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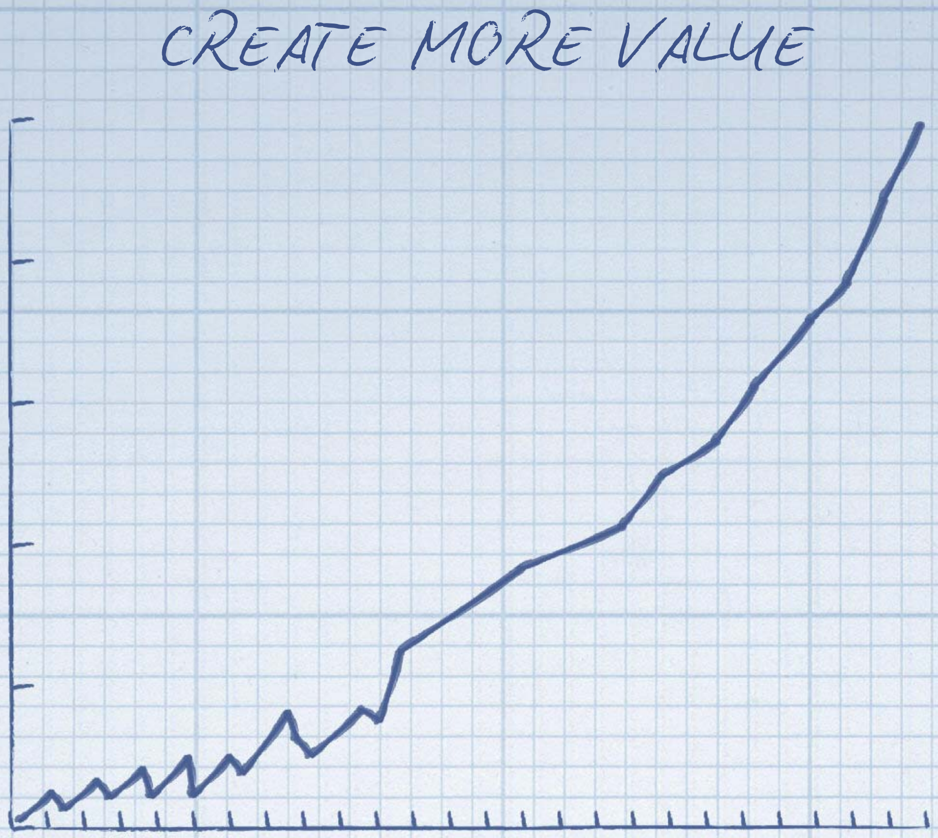

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Commingled Hedge Funds – What Are the Alternatives?

Alex Chalikiopoulos explores the world of commingled hedge funds, UCITS and managed accounts, looking at global investor preferences

In the aftermath of economic turmoil, unravelling of fraud cases within the marketplace and global financial regulator clampdowns, the growth in alternatives to traditional commingled structures of hedge funds has continued apace. The use of hedge funds structured as Undertakings for Collective Investments in Transferable Securities (UCITS) and the use of managed accounts within the hedge fund space has continued to increase in 2010 and into 2011 to counter issues of liquidity and lack of transparency in the industry. However, investments via traditional, commingled structured vehicles - either directly or through funds of funds - remain predominant within the institutional investor universe and are likely to remain the most commonly used vehicle type within the industry for the foreseeable future.

Using Preqin's data on hedge fund structural preferences we examine investor sentiment in relation to these types of fund structures and how the popularity of some has increased in the recent past. Although managed accounts in hedge funds have existed for some time, the requirements of investors for further liquidity, transparency, risk management and a greater oversight into investments made via traditional pooled funds, have instigated a fresh approach to the framework. These reasons, combined with a new era of regulation within Europe, have also led to a surge in interest in UCITS funds from institutional investors.

