Welcome to the latest edition of Hedge Fund Spotlight, the monthly newsletter from Preqin providing insights into hedge fund performance, investors and fundraising. Hedge Fund Spotlight uses information from our online product Hedge Fund Online.

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Hedge Fund Spotlight

October 2010

Feature

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Regulars

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Know Your Investors: The Institutional Investor in 2010

Amy Bensted takes a look at the way in which the hedge fund investor universe has changed over the last seven years and considers the impact of the financial downturn on investors in the asset class.

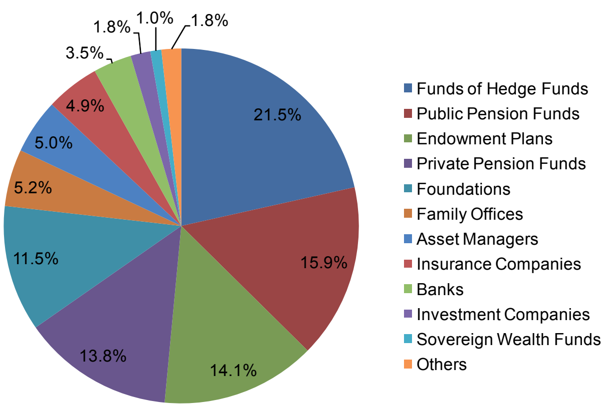
Preqin has been tracking institutional investor activity in alternative assets since 2003. The landscape of the institutional market has changed rapidly during this time. The effect of a changing financial climate in the wake of the credit crisis and global financial difficulties has had far reaching consequences in the hedge fund market. One of the most prominent changes in the hedge fund industry over the past 10 years has been the increasing institutionalization of the assets at work in these funds. Previously an asset class dominated by the high-net-worth individual, hedge funds have witnessed an influx of instititutional capital over recent years and today institutional capital represents the greatest proportion of assets at work in the industry. Institutional investors have become increasingly aware of the need to diversify their portfolios and the broad "asset class" that is hedge funds has become attractive to institutional investors, both before and after the market crisis, as a means to hedge out market risk, to tap into elusive alpha and to gain exposure to a diverse bundle of assets and investment opportunities.

Preqin's Hedge Fund Investor Profiles database tracks over 2,500 institutional investors in hedge funds. Institutional requirements from hedge fund portfolios have shifted during the ever-changing financial landscape of the past few years.

The effects of the financial crisis are still felt in the hedge fund industry. Assets have still not recovered to pre-crisis levels and investors are still approaching the asset class with some caution as well as being more demanding with regard to terms such as fees and lock-up periods. Fig. 1 shows the breakdown of the institutional investor universe as it stands in the final quarter of 2010. In this article we will discuss some of the major groups of institutional investors in terms of capital flows into hedge funds, what they look for from their hedge fund investments, and how they invest in the asset class.

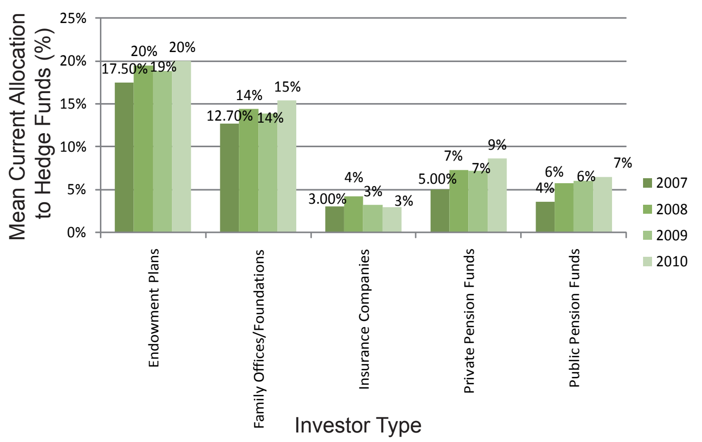
Funds of hedge funds still represent the largest groups of investors in hedge funds within the institutional landscape, with just over a fifth of all the investors which Preqin tracks coming from this sector. Funds of funds have suffered a difficult two years, and there have been many fund closures, consolidations and mergers of management groups. No fund of funds has emerged from the financial crisis unscathed. Even the largest fund management groups have suffered redemptions at the hands of their investors. The total number of funds of funds has remained relatively static over the past 12 months. However, despite fund closures in the past, and a more difficult fundraising climate at present, there are still new funds being launched and new management groups are setting up. Funds of 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 fund launches to cater for the new demand for this European regulated vehicle. Firms such as Gottex Asset Management, UBP, International Asset Management and Signet Capital Management have all launched or are on the verge of launching UCITS funds of funds over recent months. Funds of funds continue to be an important source of capital to emerging managers, and in the past 12 months we have witnessed funds

