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6 Ways Hedge Funds Need to Adapt Now

Institutional investors and fund managers speak out on what it takes to succeed in a tough climate

SEI Knowledge Partnership
Insights for Investment Managers

THE SIXTH ANNUAL GLOBAL SURVEY
of Institutional Hedge Fund Investors +
Insights from Industry Roundtables

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ABOUT THE SURVEY

SEI's sixth annual survey of institutional hedge fund investors was conducted in November 2012 by the SEI Knowledge Partnership. Online questionnaires were completed by senior investment professionals at 107 institutions.

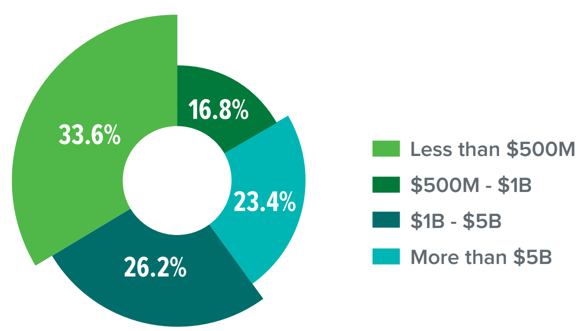
Endowments and foundations account for 19% of all survey respondents. Pension plans account for another 18% of respondents, with public plans dominating. Family offices account for 9% of responses. Funds of hedge funds (FoHF) accounted for one-third of all responses. FoHF data was tabulated separately from other institutional investor responses. Remaining responses came from banks, insurance companies, and non-profit organizations.

Participating organizations ranged in size from less than $500 million to more than $20 billion in assets [Figure 1].

Compared to last year's survey, the distribution of respondents was larger in size, particularly at the over $5 billion range, at the expense of the under $500 million segment, while it was very similar to the universe of respondents to the survey conducted in the autumn of 2010.

Half of all respondents are based in the United States. A third are based in continental Europe and the United Kingdom. The rest are based in Asia, the Middle East, and Canada.

FIGURE 1 Survey Universe by Asset Size (% of respondents)



Source: SEI Hedge Fund Investor Survey

ABOUT THE INDUSTRY ROUNDTABLES

We heard from a number of institutional investors, consultants, and industry advisors, as well as top hedge fund practitioners, in two sessions that were held in New York and London in October 2012. Both discussions were organized and moderated by industry veteran Rachel S.L. Minard, CEO of Minard Capital LLC (www.minardcapitalcom), an outsourced marketing consulting firm dedicated to helping alternative asset firms win and retain global institutional mandates. We sincerely thank all the roundtable participants who took the time to provide their insights and thoughtful perspectives on the industry's future.

Where Are We Today?

It has been nearly five years since the financial world was turned upside down. The events of 2008 and their aftermath are burned into the memories of asset managers and investors alike. For those who are still in the process of recouping their losses, the pain is all too present.

For the hedge fund industry, 2008 looms even larger as a watershed year. It was, as the R.E.M. song lyric goes, "the end of the world as we know it."[1] It's not that clients exited *en masse*, or that hedge funds suddenly lost their touch. But veteran fund managers will tell you life was certainly easier back in 2007. Even though investors had long been disabused of the notion that hedge funds could be relied upon for positive returns every year, their role as portfolio diversifiers seemed secure. "Two and twenty" was the industry-standard fee, clients assumed their hedge fund investments would add value over time, and liquidity restrictions were accepted as part of the price for access to exceptional investment talent.

What a difference five years makes. While major investors may have excused hedge funds' failures to protect assets back in 2008, given that virtually every index plunged, the industry has failed to make a dazzling comeback. In fact, it has now seen a decade of generally disappointing performance. [Figure 3]

After the financial crisis, any lingering feelings of complacency among investors dissolved. No longer is it assumed that a hedge fund will deliver unequivocal portfolio value, even if it can tout a good track record. And no longer can managers simply "show and tell." Now investors want proof; they also want to "look under the hood" to funds' inner workings, and judge for themselves.

Down for the count?
Not even close....

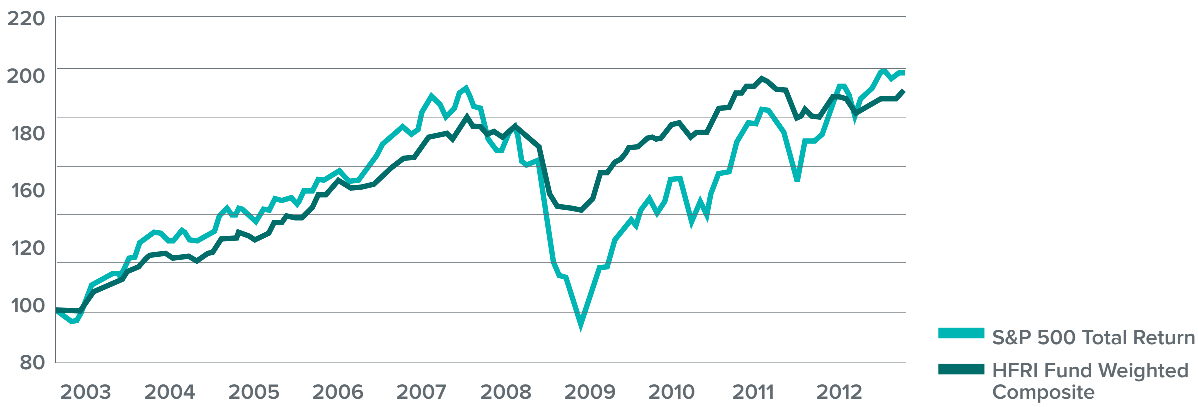
But while hedge funds may be down, they are by no means out. As the quintessential long-term investors, the institutions that have become the industry's mainstay still want hedge funds in their toolkits, even as they rethink the terms of those relationships. In fact, SEI's 2012 hedge fund survey found that institutional investors are generally maintaining, and even somewhat increasing, their allocations to hedge funds. With current allocations averaging 14.8% of total portfolio assets across all respondents, almost one-third said they plan to increase their allocations to hedge funds over the coming year; the average planned increase was 0.8%. Meanwhile, over half our respondents expect to leave their allocations unchanged and only 16% plan to decrease their exposure. Our findings of projected allocations are consistent with those of global consultancy Towers Watson, which, looking back to actual behavior, reported that its institutional investor clients worldwide allocated a record $12 billion to alternative strategies in 2012, a 70% increase from 2010.[2]

FIGURE 2 Actual and target allocations to hedge funds by investor type (% of portfolio)

Source: SEI Hedge Fund Investor Survey

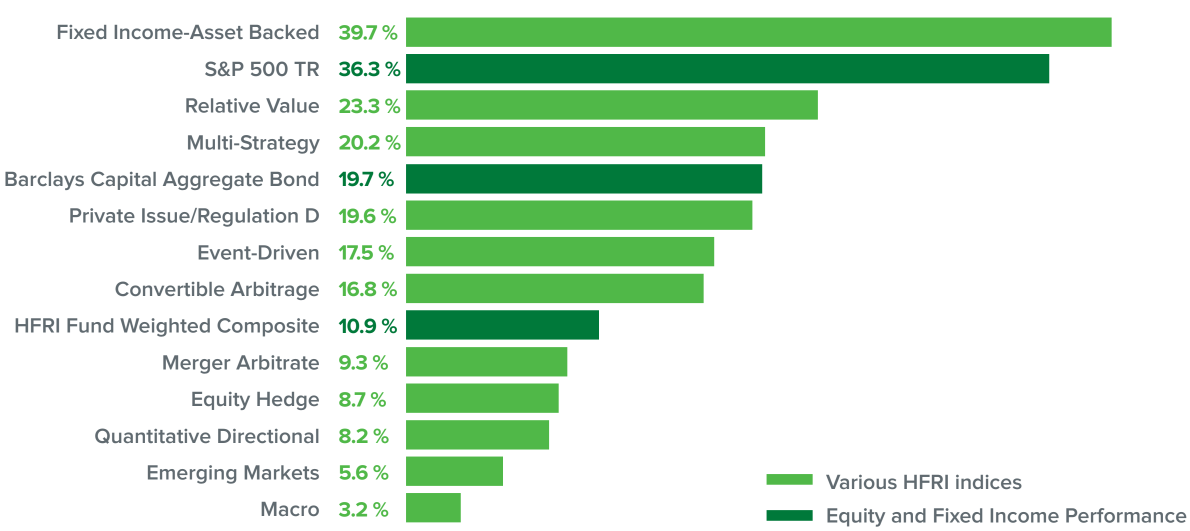
At the same time, as detailed in this report, our survey results reflect the challenges that hedge funds are facing, not the least of them rising institutional dissatisfaction with their performance. There is no doubt that today's climate of slower economic growth, low yields, elevated asset-class correlations and more competition makes it harder for hedge funds to live up to their past outperformance. That the HFRI composite index has lagged the S&P 500 since 2003 only makes it worse. It comes as no surprise that hedge fund managers increasingly object to studies and media reports that view the industry as monolithic, painting widely variegated strategies with the same broad brush of underperformance.

FIGURE 3 Trailing 10-year relative performance of HFRI Fund Weighted Composite Index vs. S&P 500 (indexed to 100) as of 12/31/2012



Source: Hedge Fund Research; Standard & Poor's

FIGURE 4 Equity and fixed income performance vs. hedge fund indices: 3-year trailing cumulative returns (as of 12/31/2012)



Source: Standard & Poor's; Barclays Capital; Hedge Fund Research

Meanwhile, institutions continue to escalate their demands for transparency and intensify their due-diligence processes. Almost a third of our institutional investor survey respondents reported making changes to their due diligence processes over the past two years, citing changes including more reporting and documentation requirements, greater detail on valuation and operational processes, and more in-depth, qualitative and quantitative consultant assessments. Yet some see the institutionalization of hedge funds over the past 15 years as a double-edged trend that may hinder performance even as it brings more discipline and accountability to the industry.

Hedge funds are also dealing with an increasingly challenging and competitive business climate. Costs are rising, and so are fee pressures, as investors demand negotiated fees more in line with the value they believe they are getting. Indeed, a recent Preqin study confirmed that fees are dropping, with only 42% of single-manager hedge funds still charging the industry standard "two-and-twenty."[3]

Presumably, larger, more established hedge funds are the ones best able to hold the line on fees—which brings up another challenge for the industry, namely the fact that, as detailed later in this report, a relatively small number of large, established funds continue to attract the lion's share of asset flows into hedge funds.

Agecroft Partners predicts that just 5% of funds will attract 80% to 90% of all net asset flows to hedge funds in 2013.[4]

These trends are only accelerating the Darwinian churn of attrition, consolidation and creation within the industry's ranks. Clearly, success has become more elusive for hedge fund managers, especially those who are struggling to recoup losses or are just getting started.

