Overview and Evolution of the Institutional Market for Hedge Funds in Europe

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Contents

Foreword

When the Global ARC community gathered at its London meeting in 2011, there was broad consensus that governments had three choices to reduce debt: growth, default, or "liquidation" of debts through inflation. With the traditional levers of money supply growth stymied by banks' unwillingness to lend, printing money appears be an ineffective policy tool.

Still, real interest rates remain negative – in part due to macroprudential regulation ostensibly designed to reduce systemic risk (capital controls, liquidity requirements etc.). Cynics say this has kept interest rates artificially low and amounts to a form of "financial repression" that effectively transfers wealth from savers (e.g. pension funds and other institutional investors) to borrowers (e.g. governments).

Volatility, fat tail risks and "financial repression" have conspired to put unprecedented pressure on European institutional investors. This suggests that active risk management such as that practised by hedge funds may now be more important than ever. Hedge fund allocations by European pensions and foundations have grown over the past five years, supplanting the traditional dominance of family offices. Despite a challenging 2011 for many hedge funds, this study finds that nearly a third of European institutional investors plan to increase the number of hedge funds to which they allocate capital.

Global ARC is pleased to have worked with Preqin on this comprehensive study of the needs of this critical segment of investors. The study finds that an astounding 18% of European institutional investors polled expect to invest over €200mn of fresh capital in hedge funds over the next 12 months. It also finds positive news for funds of funds (particularly large funds of funds) after a challenging period for the segment.

Still nearly 80% of European institutional investors cited "performance concerns" as the main reason for making a redemption. With the most popular strategies (global macro, long/short and managed futures) now taking their cue from geopolitical and macroeconomic developments, institutional investors need to better understand the broader context of their hedge fund investments. What are the mechanisms of transmission from recent geopolitical developments to the global economy, capital markets, pension deficits and ultimately to hedge fund strategies?

The Global Absolute Return Congress (Global ARC) was created a decade ago to explore these complex linkages. Thus, we encourage you read this report and to discuss and debate its findings with your hedge fund managers (if you are an institutional investor) or with your investors (if you are a hedge fund manager). We believe the resulting dialectic will contribute to the stability and growth of this increasingly important asset class.

Sincerely,

Christopher Holt
Managing Director,
The Global Absolute Return Congress

Overview of Europe as a Base for Institutional Investors

Europe represents a diverse landscape of many different types of institutions, regulatory regimes and economies. The combination of these factors makes marketing hedge funds in the region complex, and it takes a deep understanding of the investors within Europe to navigate the fundraising environment successfully. Using Preqin's database of 1,000 institutional investors based in Europe, we take a closer look at some key facts about investors in this region – which countries are the most active, what types of investors can be found in the region, and where they are allocating their hedge fund capital.

As shown in Figs. 1 and 2, the UK is the European hub of hedge fund investment. It is home to around 39% of Europe-based institutional investors in hedge funds, with the largest number of investors being located in London. The UK landscape is widely diversified by investor type, with funds of funds, public and private pension funds, insurance companies, foundations and family offices all being found with active hedge fund portfolios.

Switzerland is another prominent source of capital for hedge funds, with its world-renowned private banking and wealth management industry. Twenty-two percent of European investors are based in the Alpine nation, with a large proportion of investors domiciled in Zurich and Geneva. Zurich boasts a strong institutional investor base stemming from its heavy insurance and pension fund cluster, along with the largest asset management community in the country. Geneva also possesses a strong private banking industry as well as an established commodity trading community. Paris is a good destination for fund marketers looking to raise capital from the institutional community; however, France as a whole is still relatively cautious when investing in hedge funds, and the country represents just 3% of the European market.

European Investors' Geographical Preferences

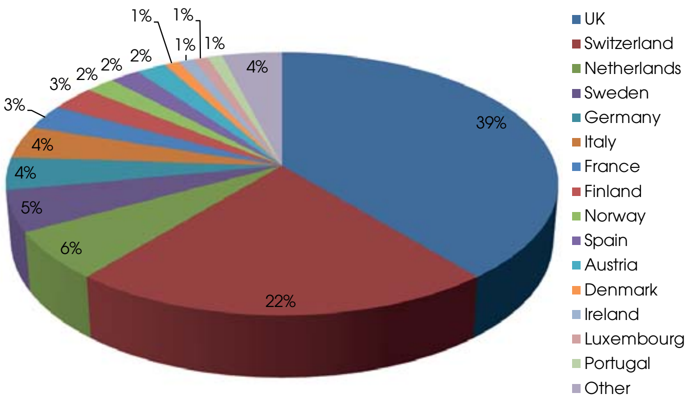
Fig. 3 demonstrates that 62% of European hedge fund investors consider Europe a key target for investment, with a larger proportion (77%) indicating that they would broaden the scope of their searches to a global scale.

Although many European investors prefer to gain some form of exposure to their developed domestic region, Fig. 3 also shows a significant proportion of European investors are looking to tap into markets in Asia and other emerging markets in order to broaden their investment focus and take advantage of growing economies within these regions. The hedge fund industry in these developing economies is much younger than its American or European counterparts, but no less dynamic, and can offer some interesting value propositions. Hedge funds in this part of the world are being pursued by European investors seeking investment talent capable of generating alpha in what continues to be a highly competitive market. Many countries in Asia and Rest of World are still classic emerging market plays, with the political interference and red tape associated with this territory. However, at the same time hedge fund managers based in these regions have access to the well-regulated liquid securities markets in Australia, Japan, Hong Kong and Singapore.

Fig. 2: Top Five European Cities by Number of Institutional Hedge Fund Investors

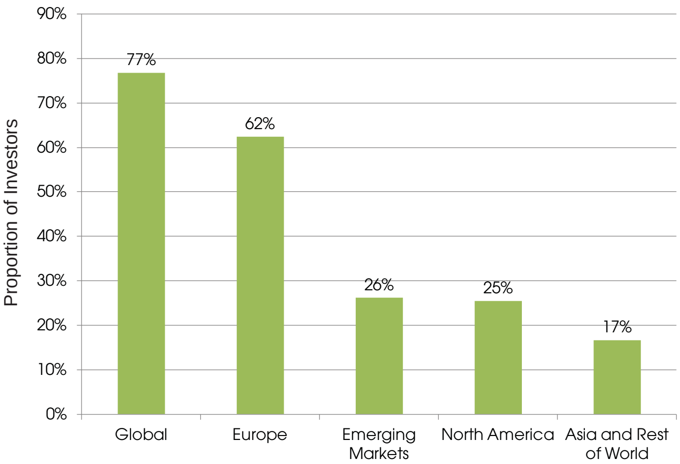
City	Number of Investors
London	205
Geneva	55
Zurich	53
Stockholm	38
Paris	28

Fig. 1: Breakdown of Europe-Based Institutional Investors in Hedge Funds by Country



Source: Preqin

Fig. 3: Regional Investment Preferences of Europe-Based Institutional Investors in Hedge Funds



Source: Preqin

Overview of the Types of European Investors Active in Hedge Funds

The European hedge fund investor landscape has fundamentally changed in recent years, as many institutional investors have become increasingly aware of the need to diversify their portfolios and tap into new sources of alpha since the financial crisis. Consequently, investments in the hedge fund space have become increasingly attractive to a wide range of different types of European institutions, from pension funds to banks to foundations.

Private Sector Pension Funds

The number of private sector pension funds active in hedge funds has been steadily increasing over recent years and these investors have become one of the fastest growing groups in terms of importance to the hedge fund industry. As shown in Fig. 4, private sector pension funds represent the largest proportion of the European investor universe after funds of hedge funds. However, as shown in Fig. 5, many have cut their allocation to hedge funds since 2010. Today, the average allocation to hedge funds of a private sector pension fund stands at 6.4%.