Fig. 1: Breakdown of Institutional Investor Universe by Type



Source: Preqin

Fig. 2: Mean Percentage Allocation to Hedge Funds by Investor Type, 2007 - 2010 YTD



Source: Preqin

> "no fund of funds has emerged from the financial crisis unscathed..."

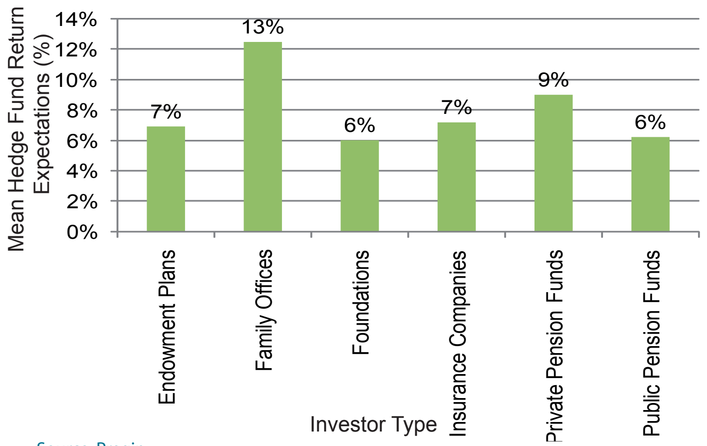
of funds and fund platforms awarding "seed" capital to more established funds which may have lost assets during the financial crisis and stalled in their endeavours to attract institutional investment. For many funds of funds, seed investments were put on hold during the financial crisis but over the course of 2010 there has been a noticable uptick in this activity and this is expected to continue into 2011.

Public pension funds represent just fewer than 16% of all institutional investors on the Preqin Hedge Fund Investor Profiles database. Public pension funds are an established group of investor within the institutional universe and their growing confidence in the ability of hedge funds to diversify their holdings and to provide absolute returns is reflected in the increased allocations to hedge funds year on year (Fig.2). As of Q3 2010 the average public pension fund invests 6.5% of its total assets in hedge funds with a mean target allocation of 7.9% of total assets (again an increase from 2009). Public pension funds have been relatively active in hedge funds over the course of 2010, with both existing investors in hedge funds increasing their exposure to the asset class and new entrants setting their first target allocations and making their first investments. For instance the UK-based West Midlands Pension Fund, which only began investing in hedge funds in 2009, has already built a portfolio of 10 hedge funds, which it could extend by as many as another five managers to run an additional £200 million. As they grow in experience in the asset class, public pension funds are continuing their shift into a direct style of investment. Investment still is predominated by the use of funds of funds, and newer retirement funds are still using these to gain their footing in a complicated asset class; however, use of a pure funds of funds portfolio is down slightly from 54% of all retirement systems to 53%. The public pension funds which are using both single and multi-manager funds are where the greatest shift to a direct style is occurring: last year these investors represented 32% of all public pension funds, today the figure stands at 29%. As a result the proportion of public pension funds which use just single manager vehicles has increased from 14% to 18% over the past year. Preqin's June research report indicated that this shift is likely to continue as public pension funds gain more experience in hedge fund investment.

