Preqin Hedge Special Report:

Institutional Investors in Hedge Funds Remain Positive

12-Dec-2007

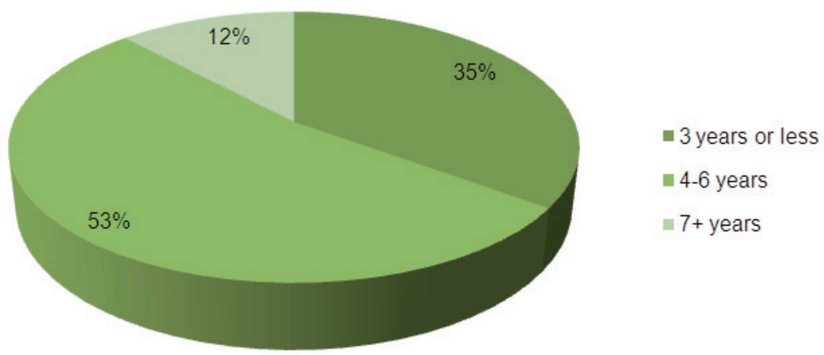
Preqin Hedge:
Special Report

Over recent years the levels of institutional investor interest in hedge fund vehicles has risen to previously unparalleled levels, with institutional capital now accounting for 40% of all commitments made to the hedge fund asset class. Traditionally more reliant on commitments from high-net-worth individuals, hedge fund managers are now having to adapt their products in order to appeal to this increasingly vital source of capital.

The increase in the importance of the institutional investor to the hedge fund asset class can be attributed to two main factors:

First is the influx of new investors that are making their initial forays into hedge funds. In the Preqin Hedge survey of institutional investors, we discovered that a significant 35% of investors have been investing in hedge funds for three years or less, with 19% of all current institutional investors having only been active for a year or less. (Fig. 1)

Fig. 1: How long investors have been active in the hedge fund asset class



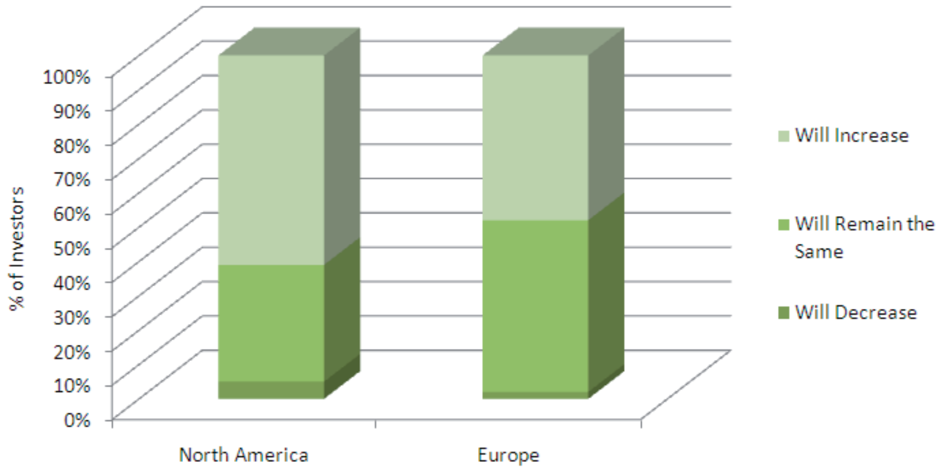
Second is the trend of increasing allocations amongst existing investors in hedge funds – a trend that looks set to continue in 2008 and beyond. The current average allocation to hedge funds stands at 12.5%, whilst the long term average target allocation to hedge funds is 15%. With the estimated current aggregate levels of institutional investment in hedge funds standing at $660 billion, this suggests that an extra $80-90bn could be pumped into the industry from existing investors alone over the next twelve months.

A good level of understanding of the needs and requirements of these investors is essential in order for hedge fund managers to attract new investors.

We analysed over 1,150 investors in hedge funds, questioning them in order to reveal what it is that investors are looking for from the hedge fund asset class in 2008 and beyond. In this special research report we reveal a few of the most pertinent results which can be seen in full along with a detailed examination of the hedge fund institutional investor universe, and detailed profiles for over 700 of the most important investors in the asset class, in our new publication The 2008 Preqin Hedge Institutional Investor Directory.

One questions we put to LPs was with regards to their long term plans towards their allocations to hedge funds, asking whether they intended to increase their allocation, decrease their exposure, or maintain current levels. The overall findings were that investors are positive in their outlook on the asset class, and the majority expect to increase their allocations. As shown by Fig. 2, no less than 61% of investors in North America, and 48% in Europe surveyed expect to increase their allocations, compared with just 5% and 2% respectively, who expect their allocations to decrease.

Fig. 2: Expected Change in Hedge Fund Allocation by Region

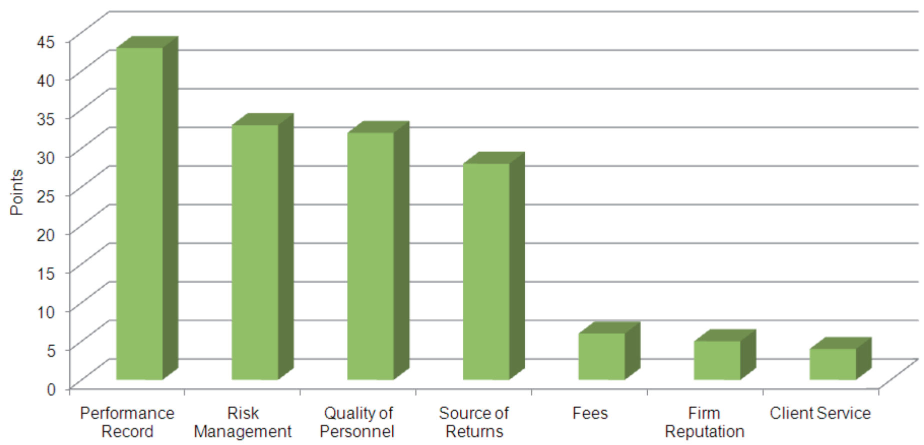


Public pension plans were amongst the most optimistic of all the investor types. In total, 55% of the public pension plans said they were looking to increase their allocation, 42% were looking to maintain their current allocation with only 3% were looking to decrease their exposure to the market.

