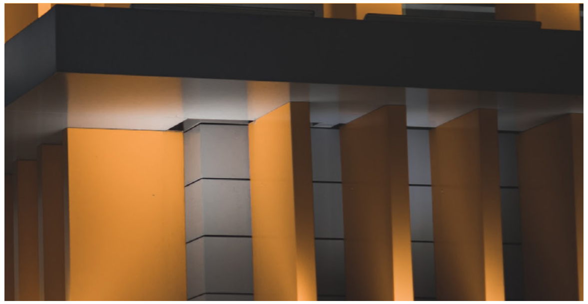
INSIGHTS

DECEMBER 2022

HEDGEWEEK



INVESTOR INTEREST 2023

ALLOCATORS' PLANS FOR HEDGE FUNDS AND BEYOND

EXECUTIVE SUMMARY

Sizable swathes of the hedge fund industry have been left battered and bruised by 2022's market turmoil. Managers across a range of strategies are nursing losses and capital outflows as the year draws to a close, while headlines suggest the appetite for less liquid alternatives – such as private equity and debt – continues to outweigh that for hedge funds among many allocator groups.

And yet, investors continue to show faith in hedge funds, as the findings of this latest Hedgeweek Insights report illustrate.

Drawing on data from a far-reaching survey of institutional, private wealth, and fund-of-funds investors, it examines where and how allocators are planning to deploy their money in 2023 and maps potential hedge fund flow trends for the coming year.

The report also gathers the expert views and perspectives of a range of hedge fund investors, managers, and consultants, exploring the key fund strategies, investment opportunities and trading ideas tipped to enhance returns next year amid predictions of a worsening economic outlook.

With performance now the top priority for allocators in the coming 12 months, the report also reflects on how long-running industry wrangles (fees; liquidity) as well as newer challenges (ESG; China; the current crypto turmoil) are set to shape manager-investor conversations in what is set to be another volatile and unpredictable year for the industry.

HUGH LEASK
REPORT AUTHOR

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METHODOLOGY

The insights in this report are drawn from multiple sources, including a Hedgeweek survey conducted in Q4 2022 of nearly 50 alternative investment allocators (roughly one third institutional investors, one third private wealth, and one asset managers and funds of funds), in-depth interviews with industry specialists, and other third-party and background research. Some charts also feature data from Hedgeweek's latest hedge fund manager survey, conducted throughout Q3 2022.

KEY FINDINGS

1

Investors are showing faith in hedge funds' ability to deliver

Despite a brutal 2022 defined by negative returns and capital outflows, 58% of investors intend to grow or maintain their hedge fund allocations next year. Unsurprisingly, double-digit gains among macro funds have put them front and centre of allocators' plans, but certain relative value and distressed credit strategies are also set to be vital destinations for investor capital in 2023.

2

Performance the priority amid a worsening economic forecast

With the global economic outlook souring, interest rates and inflation underpin investor anxieties. As such, performance now outflanks fees, liquidity and ESG as investors' top priority, with appetite for tailored hedge fund solutions taking hold among a growing number of wealth managers. ESG continues to be a critical trend, with almost one-third of investors happy to jettison a manager not committed to net-zero.

3

Private wealth appetite remains mixed – crypto may prove key

While a quarter of allocators are set to ramp up their hedge fund exposure next year, one in five private wealth investors are set to redeem capital from the sector. Yet beyond the headline ambivalence, hedge funds' coffers could see a boost from family offices and HNWs keen to swerve private equity's illiquidity premium. Private wealth may also prove a critical source of capital for crypto hedge funds looking to capitalise on current digital assets turmoil.

4

Institutional allocators could pivot on PE write-downs

Within the institutional sphere, hedge funds may trail PE in the popularity stakes – but only 10% of allocators are intent on redeeming capital next year. One in five institutions plan to grow their allocations this year - and that number could swell further as industry pros warn of looming write-downs across the private assets spectrum in the coming months.

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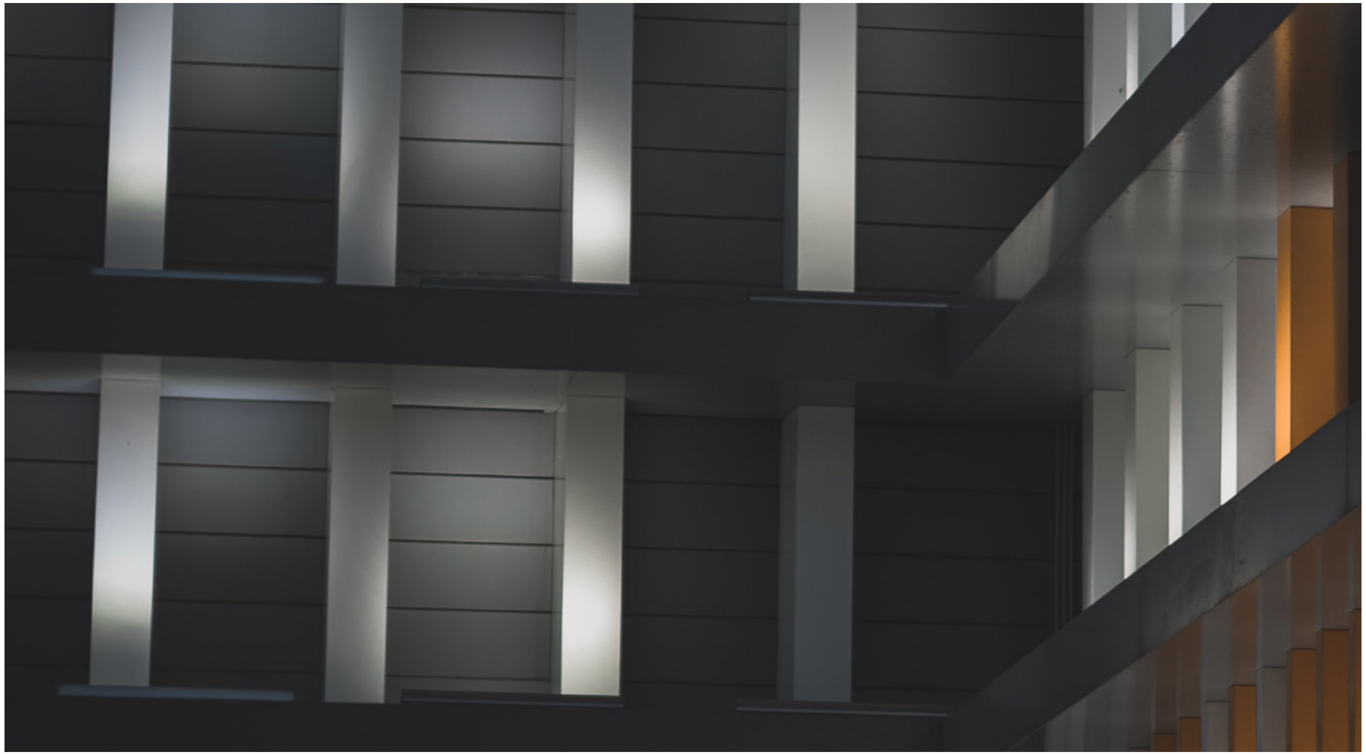

A VOTE OF CONFIDENCE

With 60% of investors set to increase or maintain their hedge fund exposure in 2023, allocators are betting on macro managers to thrive amid rising rates, with the economic upheaval also fostering alpha opportunities in relative value arbitrage and distressed credit

Investors' allocation plans for 2023 reveal a surprisingly strong vote of confidence in hedge funds' ability to enhance portfolio returns amid continued equity and bond market volatility and macroeconomic upheaval. Roughly a quarter of all allocators spanning institutional, private and FoF capital (23%) want to pour more money into hedge funds next year, with a further third (35%) set to maintain their existing allocations (see Fig. 1.1). In contrast, just 13% intend say they will withdraw money from the sector next year.

That said, overall interest in hedge funds, while solid, continues to be outflanked by appetite for other alternatives such as private equity, private credit, and real estate.

Industry practitioners cite this year's considerable dispersion in hedge fund performance, and the perception of private assets as better insulated from wider shocks, as the reasons for the lag. eVestment fund flow data meanwhile suggests investors have now pulled more than $63 billion in the period to the end of Q3 (see Fig. 1.2), with only managed futures and multi-strategy funds attracting meaningful inflows this year.

Rotation

"Hedge fund strategies with a low beta to risk assets are of natural interest following the period of rotation we're coming through into 2023," says Travis Williamson, partner and head of hedge fund research at Albourne Partners, noting that global macro, as well as CTAs – which have notched up gains on average of nearly 20% YTD (see Fig. 1.3) – offer the potential for continued success during periods of economic transition.

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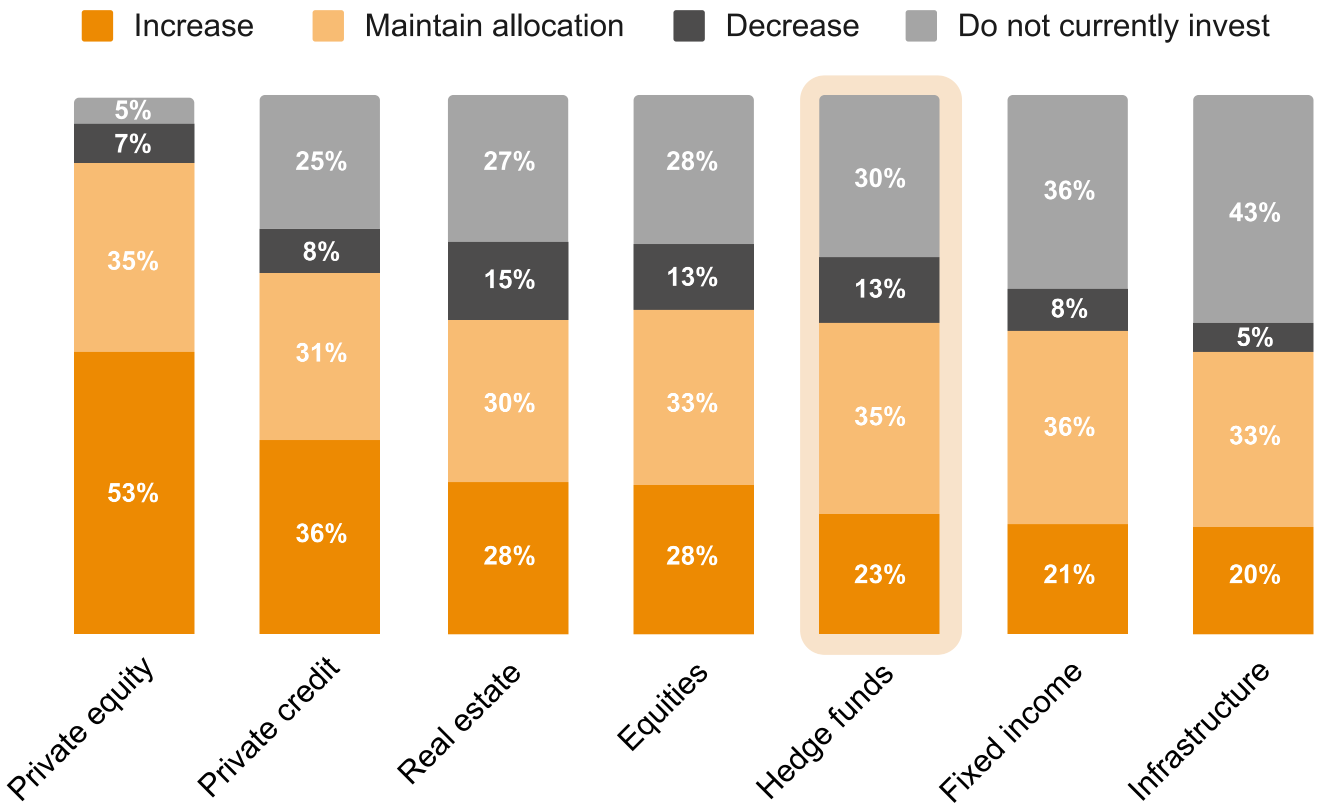
Having surged more than 11% in the 10 months since the start of this year, macro hedge funds – which trade broader macroeconomic and geopolitical trends using equities, bonds, commodities, currencies and more on a discretionary and systematic basis – are unsurprisingly the frontrunner, with almost one-third of all investors (32%) preparing to up their allocations (see Fig. 1.4).

Elsewhere, 21% of investors plan to increase their exposure to multi-strategy managers which offer diversified returns. And despite 2022's stock market turmoil – which has left equity long/short hedge funds nursing losses in excess of 11% (Fig. 1.3) – more than one in five investors are still keen to grow their allocations in what remains the industry's largest and best-known strategy type.

