Hedge fund assets have continued to expand well beyond their pre-2008 financial crisis levels as investors’ demand for their alpha potential and risk-mitigating characteristics intensifies.

This growth persists (Exhibit 1) despite challenging industry performance, regulatory changes and investors’ heightened concern regarding risk, liquidity and fees.

**Hedge funds have resumed their strong growth trend following the 2008-2009 financial crisis**

**EXHIBIT 1: ESTIMATED HEDGE FUND ASSETS OUTSTANDING AND ANNUAL NET ASSET FLOWS**

Source: Hedge Fund Research (HFR); data as of December 31, 2014.

**John Anderson**, President of J.P. Morgan Alternative Asset Management Hedge Fund Solutions (JPMAM HFS), offers his thoughts on the changing investment environment for hedge funds, the increasing demand for innovative, customized solutions and what investors should look for—and expect—from their hedge fund managers and advisors. He concludes with his team’s current hedge fund portfolio strategy views.

**Question: What is driving the continued growth in hedge fund assets?**

**JOHN ANDERSON:** Three key factors have contributed to the growing interest in hedge funds: a greater appreciation for the basic risk-return characteristics of hedge funds, innovation in portfolio implementation and investors’ current market expectations.

First, investors increasingly value the ability of hedge funds to provide meaningful participation in up markets and protection in down markets over the long term. As long as hedge funds continue to deliver these diversifying risk-return characteristics, we believe this growth will continue.
Implementing hedge funds in a changing investment environment

Second, investors are carving out a larger, more integrated role for hedge funds to capture more of the diversifying and alpha-generating capabilities of these strategies in their portfolios. Investors are partnering with hedge fund solutions providers and consultants, and becoming more adept and innovative in implementation—leading to solutions that are more closely aligned with their existing portfolio allocations and specific investment needs.

Finally, after an extended period of declining interest rates and recovering markets, some investors are concerned that U.S. equity and fixed income valuations may be at inflection points (Exhibits 2A and 2B). This view is fueling further exploration and interest in the strategic role of hedge funds within portfolios.

As the industry has matured, these factors have affected all investors, but have had their greatest impact on institutions—whose hedge fund holdings now exceed those of high net worth individuals.1

Q: Over the last few years, hedge fund returns have not kept up with traditional markets and some institutions are winding down their investments. Why should investors continue to allocate to hedge funds?

ANDERSON: While it is true that hedge fund returns have not kept up with traditional assets in the current bull market, we believe hedge funds should be measured by their contribution to the risk-return profile of the overall investment portfolio, not against traditional benchmarks. Hedge fund portfolios—including equity-focused portfolios—are not 100% long-only, making the comparison to long-only indices inappropriate, in our view. For example, the look-through net equity exposure of our diversified portfolios is generally 30% or less, meaning that for every $1.00 invested, we expect only $0.30 to be exposed to equity market (beta) risk. Such portfolios are likely to trail in equity bull markets that are driven by unconventional monetary policy while providing protection in down markets.

Over the past 15 years, broadly diversified hedge fund portfolios, represented by the HFRI Fund Weighted Composite Index, have demonstrated this ability to provide a buffer in down markets with meaningful participation in up markets, when compared to both equity and fixed income (Exhibits 3A and 3B, next page).

Hedge funds’ complementary characteristics are also demonstrated when a diversified hedge fund allocation is integrated into a traditional portfolio. For example, over the same 15-year time frame, adding hedge funds to a 60% equity/40% fixed income blended portfolio increased returns and decreased volatility (Exhibit 4, next page).

Of course, by definition, both of the above analyses simply capture the returns of the average hedge fund. Manager selection is key, given the performance dispersion across hedge funds, and can lead to significant outperformance over hedge fund indices.

As mentioned, despite these potential advantages, a few large investors have decided to exit hedge funds. There are, however, many more that are adding to existing allocations or creating new ones. According to the 2015 Institutional Investor

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Over the past 15 years, hedge funds have delivered meaningful contributions to returns in up markets and protection in down markets


![Graph showing average returns in up and down equity markets (2000–2014)](image)

**Source:** J.P. Morgan Asset Management, Bloomberg, Pertrac; data from January 1, 2000 to December 31, 2014.

Survey conducted by J.P. Morgan’s Capital Introduction Group, 94% of institutional investors plan to maintain or increase hedge fund exposure in 2015. This has been reflected in both the strong flows which have driven industry assets to an all-time high of $2.8 trillion\(^2\) and several large hedge fund commitments recently announced by state pension plans.

**Q:** You said that institutional investors are using new approaches to structuring a broader role for hedge funds in their portfolios. Can you elaborate?

