

2011 Preqin Global Investor Report Hedge Funds



Methodology:

Preqin, the alternative assets industry's leading source of data and intelligence, welcomes you to the 2011 edition of Preqin Global Investor Report: Hedge Funds, a unique look at investors in hedge funds, their current opinions of the market and the outlook for the year ahead.

This report draws on the results of two detailed studies conducted by our skilled teams of multi-lingual analysts during Q3 2010 - Q1 2011. The first was an in-depth study of over 2,500 hedge fund investors around the globe, selected from Preqin's Investor Profiles database, the most comprehensive and accurate source of information on investors in hedge funds available today. The second was comprised of in-depth interviews with 60 hedge fund managers, made up of managers diversified in terms of location and strategy.

Preqin's data is obtained through speaking directly to institutions and fund managers located across the globe, providing readers with a unique insight into the attitudes of the leading investors in hedge funds and trends affecting the fund management industry today.

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Foreword

Over the course of the past year we've seen the level of institutional support for hedge funds continue to rise. Our current estimate is that 61% of hedge fund assets now come from the institutional sector, a 36% rise from 2008 when the figure stood at 44%.

This shifting dynamic demands a new approach to both investor targeting and investor relations. Many funds have already altered their approach to reporting and have improved their levels of transparency in order to satisfy the requirements of new institutional clients. We expect that the level of attention paid to these key areas will continue to grow in the coming year.

While institutional clients do demand more developed processes on the fund administration side, the benefits that they bring can be invaluable. Their long-term investment horizons and ability to invest substantial sums of capital make them an excellent investment partner - far less likely to redeem capital at the first sign of trouble than those within the high net worth community.

In order to thrive and enjoy success in this shifting landscape, hedge fund managers must firstly ensure that their governance is brought up to scratch, and then ensure that their fund marketing efforts are appropriately focused in order to identify the best potential institutional backers. The rather generic term 'institutional investor' belies the huge amount of diversity that exists between different investor types. Endowments tend to invest differently to public pensions, which invest differently to corporate pensions... and even within groups of institutions similar in terms of size and type there exists considerable contrast in terms of appetite for different types of fund.

The good news is that there are institutional investors suited to all fund strategies, regions, sizes and experience levels. The challenge comes in identifying them. This report provides an in-depth overview of the investor universe, their current sentiment towards hedge funds and some guidance on how best to attract their support. All the findings are based on underlying investor profiles for over 2,500 institutions, all regularly updated via direct contact with our international teams of dedicated analysts. For more information on how Preqin can help you achieve your objectives, please see the final page of this report.

We hope that you find the 2011 Global Hedge Fund Investor Report to be informative, and as ever we welcome any feedback that you may have.

Best Regards,



Amy Bensted
Manager, Hedge Fund Products

The Institutionalization of Hedge Funds

Over recent years, the hedge fund universe has undergone profound changes. Traditionally seen as money managers for wealthy individuals, many fund managers are increasingly raising capital from institutional sources.

Over the past two years, i.e. since the market crisis of 2008, 47% of the fund managers surveyed stated that the amount of capital coming from institutional coffers has increased (Fig. 1), with this rising to 56% of surveyed funds over the longer time frame of five years (Fig. 2). Many fund managers have increasingly been marketing their funds to the institutional market over the past five years to capitalize on an increased appetite from this group of investor and to tap into the larger ticket sizes and stable sources of capital that they can provide.

This increased institutional investor capital is coming both from investors making their first allocations to the asset class – 38% of all institutional investors currently active in hedge funds made their first investment in hedge funds from 2005 onwards – as well as existing investors increasing their allocations to the asset class. For instance from 2007 to 2010, public pension fund investors in hedge funds (which combined represent some \$4 trillion in total assets) have increased their allocations to hedge funds from 4% of AUM to 7%.

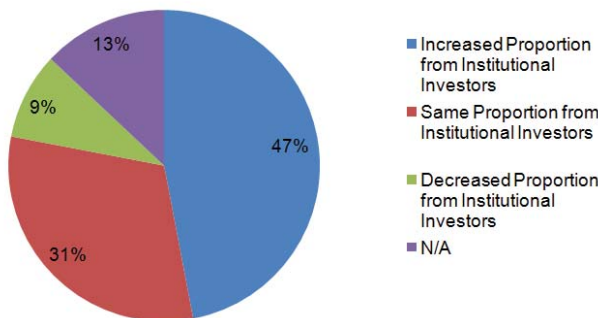
Interestingly, a relatively significant proportion of managers that participated in the Preqin study – 14% – have experienced a drop in the proportion of institutional capital in their funds over the five-year period. However, the majority of this group stated that they had seen a recovery over the past two years, so changes in institutional assets for these fund managers are likely to have been short-term fluctuations caused as a result of the turbulent markets of the recent past.

We asked the surveyed fund managers to state what proportion of their funds' assets came from institutional investors. The distribution is broad, but interestingly the same number of funds stated that none of their hedge fund capital came from institutional investors as the number of funds which stated that all of their capital came from institutional investors. The mean proportion of capital that is sourced from institutional investors stands at 61% for managers participating in the survey.

“Many fund managers have increasingly been marketing their funds to the institutional market over the past five years...”

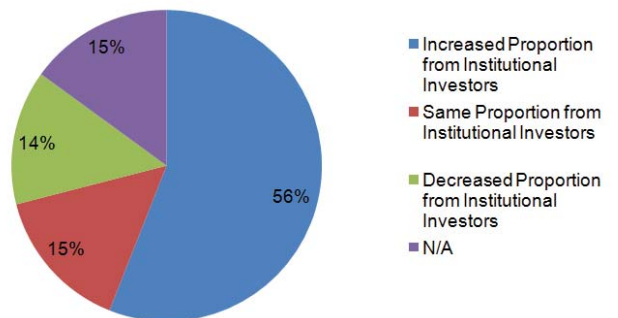
From these poles, the distribution aggregates around a mean capital-weighted average of 60.5% of hedge fund capital coming from institutional means, and 57% of respondents stated that more than half of their assets came from the institutional sector.

