alternative assets. intelligent data.

2017 PREQIN GLOBAL HEDGE FUND REPORT

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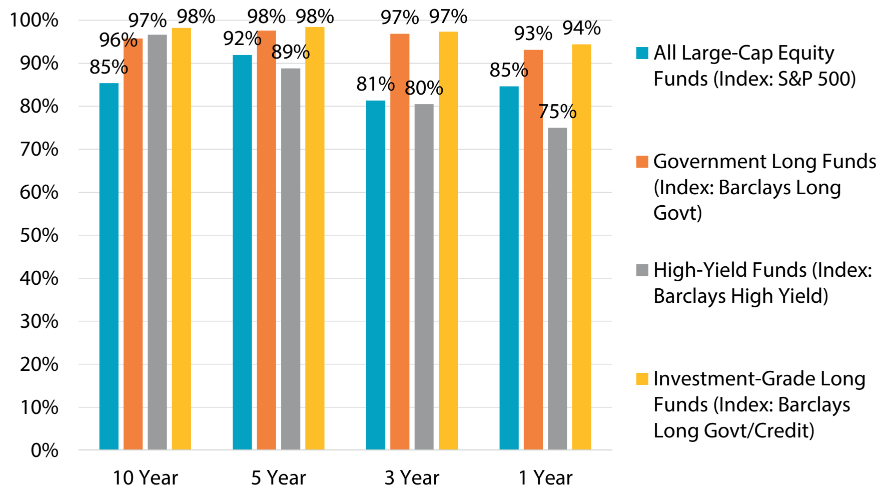
HEDGE FUND IDENTITY CRISIS RESHAPES ASSET MANAGEMENT

- Basil Williams, **PAAMCO**

Percentage of Funds Outperformed by Benchmark



Source: S&P Dow Jones Indices LLC

OVERVIEW

A paradigm shift within the asset management industry is at hand. Disappointing performance across both traditional and alternative investment approaches has opened the door for change. The barriers between traditional asset management and alternative asset management are rapidly blurring. New products that marry the investment goals of traditional active investment mandates with the trading strategies utilized by the best alternative managers are emerging, and institutional investors are taking notice. This innovative hybrid approach seeks to solve the return conundrum created by the low return environment brought on by years of easy monetary policy globally.

Active long-only asset management has performed poorly in recent years, rattling investors' confidence in their traditional investment approach. The growth of the hedge fund industry has 'stolen' some of the alpha once captured by active long-only managers. As a result, passive investments have taken significant market share from what was once an active-only world. Nonetheless, for most of 2016, hedge funds and funds of hedge funds have come into the spotlight as their value proposition of either better performance or diversified returns is being challenged. Many managers have failed to deliver the diversifying or 'alternative' performance that they had asserted was possible. In addition, clarity surrounding investment mandates, which is key to successfully measuring a manager's performance, is currently lacking within the industry, creating an identity crisis.

Along with these structural shifts, most institutional investors are failing to achieve their targeted investment returns, creating the opportunity for change. One promising innovation will be investment approaches that integrate hedge fund techniques into more traditional equity or fixed income mandates, thereby redefining the world of active investing. By utilizing investment strategies heretofore used only in the alternative arena, investment managers with the vision, skills and infrastructure to implement this multidisciplinary investment process will be in a position to attract market share from both the active and passive segments of traditional managers.

BACKGROUND

Over the last two decades, a majority of active fixed income and equity managers have failed to beat their benchmarks. In the last 10 years alone, the S&P 500 outperformed 85% of all Large-Cap Equity funds, and that lead widens to over 92% in the last five years.[1] This index outperformance is even more substantial among fixed income funds where 96% of actively managed government long-only funds were outperformed by the Barclays Long Government Index over 10 years and 98% were outperformed in the last five years. For Investment-Grade Long Funds, even the best timeframe for active funds (one year) shows that 94% of funds were outperformed by the index, and for High Yield that same time period shows 75% of funds underperformed their index.[1]

Meanwhile, since the mid-90s, the hedge fund industry has grown rapidly, with AUM increasing by over $2tn. Institutional buyers of alternative strategies are generally looking to create a mixture of investment exposures that either diversify or leverage exposure to their traditional benchmarks. Historically, hedge fund investors have been pleased with the performance of their allocations, but recently many notable managers have seen performance decline, causing some investors to question their allocation to the asset class.

Part of the recent disappointment comes from an identity crisis created by a lack of specific goals for alternative allocations. There is uncertainty around whether or not strategies are supposed to diversify risk away from traditional asset classes, or if they should provide higher performance than these traditional funds. Managers that have diversified their portfolios are often criticized for failing to beat the market, while those that have sought higher returns are then faulted for not being diversified and losing money when the markets fall. Again, clarity in the mandate is essential to understanding whether or not value is being delivered.

We see an opportunity for those alternative investment managers that can successfully create orthogonal, as opposed to leveraged, returns. These managers can integrate their strategies with those of more traditional investment approaches. This allows for active hybrid strategies which have both the market-based exposures pursued by traditional managers in combination with highly diversifying exposures generally reserved for alternative investments.

OPPORTUNITY AND SOLUTION

One of the key opportunities available to those managers able to combine hedge fund strategies with more traditional asset management techniques is the vast difference in available investor dollars. Traditional investment mandates are much larger than alternative mandates: 85-90% versus 10-15% of total portfolio allocations. Given the performance challenges faced by traditional managers and the fee pressure on hedge fund managers, traditional and hedge fund investment approaches are converging, thereby developing active hybrid products. Using hedge fund technology to extract uncorrelated return and long-only traditional techniques to achieve market exposure, better-performing products should evolve. As these products develop, clients stand to benefit from better performance within their traditional mandates and alternative asset managers stand to benefit from more available assets to manage. Given the skillset needed to implement alternative trading strategies and track records which speak to alpha capture, a select subset of alternative managers are well positioned to design these products and compete for traditional asset management mandates.

The creation of such hybrid products will challenge the normal relationship between large allocators and hedge fund managers. The allocators will themselves become active managers and will think less about a hedge fund manager as one who manages a fund and more as someone who delivers specific types of risk and return exposures. Instead of gaining exposure to a fund, investors will aim to gain exposure to specific trading strategies, which can then be pieced together into a customized mandate.

In order to succeed, the hybrid investment approach must be similar in structure to institutional long-only mandates. Separate accounts for each client, rather than commingled funds, which have historically been the default structure for alternative approaches, will be the norm. Separate account structures allow for full ownership of the assets, thereby improving the transparency of individual positions and associated risks. Such structures also give investors the ability to create specific performance benchmarks and/or return profiles for their hybrid portfolios to best suit their needs. For example, hybrid accounts could be benchmarked to beat specific equity, credit or duration indices, or alternatively could be established with the goal of creating an asymmetric return profile to provide enhanced diversification. These new account structures will help managers and investors better define investment goals, creating a more natural alignment of interests and assessment of success.

FEES

Correctly pricing these hybrid investments is critical. Their pricing will naturally carry a higher management fee than a comparable, traditional long-only account, as the strategy implementation is more complex. This may likely be augmented by a performance fee tied to the level of outperformance relative to the mandate. Aligning the interests of the asset manager and the investor to achieve excess return over the benchmark is somewhat novel within the traditional asset management world, but is likely to become more common as investors seek higher returns, and managers that can deliver will want to get compensated based upon successful performance.

CONCLUSION

The goal of this new hybrid approach is to provide better solutions for investors than are offered today. The combination of the hedge fund skillset with long-only risk exposure should allow for improved investment returns and diversification. If executed successfully, such an investment approach could reduce underfunded pension status, provide a reserve against unexpected liabilities and can even allow for the creation of asymmetric return profiles.