**ANDERSON:** Initially, hedge funds were viewed as a separate allocation or “bucket” within portfolios. Today, these strategies are seen as complements to traditional equity and fixed income allocations. For example, an investor may be seeking to reduce equity market risk by investing in long-short equity managers who can generate alpha while taking significantly less directional market risk. A fixed income investor may be interested in process-driven\(^3\) hedge fund strategies with returns not highly correlated with credit spreads or interest rates. Investors’ ability to categorize these traditional and alternative assets as part of the same asset class allocation allows for a more tailored investment approach with a greater opportunity to fine-tune the diversification of specific elements of portfolio risk.

In addition to complementing traditional assets, we are also being asked by clients to help optimize their illiquidity budgets. For clients that desire more liquidity, we recently launched a multi-strategy liquid alternatives (liquid alts)\(^4\) mutual fund and, for clients with greater illiquidity budgets seeking to generate higher returns, we have invested in strategies designed to take advantage of the dearth of capital in three- to five-year duration opportunities.

These are just some of the types of challenges our hedge fund solutions group is increasingly being asked to partner with investors to address. Implementing these customized solutions requires a deep understanding and ability to measure and monitor risk factors inherent across all types of managers and investments.

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\(^2\) As of December 31, 2014.

\(^3\) “Process-driven strategies” refers to strategies that generate returns through an operational process, such as litigation financing, rather than being dependent on market returns.

\(^4\) As used in this paper, liquid alternatives (often referred to as “alternative ‘40 Act funds”) are U.S. registered mutual funds, publicly offered under the Investment Company Act of 1940, that provide daily liquidity and invest in strategies that are not confined to long-only investing in equity, fixed income and commodity markets.
Q: More institutions are investing in hedge funds directly vs. through a hedge fund solutions provider. What should investors consider when weighing this decision?

**Anderson:** Many investors choose to go direct because they feel that hedge fund solutions providers are too expensive relative to the value they add, which in some cases may be true. That said, we believe the cost differential between direct investing vs. a partnership approach is overstated, since many investors underestimate the cost, complexity and risks of designing, building and monitoring a direct hedge fund program. A hedge fund solutions provider can often put assets to work quickly vs. the months or years it may take a direct investor to ramp up their program. Along with these opportunity costs, the most overlooked factors are staffing and fee concessions.

Staffing is a large cost and risk for direct investors. It involves hiring the right people to:

- identify, research and monitor hedge fund strategies
- construct, manage and monitor the hedge fund portfolio
- measure, monitor and manage both investment and operational risks
- provide the appropriate back office support to handle operational tasks (such as completing legal documents and interfacing with service providers)

On fees, many direct investors often end up paying standard fees because they do not have the size or industry standing to negotiate fee concessions which, in our experience, can be considerable. For example, we were able to pass through approximately 30 bps in fee savings to investors in 2013.\(^5\)

While going direct may be the right decision for very large institutions that can source talented investors and operational professionals and dedicate the appropriate resources to the program, it may not be appropriate for allocators with smaller and mid-sized staffs. We believe these investors may benefit from finding an experienced partner to develop a hedge fund investing program that meets their unique objectives and constraints.

Q: How can investors that choose the partnership vs. direct approach help maximize the value added relative to cost?

**Anderson:** The simple answer is to engage with a strong, experienced hedge fund solutions manager that is deeply resourced and committed to building a true partnership with your organization and investment team. In JPMAAM’s case, true partnership is the foundation on which we have built our platform into what it is today. Our clients appreciate our ability to add value at each stage of the investment process, given our:

- **Solid track record** of not only advising on, but constructing and managing multi-manager hedge fund portfolios: JPMAAM has successfully managed hedge fund portfolios since 1995, with approximately $12 billion in AUM and investments in roughly 90 funds.\(^6\)
- **Manager access:** A strong reputation in the industry and ample resources enable us to build relationships with and provide access to managers we believe are most likely to deliver above-average performance. Similarly, our low manager-to-analyst ratio and strategy specialist approach to due diligence allow us to identify and gain access to attractive niche strategies and emerging managers, both of which have added meaningfully to performance since our inception. We were early to invest in several niche and dislocated strategies such as equity activism, reinsurance and appraisal rights. With regard to emerging managers, over 60% of our managers were under $500 million at the time of our initial investment.\(^7\) We were investors, on or near “Day 1,” for some of the most successful hedge funds, allowing us to secure capacity and preferential terms on transparency and fees and pass these through to investors.
- **Back office support:** We also offer our clients the ability to use us as an extension of their own back office. We believe this offering is critical for most investors because operational tasks such as filling out and reviewing investment documents and working with third party service providers can overwhelm a limited staff and detract from manager research and monitoring efforts.
- **Proprietary Portfolio Management Platform (PMP):** Our powerful and flexible technology platform allows us to monitor manager- and portfolio-level risks. For example, PMP breaks our portfolios down into their underlying risk factors (equities, credit, commodities, etc.) enabling our risk-based

\(^5\) Estimated and assumed 10% gross performance; based on data from January 1–December 31, 2013.

