

Split Decisions

INSTITUTIONAL INVESTMENT
IN ALTERNATIVE ASSETS

 BNY MELLON

FT Remark
Research from the FT | Times Group



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Foreword

The last few years have been interesting times indeed for institutional investors. Many, such as insurance companies, have faced increased regulation with higher capital adequacy ratios, and all have grappled with lower returns from more traditional investments as the low interest rate environment has persisted at a time of slow global growth.

Public markets have been subject to violent swings and oil prices have risen sharply only to fall back again to levels last seen a decade ago. Generating returns in such an environment is challenging and requires investors to consider three main avenues for achieving good outcomes for their portfolios. First, using leverage to magnify returns; second, identifying (and getting comfortable with) increasing concentration in specific sectors or investment styles; and third, moving down the liquidity spectrum to consider investments with long time horizons. The various investments that make up the alternative investment landscape offer opportunities for some or all of these three return-boosting strategies, and that helps explain why alternatives are gaining ground in institutional portfolios, often at the expense of more traditional asset classes. As our study shows, appetite for alternatives is set to rise further over the coming years. This is the result of strong returns generated by alternative strategies, both on an absolute and relative basis. However, our study also demonstrates that, despite the increasing flows of capital to alternative assets, fund managers have to adapt and innovate to attract a share

of this. Investors may be keen on alternatives, but they are increasingly discerning about where and how they deploy their capital. Importantly, they are also acutely aware of the erosive effect of fees on their returns, which is exerting pressure on the traditional 2 and 20 model that alternative investment fund managers have become accustomed to. These trends are leading to wide-ranging changes in the alternatives space, from the development of new products and structures such as managed and separate accounts, liquid alternatives in the hedge fund space and the rise of co-investments in private equity. We are also seeing a bifurcation between larger players that are seeking to offer investors a range of alternative strategies under one roof and those that are carving out a niche for themselves to specialize in a particular area or strategy. The upshot, for investors, is an increasing array of choices in what was once a small corner of the investment landscape and is steadily becoming an integral part of the institutional portfolio. The alternative investment asset class is maturing – and it’s maturing fast.



Frank La Salla
Chief Executive Officer, BNY Mellon
Alternative Investment Services

Key Findings

- » Private equity is the most popular alternative investment strategy, accounting for 37% of investors' alternative exposure, followed by infrastructure and real estate, both just under 25%. Private equity is also set for the most growth, with 53% of investors saying they will increase their allocation over the next 12 months.
- » Fees are firmly in investors' sights, with 62% saying they will look for lower private equity fees in the next 12 months and 63% saying the same about hedge funds. Transparency and performance are also hot buttons for investors in both types of alternative, with around half saying they will focus on these areas when investing over the next 12 months.
- » Alternative investments have generated strong returns for investors, with 93% saying they had met or exceeded expectations over the last 12 months. Private equity appears to have outperformed its alternative peers, with 97% saying returns had met or exceeded expectations.
- » In private equity, secondaries investments look set for growth, with 77% of investors seeking to increase their sales in the secondaries market and 63% looking to buy more commitments via secondaries.
- » Overall, the majority of respondents (65%) said that alternatives had returned at least 12%, with over a quarter (28%) reporting performance of 15% or more. Hedge funds have generated the most exceptional returns, with over a tenth (12%) of respondents saying net historical returns had been 18% or more.
- » In hedge funds, distressed strategies top the list of most attractive in the current and future environment: 68% of investors currently have exposure to this strategy and 57% rank it as one of the three most attractive strategies over the next 12 months.
- » Emerging markets now make up 31% of institutions' alternative investment exposure, although further growth looks limited – investors are planning to allocate 34% of alternative investment to emerging markets.



The Asset Allocation Landscape

As alternative asset classes rise up the allocation agenda, we investigate the current climate and look to the future

Over the last few years, alternative investment strategies have earned their place in institutional investors' portfolios. According to the Financial Times, total global alternative assets under management hit US\$6.3 trillion in 2014 – an increase of 10% on 2013. And while alternatives still only represent a relatively small part of their overall investment allocations, their share is rising. Indeed, the category has more than doubled in size since 2005.

Institutional investors are increasingly finding that alternative investments can provide diversification benefits and move the needle on their overall returns, particularly as some more traditional asset classes have seen their returns fall in a low to zero interest rate environment.

“Change is being driven by two ends of the market: the large institutional investors and the retail investors. As a result, hedge funds are going to start looking more like asset managers with a suite of products – from limited partnership investments, managed accounts to UCITs and 40 Act funds.”

– Bill Santos, Managing Director, HedgeMark

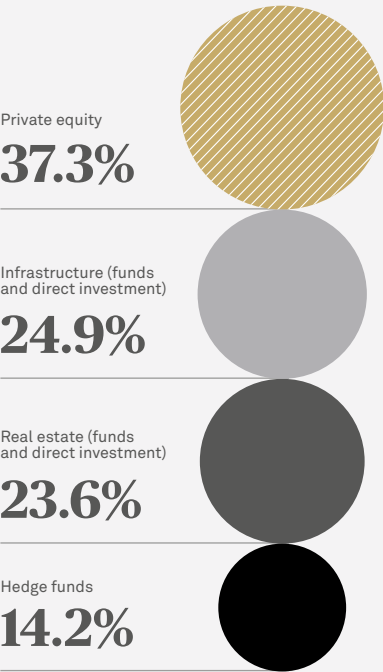
The Asset Allocation Landscape

THE LEADING ALTERNATIVE

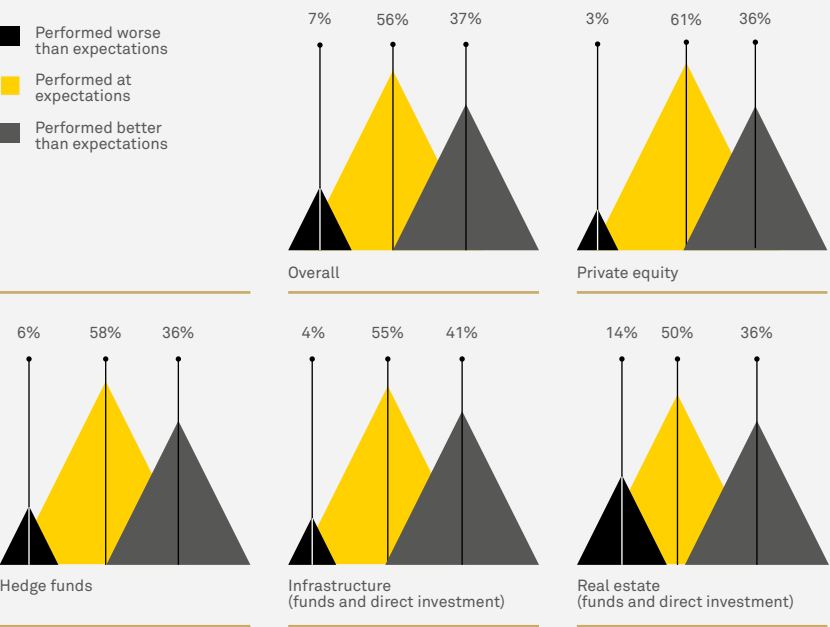
The survey reveals that private equity (PE) currently accounts for the largest share of institutional investors' alternative asset allocations, with 37.3% on average among our respondents. This reflects the PE industry's continued strength and global growth, meaning institutional investors can now achieve geographic diversification through this type of investment, as well as diversification by company stage and – to some extent – by market cycle.

Infrastructure (24.9%) and real estate (23.6%) investments are second and third on average by share of alternatives allocations, with both averaging just under a quarter, and hedge funds make up around 14.2% of institutional investors' alternatives exposure.

HOW IS YOUR ALTERNATIVE PORTFOLIO CURRENTLY ALLOCATED BETWEEN THE FOLLOWING ALTERNATIVE INVESTMENT TYPES? (MEAN PERCENTAGE)



FOR EACH OF THESE ALTERNATIVE INVESTMENT TYPES IN WHICH YOU ARE INVESTED, HOW HAVE THEY PERFORMED OVER THE PAST 12 MONTHS RELATIVE TO YOUR EXPECTATIONS FOR THE ASSET CLASS?



HAPPY RETURNS

According to our survey, institutional investors are generally satisfied with the returns they have generated through their alternatives exposure, with an overwhelming majority reporting that the performance of their investments in each of the alternative asset classes has either exceeded or met their expectations over the last 12 months.

Across all asset classes, an average of 56% said that their alternative investment returns had met their expectations, while 37% said that their expectations were exceeded. The findings for each class were fairly uniform, with the exception of real estate, for which a notable 14% felt that the asset class had underperformed their expectations.

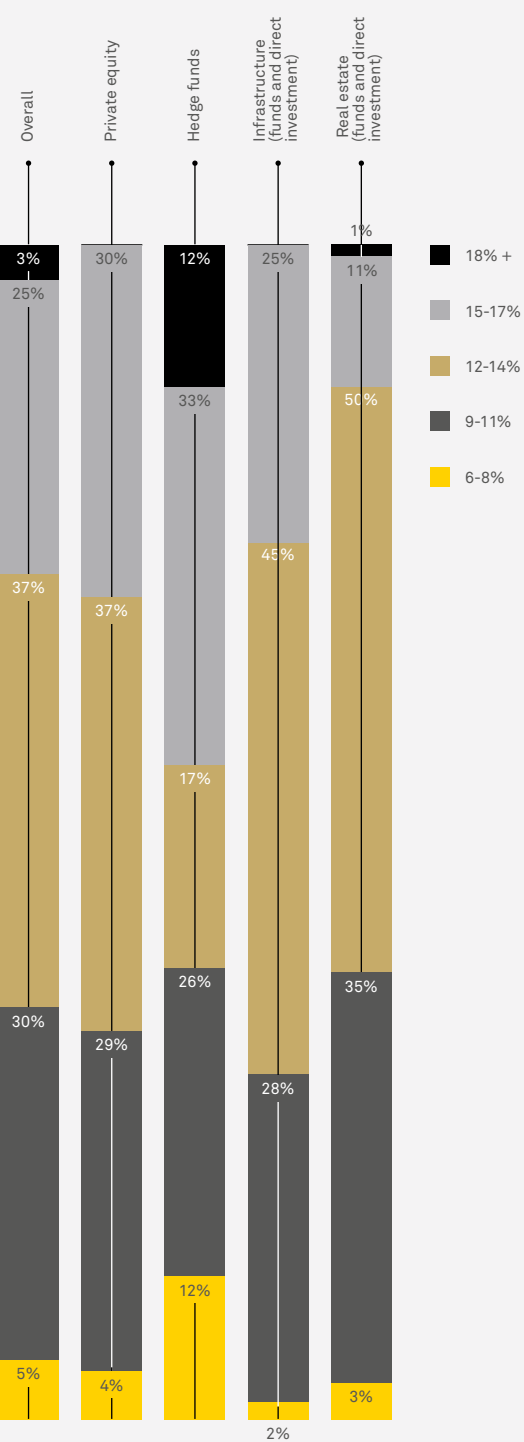
In terms of historical performance, some 65% of institutional investors report that alternative investments

have returned at least 12% on average, including 28% that report performance of 15% or more. For infrastructure, 70% of respondents report historical performance of between 12% and 17%. PE is not far behind, with 67% of institutional investors citing this range.

Historically, hedge funds were the most likely to generate exceptional returns, with over a tenth (12%) of respondents reporting net returns of 18%. However, this is balanced by the fact that 12% said that they had generated returns of just 6% to 8%.