"Macro is the big focus – there is huge demand for macro right now, as people see it as being the primary beneficiary of the higher rate environment," observes Richard Byworth,

Figure 1.1 Allocators' plans for key alternative and traditional asset classes in 2023



Analyst note: Survey respondents were asked in November 2022, 'How do you expect to change your exposure to the following asset classes over the next 12 months?' Totals may not add up to 100% due to rounding.

Source: Hedgeweek Allocator Survey, Q4 2022

managing partner and head of liquid alternatives at Syz Capital. "Either investors are having a specific conversation about macro, or they want macro as part of a multi-strategy allocation. In our portfolio breakdown, it is the macro firms that are seeing the largest outperformance, and so that makes sense for people chasing returns. With the Fed now suggesting higher rates for longer, it is logical that these strategies are of continued focus."

Tailwind

Beyond the headline-grabbing gains in macro and CTAs, the rising rate backdrop also offers catalysts for opportunities in certain fixed income arbitrage and credit hedge fund strategies next year, market participants say. That view chimes with Hedgeweek data showing that 28% of all allocators intend to pour more money to fixed income/credit strategies – second only to macro funds - with a further 28% maintaining their allocations here.

"Fixed income long/short is an alpha opportunity," says Brooks Ritchey, senior managing director, co-chief investment officer, and portfolio manager at K2 Advisors, which runs about $12 billion focusing exclusively on hedge fund strategies, funds of hedge funds, and funds of separately managed account products for institutions and private investors.

Outlining the arbitrage trade, he notes how interest rate hikes will continue to widen the gap between strong and weaker companies. "Those that don't need a lot of financing have large cash holdings – and they should do well going forward as they don't have to pay the higher interest

Figure 1.2 Hedge fund stratgey investor flows by primary asset class, YTD 2022 ($bn)

	YTD 2022	2021	2020
All hedge funds	-63.2	13.9	-59.3
Commodities	-1.8	10.3	3.4
Equity	-17.4	8.6	5.5
Fixed income/Credit	-43.0	-36.3	-27.0
Multi-asset	-0.8	31.3	-41.1

Analyst note: YTD through September 2022.
Source: eVestment

rates. Those groups that do require financing should see profit margins reduced because of higher borrowing costs."

Managers trading corporate and high-yield fixed income securities long and short, including relative value arbitrage strategies, are well-placed to deliver performance and diversification over the coming 12-15 months, he adds.

"Later, probably by early summer 2023, the fixed income long/short managers and relative value managers will see central bank policies clarified, so they will get a performance tailwind from the bond market stabilising and potentially rallying."

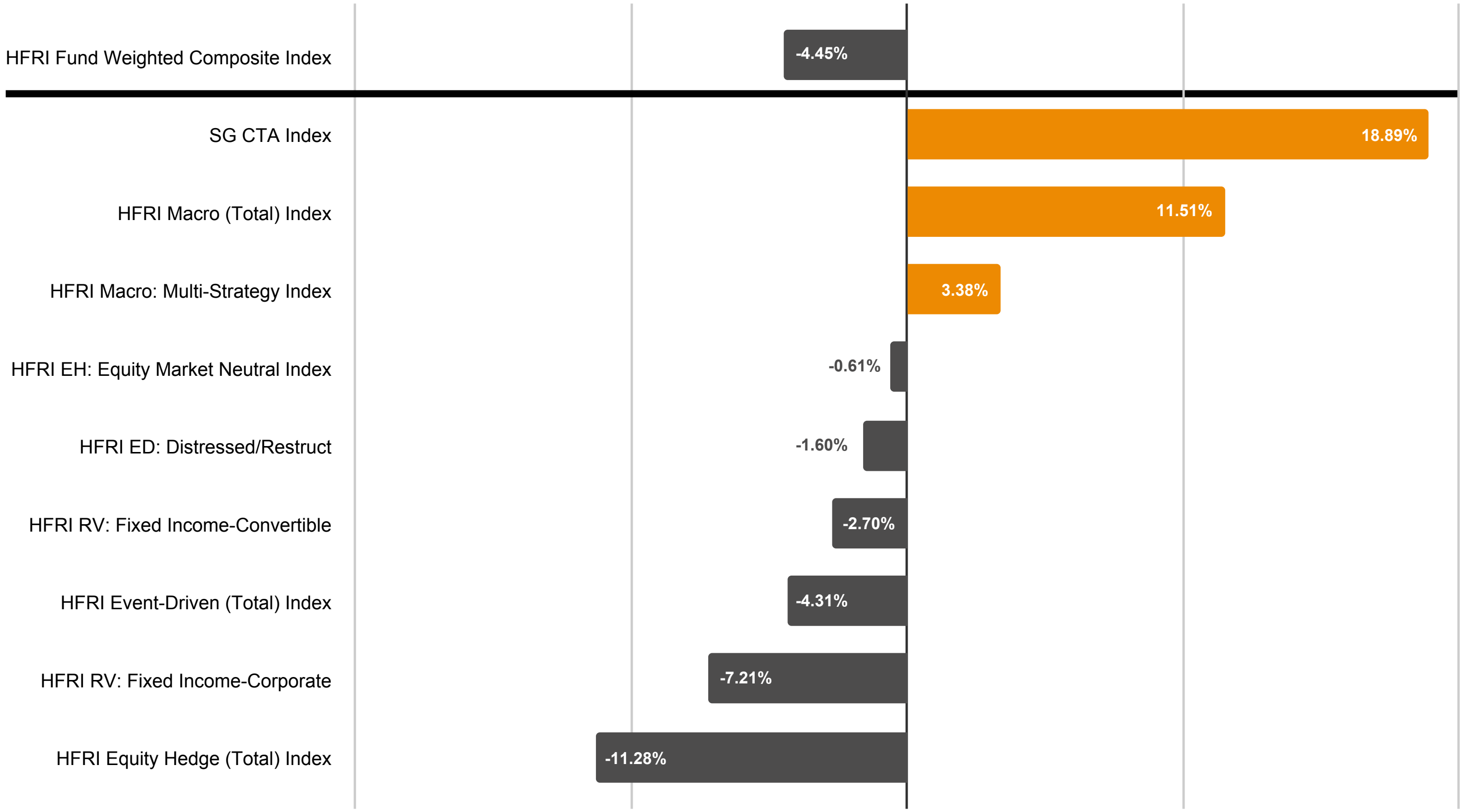
Sustainable

Elsewhere in the credit space, new research published by BNP Paribas Prime Services shows investors are preparing to pile into a range of credit hedge fund strategies, especially in the more illiquid end of the spectrum, as rate rises and a deteriorating global economy expands the distressed credit universe.

Marlin Naidoo, global head of capital introduction and consulting at BNP Paribas, says: "While private credit continues to be of interest, it's not increasing. Instead, what we are seeing is an increase on the more hedge fund side of things – more distressed or event driven-type strategies; more evergreen structures versus the drawdown-type structures."

"From an investor perspective, it's vital not to ignore credit as an asset class," says Anish Mathur, chief investment officer of Astra Asset Management, which is targeting a range of

Figure 1.3 Select hedge fund strategy performance YTD 2022



Analyst note: HFR indices are YTD through 31 October 2022. SocGen (SG) index is YTD through 2 December 2022.
Source: HFR, SocGen Prime Services

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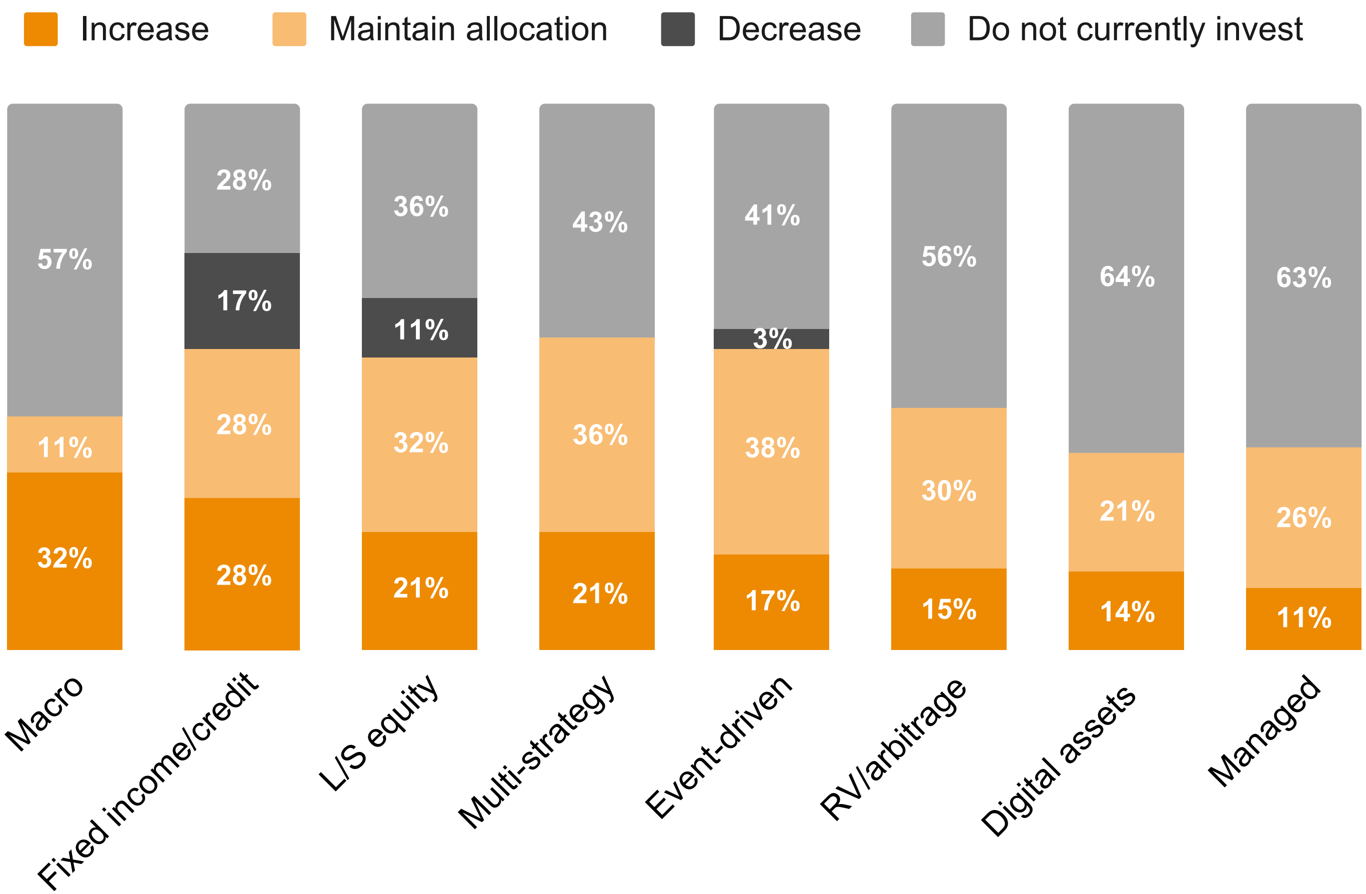
Figure 1.4 Allocators' plans for key hedge fund strategies in 2023

