Survey of Allocators' Investment Trends
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Scope of Survey

The hedge fund industry stands at about $3 trillion in AUM with an average performance of 6.2% in 2016[1]. The S&P 500's performance was 13.4%. On a sector basis, funds in Distressed Securities were up 14.4%, Event Driven gained 11.3%, Emerging Markets were up 10.3%, and Merger Arbitrage gained 6.1%[1]. Private Real Estate returned about 14.9%[2], while Private Equity returned about 16.4%[3].

We are happy to continue publishing this survey, now in its fifth year, as we try to discern industry trends. In this survey, we explore trends across time for the years 2013-2016, and show how compelling alternative investment products are among and between each other, and compared to other investment destinations like cash, mutual funds and ETFs.

Executive Summary

2016 proved to be mixed year for the alternative investing industry, with hedge funds facing challenges while other alternative assets faring better. Hedge funds' average performance have been unable to match most of the equity and bonds markets. However, in general, the interest in allocating to alternative funds in 2017 shows a slight uptick compared to 2016. This strength is probably due to heightened political uncertainty and favorable opportunistic investments generated by the new American administration's pro-growth policy that can't be harnessed by traditional investment vehicles. Going forward, we could expect some support for the alternative investing industry with its active management styles that are more prepared to take advantage of asset pricing dislocations.

Our survey shows that investors are cautiously optimistic about investing into alternatives. Among the investors who express interest, about 35% believe that "now should be a good time" to invest in a fund, while 40% have a "wait and see" attitude, and 25% are struggling with finding an appropriate fund manager.

The costs associated with high fees and administration are the largest deterrents in the decision whether or not to allocate to alternative funds.

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[1] BarclayHedge: online performance rankings for 2016
[2] Preqin Global Real Estate Report 2017: annualized for last three years till June 2016
[3] Preqin Global Private Equity Report 2017: annualized for last three years till June 2016

Alternative asset strategies such as direct investments, private equity and real estate funds remain attractive options for investors, arguably due to the more compelling returns achieved. Direct investments are in particular getting a lot of attention as they potentially provide high alpha returns resulting from high barriers-to-entry assets and without intermediary fees.

Alternative fund managers are also facing tough competition from exposure and smart beta products such as ETFs and mutual funds, especially since the broader markets have enjoyed some 'Trumpflation'.

Portfolio characteristics continue to be a very important factor in allocation decisions. However, the generation of alpha - delivering a meaningful, index-benchmarked net return – is key and the attribute that motivates investors the most.

For hedge funds, low-correlation strategies remain the flavor of the year. As 2016 ended up with a bang in equity market and short term volatility hovered at historic lows, investors in 2017 seek out strategies with diversification benefits and downside protection. The top choices are L/S Equity, Quant & CTAs, Emerging Markets, followed by Credit & Fixed Income. Emerging Markets is the sector that seen the most improvement in investor sentiment.

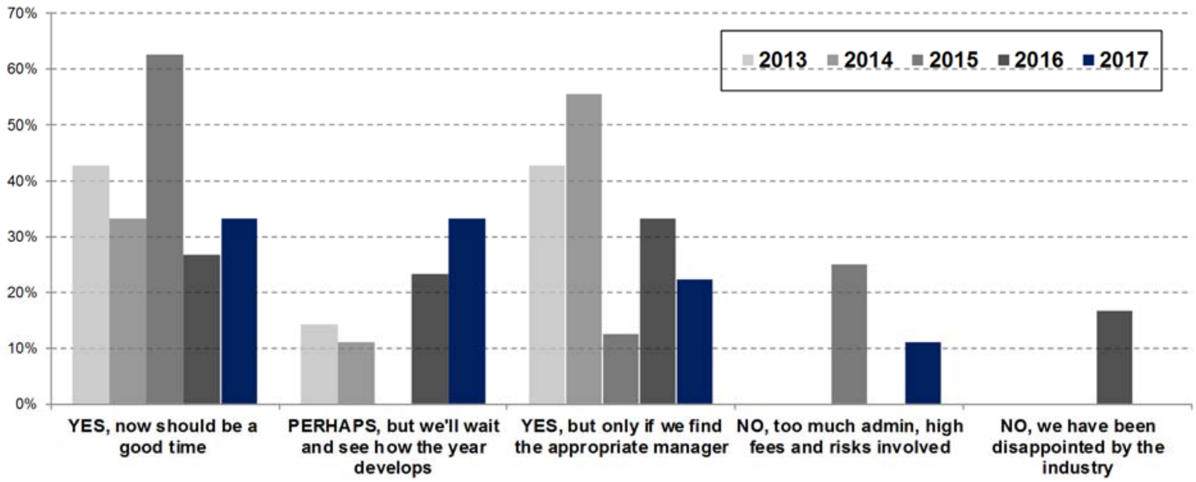
It remains to be seen whether the animal spirits released by the Trump pro-growth policy will morph into actual business investments. At the minimum, we should expect to see some repricing of assets. On the policy front, a tightening monetary policy (Fed's intention to normalize interest rates and move away from QE) and loose fiscal policy (tax cuts, infrastructure spending and deregulations) all point to reflation and rising interest rates in the near future. This will increase asset gyration, and widen the performance spreads between different industry sectors.