Meanwhile, real estate has delivered lower returns on average, with only 11% of respondents saying that this asset class generated 15% to 17% returns compared with 25%, 33% and 30% for infrastructure, hedge funds and PE respectively.

FOR EACH OF THE ALTERNATIVE INVESTMENT TYPES IN WHICH YOU ARE INVESTED WHAT RATE OF LONG TERM (10-15 YEAR) NET RETURN HAVE YOU HISTORICALLY ACHIEVED?



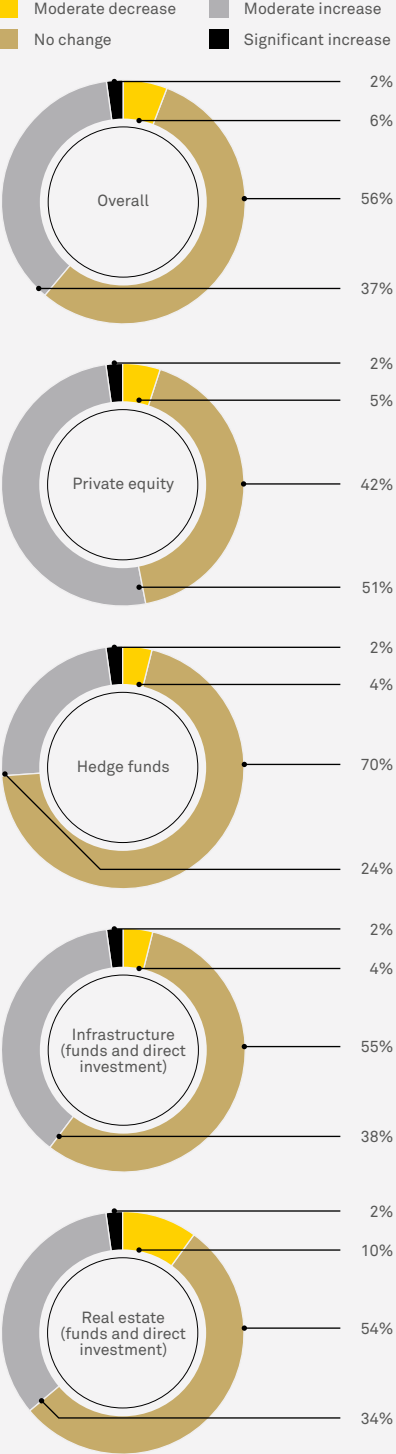
FUTURE ALLOCATIONS

With the majority of respondents reporting that returns from their alternative investments had met or exceeded their expectations over the past year, it is unsurprising that the majority of respondents are looking to maintain or increase their allocations to these asset classes over the next 12 months.

Across the four assets classes, 39% are looking to increase their allocation in the next 12 months. Indeed, over half of respondents (53%) say they are looking to increase their allocation to PE, over a third (36%) of respondents are seeking to up their exposure to real estate, 40% to infrastructure and over a quarter (26%) to hedge funds.

In contrast, only a very low proportion of institutional investors are seeking to reduce their allocations to alternatives, with real estate the asset class most likely to be singled out for a reduction, with 10% of respondents saying they will allocate less to this asset class, perhaps reflecting concerns that the cycle is starting to turn in this area of the alternatives space, particularly in markets such as China.

FOR EACH OF THESE ALTERNATIVE INVESTMENT TYPES DO YOU PLAN TO CHANGE YOUR ALLOCATION OVER THE NEXT 12 MONTHS?



The Asset Allocation Landscape

LOCAL FOCUS

The financial downturn led many institutional investors to broaden their horizons in a bid to capture the growth outside of their own domestic market. However, our survey reveals that for future allocations, institutional investors will remain heavily biased towards their own region for most alternative investment types.

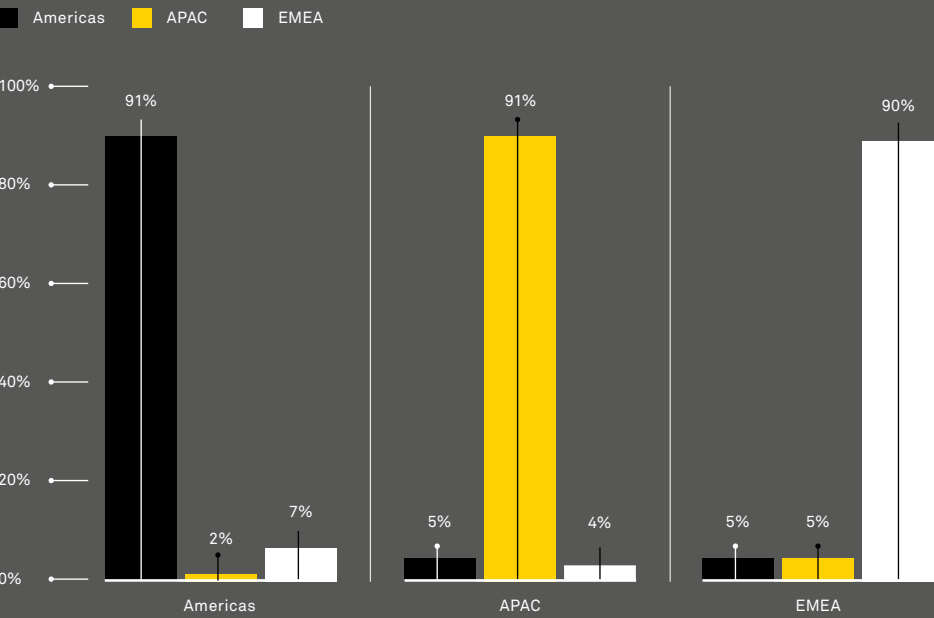
This is particularly true for PE with more than 90% of respondents indicating that they would most like to increase exposure to their own regional market when considering further investments. For hedge funds, there is slightly more willingness to explore global opportunities, driven by demand for Americas based assets. Some 34% of EMEA based investors say that they would most like to increase their exposure to the US, while the same is true of 12% of APAC based investors. Meanwhile, for infrastructure, local opportunities again dominate, although 17% of Americas based firms and 8% of EMEA based firms do say that they would most likely increase their exposure to the APAC region.

“Hedge funds will offer decent returns for the significant risks taken as long as the issues of interest alignment, less liquidity and higher fees are addressed.”

– US-based Chief Investment Officer

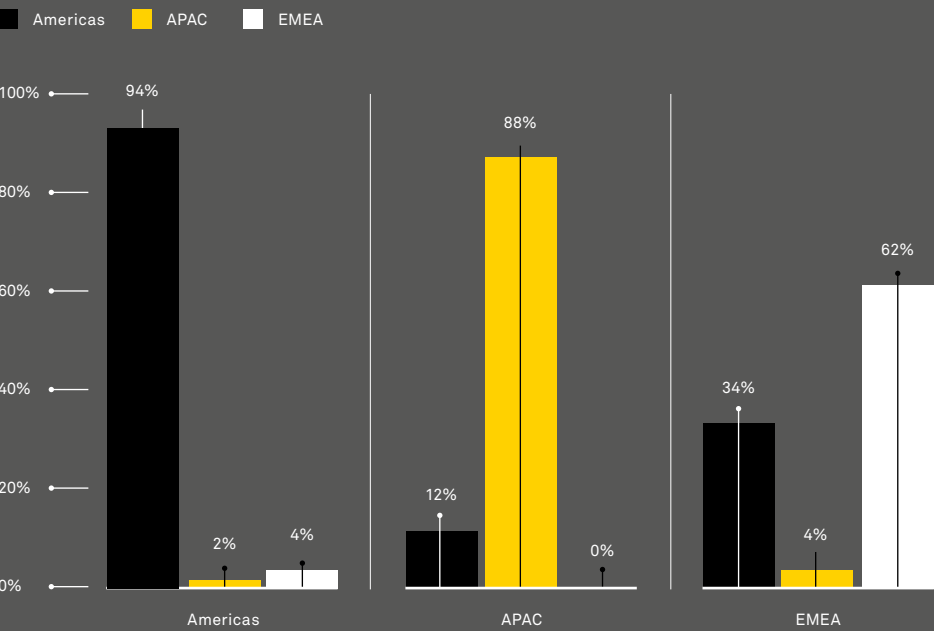
Private Equity

FOR PRIVATE EQUITY, PLEASE INDICATE THE REGION THAT YOU WOULD MOST LIKE TO INCREASE YOUR EXPOSURE



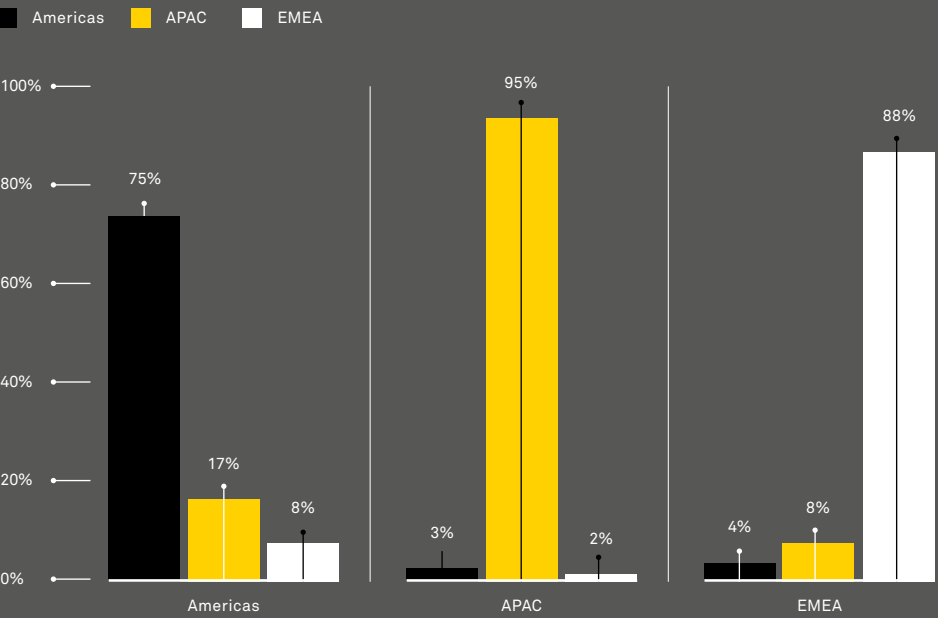
Hedge Funds

FOR HEDGE FUNDS, PLEASE INDICATE THE REGION THAT YOU WOULD MOST LIKE TO INCREASE YOUR EXPOSURE



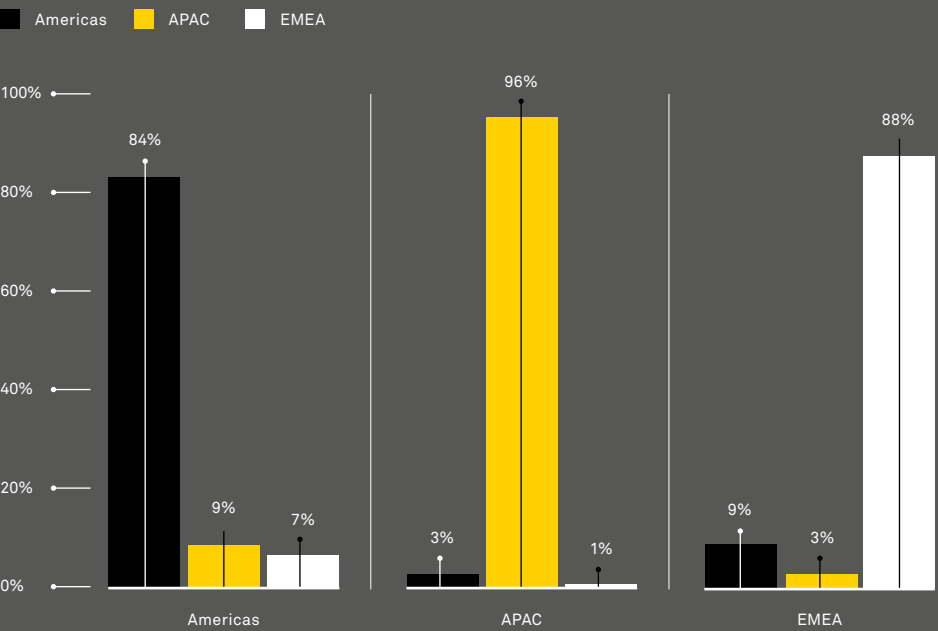
Infrastructure

FOR INFRASTRUCTURE, PLEASE INDICATE THE REGION THAT YOU WOULD MOST LIKE TO INCREASE YOUR EXPOSURE



Real Estate

FOR REAL ESTATE, PLEASE INDICATE THE REGION THAT YOU WOULD MOST LIKE TO INCREASE YOUR EXPOSURE



“In some areas of alternatives there is an issue of greater demand among institutional investors than there is supply of opportunities. That clearly affects managers’ ability to sustain performance over the long term or find the assets that can reach the required return. Investors therefore need to ensure their due diligence looks very closely at what is driving current performance to judge whether that is sustainable.”

