Hedge Fund Manager Study

A Preqin Special Report

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Hedge Fund Manager Study

In 2008, Preqin released a study based upon the institutional client base of hedge fund managers. The results of this report revealed that 55% of hedge funds had increased their institutional client base over the preceding three years, with institutional investors forming on average 45% of a hedge fund's capital. The industry has changed considerably since this time, following returns which were deemed unsatisfactory in 2008, fund closures, high-profile fraud cases and a fundamental change in institutional investors as they have looked to diversify their holdings away from an overreliance on traditional assets.

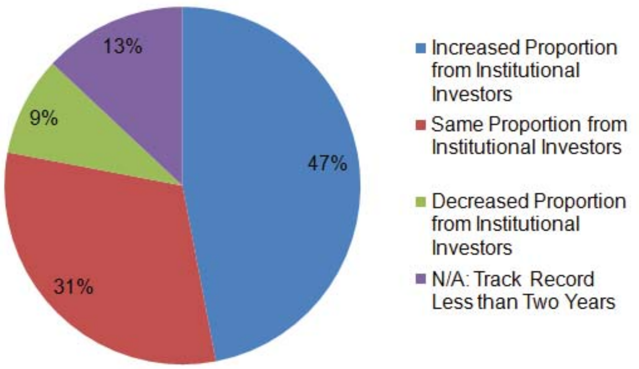
As anecdotal evidence grows on the increasing institutionalization of the asset class, and hedge funds rapidly evolve to meet the demands of a new institutional market, Preqin has undertaken a closer examination of this trend. In January 2011 we conducted interviews with 60 hedge fund managers to ascertain where they sourced capital for their funds. The firms which participated in this study collectively have $95 billion in total funds under management, represent a wide range of strategies, and are based in various different areas of the world.

Hedge fund assets are coming increasingly from institutional sources

It is clear that hedge fund managers are increasingly raising capital from institutional sources. Over the past two years, i.e. since the market crisis of 2008, 47% of the fund managers surveyed stated that the amount of capital coming from institutional coffers has increased (Fig. 1), with this rising to 56% of surveyed funds over the longer timeframe of five years (Fig. 2). Traditionally seen as money managers for wealthy individuals, many fund managers have increasingly been marketing their funds to the institutional market over the past five years to capitalize on an increased appetite from this group of investor and to tap into the larger ticket sizes and stable sources of capital that they can provide.

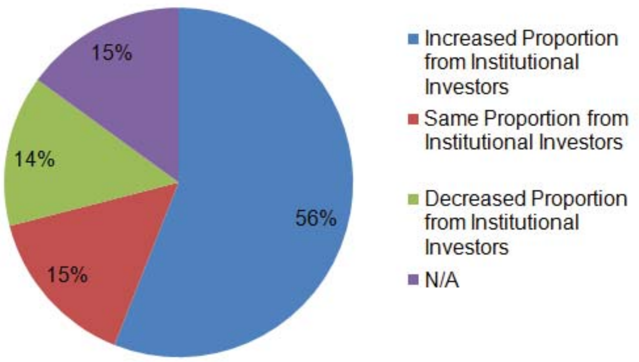
This increased investor capital is coming from both investors making their first allocations to the asset class – 38% of all institutional investors currently active in hedge funds made their first investment in hedge funds from 2005 onwards – as well as existing investors increasing their allocations to the asset class. For instance from 2007 to 2010, public pension fund investors in hedge funds (which combined represent some $4 trillion in total assets) have increased their allocations to hedge funds from 4% of AUM to 7%. Interestingly, a relatively significant proportion of managers that participated in the Preqin study – 15% – have experienced a drop in the proportion of institutional capital in their funds over the five-year period. However, the majority of this group stated that they had seen a recovery over the past two

