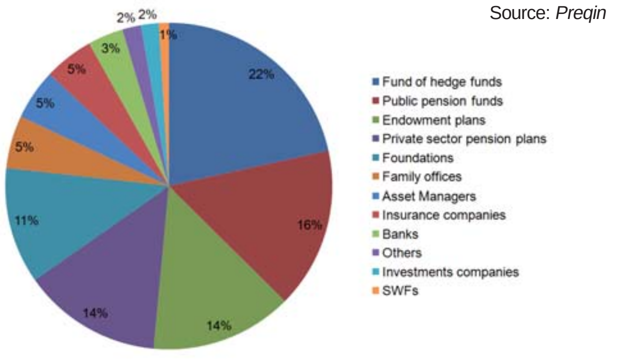
Preqin Research Report

The Institutional Investor 2010

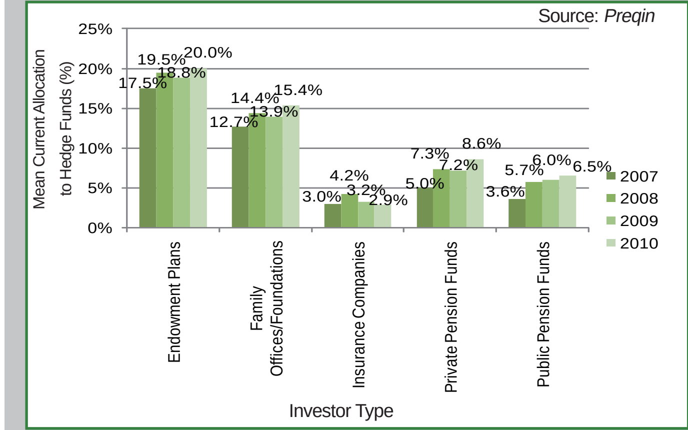
Fig. 1: Breakdown of Institutional Investors by Type



The landscape of the institutional market has changed rapidly during this time. The effect of a changing financial climate in the wake of the credit crisis and global financial difficulties has had far reaching consequences in the hedge fund market. One of the most prominent changes in the hedge fund industry over the past 10 years has been the increasing institutionalization of the assets at work in these funds. Previously an asset class dominated by the high-net-worth individual, hedge funds have witnessed an influx of instititutional capital over recent years and today institutional capital represents the greatest proportion of assets at work in the industry. Institutional investors have become increasingly aware of the need to diversify their portfolios and the broad “asset class” that is hedge funds has become attractive to institutional investors, both before and after the market crisis, as a means to hedge out market risk, to tap into elusive alpha and to gain exposure to a diverse bundle of assets and investment opportunities.

Preqin’s Hedge Fund Investor Profiles database tracks over 2,500 institutional investors in hedge funds. Institutional requirements from hedge fund portfolios have shifted during the ever-changing financial landscape of the past few years.

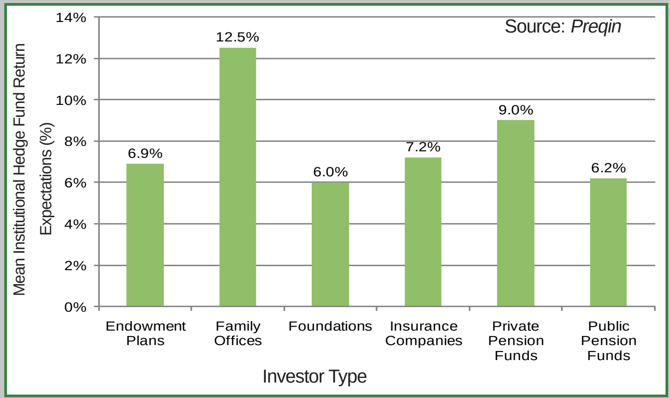
Fig. 2: Mean Percentage Allocation to Hedge Funds by Investor Type



The effects of the financial crisis are still felt in the hedge fund industry. Assets have still not recovered to pre-crisis levels and investors are still approaching the asset class with some caution as well as being more demanding with regard to terms such as fees and lock-up periods. Fig. 1 shows the breakdown of the institutional investor universe as it stands in the final quarter of 2010. In this article we will discuss some of the major groups of institutional investors in terms of capital flows into hedge funds, what they look for from their hedge fund investments, and how they invest in the asset class.

