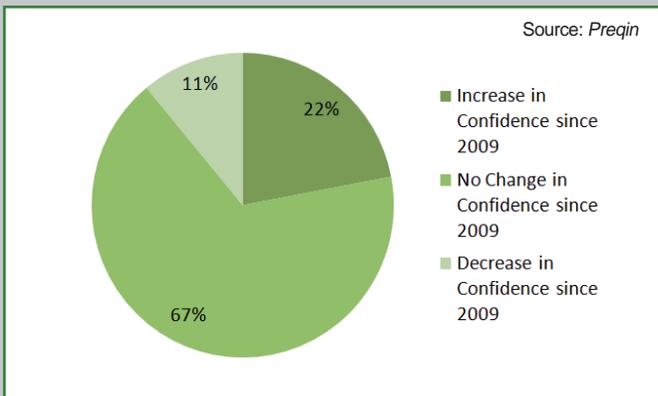


# Preqin Research Report

## A Brighter Future: Investor Outlook for Hedge Funds for 2011

Fig. 1: Change in Institutional Investor Confidence Since 2009

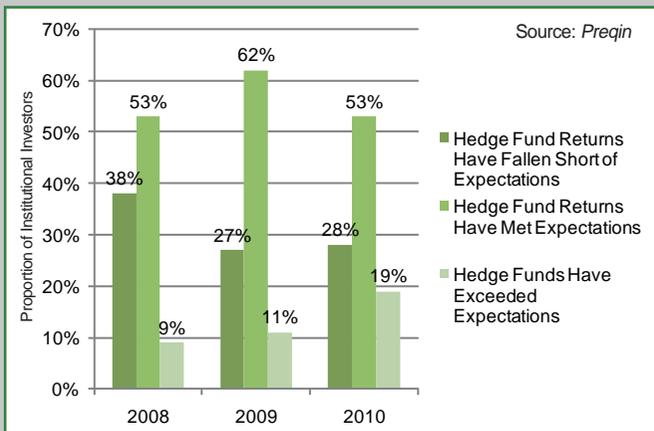


The market crisis and subsequent public backlash towards hedge funds of 2008-2009 presented a difficult time for investors and managers alike. Scepticism towards hedge funds was evident but hope of improvement was anticipated by many. The past three years have posed many difficulties for hedge fund managers. Initially, following the crisis, fund raising was extremely difficult, with new investor mandates rare and many investors both redeeming existing investments and putting plans for future allocations on ice. The pressure on managers to adapt to an increasingly tough fundraising environment or disappear completely has led to evolution in the asset class. Although the fundamentals of the industry remain unchanged, hedge funds have undergone many alterations following the market crisis, for instance in terms of greater liquidity and transparency of funds, both of which are at the forefront of investors' minds at the tail end of 2010. These adaptations have increased the attractiveness of hedge funds as an investment option over the past 12 months and have led to a restoration of confidence in the asset class by its investors. This in turn is resulting in increased inflows of capital into hedge funds.

### Investor Confidence in Hedge Funds

Hedge fund managers have had to make changes to the

Fig. 2: Institutional Hedge Fund Portfolio Performance Relative to Expectations (2008 - 2010)



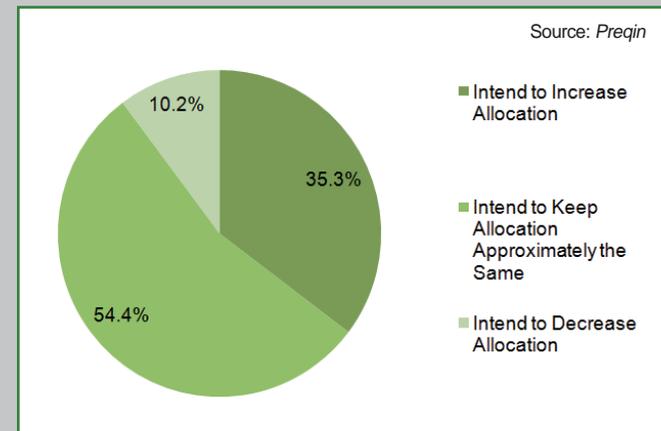
ways they structure and market their funds, not only to win back confidence from existing investors, but also to attract new investors to their funds. Earlier research from Preqin indicated that 60% of investors felt that there had been a change in fund structures that had benefited investors over the course of the past year. Changes such as these on the manager's part are leading to improvements in how existing investors perceive the asset class as well as how the institutional market as a whole views hedge funds. At the end of 2010 investor attitude towards hedge fund remains good, with 67% revealing no change in their outlook towards the asset class since 2009 (in 2009 66% of surveyed investors stated they were confident in hedge funds to perform portfolio objectives). A significant 22% of surveyed investors expressed an improvement in their levels of confidence in hedge funds over the past 12 months; this is likely a result of both concessions on the side of the manager and better

