Preqin Research Report

Are Interests Aligned?
Fund Terms Investor Survey Results

September 2010

alternative assets. intelligent data.

Preqin Research Report
Are Interests Aligned? Fund Terms Investor Survey Results

September 2010

In 2009 Preqin surveyed institutional investors to ascertain their outlook on the hedge fund industry in terms of the features of the funds they look to invest in. Transparency and liquidity emerged as key issues for the institutional investor in the post-downturn market. Hedge fund fees were an area under particular scrutiny by institutional investors, with 76% of the investors surveyed at that time believing that fees were too high. In August 2010, Preqin surveyed 45 institutional investors to gather current opinions on the hedge fund market in terms of the underlying structures of funds they were investing in. In this period positive net inflows have returned to the asset class and there has been a restoration of confidence in hedge funds. In this article we examine how this renewal of optimism has affected the way investors look at the funds they invest in.

Shifts in favour of the investor

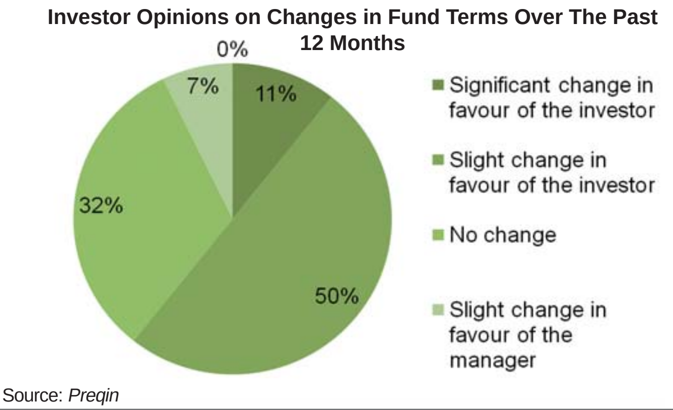
Over 60% of respondents believe that there has been a change in hedge fund terms which has benefited investors, as shown in Fig. 1. Just 7% feel that the shift in fund terms structures has been in favour of the manager. This is a positive development for the asset class, which over the past two years has been met with much questioning as well as some dissatisfaction from the institutional market.

The fee debate continues

Fig. 2 shows that the management fee was considered the most improved aspect of a hedge fund over the past 12 months. Much scrutiny has been placed on the standard 2% management fee since the market crisis began in 2008, with investors questioning the value of an investment which charges such high entry fees. An earlier Preqin study suggested that the management fee is shifting away from the perceived 2% standard fixed fee to a lower level as a result of institutional pressure. This survey provides further evidence of a shift in favour of the investor, with nearly half of all respondents agreeing that management fees are now at a more acceptable level.

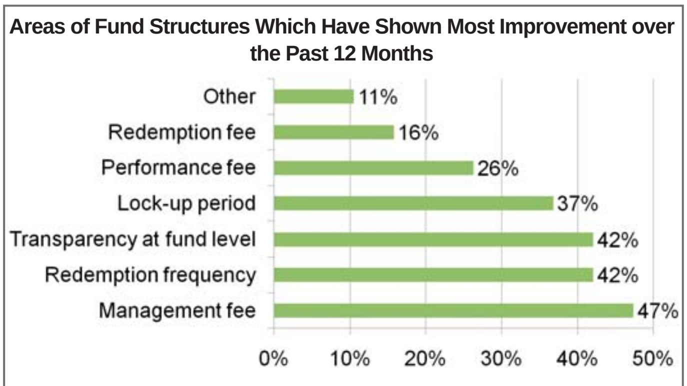
A much smaller percentage, 26%, of those surveyed feel that there has been a shift in the performance fees charged by hedge funds. Fig. 3 shows that performance fees are an area that over a third of all investors would still like to see improvement on (far outweighing the investors which still feel changes need to be made with management fees). In the next 12 months there could be a change in the performance fees charged by funds as investor attention focuses on performance incentives.

Fig. 1:



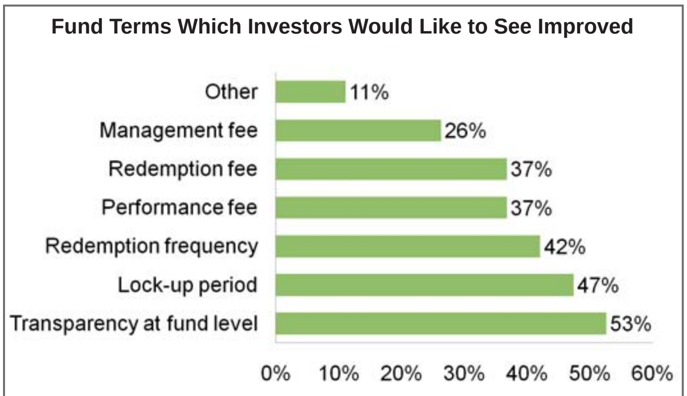
Source: *Preqin*

Fig. 2:



