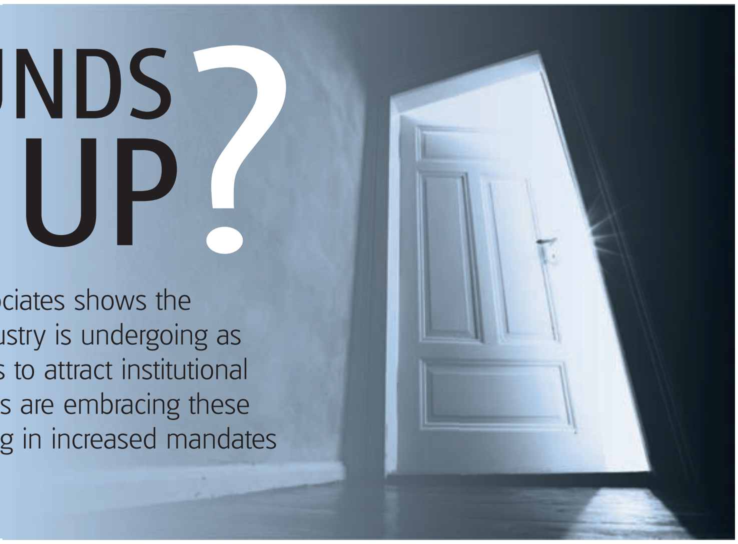
# ARE HEDGE FUNDS OPENING UP?



New research from McGladrey and Greenwich Associates shows the continuous process of change the hedge fund industry is undergoing as it seeks to adapt to new transparency requirements to attract institutional investors. *HFMWeek* examines how far hedge funds are embracing these new standards, and whether the process is resulting in increased mandates

BY KAPILA GOHEL

With the number of hedge fund investors on the rise, 'alternatives' long ago began breaking into the mainstream. This trend will further crystallise in 2010, as traditional wafer-thin allocations to hedge funds broaden into increased investment.

Institutional investors in the US have become an integral source of capital for the hedge fund industry. But while institutions, led by university endowments and foundations, have surpassed high-net-worth individuals (HNWIs) and family offices as the principal resource for the largest US hedge funds, many mid-size managers still struggle to win over this space.

Interestingly, most mid-sized hedge funds interviewed in the McGladrey and Greenwich Associates *2010 Hedge Fund Industry Survey*, exclusively seen by *HFMWeek*, believe they are highly prepared to meet the demands of the institutional investors they have set their sights on.

However, the *2010 Hedge Fund Survey* found that some of those hedge funds, which range from $100m to $500m in size, may be somewhat overconfident in their preparedness to target institutional mandates, especially those with a higher concentration of HNWI investors.

"Mid-size funds are an interesting segment of the hedge fund market as many of them are at a crossroads of business operations," said Alan Alzfan, partner at McGladrey. "These funds need to analyse what they need to do develop their organisations if they want to bring it up to the next level."

As investor demands and requirements are rapidly increasing, driven by the fall-out from the financial crisis and the Madoff fraud, the study suggests that institutional investors require much more than a track-record to be won over.

And unfortunately, despite their belief they are ready, many of those hedge funds are lacking in resources and are at serious disadvantage in winning institutional money in areas of sales, investor service and reporting.

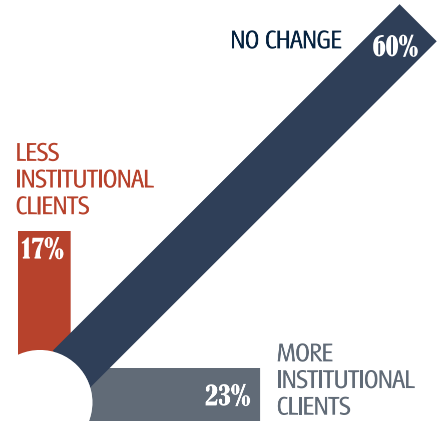
To date, the study reveals that a very small number of the hedge funds surveyed have made changes to adapt to these institutional demands. The majority of mid-size managers will need to review and change their investment management competencies if they intend to evolve their target client base. ■

## CLIENT BASE

McGladrey and Greenwich Associates' research study looked at the capital-raising activities of 52 hedge funds with assets under management of $100m to $500m in June and July 2010. Of those, almost 90% of funds managed both high-net-worth individuals (HNWIs) and institutional investor capital. The survey bundled the respondents into two groups: those with an institutional investor concentration and the other with a HNWI focus. Over the past two years most respondents had not seen much change in their client base however, as expected, the survey found that hedge funds with a institutional investor-concentrated base had fewer clients, 29 on average, than those focused on HNWI – an average of 51.

