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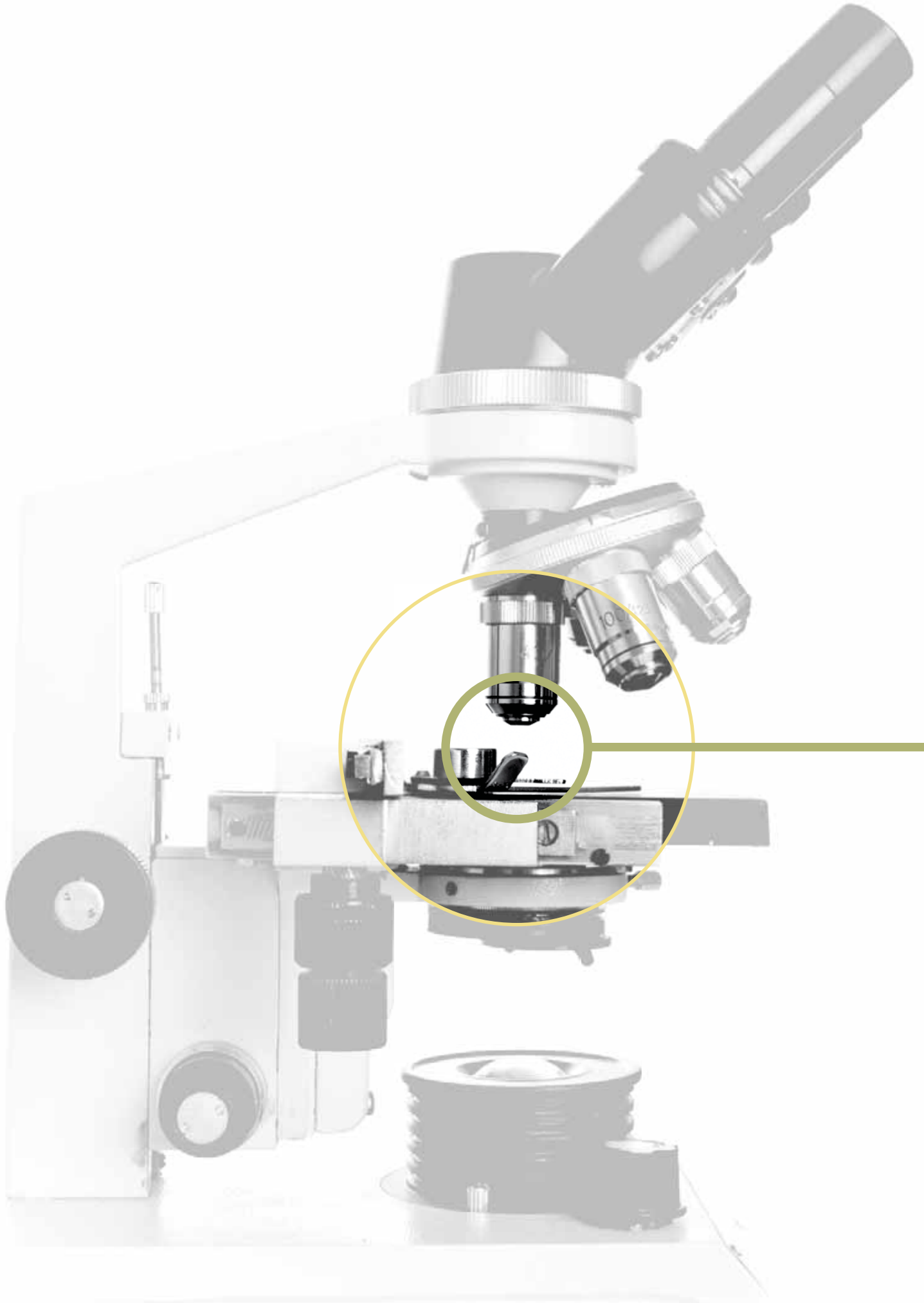


Hedge Funds Under the Microscope

Examining Institutional Commitment in Challenging Times

 **SEI** Knowledge Partnership
Insights for Investment Managers

 **GREENWICH**
ASSOCIATES



Executive Summary

Institutional investment has been a major factor in the phenomenal growth of hedge funds over the past two decades. However, despite investor expectations of enhanced diversification and absolute returns with a low correlation to broad markets, hedge funds, with a few exceptions, were not immune to the damage wreaked by the ongoing global financial crisis. Most hedge fund strategies produced double-digit losses in 2008, making it the worst year on record for hedge fund performance. Hedge funds also saw approximately \$70 billion in redemptions between June and November as many institutional hedge fund investors headed for the sidelines or rebalanced their portfolios.

Against this tumultuous backdrop, the SEI Knowledge Partnership collaborated with Greenwich Associates to conduct a global survey of institutional investors on their views concerning hedge fund investing. Initially, 95 investors in Continental Europe, the United Kingdom (U.K.), and the United States (U.S.) were interviewed in August of 2008. As the crisis deepened, SEI re-interviewed 32 participants from the original sample in November to help gauge the impact of market turmoil on institutional attitudes, policies and plans concerning hedge funds.

