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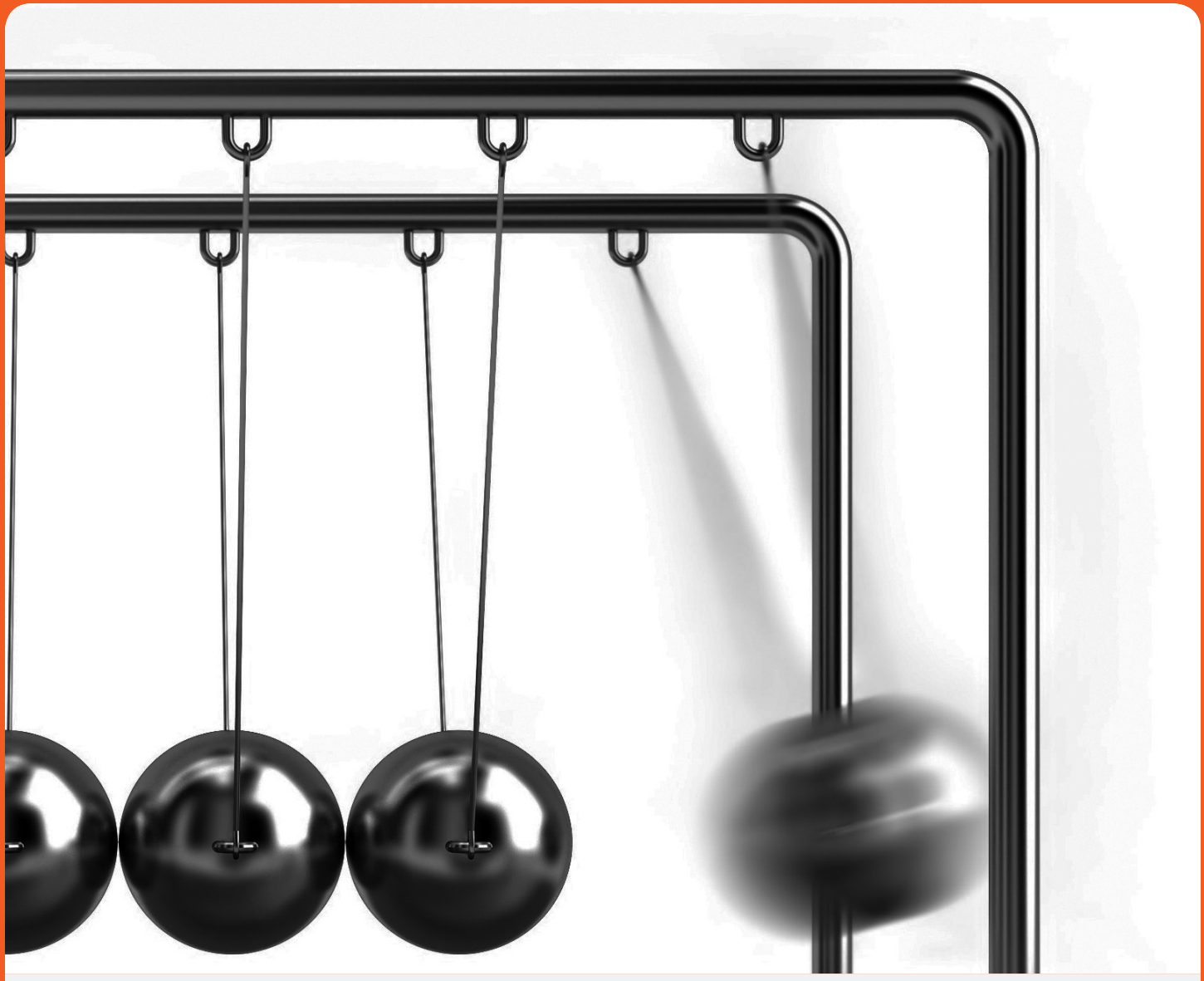


THE SHIFTING HEDGE FUND LANDSCAPE: PART II OF II

The New Dynamics of Hedge Fund Competitiveness

THE FIFTH ANNUAL GLOBAL SURVEY OF INSTITUTIONAL HEDGE FUND INVESTORS

SEI Knowledge Partnership
Insights for Investment Managers

GREENWICH ASSOCIATES

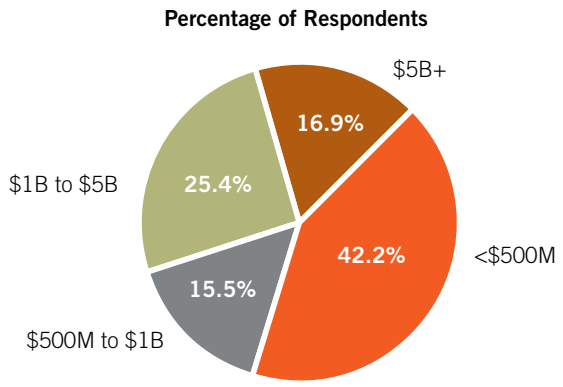
About the Survey

SEI's fifth annual survey of institutional hedge fund investors was conducted in September and October of 2011 by the SEI Knowledge Partnership in collaboration with Greenwich Associates. Online questionnaires were completed by senior investment professionals at 105 institutions.

Endowments account for more than a third of all survey respondents while foundations represent just over 17%. Family offices, corporate funds, and public pension funds each account for another 12%. The remaining responses came from consultants, union plans, and non-profit organizations.

Participating organizations range in size from less than $500 million to more than $20 billion in assets [*Figure 1*]. The distribution of respondents by size is very similar to the universe for the 2010 edition of our survey. Approximately 85% of respondents are based in the United States with the rest based in the United Kingdom, Canada, and Scandinavia.

Figure 1. 2011 survey universe by asset size



Source: SEI Hedge Fund Investor Survey

Survey results are being presented in two parts:

PART I focuses on current trends affecting the hedge fund industry, including institutional hedge fund allocations, objectives, performance, and preferences in investment strategies and vehicles.

PART II explores investors' chief concerns regarding hedge fund investing, as well as the continuing evolution of institutional standards for hedge fund evaluation, selection and monitoring.

Reputations on the Line

If 2011 was a tough year for hedge funds, 2012 may be a pivotal one. The picture that emerges from our latest survey of institutional investors is an industry landscape both rife with challenges and rich with opportunities.

Hedge funds are being tested by institutions' high performance expectations amid a volatile, uncertain global economic climate. Investors are simultaneously demanding more of fund managers in terms of risk management, liquidity, transparency, and operational quality.

Meanwhile, the full effects of 2011's extreme volatility have yet to be felt in redemptions. Many funds have not yet climbed back to pre-2008 high water marks, and managers must get by on management fees alone. With stiff competition among funds—61% of investors think there are "too many look-alike strategies"—some level of shakeout could be around the corner.

