

2013 Preqin Investor Network Global Alternatives Report

Sample Pages



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Datapack for the 2013 Preqin Investor Network Global Alternatives Report

The data behind all of the charts featured in the Report is available for free in an easily accessible datapack. It also includes ready-made charts that can be used for presentations, marketing materials and company reports.

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The Interdependence of Pension Security and Private Equity

- Bronwyn Bailey, Ph.D., Vice President, Research,
Private Equity Growth Capital Council

In the wake of the financial crisis, American pensions face an unprecedented challenge. Pension funds are struggling to recover large losses suffered during the financial crisis due to declining stock prices. Throughout this period however, private equity remained a bright spot in pension portfolios. Now more than ever, pension funds have an interdependent relationship with the private equity industry. Private equity depends on pension plans for capital commitments, and pensions rely on private equity to provide superior returns to help meet their investment targets.¹

Private Equity Funds Depend on Pensions for Capital

Pension funds are the largest investors in private equity. According to Preqin, public and private pension funds made up 43% of capital invested by private equity funds during 2001-2011. Public pensions alone make up 30% of the total capital invested. In contrast, foundations and endowments comprise only 19% of total capital invested during this period.

Moreover, pension plans continue to increase their allocations to private equity funds. Wilshire Consulting finds that the percentage of assets allocated to private equity by state pension plans more than doubled from 3.9% in 2001 to 8.2% in 2011.² Preqin estimates that public plans' current allocation (8.9%) to private equity is still below their target allocation (9.7%), based on average allocations of US-based pensions with \$5bn or more in AUM. In the post-recession economy, public pensions are putting more capital in private equity funds at an increasing rate. Given these trends and the tough fundraising environment, private equity firms have become increasingly dependent on pension plans during fund raises.

Private Equity Provides Higher Returns Compared to Other Asset Classes

Pensions' rationale for increasing their commitment to private equity is superior returns. A study by the Private Equity Growth Capital Council found that the median US public pension portfolio received an annualized 8.8% return from private equity, compared to 3.7% from public equity and 6.6% from fixed income for the 10 years ending 2011. The median US pension fund portfolio returned an annualized 5.7% the same period. Generating 3.1 percentage points above total portfolio returns on an annual basis, private equity funds are boosting the retirement security of pension members.

Investment performance is important to public pensions because these returns are a major source of revenue. Portfolio returns comprise 61% of all revenues pensions receive. The other sources are contributions by employees, i.e. pension members who pay into the system, and by employers, i.e. state and local governments, which are funded by taxpayers.

Over the past decade, public pensions' total investment returns have fallen short of their target rate of return. Pension funds have an average target return of 8%. The 8% target return is considerably higher than the 5.7% return received by the median pension plan over the last decade. Consistent underperformance – driven by low equity returns – has reduced the funded status of public pension plans. Based on a study from the Center for Retirement Research at Boston College, the overall ratio of assets to liabilities by public plans fell to 75% in 2011, from 103% in 2000.³

Pensions are More Reliant on Private Equity for Investment Returns

Given the low performance of traditional assets during the first decade of the 21st century, pension funds are looking

to alternative assets, such as private equity, for returns. Meeting the pre-set target return is essential for pensions. When pension plan returns do not meet or surpass the target, pensions' ability to fund retirement payments decreases. The gap between assets and promised retirement payments will be paid by pension employees or the taxpayers that support state and local governments.

Private Equity and Pension Funds Have an Interdependent Relationship

The private equity industry relies on pension funds to commit significant amounts of capital to their funds. Pensions, in turn, seek exposure to a high performing asset class to increase the likelihood that their portfolios will hit the assumed rate of return.

Now more than ever, there is interdependence between private equity and pension funds. A better understanding of these dynamics will aid the dialogue between investors and fund managers in their long-term commitment.

Private Equity Growth Capital Council (PEGCC)

The Private Equity Growth Capital Council, based in Washington, DC, is an advocacy, communications and research organization and resource centre established to develop, analyze and distribute information about the private equity and growth capital investment industry and its contributions to the national and global economy.

www.pegcc.org

¹ This article is based on a larger study conducted by the Private Equity Growth Capital Council.

² Julia K. Bonafede, Steven J. Foresti and Russell J. Walker. "2012 Report on State Retirement Systems: Funding Levels and Asset Allocation", Wilshire Consulting, March 2, 2012, p. 14.

³ Alicia H. Munnell, Jean-Pierre Aubry, Josh Hurwitz, Madeline Medenica and Laura Quinby. "The Funding of State and Local Pensions: 2011-2015", Center for Retirement Research at Boston College, Number 24, May 2012.