– Mark Mannion, Head of Relationship Management, BNY Mellon

The Asset Allocation Landscape

MISSED OPPORTUNITIES?

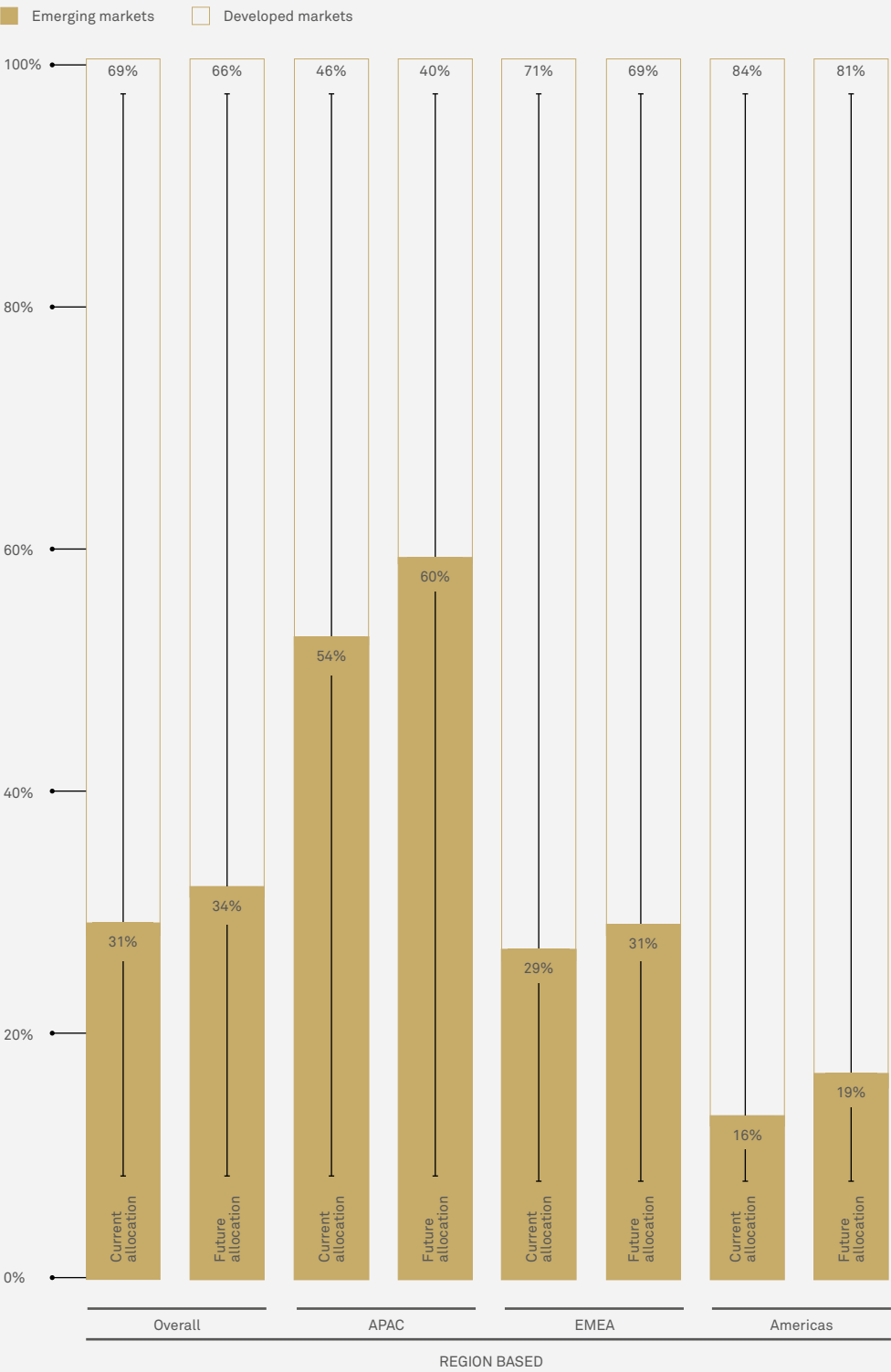
The survey finds that emerging markets now make up over 31% of institutional investors' alternative investment allocations. For APAC-based institutional investors, emerging market-based investments account for 54% of alternative portfolios, but this figure is significantly lower for companies based in EMEA (29%) and the Americas (16%).

Any further shift towards emerging markets looks likely to be fairly gradual. Overall, institutional investors plan to allocate 34% of their alternative allocation to emerging market-based assets in future, with APAC investors again driving this figure (60%), followed by EMEA (31%) and the Americas (19%).

As such, it is possible institutional investors based in EMEA and the Americas are missing out on some compelling growth opportunities. Population growth is set to continue in many of these markets – the UN projects that among the 15 countries expected to have the largest population, only one is developed – the US. Alongside that, there is a larger middle class emerging as incomes rise – professional services firm EY estimates that over the next 20 years, the world's middle class will expand by 3 billion people – with most of this coming from the emerging markets.

Meanwhile, as urbanization continues apace, together with the rapid development of new investment opportunities, the longer-term picture for emerging markets' alternative assets is underpinned by strong fundamentals.

WHAT PROPORTION OF YOUR CURRENT ALLOCATION TO ALTERNATIVE INVESTMENTS IS FOCUSED ON EMERGING MARKETS COMPARED TO DEVELOPED MARKETS? AND YOUR FUTURE ALLOCATION?



Key Insights



Allocations to alternatives have clearly increased over recent years and, as our results demonstrate, some parts of the alternative space – most notably private equity – are set for further rapid growth. This is supported by institutions experience of strong return generation in the last few years.

Yet such rapid growth is not without risk. Investors need to ensure that their due diligence focuses on managers ability to continue delivering outperformance in an environment where competition for returns is ramping up. Institutions may also need to take a contrarian view in their alternatives allocations by seeking out dislocations in the market. Recent years have seen private equity and hedge fund managers diversify into more specialist strategies, such as credit, distressed debt or even direct lending, as banks have moved out of the space, providing investors with new investment types and good return prospects.

And the continued volatility in oil prices and stock markets may well provide opportunities for those most able to identify managers well equipped to profit from the uncertainty this causes.

This rapid growth also means that institutions should be looking further afield for investment opportunities. While the local bias to which our survey points has long been a feature of institutions alternatives investment strategy, there is a risk that investors are not casting the net widely enough in their allocations. As due diligence requirements on managers have become more stringent in the wake of the crisis, investors' ability to carry out the necessary checks can be somewhat constrained by distance. However, investors should consider investing in fund of funds or similar vehicles to gain a broader geographic spread, achieve greater diversification and generate returns in newer growth markets.

“Very few investors and asset managers in the US and Europe understand just how radically Asia is going to change the alternatives space over the next decade. The sheer scale of allocation capital that will come out of the newly enriched Asian investor base will dramatically alter the way business is conducted. As a source of allocator assets and investment opportunity, Asia will increasingly become equal to, or even larger than, US and European counterparts.”

– Ed Rogers, CEO, Rogers Investment Advisors

“If investors are to continue generating strong returns from their alternatives allocations, they need to seek out dislocations in the market. Rather than fleeing from volatility, they need to look for, and work out how to profit from, more difficult situations.”

– Robert Chambers, Head of Global Product Management, BNY Mellon



Private Equity's Evolution

Private equity has the largest share of exposure among institutional investors. We reveal investor attitudes to PE and what the future holds for the asset class

With more than half of the institutional investors surveyed planning to increase their allocation to PE, there looks set to be a continued strong demand for the asset class going forward. As a reflection of this there is a clear trend for larger firms raising multi-billion dollar funds to cater to this demand. As an example, by the end of 2014, seven of the year's biggest buyout funds brought in more than US\$5 billion each, and all of them met or exceeded their targeted fundraising goal.

At the same time, some smaller funds that follow a more specialist strategy have grown in popularity among investors that are seeking to gain access to particular market niches.

Private Equity’s Evolution

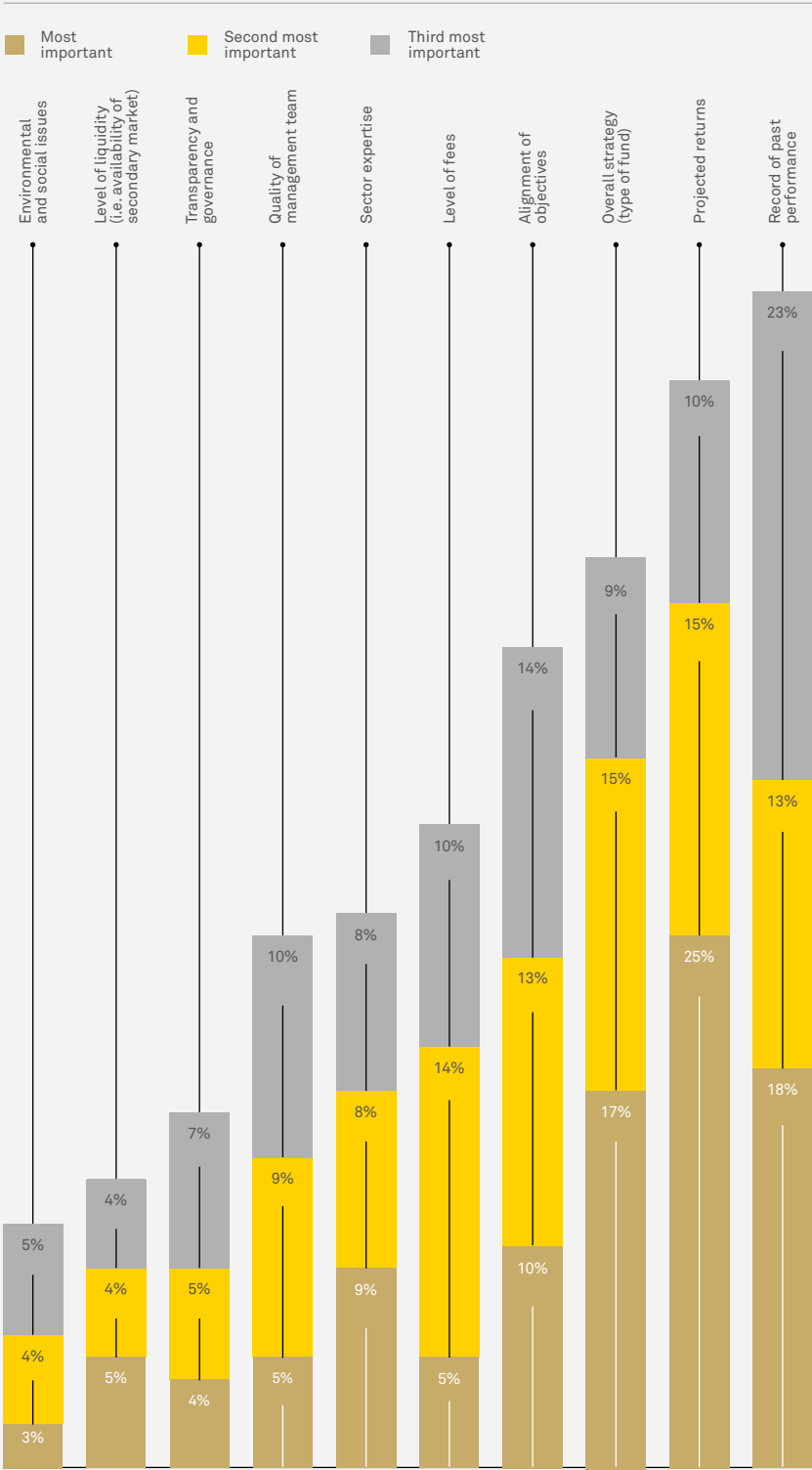
THINKING STRATEGICALLY

When considering a commitment to a PE fund, there is a range of factors that come into play. For our respondents, projected returns are top-of-mind, with 25% rating this factor as the most important and 49% seeing it as one of the top three most important criteria when making a PE fund investment.

