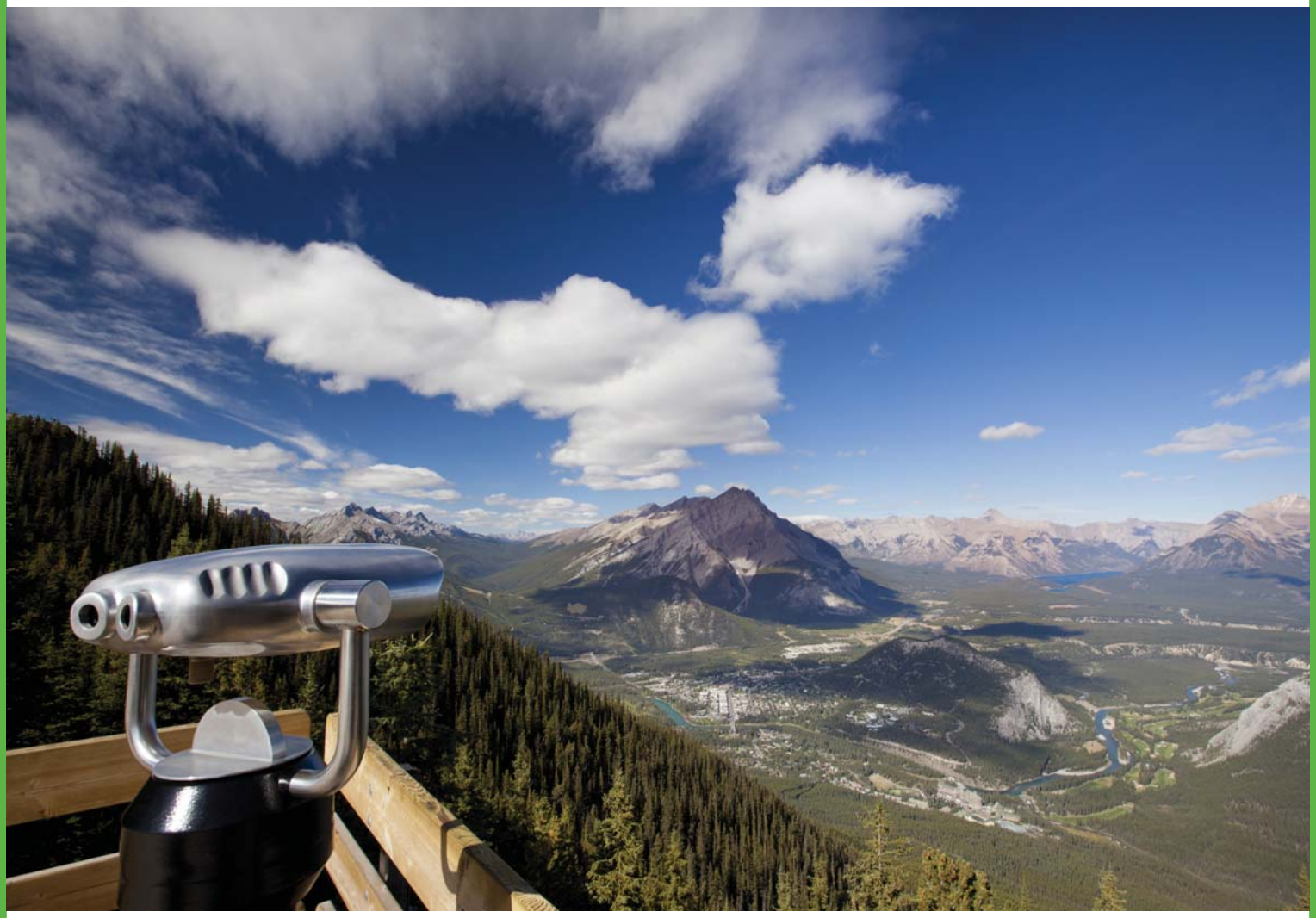
Preqin Investor Outlook: Hedge Funds H1 2015



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Hedge Funds

Institutional Investors Remain Committed Despite Performance Concerns

Institutional investment in hedge funds came into the spotlight in 2014 following the exit of California Public Employees' Retirement System (CalPERS) from the asset class in the second half of the year. Despite another notable pension scheme, Netherlands-based PFZW, announcing at the start of 2015 that it redeemed its entire hedge fund portfolio at the end of Q4 2014, CalPERS' departure has not, at least as we enter 2015, opened the flood gates for many more pension schemes to exit hedge fund investments. There are more institutions than ever investing in hedge funds, investing ever-growing portions of their total portfolio in the asset class and creating increasingly sophisticated portfolios of funds.

Hedge funds struggled to generate strong performance in 2014; the Preqin All-Strategies Hedge Fund benchmark made gains of just 3.78% over the course of the year. This poor performance did not go unrecognized by investors; 35% of investors stated that their hedge fund investments failed to live up to expectations in 2014, compared to 16% that stated the same for 2013. So why do investors continue to invest in hedge funds, even though 2014 was a disappointing year for industry performance? The industry has proven its ability to deliver consistent returns over longer timeframes, and it is this potential for solid risk-adjusted returns that appeals to investors. In fact, investors are not looking for hedge funds to match the S&P 500, but instead are turning to hedge funds to diversify their traditional equity and bond holdings with an attractive risk/return profile. With increased volatility in equity markets in 2014 and global macroeconomic events potentially leading to a difficult returns environment for traditional investments in 2015, the year could be a vital one for hedge funds to prove their true value.

