Investing in Hedge Funds: All About Returns?

The Real Drivers for Institutional Investor Allocation

June 2014

Content Includes:

Why Should Institutions Invest in Hedge Funds?

What is leading investors to increase their allocations to hedge funds? How can hedge funds add to investors' portfolios?

What Are Institutions Looking for from Hedge Funds?

We examine what investors look for from their hedge fund investments, particularly in terms of absolute and risk-adjusted returns, as well as how they plan to invest in the future.

Have Hedge Funds Lived Up to Expectations?

How satisfied are investors with the returns hedge funds provide? Do they meet expectations over shorter and longer time frames?

How Should Institutions Benchmark Performance?

With over 16,000 hedge funds to choose from, how should investors monitor the funds in their portfolio against the wider performance of the industry?

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Foreword

Since 2007, Preqin has been tracking institutional investment in hedge funds. Our teams of analysts based in London, New York and Singapore have tens of thousands of conversations with investors each year to give us a unique insight into the minds and portfolios of the institutional groups which have driven the industry to its current $2.66tn in assets.

Despite a new global regulatory framework which has resulted in increased regulatory transparency, and the vote of confidence from institutional investors worldwide who use hedge funds to diversify their return streams, the industry is still viewed as largely opaque, complex, risky, and lightly regulated by the general public and the media. With the largest investors, such as pension funds, insurance companies and sovereign wealth funds, guarding the assets of the typical member of the public, it is important to shine a light on why these gatekeepers have turned to hedge fund investment in recent years, and how these hedge funds are safeguarding assets for the future.

In this report we examine why investors are allocating their capital to hedge funds, what they seek from the funds they invest in and how they assess the success of their portfolio. With much of the criticism hedge funds have faced over recent years focusing on their relative performance to S&P 500, we look at how funds have actually performed and met investors' return expectations for risk-adjusted returns in all market conditions, as well as taking a closer look at why S&P 500 is becoming a less relevant benchmark for the industry. Central to our examination is an understanding that the hedge fund industry is not monolithic, but populated by a diversity of strategies with differing investment goals and return assumptions. This premise is often ignored or not understood by critics of hedge fund performance.

In this report we answer the following questions:

- Who is investing in hedge funds?
- Why should institutional investors allocate to hedge funds?
- What absolute and risk-adjusted returns are investors seeking from hedge funds?
- How has the industry met the return objectives for investors?
- How should investors frame the performance of their portfolios?

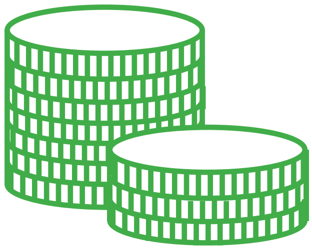
The results of this study are based on a survey of over 100 investors conducted in April this year, with these investors representing more than $13tn in assets under management. The investors were located globally and represented a broad spectrum of investor types from the largest pension funds, through to family offices and other private wealth institutions. Additional data has been taken from our Hedge Fund Online service, a fully integrated solution providing key information on over 4,600 investors in hedge funds, 16,500 hedge funds and 6,700 fund managers. Preqin's Hedge Fund Online service provides intelligence on institutional plans for hedge fund investment as well as full portfolio details, and looks at how the industry is performing with data on a fund-by-fund basis.

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.

Executive Summary

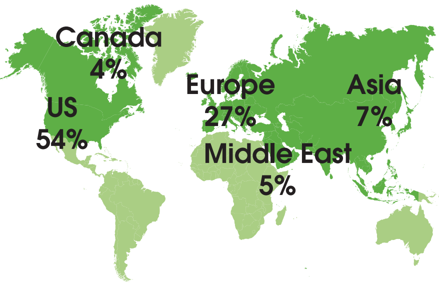
Our findings offer a valuable insight into the mindset and goals of institutional investors who decide to add hedge fund allocations to their portfolios. Our findings demonstrate that the frequent, broad comparisons of hedge fund performance to standard market indices, such as the S&P 500, are generally viewed as irrelevant by the institutions making the investments and judging their success. Rather, the survey responses point to reduced volatility, diversification of risk premia, and absolute returns as the leading objectives of the global institutional investors making hedge fund allocations.

Who Is Investing in Hedge Funds?

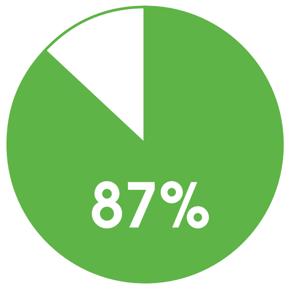


65% of hedge fund industry capital comes from institutional investors

4,600+ institutional investors allocate capital to hedge funds



Proportion of industry capital invested by institutions by regional HQ



87% of investors are maintaining or increasing their allocations in the next 12 months

What Are Investors Looking for From Hedge Funds?

59% seek uncorrelated returns

56% seek risk-adjusted returns

46% to reduce portfolio volatility

7% ...just 7% for high returns

How Are Hedge Funds Performing?

84% of investors feel return expectations have been **met or exceeded** in the past 12 months.

80% of investors believe portfolio risk would **increase** if they ceased investing in hedge funds

How Do Investors Benchmark Returns?

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S&P 500 and other public indices are commonly seen as irrelevant – just a fifth compare hedge funds to these benchmarks.

Investors are commonly using strategy-specific hedge fund indices to measure portfolio performance.