To explore what directions the industry is taking now, and how hedge fund firms can better equip themselves to succeed, we complemented this year's survey of institutional investors with wide-ranging roundtable discussions among top hedge fund practitioners in both New York City and London. Consultants and industry advisors were also represented, giving us a broad perspective on the future of the industry. On some topics, such as the need for hedge funds to provide proof of the value they deliver, we found strong consensus; on others, there was sometimes a surprising divergence of opinion—more evidence of the complexity and continuing evolution of today's industry climate. We hope this report will provide fund managers, institutional investors and other industry participants with actionable insights as well as jumping-off points for further discussion.

7 in 10 institutional investors agree:
"There are too many look-alike strategies in the hedge fund industry."

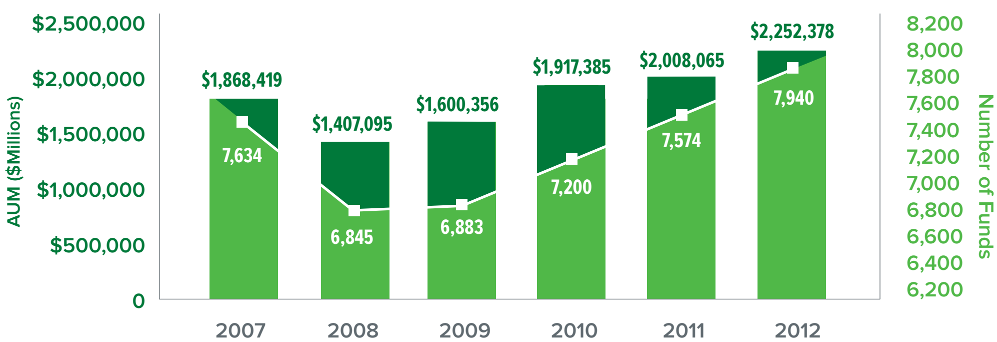
- SEI Hedge Fund Investor Survey

THE KEY CHALLENGES NOW
— And How Managers Need to Adapt

1 SUSTAINABLE EDGE

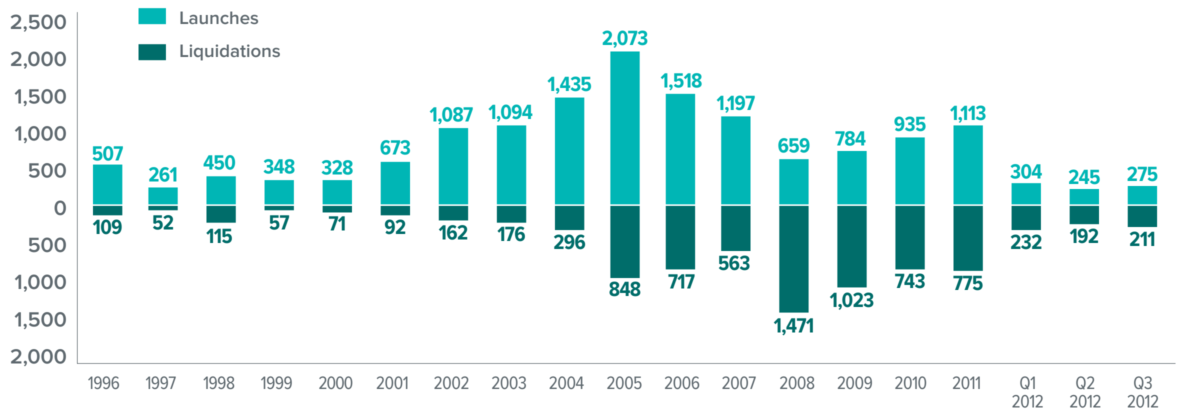
Competition among hedge funds has never been keener. That is due in large part to the sheer proliferation of funds; an estimated 7,940 hedge funds and 1,870 funds of hedge funds are in existence today, according to Hedge Fund Research (HFR). Not only is the industry not a singular monolithic entity, but rather a complex mosaic of firms, funds, and strategies, it's one that is continually shifting. Based on the HFR database, on average more than 840 funds have been shuttered each year since 2005, attesting to the Darwinian nature of the business. Meanwhile, new hedge funds keep springing up—more than a thousand in 2011 and about that many in 2012.

FIGURE 5 AUM and number of funds



Source: Hedge Fund Research (HFR)

FIGURE 6 Number of funds launched/liquidated



Source: Hedge Fund Research (HFR)

It's no wonder that institutional investors in SEI's 2012 survey named "manager selection" among the top three challenges of hedge fund investing.

For them, the task is not only finding a fund that fits their mandate and has an acceptable track record, but also determining whether that track record is due to a repeatable and sustainable investment process rather than pure luck. In their roles as investors and allocators, FoHF managers are in more or less the same situation. Compounding the challenge is the perception, expressed by seven out of ten institutional investors responding to our survey, that "there are too many look-alike strategies in the hedge fund industry today." Today's investors are clamoring not just for absolute returns, but for "differentiated alpha sources" that can produce non-correlated returns.

In short, differentiation is key for institutional investors and hedge fund managers alike. Observed Marsha Roth, senior managing director with Angelo, Gordon & Co., "Differentiation is critically important for managers in order to get institutional investors to understand the value your fund brings to their portfolio. While differentiation is a simple concept, it is difficult to accomplish because of the proliferation of funds. It is important to educate investors about what you do and how you do it, and a key part of that differentiation is the team."

As the asset management industry continues to evolve and mature, institutions and consultants keep devising new sets of tools in an effort to differentiate among managers over time. Meanwhile, for hedge fund managers, the quest for performance is just the beginning. Those who strive to stand out face an array of hurdles along the way.

"The edge among hedge fund managers is getting blurred and much harder to quantify, leading to an increased need to conduct comprehensive due diligence to find managers who will earn their fees."

- Ted Logan, Managing Director, BlackRock

Demands for proof of concept

It's not enough for hedge funds to distinguish themselves in terms of their pedigree, talent, strategies, and performance. They must also clearly articulate their investment process, and explain what makes their results repeatable (not to mention worth the fees they are asking). They must also show that their funds are scalable, from both an investment and an operational standpoint, and why they will be able to continue delivering strong results as they grow. On top of that, fund managers must provide the ongoing transparency necessary to prove that their processes are working as intended.

Back when hedge funds were outperforming and secrecy was considered part of a manager's edge, it took much less to gain investors' confidence. Today it's a completely different proposition. Instead of saying "we trust your judgment," investors want attribution and analysis. Rather than ticking off items on a checklist, as many were doing a few years ago, they are triangulating qualitative and quantitative assessments. Moreover, they may at times go granular, asking managers to justify and explain specific investment decisions in the context of their overall portfolio construction models and current macro-economic environment. Few managers would be surprised that nearly one-third of the institutions queried in SEI's 2012 survey reported making their due diligence processes more robust over the last two years.

The hunt for true alpha-generating talent

The industry's world-beating reputation was shaped by a generation of brilliant managers with unique views of the world and, perhaps, the good fortune to come along at a time when the economic winds were at their backs. The hedge fund realm is still known as a talent magnet. Indeed, a majority of respondents to SEI's latest survey agree that "hedge funds attract the world's best and brightest investment talent."

But the industry no longer resembles Garrison Keillor's mythical Lake Wobegon, where "all the children are above average." Many of our roundtable participants say it has become harder to identify exceptionally talented managers—not only because there are relatively fewer genuine stars in an increasingly populated industry, but also because delivering true alpha, and not just "closet beta," has become so much more difficult. That's due to several reasons, from tougher market conditions to the constraints that come with institutionalization, the capacity limits affecting many strategies, and investors' skittishness when return streams are volatile.

Ron Sellers, founder and CEO of Atlantic Asset Management, reported contact with nearly 300 managers in order to find four deemed worthy of sponsoring. No wonder some say the hedge fund talent hunt is like looking for the proverbial needle in a haystack.

The marketing challenge

Is it a surprise that many of the top investors on Wall Street attribute their asset and client growth not to their investment results, but to effective marketing? The idea that "perception is reality" is never more relevant than in the hedge fund industry.

Start-up fund managers are often unprepared for the level of thought and resources required to market hedge funds effectively. But it has been a long time since touting returns and philosophizing about markets was a viable strategy.

With an evolving business model that requires them to show, prove, verify—and, of course, serve—hedge funds must tell a complex marketing story, many elements of which cannot easily be quantified and bullet-pointed. "One of the hardest things to do is understand the process that's involved in generating alpha," said Jacob Gottlieb, CIO of Visium Asset Management. "Track records from the eighties and nineties are less valuable right now. Some strategies that had very good returns back then haven't done much over the last five or ten years. Markets and even individual equities have become much more efficient. There's less gross alpha available, hence the importance of a process and ability to consistently mine alpha."

What's more, firms must make their stories both compelling and concise. "You have to be able to clearly articulate your value upfront or you're going to lose the prospect," warns Matthew Stadtmauer, president of Pine Grove Asset Management.

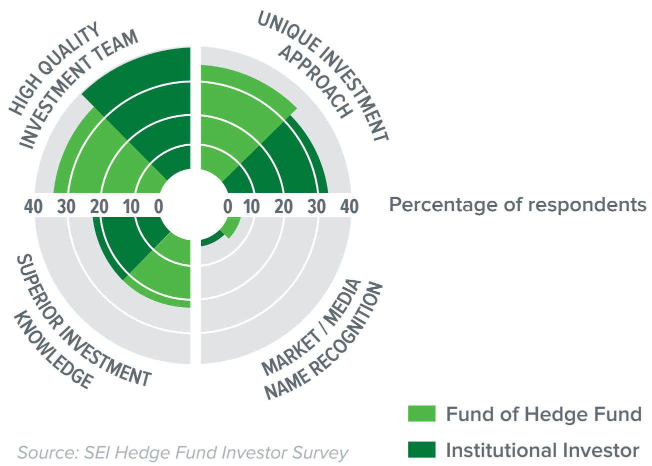
Of course, as seasoned managers understand, winning the business isn't the end of marketing; in one sense, it's really the beginning. Far from being purely informational, client communication gives a fund a recurring opportunity to help clients understand the value the fund is delivering and how its results square with the client's specific requirements and preferences. This is an area ripe with opportunities for differentiation. For example, SEI's survey found that only half of all investors say they fully understand the risk exposure of the hedge funds in which they invest, and one in four say they do not understand it at all.

Lack of consensus on "brand"

While there has been much discussion of "brand" as a way hedge funds can differentiate, its definition remains fuzzy, as does its importance in manager selection. Some maintain that brand is a key factor driving fund flows, and point to the cachet of hedge funds with high-profile founding partners. Others point to major blow-ups like Long-Term Capital Management and Amaranth Advisors, as well as studies suggesting investors are more loyal to individual portfolio managers than to the impressive names on the firm's letterhead.