Investors seeking innovative approaches to solve their return challenges should embrace this new active hybrid approach. It is a natural development following the low return environment of the past few years and helps in part to resolve the identity crisis surrounding alternative allocations of providing diversifying exposures or simply leveraged returns. Clearly there will be skeptics but also some early movers who are intrigued by the novelty of the approach and will want to be known as thought leaders among their peers.

PAAMCO
PAAMCO is a leading institutional investment firm dedicated to offering alternative investment solutions to the world's preeminent investors. Since its founding in 2000, PAAMCO has focused on investing on behalf of its clients while striving to raise the standard for industry-wide best practices. Headquartered in Irvine, California with a global footprint that extends across North America, South America, Europe and Asia, PAAMCO's clients include large public and private pension funds, sovereign wealth funds, foundations, endowments, insurance companies and financial institutions. The firm is known for its completeAlphaTM approach to hedge fund investing which focuses on delivering performance from early-stage opportunities, controlling costs, and protecting client assets. In addition, it offers long-only active equity investing in select emerging markets through PAAMCO Miren.

BASIL WILLIAMS
Basil Williams is a Managing Director and Co-Head of Portfolio Management. He is also leading the expansion of Horizons, a new division at PAAMCO that offers active fixed income solutions.

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HEDGE FUNDS: 2016 IN NUMBERS

GROWTH IN ASSETS, NUMBER OF INVESTORS AND NUMBER OF FUNDS IN 2016

$3.22tn Hedge fund industry AUM has increased by $70bn since December 2015 to $3.22tn as of November 2016.

-$102bn Investors withdrew a net $102bn from hedge funds in 2016 (as at November 2016).

5,100+ More than 5,100 institutional investors allocate to hedge funds.

+25 funds 1,006 hedge funds launched in 2016; in contrast, 981 funds closed*.

PERFORMANCE IN 2016

7.40% 2016
2.03% 2015
The Preqin All-Strategies Hedge Fund benchmark returned 7.40% in 2016, over five percentage points higher than 2015.

56% of hedge funds reported positive returns in 2016.

66% of investors believe their performance expectations were not met in 2016.

41% of fund managers believe their performance objectives were not met in 2016.

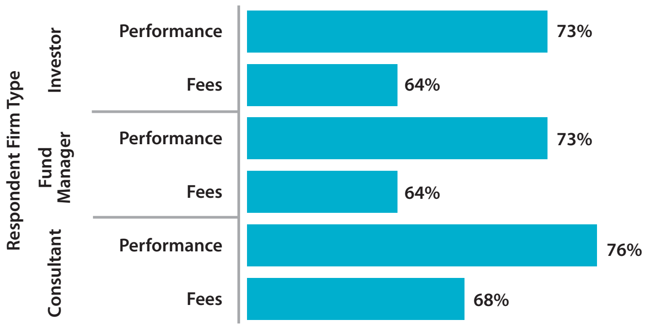
OUTLOOK FOR 2017

20%
38%
Fundraising will continue to be challenging in 2017; more institutions (38%) plan to invest less capital in hedge funds in the coming year than those that intend to invest more (20%).

37% of fund managers have plans for a new hedge fund launch in 2017.

Investors, fund managers and consultants agree that performance and fees are the leading issues for hedge funds to address in 2017:

VIEWS ON THE KEY ISSUES FACING THE HEDGE FUND INDUSTRY IN 2017 BY FIRM TYPE



The numbers of fund launches and liquidations in 2016 are likely to change as more data becomes available.

DESPITE IMPROVED PERFORMANCE IN 2016, INVESTORS REMAIN CAUTIOUS IN 2017

- Amy Bensted, **Preqin**

2016 could be characterized as a year in which the unexpected happened, with perhaps the Brexit result and Donald Trump's triumph in the US presidential election at the pinnacle of this series of largely unpredicted events. As markets struggled to respond to these surprising outcomes, volatility increased, and hedge funds, following two years of returns below 5%, were able to capture some upside, adding 7.40% over the course of 2016. However, despite hedge fund performance as a whole being well within the targeted range of most investors (see page 110), 2016 may well be remembered by hedge fund managers as a difficult year, with a net $102bn of investor capital being redeemed in the 11 months to November. Even the largest hedge funds were unable to survive the wave of redemption requests which swept through the industry in 2016. For instance, Perry Capital, which had assets of $15bn at its height, was forced to close up shop in September following significant investor withdrawals and poor performance.

It was, perhaps, the announcement of withdrawals from several of the largest investors in hedge funds – New Jersey State Investment Council, NYCERS and Metlife Insurance Company, to name a few – that characterized the reasons behind the wider redemptions in the industry. Many of these large institutions cited performance concerns and the high fees as the leading reasons driving their decisions to reduce their exposure to hedge funds. Our interviews with institutional investors in December 2016 revealed that the return expectations of two out of every three investors had not been met over 2016, and 73% and 64% of investors stated performance and fees respectively as the leading issue in the industry today, the largest proportions by some margin. So, to counter these concerns, 2017 may be a year for managers to continue to build on the solid returns of 2016 in order to demonstrate their worth in terms of performance, as well as to focus on the value they provide investors by re-evaluating the terms and conditions on their funds.

IT WASN'T ALL BAD NEWS IN 2016

However, looking beyond the headline figures, there are some bright spots. Firstly, the industry as a whole grew as a result of performance gains made in 2016. Today, collectively, hedge funds manage assets in excess of $3.2tn – the highest on record. Managed futures had a successful 2016 in regards to fundraising. CTAs built on the $25bn they raised in 2015, and added a further $17bn in fresh capital in 2016, taking the size of the CTA sector to $240bn. In addition, many investors continued to make new investments, or began investing in hedge funds for the first time. Among these was National Pension Service of South Korea, which made its first investment in hedge funds in July 2016, investing over $900mn in the asset class.

OUTFLOWS LOOK LIKELY TO CONTINUE

The fundraising challenges of 2016, however, show little sign of abating in 2017. Outflows accelerated throughout 2016, with the largest levels of investor redemptions made in the final quarter of the year (to 30 November, page 48). In our December 2015 interviews with investors, Preqin noted for the first time that more investors planned to reduce their exposure to hedge funds in the next 12 months than increase (32% versus 25%). Our December 2016 interviews (page 112) indicate that we may see continued outflows over 2017. Nearly twice the proportion of investors (38%) plan to reduce their exposure in 2017 than intend to increase (20%), a concern for managers as both retaining capital and fundraising is likely to continue to be a challenge over 2017. However, despite being squeezed on fees, fund managers are seeking to invest more in their marketing, business development and investor relations capabilities in order to combat these difficulties, which they face in retaining capital and gaining fresh inflows (page 63).

ALTERNATIVE ASSET INTELLIGENCE MAY BE MORE IMPORTANT THAN EVER

As markets respond to the unexpected events of 2016, the ramifications of which are far from clear, 2017 could be a time for hedge funds to show their worth to investors if they can continue to build on the solid returns of 2016. Undeniably, many investors have grown cautious when it comes to investing in hedge funds, with a growing proportion looking to cut back on their investments in the near future. However, despite short-term concerns around performance, hedge funds have proved their worth in institutional investors' portfolios on a risk-adjusted basis over the long term (page 34). However, with 14,500 funds open to investment, it is more challenging than ever to find the right fund in terms of strategy, performance and fees. Therefore, intelligence that can help investors cut through the noise and find the funds that meet their needs may be the first step for institutions in creating portfolios of funds that can help them meet their long-term objectives.

The industry is in a period of change. Investor pressure on performance and fees has grown and there have been large-scale redemptions from hedge funds. In addition, the gap between new fund launches and fund liquidations has narrowed to just 25. If outflows continue in 2017, we may continue to see a shake-out of those funds that have failed to meet investors' return expectations in recent years and a contraction in the size of the industry. Data and intelligence can help fund managers navigate these challenging times, not only in finding those investors looking to allocate fresh capital to hedge funds, but also in understanding the plans and needs of the institutions that currently invest in their funds. In a competitive marketplace, having intelligence on your peers – how are they performing, what fees they charge and who is invested in those funds – may also help managers set themselves apart in 2017.

