Alternative Investment Management Association

THE CASE FOR HEDGE FUNDS:

A COMPENDIUM OF AIMA'S THOUGHT LEADERSHIP REPORTS

Contents

Introduction

For further information, please visit AIMA's website, www.aima.org

Ever since the onset of the financial crisis, AIMA has worked tirelessly to demonstrate the case for hedge funds to policymakers, regulators, investors and the media. We have now pulled these various arguments and pieces of research together into a major compendium of our work, which we have called "The Case for Hedge Funds: AIMA's Post-Crisis Thought Leadership".

This booklet summarises the themes that AIMA has explored since 2008 as it has sought to demonstrate the value of the world's hedge fund industry to investors, financial markets and the broader economy.

It includes excerpts from AIMA's key research papers, including:

- The "Roadmap to Hedge Funds", the first guide about hedge funds to be produced collaboratively by the industry and investors;
- "The Cost of Compliance", a global survey of managers that revealed the significant investments they are making in order to comply with the new regulatory requirements;
- "Beyond 60/40", which demonstrated the different roles that hedge funds play in institutional investors' portfolios; and
- "Apples and Apples", an educational guide to understanding hedge fund performance.

There are also extracts from many of AIMA's white papers and articles on a range of topics including the industry's social utility, the impact of institutionalisation, shadow banking, short selling and the industry's reputation. AIMA is also well known for its comprehensive range of tools and guidance for members like our due diligence questionnaires and our suite of sound practice guides, which are available for members on the website and not covered in this compilation of thought leadership.

The work of demonstrating the value of the industry, of course, continues. We have more research in the pipeline which will enable us to continue to demonstrate the value of the hedge fund industry to the broader economy. AIMA will continue to make the case for hedge funds.

Jack Inglis
Chief Executive Officer
AIMA

AIMA's post-crisis thought leadership

2008

We set out the case for investing in hedge funds in the first guide produced collaboratively by the hedge fund industry and institutional investors[1]

2009

We defended the UK hedge fund industry in a paper for MPs[2]

2011

We set out the global hedge fund industry's social and economic value in a paper for policymakers[6]

2011

Our French translation of our global hedge fund industry paper took our message about the value of the industry to France[7]

2012

Our German translation of our global hedge fund industry paper took our message about the value of the industry to Germany[8]

2013

We published the first review of the global hedge fund industry's charitable and philanthropic activities[12]

2013

With the Investor Steering Committee we published a paper on the evolving role of hedge funds in institutional investors' portfolios[13]

2013

We demonstrated that the industry had made significant investments in infrastructure to comply with new regulatory requirements[14]

1."AIMA's Roadmap to Hedge Funds" 2.AIMA paper on the UK hedge fund industry 3.http://www.openeurope.org.uk/Content/Documents/PDFs/aifmd.pdf
4.AIMA paper on the AIFM Directive 5."AIMA's Roadmap to Hedge Funds – Chinese version" 6."Global hedge fund industry paper: The value of our industry"
7."L'Industrie Mondiale des Hedge Funds" 8."Die Globale Hedgefonds Industrie" 9."The Value of the Hedge Fund Industry to Investors, Markets and the Broader Economy"
10."The Evolution of an Industry"

2009

We explored the industry's contributions to the public purse through a survey with Open Europe[3]

2009

We defended the European hedge fund industry in social and economic terms in a paper for MEPs[4]

2010

We translated AIMA's 'Roadmap to Hedge Funds' into Chinese[5]

2012

We found that hedge funds significantly outperformed traditional asset classes such as equities, bonds and commodities from 1994-2011[9]

2012

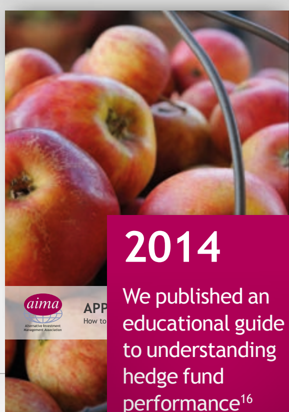
We demonstrated how the post-2008 influx of institutional money into hedge funds resulted in an increase in the industry's operational sophistication and transparency to investors[10]

2012

We updated the 'Roadmap to Hedge Funds' to include the post-crisis experience of the industry[11]

2014

We revealed how capital markets players such as hedge funds are significant drivers of economic growth[15]



2014

We published an educational guide to understanding hedge fund performance[16]

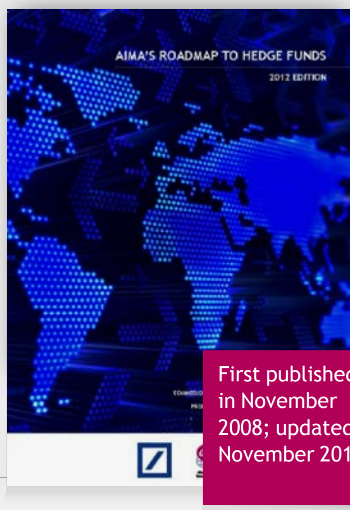
2014

We revealed how institutional investors are increasingly striking partnerships with hedge funds[17]

11."AIMA's Roadmap to Hedge Funds – 2012 Edition" 12."Contributing to Communities: A Global Review of Charitable and Philanthropic Activities by the Hedge Fund Industry" 13."Beyond 60/40: The Evolving Role of Hedge Funds in Institutional Investor Portfolios" 14."The Cost of Compliance" 15."Capital Markets and Economic Growth: Long-Term Trends and Policy Challenges" 16."Apples and Apples: How to Understand Hedge Fund Performance" 17."The Extra Mile: Partnerships between hedge funds and investors" All these reports are available on the AIMA website at www.aima.org.

AIMA's Roadmap to Hedge Funds

The first ever educational guide about hedge funds produced collaboratively by the hedge fund industry and leading institutional investors, the two ground-breaking editions of the *Roadmap* set out the case for investing in hedge funds



First published in November 2008; updated in November 2012

AIMA's *Roadmap to Hedge Funds*[18] is the most-read publication in AIMA's history. Originally commissioned by AIMA's Investor Steering Committee[19] in 2008 and updated in 2012, it remains a relevant and useful guide for institutional investors seeking to create and manage a hedge fund portfolio.

The original edition of the *Roadmap*, authored by Alexander Ineichen and co-authored by Kurt Silberstein, was the world's first educational guide about hedge funds for institutional investors. It demystified the hedge fund industry at a time when misconceptions around issues such as short-selling, fees, transparency and risk were widespread.

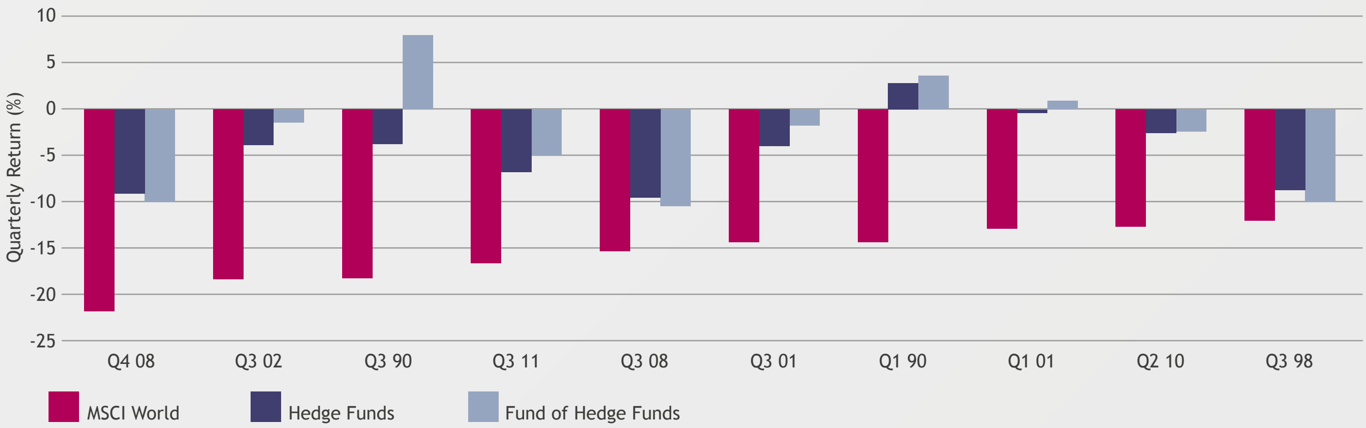
The 2012 edition, published jointly by AIMA and Deutsche Bank, outlined how the volatile external environment since the global financial crisis of 2008 had driven an ever greater need for active risk management. In re-affirming the case for investing in hedge funds, the 2012 edition highlighted how the industry responded swiftly to the losses of 2008. The average hedge fund recovered from its 2008 losses by October 2010, more rapidly than global equities the *Roadmap* found.

Other highlights from the 2012 edition included:

- Long-term performance – A hypothetical investment in the S&P 500 Total Return Index of $100 at the beginning of 2000 stood at $121 by August 2012, when research for the *Roadmap* was conducted, while a hypothetical investment of $100 in the HFRI Fund Weighted Hedge Fund Index stood at $201.
- Downside protection – Hedge funds continued to demonstrate an ability to protect capital in periods of considerable market stress. Managed futures funds were found to have delivered a positive return in 18 out of 20 equity down-markets between 1980 and 2012 (see Figure 1). Even in the 10 worst quarters between 1990 and 2012, a diversified hedge funds portfolio preserved capital better than a global equities portfolio.
- The institutionalisation of the hedge fund market – Pension funds in particular are seeking hedge fund investments to diversify equity/bond portfolios and deliver superior risk adjusted returns. In response, hedge funds have become more transparent, better governed and better understood by institutional investors.
- The case for active managers – While many aspects of hedge fund investing changed after 2008, the concept of active risk management did not. In fact, the case for active risk management increased between 2008 and 2012.

