Preqin Hedge Special Report:

Institutional Investors set to Invest $85bn into Hedge Funds

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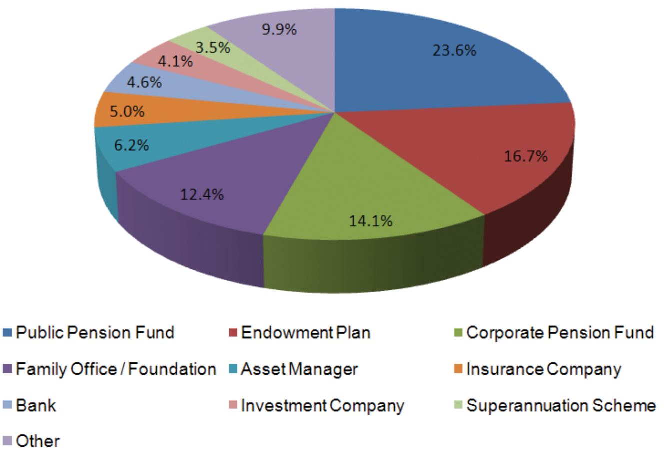
Preqin Hedge: Investor Profiles
Special Report

Towards the end of the last century the majority of commitments made to hedge fund vehicles were coming from high-net-worth individuals, with institutional support for the asset class being limited to a relatively small number of foundations and endowments. With institutional investors worldwide increasing their allocations to alternatives, the hedge fund industry is receiving greater levels of backing from investors of this type than at any other point in the history of the asset class. In order to maintain these levels of support, the industry must adapt in order to respond to the demands and requirements of these new investors.

Institutional investors are increasingly turning to alternative investment vehicles to diversify their portfolios, and these institutions are set to become increasingly important providers of capital to the hedge fund industry. In 2006 $160 billion was raised by hedge fund managers – including capital from both institutional investors and high net worth individuals. Using data taken from Preqin Hedge's Investor Profiles, which contains details for over 1,000 institutional investors in the arena, we predict that in the next 12 to 18 months an additional $85 billion will be poured into hedge funds and fund of hedge funds through institutional commitments alone.

The three largest groups of investors in the asset class are; public pension plans, endowments, and corporate pension plans, which represent 24%, 17% and 14% respectively of all the institutions investing or considering investment in hedge funds. Endowments and family offices & foundations with their greater investment freedom and less public scrutiny, were amongst the first institutional investors in the asset class – recent studies have shown that, on average, endowments have been investing in hedge funds for over 8 years (compared to 5 years for public pension plans). However pension plans have been, and continue to be, the fastest growing source of institutional capital for hedge fund managers – with many pension funds being under-funded, and forced to reconsider their investment policies and increase allocations to alternatives.

Make up of Universe of Institutional Investors in Hedge Funds by Type



Case Studies

In order to seek higher returns many public pension funds have turned to alternative asset classes, and increased their interest in hedge funds. Over the past five years these plans have begun to adapt their allocation and are increasingly seeking trustee and/or legislative approval to allow them to include hedge fund strategies as part of their diversified investment portfolios.

Using data from Preqin Hedge we can identify the public pension plans which invest the greatest amount of capital into the asset class. California Public Employee's Retirement System (CalPERS) is the largest investor – currently investing USD 11.5 billion in hedge fund vehicles, but with a target allocation of 8% this figure will rise to USD 18.4 billion over the next 3 years. In Q1 2007 CalPERS launched an Emerging Manager Fund of Funds program which will have an initial allocation of up to $1 billion to be invested on an opportunistic basis. The plan will allow CalPERS to expand investments in emerging investment management firms that manage long-only public equity strategies and have less than USD 2 billion in total firm assets.

In terms of proportion of total assets under management dedicated to hedge fund investments, the San Diego County Employees Retirement Association (SDCERA) is the most active institutional investor in hedge funds in North America, with no less than 20% of its total assets under management employed in the area. Despite coming under pressure from beneficiaries after suffering significant losses from its investment into the now defunct Amaranth Advisors, SDCERA has maintained its 20% allocation to the asset class, stating that the consistent high returns that the asset class has provided in the past outweigh the potential risks of a changing market.

One of the earliest public pension plans to utilize hedge funds as part of a diversified portfolio was Ontario Teachers' Pension Plan, which made its maiden investment in 1994. Thirteen years later it is now one of the most sophisticated institutional investors in the market, with a 12% target allocation – this equates to approximately $10 billion – providing the second largest contribution to total hedge fund capital of all public pension plans. It currently has over 150 managers on its hedge fund roster, in accordance with its strategy to commit a small amount of capital to a large number of diverse managers in order to lower the risk of its overall portfolio.

However not all public pension plans have joined the trend to invest in hedge funds. Notable abstainers from hedge fund investments include the Washington State Investment Board and California State Teachers Retirement System.

University of Texas Investment Management Company (UTIMCO) injects the greatest amount of capital into hedge funds of all endowments – investing up to 28% of its total assets under management (approximately $6.3 billion) in absolute return funds. UTIMCO is one of the most sophisticated hedge fund investors in the US – using its large dedicated hedge fund investment team, the endowment plan maintains excellent relationships with existing managers on its roster whilst liaising with its target managers to gain access to the best opportunities.

UTIMCO takes a pioneering attitude to the hedge fund market – for example it was one of the first endowments to seek hedge fund opportunities in the Far East.

Allocations

Family Offices/Foundations and endowments tend to utilize hedge funds as part of their overall investment portfolio to a greater extent than other institutional investors. With a typical hedge fund allocation in the range 15 – 25%, family offices/foundations and endowments lead the way in hedge fund investments. Some even invest 40% or more of their assets into the arena – for instance the Atlantic Philanthropies Endowment has a target allocation of 50% of total AUM. In general, however, most endowments and family offices/foundations are close to filling their target allocations to hedge funds and have few intentions to increase their allocations in the next 12 - 24 months.

