

How Investors Choose Hedge Funds

Advent Industry Intelligence

Results of the Advent Hedge Fund Investor Survey

August 2013

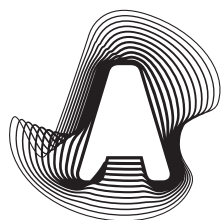


Key Findings

1. Investors say they often see managers who cannot clearly differentiate their strategy
2. Many investors decide within the first half hour of a pitch whether or not to continue
3. Operational quality is one of the most important considerations when investors and consultants evaluate a hedge fund
4. Large institutional investors are not likely to choose hedge funds that do not have a system of record in place for their investment process
5. Three out of four investors want to see research management systems in place at funds they are considering

With 10,000 hedge funds competing for the attention of investors, raising capital has never been more competitive. Demonstrating an edge is increasingly difficult in an environment where overcapacity means opportunities to produce alpha are being crowded out. Despite institutional commitment to hedge funds, recent widespread underperformance has many investors in a more skeptical frame of mind. The introduction of advertising to what has historically been a word-of-mouth business may further muddle messages. And success does not necessarily beget success. Because hedge funds are often thought to be most successful before becoming too large to effectively execute their strategy, investors tend to hunt for emerging managers. The playing field is wide open.

Investors and consultants all have their own ways of meeting, evaluating, and choosing the hedge funds with whom they want to invest. There is no prescription for success, but hedge fund managers who take the time to better understand industry best practices and the needs of their prospective investors will be several steps ahead of their less well informed competitors.

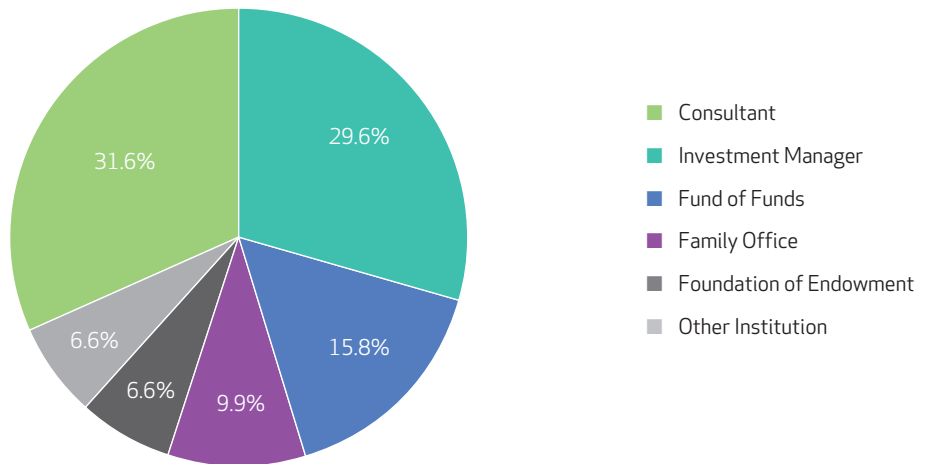


ADVENT

How hedge fund investors and consultants evaluate and choose funds.

% of respondents

Advent surveyed hedge fund investors and consultants in early 2013 on how they evaluate and choose hedge funds. A total of 152 responses came from investment advisors, funds of hedge funds, family offices, foundations, endowments, and pension plans. Assets under management ranged from less than \$100 million to more than \$50 billion. Individuals responding to the survey were typically employed in investment or operations functions.



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Advent surveyed hedge fund investors and consultants in early 2013 on how they evaluate and choose hedge fund managers. In this brutally competitive environment, the 150+ responses to the survey shed light not only on what investors look for when making new hedge fund investments, but also what stumbling blocks fund managers should take pains to avoid as they make their pitch.

Connecting with Capital

It used to be that hedge funds could pick and choose investors like high end nightclubs selecting the most desirable clientele. The velvet rope is now gone, and investors are in the enviable position of being able to invest with managers of their choosing. The new paradigm is not without its disadvantages, the most obvious being the question of how to find the right manager in the first place.