Endowment plans form 14.1% of all investors on the Preqin database. As long-term, return-driven investors they have been fundamental in shaping the institutional universe through their innovative and extensive use of hedge funds. Direct investment in funds is the most common choice for endowments, with 41% of all endowments on our database choosing this as their preferred method of investment. A mixture of both direct investment and funds of funds is used by 32% of endowment investors, with the remaining 27% investing solely in funds of hedge funds. Like public pension funds, endowments have shifted further towards a direct style of investment over the course of 2010. This year saw a reversal in the trend for endowments to reduce their exposure to hedge funds that had occurred over the past few years, and the current mean allocation of endowments globally is 20% - higher than pre-crisis levels. However this is slightly above the mean target allocation to hedge funds of endowments, at 19% of total assets. Endowments have been investing in hedge funds for many years, and have the highest average allocation to the asset class of many of the groups of institutional investor on the Preqin database. Over the years of investment experience, endowments have built large and diversified portfolios of funds and have found their optimum level of exposure to the asset class (between 18-20% on the whole) and therefore are unlikely to shift significantly large new sums of capital into hedge funds. Endowments take the longest-term stance to hedge fund investment of all the institutional investor types, accepting lock-up periods on average of well over two years. However, following the market crisis they have been gradually looking at funds which are more liquid in nature and the longest lock-up accepted has been coming down on average since that time (Fig. 3).

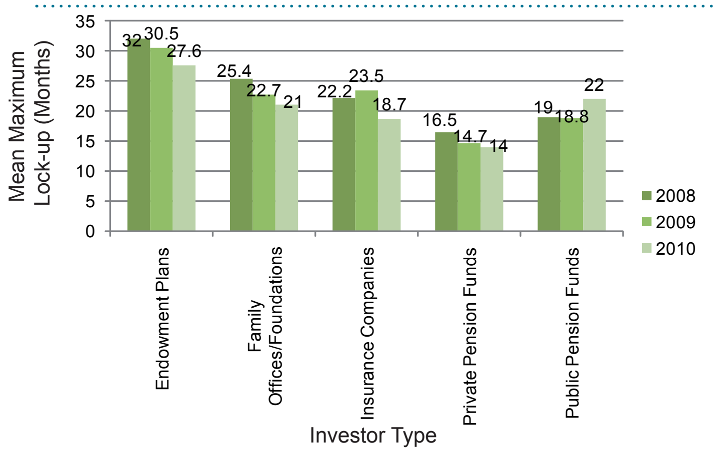
Private pension funds have been increasingly adding hedge funds to their portfolios over recent years and have been one of the fastest growing groups in importance to the hedge fund industry.

Fig. 3: Mean Institutional Hedge Fund Return Expectations by Investor Type



Source: Preqin

Fig. 4: Mean Maximum Lock-up Period Accepted by Investor Type, 2008-2010 YTD

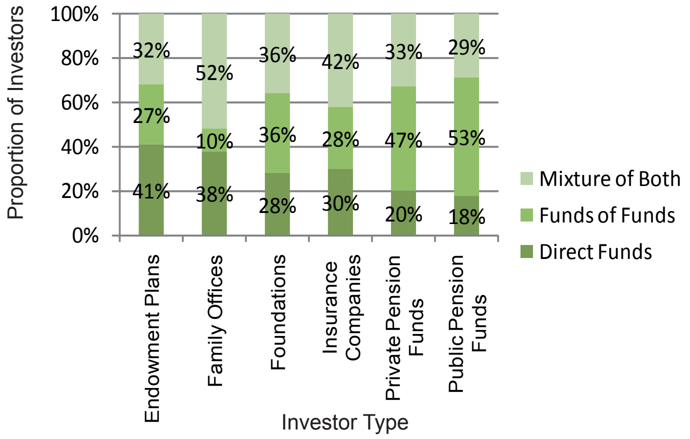


Source: Preqin

Their allocations to hedge funds have peaked this year, with each investing on average 8.6% in the asset class. 8.6% is also the mean target allocation of private sector pension funds and so growth of this group in terms of assets flowing into hedge funds is expected to slow somewhat. There has been some evidence of private pension funds losing their confidence in hedge funds in 2010, with a few incidences of portfolios being redeemed or in the process of being liquidated. For instance, the Zurich-based Pensionskasse der PriceWaterhouseCoopers announced it has redeemed all of its holdings in hedge funds as a result of performance concerns and issues with fees. As demonstrated in Fig. 3, private pension funds have become more stringent since the credit crisis in terms of their liquidity requirements and this year there is also evidence that they have become more demanding in terms of the returns they expect from their hedge fund portfolio (Fig. 4). They have also shifted towards a more direct style of investment over the course of 2010. At the end of 2009, 13% of all private pension funds invested solely in single manager vehicles. Today this figure stands at 20%.

