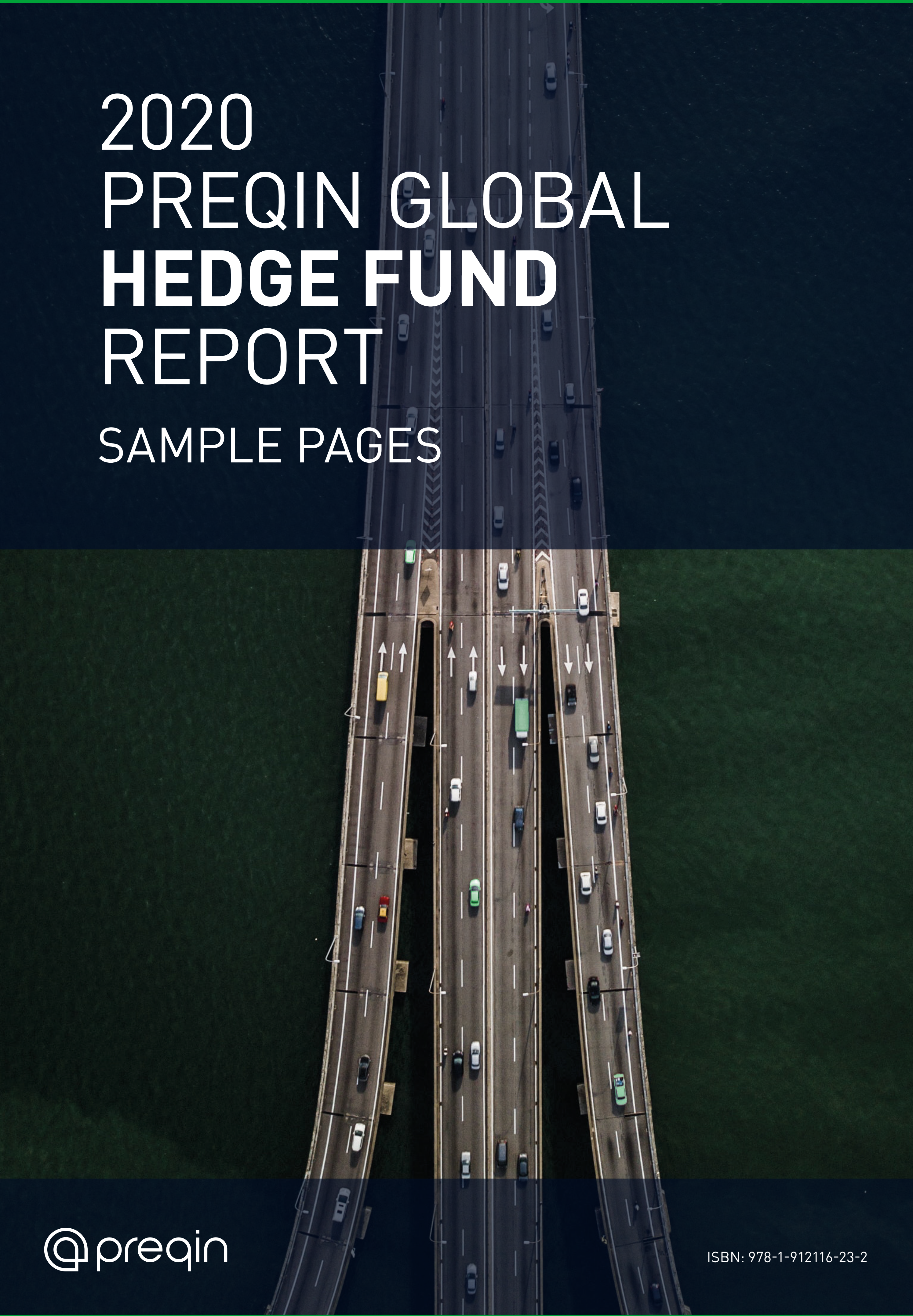
2020 PREQIN GLOBAL **HEDGE FUND** REPORT

SAMPLE PAGES



preqin

ISBN: 978-1-912116-23-2

Contents

Executive Summary

Market challenges spur greater innovation in the hedge fund industry

For hedge fund managers, 2019 marked the start of a much-needed recovery following 2018's weak performance. Capitalizing on strong equity market tailwinds, the asset class returned +11.45% over the year, bouncing back from the -3.06% return recorded the year before. As performance improved, assets under management (AUM) rose, increasing by 4.6% compared with the year before to hit $3.61tn as of November 2019. That is the highest point since Q3 2018 ($3.62tn).

Still, 40% of hedge fund investors we surveyed in November 2019 said that performance did not live up to expectations. 2019's improved performance is only the second time that industry returns have exceeded double digits in the past six years. For hedge fund managers, the pressure is on.

