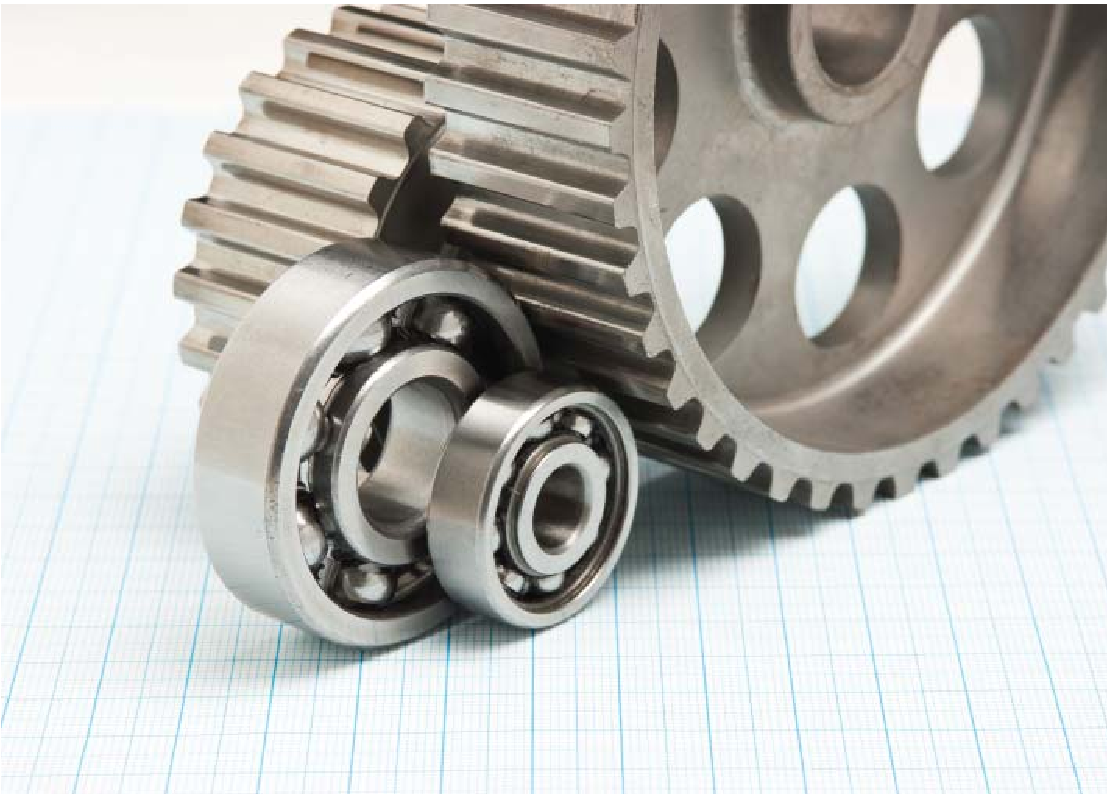
Preqin Special Report:

Funds of Hedge Funds



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Funds of Hedge Funds in 2013: An Overview

How have funds of hedge funds' assets under management changed over time? How many fund of funds launches have there been in 2013 so far?

Recent Fund of Hedge Funds Performance

Which hedge fund strategy performed the best in Q1 2013? How do single-strategy funds of funds compare to multi-strategy vehicles?

Investors in Funds of Hedge Funds

What proportion of investors allocate to funds of hedge funds? What are their longer-term plans for multi-manager investment?

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Contents

Data Source:

This report uses extracts from the February 2013 edition of Preqin's Hedge Fund Spotlight, which draws on in-depth data from Preqin's **Hedge Fund Online**. **Hedge Fund Online** provides a complete 360 degree view of the hedge fund industry, including institutional investors' plans for hedge fund investments, fund performance, fund strategies, fund managers and fund terms.

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Funds of Hedge Funds in 2013: An Overview

The fund of hedge funds industry has had a turbulent five years. The industry grew considerably in the years leading up to 2008, as new institutions began to make investments in hedge funds, attracted by the returns and non-correlation to other asset classes. New entrants into the industry sought out multi-managers to provide portfolio diversification and manager selection expertise. These characteristics of funds of hedge funds, coupled with lower levels of risk and volatility compared to direct investments, drew in investor capital and allowed the fund of hedge funds sector to reach a peak of $1.2tn in terms of assets under management in 2008.

