



Hedge Funds: Disappointing for Investors in 2012?

After a tumultuous period many are questioning whether hedge funds can still offer the alpha that institutional investors are so keen to tap into. **Dami Solebo** presents some of the key results from our recent study of the attitudes of hedge fund investors based around the world.

The last 12 months have been testing times for the hedge fund asset class. Many international economies have demonstrated sparse growth, which has had an adverse impact on fund performance, coupled with capital inflows contracting in the second quarter of 2012. On top of the fact that certain hedge fund strategies are viewed as unattractive in the current economic climate, the growing sophistication of investors has also changed the methods used to access the asset class. For fund managers to attract capital inflows they must have an understanding and appreciation of the changing dynamics affecting the hedge fund investor universe.

In July 2012 Preqin conducted extensive interviews with 85 institutional investors based around the globe, representing a cross section of institution types and sizes, from North America to emerging economies in Asia. Investors were asked to share their thoughts on the hedge fund industry and how they view the performance of their hedge fund portfolios in light of the recent disappointing returns being posted by many funds.

Falling Short of Expectations

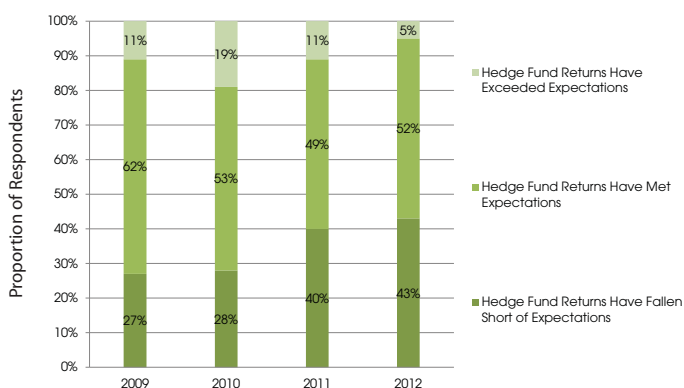
Fig. 1 shows the satisfaction with hedge fund performance from 2009 to 2012. Over the last 12 months, only 5% of investors have seen returns exceed their expectations. This contrasts with previous years, when as many as 19% of investors had returns that exceeded their expectations. The number of investors dissatisfied with returns is greater than for any of the previous years shown. This change reflects the challenging conditions within the asset class, and growing concerns over the ability

of hedge funds to achieve returns and satisfy the performance requirements of their investors.

In light of the relatively poor performance of many hedge funds, it is perhaps unsurprising that investors' confidence in the asset class has declined. As shown in Fig. 2, only a negligible proportion of investors interviewed by Preqin indicated increased confidence in the asset class since last year. This contrasts strongly with 2011, when 20% of investors expressed increased confidence about the asset class. Tellingly, nearly one-quarter of investors in 2012 stated that their confidence in the ability of hedge funds to meet portfolio objectives had declined over the past 12 months. This represents the largest impact on investor confidence in hedge funds Preqin has witnessed since mid 2009, when investors were evaluating the performance of hedge funds in light of poor returns in 2008, the impact of high profile frauds such as the Madoff ponzi scheme, and the fallout caused by the collapse of Lehman Brothers.

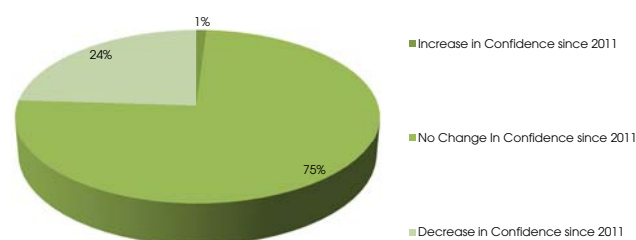
The growing scepticism among investors should be a source of concern for industry professionals, particularly given the continuing volatility seen in wider financial markets. In general, hedge fund managers have undergone many changes since 2008 in order to remain appealing to the increasingly sophisticated institutional market; however, if they are not living up to expectations then even investors satisfied with the institutional quality of a fund may begin to look elsewhere.

