

Preqin Survey Results: The Institutional Investor Outlook for 2009

In light of the fraudulent Madoff funds exposed in December 2008, and with the global economic outlook becoming increasingly uncertain, Preqin conducted interviews with over 50 institutional hedge fund investors to gauge their sentiment and attitude towards the hedge fund industry in these challenging times.

We conducted the survey in late January 2009 across a wide range of institutional investors including pension

funds, banks, endowments and insurance companies located across the globe. Investors we surveyed had assets under management ranging from USD 100 million to USD 35 billion.

Institutional investors have increasingly been a driving force behind the growth of the hedge fund industry over the last two decades, with investors looking to them as a means of diversification and for absolute returns. However with the

onset of the global financial crisis and with hedge funds performing poorly in recent months, we asked institutional investors if this had changed their investment criteria and how they will invest in hedge funds in the future.

General Outlook

Our findings revealed a significant level of optimism towards the market with a combined 76.9% of investors stating that the turbulence of the last 12 months had not affected their confidence in the asset class and that they would continue to invest or even increase their allocation. Approximately one quarter of all investors we polled stated that they would be increasing their allocations over the next 12 months and believed that there were some exciting investment opportunities opening up on the market. Our interviews with investors show that many remain committed to the asset class and are set to weather the storm and capitalise on a market upturn whenever this may occur. At the other end of the spectrum 7% of investors we polled stated that they would be decreasing their allocations citing poor returns and a lack of transparency as the key factors in this decision.

Reactions to Madoff Scandal

The fallout from the Madoff affair

Fig. 1:

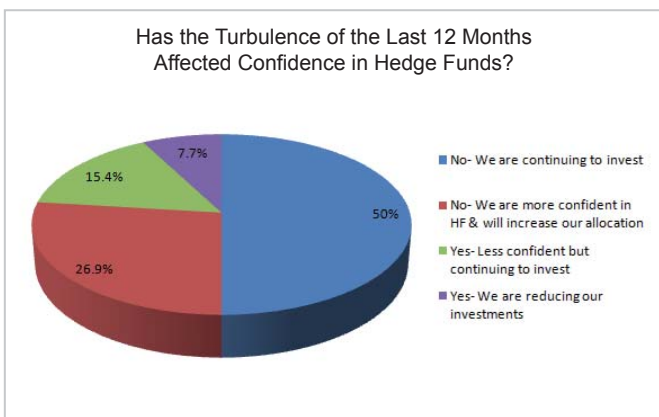
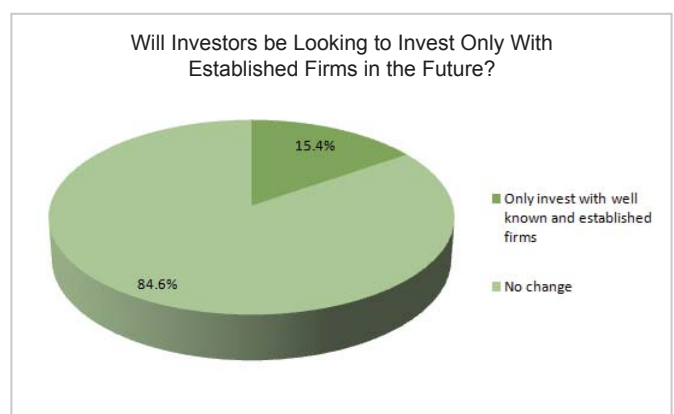


Fig. 2 & 3:



does not appear to have drastically altered what investors look for in fund managers, which is perhaps a reflection of the unprecedented nature of the scandal. A total of 15.4% reported that from now on they would be changing their strategies to only invest with well known or established managers with a proven investment strategy. Around 85% will still use the same criteria to search for new managers, and as a result Preqin expects trends witnessed over the past two years, such as emerging managers being increasingly used within investor's portfolios, to continue.

Investors Becoming more Stringent

Although the Madoff scandal has not seriously affected the types of funds that are being considered, it is having some notable effects on institutional investors with 38.5% of investors stating that going forward they would be carrying out more vigorous due diligence checks.

Whilst our findings revealed that there is no planned mass exodus from hedge funds, with some investors even increasing their allocations, for the majority of institutional investors the events of the last 12 months have changed their demands from hedge funds. Increased liquidity, lower fees, and transparency were common

demands being made by investors we spoke with. A key finding of our survey was the number of investors that stated that increased liquidity and the ability for quick withdrawal from funds especially in bad times is essential in the future.

Quality of Fund Reporting

Calls for hedge funds to be less opaque was a common request amongst investors we surveyed, with 43% of investors raising this as a fundamental issue that needs to be improved. One prominent US endowment with a large allocation to hedge funds commented that often fund managers "provide lots of verbiage and no detail". In the aftermath of the Madoff scandal investors want to know what managers are doing on a more frequent basis and to have a better understanding of how their returns are being generated.

