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The Era of the Investor

New Rules of Institutional Hedge Fund Investing

SEI Knowledge Partnership
Insights for Investment Managers

GREENWICH ASSOCIATES

Whatever analogy one chooses to describe the market decline of 2008 – tsunami, meteor strike, meltdown – it caused investors to question long-held assumptions about their investments, including their performance and liquidity expectations. Against this backdrop, the SEI Knowledge Partnership conducted its 2009 global survey of institutional hedge fund investors. Our 2008 survey, conducted in the midst of the crisis, found institutions staying the course. But how would investors view their hedge fund investments after having a year to reflect on their performance and liquidity (or lack thereof), not to mention the Madoff scandal?

For the hedge fund industry, the results of our 2009 survey come as both good news and a call to action. Institutions, which have replaced high-net-worth individuals as the core business for hedge funds, are firmly committed to preserving the role hedge funds play in their portfolios. Indeed, a portion of the survey respondents plan to increase their hedge fund allocations, albeit incrementally.

Yet it is also clear that investors' continued commitment comes with substantially increased expectations. Indeed, power has shifted. Institutional investors and their representatives are increasingly asserting themselves, changing the rules of hedge fund investing as they push managers toward greater transparency, insist on identifying demonstrable sources of alpha and intensify their focus on operational effectiveness.

January 2010

Key Findings

INSTITUTIONS HAVE MAINTAINED THEIR COMMITMENT TO HEDGE FUND INVESTING. Institutional investors drove hedge fund growth leading up to the crisis and are critical to the industry's future growth. Thus, managers may find encouragement in the fact that nearly 80% of all survey respondents said they have no plans to change their hedge fund allocations in the next 12 months while 15% expect to increase their allocations. On average, the U.S. institutions surveyed reported raising their target portfolio allocations to hedge funds from under 13% to nearly 14% over the past year, with current allocations highest among foundations and endowments.

DIVERSIFICATION AND ABSOLUTE RETURN REMAINED THE PRIMARY INVESTMENT OBJECTIVES. These were the same primary objectives cited in our 2008 survey, although investors this year placed greater emphasis on achieving non-correlated returns. Only 6% of the respondents reported investing in hedge funds in order to exploit market opportunities.

TRANSPARENCY, TRANSPARENCY, TRANSPARENCY. Institutional investors expect far greater information regarding their hedge fund investments. In fact, those surveyed named transparency as both the biggest worry and the single-greatest challenge related to hedge fund investing. What's more, a majority of investors have already acted on their transparency concerns. Over 70% reported requesting more detailed information from managers than they did a year earlier. While the type of information sought ranged from counterparty and leverage exposure data to sector and position-level detail, over 80% of the respondents reported a focus on funds' valuation methodologies.

WORRIES OVER PERFORMANCE HAVE BEEN ECLIPSED BY OTHER CONCERNS. In our 2008 survey, institutions overwhelmingly cited "poor performance" as their top worry when it came to hedge fund investing. In contrast, our 2009 respondents ranked performance fifth on their list of worries, which was led by "a lack of transparency" and "liquidity risk."

IN SELECTING HEDGE FUNDS, INVESTORS CONTINUE TO LOOK FOR MANAGERS WITH STRONG CREDENTIALS AS WELL AS A DEMONSTRABLE SOURCE OF ALPHA. People, investment philosophy, and the process for generating alpha were among top-ranked selection criteria, as they were in the 2008 survey. Significantly, the quality of reporting and communications and overall client service were both ranked as equally or more important than short-term past performance, indicating that managers would benefit from continued focus on and investment in quality client service.

AT THE SAME TIME, INSTITUTIONS PLACED MORE EMPHASIS ON OPERATIONAL QUALITY. Compliance infrastructure was ranked the third most important manager selection criterion, with nearly 50% of respondents citing it as "very important." Independent administration and a separation of investment management and operations management roles were also identified as high-ranking factors in manager selection.

FEE PRESSURES HAVE INTENSIFIED. While fees did not rank high on the list of concerns or the manager selection criteria emphasized by survey respondents, more than three out of four investors rated them as somewhat or very important in fund selection. Nearly one in five respondents reported negotiating fee arrangements different than the standard "2/20" for single-manager funds and "1/10" for funds of hedge funds over the last year.

What do These Findings Mean for Hedge Fund Managers?

The key findings of our survey demonstrate that the hedge fund industry has entered a new era in which the rules of engagement have changed. In this Era of the Investor:

- Power has further shifted to institutional investors, who have remained committed to alternative investing but are increasingly exerting their influence to reshape hedge fund practices and, in some cases, push for lower fees.
- Greater transparency is the price of continuing institutional commitment.
- Investors are looking beyond the numbers, focusing increasingly on the factors generating performance.
- More and more, the scope of the quest for quality managers is extending to operational functions in addition to those supporting the investment process.

For the hedge fund industry, these findings are a resounding call to action that should help spur managers to:

FOCUS ON THE FUNDAMENTALS. Recognizing that short-term performance is not necessarily indicative of investment capability, institutional investors are focusing on other traditional indicators of quality: the firm's team of people, investment process, and operations and compliance infrastructure.

