

PREQIN INVESTOR OUTLOOK: HEDGE FUNDS H1 2017



RETURNS IMPROVE IN 2016, BUT KEY CONCERNS REMAIN

2016 presented many challenges for hedge fund managers; as well as several high-profile investors announcing cuts from their hedge fund portfolios, investors more widely withdrew a net \$102bn from the asset class. This not only created a challenging fundraising environment but also increased the difficulty fund managers faced in retaining capital. Amid these challenging conditions in an evolving industry, Preqin conducted interviews with over 150 institutional investors active in hedge funds to provide an overview of how investors' portfolios have performed over the course of 2016, their current views on the hedge fund industry and their plans for the year ahead.

These interviews highlighted that when it comes to the hedge fund universe, two issues are at the forefront of investors' minds: performance and fees. In recent years, investors have increasingly voiced concerns about the performance of the asset class. In Preqin's June 2016 interviews with investors, 49% of respondents felt

that performance was a key issue moving into the second half of the year; six months later, 73% of respondents reported the same. The Preqin All-Strategies Hedge Fund benchmark returned 7.40% in 2016, the highest level since 2013; however, two-thirds of investor respondents reported that hedge funds failed to meet expectations in 2016.

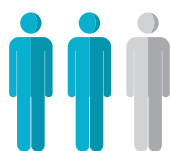
Hedge fund fees were an ever-present topic in the financial press during 2016. Some high-profile investors made significant withdrawals: New Jersey State Investment Council halved its target allocation to hedge funds in an effort to reduce the fees paid to investment managers. Furthermore, \$10.9bn Connecticut-based fund manager Tudor Investment Corporation reduced fees of one of its largest funds.

The fundraising challenges of the past year show little sign of abating in 2017. Outflows accelerated over 2016, with the largest levels of investor redemptions seen

in Q4. Looking forward to 2017, nearly twice the proportion of investors plan to reduce their exposure over the year than increase it, a concern for managers as both retaining capital and fundraising are likely to remain difficult tasks over 2017.

As a result, there are many challenges ahead for fund managers, but with these challenges come opportunities. Finding investors that are seeking to put fresh capital into the asset class looks set to be more difficult in 2017. However, those fund managers that can respond to investor demands for greater alignment of interests, harness some of the volatility resulting from uncertain markets and deliver better returns will be best placed to win investor mandates. In these challenging times, data and intelligence to help fund managers really understand their investors are more important than ever. The results of our investor interviews and data taken from Preqin's **Hedge Fund Online** highlight some ways for managers to succeed in 2017.

PERFORMANCE



2 in 3

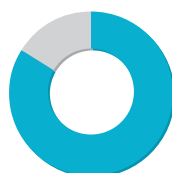
investors surveyed reported that their hedge fund portfolios had not lived up to expectations in 2016.



47%

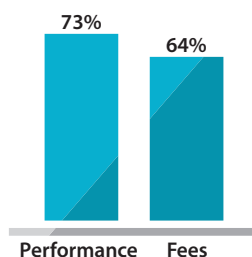
of investors surveyed issued a hedge fund redemption request in 2016, with underperformance the leading reason.

FEES



84%

of investors reported that they had not invested in a hedge fund due to the proposed fund terms and conditions.



Performance and fees are seen by investors as the key issues facing the hedge fund industry in 2017.

OUTLOOK FOR 2017



76% & 57%

of investors respectively want to see improvements in the level of management fees and how performance fees are charged in 2017.



20%

of investors are intending to increase their exposure to hedge funds in 2017.

SATISFACTION WITH HEDGE FUNDS

There are widespread levels of dissatisfaction with returns: two out of every three of the investors Preqin spoke to revealed that hedge funds had not lived up to their performance expectations in 2016 (Fig. 3.1) – this is twice the level reported in December 2015.

However, the term 'hedge fund' encompasses a broad array of fund types and strategies, with managers using a myriad of instruments and trading styles to generate returns for their investors. Therefore, the negative sentiment towards hedge funds as a whole is not seen across all hedge fund strategies (Fig. 3.2). Three-quarters of investors surveyed saw their

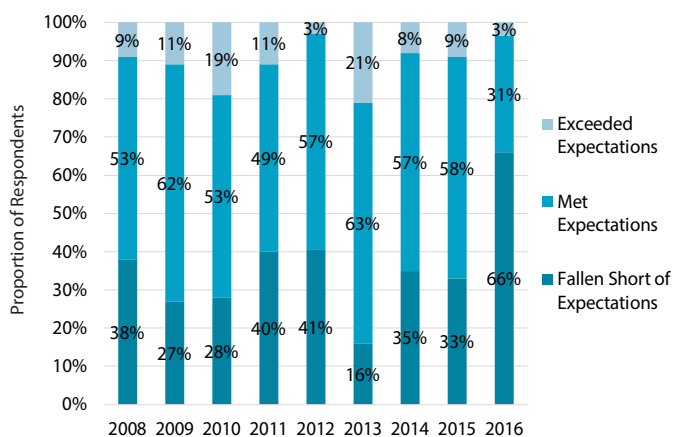
emerging markets investments meet their expectations, which is unsurprising given the Preqin Emerging Markets Hedge Fund benchmark returned 9.96% in 2016 – the second best performing top-level region behind only North America (+10.20%). This represents a sharp reversal from 2015, when 91% of investors reported that their emerging markets investments fell short of expectations. The majority (69%) of investors also saw credit strategies – the second best performing top-level strategy of 2016 – meet their expectations over the course of the year.

In contrast, 58% and 73% of surveyed investors in CTAs reported that systematic

and discretionary CTA holdings respectively did not meet expectations, with the Preqin All-Strategies CTA benchmark returning seven percentage points below that of the Preqin All-Strategies Hedge Fund benchmark in 2016.