For historical comparison purposes family offices and foundations have been grouped together in Fig. 2. Family offices currently invest an average of 19% of total assets in hedge funds, with a significantly higher target allocation to the asset class at 24.2%. Foundations have more modest investments in the asset class - currently at 14.9% rising to 15.4% as a result of their targeted exposure to the asset class. Family offices and foundations invest in a similar manner to endowments and often with the same long-term objectives in mind. However, the returns sought by family offices are in fact the highest of all institutional groups tracked by Preqin. Family office groups are often, like funds of funds and endowments, early backers of new managers or strategies, and use hedge funds to boost returns as well as for capital preservation and diversification. Unsurprisingly, direct investment in funds is the most common method of accessing the asset class, with 52% of all family offices using just direct investment in hedge funds and 38% using direct investment in funds with some tactical funds of funds holdings. As family offices are on average significantly below their target allocation to hedge funds, we can expect them to invest heavily in the asset class over the next 12 months. For instance, EXTOREL, traditionally a large backer of private equity funds, intends to move a large chunk of its assets towards hedge funds as it seeks to increase its currently modest portfolio of funds by up to 11 new investments over the next 12 months.

Fig. 5: Breakdown by Hedge Fund Investment Approach (Direct Funds, Funds of Funds or a Mixture of Both



Source: Preqin

Insurance companies form less than 5% of the investors on Preqin's Hedge Fund Investor Profiles database and currently invest an average of less than 3% of their assets in hedge funds. However, the significant size of some of insurance companies means that the assets they are directing towards hedge funds can be considerable. Insurance companies have been reducing their exposure to hedge funds over the past two years. However, with a mean target allocation of 4.3% of assets to be invested in hedge funds, there is the potential for insurance company capital to reach pre-financial crisis levels within the industry. There has been a marked shift towards insurance companies investing directly in hedge funds – from 17% in 2009 to 30% today. Last year many insurance companies were in a transition phase from a fund of funds portfolio, but many of these investors, which were exposed both to multi-and single-manager funds, are now moving their assets to be invested directly in hedge funds in greater numbers. For example, Delta Lloyd, the Dutch insurance company, which has been investing in hedge funds since 2000 through a combination of both funds of funds and direct investments, will now be shifting all of its allocation to direct investment following the ongoing liquidation of its funds of funds investments.

Outlook

The institutional investor is continuing to evolve into a more sophisticated yet demanding backer of hedge funds. As the institutional market has grown and developed over the past years, so has the hedge fund industry as it seeks to cater to this growing sector of the market. Institutional investors are continuing to move in greater numbers towards a direct style of investment, even though funds of funds are still widely used by many. Following the market crisis asset flows into hedge funds have been slower than in previous years as investors rebalanced their holdings following losses elsewhere in their portfolios and applied more caution in their investment decisions. However, we are seeing investors beginning to invest more capital in hedge funds as well as increasing their target allocations to the asset class. Using Preqin's database of over 2,500 institutional investors in hedge funds, we have estimated that there is around $96 billion in available institutional capital that has yet to be invested in the asset class. New capital inflows, plus new investors making their maiden commitments as well as the natural turnover of funds within fully allocated investors' portfolios could potentially mean that 2011 will see a return to pre-crisis levels of investment by the institutional market.

Download Data

Data Source:

Preqin Hedge Investor Profiles

Preqin's Hedge Investor Profiles has detailed information on over 2,500 institutional investors that have expressed an active interest in hedge funds. The database includes profiles for 214 institutional investors that are considering making their first investment in hedge funds over the next 12 months. In addition Preqin monitors over 200 consultants active in alternative assets advisory.For more information please visit:

www.preqin.com/hedge

Convertible Arbitrage

Suganniya Kanaganayagam takes a look at the investors pursuing opportunities to invest in convertible arbitrage hedge funds.