Our survey results reflect this ongoing debate. When we asked institutional investors to define "brand," their answers diverged. Respondents were similarly torn on the importance of brand; one-third said it makes no difference in their selection of hedge funds, one-third disagree, and one-third are neutral.

FIGURE 7 How institutional investors define "brand"



Source: SEI Hedge Fund Investor Survey

Clearly, fund managers cannot rely on investors to use one prevailing definition or attitude when it comes to brand; that is one more topic that can be illuminated only through client-by-client dialogue. It is worth noting how few of our survey respondents defined a hedge fund's brand in terms of marketplace recognition or media image; marketing hedge funds is a distinctly different proposition from selling Apple, Coke, or J. Crew.

Bruce Frumerman, CEO of investment management industry communications and sales marketing consultancy, Frumerman & Nemeth Inc., comments that, in the hedge fund context, a firm's brand is its story about how it invests. "You know your firm has graduated from commodity to brand when, after stating your fund's name and strategy category, a prospect can add two or three sentences of elaboration about how you invest," he says. "If a hedge fund doesn't actively market its investment-process story, it won't outgrow being perceived as a replaceable commodity, known only by the pigeon-hole category of its strategy and its most recent returns."

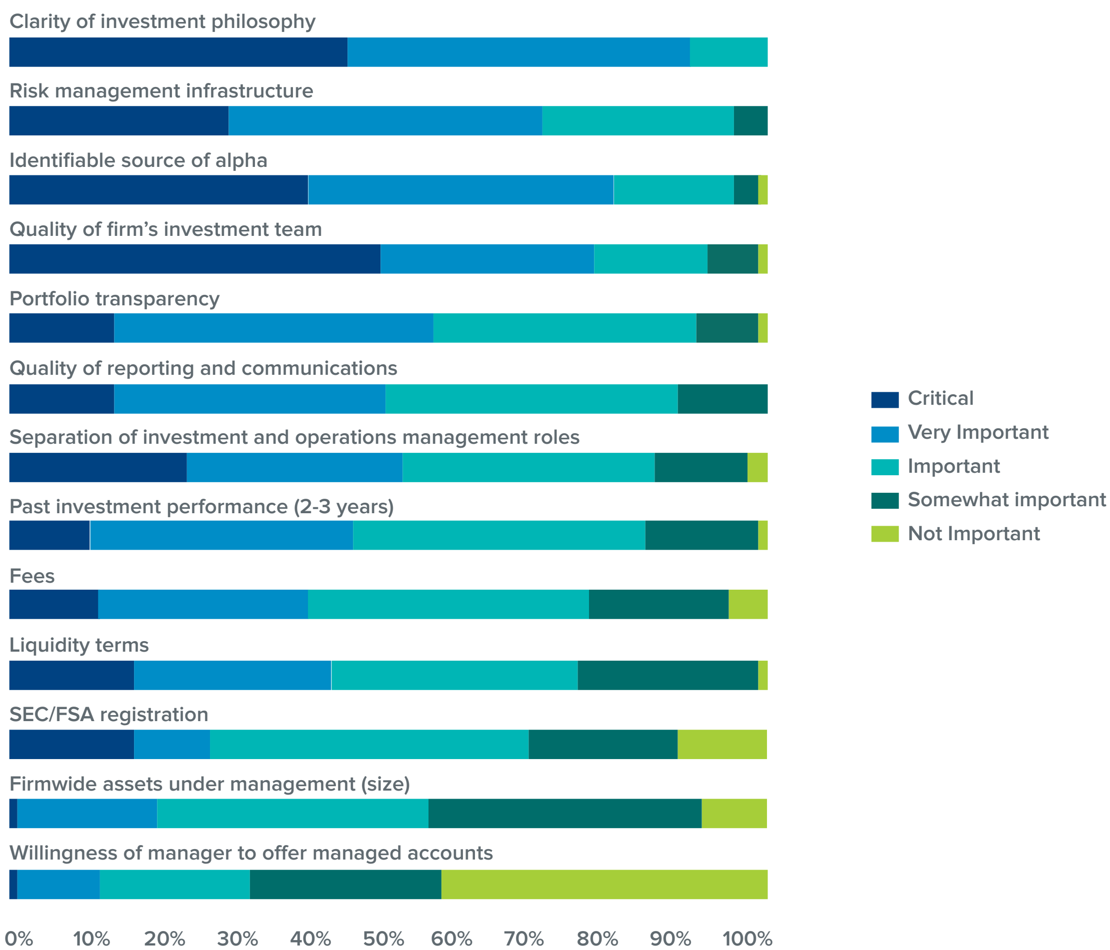
"This is an area **ripe with opportunities** for differentiation."

- Matthew Stadtmauer, President, Pine Grove Asset Management

What are institutional investors really looking for?

While the bar for competing hedge funds feels higher than ever, investors' priorities in evaluating and selecting hedge funds have changed little over the past five years of SEI investor surveys. Three of the "four P's"—philosophy, people, and process (in the form of "an identifiable source of alpha") — have consistently been among the top-ranked selection criteria. Transparency, too, has remained high on the list, even topping it at times. Interestingly, performance is not uppermost, and fees are even further down the list. But that result doesn't mean fees aren't an issue; rather, it may suggest that investors are willing to pay for capabilities that line up well with their requirements.

FIGURE 8 Importance of factors in hedge fund manager selection (% of investors)



Source: SEI Hedge Fund Investor Survey

Sustainable Edge

TAKEAWAYS

1. Articulating a fund's investment process and what makes the results repeatable is Job One for fund managers; investors are looking for proof of the value that hedge fund firms deliver

2. To define who they are, hedge funds need to tell a story that is simultaneously concise, compelling and detailed—a tall order

3. Client communication provides an ongoing opportunity for funds to differentiate themselves; our survey shows risk management is one of the areas where investors want more understanding of hedge fund methods

4. Managers should provide ample opportunities for dialogue with prospects and clients, enabling them to square qualitative and quantitative assessments and get a clear picture of what sets their firm apart

2 ADAPTABILITY

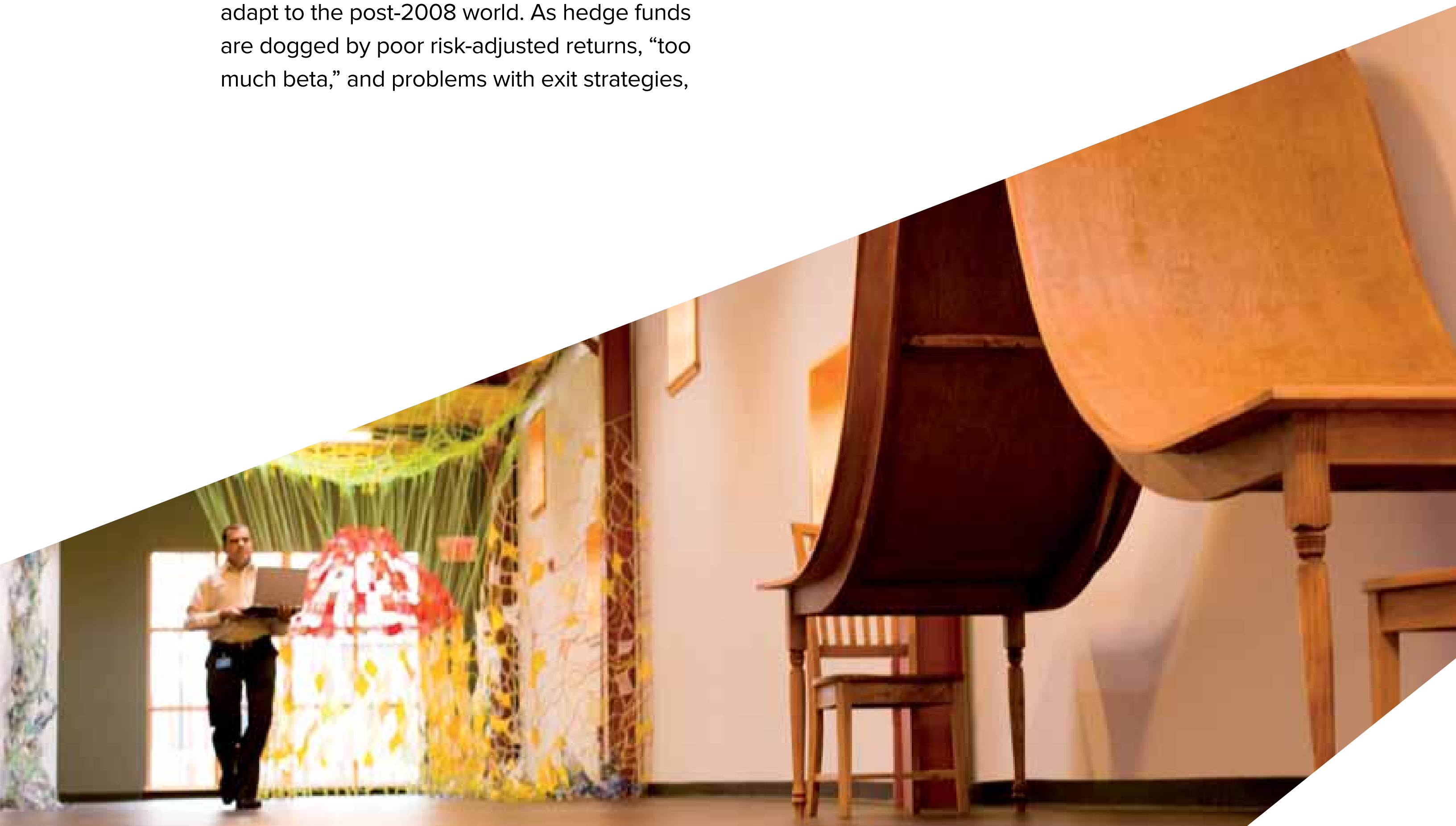
Viewed in hindsight, the days before the financial crisis now look like the hedge fund industry's golden era. Back then, the average hedge fund handily outperformed mainstream markets, major investors were happy to have a portfolio tool that could help smooth out return streams, and non-correlation was assumed.

Things are different today. Observed Chris Toomey, senior vice president with Morgan Stanley Private Wealth Management, "If you're looking to raise money in the hedge fund world, you want to be large enough, transparent, liquid, deliver steady returns, maintain strict rules of investment, and have a strategy that's easy to explain to the end user. This is completely different than what the hedge fund universe was in the 1970s."

Ironically, the industry renowned for capitalizing on change through its nimble, flexible investment strategies is itself struggling to adapt to the post-2008 world. As hedge funds are dogged by poor risk-adjusted returns, "too much beta," and problems with exit strategies, they are increasingly under pressure by consultants and investors to prove their worth and rethink their business models. Now hedge fund managers must cope not only with an investment climate of low yields and erratic, risk-on/risk-off markets, but also with a spate of trends that are fundamentally reshaping the industry.