The Worst Year for Redemptions since 2016

There are some clear warning signs for the industry. For a start, investors withdrew a net $82bn from hedge funds in the year to November 2019, which marks the worst year for redemptions since $110bn was withdrawn in 2016. What's more, net outflows occurred in every major region.

Shifting investor sentiment also made the market more challenging for new launches. Just 529 hedge funds launched in 2019 – roughly half the number seen in 2018 (1,169) – marking the seventh consecutive year of decline. Liquidations outpaced new funds entering the market, shrinking the number of active funds in the industry to 16,256.

Fund Managers Evolve and Innovate

The silver lining? Today's market challenges are creating opportunities for fund managers to do what they do best: adapt, evolve, and innovate. Take fees, which have long been a bugbear for investors. Several funds that launched recently have eschewed the industry standard of a 2% management fee and a 20% performance fee in favor of more investor-friendly fee structures. For example, when Arizona-based Camkay Capital Management launched its Crisis Alpha Intraday CTA fund in 2019, the firm offered a 0% & 30% fee model with a high-water mark.

Fund managers are also increasingly applying artificial intelligence & machine learning (AIML) techniques to improve operational efficiencies and boost returns. After all, AIML funds have outperformed the wider hedge fund market and other systematically traded hedge funds on a three- and five-year annualized basis. Nearly a quarter (23%) of systematic hedge funds launched in 2019 use AIML, which is more than double the proportion that did so in 2016 (see page 35).

Investors Seek Defensive Strategies

Although market conditions have become more difficult, the hedge fund industry keeps growing. Investors are continuing to look to the asset class to diversify their portfolios and generate high, uncorrelated returns. Delivering risk-adjusted returns with low volatility is a key benefit of a hedge fund allocation that extends beyond headline returns, and using a risk-free rate of 2%, the Sharpe ratio of hedge funds has been steady around the 2.5 mark for four years.

Amid slowing global economic growth, and jitters that the market cycle could be at its peak, investors are looking to the industry in search of defensive strategies. Demand for relative value strategies, which are designed to produce returns regardless of market direction, spiked over 2019. And relative value strategies funds made up 14% of all launches last year, the largest share achieved in over five years.

Over the next 12 months, more than three-quarters (79%) of surveyed investors say that they plan to allocate the same amount of capital or more to hedge funds. If the market cycle does turn and conditions get even tougher, star managers will have a golden opportunity to demonstrate their value.

Hedge Fund Megatrends

Key themes shaping the hedge fund industry

Emerging Manager Demand

Investors are increasingly looking to smaller or newer funds[1] in search of outperformance or favorable fee terms.

Recovering Performance

The +11.45% return of the Preqin All-Strategies Hedge Fund benchmark marks only the second time in the past six years that the annual return has reached double digits.

Industry Consolidation

The number of hedge fund launches in 2019 trailed fund liquidations for the first time on record. The number of active vehicles is therefore shrinking, creating a consolidated and leaner industry.

Fee Pressure

Following pressure from investors, the mean management fee of funds launching in the market has been decreasing. Managers are altering their structures in a bid to attract capital in a competitive market.

Market Slowdown

Almost half (43%) of surveyed investors are looking to position their hedge fund portfolio more defensively in 2020 in response to our position in the cycle.

---

[1] *Opportunities Investing with Early Lifecycle Hedge Funds: A Preqin & 50 South Capital Study, https://www.preqin.com/insights/special-reports-and-factsheets/opportunities-investing-with-early-lifecycle-hedge-funds-a-preqin-50-south-capital-study/26521*

Our Evolving Industry

The Managed Funds Association (MFA) on keeping pace with the changing regulatory and market environments in the hedge fund industry

Jon Hitchon

Managing Director and COO, Two Sigma
Chair, Managed Funds Association Board of Directors

For years, Preqin's Global Hedge Fund Report has provided interesting and useful insight into our industry and its investors and this year's is no different. Over the past year, our industry has continued to grow. Assets under management are near an all-time high and 80% of institutional investors surveyed by Preqin reported that they plan to maintain or increase their allocations to hedge funds over the longer term. And MFA has grown alongside our industry – both staff and revenue have doubled in size. Part of this growth is to help members meet the demands we feel from our client base. Institutional investors are becoming more and more sophisticated.

That is why each year MFA brings together thousands of fund managers, service providers, prime brokers, and institutional investors in the industry's leading network – a network that is one of the most valuable aspects of our engagement with MFA. The peer-to-peer networking and legal, operational, and compliance training helps us reduce risk, manage costs, and attract assets.