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Investors' Approach to Alternative Investments: Proactive or Passive?

The alternative investor universe has grown considerably in the past decade, with many investors now seeing alternative assets as an integral part of their portfolios. As institutions become more active and experienced in alternative investment, many are gaining more confidence in navigating fund opportunities and are also more proactive with their approach.

In light of the global economic downturn and greater pressure on investors to be prudent with capital and selective with where it is allocated, in April 2013 Preqin interviewed 70 institutional investors from around the globe to find out just how proactive and sophisticated they are in relation to committing to alternatives. Investors may need to consider managing a variety of areas: risk exposure, returns requirements, liquidity allowances, and capital and staff resources. This article explores what proportion of the alternative investment community considers itself proactive, how investors source investments and the resources they have to do so.

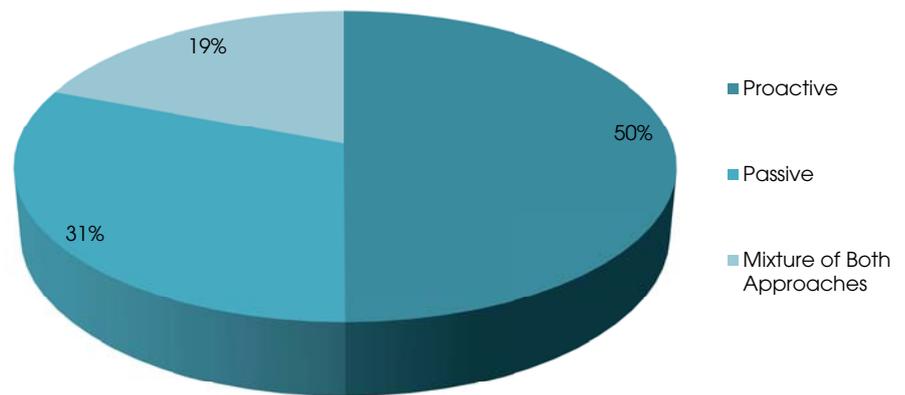
Sourcing Alternative Investment Opportunities

As Fig. 2.15 shows, 50% of investors interviewed stated that they have a proactive approach to sourcing new alternative asset fund investments, meaning they actively review and source new investment opportunities. Thirty-one percent of investors interviewed declared a passive approach to sourcing new investment opportunities, relying exclusively on third parties to present viable fund opportunities. The remaining 19% stated that they employ a mixed approach to sourcing alternative asset fund investments.

With greater transparency on fund manager activity available than ever before, investors can be proactive in sourcing funds themselves, cross-referencing information given to them by third parties, and making fund suggestions for third parties to undertake due diligence on.

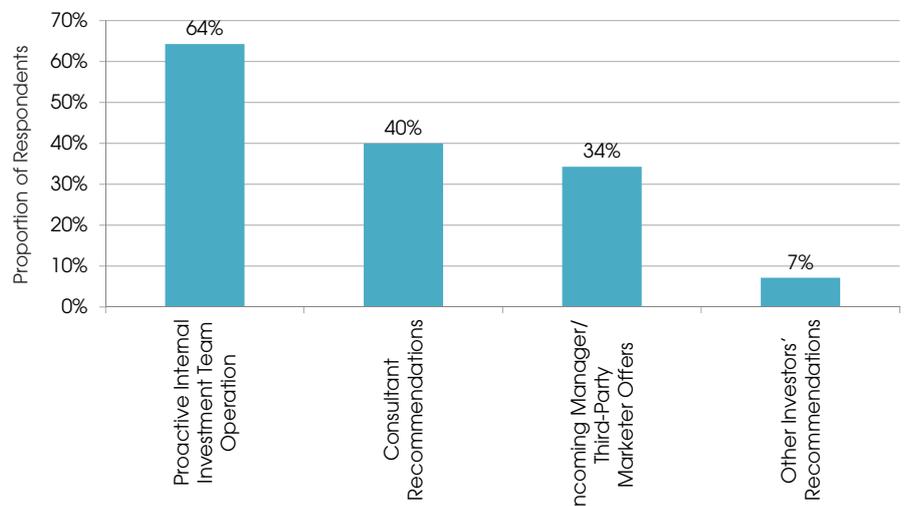
Investors in alternatives use various methods to source alternative assets fund opportunities, often concurrently. Fig. 2.16 shows that 40% of investors

Fig. 2.15: Investors' Attitudes Towards Sourcing Alternative Asset Fund Investments



Source: Preqin Investor Interviews, April 2013

Fig. 2.16: Investors' Sources of Alternative Asset Fund Investments



Source: Preqin Investor Interviews, April 2013

interviewed gain access to funds following recommendations from their consultant, while just over a third (34%) depend on incoming fund manager, placement agent and third-party contacts to commit to funds. Sixty-four percent of investors interviewed have an investment team tasked with finding appropriate opportunities and 7% find funds following recommendation from a fellow investor. One Europe-based government agency stated that it uses "mostly an internal team but sometimes

uses an external consultant when [it] wants to examine profit and risk more closely". One Middle East-based bank interviewed typically "speaks to existing managers and finds out what competitors are doing".