Past performance is another important factor for investors, cited as the top consideration by 18% of respondents and the most commonly mentioned factor in the top three considerations. This is unsurprising, given the fact that investors are committing to a blind pool – they are seeking evidence that the manager they are backing has exercised the discipline and judgment necessary to generate strong returns as they have little or no visibility on what the portfolio will ultimately contain.

The fact that alignment of objectives and fee levels ranked fairly highly (fourth and fifth, respectively) reflects the overarching environment in which PE operates today. Increased regulatory scrutiny, particularly in Europe and the US, together with concern among many investors that PE’s terms and conditions need to shift more in their favor, has put the spotlight on the types and amount of fees charged by PE funds and the related issue of ensuring that interests are aligned between fund managers and their investors.

WHAT ARE THE MOST IMPORTANT FACTORS YOU CONSIDER WHEN MAKING AN ALLOCATION TO A PE FUND?



SPECIALIST VS GENERALIST

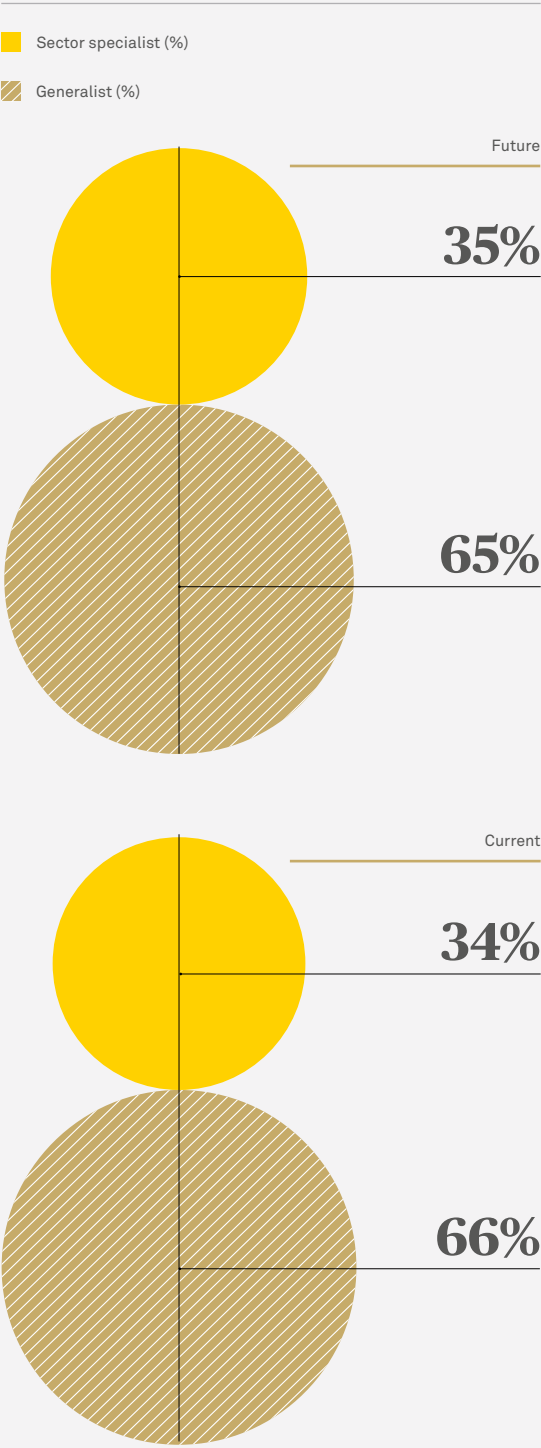
A comparatively modest 9% of respondents point to sector expertise as the most important factor (and it ranks an overall sixth in importance), yet a number of respondents believe that specialist knowledge can bring value to investments.

On average, 34% of respondents have current PE commitments to sector specialists. These respondents are vocal about the benefits of doing so. An Americas-based investment manager comments: “Sector specialists offer in-depth information and can understand better the life cycle of the investment. They will often offer more meaningful insights on the reasons to pursue an investment with better explanations.”

Sector specialists are well established in the US, where the PE market is more mature and funds have sought to differentiate their investment strategy from the competition. They are far less common in less mature markets such as Europe, Asia and Latin America, although as these markets develop further, more sector specialists are likely to emerge.

Still, the majority of respondents’ PE investment (66%) is with generalist firms, with this proportion staying constant in the future. This is likely to reflect institutional investors’ desire to achieve diversification across industries and strategies through their PE investments. While there is clearly room in institutional investors’ portfolios for specialist strategies, generalist approaches to portfolio building help with risk management and mitigation.

WHAT PROPORTION OF YOUR PE ALLOCATION IS CURRENTLY ALLOCATED TO GENERALIST INVESTORS COMPARED TO SECTOR SPECIALIST INVESTORS? AND IN THE FUTURE? (MEAN PERCENTAGE)



FUNDS VS SEPARATE ACCOUNTS

One growing phenomenon in the world of PE is the use of separate accounts. In general, these accounts, in which a client’s capital is invested separately rather than in a traditional fund, offer cheaper fees and greater control over drawdown schedules for investors. According to research group Preqin the number of separate accounts more than doubled from 46 accounts in 2005 to 93 in 2014. The news that the California Public Employees’ Retirement System, the biggest US pension, would look to pursue separate accounts will only alert others to the benefits of such investments.

“There is increased room for specialists in alternatives, including private equity, but especially hedge funds, where many are now focusing on areas such as credit and distressed debt strategies. Hedge funds are also moving into direct lending as banks have retrenched from these activities. These are strategies where hedge funds can add value.”

– Mark Mannion, Head of Relationship Management, BNY Mellon

Private Equity’s Evolution

LOOKING AHEAD

Indeed, the cheaper fees that separate accounts offer will also be a major factor in their continued rise. Fee structures look set to dominate discussions between potential investors and the funds to which they are seeking to commit to in the coming year. Nearly two thirds of respondents (62%) said they would look for lower management fees over the next 12 months. While investors have long complained about the high fees charged by PE funds, it is only recently, with increased regulatory oversight of the industry, that investors have started pushing harder on this area. “Fees could change, as the PE industry has been pressured on some aspects, such as transparency and governance,” comments a director of investment based in EMEA. “The PE industry has huge growth potential but this is dampened due to unreasonable fees.”

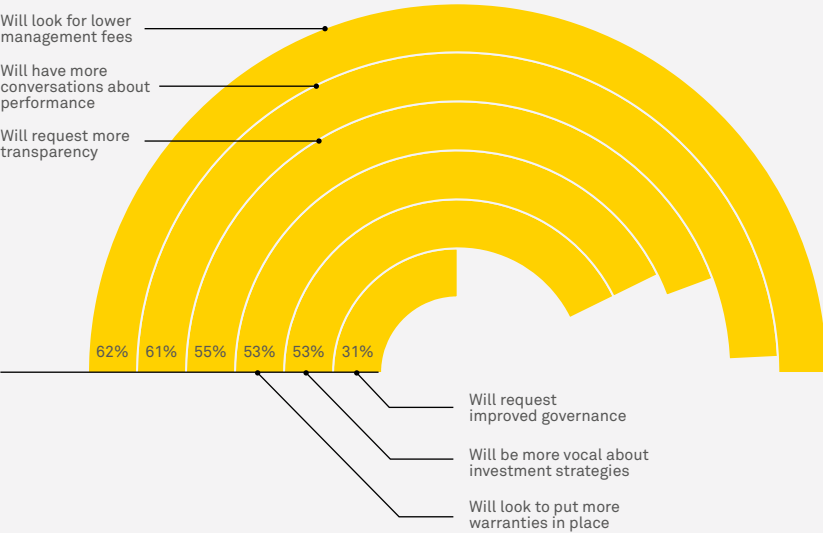
While there may be some movement on fees, many investors are seeking alternative ways of accessing the market to reduce the fee burden

on their PE portfolios. Some, for example, are committing large amounts of capital to funds through separately managed accounts in return for lower fees, while others are asking for co-investment rights when committing to a new fund – these direct investments made alongside fund managers generally attract lower management fees.

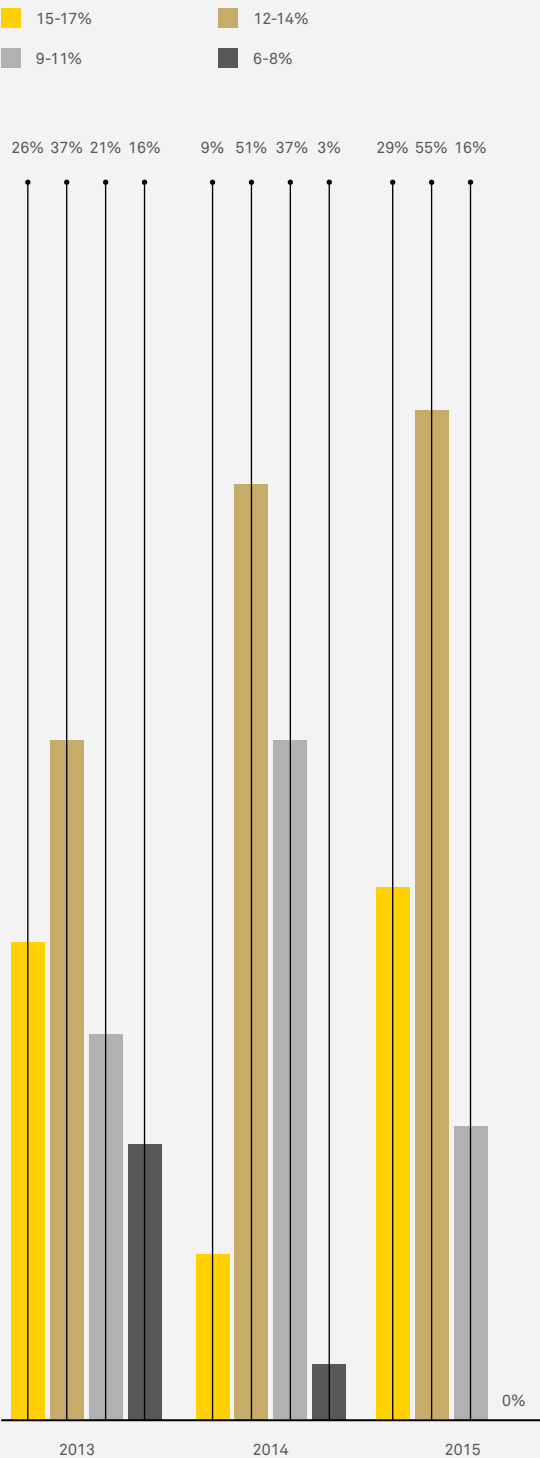
Other hot buttons for investors will be more discussions around performance (mentioned by 61% of respondents), more requests for transparency (55%), a greater use of warranties and more debate around investment strategies (53% each).

