Institutional Investment in Hedge Funds: Evolving Investor Portfolio Construction Drives Product Convergence
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Foundational shifts in institutional portfolio theory occurred in the late 1990s and early 2000s; these changes prompted investors to redirect capital out of actively managed long-only funds and channel a record $1 trillion to the hedge fund industry between 2003 and 2007.

- Rather than seeking to capture both alpha and beta returns from a single set of active portfolio managers investing across a broad market exposure, institutional investors began to split their portfolio approach in the late 1990s. These investors sought beta returns via passive investable index and exchange-traded fund (ETF) products built around specific style boxes and looking for alpha returns or positive tracking error from active managers with more discrete mandates which were measurable against clearly defined benchmarks.

- By 2002, views on how to best ensure alpha returns evolved again after Yale University and other leading endowments were able to significantly outperform traditional 60% equity/40% bond portfolios during the technology bubble by incorporating hedge funds and other diversified alpha streams into their portfolios, thus benefiting from an illiquidity premium and improving their overall risk-adjusted returns.

- To facilitate allocations to hedge funds and these other diversified alpha streams, institutions had to create new portfolio configurations that allowed for investments outside of traditional equities and bonds. One type of portfolio created an opportunistic bucket that set aside cash that could be used flexibly across a number of potential investments including hedge funds; the second type of portfolio created a dedicated allocation for alternatives which allocated a specific carve-out for hedge funds. In both instances, hedge fund allocations were part of a satellite add-on to the investor’s portfolio and were not part of their core equity and bond allocations.

In the years since the global financial crisis, a new approach to configuring institutional portfolios is emerging that categorizes assets based on their underlying risk exposures. In this risk-aligned approach, hedge funds are positioned in various parts of the portfolio based on their relative degrees of directionality and liquidity, thus becoming a core as opposed to a satellite holding in the portfolio.

- Directional hedge funds (50%-60% net long or short and above), including the majority of long/short strategies, are being included alongside other products that share a similar exposure to equity risk to help dampen the volatility of these holdings and protect the portfolio against downside risk. Other products in this category include traditional equity and credit allocations, as well as corporate private equity.

- Macro hedge funds and volatility/tail risk strategies are being included in a stable value/inflation risk category with other rate-related and commodity investments to help create resiliency against broad economic impacts that affect interest and borrowing rates.

- Absolute return strategies that look at pricing inefficiencies and run at a very low net long or short exposure are being grouped as a separate category designed to provide zero beta and truly uncorrelated returns in line with the classic hedge fund alpha sought by investors in the early 2000s.
The potential for market-leading institutions to divert allocations from their core holdings to hedge funds as they reposition their investments to be better insulated against key risks and the need for the broader set of institutions to ensure diversified portfolios to help cover rising liabilities and reduce the impact of excessive cash balances should both work to keep institutional demand for hedge funds strong.

We project that the industry may experience a second wave of institutional allocations over the next 5 years that could result in potential for another $1 trillion increase in industry assets under management (AUM) by 2016.

Although adoption of the new risk-aligned portfolio approach is at an early stage, the shift in thinking it has triggered has already had significant impact on product creation. This has resulted in the emergence of a convergence zone where both hedge fund managers and traditional asset managers are competing to offer the broad set of equity and credit strategies represented in the equity risk bucket.

- Asset managers looking to defend their core allocations are moving away from a strict benchmarking approach; they are creating a new set of unconstrained long or “alternative beta” products that offer some of the same portfolio benefits as directional hedge funds in terms of dampening volatility and limiting downside. They are also looking to incentivize their investment teams, improve their margins, and harness their superior infrastructure by competing head to head in the hedge fund space; however, long-only portfolio managers choosing to go this route may face an uphill battle in convincing institutional investors and their intermediaries about their ability to effectively manage short positions.

- Large hedge funds that specialize in hard-to-source long/short strategies, or that have chosen to limit capacity in their core hedge fund offering, are being approached opportunistically by existing and prospective investors to manage additional assets on the long-only side of their books, where they have already proven their ability to generate alpha.

- Other large hedge funds have made a strategic decision to tap into new audiences and are crossing the line into the regulated fund space, creating alternative UCITS and US Investment Company Act of 1940 (40 Act) products, as well as traditional long-only funds. These products are targeted at liquidity- constrained institutions and retail investors where the sizes of the asset pools are likely to be large enough to offset low fees.

Beyond the potential $1 trillion we see for institutional investors to increase their allocation to hedge fund strategies, we estimate that there could be an additional $2 trillion opportunity in these convergence zone products where hedge funds and traditional asset managers will compete head to head.
Institutional Investment in Hedge Funds: Evolving Investor Portfolio Construction Drives Product Convergence

To understand the industry dynamics, we conducted 73 in-depth, one-on-one interviews with an array of institutional investors (chief hedge fund allocator), hedge fund managers (COO/CFO and marketing leads), large asset managers (head of product development and business strategy), consultants (head of the hedge fund or alternatives practice area) and fund of fund managers. Taken all together, our survey participants represented $821 billion in assets either allocated, managed or under advisement in the hedge fund industry.

Our survey interviews were not constructed to provide one-dimensional responses to multiple choice questionnaires, but were instead free-flowing discussions. We collected more than 80 hours of dialog and used this material to spur internal analysis and create a holistic view of major themes and developments. This type of survey is a point-in-time review of how investor allocation theory is evolving, and how hedge funds and asset managers are in turn looking to advance their product offerings.

This report is not intended to be an exact forecast of where the industry will go, but we did construct the paper around the comments and views of the participants, so many of the themes are forward looking. We have also built indicative models based on those views to illustrate how asset flows and opportunity pools may develop in the near future.

The structure and presentation of the report is intended to reflect the voice of the client and is our interpretation of their valued feedback. To highlight key points, we have included many quotes from our interviews but have done so on a generic basis, as participation in the survey was done on a strictly confidential basis and we do not identify which firms or individuals contributed to the report.

There are a few topics that this survey has touched upon that have been covered in more detail by other recent publications from Citi Prime Finance. In those cases we have referenced the source, and where it touches on broader adjacent trends we have noted it but tried to stay on topic for the subject at hand. The following chart shows the survey participants that we interviewed this year, representing all major global markets.
Introduction

Over the last several years, a paradigm shift has occurred in both the way institutional investors include alternative strategies in their portfolios and in the way hedge fund managers and traditional asset managers position their offerings for this audience.

In Part I of the report (Sections I-III), we focus on the investor side of this story. We examine the evolution of portfolio theory and how these doctrines impacted institutional portfolio construction in the late 1990s/early 2000s, setting the stage for these participants to become the predominant investors in the hedge fund industry. We also detail a new risk-aligned approach toward constructing portfolios that has the potential to dramatically increase the use of hedge fund strategies, repositioning them from a satellite to a core holding in institutional portfolios. We conclude this examination by looking at how interest from each of the major institutional investor categories is likely to progress, and what the total impact could mean for overall industry AUM.

In Part II (Sections IV-VI), we turn our attention to how both hedge funds and traditional asset managers have evolved their offerings, examining why the gap between product types has narrowed and detailing where these managers are now beginning to offer competing products. We delve into the structural advantages and the perceptional challenges affecting asset managers’ efforts to expand their product set, and focus on which managers in the hedge fund space are best positioned to expand their core offerings and why. We then look at the range of product innovation occurring across the largest of hedge fund participants, and examine the potential fees and asset pools available in each. Finally, we calculate what the individual and total opportunity may be to add assets in long-only and regulated alternative products.

In Part III (Section VII), we bring these arguments together, discussing how hedge fund managers and asset managers looking to offer hedge fund product can best align their marketing efforts to the various portfolio configurations being used by the institutional audience. We also explore the changing role of key intermediaries, and discuss how managers can leverage these relationships to improve their contact and understanding of investors and expand their reach into investor organizations.

“To me, investing is about going back to the basics. Why do I want to be in this asset class? Why do I want this product? Where does it fit in my portfolio? Once I know the answer to those questions, then I find a manager that fits the mandate. The onus is really on the investor to know why they’re creating the portfolio they’re creating.”

– European Pension Fund
Institutional interest in hedge fund investing is a relatively new occurrence, with the majority of flows from this audience entering the industry only since 2003. The impetus for these institutions to include hedge funds in their portfolios was two-fold. Views on how to optimally obtain beta exposure in their portfolio shifted, causing institutions to separate their alpha and beta investments, and market leaders demonstrated the value of having diversified alpha streams outside of traditional equity and bond portfolios.

Modern Portfolio Theory (MPT) and the Capital Asset Pricing Model (CAPM) prompted institutional investors to pursue both alpha and beta returns from a single set of active portfolio managers investing across a broad market exposure from the 1960s through to the mid-1990s. Eugene Fama from the University of Chicago and Kenneth French from Yale University published new financial theory that resulted in a major shift in portfolio configuration by the early 2000s. This new multi-factor model transformed institutional portfolio leading investors to split their portfolio into distinct sections - one portion seeking beta returns via passive investable index and ETF products built around specific style boxes, and another looking for alpha returns or positive tracking error from active managers with more discrete mandates that could be measure against clearly defined benchmarks.

Views on how to best ensure alpha returns evolved again by 2002 after Yale University and other leading endowments were able to significantly outperform traditional 60% equity/40% bond portfolios during the Technology Bubble by incorporating hedge funds and other diversified alpha streams into their portfolios, thus benefiting from an illiquidity premium and improving their overall risk-adjusted returns.

Please the appendix for a more thorough discussion of these theories and how investor portfolios were configured prior to the 2000-2003 time period. This section will now pick up with the impact of those changes.

Institutional Investors Shift Assets Into Hedge Fund Investments

The market correction in 2002 and the outperformance of more progressive E and Fs in that period can be viewed as a tipping point for the hedge fund industry. A second shift in beliefs about their core portfolio theory occurred across many leading institutions.