Fig. 1: Key Facts: Investors in Convertible Arbitrage Funds

% of institutional hedge fund investors that state convertible arbitrage as a preference	7%
Median AUM of a convertible arbitrage investor ($bn)	1.5
Average allocation to hedge funds of a convertible arbitrage investor	13.2%
Average returns sought from convertible arbitrage investments	8.2%
Average lock-up of a convertible arbitrage fund (months)	20.6
Most favoured investment approach (direct hedge funds, funds of hedge funds, funds, mixture of both)	Direct

Source: Preqin

According to Preqin's Hedge Fund Investor Profiles database, 177 institutional investors have an active appetite for convertible arbitrage strategies. In comparison to other strategies, convertible arbitrage funds performed strongly in 2009, despite the turbulence of the previous year.

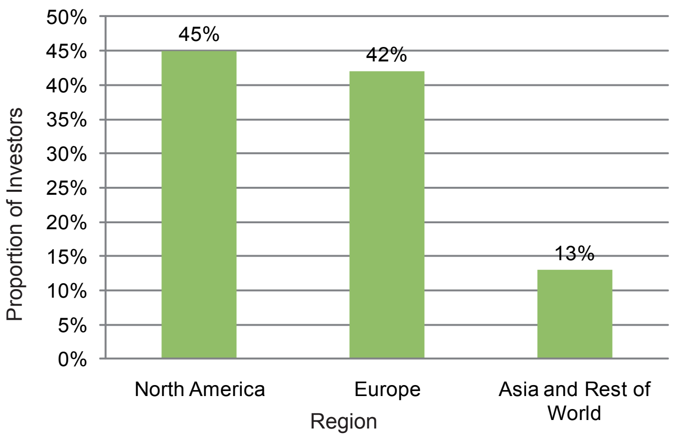
However, in 2010, there has been a decrease in the level of interest in this strategy from institutional investors. In 2009, 9.2% of the institutional investors on Preqin's database stated a preference for this strategy, but this has dropped to 7% today. Investors are currently wary of investment in illiquid assets, which has led to a decline in the popularity of longer-term strategies such as convertible arbitrage hedge funds. The typical size of an institutional investor with a preference for convertible arbitrage funds is $1.5 billion and the average allocation to hedge funds is 13.2%. Investors in convertible arbitrage funds seek returns of 8.2% from their investments on average.

Fig. 2 shows that 45% of hedge fund investors interest in convertible arbitrage funds are from North America and 42% are from Europe. Funds of hedge funds are by far the largest source of capital for this strategy, as demonstrated in Fig. 3, accounting for 64% of investors with an active interest in convertible arbitrage. Funds of hedge funds are more adaptable, highly diversified and well equipped to handle the illiquid nature of convertible arbitrage strategies, which typically have an average lock-up of 20.6 months.

Funds of hedge funds continue to actively seek new investment opportunities with convertible arbitrage managers. In September 2010, Amundi Alternative Investments, a European fund of hedge funds manager announced that it was looking for investments in a variety of strategies, including convertible arbitrage, as part of its plans to add 25 new managers across its portfolios over the next 12 months.

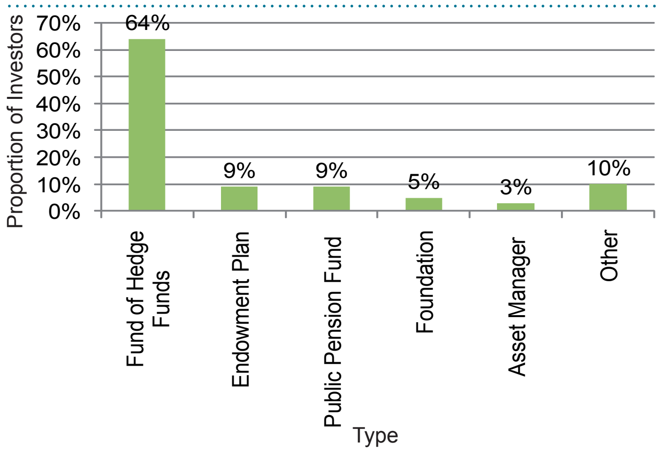
Download Data

Fig. 2: Breakdown of Institutional Investors Active in Convertible Arbitrage Funds by Region



Source: Preqin

Fig. 3: Breakdown of Institutional Investors Active in Convertible Arbitrage Funds by Type



Source: Preqin

US Endowments

Katy Johnson takes an in-depth look at the US endowments seeking to invest in hedge funds, considering their investment preferences and favoured investment approach.