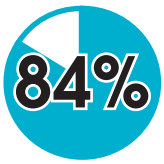
Fundraising continues to be challenging for fund managers, particularly the smaller or emerging funds. However, investors remain interested in these funds in the year ahead; 52% of investors that we spoke to for the 2015 Preqin Global Hedge Fund Report said they would either invest or consider investing in an emerging fund in 2015. In fact, as some of the largest funds reach capacity or close to new investment, we may see some smaller funds pick up new mandates as investors seek to put more capital at work in hedge funds in 2015.

Following a difficult year in terms of performance, the calls for hedge funds to cut back fees have intensified as we enter 2015. However, all fund managers – both emerging and established – will need to continue to listen and respond to all investor demands over the course of the year in order to attract capital in 2015.

Preqin conducted interviews with 134 institutional investors in November 2014 in order to gauge their outlook on industry issues such as performance, regulation and fund terms, as well as their appetite for hedge funds in 2015. Here we present a detailed analysis of the key topics affecting hedge fund investors in 2015, using results taken from our 2015 Preqin Global Hedge Fund Report.

Key Facts

Proportion of investors that believed that hedge fund returns met or exceeded their expectations in 2014.



Proportion of investors that expect to maintain or increase their hedge fund allocations over the next 12 months.

Proportion of investors that believe that performance is the key issue for hedge funds in 2015, the most commonly cited issue.

Proportion of investors that want to see an improvement in the level of management fees charged in 2015.

Satisfaction with Returns

In the 2014 Global Hedge Fund Report, Preqin reported that in 2013 investor satisfaction with hedge fund performance reached its highest levels recorded. However, in 2014 hedge funds posted their worst returns since 2011, and the Preqin All-Strategies Hedge Fund benchmark was in the red as many times as it was in the black. This choppy performance was noted by institutions, with investor satisfaction with hedge fund performance falling in 2014.

As shown in Fig. 3.1, 35% of investors surveyed stated that their hedge fund portfolio returns had fallen short of their expectations during 2014, a significant increase from 16% in 2013. In addition, 22% of those surveyed stated they had reduced confidence in hedge funds to perform portfolio objectives, an increase from 16% of respondents last year. Despite this, the majority (57%) of investors stated that their hedge fund investments had met expectations across the year. Just 8% of investors reported that performance had exceeded their expectations over 2014, down from 21% in 2013.

Coupled with this increase in the proportion of investors believing hedge funds had not met portfolio expectations in 2014, we also witnessed an increased proportion of investors stating that their confidence in hedge funds to meet portfolio objectives has reduced over the course of 2014. With this in mind, it will be important for fund managers to perform well in 2015 in order to restore confidence.

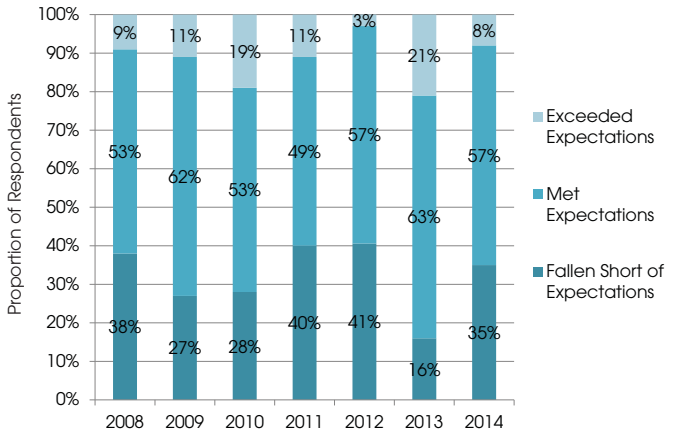
Fig. 3.2 shows the specific hedge fund strategies that investors believe have exceeded and fallen short of their expectations in 2014. The investors surveyed by Preqin were divided in their opinions on long/short equity in 2014. Similar proportions of investors stated that the strategy had exceeded expectations as had fallen short of expectations: 35% and 36% respectively. Despite the overall Preqin Long/Short Equity benchmark adding just 3.49% in 2014, there were some funds that posted significant returns in the year: seven long/short equity funds featured in the top 10 performing funds in 2014. Those investors, therefore, which were invested in the better performing long/short equity funds were rewarded with high returns.

In 2013, no investors reported that their event driven funds had not met expectations; however, in 2014, 16% of investors stated that the strategy had not lived up to their performance demands. In addition, fewer investors reported that the strategy had exceeded expectations in 2014 than reported the same in 2013 (20% and 27% respectively). In the first half of 2014 the strategy struggled to post the same consistent gains it had been adding over 2012 and 2013. In the second half of 2014, the strategy faltered and went into negative territory, particularly as a result of some high profile M&A deals falling through.