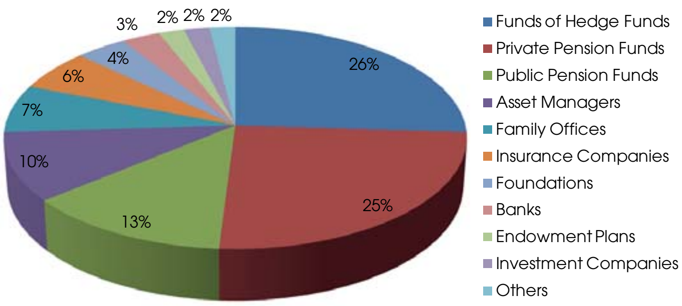
Many of these pension funds are now favouring a switch from funds of hedge funds towards direct investment in hedge funds. The drive towards a direct style of investment comes from the institutional desire to customize portfolios, and the need for increased transparency and reduced fees. Since the onset of the financial crisis we have seen that private sector pension funds have become more demanding in their liquidity and transparency requirements as well as the returns they expect from their hedge fund investments.

Public Pension Funds

Public pension funds have continued to demonstrate their commitment to the hedge fund asset class over recent years by increasingly adding hedge funds to their portfolios. There has been a slight dip since 2011 in terms of their average allocation to hedge funds as a proportion of assets under management; however, over the longer term, public pension funds remain committed to the asset class. The importance of public pension funds among European institutional investors is highlighted in Fig. 4, which shows that a significant 13% of the European hedge fund investor base is made up of public pension funds. With their large ticket sizes, the average 5.1% of total assets that they invest in hedge funds equates to a very large amount of capital being directed into hedge funds from these institutions.

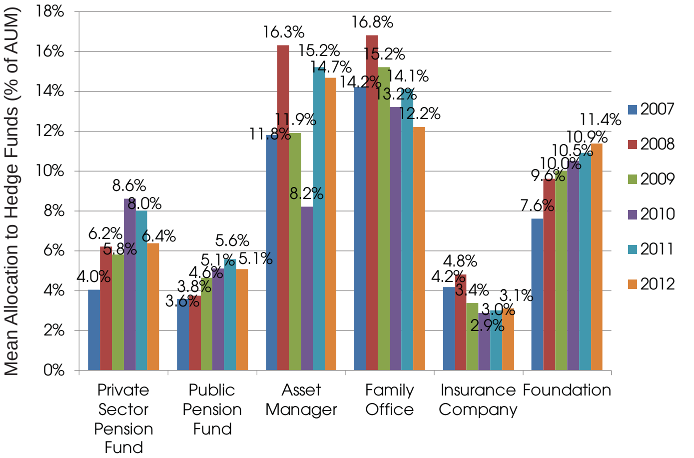
As with private sector pension funds, public pension funds have become more sophisticated in their approach to investing in hedge funds and as a result are also looking to move away from solely investing via funds of hedge funds. Despite this shift, many schemes that are new to hedge funds and are eager to gain their footing in this complicated asset class continue to seek the expertise of funds of hedge funds, with many having a particular interest in managed account structures.

Fig. 4: Breakdown of Europe-Based Institutional Investors in Hedge Funds by Investor Type



Source: Preqin

Fig. 5: Mean Allocation to Hedge Funds by Investor Type, 2007-2012



Source: Preqin

Family Offices and Foundations

Both family offices and foundations are typically long-term, results-orientated investors and have shaped the institutional universe through innovative and extensive use of hedge funds within their investment portfolios. As shown in Fig. 4, family offices and foundations make up a significant proportion (11%) of the European investor universe, making them a valuable source of capital for managers as they continue to build large and diversified hedge fund portfolios. The average allocation to hedge funds of a Europe-based family office has fallen from 14.2% in 2007 to 12.2% today, as they seek opportunities in other areas of their portfolios such as private equity. Family offices nonetheless remain good targets for hedge funds as they are known to have accumulated large and diverse portfolios of small and emerging managers and niche strategies.

Foundations have been steadily increasing their exposure to hedge funds over the past five years – from 7.6% in 2007 to 11.4% today. This commitment to hedge funds, despite the crisis of 2008 and the return to poor performance in 2011, highlights that foundations view hedge funds in a very positive light and seek to add hedge funds to their portfolios for long-term sources of alpha.

Insurance Companies

Insurance companies also represent a significant proportion (6%) of the European hedge fund investor base due to the vast insurance industry that exists across Europe. However, the crisis of 2008 severely impacted their outlook on the asset class, with average allocations falling from a high of 4.8% in 2008 to a low of 2.9% in 2010.

Despite this, there are promising signs that insurance companies are regaining their trust in hedge funds as average allocations have begun to increase again over the past two years. Though they typically have small percentage allocations to the asset class, often limited by local regulations and restrictions, the amount that insurance companies invest in hedge funds can often be significant due to the size of their total assets.

The Re-Emergence of European Funds of Funds

Investor perception of the global fund of funds market was dented following the events of 2008. Poor performance and exposure to fraudulent vehicles left many institutions disillusioned with the multi-manager industry. However, since this time funds of funds have worked hard to regain investor trust and to evolve their business into a new model to win the appeal of the institutional community. Preqin's Hedge Fund Investor Profiles database contains profiles for 249 European fund of hedge funds managers and here we use this extensive data to analyze trends in the industry and evaluate prospects for the remainder of 2012.

Since 2008 the hedge fund industry has undergone significant changes, a trend that is continuing due to wider financial market instability. With concerns over the eurozone sovereign debt crisis and slow economic growth continuing to hit hedge fund performance, many investors are proceeding with caution when investing in the asset class. This has led to several challenges for European funds of hedge funds, with a number of investors aiming to avoid the double layer of fees associated with the model and performance concerns that have resulted in a number of fund closures over the last four years. Despite this, however, the overall picture remains relatively healthy for the European fund of funds industry and total assets have grown over the past 12 months to now stand at approximately $356bn.

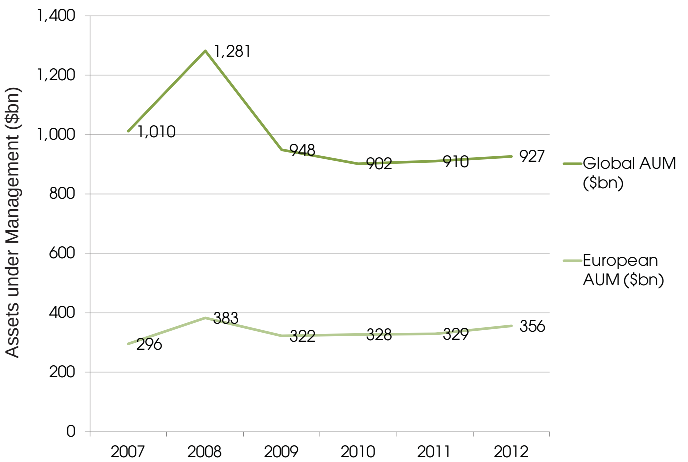
How the European Fund of Hedge Funds Industry Has Changed since 2007

Due to the financial crisis, the fund of hedge funds sector saw a decline in aggregate assets from $1.28tn in 2008 to $948bn in 2009, as shown in Fig. 6, which was a 26% decrease in the industry's total assets under management (AUM). This decline in global AUM was mirrored by the European fund of hedge funds industry, which decreased by 16% from $383bn in 2008 to $322bn in 2009. However, since 2009 there has been some evidence of a recovery, with the AUM of both European funds of funds and the industry as a whole increasing between 2010 and today. During this period the sector has seen new allocations to hedge funds as a result of improved investor demand, created by wide-ranging changes in the industry. With many investors looking to increase allocations still further in 2012, there is the potential for further growth over the course of the year, although managers must ensure that they continue to react to changing investor demands. Investors now expect more from their hedge fund managers, including increased liquidity and transparency, which means that many funds of funds may have to re-define themselves in order to continue receiving institutional capital.

