

Preqin Hedge Special Report:

The Growing Influence of Institutional Investors in Hedge Funds:
Results of Hedge Fund Manager Survey

03-Mar-2008



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In Preqin Hedge's last research report we outlined how institutional investment in hedge funds has reached unprecedented levels and we predicted that in the next 18 months \$ 80 – 90 billion would be poured into the asset class from institutional funds alone. In this month's Hedge Fund Research Report we have turned the tables and surveyed 50 hedge fund managers to find out about their institutional client bases and the changes this has led to in their firm. Managers were interviewed from across the spectrum of strategies and styles, varying in AUM, track record and location.

Firstly we asked hedge fund managers how their institutional client base has changed over the past three years. 55% of respondents replied that the number of institutional investors in their hedge funds has increased. Hedge funds have been seen traditionally as the investment vehicle of the wealthy, private individual, however over the past five years institutional investors, motivated by single digit returns from other assets and the prospect of under-funding, have flocked to the asset class. Hedge

funds, with their potential for high returns with low correlation to the equity market, are increasingly being viewed as a useful tool in an investor's portfolio. And it is not just new investors that account for the increasing institutional client base of hedge funds – existing investors, bolstered by the success of their existing hedge fund investments, are also increasing their allocation to the asset class to boost returns and add further diversity to their portfolio. Just 14% of hedge fund managers reported that their institutional investor client base had decreased over the three year time frame.

We surveyed 50 hedge fund managers and fund of funds listed on our database and we found that on average institutional investors form 44.8% of a hedge funds capital base. From Fig. 2 we can see that 59.2% of managers surveyed had less than 50% of their capital coming from institutions. With over half of managers reporting that their institutional client base has grown over the past three years we predict that this trend will continue and that within a hedge fund the average proportion of investors

Fig. 1: How have hedge fund managers' institutional investor client bases changed over the past three years?

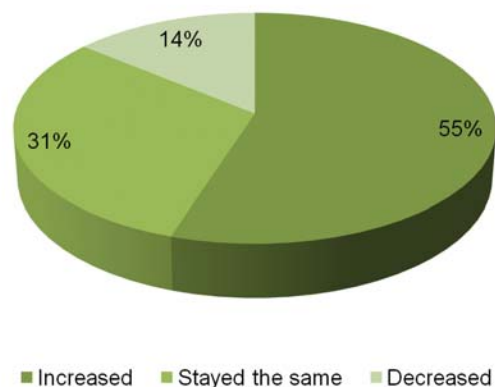
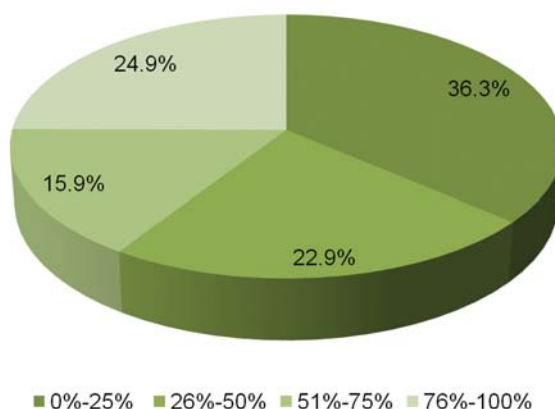


Fig. 2: % of firms' capital coming from institutional investors



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coming from an institutional background will only increase in the forthcoming years.

In order to draw the attention of institutional investors hedge fund managers have had to adapt to become more attractive to institutional clients. 40% of managers surveyed rated infrastructure changes as the most important factor in creating an institutional quality firm. Institutions are demanding their hedge funds to have not only excellent investment professionals but also to have a network of back-office staff, including dedicated investor relations professionals to deal with client enquiries as well as having out-sourced fund administrators.

Variation in Institutional Investment Based on Firm Size

Larger hedge funds often have had this institutional quality infrastructure in place for several years and their size means they can have dedicated teams dealing with different types of institutional clients. Fig. 4 shows the average percentage institutional make

up by firm size. From this we can see that the larger the hedge fund, the greater the amount of institutional investment. Having a large amount of non-investment professionals working alongside the investment team allows the portfolio managers to do what they do best – generate absolute returns. In addition to the appealing infrastructure of large firms, institutional investors are often unwilling to take too large a standing in a hedge fund, therefore a fund often has to reach a certain size in terms of AUM before they will consider investment. For the smaller sized hedge funds the picture is less clear and the institutional make-up of a firm is determined to a much greater extent by other factors such as track record and strategy.

