

Time to Join the Uprising

SUSANNE CHISHTI, CEO & Founder of FINTECH Circle, explores the impact of fintech on professional investment managers – and how the hedge fund industry can actually benefit from the revolution

THE HEDGE FUND industry shows the typical signs of a sector ripe for disruption: dissatisfied customers and extremely profitable incumbents. According to the latest HFR Global Hedge Fund Industry Report, global hedge fund capital declined to \$2.86 trillion by the end of March 2016, including investor outflows of \$15.1bn in Q1 2016, marking not only the largest quarterly outflow, but also the first consecutive quarters of outflows since 2009.

Fund manager Daniel Loeb of Third Point said that the first quarter in 2016 was “one of the most catastrophic periods” of performance that the sector had seen in 20 years. If that was not clear enough he added “there is no doubt that we are in the first innings of a washout in hedge funds”.

In March 2016 *Fortune* magazine published an article titled ‘Why Big Investors are Finally Pulling Their Money Out of Hedge Funds’, which shocked the industry with data that 32% of investors are planning to reduce their exposure to hedge funds in 2016 (according to data released by Preqin). At the same time, Bloomberg published an article titled ‘Hedge Funds Have a Performance Problem’ where the question of “what’s killing the golden goose?” was answered as follows:

“Hedge funds’ success ultimately hinges on two scarce resources – skilled managers and exploitable market inefficiencies – and there simply isn’t enough of either one to

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ILLUSTRATION by Ben Jennings

support a \$2.9 trillion industry”.

The trend of passive, low-cost indexing (which has increased in size from \$3 trillion to \$11 trillion over the past decade) will continue. Naturally, when beta returns are low due to the global economy, investors focus on minimising their costs.

If these performance problems, resulting customer dissatisfaction and trends towards low-cost investing would not be enough, the financial technology sector (abbreviated to ‘fintech’) has emerged as a further threat to the status quo. Fintech’s growing disruptive force across financial services started in payments and alternative finance, and slowly moved towards capital markets and investment management, getting closer to the hedge fund industry’s comfort zones.

More than \$22bn was invested in fintech in 2015 (an increase of 75% over 2014) as venture capitalists and private equity investors poured money into profitable investment opportunities. Most expect a shake-up of the financial services sector in the same way as the film and music industries were disrupted by new entrants and innovative products and services before.

In 1942, Austrian economist Joseph Schumpeter researched unexpected, rapid spurts of entrepreneur-driven growth and introduced the term “creative disruption” in his book *Capitalism, Socialism and Democracy*. The importance of this concept has grown, with an increased speed of change to how companies disrupt and displace each other.

Profitable big incumbents normally have a blind spot towards disruption – especially when it comes from smaller, innovative players outside their usual competitors. These fintech firms lack the incumbent’s fear of disrupting existing profit streams and don’t have the burden of old legacy systems, or high cost structure of hedge funds.

The fintech sector is focused on enhanced customer experience and better solutions at attractive prices. Hedge funds

DISRUPTORS

- ALPHA MODUS provides an ‘investment technology marketplace’. Clearly on the disruptive side, it states: “Nobody should pay a professional to throw darts at a board. Investors should only pay for the alpha component of a return.” It provides alpha-generating investment technologies to asset managers and other investment professionals with strategy prices based on the amount of alpha generated.
- QUANTOPIAN offers a platform for quant algorithms development, back testing and is also creating the first crowd-sourced hedge fund by backing selected investment algorithms. Quantopian outlines its objectives, to support talented quants without a track record and without the money to set up their own hedge funds, to test its algos, and to monetise them – leading to the democratisation of the hedge fund industry.
- ROBO-ADVISORS are already disrupting the retail investment management space. When will the first institutional robo-advisor be launched allowing institutions from small family offices to pension funds compare in sophisticated and highly visual ways the best hedge funds globally and invest on the same platform at a fraction of today’s cost? Somebody might be working on this in a ‘Fintechaccelerator’ near you.

might have to improve both their products and their fee structures. Can funds be unbundled for the benefit of their most active, sophisticated investors? Pricing will need to be more aligned with net alpha generation. Hedge funds might want to embrace a more open, collaborative ▶

► approach in both their research and investment decision making, leveraging the power of the ‘crowd’.