In setting out the case for hedge funds over 156 pages of detailed and original research, the *Roadmap to Hedge Funds* laid the foundations for AIMA's subsequent research into the value of the hedge fund industry to investors, financial markets and the broader economy.

Figure 1: Hedge fund performance in ten worst quarters for equities (1990 – Q2 2012)



Source: Ineichen research & Management, Bloomberg. Based on MSCI World Total Return Index and hedge fund indices from HFRI

18. http://www.aima.org/en/education/aimas-roadmap-to-hedge-funds.cfm
19. The AIMA Investor Steering Committee is a group of leading institutional investors in hedge funds who undertake educational initiatives and provide practical guidance within AIMA. Members of the committee represent pension fund managers, endowments, foundations, large family offices and sovereign wealth funds. Together they are responsible for managing approximately $1.5 trillion in total assets under management, with approximately $150 billion of this directly invested in hedge funds.

Global Hedge Fund Industry Paper: The value of our industry

Discusses the global hedge fund industry's value to investors, financial markets and the broader society

Published in March 2011

In our 2011 paper on the global hedge fund industry[20], we highlighted the fact that hedge funds increasingly have been performing an important social role by managing investments for pension funds, university endowments, charitable foundations and other socially-important institutional investors.

We included our estimate that there are 300,000 people employed directly or indirectly by the hedge fund industry globally – the first such statistic of its kind produced – including 240,000 in North America, 50,000 in Europe and 10,000 in Asia-Pacific. The totals include both those employed directly within the hedge fund sector and those jobs generated by the industry among service providers like administrators, lawyers and accountants. The ratio of direct jobs to indirect jobs was found to be generally 1:2, so the number of direct jobs within the industry globally is 100,000 with a further 200,000 indirect jobs generated by the industry.

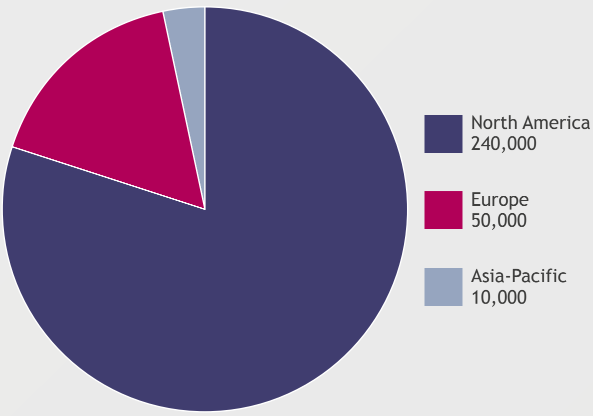
We said those employees make substantial contributions to the public purse each year; in Europe alone, the annual tax contribution by the industry was found to be more than €4 billion in a survey of AIMA members by Open Europe in 2009[21].

We also stressed the financial stability benefits that hedge funds provide to financial markets.

Additionally, the paper set out to debunk a number of popular myths about the industry, such as that short selling serves no useful broader purpose, or that the industry is "unregulated", takes excessive risks and is "secretive".

"The hedge fund industry has a major social role as a result of increased institutional investment from such organisations as public and private sector pension funds, insurers, university endowments and charities. Approximately two-thirds of total hedge fund assets under management come from such institutions."

Figure 2: Jobs created by the global hedge fund industry



300,000 people employed directly or indirectly by the hedge fund industry globally including 240,000 in North America, 50,000 in Europe and 10,000 in Asia-Pacific*

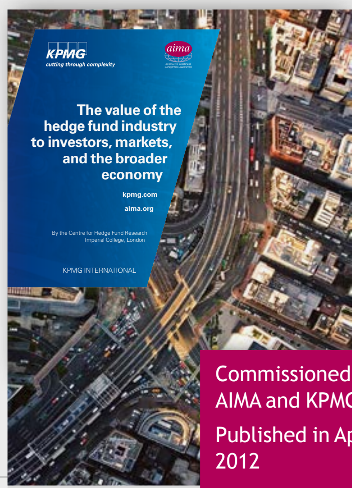
In Europe alone, the annual tax contribution by the industry was found to be more than €4 billion†

* Source: AIMA
† Source: Open Europe

20. http://www.aima.org/en/document-summary/index.cfm/docid/BEECE829-C8D4-482F-B0E260A468AF4707
21. www.openeurope.org.uk/Content/Documents/PDFs/aifmd.pdf

The Value of the Hedge Fund Industry to Investors, Markets and the Broader Economy

Reveals how hedge funds significantly outperformed traditional asset classes such as equities, bonds and commodities from 1994-2011



Commissioned by AIMA and KPMG

Published in April 2012

Hedge funds significantly outperformed the main asset classes such as equities, bonds and commodities between 1994 and 2011. This was the main finding of a study[22] that AIMA and KPMG commissioned in 2012 from the Centre for Hedge Fund Research at Imperial College in London. The research, the most comprehensive of its kind to date, found that, per annum, hedge funds returned 9.07% on average after fees over that 17-year period, compared to 7.18% for global stocks, 6.25% for global bonds and 7.27% for global commodities (see Figure 3).

The research found that hedge funds achieved these returns with considerably lower risk volatility as measured by Value-at-Risk (VaR) than either stocks or commodities and with similar volatility to bonds, an asset class considered the least risky and volatile.

In stressing the industry's value to investors, the research also confirmed that the large majority of the funds' investment returns went to the investor, rather than the manager.

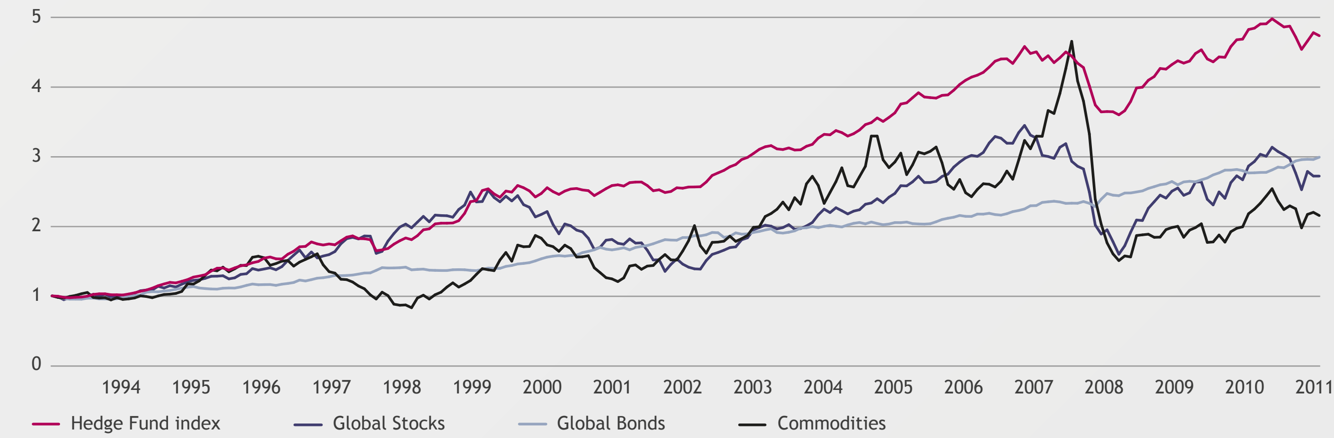
And the research demonstrated that hedge funds were significant generators of "alpha", creating an average of 4.19% per year from 1994-2011.

Portfolios including hedge funds were found to have outperformed those comprising only equities and bonds. The study showed that such a portfolio outperformed a conventional portfolio that invested 60% in stocks and 40% in bonds. The returns of the portfolio with an allocation to hedge funds also yielded a significantly higher Sharpe ratio (which characterises how well the return of an asset compensates the investor for the risk taken) with lower "tail risk" (the risk of extreme fluctuation). These findings looked ahead to a future AIMA publication, 'Beyond 60/40', also highlighted in this Compendium.

The paper also contained a review of much of the academic research into the hedge fund industry and highlighted the positive contributions that the industry has made to financial markets and the broader economy.

> "Hedge funds provide economically important risk-adjusted performance that provides investors with diversification benefits even during the most difficult macroeconomic environments"

Figure 3: Hedge fund returns compared to stocks, bonds and commodities

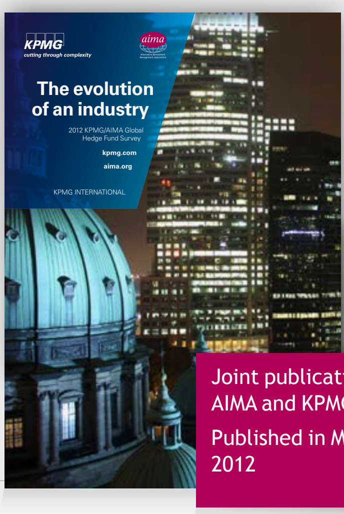


Source: Centre for Hedge Fund Research, Imperial College, London

22. http://www.aima.org/en/document-summary/index.cfm/docid/F67D5FE7-A77F-4000-97B18E5D3F938A6E

The Evolution of an Industry

Survey finds that the post-2008 influx of institutional money into hedge funds resulted in a marked increase in the global industry's operational sophistication and transparency to investors



Joint publication of AIMA and KPMG

Published in May 2012

The post-crisis influx of institutional money into hedge funds resulted in a marked increase in the global industry's operational sophistication and transparency to investors, according to 'The evolution of an industry'[23], a report released in 2012 by AIMA and KPMG.

The report was based on a survey of and in-depth interviews of 150 hedge fund management firms globally with more than $550 billion in combined assets under management. It found that hedge fund management firms increased their operational infrastructure in areas like investor transparency and regulatory compliance as allocations from institutional investors increased.

