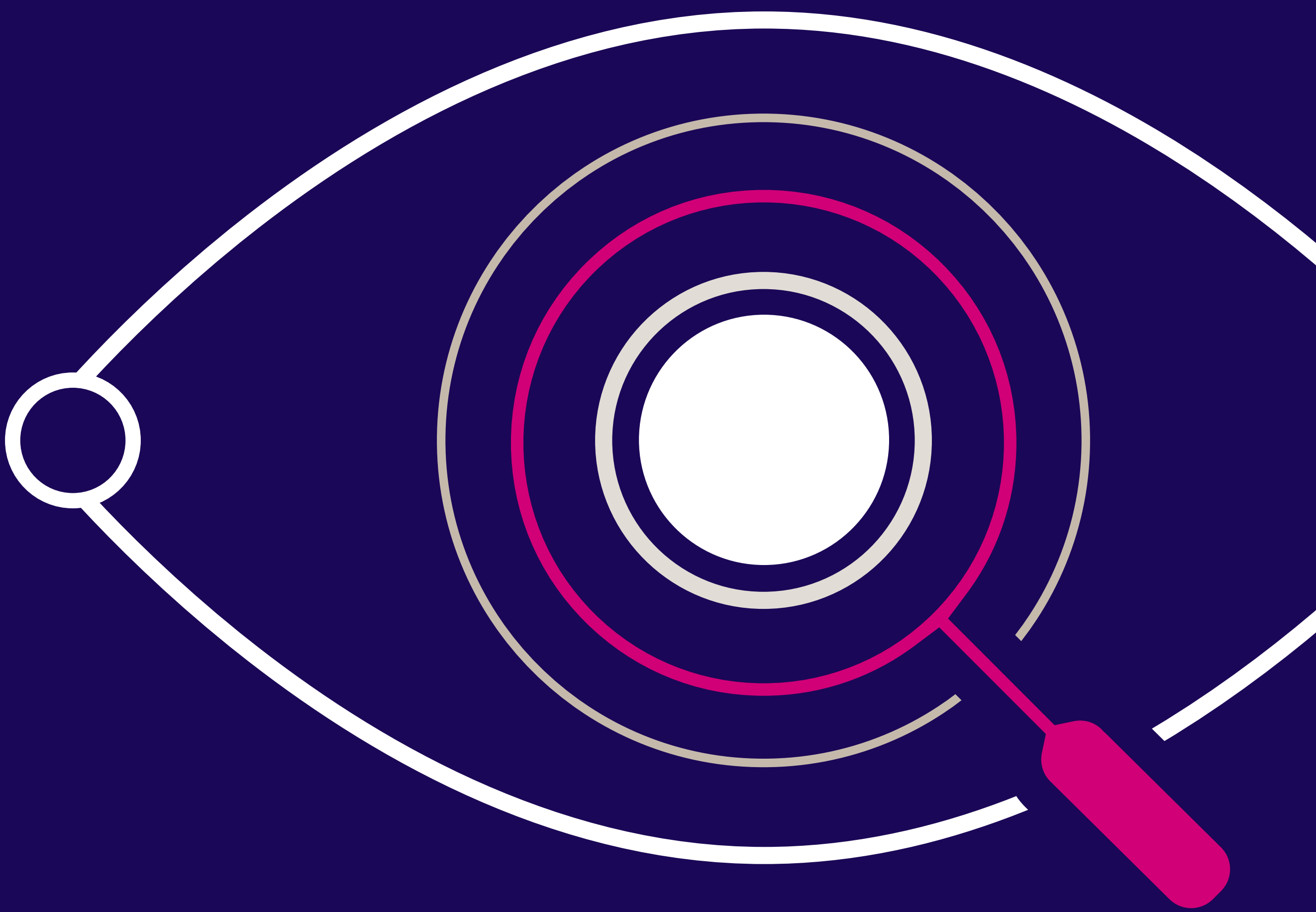
Insights+

Preqin Investor Outlook:

Alternative Assets, H2 2023 Report Extract

This is a sample of Preqin's Investor Outlook H2 2023, created for AIMA
For the full report, available with an Insights+ subscription, please visit our website here.