Fig. 1: Changes in Source of Hedge Fund Managers' Capital over Last Two Years



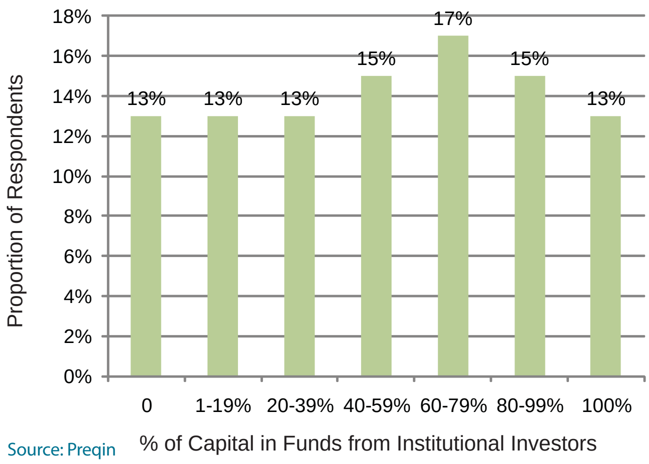
Source: Preqin

Fig. 2: Changes in Source of Hedge Fund Managers' Capital over Last Five Years



Source: Preqin

Fig. 3: Percentage of Hedge Fund Managers' Total Capital That Comes from Institutional Investors



Source: Preqin

years, so changes in institutional assets for these fund managers are likely to have been short-term fluctuations caused as a result of the turbulent markets of the recent past.

We asked the surveyed fund managers to state what proportion of their funds' assets came from institutional investors. The distribution is broad, but interestingly the same number of funds stated that none of their hedge fund capital came from institutional investors as the number of funds which stated that all of their capital came from institutional investors. The mean proportion of capital that is sourced from institutional investors stands at 61% for managers participating in the survey.

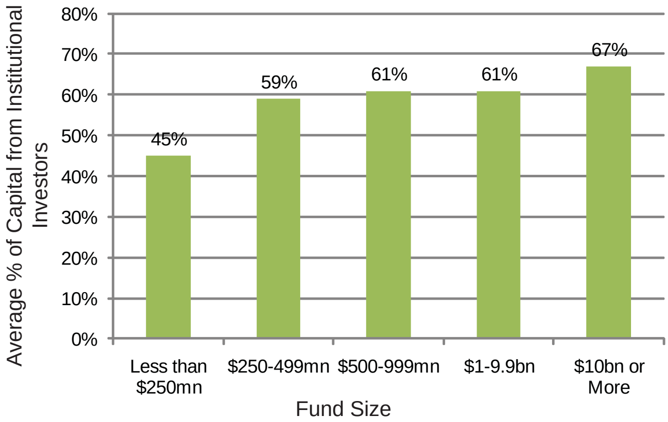
From these poles, the distribution aggregates around a mean capital-weighted average of 60.5% of hedge fund capital coming from institutional means, and 57% of respondents stated that more than half of their assets came from the institutional sector.

Institutional capital and fund size

81% of the total assets of the firms that participated in the Preqin study resides in funds where institutional investors represent 50% or more of the capital in that fund. Institutional investors are therefore shaping the global hedge fund industry in terms of the distribution of capital between the largest and smallest funds. To look at the effect of fund size on the institutional client base of the surveyed investors, we compared their assets under management to the proportion of their assets coming from institutional investors (Fig. 4). Clearly the smaller funds raise less capital, proportionately, from institutional investors, with many institutional investors imposing minimum assets under management requirements on their potential managers. Fig. 5 shows that the greatest hurdle in raising institutional capital, in the opinion of fund managers participating in the survey, is meeting institutional requirements in terms of a minimum level of assets under management.