IN FOCUS: BREXIT

At various points throughout 2016, Preqin surveyed over 500 hedge fund managers and 300 institutional investors active in hedge funds to gauge the impact of the UK's referendum of EU membership on the hedge fund industry. In Preqin's survey before the referendum, 71% of fund managers believed that Britain would vote to stay in the EU; however, this prediction proved incorrect, with 52% of voters backing Brexit. Using the results of these surveys, as well as data from Preqin's **Hedge Fund Online**, we analyze the changing sentiment of the hedge fund industry towards the Brexit vote and how the performance of hedge funds has been affected.

593
of 953 EU-based hedge fund managers are headquartered in the UK.

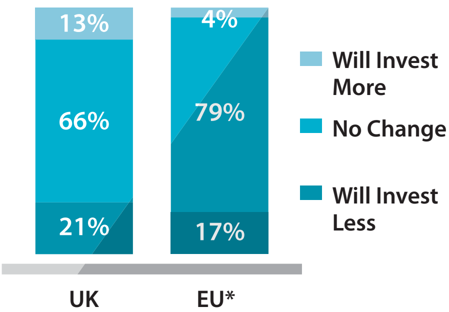
SIZE OF HEDGE FUND INDUSTRIES:

UK
$466bn

EU*
€128bn

409
of 758 EU-based institutional investors in hedge funds are headquartered in the UK.

Investor views on the impact of Brexit on their hedge fund investments in the UK vs. EU* over the next 12 months:



UK-based hedge fund managers that have no plans to move their business operations out of UK:

80%

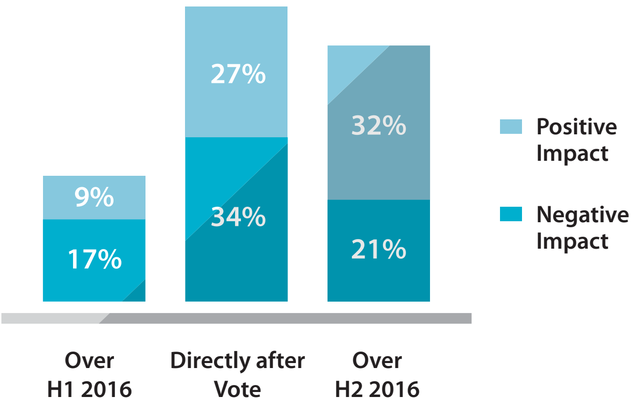
JUNE

70%

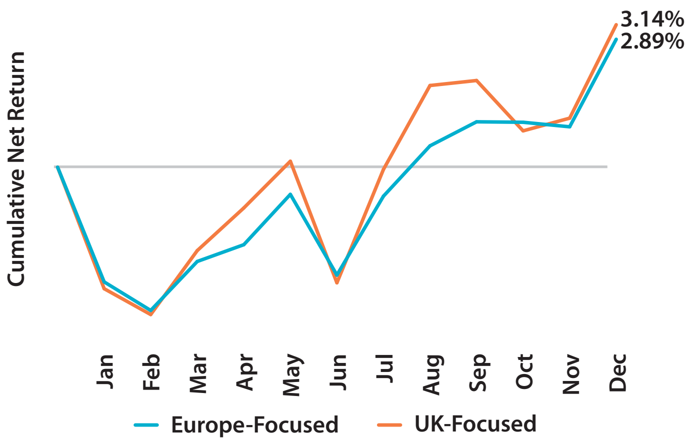
NOVEMBER

> ***The main impact of Brexit will be to increase volatility which could be either positive or negative. It will require us to be very tight on risk management***
>
> *– Hong Kong-based fund manager*

Hedge fund manager views on the impact of Brexit on performance:



Cumulative returns of UK- and Europe-focused hedge funds in 2016:



*Excluding UK.

PERFORMANCE BENCHMARKS

Fig. 4.1: Summary of Performance Benchmarks, As at December 2016 (Net Returns, %)*

	2016	2015	2014	2-Year Annualized	3-Year Annualized	5-Year Annualized	3-Year Volatility	5-Year Volatility
Hedge Funds	7.40	2.03	4.99	4.74	4.83	7.47	4.01	4.15
HF - Equity Strategies	6.65	1.13	5.44	3.92	4.43	7.86	5.87	5.94
ES - Long/Short Equity	5.49	2.33	4.68	4.00	4.27	7.43	5.19	5.20
ES - Long Bias	9.77	-2.65	6.32	3.38	4.21	9.01	8.70	8.98
ES - Value-Oriented	10.78	-1.09	15.39	4.61	8.13	12.11	8.20	8.03
ES - Sector-Focused	4.94	0.14	8.88	2.52	4.49	7.14	8.57	7.72
ES - North America	10.05	0.14	6.60	4.99	5.55	9.65	6.69	6.41
ES - Europe	-0.12	8.49	2.73	4.16	3.68	7.09	5.16	5.22
ES - Asia-Pacific	0.16	7.87	7.79	4.03	5.31	9.14	7.94	7.72
ES - Emerging Markets	8.62	-0.88	5.87	3.77	4.29	7.21	7.43	7.60
ES - Developed Markets	5.56	5.42	9.08	5.23	6.31	11.87	6.92	7.15
HF - Macro Strategies	7.09	3.26	4.70	5.15	4.99	5.53	2.43	2.51
MS - Macro	7.42	5.03	6.68	6.22	6.37	6.85	2.70	2.67
MS - Commodities	16.57	-7.51	-3.76	3.81	1.22	0.00	6.52	6.78
MS - Foreign Exchange	4.78	1.71	-3.57	3.38	0.70	1.60	3.55	3.31
HF - Event Driven Strategies	12.47	-0.78	2.65	5.74	4.71	8.38	4.76	4.79
ED - Event Driven	12.10	-0.28	3.37	5.89	5.09	9.19	5.11	5.13
ED - Distressed	15.60	-6.42	-1.22	4.26	2.40	7.50	5.47	5.26
ED - Special Situations	16.87	0.00	1.07	8.15	5.74	8.52	5.66	5.63
ED - Risk/Merger Arbitrage	8.54	6.04	3.01	7.28	5.84	5.70	2.46	2.50
HF - Credit Strategies	8.50	2.20	5.98	5.29	5.41	8.16	2.31	2.45
CS - Long/Short Credit	8.26	-0.58	3.12	3.89	3.62	6.73	2.77	2.84
CS - Fixed Income	9.11	2.43	4.87	5.83	5.56	7.02	2.30	2.38
CS - Mortgage-Backed Strategies	7.20	3.97	10.91	5.57	7.25	11.16	2.42	2.79
CS - Asset-Backed Lending Strategies	7.71	7.67	9.99	6.88	7.83	11.19	1.29	1.93
HF - Relative Value Strategies	4.74	5.65	4.87	5.21	5.28	6.78	1.76	1.76
RV - Equity Market Neutral	1.67	7.33	3.63	4.58	4.28	5.73	1.98	1.86
RV - Fixed Income Arbitrage	6.23	2.30	5.78	4.40	4.89	5.47	2.05	2.07
RV - Relative Value Arbitrage	7.85	7.50	6.58	7.02	7.61	9.86	2.55	2.42
RV - Statistical Arbitrage	3.10	4.91	5.43	4.21	4.50	5.62	1.77	2.34
RV - Convertible Arbitrage	7.76	4.42	5.10	6.38	5.48	8.12	3.62	4.06
RV - North America	6.80	5.14	7.20	6.13	6.94	7.52	2.31	1.95
RV - Europe	4.66	1.40	2.35	3.86	3.97	5.00	2.07	1.99
RV - Asia-Pacific	2.11	8.81	3.44	4.40	3.89	6.04	2.12	2.58
RV - Developed Markets	5.03	5.56	7.48	5.21	5.70	6.81	1.90	1.77
HF - Multi-Strategy	7.04	2.97	4.71	5.15	5.05	6.50	2.82	3.01
HF - Niche Strategies								
NS - Insurance-Linked Strategies	5.06	4.72	7.18	4.21	5.50	6.78	1.02	1.11
NS - Niche	11.29	6.81	1.87	9.03	6.59	10.30	3.79	4.79
HF - Trading Styles								
Activist	10.47	3.18	6.32	6.92	6.76	9.95	5.62	6.02
Volatility	8.02	6.81	5.47	6.99	6.41	7.29	2.31	2.16
Discretionary	7.51	2.51	5.16	4.98	5.06	8.87	4.39	4.63
Systematic	4.44	5.46	6.58	5.03	5.51	6.43	2.71	2.63
HF - North America	10.20	0.45	6.55	5.22	5.68	9.17	5.06	4.86
HF - Europe	2.89	5.94	2.85	4.45	3.93	6.96	3.79	3.98
HF - Asia-Pacific	1.68	7.36	6.94	4.45	5.27	8.66	6.37	6.32
HF - Emerging Markets	9.96	2.42	4.74	6.19	5.61	7.47	5.19	5.43
EM - Asia	2.60	2.02	19.59	2.31	7.77	9.72	10.04	10.30
EM - Latin America	20.15	1.74	1.73	10.84	7.82	8.03	5.87	5.22
EM - Africa	0.63	7.78	8.63	4.16	5.63	10.23	3.94	4.02
EM - Russia & Eastern Europe	15.92	1.63	-23.54	7.46	-4.16	-0.72	11.58	11.64
HF - Developed Markets	7.69	4.05	8.06	5.82	6.53	8.84	3.05	3.22
HF - USD	7.22	0.65	4.56	3.93	4.13	7.21	4.41	4.58