MFA has also taken steps to keep pace with the changing regulatory and market environments by creating three new annual conferences in the past three years alone. At MFA's inaugural DATA conference in September 2019, speakers from Amazon, Apple, and Microsoft, as well as policymakers and fund managers, discussed the compliance challenges that accompany obtaining, securely storing, and utilizing data.

At that conference, MFA released a report, authored by McKinsey on our behalf, titled 'The Lifecycle of Data in Context: How Data Proliferation is Shaping Alternatives.' That paper found that more than 60% of MFA members surveyed believe alternative data will create the potential for additional alpha as data quality and the analytical techniques applied to it improve.

On the advocacy front, MFA worked to encourage regulators to simplify systemic risk reporting mandated by Dodd-Frank. We heard from our members that they were concerned about disclosing sensitive information and worked directly with lawmakers, the SEC, and the CFTC to change this approach.

That work is part of MFA's far-reaching, on-the-ground advocacy, which is driven by the issues we, as MFA members, identify as priorities. 2020 will be a busy year on Capitol Hill and at the regulatory agencies. We will be active participants in the process – whether it is working to improve the CFTC's swaps trading framework or contributing to the SEC's efforts to modernize the Advisers Act advertising rules.

MFA has also worked closely with regulators and policymakers in Europe in support of their goal of deepening capital markets by advocating for regulation that considers the unique nature of investment firms. Our primary concern is that the post-Brexit regulatory framework ensures our members have continued access to investors – and investors have access to our members' expertise. We have also made clear that any changes to longstanding portfolio delegation rules would threaten that access.

As MFA moves into the future, we are confident our reach and impact will continue to grow in partnership with and in service to our members.

In Focus: Artificial Intelligence, Real Returns

AIML hedge funds are on the rise following outperformance and competitive market hedging

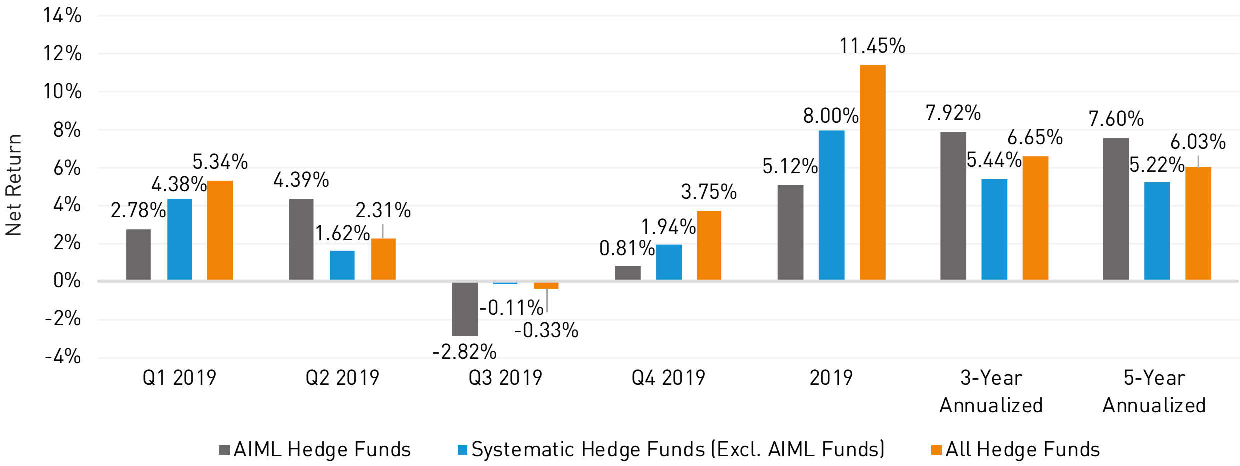
Hedge funds using artificial intelligence/ machine learning (AIML) are delivering long-term outperformance. AIML funds have outperformed the wider hedge fund market and other systematically traded hedge funds on a three- and five-year annualized basis (Fig. 3.8). With mass amounts of data on public equities, bonds, financial statements, currency movements, and even social media all publicly available, AIML can be used by the hedge fund industry in helping managers analyze data and predict market movements. With AIML developing in capability and delivering returns, more applications of AIML are being seen across the market.

Fund managers use AIML in a variety of ways. Prominent industry veterans such as Two Sigma, Man Group, and D.E. Shaw have for many years included AIML strategies in their offering, implementing AI research methods to provide deeper insight into markets. As AI applications continue to improve, the number of specialized core AI managers has risen. Paris-based Walnut Investments and San Francisco-based Numerai are among these specialist managers, with the former utilizing AI to create self-learning trading systems.

