ALTERNATIVES WATCH

Trends driving investors' hedge fund preferences

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As we kick off 2023, it is an optimal time to reflect on the hedge fund trends that characterized last year and give thought to how the industry will continue to evolve this year. Based on regular interaction with hedge fund managers and allocators, we have observed three key trends that have frequently come up in conversation.

2022 was the year of the multi-strategy manager, with many well-known managers posting double-digit returns and raising assets (in instances where their funds are open to new allocations). Aside from performance, these managers have benefited from a number of tailwinds, which we expect will continue to position them favorably with investors in 2023.

Multi-strategy managers offer an alluring mix of diversification across sub-strategies and asset classes, which is attractive to investors who do not have the in-house resources to conduct due diligence on many different single strategy managers and package them together into an overall portfolio of uncorrelated and/or complementary offerings. Investors get a solution that removes the requirement for them to manage for strategy cyclicality — as the market environment changes a multi-strategy fund is expected to dynamically reallocate risk to where the most compelling risk/return can be found. From a risk management perspective, these funds avoid the pitfalls of key person risk and are quick to reduce the size of the trading books of underlying portfolio managers who do not meet return expectations.

While these firms tend to foster a competitive environment, the compelling elements of these platforms attract significant top tier investment talent and produce strong competition between firms to hire these professionals. With the barriers to entry for starting a hedge fund at their highest levels, due to increased regulatory requirements and sophisticated operational needs, many individuals with impressive investment track records are attracted to joining a 'plug and play' operation where they can focus on generating alpha rather than dealing with the expense and risk of failure associated with setting up their own operation. The pandemic has driven this trend, as the remote working environment has led allocators to put more money to work with managers, they are familiar with, rather than engaging new managers.

We have also experienced a convergence of this trend of greater demand for multi-strategy managers with allocators' desire for greater exposure to managers with strong ESG and DEI credentials. Several allocators have expressed their interest in women-only multi-manager products, and we expect to see a greater number of such offerings come to market in 2023.

While one factor driving the success of multi-strategy managers is diversification, counterintuitively, another trend is that a growing number of investors are determining how to play directionality — when the beta sell-off ends and run-ups begin — which strategies are best positioned to benefit. A number of allocators are considering event driven, distressed credit, and special situation strategies as strong potentials when that time comes. 2021 bore witness to record levels of issuance in the high yield and leveraged loan markets. Not only have corporates been increasing the amount of debt they issue, but much of it has been issued with weak or zero covenants.

This has created a situation in which a depressed market environment, and the associated liquidity challenges that come with it, should provide the most fertile distressed opportunity since the GFC. As with every possible distressed cycle, timing is key, and we expect that in 2023 return dispersion among managers will be the result of those who may have the ability to time the opportunity correctly and avoid being too early.

Another trend we have seen as a result of positive investor sentiment is the anticipation of net positive asset flows for 2023. The vast majority of investors that we speak to continually express a desire for exposure that is uncorrelated from equity market beta, and as such, the role of hedge funds within their overall asset allocation has never been more important.

Hedge funds' outperformance of equity market indices has led to a number of first-time buyers allocating to hedge funds for their diversification benefits, as well as increased numbers of RIAs allocating on behalf of their high-net-worth individual client base.

While there has been wide performance dispersion across and within different hedge fund strategies, as a whole the industry has outperformed traditional markets and provided diversification benefits and downside protection during equity drawdowns. Investors looking to position themselves for an environment of elevated volatility and a possible recession would do well to consider how the right exposure to diversifying strategies might stand them in good stead in 2023.