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$1 Billion Plus Hedge Fund Investors

With large investors dominating the institutional hedge fund universe, Graeme Terry takes a look at investors which currently allocate more than $1bn to hedge funds.

Underwhelming performance of hedge funds and dissatisfaction with fund terms have led some investors to scale back their investments in hedge funds, making it important for hedge fund managers to effectively identify sources of capital in the institutional universe. Despite the concerns of some investors, there remain a large number which are increasing their exposure to hedge funds, presenting significant opportunities for managers to obtain capital. The largest hedge fund investors can be a reliable source of capital for individual hedge fund managers, as well as for the industry as a whole. In this article we analyze the "big players" in the institutional universe: those that currently allocate more than $1bn to hedge funds.

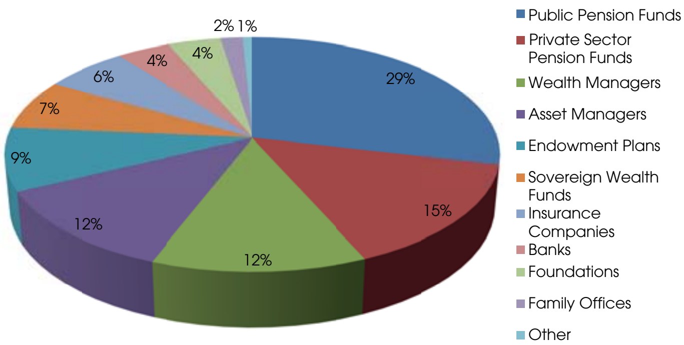
Twenty-six institutions have joined the ranks of the investors that allocate $1bn or more to hedge funds since Preqin's first study of this group in January 2012. Preqin's Hedge Fund Investor Profiles service currently contains 176 profiles for investors with more than $1bn invested in hedge funds (excluding fund of hedge funds managers). These investors represent over $550bn in combined capital allocated to hedge funds, a significant proportion of assets at work in the $2.3tn industry today. Having built up large portfolios of hedge funds at great effort and cost, the commitment of these investors to the asset class remains strong as they seek to benefit from these portfolios.

Characteristics of $1 Billion Plus Hedge Fund Investors

Public pension funds are the largest capital contributor within this group of investors, with 29% of the capital committed by $1bn plus investors coming from public pension funds. Most of these public pension funds are based in North America, with the largest public investors currently allocating more than $10bn to hedge funds. Private sector pension funds also represent a significant 15% of total capital, and this investor group has the highest number of investors (43) with $1bn or more allocated to hedge funds. Many of these private sector retirement funds have been increasing their hedge fund allocations in recent years, including UK-based TfL Pension Fund, which increased its hedge fund allocation from 5% of total assets to 15% over the course of 2012. A number of asset managers and wealth managers also have significant allocations to hedge funds, with both investor groups representing 12% of the total capital of investors with $1bn or more allocated to hedge funds.

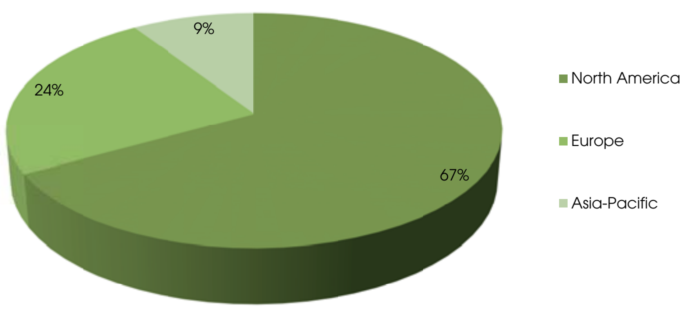
Sixty-seven percent of total capital invested by $1bn plus hedge fund investors is contributed by North America-based institutions. The region is home to a number of large pension funds, asset managers and endowment plans, all of which contribute a significant proportion of capital to the asset class. Some notable Europe-based investors have been reducing allocations to hedge funds over the past year and this region now only represents 23% of all capital contributed by $1bn plus investors, down from 33% in 2012. Only 9% of the total capital comes from Asia-based

Fig. 1: $1 Billion Plus Investors - Capital-Weighted Breakdown by Investor Type



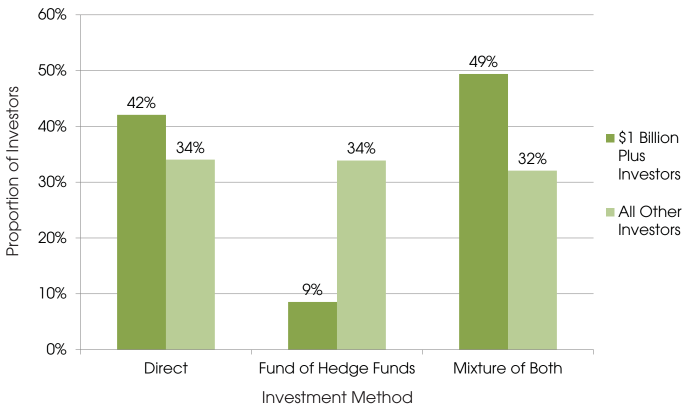
Source: Preqin Hedge Fund Investor Profiles