Who Invests in Hedge Funds?

The hedge fund industry is larger than ever, with over $2.66tn in assets managed across 16,000 vehicles worldwide. This growth has been driven by increased commitments from institutional allocators as they seek alternatives to traditional investment in equity and fixed income products. In this section we examine the current make-up of the institutional universe for hedge fund investment, using data taken from Preqin's Hedge Fund Investor Profiles online service.

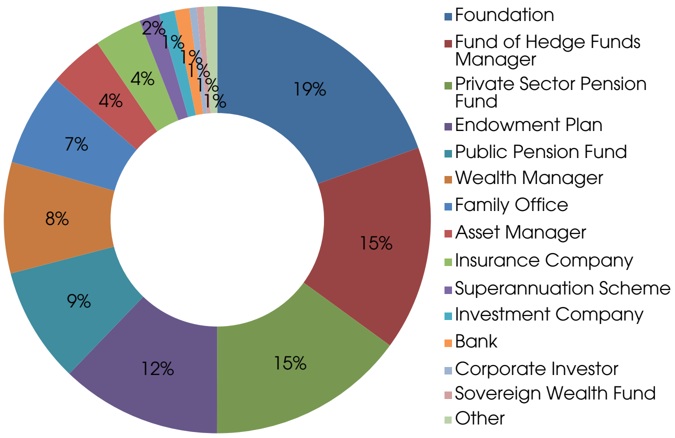
As shown in Fig. 1, there are a wide variety of institutional investor types allocating capital to hedge funds today. Each year there are more and more investors making maiden allocations to the asset class, and today Preqin currently tracks over 4,600 separate institutional groups active in the space.

Although there are institutional investors investing in hedge funds globally, over half of the assets invested by institutional investors are directed to these funds from investors based in the US (Fig. 2). Alongside the US, European investors have significant amounts of capital invested in hedge funds, with regions such as Asia, Australasia and the Middle East investing smaller amounts. However, these regions will become an increasingly important source of assets in the future as more institutions in these emerging regions realise the benefits of hedge funds and local regulatory changes open up opportunities for investing in alternatives.

In Brief

- **A wide range of investors allocate capital to hedge funds.**
- **Although the US is the largest source of institutional capital, hedge funds are important to investors globally.**
- **We have seen investors increase the amount they invest in hedge funds over recent years.**

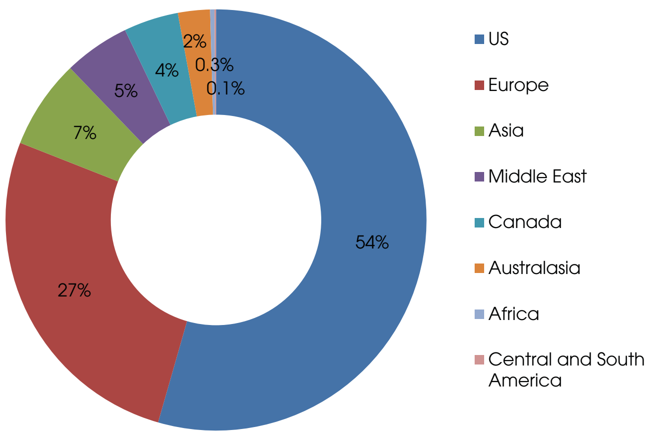
Fig. 1: Breakdown of Investors in Hedge Funds by Investor Type



Source: Preqin Hedge Fund Investor Profiles

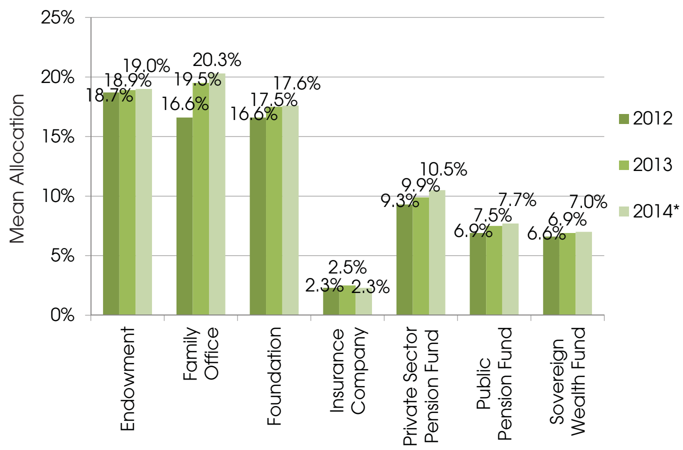
Fig. 3 shows the average allocation (as a proportion of total assets) of various institutional investor types to hedge funds from December 2012 through to April 2014. It is clear that all groups, except insurance companies, have increased their allocations over this period. In fact, if the data is taken back even further the same pattern emerges; investors are not only making maiden investments in hedge funds, they are also increasing the amount they invest in the asset class year on year.

Fig. 2: Breakdown of Institutional Investor Capital Invested in Hedge Funds by Investor Regional Headquarters (Excl. Funds of Hedge Funds)



Source: Preqin Hedge Fund Investor Profiles

Fig. 3: Mean Allocation to Hedge Funds by Investor Type, 2011 - 2014*



Source: Preqin Hedge Fund Investor Profiles

**As of April 2014, all other figures are at December.*

Why Should Institutions Invest in Hedge Funds?

