Are Emerging Hedge Fund Managers Attracting Institutional Interest?

Many institutional investors have sought refuge in established names in the hedge fund industry over recent years, despite emerging funds showing attractive returns. Graeme Terry assesses current investor attitudes towards emerging managers.

Emerging hedge fund managers have faced a tough fundraising environment in recent years, with institutional investors looking to allocate to established hedge fund managers in order to reduce risk in their portfolios by investing just in the largest funds. With investor confidence in hedge funds improving over the course of 2012 and 2013 due to improved performance, we evaluate whether or not hedge fund investors are looking to allocate capital to emerging managers in this period of renewed optimism.

Hedge funds managed by emerging managers can be attractive to institutional investors as such funds can offer the potential for greater returns, are often more nimble, and can take advantage of a wider set of opportunities or offer a more specialized investment approach. Newer funds may also be more willing to negotiate fund terms in a bid to attract investment. Also over the past year, a number of large hedge funds have closed to new investments, and as a result, some investors may be forced to consider smaller funds than they would have previously.

Institutional Investor Attitudes towards Emerging Manager Hedge Funds

Fig. 1 shows that there has been an overall reduction in appetite for emerging managers among institutional hedge fund investors since 2012. Thirty-eight percent of investors will invest in first-time funds, compared to 42% in 2012. This continues a trend of decline from 54% in 2010 and 48% in 2011, suggesting that investors are continuing to move towards investing with more established fund managers as they often perceive safety in numbers and these larger funds as less risky. However, with more than half of all investors willing to at least consider emerging managers, there remains an opportunity for successful new funds to continue attracting investment from the institutional community.

Emerging hedge fund managers typically appeal to more established hedge fund investors as their experience in the asset class can enable them to select lesser known funds. As a result, these investors will typically have strong investment resources and a substantial capital base. It is unsurprising that fund of hedge funds managers represent the highest proportion of emerging manager investors, with 73% of these firms investing in emerging funds, as shown in Fig. 2. Funds of hedge funds are vital in providing capital to new hedge fund managers due to their manager selection expertise and a number of firms have looked to expand their activity in this space in order to differentiate themselves in a challenging environment for multi-manager vehicles.

Institutional Investor Attitudes towards Emerging Manager Hedge Funds by Investor Type

Fig. 2: Institutional Investor Attitudes Towards Emerging Managers by Investor Type
Family offices and asset managers are also substantial allocators to emerging managers, with 43% and 46% of these investor groups investing in such funds respectively. However, both of these investor groups have seen a four percentage point decrease in the proportion of such firms targeting emerging managers over the past year. As these groups are managing money on behalf of wealthy individuals and private investors, they will often be willing to consider a variety of manager sizes and track records based on the wishes of their clients. Smaller hedge funds can often appeal to family offices due to their potential for increased diversification, stronger returns and access to better fund terms. Also, the investment ethos of emerging boutique fund managers is often more aligned with family office groups than extremely large institutional fund groups.

Both public and private sector pension funds have tended to prefer investing with established hedge fund managers and this trend is continuing, with almost 60% of these investors unwilling to consider investing in emerging funds. Pension funds are generally less experienced in hedge fund investing than other institutional groups and often have large ticket sizes, which means their initial investments may be too large for some of the smaller hedge fund managers to accommodate. As a result, they often look to achieve perceived security by investing with well-known funds, often the same funds their peers are invested with.

Endowment plans and foundations have also seen a reduction in the proportion of investors targeting emerging managers. These investors vary greatly in size and a number of the smaller firms do not have the resources to carry out research on emerging managers. However, some of the larger firms remain active in the emerging manager space, with the $3bn foundation Carnegie Corporation of New York an example of an investor actively seeking new investments with emerging managers.

Institutional Investor Attitudes towards Emerging Managers by Region

North America-based investors have previously been prominent in investing in emerging managers; however, the proportion of these investors willing to invest in such funds has dropped to 41% from 50% in 2012. The region is home to a number of foundations, endowment plans and pension funds and these investors have been scaling back their allocations to emerging managers over the past year. The proportion of European investors targeting emerging managers has remained relatively constant over 2013; these investors have tended to be more conservative than their North American counterparts in the past, but many may be willing to consider smaller funds as a result of smaller managers launching under the UCITS directive.