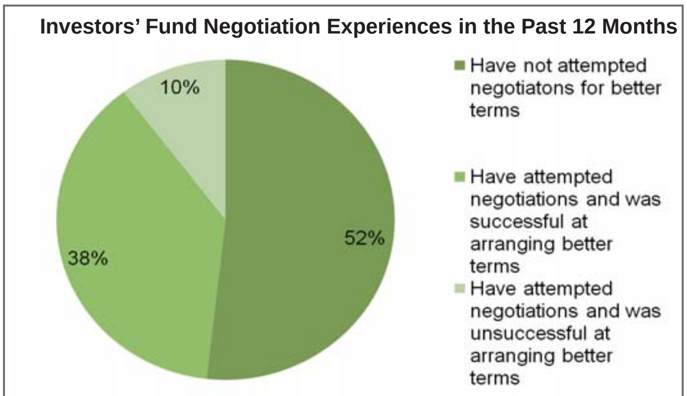
Source: *Preqin*

Fig. 3:



Source: *Preqin*

Fig. 4:



Source: *Preqin*

Fee negotiations between investors and their managers have continued in 2010. A year ago Preqin asked investors whether they have entered into negotiations with their prospective and existing fund managers – 49% of the surveyed investors revealed they had. This year the figure has dropped by a marginal amount, with 48% of surveyed investors having entered negotiations in the past 12 months. There has been an increase in the number of successful negotiations in the past 12 months; 38% of the respondents told us that they had entered negotiations with fund managers and had successfully won better terms. In 2009 this figure stood at 31%. When questioned further about actions taken following unsuccessful negotiations and their attitude to new fund proposals, 54% of surveyed investors revealed they do occasionally reject the opportunity to invest in funds when the proposed fees are too high and 11% stated that they do this on a regular basis. This indicates that investors are paying much attention to the charges associated with funds and managers should be aware of the scrutiny management and performance fees are under when setting up new vehicles. By establishing funds with fees which are too high, fund managers could potentially lose value-conscious investors.

Transparency and liquidity: still room for improvement

Fund transparency and liquidity are other areas where investors have seen improvement. Liquidity and transparency have been key issues for investors following the tumult in 2008. Gating of capital and exposure to illiquid assets were points of serious concern for institutional investors and there has been much pressure on managers to cut unwarranted lock-ups and to be more open with their investors on the underlying investments of their funds. However, although investors have witnessed improvement in fund transparency and liquidity, they still would like to see more changes. Fig. 3 shows that over half of all investors surveyed want to see greater transparency at fund level, with 47% looking for more appropriate lock-up periods and 42% seeking more frequent redemptions. Fund managers are moving in the right direction in terms of liquidity and transparency, but in order to further attract institutional clients more managers will need to move away from the "black box" style of investment. From Fig. 6 we can see that nearly half of all investors surveyed have rejected a fund proposal in the past 12 months as a result of a lack of transparency at fund level. With such a high proportion of investors refraining from investing due to lack of transparency, it is vital that managers are able to provide their investors and potential clients with as much information on their funds' sources of returns as possible.

Fig. 5:

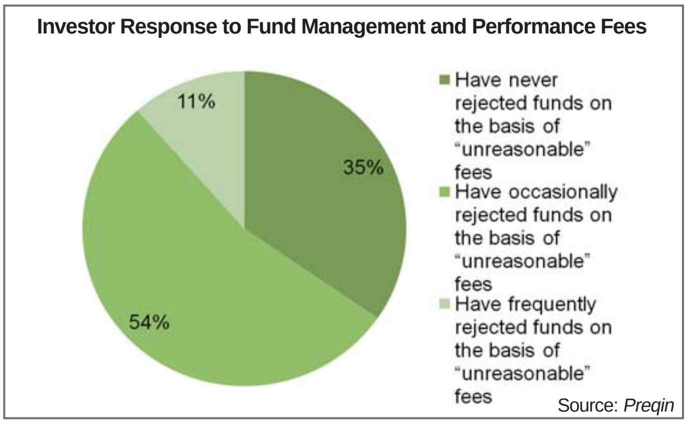
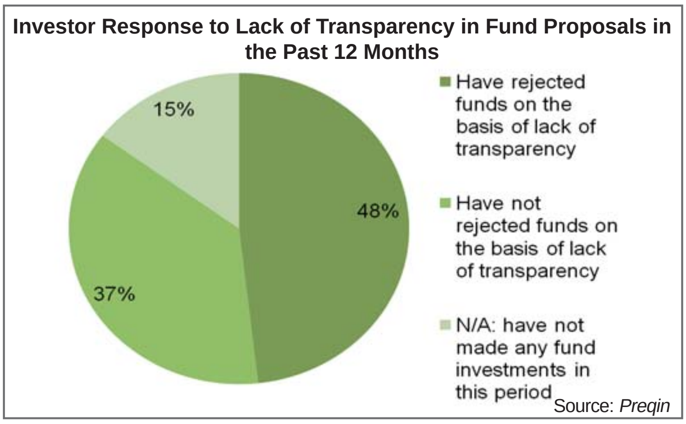