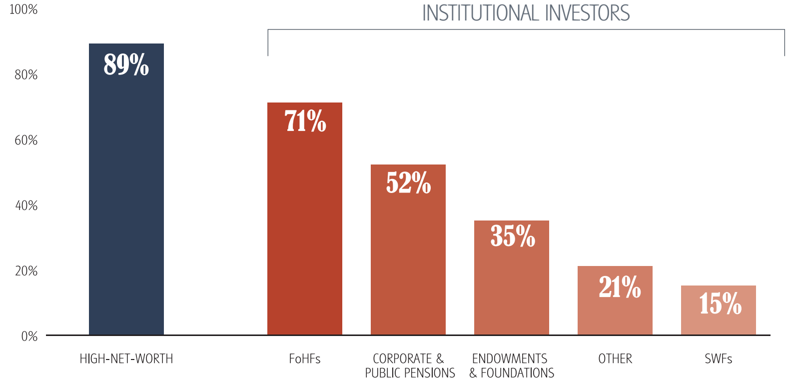
### CHANGES IN THE MIX OF CLIENTS OVER THE PAST TWO YEARS

52 RESPONSES




### TYPE OF CLIENT

52 RESPONSES

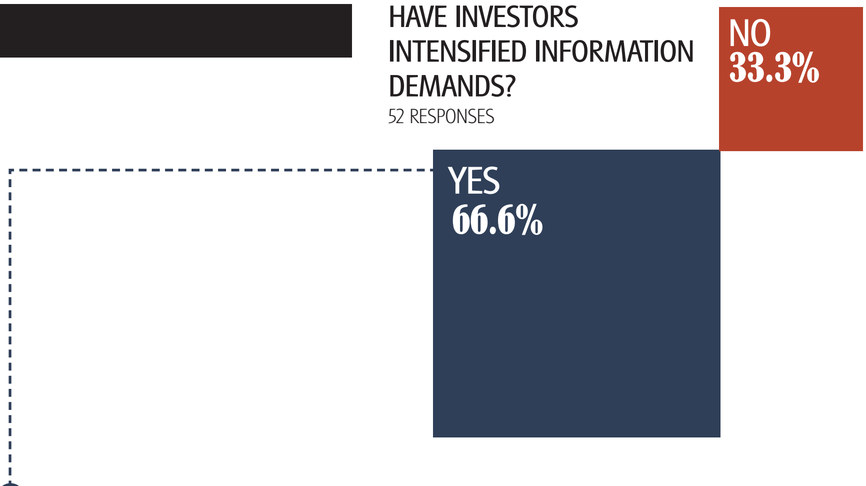


## CLIENT REPORTING

Even though almost 95% of hedge funds surveyed said they are prepared to meet the requirements of institutional investors, many have found that these demands have intensified since the beginning of the financial crisis. Prospective investors are requesting much more information during the due-diligence process. In fact, two in five funds say the time required for the sales and due-diligence process has increased since September 2008. "Those funds that don't have dedicated client service personnel and are not automated are struggling to keep up with investors," said Alzfan. Discussing existing clients, while over half of respondents have found no change, almost 40% say client reporting demands have become 'more burdensome'. Institutional-focused funds share information on performance and risk much more frequently than HNWI-focused funds, although only 10% overall describe their reporting as 'highly automated'.

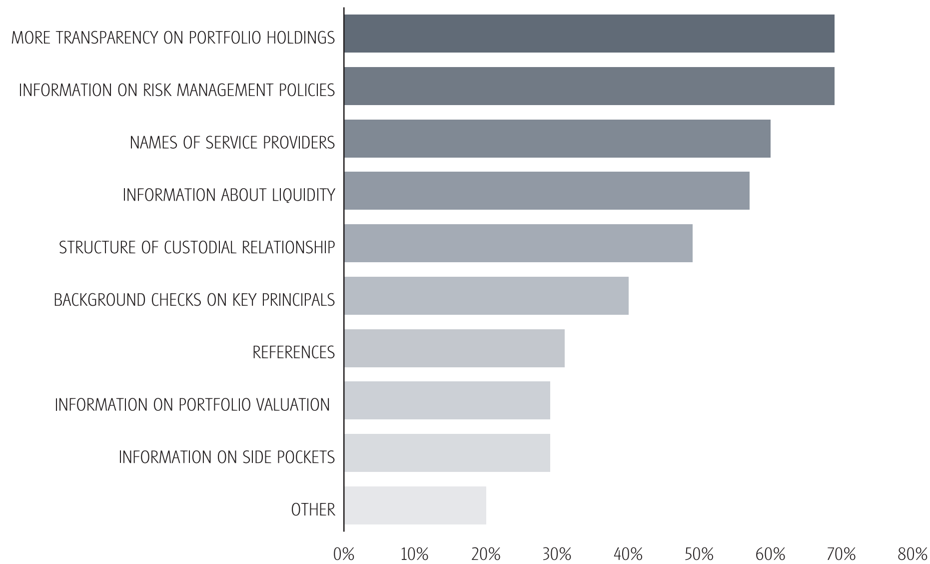
### HAVE INVESTORS INTENSIFIED INFORMATION DEMANDS?

