Prime Services
Capital Solutions
Hedge Fund Pulse

Against All Odds

Hedge Fund Industry Developments and Implications for Growth

August 2016

Contents

I. Study overview

The Hedge Fund (HF) industry has been under a substantial amount of pressure in the first half of 2016 due to perceived underperformance and frequent industry news highlighting redemptions from large institutional investors, high profile hedge fund closings, and the constant push to drive fees lower. It is therefore an important time to take the pulse of investors to better understand how recent performance and news have affected their behaviour, whether they are planning to redeem and, if not, which steps they are planning to take to make sure they are satisfied with their HF allocation going forward.

With this in mind, the Strategic Consulting team has sought to provide a mid-year analysis on the major developments in the HF industry with a view to assessing the evolving value proposition of HFs, key investor themes, and the asset raising landscape for 2016. The three main topics addressed in this study are:

1. **Hedge Fund performance**
    a. How have HFs performed in recent years on a beta-adjusted basis?
    b. What drivers do investors attribute the industry's relative underperformance to? Is there evidence to support their hypotheses?
    c. Is the HF industry too big?
    d. How have macro factors impacted the industry's ability to generate alpha?
2. **Investor sentiment**
    a. Has recent HF performance disappointed investors' expectations? What steps, if any, are investors planning to take as a result?
    b. Have HFs been additive to investors' portfolios in recent years?
    c. How are investors responding to performance challenges in their interactions with HFs?
    d. How do investors now perceive different types of HF managers?
3. **Looking ahead**
    a. How do we expect recent events to impact HF launches and liquidations in 2016?
    b. What are our expectations for the industry size going forward? How much of the change do we expect to come from performance versus flows?
    c. What HF strategies are investors most keen on increasing / decreasing allocations to?

Methodology

The team primarily used five different sources to ensure depth and breadth of data for our analyses:

1. Conducted a survey in 2Q16 of 340 investors with ~$8tn in total AUM
2. Analysed Equity HF data sourced from Novus[1]
    a. Returns and AUMs of >800 Equity HF managers from >60 countries
    b. >100k positions, totaling to ~$1.7 trillion of market value
3. Relied extensively on external data and research, including:
    a. Data from more than 50 different research publications and academic research papers
    b. ~10,000 data points on HF returns (HFR database)
4. Established ongoing dialogue with HF managers / investors in coordination with the Barclays Capital Solutions team
5. Utilized prior Strategic Consulting studies, including 'Bracing for Impact', 'Coming to Terms', and 'Mind the Gap'

Figure 1 shows the distribution of the 340 investors who participated in this study along four dimensions – investor type, amount of investor portfolio assets under management (AUM), experience investing in HFs, and investor location. Select highlights:

- The investor firms in our study represent approximately $7.7 trillion in total AUM and about $900 billion in HF AUM, ~30% of the HF industry. The investors had diverse backgrounds as ~45% of the respondents were institutional, (i.e., Pensions, Insurance Companies, Endowments & Foundations (E&Fs), and their investment consultants / advisors). Another ~24% of the sample consisted of private investors (Family Offices and Private Banks / Wealth Managers) and ~21% were Fund of Hedge Funds (FoHFs). The remainder (11%) included Managed Account Platforms (MAP), Outsourced CIOs, Sovereign Wealth Funds (SWFs), etc.
- These investors were well distributed across total AUM size categories, as investors with less than $1bn in AUM and those with $1 – $5bn each represented ~25% of the respondents, those between $5 and $30bn represented ~35%, and the balance, those with more than $30bn in AUM, represented the remaining ~15%. With regard to their experience investing in HFs, the investors indicated a significant skew toward being more experienced – those with more than 10 years of experience investing in HFs represented almost two-thirds of the respondents and those with between five and 10 years were almost one-quarter, leaving the most inexperienced HF investors as only 12% of our respondents. The geographical breakdown shows that a vast majority is based in North America (73%), while 21% are based in Europe, and only 6% are from the "rest of the world" (ROW).
- We believe our investor sample provides a good representation of the underlying HF investor universe with one important caveat. Given that this is a select group of individuals (and organisations) that chose to share their views on the HF industry, we believe they may be more knowledgeable about HFs (as can be seen by their collective experience investing in HFs), may have higher current allocations to HFs than their peers, and are more likely to be invested directly into HFs rather than through FoHFs. This also makes it potentially more bullish on HFs, in our opinion.

1. Novus is a service provider (unaffiliated with Barclays) that provides industry intelligence to institutional investors and asset managers

II. Executive summary

The following are high level takeaways from the study:

HF performance

- Although HFs have produced considerable excess returns since 1993, such levels have by and large plateaued since 2011, which may be at least partially due to managers' reducing their risk appetite.
- However, survey respondents indicated that they believe the size of the industry and macro conditions are more likely the reasons for recent HF underperformance.
- With regard to the size of the industry, across various strategies, the Compound Annual Growth Rate (CAGR) over the past six years for HFs' AUM was between 9% and 12%, with a majority of the growth driven by an increase in average fund size as opposed to an increase in the number of funds.
- Yet the global stock of financial assets has reached ~$305tn by YE 2015, which means that HF assets still account for only 1% of total assets – suggesting the size of the industry probably is not the issue, whereas the size of individual HFs may be.
- Some of this underperformance by the largest managers may be attributable to the rise in crowded trades, which has increased substantially in recent years.
- Furthermore, from the second half of 2015 onward, we observed considerable underperformance on the part of larger funds relative to smaller funds, a phenomenon that affected all strategies to varying extents.
- Macro conditions appear to have aligned against HFs in recent times, as intra-stock correlation and dispersion have been at disadvantageous levels – making it challenging for HFs to produce alpha.

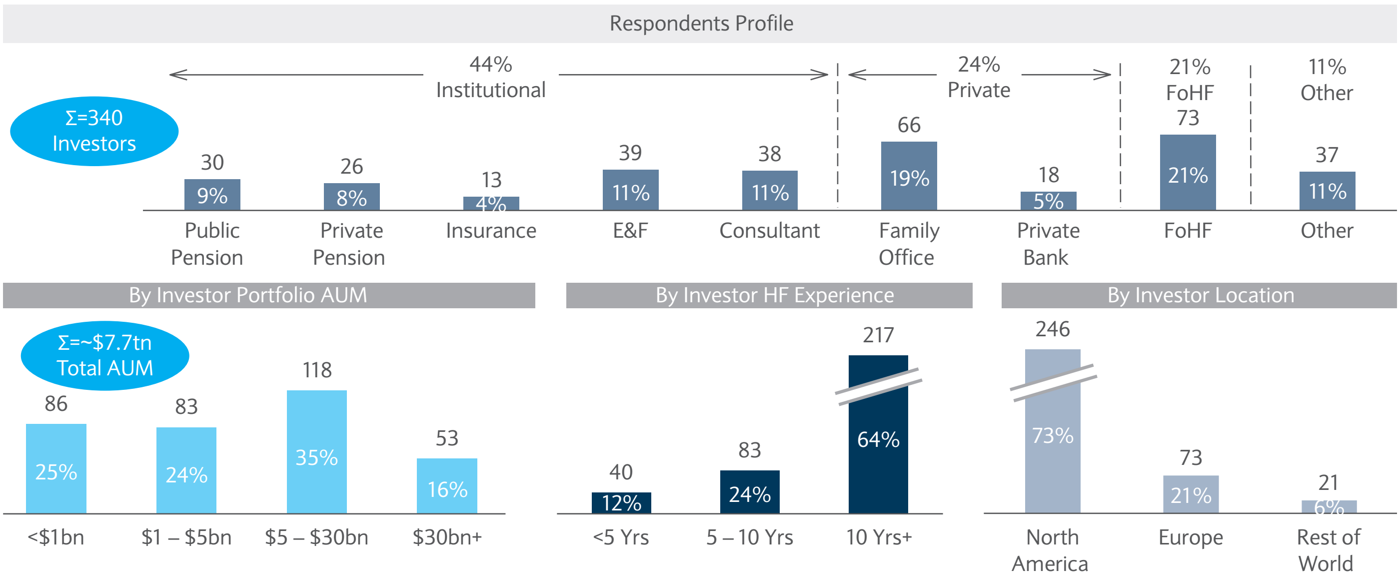
Investor sentiment

- More than half of the investors we surveyed recently indicated that HFs did not meet their expectations over the last couple of years.
- However, despite recent press to the contrary, the vast majority of investors we surveyed indicated that they are not pulling back wholesale from their HF allocations.
- The commitment to HFs can at least partially be explained by the positive attribution HFs seem to offer after combining their risk-adjusted returns with their low correlation to indices.
- Furthermore, it appears that HFs are mitigating further underperformance by securing discounts, especially to management fees, though performance fees are discounted as well, particularly by strategies without capacity issues / netting risk.
- Investors appear keen on increasing allocations to small and new managers in search of better returns and more flexibility on fees and terms.

Looking ahead

- We expect HF liquidations in 2016 to rise to 12% from a recent historical average of 10%, given the performance challenges of 2015 and early 2016.
- Additionally, if 2016 HF performance continues at, or falls below, the annualised 1Q16 / 2H15 levels, the industry may face a reduction in AUM as net new flows are unlikely to be additive.
- Based on investor input, we expect Systematic / Commodity Trading Advisors (CTA), Quant Equity, Distressed Credit, and Equity Market Neutral strategies to attract investor interest and allocations over the next 6 to 12 months.
- Conversely, Event Driven and Equity Long / Short strategies appear to be the least in favour among investors at the mid-year.