Popular Strategies

Through our survey we identified the most popular strategies invested in by institutional investors. Fig. 5 shows the average institutional make-up of funds for the seven most popular strategies. It is clear that fund of funds are a common choice for

Fig. 3: What challenges do hedge funds face when attracting new institutional investment

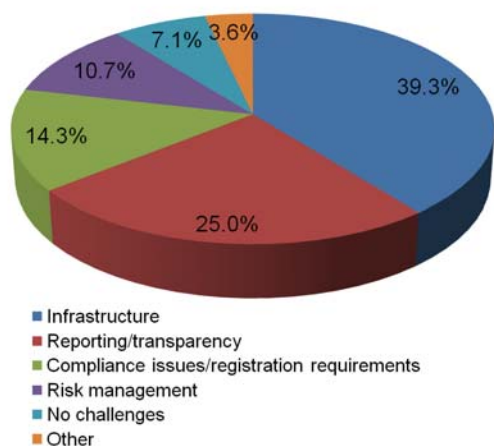
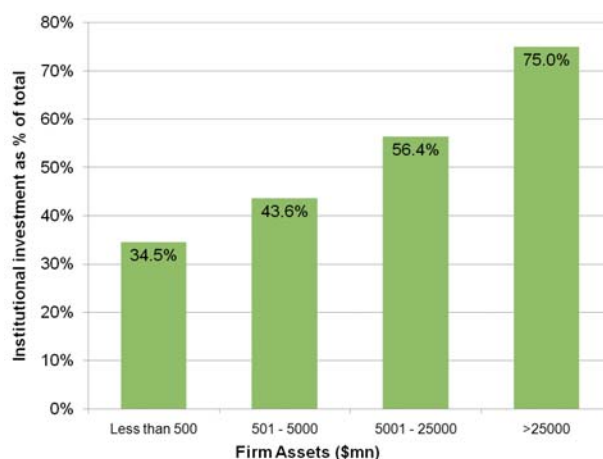


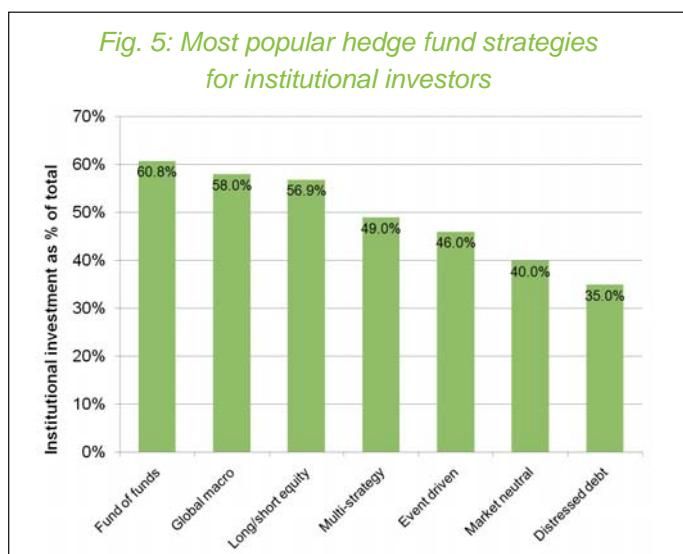
Fig. 4: Average % institutional investor make up by firm size



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institutional investors with no less than 60% of fund of funds capital, on average, coming from institutional means. Many institutional investors are risk-averse and look to generate steady returns, also the majority of institutions are new to the asset class, with nearly 90% of investors responding to a previous Preqin Hedge survey stating that they have been investing in hedge funds for 6 years or less. Fund of funds are seen as an excellent route to gain knowledge about hedge funds whilst reducing an investors overall exposure to risky strategies.

From the Preqin Hedge Institutional Investor database we have identified that the most common investors in fund of hedge funds are public pension plans (we currently monitor 226 such investors) – accounting for nearly one quarter of all investors stating a preference for multi-manager vehicles. Global macro, long/short equity and multi-strategy funds are becoming increasingly popular amongst institutional investors. Investors are viewing multi-strategy funds as an alternative to fund of funds – generating attractive returns without the double layered fees that are associated with multi-manager vehicles.



Transparency and reporting

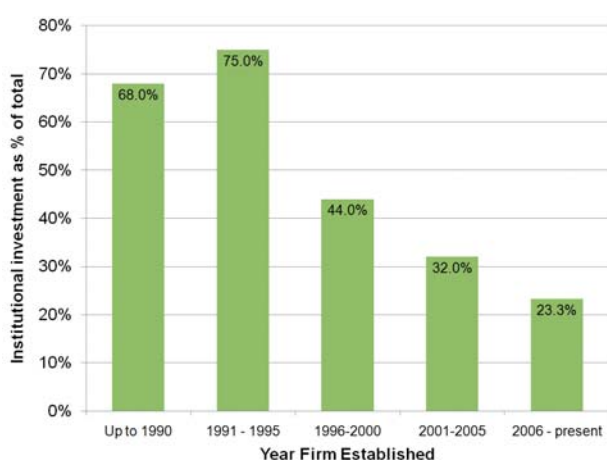
25% of managers surveyed felt that reporting and transparency issues are an important factor to be addressed when taking on institutional investors. Hedge funds have traditionally been regarded as a secretive and little understood asset class. This has deterred many institutional investors from entering the arena, as many institutions – particularly those managing public coffers – follow strict regulations on how they are allowed to invest their funds. Hedge funds that have successfully attracted institutional investors have become more transparent regarding their investment strategies and have adapted to embrace regulatory requirements that are essential for many institutional investors. By improving the transparency of their funds and submitting regular reports to investors, hedge funds are improving institutional confidence in the asset class and yielding to the due diligence requirements of the increasingly sophisticated institutional investor.