Preqin's interviews with investors confirm that alternative investments have grown in importance for investors over the years, with almost half (49%) of investors interviewed stating that their investment teams have given

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Overview of Hedge Fund Performance

The returns delivered by hedge funds in recent years have not matched the double-digit expectations some have of the industry. Hedge funds underperformed compared to prominent equity markets in 2012, and losses in 2011 have contributed to enhanced scrutiny of the asset class. However, too strong an emphasis on this recent underperformance ignores the important role that hedge funds continue to play as part of investors' diversified portfolios.

Investors face an array of complexities when making allocation decisions and must consider factors such as investment timeframes, liquidity requirements, tolerance of volatile returns and the profile of different strategies. Preqin tracks fund-level returns and performance data for over 5,400 individual hedge funds and generates benchmark data by fund structure, strategy and geographic focus in order to help investors accurately evaluate hedge fund investment opportunities.

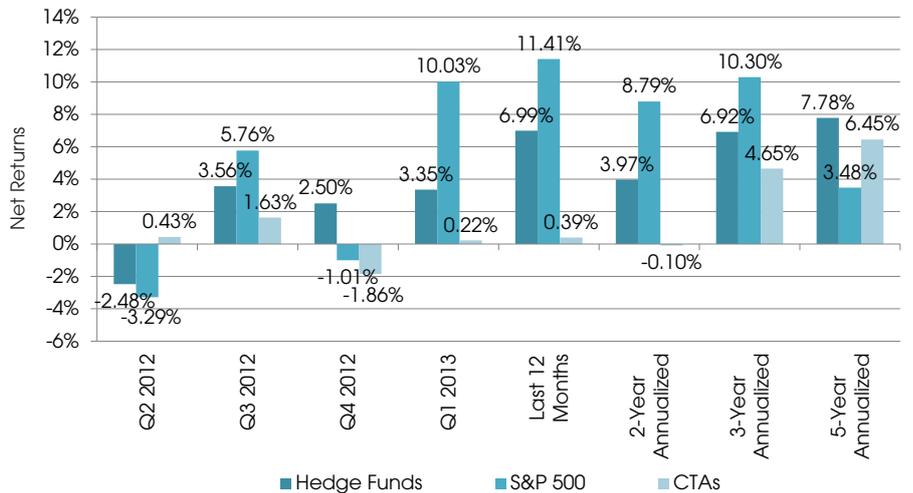
Recent Returns

Preqin's benchmarks show that hedge funds started 2013 on a positive note after experiencing mixed fortunes during 2012. Preqin's data shows that hedge funds posted net returns of 3.35% in Q1 2013 as many funds built on a strong close to 2012. Several strategies generated returns exceeding 2% in January before neutral-to-positive performance in the next two months left 12-month gains at nearly 7% by the end of March. The solid Q1 performance of hedge funds did not match the surge seen in some stock markets, with the S&P 500 rising by 10% during the quarter to reach record levels and post a price return of 11.41% over the last 12 months (Fig. 2.32).

Risk Performance

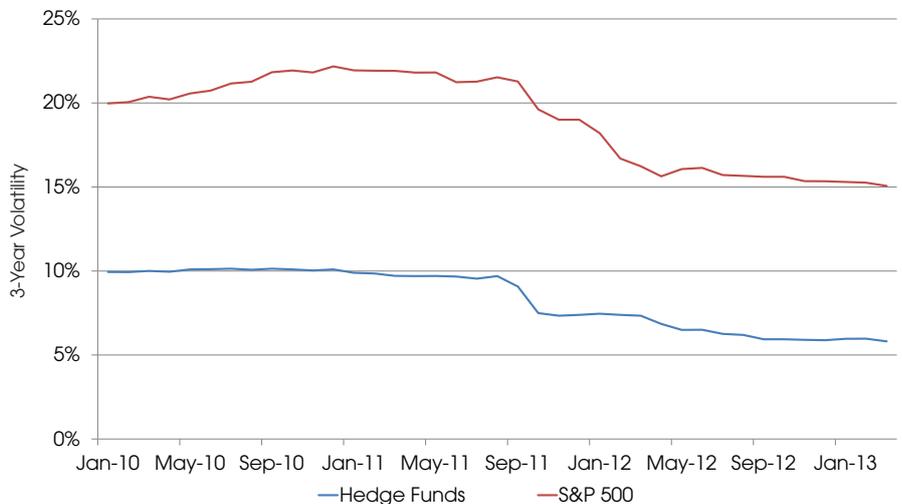
Although hedge funds were unable to capture the same upside returns as public markets over the last 12 months, they did post a less severe drawdown for the year. The average hedge fund declined by 2.72% between March and the end of May 2012, while the S&P 500 fell by 6.97% in the same period. In contrast to hedge funds, which followed this 2012