52 RESPONSES

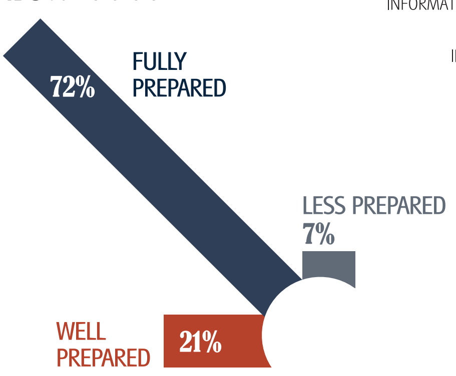



### ADDITIONAL INFORMATION REQUESTED

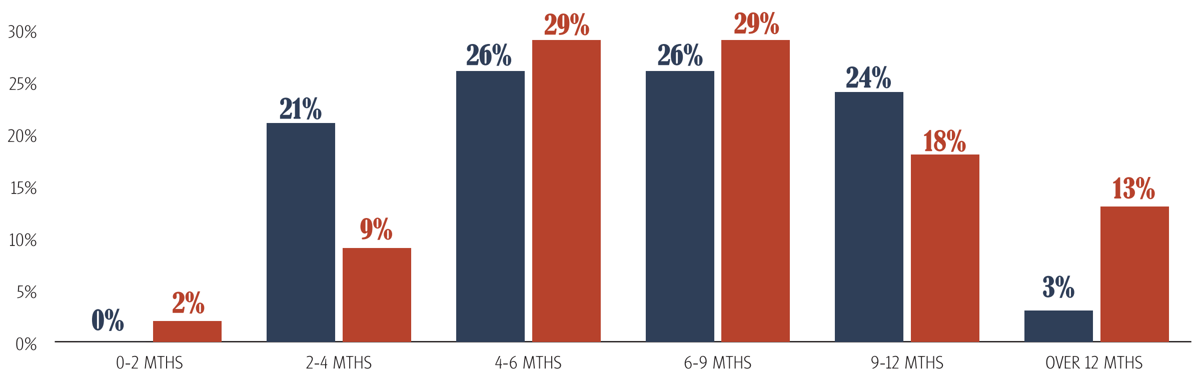
THOSE WHO SAID 'YES' ABOVE (35 RESPONSES)