However, 2008 turned out to be a defining year for the industry: the Madoff scandal touched even some of the largest funds of funds, returns were well into negative territory and below that of the single-manager hedge fund industry (which itself was down, with average returns of -17.12%) and investors began to question the value of these funds of funds which charge additional fees on top of those on their underlying investments.

In this month's Hedge Fund Spotlight we examine three facets of the fund of hedge funds industry: first, we give an overview of the strategies utilized by funds of hedge funds from a global point of view and their changing assets under management; secondly, we examine the recent performance of the funds of hedge funds industry; lastly, we explore investor appetite for funds of hedge funds and how changing investor sentiment towards multi-managers is shaping the industry.

Changing Industry Assets under Management

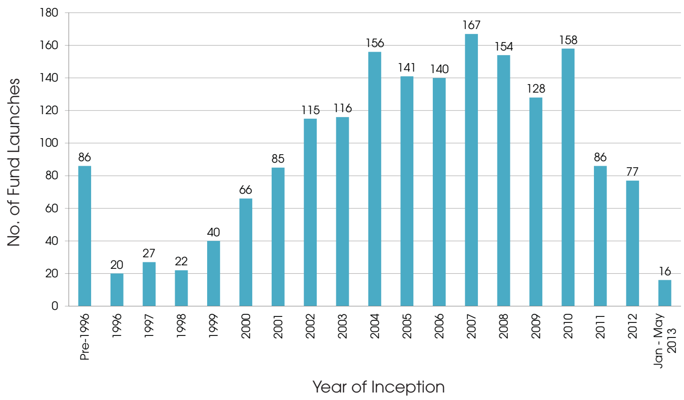
Since the events in 2008, the industry has faced many challenges in retaining investor capital and attracting new investment. The total assets under management (AUM) of fund of hedge funds managers worldwide have been on a general decline since the peak of $1.2tn in AUM seen in 2008. A further decline in assets under management over 2012 is disappointing news for the fund of hedge funds industry, which had shown some signs of recovery and slight growth over 2011. Today the industry is significantly smaller than the peak seen in 2008, with funds of hedge funds managing a total of $810bn.

Fig. 1 shows that North America-based fund of hedge funds managers continue to be the largest contributors to global fund of hedge funds AUM, with 63% of the assets under management ($508bn) in the region as of December 2012. Although this figure is still below the peak of $626bn in assets under management of North America-based fund of hedge funds managers in December 2008, North America is the only region globally that saw an increase in the aggregate assets under management of fund of hedge funds managers from 2011 to 2012, rising from $485bn in December 2011 to $508bn in December 2012.

Fig. 1: Fund of Hedge Fund Managers' Assets under Management by Location, 2007 - 2012

Source: Preqin Hedge Fund Analyst

Fig. 2: Fund of Hedge Funds Launches by Year of Inception



Source: Preqin Hedge Fund Analyst

In contrast, despite a gradual recovery in 2010 and 2011, aggregate assets under management of Europe-based fund of hedge funds managers fell significantly in 2012, from $375bn in December 2011 to $280bn in December 2012.

The relatively younger Asia-Pacific fund of hedge funds sector also ended its bull run in 2012, following two years of significant growth in aggregate assets under management. Assets under management of fund of hedge funds managers based in the region grew from $8.3bn in December 2009 to reach a peak of $34bn in December 2011, in part due to investors keen to take advantage of growth in the Asia-Pacific markets. However, the assets under management of Asia-Pacific-based fund of hedge funds managers declined significantly to $16bn in December 2012.

Although the aggregate assets under management of fund of hedge funds managers based in Rest of World began to approach levels seen in Asia-Pacific in December 2010 at $16bn, it has decreased since, dropping significantly to $5bn in December 2012 following the closure of several large fund management groups.

Fund of Funds Launches

The number of funds of hedge funds launched annually grew from 20 in 1996 to a peak of 167 new vehicles in 2007 as the industry grew in assets under management and size in terms of numbers due to an increasingly receptive institutional audience (Fig. 2). The number of annual fund of hedge funds launches declined in 2008 and 2009 during the height of the financial crisis, but then briefly rallied in 2010, with 158 fund of hedge funds launches in the year, following a return to form performance-wise in 2009 and 2010.

