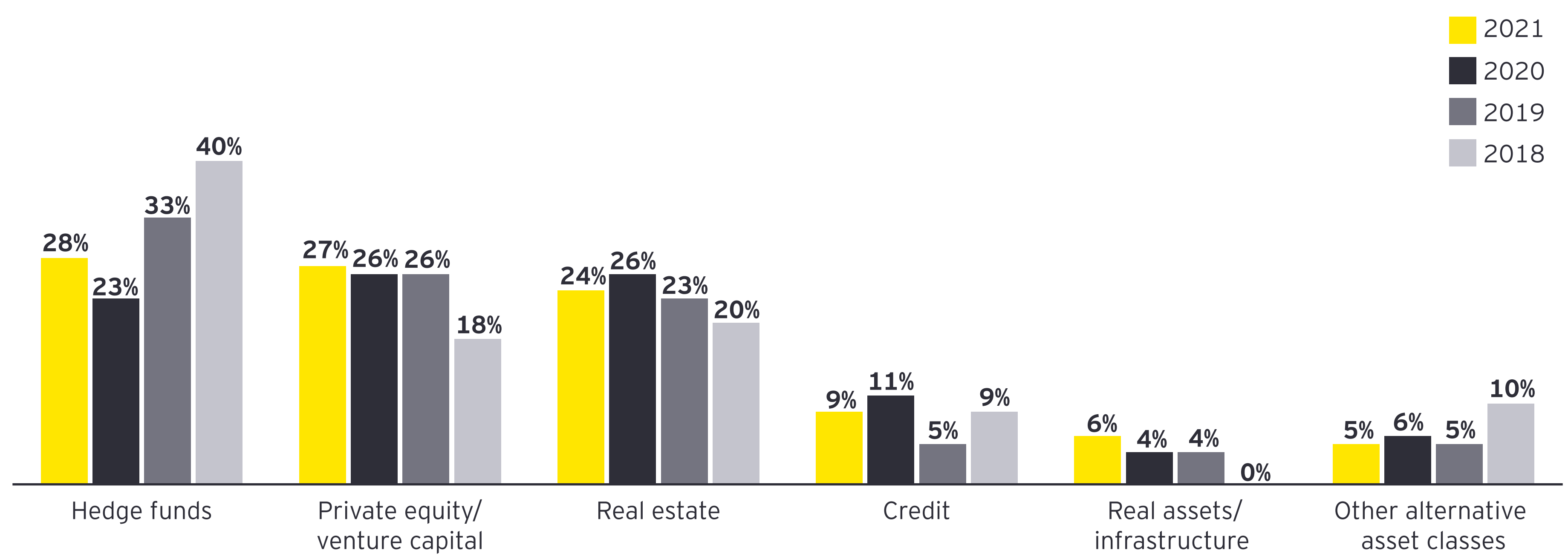
Allocations to hedge funds rebounded and are on par with private equity

Although investment in alternatives among the institutional investors we interviewed remain relatively flat — ranging from between 22% and 24% over the past several years — there have been meaningful shifts in allocations within the alternative segments.

During the past year, allocations to hedge funds reversed their multiyear downward trend, reflecting improved perceptions of performance and their ability to take advantage of opportunities as they arise. Allocations to hedge funds and private equity are now on par — a stark contrast to 2018 when hedge fund allocations outpaced private equity by a two to one margin, and in 2020, when private equity funds exceeded hedge fund allocations.

Additionally, real estate continues to be attractive to investors, with investors reporting that the proportion of their AUM allocated to real estate is running a close third behind hedge funds and private equity allocations.

Q. Investors: what proportion of your AUM that is allocated to alternatives is allocated to each of the following asset classes?



Managers have also demonstrated flexibility on fees

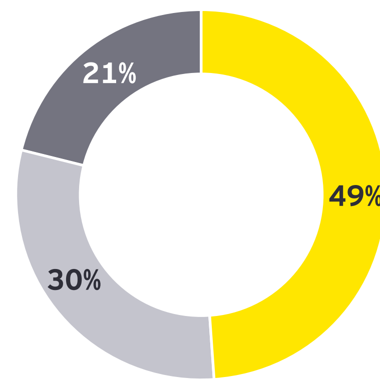
Managers have shown flexibility in their fees and fee structures, improving the value equation for investors. When investors were asked which area is the most important for their managers to offer flexibility, most investors surveyed preferred flexibility in management fees. Three in five investors had a preference for flexible management fees and one in three investors preferred performance-only structures.

In addition, nearly 40% of investors would prefer that managers offer flexibility in performance fees, with longer duration incentive fee crystallizations by far the most popular structure.

Clawbacks and hurdles continue to play factors with performance fee structures, as investors want mechanisms for managers only to earn incentives when they surpass and maintain baseline expectations.

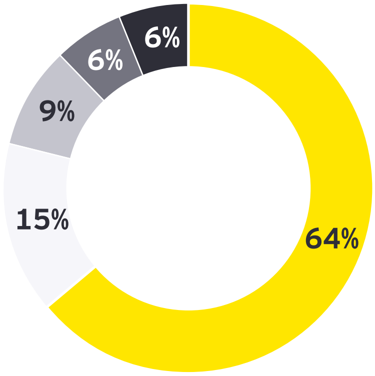
Q. Investors: which of the following fee structures are most appealing in each category?

Management fees



- Tiered management fees (based on AUM)
- Fund that only has a performance fee (no management fee)
- Cost pass-through model in lieu of management fees

Performance fees



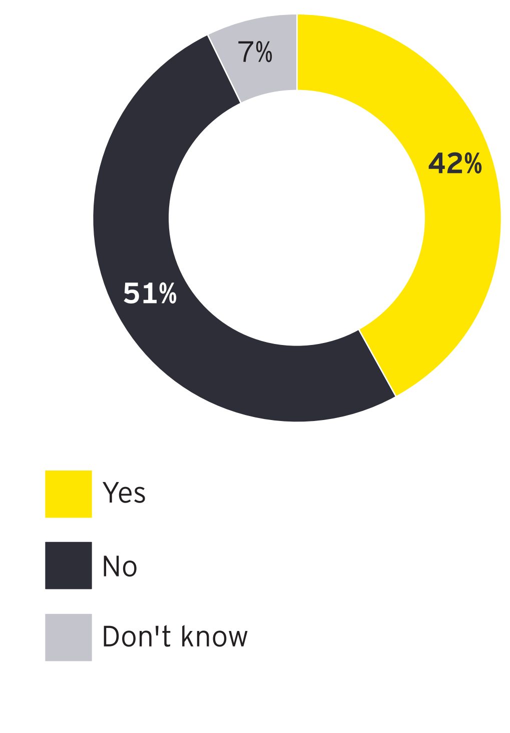
- Performance fee only charged above a hurdle
- Fund that only has a management fee (no performance fee)
- Performance fee clawbacks
- Longer duration incentive fee crystallizations
- Tiered incentive fees or carry allocations

Managers seeking growth are turning to "retail" channels as institutional allocations remain flat

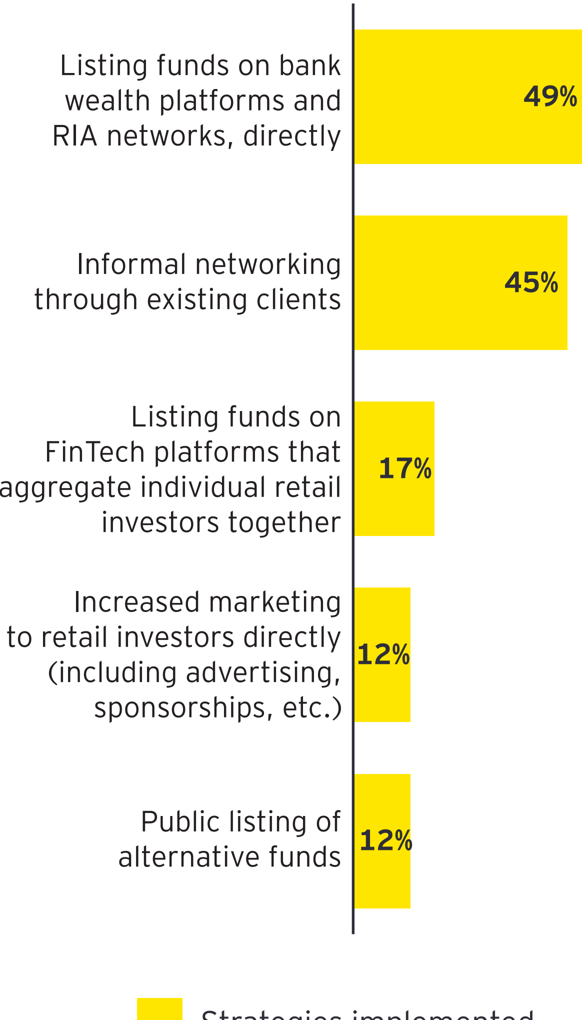
Capital raising continues to be a priority, with two in five managers turning their focus to wealth management and retail channels for growth. Managers looking to broaden their LP base, given limitations that institutional investors may have on additional flows to alternatives, are identifying retail, HNW and Family Office investors to be an opportune segment for raising assets.

A growing set of managers are also turning to FinTech platforms that aggregate retail demand and help address respective challenges retail channels have historically presented – capital "stickiness," AML/KYC, reporting and other administrative responsibilities associated with servicing many smaller clients.

Q. Managers: are you seeking to increase the amount of capital sourced from wealth management or "retail" channels?



Q. Managers: which strategies are you implementing or considering in order to increase capital inflows from those channels?



Talent management and ESG have become strategic imperatives for the future

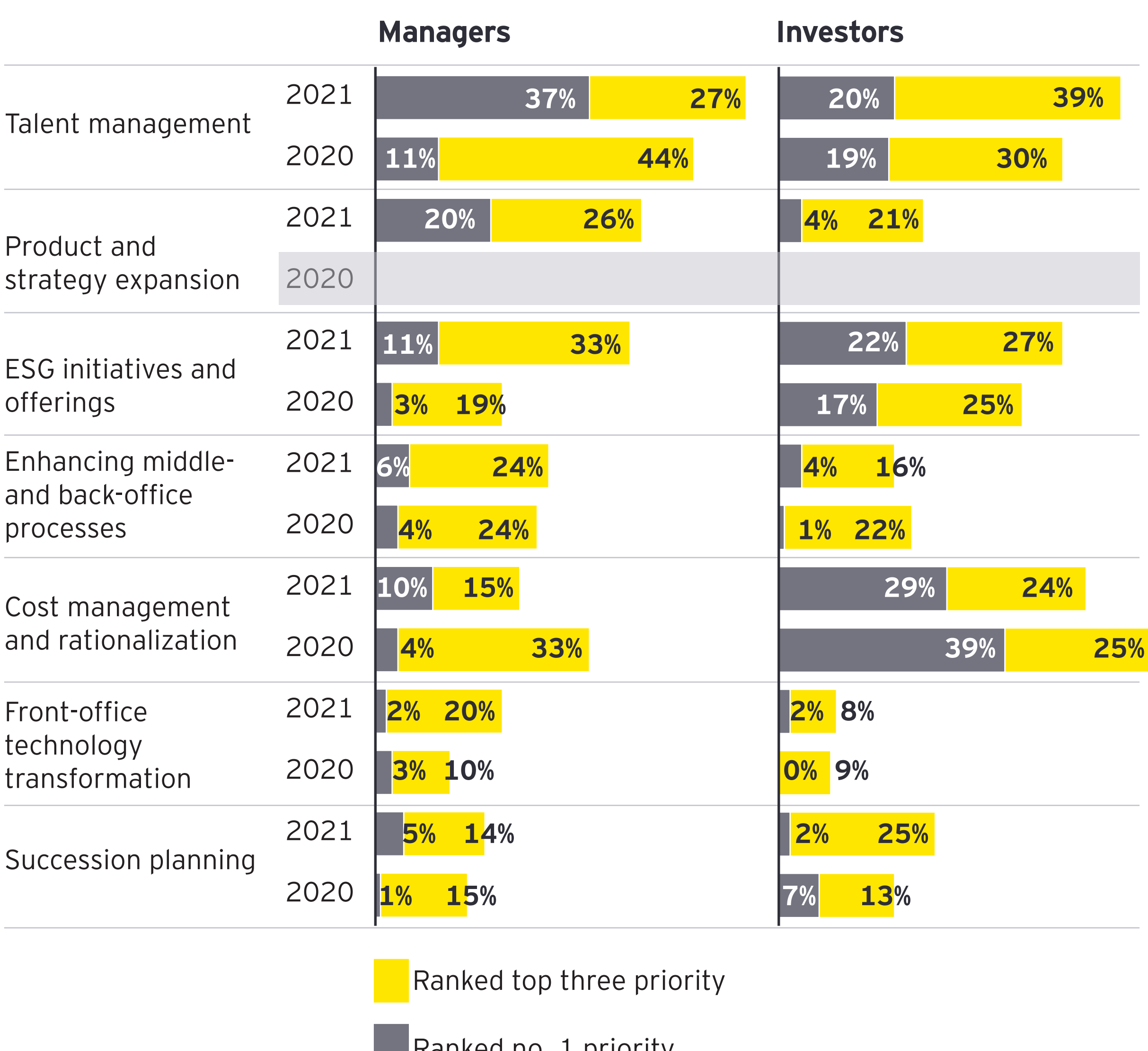
When asked to rank the top three long-term strategic priorities for their firms, aside from asset growth, our survey findings indicate that managers are focused on building for the future. As the ongoing trend of employees voluntarily leaving their jobs continues, managers are increasingly focused on establishing the right environment to attract and retain talent. They are accomplishing this by firming up hybrid work plans, reimagining employee benefits and establishing DEI policies.

Product development also remains a priority, with some managers shifting their focus from launching new structures to taking a more opportunistic approach within existing structures.

As a priority, ESG initiatives have increased the most year over year, as managers respond to investor demands for both the adoption of ESG corporate governance policies and offering ESG investments for their portfolios. The constant focus on cost management/rationalization continues to be a concern going forward.

Q. Managers: aside from asset growth, what are the top three long-term strategic priorities for your firm?

Q. Investors: in which of the following areas should managers be strategically focused to positively benefit investors?



Talent

“The war on talent,” or the demand for highly qualified workers, could be the defining catchphrase for talent management in the alternative fund industry this year. Emerging from the pandemic, “the Great Resignation,” or the exodus of millions of employees from the workforce, reflects workers re-evaluating their priorities and questioning how much time they want to spend in the office or if they work remote. With a growing shift in power away from companies and toward employees, managers are recognizing that employees have the upper hand, and in response, they’re taking actions to create an attractive, flexible and safe work environment. The alternative fund industry is better positioned than most industries, having prospered during the pandemic by leveraging a decentralized operating model and hybrid work becoming a permanent option for the future.

The industry’s embrace of diversity, equity and inclusion (DEI) policies and programs have become key priorities for both managers and investors alike and reflect society’s move toward a more equitable workplace. With managers taking tangible steps to commit to inclusion initiatives to attract and retain top talent, our research indicates that gender representation in the workforce is increasing, with PE managers succeeding in improving the proportion of women in the front office. In contrast, the proportion of underrepresented minorities in the front and back office continue to improve year over year. In addition, the increase of investor scrutiny on DEI may be due in part to recognition that diversity yields better investment outcomes and that they are being held accountable for fostering diversity by their stakeholders, too.