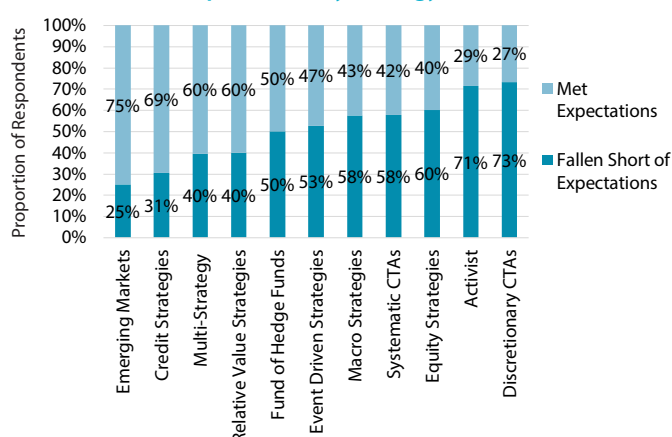
While some institutions have seen their hedge fund investments perform as expected in 2016, almost half (47%) of investors reported that their level of confidence in hedge funds' ability to achieve portfolio objectives had fallen (Fig. 3.3). Despite these concerns, more respondents believe that the asset class will perform better in 2017 (28%) than worse (19%, Fig. 3.4).

Fig. 3.1: Investor Views on Hedge Fund Portfolio Performance over the Past 12 Months Relative to Expectations, 2008 - 2016



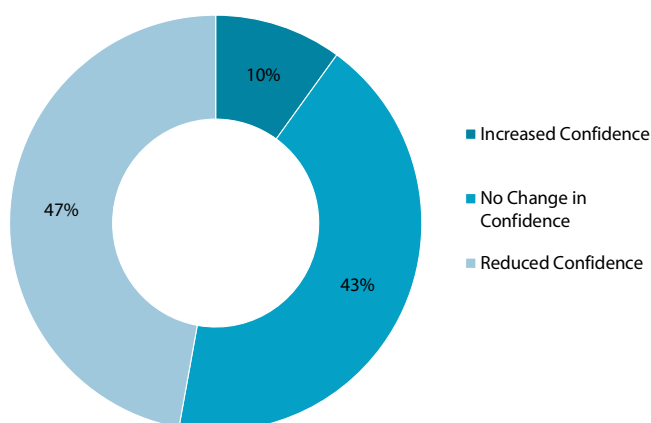
Source: Preqin Investor Interviews, December 2008 - December 2016

Fig. 3.2: Investor Views on Hedge Fund Portfolio Performance in 2016 Relative to Expectations by Strategy



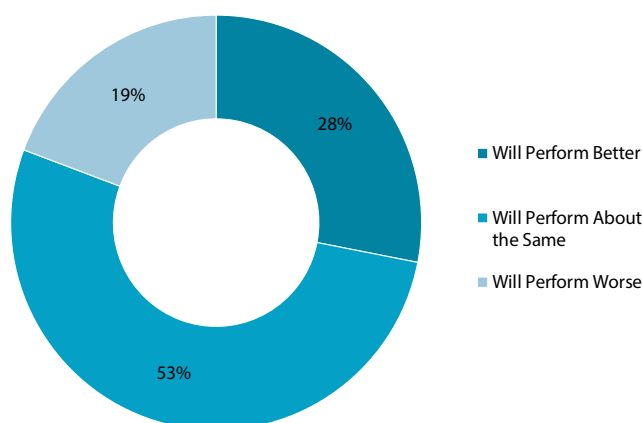
Source: Preqin Investor Interviews, December 2016

Fig. 3.3: Investors' Change in Confidence in the Ability of Hedge Funds to Achieve Portfolio Objectives over the Past 12 Months



Source: Preqin Investor Interviews, December 2016

Fig. 3.4: Investors' Performance Expectations for Hedge Funds in 2017 Compared with 2016



Source: Preqin Investor Interviews, December 2016

KEY ISSUES AND REDEMPTIONS

As seen in Fig. 3.5, there were several challenging macroeconomic factors that affected investors' hedge fund portfolios over the course of 2016; stock market volatility (54%), low interest rates (52%) and central bank intervention (50%) were cited by the greatest proportions of respondents as the factors that had the biggest impact. Investors believe these factors will remain the most influential in 2017; however, significantly more investors feel it will have an impact on their portfolios in 2017 than felt it did in 2016.

“ Performance and fees look set to be the leading factors that hedge fund managers need to address in 2017

The geopolitical landscape is predicted to have a greater impact on investors' hedge fund portfolios in 2017 than in 2016. 2016 saw the Brexit decision by the UK in June and Donald Trump winning the US election in November. With President Trump's inauguration in January 2017, the consequences of the change in President and his economic policy were far from clear in our December 2016 surveys. In

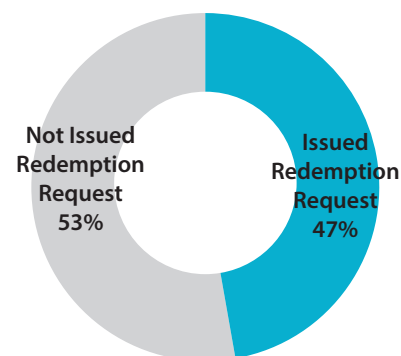
2017, there are set to be more major political events, notably elections in France and Germany.

Performance and fees look set to be the leading factors that hedge fund managers need to address in 2017— 73% and 64% respectively cited these as the key issues affecting hedge funds (Fig. 3.6). The perception of the industry by the public is also a key concern for investors. In 2016, various labour unions and trustees put pressure on CIOs to reduce the level of fees paid to underperforming investment managers and to re-evaluate their exposure to hedge funds. More widely than this, much of the financial media has focused on the difficulties faced by hedge funds and their underperformance relative to traditional benchmarks. This in turn has led to a somewhat negative view from the general public on the nature of the hedge fund investments that they may be exposed to through investments made by their pension funds.