	2016	2015	2014	2-Year Annualized	3-Year Annualized	5-Year Annualized	3-Year Volatility	5-Year Volatility
HF - EUR	0.98	2.36	1.29	1.74	1.62	4.13	3.07	3.26
HF - GBP	2.93	2.06	-0.52	2.48	1.45	2.78	2.46	2.72
HF - CHF	-0.64	1.94	2.22	0.72	1.28	4.41	3.58	3.84
HF - JPY	2.36	7.57	6.10	4.83	5.25	10.49	4.52	6.15
HF - BRL	20.22	7.81	6.29	14.02	11.45	10.88	4.25	3.68
HF - AUD	5.00	8.99	6.44	6.83	6.73	10.21	5.37	5.26
HF - CAD	9.22	2.30	5.99	5.71	5.80	6.01	4.71	4.53
HF - ZAR	3.10	14.79	12.47	8.47	9.90	12.64	4.17	3.73
HF - Emerging (Less than $100mn)	8.18	1.74	3.79	4.93	4.58	6.99	4.17	4.40
HF - Small ($100-499mn)	6.40	2.42	4.91	4.42	4.51	7.37	4.03	4.09
HF - Medium ($500-999mn)	5.53	2.76	3.68	4.17	4.12	6.82	3.48	3.64
HF - Large ($1bn or More)	4.63	1.99	6.32	3.54	4.55	7.81	3.25	3.74
Funds of Hedge Funds	**-0.25**	**1.05**	**3.99**	**0.39**	**1.58**	**4.35**	**3.25**	**3.58**
FOHF - Equity Strategies	-0.52	1.42	3.96	0.47	1.62	4.66	4.97	4.75
FOHF - Macro Strategies	1.45	-0.99	4.53	0.33	1.77	1.01	2.77	2.81
FOHF - Event Driven Strategies	3.78	-2.27	0.67	0.30	0.21	3.36	4.63	4.26
FOHF - Credit Strategies	1.34	0.63	12.89	0.45	1.62	3.58	2.72	2.68
FOHF - Relative Value Strategies	-0.78	1.41	1.52	0.27	0.76	2.54	2.10	2.06
FOHF - Multi-Strategy	-0.33	1.13	3.93	0.37	1.55	4.74	2.96	3.96
FOHF - Funds of CTAs	-3.92	-5.43	16.32	-4.87	1.70	-0.72	10.82	9.67
FOHF - North America	1.70	-0.38	5.36	0.62	2.19	5.46	4.39	4.05
FOHF - Europe	-0.28	4.34	4.12	0.92	1.49	3.35	3.24	3.11
FOHF - Asia-Pacific	-1.50	5.25	4.50	1.82	2.70	5.40	5.57	5.30
FOHF - Emerging Markets	0.87	5.29	7.57	1.94	2.96	4.73	3.57	3.49
FOHF - USD	0.38	0.16	3.10	0.28	1.24	4.54	3.48	4.24
FOHF - EUR	-2.83	0.77	1.98	-1.06	-0.02	2.05	3.35	3.26
CTAs	**0.91**	**0.15**	**10.86**	**0.75**	**3.92**	**3.57**	**4.99**	**4.57**
CTA - Discretionary	6.08	1.81	-0.64	3.76	2.37	4.63	4.18	3.95
CTA - Systematic	-0.54	-1.43	12.98	-0.73	3.54	2.74	5.97	5.70
CTA - Trend Following	-0.77	-1.15	15.00	-0.96	4.10	3.13	6.96	6.40
CTA - Macro	1.36	2.59	11.99	1.97	5.21	4.20	4.68	4.43
CTA - Counter Trend	0.54	1.87	8.37	1.20	3.54	2.81	4.74	4.58
CTA - Pattern Recognition	3.84	1.76	11.97	2.80	5.77	4.62	5.00	4.63
CTA - Arbitrage	-0.06	0.99	8.62	0.47	3.11	5.27	2.97	3.09
CTA - Option Writing	5.01	6.83	-0.76	5.92	3.64	4.87	6.09	5.69
CTA - North America	4.17	3.38	10.95	3.76	6.11	5.62	4.02	3.76
CTA - Developed Markets	-3.18	-4.16	8.01	-3.48	0.07	0.95	6.09	6.62
CTA - USD	0.74	-0.36	10.80	0.40	3.64	3.38	5.08	4.70
CTA - EUR	-3.91	3.20	12.76	-0.32	3.83	1.82	6.84	6.51
Alternative Mutual Funds	**2.71**	**-2.86**	**3.07**	**-0.07**	**1.00**	**3.93**	**3.78**	**4.05**
AMF - Equity Strategies	1.87	-1.19	5.81	0.47	2.28	6.21	5.33	5.50
AMF - Macro Strategies	1.43	-7.75	-2.18	-3.34	-3.18	n/a	3.54	n/a
AMF - Event Driven Strategies	5.67	-3.66	-0.66	0.90	0.38	2.85	3.84	3.64
AMF - Credit Strategies	4.08	-3.15	1.48	0.27	0.62	2.65	2.51	2.65
AMF - Relative Value Strategies	-0.96	-0.02	0.32	-0.49	-0.22	n/a	2.76	n/a
AMF - Multi-Strategy	4.75	-4.71	3.65	0.02	1.42	3.75	5.10	5.16
AMF - North America	3.58	-3.76	5.24	-0.03	1.64	5.66	5.24	5.38
UCITS Hedge Funds	**1.05**	**1.10**	**2.36**	**1.08**	**1.53**	**3.53**	**3.53**	**3.57**
UCITS - Equity Strategies	0.42	1.98	2.81	1.23	1.85	5.23	5.02	5.24
UCITS - Macro Strategies	1.86	-0.80	2.70	0.46	1.19	1.60	3.26	3.38
UCITS - Event Driven Strategies	-1.06	0.45	0.25	-0.44	-0.11	1.44	3.19	3.06
UCITS - Credit Strategies	3.43	-0.49	2.69	1.57	1.99	3.84	2.96	2.83
UCITS - Relative Value Strategies	0.16	1.78	0.59	0.97	0.84	1.85	1.84	1.70
UCITS - Multi-Strategy	2.28	1.26	4.41	1.76	2.12	3.26	3.03	3.30
UCITS - Europe	-0.89	5.54	2.87	2.29	2.51	5.09	3.74	3.69
UCITS - Asia-Pacific	0.65	1.32	2.74	1.08	1.88	5.06	6.51	6.28
UCITS - Emerging Markets	5.07	-5.56	0.26	-0.42	-0.04	3.35	8.65	8.34
UCITS - Developed Markets	-0.13	0.42	0.72	0.28	0.56	1.52	2.73	2.40
UCITS - USD	0.71	-0.93	0.75	-0.02	0.27	3.09	4.16	4.42
UCITS - EUR	0.44	2.13	2.52	1.22	1.68	3.51	3.47	3.43
UCITS - GBP	2.23	1.30	2.29	1.71	1.80	3.94	3.19	3.43
UCITS - CHF	-1.48	1.17	3.05	-0.14	0.90	2.63	3.41	3.70

