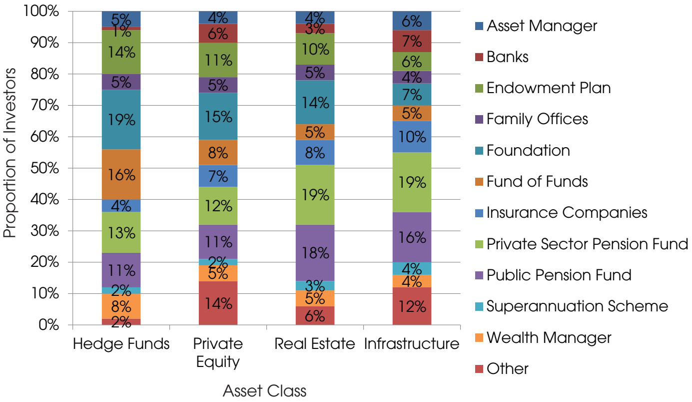
Alternative Assets in the Mainstream: How Hedge Funds Fit Within an Institutional Allocation to Alternatives

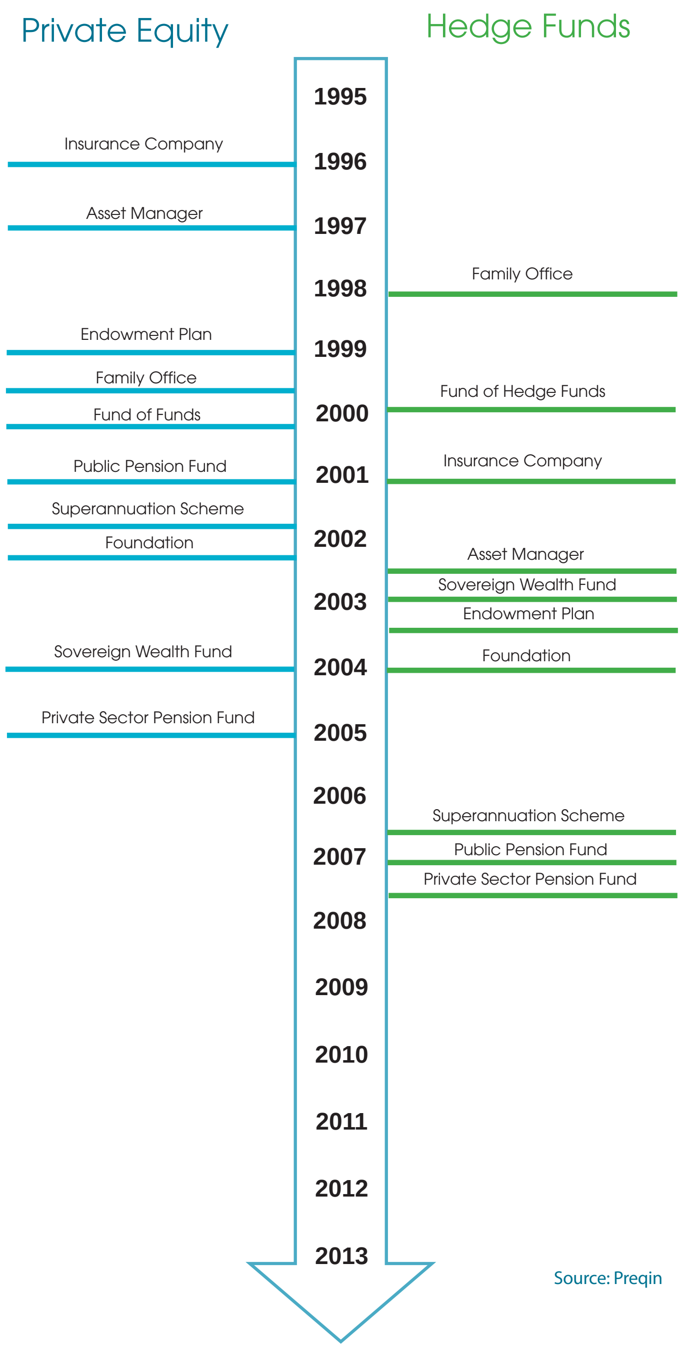
Using data from the 2013 Preqin Investor Network Global Alternatives Report, Amy Bensted looks at the importance of alternative assets in investors' portfolios, including their average allocation and year of first investment.