Just as they did when Fama’s and French’s theory caused them to divert a portion of their actively managed long funds to passive investments, new allocation concepts about diversifying alpha streams caused many institutional investors to shift additional capital away from actively managed long-only funds and significantly increase their flows to hedge funds.

CHART 1: INSTITUTIONAL INVESTOR FLOWS OF MONEY INTO HEDGE FUNDS (ASSET FLOWS ONLY—DOES NOT INCLUDE PERFORMANCE)

Source: Citi Prime Finance Analysis based on HFR data 1995-2003; eVestment HFN data 2003-2012
A massive wave of new capital entered the hedge fund market in the following 5 years. Between 2003 and 2007, more than $1 trillion in new money was channeled to the hedge fund industry from institutional investors. This was more than double the amount of flows noted over the previous 8 years, as shown in Chart 1. Indeed, up until now the flows during these years remain the largest single wave of money the industry has seen.

The impact of this move, and the earlier change in allocations from active to passive funds, are clearly evident in Chart 2. In 2003, institutional investors only had 7.0% of their portfolio allocated to passive or beta replication strategies and 2.4% allocated to hedge funds. The remainder of the portfolio (90.6%) was invested with traditional active asset managers. By 2007, a full 10% of the assets for these investors had been allocated away from active managers. Passive mandates received an additional 3% of the allocation to grow to 10% of the total portfolio, while the hedge fund allocation grew by nearly four times, to 9.2% of the total portfolio.

**CHART 2: COMPARISON OF INSTITUTIONAL AUM POOLS BY INVESTMENT TYPE**

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<thead>
<tr>
<th>December 2003 $8.7 Trillion</th>
<th>December 2007 $13.5 Trillion</th>
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<tr>
<td><strong>Hedge Funds</strong></td>
<td><strong>Hedge Funds</strong></td>
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<td>7.0%</td>
<td>9.2%</td>
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<tr>
<td>Active 7.8T</td>
<td>Active 10.9T</td>
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<tr>
<td>90.6%</td>
<td>80.7%</td>
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Comparison of institutional aum pools by investment type

Source: Citi Prime Finance analysis based on eVestment HFN & ICI & Sim Fund data

“**Institutionalization started around 2000 when people were watching their long-only equity allocations post down 20% and hedge funds were able to exploit heavy thematic trends in equity markets and alternative forms of beta that clients didn’t have anywhere else in their portfolio,**

- Institutional Fund of Fund

“**Clients are selling their long-only equity funds to buy other stuff. Everything from hedge funds to other stuff like real assets—everything from commodities to real estate to infrastructure deals. My guess would be that they’ve moved 10% out of their equities allocation with 5% going to hedge funds and 5% to real assets.**

- Long-Only & Alternatives Consultant
Institutional Inflows Change the Character of the Hedge Fund Industry

From 2003-2007, institutional inflows worked to significantly change the character of the hedge fund industry. Up until the early 2000s, the majority of investors in the hedge fund industry had been high net worth individuals and family offices looking to invest their private wealth.

As shown in Chart 3, in 2002 these high net worth and family office investors were seen as the source for 75% of the industry's assets under management. Even though these investors continued to channel assets to the hedge fund industry in the subsequent 5 years, their flows were unable to keep pace with the wall of institutional money entering the market.

By 2007, the share of capital contributed by high net worth and family office investors had fallen nearly 20 percentage points. It was for this reason that many began to talk about the industry as becoming “institutionalized”. As will be discussed, the drop in high net worth and family office interest can be directly related to this institutionalization.

At the outset of this period in 2003, institutional investors only accounted for $211 billion AUM, or 25% of the industry's total assets. Inflows from 2004 to 2007 caused this total to rise sharply, reaching $917 billion, or 43% of total industry assets.

Institutional investors entering the market were looking for risk-adjusted returns and an ability to reduce the volatility of their portfolios. This was a very different mandate from the one sought by high net worth and family office investors—namely, achieving outperformance and high returns on what they considered to be their risk capital. This difference in their underlying goals helps to explain continued shifts in the industry's capital sources in the period subsequent to 2007.

While down sharply during the global financial crisis, hedge funds were still able to post better performance than long-only managers held in investors’ portfolios, and they helped to reduce the portfolio’s overall volatility. Institutional investors focused on this outcome and saw hedge funds as having performed as desired. High net worth and family office investors saw this outcome as disappointing.

Since that time, many high net worth and family office investors have exited the hedge fund industry to seek better returns in other investment areas such as art or real estate, but institutional investors for the most part maintained and even extended their hedge fund allocations. The result has created a denominator effect. As of the end of 2011, we estimate that institutional investors as a group accounted for 60% of the industry's assets. While this appears to have jumped sharply since 2007, much of the increase is because overall high net worth and family office allocations have gone down. Between 2007 and 2011, we estimate that high net worth and family offices’ share of hedge fund industry AUM fell from 57% down to only 40% of total assets.

"All of our capital last year came from US institutional investors."  
- $5-$10 Billion AUM Hedge Fund

"Private investors just look back 3 years and see how they’ve performed and from that perspective, hedge funds have just not been sexy enough. They haven’t been able to show consistent performance across 2009, 2010, and 2011 to convince the private audience that they do what they say they do,”  
- Asset Manager with Hedge Fund Offerings
Two Main Institutional Investor Portfolio Configurations Emerge

When the massive wave of inflows began in the period from 2003-2007, most institutional investors still had their traditional 60% equities/40% bonds portfolio. To change that approach, they typically worked with an industry consultant to come up with a new allocation, and then sought approval on that configuration from their investment committees and board of directors. Since the alternative alpha streams these investors were looking to create did not fit into an existing portfolio category, investors and their advisors came up with a new bucket for these strategies. The result was two new portfolio configurations that moved institutional investors away from their traditional 60/40 mix.

Many investors sought to mimic the leading E and Fs portfolio approach by asking for a ready pool of cash that they could deploy as desired to a range of illiquid investments or investments that did not fit within a traditional asset bucket, either because of the instruments they traded or their inability to be benchmarked to a specific index. These investors approached their boards and investment committees and got authorization to create a new opportunistic allocation. This new bucket provided investment teams with ready capital that they could deploy across a broad range of potential investments including hedge funds. This portfolio configuration is illustrated in Chart 4.

For many investors, this configuration was used as a transition portfolio but for others, their approach to alternative and hedge fund investing endures via this configuration to the present day. This is especially true for many E and Fs and sovereign wealth funds that look for more flexibility with their portfolios allocations.

Indeed, some participants pursuing this approach have gotten creative in using the allocation, including remanding responsibility for portions of the portfolio to external advisors to invest as those managers deem appropriate within agreed risk limits.

Yet, as the name implies, many investors also choose to only utilize the capital in this allocation when a specific opportunity emerges. Having the ability to allocate to hedge funds or other investments does not imply a requirement to allocate in this opportunistic configuration. Several investors we interviewed have the mandate to invest in hedge funds, but are under no pressure to deploy capital.

"Our final bucket is opportunistic. Most of our hedge funds are in here. We also have a number of external CIOs in this bucket. We’ve identified 5 managers that can do anything they want to do with the money we allocate to them. We give each of these managers $500-$600 million. Their only restriction is that they can’t exceed our volatility target of 12%. All together, our opportunistic bucket has beaten the HFRI index by about 200 basis points after fees each year."

- Sovereign Wealth Fund

"It was more than a 3-year education process for the board on hedge funds. Initially we implemented an opportunistic allocation. Capital preservation and dampening the downside was part of the story to get the board to approve the allocation: ‘So when you crawl out off the hole it is not as deep as it could have been.’"

- US Public Pension
Other organizations, particularly many public pensions, came up with a different portfolio configuration to enable their hedge fund investing. The boards and investment committees at these organizations wanted to have more oversight and set tighter parameters around how capital was invested. These organizations tended to have a very structured investment process that required extensive oversight and approvals. Moreover, these investors often worked with consultants that required specific mandates around the type of assets permitted in the portfolio and the size of assets they would be advising.

These investors and their advisors developed the concept of porting their alternative alpha streams away from the main equity or bond allocation to a new sleeve within their portfolio that became broadly known as the alternatives bucket. This portfolio configuration is illustrated in Chart 5.

Each type of investment permitted within the alternatives bucket had a specific allocation and its own set of policy guidelines. In this way, the new investments were set up like an additional asset class in line with the approach used in the traditional equity and bond portions of the portfolio. This accommodation was made because there was not an appetite to have the flexibility of an opportunistic bucket. Most investors using this portfolio configuration acknowledge that they do not truly see hedge funds as an asset class, but they nonetheless count them in this way to satisfy their allocation rules.

Because many pensions have adopted this approach and they are by far the largest category of institutional investor, this has since become the dominant portfolio configuration for investors in the hedge fund industry. What is important to note about this configuration and the opportunistic approach is that in both instances the capital allocated to hedge funds is coming from a satellite part of the portfolio that typically only accounts for a small percentage of the institution’s overall pool of assets. The core of the portfolio remains in the equity and bond allocations.

As will be explored in the next section, there are signs emerging that institutional investors may be in the midst of another foundational shift in how they look to configure their portfolios, the result of which may work to reposition hedge funds from a satellite into the investor’s core allocations.