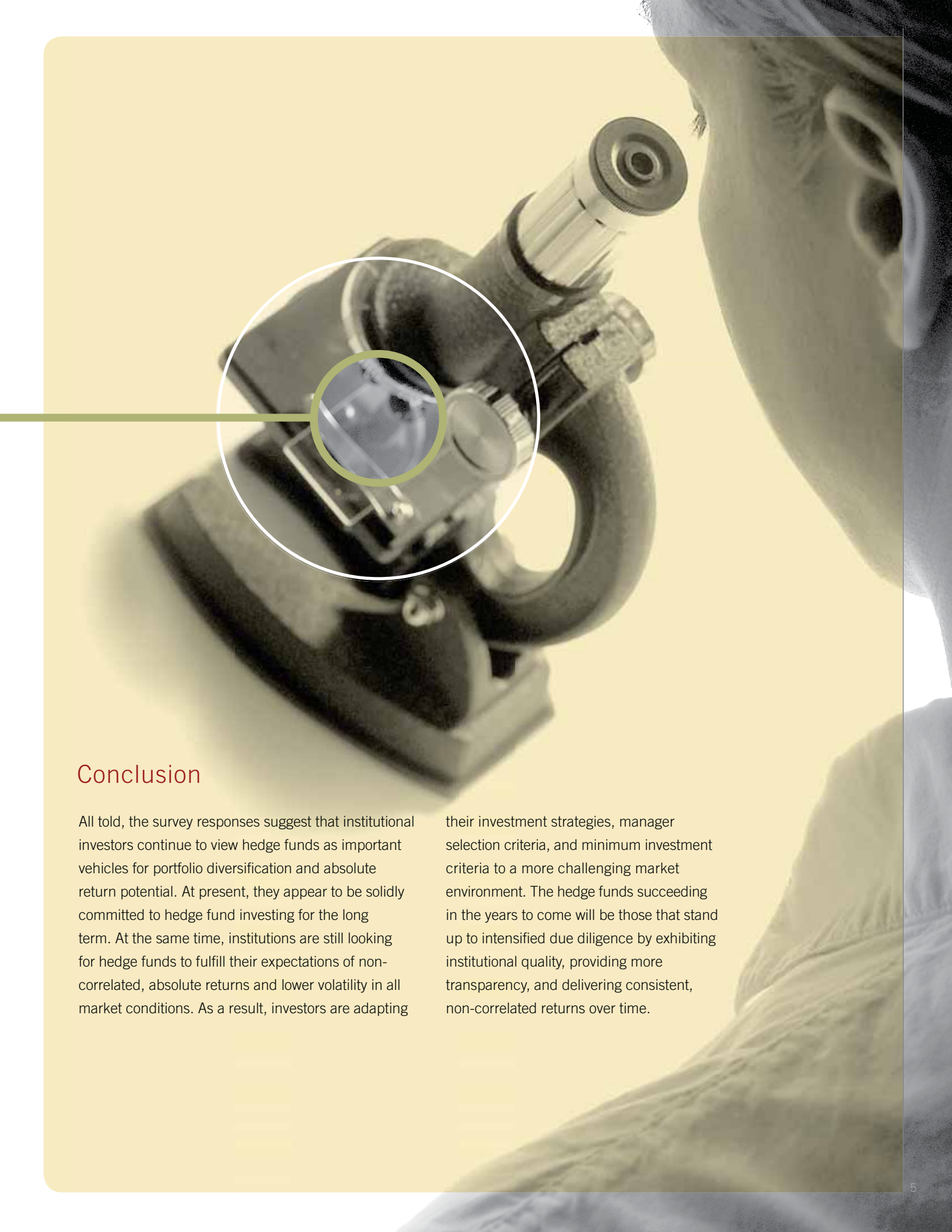
Key Findings of the Survey Revealed

- 1 Institutions have been strengthening their commitment to hedge fund investing.** In fact, 62% of first-round respondents said they had increased their allocations to hedge funds in the last two years, with 29% maintaining the same levels. They reported current hedge fund allocations averaging 7.4% of total portfolio assets, slightly lower than the average target allocation of 8.4%. Moreover, 44% said they planned to increase target allocations significantly over the next three years, and nearly half expected to maintain allocations.
- 2 Thus far, most institutions are not backing off from their long-term commitment to hedge funds.** However, the potential impact of the Madoff allegations, which were revealed in December, has yet to be fully determined. Three out of four investors re-surveyed in the November round of interviews said they had taken “no action” in response to the crisis. When asked why, 83% of those taking no action indicated their commitment to hedge funds has remained unchanged. The remaining respondents had investments that were subject to lock-up provisions and could not be withdrawn in any case. Although the percentage planning to increase target allocations dropped significantly between the first and second surveys, only one institution reported lowering its target hedge fund allocation since the first-round survey. More importantly, 85% of the second-round interviewees said they plan to maintain or increase their target allocations.
- 3 A desire for diversification is the most important reason investors are staying the course, although transparency remains a concern.** In the first-round survey, a majority of investors cited diversification as their main objective in allocating to hedge funds. Among the second-round interviewees who were planning to increase their target allocations by 10% or more, half named diversification as the motivating factor. Among the approximately one in ten who were planning to decrease allocations by at least 10%, concern with a lack of transparency was the most frequently cited reason.
- 4 Institutions are thinking and acting as long-term investors.** While almost a quarter of second-round interviewees said they have liquidated some investments or plan to do so, overall the investors surveyed showed no inclination toward a long-term exodus from hedge funds. This is understandable, considering that 93% of all interviewees said they make hedge fund investments with a time horizon of at least three years, and more than half have a time horizon of five years or more.
- 5 Investors are, however, realigning the strategies they pursue.** Overall, investors said they most favor multi-strategy, event-driven, global macro, and market-neutral funds for investment in the next 12 months. Convertible arbitrage funds and emerging markets funds of all major regions were most often identified as strategies they intend to avoid. Second-round interviewees also reported planning a moderate shift in allocations toward investing in both funds of hedge funds and single-manager hedge funds, rather than single-manager hedge funds alone.

- 6 Institutions express growing concerns with their hedge fund investments, topped by “poor performance.”** Between the first and second surveys, the number of investors naming performance as their biggest worry about hedge funds rose from 67% to 84%. In the 2007 SEI-sponsored survey of U.S. institutional investors, “poor performance” was only the third-ranked concern and was named by fewer than one in six of those interviewed. Other top-ranked concerns identified in the current survey were a lack of liquidity, funds not accomplishing their stated goal, and headline risk.
- 7 In response, institutions are significantly tightening their investment criteria and intensifying their scrutiny of funds.** “Capability of investment professionals” was named a very important factor in the selection of hedge fund managers by 82% of first-round respondents, followed by “firm’s management team,” “clarity and consistency of investment philosophy,” and “clarity of investment decision-making process.” When asked which criteria they will give more emphasis to in light of market conditions, second-round interviewees identified several criteria, led by “portfolio transparency.” Concerning the minimum standards for consideration of hedge funds, investors said they most commonly apply minimum standards concerning a fund’s track record and assets under management.
- 8 While increasingly concerned with “institutional quality,” investors define it in varying ways.** Overall, “pedigree and reputation” was the top-ranked “quality” factor, named by more than half of all respondents, followed by length of track record and assets under management. U.K. investors stand out as gauging institutional quality based on a wide range of factors, while U.S. investors indicated more focus on assets under management and length of track record.
- 9 A focus on operational quality also is revealed in the pattern of survey responses.** Operational factors including portfolio transparency, communication, and reporting were all ranked among the top selection criteria given added weight in light of current market conditions. Respondents expressed ambivalence when it came to internal fund administration versus independent, external administration. However, in light of recent scandals, it seems likely that investors will increasingly demand a separation of duties, accelerating the trend toward independent administration and custody.

Key Takeaways for Hedge Fund Managers

- 1 Expect more rigorous due diligence.** Always concerned with the factors that drive the pattern of portfolio returns, investors are intensifying their scrutiny of hedge fund investment processes and organizational structures. Additionally, the Lehman insolvency and the fundamental nature of the Madoff allegations have highlighted issues related to hedge fund operations, counterparty risk, and risk management generally. The survey responses confirm these observations, identifying portfolio transparency and headline risk as top concerns. As the survey results indicate, the events of 2008 assure that investors will be conducting wider-ranging and more in-depth evaluation of hedge funds than before. Investors will have an intensified focus on operations, risk management, and key non-investment functions in addition to investment processes.
- 2 Focus on the “four Ps.”** Survey results clearly revealed investors’ focus on the fundamentals — people, process, philosophy, and performance — as their top concerns. While other functions and processes remain important, they will not be the drivers of future success. In fact, investors may increasingly prefer a separation of investment and non-investment functions as it contributes to operational quality and risk management.
- 3 Anticipate significantly increased client communication, reporting, and transparency requirements.** In the second-round survey responses, investors ranked portfolio transparency as the top criterion given increased emphasis in light of recent market conditions. They also indicated that client reporting and communications are receiving increased emphasis. The Madoff allegations will certainly increase the pressure to provide greater transparency, and managers should consider measures that proactively respond to these expectations.



Conclusion

All told, the survey responses suggest that institutional investors continue to view hedge funds as important vehicles for portfolio diversification and absolute return potential. At present, they appear to be solidly committed to hedge fund investing for the long term. At the same time, institutions are still looking for hedge funds to fulfill their expectations of non-correlated, absolute returns and lower volatility in all market conditions. As a result, investors are adapting

their investment strategies, manager selection criteria, and minimum investment criteria to a more challenging market environment. The hedge funds succeeding in the years to come will be those that stand up to intensified due diligence by exhibiting institutional quality, providing more transparency, and delivering consistent, non-correlated returns over time.

The Context: A Meteoric Rise

The surveys took place at a defining moment not only for hedge funds and their investors, but also for the entire global financial services industry.

During the period leading up to the current economic crisis, hedge funds enjoyed an unprecedented and meteoric rise in popularity. Institutional and retail investors alike sought out increasingly esoteric strategies in their quest for alpha and for more effective ways to lower portfolio risk. As a result, by mid-2008 the number of hedge funds had mushroomed to in excess of 10,000, and their assets under management had approached or surpassed \$2 trillion.¹

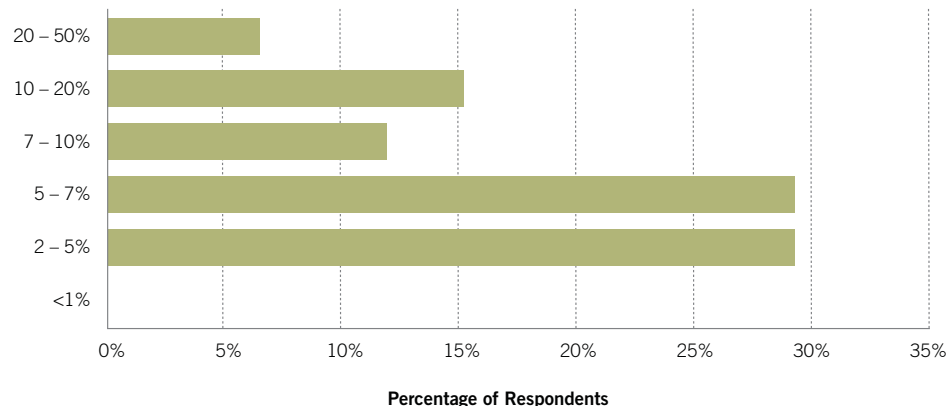
Growing acceptance within the broad institutional marketplace has been instrumental in the rapid growth of hedge fund investing, which was formerly the province of high-net-worth individuals and certain foundations and endowments.