At the same time, industry sources project that hedge funds will see $80 billion in net new flows this year, and that 60% of investors will increase the number of managers in their portfolio. What's more, Barclays Capital estimates that $350 billion to $400 billion in existing hedge fund allocations will be in play as investors reallocate to other funds and strategies.

Those who can articulate and execute a differentiated, well-thought-out strategy have a good shot at increasing AUM and market share. Our survey also shows that many institutions are willing to consider small, emerging managers—sometimes regardless of length of track record.

It's going to be an interesting year.

Key Findings

Rising Expectations

PERFORMANCE IS JOB #1. More than one in four respondents named performance among the greatest challenges of hedge fund investing, double the percentage in 2009.

LIQUIDITY IS A GROWING WORRY. The inability to control an exit strategy was among top concerns for 46% of investors, and 31% cited liquidity risk as a broad area of concern. Groups giving these responses could be somewhat overlapping, as multiple responses were allowed, but it's clear that liquidity has become a top-of-mind issue.

RISK MANAGEMENT IS A WORK IN PROGRESS. Only one in five of those we polled agreed that "most hedge funds do a good job of risk management."

INVESTORS ARE REACHING FOR THE NEXT LEVEL OF TRANSPARENCY. While transparency has improved, investors still see it as a top worry. The top unmet information need is detail on the use of leverage, named by 57% of those we surveyed. However, nearly half say system-generated portfolio data is "irrelevant" without direct manager access.

Competitive Shifts

OPERATIONAL STRENGTH HAS BECOME A MAJOR COMPETITIVE ADVANTAGE. Eighty percent of investors say it is the hallmark of an institutional-quality fund.

LOOK-ALIKE STRATEGIES ARE A PROBLEM. Six in ten investors agree that hedge fund strategies are too similar.

SMALL SIZE NEED NOT BE A BARRIER. Nearly half of those we surveyed said they would consider smaller, emerging managers; more than 30% of respondents had asset minimums of $100 million or less. Likewise, having a limited track record is not a deal-breaker; 38% would invest with firms with minimum track records of three years or less and 14% would consider a promising fund with no record at all.

Only one in five of those we polled agreed that "most hedge funds do a good job of risk management."

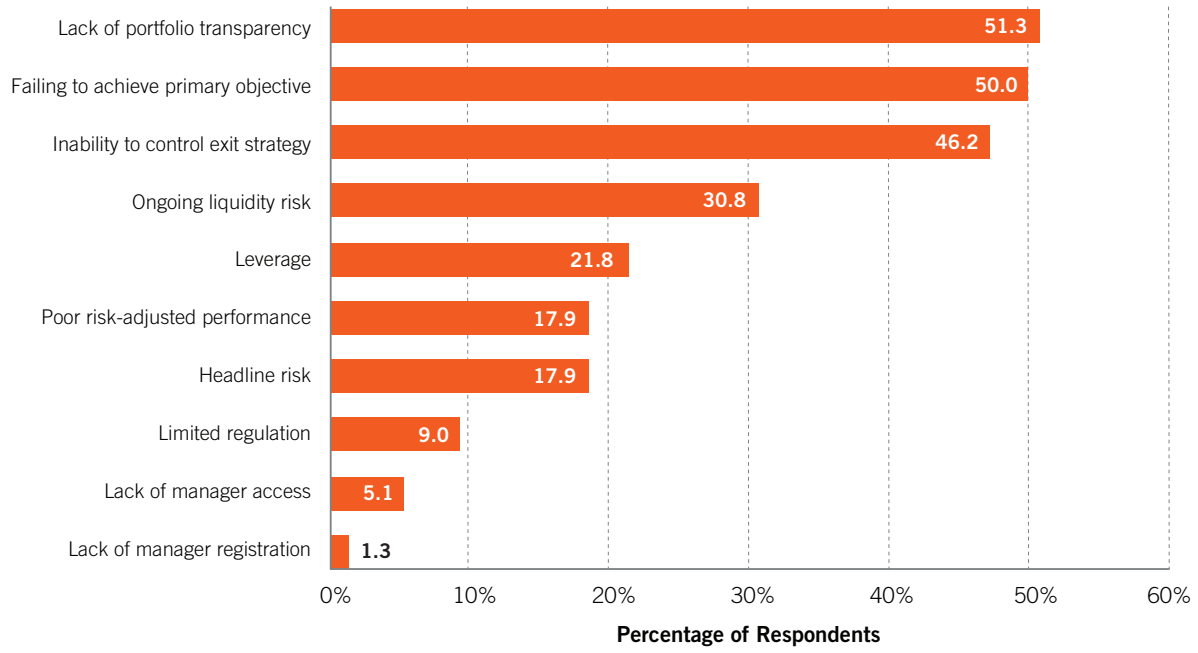
Survey Results

Investor Worries Persist, with Heightened Concern over Liquidity Risks

In Part I of this report, we documented that investors are increasingly concerned with hedge funds' ability to meet performance expectations. The percentage of survey respondents who named performance among the greatest challenges of hedge fund investing has more than doubled in the past two years, rising from 12% in 2009 to 22% in 2010 and 26% in 2011. The fact that investors were feeling performance pressures is no surprise, given that the HFRI Fund Weighted Composite Index fell 5.0% in 2011.

In response to a different question, "What are your biggest worries when it comes to hedge fund investing?", institutions identified the same risk factors and concerns, in roughly the same order, as they have since the 2008 financial crisis. "A lack of portfolio transparency" remained at the top of investors' worry list, followed closely by "failure to achieve the primary objective" [*Figure 2*]. In third place was "an inability to control exit strategy," named by 46% of respondents in addition to the nearly 31% who cited liquidity risk as a broad concern. There may be substantial overlap in the survey respondents who named those two items, as multiple responses were allowed. Still, these percentages suggest that, all told, liquidity risks may loom as large as transparency concerns in the minds of investors. Poor performance and leverage were also high-ranked concerns, as they were in 2009 and 2010.

Figure 2. Biggest worries about hedge fund investing



Multiple responses allowed.