PREQIN

Executive summary

Optimism evident as economic cycles turn

The denominator effect has played a part in influencing capital allocation decisions over the past year, but perhaps not as big a part as expected. Among respondents to our recent investor survey, 41% indicated that this had no effect on their private capital portfolios (Fig. 1.11). However, sentiment is split depending on the size of the investor. Those with assets under management (AUM) greater than $25bn have been more heavily hit, as they don't have the luxury of moving larger amounts of capital with ease. As such, 82% noted some impact from the denominator effect.

There may be some reason to be optimistic. More than three-quarters (81%) of investors surveyed think we are currently on a decline or approaching the bottom of both the macroeconomic and real estate market cycles (Fig. 1.4). Respondents' view on the equity market cycle is that it is further ahead – 26% think it is already starting to recover. Equity markets tend to be an indicator of investor sentiment, so this view is in line with the survey response on the macroeconomic and real estate cycles.

Alternatives remain an important component of multi-asset portfolios, as investors look to hedge against uncertainty. Private equity and venture capital (VC) appear less favored this year (Fig. 1.9), as the exit environment and asset prices exert downward pressure on the asset classes, but investors remain bullish on the longer-term outlook (Fig. 1.10). Private debt and infrastructure are currently of most interest to the investors surveyed, who plan to deploy more capital to these asset classes (45% and 41%, respectively) over the next 12 months.. Where we are in the debt cycle and the effects of inflation have crystalized both asset classes in the minds of investors.

Key findings

1

Private equity investors look to H2
Private equity fund commitments are being scheduled for the second half of the year, with more than half of all investors surveyed (55%) targeting deployment in the third quarter and 84% expecting to do so by the end of the year. Only 15% of respondents are planning to wait until next year to make a fresh capital commitment. However, we also see a softening in longer-term appetite as the number of respondents looking to increase allocations in the long term has declined.

2

Real estate cycle nears end
Eight out of 10 investors say that the real estate cycle is starting to decline or approaching the bottom. Among investors in the asset class, 66% of respondents suggest the market is overvalued and expect a correction – a slight uptick on last year. Almost half of investors (47%) surveyed think their real estate portfolio will perform worse in the coming 12 months, compared with 41% in June last year. Interest rate hikes and asset valuations are seen as the key challenges to returns.

3

Private debt continues to shine
Momentum is building among private debt investors based on performance over the past 12 months. Of respondents, 90% said that private debt 'met or exceeded expectations', while only 10% said that it had 'fallen short of expectations'. It is now the only asset class where most LPs expect returns to improve over the next year and the only one in which a majority of respondents intend to increase long-term allocations.

4

Core infrastructure rises on inflation
Inflation fears are driving interest in core infrastructure funds, now the most popular infrastructure fund strategy according to 44% of investors surveyed. At the same time, rising interest rates – a direct result of persistent inflation – are the primary challenge to infrastructure fund returns over the next 12 months, according to investors. We must go back to asset valuations during the uncertainty around the global pandemic in June 2020 to find a topic that concerned investors more.

Hedge funds for all seasons

Tom Kehoe, Global head of Research and Communications at the Alternative Investment Management Association (AIMA) details the advantages of hedge fund investments amid today's market fluctuations.

Tom Kehoe
CAIA, Global Head of Research and Communications
AIMA

During economic periods like we are experiencing, when financial markets exhibit increasing levels of uncertainty and volatility, investors need to look beyond generating investment returns that simply beat an equity or fixed income benchmark and consider making an allocation to the unconstrained strategies offered by hedge funds.

Over the coming years, the expectation is that long-only equity investors will endure a more challenging period and the resultant double-digit returns posted annually over the past ten years are less likely to be repeated over the coming decade. The most optimistic estimate for the classic 60/40 investor portfolio (historically regarded as the foundational investment portfolio), suggests annual returns for the next decade will be just over half that earned over the past ten years.

Given this outlook, allocating to a diverse set of investment strategies is arguably more important than ever for institutional investors faced with the twin objective of managing investment portfolio risk and delivering performance to meet the expectations of an increasing number of investors with different mandates.

