Preqin Investor Outlook: Hedge Funds H2 2015

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Investors Seek Improved Performance with More Favourable Fees in H2 2015

Following a difficult 2014, a poor year in terms of performance and a year that saw the departure of some high-profile investors from investment in the asset class, Preqin predicted, in our 2015 Global Hedge Fund Report, that 2015 would need to be a year in which hedge funds showed what they are worth. The triple threat of generating **better performance**, gaining investment in a **competitive fundraising environment** and navigating the **regulatory environment** were the key issues that fund managers identified as challenges for the year. The results of our institutional investor survey, conducted in June 2015 and in which over 190 institutions participated, have revealed that many of the concerns of fund managers are proving to be true.

The Difficulties in H1 2015

Investor disappointment with the 12-month performance of hedge funds has reached its highest level since Preqin started tracking this data in 2008 (see page 20). Investors are also wary of putting more money to work in hedge funds; a third of investors plan to invest less capital in the next 12 months than the previous year and just 19% intend to invest more (see page 21). In addition, investors have identified performance and fees as the key issues in the year ahead, suggesting that the value of hedge funds is something that many investors are actively scrutinizing.

The Opportunities for H2 2015

Although the hedge fund sector faces many challenges, our survey does reveal some bright spots. When evaluating hedge fund performance over the first half of 2015, investors show greater levels of satisfaction with returns than over the 12-month period to June 2015. Seventy-nine percent of investors stated that return expectations had been met or exceeded in the first half of 2015, compared to 57% that stated the same for the 12-month period to June 2015. This indicates that there is improved sentiment about hedge fund performance in 2015, a period in which hedge funds have made gains of 5.65% compared with the 3.37% logged by the S&P 500. Some strategies have particularly impressed institutional investors; multi-strategy and equities strategies were highlighted by 90% and 80% of investors in these strategies as having satisfied performance expectations respectively.

Investor concerns expressed in our June 2015 investor interviews reflect that fundraising is likely to be even more challenging in the year ahead. However, in our H2 2015 Preqin Investor Outlook, Preqin aims to help navigate the difficult environment of 2015 with insight into institutional investment in hedge funds. Our special feature 'How Investors Source and Select Hedge Funds' (page 24) takes a closer look at how investors find and filter the hedge funds that meet their needs from the 15,000+ open for investment today.

Key Facts

43% Proportion of investors that believe hedge fund returns have not met expectations over the previous 12 months.

47% Proportion of investors that source new fund opportunities from consultant recommendations, the most commonly utilized method of finding new funds.

44% Proportion of investors that believe that performance is the key issue for hedge funds in 2015, the most commonly cited issue.

156 The average number of hedge fund proposals received each year by institutional investors.

Satisfaction with Returns

Fig. 3.1 shows how institutional investors rank the performance of hedge funds over the preceding 12 months. There has been a notable increase in the proportion of investors interviewed by Preqin that indicated that their hedge fund portfolio returns over the past 12 months, to June 2015, had fallen short of their expectations, up from 35% at the end of 2014 to 43% in H1 2015. This is the highest level of dissatisfaction with 12-month returns recorded by Preqin.

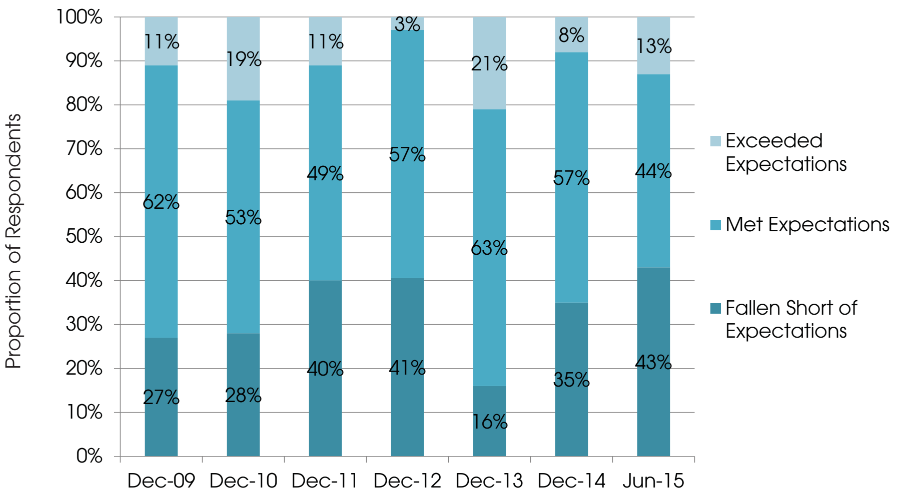
However, following a five-month streak of positive returns from the start of 2015 until May, there appears to be some degree of positivity returning to the investor outlook on hedge funds. When specifically asked about the performance in H1 2015, the solid returns produced by hedge funds in the first half of the year has led to a larger proportion of investors (79%) stating their returns expectations had been either met or exceeded in this timeframe (Fig. 3.2), compared to the longer 12-month period (57% in Fig. 3.1). Therefore, it is likely the poor performance in the second half of 2014, when the Preqin All-Strategies Hedge Fund benchmark added just 0.30% in the final six months of the year, that has led to such high levels of investor dissatisfaction.