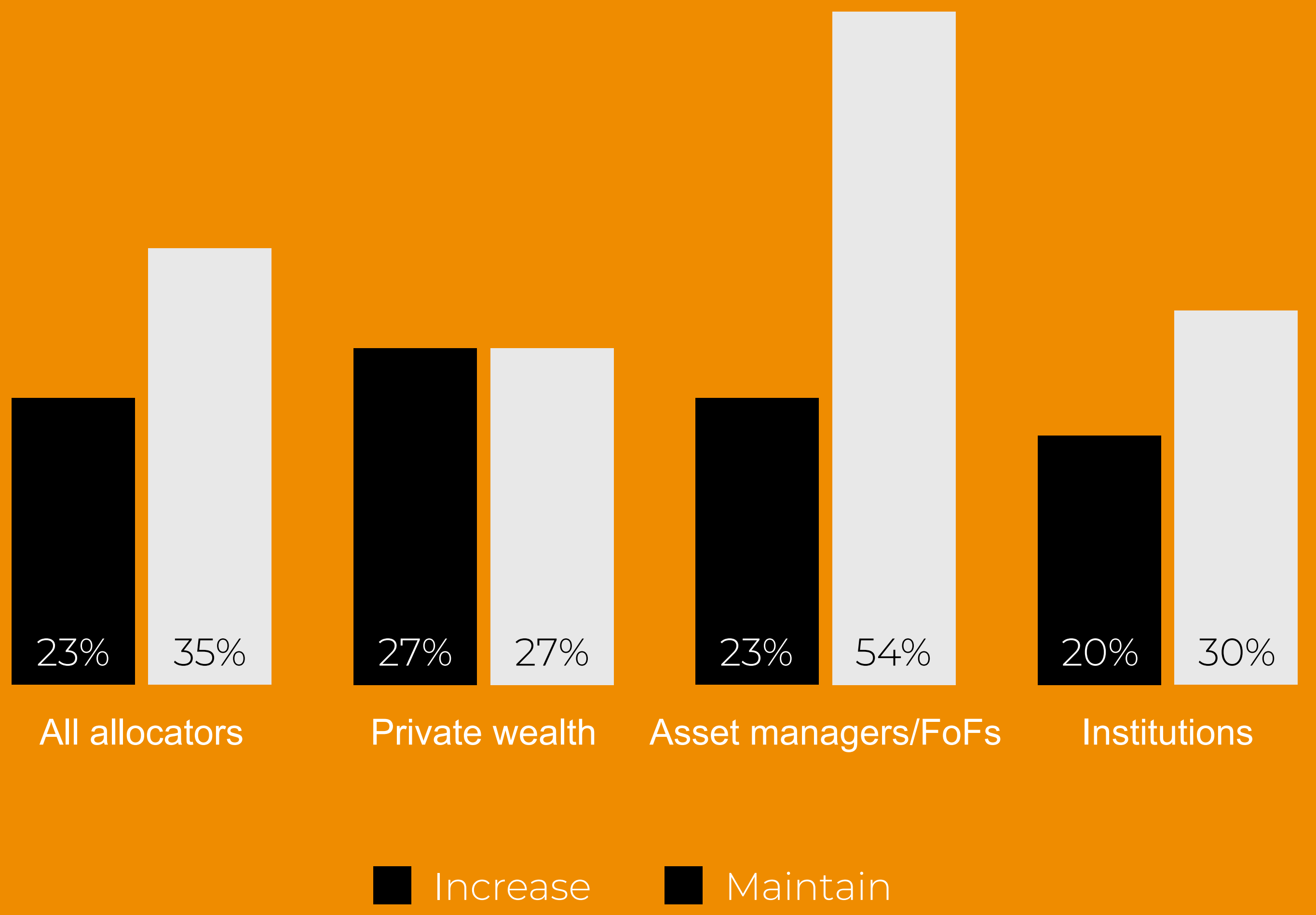


Analyst note: Survey respondents were asked in November 2022, 'How do you expect to change your exposure to the following hedge fund strategies over the next 12 months?' Totals may not add up to 100% due to rounding.
Source: Hedgeweek Allocator Survey, Q4 2022

KEY FINDING

Investors are showing faith in hedge funds' ability to deliver

Nearly 60% of investors intend to grow or maintain their hedge fund allocations next year.



relative value and hidden arbitrage opportunities in the asset- and mortgage-backed securities sector.

"It's really a time where you can differentiate one manager from the other – if people are looking for alpha, they should look at specialist managers. Asset-backed credit provides one of the best quality, substantial and sustainable returns."

He adds: "There hasn't been a lot of expertise left in the market on the areas that are more complex than vanilla lending. The time has now come back again for active investing."

Overall, demand for hedge fund strategies across private wealth outfits, institutional investors and asset managers/funds of funds remains solid – with roughly a quarter of private wealth firms (27%) and asset managers/FoFs (23%) planning additional allocations hedge funds in 2023, slightly more than institutional investors (20%) (see Fig. 1.5)

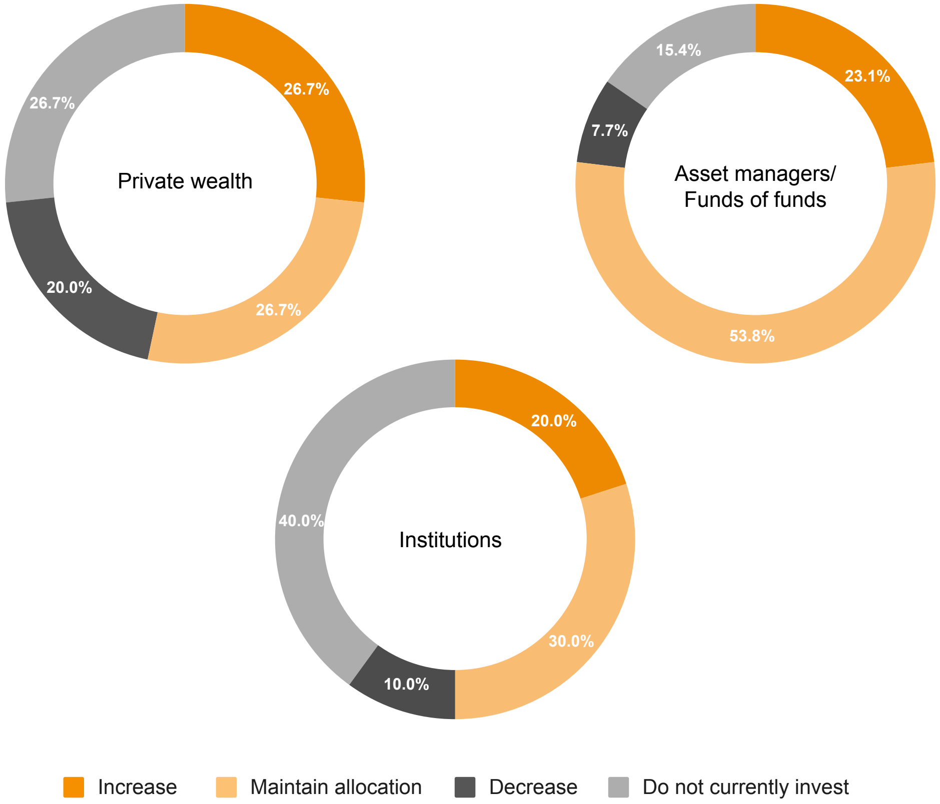
However, survey data suggests much bigger churn within the private wealth sector: here, allocators are also much more likely to slash their hedge fund holdings next year – one in five private managers say they plan to do so, compared to one in 10 institutional managers (See chapters 3 and 4 for further discussion about private wealth and institutional allocators' allocation plans, respectively).

"Overall, there certainly is a lot of continued appetite for alternative strategies of all shapes and sizes," says Darren Wolf, global head of investments, alternative investment strategies at abrdn. "Investors need to get returns from somewhere, and traditional markets are just not offering them the forward-looking returns relative to the underlying risk."

KEY TAKEAWAY

Almost 60% of all investors will maintain or grow their hedge fund exposure next year, with macro funds' stellar gains in the rising rate environment seen as a key destination for capital. Investors looking for low equity beta are also eyeing selected multi-strategy, relative value, and distressed credit opportunities in 2023.

Figure 1.5 Allocators' plans for hedge funds in 2023, by investor type



Analyst note: Survey respondents were asked in November 2022, 'How do you expect to change your exposure to hedge funds over the next 12 months?' Totals may not add up to 100% due to rounding.
Source: Hedgeweek Allocator Survey, Q4 2022

PERFORMANCE PRESSURE

Rising rates and an inflation squeeze are fuelling an increasingly downbeat economic assessment. For hedge fund investors, capital preservation is now critical

Investors are taking a resolutely gloomy stance on 2023's economic prospects. A clear majority (56%) of all allocators surveyed believe the global economy will worsen next year – vastly outweighing those who say it will remain similar (26%), and those who think the outlook will improve a year from now (9%) (see Fig. 2.1).

"Just because the markets are down 20% or 25%, that does not mean they can't be down further by another 20%," observes Darren Wolf, global head of investments, alternative investment strategies at abrdn, reflecting on the broader downbeat outlook.

He says the last decade offered "the perfect backdrop" for corporate earnings, particularly in the US, underpinned by low interest rates, low inflation, no geopolitical risk, no war, low commodities prices, and high globalisation.

"Every one of those things has now precisely turned on its head 180 degrees," says Wolf. "If that was a tailwind for corporate profits when those factors were supporting them, then conversely, when those same factors are headwinds, we shouldn't ignore their impact now, as well."

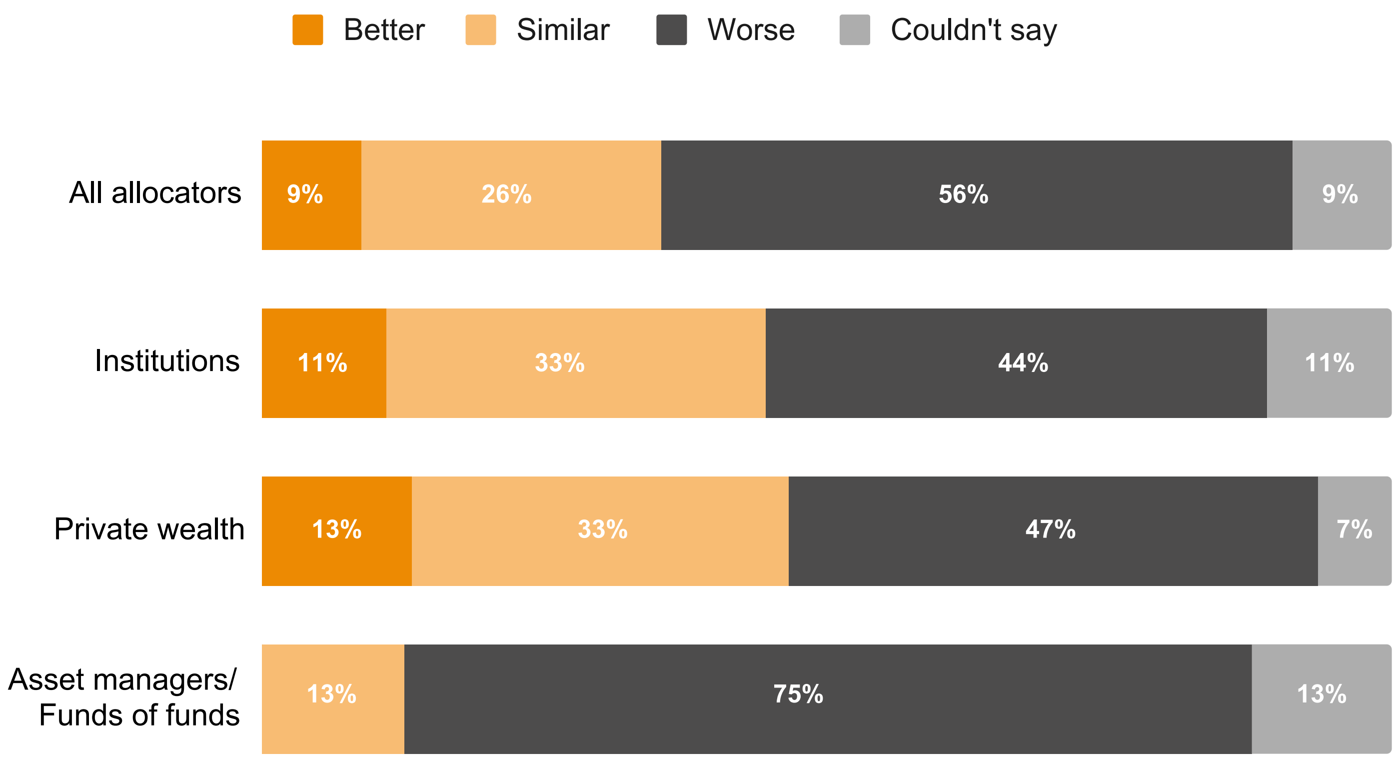
Concerns

Allocators say the rising interest rate environment is now their biggest concern (see Fig. 2.2), followed closely by higher inflation. With the Covid-19 pandemic receding from view, and energy costs large priced in by market practitioners, the impact of the Russia-Ukraine war is the third main concern.

Industry participants say rising rates – a key issue in IR teams' discussions with allocators – pose far-reaching questions for both investors and managers looking to navigate the dramatically-altered landscape.