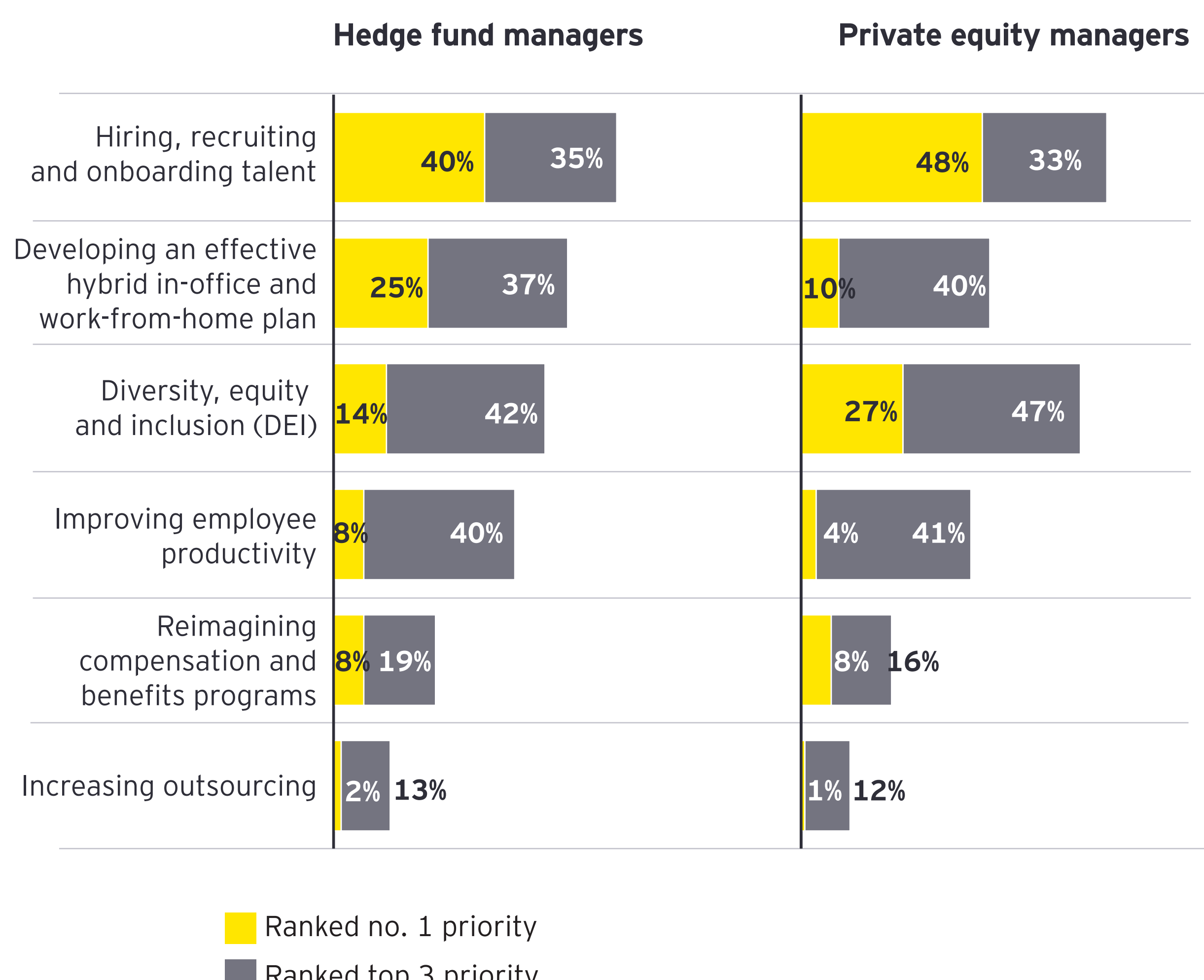
As managers seek talent, flexibility in the work environment and DEI are their top focus

Searching for and retaining talent is top-of-mind for managers, with hedge fund managers responding by developing effective hybrid in-office/ work-from-home plans in recognition of employees wanting to retain some of the flexibility that working from home offers.

Diversity, equity and inclusion (DEI) policies and initiatives are also key priorities, with managers developing policies to foster DEI with the understanding that diversity in the workforce leads to better outcomes. Recent workforce diversity statistics indicate that private equity managers appear to be more focused on DEI.

With hiring topping the priority list for managers in every region, our polling reports that North American managers are most advanced in prioritizing DEI. In contrast, European managers are more focused on hybrid work arrangements, and APAC managers are focused on improving employee productivity.

Q. Managers: which of the following are your firm's three most important talent management priorities?

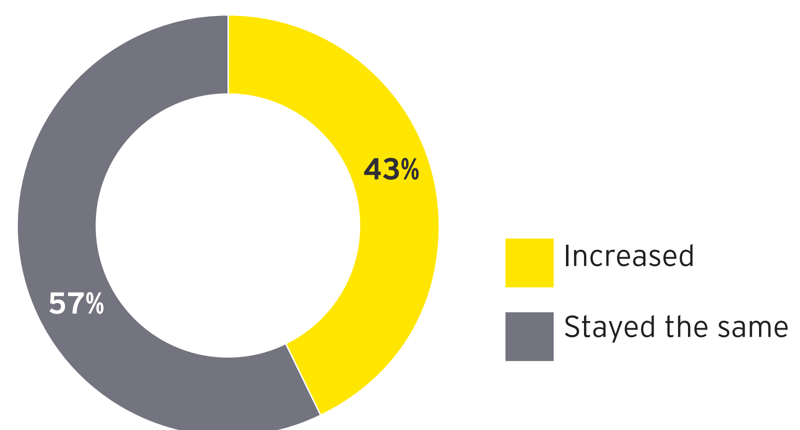


Investors are increasing their scrutiny of managers' talent management programs

Investors concerned with turnover are increasing their scrutiny of their managers' talent management programs. Our research indicates that investors recognize that formalized talent management and benefits programs are key to attracting and retaining the right talent, with one in three investors interviewed saying that managers with strong talent management have demonstratively better outcomes in attracting and retaining talent.

In addition, nearly all investors we interviewed stated that they questioned their managers about turnover levels. And although the percentage of overall turnover that investors find concerning varies, one in three find anything over 10% concerning, and two-thirds find 15% a concern.

Q. Investors: how has your scrutiny of managers' talent management programs and policies changed over the past two to three years?

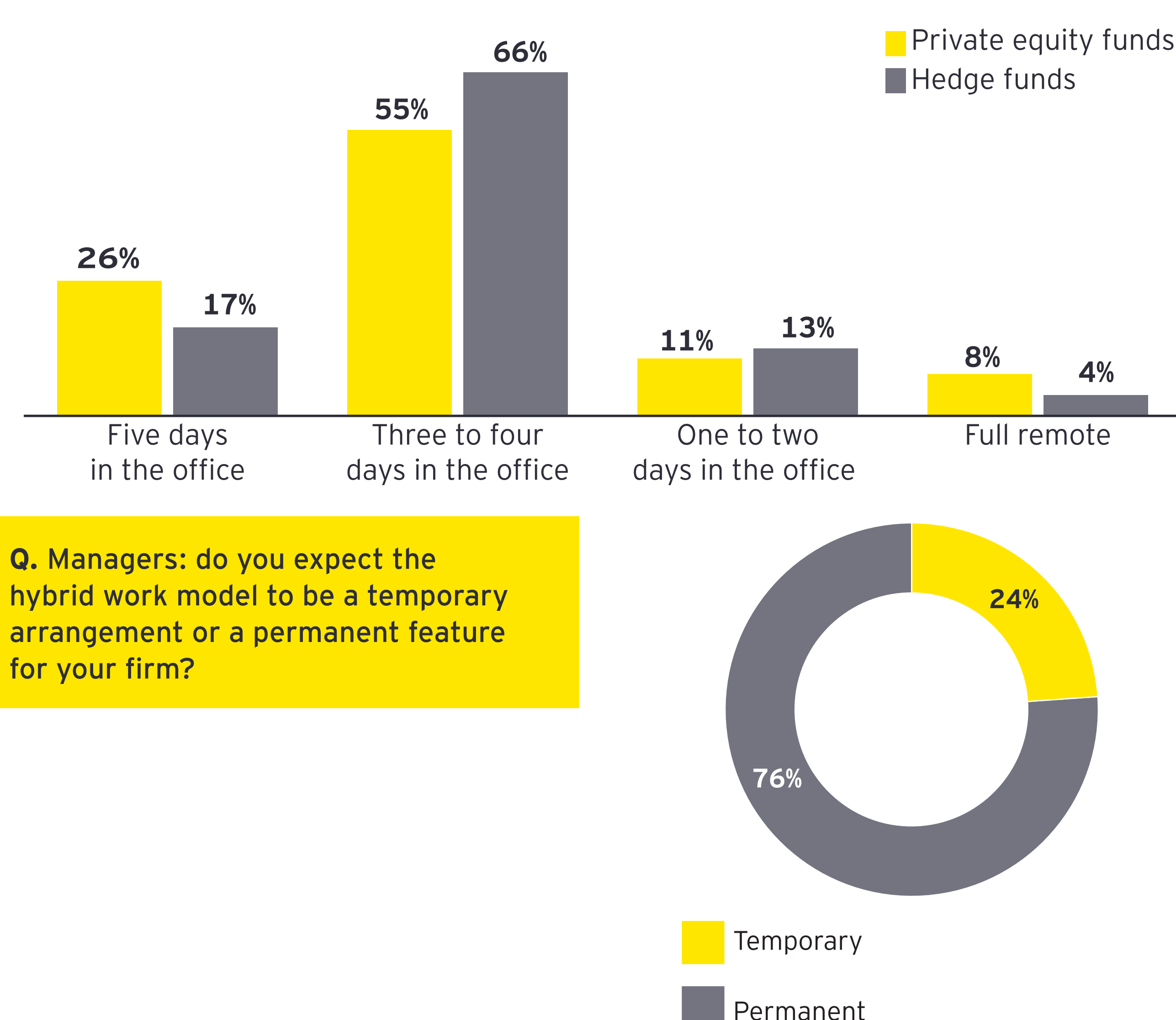


Hybrid work will remain a permanent feature of the future work environment

As managers develop plans for their future work model, most agree that hybrid work will become permanent with more flexibility around where and when employees work. The EY 2021 Work Reimagined Employee Survey found that 9 in 10 employees across industries want flexibility in where and when they work and expect, on average, to work two to three days a week remotely. And as managers compete for talent, they are responding to their employees' flexibility requirements.

Most managers expect to require at least some time in the office for both front- and back-office personnel and are coalescing around three to four days in the office in the next 6 to 12 months. Fewer than one in four hedge funds will require a return to a full in-office work week, with private equity firms marginally more likely to require this approach.

Office time can be prioritized for collaboration and ideation around new initiatives, for mentoring and coaching, and ensuring continuity of firm culture and norms.



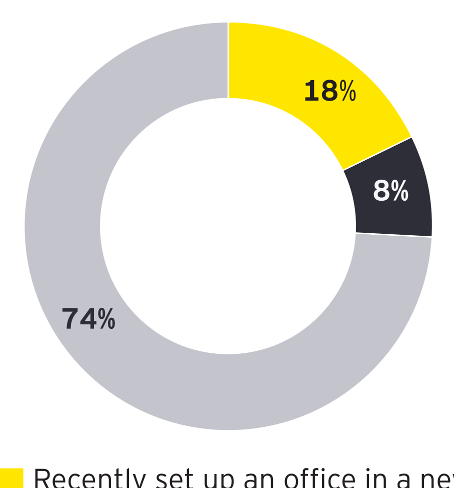
Talent is a driving factor in location strategy

As part of the hunt for talent, managers are also revisiting their location strategies to ensure they draw from strong and potentially untapped talent pools as well as to improve their employees' quality of life. Taxes and the overall business environment are clearly also a driving factor.

More than one in four managers in the US have opened or are considering opening offices in a new geographic location, and for those firms, Florida was cited by 50% of the managers polled.

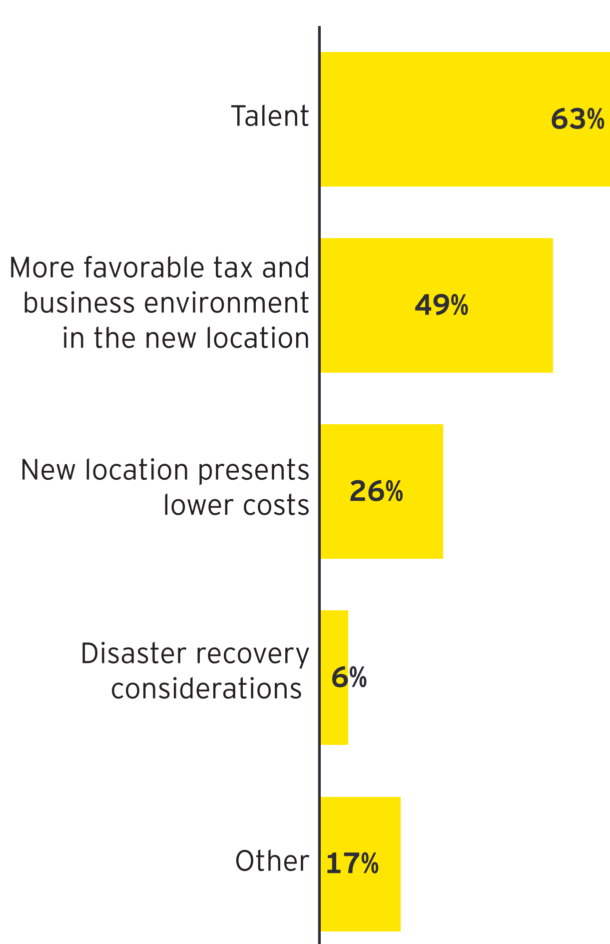
In addition, the top considerations when contemplating a geographic move varied somewhat between hedge fund managers and private equity firms, with hedge fund managers predominantly motivated by taxes, a favorable business environment and lower costs. Private equity firms appear motivated by talent considerations and their desire to be forward-thinking in relation to attracting diverse talent.

Q. Managers: have you recently set up an office in a new geographic location or are you considering doing so in the next 12 months?



- Recently set up an office in a new geographic location
- Considering setting up an office in a new geographic location
- No, we have not set up a new office nor are considering doing so

Q. Managers: what factors made relocation attractive?



Managers are taking tangible steps at implementing DEI policies

Managers, recognizing the value of diverse perspectives on both investment outcomes and business success, coupled with increased investor scrutiny, are formalizing their DEI initiatives to create an inclusive culture.

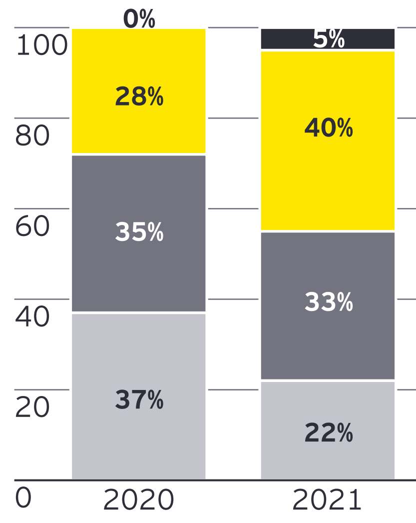
Year over year, the proportion of firms with documented DEI initiatives increased by over 60%, with just 20% reporting not having any formal or informal DEI initiatives. This percentage is down from nearly two times as many reporting a lack of DEI initiatives a year ago.

Private equity firms are leading the way in having formal or informal DEI initiatives, with nearly 90% saying they have initiatives compared with 70% of hedge fund managers.

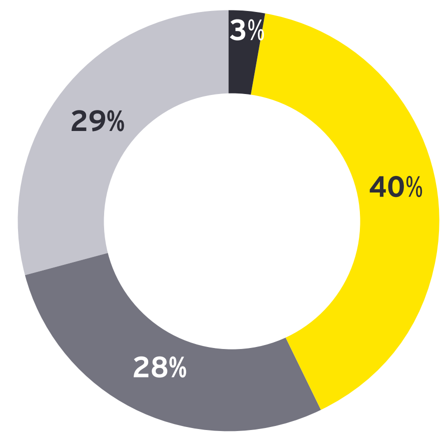
Although the number of firms that have linked DEI initiatives to leadership compensation is still small, we anticipate this correlation to grow, as investors look for evidence that DEI is a priority for management and will yield tangible results.