EMBRACE TRANSPARENCY. Enhanced due diligence is not a fad. Our survey reveals that investors now are concerned with issues including liquidity risk, compliance infrastructure, valuation methodology, and whether performance characteristics are in line with stated strategies. As they seek to better manage the risks of investment, investors are intent on understanding a firm's culture, investment strategies and operations. To remain competitive, fund managers will need to be proactive in enhancing their transparency and investor communications and reporting.

INSTITUTIONALIZE RESPONSES TO TRANSPARENCY DEMANDS. Satisfying investor expectations may entail cultural as well as business process and operational changes. It is in the industry's own interests to provide for transparency in ways that create operating efficiencies and help firms deliver a consistent investor experience.

CLEARLY IDENTIFY AND EXPLAIN SOURCES OF ALPHA. Increasingly questioning the value they receive in exchange for high hedge fund fees and focused on achieving non-correlated, absolute returns, institutions are showing reluctance to pay for "alternative beta." It is therefore unsurprising that being able to identify a clear source of alpha has emerged as one of the chief factors in manager selection.

ADOPT VALUATION BEST PRACTICES. Valuation methodology is an important focus for institutional investors, who are seeking enhanced independence and a robust valuation process.

INVEST IN CLIENT SERVICE. As institutions seek a better understanding of the dynamics and complexities of their hedge fund investments, investor reporting and communication emerge as key aspects of manager quality and differentiation. In fact, our survey shows that client service is on a par with past performance as a factor in manager selection. On this score, fund managers also have an opportunity to add value by helping educate the investment committees and boards of institutional investors.

The Backdrop: Recovering from a Reversal of Fortune

SEI's 2009 survey reveals how the perceptions and practices of institutional hedge fund investors have evolved against the backdrop of a radically altered investment landscape. The previous edition of SEI's annual survey was conducted in August 2008, as the global financial crisis was unfolding. It was augmented by a second round of interviews in November, by which time the scope of the damage was more evident. At that point, the institutions responding to our survey largely affirmed their long-term commitment to hedge funds, with 85% of November interviewees reporting an intention to maintain or increase their target allocations. But investors did express growing concerns with the returns on their hedge fund investments, citing "poor performance" as their biggest worry. They also reported significantly tightening their investment criteria and intensifying their scrutiny of the funds in which they invest.

A PERIOD OF CONTRACTION

The year 2008 turned out to be the worst on record for overall hedge fund performance although the performance dispersion was significant. In fact, Hedge Fund Research (HFR) data on the industry's 2008 returns showed a 103% spread separating the top and bottom performance deciles, a historically wide gap.

Although hedge funds could boast a compelling long-term performance record, during the financial crisis they failed to deliver the absolute returns investors expected *[Figure 1]*. The lack of liquidity of their hedge fund investments and the high degree of correlation between hedge fund and market indices were particularly jarring to investors.

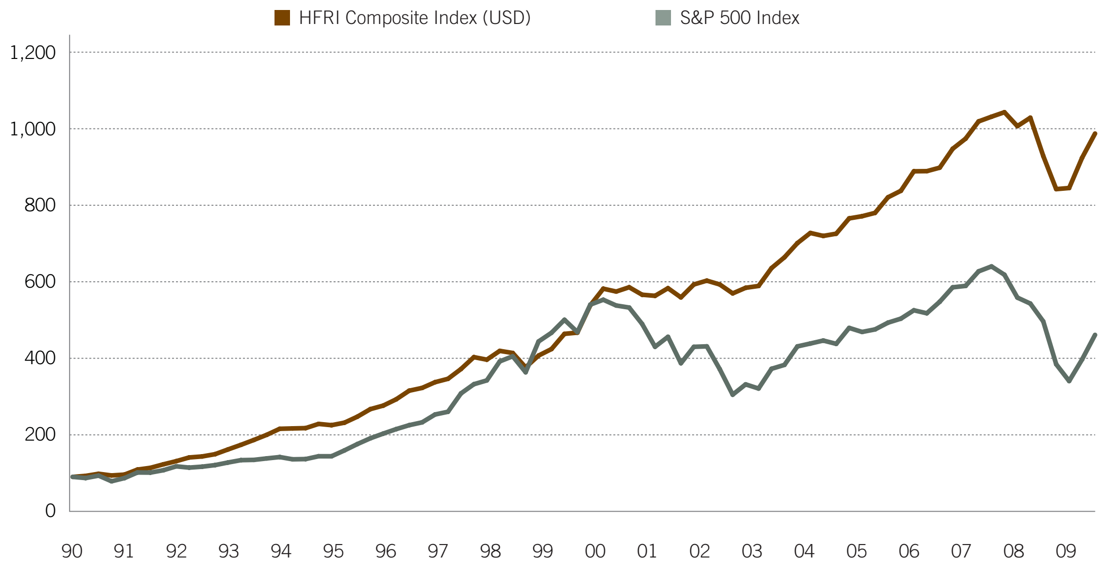
According to HFR, hedge funds saw four consecutive quarters of net withdrawals, from the beginning of the third quarter of 2008 through the second quarter of 2009. All told, hedge fund investors (both high-net-worth and institutional) withdrew some $330 billion during the 12-month period. This amount would have been even greater had many funds not suspended redemptions or instituted "gates."[1]

Still, the hedge fund industry could point to one undeniable fact: right through the crisis, hedge funds as a group consistently outperformed the broad-based securities indices, as they had historically. More recently, hedge fund performance rebounded dramatically in 2009, as the HFRI Fund Weighted Composite Index gained 17.1% through the third quarter of the year and some strategies produced 20%-plus returns over the same period.

