Preqin Special Report

Institutional Investor Outlook for Hedge Funds in 2012

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Institutional Investor Outlook for Hedge Funds in 2012

The toxic blend of the sovereign debt crisis and slow economic growth impacted some of the biggest and best known hedge funds in 2011. However, even in times of heightened global market volatility institutional investors remain committed to investing in hedge funds, with the size of the industry now reaching pre-crisis 2006 levels. As institutional investors demonstrate ongoing faith in the asset class through planned increases in allocations over 2012, the time is ripe for hedge fund managers to market to the growing institutional sector of the investor community. Although the fundamentals of the hedge fund space have remained unchanged, the industry has embarked on a renaissance of sorts since the market crisis, including increased liquidity and transparency offered by managers which continues to be at the forefront of investors' minds. These adaptations have increased the attractiveness of hedge funds as an investment option over the past 12 months, resulting in inflows of capital into the hedge fund space which are set to continue into 2012.

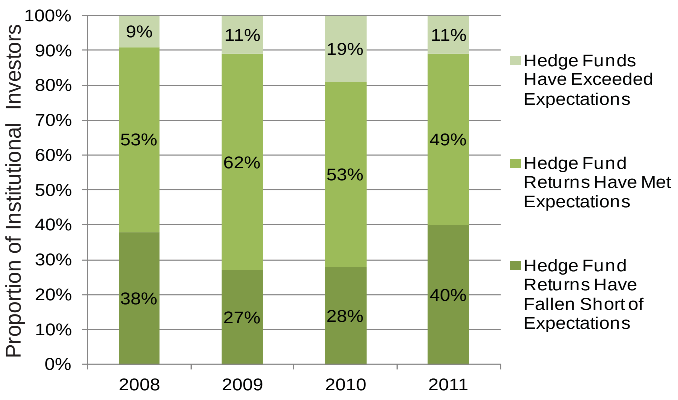
Change in Investor Confidence over 2011

Fig. 1 shows that institutional investor satisfaction with hedge fund performance has fallen in 2011, with 40% of investors interviewed having experienced returns that did not meet their expectations during the year, which is a similar proportion to 2008. This decrease in investor satisfaction reflects the challenging conditions experienced in 2011 due to market volatility. With concerns over slow growth and the eurozone sovereign debt crisis continuing to hit hedge fund performance, investors retained a degree of scepticism towards the asset class over 2011. Despite these results, investors still retain confidence in the asset class to perform its portfolio objectives. Fig. 2 shows that institutional investors remain confident in hedge funds, with 20% of those interviewed stating that their confidence in hedge funds has increased since 2010, compared to 14% stating that it had decreased. Around two-thirds said their confidence towards hedge funds had remained unchanged since 2010.

Large Inflows of Capital Expected from Institutional Investors in 2012

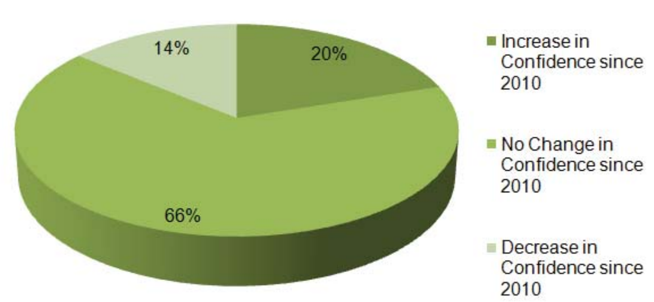
Institutional investors seem committed to hedge funds in this challenging environment, and growth of the industry could be the greatest since before the onset of the global financial crisis in 2008. Fig. 3 shows that 38% of investors interviewed by Preqin plan to increase the amount of capital invested in hedge funds over the course of 2012. Undaunted by poor economic conditions, hedge fund investors will continue to push hedge fund assets towards the $2.6 trillion high reached in 2007 prior to the financial crisis. Over half of investors surveyed plan to keep their allocations to hedge funds the same over 2012 and only a small proportion of investors, 9%, plan to decrease the amount of capital they have invested in the hedge fund space. Net inflows are expected to remain positive over 2012, reaching levels higher than we have seen in any year since the market downturn. Details for over 1,000 institutional investors in hedge funds, including how many funds and how much capital they

Fig. 1: Institutional Investors' Hedge Fund Portfolio Performance Relative to Expectations, 2008 - 2011



Source: Preqin

Fig. 2: Change in Institutional Investor Confidence in Hedge Funds since 2010



Source: Preqin

are looking to invest in hedge funds over the next year, are available in the newly released 2012 Preqin Hedge Fund Investor Review.