“Interest has come from the public plans and has been driven by adoption of policy change to allow them to invest in alternative strategies,”
- $1-$5 Billion AUM Hedge Fund

“Big institutions out there had governors on their long-only buckets that limited their ability to allocate to alternatives. That’s why they came up with portable alpha.”
- <$1 Billion AUM Hedge Fund

“For allocation purposes, we treat hedge funds like a separate asset class even though we realize that they’re not,”
- European Public Pension

“Liquidity issues and impacts of hedge funds that differ from traditional investments drive the thought of putting hedge funds into alternative buckets,”
- US Corporate Pension Plan

“Most of our clients view hedge funds as a strategy, but bucket it as an asset allocation. Our clients understand that you can’t determine whether hedge funds are over- or undervalued. It’s a strategy, but they track it as an asset class,”
- Institutional Fund of Fund

“Family offices can invest in what they want. Sovereign wealth funds also can do what they want. They set up an opportunistic bucket just so that they’ll have a place to invest in what they want,”
- >$10 Billion AUM Hedge Fund

“We have a 0%-8% allocation to an opportunity fund. We can put anything short term in nature here or something that doesn’t fit in the portfolio like hedge funds or commodities. There is no pressure to put anything in, though,”
- US Public Pension
Institutional Investment in Hedge Funds: Evolving Investor Portfolio Construction Drives Product Convergence

Institutional Investors Initially Seek Diversified Hedge Fund Exposure via a Singular Allocation

When large institutional flows commenced in the early to mid-2000s, the goal of the investment was to obtain exposure to a diversified hedge fund return stream in order to have an alternate alpha source and to capture an illiquidity premium. The mechanics behind how investors sought that exposure in those early years pre-crisis were extremely different than the model that has emerged in the subsequent period.

As discussed in last year’s annual survey, Pension Fund & Sovereign Wealth Fund Investments in Hedge Funds: The Growth & Impact of Direct Investing, the majority of institutional investors commenced their hedge fund programs by making a single allocation, typically to a fund of fund, with the goal of obtaining a diversified exposure to a broad set of hedge fund strategies and their associated return streams. Using a fund of fund as an intermediary allowed institutional investors to leverage that team’s knowledge of the hedge fund space and their access to managers. Expectations were that the fund of fund manager would move allocations around as needed to ensure the maximum diversification and optimal performance of the portfolio. This was not something most institutional investors were prepared to handle given resource-constrained investment teams that typically had little familiarity with the hedge fund space.

As the investor’s knowledge of hedge funds increased, and as many investment committees and boards became uncomfortable with the fees they were paying to fund of funds, many institutional investors began making direct allocations to hedge funds. Many of these investors began their direct investing program by again placing a singular allocation with a multi-strategy manager and relying on the CIO of that organization to direct capital across various approaches based on their assessment of market opportunities.

In contrast, a set of allocators at some of the leading institutions began to create customized portfolios of hedge funds. Instead of making a single hedge fund allocation, these investors began to think about breaking that allocation out across a number of managers. To do this effectively, these allocators began to divide the hedge fund space into multiple categories. After the global financial crisis, this tendency to view hedge funds as belonging in multiple buckets accelerated as performance in that time period revealed that hedge funds performed very differently based on their underlying directionality and liquidity.

Investors Begin to Categorize Hedge Funds Based on Their Directionality and Liquidity

As investors evolved toward direct hedge fund investing programs, they could no longer rely on a fund of fund manager or on a multi-strategy fund CIO to provide a diversity of return streams in their portfolio. It was the investors themselves that needed to ensure their hedge fund portfolio was suitably diverse across investment strategies. In order to manage this challenge, the investors built out their alternatives team, hiring individuals with specialized skills to cover the various strategies. In the majority of cases, the investors also forged relationships with an emerging set of alternatives-focused industry consultants to support their portfolio construction and due diligence efforts.

Initially, investors pursuing direct allocations sought diversity by allocating varying amounts of money to a representative set of hedge fund strategies, giving some capital to long/short, some to event driven, some to macro, some to distressed, etc. This was done with little consideration of the underlying liquidity of assets held within each fund and since investors had very little transparency into the holdings of managers in the pre-crisis period, allocations were also done with little consideration of how the hedge fund’s positions and exposures aligned to the investor’s broader core portfolio.

Section II: A New Risk-Based Approach to Portfolio Construction Emerges

Maturing experience with the hedge fund product and improved transparency after the GFC Global Financial Crisis are allowing institutional investors to better categorize managers based on their directionality and liquidity. This has facilitated efforts by market leading organizations to re-envision their portfolios based on common risk characteristics rather than asset similarities. The result has been a new portfolio configuration that repositions hedge funds to be a core part of investors’ allocations.

“...We have many investors that look at hedge funds as a singular portfolio. They focus on an absolute return portfolio as an equity replacement.”

- Alternatives Focused Consultant
Performance during the global financial crisis revealed two problems with this approach. First, investors could be locked into investments if there was a mismatch between the liquidity of the fund’s holdings and the fund’s liabilities in terms of needing to cover investor redemptions. Many hedge fund managers threw up gates or created side pockets that excluded investors from redeeming capital at the height of the crisis. This asset-to-liability mismatch prompted investors to put much more focus on the relative liquidity of the hedge fund strategies in their portfolios.

The second factor emerging from the crisis was that while many investors thought that they had been pursuing alpha through their hedge fund allocations, they found that in some instances they were instead paying high fees for what many considered to be alternative beta. That is, managers were levering directional bets or taking advantage of carry structures to capture the same type of market returns that active long-only managers were pursuing in the core of the portfolio.

Hedge Funds Allocations Begin to Be Broken Out Across Multiple Types of Exposures

The result of these realizations was that many institutional investors began to increasingly think about the hedge fund industry not as a singular exposure, but as multiple types of investments with varying degrees of liquidity and directionality. This is illustrated in Chart 6.

While there is not a single standard approach to how investors are breaking up the hedge fund space, we have tried to represent the three most commonly mentioned categories and show how they differ.

Directional hedge funds group those strategies that have an underlying exposure to movements in the equity or credit markets. Of key importance in evaluating this grouping of strategies is understanding the net long or short position of an individual manager. Not all long/short, event-driven, or distressed funds have equal amounts of long and short positions in their portfolio. Managers are typically considered directional if their holdings are more than 60% net long or short. At this level, the manager’s holdings are going to be highly influenced by moves in the underlying market.

Moreover, as shown in Chart 6, there is a distinct difference in the liquidity profile of long/short and event-driven managers versus distressed managers. This category can thus be subdivided into liquid and illiquid directional hedge funds.

In contrast, strategies that reside in the absolute return bucket tend to have a much closer balance of long and short positions in their portfolio. For the most part, these managers run a net position of only 0% to 20% net long or short. As such, they are seen as having low directionality, and they generate returns by capturing relative pricing inefficiencies between assets. Based on this profile, they are often discussed as offering zero beta. The strategies in the absolute return category offer a range of liquidity across market neutral, arbitrage, and relative value approaches.

“Clients initially start with hedge funds as a stand-alone asset class. But they have slowly been moving hedge funds into other categories. This is a gradual process but they are disaggregating the risk more recently,”

- Alternatives Focused Consultant

“There are so many of closet beta hedge funds that were long-only biased funds that effectively were levered S&P. Alpha is not simple outperformance; it is uncorrelated outperformance,”

- Alternatives Focused Consultant & Fund of Fund

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“A manager that was 50%-60% long would fall between the cracks in our portfolio. That’s not really shorting and not really tied to the benchmark. We probably wouldn’t take too hard a look at them,”

- Endowment
Strategies that are more than 20% net long or short, but less than 60%, may fall through the cracks in this approach. Indeed, many investors and consultants mentioned that managers in this range are hard for them to consider in compiling a portfolio of single strategies because they do not know how to evaluate their underlying risks and likely performance in different types of market scenarios.

The final most frequently mentioned category was macro funds. Strategies in this bucket include global macro, commodity trading advisor (CTA)/macro, volatility, and tail risk strategies. There is some directionality to these strategies, but that directionality can be obtained from both the long and the short side with equal ease based on supply and demand fundamentals as opposed to valuations. Alternatively, these strategies seek to hedge the investor against certain types of macro environmental risks such as inflation or periods of market crisis.

Multi-strategy hedge funds often have sleeves in each of these buckets and thus cannot be easily classified by their directionality or neutrality. As such, they tend to not fit cleanly in any one category. Survey participants indicated that multi-strategy funds are most often broken out and placed alongside those strategies they most closely resemble by investors pursuing this approach.

This move from having a singular hedge fund exposure to thinking of hedge funds as a varied set of investments has become more common in the years after the global financial crisis. The hallmark of this method is that investors are able to evaluate their portfolios on the underlying risks posed by each category of hedge funds within their portfolio, and they can relate those risks to other parts of their broader portfolio holdings. This has been a critical precursor to broader changes in investors’ approach.

Investors Begin to Group Directional Hedge Funds as Part of a Broad Equity Risk Bucket

One of the most commonly discussed changes in many institutional investors’ portfolio approach, particularly in the years after the global financial crisis, has been the move toward aggregating all those strategies that are subject to a similar underlying exposure to changes in a company’s equity or credit position, and then looking at that exposure in its entirety rather than as separate investment pools.

As part of that trend, many institutional investors are beginning to re-categorize their exposure to directional hedge funds and combine these allocations with their broader equity and/or bond allocations. This puts directional hedge funds into a common category with passive index and ETFs, with actively managed long-only equity and credit funds, and in many instances with corporate private equity holdings. Together, this set of strategies is said to reflect the investor’s exposure to equity risk. This is illustrated in Chart 7.

This shift in investor thinking about how to configure their portfolio is gaining traction and was the most commonly discussed change away from the two main portfolio configurations discussed at the end of Section I. Even if investors are not yet reordering their portfolio to align to this approach, they are considering it as evidenced by the statements below.

