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PERSPECTIVES

ALLOCATOR APPETITE

Pershing Prime Services' David Kaufman highlights strategies in high demand across hedge funds.

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With the first quarter firmly behind us and in the wake of several Fed rate hikes over the last year, our Capital Introductions team has been hearing a consistent drumbeat of interest from investors surrounding their hedge fund appetite. Faced with global inflation, quantitative tightening, the risk of recession, and recent market volatility, we continue to see strong appetite for hedge funds from a diverse mix of institutional and private wealth investors.

Driven in part by the rising rate environment and resulting wider dispersion of securities pricing creating potential opportunities for generating alpha, the clear message we have received from most of our investor contacts is their intent to maintain or grow their hedge fund portfolio — especially around strategies offering low equity market correlations.

Where is investor interest particularly focused? Conversations with allocators since the beginning of this year support the takeaways from our last investor survey that uncovered four key areas at the top of many investors' wish lists:

Pursuing an Ambitious Goal

Coming off an already strong 2022, distressed debt is firmly in focus for many of our investor relationships. In early 2022, we heard tacit interest from investors in the distressed space as groups built a bench of manager peers to track and evaluate before writing subscription checks. Their interest has piqued and escalated since summer 2022 with active allocations in anticipation of the credit cycle's progression to higher corporate defaults. In tandem with their appetite for stressed and distressed credit strategies, we also hear the growing refrain from investors for such strategies in liquid fund structures and their associated terms. Evergreen funds are particularly in high demand, while some allocators still approach drawdown funds cautiously.

Market Neutral, Arbitrage/Relative Value

As has been the case for the last 12 months, market neutral, arbitrage/relative value strategies across a broad spectrum — both equity- and credit/fixed income-based — remain highly sought after by hedge fund allocators. Whether it is equity market neutral, capital structure arbitrage, convertible arbitrage or fixed income RV, our team continues to see significant demand for managers in these specialties from allocators across all investor types. Higher market volatility and wider spreads are significant factors driving interest in these spread-based strategies, also supported by investors' biases toward low market beta and their retreat from many directional strategies.

Low-Net Long-Short Equity

Just as the enthusiasm for market neutral strategies has reached a crescendo in recent months, we also should note the evolving sentiment of investors around their long-short equity appetite. Longer-biased, directional strategies — particularly among large-cap focused generalists — have seen a significant decline in demand over the last year as turbulence in the equity markets has continued. However, certain sector specialties, including healthcare/biotech and energy transition strategies, currently enjoy strong interest from allocators, particularly for those managers running low net exposures (generally less than 30%). In contrast, demand for technology, media and telecommunications (TMT) and consumer specialists remains muted relative to the levels seen 2-3 years ago.

> ***"Overall, we see a continued bullish environment for hedge funds offering liquid terms through the remainder of 2023, both from institutional and private wealth investors."***

Multi-Strategy Multi-Manager Platforms

Lastly, there has been a growing interest expressed in recent months for multi-strategy multi-manager platforms, as it has proliferated widely across all investor types. As recently mentioned by my colleague Aaron Steinberg in Alternatives Watch[1], multi-strategy platforms have captured the attention of many investors, spurred by the strong and well-publicized returns last year from some of the largest names in that space. With the ability to dynamically reallocate risk exposures across their managers' range of strategies as market cycles and conditions change, platforms can efficiently optimize risk in a manner that sets them apart.

Further, as platforms enjoy significant advantages by virtue of their scale and ability to attract top investment talent, even allocators who previously avoided this segment of the hedge fund market are now taking interest. Interestingly, this demand is not merely for the biggest brands (only some of which have funds that remain open to new subscriptions), but also increasingly for smaller, newer multi-strategy platforms that are seen as allocators a more favorable balance of fees and investment opportunity set, while still having the scale to attract top-tier talent.

Across the spectrum of our investor relationships, we continue to hear enthusiastic interest from most groups to maintain or grow their overall hedge fund allocation, given recent performance. While low-net and market neutral strategies enjoy the broadest appeal now, distressed strategies and select directional long-short sector specialties are receiving some of the strongest enthusiasm from allocators. Overall, both institutional and private wealth investors have expressed their bullish interest in hedge funds offering liquid terms through the remainder of 2023.

[1] Alternatives Watch, February 24, 2023.