Q. Managers: which of the following best describes your current DEI initiatives?

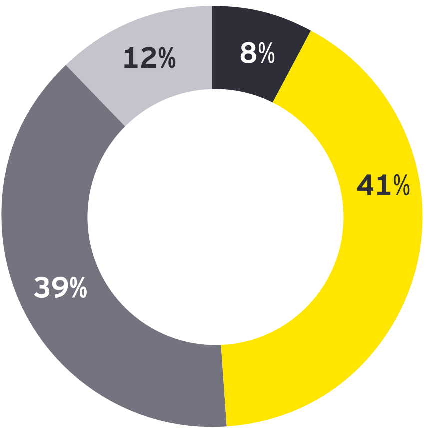
- Documented DEI initiatives and compensation-linked DEI metrics that our leadership team must meet
- Have documented DEI initiatives
- Have informal DEI initiatives
- Do not have any formal or informal DEI initiatives



Hedge fund managers



Private equity managers



Managers and investors are largely aligned on the most important elements of DEI

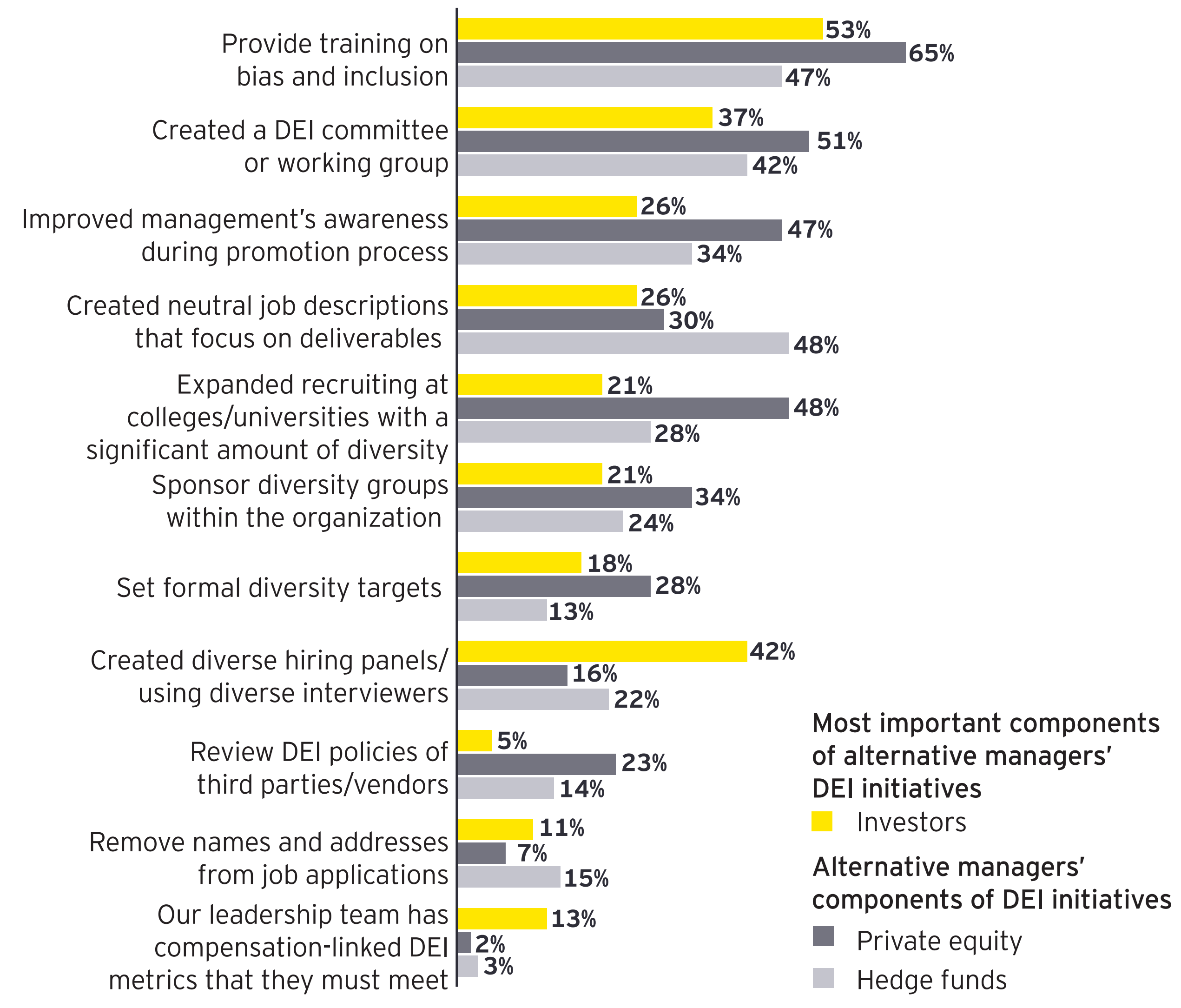
When asked to specify components of their current DEI initiatives, the managers interviewed indicated that training on bias and inclusion, establishing DEI committees, improving awareness in the organization and promoting a culture that can foster diversity were important components.

In addition, private equity firms are generally ahead of hedge fund managers in implementing DEI initiatives, and are implementing a wider range of initiatives and outpacing hedge fund managers on initiatives that can yield tangible outcomes – including expanding recruiting to universities with greater diversity, sponsoring diversity groups and setting formal diversity targets.

It's important to note that the investors surveyed recognize the importance of having training and working groups to focus on DEI, but also recognize the need for managers to create diverse hiring panels to eliminate affinity bias and improve diversity in hiring.

Q. Managers: what are the components of your current DEI initiatives?

Investors: what are the most important components of your alternative managers' DEI initiatives?



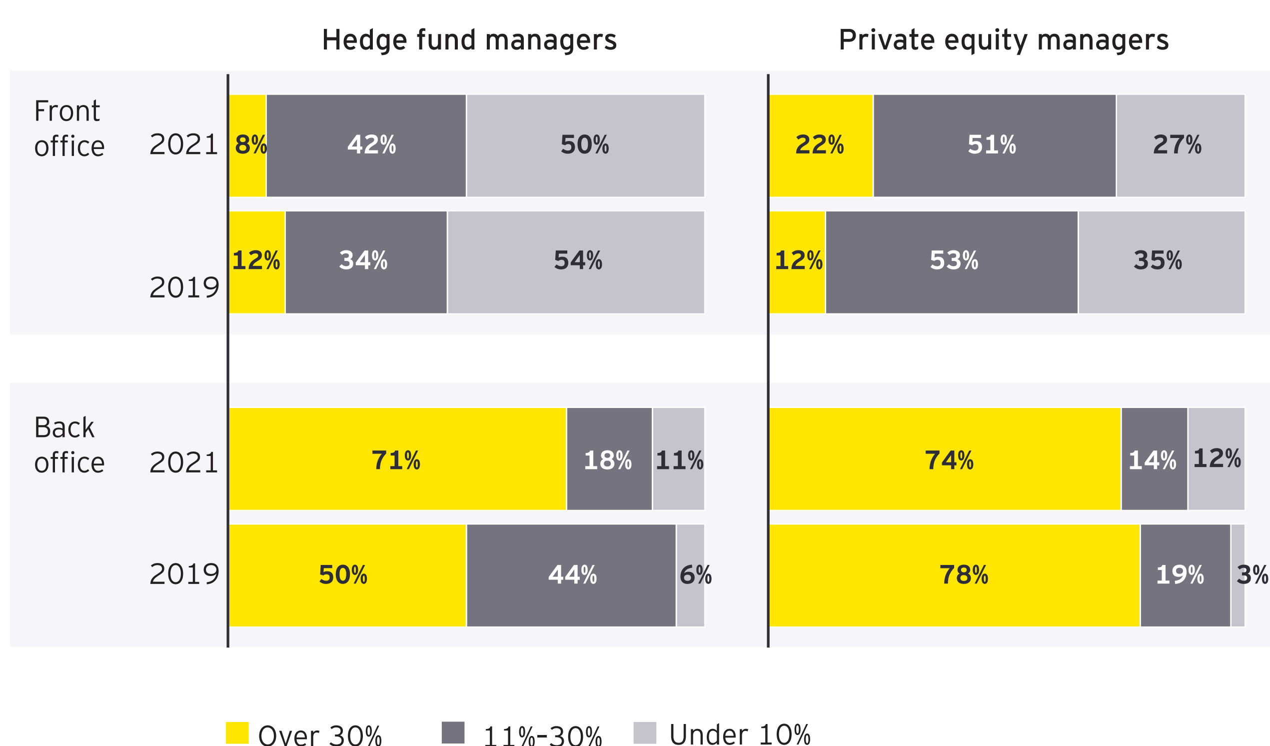
Private equity managers are ahead of hedge fund managers in improving the proportion of women in the front office

The managers surveyed are making progress in improving gender representation in the workforce, with private equity managers successful in improving the proportion of women in the front office and are well ahead of hedge fund managers in this regard.

But hedge fund managers have closed the gap with private equity in the proportion of women in the back office. The pandemic may have played a role in this shift, as women had to reevaluate their priorities, particularly those in caregiving roles. Managers who could offer increased flexibility, remote work and other tangential services were the beneficiaries of this talent.

However, more progress is needed, as less than one in ten managers cited that they have more than 50% female representation within their C-suite and senior leadership. Investors are trying to contribute to the change by ensuring they include female managers in their manager's searches whenever possible.

Q. Managers: what proportion of your firm's front-office and back-office employees are women?



Managers have made progress in hiring underrepresented minorities in the front office

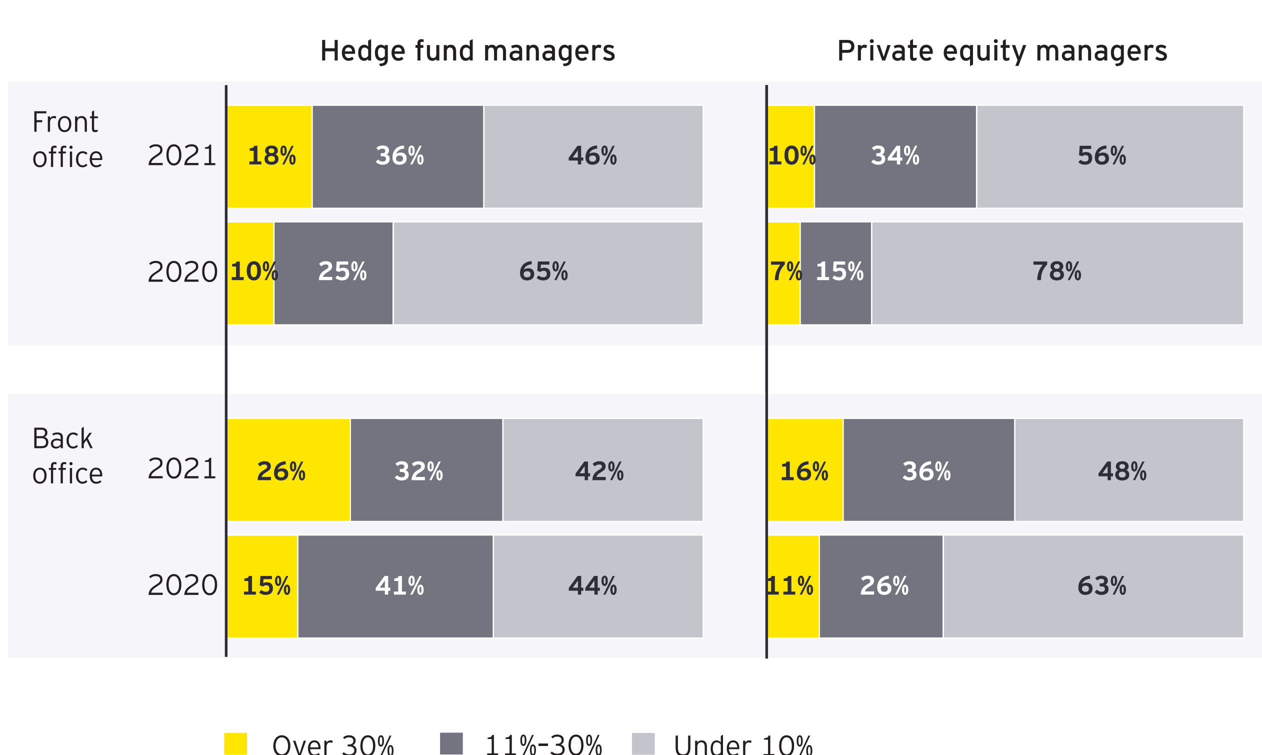
Managers continue to improve the proportion of underrepresented minorities in the front- and back-office year over year, however racial and ethnic minorities make up less than 10% of the workforce at a significant proportion of managers.

As the overall population becomes increasingly diverse, managers need to ensure they are supporting a welcoming and inclusive work environment and developing recruiting and hiring practices that ensure it better reflects the diversity of the workforce.

One in 10 investors stated that DEI managers' policies are critical to their decision to invest or remain invested with a manager, and we anticipate this will increase as investors hold managers accountable for DEI progression.

In order to track their progression, managers need to be thinking about how to best collect and house this data, which can be challenging particularly for small and mid-sized managers.

Q. Managers: what proportion of your firm's front-office and back-office employees are underrepresented minorities?



Investors are starting to hold managers accountable for inadequate DEI policies

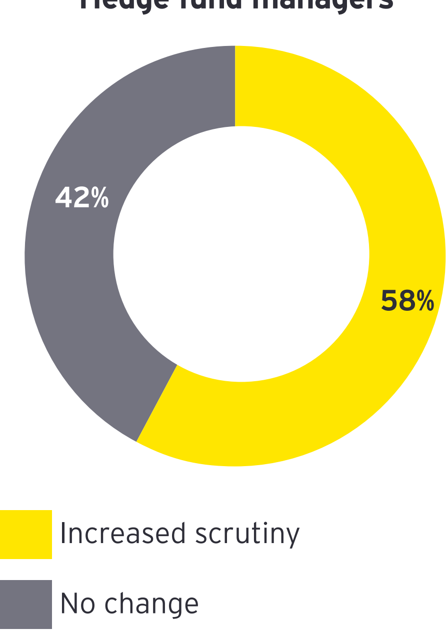
Roughly two-thirds of managers surveyed reported that inquiries from their investors regarding their DEI initiatives have increased, with most investors admitting that scrutiny is increasing.

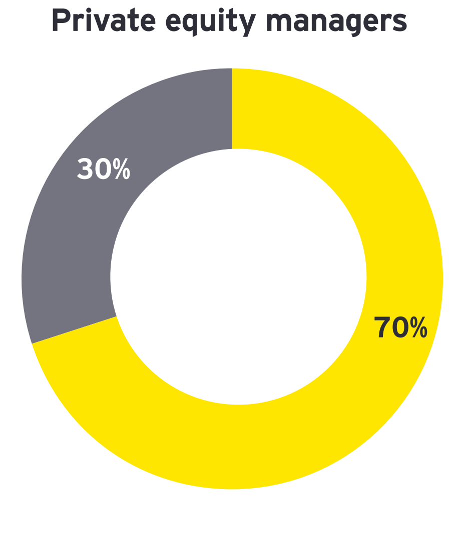
This may be because institutional investors not only recognize that diversity yields better investment outcomes but because they are being held accountable for fostering diversity by their own stakeholders, i.e., boards and shareholders for corporate funds and public entities.

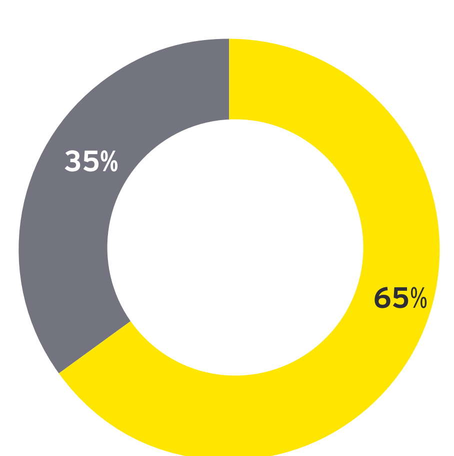
Investors reported that their managers have made "significant" progress on DEI, with 60% of investors stating that they've seen evidence of progress but would like to see more, and another 34% stating that although managers are saying the right things, they have not made tangible progress.

Q. Managers: has your organization received increased scrutiny from current or prospective investors around DEI initiatives and the impact of those initiatives at your organization?

