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Is Investor Appetite for Emerging Manager Hedge Funds Declining?

In today's turbulent economic climate, many investors in hedge funds are pursuing the stability of established managers, leaving emerging managers with a shortfall in institutional investor interest in their offerings. Graeme Terry explores the latest trends in investor appetite for emerging funds and the outlook for the future.

Hedge funds managed by new and emerging managers can be attractive to investors as such funds are often more nimble, provide a larger opportunity set and a more streamlined decision making process. However, investing in emerging managers is often perceived to be riskier than investing with established managers due to the lack of track record.

2011 was a challenging year for emerging managers seeking institutional capital and 2012 has continued to prove difficult. Confidence in hedge funds among investors has decreased over the past year and institutions have begun to re-evaluate hedge funds and their role in their portfolio, and as such, it has become even more difficult for emerging funds to attract capital from institutional investors. As a result, overall appetite for emerging managers has decreased over the past 12 months as investors continue to look for more established funds amid ongoing financial uncertainty.

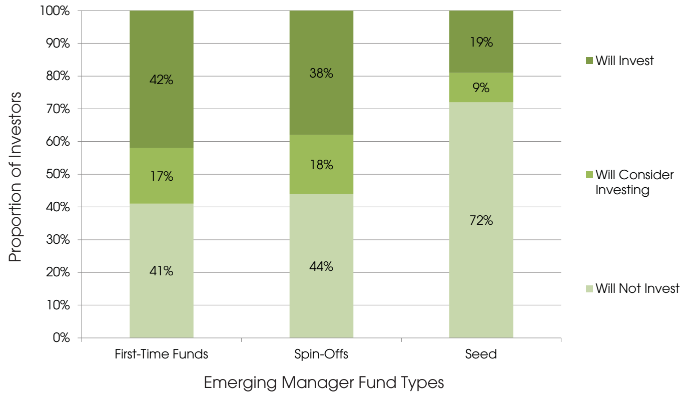
Institutional Investor Attitudes to Emerging Manager Hedge Funds

A Preqin study in December 2011 indicated that 83% of investors in hedge funds allocate to emerging managers due to their potential to offer stronger returns. If the performance of established hedge funds continues to disappoint, then there may be opportunities for emerging managers to attract capital from dissatisfied investors. Other reasons for investors targeting emerging managers include an ability to negotiate better terms, access to new strategies, a greater alignment of interests between manager and investor, and the fact that emerging managers can offer long-term investment prospects.

As shown in Fig.1, first-time funds continue to attract the most attention of all emerging manager funds among institutional investors in hedge funds on the Preqin database, with 42% of these investors willing to commit capital to these vehicles. While this is a healthy percentage of interested investors, it is significant that this figure has decreased from 54% in 2010 and 48% in 2011, demonstrating that appetite for these funds is continuing to decline. A further 17% of investors would consider making commitments to first-time funds, but 41% will not invest in first-time funds, a proportion that has increased from the 38% of investors which indicated they would not invest in first-time funds in 2011.

Interest in hedge funds managed by spin-off teams has also dropped over the past year, with 38% of investors indicating they are interested in such funds compared to 43% in 2011. Spin-offs had previously shown the largest fall in investor appetite, decreasing

Fig. 1: Institutional Hedge Fund Investor Attitudes towards Emerging Manager Fund Types



Source: Preqin Hedge Fund Investor Profiles

from 61% to 45% between 2009 and 2010. Spin-off funds provide access to experienced industry professionals but they do not always offer exposure to the value-added niche strategies that investors typically look for in an emerging manager allocation.

There has also been a reduction in the number of investors that are willing to provide seed capital to start-up hedge funds over the past year. Interest in seeding hedge funds among investors almost doubled between 2009 and 2010 but decreased in the following years from 21% in 2011 to 19% in 2012. Seeding can provide benefits to investors as they can take ownership stakes in hedge funds; however, there is higher risk involved in investing in funds with no previous track record. There has been an increase in the number of specialist seeding platforms in recent years, with seeding specialists offering investors the opportunity to gain exposure to start-up hedge funds without the risk involved in selecting funds themselves. Fund of hedge funds manager Hermes BPK announced earlier this year that it planned to launch a hedge fund seeding platform with the assistance of private equity firm Northern Lights Capital Group.