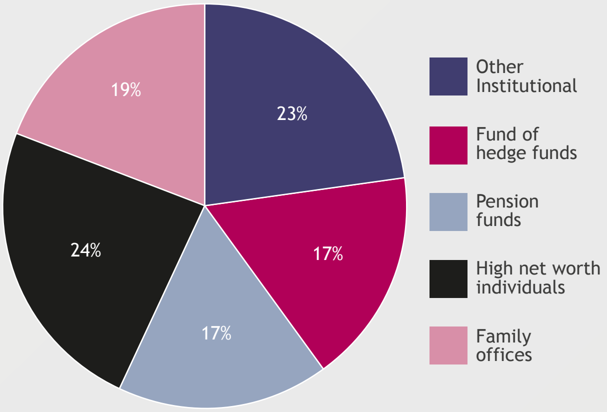
Seventy-six per cent of respondents observed an increase in investment by pension funds after 2008, while institutional investors and funds of funds accounted for a clear majority (57%) of assets under management (a proportion that has since increased).

The report found that the increase in institutional investment led to more thorough due diligence and greater demands by investors for transparency, with 90% of respondents reporting an increased demand for due diligence after 2008.

Eighty-four per cent of all respondents indicated they had increased transparency to investors, reflected by the fact that the majority of firms took on multiple members of staff to respond to these increased investor demands.

The report also found that hedge fund management firms had almost universally increased investment in regulatory compliance, with 98% of firms hiring additional staff in this area.

Figure 4: Global hedge fund AUM by investor type



Source: KPMG International 2012

> "Because institutional investors are extremely demanding in terms of due diligence, they require robust operational infrastructure in the managers they allocate to, so managers have responded by strengthening their own infrastructure. And because these institutional investors seek increased transparency, managers have increased their capacity to provide that too."

23. http://www.aima.org/en/document-summary/index.cfm/docid/4204D3F3-0014-454F-B6B9798E6BC0B3D1

Contributing to Communities: A global review of charitable and philanthropic activities by the hedge fund industry

The first review of the global hedge fund industry's charitable and philanthropic activities

Published in May 2013

In 2013 we published 'Contributing to Communities', the first review of its kind of the charitable and philanthropic activities of the hedge fund industry worldwide.

The industry has always engaged in charitable giving and philanthropy. In this report, we focused just on those activities that are in the public domain (much charitable activity being private).

The 44-page report gave a detailed picture of the global hedge fund industry's public charitable activities. It found these to be widespread. Hedge fund managers and staff were found to be engaged with charities in a multitude of different ways, from workplace-giving schemes and industry fundraising campaigns for charity to individual examples of philanthropy.

The report focused on the beneficiaries of hedge fund industry giving around the world, including schools, colleges, hospitals, community facilities and cultural landmarks. And it outlined some of the additional benefits of the industry's activities including improvements to charities' strategic planning and operations.

The findings were based on interviews with individuals at charitable bodies and hedge fund manager firms and on publicly-available data from organizations, companies and individuals.

The report's findings were based on interviews with individuals from the hedge fund industry who are active in the charity sector and representatives of charities, which were carried out during 2012 and 2013. Those responses were used in tandem with publicly available data on the financial and social activities of hedge fund charities to gain a detailed picture of global hedge fund charitable activity.

"Our primary focus has been on where the money raised ultimately goes – whether a school in a deprived part of London, a much-loved public park in America, a facility in Britain for developing the next generation of scientists or a hospital for sick children in Asia."

The RICE fund, a hedge fund industry co-operative foundation in Asia, has been contributing to children's educational and welfare projects across developing areas of Asia like Cambodia and Nepal since 2006.

Workers at the Connection at St-Martin-in-the-Fields, a homeless charity in London that has received grants from the hedge fund industry, meet to organise a variety of creative activity groups.

Beyond 60-40: The evolving role of hedge funds in institutional investor portfolios

Global investor survey finds that institutional investors are increasingly moving away from the traditional 60% equities/40% bonds portfolio structure and using hedge funds to customise their portfolios

Published in May 2013

The evolving role of hedge funds in institutional investor portfolios was the theme of 'Beyond 60/40'[24], commissioned in 2013 by the AIMA Investor Steering Committee.

Institutional investors have been the main source of the industry's asset growth since the crisis. But why has so much money flowed into the industry at a time of relatively modest returns for many hedge funds? This paper, by the members of AIMA's Investor Steering Committee (ISC), set out to answer this broad question.

It was the product of a survey of many leading institutional investors in hedge funds worldwide. The respondents included North American, Asian and European pension funds, endowments, foundations and family offices, regarded as among the most influential institutional investors in hedge funds, with combined assets of more than $400 billion. They were asked a series of questions about their hedge fund investments, including the size of their allocations and the role that hedge funds play in their portfolios.

They were questioned about the processes that they follow in making those allocations, including their due diligence and risk management requirements. And they were invited to suggest changes that the industry could make to encourage further increases in allocations.

The paper's key finding was that institutional investors are moving away from the traditional 60% equities/40% bonds portfolio structure and increasingly using alternatives in general and hedge funds in particular as tools to customise their portfolios.

The investors said they were using hedge funds to meet individual objectives in terms of risk-adjusted returns, diversification, lower correlations, lower volatility and downside protection. The paper found that hedge funds are increasingly regarded as a means to access opportunities and tailor portfolios, rather than as a separate asset class.

The survey also found that most investor-respondents had increased their allocations to hedge funds since the financial crisis, with most planning to continue to increase the size of their investments in subsequent years.

Hedge fund due diligence was found to be taking longer. The increasing emphasis placed by hedge funds on transparency since the crisis was generally welcomed, although some investors cautioned that they did not want to be swamped with unnecessary information.

Many investors welcomed the increased regulation of the hedge fund industry, but some expressed concern that the reforms could be onerous or restrict their ability to allocate to managers in certain jurisdictions.

In addition, many of the respondents said they would like hedge funds to take fewer investors and build stronger strategic partnerships with them in future – a theme which we went on to explore in 'The Extra Mile' (see page 14).

> "The paper sets out to explain why traditional portfolio construction techniques have been revisited by many investors since the crisis and what some of the new thinking in that space involves, including the role of alternatives in general and hedge funds in particular in the portfolios of tomorrow."

24. http://www.aima.org/en/document-summary/index.cfm/docid/77A589A0-3BEA-4559-B0F0EE38CF21B1CF

The Cost of Compliance: Global hedge fund survey by AIMA, MFA and KPMG

Major survey finds that the global hedge fund industry has made significant investments in infrastructure to comply with new regulatory requirements

Published in October 2013

Published jointly with the Managed Funds Association (MFA) and KPMG in 2013, 'The Cost of Compliance'[25], a major global industry survey, revealed that hedge fund managers are making significant investments in their infrastructure to comply with new regulatory requirements.

According to the report, the average spend on compliance since the crisis has been at least US$700,000 for small fund managers, $6 million for medium-size fund managers, and $14 million for large fund managers.

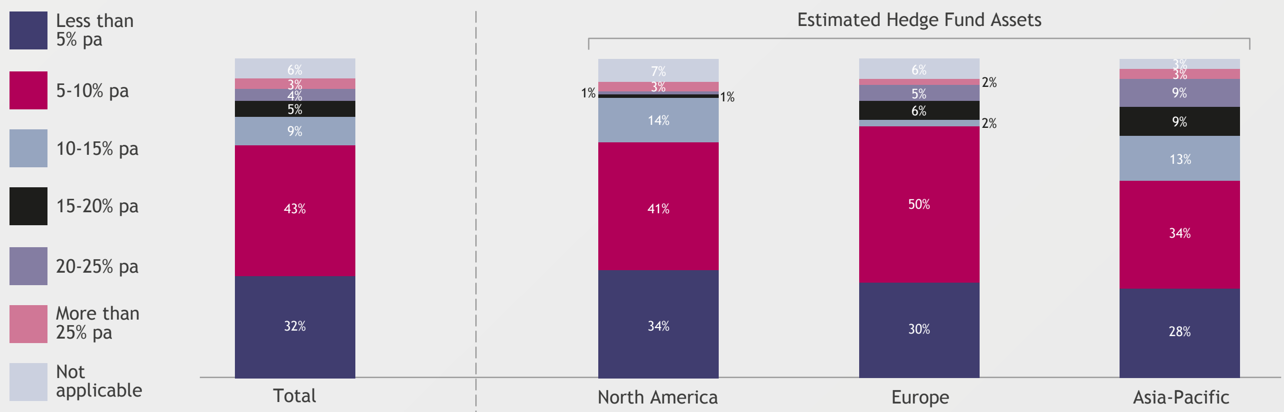
The survey, one of the largest global surveys of hedge fund managers, included the views of 200 hedge fund managers representing more than $910 billion in assets under management. It also included in-depth interviews with managers from North America, Europe and Asia.

It found that the hedge fund industry has already invested heavily in compliance efforts to meet new global regulations, having spent more than $3 billion to date on compliance costs. Hedge fund managers were found to be spending anywhere between 5% and upwards of 10% of their operating costs on compliance technology, headcount and strategy.

The survey found that the cost of compliance is creating a heavier burden on smaller firms and could become a barrier to entering the market. The smaller firms are spending more – both as a percentage of AUM and relative to operating costs – than their larger counterparts. In fact, more than a third of hedge fund managers polled with less than $250 million in AUM said compliance requirements consume more than 10% of their total operating costs. The survey also found that overwhelmingly, managers are shouldering the majority of the costs associated with compliance, and not passing them on to the funds.

> "The hedge fund industry is taking its compliance obligations seriously. Not only have most firms already put significant time, effort and capital into meeting regulatory requirements, the majority have also elected to allocate these costs to the fund manager rather than the funds themselves."