Personal networks remain the most useful channels for sourcing hedge fund managers according to most investors and consultants (Figure 1). It may seem counterintuitive to rely on the relatively limited perspectives available among friends and acquaintances, but the trust embedded in such relationships is valuable. Market reputation is also widely seen as a useful channel. If managers wish to be top of mind on the cocktail circuit, they should consider a range of promotional activities that could raise their profile. PR strategies,

sponsorships, and thought leadership campaigns can all create buzz.

Manager databases present a more straightforward way of getting investors to take notice. Databases from firms like HFR, HFI, and Morningstar are all seen as useful channels, with consultants indicating that they are particularly avid users.

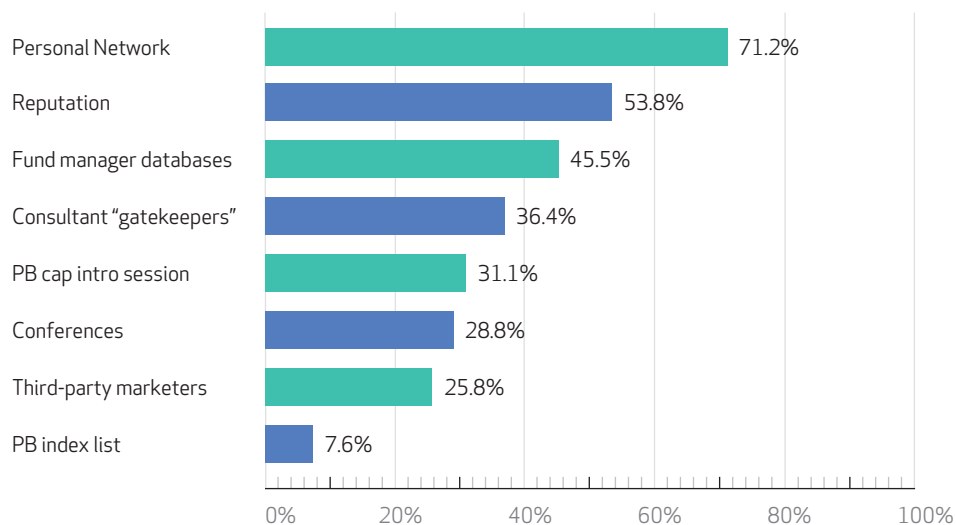
Hedge fund managers using third-party marketing firms may not want to make them a centerpiece of their distribution strategy. Only one in four survey respondents view these firms as an important way for them to source hedge fund managers.

Conferences can play an important role in connecting funds to capital, but fund managers will not want to limit their fundraising strategies to the conference circuit. Many investors participating in the survey made a point of saying they do not often attend or source managers at conferences. Foundations and endowments are the least likely to attend conferences, while family offices, investment advisors, and consultants are the most likely to find conferences useful in identifying hedge fund managers. Events sponsored by GAIM and Goldman Sachs are the most likely to be attended by investors searching for new hedge funds. Other conferences of note include those hosted by AlphaMetrix, Bloomberg, Institutional Investor, HedgeWorld, Morgan Stanley, and Morningstar.

Figure 1

What are the three most useful channels for sourcing hedge funds?

% of respondents



Long-winded presentations are a common problem.

Two thirds of all investors and consultants decide within the first half hour of a pitch whether or not they intend to continue.

Making the Pitch

Introductions are only the beginning, leading to pitch presentations that can often make or break budding relationships between investors and fund managers. Consultants and most types of investors hear fewer than ten presentations a week, underscoring the fact that pitch opportunities should not be taken lightly (Figure 2). Family offices tend to attend more pitch presentations than other investors, a fact that fund managers should be aware of if raising capital from this segment of the market.

There is broad consensus that pitch presentations are best when 11 to 30 slides in length (Figure 3). Fewer than 20 slides are preferable. Consultants in particular like concise decks. Pension funds, on the other hand, are more patient, with almost half saying 21 or more slides are appropriate.

