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SHIFT IN INSTITUTIONAL ALLOCATION FRAMEWORK MAY HAVE LARGE IMPLICATIONS FOR HEDGE FUNDS

Key Take-aways:

1. Institutional investors are changing the structure of their asset allocation framework, moving hedge funds from a fairly nebulous "opportunistic" bucket to a core allocation

2. Citi forecasts that this switch will help bring in a "second wave" of hedge fund allocations that may top $1 trillion over the next 4 years

3. We feel that the dynamics described in the survey will be particularly beneficial for Absolute Return strategies

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Citigroup Prime Finance has recently published their findings from a fairly in-depth, qualitative survey of institutional investors and their vendors.[i] We highly recommend it as a bit of summer reading for the following reasons (you can download the full report here [ii]):

1. It is a refreshingly qualitative instead of quantitative survey incorporating over 80 hours of dialog with 73 participants in the institutional investment market representing $821 billion in assets. Our view is that qualitative surveys are more enlightening than quantitative surveys due to the subtle nuances that can exist in the investment world.

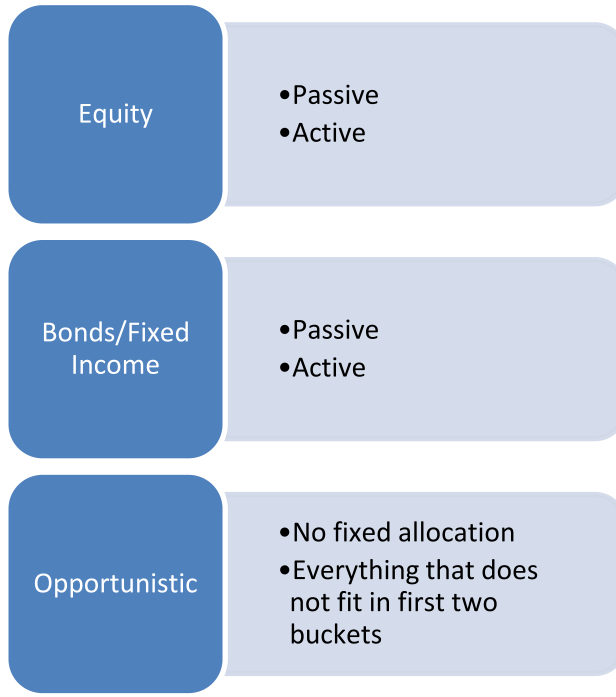
2. It has identified what we feel is a significant structural shift in the institutional marketplace that has several implications for the hedge fund managers. Many of these implications touch on or expand upon themes we have reported in the past.

The New Allocation Frameworks Make Hedge Funds a Core Allocation

The central finding of the survey was that institutional investors are changing the way they bucket their investments for asset allocation purposes, particularly in regard to how they think about alternative asset classes. Specifically, there is evidence that institutions are starting to move hedge funds from a somewhat nebulous "opportunistic" bucket to a core allocation. Citi believes, and we agree, that the net result of these new regimes will be a marked increase in allocations to hedge funds.

"Opportunistic" Approach

Traditional Equity/Bond allocation framework with a third "opportunistic" bucket to capture everything that does not fit in the traditional buckets. By definition, there is no target allocation to the opportunistic bucket (although there is typically a cap). Investments are made on a discretionary basis, generally on the stand alone merits of the investment at hand. Not a holistic approach in that there may or may not be overlapping exposure with the other buckets.