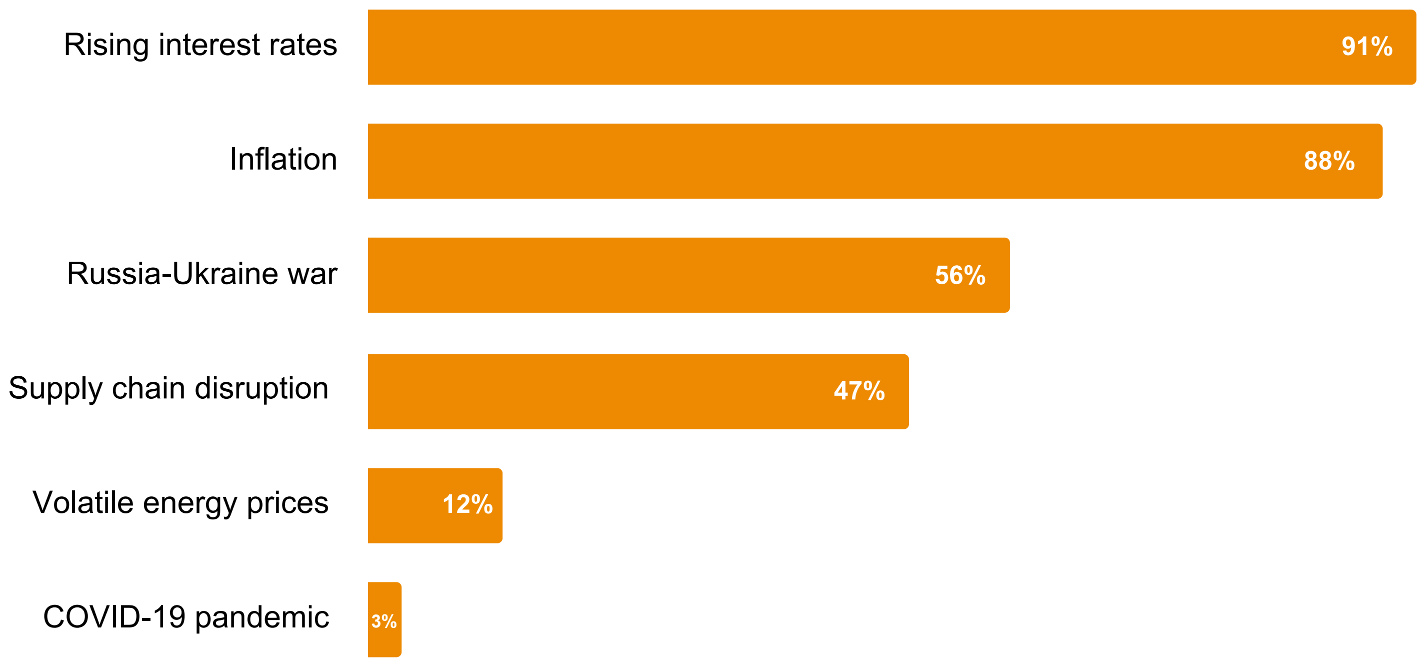
"The biggest thing people will need to wrestle with is that interest rates are higher, and for the first time in a long time there is yield again," says Patrick Ghali, managing partner and co-founder of hedge fund advisory firm

Figure 2.1 Allocators' outlook for the health of the global economy in 12 months' time



Analyst note: Totals may not add up to 100% due to rounding.
Source: Hedgeweek Allocator Survey, Q4 2022

Figure 2.2 Allocators' biggest macroeconomic concerns for 2023



Analyst note: Survey respondents were asked in November 2022, 'In terms of the way your firm positions its portfolio, what are your three biggest macroeconomic concerns?'
Source: Hedgeweek survey, Q3 2023

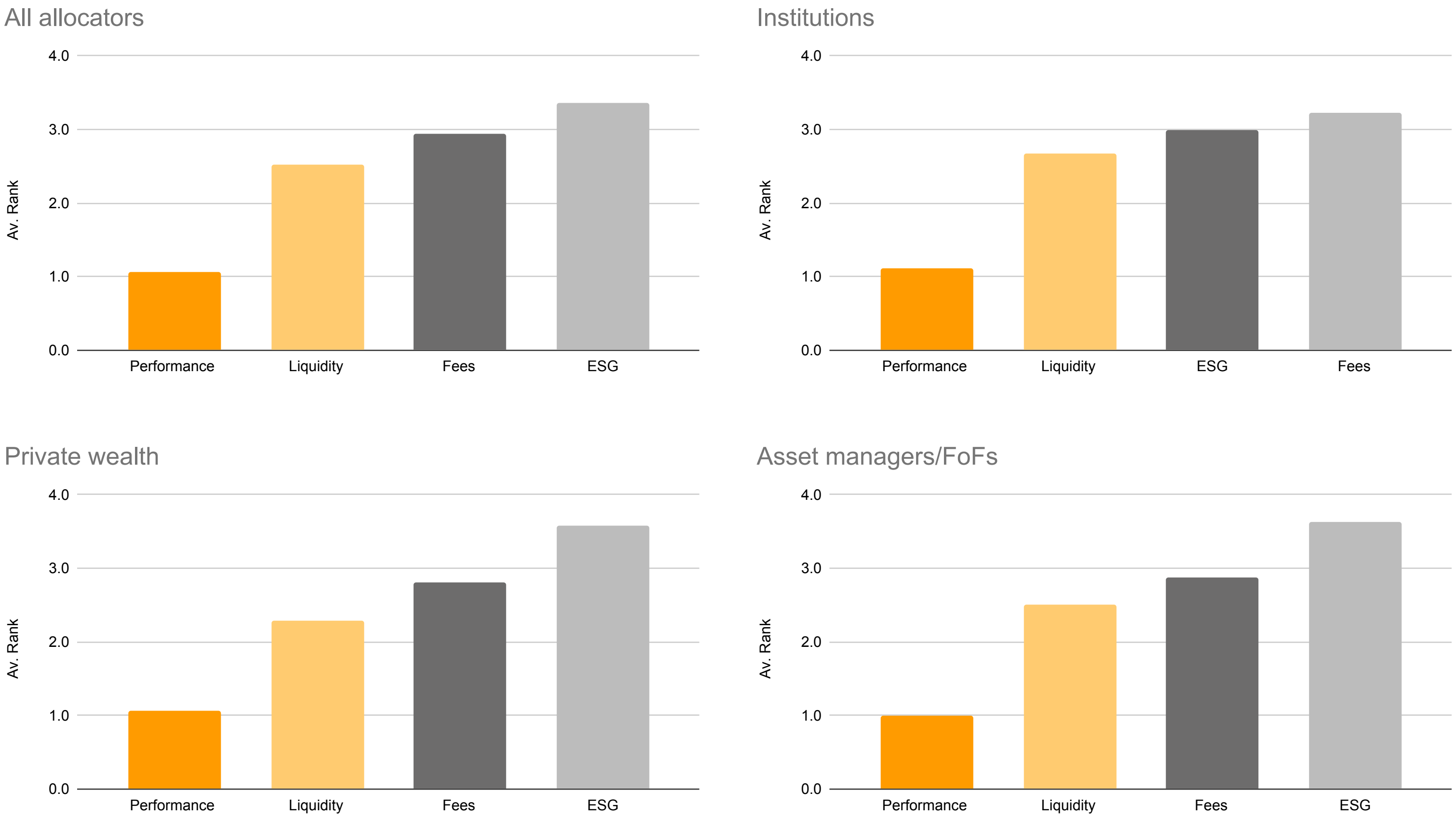
Sussex Partners.

"For investors, this is now key. A lot of hedge fund managers need to think about how they will generate returns in excess of the risk-free rate in a higher interest rate environment. A manager who is only making 5% a year when investors can get that risk-free is probably not going to stay in business for very long."

Priorities

With that in mind, it's little wonder that investment performance is now at the centre of investors' priorities heading into 2023. On a scale of 1-4, where 1 is the

Figure 2.3 Allocators' top priorities for 2023



Analyst note: Survey respondents were asked in November 2022, 'In the current market, in terms of your allocation strategy, how do you rank the following in order of priority (1=Most Important; 4=Least Important)'
Source: Hedgeweek survey, Q3 2023

most important and 4 is least important, performance ranked as the main priority across all allocator types, with an average ranking of 1.1 among institutions, private wealth, and asset managers/FoFs (see Fig. 2.3). Liquidity and fees appear somewhat level in order of priority, with investors ranking them 2.5 and 2.9, respectively, in order of priority.

"Relative performance has been the priority in 2022, as opposed to absolute performance," says Brooks Ritchey, senior managing director, co-chief investment officer, and portfolio manager at K2 Advisors. "For now, investors are focused on capital preservation. However, by early next summer, investors will refocus on absolute performance."

Meanwhile, Jens Foehrenbach, chief investment officer at Man FRM, says liquidity risks remain "at the forefront of our concerns."

"More than a decade of extreme monetary and fiscal policies has occasionally led to extreme volatility in asset prices, but now we are also seeing accompanying market fragility. This is clearly illustrated by September's surprising and sudden volatility in UK government bonds, which prompted emergency central bank intervention in one of the safest and most liquid markets," he says.

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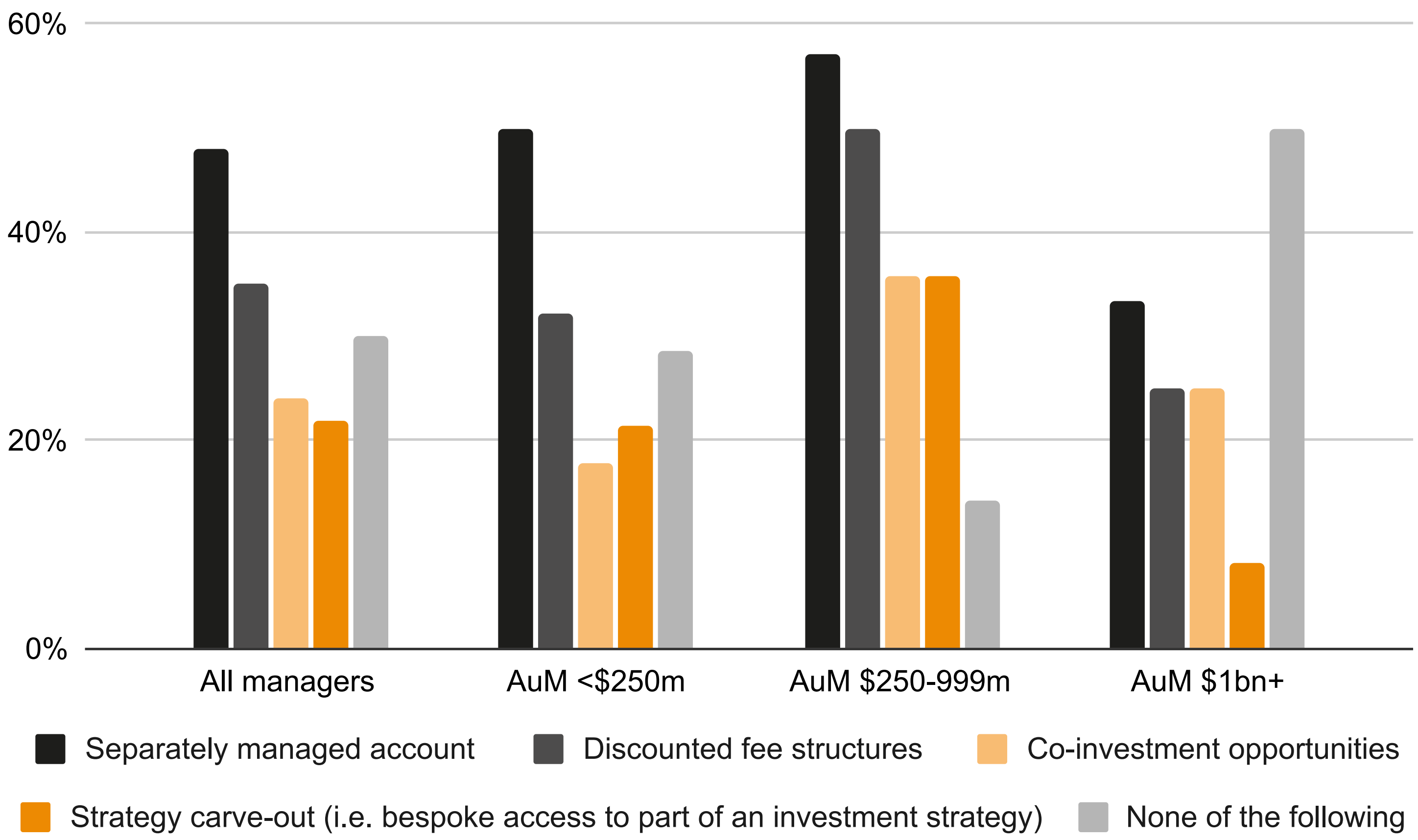
Figure 2.4 Proportion of hedge fund firms to field investor requests for bespoke products or terms, by firm AuM

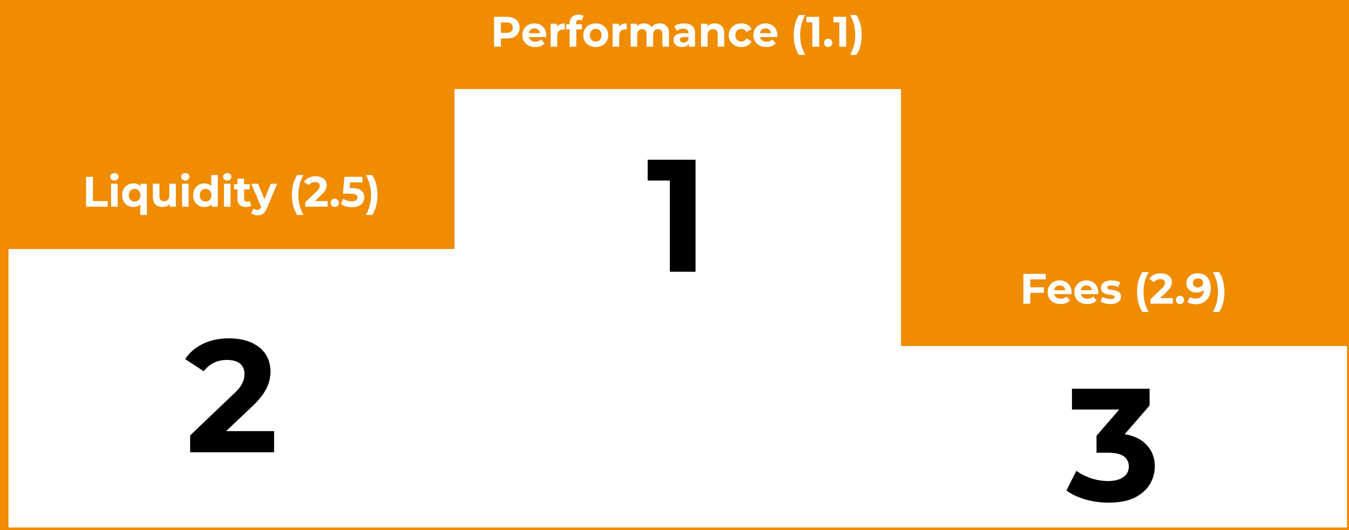


Source: Hedgeweek survey, Q3 2022

KEY FINDING

Performance is the priority. Everything else is taking a backseat.