Q. Investors: how has your scrutiny of managers' diversity and DEI policies changed over the last 2–3 years?







DEI policies are beginning to impact investors' decision to invest

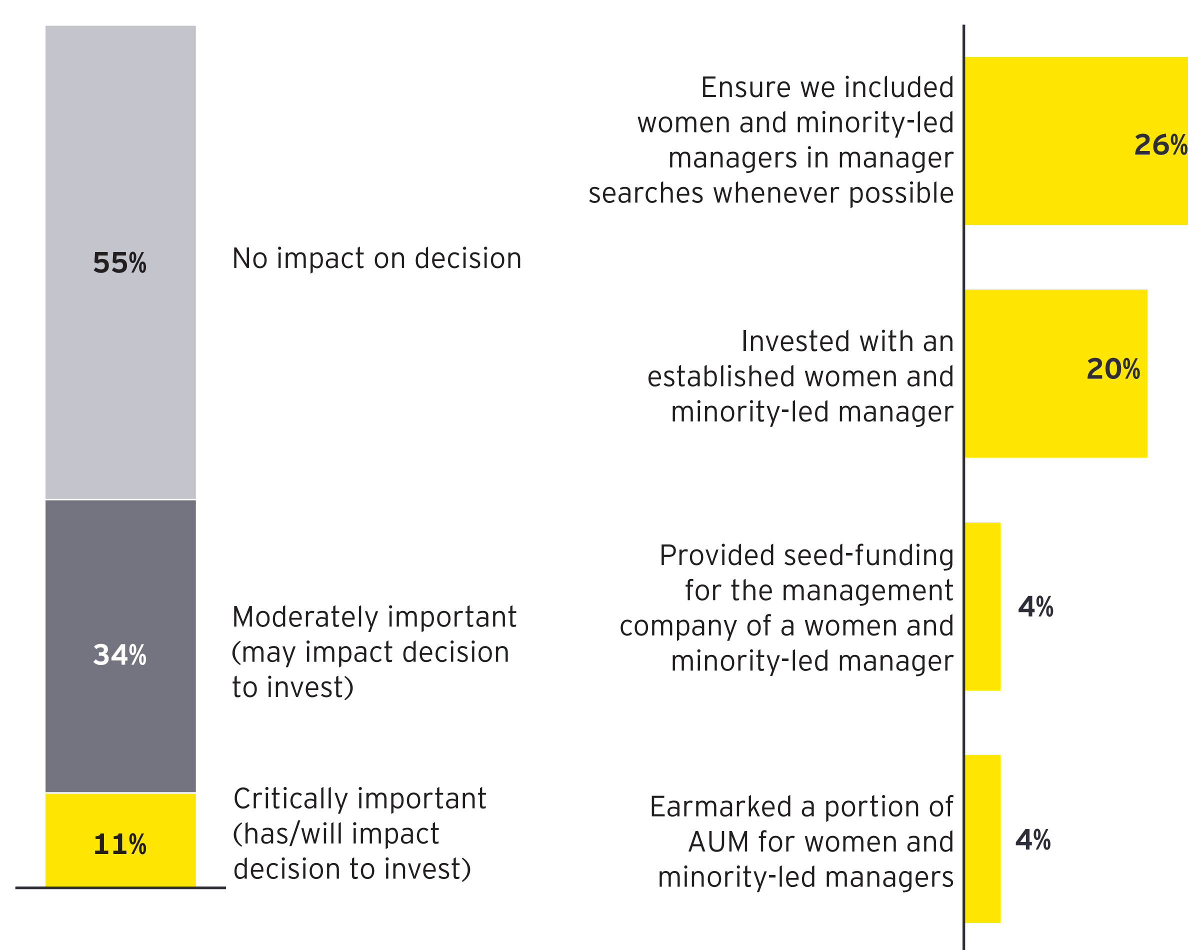
Almost 50% of investors surveyed reported that managers' DEI policies will impact their decision as to whether to invest, demonstrating that it's imperative that managers have documented policies and initiatives in place.

The number of managers that previously did not have DEI policies in place, formal or informal, declined by 16% year over year – demonstrating that managers are taking action to make changes.

Of these investors surveyed, more than one in four have included women and minority managers in their searches whenever possible, and one in five invested with established women/minority-led managers. The number of investors acting by seeding capital with these managers still needs improvement, but hopefully as managers enact DEI policies and initiatives, investors will have more opportunities to support minority and women-led managers.

Q. Investors: what impact does a manager's DEI policies and initiatives have on your decision to invest or remain invested?

Q. Investors: what actions have you taken to support women and minority-led alternatives managers?



Environmental, social and governance (ESG)

Two decades ago, a corporate social responsibility program started by the UN has grown into the environmental, social, and governance (ESG) cause that we see today. In 2021, spurred by the climate and social justice issues in the news, investors are taking note and expect their alternative fund managers to increase integration of ESG and sustainable investment products across their corporate policies and investment portfolios. Managers understand that incorporating a focused ESG strategy is critical to their ability to meet investor expectations. Still, as our research indicates, although most managers are incorporating ESG risks into their corporate governance and investing, they are early in their ESG journey, with Europe the furthest ahead in adopting ESG. Four in five investors say climate risk is a top ESG factor in their investment decision-making, with a majority indicating that it is one of the areas of increased focus this year.

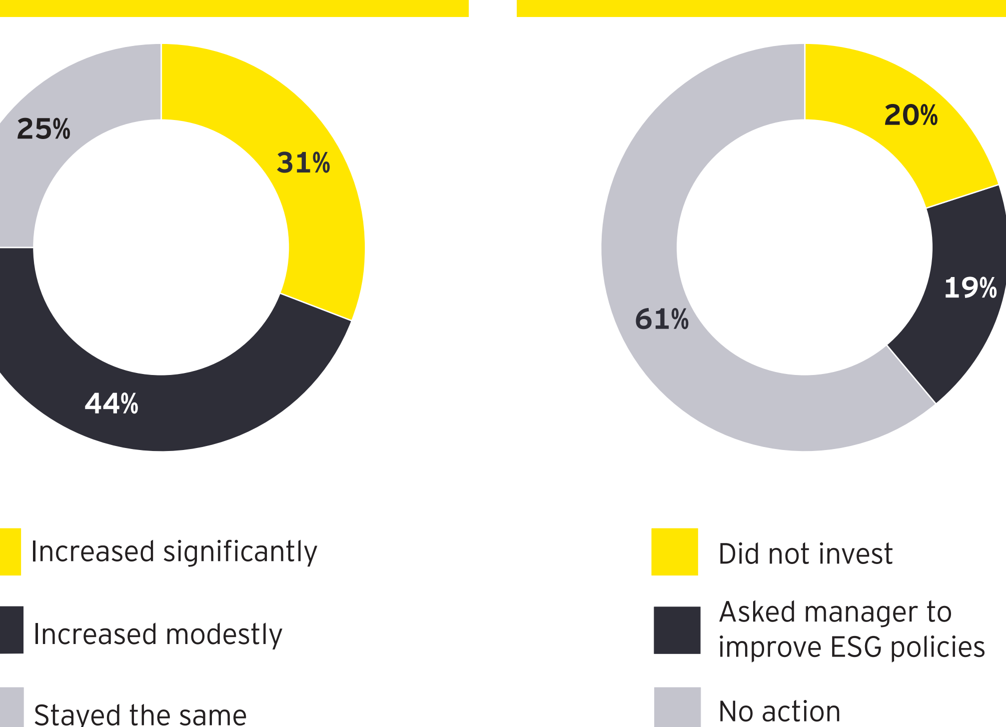
And although most managers are providing their ESG policies and procedures upon request, investors want increased transparency in reporting to demonstrate that their managers are meeting their ESG requirements. In response, managers point to a lack of quality data as one roadblock to adoption — but adopt they must, for in the past year, one in five investors decided not to invest with managers without policies, citing inadequate ESG integration as a primary reason for their decision. As a result, managers who neglect this trend may lose out on investor interest and capital allocations.

One in five investors say they decided not to invest with a manager because their ESG policies were inadequate

ESG and ESG investing have become significantly more prevalent in the alternatives industry over the past few years. Our research indicates that three in four investors say their scrutiny of managers' ESG policies has increased relative to two or three years ago.

Investors are also deciding that ESG needs to be more than just talk. Twenty percent of investors reported that they decided not to invest with a manager because of inadequate ESG policies, with nearly another 20% asking their managers to take action to improve their policies.

Investor imperatives regarding ESG are most important in Europe, becoming a necessary focus to continue to successfully raise capital as regulatory requirements increase. In fact, nearly all investors interviewed that decided not to invest with a manager because of inadequate ESG policies were EMEIA-based.



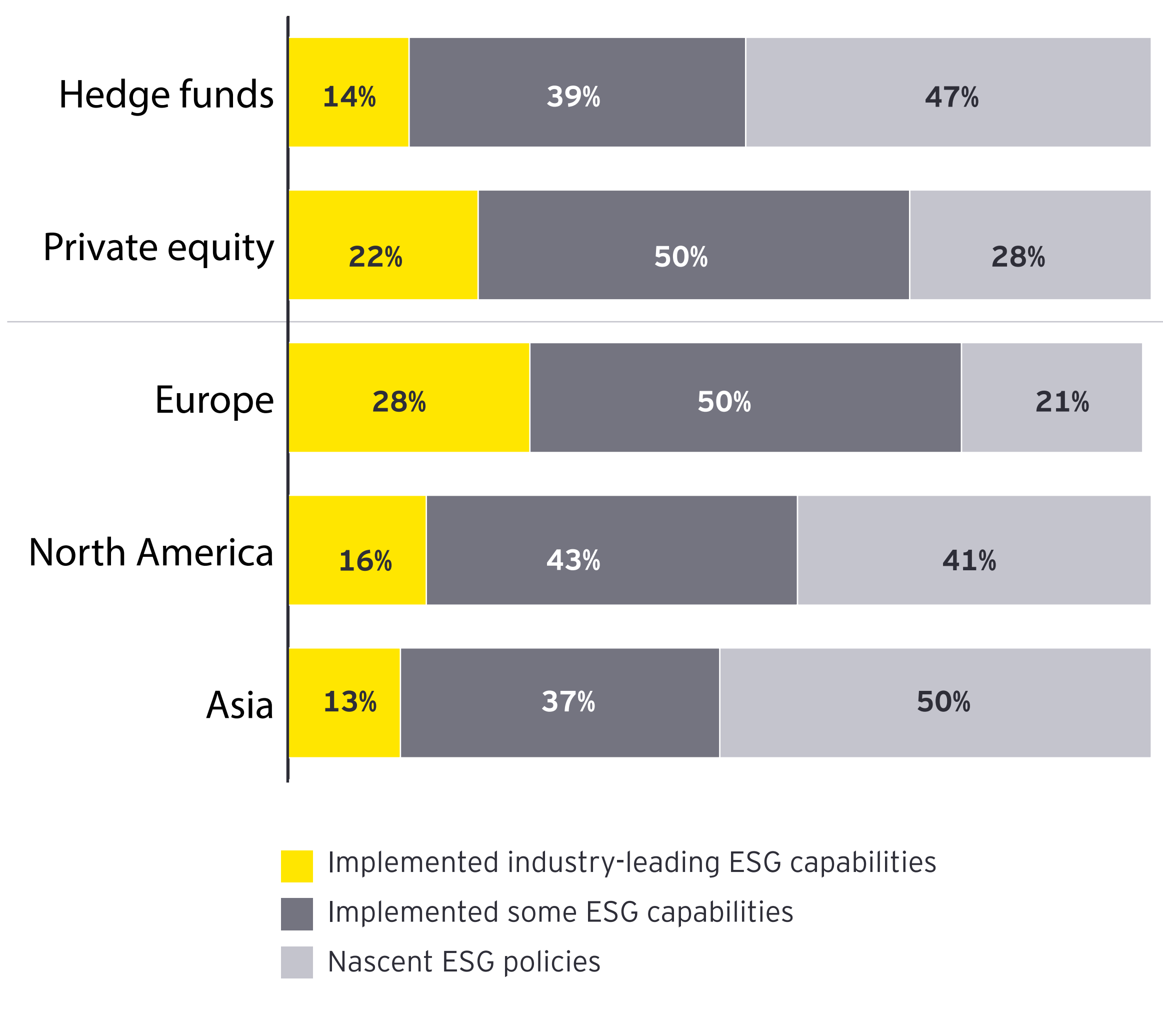
Private equity managers and managers located in Europe are ahead in implementing ESG

Alternative managers are responding to investor demand but are early in their ESG journey. ESG is evolving quickly as regulations are enacted, market standards emerge and investor appetite matures.

Europe is farther ahead of other regions in adopting ESG, and demand for ESG products is high. With the first phase of the EU's Sustainable Finance Disclosure Regulation (SFDR) in effect, managers doing business in the EU need to begin disclosing their approach to incorporating sustainability considerations into their investing.

Among managers, the private equity industry is ahead of hedge funds in implementing ESG policies, but consistent and comparable data to measure ESG compliance at the security and portfolio level is still challenging. Hedge funds that invest in public securities can exclude non-ESG friendly sectors, but data to measure ESG compliance at the security and portfolio level is scarce.

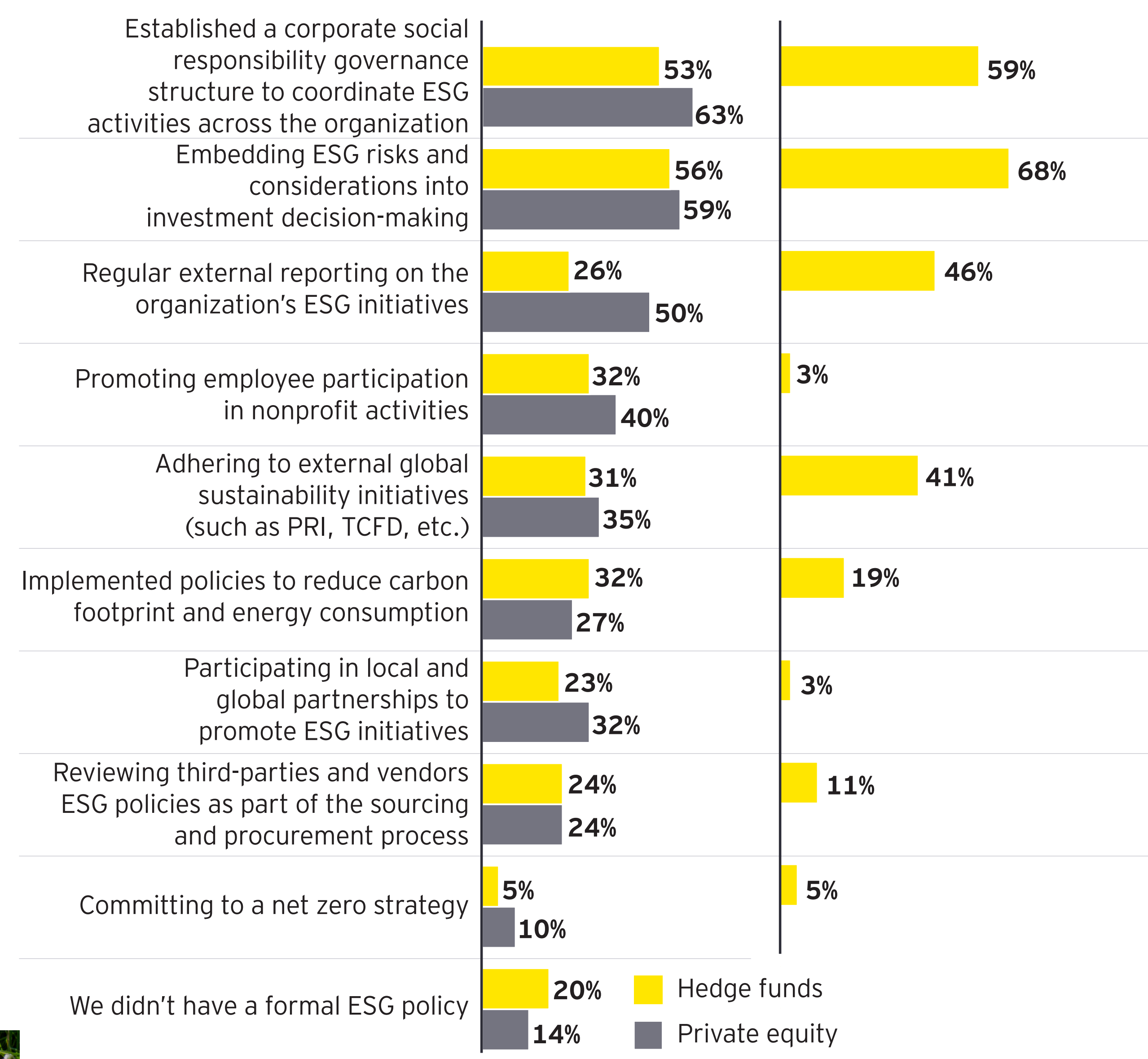
Q. Managers: where is your firm on its ESG journey?



Most managers are incorporating ESG principles into their corporate governance and investing

Managers are formalizing ESG policies at the management company level and in their investing processes by changing their corporate governance structure to embed ESG, with nearly 60% of managers reporting that ESG risks and considerations are also included in their investment decision-making. Investors concur but are also seeking more regular ESG reporting from their managers. Although private equity firms outstrip hedge fund managers in providing regular reporting, just 15% of investors are satisfied with their managers' reporting.

Investors would like their managers to adhere to global sustainability initiatives, yet only one in three managers do. And given the growing importance of ESG and the emergence of EU regulatory imperatives, 20% of hedge fund managers and nearly 15% of private equity managers who say they lack a formal ESG policy will need to act.