REDEMPTIONS

Over the course of 2016, New York City Employees' Retirement System, AIG, New Jersey State Investment Council and Kentucky Retirement System all announced their intentions to either

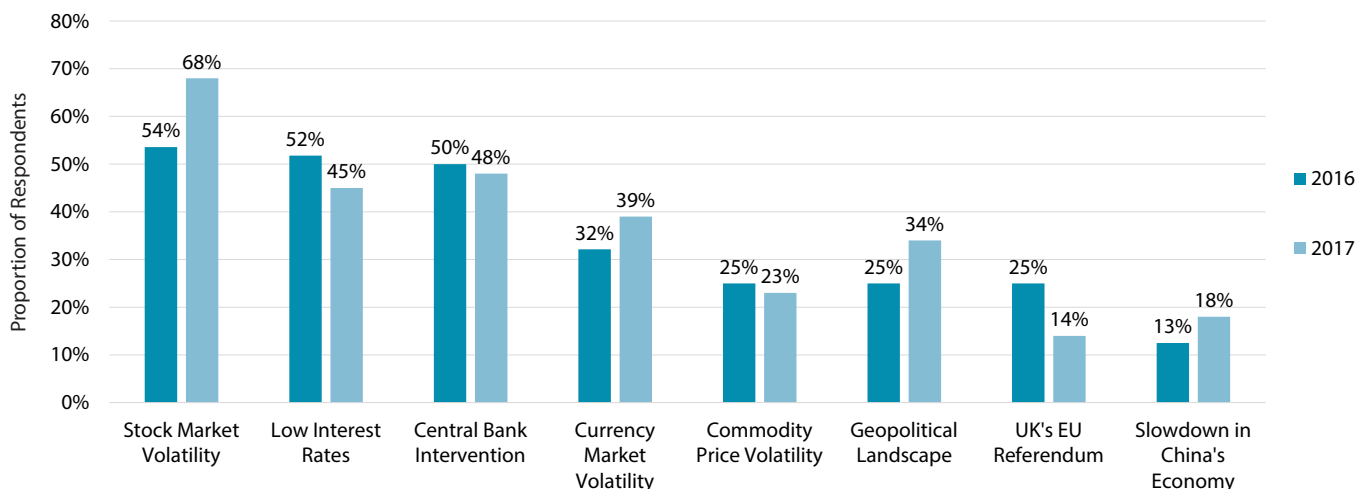
INVESTORS THAT HAVE ISSUED A HEDGE FUND REDEMPTION REQUEST IN 2016



redeem holdings or exit the asset class entirely, often citing performance and fees as a factor in this decision. Nearly half (47%) of investors Preqin interviewed issued redemption requests in 2016, highlighting the difficulties fund managers faced in retaining assets throughout the year.

Underperformance was the leading driver behind investors' decisions to issue redemptions in 2016; the largest proportions cited the failure of funds to match benchmark returns (35%) and individual targets (27%) as the reasons behind their redemption requests (Fig. 3.7). While one-quarter of respondents

Fig. 3.5: Investor Views on the Macroeconomic Factors that Had the Biggest Impact on Their Hedge Fund Portfolios in 2016 vs. Predictions for 2017



Source: Preqin Investor Interviews, December 2016

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redeemed certain hedge fund holdings to allocate to other hedge funds in an attempt to rebalance their hedge fund portfolio, some respondents planned to allocate the redeemed capital elsewhere in their portfolio. Fifteen percent of investors said when they issued redemption requests that they would allocate the returned capital to other areas of their portfolio; a further 8% reported it was specifically to direct this redeemed capital to other alternative assets such as private equity.

“Underperformance was the leading driver behind investors’ decisions to issue redemptions in 2016

With performance disappointing two-thirds of investors in 2016, as well as being a driving factor behind redemptions, Preqin turned its attention to the length of time investors would tolerate the underperformance of a fund before issuing redemptions. The majority of respondents reported that they would only tolerate 18 months or fewer of fund underperformance before considering issuing a redemption request (54%, Fig. 3.8). As of December 2016, the cumulative return over the past 18 months of the Preqin All-Strategies Hedge Fund benchmark was 4.92%, lower than the 2016 annual return (+7.40%), highlighting the industry underperformance in 2015 which may have been a driver behind the requests in 2016. However, the largest proportion (28%) of investors reported they would stay invested in an underperforming fund for more than 18 months before redemption, and a further 16% said they would consider each fund on a case-by-case basis.