By 2007, 45% of all institutional investors in the U.S. were invested in hedge funds, according to Greenwich Associates, with those investments representing 2.6% of total institutional assets — almost double the allocation two years prior.

Institutional acceptance of hedge funds has been most rapid in Japan and Europe, followed by the United States. U.K. and Canadian investors, in contrast, have been slower to embrace hedge funds. Even so, by 2008, U.K. pension funds had raised their exposure to hedge funds to 1.9% of total assets, up from only 1% two years earlier.²

As impressive as the growth in allocations has been, these numbers significantly understate the level of commitment to hedge funds made by the institutional investors that invest in these products, because averages include institutions with no allocations to hedge funds. Among those that do incorporate hedge funds in their portfolios, allocations are significantly higher than the average. The institutions participating in SEI's survey reported a range of allocations to hedge funds, with an average allocation of 7.4% of total assets, at the time of the first-round survey in late August (*Figure 1*). Allocations varied substantially by region and were highest among U.S. investors. Half of the U.S. institutions surveyed, but only 4% of U.K. investors and 14% of European investors, had 10% or more of their portfolios allocated to hedge funds.

Figure 1: Proportion of assets invested in hedge funds as of most recent valuation (1st round survey)³

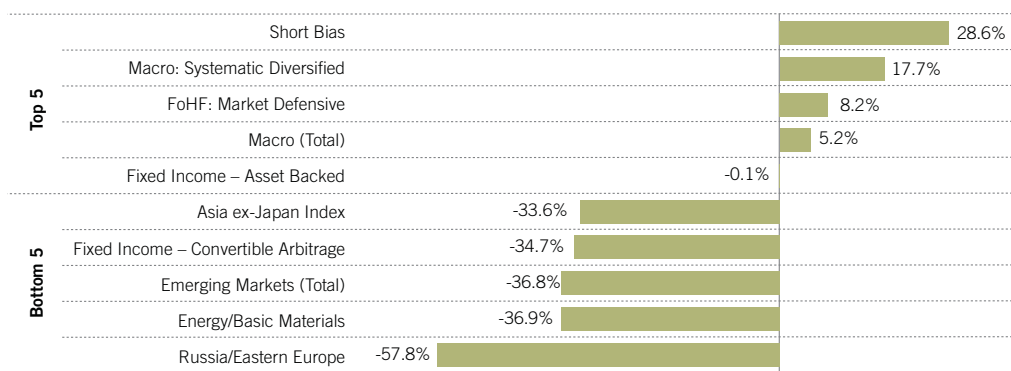


Source: SEI/Greenwich Associates

¹Estimates of \$2.7 trillion in July 2008 (HedgeFund Intelligence) and \$1.9 trillion in first half of 2008 (Morgan Stanley).

²34th National Association of Pension Funds' Annual Survey of UK Pension Funds 2008.

³As of most recent valuation of the investor's overall portfolio, including hedge funds. Unless otherwise indicated, "hedge funds" refers to both single-manager hedge funds and fund of hedge funds throughout this paper.

Figure 2: Top / bottom five hedge fund strategies by YTD returns

Source: HFRI monthly indices through December 31, 2008

Caught Up in the Crisis

In the fall of 2008, as the credit crisis developed into a global economic downturn, liquidity evaporated, uncertainty spread, and markets became engulfed in a wave of selling. Hedge funds were not immune. Even the most flexible and nimble managers struggled to find a safe haven. Temporary bans on short-selling in the U.S. and U.K. deprived funds of one of their most vital management tools, further disrupting many strategies. Most strategies saw double-digit losses by the end of November (Figure 2), making 2008 the worst year on record for hedge fund performance, according to Hedge Fund Research.

With global markets still in the grips of the downturn, many institutions find themselves facing significant paper losses, their hedge fund investments included. These losses could eventually put pension plan sponsors in the difficult position of raising contributions or possibly reducing benefits to future retirees. State and local governments may have to consider raising taxes or reducing services in order to meet the obligations of public retirement plans.

It is thus no surprise that many institutional investors are heading for the sidelines, despite signs of some dampening of the volatility that has plagued the

markets. Between June and November, hedge funds saw over \$70 billion in outflows, according to Hedge Fund Research. As redemptions mount and hedge funds face the prospect of shrinking assets under management for the first time in a decade, alarm bells are ringing throughout the industry and the media.

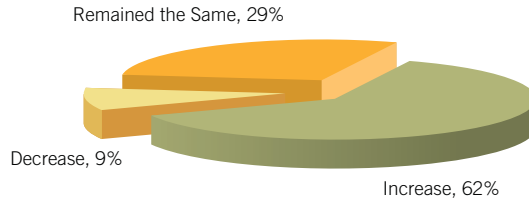
But the tide of bad news has left unanswered the questions of greatest importance to hedge fund managers and investors: To what extent do institutional redemptions signal a long-term exodus from hedge funds versus a temporary retreat to the sidelines? How much and how fundamentally has investors' confidence in hedge funds been shaken? And how significantly have institutions already altered their long-term investment plans as a result of the crisis? Given the timing of its original survey and the decision to re-interview a representative sample of respondents in the wake of the crisis, the survey results add important perspective to the ongoing evaluation of the financial crisis and its emerging impacts.

An Enduring Commitment So Far

Consistent with overall industry trends, the first-round survey results show institutional investors as strongly and increasingly committed to hedge fund investing up through the early days of the financial

crisis. In the two years prior, the vast majority of participants had either increased or maintained their target allocations to hedge funds, according to survey responses (Figure 3).

Figure 3: Change to hedge fund allocation over past two years (1st round survey)

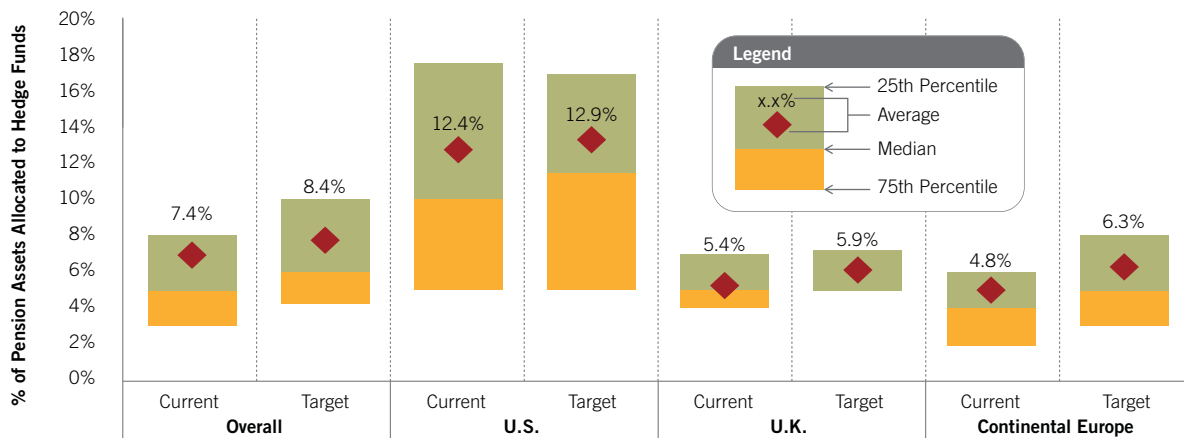


Source: SEI/Greenwich Associates

During the first-round interviews, respondents reported current allocations to hedge funds averaging 7.4% of total portfolio assets, with 58% of those sampled showing allocations between 2% and 7% (Figure 4). Few respondents indicated that they had already reached their target allocations. U.K. and U.S. institutions were, on average, a half percentage point shy of their targets, while European investors reported an average gap of 1.5% between current and target allocations.

