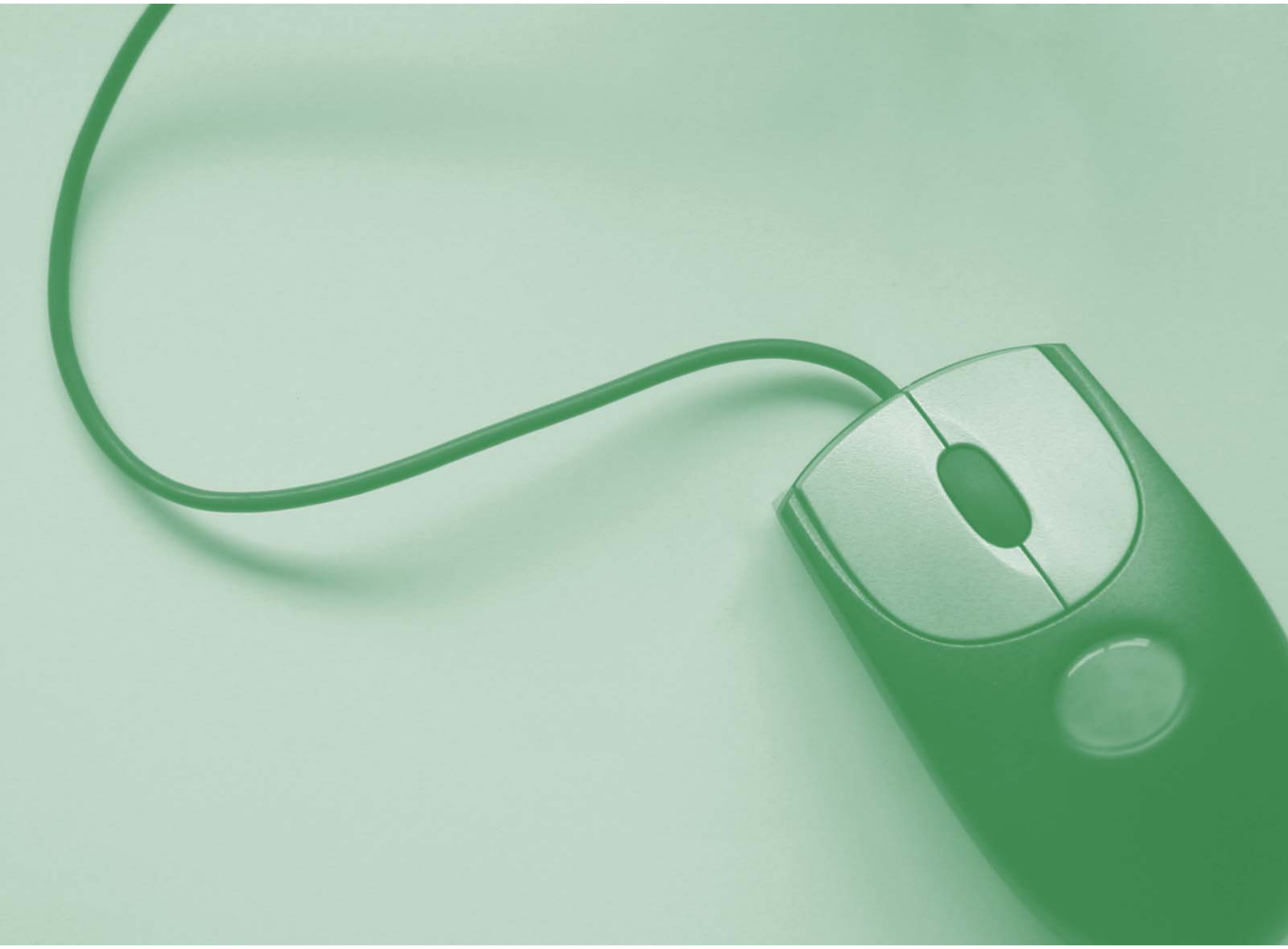
Preqin Research Report
The Next 12 Months: Institutional Appetite For Hedge Funds