Figure 5: To date, what percentage of your firm's total operating costs is allocated to regulatory compliance (technology, headcount or strategy)?



Source: KPMG International 2013 (Percentages may not add up to 100 due to rounding off)

25. http://www.aima.org/download.cfm/docid/1ED2D8EA-F096-4765-88DDAA8F60392512

Capital Markets and Economic Growth: Long-term trends and policy challenges

Academic research demonstrates that hedge funds and other capital markets participants are significant drivers of economic growth

Published in March 2014

We explored the positive impact that hedge funds and other capital markets participants bring to economic growth in 'Capital Markets and Economic Growth: Long-term trends and policy challenges'[26].

According to research which we commissioned, capital markets are significant drivers of economic growth and increasing their size could compensate for the post-financial crisis decline in bank lending. Growing capital markets by one-third could fuel a long-term real growth rate in per-capita GDP of around 20%, according to the original research outlined in the paper by Christoph Kaserer, Professor of Finance, Chair of Financial Management and Capital Markets, TUM School of Management, Munich; and Marc Steffen Rapp, Professor of Finance, Accounting & Finance Group, School of Business and Economics, Philipps-Universität Marburg, Germany.

The research found that capital markets support economic growth by providing new sources of funding for long-term investment and facilitating improvements in corporate governance. It went on to link activities by hedge funds and other capital markets participants such as pension funds to growth in the real economy. Capital markets comprise stock and bond markets and capital markets activity includes both debt and equity financing.

The paper also revealed the extent to which economies traditionally regarded as bank-based have embraced capital markets and suggested that the old distinctions between the bank-based economic structure of parts of Europe and the more market-based structure of the UK and US are rapidly disappearing.

Although the paper takes as an example the economies of the European Union, it showed how governments globally could benefit from a well-developed capital markets policy. We believe this is especially true for countries where a bank-based economic model still dominates. At a time when bank lending is not keeping pace with demand, the global economic recovery could be jeopardised unless new sources of financing can be found, particularly from the investment management community, AIMA said. We therefore encourage governments globally to implement policies that help to protect and grow capital markets.

> "The study highlights the positive role that hedge funds can play [in the real economy], using their expertise and willingness to create positive governance changes in the firms in which they invest. Hedge funds are also important providers of liquidity, risk management and price discovery in capital markets."

26. 'Capital Markets and Economic Growth – Long-Term Trends and Policy Challenges', by Christoph Kaserer and Marc Steffen Rapp.
To download a copy, click here: www.aima.org/download.cfm/docid/5D6152C4-C9A0-4FDA-B2DD415168ED658B
To download an AIMA position paper on the research, click here: www.aima.org/download.cfm/docid/7E7766E3-A0FA-4C21-A471A21E879EEA9D

Apples and Apples – How to better understand hedge fund performance

Research paper finds that measuring hedge funds against the S&P 500 is a false comparison and is not the way most institutional investors judge hedge fund performance

Published in April 2014

In 2014, against the backdrop of a debate into hedge fund performance, AIMA published ‘Apples and Apples: How to better understand hedge fund performance’[27]. The guide said that comparing hedge fund performance to the S&P 500 was an “apples and oranges” comparison and proposed five steps to improving understanding of hedge fund performance:

1. **Look at risk-adjusted returns:** The guide revealed that hedge funds consistently outperform US equities (as measured by the S&P 500), global equities (MSCI World) and global bonds (Barclays Global Aggregate ex-USD Index) on a risk-adjusted basis, a crucial measure for investors. Even during the stock-market rally of 2009-2013, hedge funds performed better on a risk-adjusted basis than the S&P 500 and MSCI World.
2. **Look at long-term data:** The guide said that short-term data such as monthly comparisons can be misleading and argued that greater clarity could be gained by looking at long-term figures. It pointed out that hedge funds outperformed the main standalone asset classes over the 10 years to the end of 2013 both in terms of “headline” returns and on a risk-adjusted basis.
3. **Look at the returns by strategy:** The guide explained how hedge fund strategies are enormously diverse and have different characteristics which can play different roles in investor portfolios. It also stressed that hedge funds are not an asset class and that there is no such thing as the “average” hedge fund.
4. **Compare with the most relevant asset class:** The guide said that reference should be made to how different strategies perform in relation to the most relevant asset class to that strategy. In other words, it may make much more sense to be comparing a particular strategy to bond performance than equities.
5. **Be aware of differences between hedge fund indices:** The guide noted that during the five years to the end of 2013, the main hedge fund indices produced notably different results, reflecting variations in constituency and methodology.

“Informed investors do not only look at ‘headline’ return figures. They often also look at ‘risk-adjusted’ returns – a way of measuring the value of the return in terms of the degree of risk taken. They would often rather have steadier returns with lower volatility than higher ones with greater volatility, because of the risk of potential loss that higher volatility brings (as in 2008 when equity markets plunged).”

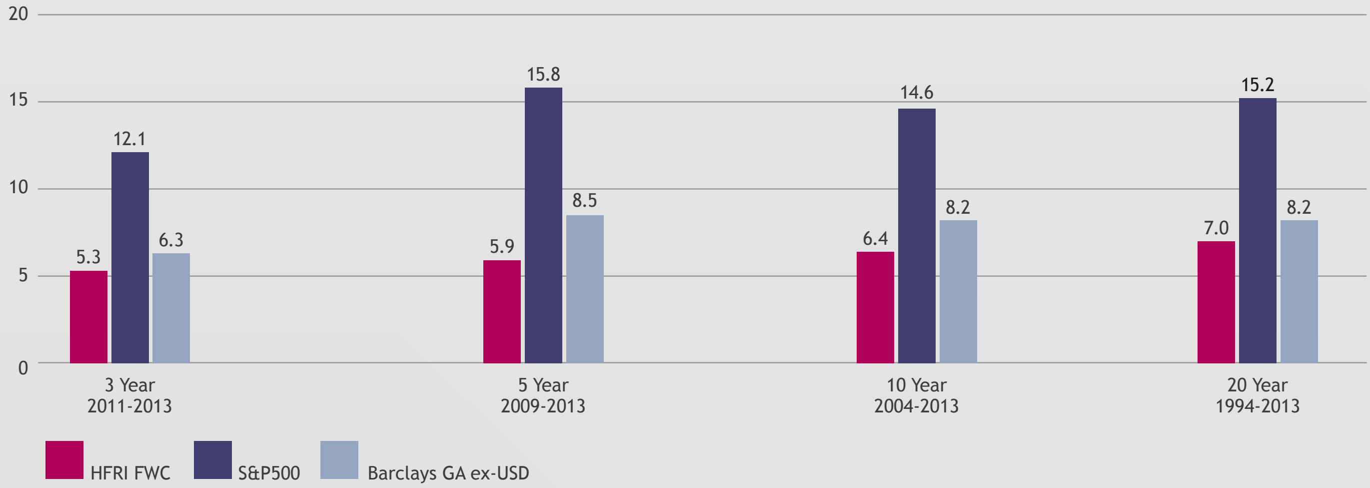
27. http://www.aima.org/download.cfm/docid/4FD1E0A5-E66F-46A9-956F3A983ECB518F

Figure 6: Comparison of both annualised 'headline' returns and risk-adjusted returns for hedge funds as a whole, equity hedge funds, bonds and equities, for various periods to end 2013.

	5 year			10 year			20 year		
Index	Annualised 'headline' return	Annualised standard deviation	Sharp Ratio*	Annualised 'headline' return	Annualised standard deviation	Sharp Ratio*	Annualised 'headline' return	Annualised standard deviation	Sharp Ratio*
HFRI Fund Weighted Composite	7.79%	5.88%	1.28	5.71%	6.39%	0.84	8.84%	6.99%	1.23
HFRI Equity Hedge (Total)	9.14%	8.45%	1.05	5.26%	8.71%	0.56	10.30%	9.18%	1.09
S&P 500	15.40%	15.85%	0.95	5.21%	14.63%	0.33	7.13%	15.21%	0.45
MSCI World	12.54%	18.07%	0.68	4.87%	16.41%	0.28	5.24%	15.55%	0.32
Barclays Global Aggregate ex-USD	3.51%	8.45%	0.38	4.35%	8.25%	0.49	5.52%	8.17%	0.64

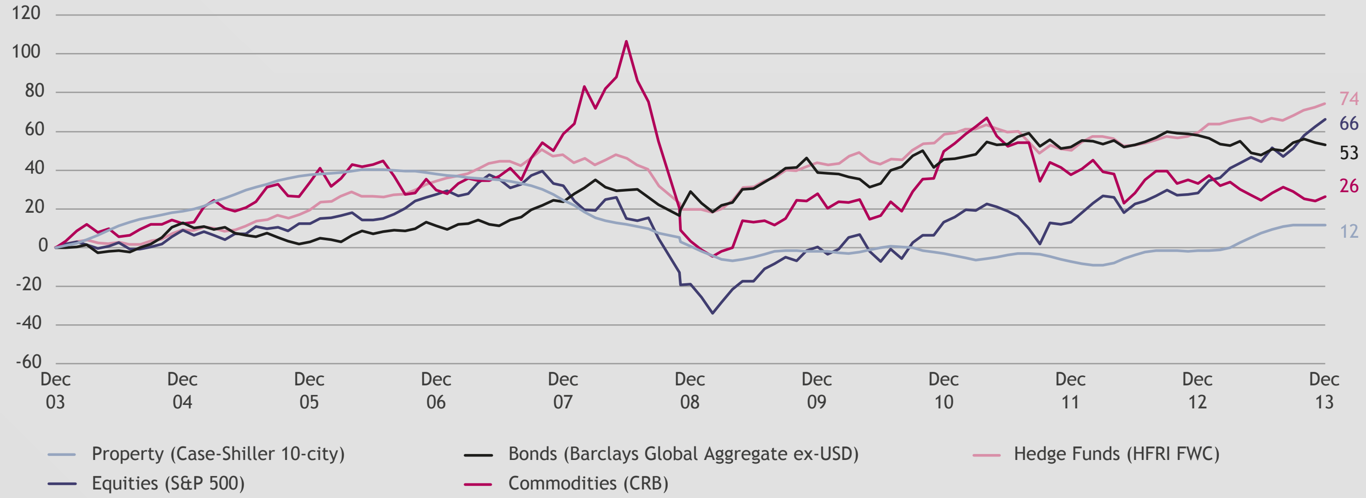
* Sharpe Ratio calculations assume an annualised risk free rate of 0.3%, 0.35% and 0.25% over the 5, 10 and 20-year periods respectively. The risk free rate is calculated as the average rate of a US treasury security during the relevant period for a security of the same maturity as the period in question (eg. for the 5 year period, the risk free rate is the average rate of a 5 year treasury note over the 2009-2013 period). Source: AIMA>