Preqin asked investors to rate the strategies that they currently invest in by whether they had performed well or underperformed in the first half of 2015. Ninety-six percent of the investors that participated in the Preqin study have a current investment in an equities strategy fund and 80% have been satisfied with the performance of the strategy over the first half of 2015 (Fig. 3.3). Despite a difficult June, the Preqin All-Equities Strategies benchmark had recorded gains of 4.33% in H1 2015, higher than the 3.37% logged by the S&P 500 in the same timeframe.

Ninety percent of investors with an investment in a multi-strategy fund ranked the strategy as performing well in the first half of 2015. Multi-strategy funds enjoyed a seven-month streak of positive monthly returns between November 2014 and May 2015. Activist funds have also been rated as good performers by the investors in these funds, having delivered the highest year-to-date net return (7.60% as of 30 June 2015) of all the hedge fund strategies.

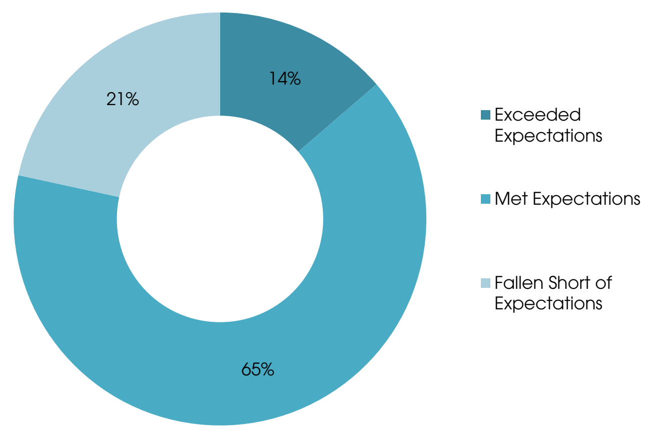
In contrast, 80% and 73% of investors in systematic and discretionary CTA strategies respectively feel that these funds had not performed well in the first half of 2015. Systematic CTAs started the year strongly, adding 5.27% in Q1 2015; however, a difficult Q2 led the strategy to lose all of the first quarter gains, and record net losses year to date, as of June 2015, of -0.83%. This volatile and poor performance has not gone unnoticed by investors in the strategy.

Fig. 3.1: Hedge Fund Portfolio Performance Relative to Expectations of Institutional Investors, December 2009 - June 2015



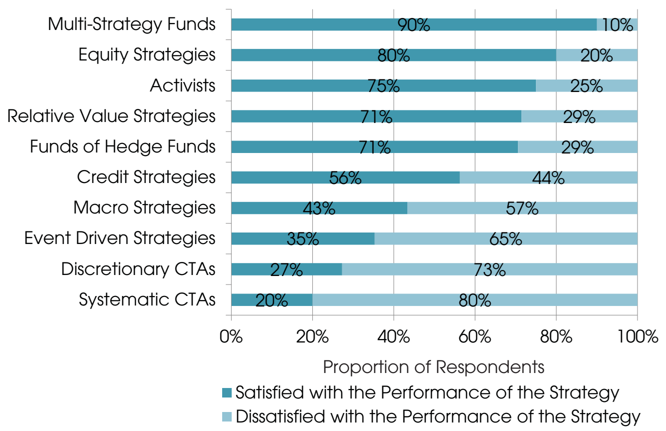
Source: Preqin Investor Interviews, December 2009 - June 2015

Fig. 3.2: Investor Satisfaction with Hedge Fund Performance in H1 2015



Source: Preqin Investor Interviews, June 2015

Fig. 3.3: Investor Satisfaction with Hedge Fund Performance in H1 2015 by Strategy



Source: Preqin Investor Interviews, June 2015

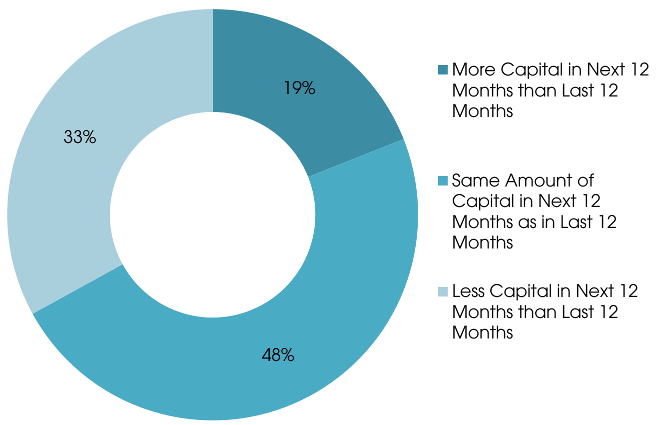
Investor Activity in the Next 12 Months

A larger proportion of investors plan to invest less capital in hedge funds over the next year than are planning to invest more capital in the asset class (Fig. 3.4). The failure of hedge funds to meet investors' expectations, in terms of performance, over the past 12 months (page 20) may have contributed to the reluctance of many investors to put more money to work in the asset class in the year to come, as they put portfolios on ice or re-evaluate the weighting of hedge funds in their portfolios.