Investor Appetite for New Manager Relationships Continues into 2012

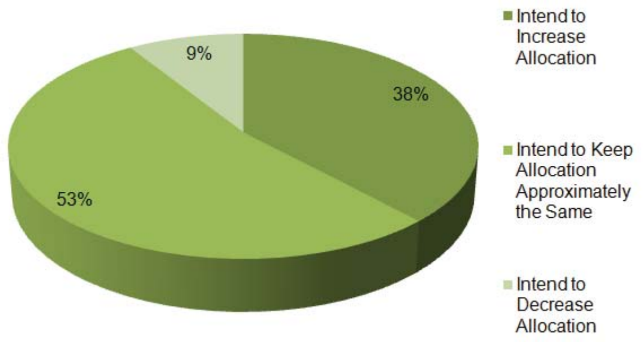
With the expected influx of capital into hedge fund vehicles over the next 12 months, is this capital likely to be directed towards investment with new managers or managers with which investors have an established relationship? The vast majority of investors on the Preqin database plan to seek investment with new managers to some extent over the next 12 months, compared to 20% of investors focusing solely on maintaining existing relationships with managers. A relatively small proportion of investors, 10%, plan to invest only with new managers over the next 12 months. With an additional 49% of investors planning to consider investing in new managers over the next 12 months while maintaining or increasing their investments in current funds, as well as a further 21% looking at new proposals on an opportunistic basis, there is great potential for hedge fund managers to seek capital from previously untapped institutional sources. The 2012 Preqin Hedge Fund Investor Review provides listings of key investors in each hedge fund strategy type, allowing you to assess whether they might be interested in a particular fund.

Strategic Opportunities for Hedge Fund Investors in 2012

Long/short equity is set to continue to feature heavily in institutional investor portfolios over the next 12 months, with 38% of investors on the Preqin database actively seeking to invest in the strategy in 2012. The strategy's continued popularity is due to its ability to provide a level of protection in falling markets, while capturing the majority of the upside in rising markets. Global macro will also be popular over the coming months, with 26% of investors on the Preqin database looking to invest in the strategy, due to its liquid approach and ability to profit from big market moves. This could lead to new inflows coming into the strategy over 2012. CTA funds also continue to interest institutional investors as they seek safe havens amid the 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. The 2012 Preqin Hedge Fund Investor Review contains listings of key investors active within the various hedge fund strategies, as well as overview analysis of all investors in each area.

Although up and coming structures such as UCITS have continued to gain traction with institutional investors, we can expect traditional fund structures to remain dominant over 2012. Commingled direct managers can expect to see the

Fig. 3: Institutional Investors' Hedge Fund Allocation Plans for 2012



Source: Preqin

Fig. 4: Institutional Investors' Plans for Hedge Fund Manager

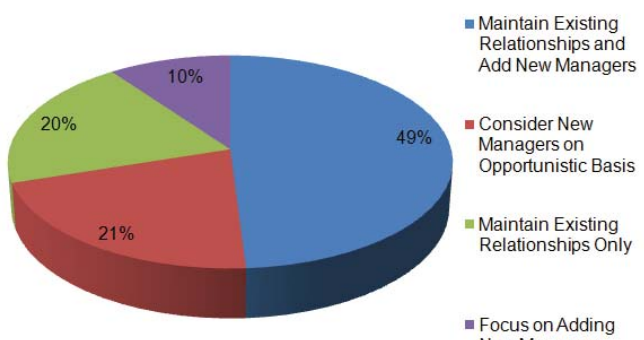
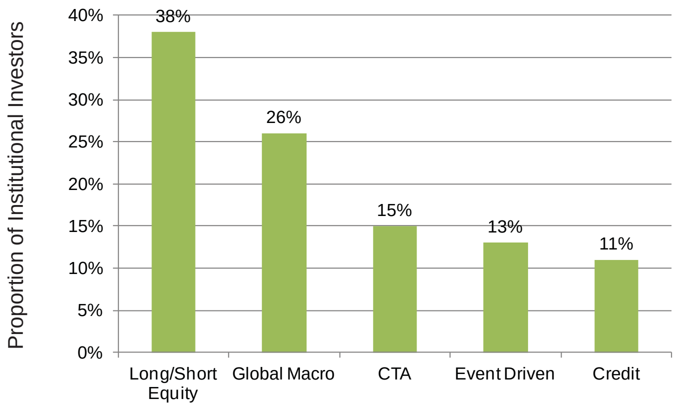