Investors want to understand how managers are implementing policies

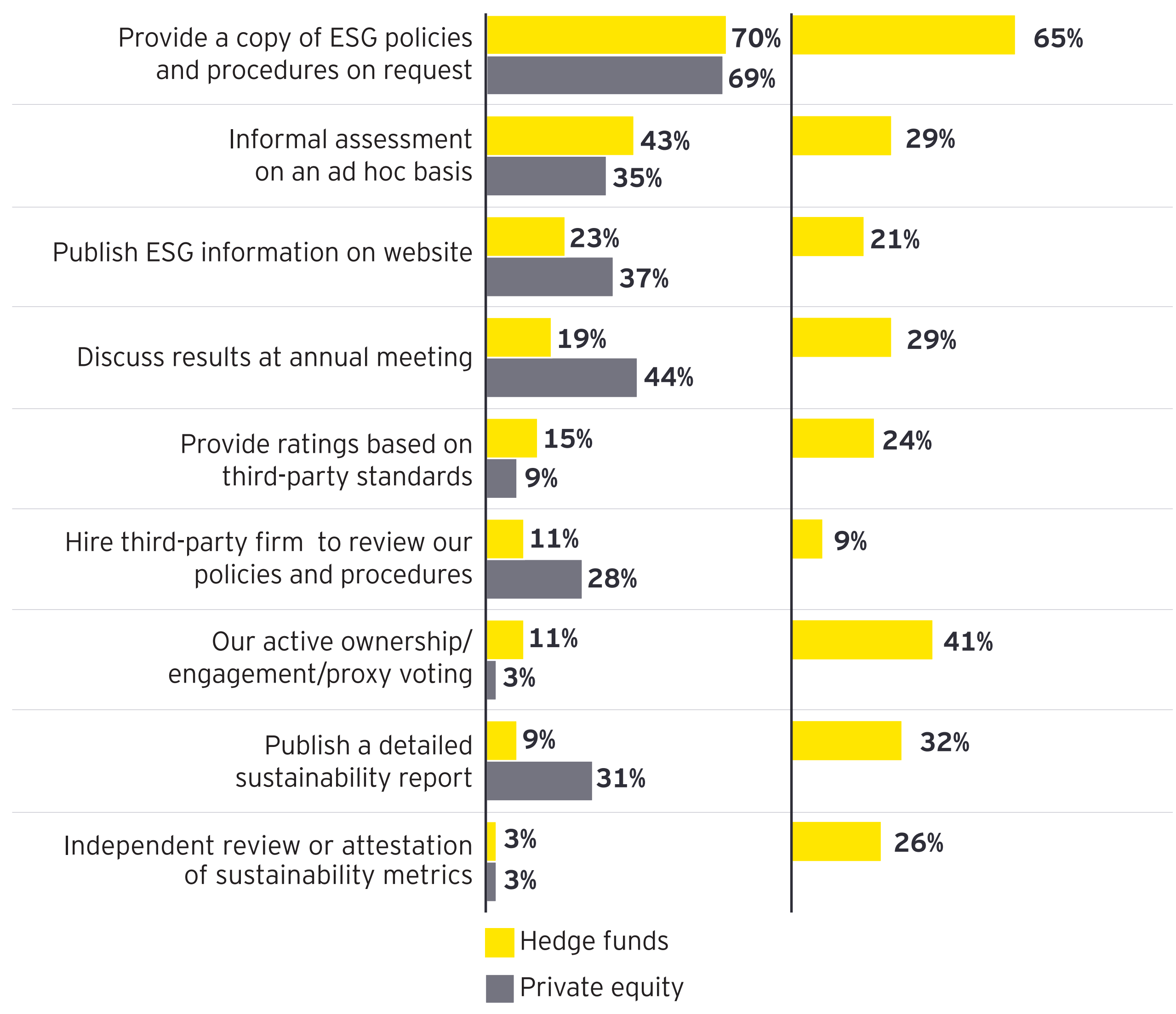
Although most managers are providing their investors with their ESG policies and procedures upon request, investors want more, for they need to understand how ESG policies are being implemented. Our research indicates that two in five investors surveyed want reporting on active ownership and proxy voting, one third are asking for detailed sustainability reporting, and one in four want independent attestation of sustainability metrics.

Private equity managers, having been more proactive than hedge fund managers in their reporting, are more likely to discuss ESG results at annual meetings and publish ESG information on their websites. Nearly one in three are publishing detailed sustainability reports and nearly as many have hired third-party firms to review their policies.

However, few managers have obtained independent review or third-party attestation of their sustainability metrics, but we expect this to be the next evolution.

Q. Managers: what information do you provide to your investors to demonstrate that you are complying with your ESG policies?

Q. Investors: what information do you expect or request of your managers to demonstrate that they are complying with their ESG policies?



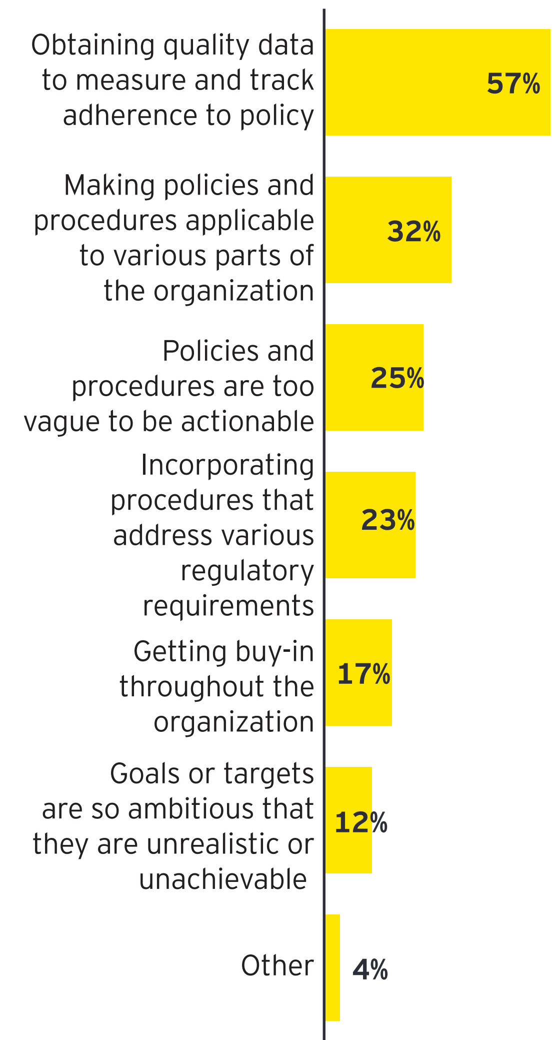
Data to track adherence to ESG policies remains the primary challenge

Hedge funds and private equity managers point to the lack of quality data as one of the biggest challenges in ESG policy administration. While there are data providers, the lack of standard data sets and methodologies impede managers' ability to track adherence. But demand for vendor solutions are growing, with 40% of hedge fund managers stating that they are using third-party providers of ESG information and analytics to help them measure ESG risks in their investing.

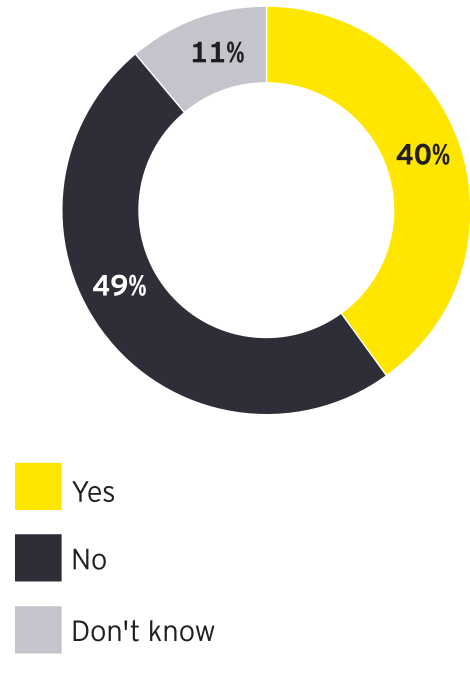
Managers, facing challenges in developing policies that can be applicable to their diverse products and strategies, are trying to find the right balance between a principles-based approach and a more prescriptive approach to ensure policies are applicable, actionable and measurable.

The evolving regulatory landscape adds an additional challenge, as developing a set of policies to comply with multiple possible regulatory regimes will require managers to have well-developed ESG strategies.

Q. Managers: what challenges does your organization face in drafting and complying with ESG policies?



Q. Managers: do you use third-party ESG vendors for information to evaluate the public companies in which you invest?



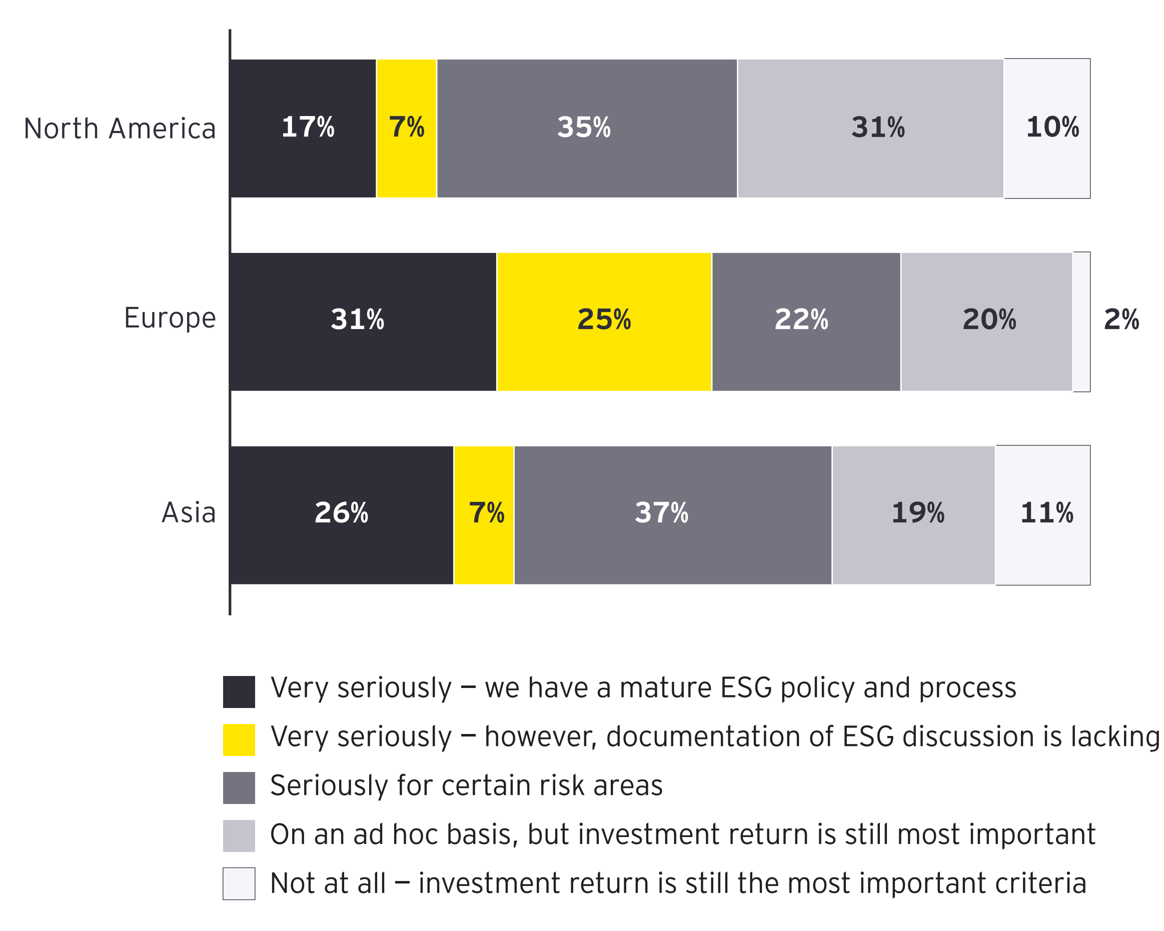
European managers lead incorporating ESG in the investment decision-making process

By necessity, European managers are well ahead of their global counterparts at incorporating ESG risks in the investment decision-making process. ESG investing has been an emerging investment strategy in Europe for longer than in other regions, and as these managers begin reporting under the directives of the SFDR – they will need to demonstrate how they contemplate sustainability in their investment process.

Given these realities, it is surprising that one in five European managers interviewed say that incorporating ESG risk considerations remain ad hoc.

And although regulatory pressure in other parts of the world is not as acute, if managers domiciled outside of Europe want access to EU investment capital, they need to consider, create and implement policies to support how ESG risks are incorporated across their investment decision-making.

Q. Managers: how seriously are ESG characteristics contemplated in the investment decision-making process?



Investors are increasing their focus on climate risk in their investment decisions

Climate risk awareness has become both "top of mind" and mainstream, and investors have responded. Four in five investors surveyed say that climate risk is a top ESG characteristic in their investment decision-making, with a majority saying it is one of the areas of increased focus this year.

And in the wake of the social justice movement, investors as they consider making investment decisions are also increasing their focus on DEI. This attention by investors will encourage, if not compel, managers to focus on improving their DEI policies and also understand how their investments may be impacted.

In addition, strong governance has always been a key focus, not just because it encourages ethical and effective action across an organization, but because companies with strong shareholder rights are proven to have better returns as they have more input.

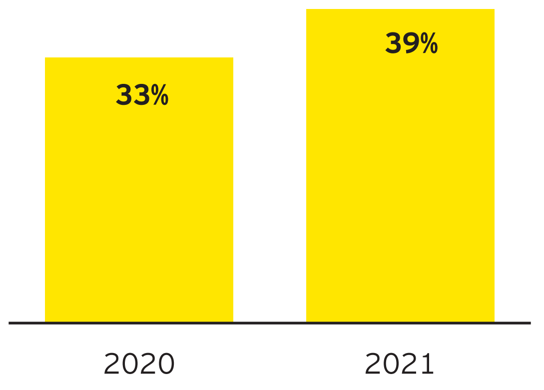
Q. Investors: what are the top ESG characteristics you include in your investment decision-making process?

The proportion of investors that are investing in ESG is increasing

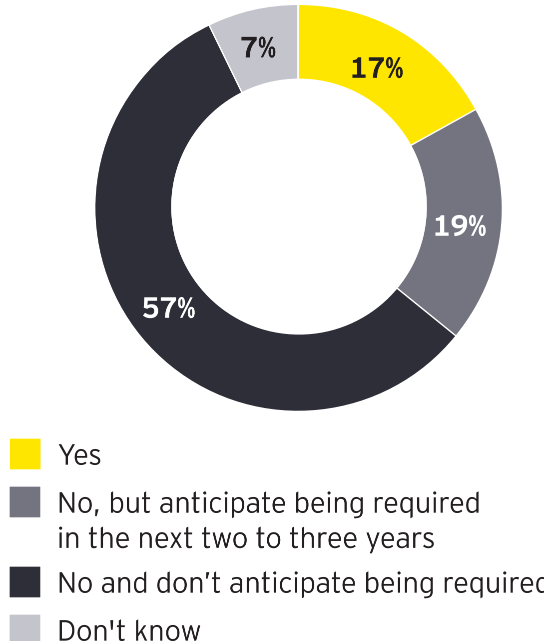
Our survey findings indicate that nearly two in five investors say they invest in a range of dedicated ESG products, up from one in three a year ago. Products range from socially responsible funds to impact funds or, to a lesser extent carbon funds. Still, more investors are obtaining exposure to ESG products with funds that have an allocation to ESG issues or ESG share classes.

And when asked whether their organization is required to invest in socially responsible products, 36% of investors surveyed indicated that they will be required to do so within the next two to three years. The implication of this data signifies that managers who neglect this trend could lose out on investor interest and capital allocations.

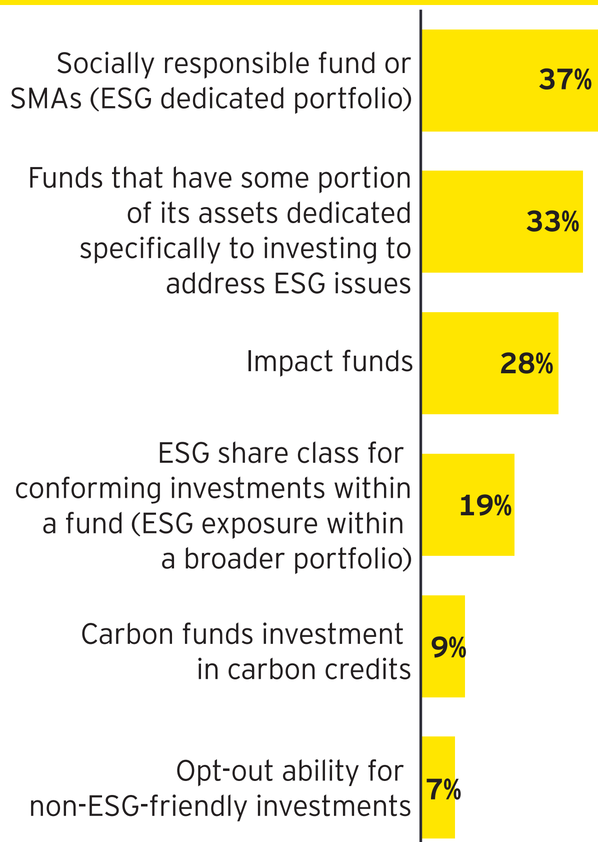
Q. Investors: do you currently invest in ESG products?