Fig. 2.32: Performance of Hedge Funds, CTAs and S&P 500 (As at March 2013)*



Source: Preqin Investor Network

Fig. 2.33: Rolling Volatility of Hedge Funds vs. S&P 500, January 2010 - March 2013*



Source: Preqin Hedge Fund Analyst

drawdown with 10 consecutive months of gains, the equity index also ended last year in drawdown after failing to make up for a fall of almost 2% in October.

Risk profile is a key consideration for hedge fund investors and the industry has maintained its reputation for offering low volatility of returns. Hedge fund returns had a volatility (measured by annualized standard deviation) of 4.26% in the 12 months to March 2013, compared to the

S&P 500's level of 10.45%. Investors with a longer investment horizon will see a similar pattern. Fig. 2.33 plots the three-year rolling volatility of hedge fund returns compared to the S&P 500 since January 2010. It shows that the generation of less volatile returns is a familiar occurrence over the long term. Volatility of hedge fund returns was in the range of 5-10%; the same measure of the S&P 500 did not drop below 15% and peaked at just over

* Please note, all performance information includes preliminary data for March 2013 based on net returns reported to Preqin in early April 2013. Although stated trends and comparisons are not expected to alter significantly, final benchmark values are subject to change.

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Investment Opportunities in Private Equity: Funds in Market

As a global asset class, private equity provides investors with the opportunity to commit to a variety of fund strategies targeting investment opportunities around the world, from the traditional private equity hubs of North America and Europe to the developing regions of Asia and Latin America.

The number of private equity funds currently in market is near record levels, with 1,908 private equity vehicles, including real estate and infrastructure, vying for an aggregate \$778bn in investor commitments. Both the number of funds and aggregate capital sought have increased in comparison to the previous year. With a large variety of funds seeking capital offering both traditional and new strategies, investors are faced with the challenge of filtering through and identifying the most appropriate investment opportunities that suit their current investment objectives.

Fund Type Breakdown

Fig. 3.2 shows the variety of private equity funds in market seeking investor commitments by fund type. Buyout funds continue to seek the largest amount of capital, with 264 buyout vehicles on the road looking to raise \$230bn. In particular, many investors view small to mid-market buyout funds as presenting the best investment opportunities, which is helping to drive interest in buyout investments. Private real estate funds are the most numerous fund type in market and collectively these vehicles are seeking the second largest amount of capital, with 436 funds looking to raise a total of \$150bn. Venture capital funds are the second most numerous in market, with 369 seeking capital.

Regional Focus

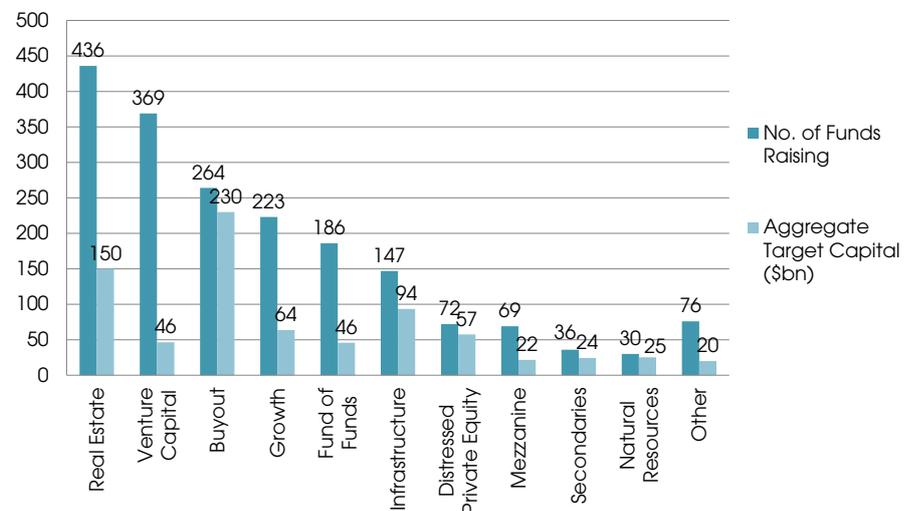
North America represents the largest private equity market in the world and is home to large numbers of institutional investors and fund managers alike. Investors looking to allocate capital to North America-focused private equity funds have a wealth of opportunities to assess. Fig. 3.3 shows that there are currently 871 North America-focused vehicles targeting \$401bn in aggregate capital, accounting for almost 46% of private equity funds in market and 52% of aggregate capital sought.