A hedge fund constitutes an investment program whereby fund managers seek returns by exploiting investment opportunities, while protecting its principal from potential financial loss. An allocation to hedge funds can provide investors with more flexibility to protect and grow the capital of their beneficiaries.

Many of the most experienced allocators no longer consider hedge funds as a separate bucket ring-fenced somehow from the traditional assets in the portfolio but as substitutes for long-only investments and diversifiers capable of transforming the risk and return characteristics of their entire investment portfolio.

Taking the first instance, where hedge funds take on the role of substitute and/or complement, investors may allocate to certain hedge fund strategies to replace some or all their investment in traditional long-only equity, and/or fixed-income investments. Such hedge fund strategies ought to reduce the overall volatility (i.e., reduce the risk) of the portfolio's public markets allocation with a more attractive risk-reward profile. Taking this approach should result in the capital of the investor being better preserved while the risk is also reduced.

Other hedge funds are simply too uncorrelated to equities or bonds, say, to be a straight swap since the way they behave under certain market conditions is different to the way the underlying assets of the rest of the investment portfolio behave. These are the diversifiers, providing the highest possibility of generating out-performance.

Deploying certain hedge fund strategies as a portfolio diversifier can help investors access new markets and investments that have the potential to produce out-performance and can offer a less correlated source of returns to a portfolio comprised of bonds and equities. The diversifiers comprise hedge fund strategies that are particularly uncorrelated to the underlying traditional assets in the portfolio and provide the potential for significant diversification and the highest possibility to generate out-performance.

Combining what we have learned above, here are just some examples of how hedge fund investment strategies could positively impact an institutional investor's portfolio in the current market environment.

Substitutes/complements:

- Long/short equity/credit hedge funds can theoretically limit the losses suffered by their investors during a downturn in equity prices. The successful management of a fully integrated portfolio of long and short positions can help increase portfolio returns even in the most difficult market conditions. Hedge fund managers that have employed the long/short strategy have proven to be very adaptable, as these funds are able to generate returns in both up and down markets as well as flat and trendless markets.

- Relative value strategies should have a broader opportunity set that can benefit from ongoing volatility and actions by central banks. Dependent on stringent fund selection, an allocation to relative value strategies could lower the risk of the overall bond portfolio.

Diversifiers:

- Trend-following strategies provide a dynamic risk-management mechanism which can help investors to avoid prolonged market downturns while participating in potential uptrends.

- Global macro funds – the unconstrained mandate of a global macro trading strategy has been proven to deliver solid positive risk-adjusted returns and has an attractive investment diversification which shares similar risk management properties to investing in a bond. Global macro funds generally exhibit a low correlation to tradition asset classes, and incorporating the strategy into a traditional portfolio has the potential to enhance the portfolio's overall return while decreasing its risk.
- The low volatility and beta-neutral characteristics of an equity market neutral strategy have demonstrated their resilience posting steady long-term risk-adjusted returns over the long term.

To read more about how institutional investors are considering the role of hedge funds to transform the risk and return characteristics of their entire portfolios, visit **AIMA/CAIA: Portfolio Transformers - Examining the role of hedge funds as substitutes and diversifiers in investor portfolios.**

The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with around 2,100 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than $2.5tn in hedge fund and private credit assets.

AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programs, and sound practice guides.

Hedge funds: bouncing back in calmer markets

By Rachel Dabora, Charles McGrath

After 2022's difficult market conditions, hedge funds are poised for recovery as investors regain some optimism for the coming year