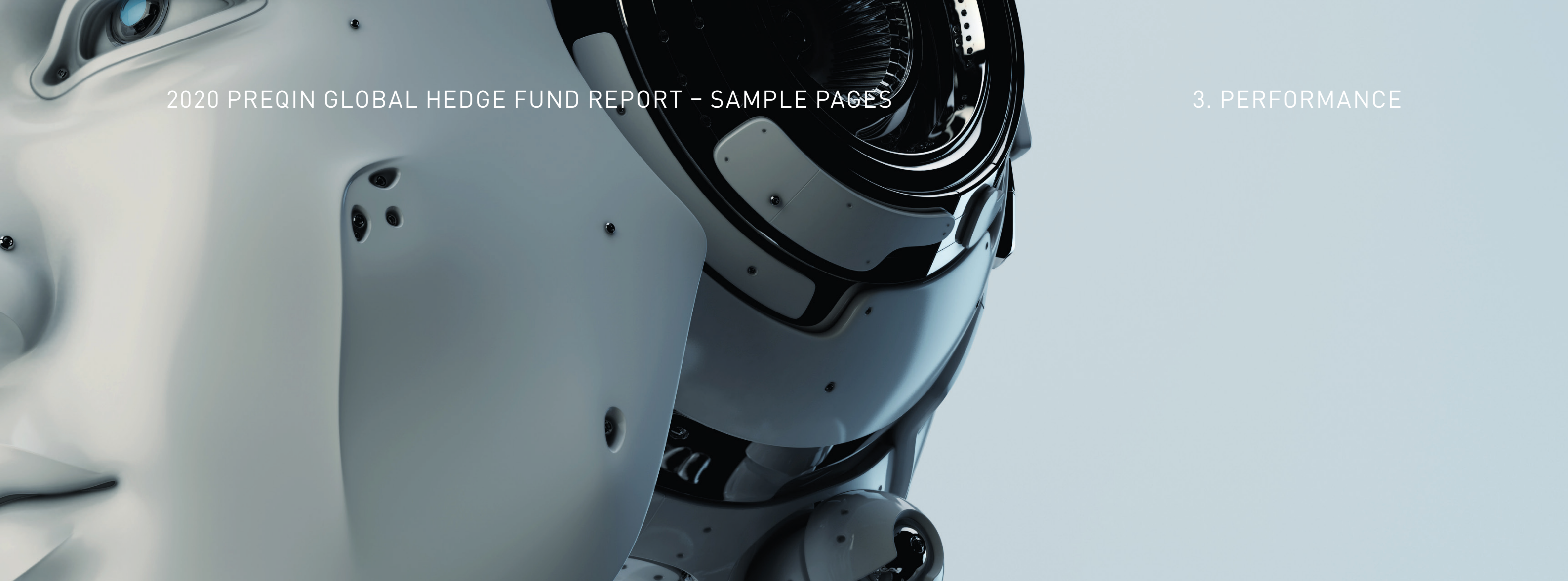
More systematic hedge funds are utilizing AIML. The proportion of systematic hedge funds launched in 2019 that use AIML is over double the proportion in 2016 (23% vs. 10% respectively, Fig. 3.10). In a tough fundraising environment, AIML can help fund managers to differentiate themselves from competitors and appeal to investors.

As the capability of AIML systems improves over time, the impact on the hedge fund market will increase.

Fig. 3.8: Performance of AIML Hedge Funds vs. Systematic Hedge Funds (Excl. AIML Funds) and All Hedge Funds

