Investor Opinions on Hedge Fund Terms and Conditions

Over recent years institutional investors have placed increasing pressure on hedge fund managers to reduce their headline fund terms and conditions. Has this occurred, or do investors' concerns remain? Sarah Corran presents some of the key results from our recent study of investors based around the world.

Change is often driven by crisis and this is certainly the case in the hedge fund arena, which has seen the dynamic between fund managers and investors reshaped since the financial crisis. Many institutional investors have pushed for increased transparency, more investor-friendly fee structures and stronger alignment of interests within the hedge fund industry. Due to the increasing institutionalization of the asset class, it has been necessary for fund managers hoping to attract capital to match the changing demands of sophisticated and knowledgeable investors.

On the whole, hedge fund managers have been responsive in negotiating key terms and conditions with investors, and this has been crucial to the ongoing revival and growth of the hedge fund industry. Despite these improvements, the return of investor dissatisfaction following widespread underperformance and sustained financial market volatility has led to further pressure from investors. Consequently, the ongoing uncertainty surrounding the current financial climate has opened the door to further shifts in the fees and levels of transparency offered by hedge funds to investors.

Preqin regularly interviews institutional investors to gather information regarding views on hedge fund terms and conditions. In this feature article we review the results of the latest study, which features interviews with over 80 investors, representing a cross section of institution types and sizes, from North America to emerging economies in Asia. Investors were asked to share their views on the current terms being offered by hedge fund managers and the outlook for the future in light of the recent disappointing returns being posted by many funds.

Continued Shifts in Favour of the Institutional Investor

The growing complexity of the hedge fund industry, coupled with an increasingly sophisticated institutional investor base, has led to a greater need for communication between fund managers and investors. The gap between what investors require and what managers are able or willing to provide is not a new phenomenon, but the current financial climate has served to highlight this disconnect. Fig. 1 shows that the majority of investors currently consider the alignment of interests between fund managers and investors satisfactory. Sixty percent of investors interviewed agreed that the interests of investors and managers are properly aligned and an additional 14% of investors strongly agreed with this statement.

When considering how the balance of power between investors and managers has changed over the past 12 months, the majority of investors (64%) noted there had been no major changes over this period (Fig. 2). Where slight changes had been seen they were in favour of the investor, with 26% of investors experiencing a slight shift towards their own interests. This is supported by Fig. 3, which shows 43% of participants in the study experienced a change in fund terms in favour of the investor, up from the 30% that experienced such a shift in a similar study conducted in 2011. This suggests that fund managers have become more willing to negotiate on fund terms and fees in order to provide more attractive risk/reward propositions to institutional investors. As a result, institutional investors with a long-term investment horizon making sizeable allocations are now finding themselves in a position of considerable negotiating power. However, 8% of

Fig. 1: Investor Opinion on the Alignment of Interests between Investors and Managers

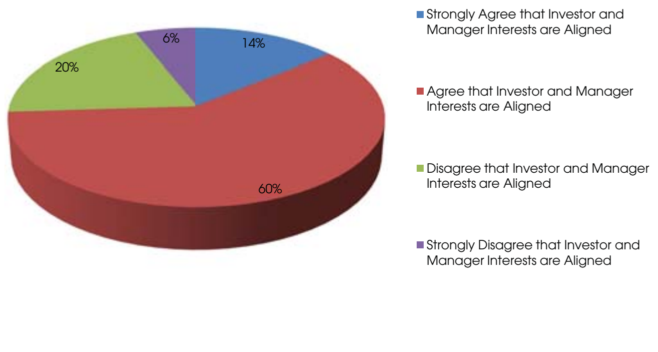

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Fig. 2: Investor Opinion on Changes in the Balance of Power between Investors and Managers over the Past 12 Months

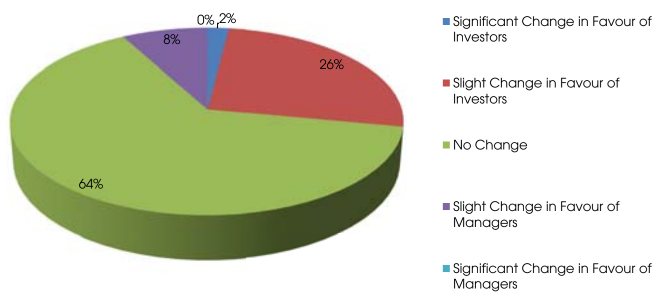

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Fig. 3: Investor Opinion on Changes in Fund Terms over the Past 12 Months