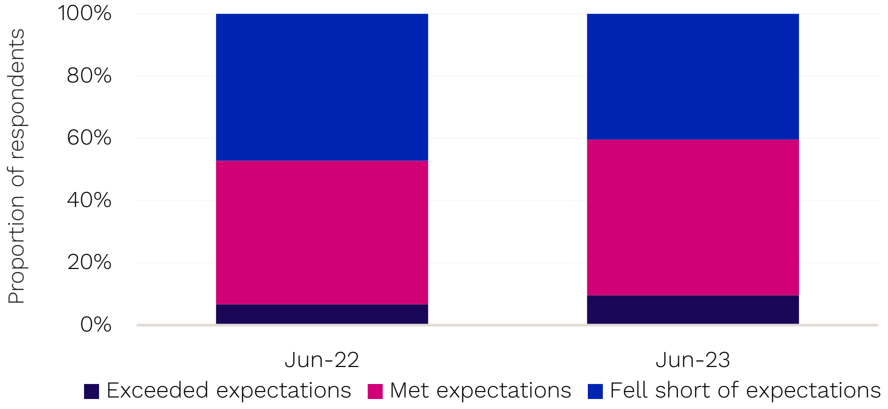
Hedge funds have been somewhat reinvigorated. Net inflows in the first quarter came alongside the US banking crisis and continued fears of recession, which added volatility to the market. But that wasn't new as 2022 was a difficult year for investors in the equity, bond, and FX markets. Traditional 60/40 portfolios of US equities and bonds were down by double digits – the toughest year in decades – but this gave hope to hedge fund managers offering uncorrelated returns. The Preqin All-Strategies Hedge Fund Benchmark is up by 7.09% so far this year,[1] a vast improvement since 2022, when returns were down by 7.32%.

In response to our latest investor outlook survey, 60% of investors said that hedge funds either met or exceeded their expectations (Fig. 5.1). This is a slight improvement from 2022. Investors also remained optimistic about the performance of the asset class through 2023 and into 2024. A third of respondents

1 (As of 05/07/2023)

Fig. 5.1: Hedge funds continue to meet investor expectations

Investors were asked: 'Have investments met expectations over the past 12 months?'

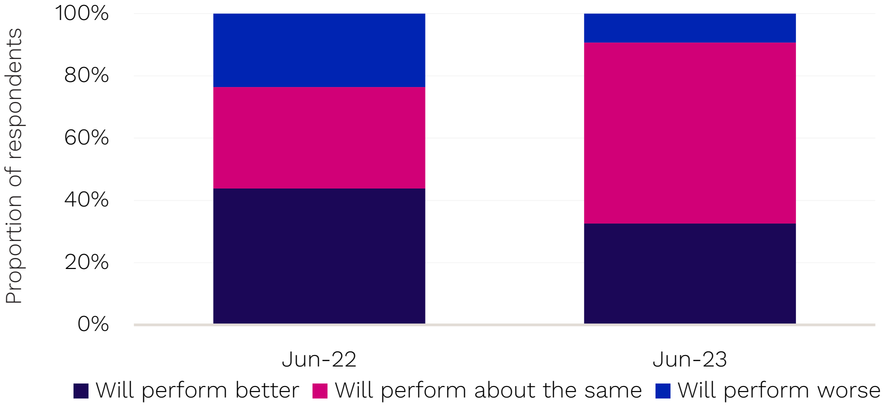


Source: Preqin Investor Surveys, June 2022 – 2023

(33%) expect hedge funds will perform better over the next 12 months compared with the previous 12 months, and 58% expect similar performance (Fig. 5.2). Only 26% of investors plan to allocate less capital to hedge funds over the next 12 months, while 28% plan to invest more capital – an increase of two percentage points (ppts) since June 2022 in both categories (Fig. 5.3). More than half of investors (55%) said they plan to maintain their current hedge funds allocations over the longer term (Fig. 5.4).