Key Facts: US Endowments Investing in Hedge Funds

Average number of hedge funds in their portfolios	5
Most favoured investment approach (direct hedge funds, funds of hedge funds, both)	Direct
Average allocation to hedge funds (% of AUM)	20.5%
Typically been invested in hedge funds since	2001
Average Returns Sought	7%

Source: Preqin

Historically, endowments have been an important source of capital for hedge fund managers, and due to their early entry to the asset class they have become one of the most sophisticated institutional investor types. The majority of endowments are based in North America and are mainly academic institutions such as colleges and universities. The largest endowment in the US is run by Harvard University; it manages around USD 27 billion in total assets, 16% of which is allocated to hedge funds.

US endowments invest in hedge funds as a means of diversification as well as growth, but most importantly for the preservation of capital for future generations. On average, endowments invest around 20.5% of their total assets under management in hedge funds, which far exceeds other investor groups (please see feature article). Many US endowments allocate sums far greater than even this – for instance Mount Sinai School of Medicine Endowment currently has three-quarters of its assets under management at work in the asset class. Endowments invest with absolute returns as their framework, and pioneer investors such as Yale and Harvard have paved the way for other endowments to invest heavily in alternative assets.

The majority of US endowments prefer to invest in hedge funds through direct hedge fund vehicles; however a smaller proportion, 34.5%, holds investments in funds of hedge funds. Unlike many institutional investors, US endowments generally have the expertise and internal resources required to develop and maintain a hedge fund portfolio through direct investments. They can seek to tap into the best sources of alpha while avoiding the extra layer of fees associated with funds of funds. Long/short equity and macro are popular strategy types for US endowments, as well as CTA, multi-strategy, distressed and event driven.

Nearly 60% of US endowments have a preference for investment in North America (Fig. 4). There are many benefits of investing domestically: the close proximity to their managers makes due diligence easier, and there is greater choice of funds. Over half of all US endowments will invest globally; their experience in hedge fund investing has made them more confident to search for managers outside their domestic reach, which enables them to find the best opportunities from across the globe. Over a fifth of US endowments on the Preqin database have a specific interest in Asia and Rest of World hedge funds.

Endowments based in the US will continue to be a relevant source of capital for all types of hedge fund manager. With high allocations to the asset class, endowments make many new investments in hedge funds each year in order to complement their existing portfolios. For example the $3.2 billion California Endowment has plans to increase its allocation to hedge funds in the next 12 months, and the $432 million Davidson College Endowment will be seeking an additional three hedge fund managers.

Download Data

Data Source:

Preqin Hedge Investor Profiles

Data for the US Endowments and Convertible Arbitrage pieces was taken from Preqin's Hedge Investor Profiles service.

For more information or to arrange a demo please visit:

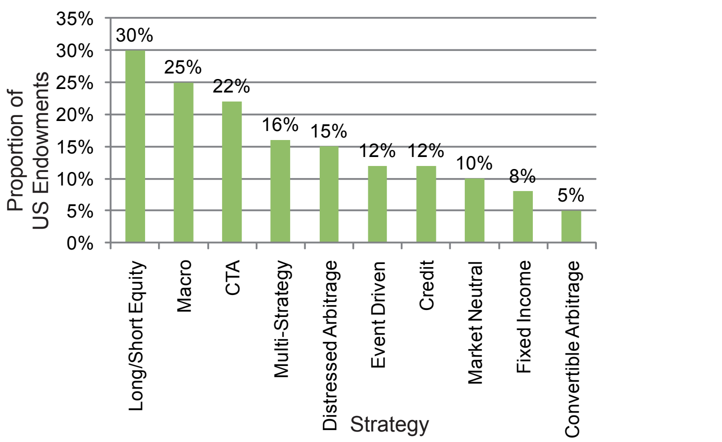
www.preqin.com/hedge

Fig. 2: Top 10 US Endowment Fund Investors

Fund Manger	No. of Investments in Last 12 Months
Harvard Management Company	4,384
DUMAC	4,168
Princeton University Investment Company (Princo)	3,500
Yale University Endowment	3,173
University of Texas Investment Management Company	2,976
Stanford Management Company	2,175
Columbia University Endowment	2,166
Atlantic Philanthropies Endowment	1,836
University of Chicago Endowment	1,455
University of Pennsylvania Endowment	1,450