FIGURE 1: Survey Respondents – Investors



Note: The results presented are from a relatively small number of respondents and therefore are indicative only and not meant to reflect conclusive industry trends. Data and other information presented are derived directly from respondents and we cannot confirm the accuracy of such information. All figures refer to Barclays Strategic Consulting analysis

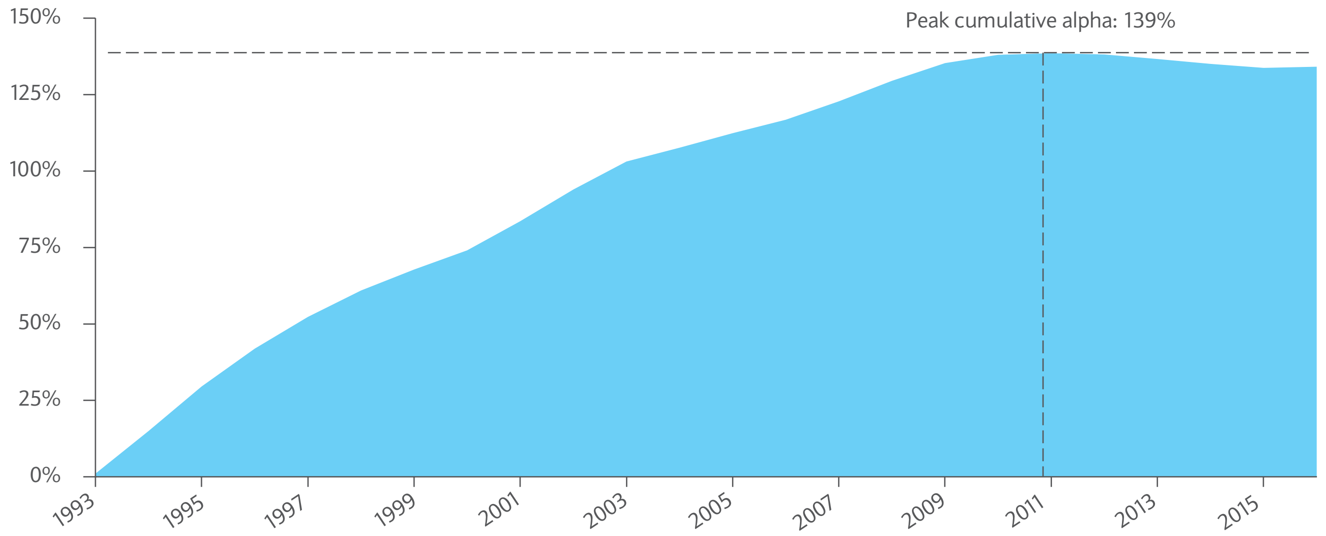
III. Hedge Fund performance and flows

HF performance – Excess returns

When we discuss HF performance, the most important criterion is generally the alpha generated by HF managers (i.e., excess returns beyond what is attributable to beta or exposure to a market benchmark). We looked at alpha across several different lenses, the first of which can be seen in Figure 2. In this chart, we regressed monthly HF returns against key market indices (a proxy for beta) from 1993 to May 2016 (including S&P 500 for Equity Hedge and Event Driven, Barclays Agg for Macro, and Barclays HY Index for Fixed Income Relative Value (FIRV)) and then we aggregated the excess returns on a monthly basis and showed the results on a 36-month rolling basis. It shows us that from 1993 – May 2016, HFs produced cumulatively ~134% of alpha. However, peak cumulative alpha over the period was 139%, achieved in 2011, which suggests that in the last almost 4.5 years, HFs actually generated negative cumulative alpha. More specifically, the average monthly alpha has declined to -0.07% (annualised ~0.8%) from 2011 to May 2016 compared to an average of +0.48% (-5.9% annualised) for the entire period analysed (1993 to May 2016).

FIGURE 2: HF Performance – Excess Returns (I / III)

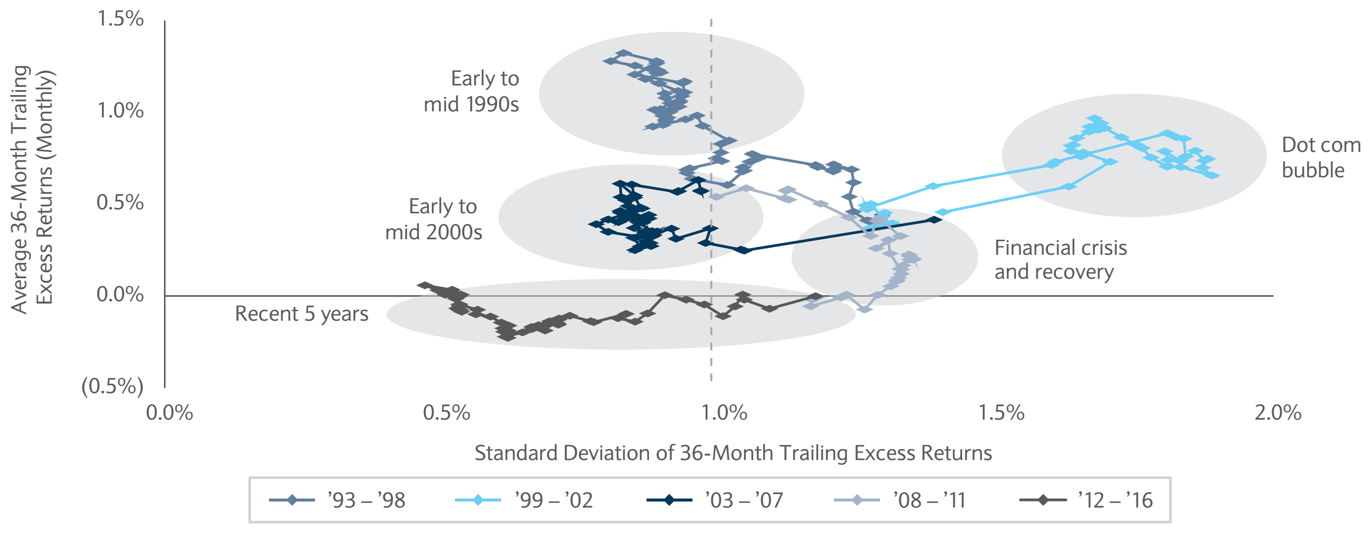
Cumulative HF Alpha / Excess Returns (1993 – May 2016)[1]



1. HFR, S&P 500, Barclays Strategic Consulting analysis. Performance is calculated net of different exposures; Between 1993 – May 2016 exposures were: 0.21 to S&P 500, (0.08) to Barclays Aggregate and 0.30 to Barclays HY Index

FIGURE 3: HF Performance – Excess Returns (II / III)

HF 36-Month Trailing Excess Returns and Standard Deviation (1993 – May 2016)[1]



1. HFR, S&P 500, Barclays Strategic Consulting analysis. Performance is calculated net of different exposures; Between 1993 – May 2016 exposures were: 0.21 to S&P 500, (0.08) to Barclays Agg and 0.30 to Barclays HY Index; Risk is standard deviation of 36-month rolling Alpha

The next lens we used to evaluate HF alpha was to compare the risk and returns of HFs from the same time frame. Figure 3 illustrates the relationship between the 36-month trailing excess returns versus the 36-month standard deviations of those returns (we use this as a proxy for risk) over various market cycles (i.e., '93 – '98, '99 – '02, '03 – '07, '08 – '11, '12 – '16). As we looked at the various market cycles we found an interesting 'pattern' in the relationship between risk and returns. If you exclude the first market cycle in the early to mid '90s, when HFs were able to generate significant excess returns quite steadily, there is a clear relationship between the excess return HFs generate and the standard deviation of those returns, a measure of the 'active risk' taken by HFs. Since 1993, average excess returns have been decreasing rather steadily, while risk has gone up / down over the various periods – in the last cycle, starting in 2011, risk has gone down to its lowest levels, which may help explain / contribute to the industry's recent underperformance.

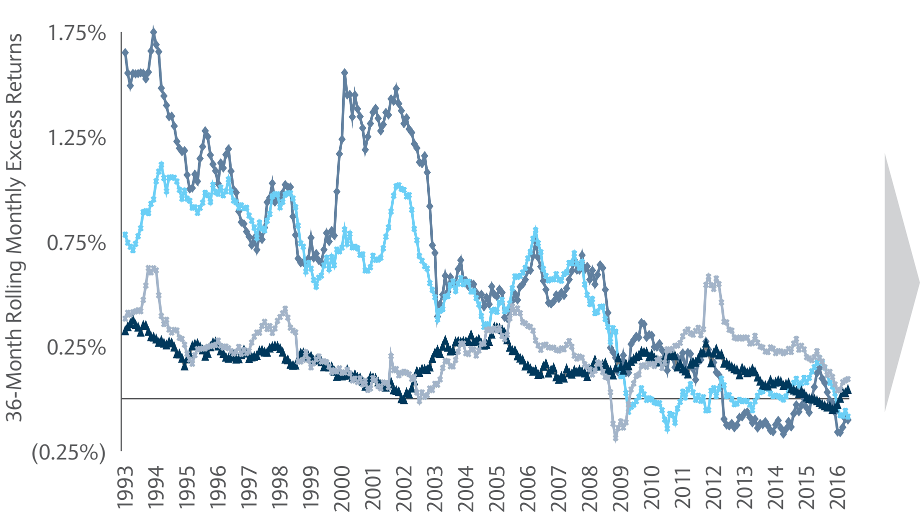
The final lens we used is a variation on the prior analyses, only now we are comparing the excess returns across HF strategies. Figure 4 shows the regression of monthly HF returns by strategy against the same key market indices used previously. The results tell two distinct stories. The annualised excess returns across all strategies from 1993 to 2011 were robust. Since then, however, excess returns across all strategies have declined. The results are particularly striking for Equity Hedge and Event Driven strategies, which provided investors 810 bps and 660 bps of alpha respectively in the earlier period while they created negative annualised excess returns from 2011 – May 2016 (i.e., Equity Hedge generated -200 bps of alpha and Event Driven -80 bps).