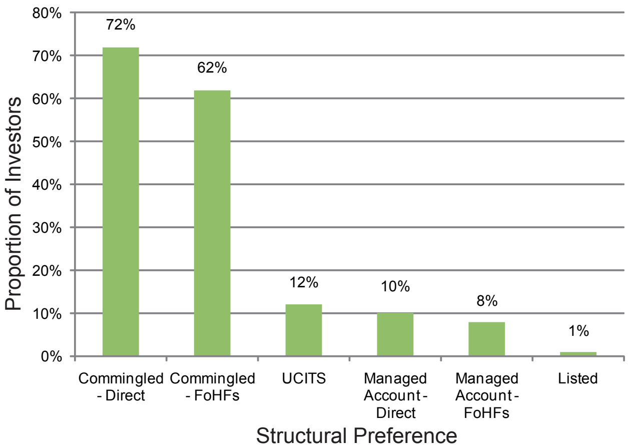
Commingled Direct Funds

More than 70% of institutional investors use direct investment in single manager funds to some degree within their hedge fund portfolios. Investors based in Europe, where other options such as UCITS are readily available, are the least likely to have a preference for commingled direct funds out of all the regions, as Fig. 2 shows. 73% of investors based in North America have a preference for this structure, and 79% Asian investors use commingled direct funds, the highest proportion of any region. Family offices are the institutional investor type with the highest proportion (96%) opting for a commingled direct fund structure, relying on the expertise of their internal investment teams to create diversified portfolios of funds without the need for fund of funds managers. Pension funds – both public and private – are the least likely to have a preference for investing in such vehicles, with just over 50% of investors within each respective category committing capital to commingled direct funds (Fig.3).

Commingled Funds of Hedge Funds

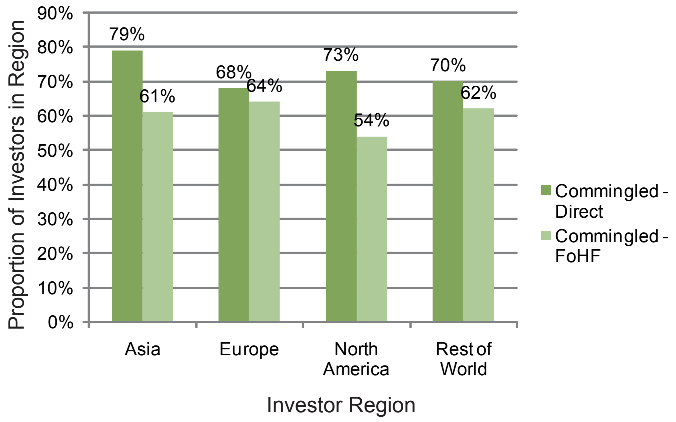
Around 62% of institutional investors use commingled funds of funds to some degree within their hedge fund portfolios. As Fig. 2 shows, European investors place top (64%) in terms of favouring this structure. About 62% of investors in the US maintain an interest for commingled fund of funds vehicles, while 61% of Asia-based investors and 54% of investors based in Rest of World also do so. Commingled funds of hedge funds are least popular amongst asset managers (48%) and family offices (42%), both of which tend to invest directly in funds. On the flipside, a majority of foundations and pension funds have a preference for these kinds of funds, as Fig. 3 overleaf shows. However, since the reputation of funds of funds were rather more affected than single manager funds following the market crisis, an increasing number of institutional investors are beginning to allocate capital to direct investments with single manager hedge funds. For instance, the $1.8 billion San

Fig. 1: Proportion of Institutional Investors with a Preference for Each Fund Structure



Source: Preqin

Fig. 2: Proportion of Institutional Investors in Each Region with a Preference for Each Commingled Fund Structure



Source: Preqin

Antonio Fire and Police Pension Fund revealed plans to completely liquidate its hedge fund portfolio, which consisted solely of funds of funds, with plans to push into commingled direct vehicles only over the next 12-month period. Additionally, the $3.6 billion Philadelphia Board of Pensions & Retirement fund intends on allocating about $140 million over the next year to 12 single hedge fund managers.