Of those investors that are actively looking to make new investments in the year ahead, the majority (59%) will be seeking to make investments of $49mn or less, whereas just 12% of these investors are planning to put $250mn or more to work in the asset class in the next 12 months (Fig. 3.5). However, while most investors will be deploying relatively small amounts of capital in hedge funds, this will be distributed across multiple funds. Two-thirds of the active institutional investors on Preqin's Hedge Fund Investor Profiles service are planning to invest in at least three funds in the next 12 months (Fig. 3.6)

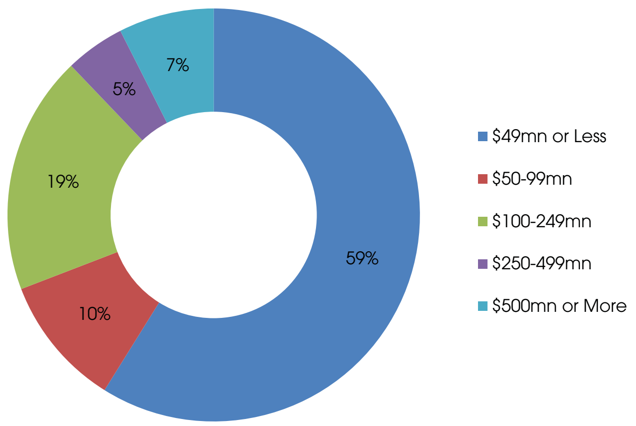
Long/short equity and macro funds are the most commonly sought-after strategies by those investors looking to make new investments; 55% and 30% of current fund searches respectively include these strategies as a preference (Fig. 3.7). At the other end of the liquidity spectrum, event driven funds, with their longer investment horizons and potential for return premiums, are also commonly sought by institutional investors. Twenty-three percent of investors currently searching for new funds in the year to come include event driven funds as part of their search, potentially for the strategy's ability to generate higher returns over the longer term, something that many investors have found hedge funds have not managed to do in the past year.

Fig. 3.4: Investors' Plans for their Hedge Fund Investments over the Next 12 Months Compared with the Last 12 Months



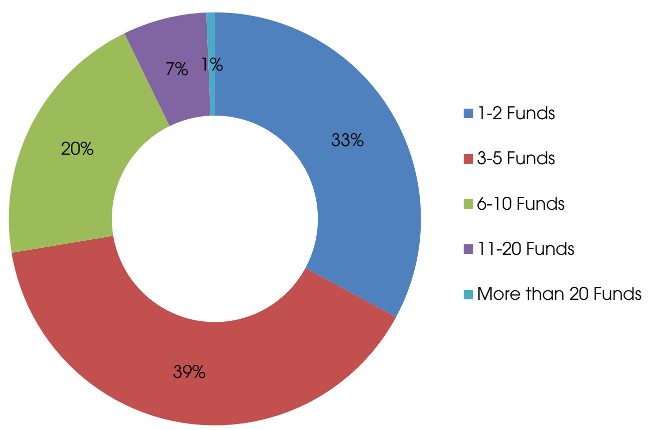
Source: Preqin Investor Interviews, June 2015

Fig. 3.5: Amount of Fresh Capital Institutional Investors Expect to Invest in Hedge Funds over the Next 12 Months



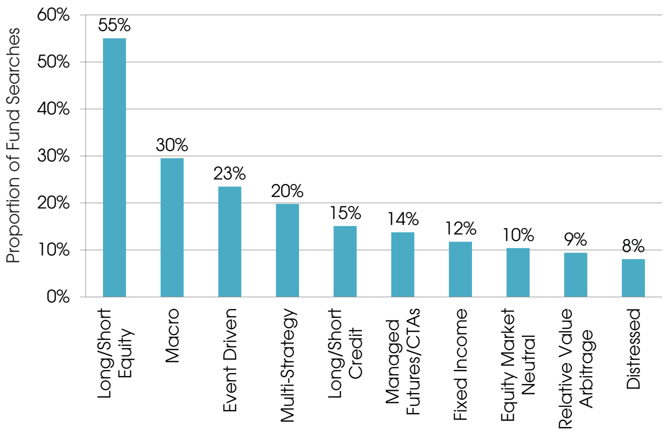
Source: Preqin Hedge Fund Investor Profiles

Fig. 3.6: Number of Hedge Funds Institutional Investors Expect to Add to Their Portfolios over the Next 12 Months



Source: Preqin Hedge Fund Investor Profiles

Fig. 3.7: Breakdown of Hedge Fund Strategies Sought by Institutional Investors over the Next 12 Months



Source: Preqin Hedge Fund Investor Profiles

Key Issues and Regulation

Investor dissatisfaction with the 12-month returns of hedge funds is at its highest level since Preqin started tracking this information (page 20). With such high levels of investors disappointed with the performance of the sector over the past year, it is perhaps unsurprising that hedge fund performance is the foremost concern among hedge fund investors for the rest of 2015 (Fig. 3.8). Since the last Preqin study of institutional investors in December 2014, we have seen an increase in the proportion of investors stating that performance is the key issue in the industry, up from 33% at the end of 2014 to 44% as of June 2015.