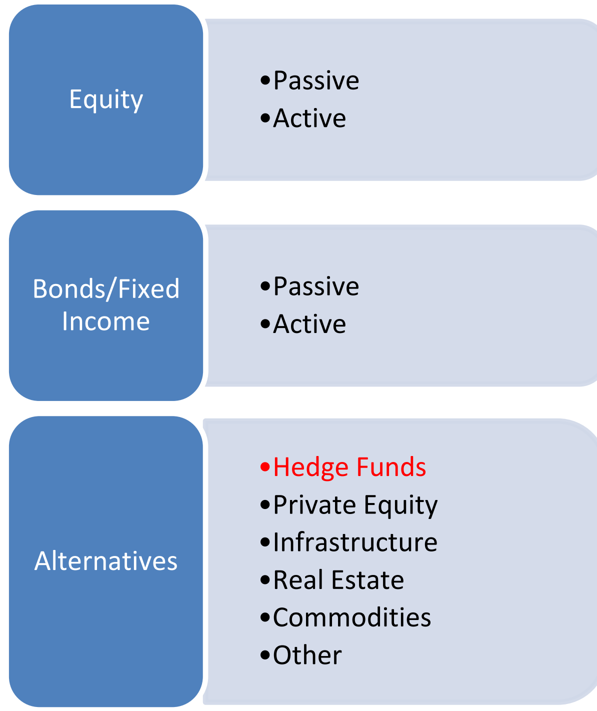
Source: Citigroup

The old hedge fund allocation framework places hedge fund investments into a catch-all "Opportunistic" bucket along with many of the other alternative investments such as Private Equity, Infrastructure, etc. This bucket does not carry a target allocation and investments are made on an ad-hoc basis based on the stand alone merits of the opportunity. The problem with this approach is that opportunistic investments are generally not considered within the context of the whole portfolio. This may lead to less diversification or an unintended overlap with equity/debt exposures. As such, opportunistic buckets are typically held to a small percentage of the overall portfolio.

In order to better integrate alternatives into institutional portfolios, some organizations have replaced the "Opportunistic" bucket with a dedicated "Alternatives" bucket that includes hedge funds, private equity, etc. The dedicated alternatives bucket generally differs from the opportunistic bucket in that it has a fixed target allocation and, hopefully, fixed sub-allocations to hedge funds vs. private equity et al. This gives the organization a clearer picture of their ultimate equity/bond mix since the fixed nature of the allocations will help guard against any "surprise" equity exposure that may come with an opportunistic allocation. It is also our observation that organizations that switch to this allocation framework tend to increase their allocations to hedge funds, possibly because they are better able to gain insights into the performance of hedge funds and how they fit in to the portfolio.[iii]

"Alternatives" Approach

Similar to the opportunistic approach except there is a specific target allocation for alternatives. There may also be target allocations for the sub-sets of the alternatives bucket. This provides for enhanced visibility into the ultimate equity/debt mix of the portfolio since there are predictable allocations. When properly deployed, it can place an increased emphasis on diversification. In our experience, organizations that switch to this allocation framework are more likely to increase their hedge fund exposure.



Source: Citigroup

However, Citi has found that investors may be switching to a risk-based allocation framework. This framework groups assets together by underlying risk. The impetus for this allocation framework seems to have arisen out of the global financial crisis, which highlighted the fact that many asset classes share common baseline risks. It also was born out of the realization that the "alternative" asset class was less a monolithic block of exposure and more a mosaic of many, very different exposures. As such, this allocation framework seeks to bring all asset classes back to their fundamental risk exposure: Equity, Inflation/Stable Value, Absolute Return, and Real Assets.

For example, Private Equity gets moved into the equity bucket, Infrastructure and Real Estate get moved into the "Real Assets" bucket, and Commodities gets moved into the "Inflation" bucket. Importantly, this allocation framework recognizes that "hedge funds" are not a single asset class, but a collection of different asset classes/strategies that can have very different fundamental risk exposures. As such, the hedge fund sub-bucket is broken down into its components and distributed to the most appropriate risk bucket. For example, a long/short equity fund that generally maintains a high net-long market exposure would be appropriately placed in the "Equity" bucket since it may have a 70-80% correlation to the S&P 500. However, a market neutral fund that maintains a zero net exposure would be appropriately placed in the "Absolute Return" bucket.

There are several key advantages to the risked-based framework that we believe will continue to drive it more into the mainstream of asset allocation:

1. It dispenses with the empirically incorrect notion that all alternatives are similar from an investment standpoint. As it turns out, nothing could be further from the case. Proper deployments of this framework will also account for the fact that different hedge fund strategies can perform very differently. By switching from an "asset-class" based approach to a risk-based approach, investors now have the flexibility to analyze investments by what they do, not by what they are called.