By the third quarter of 2009, the pattern of net outflows reversed. But while more than two-thirds of all hedge funds had capital inflows in Q3, they only narrowly outpaced redemptions, which were more focused on specific strategies than in the prior quarters. The result was a quarterly net inflow of just $1.1 billion, according to HFR.

Thus, while now in recovery mode, the hedge fund industry also finds itself smaller and leaner than

Figure 1: Relative performance of HFRI Composite Index since 1990 (Indexed to 100)



Sources: Hedge Fund Research, SEI analysis

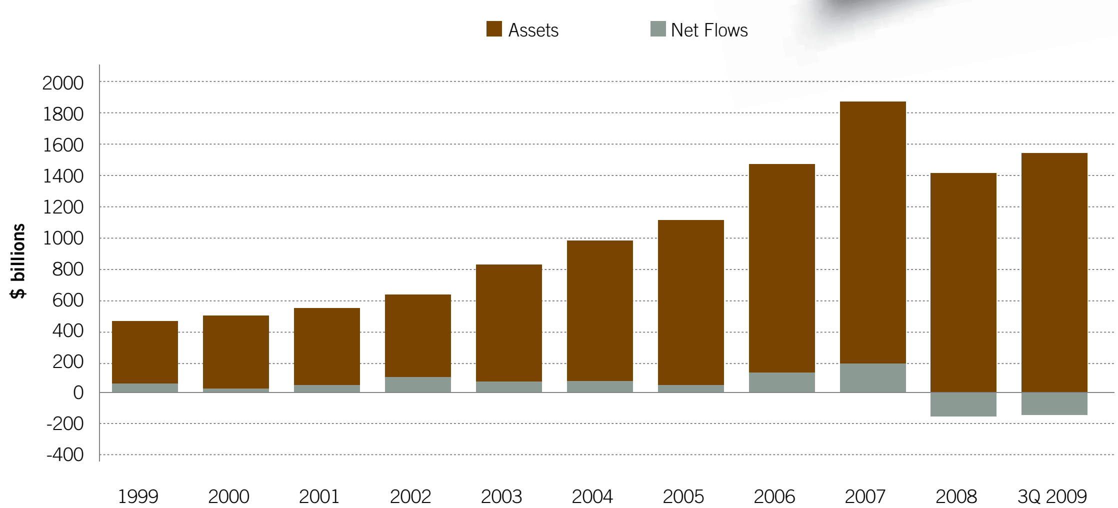
before. As of the end of the third quarter, global hedge fund industry assets stood at $1.535 trillion, a gain over 2008 but still below the peak of $1.868 trillion recorded in 2007 *[Figure 2]*. With its assets diminished and investors becoming more selective, the industry has also seen some contraction in the number of funds. Overall, according to HFR, the ranks of funds declined 11% between their 2007 peak and late 2009. A record 1,471 hedge funds liquidated in 2008 alone. As of the third quarter, however, HFR data shows fund launches beginning to outstrip liquidations, pointing toward a potential new cycle of expansion.

ANCHOR INVESTORS

With vast sums of "patient money" to invest, institutions have been the driving force behind the hedge fund industry's phenomenal growth throughout this decade. One result of the financial crisis has been to increase the hedge fund industry's dependence on its institutional client base. High-net-worth investors, particularly those in Asia and Europe, accounted for an estimated 80% of hedge fund redemptions from late 2008 through the third quarter of 2009, increasing the prominence of North American institutions as the industry's predominant investor base.[2] In fact, institutional investment currently accounts for about 72% of all hedge fund assets, including funds of hedge funds.[3]

As large pension funds, corporate funds, and endowments have gained presence and influence in the hedge fund industry, they have exerted both indirect and overt pressure on fund managers to evolve their entrepreneurial operating style to a more institutional and transparent model. A power shift has occurred as industry practices have come under increasingly intense scrutiny by the investor segment on which the industry's fortunes most depend.

Figure 2: Global hedge fund assets and net flows through Q3 2009



Source: Hedge Fund Research

This past year brought several high-profile examples of institutional investors asserting themselves. In January, 2009, the Investors' Committee of the President's Working Group on Financial Markets, which represents a broad array of institutional investors and investor advocates, issued its report, *Principles and Best Practices for Hedge Fund Investors* — a sweeping review that called on investors to push for best practices that would reduce the "systemic risk" associated with hedge funds and address investor concerns. Soon afterward, CalPERS and several other of the nation's largest pension funds issued a public "statement of principles" urging reforms to protect pension assets, including greater disclosure and transparency regarding investments and increased regulatory oversight. Meanwhile, the U.S. Department of Labor issued guidance for corporate pension plans regarding valuation of hedge fund assets.

The experiences of the last eighteen months have not only underscored the fallibility of hedge funds, but also triggered an investor empowerment movement. In these uncertain times, both hedge fund managers and investors can be sure of one thing: new rules of engagement are being written.

Rule 1:

If there ever was any doubt, now it's clear that institutional investors hold the power

SEI's 2008 and 2009 survey results underscore and document this power shift as well as the continued commitment of institutional investors.