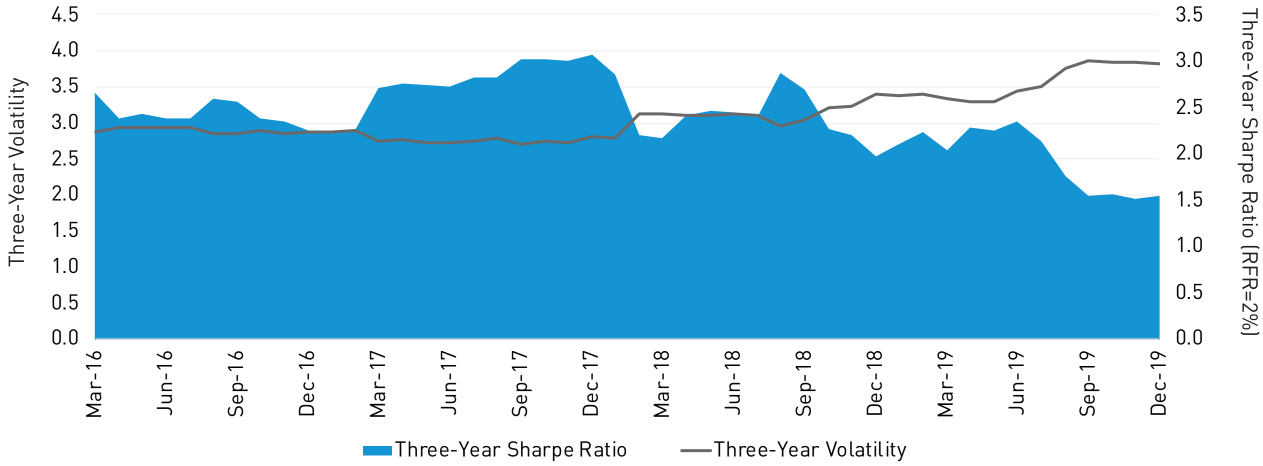


Source: Preqin Pro



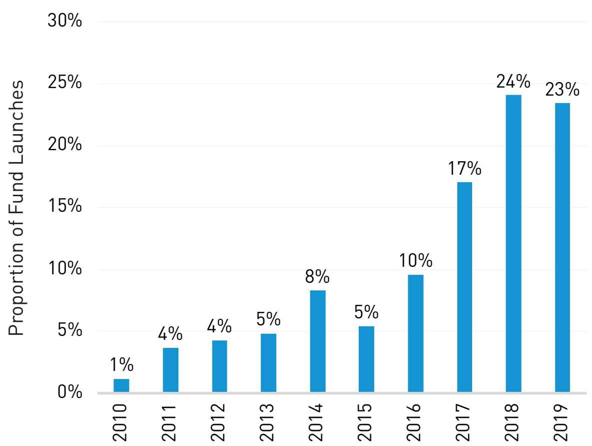
With the ability to rapidly process and analyze massive amounts of data, AIML systems can quickly adapt to changing market conditions. Given the advantages afforded by this cutting-edge technology, it is no surprise to see hedge funds look to AI in a bid to aid performance and gain a competitive edge in the market.

Fig. 3.9: Rolling Three-Year Volatility and Sharpe Ratio of AIML Hedge Funds, 2016 - 2019



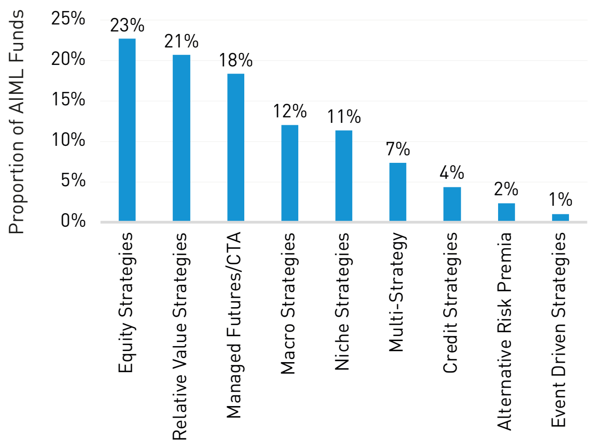
Source: Preqin Pro

Fig. 3.10: Proportion of Systematic Hedge Fund Launches that Use AIML, 2010 - 2019



Source: Preqin Pro

Fig. 3.11: Hedge Funds Using AIML by Top-Level Strategy



Source: Preqin Pro

Managers Faced Challenging Conditions

Consolidation and volatility concerns are reshaping the global hedge fund industry

Two key trends characterized the global hedge fund landscape in 2019: consolidation and investor concerns over market volatility.