Priorities for allocators in 2023 (average ranking in brackets)



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"In this environment, we must especially concentrate on risk managing our portfolios and identifying risks in our invested managers. That is an important part of how we intend to generate alpha for our clients next year. We will continue to avoid managers whose liquidity in stress scenarios is unlikely to meet the requirements of our portfolios. The value of liquidity is high."

Engagement

Meanwhile, with ESG ranked fourth, are investors beginning to shun the drive towards responsible investing – a major industry trend in recent years – as performance and portfolio protection take priority?

New data published by bfinance suggests not. Its 'Global Asset Owner Survey', which polled almost 400 respondents accounting for $13 trillion in assets, found that despite macroeconomic challenges, 32% of investors are cutting portfolio carbon emissions, with a further 34% planning to do so. One-quarter of allocators are themselves targeting net-zero themselves, and 32% would be "unlikely to hire an external manager" not committed to net-zero.

Carl-Johan Brodowsky and Jonas Börjesson, co-heads of investor relations at multi-strategy manager Brummer & Partners, say ESG remains a prominent theme in investor due diligence discussions, both in Europe and, increasingly, the US.

"I don't think there has to be a conflict between returns and having an ESG initiative implemented in the portfolio," says Brodowsky. "It's a demand from investors, and it's crucial for performance."

Börjesson adds: "There are always different discussions on how to implement ESG, whether it's through engagement and activist strategies, or through exclusion. I'm a strong believer in engagement and that's something that can add to alpha generation."

Alignment

Meanwhile, close to half of all managers surveyed by Hedgeweek (48%) say investors have enquired about separately managed accounts in the past year, and more a third (35%) of managers have asked for discounted fee structures (see Fig. 2.4). Some 24% have received questions about co-investment opportunities, while 22% have discussed strategy carve-outs.

Ritchey says custom bespoke accounts, for both institutional and private wealth groups, is "the biggest asset growth area that we've seen over the last 18 months", citing a number of pension fund clients who have sought tailored risk mitigation hedge fund portfolios to reduce equity and bond sensitivities.

"We've had a couple of institutional plans ask us if we would build and manage a risk mitigation strategy for them. It's something we had not seen for quite a while. We look at their stock, bond, and private investment allocations and then work with them to build a custom-made portfolio that hedges out the market risks they wish to avoid," Ritchey says.

"It does take a while to set up a bespoke account – it's very collaborative, and you're building a custom hedge fund product, so it takes maybe two to three months."

Wolf, who describes abrdn as "very big proponents" of separately managed accounts, says a major benefits of SMAs is in allowing managers to focus on buying assets and managing portfolios.

"If you can reduce, or even eliminate, the risk of all the other things – operations, back-office, infrastructure – and have the manager focused on the asset management side, and improve the alignment of interest between allocator and hedge fund, then a separately managed account makes sense," Wolf adds.

"What's driving this is the continued maturity of the industry, and the overall recognition that there is no such thing as a one-size-fits-all approach to accessing your hedge fund exposure."

KEY TAKEAWAY

Performance is now the top priority among hedge fund investors as concerns over interest rates and inflation underpin broader anxieties over the gloomy market outlook, with more allocators mulling customised solutions to protect portfolios. They also appear steadfastly committed to ESG initiatives, despite growing economic uncertainty.

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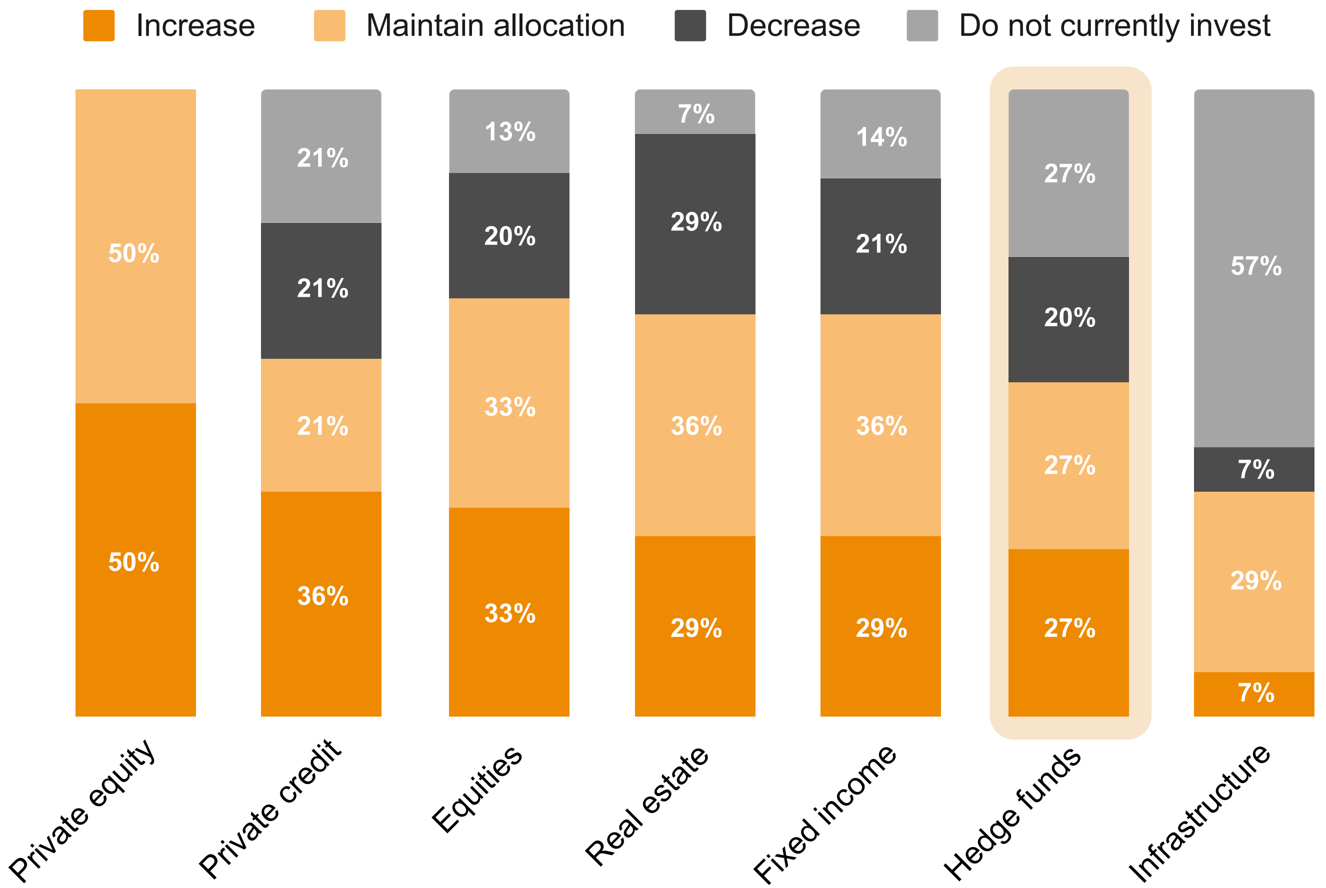
TIPPING THE BALANCE

Private wealth sentiment towards hedge funds appears decidedly mixed. But attractive liquidity and return profiles – coupled with burgeoning opportunities stemming from the cryptocurrency upheaval – offer the chance of inflows

Roughly 27% of private wealth investors plan to increase their hedge fund allocations next year, with another 27% set to maintain their allocation to the asset class, according to Hedgeweek data. However, 20% of private wealth investors intend to decrease their allocations in 2023, while the remaining 27% do not invest in hedge funds at all (see Fig. 3.1).

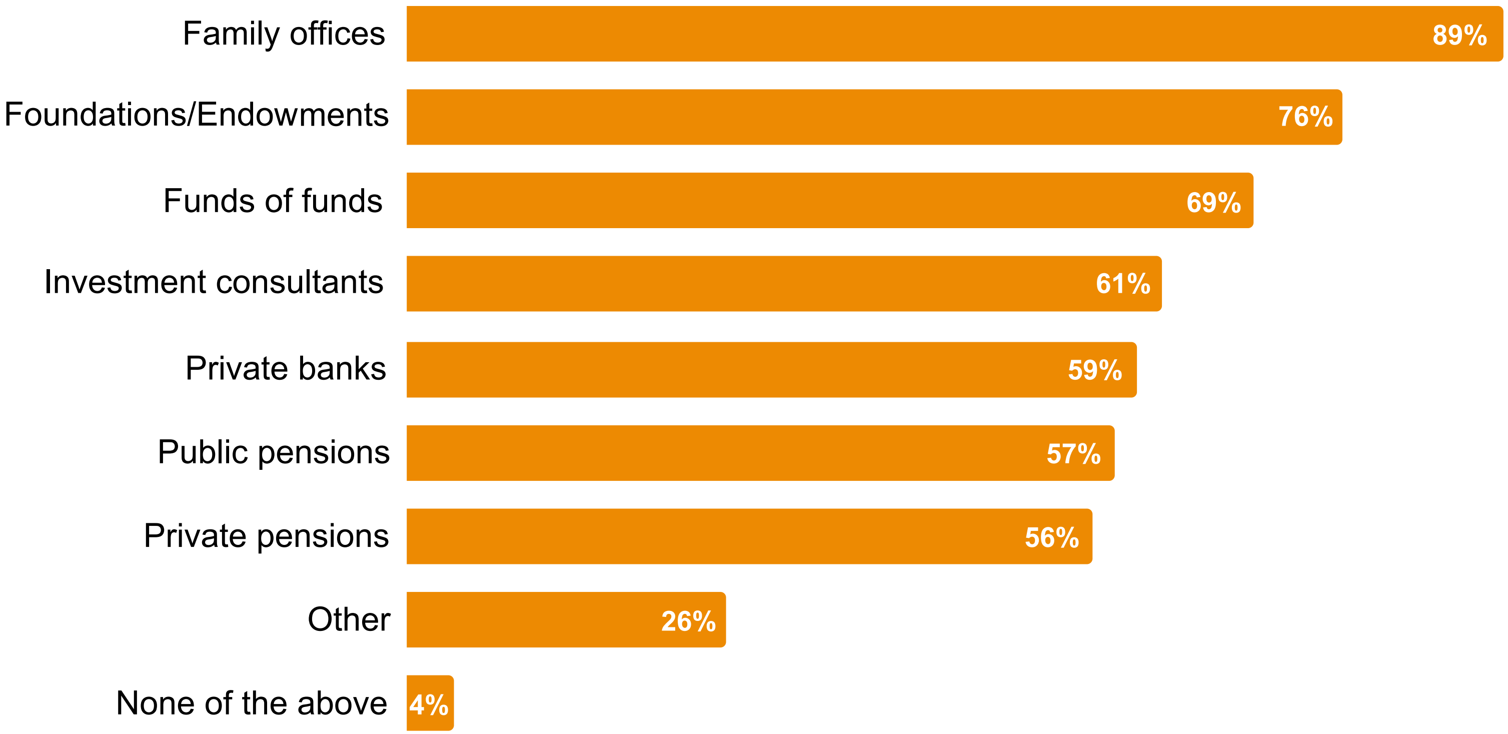
Those numbers contrast sharply with appetite for other alternatives: 50% of private wealth investors are set to grow their private equity exposure in the next 12 months, with another 50% planning to maintain their allocation. At the same time, 36% and 29% say they will increase their holdings of private debt and real estate assets, respectively.