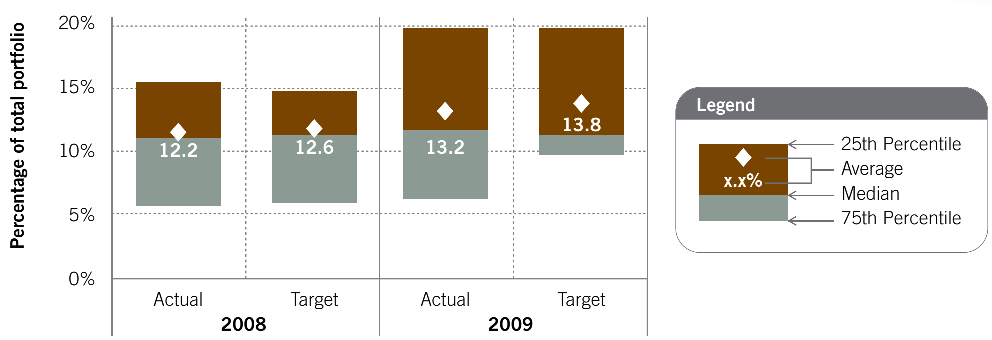
SOLID COMMITMENT

Our 2008 survey found institutions resolute in maintaining a long-term perspective even as the crisis deepened. Most respondents said they were maintaining their commitments to hedge funds, with only 7% planning to reduce their target allocations.

A year later, our 2009 survey demonstrates that institutions remain committed to allocating some portion of portfolio assets to hedge funds as a long-term strategy. Investors were certainly disappointed that hedge funds did not fully deliver the absolute returns and downside protection investors expected. But mitigating their distress was the fact that they would likely have fared far worse with unhedged portfolios. In fact, it appears that if anything, the economic crisis has reinforced the ongoing trend toward alternative investing. This conclusion is echoed by a recent SEI survey revealing that institutions are also maintaining their commitment to private equity investments.[4]

But while confirming institutional investors' intentions to stay the course with hedge funds, survey results also show that investors are also exerting their influence to demand greater portfolio and process transparency *[see Rule 2]*, to broaden fund selection criteria *[see Rule 4]* and, in some cases, to press for lower fees.

Figure 3: Hedge fund allocation trends, 2008 - 2009

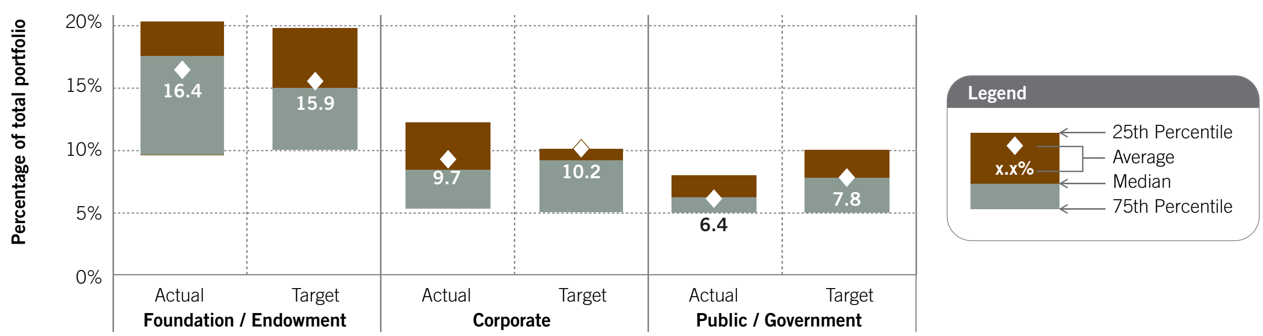


Source: SEI Knowledge Partnership

GRADUALLY RISING ALLOCATIONS

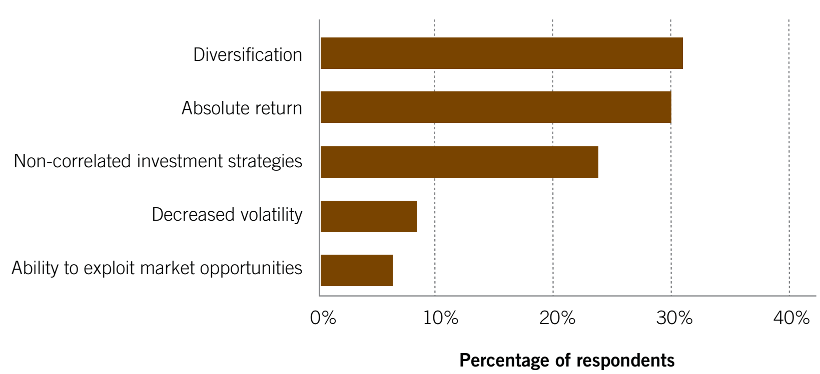
Based on our 2009 findings, institutional allocations to hedge funds remained steady or even rose modestly over the past year in terms of their share of portfolio assets *[Figure 3]*. Among U.S. investors, statistically the best gauge of allocation trends within our sample, the average target allocation rose from 12.6% in 2008 to 13.8% in 2009, with actual allocations only slightly trailing the target. Consistent with historical patterns, reported allocations were highest among foundations and endowments, which reported actual allocations nearly three times the size of those by public and government plans *[Figure 4]*.