In terms of results for investments made in 2015, respondents are optimistic: 84% are expecting returns of 12% or greater. This compares with 60% in 2014 and 63% in 2013. Interestingly, respondents are more conservative for their PE investments made in 2014 than in respect of those made in either 2013 or 2015, with only 9% anticipating returns from 15% to 17%.

IN WHICH WAYS DO YOU EXPECT YOUR APPROACH TO INVESTING IN PE TO CHANGE IN THE NEXT 12 MONTHS? (SELECT ALL THAT APPLY)



WHAT NET RETURNS ARE YOU TARGETING FOR YOUR PRIVATE EQUITY INVESTMENTS OF THE FOLLOWING VINTAGES?



GROWTH IN THE SECONDARIES MARKET

The private equity secondaries market has grown significantly over recent years to provide increased liquidity to sellers. For buyers, it is offering investors opportunities to follow a faster route to good returns, gain diversification by fund vintage year and greater visibility on the investments they make (compared with the blind pools inherent in primary fund investing).

PE secondaries funds raised a total of US\$27 billion globally by the end of 2014, up from just US\$9.9 billion in 2011, according to Preqin figures, with 2015 looking like another good year (by June, secondary funds had raised US\$10.4 billion).

Adding to the strong fundraising environment is the fact that many more investors are now looking to sell their positions on the secondaries market. Part of this is driven by increased valuations, with some funds trading at close to par (as opposed to double-digit discounts seen more historically), which is encouraging investors to sell. However, the longer-term driver is the maturity of PE as an asset class. Where previously PE fund sellers were often distressed, there are now many long-established investors in PE funds looking to clean up their portfolios and reduce the number of PE fund relationships they manage.

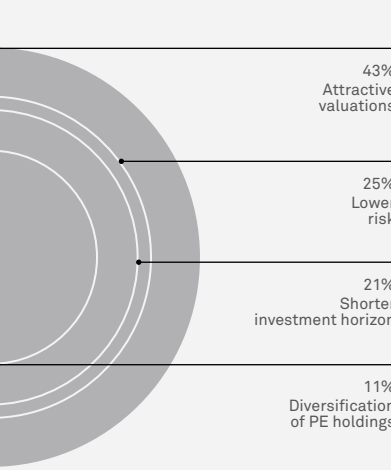
The vibrancy of this part of the PE market is apparent in the responses to our survey. Over three quarters (77%) of respondents said they currently access the secondaries market to acquire PE fund commitments and half said they would sell fund positions in the market. Looking ahead to the next 12 months, 72% of respondents said they would increase their sales of commitments in the

secondaries market, including 11% that expected to significantly increase this activity. In addition, a total of 63% said their acquisition of secondary positions would increase over the coming year.

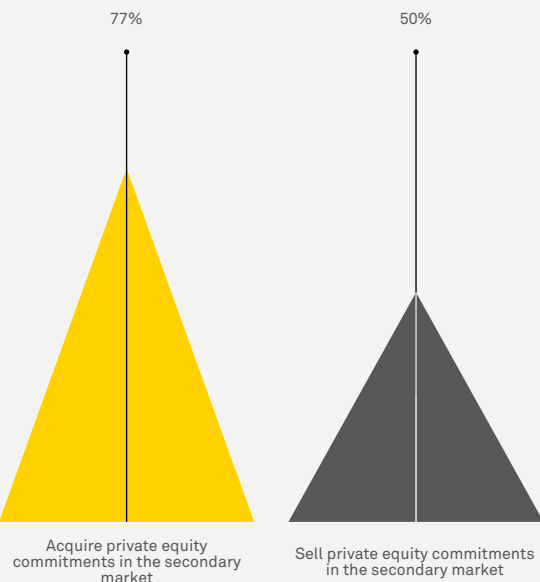
While good valuations are the primary attraction for institutional investors in our survey, cited by 43%, a significant minority (25%) said lower risk was the most important feature of the secondaries market. This is reflected in a comment made by an Asia-Pacific based chief investment officer, who says: “There is a robust and maturing secondary fund market, which has attracted investor attention as the returns are more promising and the risks are lower compared with the other types of funds.”

A shorter investment horizon and increased diversification were also cited as important factors in institutional investors’ decisions to make secondary fund investments.

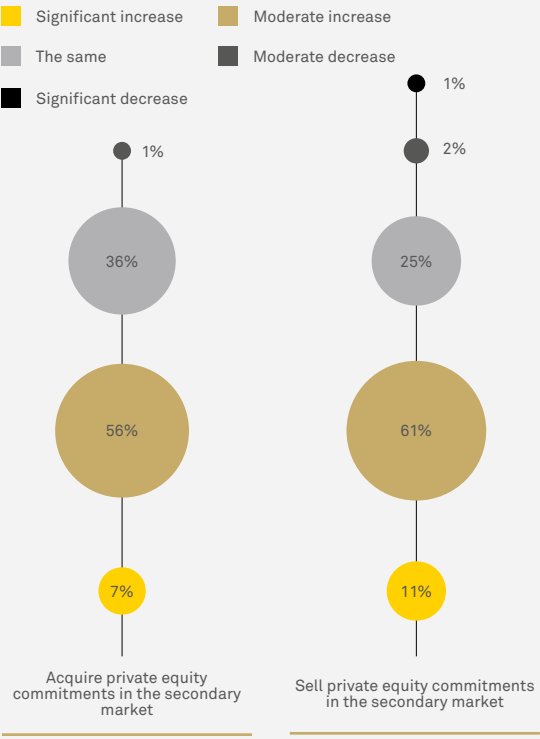
WHAT IS THE MOST IMPORTANT FEATURE THAT ATTRACTS YOU TO MAKING ACQUISITIONS IN THE SECONDARY MARKET?



WHICH OF THESE ACTIVITIES DO YOU CURRENTLY UNDERTAKE?



FOR EACH OF THESE ACTIVITIES DO YOU EXPECT TO DO MORE OR LESS OVER THE NEXT 12 MONTHS?



Key Insights

The development of separate accounts and co-investments speaks to the increased maturity of the private equity market as investors seek greater control over their allocations to this part of the alternatives space, improved economics and greater flexibility over capital calls and drawdowns. It is also bringing about changes to private equity structures as investors seek alternatives to the traditional ten-year vehicle predicated on a 2 and 20 fee model.

“Institutional investors have much more control over capital calls and investment term with separate accounts and co-investment than with a traditional fund - they may not want to be locked into a ten-year term or they may be happier with a longer lifespan. So their appetite for separate accounts and co-investments is creating a shift by challenging the structures traditionally used by private equity.”

– Mark Mannion, Head of Relationship Management, BNY Mellon

Such developments provide investors with clear additional benefits, such as improved transparency and reporting, as well as greater insight into how managers operate and reach investment decisions. However, while their use will continue

growing, these tend to be structures that are best suited to larger investors – those that can commit large amounts of capital (in the case of separate accounts) and those with the resources and procedures that allow them to make timely decisions about whether to invest directly in a private company (in the case of co-investments). In addition, investors should take note that managers do not always take a stake in the investments made by single managed accounts or separate accounts, thereby eroding one of the fundamental principles of the private equity model of alignment of interest. Institutions need to consider this last point carefully when ensuring due diligence processes.

And, as we noted in Chapter 1, the creation of more specialist private equity strategies, either in terms of sector or investment type (credit funds, for example), can provide attractive return potential at a time when the industry is expanding rapidly and competition for assets is intensifying. The results of this research demonstrate that institutions could consider specialist funds more seriously than is currently the case.





Hedging Bets

We explore investor attitudes to hedge funds and what the future holds for the asset class

Respondents report high levels of satisfaction with their current hedge fund investments, in terms of levels of returns and service: 94% are satisfied or very satisfied on both counts. However, hedge funds are the least used alternative investment category analyzed in our survey, accounting for 14% of institutional investors' alternative allocation on average.

Indeed, 45% of those surveyed indicated that they currently have no money allocated to hedge funds at all. This comes on the back of the news that a number of large institutional investors have pulled out of the asset class. This year CalPERS, the biggest pension fund in the US, and PFZW from the Netherlands both announced that they would no longer invest in hedge funds.

It is also the asset class that is expected to have the smallest increase in demand, with only a quarter of those surveyed planning to increase their allocation. This points to a continued reticence among some institutional investors to dedicate funds to an investment strategy that faced considerable difficulty in the immediate aftermath of the financial crisis, remains relatively expensive from a fee perspective, while also being challenging to analyze and is illiquid. To overcome this relative reticence the hedge fund industry is developing a range of solutions to make it easier, and cheaper, for institutional investors to access the strategies that they offer. And, while the numbers may suggest a more limited appetite for hedge funds than some other alternatives, there are signs that many of the world's

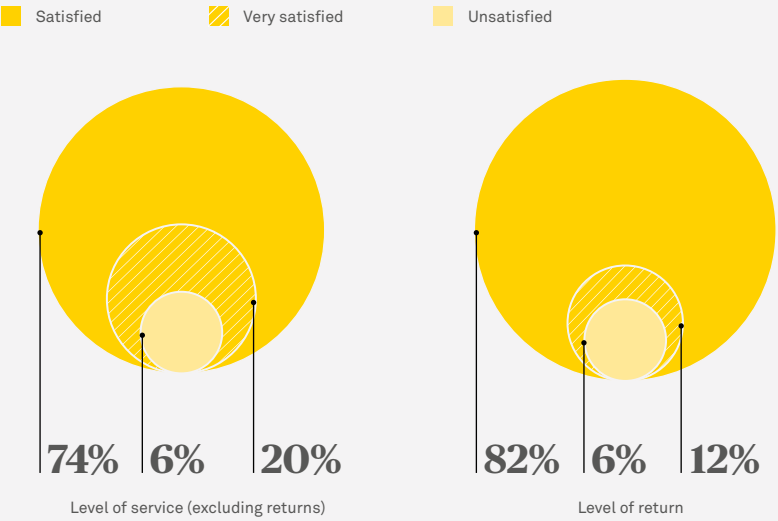
Hedging Bets

largest investors remain committed to this type of investment or are even seeking to increase exposure. CalSTRS, for example, recently announced that it is seeking to reduce its exposure to some public equities and bonds to free up capital to invest in strategies such as hedge funds through managed accounts as a way of protecting its returns from the possibility of another downturn.

“Hedge funds are looking to outsourcing for solutions that meet investor demands, their own needs and to help them meet certain fiduciary standards. They wish to minimize operational risk and reduce cost.”

– Robert Chambers, Head of Global Product Management, BNY Mellon

HOW SATISFIED ARE YOU WITH YOUR CURRENT HEDGE FUND INVESTMENTS IN TERMS OF RETURN AND IN TERMS OF OVERALL SERVICE (EXCLUDING RETURNS)?