We have also seen continued growth in the number of investors stating that fees will be a key issue; 35% of investors cited this as an important issue in the hedge fund sector in June 2015, compared with the 21% that stated the same at the end of 2014. With hedge funds failing to meet the expectations of many investors, more institutions are questioning the value of the asset class. The higher costs involved when investing in hedge funds compared to other assets is a key consideration for investors in the current returns environment and something that is becoming an increasing concern.

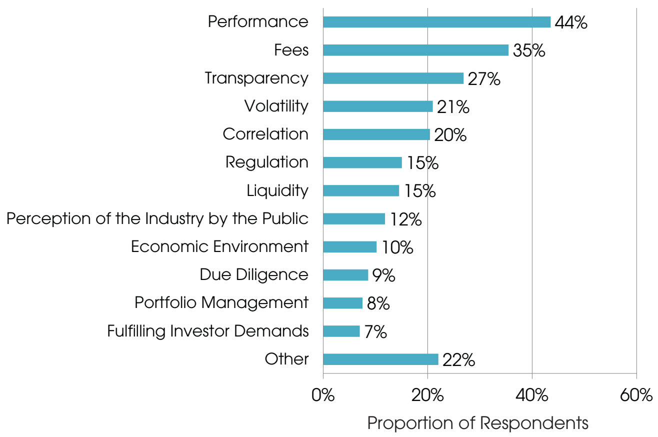
The hedge fund industry has become increasingly regulated over recent years and investors, as participants in the sector, continue to be impacted by its effects. Fifteen percent of the survey participants noted it as a key issue facing the industry over the rest of the year, an increase from the 6% that echoed this view when interviewed by Preqin in December 2014. The Alternative Investment Fund Managers Directive (AIFMD) has been one of the more prominent pieces of legislation introduced to the hedge fund industry. Despite the regulation passing its two-year anniversary of implementation in July, there is still a great deal of uncertainty surrounding the effect of the AIFMD on the industry by institutional investors. Nearly half (49%) of the surveyed institutions are unsure of the impact of the AIFMD on the hedge fund sector (Fig. 3.9).

Written into national law in July 2013, the AIFMD is still in its infancy and many investors may not yet have felt the effects of the new regulations upon their choice of fund manager. As we pass the two-year landmark of the implementation of the AIFMD, it still appears as though a large proportion of hedge fund investors are yet to determine whether the directive is beneficial to the industry or will disrupt their investment objectives.

Twenty-eight percent of investors believe the AIFMD will be good for the industry and half of these investors argued that the directive will provide greater transparency on hedge funds. Thirty-five percent of these investors believe that the AIFMD provides additional levels of protection for the investor, while 12% suggested it produces a better quality of alternative fund.

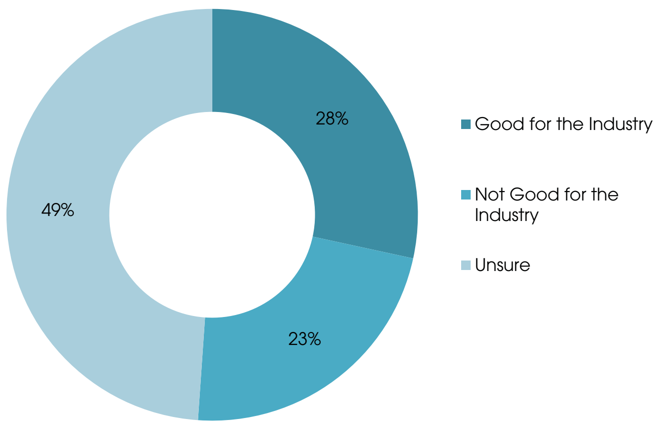
Europe-based hedge funds have been expected to become fully compliant with the new regulation brought about in the wake of the financial crisis, but there still remains negativity surrounding its impact on the hedge fund industry; 23% of hedge fund investors feel the AIFMD is not good for the industry. Among this group of investors, a significant proportion (57%) believe that the AIFMD is an unnecessary regulation to protect qualified investors, while a further 24% stated that the directive has led to reduced choice as an investor.

Fig. 3.8: Key Issues Facing the Hedge Fund Industry in H2 2015 According to Institutional Investors



Source: Preqin Investor Interviews, June 2015

Fig. 3.9: Institutional Investors' Views on Whether the AIFMD Regulation is Good for the Hedge Fund Industry



