

Preqin Investor Outlook: Hedge Funds, H2 2013



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Foreword

There are three key pressures on fund managers in this challenging fundraising environment: to generate strong risk-adjusted performance, to show flexibility to respond to investor demands for alignment of interests, especially fees, and to comply in this new era of regulation.

Positively, investor sentiment towards hedge fund performance has shown a marked improvement over the past 12 months; the majority of investors feel that hedge fund investments have met expectations over the previous year, with the proportion of investors stating hedge funds had fallen short of expectations (26%) dropping to its lowest level since Preqin began conducting this study in 2008. Although a return to good performance is important for restoring confidence in the industry as a whole, investors recognize there are other more important factors to consider when looking individually at hedge funds, with the strategy of the fund and the managers experience topping investors list of key attributes to assess when looking at a hedge fund.

Coupled with an improved outlook on performance, investors have also seen management and performance fees reaching a

more acceptable level over the past 12 months. However, fund managers should not rest on their laurels; there is more work to be done in aligning interests in terms of fees, and greater transparency at a fund level is also an area where further improvements seem necessary.

Regulation is a cause for much uncertainty in the industry, with the full impact of the latest wave of regulations yet to be felt. Many investors are unsure how it will affect the hedge fund industry as a whole and their allocations individually, with 22% of investors believing regulation to be negative and 43% unsure of its impact. It may be many months or even years before the full influence of regulation on the industry becomes clear. However, what is certain is both fund managers and investors alike will be paying particular attention to how these regulations are affecting their businesses and investments in the asset class.

Preqin conducted interviews with institutional investors in hedge funds in July 2013 to uncover their outlook on performance, alignment of interests, regulations and more. Here we present the findings of our investigation into a number of key topics that affect investors in hedge funds and the industry as a whole.

Key Facts

88% of hedge fund investors plan to commit the same amount or more capital to hedge funds over the next 12 months.

45% of current investor searches include a long/short equity component, making it the most sought after strategy currently.

77% of investors stated that there has been no change in their confidence in hedge funds to meet portfolio objectives in the last year.

64% of investors either agreed or strongly agreed that manager and investor interests are properly aligned, compared to 74% in 2012.

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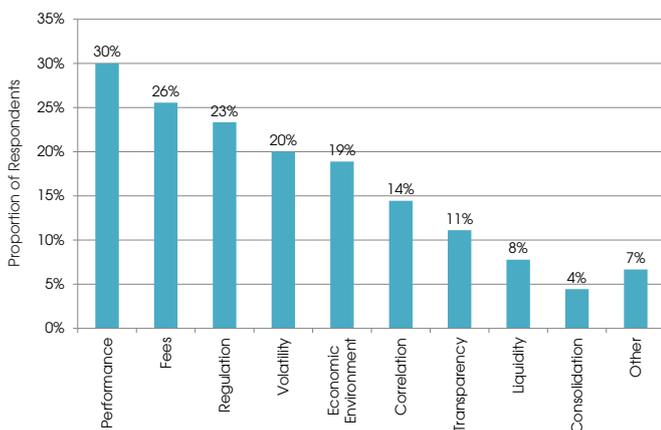
Key Issues and Regulation

Preqin's interviews with leading institutional investors in hedge funds reveal that performance is still a key issue for many investors in the asset class, along with fees and the potential impact of regulation, such as the Alternative Investment Fund Managers Directive (AIFMD).

Institutional investors interviewed by Preqin were asked what they feel the key issues are in the hedge fund industry, with the results presented in Fig. 3.1. Performance was the most commonly named issue, with 30% of investors interviewed stating returns to be a key issue for the hedge fund industry at present. This demonstrates that a number of investors remain concerned about hedge fund performance, although the proportion of investors stating this as a key issue has decreased from 47% in December 2012, suggesting that hedge funds have performed well enough to convince some investors in the early stages of 2013. There is a sense that investors are looking for more consistency in hedge fund returns however, with the proportion of investors interviewed citing volatility as a key issue increasing from 9% to 20% between December 2012 and July 2013. Investors are looking for hedge funds to produce consistent positive returns in all market environments and some may be willing to accept lower returns in return for reduced volatility.

There was also a noticeable increase in the number of investors stating correlation, separating alpha from beta, as a key issue, with a 12 percentage point increase from 2% in December 2012 to 14% in July 2013. Fees and regulation remain important issues to hedge fund investors, with these issues stated by 26% and 23% of respondents respectively. The proportion of investors stating transparency as a key issue has dropped by twelve percentage points since the end of 2012, from 23% in December 2012 to 11% in July 2013, indicating that investors have become more satisfied with the information being provided by hedge fund managers.

