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**Hedge Fund Market Overview - Capital Flows and Fundraising in H1 2017**



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The hedge fund industry is recuperating after two years of struggle. During the first half of 2017 hedge funds lived up to their investors' expectations, who are looking to increase their hedge fund exposure for diversification and risk-return enhancement. The industry approximates \$3.2 trillion in assets under management (AuM) across all strategies according to BarclayHedge with over five thousand institutional investors eyeing on the space of over 15,000 hedge fund strategies globally. Those numbers suggest an overcrowded space and considering data from the Asset Management Association of China, managers in China reach 25,000, the industry is in need of more regulatory attention.

Active management is again in demand and hedge funds will have to compete with their peers to attract more assets and it will be worthy to observe the fundraising arena. Using data from BarclayHedge for five main core strategies AUM, we observe that the main investor focus is on equity hedge (long/short, long-only and market neutral) and fixed income strategies, which are accounting for 25% and 18% respectively of hedge fund AuM. Macro and CTA strategies with \$600bn account for 18%, while event-driven strategies are occupying only 5% of the industry's AuM.

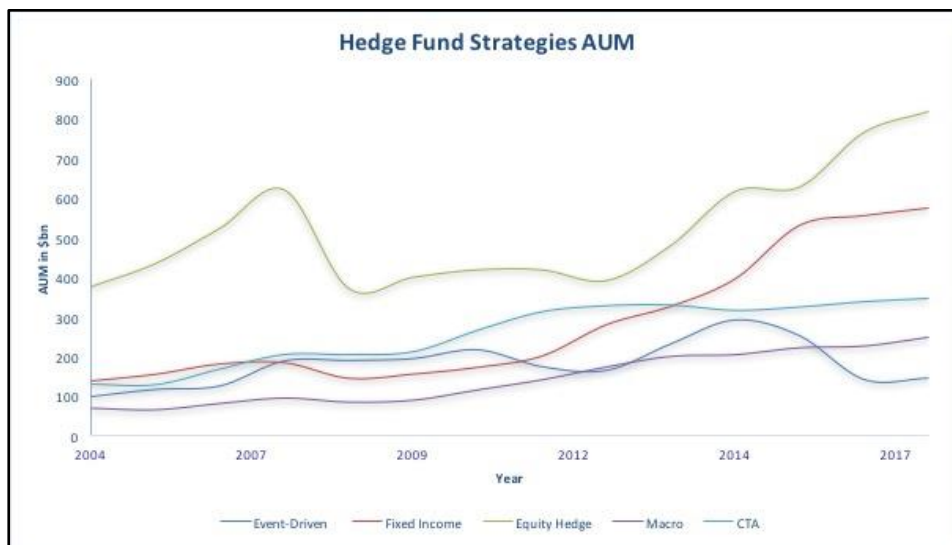


Figure 1. Core Hedge Fund Strategies AuM, Source: BarclayHedge, Stone Mountain Capital Research

We analyse inflows in each sub-asset class as compared to their performance since 2004. Event-driven strategies suffered massive outflows in 2011 and 2012, after a flat performance in 2010 before reaching their AuM peak in 2014. Two consecutive drawdown years urged investors to redeem from the space from 2014 to 2016, but the strong performance in 2016 and year to date in 2017 is reversing the situation. Fixed Income strategies, as evidenced in Figure 2, were the best performing strategies over the examined period and suffered redemptions only during 2008 crisis. Equity hedge and macro strategies exhibited relatively flat performance, with investors retreating from equity hedge funds during 2008 crisis and in 2012 after a huge drawdown in 2011, whereas macro managers are constantly attracting new money as investors seek for top quality managers. Finally, CTAs find themselves in all-time highs in the assets they manage, but without performing as expected.

