2015 Preqin Global Hedge Fund Report

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The 2015 Preqin Global Hedge Fund Report
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Keynote Address - Anne-Gaelle Pouille, Senior Portfolio Manager, PAAMCO

What investment strategies or sectors do you think will succeed in 2015?

In 2014, investor worries over global growth rattled markets. The wide dispersion in economic indicators, increased political risk and second half oil shock all led to a challenging investing environment and disparate outcomes across markets. Looking ahead to 2015, while it remains difficult in many regions to invest with clarity, this also signals opportunity for long/short investors with medium- to long-term investing horizons.

As investors in hedge funds, PAAMCO aims to build all-weather portfolios; nonetheless, we see a number of fulcrum market drivers to watch in 2015. Perhaps the most obvious is energy prices that have both first order (e.g. on the oil, transportation or renewable energy sectors) and second order effects (e.g. on the consumer sector). A second key factor is Central Bank policy divergence: this yields opportunities for relative value trading from increased and mispriced rate volatility. Our third bellwether factor for global investing is Europe: will 2015 be the year of Europe's recovery, or of its descent into deflation? While the US engine is ticking along fairly reliably, Europe remains less certain at the very least until the January-end ECB meetings and Greek elections.

Our base case at PAAMCO this year is the continuation of the macro versus micro debate, with sentiment playing a critical role. In this environment, we believe that the best chance for above market returns is the combination of tactical trading of mis-valued securities with staying power while other investors may be forced to exit. A word on event driven strategies: yes 2014 was challenging, but we continue to believe 2015 will be an alpha-rich environment if you pick your spots – in that respect we prefer hard catalysts, shorter time horizons and smaller "off the radar" situations (to limit crowdedness), such as those favoured by small or emerging managers. Of course risk/reward can change very fast in any geography or strategy and therefore PAAMCO is constantly re-evaluating.

Are there strategies, sectors or regions you will be avoiding or underweighting in the year ahead?

In aggregate we are excited but cautious about the investing environment. We advocate a relatively market-neutral approach in Europe until the fog clears. We have little exposure to Russia as the way forward there is very uncertain. There are much clearer winners (Japan for example) and losers (such as Nigeria or Venezuela) from the recent oil price decline. Broadly speaking, we're wary of many emerging markets. Specific examples include Eastern European emerging markets because of the political risk and Brazil, which continues to struggle even post-election.

What does 2015 hold for smaller or emerging managers? Has the task of being a smaller fund become more difficult?

On balance, I expect more of the same in the US; I wouldn't say it is more difficult in 2015 because the big regulation step-up happened a few years ago. In Europe there is still substantial uncertainty on the AIMFD front. I definitely think emerging managers need to be realistic about how hard it remains to raise capital. That said, PAAMCO expects rich opportunities for smaller funds in 2015 because of increased market dispersion. Also, the trend that several large "go-to" funds are closing or are increasingly capacity constrained should help smaller funds, especially as the net dollar inflows into hedge funds witnessed these past several years are expected to continue. Anecdotally there is growing interest in emerging manager programs and smaller funds appear to be sought after, either as a standalone investment or as a complement to portfolios of larger managers.

What can emerging managers do to stand out?

Obviously, convincing the prospective investor that future performance will be strong helps. Beyond that, PAAMCO looks for a willingness to work within an institutional framework, specifically with regards to structuring, transparency or customization. In brief, emerging managers can help their case materially by being investor-friendly. In exchange, a good partner will help the fund become "institutional grade" and build a track record from which it can springboard into whatever its growth plans are.

Why should investors consider smaller or emerging managers as part of a diversified portfolio?

Ok, so the argument that emerging managers tend to outperform during their first years of existence is well documented. Substantial academic research supports this outperformance, as do the popularity and performance of live emerging manager programs. So investors already seek out the emerging premium – they just want to access it in a way that mitigates the specific risks. That's their biggest concern. The second biggest hurdle is probably sizing. Many investors do not have the resources to source and coach these younger funds, and when they do find them they can invest maybe $100mn or $200mn with them. So it is rarely economical – in that sense, funds of hedge funds can be very helpful. Specific funds of hedge funds can credibly offer economies of scale on the research front, deep emerging manager expertise and inbuilt diversification.

Benchmark returns across hedge funds were relatively poor in 2014; do you think this will have any impact on investor allocations in 2015, or do you think investors can see value in hedge funds beyond sheer returns?

Hedge funds need to continue to make money on a risk-adjusted basis. 2014 was not a banner year for hedge funds, but looking over the medium and long term, hedge funds should continue to deliver. When thinking about possible flows into hedge funds, bear in mind also that most investors have 5%, 10% or typically at most 25% of their total program invested in hedge funds, so it is still quite small with room to grow. A growth tailwind we have noticed at PAAMCO is the rotation from fixed income and equity allocations into hedge funds in order to mitigate duration risk or equity risk overweights. So whereas before hedge fund allocations would come from some sort of alternatives bucket and maybe got reallocated from private equity or real estate, increasingly hedge fund allocations are sourced from long equity or long fixed income. This is a big shift for the hedge fund industry, because these are much bigger pools.

How is the fund of hedge funds model continuing to evolve?

A fund of funds that does just manager selection is probably going to fail. You have to offer much more than that. I think you have to address whatever pressure point exists with your client and try to be helpful. Often it is addressing a certain specific investment need – maybe an LDI-focused hedge fund program, or an emerging markets portfolio, or some other sort of customized solution. In addition, we have found that the ability to construct tailored portfolios fast, and to do so in scale and with enhanced asset control, is very valuable to many large investors who may not want to acquire the required internal resources to achieve all this. Today, best-in-class funds of hedge funds are both disciplined and nimble. They capture investment opportunities quickly. To achieve this they use separate accounts, receive full position-level transparency, and have large global investment teams that scour the opportunity set. This value added is often difficult to replicate in-house for all but the largest investors. To be clear – on the insource/outsource debate, there is no uniform "right decision." Rather you should just know what you are paying for and I would advocate that the best funds of hedge funds do add quantifiable value.

What is important to investors in 2015?

Regarding value, I think cost will continue to be topical. Recent studies indicate that most management fees for large tickets are around 1.5% to 2%, while most performance fees are still in the high teens or more. Yes, net-of-fee returns are all that should matter, but headline fees paid make, well…headlines. On a positive note, progress was made in 2014 with regard to fee transparency, meaning the industry is focusing more on "all-in" fees. This is about seeing what expenses have been charged to your fund; so, for example, a fund will say its management fee is 1.5% but when you look they are charging 50bps in expenses to the fund, so really it is 2%. Just dig and ask. Apart from value, another trend for 2015 is expected to be conviction, with many investors exhibiting a preference for higher conviction (higher concentration) mandates. Finally, improved asset control and transparency (think managed accounts) will continue to be of interest to large, sophisticated allocators as the standards that they are accustomed to in the "long only" world continue to become more common requirements for their "alternatives" exposures – this is a critical medium-term convergence trend between the two.