About two thirds of all investors and consultants decide within the first half hour of a pitch whether or not they intend to continue evaluating a fund (Figure 4). Of these, one in four makes a decision within the first ten minutes. Family offices, which see the most pitches, tend to reach a decision the most rapidly. FoHFs and investment advisors are also quick to pull the trigger. Endowments and pension plans tend to take the longest time making decisions, with more than a third waiting until after the initial meeting. Whether or

not they change the actual length of their decks, fund managers may want to pace their presentations according to their audience.

Presentation Mistakes

Overly complex or long-winded presentations are a problem, but blithely abridging a presentation can lead to other problems. Half of all investors and consultants say it is all too common for data to be presented without sufficient explanation.

Despite strides in the right direction over the past few years, transparency in general remains a problem. More than half of those in the survey say there is not enough of it in the pitches they attend. Transparent investment processes are likely to score points for managers making a pitch. Research management systems may be used by astute managers wishing to illuminate some of the more complex aspects of their investment processes.

Fund managers will be even more successful if they take the time to do a little homework on their audience. Highlighting an approach that is probably an artifact of an earlier time when fund managers held all the cards, more than four out of ten investors say too many managers do not know enough about their needs.

Figure 2

How many pitches do you attend in person or via phone/online?

% of respondents

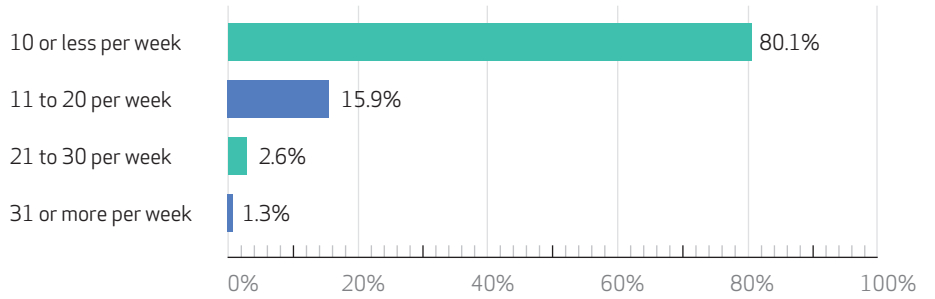


Figure 3

How many slides do the most successful pitch books contain?

% of respondents

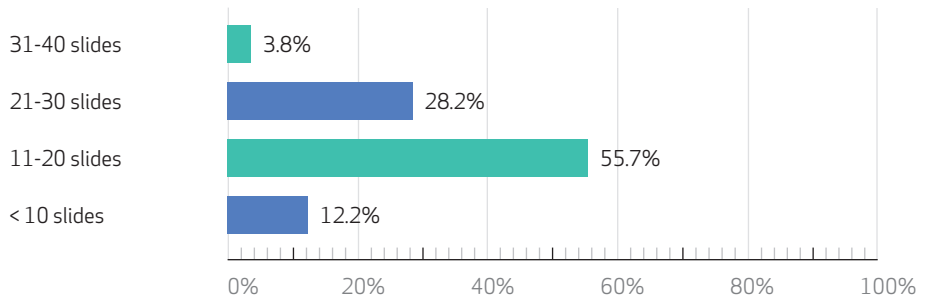


Figure 4

After how many minutes into an initial pitch presentation do you decide whether or not to continue evaluating a hedge fund?