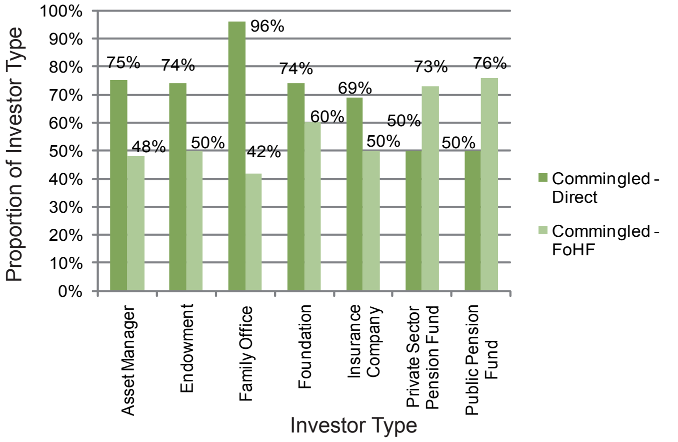
UCITS

Over the past few years and ever since the global economic downturn, one of the key topics within the hedge fund industry has revolved around the growth and popularity of UCITS-type vehicles. Although predominantly constructed in order to harmonize domestic EU markets for collective investments schemes, interest in hedge fund managers applying the UCITS framework to their strategies is not restricted to within the region's borders. 9% of investors with an active preference for UCITS vehicles are from outside Europe. Even in the US, where managers must conform to distinct rules enforced by the Securities and Exchange Commission (SEC), UCITS vehicles have begun to draw attention. In particular, we have witnessed instances of US-based funds of funds launching UCITS vehicles. For instance, the $1.6 billion New York-based Kenmar recently told Preqin that it planned to launch a new UCITS-compliant fund of hedge funds vehicle within the next 12 months. Although 91% of investors actively searching for funds within the UCITS framework on the Preqin database are based in Europe, there are clear signals that interest and participation outside of the EU in this regulated vehicle structure is a growing trend.

Just under 23% of institutional investors on the Preqin database that have a preference for UCITS-compliant vehicles are private sector pension funds, as Fig. 4 shows. Asset managers constitute around 19% and public pension funds a similar proportion. Other investor categories active within the space include insurance companies, family offices and foundations. Contrary to managed accounts, the uptake of UCITS vehicles amongst institutional investors tends to be by the smaller allocators to hedge funds (Fig. 8), which falls in line with the more retail nature of the structure.

27% of European investors tracked by Preqin state a preference for, and allocate capital to UCITS funds, or are considering doing so in the next 12 months. Of those investors, over half are located in the UK and Switzerland collectively, with 11% located in Italy and a similar proportion based in France, as Fig. 5 shows. For example, the Italian-based Duemme Hedge fund of hedge funds lately revealed preparations to not only invest in more UCITS hedge funds through its fund operations over the next 12 months, but also plans to launch a UCITS-compliant fund of hedge funds vehicle.

Fig. 3: Proportion of Each Type of Institutional Investor with a Preference for Each Commingled Fund Structure



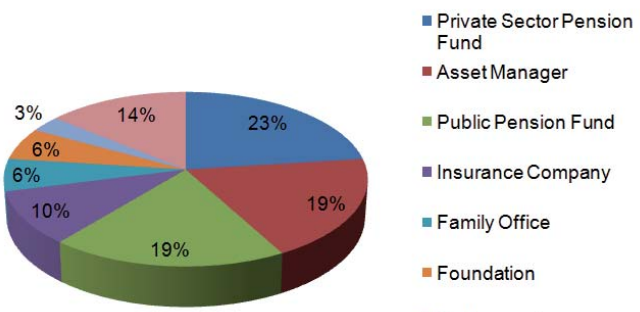
Source: Preqin

Managed Accounts

Managed accounts have grown significantly in popularity over the recent past. The increased transparency offered by such vehicles, coupled with investors' requirements to mitigate risks, has continued to attract a significant number of investors committing capital to managers offering this approach. The ability to attain a greater control over assets, in addition to gaining more flexibility when having to deal with negative performance, comes at a greater 'cost'; the minimum required initial investment is relatively high, and as such acts as a clear deterrent to all but the largest investors (Fig. 8).

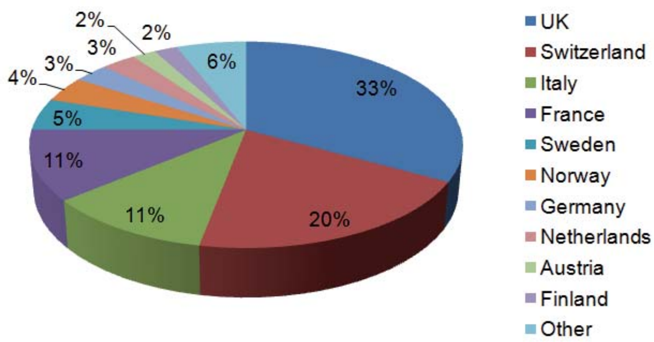
Excluding funds of funds (which represent 69% of all current allocators to managed account versions of hedge funds) the largest proportion of investors in direct managed accounts are public and private pension funds, accounting for about 24% and 17% of institutional investors respectively.