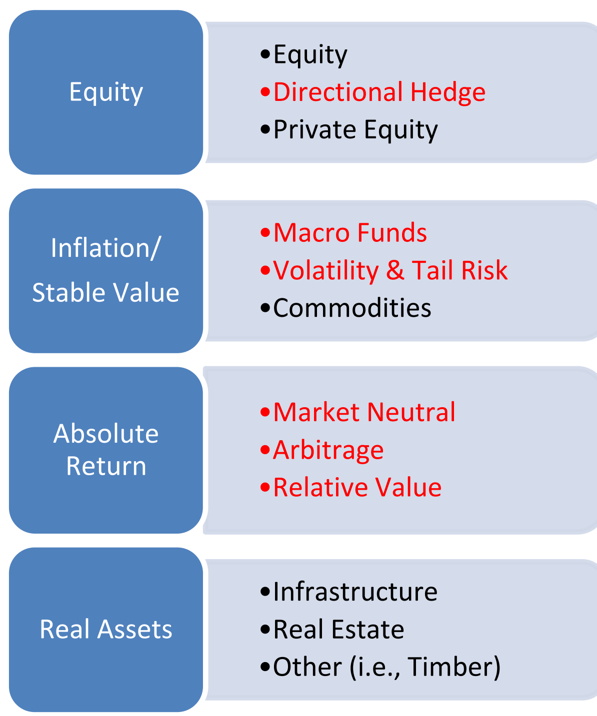
2. It allows investors to better understand their risks, particularly in regard to scenario analysis. It is our belief that many investors were surprised by the amount of fundamental equity risk in their portfolios during the global financial crisis. Allocating in this manner may help to make such a surprise less likely in the future.

3. It can help to emphasize true diversification, which can help promote more stable return rates over time and across cycles.

The adoption rate for this allocation framework is still low, but growth is increasing and we believe it will become the dominant model within 5 years (at least with respect to the existing models).

"Risk-Based" Approach

Assets and strategies are grouped together based upon key risks. Key risks buckets are generally along the lines of Equity (Economic Growth), Inflation, Absolute Return (No/Low Systemic Risk), and Real Assets. The hedge fund sub-bucket is dispersed based upon sub-strategy and primary risks for that sub-strategy. We note that Citigroup puts Volatility & Tail Risk into their Inflation/Stable Value bucket, but we feel that this is a bit off the mark unless the strategy is specifically paired with a directional strategy to create a stable value product.



Source: Citigroup

Sparking the "Second Wave" of Hedge Fund Allocations

Citi believes that switching the allocation framework in this manner will help usher in a "Second Wave" of hedge fund allocations that may top $1 trillion by 2016. It is unclear to us if the new allocation framework will drive the demand for hedge funds or if a heightened demand for hedge funds is what is actually driving the new allocation framework, but we suspect that the answer is "both."

In our view, the biggest effect the risk-based framework will have in the near term is to increase the understanding of the proper uses and benefits of hedge funds in a portfolio. Although institutions have made significant strides in this area, most investors are still not as comfortable investing in hedge funds as they are in more established asset classes. We have observed that, as investors gain comfort and expertise around hedge fund investing, they tend to increase their allocations.

In general, there are three ways that the new allocation regimes increase investor knowledge:

1. By shifting to a core allocation, investors are essentially forced to think deeply on how that allocation fits in with the portfolio. Under the "opportunistic" approach, investors only had to think about a particular hedge fund as a separate entity.

2. As a separate line item, hedge fund performance will now be more visible, which will hopefully illustrate the portfolio benefits of hedge funds in a more tangible manner.

3. We feel that many institutions will now develop in-house hedge fund expertise, or at least will have a hedge fund expert incorporated into their allocation process in some way.

4. By switching to a risk-based framework, investors will finally realize that "hedge funds" are not a monolithic asset class, but a collection of very different strategies that have different risk and benefit profiles.