Preqin currently estimates that institutional capital could account for as much as 65% of the $2.66tn of capital managed in the hedge fund industry today. What is leading these investors to increase their allocations to hedge funds, moving these types of investments from an alternative in their portfolio to a mainstream investment option?

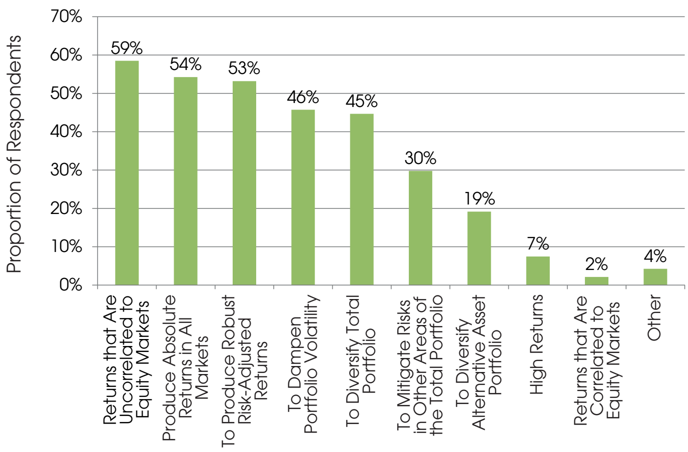
It is clear that investors are looking to hedge funds to perform a variety of functions – from producing uncorrelated returns through to risk mitigation (Fig. 4). However, producing high returns, a perception many outside of the industry believe is the domain of the hedge fund, is a priority for just a small proportion (7%) of the investors that participated in Preqin's survey. When investors were questioned further about what their single reason for recommending hedge funds would be, three key benefits came out time and time again – to reduce volatility, diversify risk premia, and produce absolute returns.

Alongside these reasons, many of the investors interviewed would recommend investing in hedge funds on the basis of the chance to tap into talented individuals, with one North American family office responding "we, as investors, are given the opportunity to align ourselves with some of the smartest guys in the world, who are attracted to this space due to high potential incentive fee generation". However, this potential incentive fee generation is a cause for concern for many investors, with 22% of the investors that participated in Preqin's study stating that fees are their single largest impediment to investing in hedge funds (Fig. 5).

In Brief

- **It is uncorrelated and risk adjusted returns rather than high returns institutional investors seek.**
- **Hedge funds have largely met these objectives over recent years**
- **Investors need help sourcing the right hedge fund investment opportunities.**

Fig. 4: Key Objectives of Institutional Investors From Their Hedge Fund Portfolios

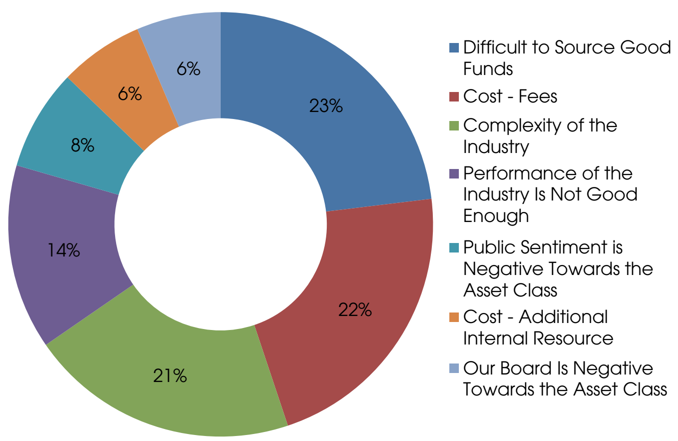


Source: Preqin Investor Survey, April 2014

Nevertheless, fees have come down over recent years with the "2&20" model no longer being the accepted standard, and fund managers are more open to negotiation than they were in the pre-crisis era. Therefore, investors may be able to overcome this hurdle through pre-investment screening and negotiations.

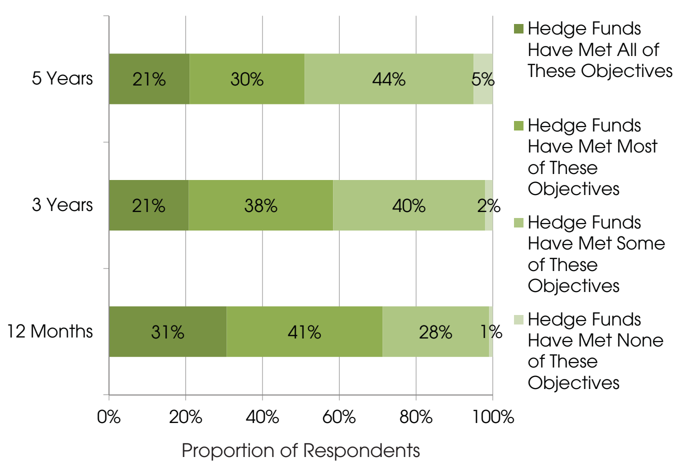
The complexity of the industry and the difficulty in sourcing the right funds both act as barriers for a large number of investors. However, investors are becoming more proactive in sourcing and selecting hedge funds. Tools such as Preqin Investor Network are helping these increasingly sophisticated groups of institutions to navigate the complex alternative assets market and connect with the right investment manager for them.

Fig. 5: Single Largest Impediment to Investing in Hedge Funds



Source: Preqin Investor Survey, April 2014

Fig. 6: Investor Outlook on How Hedge Funds Have Met Key Objectives over a 12-Month, 3-Year and 5-Year Period



Source: Preqin Investor Survey, April 2014

What Are Institutions Looking For From Hedge Funds?