Source: Preqin Investor Interviews, June 2015

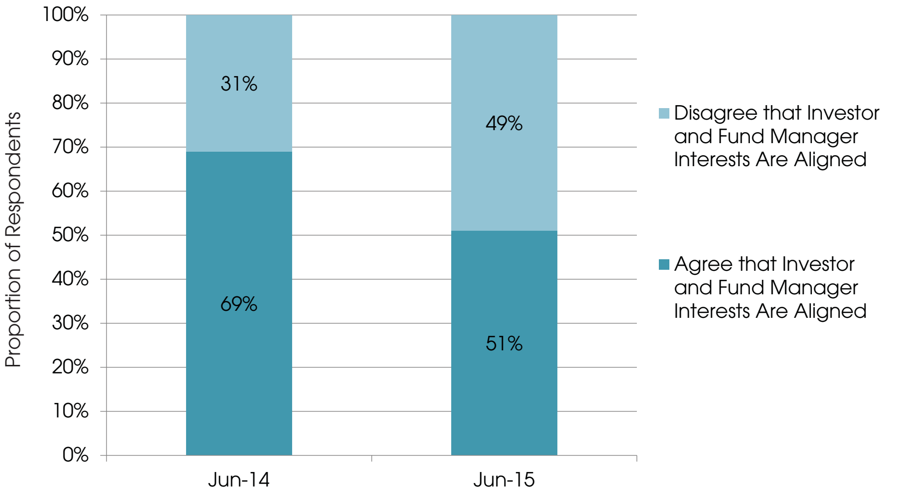
Fig. 3.10: Institutional Outlook on the Benefits and Disadvantages of the AIFMD

Why the AIFMD is Positive for the Industry	Why the AIFMD is Negative for the Industry
Will lead to more transparency (50%)	It is unnecessary regulation (57%)
It provides extra levels of protection for investors (35%)	Will lead to less choice for investors (24%)
Will lead to better quality of funds (12%)	Will lead to higher fees (14%)

Source: Preqin Investor Interviews, June 2015

Fees and Alignment of Interests

Fig. 3.11: Proportion of Investors that Believe Investor and Fund Manager Interests Are Properly Aligned, June 2014 - June 2015



Source: Preqin Investor Interviews, 2014 - 2015

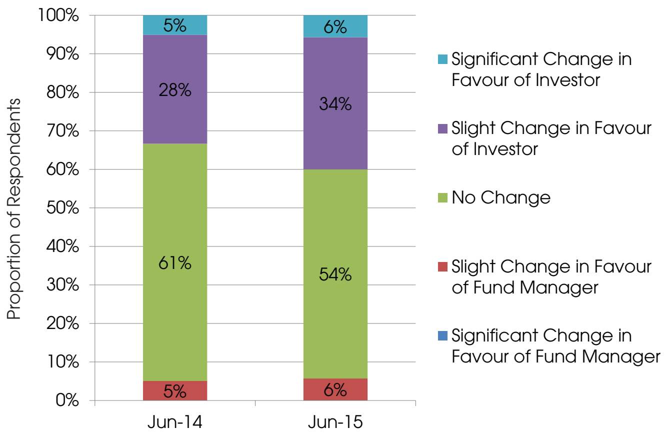
Thirty-five percent of investors believe that fees form one of the key topics affecting the hedge fund industry today (see page 22). This represents an increase from the 21% that stated the same in our survey conducted in December 2014. There has, in conjunction with this increase in investor awareness of fees, been an increase in the proportion of investors that believe that fund manager and investor interests are not aligned from a similar study conducted in June 2014 (Fig. 3.11). Today, investors are almost evenly split between agreeing that interests are aligned and disagreeing.

Despite more investors being dissatisfied with the alignment of interests between their institutions and their hedge fund managers, there has been a shift towards more investors seeing an improvement in fees in favour of the investor. In June 2014, a third of the investors that participated in the Preqin survey had seen a shift in fund terms in favour of the investor; in our June 2015 study this increased to 40% (Fig. 3.12).

With almost half of all investors believing that their interests are not aligned with those of the funds they invest in, how important is it for fund managers to reconsider their fee structures? Ninety percent of investors have rejected a fund because of the fees charged, 36% do so on a regular basis (Fig. 3.13). It is clear that having inappropriate fees, or fees that investors deem too high or incorrectly structured, can affect fund managers' abilities to gain investment from institutions.

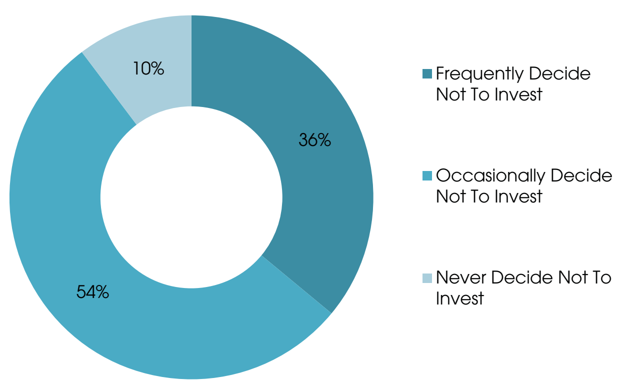
With investor dissatisfaction with the performance of hedge funds at high levels, the question of fees and the value that hedge funds represent has become more important to investors over the past year. Significant numbers of investors are dissatisfied with the alignment of interests in the hedge fund industry and also reject funds on the basis of inappropriate fees. Therefore, it seems the fee debate does not appear to be abating; in the competitive fundraising environment of 2015, it is more important than ever for fund managers to pay close attention to investor demands in regard to fund terms and conditions and tailor products accordingly in order to attract institutional capital.