Source: SEI Hedge Fund Investor Survey

CONTEXT / PERFORMANCE UPDATE

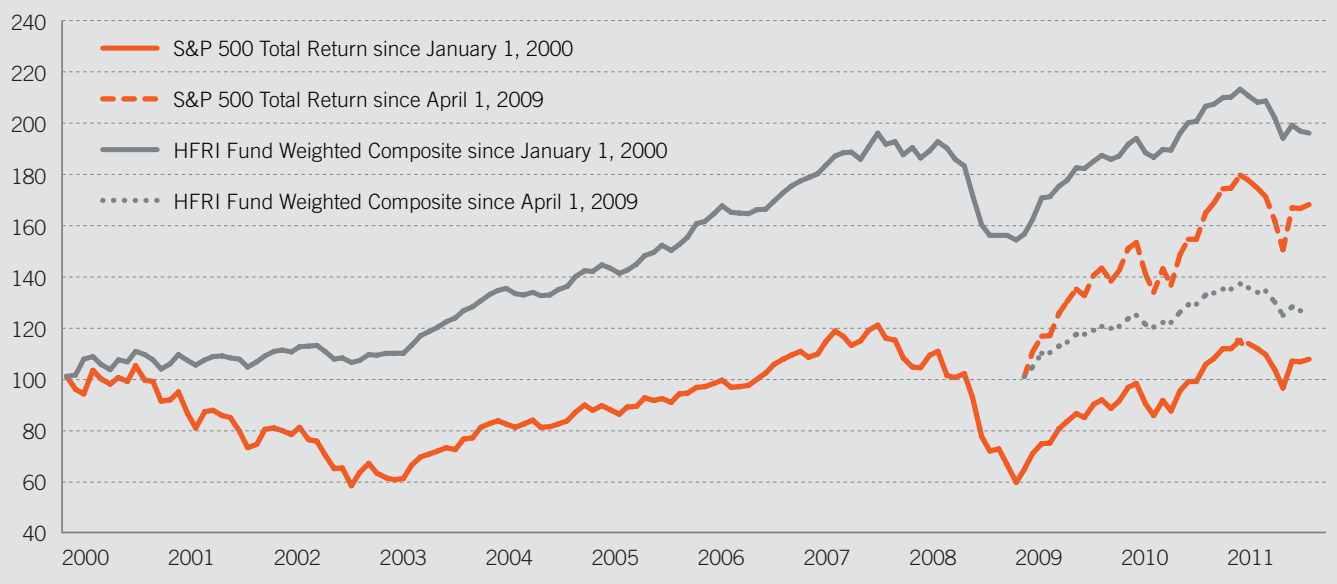
In the past, hedge funds have often demonstrated their ability to thrive on volatility and market upheaval. But 2011 was different. The HFRI Fund Weighted Composite Index posted a 5.0% annual loss for 2011 vs. a positive 2.1% total return for the S&P 500—only the third year of decline since inception of the index in 1990, but the second year of losses out of the past four. Moreover, four out of the five strategies included in the HFRI Fund Weighted Composite Index experienced negative returns for 2011.[1] A lack of market direction and record volatility made conditions challenging enough. Beyond that, investors moving en masse with a risk-on/risk-off mindset drove up asset class correlations to the point where few strategies worked, a disturbing reminder of 2008.

On the positive side of the ledger, however, hedge funds as a group exhibited substantially lower volatility than the S&P 500 during 2011, even during the market's most dizzying period of up-and-down spikes in August and September. The HFRI Fund Weighted Composite Index had a maximum monthly drawdown of 3.9% and a standard deviation of 1.9%. Meanwhile, the S&P 500 had a maximum monthly decline of 7.0% and a standard deviation of 4.6%.

Thus, while they collectively failed to deliver positive absolute returns, our respondents' #1 objective for hedge fund investing (as documented in our Part I report), hedge funds did serve investors' other top-ranked goals—non-correlated return, diversification, and dampening of volatility.

[1] Hedge Fund Research

Figure 3. Relative performance of HFRI Fund Weighted Composite Index (Indexed to 100)



Sources: Hedge Fund Research, Standard & Poor's

Investors Continue to Raise the Expectations and Standards They Apply to Hedge Funds

Part I of our survey report detailed institutional investors' growing focus on the ability of hedge funds to meet performance expectations. Those expectations remain lofty despite challenging market conditions, suggesting that the hedge fund industry's reputation is now on the line. Will investors keep up the level of confidence in hedge funds—and the uptrend in allocations—that they have maintained through thick and thin?

Much depends not only on how well hedge funds perform in 2012, but also on how the industry responds to investor demands. As our survey results show, when it comes to high investor expectations, performance is only the beginning. As hedge fund investing continues to evolve, institutions are recalibrating standards, expanding their toolkits, and redefining best practices across the board.

Risk management demands additional manager focus and resources

High sensitivity to both the known and the hidden risks of hedge fund investing is a theme running through many of our survey findings. Investors remain intent on selecting hedge funds whose strategies they can understand: more than 95% of our respondents named "clarity of investment philosophy" as important in fund selection, making it the top-ranked factor in 2011, as it was the previous year.

Ernst & Young's 2011 hedge fund survey highlighted the importance of risk management as a factor in hedge fund selection. In fact, investors in that poll identified a lack of adequate risk management as the #1 reason for not hiring candidate hedge funds.[2]

Respondents to SEI's survey also cited "understanding risk" as one of the top challenges of hedge fund investing; it ranked fifth on the list of challenges named [*Figure 4*].

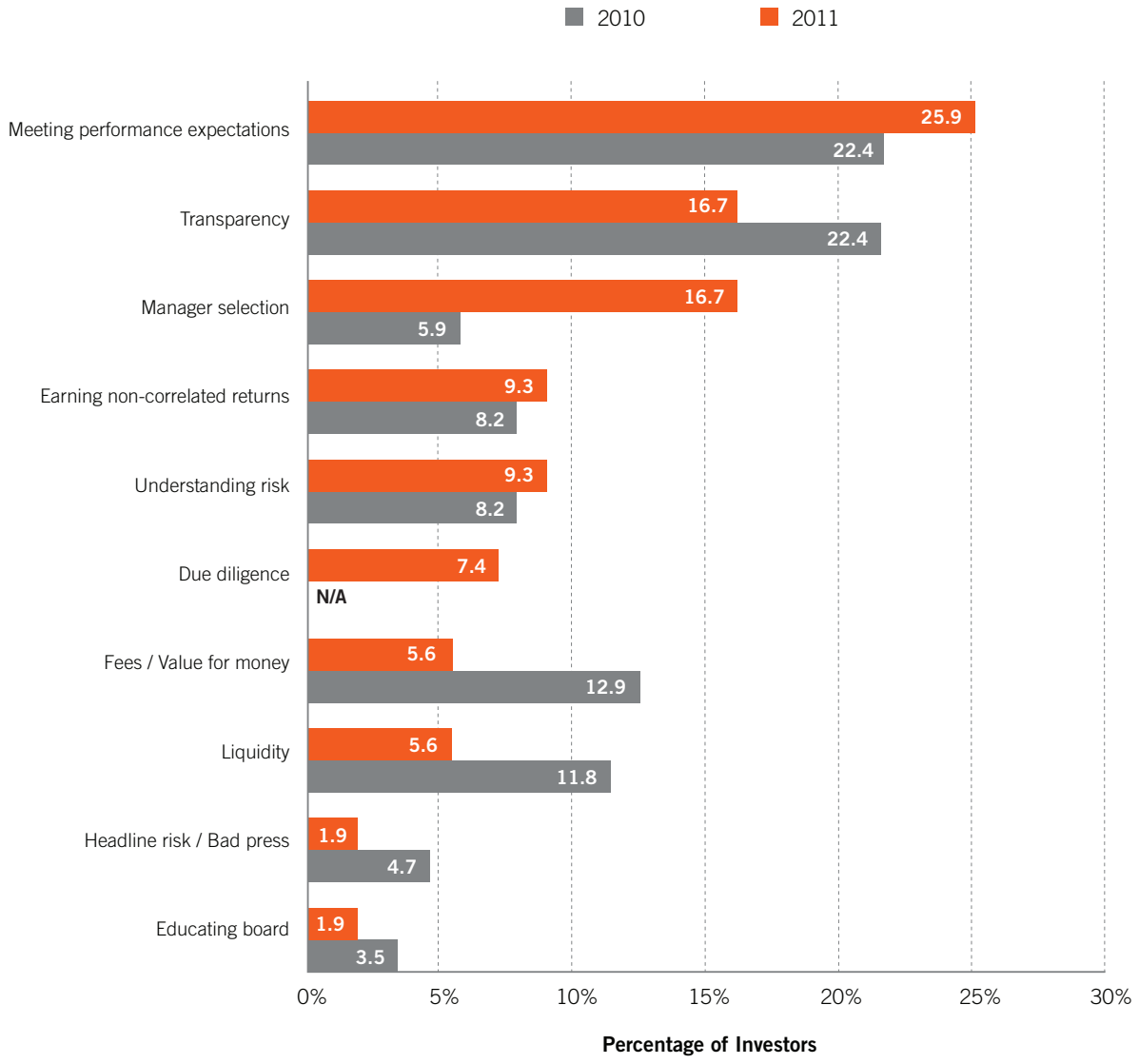
Most tellingly, when respondents were asked directly whether hedge funds generally do a good job of risk management, only one in five answered affirmatively. While only 28% disagreed, more than half of respondents were on the fence—hardly a rousing vote of confidence. This is a point of prime concern to the industry, as investors named "risk management infrastructure" the third most important factor they weigh in evaluating and selecting hedge funds [*Figure 8, page 14*].