As shown, investors are looking at hedge funds to do more than produce high returns; in fact it is their ability to produce risk-adjusted absolute returns which are uncorrelated to equity markets that appeals to these institutions. In this section we look at what the precise requirements of investors from their hedge funds in their portfolio are, both in terms of the absolute returns generated, as well as over what time frames they judge the success of their portfolio.

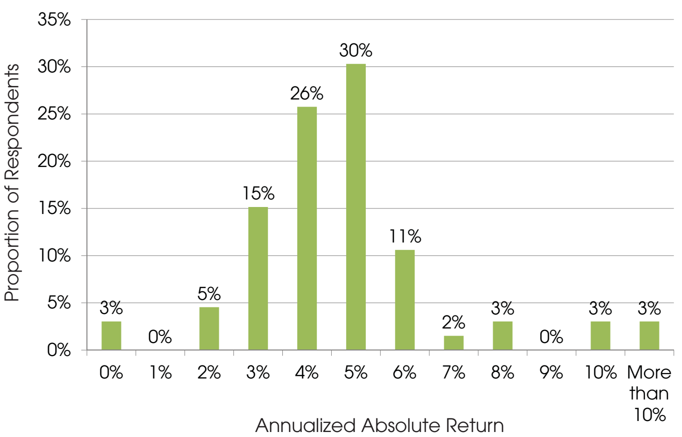
In Brief

- **67% of investors seek annualized returns between 4% and 6%.**
- **Investors look for hedge funds to produce returns with lower volatility than equity markets.**
- **Institutional investors are committed to investing in hedge funds for long periods of time.**

As shown in Fig. 7, for most of the investors that participated in this study the absolute annualized returns sought are relatively modest. Two-thirds of the investors that participated stated they seek returns between 4% and 6% per annum. Just 6% of investors look for their portfolios of funds to add more than 10% each year, confirming the findings in the previous section that only a few investors, just 7%, stated that they choose to invest in hedge funds as a result of their high returns expectations. In regards to volatility and risk expectations, 95% of the investors interviewed stated they had created portfolios of funds designed to exhibit lower volatility than equity markets (Fig. 14). The combination of reduced volatility and reduced risk is important to investors. As one wealth manager, with more than 60% of its assets invested in hedge funds, put it, "If you are attempting to reduce volatility and improve the quality of your returns, you need hedge funds".

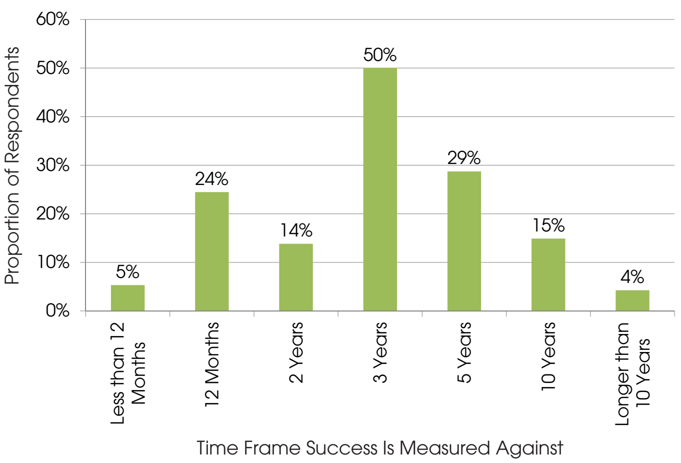
Although hedge funds are seen as a relatively liquid alternative asset, most investors see the industry as a long-term investment solution within their portfolio. The investment when committing to hedge funds is calculated in more than just the amount invested in the fund; creating a portfolio of funds to meet a particular set of risk/return requirements takes time by both the investors and their consultant to assess the opportunities in the market, source compatible funds and carry out due diligence on the potential vehicles. Additionally, once an investment is made and a portfolio is created, ongoing monitoring and management are also both resource intensive. As a result most institutional investors, once they have set up their hedge fund program, are committed to investing in hedge funds for long periods of time. As shown in Fig. 8, the most common time frame over which investors measure the success of their portfolio is three years; however, significant proportions of investors, 29% and 15% of respondents respectively, look at their portfolio success over five- and ten-year periods.

Fig. 7: Absolute Returns Sought by Institutional Investors from their Hedge Fund Portfolios



Source: Preqin Investor Survey, April 2014

Fig. 8: Time Frame(s) Against Which Institutional Investors Measure the Success of their Portfolio



Source: Preqin Investor Survey, April 2014

Download the data pack:
www.preqin.com/HFJun14

Have Hedge Funds Lived Up to Institutional Expectations?

Most investors look to hedge funds to add sources of consistent, low volatility mid-single digit returns to their portfolios. With investors looking at hedge funds over the short (12 months), medium (three years), and long (five years) timeframes, we examine how hedge funds have met investors' expectations outlined earlier in this report over these periods using data from Preqin's Hedge Fund Analyst online service, and the results of our interviews with 100 institutional investors.

As shown in Fig. 9, the largest proportion of investors (84%) feel that over the past 12 months their returns expectations have been met or exceeded (measured to Q1 2014). This is the same level of satisfaction with returns as seen in the 12 months to the end of 2013 (as shown in the 2014 Preqin Global Hedge Fund Report), and represents the highest level of investor satisfaction with hedge fund performance since Preqin started recording this data. This will come as a relief to fund managers in the industry, which has had its worst start to the year since 2008.

