2012 Overview and 2013 Outlook: Institutional Investors and Fund Managers Examine the Hedge Fund Industry

Amy Bensted takes a closer look at key data on institutional investors in hedge funds and hedge fund managers from the **2013 Preqin Global Hedge Fund Report**.

In December 2012, Preqin analysts conducted in-depth interviews with 85 investors and 60 hedge fund managers from around the globe in order to gain a 360 degree view of the industry as we enter 2013. Investors were asked for their opinion on a range of topics, from their views on the industry's performance in 2012, how this has affected their attitude to the asset class, and their outlook on regulations. Managers were asked to comment on a variety of topics, from their outlook on 2013 in terms of changes in industry assets under management and performance, to regulations and the challenges they face in the future.

How Have Institutional Hedge Fund Portfolios Fared in 2012?

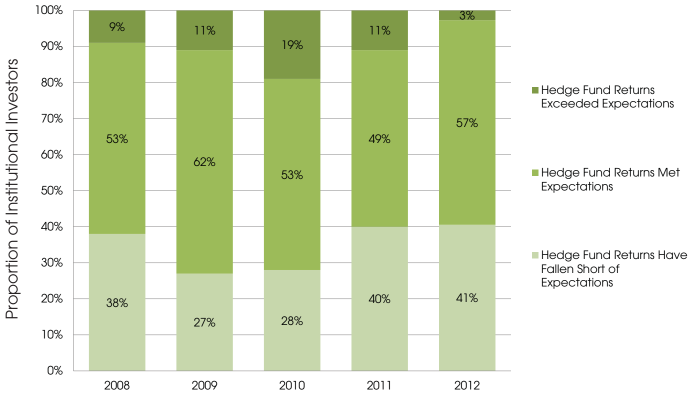
Fifty-seven percent of investors interviewed reported that hedge fund returns have met expectations in 2012 (Fig. 1). While this figure is higher than in 2011 and 2010, the proportion of investors reporting that hedge fund returns have exceeded expectations has fallen from 11% in 2011 to 3% in 2012. The proportion of investors reporting that hedge fund returns have fallen short of expectations remained almost the same, standing at 40% in 2011 and 41% in 2012. Despite hedge fund performance being significantly higher than in 2011, it failed to reach the double digit cumulative figures of 2010 and 2009 and hedge fund returns have been surpassed by S&P 500 over the course of 2012. With 41% of institutions reporting that hedge funds have not met their return expectations, disappointment with performance is at its highest level since Preqin began collecting this data in 2008.

Investor and Fund Manager Outlook for 2013

Investors and managers interviewed by Preqin were asked whether they are positive, negative or neutral in their outlook towards the industry (Fig. 2). Forty-four percent of investors reported holding a neutral view towards the industry in 2013. A further 36% of investors interviewed hold a positive view towards the hedge fund industry in 2013, twice the proportion of investors holding a negative view (18%). Despite another year when returns have disappointed a large proportion of hedge fund investors, outlook for the industry over the next 12 months remains largely positive.

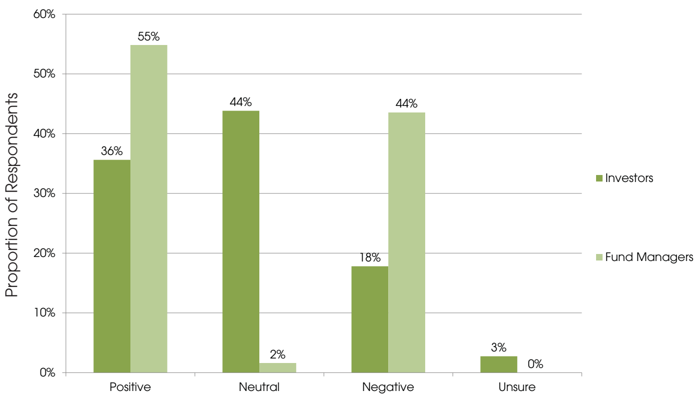
The views of fund managers towards the outlook for the industry in 2013 are more polarized than investors, with 55% of fund managers feeling positive, 44% feeling negative and just 2% holding a neutral outlook. Despite a disappointing 2012, when hedge fund performance lagged equity markets, the majority of managers interviewed are optimistic about the industry in 2013; this is further shown by the 62% of hedge fund managers interviewed by Preqin that are bullish on their outlook towards hedge fund industry's total assets under management,