In contrast, managed futures/CTAs had a more successful 2014, adding 9.96% over the year, their best annual return since 2010, and beating the performance of the Preqin All-Strategies Hedge Fund benchmark. Nineteen percent of investors reported that the strategy had exceeded expectations, a marked increase from the 2% that stated the same for 2013. Despite a greater proportion (22%) of investors affirming that the strategy had not met expectations, this was a much smaller proportion than in 2013, when nearly half of all investors felt CTAs had not met expectations.

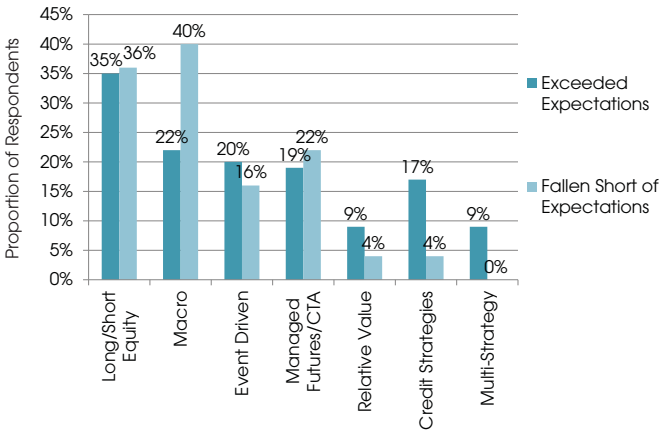
Macro funds continued to disappoint; 40% of investors surveyed believed the strategy's performance had fallen short of expectations. This, however, is a slight improvement on 2013, when 43% of investors felt they underperformed. Positively for the strategy, 22% of investors felt macro funds had exceeded their expectations, up significantly from just 2% of investors last year. This perhaps reflects the strategy's mid-year run of solid performance, particularly in a period when equity markets were proving difficult to navigate and investors looked for non-correlated assets.

Fig. 3.1: Hedge Fund Portfolio Performance Relative to Expectations of Institutional Investors, 2008 - 2014



Source: Preqin Investor Interviews, November 2014

Fig. 3.2: Hedge Fund Portfolio Performance Relative to Expectations of Institutional Investors by Strategy



Source: Preqin Investor Interviews, November 2014

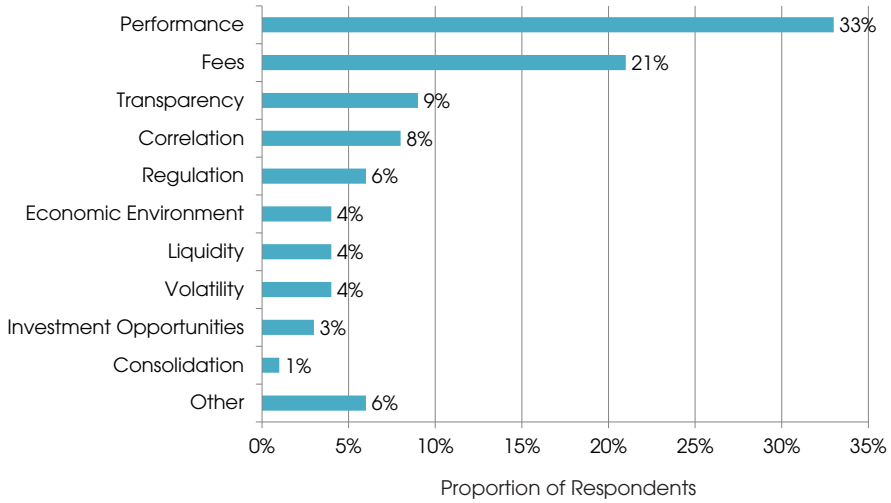
Key Issues and Regulation

Fig. 3.3 shows the key issues investors felt the hedge fund industry would face in 2015. Performance, the most cited issue in last year's survey, remained the most common issue, cited by a third of investors. The disappointing performance of hedge funds in 2014 and an uncertain outlook for 2015 has put the ability of the asset class to deliver investors' return objectives at the forefront of investors' minds. There has also been a significant shift in the proportion of investors stating that fees will be a key issue in 2015 as compared to 2014. Twenty-one percent of investors felt fees would be the key issue moving into 2015, nearly double the proportion of investors that said the same the previous year.

Although the majority of investors surveyed were satisfied with their hedge fund investments, failure to perform in 2015 will fuel investors' continued questioning of hedge fund fees and the value they are getting from their hedge fund portfolios. The high profile exit of CalPERS from hedge funds, citing operational costs, has also helped propel the issue of hedge fund fees to the fore. In a competitive fundraising environment, some managers may find themselves needing to re-evaluate their fees, particularly in strategies that are saturated and have relatively low barriers to entry.