Fig. 5.2: Hedge funds investors see past performance continuing

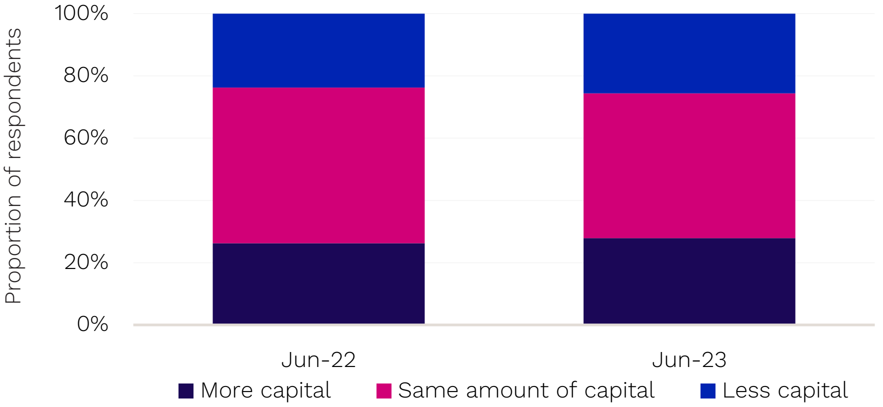
Investors were asked: 'How will next 12 months' performance compare to previous 12 months?'



Source: Preqin Investor Surveys, June 2022 – 2023

Fig. 5.3: Investors consider increasing capital commitments to hedge funds

Investors were asked: 'How much capital will you commit in the next 12 months?'



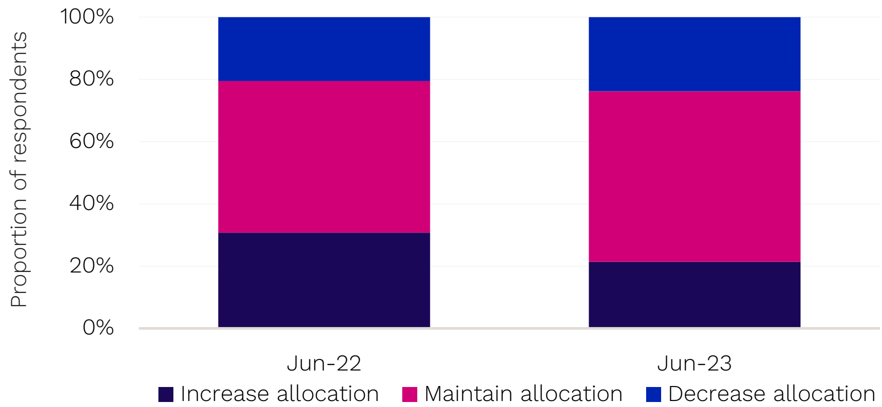
Source: Preqin Investor Surveys, June 2022 – 2023

Among investors with exposure to credit strategies, 48% plan to increase and 41% plan to maintain their exposure (Fig. 5.5). Early life-cycle hedge funds and funds of funds also received majority 'increase exposure' responses from investors. Cryptocurrency and blockchain strategies continued to disappoint into 2023, and 44% of investors plan to decrease their exposure to these fund types – more than for any other fund type.

Most hedge fund investors (79%) think that the US presents the best opportunities for investment across developed markets (Fig. 5.9). Investor perception of the UK has soured, with the country seeing the largest decrease in sentiment. Only 8% of investors surveyed stated that they thought it presented the best opportunities, down from 22% in 2022.