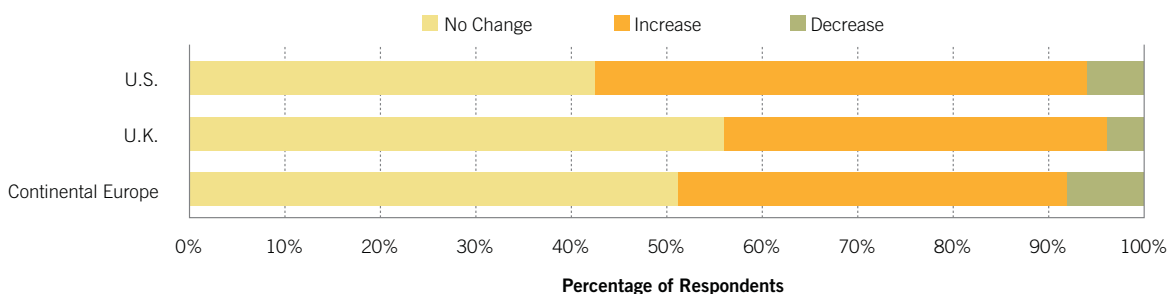
Regarding future allocation plans, 44% of all those interviewed in the first round said they plan to increase their target hedge fund allocations significantly over the next three years, with another 49% planning to maintain their allocations; only 6% planned to lower allocations by a significant amount. U.S. investors showed the highest propensity to increase allocations (Figure 5).

Figure 4: Current and target allocation to hedge funds (1st round survey)



Source: SEI/Greenwich Associates

Figure 5: Plans to significantly alter target allocation in the next three years (1st round survey)



Source: SEI/Greenwich Associates

Allocations Holding Steady

In November 2008, as funds and investors were experiencing the brunt of the crisis, SEI had Greenwich Associates re-interview a representative sampling of first-round participants about their decisions and actions in the wake of global market upheaval. Overall, the results reflect a cautious and measured reaction despite the high anxiety pervading financial circles. A large majority of the investors surveyed had taken “no action” by the second-round survey in November, although one in four indicated they had liquidated some investments or had plans to do so (Figure 6).

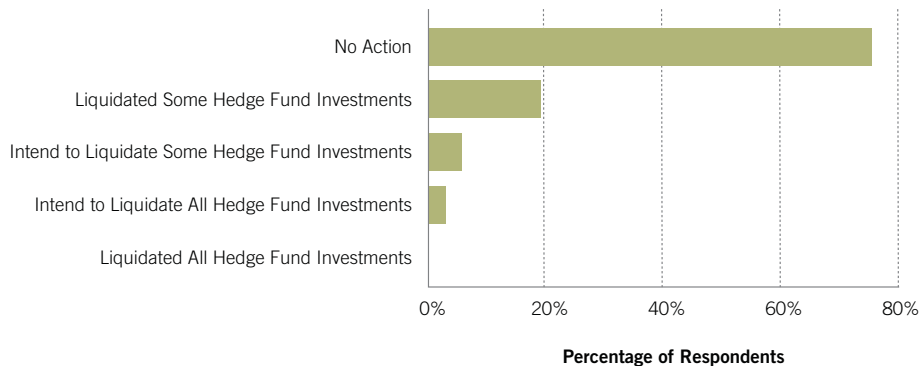
When asked the reason for their inaction, 83% of the “no action” respondents said it was because their commitment to hedge funds has remained unchanged. The remaining 17% had investments that were subject to lock-up provisions and could not be withdrawn.

Moreover, among all second-round interviewees, only one institution reported changing (in this case lowering) target hedge fund allocations between late summer and early November of

the year. All of the other respondents said they were holding steady on their allocation plans. In fact, 85% of the November interviewees said they plan to maintain or increase their target allocations (Figure 7).

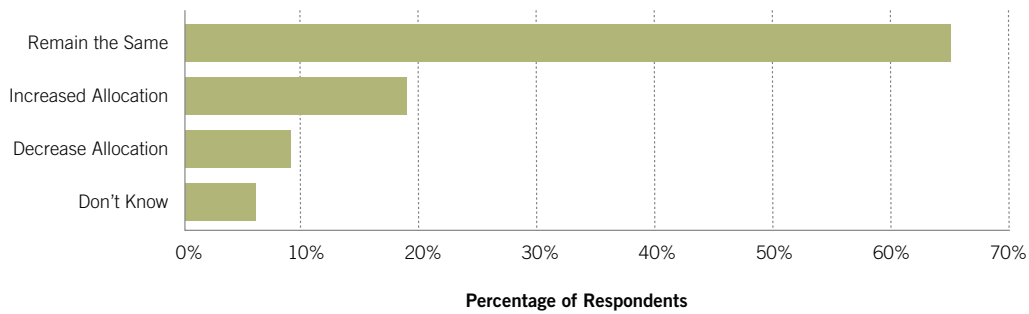
It should be noted that 19% of second-round respondents said they plan to increase their target allocations, compared with 44% who gave that response in the first-round survey. Thus, some investors have put plans to increase allocations on hold due to the crisis. Responses differed somewhat geographically, with U.S. investors most inclined to preserve allocations at current levels.

Figure 6: Actions taken as a result of current market conditions (2nd round survey)



Source: SEI/Greenwich Associates

Figure 7: Hedge fund allocation plans in light of current market conditions (2nd round survey)



Source: SEI/Greenwich Associates

Those second-round interviewees planning to alter their target hedge fund allocations were also asked why they intended to do so.⁴ Among the 19% planning to *increase* allocations by 10% or more, the most frequently cited reasons were:

- Diversification (named by 50% of the sample subset),
- Absolute returns (33%),
- Stable returns (33%),
- Performance opportunity (17%).

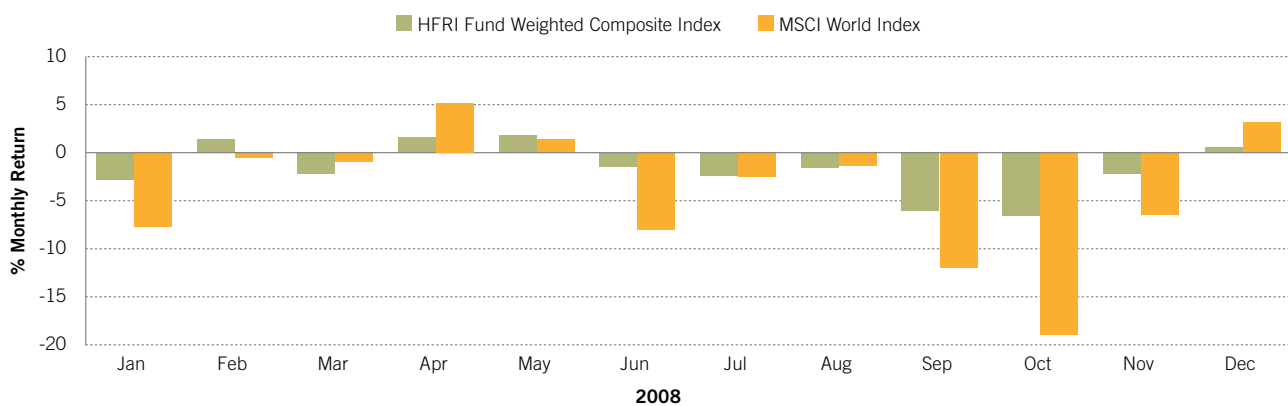
Among those 9% of participants planning to *decrease* allocations by at least 10%, the top-ranking reasons were as follows. Interestingly,

no respondents cited poor performance, lack of liquidity, or volatility of returns.

- Lack of transparency (named by 67% of the sample subset),
- Lack of diversification (33%),
- Valuation concerns (33%).