Fig. 3.6: Investor Views on the Key Issues Facing Hedge Funds in 2017

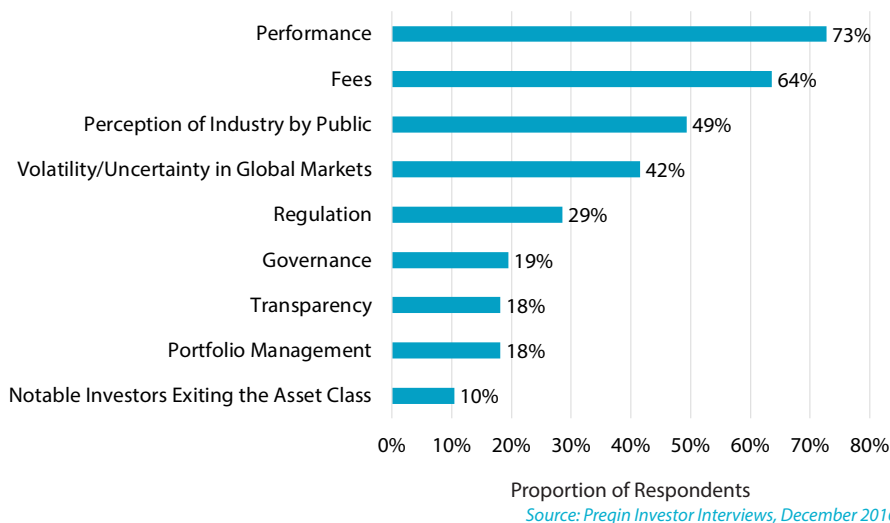


Fig. 3.7: Reasons Why Investors Have Issued Redemption Requests in 2016

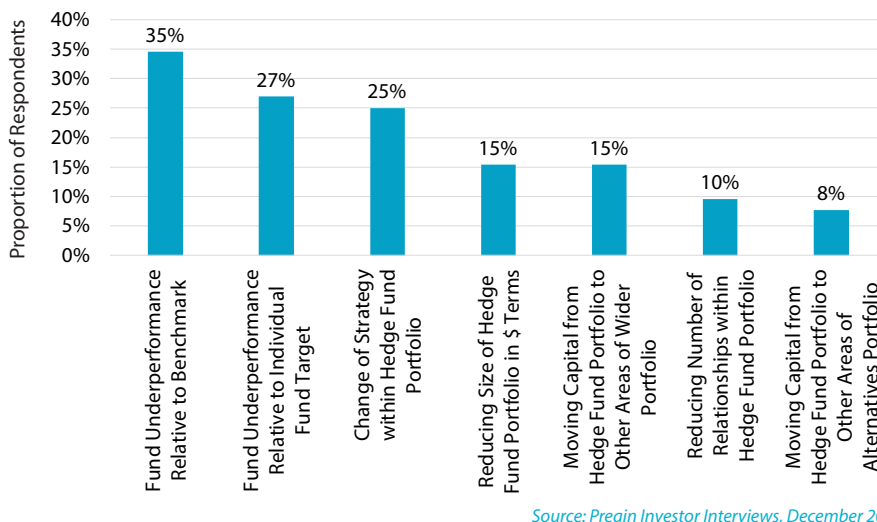
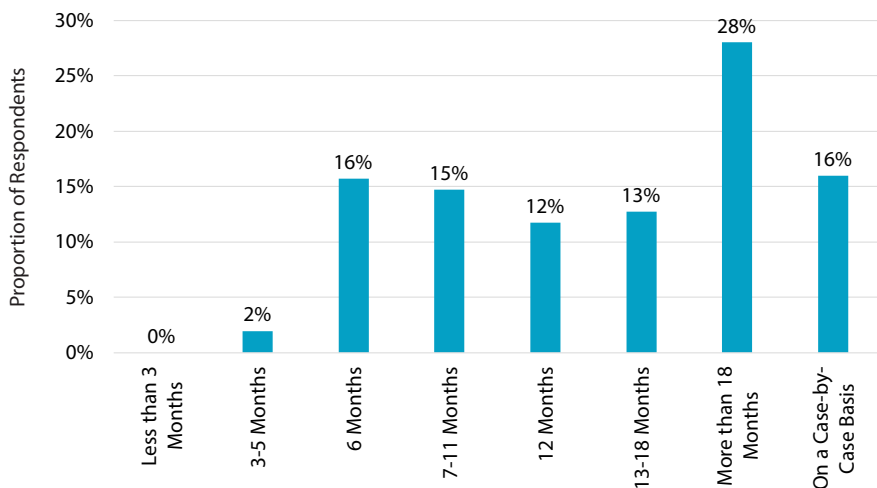


Fig. 3.8: Investor Views on How Long They Will Tolerate Hedge Fund Underperformance before Redemption



FEES AND ALIGNMENT OF INTERESTS

As seen in Fig. 3.9, over two-thirds (69%) of investors interviewed at the end of 2016 believe that their interests are not aligned with their fund managers', a reversal of sentiment from Preqin's December 2015 interviews. With two-thirds of investors surveyed reporting that their hedge fund portfolios had fallen short of expectations in 2016 (see page 23), investors are seeking greater alignment of interests between themselves and their managers, not only to better encourage managers to take on appropriate levels of risk to generate returns, but also to ensure that investors extract good value from their hedge fund investments.

CHANGES IN 2016

Despite the vast majority of investors agreeing that their interests have become less aligned with those of their fund managers, 58% have seen favourable changes in fund terms over the course of 2016 (Fig. 3.10). This highlights the efforts fund managers are going to in an attempt to improve the alignment of interests with investors. However, continued efforts are needed in 2017 in order to win the approval of those investors that still believe fees are too high.

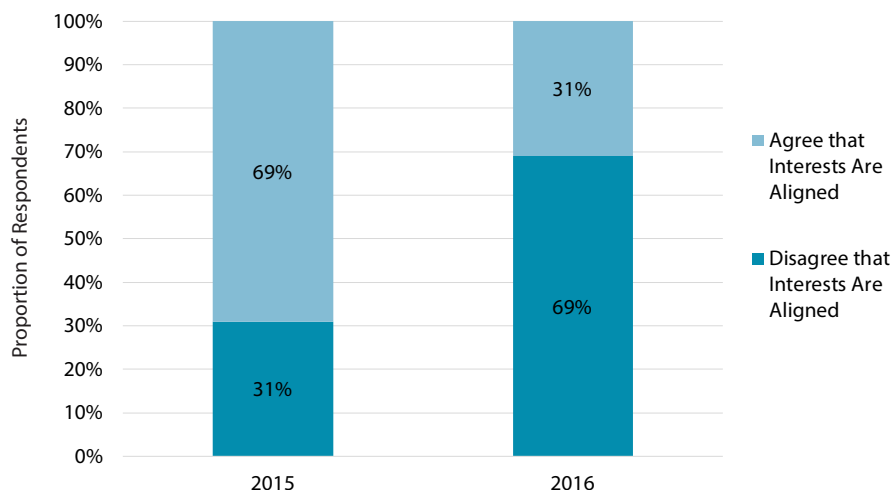
MANAGEMENT FEES

Fig. 3.11 provides insight into the specific areas of fund terms and conditions that investors feel have improved throughout 2016 and which areas investors still want to see improvement in over the coming 12 months. Management fees are at the forefront of investors' minds; despite the majority (55%) of respondents witnessing an improvement in management fees in 2016, over three-quarters (76%) see room for further reductions in management fees over 2017. This is thirty percentage points higher than the proportion of investors that sought improved management fees in 2016 from our December 2015 survey.