What will be the key challenge for the hedge fund industry in 2015?

I think the hedge fund industry may face some continued regulatory or performance headwinds in Europe. Aside from that, as I mentioned how hedge funds fit in institutional portfolios is undergoing a paradigm shift and the hedge fund industry will need to continue to adapt – this is both a challenge and a very exciting opportunity.

PAAMCO

PAAMCO is a boutique investment manager, serving the largest institutional investors worldwide. PAAMCO has a long track record of successfully creating value using hedge funds. Its headquarters are in Irvine California, with additional offices in London and Singapore. The firm is well known for its completeAlpha™ approach, which focuses on delivering performance from early stage opportunities, while controlling costs and protecting client assets. PAAMCO is privately held and currently has 18 Partners and over 135 Employees.

Anne-Gaelle currently serves as a member of PAAMCO's Portfolio Construction Group, where she allocates capital to the firm's hedge fund strategies and sets the investment direction for PAAMCO's flagship Moderate Multi-Strategy portfolio. Anne-Gaelle is also the Portfolio Manager for PAAMCO's Pacific Corporate Opportunities fund. In addition to her portfolio responsibilities, Anne-Gaelle serves on the firm's Risk Management Committee and leads several initiatives contributing to the firm's overall business success and direction. Anne-Gaelle is also a Partner responsible for several large client relationships in North America. As such she has led the design of higher concentration hedge fund solutions, with a focus on using early-stage hedge fund managers for implementation.

Anne-Gaelle joined PAAMCO in 2007. She began her financial career at UBS Investment Bank's London headquarters in 2000. As an investment banker for five years, Anne-Gaelle accrued substantial global transactional experience by working on several high profile M&A transactions, notably in the Transportation and Insurance sectors. Originally from France, Anne-Gaelle earned her Bachelors in Pure Mathematics with first class honors from Imperial College London and a Masters with Distinction from the London School of Economics. In 2007 she earned her MBA from Harvard Business School.

www.paamco.com

2015: A Year for Hedge Funds to Show What They Are Worth - Amy Bensted, Preqin

2014 Was a Challenging Year

Fund managers and investors alike entered 2014 with a positive outlook on the hedge fund sector. 2013 marked the second year of back-to-back double-digit returns; the industry continued to accumulate assets and investors looked set to put more money to work in the asset class over 2014. However, the first few months of 2014 dampened this enthusiasm, with the Preqin All-Strategies Hedge Fund benchmark in the red for three of the first four months of the year. The rest of the year proved difficult for both fund managers and investors to navigate, with the strategies that performed the best in the first half of 2014, such as event driven strategies, dropping to the bottom of the pile in the second half of the year. In contrast, the worst performing strategies experienced a reversal of fortune in H2 2014.

With hedge fund performance continuing to lag leading equity benchmarks, such as the S&P 500, the real value of hedge fund investment was called into question. In addition, the exit of CalPERS from hedge fund investment was one of the biggest stories of the year, and left industry commentators wondering if this would signal the start of the wider departure of pension schemes from hedge fund investment.

...But Also a Successful One

Despite all of the obstacles that 2014 presented, the industry continued to grow, adding $355bn in assets over the year. With the Preqin All-Strategies Hedge Fund benchmark making gains of just 3.78% over all of 2014, Preqin estimates that approximately $250bn of the assets added in 2014 was due to investor inflows. In addition, fund managers continued to launch new funds; 764 new single-manager funds were launched over the year, and 27% of fund managers have plans to launch a new vehicle in 2015.

The North American, in particular the US, hedge fund industry continued to show the strongest growth; US-headquartered hedge fund managers added $261bn in assets in 2014. Fund managers in Asia-Pacific also had a successful 2014; recent regulatory changes and continued interest in the region helped Asia-Pacific-based firms to amass an additional $33bn in 2014, taking their assets to $145bn.

Europe-based fund managers, however, have had a more challenging 12 months. Regulatory changes within the European Union (AIFMD) continue to cause concerns for fund managers based in the region (see pages 42-43). A smaller proportion of fund managers in Europe witnessed asset growth in 2014 than other fund managers globally.

Why Are Investors Continuing to Invest?

Despite another notable pension scheme, Netherlands-based PFZW, announcing at the start of 2015 that it redeemed its entire hedge fund portfolio at the end of 2014, CalPERS' departure has not, at least as we enter 2015, opened the flood gates for many more pension schemes to exit hedge fund investment. There are more institutions than ever investing in hedge funds, investing ever-growing portions of their total portfolio in the asset class and creating increasingly sophisticated portfolios of funds (see pages 80-83).

So why do investors continue to invest in hedge funds, even though 2014 was a disappointing year in regards to industry performance? The industry has proven its ability to deliver consistent returns over longer timeframes (see pages 14-17), and it is this potential for solid risk-adjusted returns that appeals to investors. In fact, investors are not looking for hedge funds to match the S&P, but instead are turning to hedge funds to diversify their traditional equity and bond holdings with an attractive risk/return profile. With increased volatility in equity markets in 2014, and global macroeconomic events potentially leading to a difficult returns environment for traditional investments in 2015, the year could be a vital one for hedge funds to prove their true value. Indeed, as Anne-Gaelle Pouille from PAAMCO observes (page 5), "looking ahead to 2015, while it remains difficult in many regions to invest with clarity, this also signals opportunity for long/short investors with medium- to long-term investing horizons." If fund managers are able to successfully capitalize on the market volatility, hedge funds could reaffirm their value by generating some strong performance, uncorrelated to other asset classes, in 2015.

What Are the Challenges Fund Managers Face in 2015?

Regulation, generating returns in the current environment and fundraising are all key concerns for fund managers in the year ahead (see page 41). Smaller or emerging fund managers continue to face a challenging fundraising task; however, investors remain interested in these funds in the year ahead: 52% of investors that participated in our survey said they would either invest or consider investing in such a fund in 2015 (page 84). In fact, as some of the largest funds reach capacity or close to new investment, we may see some smaller funds pick up new mandates as investors seek to put more capital to work in hedge funds in 2015.