Fig. 1: Breakdown of Investors Active in Alternative Assets by Asset Class and Type



Source: Preqin

Fig. 2: Investors' Average Year of First Investment in Private Equity and Hedge Funds

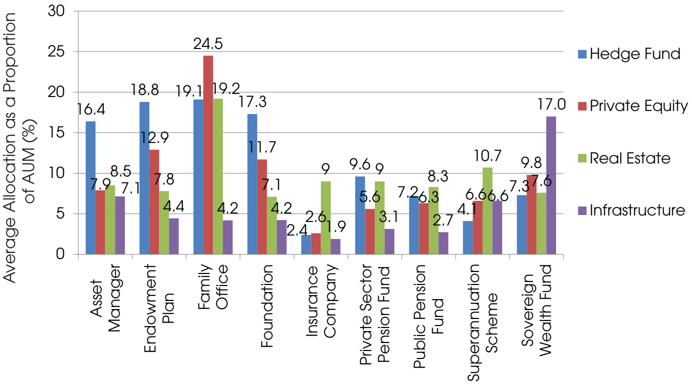


Source: Preqin

Preqin is celebrating its tenth year of providing information and services to and on the alternative assets industry. In this time we have seen many changes in the alternative assets sector driven by the changes in the economic environment, increased intervention from governing regulatory regimes, and the continuing boom in new technologies, among many others. Arguably the biggest driver of change in the alternative assets industry has been the flood of institutional capital into the four groups of alternative assets: hedge funds, private equity, private real estate and infrastructure. This influx of capital from institutions such as pension funds, foundations, insurance companies and sovereign wealth funds has caused the alternatives sector to hit assets under management of over $5.5tn. Institutional inflows have not only led to growth in the size of the industry and a proliferation of funds pursuing alternative strategies, but also a wider "institutionalization" of alternative assets, as private equity, hedge fund and real assets managers have built robust infrastructures to support their trading activities. To support this, the number of people working in the alternative assets industry has also shown a rapid growth over the past 10 years.

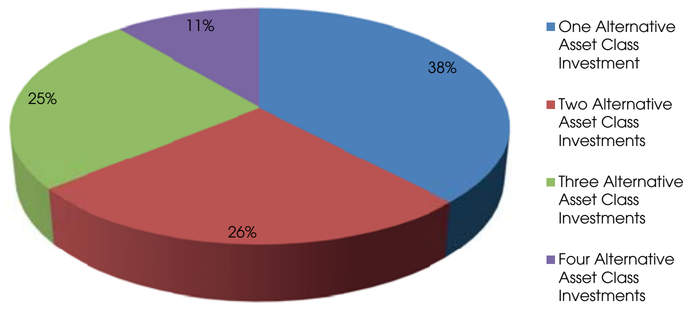
This feature article draws on data from our newly launched 2013 Preqin Investor Network Global Alternatives Report, a 100 plus page report covering all the key issues that investors in alternative assets need to know about in the industry today. We will examine which types of investors are currently investing in alternative assets, how much these investors are allocating and what alternative assets are of interest to these investors in the next year. As a manager it is important to understand the key allocators in your sector and as an investor already committing to alternatives or considering

Fig. 3: Investors' Average Current Allocations to Hedge Funds, Private Equity, Real Estate and Infrastructure by Type



Source: 2013 Preqin Investor Network Global Alternatives Report

Fig. 4: Number of Alternative Asset Classes Within an Investor's Portfolio (Investors With an Allocation to at Least One Alternative Asset Class)



Source: Preqin

doing so in the future, knowing more about your peers' plans for their alternative asset investments can help as you look to build a portfolio of alternatives.

Who Is Investing in Alternative Assets?

Fig. 1 shows a breakdown of investors by the number within each broad type allocating capital to each group of alternative asset. As this demonstrates, there is a wide range of types of institutional and private wealth groups investing in alternative assets today. There are some notable differences between investors in hedge funds compared to private equity, real estate and infrastructure. Perhaps most significant is the prevalence of funds of funds dedicated towards hedge fund investments in comparison to other alternative assets. Although the fund of hedge funds model has been called into question over recent years, the multi-manager model in the hedge fund industry is much larger than it is in the private equity asset classes, with around $800bn of hedge fund capital being siphoned through funds of funds.