PERFORMANCE FEES

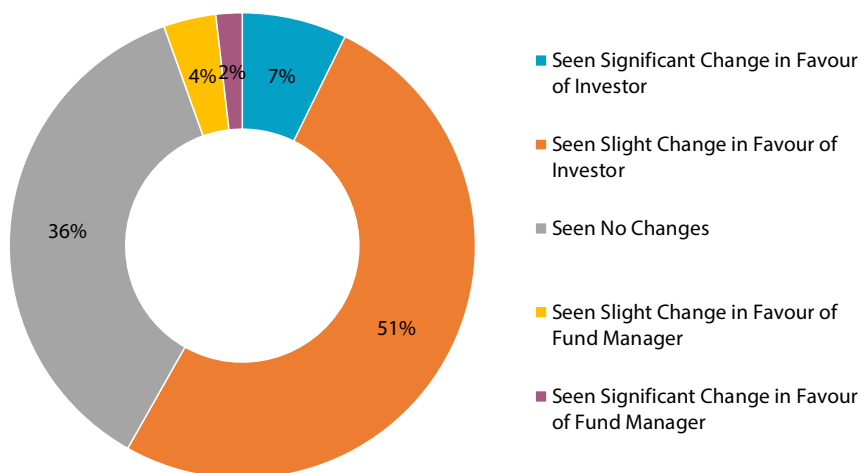
Although nearly half (48%) of all investors interviewed in December 2016 are seeking

Fig. 3.9: Extent to Which Investors Believe Fund Manager and Investor Interests Are Properly Aligned, 2015 vs. 2016



Source: Preqin Investor Interviews, December 2015 - December 2016

Fig. 3.10: Investor Views on Changes in Prevailing Fund Terms over 2016



Source: Preqin Investor Interviews, December 2016

a reduction in the level of performance fees charged, a greater proportion are looking for changes in how performance fees are charged – the first time Preqin has noted this. When performance is not meeting expectations, investors look to managers to implement more favourable terms such as hurdle rates, to better align interests and incentivize managers, or methods such as clawbacks, to return fees to investors following reversals in performance.

TRANSPARENCY AND FUND MANAGER COMMITMENTS

Although 39% of respondents have seen an improvement in the level of transparency offered by fund managers, there is still more work to be done by hedge funds to meet the demands of an increasingly sophisticated audience of investors. Fifty-seven percent of investors want managers to improve the level of transparency they offer in 2017. Although adding the necessary staff and infrastructure to provide the transparency that investors demand can

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be burdensome, those that are willing to incur the costs to meet these transparency demands – either internally or through outsourcing – may be rewarded with both inflows from institutions as well as capital that is invested for longer.

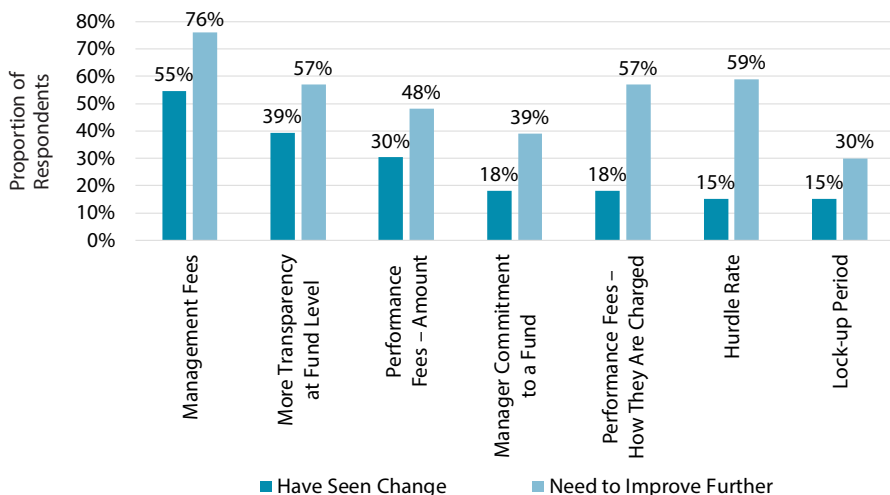
The majority (52%) of fund managers surveyed by Preqin believe that making a commitment to their own fund is the most effective way of showing alignment of interests with investors; however, just 18% of investors reported that they had seen an improvement in managers having ‘skin in the game’ over the course of 2016. With 39% of investors seeking improvement on this front, fund managers may need to re-evaluate how much of their own capital they have tied up in their fund and whether this is appropriate to both encourage better performance without taking excessive – or indeed too little – risk.

THE ROLE OF FEES IN THE DECISION-MAKING PROCESS

When investors begin their screening process when evaluating fund opportunities, the strategy and performance are the two leading characteristics that institutions consider. A large proportion (41%) of investors, however, reported that they also look for attractive fund terms charged by a manager as part of this process.

The importance of fees in the fundraising process is again emphasized in Fig. 3.12. The vast majority (84%) of investor respondents have frequently or occasionally decided not to invest in a fund due to the proposed terms and conditions. In addition, nearly one in four investors reported that there is insufficient information on fees contained in fund manager marketing materials. Therefore, not only is it important to evaluate fund terms and set appropriate levels of fees, it is also vital that fund managers effectively communicate to investors about the fees they will incur should they invest in the fund. Failure to do this may lead to institutional investors rejecting a fund which may otherwise meet their needs.

