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Redemptions

Credit Suisse Investor Survey Finds Steady Demand for Hedge Funds and Growing Demand for Less-Liquid Products

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Credit Suisse Capital Services (CS) recently released the results of its 2017 hedge fund industry survey, entitled "Shifting Tides: The 2017 Credit Suisse Global Survey of Hedge Fund Investor Appetite and Activity," which covered anticipated asset flows by strategy and region; hedge fund selection and redemption drivers; fees; industry risks; early stage investing; and non-traditional hedge fund products.

Among the survey's key findings is that steady growth in allocations to hedge funds is coinciding with rising interest in non-traditional products (*e.g.*, illiquid credit/direct lending and alternative mutual funds). This corroborates other industry survey findings and should put traditional fund managers on notice as they pursue their fundraising efforts. This article summarizes CS' key findings.

For coverage of past CS investor surveys, see "Despite Significant Redemptions, Credit Suisse Survey Finds Investors Remain Committed to Hedge Funds" (Aug. 4, 2016); "Growing Demand by Hedge Fund Investors for Managed Accounts, Long-Only Funds and Alternative Mutual Funds" (Apr. 7, 2016); and "Investor Appetite for Alternative Investment Vehicles and Strategy Preferences" (Aug. 27, 2015).

Survey Respondents and Demographics

As in its prior studies, CS sorted more than 320 respondents collectively representing $1.3 trillion in single-manager hedge fund assets under management (AUM) into three categories:

1. *End Investors*: Endowments, foundations, family offices, pensions, insurance companies and proprietary capital. Each of these participants had, on average, over $1.6 billion in AUM;
2. *Institutional Intermediaries*: Consultants; funds of funds (FoF) and asset managers with primarily institutional investors; and hedge fund seeders and incubators. Each had nearly $9.3 billion in average AUM; and
3. *Retail Intermediaries*: FoF and asset managers with primarily retail investors and private banks. Each had approximately $2.4 billion in average AUM.

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More than half of the respondents were end investors, but they accounted for only 19% of the AUM in the study. Just over one-third of the respondents were institutional intermediaries, accounting for nearly three-quarters of the AUM. The rest of the participants were retail intermediaries, accounting for 8% of the AUM in the study.

The largest categories of respondents in number were FoF (26%); single- and multi-family offices (25%); advisers and consultants (together, consultants) (11%); asset managers (10%); and endowments and foundations (9%). Further, the most sizable survey participants by hedge fund AUM were consultants (40%), FoF (24%) and asset managers (12%).

Two-thirds of the participants in number were U.S.-based, with the remainder based in Europe, the Middle East and Africa (EMEA) (21%) and Asia (12%). On the basis of participants' AUM, respondents were largely concentrated in the U.S. (58%) and EMEA (39%).

Survey respondents had, on average, 35 distinct single-manager hedge fund investments. At the high end, private banks and institutional FoF had 63 and 58 such investments, respectively. Asset managers and consultants had, respectively, 47 and 44 such investments. At an average of 16 such investments, endowments and foundations were at the lowest end of the spectrum. Most of the other categories of investors had, on average, between 25 and 33 such investments.

The average position size of the respondents was $75 million. Institutional intermediaries in the study had an average position size of $114 million, significantly higher than both end investors ($58 million) and retail intermediaries ($45 million). Average position size was somewhat higher in the Americas ($80 million) than in EMEA ($67 million) or Asia ($61 million).

Anticipated Asset Flows

CS estimated total hedge fund industry AUM at just over $3 trillion at the end of 2016, up from about $2.9 trillion in 2015. It reported that there were net hedge fund industry outflows of about $70 billion in 2016 – the first year with net outflows since 2009 – which were offset by performance gains of about $200 billion.

Nearly half of respondents said they made between one and three new hedge fund allocations in 2016. About one-seventh made four or five new allocations, and nearly one-quarter made more than five. The rest (15%) made no new allocations.

Half of respondents said they made from one to three new redemptions in 2016, one-fifth made four or five and a similar proportion, including more than one-third of institutional intermediaries, made more than five. Just one-tenth did not make any new redemptions.

Nearly half of the respondents, including nearly two-thirds of retail intermediaries, indicated that they planned to increase their "notional exposure" to hedge funds in 2017. Just over two-fifths said they plan to maintain that exposure, and only 13% plan to decrease it.

By Strategy

As in prior studies, CS measured changes in "net demand" – *i.e.*, the percentage of respondents increasing allocations to a given strategy, less the percentage decreasing such allocations – for various investment strategies.

In the current study, the top strategy by far is discretionary global macro, for which CS found net positive demand of 26%. The second and third most popular strategies, each with net positive demand of 18%, are fixed income arbitrage/relative value and emerging market equity.