Fig. 3.1: Private Equity Funds in Market Over Time, 2007 - 2013



Source: Preqin Investor Network

Fig. 3.2: Composition of Current Funds in Market by Fund Type



Source: Preqin Investor Network

Investors not only have various strategies to consider if looking to access North American markets, but they must also decide upon the best route into the market: North America-focused private equity is a global industry, with managers targeting the region for investment located around the world. Four percent of North America-focused funds seeking capital are managed by firms headquartered outside of the region. Excluding real estate and infrastructure funds, 23% of North America-focused private equity funds are targeting buyout

opportunities; these funds represent 43% of the aggregate capital sought by private equity funds targeting the region. A further 30% of North America-focused funds are targeting venture capital investments, representing 9% of aggregate capital sought by North America-focused private equity funds.

As of April 2013, there are 448 Europe-focused funds on the road seeking an aggregate \$199bn in investor capital. Investor appetite for distressed private equity investments has grown in recent

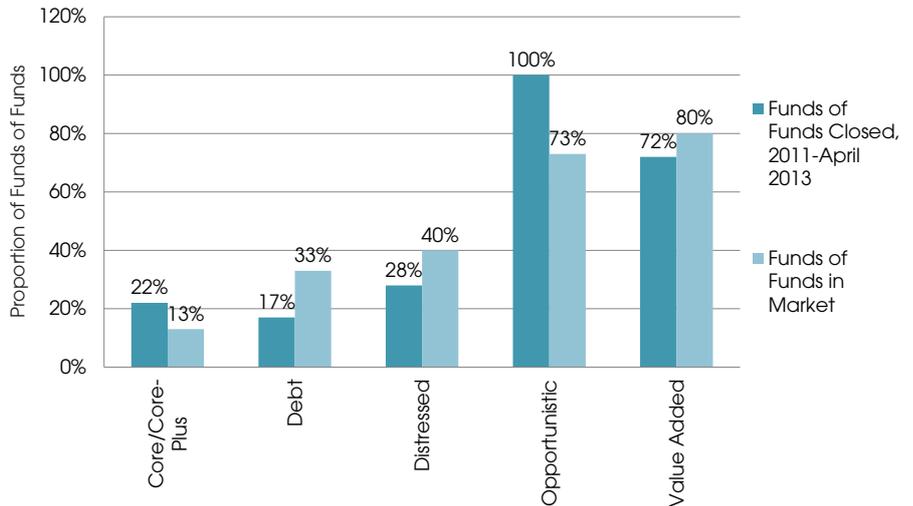
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Spreading the Risk: Real Estate Funds of Funds

Real estate fund of funds managers are influential investors in the private real estate market. The significant resources of these firms are required for implementing the necessary research and due diligence on potential investments, meaning that they are a particularly sophisticated and specialized group of investors. Analyzing the investment preferences of these managers can provide investors with a good indication of where the best opportunities reside in the market.

All real estate funds of funds that closed between 2011 and April 2013 targeted funds with an opportunistic strategy. However, this fund type is being targeted by less than three-quarters (73%) of real estate funds of funds that are currently in market (Fig. 3.36). A higher proportion of funds of funds in market are favouring value added, debt and distressed strategies than those funds of funds that closed in the period 2011 to April 2013, with value added the most sought after strategy for the real estate funds of funds in market. Underlying debt funds are more prominent as decreasing availability of bank financing has offered real estate firms the opportunity to address the demand for funding. Real estate fund of funds managers are often able to adapt to market changes promptly, shifting strategy to capitalize on market movements. Accessing funds of funds gives investors the opportunity to tap into the relative flexibility funds of funds can enjoy.

