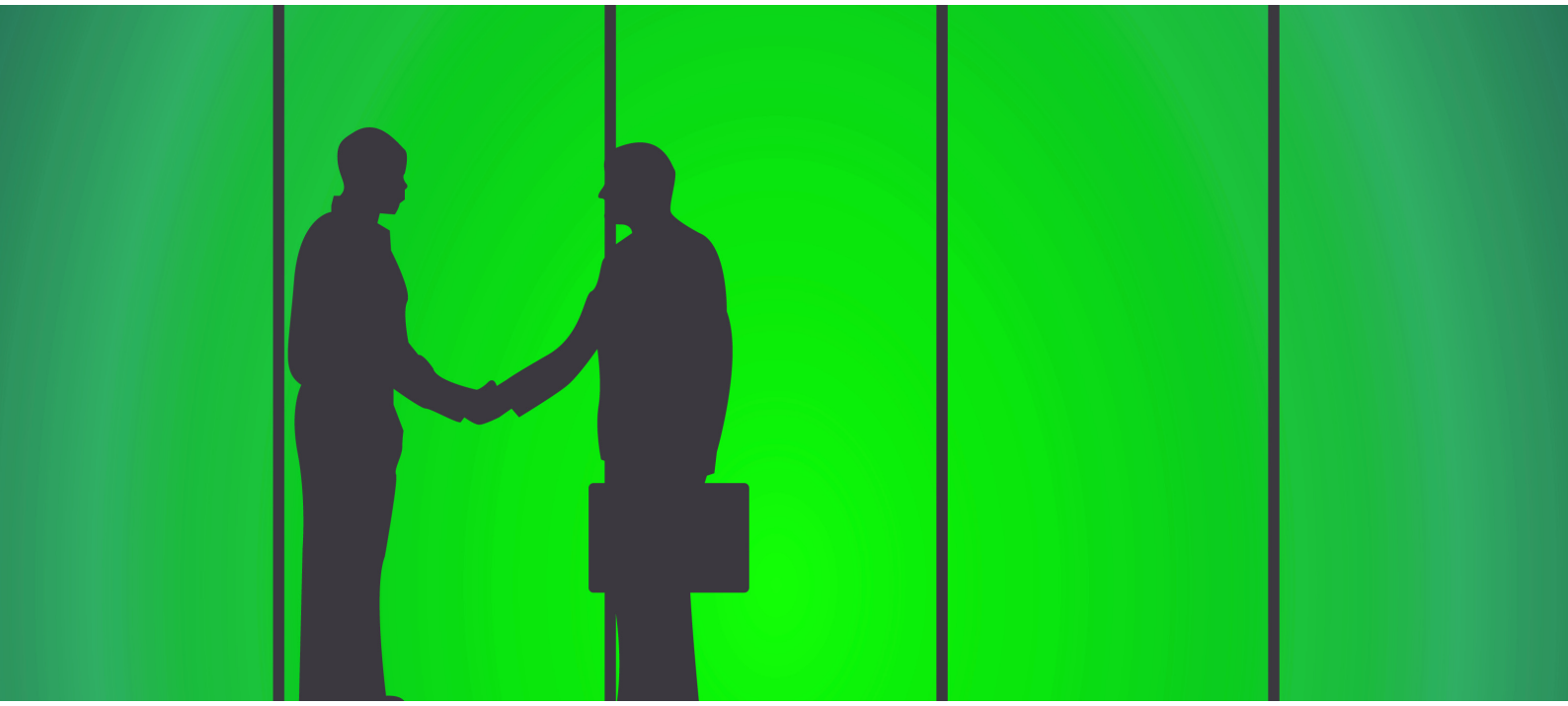
Does "2 and 20" Still Exist?

