PREQIN SPECIAL REPORT: HEDGE FUND MANAGER OUTLOOK

H1 2017

preqin

alternative assets. intelligent data.

FOREWORD

2016 could be seen as a year in which the unexpected happened, with perhaps the result of the Brexit vote and Donald Trump's triumph in the US presidential election at the pinnacle of this series of largely unpredicted events. As markets struggled to respond to these surprising outcomes, volatility increased, and hedge funds, following two years of disappointing returns, were able to capture some upside, adding 7.34% over the course of 2016.

Investors withdrew a net $110bn in investor capital in 2016. It was, perhaps, the announcement of withdrawals from several of the largest investors in hedge funds – New Jersey State Investment Council, NYCERS and Metlife Insurance Company, to name a few – that characterized the reasons behind the wider redemptions in the industry. Many of these large institutions cited performance concerns and high fees as the leading motives for reducing their exposure to hedge funds. Even the largest hedge funds were unable to survive the wave of redemption requests which swept through the industry in 2016. For instance, Perry Capital, which had assets of $15bn at its height, was forced to close up shop in September following significant investor withdrawals and poor performance.

Following a year which saw hedge funds post their highest return since 2013, as well as high-profile investors withdraw from the asset class, Preqin surveyed over 270 hedge fund managers in November 2016 to find out their views on how events in 2016 affected their portfolios and their plans for addressing investors' current sentiment towards the asset class.

Since Preqin's **H1 2016 Hedge Fund Manager Outlook**, the proportion of respondents citing performance and fees as the drivers of change facing the industry has increased, with nearly three-quarters (73%) of fund managers viewing hedge fund returns as a key challenge for the asset class in 2017.

Significant proportions of fund managers found both attracting new capital (47%) and retaining their assets (36%) more challenging in 2016 when compared to 2015, while the new sources of investor capital are becoming increasingly important to fund managers, with respondents reporting that the proportion of capital coming from institutional investors has decreased for three consecutive years. This fundraising environment has led managers to re-evaluate how they charge fees to their investors, and provisions such as high-water marks and clawbacks are being included in an increasing proportion of funds.

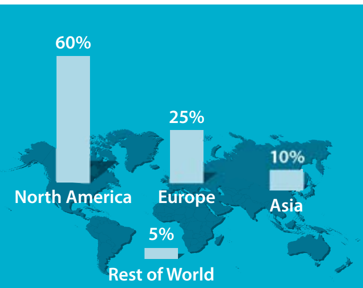
We hope you find this report useful, and welcome any feedback you may have. For more information, please visit www.preqin.com or contact info@preqin.com.

276

Number of hedge fund managers surveyed.

$279bn

Aggregate AUM of respondents.



Location of respondents.

ASSET FLOWS

Preqin's **Hedge Fund Online** database holds performance and asset data for over 15,000 hedge funds. Using this extensive coverage, Preqin is able generate estimates of the capital flowing in and out of the industry, and determine which strategies and regions have seen net asset growth or decline over the course of 2016.

NEGATIVE FLOWS, POSITIVE PERFORMANCE

Following a year of strong inflows in 2015, the industry saw net outflows of $110bn in 2016 (Fig. 1). Q4 2016 represented the fifth consecutive quarter in which the hedge fund industry recorded net outflows, as concerns around performance and fees saw some investors pull capital out of their hedge fund allocations (Fig. 2). Equity and credit strategies recorded the largest net outflows over the year; however, the total assets of equity strategies funds increased by 2% over 2016, driven by an annual net return of 6.85%. Investor sentiment towards CTAs, however, is strikingly different to that of hedge funds: CTAs attracted $26bn in new capital in 2016 as investors looked for sources of uncorrelated returns. Despite outflows across all but one top-level strategy, the AUM of the global hedge fund industry increased 3.2% since December 2015 to $3.25tn as performance gains added value to the industry's holdings.