Q. Investors: Is your organization required to invest in socially responsible products?



Q. Investors: What ESG structures do you currently invest or plan to invest?



Managers are responding to ESG product demand but obstacles remain

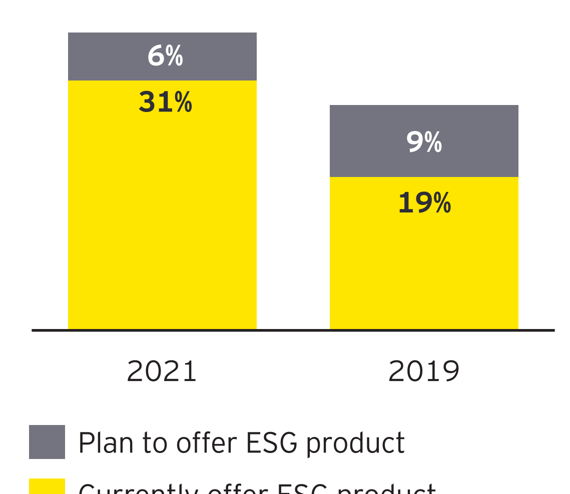
Our research indicates that the proportion of managers that offer ESG products increased by 50% year-on-year, with approximately one in three managers offering ESG products.

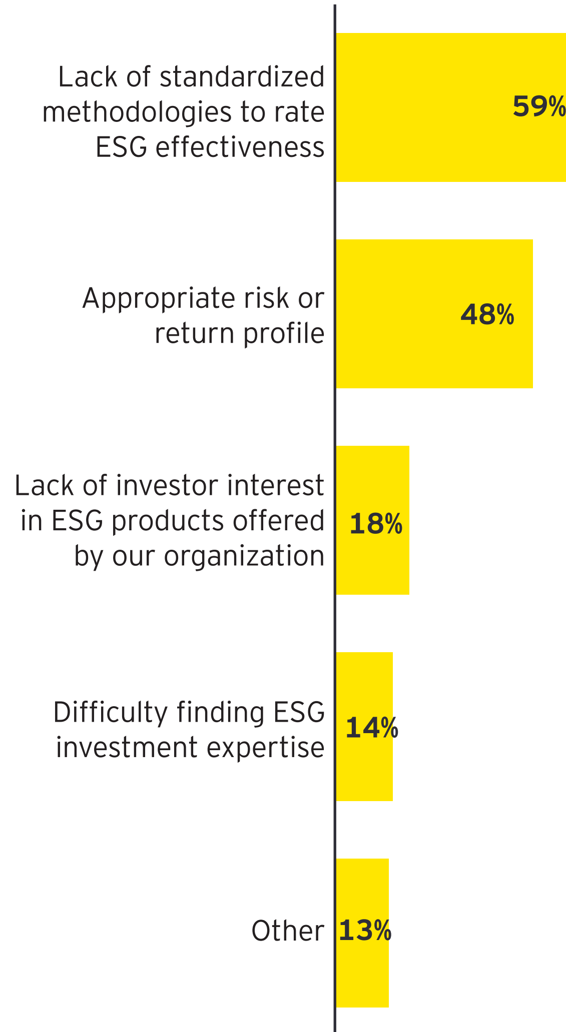
When asked the greatest obstacles to launching ESG products, most managers selected two key concerns: the lack of data and standardized methodologies for evaluating ESG effectiveness and a company's performance, compounded by the lack of consensus on how to evaluate the KPIs associated with ESG portfolios. And skepticism of the return profile of ESG, which is exacerbated by the difference in the measurement horizon, remains a concern.

ESG is about long-term sustainability, and this creates a disparity with managers, particularly hedge fund managers, who measure performance in much shorter time frames.

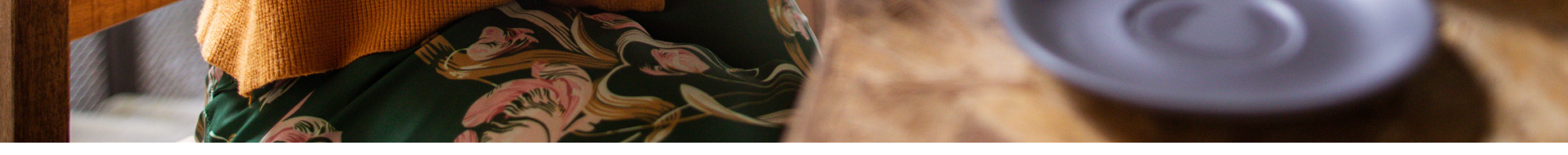
Standards for measurement of ESG effectiveness and for ESG performance will be important for continued evolution of these investment products.

Q. Managers: do you currently offer or plan to offer ESG investment products?





Investment strategies



One year can make a difference. With a slowly recovering economy, investors are turning to alternatives for improved risk-adjusted returns. For years alternative asset managers have broadened their offerings, with many managers having a multitude of products that allow them to invest across asset classes and the liquidity spectrum. This investment in diversification resulted in a convergence among managers and has facilitated many of the strategic innovations and developments that we witnessed during 2021, including but not limited to crossover public/private funds, an explosion in SPACs and increased institutional embracement of digital assets and others.

Perhaps the most pronounced of the strategy innovations during 2021 has been the increased focus on private investing, with hedge funds making private company investments to enhance returns and attract capital, and investors becoming more comfortable with this strategy as well. Private investment opportunities have been significant contributors to performance during 2021 while also providing a diversified return profile against public market investing.

In addition, alternative fund managers have been active participants in the SPAC market, with one in three actively engaged or considering sponsoring or investing in a SPAC, as evidenced by the Q1 surge in activity.

Cryptocurrencies and the digital asset ecosystem perhaps garnered the most mainstream public interest during 2021. Alternative fund managers have become more active participants, drawn by uncorrelated return profiles and continued investment in institutional-grade infrastructure to support this evolving asset class. As the industry and regulators continue to better understand this asset class, the alpha-generating opportunities will certainly create more incentive for alternative fund managers to participate in this strategy.

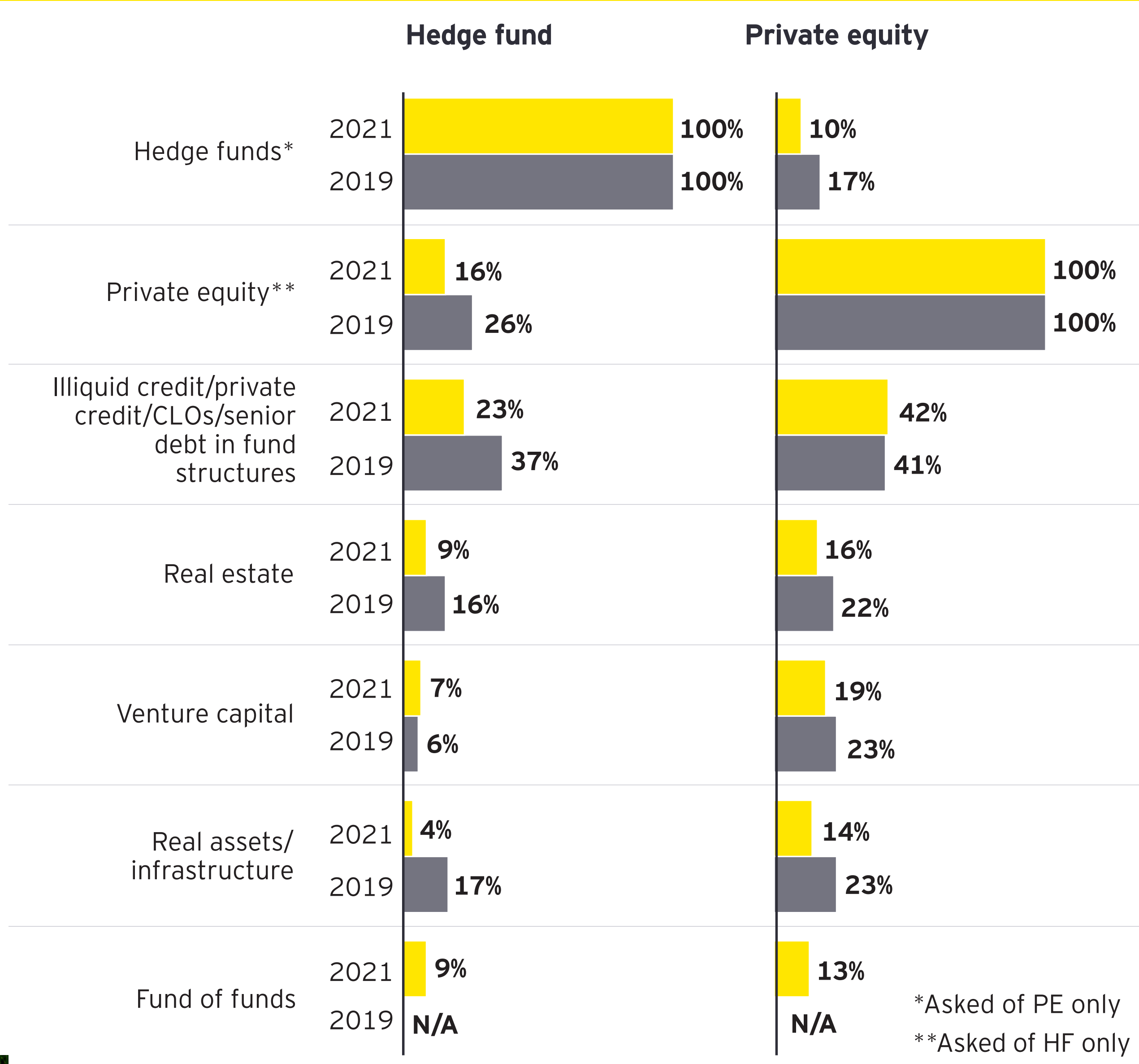
Convergence across strategies remains relatively consistent

Alternative managers are focusing on their traditional strengths, with a relatively equal amount of managers in 2021 indicating they have various offerings across hedge, private equity, credit, real estate, as reported two years ago in 2019.

Launching new product structures requires cross-disciplinary collaboration across front- and back-office functions, with work-from home environments making it even more challenging. Managers reported that a smaller proportion of fund flows were into new products, 22% down from 27% a year earlier. While challenges do exist in launching new structures, managers who invest and are successful are able to better diversify their business and expand their offerings to allocators who may previously have been out of reach. Whether organically or via M&A, we continue to see a trend of managers looking to diversify and broaden their capabilities.

Managers are still innovating by exploring new investment strategies that take advantage of emerging opportunities but are doing so within their existing structures.

Q. Managers: which of the following products do you currently offer or plan to offer to clients in the next two years?



Hedge funds are making private company investments to enhance returns and attract capital

In addition to those hedge fund managers who have dedicated private equity and venture capital funds, many hedge fund managers reported that they are making private equity and venture capital investments within their co-mingled hedge fund products.

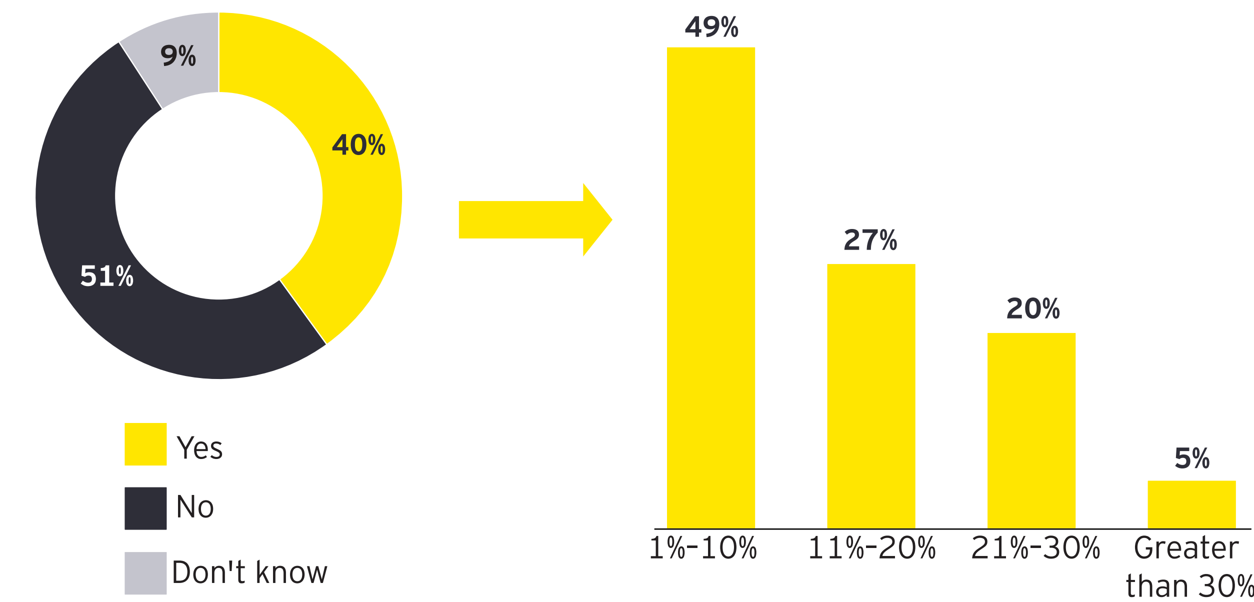
But nearly all managers interviewed reported limits on the proportion of their assets that could be invested in private equity/venture capital investments, with half saying that the limit was 10% or less.

Because of the illiquid nature of these investments, allocations beyond 20 or 30% can cause challenges and may require structures to support longer investment horizons. Forty-four percent of hedge fund managers say they offer co-invest vehicles and 23% offer side-pocket structures specifically for illiquid investments in their portfolio.

This diversification in asset classes helps bridge the gap in allocation between private equity and hedge funds as it allows for hedge funds to have exposure to various risk profiles.

Q. Hedge fund managers: within your co-mingled hedge fund product, do you have the ability to make PE and VC-like investments (regardless side pockets and structures put in place)?

Q. Hedge fund managers: what is the maximum percentage that you can invest in PE and VC-like investments?



Hedge funds are adding exposure to private equity and venture capital as investor comfort levels increase

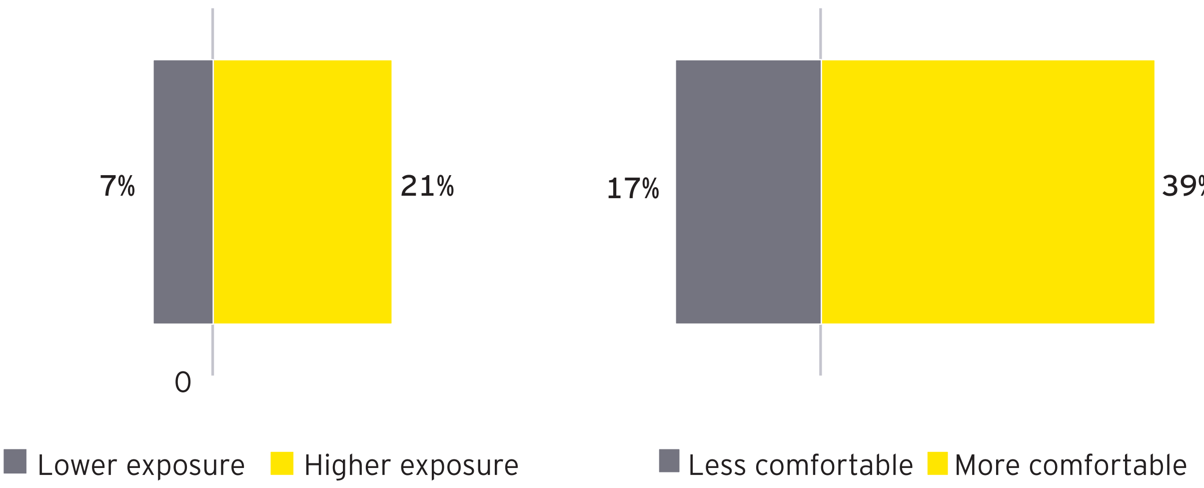
Exposure to private equity and venture capital assets have been growing over the past few years as market disruptions have created opportunities. More hedge fund managers polled say their exposure has grown than hedge fund managers reporting that they have reduced their exposure.

