



September 2004

Institutional Demand for Hedge Funds: New Opportunities and New Standards

- **We estimate that U.S. institutional investor capital in hedge funds will increase from \$60 billion to \$300 billion within five years.** To date, the majority of money has come from endowments and foundations; defined benefit plans and other institutional investors will soon represent a more proportionate market share.
- **Institutional capital will soon account for more than 50% of annual net new flows into the hedge fund industry.** This is an increase from negligible amounts only five years ago.
- **Institutions' hedge fund return expectations are relatively modest at 8% annually.** Relative to individual investors, institutions place a greater emphasis on lower volatility and low correlation with broad markets.
- **This transformation of capital sourcing is driving an overall industry maturation.** Tapping into institutional opportunity will not be easy. Successful firms will balance investment excellence with business, operations, and client relationship acumen. We identify seven characteristics as critical to attracting ongoing institutional capital.
- **Fund of hedge funds ("FoHF") will direct half of institutional capital.** For many institutions, FoHF are becoming the de facto consultant for hedge fund investing. As their hedge fund experience grows, rather than abandon FoHF, many institutions will pursue a dual strategy of direct investing with their FoHF resources.
- **Institutional investors' allocations to traditional active long-only portfolios may shrink over the next three to five years.** Traditional managers may be caught in an *alpha-beta squeeze* where allocations move both to index-oriented products and to perceived higher alpha strategies.

CONTENTS

1	Introduction
2	Acknowledgements
4	Current State of Institutional Demand
9	Impact of Increasing Demand
14	Attracting Institutional Capital
19	Conclusion

Table of Contents

Introduction

ORGANIZING OUR THOUGHTS1
ACKNOWLEDGEMENTS2
RESEARCH APPROACH3
DEFINITIONS3

1. Current State of Institutional Demand

CURRENT DEMAND BY SEGMENT4
PORTFOLIO ROLE FOR HEDGE FUNDS5
RETURN EXPECTATIONS5
FUND OF FUNDS
VERSUS DIRECT INVESTING6
BARRIERS TO HEDGE FUND INVESTING7

2. Impact of Increasing Demand

FUTURE CAPITAL FLOWS9
WHERE WILL
THE CAPACITY COME FROM?11
CHALLENGES TO
TRADITIONAL ACTIVE MANAGEMENT12

3. Attracting Institutional Capital

THE CHECKLIST14

Conclusion19

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Casey, Quirk & Acito and The Bank of New York jointly prepared this paper.

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Casey, Quirk & Acito (CQA) provides management consulting services exclusively to investment management firms. CQA specializes in developing business strategy, enhancing investment practices, and crafting distribution plans. CQA draws on 35 years of experience in delivering value to its clients and partners through a unique combination of deep industry knowledge and experience, solutions-oriented thought leadership, and a proven ability to create change within organizations.



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Introduction

The hedge fund industry is midway through an important transition in its source of capital. Five years ago, hedge funds derived virtually all of their assets from wealthy individuals. Institutional interest was limited to a small number of endowments and foundations. Over the next five years, institutions (including pension funds) are likely to provide an additional \$250 billion of hedge fund capital, accounting for 35 percent of net new flows in this period. Coupled with the increasing influence of the fund of hedge fund industry, new hedge funds will be dependent on “professional” sources of capital for 70 percent of their capital.

The thesis of our report is that this transition is having a dramatic impact on the hedge fund industry. Relative to individual investors, institutions have significantly different product demand and return expectations. They also require hedge funds to have business models that are more robust and resource-intensive than has been heretofore acceptable. The result will be an industry much more mature than it is today.

This is, therefore, an auspicious time to be studying hedge funds. Yes, there will be a surge in institutional capital. Capturing that opportunity, however, will be challenging. Though many hedge funds are making the appropriate adjustments, the great majority of hedge fund managers are unlikely to meet the new stringent requirements.

ORGANIZING OUR THOUGHTS

Our objective in this report is to be both descriptive of and prescriptive to the hedge fund industry.

Chapter 1 presents the **current state of institutional demand** for hedge funds. We describe, among other topics: the size of demand by segment; return expectations; use of fund of hedge funds versus direct investing; and barriers to hedge fund investing.

Chapter 2 anticipates the **impact of increasing demand on hedge funds**. Over the next few years, how much capital is likely to flow from institutions? How can the hedge fund industry absorb more money? What will be the impact on traditional long-only investing?