"The industry is crossing its fingers, closing its eyes, and hoping everything will go back to the way it was. **But it won't**."

- Lora Goldwater, Managing Director, Kingdon Capital



The search for solutions

No longer is it enough for hedge funds to offer investment products and capabilities. Investors now are seeking multi-faceted solutions—strategies that can not only deliver attractive returns with low volatility, but also help address a variety of portfolio issues, from high correlations and limited liquidity to the matching of return streams with liabilities. Hedge funds are being challenged to function as the "Swiss Army knife" in investors' toolkits, even as they are hobbled by today's low yields and a rallying equity market in which long-only strategies can do well while charging lower fees.

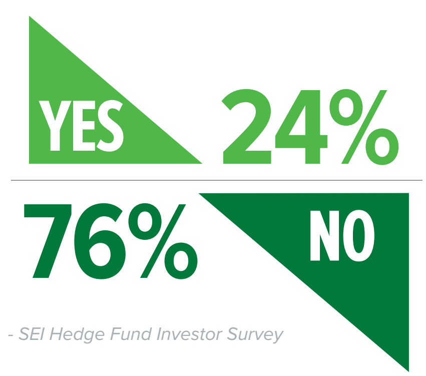
In the process, fund managers are dealing with capital markets that are being driven more by macro and policy factors than by fundamental valuation factors. Said Neil Collins, head of the Client Solutions Group within Alternative Investment Solutions at UBS, "It's an extremely difficult environment for hedge funds that are trying to drive in the middle of the road. It will not last forever, but things could remain this way for the foreseeable future."

Interest in registered products

Recent years have seen explosive growth in the packaging of hedge-fund-style strategies as registered mutual fund and UCITS products—a relief to individual investors and advisors frustrated by the constraints of long-only strategies. By the end of 2012, there were 317 SEC-registered mutual funds with assets of nearly $140 billion in Morningstar's "alternative" category. According to Strategic Insight, as of the end of November 2012, there were also 1,441 alternative UCITS funds with close to $250 billion in assets.

While it remains to be seen how deeply these strategies will penetrate the institutional market, registered products are certainly making some inroads. About one in four of the respondents to SEI's latest institutional survey say they plan to direct part of their hedge fund allocations to registered products, with banks, family offices and smaller institutional investors leading the way. They most frequently cite improved liquidity and transparency as the reasons they invest in these types of products, with regulatory oversight and the ability to access quality managers at relatively low cost named among other motivations.

Planning to invest in registered products?



- SEI Hedge Fund Investor Survey

However, only 11% of the large investors we surveyed (that is, those with more than $5 billion in assets) say they plan to invest in registered products, preferring to stay the course with limited partnerships and some use of managed accounts. On the other hand, adoption rates are highest among FoHFs, with about one in three FoHF managers saying they plan to use registered instruments.

There is no doubt that the uptick in interest in registered products is double-edged, spelling both competition and opportunity for hedge funds across the retail and retirement as well as institutional markets. Some firms have already succeeded in raising assets and diversifying their client bases by offering registered products, and others have announced plans to do so. The firms moving into registered products include such high-profile names as KKR, Arden, Blackstone, and Grosvenor, to name just a few, suggesting that this trend is one that managers will need to keep on their radar.

"We get a steady flow into our '40 Act alternative mutual funds. The opportunity set in the defined contribution space is huge and no one's really cracked the code. It's an exciting space right now," said Michael Rees, managing director of Neuberger Berman.

The rise of the specialists

Many asset allocators, including pension consultants such as Segal Rogerscasey and Fund Evaluation Group, are moving away from multi-product firms offering a plethora of capabilities in favor of specialists with clearly defined parameters around what they will and will not do. Accordingly, some consultants are also changing how they organize their investment research teams, establishing separate "alpha" and "beta" teams rather than having teams of generalists covering major asset classes.

The same trend can be seen in the FoHF business. Multi-strategy FoHFs are increasingly being disintermediated by investors using a core-and-satellite approach; that is, they make their largest allocations to core strategies and then diversify their exposures with smaller, directional investments with niche or boutique specialists.

New focus on business models

The combination of converging investment vehicles, challenging market conditions and rising investor demands is leading hedge fund managers to refine and rethink the business models by which they bring their strategies to the institutional marketplace.

"The institutionalization of the industry is leading to a classification of strategies by business models—be it traditional long-only, hedge funds, or private capital—and in terms of the asset classes in which they operate," comments Rick Nelson, CIO of Commonfund.

The key for fund managers is mapping their strengths and capabilities to the right models. As Jeff Keswin, founder and managing partner of Lyrical Partners, explained, the issue isn't a matter of economic structure alone, but gets to the building blocks of firm and brand identity. "What do you, as a hedge fund manager, want to stand for? Do you want to be all things to all people?' Get paid for high performance? Offer low fees? All of these decisions bring tradeoffs," he explained. "It comes down to who you want to be and how long you believe you can succeed in such determination."

What's next for funds of hedge funds?

Of all hedge fund industry segments, funds of hedge funds may be the one that has been most roiled by changing institutional demands. There is no doubt that FoHFs are diminishing in collective size and presence. In contrast to the strong rebound in assets under management by single-manager hedge funds after the financial crisis, total assets managed by FoHFs fell from their 2007 peak of $798 billion to less than $638 billion as of year-end 2012, according to Hedge Fund Research.

Meanwhile, the casualty count is rising. Although some FoHF firms are doing well, particularly the larger ones, many have shuttered, and many more are on the ropes and revenue-starved. The financial crisis has certainly contributed to their troubles; indeed, some FoHFs are still struggling to recoup the losses they suffered in 2008 and 2009. But widespread questioning of FoHFs' value proposition signals a more fundamental shift in their fortunes.

Our survey findings confirm that single-manager funds are steadily gaining popularity and momentum. More than three-fourths of our 2012 respondents said they invest in single-manager funds—up substantially from 40% the previous year and 24% in the 2010 survey—and six in ten of those with more than $5 billion in assets reported using single-manager funds exclusively [Figures 9 and 10].

Still, FoHFs are far from obsolete. Almost one in four institutions in our survey said they use FoHFs exclusively, while another 42% use them in tandem with single-manager funds. As discussed in the 2012 SEI study, *Seven Ways to Reinvention: Evolving and Enhancing the Funds of Hedge Funds Model*, FoHF firms may also be able to repackage their capabilities in ways more relevant to institutional clients—from serving as outsourced CIOs and offering customized accounts or "funds-of-one" to focusing on the discovery of promising new managers, and perhaps even providing lower-cost alpha-generating solutions.

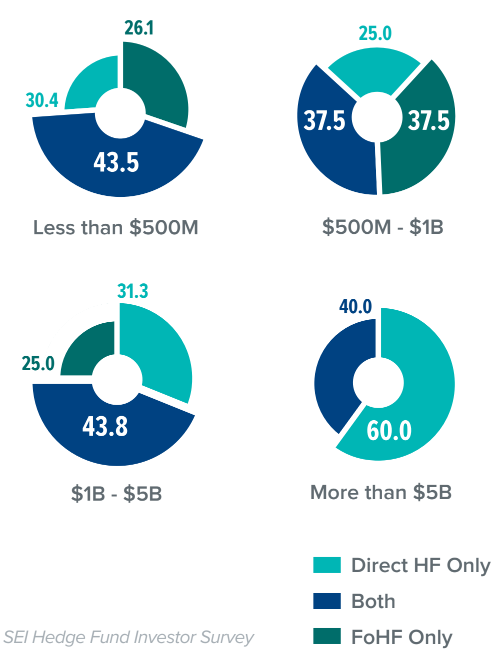
"If you go back twenty years, the role of funds of hedge funds was around manager access. You didn't have to do that much research because there weren't that many funds. Pension consultants and FoHFs are now doing much the same thing: providing research. There is clearly a convergence and both sides add value," said Brooke Parish, CEO of Oakum Bay Capital. "Now FoHFs just have to figure out their economic model."

FIGURE 9 Percentage of hedge fund investments in single-manager hedge funds vs. funds of hedge funds (median %)

	% Direct HF	% FoHF
Less than $500M	50.0	50.0
$500M - $1B	63.2	63.2
$1B - $5B	87.1	87.1
More than $5B	100.0	100.0
All Investors	75.0	75.0

Source: SEI Hedge Fund Investor Survey

FIGURE 10 Use of single-manager hedge funds vs. funds of hedge funds (% of investors)



Source: SEI Hedge Fund Investor Survey

Adaptability

TAKEAWAYS

1. The trend is toward greater specialization in investment strategies and research; at the same time, institutions increasingly are seeking solutions that can serve multiple objectives

2. Registered products are making inroads into the institutional market, especially among smaller investors, as well as offering retail and retirement market opportunities

3. Fund managers need to make sure their business models are still relevant and offer effective ways of packaging their capabilities

3

CLEAR VALUE ADDED

If there was one overriding theme that emerged from our institutional investor roundtables, it is the notion that hedge funds now need to prove their worth. After the shocks of 2008 and periods of lackluster performance since—not to mention the news that even the best-performing hedge fund strategies trailed U.S. equity market returns in 2012—it is no longer assumed that hedge funds will deliver positive returns in any investment climate; nor is the non-correlation of returns taken for granted.

Institutions increasingly are asking tough questions about the value they are getting from their hedge fund investments, such as what share of returns is deemed true alpha, as opposed to beta exposure that could be achieved through passive—and far less expensive—investment vehicles. That concern certainly came up in SEI's 2012 survey findings: institutional investors and consultants placed "identifiable source of alpha" among their top three criteria for manager selection, with nearly 40% describing it as "critical" and another 55% as "important" or "very important" [Figure 8, page 12].

Fund of hedge fund (FoHF) managers, with their two-layered fee structure and an expanding universe of competitors (including institutional consultants themselves), are especially under the microscope. "Looking at our research, we found that fund of hedge funds, on average, don't create any value beyond the systematic exposures they sit on, and many actually diversify away alpha. That's a stark finding," said Subhra Tripathy, head of portfolio at Aberdeen Asset Management plc. While there is still institutional demand for the services and capabilities FoHF managers can provide, as discussed in SEI's recent study on FoHFs,[5] investors are questioning the value they provide through their traditional business model.

While SEI's surveys show that institutions are generally maintaining their commitment to hedge funds and making only incremental changes to their hedge fund allocations [Figure 2, page 4], our 2012 findings do reflect concern among investors and consultants as to the value derived. One striking example: fewer than four out of ten agree with the statement that "we would not be able to meet our return objectives without hedge funds," with only one out of ten agreeing "strongly."