Source: Preqin Hedge Fund Online

**Please note, all performance information includes preliminary data for December 2016 based on net returns reported to Preqin in early January 2017. Although stated trends and comparisons are not expected to alter significantly, final benchmark values are subject to change.*

ASSET FLOWS IN 2016

	MACRO STRATEGIES	EQUITY STRATEGIES	MULTI-STRATEGY	RELATIVE VALUE STRATEGIES
Industry Assets by Strategy	$955bn	$822bn	$425bn	$341bn
Change over 2016	▲ 3.9%	▲ 1.8%	▼ 1.4%	▼ 0.9%

Preqin's **Hedge Fund Online** database holds performance and asset data for over 15,000 hedge funds. Using this extensive coverage, Preqin is able generate estimates of the capital flowing in and out of the industry, and determine which strategies and regions have seen net growth or a decline in assets over the course of 2016 as at 30 November 2016.

NEGATIVE FLOWS, POSITIVE PERFORMANCE

Following a year of strong inflows in 2015, the industry saw net outflows of $102bn in 2016 (Fig. 5.1), with 54% of hedge funds recording net outflows over the course of the year as performance and fee concerns saw some investors pull capital from hedge fund portfolios. Credit and equity strategies recorded the largest net outflows over the year; however, the total assets of equity strategies funds increased by 1.8% over 2016, driven by an annual net return of 6.65%. Investor sentiment towards CTAs, however, is strikingly different to that of hedge funds: CTAs have attracted $17bn in new capital in 2016 as investors look for sources of uncorrelated returns.

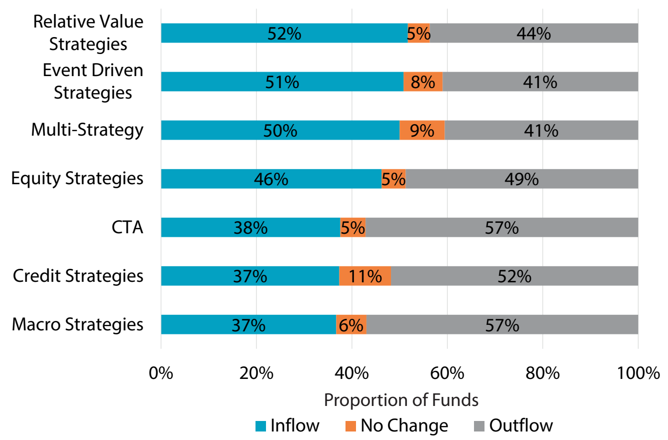
Despite the majority of hedge fund strategies recording net investor

Fig. 5.1: Hedge Fund Asset Flows by Core Strategy

Strategy	2015 ($bn)	Q1 2016 ($bn)	Q2 2016 ($bn)	Q3 2016 ($bn)	Q4 2016 ($bn)*	2016 ($bn)
CTA	24.6	13.7	2.9	10.5	-10.4	16.7
Event Driven Strategies	-1.8	-2.8	3.4	-0.6	3.5	3.6
Niche Strategies	1.3	-1.5	-0.2	0.3	0.3	-1.0
Multi-Strategy	27.5	12.8	-1.6	-25.0	-2.8	-16.5
Macro Strategies	-25.8	-6.4	-4.9	-1.2	-4.4	-16.9
Relative Value Strategies	-18.8	-8.7	10.4	-16.4	-7.2	-21.8
Credit Strategies	4.2	-11.9	-14.3	2.0	1.5	-22.7
Equity Strategies	60.3	-9.7	-15.6	-2.2	-15.5	-42.9
Total Industry	**71.4**	**-14.3**	**-19.9**	**-32.5**	**-34.9**	**-101.6**

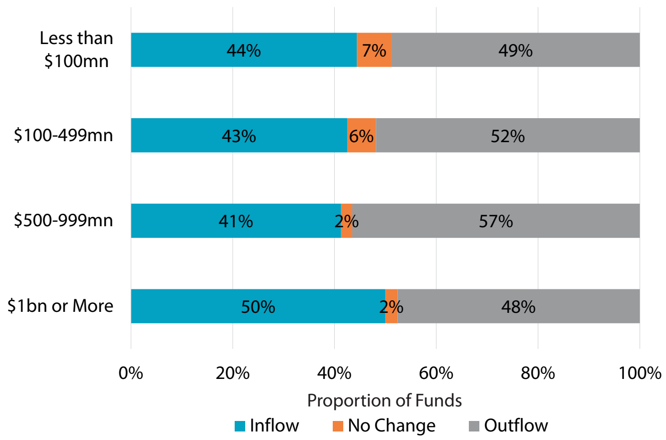
Source: Preqin Hedge Fund Online

Fig. 5.2: Hedge Fund Asset Flows over 2016 by Core Strategy



Source: Preqin Hedge Fund Online

Fig. 5.3: Hedge Fund Asset Flows over 2016 by Fund Size



Source: Preqin Hedge Fund Online

**Q4 2016 asset flows estimated to 30 November 2016.*

> ***This could be an early indication, along with the significantly smaller number of new managers setting up in 2016, that there could be a plateauing or even a contraction of the industry in terms of size in the next couple of years***

in 2016 (see page 142), and in the event driven strategies sector, with 13% of funds launched in 2016 pursuing this strategy, an increase from 10% in 2015. This has been accompanied by net growth in the number of event driven strategies in the market (Fig. 6.10): 35 more event driven strategies came to market than closed over the course of 2016. In contrast to the growth in the event driven strategies sector, there was a contraction in the number of hedge funds pursuing a multi-strategy, CTA or credit strategy in 2016.

Nearly three-quarters (74%) of funds launched in 2016 are managed by firms based in North America, with the number of active hedge funds based in the region increasing by 65 since the end of 2015. The reverse, however, is seen in Europe, with liquidations outnumbering launches by managers based in the region.