Figure 3.1 Private wealth allocators' plans for key alternative and traditional asset classes in 2023



Analyst note: Survey respondents were asked in November 2022, 'How do you expect to change your exposure to the following asset classes over the next 12 months?' Our pool of private wealth allocators comprises mainly family offices, as well as wealth managers. Totals may not add up to 100% due to rounding.
Source: Hedgeweek Allocator Survey, Q4 2022

Figure 3.2 Top investor targets for hedge fund firms in 2023



Analyst note: Hedge fund manager survey respondents were asked in Q3 2022, 'Which investor groups/intermediaries are you hoping to engage with over the next 12 months? Source: Hedgeweek survey, Q3 2023

Security

"There is definitely a big trend into illiquid markets," observes Patrick Ghali, managing partner and co-founder of Sussex Partners. "Many of the large private banks have raised huge amounts of money – there is a sense of security and stability, though whether it actually turns out to be the case, we will see down the road."

However, Ghali also suggests it is not all one-way traffic within the private sphere. "There is more of a push, ironically, on the hedge fund side towards very liquid products, and even daily liquidity. On one hand, many private wealth investors are very happy to lock capital up for a long period of time. On the other hand, they want a lot of liquidity."

This apparent ambivalence among wealth managers towards hedge fund managers is not reciprocated. Asked which investor groups and intermediaries they hope to engage with in the coming year, family offices are overwhelmingly hedge funds' most common target: overall, 89% of all managers – and 95% of emerging hedge funds – hope to connect in 2023 (see Fig. 3.2).

Damage

Such a drive may yet yield inflows in the coming year, particularly from some private wealth investors.

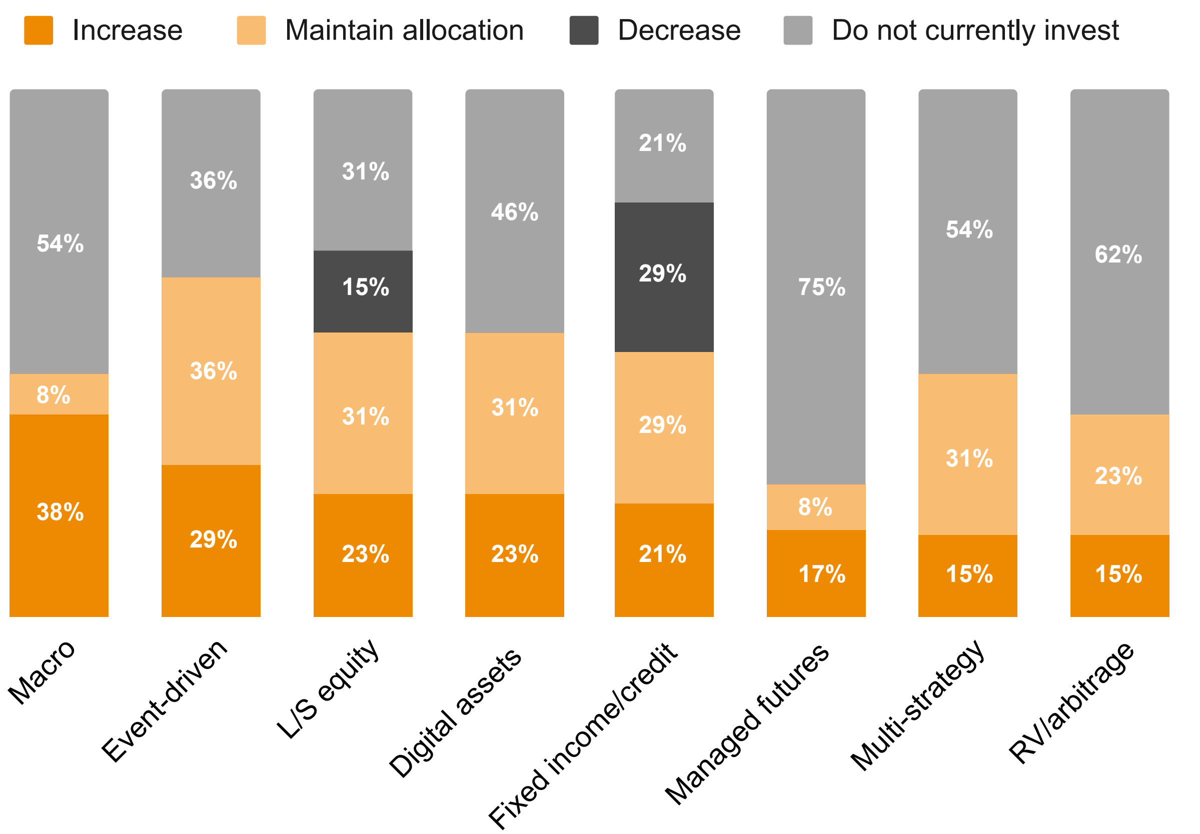
Richard Byworth, managing partner and head of liquid alternatives at Syz Capital, says there is a view among certain family office investors that larger, brand-name private equity firms have "done themselves reputational damage" from a fee perspective, particularly by charging on non-drawdown capital.

"This is a valid question that comes up in due diligence meetings and conversations with seasoned private equity investors," Byworth observes. "To some degree that pushes cheques a little bit more towards the direction of hedge funds."

With close to 40% of private wealth investors already set to increase their allocation to global macro strategies, it is a major opportunity for some managers (see Fig. 3.3).

Byworth says: "With hedge funds, you have a better liquidity profile for, in some cases, the same sort of return profile in a rising rate environment. You may have a big-name private equity fund targeting 8-12% with an 8-year lock-up, whereas you can now move into macro hedge funds and get similar returns without that illiquidity. The traditional 60/40 allocation has blown up in your face this year, so I think people who are coming from public markets, and that level of liquidity, will feel more comfortable with hedge funds."

Figure 3.3 Private wealth allocators' plans for key hedge fund strategies in 2023



Analyst note: Survey respondents were asked in November 2022, 'How do you expect to change your exposure to the following hedge fund strategies over the next 12 months?' Our pool of private wealth allocators comprises mainly family offices, as well as wealth managers. Totals may not add up to 100% due to rounding.
Source: Hedgeweek Allocator Survey, Q4 2022

DIGITAL DIVERGENCE

The digital assets space is emerging as a major fault-line between private and institutional capital. More than half of private wealth allocators now plan to increase or maintain their allocations to digital assets hedge funds in 2023, in stark contrast with institutional respondents, none of whom currently invest – or plan to invest – in the sector (see Fig. 3.4).

While the implosion of the FTX Exchange in early November dealt a huge reputational blow to the crypto sector, "our focus is not on the directional volatility of crypto, but on the alpha opportunity created by dislocations," says Brooks Ritchey, senior managing director, co-chief investment officer, and portfolio manager at K2 Advisors.

"The volatility is what creates the dislocations, and massive relative value opportunities, which is an area where, over the next two or three years, there should be good performance gains possible. Those arbitrage opportunity, relative value trades are areas which hedge fund managers are looking at."

Despite the FTX blow-up, Man Group's systematic hedge fund unit Man AHL is reportedly launching a crypto-focused hedge fund imminently.

The inefficiencies, fragmentation, and lack of institutional capital means crypto potentially heralds "a multiplier effect" on the alpha available within traditional finance, notes Byworth

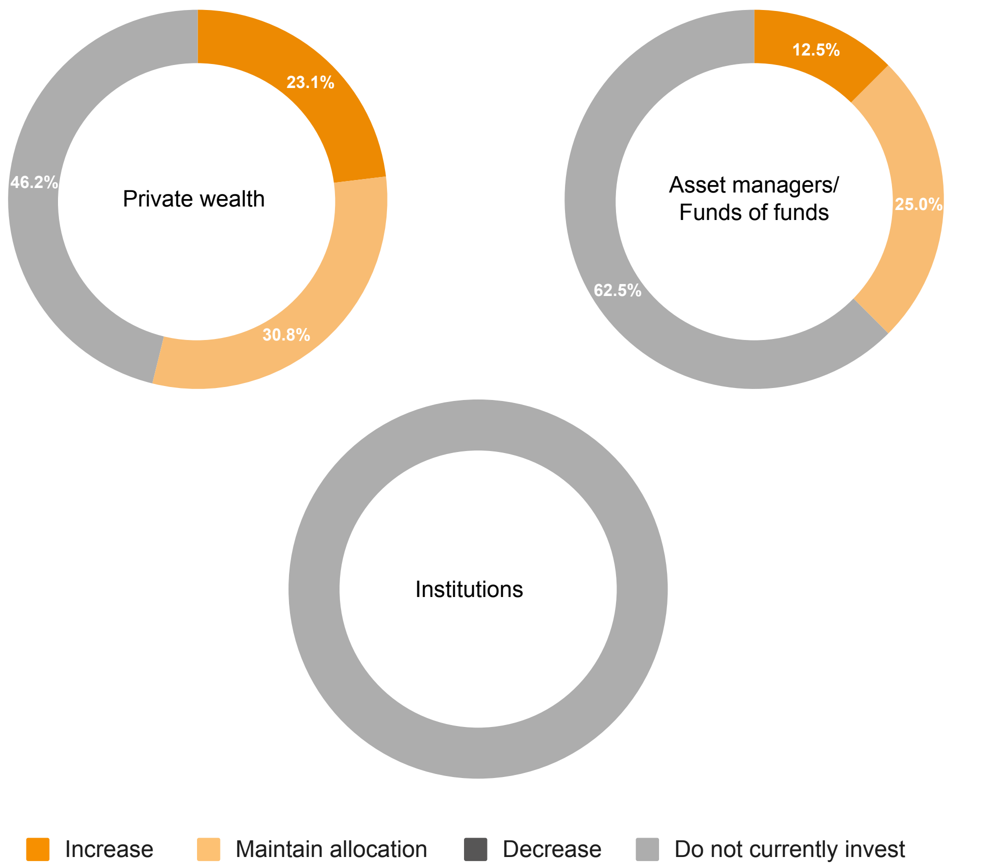
"Fundraising may be painful. Some people will look at it as a catastrophic raging bonfire unlikely to die down anytime soon. But shrewder investors will look for those who have analysed hedge funds, and the risk around hedge funds, and who can understand the value proposition, and identify and capture that alpha."

A GENERATIONAL DIVIDE

"If you look across private investors, particularly within the single- or even multi-family offices, you'll see generational differences," Marlin Naidoo, global head of capital introduction and consulting at BNP Paribas, observes of the ways in which the varying appetite for risk in the private space are shaping allocation plans.

"If it's an earlier-generation family office, there's a higher tolerance for risk – and some of these groups might have portfolios that are more directional, and would have endured more pain this year and will be looking to address that. If it's a third-, fourth- or fifth-generation family office, where capital preservation is the focus, they may end up having a portfolio that looks more like a pension fund portfolio."

Figure 3.4 Allocators' plans for digital asset hedge fund strategies in 2023

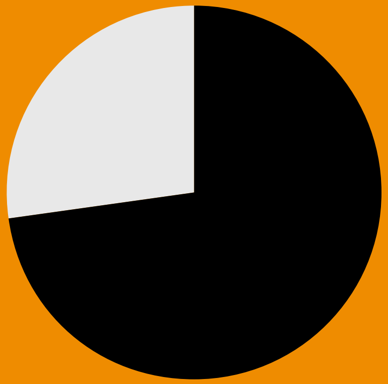


Analyst note: Survey respondents were asked in November 2022, 'How do you expect to change your exposure to the following hedge fund strategies over the next 12 months?' Our pool of private wealth allocators comprises mainly family offices, as well as wealth managers. Totals may not add up to 100% due to rounding. Source: Hedgeweek Allocator Survey, Q4 2022

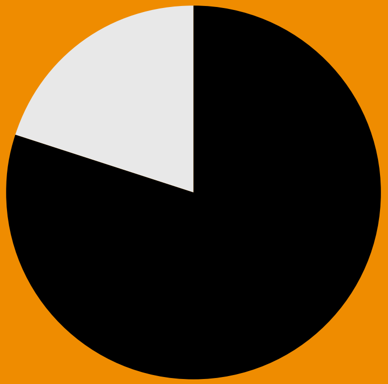
KEY FINDING

Private wealth's appetite remains mixed – but crypto may prove key

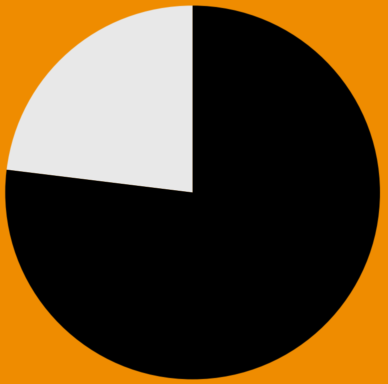
Among private wealth allocators surveyed:



27% – plan to increase exposure to HFs



20% – plan to decrease exposure to HFs



27% – plan to increase exposure to HFs

Q & A

Travis Williamson, partner and head of hedge fund research, Albourne Partners

What are some of the major trends among private wealth investors when it comes to hedge fund allocation in 2023, particularly when compared to interest in other alts?