Fig. 4: Breakdown of Institutional Investors That State a Preference for UCITS Funds by Investor Type



Source: Preqin

Fig. 5: Breakdown of European Institutional Investors That State a Preference for UCITS Funds by Country



Source: Preqin

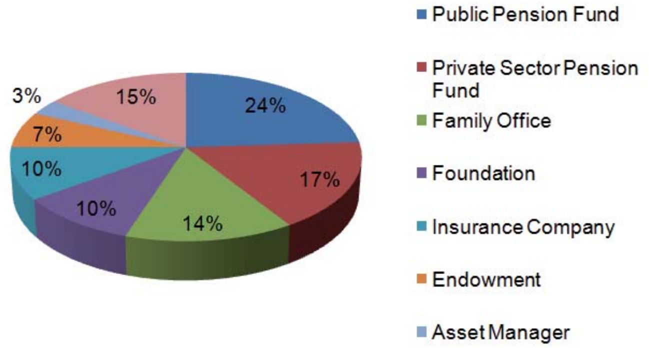
Family offices, foundations and insurance companies are also prominent investors in this type of fund, as Fig. 6 shows. The picture is quite similar in terms of the investor type breakdown when looking at managed account versions of funds of hedge funds: public pension funds, foundations and insurance companies are the leading investors. Fig. 7 shows that 13% of investors with a preference for this managed approach to multi-manager portfolios are private sector pension funds.

The common reasoning behind investors' increased inclination towards managed accounts is similar to the rationale that has promoted the growing popularity of UCITS vehicles – better liquidity terms being a key factor that investors clearly pursue through such vehicles. This fund structure also allows for the more prominent institutional investors, with larger resources and more advanced back office operations, to take full advantage of more control and transparency offered through investments made. In addition, the ability to eliminate co-investor risk acts as a particular attractive feature to investors considering a move into managed accounts.

Mean Allocations to Each Structure

When considering the allocation of investors to each fund structure, and taking into account the predominant investor type in each category, it is unsurprising that the largest mean allocators of capital are the ones with more activity in managed accounts. Managers' initial investment requirements for providing such a platform generally mean that those investors with substantial assets under management (for instance certain public pension funds) can effectively seek advantages from not pooling funds with other investors. This is especially the case for fund of hedge funds managed accounts, where the mean allocation by institutional investors to this structure is in excess of $1 billion (Fig.8).

Fig. 6: Breakdown of Institutional Investors That State a Preference for Direct Managed Accounts by Investor Type



Source: Preqin

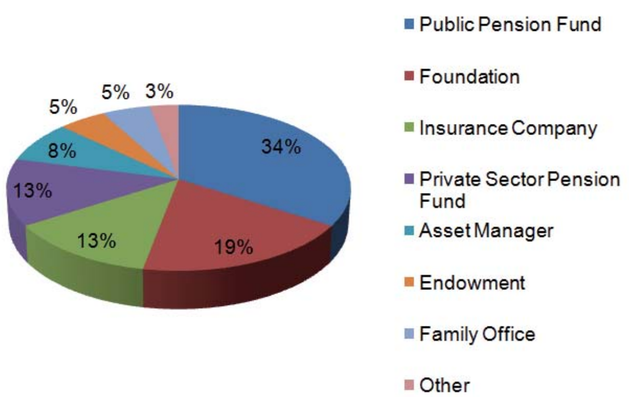
In retrospect, given the tough few years the industry has experienced, the only options available to many institutional investors remain commingled investments. The lower barriers to entry related with these types of structures clearly tie in with the mean allocation for such investments, being lower than managed account offerings. Furthermore, investors may not have the infrastructure or expertise to exploit advantages through further transparency or greater control that is associated with managed account vehicles, and will therefore choose to invest in commingled funds.

Conclusions

Following the recovery of the hedge fund industry since the turbulent market conditions in the latter part of the last decade, institutional investors have expressed growing interest in vehicles that can relate to greater transparency, provide enhanced liquidity terms and, on the whole, conform to greater regulatory oversight. Fund offerings complying with the UCITS III regulatory framework – albeit limited in terms of leverage and strategies that can be executed through this structure – continue to attract investors, not only within the EU borders but beyond them as well, particularly in Asia, Latin America and the Middle East. With UCITS IV to be implemented in EU member states by mid-2011, the scope for further improvements and clarifications within the UCITS framework will be sure to reinforce the opinion of many within the space.

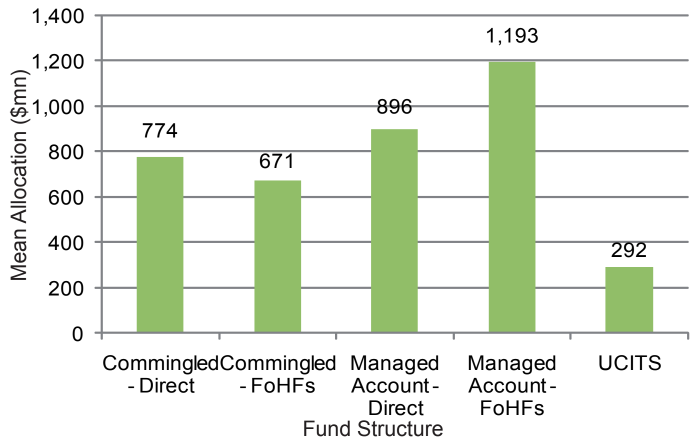
In terms of managed accounts, the sentiment among investors is somewhat similar to that of UCITS fund structures. The benefits range, as earlier suggested, from a greater control over the investments made, to an open approach, allowing for the detection of 'style drift'.