“The traditional long-only consultants that have moved into the alternatives space are great as a gatekeeper. They can see how they can enhance a portfolio and where a fund can fit. They’re helping to drive this trend toward moving long/short funds into the equities and fixed-income allocations. It’s not a massive trend, but an emerging one, particularly since 2008. When I think about how to structure the fund, this is definitely something I think about now but it wasn’t something I thought about 2 years ago,”

–>$10 Billion Hedge Fund

“Things have changed. Most people put us in alternatives and in their hedge fund allocation. More and more you hear people talk about putting us in their equity bucket. Do we see a lot of people doing that? No, but we definitely see people thinking about the core exposure they’re taking on,”

–>$10 Billion AUM Hedge Fund

“We like to understand the exposures we have looking across all our managers. When we add a manager into the portfolio, no matter what part of the portfolio, we want to understand what the impact is on the overall risk. Are we adding more equity risk when we roll up the portfolio? More credit risk? We’re moving toward a more risk budget approach;”

– US Public Pension
Better Transparency and Investors’ Desire to See Total Securities Exposure Drives Change

A shift in how investors’ internal teams communicate is helping to drive this change. There is more discussion starting about what assets are being held in traditional equity and/or credit portfolios, and the extent to which those assets overlap with directional hedge fund holdings. For many years, the teams charged with administering these two areas of institutional investor portfolios operated in separate spheres. There was very little communication across groups and for the alternatives focused allocators, there was also very little transparency into hedge fund holdings.

This began to change after the global financial crisis. Hedge fund managers have become much more transparent about their positions and exposures, as will be discussed further in Section IV. This has created an improved flow of information, and in many instances hedge funds are now willing to send data on their holdings directly to investors via either reports or risk aggregation engines. This has made it easier for the alternatives team to share information with the broader investment team.

As the flow of information about hedge fund holdings has improved, there has also been an emerging sense that administering their hedge fund holdings separately from their core positions is creating exposures that the investor is unaware of and thus not managing properly. This view is being fed by many in the traditional consulting community that have recently expanded their practices to include groups focused on alternative investments.

“For us, private equity would live within our equity allocation. Long/short strategies would live within equities. It’s the driver of returns. What are you buying and how do you crystallize that purchase? We’re starting to see our clients come around to this point of view.”

– Long-Only and Alternatives Consultant
These traditional consultants saw new competitors (alternatives-focused consultants) entering the market and quickly gaining traction across the traditional consultants’ core client base. In response, long-only consultants began to hire new talent with an understanding of hedge fund strategies. Armed with this new skill set, many traditional consultants saw an opportunity to differentiate themselves from alternatives industry consultants by helping their clients understand how their total book fit together.

The rationale regarding why directional hedge funds and traditional equity or credit holdings should be viewed in tandem is easy to understand. When the equity or bond markets move substantially in either direction, all the managers in this category would be affected. This dynamic is the fundamental basis for grouping all of these investments together. What is critical to understand is that in this emerging view, the role that directional hedge funds play in the portfolio changes and is no longer seen as primarily providing an alternate stream of alpha.

Directional Hedge Funds Gain Traction for Their Ability to Dampen Equity Volatility

Another factor encouraging investors to combine their directional hedge funds with their core equity and credit holdings relates to a new understanding of portfolio risk and the role directional hedge funds play in reducing volatility.

Articles began to emerge from leading asset managers as early as 2005 arguing that the classic MPT/CAPM approach was too focused on assets and not focused enough on risk. Indeed, they pointed out that while the classic 60% equities/40% bonds portfolio seemed to be balanced from a capital perspective, if that same portfolio were viewed in terms how risk in the portfolio was budgeted, the result was extremely skewed toward equities. Specifically, in the 60/40 portfolio, 90% of the portfolio’s overall risk was seen coming from the equity holdings and only 10% of the risk was coming from the bond allocation.

These articles were initially viewed as intellectually interesting but not particularly relevant to the majority of investors. The performance of traditional 60/40 portfolios during the financial crisis when major equity indices were down 40% changed investors’ receptivity to this argument, particularly when it came to light that investors who had reallocated their assets based on a more optimal risk budget outperformed those with traditional portfolios.

One repercussion of this has been that many investors that continue to have large equity allocations because of the potential returns they add to the portfolio are looking for ways to reduce their risk exposure in this bucket without having to dramatically reallocate their portfolio. Directional hedge funds are seen as a solution to that challenge.

Though many people perceive hedge funds to be riskier than long-only holdings, the opposite is true. Hedge funds offer more controlled risk profiles, and their inclusion in the portfolio typically helps to reduce overall volatility. Again, the financial crisis provides a striking example. While major equity indices were down 40%, the equity-focused hedge indices showed managers down only 20% in the same period. Blending a larger share of their equity allocation with directional hedge fund managers, particularly equity long/short-focused managers, is seen as offering investors a way to reduce their portfolio volatility while maintaining their returns potential.

"When I think of the sovereign wealth funds, they’ve been forced to create committees that sit the different investment areas down and say, ‘What do we want to do? We have overlapping exposures and we have to decide how to manage them’"

- >$10 Billion AUM Hedge Fund

"We are seeing more and more that our products are included in the equity bucket of the institutional investor allocation. As we trade listed equities we are a natural part of the beta risk profile for the equity bucket"

- Asset Manager With Hedge Fund Offerings

The rationale regarding why directional hedge funds and traditional equity or credit holdings should be viewed in tandem is easy to understand. When the equity or bond markets move substantially in either direction, all the managers in this category would be affected. This dynamic is the fundamental basis for grouping all of these investments together. What is critical to understand is that in this emerging view, the role that directional hedge funds play in the portfolio changes and is no longer seen as primarily providing an alternate stream of alpha.
Including Directional Hedge Funds in Equity Risk Bucket Helps Limit Downside Exposure

There is one final aspect as to why some institutional investors are considering it advantageous to combine directional hedge funds with their traditional equity and credit allocations. This is based on the ability for hedge funds to offer downside protection. While we have focused extensively on how hedge funds initially drew institutional interest because of their ability to add alpha to the portfolio, this argument instead speaks to their role in limiting equity beta and is a corollary to hedge funds having a lower volatility profile.

As already discussed, directional hedge funds, most specifically equity long/short managers with a high net long exposure, will move in tandem with the underlying markets, thus producing some degree of equity beta. They will not fully mimic such movements, however, because the short portion of their investment is going to be moving counter to the broad market.

This means that in up markets, it is unlikely that the long/short manager will be able to equal the returns of long-only managers, but when markets are falling, they should be able to limit their downside in relation to those same long-only managers. This was true during the 2008 crisis and many investors now see this as an important role for directional hedge funds.

Remember, most institutional investors are focused obsessively on capital protection, as they have limited pools of assets they are managing to meet obligations. For pension funds, these obligations relate to the institution’s need to meet liabilities owed to their members. E and Fs need to fund activities over a long-term period. Sovereign wealth funds need to diversify their account balances. In all these instances, there is an extreme aversion to losing money.

As the statements below show, many institutional investors would rather engineer their portfolios to have less upside in order to insure that they do not suffer excessive losses that would impact their ability to meet their obligations. Including directional hedge funds alongside their core equity and credit holdings can provide this protection.

“Of those investors moving their long/short equity into their equity bucket, the goal is to dampen the volatility and change the risk profile—recast the risk profile. It’s coinciding with the whole trend toward risk parity. Even if their equity bucket is only 60% of their allocation, it is much more on a risk budget,”

- Alternatives Focused Consultant

“We’re a conservative investor. By conservative, we mean that we’d rather protect on the downside and miss a little bit on the upside. That works better for us in the long term. We think about equity beta as covering equity long-only managers, equity long/short managers, and private equity. Credit beta includes investment grade, high-yield, and asset-back securities,”

- Endowment

“The evolution of institutional investors allocating to long/short equity from the equity bucket is still really in its early stage. They still remember how bad 2008 was, and still worry about downside volatility so they are interested in what equity long/short can bring to their portfolio”

- $5-$10 Billion AUM Hedge Fund

“Institutions had alternative funds as a carve-out in a separate bucket but that is changing. Performance has been disappointing and correlated to equities. So now hedge funds are looked at as an alternative to equities with the expectation that they partly participate in the upside of markets with protection to downside markets.”

- European Fund of Fund

Investors Allocate Capital to Strategies that Reduce Macroeconomic Impacts

Chart 8 shows the emerging second risk-aligned portfolio configuration that combines hedge funds within the macro bucket with other rate-related and commodity investments to create resiliency against a different type of exposure. Namely, investors are looking to group strategies that can help their portfolio capture thematic moves related to supply and demand.

In this context, supply and demand cover areas with broad economic impacts such as monetary policy, sovereign debt issuance, and commodity prices—all factors that affect interest rates and thus borrowing rates. This contrasts to the supply and demand of specific securities.

The goal of combining these investments is to create stable value in the investors’ portfolio by protecting them against excessive moves in interest rates triggered by economic factors. Because one of the most common outcomes of large interest rate moves is inflation, this group of investments is also sometimes referred to as insuring the portfolio against inflation risk.
The performance of CTA and macro-focused hedge funds during the 2008 crisis was one factor that has helped spur interest in this new portfolio configuration. These managers were able to post uncorrelated returns and generate large profits at a time when equity markets were down sharply. For calendar year 2008, the Morgan Stanley Capital International Indices (MSCI) global equity indices were down -40.3% and the S&P 500 index was down -37.0%, while the Hedge Fund Research, Inc. (HFRI) systematic diversified index was up +17.2% and the Barclay Hedge discretionary traders index was up +12.2%.

As highlighted in our recent CTA Survey, Moving Into the Mainstream: Liquid CTA / Macro Strategies and Their Role in Providing Portfolio Diversification, many CTA and liquid macro managers were also able to provide important liquidity to investors in a period when they were unable to pull money out of other investments. These two factors together were coined the ‘2008 effect’ and helped create a perception that having an allocation to CTA or macro strategies could work to substantially improve diversification and enhance returns by adding a differing source of beta to the portfolio.

