Preqin Hedge Special Report:

The Growing Appetite of Institutional Investors for Emerging Manager Hedge Funds

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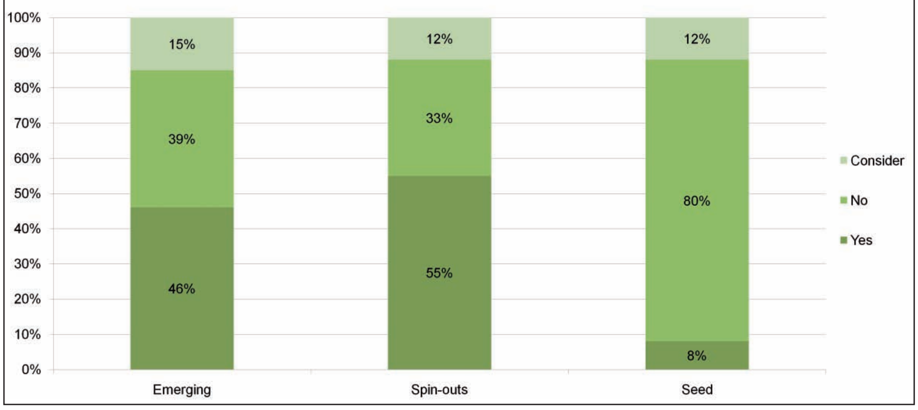
In the last Preqin Hedge Research Report (available on our website) we found that institutional investors form on average 44.8% of a hedge fund client base. Institutions are increasingly becoming more sophisticated investors which are important to the asset class, and as such are becoming major targets for capital from new funds. In this month's Preqin Hedge research report we conducted a survey of over 50 institutional investors (excluding fund of hedge funds) in hedge funds to find out more about their appetite for emerging manager hedge funds.

Fig. 1 shows the willingness of respondents to invest with emerging managers, spin out teams and seed funds. Unsurprisingly institutional investors are most willing to invest in hedge fund managers that have spun out of another firm. These managers have a proven track-record in other funds, and are often higher profile managers that have well documented success in managing hedge funds in larger firms. Proven investment records at another fund are often a big selling point for institutional investors, and in many cases investors will award capital to new funds when they have invested successfully with the management team when they worked at another firm.

Fig. 1: The percentage of respondents that invest/do not invest/would consider investing in various types of early stage hedge funds



Just under half of investors surveyed revealed they would invest in an emerging hedge fund manager (those with less than 2 years track record). This relatively high figure shows the growing confidence that institutions have when investing in the asset class. Institutional investors are often viewed as very cautious and conservative members of the hedge fund investor universe – however with growing experience institutional investors are now choosing to invest in younger funds, imposing fewer restrictions in terms of assets under management and track record requirements.

Many investors choose to invest their money with emerging managers in order to access potentially high returns and also with an eye to invest in new and interesting investment strategies. It is also the case that the best performing less-experienced firms of today will go on to be the most in-demand players in the future, and establishing relationships with such managers at an early stage can ensure entry to over-subscribed vehicles in the future.

Only a small proportion – 8% of respondents would provide seed capital to new funds. In addition to being an early investor in an emerging manager, a provider of seed capital often also provides or assists a manager in putting in place infrastructural provisions (often in return for a stake in the management fees generated by the seeded fund). Most institutional investors do not have the resources to do this or the resources to carry out the required due diligence. Fund of hedge funds are the predominant hedge fund seed capital providers but additionally a few family offices or large endowments may award seed capital to promising new managers. 2008 has seen the launch of numerous hedge fund seeding and incubation platforms – First Avenue Partners, Arrow Hedge Partners, RAS Capital Management and FRM to name just a few fund of funds that have launched such vehicles over the last 5 months. Fund of funds have much experience in selecting hedge fund managers and have the resources and skills to select new funds to seed. It is expected that many more seeding platforms will be launched to tap into the very young hedge fund market and the opportunity for strong returns and a stake in what could be a very successful fund.

Approximately 40% of institutional investors will invest in hedge fund managers with a track record of two years or less. This again demonstrates that institutional investors are willing to consider younger hedge funds when adding new managers to their portfolios. Around a quarter of respondents stated they required a track record of 5 years or more which shows that many investors remain cautious when selecting new hedge fund managers and stick to investing in established firms.