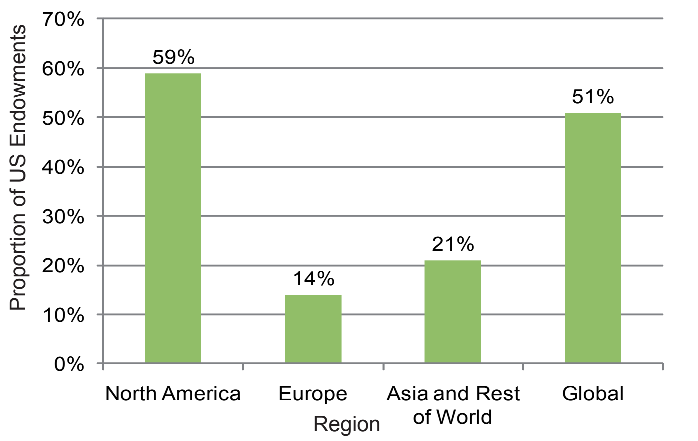
Source: Preqin

Fig. 3: Strategic Preferences of US Endowments Active in Hedge Funds



Source: Preqin

Fig. 4: Regional Preferences of US Endowments Active in Hedge Funds



Source: Preqin

Conferences Spotlight: Forthcoming Events

Conference	Dates	Location	Organizer
Shorex Wealth Management Forum Geneva	19 - 20 October 2010	Geneva	Shorex
Due Diligence for Fund of Funds & Hedge Funds	20 October 2010	London	IBC
GAIM Ops Europe	26 - 28 October 2010	Dublin	IIR
Hedge Funds World Africa 2010	1 - 4 November 2010	Cape Town	Terrapinn
AIS 2010 Abu Dhabi Showcase of Alternative Investment Funds	3 - 4 November 2010	Abu Dhabi	Leoron Events
High Frequency Trading World Europe 2010	8 - 10 November 2010	London	Terrapinn
Hedge 2010	9 - 11 November 2010	London	Terrapinn
Hedge Fund Regulation 2010	22 November 2010	London	InvestoRegulation
AIFM Directive	30 November - 1 December 2010	London	Infoline
Alternative Investing Summit	5 - 7 December 2010	Dana Point, CA	Opal Financial Group
Hedge Funds World Australia 2010	7 - 8 December 2010	Sydney	Terrapinn

High Frequency Trading World Europe 2010

Date: 8th - 10th November
Location: Hilton Canary Wharf, London, UK
Organiser: Terrapinn

High Frequency Trading World brings together the leading HFT firms and thought leaders within the market. Through thought provoking presentations and debates, best practices and insights into the solutions to the market's current challenges will be found and shared.

Information:
http://www.terrapinn.com/2010/hfteurope/

Terrapinn Hedge 2010

Date: 8 – 11 November 2010
Location: Hilton Canary Wharf, London
Organiser: Terrapinn

Hedge 2010 will give you unrivalled insights into the future of HF investing. Whether you are an investor, hedge fund manager or service provider, this conference will provide you with the rare opportunity to meet and network with the top names from across the investment spectrum and develop your own knowledge and investment strategy

Information:
www.terrapinn.com/2010/hedge

Alternative Investment Strategies - AIS 2010

Date: 10th - 11th November
Location: ADNEC Abu Dhabi
Organiser: Leoron events

AIS is the largest funds showcase in the Middle East. AIS is a place for fund managers to launch and present their strategies and funds, for investors to do fund selection, a platform for capital introductions and a marketplace for service providers to present their products and services to the industry.

Information:
http://leoron.net/event/ais_2010_abu_dhabi

Hedge Funds World Zurich

Date: 7 - 9 December 2010
Location: Dolder Grand, Zurich, Switzerland
Organiser: Terrapinn

Join Switzerland's longest established annual gathering for Family Offices, Pension Funds and Private Banks; Learn how increasing regulation and sovereign debt risk will affect your investment allocation; Examine new trends in investment products such as UCITS and Managed Accounts

Information:
www.terrapinn.com/2010/zurich

Institutional Investor News

Reichmuth & Co. liquidates flagship fund of hedge funds in order to launch two new liquidity-orientated vehicles.