\(^6\) As of January 2015.

\(^7\) As of January 2015.
approach to asset allocation. PMP is also integrated with our portfolio construction framework to ensure our top-down macro views and manager conviction scores are reflected consistently in the portfolios that we manage.

Finally, “partnership” can mean many things. What makes our approach a true partnership is our commitment to working with investors to evolve their hedge fund portfolios through on-site cross-functional education and training, participation in due diligence and internal manager reviews, customized reporting and access to our proprietary technology. We recognize that some clients may eventually want to manage their portfolios in house and we are happy to work with them in transition.

Q: Can you walk through some examples of how your partnership approach has added value for your clients?

ANDERSON: Sure, I will give you two examples.

Several years ago, we assumed responsibility for a corporate pension plan’s hedge fund portfolio that included both fund of funds and direct investments. In order to meet the plan’s goals, we performed full due diligence of all existing managers and deconstructed the portfolio to give the client a more meaningful look at its underlying risk factors. By mapping these risk factors to the underlying assets, the client recognized that they were taking more equity risk than originally thought and we were able to reposition the portfolio as a result. This client became an early adopter of the risk-based approach to asset allocation; they now include long-short equity managers’ net exposures within an equity allocation rather than a hedge fund “bucket.” The client ultimately established dedicated portfolios to take advantage of dislocations in the credit market in 2009 and an equity-oriented portfolio in 2010.

More recently, we have had a number of conversations with investors who want to optimize portfolio illiquidity. In one case, a large corporate pension plan was looking to reduce the amount of illiquid investments in its portfolio in favor of investments that are more liquid than private equity and less liquid than traditional hedge funds. In response, we developed a differentiated approach designed to maximize net return by taking advantage of market dislocations, while investing in strategies and managers with different investment and harvest periods. This staggered array of investment horizons should allow a regular return of cash flow, providing the flexibility to invest tactically as the market environment changes over time.

In both cases, we engaged our clients early in a collaborative dialogue in which they could have as much input and involvement as desired. Throughout the investing process we delivered frequent updates, offered access to senior JPMAM HFS team members, provided back office support and initiated a knowledge transfer program that included access to our proprietary Portfolio Management Platform.

Q: How are regulatory changes impacting the industry and its growth?

ANDERSON: Changing regulations are impacting the hedge fund industry in both positive and negative ways.

On the negative side, some regulations have the potential to restrict certain investment opportunities. For example, regulations requiring banks to hold more regulatory capital and generate higher returns on equity have led to lower availability and higher cost of financing—a challenge for leverage-intensive strategies such as relative value. At the same time, prime brokers are becoming more selective in doing business with smaller hedge funds, preferring to engage with larger managers as they tend to be more profitable. This can make new hedge fund launches difficult, possibly constraining the universe of emerging managers.

Other regulatory changes, however, appear to be having a more positive impact. Rules prohibiting proprietary trading, for example, have prompted banks to spin out talented managers, opening their strategies to outside capital. Regulation has also contributed to industry innovations that are helping hedge fund solutions providers address specific client needs. We have already discussed innovative longer-duration strategies designed to take advantage of illiquidity premiums resulting from the pullback of bank capital. On the other hand, for some liquidity-constrained investors seeking to incorporate the risk-return characteristics of hedge funds into their portfolios, liquid alts may be a partial solution. For large hedge fund managers considering liquid alternative mutual funds as a new way to put their years of expertise to use, SEC registration requirements that are part of the Dodd-Frank Act have lowered the barriers to entry.

Separately, as the industry continues to garner strong interest from retail investors in liquid alts, we expect the scrutiny of these publicly listed vehicles to intensify. The precise implications of the SEC’s coordinated examination (or “sweep”) of liquid alt managers and funds initiated this past year are not yet fully known. However, we view this scrutiny as a
positive for the industry since providers will be reviewed to ensure they are in compliance with the spirit and letter of the Investment Company Act of 1940 (‘40 Act).

Q: You mentioned liquid alts. How should investors evaluate these offerings and what are the trade-offs relative to investing in private funds?