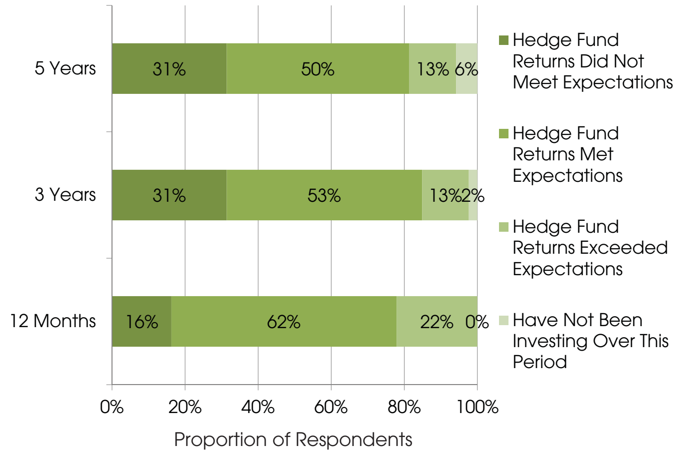
As shown in Fig. 10, hedge fund performance in the past 12 months and over the longer five-year period has matched the 4-6% requirements set by the majority of institutional investors. Over a three-year period, annualized returns of hedge funds failed to reach 6% (Fig. 10), largely caused by a problematic 2011. However, with only 22% of investors stating they seek returns of 6% or more (Fig. 7) and just 33% stating that their returns objectives had not been met in a three-year period (Fig. 9), even this relatively low level of annualized performance is seen as satisfactory by the bulk of investors.

In addition to hedge funds generally matching absolute return expectations, these funds have also managed to exhibit both lower volatility than equity markets (Fig. 11) and better risk-adjusted returns (Fig. 12) when measured against the S&P 500 over a three-year period. The S&P measurements are based on the month-end to month-end movement of the S&P 500, in order to compare to hedge funds data which is gathered monthly. As shown in Fig. 14, 95% of investors which participated in this study have designed their portfolios to exhibit less volatility than equity markets, so it is clear the industry is meeting this objective.

In Brief

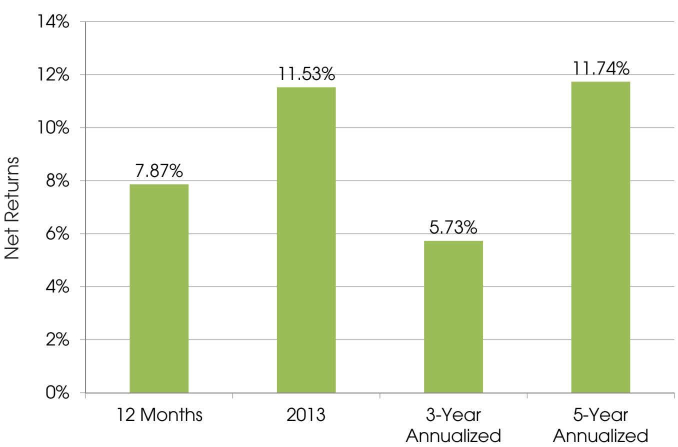
- **Investors are the most satisfied with returns they have ever been.**
- **Hedge funds are meeting investor expectations on an absolute and a risk-adjusted basis.**

Fig. 9: Proportion of Institutional Investors that State Hedge Fund Returns Have Lived Up to Expectations over a 12-Month, 3-Year and 5-Year Period



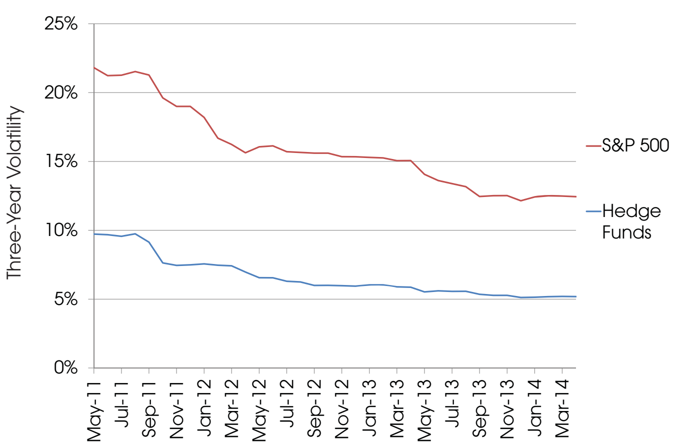
Source: Preqin Investor Survey, April 2014

Fig. 10: Hedge Fund Returns (As at April 2014)