However, the number of annual fund of hedge funds launches declined significantly in 2011 and 2012, with these years representing some of the lowest numbers of launches since the early 2000s. Annual fund of hedge fund launches fell from 158 in 2010 to 87 in 2011 and 77 in 2012 as managers chose to focus marketing campaigns on existing vehicles in the difficult fundraising environment; 2012 saw the lowest levels of annual fund of hedge funds launches since 2000. With only 16 funds of hedge funds having been launched through April 2013, 2013 seems set to follow the downward trend in the number of fund of hedge fund launches witnessed since 2010.

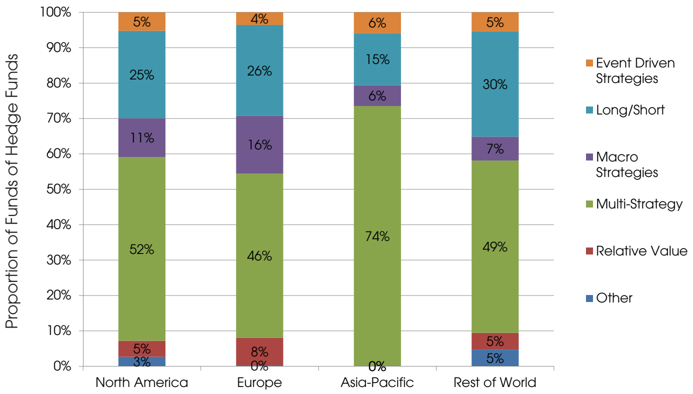
Fund of Funds Strategies by Region

One of the attractions of funds of hedge funds for investors is their ability to provide diversification. Multi-strategy hedge funds represent both the largest proportion of funds of hedge funds globally and in all regions, particularly in Asia-Pacific where multi-strategy funds represent nearly three-quarters (74%) of the entire Asia-Pacific fund of hedge funds universe (Fig. 3). Investing with a multi-strategy fund of hedge funds provides investors with broader diversification, and also gives fund of hedge funds managers strategic breadth to exploit investment opportunities in a changeable market environment.

Fig. 3 shows that 25% of the funds of hedge funds from North America focus on long/short strategies, which include strategies such as long/short equity, long biased, short biased and long/short credit. These strategies are sought by investors looking to provide short exposure to hedge their traditional portfolios of equities. The highly flexible macro strategies are also prominent in North America, with 11% of the funds of hedge funds in the region primarily focused on macro strategies.

Compared to North America, where 52% of funds of hedge funds are multi-strategy vehicles, funds of hedge funds in Europe exhibit a slightly greater preference for strategy-specific vehicles, rather than multi-strategy funds. Forty-six percent of funds of hedge funds in Europe follow a multi-strategy approach, 26% pursue a long/short approach and 16% pursue a macro approach. One notable difference between the two regions is that Europe-based fund of

Fig. 3: Strategies Used by Funds of Hedge Funds by Region



Source: Preqin Hedge Fund Analyst

hedge funds managers also show a greater preference for relative value funds compared to their North American counterparts, with 8% of the funds of hedge funds in Europe focusing on the strategy compared to 5% in North America, 5% in Rest of World and 0% in Asia-Pacific.

Among funds of hedge funds based outside of North America, Asia-Pacific and Europe, long/short equity-focused vehicles are more common (30%). However, as in the three core regions, multi-strategy funds are the most commonly operated, with just under half (49%) of all funds of hedge funds based outside of North America, Europe and Asia-Pacific following this strategy.

Event driven strategies form only a small part of the funds of hedge funds universe, never representing more than 6% of funds of hedge funds in any one particular region. This is in part due to the inherent liquidity mismatch of such an illiquid fund strategy and the enhanced liquidity requirements of investors in funds of hedge funds.

Recent Performance of Funds of Hedge Funds

Here we look at the recent performance of funds of hedge funds and the variations in performance among vehicles with different areas of focus. We also consider the future role they will play in investor portfolios and what value they can provide to institutional investors.

Funds of hedge funds delivered returns of 4.63% in 2012, having posted negative returns in the previous year. Despite generating a positive return in 2012, fund of hedge funds managers suffered from the relatively low returns delivered by single-manager vehicles. As a consequence, many have struggled to fully recover the losses seen in 2011 when benchmark returns for funds of hedge funds were -4.97%. As shown in Fig. 4, returns for these vehicles have also been low over the longer term. The annualized returns of funds of hedge funds over the last three and five years stand at 1.79% and -0.25% respectively.