Fig. 1: Changes in Source of Hedge Fund Managers' Capital over Last Two Years



Source: Preqin

Fig. 2: Changes in Source of Hedge Fund Managers' Capital over Last Five Years



Source: Preqin

Institutional Investor Outlook for 2011

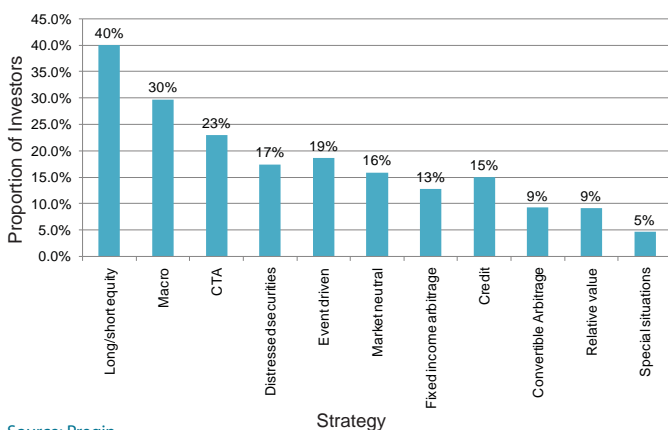
As the economic climate has stabilized, institutional investor confidence is returning to the hedge fund universe. How have investor attitudes changed towards the asset class and what are their plans for the future?

With global markets returning to pre-crisis levels, institutional investor trust in the hedge fund space is also returning. 67% of those surveyed by Preqin during Q4 2010 stated that their faith in the asset class had remained unchanged over the past 12 months, whereas a significant 22% stated an increase in confidence. This increase in confidence is a result of the changes that have taken place within the industry since the start of the market crisis, and the performance of hedge fund portfolios. 60% of investors stated that they had noticed a beneficial change in fund structures that had been of benefit to them during the last year. Fee structures, liquidity, transparency and the marketing techniques used by fund managers have all been modified, enhancing investor confidence.

In general, investors were satisfied with the performance of their hedge fund investments between 2008 and 2010. Almost one-fifth stated that returns exceeded their expectations in 2010, compared to 9% and 11% in 2008 and 2009 respectively. Moving forward, investors are looking to invest more capital in the asset class; 35% intend to increase their hedge fund commitments across 2011 and half of these investors will invest with new managers while at the same time seeking opportunities offered by managers with whom they already have a relationship.

Fig. 3 shows the breakdown of hedge fund strategic preferences currently held by the entire hedge fund institutional investor universe. Long/short equity and macro are the most popular strategies; however credit-based hedge funds are the funds that have seen the largest proportion increase in popularity over the last few years. When asked what would be popular trends

Fig. 3: Breakdown of Institutional Investors' Strategic Preferences

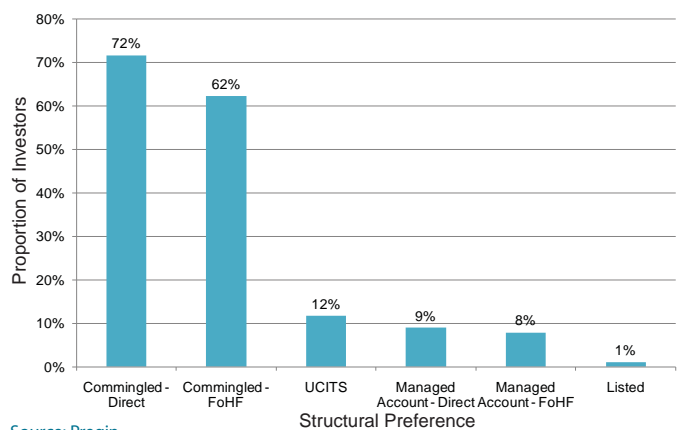


Source: Preqin

for hedge fund investment across 2011, almost three-quarters of investors surveyed stated that global macro hedge funds will present good opportunities, and 60% are keen to invest in distressed hedge funds. Asia is considered an attractive region in which to invest by 63% of those surveyed, while just over half are interested in North America. Just 5% feel that the Middle East will offer good opportunities for hedge funds in the year ahead.

The majority of institutional investors in hedge funds prefer to use a combination of both multi-manager and single-manager hedge funds; however as knowledge and sophistication increases it is likely that we will see a continuation of the general move of institutions towards investment via single-manager funds. The largest proportion of investors (72%) exhibit an interest in commingled direct funds, and 62% have a preference for commingled funds of hedge funds, as shown in Fig. 4. UCITS has become a buzz word in the industry over the last 12-18 months and has presented a compelling investment opportunity for many investors. UCITS III-compliant managers offer increased liquidity and transparency, and are subject to more regulation than offshore funds. With the growing demand for all of these elements from investors, UCITS managers are an important part of the evolving industry. 12% of investors on the Preqin database have stated a preference for UCITS-structured funds; a significant proportion given that such funds have only emerged in recent years and the current universe of funds is still relatively small (500-600 funds).

Fig. 4: Breakdown of Institutional Investors' Structural Preferences



Source: Preqin

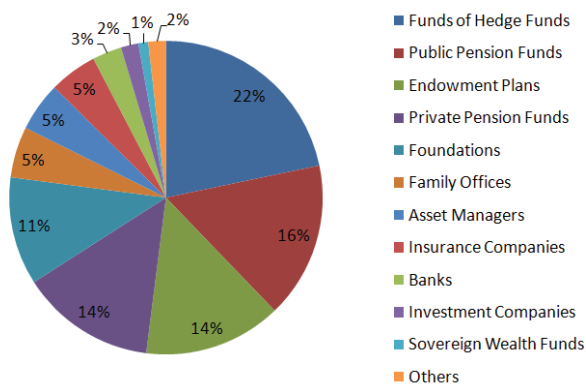
Institutional Investor Universe

With 2011 set to be a key year for hedge fund allocations, it is more important than ever to understand the institutional investor universe.

In recent years the overall hedge fund investor landscape has fundamentally changed. The turmoil caused by the financial crisis has resulted in many institutional investors becoming increasingly aware of the need to diversify their portfolios and to tap into alpha. Consequently, the broad 'asset class' that is hedge funds has become more attractive to a wide range of different types of institutions, as highlighted in Fig. 5.