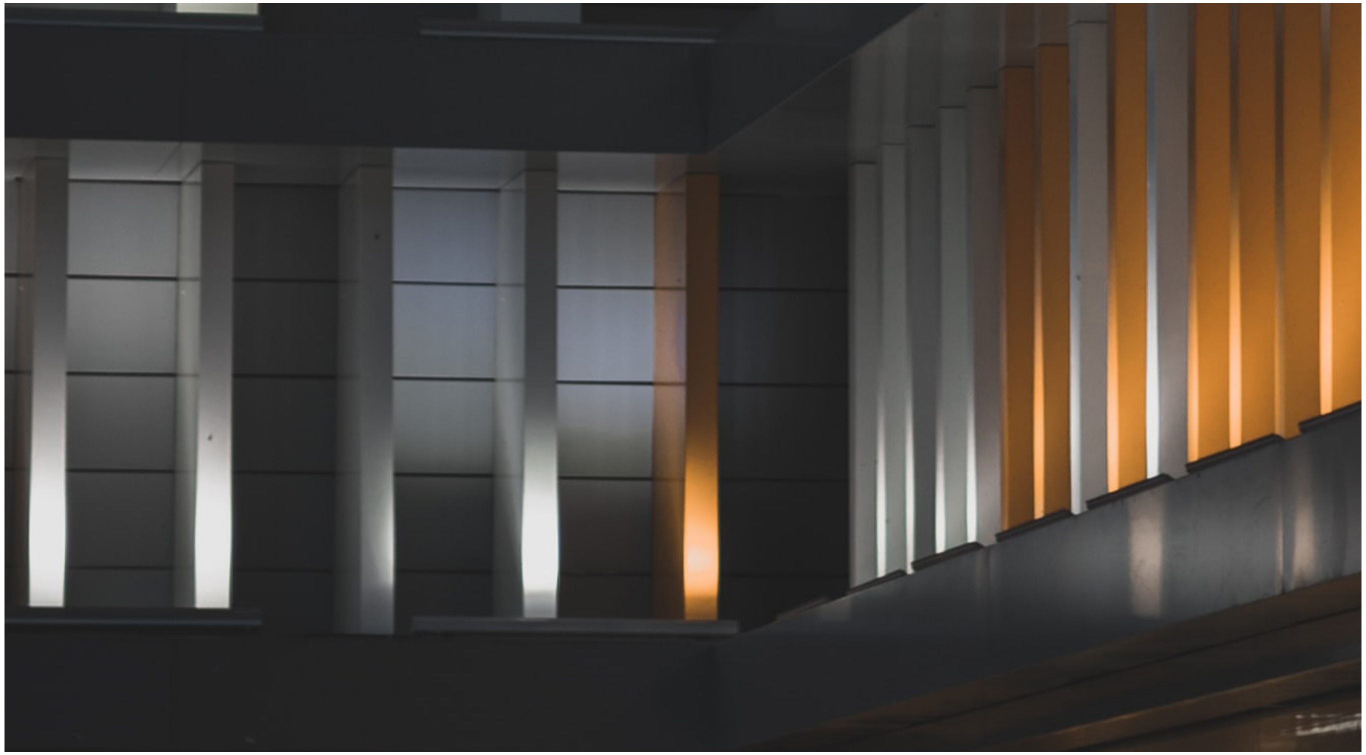
TW: "The appetite for alternative investments among the HNW group continues to grow. Many sophisticated investors are looking for ways to diversify, particularly following a period where some historically sound allocation frameworks have been challenged."

What are some of the issues keeping hedge fund allocators up at night?

TW: "Many issues and trends are strategy specific, but the overall trend of hedge funds becoming less liquid, from an LP perspective, is a significant trend. Hedge fund managers have become more dynamic in the pricing and liquidity profile of their offerings, and given the capacity constraints faced in many strategies, hedge fund managers are introducing more pass-through fee structures with reduced investor liquidity. This trend began in the large players within multi-strategy space and has permutated the industry."

KEY TAKEAWAY

Despite mixed appetite for hedge funds within the broader private wealth sphere, family offices remain a critical capital target for hedge funds large and small, particularly first-generation firms looking to grow their wealth. Elsewhere, a majority of private wealth investors are planning to grow or maintain their crypto hedge fund allocations, as ongoing digital assets dislocation proffers unique arbitrage opportunities.



A TIMELY SHIFT

Market commentators say sweeping write-downs on private assets next year could see institutional flows rebalance in favour of hedge funds as fees, liquidity and capacity issues focus minds

More institutional investors are opting for private assets over hedge funds as a means of protection against prevailing macroeconomic headwinds. Roughly three times as many institutional investors will increase their private equity exposure (55%) next year than they will add to hedge funds (20%) (see Fig. 4.1), with more allocators also favouring increases in private credit allocations (30%).

Nevertheless, just one in 10 institutions actually intend to withdraw capital from hedge funds, with close to a third of institutions keen to maintain their exposure next year, as inflation and interest rate challenges remain high on the agenda.

Exposed

Travis Williamson, partner and head of hedge fund research, Albourne Partners, says investors are looking for assets that are correlated with inflation, have return streams unrelated to economic activity, and that provide a hedge to the higher market volatility that inflation creates.

“Hedge funds are a particularly helpful asset class when thinking about the latter, as they are relatively liquid. Elsewhere we see continued focus on real assets, due to its inflation linked return profile.”

Meanwhile, an increasing number of market pros are now sounding the alarm on mark-to-market write-downs looming over private assets – and the potential fall-out on investor portfolios.

“Over the past few years, people have put a lot of money into private investments, semi-liquid or illiquid. The issue is that a lot of people are now over-exposed to the illiquid market, and a lot of those assets have

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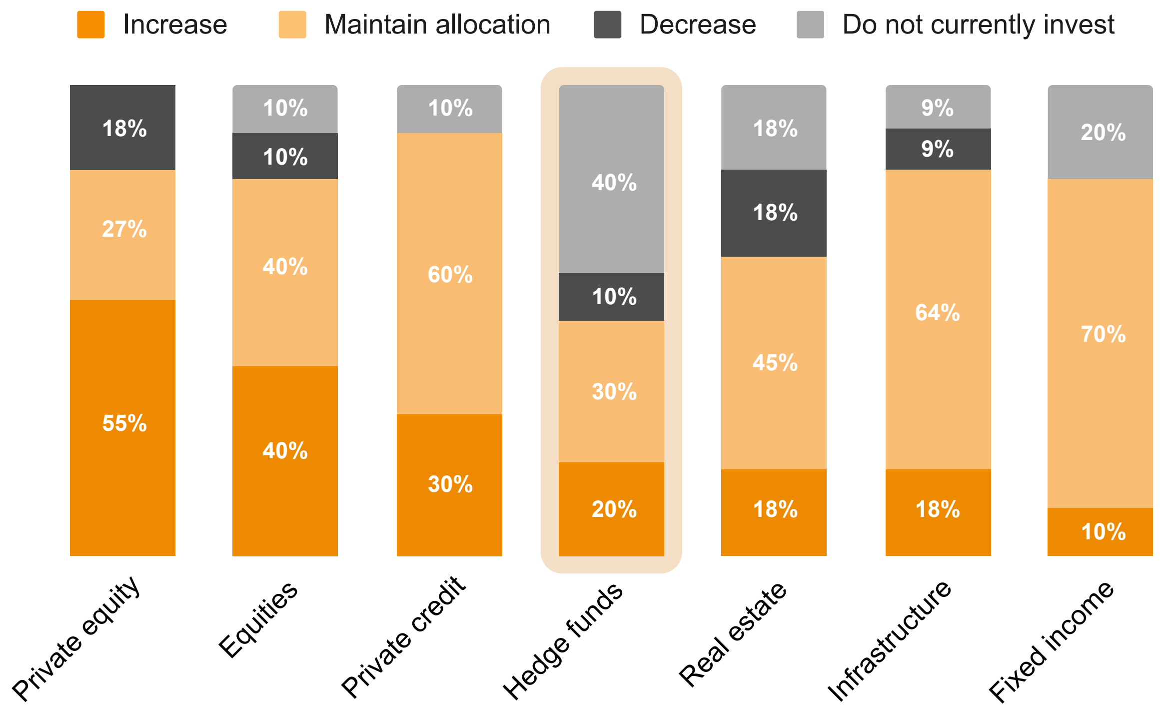
not been marked down yet properly," Patrick Ghali, managing partner and co-founder, Sussex Partners.

Industry practitioners explain that marks on private portfolios are typically delayed by a quarter or two, and so now private asset valuations are falling under closer scrutiny just as institutions are weighing up their allocation plans for 2023.

Ghali says: "You have two problems. One is that you have too much of an allocation to your private investments because everything else is down and they are stable. But the other problem is that they are probably not as stable, as they haven't yet been marked down properly. We're speaking to clients who are now getting capital calls. I think there is going to be a lot of issues here."

With the potential for certain private assets to be marked down as much as 20%, in line with public assets, Ghali predicts a growing

Figure 4.1 Institutional allocators' plans for key alternative and traditional asset classes in 2023



Analyst note: Survey respondents were asked in November 2022, 'How do you expect to change your exposure to the following asset classes over the next 12 months?' Our pool of institutional allocators comprises mainly private pensions, as well as public pensions and insurers. Totals may not add up to 100% due to rounding.
Source: Hedgeweek Allocator Survey, Q4 2022

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reluctance to allocate more money into illiquid strategies.

Complement

Against this potentially shifting backdrop, the biggest hedge funds are circling pension capital, with three-quarters of $1 billion+ managers looking to engage with public pensions next year and nearly 60% with private pensions (see Fig. 4.3).

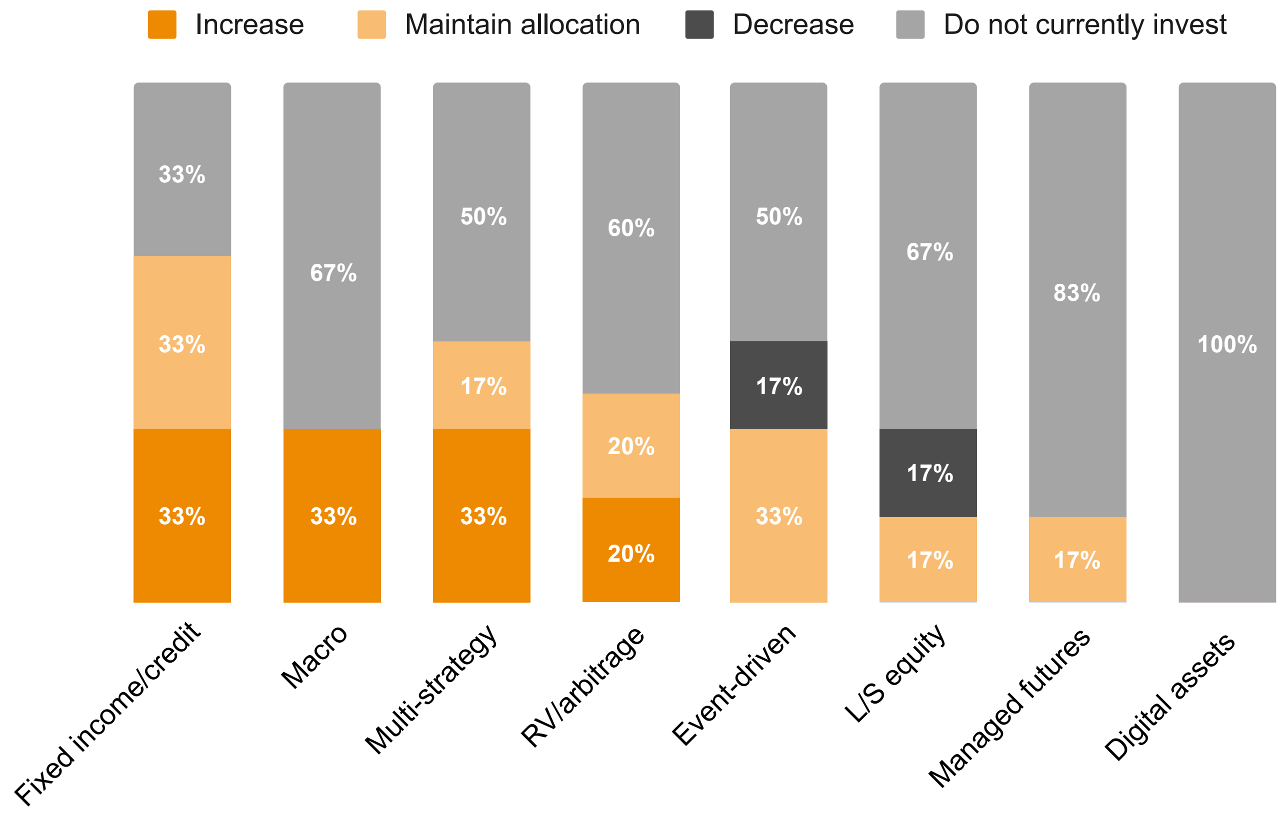
"Many institutional allocators are still coming to an understanding of what their portfolio will look like after 2022," Williamson says. "Given the decline in public equities, it's likely they are overweight in private assets, which at large, haven't experienced markdowns like public assets, and depending on where hedge funds are placed in their portfolio construct, this could impact investor reaction.