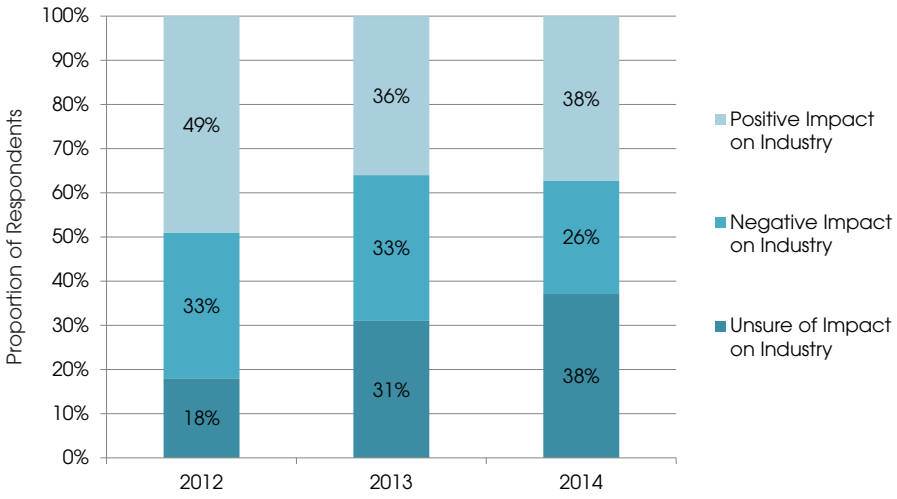
Regulation was a key theme identified by investors last year, with 24% of investors stating that it would be the key issue in 2014. However, just 6% of investors considered it the main issue moving into 2015. The industry has become increasingly regulated over recent years; much of the uncertainty surrounding the changes, from an investor's perspective, have been clarified over 2014 following the final introduction of changes to regulations such as the Alternative Investment Fund Managers Directive (AIFMD). However, Fig. 3.4 shows that more investors are still unsure about the impact that recently introduced regulation will have on the industry compared to recent years; only 26% of investors in 2014 believe that such regulation will have negative consequences for the industry. As investors become more accustomed to investment in a regulated hedge fund industry, and the impact this will have on their fund choice, as well as the additional transparency and protection this may offer them, regulation could continue to be less of a concern for institutions.

Fig. 3.3: Key Issues Facing the Hedge Fund Industry in 2015 According to Institutional Investors



Source: Preqin Investor Interviews, November 2014

Fig. 3.4: Investor Outlook on Hedge Fund Industry Regulations Introduced in Recent Years, 2012 - 2014



Source: Preqin Investor Interviews, November 2012 - November 2014

Data Source:

With fees and performance emerging as key issues for investors in 2014, use Preqin's **Hedge Fund Analyst** to find out more about hedge fund terms and returns in 2014.

For more information, please visit:

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Investor Activity in 2015

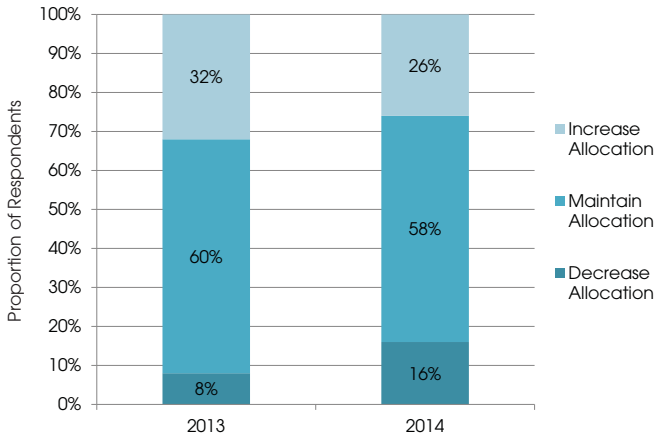
Despite underwhelming performance posted by hedge funds in 2014, the majority of institutional investors appear to be committed to the asset class. At the end of 2014, there was a noticeable increase in the proportion of investors that indicated that they would reduce their allocation to hedge funds over the next 12 months compared to 2013 (16% and 8% respectively), as illustrated in Fig. 3.5. However, investor activity over the next 12 months looks encouraging for hedge fund managers, with the majority (84%) of institutional investors intending to maintain or increase their allocations to the asset class.

Fig. 3.6 illustrates the breakdown of the amount of capital institutional investors will be looking to commit to hedge funds over the next 12 months. The majority of investors (54%) have indicated that they each intend to invest up to $49mn of fresh capital in hedge funds over the next 12 months. At the other end of the spectrum, a relatively small proportion of investors (8%) indicated that they would invest $500mn or more in 2015.

Sixty-nine percent of investors plan to invest in at least three funds over the course of the year (Fig. 3.7). Therefore, it is clear that the majority of investors remain committed to investing in a variety of funds to diversify portfolios and spread risk.