Commercial real estate has enjoyed strong capital inflows over the recent years. Investors have been taking advantage of the improving commercial real estate market which has been supported by the economic recovery and low vacancy rates. As the market seems to be getting extended, the marginal rate of return will likely start to drop. This should lead investors to turn to specialty markets, such as health-care-related and light industry - which is the most sought after Real Estate sector in 2017- to try to capture excess returns.

In conclusion, for 2017, sophisticated investors' enthusiasm in the alternative investing space remains fairly high, but mixed, with one-third considering to allocate at this moment. Hedge funds are suffering from low average returns, with Private Equity and Real Estate funds faring better. For Hedge funds, the top investment choices are L/S Equity, Quant & CTAs, Emerging Markets, followed by Credit & Fixed Income. Investors prefer funds with a long track-record, in order to identify the most appropriate portfolio manager. Direct investments are getting considerable attention as sources of alpha, and in Real Estate specialty markets like light-industry and health care are getting extra attention too.

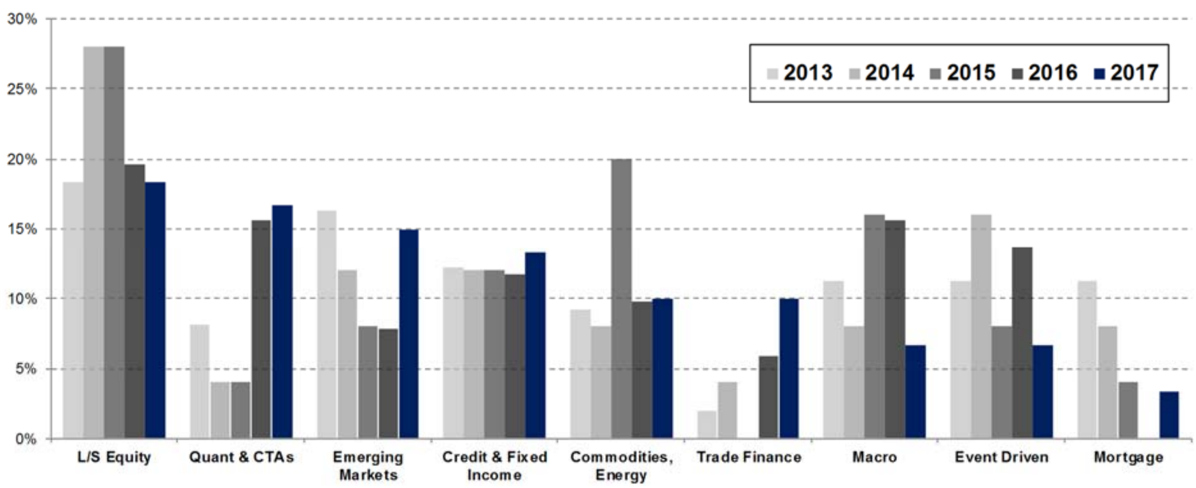
Survey Results

1. In 2017, would you consider allocating to alternative investing funds?



- The interest in alternative investing funds in 2017 shows a slight uptick from last year. About 33% are actively considering investing, up from 28% in 2016. Furthermore, a smaller portion of investors are saying No than previously.
- "Too much admin, high fees and risks involved" is the biggest deterrent for investors to invest into alternative funds. In comparison, in 2016 investors were turned away by the disappointment by the industry.