An era of performance challenges

Of course, hedge funds aren't the only asset managers facing headwinds in today's markets. Despite last year's U.S. equity market rally, the climate of generally slower economic growth and rock-bottom yields is hampering many alternative and mainstream investment strategies alike. This reality has led many institutions to cut their annualized return targets, sometimes pegging them as low as 6% or 7%—a far cry from the double-digit returns that major investors could assume 10 or 15 years ago.

According to the National Association of College and University Business Officers (NACUBO), in 2000 the median five- and ten-year average compounded nominal rates of return for U.S. endowments were 15.4% and 13.0%, respectively. By mid-year 2008, those return rates had fallen to 9.7% and 6.3%.[6] Still, based on the idea that hedge funds can exploit opportunities and market anomalies that traditional strategies can't touch, institutions still look to hedge funds to help lift overall returns while diversifying their portfolios. But, depending on the strategy employed, the current investment climate is making it harder for many managers to deliver the kinds of return streams clients are seeking.

For one thing, structural market changes have dramatically altered the depth and breadth of markets. Not only is this compounding liquidity challenges, our roundtable participants say it is also fundamentally shifting how hedge fund managers think about risk. The structural shift has led to an intellectual one.

"The current breed of hedge fund managers is different from those operating ten or fifteen years ago," observed Kevin Gundle, CEO of Aurum Funds, Ltd. "They have become more afraid of losing money, because if you're down 2%, how many years will it take until you make it back? Unfortunately, you're mixing contemporary risk-taking with a historic, performance-led mindset."

Even diversification is proving harder to achieve in light of global trends. "There are very few diversifying assets left," commented Ali Akay, CIO of Carrhae Capital. "If you're going to run any strategy based on arbitrage or relative value, correlation is your enemy. So how do you create value when every asset class globally is getting more and more correlated?"

Under these circumstances it is no surprise that institutions are growing more dissatisfied with the performance of their hedge fund investments. Our 2012 survey found that only 38% of respondents reported being either "satisfied" or "very satisfied" with their risk-adjusted hedge fund returns—a substantial drop from the 62% who expressed satisfaction the previous year [Figure 11, page 23].

"Institutionalization has brought more bucketing of hedge funds and the **demand for greater predictability** in what managers do every day."

- Andrew Beer, CEO, Beachhead Capital Management

Institutionalization: Killing the golden goose?

Many believe that investors themselves have undercut hedge funds' ability to perform by putting managers on ever-shorter leashes. While growing institutionalization has brought greater professionalism and accountability to the industry, it is also limiting the flexibility hedge fund managers have to pursue far-flung opportunities and exploit market volatility.

Andrew Beer, CEO of Beachhead Capital Management, sees this trend as the single biggest problem for hedge fund managers today. "The creeping growth of these constraints keeps managers from going outside their usual areas and diminishes returns over time," he observed. He also points to shorter time horizons for evaluating managers, noting that managers who might once have been willing to wait several months for a big movement in one of their positions must now placate investors who grow nervous with any sign of negative monthly returns.

Lionel Erdely, CIO of Lyxor Asset Management, believes that despite the long-term investment goals of institutional investors, such investors are also sensitive to short-term performance. "Are investors willing to take a three-year view and tolerate some volatility in order to get outsized returns? Yes, they are, but it is also critical for institutional investors to have a clear view and budget for the volatility and potential drawdowns of their investments on a shorter term time horizon."

"Post-crisis, there's a very limited appetite for material drawdowns," agreed an investment officer to a large U.S. pension plan, taking a fiduciary perspective. "I don't think our committee members expect a double-digit return in this environment, but I do think they put preservation of principal above all."

Since 2008, when some institutions were burned by hedge fund "gating" policies invoked as markets plunged, liquidity has been another hot-button concern for investors. Said Andrew Beer, "As managers go to raise capital, they are under pressure to identify how quickly they can get out of every position, as opposed to what they would hold in a down market or buy if volatile markets presented better opportunities." To the extent that institutions may require hedge funds to invest only in liquid instruments, they are dampening returns as managers forgo the "illiquidity premium" they might otherwise earn.

Weighing costs and benefits

Meanwhile, the ways that investors assess the value of their hedge fund investments are shifting, for a variety of reasons. One is the trend toward convergence among all types of investment strategies. Whereas hedge funds were once evaluated on their own terms, whether against their peers or their stated benchmark indices, now they are judged against multiple portfolio objectives and a broadening range of investment choices. That is especially true with strategies such as long/short equity, which may be judged against less costly registered long/short or even long-only equity products. Even though hedge funds still have some tools that mutual fund and ETF managers don't, the difference may not always be evident in hedge fund returns. As a result, hedge funds are already fighting for "shelf space" within diversified institutional portfolios.

"As an industry, we would be well served to move away from this self-fulfilling prophecy of comparing a fund against other hedge funds and instead determine whether it's done well or not in its asset class, and added alpha," said Rick Nelson, CIO of CommonFund.

Those in the industry also chafe at what they see as misleading "bucketing" of hedge fund strategies that sound similar, but may differ dramatically in their performance characteristics. Asked Daniel Broby, deputy CEO and CIO of public markets with frontier markets manager, Silk Invest, "How can you compare a true alpha-generating manager with one who delivers much more beta with the same fee structure and time horizon for generating those returns? Consultants need to see us for what we expect to deliver and what resources and frameworks we're using to achieve those returns. It is on that basis that we should be paid and graded."

> "The meshing of traditional and alternative strategies is the industry's biggest issue. Investors are finding it hard to look at hedge funds' performance right now, look at their fees, and say they're getting a good deal."
>
> *- Morten Spenner, CEO, International Asset Management*

Rising fee pressures

The upshot is that hedge fund fees are now negotiated, rather than set. Ten or fifteen years ago, there was a simple answer to the question "What is a hedge fund worth?" The automatic response was "two and twenty," the industry-standard 2% asset management fee plus a 20% performance fee, with an added "one and ten" for FoHF managers. This structure was seen as providing for an alignment of manager and client interests. Now the discussion revolves around what value clients are getting for the fees they pay.

"The industry hasn't proved that it's worth two and twenty," said Daniel Broby. "We're trying to sell a story to people who are scratching their heads and wondering what you do that's any different than the last ten managers they met with that day. What you do and if it's sustainable: answer this and it might warrant your getting paid what you're asking for."

According to the 2012 global asset manager fee survey conducted by the Mercer consulting firm, alternatives, including hedge funds and private equity funds, is the only asset class that has experienced "a material drop" in asset management fees over the past year. Mercer concluded that the industry standard "continues to move toward '1.5 and 20' as supply-and-demand dynamics have led managers to be more flexible in negotiating fees." [7]

But this broad finding looks past the questioning and the give-and-take occurring in the industry on a daily basis. Is a hedge fund firm willing to take a separately managed account for 50bps? Or put its fund on a global distribution platform for 35bps? Have returns been strong enough that the manager can stick with its pre-2008 asset management fee of 2%? Or would an incentive fee of 7% alongside a 1% management fee be more palatable?

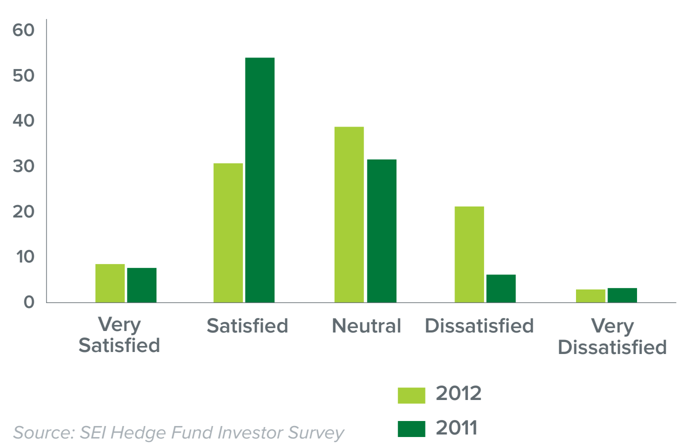
Concluded Daniel Broby, "We can expect to watch fees change across the industry. It's not going to be 'one fee set fits all.' It will be specific to the actual value being added by the entity, be it hedge funds, funds of hedge funds, or consultants. Investors will come to expect this from each of us."

Jeff Keswin, founder and managing partner of Lyrical Partners, is among those who have evaluated and brought to market outside-the-box fee approaches. His long-only equity business bases incentive fees on pure alpha rather than straight returns. In his experience, however, "the institutional community has a really tough time paying for alpha in the long-only space. Even where there is an obvious benchmark and demonstrable alpha, institutional investors are inured to seeking a fixed fee," he reported.

Declining investor satisfaction

The fact that hedge fund indices lagged broad equity markets over the past year was no doubt a factor in investors' unhappiness, despite their stated focus on diversification over absolute returns.

FIGURE 11 How satisfied are you with the risk-adjusted returns of your hedge fund investments? (% of investors)



Source: SEI Hedge Fund Investor Survey

Clear Value Added

TAKEAWAYS

1. Institutional investors' level of satisfaction with their hedge fund investments has declined, survey results show, and hedge funds are being constantly challenged to prove their worth
2. Yardsticks are changing; hedge funds now are measured against multiple portfolio objectives and a widening range of competitors
3. Institutional clients are increasingly sensitive to how much true alpha they are getting for the fees they pay, and also worry about "diversifying away alpha"
4. The notion of standard hedge fund fees is quickly becoming obsolete; more and more, institutional investors expect to negotiate fees based on the value delivered

4

THE RIGHT FIT

There was a time when investors looked to hedge funds primarily for absolute returns. Then they began using hedge funds to help them insulate portfolios against market volatility and, eventually, mitigate other forms of risk—especially after the multiple shocks of 2008. The industry has continued to mature, and today's investors use hedge funds in increasingly varied, sophisticated and nuanced ways.

This means it's not enough for hedge fund managers to offer robust, institutional-quality investment capabilities. They must also figure out how and why those capabilities fit their prospects' and clients' individual needs. The days of simply touting performance numbers are long over. Fund managers who want enduring client relationships must work at establishing all the elements of compatibility and satisfaction from the outset—and as our roundtable participants pointed out, they can't do it alone. Investors need to be just as actively engaged in finding the right fit.

A problem-solving approach

Hedge fund managers can no longer assume that they know what investors want. In the minds of our panelists, managers need to think of themselves not as product providers, but almost as outsourced CIOs.

That implies a very different kind of marketing and sales process. Rather than simply pitching strategies, hedge fund managers must take a more exploratory approach that starts with the right questions and focuses on matching capabilities with investor needs.

To Ron Sellers, founder and CEO of Atlantic Asset Management, a successful marketing meeting is one where the manager comes away knowing what the investor wants to buy. As he observed, "If you want to manage a hedge fund business for the intermediate or long term, you've got to know and respond to what investors are looking for."