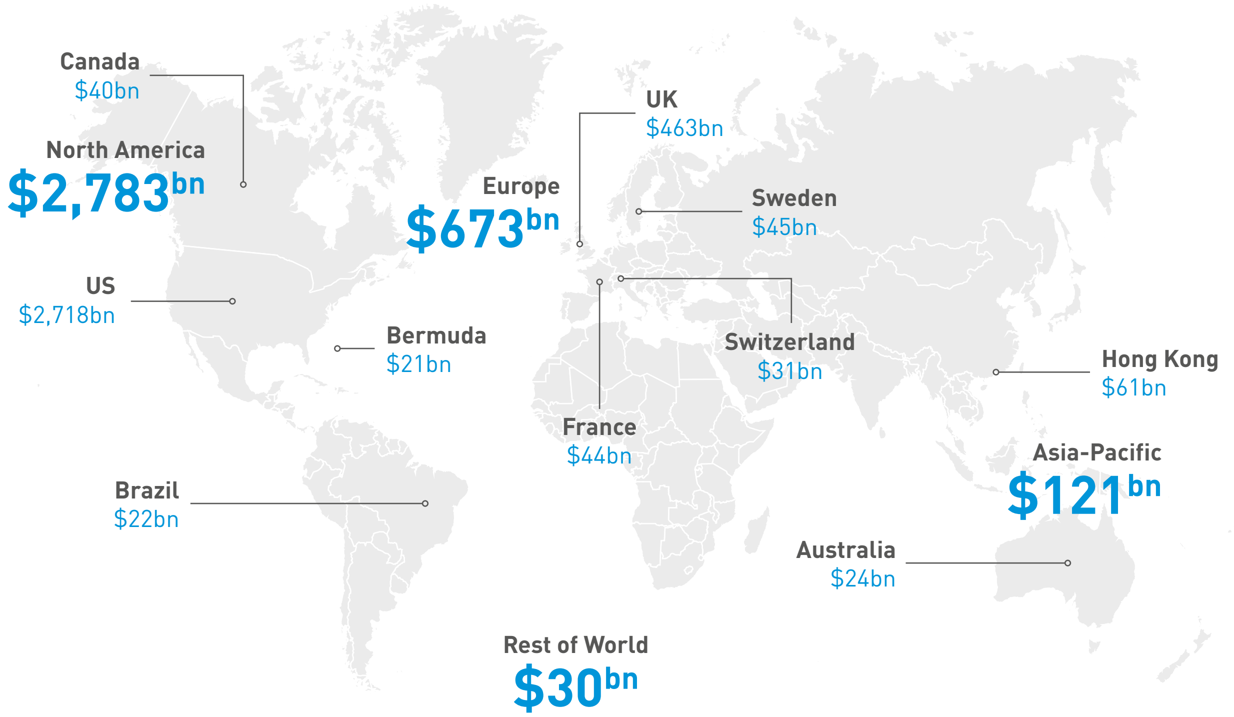
Consolidation of a Saturated Market

Between 2012 and 2018, new hedge fund launches outpaced liquidations. But, as the industry has grown, the number of fund launches has trailed liquidations. Just 529 hedge funds and CTAs launched in 2019, fewer than half the number (1,169) that launched in 2018 (Fig. 2.10).

Why? The size of the market, for a start. "There were just 530 hedge funds in 1990, managing a total of $39bn," industry titan Jeffrey Vinik, whose Tampa-based firm Vinik Asset Management closed in 2019, noted in the Wall Street Journal.[1] Today, there are more than 16,300 active hedge funds, all competing for $3.61tn of active capital in an evolving market.

As a result, fund managers are having to work harder to retain existing clients and win new investor capital. There are also additional challenges to consider – such as increasing investor demand for favorable terms, a

Fig. 2.8: Hedge Fund Industry AUM by Manager Location



Source: Preqin Pro. Data as of November 2019

[1] *Wall Street Journal, https://www.wsj.com/articles/twilight-of-the-stock-pickers-hedge-fund-kings-face-a-reckoning-11572197217*

growing focus on ethical investment, and the higher costs of starting a fund amid increasing regulation – all while maintaining performance.

Fund managers of all sizes have grappled with changing market conditions. Prominent names such as London-based Arrowgrass Capital Partners and New York-based Hoplite Capital Management opted to close. Other firms have pursued mergers. Nordea Asset Management, part of Helsinki-based financial services group Nordea, shut down one fund to reduce operational costs before merging the capital into another fund. Some managers have acquired other firms. London-based alternative asset manager Trium Capital bought Sabre Fund Management, a boutique investment management firm also based in London, to expand its existing quantitative offerings and "create a new force in the quantitative alternatives world," Trium Capital's co-head Donald Pepper said in a statement.[2]