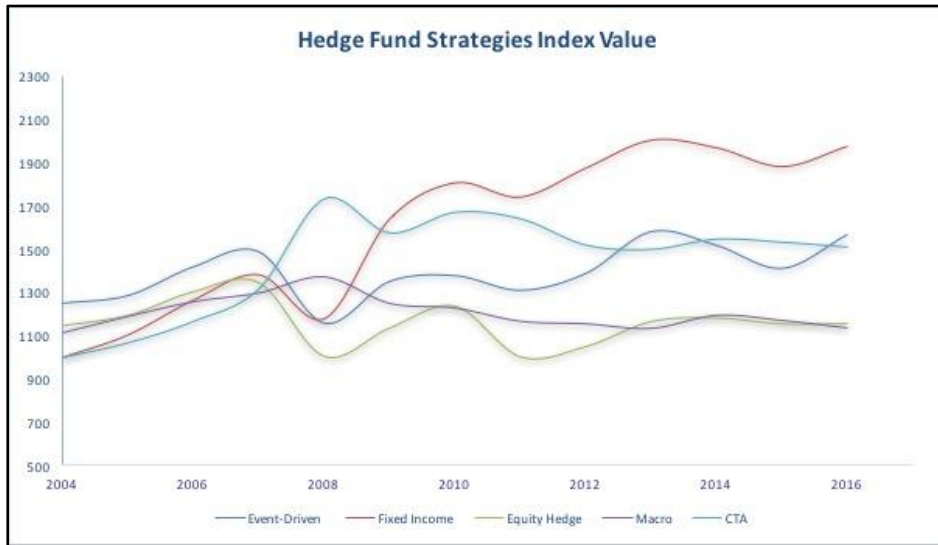


Figure 2. Core Hedge Fund Strategies Index Value, Source: HFR, Stone Mountain Capital Research

The above figure exhibits clearly the appetite for equity and fixed income hedge funds over the last years, but this year’s outlook seems changed as investors’ preferences turn to more systematic strategies despite their underperformance. The reason is that the industry is shifting to a more data-driven model that utilizes advanced mathematics and statistics to navigate the markets. Removing the human bias during crisis events maybe another reason as investors are concerned of the future ahead, which looks challenging to judge. Investors eye an increase in volatility and this perception urges investors to look for diversification in CTAs and pure volatility strategies, while discretionary macro managers are enjoying a set of opportunities within the current environment in rates, currencies, emerging markets and commodities. Long/Short equities witnessed some outflows, which mainly hit the “1-billion club” managers, while investors are targeting niche equity managers with lower capacity for new allocations. Traditionally, managers with established AuM have been attracting most of the industry’s assets, with 701 firms managing around 88% of total assets, with most managers Theron being between \$1 to \$5 billion AuM. Most of equity, relative value, macro and CTA “1-billion club” managers manage more than \$20billion, whereas the majority of managers within credit and event-driven space manage between \$10 and \$20 billions.

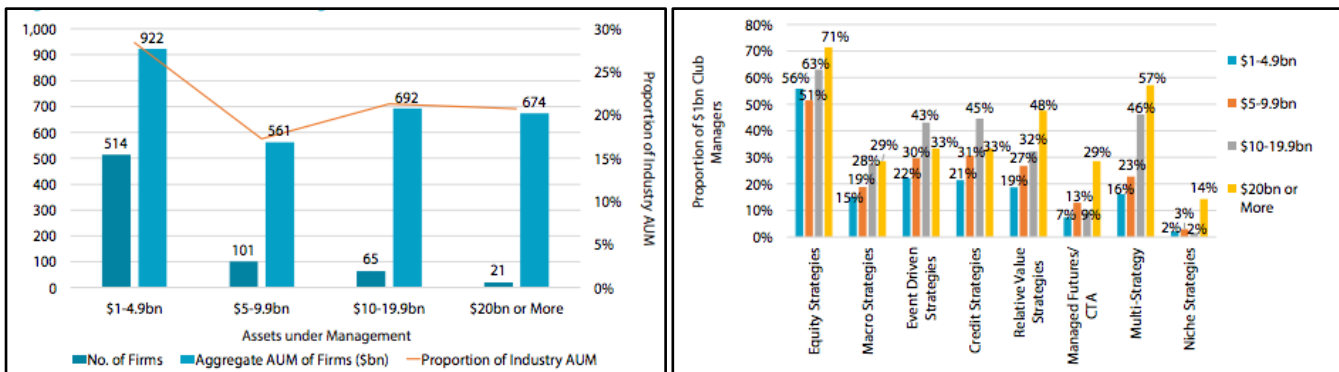


Figure 3. One-Billion Club AuM and Strategies, Source: Preqin

The concentrated industry combined with the excessive number of hedge funds fighting for capital leads to more closures than launches. Regulatory costs and the need for track record does not allow many managers to progress and establish their brand in the space. Institutional first-stage focus is mainly on liquidity, size, structure and track record of the manager. With only 701 firms occupying around \$2.8bn, there are at least 14,000 (excluding Chinese unregulated vehicles) that compete for the rest \$400bn. The industry may grow to higher levels, but allocations will be directed to mid-sized managers leading to a consolidation of the industry in terms of number of funds. This consolidation is expected to favor managers between \$300 million and \$1 billion, which have the capacity and the flexibility to execute in a market with less crowded trades.