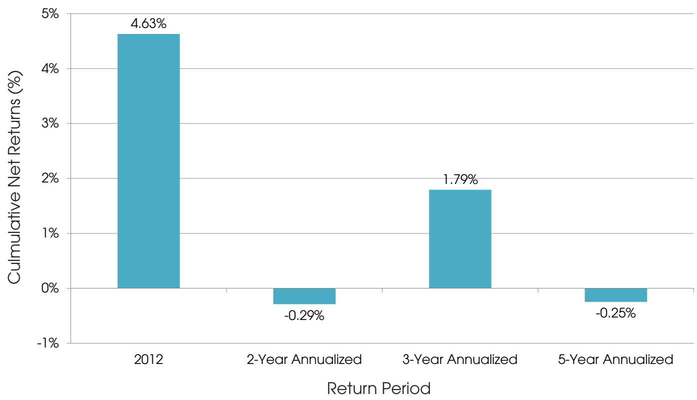
Although returns posted by many funds of hedge funds in recent years will have disappointed investors, the multi-manager fund model offers investors access to a diversified portfolio of hedge funds, helping to mitigate fund-specific risk. Fig. 5 shows the 12-month rolling returns and volatility of funds of hedge funds in 2012. Volatility was highest and returns lowest in the months leading up to August 2012. This trend was reversed as the low returns experienced in August and September 2011 dropped from the 12-month statistic. The overall volatility of returns posted by funds of hedge funds during 2011 and 2012 was low at 3% to 5%, compared to a high of 7.6% for single-manager funds and 18.6% for the S&P 500. This suggests that multi-managers are successful at reducing the volatility of returns for investors.

North America vs. Europe

Hedge fund managers struggled to accurately read or benefit from the European sovereign debt crisis and equity market movements in 2012. Direct investment funds with a primary focus on the region were comfortably outperformed by their US-focused counterparts but the effect was particularly pronounced among fund of hedge funds vehicles. As Fig. 6 illustrates, funds of hedge funds primarily targeting exposure to North America posted superior returns to Europe-focused funds in 11 months out of 12 in 2012. This led to overall net returns for the year of 7.88% for multi-manager funds targeting North America and 2.01% for those focusing on Europe.

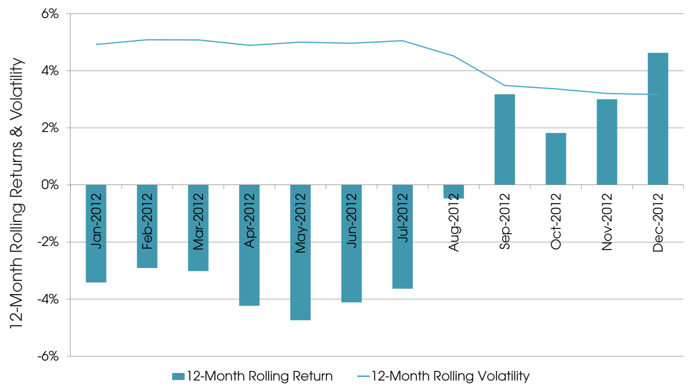
Although the returns delivered to investors in Europe-focused funds of hedge funds have been slightly less volatile than those from vehicles targeting North America, this has not been sufficient to outweigh the poor returns generated (Fig. 7). The benchmark Sharpe ratio for Europe-focused funds of hedge funds reflects this; it has been negative over the trailing two-, three- and five-year periods to the end of 2012.

Fig. 4: Performance of Funds of Hedge Funds (As at December 2012)