94%

of respondents are satisfied or very satisfied (in terms of levels of returns and service) with their current hedge fund investments

14%

Institutional investors' average alternative allocation to hedge funds in our survey

45%

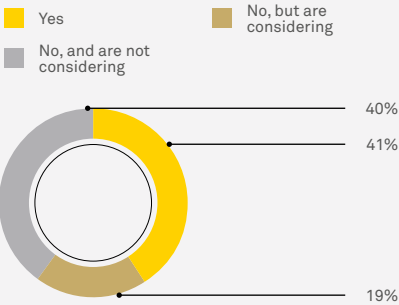
of respondents that currently have no money allocated to hedge funds

INVESTMENT VEHICLES

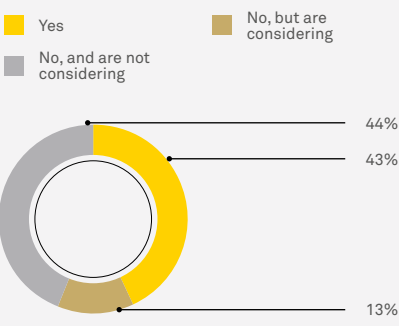
One of the faster growing, and most promising, of these solutions is liquid alternatives. These products typically use investment strategies that do not move in correlation with the equity or bond markets and include the ability to utilize a broad array of financial markets, derivatives, leverage, and take both long and short positions. A recent study by McKinsey & Co suggested that global inflows to liquid alternative funds would reach US\$900 billion by the end of 2015, mainly at the expense of traditional hedge fund investments. Indeed, according to a report from Cerulli Associates, liquid alternatives are one of the fastest growing segments of the funds market. Forecasts predict that liquid alternatives will represent 14% of total industry assets by 2023. Of those institutional investors that currently have at least some of their alternative investment allocation in hedge funds, some 41% currently invest in hedge funds through liquid alternatives, while 19% are considering using them. One UK investment manager explains why they are exploring using liquid alternatives in the future. “We may consider liquid alternatives as we see shifting demand and as a focus on gaining liquidity flexibility,” he says.

The results for managed accounts – another rapidly growing area of the hedge fund investment market – show a similar picture. These accounts are generally single-investor hedge funds established for the exclusive use of, and owned and controlled by, an institutional investor. Over two fifths (43%) of respondents invest in hedge funds through managed accounts, while a further 13% are considering doing so.

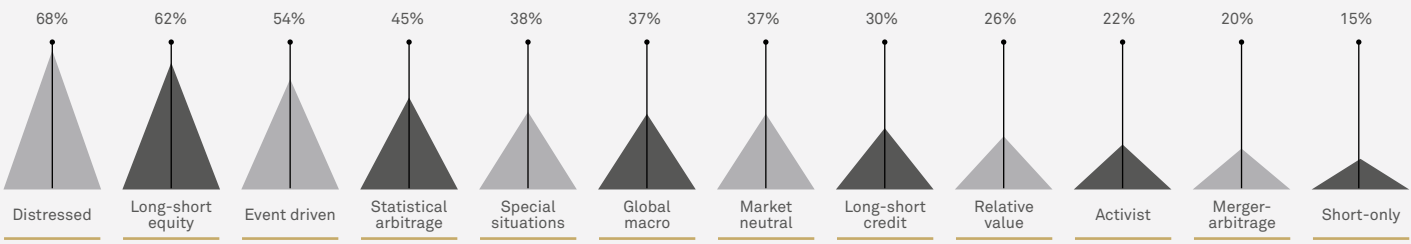
DO YOU CURRENTLY INVEST IN HEDGE FUNDS THROUGH LIQUID ALTERNATIVES?



DO YOU CURRENTLY INVEST IN HEDGE FUNDS THROUGH MANAGED ACCOUNTS?



WHICH HEDGE FUND STRATEGIES DO YOU CURRENTLY HAVE EXPOSURE TO? (SELECT ALL THAT APPLY)



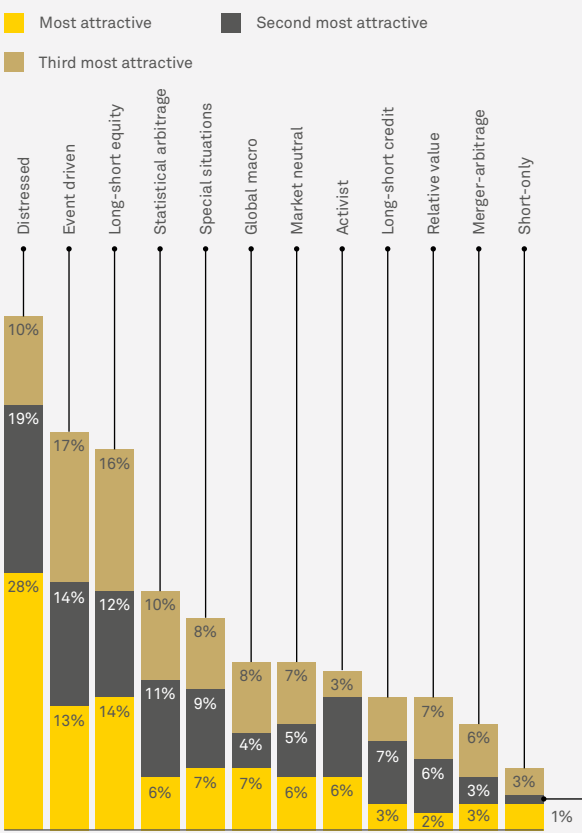
TACTICAL LESSONS

Respondents are divided about how they are using their hedge fund investments in relation to their overall portfolio, with 43% saying that they focus on absolute return and the remaining 57% on diversified/uncorrelated returns. This division looks set to persist, with roughly similar proportions for the two rationales in future hedge fund investments, albeit with a slight shift towards an increased focus on absolute returns (49% of respondents).

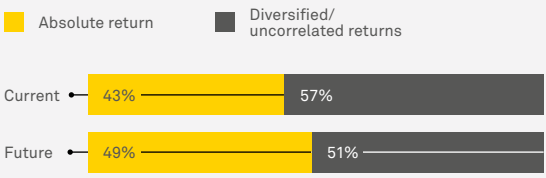
Funds focused on distressed strategies were the most popular among the respondent group, with 68% of those that currently invest in hedge funds having some exposure to this fund type. And, unsurprisingly, given the volatility experienced in global public markets over recent years, long-short equity strategies were also high on institutional investors' lists, with 62% of respondents having exposure to these funds. This was followed by event-driven strategies, with 54% – a category that has been buoyed by the significant uptick in M&A activity over the past two years – and statistical arbitrage with 45%.

When it comes to future investments, respondents point to the same four strategies as being the most attractive. Here, distressed stands on its own with 28% of respondents identifying it as the most attractive strategy, and more than half of those surveyed placing it in their top three.

WHICH HEDGE FUNDS DO YOU SEE AS THE MOST ATTRACTIVE FOR THE NEXT 12 MONTHS? (PLEASE RANK TOP THREE)



FOR YOUR CURRENT INVESTMENTS WAS THE PRIMARY RATIONALE FOR INVESTING IN HEDGE FUNDS DIVERSIFICATION OR ABSOLUTE RETURN? AND FOR FUTURE INVESTMENTS?



Hedging Bets

ON THE HORIZON

When considering what’s next for hedge fund investments, respondents indicate that they will make a number of changes to their approaches. As with private equity investments, the largest share (63%) say that they will look for lower management fees.

Respondents explained their increasing awareness of these fees’ impact on their returns: “Lower management fees are the first priority for us while investing as we have determined in previous years that the returns could have been much higher, but our failure to fully understand the complex fee structures had restricted that,” comments an EMEA-based director of investment.

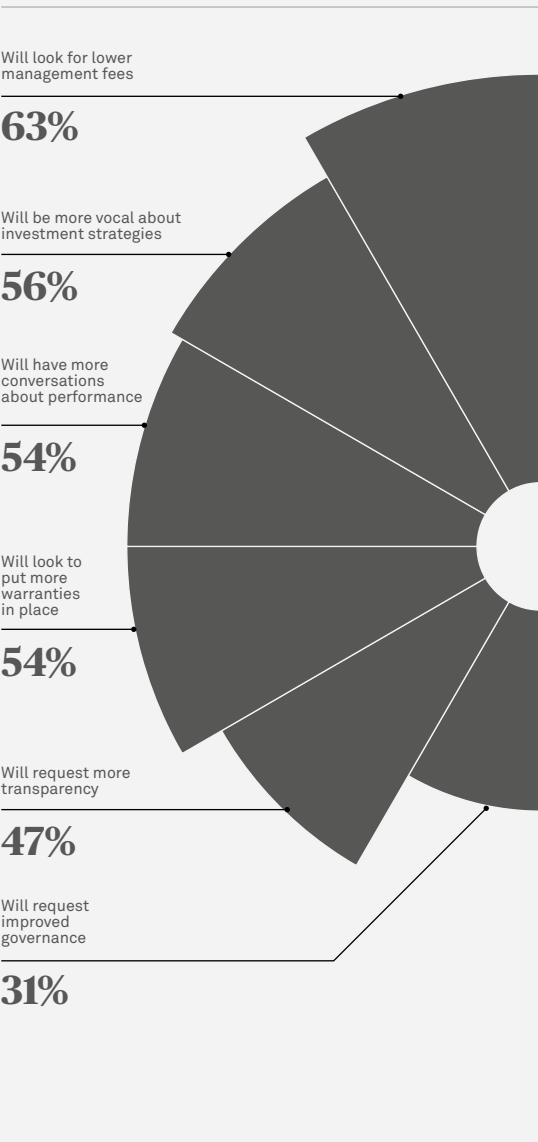
Over half (56%) also said they would be more vocal about investment strategies and a similar proportion said they would be discussing performance. Warranties and improved transparency also featured as relatively high on institutional investor agendas for the next 12 months.

There is a relatively wide range of expected returns for hedge fund investments made in 2015. While 5% have very high expectations – of 18% or more – nearly a third (32%) anticipate net returns to be in the order of 15-17% and 30% between 12% and 14%. A further 32% said they are expecting returns of 11% or less, including 1% that anticipated 6-8% returns.

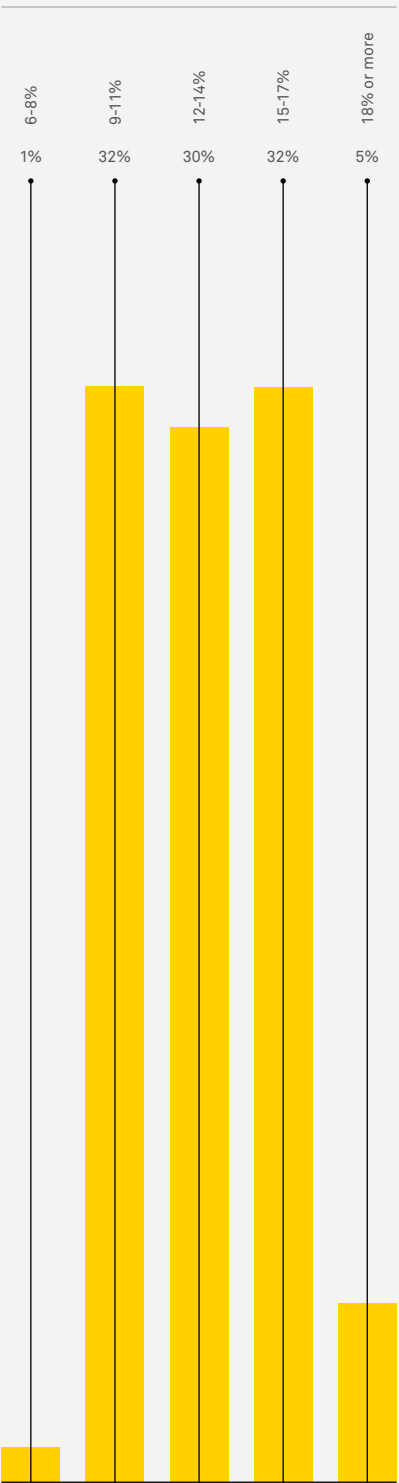
“There may well be a move towards using hedge funds to achieve non-correlated returns (as opposed to absolute returns) over the next few years because of the volatility playing out in markets. Investors will seek out strategies that offer some protection against the kind of big swings seen over recent times.”