EXISTING VS. NEW FUND MANAGERS

Fig. 6.12 shows the annual number of hedge funds launched by existing and new fund managers (defined as fund managers launching their first fund). As the hedge

GROWTH OF ACTIVE HEDGE FUNDS

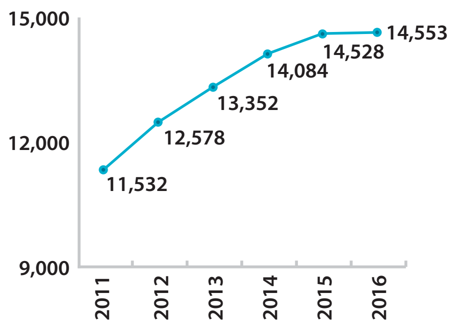
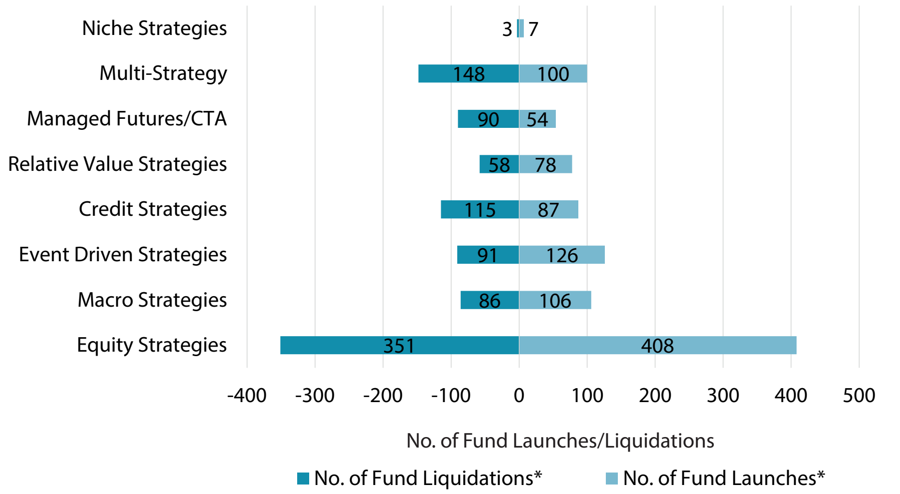
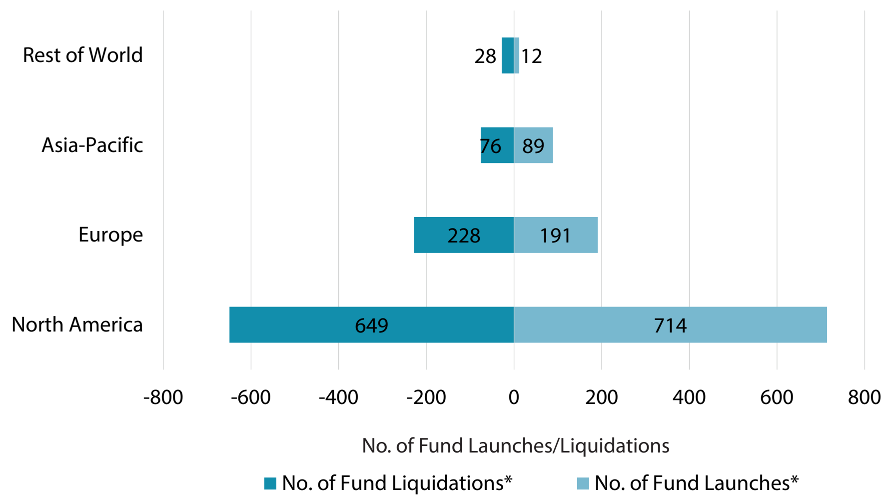


Fig. 6.10: Hedge Fund Launches and Liquidations in 2016 by Top-Level Strategy



Source: Preqin Hedge Fund Online

Fig. 6.11: Hedge Fund Launches and Fund Liquidations in 2016 by Fund Manager Location



Source: Preqin Hedge Fund Online

fund industry has matured, both the number of funds launched by first-time fund managers and the proportion of launches these funds account for has declined. At the height of the financial crisis in 2008, 37% of new launches were by first-time fund managers, but by 2015, this had fallen to 25%.

In 2016, first-time fund managers accounted for a larger proportion of niche strategies launches than any other top-level core strategy (Fig. 6.13). In contrast, less than 20% of the event driven strategies funds launched in 2016 were managed by a newly launched firm.

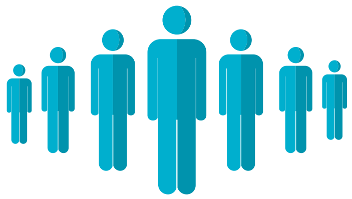
OUTLOOK

At the start of 2016, Preqin predicted that the hedge fund sector may have

> ***Even the largest funds were unable to escape the effects of ebbing investor appetite for hedge funds***

a challenging year as a result of the growing levels of investors expressing dissatisfaction with the asset class and planning to reduce their exposure to these funds. What we could not predict at that time would be the other challenges that might impact the hedge fund sector, particularly the global political events that have led to market movements and growing uncertainty within some jurisdictions and regulatory regimes. Over the course of the year, the outflows predicted by Preqin did occur – the hedge

CREDIT STRATEGIES



2,054 INVESTORS **661** FUND MANAGERS

have a preference for/operate credit strategies funds respectively.

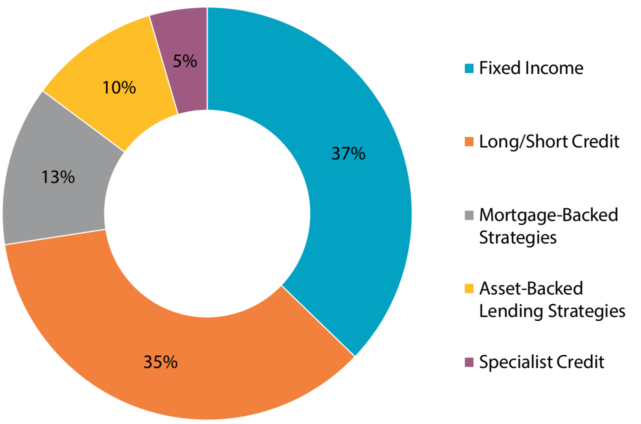
1,642

credit strategies funds are active globally.

$239bn

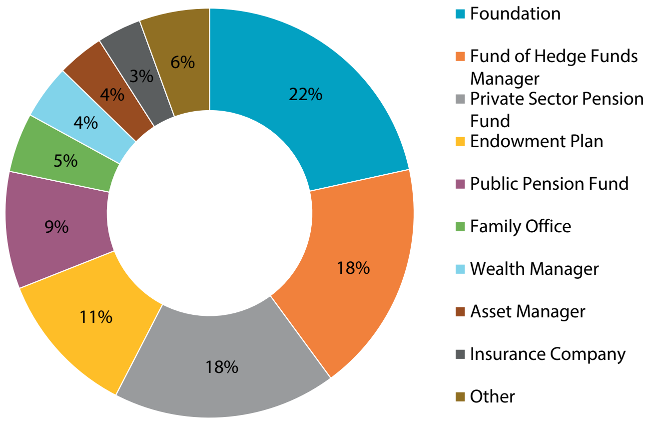
AUM of credit strategies funds.

Fig. 8.28: Credit Strategies Funds by Core Strategy



Source: Preqin Hedge Fund Online

Fig. 8.29: Investors in Credit Strategies Funds by Type



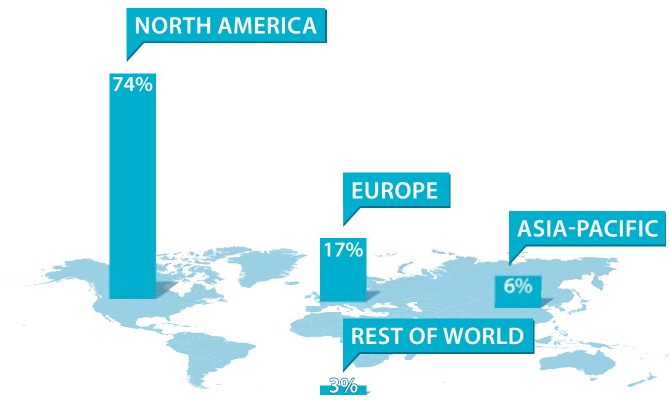
Source: Preqin Hedge Fund Online

Fig. 8.30: Net Returns of Top Performing Credit Strategies Funds in 2016

Fund	Manager	Core Strategy	Net Return in 2016 (%)
Sancus Capital Select Master Fund	Sancus Capital Management	Long/Short Credit	50.82
Cheyne Total Return Credit Fund - December 2017 $ Dis Series 1	Cheyne Capital Management	Specialist Credit	46.49
Avondale Income Fund - Class F	Spartan Fund Management	Fixed Income	45.35
Wasserstein Debt Opportunities Fund, LP - Founder's Class	Wasserstein Debt Opportunities Management	Fixed Income	36.98
Varden Pacific Opportunity Partners Fund I LP	Varden Pacific	Long/Short Credit	33.03
Serica Credit Balanced Fund	Serica Partners Asia	Long/Short Credit	31.19
Hermes Multi-Strategy Credit - Class F - GBP (Acc)	Hermes Investment Management	Fixed Income	30.46
Triada Asia Credit Opportunities Fund Ltd - Class A2	Triada Capital	Long/Short Credit	29.94
BlackGold Insurance Dedicated Fund	BlackGold Capital Management	Fixed Income	29.31
CSS Alpha Fund - Class A GBP	Charles Street Securities Europe	Long/Short Credit	29.10