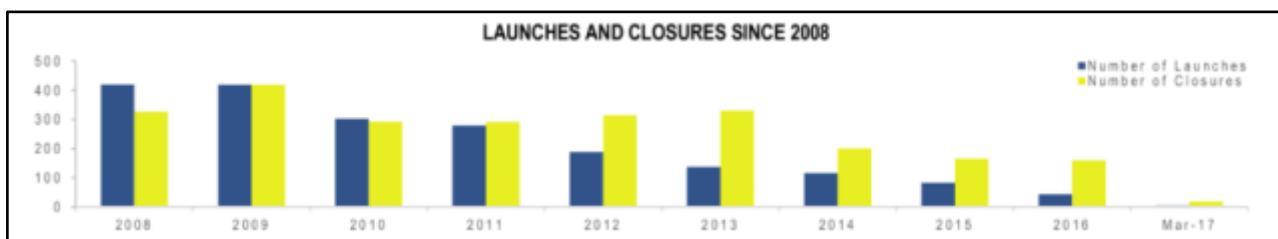


Figure 4. Number of Strategies Launched and Closed, Source: EurekaHedge

In the fundraising arena, we should not forget private debt strategies as a main competitor to hedge funds. Strategies offering monthly liquidity and income will compete with more “traditional” hedge fund strategies. The recent retrenchment of banks from middle market and SME lending due to high regulatory capital requirement in RWA (risk-weighted assets) provides managers and investors with opportunities. US and Europe are the main markets that have strong fundamentals and generate robust returns due to the crucial importance of these companies to the real economy. Private debt constitutes a \$600 billion industry, one fourth of which is attributed to direct lending strategies. Figure 5 illustrates the appealing risk-return profile of direct lending strategies both in the US and Europe compared to other corporate debt related strategies.

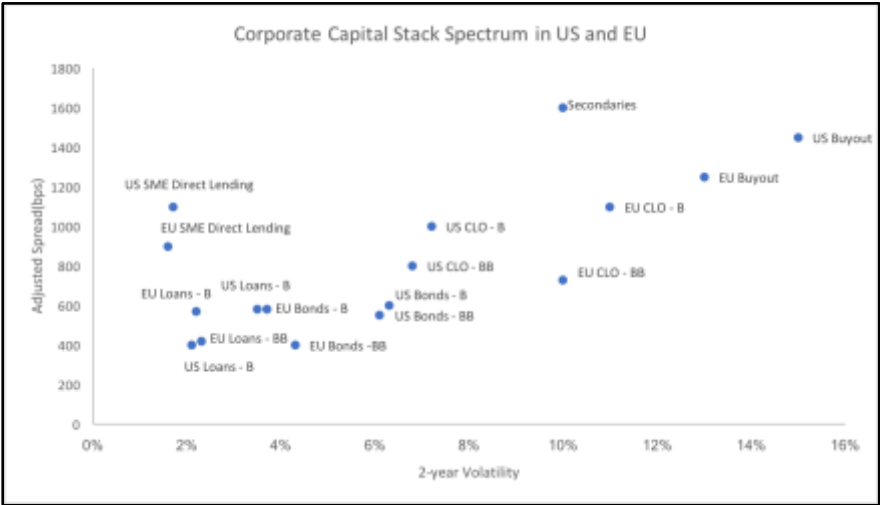


Figure 5. Corporate Capital Stack Spectrum in US and EU June 2017, Source: Barclays Research, Stone Mountain Capital Research

The direct lending market has developed over the last decade as seen in figure 6, and more managers set up vehicles to exploit the opportunity created. Investors are looking for more senior lending opportunities to navigate the current debt cycle and the credit quality of the underlying loans is of highest importance. The momentum favors direct lending strategies with the prevailing market conditions and yield compressions, and the diversification offered to every institutional portfolio is leading the fundraising efforts.

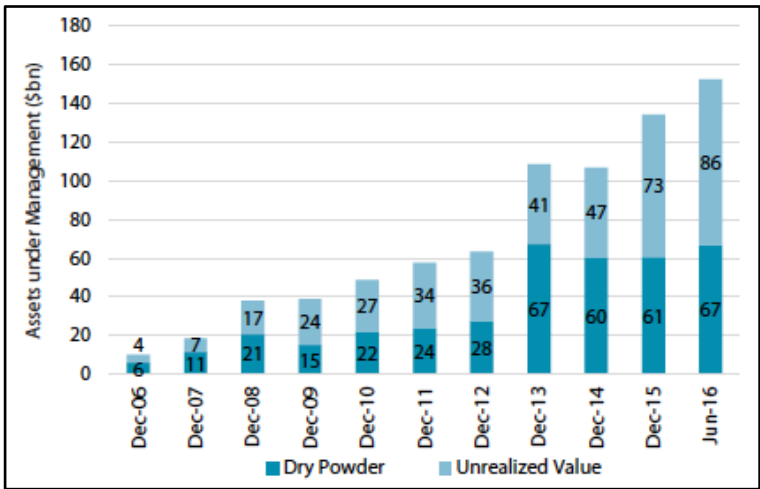


Figure 6. Direct Lending Assets under Management, 2006 - 2016, Source: Prequin Private Debt

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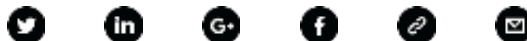
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