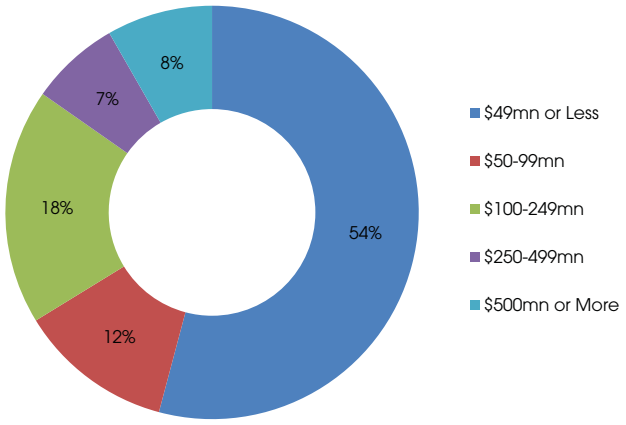
Investors were asked about their specific plans for 2015 in relation to the strategy weighting within their portfolios; across all strategies, more investors were looking to increase their exposure than decrease exposure (Fig. 3.8). As demonstrated previously in Fig. 3.5, the net movement of investor portfolios is towards investors increasing the amount of capital they plan to invest in hedge funds in 2015, with this capital likely to flow into a variety of strategies. However, long/short equity strategies look set to be the biggest winners in 2015.

Fig. 3.5: Investors' Intentions for Their Hedge Fund Allocations in the Next 12 Months, 2013 - 2014



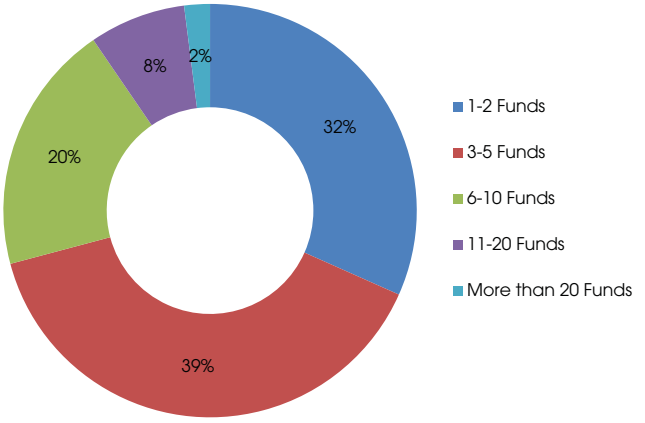
Source: Preqin Investor Interviews, November 2013 - November 2014

Fig. 3.6: Amount of Fresh Capital Institutional Investors Expect to Invest in Hedge Funds over the Next 12 Months



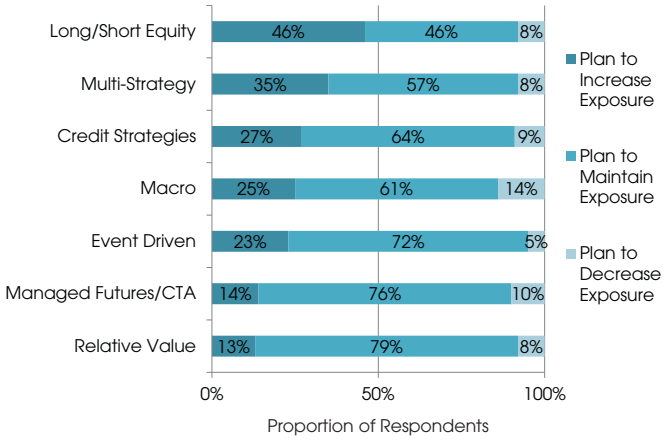
Source: Preqin Hedge Fund Investor Profiles

Fig. 3.7: Number of Hedge Funds Institutional Investors Expect to Add to Their Portfolios over the Next 12 Months



Source: Preqin Hedge Fund Investor Profiles

Fig. 3.8: Breakdown of Investors' Strategy Allocation Plans for 2015



Source: Preqin Investor Interviews, November 2014

Attracting Investor Capital

It is fundamental that fund managers looking to attract and retain investor capital from institutional investors recognize their unique needs and requirements. Indeed, key aspects such as manager experience and high risk-adjusted returns are prominent, but what other considerations are investors looking for?

Return Objectives

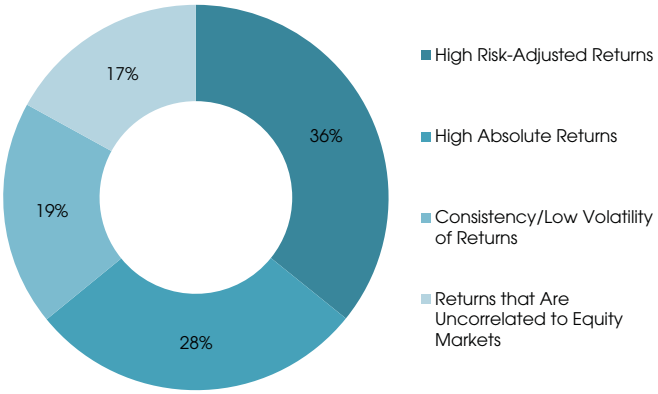
Thirty-six percent of investors cited high risk-adjusted returns as a key objective from their hedge fund portfolio (Fig. 3.9), an 11 percentage point increase from the proportion of investors surveyed at the end of 2013 (25%). This illustrates the need for investors to see managers produce returns relative to the risk of the underlying strategy. Moreover, high absolute returns were a key return objective for a notable proportion (28%) of investors allocating to the asset class. Nineteen percent of investors required consistency or low volatility from their hedge fund holdings.

