

fs viewpoint

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From good to growth:
Why institutionalizing hedge funds
creates value for owners and investors

pwc

Point of view



Hedge funds are searching for ways to boost fund value, increase ROI, and ensure the sustainability of their businesses. In our view, few have the level of institutionalization in place to succeed.

Many growing hedge funds continue to operate as they did when they were smaller, younger firms doing business in a less complex environment. These funds require more formalized infrastructure to realize the maximum value of their franchises, provide the level of transparency that investors and regulators demand today, and ensure that their business models are sustainable.

In the aftermath of the financial crisis, hedge funds face growing pressure from regulators, investors, the media, and the public to increase transparency and enhance risk management.

Hedge funds face a myriad of regulatory initiatives designed to increase transparency and improve reporting. These include, among others, Dodd-Frank (including Form PF regulation), the Foreign Account Tax Compliance Act (FATCA), IRS form 5500 schedule C, and GASB Statement No. 53.

Institutional investors, which accounted for 60% of hedge funds' total capital in 2011, have substantial influence in determining how funds are managed today.¹ These investors are becoming more rigorous in evaluating fund managers' execution of investment strategies. They are demanding higher quality reporting and infrastructure, and avoiding funds that fail to clearly demonstrate adherence to, and support for, regulatory risk management standards.

In the wake of the financial crisis, the media and the public also are calling for greater accountability from hedge funds and more transparency in how returns are achieved.

Increased operating costs and declining fees are squeezing profit margins.

Unprecedented demands for greater transparency and better reporting have increased administrative costs and complexity within the hedge fund industry. At the same time, both institutional and retail investors have become more cost conscious about fees, generating competition in the industry and driving average fees lower. The combination of rising costs and shrinking fees is forcing profit margins downward.

To succeed in this challenging environment, hedge funds will find it necessary to institutionalize their core business functions and capabilities.

As noted in PwC's white paper entitled "From Black Box to Open Book: US Hedge Fund Trust and Transparency," the industry has refined its investment processes but its operations and governance functions are not as well developed.² Historically, hedge funds have succeeded because of their founders' leadership skills, entrepreneurship, and investment processes. As institutions grow, however, they can no longer rely on the operational processes and technology that led to their initial success. To become more efficient, meet increasing demands of stakeholders, and achieve growth and sustainability, funds should *institutionalize* their core business functions. The development of high-quality infrastructure—including having the right people, processes, and technology in place—will prepare hedge funds for the next stage of growth.³

1 Azam Ahmed, "Despite a Rough Year, Hedge Funds Maintain Their Mystique," The New York Times Dealbook, November 22, 2011, www.dealbook.nytimes.com, accessed September 25, 2012.

2 PricewaterhouseCoopers, "From Black Box to Open Book: US Hedge Fund Trust and Transparency," 2012, www.pwc.com/alternatives, accessed September 25, 2012.

3 PricewaterhouseCoopers, "Infrastructure: From Cost to Benefit—Hedge Funds 2.0," June 2011, www.pwc.com/assetmanagement.

We have observed hedge funds responding to the rapidly changing environment by strengthening core functions, acquiring additional capabilities, and instituting improved governance.

Facing pressure to increase transparency and enhance operational risk management, hedge funds are responding to due diligence requests and hiring senior executives to address operations, strategy, marketing, technology, and risk exposure.

We have observed many funds establishing more formalized governance processes and compliance departments, and engaging third-party service providers to deliver investor services and reporting. Some firms are also investing in technology and targeted relationship management tools that reveal how their portfolios are invested without disclosing confidential or proprietary information to investors.

We have observed some leading practices across the industry, while other practices have yet to be formalized:

Core function	Industry observations
Marketing and investor relations	<ul style="list-style-type: none">Many hedge funds lack consistent processes in the areas of sales and client service, including client segmentation, relationship management, and quality and depth of reporting. Many also struggle to provide standardized responses to investor due diligence questionnaires in an efficient manner. This function is potentially responding to numerous unique investor queries.
Human resources	<ul style="list-style-type: none">Many funds are increasing investments in both experienced and entry-level hiring practices. We have observed funds boosting retention through creative non-monetary incentives as they strive to retain top talent.
Risk and regulatory	<ul style="list-style-type: none">An increased compliance burden has pushed the industry toward reliance on automated exceptions reporting (e.g., the capability to automatically prevent trades from going through if they are improperly allocated).
Systems and technology	<ul style="list-style-type: none">There is a tendency for hedge funds to develop their own customized software. This often results in an IT environment that's needlessly complicated and must be managed on an ongoing basis via inefficient manual processes.
Tax and finance	<ul style="list-style-type: none">Manual processes are still commonly used in the industry as low-cost substitutes for higher-cost, third-party systems. Tax advice is often reflected in the design of tax and legal entity structure of the fund. Services such as tax and net asset valuation (NAV) are sometimes fully outsourced, with inconsistent levels of maturity in hedge fund vendor management and oversight.

Ideally, these core functions should be integrated through an effective governance structure. We have observed that many hedge funds managers have not embedded clearly defined decision-making processes throughout the organization. In many firms, while separate reporting lines exist for front- and back-office functions, both lead to the CEO, who makes all key decisions.

Recently, we have observed a group of leading hedge funds institutionalizing their core functions, positioning themselves to improve profitability over the long term.

The most successful hedge funds have developed leading practices across core functional areas and have a mature governance structure in place:

Core function	Leading practices
Marketing and investor relations	<ul style="list-style-type: none"> The institutionalized marketing function gives leading firms a core capability that helps to secure client relationships and raise new capital. Investments are made in sales and service capabilities, relationship management, client segmentation, and enhanced performance reporting. The marketing function also provides a means of robust screening for any unqualified investors, in keeping with escalating regulations. The investor relations function goes beyond standard reporting and communications. Information is proactively provided to investors. Managers and administrators standardize responses to operational due diligence questions as they seek to reduce the costs of transparency and control.¹
Human resources	<ul style="list-style-type: none"> Organization and job design architecture (including criteria on sizing, leverage ratios, levels, job roles, and compensation) are established and evolve to meet changes in internal and external environments. Desired technical and behavioral competencies are established and measured by function and role. Talent review processes established to monitor and mitigate competency gaps and guide investments in learning & development, hiring selection criteria, and talent sourcing strategy. HR deploys world-class talent management processes (onboarding, career paths, retention and succession planning) and champion culture change.
Risk and regulatory	<ul style="list-style-type: none"> The risk management function has a high level of expertise and is well positioned to educate business owners on common issues and specific problems identified. All business areas receive the appropriate level of oversight. Risk management efforts are independent of the process for monitoring investment performance. The effectiveness of risk management programs is validated by independent controls to reduce the potential for conflicts of interest.
Systems and technology	<ul style="list-style-type: none"> Technology solutions support highly automated transaction processing, enhanced client service capabilities, and fund scalability (e.g., enabling fund managers to execute multiple trades on a single screen).² Infrastructure accommodates complex trading strategies and provides general ledger accounting and controls, extensive audit trails, and a centralized location for all portfolio data that enables customized, detailed, and real-time fund reporting. Outsourcing of middle- and back-office services is implemented as appropriate, including custody and fund administration. Many firms leverage the sophisticated systems of outsourcing providers that have invested heavily in IT. This decreases manual processes and increases efficiencies, enabling employees to focus more time on their key functions.
Tax and finance	<ul style="list-style-type: none"> Technology is leveraged (either in-house or via a third-party provider) to create an integrated finance application platform that promotes automation and provides timely, accurate, and consistent real-time information for decision-making at a reasonable cost. The manager has in-house expertise and competencies in finance and tax to oversee any of these outsourced functions. Underlying data supports tax needs and is frequently accessed and analyzed to confirm tax strategies.