Fig. 2, which shows the mean year of first investment of various types of investors, demonstrates that hedge fund investment is relatively new to most types of institutions. It shows that all investors, excluding family offices and sovereign wealth funds, made their first steps into alternatives through private equity funds. Funds of funds are often the chosen route into an asset for less experienced investors and this proliferation of new investors into hedge funds over the past 10 years has given the fund of funds sector a broad base of investors to serve.

Although foundations and endowments began investing, on average, earlier in private equity compared to hedge funds (Fig. 2), both foundations and endowments also represent a significantly larger proportion of the hedge fund investor universe in comparison the other asset classes. The early adoption of alternative assets by endowment plans, particularly the US-based institutions such as Yale, the pioneer of the so-called "Yale-Model" of portfolio management, paved the way not only for other endowments to invest in alternative assets, but also for a wider group of institutions that took note of the success of this new approach to money management.

Pension funds, both private and public, represent similar proportions of the investors in both private equity and hedge funds. Public pension funds began investing in private equity funds on average in 2001, a full six years earlier than the mean year of first investment for a public pension fund investing in hedge funds. Despite choosing to invest in hedge funds later than private equity, these pension funds have shown significant backing of hedge funds over the past five years, and have increased their allocations steadily since 2007. Today, hedge funds form a larger proportion of a pension fund's portfolio than private equity, and in the case of private sector pension funds, hedge funds are the single largest group of alternative assets held (as measured by average current allocation). Hedge funds are the second largest component of a public pension fund's portfolio, with public schemes investing the most capital in real estate. Eighteen percent of the investors in real estate funds are public pension funds – significantly higher than in hedge funds – which indicates that these investors are a significant driver of growth in real estate funds.

Number of Alternative Strategies Pursued

Fig. 4 shows the number of alternative asset classes (either hedge funds, private equity, private real estate or infrastructure) that each of the 7,700 active investors tracked by Preqin commit to. The largest proportion of investors (38%) commits to just one alternative asset class, with just 11% of institutions investing in all four. The remaining 51% invest in two or three groups of alternatives. Those investors with a wider variety of alternative assets in their portfolios tend to be those that adopted an alternative approach to investment earlier, and over time have diversified their portfolios further by adding new groups of alternative assets to their holdings. The wider trend for investors is to create larger and more complex portfolios of alternative investments by increasing allocations to strategies they already know, as well as diversifying into new strategies (be that private equity, real estate, infrastructure or hedge funds). With such a large proportion of investors only committing to one or two alternative asset classes, there is potential for significant growth in all four alternative asset classes.

Summary

Although hedge funds have been in existence for over 60 years, it has largely been over the last 10 years that these funds have caught the attention of institutional investors. Prior to that, family offices and high-net-worth individuals were the primary investors in the hedge fund space, and institutional investors sought to diversify into alternative assets through private equity funds initially. The difficult economic environment over the past five years has proven to institutional investors that there is a need to diversify portfolios from an overreliance on traditional fixed income and equity products, and the desire for liquid alternatives has led to an increase in interest in hedge funds in particular. Some investors, notably family offices, endowments, foundations and asset managers, invest on average over 10% of total assets in hedge funds, and for some investors, such as private sector pension funds, hedge funds are the most used alternative asset class within their portfolios. Other investors, such as sovereign wealth funds, invest relatively smaller proportions in hedge funds, and choose to put more of their alternative asset capital at work in private equity, real estate and notably in the case of sovereign wealth funds, infrastructure assets.

Despite the increased interest in alternative assets over the past two decades, many investors still only have relatively simple portfolios of alternative investments, with just one or two types of assets held. For these investors the challenge is to gain the necessary set of skills to add new levels of complexity to their portfolios by carving out new risk allocations within their portfolios for different alternative assets. They will then need the right tools to successfully source the alternative asset funds that best fit their needs. For fund managers the challenge is to successfully identify and connect with these investors that are looking to ramp up their exposure to alternative assets. Preqin has 10 years of experience within the alternative assets industry, and our Preqin Investor Network platform, available free of charge to accredited investors, monitors over 11,600 alternative asset funds in market.

Data Source:

This article uses data from the 2013 Preqin Investor Network Global Alternatives Report, the 104 page comprehensive review of the alternatives industry aimed exclusively at institutional investors ever undertaken. The Report covers a wide range of topics, including asset allocation, fund selection and due diligence.

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New York	London	Singapore	Silicon Valley
+1 212 350 0100	+44 (0)20 7645 8888	+65 6305 2200	+1 650 632 4345

pin.info@preqin.com