Breakdown of European Fund of Hedge Funds Managers by Size

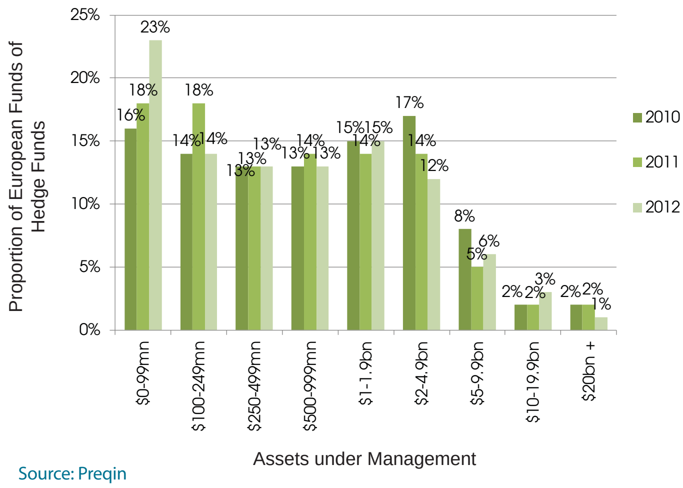
European funds of hedge funds vary in size considerably; the smallest fund of hedge funds manager currently tracked by Preqin manages less than $1mn in assets, whereas the largest currently manages close to $35bn. Fig. 7 demonstrates that between 2010 and 2012 there was a noticeable increase in the proportion of smaller fund of hedge funds managers, with 37% of managers having total assets of less than $250mn in 2011 compared with 30% in 2010. As a result some of the larger size groups have shown a proportional decrease since 2010, with the $2-4.9bn range showing a five percentage point decrease. However, many of the largest European funds of hedge funds have retained their presence in the hedge fund industry in the wake of the financial crisis.

Fig. 6: Assets under Management of Global Fund of Hedge Funds Industry vs. European Fund of Hedge Funds Industry, 2007-2012



Source: Preqin

Fig. 7: Breakdown of European Funds of Hedge Funds by Assets under Management, 2007-2012



Source: Preqin

Handful of Giants

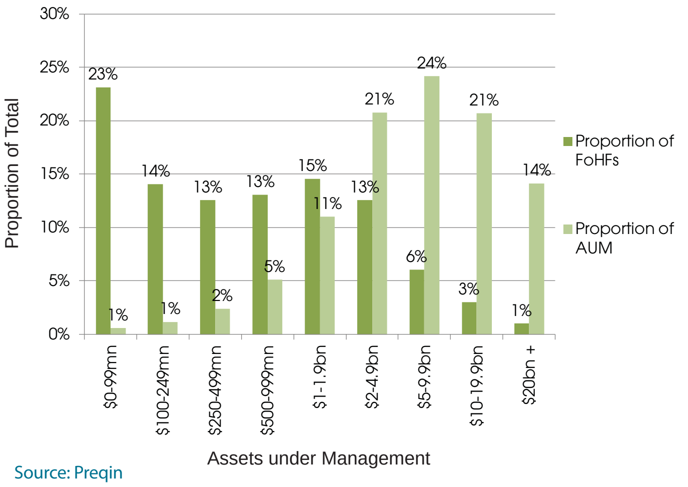
Fig. 8 shows the breakdown by AUM of European fund of funds managers versus a capital-weighted breakdown. From this figure we can see that there are only a handful of fund of funds managers with assets of $10bn or more. While these managers represent approximately 4% of the number of European funds of funds, in terms of assets they represent approximately 35% of all capital in the multi-manager space: a large proportion of the assets in the industry are controlled by a relatively small number of funds. It is these large European fund of hedge funds managers that can be vital to the success of a fund manager – they not only invest in a significant number of vehicles, but also have large ticket sizes that can transition a small emerging vehicle into an established fund capable of appealing to the broader spectrum of institutional investors.

Allocations to hedge funds in general among institutional investors are continuing to rise and this trend is expected to continue throughout 2012. Overall trends suggest that favour for single-manager hedge funds is growing, which means that funds of funds may need to make changes in order to remain successful and relevant to investors. Many European multi-managers have already made structural changes, but more work is required in order to meet investor demands on transparency, customized portfolios and fee structures.

Despite recent negative publicity regarding the fund of funds model, there remains the potential for such managers to continue to attract further capital over the next few years, as the model on the whole still remains popular with investors. Hedge fund investors that are small, inexperienced, lacking internal resources, or those that are looking to invest in niche strategies/geographies, can benefit significantly from accessing the experience and resources of funds of hedge funds.

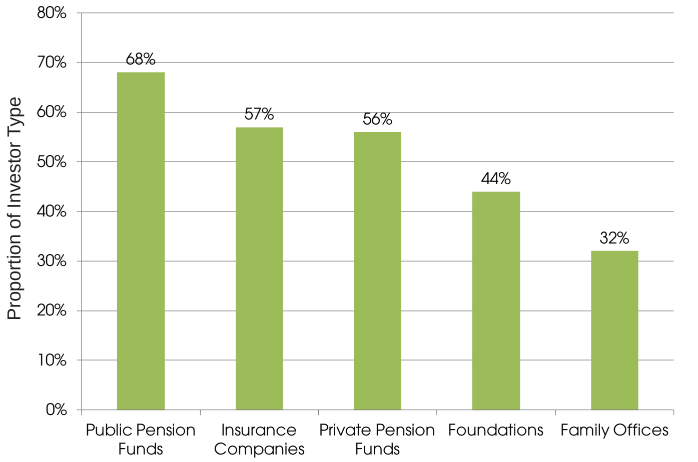
To tap into investor demand, several European managers have recently launched new fund of hedge funds products and this trend is likely to continue over 2012 as they look at fresh ways of gaining additional capital. For example, UK-based fund of hedge funds manager Stenham Asset Management recently launched a new global macro-focused fund of hedge funds that offers investors monthly liquidity.

Fig. 8: Breakdown of Number of European Fund of Hedge Funds vs. Breakdown of Assets under Management (as of April 2012)



Source: Preqin

Fig. 9: Proportion of Europe-Based Institutional Investors that Have a Preference for Funds of Hedge Funds by Investor Type



Source: Preqin

Future Prospects for the European Fund of Hedge Funds Industry

Since 2008, European funds of funds have had to change in order to remain competitive and continue attracting capital from investors. Due to the challenging economic environment, many investors now look for greater transparency from their managers and as a result more managers are now offering managed account versions of their vehicles. This new investor attitude is exemplified by Avon Pension Fund, which began moving its commingled fund of hedge funds investments into managed account structures in 2011. A further example of this growing trend is Hermes BPK, which offers managed account platforms and has recently launched a new managed account vehicle focusing on managed futures. A further development in recent years is the growing popularity of UCITS-compliant hedge funds, which can offer the increased levels of transparency and liquidity that many investors now require.

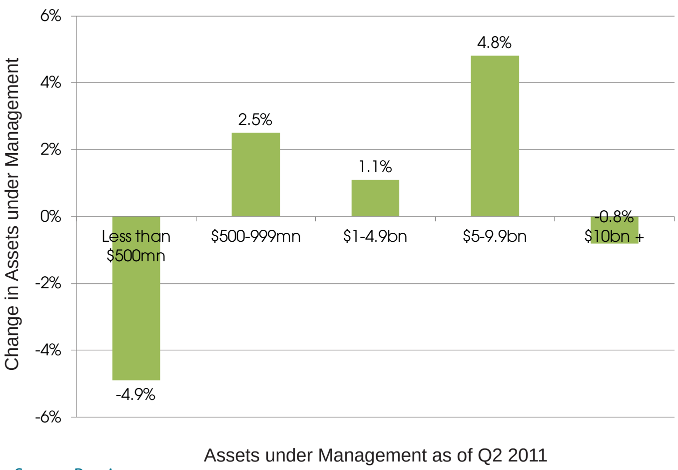
2011 was a challenging year for the hedge fund industry overall due to poor performance. Compared to the poor performance experienced as a result of the financial crisis in 2008, when the fund of funds sector was worse affected than direct hedge funds, the performance of funds of hedge funds in 2011 was more in line with wider hedge fund industry performance; however, across all funds of hedge funds, returns were still in negative territory, with the sector-wide figure standing at approximately -4.9%.

When looking to the future it is important to remember the past – many funds of funds are still continuing to struggle when it comes to retaining capital. Fig. 10 clearly shows that managers at both ends of the fund of funds spectrum have lost capital over the past 12 months. The smallest fund of funds managers – those with assets under management of under $500mn – suffered the most, with each manager decreasing on average by 4.9%.

However, the mid- to large-sized managers were more successful, with funds between $5bn and $10bn growing the most over the course of 2011. However, even at the top end of the spectrum, the largest funds of funds shrank by an average of 0.8% as they struggled with investor outflows coupled with performance issues. Despite funds shrinking at the poles of the AUM spectrum, we can still expect inflows into funds of hedge funds in the next 12 months, with 24% of the mandates currently being sought on the Preqin database being for funds of funds. It seems that even though investors are turning away from the smallest fund of funds management groups, they are looking for more than just sheer size of the firm when it comes to placing fresh capital in the sector.