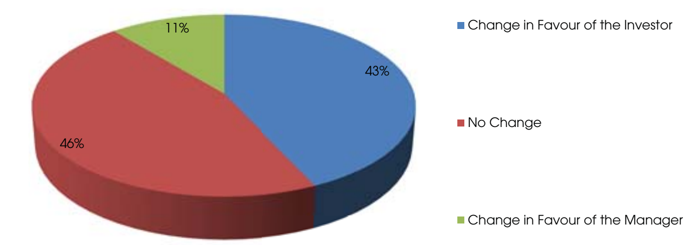

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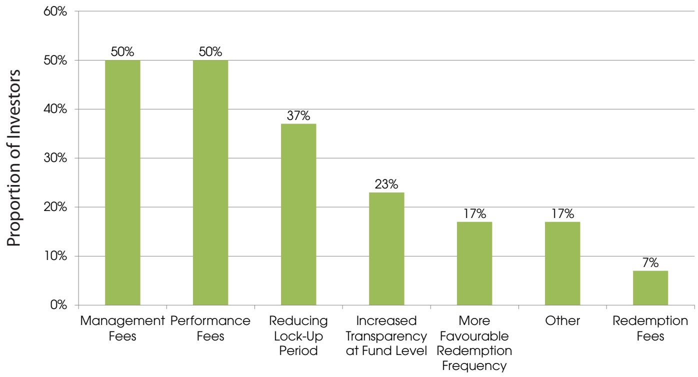
Fig. 4: Areas of Fund Terms Investors Feel Have Shown the Most Improvement over the Past 12 Months



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investors did note a slight change in favour of fund managers, an increase since 2011 when no investors experienced a shift back towards more manager-friendly terms. Despite a general swing in the perceived balance of power towards investors, it is clear that some managers are in a position to pull their fund terms back in their own favour.

Fee Structure Remains a Key Issue

The traditional 2&20 fee structure has come under increasing pressure over recent years, with many investors seeking reduced fees. Fig. 4 indicates that managers have responded to this increase in investor pressure, as half of investors interviewed noted an improvement in the management and performance fees offered by fund managers in 2012. In particular, the proportion of investors observing an improvement in the performance fees offered by managers has increased significantly compared to 2011, when only 11% of investors had experienced a positive change. Such changes may be in response to investors' growing concerns over the ability of hedge funds to achieve absolute returns and satisfy performance requirements following periods of widespread financial market volatility. With the ongoing uncertainty surrounding the global economic system, performance concerns are unlikely to disappear in the short term, which may have a long-term impact on fund terms negotiations. Despite these concessions, there is still room for improvement, with over half of investors interviewed still wanting to see further reductions in management and performance fees, as shown in Fig. 5.

With many investors looking to avoid the traditional 2&20 fee structure, fee negotiations have become standard practice for investors in the pre-investment stages. Throughout 2012 46% of investors have attempted to negotiate lower fees, as shown in Fig. 6, which is the same proportion of investors that were looking to negotiate fees in 2011. Of those that entered into negotiations with their managers, 89% of investors were successful in securing more favourable terms. This is a marked increase compared to the proportion of successful negotiations in 2011, when 71% were successful. Clearly institutional pressure continues unabated, and managers are beginning to really focus on satisfying investor demands due to the persisting difficult fundraising conditions.

Since 2011, there has also been an increase in the proportion of investors rejecting funds on the basis of unreasonable fees. As

Fig. 5: Areas of Fund Terms Where Investors Would Like to See Improvement

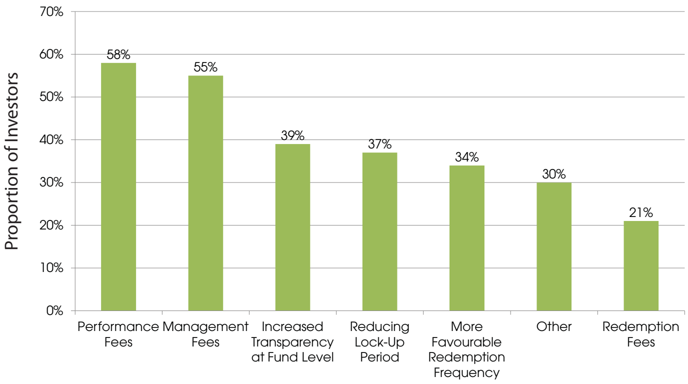

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Fig. 6: Investors' Fund Negotiation Experiences in the Past 12 Months

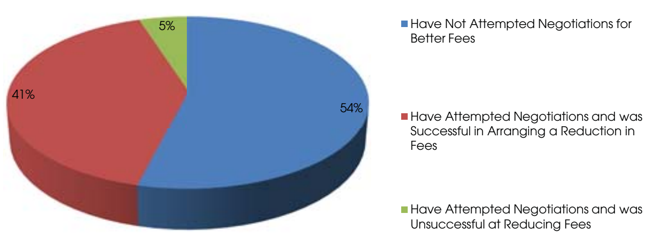

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Fig. 7: Investors' Response to Fund Management and Performance Fees