Key Factors in Fund Manager Selection

In 2015, investors plan to place more emphasis on the experience of the management team and the strategy of the funds than they did in 2014, with fewer investors looking at returns and the fund track record (Fig. 3.10). However, the shift is relatively small, and it is clear that all four factors are an important part of the decision-making process for institutional investors.

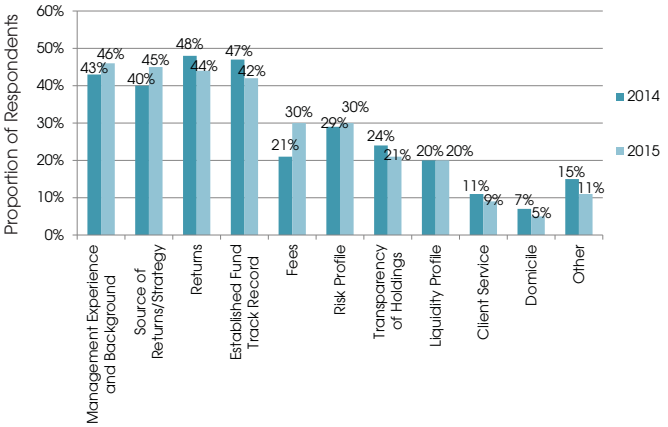
The proportion of investors that look at fees when assessing managers increased from 21% in 2013 to 30% in 2014. Given the tough year some managers have had in terms of performance, it is unsurprising that the question of fees has been awarded higher priority within investors' selection criteria. Managers may find fee structures under increased scrutiny from investors if performance continues to be volatile.

Fig. 3.9: Investor Returns Objectives from Hedge Fund Investments



Source: Preqin Investor Interviews, November 2014

Fig. 3.10: Key Factors Used by Institutional Investors to Evaluate Hedge Fund Managers, 2014 vs. 2015



Source: Preqin Investor Interviews, November 2014

Fees and Alignment of Interests

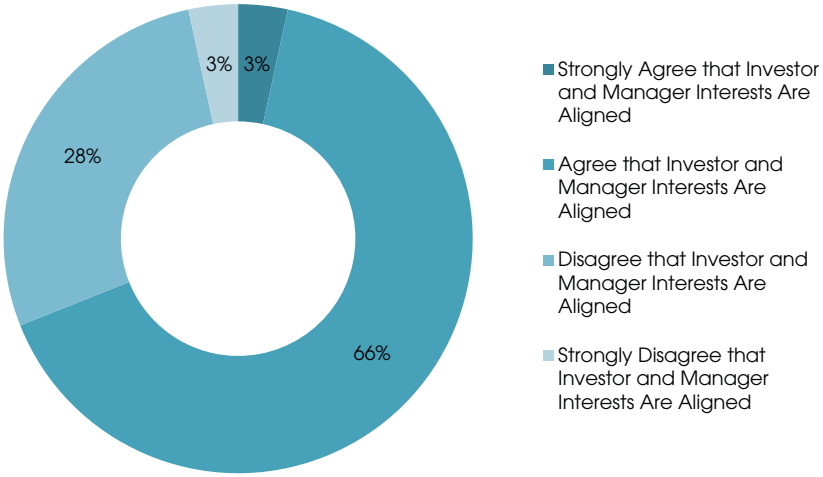
The fund terms attached to a hedge fund are an important consideration for an investor when selecting an investment opportunity. Central to these terms are the fees attached to the performance and management of hedge funds, which have evolved following several years of investor pressure to reduce fees and to better align the interests of fund managers and investors.

Alignment of Interest

Hedge fund managers strive to achieve the optimal balance of having appropriate fees and structures to run a fund efficiently while maintaining good value in order to attract investment. Sixty-six percent of hedge fund investors believe that fund manager and investor interests are aligned, while an additional 3% strongly agree with this assertion (Fig. 3.11). However, over 30% of investors believe their interests are not aligned with fund managers.

When considering how the balance of power between investors and managers has changed over the past 12 months, the majority of investors (61%) stated there had been no change (Fig. 3.12). There was, however, a notable proportion (33%) of investors interviewed that witnessed a shift in favour of the investor regarding the alignment of interests over the past 12 months, compared to just 5% that feel there has been a change in favour of fund managers.

Fig. 3.11: Investor Opinion on the Alignment of Interests between Investors and Managers