% of respondents

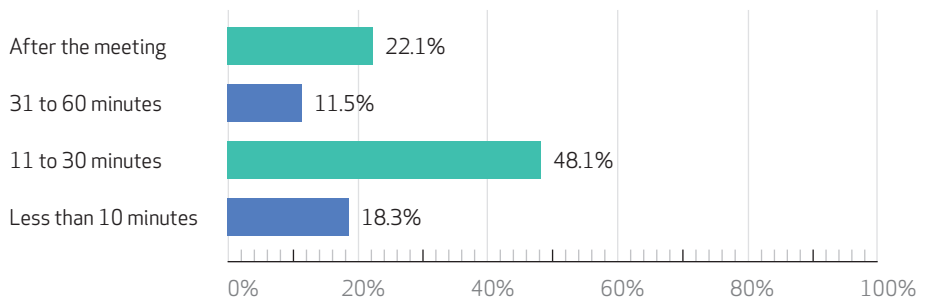
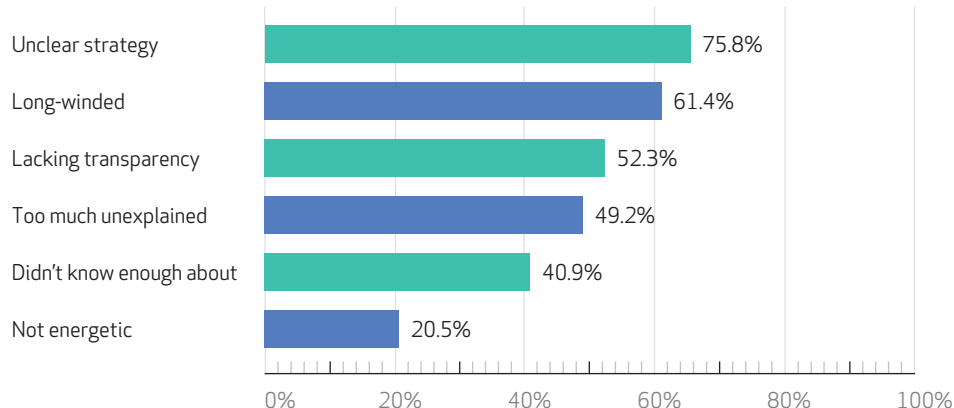


Figure 5

What are the top three mistakes that funds make when pitching to prospective investors?

% of respondents



Three out of four investors say they all too often see presentations by managers who are unable to clearly differentiate their strategy.

The most common mistake? Three out of four investors say they often see presentations by managers who are unable to clearly differentiate their strategy or effectively communicate the advantages of their fund (Figure 5). This is a call to action for hedge fund managers. Investors want to know how you plan to invest their capital, but they also need to know how your approach is distinct and superior to the thousands of other investment strategies available to them.

Evaluation Criteria

How do investors evaluate funds in which they are interested? Risk-adjusted returns are commonly used as an early screen. Many also look at volatility statistics. Liquidity terms became another common criterion in the wake of the financial crisis. Beyond these commonly used measures, investors are most likely to look at the caliber and integrity of the professionals running a fund (Figure 6).

Transparent and Robust Ops

Highlighting the growing institutionalization of the business, investors say the quality of fund operations is the next most important evaluation criteria. Over half of those responding to the survey say transparent reporting is one of their top three evaluation criteria. Managers lamenting

the apparently insatiable appetite among investors for more transparency may be heartened by the tradeoff; fewer investors are looking for investment teams to be readily accessible.

Investment consultants are more likely to appreciate demonstrably efficient and repeatable processes, once again underscoring the benefits of systematic approaches and tools like research management systems. Consultants also place slightly more emphasis on due diligence, saying that a manager with a proven ability to perform exhaustive research would boost their confidence (Figure 7).

Investors, on the other hand, are more likely to highlight transparency in the research process. Half say it boosts their confidence. Some types of investors are more likely to need hand holding. Family offices, for example, are the most likely to say that better reporting capabilities would inspire confidence in a manager.

Mission Critical Systems

Supply and demand dynamics have shifted and investors are in the driver's seat. A charming personality and a black box approach is no guarantee when raising capital. With an increasingly attentive and demanding audience, hedge fund managers need to be able to demonstrate a differentiated strategy, solid operation

Figure 6

What three characteristics are most important to you when evaluating a fund (beyond risk/return, volatility and liquidity)?