Fig. 3.1: Key Issues Facing the Hedge Fund Industry According to Institutional Investors



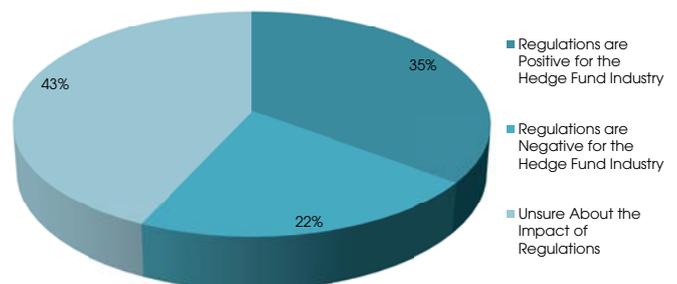
Source: Preqin Investor Interviews, July 2013

Impact of Regulations on Hedge Fund Investors

Regulation has been a topic of increased discussion in the hedge fund industry in recent years as a result of proposed regulations such as the Alternative Investment Fund Managers Directive (AIFMD). Preqin's interviews with hedge fund investors in July 2013 indicated that the vast majority (94%) have yet to notice any direct effect on their hedge fund allocations as a result of recent regulations, although a number of investors indicated concerns over how regulations would affect the industry in the future. In terms of the overall effect on the hedge fund universe, 35% of investors feel regulations are positive for the hedge fund industry, with 22% stating that they believe regulations will have a negative impact. The remaining 43% of investors are unsure about the impact of proposed regulations, suggesting that they are waiting to see how they are implemented in full before forming a definitive view. This is a significant increase compared to the 18% of investors interviewed in December 2012 which stated the same, suggesting that investors have become unsure about the benefits of proposed regulations during the first half of 2013.

Having a consistent regulated standard for hedge funds, along with more transparent reporting, could help institutional investors in assessing managers. One of the main concerns regarding regulation centres on a lack of clarity and there is a fear that this could lead to a tougher environment with more complications and ultimately less choice for investors as managers struggle to comply. Institutional investors will be watching closely to see the effect of proposed regulations and it may be 2014 before it is possible to tell if the new proposals will have any direct effect on investors' hedge fund allocations.

Fig. 3.2: Investor Outlook on Hedge Fund Industry Regulations Launched in 2011 - 2013



Source: Preqin Investor Interviews, July 2013

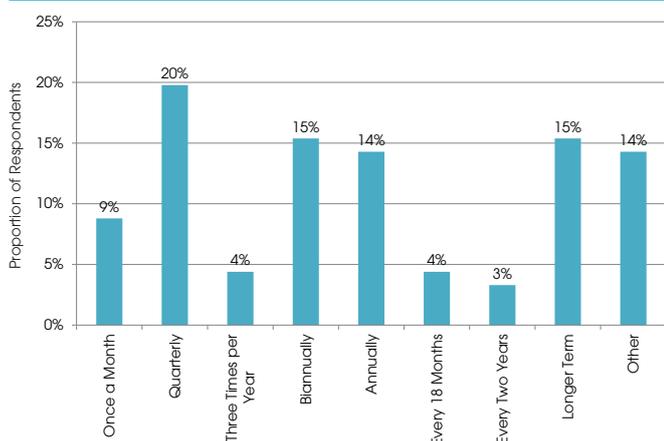
Fund Searches Overview

In general, hedge fund investors are mainly positive about the asset class, with the majority planning to at least maintain their current allocations to hedge funds going forward, and a significant proportion looking to increase their exposure.

Institutional investors regularly review their hedge fund portfolios in order to take advantage of the best opportunities and tap into new sources of returns. In July Preqin interviewed hedge fund investors to ask about their outlook for the asset class and whether or not they expect to make further allocations over the coming 12 months. Of those investors interviewed, 59% said they plan to invest the same amount of capital in hedge funds over the next 12 months as they have in the previous 12 months, with 29% planning to invest more and 12% planning to invest less. In terms of hedge fund allocations in the longer term, the majority again plan to maintain current hedge fund exposure (59%), with 23% expecting to increase their allocations and 18% expecting to decrease their allocations (Fig. 3.3). This shows that the outlook among hedge fund investors is mainly positive as the majority of investors plan to at least maintain their current level of exposure going forward, with the net movement towards an increase in allocations. Investors regularly make new additions to their hedge fund portfolios, with the majority of investors interviewed (62%) making new hedge fund investments at least once a year (Fig. 3.4). Twenty-nine percent of investors make hedge fund additions every quarter; as a result, there are regular opportunities for hedge fund managers to obtain capital from the institutional universe.

Long/short equity continues to be the most sought after strategy among institutional hedge fund investors, with 45% of current investor searches including a long/short equity component (Fig. 3.5). Long/short equity funds have enjoyed mostly positive performance over the past 12 months and investors are attracted to these funds due to the diversification they can provide. Macro funds are being targeted by 28% of investors searching for new funds, despite recent disappointing performance, with event driven funds appearing in 17% of current mandates. It seems that despite event

Fig. 3.4: Frequency of New Hedge Fund Investments Made by Institutional Investors



Source: Preqin Investor Interviews, July 2013

driven being the best performing strategy over the past 12 months, many investors remain reluctant to take on the illiquidity of these investments as part of their hedge fund allocations.

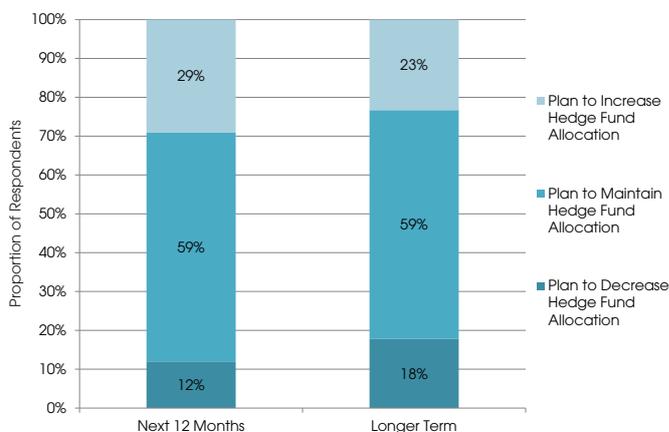
Looking to source new investors for your hedge fund?