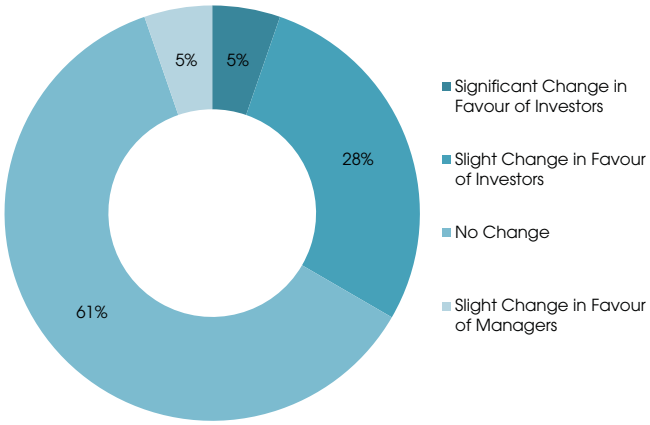


Source: Preqin Investor Interviews, November 2014

Fees

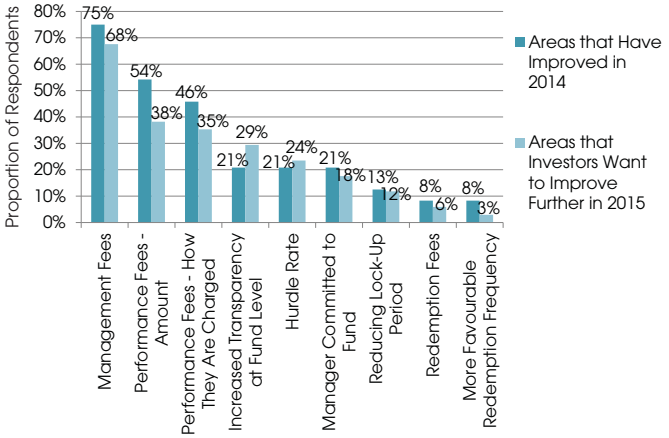
Although a large group of investors noticed a positive shift regarding fees, a high number of investors interviewed still want fees to improve in 2015 (Fig. 3.13). Managers have reacted positively to the growing pressure on management fees as three-quarters of investors noted an improvement in this area over the past year. However, with 68% of investors still seeking improved management fees over the next 12 months, there is clearly a degree of disparity between investor and manager interests on this subject. In fact, significantly more investors stated they wanted to see an improvement in management fees in 2015 (68%) than stated the same in our previous study for 2014 (45%). This highlights the growing concerns investors have surrounding fees, particularly in the low return environment of 2014.

Fig. 3.12: Investor Opinion on Changes in the Alignment of Interests between Investors and Managers over the Past 12 Months



Source: Preqin Investor Interviews, November 2014

Fig. 3.13: Areas of Fund Terms Investors Feel Have Shown the Most Improvement over the Past 12 Months and that Need to Improve Further in 2015



Source: Preqin Investor Interviews, November 2014

Investor Interest in Emerging Managers

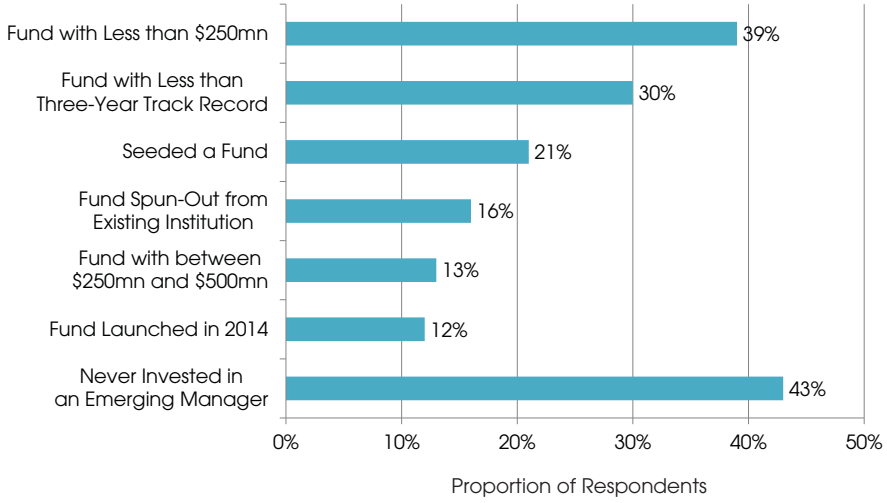
The challenge of being an emerging manager has increased in recent years, with growing competition against more established managers and higher barriers to entry as a result of regulation and the need for a robust quality infrastructure. However, some investors are keen to explore the unique offerings of small and emerging managers.

With an increased number of funds coming to market in recent years, the fundraising environment has become extremely competitive. Over the last few years, much of the inflows from institutions have gone to the larger managers. However, with over two-thirds of all hedge funds having less than $250mn in assets under management, Preqin turned its attention to small and emerging funds to assess institutional interest in these funds. Despite investors ranking an established fund track record and fund management experience highly (Fig. 3.10), 57% of investors have invested in what they would deem an emerging manager; Fig. 6.14 outlines the types of small or emerging funds to which institutional investors have allocated capital. The largest proportion (39%) has allocated capital to a fund with less than $250mn in assets under management.

Investors allocate capital to small or emerging hedge funds for a variety of reasons: their potential for higher returns, their ability to negotiate better fund terms with emerging managers, as well as their access to a unique strategy (Fig. 6.15). One US-based family office stated: "Emerging managers have a greater hunger to perform than established ones. Overall, through our emerging manager investments, we've been able to get the same performance at a cheaper cost."