Of course, allocation trends will need to be monitored prospectively as investors continue to assess and respond to the situation. To that end, some public pensions have indicated they will be reviewing their allocations to alternative investments (including hedge funds, private equity and real estate) in early 2009 — earlier than previously scheduled in some cases.⁵

Figure 8: Monthly returns, January – December 2008



Source: Hedge Fund Research, Inc., MSCI Barra

⁴ Interviewees could select more than one reason.

⁵ See "Once Burned, Twice Shy: Pension Funds Rethink Alternatives After a Tough '08" (January 3-4, 2009 Wall Street Journal).

See also "Pension Funds Still Committed to Hedge Funds Despite Woes" (December 23, 2008 Dow Jones New Service).

Why the Institutional Composure?

At first glance, investors' reported actions and allocation plans may seem difficult to square with the recent spate of bad news concerning hedge fund liquidations and performance, not to mention rising redemptions. But other facts and findings help explain why institutional investors are not making a mass exodus from hedge funds.

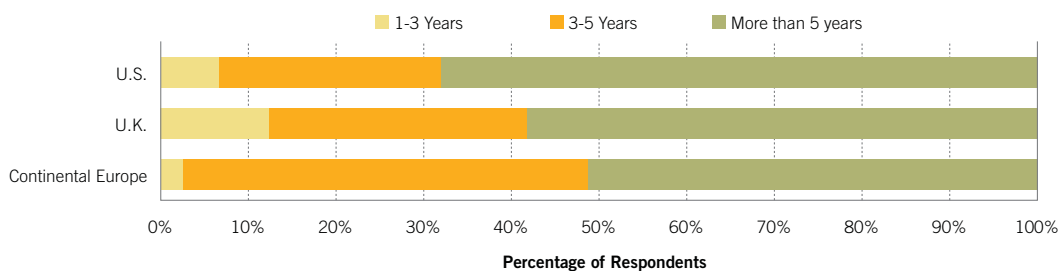
While down, hedge funds still outperformed many other strategies. Exposure to illiquid assets compounded by leverage hurt performance at many hedge funds, but comparative monthly return data show that the majority of funds still managed to hedge risk to some degree, protecting their investors from the greater losses they would have suffered in many long-only strategies (Figure 8). Hedge funds lost an average of 18% year to date through December 31, 2008. By way of comparison, the MSCI World Index declined 41% over the same period.

Institutions are long-term investors by nature. While not immune to the vagaries of the market, given the nature of their obligations institutional investors go to great lengths to design processes and systems that allow them to execute a carefully considered long-term strategy. Overall, 93% of first-round interviewees said they have a time horizon of at least three years for the hedge fund portion of their portfolios, and 58% have a time horizon of five years or more

(Figure 9). Of course, in this context, "no action" can also be interpreted to reflect a conservative bias toward the status quo or a deliberate decision to "wait and see." In any case, operating with a long-term perspective also encourages investors to remain in a position where they can capitalize on the market's upturn, whenever that might occur.



Figure 9: Investment time horizon for hedge fund investments (1st round survey)



Source: SEI/Greenwich Associates

Perspective and confidence may have grown with experience.

Nearly two-thirds of those interviewed said they have been investing in hedge funds for three years or more, and more than one-third have been at it for five or more years (Figure 10).

Somewhat paradoxically, it may also be that those institutions relatively new to hedge funds — as in the U.K., where more than half the first-round respondents said they had been investing

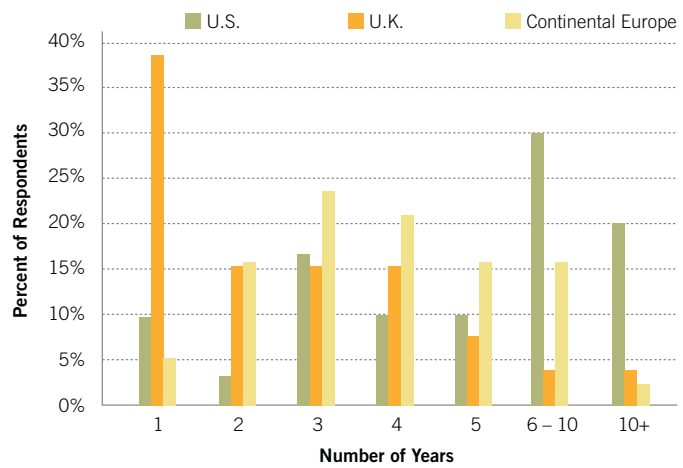
in hedge funds for just one or two years — are not willing to capitulate quickly, given the extensive due diligence and long decision-making process involved. In fact, more than 90% of the U.K. investors interviewed in the second round said they were taking no action to alter their hedge fund investments.

Diversification is the primary motivation to invest.

More than three quarters of first-round interviewees said they had invested seeking “diversification,” decreased volatility, or a stake in non-correlated

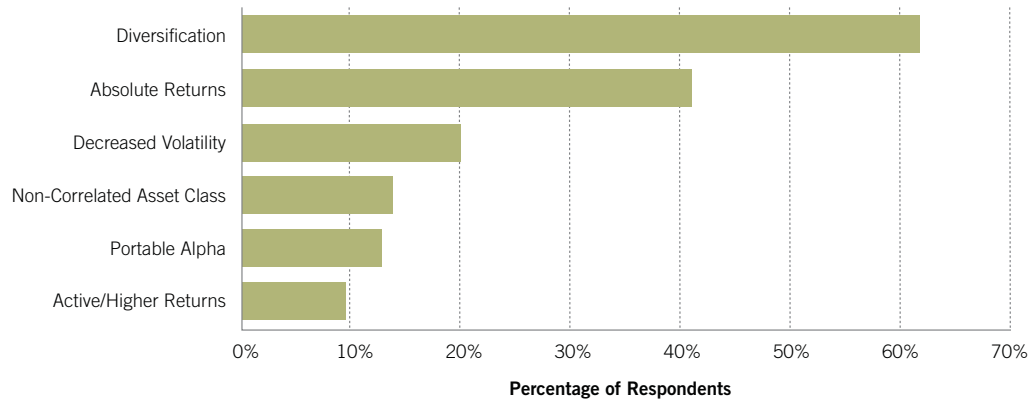
asset classes.⁶ Just over 41% said they were looking for absolute returns, while only 9% said they had invested primarily to get higher returns (Figure 11). Although hedge funds became increasingly correlated with mainstream investments during the period when every asset class was down, they did outperform many other strategies as noted above. Meanwhile, the minority of investors focused primarily on absolute or higher returns may have concluded there was no better place to invest.

Figure 10: Length of time invested in hedge funds (1st round survey)



Source: SEI/Greenwich Associates

Figure 11: Main objectives in allocating to hedge funds (1st round survey)



Source: SEI/Greenwich Associates

⁶ Interviewees could select more than one objective.

What Has Changed

While the survey found institutional investors expressing little inclination to retreat from their long-term commitment to hedge fund investing, it is not to say that their attitudes and methods have gone unaltered by the financial crisis. Second-round survey findings reveal that institutions are significantly

shifting their strategy preferences, re-evaluating their investment criteria, intensifying their scrutiny of investment candidates, demanding greater transparency, and requiring more complete reporting from managers.