Following a difficult year in terms of performance, the calls for hedge funds to cut back fees have intensified as we enter 2015. However, all fund managers – both emerging and established – will need to continue to listen and respond to all investor demands over the course of the year in order to attract capital in 2015.

Outlook

Although 2014 was undeniably disappointing for fund managers, and for the investors in their funds in terms of performance, the year was another successful one for the industry. Inflows continued to outpace redemptions, even taking into account that some high-profile investors cut hedge funds from their portfolios; fund managers still saw opportunities to launch new strategies and the proliferation of new products, such as liquid alternatives, has opened up hedge fund investment to a wider audience.

2015 looks set to be another year for asset growth; investors plan to put more money to work in hedge funds, and fund managers are similarly predicting the industry will grow further over the year. Although the year will undoubtedly pose challenges for hedge funds, if managers can capitalize on the opportunities that have arisen as volatility returns to markets, then it may be a year in which hedge funds can show their true value as a risk-adjusted returns stream within a diversified portfolio.

Hedge Funds in Numbers

2014 in Review

Industry Assets Surpassed $3tn

$3.019tn

$355bn
of assets added in 2014

Hedge funds struggled with performance

+3.78%

Worst year since **2011**

CTAs fared better

+9.96%

Best year since **2010**

4,800+ Institutions Invest in Hedge Funds

Net Increase in the Number of Hedge Funds in the Market

764 Funds launched in 2014

260 Funds liquidated in 2014

Outlook for 2015

Fund Managers Are Expecting the Industry to Grow

80% of fund managers believe the industry will add assets in 2015.

4% of fund managers believe the industry will lose capital in 2015.

Fund Managers Are Largely Confident of Better Performance

60% believe the Preqin All-Strategies Hedge Fund benchmark will end up higher in 2015 than in 2014.

2014 Performance: 3.78%

12% believe the Preqin All-Strategies Hedge Fund benchmark will end up lower in 2015 than in 2014.

Investors' Plans for Hedge Fund Allocations in 2015

26% Increase allocation to hedge funds

58% No change to allocation to hedge funds

16% Decrease allocation to hedge funds

27% of fund managers have plans for a new launch in 2015.

Performance Benchmarks

Fig. 3.1: Summary of Performance Benchmarks (As at December 2014) (Net Returns, %)*

	2014	2013	2012	2-Year Annualized	3-Year Annualized	5-Year Annualized	3-Year Volatility	5-Year Volatility
Hedge Funds	**3.78**	**12.25**	**10.80**	**7.93**	**8.88**	**7.74**	**3.94**	**5.15**
HF - Equity Strategies	3.86	15.41	11.04	9.48	10.00	7.59	5.45	7.13
ES - Long/Short Equity	3.49	14.52	9.61	8.86	9.11	6.99	4.80	6.33
ES - Long Bias	3.68	18.97	16.65	11.07	12.90	9.80	8.18	10.51
ES - Value-Oriented	11.88	18.17	17.53	14.98	15.83	10.91	7.23	9.25
ES - Sector-Focused	9.72	12.41	0.84	11.06	7.54	n/a	6.57	n/a
ES - North America	5.88	22.18	10.67	13.74	12.71	10.45	5.71	7.81
ES - Europe	2.12	15.63	9.12	8.67	8.82	5.56	4.99	5.84
ES - Asia-Pacific	5.45	19.37	13.54	12.19	12.64	8.31	6.30	7.89
ES - Emerging Markets	2.82	7.31	15.07	5.04	8.28	5.92	7.46	8.55
ES - Developed Markets	9.78	16.07	14.79	12.88	13.52	8.98	5.00	5.85
HF - Macro Strategies	1.99	4.77	8.39	3.37	5.02	5.70	2.75	3.31
MS - Macro	5.07	6.26	9.64	5.67	6.98	7.14	2.76	3.26
MS - Commodities	-9.71	-5.19	3.96	-7.47	-3.81	0.26	7.09	7.82
MS - Foreign Exchange	-4.87	1.16	3.66	-1.90	-0.08	1.48	3.56	3.62
HF - Event Driven Strategies	1.54	15.62	12.38	8.35	9.68	8.63	4.70	6.01
ED - Event Driven	2.60	18.44	13.04	10.24	11.16	9.41	4.77	6.19
ED - Distressed	-3.24	16.81	16.89	6.31	9.73	9.50	5.45	6.67
ED - Special Situations	-0.95	14.20	9.71	6.35	7.46	6.86	6.59	7.38
ED - Risk/Merger Arbitrage	2.26	6.67	5.31	4.44	4.73	4.90	2.56	2.51
HF - Credit Strategies	5.59	9.36	15.58	7.46	10.10	10.88	2.19	2.96
CS - Long/Short Credit	4.00	9.39	14.45	6.66	9.19	9.47	2.44	3.09
CS - Fixed Income	4.45	5.94	13.25	5.19	7.81	8.92	2.41	3.11
CS - Mortgage-Backed Strategies	9.53	12.23	20.81	10.87	14.09	15.05	2.44	3.00
CS - Asset-Backed Lending	9.26	13.33	18.15	11.28	13.52	15.17	1.97	3.50
HF - Relative Value Strategies	4.56	8.95	7.60	6.73	7.02	7.17	1.50	1.79
RV - Equity Market Neutral	3.30	8.65	4.73	5.94	5.54	5.55	1.41	1.45
RV - Fixed Income Arbitrage	3.57	5.10	10.26	4.33	6.27	7.60	2.16	2.32
RV - Relative Value Arbitrage	5.89	11.74	11.07	8.77	9.53	9.07	1.63	2.27
RV - Statistical Arbitrage	6.71	8.41	4.18	7.56	6.42	7.49	3.41	3.15
RV - Convertible Arbitrage	6.12	17.43	11.74	11.63	11.67	9.26	4.84	5.96
RV - North America	4.64	6.19	8.03	5.41	6.28	7.40	1.44	2.04
RV - Asia-Pacific	4.84	18.59	8.04	11.50	10.34	8.62	3.61	3.64
HF - Multi-Strategy	4.30	8.38	8.98	6.32	7.20	6.88	3.09	3.89
HF - Niche Strategies	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
NS - Insurance-Linked Strategies	7.88	6.48	6.97	7.18	7.11	n/a	1.09	n/a
NS - Niche	1.08	3.36	13.68	2.22	5.90	n/a	6.50	n/a
HF - Trading Styles	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Activist	5.10	16.74	11.74	10.77	11.09	8.36	5.92	8.11
Volatility	2.66	7.67	8.97	5.14	6.40	7.32	2.12	1.94
Discretionary	4.20	17.66	12.84	10.72	11.42	8.84	4.68	6.11
Systematic	4.13	8.96	6.68	6.52	6.57	6.70	2.40	2.93
HF - North America	5.75	17.39	11.86	11.42	11.56	10.67	4.21	5.95
HF - Europe	2.91	13.50	10.16	8.07	8.76	6.72	3.85	4.76
HF - Asia-Pacific	5.46	18.09	12.53	11.60	11.91	8.44	5.36	6.55
HF - Emerging Markets	2.54	6.68	13.08	4.59	7.35	6.19	5.62	6.44
EM – Asia	17.51	8.48	17.32	12.91	14.36	7.27	9.34	11.27
EM – Latin America	1.55	1.93	14.74	1.74	5.90	6.36	5.11	5.07
EM – Africa	6.22	20.61	15.69	13.19	14.02	12.11	4.18	4.19
EM – Russia & Eastern Europe	-24.50	1.02	6.53	-12.67	-6.69	-3.92	12.89	14.18
HF - Developed Markets	6.29	11.29	11.21	8.76	9.57	8.66	2.59	3.27
HF - USD	3.35	12.75	11.07	7.95	8.98	7.91	4.34	5.81