21% AGREE
28% DISAGREE

Most hedge funds do a good job of risk management

[2] Ernst & Young, *Coming of Age: Global hedge fund survey 2011,* November 2011

Figure 4: Single most important challenge faced as hedge fund investors



Source: SEI Hedge Fund Investor Survey

Of course, "risk management" is a sweeping term that encompasses issues at every level of hedge fund management—from firm structure and investment strategy to portfolio management and operations. At the same time, recent experience has made hedge fund investors more aware of counterparty and liquidity risks, not to mention the risks of underperformance, in addition to their perennial concerns with potential blow-ups, excessive leverage, and headline risk. All this suggests that, going forward, risk management infrastructure deserves to be an even greater focus of investor and hedge fund due diligence than it has been in the past.

Improved transparency has eased concerns—yet unmet demands remain

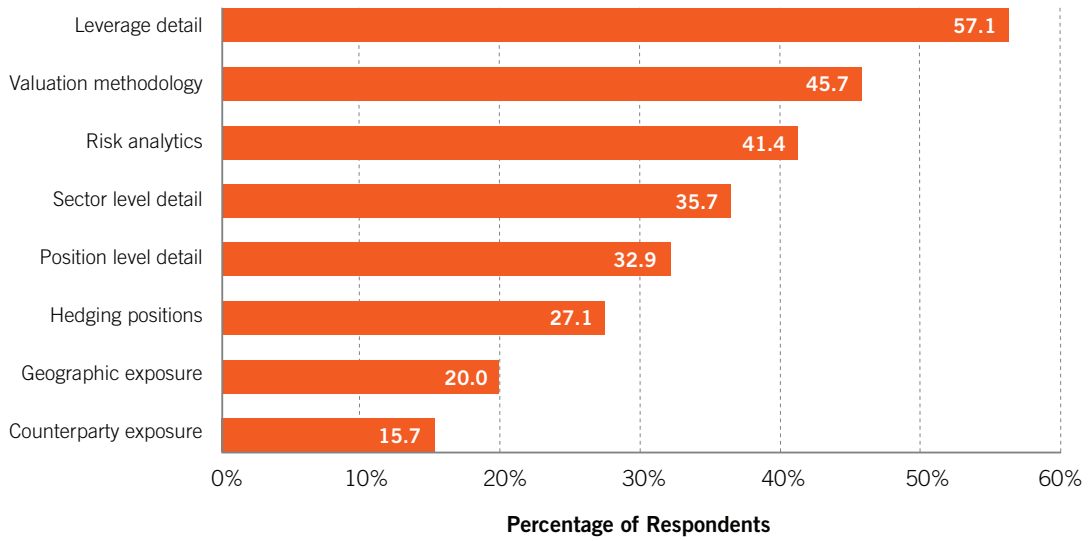
For the first time in four years, "transparency" was not named the number-one challenge in hedge fund investing. Moreover, while transparency tied for second place, the percentage naming it as a top challenge dropped to 17% from 38% two years earlier. This suggests that hedge fund managers have increased their openness to the point where investors have become more comfortable with the depth and breadth of information provided. Supporting this interpretation are findings of the recent 2011 Preqin Transparency Study, in which 96% of the institutional investors Preqin surveyed said the level of hedge fund transparency had improved.[3]

Yet, when it comes to the things that worry investors the most, transparency is still at the top of the list, neck-and-neck with "failure to achieve primary objective" [*Figure 2, page 3*]—an indication that institutions remain wary of hidden or unforeseen risks.

Since last year's survey, leverage has shot up to the top of the list of items on which respondents want

[3] Preqin, *Global Hedge Fund Investor Review,* June 2011

Figure 5. Types of information sought from hedge fund managers



Multiple responses allowed.

Source: SEI Hedge Fund Investor Survey

more information from hedge fund managers—not surprising, given that 22% cite use of leverage among their biggest worries about hedge fund investing, and that fund managers may be making greater use of leverage to boost returns in light of low interest rates. Our 2011 respondents placed less priority, overall, on getting additional sector-level portfolio data than did those in the previous year. The percentage seeking more position-level detail dropped from 48% in 2010 to about 33% in 2011 [*Figure 5*].

On the subject of transparency, the findings of our survey were strikingly similar to those of SEI's 2011 poll of institutional private equity investors.[4] While most investors agreed that private equity managers have improved reporting and are meeting basic transparency expectations, 75% seek more information on areas such as leverage and volatility.

Trends on the issue of transparency reflect the maturing of alternative investing. Clearly, fund managers have accepted the need for greater transparency and are advancing their reporting by degrees and over time. With heightened disclosure, institutional investors have grown more comfortable with alternative investments. Yet at the same time, institutions are becoming increasingly sophisticated in their expectations and their scrutiny. When their demands for more portfolio-level information were satisfied, investors began seeking greater security-level disclosure, and are now seeking data to support more complex and comprehensive risk analytics, such as leverage detail and full counterparty exposure. At the same time, investors' heightened sensitivity to liquidity, counterparty, and other risks since the financial crisis has certainly done much to increase the scope and depth of their information demands.