Fig. 3.11: Investor Views on the Areas of Fund Terms and Conditions that Have Changed over the Past 12 Months and that Need to Improve Further in 2017

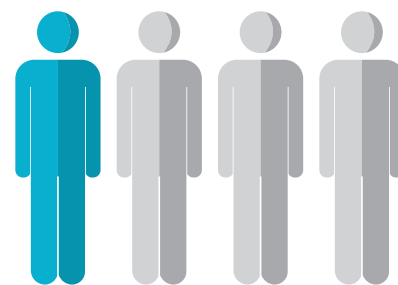


Source: Preqin Investor Interviews, December 2016



41%

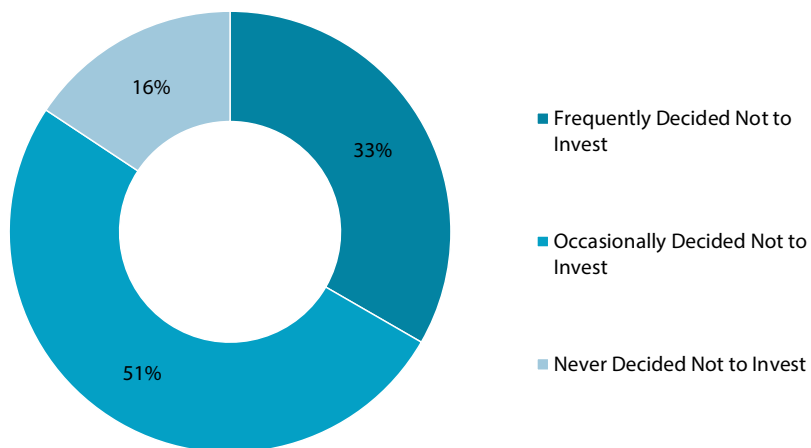
of investors look for attractive fund terms when evaluating a new hedge fund opportunity.



1 in 4

investors reported that marketing materials do not provide enough information on terms and conditions.

Fig. 3.12: Frequency with Which Investors Have Decided Not to Invest in a Hedge Fund Due to the Proposed Terms and Conditions



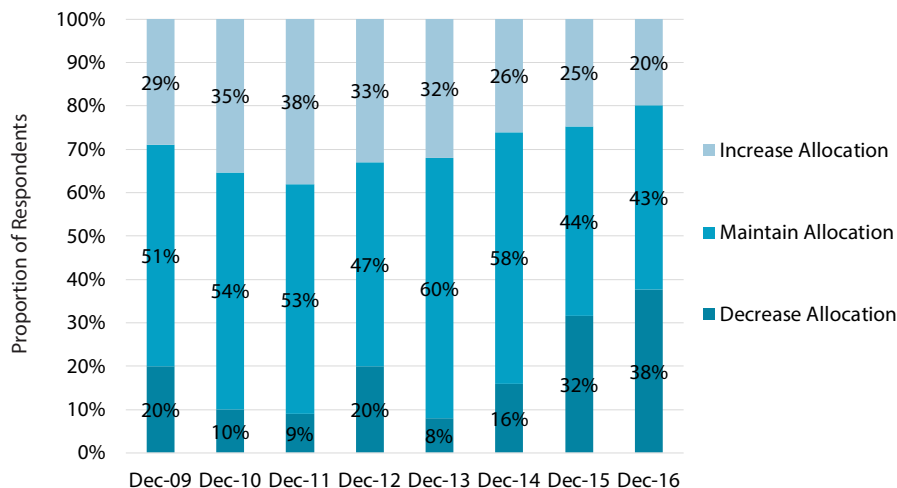
Source: Preqin Investor Interviews, December 2016

INVESTOR ACTIVITY IN 2017

In Preqin's December 2015 investor interviews, Preqin noted that for the first time since we began tracking this data in 2009, more investors planned to decrease their allocations to hedge funds than planned to increase their exposure to the asset class in the coming year (Fig. 3.13). At the time, we predicted this could be the first sign of outflows from the asset class; this prediction proved correct over the course of the year as investors withdrew a net \$102bn from the industry. One year on, and Preqin's December 2016 interviews reveal that not only are a greater proportion of investors planning on decreasing their allocation to hedge funds in the next 12 months (38%, compared to 32% in December 2015) but the proportion of investors planning to increase their allocation to the asset class in 2017 has decreased (20%, compared to 25% in December 2015). With the gap widening between the number of investors decreasing their exposure and those increasing their investment in hedge funds, it looks like not only will 2017 be another year in which outflows are likely, but one in which they could even accelerate.

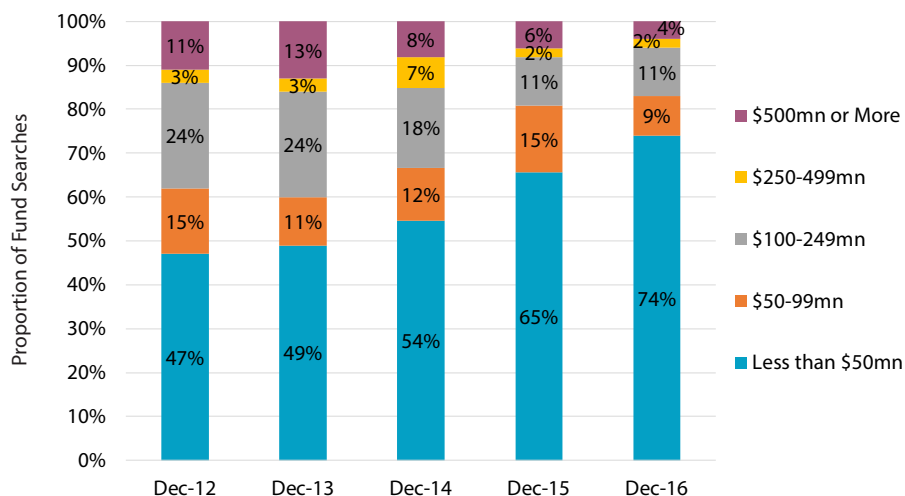
As well as the expected decrease in investor allocations in 2017, those investors that are looking for new hedge funds are planning to put smaller sums of capital to work than in any previous year. Data from Preqin's **Hedge Fund Online** shows that since 2013, an increasing proportion of mandates have been for less than \$50mn, while the proportion of searches for a commitment of \$500mn or more has steadily declined: three in four mandates for 2017 are for \$49mn or less (Fig. 3.14). However, a potentially positive development is that there has been an increase in the proportion of mandates for three or more funds compared to the previous year (Fig. 3.15). Sixty-five percent of investors searching for new hedge funds in 2017 will be looking to commit capital to three or more funds, compared to 58% of investors that issued searches for 2016. Therefore, although there will be

