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Investor Strategy Expectations 2015 | Hedge Fund Strategies

Summary

- Investor focus remains on less capacity-constrained managers. Current searches are concentrated in European equities, market-neutral, esoteric credit, energy and real estate
- Top performing strategies in 2014 included Managed Futures/CTA, long/short equity, fixed income (non-arb) and equity sector-focused funds. Among equity managers, Asian equities and healthcare led
- Hedge fund launches in 2014 were in line with 2013 and industry assets topped US$2.8T

Review and Outlook

We are optimistic about 2015, coming off a challenging 2014, when most hedge fund strategies were laggards. To gauge market sentiment, Decagon conducted our annual survey of alternative investors. We found investors "cautiously optimistic" for higher returns in 2015.

Capacity is a key concern; many investors interviewed felt that reward versus risk may be greater with mid-sized managers with strong business integrity.

In early 2014, investors bemoaned hedge fund returns while equity markets reached new highs. Late in the year, after multiple bouts of vertigo, hedge fund investors sourced returns in more active traders and trend-following managed futures managers.

In 2014, Managed Futures/CTA investors were rewarded, with mid-teen returns, on average, and 32%+ for top performers (5th percentile) after many lean years. Conversely, after many years of good returns, event-driven managers were confronted with tax inversions, commodity price volatility and quixotic CEOs, resulting in low single digit returns, on average, and only 15%+ for top performers (5th percentile).

2014 was a twist in prior years' trends notable among convertible arbitrage and merger arbitrage managers who produced negative returns, on average. As the table on the next page demonstrates, only 7 of the 18 strategies' top performers (5th percentile) produced 20%+ returns, compared to 13 out of 18 in 2013.

Investors had their work cut out for them in 2014. Picking the right manager within a strategy remained challenging due to wide negatively-skewed return dispersion. Selection was most difficult within energy-sector focused, emerging markets and event-driven strategies.

Investor Focus for 2015

Difficult questions investors are grappling with include:

- What is the back-stop for credit market liquidity, without bank proprietary trading?
- How will currency volatility impact strategy performance?

For allocations in 2015, European equities, market neutral, esoteric credit, energy and real estate remain on investors' favored list. Energy is stressed and investors are assessing opportunity funds. Strategy aside, our survey found many investors had a preference for managers whose strategies were well below capacity and trade in uncrowded names.

Launch Highlights

Despite Calpers publicized exit, HFRI reports hedge fund assets rose in 2014, the highest growth rate since 2007.

Strong results for 2014 included:

- 800+ hedge fund launches, although closures accelerated
- US$2.8T+ hedge fund industry AUM, up from US$2.6T in 2013

The most successful fund launches in 2014 were often supported by strategic partners, seeders, family offices or multi-strategy firms.

Investor Strategy Expectations 2015

Category / Strategy	2014			2015	
	Average Return (1)	Return Dispersion 95/5th Percentile(1)	Difficulty Picking the Right Fund (2)	Investors' Expectations	Forward Looking Comments
Relative Value & Arbitrage					
Market Neutral Equity	☹	-14% / 12%	⌛⌛⌛	Positive	Returns expected as fundamentals have diverged during volatile markets. Deleveraging periods could be painful.
Statistical Arbitrage	☺	-10% / 15%	⌛⌛⌛	Positive	Politics and policies continue to get in the way of shorter term signals.
Convertible Arbitrage	☹	-15% / 12%	⌛⌛	Neutral	Issuance is weak and further spread widening is expected but continued volatility may be supportive.
Risk Arbitrage	☹	-24% / 5%	⌛⌛⌛	Positive	Favorable trends for catalysts and mergers. Large trades appear overly crowded with more market risk.
Fixed Income Arbitrage	☺	-2% / 5%	⌛⌛	Cautiously Positive	Creativity is required to generate returns. Relative value players are still finding ample opportunity.
Long, Long-Short Equity & Fixed Income					
G-7 Equity Long-Short	☺☺	–19% / 20%	⌛⌛⌛	Cautiously Positive	Equity indexes have been a difficult lead car to catch. Asset price inflation is assisting.
Emerging Mkt Equities L/S	☹	-49% / 14%	⌛⌛⌛⌛	Neutral	Downgrade cycle in credit will impact equities. Commodity exporters' vulnerability has intensified.
Event Driven/Special Sits.	☺	-33% / 14%	⌛⌛⌛⌛	Cautiously Positive	Preference for managers with diversified transactional exposures. Activists are taking aggressive bets.
Fixed Income (non-arb)	☺☺	-3% / 18%	⌛	Neutral	Liquidity, when challenged, will be hard to find as bank desks have sharply reduced dedicated capital.
U.S. Mortgages	☺☺	-9% / 20%	⌛⌛	Neutral	Housing is recovering but rates and tight spreads hamper outsized returns.
Distressed Corporate	☺	-10% / 15%	⌛⌛	Positive	Distressed supply is increasing with select industries (consumer, energy) in focus.
Short Bias	☹☹	n/a	⌛⌛⌛⌛	Cautiously Positive	Late equity cycle valuations may provide fresh opportunity to this diminished strategy.
Global Macro & Managed Futures					
Global Macro G-7	☺	-18% / 21%	⌛⌛⌛	Cautiously Positive	Currency wars and divergent central banking policies are creating fertile ground this year.
Managed Futures/CTA	☺☺☺	-18% / 32%	⌛⌛⌛	Cautiously Positive	Ample opportunity but manager selection is trying as talent may not translate from one environment to the next.
Sector Specific					
Energy	☹☹	-48% / 25%	⌛⌛⌛⌛	Cautiously Positive	Disrupted industry unlikely to recover quickly. Opportunity funds are percolating.
Real Estate	☺	-2% / 18%	⌛⌛	Positive	Supply constraints, low rates and deal flow provide tailwinds. Likely to be among beneficiaries of lower energy.
Finance	☺	-1% / 20%	⌛⌛	Positive	Volckerization appears to have wreaked its worst. Rising rates may support traditional players.
Technology	☹	-10% / 12%	⌛⌛	Positive	Ongoing fertile ground for ample long and short opportunities as players battle for eyeballs.
Healthcare	☺☺	-14% / 32%	⌛⌛	Cautiously Positive	Hard to wade in after many years of outsized gains.

1. 2014 Average Return and Return Dispersion 95/5th references were constructed by reports from data within the Credit Suisse Hedge Fund Indices, HFRI Hedge Fund Indices and HFN.
   Ranges include: ☹☹ < -5% return, ☹ 0% to -5% return, ☺ 0 to 5% return, ☺☺ 5 to 10% return, ☺☺☺ greater than 10% return.
2. Difficulty in picking the 'right' fund is an interpretation of the width and shape of the dispersion and an indication of the ability to source managers with this expertise. ⌛(hour glasses) indicate increasing difficulty.
   2015 Investor Expectations and Forward Looking Comments have been compiled from interviews with family offices, endowments, hedge fund platforms and fund of hedge fund managers. The comments, opinions and estimates contained herein are based on or derived from sources we believe to be reliable. We do not guarantee their accuracy. This material is for informational purposes only and sets forth views as of January 2015. The underlying assumptions and these views are subject to change without notice.

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Based in New York, the Decagon team provides comprehensive COO, Due Diligence and IR support globally to institutional investors and hedge fund owners. The Decagon team accelerates the success of investment teams and institutional due diligence processes by providing a competitive advantage. We offer our operational advisory services to managers that exhibit skill, experience, drive and a strong sense of fiduciary duty.

Our goal is to support innovation, firm creation and job growth within the alternative investment management industry based on a foundation of best practices.

Disclaimer

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