Clear objectives

As our 2012 survey results show, today's investors view hedge funds not just on their own merits, but in terms of how well they serve multiple objectives within an overall portfolio mix. Respondents were far more focused on diversifying their portfolios with non-correlated strategies than they were with absolute returns. Close to 50% named diversification as a primary objective, as compared with just 21% who said they mainly seek absolute return and 10% who want "enhanced alpha generation" [Figure 12, page 27].

It's up to fund managers to make sure they understand investors' overall and strategy-specific objectives, delving beneath the surface of broad goals such as "generate alpha." Managers cannot pursue that kind of sweeping objective without probing for other concerns. "Knowing investors' thresholds for issues such as unwanted beta exposure or liquidity is paramount," agrees Basil Williams, founder and CEO of Concordia Advisors.

"We need to listen first, and find out precisely what investors need, before we can prescribe any solution."

- Neil Collins, Head of Client Solutions Group within Alternative Investment Solutions, UBS

Of course, investors and consultants must do their own homework to bring clarity to the process. What are we hiring the fund manager to do? Is the fund best used to generate alpha, mitigate liabilities, or hedge against inflation? What are the characteristics of the investment instruments? How would we expect them to respond to market and economic change?

As our roundtable participants emphasized, hedge funds and their clients can't come to a real understanding without meaningful, face-to-face dialogue. "There is a gross overreliance on quantitative screening in the hedge fund selection process. That only gets you 20% or 30% of the way; it's just the foundation," says Neil Collins, head of the Client Solutions Group within Alternative Investment Solutions at UBS. "The real work comes with the qualitative, face-to-face assessments that allow a deeper understanding of the manager and the mechanics behind the strategy."

For some, this "deeper understanding" extends beyond the strategy, taking into account the personality of the manager responsible for executing it—one more basis for differentiating among funds. "The popularity of hedge funds has created a plethora of frameworks and caused great confusion. We look at behavioral characteristics of managers and try to figure out whether they are defensive by nature. To us, it's the manager's behaviors that need to fit in the overall portfolio," said Morten Spenner, CEO of International Asset Management.

Focused mandates

For investors, framing their mandate to a hedge fund manager and making sure that the hedge fund's investment strategy and philosophy is in line with their investment objectives may be the biggest and most important challenge in the process, noted Lionel Erderly, CIO of Lyxor Asset Management. It's crucial that investors not only identify their needs, but spell them out with a high degree of specificity. Otherwise, hedge funds are left trying to be too many things to too many different kinds of investors, and that's a sure recipe for suboptimal performance and investor discontent.

In our roundtables we also heard resistance to the notion that having wide latitude helps fund managers respond to rapidly shifting markets. "This idea that a talented manager can easily and rapidly shift between risk-on and risk-off situations—it's heightened expectations too much. If you give a manager a wide-ranging mandate and it turns out their talent isn't as broad, can you be angry with them afterwards? Perhaps you didn't understand the manager or the manager didn't very well represent what they could do," commented Rick Nelson, CIO of CommonFund.

"If clients can become better at articulating what they want, we can have managers who produce the right result for the right client."

- Michael Green, CEO, International, American Century Investments

Realistic expectations

As our roundtable participants observed, clients' satisfaction with their hedge fund investments has as much to do with expectations as with the actual performance delivered. "How you set expectations is critical," commented Daniel Broby, deputy CEO & CIO, public markets of Silk Invest. "For instance, when we say absolute return, how are we defining this? Is it in terms of weekly numbers, quarterly, or over a five-year period?"

But no matter how careful fund managers are with their implied promises and stated caveats, they must face reality: no investor likes to lose money. "Even though institutions look at performance annually and say they are long-term investors, they don't like monthly drawdowns, and when they see them, you're going to get that call," continued Daniel Broby.

Fine-grained transparency

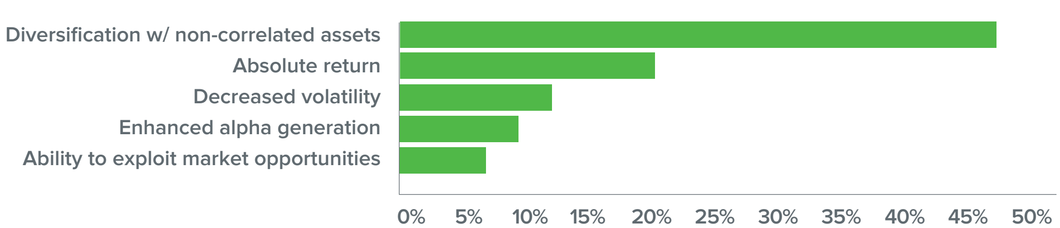
Despite the strides managers have made in providing timely, detailed portfolio information, transparency has consistently been a hot-button issue among SEI's survey respondents since 2008. In fact, respondents to our 2012 survey ranked it number two on their list of worries regarding hedge fund investing.

"Every investor wants to know how alpha is created," commented Dan Smaller, partner and head of global sales at Duet Group. "What you can do is be transparent going forward in terms of how you run your business and the positions you have. You need to provide a steady information flow and regular conference calls, rather than just one-page NAV sheets."

What do hedge fund investors want?

As our 2012 survey results show, investors are less focused on achieving absolute return numbers than they are on capturing differentiated, non-correlated return streams.

FIGURE 12 Primary objective when investing in hedge funds (% of investors)



Source: SEI Hedge Fund Investor Survey

The Right Fit

TAKEAWAYS

1. The needs of institutional investors have become more complex and sophisticated; rather than merely pitching products, hedge fund managers should make sure they understand individual client needs and preferences and offer solutions tailored accordingly

2. Ongoing transparency is essential to continually prove and reinforce a hedge fund's fit with institutional needs

3. Successful client relationships depend on developing clear, specific mandates and setting realistic expectations, tasks that require diligent effort by institutional investors and managers alike

5 SCALE OR SIZZLE

When it comes to hedge funds, size is a double-edged sword. While bigger isn't always better, scale does have its advantages. Meanwhile, the industry buzz is often around smaller managers with intriguing strategies and strong performance characteristics. Yet, despite the appeal of nimble start-ups run by original thinkers, it's still much tougher for small managers to get past consultant and gatekeeper screens, let alone win mandates. In short, size can present both a challenge and an opportunity for hedge fund managers no matter what their AUM.

Why size confers power

There's no doubt that with some hedge fund strategies, large size can be a hindrance. An investment approach may outperform with a $50 million portfolio but crumble under the weight of $500 million to invest. No matter how inspired the strategy or accomplished the portfolio manager, funds can't deliver if too large a quantity of assets is chasing too few investment ideas.

Size does, however, give hedge funds the resources it takes to develop the fully articulated investment, risk management, and operational processes that major investors have come to demand. Some worry that institutionalization may squelch the kind of original thinking and audacious risk-taking that made legends of George Soros, Julian Robertson and their ilk. Indeed, our survey found that 70% of investors worry that too many hedge fund strategies seem to be more or less the same.

Still, there is no doubt that large, well-established funds can provide a level of comfort and confidence that many investors are unwilling to give up, even if it costs them an increment of performance. And with their jobs and reputations at stake, why would investment consultants risk recommending a fund that can't check every box in RFPs and DDQs, let alone one whose process and strategy aren't fully evolved? As the adage goes, "Nobody gets fired for buying IBM." The more institutionalized the hedge fund industry becomes, the more gatekeepers and decision-makers are inclined to play it safe.

Explained Michael Green, CEO, International with American Century Investments, "The due diligence around business structure, compliance, regulatory requirements, operational frameworks—all those things are more important today than they used to be. We have a different sort of buyer today who favors the big guys for this very reason."

Working with substantial blocks of AUM also enables managers to develop and execute more customized investments or portfolios. For example, Neil Collins, head of the Client Solutions Group within Alternative Investment Solutions at UBS, described a recent allocation of $120 million to a manager who was asked to structure the investment around a specific trade, with a fee of 50 bps for the execution. "You wouldn't have got that manager to do it with only $20 million," he notes. "One of the advantages of scale is having the resources, personnel, information, technology systems and market muscle to create capacity and bespoke opportunities."

Armed with these advantages, the "big guys" remain "large and in charge," getting the majority of institutional hedge fund business despite performance that has often lagged that of smaller funds. According to Pertrac research, at the end of 2011, just 322 single-manager hedge funds had AUM of $1 billion or more, but this rarefied group of funds managed a total of about $1.08 trillion in assets—close to 60% of all assets in single-manager hedge funds.[8]

...But small can be beautiful

This is not to say that smaller funds are lacking in advantages of their own. Investors know that small firms are the place to find undiscovered investment talent. They are also paying attention to the fact that smaller funds have generally been outperforming their multi-billion-dollar competitors, a trend that has been particularly noticeable in the tough environment since 2008. In 2012, another year of mediocre performance for many hedge funds, most of those boasting 20%-plus returns had under $1 billion in assets.

Indeed, small hedge funds as a group have outperformed large funds in 13 out of the last 16 years, according to a recent PerTrac report, *Impact of Size and Age on Hedge Fund Performance: 1996-2011*. Since 1996, the cumulative return for "young funds" (those less than two years from start-up) has averaged 827%, nearly double the 446% average return for middle-aged funds (with two to four years in business) and well beyond the 350% posted by "tenured" funds (those in operation for more than four years), PerTrac found.

Another recent study, by Beachhead Capital Management, analyzed nearly 3,000 equity long/short hedge funds. It found that small funds in the $50 million-to-$500 million AUM category outperformed larger funds by 254 bps per annum over five years and 220 bps per year over ten years; what's more, virtually all of the outperformance was due to alpha, not beta.[9] The study also found that the large firms in the study had tripled over the last decade while small firm assets had remained roughly the same.

19% AGREE

59% DISAGREE

Smaller emerging managers have no place in our portfolio.

- SEI Hedge Fund Investor Survey

With less money to put to work, small hedge funds can capitalize on niche markets and specialized opportunities that big funds must bypass. David Swensen, the pioneering CIO of Yale University, is famously quoted as saying "Size is the enemy of performance." Andrew Beer, CEO of Beachhead Capital Management, agreed that "with the institutionalization of the industry, a billion-dollar fund simply can't produce the kinds of excess returns you can generate with a ten or twenty million dollar fund."

Small, independent managers may also be better able to avoid the groupthink that produces "me-too" strategies. For investors, small funds offer the chance to discover new talent and invest with promising managers early, when capacity isn't an issue and fees and minimums are low.

So why aren't smaller hedge funds winning more institutional assets? Even if major pension funds tend to opt for the safe choice, shouldn't promising start-ups be attracting more flows from the endowments, foundations, family offices, and financial advisors that qualify as their natural buyers?

One answer is that institutions prize consistency over intervals of brilliance. They tend to focus on managers who have longer track records and can show that their returns derive from a disciplined process, and are not just a flash in the pan. Corroborating this, nearly half the respondents to SEI's 2012 survey said they would only consider a manager with a track record of at least three years, and another third insisted on a record of at least one to three years; nearly 85% also impose minimum asset thresholds [Figure 14, on page 33].