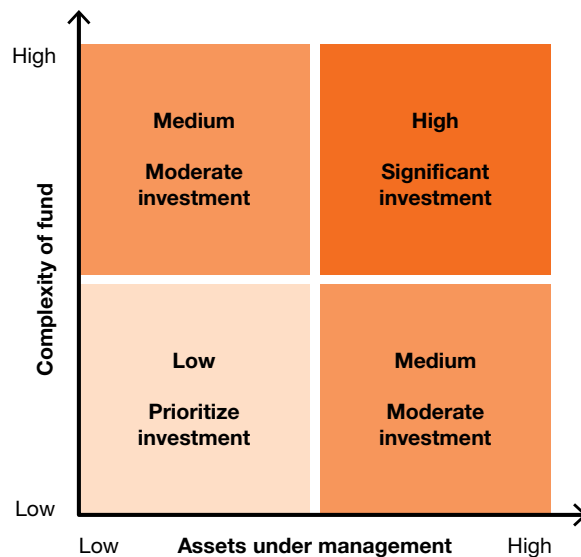
We have observed leading hedge funds link these core functions with a robust governance structure. Clear separation of duties is established among the front office, back office, and compliance functions. This allows for efficient coordination and oversight among vital functions. A robust governance function also enables coordination and decision authority between operating committees.

¹ PricewaterhouseCoopers, "From Black Box to Open Book: US Hedge Fund Trust and Transparency," 2012, www.pwc.com/alternatives, accessed September 25, 2012.

² Northern Trust "Northern Trust launches intraday automated updates for hedge fund managers across the globe" — Plus Media Solutions Pvt. Ltd. June 20, 2011, www.northerntrust.com, accessed September 25, 2012.

In our view, the appropriate level of institutionalization depends on a hedge fund's growth trajectory, complexity, and strategic goals. No one size fits all.

Institutionalization decision matrix



The appropriate level of institutionalization is driven by both AUM and complexity. Complexity factors include fund structure, strategy, product mix, and legal structure.

Evaluating a fund's growth trajectory and operational capacity requirements is the first step in determining whether the fund is investing appropriately in core business functions.

An organizational self-assessment can then be performed to identify which functions and capabilities must be strengthened or standardized. Rapidly growing funds should focus first on areas of operations that require the highest level of maturity for their circumstances.

For instance, a hedge fund looking to build capabilities and improve succession planning needs to focus on developing its human resources function and talent management capabilities. Another hedge fund undergoing regulatory scrutiny needs to invest in enhancements to its risk and regulatory function.

Link investments in institutionalization to long-term strategy:

Many hedge funds—especially those in early stages of growth—focus their resources on investment-related functions and reduce spending in other areas to manage overall costs. However, under-investing in key controls, processes, training, and other core capabilities in order to reduce costs in the short term may lead to higher expenses in the long term, to remediate issues.

In order to justify investments in formalizing core business functions, hedge fund managers should link these investments to the long-term growth plans for the fund. To make the business case, management might emphasize the need to invest in back-office functions to make them robust, scalable, and flexible enough to meet future requirements.

Appropriate level of institutionalization:

- **Low:** Limited benefits of incremental investments in people practices, automation of manual processes and enhanced systems. Priority investments focused only on driving sustainability of the business.
- **Medium:** Significant benefits of investments in process standardization, systems and organization simplification resulting in increased transparency, enhanced fund value and increased returns.
- **High:** Significant benefits of process, systems, organization and people-driven changes, enabling the firm to meet today's business, client, and regulatory goals, scale to achieve future growth objectives and adapt to market changes as required.

By institutionalizing their core functions, hedge funds can benefit as they are able to focus on delivering reasonable returns to stakeholders, and in the process satisfy customers and drive growth.

Many hedge funds are focused on growing, either organically or via mergers and acquisitions.

A fund's growth prospects depend on having efficient business operations, with critical functions and operational processes institutionalized. This enables the fund to react more rapidly and effectively to changing market conditions and stakeholder demands, build investor trust, and differentiate itself in the marketplace.

Institutionalization requires redesigning functions and capabilities with people, processes, and technology in mind.

Among other things, this may involve clarifying roles and responsibilities, replacing generalists with specialists, automating and standardizing management controls, and upgrading systems and reporting capabilities to support emerging business requirements.

The table below highlights the core business functions that hedge funds should examine to determine their level of maturity and identify targets for institutionalization.

Core function	Objectives/benefits of institutionalization
Marketing and investor relations	<ul style="list-style-type: none">• Manage branding, attract new investors, and retain current investors.• Establish repeatable/verifiable reporting and valuation processes.• Design scalable sales and client service organization capabilities and processes.• Enhance ability to identify risks before they can damage the firm's brand.• Communicate more effectively with key stakeholders, such as investors and tax authorities.
Human resources	<ul style="list-style-type: none">• Recruit and retain top talent for critical functions—a competitive differentiator in the hedge fund industry.
Risk and regulatory	<ul style="list-style-type: none">• Enhance regulatory compliance, safeguard operations, and promote brand integrity.• Proactively identify and manage risks that can result in financial loss, regulatory scrutiny, and damage to firm reputation.• Attract investors by demonstrating the fund's ability to manage the risks related to a changing competitive and regulatory environment.• Increase organizational transparency—a key demand of investors.
Systems and technology	<ul style="list-style-type: none">• Promote scalability of, and control over, the fund's technology infrastructure and applications.• Reduce administrative overhead and increase data analysis capabilities.• Satisfy client demands for greater transparency and better reporting.• Reduce risk by decreasing the potential for human error.• Enable better understanding of investors (e.g., demographics, tax elections).
Tax and finance	<ul style="list-style-type: none">• Promote proper financial reporting and controls, support organizational objectives, and reduce organizational risk.• Enable delivery of efficient, high-quality services (e.g., budgeting, tax and strategic planning, consolidation, reporting, and analytical solutions) for all stakeholders, including investors and employees.

Governance spans all aspects of fund operations, playing a key role in establishing decision rights and setting organizational direction. As such, a mature governance capability is critical to success.

A well-established governance capability brings to light the layers of control in an organization. It clarifies required decisions, individual and committee accountabilities, supporting management processes, and information requirements. Examples of key decisions required in a hedge fund include: changes in strategy, new product development, risk tolerances, client onboarding, firm processes and policies, hiring, performance reporting, and compensation. Effective governance reduces duplication of activity among teams, decreases potential conflicts of interest within management, and enhances risk management.

How the hedge fund is governed is influenced by factors including the firm culture, role and attitude of the founder(s) and principals, and how performance is rewarded.

An institutionalized governance capability may require significant changes in firm culture. This may include the need to establish committees as well as formalize and codify business decisions. A clear articulation of the long-term benefits of effective governance is necessary to embed this into the everyday “way of working.”

The benefits of a well-established governance capability include:

- Clearer focus on strategy execution.
- Enhanced transparency.
- Improved risk management.
- Increased investor confidence.
- Improved long-term business sustainability.



Key barriers must be overcome before hedge funds can realize the benefits of institutionalization.

In striving to formalize core functions, many hedge funds face obstacles in the form of roles and responsibilities, processes, and technology established in the early days and embedded deep within the firm. It is often difficult to quantify the benefits of making investments in anything that does not immediately impact fund performance.