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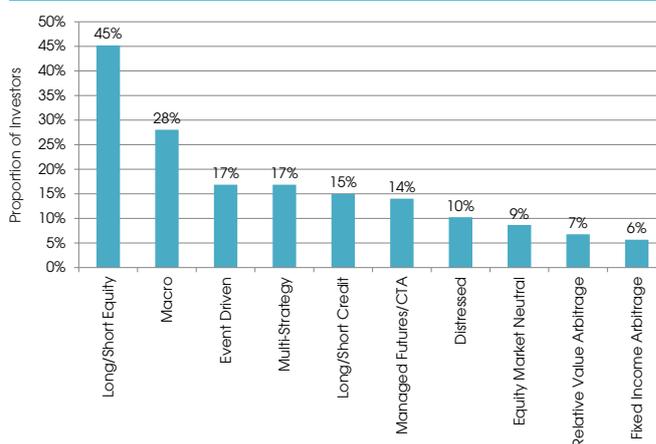
www.preqin.com/hfip

Fig. 3.3: Investor Plans for their Hedge Fund Allocations in the Next 12 Months and the Longer Term



Source: Preqin Investor Interviews, July 2013

Fig. 3.5: Strategies Being Targeted by Hedge Fund Investors over the Next 12 Months



Source: Preqin Hedge Fund Investor Profiles

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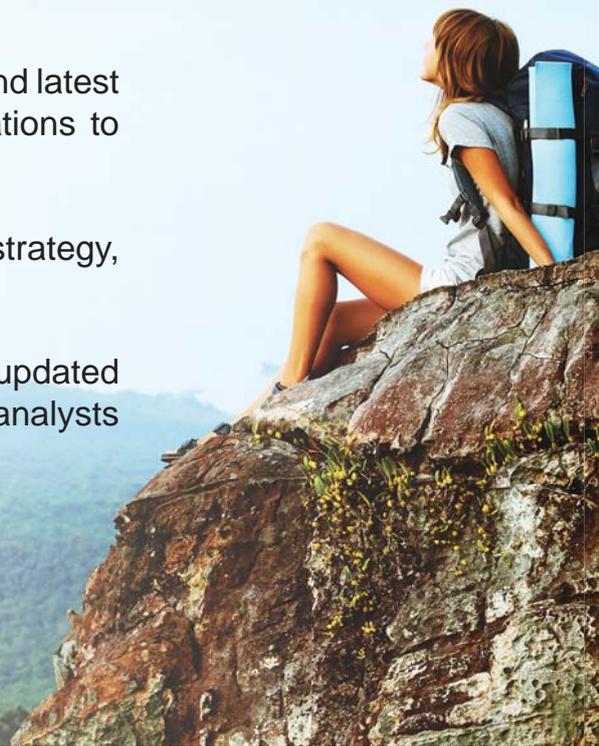


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What Are Investors Looking for in a Hedge Fund Manager?

In general the outlook of institutional investors interviewed by Preqin in July 2013 was more positive than in a similar study in 2012, with investors boosted by a run of positive performance for the hedge fund industry. Investors are demanding more from their hedge fund managers and they take a number of factors into account when selecting appropriate funds for investment.

Key Factors in Hedge Fund Manager Selection

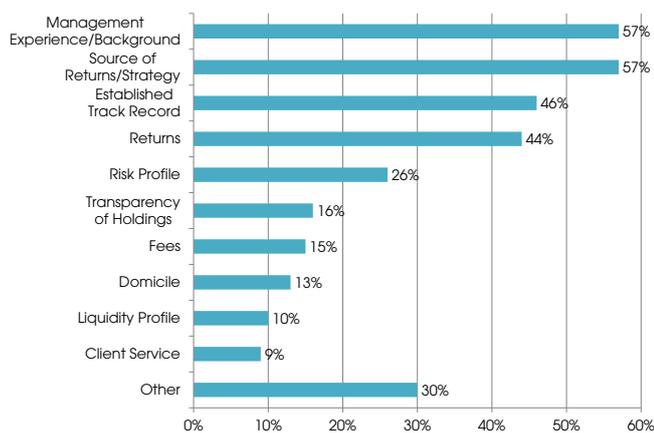
The key factors highlighted by investors in the manager selection process were source of returns/strategy and management experience/background, with both of these factors mentioned by 57% of respondents (Fig. 3.6). The proportion of investors interviewed indicating the source of returns/strategy as a key factor has increased from a similar study in December 2012, when 39% of respondents mentioned this factor, suggesting that investors are now more concerned about the method behind the performance. Investors are realizing that examining the source of returns/strategy of a manager could be more effective in the longer term, rather than simply selecting managers with positive short-term returns. Performance remains important to investors, although the proportion of respondents stating returns as a key factor in the initial selection process has dropped from 54% to 44% over the same period.

Investors also take a number of other factors into account when selecting hedge fund managers. Liquidity, transparency, and risk profile were also stated as key factors by investors interviewed, although the proportion of investors mentioning all three has decreased over the past year. Fees are less important in the initial screening process, with only 15% of investors selecting this as a key factor; investors are keen to look for suitable funds before considering costs.