Fund Manager Survey - Fund Manager Outlook for 2015

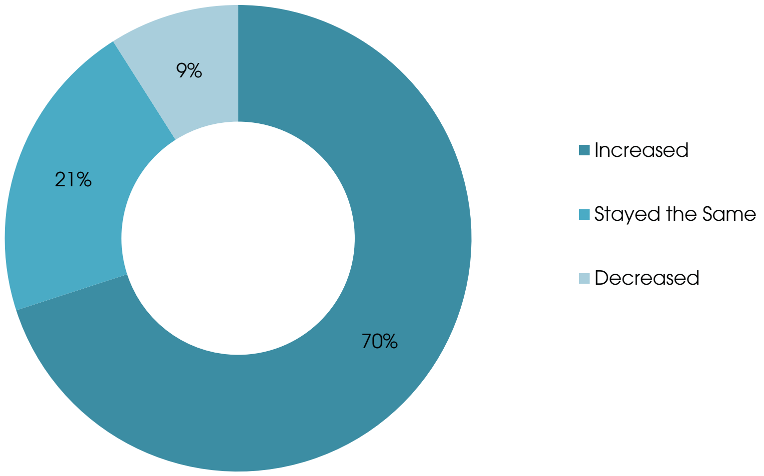
Preqin conducted a series of interviews with over 150 hedge fund managers in November 2014 in order to ascertain their current views on the pressures they face as managers and their outlook for 2015. Hedge fund managers were asked to give their opinion on a variety of issues they face in the industry today, the key challenges in 2015, regulation and their outlook on the industry's growth potential over the year.

Hedge Fund Managers Accumulate Assets in 2014

2014 has presented many challenges to fund managers, in particular, a volatile macro environment has led to the monthly hedge fund benchmark dipping into negative territory on six occasions; despite this, the hedge fund industry accumulated $355bn in assets as a whole over the course of 2014. A large proportion (70%) of individual fund management groups noted that they had grown over the course of the year (Fig. 4.33). Just 9% of fund managers witnessed outflows.

Fig. 4.34 shows the reported change in assets from institutional investors over the course of 2014. Fund managers continue to see an increase in the amount of capital they receive from institutional investors: 44% of fund managers witnessed an increase in 2014, compared to 41% in 2013.

Fig. 4.33: Reported Change in Assets Managed by Hedge Fund Managers



Source: Preqin Fund Manager Survey, November 2014

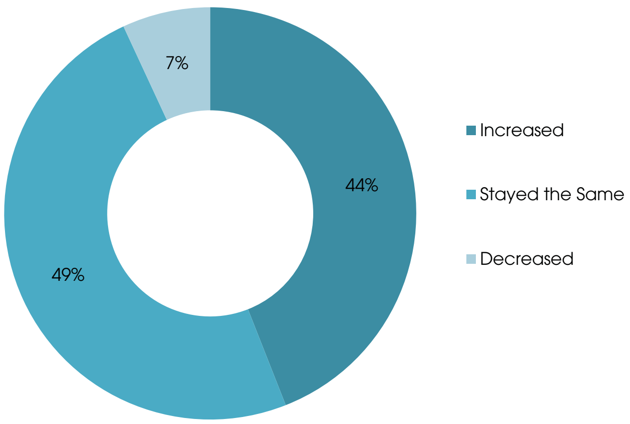
Fig. 4.35 shows the reported change in assets from private wealth groups and retail clients. Continuing a trend witnessed over 2013, inflows from sources of private wealth such as family offices, wealth managers and high-net-worth individuals have outpaced that of institutional investors in 2014. Fifty-eight percent of hedge fund managers whose investors include family offices and wealth managers, and 59% of fund managers that have high-net-worth support reported that they have seen inflows from these investors in 2014.

At the end of 2013, we estimated that 65% of hedge fund assets came from institutional investors; however, as a result of the inflows from private capital sources over the past 18 months, this has fallen slightly to 62% today.

Equity Strategies and CTAs Planned for 2015

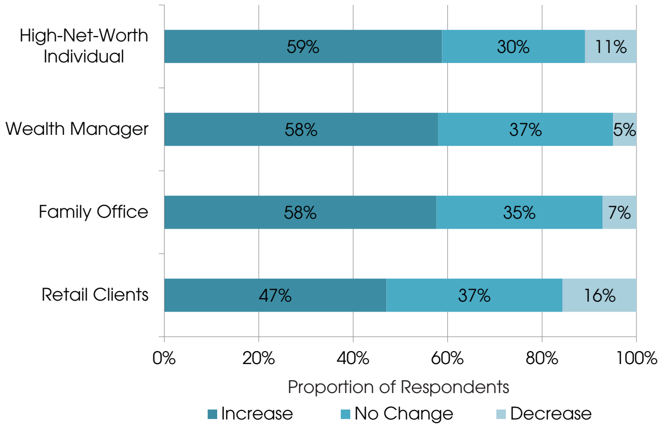
Preqin asked fund managers about their intentions to launch new funds in 2015, as well as their outlook on the performance of the industry for the year ahead, in order to assess where this

Fig. 4.34: Proportion of Fund Managers that Noted a Change in the Amount of Capital Coming from Institutional Investors in 2014