“The biggest thing I’ve seen is pensions and endowments and other allocators now knowing where there betas are and looking at macro and nondirectional hedge funds to add to their portfolios to move them more along the efficient frontier,”

~ Endowment

“People are starting to group macro with long volatility strategies to call them the stable value hedge funds. People have come to believe that market dislocations are accompanied by high periods of volatility and that these strategies generate ‘stress’ returns,”

~ <$1 Billion AUM Hedge Fund

“Directional hedge funds and stable value hedge funds complement each other. Directional funds establish profits in certain markets and stable value funds provide returns in other markets,”

~ <$1 Billion AUM Hedge Fund
Since periods of extreme economic stress also correspond to increased periods of market volatility, managers focused on protecting investors from these types of exposures are also grouped in this risk category. Given the severity of the 2008 move, many investors began to express an interest in one type of volatility protection in particular: tail-risk hedging.

Managers pursuing this type of strategy have an unusual profile; during most years they pursue neutral investment programs that result in returns that tend to be close to 0%, but in periods when volatility spikes, their out-of-the-money puts or swaptions will jump in value and offer high returns to offset losses elsewhere in the portfolio.

The challenge with tail-risk hedging funds is that they usually end up as a cost to the portfolio and their benefit is evident only in extremely rare instances. For this reason, many investors are either looking at managers that have funds capable of generating returns based on more varied types of market volatility or they are opting to handle tail-risk hedging on their own.

Some Investors Pursue Their Own Tail Risk Hedging or Tactical Asset Allocation (TAA)

To avoid the costs associated with tail risk or volatility hedging funds, some investors have built out their own programs to manage these exposures. This is often accomplished through a dedicated put- or swaps-buying regime. Because of the cost of this approach, some investors are instead looking to handle this protection in one of three other ways: tactical asset allocation, portfolio hedging, or the use of custom overlays.

Employing a TAA approach requires active management from the investment team; it generally entails moving allocations between equity and fixed-income allocations and using futures contracts to balance the overall portfolio. Trades are placed at somewhat frequent intervals, up to several a week.

“People are not looking at tail risk per se as an allocation because of the costs involved. Rather than a dedicated put-buying program which is a losing proposition, they are instead looking to get long volatility. Volatility is the new gold,”

- <$1 Billion AUM Hedge Fund

This approach is typically employed by investment teams that have prior sell-side or buy-side trading expertise and are comfortable managing an active book.

Some institutional investors are seeking a structured exposure that gives them protection across a large swath of their portfolio. These structured solutions often feature custom swaptions that provide the buyer the right, (but not the obligation) to enter into a swap position that broadly hedges the portfolio. In addition, many investors use collars or other structures to employ protection against large losses while giving up some potential gains.

“[The way we’ve done tail-risk hedging is more subtle. We’ve done volatility management by shifting our asset class allocation],”

- Endowment

“Tail-risk hedging is an important concept to us and we’re putting that concept into place in the portfolio in our own way. We’re not really looking at the tail-risk funds. We’re applying tail risk across the entire portfolio,”

- US Corporate Pension

Finally, there is an emerging group of institutional investors that work with a hedge fund manager to create bespoke overlay strategies. These managers will review the entire portfolio and craft a custom investment product, often using liquid currency and other macro-themed instruments. Many times, pensions have tail risk on their liabilities via rates, so employing an overlay program can provide downside protection.

It’s important to note that the investment teams employing these approaches tend to be among the most sophisticated institutional investors and have large, dedicated groups looking across both the long-only and hedge fund portfolios. These teams tend to be more experienced and better compensated than the average institutional allocator. The quest for talent to start and grow these programs can be quite challenging. An
adequately structured reward system is an important factor for success, and one that far too many institutional investors are still unable to offer.

“There has been a lot of emphasis on on-risk, off-risk strategies based on signals. Pensions are approaching stable value from a tactical side. They’ll sell S&P futures and buy treasury futures and vice versa,”

– <$1 Billion AUM Hedge Fund

“We’re looking at a number of options or overlay strategies because we also have tail risk on the liability side via rates. If our managers are up 30% on their risk assets and we’re up only 15%-17% because we’ve applied these overlays, we’re okay with that because our target is 8.75%,”

– US Corporate Pension

Risk-Based Portfolio Groupings Focus on Low-Directional Products

Investors that are moving their entire portfolio to a risk-aligned approach note that after they have determined their equity risk and stable value/inflation exposures, they are then left with strategies that offer them little to no beta since they are not aligned with any specific market returns. There are two types of these exposures, as shown in Chart 9.

In the public markets, the strategies most able to provide this type of exposure are those absolute return strategies that look at pricing inefficiencies and run at a very low net long or short exposure. These strategies are seen by many as delivering the classic hedge fund alpha sought by investors back when the first wave of massive allocations began in the early 2000s.

There are also a group of strategies that are either fully in the private markets or that bridge the private and public markets and base their return stream around real assets, or what some investors refer to as hard assets. This category is growing in popularity across the institutional investor spectrum. These strategies are typically offered by private equity managers.

“Our third bucket is real assets. This includes real estate, infrastructure and this is where physical commodities would go but we don’t have a lot of commodities,”

– Sovereign Wealth Fund

“If people can get the stomach and the resources to really diligence infrastructure in the frontier markets or even Africa, there’s a huge opportunity there. Even simple things like toll roads. That’s a great investment. You see something like that but it’s hard to take advantage of,”

– US Corporate Pension
that focus on resource-based offerings rather than corporate restructurings, although more hedge fund managers are also beginning to explore this space.

Traditional real estate investment structures like real estate investment trusts (REITs) sit in this category. There are also new vehicles emerging to give investors access to a vertically integrated portfolio of companies related to a specific natural resource. The most common of these structures are managed limited partnerships (MLPs) that allow investors to buy into an ownership stake in a set of companies that handle the extraction, processing, and distribution of oil and gas or coal resources. Other emerging funds are not publicly traded but offer investors a similar ability to have an ownership stake in the production, processing and distribution of other natural resources such as timber. Finally, direct infrastructure investment funds are beginning to be launched that offer investors ownership stakes in emerging markets or frontier region projects such as toll roads or power plants.

Risk-Aligned Portfolios Reposition Hedge Funds From Satellite to Core Holdings

By aligning the strategies in their portfolio around their common risk profiles, institutional investors have begun to create a new portfolio configuration that completely diverges from the traditional 60/40 portfolio and from the two approaches that expanded that traditional portfolio to include either opportunistic or alternative investments that we highlighted at the end of Section I. This new configuration is summarized in Chart 10.

“Right now all of our hedge funds are in our absolute return bucket. This is purely a function of how we defined the absolute return portfolio. We have sold the board on there being zero beta in risk assets—zero correlation to anything else in the portfolio,”

~ US Corporate Pension

“People still are not clear on risk allocation versus asset allocation. Starting with an ad hoc traditional allocation of 60% equity / 40% bonds and then trying to somehow risk budget it is very difficult. The way we do it here is we create the asset allocation from the risk allocation after setting risk/return targets, assign correlations, variances, and expectations to various asset classes. Then you come up with optimal asset allocation to serve that risk. Some people have gotten into it but others still don’t,”

~ Alternatives Focused Consultant and Fund of Fund

In this approach, hedge funds have evolved from being a satellite portion of the portfolio to become an essential, core portfolio component. Different types of hedge fund strategies are also included in various parts of the portfolio instead of there being a single hedge fund allocation. If this approach toward portfolio construction takes hold, there is potential for this to spark another period of strong inflows for the hedge fund industry.

Indeed, as we will discuss in Section III, while endowments and foundations typically have a fairly substantial portion of their assets allocated to alternative investments and hedge funds, the size of pension funds’ and sovereign wealth funds’ core asset pools are multiples of the typical allocations they have carved out for their current alternatives and hedge fund investments.

“Right now all of our hedge funds are in our absolute return bucket. This is purely a function of how we defined the absolute return portfolio. We have sold the board on there being zero beta in risk assets—zero correlation to anything else in the portfolio,”

~ US Corporate Pension

“We start off with a risk score. How much directional risk do we want to take on and then we think about what investments to take on. We are indifferent as to asset class. We are focused on the risk adjusted returns and we look at that against our top-down views on the macro environment,”

~ Long-Only and Alternatives Consultant

“The thought leaders on the investor side are creating task forces to incubate ideas and then determine the home for their ideas. The hedge fund team is educating the broader investment team and the senior investment staff can think about being more inclusive on the broader buckets,”

~ $1-$5 Billion AUM Hedge Fund
Thus far, uptake of this new portfolio approach is limited and is estimated to be no more than 10%-20% of the institutional investor universe. Interest is also highly regionally focused, with US investors most receptive to this approach, European investors showing some curiosity and Asian Pacific investors not really showing much movement in this direction.

One signal that we may be at just the start of this trend, however, has been the sharp increase in interest in all-weather funds that pursue a form of this risk-aligned portfolio construction, known as risk parity.

**All-Weather Products Create Risk Parity Across Asset Classes to Deliver Returns**

A form of risk-aligned portfolio that has gotten a lot of press attention recently is an approach called risk parity. When pursuing risk parity, investors divide their risk budget out equally across every asset in their portfolio and then determine how much of each asset type they need to hold in their portfolio to keep that risk allocation in a steady proportion, actively moving their allocations around to maintain this balance. The origins of risk parity go all the way back to the original emergence of Markowitz’s MPT. As discussed in Section I, the risk-free assets line (sometimes known at the capital market line) intersects the efficient frontier at the point of the tangency portfolio. This capital line also serves to illustrate another principle. In 1958, James Tobin, another financial markets academic of Markowitz’s vintage, drew the line to show the inclusion of cash or an equivalent risk-free asset, such as a 90-day treasury bond, on a potential portfolio.