Investors appear to have been satisfied with their portfolios of emerging hedge funds: 91% of emerging manager investors felt that their investments had met or exceeded expectations (Fig. 3.16). Despite track record and management experience being such a key factor in investors' decision-making processes for 2015, emerging managers may win institutional mandates if they can show strong performance and expertise in their field.

Fig. 3.14: Types of Small/Emerging Funds Invested in by Institutional Investors



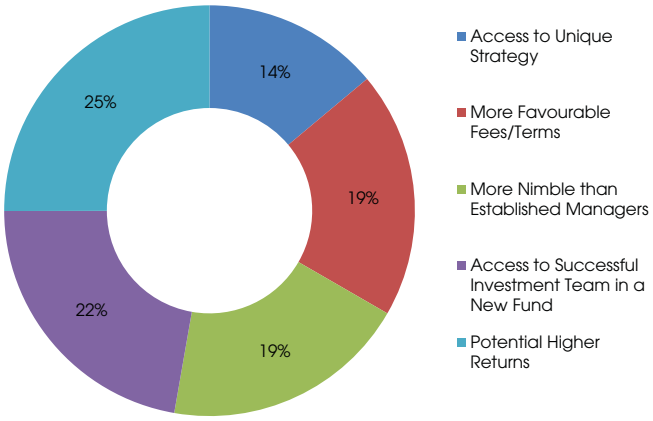
Source: Preqin Investor Interviews, November 2014

Data Source:

Preqin's **Hedge Fund Investor Profiles** features detailed profiles for approximately 1,200 investors that consider investing with emerging managers.

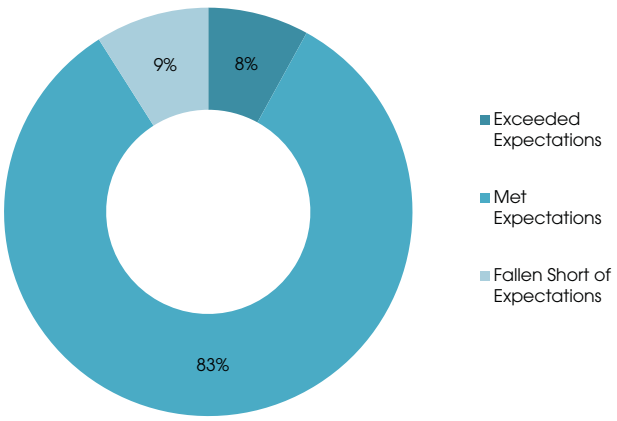
For more information, please visit: www.preqin.com/hfip

Fig. 3.15: Reasons for Investors Allocating Capital to Small/Emerging Hedge Funds



Source: Preqin Investor Interviews, November 2014

Fig. 3.16: Small/Emerging Hedge Funds' Performance Relative to Investors' Expectations



Source: Preqin Investor Interviews, November 2014

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The Fundraising Challenge in 2015

As the sector grows, the hedge fund industry has become evermore competitive. With more funds in market and investors becoming more demanding, it is vital that fund managers meet investor needs and structure their products to attract investor capital in 2015. In this section, we take a closer look at how successful fund managers were at amassing assets in 2014, and what managers can do to respond to the fundraising challenge in 2015.

Fund Managers Anticipate Industry Growth in 2015

80% Proportion of managers that believe industry assets under management will grow in 2015.

37% Proportion of managers that believe the challenging fundraising environment will be a key industry issue during 2015, after regulation (53%) and ongoing volatility (41%).

73% Proportion of managers that felt there was an increased level of competition in 2014.

Source: Preqin Fund Manager Survey, June 2014 and November 2014

Fundraising Opportunities for 2015

26% Proportion of investors looking to invest more capital in hedge funds in 2015.

Long/short equity funds are the most sought by investors in 2015 (as a proportion of investors searching for new funds).

35% Proportion of investors that believe North America will present the best opportunities in 2015.

Source: Preqin Investor Interviews, November 2014

Meeting Investors' Needs and Demands

40% Proportion of alternatives investment consultants that recommended an increase in investment in managed accounts in 2015.

66% Proportion of managers that have offered investors lower fees in return for terms more in their favour, such as longer lock-ups.

68% Proportion* of investors that want to see improvements to management fees in 2015.

Source: Preqin Investment Consultant & Fund Manager Survey, November 2014
** Of those investors that are unhappy with the alignment of interests between investors and managers.*

Leading Factors Used by Institutional Investors when Evaluating Fund Managers

46% - Management Experience and Background

45% - Strategy

44% - Returns

Source: Preqin Investor Interviews, November 2014

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NY 10165

Tel: +1 212 350 0100
Fax: +1 440 445 9595

London:

Vintners' Place
68 Upper Thames Street
London
EC4V 3BJ

Tel: +44 (0)20 3207 0200
Fax: +44 (0)87 0330 5892

Singapore:

One Finlayson Green, #11-02
Singapore 049246

Tel: +65 6305 2200
Fax: +65 6491 5365

San Francisco:

1700 Montgomery Street
Suite 134, San Francisco
CA 94111

Tel: +1 415 835 9455
Fax: +1 440 445 9595

Email: info@preqin.com
Web: www.preqin.com