48% AGREE
21% DISAGREE

System-generated portfolio transparency is irrelevant without manager access

Direct access and frequent communication are high priorities

Survey findings make it clear that a high degree of portfolio transparency is necessary—but by no means sufficient—to address investors' concerns with the risks of hedge fund investing. Throughout the five years of this annual survey program, our findings have shown that investors want above all to understand the philosophy and strategy that underlie a hedge fund portfolio, and not just the composition and attributes of the portfolios themselves.

Thus, to keep up with client expectations and industry best practices, hedge funds must regularly augment portfolio data with informative, insightful client communications as well as direct access to investment teams and other key personnel. By a better than two-to-one margin, our survey respondents agreed that "system-generated portfolio transparency is irrelevant without manager access."

When SEI's survey respondents were asked to translate their desires for manager access into a regular meeting schedule, about 43% of investors said they wanted annual meetings, while 26% preferred quarterly sessions [*Figure 6*]. When it comes to routine communications, nearly two out of three investors said they want monthly reporting while 23% said they would be satisfied with quarterly reports [*Figure 7*].

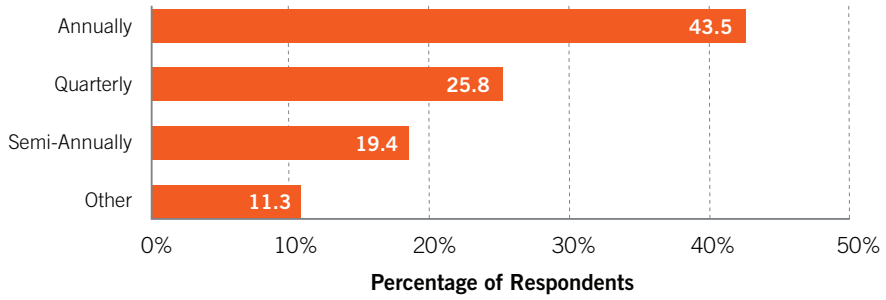
What fund managers may overlook, given the industry's continuing focus on the data aspects of client reporting, is how vital it is to ensure that

[4] SEI Knowledge Partnership, *The 2011 SEI Private Equity Survey, Part II: Searching for Alignment,* October 2011

client communication channels are interactive, offering ample opportunity for discussion and client feedback. Without honest, unimpeded dialogue, fund managers may never appreciate clients' true aims and concerns, let alone understand the nuances coloring the relationship.

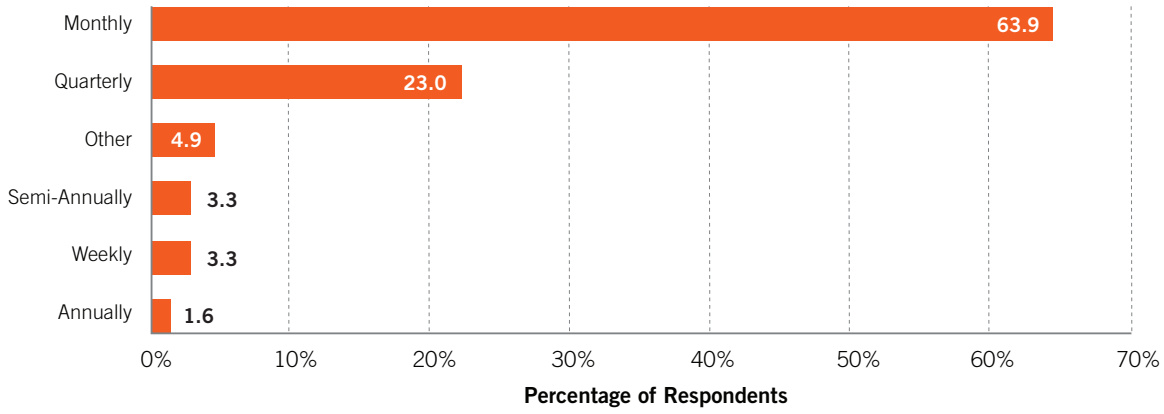
This point was highlighted in Ernst & Young's latest hedge fund survey, which covered both fund managers and institutional clients. In a major disconnect, the lack of adequate risk management was investors' most commonly cited reason for not hiring a hedge fund they had considered, yet fund managers gave that factor the *lowest* ranking among reasons they had not been hired.[5] Clearly, two-way communication is an area in which hedge funds need to make major improvements. They have strong incentives to do so, given the potential to increase client retention, hone their marketing, and potentially gain a competitive advantage.

Figure 6. How often do you want to meet personally with your hedge fund managers?



Source: SEI Hedge Fund Investor Survey

Figure 7. How regularly do you want your hedge fund managers to communicate with you?



Source: SEI Hedge Fund Investor Survey

[5] Ernst & Young, *Coming of Age: Global hedge fund survey 2011,* November 2011

Operational excellence is a requisite for hedge funds seeking institutional business

No other attitudinal question posed in the survey elicited a stronger response than the one on this topic. Eight in ten investors agree—with 21% agreeing "strongly"—that operational strength is a hallmark of an institutional-quality fund.

80% AGREE
3% DISAGREE

Operational strength is a hallmark of an institutional-quality hedge fund

This indicates that investors will increasingly insist on quality factors that may once have been considered optional. For example, better than half of the investors in our survey said that a separation of investment and operational roles is an important factor in hedge fund selection. Increasingly investors are also assessing funds based on the rigor and documentation of key operating processes, as well as such checks and balances as the oversight of independent boards and third-party risk and performance analysis.

Survey responses also suggest that the quality of operations is a major consideration in institutions' screening and evaluation of hedge funds. Nearly 55% of survey respondents named the quality of reporting and communication as an important or very important selection factor [*Figure 8, page 14*].

Evaluating and Selecting Funds Is a More Complex Endeavor than Ever

The difficulties of manager selection and due diligence are now top-of-mind concerns

Given the proliferation of hedge funds and strategies, it's not surprising that, for the first time in this survey's five-year history, "manager selection" has cropped up among top challenges named by investors, ranking third on the list [*Figure 4, page 6*].

In a related finding, "due diligence" also made its first appearance on the "top challenges" list, as investors continue working to strengthen their tools and methods in analyzing potential investments.

That daunting nature of hedge fund evaluation and selection appears to stem in part from the difficulty of distinguishing among hedge funds using similar strategies and methods. By a more than 10-to-1 margin, surveyed investors believe that there are "too many look-alike strategies" in the hedge fund industry. While this perception poses a major challenge to fund managers, particularly those in the more popular categories, it also points to a clear opportunity for those who can clearly articulate and differentiate their strategies and methods.

61% AGREE
5% DISAGREE

There are too many look-alike strategies in the hedge fund industry

This brings up the subject of "brand," a topic of growing interest in the increasingly crowded hedge fund field. In SEI's survey, responding institutions were split on whether strength of a hedge fund's "brand" offers meaningful guidance in picking a hedge fund, and nearly 48% were neutral. This ambivalence mirrors ongoing industry debate as to the importance of brand, which may stem in part from the lack of a uniform definition for the term as well as regulatory constraints on the public marketing of hedge funds.