Fig. 1: Hedge Fund Portfolio Performance Relative to Expectations of Institutional Investors, 2008-2012



Source: 2013 Preqin Global Hedge Fund Report

Fig. 2: General Perception of the Hedge Fund Industry in 2013 Among Institutional Investors and Fund Managers

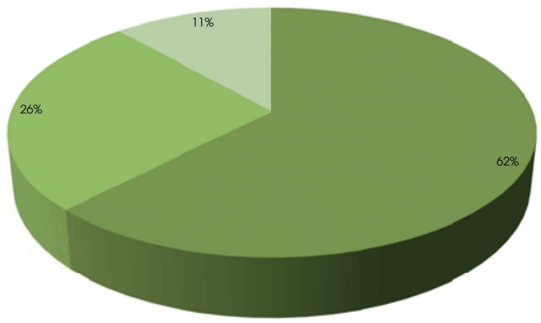


Source: 2013 Preqin Global Hedge Fund Report

expecting it to increase in 2013 (Fig. 3). Just 11% of managers interviewed feel that the industry's assets will contract in 2013. This belief that investor inflows and positive returns will further bolster the size of the hedge fund universe is encouraging for an industry which has steadily been recovering its assets under management in recent years following a contraction in size in 2008.

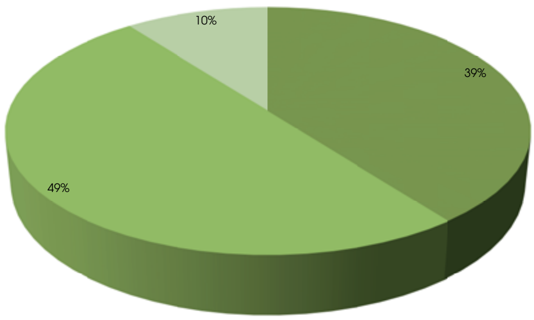
However, with many regulations coming into effect in 2013 and the sovereign debt crisis still not resolved, it is unsurprising that almost half (44%) of fund managers interviewed had a negative perception of the hedge fund industry moving into 2013.

Fig. 3: Proportion of Fund Managers that Feel Hedge Fund Industry Total Asset Under Management Will Increase, Decrease or Stay the Same in 2013



Source: 2013 Preqin Global Hedge Fund Report

Fig. 4: Proportion of Fund Managers that have Noted a Change in Proportion of Capital Coming from Institutional Investors in 2012



Source: 2013 Preqin Global Hedge Fund Report

Institutional Assets

When managers were asked how the proportion of their assets under management coming from institutional investors had changed over the past year, almost half (49%) of hedge fund managers interviewed responded that it had stayed the same, and 39% of fund managers reported an increase in their institutional assets over 2012; only 10% reported a decline (Fig. 4).

The increasing amount of institutional assets flowing into hedge funds is a topic Preqin has been following since 2008. In 2008, institutional capital represented a capital weighted average of 45% of a fund's assets under management. When we repeated the study in 2011, this figure had increased to 61%. As of Q4 2012, this had increased further , with 63% of a fund's assets under management coming from institutional investors' commitments. In 2008, many funds witnessed outflows, largely as a result of high-net-worth or family office redemptions, and at this time it was institutional capital that remained the most resilient. Over the past five years high-net-worth, retail and family office capital has returned to the asset class. Coupled with institutional investors increasing their allocations to hedge funds, this has led to industry assets under management recovering and growing beyond its 2008 peak, and institutional capital remains a significant part of hedge fund assets under management.

Key Issues Facing the Hedge Fund Industry in 2013

Despite total assets under management surpassing its previous high in 2008, and managers and investors being largely optimistic going into 2013, 2012 was another difficult year in the industry. New regulations created an added burden for fund managers, and high-profile SEC enquiries into leading industry names and continued market volatility which led to performance concerns, resulting in further investor dissatisfaction.