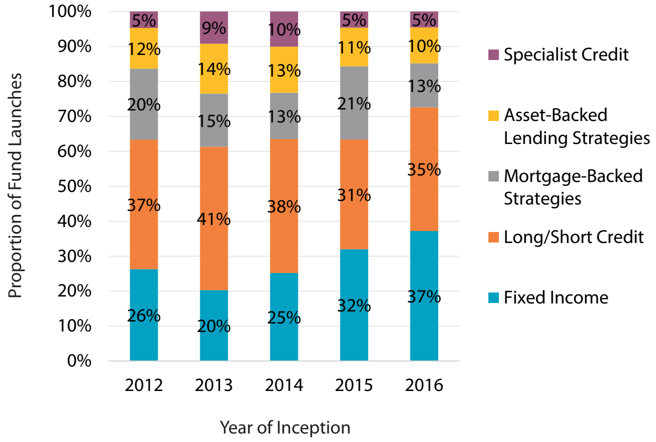
Source: Preqin Hedge Fund Online

Fig. 8.31: Credit Strategies Funds by Fund Manager Location



Source: Preqin Hedge Fund Online

Fig. 8.32: Credit Strategies Fund Launches by Core Strategy and Year of Inception, 2012 - 2016



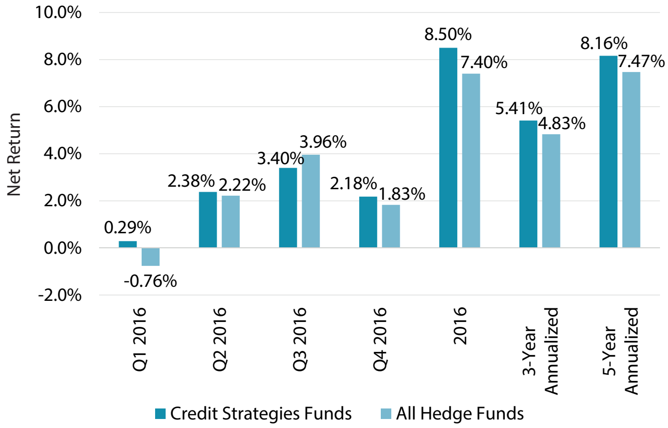
Source: Preqin Hedge Fund Online

Fig. 8.33: Sample Credit Strategies Hedge Funds Launched in 2016

Fund	Inception Date	Core Strategy	Manager Location
Ewing Morris Flexible Fixed Income Fund LP	Feb-16	Fixed Income	Canada
Antecedo Convex Invest	Apr-16	Fixed Income	Germany
EM Credit Opportunities Fund Ltd	Jun-16	Long/Short Credit	US

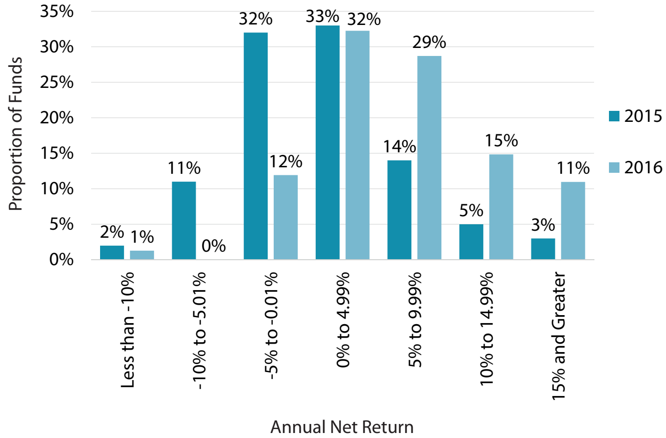
Source: Preqin Hedge Fund Online

Fig. 8.34: Performance of Credit Strategies Funds (As at December 2016)*



Source: Preqin Hedge Fund Online

Fig. 8.35: Distribution of Credit Strategies Fund Returns, 2015 vs. 2016*



Source: Preqin Hedge Fund Online

Fig. 8.36: Credit Strategies Performance by Sub-Strategy (As at December 2016)*

Q1 2016	Q2 2016	Q3 2016	Q4 2016	2016	3-Year Annualized	3-Year Volatility
Fixed Income 1.20%	Fixed Income 3.02%	Long/Short Credit 3.78%	Mortgage-Backed Strategies 2.83%	Fixed Income 9.11%	Asset-Backed Lending Strategies 7.83%	Asset-Backed Lending Strategies 1.29%
Asset-Backed Lending Strategies 1.01%	Long/Short Credit 2.30%	Mortgage-Backed Strategies 3.07%	Long/Short Credit 2.38%	Long/Short Credit 8.26%	Mortgage-Backed Strategies 7.25%	Fixed Income 2.30%
Long/Short Credit -0.42%	Asset-Backed Lending Strategies 2.09%	Fixed Income 2.98%	Asset-Backed Lending Strategies 1.93%	Asset-Backed Lending Strategies 7.71%	Fixed Income 5.56%	Mortgage-Backed Strategies 2.42%
Mortgage-Backed Strategies -1.22%	Mortgage-Backed Strategies 1.63%	Asset-Backed Lending Strategies 2.74%	Fixed Income 1.63%	Mortgage-Backed Strategies 7.20%	Long/Short Credit 3.62%	Long/Short Credit 2.77%

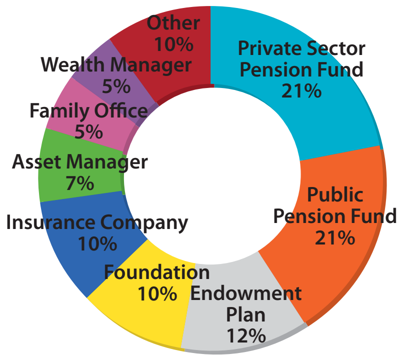
Source: Preqin Hedge Fund Online

**Please note, all performance information includes preliminary data for December 2016 based on net returns reported to Preqin in early January 2017. Although stated trends and comparisons are not expected to alter significantly, final benchmark values are subject to change.*

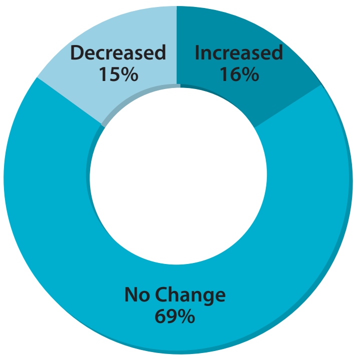
IN FOCUS: PUBLIC PENSION FUNDS

2016 has seen some high-profile public pension funds vote to redeem part of their hedge fund allocation or exit the industry entirely. However, despite these well-known redemptions, many public pension funds have continued to search for new fund manager relationships and adapt or reshape their portfolios. In this section, we detail a selection of public pension funds' mandates tracked on Preqin's **Hedge Fund Online** throughout 2016 and the subsequent commitments of these investors.