ANDERSON: Liquid alternative mutual funds are an area that we are very excited about. For retail investors, the growth in liquid alts represents an opportunity to access hedge-fund-like strategies in a publicly offered, daily liquidity format, which can improve the risk and return profile of traditional asset class portfolios. While the number of vehicles in the space continues to expand, ultimately, the most successful funds will be those with the strongest manager sourcing capabilities, deepest due diligence processes and best understanding of what it takes to translate private success into a public product.

There are a number of trade-offs when comparing investments in liquid alts and private funds. First, while the number of successful liquid alt managers continues to grow at a rapid pace, there is still a sizable— albeit shrinking—talent gap in favor of private hedge funds. We do, however, expect that gap to close meaningfully over the next couple of years as more hedge fund managers (including those firmly established within the institutional market) come to recognize the incredible demand for liquid alts and decide to diversify their investor bases.

Second, while the ‘40 Act restrictions on leverage and illiquidity within SEC-registered funds are a positive from a risk standpoint, they can limit the return potential of certain strategies and prohibit others entirely. For example, many relative value strategies which rely on a high degree of leverage to generate attractive risk-adjusted returns are not conducive to a ‘40 Act format. Further, credit strategies that involve illiquid distressed companies would not be suitable under ‘40 Act liquidity rules. On the other hand, among the 29 hedge fund sub-strategies that we cover, we believe about two-thirds are viable in a ‘40 Act format, including many long-short equity, merger arbitrage-event driven and opportunistic-macro strategies.

Third, the costs to investors can be substantially lower in liquid alternative mutual funds when compared to similar private funds. Private funds generally charge a performance fee in addition to a management fee (subject to a hurdle rate and high water mark), while the ‘40 Act rules do not allow for performance fees.

Given these trade-offs, we believe that a thoughtfully constructed portfolio of liquid alternative strategies could produce attractive risk-adjusted returns similar to portfolios of private hedge funds.

Q: Finally, for 2015, where do you see opportunities and which strategies are you more cautious about?

ANDERSON: From a top-down standpoint, we are incrementally allocating to discretionary macro, quantitative/systematic strategies and balanced commodity managers. Our decisions are driven by divergent monetary policies across regions, significant outflows in each space over the last few years and decreasing cross-asset correlations.

We have been increasingly excited about the prospects for a number of relatively uncorrelated quantitative strategies. From a bottom-up standpoint, we have recently identified a number of statistical arbitrage and quantitative managers that are developing new and robust factors/techniques, which have expanded capacity for their strategies.

We are also more favorable on the overall environment for these strategies and discretionary macro managers. We believe that increased dispersion in central bank policy will lead to higher levels of volatility as well as inter- and intra-asset-class dispersion that can benefit these strategies and provide potential opportunities to exploit. That said, any related volatility spikes could make for a challenging short-term environment.

In addition, our broad theme of banking system dislocation continues to present attractive opportunities across a number of semi-illiquid credit-related and niche investment strategies. This theme is global in nature and is helping fill the void of capital for private and public credit caused by many banks severely curtailing lending in the wake of the financial crisis.

We have been overweight equity-oriented strategies for the last three years—including activism, event and long-short equities. While we continue to have exposure, we reduced it in 4Q 2014 and plan to continue to do so, especially to longer-biased long-short and event funds. Increased equity valuations, crowded trades, expectations of increased volatility and a desire to decrease equity correlations across our client portfolios all play a role in the reduction in exposure. Also of note, while we are reducing our allocations to equity-focused managers, we are also seeing our managers reducing the net equity exposures in their books for similar reasons.
We continue to be underweight high yield and most interest rate and credit-spread-sensitive strategies—aside from some niche credit opportunities that often happen to be less liquid than traditional hedge funds and have low credit beta. Finally, we have reduced our exposure and outlook for reinsurance. We were early to add exposure to our portfolios in 2011, after the devastating Japanese earthquake and tsunami, but continued pressure on pricing and capital flooding the space has made the strategy less attractive, in our view.

ABOUT J.P. MORGAN ALTERNATIVE ASSET MANAGEMENT HEDGE FUND SOLUTIONS

J.P. Morgan Alternative Asset Management Hedge Fund Solutions is a leading third-party hedge fund manager, focused on developing customized hedge fund solutions to help investors achieve their unique strategic investment objectives. The team has managed multi-manager funds since 1995, providing research, analytics and access to best-in-class hedge fund managers.

With approximately $12 billion in AUM and investments in 90 funds (as of January 2015), the team has successfully implemented a full range of solutions across the spectrum of hedge fund investing on both a discretionary and advisory basis. JPMAAM Hedge Fund Solutions is a global team of 78 people, with a senior management team that has been together for an average of 14 years, providing customized solutions for some of the world’s leading institutional investors.
Implementing hedge funds in a changing investment environment

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