Fig. 3.36: Proportion of Closed-End Private Real Estate Funds of Funds Targeting Various Fund Types

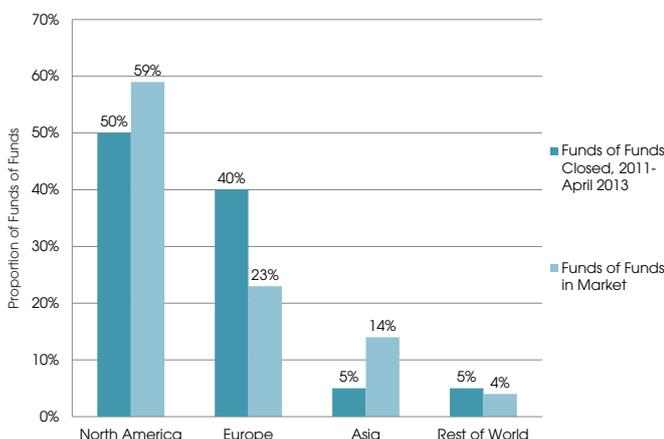


Source: Preqin

As seen in Fig. 3.37, real estate funds of funds in market are more likely to invest in North America and Asia compared to vehicles that closed in 2011-April 2013. Appetite for Europe-focused funds has decreased among real estate funds of funds in market, with only 23% of funds of funds on the road targeting Europe in comparison to 40% of funds of funds that closed between 2011 and April 2013. Again, this is partly a result of these multi-managers altering their investment focus to target the regions they believe are presenting the best investment opportunities.

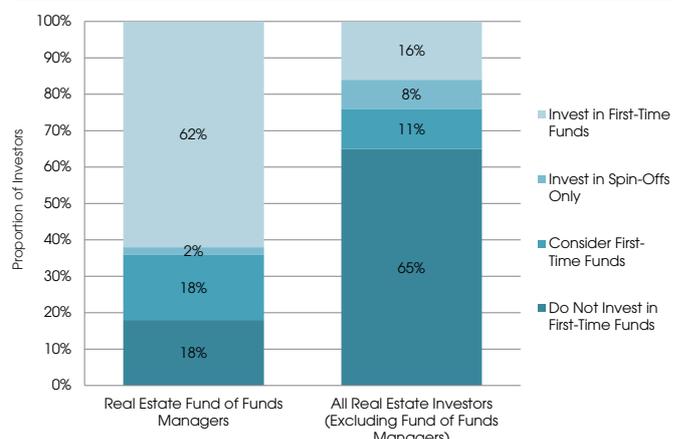
Fig. 3.38 shows that 62% of real estate fund of funds managers are willing to commit to first-time funds, 18% will consider these vehicles, and a further 2% will invest with spin-off teams only. In contrast, only 16% of institutional investors will commit to first-time funds, and a significant 65% are not willing to commit to first-time funds at all. Funds of funds as multi-managers can afford the associated greater risk of investing in fund managers raising their first private real estate vehicle, and can take advantage of more favourable fund terms. Investors not willing or able to take such risk can capitalize on first-time funds via fund of funds managers.

Fig. 3.37: Breakdown of Closed-End Private Real Estate Funds of Funds by Main Geographic Focus



Source: Preqin Investor Network

Fig. 3.38: Appetite for First-Time Funds, Real Estate Funds of Funds Managers vs. All Other Real Estate Investors



Source: Preqin Investor Network

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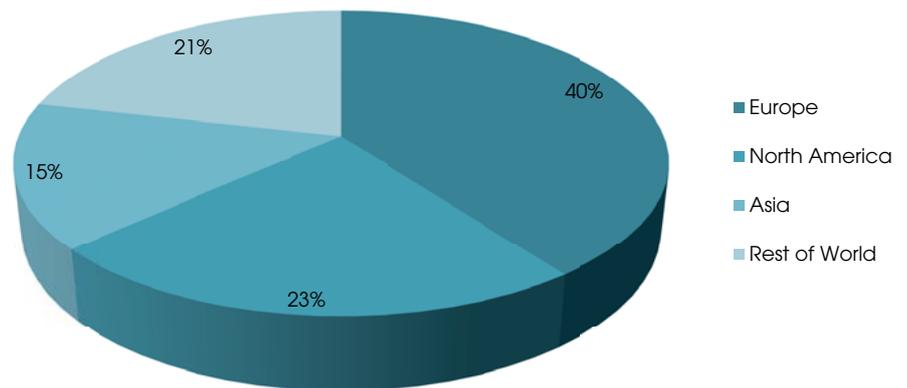
Private Infrastructure Fund Managers in Market

The growth of the private infrastructure market over recent years has been fuelled by a surge in investor demand for exposure to infrastructure assets and a significant number of private fund managers launching new funds. Preqin is currently tracking over 320 active unlisted infrastructure fund managers, which have together launched almost 600 private infrastructure funds. These fund managers are based in many different countries around the world and have varying levels of fundraising experience and track record. The market also features a host of different risk/return opportunities dependent on the strategy pursued by the fund manager. As a result, an investor's ability to accurately identify and select the best and most appropriate infrastructure fund managers is vital when looking to build a successful portfolio.