Breakdown of Emerging Hedge Fund Managers by Investor Type

Investors in emerging hedge fund managers typically tend to be those with a large capital base and strong investment resources. As a result, it is unsurprising that funds of hedge funds remain the investor type most likely to invest in small and emerging funds, as shown in Fig. 2. The proportion of funds of hedge funds interested in emerging managers has remained relatively constant over the previous year and currently 70% indicate an interest in such funds.

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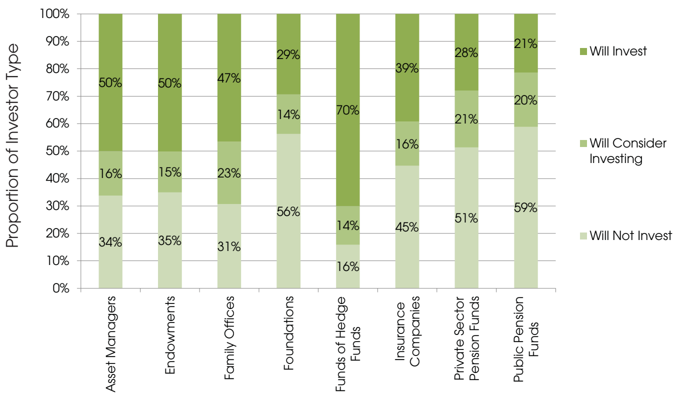
Fig. 2: Institutional Hedge Fund Investor Attitudes towards Emerging Managers by Investor Type



Source: Preqin Hedge Fund Investor Profiles

Endowments are typically experienced investors with a long-term outlook on the asset class – they have traditionally been one of the most active investor groups in terms of investing in emerging managers. However, appetite for emerging managers among endowments appears to be decreasing, with 50% currently interested compared to 65% in 2010 and 58% in 2011. Although this is disappointing for emerging managers, endowments remain second in terms of proportional interest in such hedge funds and a number of these remain active in the space. Hawaii-based Kamehameha Schools is an example of an endowment that actively considers investments in emerging managers. Asset managers are another investor group which targets emerging manager hedge funds, with 50% of these investors indicating an interest. Similar to funds of hedge funds, these investors are likely to have a strong investment team, allowing them to carry out the necessary due diligence on lesser-known funds.

Family offices have shown a slight increase in appetite for emerging manager hedge funds over the previous year, with 47% of these investors interested compared to 44% in 2011. This is still well below the 54% that indicated an interest in 2010, but the small increase shows that family offices may be starting to regain faith in the benefits offered by emerging funds. Smaller, more entrepreneurial funds often appeal to family offices for their potential for greater diversification, stronger returns, and access to better fund terms. The percentage of foundations interested in emerging managers has also increased slightly in the past year to 29% compared to 26% in 2011. Foundations vary signficantly in terms of size and resources and while some of the larger foundations are happy to actively seek emerging managers, the smaller foundations are more likely to invest with well-known managers.

Pension funds have traditionally been more conservative hedge fund investors and, as a result, they have tended to prefer investing with established names over emerging managers. Interest in emerging manager hedge funds among pension funds has remained relatively static over the past year, with 28% of private sector pension funds and 21% of public pension funds currently interested in such funds. Over the past few years, pension funds have tended to target investments with experienced managers in order to obtain the perceived security offered by well-known funds. Despite this, pension funds can still be a key source of capital for emerging managers due to their large dollar allocations. Some