Chapter 3 summarizes what we believe to be the **keys to attracting institutional capital**. We present a list of seven attributes against which hedge fund firms can benchmark whether they meet the emerging industry standards for a leading hedge fund firm. (We encourage institutional investors to employ this list similarly.)

Acknowledgements

Over 50 senior professionals from leading institutions, hedge funds, and other hedge fund related organizations provided their thoughts in individual interviews in the Spring of 2004. We gratefully acknowledge their willingness to share their time and unique perspectives.

INDIVIDUAL INTERVIEWEES INCLUDE¹:

Firm Name	Individual	Title
AFK & Partners	Anton Freda	Principal
Angelo, Gordon & Co.	John M. Angelo	Chief Executive Officer
Angelo, Gordon & Co.	Michael L. Gordon	Chief Investment Officer
Barclays Global Investors	Peter V. Landin	Chief Executive Officer, U.S. Institutional Business
Gartmore Investment Management PLC	Glyn P. Jones	Chief Executive Office
General Motors Asset Management	B. Jack Miller	Chief Investment Officer, Affiliated Funds
GLG Global Investment Management	Paul Harvey	Managing Director
Iowa Public Employees Retirement System	Kathy S. Comito	Chief Investment Officer
Ivy Asset Management Corporation	Lawrence J. Simon	Chief Executive Officer
Maine State Retirement System	Rex Holsapple	Chief Investment Officer
Rocaton Investment Advisors, LLC	Robin S. Pellish	Chief Executive Officer
The Rohatyn Group	Brian C. Lippey	President and Chief Operating Officer
Seattle City Employees Retirement System	Mel Robertson	Chief Investment Officer
State of Arkansas Retirement System	Gail H. Stone	Executive Director
Strategic Investment Group	Deborah D. Boedicker	Director
Symphony Asset Management	Neil Rudolph	Chief Operating Officer
Symphony Asset Management	Jeffrey L. Skelton	President and Chief Executive Officer
Thunderbay Capital Management	Dean Barr	Chief Executive Officer and Managing Partner
United Mine Workers	John C. Mogg	Investment Advisor
University of North Carolina Management Company, Inc.	Mel A. Williams	Vice President Director of Private Investments
University of Rochester	A. Duff Lewis Jr.	Investment Officer
University of Southern California	Jeffrey A. Fischer	Assistant Treasurer
Verizon Investment Management Corp.	Kevin E. Lynch	Director of Research

We also thank Institutional Investor for allowing us to conduct a poll of the attendees at their June 2004 *Spring Hedge Fund Investment Roundtable*. Over 80 institutions were represented.

¹ Most interviewees requested to remain anonymous. Their names are not listed above.

RESEARCH APPROACH

Given the current dynamic industry environment, we felt it essential to talk firsthand with over 50 leading institutional investors, hedge fund managers, and experts about this so-called “institutionalization” of hedge fund investing. (A partial list of interviewees can be found in the Acknowledgements on Page 2.) We focused our discussions on topics such as:

- What are institutions’ objectives in hedge fund investing?
- Where do hedge funds fit within an institution’s portfolio?
- What do institutions look for in a hedge fund firm?
- How is the role of fund of funds changing?
- How will increased institutional demand change the industry itself?

We conducted additional primary research through a survey of over 80 participants at Institutional Investor’s June 2004 Spring Hedge Fund Investment Roundtable. Here, investors and managers were asked an extensive series of closed-end questions, the results of which are incorporated throughout this document.

Finally, using secondary sources, we created a bottom-up view of hedge fund demand by building a database of about 400 U.S. institutions identified as currently making hedge fund investments.

DEFINITIONS

The term “hedge fund” is challenging to define. We view hedge funds more by investment approach than by legal vehicle. For us, hedge funds are a sub-set of alternative investments that incorporate all investment strategies run with an orientation to producing primarily absolute returns using largely marketable securities. These strategies typically include short-selling and often include leverage. As a result, correlations with broader markets are expected to be modest to low.

Our paper will focus on four primary U.S. institutional investor segments: corporate defined benefit plans, public defined benefit plans, endowments and foundations, and insurance companies. We exclude banks and broker dealers (who are increasingly putting proprietary capital to work in internal and external hedge funds) and family offices. We focus on the U.S., but believe our exposition to be generally applicable to all geographical markets and client segments.

Chapter 1: Current State of Institutional Demand

This chapter provides a snapshot of the current institutional interest in hedge fund investments. We size the market and describe each institutional segment's investing behavior, including performance objectives, non-performance criteria, and predilection to using fund of funds. We conclude with a discussion of the reasons why many institutions have not and will not invest in hedge funds.