Drivers of recent HF underperformance

Regardless of the way we analysed recent HF performance, it appears that HFs have been underperforming lately. Let's then turn to the question of why that is the case, a question we posed to our investors. Figure 5 shows that the most common driver perceived to adversely impact recent HF performance (chosen by almost 75% of investors) has been that the HF industry has become too big relative to the opportunities available. More than half of respondents (57%) indicated that macro conditions (e.g., political, central bank, etc.) have contributed to the underperformance. The balance of factors (i.e., changes to market behaviour, 'high' fees, 'other') suggest that there are many other perceived explanations for the poor results, though these are much less widely held. One of the key considerations when discussing underperformance of HFs is the reference point for investors' expectations. As one of the investors we interviewed mentioned, the HF market has changed considerably (e.g., new regulations, monetary intervention, increased operational burden, etc.) and it might make sense to change the expectations of HFs commensurately. While this will not relieve HF managers from the pressure of pushing fees down for instance, it might change the conversation with investors regarding what the objectives / expectations of an allocation should be.

FIGURE 4: HF Performance – Excess Returns (III / III)

Average Excess Return by HF Strategy (1993 – May 2016)[1]



Annualised Excess Return (bps)	Cumulative (1993 – 2011)	4.5-Year (2011 – May 2016)	Difference
EH	810	(200)	(1010 bps)
ED	660	(80)	(740 bps)
Macro	210	70	(140 bps)
FIRV	250	200	(50 bps)

1. HFR, Barclays Strategic Consulting analysis. Performance is calculated net of different exposures; Between 1993 – May 2016 exposures were; Equity Hedge (0.45 to S&P 500), Relative Value (0.31 to Barclays Global HY and (0.05) to Barclays Aggregate), Event Driven (0.16 to the S&P 500 and 0.35 to Barclays Global HY) and Macro (0.33 to Barclays Agg)

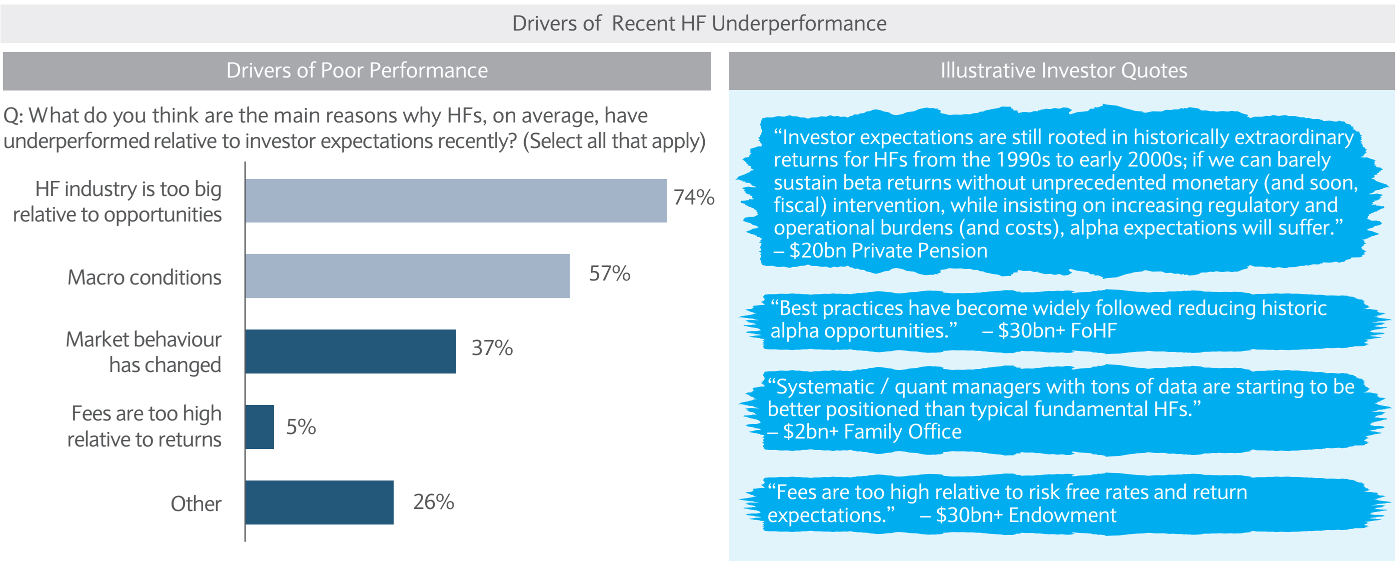
HF AUM growth

Regarding the most common driver referenced above, 'the HF industry has become too big relative to the opportunities available', we decided to evaluate how the HF industry has grown. Figure 6 shows us that the overall CAGR for HF AUM from 2009 – 2015 was 10% and that the individual strategy components each went up by between 9% and 12%. Across the various strategies, it appears that, on average, asset growth in the individual funds account for two-thirds of the overall growth by strategy while the number of new funds accounts for only one-third. This suggests that, on average, HFs are growing their AUM quite considerably and that the bigger HFs are in fact getting bigger.

Despite the HF industry's significant growth since 2009, it is still very small relative to the pool of global financial assets. Figure 7 shows that the estimated value of all financial assets in 2015 was $305tn and that HFs at $2.9tn account for just under 1% of the total. Although over the period HFs had a CAGR of ~10% they only increased their portion of the pool by about 300 bps, from 0.7% to 1%. Furthermore, Public Equities and Public Debt had CAGRs of 7.5% and 6.6% versus 4% for all financial assets and therefore did a much better job of keeping pace with the growth in HFs. This suggests that the issue is likely not the growth in size of the overall HF industry, as there appears to be an ample supply of assets. The issue may be, however, the growth in size of many individual HFs, which are pursuing similar strategies leading to crowding.

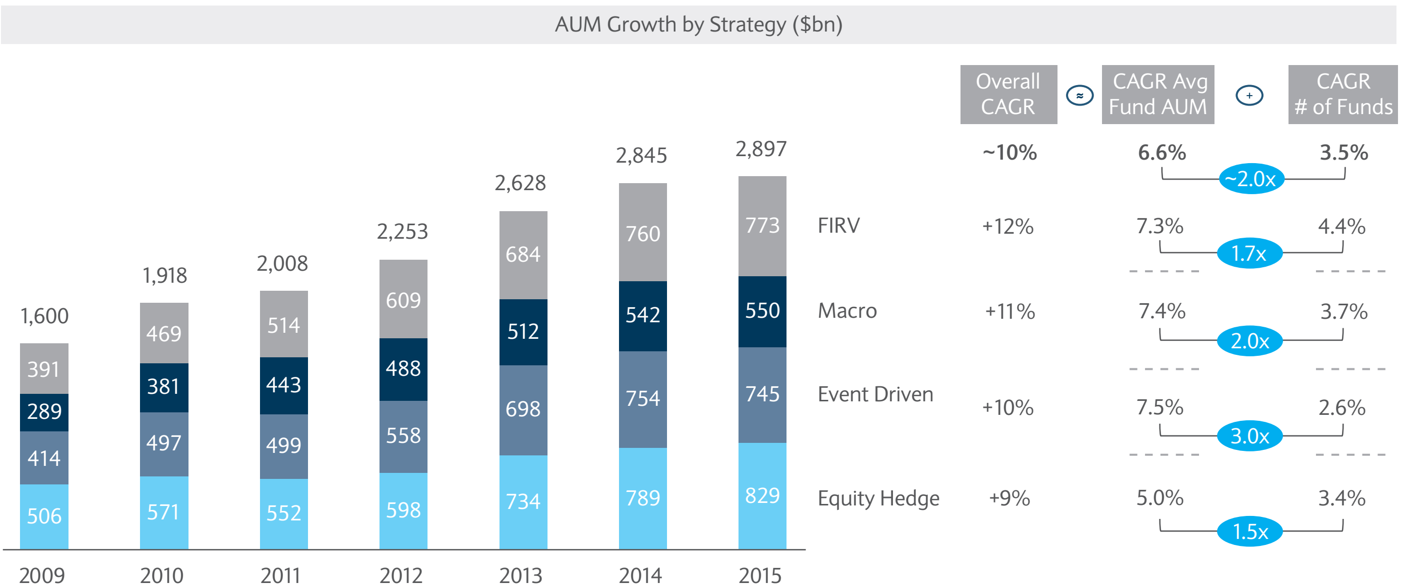
FIGURE 5: Drivers of Recent HF Underperformance

The size of the industry and macro conditions are the most often-cited reasons by investors for recent HF underperformance



Source: Barclays Strategic Consulting analysis

FIGURE 6: HF AUM by Strategy



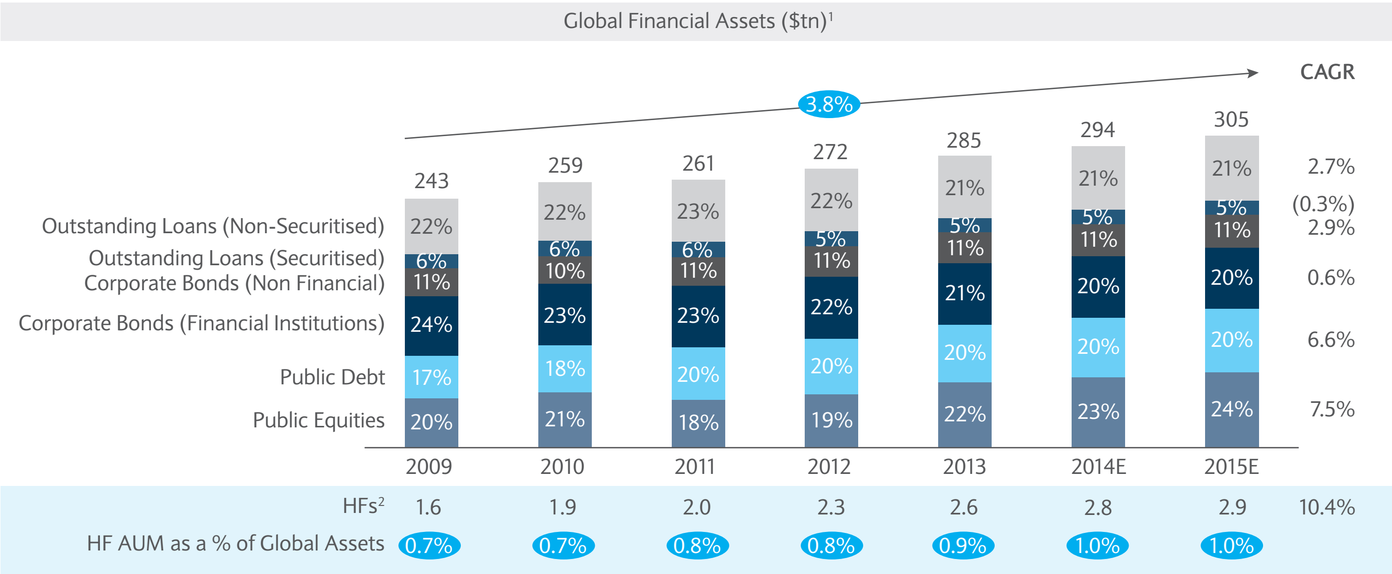
Source: HFR; Barclays Strategic Consulting analysis