The Rise of Absolute Return Strategies

We believe that a shift to a risk-based allocation framework will be of particular benefit to absolute return managers as opposed to directional managers. As a point of clarification, directional strategies hedge some, but not all, market exposure while absolute return strategies seek to hedge all market exposure. The clearest illustration of this is perhaps Long/Short Equity (directional) vs Market Neutral Equity (absolute return). We have noted in prior publications that there are several secular and cyclical themes may serve to increase investor preference for absolute return strategies vs directional hedge strategies:

1. Increased desire to lower portfolio volatility.
2. Increased comfort level and understanding of more complex hedge fund strategies.
3. Increased perception of hedge funds as a diversifying investment instead of just a return generating investment.

We now add to this list the advent of a risk-based allocation framework. With a separate and dedicated allocation bucket, we believe allocations to absolute return will increase disproportionally relative to directional strategies. If nothing else, creating a discrete and observable allocation bucket for absolute return will shine a fair amount of daylight on the performance of these strategies. If past performance is any guide on the matter, we believe that investors will come to fully understand and approve of the diversification benefits of absolute return strategies and will allocate accordingly. Although the absolute return bucket will undoubtedly start off on the small side at many institutions, as investors gain confidence and expertise, we would not be surprised to see allocations to absolute return become material or even strive to rival equity allocations, particularly if LDI takes greater hold in the US.[iv]

This is not to say that directional strategies will not also experience growth. In fact, we believe that placing Long/Short Equity in the Equity bucket may serve as a significant catalyst for increased allocations given the current sanguine outlook for equity performance and the post-2008 view that protecting to the downside is more important than achieving double-digit returns. Given the sheer size of institutional equity allocations, we expect the absolute amount of dollars flowing into the Long/Short Equity strategy could be quite large.

It is possible, or perhaps even likely, that the absolute amount of dollars flowing into directional strategies is larger than for absolute return strategies in the immediate term. However, there are two mitigating factors to consider when assessing the opportunity in absolute return strategies from a business development standpoint:

1. The existing absolute return universe is much smaller than the directional universe both in terms of number of managers and assets deployed. When assessing the relative opportunities, we feel it is important to look at the *percentage* growth, not the *absolute* growth. We estimate that the percentage growth in absolute return demand will far outstrip that of directional strategies.

2. There are several strong themes unfolding that favor absolute return, as noted earlier.

3. We feel it is becoming increasingly important for managers to present a *diversified* product offering. Looking back to our experience in the 1980s, we saw that diversified equity managers ultimately prevailed over boutique managers. We feel the same dynamic will play out again in the hedge fund space this decade. Given that most hedge funds are one-product directional, this may pose a business risk at many hedge funds.

We strongly advise all managers to launch at least one absolute return strategy. Preferably, these strategies should be somewhat synergistic with the manager's main-line products. From the standpoint of a Long/Short Equity manager, we would recommend fundamentally-based strategies within the equity, convertible debt and equity option asset classes such as: Equity Pairs Trading, Convertible Arbitrage, Merger Arbitrage, and Fundamental Volatility. Equity Market Neutral may seem like a synergistic choice at first, but unless the manager has sufficient quantitative and technological resources in place already, a fairly sizeable upfront investment may be required.

Above all, we would discourage directional managers from simply wrestling their net exposure down with broad-based short futures to create an "absolute return lite" strategy. In our experience, investors take a dim view of this practice, although such a product might enhanced if more value-added hedging strategies were employed, such as long volatility.

[i] "Institutional Investment in Hedge Funds: Evolving Investor Portfolio Construction Drives Product Convergence" Citigroup, June 2012

[ii] Full link for paper: http://icg.citi.com/transactionservices3/homepage/demo/tutorials41/IIHF_June2012/

[iii] An alternative explanation might be that institutions switch to this framework because they desire to increase their hedge fund exposure. However, even if this is the case, we believe a dedicated alternatives/hedge fund bucket allows for more productive observation of performance, which in turn can lead to increased allocations.

[iv] For more detail, see Kendrick Wakeman, CFA, "A Secular Growth Case for Absolute Return" *Alternative Markets Update Series,* 21 APR 2010