Reasons for Investor Redemptions from Hedge Funds

Investors are willing to make changes to their hedge fund portfolios where necessary, with more than half of the investors surveyed

Fig. 3.6: Key Factors Used by Institutional Investors to Evaluate Hedge Fund Managers



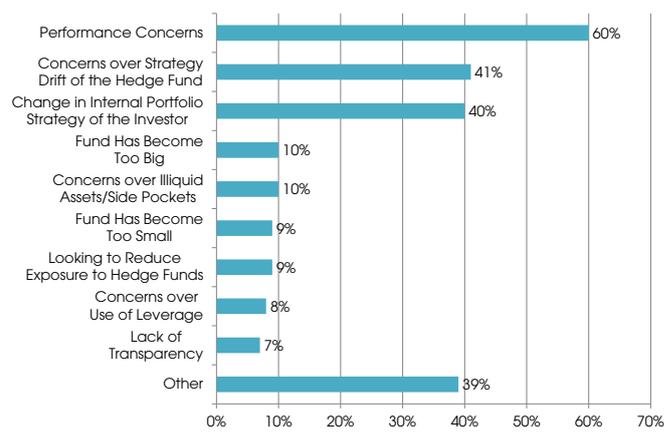
Source: Preqin Investor Interviews, July 2013

(55%) stating that they make redemptions from their hedge fund portfolio at least once a year. Investors were also asked about their typical reasons for exiting hedge fund investments, with the results presented in Fig. 3.7. Although performance was not the top factor in manager selection, it is the main reason for investors redeeming from hedge funds, with 60% of investors stating unsatisfactory returns as a key reason for exiting investments. Strategy or style drift is also an important factor in redemptions, named by 41% of respondents, as investors can become concerned if a manager switches from its initial investment strategy. A sizeable proportion of investors (40%) make redemptions as a result of their current macroeconomic view, in order to take advantage of the strategies that are presenting the best opportunities. Investors cited a number of other factors as reasons for making redemptions including concerns over fund size, concerns over illiquid assets, personnel concerns and a need to make redemptions for liquidity or rebalancing purposes.

Outlook

From Preqin's detailed interviews with hedge fund investors, it is clear that performance, manager experience, and fund strategy are the components that investors view as the most important in the fund selection process. Investors are willing to make regular changes to their portfolios if funds have poor performance or a drift in strategy in order to ensure they are invested with the most effective managers that meet their portfolio objectives. As a result, managers need to ensure they have consistent returns and a clearly defined strategy, as well as ensuring all other aspects of their operation are satisfactory, in order to continue to obtain capital from institutional investors.

Fig. 3.7: Institutional Investors' Reasons for Exiting Hedge Fund Investments



Source: Preqin Investor Interviews, July 2013



Satisfaction with Returns

Hedge funds face a constant battle to live up to expectations, with institutional investors becoming more demanding with regards to their hedge fund portfolios. Preqin's recent interviews with hedge fund investors provide an important insight into investors' expectation and confidence in the asset class.

The majority of investors interviewed (64%) stated that their hedge fund investments had met expectations over the past 12 months, with 26% stating that hedge funds had fallen short of expectations and 10% stating that hedge funds had exceeded expectations (Fig. 3.8). This shows that the majority of investors have been satisfied with hedge fund performance over the previous 12 months, suggesting that the outlook for the asset class is fairly positive. The proportion of investors stating that hedge funds have fallen short of expectations has reduced from 41% in 2012 and is at its lowest level since Preqin began conducting this study in 2008.

Fig. 3.9 shows those strategies that investors feel have exceeded or fallen short of expectations over the previous 12 months. CTA and macro funds have been the most disappointing to investors over the last year, with 31% and 27% of investors stating that these strategies have underperformed respectively. These strategies have struggled for positive performance over the past 12 months. Long/short equity was the strategy most commonly cited as having performed well over the last 12 months. However, 25% of investors felt that long/short equity funds have performed poorly in the last year, suggesting that there is a large variation between the best and worst performers in the strategy. Event driven has been the best performing strategy over the past 12 months and 23% of investors stated that they feel these funds have exceeded expectations over this period.

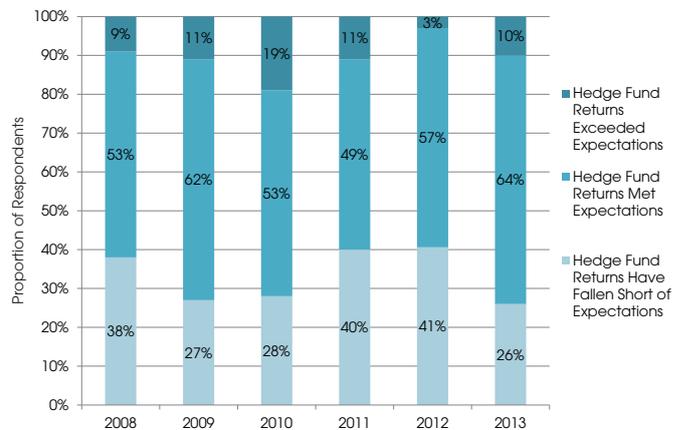
Investor confidence in hedge funds has remained relatively constant over the past 12 months, with 77% of investors stating that there has been no change in their confidence in hedge funds to meet portfolio objectives. Those reporting a change were almost equally split, with 11% reporting increased confidence in

hedge funds and 12% reporting decreased confidence in hedge funds. This is more positive than a similar Preqin study in August 2012, which revealed that 24% of investors reported decreased confidence in hedge funds over the previous 12 months and just 1% of investors reported having increased confidence. Overall, it seems that the majority of investors are becoming more confident in the benefits of hedge funds, as funds have improved in generating sustained risk-adjusted returns.