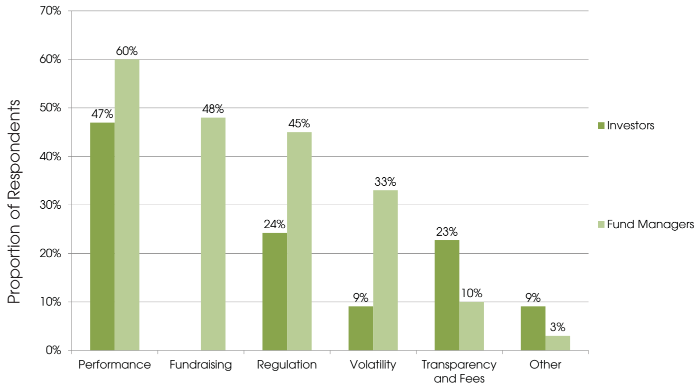
Fig. 5 shows the key issues investors and fund managers feel are facing the hedge fund industry in 2013. Both investors and managers are aligned in their agreement that performance is the number one issue that needs to be addressed in the following year; 47% of investors stated that performance was a key issue and 60% of fund managers stated the same. 2013 could prove to be a vital year for the industry, and hedge fund managers will need to post strong returns in order to satisfy those investors that have been disappointed with the industry's performance over the past few years. Alongside fundraising and regulation, ongoing volatility and uncertainty in the global markets are external factors that emerge as some of the most challenging obstacles for managers in 2013. If this continues it will be difficult for some fund managers to generate the performance they feel is critical.

Fees and transparency are key issues for investors for 2013, with 23% of respondents naming them. However, fulfilling investor demands is a concern for just 10% of fund managers. The bulk of managers hope that by focusing on generating strong returns in 2013 rather than on other investor demands for fee concessions or increased transparency they will win over investors that have been dissatisfied with performance over the past few years.

The Effect of Regulation

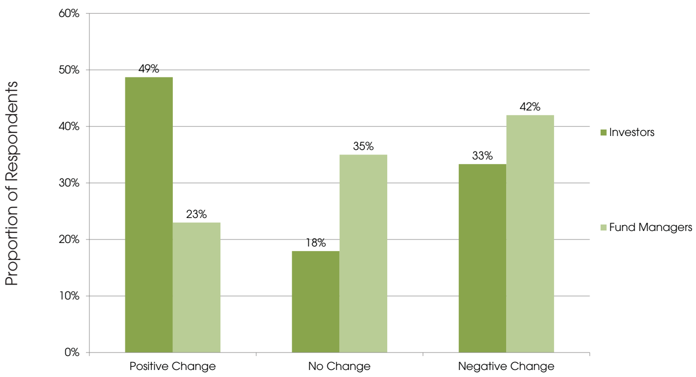
From Fig. 5 we can see that 45% of fund managers and 24% of investors interviewed feel that regulations will be a significant challenge in 2013. When this was examined in greater detail, we found that 42% of managers feel that regulation will have a negative impact on the industry as a whole, 35% feel that it will not change the hedge fund landscape and the remaining 23% believing that regulation will result in positive change (Fig. 6). When looking at three of the most prominent regulations – the European AIFMD (Alternative Investment Fund Managers Directive), the JOBS (Jumpstart our Business Start-ups) Act and the Dodd-Frank Act, it is clear that Dodd-Frank is causing the largest amount of concern for the hedge fund community (Fig. 7). The Dodd-Frank Act's requirement for the mandatory registration of hedge funds and the resulting burdensome compliance that comes with this explains why this regulation is the one the highest proportion of fund managers (43%) believe will adversely affect the hedge fund industry. The impact of Dodd-Frank has been felt more by European fund managers as the extra-territoriality regulations cause problems when complying with both US and European restrictions. Fifty-two percent of European fund managers believe Dodd-Frank to be a negative step for the industry.