"The managers in the sweet spot between $500 million and $3 billion are not raising assets. And yet, that's where the returns are."

- Kevin Gundle, CEO, Aurum Funds Ltd.

Catherine Doherty, global CEO of Investit, believes that institutional investors are increasingly judging hedge fund managers based on the number of professionals they employ. "If that number isn't a credible number—which might be fifteen or fifty, depending on the circumstances, but certainly isn't five—don't bother filling in the other two thousand RFP questions," she said. "That's the end of it."

Our panelists observed that, ironically, the value-added spark that helps smaller funds achieve above-average returns may go unnoticed in the institutional selection process. "It is hard sometimes for even a great smaller manager to be evaluated, because their edge lies in idiosyncrasies the consultants don't pick up because they are not looking for them," commented Ron Sellers, founder and CEO of Atlantic Asset Management.

Limited time and resources for manager evaluation is another factor weighing against small funds. "Those investing for institutions don't have the bandwidth or acumen to look at smaller managers," said Kevin Gundle, CEO of Aurum Funds Ltd. Practically speaking, large institutions can't really afford to invest effort in smaller funds. A 10%, 15% or even 30% share in a small hedge fund won't make a ripple in a multi-billion-dollar institutional portfolio, no matter how sky-high the return. Investing in an array of small managers is simply too resource-intensive—although this may be a constraint that some enterprising FoHF managers may be able to turn into an opportunity.

Opposing scenarios

So what does the future hold for smaller hedge funds? On this question, consensus dissolves. Some believe that the demands and costs of being in the business are getting so high that smaller funds won't be able to go it alone. That leaves them little choice but to join a platform or exist within a larger, more traditional asset manager. Even if small funds were seeded or launched by a larger sponsoring entity, by no means does that assure their survival.

Indeed, few weeks go by without news of a hedge fund closing, merging, or being up for sale. Among funds of hedge funds, in particular, a rising number with less than $3 billion in assets are seeking alternatives to remaining independent. "Most of these firms will wind up merging or closing in the coming six months. Many will wake up one day in the next twelve months and find 25% of their capital being pulled. If they were already operating at break-even…well, things just got a whole lot worse," commented Anthony Gordon, CIO of the Gordon Family Office.

Others are bullish on the future for small hedge funds, seeing them as a major area of opportunity for the industry over the next three years. It's true that a variety of heavy hitters, such as Protégé Partners, Visium, Atlantic Asset Management, Cantor Fitzgerald, and Blackstone, are already using their platforms to create an access point for smaller managers with differentiated strategies.

A focus on emerging managers could also spell salvation for some FoHFs. In SEI's recent SEI study on FoHFs,[10] more than 54% of the investors and consultants we surveyed named "access to lesser-known or emerging managers" as one of the top three reasons for investing in FoHFs. Jacob Gottlieb, founder and CIO with Visium Asset Management, reported that "we're seeing greatest interest in a global, multi-portfolio fund that has something like twenty smaller portfolio managers."

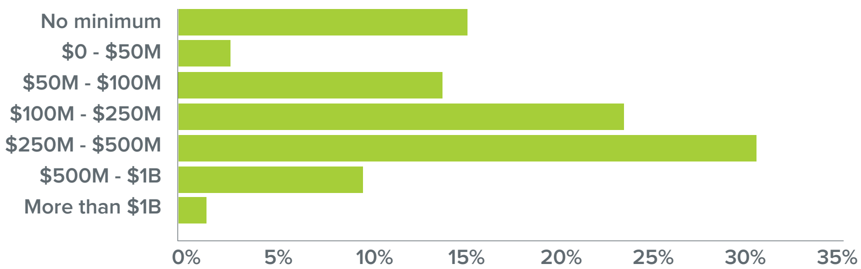
Some of our roundtable participants also predicted that institutions will generally become more amenable to working with small funds. "Investors will come to appreciate the smaller, more nimble managers," said Jamie Taylor, partner in THIS Capital. "Differentiation will shift to being about niche strategies and the sub-one-billion-dollar funds."

Only time will tell whether institutional investors are going to stick with managers who operate at scale, or shift their sights toward smaller ones with the "sizzle" of fresh ideas and potentially strong performance. Indeed, according to Rachel Minard, CEO of Minard Capital, for some institutions "the natural next step is to supplement the larger core investments with non-correlated, directional niche (or smaller) hedge funds that complement the core positions while providing the much-coveted idiosyncratic risk smaller hedge fund managers often provide." However the trends shake out, it would not be surprising if the biggest losers turned out to be the funds with middling AUM, unremarkable performance, and plain-vanilla strategies—that is, those with no way at all to stand out from the burgeoning hedge fund crowd.

Setting the bar: Institutional minimums

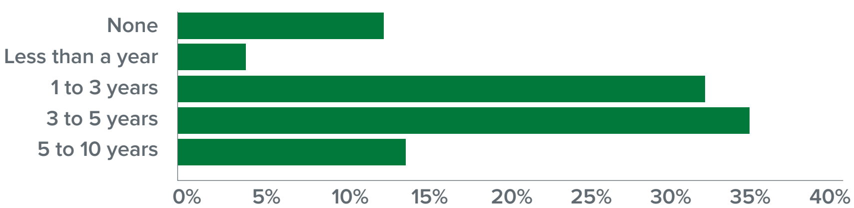
While 84% of our 2012 survey respondents said they have minimum asset thresholds that managers must clear just to qualify for further screening, those minimums vary widely, with about two-thirds of investors setting them at $100 million or above. Minimum track records are similarly varied. But it's interesting to note that the percentage of investors requiring no track record at all is nearly as great as the percentage requiring five years or more.

FIGURE 13 Minimum assets under management (% of respondents)



Source: SEI Hedge Fund Investor Survey

FIGURE 14 Minimum track record (% of respondents)



Source: SEI Hedge Fund Investor Survey

Scale or Sizzle

TAKEAWAYS

1. Large firms have the resources to develop institutional-quality processes and infrastructure, an advantage they can leverage through their marketing and client service

2. Small funds—which have generally outperformed larger funds—stand out with some prospects for their ability to pursue creative strategies and niche opportunities, but may not fit the profile it takes to get on the radar of larger investors

3. While the outlook for independent smaller managers is unclear, given the high costs and demands of the business, the growth of sponsored hedge fund platforms and FoHFs that specialize in emerging managers should help some to survive and even thrive

6 BUSINESS AND MARKETING ACUMEN

Tough as it may sometimes be for hedge fund managers to achieve strong, sustainable investment performance, many find that running a sustainable hedge fund business is equally difficult.

"That was really a shock," recalled Daniel Broby, deputy CEO and CIO public markets for Silk Invest. "I had thought my priority was to run money, to deliver the best performance…but it's really about running a business. If I'd known then what I know now, I would have been less focused on 'Let's have the best Sortino Ratio ever' and much more focused on being a businessman."

It may seem obvious that someone who is a brilliant investor may not necessarily excel at managing people and business operations. But it is a lesson that all too many hedge fund founders have learned the hard way.

Like their traditional counterparts, alternative asset managers must also remember that they aren't simply selling funds. Rather, they are marketing the broad expertise and capabilities of their firms, not to mention how good a job they do of putting those resources in the service of institutional clients. Investment performance is certainly important, but when it comes to building a successful hedge fund business, performance is just the beginning.

> "In our business, the biggest pitfall for sales professionals is forgetting the 2:1 ratio of ears to mouth."
>
> *- Brooke Parish, CEO, Oakum Bay Capital*

Marketing imperatives

On one point our roundtable participants resoundingly agreed: growth in a hedge fund's assets and client base has less to do with investment performance than with effective marketing. Not only do successful hedge funds make marketing a top priority, they also understand what it takes to get positive results—a task that is harder than one might think, given the complexity of investment strategies and instruments. On that score our panelists offered a variety of recommendations:

- ***Tell a compelling story.*** "Great marketers should be able to explain in simple terms what the product does," said Andrea Malagoli, a consultant with Buck Consultants who has spent many years in the alternative investments industry. "I have seen so many presentations that follow the same old pattern: pedigree of the managers, number of years' experience, and so on. What you really need to do is tell a compelling story that captures attention upfront."
- ***Hone your messages.*** "There are those who get it right, and gather billions in assets, and those with no idea of how to get their message across. They just use the same mumbled jargon and rarely convey what is actually happening. Marketers who think they don't need to put it down on paper and convince others their process makes sense will get nowhere," declared a managing director at a large European institutional investor. Our panelists also emphasized how important it is to spend the time and resources needed to make complex processes clear and simple. "Explaining simply just what it is you do is the single greatest feat for hedge funds," said Michael Green, CEO, International with American Century Investments.

- ***Don't get mired in the past.*** What people want to invest in is future alpha, not what was generated in the past, emphasized Daniel Broby. "You have to explain how you're going to achieve alpha in the future through your process and your method. That's the true marketing challenge since so few know how to do this," he commented.

- ***Think through your positioning.*** As Catherine Doherty, global CEO of Investit, pointed out, "You're not just trying to convince an investor you're unique. What you want to demonstrate is that you are trustworthy and reliable. You need to instill confidence by proving that what you're doing really works and you didn't just get lucky. You also need to show that your investment and operational processes are strong enough that you can take the new business without falling over."

- ***Be consistent.*** Even the most memorable marketing presentation can fall flat if clients or prospects are hearing different messages from different people in the firm. "It's a terrible thing when you dig through a firm and get different signals. You start doubting what you've heard, including the firm's ability to deliver in the future," said Anthony Gordon, CIO of the Gordon Family Office.

- ***Value conversation over collateral.*** "Everyone asks for the whole collateral set for their files," said Morten Spenner, CEO of International Asset Management. "But it's much more important to have the face-to-face dialogue so we can find out: Are we in the right place at the right time? Does this fund make sense for the person at the other end of the table? Because if it doesn't make sense for them to be here, it certainly won't for us."

Kevin Gundle, CEO of Aurum Funds, agreed that marketing material is often "a distraction," explaining that "it was never about the glossy marketing materials. It's about substance and being able to understand how managers translate a full process into a portfolio. I can't remember when I last looked at my managers' websites."

Bruce Frumerman, CEO of communications and sales marketing consultancy, Frumerman & Nemeth Inc., concurs and states that "Too few hedge funds are communicating enough detail about how they think and how they invest." In this regard, good marketing materials can indeed be invaluable—if the right tool is used for the job it can do best. He points out that while a flip-chart pitchbook is a good tool for communicating data-based information such as performance related charts, graphs and tables, it is a poor tool for communicating the needed text-based detail about a hedge fund's investment beliefs and investment process. "Managers need to remember that an investment committee that is considering a handful of finalists is not debating which has the better Sortino Ratio, they're discussing which fund has the clearest investment process and value proposition that they can understand, buy into and be able to discuss, if need be, with the constituents they invest for and report to."

