

Hedge Funds Under the Microscope

Examining Institutional Commitment in Challenging Times

Institutional investors have been a major factor in the phenomenal growth of hedge funds over the past two decades, looking to them for diversification and absolute returns with a low correlation to broad markets. But, with 2008 the worst year on record for hedge fund performance, how do institutions view hedge fund investing now?

To find out, the SEI Knowledge Partnership collaborated with Greenwich Associates to conduct a global survey of institutional investors in continental Europe, the U.K. and the U.S. The survey was conducted in August 2008. As the financial crisis deepened, SEI decided to gauge its potential impact on the hedge fund industry by conducting another round of interviews with a sampling of respondents from the original survey.

Key survey findings reveal that:

Institutions have been strengthening their commitment to hedge fund investing. Sixty-two percent of first-round respondents said they had increased their hedge fund allocations in the last two years.

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 second-round interviewees said they had taken “no action” in response to the crisis. Survey responses suggest that institutional investors continue to view hedge funds as important vehicles for portfolio diversification and absolute return potential. While many investors have moved to the sidelines as the financial crisis continues to unfold, they are not yet dramatically altering their allocation plans.

Institutional investors’ concerns with hedge funds are growing, however, topped by “poor performance” as their biggest worry.

Investors are actively adapting their mix of funds and investment criteria to a more difficult environment, as they:

- **Realign the hedge fund strategies they pursue**, strongly preferring some while avoiding others over the next 12 months. Interestingly, those preferences vary markedly by geographic region.
- **Significantly tighten their investment criteria** and intensify their scrutiny of funds.
- **Demand greater transparency** as well as better client communication and reporting.

Based on survey results, hedge fund managers should:

- **Expect more rigorous due diligence** around investment processes, operations and company structures.
- **Focus on the fundamental four Ps** — people, process, philosophy and performance.
- **Strengthen client communication, reporting, and transparency** to ease worries that hedge funds may not be staying true to their stated goals, strategies and methods.

The survey results provide hedge fund managers with a clear picture of what it will take to meet investors’ rising standards for “institutional quality” in the months ahead.

To request the full copy of this white paper, please visit www.seic.com/ims/HFMicroscope