Use Preqin's **Hedge Fund Analyst** to access the performance of over 6,300 hedge funds and share classes, view how different strategies are performing, and much more.

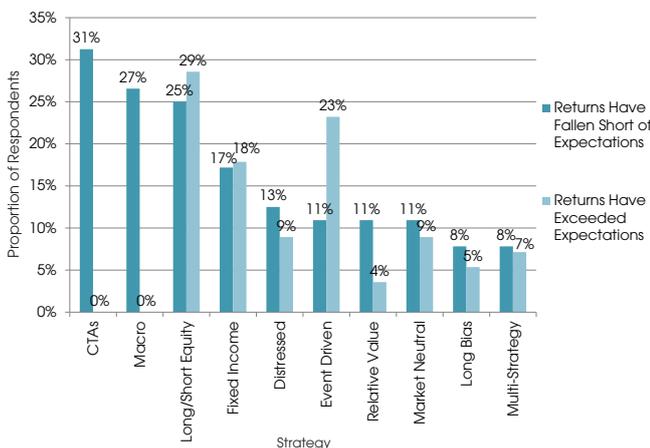
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Fig. 3.8: Hedge Fund Portfolio Performance Relative to Expectations of Institutional Investors, 2008 - 2013



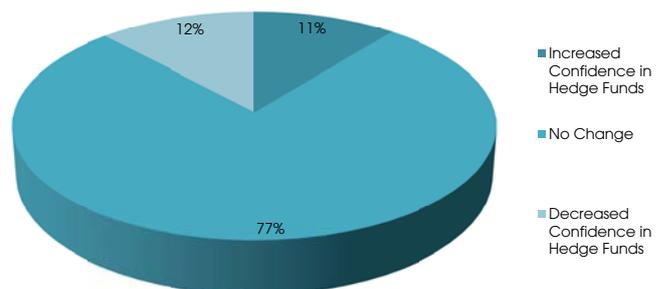
Source: Preqin Investor Interviews, July 2013

Fig. 3.9: Hedge Fund Portfolio Performance Relative to Expectations of Institutional Investors by Strategy



Source: Preqin Investor Interviews, July 2013

Fig. 3.10: Change in Investor Confidence in Hedge Funds over the Last 12 Months



Source: Preqin Investor Interviews, July 2013

Fees and Alignment of Interests

One of the key topics in the hedge fund industry over the past few years has been the discussion over the terms and conditions of hedge funds, as investors question both the traditional 2 and 20 structures and the liquidity and transparency of these alternative assets. Preqin's interviews with institutional investors in July 2013 reveal important trends in investors' attitudes towards fund terms and conditions, and how they have evolved over time.

In this new era of heightened regulation and scrutiny of funds, the terms on hedge funds have never been more relevant; as manager costs increase in order to comply with various international regulations, investors will be watching to see if these costs are passed on, as well as the effect regulations have on reporting and transparency requirements. Preqin has conducted studies of investor attitudes towards fund terms and conditions since 2009. Here we present the results of our latest study of investors conducted in July 2013.

Alignment of Interests Remains an Issue for Some Investors

A significant proportion (42%) of all investors interviewed witnessed a shift in favour of the investor regarding changing terms and conditions over the past 12 months, compared to just 4% that feel that there has been a change in favour of fund managers (Fig. 3.11). However, fewer investors in 2013 feel that manager and investor interests are aligned than in the previous year. Sixty-four percent of investors interviewed in July 2013 either agreed or strongly agreed that manager and investor interests are properly aligned, as shown in Fig. 3.12, compared to 74% in 2012. With more than half of respondents (54%) indicating that they had seen no change in fund terms over the past year, managers still have a way to go in reaching an optimum equilibrium of having appropriate fees and structures to run a fund in the best possible way while representing good value for the investor.

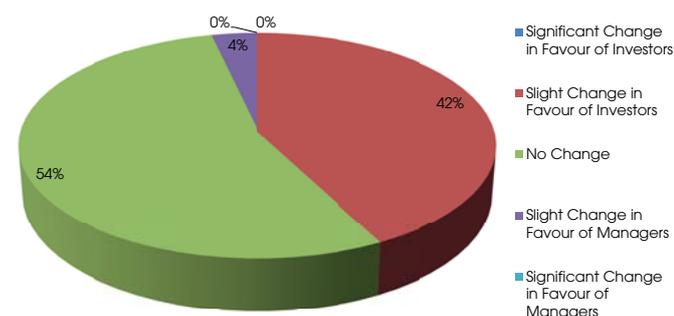
Fees Have Shown Improvement

The traditional 2 and 20 fee structure has come under increasing pressure over recent years, with many investors seeking reduced

fees. Fig. 3.13 indicates that managers have responded to this, with 68% of investors seeing an improvement in management fees charged over the past 12 months and 58% stating the same for performance fees. Where there have been improvements, many investors specified that these are often just for the larger investors, on smaller funds, or on funds which only produce "mediocre" performance. As a result, many investors believe there is still room for improvement across the wider industry, with 55% of investors interviewed still seeking further reductions in the level of both management and performance fees. However, this is the first year that Preqin has conducted the fee study in which more investors have indicated they have witnessed improvements in management and performance fees than have signalled they want further improvements. Where further improvement seems particularly necessary is on the performance fee side. Investors would like to see more fund managers considering alternative structures for charging fees, such as instigating clawback provisions or putting in a hurdle which must be met before a performance fee is charged, or increasing the level of the existing hurdle.