TOP PERFORMERS ATTRACTING INFLOWS

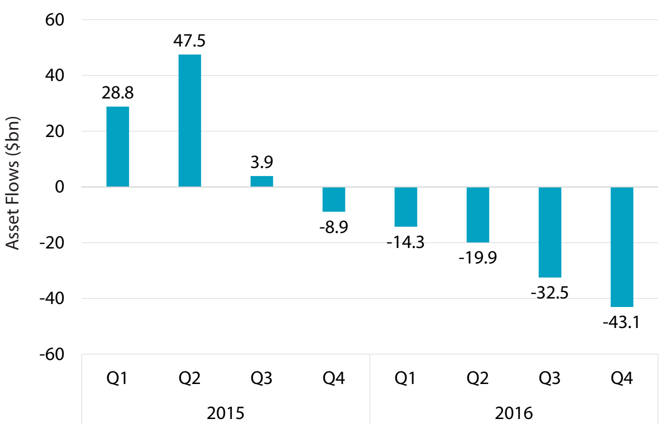
Fig. 3 shows that while investors have been withdrawing capital from the industry, funds with strong performance in recent years have attracted new capital: the majority (54%) of funds that generated a net return of 5% or more during 2015 recorded net inflows during 2016. This is in stark contrast to funds at the opposite end of the return spectrum: less than one-quarter (24%) of funds that lost more than 5% in 2015 recorded net inflows in 2016. This is a clear indication of the importance of a recent track record as investors decide where to allocate new capital within the industry.

Fig. 1: Hedge Fund Asset Flows by Strategy, 2015 - 2016

Strategy	2015 Asset Flows ($bn)	Q1 2016 Asset Flows ($bn)	Q2 2016 Asset Flows ($bn)	Q3 2016 Asset Flows ($bn)	Q4 2016 Asset Flows ($bn)	2016 Asset Flows ($bn)	Q4 2016 AUM ($bn)	Percentage Change in AUM over 2016
CTAs	24.6	13.7	2.9	10.5	-1.6	**25.5**	251	12.30%
Niche Strategies	1.3	-1.5	-0.2	0.3	0.6	**-0.8**	15	3.00%
Event Driven Strategies	-1.8	-2.8	3.4	-0.6	-3.0	**-2.9**	177	6.70%
Macro Strategies	-25.8	-6.4	-4.9	-1.2	6.6	**-5.9**	979	6.50%
Multi-Strategy	27.5	12.8	-1.6	-25.0	-8.7	**-22.5**	425	-1.30%
Relative Value Strategies	-18.8	-8.7	10.4	-16.4	-10.1	**-24.7**	341	-0.90%
Credit Strategies	4.2	-11.9	-14.3	2.0	-4.0	**-28.2**	237	-2.00%
Equity Strategies	60.3	-9.7	-15.6	-2.2	-22.9	**-50.3**	823	2.00%
Industry Total	**71.4**	**-14.3**	**-19.9**	**-32.5**	**-43.1**	**-109.8**	**3,247**	**3.20%**

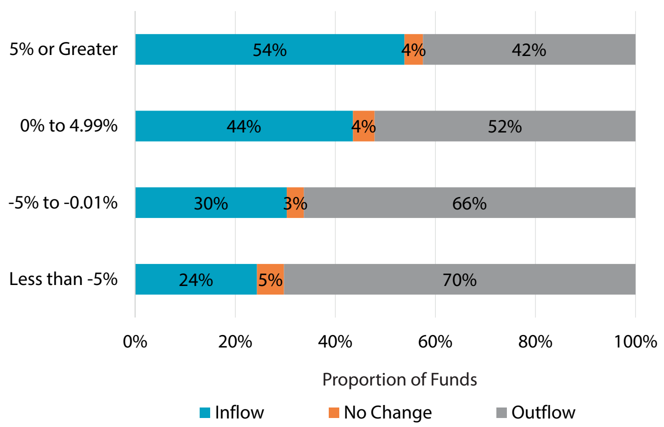
Source: Preqin Hedge Fund Online

Fig. 2: Hedge Fund Asset Flows, 2015 - 2016



Source: Preqin Hedge Fund Online

Fig. 3: Hedge Fund Asset Flows over 2016 by 2015 Performance

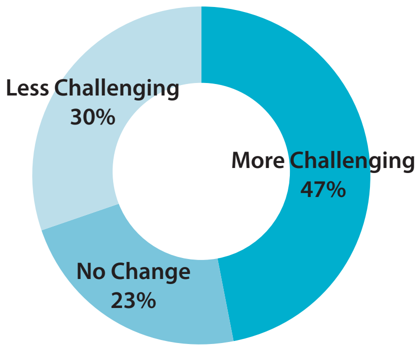


Source: Preqin Hedge Fund Online

REVIEW OF 2016

The majority of respondents to Preqin's fund manager survey in November 2016 witnessed asset growth in 2016, with nearly two-thirds reporting an increase in AUM, up six percentage points from 2015.

