Deutsche Bank
Markets Prime Finance

Eleventh Annual

Alternative Investment Survey

Out with the old, in with the new:
Investors' expectations for hedge funds in 2013 and beyond

Passion to Perform

In our eleventh annual Alternative Investment Survey, over 300 global hedge fund investors provide insights into their current sentiment and allocation plans for 2013. Their collective feedback highlights the underlying trends that are shaping new industry norms and driving growth. This year investors predict hedge fund industry assets to increase by 11%, reaching $2.5tn by year end.

For our 2012 survey, in celebration of our 10 year anniversary, we focused on the transformative change that occurred in the hedge fund industry over the past decade, highlighting 2008 as a catalyst.

This year, what caught our attention was not headline change but rather the subtle and nuanced evolution of hedge fund investing brought on by new investor expectations. Hedge funds are becoming an ever more respected part of the institutional investor's wider portfolio, and as such their role in the portfolio is evolving. As will be discussed, those hedge funds that can demonstrate steady and consistent returns, as well as a willingness to engage in an open and thoughtful conversation on the topic of alignment of interest, will be well placed to win investor attention and asset flows in 2013 and beyond.

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In this year's survey we let go of old expectations and introduce the new, all the while acknowledging that the pillars of hedge fund investing have remained the same.

Old: "Industry growth driven by family offices and private banks"

New: Industry growth backed by institutional investors

Industry growth since 2008 has been largely driven by increased institutional participation, with 2012 being no exception. Whilst 57% of private banks decreased hedge fund assets under management ("HF AUM") in 2012, almost 70% of pension funds increased their allocations. Institutional-led growth is set to continue in the coming year, with almost half of pension funds expecting to ramp up allocations by $100mn or more in 2013.

Old: "Hedge funds may get an allocation from the 'alternative bucket' within institutional portfolios"

New: Hedge funds no longer viewed as a separate asset class

Institutional investors are looking beyond the traditional asset allocation approach of bonds, equities and alternatives, and instead moving towards a risk-based approach. Indeed a quarter of institutional investor respondents have adopted this approach, and half of the consultants are recommending it to clients.

Old: "Hedge funds offer outsized returns in all market environments"

New: Hedge funds expected to deliver steady, predictable return streams

In 2010, more than half of investors were targeting double-digit returns for their hedge fund portfolios.[1] Just three years later, this percentage has fallen to less than a third. Nearly two thirds of respondents feel that hedge funds performed as expected or better in 2012, after the HFR Fund Weighted Composite index returned 6.2% for the year.[2] For 2013, 65% of investors, and 79% of institutional investors are targeting returns of 5–10% for their hedge fund portfolios.

Old: "Hedge fund fees will collapse"

New: Greater alignment of interest between managers and investors

Almost 80% of investors continue to pay an average management fee of 1.5–2.0%, with over half of these investors paying 1.75–2.0%. Three quarters of investors pay an average of 17.5–20% for performance. Investors increasingly recognise that successful fee negotiations typically involve a compromise: only 29% of investors who negotiate fees are successful over 50% of the time, and half of these investors have their capital locked up for at least 2 years and manage at least $2.5bn in HF AUM. Concurrently, 83% of investors suggest that managers should use a hurdle rate. Whilst ongoing, fee negotiations are not the most prominent theme this year. This is substantiated by the finding that consultants do not place "downward pressure on fees" in their top 3 largest trends amongst their clients.

Old: "The fund of funds model is broken"

New: Funds of funds attract institutional capital with an evolved business offering

29% of funds of funds state that over half of new business in 2012 has been for bespoke portfolios, whilst 58% of end-allocators state that the main benefit of their fund of funds allocations is to access niche managers, including smaller or younger funds. Furthermore we are starting to see a convergence between funds of funds and consultants.

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1 2010 Deutsche Bank Alternative Investment Survey
2 HFR Industry Reports © HFR, Inc., www.HedgeFundResearch.com