HOW MUCH DOES "BRAND" REALLY MATTER?

The institutions participating in SEI's survey were decidedly mixed in their views on the importance of brand in hedge fund selection. Nonetheless, within the industry there is considerable discussion of "brand" as a critical factor in helping investors winnow through the growing ranks of hedge funds, now estimated to number more than 10,000.[6]

A recent Cogent Research survey found that institutional investors' perceptions of hedge funds' "integrity and transparency"—traits the study equated with "brand"—weighed as heavily as investment performance in the selection of funds.[7]

Don Steinbrugge, chairman of Agecroft Partners, marketing consultants to hedge funds, maintains that branding drives a majority of asset flows in the industry, as investors seek ways to distinguish among an avalanche of competing funds. In a recent opinion piece, he describes how the notion of a strong hedge fund brand, which was long associated with large, high-profile firms, has recently evolved to include small and medium-sized firms with high-quality offerings, good performance potential, and one or more principals who have forged a reputation in the industry, often through an earlier affiliation.[8]

Quite a different perspective is offered by Ernst & Young's recent industry survey, which found that institutional investors felt the greatest degree of loyalty not to founding partners of hedge funds, who often personify a fund's brand, but to individual hedge fund portfolio managers.[9] This finding was 180 degrees from the perceptions of the fund managers E&Y surveyed, who believed that investor loyalty was attached primarily to founding partners.

26% AGREE
28% DISAGREE

When it comes to picking hedge funds, brand does not matter

While investors may gain a degree of comfort from investing with firms headed by highly regarded investment thinkers, this "halo effect" may be undercut by the well-publicized failures of several once legendary fund managers over the years—from the 1998 blow-up of Long-Term Capital Management, whose partners included two Nobel Prize winners, to the more recent troubles of industry stars like John Paulson, whose flagship Advantage Plus fund lost half its value in 2011.[10] Indeed, some sophisticated investors have opined that large, established managers may sometimes be a riskier bet than smaller ones. To the extent that larger managers overlap in their strategies or trades, increasing the level of cross-investment correlation, investors may have more risk exposure should conditions deteriorate.

The importance of brand will no doubt remain a hot topic among investors and hedge funds alike. Still, our survey suggests that institutions may place as much store in systematic, objective methods of evaluating funds as they do in the vaguer, more subjective criteria described as "brand."

[6] http://www.finalternatives.com/node/18648
[7] Cogent Research, *Institutional Investor Brandscape,* January 2012
[8] http://www.opalesque.com/639275/Agecroft_Partners_believes_Hedge_fund_branding_drives927.html
[9] Ernst & Young, *Coming of Age: Global hedge fund survey 2011*, November 2011
[10] http://www.reuters.com/article/2012/01/09/us-hedgefund-paulson-idUSTRE80819J20120109

The "four P's" still dominate manager selection criteria

While respondents' ranking of manager selection criteria did not change substantially from 2010 to 2011, some priorities have shifted. Three of the classic "four Ps" remain high on the list: Philosophy and People were the first- and second-ranked criteria in this survey edition, as they were the previous year—although in 2011 the quality of the firm's investment team garnered the most citations as "very important" [*Figure 8, page 14*].

51% AGREE
17% DISAGREE

Monthly liquidity is acceptable for hedge fund investments

Process, expressed as an "identifiable source of alpha," was again #4 on the list, although it took a back seat to risk management infrastructure, which remained among the top three criteria.

The fourth "P," Past Performance, ranked ninth among selection criteria. As sophisticated investors who fully understand that "past performance is not indicative of future success," institutions are clearly placing greater weight on the inherent clarity, repeatability, and risks of investment strategies than on their recent returns. As a fund selection factor, performance was also superseded by portfolio transparency, liquidity terms, the quality of client reporting, and the separation of investment and operations roles in fund governance.

Liquidity terms, which were first named among investors' top selection criteria in 2010, were again on the list in 2011. In this context, it's worth noting that when respondents were specifically queried about liquidity terms, their views were mixed. While half found monthly liquidity to be "acceptable" for hedge fund investments, about a third of respondents were on the fence and 17% disagreed outright. Providing another angle on liquidity issues, investors polled in a recent Barclays Capital survey reported that 90% of their current hedge fund allocations had been to funds with either no initial lock-up or only a one-year lock-up.[11]

[11] Barclays Capital, *The Money Trail,* January 2012

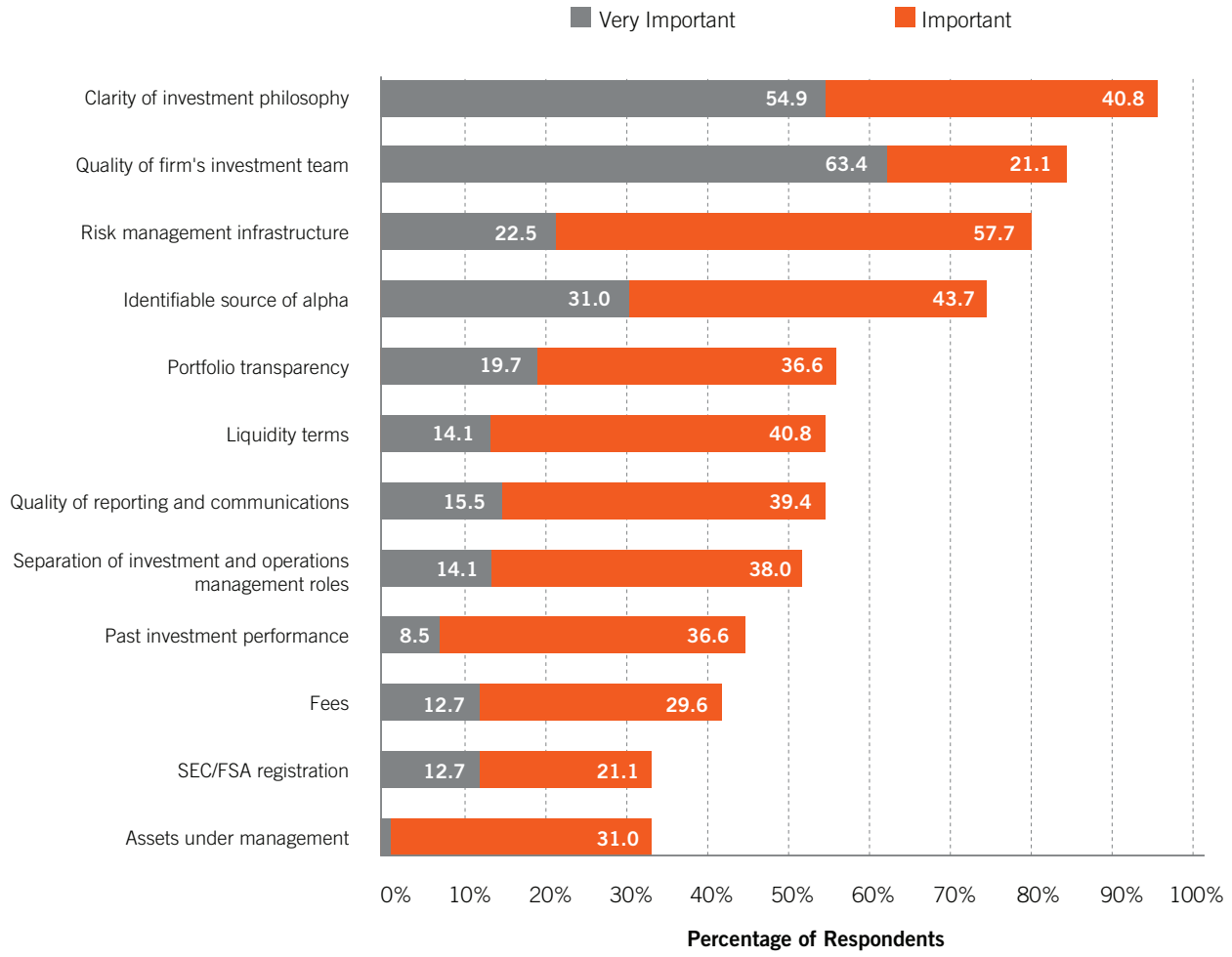
Institutions place greater weight on the clarity, repeatability, and risks of hedge fund strategies than on recent returns.