"Interest in hedge funds has increased, but given current allocation weightings, capital flows have not yet materialised."

Reflecting on the hedge fund-private equity dynamic among institutional allocators, Darren Wolf, global head of investments, alternative investment strategies at abrdn, points to the relative opacity in private equity compared with hedge funds and other alts.

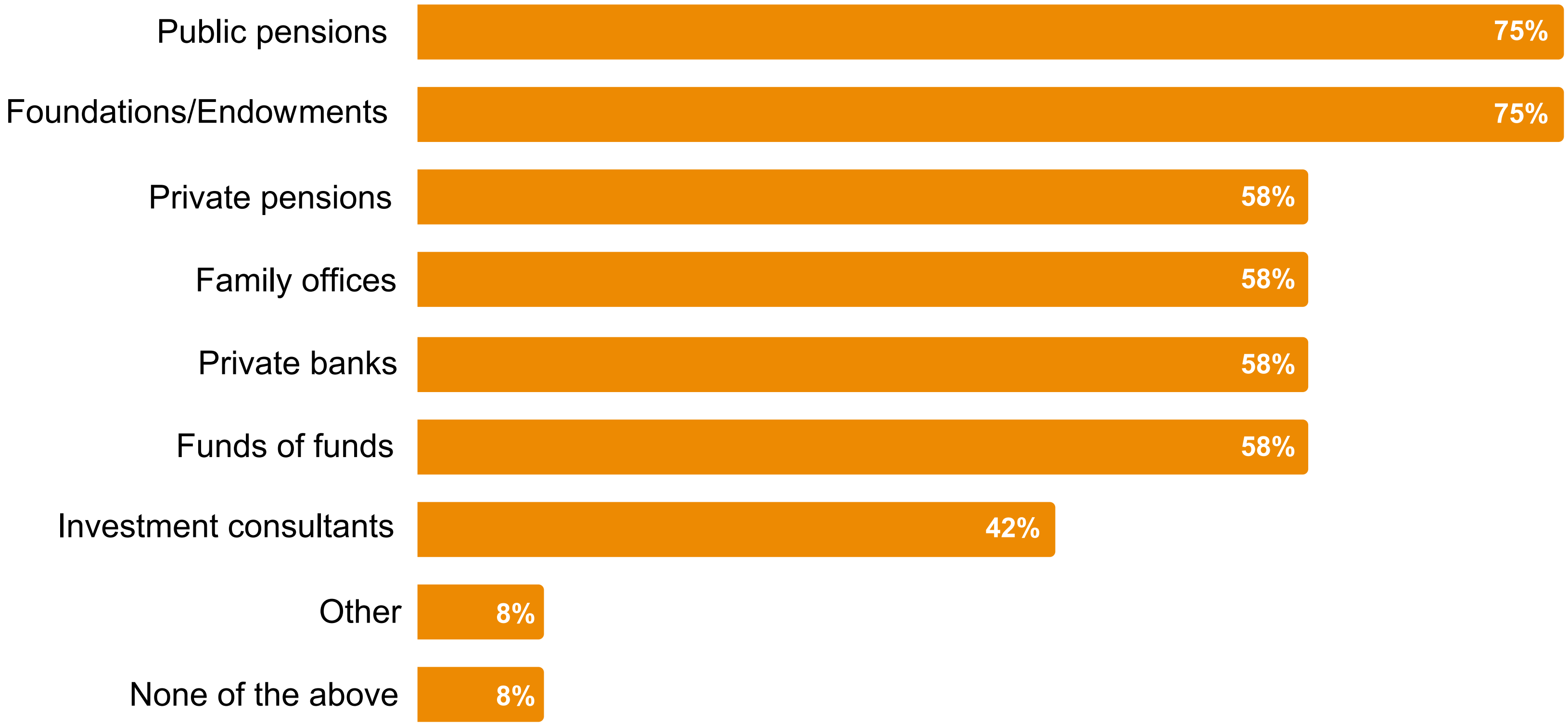
"Private equity has done very well for a very long time among institutional investors – but with private equity you are outright long equities in which you do not have any liquidity. Hedge funds and private equity tend to complement each other nicely: when things are humming along, the markets are quiet, volatility is low, and

Figure 4.2 Institutional allocators' plans for key hedge fund strategies in 2023



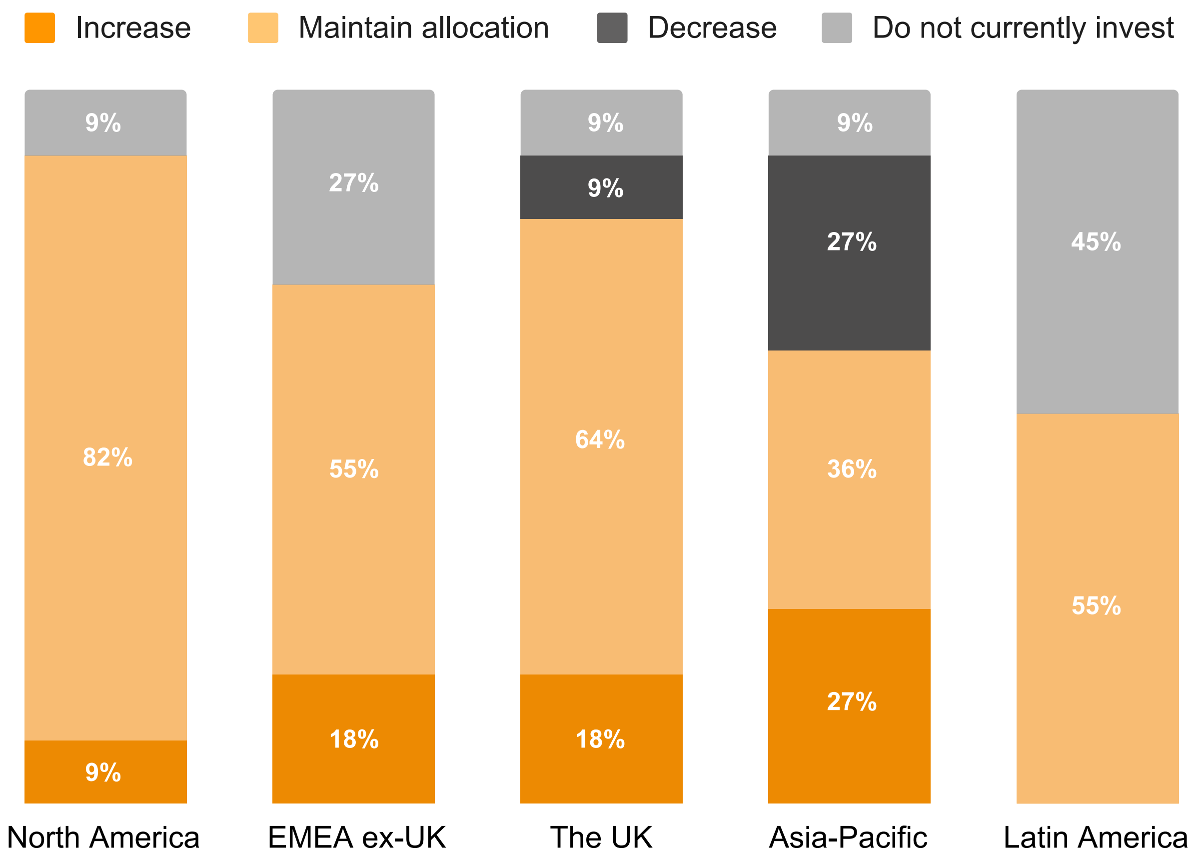
Analyst note: Survey respondents were asked in November 2022, 'How do you expect to change your exposure to the following hedge fund strategies over the next 12 months?' Our pool of institutional allocators comprises mainly private pensions, as well as public pensions and insurers. Totals may not add up to 100% due to rounding.
Source: Hedgeweek Allocator Survey, Q4 2022

Figure 4.3 Top investor targets for $1bn+ AuM hedge fund firms in 2023



Analyst note: Hedge fund manager survey respondents were asked in Q3 2022, 'Which investor groups/intermediaries are you hoping to engage with over the next 12 months?
Source: Hedgeweek survey, Q3 2023

Figure 4.4 Allocators' plans for key hedge fund strategies in 2023



Analyst note: Survey respondents were asked in November 2022, 'How do you expect to change your exposure to the following hedge fund strategies over the next 12 months?' Totals may not add up to 100% due to rounding.
Source: Hedgeweek Allocator Survey, Q4 2022

CHINA IN FOCUS

As many allocators are preparing to redeem capital from the Asia-Pacific as are planning to allocate in 2023, with more than one-quarter of institutional investors set to withdraw (see Fig 4.4). Industry pros see China as pivotal, as re-emerging geopolitical tensions and the potential for rising opposition to President Xi recalibrating investors' focus.

"Is China still investable? You have people with very different views," observes Patrick Ghali. "There are those who think it is very cheap. You have other investors who just don't want to touch it right now because they are worried it could go the same way as Russia, and introduce capital controls, and capital could be trapped. It's an interesting part of the hedge fund market, and now have an additional geopolitical filter or consideration on top of it – not just investment considerations."

companies are buying other companies – that's a great environment for private equity. It's more of a bull market-type of strategy.

"But on the flipside, during these types of cycles we have right now, hedge funds tend to outperform as things become more volatile," Wolf observes.

SHIFTING THE BALANCE

With a strategy rotation into blue-chip hedge funds potentially on the cards among allocators next year, long-standing wrangles over liquidity, capacity, and fees are coming into sharp focus.

"The issue with discretionary global macro, as well as those systematic trading strategies which can take advantage of the increasing volatility and dispersion, is that they don't have so much capacity," says Robert Khoury, director of investor relations at multi-strategy quant-focused manager Varuna Technologies AG and former senior portfolio manager at Union Bancaire Privée.

"In terms of drawdown, the large hedge fund managers, which have AUMs of above $5 billion, have been outperforming smaller managers – but a lot of the best-known managers have restrictions in terms of capacity. Many of them are closed."

Regarding the fee-liquidity dynamic, Marlin Naidoo says: "Allocators have historically wanted discounted fees and liquidity aligned to the liquidity of the underlying investments. Today the biggest demand is for the most expensive hedge funds that are extending their liquidity terms. On that basis, you can see that the balance of power is shifting to the manager versus the investor. For some institutional investors, if they weren't necessarily able to meet those terms or pay those fees, they would often have stepped away. But now for the most part, this is what they want. This is where the new price point is, both from a liquidity standpoint and an actual fees standpoint."

KEY TAKEAWAY

Private equity valuations may potentially face sharp write-downs next year, boosting interest in hedge funds among institutional investors seeking uncorrelated performance. Data shows the biggest managers are eyeing public pension funds, but industry practitioners warn that finding capacity in high-quality funds will prove a key challenge in 2023.

Q & A

Jens Foehrenbach, chief investment officer, Man FRM

How are institutions' allocation plans shaping up for 2023?

JF: Our conversations with large institutional investors indicate that owning sources of liquid diversifying returns will remain highly relevant in 2023, and we therefore expect a shift from illiquid alternatives whose realised returns are dependent on economic growth drivers to liquid alternatives that offer true diversification. We believe that the macroeconomic environment will continue to create difficult market conditions next year, further fuelling interest in customised hedge fund solutions that provide diversifying and liquid returns – both of which are desperately needed by investors in this environment.

Are investors asking for more bespoke products?

JF: A cornerstone of our value proposition to institutional clients is our ability to tailor customised solutions that address specific shortfalls in their portfolios. We can lever the analytical capabilities developed across Man Group to analyse client portfolio needs in a multi-dimensional framework. It helps us select targeted investment strategies and run them in a capital efficient manner, while considering each clients' specific liquidity and fee constraints.

KEY FINDING

Few institutions plan on decreasing their allocation to hedge funds…

…But many still don't allocate. Institutions' plans for hedge funds in 2023:

1 in 10 decrease

2 in 10 increase

3 in 10 maintain

4 in 10 do not allocate

INSIGHTS

HEDGEWEEK

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