Fig. 3.12: Proportion of Investors that Have Seen a Change in Fund Terms over the Last 12 Months, June 2014 - June 2015



Source: Preqin Investor Interviews, 2014 - 2015

Fig. 3.13: Frequency with Which Investors Have Decided Not to Invest in a Fund Due to Its Fees



Source: Preqin Investor Interviews, June 2015

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How Investors Source and Select Hedge Funds

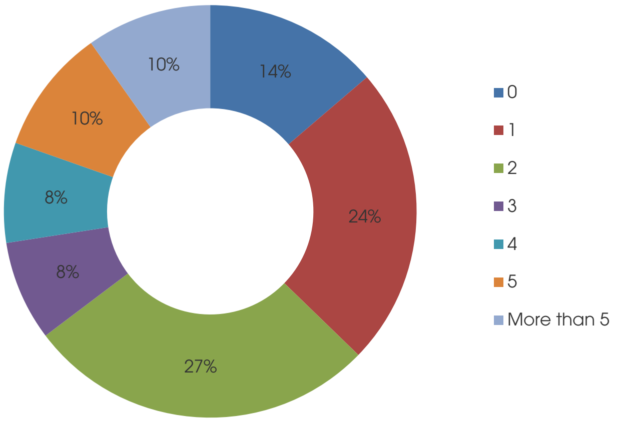
Fundraising remains a key challenge for hedge fund managers. With more investors looking at investing less capital in the year to come than are planning to invest more, it is more important than ever to understand how investors source and select new investment opportunities in order to be in with a greater chance of gaining some of the capital earmarked for new investment.

As Fig. 3.14 shows, 51% of the institutional investors that participated in the Preqin survey typically make one or two investments each year. Some institutions make significantly larger numbers of investments, for instance, 20% of the surveyed investors add five or more new hedge funds to their portfolio on an annual basis.

With the greatest number of institutions making just a modest number of investments each year, fund managers need to find out how to gain their attention in the first place in order to have a chance at winning a mandate. Getting on the radar of investment consultants is a good step to being noticed by institutional investors; nearly half (47%) of investors source new investment opportunities through recommendations made by their consultants (Fig. 3.15). Investors are also proactively searching for hedge funds, with 36% of the participants in the Preqin study sourcing new funds through their investment teams reaching out to the industry. In addition, 25% of institutions find funds through peer networks and the recommendations of other investors, and 21% use industry databases, such as Preqin's Hedge Fund Analyst, to find and review new funds.

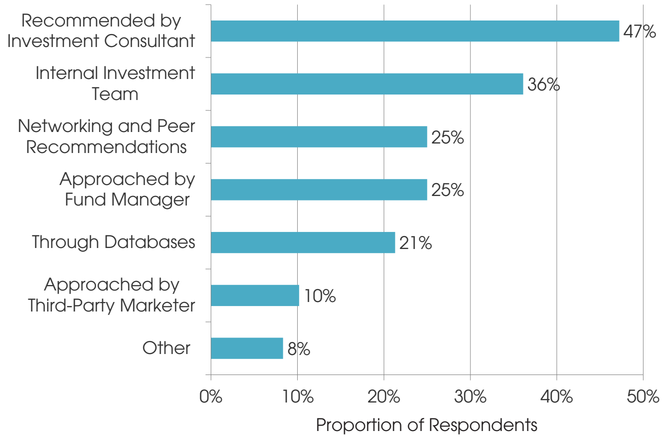
There are currently over 15,000 hedge funds open to investment globally. With such a large number of funds in the marketplace, investors face a challenging job to find the best and most suitable investment opportunities. As shown in Fig. 3.16, investors are receiving varied amounts of proposals each month. Just over a third (34%) of institutional investors receive fewer than 10 fund proposals on a

Fig. 3.14: Typical Number of New Hedge Fund Investments Made by Institutional Investors Each Year



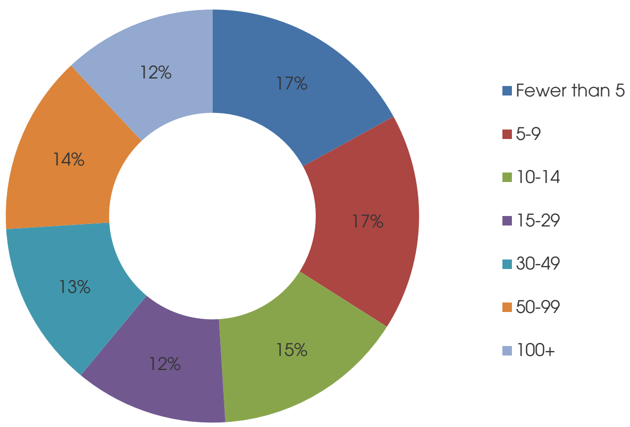
Source: Preqin Investor Interviews, June 2015

Fig. 3.15: Methods Used by Institutional Investors to Source New Hedge Fund Opportunities