Position crowding

While there are many advantages that larger HFs have (e.g., access to talent, institutional infrastructure, etc.), there are also several drawbacks. One such drawback is that as HFs become larger, their investable universe can often be diminished (e.g., due to position limits) as it is often not 'worth it' to invest in smaller situations that can hardly move the PnL needle. Figure 8 illustrates how since the middle of 2012 position crowding in US Equities has increased significantly – rising from 2.2% at 3Q12 to 5.2% in 3Q15. Historically, investing in crowded names has generated positive returns, particularly in stable, rising markets. However, when the reverse happens, it tends to be sharp and painful. The reverse, in this case, started in 3Q15, with indices composed of crowded names dropping significantly. We discussed this phenomenon in our recent piece 'Hanging Tough: Landscape and Recent Developments in Event Driven Strategies'.

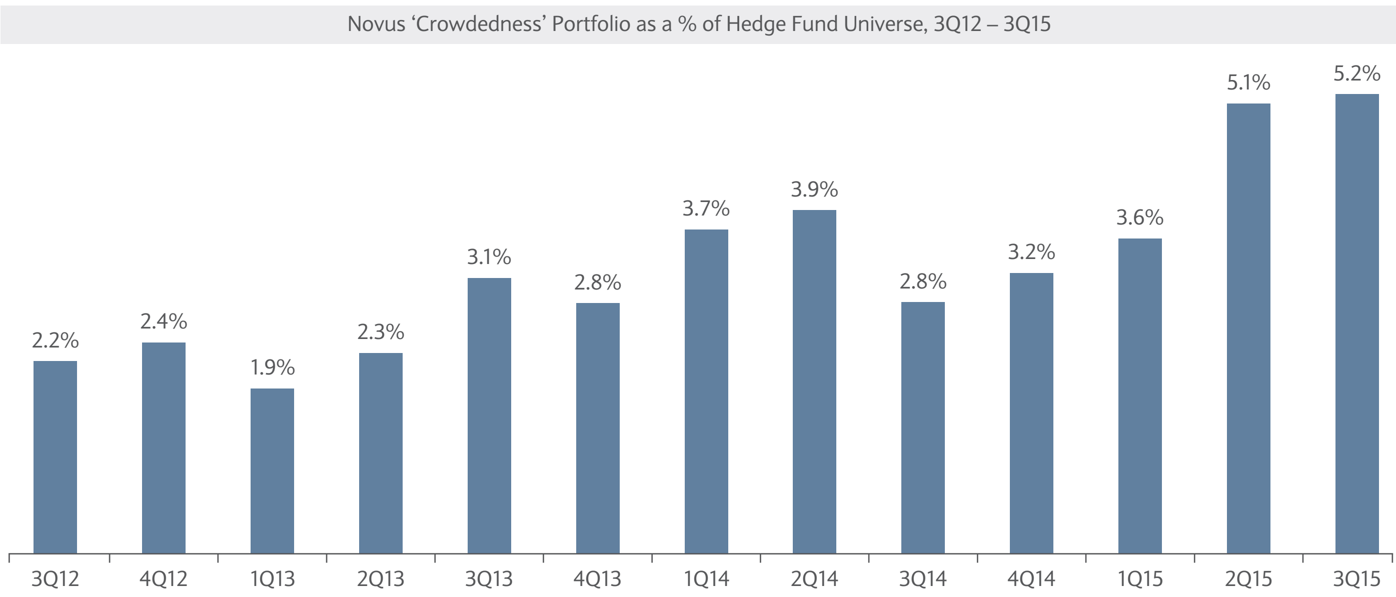
What is worthwhile to mention here is how this coincides with a significant underperformance of larger funds, evident in the difference between the 12-month rolling returns of the HFRI Fund Weighted (i.e., equally weighting all funds) and Asset Weighted (e.g., all funds are not counted equally) indices. In Figure 9, we can see that from July 2011 through July 2015 the results were variable and inconsistent, whereas since July 2015 the pattern seems to be much clearer and it appears to be trending down across strategies. This suggests that the

FIGURE 7: AUM Growth – Global Financial Assets vs. HFs



1. Business Insider, 'The $64 trillion question, Convergence in asset management,' McKinsey & Company; Barclays Strategic Consulting Analysis; 2. HFR

FIGURE 8: Position Crowding in US Equities



Source: Novus, Barclays Strategic Consulting analysis

Asset Weighted indices significantly underperformed the Fund Weighted indices. The most severe decline comes from Event Driven where the asset weighted index underperformed the fund weighted index by nearly 6% over the last 12 months through June 2016.

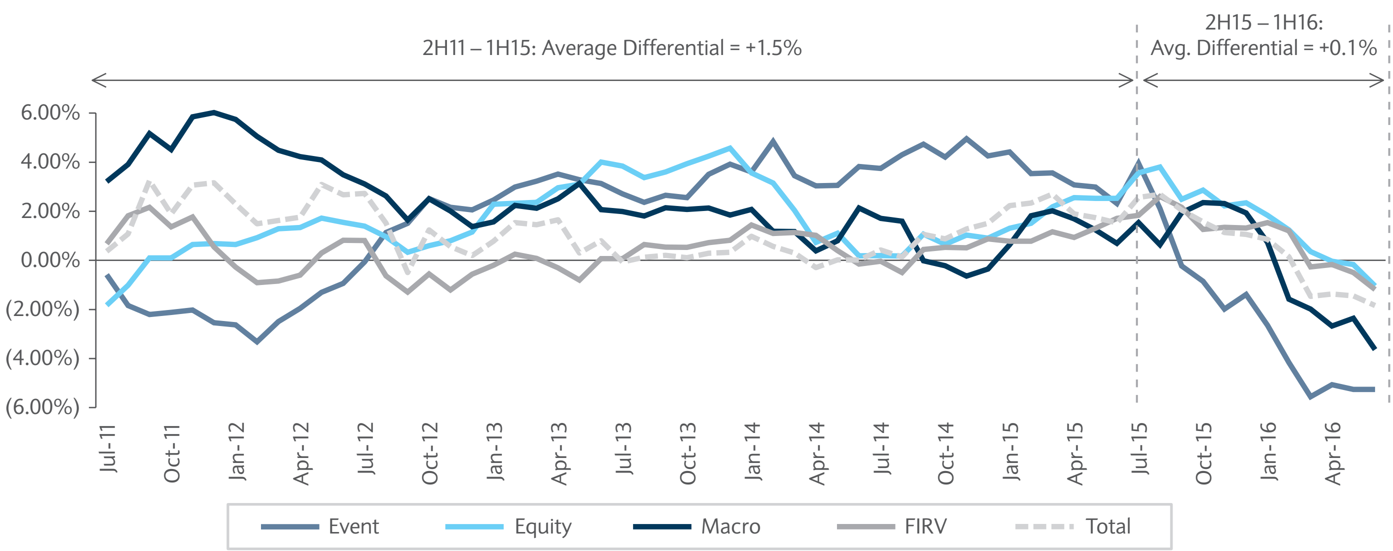
Macro conditions

The second most commonly mentioned driver of underperformance by investors was that macro conditions have been working against HFs. Macro managers have been mentioning this issue for a while, but Figure 10 appears to also confirm this thesis with regard to Equity strategies. The chart on the left shows the amount of alpha HFs were able to generate in different market conditions from 2000 – 2015, specifically when there was high and low levels of realised correlation (e.g., the degree to which different stocks in the S&P 500 move in the same direction) and of dispersion[2] (e.g., the difference in stock movements regardless of whether they are going in the same direction or not). HFs generate almost 10% of alpha when dispersion is high and correlation is low, conversely, when dispersion is low and correlation is high HFs only generate 0.8% of alpha. The charts on the right show how correlation

2. To further explain dispersion, it calculates the degree to which stocks move relative to each other. For instance, to calculate the dispersion of two stocks, if one goes up by +5% and another by +10%, the 'dispersion score' would be 5%; meanwhile if one stock goes down by -2.5% and another goes up by +2.5% it would also have a 'dispersion score' of 5%

FIGURE 9: **Recent Performance by Hedge Fund Size**

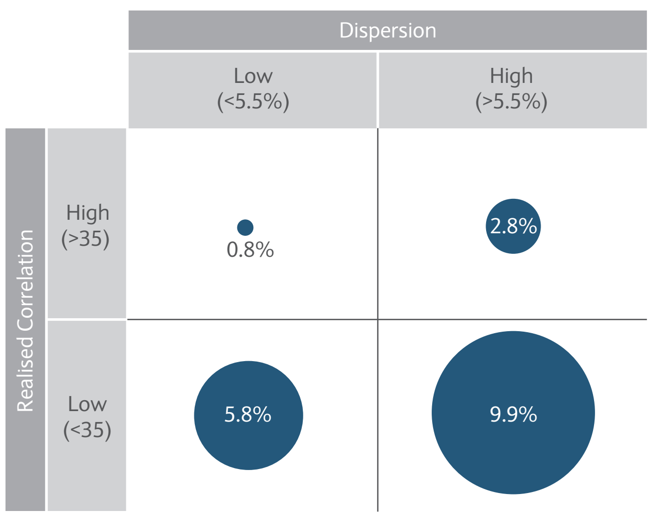
2H11 – 1H16: HFRI Asset vs. Fund Weighted Index, 12-Month Rolling Performance Differential



