

The Era of the Investor

New Rules of Institutional Hedge Fund Investing

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.

Welcome to the Era of the Investor.

Key Findings

Institutions have maintained their commitment to hedge fund investing.

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.

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. Over 70% reported requesting more detailed information from managers than they did a year earlier.

Worries over performance have been eclipsed by other concerns. 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.

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. 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.

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