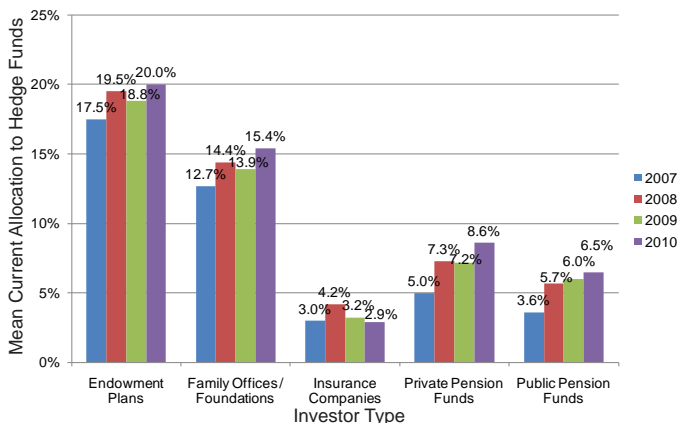
In addition to more types of institution than ever investing, mean allocations to the asset class have also steadily increased.

Fig. 5: Breakdown of Institutional Investor Universe by Investor Type



Source: Preqin

Fig. 6: Mean Allocation to Hedge Funds by Investor Type 2007-2010



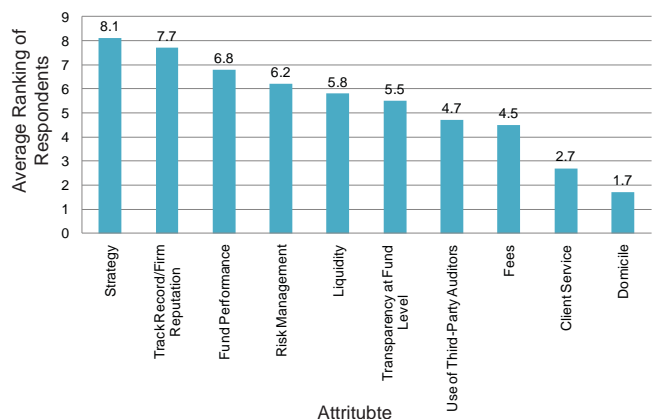
Source: Preqin

As shown in Fig. 6, the wider market downturn negatively affected allocations to hedge funds across most institutional investor types in 2009; however until this time allocations had increased year-on-year. During 2010 the mean hedge fund allocations for the majority of institution types increased again, exceeding pre-crisis levels. Despite a return of capital inflows to the industry, the market crisis and the industry scandals of the period have changed the general attributes sought by investors when searching for new hedge fund managers. During the boom years many institutions were focused predominately on proven returns and past performance; however as demonstrated in Fig. 7, investors surveyed by Preqin noted that they are now also targeting funds that can demonstrate high degrees of liquidity and transparency.

Public Pension Funds

Public pension funds have steadily increased their allocations to hedge funds over recent years and, despite the dip caused by the market crisis, remain committed to the asset class. In general, these investors are becoming more sophisticated in their approach to hedge fund investment and as a result are moving away from solely investing via funds of hedge funds. During the last 12 months the proportion of public pension funds that prefer to use single-manager hedge funds only has increased from 14% to 18%. Despite this shift, the public pension sphere is still predominated by the use of funds of hedge funds in some form, as shown in Fig. 8. This is particularly the case for schemes that are unfamiliar with the industry and eager to gain their footing in a complicated asset class.

Fig. 7: Average Ranking of Attributes Sought by Investors When Searching for a New Fund



Source: Preqin

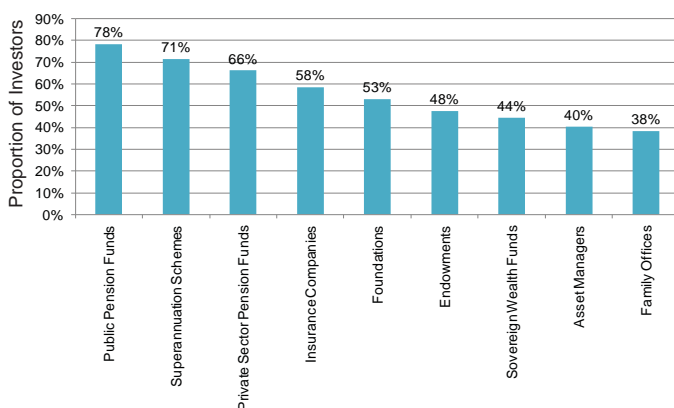
Private Pension Funds

Private pension funds have been increasingly adding hedge funds to their portfolios over recent years and are one of the fastest growing groups in terms of importance to the hedge fund industry. Their allocations to the asset class peaked during 2010; however a number of portfolios have also been redeemed, or are currently in the process of being liquidated, suggesting that the confidence of some of these investors is waning. Those that remain committed to the asset class have favoured a switch towards direct investment in hedge funds in recent years. In 2009 13% of all private pensions invested solely in single-manager vehicles, but by the end of 2010 that figure had reached 20%. Since the financial crisis we have also seen that private pension funds have become more demanding in both their liquidity requirements and the returns they expect from their hedge fund investments.

Endowment Plans

Endowment plans are long-term, return-driven investors and have shaped the institutional universe through innovative and extensive use of hedge funds. Like public pension funds, endowments have recently started to shift in favour of direct investments; however just over a quarter of those on the Preqin database retain a preference for investing solely through funds of hedge funds. Endowments have been investing in hedge funds for many years, and over this time have built large and diversified hedge fund portfolios. As a result these institutions have generally found their optimum exposure level (18-20%, on the whole) and are unlikely to shift significantly large new sums of capital into the asset class. Despite this, endowments have the largest mean allocation to hedge funds of many investors, and whilst they accept the longest lock-up periods of all investors, they are increasingly favouring more liquid strategies, making them a valuable source of capital for managers that can demonstrate these qualities.

Fig. 8: Proportion of Institutional Hedge Fund Investors That Invest in Funds of Hedge Funds by Investor Type



Source: Preqin

Family Offices and Foundations

Family offices and foundations typically invest in a similar manner to endowments. Family offices utilize a long-term outlook and often invest with new managers, or in new strategies. Family office groups typically have the highest average allocations to the asset class (24.2%) but also have the highest return requirements of all investors on the Preqin database. In comparison foundations typically have lower return expectations and more modest allocations - currently at 14.9% but rising to 15.4% as a result of their targeted exposure to the asset class.

Insurance Companies

Insurance companies only account for a small proportion of the institutional investor universe and their average allocation levels have remained depressed since the market crisis. Despite this, the assets they are investing in hedge funds can often be significant due to their relative size. Over 2010 there was a marked trend of insurance companies preferring investment with single-manager hedge funds.