Fig. 5.4: Hedge fund allocations will be maintained in the longer term

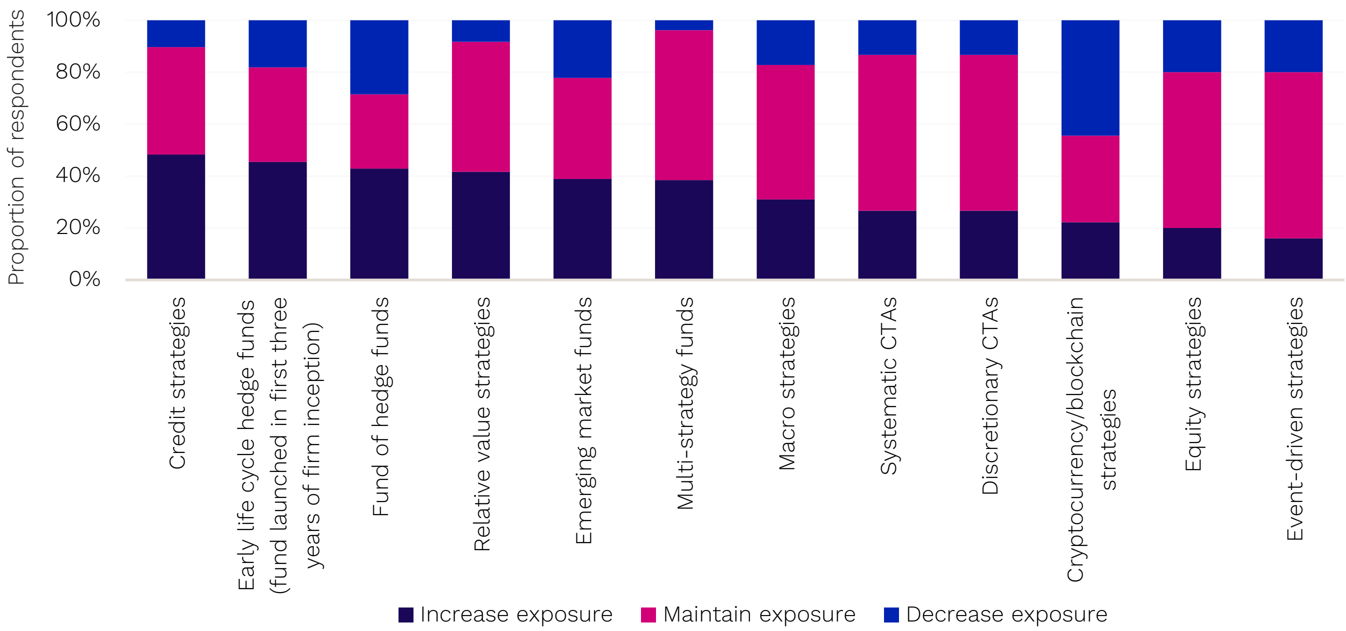
Investors were asked: 'How will you allocate to hedge funds over the longer term?'



Source: Preqin Investor Surveys, June 2022 – 2023

Fig. 5.5: Credit strategies garner most interest from investors

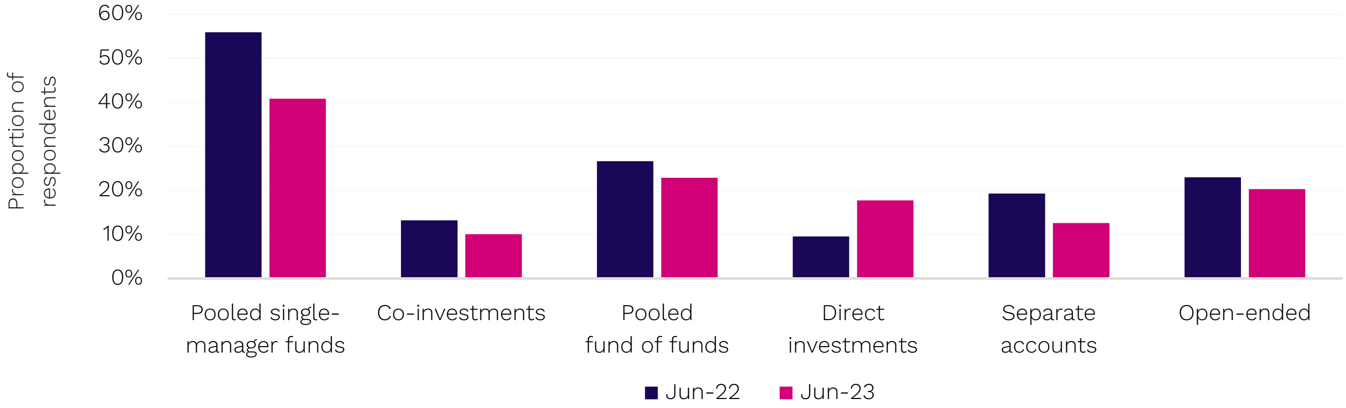
Investors were asked: 'Which fund types present the best opportunities?'