	People	Process	Technology
Challenges	<p>In smaller firms, employees often have multiple responsibilities, as resources are limited. As an organization grows, it becomes difficult for employees to fulfill their critical responsibilities while wearing several hats. In addition, employees may not be fully aware of each other's scope of obligations, and this could lead to potential gaps in execution of responsibilities.</p>	<p>Employees of smaller funds are often accustomed to creating reports or performing functions on an ad hoc basis using undocumented processes. The idea of formalizing and documenting processes is often viewed as unnecessary because such a small group of employees is involved with all aspects of the process. As the fund grows, this lack of formality may result in inefficiency, poor quality control, and increased risk.</p>	<p>The IT infrastructure that served the organization well when it was an emerging fund may become inefficient as the firm expands. If leadership does not allocate sufficient resources to technology for each core business function, there could be a heavier reliance on manual processes, leading to longer execution times and increased potential for mistakes.</p>
Potential solutions	<p>The solution for a growing hedge fund is to delineate roles and responsibilities and hire more dedicated, role-specific resources. But employees accustomed to multiple roles and responsibilities may be reluctant to relinquish them, fearing the loss of control and power this represents. If the transition is not managed well, this could lead to retention problems, as valued employees who joined the firm to be a part of a start-up culture leave to seek that experience elsewhere.</p> <p>Shape, articulate, and lead the culture and behavioral changes needed by leaders and staff to transition to an institutionalized "way of working."</p>	<p>At some point, the organization must formalize and document processes, establish ownership and communication lines, and create efficiency metrics to drive quality.</p> <p>While institutionalization is a necessary step, implementing more formal processes may be a challenge, for several reasons. It can be difficult to gain consensus on new processes. Employees may resist the added bureaucracy involved and fail to see the value of a more formal (and likely more time-consuming) approach. Further, it may be difficult to define processes that are relevant to all employees, and this could create additional resistance to adoption.</p> <p>Establish changes in investment approval and governance processes to help ensure that long-term horizon and business sustainability are considered as part of decisions to invest in new process or technology.</p>	<p>To overcome this barrier, firms must make strategic investments in middle- and back-office technology to automate processes and enhance capabilities. "One-off" IT purchases must give way to a well designed strategic plan for implementing technology that meets information management needs (both enterprise-wide and within specific functions) and supports growth objectives.</p> <p>Employees accustomed to an informal IT procurement process and autonomy in the computing devices they use, and how they use them, may resist the transition to a more institutionalized technology environment and the common IT standards required to maintain security, achieve transparency, and operate efficiently. Because of this, a sound change management plan is a critical component in implementing a more formal, sustainable IT structure.</p>

Leaders tend to follow a scalable methodology for institutionalizing core functions.

In our experience, the methodology generally consists of four steps.

Each step includes structured activities and target outcomes. Although shown as a linear process, in practice, the steps may evolve as the design develops, priorities change, and the new culture emerges.



The appropriate level of institutionalization is driven by both AUM and complexity.

Step 1: Define institutionalization strategy and conduct diagnostic

The first step focuses on an assessment of the current state of the hedge fund's core business functions, identifying gaps that must be filled in order to meet future needs, based on the fund's growth strategy.

Step 2: Define functional priorities

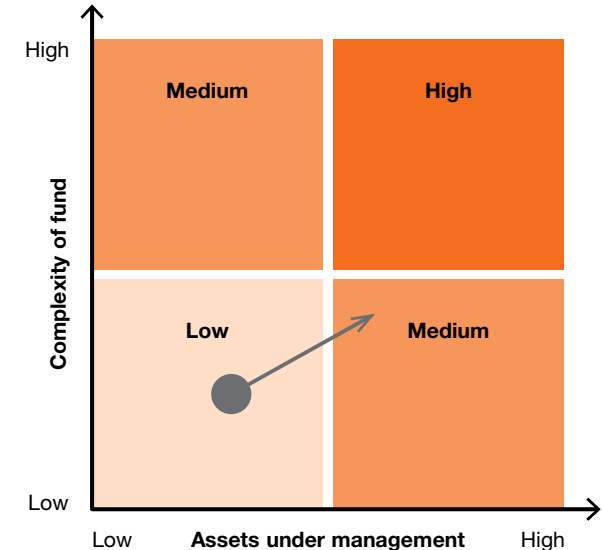
The fund identifies requirements for enhancing functions and capabilities targeted for institutionalization, focusing on people, process, and technology dimensions, and determines priorities for implementing change.

Step 3: Design solutions

The target operating model components (people, process, and technology) are developed, and implementation and change management plans are created.

Step 4: Implement solutions

The target operating model is implemented and modified as needed, and organizational change (communications, training, and culture) is managed.



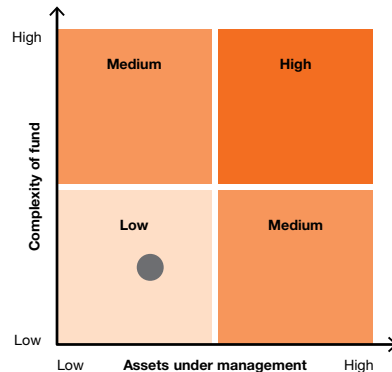
For example, this small fund wants to increase its AUM and increase the complexity of its product offering. Currently, the fund does not have systems to manage growth.

Firms that do not achieve the proper level of institutionalization will find it increasingly difficult to grow and sustain their businesses in the coming years.

How well a hedge fund institutionalizes its core business functions is one of many important factors that will determine whether the firm grows, stagnates, or declines.

The non-investment side of hedge funds—infrastructure and operational soundness—is critical to investment decisions today.

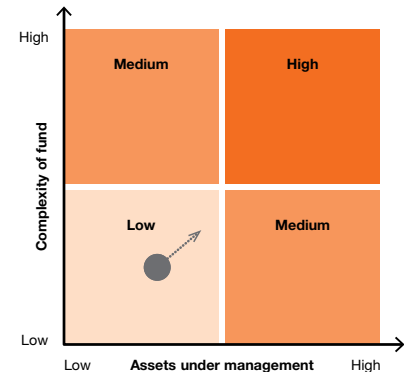
If a hedge fund makes no investments in key functional areas



Little to no growth potential

- Front office and portfolio managers' time spent on non-essential functions.
- Outdated IT systems and too many non-integrated systems, resulting in substantial inefficiency.
- Loss of investors due to concerns over weaknesses in risk management.
- Increased regulatory scrutiny.
- Loss of top investment talent due to lack of competitive recruiting practices.
- Potential under-valuation of the fund.

If a hedge fund makes only a few investments in key functional areas



Status quo






- Steady growth in AUM but falling behind competitors.
- Steady/stagnant flow of products and investors.
- Reactive formalization of front office and core functions.
- Inability to scale operating model.
- Concerns in terms of sustainable performance, succession planning and ability to adapt to change.
- Limited investments in process, systems due to no immediate improvement in firm value.

Competitive intelligence







*Our observations of
industry practices.*


A mature corporate governance process ties all the core business functions together and offers clarity of roles to reduce duplication of activity among teams and reduce potential conflicts of interest within management.

Key core business function	Hedge fund A	Hedge fund B	Hedge fund C
Governance	<p> A global investment management firm has a clearly developed organizational chart, complete with clear reporting relationships. In addition, the relationships depicted in the chart correspond with performance reviews.</p> <p> The firm has developed a conflict matrix that outlines potential issues, such as personal conflicts of interest, institutional conflicts, and role overlap conflicts. This enables the fund to resolve any issues with a review committee to effectively mitigate any risks of conflict.</p>	<p> To avoid sole discretion by any one individual, a large corporate hedge fund (>\$1.5B in AUM) approves major investment and operational decisions by steering committee.</p> <p> The fund has dedicated resources to develop policies and communicate any policy changes across the organization.</p>	<p> A medium-sized hedge fund with a strong domestic presence has a loose supervisory structure. Since there is no documentation of the organizational chart, no visibility into the reporting lines or the individual areas of responsibilities exists.</p>




 Leading
  On Par
  Lagging

By institutionalizing the client relations and marketing function, hedge funds are building core marketing capabilities and proactively scanning the environment for perception risks to avoid negative association.






Key core business function	Hedge fund A	Hedge fund B	Hedge fund C
Marketing and investor relations	<p> A large, value-oriented hedge fund has established a disciplined and documented investment process that verifies its repeatability. In addition, it has audited investment returns for all periods since inception. The firm has a robust compliance function in place to work with marketing. This helps the quality and accuracy of materials, resulting in strong policies and procedures around what can be marketed and distributed to investors.</p> <p> The fund could be exposed to risk because the marketing function lacks appropriate controls. In particular, the marketing materials may be modified by any client-facing individual without a centralized and controlled signoff process. Specifically, the customization of both sales materials and client reports by the individual sales and client services individuals is cleared by neither compliance nor legal, except at a high level. This results in the use of language and representations that may put the firm at risk.</p>	<p> To become known as a high-performing firm, this large hedge fund has engaged in a public relations campaign focused on print magazine rankings and news. While the results are helping to attract top talent, the lack of substance and detail around the investment process and performance may put the firm at risk. In addition, short-term bonuses provided to the sales and service organization provide incentives to engage in practices that build assets at the risk of the firm's reputation. Because insufficient attention is paid to appropriate investor education, investor returns are unaudited and thus non-compliant, and the client reports are customized to investor expectations.</p>	<p> A small hedge fund manager allows its business to be driven by its founder/ chief investment officer, who does not enforce independent returns verification or legal/compliance review of marketing materials. In addition, there is no formal process for prospectuses, pitch books, or due diligence questionnaires (DDQ). As a result, there are inconsistencies across current and historical statements, among other materials, used in the marketing activity. This is aggravated by the non-investment teams' fear of annoying the founder. This results in significant exposure to regulatory risk and client litigation.</p>

 Leading  On Par  Lagging






To recruit and retain talent, the human resources function should be able to conduct inventory and gap analyses of current skills and resources.