Fig. 2: The track record requirement (years) of respondents

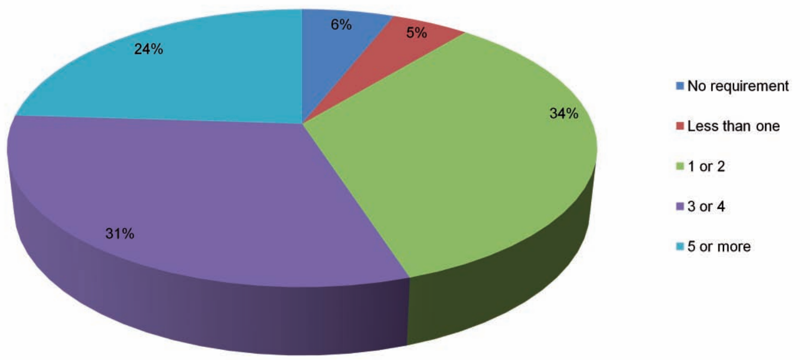
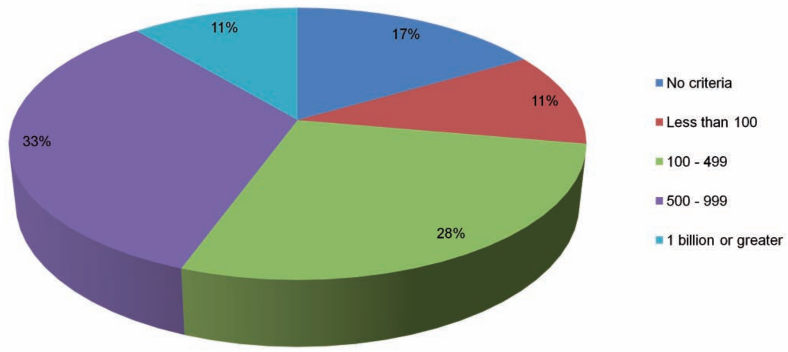


Fig. 3: The assets under management requirement ($mn) of respondents



Only a very small proportion, 6%, of respondents stated that they had no restrictions in terms of track record. This is much lower than the percentage of respondents that stated that they had no restrictions in terms of AUM when it comes to selecting new managers (17%, Fig. 3). From this we can conclude that investors are willing to take a small portion in a small hedge fund provided that the fund a) is either managed by a hedge fund manager with previous experience at another firm or b) has a proven track record and at least two years monthly reports to check before investing. However institutional investors often will not invest in very small funds because they do not wish to take too large a standing in any one vehicle. If an institutional investor typically invests USD 25 million in a hedge fund and does not want to take more than a 10% position in the vehicle then it will require a fund to have at least USD 250 million in AUM before it would even consider investment. This can be a big challenge for hedge funds – to reach the critical amount of assets under management before institutional investment becomes feasible.

From Fig. 4 we can see that investors differ in their likelihood of investing in emerging managers depending upon what type of investor they are. Endowments and family offices/foundations were the earliest institutional investors in hedge funds and some have been investing in the asset class for upwards of 10 years. These are seen as amongst the savviest investors in the arena with large allocations and sophisticated portfolios of hedge funds. Some endowment investment officers have even started their own hedge funds – for example Mark Yusko of Morgan Creek Capital Management is a former CIO of the endowment of University of North Carolina at Chapel Hill. Many endowments and family offices have the knowledge and confidence in the asset class to be able to invest in emerging manager hedge funds successfully without making expensive errors. Public pension plans are also becoming important investors in emerging managers – particularly the largest retirement funds. These funds are allocating capital to emerging managers as they have the resources to carry out thorough due diligence and analyse the best opportunities in the arena. A trend which has been growing over the past 18 months is for large investors to set up a specific "emerging manager program". Investors such as CalPERS have a specific allocation to emerging (and in some cases minority) managers which are put in place for philanthropic as well as financial reasons. In 2007, CalPERS launched an emerging manager customised fund of hedge funds program with an initial allocation of USD 1 billion. The pension fund set this scheme up with the intention of getting early access to managers that will diversify its hedge fund portfolio, whilst ensuring long term investment returns. That is to say CalPERS created this allocation to emerging manager funds in order to "talent spot" the future alpha generators that will produce outstanding returns.

In this study we found that an approximately equal proportion of both European and US institutional investors would consider investment in emerging hedge funds, which demonstrates this is a global phenomenon, and not localised to the largest institutional investor market – the US.