Source: Preqin Investor Survey, June 2023

Fig. 5.6: Pooled single-manager funds remain preferred structure

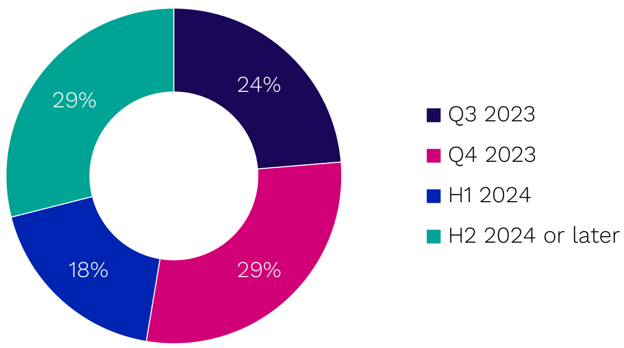
Investors were asked: 'What fund structures are you targeting in the next 12 months?'



Source: Preqin Investor Surveys, June 2022 – 2023

Fig. 5.7: Higher inflows anticipated for Q4

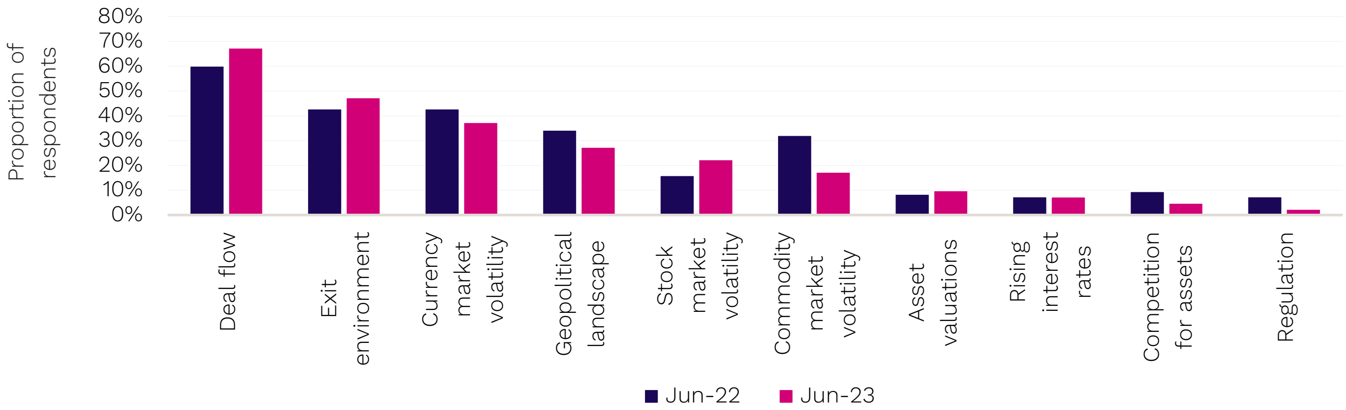
Investors were asked: 'When will you make next commitment to a hedge fund?'



Source: Preqin Investor Survey, June 2023

Fig. 5.8: Deal flow seen as the biggest challenge to hedge funds

Investors were asked: 'What are key challenges for return generation in the next 12 months?'



Source: Preqin Investor Surveys, June 2022 – 2023

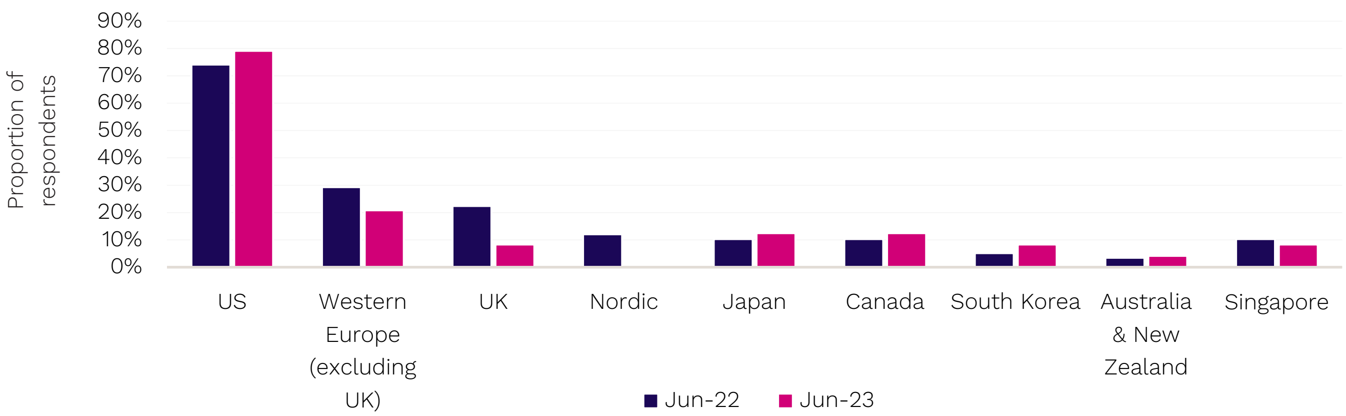
Views on China have also turned, dropping from 43% of investors viewing it as presenting the best opportunities among emerging markets in 2022 to 18% in 2023 (Fig. 5.10). This trend did not extend across APAC, as interest in Southeast Asia has jumped from 14% to 29%. Investors responded that they think Central & Eastern Europe is the most attractive region, with 47% reporting that they believe it presents the best opportunities, up from 9% in 2022.