Fig. 3.13: Investors' Intentions for Their Hedge Fund Allocations in the Next 12 Months Compared to the Previous 12 Months, 2009 - 2016



Source: Preqin Investor Interviews, December 2009 - December 2016

Fig. 3.14: Amount of Fresh Capital Investors Plan to Invest in Hedge Funds over the Next 12 Months, 2012 - 2016



Source: Preqin Hedge Fund Online

a smaller number of investors looking at making new allocations in the year ahead, those that are will be looking for more funds than in 2016.

STRATEGIES TARGETED

Relative value strategies are attracting investors' attention in 2017: 26% of investors in these funds plan to increase their exposure to these strategies over the year, and just 6% plan to reduce the amount of capital they have invested in these funds (Fig. 3.16). Although a similarly

high level of investors in macro strategies plan to increase their exposure to these funds in 2017, a fifth plan to reduce their exposure, highlighting the rather mixed outlook from institutional investors on macro strategies in 2017. Managed futures may have a more challenging year in terms of fundraising in 2017 as compared to 2016, a year in which CTAs saw inflows of \$17bn. Twice the level of investors in CTAs plan to reduce their exposure to the strategy over 2017 than plan to increase their exposure. This represents a reversal

PREQIN INVESTOR OUTLOOK: ALTERNATIVE ASSETS, H1 2017

of the trend we saw in our December 2015 investor interviews, and may indicate that these funds will see outflows in 2017, particularly as both systematic and discretionary CTAs have disappointed the majority of investors (see page 23).

STRUCTURES TARGETED

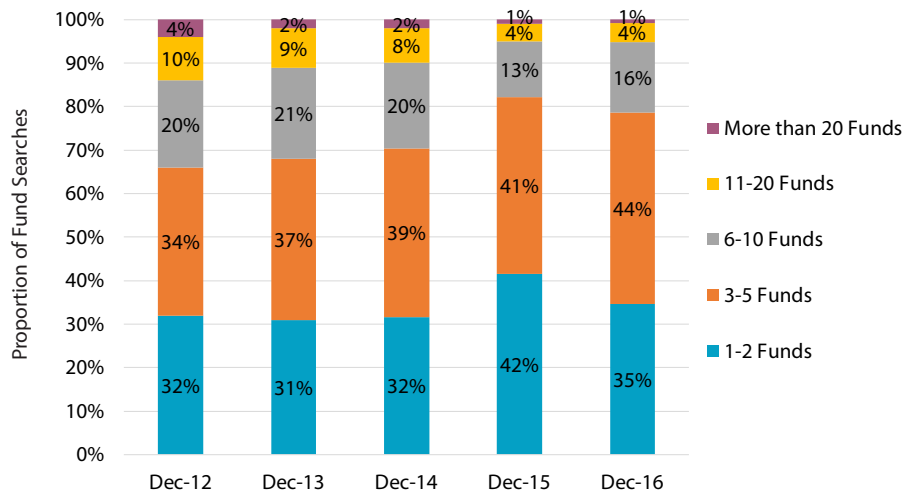
Nearly half (41%) of investors in alternative UCITS funds plan to increase their exposure to UCITS vehicles in the coming year (Fig. 3.17). One-third of respondents are planning to increase their exposure to separately managed accounts in 2017, while none indicated plans to decrease their exposure to this structure. Just under one-quarter of respondents reported plans to increase their exposure to traditional commingled funds in 2017; however, a notable 13% are planning to decrease their exposure to this structure over the coming year, perhaps as they move money towards alternative structures such as UCITS or managed accounts in order to lower fees or increase the transparency of their hedge fund holdings.

“ 2017 will not only be another year in which outflows are likely, but one in which they could even accelerate ”

OUTLOOK

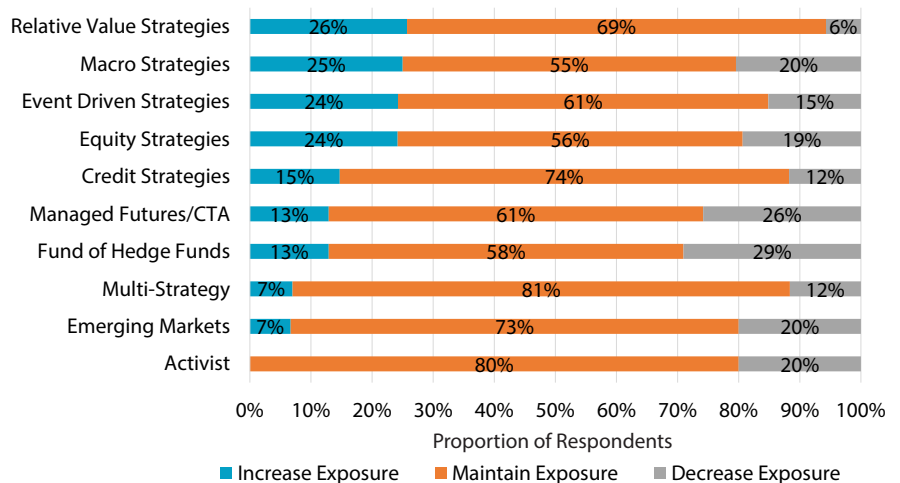
As we move into 2017, it will be the twin issues of fees and performance that the industry must address in order to win back the favour of institutional investors. However, 2016 represents the best performing year for the Preqin All-Strategies Hedge Fund benchmark since 2013, and the outlook of the majority (53%) of investors is that this will be matched in 2017, while over a quarter (28%) believe the industry will perform better in the coming year. With investors recognizing that equity market volatility could have a bigger effect on their hedge fund portfolios in 2017 than in 2016, and with continued political and market uncertainty expected over the year, the value of hedge funds to reduce risk and minimize losses may indeed be proved to these sceptical investors.