Results of Preqin's Hedge Fund Terms & Conditions Survey – Fees Special Report

July 2009



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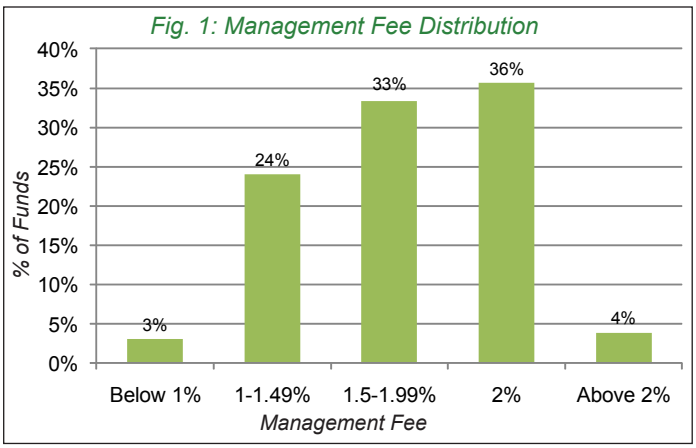
Over the course of April to June 2009, Preqin, the industry-leading provider of information on institutional investors in hedge funds through its Hedge Investor Profiles service, conducted a survey of hedge fund managers in order to present a snapshot of the industry's terms and conditions as they currently stand. Preqin's survey was designed to assess how the current economic downturn had affected the terms of investment laid down by managers, and whether it had affected the composition of investors in the asset class. We surveyed both single manager fund managers and fund of funds managers across a wide variety of strategies and global regions. The following research report contains a brief summary of our findings specifically regarding fees.

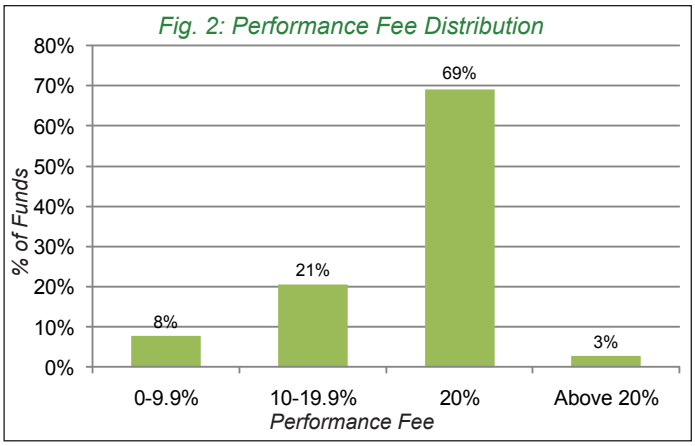
Management Fees

As illustrated by Fig. 1, more than two-thirds of funds have management fees of 1.5% to 2% inclusive, and 93% fall between 1% and 2% inclusive. Very few funds differ significantly from this norm. The mean management fee for the funds that we surveyed was 1.63%, which is significantly lower than what has traditionally been considered the industry standard of 2%. A single fund reported having no management fees at all, relying solely on a performance fee. At the other extreme, one specialised CTA fund had a management fee of 7.5%, which in turn was balanced out by a very low performance fee.

Performance Fees

As Fig. 2 shows, nearly 7 in 10 hedge funds still maintain a performance fee of 20%, which demonstrates that many investors are still willing to reward top performance. However, an increasing minority have lower fees of between 10% and 20%. In fact, 12% of surveyed funds have a 10% performance fee, significantly lower than the traditional 20% fee. At the top end of the range, a CTA fund had a performance fee of 33%, while several specially-structured fund of hedge funds had no performance fee at all. The mean performance fee we found was 17.21%.





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Breakdown by Strategy

As mentioned in the previous section, one CTA fund we surveyed has a 7.5% management fee, and as Fig. 3 shows, this is not an isolated occurrence, with CTAs having the highest average management fees of any fund type surveyed. Longer-term strategies, such as special situations and distressed securities, command some of the highest fees, while fund of hedge funds unsurprisingly demand much lower fees. More traditional hedge fund strategies, such as long/short equity and market neutral, also charge lower fees, likely reflecting the high levels of competition within these strategies.

There is some correlation between the strategy breakdowns for performance fees and management fees in Fig 3. Event driven, CTA, distressed securities and special situations funds are all again high up the fee scale, while fund of hedge funds and multi-strategy funds again charge quite low fees. Most other strategies have moderate fee levels.