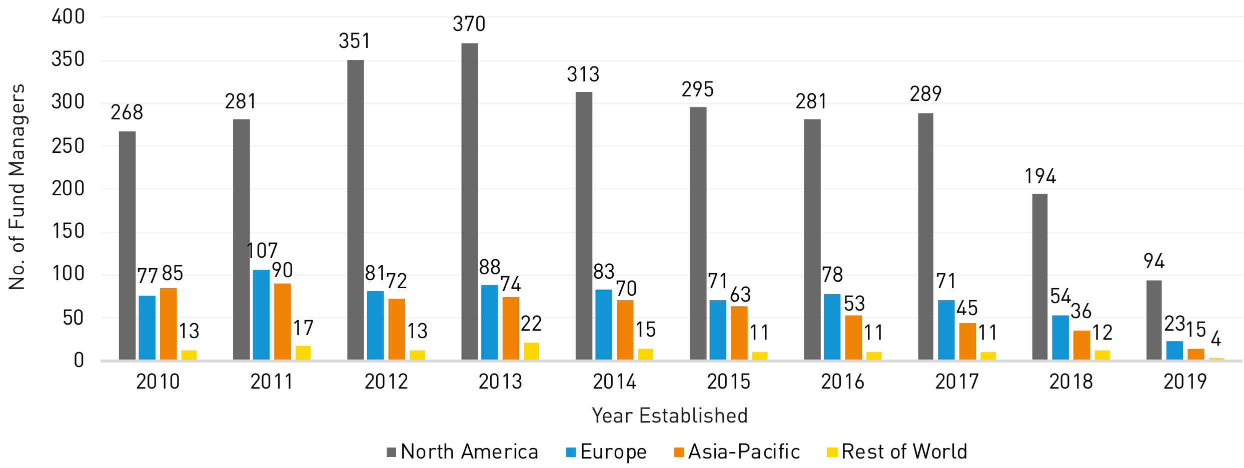
Heightened Market Volatility

Amid concerns that a 10-year bull run in equity markets may be coming to an end, 43% of investors we surveyed in November 2019 are positioning their hedge fund portfolios more defensively in the year ahead, up from 33% in 2018.

Investors are looking to actively managed hedge fund strategies, such as relative value and macro, to help generate returns on a risk-adjusted basis. Indeed, the share of relative value strategies fund launches rose from 8% in 2018 to 14% in 2019 (Fig. 2.14). There are also indicators of increasing investor appetite for macro strategies: macro funds appeared in 36% of

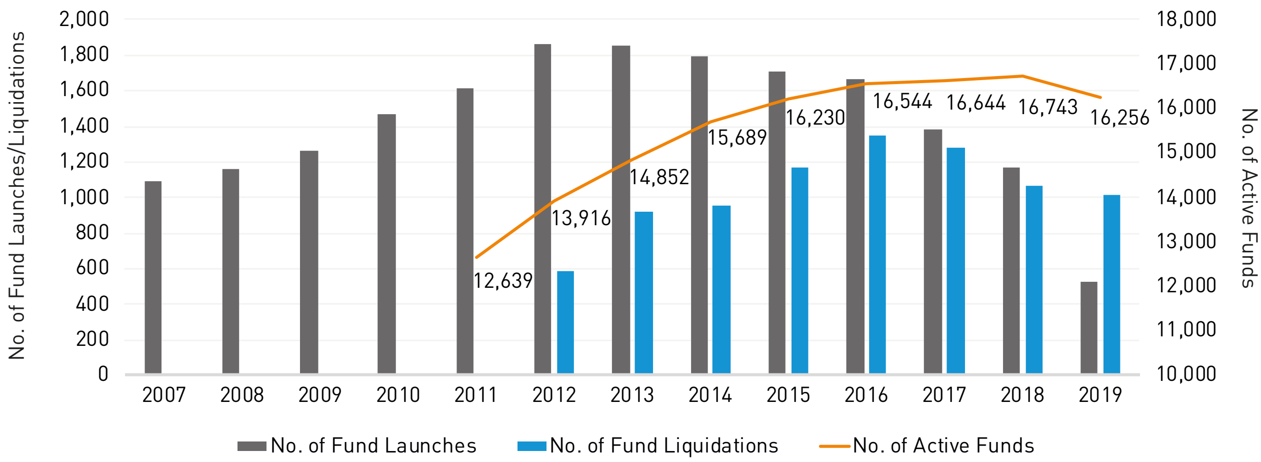
[2] *Trium Capital, https://trium-capital.com/library/news/trium-in-the-news-trium-capital-expands-quant-equity-capabilities-with-sabre-fund-management-tie-up*

Fig. 2.9: Hedge Fund Managers by Location and Year Established



Source: Preqin Pro

Fig. 2.10: Hedge Fund Launches and Liquidations, 2000 - 2019*



Source: Preqin Pro

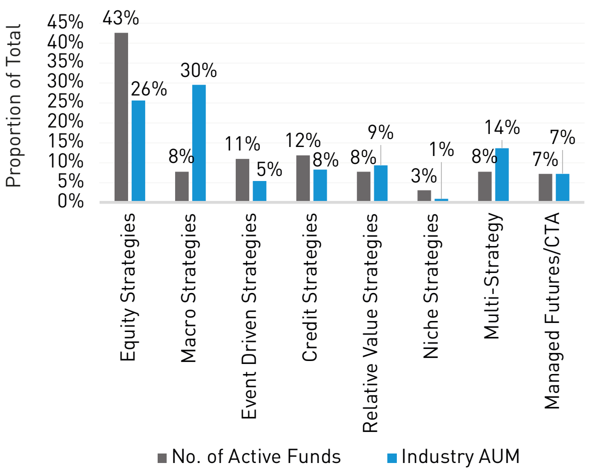
**Liquidations data starts at 2012, the year Preqin begawn tracking hedge fund data.*

investors' searches in 2019, up from 34% in 2018 (see page 44).