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Fig. 3: Institutional Investors Plans for 2011



performance in their hedge fund portfolios. From Fig. 2 it is clear the trend for improved investor satisfaction towards hedge fund performance is continuing, with 72% stating that returns have either exceeded or met expectations in 2010, compared to 73% in 2009 and 62% in 2008. As



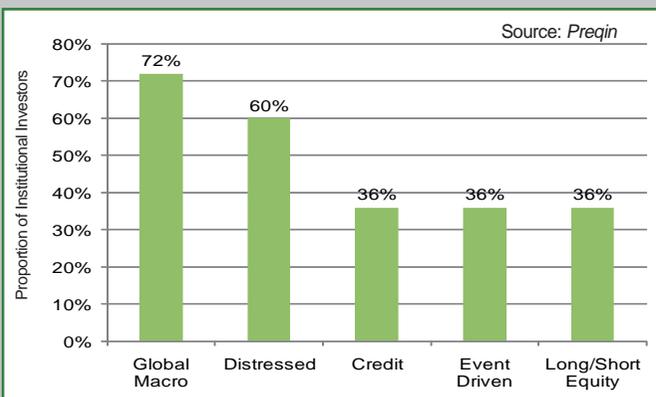
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Fig. 4: Strategies That Investors Feel Present the Best Opportunities for Hedge Fund Investment in 2011



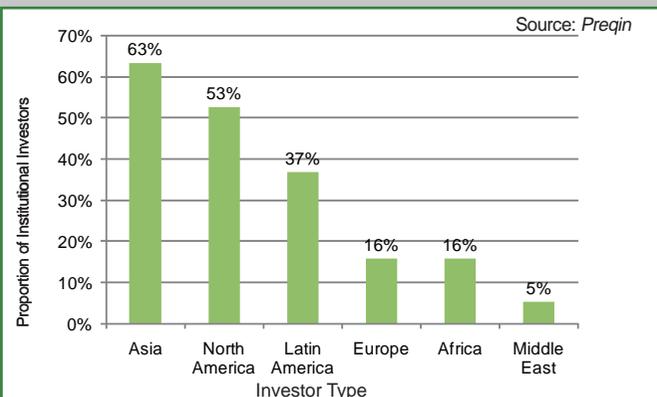
shown in Fig. 2, 19% of investors revealed that their hedge funds have exceeded expectations in 2010, a significant increase from the 11% of investors which felt similarly in 2009, showing that the industry is recovering.

11% of investors expressed a decrease in their confidence of hedge funds to perform portfolio objectives in 2010. There remains a degree of sceptism towards the asset class – hedge fund returns did not meet expectations for just over a quarter of all investors surveyed and some earlier Preqin research indicated that although investors are witnessing improvements in fund structures they feel there is room for improvement, wanting in particular further transparency at fund level and better alignment of liquidity terms. Further changes are still expected within the industry and are necessary if managers are to fully restore the confidence of the institutional market.

### Large Inflows Expected in 2011 from Institutional Investors

The increasing confidence in hedge funds as an asset class and satisfaction in the returns they generate is leading to a growth in new capital being earmarked for investment in hedge funds over the next 12 months. 35% of surveyed investors stated that they plan to increase the amount of capital they invest in hedge funds over the course of 2011. This capital will come from both investors reallocating capital redeemed from hedge funds or put on ice during the past three years and investors increasing their current allocations

Fig. 5: Regions That Investors Feel Present the Best Opportunities for Hedge Fund Investment in 2011



to the asset class. This is an extremely positive prospect for the hedge fund industry which has been through a tough fundraising environment in the past three years. Investors are becoming less cautious about making new investments, and are expecting to branch out from their current portfolios and look for new opportunities. Over half of investors plan to keep the amount that they have invested in hedge funds the same. Just a small proportion of surveyed investors, 10%, plan to decrease the amount that they have invested in the asset class, therefore net inflows over 2011 are expected to not only be positive but much higher than we have seen in any year since the market downturn.

