HEDGE FUNDS REVIEW

Industry surveys paint a rosy picture

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Investors continue to harbour gripes about hedge funds, with concerns ranging from liquidity and transparency through to fee structures and the alignment of long-term interests. However, they still plan to pump a record amount of money into the sector in 2010.

Graphs - survey results (PDF)

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Investors expect to make significant allocations to hedge funds in 2010, according to a major survey of institutional investors conducted by Deutsche Bank in February.

Investors surveyed believed hedge funds will continue to generate strong performance in 2010, with 73% predicting inflows of at least $100 billion into the industry this year.

Deutsche Bank's own analysis indicated inflows could be as high as $222 billion in 2010. That would be a record, surpassing the $194.5 billion the industry attracted in 2007, according to figures from Hedge Fund Research. If it materialises, the projected inflow would bring total industry assets to $1.7 trillion, close to its peak in 2007.

Investors are keenest to allocate to funds investing in Asia and emerging markets. Equity long/short, distressed debt, global macro and event-driven funds were also popular among investors surveyed by Deutsche Bank.

Investors believe hedge fund performance will be strong in 2010. Almost 50% of investors said they expected their hedge fund investments to return 10%–15% in 2010. Less than 15% of investors think the S&P 500 will match those returns.

However, it was not all good news. Deutsche Bank found investors were allocating to fewer managers and favouring larger players. Half of the survey respondents said they would only invest in funds that had at least $100 million in assets and 42% said the average size of the hedge funds they invested in was over $1 billion.

Deutsche Bank said investors were rationalising their hedge fund portfolios due to the cost and time associated with conducting due diligence and a desire to monitor individual investments more closely.

There was also bad news for managers that restricted liquidity in the wake of the financial crisis: 80% of investors said they would not make new allocations to a manager that had suspended redemptions or created side pockets in the past.

Deutsche Bank surveyed 606 investors with a total of $1.07 trillion in hedge fund assets. Funds of funds accounted for 42% of the sample, with asset management companies and family offices accounting for a further 21% and 12%, respectively.

A separate survey by Bank of America Merrill Lynch (BAML) found institutional investors like pension funds, foundations and endowments were more forgiving of managers that imposed gates than Deutsche Bank's sample.

Investors responding to BAML's survey said it was appropriate for managers to restrict redemptions to protect longer-term investors. Of those surveyed only 29% said they would not invest in a manager that had imposed gates in the past while 61% said they would consider the circumstances under which a manager suspended redemptions or gated and evaluate them on a case-by-case basis.

BAML's study found institutional investors' primary concern was ensuring a proper alignment of interests with hedge fund managers. That has led to an increased focus on the fee structures and liquidity terms offered by hedge funds.

Institutional investors said they planned to hold their hedge fund investments for longer than the one calendar year on which performance fees are calculated. They expect to see this reflected in compensation structures.

BAML found support among investors for rolling incentive fee structures, hurdles and fee deferments. Because investors do not want to pay hedge fund fees for beta returns, the concept of an ex post-beta fee adjustment has also gained traction.

On liquidity terms investors generally have less tolerance for lock-ups in relatively liquid strategies but are still prepared to accept them in strategies like distressed debt or activist investing. Asked about the maximum lock-up that they would consider, more than 50% of respondents said they would invest in hedge funds with lock-ups longer than two years, provided this is necessary to properly execute the strategy.

The surveys showed interest in managed accounts had reached a plateau. Only 26% of investors responding to Deutsche Bank's survey said they were more likely to invest via managed accounts in 2010, compared to 43% in 2009.

BAML reported around a third of investors already used or planned to use managed accounts, while around 66% said they had no plans to do so. Researchers at the bank concluded demand for managed accounts may have peaked.

Deutsche Bank was far more bullish on managed accounts. It said the number of investors using managed accounts had grown from 9% in 2009 to 14% in 2010 and predicted the number of investors employing managed accounts would continue to rise in the coming years.

Of the investors who already use managed accounts, 47% are funds of funds, according to the Deutsche Bank survey. Pension plans and private banks are also significant users of managed accounts.

Deutsche Bank also found clear demand for Ucits-compliant hedge fund structures. Around a third of investors surveyed by the bank said they had already invested in Ucits hedge funds or would do so during the next 12 months. Of those, 74% were based in Europe, 16% in the US and 6% in Asia.

Among funds of funds, 5% said they had already set up a vehicle to invest purely in Ucits-compliant hedge funds, and 11% said they planned to do so in the next 12 months.

Deutsche Bank estimates there are around 256 single-manager hedge funds operating within a Ucits wrapper, with combined assets of $47 billion. It expects the number of Ucits-compliant hedge funds to hit 400 by the end of the third quarter of 2010.

Taken together the surveys suggest the outlook for hedge funds is overwhelmingly positive. Institutional investors surveyed by BAML said they remained committed to investing in hedge funds, citing diversification and uncorrelated absolute returns as the main reasons for doing so.

“This audience remains consistent in their approach to the space, with a majority of institutional investors indicating that their original premise for investing in hedge funds is still valid,” said BAML in the report that accompanied its survey.

That view is supported by a separate survey conducted by SEI Investments, which found that nearly 80% of institutional investors had no plans to change their hedge fund allocations in 2010, while 15% said they expected to increase allocations.

Institutional investors were the biggest drivers of inflows into hedge funds in 2009, with US public pension plans being the most active, according to Deutsche Bank.

Last year saw the return of European investors to the industry. Of those investors making more than 10 allocations to hedge funds in 2009, 54% were European, according to the Deutsche Bank survey.

Deutsche Bank said it was “surprised that European investors in 2009 have been so active.” One explanation is that many of the European investors that redeemed in 2008 have started to return to the industry.

A separate survey by Capintro Partners found increased appetite for hedge funds among investors in the Middle East. Over a third of respondents to Capintro’s 2010 Middle East hedge fund investor survey said they intended to increase allocations to hedge funds, while less than 10% said they intended to decrease allocations.

The results are in stark contrast to 2009, when 55% of respondents said they planned to decrease allocations.

The majority of Middle Eastern investors said they favoured funds offering monthly liquidity. More than a quarter said they would require the funds they invest in to provide position-level transparency.

Three quarters of investors said they were happy with reports outlining the fund’s overall portfolio exposure.

Middle Eastern investors also said they favoured long/short equity, global macro and distressed debt strategies. The vast majority of investors said they would only invest in funds that targeted volatility of below 7% annually.

There was limited interest in Shariah-compliant hedge funds, with only 19.7% saying they invest in them.

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