Fig. 3.15: Number of Hedge Funds Institutional Investors Expect to Add to Their Portfolios over the Next 12 Months, 2012 - 2016



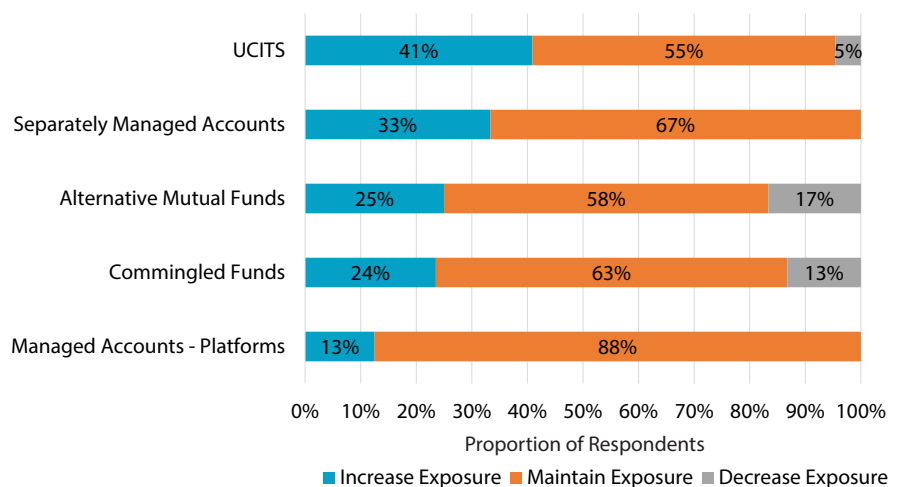
Source: Preqin Hedge Fund Online

Fig. 3.16: Investor Allocation Plans for 2017 by Strategy



Source: Preqin Investor Interviews, December 2016

Fig. 3.17: Investor Allocation Plans for 2017 by Structure



Source: Preqin Investor Interviews, December 2016

HOW INVESTORS SOURCE AND SELECT HEDGE FUNDS



42%

of investors found it more difficult to source attractive investment opportunities in 2016 compared to 2015.



63%

of investors believe marketing documents fail to meet their needs.

HOW INVESTORS SOURCE FUNDS:

16%

Through internal investment team

31%

Mainly internal or consultant recommendations, some external approaches

35%

Mix of internal and external recommendations

16%

Mainly approaches from managers or marketers, some internal recommendations

2%

Solely from external approaches

HOW INVESTORS SELECT FUNDS:

The average investor receives

234

fund proposals each year

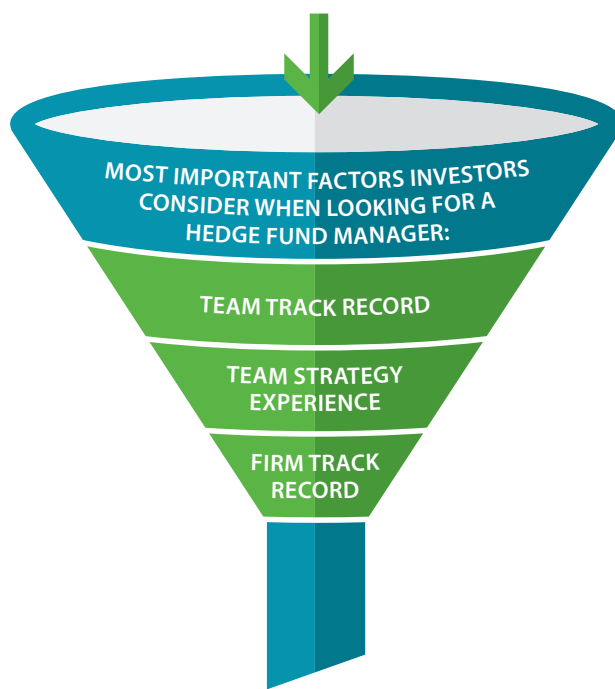
ACTIVE INVESTORS' PLANS FOR THEIR NEXT FUND COMMITMENT:

53%
of investors feel they get insufficient information on track record.

60%
of investors feel they get insufficient information on the strategy of a fund.

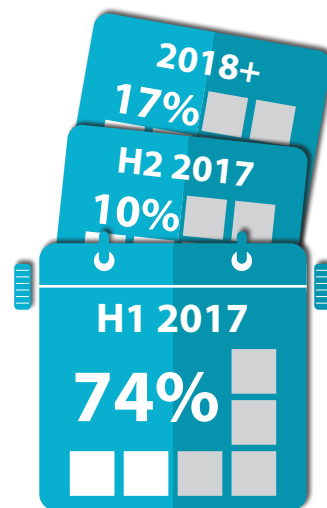
KEY REASONS INVESTORS REJECT A FUND MANAGER:

- Below-average team track record
- Fees/terms
- Length of team track record



8%

of proposals, on average, are sent through for a second round of screening.



The average investor makes



2

commitments to hedge funds each year.



PREQIN INVESTOR OUTLOOK: HEDGE FUNDS

H1 2017

PREQIN

Alternative Assets Data & Intelligence

Preqin provides information, products and services to fund managers, investors, consultants and service providers across six main areas:

- **Investors** – Allocations, Strategies/Plans and Current Portfolios
- **Fund Managers** – Funds, Strategies and Track Records
- **Funds** – Fundraising, Performance and Terms & Conditions
- **Deals/Exits** – Portfolio Companies, Participants and Financials
- **Service Providers** – Services Offered and Current Clients
- **Industry Contacts** – Direct Contact Details for Industry Professionals

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