BNY MELLON | PERSHING

PERSPECTIVES

Five Lessons Hedge Funds Have Learned from the Pandemic

Lisa Lewin
Vice President—Prime Services

Hedge fund managers have faced a litany of unique challenges since the onset of COVID-19, but what lessons have been learned over the last year? And what should be the best practices looking into the next 12 months as remote working continues to be a prevalent reality?

BNY Mellon | Pershing hosted a panel discussion with several industry experts to discuss the two sides of the capital-raising coin—both the manager perspective and the allocator point of view. The conversation covered topics ranging from fundraising best practices to transparency to process modifications, as well as addressed which changes might be permanent and which likely will be temporary. The takeaways fall very much in line with feedback we have heard from a wider cross section of fund managers and investors, and should serve as good reminders for what this crisis has taught us:

1. **Transparent communication is key:** Given the continuing and all-permeating air of uncertainty, it has become increasingly important to continue to share experiences with colleagues and partners in the industry. A CCO of a $2B long/short equity fund points out that extra transparency and robust communications are key. That goes not only for communication with investors, but also managers talking with each other. As a manager in the current environment, there is no one person or one service provider who can tell you how to handle all issues of COVID flawlessly. When a leading hedge fund experiences significant losses from changing market dynamics and then liquidates, the entire industry can be spooked—and dropping even the suggestions of secrecy will help avoid unintended consequences.

   We're in a shared experience of less in-person connectivity so looking ahead, transparency will benefit both manager/investor relationships as well as those with other market participants. Avoiding communication lapses will help both parties to make decisions based on facts and not assumptions brought on by lack of connectivity.

2. **The pros and cons of virtual connections:** For better or for worse, today's managers are more available thanks to more flexible working hours, limited travel and an array of virtual conferencing tools that have allowed our industry to largely continue with business as usual. However, one panelist pointed out that it is not uncommon to be receiving emails at 10:00 p.m. and that virtual meetings tend to lead to more follow-ups. One best practice to optimize the flexibility that technology currently provides is to split due diligence meetings over two or more days. More participants can be involved in real time and open items can be answered more efficiently, as well as providing the time to make everyone more familiar with each other.

   One word of caution: virtual meeting fatigue is just as real as the fatigue in our prior lives. Be cautious of being too ambitious with meeting marathons. While your counterparts may appear more available as less time is spent commuting and more time is spent in front of the computer, it's important to find the right balance of virtual meetings and calls to respect the bookends of a traditional work day.

3. **Technology will never replace everything:** A fiduciary's job must continue even if there's a global pandemic. But after it's safe to travel again, it's highly unlikely that the "new normal" will not include onsite due diligence visits, especially when it comes to relationships where investors have never met a particular manager in person.

   When it comes to technology in general, there is an added emphasis placed by investors and consultants on getting further into the weeds to learn more details about a firm's systems, especially as they relate to business continuity. When a prospective investor can't see the servers in person, it's more comforting when they know details about the infrastructure.

Anecdotal consensus from allocators points to the resurrection of the onsite walkthrough, suggesting that while virtual due diligence has largely been beneficial to maintaining the industry's usual pace for now, it cannot replace the real thing. "They want to get out onto the road again," said one panelist, proving that the last ten months has shown us once and for all that we do ultimately work in an industry built on human relationships.

4. **Hedge funds have re-asserted their worth:** According to *HFM Insights's* September report titled "Capital raising in a crisis,"[1] 76% of surveyed investors felt that hedge funds were delivering value for money in 2020. Still, there has been a notable dispersion in performance across strategies. For example, quants (and CTAs in particular) have on average failed to show an ability to perform in unusual market environments, whereas long/short equity strategies have seen a spike in investor interest. It was also recommended that managers stay abreast of co-investments as an area of growing interest from investors, and that emerging markets are approached with caution given a complex global macro environment shaken up by COVID-19, geopolitical tensions, and unique due diligence demands. With record issuance levels of convertible securities this past year, renewed attention also is being paid to convertible arbitrage strategies, which is one of the best-performing strategies in 2020 (HFRI Indices showed their convertible arbitrage index finishing 2020 at roughly +12%[2]).

5. **Still, fundraising requires an innovative approach:** Way back in the spring of 2020, when the market was struggling in the initial months of the pandemic, nimble fund managers amended their plans for the year. They reasoned that later stage fundraising situations were easier to wrap up than those in early stages. Data from *HFM*[3] corroborates this, showing that investors were much more amenable to increasing existing allocations in Q3 2020, rather than starting new relationships during lockdown and virtual due diligence processes. Investors also paid close attention to the size of the firms in question. Even in the 12 years leading up to the pandemic, fundraising tended to be more of a challenge for smaller managers, and the current situation hasn't helped their predicament. One solution presented suggests that those managers leverage existing investors as referral sources. Such an "informational shortcut" could lead to new opportunities and help a manager perform through this environment.

The final word: Looking back as we look ahead, consensus on what we have learned in the last year largely centers on the importance of transparency and connectivity. Flexibility and adaptation on the fundraising side have also proven themselves as key areas of focus. However, much like adjusting to a digitalized work-from-home scenario, straying too far from your personal norm may be more of a distraction than a best practice. The discipline of running a hedge fund continually evolves over time, and this evolution accelerates during events such as the pandemic. Managers must adjust accordingly to ensure they are able to deal with the new realities of operational due diligence that now present themselves. These new practices from an extraordinary time could differentiate managers as the launch and fundraising environment remains a challenge—and as returning to business as usual is still an unknown.

Lisa Lewin is a Vice President for the Prime Services division of BNY Mellon | Pershing and is responsible for new business development and managing existing relationships with hedge funds and other alternative asset managers. Lisa participates in a number of speaking engagements aimed at educating investors on the benefits of including alternative strategies in their portfolios.

[1] *HFM Insights*: "Capital raising in a crisis", September 2020

[2] Hedge Fund Research, Inc., HFRI Indices https://www.hfr.com/family-indices/hfri

[3] *HFM Insights*: "Capital raising in a crisis", September 2020

pershing.com

One Pershing Plaza, Jersey City, NJ 07399

PER_PPS__3661_ARTCL__Prime Services Top 5 ODD Lessons Perspectives__0221