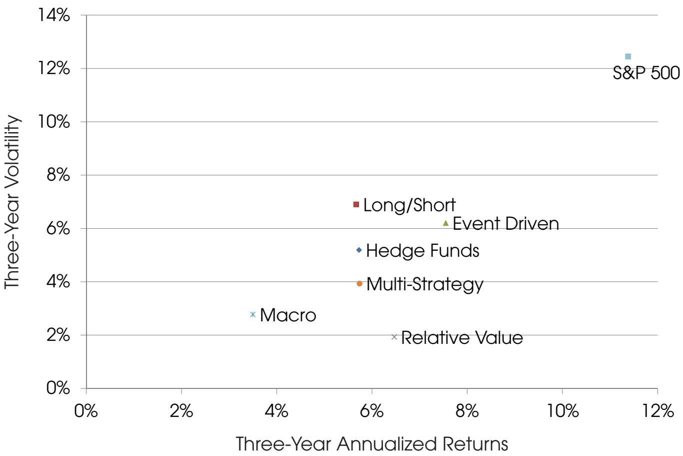
Source: Preqin Hedge Fund Analyst

Fig. 11: Rolling Volatility of Hedge Funds vs. S&P 500, May 2011 - April 2014



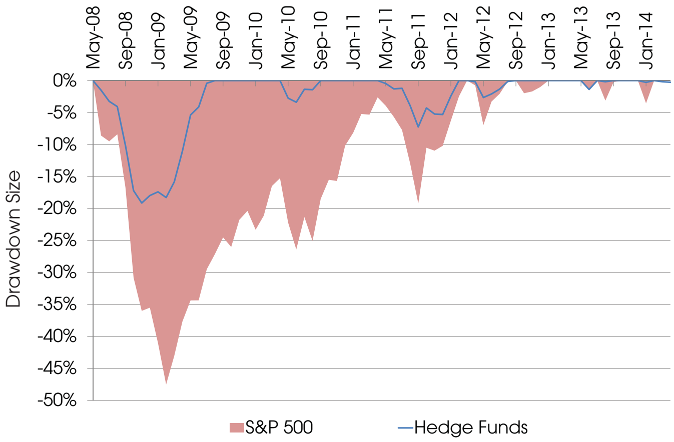
Source: Preqin Hedge Fund Analyst

Fig. 12: Risk-Return Profile of Hedge Funds vs. S&P 500 (As at April 2014)



Source: Preqin Hedge Fund Analyst

Fig. 13: Drawdowns of Hedge Funds vs. S&P 500, May 2008 - April 2014



Source: Preqin Hedge Fund Analyst

Fig. 13 depicts the lossmaking periods suffered by hedge funds and the S&P 500 during the last six years. The equities index has seen both more instances of drawdown and more severe drawdowns than hedge funds over the course of this period.

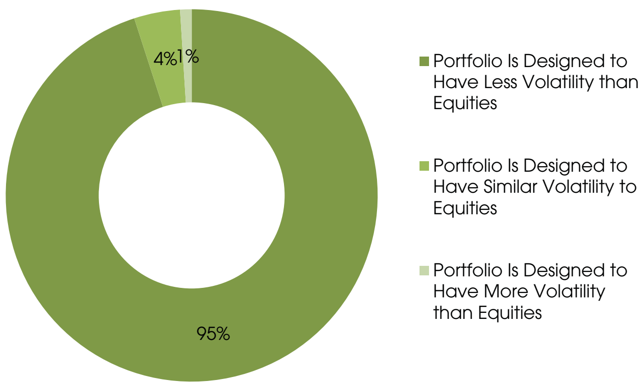
Thirty percent of investors stated that they use hedge funds to mitigate risks in other areas of their portfolio (Fig. 4). As shown, in Fig. 15 investors are largely confident that hedge funds are doing this; eighty percent of institutions believe that if they were to remove hedge funds from their portfolio the overall level of risk of their investments will increase.

One area where hedge funds may be failing to meet investor expectations is uncorrelated returns; the current correlation coefficient of hedge funds to S&P 500 is 0.69 when the index is positive and 0.72 when it is in negative territory. In the current bull market this has driven returns upwards; however, some investors may be looking at other hedge fund strategies such as macro funds and CTAs to provide some downside protection for when the bull run ends.

In Brief

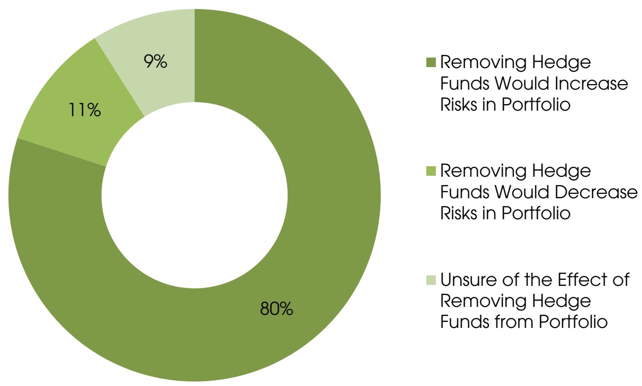
- Most investors feel that if they were to cease investing in hedge funds, the amount of risk in their portfolio would increase.
- However, correlation to equity markets may be a concern for some investors.

Fig. 14: Investors Opinions' on Hedge Fund Portfolio Volatility vs. Equity Volatility



Source: Preqin Investor Survey, April 2014

Fig. 15: Investors' Opinions on the Effect of Removing Hedge Funds from their Portfolio on Risk



Source: Preqin Investor Survey, April 2014

How Should Institutions Benchmark Performance?