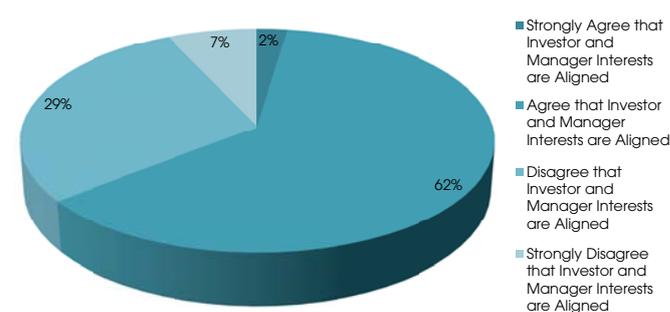
As more managers are setting their fees lower than the perceived 2 and 20 standard, investors are also looking to enter negotiations over terms in the pre-investment stages. Since 2012, we have witnessed more investors asking their managers for concessions; the number of investors looking to negotiate has increased from 46% in 2012 to 57% in 2013. Of those that entered into negotiations with their managers, 83% of investors were successful in securing more favourable terms, slightly below the 87% that were successful in negotiations in 2012.

Fig. 3.11: Investor Opinion on Changes in the Alignment of Interests between Investors and Managers over the Past 12 Months



Source: Preqin Investor Interviews, July 2013

Fig. 3.12: Investor Opinion on the Alignment of Interests between Investors and Managers



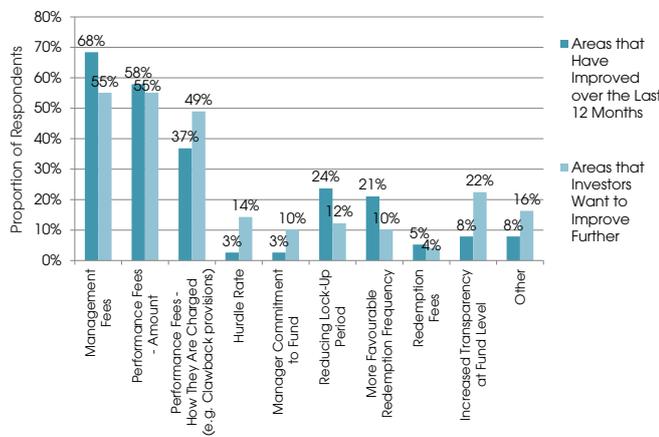
Source: Preqin Investor Interviews, July 2013



Managers Have Responded to Liquidity and Transparency Demands

There have been significant improvements in how investors view the liquidity and transparency terms of hedge funds over the past year. In 2012, 39% of investors were looking for increased transparency from their hedge fund managers, whereas in 2013 this has fallen to 22%. However, it is important to note that just 8% of investors feel that they have seen improvements to the amount of transparency offered to them by their fund managers over the past year; managers may feel that their work on reporting more data more frequently to investors is complete, whereas many investors still want more transparency on the performance, risk and investments of their funds.

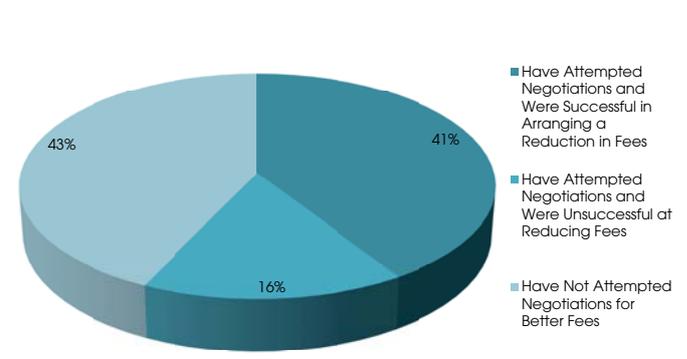
Fig. 3.13: Areas of Fund Terms Investors Feel Have Shown the Most Improvement over the Past 12 Months and that Need to Improve Further in the Future



Source: Preqin Investor Interviews, July 2013

Hedge fund investors have become more comfortable with the level of liquidity in the industry following several years of improvements by fund managers. Approximately a quarter and a fifth of investors interviewed stated they have seen reduced lock-ups and more frequent redemption policies on hedge funds over the past year respectively. In 2012, 37% of investors wanted to see improvements on the lock-up terms of a fund, whereas in 2013 this has fallen to 12%. Similarly, in 2012, 34% of investors wanted to see more appropriate redemption frequencies, while today this has fallen to just 10% of investors. So for some investors, further improvements are needed, but for the industry as a whole, it is largely reaching a level where investors feel that the liquidity terms on funds have become appropriate based on the fund's strategy.

Fig. 3.14: Investors' Fund Terms Negotiation Experiences in the Past 12 Months



Source: Preqin Investor Interviews, July 2013

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Direct Hedge Funds vs. Funds of Hedge Funds: In Focus

The institutional hedge fund investor landscape continues to change over time as investors become more experienced when investing in the asset class. Over time we have seen new investors entering the asset class via funds of hedge funds while the more experienced investors move towards direct investments. In this section, we examine current investor attitudes towards the two investment styles.

