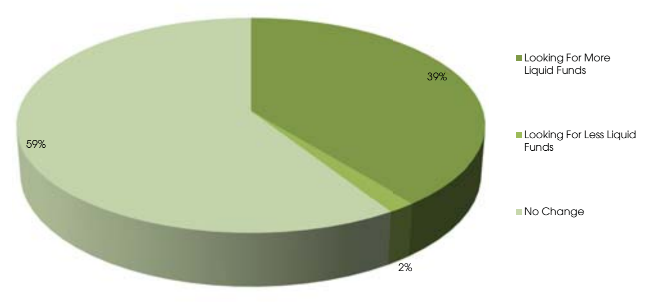
Liquidity: Preqin Investor Survey
What Do Hedge Fund Investors Want?

Preqin recently conducted detailed interviews with more than 50 leading institutional investors in hedge funds in order to find out more about their current views on the issue of liquidity. Fig. 6 shows that 39% of investors surveyed are looking for more liquidity in their hedge fund portfolios than they were three years ago. While this is not as significant a proportion as the results of a similar study last year (in September 2011, 75% of investors indicated that they were looking for more liquidity than they were in 2008), it suggests that a number of investors have been taking steps to improve liquidity in recent years and are continuing to do so. The reduced figure likely represents a levelling out as investors achieve the desired level of liquidity in their portfolios.

Fig. 6: Change in Hedge Fund Investor Attitudes Towards Liquidity Over the Last Two To Three Years



Source: Preqin Hedge Fund Institutional Investor Survey - November 2012

Current Liquidity Preferences

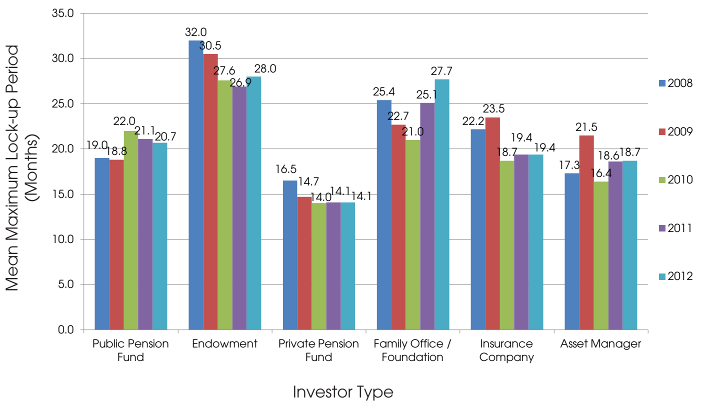
In most cases, the average maximum lock-up restrictions accepted by each investor group has remained relatively consistent from 2011 to 2012, as shown in Fig. 7. Few investors are currently willing to accept a lock-up period of more than three years. Endowments and foundations have shown an increase in the average maximum lock-up they will accept over the past year. These investor groups are typically long-term investors and the results suggest that they will continue to accept longer lock-ups in cases where the strategy is appropriate for such a restriction. The stronger performance of more illiquid funds is also proving attractive to those investors with longer investment horizons that can afford to lock capital in for more prolonged periods of time.

Fig. 8 shows the current liquidity preferences of institutional investors in terms of redemption frequencies and notice periods. The majority of investors are looking for at least quarterly liquidity, and there has been a sizeable increase in investors looking for funds with weekly and daily liquidity over the past year, 23% and 20% respectively compared with 7% and 3% in 2011. The greater liquidity requirement is also highlighted by a reduction in the proportion of investors accepting semi-annual and annual liquidity, dropping to 5% and 7% respectively in comparison to 8% and 9% respectively in 2011. These results show that despite investors' lock-up restriction preferences stabilizing (or even increasing for some investors), investors continue to seek funds which have greater underlying liquidity and more regular access to capital. The previous section demonstrated that funds with longer than quarterly redemptions can produce stronger returns. However, following the higher volatility and larger drawdown in 2008 many investors are willing to forego the potential for stronger returns in order to tap into funds which can offer more stable sources of alpha.

Why Choose Liquidity?