Funds of hedge funds still represent the largest groups of investors in hedge funds within the institutional landscape, with just over a fifth of all the investors which Preqin tracks coming from this sector. Funds of funds have suffered a difficult two years, and there have been many fund closures, consolidations and mergers of management groups. No fund of funds has emerged from the financial crisis unscathed. Even the largest fund management groups have suffered redemptions at the hands of their investors. The total number of funds of funds has remained relatively static over the past 12 months. However, despite fund closures in the past, and a more difficult fundraising climate at present, there are still new funds being launched and new management groups are setting up. Funds of funds, although under more scrutiny following the financial crisis, will continue to be important allocators of capital to the hedge fund industry and innovators in their field. The emergence of a new breed of UCITS-compliant hedge funds has resulted in a wave of new fund launches to cater for the new demand for this European regulated vehicle. Firms such as Gottex Asset Management, UBP, International Asset Management and Signet Capital Management have all launched or are on the verge of launching UCITS funds of funds over recent months. Funds of funds continue to be an important source of capital to emerging managers, and in the past 12 months we have witnessed funds of funds and fund platforms

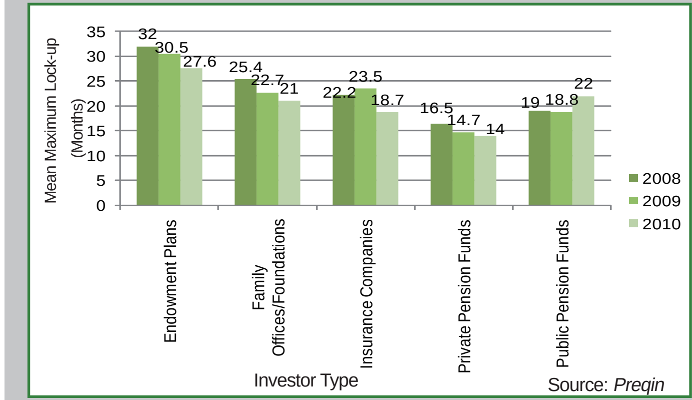
Fig. 3: Mean Institutional Hedge Fund Return Expectations by Investor Type



awarding "seed" capital to more established funds which may have lost assets during the financial crisis and stalled in their endeavours to attract institutional investment. For many funds of funds, seed investments were put on hold during the financial crisis but over the course of 2010 there has been a noticable uptick in this activity and this is expected to continue into 2011.

Public pension funds represent just fewer than 16% of all institutional investors on the Preqin Hedge Fund Investor Profiles database. Public pension funds are an established group of investor within the institutional universe and their growing confidence in the ability of hedge funds to diversify their holdings and to provide absolute returns is reflected in the increased allocations to hedge funds year on year (Fig.2). As of Q3 2010 the average public pension fund invests 6.5% of its total assets in hedge funds with a mean target allocation of 7.9% of total assets (again an increase from 2009). Public pension funds have been relatively active in hedge funds over the course of 2010, with both existing investors in hedge funds increasing their exposure to the asset class and new entrants setting their first target allocations and making their first investments. For instance the UK-based West Midlands Pension Fund, which only began investing in hedge funds in 2009, has already built a portfolio of 10 hedge funds, which it could extend by as many as another five managers to run an additional £200 million. As they grow in experience in the asset class, public pension funds are continuing their shift into a direct style of

Fig. 4: Mean Maximum Lock-up Period Accepted by Investor Type

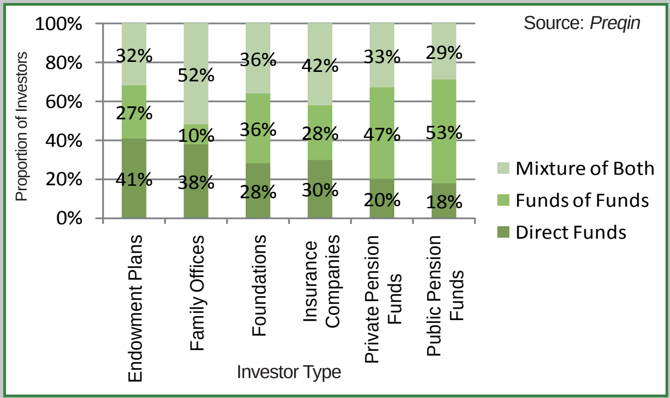


investment. Investment still is predominated by the use of funds of funds, and newer retirement funds are still using these to gain their footing in a complicated asset class; however, use of a pure funds of funds portfolio is down slightly from 54% of all retirement systems to 53%. The public pension funds which are using both single and multi-manager funds are where the greatest shift to a direct style is occurring: last year these investors represented 32% of all public pension funds, today the figure stands at 29%. As a result the proportion of public pension funds which use just single manager vehicles has increased from 14% to 18% over the past year. Preqin's June research report indicated that this shift is likely to continue as public pension funds gain more experience in hedge fund investment.

Endowment plans form 14.1% of all investors on the Preqin database. As long-term, return-driven investors they have been fundamental in shaping the institutional universe through their innovative and extensive use of hedge funds. Direct investment in funds is the most common choice for endowments, with 41% of all endowments on our database choosing this as their preferred method of investment. A mixture of both direct investment and funds of funds is used by 32% of endowment investors, with the remaining 27% investing solely in funds of hedge funds. Like public pension funds, endowments have shifted further towards a direct style of investment over the course of 2010. This year saw a reversal in the trend for endowments to reduce their exposure to hedge funds that had occurred over the past few years, and the current mean allocation of endowments globally is 20% - higher than pre-crisis levels. However this is slightly above the mean target allocation to hedge funds of endowments, at 19% of total assets. Endowments have been investing in hedge funds for many years, and have the highest average allocation to the asset class of many of the groups of institutional investor on the Preqin database. Over the years of investment experience, endowments have built large and diversified portfolios of funds and have found their optimum level of exposure to the asset class (between 18-20% on the whole) and therefore are unlikely to shift significantly large new sums of capital into hedge funds. Endowments take the longest-term stance to hedge fund investment of all the institutional investor types, accepting lock-up periods on average of well over two years. However, following the market crisis they have been gradually looking at funds which are more liquid in nature and the longest lock-up accepted has been coming down on average since that time (Fig. 3).