Fig. 4: Emerging manager appetite by investor type

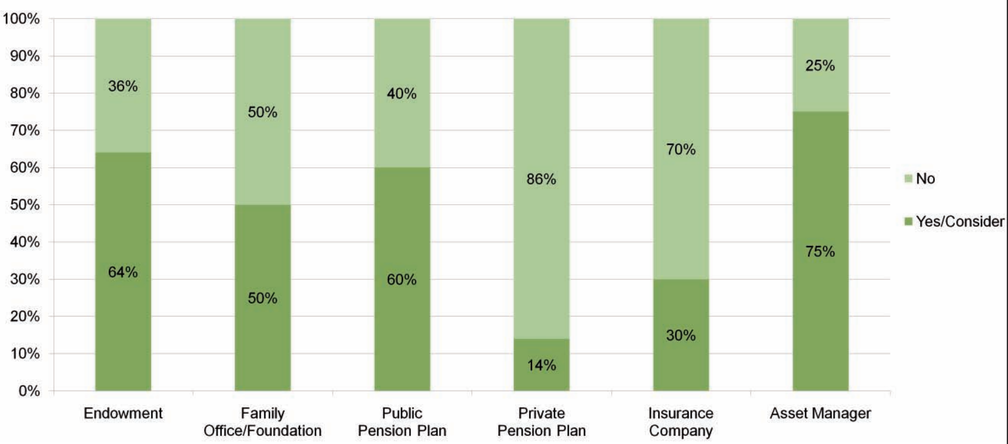


Fig. 5 shows the likelihood of a respondent to invest in emerging manager hedge funds depending upon the percentage allocation they invest in hedge funds. The trend is clear - the more an investor allocates to hedge funds the more likely that investor is to invest in emerging manager hedge funds. Investors tend to allocate larger sums of capital to hedge funds when they have been investing

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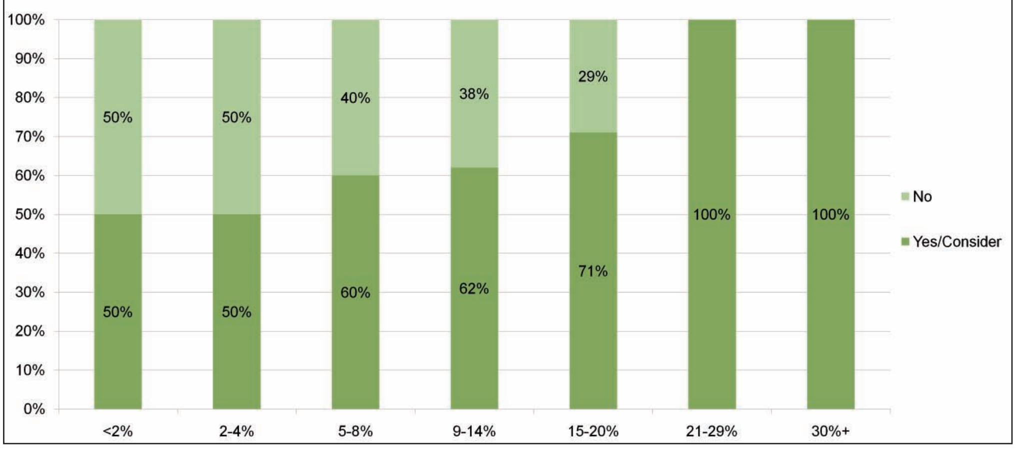
in the asset class for a longer period of time. These investors often add emerging managers to their portfolios for additional diversification and to access the higher returns associated with newer fund managers. 100% of investors allocating more than 20% of assets to hedge funds would consider investment in emerging manager vehicles. Whilst it is not expected that all of this allocation will be to emerging managers, many investors set a side a portion of its hedge fund capital to be invested specifically in younger hedge funds. DUMAC – the manager of the Duke University Endowment, is a long-term sophisticated investor with an allocation to hedge funds of 40%. Not only will DUMAC invest in emerging manager funds, but it will also provide seed capital to the youngest hedge funds.

Conclusions

The institutional investor market is maturing – with experience comes confidence and many investors, buoyed by the success of their hedge fund portfolios over the years are boosting their allocations to the asset class and looking outside the brand name established firm box. These investors are allocating capital to managers with a shorter track record and less assets under management than they might have previously stipulated in order to get early access to the next generation of "star" hedge fund managers and for new sources of alpha. Spin-outs firms, that is to say hedge funds which are formed by managers which have left a large well established firm or investment company, are the most popular choice of first time fund for institutional investors. The track record and notoriety that a manager has garnered at a mature fund gives the investor extra confidence when being an early investor in a new fund. Emerging managers are often reported to be "hungrier" for returns than their more established colleagues – in order to attract more assets younger funds have to generate good returns. However in order to get the most out of investing in emerging hedge fund managers, thorough due diligence is required to avoid costly failures. Smaller investors often do not have the resources to make this worthwhile, therefore many emerging manager investors are larger institutions or those that invest a large proportion of their total assets in the arena. For instance several large pension funds are now beginning to invest in emerging manager hedge funds because they have large investment teams which can thoroughly assess all manager opportunities. Investors that have been investing in the asset class for a long time and have large allocations to hedge funds – i.e. family offices and endowments also invest in emerging managers because they have much experience in selecting funds and add emerging funds to their portfolio to add diversity and boost returns.

Fig. 5: Emerging manager appetite by allocation to hedge funds (% current allocation)



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With around 300 investors on the Preqin Hedge Investor Profiles database indicating that they either invest or will consider investment in emerging manager hedge funds, investor appetite for young funds is clearly a growing feature of the hedge fund industry. Emerging managers with a sound investment strategy and appropriate risk management procedures in place are becoming more appealing to investors despite their lack of track record and small amount of assets. We expect as investors become more comfortable with the asset class that this trend will continue to grow.