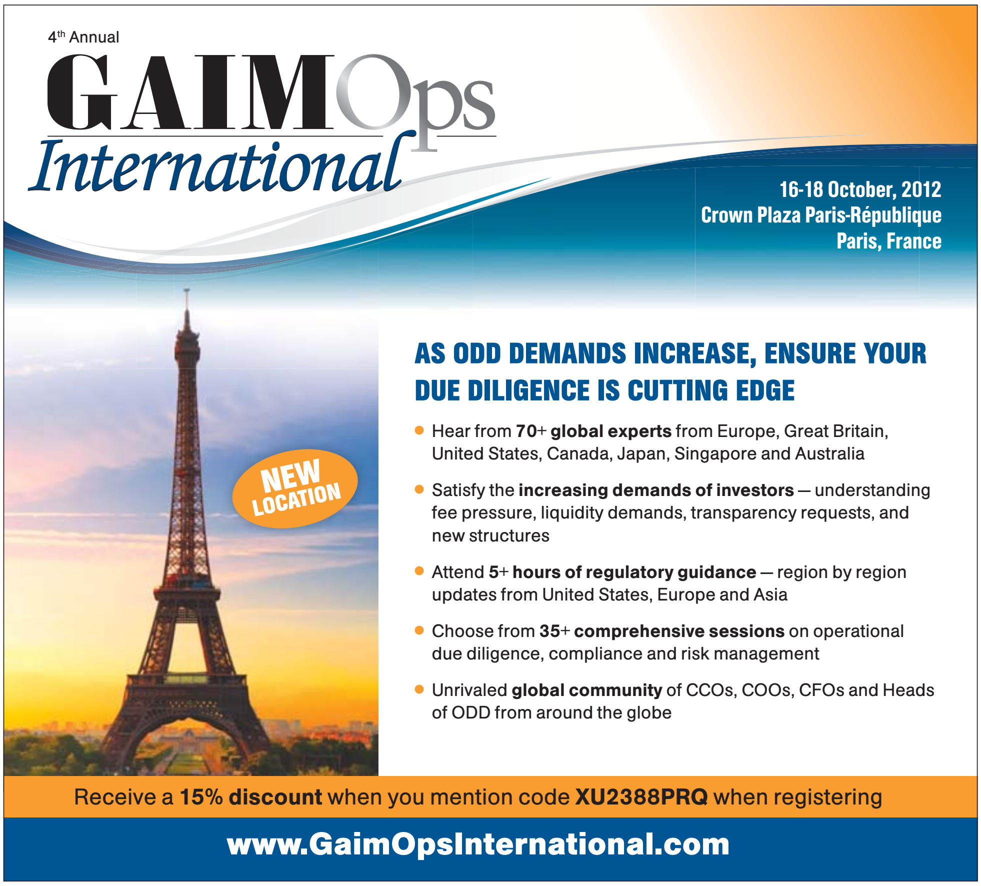


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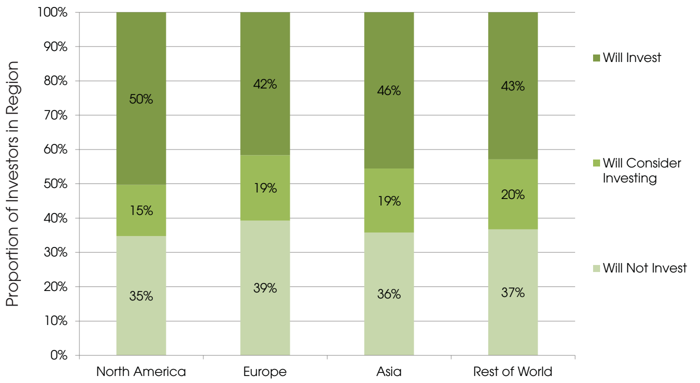
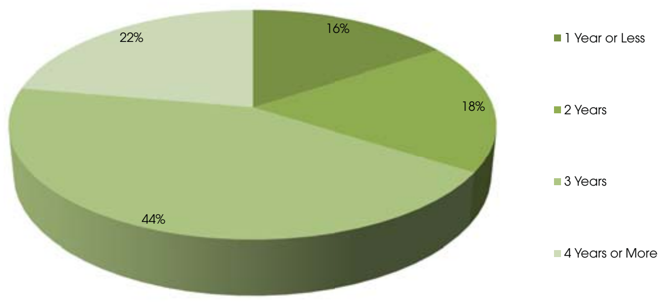
Fig. 3: Institutional Hedge Fund Investor Attitudes towards Emerging Managers by Investor Region



Source: Preqin Hedge Fund Investor Profiles

Fig. 4: Minimum Fund Manager Track Record Required by Institutional Investors in Hedge Funds



Source: Preqin Hedge Fund Investor Profiles

pension funds are keen to invest with emerging managers in order to diversify their holdings and tap into new sources of alpha.

Geographic Breakdown of Investors in Emerging Hedge Fund Managers

North America is the most established region in terms of hedge fund investing and the majority of capital committed to emerging managers comes from this region. The number of fund launches in this region is currently significantly higher than in other regions worldwide, meaning there are more opportunities for investors based in North America to access emerging manager funds being raised in their region. Overall appetite for emerging managers in North America has grown marginally over the last 12 months, with Fig.3 showing 50% are now willing to commit to emerging managers compared to 48% in 2011. This proportion is still some way below the 60% of investors that planned to commit to such funds in 2010. Interest from Europe-based investors in emerging managers has also shown an increase over the past year from 39% in 2011 to 42% in October 2012. Investors in this region are typically more cautious, particularly in light of the ongoing sovereign debt crisis.