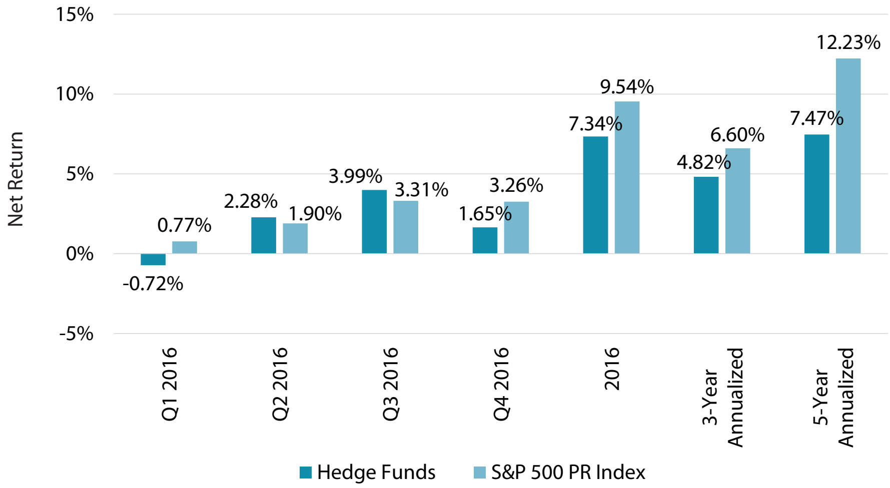
FUND MANAGER VIEWS ON THE FUNDRAISING ENVIRONMENT IN 2016 vs. 2015



FUNDRAISING

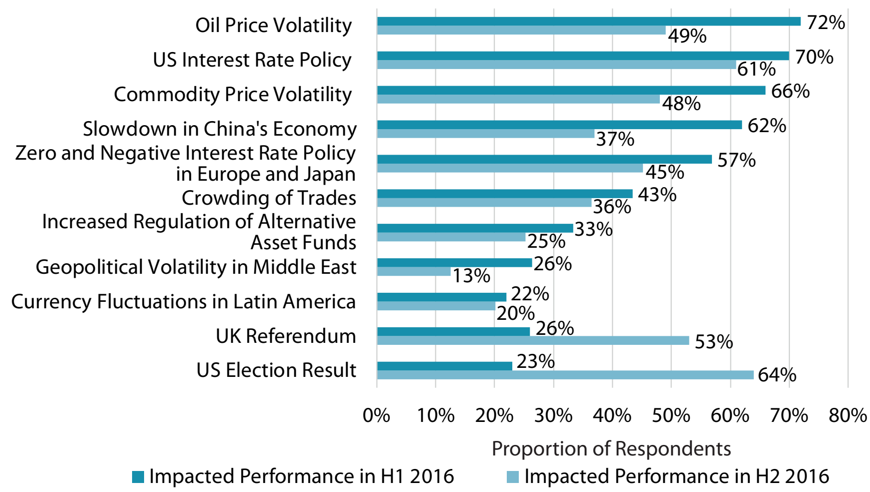
As reported in the **2016 Preqin Global Hedge Fund Report**, nearly a third (32%) of investors planned to deploy less capital in hedge funds in 2016 than in 2015, compared with 25% that planned to commit more capital. This investor sentiment looks to have impacted fundraising in 2016, with nearly half (47%) of fund managers experiencing a more challenging fundraising environment over the past year. In addition, 36% believe it was harder to retain assets in 2016 compared to 2015 as investors continued to evaluate their hedge fund allocations.

Fig. 4: Performance of Hedge Funds vs. S&P 500 PR Index (As at December 2016)



Source: Preqin Hedge Fund Online

Fig. 5: Fund Manager Views on the Macroeconomic Events that Had the Greatest Effect on Fund Performance: H1 2016 vs. H2 2016



Source: Preqin Hedge Fund Manager Survey, November 2016

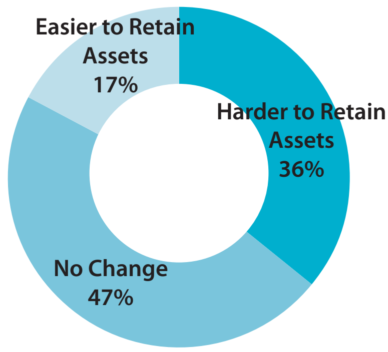
PERFORMANCE IN 2016

2016 saw hedge funds post 7.34%, their best annual return since 2013 (+12.49%) and more than treble the gains of 2015 (+2.14%). However, the Preqin All-Strategies Hedge Fund benchmark still lagged the S&P 500 Index (+9.54%) by two percentage points (Fig. 4).