Fig. 5: Top Five Hedge Fund Strategies Being Sought by Institutional Investors in the Next 12 Months



Source: Preqin

largest inflows in capital over the next 12 months, with 79% of investors on the Preqin database looking to invest directly in hedge funds in 2012. In contrast, there has been a significant decline in the proportion of investors planning to invest in commingled funds of hedge funds in the next 12 months, from 42.5% in Q4 2010 to 24% in Q4 2011. Such a decrease may be due to the increasing numbers of institutional investors looking to benefit from customized portfolios, increased transparency and reduced fees by making the transition away from funds of hedge funds towards a direct style of investment. For example, Massachusetts Pension Reserves Investment Management Board reduced its allocation to funds of hedge funds in order to finance the launch of its direct hedge fund investment program, in which it planned to triple direct hedge fund exposure to $1.5 billion. Despite this increasingly common transition, funds of hedge funds still remain the vehicle of choice for new investors in hedge funds, as well as being utilized alongside direct investments by more experienced investors to access niche strategies, or emerging regions and themes. Demand for managed accounts continues to grow amongst investors seeking greater transparency and liquidity, in response to financial instability and various scandals that have rocked the industry over the past few years. Fifteen percent of all institutions planning to make new investments over the next 12 months prefer their capital to be held in separately managed accounts.

What Institutional Investors Look for in Hedge Funds

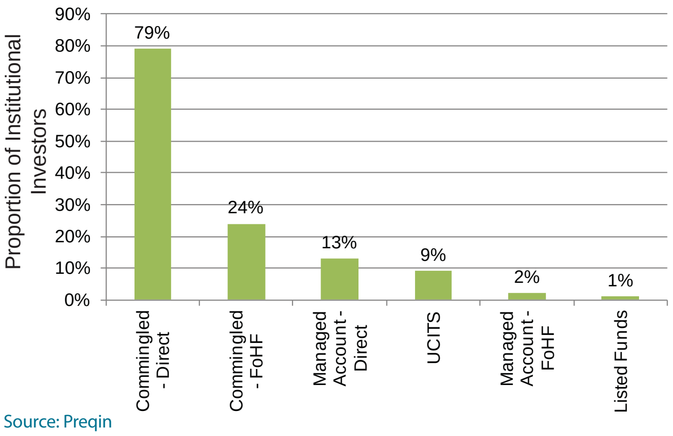
Preqin interviewed a sample group of investors and asked them to consider what the most important parameters are in terms of fund selection. The results (Fig. 8) show that investors consider track record/firm reputation to be the most important criterion closely followed by fund performance and strategy. The top three criteria have remained the same as last year, while transparency has moved up on the list. Transparency has become increasingly important to investors; this was highlighted by an earlier Preqin study which revealed that 58% of respondents had rejected a fund investment opportunity in 2011 on the basis of a lack of transparency.

Risk management and liquidity are also considered important fund criteria amongst institutional investors, with just over 20% indicating each of these as key criteria. A recent Preqin study showed that 75% of institutional investors now require greater liquidity in their portfolios than they did in 2008. These liquidity concerns have driven the development of specialized hedge fund products such as managed accounts and UCITS funds. Fees are not an issue of great importance for investors when compared to other criteria, highlighting the fact that investors are typically willing to pay higher fees if they are getting a good deal in return with respect to other fund criteria.

What Can Hedge Fund Managers Expect in 2012?

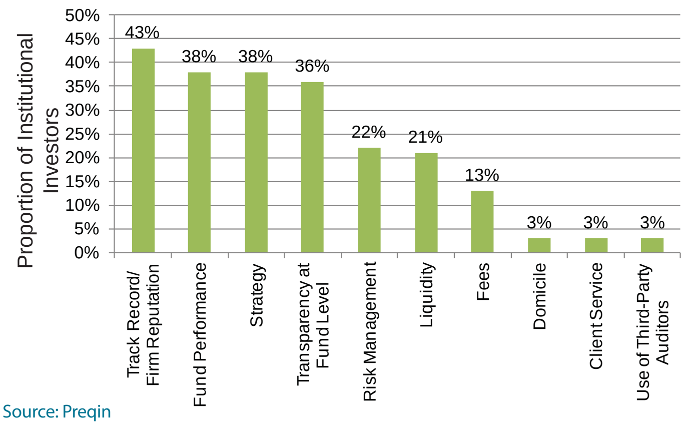
Although institutional confidence has been dented in the wake of poor returns in the latter half of 2011, the outlook for the next year remains positive. Hedge fund managers can expect a large influx of capital into hedge funds from institutional sources over the next 12 months, enabling hedge fund assets to potentially reach or exceed the pre-crisis watermark of $2.6 trillion. We can also expect the ongoing trend for further liquidity and transparency to continue, with increasing numbers of investors choosing to invest in separately managed accounts. However, traditional fund structures will remain at the forefront of investment portfolios. Hedge fund strategies looking to profit from macro events, such as global macro and CTA, are expected to pick up further investments from institutional investors in 2012.