Key core business function	Hedge fund A	Hedge fund B	Hedge fund C
Human resources	<div>  <p>This firm focuses on retaining talent through learning and continuous improvement courses provided by specialized vendors. The firm also has an onboarding process to help ensure that employees know its policies and risk management processes.</p> </div>	<div>  <p>At a large hedge fund, HR services are minimal and limited to benefits and administrative tasks. Recruitment of talent is outsourced to vendors and firm lacks the necessary visibility into the skills of the workforce so as to properly conduct gap analyses and support the needs of other areas as the firm expands. There are no employee engagement survey results to help the firm monitor overall morale, workforce perceptions or issues to help management manage turnover. IT support of HR is weak in terms of gathering workforce data and performance metrics.</p> </div>	<div>  <p>The HR team of a large hedge fund consists of 5 to 6 people who provide high-touch concierge support for an asset management team of about 125 people (or a 1:25 coverage ratio). In order to keep a high level of service available to its employees, the firm chooses to keep HR in-house rather than outsourcing it. This strategy allows the fund managers to focus on their job, shifting talent management work to HR and reducing spend on a large HR technology infrastructure.</p> </div>

Risk management requires a high level of expertise to educate business owners on common issues and specific problems, and helps ensure that all business areas receive appropriate oversight.

Key core business function	Hedge fund A	Hedge fund B	Hedge fund C
Risk management	<div>  <p>The risk function is not formalized, and limited resources are dedicated to it. Risk is seen as something to be managed by the portfolio manager. The portfolio manager receives daily risk reports, but conducts limited analyses that may not be appropriate for a growing firm. Since risk is isolated to the jurisdiction of the portfolio manager rather than being proactively assessed across the firm, risks that the organization is exposed to in other areas may remain hidden.</p> </div>	<div>  <p>This large hedge fund has leveraged decades of experience in trading equity securities to develop a highly automated decision-making process. Very little human interaction is involved unless there is a trade discrepancy. The fund also employs a liquidity management system (LMS) and execution management system (EMS), among other tools that many other funds lack.</p> </div> <div>  <p>Systems installed are on par with industry standards to automate as many fixed income trading processes as possible. Nevertheless, the firm still relies on desktop spreadsheet models to compensate for gaps in system capabilities.</p> </div> <div>  <p>Non-critical operations at the fund have manually intensive processes, such as hand-signed checks and data reporting through hard-copy print only.</p> </div>	<div>  <p>This large global fund has a strong risk function that begins its oversight at trade entry. When a trade is placed, the fund executes pre-trade compliance processes. When the analyst team places an order, the trader who receives the order must put in an order management system entry that supports risk monitoring across the portfolio.</p> </div>

Systems and technology should accommodate complex trading strategies and support the hedge fund's strategy.

Key core business function	Hedge fund A	Hedge fund B	Hedge fund C
Systems and technology	<p> A large global fund relies on duplicate keying of data into its trade management and accounting systems rather than having it flow through.</p> <p> The fund has inflexible, non-standard security master data that is incapable of accurately classifying complex securities. For example, both bank loans and bonds would be broadly classified under fixed income, making it difficult to properly analyze a portfolio and understand its exposures.</p>	<p> This large fund has installed a leading collateral management system to enhance its derivatives trading capabilities. The fund also has a dedicated IT team to develop on-the-fly Microsoft® Excel tools and models for any shortfall of its full-feature system.</p>	<p> A large hedge fund lacks proper access controls or processes to review its employees' systems-access rights on a regular basis. Without regular updates or controls in place, there is no protection of confidential information, nor are any restrictions placed on the viewing of information by certain individuals in the firm.</p> <p> This fund has a centralized trading desk that services six different trading entities. It also has an overnight trading desk to accommodate time zones abroad and a continuous trading operation. For foreign exchange trades, the trader can conduct trades through proprietary systems, with no need for any human intervention or hand-off.</p>

 Leading
  On Par
  Lagging

Mature tax and finance functions can create standardized, streamlined processes and reporting that deliver efficient, high-quality services to all stakeholders.

Key core business function	Hedge fund A	Hedge fund B	Hedge fund C
Tax and finance	<div><div></div><div>A large, value-oriented hedge fund consults its tax function about the potential impact of major portfolio allocation decisions, resulting in a proactive stance toward tax related issues.</div></div> <div><div></div><div>The fund contains a highly experienced multi-person team directing tax and finance. Strong policies and procedures exist to address reconciling positions, broker cash, accruals, profits and losses, transactions, and valuations.</div></div>	<div><div></div><div>A medium-sized hedge fund with a strong domestic presence lacks finance function oversight. Since finance and accounting are viewed as a cost center, only minimal financial and staff resources are provided. Finance and accounting systems are not integrated, resulting in manual processes. The fund's tax resource specialist is not part of the management committee, resulting in inefficiencies: the tax function may not be brought in to provide input early enough in key processes. Accounting and valuation processes are not documented, aligned with, or able to support constantly changing investment strategies or products.</div></div>	<div><div></div><div>A large global fund relies on spreadsheets for some of its middle- and back-office functions, such as tracking bank debt and term loans being traded.</div></div>