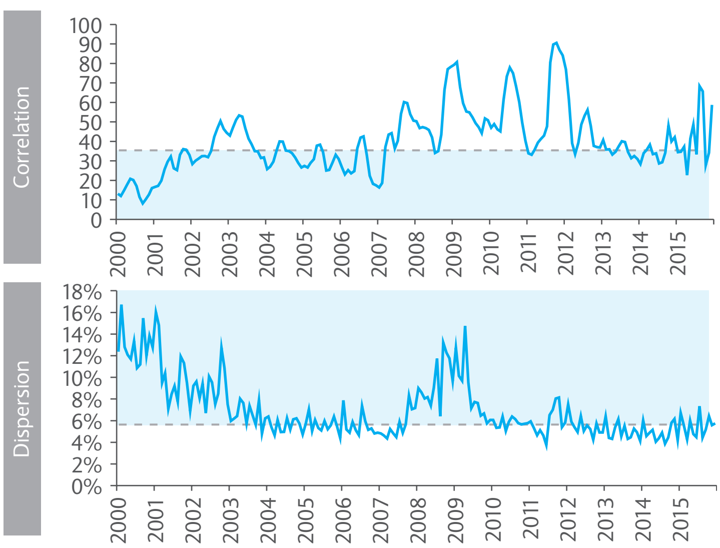
Source: HFR, Barclays Strategic Consulting analysis

FIGURE 10: **Equity Alpha as a Function of Macro Conditions**

HF Alpha as a Function of Correlation and Dispersion



Levels of S&P 500 Intra-Stock Correlation / Dispersion, 2000 – 2015



Source: S&P Dow Jones Indices, HFR, Barclays Strategic Consulting analysis; 2015 data is as of November and dispersion have moved over time and it appears that we have been experiencing an adverse scenario for HFs over the last two years or so – high correlation and low dispersion.

Thus, it is apparent that the respondents in our survey have a pretty clear grasp of the issues facing HFs as there appears to be evidence behind the two common causes of the recent underperformance cited by investors.

IV. Investor sentiment

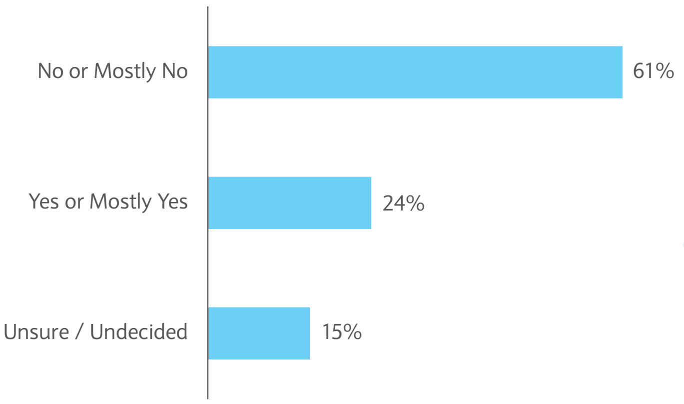
In the second section of this study, we endeavour to understand how recent HF performance has affected investors' general perceptions of HFs. We take a look at how investors' perceptions of HF performance aligned with their expectations, what their allocation plans may be, what the portfolio effects have been from recent HF performance, how investor sentiment toward new and small HF managers has changed, and the importance of manager selection.

FIGURE 11: HF Performance vs. Investor Expectations

Investor Perception of Recent HF Performance

Recent HF Performance Relative to Expectations

Q: Do you feel that Hedge Funds in your portfolio have met your expectations in the last couple of years (2014 – YTD 2016)?



Recent HF Performance Relative to Expectations by Investor Type

	Public Pension	Private Pension	Insurance	E&F	Private Bank	Family Office
No or Mostly No	60%	58%	54%	77%	61%	62%
Yes or Mostly Yes	30%	31%	8%	13%	22%	23%
Unsure / Undecided	10%	11%	38%	10%	17%	15%

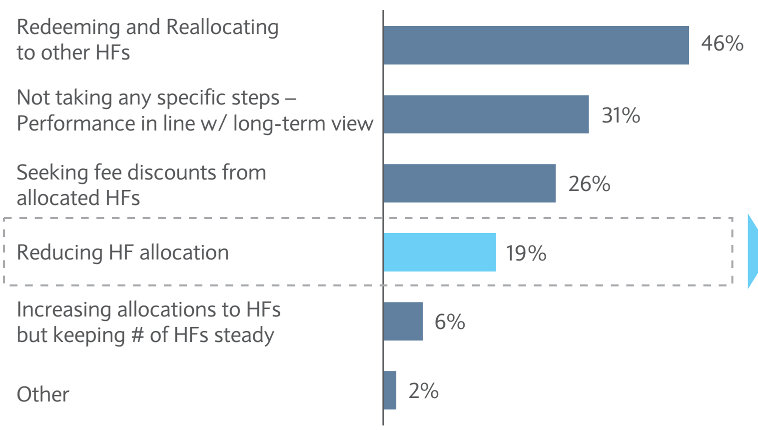
Source: All figures refer to Barclays Strategic Consulting analysis collected in May 2016

FIGURE 12: Investor Allocation Plans

Investor Planned Changes to Portfolio

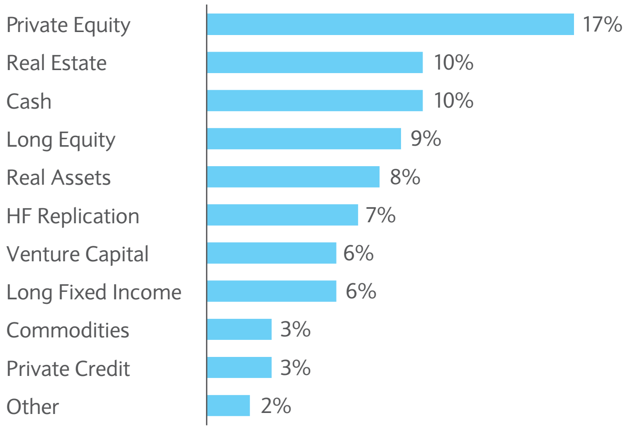
Investor Planned Changes in Response to HF Performance

Q: What steps, if any, have you taken or are planning to take in response to the performance of HFs in your portfolio recently? (Select all that apply)



Planned Reallocations

Q: If reducing overall HF allocations, where are you increasing allocations? (Select all that apply)



Source: Barclays Strategic Consulting analysis

HF performance vs. investor expectations

We began by asking investors how their HF portfolios performed relative to their expectations over the last two years. The overall sentiment (shown in the left chart of Figure 11) appears to be fairly negative as more than 60% of our respondents indicated that HFs did not meet their performance expectations. Conversely, about a quarter of the investors indicated that HFs had at least mostly met their expectations. E&Fs and Family Offices appear to be the most dissatisfied channel, while Private Pensions are the most satisfied, with 31% of them stating that HFs have met their expectations. This is not a surprising result: E&Fs and Family Offices generally have higher return targets for their allocations compared to pensions and also a stronger preference for equity strategies, which have recently disappointed.

Investor allocation plans

As a result of the general perceptions of underperformance by our respondents and the recent press[3] concerning large-scale redemptions by pensions, we wanted to understand what our broad set of surveyed investors plan to do regarding their allocation plans to HFs. The left hand side of Figure 12 shows that less than 20% indicated an intention to reduce their allocations to HFs. However, HFs should not take that as a sign that the status quo will remain. For instance, almost half of respondents indicated that they plan to redeem from poor performing HFs and reallocate to strong performers, while another ~25% of respondents indicated they will seek discounts from the HFs they are currently allocated to – about half of the public pensions and 40% of FoHFs plan to seek fee discounts. Among investors who plan to reduce allocations to HFs (see right hand side of Figure 12), illiquid alternatives seem a popular investment alternative, with ~20% planning to allocate more to Private Equity and ~10% planning to allocate more to Real Estate. The next most popular response regarding allocation plans was Cash, which could be a hedge against recent volatility in order to make a more strategic allocation in the future when markets settle down.

There are various reasons why investors are still by and large faithful to Hedge Funds, even if they are disappointed by their recent performance. One of the most important reasons is that it is difficult to find an alternative with similar risk / return characteristics. And when the risk-adjusted returns are combined with the low correlation they tend to have, the impact on investors' portfolios tend to be positive. Indeed, according to our analysis in Figure 13, a majority (55%) of HFs, even in a year like 2015 where HFs did not perform particularly well, would have been additive and improved the efficient frontier of the 60 / 40 portfolio. Thus while performance may have seemed poor on a stand-alone basis, there appears to be a role for HFs in investors' portfolios.