Using data taken from Preqin's database of 2,500 institutional investors in hedge funds, the mean AUM requirement of a hedge fund investor is around $320 million. This is reflected in Fig. 4, with a large jump in the average proportion of institutional

Fig. 4: Average Percentage of Hedge Fund Managers' Total Capital That Comes from Institutional Investors by Size of Fund



Source: Preqin

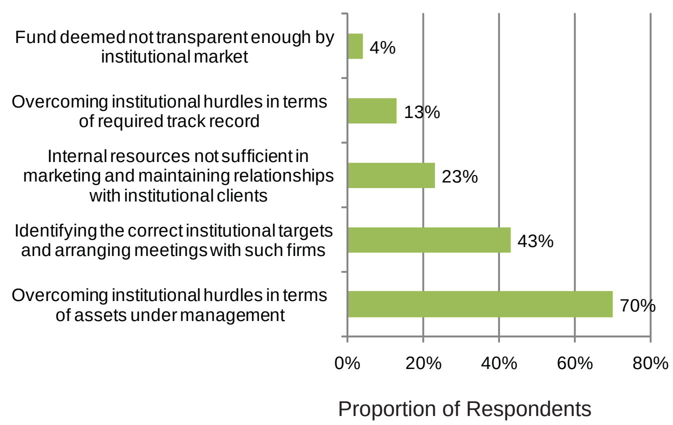
capital for funds in the $250-499mn size group. However, some institutional investors are willing to invest in even the smallest funds. For example, Chrysler Master Trust, which allocates over $2.4 billion to hedge funds, has no minimum assets under management requirements for its underlying fund managers; it will invest in small funds provided they have at least a three-year track record.

The largest hedge funds – those with more than $10 billion in assets under management – have significantly more institutional clients than their smaller counterparts. These largest funds have the institutional-quality infrastructure in place to cater for this sector of the market and many institutional investors look to seek safety in numbers by allocating only to the largest hedge funds.

Institutional investors are effecting change in the industry

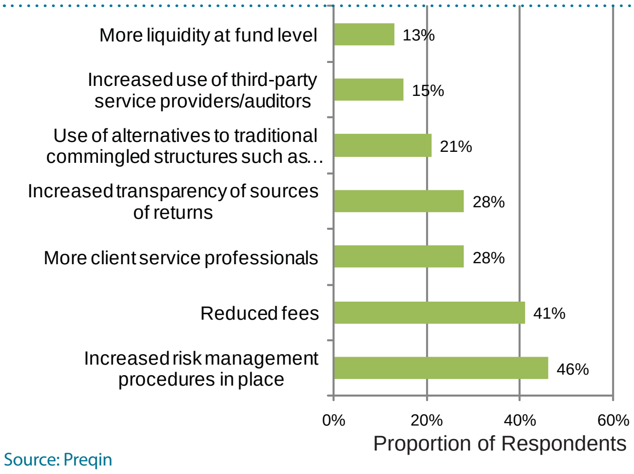
Moving from an asset class predominated by wealthy individuals and family offices to an institutionally focused industry has fundamentally changed the hedge fund market. Nearly half of respondents (46%) stated that having more institutional investors in their funds has resulted in the firm putting more risk management procedures in place (Fig. 6). Institutional investors

Fig. 5: Challenges Faced by Hedge Fund Managers in Raising Capital from Institutional Investors



Source: Preqin

Fig. 6: Effect of an Increasingly Institutional Client Base on Hedge Fund Managers



Source: Preqin

have to take into account their responsibilities to meet funding needs, as well as fulfilling regulatory procedures put in place by boards of trustees or wider legislature within their jurisdictions. Following fund failures and well-publicized fraud cases, investors have become more aware of the potential risks of investing in hedge funds and have become increasingly demanding of their fund managers to put extra protection in place.