Our panelists had divergent views on some aspects of marketing, such as how much technical product knowledge hedge fund marketers must have. Matthew Stadtmauer, president of Pine Grove Asset Management, is one of those who uses the ability the complete a blank RFP as a litmus test. "You'd be shocked at how many people in sales cannot fill out an entire RFP, which means they really don't understand your business or your firm," he said. "That's a big problem."

On the other hand, Michael Rees, managing director at Neuberger Berman, draws a line between relationship managers and product specialists. Our sales people are true relationship managers who partner with the portfolio managers to discuss the funds in detail," he explained. "We found this to be the most effective approach for the size and shape of our organization."

Our London roundtable also included a lively debate on the role of LinkedIn, Facebook, Twitter, and other social media. While acknowledging that social media may help in gathering market intelligence and building personal networks, some panelists expressed concern that publishing investment ideas on Twitter could be a credibility-killer. But Daniel Weston, CIO of Munich-based Aimed Capital Management, uses Twitter daily and is among those who believe social media cannot be ignored. "Some of the best ideas I see are on Twitter. Seriously clever people are out there with powerful trading ideas and convictions," he said. "I think that's where the next generation is going to come from."

High-touch client service

In light of the intensified competition among fund managers, and institutional clients' heightened demands for transparency, client service is now less a discrete function than a mindset shaping all activities. These days, competitive firms think in terms of providing "a holistic platform of investor care and investment management" through a variety of measures. --

"Every investor wants to know how alpha is created," observed Dan Smaller, partner at Duet Group. "Ask yourself what can you do to be more transparent about the ways you run your business, the positions you have, the information flow, the conference calls, rather than simply giving clients one-page NAV sheets."

Technology can help firms manage and fine-tune that constant information flow. For example, Neil Collins, head of the Client Solutions Group within Alternative Investment Solutions at UBS, reported that his firm recently made a major push to put sophisticated analytical tools and real-time fund data on its clients' desktops, enabling them to aggregate risk and return data across their entire portfolios.

SEI's survey results show that communication about risk factors is one of the service areas in which hedge funds could do a better job. While almost two-thirds of respondents said their managers "do a good job with risk management," only half say they fully understand the risk exposures of the hedge funds in which they invest.

Several of our institutional investor panelists also emphasized the importance of giving clients direct access to portfolio managers, and not just portfolio data. Indeed, 40% of the institutions SEI surveyed agreed that "system-generated transparency is irrelevant without access to managers." The survey also underscored the importance of meeting and communicating regularly with clients. While 42% of our institutional respondents were satisfied with annual face-to-face meetings with hedge fund managers, 30% wanted to meet at least semi-annually and another 23% preferred quarterly meetings.

"Flexibility, adaptation…being ready for change, accepting new ideas, not being staid—**this will be the future of our industry.**"

- Matthew Lonergan, Fund Manager & Partner, Stratton Street Capital

"Yes, it's a relationship business. But in the end you've got to have a business that runs good funds, not good friends."

- Catherine Doherty, Global CEO, Investit

Our roundtable participants agreed that, regardless of how firms package and present fund information, an effective client service model is grounded in listening to clients and probing for a deep understanding of their needs. Rachel Minard, CEO of Minard Capital, observed that her first meetings with prospects typically are dedicated to discovery: listening to their issues and concerns, clarifying their goals and motivations, and homing in on what they are seeking. "What our firm has to offer and what makes it unique come later," she said.

Grosvenor Capital Management has taken a proactive approach to understanding clients, segmenting its client service and business development model in order to better identify the issues and preferences specific to each type of institutional client, revealed Nick Parrish, vice president. To help it shed more light on the issues facing public funds, Grosvenor added the former Executive Director of a state public pension plan to its business development team.

Judicious outsourcing

Outsourcing is one solution for managers who are trying to direct investment strategies and business operations at the same time while appeasing the demands of institutional investors—never an easy task. It is an approach our panelists advocated as offering a potentially high ROI when used under the right circumstances and with sensitivity to associated risks. They also suggested that fund managers should try not to let ego keep them from handing off business functions.

"You have to understand what you're good at and outsource those things you're not. It's your only chance to stay in business,"

- Michael Green, CEO, International, American Century Investments

Which functions should be considered for outsourcing? Investment and risk analytics, performance attribution and fund operations might be contenders, considering that more than seven in ten of SEI's institutional survey respondents identified "operational strength" as a hallmark of an institutional-quality hedge fund. It is a rare firm indeed that can attract significant investment dollars without utilizing independent third-party service providers such as custodians, prime brokers, fund administrators and the like.

Yet as the industry continues to evolve and institutionalize, the degree to which outsourcing is acceptable and indeed, expected, has grown. The range of functions that firms might consider outsourcing goes far beyond operations to include a variety of technology solutions, data management, background checks, marketing, presentation training, and more, said Muzaffar Khan, managing director of Alchemy Ventures, who has advised some 40 start-up hedge funds over the last five years. “Prospects need to know they can trust the investment part of the process. Anything else can be outsourced, allowing the manager to focus on generating returns,” he noted, adding that other benefits of outsourcing include an improved cost structure and the ability to rapidly scale up (or down) functions such as operations and distribution.

At the same time, fund managers need to be careful not to outsource functions that are natural channels for the value they themselves can add. “There is absolute logic in delegating responsibility, but there can be a fine line between delegating and abdicating responsibility. Get it wrong, and it’s going to end in tears,” warned Kevin Gundle.

Sage Advice for Start-ups

During our roundtables we asked several successful fund managers who started small to tell us what they wish they had known back then. Among the nuggets we heard:

- **Don’t begin calling on prospects too quickly**. Especially with pension consultants, you only get one chance—and if it doesn’t go well, it may be five years or longer before you get to come back. Even if a consultant wants to see you right away, don’t do it until you feel sure you are 100% ready.
- **Be ready to knock on a lot of doors**. Ticking RFP boxes alone won’t get you assets, our panelists said. You’ve got to do your homework, burn some shoe leather, and show up in person. Investors want to get to know the team they may be partnering with.
- **Be realistic about the lead time required**. The start-up veterans in our groups all said they had drastically underestimated how long it takes to get rolling. For example, think about needing to have at least 40 to 50 conversations at the outset, with each meeting requiring days or weeks to set up, attend, and follow up. Try to realistically plot start-up tasks and the length of time it will take you to get set up. Then double your estimate.
- **Know the limits of your capabilities**. Some managers get started by investing their own money or family assets, and find they have a real talent for it. Then they begin adding macro, interest rate, or currency hedges in an effort to dampen volatility. If they don’t have the expertise or the systems to fully understand the intentional or unintentional bets they are making, “It usually manifests as downside surprise,” cautioned Jacob Gottlieb, founder and CIO of Visium Asset Management.
- **Sort out your psychological issues first**. Forget the “masters of the universe” hype. The types of personalities who hate to be wrong, or can’t stand to be lectured to, or don’t like dealing with the details of business decisions, don’t do very well in a milieu where clients, consultants, and sponsoring fund platforms rule. Said Muzaffar Khan, managing director of Alchemy Ventures, “If you start a hedge fund, you have to understand what is going to be asked of you—which is everything.”

Business and Marketing Acumen

TAKEAWAYS

1. Running the business is as important to hedge funds' long-term success as their investment strategies and performance

2. Effective marketing is a must--which means listening first, tailoring solutions to clients' unique needs, positioning your firm thoughtfully, and conveying clear, consistent messages

3. Marketing doesn't end when a new client comes on board; that's when the ongoing process of marketing through client service and regular communication begins

4. Where marketing materials are concerned, a top priority is a concise, yet detailed description of the investment process—a key point of differentiation that prospects need for their internal decision-making and due diligence

5. To increase their chances of success, firms should consider outsourcing anything that isn't core or they can't do well themselves, as long as it doesn't undercut their own value-added

CONCLUSION

When all is said and done, it is clear that the hedge fund industry is here to stay. Exceptionally talented investment managers with original investment ideas will continue to seek the flexibility and opportunity that the hedge fund structure provides. Likewise, institutional investors will continue to want access to that top talent, and to differentiated alpha-generating strategies and return streams.

At the same time there is no doubt that the industry's value proposition is being seriously questioned, and not only by investors. We heard many hedge fund practitioners themselves questioning whether the industry has lived up to its promise to investors—a healthy sign that fund managers' standards remain high despite the adversities in today's investment and business climate.

This report highlights many areas of potential change and improvement in hedge fund practices and client relationships—from a greater focus on defining the value funds deliver to more robust and multi-faceted client communication.

The overarching message that emerges is one centering on the need for better understanding among hedge fund management firms and institutional clients. Better-written mandates, more fully articulated investment processes, and added documentation may address symptoms of the industry's current problems. Only through unhurried, unfettered and ongoing dialogue can true alignment of fund managers and investors—and truly successful relationships—be achieved. We hope this exploration of the industry's future provides some guideposts along the way.

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ROUNDTABLE PARTICIPANTS

New York

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About Minard Capital

Founded in 2011, Minard Capital LLC is an independent, global marketing strategy firm headquartered in San Francisco, California. The firm is the first outsourced marketing consulting firm dedicated to providing the marketing strategy, investor introductions and targeted sales process necessary for alternative investment firms to win and retain global institutional mandates. Minard Capital is not a broker dealer, nor a third-party marketing firm. The firm is fee-for-service consultancy, dedicated to delivering more efficient and effective marketing and branding tactics to raising a firm's assets, brand profile and sales efficiency.

Before building Minard Capital, Founder and Chief Executive Officer Ms. Minard built and managed global institutional investment businesses for 20 years, including 14 years building fund of hedge fund firms, notably Cadogan Management and Corbin Capital Partners. Having raised over $10 billion in her career, Ms. Minard started her marketing profession in 1991 after her first company was hired to build the Ronald Reagan Presidential Library.

Ms. Minard has been the Wesley W. Marple Distinguished Lecturer at Northeastern University, serves on several high-profile advisory boards, has been featured on CNBC, TEDx and NPR, has won numerous industry awards for institutional marketing and serves on the Investment Sub-Committee of the Westover School Endowment. Ms. Minard is also on the Board of Directors of the Association of Women in Alternative Investing, an organization she co-founded in 2008.

Rachel's first two books, "Speaking in Thumbs: The Handbook of Empathy" and "The Art of the Institutional Sale" are slated to be published in 2013. An accompanying website—www.speakinginthumbs.com—was launched in 2011. Minard Capital will also be launching the Minard Capital Summit ("MCS") in 2013, focused on bringing together the top pension consultants, wealth advisors and family offices actively allocating to alternative investments.

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