Overview of the Global Hedge Fund Institutional Investor Universe

Special Report

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Make-up of Institutional Investor Universe by Type
Institutional Investors Attitudes to Hedge Fund Investing

Overview

In previous Preqin hedge fund research reports (available on our website) we found that institutional investors form on average 44.8% of a hedge fund client base. The hedge fund asset class has developed from a niche market primarily dependent on commitments from high-net-worth individuals, to a distinct alternative investment strategy that attracts a significant portion of assets from sophisticated institutional investors. We have found that 55% of hedge fund managers have experienced a rise in the proportion of their investment coming from the institutional sector over the past three years, with only 14% experiencing a decrease. With many of the recent redemptions affecting the industry coming from the high-net-worth sector, hedge fund managers will increasingly be looking for the more long-term support of institutional investors in order to maintain their assets under management at targeted levels.

This month's research report is taken from our latest publication, the 2009 Preqin Global Hedge Fund Investor Review. In this we conducted a survey of institutional investors, as well as analysing information from our online database, to find out more about why institutional investors were investing in hedge funds and their attitude to the asset class in 2009 and beyond.

More information on the 2009 Preqin Global Hedge Fund Investor Review can be found on page 6 of this report.

Make-up of Institutional Investor Universe by Type

Preqin's online database Hedge Investor Profiles currently holds information and profiles for 2,023 institutional investors worldwide who are either actively investing, or considering investment in hedge funds. The three largest groups of investors on the database are fund of hedge funds, public pension funds and endowments, which make up 26.1%, 16.5% and 15.2% respectively of the universe. Fig. 1 shows the breakdown of different investors in the hedge fund institutional investor universe.

Institutional Investors Attitudes to Hedge Fund Investing

To help analyse institutional investor's attitudes to hedge funds we sought to discover the main reasons why these investors look to hedge funds.

Fig. 1: Make up of Universe of Institutional Investors in Hedge Funds by Type

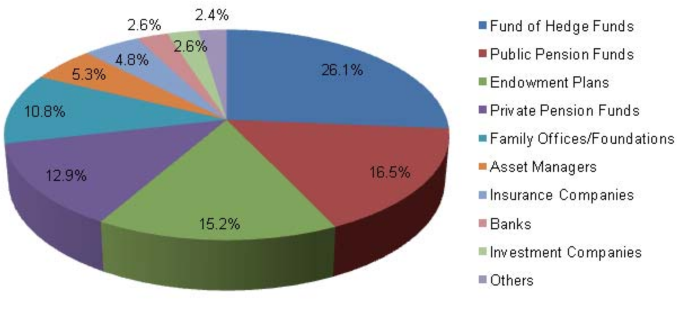


Fig. 2 shows that the majority of institutional investors have allocated capital to hedge funds in order to increase the diversity of their portfolio and reduce the overall volatility of their investments. Hedge funds are seen as an effective way of reducing overall risk whilst in theory they should be able to provide returns regardless of market conditions. A large number of public pension funds cited this as the primary factor for investing in hedge funds. As relatively conservative investors with a number of liabilities, these institutions view diversification for capital preservation purposes as a very important issue.

A total of 18% of all investors surveyed stated that the most important factor for them investing in hedge funds was to improve the overall risk/return makeup of their portfolio. Similarly, 15% of all respondents stated that they invest in hedge funds to increase the overall returns of the portfolio.

Future Capital Inflows to Hedge Funds from Institutional Investors

As institutional investors have increased their hedge fund allocations over a number of years, there is huge potential for long term growth within the industry, although some allocations are currently on hold. Fig. 3 shows that just over two thirds of investors have an unfilled target allocation, indicating that the institutional investor contribution to the asset class will continue to grow. In addition, Preqin has identified 160 institutional investors that are poised to make their first investments in hedge funds in the next 12-18 months.