Markets around the world witnessed volatility in 2016: the pound hit a 31-year low against the dollar following the Brexit vote, oil prices surged as OPEC and non-OPEC states agreed to restrict output and US stock markets reached record highs following Trump's election. As seen in Fig. 5, nearly three-quarters (72%) of respondents saw their H1 2016 performance affected by oil price volatility, while 64% of respondents saw the US election impact their performance in the latter half of the year.

Twelve months ago, two out of five fund managers surveyed by Preqin reported that they had underperformed relative to expectations. The trend is similar in 2016: 41% of respondents reported that their return goals for 2016 were not met.

FUND MANAGER VIEWS ON THE DIFFICULTY OF RETAINING ASSETS IN 2016 vs. 2015

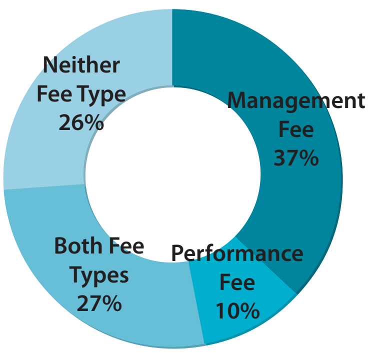


ALIGNMENT OF INTERESTS AND FEES

ALIGNMENT OF INTERESTS

Over half (52%) of fund managers surveyed believe the most effective way to align their interests with those of investors is through having 'skin in the game'. Greater transparency (16%), differing terms available to investors (4%) and offering customized solutions and separate accounts (3%) are among alternative methods to align interests; however, nearly a quarter (24%) of respondents believe it is important to offer all of these methods as a way of aligning interests with investors.

HEDGE FUND MANAGER VIEWS ON THE FEE STRUCTURE THEY ARE MOST LIKELY TO REDUCE IN 2017

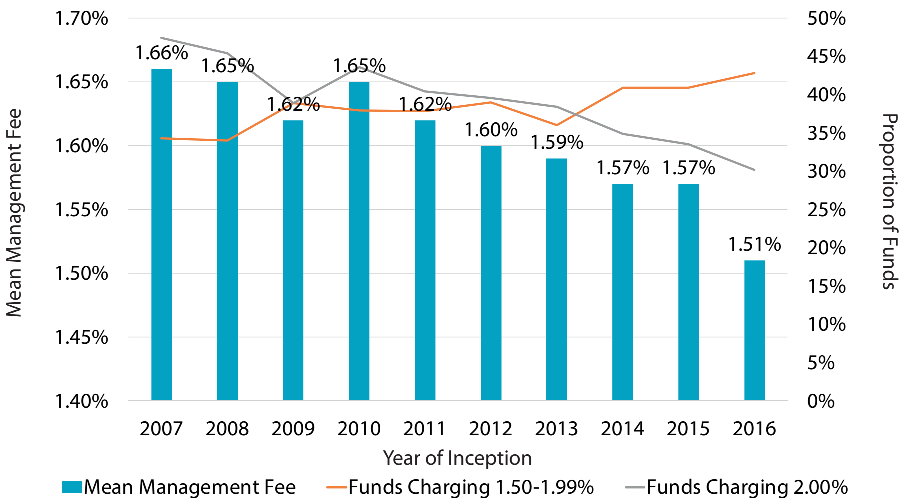


CHALLENGING THE 2/20

Hedge funds are traditionally associated with a 2/20 fee structure. However, Preqin data shows only 17% of active single-manager hedge funds actually deploy a strict 2.00% management and 20.00% performance fee structure; the average management and performance fees across the industry are currently 1.56% and 19.30% respectively. Of the fund managers Preqin surveyed in November 2016, 74% were willing to reduce fees, with over half reporting that they would cut their management fee. This shows that fund managers are receptive to lowering their fees in the current climate as competition for institutional capital intensifies.

Since 2007, the average management fee of hedge funds launched each year has been gradually decreasing from 1.66% to 1.51% in 2016 (Fig. 6).

