# Alternative Routes into Hedge Funds: Liquid Alternatives and Managed Accounts

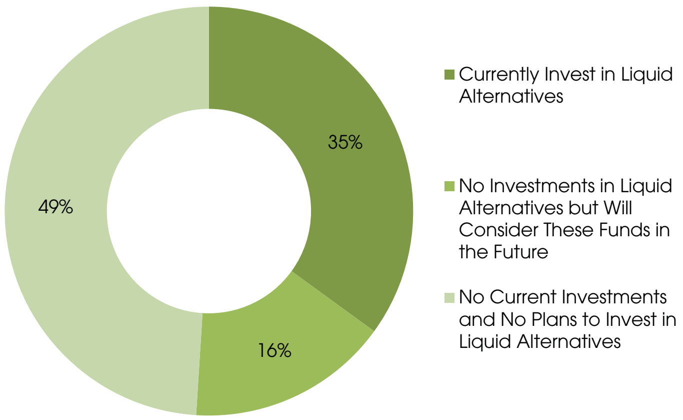
As investors look for new ways to diversify their portfolios and gain maximum benefit from their alternatives allocation, we have witnessed growth in investor appetite for liquid alternatives and managed account structures in recent years. In this section we assess investor appetite for these funds and examine the reasons why investors are turning to these specialized structures.

In recent years, demand for greater liquidity and transparency among institutional investors has led to growing appetite for liquid alternatives and managed account structures. These fund structures offer investors an alternative to pooled hedge fund investments and help to make hedge fund strategies accessible to different investor groups which may have previously been unable to invest in the asset class. This special feature looks at investor attitudes towards these two approaches and assesses whether or not demand for these structures is likely to grow further in the future.

## Liquid Alternatives

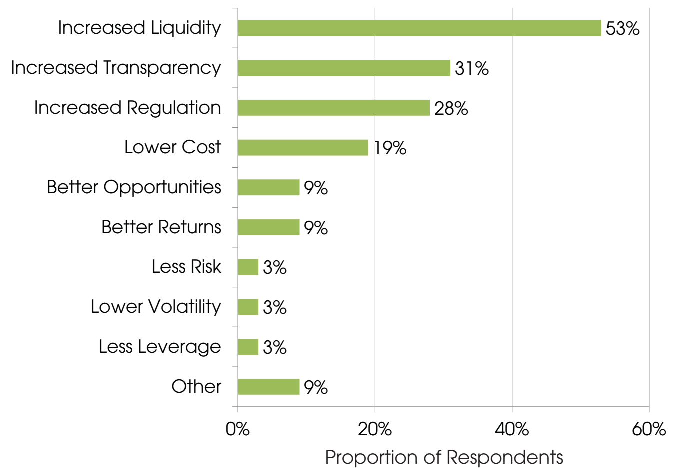
Regulation remains a key issue in the hedge fund industry and demand for increased regulation from investors is leading to a growth in appetite for liquid alternatives. Within Europe, UCITS-compliant funds have been a viable hedge fund investment approach for a number of years, with investors attracted to the increased liquidity, transparency and regulation that these funds can provide. A similar structure in the US, registered '40 Act' alternative mutual funds, has been growing in prominence in recent years, with these funds providing retail investors with the ability to gain exposure to hedge fund strategies in a mutual fund format. Of the investors surveyed by Preqin in July, 35% stated that they currently have an allocation to liquid alternatives (alternative mutual funds and/or UCITS-compliant hedge funds), while a further 16% of respondents stated that they were likely to consider these funds in the future (Fig. 1). With approximately half of all respondents either investing in liquid alternatives or willing to consider doing so in the future, there appears to be significant demand among investors for these regulated products.