Fig. 7: Breakdown of Institutional Investors That State a Preference for Fund of Hedge Funds Managed Accounts by Investor Type



Source: Preqin

Fig. 8: Institutional Investors' Mean Allocation to Each Fund Structure (Only Includes Investors That Invest in the Structure)



Source: Preqin

The use of these products is not new but the increased call for them is. However, drawbacks regarding these two fund structures certainly exist and questions continue to be raised on the advantages marketed. Furthermore, despite the evident growing popularity, constraints on both sides mean that managers are unlikely to replace all traditional pooled funds for these types of fund structures. With the relatively good performance of hedge funds through 2010 and global markets showing signs of recovery, commingled fund structures are bound to remain the popular choice of institutional investors within the hedge fund asset class. It is more likely that managers will continue to run UCITS vehicles or managed accounts alongside their traditional hedge funds, if the strategy allows for this. Certainly, both types are still amidst a period of evolution within the hedge fund industry, and while they offer a greater degree of transparency and solutions to alleviate certain risks, they are not a panacea.

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The 2011 Preqin Global Hedge Fund Investor Review provides profiles and analysis for the most important institutional investors in hedge funds from around the world.

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- Profiles include fund preferences by strategy and geography, key financial information, direct contact details for key personnel, sample investments
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- Analysis for investors in each of the ten most important hedge fund strategies with listings for active investors
- Analysis and listings for investors looking to allocate to UCITS or managed account vehicles
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Natural Resources Hedge Funds

Amy Bensted takes a look at this niche market, considering the type of investor that may choose to invest in natural resources hedge funds

Fig. 1: Key Facts: Investors in Natural Resource Funds

% of institutional investors that state natural resources hedge funds as a preference	2.9%
Median AUM ($mn)	1,410
Mean allocation to hedge funds	13.8% / $195mn
Average returns sought from natural resources hedge funds	8.6%
Most favoured investment approach (direct funds, funds of funds, mixture of both)	Direct funds

Source: Preqin

Natural resources hedge funds remain a relatively niche choice of investment for the institutional community, with the Preqin database of hedge fund investors, Hedge Fund Investor Profiles, listing 72 investors in such funds. Just fewer than 50% of these investors are funds of hedge funds. Funds of funds often use more niche strategies such as natural resources funds in order to tap into returns that have yet to be exploited by a wider group of investors, which can allow for early investment in the next strong performing strategy. Although it is more common for funds of funds to add natural resources funds to their multi-strategy vehicles, some multi-manager firms do run focused vehicles on these strategies. Fundraising for vehicles focused on natural resources proved particularly difficult during the market downturn and there were several vehicles that launched in 2007 by large fund groups, such as 3A, which never gained investor traction and subsequently shut. However, institutional interest in this sector is beginning to return and the fundraising environment is looking more positive.

Public pension funds show a relatively strong preference for natural resource hedge funds, representing 17% of all investors in this strategy. Public pension funds are beginning to allocate on a more regular basis directly to single strategy, single manager hedge funds in the pursuit of stronger returns and to diversify their holdings away from a reliance on the relatively more expensive funds of funds. In the main part these public bodies are investing in "traditional" strategies such as long/short equity, global macro, etc. However, there are a growing number of public pension funds which are looking at more niche strategies as a source of alpha and to exploit new areas of investment for their portfolio. Alongside direct investment in natural resources funds, some institutional investors will gain access to these strategies through multi-manager or fund of funds vehicles. For instance, Lincolnshire County Council Pension Fund hired Morgan Stanley Alternative Investment Partners in December 2010 for a £180 million "alternatives mandate" which would include natural resources investments. Institutional investors that state natural resources as a strategic preference of their hedge fund holdings tend to invest larger amounts in the asset class as compared to their peers. On average these investors allocate just under 14% of their assets to hedge funds (above the global mean allocation to hedge funds of 11.6%), which suggests that it is those investors with more capital at play, likely the more sophisticated and experienced investors, which are using