Figure 7: Annualised Volatility (%)



Source: KPMG International, 2012

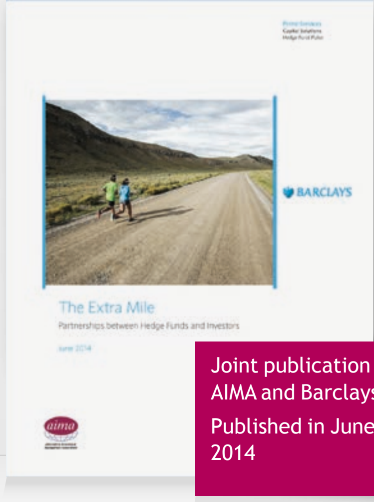
Figure 8: Hedge funds versus main asset class cumulative returns (%)



Source: AIMA.

The Extra Mile: Partnerships between hedge funds and investors

Survey finds that institutional investors are increasingly striking partnerships with hedge funds



Joint publication of AIMA and Barclays

Published in June 2014

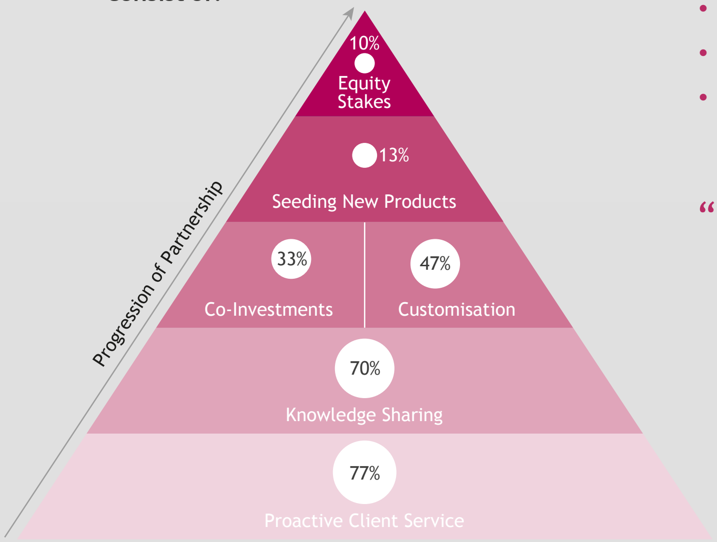
The evolving relationship between hedge funds and their investors was explored in ‘The Extra Mile: Partnerships between Hedge Funds and Investors’[28], which AIMA and Barclays published jointly in 2014.

The publication of this paper came at an important time in the evolution of the hedge fund industry globally. Amid the ongoing process of institutionalisation (a theme that was first addressed in AIMA’s Roadmap to Hedge Funds in 2008), institutional investors were found to be actively pursuing a more direct engagement with the underlying hedge funds in which they are invested.

This paper explored the changing relationships between hedge fund managers and investors. As the title of the paper implied, both parties were found to be properly investing in these relationships – they are going the extra mile – and, in doing so, are achieving significant benefits for both sides.

The paper, based on a survey of investors and managers, found that investors increasingly are striking partnerships with hedge funds, underlining the closer collaboration taking place between the hedge fund industry and its investor base.

Figure 9: What do your partnerships with hedge funds consist of?



Source: Barclays Strategic Consulting Analysis; 1 Institutional includes pensions, endowments and foundations

These partnerships, the survey found, take many forms, including the sharing of knowledge on expertise and risk management, the building of more customized products, co-investment solutions, product seeding and equity investment.

More than three-quarters of managers and two-thirds of investors who took part in the survey said they had entered into partnerships.

The investors surveyed manage a combined $2 trillion in assets, of which approximately $260 billion is allocated to hedge funds. They include pension funds, endowments, foundations, sovereign wealth funds and family offices globally.

Benefits cited by the investors we spoke to included:

- Improved knowledge and understanding
- Better alignment of interest with managers
- Better value for money

Both larger and smaller managers and hedge funds of all strategies were found to be striking partnerships. The managers surveyed manage approximately $200 billion in assets. Benefits to managers included:

- "Stickier" or more loyal investors
- Support for new product development
- Cross-selling opportunities
- Investor references

> “Both parties are properly investing in these relationships – as the title of the paper implies, they are going the ‘extra mile’ – and, in doing so, are achieving significant benefits for both sides.”

28. http://www.aima.org/en/document-summary/index.cfm/docid/C2EC4BE7-D014-49A0-8195917E4849C81D

Section 2
Key articles by AIMA on the case for hedge funds

In this section, we publish extracts from some of our key 'thought leadership' articles since the financial crisis

TOPICS

2

The response to the crisis

"Whilst AIMA is extremely supportive of the ongoing efforts to resolve the global financial crisis, there is still a misconception that hedge funds played a significant role in the credit crisis and there is a very real threat that through this misunderstanding ill-thought out or politically-driven regulation may be imposed. Many of the concerns expressed loosely about a 'hedge fund problem' relate to wider financial market issues; for too long hedge funds have been wrongly targeted as universal scapegoats for a wider market malaise. If all hedge funds disappeared tomorrow, these issues would still remain.

"Hedge funds did not cause the present market turmoil – they have an essential role in providing liquidity to the markets and will be important in assisting in any eventual recovery. With a significant part of assets under management coming from institutional investors, the hedge fund industry plays a key role in preserving savings and pensions across Europe and also generates tens of thousands of jobs across the continent. It is part of the solution, not part of the problem."

"AIMA's role, as the global hedge fund industry's voice, is to ensure that the voice of the hedge fund industry is heard by regulators and policy makers, to bring to their attention the benefits of the hedge fund industry and dispel the misconceptions surrounding it and, in doing so, add value to the current regulatory debate.

"The global crisis requires a global solution. AIMA is working closely with key authorities at a national, European and international level to reach global consensus on the issues concerning the hedge fund industry. Having set out its views to various authorities – such as the UK Financial Services Authority, the European Commission and the International Organization of Securities Commissions (IOSCO) – on what an enhanced, appropriate and proportionate regulatory framework could look like, AIMA has now publicly announced its new policy platform."

'A time for clear thinking', by Andrew Baker, AIMA; HEDGE magazine, April 2009[29]

Financial stability

"Throughout the G20, policymakers and practitioners are striving to construct a global system of oversight and supervision capable of identifying the build-up of excesses and stresses in the financial system, and address them in a timely and effective manner. The goal is to mitigate systemic risk and market melt-downs, and the related negative effects on the real economy.

"A fundamental premise underpinning the policy discussions is a desire to improve transparency; both at the market and counterparty level, and with and among supervisors. The global hedge fund industry, through AIMA, in February 2009 announced its support for a variety of policy initiatives focused on improving transparency. These included mandatory manager registration and the periodic reporting by larger managers of systemically relevant information to supervisors and other macro-prudential authorities. These principles are now universally recognised as the correct way forward.

"AIMA has been working with national and supranational authorities to develop a supervisory framework. Most appreciate the difficulties inherent in devising a reporting system for systemically relevant information. The data gathered needs to be relevant to the risks we seek to mitigate, and it must be understood that neither the public nor the private sector can draw on infinite resources.

"The primary goal is to improve the supervisory understanding of market dynamics, not to interfere in markets or to seek a 'zero-failure' regime. Policymakers should recognise that they will not be able to prevent all failures; nor is that a desirable goal.

"Hedge funds are not systemically 'important' institutions, based on the risk they pose to the financial system. But as mature market participants, they can and should contribute to financial stability analysis by providing authorities with systemically 'relevant' information. It should be noted that many of the largest hedge fund managers have been voluntarily sharing information with national and international authorities for many years."

'Hedge funds should contribute to stability', by Todd Groome, AIMA; Financial Times, 31 January 2010[30]

29. http://issuu.com/squareupmedia/docs/h_7 (page 57)

30. http://www.ft.com/cms/s/0/568463a8-0d08-11df-a2dc-00144feabdc0.html?siteedition=uk#axzz38SxFG5DE

Hedge fund myths

"There is a famous scene in Don Quixote by Miguel de Cervantes when our hero attacks windmills that he imagines to be giants. The idiom 'tilting at windmills' is derived from this scene, and is used to illustrate the folly of attacking imaginary enemies. The phrase was used by Treasury minister Lord Myners to criticise Europe's proposed Alternative Investment Fund Managers Directive. He said the regulation 'tilted at mythical windmills and at times panders to prejudice'. Our industry is often portrayed as capable of single-handedly bringing entire countries and economies to their knees. The industry has been accused of causing the global financial collapse, of being dangerously over-leveraged, of ruining countless banks, and now of provoking a new sovereign debt crisis. The truth, of course, is far more prosaic and even dull.