% of respondents

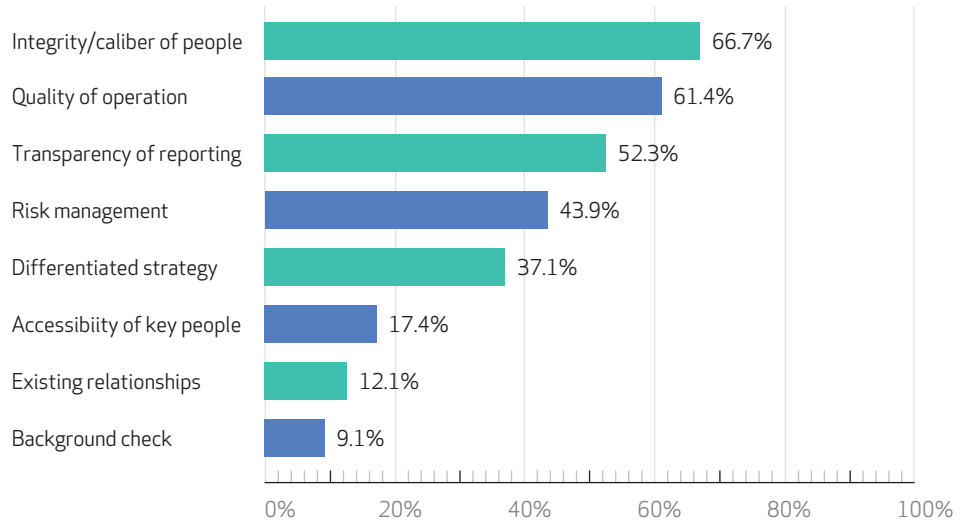


Figure 7

What factors would improve your confidence as an investor most beyond performance?

% of respondents

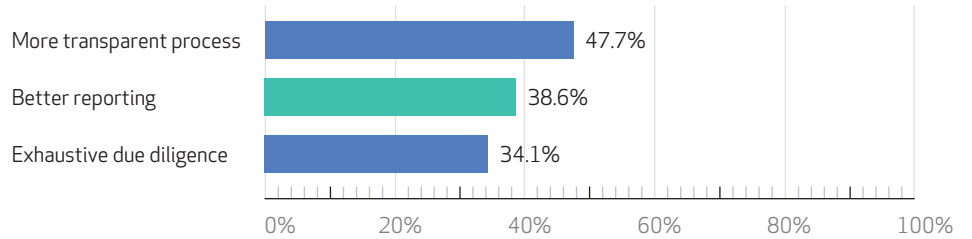


Figure 8

How important is it for funds to have a portfolio management, reporting and accounting system in place?

% of respondents

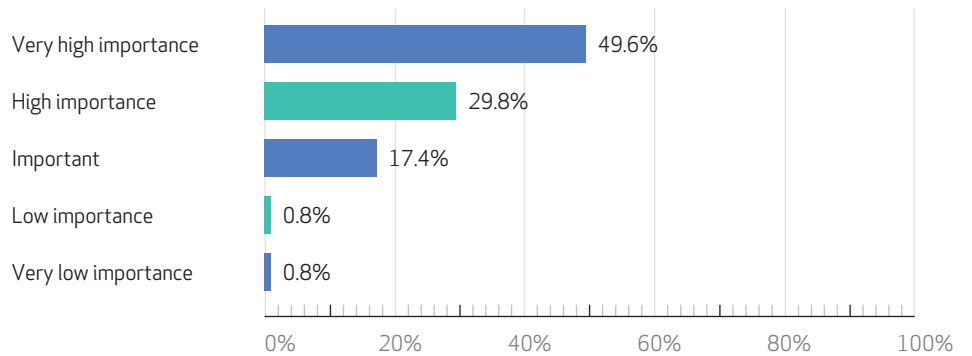
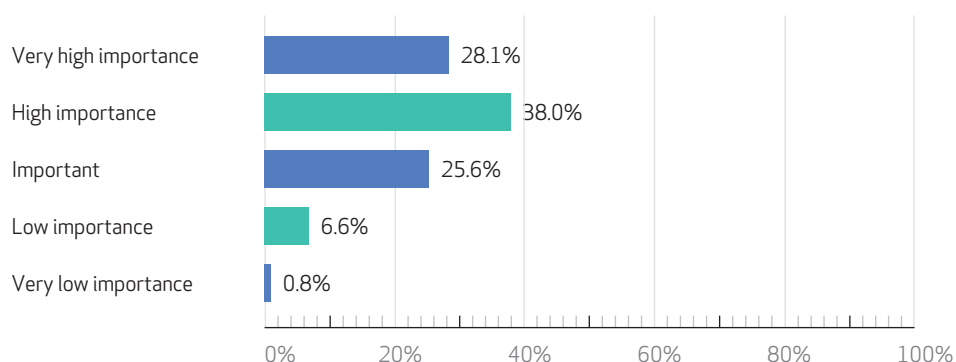