Investors in Asia and Rest of World have shown the largest change in appetite for emerging manager hedge funds over the past 12 months. Overall hedge fund performance has been disappointing, which has led to many investors in the region to try to reduce risk in their portfolios. Current investor appetite for emerging managers stands at 46% for Asia and 43% for Rest of World, which is a significant decline on the 53% and 58% respectively that were interested in 2011. Investors in these regions do not typically have the same experience as investors in Europe or North America and may feel that investing with established managers poses fewer risks in the uncertain financial climate.

Barriers to Entry for Emerging Hedge Fund Managers

As a result of growing concerns over hedge fund performance, investors are now more demanding than ever when it comes to selecting hedge fund managers. Over recent years there has been a decrease in investors targeting funds with a two-year track record or less. Thirty-four percent of investors in hedge funds said they would invest in such a manager in 2011 compared to 54% in 2009. This trend has continued over the course of 2012, with 34% of investors still indicating they would be willing to invest in a manager with a two-year track record or less (Fig. 4). Forty-four percent of all investors in hedge funds look for at least a three-year track record, with a further 22% requiring managers to have at least four years of previous experience. Managers with a track record stretching back at least three years have shown themselves to be able to cope in challenging economic circumstances, making them attractive to cautious investors. Preqin's historical data on investor track record requirements show that currently the majority of investors (66%) will not invest in a fund with a track record of less than three years, which is a substantial increase compared to 2009 when this proportion stood at 46%. This suggests that investors are trying to reduce risk by investing with managers with strong previous experience.

More investors are also looking to invest in larger managers in an attempt to find funds which can produce consistent and reliable returns and have shown considerable success in gaining commitments from other investors, according to Fig. 5. Seventy-four percent of institutional investors will invest in managers with less than $500mn in assets under management, which is a slight reduction on the 78% that indicated this in 2011. Public pension funds are most likely to look for larger funds, with 62% of this investor group requiring assets under management of at least $500mn. Despite this trend towards larger funds, a number of investors retain a preference for smaller funds as these funds are typically in a better position to react quickly to market changes.

Outlook

2011 and 2012 have proved to be challenging years for hedge fund investors and there has been a noticeable shift of investors moving towards investing with more experienced hedge fund managers in the wake of market uncertainty. This has led to a difficult environment for emerging managers attempting to raise capital, with investors often unwilling to take too many risks in these challenging economic times. Despite this, 42% of institutional investors remain happy to allocate to emerging managers, which means there should continue to be opportunities for potential investment. The emerging manager hedge fund space is continuing to evolve and these managers are

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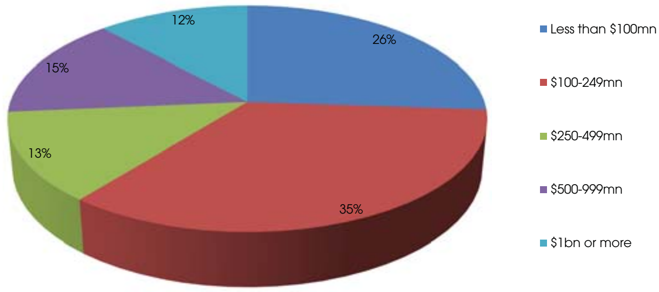
capable of producing strong returns and additional diversification benefits. Investors are becoming increasingly disappointed with hedge fund returns and so may be tempted to look towards smaller managers that can offer higher alpha, lower fees, and greater transparency.

In this difficult fundraising environment, hedge fund managers must work to understand the institutional community of investors and market an emerging fund to the appropriate sources of capital. Preqin currently has information on more than 950 institutional investors that have indicated a preference for small and emerging funds and, as a result, Preqin's Hedge Fund Investor Profiles database can be indispensible to those managers looking to gain the attention of the institutional investors.

Fig. 5: Minimum Fund Manager Assets under Management Required by Institutional Investors in Hedge Funds



Source: Preqin Hedge Fund Investor Profiles

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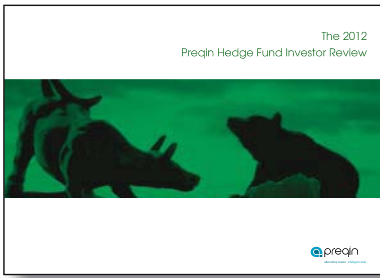
- Analysis of emerging manager investors.
- Exclusive information gained through direct contact with institutional investors.



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