– Bill Santos, Managing Director, HedgeMark

IN WHICH WAYS DO YOU EXPECT YOUR APPROACH TO INVESTING IN HEDGE FUNDS TO CHANGE IN THE NEXT 12 MONTHS? (SELECT ALL THAT APPLY)



WHAT NET RETURNS ARE YOU TARGETING FOR YOUR HEDGE FUND INVESTMENTS IN 2015?



Key Insights

New hedge fund structures and products, such as managed accounts and liquid alternatives, are likely to have a dramatic effect on this part of the alternatives space. In the case of managed accounts, investors in all regions of the world are now in the process of working out how best they can benefit from a structure that takes governance, custody and reporting away from the hedge fund manager and into the hands of expert, dedicated service providers. Managed accounts not only enable investors to retain governance of their hedge fund investments, but also understand their positions and performance on a daily basis, thereby allowing them to be more tactical in their approach to this part of the alternatives spectrum. Similarly, liquid alternatives are proving attractive to investors, given their stronger regulatory, transparency and liquidity requirements than traditional hedge fund limited partnerships. Both will likely drive an increased appetite over the medium term among investors for hedge fund investments, although investors do need to be wary of the effect on alpha of investing in highly liquid platforms.

These products also feed into the desire for lower fees among investors and it is perhaps their development that explains the confidence highlighted by our report among investors to seek reduced fees in their hedge fund investments. While there is clearly downward pressure in this area, we still believe that the most successful managers – those in most demand – will continue to be able to maintain a more traditional hedge fund fee structure.

In addition, while our survey suggests that investors will

continue to be evenly split over their rationale for investing in hedge funds – absolute return versus diversified return – given the continued volatility in other investment strategies, such as public stocks, and the fall in oil prices, there is likely to be an increased search for uncorrelated strategies that will help smooth out the returns profile of investors’ overall portfolios.

“It feels as though 1.5% is the new 2% in fees. As new ways of accessing the market, such as liquid alternatives, gain traction, there is increasing compression on fee levels.”

– Robert Chambers, Head of Global Product Management, BNY Mellon



The Hedge Fund Perspective

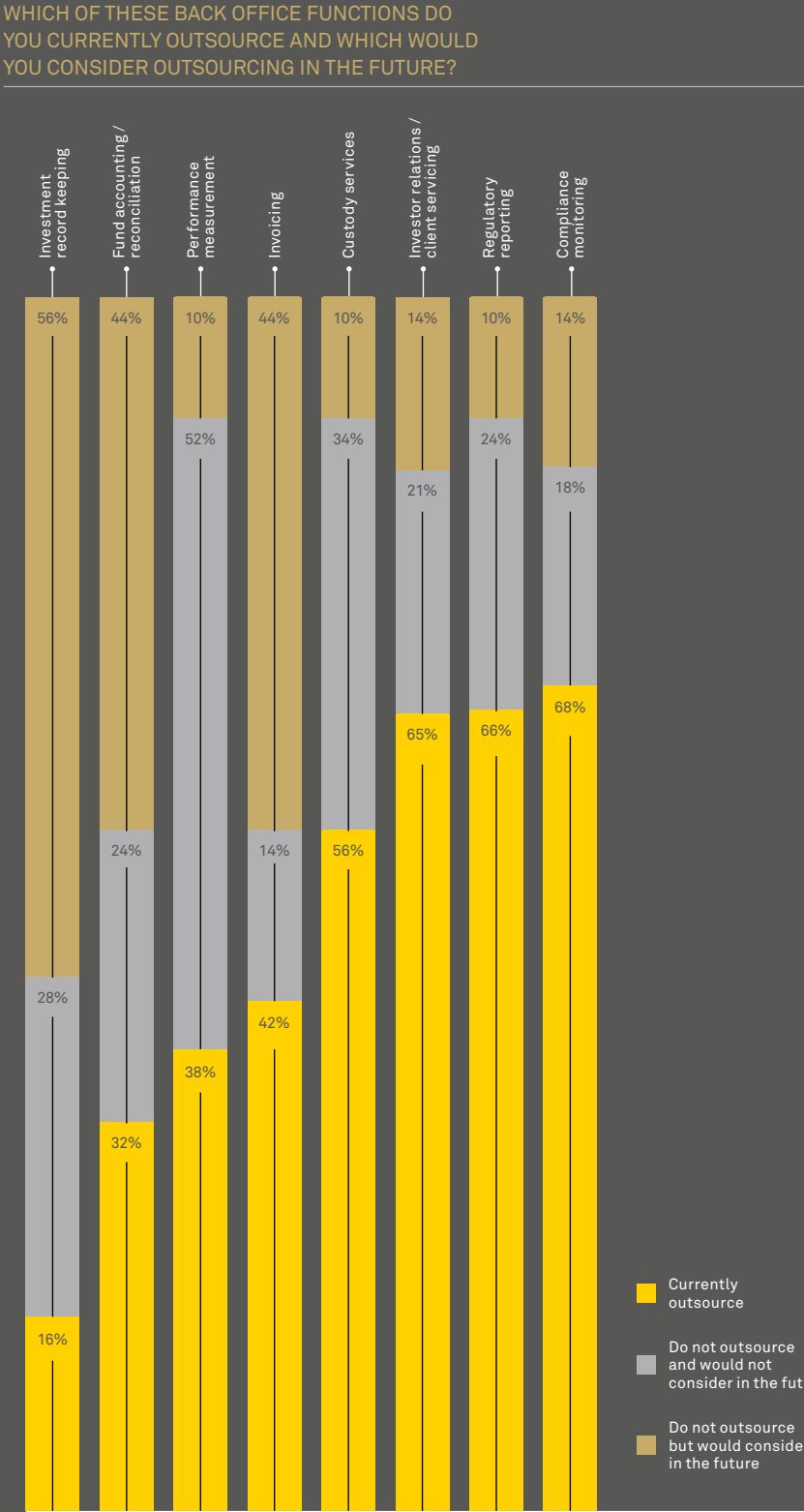
In Q3 2015, we also spoke to 50 hedge fund respondents from the Americas, EMEA and Asia Pacific, in order to understand how they are reacting to a changing regulatory landscape as well as increasing demands from their institutional investor client base.

There are wide ranging changes afoot in the hedge fund industry as regulatory oversight comes to bear, investors demand improved reporting and firms look to improve the efficiency of their operations and concentrate on core competencies.

Over the coming year, hedge funds will be most concerned with minimizing operational risk. Our respondents ranked this as the most important area of focus: minimizing operational risk achieved an average score of 5.22 on a scale from 1 to 6.

The second highest rated operational priority is increasing front to back office efficiency, with an average score of 4.80. This has become an important area for hedge funds to manage as firms and their assets under management have grown, requiring them to run their operations along more institutional lines. Minimizing operating costs came in a close third (scoring 4.78), reflecting the fact that pressure is being brought to bear on the quantum of fees being charged to fund investors. The increased use of outsourcing is the fourth highest item, with a score of 4.64, and hints at how many of these changes may be brought about, as hedge funds increasingly look to outside experts to help them better manage their operations.

When asked which functions they currently outsource, the most common are compliance monitoring (68%), regulatory



REGARDING YOUR OPERATIONS, PLEASE RATE THE LEVEL OF FOCUS YOUR FIRM WILL PLACE ON THE FOLLOWING OVER THE NEXT YEAR: (PLEASE RATE ON A SCALE OF 1 TO 6, WHERE 6 = VERY IMPORTANT, AND 1 = NOT AT ALL IMPORTANT) MEAN SHOWN

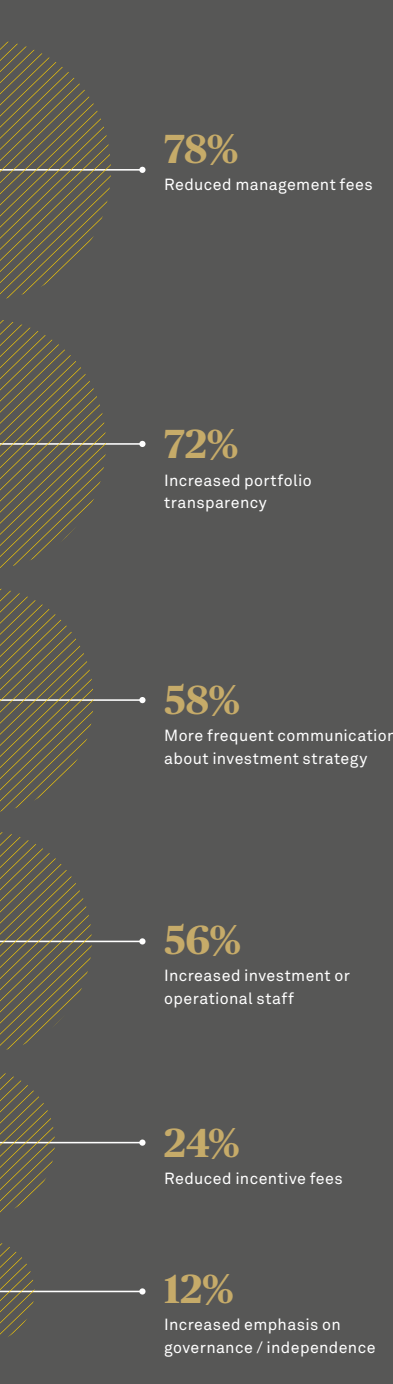


reporting (66%) and investor relations and client servicing (65%). These are areas that look set to be further outsourced in the future, as around 20% of respondents who do not currently outsource these functions are considering doing so. The effect of increased regulatory oversight, such as the SEC's alternative investment manager examination program in the US and the implementation of the AIFMD in Europe, is reflected in some of the other responses. While performance measurement is currently outsourced by 38% of respondents, over half (52%) are considering putting this function out with an independent third party, while custody services (currently outsourced by 56%) is under consideration by 34%.

As competition for investor allocations intensifies between hedge funds, many are looking at ways of increasing the attractiveness of their offering. The pressure being exerted on fees by investors is leading 78% of respondents to say that they will consider reducing their management fees over the next 12 months. An Americas based managing director explains: To encourage confidence in existing investors and to attract new investors, we will put forward a proposition of reduced management fees.

Increasing portfolio transparency is another key objective for hedge funds over the next year, with 72% of respondents saying they are working on this. More frequent communication about investment strategy was the third most important change, cited by 58% of respondents.

