



Hedge Fund Investors' Attitudes Towards Fund Terms and Conditions

Amy Bensted examines the results of our latest study of investor attitudes towards hedge fund terms and conditions, including the areas within fund terms and conditions that have seen improvement in the last 12 months and those that still require work in the year ahead.

One of the key topics in the hedge fund industry over the past few years has been the discussion over the terms and conditions of hedge funds, as investors question both the traditional 2 and 20 structures and the liquidity and transparency of these alternative assets. In this new era of heightened regulation and scrutiny of funds, the terms of hedge funds have never been more relevant; as manager costs increase in order to comply with various international regulations, investors will be watching to see if these costs are passed on, as well as the effect regulations have on reporting and transparency requirements. Preqin has conducted studies of investor attitudes towards fund terms and conditions since 2009. Here we present the results of our latest study of investors conducted in July 2013.

Alignment of Interests Remains an Issue for Some Investors

Despite a significant proportion (42%) of all investors interviewed witnessing a shift in favour of the investor regarding changing terms and conditions over the past 12 months, as displayed in Fig. 1, fewer investors in 2013 feel that manager and investor interests are aligned than in the previous year. In the July 2013 study, 64% of investors either agreed or strongly agreed that manager and investor interests are properly aligned, as shown in Fig. 2, compared to 74% in 2012. With more than half of respondents (54%) indicating that they had seen no change in fund terms over the past year, managers still have a way to go in reaching an optimum equilibrium of having appropriate fees and structures to run a fund in the best possible way while representing good value for the investor.

Fees Have Shown Improvement

The traditional 2 and 20 fee structure has come under increasing pressure over recent years, with many investors seeking reduced fees. Fig. 3 indicates that managers have responded to this, with 68% of investors seeing an improvement in management fees charged over the

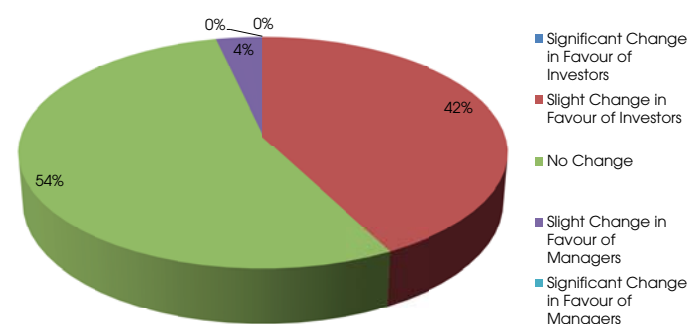
past 12 months and 58% stating the same for performance fees. Where there have been improvements, many investors specified that these are often just for the larger investors, on smaller funds, or on funds which only produce "mediocre" performance. As a result, many investors believe there is still room for improvement across the wider industry, with 55% of investors interviewed still seeking further reductions in the level of both management and performance fees. However, for the first time since Preqin began conducting this study, more investors have indicated they have witnessed improvements in management and performance fees than have signalled they want further improvements. Where further improvement seems particularly necessary is on the performance fee side. Investors would like to see more fund managers considering alternative structures for charging fees, such as instigating clawback provisions or putting in a hurdle which must be met before a performance fee is charged or increasing the level of the existing hurdle.

As more managers are setting their fees lower than the perceived 2 and 20 standard, investors are also looking to enter negotiations over terms in the pre-investment stages. Since 2012, we have witnessed more investors asking their managers for concessions; the number of investors looking to negotiate has increased from 46% in 2012 to 57% in 2013, as shown in Fig. 4. Of those that entered into negotiations with their managers, 81% of investors were successful in securing more favourable terms, slightly below the 87% that were successful in negotiations in 2012.

Managers Have Responded to Liquidity and Transparency Demands

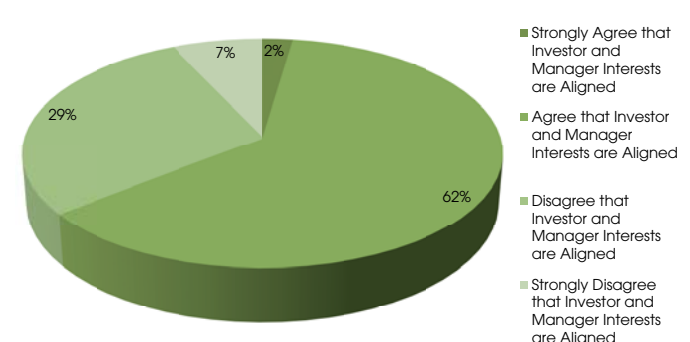
There have been significant improvements in how investors view the liquidity and transparency terms of hedge funds over the past year. In 2012, 39% of investors were looking for increased transparency from their hedge fund managers, whereas in 2013 this has fallen to 22%. However it is important to note that just 8% of investors feel that they have seen improvements in the amount of transparency offered to

Fig. 1: Investor Opinion on Changes in the Alignment of Interests between Investors and Managers over the Past 12 Months



Source: Preqin Investor Outlook, Alternative Assets, H2 2013

Fig. 2: Investor Opinion on the Alignment of Interests between Investors and Managers



Source: Preqin Investor Outlook, Alternative Assets, H2 2013



them by their fund managers over the past year; managers may feel that their work on reporting more data more frequently to investors is complete, whereas many investors still want more transparency on the performance, risk and investments of their funds.

Hedge fund investors have become more comfortable with the level of liquidity in the industry following several years of improvements by fund managers. Approximately a quarter and a fifth of investors interviewed stated they have seen reduced lock-ups and more frequent redemption policies on hedge funds over the past year respectively. In 2012, 37% of investors wanted to see improvements in the lock-up terms of a fund, whereas in 2013 this has fallen to 12%. Similarly, in 2012, 34% of investors wanted to see more appropriate redemption frequencies, while today this has fallen to just 10% of investors. So for some investors, further improvements are needed, but for the industry as a whole, it is largely reaching a level where investors feel that the liquidity terms on funds have become appropriate based on the fund's strategy.