Source: Preqin Hedge Fund Analyst

Fig. 5: Returns & Volatility of Funds of Hedge Funds, January - December 2012



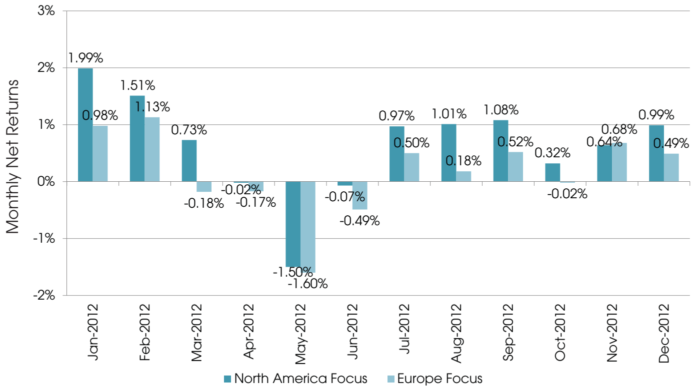
Source: Preqin Hedge Fund Analyst

Single-Strategy & Multi-Strategy Funds of Hedge Funds

Diversification is a key reason cited by investors for participating in funds of hedge funds and this can take different forms. Many investors opt to invest in funds of hedge funds to gain diversified exposure to the asset class, choosing multi-strategy managers that invest across a range of hedge fund types. Other investors participate in single-strategy fund of hedge funds products to gain access to and reduce the risk of investing in a portfolio of hedge funds employing similar strategies. In this section we examine how multi-strategy funds of funds performed recently compared to vehicles targeting two different specific strategies – long/short and macro.

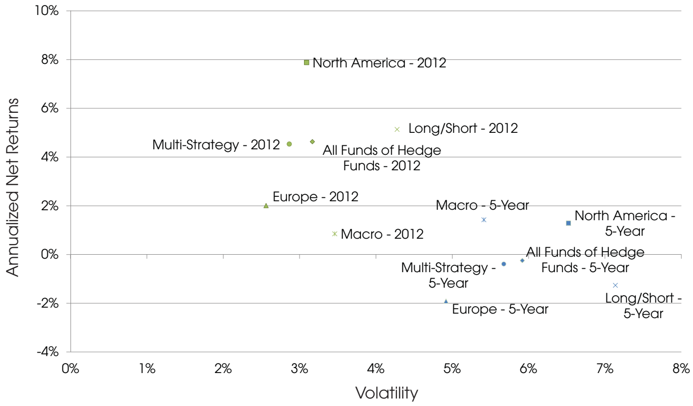
Funds of long/short hedge funds ended 2012 up 5.13% after recovering from a 2.98% drawdown between March and June 2012. The diversified nature of their investments meant that the drawdown

Fig. 6: Monthly Returns of Funds of Hedge Funds in 2012: North America vs. Europe



Source: Preqin Hedge Fund Analyst

Fig. 7: Risk-Return Profile of Different Funds of Hedge Funds (As at December 2012)



Source: Preqin Hedge Fund Analyst

suffered by multi-strategy funds of funds was less severe and these vehicles were up 4.53% at the end of the year. Funds of macro hedge funds posted 0.85% in 2012 as the unpredictability of policy makers and the value of the euro challenged macro hedge fund managers.

Multi-strategy funds of hedge funds, with annualized returns over the two- and three-year periods of -0.02% and 1.97%, respectively, have outperformed their single-strategy counterparts targeting long/short funds (-1.35% and 0.82% over the two- and three-year periods respectively) and macro funds (-1.78% and 1.10% over the two- and three-year periods respectively). Diversification and the ability to switch the strategies being targeted has helped multi-strategy funds of hedge funds achieve this while also maintaining low volatility in their returns of 3.6-3.9% compared to 3.7-4.2% for funds of macro hedge funds and 5.4-5.6% for funds of long/short hedge funds.

Although funds of macro hedge funds have posted low returns recently, these vehicles have delivered superior performance over the last five years compared to long/short and multi-strategy funds of hedge funds (Fig. 7). The low volatility of these vehicles and low correlation to equity markets in 2008 has seen macro-focused funds of hedge funds post positive returns over the five years to December 2012, while multi-strategy and long/short vehicles were in negative territory for the same period.

Encouraging Start to 2013

Preqin's benchmarks show that funds of hedge funds made a promising start to 2013. The first quarter return of 3.16% represented the best quarterly performance for multi-manager funds since Q1 2012. It was also a marked improvement on the final three months of 2012, which saw a gain of 1.45%, and was only slightly short of the Q1 2013 returns of single-manager funds (+3.35%).

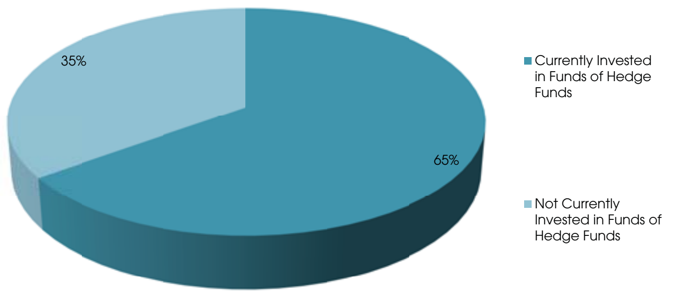
The performance posted by funds of long/short funds (+3.84%) underpinned the encouraging returns of multi-manager vehicles during the first quarter. The limited number of funds of funds targeting event driven vehicles enjoyed a Q1 return of 4.14%, while multi-strategy funds of funds also made a key contribution with gains of 3.18%. Funds of macro funds continued a difficult run with a return of 0.86%, detracting slightly from average performance. Relative value multi-manager funds posted 2.04% for the quarter.