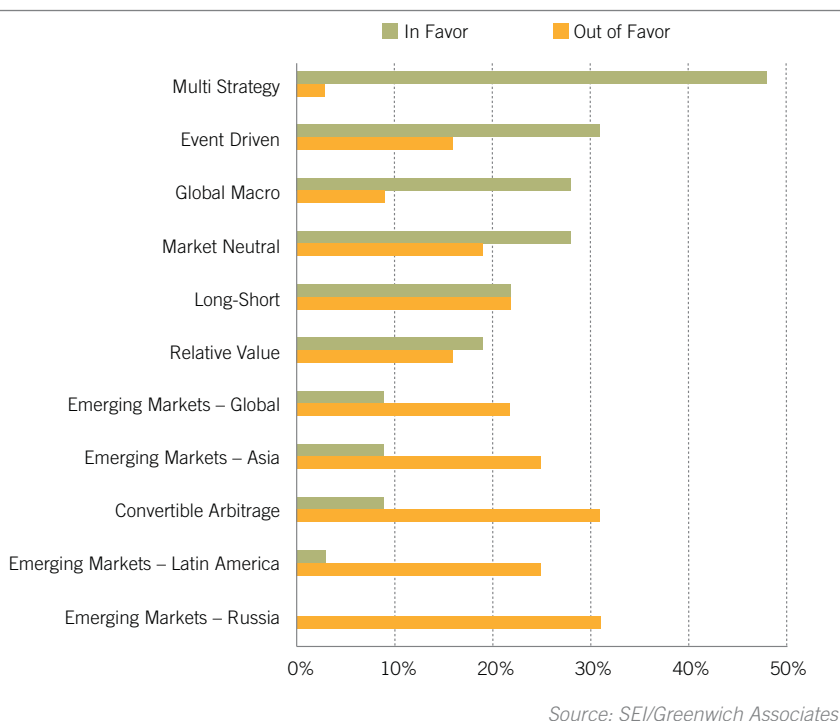
Current Strategy Preferences

Second-round interviewees expressed a wide range of opinions on which hedge fund strategies are the best and worst investment opportunities over the next 12 months (*Figure 12*). It is interesting to note, for example, that respondents were evenly split in their views on future investments in long-short strategies. In any case, based on the survey results, emerging market funds will likely face a harder time attracting new investors. After a long and sustained run fueled by impressive economic growth in several emerging markets, these products suffered mightily as the financial meltdown became a contagion afflicting markets worldwide.

Rather than looking for varied geographic exposure, institutional investors have shifted their attention largely to more flexible strategies. Based on the survey results, multi-strategy funds promise to be the most popular strategy over the coming year, followed by event-driven and global macro funds. Market-neutral funds also continue to attract attention.

Some geographic differences among respondents are evident. For instance, the antipathy toward emerging market strategies was driven largely by European investors, who were particularly bearish on Russia-focused funds. Europeans were also most likely to point toward multi-strategy funds as future investments, as were their U.K. counterparts. U.S.

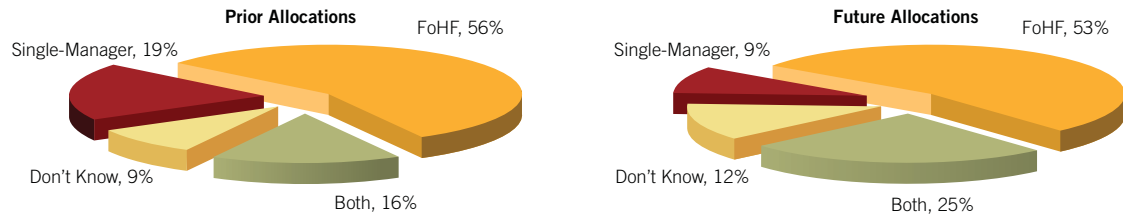
Figure 12: Strategies in and out of favor over the coming twelve months (2nd round survey)



investors, on the other hand, reported long-short strategies as their top pick.

Second-round interviewees also reported planning a moderate shift in allocations toward investing in both funds of hedge funds and single-manager hedge funds, rather than single-manager funds alone (*Figure 13*). This finding, while prior to the Madoff allegations, suggests investors may be more likely to view the diversification and risk-management aspects of funds of hedge funds as outweighing the added layer of fees.

Figure 13: Allocations to single-manager hedge funds versus funds of hedge funds (2nd round survey)



Source: SEI/Greenwich Associates

A New Crop of Worries

Not surprisingly, in querying investors about what keeps them up at night, the survey revealed a ratcheting up of all worries during the period between the first and second surveys, with “performance” heading the list among all investors and in all geographic regions (Figure 14).⁷

It is interesting to note that in an SEI-sponsored survey of U.S. institutional investors conducted in 2007, “poor performance” was only the third-ranked concern with hedge funds and was named by fewer than one in six of those interviewed. Headline risk ranked as the number-one concern at that time, but has since been eclipsed by performance concerns resulting from market upheaval.

As the gravity and severity of the crisis sinks in, image and reputation are once again becoming prominent concerns. While 15% of respondents in the first-round 2008 survey cited headline risk and bad PR as one of their biggest worries, that number rose to 41% among respondents in the second round of interviews.

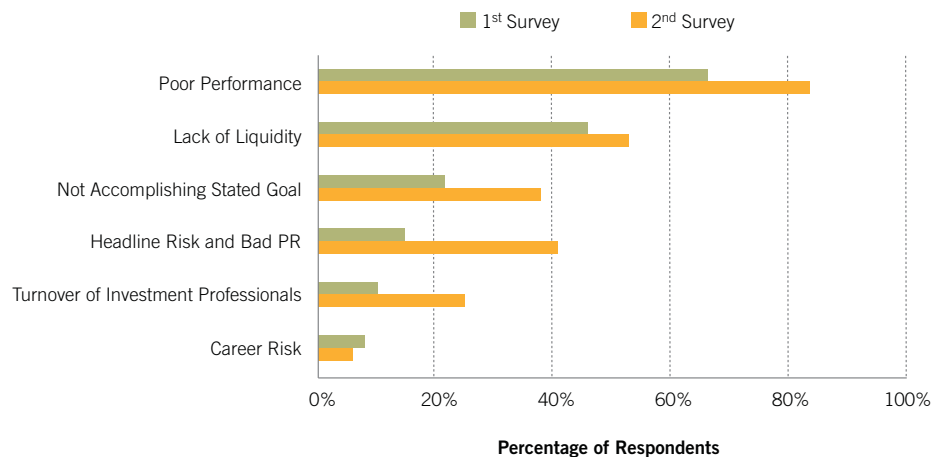
A number of comments volunteered by interviewees revolved around concerns that hedge funds may not be fulfilling their objectives, particularly those relating to diversification and non-correlation. For example, several investors cited such worries as funds that “appear to be more

correlated with movements in the equity markets than we expected,” “a lack of diversification, which is not uncorrelated to the prices of stocks and bonds,” and funds “operating way outside their stated philosophy.”

Among other worries cited by interviewees in open-ended responses were:

- “Transparency regarding the pricing of the underlying assets” given the imposition of “mark-to-market” standards.
- Whether fund managers are operating in ways consistent with their stated approach and methods.
- A “run on hedge funds by other limited partners,” hedge funds “being overwhelmed by redemptions.”
- “Groupthink” in the industry. As one respondent put it, “now too many hedge funds imitate each other and become clones.”

Figure 14: Biggest worry about hedge funds



Source: SEI/Greenwich Associates

⁷ Interviewees could select more than one worry.