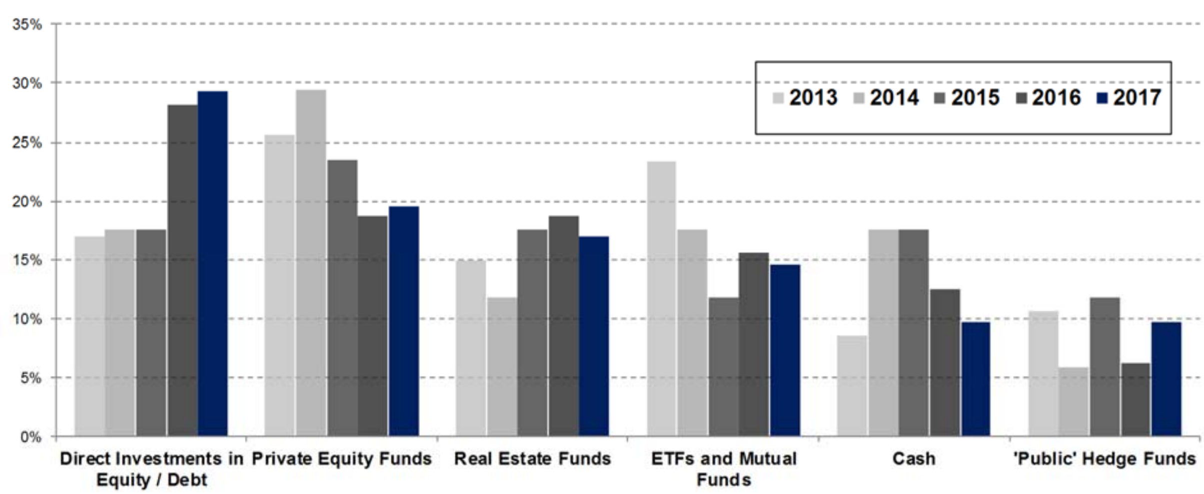
2. Within the hedge fund space, what sectors do you think would be especially interesting in 2017?



- **Low-correlation strategies remain the flavor of the year**. The top preferences are L/S Equity, Quant & CTAs, Emerging Markets, and Credit & Fixed Income.

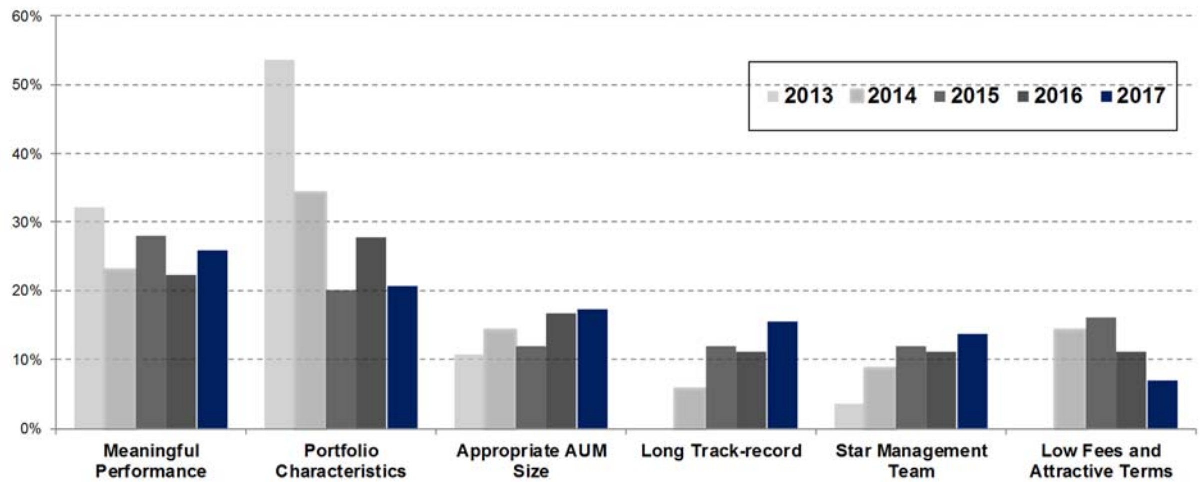
- **Investors are expected to invest the most into L/S equity and Quant & CTAs strategies.** The expectations of rising interest rates and potential deregulation will likely favor some sectors over others. Hence the performance among the different sectors will diverge. This should be a favorable environment for managers with an active management style that can capture price spreads and arbitrage.
- **Emerging Markets return to be a favorite with the biggest jump in interest among investors.** Emerging Markets has been out of flavor in the past two years. Investors are now returning and seem willing to redeploy into the space. During a time of global asset reevaluation, emerging markets, as a less efficient market, will likely experience a higher degree of price movements.
- **Interest in Credit & Fixed Income strategies remains strong, relatively consistent from 2016.** There is no doubt that the Fed's normalization of interest rate will change the level, steepness and curvature of the yield curve**.** In addition to interest rate risk and inflation risk, credit risks will increase as companies will be under higher pressure resulting from a rising interest rate.
- **Interest in Commodities & Energy remains relatively mute.**
- **Trade Finance exhibits the second biggest increase.**
- **Investors' interest in Mortgage related fund is relatively low but increased from last year.** Credit availability starts to getting tight on the back of a strong real estate market and expected rate changes. People are turning to alternative sources for financing, which leads to more attractive returns by mortgage related funds.
- **It is noteworthy that interest in Global Macro and Event-Driven strategies are low in our survey.**