Headline fees and discounts

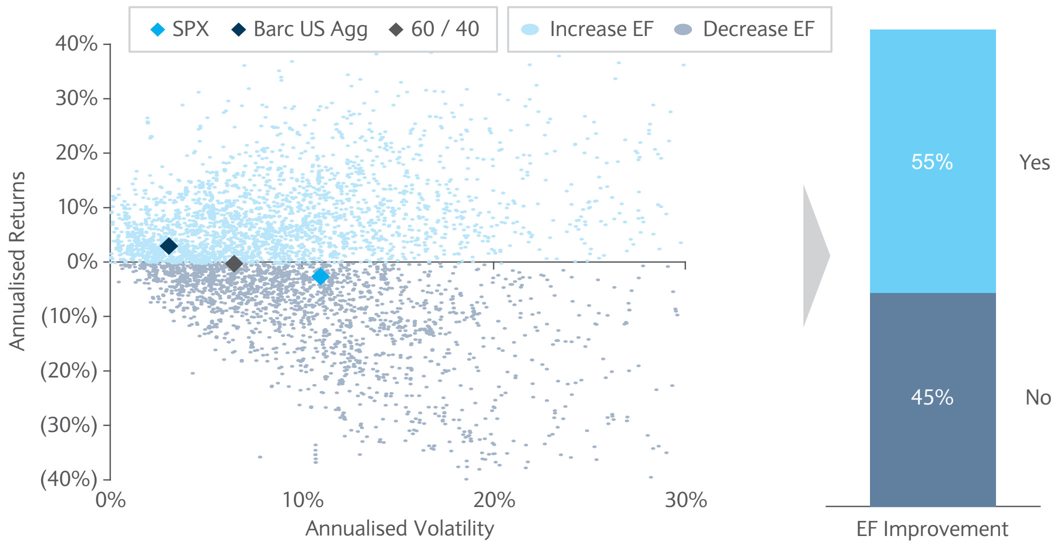
As discussed, the majority of investors do not plan to reduce their allocations to HFs. What they want to do, however, is take some actions to make sure their allocations deliver on their objectives. One of the most popular actions is to seek out fee discounts from HF managers. Indeed, the depth of discounting that goes on for both management fees (left chart in Figure 14) and performance fees (right chart in Figure 14) is quite significant. These figures depict the average manager's (by strategy in our sample) flagship headline management and performance fees, the lowest average discounted fees paid by investors and, as the difference of the two, the maximum discount[4] granted. When it comes to management fees, the largest discounts are happening in the Systematic space, mainly driven by competition from less expensive products such as 'trend following' and 'alternative beta'. Performance fees tell a different story: performance fee discounts are more common in

3. Recent examples of press announcements related to HF redemption plans: NYCERS – April 14, 2016; AIG – May 3, 2016; Metlife – May 5, 2016

4. Maximum discount refers to the difference between the headline rate and the lowest mgmt / perf fee paid by an external investor in a flagship fund or in an SMA / FOO (comparable to a flagship fund)

FIGURE 13: Portfolio Effects of HF Performance

2015 HF Performance vs. Passive Indices and Efficient Frontier Improvement[1]



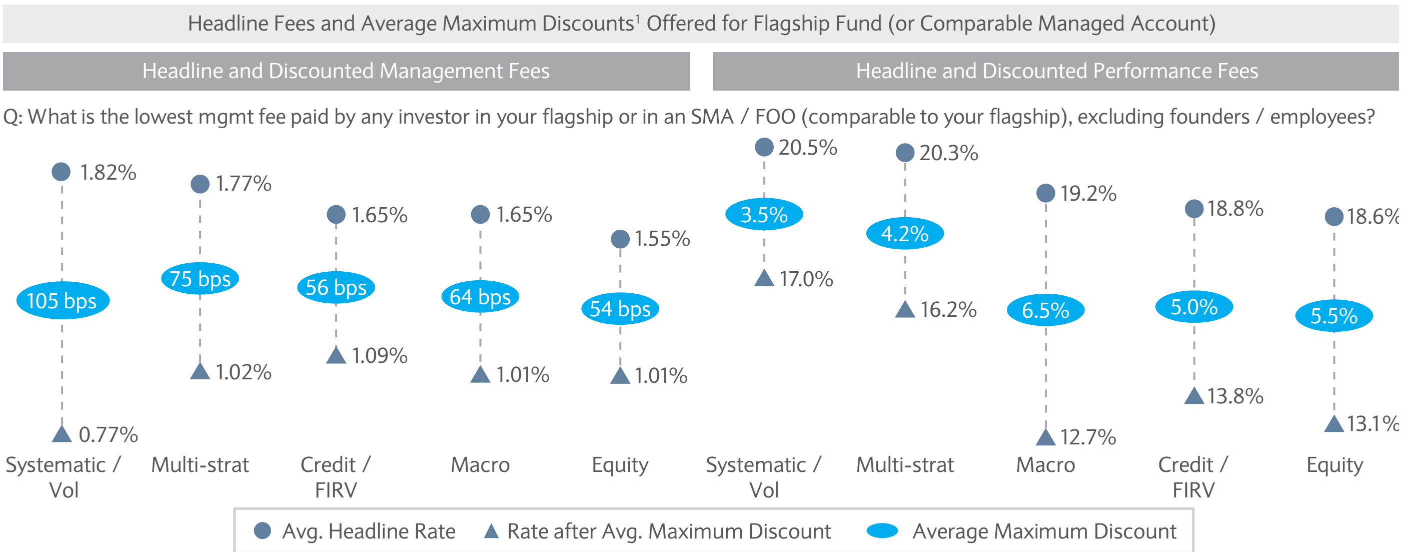
Source: HFR, Barclays Strategic Consulting analysis; 1. Fund judged to improve efficient frontier of a passive 60 / 40 portfolio of S&P500 and Barclays US Agg if: Sharpe of fund > (Sharpe of 60 / 40 portfolio * correlation between fund and 60 / 40 portfolio); Data as of Q315 strategies with less capacity issues / netting risk (e.g., Macro, Equity L / S), whereas strategies that are more likely to be sought after / capacity constrained (as some systematic managers are) or have netting risk associated with them (many Multi-strategy HFs) have higher headline performance fees and lower discounts, on average.

HF manager selection

Beyond fee negotiation, the other important lever investors are using to adjust their HF allocation is manager selection. Based on conversations with investors, we developed an HF segmentation matrix based on HF firm size (proxy for scale) and performance (proxy for manager skill), shown in Figure 15. We believe that investors increasingly view HFs in these four broad categories and they are interested in investing in only three of them:

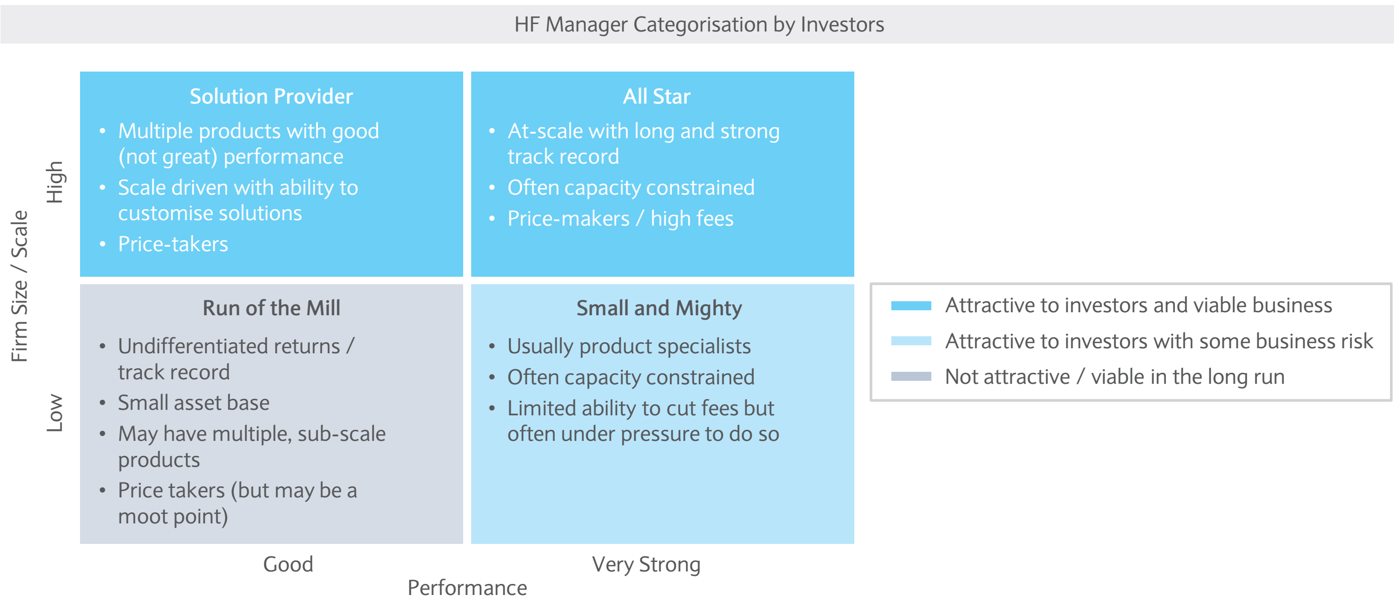
- All Stars – They are the 'holy grail' of HFs. These managers usually have a long track record of strong performance (hence relatively few in number) and are often capacity constrained, collectively means they can charge high fees. The culture / incentive structures at these firms are integral components to posting consistent positive returns. These firms can and often do adopt a 'take it or leave it' attitude toward investors.
- Solution Providers – These managers typically have multiple products with good (but not great) performance, and they often leverage their scale to drive innovation through product development. They can offer holistic portfolio solutions to their investors across asset classes. They are usually flexible on product and fee structures and tend to be 'price takers'. A key risk these managers run is of being perceived as 'unfocused' and / or 'asset gatherers'. On

FIGURE 14: Headline Fees and Discounts



Note: The results presented are from a relatively small number of respondents and therefore are indicative only and not meant to reflect conclusive industry trends. Data and other information presented are derived directly from respondents and we cannot confirm the accuracy of such information. All figures refer to Barclays Strategic Consulting analysis
1. Maximum discount refers to the difference between the headline rate and the lowest mgmt / perf fee paid by an external investor in a flagship fund or in an SMA / FOO (comparable to a flagship fund)

FIGURE 15: HF Manager Perception by Investors



Data and other information presented are derived directly from respondents. All commentary is from Barclays Strategic Consulting analysis a net basis, however, given their partnership approach, ability to offer customised mandates, free advisory services, and flexibility on fees, many investors (pension funds in particular) find their offerings attractive.

- Small and Mighty – As the name suggests, these managers are small in AUM, are usually focused on a single product / strategy, and have strong (though usually limited) track records. They may be capacity constrained and run the risk that their performance could decline, resulting in their relegation to the 'Run of the Mill' category before they can gain scale. Investors looking for performance increasingly turn to these managers.
- The remaining managers not perceived to be among one of the three categories above are defined as 'Run of the Mill', and there will be limited interest in investing in them.