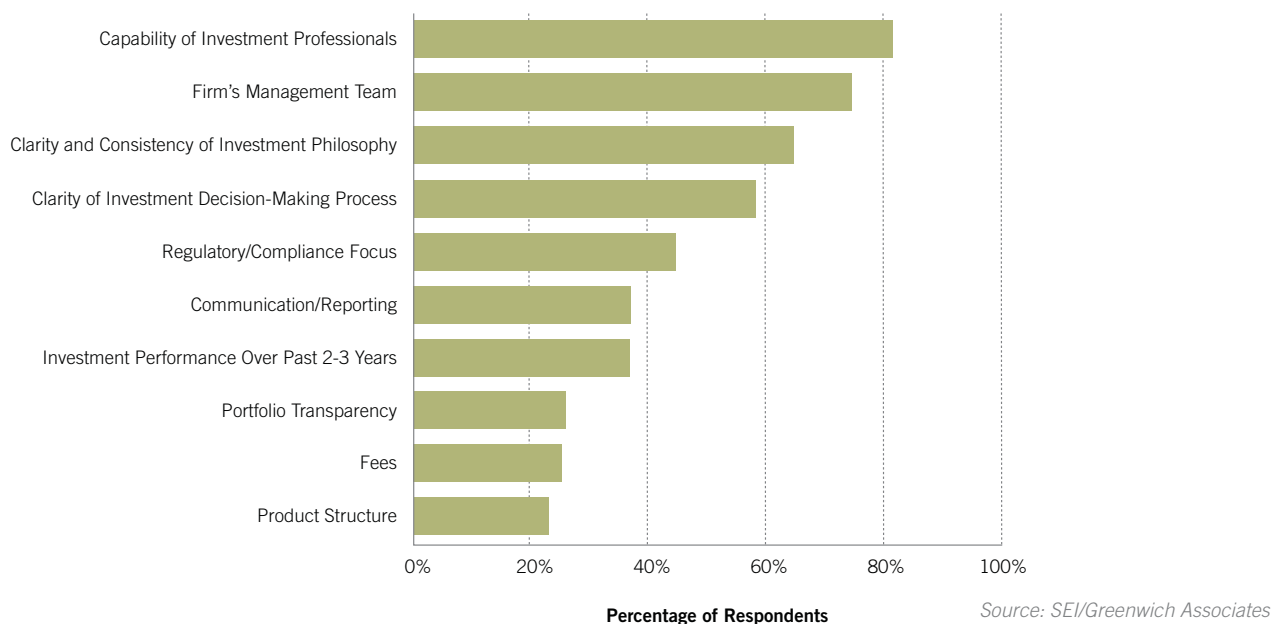
Flight to Quality

While institutions have not backed off from their commitment to hedge fund investments, the survey revealed how they have intensified and broadened their scrutiny of hedge funds in which they currently or may potentially invest. In particular, institutions have revamped their selection criteria to reflect a more challenging market environment.

When asked about the most important factors in hedge fund selection, first-round interviewees validated the traditional “four Ps” in manager selection. They resoundingly ranked factors relating to “people” as most important, followed by “philosophy,” “process,” and “performance”

(Figure 15). In open-ended comments on the most important issues in hedge fund management, a number of respondents expressed the “people factor” in terms of expertise or experience, while others focused on what one interviewee described as “the honesty and character” of the individuals involved. The Madoff allegations will only intensify investors’ scrutiny of the investment managers they hire, including hedge fund managers. It may also accelerate the trend toward independent administration of hedge funds, which mitigates many of the risks associated with a lack of a separation of duties present in the Madoff matter as well as the Bayou scandal of 2005.⁸

Figure 15: Factors rated ‘very important’ when selecting hedge fund managers (1st round survey)⁹



Expanded Criteria

When asked which selection factors they are giving greater emphasis in light of current market conditions, the overall response from second-round interviewees was, in effect, “all of the above.” However, portfolio transparency, named by just one out of four as a “very important” selection factor in the first survey, was the factor most frequently named as demanding more weight in the second survey (Figure 16). Factors relating to people,

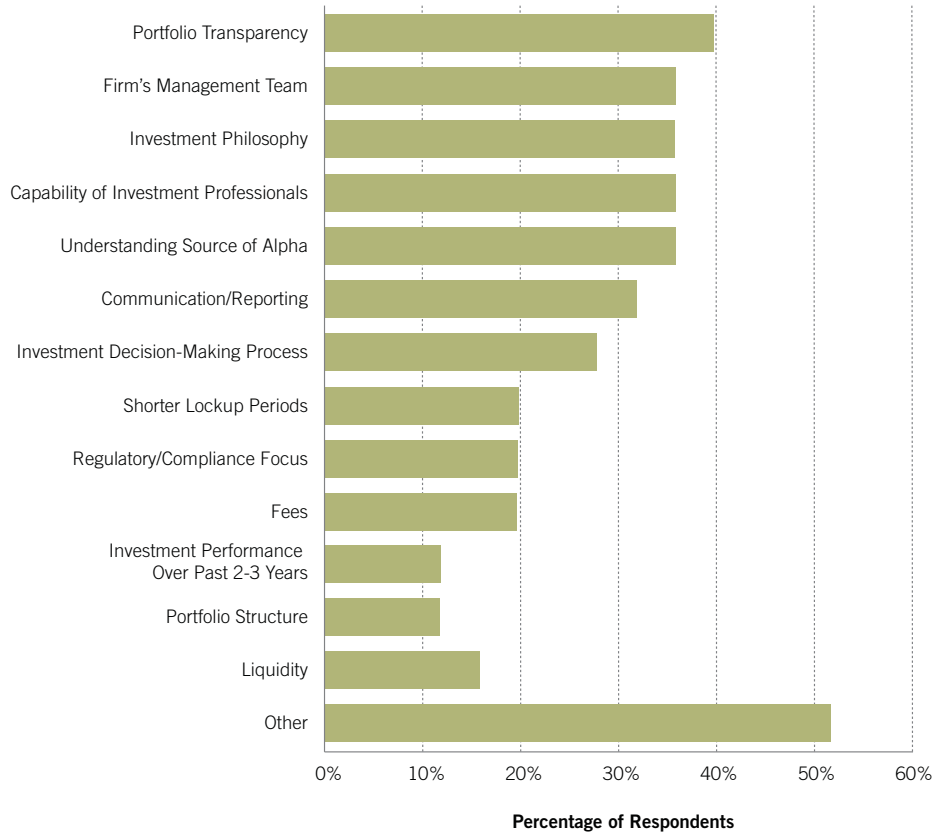
philosophy, and process were all cited as being of increased importance, as were client communication and reporting. A number of interviewees explicitly underscored the notion of heightened scrutiny with added comments such as “we are monitoring leverage more than in the past,” “there is now more emphasis on controlling the [selection] process,” and “we’re more concerned about the stability of the fund’s client base.”

⁸ One of the largest fund of hedge fund managers in the world, Union Bancaire Privée, has indicated that it will require funds in which it invests to have an independent administrator. See “Tougher Safeguards for Investors on the Way” (Financial Times, December 29, 2008).

⁹ Interviewees could select more than one factor.

In terms of setting the bar for funds to even be considered as investment candidates, two-thirds of the investors surveyed set minimum standards for a fund’s track record and nearly half require a minimum level of assets under management (Figure 17). U.K. investors stand out for having the widest array of minimum standards; nearly half of those interviewed said they require registration with the U.K.’s Financial Services Authority, one-third consider the number of employees, and one-third insist on use of a consultant. European and U.K. investors were far more likely than their U.S. counterparts to cite the length of a hedge fund’s history as a minimum selection criterion.

Figure 16: Manager selection criteria given more emphasis in light of current market conditions (2nd round survey)¹⁰



Source: SEI/Greenwich Associates

Figure 17: Minimum criteria when selecting hedge fund managers (1st round survey)



Source: SEI/Greenwich Associates

¹⁰ Interviewees could select multiple criteria.

Defining Excellence

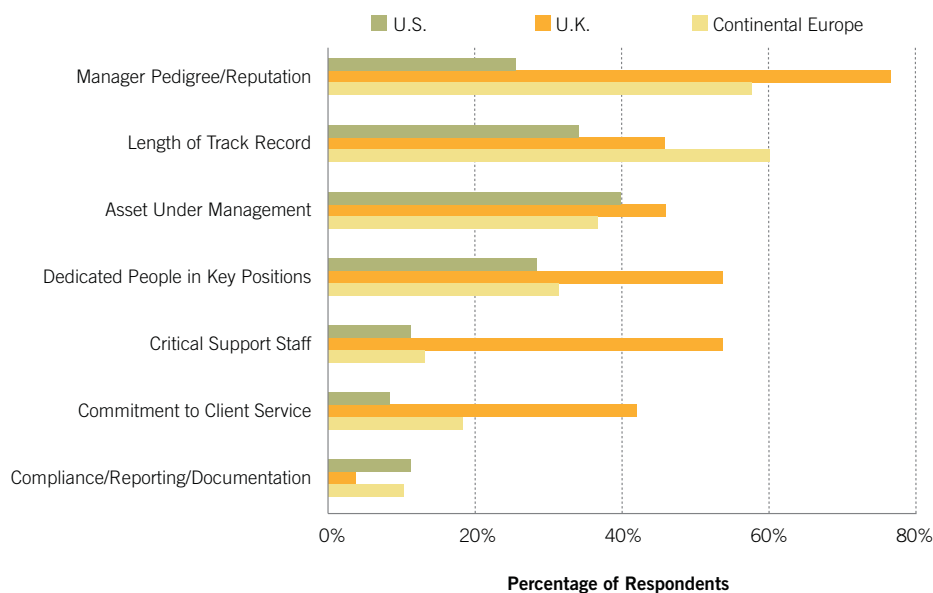
Overall, the responses reflect a heightened institutional focus on the quality of funds and the level of excellence shown in their structure, management, and operations. Yet the survey responses reflect widely varying definitions on what constitutes “institutional quality” (Figure 18). Overall, “pedigree and reputation” was the top-ranked factor, named by more than half of all respondents, followed by length of track record and assets under management, named by 47% and 40% of interviewees, respectively. Investors also expressed sensitivity to management and operating quality in their concern with the staffing of key positions and support functions.