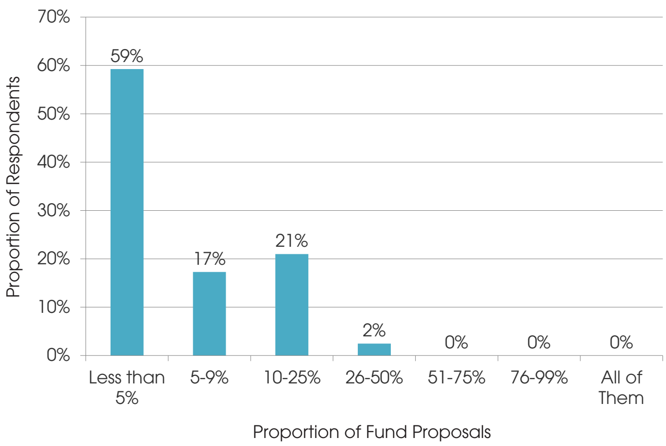
Source: Preqin Investor Interviews, June 2015

Fig. 3.16: Number of Hedge Fund Marketing Proposals Received by Institutional Investors Each Month



Source: Preqin Investor Interviews, June 2015

Fig. 3.17. Proportion of Hedge Fund Proposals Received by Institutional Investors Which Get Through the First Round of Screening



Source: Preqin Investor Interviews, June 2015

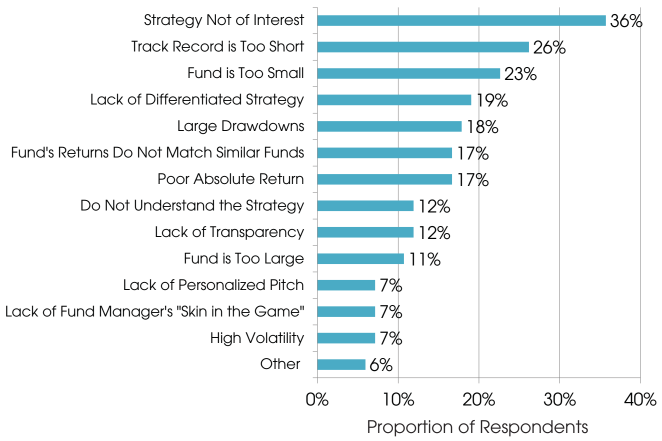
monthly basis. However, over half (51%) receive 15 or more hedge fund proposals. A notable proportion (12%) receive 100 or more fund proposals each month.

Investors certainly face a difficult task in sorting through the large number of proposals they receive to select funds that they might want to investigate further. Fifty-nine percent of investors reject 95% or more of the fund proposals they receive in the first round of screening (Fig. 3.17). Ninety-eight percent of investors reject at least three-quarters of the fund proposals they receive when they initially screen the opportunities. Most commonly, investors reject funds because the strategy is not of interest to them, with 36% of investors stating this as a reason why a fund is rejected in the first stages of screening (Fig. 3.18). The results also highlight the continued challenge that emerging fund managers face in terms of raising capital; the next leading two reasons why funds are rejected are that the fund is either too small or the track record too short. Other reasons investors highlighted included the fund strategy not being different enough from others in the market, and various factors related to the fund's performance, notably large drawdowns, poor performance relative to its peers and poor absolute returns.

Preqin's survey reveals that across all of the investors interviewed, institutions receive, on average, 13 hedge fund proposals each month. This equates to more than 150 funds on an annual basis. With most of these proposals being rejected at the first stage, the majority of investors (57%) are only monitoring 10 hedge funds or fewer on a pre-investment basis (Fig. 3.19). The institutions surveyed by Preqin vary in the amount of time it takes to evaluate each new fund opportunity and to make an investment decision. A third of investors take up to three months to make a decision to invest in a fund from the day the initial proposal was received (Fig. 3.20). Other investors take more time in evaluating a potential new fund investment; 38% of investors spend at least six months evaluating a fund before they make an investment.

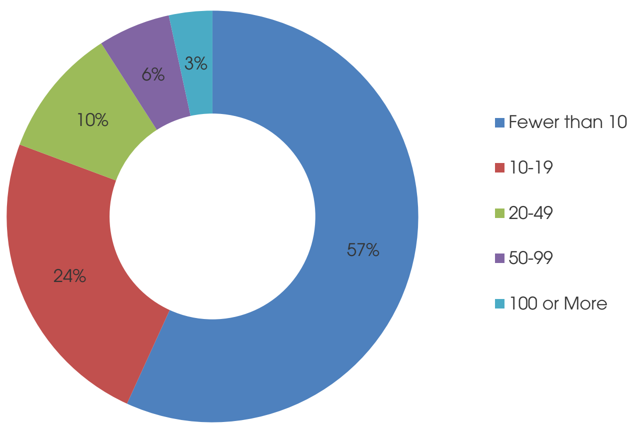
Sourcing and selecting new hedge funds for investment is a resource-intensive activity for institutional investors and therefore, once they have decided to commit to a new fund, that capital is likely to stay invested for several years. In fact, two-thirds of institutions will remain invested in a fund for at least three years (Fig. 3.21). Therefore, although gaining the attention of institutional investors is difficult, the efforts involved in providing the right information and meeting the requirements of institutions can have a significant effect on the success of a hedge fund. Not only do institutional investors invest significant sums, but their capital is 'sticky' and remains invested for long periods of time.