The increased interest in 'small and mighty' managers is clearly visible from the results of our survey. As shown in the left chart of Figure 16, more than two-thirds (70%) of respondents indicated they are allocated to smaller managers (i.e., HFs with less than $500mn) and just over one-third (36%) indicated they are allocated to new launches. For both small / new HFs, as could be expected, Private Banks and FoHFs, which we refer to as intermediaries, are the most typical allocators followed by Family Offices and E&Fs. With regard to the intermediaries, for many, this is a big part of their value proposition to end investors. We also looked into how allocations to these types of managers may take place going forward and we expect allocations to both to materially increase in 2016 (i.e., investors are 35% more likely to invest in small managers and 16% more likely to invest in new launches).

V. Looking ahead

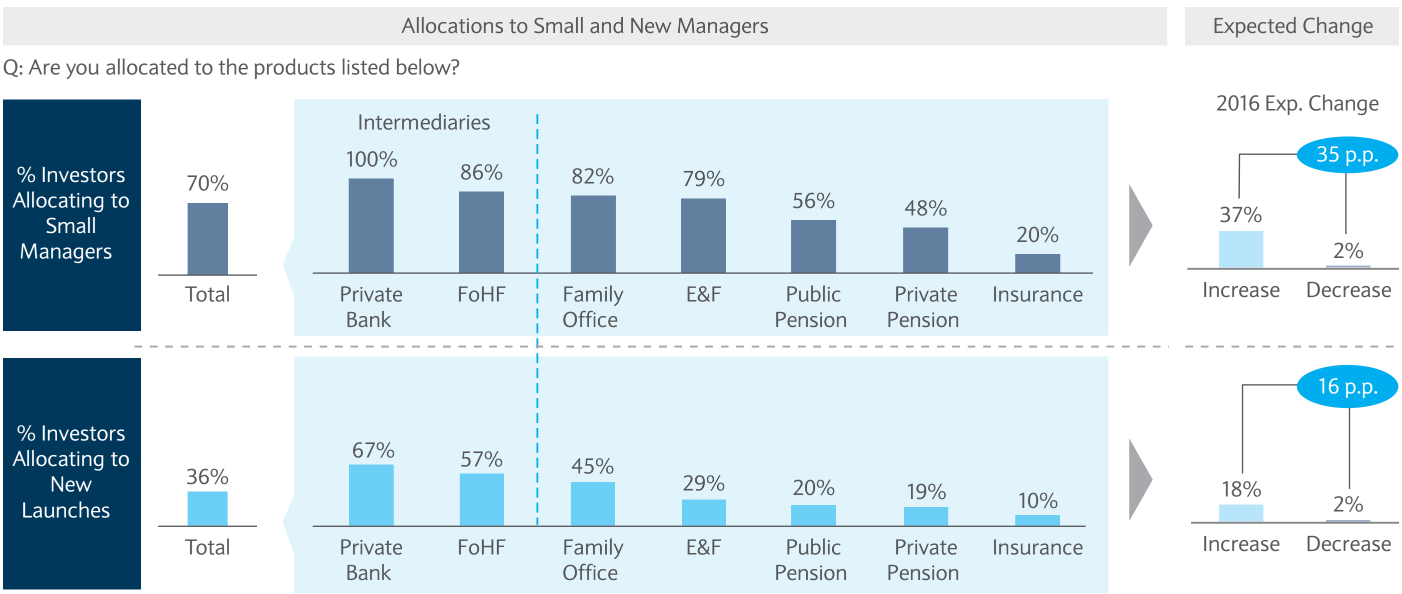
In this section we take a look at several possible scenarios for HFs over the balance of 2016. We project the number of HF launches and liquidations as well as the potential size of the HF industry by year end. Additionally, based on our survey responses, we describe the possible adjustments Investors may make to their HF allocations over the second half of 2016.

HF launches and closures

Based on recent HF performance and the increased challenges to launching an HF,[5] we estimate that there would be a net decrease in the number of funds by YE 2016. In order to estimate the projected levels of HF launches and closures, we took a look at historical results. Figure 17 depicts the percentage of HF launches and liquidations (the number of each relative to the existing total number of funds) as well as the estimated percentage of launches and liquidations for the full year of 2016. According to HFR, the number of new HF launches and liquidations (as a percentage of the existing HFs) has been fairly stable from 2010 through 2015 (other than 2011). Over this time frame, on an annualised basis, new launches were about 12% – 13% and liquidations were about 10%, which results in 2% – 3% additional new funds annually. In 2016, based on our ongoing conversations with managers, investors, and external research, we expect the launch rate to decline to ~8% and the liquidation rate to rise to ~12%, resulting in a net decline in the number of HFs by ~4% (i.e., ~340 funds). There have been several established HFs with relatively long track records, particularly in the Fundamental Equity L / S space, that have shuttered their doors recently in addition to the normal attrition across the less prominent, newer HFs. As a point of reference, in 2008, when the industry was under severe stress, the liquidation rate increased to 21%.

5. Anecdotally, it is believed the minimum AUM to successfully launch an HF has increased almost threefold since the '08 – '09 Financial Crisis and investors' expectations for a track record and institutional infrastructure have similarly increased

FIGURE 16: Investor Sentiment toward Small and New Managers



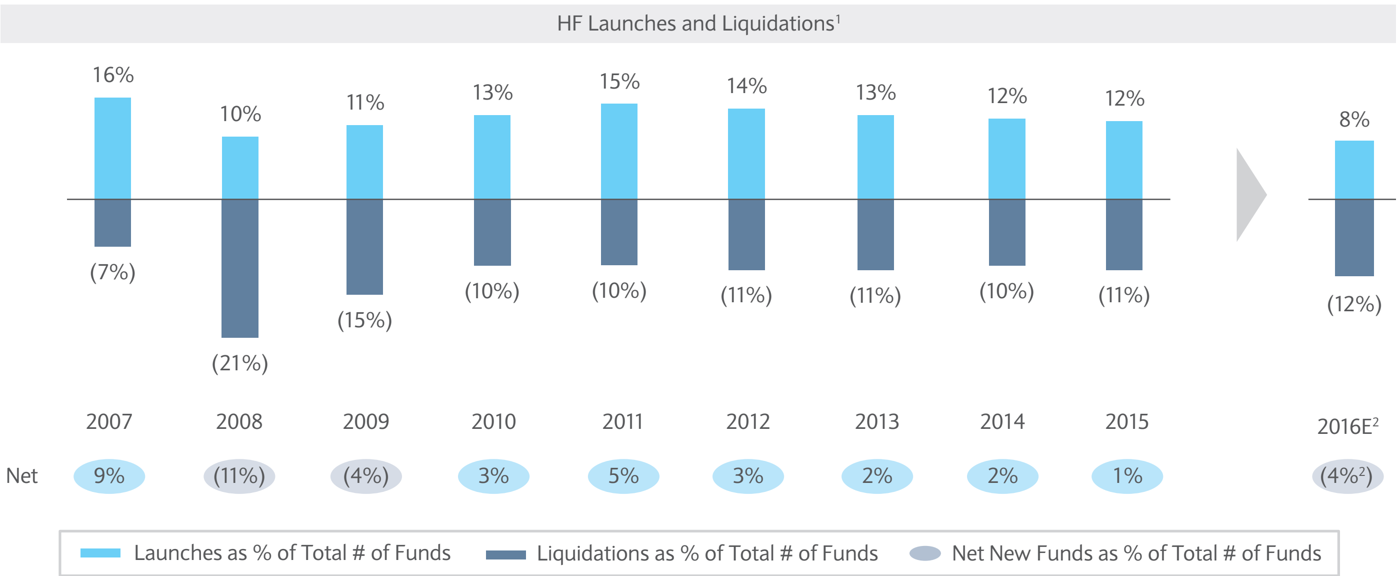
Note: All figures refer to Barclays Strategic Consulting analysis

Industry size in 2016

In 'Bracing for Impact', published earlier this year, we estimated that 2016 will be the first year since 2009 with net outflows from the HF industry. To be precise, we estimated $30bn of net outflows with a range between zero and $50bn. To assess at what AUM level the industry will settle at the end of 2016, we also need to take performance into consideration. Our base scenario is that performance will be muted (0% – 4% return) and therefore the industry will likely end up in 2016 with roughly $2.9tn AUM, roughly the same (or slightly higher) compared to the beginning of the year. In Figure 18, we look at three potential scenarios for YE 2016 based on the estimated flows and HF returns:

- Optimistic – HF performance rises to a healthy range of 4% – 8% in 2016 and flows are flat. Overall, AUM is likely to rise by $180bn to $3.1tn, driven by performance gains.
- Baseline – HF returns improve from 2H15 and 1Q16 levels, but only to a low positive level (i.e., 0% – 4% return for 2016), while investors redeem a net of $30bn, resulting in a slight overall increase in AUM from a year ago.
- Pessimistic – Industry returns deteriorate (i.e., -4% – 0% return for 2016) and net outflows increase to $50bn, which would result in industry assets declining by over $100bn for YE 2016.