Source: Preqin Fund Manager Survey, November 2014

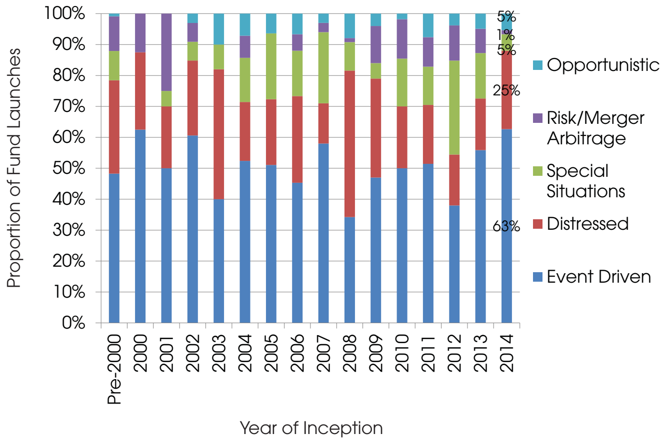
Fig. 4.35: Proportion of Fund Managers that Noted a Change in the Amount of Capital Coming from Private Wealth Groups in 2014



Source: Preqin Fund Manager Survey, November 2014

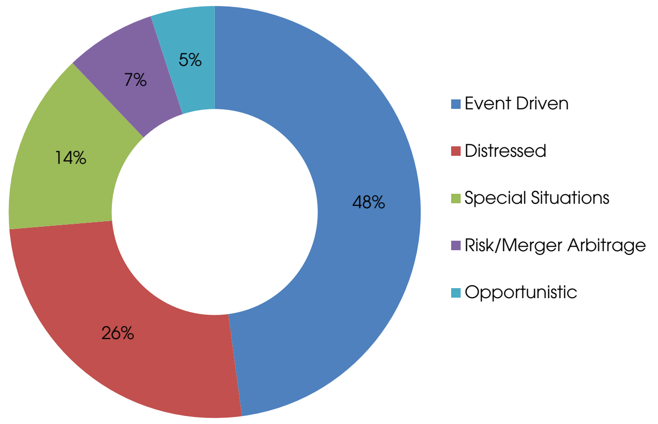
Event Driven Strategies Funds

Fig. 5.17: Breakdown of Event Driven Strategies Fund Launches by Year of Inception and Strategy



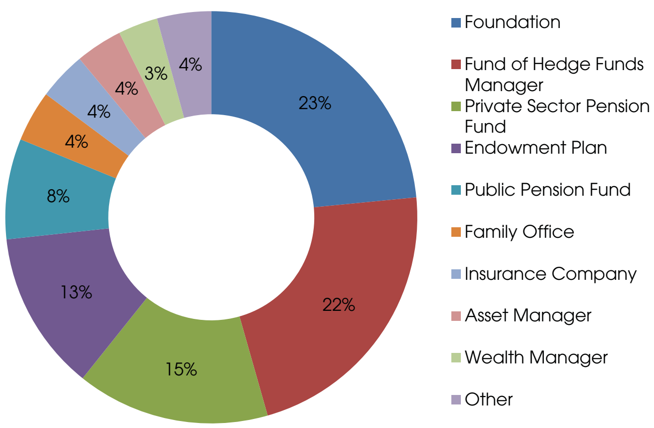
Source: Preqin Hedge Fund Analyst

Fig. 5.18: Breakdown of Event Driven Strategies Funds by Strategy



Source: Preqin Hedge Fund Analyst

Fig. 5.19: Breakdown of Investors in Event Driven Strategies Funds by Type



Source: Preqin Hedge Fund Investor Profiles

In Brief

586 Number of hedge fund managers offering an event driven strategies fund.

29% Proportion of event driven strategies funds that posted losses in 2014.

1,304 Number of active event driven strategies funds in market.

+1.54% Event driven strategies funds posted their lowest annualized return in 2014 since 2011 (-2.24%).

2,138 Number of institutions currently investing in event driven strategies funds.

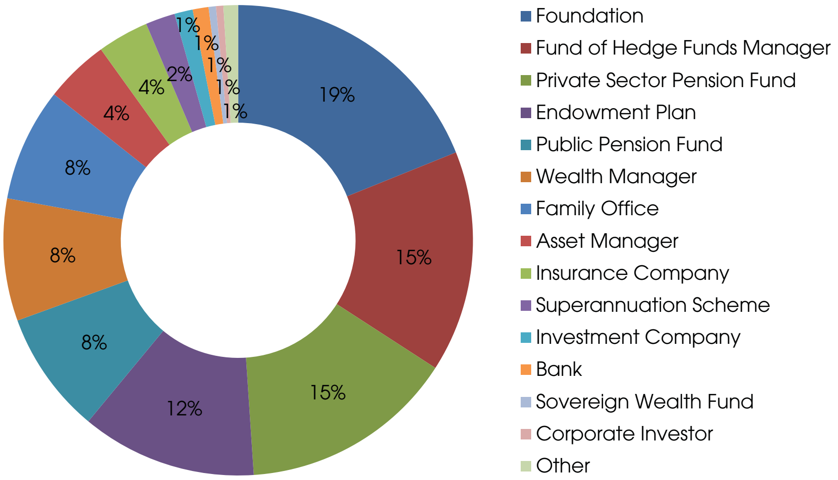
4.70% Three-year volatility of event driven strategies funds is higher than the industry benchmark (+3.94%).

Know Your Investor – The Institutional Investor Universe

Over 4,800 institutional investors across the globe are using hedge funds to diversify their portfolios and to add a source of risk-adjusted returns to their holdings (see page 76: Investor Survey to find out more about why investors allocate to hedge funds). Hedge funds are moving from the peripheries of investor portfolios into the mainstream, as a wider group of institutions look to hedge funds to meet their liabilities and to meet wider portfolio expectations. With the introduction of new regulations and the ongoing review of existing ones, as well as a growing understanding of the importance of these funds, institutional investors have gained confidence in the wealth creation and protection that the asset class can offer.