"There are individual banks with bigger balance sheets than the entire global hedge fund industry. The industry is often said to be highly leveraged, yet leverage levels in the hedge fund industry are usually in the order of one or two times assets. Some sources have suggested the hedge fund industry accounts for half of all trading on stock exchanges, yet no figures have ever been produced to validate this. Other policymakers have suggested that hedge fund activity in the sovereign CDS market exacerbated the Greek debt crisis, causing Greece to pay significantly more on its debt. But again, the available data does not back this up. Similarly, short-selling of financial stocks was argued to be ruinous for those banks affected. But an examination of the figures shows that not only did short sellers account for low (single figure) percentages of total capitalisation of banking stocks but the subsequent bans failed to prevent the continuing fall in value of those bank shares.

"The critics of the world's hedge fund industry should find some real monsters to slay. Rather than making the industry a scapegoat for all the ills of the modern world, they should devote their efforts to producing lasting solutions for the genuine and critical problems we all face."

'Don't blame hedge funds for world's woes', by Florence Lombard, AIMA; Financial Times, 2 May 2010[31]

The investor transformation

"The perception has long been that those who invest in hedge funds are high net-worth individuals – the very wealthy. That was largely true when hedge funds first began many years ago, but it is no longer the case. Today, investors in hedge funds are more likely to be institutions such as university endowments, charitable foundations, public and private sector pension funds and sovereign wealth funds.

"This investor transformation has been a gradual process that reached a material milestone last year when, according to research by AIMA, institutions for the first time accounted for an absolute majority of hedge fund assets under management. Research has also shown that during much of the past 10 years, institutional investors represented the majority of net new investment capital in the industry. Such institutional interest is also evident among smaller hedge fund managers and many institutional investors are early stage investors with smaller funds, even start-ups, believing they offer the opportunity for attractive returns.

"Of capital from institutions, AIMA's research suggests that about one-third comes from pensions. Pension managers describe their interest in hedge funds as higher quality returns as well as additional risk management expertise and trading or market nimbleness – attributes which are particularly valued in recent volatile markets. From a macro perspective, advanced economies across the world are facing demographic pressures, and the funding positions of many pensions are challenged. Hedge funds are viewed as offering better risk-adjusted returns than other asset classes.

"The institutionalization of the hedge fund industry has been a developing theme for the past 10 plus years, and is likely to continue. As participants in a maturing industry, hedge fund managers of all sizes and from all regions are equipped today to attract and professionally service the growing institutional investor base. The infrastructure evident among asset managers and firms today will also assist them to meet new regulatory demands, and to offer a growing variety of products to the expanding institutional and individual investor base."

'The institutionalization of the hedge fund industry', by Todd Groome, AIMA; Institutional Investor, 22 July 2010[32]

31. http://www.ft.com/cms/s/0/2b45996c-5481-11df-8bef-00144feab49a.html#axzz38N9qO9Y9

32. http://www.institutionalinvestor.com/article/2636311/asset-management-hedge-funds-and-alternatives/the-institutionalization-of-the-hedge-fund-industry.html#.U9EbQECtwVI

The industry's social utility

"We have heard a lot about speculation recently. Whether it has been cocoa in particular or commodities in general, or the pound, the Euro, or sovereign debt, policymakers and self-appointed experts have queued up to attack 'speculators' whose speculation is allegedly ruining markets, bringing down currencies and economies – and even threatening to make chocolate more expensive.

"Some of the language used has been pretty choice. Some leaders talked of Europe being 'under attack' from speculators. Jean-Claude Juncker, the Prime Minister of Luxembourg and head of the Eurozone Finance Ministers' group, commenting on a possible collapse of the currency zone, told Handelsblatt:'"We have the instruments of torture in the basement, and we'll use them when it's necessary.'

"There is a way to neutralise ignorant and prejudiced attacks [about the hedge fund industry], and it is education. Making people understand that our industry is not part of the problem, but part of the solution. Showing them that we genuinely contribute to the economies in which we operate and to the global economy as a whole. Not only in terms of delivering returns to investors and price-discovery and liquidity to markets, although that is important, but in real tangible terms that people really understand.

"Jobs are one important example of that, but perhaps even more important is the social dimension the industry now has as the guardian of many people's pensions and savings and the facilitator of their business loans and mortgages. In many instances it is hedge fund activity that enables pension funds, insurers and banks to offer the services that they do because they are niche operators capable of assessing and pricing risks that others are unwilling or unable to undertake.

"Ultimately the best antidote to attacks on 'speculation' is to demonstrate the social utility of financial services in general and our industry in particular. If our industry is perceived by policymakers as rich people making money for rich people using borrowed money then they will not hesitate to impose punitive regulation. If they understand that we are a vibrant, creative and indivisible part of the asset management sector delivering real and important benefits to society, they might think twice."

'Speculation and social utility', by Andrew Baker, AIMA; HFMWeek, August 2010

Value to investors

"The hedge fund industry has had no shortage of critics. It has been described as 'locusts', 'parasites' and other unsavoury terms. The main charge is that the industry contributes nothing to society or to the broader economy. The charge is mistaken and shows a misunderstanding about how the industry operates and who its investors are.

"A significant majority of its assets come from institutional investors like pension funds, insurance companies, charities and university endowments. There are very good reasons why institutional investors have chosen to invest ever-greater allocations into hedge funds. Because hedge fund managers use a variety of investment tools, they are better able to 'hedge' (remove unwanted risks) and thus deliver better risk-adjusted returns. If you look at risk- adjusted returns over the last decade, hedge funds have consistently outperformed unhedged mainstream investments like equities and bonds. And they have done so with lower volatility. Steady returns with low risk and low volatility are of course valuable to institutional investors like pension funds.

"The figures suggest that institutional investment now makes up about two-thirds of all assets being managed by the hedge fund industry. These institutional investors do extensive due diligence on the hedge fund managers they appoint. If they think it's worth investing in hedge funds, it is worth listening to them. Investment by pension funds in hedge funds could mean a more secure or even a bigger pension for you when you retire and lower pension contributions while you are still working. Investment by university endowments and charities in hedge funds could mean more resources for them to devote to their important work, and less risk of market-related losses."

'Hedge fund critics misunderstand the industry', by Andrew Baker, AIMA; Bloomberg, 29 September 2010

Short selling

"Of course short selling has its critics, often within those companies that are shorted. With Lehman, HBOS, Northern Rock, Anglo Irish, Kaupthing and others during the crisis, it was the same story – short sellers were blamed for their troubles. However, the picture that has emerged of those companies that failed is not of innocent victims of ruthless short sellers, but of badly run and often over-leveraged institutions. They fell not because they were shorted, but because they had been mismanaged.

"Short selling is really just a way of expressing a view that a particular stock is over-valued, and it appears now that the doubts many short sellers had about the companies they shorted were more than justified. And it is important there is a powerful incentive for investors to find out what is wrong with individual companies. For example, it was shorters who were the first to work out that something was up with Enron. Short sellers devote considerable time, effort and resources to establishing the reality behind corporate rhetoric.

"An enlightened supervisory regime, therefore, would observe their market signals and use them as a sort of early warning system. Rather than being a source of trouble, the practice actually offers regulators a useful way of anticipating trouble."

'Why short selling is good for capital markets', by Andrew Baker, AIMA; Financial Times, 20 February 2011[33]

"There are plenty of other examples where hedge funds were the "canary in the coalmine" that first noticed the approaching danger. It will not have escaped anyone's attention that it was a hedge fund that first took a sceptical view about the over-valuation of the US housing market, well before the crisis. A decade before that it was hedge funds who first began to wonder if dot.com stocks were over-valued. More recently, hedge funds have expressed doubts about the ability of various sovereign and public entities to manage their fiscal positions, and have bought protection in the credit default swap market before those countries actually ran into financing difficulties and credibility problems in the bond markets."

'Good value in short selling', by Andrew Baker, AIMA; Financial News, 1 November 2010[34]

'Shadow banking'

"We have been hearing a lot recently about the 'shadow banking' sector. Senior bankers and lawmakers seem to have found a new bogeyman. The International Monetary Fund has called for enhanced oversight of "shadow banking activities", while the G20 has instructed the Financial Stability Board to develop regulatory recommendations by the autumn.

"The broader point made by critics of "shadow banking" – that hedge fund managers are part of a vast, unregulated sector that threatens the stability of global financial markets – is wrong. Hedge funds do not inhabit the regulatory equivalent of the shadows. All the major jurisdictions where they operate – whether in North America, Europe or Asia- Pacific – regulate the industry rigorously, and generally have done so for years. What is more, this already significant level of regulation is being increased, not lessened, by legislation introduced since the financial crisis.

"It is of course no accident that the re-emergence of the 'shadow banking' term has coincided with the efforts of the US Financial Stability Oversight Council, among others, to identify systemically-important financial institutions that will be the subject of additional supervision. But there is no evidence to suggest that a single hedge fund is sufficiently large, leveraged, complex or interconnected that its failure or financial stress would cause such severe disruption.

"Do not just take AIMA's word for it. The UK Financial Services Authority conducts twice-yearly surveys of the 50 largest UK-based hedge fund managers, including some of the behemoths of the global industry, and has yet to find an individual hedge fund that poses a systemic risk.

"Of course it is possible that individual hedge funds could act together to create systemic impacts. But the hedge fund industry's heterogeneous and proudly contrarian nature makes such unified action highly unlikely. The truth is that systemic risk continues to reside in 'too big to fail' institutions. Hedge funds, for their part, are not unregulated, shadowy or even bank-like. They are, as independent academics have noted, rigorously regulated, transparent to their supervisors, not systemic, and 'small enough to fail'."