Europe-focused funds of hedge funds rallied in the first three months of 2013 to generate a return of 3.65% and eclipse the gains made over the whole of the previous year. Despite this, North America-focused vehicles maintained a superior level of performance with Q1 returns of 4.61%. Similarly, US dollar-denominated funds of funds posted 3.34% compared to a return of 2.79% achieved by euro-denominated vehicles.

Multi-manager funds with a focus on the Asia-Pacific region benefited from robust performance by single-manager counterparts, posting 4.53% in Q1 2013. Overall, the first quarter performance generated by funds of hedge funds was driven more by vehicles targeting multiple developed markets (+3.33%) around the world than those with a focus on emerging markets funds (2.89%).

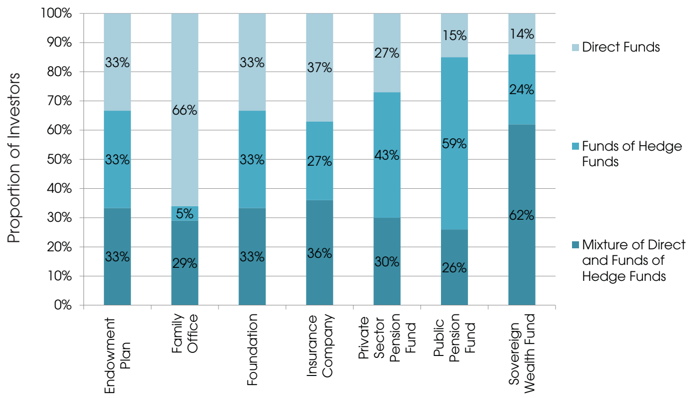
Investors in Funds of Hedge Funds and Their Outlook for 2013

Fig. 8: Proportion of Investors Currently Invested in Funds of Hedge Funds



Source: Preqin Investor Interviews, December 2012

Fig. 9: Breakdown of Institutional Investor Types by Hedge Fund Investment Approach (Direct Funds, Funds of Hedge Funds, or a Mixture of Both)



Source: Preqin Investor Interviews, December 2012

As our previous sections have shown, the fund of hedge funds model has come under pressure over the past five years. In this section we examine current investor appetite for funds of funds, and take a look at what the future could hold for the sector.

Fig. 8 shows that 65% of investors include funds of hedge funds as part of their hedge fund allocation. Fig. 9 breaks down this data further, showing what proportion of several leading types of investor in hedge funds allocate directly, through funds of funds, or use a mixture of both. Pension funds in particular have a preference for committing to the asset class solely through fund of hedge funds managers.

We also examined some characteristics of investors which allocate directly, through funds of funds alone or through a combination of both approaches in Fig. 10. Investors in funds of hedge funds tend to be newer entrants into the asset class, with a mean year of first investment of 2006 compared to 2003 for direct-only investors. These investors also generally have smaller AUM and less capital, both in terms of proportion of assets under management allocated to hedge funds and capital invested in the asset class. Funds of hedge funds are an attractive investment option for these newer or smaller investors because a complete portfolio of investments can be achieved through a single allocation to hedge funds, the need for due diligence can be outsourced to the fund of hedge funds manager, and the use of funds of hedge funds can represent good value for money for those investors without internal investment specialists in the area.

What Does the Future Hold?

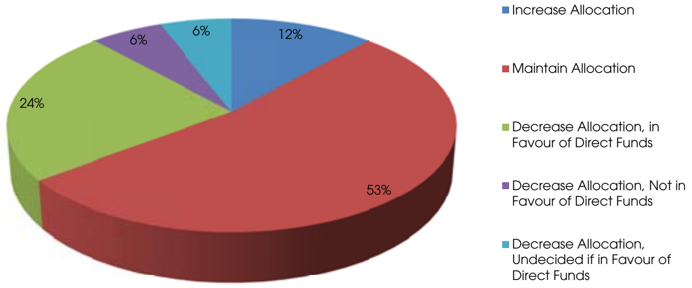
In December 2012, Preqin interviewed 80 investors in hedge funds to ascertain their outlook for 2013. The full results of these interviews can be found in our 2013 Global Hedge Fund Report. We asked those investors with current portfolios of funds of hedge funds what their plans were for their fund of hedge funds portfolios in 2013.