3. What other investment opportunities would you consider, if unwilling or unable to consider hedge funds?



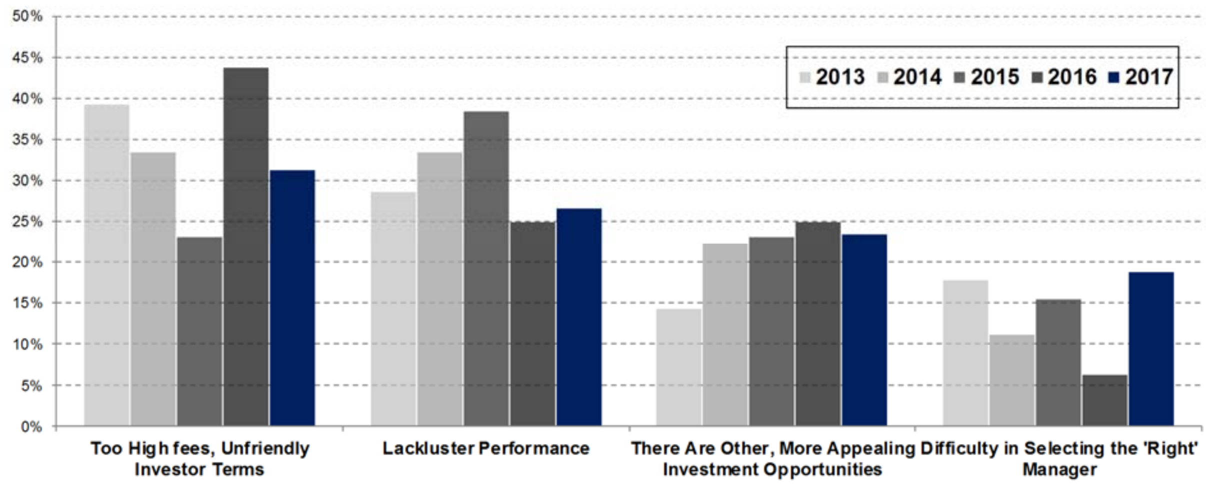
- The interest in Private Equity and Real Estate funds remain relatively steady the last few years.
- The interest in Direct Investments remains very high and is up slightly from last year. These types of investments potentially provide high alpha returns in high barriers-to-entry assets, and without intermediary fees.
- ETFs and mutual funds still appear to be less attractive substitutes to hedge funds and other alternative assets, among the investors covered in the survey.
- Investors are less inclined to hold cash. Investors probably anticipate that Trump pro-growth policy will likely spur economic growth and reflation.