Private pension funds have been increasingly adding hedge funds to their portfolios over recent years and have been one of the fastest growing groups in importance to the hedge fund industry. Their allocations to hedge funds have peaked this year, with each investing on average 8.6% in the asset class. 8.6% is also the mean target

Fig. 5: Breakdown by Hedge Fund Investor Approach (Direct Funds, Funds of Funds or a Mixture of Both)



allocation of private sector pension funds and so growth of this group in terms of assets flowing into hedge funds is expected to slow somewhat. There has been some evidence of private pension funds losing their confidence in hedge funds in 2010, with a few incidences of portfolios being redeemed or in the process of being liquidated. For instance, the Zurich-based Pensionskasse der PriceWaterhouseCoopers announced it has redeemed all of its holdings in hedge funds as a result of performance concerns and issues with fees. As demonstrated in Fig. 3, private pension funds have become more stringent since the credit crisis in terms of their liquidity requirements and this year there is also evidence that they have become more demanding in terms of the returns they expect from their hedge fund portfolio (Fig. 4). They have also shifted towards a more direct style of investment over the course of 2010. At the end of 2009, 13% of all private pension funds invested solely in single manager vehicles. Today this figure stands at 20%.

For historical comparison purposes family offices and foundations have been grouped together in Fig. 2. Family offices currently invest an average of 19% of total assets in hedge funds, with a significantly higher target allocation to the asset class at 24.2%. Foundations have more modest investments in the asset class - currently at 14.9% rising to 15.4% as a result of their targeted exposure to the asset class. Family offices and foundations invest in a similar manner to endowments and often with the same long-term objectives in mind. However, the returns sought by family offices are in fact the highest of all institutional groups tracked by Preqin. Family office groups are often, like funds of funds and endowments, early backers of new managers or strategies, and use hedge funds to boost returns as well as for capital preservation and diversification. Unsurprisingly, direct investment in funds is the most common method of accessing the asset class, with 52% of all family offices using just direct investment in hedge funds and 38% using direct investment in funds with some tactical funds of funds holdings. As family offices are on average significantly below their target allocation to hedge funds, we can expect them to invest heavily in the asset class over the next 12 months. For instance, EXTOREL, traditionally a large backer of private equity funds, intends to move a large chunk of its assets towards hedge funds as it seeks to increase its currently modest portfolio of funds by up to 11 new investments over the next 12 months.

Insurance companies form less than 5% of the investors on Preqin's Hedge Fund Investor Profiles database and currently invest an average of less than 3% of their assets in hedge funds. However, the significant size of some of insurance companies means that the assets they are directing towards hedge funds can be considerable. Insurance companies have been reducing their exposure to hedge funds over the past two years. However, with a mean target allocation of 4.3% of assets to be invested in hedge funds, there is the potential for insurance company capital to reach pre-financial crisis levels within the industry. There has been a marked shift towards insurance companies investing directly in hedge funds – from 17% in 2009 to 30% today. Last year many insurance companies were in a transition phase from a fund of funds portfolio, but many of these investors, which were exposed both to multi-and single-manager funds, are now moving their assets to be invested directly in hedge funds in greater numbers. For example, Delta Lloyd, the Dutch insurance company, which has been investing in hedge funds since 2000 through a combination of both funds of funds and direct investments, will now be shifting all of its allocation to direct investment following the ongoing liquidation of its funds of funds investments.

Outlook

The institutional investor is continuing to evolve into a more sophisticated yet demanding backer of hedge funds. As the institutional market has grown and developed over the past years, so has the hedge fund industry as it seeks to cater to this growing sector of the market. Institutional investors are continuing to move in greater numbers towards a direct style of investment, even though funds of funds are still widely used by many. Following the market crisis asset flows into hedge funds have been slower than in previous years as investors rebalanced their holdings following losses elsewhere in their portfolios and applied more caution in their investment decisions. However, we are seeing investors beginning to invest more capital in hedge funds as well as increasing their target allocations to the asset class. Using Preqin's database of over 2,500 institutional investors in hedge funds, we have estimated that there is around $96 billion in available institutional capital that has yet to be invested in the asset class. New capital inflows, plus new investors making their maiden commitments as well as the natural turnover of funds within fully allocated investors' portfolios could potentially mean that 2011 will see a return to pre-crisis levels of investment by the institutional market.