Funds of Hedge Funds

Despite the general trend of many institutional investors moving towards direct investment via single-manager funds, multi-manager investment vehicles remain important, with 62% of all institutional investors stating a preference for funds of hedge funds. Indeed, many institutional investors prefer to use multi- and strategic single-managers in tandem in order to increase diversification. In general, funds of hedge funds offer smaller or less experienced investors access to a broad range of funds and a level of industry expertise that would normally be beyond their capabilities.

Despite their popularity, it has been a difficult two years for funds of hedge funds; there have been many fund closures, consolidations and mergers of management groups. No fund of hedge funds has emerged from the financial crisis unscathed and even the largest management groups suffered redemptions at the hands of their investors. However, despite fund closures in the past and a more difficult fundraising climate at present, there are still new multi-manager funds being launched and new management groups setting up.

Funds of hedge 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 launches to cater for the new demand for this European regulated vehicle. In addition, funds of hedge funds continue to be an important source of capital to emerging managers, and in the past 12 months we have witnessed funds of hedge funds awarding seed capital to more established funds which may have lost assets during the financial crisis and stalled in their endeavours to attract new investment. For many funds of hedge funds, seed investments were put on hold during the financial crisis, but over the course of 2010 there was a noticeable uptick in activity and this is expected to continue during 2011.

Institutional Investors By Region

While established markets remain vital, 2010-2011 has seen hedge fund investors in emerging markets becoming more important sources of capital.

Given that the hedge fund industry is well established in the US, it is no surprise that North America is by far the largest source of institutional hedge fund capital. 56% of investors are domiciled in the region; 54% are US-based, and the remaining 2% are Canadian. University endowments account for the highest proportion of investors in the region.

Almost a third of institutional investors in hedge funds are European, and the UK is the second largest country globally in terms of the number of hedge fund investors – 12% of all institutions active in hedge funds are based in the country. Switzerland, Germany, Netherlands, Sweden and France are also amongst the top 10 countries investing in hedge funds at present. Funds of hedge funds and private sector pension funds account for over half of European hedge fund investors.

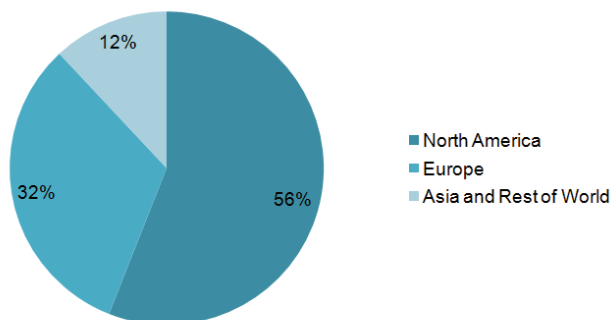
“Almost a third of institutional investors in hedge funds are European...”

The last 12 months have seen increasing numbers of hedge fund launches in Asia, resulting in larger amounts of capital and significant amounts of industry talent being focused in the area. Currently, 12% of hedge fund investors globally are based in Asia and Rest of World; however as the nascent hedge fund industry in the region develops and matures, it is likely that

we will continue to see more institutional investors in the area gaining exposure to the asset class.

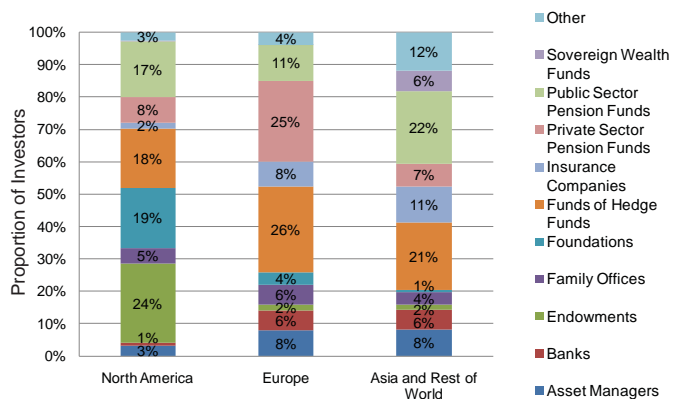
Most countries in this region are new to the asset class, with the exception of Japan and Australia, which both feature in the top 10 countries by number of investors in hedge funds. Superannuation schemes are the predominant hedge fund investors in Australia, while insurance companies and pension funds provide the largest amount of institutional hedge fund capital from Japan. In terms of number of investors, funds of hedge funds and public sector pension funds are two of the most important investors in hedge funds in Asia and Rest of World. However, it is likely that sovereign wealth funds allocate the greatest sums to hedge funds of all investor types in the region; they have large pools of capital and fewer restrictions on their investment portfolios.