Predicted increases in institutional allocations to hedge funds in 2012 mean that European fund of hedge funds managers need to react to the demands of investors if they are to gather a significant proportion of this new capital. Current trends show that funds of funds around $5bn in size are continuing to attract investors in the early stages of hedge fund investment looking for established names. Despite this, more established and experienced investors are demanding greater transparency and flexibility from their fund of funds managers, in addition to more investor-friendly fee structures. This is likely to lead to an increase in niche hedge fund strategies and innovative products as fund of funds managers look at inventive ways of attracting institutional capital ahead of single-manager offerings. The next generation of European funds of hedge funds will need to accommodate the needs of the ever-evolving hedge fund investor group, and managers that react to this are more likely to be most successful in increasing their AUM. Providing managers are pragmatic and respond to the changing demands of investors, there is the potential for the European fund of hedge funds industry to continue to grow and send the total AUM back towards the pre-crisis $383 billion mark.

Fig. 10: Change in Fund of Hedge Funds Managers' Assets under Management from Q2 2011 to Q2 2012



Source: Preqin

European Investor Outlook on Hedge Funds

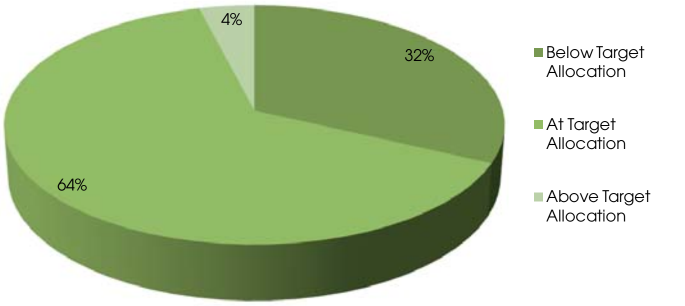
The last five years have been challenging times for hedge funds and investors alike. Market volatility, a challenging returns environment, and concerns over hedge fund operations have all taken their toll on the asset class. However, institutional investors remain committed to allocating fresh capital to hedge funds, as they seek to boost the overall performance of their portfolios and to gain access to new strategies. Preqin conducted in-depth interviews with over 50 European institutional investors active in hedge funds to ascertain their outlook on the asset class going forwards.

Hedge Fund Inflows Expected in 2012

Following a turbulent 2011, European institutional investors remain committed to their hedge fund portfolios in 2012. Fig. 11 demonstrates that the bulk of European hedge fund investors are either at or below their target allocation to hedge funds. This suggests that the majority of investors will continue to actively invest in the asset class over the next 12 months, in order to maintain or boost their allocation towards their target level. This is highlighted further in Fig. 12, which shows that 50% of European investors surveyed plan to invest fresh capital in the hedge fund space over 2012. This indicates that many investors have retained confidence in the asset class, despite the challenging market conditions resulting from increased volatility.

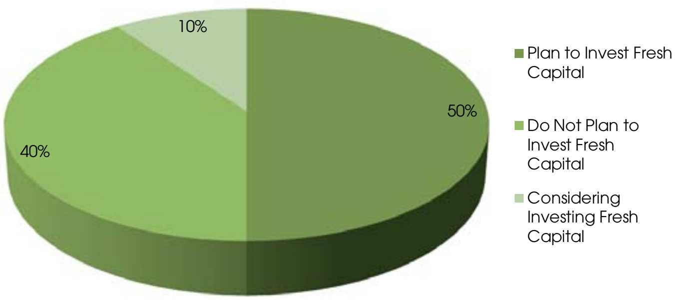
Forty-seven percent of investors planning to invest fresh capital in hedge funds over the next 12 months are looking to invest around €5-20mn in the move, as shown in Fig. 13. A smaller proportion of investors surveyed (11%) were yet to decide how much capital to commit and therefore planned to take a more opportunistic approach, investing when attractive opportunities arise or when further investment is deemed necessary from an overall portfolio perspective. Nearly a fifth of the investors planning to allocate fresh capital indicated that they would commit over €200mn to hedge fund investments in the next 12 months, which is very positive news for the industry and could mean significant growth of European hedge fund assets being driven by these large investors in the asset class.

Fig. 11: Proportion of Europe-Based Institutional Investors At, Above or Below their Target Allocation to Hedge Funds



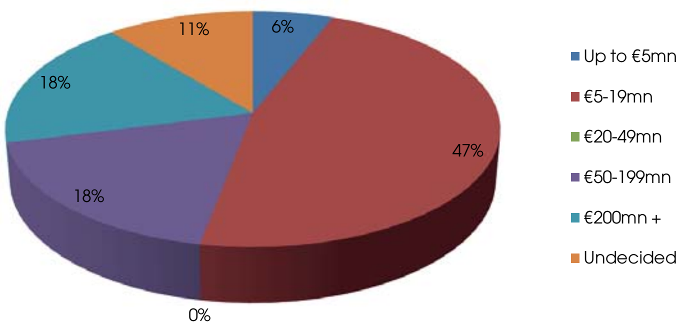
Source: Preqin

Fig. 12: Proportion of Europe-Based Institutional Investors Planning to Invest Fresh Capital into Hedge Funds over the Next 12 months



Source: Preqin

Fig. 13: Amount of Fresh Capital Europe-Based Institutional Investors Expect to Invest in Hedge Funds over the Next 12 Months



Source: Preqin

European Investor Portfolio Turnover

Sixty percent of European institutional investors have indicated that they could potentially allocate fresh capital to hedge funds in the next 12 months. With some investors suggesting that their new allocations could be above €200mn, this could amount to a significant level of inflows for managers, both within Europe and globally. With this in mind we now examine where this money is coming from and which types of managers it is likely to flow to.

Many European hedge fund investors are likely to devote a significant proportion of their hedge fund investments in 2012 to managers they have not previously invested with. As Fig. 14 demonstrates, 38% of European investors stated that they plan to add new managers to their hedge fund portfolios over the coming 12 months. However, many investors surveyed (36%) plan to increase investments with existing managers as part of their strategy for 2012.

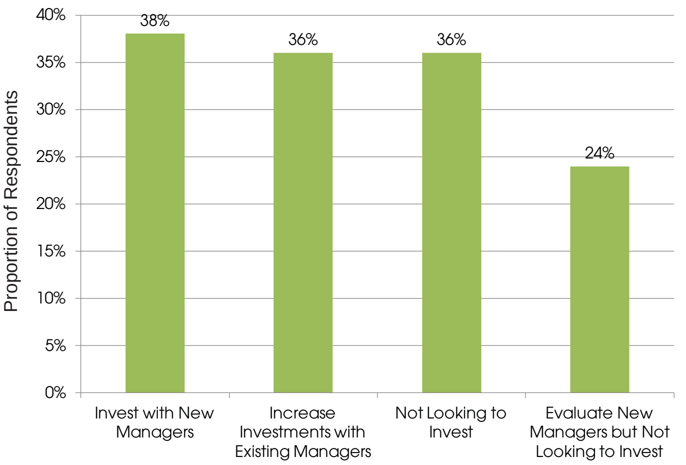
This shows there is great potential for hedge fund managers to seek capital from both existing investors and previously untapped European institutional sources. Additionally, around a quarter of the investors that participated in the study stated that they will actively be evaluating new hedge fund proposals but are unlikely to make any new allocations until 2013.

Portfolio Turnover of European Hedge Fund Investors

Portfolio turnover has become of particular interest over the past 12 months as turbulent and volatile markets continue to impact the level of redemptions and additions to investors' hedge fund portfolios. Figs. 16 and 17 show that European investors typically add and redeem hedge fund investments at similar rates, thus generally maintaining the overall number of hedge fund relationships in their portfolios, and adding and removing hedge funds on a 1:1 basis. As shown in Fig. 15, 62% of investors are looking to maintain the number of hedge fund manager relationships in their portfolio over 2012.