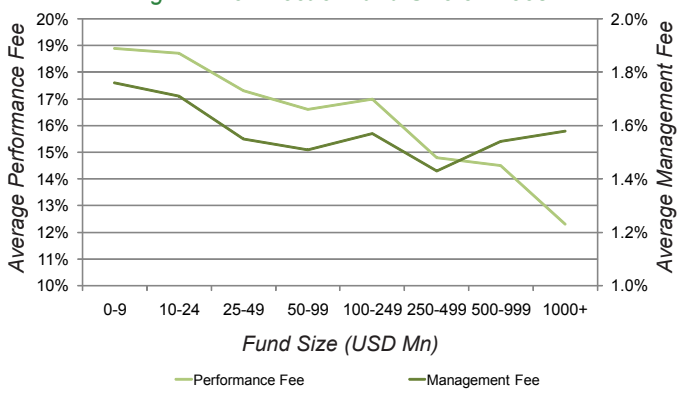
Fig. 3: Average Fees by Investment Strategy

Strategy	Management Fee	Performance Fee
CTA	2.17%	18.90%
Event Driven	1.71%	20.00%
Special Situations	1.71%	20.00%
Distressed Securities	1.70%	19.30%
Credit	1.69%	18.10%
Relative Value	1.67%	16.70%
Macro	1.67%	16.30%
Other	1.63%	18.20%
Multi-Strategy	1.55%	16.60%
Market Neutral	1.53%	18.90%
L/S Equity	1.53%	18.60%
Fixed Income Arbitrage	1.44%	18.30%
FOHFs	1.26%	10.60%

Breakdown by Fund Size

There is a clear correlation between the size of a fund and fees charged, as shown in Fig. 4. Both management and performance fees trend downwards as fund size increases. Performance fees in particular show a sharp drop as fund size increases. To some extent, this reflects the fact that many of the larger funds are fund of hedge funds, which levy much lower performance fees. The exception to this downward trend is in the highest fund size brackets, where management fees actually rise again. This is indicative of the higher demand that the largest funds can generate, due to both the security they offer through sheer scale and the returns they often deliver that helped make them so in demand in the first place. Many investors are therefore willing to pay higher management fees to access these funds. At the other end of the scale, small funds tend to invest in niche strategies that are often more volatile, but

Fig. 4: The Effect of Fund Size on Fees



with the potential for higher returns, and they charge higher fees to reflect this expected higher performance.

Manager Location & Fees

Fig. 5 shows that there are significant differences between managers based in different regions. Perhaps due to greater competition, or the greater maturity of its hedge fund market, North American managers have markedly lower fees for investors than their European counterparts. The emerging hedge fund markets in Asia have lower fees than both, likely in order to attract previously sceptical investors to the region.

Summary & Conclusions

It is clear that the idea of the '2 and 20' structure as the industry standard is becoming outdated. Our analysis in fact suggests a '1.63 and 17.21' formula – although less succinct – would be more accurate. Fees which for years have conformed to the industry standard of '2 and 20' are now being driven down as investors become more powerful in the manager/client relationship. US pension funds such as CalPERS and Utah Retirement System have been vocal in their belief that the hedge fund compensation structure needs to evolve and managers, in response to these demands and those of other institutional investors, are changing their fee structures. The troubles the industry faced last year have resulted in a significantly smaller universe of hedge funds, and those funds which are flexible in the terms they can offer their investors are the ones which are picking up the new investment now assets are flowing back into hedge funds. Less liquid strategies that demand longer timeframes to come to fruition, but promise greater returns, such as distressed securities and special situations, still largely command '2 and 20' fees, but they are the exception now, rather than the rule.

Fig. 5: The Effect of Manager Location on Average Fees

	Management Fee	Performance Fee
North America	1.54%	16.33%
Europe	1.72%	17.94%
Asia	1.55%	15.88%
RoW	1.67%	19.25%

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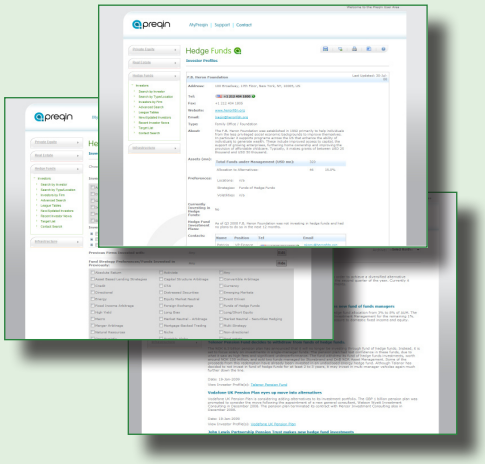

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