Fees, the subject of significant debate over the past few years, were ranked lower as a selection factor in 2011 than in prior years—perhaps because fund managers have been under greater pressure to negotiate fees in order to attract or retain assets. As average hedge fund performance has recently been comparable to that of long-only managers and fees are often four or five times greater, fee pressure is not unexpected.

Registration of hedge funds with the Securities Exchange Commission (SEC) or Financial Services Authority (FSA) was not an important consideration for investors, although it did appear among the top 12 selection criteria. However, except for very small funds and start-ups, this factor will become largely moot as of March 31, 2012, by which time all hedge funds and private equity funds with more than $150 million in assets or 15 or more U.S. clients will be required to register with the SEC.[12] Among our respondents, 82% said they support an SEC/FSA registration mandate.

[12] http://www.marketwatch.com/story/sec-oks-new-oversight-for-hedge-funds-2011-06-22

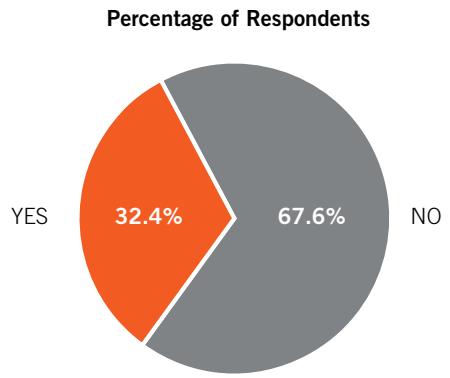
Figure 8. Important or very important factors when selecting hedge fund managers



Multiple responses allowed

Source: SEI Hedge Fund Investor Survey

Figure 9. Has your organization changed its due diligence process over the past two years?



Source: SEI Hedge Fund Investor Survey

Due diligence has intensified

Consistent with their perception that due diligence has grown increasingly challenging, nearly one-third of survey respondents said they had changed their due diligence procedures over the previous year [*Figure 9*]. Investors generally reported moving toward more intensive and robust due diligence, with more frequent onsite meetings, sometimes involving investment committee members. Some investors in funds of hedge funds are even making a point of visiting underlying fund managers.

Respondents also said they are more often requesting additional detail on topics ranging from investment and valuation methodologies to liquidity and counterparty risk. Detailed background and reference checks are becoming more common, as are efforts to validate and substantiate facts and figures supplied by managers.

It is worth noting that due diligence is of necessity becoming a bilateral process. That is, hedge fund managers should not only respond to investors' information requests, but also conduct their own inquiry regarding investor objectives, standards, methods, and preferences. If those are explicitly understood right from the start, fund managers will be better equipped to address issues and meet expectations.

Minimum AUM and track record thresholds vary considerably

Fund size does matter, to a point. Assets under management (AUM) ranks low among fund evaluation factors, and almost 20% of respondents said they have no asset minimum at all, while another 15% said they would consider hiring a firm managing $50-$100 million in assets [*Figure 10*].

Still, about one-third of our survey respondents consider fund AUM to play an important or very important role in selection decisions. There are some good practical reasons why. Under ERISA rules, large pension plans are prevented from making up too much of any one hedge fund's portfolio. Large investors may also want to avoid the complexities that come with managing a plethora of small hedge fund positions, although this problem can be circumvented by investing via a fund of hedge funds focused on seeking out emerging managers.

16% AGREE
49% DISAGREE

Smaller, emerging managers have no place in my portfolio

But survey results debunk the notion that only large and seasoned hedge fund managers can attract substantial allocations. Two out of three investors we surveyed have minimum AUM requirements of $500 million or less. Moreover, almost half of respondents generally indicated a willingness to hire smaller, emerging managers, with large institutions (i.e., those with $5 billion or more in assets) expressing the most willingness to give start-ups a chance. The smaller the institution, the more likely it is to prefer larger, more established managers.

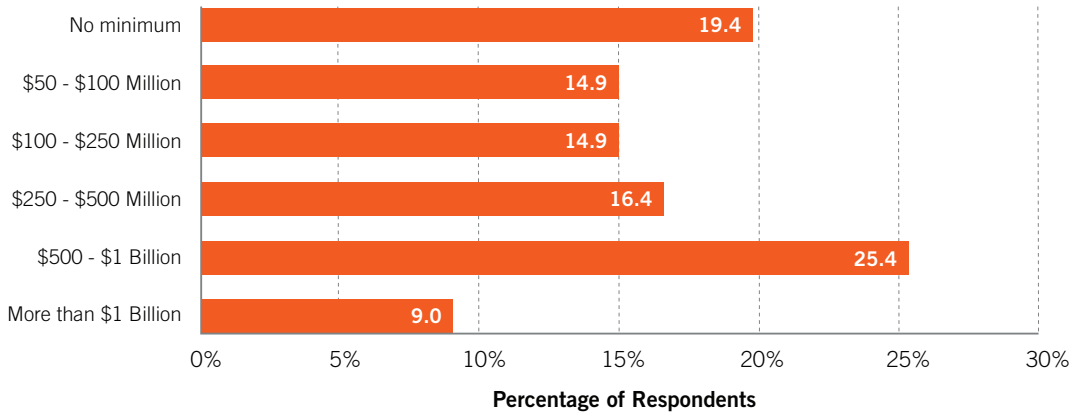
These findings are consistent with those of a recent Barclays Capital poll, in which more than three out of four investors said they might allocate to small hedge funds, which that survey defined as those with less than $1 billion in AUM.[13] The Barclays Capital report notes that in the first nine months of 2011, small hedge funds captured 18% of net new flows, double the 9% share they attracted in the full year 2010. It projects a continuation of this trend, since 77% of the investors sampled said they favor allocations to small funds, with only 10% indicating a tilt toward large funds.