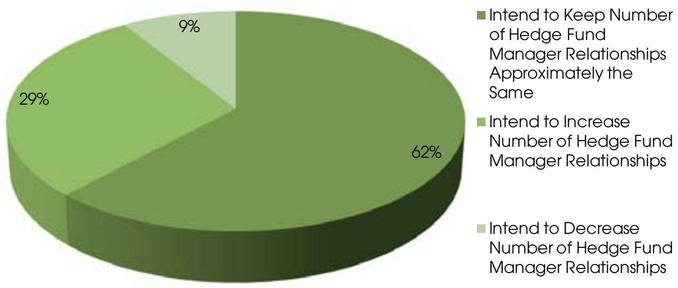
A large proportion of European institutional investors have a relatively high turnover rate, adding hedge funds and redeeming from others at least every six months. This suggests that they are willing to modify their portfolios on a regular basis as they deem appropriate. However, a significant proportion of investors continue to follow a less active approach and typically only make redemptions and additions to their portfolio on an annual basis or every two years.

Fig. 14: Europe-Based Institutional Investors' Plans for Hedge Fund Manager Selection



Source: Preqin

Fig. 15: Europe-Based Institutional Investors' Plans for the Number of Hedge Fund Manager Relationships in 2012



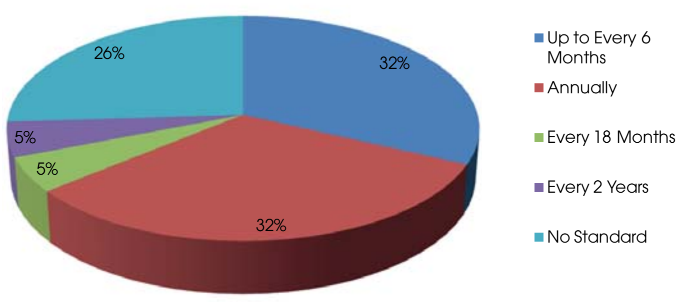
Source: Preqin

Acquiring institutional support offers many benefits for the growing hedge fund. Firstly, the typical institutional ticket size is larger than the typical high-net-worth individual ticket size, and gaining a few key investments from the institutional market can catalyze future fund growth. In addition, institutional assets are often reported to be "stickier", i.e. these investors remain invested in funds for a longer period of time than private individuals. With this in mind we asked institutional investors about their typical holding periods for hedge funds. Fig. 18 shows that around a third of investors questioned invest in a hedge fund for six months to one year as a minimum. A similar proportion (32%) have a maximum holding period of 25 months to three years. However, more than a fifth of investors are open to keeping capital invested in a fund for over five years, with 16% stating that five years is the minimum amount of time they would stay invested in a fund. This shows that the institutional market can be a long-term and stable source of investment for those funds meeting institutional portfolio objectives. However, a not insignificant 7% of institutional investors surveyed would redeem from a fund in less than six months if it failed to deliver.

Factors Leading to Investor Redemptions

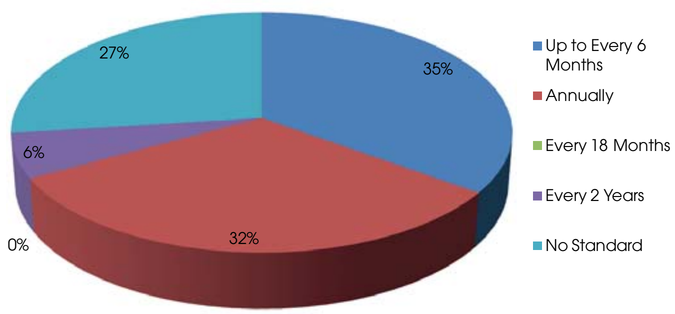
The majority of investors surveyed (79%) revealed that they typically make redemptions due to performance concerns, as shown in Fig. 19. The crisis of 2008 has undoubtedly left investors increasingly cautious and more diligent when reviewing their hedge fund portfolios, and the ongoing performance issues which have dogged the asset class since the credit crisis have led to investors looking ever more closely at how well their managers are performing. Managers which cannot meet institutional portfolio objectives will come under pressure from investors to improve or face redemption requests. Second to performance issues, concerns over other aspects of the fund such as strategy drift or overuse of leverage, were the most cited reason as to why investors liquidated their holdings in funds. A fifth of investors stated that internal changes in their own portfolio strategy have led to redemptions.

Fig. 16: Frequency of Additions to Europe-Based Institutional Investors' Hedge Fund Portfolios



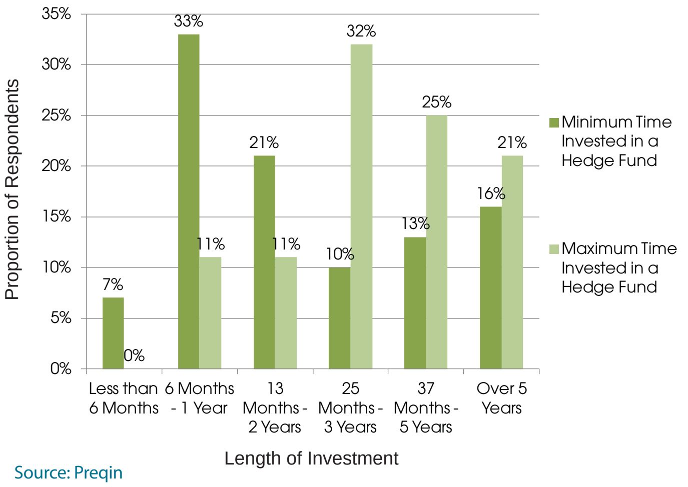
Source: Preqin

Fig. 17: Frequency of Redemptions from Europe-Based Institutional Investors' Hedge Fund Portfolios



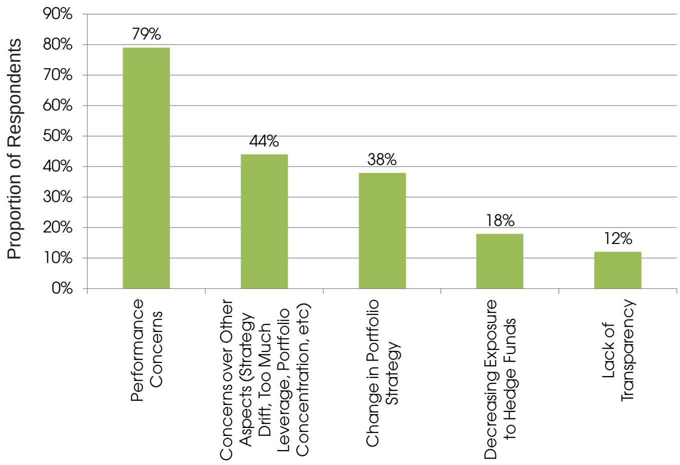
Source: Preqin

Fig. 18: Breakdown of Europe-Based Institutional Investors' Typical Time Invested in a Hedge Fund



Source: Preqin

Fig. 19: Europe-Based Institutional Investors' Reasons for Making Portfolio Redemptions



Source: Preqin

Strategies Presenting Attractive Opportunities for European Hedge Fund Investors in 2012

It is clear that fresh capital will be coming into the hedge fund industry from European institutional investors throughout the rest of 2012 and into 2013. The question is – where will this money go? And what can managers do to ensure they receive a portion of this capital?