Fig. 6: Mean Management Fee and Fee Distribution by Year of Inception



Source: Preqin Hedge Fund Online

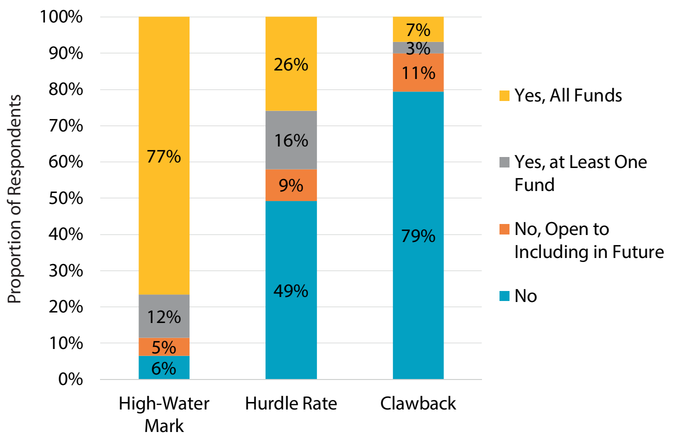
PERFORMANCE FEE EVOLUTION

A growing proportion of managers are implementing provisions on their performance fee. High-water marks, in which previous losses must be regained before a manager is eligible for a performance fee, are the most widely used provision, whereas clawbacks are less utilized by fund managers.

FEE CONCESSIONS

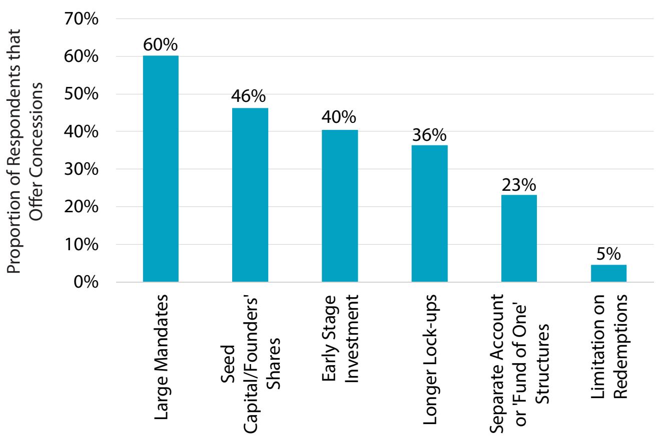
The greatest proportion of respondents (60%) cited they were most likely to offer fee concessions for larger mandates (Fig. 8). Early stage or seed investors are also likely to receive concessions in return for their investment in a fund's founding stages.

Fig. 7: Fee Provisions Provided by Hedge Fund Managers



Source: Preqin Hedge Fund Manager Survey, November 2016

Fig. 8: Reasons Why Hedge Fund Managers Have Offered Fee Concessions



Source: Preqin Hedge Fund Manager Survey, November 2016

OUTLOOK FOR 2017

In the face of a more challenging fundraising environment, fund managers remain upbeat: 40% of survey respondents believe hedge fund industry assets will increase over the course of 2017 (Fig. 9). Fund managers are increasing their spending efforts in marketing and investor relations as they look to grow their assets and reverse the net outflows seen in 2016. While addressing investor concerns around performance and fees will be a key challenge in the year ahead, fund managers will look to build on the improved performance of the past 12 months and make 2017 a year in which to revive investor sentiment.