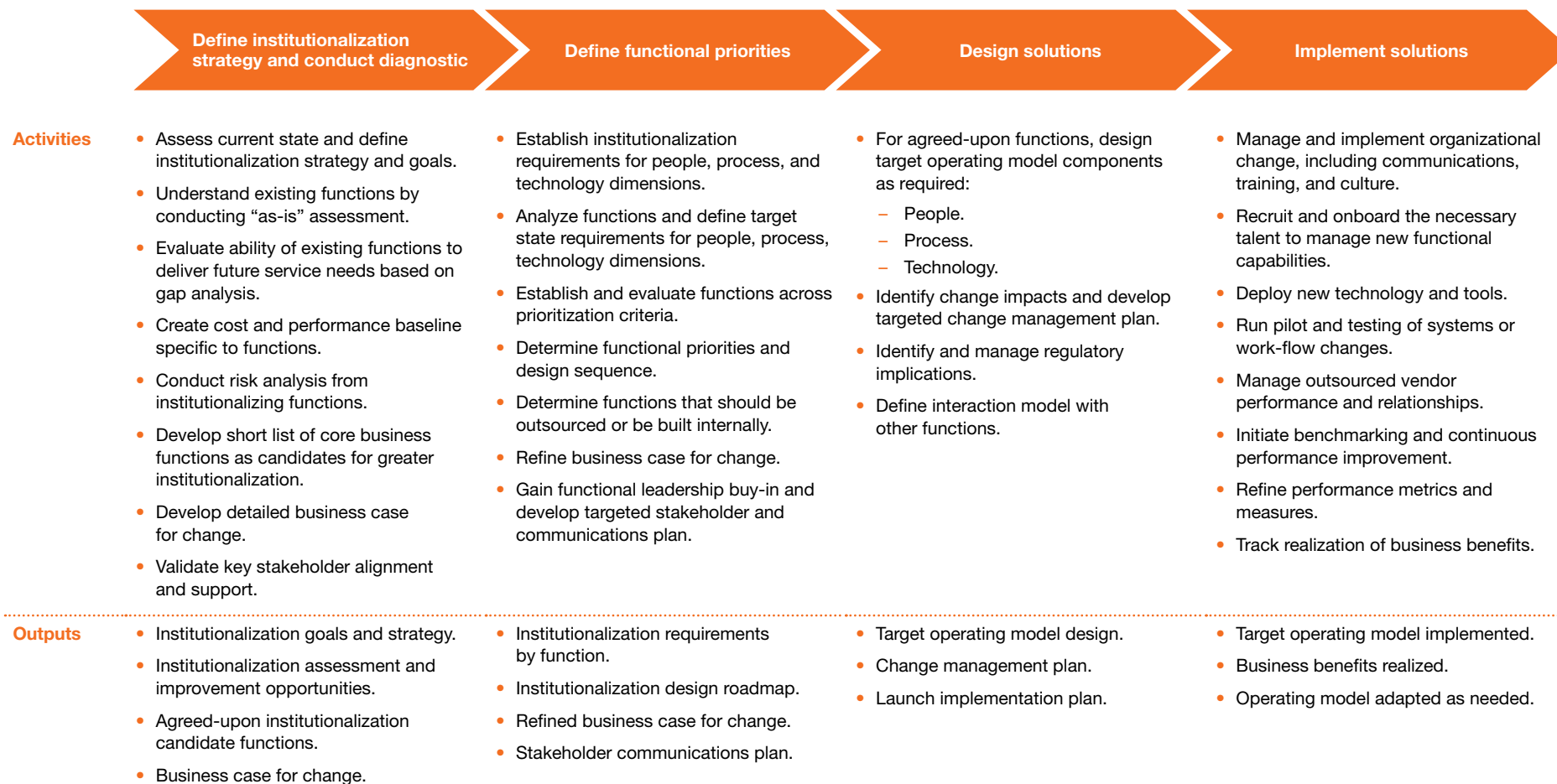
A framework for response



*Our recommended approach
to the issue.*

The following describes PwC's scalable approach for institutionalizing core business functions.

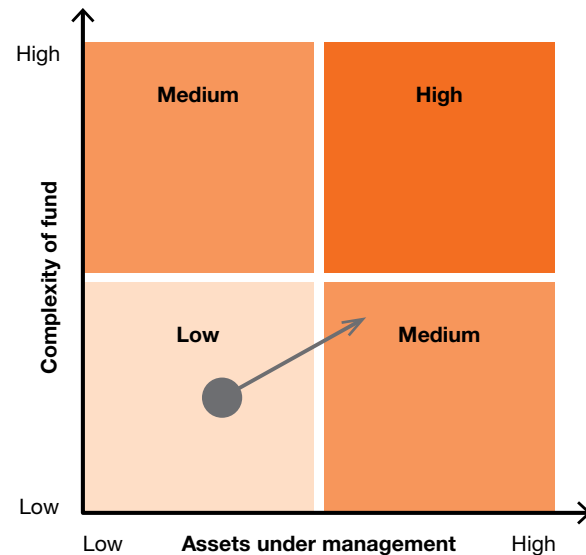
The diagram below illustrates how a firm can determine which core business functions it should institutionalize over time in response to growth. Although shown as a linear process, in practice, the steps may evolve as the design develops, priorities change, and the new culture emerges. Additional approaches include evaluating a number of options to identify the preferred design, and working on the organizational self-assessment first before finalizing the end-state design.



Define institutionalization strategy and conduct diagnostic.

A preliminary understanding of the current state of the fund allows you to lay out future direction and an appropriate institutionalization strategy.

The appropriate level of institutionalization is driven by both AUM and complexity. Complexity factors include fund structure, strategy, product mix, and legal structure.



For example, this small fund wants to increase its AUM and increase the complexity of its product offering. Currently, the fund does not have systems to manage growth.

The appropriate level of institutionalization for a given hedge fund depends on the fund's growth expectations and degree of complexity in the overall fund.

The hedge fund's AUM growth expectations

- What is the strategy for organic growth? Potential strategies include increasing market share, prospecting new clients, increasing share of wallet, and revamping product innovation and launch.
- To what extent is inorganic growth (merger & acquisition) part of the growth strategy?
- What are the anticipated timeframes and associated risks?

Degree of complexity in the overall fund

- What is the fund structure and strategy?
- What is the legal structure (including tax domicile and type of legal entity) and product mix?

In addition to these questions, changes in the external environment (macroeconomic trends, market performance, competitive landscape, investor preferences) will also impact the ability of the hedge fund to achieve its growth and complexity targets.

Understanding where the fund is today, as well as the degree of institutionalization required, provides guidance into the diagnostic and specific institutionalization changes (people, process, technology) necessary for the relevant core functions.

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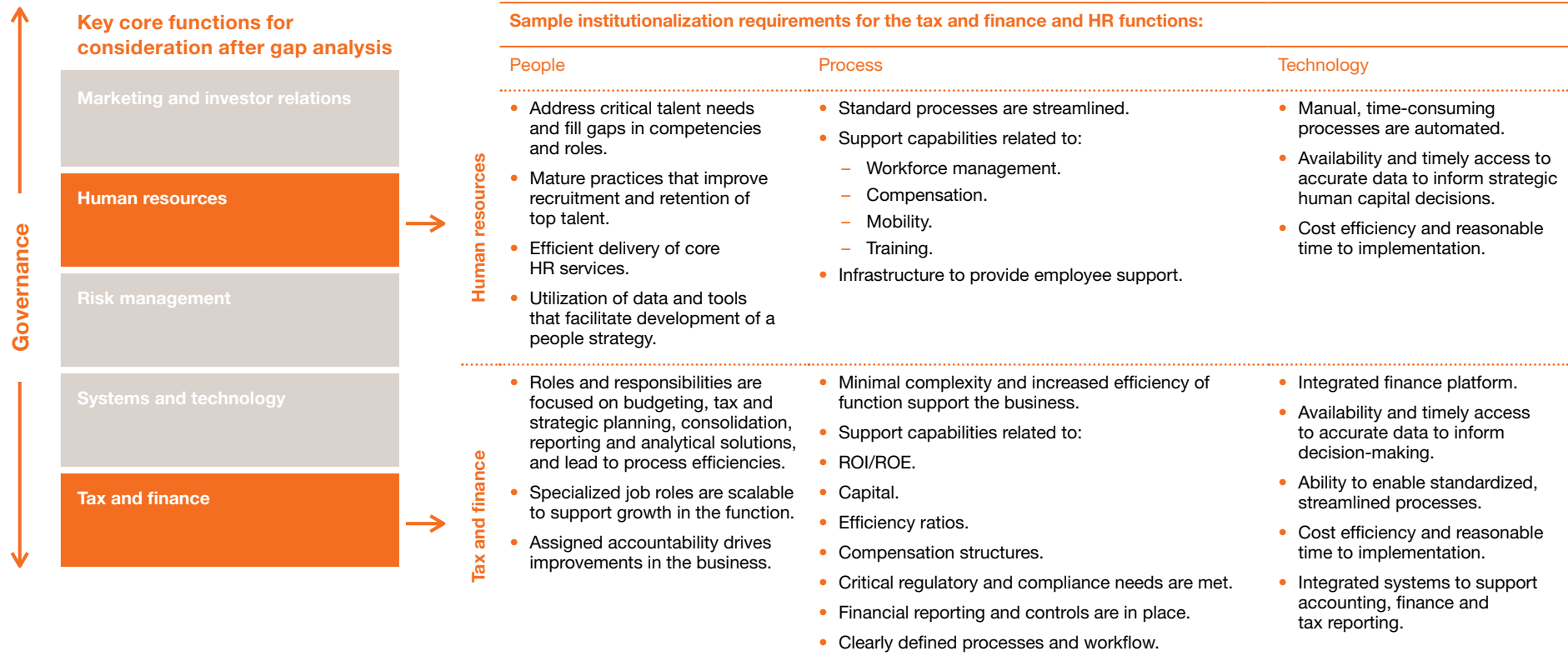
Define functional priorities.

A gap assessment should evaluate the capabilities of each core business function and the people, process, and technology behind it.

The following are the three foundational elements of core business functions that represent levers that hedge fund managers can pull to increase efficiency:

- People—Organization & job design, talent strategy.
- Process—Reengineer processes and policies.
- Technology—Identify changes in technology applications, data or infrastructure.