Funds of hedge funds have endured a difficult time over the last few years as a result of poor performance and some concerns about their role in the industry. A number of investors have shifted towards direct investments as they aim to gain more control over their hedge fund portfolios and as a result we have witnessed a decline in the size of the funds of hedge funds sector.

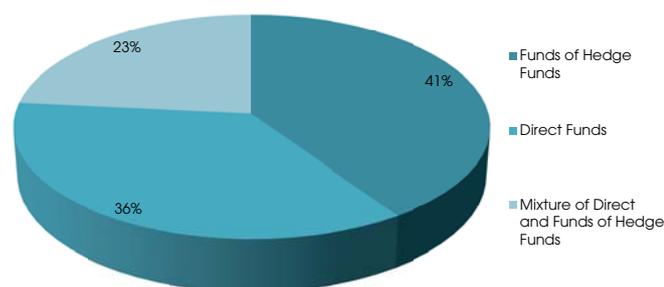
Direct Funds versus Funds of Hedge Funds

Using data from Preqin's Hedge Fund Investor Profiles, the current breakdown of the method of investment for each hedge fund investor type is presented in Fig. 3.15. All investor groups have shown a reduction in the proportion of investors utilizing funds of hedge funds over the past 12 months. The biggest change has been noted among private sector pension funds, with a six percentage point reduction in investors of this type committing solely through funds of hedge funds between December 2012 and July 2013. Public pension funds have the greatest proportion of investors investing through funds of hedge funds, with 57% of this investor type committing to hedge funds solely through multi-manager vehicles, but these investors have also seen a decrease in appetite for funds of hedge funds, with a two percentage point swing from funds of hedge funds to direct investments so far in 2013.

Changing Landscape of Hedge Fund Investing

Fig. 3.16 shows the investment method of institutional hedge fund investors when they first entered the hedge fund asset class. The highest proportion of investors (41%) began investing in hedge funds solely through funds of hedge funds, with 36% investing solely through direct investments and 23% investing through a combination of the two methods. Investors see the benefits of investing through funds of hedge funds initially, as it allows them

Fig. 3.16: Investment Method of Institutional Investors when First Investing in Hedge Funds



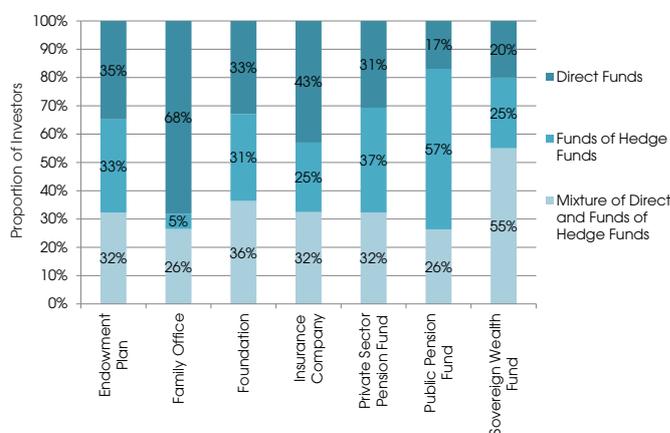
Source: Preqin Investor Interviews, July 2013

to outsource manager selection to industry experts while they gain experience investing in hedge funds. Investors will often switch to direct investments as they gain more knowledge of hedge funds; Fig. 3.17 shows that only 22% of the same investors now invest solely through funds of hedge funds. However, funds of hedge funds are still utilized by 62% of these investors in some capacity, showing that the investment method remains relevant to many investors.

Direct Investments

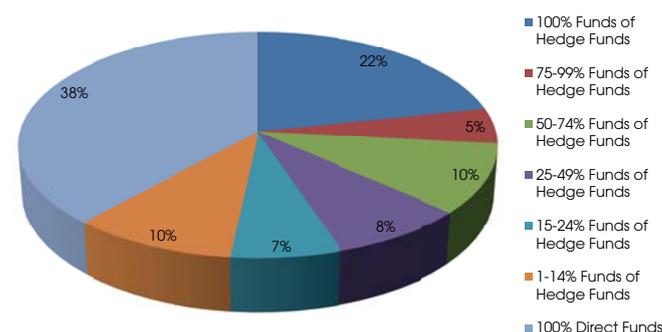
Of those investors interviewed that now invest solely through direct investments, 63% had previously invested through funds of hedge funds, highlighting that the majority of these investors have changed their investment style since they first began investing in the asset class. Avoiding the double layer of fees is the most common

Fig. 3.15: Breakdown of Institutional Investor Types by Hedge Fund Investment Approach



Source: Preqin Hedge Fund Investor Profiles

Fig. 3.17: Breakdown of Investor Hedge Fund Allocations by Proportion of Allocation Invested via Funds of Hedge Funds



Source: Preqin Investor Interviews, July 2013



reason for investors moving away from funds of hedge funds into direct investments, with two thirds of respondents stating this as a key factor (Fig. 3.18). More than half of investors interviewed also mentioned that they have constructed a direct hedge fund portfolio in order to gain more control over their investments. Once investors have sufficient experience in the hedge fund asset class they often feel that they can conduct their own due diligence in order to select suitable hedge fund managers. After they reach this stage they are less likely to be willing to pay the extra layers of fees associated with funds of hedge funds.