### LEVEL OF READINESS TO MEET INSTITUTIONAL INVESTOR DEMANDS 50 RESPONSES



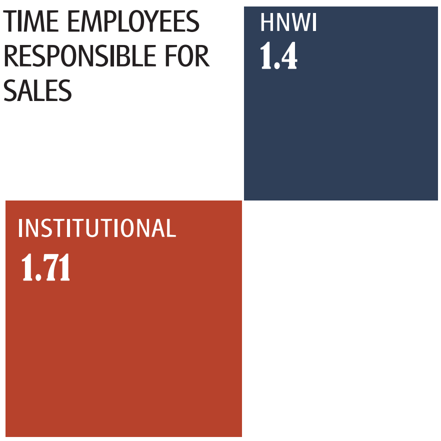

### MONTHS REQUIRED FOR SALES AND DUE DILLIGENCE PROCESS

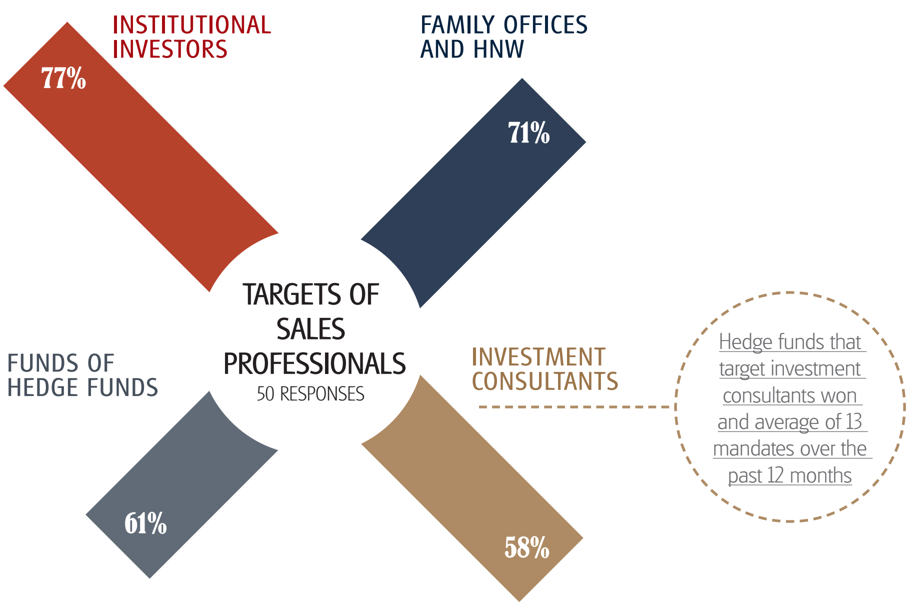


## STAFFING

Analysing the sales infrastructure of the hedge funds surveyed, the research found only 45% had two or more full-time staff dedicated to sales, which were less likely to outsource to third-party marketing firms, while a quarter had less than one full-time equivalent focused on sales on a full-time basis. "One thing institutional investors like to see is a segregation of duties and a dedicated client-servicing team," reveals Alzfan. On average, hedge funds with a majority institutional client base recognised the importance of investments in sales and infrastructure.