In addition to the dissatisfaction shown over the level of information they receive over strategy, over a third of investors were not completely satisfied with the quality of information on liquidity and fund reporting generally. Investors noted that the levels of communication between them and the fund manager can on occasion be rather poor and the amount of information they received is an area

that needs to be improved. Some managers have been quick to respond to these concerns, with one example being US hedge fund manager Tuckerbrook Alternative Investment, which is offering its hedge fund investors daily asset statements, which will be prepared and delivered by the fund's independent administrator.

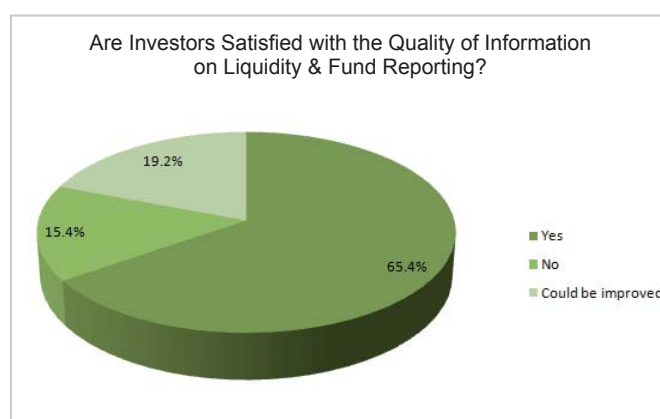
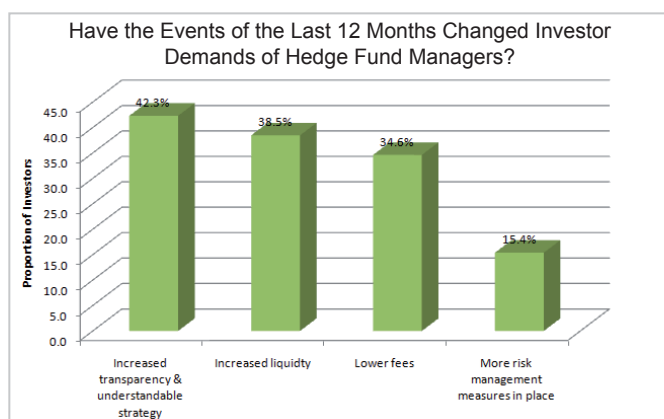
Independent Administration Essential

After the Madoff scandal hit the headlines in December, investors have been more stringent when it comes to the use of independent administrators and custodians. The absence of full time independent administrators and custodians at some large US hedge funds has caused some big name investors notably Union Bancaire Privee (who acknowledged a USD 700 million exposure to fraudulent Madoff funds) to publicly threaten to pull capital out of funds that do not employ independent administrators.

New Areas of Interest

Several investors stated that whilst they will continue to invest in hedge funds they have refocused their investment strategy and will be looking to invest with managers that employ a clear and understandable strategy. Investment strategies that investors expressed a keen interest in were

Fig. 4 & 5:



global macro, credit and event driven strategies whilst convertible arbitrage and emerging markets were less popular with investors.

Power Shifts to Investors

One of the most interesting findings of our survey was the proportion of investors that suggested the downturn in the market had reinforced their bargaining power when negotiating fees with managers. Approximately 35% of investors felt more confident to negotiate on fees. One UK bank noted that in the last 6 months they had noticeably more leverage and leeway when dealing with hedge fund managers, plus more opportunities with previously inaccessible managers. Another pension fund noted that they had been able to half fees with one of its fund of funds managers. On the other hand some investors reported that they would no longer be investing in fund of funds vehicles as they did not believe they were “value for

money” because of the double layer of fees. In addition investors are also demanding that the structure of fees needs to be changed, with changes in performance fees if successful years are followed by losses and information about who other investors in the fund are. In order to hang onto investor capital some fund managers have actively responded to these demands by lowering management fees to meet with investor demands.

Conclusions

The key findings of our survey reveal that while investors on the whole remain committed to investing in hedge funds, they are re-evaluating their investment criteria and objectives. Although over 92% of investors we surveyed are continuing to invest in hedge funds, calls for increased transparency, lower fees and liquidity are key concerns amongst investors. In 2009 stricter demands will be placed upon fund managers and

they will need to work hard to meet these demands if they are to secure investor capital. Transparency is a crucial concern amongst investors and there is a need for fund managers to communicate with investors on a more frequent and unambiguous basis. Institutional investors will be scrutinizing funds more closely. In particular investors will be looking at the investment processes fund managers undertake and will only invest in funds that employ independent administrators and custodians.

The turbulence of the financial markets over the last 12 months has shifted the balance of power towards institutional investors. In terms of fees, more investors are demanding reductions in the fees being charged and are also becoming increasingly vocal about the fee structures in place.