'Hedge funds are not "shadow banks"', by Andrew Baker, AIMA; Financial Times, 15 May 2011[35]

33. http://www.ft.com/cms/s/0/cb22ac84-3cdb-11e0-bbff-00144feabdc0.html#axzz38N9qO9Y9
34. http://www.efinancialnews.com/story/2010-11-01/good-value-in-short-selling
35. http://www.ft.com/cms/s/0/611b8e26-7d8d-11e0-b418-00144feabdc0.html?siteedition=uk#axzz38N9qO9Y9

The industry's reputation

"Three years on since the last crisis, it's worth considering what has changed since 2008 and what progress the industry has made in terms of how it is perceived not only by the general public, but by investors, regulators, policymakers and the press. It's easy to forget just how bad some of those headlines were three years ago: 'Hedge fund horsemen of the apocalypse', 'Beasts who can tear firms apart' and 'Greedy pig billionaires' were all real headlines. We are not seeing the same kind of hostility today. Where hedge funds were specifically blamed for the crisis three years ago, politicians now, insofar as they attribute blame, tend to point the finger at 'speculators' and their 'speculation'.

"It may appear a subtle distinction but it is an important one. It means our industry is no longer in the crosshairs. Analysts and commentators have moved on too. Whereas three years ago it was common for our industry to be blamed for the crisis, now there is broad agreement that this is a debt crisis caused by political failures. In fact, some previously critical commentators have changed their tune. BBC business editor Robert Peston, not noted as a friend of the industry, now says hedge funds are 'a model for how the banking system should be reformed'.

"What the industry can do is to seek to demonstrate its value to the general public. Because institutional investment now makes up a majority of the industry's AuM it means the industry is now acting as the guardian of many ordinary people's pension money and other investments. That is an important message for the industry to convey."

'Our industry is no longer in the crosshairs', by Christen Thomson, AIMA; HFMWeek, 7 December 2011[36]

Investor satisfaction

"The latest hedge fund performance figures show the average fund was down nearly 5% in 2011, and have prompted some to say: 'The hedge fund model is broken'. It is worth noting that global shares, according to the MSCI All-Country World Index, were down 9.4% in 2011, but nobody is arguing that the joint-stock company model is broken. And no-one would argue that the mutual fund model was broken, either, after one bad year.

"It is worth putting 2011 in context as one of three down years in the last 20 for the global hedge fund industry. During 1999-2010, the major hedge fund indices averaged overall returns (after fees) of more than 8% per annum.

"Investors continue to express confidence in the industry. Barclays Capital has just put out a report saying that investors may add about $80 billion of net new capital to hedge funds globally in 2012, the most since 2007. More than half the investors surveyed by BarCap plan to increase their hedge fund investments in the coming year, more than seven times the number that plan to reduce their allocations.

"This may be because many strong managers with excellent performance-to-risk track records have continued to succeed in a harsh investment environment. And even those with poor results this year can often point to many years of success before this one. It is also because hedge funds can provide an important source of diversification for many investors. Pension funds have traditionally invested a large part of their portfolios in stocks and bonds, but there are now question marks hanging over the risk/return characteristics of both as a result of the sovereign debt crisis and concerns over the outlook for corporate profitability and growth.

"Indeed many investors actually see hedge funds as a port in the storm. At least in theory, in a volatile and uncertain world, an investment manager who is active and who can hedge, which is to say, one who can offer protection on the downside, ought to be well placed to navigate the stormy weather we're seeing right now."

'In defence of hedge funds: Institutional investors are giving a vote of confidence', by Andrew Baker, AIMA; City AM, 20 January 2012[37]

36. https://www.hfmweek.com/comment/the-long/christen-thomson/comment-christen-thomson?fav

37. http://www.cityam.com/article/defence-hedge-funds-institutional-investors-are-giving-vote-confidence

Long-term gains

"Hedge funds, their role within financial markets and the returns they generate have been under considerable debate since the global financial crisis of 2008. Some policymakers have been quick to blame hedge funds for market failures, while some critics have questioned their performance.

"A newly published study from the Centre for Hedge Fund Research at Imperial College London, however, uses compelling empirical data backed by detailed analysis to contribute some much-needed objectivity to the debate about the merits of hedge funds. The research – commissioned by KPMG, the international audit, tax and advisory firm, and AIMA – provides powerful proof of hedge funds' ability to generate stronger returns than equities, bonds and commodities, and to do so with lower volatility and risk than equities and commodities.

"The publication of this study comes during a momentous period for the industry. There has probably never been a time when there has been more interest in – and scrutiny of – the activities of hedge funds, whether by investors, policymakers, regulators or the media. Much of this is welcome and is in the long-term interest of the industry. Performance, fees and transparency have always been pivotal issues, but they have assumed even greater importance since the crisis. By focusing on a time period of some 17 years, the researchers have been able to present an informed and balanced view. Despite a desire in some quarters to focus on ever-shorter periods of performance, the real picture, as the study shows, is that hedge funds have been a very solid investment for a long time."

'Hedge funds prove their worth over the long term', by Andrew Baker, AIMA; Institutional Investor, June 2012[38]

Building a more robust financial system

"In terms of investor protection, we offer our support to policies and regulations designed to maintain and enhance sound legislative and regulatory structures which protect and enforce investors' property, shareholder and creditor rights in a fair, equitable and proportionate manner. There is ample evidence showing that economies which provide robust regimes for the protection of property and contractual rights develop deep and liquid capital markets which are the source of economic growth.

"In terms of regulatory consistency, AIMA believes that all financial markets participants should be regulated in an appropriate and proportionate manner. Consistent and effective regulation of the financial sector, and the hedge fund industry in particular, should reflect the value of the industry to market liquidity and efficiency, the interests of its investors and the economy at large.

"In terms of understanding and mitigating systemic risk, we believe that it is desirable to have diverse participants in the financial markets with different capacities to take on particular risks. Micro prudential regulation which does not recognise the different risk-bearing capacities of various financial actors could increase homogeneity of participants in the market. Rules which produce the same responses to economic shocks will aggravate those shocks.

"Regarding the problem of 'too-big-to-fail', we recognise that each type of financial services-related entity poses its own types of financial and, potentially, systemic risks. We believe that those risks should be adequately addressed in order to ensure that financial institutions are capable of failing without endangering public finances and the economy.

"In terms of market integrity, we call for clear and internationally harmonised definitions of market abuse. But we stress that the most effective way to combat market abuse is to target the actual abusive behaviours, not to restrict legitimate activities or the use of certain technologies wrongly seen as proxies for market abuse.

"In conclusion, AIMA believes that capital markets are crucial in the financing of the economy and the hedge fund industry plays an ever-increasing role in the entire chain of investing and financial intermediation, contributing to market depth, sophistication, transparency and thus its ability to support growth. It is important for the industry that the financial markets on which it operates are well-functioning. We therefore wish to participate actively in the elaboration of policies in the areas of asset management and financial markets regulation with the aim of improving investor protection, market transparency and financial stability overall."

'AIMA's Policy Principles reflect the importance of capital markets', by Andrew Baker, AIMA; HFMWeek, 9 October 2013[39]

38. http://www.institutionalinvestor.com/Article/3036792/AIMAs-Andrew-Baker-Hedge-Funds-Prove-Their-Worth-over-the-Long-Term.html?ArticleId=3036792#.U9Eq2UCtwVI

39. http://www.hfmweek.com/comment/the-long/andrew-baker/comment-andrew-baker4?fav

The institutionalisation of the hedge fund industry

"The global hedge fund industry has made substantial investments in operational infrastructure and regulatory compliance since the financial crisis. This investment, already counted in the billions of dollars, will continue to rise as the industry becomes ever more institutionalised and is required to meet the new challenges posed by regulatory reform.

"AIMA has sought to examine this process in depth. In 2012, we produced a report with KPMG called 'The Evolution of an Industry' that looked at the increase in the global industry's operational sophistication and transparency to investors. We followed this up in 2013 with arguably the most comprehensive survey of compliance investments made by hedge fund managers globally. That report - produced with KPMG and the Managed Funds Association (MFA) – included the views of 200 hedge fund managers representing more than $910 billion in assets under management.

"What we hoped to discover was how greater regulatory scrutiny was impacting managers and uncover some of the solutions that managers had implemented in response. We also wanted to compare the cost of compliance across different regions.

"The report, called 'The Cost of Compliance', found overwhelmingly that the sector was taking its compliance obligations seriously, with significant investments already having been made by many of those operating in the sector. Not only were managers putting significant time, effort and capital into meeting regulatory requirements, the majority had also elected to absorb these costs themselves, rather than passing them on to their funds and their investors.

"Ultimately, the addition of new resources and sharpening of focus on regulatory compliance and risk management suggest that managers are committed to meeting regulatory requirements as well as the increased demands of institutional investors. But it is important that regulation does not raise barriers to entry to the industry, since next generation managers are an important source of new ideas and talent. Getting the balance right will be key."

'Investing in regulatory compliance', by Andrew Baker, AIMA; Preqin's Hedge Fund Report January 2014

Value to the 'real economy'

"The financial crisis of 2008 threw into sharp relief the weaknesses of the banking sector, prompting massive state bail-outs and decisive supervisory action by G20 nations. But this has left policymakers in the EU with a dilemma. How do they ensure that building a more stable, resilient financial system does not come at the expense of economic growth? New rules have required banks to scale back the amount of money that they lend, which in turn means that European firms – particularly the region's legion of small and medium sized enterprises (SMEs) – are less able to access the capital that they need to be able to invest in and grow their business.

"This has led to increasing interest on the part of EU policymakers in the role that market finance – sometimes referred to as part of the 'shadow banking' system – could play in terms of filling the lending gap and allowing firms to access the capital that they need for growth. In its simplest form, market finance is based on a model whereby businesses are able to raise capital from investors by issuing shares and bonds – by accessing capital markets.