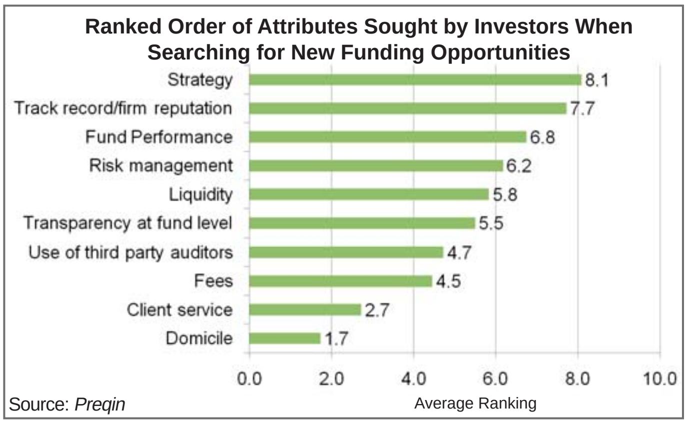
Fig. 6:



Key considerations of investors when searching for hedge funds

The surveyed investors were asked to rank 10 parameters associated with hedge funds in order of importance to their fund selection process. Parameters which scored the highest are considered the most important to institutional investors when considering a new fund opportunity. Investors consider the fund strategy as the highest priority when looking at potential fund opportunities. Fund track record and firm reputation is the second most valued feature of a fund. Investors have alway valued the track record of a hedge fund as a way of evaluating past performance and potential for future returns.

Fig. 7:



Over the past three years' surveys, track record has always been in the top three highest ranked attributes of a potential fund opportunity. Last year transparency was the second most sought after feature of a hedge fund; however transparency has now fallen to sixth on the list. As shown in Fig. 6, investors are rejecting fund opportunities as a result of lack of transparency, so this is clearly still a very important factor for investors when looking at new funds. However, as investors are now finding that an increasing number of funds are becoming more transparent about the sources of their returns, they have enough choice of transparent vehicles to no longer view this as such an important factor as previously.

Risk management procedures are another vital aspect of a fund which investors will look to see in place before investment. Following high-profile fund meltdowns and frauds, investors have become much more cautious when it comes to manager selection, and look for strong risk procedures to be implemented as well as the use of third-party groups to audit returns and assets. Investors do want value for money and are entering into negotiations to reduce fees (Fig. 4) as well as rejecting funds which have inappropriate fees (Fig. 5). However, investors recognize that saving money in fees may result in sacrificing other, more important factors such as strategy diversification and sources of portfolio return. Investors are willing to pay higher fees if they are justified.

Outlook

Institutional attitude towards managers and their fund offerings is improving. Investors feel that fund terms are shifting in their favour, and of the surveyed institutions, 69% stated that they felt that institutional interests were aligned with those of their fund managers. The past two years have resulted in many changes in the industry and there has been a period of adjustment on the part of hedge fund managers as investors have become more demanding. Investors still value returns and track records as vital criteria when selecting funds; however, as Madoff proved, high performing "black box" strategies may not be what they seem, so the institutional market is becoming much more stringent in looking for transparent sources of alpha. Fees continue to be an issue for institutional investors; however they have noted a swing in their favour – particularly in reductions to the standard 2% management fee. Investors are still entering into fund negotiations with their fund managers and would like to see further changes to performance fees, so in the next 12 months there is likely to be continued pressure on this front

If managers continue to listen and respond to the demands of an evolving institutional market, this period of renewed optimism of investors is likely to continue. This in turn could lead to more capital inflows to those managers that are able to offer funds which have adapted to cater to the new requirements of the institutional investor.

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**

If you have any comments on this report, please contact:
info@preqin.com

If you want any further information, or would like to apply for a demo of our products please contact us:

London:

Scotia House
33 Finsbury Square
London EC2A 1BB

Tel: +44 (0)20 7065 5100
Fax +44 (0)87 0330 5892

New York:

230 Park Avenue
10th Floor
New York
NY 10169

Fax: +1 212 808 3008
Tel: +1 440 445 9595

Email: info@preqin.com
Web: www.preqin.com

preqin
alternative assets. intelligent data.