Fig. 9: Breakdown of Hedge Fund Investors by Region



Source: Preqin

Fig. 10: Institutional Make-up of Hedge Fund Investors within Each Region



Source: Preqin

Investors to Watch

Investor	Type	Location	Plans for 2011
State of Wisconsin Investment Board	Public Pension Fund	US	As a new entrant into the asset class, State of Wisconsin Investment Board is expected to hire as many as 20 managers within the next few years as part of its new hedge fund allocation plan. The retirement board intends to build a portfolio of hedge funds worth \$3.8 billion over this period. Cliffwater will advise the board on its strategy, investment policy and recommendations for managers. It will invest on a global scale in a diverse range of hedge fund strategies, regions and managers. It wishes to invest directly in single hedge fund managers with potential allocations between \$90-110 million in each manager.
Centrum Bank	Bank	Liechtenstein	Centrum Bank, which invests just under CHF 400 million in seven hedge funds is expected to make further investments in hedge funds over 2011. Its investments over the year will be determined by changes in the regulatory framework of the asset class. It plans to decrease its focus on offshore funds of hedge funds managers and increase its holdings in UCITS funds and single manager funds if there are less restrictions and greater transparency in regards to tax.
Clariden Leu	Fund of Hedge Funds	Switzerland	Clariden Leu plans to make commitments to 10-15 new managers in the next 12 months. It will seek managers with some proven track record but which have not received support from Clariden Leu before. The firm will prefer to invest in managers that offer managed accounts. Managers that follow liquid strategies will be chosen for the mandate, which is expected to be between EUR 10-75 million.
SunAmerica Financial Group	Insurance Company	US	SunAmerica Financial Group plans to add as many as ten new hedge funds to its portfolio over 2011. It plans to continue expanding its current portfolio of long/short equity, event driven, multi-strategy and distressed credit managers on a global scale. SunAmerica has a preference for direct hedge fund managers and will not consider investing through funds of hedge funds. Its current portfolio is over 60 funds strong.
Akershus County Council Pension	Public Pension Fund	Norway	The EUR 1.3 billion pension fund has recently reduced its hedge fund allocation by redeeming from its funds of hedge funds investments and going forward will only invest in direct hedge fund managers. It now plans to increase its allocation from 1.6% to 3% by investing in two additional hedge fund managers. It will look for uncorrelated hedge fund strategies and will employ a global mandate. It has a preference for established managers.
ATP Lifelong Pension	Public Pension Fund	Denmark	The \$140 billion pension fund has revealed plans to invest up to 5% of its total AUM in hedge funds over the next 3 to 4 years, through its wholly owned subsidiary – ATP Alpha. As of Q1 2011, it intended to make its first investment into the asset class within the following months, allocating up to 1% of total assets in the next 12 months alone. The group will invest on a global scale, seeking managers that pursue a range of strategies including: long/short equity, macro, event driven, fixed income, foreign exchange, relative value arbitrage and opportunistic, to mention a few. ATP will not invest in emerging managers or spin-off teams, preferring instead to allocate to established managers with a proven track record and substantial assets under management. In addition, ATP will invest in lock-ups, determining the maximum period it will accept on a case by case basis. It intends to invest in funds with high standards of transparency and accountability.
Aberdeen Asset Management	Fund of Hedge Funds	UK	The £4 billion fund of hedge fund manager has announced plans to search for UCITS compliant managers. It will look for funds that offer both daily and fortnightly liquidity to add to a new UCITS multi-manager fund. When looking for new funds it typically looks for managers with assets under management of \$500 million and a three year track record. It will invest in lock-up periods of no longer than 12 months. Aberdeen will invest globally, including emerging markets.
KTOs Capital Partners	Fund of Hedge Funds	Japan	The Japan based funds of hedge funds manager has revealed plans to increase its total holdings of hedge funds to 13-14 vehicles over the next 12 month period. The group, which manages two funds of hedge funds and is invested in 12 underlying hedge funds through its funds, will make the investments dependent upon the amount of capital raised. It will be seeking managers globally, with a preference for long/short equity, CTA and emerging markets strategies. Typically, KTOs Capital Partners will accept lock-up periods up to a maximum of one year and when looking for new managers, does not impose any restrictions in terms of a track record or a minimum set amount of assets under management. KTOs will invest in emerging managers and spin-off teams in addition to seeding funds.
Peddie School	Endowment	US	The New Jersey based school's \$260 million endowment fund has revealed that it is still to allocate around \$10 million of its hedge fund budget. Peddie School has around 16% of its assets invested in hedge funds, and expects to reach its target allocation of 20% by the end of 2011. The school is looking in particular for long/short equity managers, and in the non-directional space is seeking market neutral multi-strategy managers. It is prepared to invest globally, including in emerging markets, but will not consider funds of hedge funds. Peddie School makes its hedge fund investment decisions on a case-by-case basis, and has not ruled out investing in emerging managers.
Nationwide Building Society Pension Fund	Private Sector Pension Fund	UK	Nationwide Building Society Pension Fund redeemed its investments in its sole fund of hedge funds investment at the end of 2010. It plans to not only redeploy this redeemed capital but to also increase its target exposure to 4% of AUM. The pension fund will then make 3-4 direct investments in long/short equity hedge fund managers.

Source: Preqin

Fundraising in an Institutional Universe

Moving from an investor base predominated by wealthy individuals and family offices to an institutionally focused industry has fundamentally changed the ways that fund managers approach fundraising and the industry in general.

Institutional Capital and Fund Size

81% of the total assets of the hedge funds that participated in Preqin's study resides in funds where institutional investors represent 50% or more of the capital in that fund. Institutional investors are therefore shaping the global hedge fund industry in terms of the distribution of capital between the largest and smallest funds. To look at the effect of fund size on the institutional client base of the surveyed managers, we compared their assets under management to the proportion of their assets coming from institutional investors (Fig. 11). Clearly the smaller funds raise less capital, proportionately, from institutional investors, with many institutional investors imposing minimum assets under management requirements on their potential managers.

Fig. 12 shows that the greatest hurdle in raising institutional capital, in the opinion of fund managers participating in the survey, is meeting institutional requirements in terms of a minimum level of assets under management. Using data taken from Preqin's database of 2,500 institutional investors in hedge funds, the mean AUM requirement of a hedge fund investor is around \$320 million. This is reflected in Fig. 11, with a large jump in the average proportion of institutional capital for funds in the \$250-499mn size group. However, some institutional investors are willing to invest in even the smallest funds. For example, Chrysler Master Trust, which allocates over \$2.4 billion to hedge funds, has no minimum assets under management requirements for its underlying fund managers; it will invest in small funds provided they have at least a three-year track

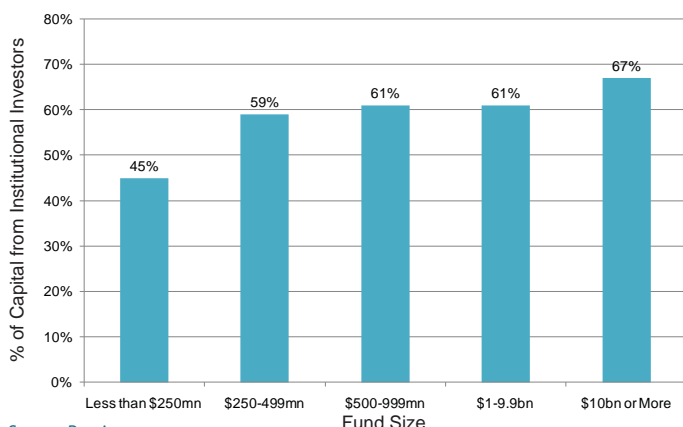
record. The largest hedge funds – those with more than \$10 billion in assets under management – have significantly more institutional clients than their smaller counterparts. These largest funds have the institutional-quality infrastructure in place to cater for this sector of the market and many institutional investors look to seek safety in numbers by allocating only to the largest hedge funds.

Changes and Challenges

Nearly half of respondents (46%) stated that having more institutional investors in their funds has resulted in the firm putting more risk management procedures in place (Fig. 13). Institutional investors have to take into account their responsibilities to meet funding needs, as well fulfilling regulatory procedures put in place by boards of trustees or wider legislature within their jurisdictions. Following fund failures and well-publicized fraud cases, investors have become more aware of the potential risks of investing in hedge funds and have become increasingly demanding of their fund managers to put extra protection in place.