Track record

From a previous survey carried out in December 2007, Preqin Hedge found that institutional investors cited track record and quality of personnel as one of the most critical factors involved when selecting hedge fund managers. From Fig. 6, we can see that this is the case. More well established hedge funds have institutional investors making up a significantly greater proportion of their investors compared to newer – less well known firms. Many institutions – particularly the more conservative investors such as pension funds and insurance companies – often add hedge funds to their portfolio to generate consistent and stable returns rather than strong returns. Track record is vital to these investors so they can accurately assess the returns of a hedge

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Fig. 6: Effect of firm experience on make up of institutional investment as % of total investment



fund over a long time period and mitigate the risk of investing in a younger hedge fund with unproven returns.

Conclusions

So what does it take to be successful when attracting institutional capital? An institutional quality infrastructure is vital if you want to draw the eye of the institutional investor – back office staff, dedicated investor relation personnel as well as outsourced fund administration are essential for many of the more conservative institutions. Improved reporting and transparency are also key to gaining institutional commitments. The majority of institutional investors are relatively new to the asset class and they will not invest in a strategy that they do not understand, and whilst they may not demand portfolio level of transparency, full regular disclosures in terms of performance, risk and overall portfolio activity are vital for institutions due diligence requirements and to ensure that hedge fund managers are adhering to their initial mandate. Larger more well established hedge funds are also

more popular amongst institutional investors. “Headline risk” is a major concern for many investors – by investing in firms with a longer track record, a well-known brand and a greater amount of assets under management, institutions feel more reassured that their capital is safe.

With 55% of managers surveyed reporting that their institutional client bases having grown over the past three years, we expect this trend to continue and for institutional capital forming a greater proportion of their hedge funds. Hedge funds will have to adapt to respond to the regulatory issues and demands of institutions if they want to receive some of this inflow of capital. However as institutional investors become more sophisticated their appetite will change. Emerging managers often produce larger returns than well established firms – however investment is often riskier, so experience and knowledge of the asset class is needed before committing capital to these firms. The longer-term institutional investors, for example endowments such as Harvard Management Company who have been investing in hedge funds for ten years, are already investing in emerging managers. We expect as other institutional investors such as public pension plans and insurance companies become more experienced they will look to invest in emerging managers. This trend is already evident, with large pension funds such as CalPERS, setting up emerging manager programs over the past twelve months.

Fund of funds are a common route for institutional investment, and we expect these multi-manager vehicles to remain a popular choice with the institutional investor. However, investment in single strategy hedge funds is becoming increasingly widespread amongst institutions as their level of understanding about the asset class grows.

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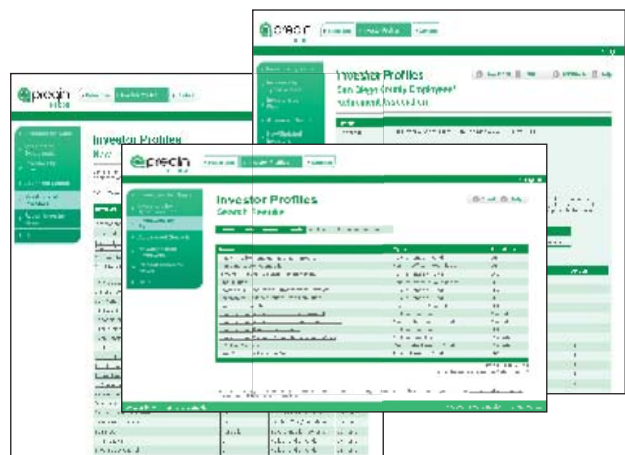
The relationship between the hedge fund manager and its institutional clients is becoming an increasingly important driver within the industry. With new firms being formed every week, hedge funds will have to put in place important infrastructural and regulatory procedures if they want to attract the interest of the discerning institutional investor. However the institutional investor is changing too – with more experience comes new appetites and requirements from hedge funds and we expect investors to become increasingly interested in new areas of the asset class.

Preqin Hedge is the industry's leading source of information on institutional investors in hedge funds, with data available via printed directories and online databases.
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