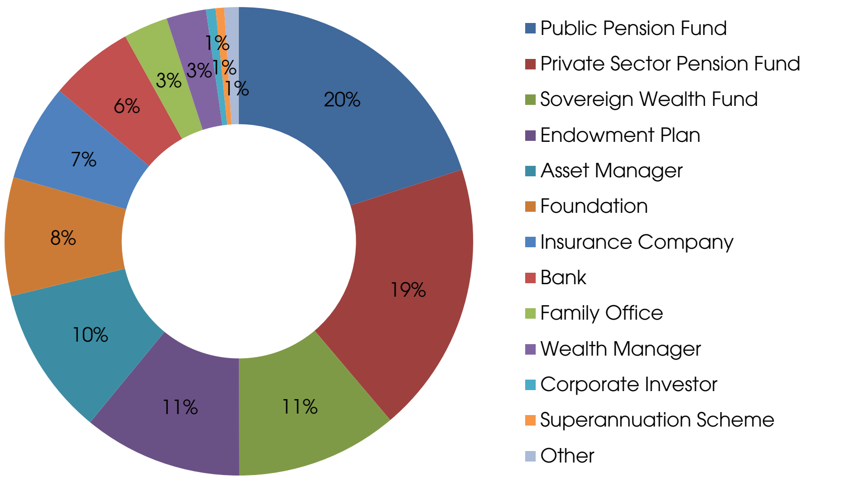
In this section, we examine the hedge fund investor universe by investor type and how this marketplace has grown and evolved in recent years. Figs. 6.22-27 show breakdowns of the hedge fund investor universe by investor type, including the proportion of all hedge fund capital invested by these investors, the mean maximum lock-up period accepted by them, mean returns expectations, mean allocation to hedge funds, and overall investment approach.

Fig. 6.22: Breakdown of Hedge Fund Investor Universe by Investor Type



Source: Preqin Hedge Fund Investor Profiles

Fig. 6.23: Breakdown of Institutional Investor Capital Invested in Hedge Funds by Investor Type



Source: Preqin Hedge Fund Investor Profiles

Public Pension Funds

The involvement of public pension funds in the hedge fund industry came under the microscope in the second half of 2014, after a handful of large US schemes, most notably California Public Employees' Retirement System (CalPERS), reduced or cut their allocations to the asset class. CalPERS held investments totalling $4.5bn at that time, and at the end of 2013 was the sixth largest US public pension fund in terms of capital allocated to the asset class. Following these high profile departures from investment in hedge funds, questions were asked about whether this would signal a wider exodus from the asset class by this influential group of investors. However, the signs at the moment remain positive; the average allocation of a public pension fund investing in hedge funds has continued to increase over 2014 (Fig. 6.26) and more public pension funds than ever before are using hedge funds in their portfolios. Indeed, public pension funds remain the most significant group of investors which allocate capital to hedge funds today, representing 20% of all institutional capital invested in the asset class (Fig. 6.23), and 8% of the total number of investors (Fig. 6.22).

CalPERS cited the cost and complexity of hedge funds as well as difficulties in scaling up its program as the reasons behind its departure from the asset class. Other public pension funds have been able to navigate these problems by hiring more internal resource to manage their hedge fund programs, as well as boosting their allocations to hedge funds over recent years. Today public pension funds on average allocate 7.8% of their portfolios to investments in the asset class (Fig. 6.26), an increase from 2013. Some pension schemes have amassed sizeable portfolios – for instance, Maryland State Retirement and Pension System (MSRPS) invests 17% of its total assets under management in hedge funds, which amounts to more than $7.7bn.

As well as increasing their allocations to hedge funds, public pension funds have rally in the performance of CTA strategies in 2014, investment consultants continue to take a cautious stance towards the strategy. Just 11% of consultants are advising their clients to increase allocations to managed futures/CTA in 2015, and a further 26% are advising their clients to reduce their exposure.

The majority of consultants, 55% (Fig. 6.42), plan to recommend that their clients invest less capital in funds of hedge funds in 2015 than in 2014. In recent years, there has been increased competition between the fund of funds sector and alternative investment advisors. Consultancy groups can offer discretionary fund selection services, and some even offer fund of funds-like products to their clients. These services can offer the same fund selection, diversification and volatility-reduction benefits of a traditional fund of hedge funds, but at a lower cost.

When looking at consultant recommendations in terms of fund structures in 2015 (Fig. 6.43), there is a clear preference in favour of investment through managed accounts over commingled structures in the year ahead. Forty percent of the surveyed consultants intend to recommend that their clients invest more of their hedge fund capital through separately managed accounts, with just 10% recommending reductions in allocations via the structure. In contrast, only 9% of consultants are recommending their clients increase their exposure to commingled funds, and 29% plan to recommend investors allocate less capital via these structures.

Managed accounts can offer many benefits to clients. These structures give investors more control over their investments, and can offer greater transparency and liquidity than commingled funds. As a result of a challenging fundraising environment, more fund managers have begun to offer managed accounts to investors, particularly as the largest institutional investors with larger ticket sizes have shown an interest in such structures. Consultants are well-placed to help investors to source fund managers willing to offer managed accounts, as well as to assist their clients in processing the increased levels of transparency reported as a result of the nature of the structure.

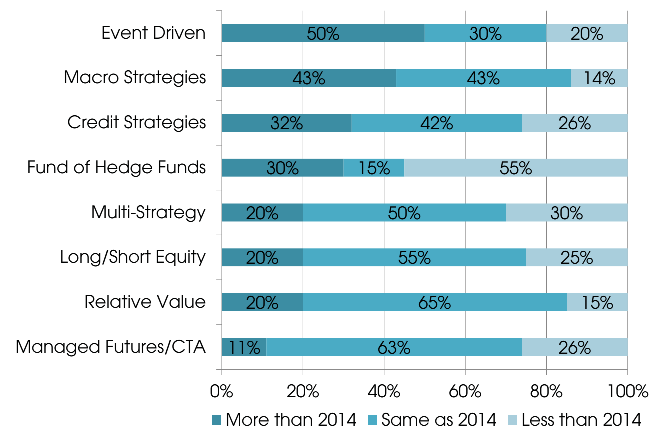
Investment Consultants' Selection Process

Investment consultants were asked to rank a variety of factors in terms of their importance in the screening and fund manager selection process. The fund manager's experience/expertise in running the fund strategy was ranked as the most important factor consultants use when assessing fund opportunities (Fig. 6.44). Consultants also ranked familiarity with the investment team highly. However, the track record of the firm is less important, with consultants largely only wanting to see a one-year track record at a specific firm when assessing new opportunities. Therefore those fund managers that can demonstrate considerable experience in their field, as well as having some previous relationship with the consultant, could be successful in gaining the attention of gatekeepers in 2015, even if they have only recently launched a new hedge fund enterprise.

Transparency is also important to consultants when making recommendations. A transparent and clearly defined strategy was ranked as the second most important factor considered when assessing opportunities. In addition, consultants want hedge fund managers to provide monthly performance and risk reports.