The USD 486 million Swiss fund of hedge funds manager has announced that the ongoing liquidation of its 1997 Reichmuth Matterhorn fund of hedge funds vehicle is nearing completion. The move to wind up its long-standing flagship fund was decided as it wished to offer its clients a greater degree of control over the liquidity in their hedge fund investment choices. As a result it has launched two new successor funds – Reichmuth Matterhorn 24 and Reichmuth Matterhorn 3. The two new funds are effectively a division of the strategies employed by the Matterhorn vehicle into ‘long’ and ‘short’ variants. While Reichmuth Matterhorn 24 favours a longer strategic outlook with a lock-up period of 24 months, Reichmuth Matterhorn 3 focuses on shorter opportunities and operates a three-month lock-up period.

UBI Pramerica SGR prepares to set up its first ever UCITS-compliant fund of hedge funds vehicle.

The EUR 300 million fund of hedge funds manager has revealed plans to launch a new UCITS-compliant fund of funds in the early part of 2011. It plans to make its first investments through that fund in Q1 2011 and hopes to add approximately 10-12 managers to the portfolio over the following 12-month period. UBI will target managers globally, with a preference for long/short equity, event driven, macro and credit strategies. When seeking new managers, the group requires evidence of a two-year track record, in addition to a minimum of EUR 100 million in assets under management.

Goodhart Partners en route to adding South American hedge fund managers to its portfolio.

The USD 900 million funds of hedge funds manager has revealed that it expects to invest in at least one South American-based hedge fund manager within the next 6-12 months. The London-based fund of hedge funds manager intends to make further commitments to new managers, but will also allocate additional capital to existing ones. Typically, it invests approximately USD 10-15 million per hedge fund and will accept lock-up periods of no more than 12 months. It invests in emerging managers and spin-off teams and it began investing in hedge funds in 2006.

Merkur Versicherung considers adding a fund of hedge funds to its portfolio.

The EUR 1 billion insurance company is considering adding a fund of hedge funds manager to its hedge fund portfolio. Its current portfolio consists of three direct hedge fund managers, all based in Austria. If it goes ahead with the move it will start looking for a multi-manager fund in 2011 and will employ a global mandate. It will consider UCITS III-compliant managers as well as managed accounts.

Lancashire County Pension Fund considers direct hedge fund investment and increase of allocation to portfolio.

The GBP 3.9 billion public pension fund has begun an internal review of its current 1.8% allocation to hedge fund investments. For three years the pension has accessed the asset class on a global basis through its sole fund of hedge funds manager, Gottex Fund Management. However, it is now considering a reallocation of assets to direct investment with a series of single hedge fund managers. The proposed shift to direct investment will likely take place over the coming 12 months, and at this time the pension will also review the possibility of increasing its overall allocation to the asset class.

Florida State Board of Administration looks for direct hedge fund managers.

The USD 118 billion public pension fund made its first commitment to hedge funds this year, when it allocated to four activist hedge fund managers. In Q2 2010 it announced that due to a revised investment policy it was able to invest more money in hedge funds. It is now in the process of looking for managers to add to its portfolio and plans to invest as much as USD 3 billion in the next 2-3 years. It will look for around 20 direct hedge fund managers and will consider a diversity of strategies. It is using the help of its investment consultant, Cambridge Associates, for the move.

Davidson College Endowment seeking three new managers over the next 12 months.

The USD 432 million endowment has revealed that it expects to invest in three new hedge fund managers over the course of the next 12 months. It currently has commitments to 14 funds, and has allocated 37% of its assets under management to the asset class. The new investments will be with managers following credit or long/short equity strategies, continuing the endowment’s existing preference for these strategies. Davidson College Endowment is looking for managers that have at least USD 100 million in assets under management and a proven track record. The new commitments are not expected to have a significant effect on the endowment’s current hedge fund allocation.

Data Source:

Preqin Hedge Investor Profiles

Each month Spotlight provides a selection of the recent news on institutional investors in hedge funds

For more information please visit

www.preqin.com/hedge