Since the 2008 financial crisis, the hedge fund industry has more than doubled in size, from $1.41tn to $2.85tn, fuelled by massive flows of institutional capital, steady performance-based gains and a flexible hedge fund business model. Historically, industry assets were distributed among firms of all sizes and shapes, connected by a shared single objective of outsized, double-digit performance. Today, however, they are concentrated among the largest managers, who are increasingly standing out for their ability to provide comprehensive portfolio solutions to sophisticated institutional investors.

Investors’ appetite for risk and liquidity, along with their sensitivities around fees, transparency and fund structures, continues to evolve and diverge. As a result, more and more investors are looking to partner with the largest hedge fund managers who have the resources, capacity and willingness to address those needs. Indeed, since 2008, assets managed by firms with more than $5bn in firm AUM have grown by 141%, compared to 53% for firms with less than $5bn. Deutsche Bank estimates that less than 200 hedge fund firms today account for more than two thirds of total industry assets.

A new day has come for hedge fund managers, one that involves servicing institutional investors across the portfolio with a suite of different strategies, structures and products. With a focus on partnership and alignment of interest, married with a flexible and adaptive approach to product development, the largest hedge fund firms are playing an increasingly influential role within the wider asset management industry. It is with this theme in mind that we publish this survey, and we expect this trend to shape, define and strengthen the industry in 2015 and beyond.

For more information or to request a copy of the survey, please contact:
Europe: +44 20 754 73792 Americas: +1 212 250 4950 Asia Pacific: +852 2203 6797

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435 global hedge fund investors, representing $1.8tn in hedge fund assets, share insights into their current sentiment and allocation plans for 2015.
Key findings:

Hedge fund industry assets expected to surpass $3 trillion

In 2015, investor respondents expect the hedge fund industry to grow a further 7%, based on predictions for net inflows ($60bn) and performance-based gains (+5.22%, or $149bn). This comes after the industry experienced 8% growth in 2014, led by investor net flows ($76bn) and moderate performance-based gains (+3.33%, or $140bn). 39% of responding investors plan to grow their hedge fund allocation in 2015. This includes 22% that expect to have an additional $100m or more to allocate to hedge funds.

With performance dispersion rising, selecting the right fund is ever more critical

The average hedge fund returned 3.33% in 2014, however the top 5th percentile produced returns greater than 22%. Not only was strong performance limited to a small number of funds, but many of these funds have been inaccessible to investors for several reasons (e.g. closed to new capital, high fees, esoteric strategies, off-shore fund structure). We expect performance dispersion to further bifurcate the market in 2015, making manager selection increasingly important.

Hedge funds increasingly offer higher yielding investment opportunities for those who can accommodate illiquidity and volatility

Investors risk/return expectations for traditional hedge fund products continues to come down in favour of steady and predictable performance: only 14% of respondents still target returns of more than 10% for the hedge fund portfolio, compared to 37% last year. Meanwhile, 97% of investors target high single digit volatility for the typical hedge fund portfolio, compared to 90% last year.

With this in mind, however, 40% of respondents now co-invest with hedge fund managers as a way to access enhanced and diversified return streams. 72% of these investors plan to increase their allocation in 2015. 43% of investors also invest in longer dated hybrid private equity/hedge fund vehicles, exhibiting a willingness to give up liquidity in exchange for potentially higher yielding, uncorrelated performance. 61% of these investors plan to add to such investments in 2015.

Assets managed by diversifying quantitative strategies set to grow

Following a strong year of performance, at least one in every three respondents is planning to increase exposure to quantitative strategies in 2015, with CTA/trend following, quantitative equity market neutral and quantitative equity receiving the greatest interest. Notably, CTA/trend following is the 4th most sought after strategy in 2015, marking a sharp reversal of trend from the last two years, when the vast majority of investors were planning to reduce their allocation.

Asia sees renewed interest

Investor demand for Asia including Japan is on the rise amid continued outperformance. The portion of respondents (by AUM) planning to allocate to the region has increased from 19% to 30% year on year. The universe of investors waking up to the opportunity in China is noteworthy: 25% of respondents (by AUM) plan to increase investment in the region over the next 12 months, compared to only 11% last year. India is also expected to benefit from increased flows in 2015, with 26% of investors (by AUM) planning to increase exposure to the region over the next 12 months, compared to only 4% who said the same last year. Beyond Asia, continued growth is expected for North America, with the United States / Canada expected to be the top performing region and the most sought after one for investment in 2015.

The largest intermediaries play an increasingly important role in institutional portfolios

As a result of the ongoing evolution and convergence of funds of funds and consultants, as well as the rising influence of the outsourced Chief Investment Officer (“outsourced CIO”), today’s leading intermediaries seek to provide comprehensive portfolio solutions to the institutional investor from an advisory and/or fiduciary capacity. The current intermediary landscape is dominated by the largest, well resourced players and these firms are seeing strong demand from institutional investors. 13% of fund of funds respondents manage 55% of total fund of funds assets in the survey, while 28% of investment consultants account for 89% of total hedge fund assets managed and/or advised on by this investor segment. 60% of investment consultants and 48% of pension funds utilise a fund of funds in some capacity, while 65% of pension funds and 48% of endowments, foundations and insurance companies utilise an investment consultant.

3 2014 Deutsche Bank Alternative Investment Survey
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