Fig. 2: Breakdown of Investors in Natural Resources Hedge Funds

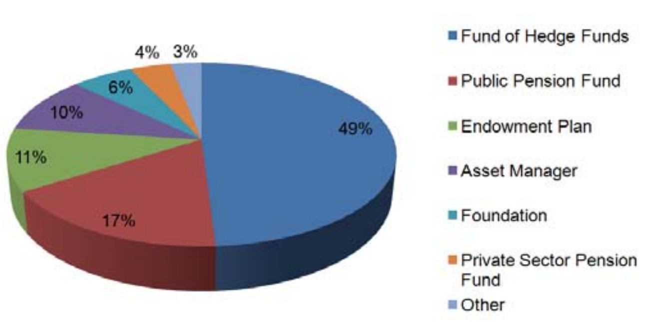
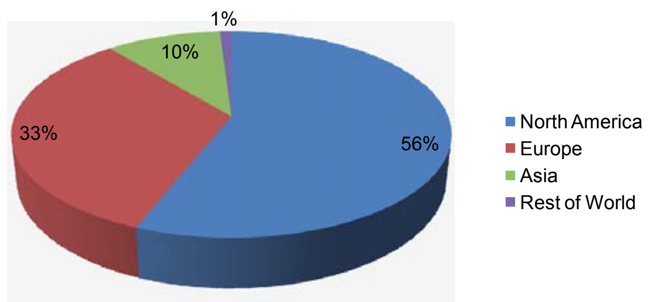


Fig. 3: Breakdown of Investors in Natural Resources Hedge Funds



Source: Preqin

niche themes to diversify their exposure within their portfolios.

The largest proportion of natural resources hedge fund investors are based in the established markets of North America and Europe. These regions hold some of the largest and most sophisticated institutional investors in the market, and it is these investors which have the resource to assess opportunities in less traditional hedge fund strategies. However, although Rest of World-based investors only currently represent a small proportion, this could increase in the near future as more investors from these regions take their first steps in the asset class. With a growing investor base in Rest of World and more funds launching to take advantage of the natural resources-rich economies of some of these emerging countries, we could expect an increasing number of investors to invest in funds utilizing opportunities within their domestic regions.

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US Private Sector Pension Funds

Joanna Hammond looks at the US private sector pension funds that are actively investing in hedge funds across the globe

Fig. 1: Key Facts: US Private Sector Pension Funds

% of US-based private pension funds investing in hedge funds	55.7%
Average allocation to hedge funds	9.8%
Average target allocation to hedge funds	8.5%
Most favoured investment approach (direct funds, funds of funds, mixture of both)	Funds of funds
Average number of investments in HF portfolio	18
Typically been investing for...	6 years

Source: Preqin

The Preqin Hedge Fund Investor Profiles database contains 85 US-based private sector pension funds that actively invest in hedge funds and a further 17 US private pension funds that are currently considering making their initial investment in the asset class within the next 18 months. Over 55% of US-based private sector pension funds on Preqin's database of institutions have a proportion of their assets invested in hedge funds.

On average, US private pension funds allocate 9.8% of their assets under management to investments in hedge funds. Some US-based private sector pension funds, however, have a significantly greater proportion of their assets allocated to hedge funds. For example, Weyerhaeuser Company Master Retirement Fund, the pension fund for a major forest products company, has 55.9% of its total assets invested in hedge funds. It is subsequently one of the leading hedge fund investors amongst US-based private pension funds, with $2.3 billion committed to hedge funds.

The average target allocation to hedge funds for US private sector pension funds is 8.5% of assets under management, 1.3 percentage points lower than the average current allocation. However, any reduction in exposure to hedge funds from existing investors is likely to be met by new allocations being made in the medium term from the notable number of US private pension funds currently expecting to gain exposure to the asset class for the first time.

US-based private pension schemes represent six of the world's 10 largest private sector pension fund hedge fund investors. The five leading investors in hedge funds amongst private sector pension funds based in the US are shown in Fig. 4.

The most popular approach to hedge fund investing amongst US-based private sector pension funds is through funds of funds, with 61% of US private pension funds on the Hedge Fund Investor Profiles database preferring this method over investing directly in hedge fund managers. US private pension schemes have been investing in hedge funds for an average of six years.

Typically, newer investors choose to gain exposure to the asset class via fund of funds investments, and they may then move towards investing directly in hedge fund managers as they acquire knowledge and experience, and increase their allocation to the asset class. Of the US private pension funds that invest directly in hedge funds, long/short equity, absolute return, multi-strategy and global macro vehicles are some of the most favoured, as shown in Fig. 2. The use of multi-strategy funds indicates that the more confident US private pension fund investors may seek to replicate the diversified portfolio that a fund of funds investment would generate, but while avoiding the double layer of fees that is associated with multi-manager funds.