Figure 4: Actual and target allocations to hedge funds by investor type



Source: SEI Knowledge Partnership

Figure 5: Primary objective when investing in hedge funds



Source: SEI Knowledge Partnership

Interestingly, results show a direct correlation between the level of allocations and the institutions' years of experience with hedge fund investing. The 2009 allocations made by respondents with a track record of ten years or more were triple the allocations of those with five or fewer years of hedge fund investing experience.

Of course, hedge funds still represent a relatively small percentage of investments for most investors. Nearly half the 2009 respondents reported allocating 10% or less.

Our survey respondents did not anticipate a shift in their current allocations trend; nearly 80% said they planned "no change" in the share of assets invested in hedge funds over the coming year. Nonetheless, approximately 15% expect to increase their allocations — twice the percentage who said they plan to cut back.

IN FOR THE LONG HAUL

The institutions surveyed made it clear why they remain committed to hedge fund investing despite the shocks and losses of 2008. They are long-term investors who invest in hedge funds seeking diversification and absolute return. As in 2008, this year's survey respondents ranked those two aims as their primary objectives for hedge fund investing *[Figure 5].*

INVESTORS EXERTING AUTHORITY

Given all the other pressing issues at hand, fees ranked low on the list of worries and challenges named by survey respondents. Moreover, only one in four respondents named fees a "very important" manager selection criterion, only a modest increase over last year's results.

But that does not mean investors have ignored fees. Indeed, nearly 19% of our survey respondents reported successfully negotiating fee structures different than the standard 2/20 (for single-manager funds) or 1/10 (for FOHFs) formula in the previous year. Larger institutions with more than $1 billion in assets were the most likely to report success in renegotiating fee arrangements. Respondents more commonly reported negotiating a lower management fee while leaving the performance fee intact.

A Word About Managed Accounts

The recent flurry of discussion and activity regarding managed accounts is one more example of institutional investors asserting their influence. After Madoff and other scandals, investors registered growing interest in shifting toward a managed account structure, as a way to enable greater transparency, liquidity and control. Some hedge fund managers have accommodated this change, perhaps with an eye to resetting high-water marks as well as attracting new capital. Nonetheless, our survey results confirm only a modest shift toward managed accounts. Only 5% of our survey respondents said they had made any move from a pooled fund to a managed account structure during the previous 12 months, and only 7% reported plans to do so in the coming year.

Rule 2:

Greater transparency is the price of institutional commitment

In the current institutional investor mindset, none of the issues raised by our 2009 survey looms larger than transparency — or the lack thereof — which respondents named as both their biggest worry and, in response to an open-ended question, as their single greatest challenge as hedge fund investors *[Figure 6].* This is no surprise. For many institutional investors, 2008 brought the stark realization that they can no longer afford to be in the dark about the risks and inner workings of their hedge fund investments. At the same time, after a year in which assumptions of non-correlation and downside protection were battered, fund managers can less easily justify a veil of secrecy in the name of competitiveness.

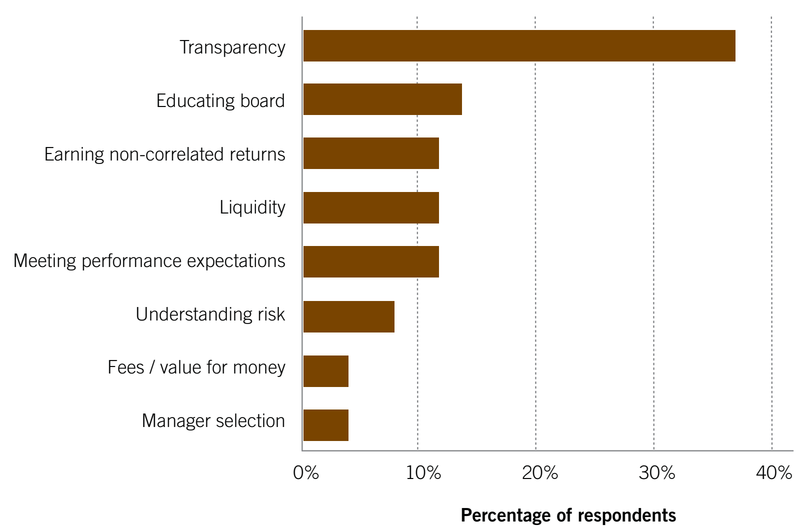
Investors' focus on the issue indicates they will not only push hard for greater transparency, but also will increasingly make it a prerequisite for hedge funds in which they invest. Nearly 80% cited "portfolio transparency" as an important or very important factor in manager selection, *[Figure 10, page 14].*

In their open-ended comments, survey participants described their transparency expectations in varying ways. For example, one defined the challenge as "obtaining adequate information to fully understand the fund's strategy," while another explained it as "having a deep understanding of the underlying positions to be sure that the risk profile is well in line with what we are looking for." All in all, survey responses make it clear that institutions are concerned with transparency as it applies to a hedge fund's investment process, as well as its portfolio. Investors want sufficient communication and reporting to assure them that hedge funds are generating alpha from a consistent approach that is in line with the fund's stated strategy. They also want a thorough understanding of the risk characteristics of fund performance, as well as risk management methods and controls being utilized.

Investors' focus on transparency also related directly to the second greatest challenge they cited, "educating board members." In their responses, survey participants spoke to the difficulties of "explaining why absolute return funds did not perform as expected," "convincing trustees of the added value of investing in hedge funds," and "educating the board on the use of hedge funds within a diversified portfolio."