Fig. 1: Institutional Investors' Hedge Fund Portfolio Performance Relative to Expectations, 2009 - 2012



Source: Preqin

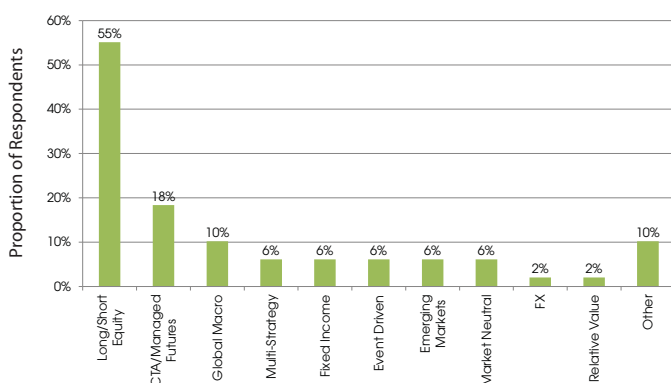
Fig. 2: Change in Institutional Investors' Confidence in Hedge Funds since 2011



Source: Preqin



Fig. 3: Hedge Fund Strategies that Have Fallen Short of Institutional Investors' Expectations in the Last 12 Months



Source: Preqin

Attitudes towards Different Hedge Fund Approaches

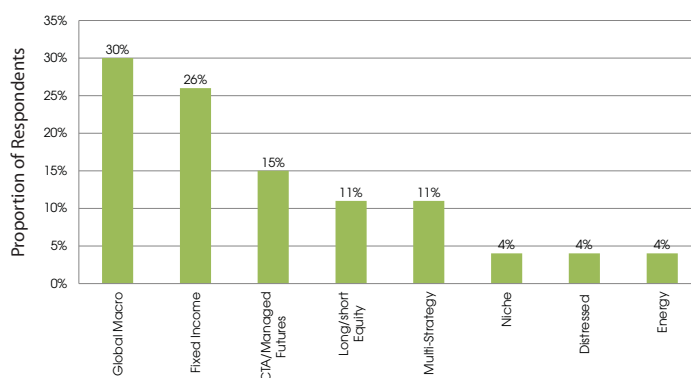
High expectations amid a volatile economic climate have had a profound effect on institutional investors' confidence in the asset class, but no two hedge funds have had the same experience. Have some strategies underperformed more than others? To investigate further we asked investors to identify strategies that they felt have not lived up to expectations over the past 12 months.

The strategy most commonly cited by investors as underperforming over the last 12 months was long/short equity. More than three times as many investors stated long/short equity as performing poorly in the past year as compared to the second most commonly cited strategy - CTA. Considering the level of capital invested in long/short equity funds, this highlights that there is considerable dissatisfaction across many investors on a global scale. However, there is still a large proportion of investors (around 40%) that state that long/short equity forms part of their current fund searches. Given the large number of funds in market that operate this strategy, and the significant level of diversity between funds in terms of sector, capitalization and regional exposure, many investors clearly still feel that it is possible to identify successful managers in the long/short equity space.

Some strategies are centred on investment themes that are better suited to take advantage of macro economic conditions and the heightened levels of financial market volatility. Given the prevailing environment, strategies such as global macro have attracted more attention from investors. When asked which particular strategies exceeded expectations, 30% of investors noted that global macro-oriented funds have outperformed over the past 12 months, as shown by Fig. 4. Fifteen percent of investors believed that the CTA funds in their portfolios surpassed expected returns, while 11% of investors identified long/short equity funds.

While fund strategy is typically a key concern of investors, the geographic focus of investments is also an important

Fig. 4: Hedge Fund Strategies that Have Exceeded Institutional Investors' Expectations in the Last 12 Months



Source: Preqin

consideration as performance varies across regions. Europe was the region most commonly cited as being avoided by investors worldwide, many of which mentioned macro economic concerns. The ongoing sovereign debt crisis and the contracting growth being experienced by many countries in Europe has had an adverse effect on the confidence of investors. Investors interviewed by Preqin also expressed dissatisfaction with funds focused on investment in emerging markets, a view that is particularly prevalent among Asia-based institutional investors. Consequently, we may see an increasing number of allocations made to US-focused strategies as investors look to reduce exposure to specific regions.

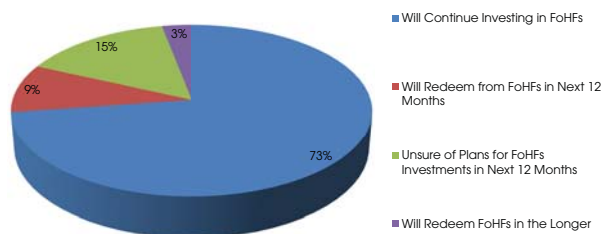
The Future for Funds of Funds

Funds of hedge funds have faced immense pressure from the hedge fund community in recent years, with the future of multi-manager vehicles being called into question as the make-up of hedge fund investors becomes increasingly institutional, sophisticated and experienced. Of the investors we interviewed, 55% currently invest in multi-manager hedge funds. We asked these investors whether they planned to continue investing in funds of funds going forwards, the results of which are shown in Fig. 5.