Fig. 11 shows that 12% of fund of hedge funds investors interviewed plan to increase their allocations to funds of hedge funds in 2013, with the majority of fund of hedge funds investors (53%) planning to maintain their exposure in 2013. The remaining 35% of current fund of hedge funds investors plan to decrease their allocations to funds of hedge funds in 2013. Twenty-three percent of fund of hedge funds investors interviewed plan to decrease their allocations in favour of direct investments and 6% plan to decrease their holdings in funds of hedge funds while simultaneously reducing their overall exposure to hedge funds. A further 6% plan to decrease their allocations to funds of hedge funds, but have no fixed plans as to how the capital will be reallocated.

Unsurprisingly, of those investors interviewed that are considering or planning to reduce their exposure to funds of hedge funds, 54% are doing so due to performance concerns (Fig. 12), a general concern in the asset class as a whole. Twenty-seven percent of fund of hedge funds investors stated they were exiting fund of hedge funds investments because they felt that investing through their own portfolio of direct investments could provide them with better opportunities. Eighteen percent of fund of hedge funds investors named high fees as a reason for exiting their fund of hedge funds investments; some investors may feel that what they save in fees can be used to build their own internal teams to carry out fund research and due diligence.

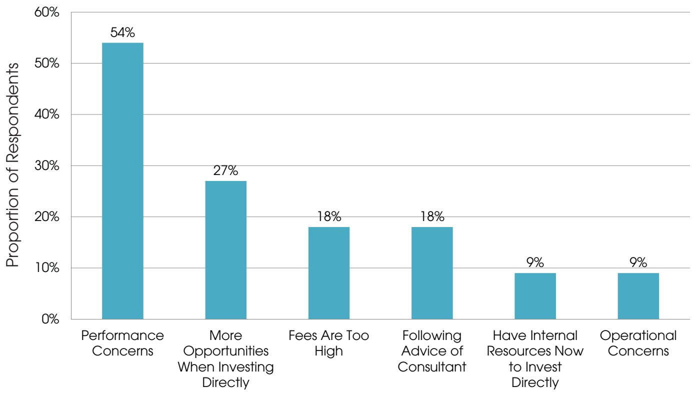
With 65% of all institutions investing through funds of hedge funds and 65% of these investors planning to increase or maintain their allocations in 2013, the structure will continue to be utilized by a significant proportion of hedge fund investors. Despite over a third of investors in funds of funds planning to decrease their exposure to the structure in 2013, the hedge fund industry as a whole is likely to benefit from this reduction as capital will be redirected to single-manager funds.

Fig. 11: Investors' Plans for Fund of Hedge Funds Allocations in 2013



Source: Preqin Investor Interviews, December 2012

Fig. 12: Institutional Investors' Reasons for Exiting Fund of Hedge Funds Investments



Source: Preqin Investor Interviews, December 2012

Outlook

Funds of hedge funds face some significant challenges in 2013. On the whole, the returns of funds of hedge funds have been largely underwhelming in recent years and the industry has shown a significant contraction in assets under management as result of poor performance and investor outflows. However, some managers in the sector continue to demonstrate the ability to deliver strong absolute returns; funds of funds in the top performance quartile posted net returns in excess of 7% in 2012, while the most successful vehicle made gains of more than 24%.

There are some noticeable differences by region in regards to the changing fortunes of the fund of hedge funds industry. North America-focused funds of hedge funds have had a more successful 2012 than their European counterparts, both in terms of the returns posted and growth in the aggregate assets under management of fund of hedge funds managers based in the region. The assets under management of European fund of hedge funds managers decreased by $95bn over 2012, and Europe-focused funds of hedge funds posted significantly lower returns than North America vehicles.

Despite difficulty in recent years, Preqin's performance benchmarks indicate that funds of hedge funds have made a promising start to 2013, posting 2.10% in January. This represents the sixth positive return in the last seven months and the best single month in more than two years. This is an encouraging start to 2013 for institutional investors, which have cited strong performance as a key requirement which needs to be met in the year ahead. In addition to this strong start to the year, 44% of all investors planning to make new investments over the next 12 months are including a fund of hedge funds element as part of their search. More than half (52%) of all investors looking to make new investments in funds of hedge funds over the next 12 months are pension funds, with their large ticket sizes and long-term investment horizons. However, 35% of current fund of hedge funds investors plan to reduce their exposure to multi-manager vehicles over the next 12 months, a concern for fund of hedge funds managers.