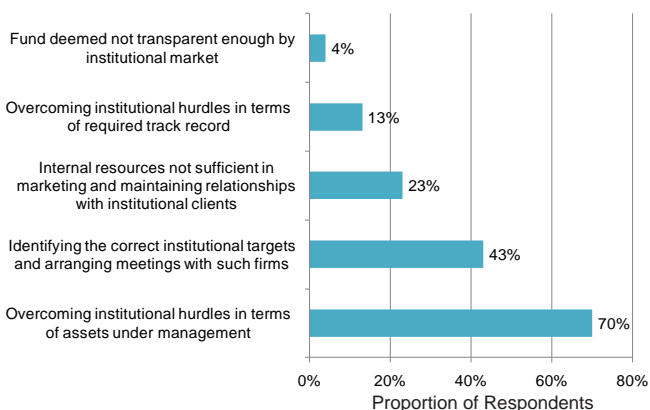
Just over 40% of respondents informed Preqin that an increasingly institutional base of clients has led to a reduction in the fees they charge on their funds. Fee pressure from institutional investors has been a much-publicized topic of discussion in the industry over the past two years, and recent Preqin research has revealed that investors are just now beginning to feel that the fees charged by hedge fund managers have reached a level which is mutually acceptable to both fund

Fig. 11: Percentage of Hedge Fund Managers' Total Capital That Comes from Institutional Investors



Source: Preqin

Fig. 12: Challenges Faced by Hedge Fund Managers in Raising Capital from Institutional Investors



Source: Preqin

manager and institutional client. Evidently managers have shown concessions on their side in terms of fees in order to attract institutional investors that can significantly increase the overall assets under management of their firms. 21% of surveyed fund managers have introduced alternatives to traditional commingled funds in order to attract and retain the institutional market. These include both UCITS (predominantly implemented by European fund managers) and managed account vehicles (predominantly utilized by fund managers looking to satisfy the needs of the largest investors in their funds).

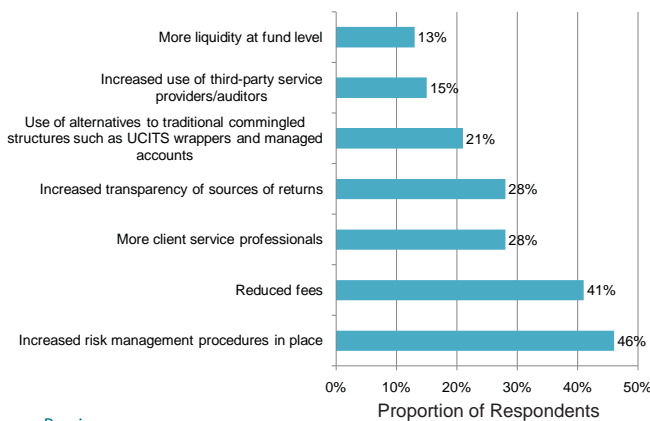
So how do fund managers source institutional investors for their funds? 78% of the fund managers interviewed by Preqin for this study market to institutional investors through their internal sales force, with teams of client service professionals dedicated to sourcing and forming relationships with institutional investors. However, with 43% of the respondents stating that one of the greatest challenges they have when marketing to institutional investors is sourcing and arranging meetings with institutions, many fund managers are turning to external

groups to assist in specifically marketing to the institutional arena. 35% of the managers interviewed by Preqin have formed relationships with institutional consultants to promote their funds to the wide audiences of institutional investors that such consultancy firms advise. Around 30% of fund managers enlist the help of third-party marketers and prime brokerage capital introduction services. A fifth of the fund managers which participated in this study utilize third-party database providers to market specifically to the institutional market. By using external databases to keep on top of institutional investor mandates in conjunction with internal or external marketing efforts, many fund managers are able to better understand the emerging trends and better source institutional investors.

Outlook for the Future

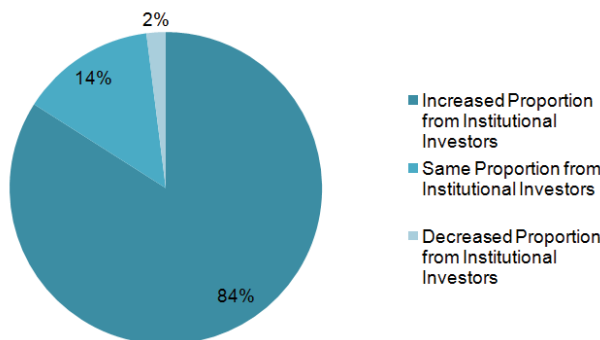
Hedge fund managers overwhelmingly predict that institutional investor capital will become more important to the industry over the next 12-18 months, with nearly 85% of all fund managers surveyed stating that they expect the proportion of their assets coming from institutional investors to increase over this time frame (Fig. 14). If institutional inflows live up to managers' expectations over the course of 2011/2012 then we will witness the greatest rate of institutional growth in the asset class to date. Nearly half of all participants in the Preqin study stated that they plan to specifically market to the institutional sector in 2011 and this ranked as the most often-cited plan for fund managers over the next 12 months (Fig. 15). 38% of respondents intend to launch new funds in the next year, which indicates that the industry is continuing to recover, and that fund managers are looking to capitalize on revived investor confidence and new opportunities to produce absolute returns. Further to this, 15% of participating firms plan to launch UCITS-structured hedge funds to take advantage of the burgeoning demand within the market. UCITS wrappers have traditionally catered for the retail market but institutional investors are increasingly tapping into the transparency and liquidity which are at the forefront of their demands from their hedge funds managers in this post-downturn era.