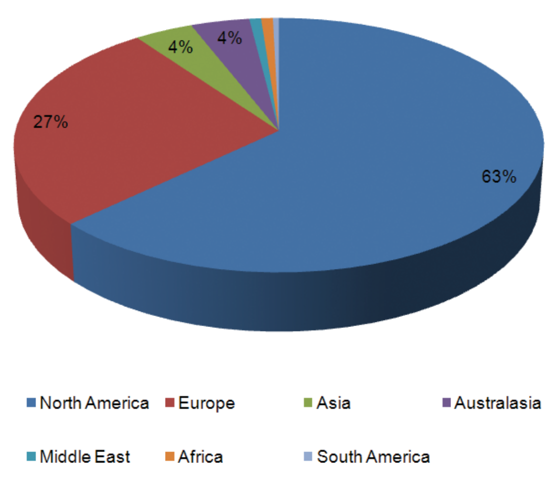
Public pension plans, on the other hand, allocate on average, 6% of total AUM to hedge funds (with the ceiling being around 15%) but are keen to increase their allocation and make new investments in the forthcoming years. We predict that in the next 2 years the average allocation to hedge funds made by a public pension funds will increase to around 8 – 9% of AUM, and as such public pension plans will become one of the most important investors in the arena, contributing the most significant proportion of the $85 billion we predict will be raised by hedge fund managers in the next 12 -18 months.

Geographic Distribution

Amongst the top 25 hedge fund investors as identified by our Preqin Hedge Investor Profiles product, five are European, the largest of these being ABP Investments based in the Netherlands. We estimate that approximately 35% of the total number of public pension plans investing in hedge funds are European with the remaining 65% based in North America.

Hedge fund investments from UK pension funds are booming, with pension funds making their first forays into the market all the time. New entrants from the UK include Bexley Council Pension Fund and Warwickshire Pension Fund, each making its maiden investment in the latter part of 2006.

Make up of Universe of Institutional Investors in Hedge Funds by Location



Contrary to the geographic diversity exhibited by public pension plans, endowments and family offices/foundations tend to be much more US-centric, with less than 2% of all endowments investing in hedge funds based outside of North America and just 11% of all foundations. Probably the most significant investor of these is the UK-based Wellcome Trust, which currently invests nearly £2 billion in hedge funds. The charitable foundation implements a direct investment policy with over 50 managers in its portfolio and is the second largest foundation investor worldwide.

Investment Preferences

So what type of vehicles do institutional investors invest with? Our Investor Profiles reveal that the most popular fund managers (in terms of number of investors) are Quellos Capital Management, Arden Asset Management, Grosvenor Capital Management, Goldman Sachs Hedge Fund Strategies and Blackstone Alternative Asset Management. These are all fund of hedge fund managers which attract investments from the largest public pension plans in North America and the UK, as well as investments from North American endowments and family offices and foundations. Our database reveals that pension fund portfolios often contain a number of fund of hedge funds in order to increase diversity and to reduce the overall risk exposure of their hedge fund investments. We estimate that approximately 65% of active public pension plans seek fund of hedge funds as a strategic target.

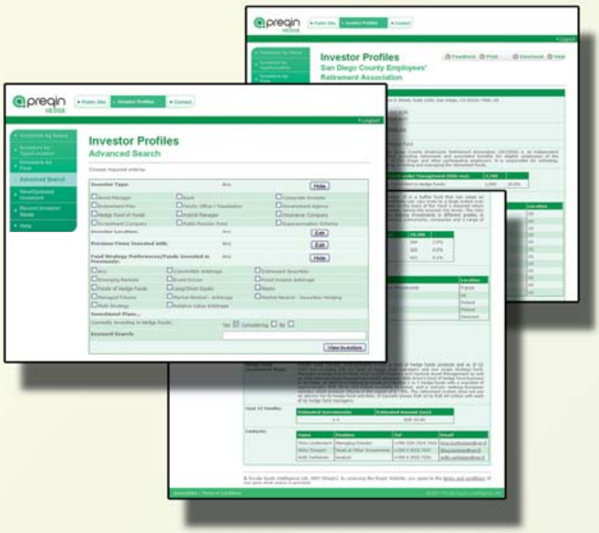
Often fund of hedge funds form part of a wider portfolio that also contain some direct investments, which allow the pension funds to have greater exposure to managers or strategies that they believe will generate the greatest returns. A relatively small proportion - about 20% - of public pension plans are put off by the double layered fees of fund of funds and make solely direct investments. These plans tend to be more experienced with larger resources (which are needed to implement a direct investment program).

Contrary to this, endowments and family offices/foundation – which have been investing in hedge funds for a much longer period than pension plans – are far more likely to implement a direct-only investment strategy. Just 18% of endowment and family offices/foundations specify fund of funds as a strategic preference, choosing instead to invest directly into hedge funds in order to tailor their portfolio using specific strategies to match their risk/return profile.

The future looks bright for the hedge fund industry – we estimate that a third of public pension funds are below their target allocation towards the asset class, and will continue to invest at a high level over the next 18 months. With other institutions continually reassessing their exposure to hedge funds, and with new investors – particularly public pension plans - constantly entering the arena, institutional interest in hedge funds is set to grow significantly.

INVESTOR PROFILES: HEDGE FUNDS

INVESTOR PROFILES, the newest product from Preqin Hedge, is a vital source of information for all professionals working within the hedge fund marketing industry, with detailed profiles for 1,000 institutional investors in hedge funds...



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