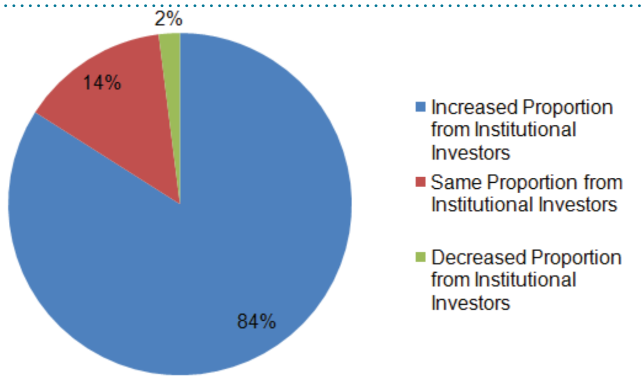
Nearly 42% of respondents informed Preqin that an increasingly institutional base of clients has led to a reduction in the fees they charge on their funds. Fee pressure from institutional investors has been a much-publicized topic of discussion in the industry over the past two years, and recent Preqin research has revealed that investors are just now beginning to feel that the fees charged by hedge fund managers have reached a level which is mutually acceptable to both fund manager and institutional client. Evidently managers have shown concessions on their side in terms of fees in order to attract institutional investors that can significantly increase the overall assets under management of their firms.

21% of surveyed fund managers have introduced alternatives to traditional commingled funds in order to attract and retain the institutional market. These include both UCITS (predominantly implemented by European fund managers) and managed account vehicles (predominantly utilized by fund managers looking to satisfy the needs of the largest investors in their funds).

Outlook for 2011

Hedge fund managers overwhelmingly predict that institutional investor capital will become more important to the industry over the next 12-18 months, with nearly 85% of all fund managers surveyed stating that they expect the proportion of their assets coming from institutional investors to increase over this time frame (Fig. 7). If institutional inflows live up to managers' expectations over the course of 2011 and into 2012 then we will witness the greatest rate of institutional growth in the asset class to date. Nearly half of all participants in the Preqin study stated that they plan to specifically market to the institutional sector in 2011 and this ranked as the most often-cited plan for fund managers over the next 12 months (Fig. 8). 38% of respondents

Fig. 7: Expected Changes in Source of Hedge Fund Managers' Capital over Next 12-18 Months

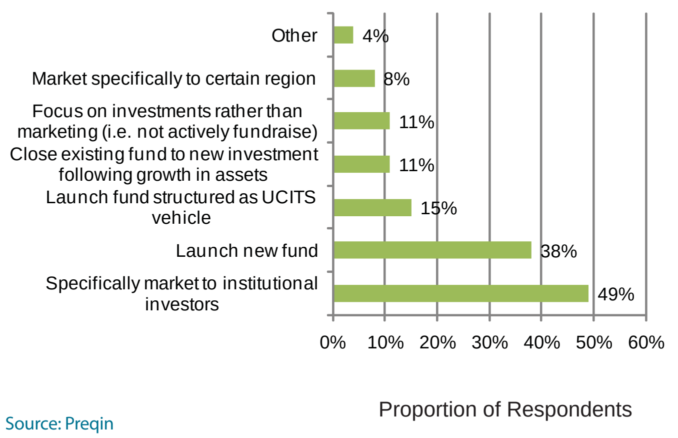


Source: Preqin

intend to launch new funds in the next year. This indicates that the industry is continuing to recover, and that fund managers are looking to capitalize on revived investor confidence and are seeing new opportunities to produce absolute returns within the wider financial markets. Further to this, 15% of participating firms plan to launch UCITS-structured hedge funds to take advantage of the burgeoning demand within the market. UCITS wrappers have traditionally catered for the retail market but institutional investors are increasingly turning to these funds in order to tap into the transparency and liquidity which are at the forefront of their demands from their hedge funds managers in this post-downturn era.