The value added by smaller, emerging managers does, however, remain a topic of industry debate. There is ample research to suggest that early-stage funds are nimbler and deliver higher alpha than larger, more established funds. Critics contend, however, that survivorship and backfill bias in hedge fund databases largely account for the purported outperformance of smaller funds.[14] This issue will no doubt be the subject of additional study.

When it comes to minimum fund track record, responses again varied widely [*Figure 11*]. While 62% of those surveyed said they seek hedge funds with a history of at least three years, 24% would consider a one- to three-year record and 14% would not eliminate a fund with no record at all.

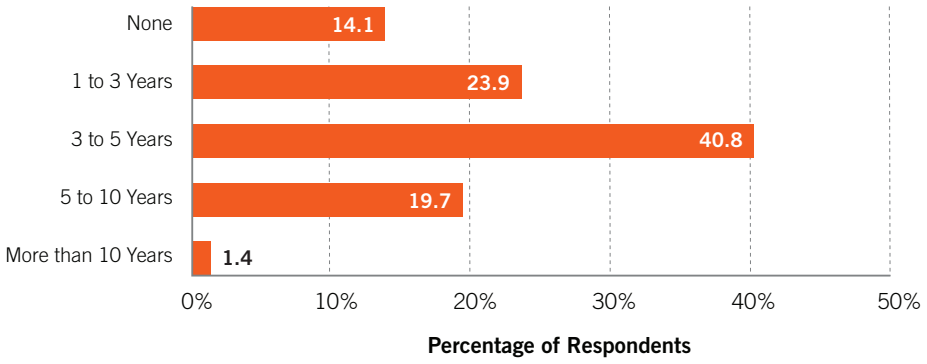
[13] Barclays Capital, *The Money Trail,* January 2012
[14] Investment News, *Emerging hedge fund performance questioned,* December 4, 2011

Figure 10. Minimum assets under management required for investment



Source: SEI Hedge Fund Investor Survey

Figure 11. Minimum track record required for investment



Source: SEI Hedge Fund Investor Survey

Outside expertise is sought by a majority of investors

Nearly 69% of respondents said they presently engage an investment consultant or outsourced CIO to assist in the evaluation, selection and monitoring of hedge funds.

Yet respondents are divided on the necessity of such assistance. Although about half of respondents believe hedge funds are too complex to evaluate without a consultant's help—and nearly 15% agree strongly—almost four in ten disagree.

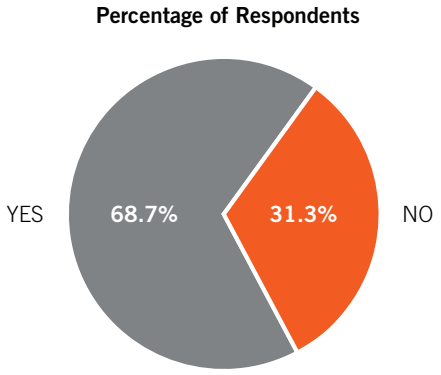
51% AGREE
38% DISAGREE

Hedge funds are too complex to evaluate without a consultant's help

Not surprisingly, responses were stratified by institutional asset levels. Smaller investors were much more likely to feel that a consultant's guidance is necessary. On the other hand, larger institutions with greater resources and more experience in the hedge fund space were more confident in their abilities to evaluate and select candidate funds on their own.

The percentage of respondents who use consultants in their hedge fund investing has dropped somewhat from the 2010 survey, when three out of four respondents reported using outside help [*Figure 12*]. This may reflect investor efforts to beef up their internal due diligence; in some cases, this could be a reaction to how well consultants helped their institutional clients to navigate the financial crisis and its aftermath. The trend may also be due partly to the growing number of funds of hedge funds that offer general assistance in hedge fund assessment.

Figure 12. Currently use an investment consultant or outsourced CIO to assist in the evaluation, selection and monitoring of hedge fund managers



Source: SEI Hedge Fund Investor Survey

Conclusion / Recommendations

Despite the disappointments of 2011, institutional investors have continued to deepen their commitment to hedge funds and grow their allocations. For them, hedge funds have become a go-to resource, providing the flexible structure and deep talent pool that investors need in order to meet their portfolio objectives. And while the industry keeps changing, many of those changes translate into more opportunities for hedge funds in the years ahead.

Still, it would be a mistake to underestimate the challenges facing the industry today. As they endeavor to meet return targets in a perplexing investment climate, hedge funds must also keep building institutional-quality organizations in order to remain competitive. The findings of our two part survey suggest that hedge fund managers should:

CONDUCT THEIR OWN DUE DILIGENCE aimed at better understanding client and prospect expectations, sensitivities, and preferences—particularly when it comes to performance. Some areas of disconnect are evident.

FOCUS ON CHANGES OR IMPROVEMENTS NEEDED to meet institutional standards in areas of prime investor concern, including risk management, liquidity, transparency, and operational quality. Our survey respondents cite all of these factors as bearing on fund selection, and expectations continue to rise across the board.

TAKE CARE TO ARTICULATE STRATEGIES CLEARLY, including points of differentiation. Investors have shown they want to invest in strategies that are understandable and have an identifiable source of alpha. The strong concern they voiced with the prevalence of "look-alike" strategies is a challenge to fund managers, but also an opportunity for those with distinctive insights and methodologies.

CREATE MORE OPPORTUNITIES FOR DIALOGUE and interaction with clients. Institutional investors are clearly seeking more direct access to investment teams and other key personnel. When it comes to reporting, investors indicate that they want insights concerning the dynamics of performance, and not just a set of numbers.

ILLUMINATE THE VALUE PROPOSITION being offered. With investors' heightened performance concerns and the challenges of today's investment climate, fund managers need to show how their strategies and methods are enhancing clients' risk-adjusted portfolio returns.

As our survey results suggest, the fund managers that thrive in the years ahead will be those that continue to evolve. Close collaboration will be needed if the industry is to keep advancing its methods and infrastructure while preserving its entrepreneurial spirit. We hope our findings will help fuel dialogue toward that end.

About SEI

SEI (NASDAQ:SEIC) is a leading global provider of investment processing, fund processing, and investment management business outsourcing solutions that help corporations, financial institutions, financial advisors, and ultra-high-net-worth families create and manage wealth. As of December 31, 2011, through its subsidiaries and partnerships in which the company has a significant interest, SEI manages or administers $404 billion in mutual fund and pooled assets or separately managed assets, including $172 billion in assets under management and $232 billion in client assets under administration. For more information, visit www.seic.com.

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