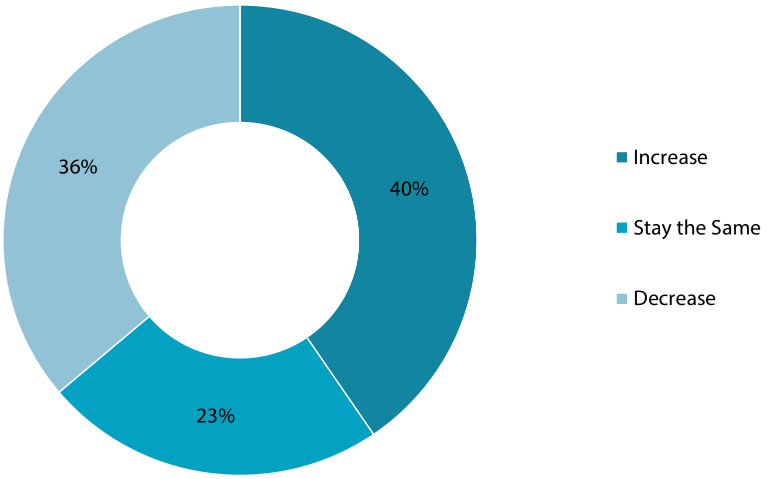
PERFORMANCE IN 2017

With the 2016 Preqin All-Strategies Hedge Fund benchmark (+7.34%) outperforming the 2015 benchmark (+2.14%), Preqin asked respondents for their expectations of performance in 2017 relative to 2016. A significant proportion (47%) believe the improvement in hedge fund performance will continue and the 2017 benchmark will surpass the 2016 return (Fig. 10). Interestingly, nearly a quarter (23%) of fund managers were unsure how performance in 2017 would compare to 2016, perhaps an indication of general uncertainty in the industry at present.

In 2016, event driven strategies generated the highest annual return (+13.11%) of all top-level hedge fund strategies. At the other end of the performance spectrum were managed futures/CTAs, which recorded the best Q1 2016 return of all top-level strategies (+1.68%), but finished the year with a return of just 1.12%.

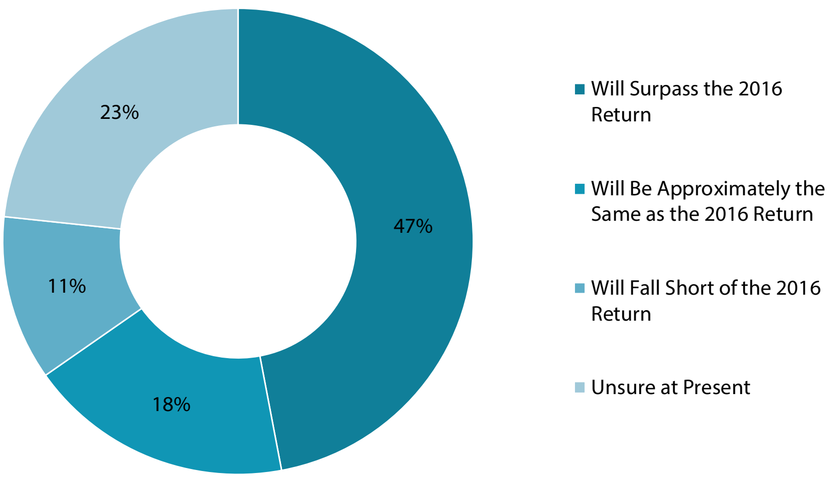
Preqin asked respondents to predict how the seven top-level strategies would perform in 2017; using a weighted average of the rankings, fund managers predict that equity strategies will be the leading strategy in 2017 (Fig. 11). Credit strategies, the second best performing top-level strategy in 2016, are predicted to be the worst performing strategy in 2017 for the third year in a row. Meanwhile, with macro

Fig. 9: Fund Manager Expectations for Hedge Fund Industry Assets under Management in 2017



Source: Preqin Hedge Fund Manager Survey, November 2016

Fig. 10: Fund Manager Expectations for the Performance of the Preqin All-Strategies Hedge Fund Benchmark in 2017 Compared to 2016



Source: Preqin Hedge Fund Manager Survey, November 2016

Fig. 11: Top-Level Strategy Performance: 2016 Rank vs. Fund Manager Prediction for 2017

2016 Performance Rank	Top-Level Strategy	2017 Performance Rank Prediction
1st	Event Driven Strategies	3rd
2nd	Credit Strategies	7th
3rd	Macro Strategies	2nd
4th	Multi-Strategy	4th
5th	Equity Strategies	1st
6th	Relative Value Strategies	6th
7th	Managed Futures/CTA	5th

Source: Preqin Hedge Fund Manager Survey, November 2016 strategies expected to be the second best performing strategy in 2017 and managed futures/CTAs up to fifth, despite posting the lowest returns in 2016, fund managers anticipate opportunities in commodity markets in the coming year.

MAJOR CHALLENGES FOR 2017: PERFORMANCE AND FEES

By a significant margin, fund managers surveyed in November 2016 view performance (73%) and investor demand for more favourable fees (64%) as the leading challenges facing the hedge fund industry in 2017, issues that have become more prominent since Preqin's survey in November 2015 (Fig. 12). While industry performance has improved over the past 12 months, fund managers will want this improvement to continue as we move into 2017.