Over 73% of private sector pension funds based in the US diversify their hedge fund investment portfolios on a geographical basis through exposure to funds based around the world. However, much of this global diversification results from the pension funds investing in US-based funds of funds, which then invest on a global scale. When the hedge fund investments of US-based private pension funds are examined on a regional level, North America is the preferred location. One of the main advantages to US investors of investing in hedge funds based in their own region is that due diligence undertaken during the manager selection process, and meetings once managers have been selected, are facilitated by the proximity of North American-based fund managers.

Fig. 2: Top 10 Strategic Preferences of US-Based Private Sector Pension Funds

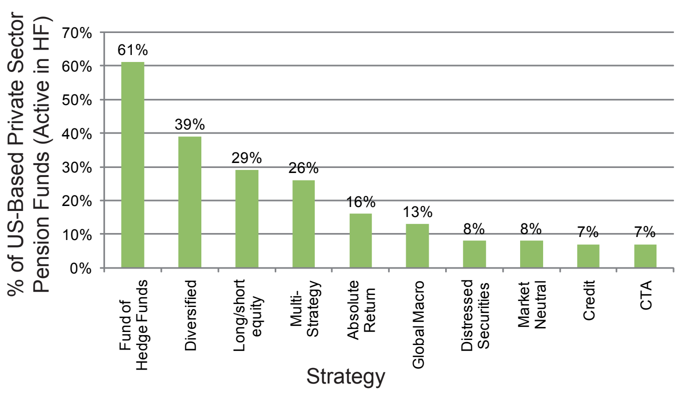

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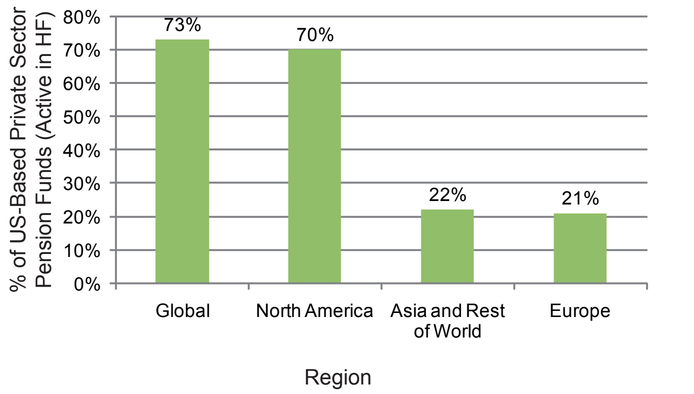
Fig. 3: Regional Preferences of US Private Sector Pension Funds



Source: Preqin

Fig. 4: Five Leading US-Based Private Sector Pension Funds Investing in Hedge Funds

Investor	Hedge Fund Allocation ($mn)
Chrysler Master Retirement Trust	2,420
Partners Healthcare System Pension Plan	2,400
Weyerhaeuser Company Master Retirement Fund	2,291
General Electric Pension Trust	2,200
United Auto Workers VEBA	2,025

Source: Preqin

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Preqin Hedge Investor Profiles

Data from Strategy in Focus and Investors in Focus was taken from Preqin's Hedge Investor Profiles service.

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Conferences Spotlight: Forthcoming Events

Conference	Dates	Location	Organizer
Middle East Investment Summit 2011	7 - 10 March 2011	Dubai	Terrapinn
UCITS, Newcits and ETFs 2011	9 - 10 March 2011	London	C5
Global Alpha Forum 2011	17 - 18 March 2011	Stamford	Connecticut HF Association
Fund Management Regulation 2011	30 - 31 March 2011	London	Infoline
Asian Wealth Management Forum	12 - 13 April 2011	Singapore	Shorex
Global Hedge Fund Summit	1 - 3 May 2011	Bermuda	Institutional Investor
GAIM Ops Cayman	1 - 4 May 2011	Cayman Islands	IIR USA
EuroHedge Summit 2011	4 - 5 May 2011	London	Hedge Fund Intelligence
FX Investment World	14 - 16 June 2011	London	Terrapinn
GAIM International 2011	21 - 23 June 2011	Monaco	ICBI

Hedge Funds Middle East Investment Summit

Date: 7-10 March 2011
Location: Jumeirah Beach Hotel, Dubai, UAE
Organiser: Terrapinn

The region's must attend hedge fund conference, with over 40 institutional investors speaking, over $3 trillion worth of investors in one room this a unique opportunity to meet hedge fund managers, investors, financiers or other industry experts including legendary economist, Nouriel Roubini.