Figure 9

How important is it for managers to have a system of record for their research and investment decision-making process?

% of respondents



It is critical that hedge fund managers have a system of record in place for their investment process.

backbone, effective reporting capabilities, and thorough risk management.

A well-rounded operation requires robust technical underpinnings. Investors and consultants are almost unanimous in saying they would like to see portfolio management, reporting, and accounting systems at hedge funds where they consider investing their capital (Figure 8). They are also inclined to agree it is critical that hedge fund managers have a system of record in place for their investment process (Figure 9). This is a particularly critical issue among larger organizations. Not a single investor administering more than \$5 billion says that a system of record is of low importance, and all of those with \$50 billion or more say it is of “high” or “very high” importance.

Managing Research

Research management systems (RMS) are also important. A research paper released by Advent in 2010 (Bringing Order to Chaos: Managing Investment Research in an Era of Change) highlighted some of the challenges confronting managers faced with an unprecedented volume of information. A thorough study of research processes found that two thirds of investment professionals were overloaded by information and concluded that:

“Despite being at the very core of most organizations’ value proposition, research

often remains scattered, disorganized, and largely unmanaged. The costs cannot be overstated. Intellectual capital evaporates. Institutional memory is constrained. Collaboration becomes more difficult. Time and expensive resources are wasted.”

Effectively integrating and leveraging meeting notes, expert commentary, sell-side research, market data, and internally developed models is challenging at the best of times. Increasingly demanding investors and regulators make the case for an RMS even more compelling. It is no wonder that three out of four respondents like to see such systems in place (Figure 10). Systems from external vendors are preferred, particularly among consultants and larger investors.

Hitting the Right Notes

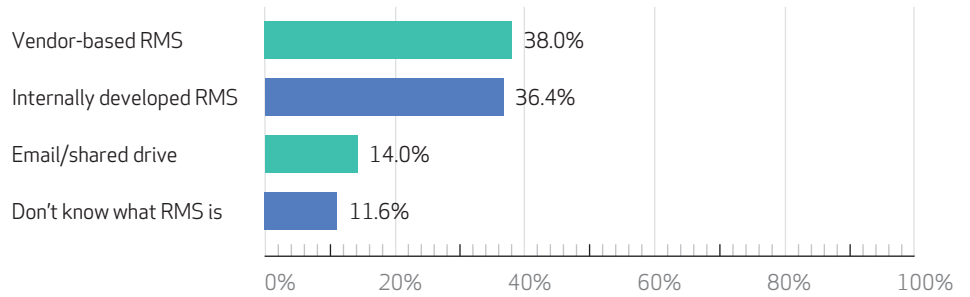
Today’s hedge fund investors are no different from their predecessors in that most are simply looking for exceptionally talented teams who can deliver superior risk-adjusted returns. How they go about finding, evaluating, and choosing these teams, on the other hand, is worlds apart from the relatively casual approaches employed in the past.

Personalities and investment strategies may or may not resonate, but in this ultra-competitive market, institutional investors have raised the bar and hedge fund managers need to step up their

Figure 10

Which type of research management system (RMS) or support do you prefer to see at funds for prospective investment?

% of respondents



Increasingly demanding investors and regulators make the case for a research management system even more compelling

game in order to meet heightened expectations. Understanding the needs of their prospective investors, articulating a strategic edge, and having the appropriate systems in place should help in distinguishing themselves in a crowded and competitive, and challenging market.

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