# Preqin Research Report

## Funds of Funds vs Direct Investment: The Institutional Investor Perspective

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# Funds of Funds vs Direct Investment: The Institutional Investor Perspective

There have been significant changes in the hedge fund industry over the last two years. Institutional investors now constitute a significant proportion of the investors in hedge funds and their demands for transparency, liquidity and better fee terms are shaping the industry as it emerges from the financial crisis.

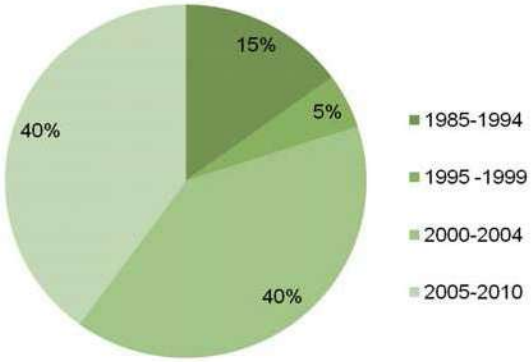
In June 2010, Preqin surveyed 50 global investors from a wide range of institutions including public and private sector pension funds, asset managers, insurance companies, banks, foundations, family offices and endowments, to gather information about their hedge fund portfolios and appetite for funds of hedge funds and single manager hedge funds.

Preqin's interviews with institutional investors in recent months show funds of funds coming under scrutiny following the onset of the financial crisis for several reasons: their relatively poor performance compared to directly investing in the asset class, the gating of assets and their exposure to high profile fraudulent funds. This article will examine the extent to which institutional investors have moved away from funds of hedge funds and what the future holds for the asset class in terms of institutional mandates.

### Initial investment in hedge funds

Fig. 1 shows when investors made their first hedge fund investment. Many have been actively investing in hedge funds for a number of years and the average entry date for those surveyed is 2001. Fig. 2 shows 64% of investors gained initial exposure to the asset class through a multi-manager vehicle. As Fig. 3 shows, only 36% of respondents still invest solely through funds of hedge funds, with 34% stating a preference for both types of investment. None of the surveyed investors began investing directly and then moved towards a funds of funds style of investment.

**Fig. 1: Year of Survey Respondents' First Hedge Fund Investment**



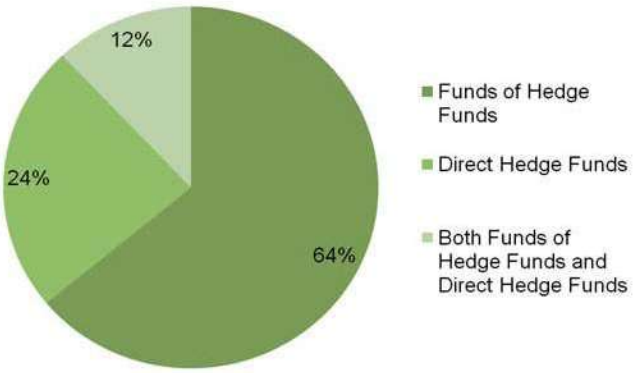

Source: *Preqin*

Many investors still enter the hedge funds industry through funds of funds. Institutional investors such as Metropolitan Government of Nashville & Davidson County Employee Benefit System, Illinois Student Assistance Commission and Powys County Council Pension Fund have all either released funds of funds mandates in the past six months or have made their first investments in the asset class through a fund of funds.

### Moving from funds of funds to direct investment

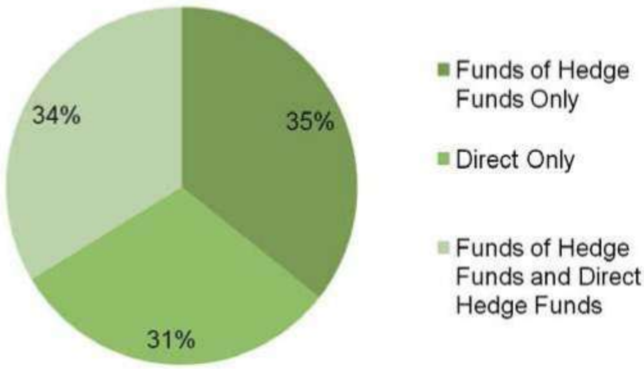
Most investors that have moved away from funds of hedge funds did so during or after 2008 (Fig. 4). This is in line with the downturn in the financial markets and the Madoff scandal, both of which negatively affected the appeal of funds of hedge funds for a number of different reasons. Fig. 5 shows reduced fees to be the main reason why respondents decided to move away from funds of hedge funds and into direct investment. The higher fees and poor performance of funds of funds during and following the financial crisis left many investors questioning the value of such vehicles in their portfolio. In

**Fig. 2: Split of Initial Investment Type Made by Institutional Investors**




Source: *Preqin*

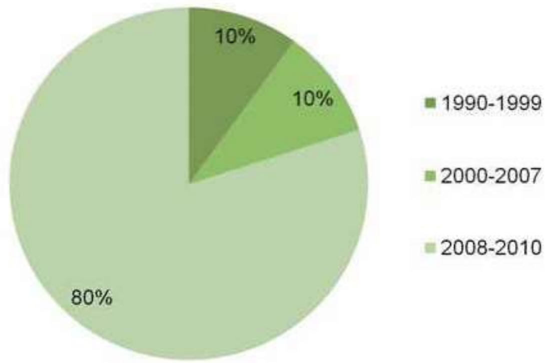
**Fig. 3: Split of Current Institutional Investor Portfolios: Direct vs. Funds of Funds**




Source: *Preqin*

2008 and 2009, many institutional investors liquidated portions of their hedge fund holdings and put further investment on ice until markets stabilized. When the time came to reinvest this available hedge fund capital, many institutions chose to invest directly in funds, avoiding the extra layer of fees they would be subject to if they invested in funds of funds.