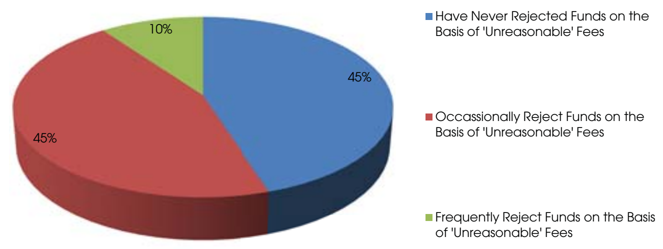

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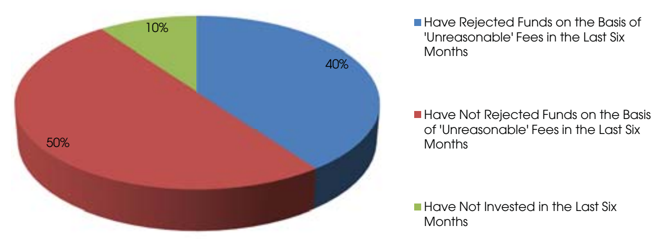
Fig. 8: Investors' Response to Fund Management and Performance Fees in the Last Six Months



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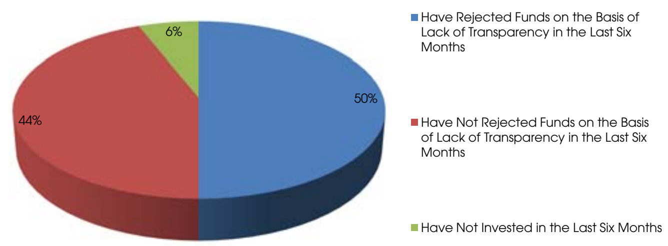
shown in Fig. 7, 55% of investors interviewed stated that they have previously rejected funds on the basis of unreasonable fees, compared to 47% in our 2011 study. A significant 40% of investors noted that they have rejected funds over the last six months in response to the fee structure (Fig. 8). This highlights the heightened relevance of such fund terms in the current financial climate and the importance of constructive negotiations between managers and investors in order to instigate change and form strong relationships. Despite the continuing interest in fee structures, it is also important to note that they are not the only factor taken into consideration by investors. As noted by a UK-based asset manager we spoke to, funds are not rejected solely due fee structures, as other aspects of the fund such as track record naturally also need to be taken into account.

Transparency and Liquidity

While hedge funds have evolved a great deal since the 'black box' days, transparency and liquidity continue to remain at the forefront of investor concerns in 2012. Investors still feel managers can do more to improve transparency, with 39% of investors interviewed looking to see an increase in the levels of disclosure offered (Fig. 5). Furthermore, 50% of investors stated that they had rejected a fund due to lack of transparency over the past six months, as shown in Fig. 9. This indicates that increased disclosure is no longer a preference that fund managers may or may not provide to their investors, but rather a basic requirement to get past the initial due diligence barriers of most institutions. Furthermore, in a crowded fundraising environment, a willingness to disclose detailed information can be a key factor that differentiates fund managers from competitors.

Fig. 9: Investors' Response to Transparency in the Last Six Months



Source: Preqin

Investor perception of the levels of liquidity offered by fund managers has shown a marked improvement since 2011. As shown in Fig. 4, 17% and 37% of respondents experienced improvements in redemption frequencies and lock-up periods respectively, compared to 5% and 8% in our 2011 study. However, as in the case with fee structures, investors clearly feel that there is still room for further improvement, as shown in Fig. 5. Where lock-up periods are in place, investors are pushing for performance fees to be crystallized over the same period as the assets are tied in, as noted by a prominent US-based pension fund we spoke to. Clearly, while institutional investors are striving for such changes, many are willing to favour concessions on fees in response to reduced liquidity.

Outlook

The past few years have seen considerable changes in the hedge fund industry, with financial market upheaval, notable cases of fraud, and increasing institutionalization of the core investor base of the asset class. As the market has matured and developed, investors have become more sophisticated and demanding than ever. This general evolution of the hedge fund space, coupled with the fact that underperformance remains a concern, means that negotiations on fund terms and conditions are playing a larger role than ever in the investment process.

The issue of fees remains central to investors, and the ongoing departure from the 'standard' 2&20 fee structure looks set to continue as more negotiating power shifts towards investors. Transparency and liquidity also continue to be a key issue for most investors amid widespread and persistent market volatility. In response to investor concerns, hedge fund managers have continued to build and develop processes and capabilities commensurate with the increasing needs of their investors; however, the question remains as to whether this changing landscape will impact long-term returns for the asset class, as with complete transparency and a diminished information advantage returns may begin to more closely mirror public market returns. Nonetheless, fund managers hoping to stand out and secure mandates from institutional investors must continue to meet their changing requirements.

Data Source:

This month's feature article draws on information from Preqin's industry leading Hedge Fund Investor Profiles database.

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