By looking at these three elements for each core business function and understanding the current state, your organization can define the institutional requirements that will drive prioritization criteria.



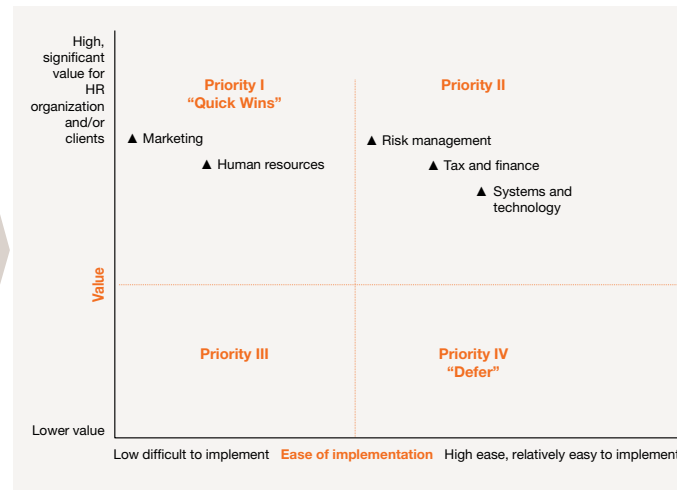
Define functional priorities.

With an understanding of which core business functions have the highest potential for improvement, prioritize functions according to the firm's strategy.



Determine the business functions that will serve as candidates for investment and institutionalization.

Sample prioritization matrix

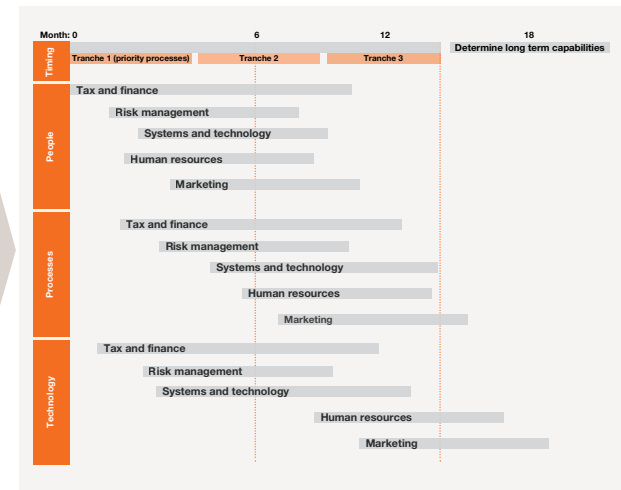


After defining a target state for institutionalization requirements, key core business functions should be evaluated across prioritization criteria. The two-by-two prioritization matrix provides the opportunity to think about functional priorities and sequence design by weighing trade-offs between value and ease of implementation.

Evaluation criteria may include:

- Value:
 - Potential degree of impact.
 - Level of risk.
 - Regulatory/compliance needs.
- Ease of implementation:
 - Level of investment required.
 - Degree of change.
 - Cost and timing.

Sample institutionalization design roadmap



Once functional priorities have been defined, a high-level implementation design should follow.

The institutionalization design roadmap guides the sequencing design of the key core business functions based on the prioritization matrix.

Design solutions.

To achieve organizational maturity, designing solutions requires a target operating model that considers the three levers of people, process, and technology.

Design a solution with a target operating model that addresses people, process, and technology:

For agreed-upon functions, a target operating model will inform the detailed structures required to deliver efficiencies and desired performance. The intended changes of a chosen function for institutionalization rest on the following three foundational elements to successfully capture expected benefits and ROI from the progression toward functional maturity.



Design solutions.

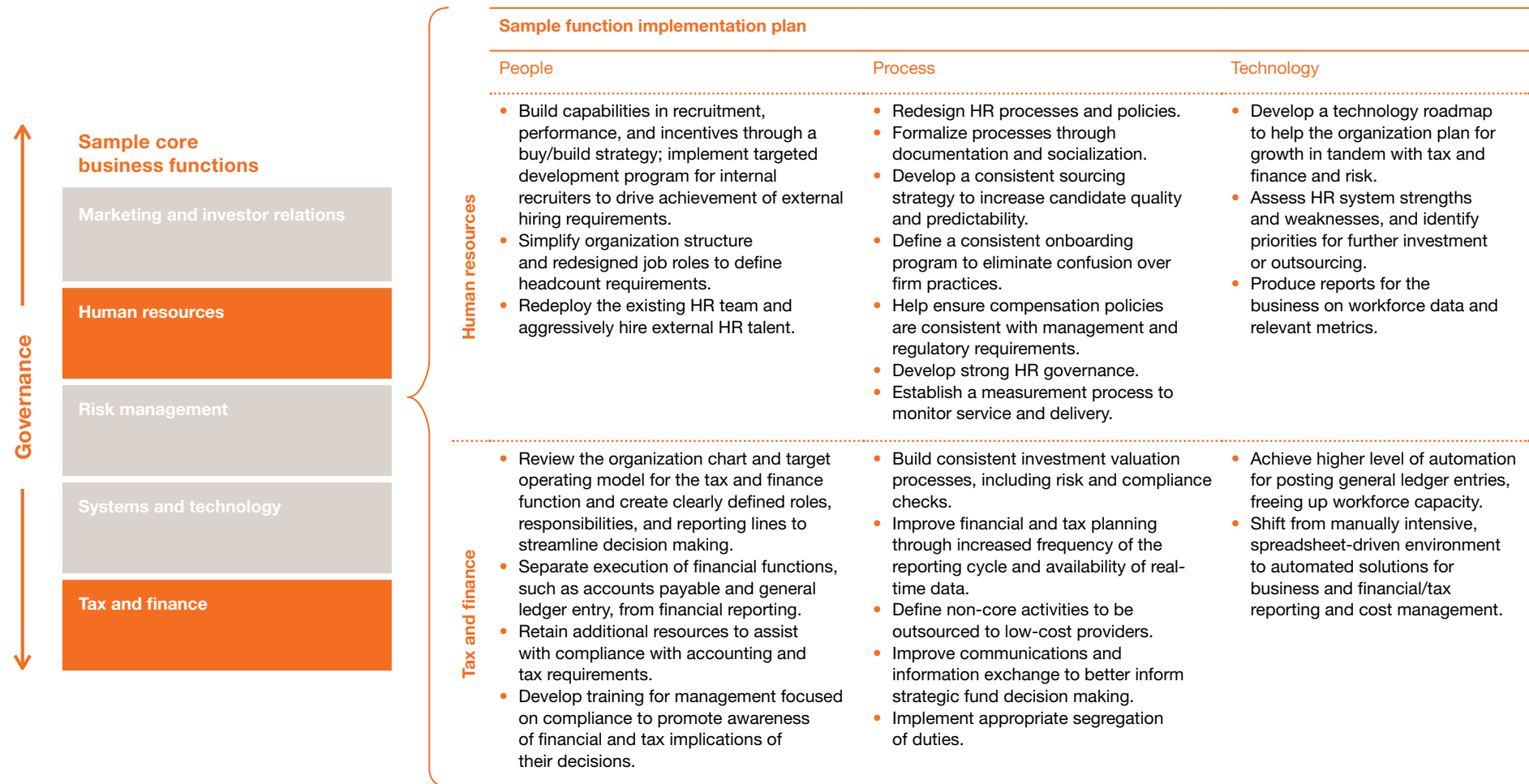
Design a solution with a target operating model that addresses people, process, and technology:

- Based on the findings of the current-state assessment and recommendations and priorities for the business, partner with key stakeholders to design the appropriate target operating model, balancing risk management and mitigation with growth objectives.
- The solution design determines how institutionalizing a core business function impacts the organization, inclusive of change management considerations. A formal plan is needed, along with executive buy-in on proposed processes, practices, and structures.