Fig. 13: Effect of an Increasingly Institutional Client Base on Hedge Fund Managers



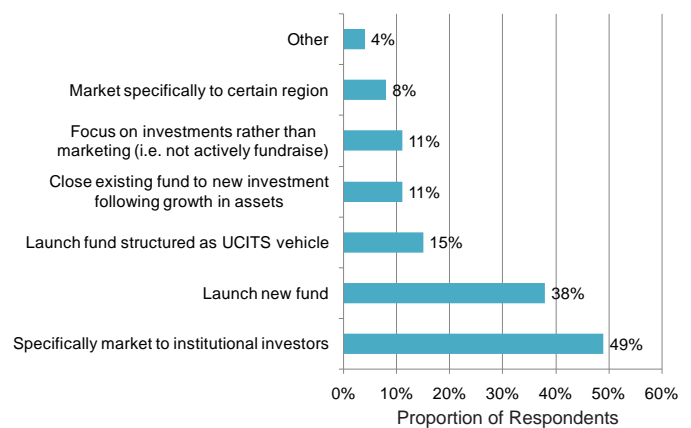
Source: Preqin

Fig. 14: Expected Changes in Source of Hedge Fund Managers' Capital over Next 12-18 Months



Source: Preqin

Fig. 15: Hedge Fund Managers' Plans for 2011



Source: Preqin

Emerging Managers After the Crisis

Emerging manager hedge funds can present a compelling investment for institutional investors that are looking to tap into new opportunities in the hedge fund arena. How have things changed after the market crisis?

Although investment in a fund with less of a proven track record can be seen as riskier than investment with established managers, first-time funds have the potential for stronger returns and access to new strategies. There is a belief that such managers are hungrier for returns than those in more established firms and more receptive to the needs and requirements of their investors.

Over the recent past, investors have increasingly been adding emerging managers to their hedge fund portfolios in order to gain access to the next generation of manager. However, the events of the past two years have begun to be felt by the newer fund managers, and it has become more difficult for emerging managers to pick up capital from the institutional market. An era of heightened caution brought on by hedge fund failures and high profile blow-ups has led to a decrease in the uptake of emerging managers by investors over the past 12 months.

As shown in Fig. 16, 54% of institutional investors on Preqin's hedge fund investor database have stated they will consider investing in first-time hedge funds. There has been a noticeable decline in the number of investors that allocate to these emerging managers from 2009, when 59% of institutional investors were investing in such funds.

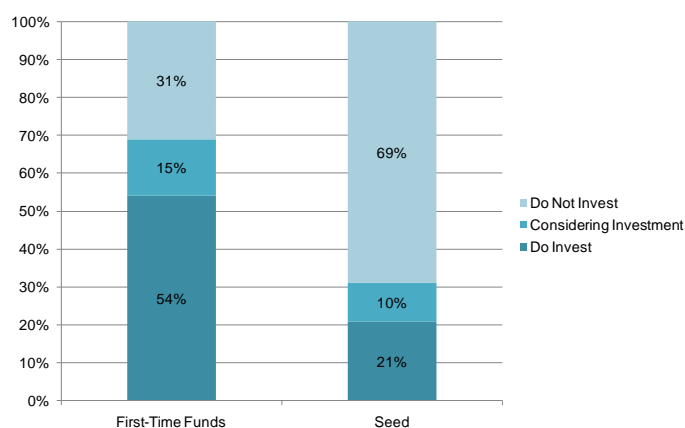
Although the current fundraising environment is more difficult for an emerging manager, the outlook for the future looks more positive – Fig. 16 shows that 15% of institutional investors are considering adding emerging manager funds to their holdings in the near future, which could see a resurgence in

the use of first-time funds back to pre-crisis levels. Since 2008 investors had mainly been shying away from seed deals as they waited for more stability to return to the asset class and the wider financial markets in general. In 2009, just 11% of investors would provide seed capital to a fund; today this has nearly doubled to 21% of the institutional market.

“...opportunities in the seeding market have rapidly grown in the past 12 months...”

Many investors feel that there are numerous opportunities in the current environment for investment of this kind, and the benefits of fund ownership, fee negotiations and early access to the next generation of hedge funds outweigh the potential risk of such an investment. Seed arrangements are also beginning to evolve in this post-crisis era, with many investors not just providing seed capital to the youngest funds but also awarding seed capital to the more established vehicles, with years of track record under their belt, but which may have either stalled in their fundraising and need a capital injection to reach institutional size, or have lost assets through the market crisis. Before the crisis, many fund managers were wary of entering seed arrangements that could see a loss of earnings through fee-sharing arrangements with the investor, but in a more difficult fundraising climate many more funds are now seeking these kinds of capital injections. As a result the opportunities in the seeding market have rapidly grown in the past 12 months.

Fig. 16: Investor Attitude Towards Emerging Managers



Source: Preqin

Investor Attitude Towards Emerging Managers

There is no doubt that the environment for newer and smaller funds has become more difficult since the market crisis, but knowing which investors to target can increase fundraising success.

Emerging manager investors are most commonly those that have large resources behind them or extensive experience within the hedge fund industry. Funds of hedge funds have the highest preference for first time funds; 72% of funds of hedge funds on the Preqin database reveal that they would invest in an emerging manager and 13% would consider this type of investment. Funds of hedge funds are undoubtedly at the forefront of hedge fund investing and are more willing to take the risks involved in investing with a much less established manager. KCPS, an Israel-based fund of hedge funds, has recently announced plans to invest with up to 10 emerging managers over the next 12 months. Endowments have changed very little in their attitude towards emerging manager funds in the past 12 months, which considering their long-term outlook on the asset class is unsurprising. 66% of endowments will invest in emerging manager funds (in 2009 this figure was 65%). As experienced investors, often with dedicated investment teams, they are able to select funds based on the fit of the strategy in their portfolio rather than the experience of the manager.

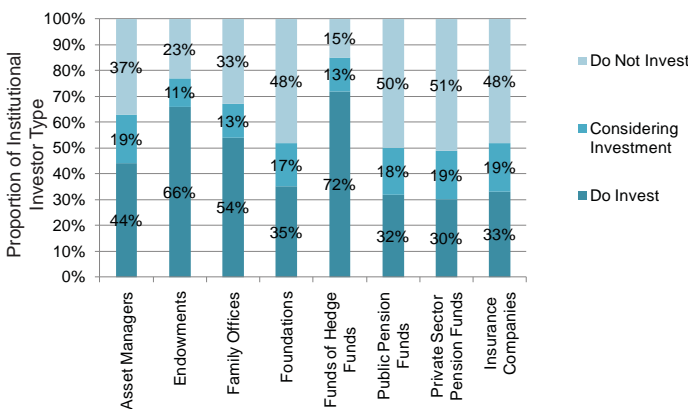
Family offices, one of the traditional backers of emerging managers and younger fund groups, remain one of the leading groups active in first-time funds going into 2011. For instance, Legacy Trust, a \$1.8 billion multi-family office, announced that it would look for 5-10 hedge fund managers over 2011 and would include emerging managers in its search. However, there has been a decline in the use of emerging managers over the past 12 months within this investor group – from 63% of family offices in 2009 to 54% today.