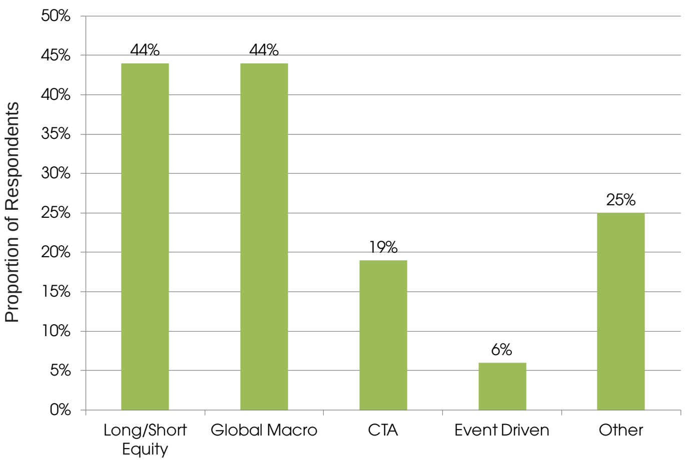
European investors were asked about their opinions on which strategies are offering the best opportunities in 2012. Long/short equity and global macro are the most popular strategies currently among institutional investors, with an equal proportion (44%) of investors stating that these strategies present attractive prospects for 2012. Long/short equity continues to be seen as an attractive strategy by many hedge fund investors due to its ability to provide a level of protection in falling markets, while capturing the majority of the upside in rising markets. Investment in global macro remains prevalent as the strategy is seen by many investors as useful in times of uncertainty, due to its liquid approach and ability to profit from big market moves. Fig. 20 also shows that many investors stated 'other' strategies as a preference for 2012. It is no coincidence that these strategies include those which survived the volatility of 2011, such as asset-backed securities, which had one of the best performance records in 2011. The chart also demonstrates the popularity of CTA, with 19% of investors stating that CTA hedge funds are an attractive prospect for 2012. CTA has been one of the best performing hedge fund strategies over the past three years and therefore continues to interest institutional investors looking for safe havens amid adverse economic conditions. In such a volatile environment this style of fund has the ability to move quickly with a focus on highly liquid investments.

Making Your Impression on the Institutional Market

As the industry continues to grow and more funds come to market, managers will need to stand out from the crowd to be noticed by the institutional community. We asked investors what is the single most important factor they look for when short-listing fund proposals. A large portion of investors, 20%, said that the returns were the most significant factor when deliberating over a fund. Investors look for funds with a proven track record of good performance, and although historical performance is no guarantee of future returns, it can provide the investor with insight into how the fund has fared during periods of volatility in the past. Twenty percent of the surveyed investors also said that the source of the returns and the strategy used by the fund was the most important factor.

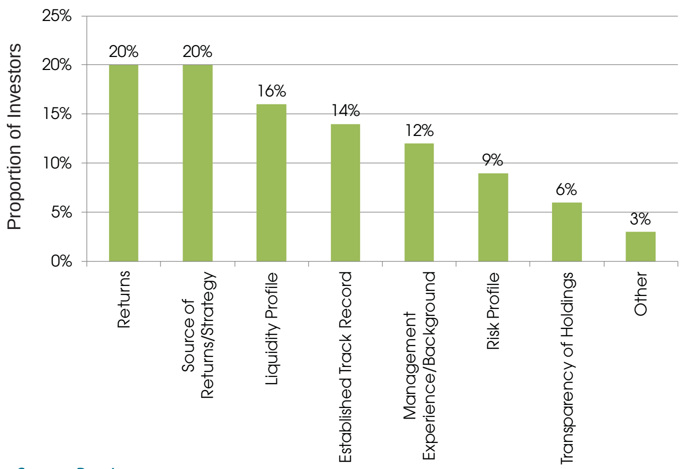
Investors look to pick funds that complement their existing portfolios of hedge funds as well as their wider holdings, and therefore getting access to the right strategy is a significant factor in selecting a potential investment. Liquidity also plays an important role for many investors when assessing potential hedge fund investments. Liquidity has been a key issue for investors since the financial crisis and remains relevant today. In times of market volatility the ability to access capital is important for institutional investors, many of which were caught with their capital gated in 2008. Therefore even though investors do look to stay in funds for relatively long periods, having the comfort of short lock-ups or redemption notice periods reassures investors that they can access their money should the wider market environment turn hostile again.

Fig. 20: Top Five Hedge Fund Strategies that Europe-Based Institutional Investors Feel Present Attractive Opportunities in 2012



Source: Preqin

Fig. 21: Europe-Based Institutional Investors' Most Important Factor when Assessing a Potential Fund Investment



Source: Preqin

The European Outlook on Emerging Managers

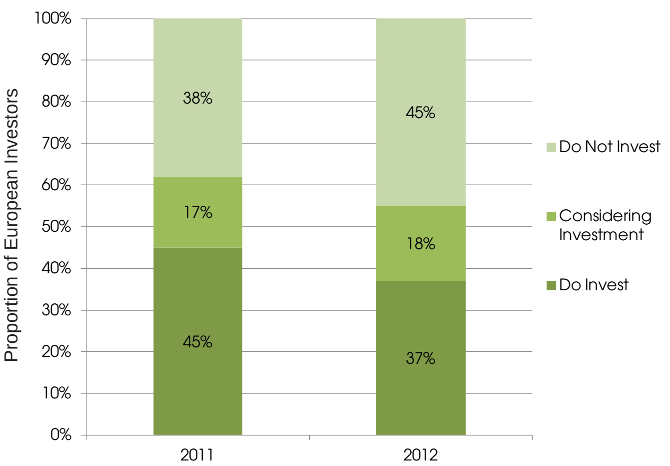
Emerging managers have endured a challenging period for fundraising in recent years, as much of the new capital being allocated to hedge funds was only flowing into the largest and most established funds. The fundraising environment faced by younger funds in the wake of the eurozone crisis has remained challenging as investors look to invest in less risky, more established funds in response to heightened market volatility – around 80% of the investors we surveyed stated that their appetite for emerging managers had been dampened over the last year. Despite this, emerging managers still appeal to the institutional community, and we now examine this topic in more detail.

As Fig. 22 shows, the proportion of European investors that will invest in emerging managers has dropped significantly over the past 12 months, with 45% of institutional investors now ruling this out completely as compared to 38% a year ago. However, 55% of European investors today still look at emerging managers, which is encouraging news for the smaller and younger funds looking to gain some institutional capital.

Emerging manager vehicles are likely to appeal to European investors disappointed by the returns from their existing hedge fund portfolios. Some investors look to invest in smaller, more nimble funds as they feel that these funds are in a better position to adapt quickly to changes in market conditions. With fees also a key issue for institutional investors, emerging managers that are willing to negotiate fund terms with potential investors could also be successful in attracting capital.

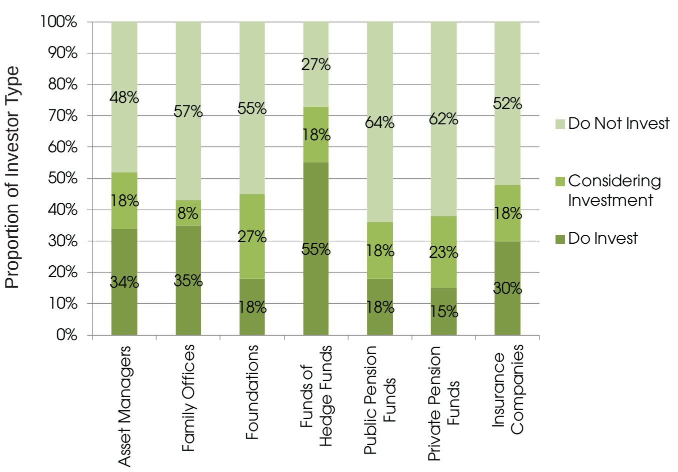
Emerging manager investors are most commonly those that have large resources behind them or extensive experience within the hedge fund industry. Funds of hedge funds have the largest appetite for emerging manager funds, with 55% stating that they will invest in young or small vehicles and 18% considering it going forwards. Funds of funds are undoubtedly at the forefront of hedge fund investing and are more willing to take on the risks involved in investing with a much less established manager. Other types of asset managers also show a strong preference for emerging manager vehicles in their pursuit for funds producing strong returns. Family offices, one of the traditional backers of emerging managers and younger fund groups, remain one of the leading groups active in emerging funds. The objectives of family offices are often closely aligned to investment in smaller funds, as they seek to produce large returns without being as risk averse as groups of investors such as pension funds, which have to consider their fiduciary responsibilities. Interestingly, 30% of European insurance companies currently invest in emerging manager vehicles. Typically, insurance companies are more conservative investors, but many have opted to invest in emerging manager funds through funds of funds or other platforms in order to get exposure to emerging funds while reducing risk through diversification in a multi-manager format.