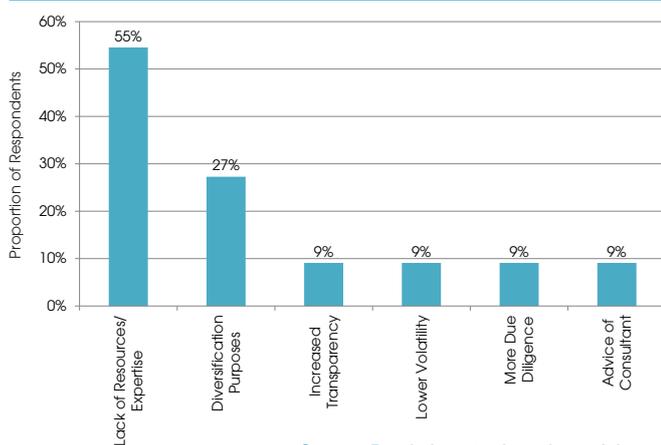
Funds of Hedge Funds

Despite funds of hedge funds enduring a difficult time in recent years, the multi-manager structure is still utilized by a significant proportion of investors. The main reason for investors choosing to invest through multi-manager vehicles is a lack of internal resources, which means they do not have the necessary expertise to invest directly, with 55% of respondents highlighting this as a key reason (Fig. 3.19). Investors are also attracted to funds of hedge funds for diversification purposes as such investments allow them to gain exposure to a broad range of hedge fund managers through a single investment. The multi-manager model can be valuable for less established hedge fund investors as it allows them to gain access to hedge funds while being able to outsource manager selection and due diligence to fund of hedge funds managers.

Combination of Direct Funds and Funds of Hedge Funds

Of those investors that currently invest through a mixture of direct fund investments and funds of hedge funds, 54% stated that they expect their allocation between the two investment types to remain approximately the same over the next 12 months (Fig. 3.20). A further shift to direct investments is highlighted, with 38% of investors expecting to increase their allocation to single-manager hedge funds, compared with just 8% of investors that expect to increase their allocation to funds of hedge funds. Lower fees was again the most common reason for investors switching to direct investments (57% of investors interviewed stated this as a key reason). Stronger returns was another common reason (43%), suggesting that investors are disappointed with the recent poor performance of the fund of hedge funds industry when compared to the wider hedge fund performance benchmarks.

Fig. 3.19: Reasons for Investors Preferring Fund of Hedge Funds Investments



Source: Preqin Investor Interviews, July 2013

Outlook

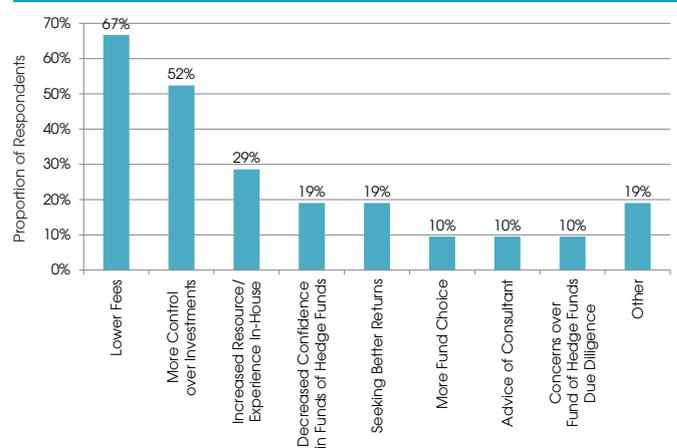
Preqin's latest interviews with investors highlight the challenging environment for fund of hedge funds managers, with investors continuing to shift their portfolios towards direct investments. Investors have been making the switch in recent years in order to gain more control over their investments and avoid the additional layer of fees associated with multi-manager structures. The relatively dampened performance of funds of hedge funds has added to this challenge, and managers of these structures need to convince institutional investors that they remain relevant. However, with more than half of all institutional investors continuing to utilize at least one fund of hedge funds, there remains attractive opportunities for those fund of hedge funds managers that are best at adapting to investor demands.

Filter extensive profiles of over 4,200 active hedge fund investors by their strategy preferences on Preqin's [Hedge Fund Investor Profiles](#).

For more information, or to arrange a demonstration, please visit:

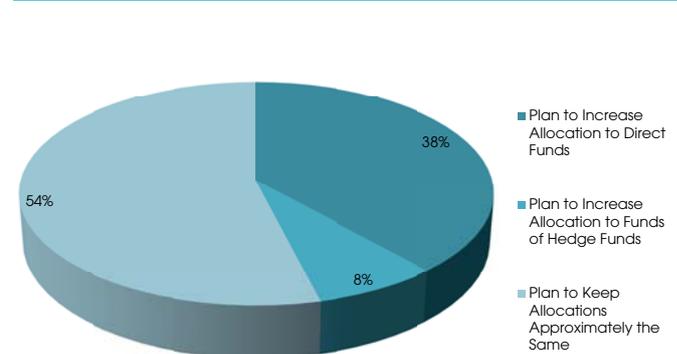
www.preqin.com/hfip

Fig. 3.18: Reasons for Investors Preferring Direct Hedge Fund Investments



Source: Preqin Investor Interviews, July 2013

Fig. 3.20: Next 12 Month Plans for Investors Currently Investing in Both Direct Funds and Funds of Hedge Funds



Source: Preqin Investor Interviews, July 2013

Preqin Investor Outlook: Hedge Funds, H2 2013



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