**Fig. 1:** Hedge Fund Investor Allocations to Liquid Alternatives (Alternative Mutual Funds and UCITS Hedge Funds)



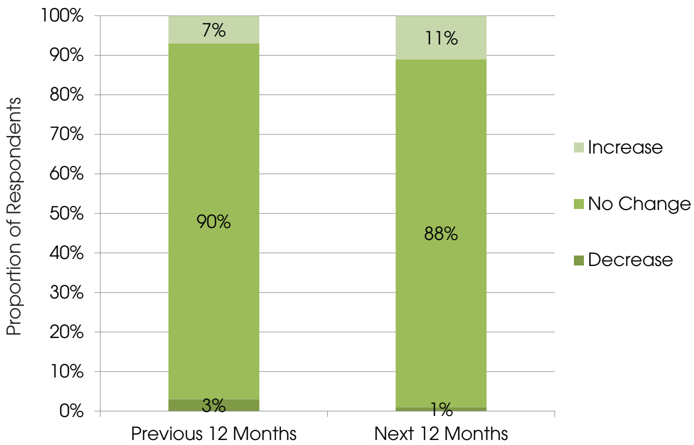

*Source: Preqin Investor Outlook: Alternative Assets, H2 2014*

**Fig. 2:** Investors' Reasons for Investing in Liquid Alternatives




*Source: Preqin Investor Outlook: Alternative Assets, H2 2014*

**Fig. 3:** Investors' Changes in Managed Account Allocation over Last 12 Months and Expected Changes in Next 12 Months




*Source: Preqin Investor Outlook: Alternative Assets, H2 2014*

Those investors that are interested in liquid alternatives were asked to state their main reasons for allocating to these funds. The increased liquidity of these structures was cited as a key factor by more than half (53%) of those investors that invest in liquid alternatives (Fig. 2), as the liquidity terms of these funds are attractive to those investors which require access to capital on a regular basis; alternative mutual funds offer investors access to capital on a daily basis whereas UCITS funds offer at least fortnightly liquidity. Increased transparency (cited by 31% of respondents) and increased regulation (28%) of these fund structures are also attractive characteristics for investors that are looking for assurances in terms of how their funds are investing. Nineteen percent of respondents mentioned lower cost as a factor, with alternative mutual funds and UCITS funds typically offering lower fee structures than hedge funds (Fig. 6).

## Managed Accounts

Investing via managed accounts is another method used by investors that are looking for more transparency and control over how their hedge fund capital is invested. Twenty-nine percent of surveyed investors stated that they include an allocation to hedge fund managed accounts, with the proportion of their hedge fund portfolios that are invested via managed accounts ranging from 5% to 100%. While the majority of investors reported that they had not changed their allocation to managed accounts in the previous 12 months (90%) and had no plans to change this allocation in the next 12 months (88%), there were more investors increasing the proportion they allocate to managed accounts than decreasing (Fig. 3). Seven percent of investors reported that they had increased their managed account allocation over the past year and 11% stated they planned to increase their allocation over the next year, compared to 3% and 1% that stated a decrease respectively. This shows that, while managed accounts remain a fairly niche aspect of hedge fund investing, they are becoming more prominent as investors look for more control over their investments.

Those investors that allocate to hedge funds via managed accounts were asked about their main reasons for investing through these structures, with the results presented in Fig. 4. Improved transparency was the most commonly stated factor, mentioned by 52% of respondents, as managed accounts provide investors with more information about where their capital is being invested. Improved liquidity (cited by 39% of respondents) is also a significant factor as managed accounts tend to allow investors more frequent access to capital than commingled fund structures. Some investors have a preference for investing via managed accounts due to the ability to create customized solutions; the ability to impose guidelines and restrictions on managers was considered a key benefit of managed accounts by 26% of respondents.

## Growth in Liquid Alternatives and Managed Accounts

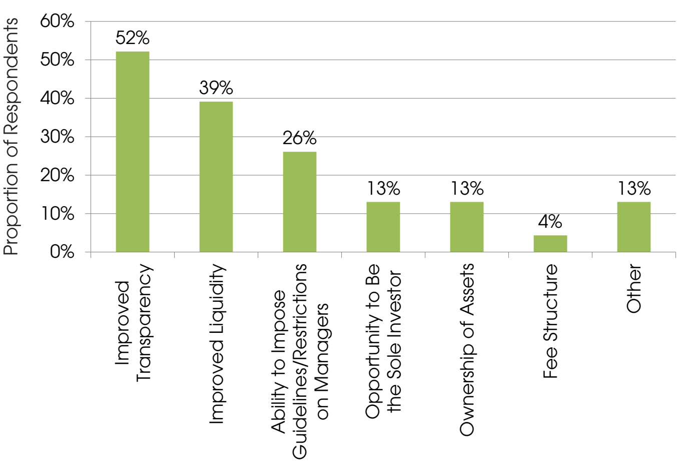
In July 2014, Preqin surveyed 150 hedge fund managers to find out more about their plans for the remainder of the year. As shown in Fig. 5, 22% and 23% of these fund managers reported that they offer alternative mutual funds and UCITS funds to their clients respectively, with 7% of each having done so in the 12 months leading up to July 2014. The growth in the liquid alternatives space looks set to continue in the year ahead, with 11% and 14% of firms planning to introduce either an alternative mutual fund or UCITS fund to their line-up of products in the next 12 months.