The broad investment scope and additional fees involved in investing with multi-manager hedge funds inevitably leads to dampened returns. One of the main attractions of investing in a fund of hedge funds, however, is not to achieve superior returns but to manage downside risk. Funds of hedge funds offer both strategy and manager diversification and for many investors the additional fees are offset by the savings made via the outsourcing of due diligence and administration costs involved in operating a hedge fund portfolio. The knowledge and expertise of experienced fund of funds managers can also offer investors a route into niche or specialist markets and strategies that provide greater diversification and the potential for stronger returns. The challenge for investors is to identify managers that are able to diversify either within a strategy or across strategies as well as delivering stable returns effectively.

Fig. 10: Key Characteristics of Investors that Invest in Hedge Funds Through Direct Funds, Funds of Hedge Funds, or a Mixture of Both

	Direct Funds	Funds of Hedge Funds	Mixture of Direct Funds and Funds of Hedge Funds
Mean Year of First Investment	2003	2006	2005
Mean Assets under Management ($bn)	10.9	8.4	18.2
Allocation (%)	16.6%	9.3%	12.0%

Source: Preqin Hedge Fund Analyst

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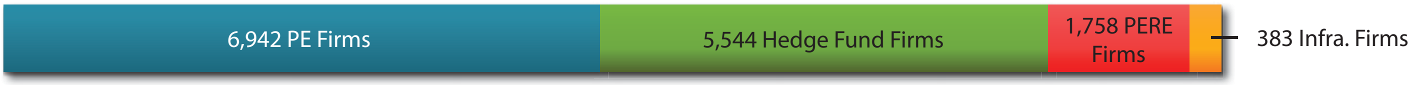
Preqin Global Data Coverage

As of 1 June 2013

Fund Coverage: 30,190 Funds

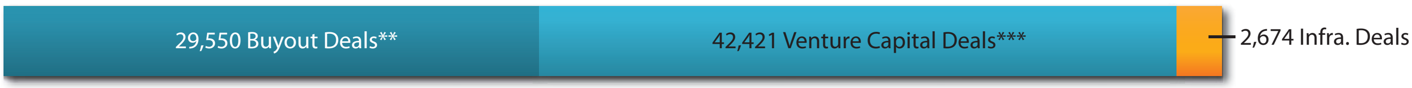
Firm Coverage: 14,627 Firms



Performance Coverage: 11,743 Funds (IRR Data for 4,993 Funds and Cash Flow Data for 2,275 Funds)

Fundraising Coverage: 12,322 Funds Open for Investment/Launching Soon Including 1,939 Closed-Ended Funds in Market and 403 Announced or Expected Funds

Deals Coverage: 74,645 Deals Covered; All New Deals Tracked



Investor Coverage: 10,801 Institutional Investors Monitored, Including 7,700 Verified Active**** in Alternatives and 81,211 LP Commitments to Partnerships

Alternatives Investment Consultant Coverage: 447 Consultants Tracked

Fund Terms Coverage: Analysis Based on Data for Around 7,500 Funds

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****Preqin contacts investors directly to ensure their alternatives programs are active. We emphasize active investors, but clients can also view profiles for investors no longer investing or with programs on hold.

Preqin Special Report:
Funds of Hedge Funds

Preqin: Hedge Fund Data and Intelligence

With global coverage and detailed information on all aspects of the hedge fund asset class, Preqin's industry-leading Hedge Fund Online services keep you up to date on all the latest developments across the hedge fund universe.

Source new investors for funds

Find the most relevant investors, with access to detailed profiles for institutional investors actively investing in hedge funds, including insurance companies, pension funds, family offices, foundations, wealth managers, endowment plans, banks and more.

Identify potential investment opportunities

View in-depth profiles for hedge funds seeking capital, including information on investment strategy, geographic focus, structure, service providers used, sample investors, direct contact information and more.

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Access fund-by-fund and industry level fund terms and conditions data for individual hedge funds, which provide a market overview, enabling you to see the current trends for specific strategies, structures, sizes, and more.

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