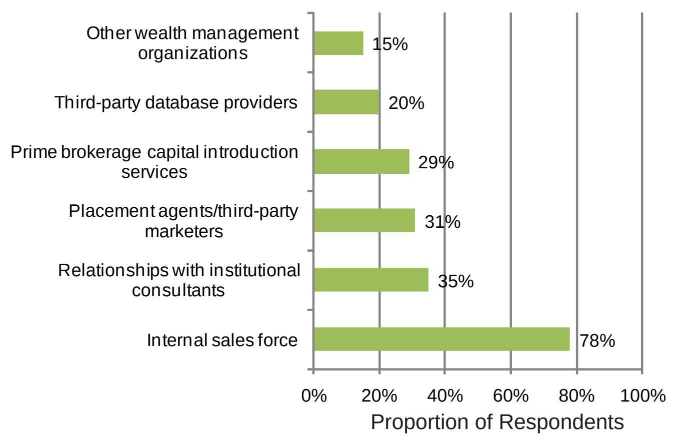
So how do fund managers source institutional investors for their funds? 78% of the fund managers interviewed by Preqin for this study market to institutional investors through their internal sales force, with teams of client service professionals dedicated to sourcing and forming relationships with institutional investors. However, with 43% of the respondents stating that one of the greatest challenges they have when marketing to institutional investors is sourcing and arranging meetings with the institutions, many fund managers are turning to external groups to assist in specifically marketing to the institutional arena. 35% of the

Fig. 8: Hedge Fund Managers' Plans for 2011



Source: Preqin

Fig. 9: Methods Used by Hedge Fund Managers to Raise Institutional Capital



Source: Preqin

managers interviewed by Preqin have formed relationships with institutional consultants to promote their funds to the wide audiences of institutional investors that such consultancy firms advise. Around 30% of fund managers enlist the help of third-party marketers and prime brokerage capital introduction services. A fifth of the fund managers which participated in this study utilize third-party database providers to market specifically to the institutional market. The institutional investor arena is constantly growing and globalizing; keeping up to date with trends and new allocators is a challenge. By using external databases to keep on top of institutional investor mandates in conjunction with internal or external marketing efforts, many fund managers are able to better understand the emerging trends and to better source institutional investors.

Summary

The consensus is clear: hedge fund managers are witnessing large inflows of capital from institutional investors. Since Preqin's first study regarding the proportion of hedge funds' asset sourced from institutional investors in 2008, when institutional investment represented 45% of capital in hedge funds, the institutional proportion of capital has grown to account for 61% of all capital at work in the asset class. With most fund managers expecting more money from institutional coffers over 2011 we can expect this figure to be even higher in 2012. Smaller funds continue to find it difficult to attract institutional investors, as many do not have sufficient assets under management to be a viable investment option for certain institutional investors. As a result, the largest hedge funds attract the most capital from institutional investors. Fund managers are using several methods to attract institutional investors, from using internal sales teams to subscribing to databases and news providers to keep on top of all the latest happenings in this important sector of the asset class.

As institutional investors have evolved, so have the hedge fund managers that serve these investors. Many fund managers have put increase risk management procedures in place, dropped fees and increased transparency at fund level as a result of trying to attract and retain institutional investors in their funds. Managers are also increasingly looking to alternatives to traditional hedge fund structures to attract institutional investors, with many funds arranging managed accounts for their investors to satisfy institutional requirements for transparency and liquidity, as well as launching new regulated UCITS versions of their funds.

About Preqin

Preqin provides hedge fund managers, marketers and others with a database of over 2,500 institutional investors in hedge funds.

Our customers can access this market intelligence in four different ways:

- Hard copy publications
- Online database services
- Consulting and research support
- Tailored data downloads

Preqin's Hedge Investor Profiles Online is a vital resource for all hedge fund managers and marketing professionals seeking backing from institutional investors. Preqin's team of dedicated analysts is constantly contacting institutional investors from around the world in order to ensure that the data we hold is up to date, reliable and complete. To register for a demo, please visit: **www.preqin.com/demo**

Preqin regularly releases research and information on fundraising and all other aspects of the hedge fund industry as both research reports, and as part of our monthly Spotlight newsletter. To register to receive more research and analysis, please visit **www.preqin.com/spotlight**

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