Fig. 3.18: Reasons Why Institutional Investors Reject Proposals During Initial Screening



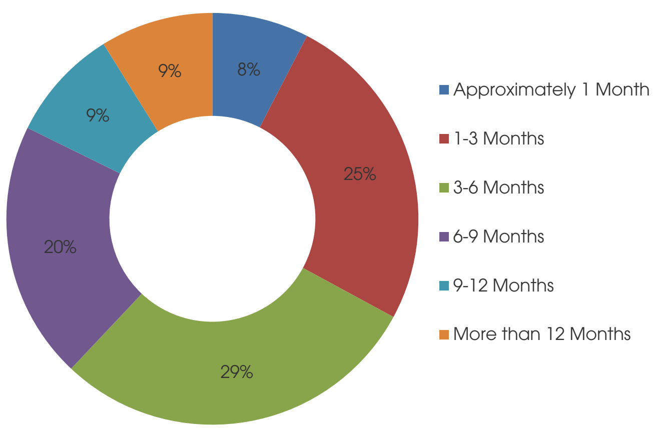
Source: Preqin Investor Interviews, June 2015

Fig. 3.19: Number of Hedge Funds Institutional Investors Are Currently Monitoring Pre-Investment



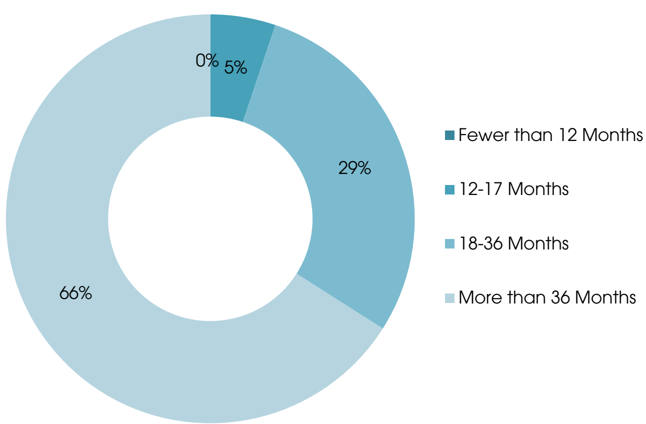
Source: Preqin Investor Interviews, June 2015

Fig. 3.20: Typical Time Taken for an Institutional Investor to Decide to Invest in a Hedge Fund from the Date of Fund Proposal



Source: Preqin Investor Interviews, June 2015

Fig. 3.21: Typical Length of Time Institutional Investors Remain Invested in a Hedge Fund



Source: Preqin Investor Interviews, June 2015

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How Investors Source and Select Hedge Funds: In Brief

How Investors Source Funds*:

47% through **consultant recommendations**

36% through **internal investment team**

25% through **networking** and **peer recommendation**

25% through **direct approaches** from fund managers

21% through **fund databases**

10% approached by **third-party marketer**

The average investor receives **156** fund proposals each year

The three leading reasons why a fund is rejected during initial screening are*:

- Fund Strategy Is Not of Interest
- Fund Is Too Small
- Track Record Is Too Short

Average Time Taken to Make an Investment Decision: **5 Months***

The average investor is pre-screening **seven** funds at any one time*

The average investor makes **three** investments each year*

Two-thirds of investors remain invested in a fund for **36 months or more***

How Can Preqin Help Raise Funds?

- Find out what strategies investors are interested in with our dedicated **Fund Searches and Mandates** portal
- Find out which consultants work with which investors and the key contacts at each group
- Gain detailed insights into over **5,500** institutional investors to build tailored pitches to those investors looking for your fund
- Over **7,000** investors are looking at funds on **Preqin Investor Network**, ensure your details are accurate and up-to-date so investors can find you!

www.preqin.com/sharedata

*Source: Preqin Investor Interviews, June 2015

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With global coverage and detailed information on all aspects of alternative assets, Preqin's industry-leading online services keep you up-to-date on all the latest developments in the private equity, hedge fund, real estate, infrastructure and private debt industries.

Source new investors for funds and co-investments

Find the most relevant investors, with access to detailed profiles for over 9,200 institutional investors actively investing in alternatives, including current fund searches and mandates, direct contact information and sample investments.

Identify potential fund investment opportunities

View in-depth profiles for over 2,200 private equity, real estate, infrastructure and private debt funds currently in market and over 15,000 hedge funds open to new investment, including information on investment strategy, geographic focus, key fund data, service providers used and sample investors.

Find active fund managers in alternatives

Search for firms active in alternative investments. View information on key contacts, firm fundraising/AUM and performance history, key investment preferences, known investors and more.

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Benchmark performance

Identify which fund managers have the best track records, with customizable fund performance benchmarks and performance details for over 20,000 individual named private equity, real estate, infrastructure, private debt and hedge funds.

Examine fund terms

See the typical terms offered by funds of particular types, strategies and geographical foci, and assess the implications of making changes to different fees.

View detailed profiles of service providers

Search for active administrators, custodians, prime brokers, placement agents, auditors and law firms by type and location of funds and managers serviced. Customize league tables of service providers by type, location of headquarters and total known number of funds serviced.

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