Managers that invested in private equity and venture capital investments reported an average of five percent allocated in these investments, marginally higher than historical norms of around two to three percent. More than 40% of hedge fund managers said they expect private investing to become a larger part of their future portfolio, a proportion that increases to more than 60% among managers with more than US$10b in AUM.

In addition, by nearly a three to one margin, investors stated that they are more comfortable with exposure to private investments than they were in the past.

Q. Hedge fund managers: how does your hedge fund's exposure to PE and VC-like investments compare with two to four years ago?

Q. Investors: how has your firm's comfort-level changed with regards to hedge fund managers increasing exposure to PE and VC-like investments in their open-ended funds over the last three to five years?



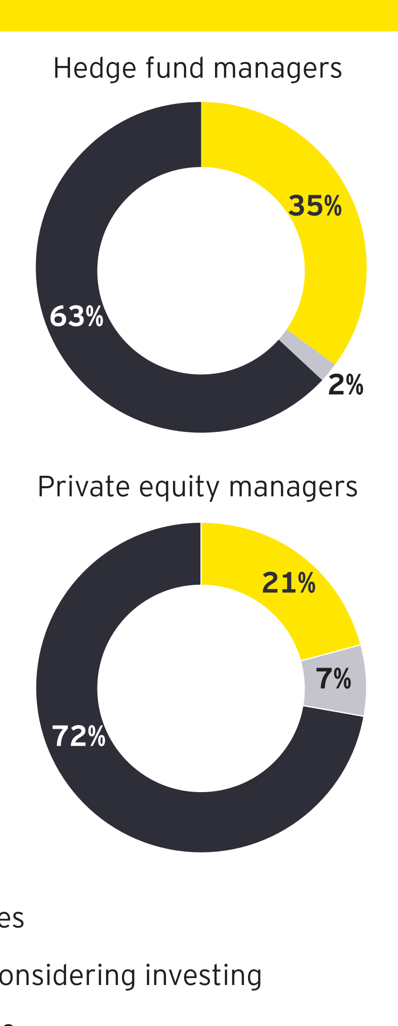
Nearly 30% of managers participated in the SPAC market

Although SPACs have been around since the 1990s when they were formed as a response to the regulatory reform of blank check companies, the market only began to heat up in 2017 and truly began to skyrocket in 2019, continuing at high levels with 560 SPACS having been brought to market through June 2021.

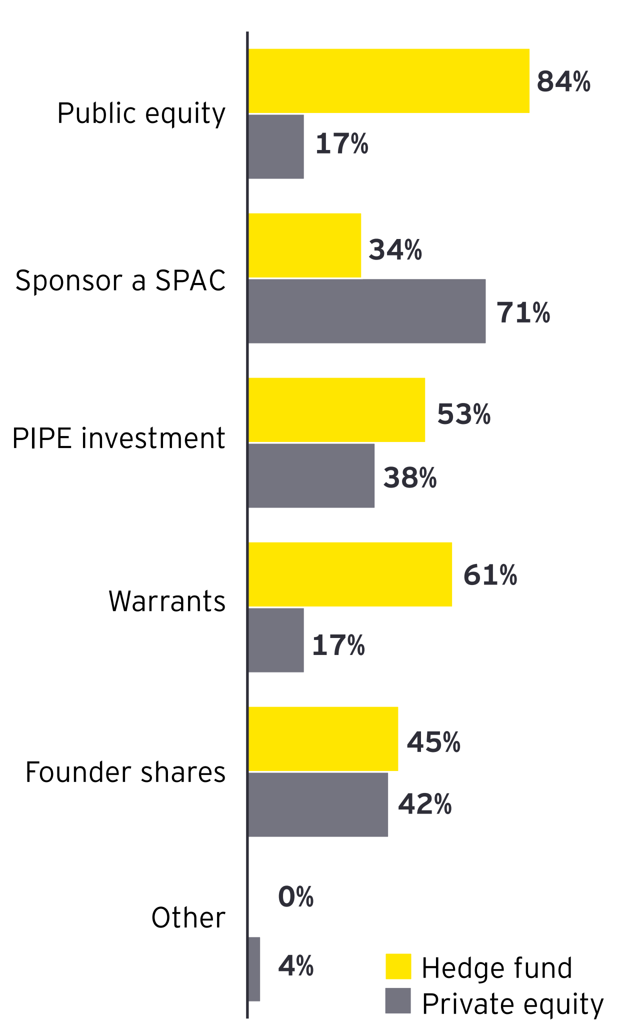
Alternative managers have been active participants in the SPAC market, with one in three managers reporting being actively engaged or considering sponsoring or investing in a SPAC. Activity was at its peak during the first half of 2021 prior to regulatory intervention in the space which slowed, but did not eliminate, the number of transactions occurring in the second half of 2021.

When asked how their firms invest or plan to invest in SPACs, it is not surprising that when deciding how to participate in SPACs, private equity firms tend toward the private markets and hedge funds toward the public markets.

Q. Managers: in the past 12 months, has your firm sponsored a SPAC or invested in SPAC related securities (e.g., via public equity, PIPE investments, warrants, founder shares)?



Q. Managers: how does your firm currently invest (or plan to invest) in SPACs?



Consensus from managers and investors is that the SPAC market was overheated, will retrench and slowly recover

SPAC activity, both in terms of new SPACs coming to market and transactions consummated, peaked during the first half of 2021. Subsequent regulatory intervention and other market conditions resulted in a slowdown of activity in the latter part of 2021; however, this market continues to be opportunistic.

During our interviews, both investors and managers agreed that the market was overheated but would recover from the current period of retrenchment and reach a new equilibrium.

The nature of SPAC transactions lends itself to alternative fund managers participating in various capacities. Private equity managers are most likely to sponsor a transaction, which is no surprise given their experience and expertise in identifying attractive private companies for investment. Hedge fund managers are more likely to participate in the public SPAC securities and associated PIPE and warrant opportunities.

	Managers	Investors
The SPAC market was a bit exuberant, will retrench for a period, and then slowly recover	50%	37%
The SPAC market has reached a sustainable plateau and is a viable investment option	18%	26%
The SPAC market has begun a slow and steady decline	11%	7%
The SPAC market is a bubble about to burst	9%	11%
The SPAC market will continue to grow at a similar rate and is a viable investment option	8%	7%
The SPAC market is a bubble that has burst	4%	7%
The SPAC market growth will accelerate	0%	4%

	Managers	Investors
Regulatory scrutiny or uncertainty	32%	29%
Poor long-term performance of companies taken public via SPAC	29%	25%
Not enough attractive acquisition targets	20%	25%
Too many IPOs coming to the market	14%	14%
Industry infrastructure is not sufficient to keep up with the SPAC market activity	3%	0%
Other	2%	0%

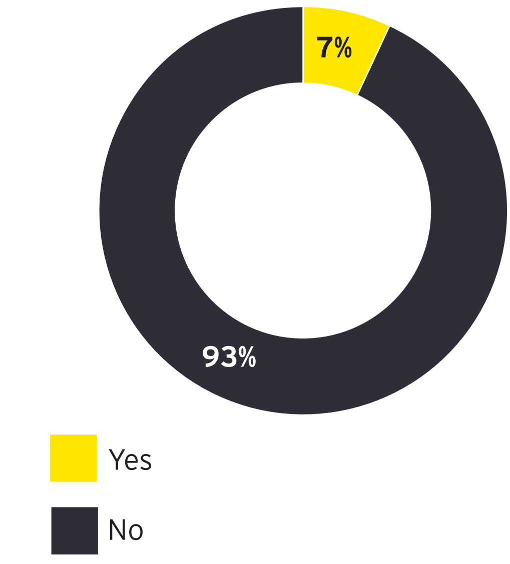
Crypto allocations remain low as managers are cautious to enter; however, 2021 saw increases in activity

Only a small number of the managers we interviewed reported that they have exposure to crypto markets, with 10% of the hedge fund managers and just four percent of the private equity managers reporting crypto allocations. The managers we interviewed generally offer more traditional alternative strategies, and among those that do have exposure in crypto as part of their overall portfolio, AUM dedicated to crypto remains small, at one to two percent for hedge fund managers.

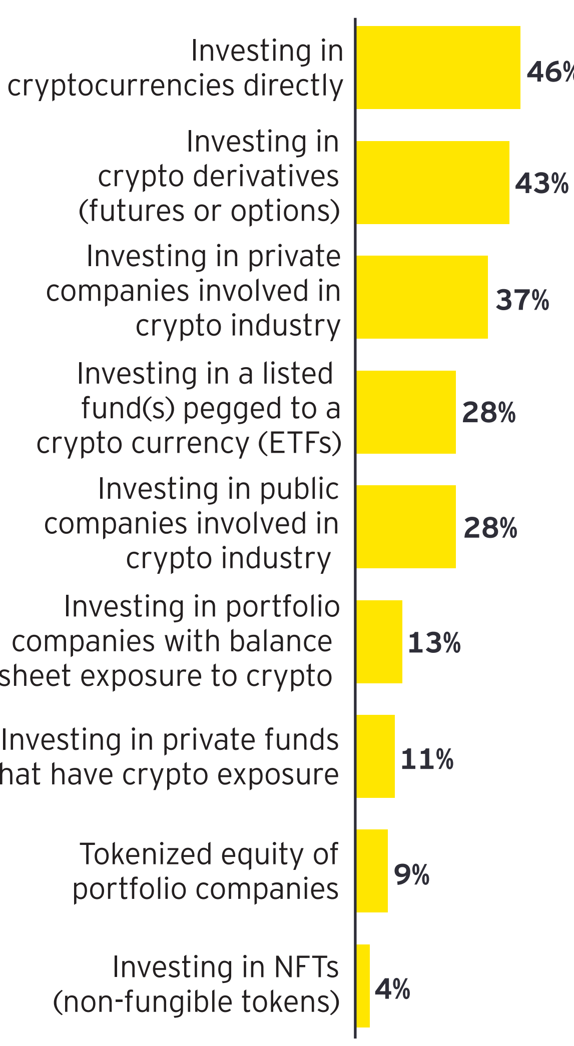
However, for those managers who are allocating funds to crypto, they have a variety of ways to achieve their exposure beyond investing in crypto currencies directly. This includes investing in crypto derivatives, listed funds, and investing in companies with exposure to crypto markets.

Current allocations from alternative managers remain small but are growing. Opportunities exist for those managers who are developing an understanding of – are building risk management and infrastructure to support – this newer asset class.

Q. Managers: is your firm invested in crypto-related assets?



Q. Managers: how have you created or plan to create exposure to crypto or digital assets?



Crypto does not align with most managers' current investment strategy

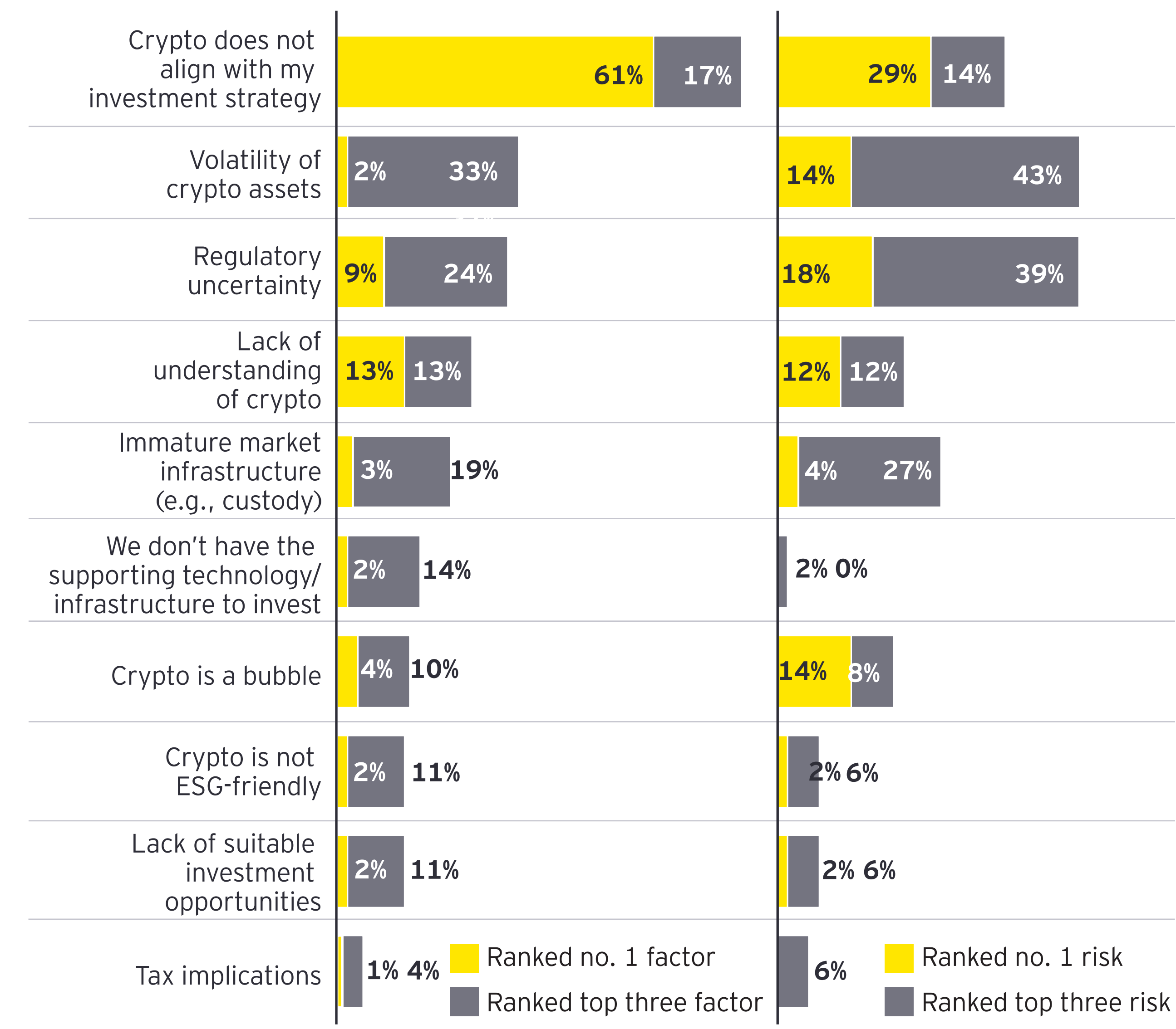
When asked about the top three factors preventing them from investing in crypto-related assets, managers surveyed reported that crypto did not fit with their investment strategy. They also pointed to additional challenges, such as uncertain regulatory treatment of crypto, high volatility, ESG concerns, and immature market structure, but these tend to be secondary and tertiary concerns.

In addition, investors interviewed place volatility, regulatory uncertainty and alignment at the top of their list of risks.

But as market infrastructure evolves, exchanges become more established, and investors are more comfortable with asset custody solutions, we expect more institutional investors will become active and gradually increase their crypto exposure.

