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Investors Bump Up Pressure as Hedge Funds Face More Outflows

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By Lydia Tomkiw November 2, 2016

The third quarter saw the largest hedge fund industry outflows since the first quarter of 2009, with net redemptions totaling $29.9 billion – and the bloodletting is increasingly prompting investors who want to stay with hedge funds to get creative and look to approaches they might not have in the past.

Investors pulled an estimated $10.3 billion from the sector in September, bringing year to date outflows to $59.9 billion, according to eVestment's latest report. The report described the current flow trends as "emblematic of an industry in crisis" that "must save itself, whether through transformation of structure or delivering returns, but more likely by a combination of both."

Rhode Island's state investment commission was the latest big institution to revamp its hedge fund portfolio, voting last week to terminate investments in more than a half dozen hedge funds, general treasurer **Seth Magaziner** announced. The $7.7 billion state pension fund's redemptions from **Ascend Capital**, Brevan Howard, Brigade Capital Management, former Carlyle Group affiliate **Emerging Sovereign Group**, **Partner Fund Management**, **Samlyn Capital** and Och-Ziff Capital Management, as well as a 50% redemption from Viking Global Investors, are expected to total approximately $585 million. Rhode Island had previously commenced full redemptions from **Indus Capital Partners**, **Luxor Capital Group** and Carlyle affiliate **Claren Road Asset Management.**

"These redemptions may not fully represent the target reduction," says a spokesperson from the Treasurer's Office, noting that the state is expecting consistent returns and non-correlation to the equity market from funds it is keeping, including Davidson Kempner **Capital Management,** Elliott Associates**, Capula Investment Management, DE Shaw Group, Graham Capital Management** and **Winton Capital Management**.

Finding bright spots in performance within specific strategies has proven difficult, says **Peter Laurelli**, eVestment's v.p. and global head of research. Though large multi-strategy managers followed performance drops of almost 3% in the nine months that ended in February with returns of nearly 5% since then, investors were already looking to exit.

"If there's underperformance in Q4, that will be a poor bookend to 2016, and make the beginning of next year difficult," Laurelli says regarding multi-strategy funds. "If that universe can show the beginning [of 2016] was an aberration…then hopefully they can go back to leading the industry in terms of investor interest."

More Bad Numbers

Hedge fund industry flows in the billions of dollars.

	September	Q3 2016	YTD 2016	2015	Estimated AUM
All Hedge Funds	($10.29)	($29.16)	($59.92)	$44.09	$3,026.77
Equity	($4.15)	($11.76)	($28.54)	$16.46	$1,017.95
Fixed Income/ Credit	($4.99)	($14.15)	($32.68)	($20.16)	$935.04
Commodities	($0.62)	$5.16	$11.24	$0.01	$79.50
Multi-Asset	($0.16)	($8.48)	($9.13)	$51.08	$1,052.96

Source: eVestment

Investors have noticeably soured on some strategies, but not hedge funds overall, as they start to make more specific demands of managers, says **Arvin Soh**, portfolio manager at **GAM Alternative Investments Solutions**. Clients are increasingly asking about hurdle rates, the possibility of becoming seeders and investing with newer managers as they look for returns.

"The hedge fund industry is kind of in an identity crisis," he says. "I think end investors are to trying to figure it out, too."

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That's leading some allocators to look to smaller funds than they would have in the past, ranging between $500 million to $2 billion in assets under management, says **Evan Katz** managing director at **Crawford Ventures**.

"What we are seeing, with some of the larger 800 pound gorillas having some issues for whatever reason, is that a lot of investors are taking a look at other funds and strategies that maybe they should have looked at a long time ago," he says.

Rhode Island's decision comes after Kentucky Retirement Systems, citing high fees and poor performance, decided earlier this month to end its hedge fund investments, following others, such as New Jersey's state investment board slashing its hedge fund portfolio in August and a pull-out from the New York City Employees' Retirement System in April. But while high fees and bad press have set off debates on hedge fund allocations across the U.S., not everyone is deciding to exit.

Colorado’s $325 million **El Paso County Retirement Plan** discussed its hedge fund allocation at a meeting last week, ultimately deciding the pension’s $16 million hedge fund portfolio remains an appropriate diversifier, sister publication *MandateWire* reported. The $105 million **Francis Family Foundation** in Missouri also decided to stick to its 15% hedge fund allocation following a debate that operations manager **Kim Foster** told *MandateWire* was initiated because “there has been much news about other [foundations] leaving hedge fund [investments].”

While challenges remain, they won’t be there forever for the hedge fund sector, says **Douglas Smith**, senior investment consultant at Willis Towers Watson.

“We are still seeing interest in the alpha driven hedge fund space, but the low cost alternative beta space resonates fairly well with clients now,” he says.

But with several high-profile pension fund exits, it remains unlikely those big investors will return to hedge funds any time soon “unless you have a crisis like ’08, where everything implodes except for hedge funds,” Soh says.