WHAT CHANGES, IF ANY, ARE YOU CONSIDERING TO ADAPT YOUR INVESTMENT OFFERING(S) OVER THE NEXT 12 MONTHS TO INCREASE ATTRACTIVENESS? (SELECT ALL THAT APPLY)

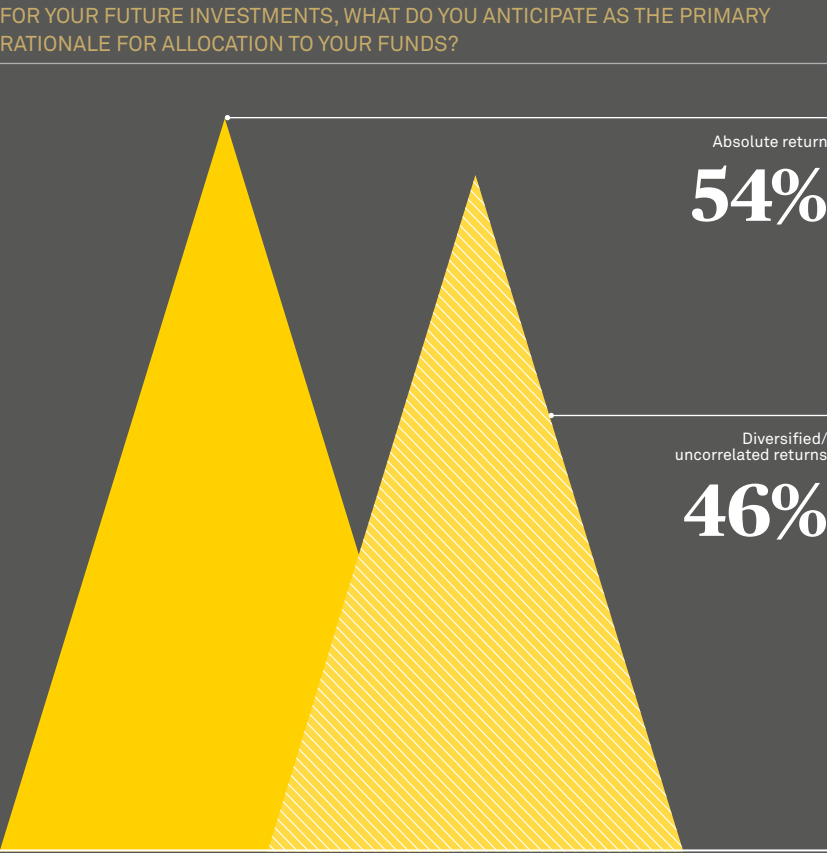


The Hedge Fund Perspective

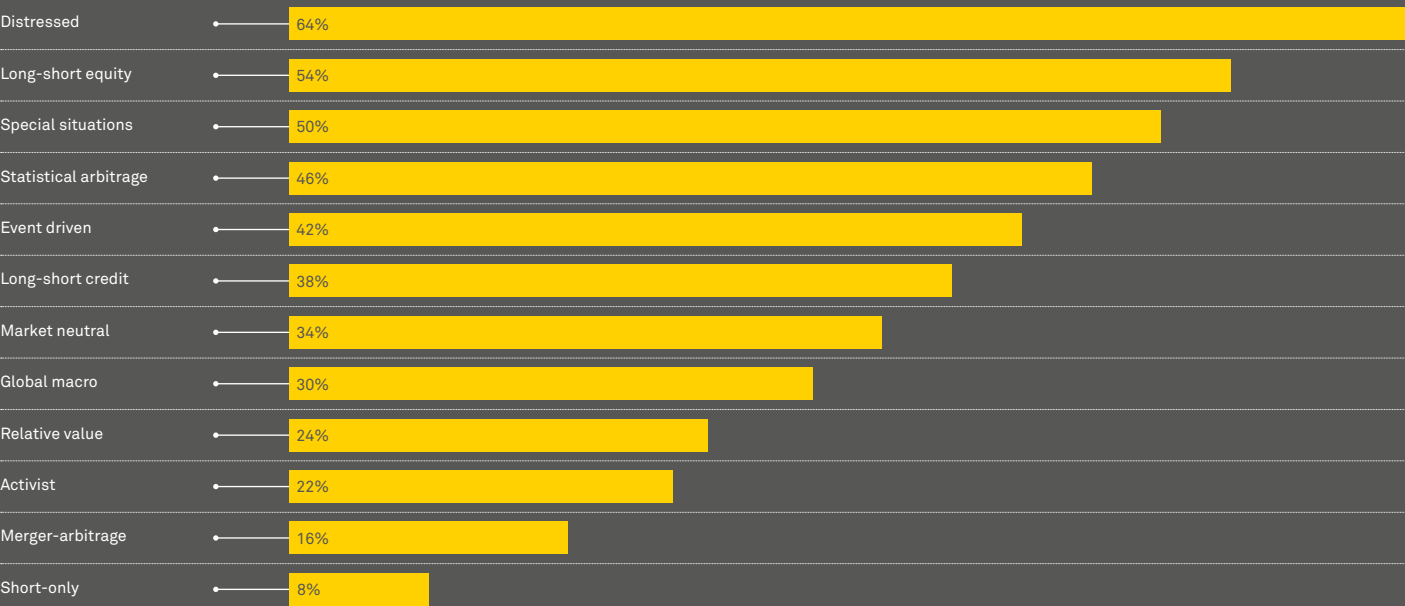
STRATEGIC MOVES

As with institutional investors, hedge fund respondents are nearly evenly divided about the primary rationale for investors making an allocation to their fund, with 46% pointing to diversified/uncorrelated returns, and 54% pointing to absolute returns.

The largest share of hedge fund respondents (64%) are pursuing distressed investments, reflecting the appetite among institutional investors for this strategy. Many believe there are many distressed opportunities to be found, given the current market conditions. For instance, an Asia-Pacific based managing director comments: “Distressed driven strategies are more likely to be pursued over the next 12 months, as the previous conditions in the global financial environment have created a financial imbalance in many businesses and we have an opportunity to acquire these assets at attractive valuations.”



WHICH STRATEGIES DO YOU CURRENTLY PURSUE? (SELECT ALL THAT APPLY)



Key Insights

The finding that over three quarters of hedge fund managers are considering fee reductions suggests they are listening to investors and that innovation in this area will follow. Over recent times, the market has seen smart moves by some newer managers that are charging enough at the outset to build up competent teams, but under the premise that as their assets under management scale up, their management fees will scale down, thereby sharing the benefits of scale with their investors and keeping interests aligned. There have also been changes to the timing of incentive payments and the adoption of clawbacks. These initiatives, together with the development of managed accounts and liquid alternatives, will go some way to addressing investors’ concerns around fees.

Allied to the need to meet investor requirements and fee reduction requests is the trend towards the outsourcing of middle and back office operations among hedge funds. Performance measurement is one area that is in sharp relief as investors increasingly seek independent verification and improved transparency, although outsourcing other areas, such as fund accounting, regulatory reporting and investment record keeping, should help hedge funds improve efficiency, manage operational risk and lower operational costs.

“There is currently a transformation in the way institutions invest in hedge funds - managed accounts are giving investors control over the governance of the investments, with third parties running middle-office operations. That shifts the counterparty risk away from hedge funds and into independent, often well-known and reputable names that offer greater transparency and allows investors to see their positions daily.”

— Bill Santos, Managing Director, HedgeMark



Conclusion

Over the last decade, institutional investors have been steadily building out their alternative asset portfolios, spanning across the alternative universe of private equity, hedge funds, infrastructure and real estate. Our study suggests that this trend is likely to continue, with the vast majority of institutional investors satisfied with the performance of their alternative investments and a substantial proportion planning to increase their allocation. However, this does not mean that the industry can become complacent, with institutional investors also becoming more sophisticated and demanding.

As such, further growth in alternative allocations will be underpinned by the continued development of new products in the alternatives space as fund managers cater for increasing amounts of capital that are destined towards alternative assets. In private equity, where interest among institutional investors is greatest, a rapidly developing secondary market and an increase in listed vehicles AUM will help some investors achieve greater liquidity. At the same time, the move in private equity towards negotiating separate accounts and co-investment rights will assist in lowering overall fee levels for investors.

In hedge funds, the trend towards investing via managed accounts and liquid alternatives, together with the development of enhanced platforms, is creating an area of investment with multiple entry points to account for investors different return, liquidity and reporting requirements. The development of managed accounts, in particular, looks set to allay some investor concerns around transparency, governance and fees and may encourage more investors to allocate to this part of the alternatives landscape.

Overall, the stage is set for further expansion in the alternatives space. While much of this will be centered on developed markets, institutional investors should also keep their eye on opportunities that could come out of the emerging markets, given their capacity for growth and strong fundamentals. For their part, institutional investors have now built up the knowledge and expertise required to manage alternative asset portfolios, with many seeking to fine tune and hone their exposure to ensure they are meeting their investment goals and return expectations. Alternatives, once a small niche in the landscape, are now part of the mainstream set of investment options for institutional investors.

Methodology

In Q3 2015, FT Remark interviewed senior executives from 400 large institutional investors to understand their strategy for allocating funds to alternative investments (defined as private equity, hedge funds, real estate and infrastructure). Respondents were split across pension funds (30%), investment managers (25%), endowments/foundations/sovereign wealth funds (25%) and insurance funds (20%). Geographically, respondents were split across the Americas (37.5%), EMEA (37.5%) and Asia-Pacific (25%).

At the same time, FT Remark interviewed 50 senior executives within large hedge funds, to understand how they are reacting to a changing regulatory landscape, as well as increasing demands from their institutional investor client base. For this survey, respondents were split across the Americas (40%), EMEA (40%) and Asia-Pacific (20%).

For both surveys, results were analyzed and collated by FT Remark and all responses are anonymized and presented in aggregate.

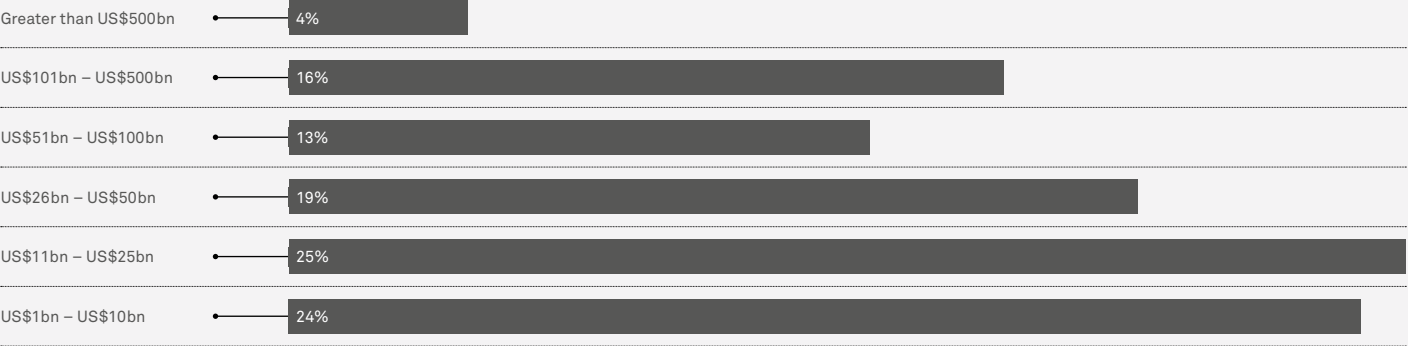
INSTITUTIONAL INVESTOR RESPONDENT SPLIT

	AMERICAS	EMEA	ASIA	TOTAL
Pension fund	45	45	30	120
Investment Manager	37	37	26	100
Endowment/Foundation/ Sovereign Wealth fund	37	37	26	100
Insurance fund	30	30	20	80
Total	150	150	100	400

HEDGE FUND RESPONDENT SPLIT

	AMERICAS	EMEA	ASIA	TOTAL
Hedge fund	20	20	10	50

WHAT IS THE CURRENT VALUE (US\$BN) OF YOUR FIRM'S ASSETS UNDER MANAGEMENT?



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