Institutional investors have generally been increasing their allocations to hedge funds over the last few years. Some of the largest groups of investors, both public and private pension plans, have a much higher level of scrutiny when making investments. Due to their liabilities these investors must carry out very careful due diligence before any investments are made and with the current scenario of hedge funds making losses, it is not surprising that a number of pension plans have put their investments on hold and are waiting to see how the market develops in the next few months. Historically, pension funds have looked to hedge funds to help meet their long-term obligations but losses have led to the investment committees

Fig. 2: Primary Reasons for Investing in Hedge Funds

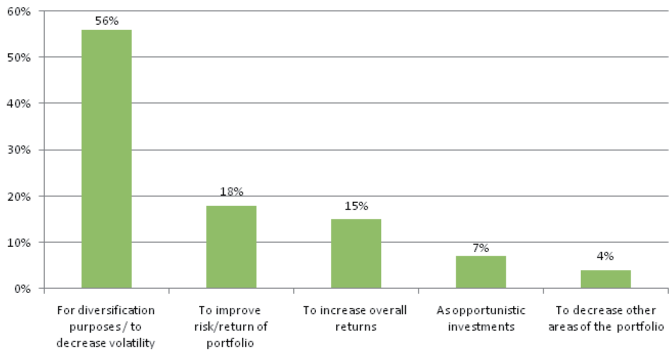
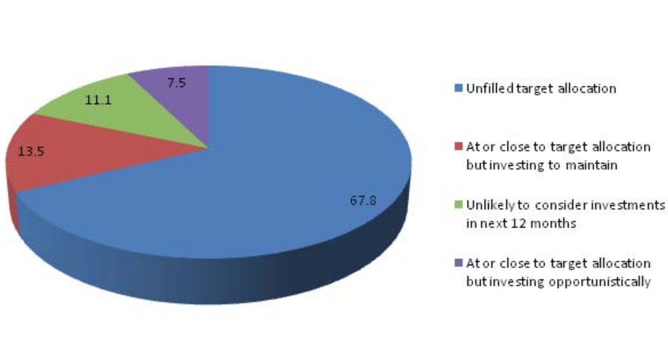


Fig. 3: Institutional Investors Long-Term Plans for the Asset Class

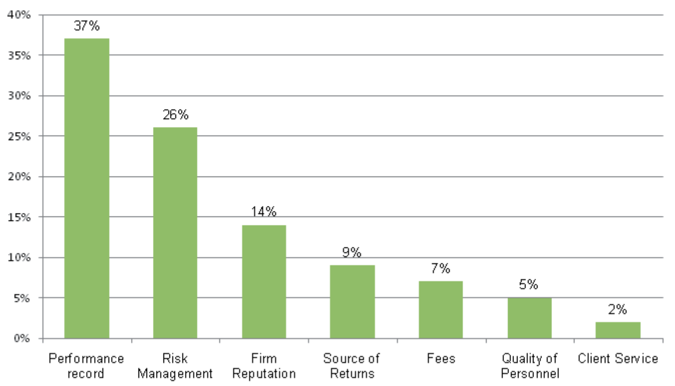


at some pension funds reviewing their allocation. An additional problem facing public pension funds is that with the value of their investment portfolios dropping, some pension funds have now exceeded the percentage that their trustees permit them to allocate to hedge funds as a result of this denominator effect.

In the current market conditions investors are more wary of making new investments than ever before. It is therefore vital that managers pay careful attention to the factors deemed as most important by institutions when reviewing new managers and proactively form relationships with institutional investors today if they are to gain new investments in the future.

As it is becoming increasingly more difficult for hedge fund managers to attract commitments, we looked at the most important criteria for investors when selecting and reviewing hedge fund, or fund of hedge funds managers. With the development of the hedge fund industry, we have already seen hedge fund managers having to change their service to attract institutional investors. When high-net-worth investors made up the majority of hedge fund investors, fund managers had

Fig. 4: Most Important Factors When Choosing a Hedge Fund Manager



to provide a different kind of service due to the investors' lack of accountability and public profile. We have seen managers increasingly tailor their products for the increasing number of institutional investors and with the current market conditions, it is likely we will increasingly see even more change with hedge fund managers having to become ever more adaptable in fear of potential redemptions and to encourage new investments.