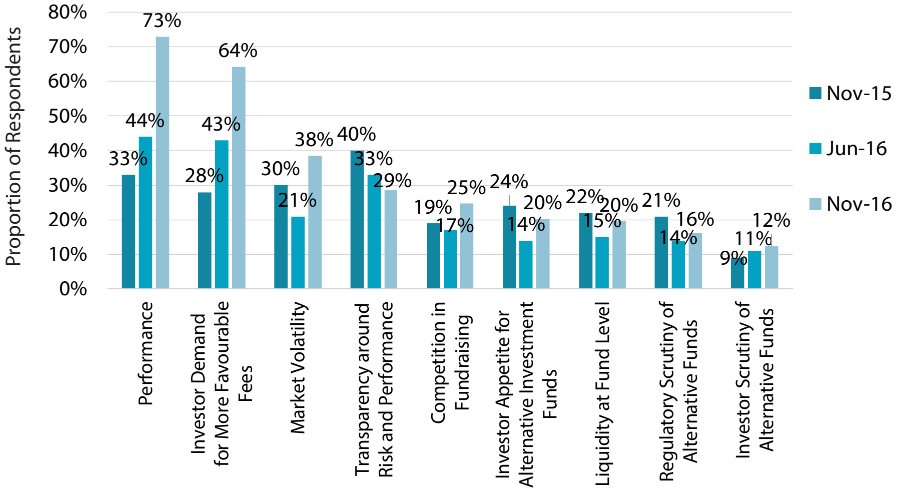
Twelve months ago, fund managers saw transparency around risk and performance as the leading driver of change in the year to come, a factor that ranks fourth in this year's survey, behind market volatility. 2016 has been a year of noteworthy global events that have had a significant impact on financial markets over the past 12 months, and fund managers clearly anticipate further reverberations from these events over the course of 2017.

PLANNED LAUNCHES IN 2017

Compared to the 29% of respondents that were planning on launching a new fund in 2016, 37% plan to bring a fund to market in 2017, a significant increase (Fig. 13). Furthermore, over a quarter of respondents planning to launch a fund in 2017 will be launching a strategy that is new to their firm, thereby increasing their range of solutions available to investors.

Alternative risk premia has been a hot topic over the past couple of years, attracting growing interest from fund managers and institutional investors alike. This area of the hedge fund industry looks set to continue its growth in 2017 with 8% of fund managers surveyed by Preqin looking to bring a new alternative risk premia strategy to market in 2017.

Fig. 12: Fund Manager Views on the Key Drivers of Change Facing the Hedge Fund Industry, 2015 - 2016



Source: Preqin Hedge Fund Manager Survey, November 2015 - November 2016

Fig. 13: Strategies Fund Managers Plan to Launch in 2017

37%

of respondents are planning to launch a new fund in 2017...

...of which

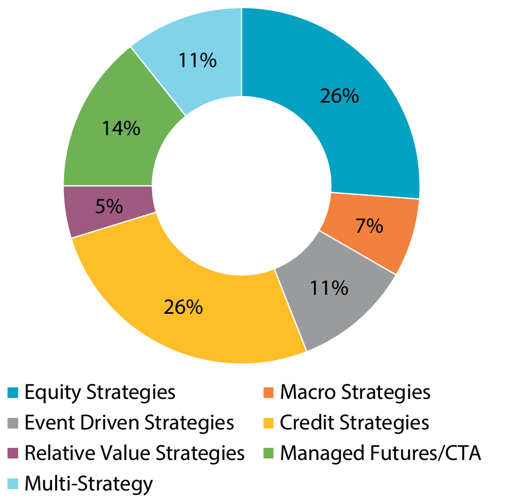
66%

are planning to launch their new fund in Q1...

...and

29%

reported that it would be a new strategy for their firm.



Source: Preqin Hedge Fund Manager Survey, November 2016

Fig. 14: Investor and Fund Manager Views on Risk Premia Funds

13%

of hedge fund investors currently invest in alternative risk premia funds…

...and a further

6%

are considering it.

10%

of hedge fund managers offer an alternative risk premia strategy.

8%

of hedge fund managers plan to bring a new risk premia strategy to market in 2017.

PREQIN SPECIAL REPORT:
HEDGE FUND MANAGER OUTLOOK

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

New York ■ London ■ Singapore ■ San Francisco ■ Hong Kong ■ Manila

info@preqin.com
www.preqin.com