Forty-five percent of the fund managers that participated in the July study reported that they offer managed accounts to their investors (Fig. 5). Nearly a fifth of fund managers intend to begin offering these structures over the course of the next year, which will give investors more choice of strategies when they are planning to invest through managed accounts.

## Outlook

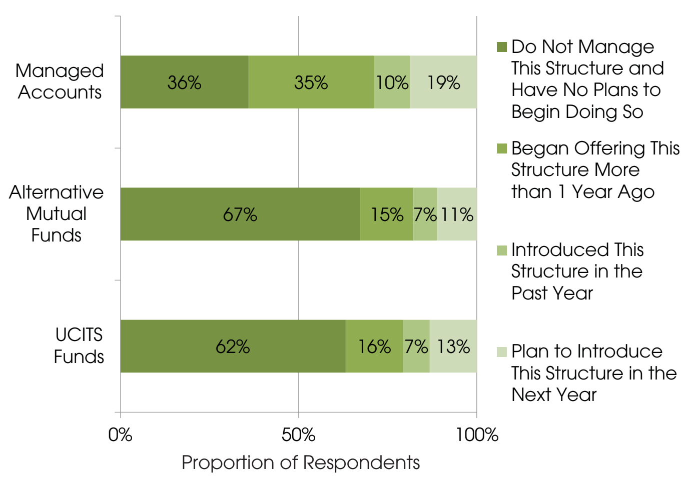
The Preqin Investor Outlook: Alternative Assets, H2 2014 highlights the growing prominence of liquid alternatives and managed account structures as part of the hedge fund landscape. The growing prominence of each structure is leading to more choice for investors, and in turn a broader demographic of investors allocating capital in the asset class. Whilst liquid alternatives may appeal to smaller investors or those serving private or retail clients, due to the familiarity of the structure, as well as its lower fees and barriers to entry, they are being increasingly used by larger investors as a regulated

**Fig. 4:** Investors' Reasons for Investing in Hedge Funds via Managed Accounts




*Source: Preqin Investor Outlook: Alternative Assets, H2 2014*

**Fig. 5:** Fund Managers' Plans for Launching Alternative Hedge Fund Structures




*Source: Preqin Investor Outlook: Alternative Assets, H2 2014* and liquid way of investing in hedge funds. In contrast, managed accounts often require higher capital investment by institutions, and typically are more widely utilized by the larger investors in the space. However, with a variety of ways to allocate capital via managed accounts, such as in separately held accounts via funds of one or through platforms, there are other options for the smaller investor looking to avoid co-investor risk, and employ transparent and liquid hedge fund strategies.

Investors are planning to increase their exposure to both of these structures over the coming year and beyond, and more fund managers are looking to enter the space. While investing via pooled products remains the most common way of allocating to hedge fund strategies, there is clearly the potential for both of these industries to significantly increase assets in the future. With these alternative fund structures typically offering increased transparency, liquidity, control and regulation, it will be interesting to see whether the increased options for investors lead to less capital being invested in pooled funds, or all funds benefitting as a result of the increased interest in hedge fund strategies.

**Fig. 6:** Mean Management Fees and Redemption Frequencies of Each Hedge Fund Structure

| Structure | Mean Management Fee (%) | Mean Redemption Frequency (days) |
|---|---|---|
| Commingled Direct | 1.58 | 64 |
| UCITS | 1.37 | 3 |
| Alternative Mutual Fund | 1.02 | 1 |
| Managed Account - Direct | 1.52 | 27 |

*Source: Preqin Investor Outlook: Alternative Assets, H2 2014*

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## Preqin Investor Outlook: Alternative Assets, H2 2014

The data in this report draws on the recently released Preqin Investor Outlook: Alternative Assets, H2 2014, a unique and in-depth look at the appetite, plans, expectations and concerns of institutional investors in infrastructure, private equity, hedge funds and real estate.

This report draws on in-depth conversations between Preqin's dedicated research analysts and key investment decision makers at over 380 institutional investors from across the globe.

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