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Respondents showed net positive demand of 15-17% for several other strategies, including quantitative equity market neutral, systematic global macro, healthcare equities and financial equities.

Net demand for last year's top strategy pick – fundamental equity market neutral – fell from 34% to 11%, the largest change in net demand of all strategies CS considered. Net demand for long-short equity strategies fell by 18%, the second largest drop. CS found the greatest positive changes in net demand in asset-backed securities/structured credit and emerging market equity, which increased by 15% and 11%, respectively.

CS pointed out that, although discretionary global macro has been a "top three" strategy in each of the past three years, net demand for it has fallen each year, from 32% in 2015 to 26% this year. Net demand for fundamental long-short equity, CTA/managed futures and multi-strategy has also fallen each year. Net demand for general event-driven strategies fell from 26% in 2015 to -3% in 2016, recovering to just 5% this year.

By Region

CS used a similar "net demand" measure to gauge investor appetite for investment by region or country. This year's top pick, by region, is the Asia-Pacific region, for which there was net positive demand of 24%, followed by emerging markets (22%), global (14%), developed Europe (13%) and North America and Latin America (11% each). By country, the greatest net positive demand was for India (19%), followed by Japan (13%) and greater China (9%). There was also net positive demand of 10% for "country-specific funds in general."

The greatest year-over-year increases in net demand were for emerging markets and Latin America, which increased by 11% and 5%, respectively. The greatest decline in net demand by far was for developed Europe, which was the top pick in 2016 but which experienced a 23% decrease in net demand from 36% to just 13% this year. The second greatest decline was in global, which fell from 26% to 14%.

Although the Asia-Pacific region remains a top choice, demand for it has fallen each year since 2015, as has demand for global. Net demand for emerging markets in general, and Latin America in particular, has grown each of the past three years.

For more on potential asset flows and allocations, see "Deutsche Bank Alternative Investment Survey Explores Hedge Fund Asset Flow Trends; Highlights Greater Allocator Interest in Alternative Beta Strategies (Part One of Two)" (Mar. 30, 2017); and "Deutsche Bank Alternative Investment Survey Explores Potential Asset Flows, Investor Allocation Plans and Portfolio Construction Considerations (Part One of Two)" (Mar. 17, 2016).

Drivers of Hedge Fund Selection and Redemptions

Seven out of ten respondents indicated that hedge fund performance in 2016 failed to meet their expectations, compared with about 25% whose expectations were met and 7% whose expectations were exceeded. For 2017, respondents overall predicted hedge fund returns of 7.25%; institutional intermediaries are the least optimistic subset of respondents, predicting only 6.76% returns. CS noted that overall hedge fund performance in 2016 was just 5.53%.

Unsurprisingly, half of respondents cited performance as the most important factor in selecting hedge funds. Rounding out the top three factors considered by respondents, nearly one-quarter

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cited "pedigree of risk takers and core team stability," and nearly one-seventh cited diversification.

Less than one-quarter cited fees as one of the top three factors. Even fewer ranked transparency (15%), volatility (13%) or liquidity and short-side performance (12% each) in the top three. Least important were "quality of other investor base" and vehicle structure, which were "top three" factors for less than 5% of respondents.

The top driver of redemptions in 2016 was poor performance, cited by four-fifths of respondents. Other significant drivers were manager changes, such as style drift or departure of key personnel (52%), and change in strategy preference (45%). Nearly one-fifth cited hedge fund industry underperformance or fees, while only 11% cited a breach of risk guidelines.

Fee Structures

Roughly three-in-five respondents said that some of their hedge fund investments included hurdle rates or lowered management fees. Roughly two-in-five cited reduced management fees or a sliding model where fees move inversely with AUM size (*e.g.*, fees decrease and AUM increases, or vice versa). Nearly one-quarter cited a pass-through cost structure, while 16% cited a "loyalty" feature where fees are reduced if an investor stays with a fund for a specified period of time. CS noted a trend toward greater alignment of the interests of investors and fund managers through a "diversity of terms," including novel fee structures, liquidity, longer-duration investments and customized accounts.

For more on fees, see "ACA 2016 Compliance Survey Addresses Custody; Fee Policies and Arrangements; Safeguarding of Assets; and Personal Trading (Part Two of Two)" (Feb. 2, 2017); and "AIMA Survey Identifies Key Ways That Managers Align With Investors, Including Alternative Fee Structures, Skin in the Game and Customized Investment Solutions" (Sep. 22, 2016).