U.K. investors again stand out for giving weight to a greater variety of factors. Interestingly, U.S. investors placed less emphasis on the subjective factor of

pedigree or reputation than on the quantitative factors of assets under management and length of track record.

Investors’ comments on manager selection likewise revealed the differing yardsticks they use to assess subjective, yet all-important factors such as “quality” and “excellence.” Commenting in response to questions on manager selection, several participants indicated they are focusing on larger funds, while others said they look to “brand” and experience, giving the most weight to managers who “have had relationships for years and are known in the investment community.” As one put it, “We want to deal with a company that has a great reputation.”

Figure 18: Characteristics that define an ‘institutional quality’ manager (1st round survey)



Source: SEI/Greenwich Associates

Conclusion

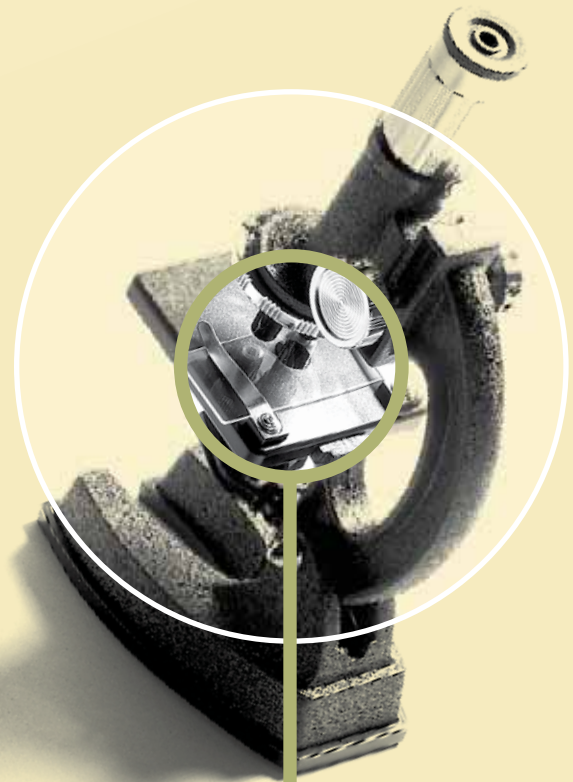
With the markets substantially declining and many institutions rebalancing their portfolios, the hedge fund industry is in a period of contraction and enormous uncertainty. The results of SEI's survey show that at this juncture, the institutional commitment to hedge funds remains largely unshaken, although investors will continue to assess their commitment and allocation levels as time progresses.

While it took some years for institutional investors to become comfortable with hedge fund investing, their caution and deliberation appear to have helped bolster their commitment through both good times and bad. Increasingly, institutions have come to see hedge funds as an important vehicle for portfolio diversification and absolute return potential in all market environments. Consistent with their long-term orientation, institutions appear to be patient as they assess how well hedge funds can help them achieve their objectives in the still unfolding post-crisis environment.

In the interim, survey responses show, hedge funds will find every aspect of their investment capabilities and operations under the microscope, as institutions carefully scrutinize the strategies and organizations

in which they invest. Institutions still expect hedge funds to deliver on the goals of non-correlated, absolute returns and lower volatility in all market conditions. As a result, institutional investors are actively adapting their investment strategies, manager selection criteria, and minimum investment criteria to a more challenging market environment, in addition to demanding greater transparency.

Those hedge funds best fitting the institutional definition of quality — as it applies to people, philosophy, process, and operational effectiveness as well as performance — will be the ones to survive and prosper in the years ahead.



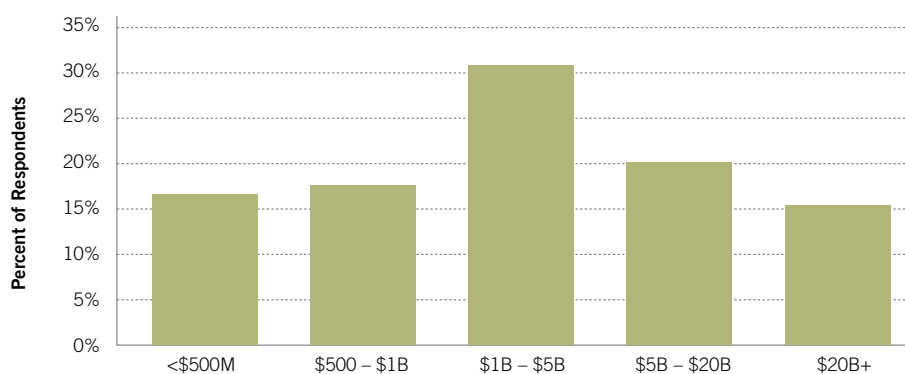
About the Survey

In the fall of 2008, the SEI Knowledge Partnership collaborated with Greenwich Associates to conduct a global survey of institutional investors concerning their hedge fund investments. Topics covered in the interviews included the respondents' hedge fund investment objectives, allocation policies and plans, strategies, concerns, and selection criteria.

The survey team interviewed senior investment professionals at 95 institutions in Europe (n=39), the United Kingdom (n=26), and the United States (n=30). Participants included public and corporate retirement plans as well as foundations and endowments. Pension plan participants ranged in size from less than \$500 million to well over \$20 billion in assets (*Figure 19*). Assets under administration by those surveyed totaled \$772 billion, and they reported hedge fund investments totaling \$45 billion.

The survey was conducted late in the summer of 2008, when market conditions were already fragile and deteriorating quickly. By mid-October, it became clear that the financial crisis was reaching historic proportions. To determine how investors were responding to the crisis and gauge the relevance of survey responses, the SEI Knowledge Partnership conducted a second round of interviews in November with 32 participants from the original sample. As in the first round, participants in this subset were distributed among Europe, the U.K., and the U.S., with 10 or 11 respondents in each region. The second wave of interviews not only validated the initial results, but produced surprising new findings about investors' reactions to the crisis.

Figure 19: Dollar value of respondents' DB and DC assets as of most recent valuation (1st round survey)



Source: SEI/Greenwich Associates



About SEI

SEI (NASDAQ: SEIC) is a leading global provider of outsourced asset management, investment processing and investment operations solutions. The company's innovative solutions help corporations, financial institutions, financial advisors, and affluent families create and manage wealth. As of September 30, 2008, through its subsidiaries and partnerships in which the company has a significant interest, SEI administers \$431 billion in mutual fund and pooled assets and manages \$162 billion in assets. SEI serves clients, conducts or is registered to conduct business and/or operations, from more than 20 offices in over a dozen countries.

SEI's Investment Manager Services division provides total operations outsourcing solutions to global investment managers focused on mutual funds, hedge and private equity funds, exchange traded

funds, collective trusts, separately managed accounts and institutional and private client services. The division applies operating services, technologies, and business and regulatory knowledge to each client's business objectives. Its resources enable clients to meet the demands of the marketplace and sharpen business strategies by focusing on their core competencies.

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

About Greenwich Associates

Greenwich Associates is the premier strategic consulting and research source for providers and users of institutional financial services worldwide. Founded in 1972, Greenwich provides institutional financial services firms and those who participate in its research with accurate, systematic management information that helps them meet their global business needs.

The firm's research and consulting services span the following markets:

- investment management
- foreign exchange
- equities
- derivatives
- fixed income
- cash management
- investment banking
- commercial banking
- large corporate banking
- insurance

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