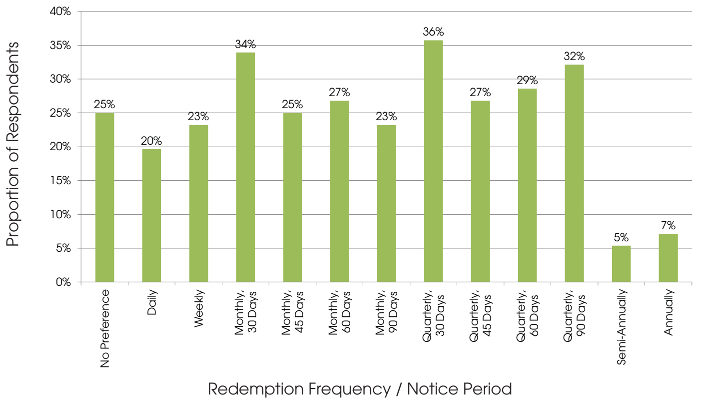
Despite some evidence to show that less liquid funds can offer better performance, what is the appeal of liquidity to institutional investors? There can be a number of reasons why institutional investors may

Fig. 7: Mean Maximum Lock-Up Period by Hedge Fund Investor Type



Source: Preqin Hedge Fund Institutional Investor Survey - November 2012

Fig. 8: Hedge Fund Investors' Preferred Fund Redemption and Notice Periods



Source: Preqin Hedge Fund Institutional Investor Survey - November 2012

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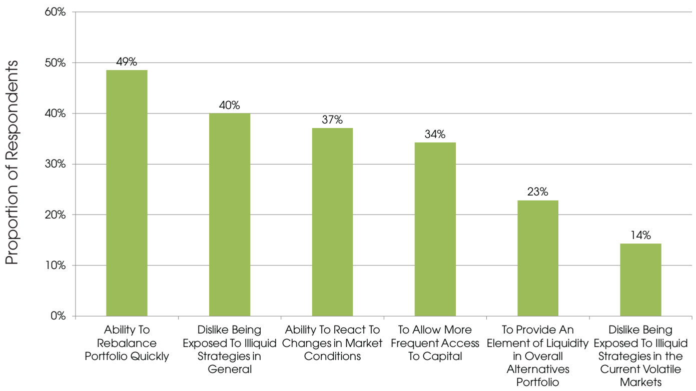
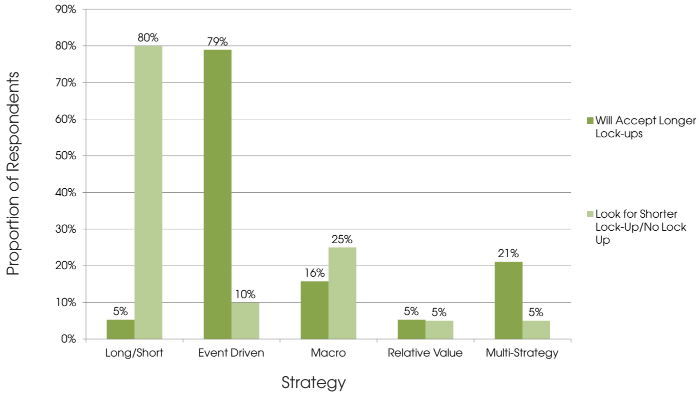
Fig. 9: Reasons Why Hedge Fund Investors Seek More Liquid Hedge Funds



Source: Preqin Hedge Fund Institutional Investor Survey - November 2012

Fig. 10: Hedge Fund Investors' Lock-up Restriction Preferences by Strategy



Source: Preqin Hedge Fund Institutional Investor Survey - November 2012

look for additional liquidity in their hedge fund portfolios, as indicated by the responses in Fig. 9. The most commonly cited reason was in order to allow investors to rebalance their portfolios quickly, with 49% of investors surveyed indicating this as a reason for targeting more liquid funds. This is important to investors as it means that they can change their portfolio if a manager is underperforming. It also allows them to take advantage of new opportunities, both in terms of fund offerings as well as opportunities in the wider markets, as the financial climate continues to evolve.

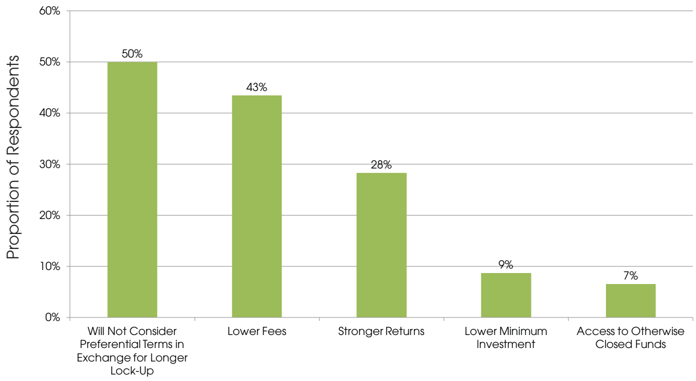
Similarly, a number of investors choose liquid funds because they allow more frequent access to capital and an ability to react to changes in market conditions. Forty percent of respondents indicated that they do not like being exposed to illiquid strategies in general, with 14% stating they are unwilling to be exposed to illiquid strategies in the current volatile markets. Twenty-three percent of surveyed investors state that they look for liquidity in hedge funds in order to add a degree of liquidity to their overall alternative assets portfolios. With other alternative assets such as private equity funds locking investor capital in for 10 years or more, hedge funds can be a useful tool to provide some much needed liquidity in this segment of their portfolios.