Fig. 2: $1 Billion Plus Investors - Capital-Weighted Breakdown by Investor Location



Source: Preqin Hedge Fund Investor Profiles

Fig. 3: Method of Investing in Hedge Funds: $1 Billion Plus Investors vs. All Other Investors



Source: Preqin Hedge Fund Investor Profiles

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Fig. 4: Key Facts: $1 Billion Plus Investors vs. All Other Investors

Key Facts	$1bn Plus Investors	All Other Investors
Mean Allocation to Hedge Funds ($mn)	3,186	137
Mean Allocation to Hedge Funds (% of AUM)	15.0	13.7
Mean Target Allocation to Hedge Funds ($mn)	3,832	196
Mean Target Allocation to Hedge Funds (% of AUM)	14.1	13.9
Typical Number of Hedge Funds in Portfolio	28-35	13-16
Average Track Record Required for Underlying Funds	2.9 years	3.3 years
Average Assets under Management Required for Underlying Funds ($mn)	818	474
Time Period Typically Been Investing For	11 years	9 years

investors; however, some prominent investors are located in these areas, such as Japan-based Pension Fund Association, which currently allocates more than $4bn to hedge funds.

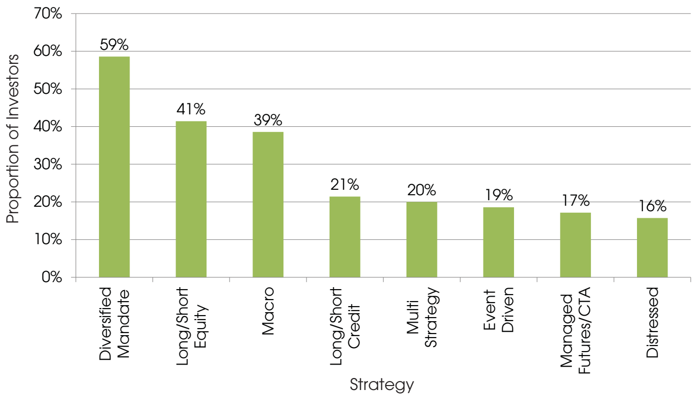
Comparison with Other Institutional Investors

Fig. 3 shows a breakdown of investment method for the $1bn plus investors compared to the rest of the hedge fund investor universe. A striking difference between the two groups is that whereas only 9% of these investors solely invest through funds of hedge funds, 34% of all other institutional investors only use multi-manager funds for their hedge fund allocations. These larger investors tend to have more internal resources dedicated towards hedge funds, giving them the platform and expertise to construct their own single-manager portfolio, rather than relying on the expertise of fund of hedge funds managers. Despite this, 49% of $1bn plus investors include both direct investments and funds of hedge funds in their portfolio, meaning that more than half of these investors still include an allocation to at least one multi-manager structure. This indicates that funds of hedge funds still remain valued by some of the larger investors in order to tap into niche strategies, lesser known managers and emerging regions.

As Fig. 4 demonstrates, $1bn plus investors have, on average, been investing in hedge funds for 11 years, approximately two years more than the average for other institutional investors. These investors also typically have larger hedge fund portfolios (28-35 hedge fund investments compared with 13-16 for all other investors) and have a higher average percentage allocation to the asset class (15.0% versus 13.7%). Larger investors are generally able to create larger hedge fund portfolios as their greater resources and investment knowledge allows them to conduct due diligence on a wide range of funds.

These additional investment resources also allow $1bn plus investors to conduct due diligence on emerging managers and lesser-known funds. Eighty-one percent of investors with $1bn or more invested in hedge funds will consider emerging managers, compared with 43% of all other institutional investors. These investors are also more likely to seed new hedge funds, with 37% of $1bn plus investors willing to consider seeding a hedge fund, compared with just 17% of other investors. The average minimum track record requirement for $1bn plus investors is 2.9 years, compared with 3.3 years for other investors. These investors do, however, have a higher average AUM requirement, with an average of $818mn compared to $474mn for other investors in hedge funds. Larger investors have larger ticket sizes, and so they may have internal restrictions prohibiting them from allocating to funds where their assets dominate the fund's total assets under management, or may prefer not to do so.

Fig. 5: Strategies Sought by $1 Billion Plus Investors over the Next 12 Months



Source: Preqin Hedge Fund Investor Profiles

Where are $1 Billion Plus Investors Looking to Invest in the Next 12 Months?