Fig. 22: Emerging Manager Appetite among Europe-Based Institutional Investors, 2011-2012



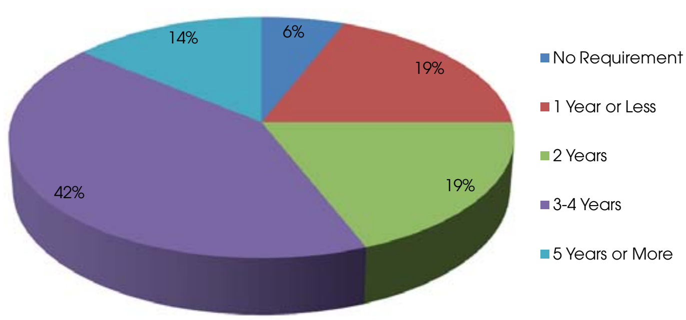
Source: Preqin

Fig. 23: Breakdown of Emerging Manager Appetite among Europe-Based Institutional Investors by Investor Type



Source: Preqin

Fig. 24: Fund Manager Track Record Required by Europe-Based Institutional Investors



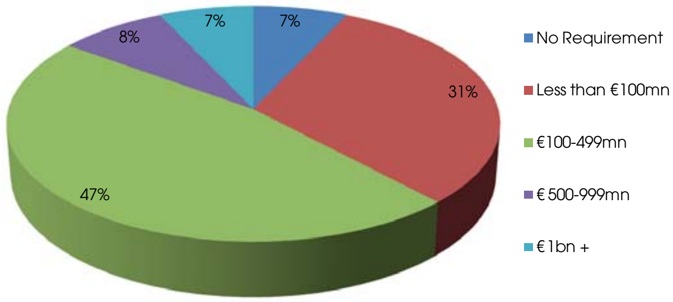
Source: Preqin

Although emerging managers need to work harder to attract investors, there are still opportunities available to them, particularly those that have managed to build up a track record in the industry. With a number of established funds performing below expectations in 2011, emerging managers can look to capitalize on this when seeking to attract institutional investor capital. Therefore, if marketed correctly, these funds could have plenty of opportunities to attract further investment.

Barriers to Entry

The new era of caution in terms of emerging manager investment can be seen in changes to track record and assets under management requirements of the institutions on Preqin's database of investors. The majority of investors, 54%, look for managers with a three-year track record or more. However, compared to their global counterparts, European investors are more likely to look at younger funds, with 46% of Europe-based investors considering a fund with a two-year track record or less, compared to 38% on a global basis. European investors will also consider funds of a relatively small size; 31% of Europe-based institutional investors are willing to allocate capital to hedge funds with less than €100mn in assets under management. However, for many investors, such funds are too small to feasibly invest in without representing too large a proportion of the fund's total assets. Therefore a higher proportion of investors look at funds at least in the range of €100-499mn.

Fig. 25: Fund Manager Assets under Management Required by Europe-Based Institutional Investors



Source: Preqin

UCITS and Managed Accounts

Liquidity and transparency have been the words on everyone's lips since the events of 2008. Many investors, both in Europe and across the globe, were caught invested in assets they were not aware of. This was then followed by gating of their capital as managers struggled to liquidate illiquid positions. The rise to prominence of UCITS vehicles and managed accounts over the past five years can be attributed to a demand for liquidity and transparency from the investor community, as both offer advantages in these areas over traditional commingled offshore funds.

European Investor Appetite for UCITS-Compliant Hedge Funds

UCITS-compliant hedge funds are continuing to grow in prominence among institutional investors, with a broad range of organizations making allocations to hedge funds structured under the wrapper. In Europe, UCITS-compliant hedge funds have been the most popular type of new fund structure to emerge since the onset of the financial crisis, as many investors seek increased liquidity with less risk during turbulent times. Fig. 26 demonstrates the significant appetite for UCITS funds among European investors, with 45% either currently investing in UCITS or considering making an allocation to such funds in the future. European investors are taking comfort from knowing that UCITS-compliant hedge funds have restricted types of underlying investments, limited leverage and attractive liquidity terms. In terms of liquidity, the structure provides more frequent redemption periods compared to other fund structures. The importance of these liquidity terms to European investors is demonstrated in Fig. 27, which shows that a large proportion of investors (63%) consider increased liquidity to be the most important factor behind their investment in UCITS funds.

The chart also highlights the importance of increased transparency and improved risk management to investors, as they seek greater predictability in the way that funds are managed.

There has been considerable growth in the prevalence of hedge fund managers offering UCITS products to investors as they look to source institutional money from a broader investor base. By offering UCITS-compliant hedge funds, managers are able to tap into demand from less experienced institutional investors seeking hedge fund-type returns and the protection of a defined regulatory structure.

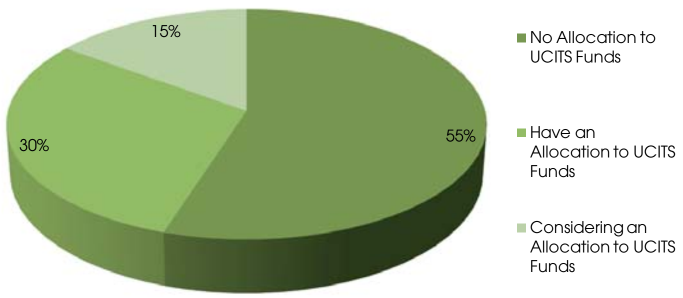
Looking forward, UCITS funds will continue to attract investors that place high importance on liquidity and transparency when investing in hedge funds. The introduction of UCITS IV will attract a new institutional audience to funds structured under these European Union directives. Although up-and-coming structures such as UCITS have continued to gain traction with institutional investors, we can expect traditional fund structures to continue to dominate portfolios.

European Investor Appetite for Managed Accounts

Another structure that has attracted increasing numbers of investors since the financial crisis is the managed account. Demand for managed accounts has grown among investors that seek greater transparency and liquidity in response to ongoing financial instability and various scandals that have rocked the industry over the past few years. By investing in managed accounts, investors are able to monitor their investments to ensure the returns are generated through genuine trades, and monitor the risk of their capital being gated by the fund manager.

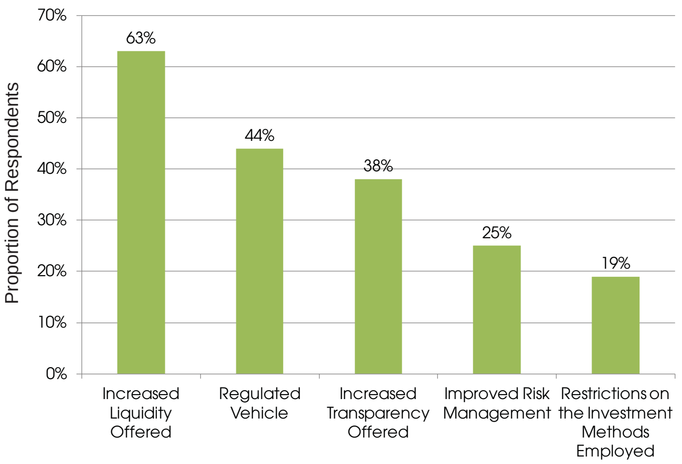
However, despite the benefits of investing in this fund structure, Fig. 28 shows that the majority of European investors (78%) have no plans to set up separately managed accounts over the next 12 months. Nine percent of European investors plan to take advantage of the fund structure, with a further 13% considering it. This demonstrates the fact that the structure has relatively high barriers to entry. For instance there are increased costs associated with setting up managed accounts, as investors must find, engage and manage the fund manager, bankers and custodians, which can be an excessive burden. Another challenge faced by investors looking to set up managed accounts is that some hedge fund managers prefer to provide portfolio transparency rather than managed accounts as the cost of running this structure is typically much higher. Therefore the ability to select the best managers may be limited by their unwillingness to set up the account in the first place.