"Europe is an interesting region to consider, because it is characterised by differences between countries in terms of the balance between market-finance and bank-based lending. We at AIMA, the global hedge fund industry body, were keen to explore these differences, to see whether this could provide broader insights into global financial structure and its future evolution. Specifically, what do differences in the balance between bank lending and capital markets mean for economic growth? Do capital markets offer a source of finance that has positive spill-over effects on the economy?

"AIMA asked two leading German academics in this field – Christoph Kaserer, Professor of Finance, Chair of Financial Management and Capital Markets, TUM School of Management, Munich; and Marc Steffen Rapp, Professor of Finance, Accounting & Finance Group, School of Business and Economics, Philipps-Universität Marburg – to explore these questions. Their work has resulted in the publication of a new study, titled 'Capital markets and economic growth – Long-term trends and policy challenges', which was launched in Brussels on 20th March. The study's key finding is that the balance between market finance and bank lending does matter and that overreliance on banks comes at a cost in terms of reduced economic growth."

'Capital markets and the EU's growth strategy', by Adam Jacobs, AIMA; EU Reporter, 25 March 2014[40]

40. http://www.eureporter.co/economy/2014/03/25/comment-capital-markets-and-the-eus-growth-strategy

Leverage and systemic risk

"Anyone skimming over the FCA's latest Hedge Fund Survey could be forgiven for thinking that the UK's hedge fund firms had suddenly loaded up on risk. After all, one of the survey's main findings was that "collectively hedge funds have raised their leverage to 64 times fund assets" which is a figure far higher than normally associated with hedge fund leverage.

"A closer look at the data solves this paradox. The increase in leverage had been caused not by a dramatic increase in borrowing but rather by the FCA looking at a different measure of leverage which includes gross notional exposures. Gross exposure, which includes the notional amounts of all derivatives positions, will soon need to be reported under AIFMD and it is also contemplated as a measure of hedge fund leverage by the recent FSB-IOSCO paper on systematically important financial institutions in the asset management sector.

"The fact that AIFMD and FSB-IOSCO look at gross notional exposures highlights a growing divergence and inconsistency in the way that risk data is gathered and interpreted in the financial system. Leverage numbers for banks, asset managers, broker dealers and hedge funds are being calculated differently. What is good about the FCA survey is that it provides the elements to be able to piece together a more adequate picture of risk incurred by hedge funds and compare it to the rest of the financial sector.

"So while the hedge fund sector has grown in recent years, the industry as a whole remains diverse, with even the largest managers being smaller than medium sized banks. They have considerable liquidity in their portfolios and are employing much lower levels of leverage than other parts of the financial sector. The FCA data supports the thesis that, today, no individual hedge fund or manager is systemically important to the extent that its failure would endanger financial stability in Europe or globally."

'Hedge funds do not pose a systemic risk', by Jack Inglis, AIMA; Financial News, 7 April 2014[41]

Performance

"It is a debate possibly as old as the hedge fund industry itself. Investors, commentators and the media have long mulled over how to understand hedge fund performance and compare it to other investments. But since the financial crisis, and the QE-fuelled boom in public equities markets that followed it, these debates have intensified.

"It is all too common today for comparisons between aggregated hedge fund indices and equities indices like the S&P 500 to be made. For example, a set of monthly hedge fund index figures is often compared to the S&P 500 in that period with the latter used as a proxy for the 'market', with the difference between the two interpreted as hedge funds either under- or over-performing "the market".

"This of course is not the way most institutional hedge fund investors or funds of hedge funds measure the performance of their allocations. They may have a particular return figure in mind for the hedge fund part of their portfolio – the 'risk-free' rate plus X, say – or be seeking to lower volatility or provide downside protection. They are not generally looking at their hedge fund allocations and thinking, 'we must beat the S&P 500'. Just as there are many different types of hedge funds, so there are many different things that investors are seeking from their hedge fund allocations.

"Indeed, it is striking that recent surveys have highlighted high levels of investor satisfaction in hedge funds at a time when many commentators have claimed that the industry is being out-performed by the 'market'. The reason for this is that investors are not allocating to hedge funds to beat the S&P 500 but to allow them to meet their asset-liability management objectives in terms of risk-adjusted returns, diversification, lower correlations, lower volatility and downside protection."

'Understanding hedge fund performance better', by Jack Inglis, AIMA; InvestHedge, 9 June 2014[42]

41. http://www.efinancialnews.com/story/2014-04-07/hedge-funds-do-not-pose-a-systemic-risk-jack-inglis-aima-comment

42. http://www.hedgefundintelligence.com/Article/3349584/Understanding-hedge-fund-performance-better.html

Glossary

AIMA for many years has maintained a Glossary[43] on the AIMA website. The full glossary comprises dozens of terms. The following are some of the key ones:

Accredited investor – An institution or high-net worth individual, to whom securities may be promoted pursuant to a private placement in reliance on the safe harbour provided by Regulation D of the US Securities Act of 1933 and defined as one of the following: (1) a bank, insurance company, registered investment company, business development company, or small business investment company; (2) an employee benefit plan, a charitable organization, corporation, or partnership or a trust not formed to acquire the securities offered with assets exceeding $5 million; (3) a director, executive officer, or general partner of the company selling the securities; (4) a business in which all the equity owners are accredited investors; (5) a person who has individual, or joint net worth with the person's spouse, exceeding $1 million; or (6) a person with income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000.

Asset allocation – The structure of a portfolio - namely the allocation of specific portions of it across different assets classes, i.e. securities, property, cash, fixed interest, etc.

Assets under management – Includes all investments, leveraged and unleveraged, including cash, that are managed and administered by a fund manager for itself and its customers.

Diversification – Generally refers to the variety of investments in a fund's portfolio. Risk-averse fund managers seek to combine investments that are unlikely to all move in the same direction at the same time.

Downside risk – Downside risk is a similar measure to Volatility, except that this statistic calculates an average return for only the periods where return was lower than zero (or another benchmark rate) and then measures the variation of only these "losing" periods around the calculated average. In other words, this statistic measures the volatility of the downside performance.

Hedge fund – There is no standard international/legal definition though they may have all or some of the following characteristics: May use some form of short asset exposure; may use derivatives and/or more diverse risks or complex underlying products are involved; may use some form of leverage, measured by gross exposure of underlying assets exceeding the amount of capital in the fund; Funds charge a fee based on the performance of the fund relative to an absolute return benchmark as well as a management fee; investors are typically permitted to redeem their interest only periodically, e.g. quarterly or semi-annually; often, the manager is a significant investors alongside other fund investors.

Hedging – The process of protecting the value of an investment from the risk of loss in case of an adverse price movement.

High water mark – The existence of the high water mark ensures that a fund only takes performance-related fees on new profits.

Leverage – The borrowed money that an investor employs to increase buying power and increase its exposure to an investment. Users of leverage seek to increase their overall invested amounts in the hope that the returns on their positions will exceed their borrowing costs. The extent of a fund's leverage is stated either as a debt-to-equity ratio or as a percentage of the fund's total assets that are funded by debt. Example: If a fund has $1 million of equity capital and it borrows another $2 million to bring its total assets to $3 million, its leverage can be stated as "two times equity" or as 67% ($2 million divided by $3 million).

Management fee – A fee paid to a fund manager for managing and providing services to the fund as well as to cover certain operating expenses. Investors are typically charged separately for costs incurred for outsourced services. The management fee is generally expressed as a charge against investor assets and typically ranges from an annual 0.5% to 2% of an investor's entire holdings in the fund, and usually collected on a quarterly basis.

Performance fee – A fee paid to a fund manager for providing returns on an investment, often by reference to a benchmark or Hurdle rate. This fee is based on net new profits and is earned by the hedge fund manager for the period concerned. It may be paid annually or quarterly but accrues monthly in the fund valuation.

Redemption – Liquidation of shares or interests in an investment fund.

Risk-adjusted performance – Risk relative to return: the return achieved per unit of risk or the risk associated with a particular level of reward, typically represented by the Sharpe ratio. Improving the risk-adjusted return depends either on increasing returns without a commensurate increase in the level of risk, or maintaining the level of returns whilst lowering the associated risk.

Short selling – Short Selling funds sell securities short in anticipation of being able to buy them back in the future at a lower price. The manager estimates that the securities, or the market, are overvalued or anticipates earnings disappointments, often due to accounting irregularities, new competition, change of management, etc. Short Selling funds are often used as a hedge to offset long-only portfolios and by those who feel that the market is approaching a bearish cycle. Short Selling funds are by nature strongly exposed to extreme risks since their short positions present infinite loss potential. As a result, short selling is strictly regulated and should be regarded with caution. Short Selling is a Directional strategy generally characterized by relatively volatile returns and a significant correlation with major stock indexes.

Strategy – The particular investment process employed by a manager in the application of an investment style.

43. The AIMA Glossary was produced with the assistance of Stanley Marchon, Vincent Kuhn, Nicolas Watin-Augouard, Stephen Foster and Sunil Gopalan

About AIMA

As the global hedge fund association, the Alternative Investment Management Association (AIMA) has over 1,400 corporate members (with over 7,000 individual contacts) worldwide, based in over 50 countries. Members include hedge fund managers, fund of hedge funds managers, prime brokers, legal and accounting firms, investors, fund administrators and independent fund directors. AIMA's manager members manage a combined $1.5 trillion in assets (as of March 2014).

All AIMA members benefit from AIMA's active influence in policy development, its leadership in industry initiatives, including education and sound practice manuals, and its excellent reputation with regulators worldwide.

AIMA is a dynamic organisation that reflects its members' interests and provides them with a vibrant global network. AIMA is committed to developing industry skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the industry's first and only specialised educational standard for alternative investment specialists.

For further information, please visit AIMA's website www.aima.org

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