On the CTA front, even though in 2019 these funds posted their strongest performance since 2014, liquidations outnumbered launches by nearly six to one (62:11). CTAs are predominantly trend following in their strategy, and have been caught out in periods of short-term market volatility. But, given how well they performed last year, we may see demand for CTAs pick up in 2020.

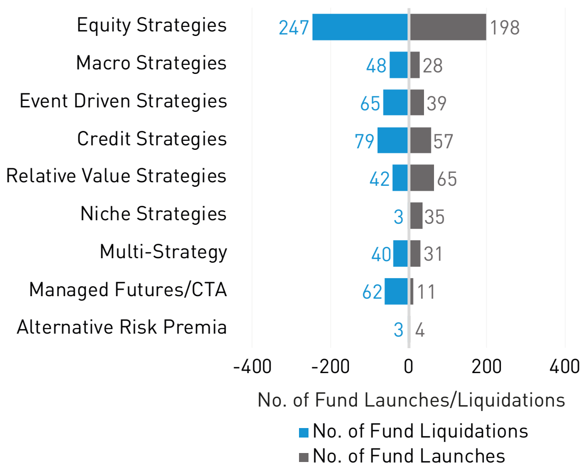
Looking ahead, as investors brace for further volatility in equity markets, expect to see more demand for actively managed strategies. And as competition intensifies, watch for further consolidation in a rapidly evolving industry.

Fig. 2.11: Proportion of Number and AUM of Hedge Funds by Top-Level Strategy



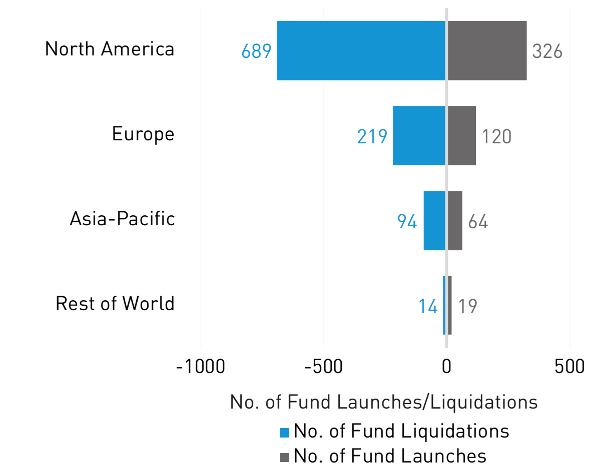
Source: Preqin Pro

Fig. 2.12: Hedge Fund Launches and Liquidations in 2019 by Top-Level Strategy



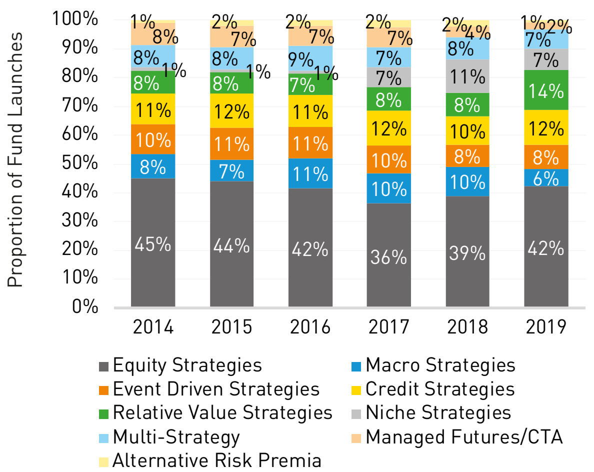
Source: Preqin Pro

Fig. 2.13: Hedge Fund Launches and Liquidations in 2019 by Manager Location



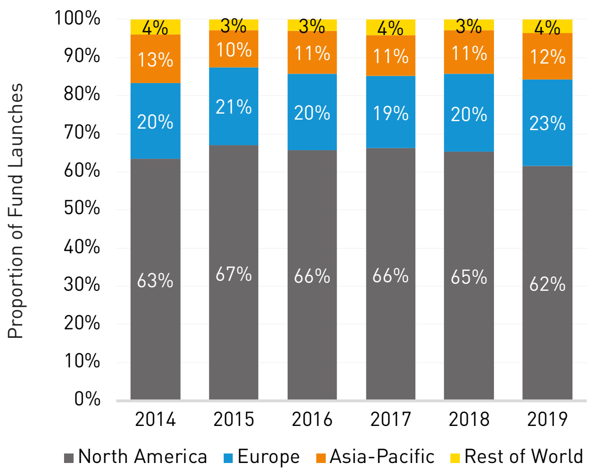
Source: Preqin Pro

Fig. 2.14: Hedge Fund Launches by Top-Level Strategy, 2014 - 2019



Source: Preqin Pro

Fig. 2.15: Hedge Fund Launches by Manager Location, 2014 - 2019



Source: Preqin Pro