Seventy-three percent of investors accessing hedge funds via funds of funds plan to continue allocating capital through multi-manager platforms over the next 12 months. Of the investors that have exposure to fund of hedge funds vehicles, 9% are expected to withdraw from investing via such structures in the next 12 months, while a further 3% plan to move away from the structure in the longer term. Moreover, a further 15% are unsure about their future investments and may exit funds of funds at some point in the future. With three-quarters of investors in funds of hedge funds looking to remain in these structures for the immediate future, the outlook for multi-managers is relatively positive.



Fig. 5: Institutional Investors' Plans for Fund of Hedge Funds Investments over the Next 12 Months



Source: Preqin

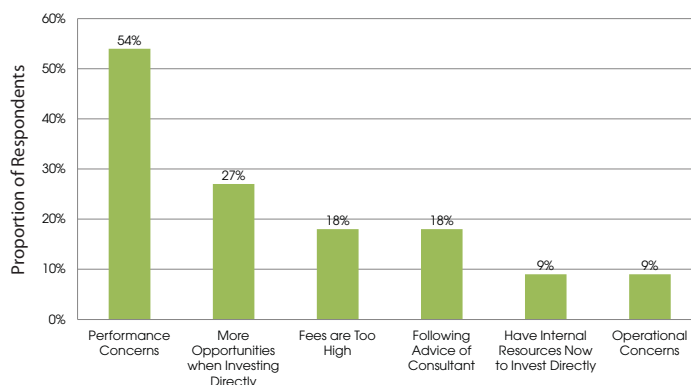
Despite this, when we asked those investors considering or planning to exit funds of funds about their reasons why, it would seem that – as with the general concerns with the asset class as a whole – poor performance is the biggest turn-off to institutional investors. Fig. 6 shows that 54% of investors intending to exit multi-manager vehicle investments are doing so because of the returns generated by these investments, while 27% felt that investing through their own portfolio of direct investments can provide better opportunities in the hedge fund space. Fees are also an important consideration to those institutional investors looking to exit funds of hedge funds, particularly as they may feel that cash saved through avoiding the additional layer of fees could be used to build their own internal fund research and due diligence resources. A significant proportion (9%) of investors in multi-managers stated that they now intend to invest directly in hedge funds, because they now have the requisite internal resources.

Outlook

The outlook for the hedge fund industry is one of great uncertainty, and investor dissatisfaction with hedge fund performance has grown significantly over the last year. With the ongoing uncertainty and volatility in many financial markets across the world, performance concerns are unlikely to disappear in the short term, which has led to many investors reassessing their plans. One immediate effect of this is that growing numbers of institutional investors are avoiding hedge fund investments in troubled regions, most notably in Europe due to the impact of the eurozone sovereign debt crisis.

Long/short equity has proven to be the most disappointing strategy for investors in the past 12 months, which is a concern given the prevalence of the strategy throughout institutional investors' portfolios. Despite this, however, many investors will keep their capital invested in such strategies due to the diversification benefits that this mainstay of the hedge fund industry can offer. While performance across the whole spectrum of hedge fund strategies has been disappointing over the past year, some

Fig. 6: Institutional Investors' Reasons for Exiting Fund of Hedge Fund Investments



Source: Preqin

strategies and approaches have exceeded expectations. Global macro and fixed income hedge funds have been lauded by the investor community for performing particularly well in the volatile returns environment.

Prior research carried out by Preqin indicated that nearly 40% of investors cite performance concerns as their reason for making portfolio redemptions. Given the fact that investor dissatisfaction with returns is at its highest level since the crisis, while investor confidence in the asset class has reached 2008 lows, hedge fund managers need to concentrate on rebuilding investor belief in the industry. Increased communication and transparency will go some way to improving investors' attitudes towards the asset class; however, this will need to be accompanied by stronger returns in the second half of this year should managers hope to retain institutional backing.

Data Source:

This month's feature article draws on information from Preqin's industry leading [Hedge Fund Investor Profiles](#) database.

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2012 Preqin Hedge Fund Investor Review

The 2012 Preqin Hedge Fund Investor Review provides profiles and analysis for the most important institutional investors in hedge funds from around the world. This invaluable resource contains the following key features:

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