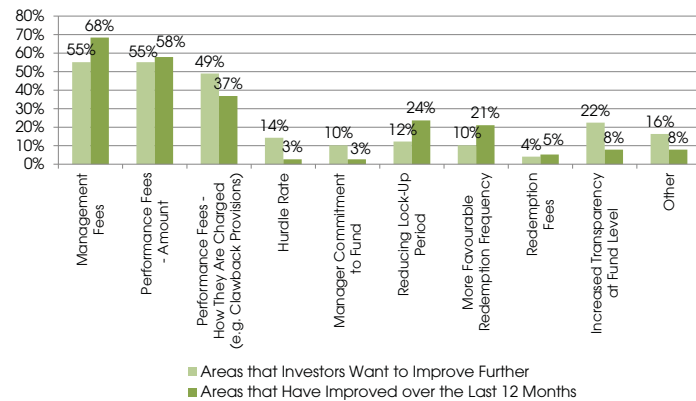
Outlook

Following the immediate aftermath of the credit crisis and other key events of 2008, such as the fall of Lehman and the Madoff revelations, liquidity and transparency were seen as key issues that hedge fund managers needed to address in order to not only attract new investment, but also to retain existing investors. Over the past five years, managers have sought to report more frequently with greater disclosures on the holdings of their funds. With funds also deleveraging and disclosing

more information on any illiquid assets or side pockets, investors are finally reaching a level where they feel the industry is reporting enough data and can cater to their liquidity needs. With the rise of regulation over the past few years, reporting and transparency are now often required of managers by regulators. Therefore, those managers that already have robust infrastructures in place to provide this information to their investors will have put in some solid groundwork for some of their compliance concerns.

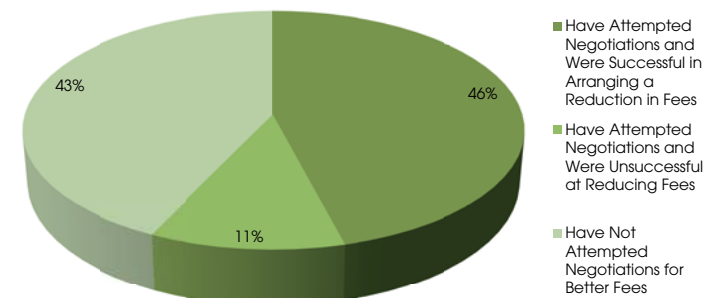
For fund managers, fees and compensation are a contentious issue as a result of regulation; some regulations such as the AIFMD have restrictions on their compensation regimes. Regulations also are driving up the costs of running a hedge fund, as managers need to spend time and money to comply with international regulations. Although many investors have witnessed improvements in the fees they pay to hedge fund managers, more than half want to see further improvements in the levels of fees charged, with a significant number of investors looking for managers to change fee structures or add or increase hurdle rates. For fund managers, the issue of balancing increasing costs with investor demands for more appropriate fees could be resolved by offering more innovative fund structures more aligned to not only investor demands, but their own business strategy as well. For instance, smaller managers could offer concessions to early investors, or for funds which require capital to be locked in for longer, they could structure performance fees to be charged over longer periods.

Fig. 3: Areas of Fund Terms Investors Feel Have Shown the Most Improvement over the Past 12 Months and that Need to Improve Further in the Future



Source: Preqin Investor Outlook, Alternative Assets, H2 2013

Fig. 4: Investor's Fund Terms Negotiation Experiences in the Past 12 Months



Source: Preqin Investor Outlook, Alternative Assets, H2 2013

Data Source:

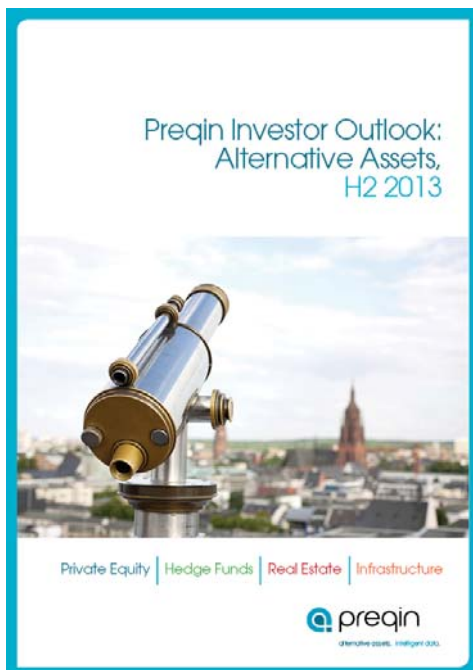
The data used in this feature article comes from the recently launched [Preqin Investor Outlook: Alternative Assets, H2 2013](#) which draws on the results of extensive interviews with 450 investors across alternative assets conducted by Preqin from June to August 2013. [Preqin Investor Outlook: Alternative Assets, H2 2013](#) explores investor appetite in the coming year, strategies and geographies targeted, key issues and satisfactions with returns, and more.

Preqin tracks over 7,800 active alternative asset investors globally and is in constant contact with these investors in order to maintain accurate and up-to-date information on their activities.

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Preqin Investor Outlook: Alternative Assets, H2 2013

Based on the results of extensive interviews with 450 institutional investors in alternative assets, Preqin Investor Outlook: Alternative Assets, H2 2013 features in-depth analysis on:



- ▶ Investor appetite in the year ahead
- ▶ Strategies and geographies targeted
- ▶ Key issues in the industry today
- ▶ Satisfactions with returns
- ▶ Fund terms and conditions and more

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