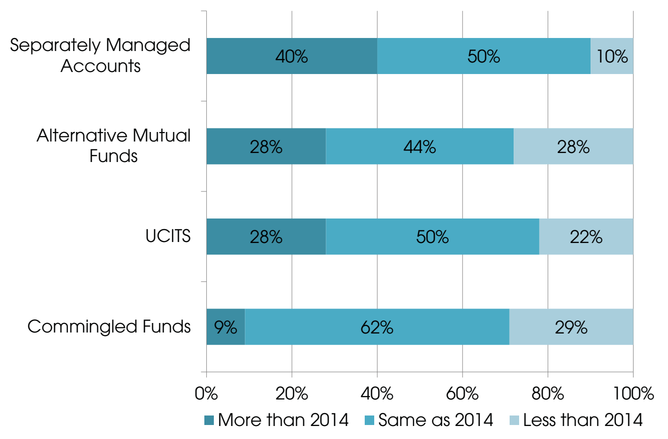
The outperformance of a benchmark by the fund is less important to the consultant when making selection decisions. The relative outperformance over a one-year

Fig 6.42: Breakdown of Investment Consultants' Recommendations for 2015 by Strategy



Source: Preqin Investment Consultant Interviews, November 2014

Fig. 6.43: Breakdown of Investment Consultants' Recommendations for 2015 by Structure



Source: Preqin Investment Consultant Interviews, November 2014

Consultant Recommendations for 2015

Event Driven

Macro Strategies

Managed Accounts

Multi-Strategy Funds

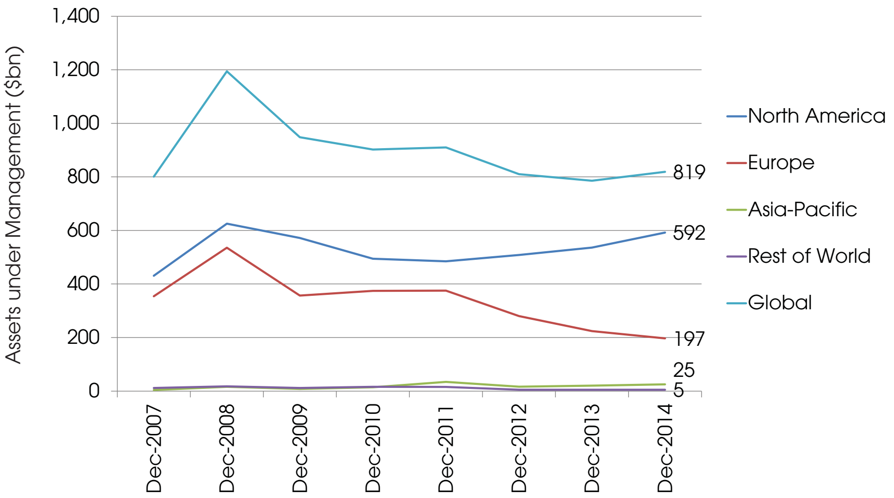
Funds of Hedge Funds

Commingled Funds

Overview of Funds of Hedge Funds

Funds of hedge funds have had a challenging road to recovery following the fall out of the global financial crisis and the events surrounding the Madoff scandal in 2008. The industry's assets under management fell from a peak of $1.2tn in December 2008 to $948bn by the end of the following year. Further outflows have been witnessed, and despite some signs of improvement in 2011, the industry reached its lowest level since 2006 with $786bn in assets under management as of December 2013. However, the sector has reinvented itself in order to win back the attention of investors, as well as to match the competitive threat of consultants in offering portfolio advice and fund selection. Today, the industry has recovered some of the assets lost over recent years, and has reached its highest level since 2011, with total assets reaching $819bn.

Fig. 7.1: Fund of Hedge Funds Managers' Assets under Management by Manager Location, December 2007 - December 2014



Source: Preqin Hedge Fund Investor Profiles

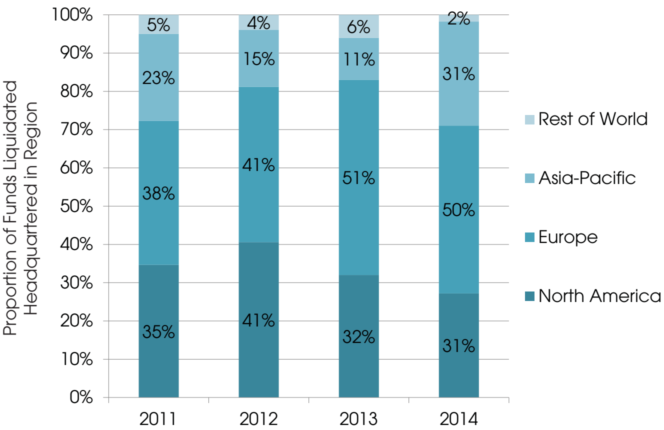
Changing Industry Assets under Management

There has been a divergence in fortunes of the North American and European fund of hedge funds sectors since 2011 (Fig. 7.1). Before this period, the growth or decline within each region was similar each year; however, where North America-based fund of hedge funds managers have enjoyed three consecutive years of expanding assets under management, Europe-based managers have suffered three years of decline. In December 2011, just $110bn separated the assets under management of each region; as of December 2014, this figure expanded to $395bn.

North America-based funds of hedge funds added $56bn over the course of 2014, taking the assets under management in the region to $592bn as of December 2014. North America-based funds of hedge funds have become the dominant force in the sector; at the height of the financial crisis these funds represented 52% of the industry's capital; today, that figure has increased to 72%, with the bulk of investor inflows going into funds of hedge funds headquartered in the region.

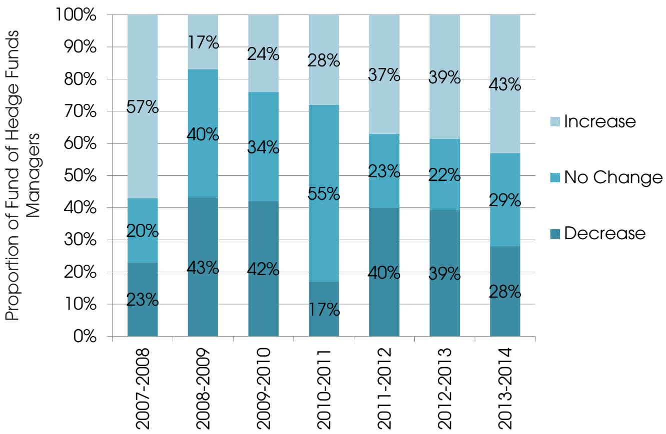
In contrast, European funds of hedge funds lost $27bn in assets under management over 2014. The instability of financial markets in the wake of the eurozone crisis and the implementation of the Alternative Investment Fund Managers Directive (AIFMD) has significantly curbed the operation of Europe-based firms over the past few years. In 2014, exactly half of the hedge

Fig. 7.2: Fund of Hedge Funds Liquidations by Location of Headquarters, 2011 - 2014



Source: Preqin Hedge Fund Analyst

Fig. 7.3: Proportional Change in Fund of Hedge Funds Managers' Assets under Management, 2007 - 2014



Source: Preqin Hedge Fund Investor Profiles

Overview of CTAs

During the period 2011 to 2013, when global GDP is estimated to have grown by 11% and the MSCI World Index climbed almost 30%, the average CTA lost 5%. However, the returns posted in 2014 were more encouraging for investors as CTAs made their strongest gain (+9.96%) since 2010 (Fig. 8.1).