Fig. 6: Hedge Fund Structures That Investors Feel Present the Best Opportunities for Hedge Fund Investments in 2012



Source: Preqin

Fig. 7: Attributes Most Sought by Investors when Searching for New Hedge Fund Opportunities



Source: Preqin

Institutional Investor Outlook for Hedge Funds in 2012

Since Preqin launched its first institutional investor service back in 2003 there have been many changes in the alternative assets industry as a result of investments such as hedge funds becoming more "mainstream" than "alternative" within institutional portfolios. With a new institutional audience the hedge fund industry has rapidly evolved to meet the demands of a more stringent and demanding investor base. Even more changes are expected over the next few years as the industry continues to grow and adapt following the financial crisis. Overall, investors remain confident about the benefits of investing in hedge funds despite the challenging financial climate leading to underperformance in 2011.

Endowments make up 14.7% of all investors on the Preqin database and continue to be one of the main sources of institutional investment in hedge funds. Typically these are long-term, return-driven investors and over the past 10 years they have been fundamental in shaping the institutional universe. The structural preferences of endowments are varied, with an almost equal split between those that invest directly through single managers, those that invest through funds of hedge funds and those that invest via a mixture of the two methods.

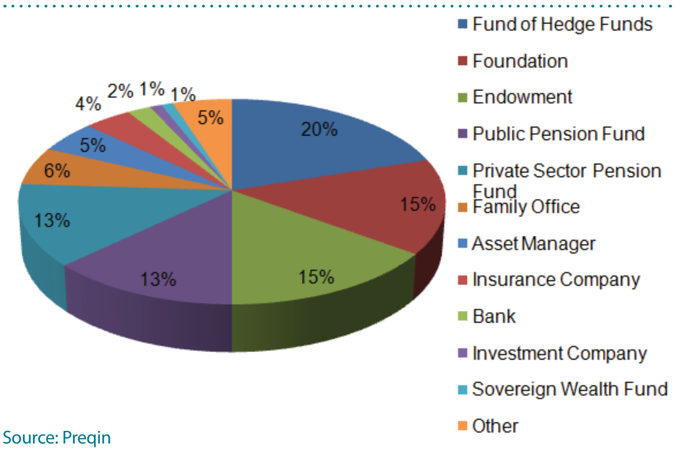
Public pension funds represent just over 13% of all investors on the Preqin database and are an established group of investors within the institutional universe. The mean allocation from this group of investors has been steadily growing over the past few years and currently stands at 6.8%. The mean target allocation for pension funds stands at 7.7%, and as a result these investors are likely to continue to be active over the next 12 months as they seek to move towards their targets.

Private sector pension funds are also an important contributor to institutional investment in hedge funds, and although their mean allocation has dropped back slightly in the past year to 8.2% (down from 8.6% in 2010), it has generally been growing in recent years. However, the current mean target allocation amongst private pension funds is 9%, suggesting that a number of these investors are still looking to increase their level of investment in hedge funds. This is positive news for the hedge fund industry following 2010, when there was some evidence that private sector pension funds had concerns with the asset class and many were putting investment in hedge funds on hold or completely redeeming portfolios.

Foundations are increasing their allocations to hedge funds and currently invest, on average, 15.5% of their total assets in the asset class. Their mean target allocation is 16.5%, which suggests a number of foundations are looking to expand their hedge fund portfolios. The majority of foundations still prefer to invest through funds of hedge funds.