As of April 2013, there are 132 unlisted infrastructure fund managers actively marketing 147 infrastructure funds. As shown in Fig. 3.44, a significant 40% of these firms are based in Europe, while 23% are based in North America. Fifteen percent of infrastructure fund managers actively raising a fund are based in Asia, while 21% are based outside these core markets in regions such as South America, Australasia, Africa and the Middle East.

Fig. 3.45 illustrates the top five cities acting as a base for the 132 unlisted infrastructure fund managers actively raising capital. London is the most

Fig. 3.44: Breakdown of Unlisted Infrastructure Fund Managers with a Fund in Market by Location of Headquarters



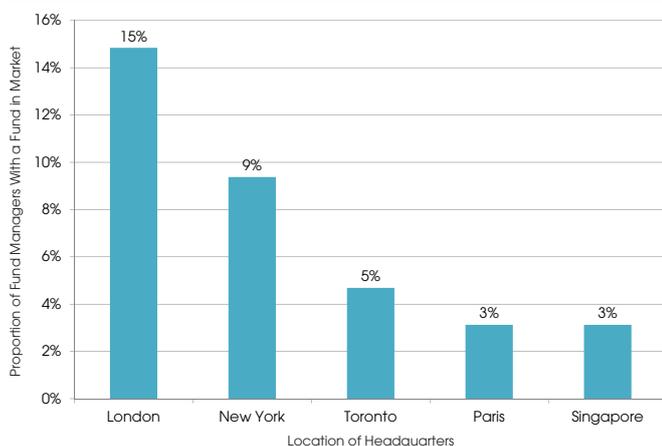
Source: Preqin Investor Network

prominent city, with 15% of infrastructure fund managers with a fund in market based there. Nine percent of active infrastructure fund managers are based in New York, while a further 5% are based in Toronto. Both Paris and Singapore provide the base for 3% of active infrastructure fund managers.

Fund manager experience, past performance and track record is of primary importance as investors look to select a fund manager. Of the infrastructure funds to reach a final close in the past 12 months, 46% were launched by firms with previous

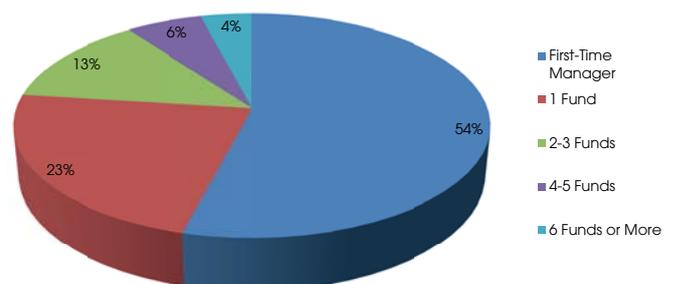
fundraising experience (those managing at least one other infrastructure fund). In contrast, 54% of fund managers currently in market are raising their first fund as shown in Fig. 3.46, and only 10% have previously raised four or more vehicles. Consequently, there are only a limited number of fund managers in the market with previous fundraising experience. This will result in increased competition to gain access to the most desirable vehicles managed by the most experienced firms, but will also provide room to negotiate on the terms linked to funds managed by less experienced managers.

Fig. 3.45: Top Five Metropolitan Areas for Unlisted Infrastructure Fund Managers with a Fund in Market (Based on Headquarters)



Source: Preqin Investor Network

Fig. 3.46: Breakdown of Unlisted Infrastructure Fund Managers with a Fund in Market by Number of Funds Raised Previously



Source: Preqin Infrastructure Online

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Paying for Alpha?: Hedge Fund Terms and Conditions

Since its inception, the hedge fund industry has been synonymous with a 2/20 fee structure. The fees charged by hedge fund managers have come under scrutiny in recent years, with investors now rallying for change within the industry. Preqin data shows that the mean fees for the industry are a 1.62% management fee with a 19.17% performance fee. With just 37% of hedge fund managers still employing the flat 2/20 fee structure, it is clear this fee schedule is no longer quite the norm. With the fee landscape constantly evolving, what fees should investors expect to pay?

Fees by Strategy

The average fees charged by fund managers based on the core investment strategy of the fund are shown in Fig. 4.32. As the chart demonstrates, investors that are looking to add macro strategy funds to their portfolio should expect to pay above average fees, with macro strategy fund managers charging the highest mean fees of any hedge fund strategy. The mean management fee of a macro fund stands at 1.72% and the mean performance fee at 19.52%. These fees reflect the higher operational and trading costs of running this type of actively managed fund. The competitive long/short sector charges comparatively lower fees. Relative value funds charge the lowest management fees of any hedge fund strategy of 1.50%, although investors in these funds have to pay one of the highest performance fees of any strategy at 19.44%.