The highest proportion of institutional investors interested in emerging managers are based outside of North America and Europe. Forty-seven percent of Asia-Pacific-based investors and 52% of investors based outside of North America, Europe and Asia-Pacific are willing to invest in emerging funds. The hedge fund industry in these regions is less developed than in Europe and North America and investors based in these regions may prefer to invest with local funds, which are typically less established.

Minimum Manager Requirements for Hedge Fund Investors

In line with a reduction in appetite for emerging managers, the average minimum track record required by hedge fund investors before committing to a manager has increased. In 2012, 16% of investors were willing to invest with a manager with less than a year track record, but this has decreased to 11%, as shown in Fig. 4. Investors are becoming more demanding when selecting hedge fund managers and, as a result, they want to see a longer track record before investing with a manager. There has been an increase in the proportion of investors requiring four or more years track record over the past year, up from 22% to 26%. The most common minimum length of track record requirement is three years, with 45% of investors having this policy. With over 70% of investors requiring at least three years track record, it is clear that the majority of investors are continuing to try to reduce risk by investing with managers with strong previous experience. As Preqin’s performance data shows, it is often these funds with a shorter track record that can provide strong returns. However, the volatility and dispersion of performance is higher, and therefore many investors are deterred from investment.

In terms of required assets under management, the proportion of investors willing to consider funds with less than $500mn in assets has remained relatively constant at 75%. This suggests that the majority of investors are continuing to consider investments in smaller funds despite requiring a substantial track record. The proportion of investors that consider funds with less than $100mn in assets has decreased from 26% in 2012 to 22% in 2013, with the proportion requiring minimum assets in the range of $100-249mn increasing by five percentage points over the past year. Both public and private
sector pension funds tend to prefer investing with larger hedge fund managers, with 58% and 56% of these investors respectively targeting managers with at least $500mn in assets.

Outlook

The last few years have been challenging for institutional investors in hedge funds and there has been a continuing trend of fewer investors considering emerging managers as they look for investments that are perceived to be less risky. The greater volatility of emerging funds is proving to be a deterrent for some investors. Most investor groups are less willing to consider emerging managers than they were a year ago and investors on average are looking for a longer track record from managers before considering them for investment. However, the majority of investors will consider smaller managers with less than $500mn in assets and this is something that more investors may have to think about as larger funds become closed to new investment.

Although the current fundraising environment for emerging funds is tough, investors are looking for hedge fund managers that can differentiate themselves from their competitors through both strategy and performance. Emerging managers need to ensure that they have a strong team, robust infrastructure and a coherent strategy, as well as strong early performance in order to attract investment from the ever-demanding institutional community. It is vital that these firms understand the institutional investor universe in order to focus their efforts on targeting investors that are most likely to provide them with early stage capital.

Data Source:

Subscribers to Preqin’s Hedge Fund Investor Profiles can click here to view detailed profiles for all 1,089 investors that consider investing with emerging managers. Profiles include strategy and geographic hedge fund preferences, assets under management, current and target allocations to hedge funds, minimum lock-up period required, target returns and much more.

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As of 5 November 2013

Fund Coverage: **33,646** Funds
- 14,903 Private Equity* Funds
- 13,561 Hedge Funds
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- 742 Infrastructure Funds

Firm Coverage: **15,755** Firms
- 7,348 PE Firms
- 6,161 Hedge Fund Firms
- 1,845 PERE Firms
- 401 Infra. Firms

Performance Coverage: **14,323** Funds
- 5,316 PE Funds
- 7,748 Hedge Funds
- 1,117 PERE Funds
- 142 Infra. Funds

Fundraising Coverage: **13,818** Funds
- 1,723 PE Funds
- 10,910 Hedge Funds
- 930 PERE Funds
- 255 Infra. Funds

Deals Coverage: **87,115** Deals Covered; All New Deals Tracked
- 31,604 Buyout Deals**
- 50,217 Venture Capital Deals***
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- 4,391 Active Hedge Fund Investors
- 4,063 Active RE LPs
- 2,105 Active Infra. LPs

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- 7,748 Hedge Funds
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