Fig. 5: Key Issues Facing the Hedge Fund Industry According to Institutional Investors and Fund Managers



Source: 2013 Preqin Global Hedge Fund Report

Fig. 6: Investor and Fund Manager Outlook on Hedge Fund Industry Regulations Introduced and Proposed in 2011-2013



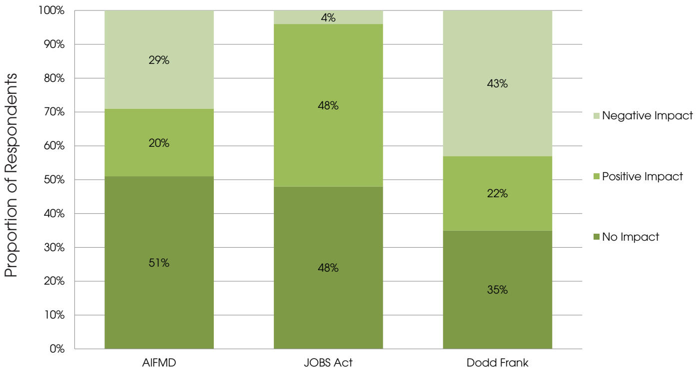
Source: 2013 Preqin Global Hedge Fund Report

The impending AIFMD and uncertainty around the final statutes has led to a mixed outlook among fund managers interviewed towards this new regulation. Fifty-one percent of fund managers feel that it will not significantly impact the hedge fund industry, a fifth feel that it could effect positive change and 29% believe it will lead to negative changes in the hedge fund universe.

The JOBS Act (JOBS) is by far the most well received piece of legislation for fund managers that feel that its potential to lighten marketing restrictions can lead to new inflows from investors in the future and help smaller emerging managers come to market. An equal proportion of fund managers feel that it will have no effect or a positive impact on the industry as a whole, with just 4% stating they feel it will be detrimental to hedge funds.

Contrary to the firms that manage their capital, institutional investors have a much more positive outlook on regulation in the hedge fund industry. Nearly half (49%) of investors interviewed stated they believe the regulations in question are positive for the hedge fund industry (Fig. 6). Of this group of investors the increased transparency and

Fig. 7: Fund Manager Perception of the Effect of AIFMD, JOBS Act and Dodd-Frank Act



Source: 2013 Preqin Global Hedge Fund Report

oversight of funds through regulation was most commonly cited as being attractive, and many of these investors also feel that further regulations will improve the pool of managers to choose from.

However, a significant 33% of investors feel that regulation will have negative repercussions for the industry. Those investors which see further regulation of the hedge fund industry as a negative development cite increased complexity in compliance driving up costs for managers, which could be passed on to investors. Furthermore, some investors with an interest in smaller, more nimble managers feel that increased regulations will make the hedge fund manager universe less entrepreneurial and more consolidated.

Outlook

Following another year where hedge fund returns have trailed major equity indices, 2013 will need to be a year of strong performance for hedge funds, with the majority of managers agreeing, alongside almost half of investors, that this is the key issue that faces the industry. Both investors and fund managers will need to pay close attention to any changes in industry-wide performance levels, to assess whether the desire for improved returns is being met.

Regulations are also leading to concerns from the fund management community as the extra compliance burden leads to greater costs and complexity within their firms. Institutional investors differ in their outlook towards regulation and over half of the investors that participated in this study believe that recent regulations and those proposed for 2013 are good for the industry as a whole. Although operating in a new regulated environment poses many challenges for hedge fund managers, it also presents many opportunities for funds to tap into the institutional investor market that is keen to invest in vehicles with some degree of regulated oversight.

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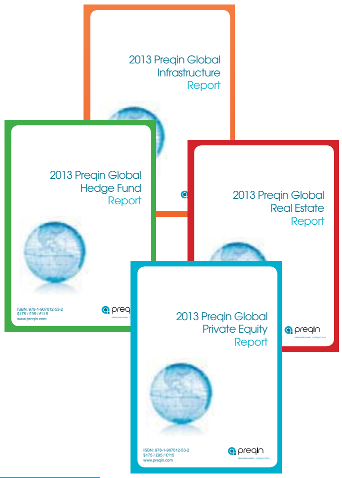

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