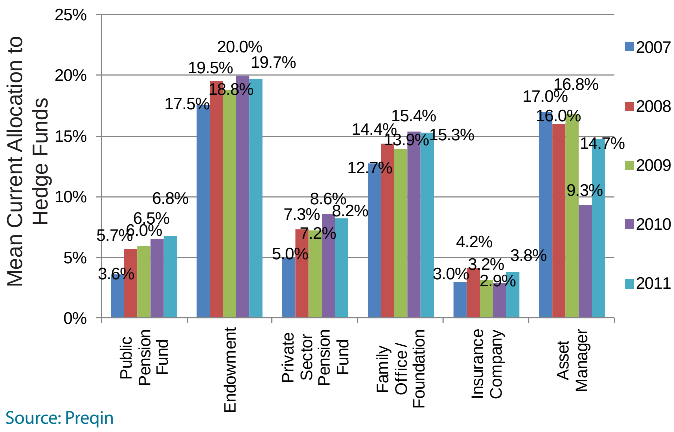
Family offices remain an important part of the institutional investor community, and they currently have a mean allocation of 13.3% and a mean target allocation of 18.8%, suggesting that they are likely to be very active investors over the next 12 months. The majority of family offices prefer to invest in hedge funds directly, with 87% including direct fund investments in their portfolio, as these investments are typically more liquid than funds of hedge funds. Family offices have the highest average target returns of all investor types tracked by Preqin.

Fig. 8: Breakdown of Institutional Investors in Hedge Funds by Investor Type



Source: Preqin

Fig. 9: Mean Allocation to Hedge Funds by Investor Type, 2007 - 2011



Source: Preqin

Investors to Watch

Firm Name	Type	Country	Total Assets (mn)	HF Allocation		Investment Plans
				%	Amount (mn)	
AC Investment Management	Fund of Hedge Funds	US	USD 562	100	562	The USD 562 million fund of hedge funds manager plans to invest between USD 50 million and USD 100 million in three to seven hedge fund managers over the next 12 months. The firm currently manages two funds of hedge funds, with 40 underlying managers in its portfolio. It invests solely in CTAs, commodities and energy funds, through both commingled funds and managed accounts, and will consider investing in emerging managers.
Bryn Mawr College Endowment	Endowment	US	USD 700	22	154	Bryn Mawr College Endowment is set to increase its hedge fund allocation while simultaneously creating a more concentrated hedge fund portfolio. The endowment invests 22% of its assets across approximately 20 managers, but it plans to reduce this number. It will still be selecting new managers in 2012, however. The endowment has no exposure to emerging markets, but it is possible that future allocations will be made to vehicles in less developed regions.
Woori Absolute Partners	Fund of Hedge Funds	Singa-pore	USD 100	100	100	The Singapore-based fund of hedge funds manager will make a number of new seed investments in 2012 through the multi-manager vehicle that it launched in conjunction with NewAlpha Asset Management. The fund will have an Asian focus and will provide seed capital to emerging managers across a broad range of strategies. The vehicle currently has assets of USD 100 million and the aim is for it to close with assets of USD 200 million.
Ilmarinen Mutual Pension Insurance Company	Insurance Company	Finland	EUR 28,000	2.4	672	Ilmarinen Mutual Pension Insurance Company aims to add up to five new investments to its hedge fund portfolio over the next 12 months. The EUR 28 billion Finnish insurance company began investing in 2002 and plans to commit up to EUR 200 million to a range of hedge funds in 2012. Ilmarinen will invest in funds with lock-up periods of up to 12 months and typically looks for managers which have at least a two-year track record. It typically allocates EUR 10-50 million to each hedge fund as an initial investment.
Trafalgar House Pension Trust	Private Sector Pension Fund	UK	GBP 1,414	32.4	458	The USD 1.4 billion pension fund will be increasing its exposure to global macro hedge funds in 2012. Trafalgar House invests 32-35% of its total assets in hedge funds and makes most of its investments through single-manager funds. Over an extended period, the pension fund may also make additions to its equity-focused array of funds and it is likely that any additions made will be at the expense of multi-strategy hedge funds.

2012 Preqin Hedge Fund Investor Review

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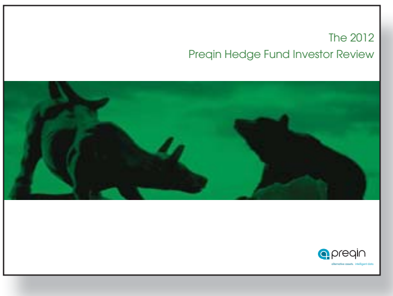
The 2012 Preqin Hedge Fund Investor Review provides profiles and analysis for the most important institutional investors in hedge funds from around the world. This invaluable resource contains the following key features:

- Profiles for 1,000 key institutional investors arranged into 23 key regions from around the world.
- Profiles include fund preferences by strategy and geography, key financial information, direct contact details for key personnel, sample investments.
- Analysis for investors from each region.
- Analysis for investors in each of the ten most important hedge fund strategies with listings for active investors.
- Analysis and listings for investors looking to allocate to UCITS or managed account vehicles.
- Analysis of emerging manager investors.
- Exclusive information gained through direct contact with institutional investors.



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