Fig. 26: Proportion of Europe-Based Institutional Investors that Invest in UCITS-Compliant Hedge Funds



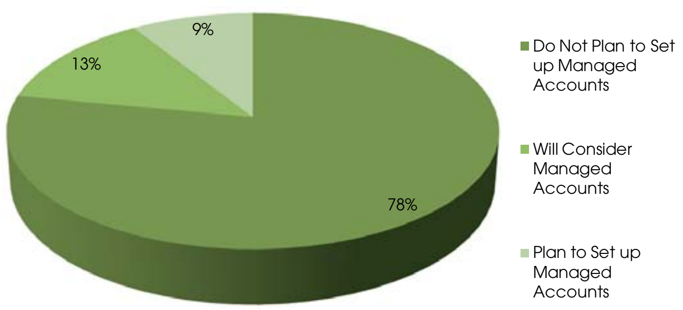
Source: Preqin

Fig. 27: Europe-Based Institutional Investors' Reasons for Investing in UCITS-Compliant Hedge Funds



Source: Preqin

Fig. 28: Europe-Based Institutional Investors' Appetite for Separately Managed Accounts over the Next 12 Months



Source: Preqin

Impact of the Sovereign Debt Crisis and Regulation on Hedge Fund Portfolios

With the outcome of Europe's sovereign debt crisis far from certain, political and macro economic risks loom large. Despite the uncertainty surrounding the current economic climate in Europe, a 77% majority of European investors interviewed stated that the sovereign debt crisis was yet to have any impact on their hedge fund portfolios. However, a small minority of investors stated that the crisis may impact their portfolios in the future, leading to a decrease in their exposure to European funds or the euro in general through their hedge fund allocation.

The largest potential impact investors cited in regards to the sovereign debt crisis is that it will lead them to search for more liquid funds. In times of economic uncertainty they do not wish to be exposed to funds with unnecessary lock-ups or exposure to illiquid assets which they cannot exit due to fund gates being imposed.

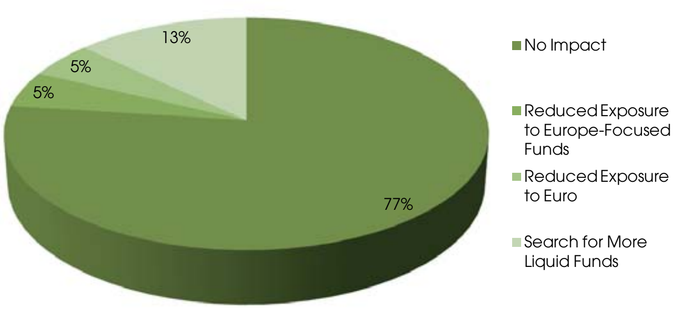
In addition, several investors interviewed specifically expressed their concerns over the sovereign debt crisis, with one UK-based public pension fund stating that long/short equity and distressed debt strategies in particular had been affected. In contrast, a UK-based private sector pension fund had a more positive outlook on the crisis, noting that the current market had created more opportunities for investors.

Investors Not Concerned about Impending Regulation

The impact of European regulation is increasingly driving change in the hedge fund industry. A wave of EU regulation is set to make even greater demands on hedge fund managers' operations and transparency. The Alternative Investment Fund Managers Directive (AIFMD), scheduled to come into force in 2013, the Markets in Financial Instruments Directive (MiFID II) and Solvency II are all major pieces of European legislation affecting the hedge fund industry. These key directives are aimed at increasing overall supervision and disclosure within the industry. Therefore, in addition to the US Dodd-Frank Wall Street Reform and Consumer Protection Act and the US Foreign Account Tax Compliance Act, Europe's hedge fund industry is set to become among the most heavily regulated in the world.

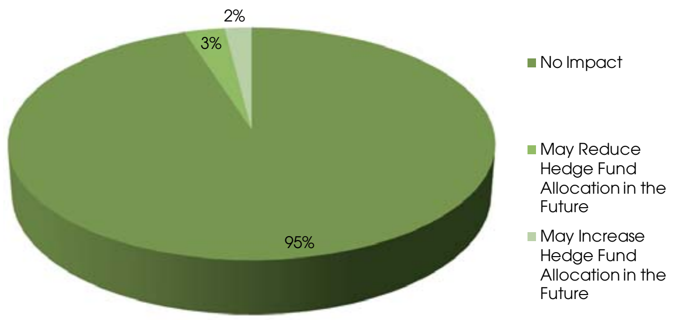
Despite this imminent increase in regulation, the bulk of European investors surveyed (95%) stated that their hedge fund portfolios had not yet been impacted by these regulatory changes, as shown in Fig. 30. However, with much regulation still to come into force, we are yet to see if there will be any impact in the long term. In order to succeed in this new, highly regulated world, hedge fund managers must look to adhere to the requirements of investors and regulators, through improved governance and controls.

Fig. 29: Impact of the Sovereign Debt Crisis on Europe-Based Institutional Investors' Hedge Fund Portfolios



Source: Preqin

Fig. 30: Impact of Recent Regulatory Changes and Proposals, such as AIFMD and Solvency II, on Europe-Based Institutional Investors' Hedge Fund Portfolios



Source: Preqin

Views of European Institutional Investors in Hedge Funds

"The European sovereign debt crisis is yet to have any impact on our hedge fund portfolios. However, managers using the current economic climate as an excuse for poor performance may cause us to decrease our hedge fund allocation in the future." – UK-based private sector pension fund

"Redemptions are typically made from our hedge fund portfolio in response to a fund becoming too large. Funds that are too big will limit our flexibility in making investments." – Finnish investment company

"When investing in new hedge funds we look at funds performing independently rather than seeking specific strategies." – Swedish fund of hedge funds

"Despite the uncertainty surrounding the sovereign debt crisis we believe there has also been a positive impact on the industry in that more opportunities have been created for investors." – UK-based institutional investor

"We believe that hedge funds investing in asset-backed securities are providing the best opportunities for 2012." – UK fund of hedge funds

"The eurozone crisis has had a negative impact on the hedge fund industry overall in that there is now less demand for hedge funds among investors, which has indirectly affected their performance." – Swiss fund of hedge funds

"Although we do invest in UCITS-compliant funds we do not consider these funds to add significant value to our portfolio. Therefore it is not a prerequisite." – Portuguese fund of hedge funds

"Concern over a fund's performance is the main reason why we would look to redeem from a hedge fund. However, there are also various other factors that would influence our decision, such as overexposure, risk and operational issues." UK-based institutional investor

"Our appetite for emerging managers has increased slightly over the past 12 months. However, generally we prefer to invest in established managers with a reputable track record." – Swiss private sector pension fund

About Global ARC

The Global Absolute Return Congress ('Global ARC')

Founded in 2002, Global ARC convenes meetings of the world's foremost pension funds, sovereign wealth funds, endowments, foundations and asset managers to discuss macroeconomic developments, capital markets, and alternative investments.

Global ARC is an independent organization, wholly owned by its founder David Stewart. Global ARC is not affiliated with any media company or with any individual supplier to the investment industry. All Global ARC gatherings are held strictly off-the-record with no media in attendance.

Locations for past and forthcoming Global ARC meetings include Boston, San Francisco, Singapore and London.

The dates for Global ARC's meetings in 2012 are:

- Global ARC Boston: October 15-17, 2012 – the Hyatt Regency, Boston
- Global ARC Singapore: February 25-27, 2012 – the Ritz-Carlton, Singapore
- Global ARC London: May 20-22, 2013 – the Landmark Hotel, London

If you have any questions about Global ARC or its events, please contact David Stewart at +1 289 290 4460.

Please check our website www.global-arc.net for updates as we confirm additional keynotes in the coming months.

About Preqin

Preqin's hedge fund products are utilized by numerous fund managers and third-party marketing professionals to profile and identify potential investors, understand industry trends, and ensure they are up to date on the latest developments in the institutional investor universe.

Hedge Fund Investor Profiles is a powerful online database featuring details of over 3,300 institutional investors in hedge funds, with more being added every day. Key features include:

- Hedge fund allocations, sample investments and fund preferences, key contacts, investment plans, and more.
- Intricate search options to help identify the best targets.
- Premium subscribers can download targets and contact details to Excel.

In addition to Hedge Fund Investor Profiles, Preqin's exclusive data is available in various other formats:

- The 2012 Preqin Hedge Fund Investor Review is a hard-copy publication featuring profiles and analysis for the 1,000 most important investors worldwide.
- The Emerging Manager Download is a searchable spreadsheet detailing over 700 globally distributed institutional investors that have expressed an interest in emerging managers and spin-off teams, or in providing seed capital.
- The Fund of Hedge Funds Download is a searchable spreadsheet detailing 600 multi-manager hedge funds with full contact details for 2,000 specific individuals.

Preqin regularly release research and information on institutional investors in hedge funds, both as research reports and as part of our monthly Spotlight newsletter. To register to receive more research and analysis, please visit:
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