Information:
www.terrapinn.com/2011/hfwme

Hedge Funds World Middle East

Date: 7-10 March 2011
Location: Jumeirah Beach Hotel, Dubai, UAE
Organiser: Terrapinn

The Middle East Investment Summit brings together 400+ local and international investors to explore the region's latest investment opportunities. Speakers include Dr. Nouriel Roubini and Indranil Ghosh, Head of Strategy for Abu Dhabi sovereign wealth fund Mubadala. With representatives from the biggest banks, SWFs and private investors, the event is a must for anybody interested in Middle East investments.

Information:
www.terrapinn.com/2011/meis

Institutional Investor News

Lincolnshire County Council Pension Fund has awarded Morgan Stanley Alternative Investment Partners with an investment mandate.

The GBP 1.2 billion pension fund has awarded Morgan Stanley AIP with a GBP 180 million alternatives mandate. The appointment follows an extensive investment manager search conducted with JLT Employee Benefits, an employee benefits provider which provides services covering actuarial consulting, employee healthcare and protection, wealth management and investment consulting. Morgan Stanley AIP will manage the mandate, which will cover the whole spectrum of alternative investments, including hedge funds, commodities, and newer alternatives such as timber funds, as well as the pension fund's current private equity portfolio. It is an open mandate that allows Morgan Stanley AIP to invest in any alternatives it sees value in.

Mubadala Development Company allocates USD 100 million to Russian hedge fund.

The USD 24 billion sovereign wealth fund has revealed that it has allocated USD 100 million to a Russia-based hedge fund, Verno Capital. Verno employs a long/short equity approach to the Russian equities market and is the sovereign wealth fund's first foray into investment in the region.

New Mexico Public Employees' Retirement Association (NMPERA) announces new allocations to hedge funds and increases three existing mandates.

The USD 10.5 billion public pension system has revealed that it has approved a USD 35 million mandate to hedge fund manager Wexford Spectrum Fund. NMPERA has made the new allocation to replace its current investment with Farallon Capital Management, which is under redemption. The pension fund intends to complete this process by February 2011. In addition to this new mandate, NMPERA has also approved the allocation of additional capital to several existing hedge fund investments, including an additional USD 20 million to existing managers BlueCrest Capital, Lynx Asset Management and James Caird Asset Management. NMPERA also awarded an additional USD 5 million to Samlyn Capital, which was awarded an initial USD 20 million mandate in January 2010.

City Financial to continue adding vehicles to its flagship fund of hedge funds.

The USD 56 million fund of hedge funds manager has revealed plans to continue adding vehicles to its portfolio over the next 12 months. The group, which typically invests USD 3-6 million per vehicle, will be seeking managers in Asia that pursue the more 'traditional' type of strategies such as long/short equity, macro and event driven, but also credit. City Financial will accept lock-up periods up to a maximum of one year and will invest in emerging managers and spin-off teams. In terms of a minimum track record and the required assets under management of a prospective manager, the group will determine these on a case-by-case basis. Finally, although the group has yet to invest in a UCITS-compliant vehicle, it has not ruled out doing so in the future.

Shin Kong Life Insurance Co. to restructure hedge fund portfolio and make new investments.

The TWD 1.4 trillion Taiwan-based insurance company has revealed that it is to make its first new hedge fund investments since 2008. The move comes as the firm restructures its hedge fund investment portfolio with the intention of moving away from direct investments with single managers to develop a more multi-manager-focused approach. In 2011, Shin Kong Life Insurance Co. intends to invest with two new funds of hedge funds and will be focusing on fund managers offering CTA and global macro strategies.

Florida State Board of Administration (FSBA) to add USD 850 million to six new hedge fund investments and hire new Senior Portfolio Manager for Strategic Investments.

The USD 148 billion public pension fund has announced the approval of three new hedge fund managers to its hedge fund investment portfolio and is currently undertaking due diligence on three more as yet unnamed fund managers. FSBA has revealed that the approved firms are focused on event driven merger arbitrage, credit and long/short equity strategies, raising FSBA's total allocation to hedge funds to date up to USD 1.175 billion since it began investing in Q2 2010. These latest allocations follow the pension fund announcing that it will allocate as much as USD 2.5 billion to alternatives by Q3 2011 and up to around USD 3 billion over the following years. To assist in the process of increasing its hedge fund allocation, FSBA is now searching for a Senior Portfolio Manager of Strategic Investments.

Data Source:

Preqin Hedge Investor Profiles

Each month Spotlight provides a selection of the recent news on institutional investors in hedge funds

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