Factors affecting manager selection

With the increased capital being committed to the hedge fund market from institutional investors we looked to analyse the most important criteria for investors when they chose a hedge fund, or fund of hedge funds manager. We asked investors for their top 3 factors and then calculated the results on a points scoring basis. For the investor's most important factor we would award 3 points, 2 points for the next factor and then 1 point for the third most important factor. These results can be seen in Fig. 3.

Fig. 3: Critical Factors Affecting Investors' Hedge Fund Selection Criteria



The results of our survey show that the most important factor for investors when choosing a new hedge fund manager is the performance record of the firm. One of the primary reasons that institutional investors are moving away from the traditional markets into hedge funds is an attempt to achieve strong returns, uncorrelated to other investments in their portfolio. It is therefore of little surprise that performance record emerged as the most important search criteria for investors seeking to maximise their potential returns.

The hedge fund manager's risk management is also seen as very important and this can be linked with the source of the manager's returns. A prominent North American based fund of hedge fund manager commented that funds that have withstood market pressures due to excellent risk management frameworks have helped restore client's confidence.

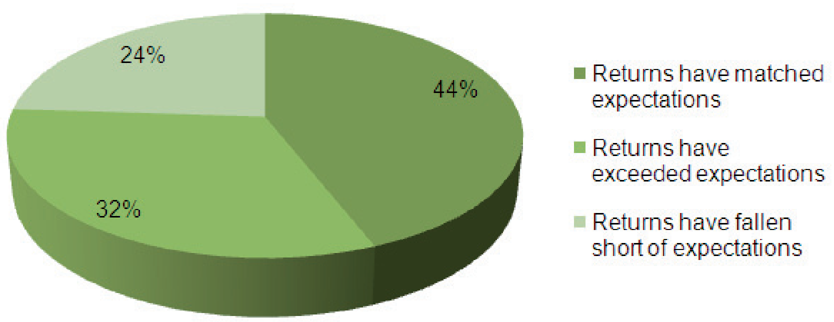
The quality and experience of investment personnel is another important factor for investors when considering investment. All the different types of investors claimed that quality of personnel was important, however, it was interesting to note those that this was seen as especially important amongst a number of public pension funds, a number of which also cited firm reputation as an important factor. A Scandinavian pension plan commented that, "Some of the risk parameters we take into account are firm reputation and age of firm. One thing that is of utmost importance is track-record and experience of the current personnel."

Institutional Investor's Hedge Fund Returns

Through our hedge fund investor survey we wanted to investigate whether institutional investor's hedge fund returns were reaching the levels they expected. As shown in Fig. 4 the majority of investors claimed that their returns were either exceeding, or matching their expectations.

In total 44% of the investors in the survey noted that the hedge fund returns that they have received have matched their expectations. A leading UK private pension plan noted that returns have consistently been about 10% per annum for the past three years from investments in 3 fund of hedge funds.

Fig. 4: How have hedge fund returns lived up to investor expectations?



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Some hedge fund returns have exceeded institutional investor's expectations. A total of 32% of the investors in our survey claimed this to be the case. Generally endowments, with more sophisticated investment models and a tendency to invest directly, therefore avoiding extra layers of fees, have achieved returns that have exceeded their expectations.

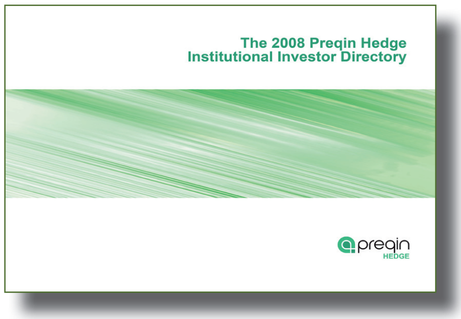
Conclusions

Through our analysis we have uncovered a number of important industry trends. The overall feeling from investors towards the asset class remains positive. Although we have seen the market experience turbulent conditions of late, this has not shaken investor confidence. There has been, and may continue to be a slowdown in growth but our research points to the fact that the industry will continue to evolve and expand. Those managers that have the best risk management practices will continue to flourish and a number of fund managers may reallocate capital between underlying strategies. There will continue to be a number of opportunities for investors to achieve high returns. Investors may well look to conduct even more thorough due diligence on the strategies used by the managers in their portfolio but institutional investor appetite for hedge funds sees no signs of abating.

2008 Preqin Hedge Institutional Investor Directory: Order Form

The 450 page 2008 Preqin Hedge Institutional Investor Directory is the leading source of information on institutional investors in hedge funds, and is an essential purchase for all hedge fund managers and marketing professionals.

- Detailed analysis on the make up of the investor universe, plus latest investor trends, including the full results of our 2008 investor survey.
- Full profiles for over 700 of the most important institutional investors in hedge funds worldwide, including up to date investment plans, full financial details, contact information and much more.



For more information please visit: hedge.preqin.com

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