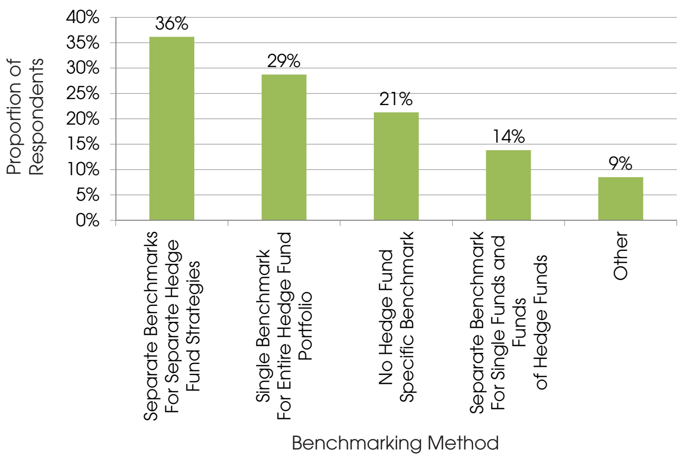
Investors are largely satisfied with the level of performance of their hedge fund portfolios, both in absolute terms and on a risk-adjusted basis (Fig. 9). However, with over 10,000 hedge funds to choose from, how do investors monitor the funds in their portfolio against the wider performance of the industry?

Hedge fund investors use a variety of methods to benchmark their portfolios against the wider hedge fund industry (Fig. 16). The largest proportion of investors (36%) use separate benchmarks to compare the separate strategies in their hedge fund portfolios. The term "hedge fund" encompasses a wide variety of strategies and trading styles, underlying investment holdings and regional foci. It is this very variation from fund to fund which makes aggregating performance across all funds irrelevant for many investors (Fig. 18); by looking at strategic specific benchmarks to compare performance investors may be able to better gauge how each element of their hedge fund portfolio is performing.

The S&P 500 is the most favoured non-hedge fund specific benchmark among investors (Fig. 17). However, nearly a quarter of all investors felt that public market indices such as the S&P 500 are not relevant to hedge fund performance (Fig. 18). Certainly, when you compare the performance characteristics of the S&P 500 to hedge funds (Fig. 11 and Fig. 12) as well as from the return characteristics sought by institutional investors (Fig. 4), then it is clear that hedge funds' risk/return profile and volatility are superior to these equity indices, even if the actual returns have not been over the past few years.

Alongside the diversity of the industry making it less relevant to benchmark across all strategies and the S&P 500 being no longer relevant to benchmark hedge funds to, investors also felt that some benchmarks might be unreliable or overestimate industry performance (Fig. 18). The investors suggested that these benchmarks can be improved by creating more specific benchmarks.

Fig. 16: Methods Institutional Investors Utilize to Benchmark Hedge Fund Performance

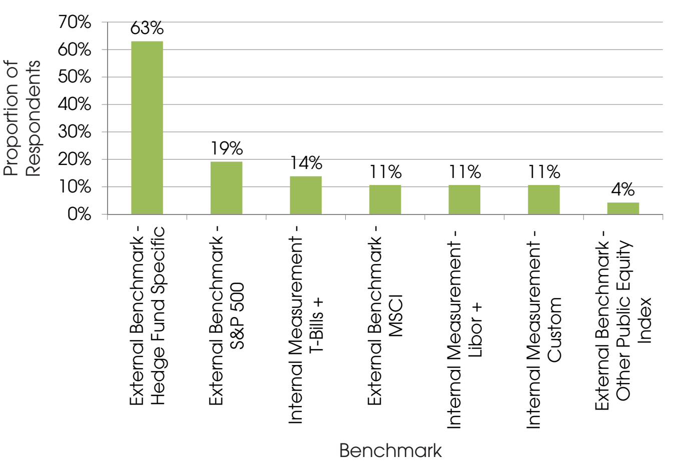


Source: Preqin Investor Survey, April 2014

In Brief

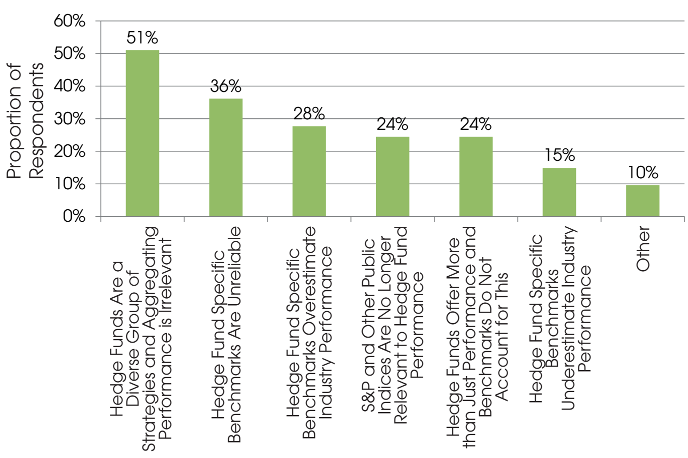
- **Investors commonly use strategy-specific benchmarks to compare their portfolio to the wider industry.**
- **Equity indices do not reflect the diversity of the hedge fund industry or its risk/return characteristics.**
- **Therefore equity indices such as the S&P 500 are becoming less relevant for benchmarking hedge fund performance.**

Fig. 17: Benchmarks Used by Institutional Investors to Assess Hedge Fund Performance



Source: Preqin Investor Survey, April 2014

Fig. 18: Institutional Investor Concerns with Existing Benchmarks



Source: Preqin Investor Survey, April 2014

What's Next for Institutional Hedge Fund Portfolios?

Over the past decade we have seen more and more institutional investors add to their hedge fund portfolios in order to add a source of low-volatility, risk-adjusted and non-correlated returns. Investors have been largely satisfied with the asset class's ability to match these objectives and with the performance of the industry in general. In fact we are currently in a period when investor satisfaction with performance is at an all-time high. So, with the industry largely meeting the needs of investors, how will they change their hedge fund portfolios moving forwards?