Q. Managers: what are the top three factors preventing you from investing in crypto related assets?

Q. Investors: what are the top three risks to investing in crypto-related assets?



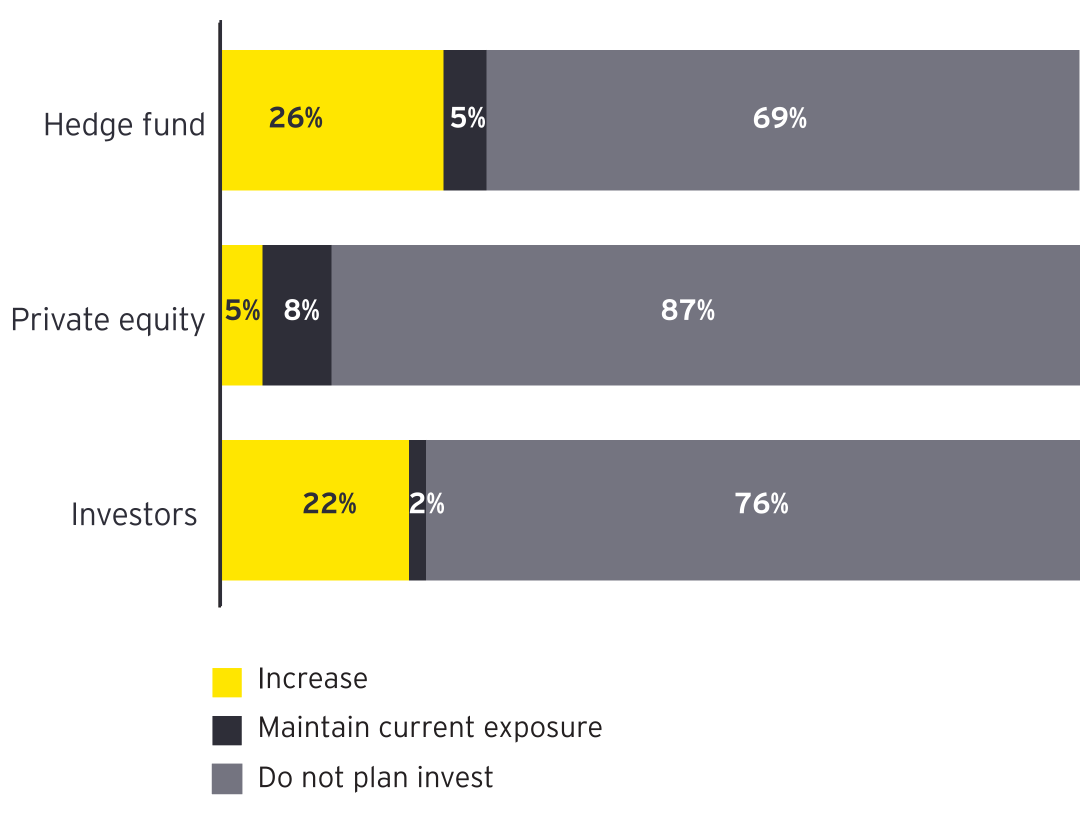
One in four hedge fund managers expect to increase their crypto exposure

When describing their expectations for exposure to crypto-related assets in the next one to two years, more than 20% of institutional investors and 25% of hedge fund managers stated that they expect to increase their exposure.

The largest managers were most likely to increase their exposure, with 36% of hedge fund managers with over US$10b in AUM, and 32% of managers with US$2b-US$10b in AUM reporting that they expect to increase their crypto AUM.

The earliest days of crypto were marked by challenges of self-custody and a limited market, but those have started to fade. With some risk mitigation now place, there is a willingness for other institutions to look at digital assets as an alternative option for investment purposes or for treasury management. With other 2,000 different digital asset types currently, various investment opportunities exist.

Q. Managers and investors: what are your expectations for exposure to crypto-related assets in the next one to two years?



Future landscape

The saying "always expect the unexpected" has added significance in the aftermath of the COVID-19 pandemic, with alternative fund managers seeking ways to bolster their ability to withstand unexpected disruption and increase their ability to identify and leverage new opportunities. The new investment opportunities emerging today and, in the future, reflect transformative forces impacting the world, including business. The challenges surrounding talent management, the ability to provide employees with an attractive, flexible and safe work environment are a direct result of the forced lockdowns and remote working conditions of the pandemic. And the adoption of DEI policies and programs spring from the acknowledgment that it's time that business moves forward toward creating a more equitable workplace.

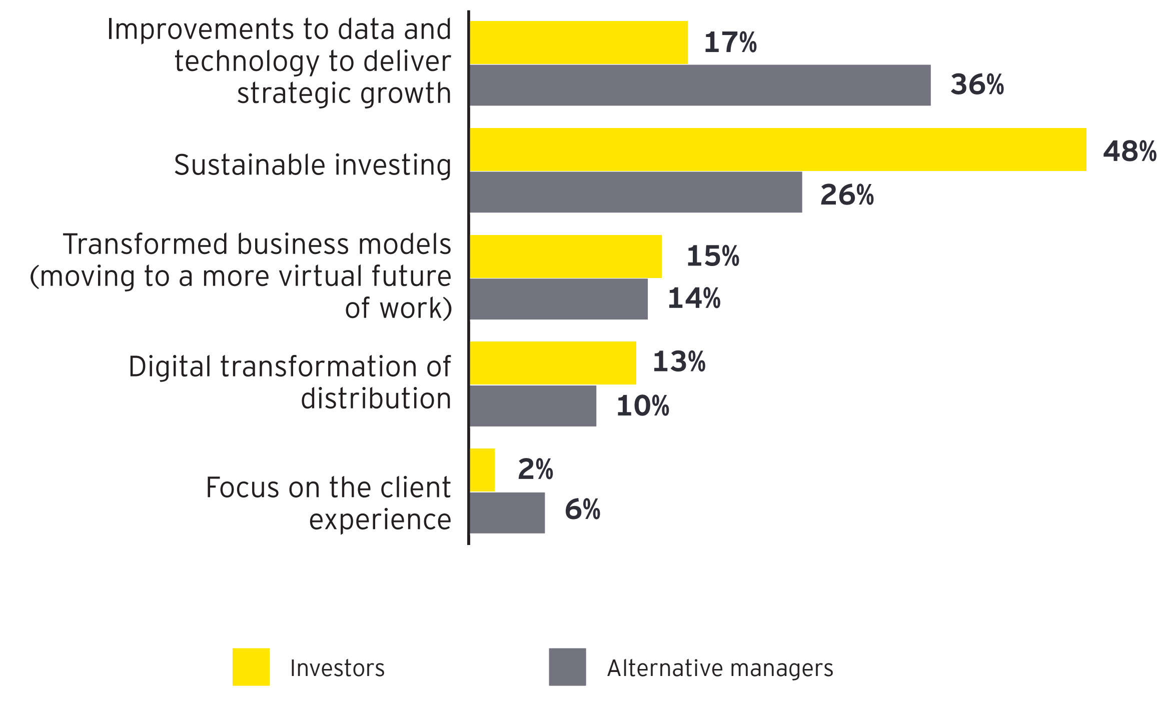
Alternative fund managers need to consider these trends going forward, as investors are shaping investment portfolios to reflect their values. This is increasingly evidenced by their focus on ESG. With global environmental and societal challenges mounting, the demand for sustainable investments will continue to grow, with nearly half of investors surveyed viewing sustainable investing as having the most significant impact on the future of asset management. In addition, increasing investments in cryptocurrency and including "retail" channels to increase capital flows provide attractive future opportunities. But deficiencies in digital infrastructures and IT capabilities still exist, impairing increased investor reporting requirements surrounding both financial and nonfinancial imperatives. But, by prioritizing technology investments and outsourcing parts of their operational processes, these issues can be addressed, including a critical component of the investment process, practicing due diligence, albeit remotely.

In addition to sustainable investing, improvements to data and technology will shape the future of asset management

More than one in three managers interviewed point to improvements in data and technology as important in shaping the industry going forward. Managers increasingly need to invest in technology, while data engineering/data science professionals have proven to be essential resources in evaluating, collating, processing and interpreting data from a myriad of sources to drive investment decision-making.

Data and technology investments are also critical in operations. Strong data governance allows for more streamlined operations, controls and reporting, and allows for effective outsourcing.

Q. Managers and investors: what do you think will have the most significant impact to the future of asset management?



Investors are most comfortable outsourcing middle and back-office functions for highly liquid strategies

Investors reported that they are generally comfortable with outsourcing back-office processes, and for highly liquid strategies' middle-office processes and even trade execution, to some extent.

Given the challenges in sourcing qualified talent, we expect an uptick in outsourcing as evidenced by more than half of investors comfortable with outsourcing back-office processes, and one in three investors comfortable with outsourcing middle-office processes.

But investor comfort with outsourcing begins to decline as the complexity of strategies increase, and data and data management challenges compound, resulting in declining investor comfort with outsourcing, particularly for middle-office processes, and trade execution. In addition, few investors report being comfortable with outsourcing of CFO, COO or CIO functions, regardless of the manager or fund's complexity.

Q. Investors: how comfortable are you with a single-strategy manager investing in highly liquid products and strategies outsourcing each of the following functions?

Q. Investors: how comfortable are you with a multi-strategy manager invested in more complex products and strategies outsourcing each of the following functions?

Investors anticipate more due diligence to be conducted remotely

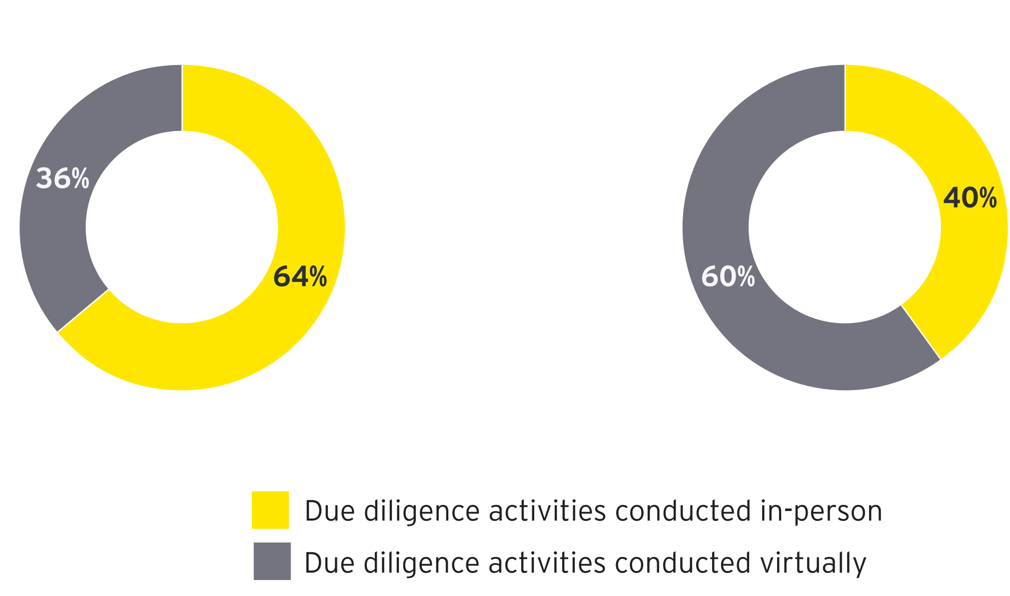
Changes in how we work were accelerated by the pandemic and investors' expectations for due diligence processes have shifted. Investors interviewed expect to conduct a significantly smaller proportion of their due diligence activities in person, just 40%, compared with nearly 65% prior to the pandemic.

This is not to say that in-person operational due diligence (ODD) will go away. Forty-three percent of investors interviewed still believe that on-site ODD meetings are very important when investing with a new manager.

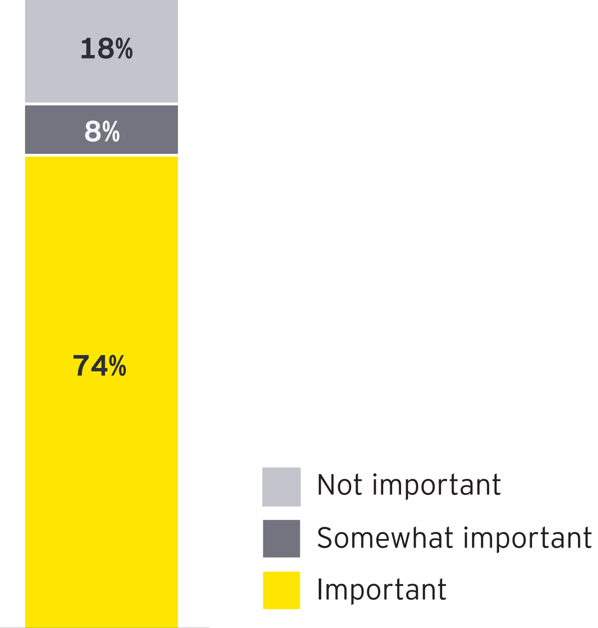
Nearly 60% of investors interviewed state that they would prioritize in-person meetings with C-suite management and investment personnel once travel restrictions are lifted, with nearly 60% saying that they would prioritize an in-person ODD review. Few say they would prioritize meetings with non-C-suite personnel or would hold annual investor conferences in person.

Q. Investors: prior to the pandemic, what proportion of your due diligence activities with prospective managers were conducted in-person?

Q. Investors: what proportion of your due diligence activities do you expect to conduct in-person in the next two to three years?



Q. Investors: how important is an in-person on-site ODD meeting when you are investing with a new manager?

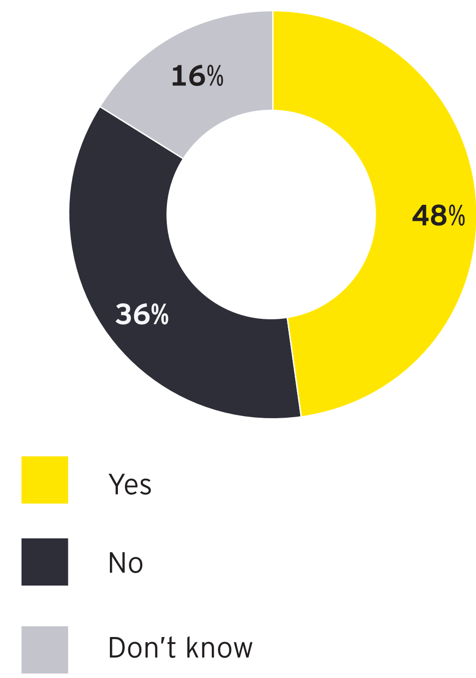


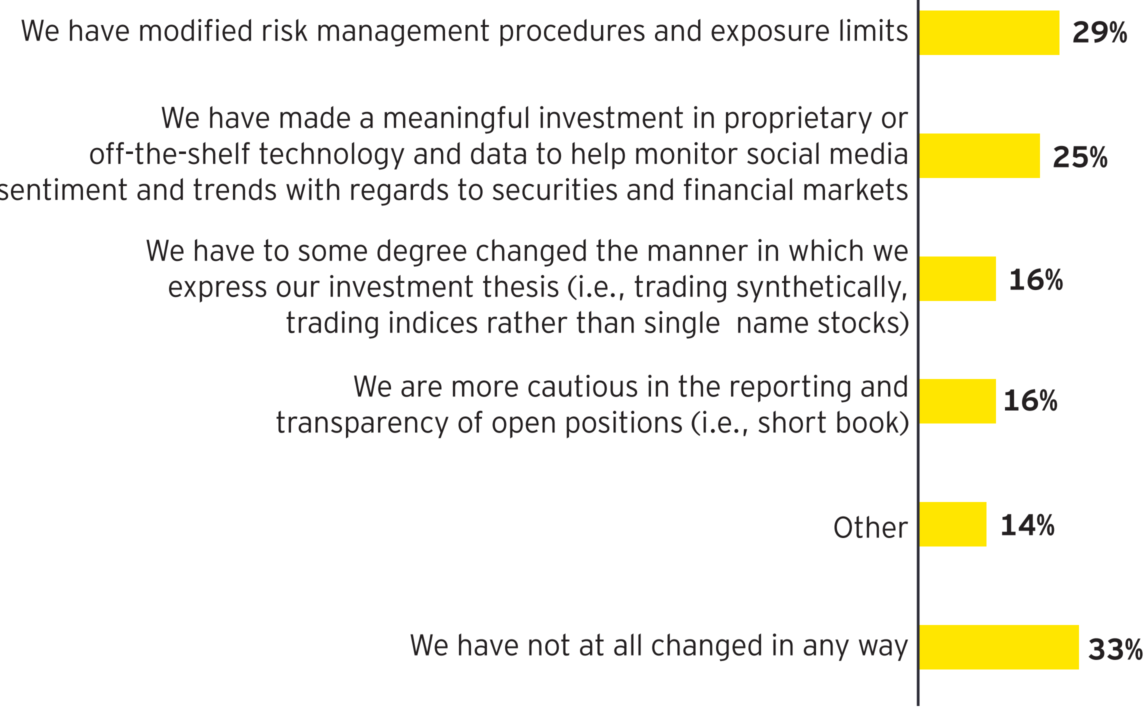
Half of hedge fund managers are paying closer attention to the impact of retail investors

Nearly half of the hedge fund managers interviewed, and 60% of managers in the US say they are more cognizant of retail investor behavior and its impact. Managers have taken a variety of steps, including modifying their risk management procedures and setting exposure limits, investing in social media monitoring tools and carefully examining how they express their investment propositions. In some instances, besides more careful monitoring of concentrated positions, managers have altered trading behavior to reflect short positions with derivatives rather than physical securities to avoid both public reporting of exposures and limit risk in periods of volatility.

Q. Hedge fund managers: in the past six to 12 months, has your firm become more cognizant of the investment activities and behavior of retail investors?

Q. Hedge fund managers: what actions, if any, have you taken as a result of the investment activities and behavior of retail investors?





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