August 2010



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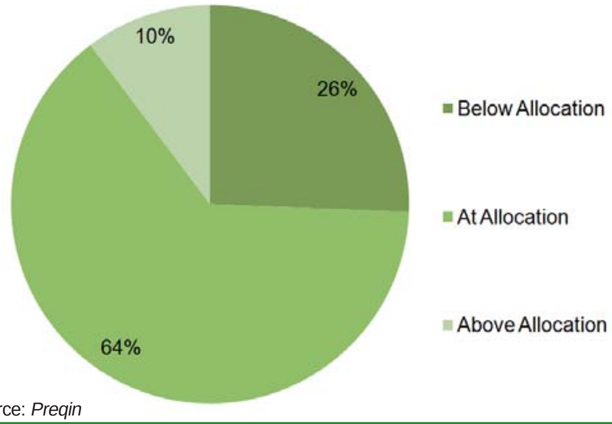
The Next 12 Months: Institutional Appetite For Hedge Funds

The hedge fund industry has experienced challenging conditions over the past two years following the onset of the financial crisis, with the asset class emerging from the downturn having undergone a number of significant changes.

Perhaps the most notable shift has been the move towards a more institutional investor base and the consequent evolution in fund management that this shift demanded, such as more transparent and detailed reporting standards. Although initially dictated by a reduction in high net worth capital available to the industry, the advantages of more stable long term capital in the form of institutional support have become increasingly appealing to hedge fund managers, with many firms previously only utilising high net worth capital now seeking to garner institutional commitments for the first time.

Fig. 1: Proportion of Hedge Fund Investors Below, At or Above Target Hedge Fund Allocation



Source: *Preqin*

Allocation to Hedge Funds

With the institutional sector being increasingly important to the industry, and with increasing numbers of fund managers seeking to position themselves effectively to attract institutional support, Preqin undertook a survey of 50 leading institutional investors from around the world in July 2010 in order to ascertain their hedge fund investment plans for the coming 12 months. This month's feature article examines the findings of this survey.

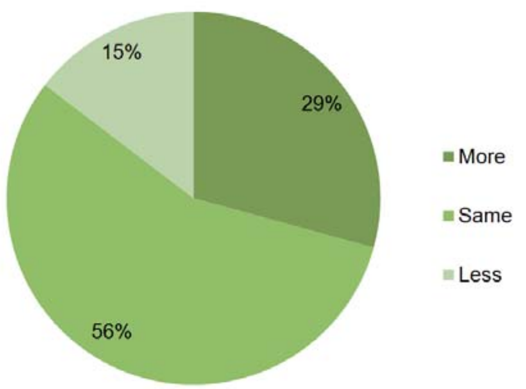
Just over a quarter, 26%, of institutional investors are below their target allocation to hedge funds and will therefore continue to look for new investment opportunities over the next 12 months. This suggests a positive shift in asset flow into the sector, which is encouraging news for hedge fund managers that are seeking institutional support.

Plans for the Next 12 Months

Investors were asked if they would be allocating more, less or the same level of capital to hedge funds as they had done in the previous 12 months. Fig. 2 shows that the results were again encouraging, with only 15% of respondents saying that they would be investing less capital. 56% plan to allocate the same amount of capital to the asset class, and 29% will invest more capital in hedge funds than they have in the previous 12 months. This suggests that investor confidence is returning and that institutional investors will be actively pursuing new opportunities in the coming year.

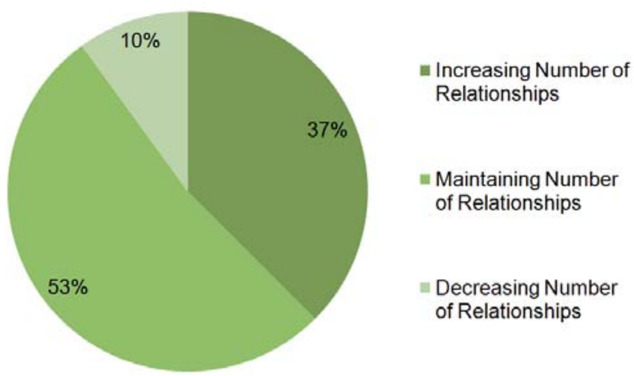
As shown in Fig. 3, the majority (53%) of investors plan to maintain the number of hedge fund manager relationships in their portfolios over the next 12 months, and more than a third, 37%, will be seeking to increase the number of relationships they have. Although 10% of investors plan to reduce the number of hedge fund relationships they currently maintain, investors