As these investors seek to maintain their portfolios through reinvestment of redeemed capital, as well as adding fresh capital to funds in order to reach target allocations, they are likely to continue to be the most active institutional investors in hedge funds going forward. Consequently, it is interesting to examine their investment preferences for the year ahead. Long/short equity and macro are the most commonly preferred strategies by investors allocating $1bn or over to hedge funds (Fig. 5), followed by long/short credit. However, more than half of these investors are targeting a diversified mandate for new investments in the coming 12 months, suggesting that the majority of investors will consider a broad range of strategies as they seek to identify the best hedge fund opportunities.

Although more than 50% of the $1bn plus investors currently have at least one fund of hedge funds in their portfolio, less than a third of these investors are targeting new investments in funds of hedge funds over the coming year (Fig. 6). This is a result of a shift which has seen more of the larger investors focus on building direct hedge fund portfolios in a move to save money on fees, as well as allowing more freedom in building a portfolio which directly matches an investor's requirements. The majority of $1bn plus investors are targeting commingled fund structures, although 23% are targeting managed accounts over the coming year, highlighting that there is continued appetite for segregated accounts among the larger hedge fund investors. This is in comparison to 6% of all other investors which are seeking managed accounts in the year ahead. Larger investors are far more likely to demand separate

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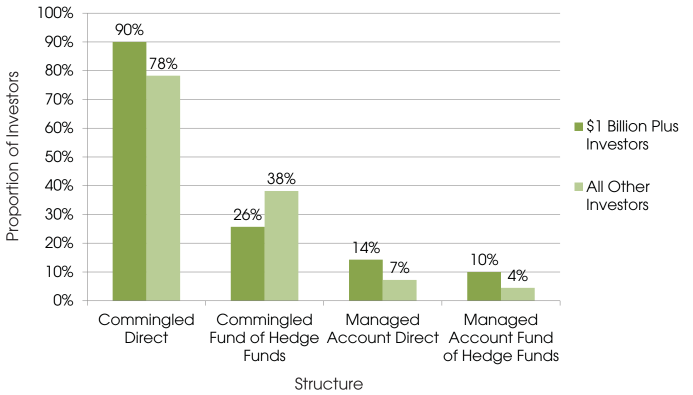
account mandates from their managers than the rest of the investor universe, as they have the internal resources to cope with the additional management burden of managed accounts, as well as the desire for the ownership of the fund through this structure.

One investor which expects to be active in hedge funds over the coming 12 months is Arizona Public Safety Personnel Retirement System. The $7.2bn pension fund currently allocates around 20% of its total assets under management to various hedge fund strategies and plans to make six new hedge fund investments over the coming year. It is targeting direct investments in commingled multi-strategy hedge funds and will consider managers on a case-by-case basis. Dutch asset management firm MN also expects to be active in hedge funds over the coming year. The group currently allocates approximately 5% of its €90bn assets under management to a portfolio of 27 hedge funds. It plans to make four new investments over the course of the year, with strategies such as managed futures/CTA, macro and equity market neutral under consideration for new investments.

Outlook

Due to their investment resources and strong capital base, the group of investors allocating $1bn or more to hedge funds will remain a key component of the institutional universe over the coming year. These investors represent more than $550bn in hedge fund assets and their large investment sizes make them key targets for hedge fund managers looking to source institutional capital. Many of the $1bn plus investors regularly turn over hedge funds in their portfolio in order to take advantage of the best opportunities. This group of investors is also likely to provide a significant source of capital to emerging managers, with 81% of the investors that allocate $1bn or more to hedge funds considering investing with emerging managers.

Fig. 6: Structures Sought Over the Next 12 Months: $1 Billion Plus Investors vs. All Other Investors



Source: Preqin Hedge Fund Investor Profiles

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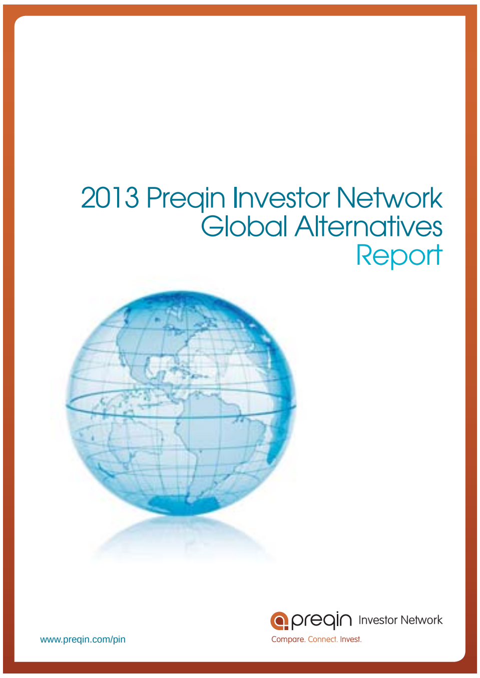

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