As shown in Chart 11, all of those portfolios that lie along the lower portion of the capital market line (between a 100% risk-free asset portfolio and the tangency portfolio) represent some combination of risky assets and the risk-free asset. When the line reaches the tangency portfolio intersection, this is the point at which the portfolio has all risky assets (ie, equities and bonds) and no cash or risk-free assets. The extension of the capital market line above the tangency portfolio shows the impact of borrowing risk-free assets and applying leverage to a portfolio by using those assets to purchase more of one of the risky assets.

In the risk-parity approach, investors take a balanced portfolio that typically works out to be close to the tangency portfolio, but then apply leverage to the lower risk portions of that portfolio using borrowed risk-free assets to lever the tangency portfolio and move up the capital market line. As shown, these portfolios can provide superior risk-adjusted returns versus the traditional 60/40 portfolio because they have a higher Sharpe ratio—meaning they deliver better returns for each unit of risk.

In 1996, Bridgewater Associates introduced a product called the all-weather fund that was based on risk-parity principles. The lore around the all-weather fund suggests that Bridgewater’s founder, Ray Dalio, created the fund to

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**CHART 11: ILLUSTRATION OF UNDERLYING APPROACH TOWARD RISK PARITY PORTFOLIOS**

Data shown in this chart are for illustrative purposes only. Source: Citi Prime Finance abstracted from work by Tobin, Markowitz, Sharpe & Lintner

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“Pre-2008, one out of every 100 pensions had the risk parity approach. Now you see a lot of people considering it, moving toward it or adapting it outright. Now we’re up to about 10 out of 100 having adopted risk parity, but everyone is thinking about it,”

- <$1 Billion AUM Hedge Fund

“Risk parity is critical to our investment philosophy and to our investors’ portfolio,”

- Outsourced CIO

“We’ve taken about 6% of the portfolio and dedicated it to opportunistic, because sometimes things don’t fit in one of the buckets and we don’t want to bucket something just for the sake of bucketing. This opportunistic bucket for us is based on a risk-parity approach. Instead of putting this money in cash, we’ve put it in risk parity for the interim 2-3 year investments,”

- US Corporate Pension
mimic the approach he used in managing his own personal wealth. In subsequent years, other market leaders such as AQR followed with similar products. These portfolios were able to significantly outperform traditional 60/40 portfolios in the 2008 crisis and have since gained many proponents.

The principles of the All-weather fund are illustrated in Chart 12. The portfolio incorporates all of the assets typically held in the equity risk and stable value/inflation bucket. The portfolio manager then applies an active management overlay to those assets that indicates the optimal mix of assets based on varying economic circumstances related to growth and inflation. More of certain assets and less of others are required to keep the portfolio in parity during each scenario—rising growth, falling growth, rising inflation, or falling inflation. The overall portfolio is actively rebalanced in order to hold the assets in parity and to adjust for shifts in view between varying scenarios.

"The all-weather fund is creating a change in allocation logic whereby an alternative manager can be part of the core of the investors allocation and not a part of the satellite hedge fund allocation,"

- $1-$5 Billion AUM Hedge Fund

"We look at Bridgewater and like their approach toward risk parity. It would be a perfect fit with our portfolio,"

- US Public Pension

Massive amounts of money have reportedly been diverted to these risk-parity funds. One clue of how popular they are can be found in looking at Bridgewater’s AUM holdings as shown in Absolute Return’s Billion Dollar Club. In 2004, Bridgewater’s overall AUM was listed at $10.5 billion, and by the end of 2011 that figure had jumped to $76.6 billion.

Allocating to a risk-parity fund is an alternate approach to reordering an institution’s entire portfolio configuration into risk-aligned buckets. It can offer institutions an opportunity to get comfortable with the concept of risk budgeting and allows them to monitor how this approach performs relative to their traditional portfolio without being overcommitted to the risk-budget paradigm. In this way, the risk-parity fund provides much the same function that a multi-strategy hedge fund does for investors just beginning their direct investing programs.

"The Bridgewater all-weather fund is a very diversified portfolio, they actively move assets around based on this idea that they are always adjusting to economic developments. They have frameworks that explain what the asset classes are going to do. They know what their risk boundaries are. There’s no question that Bridgewater has an active risk view and that they trade like crazy around those views. AQR too. The reason that people are interested in these all weather fund type products is that you can show a recent back test where this approach worked."

- <$1 Billion AUM Hedge Fund

CHART 12: ILLUSTRATION OF ALL WEATHER FUND OVERLAY TO EQUITY RISK & STABLE VALUE/INFLATION ASSET CATEGORIES

Source: Source: Citi Prime Finance
Changes in Institutional Allocations Confirm Shift in Views About Risk Budgeting

The signal that investors are moving toward a risk-aligned portfolio is their willingness to reduce their equity allocations and up their actively managed fixed-income and hedge fund portfolios. Reviewing institutional portfolio allocations over the past 5 years reveals a telling story on how institutional investors are moving toward a more risk-aligned approach and confirm that we may be at the outset of a third major shift in institutional investor portfolio configuration.

Chart 13 shows the shift in institutional portfolio holdings between 2007 and 2011. As expected, there has been a massive reallocation of money from actively managed equities to actively managed fixed-income funds. The absolute and relative amount of money allocated to active equity strategies fell in the period, dropping from $5.9 trillion in 2007 (43% of total assets) to $4.3 trillion (31%) in 2011. The absolute and relative amount of money allocated to active fixed-income and tactical asset allocation strategies rose from $5.1 trillion (38%) in 2007 to $6.1 trillion (44%) in 2011.

Hedge fund allocations also posted increases, rising from $1.2 trillion (9.2%) to $1.5 trillion (10.5%) and the trend toward higher passive allocations also continued.

This change in allocations is striking. Institutional investors have moved significant amounts of capital out of their actively managed equities into other asset classes and approaches as they diversified their portfolios to lower risk assets. Hedge fund allocations grew in this latest 5-year period even as performance has been difficult. As discussed in this section, part of the reason for this growth has been the change in some leading investors’ views about where hedge funds fit into the portfolio.

Whereas at the end of 2007, most participants saw hedge funds as a satellite portion of their portfolio, offering the potential for a diversified alpha stream, that view is beginning to change. Increasingly, investors view or are at least are starting to think about hedge funds in a more nuanced manner.

The emerging belief is that various types of hedge fund strategies have differing roles in investors’ core portfolios. Directional hedge funds are seen as providing volatility dampening and downside protection when grouped with other equity risk exposures. Macro strategies are viewed as offering uncorrelated returns and protection against macroeconomic exposures when combined with actively managed rates and physical commodities. Absolute return hedge funds are seen as fulfilling the role of the classic hedge fund allocations that provide pure alpha/zero beta returns.

How widespread the adoption of these views become could determine the shape of the hedge fund industry for the foreseeable future. As it stands today, many investors and industry participants feel that the industry is poised for another period of dynamic growth. This will now be discussed in Section III.

“...The risk parity paradigm ideal would say that I want 50% of my risk in equities and 50% of my risk in bonds and I want my overall portfolio to have 8% volatility. To get that, you’d have to have a 320% exposure—35% in equities and 285% in bonds. The only way to get that bond exposure is through leverage and the use of swaps and repo.”

- <$1 Billion AUM Hedge Fund

“People understand that if you did a proper risk balance across all your risks, equity is only one risk factor. You’d want to balance across inflation and all the other risks. You can go straight down the list. What this typically means is taking down your equity exposure and taking up your fixed-income exposure,”

- <$1 Billion AUM Hedge Fund

“There is clearly a sense whereas in the past, a guy had 40% long-only allocated in their portfolio to long-only fixed income, now he’ll take 10% of that allocation and give it to an alternatives guy and only run 30% with traditional long-only,”

- $5-$10 Billion AUM Hedge Fund
The majority of interviews conducted for this year's survey exposed three key drivers that are likely to spur increased allocations to hedge funds from the institutional investor world over the coming years.

First, institutional market leaders shifting to a risk-aligned portfolio configuration are likely to divert allocations from their core allocation buckets to hedge funds as they reposition their investments to be better insulated against key risk factors.

Second, institutions that began with an exploratory stake in hedge funds over the past decade to test their diversification benefit are likely to increase their allocations to address rising liabilities or to reduce the impact of excessive cash balances.

Finally, new institutions that had been considering an allocation to hedge funds prior to the GFC and that were sidelined in the turmoil following that period are now positioned to launch their investment programs.

Based on these considerations, we created a model showing the impact of industry growth and flows on par with that seen between 2006 and 2011. Projections emerging from this model show that the hedge fund industry could be poised to receive a second $1 trillion wave of institutional flows by 2016.

In compiling our forecast, we decomposed the institutional category and examined trends separately for E and Fs, pension funds, and sovereign wealth funds.

Before we detail this forecast, however, we will instead explore concerns expressed by some participants that recent market performance could dampen institutional enthusiasm and cause interest in hedge funds to wane. While this is not a likely scenario, it is still possible and we will thus similarly model the potential impact. To begin that analysis, we will start by profiling the various segments of the institutional investor base and their respective interest in hedge funds.

Institutions Enter Hedge Funds at Varying Rates

As noted earlier, E and Fs were the original category of institutional investor to focus on alternatives and on hedge funds. Market leaders in this category were already putting substantial sums of money into play in the hedge fund space by the early 1990s. From there, interest in hedge fund investing rippled downstream as smaller E and Fs emulated the model of the early adopters.

By the mid-2000s, there was broad participation from E and Fs and approximately 20% of all assets from this category were invested in hedge funds by 2011, as shown in Chart 14. Although the asset size of other institutional investor categories is much larger than E and Fs holdings, it is important to note that these other segments are not as far along in terms of their overall interest in either alternatives or hedge funds.