4. What are the most important criteria for an alternative fund that you would consider investing in?



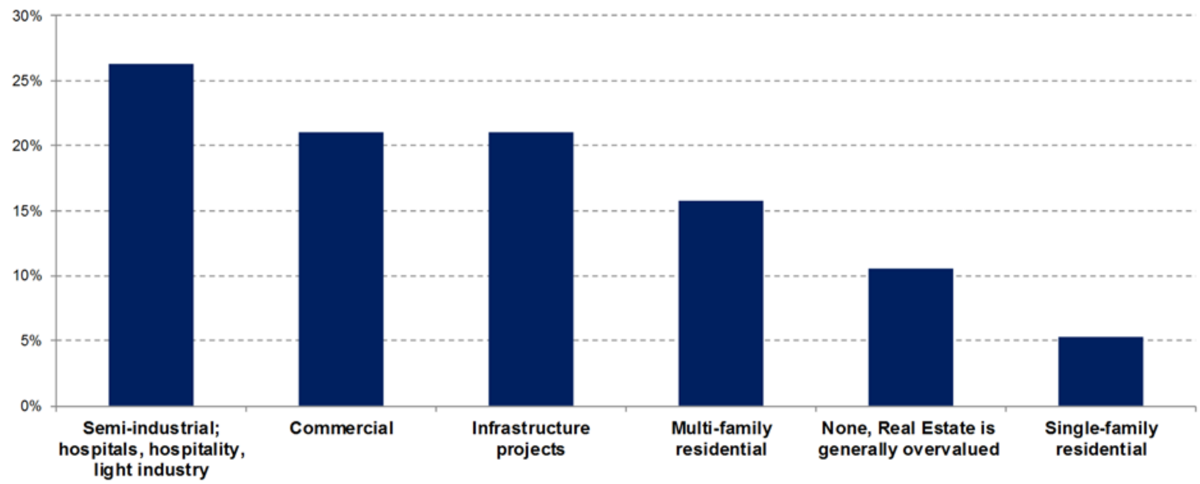
- **Meaningful performance is the most important criteria.** Investors want funds that generate alpha.
- **Portfolio Characteristics are important, and in second place:** How an investment product fits in an investor's portfolio and what portfolio benefits it may bring, continues to be a crucial determinant.
- **AUM size is important. But we see the biggest percentage jump on Long track-record.** In order to identify a skillful portfolio manager, investors need funds with a long track-record.

5. What are the considerations that discourage you most in investing in an alternative fund?



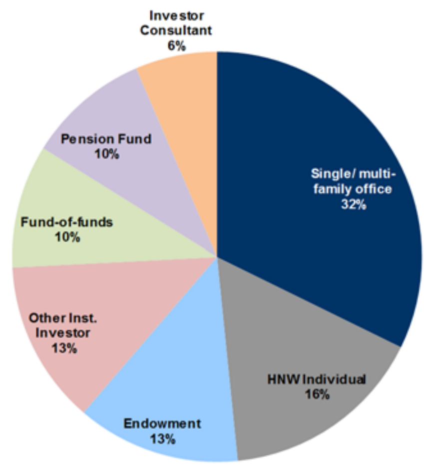
- **High fees and unfriendly investor terms keep allocators at bay.** This consideration has however dropped relatively in importance from 2016.
- **Investors emphasize investment returns**. Compared to stellar broader market returns in 2016, hedge fund performance was lackluster on average, with better returns for Private Equity and Real Estate.
- **It is increasingly difficult to identify the "right" manager**. Given the many styles and large number of funds, it is difficult for investors to search and select funds. The rising markets have added additional difficulty in differentiating skill from luck. This makes having a long track record even more important.

6. In Real Estate, for 2017, I think the best opportunities could be found in the following sector(s):



- Real Estate funds provide additional protection from rising interest rates and reflation.
- **The interest in Commercial, Infrastructure, and Multi-family real estate is high.** Institutional investors have been building core real estate portfolios to take advantage of strong real estate markets.
- ***Specialty* markets, such as health-care-related and light industry, are getting the most interest.** As most core real estate is at the end of its economic cycle, specialty markets should have some distance to go. In addition, health-care-related assets, such as hospitals and clinics, continue to benefit from demographic changes.
- **Strong interest in infrastructure projects**, which possibly reflects the current administration's commitment to infrastructure projects.

What type of allocators participated in the survey?



- **Over 500 allocators were sent the survey in early 2017, of which a portion responded.** The largest groups of responders were investor consultants and family offices.
- **Seven types of allocators responded.** There was no analysis made on the basis of allocator type; the survey responders were anonymous and the answers aggregated.

About the Authors

Carl Berg runs Catalyst Financial Partners, an investor events firm for the private funds industry. The firm links alternative investment managers and investors together through investor events. It has established itself as one of the leading, independent cap intro providers. He also works with selected alternative investment firms in a capital raising capacity and consults with investors on their allocation decisions.

Susan Weerts is an independent research analyst, investment consultant and a contributing writer to Seekingalpha.com. Current research areas are strategic trading games on ETF and its underlying index, market-neutral L/S strategy. She is also a consultant on China-related business.
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