In *The Fintech Book: The Financial Technology Handbook for Investors, Entrepreneurs and Visionaries*, Vinesh Jha points out that investment managers have access to innovative data sets nowadays which “crowdsource alpha” and which allow them to differentiate their return streams from those investors who continue to only use commoditised data sets. He summarises the benefits of crowdsourced data as follows: “These data sets offer significant, measurable performance improvements over traditional sources. As more data becomes available to investment managers, and as the types of forecasts which can be crowdsourced proliferate, investment managers and their clients will benefit.”

THE WAY FORWARD

Forward-thinking hedge funds could turn their once perceived ivory-tower mentality on its head and create open platforms, which allow them to incentivise the best alpha generators to develop strategies for the benefit of their clients.

Oscar Wilde said, “The future belongs to those that can recognise opportunities before they become obvious.” The WealthTech programme of FINTECH Circle Innovate provides guidance for investment managers, including hedge funds, on how to respond to the fintech challenge before the vast potential becomes obvious to all.

First, consider a collaborative focus. Great products, services and ideas can come from anywhere. No investment manager has a monopoly on good insights, therefore building up a community of alpha-generating partnerships will be key.

Second, take a portfolio approach to

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COLLABORATORS

- ABLE MARKETS offers diagnostic and predictive analytics to support the hedging of HFT, the collection of intelligence from tracking activity of other institutions and real-time diagnostic tools such as block-trading and abnormal trading activity across most asset classes.
- ALGDYNAMIX is an innovative risk analytics company that detects disruptive events in global financial markets and anticipates price movements, thus providing advance warning to asset managers to improve higher risk-adjusted returns.
- ALMAX ANALYTICS is the first news analytics system that functions like the human brain by putting information into context through its Artificial Intelligence (AI) technology. Qualitative and quantitative results can be used by hedge fund managers, traders and analysts to discern relevant news and understand its impact, thereby providing actionable insights.
- EIDOSEARCH is pioneering the use of objective statistics and return probabilities to enhance investment decision making and improve profitability; targeting idea generation for new positions, and improved monitoring and scenario analysis for existing positions.
- ESSENTIA ANALYTICS is a cloud-based software solution that uses behavioural data analytics to help professional investors to make more skilled investment decisions. It enables fund managers to capture richer data about both their own behaviour and its context, turning trade, market and biometric data into actionable, personal insights. The result is a simple, accurate, continuous feedback loop.
- PROPHIS identifies those emerging developments that are most likely to have an impact on the performance of a particular portfolio and communicates them in a novel way.
- WALNUT ALGORITHMS provides advanced machine learning and applied mathematics for absolute return quantitative investment strategies.
- EDGEFOLIO supports hedge funds in their client and prospect engagement by connecting institutional investors with hedge funds offering a secure and compliant documentation sharing platform, and peer comparison tools.

FINTECH Circle members have invested in both AlgoDynamix and Almax Analytics. AlgoDynamix, Prophis and Walnut Algorithms have been selected for FINTECH Circle Innovate's WealthTech program.

explore fintech solutions for your hedge fund business. The impact of innovation can be felt by your customers through incremental improvements to meet immediate client needs. Long-term funds need to integrate disruptive innovation to increase their returns, reduce cost and risks, while deepening their customer relationships by gaining strategic relevance.

Finally, explore new emerging fintech asset classes such as peer-to-peer loans and social trading portfolios.

Overall, do not underestimate the seismic shift that fintech will have on the asset management industry overall – and on the hedge fund sector in particular.

The power of innovation is difficult to foresee because the outcomes of disruption are not linear. Technology innovation starts

slowly and builds up speed at the end.

The hedge fund industry has the opportunity now to challenge its own structures, business and revenue models to reinvent itself. The winners will be those hedge funds who interpret the current storm of low returns, fee pressure and new entrants as a wake-up call to fight complacency and act.

It is crucial to identify new sources of alpha and become true partners of clients sharing thought leadership. The future leaders will increase their technology spend to offer their funds at lower costs, with better returns and customer experience. ■ *The FINTECH Book: The Financial Technology Handbook for Investors, Entrepreneurs and Visionaries by Susanne Chishti and Janos Barberis is out now (Wiley, £23.99).*