**Fig. 4: Year Moved Away from Funds of Hedge Funds for Investors Now Only Investing Directly**




Source: *Preqin*

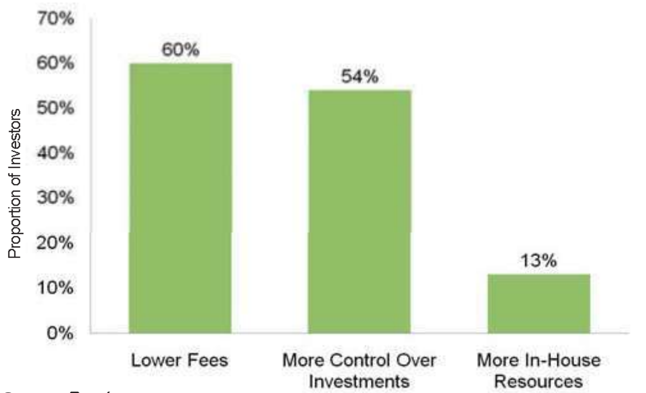
Once investors have the in-house resources and knowledge to create their own portfolio of funds, many begin investing directly in order to avoid the extra layer of fees. Another popular reason for moving away from such funds was so investor could gain more control over their hedge fund portfolio. Through the typical commingled funds of hedge funds structure, investors do not choose the underlying investments that they are exposed to. By investing directly institutional investors have complete control of their portfolio, and are able to balance their holdings to match their objectives. Some large funds of funds were invested in the fraudulent Madoff vehicles, so carrying out the due diligence for each fund in-house may give more peace of mind in regards to the funds they are exposed to.

Investors that entered the asset class nearly 10 years ago have a much better understanding of hedge funds than they did when they first began investing, giving them more confidence to move away from multi-manager vehicles and to build their portfolios directly. A proportion of the investors surveyed stated that increased in-house resources and ability to invest themselves was part of the reason they moved away from multi-manager vehicles. Many investors use funds of hedge funds to learn how to create a well diversified hedge fund portfolio and more experienced institutions are now using what they have learnt to build their own portfolio of direct hedge funds. (Fig. 6) As the hedge fund industry has evolved, so have investors. Those institutions that began investing with a small in-house investment team may since have increased the size of their investment team and the resources devoted to hedge fund investment in order to get the most out of their portfolio.

### Why do investors stick with funds of funds?

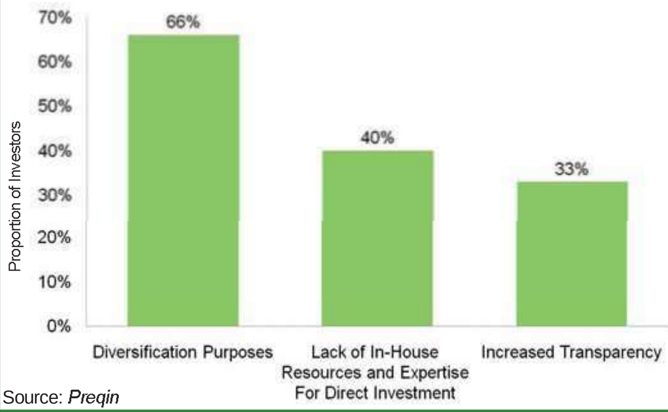
A significant number of investors have decided to maintain their funds of hedge funds investments for the foreseeable future. While many investors see the advantages of moving into direct investments, others are satisfied with their existing portfolios and plan to maintain their investment style. Diversification was the main factor respondents stated for continuing to invest solely in funds of hedge funds. Despite the extra layer of fees, funds of hedge funds are beneficial for investors seeking to diversify their portfolios, and for those that have limited amounts of capital to invest in the asset class. A lack of in-house resources and expertise is another reason why some investors intend to stay with funds of hedge funds. Many investors have small investment teams and are therefore not equipped with the expertise to make their own diversified portfolio. It is more appropriate and

**Fig. 5: Top Reasons Given for Moving Away from Funds of Hedge Funds to Direct Investment**




Source: *Preqin*

**Fig. 6: Top Factors Influencing Decision to Invest in Funds of Funds by Funds of Funds Investors**




Source: *Preqin*

less risky for such investors to commit to funds of hedge funds.

### Summary

Funds of funds are still viewed positively by institutional investors, with a significant proportion utilizing multi-manager vehicles as an educational tool to familiarize themselves with the asset class. Fund of hedge funds managers can expect a steady flow of mandates as new investors are constantly commiting to the asset class.  However, as the institutional market continues to mature, we can expect an increasing number to allocate capital to single manager funds. As a manager of funds of funds it is increasingly important to be aware of which investors are looking to take their first steps into the asset class in order to market your fund to the correct audience.