Fig. 19 shows investors plans for their portfolios in the next 12 months, three years and five years in regards to the amount they invest in hedge funds. As would be expected, in the short term investors in general are more likely to have fixed plans for their portfolio, with the largest proportion, almost two-thirds, unlikely to change their exposure to hedge funds. However, 19% of respondents have plans to increase their target allocations, and just 4% plan to decrease the amount invested in hedge funds, which means that 2014 is likely to be another year when there are good levels of net inflows from institutional investors. When looking at the number of funds they plan to invest in (Fig. 20), the picture looks positive for hedge fund managers currently seeking new investment; 45% of investors are either considering increasing the number of funds in their portfolio or have definite plans to do so, compared to 9% looking to reduce their number of relationships.

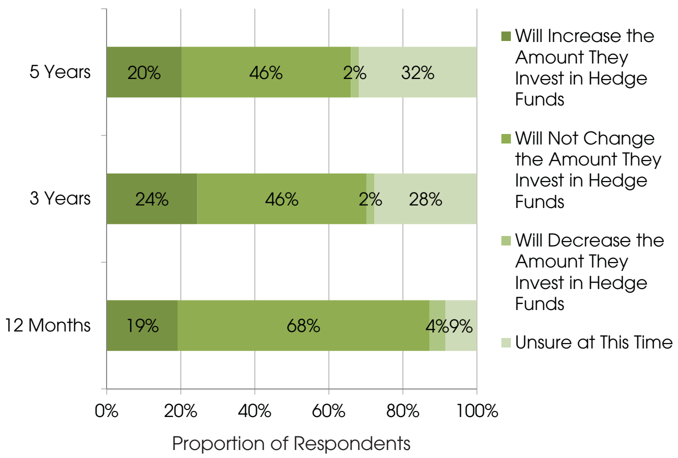
In the longer time frames, investors are less likely to have fixed their plans, but the patterns look similar to the 12-month time frame. In fact, when discarding the investors which are unsure what they intend to do, the picture looks even more promising, with larger proportions of the remaining investors seeking to increase their exposure in the next three years and the next five years.

As a result, the outlook for the industry looks promising; it is clear that in both the short, medium and long term investors will be putting more of their money to work in hedge funds and, at the same time, will be giving this to a larger number of managers. Of course, hedge funds will need to continue to provide the returns that investors seek – both on an absolute and risk-adjusted basis – in order to maintain the institutional enthusiasm for the asset class. As we see the industry become more institutionalized, with investors taking a deeper look at performance, it is likely that we will see this continued shift away from comparing hedge fund performance to equity indices such as the S&P 500. As investors begin to view hedge fund performance more in relation to specialized hedge fund indices which better reflect what investors need from the asset class, we may see more investors begin to invest in the asset class for the first time as the true value of investing in hedge funds is revealed.

In Summary

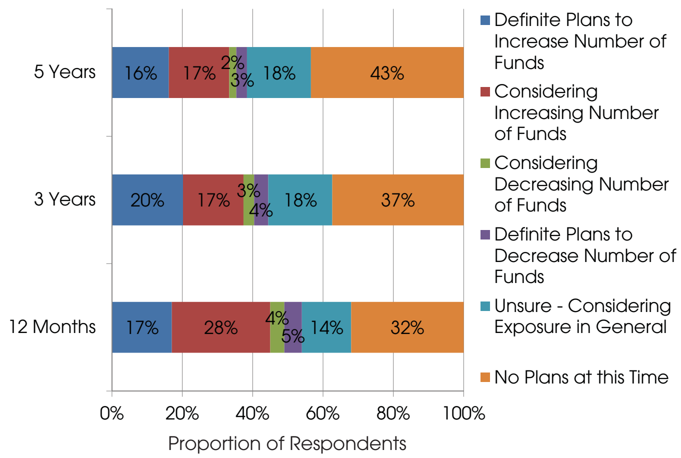
- **Thousands of institutional investors allocate capital to hedge funds.**
- **The amount of money they invest has increased over recent years and is likely to increase significantly in the years to come.**
- **Investors use hedge funds to add a source of uncorrelated, risk-adjusted returns to their portfolio, NOT for double-digit returns.**
- **Equity indices, such as the S&P 500, are increasingly seen as an irrelevant method of benchmarking hedge fund performance.**
- **Hedge funds have largely lived up to investors' expectations on an absolute and risk-adjusted basis over the short, medium and longer term.**

Fig. 19: Institutional Investors' Plans to Change the Amount They Invest in Hedge Funds over the Coming 12-Month, 3-Year and 5-Year Periods



Source: Preqin Investor Survey, April 2014

Fig. 20: Institutional Investors Plans to Change the Number of Hedge Funds Invested in over the Coming 12-Month, 3-Year and 5-Year Periods



Source: Preqin Investor Survey, April 2014

Investing in Hedge Funds: All About Returns?

June 2014

Preqin: Global Data and Intelligence

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

Source new investors for funds

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

Identify potential investment opportunities

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

Find active fund managers in hedge funds

Search for firms operating hedge funds. View information on key contacts, assets under management, performance history, key investment preferences, known investors, and more.

Benchmark performance

Identify which fund managers have the best track records with fully customizable performance benchmarks and view performance details on individual named funds and share classes.

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