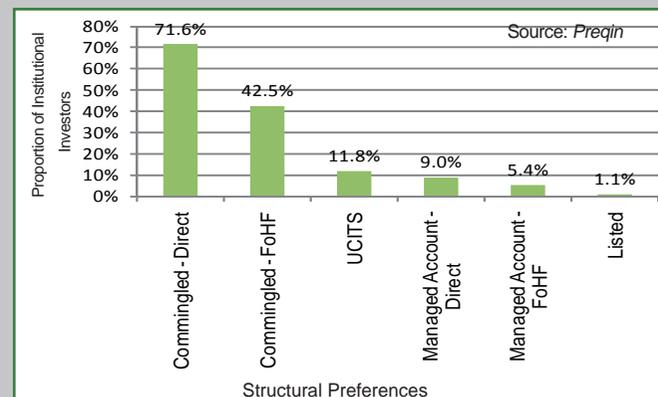
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Fig. 6: Institutional Investors Structural Preferences



### Institutional Investors Plans for 2011

Investors surveyed were asked to select up to three hedge fund strategies that they feel will present the best opportunities in 2011. Global macro came out as the strategy in which institutional investors see the best potential for 2011. Macro strategies have underperformed



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somewhat in 2010 and there has been a slowdown in uptake by investors over the past year. However, there has been an improvement in the returns of the strategy at the tail-end of 2010, and investors now feel that macro could offer the best potential for 2011. This could lead to new inflows coming into the strategy over 2011 as investors look to rebalance their holdings in its favour over the next 12 months. Distressed funds continue to interest institutional investors, and although in the past some investors have held off from investment in these funds (choosing instead more liquid strategies), 2011 could see large inflows for this fund type if institutional interest remains strong.

Preqin also surveyed institutional investors on which regions they believe will offer the most compelling opportunities for hedge fund investment in 2011. Asia comes out as a clear theme for hedge fund investors in 2011, with nearly a third of all the surveyed institutions feeling that investment in Asia will be attractive over the next year. North America and South America also came out as popular choices for the most compelling opportunities in hedge funds in 2011. Europe is ranked much lower by hedge fund investors, with only 15.8% surveyed believing that the region offers a compelling investment opportunity in 2011.

### New Opportunities for Investors in Hedge Funds

UCITS has become a buzz word in the hedge fund 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 far more regulated than offshore hedge funds. With the growing demand for all of these elements from investors, UCITS managers have established themselves as an important part of the evolving hedge fund industry. 11.8% of all investors on the Preqin database have revealed a preference for UCITS hedge funds, which is a significant figure considering such managers have only come into the spotlight over recent years and the current universe of funds is still relatively small (estimates range from 300-500 funds). 13.4% of institutional investors on the Preqin database use managed accounts within their portfolios. Investors with the larger ticket sizes have increasingly been requesting separately managed accounts from their managers in

order to gain full transparency, increased liquidity and to avoid co-investor risk.

Although new structures are gaining traction with institutional investors, we can expect the traditional structures of funds to remain dominant over the next 12 months. Over 70% of the investors on the Preqin database invest directly in hedge funds and more than 40% invest through funds of hedge funds. We can expect much of the predicted large inflows into hedge funds over 2011 to go into these structures.

### What Can Hedge Fund Managers Expect in 2011?

Hedge fund professionals can expect a large influx of capital into hedge funds in 2011 from an institutional market which has seen a restoration of the confidence lost in 2008. With the majority of investors content with the performance of their hedge fund portfolios, we can anticipate hedge funds remaining on the agenda for many. The need for diversification in investment portfolios initially led to institutional investors entering the asset class and many still look to hedge funds to diversify their holdings away from an over-reliance on traditional assets. A high proportion of investors plan to increase their hedge fund holdings over 2011, marking a positive time for the industry and the potential for assets in the industry to approach or exceed pre-crisis levels. Institutional investors are branching out from the more common investment approaches and we can expect further inflows of capital into Asia and emerging markets such as Latin America during 2011. We can also expect the ongoing trend for further liquidity and transparency to continue, and interest in UCITS and managed accounts to increase.

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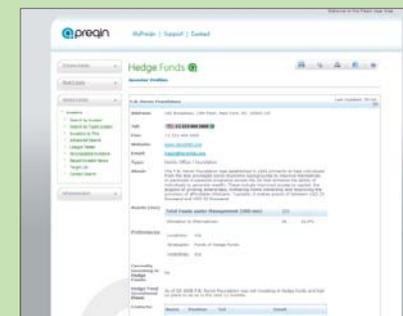
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