Hedge Fund Industry Risks

Crowded trades and herd behavior were cited as the most significant hedge fund industry risk by 69% of respondents, with the remainder citing them as "somewhat of a risk." Similar proportions of respondents cited this as the top risk in 2016 as well. See "Barclays Survey Suggests Hedge Funds Fell Short of Investor Expectations Due to Industry Growth, Position Crowding and Macro Conditions" (Aug. 25, 2016). Market liquidity was the second-ranked risk in both 2016 and 2017, but the proportion of respondents that cited liquidity as a significant risk declined from 66% in 2016 to just 38% this year.

Other risks deemed "significant" by at least one-third of respondents and "somewhat of a risk" by roughly half are political uncertainty, central bank actions and attrition due to underperformance. At the other end of the spectrum, only 7% of respondents cited increased regulations as a significant risk. See also "FCA Hedge Fund Survey Examines Key Risk Metrics Applicable to Hedge Funds" (Jul. 9, 2015).

Early Stage Investing

Forty-three percent of respondents said they invested in at least one newly established manager in 2016. Of those that did, 75% received a discounted or founder share class. Nearly one-quarter,

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consisting primarily of end investors and institutional intermediaries, contributed seed capital. Three-fifths said the "management team had a prior working history," and half indicated that they had a preexisting relationship with the manager of the start-up. Two-fifths said the new manager had an audited track record. See "Deutsche Bank Alternative Investment Survey Explores Fund Fees, Early Stage Investing and AIFMD (Part Two of Two)" (Mar. 24, 2016).

Non-Traditional Hedge Fund Products

CS found that respondents were most interested in illiquid credit/direct lending and hybrid/longer lock products. In each case, more than two-fifths said they planned to maintain current allocations, increase existing allocations or make new allocations. For more on direct lending, see "The Current State of Direct Lending by Hedge Funds: Fund Structures, Tax and Financing Options" (Oct. 27, 2016).

Two-fifths of survey respondents expressed an interest in long-only funds offered by hedge fund managers. Roughly one-third cited credit and equity co-investments and risk premia strategies. One-quarter or fewer said they planned to maintain, increase or make new allocations to alternative mutual funds, smart beta, general partner equity stakes and registered closed-end funds. See "Ernst & Young's 2016 Global Hedge Fund and Investor Survey Examines Industry Risks; Customized and Non-Traditional Products; Investor Allocation Preferences; Fees; and Hedge Fund Growth Priorities (Part One of Two)" (Dec. 1, 2016).

Alternative Mutual Funds and UCITS

The proportion of respondents interested in increasing or making new allocations to alternative mutual funds and Undertakings for Collective Investments in Transferable Securities (UCITS) declined from 24% and 13%, respectively, in 2016, to 16% and 9%, respectively, today. Retail intermediaries expressed the greatest demand for UCITS, which are also most popular in the EMEA region. See "PLI 'Hot Topics' Panel Addresses Operational Due Diligence and Registered Alternative Funds" (Dec. 10, 2015).

Co-Investments

Interest in increasing or making new allocations to credit and equity co-investments declined only slightly from 2016, to 20% and 24%, respectively. Co-investments are more common among end investors and institutional intermediaries than among retail intermediaries, four-fifths of which said they do not make, or plan to make, co-investments.

End investors expressed more interest in increasing equity co-investments than institutional or retail intermediaries. Investors are most interested in making co-investments in the Americas. "Private Equity Firms From Across the Industry Spectrum Advise on Trends and Terms in the Current Co-Investment Market" (Aug. 11, 2016).

Illiquid Credit and Direct Lending

Interest in increasing or making new allocations to illiquid credit/direct lending strategies grew from 22% in 2016 to 25% this year. The strategy is more popular among end investors and institutional intermediaries than retail intermediaries. See "Institutional Investors Increasingly Concerned by Risk of Marketplace Lending Regulation" (Apr. 21, 2016).

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Hybrid/Longer-Lock Products

As with illiquid credit/direct lending, these products are more popular among end investors and institutional intermediaries than retail intermediaries. Overall interest in commencing or increasing allocations grew slightly, from 21% in 2016 to 23% this year. The greatest interest for these products lies in the Americas. See "Lock-Ups and Investor-Level Gates Prevalent in New Hedge Funds" (Mar. 23, 2017).

Hedge Fund Long-Only, Smart Beta, General Partner Equity Stakes and Closed-End Funds

Respondents' interest in increasing or making new allocations to each of these four types of products increased marginally from 2016 to 2017. Long-only and general partner equity stakes are more popular among end investors and institutional intermediaries than retail intermediaries. Smart beta is more popular among institutional and retail intermediaries than end investors. The greatest interest for new or additional allocations to each of these products lies in Asia.

Risk Premia

Risk premia products, which were not covered in prior CS studies, are somewhat more popular among institutional and retail intermediaries than end investors. Demand for new or increased allocations appears to be strongest in EMEA and Asia.

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