What do Investors Want?

2008 was a traumatic year for investors in pretty much any asset class or strategy. In 2009, I’ve been reading a number of investor surveys seeking to discover what investors want. I am as usual focusing in particular on the hedge fund industry.

Key findings:

1. Investors continue to favour larger hedge funds in the 1 to 5 billion USD range.
2. There is a decided preference for managed accounts.
3. Investors are against leverage of any sort.
4. Investors require better risk management and transparency from their managers.
5. Performance remains the number one factor in assessing a hedge fund manager.
6. Investors expect global macro, CTAs and equity long short to perform best going forward.
7. In terms of what they intended to invest in, investors preferred global macro, distressed credit, CTAs and credit long short.

It is difficult to comment on these findings without knowing the history and context of the investors. One can make a couple of simplistic observations.

1. If larger investors favour larger hedge funds, you will end up with the larger investors having more hedge funds in common. Also, you will end up having more hedge funds with investors in common. This creates a very interesting and amusing correlation through instrument variables. The investors are each others’ hidden instrument variables with the dual situation that the hedge funds are each others’ hidden instrument variables.
2. The case for and against managed accounts is best dealt with in more detail in another article. With a managed account one gets validation of assets, better liquidity, better transparency, no gating, independent valuation, ability to be the sole investor. Yes, maybe, yes, yes, yes, and yes. Validation of assets is unparalleled in a managed account especially if the managed account is established by the investor. Independent valuation is

available through appropriately structured hedge funds. Better transparency is also unparalleled through a managed account but can be available through an appropriately structured hedge fund. No gating is definitely a plus. But better liquidity is not so clear. If the underlying assets are illiquid, the ability to sell them is really the ability to fire-sell them. Then it becomes, I want a managed account where I am the only investor who can fire-sell assets but I want everyone else in the fund to be gated or suspended. Not really feasible. If the assets are indeed liquid, a managed account means that the investor has full benefit of the liquidity of the underlying market. On the other hand, there are costs associated with managed accounts that require a minimum size which can be quite sizeable. The performance of the managed account may not track the performance of the commingled fund for all sorts of reasons. Some assets are not divisible. Timing issues can result in managed accounts not having the same portfolio compositions as the commingled fund. And there are a host of other issues which may be neither good nor bad but complicate the implementation and analysis of managed accounts.

3. See my article on Leverage on 17 March 2009: **Leverage: Nothing is Good or Bad…**
4. Investors require better risk management and transparency from their managers. Transparency is one of the most important factors in the investment decision because at its heart is the ability to verify the representations made by a manager pre-investment. It allows investors to see if managers are doing as they say they would. Transparency goes beyond mere position level reports. Position level reports are useful to prove the assets and the strategy. Risk reports are useful and reduce the complexity of the position level reporting to a more manageable form. Having access to the manager and to the various people in the team are important elements of transparency as they provide not just the static snapshot of risk, or the historical trading behaviour but they also provide an insight into the views and intentions of the manager on a forward looking basis.
5. Performance is a difficult one. Everyone loves a fund that is generating good returns whether they are high or stable. But how does one distinguish between skill and luck? Track record is but one measure. (See my article 22 Jan 2008 about **The Importance of Track Record in Hedge Fund Investing**) See also my articles **Skill and Luck 1, and Skill and Luck 2**.
6. I find it quite interesting that investors expect global macro to do well going forward. At risk of being circular, the call that global macro should

do poorly or well in a given year is a global macro call in itself. Thus, the only people who can claim that macro will do well at any particular point in time is someone qualified enough not to need to outsource macro to some guys who charge 2 and 20 to take your money to have a go at Roulette. If you don’t know whether macro will do well or not then you outsource to a macro manager whose head of marketing will tell you that macro will do well this year.

7. It is interesting to note that investors want to increase their allocations to credit hedge funds, a strategy which they do not have a strong opinion about in terms of returns.

Obviously there are more interesting things going on behind these findings and my comments are on the output without the benefit of the underlying data.