According to Towers Watson, alternatives overall were only 14% of global pension holdings in 2006 for the seven largest pension nations that accounted for 97% of total assets. That total rose only modestly to 16% by the end of 2011. Hedge funds still accounted for less than 3% of global pension holdings by the end of 2006, and our estimate is that those figures are almost unchanged to the present day at only 3.6%.
Sovereign wealth funds emerged even later as an institutional category. The majority of these participants began to deploy excessive cash balances to diversify their income streams only in the past decade. Interest in alternatives and hedge funds did not really emerge until the mid-2000s, although these participants were able to gear up their allocations more quickly as they had large, internally directed investment teams.

Our estimates show sovereign wealth funds having diverted 7.6% of their total assets to hedge funds by 2011.

**Chart 14: Growth of Institutional Investor Interest in Hedge Funds by Segment**

```
<table>
<thead>
<tr>
<th>Year</th>
<th>Endowments &amp; Foundations</th>
<th>Sovereign Wealth Funds</th>
<th>Pension Funds</th>
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<tr>
<td>2011</td>
<td>19.9%</td>
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</tr>
</tbody>
</table>
```

Source: Citi Prime Finance Analysis

**2011-2012 Performance Raises Concerns About Hedge Funds**

While most survey participants expected interest from these participants to continue higher, some respondents expressed concern about hedge funds’ relative level of underperformance to the equities markets in the past year.

As shown in Chart 15, hedge fund returns protected investors on the downside relative to the broad equity markets in only 3 of the past 15 months between January 2011 and March 2012. They were equally flat or down in an additional 3 months, but they significantly underperformed in 9 of the last 15 months, failing to capture even half as much of the upside gains in 6 of those months and were down when the overall markets were up in 2 of those months. Even more worrying was November 2011, when the major hedge fund indices were down more than broad equity market indices were down.

This disappointing performance has concerned many market participants and caused some investors to question their core assumptions about the role hedge funds play in their overall portfolios.

Some survey participants worried that there could be a loss of confidence in hedge funds and that investors may begin to rethink their level of interest. At a minimum, investors are calling into question how well directional hedge fund strategies will fare in the coming period.

**“The advent of sovereign wealth funds into the space has been the only really new entrant,”**

- Institutional Fund of Funds

**“When I arrived we had one pension and now we have money from 100. We had zero money from sovereign wealth funds and now we have money from 5,”**

- >$10 Billion AUM Hedge Fund

**“Endowments are more fully invested. We haven’t really seen any who aren’t in the hedge fund space,”**

- Institutional Fund of Funds

**“We can’t talk about investors like "an" investor. Endowments are very different than corporate pensions. Public pensions are very different from family offices. Are there some that act like the other? Sure, but they’re just different organizations that make decisions differently and that influences how they allocate,”**

- >$10 Billion AUM Hedge Fund
Asset allocation trends from the largest E and Fs are adding to the overall level of concern. The National Association of College and University Business Officers (NACUBO) Commonfund Endowment Study that surveys more than 800 US and Canadian endowments found that overall hedge fund allocations from this segment have declined since their peak in 2009. These declines were most evident from the largest endowments with more than $1 billion in assets.

As shown in Chart 16, E and Fs with more than $1 billion in assets had steadily increased their hedge fund allocations between 2002 and 2009, growing from 17.8% to 24.4% of their total assets. This trend reversed in 2010 and continued lower in 2011 as this group’s total allocation declined to only 20.4% of assets.

Because of the skew these large organizations represent in terms of total E and Fs capital, their shift in course is causing the segment’s entire dollar-weighted allocation to hedge funds to dip as well.

For many years, E and Fs with more than $1 billion in assets had the highest share of money allocated to hedge funds, and those organizations at lower asset bands had less of their wallet focused on hedge funds. In recent years, however, that pattern has reversed and by 2011, the E and Fs structure had inverted. The largest organizations had the lowest allocation to hedge funds, and the smaller E and Fs had the highest allocation.

These large endowments were the market leaders on which other institutional investors modeled their approach of including hedge funds and alternate alpha streams in their portfolio. Seeing a reversal of the more than decade-long trend toward increasing assets from this segment has many investors worried that this may be seen as a signal by other institutional investors. As noted in the following quotes, there were indeed some signs of institutional investors reversing or pausing in their hedge fund investment programs.

"S&P is the internal yardstick. When individual hedge fund managers are down more than the market, a lot of allocators didn’t even think that was possible as a concept in equity long/short. There’s more runway for macro and other strategies where there is not as obvious a yardstick,”
- Long-Only and Alternatives-Focused Consultant

“If hedge funds offer 80% of the performance with 40% of the volatility, that may not be enough. With our client base, the associated operational headaches, the lock-ups, the lack of transparency requires equity-like returns to warrant all the headache. 100% of the returns at 50% of the volatility might be OK, but 80% and 40% won’t cut it.”
- Long-Only and Alternatives-Focused Consultant

"We are at a real tipping point. A lot of clients still really believe in risk-adjusted returns, but returns for the past 2 years have pretty much been aligned to long only. This is going to call into question the huge asset flow from long only into hedge funds. The risk is that this trend could reverse or at a minimum pause,”
- Long-Only and Alternatives-Focused Consultant

“Clients are wondering why hedge funds are not performing and they can’t compete in an up market rally”
- Fund of Fund

E and Fs Trim Hedge Fund Allocations
Industry AUM May Be Near Peak if Institutional Interest Stalls

In an attempt to quantify how slowing interest in alternatives and hedge funds may impact overall AUM, we dug into the pattern of industry change over the past 5 years. One key point to note is that even with the dramatic events of 2008-2009, our estimates show that the overall level of global institutional assets grew 24.5%, from an estimated $26.5 trillion to $33.0 trillion between 2006 and 2011. Gains in overall assets were evident from each major institutional audience, as shown in Chart 17.

According to Towers Watson, pension funds that represent the vast majority of institutional capital increased their global holdings from $23.2 trillion to $27.5 trillion in this 5-year window. Sovereign wealth fund capital increased from $2.9 trillion to $4.8 trillion based on figures emerging from both the Organisation for Economic Co-operation and Development (OECD) and the Sovereign Wealth Fund (SWF) Institute. Finally, according to NACUBO, the total amount of assets held by US and Canadian endowments and foundations grew from $340 billion to $546 billion and since our estimate is that these institutions represent approximately 80% of the global endowment and foundation market, we see overall endowment and foundation capital having increased from $425 billion to $670 billion.

The share of that capital being targeted for alternatives also rose across each of these audience segments, as also shown in Chart 17.

Within the pension space, detailed asset allocations are provided by Towers Watson for the top seven nations—the United States, the United Kingdom, Switzerland, the Netherlands, Japan, Canada, and Australia. These countries represented 97% of global pension assets in 2006 and 89% of assets in 2011. Their allocation to alternatives rose from 14% to 16% of total capital in that period.
“The target we set for our hedge funds influence our allocation. Precrisis, we had 15-16% of the portfolio in hedge funds. Post-crisis we’ve taken that down to 10%-11%.”

- European Public Pension

“Last year, the equity markets collapsed in the summer and the equity long/short funds had a high correlation with the equity markets and we began then to reconsider our equity long/short allocation.”

- Asian Corporate Pension

Using those levels as a guide, we have estimated that pension funds’ total allocation to alternatives rose from $3.25 trillion in 2006 to $4.40 trillion in 2011. We also have estimated that the share of alternatives targeted at hedge funds increased from 21% to 22% of alternatives. This implies that pension allocations to hedge funds rose from $683 billion in 2006 to $977 billion in 2011, equating to a jump from 2.9% to 3.6% of total global assets.

In the sovereign wealth fund space, there is a less precise breakdown of how assets are allocated, but various industry publications and our own set of interviews have led us to believe that in 2006, these participants collectively had targeted 20% of their total allocations to alternatives and that by 2011, that figure had increased to 25%. Within their alternatives category, we see hedge funds having risen from 25% to 30% of the allocation. The results of these calculations show an estimate on sovereign wealth fund allocations to hedge funds of $145 billion in 2006 and a jump in that figure to $364 billion by 2011.

Finally, figures provided by NACUBO give us a good guideline to follow in estimating E and Fs allocations to hedge funds. Between 2006 and 2011, these organizations dramatically increased their alternatives allocation from 39% to 53% of total assets, but in part this represented a denominator effect due to sharp losses in the portfolio in 2010. Within the alternatives category, there was a decrease in the allocation to hedge funds as discussed in the section above, but this was partially offset by growth in the overall alternatives bucket. Our estimate for this segment is that hedge fund allocations rose from $89 billion to $133 billion between 2006 and 2011.

The reason we have broken out these changes so precisely is to provide the foundation for a forecast of what might happen to the hedge fund market if interest from institutions stalls.

Chart 18 shows the result of that projection. Because trends within the alternatives and hedge fund space do not impact the overall size of assets, we have used the average rate of growth between 2006 and 2011 and come up with a forecast on the size of the total global pool of institutional assets, showing that these holdings will increase from $33.0 trillion to $41.6 trillion by 2016.