The fundraising market remains challenging for hedge funds, but conditions and sentiment appear to have improved since 2022. As North America continues to be the main region for hedge funds, the upcoming decisions by the US Federal Reserve will have substantial impact on the performance and investor sentiment on the asset class. Traders' forecasts for reductions are aligned with officials' forecasts for a 2024 start, at the earliest, to cut its benchmark rate.[2] That said, considering the positive momentum in the market showed by Preqin's survey data, hedge funds may be able to find greater fundraising opportunities than they did at the beginning of the year.

2 https://www.ft.com/content/337b80f1-a52b-4a27-bd68-76ac7029292f?emailId=2d3e01ef-ac56-44c0-bde7-c43775dacdb5&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22

Fig. 5.9: UK loses investor interest as a target market

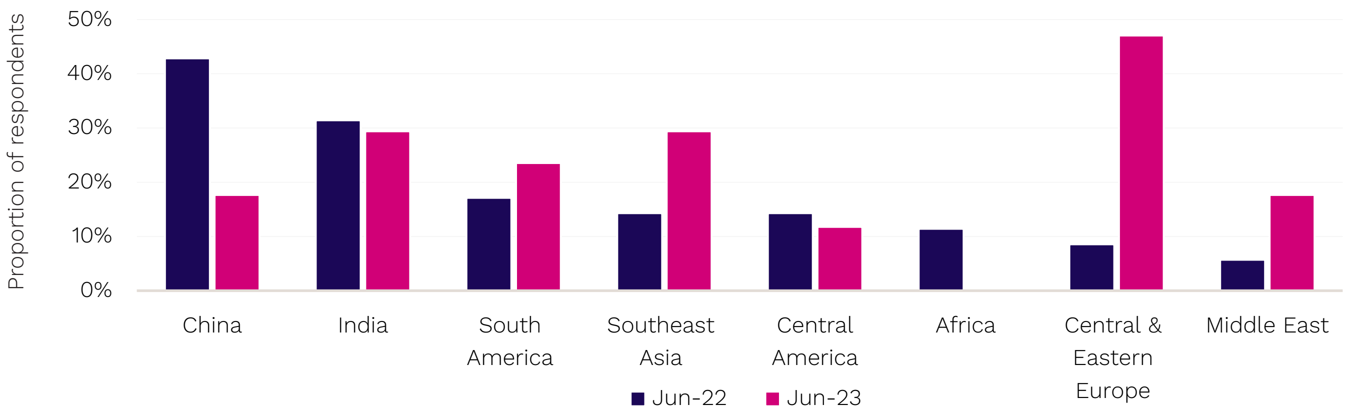
Investors were asked: 'Which developed markets present the best opportunities?'



Source: Preqin Investor Surveys, June 2022 – 2023

Fig. 5.10: Central & Eastern Europe increasingly shows promise

Investors were asked: 'Which emerging markets present the best opportunities for hedge funds?'



Source: Preqin Investor Surveys, June 2022 – 2023

PREQIN