RESEARCH PAPER

DiMeo Schneider & Associates, L.L.C.

Recent Trends in Hedge Funds

An Ever-Evolving Industry

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During the last few years, the hedge fund industry has seen its share of undesirable headlines, and yet investors continue to allocate to the space, with portfolio managers adapting to this ever-evolving industry. Here, we highlight some key trends, including the expanded definition of the term "hedge fund", increased competition for assets and corresponding fee pressure, the rise of quant shops, demand for exposure in Asia and the launch of impact funds as well as the incorporation of ESG factors. As Heraclitus the Greek philosopher once said, "change is the only constant in life."

New Structures to Meet Investor Interests

"Hedge funds" are not an asset class, as cited in previous research papers, but rather a legal structure facilitating an amalgam of strategies invested across asset classes. While this statement holds true, some managers have expanded the definition to include investment vehicles that are not typical hedge-fund structures.

The term "hedge fund" might include structures such as co-investment vehicles, separately managed accounts, drawdown vehicles and '40 Act mutual funds. Hedge fund managers introduced funds to meet the demands of various types of investors. When the market demanded better liquidity and lower fees, '40 Act funds were in vogue. More recently, investors' increased willingness to lock up capital has resulted in the launch of drawdown vehicles. As a result, reported assets under management can include a more expansive universe of strategies and funds.

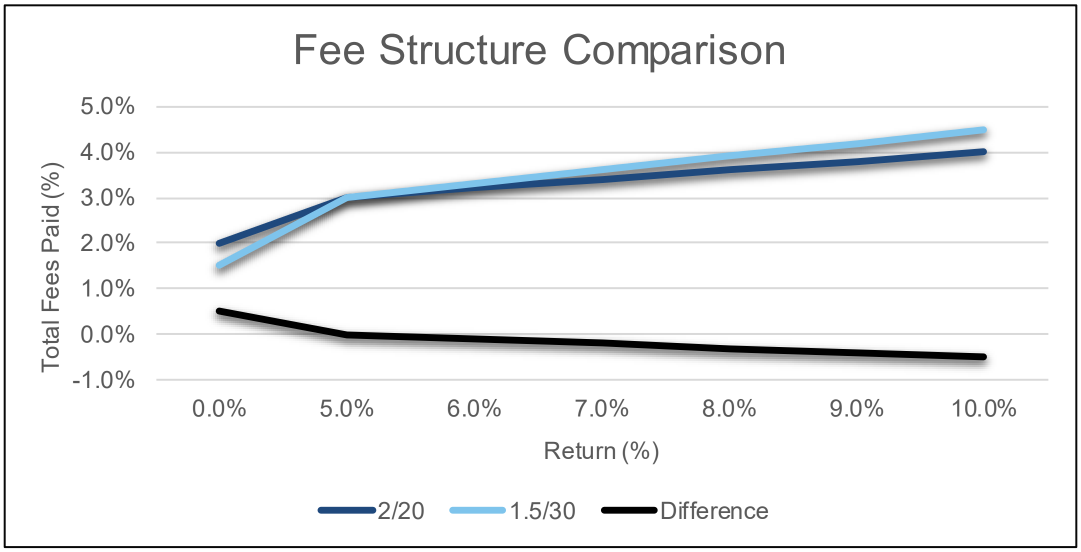
Fee Pressure

With regards to co-investments, we have seen managers continue to invest and upsize specific investment opportunities outside of their main strategies. This could be due to a compelling opportunity that may breach certain position-size and/or liquidity limits in the fund, or it could simply be because the hedge fund might lack the necessary cash to take advantage of the opportunity.

Typically, only a performance fee is charged on these assets, so the investor earns a lower management fee across their respective asset base since it includes the co-investment. Investors have sought co-investment opportunities that allow them to capitalize on "best ideas" and lower fees.

Co-investment vehicles are an example of the solutions created to address increased fee pressure. The new-launch environment has been challenging in recent years and most hedge fund managers cannot charge a two percent management fee and a 20 percent performance fee out of the gate. Therefore, hedge funds have introduced lower management fees, even as low as zero, in exchange for higher performance fees.

However, this example shows that a client might pay more in fees under this structure despite lower management fees.



Source: DiMeo Schneider & Associates, L.L.C.