AVERAGE FULL-TIME EMPLOYEES RESPONSIBLE FOR SALES



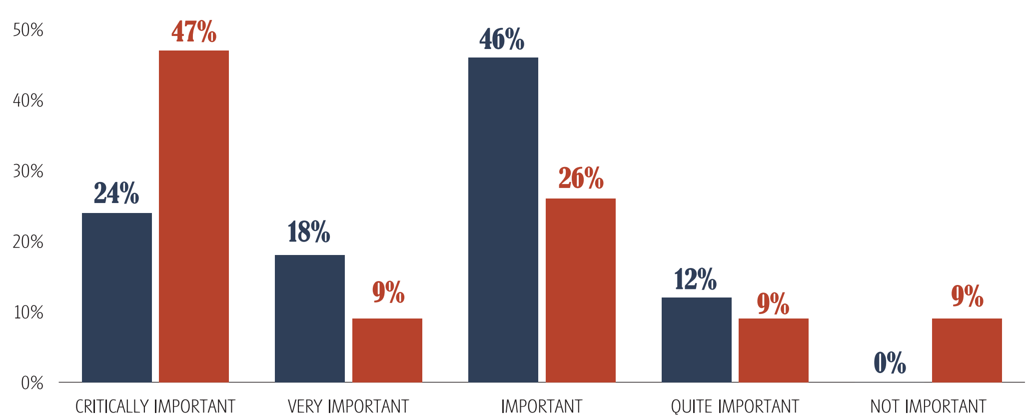




IMPORTANCE OF DEDICATED CLIENT SERVICING TEAM ON WINNING MANDATES

43 RESPONDENTS

HIGH-NET WORTH VS

INSTITUTIONAL INVESTORS




KEY POINT

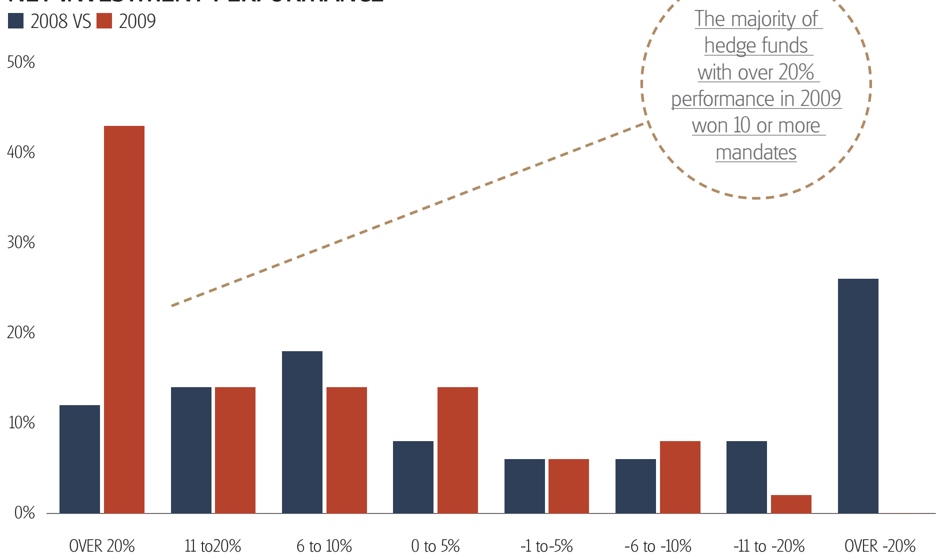
### LIQUIDITY

A new emphasis on liquidity has called for many changes from investors. Hedge funds that won 10 or more mandates in the past year stated liquidity was one of the key drivers behind investors' selection process, the survey found. And those that experienced terminations over the past two years, around 41% of participants, attributed the client's decision to liquidity issues. However, only a third of the managers surveyed said they plan to allow liquidity more frequently, and a similar number say they have reduced their lock-up periods. Those planning not to make any changes will have to consider whether it is feasible to pursue institutional clients.

## WINNING MANDATES

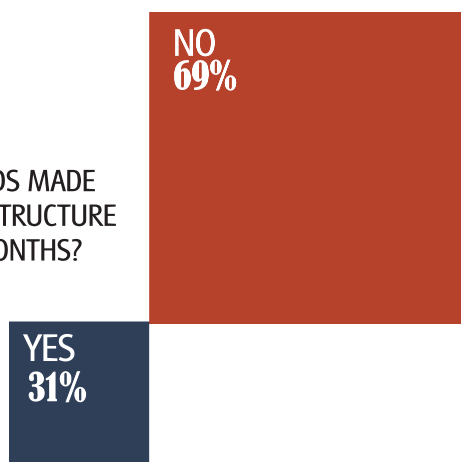
The participants of the survey reported an average investment performance of 26% in 2009, up dramatically from -6% in 2008. The research seems to support the belief that investment performance wins mandates – of those funds that reported performance of 20% and higher in 2009, 60% won 10 or more mandates. That belief may have been true in the past, but isn't likely to hold up for much longer if mid-sized hedge funds wish to attract institutional capital. Those funds will need to step up their efforts in sales, investor servicing, automation and reporting, and make decisions on their willingness to commit capital to these areas. "Hedge funds that want to grow their business are specifically targeting institutional mandates," states Alzfan. "One of my clients has spent over a year expanding their organisation and infrastructure in order to be able to attract institutional investors. They realise they need to make these changes, and we are making recommendations to them to start establishing these best practices."

### NET INVESTMENT PERFORMANCE



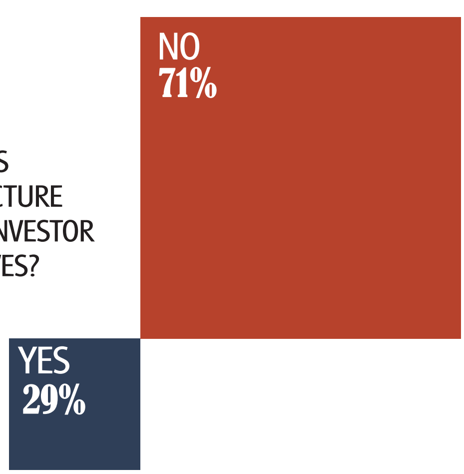

### HAVE HEDGE FUNDS MADE CHANGES IN FEE STRUCTURE IN THE LAST 18 MONTHS?

52 RESPONSES




### HAVE HEDGE FUNDS ALTERED FEE STRUCTURE TO BETTER ALIGN INVESTOR AND FIRM OBJECTIVES?

52 RESPONSES




KEY POINT

## CHANGES

In the past 18 months, some hedge funds have made the changes to adapt to investor needs; while a quarter of respondents have lowered management fees and/or incentive fees, around 30% have changed their fee structures to better align themselves with investors objectives. The study also reveals that hedge funds with an institutional focus have begun making investments to their resources. Overall, 79% of all the funds surveyed say they are making investments in technology or headcount. Those that are institutionally focused are more likely to be adding staff in critical areas such as trading operations, investor relations and sales.