Fig. 2: Proportion of Investors Planning to Allocate More, the Same, or Less Capital to Hedge Funds in the Next 12 Months



Source: *Preqin*

Fig. 3: Proportion of Investors Increasing, Maintaining or Decreasing the Number of Hedge Fund Managers In Their Portfolio



Source: *Preqin*

are generally positive and are seeking new opportunities and looking to form new relationships with managers.

Investor Appetite for Existing Managers vs. New Managers

It is likely that there will be an increasing amount of capital invested in hedge funds in the short to medium term and investors were asked whether they plan to invest this capital with new or existing managers. Fig. 4 shows that 37% will maintain relationships with their current managers and will not be seeking new managers for their investment portfolios. A further 37% will be investing in a mixture of both existing and new managers and 23% will be adding funds with new managers only. Although investors are satisfied with the relationships they already have, a significant proportion will be looking to invest only with new managers. This is likely to be due to a combination of factors such as investors seeking new fund strategies and dissatisfaction with fee structure and fund terms.

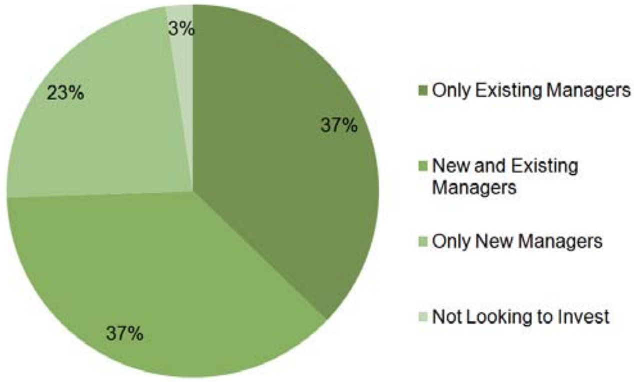
Longer Term Plans

Fig. 5 shows that 46% of investors plan to increase their hedge fund allocation in the next three to five years, a higher proportion than are planning to do so in the next 12 months. Only a small proportion (10%) intend to reduce their exposure to hedge funds and 44% foresee their hedge fund allocation staying the same.

Hedge Fund Performance

Fig. 6 shows that investors are generally satisfied with the performance of their hedge fund investments over the last 12 months, with 69% of respondents stating that their investments met or exceeded their expectations. However, just under a third of investors surveyed felt that the performance of their hedge fund portfolios had fallen short of expectations.

Fig. 4: Proportion of Investors That Will Be Investing With New Managers vs Those Investing With Existing Managers