Alternatively, managers offer longer lock-up vehicles in exchange for lower management and performance fees. We have even witnessed managers introduce hurdle rates, which are a minimum required return on investment prior to earning a performance fee. We expect this trend to continue as hedge funds are faced with steep competition for assets and investors push for lower fees and stronger alignment.

Rise of the Quant Shop

Big Data! Artificial Intelligence! Machine Learning! The industry greatly accelerated its reliance on technology to source, research and trade investment ideas. The reallocation of capital to quantitative and systematic strategies has altered the markets for fundamental investors.

Understanding how these new and powerful trading participants act allows managers to better execute bottom-up and company-specific views. Prudent hedge fund managers have and continue to incorporate quantitative tools into their investment process. These managers blend sophisticated technology with human acumen to drive alpha.

Many managers have tried (and some have failed) to develop statistical arbitrage strategies. The challenge for these managers is they do not have the depth of talent or institutional knowledge for a competitive edge. Within the last few years, many concluded they cannot compete with the large and reputable quant shops. We have seen numerous managers exit the statistical arbitrage business.

Investor assets flowed to the most reputable and tenured managers in the space. For decades, these managers have constructed proprietary models and have teams of PhDs, coders and data-scientists as opposed to the more traditional Wall Street-trained analysts. They have deep resources and invest heavily in research and development. We believe that these quant shops will continue to be successful in the space for the foreseeable future.

Demand for Asia Exposure

Investor appetite for Asia continues to grow despite geopolitical fears and concerns regarding the validity of Chinese economic data. According to a recent investor survey conducted by Preqin[1], institutions are investing more globally as of Q3 2020, possibly to mitigate country-specific COVID-related risks in domestic financial markets. Preqin also notes that the proportion of fund searches in the Asia-Pacific region has increased from 20 percent to 24 percent year-over-year.

Despite China and Japan being the second and third largest economies in the world, respectively, most investors' portfolios are underweight the region. Those same investors have recognized the value in gaining exposure to other economies. In addition to investing in high-growth countries like China and India, investors also see the importance in improving geographical diversification to reflect a more global portfolio.

Incorporating Impact Investing and Environment, Social and Governance Criteria

A trending topic in the industry among asset managers right now is mission aligned investing, including impact investing and the incorporation of environment, social and governance ("ESG") considerations. Mission aligned investing within the hedge fund space is both in its infancy and a more challenging exercise relative to other asset classes (specifically that of private markets). Hedge fund managers have been slow to adopt these mandates, many noting a lack of consistent and robust sustainability data as the biggest hurdle.

There are an increasing number of hedge fund managers that have launched impact investing funds while others introduce ESG criteria as factors into their investment process. These are typically in the event-driven or equity long/short space, and many tend to be long-biased. These managers invest with a more private equity style mindset and rarely use hedging techniques. For many hedge fund managers, however, it simply does not make sense to employ an impact investing strategy. This is especially true for managers who trade at high frequencies or rely on holding securities for short periods of time, as well as managers who trade currencies, managed futures or structured credit products.

Our clients invest across a broad range of hedge fund strategies, many of which are not conducive to mission aligned investing. Given this is one of the fastest-growing areas in money management, we expect hedge funds to adopt such mandates with increased fervor; as a result, overall, we plan to monitor the launch of these strategies accordingly.

For more information, please contact any of the professionals at DiMeo Schneider & Associates, L.L.C.

[1] *Preqin Quarterly Update: Hedge Funds Q3 2020, October 2020.*

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Angelique is a Senior Research Analyst in the firm's Global Private Markets Group. Within this group, Angelique is responsible for sourcing and performing due diligence on investment opportunities across private equity, private credit and private real assets. Angelique is a member of the firm's Global Private Markets Group and Global Hedge Fund Strategies Group. Prior to joining the firm in 2018, Angelique was a Senior Investment Analyst at Granite Associates and an Investment Research Associate at Utah Retirement Systems. Angelique graduated summa cum laude with a BA in Finance from Westminster College in Salt Lake City. She is a CFA® charterholder and a member of the CFA Society of Chicago, the CFA Institute and 100 Women in Finance. Angelique is also pursuing her MBA from the Kellogg School of Management at Northwestern University. She enjoys world-travel, cooking, reading and being active in her free time.