Fees by Fund Manager Location

Investors in North America-based funds can expect to pay the highest performance fee of any region, with an average of 19.70% (Fig. 4.33). With North America home to some of the largest and most successful funds in the hedge fund market place, investors often have to pay larger fees in order to tap into the most competitive funds. While Europe also has a strong presence in the hedge fund industry, it has lower management and performance fees, resulting from a variety of factors, including the high proportion of UCITS funds in Europe, and tougher fundraising conditions.

Fig. 4.32: Mean Hedge Fund Fees by Fund Strategy

Fund Strategy	Mean Management Fee (%)	Mean Performance Fee (%)
All Single Manager Hedge Funds	1.62	19.17
Event Driven	1.60	19.48
Long/Short	1.58	18.81
Macro	1.72	19.52
Multi-Strategy	1.63	18.93
Other	1.56	18.63
Relative Value	1.50	19.44

Source: Preqin Investor Network

Fig. 4.33: Mean Hedge Fund Fees by Fund Manager Location

Region	Mean Management Fee (%)	Mean Performance Fee (%)
Asia-Pacific	1.63	18.45
Europe	1.61	18.55
North America	1.62	19.70
Rest of World	1.64	18.95

Source: Preqin Investor Network

Asia-Pacific-based hedge fund managers offer the lowest performance fees, with an average performance fee of 18.45%; this is lower than those charged on average by any single hedge fund strategy. The hedge fund industry in the region is still developing and fund managers are more flexible on fee structure in order to attract investment.

Hedge Fund Liquidity

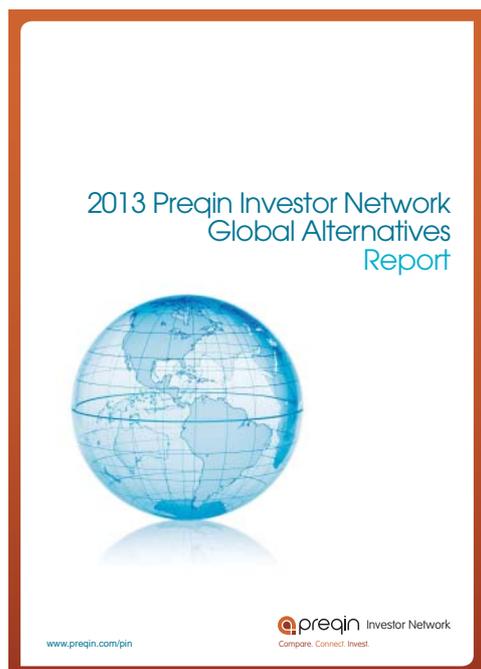
Fig. 4.34 shows the liquidity spectrum of the main groupings of hedge fund strategies. Macro strategies provide investors with the greatest amount of liquidity, allowing investors access to their capital, on average, more than once per month, with the shortest notice period of all hedge fund strategies (23 days on average, for all macro strategies). As we have already seen, investors in macro strategy funds are likely to have to pay higher fees but they will be allowed greater access to capital once it is invested in the fund, an important consideration if liquidity is a key concern. In cases where a lock-up is in place, these also tend to be quite short, at approximately 2.8 months on average. Macro funds tend to be more

liquid than some of their counterparts in the wider hedge fund industry. Some macro strategies, such as those that trade foreign exchange markets, may have daily or intra-daily trading.

At the other end of the spectrum, investors in event driven funds have the lowest levels of liquidity of any hedge fund strategy, with the majority of funds only offering quarterly redemptions. On average, investors can only access their capital every 2.7 months with a two-month notice period. Event driven strategy hedge funds can also have significant lock-up periods; for event driven funds which initially lock up capital, the average period amounts to over 10 months. Event driven hedge funds look for inefficiencies caused by corporate events; in order to create value from these positions, investments are often held for significant periods of time. Investors in event driven funds therefore need to expect liquidity restrictions in order for the fund to fulfil its investment period and ensure that they do not need to exit an investment prematurely before value is created. Distressed hedge

2013 Preqin Investor Network Global Alternatives Report

The Report is the most comprehensive review of the alternatives industry aimed exclusively at institutional investors ever undertaken. It includes in-depth analysis on:



- ▶ **Methods of investing** in alternative assets.
- ▶ **Performance** of alternative assets, including industry benchmarks.
- ▶ Alternative **funds open for investment**, including league tables.
- ▶ **Consistent performing** managers, and top performing funds.
- ▶ **Terms and conditions, funds of funds, secondary market**, and more.

Plus hear from some of the industry's most significant voices, including David Rubenstein, Josh Lerner, and Luke Ellis.

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