Investors in the process of redeeming their entire hedge fund portfolio by type:



Change in public pension fund allocations to hedge funds over 2016 (as a proportion of AUM):



> ***"The new initiative sends a message to the hedge fund community that fee structures must be more closely aligned with the interests of beneficiaries***
>
> *- US public pension fund New Jersey State Investment Council, 3 August 2016, regular meeting minutes*, in response to its plan to reduce its exposure to hedge funds*

Investors' investment plans detailed on Preqin's Hedge Fund Online and their subsequent commitments:

Investor	Fund Search Planned in 2016	Allocation
Iowa Public Employees' Retirement System (IPERS)	The $28bn Des Moines-based public pension fund issued an RFP for managers of liquid absolute return strategies to manage a total of $700mn in **Q1 2016**. The investor announced its intention to hire several managers with proposals due in March, representing IPERS' first investment in the hedge fund industry.	It was announced in **December 2016** that IPERS had selected seven fund managers to fill this mandate. IPERS committed $100mn each to Graham Capital Management, FORT and Lynx Asset Management, and planned future allocations to AQR Capital Management, Kaiser Trading Group, Quantmetrics Capital Management and Wadhwani Asset Management.
Texas Municipal Retirement System	It was announced in **February 2016** that Texas Municipal Retirement System intended to commit an undisclosed amount to five or six hedge funds in the next 12 months, seeking funds with global investment exposure.	**March 2016** saw the Austin-based investor allocate to Man Group, PDT Partners, DSAM Partners, East Lodge Capital, River Birch Partners, Field Street Capital and Paro Management, while later in the year the public pension fund allocated to Redmile Group, moving the investor 10bps above its target allocation to hedge funds as of **June 2016**.
Missouri Local Government Employees Retirement System	Also in **February**, Missouri Local Government Employees Retirement System announced plans to expand its exposure to hedge funds, looking to commit $100mn to a portable alpha program.	The Jefferson City-based pension fund hired Wellington Management to run a $100mn global equity absolute return strategy via a separate account in **July 2016**.

Largest public pension funds by current allocation to hedge funds:

NORTH AMERICA

CPP Investment Board

Allocation: **$13.5bn**

Location: **Canada**

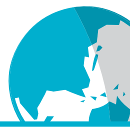
EUROPE

ABP

Allocation: **$19.5bn**

Location: **Netherlands**

ASIA-PACIFIC



National Pension Service

Allocation: **$923mn**

Location: **South Korea**

* *http://www.nj.gov/treasury/doinvest/pdf/ApprovedMinutes/2016/AgendaItem1MinutesRegularMeeting08032016.pdf*

and +0.52% respectively), with the Preqin Multi-Strategy Fund of Hedge Funds benchmark ending 2016 in a similar position (+0.72%). Funds of CTAs exhibited higher levels of volatility than funds of hedge funds over the course of two years, and lost 9.40% over the same period.

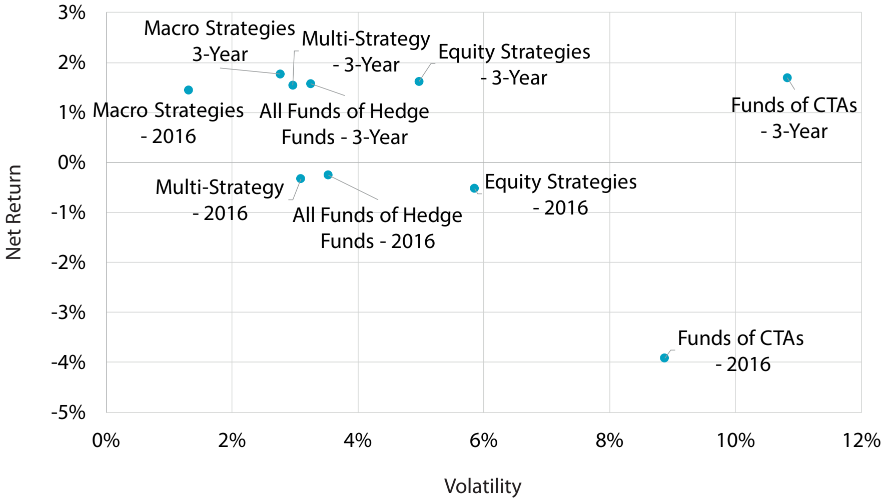
> ***With significant levels of funds of hedge funds failing to generate returns above water, investors are finding it increasingly difficult to find attractive investment opportunities***

Emerging markets-focused funds of hedge funds built on their solid returns of 2015, returning 3.92% on a two-year cumulative basis (Fig. 10.9). In contrast, North America-focused funds have had a more challenging 24 months. Improved performance in 2016 erased the losses of the previous year; however, the two-year cumulative figure sits below all other top-level regional benchmarks at 1.23%. In contrast, Europe- and Asia-Pacific-focused funds lost 0.28% and 1.50% in 2016 respectively, eating into the gains made in 2015.

When looking at the distribution of fund of hedge funds returns since 2014, the proportion of funds delivering positive annual returns has decreased (Fig. 10.10). In 2014, four out of every five funds of hedge funds added gains over the year; in contrast, only 49% of funds exhibited positive returns in 2016. Seventeen percent of funds of hedge funds added more than 5% in 2016; the same feat was achieved by 19% and 20% of funds of hedge funds in 2014 and 2015 respectively. With significant levels of funds of hedge funds failing to generate returns above water, investors are finding it increasingly difficult to find attractive investment opportunities.

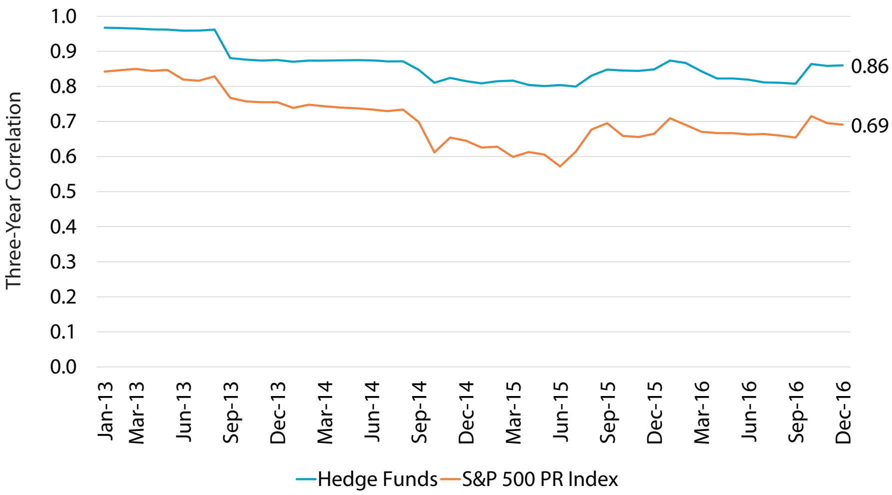
The risk/return profile of a fund is one of the central factors investors take into account when evaluating potential investment opportunities. Over the past three years, macro strategies funds have delivered the highest returns (+1.77%) with the lowest volatility (2.77%). In contrast, funds of CTAs delivered the second highest returns (+1.70%), but this was coupled with the highest volatility (10.82%), demonstrating that even though some focused fund of hedge funds strategies can deliver superior returns, this could come with additional risk.

Fig. 10.11: Risk/Return Profile of Single-Strategy and Multi-Strategy Funds of Hedge Funds in 2016 vs. Three-Year Annualized



Source: Preqin Hedge Fund Online

Fig. 10.12: Rolling Three-Year Correlation of Funds of Hedge Funds to Single-Manager Hedge Funds and S&P 500 PR Index, January 2013 - December 2016



Source: Preqin Hedge Fund Online

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Private Debt	$175/£125/€150	$90/£65/€75		$1,000/£715/€860	☐	$300/£215/€260	☐
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