Pension funds and insurance companies – some of the largest groups of allocators to hedge funds in dollar terms – have decreased their use of emerging manager teams markedly over the past 12 months, cutting their exposure to these kinds of fund groups in favour of established “brand name” fund management teams. For instance, in 2009 44% of public pension funds invested in emerging manager funds. Today this figure is 32%. Despite these broad cuts across the group, some large public pension funds continue to actively invest in emerging manager hedge funds; for instance New York State Common Retirement Fund put its maiden emerging manager program in place in 2010.

Geographic Breakdown of Emerging Manager Investors

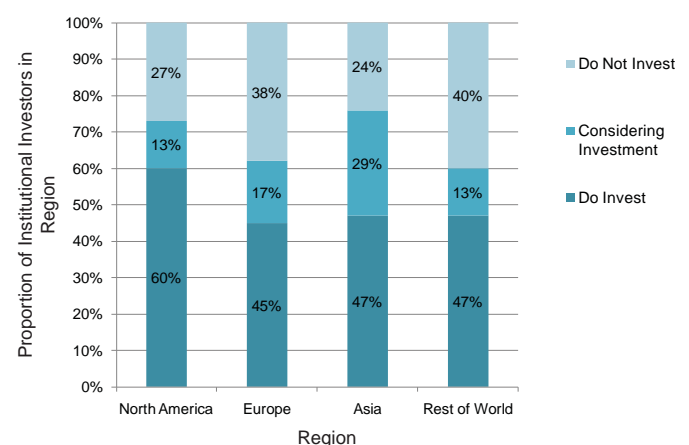
North America represents both the greatest number of emerging manager investors (57% of the total number) and the greatest proportional preference for such managers (60% of North American hedge fund investors will invest in emerging manager funds). Investors in this region are investing in significantly larger numbers than their counterparts from around the globe. The sheer number of opportunities within North America in terms of new fund launches, as well as being more experienced in hedge fund investment in general, enables institutions in this region to consider the emerging manager market more. Over a third of emerging manager investors are based in Europe. However, European investors are in general much more cautious when it comes to investment in emerging manager hedge funds and are proportionally investing the least in these types of fund managers. Although in comparison to North America investors

Fig. 17: Emerging Manager Appetite Split by Investor Type



Source: Preqin

Fig. 18: Emerging Manager Appetite Split by Investor Location



Source: Preqin

in Asia are investing less in emerging managers, this region offers many opportunities for the marketing of first-time funds in the next 12 months. The hedge fund industry is starting to develop within Asia and almost 30% of all investors in this region would actively consider adding an emerging manager fund to their portfolio over the course of 2011.

Barriers to Entry

The new era of caution in terms of emerging manager investment can be seen in changes to track record and assets under management requirements of the investors on Preqin's database of institutional investors. In 2009, more than 50% of institutional investors would consider investment in a fund with a track record of two years or less. However, this figure has now fallen to 38%, as investors set higher barriers to entry for their fund managers. A larger proportion of investors now look for a track record of around three to four years. Hedge funds that have been around for this length of time, since before the financial crisis, have demonstrated their abilities in a tough financial climate, which has made them more appealing to investors.

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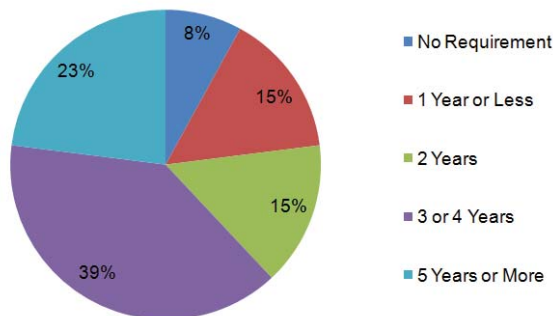
Over the course of 2010, in a trend contrary to the track record requirements, institutions have shifted to accept investment in smaller funds. In 2009, a quarter of all investors would only look at funds with at least \$500 million in assets under management, but this year the figure has fallen to 19%. Following the market crisis the industry contracted in size and most funds lost assets. Institutional investors have recognized that funds have become smaller and correspondingly have reduced their minimum track record requirement. Managers of smaller funds are now able to

attract the attention of institutional investors and as a result will be able to reach institutional size more quickly than in previous years.

What Emerging Managers Can Expect in 2011

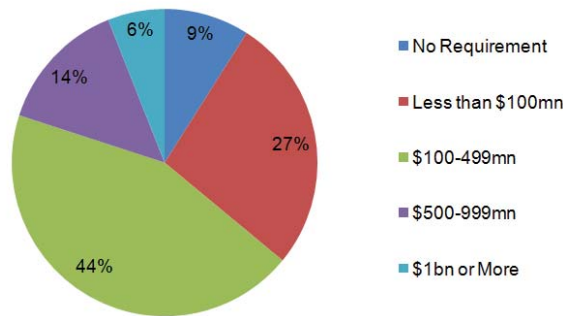
Over the course of 2010, many investors have shifted assets away from emerging fund teams towards the perceived safe haven of established and large hedge fund groups. However the prospects for 2011 and beyond look more promising. With many investors beginning to consider investment in emerging manager teams, particularly investors from emerging regions for hedge fund investment such as Asia, the first-time fund managers that market their funds to the right audience will be able to pick up institutional capital in 2011. Although investors are more wary of investment in funds in their very early stages, those fund managers that are able to build up a track record through investment of their own capital (or of a small fund) will be attractive to the institutional market. Many investors are now looking at smaller funds that have a demonstrable track record of greater alpha production and stronger returns, as well as those funds that can offer lower fees and new strategies. Investor confidence is continuing to grow and the benefits of investment in emerging manager teams may outweigh caution within the industry. As a result, in 2011 we can expect investors to once again start to look at smaller and emerging fund managers and for more capital to flow into the sector.

Fig. 19: Fund Manager Track Record Required by Institutional Investors



Source: Preqin

Fig. 20: Fund Managers Assets Under Management Required by Institutional Investors



Source: Preqin

Preqin: A Direct Approach to Investor Intelligence

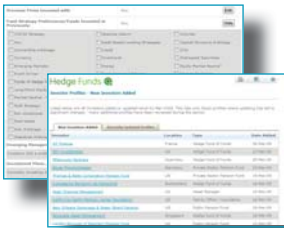
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