Investors rank transparency #1 among worries and challenges in hedge fund investing

Figure 6: Single most important challenge faced as hedge fund investors



Source: SEI Knowledge Partnership

A PROACTIVE APPROACH

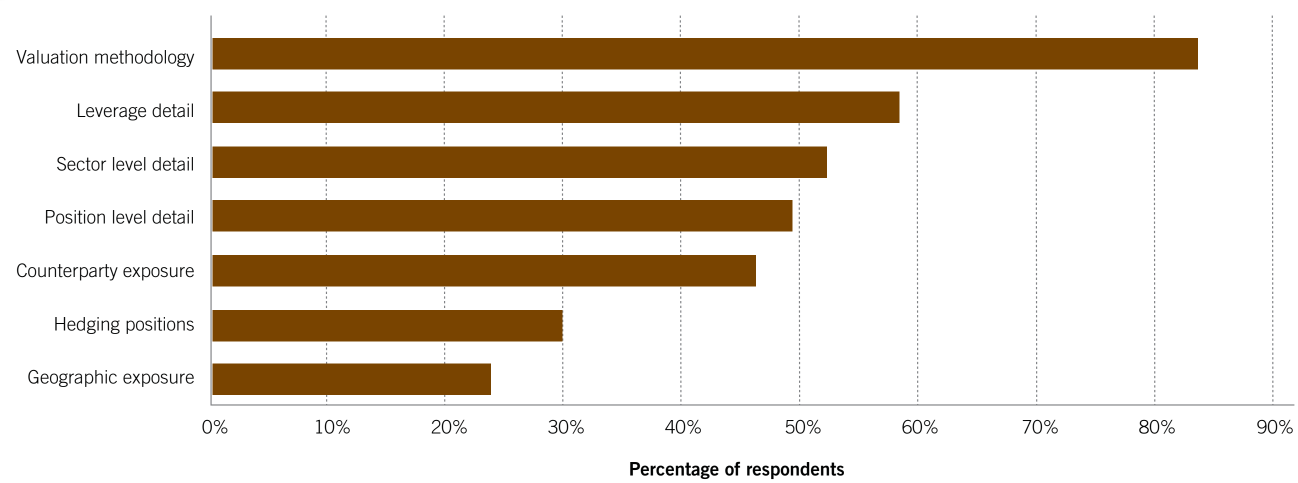
Our survey also demonstrates that investors are acting on their expectations of greater transparency. Overall, 71% of respondents said they were requesting more detailed information from managers than they did a year earlier. More seasoned hedge fund investors emerged as more proactive on this score. Among respondents with five or more years of experience, more than three-fourths reported seeking more transparency from managers, as opposed to about two-thirds of those with less experience.

SPOTLIGHT ON VALUATION

When asked what kind of new information they were seeking, investors overwhelmingly named valuation as the function on which they most want more information, followed by detail regarding leverage, sector exposure, portfolio positions, and counterparty exposure *[Figure 7]*.

When asked what contributes to accurate valuation of hedge fund holdings, respondents emphasized the importance of independent auditing, which was named "very important" by 72% of those surveyed. Those surveyed also looked for independence in the form of third-party valuations and independent administration, which were named "very important" by 47% and 40% of respondents, respectively.

Figure 7: New types of detailed information sought from managers



Source: SEI Knowledge Partnership

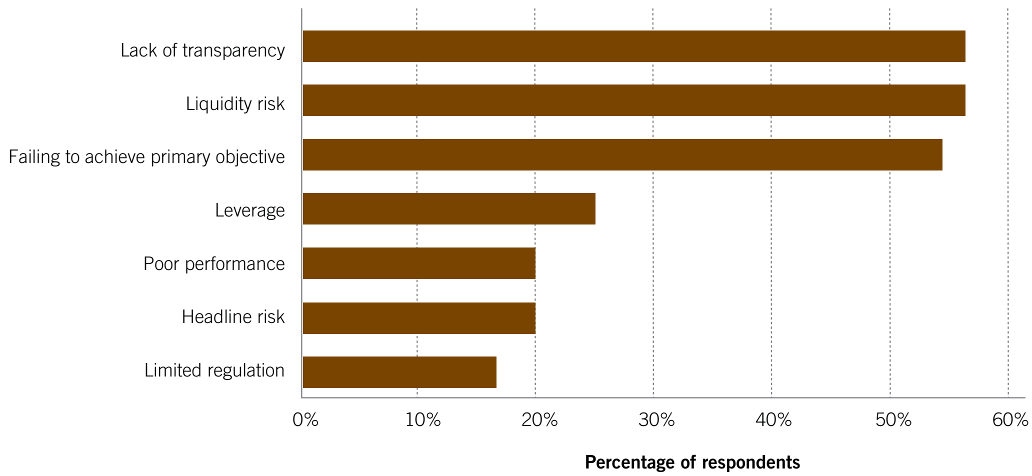
Rule 3:

Performance is important, but what's behind the numbers is equally important

Investors' worries and perceptions of risk show how much their views on hedge fund investing have been altered by the financial crisis. In SEI's 2008 survey, "poor performance" was investors' top worry by far, named by 84% of those queried. In the 2009 edition, short-term performance ranked only fifth on the list of investor concerns, having been eclipsed by worries over inadequate transparency, liquidity risk, and funds that fail to fulfill primary investment objectives such as diversification and absolute return *[Figures 8 and 9].* The fact that performance concerns dropped substantially may have been due to hedge funds' improved performance in 2009 and the diversification benefits they generally provided relative to long-only indices in 2008.