CTAs in 2014

A sustained period of high launch activity in the CTA sector came to an end in 2014, with only 71 new programs brought to market during the year (Fig. 8.2). The new launches made up 9% of the total number of hedge funds established in 2014, and represented a notable decline in the volume of new vehicles compared to recent years. Over 100 new programs – representing 10% or more of total launches – were incepted every year between 2008 and 2013 as fund managers saw opportunities in the sector following the financial crisis. The recent fall in the number of launches may reflect the difficulties fund managers have had in raising capital for CTAs, as a result of the cooling attitude from investors towards these funds, following several years of equity market outperformance.

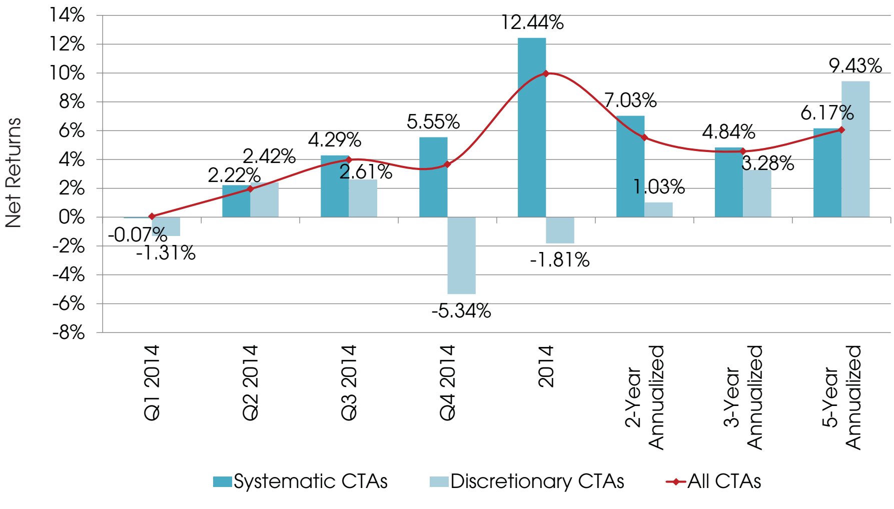
A systematic approach continues to be the dominant trading method employed by CTAs, with just 11% of newly launched vehicles adopting a purely discretionary approach in 2014 (Fig. 8.3). Despite making up a minority of programs, discretionary strategies outperformed their systematic counterparts every year between 2009 and 2013, with a drop in volatility making it difficult for many systematic programs to identify and exploit market signals and trends. This environment may have contributed to the higher level of discretionary programs launched in 2013 compared to previous years. However, as asset correlations started to decrease and policymaker interventions began to diverge, the conditions in 2014 proved to be more conducive to systematic traders, who delivered better returns in 2014 (+12.44%) than discretionary vehicles (-1.81%) for the first time since 2008.

The solid gain made by CTAs in 2014 was largely driven by third quarter performance (+3.97%), which saw 2% gains in both August and September, and was flanked by further gains in Q2 (+1.95%) and Q4 (+3.67%). Most managed futures investors will have certainly seen an improvement on 2013, with 63% of programs gaining 5% or more in 2014 compared to 31% of programs the year before (Fig. 8.4).

CTA Strategies

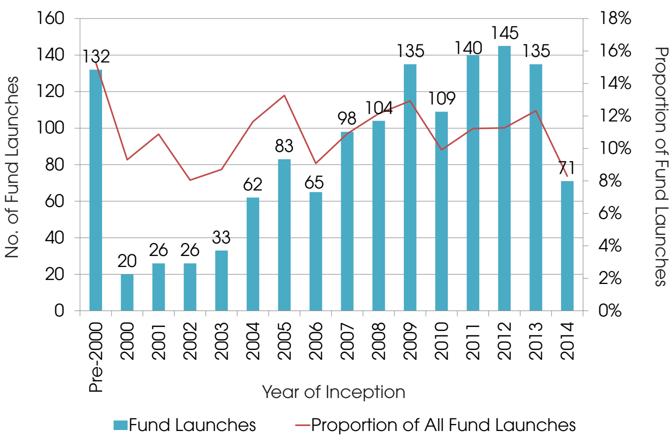
Fig. 8.5 shows that the majority of CTAs (68%) employ a traditional trend

Fig. 8.1: Performance of CTAs (As at December 2014)*



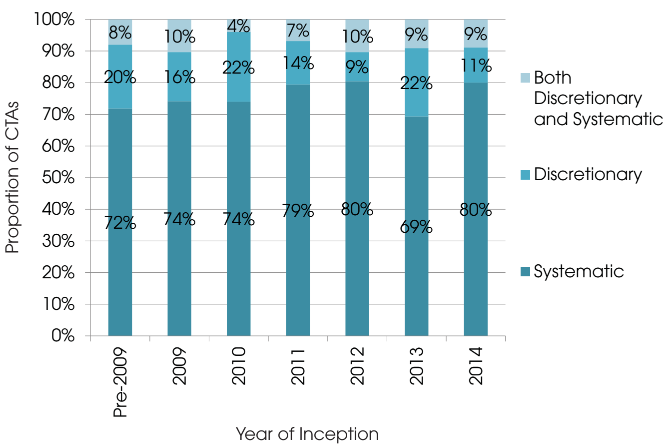
Source: Preqin Hedge Fund Analyst

Fig. 8.2: CTA Launches by Year of Inception and as a Proportion of All Fund Launches that Year



Source: Preqin Hedge Fund Analyst

Fig. 8.3: Trading Methodology Employed by CTAs by Year of Inception



Source: Preqin Hedge Fund Analyst

**Please note, all performance information includes preliminary data for December 2014 based on net returns reported to Preqin in early January 2015. Although stated trends and comparisons are not expected to alter significantly, final benchmark values are subject to change.*