The results of the survey highlight that the most important factor for investors when choosing a new hedge fund manager is the performance record of the firm. Investors will also look at a manager's historic performance, with the most successful managers, with the largest assets under management and internal infrastructure being most likely to be able to weather the storm and attract more new investments in future.

Risk management is seen as a very important factor for investors when selecting hedge fund managers. With the uncertainty currently overshadowing the market, risk management is taking on increasing significance. This factor is also closely linked with the source of returns from the manager. As institutional investors become more sophisticated, and with the uncertain market conditions, they are looking at factors such as the make-up of the fund manager's portfolio to ensure that returns are not overly dependent on particular conditions or strategies. They are also looking for other information, such as the prime broker that the manager uses. Some institutional investors are also demanding external auditors from their hedge fund managers in order to ensure accuracy and transparency.

The reputation of the hedge fund manager is another important factor for investors. Investors tied this in closely with the quality of the investment personnel at a firm. All investors saw this as important. The majority of institutions that wanted to invest with the largest, and most established hedge fund, and fund of hedge funds managers, were public pension plans based in Europe and the US. As they have a higher level of public scrutiny and accountability, an established track record is seen as very important.

The quality of personnel is strongly linked with firm reputation and those investors seeking well established firms. However, some investors stated that they look for quality of personnel at smaller, boutique firms. Some investors believe that the best opportunities are in the more niche strategies and for newer, relatively inexperienced firms with smaller assets under management. Some of the most sophisticated investors we spoke to highlighted this and commented that they look for opportunities that fit in with these criteria. Some investors cited the fees charged by the hedge fund manager as a very important criterion when evaluating fund managers.

Conclusions

Many people believe that the hedge fund industry was becoming saturated and too dependent on leverage to produce returns. Hedge funds are designed to protect investors from volatile markets, and provide returns completely uncorrelated to market indexes. Although the returns of late have not lived up to these expectations, as with any market cycle it is likely that those managers and investors that weather the financial storm will be presented with very attractive investment opportunities.

The number of hedge fund managers, which has been growing substantially in recent years, is likely shrink in the next 6-12 months as the industry goes through a period of consolidation. The expected level of reduction differs, with estimates of between a third to two thirds of managers disappearing. Those managers that have the most robust infrastructures and defined investment strategies will be able to continue operations, but will be faced with a different investment environment in which they will be under increased pressure to reduce fees and will not be less able to rely on strategies dependent on borrowing to drive returns. There will be hedge fund strategies that will disappear and managers will be under more pressure to listen to investors and negotiate fees for longer term commitments. However, faced with cheap assets and rivals who will also be able to take less investment risks, there will be a number of very attractive investment opportunities and the potential for huge returns. The hedge fund industry produced particularly high returns in 1999, the year after Long Term Capital Management's demise, and 2009 could follow a similar path.

Through our research and analysis it is clear that a number of institutional investors are delaying making new investments with hedge fund managers, however, few are redeeming their investments. As institutional investors have a longer term investment horizon many still believe in the ability of hedge funds to provide returns and a significant number have seen hedge funds as some of the better performing aspects of their portfolio. With this continued strong interest in the asset class, and the greater stickability of their capital, we will see institutional investors increasing their market share of the hedge fund market.

Institutional investors are carefully tracking hedge fund managers through these difficult current market conditions to evaluate which funds have produced acceptable returns. Due to the current financial climate there will undoubtedly be a number of new opportunities for investors when more financial stability returns. Institutional investors will look to conduct even more thorough due diligence on their future investments and in order to attract institutional capital, hedge fund managers need to act today to form relationships with the vital institutional investors of tomorrow.

2009 Preqin Global Hedge Fund Investor Review

A Guide to Institutional Investors in Hedge Funds

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