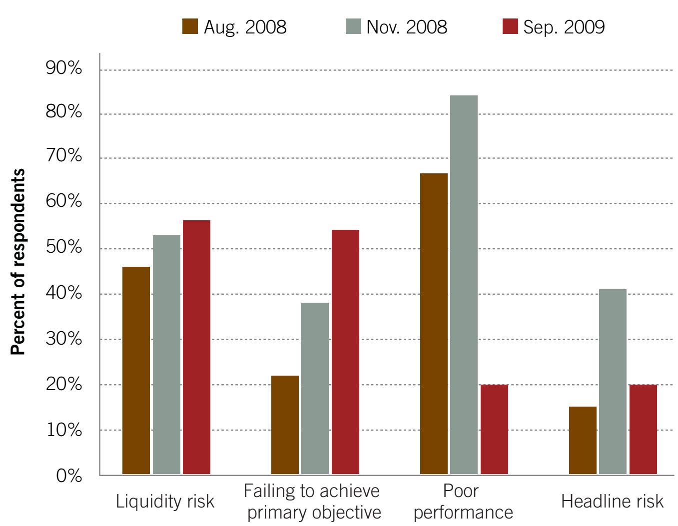
In any case, survey results show how institutional investors are adapting their selection criteria to a more challenging environment. Investors were more focused than ever on understanding the fundamental risks associated with managers and their investment strategies. In particular, they were looking beyond performance numbers to focus on the factors generating the performance. In fact, three of the classic "four P's" — people, philosophy, and the process for generating alpha — remained at the top of the list, as they were in 2008 *[Figure 10].*

Figure 8: Biggest worries about hedge fund investing



Source: SEI Knowledge Partnership

Figure 9: How worries have shifted



Source: SEI Knowledge Partnership

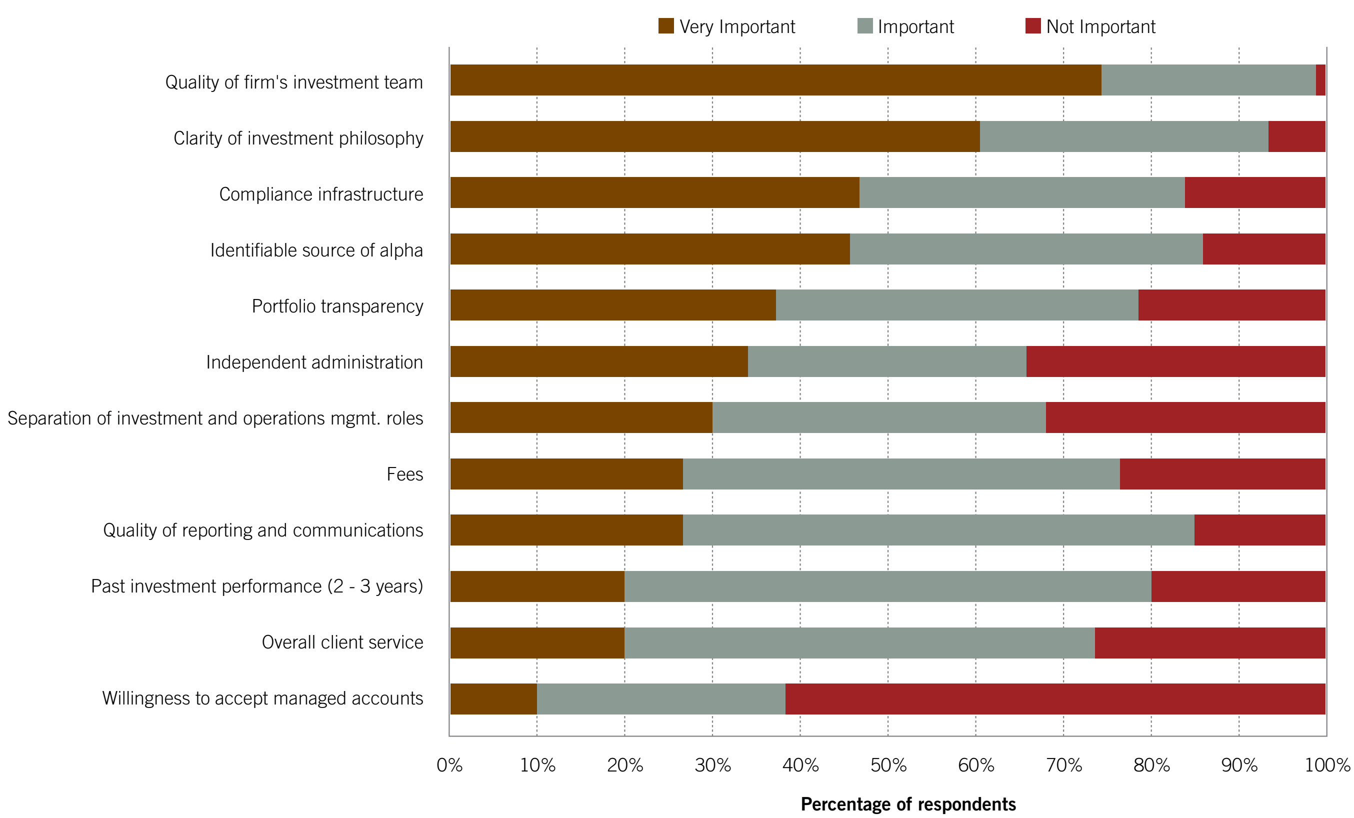
Rule 4:

More and more, the quest for quality managers extends from investment functions to operations

Enhanced due diligence is not a temporary reality. Our survey reveals that investors now are concerned with issues ranging from liquidity risk, counterparty risk, compliance infrastructure and controls on valuation methods.