Outputs	Description	Illustrations
Target operating model design	<ul style="list-style-type: none"> The target operating model (TOM) identifies the functions, key processes and material personnel aspects, systems, technology architecture, data requirements and flows associated with a hedge fund's target state vision: <ul style="list-style-type: none"> Updated policies, procedures and guidelines. Redesigned business processes and controls. Tiered due-diligence models based on risk levels. Improved business capabilities. Organization structure and governance/ decision rights/interactions. High level technology architecture and capabilities. Guiding principles for design, including operational efficiencies and cost savings balanced with growth opportunities, risk management/ compliance requirements, dedicated vs. shared functions, governance and decision rights, etc. 	<div> <div> <p>Organization and governance model</p> </div> <div> <p>Process models</p> </div> </div>
Change management plan	<ul style="list-style-type: none"> Implementation plan for target operating model design and prioritized initiatives. Quick wins and recommendations for areas for immediate focus. Stakeholder alignment and approval. Organizational readiness and change management considerations for transformation. Employee communication and training support needs. Recommendations to mitigate the risk of disruption during the transformation. Supervision, control, and compliance monitoring enhancements. 	<div> <p>Change management plan</p> </div>
Launch implementation plan		<div> <p>Implementation roadmap</p> </div>

Implement solutions.

Solutions should be detailed, tactical, and address all three foundational elements. Developing an executable action plan is key.



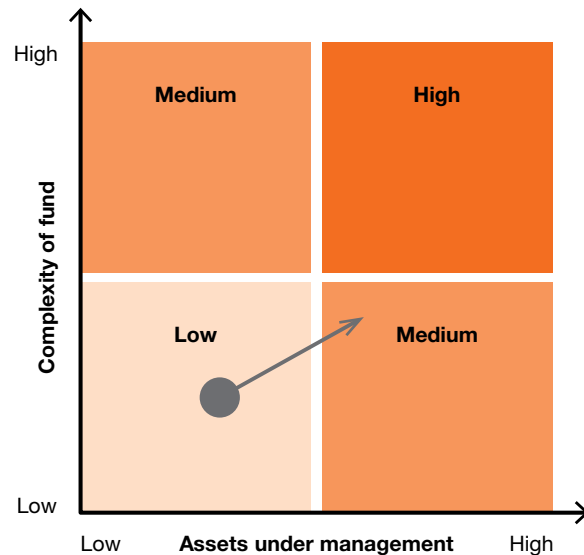


Implement solutions.

Leverage available technology and the solution design to continuously improve performance. Once the core business functions have been identified and a solution has been designed, the implementation stage converts the plan into tangible results.

Outputs	Description	Illustrations
Target operating model implemented	<ul style="list-style-type: none"> Design roadmap serves as the starting point for creating a blueprint that translates the initial vision/scope into practical plans that drive the implementation of the target operating model. Conduct recruiting and onboarding of necessary talent to manage new functional capabilities and implementation of the design roadmap. Considerations for implementing design roadmap include: <ul style="list-style-type: none"> If using a pilot, where would you test the process? Are the relevant stakeholders already engaged in the process? What structure will be put in place to support staff during the launch and implementation periods? What is the leadership team's role in the launch? What are the process measures (such as quantity and adherence to process) to determine compliance during the launch? What are the quality measures to determine impact? 	<p>Institutionalization design roadmap</p>
Business benefits realized	<ul style="list-style-type: none"> Implement communications plan about changes to the wider organization. Management tracks the realization of the business case. Dashboard facilitates continual monitoring of the realization of anticipated business benefits. Monitor and refine the implementation design as required. Deploy new policies and procedures through training programs. Progress is reviewed and compared to original baseline assumptions, vision, and growth trajectories. 	<p>Performance dashboard</p>

Case study



After implementing these changes, the firm was able to attract more investors, attract more seasoned talent, and increase assets under management by 80% in four years.

Client issue:

A small emerging hedge fund manager was pursuing a strategy to double revenue in five years. The management team included the original portfolio management team, along with several new portfolio managers recruited to support the firm's growth strategy. The organization had invested heavily in IT, believing that cutting-edge technology would give it a competitive advantage, but had minimally invested in other core business functions. The weakness of its back-office operations had begun to impact front-office performance.

Results and benefits

Assessments performed and issues identified

A leadership assessment identified strengths and weaknesses within the leadership team.

An organizational assessment identified the lack of clear roles and responsibilities.

A review of the organizational structure indicated that there was overinvestment in some core business functions and underinvestment in others. While the fund had a strong technology function, the tax and finance and risk management areas were identified as critical for development.

Actions taken to address issues

- The leadership structure was reorganized to address resource gaps identified in the assessment. The new structure was better positioned to support the fund's growth strategy.
- The new governance structure also provides leaders more and better information, enabling faster execution on key issues.

- Roles and responsibilities for key functions were agreed upon, documented, and communicated to all employees.
- Communication processes (e.g., monthly meetings) were also developed for the new governance team to help ensure the proper flow of information. This increased the efficiency of decision-making within the organization and helped create a more transparent environment.

- The organizational structure was redesigned to more effectively support the organization in achieving its objectives.
- The organization leveraged its technology expertise to decrease manual data entry within tax and finance, which allowed employees within the function to spend more time on business analytics.
- The risk management function was strengthened with new controls developed to decrease the fund's exposure and increase regulatory compliance. The lower risk levels and increased ability to comply with government regulations led to the fund's ability to attract new clients.

How PwC can help



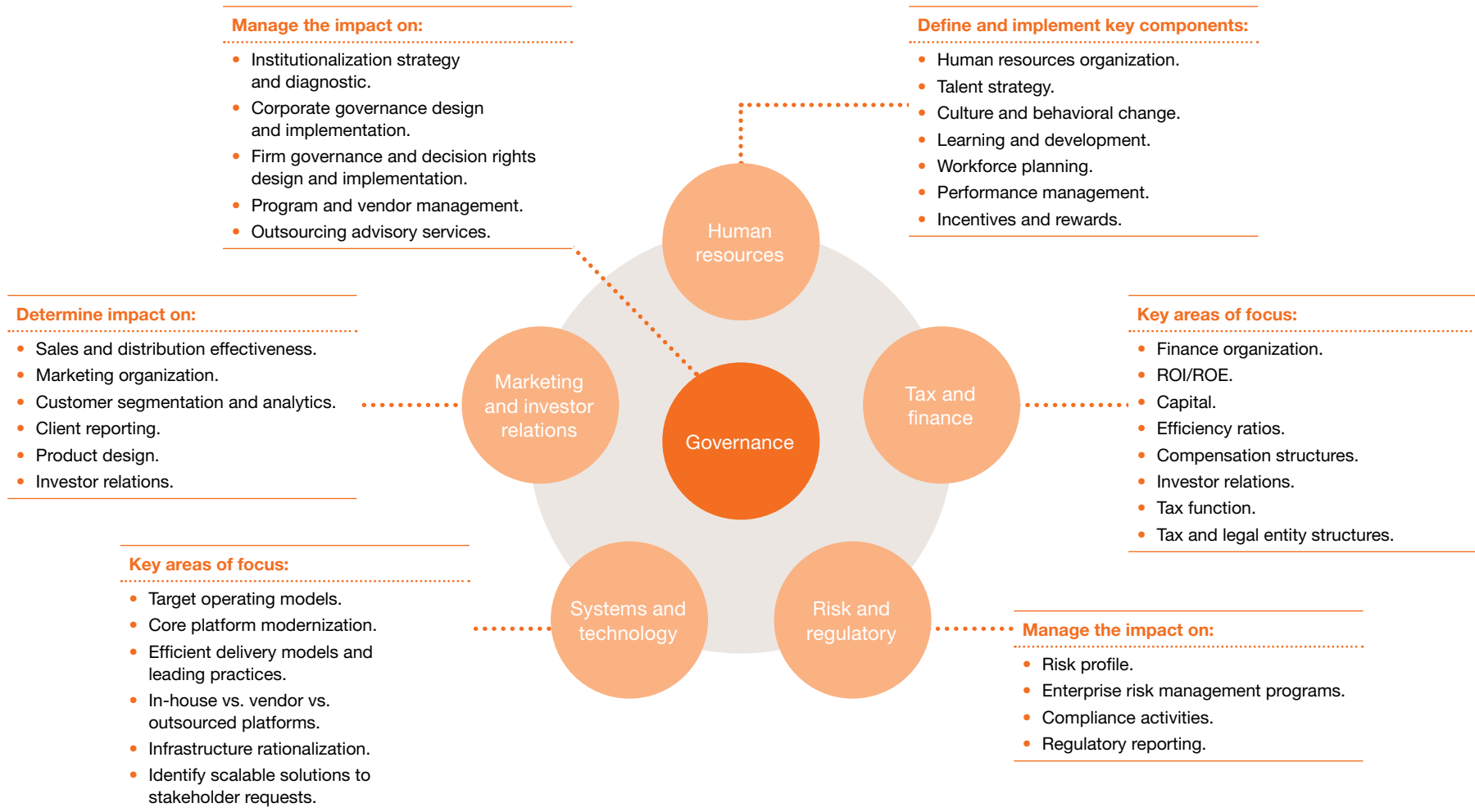
*Our capabilities and
tailored approach.*

What makes PwC's Financial Services practice distinctive.