Most investors will assess redemption frequencies and lock-up restrictions based on a number of factors, with one of the key issues being the fund strategy. Investors are likely to be willing to accept longer lock-ups for illiquid strategies where funds are specifically targeting illiquid assets. Fig. 10 shows that event driven strategies are where investors are most likely to accept a longer lock-up, with distressed hedge funds in particular being cited as a fund strategy where illiquidity would be accepted by investors. Eighty percent of investors interviewed said that they would prefer shorter lock-up periods or no lock-ups for long/short strategies with long/short equity the most commonly cited strategy. Other strategies mentioned with regards to shorter lock-ups include strategies such as liquid macro, managed futures and liquid credit strategies.

Why Lock Up Capital?

Fig. 11 shows that half of the investors surveyed indicated that they would not accept a longer lock-up for a reduction in fees or other more

Fig. 11: Hedge Fund Investor Consideration of Preferential Terms in Exchange for Longer Lock-up Periods



Source: Preqin Hedge Fund Institutional Investor Survey - November 2012

favourable terms, representing a considerable increase from the 34% that suggested this in 2011. A number of investors commented that liquidity is more important than a small saving on fees, while others prefer to consider the strategy of the fund rather than the specific terms offered. Forty-three percent of investors indicated that they would accept a longer lock-up period if this was coupled with correspondingly lower fees. Twenty-eight percent of respondents indicated they would accept less liquidity in exchange for higher returns, highlighting that a number of investors are still willing to accept longer lock-ups if they feel they can get access to better performing funds as a result. Our study shows that less liquid hedge funds can often perform better than more liquid funds, suggesting that there can be a number of benefits for investors that choose to accept illiquidity in their portfolios.

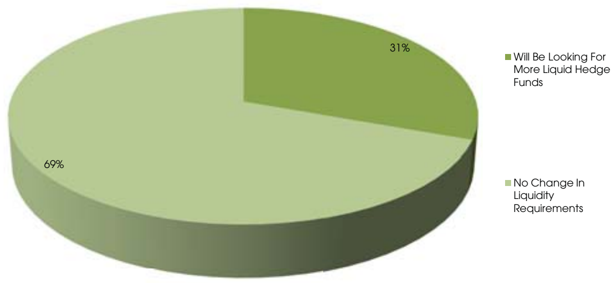
Fig. 12 shows the liquidity plans of institutional investors for the coming 12 months. Thirty-one percent of respondents indicated that they will be searching for funds that they perceive as "more liquid" over the next year. While this is less than half of respondents, it highlights that a significant proportion of investors are continuing to improve the liquidity profile of their portfolio, whereas many investors have already reached the desired level of liquidity within their hedge fund holdings. Investors that already have substantial liquidity in their portfolios indicated that they would maintain this outlook in 2013, while other investors are more flexible regarding liquidity if they have longer term investment horizons and do not need to have ready access to capital with their wider alternative holdings over the next 12 months (for instance for capital call-ups from private equity managers).

Outlook

There is a liquidity spectrum within the hedge fund industry, with some strategies being inherently less liquid than others. Within strategies there is also a high degree of variation as some funds offer daily redemption frequencies and others offer up to annual capital redemption. Funds which offer monthly or greater redemption frequencies tend to perform better than their more liquid peers. However, in crisis periods funds offering less-than-monthly access to capital have underperformed more liquid funds.

Funds which offer quarterly redemptions appear to offer the best balance between investor liquidity requirements and performance. Many investors seem to agree with this, with funds that offer quarterly redemptions being among the most commonly sought. Funds with semi-annual or annual redemptions are falling out of favour with institutional investors. This has been coupled with a significant growth in demand for funds which can offer daily or weekly liquidity, despite evidence that these funds produce lower returns.

Fig. 12: Hedge Fund Investor Searches for Funds in 2013



Source: Preqin Hedge Fund Institutional Investor Survey - November 2012

However, on the whole hedge fund investors' calls for greater liquidity appear to be abating as fewer investors state that they are seeking more liquidity than in previous years. This may be because they have adjusted their portfolios over the past four years and have reached a satisfactory level of liquidity, or because stronger performance of more illiquid funds has proved appealing to some groups. Nonetheless, with around a third of investors continuing to search for more liquid funds in 2013, it is clear that the issue of liquidity will remain a key topic for at least the 12 months ahead for a significant proportion of institutional investors and the hedge funds they invest in.