Having suffered a period in which no asset class provided protection from a wholesale market decline, investors now are paying greater attention to managers' operational infrastructure. "Compliance infrastructure" and "independent fund administration" have risen higher on institutional checklists. In addition, in the 2009 survey, two out of three respondents also identified a separation of investment management and operations management roles as an important or very important factor in selecting managers.

Figure 10: Importance of factors in hedge fund manager selection



Source: SEI Knowledge Partnership

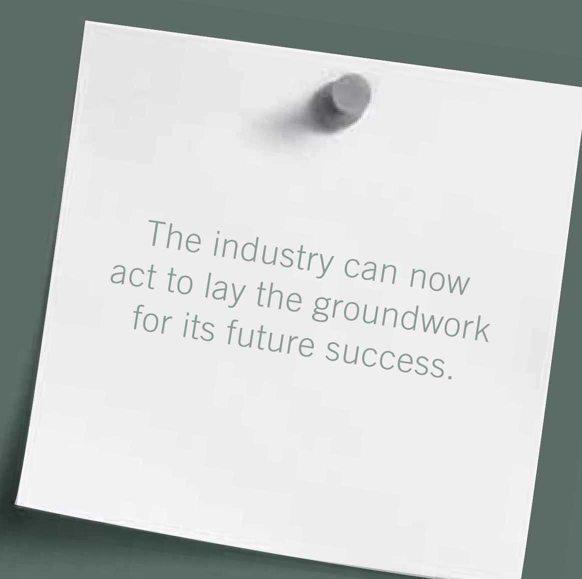
Conclusion

SEI's 2009 survey documents the enduring relevance and appeal that hedge funds have for institutions operating in a long-term investment framework. While the fallout of last year's financial crisis shocked hedge fund investors, who saw returns significantly lower and more correlated with unhedged indices than anticipated, they are maintaining and even strengthening their commitments to hedge fund investing.

But by no means can hedge fund managers expect a resumption of "business as usual." Over the past year, hedge fund investors have become aware of some of the hidden risks inherent in their quest for diversification and absolute returns.

As a result, institutions are delving into fund strategies and practices as never before. They are intensifying their scrutiny of funds, broadening their selection criteria, conducting even more thorough due diligence, and demanding greater transparency. In short, investors are rewriting the rules of engagement as they continue absorbing the lessons of the past 18 months.

With their continued commitment of assets, institutions have given the hedge fund industry a provisional vote of confidence accompanied by a strong mandate and clear blueprint for change. Having navigated through the worst of times, the industry can now act to lay the groundwork for its future success.

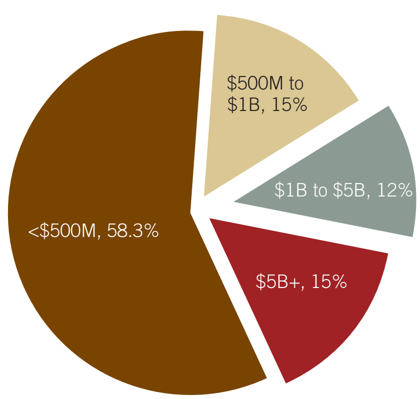


About the Survey

SEI's third annual global survey of institutional hedge fund investors was conducted in November 2009 by the SEI Knowledge Partnership in collaboration with Greenwich Associates. Online questionnaires were completed by senior investment professionals at 96 institutions. Characteristics of the survey universe were as follows:

- Participating organizations ranged in size from less than $500 million to more than $20 billion in assets.
- Investor type: 56% of respondents represented foundations or endowment funds, 23% corporate funds, 19% public or government funds, and 2% Taft Hartley funds.
- Geography: 83% are based in the U.S., 10% in the United Kingdom, and 7% in continental Europe.

Figure 11: Survey universe by asset size



Source: SEI Knowledge Partnership

[1] Lawrence Cohen and Thomas M. Griffin, "A Run on Hedge Funds: Redemption Strategies and Responses," *FINalterantives.com,* December 30, 2008

[2] Jack Willoughby, "The Hedge Fund 100: Acing a Stress Test," *Barron's,* November 23, 2009

[3] Christine Williamson, "Preqin: 72% of hedge fund assets from institutions," *Pensions & Investments,* November 9, 2009

[4] "Private Equity Investors – Committed Yet Concerned," *SEI Knowledge Partnership,* December 2009. To access this report, visit www.seic.com/PESurvey

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The SEI Knowledge Partnership is an ongoing source of action-oriented business intelligence and guidance for SEI's investment manager clients. It helps clients understand the issues that will shape future business conditions, keep abreast of changing best practices, and develop more competitive business strategies. The Partnership is an initiative of SEI's Investment Manager Services division.

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