Within each category, we then took down the share of capital being allocated to alternatives back to the levels last seen in 2006. We also reduced the share of alternatives being

CHART 18: PROJECTED BREAKDOWN OF INSTITUTIONAL ASSETS BY 2016 BASED ON DECLINING ALTERNATIVE & HEDGE FUND INTEREST (BILLIONS OF DOLLARS)

<table>
<thead>
<tr>
<th></th>
<th>Pension Funds</th>
<th>Sovereign Wealth Funds</th>
<th>Endowments &amp; Foundations</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Assets</td>
<td>$23,237</td>
<td>$27,510</td>
<td>$32,568</td>
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</tr>
<tr>
<td>Alternative as % of</td>
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<td>Total Assets</td>
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<td>Alternative Asset</td>
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<td>Hedge Fund as % of</td>
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<td>3.5%</td>
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</table>

Based on Continued Growth in Alternate & Hedge Fund Interest Millions of Dollars

Assumptions:
1. Entire Alternatives allocation of global pension fund assets is held by institutional investors
2. Alternatives percent of global pension funds based on top 7 nations share of global assets (97% 2006/89% 2011)
3. Sovereign Wealth Fund allocation to Alternatives & Hedge Funds estimated based on Citi Prime Finance interviews & OECD, SWF Institute Data
4. US & Canadian Endowments & Foundations estimated at 80% of global E&F
5. E&F share of Alternatives & Hedge Funds based on NACUBO Endowment Study US/Canadian Estimates
6. 2016 total assets based on average rate of growth by category from 2006 to 2011
allocated to hedge funds back to the 2006 levels for both pension funds and sovereign wealth funds. Instead of following this same methodology for E and Fs, where we have already seen a decline in the share of alternatives being targeted at hedge funds, we instead opted to hold that allocation at the 2011 level.

As shown, if this scenario holds true our forecast is that total institutional assets will flatten out near the industry’s current levels, rising only minimally from $1.47 trillion to $1.51 trillion by 2016. This forecast is detailed in Chart 19. As shown, overall allocations remain broadly unchanged from each segment in this forecast.

While this scenario is certainly possible, the majority of survey participants did not share some participants’ pessimism about how returns of the past 15 months are likely to affect the industry overall, and instead expressed a much more optimistic view.

**Most Participants See Institutional Interest Continuing to Rise**

While a number of interviewees did express concern about institutions’ continued interest in hedge funds, most participants instead pointed out factors that were likely to drive institutional interest even higher for some time to come. Many of the organizations we interviewed had either recently increased or were newly entering the alternatives and hedge fund space.

Foremost among the factors driving a view that institutional interest will continue to grow was the nature of their portfolios. These investors are looking to address long-term obligations or structural cash imbalances. Based on actuarial estimates and funding needs, many of this institutions’ return goals are 8%-10%, and they wish to achieve these returns without excessive downside risk.

"Most institutions in Europe are not there yet in terms of hedge funds. We and the Dutch have been moving ahead, but other organizations are still gearing up,"

- European Public Pension

“I see hedge funds remaining in some way shape or form in our book for the long run. We’ve been in the space much longer than many other pensions and we see our interest continuing. We’re now also seeing more and more other pensions getting into the space.”

- US Public Pension

This is not the type of “fast money” that pursues octane-fueled returns, nor is it the type of money that is likely to cause investors to rethink their allocation approach based on 1 or 2 years of market performance. As we explored in depth in last year’s survey, these participants take long-term views of their portfolio and are known across the hedge fund community for offering “sticky money”.

For pension funds in particular, rising liability gaps and an aging population are driving participants to remain aggressive in seeking diversification and pursuing strategies that will limit their downside exposure.

According to Towers Watson, the US represents 58.5% of global pension assets. The asset-to-liability gap in US state pensions has been estimated at more than $1 trillion according to the latest Pew Center for The States survey, and some academic studies suggest that the figure could actually be as much as $3-$4 trillion. US corporate pension funds recorded their largest deficits ever in 2011, with the gap between assets and liabilities for the 100 biggest portfolios hitting a record $327 billion according to industry specialist consulting firm Milliman, publishers of the Milliman 100 Pension Funding Index.
Similar pension funding gaps exist in Europe and Asia. Towers Watson notes that Japan is the world’s second largest source of pension assets, with 12% of total global holdings. Japan’s Ministry of Health, Labor and Welfare announced earlier this year that about 75% of nearly 600 pension funds in Japan set up by small businesses in sectors like transportation, construction, and textiles didn’t have enough assets to cover expected payouts. Aviva, the UK’s largest insurer and one of Europe’s leading providers of life and general insurance, estimated that the European pension gap between assets and liabilities stands at €1.9 trillion across the 27 European Union member states.

Meanwhile, there have been 20 new sovereign wealth funds created just since 2005 according to the SWF Institute, with many of these entities looking to diversify state revenues in the wake of surging gas, oil, and other commodity prices. These organizations are looking at broad investment portfolios and are showing an increased interest in both alternatives and hedge funds.

These structural issues, along with low global interest rates and low equity market returns in recent years, are likely to drive participants to continue expanding their portfolios into alternatives and hedge funds. As discussed in Section II, the level of interest in hedge funds could even accelerate if investors begin to move toward the risk-aligned allocation approach that places hedge funds in the core as opposed to the satellite portion of the investor’s portfolios.

Many of the participants we interviewed, particularly those that have been in the markets for a decade or more, discussed either recently having increased or planning to increase their overall allocations. There were also a number of new institutions that had either just begun or were on the cusp of beginning their hedge fund programs. This was true across the US, Europe, and Asia.

Another Massive Wave of New Capital Could Be Forthcoming

While a minority of participants worried that near-term hedge fund performance could endanger future institutional flows, others pointed toward broader macro trends as driving the opposite — a resurgence of active inflows that could rival the wave of money seen in 2003-2007. This was based on a belief that we are close to completing the massive deleveraging that began in 2007-2008, and that a renewed focus on risk assets will benefit the hedge fund industry and encourage investors to increase their allocations.

If we use the actual 5-year growth rates registered by each institutional segment between 2006 and 2011 and extend those forecasts to the next 5-year window, projections about a potential wave of new money can be supported. Chart 20 shows the breakdown of such analysis. The starting point in terms of overall assets is the same as in our earlier projection and is based on the average increase in total assets by segment between 2006 and 2011; but instead of going back and using the 2006 level of interest for alternatives and hedge funds, we will use the change in allocations between 2006 and 2011 and apply that going forward to reflect continued growth.

“Another Massive Wave of New Capital Could Be Forthcoming”
Starting with pension funds, we forecast that the total allocation to alternatives will rise from 16% to 18% of total assets, in line with the gain from 14% to 16% noted between 2006 and 2011. Similarly, we project that the share of those alternatives being targeted at hedge funds increases 1%, from 22% to 23%. The result of this analysis shows potential for pension fund allocations to hedge funds to jump from $977 billion to $1.4 trillion, rising from 3.6% to 4.3% of total pension fund assets.

For sovereign wealth funds, we project a 5% increase in allocations to alternatives, from 25% to 30% of total assets, and within that alternative category we see interest in hedge funds also rising 5%, from 30% to 35% of total alternatives. The result is a large jump in hedge fund interest from $364 billion to $839 billion, rising from 7.6% to 10.5% of total sovereign wealth fund holdings.

These figures seem to be in line with this segment’s likely growth, as the profile of sovereign wealth funds is seen as being located somewhere between conservative pension funds and aggressive E and Fs. Survey participants noted that younger sovereign wealth funds are more returns-focused with higher returns targets while more established funds present a more conservative pension fund-like profile.

Because E and Fs allocations have already begun to retreat, we had to estimate interest in this scenario. As noted earlier, smaller organizations in this segment are increasing their alternative and hedge fund allocations, even as larger organizations are slowing their allocations. Since these smaller participants do not carry as much influence on a dollar-weighted basis, we have forecast only a modest increase in the allocation to both alternatives and hedge funds rather than use the changes noted between 2006 and 2011. The result is that we see continued growth in hedge fund interest; however, from a total assets perspective, the impact of that growth is only likely to raise hedge fund allocations from 20% to 22% of total endowment and foundation holdings.
As Chart 21 details, based on the 5-year growth rates noted between 2006 and 2011, the total institutional allocation to alternatives could rise from 25% of total assets in 2011 to 28% in 2016, and the allocation to hedge funds from these participants could rise from 4.5% to 5.9%. From a dollar-value perspective, this would equate to a jump in hedge fund industry AUM from $1.47 trillion in 2011 to $2.47 trillion by 2016, as detailed in Chart 21.

One of the key questions to consider in this scenario is whether these rising allocations will be targeted at today’s traditional hedge fund industry participants or whether an emerging class of hedge fund-like strategies and offerings from traditional asset management firms will instead be able to attract an increased share of these assets. Conversely, there are growing signs that hedge funds themselves are cutting into long-only allocations and that they are looking to compete to manage a share of traditional institutional investor assets.

Having explored changes in investor portfolios and how their interest may evolve, we will now turn our analysis toward the investment management community, where there is a tremendous amount of product innovation occurring that is narrowing the gap between hedge funds and traditional asset managers.

As Chart 21 details, based on the 5-year growth rates noted between 2006 and 2011, the total institutional allocation to alternatives could rise from 25% of total assets in 2011 to 28% in 2016, and the allocation to hedge funds from these participants could rise from 4.5% to 5.9%. From a dollar-value perspective, this would equate to a jump in hedge fund industry AUM from $1.47 trillion in 2011 to $2.47 trillion by 2016, as detailed in Chart 21.

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Having explored changes in investor portfolios and how their interest may evolve, we will now turn our analysis toward the investment management community, where there is a tremendous amount of product innovation occurring that is narrowing the gap between hedge funds and traditional asset managers.

CHART 21: SCENARIO II: PROJECTED INSTITUTIONAL HEDGE FUND ASSETS BY 2016 – RISING SHARE OF ALTERNATIVES (BILLIONS OF DOLLARS)

<table>
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<th>Endowments &amp; Foundations</th>
<th>Total</th>
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<td>$27,510</td>
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<tr>
<td>Alternative as % of Total Assets</td>
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<td>16%</td>
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<td>20%</td>
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<td>Alternative Asset</td>
<td>$3,253</td>
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<td>Hedge Fund as % of Alternatives</td>
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<td>Hedge Funds Assets</td>
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<td>Hedge Fund as % of Total Assets</td>
<td>2.9%</td>
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Based on Continued Growth in Alternate & Hedge Fund Interest Millions of Dollars

Assumptions:
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