Integrated global network	With 34,000 industry-dedicated professionals worldwide, PwC has a network that enables the assembly of both cross-border and regional teams. PwC's large, integrated global network of firms with industry-dedicated resources means that PwC deploys the right personnel with the right backgrounds on our clients' behalf whenever and wherever they need it.
Extensive industry experience	PwC serves multinational financial institutions across banking and capital markets, insurance, the asset management/hedge fund/private equity industry, payments, and financial technology. As a result, PwC has the extensive experience needed to advise on the portfolio of business issues that affect the industry, and we apply that knowledge to our clients' individual circumstances.
Multi-disciplinary problem solving	The critical issues that financial services companies face today affect their entire business. Addressing these complexities requires both breadth and depth, and PwC service teams include specialists in strategy, risk management, finance, regulation, and technology. This allows us to provide support to corporate executives as well as key line and staff management. We help address business issues from client impact to product design, and from go-to-market strategy to operating practice across all dimensions of the organization. We feel equally comfortable helping the heads of business and the heads of risk, finance, operations, and technology; we have helped clients solve problems that cross all of these areas.
Practical insight into critical issues	In addition to working directly with clients, our practice professionals and PwC's Financial Services Institute (FSI) regularly produce client surveys, white papers, and points of view on the critical issues that face the industry. These publications—as well as the events we stage—provide clients with new intelligence, perspective, and analysis on the trends that affect them.
Focus on relationships	PwC US helps organizations and individuals create the value they are looking for. We are a member of the PwC network of firms with 180,000 people in more than 158 countries. We are committed to delivering quality through assurance, tax, and advisory services.

Our market-tested approach

PwC's Financial Services practice has a specialized cross-functional hedge fund team of specialists that help our clients with an initial hedge fund institutionalization strategy and diagnostic or focused design and implementation of institutionalization across a number of core business functions.



Appendix



Select qualifications.

Integration of fund acquisition— Middle-tier hedge fund manager

Issues

A middle-tier hedge fund manager embarked on an acquisition of a significantly larger target. While the transaction held promise, achieving the deal's goals required substantial changes and adjustment by both the acquirer and its target. Among the key issues that were encountered were:

- Melding of two vastly different, entrenched cultures.
- Managing large-scale staff displacement.
- Rationalizing systems and processes.
- Redesigning organizational structure, including rationalizing redundant departments.
- Meeting aggressive, long-term integration savings goals.

Approach

As soon as the transaction was announced, PwC was brought in to help build and lead an Integration Management Office (IMO) to act as a central point of contact for integration-related affairs. PwC worked with the client to:

- Perform project management tasks, such as managing timelines, staffing, and integration teams.
- Report and communicate to mid-level and senior management.
- Perform ad hoc analyses, including the development of a plan for rationalizing/validating synergy targets.
- Support change management, including development of communication plans.
- Augment resources to support specialized tasks (such as financial reporting) for deal closing.

Benefits

PwC's involvement from the onset helped to create consistency and transparency for the client. The IMO's reporting and structured meetings helped to open lines of communication, and issues were addressed in a timely manner. The IMO's ability to tap PwC's highly skilled network on an as-needed basis provided the client with the right resources when and where they were most needed. The skilled network also advised on sensitive systems and process-related questions, thereby helping the client develop a better plan. Most importantly, PwC's team supported acquisition-related tasks, freeing the hedge fund's employees to focus more of their time on running the company. Knowing that an independent group of experienced professionals would guide them from start to finish helped to inspire confidence in employees.

Data integration and business intelligence roadmap— Global asset manage- ment company

Issues

A global asset management company with assets of approximately \$5.5 billion under management required a data warehouse framework to monitor its key performance indicators and empower business users with analytics and reports. The organization planned to expand its distribution and portfolio. But, because of the multitude of source systems and the numerous desktop spreadsheets used for reporting, the company had issues with data integrity, speed of access to the information needed by management, and a lack of historical data for analysis.

Approach

The PwC team brought a focus on enterprise data management and data quality management leading practices relevant to the client's situation. The team helped develop a data warehouse strategy, a strategic roadmap, and a data model to rationalize a multitude of data sources. The team provided an approach to extraction, transformation, and loading of data from multiple sources, including custom Oracle systems, multiple large flat files daily, and XML from a number of sources.

PwC also helped build business intelligence analytics and reporting capabilities, so that the client could better analyze the key performance indicators.

Benefits

PwC's solution helped the client gain a better understanding of its analytical needs and the technology architecture needed to support those needs. Upon completing the implementation, the client migrated to a substantially enhanced environment for data analysis.

Customer relationship management and risk management solutions— Large hedge fund of funds manager

Issues

The client was experiencing numerous operating model breakdowns, trade breaks, and client-data issues due to (a) significant growth over the past few years in terms of AUM from institutional investors, and (b) increasing regulatory compliance pressures in the wake of the financial crisis. The client wanted to streamline complex and labor-intensive multi-manager portfolio accounting, investor reporting, sales and marketing, and portfolio monitoring functions into a single application, as opposed to storing information in disparate applications and spreadsheets, which could not be used for enterprise-wide risk reporting purposes.

Approach

Working with the hedge fund of funds management team, PwC assisted the client with its vendor selection program. As part of this program, we collaborated with the client to:

- Identify and quantify root causes for process and trade breakdowns.
- Assist the client in the vendor selection process for new front- to back-office client relationship management (CRM) and risk management solutions.
- Analyze vendors based on product features, execution capability, customization, cost, and after-sales service.
- Institute a program management model to coordinate and manage various aspects of the engagement, which included generating status reports, coordinating with various internal departments to review and implement end-to-end processes, and setting up reporting structures for risk management, compliance, investor relations, investor and portfolio-level liquidity.
- Train employees to conduct business in using the new model and enable the users to utilize the new system for generating ad hoc reports.

Benefits

The project enabled the client to streamline its client and business relationships, monitor investor accounts, build and monitor multi-manager portfolios, and track investor and investment liquidity under a single software platform. Robust reporting capabilities allowed the client to efficiently provide reports to internal and external sources. Moreover, the vendor solution allowed the client to reengineer its business capabilities and provide out-of-the-box solutions to its clients.

Enterprise applications and integration— Large hedge fund manager

Issues

The client wanted to replace a complex environment of vendor and bespoke systems with a streamlined, multi-product trade processing platform to reduce future system spend, improve the quality and timeliness of its reporting, and decrease reliance on disparate systems and spreadsheets that had become cumbersome and risky to manage.

Approach

PwC collaborated with the hedge fund management team to:

- Assist in the requirements-gathering phase by defining more than 750 requirements and creating more than 50 functional scenarios for the client.
- Conduct analysis for 18 short-listed third-party vendors based on product offerings, platform integration, execution capabilities, after-sales service, and cost.
- Draft and distribute requests for proposals.
- Provide guidance and negotiation support for final vendor selection.

Benefits

The project enabled the client to control and improve upon the handling of volume increases, including new instruments, in an efficient manner. Additionally, the client reduced future system spending through the software conversion.

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***To have a deeper conversation,
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"From good to growth: Why institutionalizing hedge funds creates value for owners and investors," PwC FS Viewpoint, November 2012. www.pwc.com/fsi

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