FIGURE 17: **HF Launches and Closures**



1. HFR, Barclays Strategic Consulting analysis; 2. Strategic Consulting estimate

FIGURE 18: **Industry Size in 2016**

Three Potential Scenarios		Impact of Flows		Impact of Returns		Projected AUM (EOY 2016)	
		Annual Flows	Avg $ Impact	Annual Returns	Avg $ Impact	Change from EOY 2015 ($bn)	Total AUM
Optimistic	Performance returns to general expectations / recent average (post crisis)	0%	$0bn	4% to 8%	~$180bn	240 / 180 / 120	~$3.1tn
Baseline	Performance below long-term expectations but improves from 2015 / Q116 levels	(1%)	($30bn)	0% to 4%	~$60bn	90 / 30 / (30)	~$2.9tn
Pessimistic	Performance remains at or falls below 2015 / Q116 levels	~(2%)	($50bn)	(4%) to 0%	~($60bn)	(50) / (110) / 170	~$2.8tn

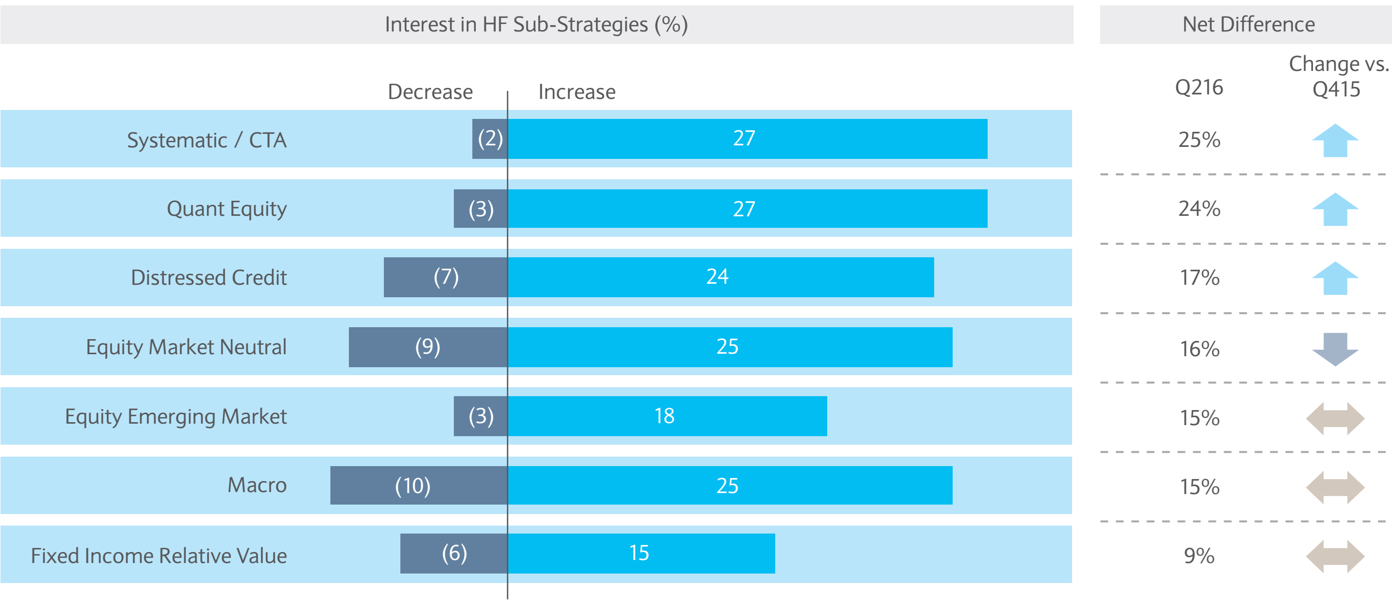
Source: Barclays Strategic Consulting analysis

Investors' HF strategy preferences

Our final analysis was derived completely based on investors' feedback with regard to their strategy preferences for 2016. Figures 19 and 20 show our respondents' intentions with regard to increasing / decreasing their allocations to various HF sub-strategies for the second half of 2016. The increase versus decrease preference difference is listed on the right hand side of the respective figures and we use this as a crude proxy for investor interest. The arrows on the far right hand side of the chart show the change in sentiment toward the sub-strategy between 4Q15 and 2Q16 (e.g., a blue arrow shows an increase in the level of interest in 2Q16 versus 4Q15). Key takeaways:

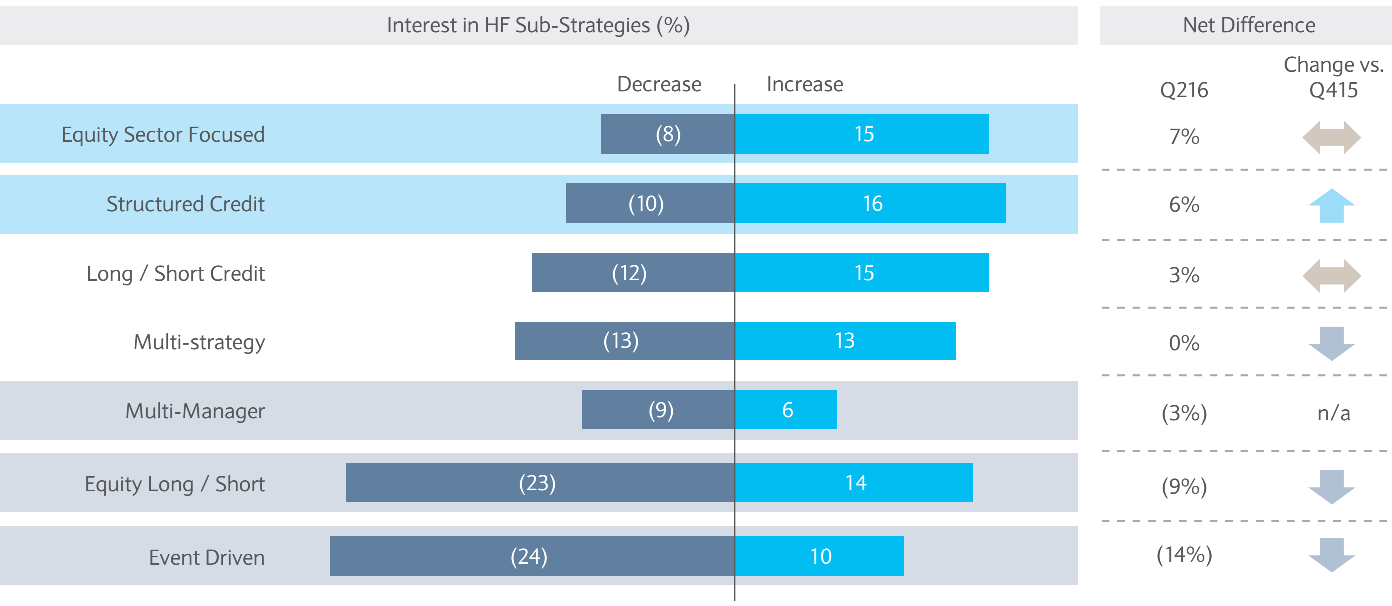
- It appears that systematic strategies, Systematic / CTA (+25%) and Quant Equity (+24%), are not only the most in favour (on a net basis) over the next six to 12 months, but also are the strategies that gained the most in investor interest since the end of 2015.
- Equity Market Neutral, Equity Emerging Markets, Macro, and FIRV all had net positive interest at 2Q16, but appear to have less net interest from investors since YE 2015.
- Meanwhile, Equity L / S and Event Driven have the lowest level of investor interest (on a net basis) and have actually seen the level of interest decline since YE 2015.

FIGURE 19: Investors' HF Strategy Preferences (I / II)



Source: All figures refer to Barclays Strategic Consulting analysis

FIGURE 20: Investors' HF Strategy Preferences (II / II)



Source: All figures refer to Barclays Strategic Consulting analysis

- Multi-strategy (flat at 2Q16, but declining since YE 2015) and Multi-Manager (-3% at 2Q16) also appear to be garnering less investor interest relative to the balance of strategies.

Overall trends appear to point to investors positioning their portfolios more toward systematic and quant type strategies. In addition to systematic strategies, we expect distressed type managers to attract significant interest for the remainder of the year, which might translate into flows if investment opportunities in the space increase.

VI. Key considerations

We leave HF managers and investors with the following thoughts / considerations:

1. 2015 was a tough year for HF managers and 2016 continues to be challenging.
   a. While there are some exceptions, HFs in general continue to face performance challenges.
   b. Although there are some diversification benefits to adding HFs to liquid portfolios, the industry's recent underwhelming performance has heightened investors' concerns about their HF allocations – as evidenced by recent industry headlines.
2. Investors are clearly dissatisfied with HF performance, but it does not seem that they have given up on HFs.
   a. While more than half of surveyed investors said they are dissatisfied with the performance of HFs in their portfolios, only a minority are looking to reduce their HF allocations. Most are looking to reallocate to other HFs, seek fee discounts from their current HFs, or just leave their current allocations unchanged.
   b. Many investors are also seeking alternative ways to improve their return profile or terms (e.g., by investing with emerging or small managers).[6]
   c. Investor interest in certain strategies remains strong (e.g., Systematic / CTA, Macro, Distressed, Emerging Markets).
3. Our baseline estimate is that the size of the industry in 2016 (versus 2015) is likely to remain unchanged at $2.9tn.
   a. Our analysis shows that HF performance impacts flows with a lag of one to three quarters, which we believe will result in net outflows for 2016, at least in part, to reflect the performance challenges of 2H15 and early 2016.
   b. However, our projection of a modest increase in HF returns (to around 0% – 4%) will likely result in assets remaining flat versus 2015 as performance and flows balance each other out in 2016.
   c. That said, there are also optimistic and pessimistic scenarios which could see the industry grow assets by $180bn or see a reduction in assets of $110bn, respectively.

VII. Capital Solutions

The Capital Solutions team within Prime Services offers a unique blend of industry insights and tailored client solutions for a broad range of issues.

Strategic Consulting

- Development of industry-leading content, driven by primary analysis, on the HF industry and its participants (e.g., HF and FoHF managers, institutional investors, investment consultants).
- Provision of management consulting services to HFs, asset managers, institutional investors and internal management on a wide array of business topics including the launch of a new strategy, marketing effectiveness, product development and organisational efficiency.
- Acting as an HF competence center internally for Barclays.

Capital Introductions

- Maintenance of ongoing investor dialogue to provide valuable feedback to HF managers.
- Introducing HF managers to a select number of interested investors. Hosting events that provide a forum for knowledge transfer and discussion / debate on industry issues that helps educate and inform both clients and investors.
- Helping HF managers identify and source high quality talent to fill openings across their organisations through a talent management effort.

6. Many HFs are, in turn, offering different liquidity structures, lower fees, and new vehicles such as long only products

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