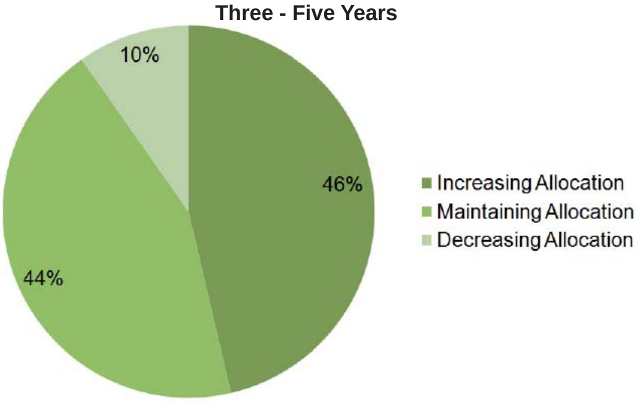


Source: *Preqin*

Strategic Preferences

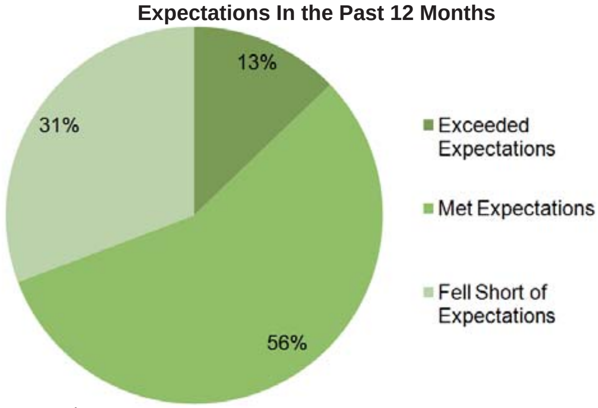
Long/short equity and global macro are amongst the most favoured hedge fund strategies, and in the current economic climate it is not surprising to see that institutional investors are seeking to invest in more liquid hedge fund strategies. While credit and distressed securities/debt are still popular strategies, none of the surveyed investors favour funds of hedge funds, as shown in Fig. 7. Those that have been investing in hedge funds for a while tend to move away from this type of fund as they become more familiar with the asset class, preferring to invest directly instead. There are a number of reasons for this, such as the additional layer of fees associated with multi-manager funds and the desire for a greater control over investments. Foreign exchange and relative value arbitrage are amongst the least targeted strategies and this is again a result of the change in the wider economic climate.

Fig. 5: Proportion of Investors Increasing, Maintaining or Decreasing Their Allocations to Hedge Funds Over the Next Three - Five Years



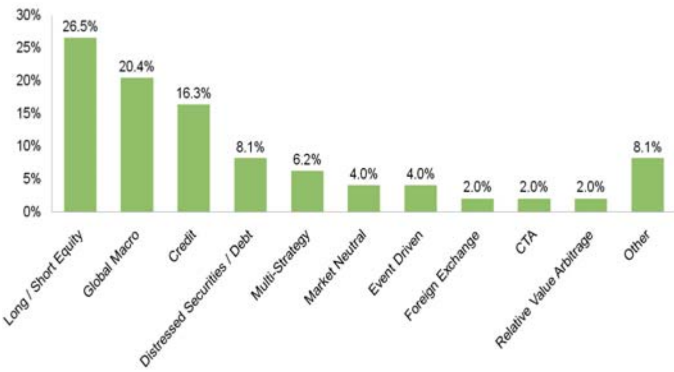
Source: *Preqin*

Fig. 6: Proportion of Investors That Believe Hedge Fund Performance Has Exceeded, Met or Fallen Short of Expectations In the Past 12 Months



Source: *Preqin*

Fig. 7: Strategies In Which Investors Are Seeking To Invest During 2010/2011



Source: *Preqin*

Summary

The results of the survey indicate that institutional support for hedge funds is set to increase modestly in the coming year, with longer term plans pointing to a more significant increase in commitment levels. With new investors also continuing to enter the asset class all the time, the institutional investor base continues to grow in significance, and it will become increasingly vital for fund managers to adopt fund management practices that are suited to institutional capital if they are to attract such support. One of the most significant findings of the survey is the relatively high proportion of institutions that will be considering exposure with new managers rather than simply increasing or maintaining allocations to existing managers. During this period of transition we are seeing investors paying close attention to existing investments and becoming especially active in ensuring that they are assembling an effective portfolio aligned to their appetite for risk and general strategy through reviewing potential new investments.

As a result there are many opportunities to gain institutional support for hedge funds in the current market, and it is especially important that managers seeking to raise capital are able to identify those investors exhibiting a preference for their fund types in order to be efficient and successful in the fundraising market.

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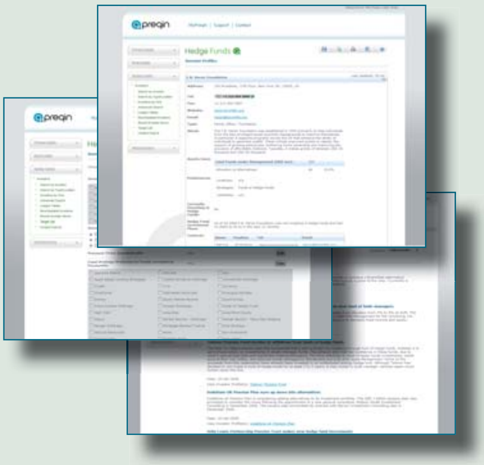

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