CURRENT DEMAND BY SEGMENT

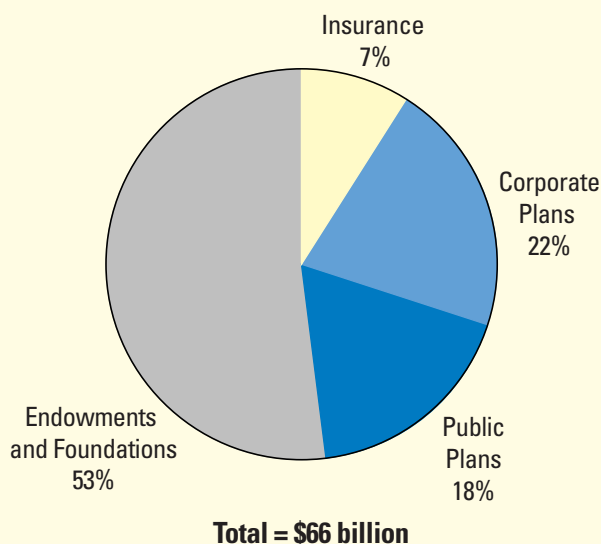
We estimate that, at the end of 2003, U.S. institutions had invested approximately \$66 billion in capital with hedge fund managers. This capital came primarily from about 400 institutions.

As indicated in *Exhibit 1*, endowments and foundations have been at the vanguard of institutional hedge fund investing. Generally speaking, trustee familiarity with finance, more modest regulatory constraints on fiduciary responsibility, and less public scrutiny have allowed endowments and foundations to be early and rapid adopters of alternative investing. Currently, they account for about half of all institutional capital. Nearly 40 percent of all endowments and foundations with more than \$100mm in this segment have made some investment, with average allocations of nearly 12 percent of their total portfolio and some allocations nearing 50 percent. Many are close to reaching their target allocations of between 15 and 20 percent of the total portfolio.

Despite representing nearly five times as much in assets as endowments and foundations, defined benefit plans currently account for just 40 percent of institutional hedge fund capital, roughly evenly split between corporate and public plans. Only about 15 percent of pension funds currently invest in hedge funds and, among investors, allocations average merely 3 percent of invested portfolio assets.

Defined benefit plans, however, are the fastest growing source of institutional capital. Five years ago, pension interest in hedge funds was minimal. The stock market bubble and the ensuing dramatic bear market and resulting swing to under-funded status has forced pension funds to reassess their investment policies. As a result, many pensions began in the early part of this decade a systematic study of hedge fund investing. At first accused of more talk than action, a large number of pensions have begun making investments into hedge funds over the last 18 months. More importantly, these plans have begun to adapt their investment policies and sought legislative approval to systematically include hedge fund

Exhibit 1: **Institutional Capital Allocations to Hedge Funds: Year End 2003**



SOURCE: Casey, Quirk & Acito and The Bank of New York analysis.

Defined benefit plans are the fastest growing source of institutional capital

strategies—a step that will ensure continued capital flows over the next several years.

Insurance companies (for their general account) represent the least developed institutional market for hedge funds—less than 10 percent of all institutional hedge fund capital. Demand is not systematic, coming from a relatively small number of firms. Insurance firms face multiple impediments: the tax-inefficient nature of many hedge fund strategies; the challenges of insurance accounting rules; variations in state laws regarding hedge fund investing; and regulatory capital requirements.

PORTFOLIO ROLE FOR HEDGE FUNDS

Most institutions that have hedge fund investments have done so via a dedicated allocation, with investors split evenly between those that include them as part of a broader “Alternative Investment” mandate and those that have a specific “Absolute Return” sleeve. Only a small minority identifies their hedge funds as part of existing “traditional” policy ranges (e.g., long-short equity as part of a domestic equity sleeve). To circumvent hedge fund restrictions, a few institutions have turned to more creative solutions, for example, using portable alpha strategies or using hedge funds as a liquidity pool for private equity investments.

Where has the capital now dedicated to hedge fund allocations come from? For endowments and foundations, the rise in hedge fund investing has occurred in parallel with a systematic reduction in both long-only equity and fixed income investments, but particularly the latter. In effect, many endowments and foundations have been using a diversified pool of hedge funds as a substitute for fixed income, though this has been an implicit rather than explicit policy. For pensions, the capital commitments have been small enough to be funded through ongoing portfolio rebalancing. For most pensions, hedge fund capital has come from a decline in fixed income allocations, though this has been a tactical, not strategic decision, given current low but expected increases in interest rates.

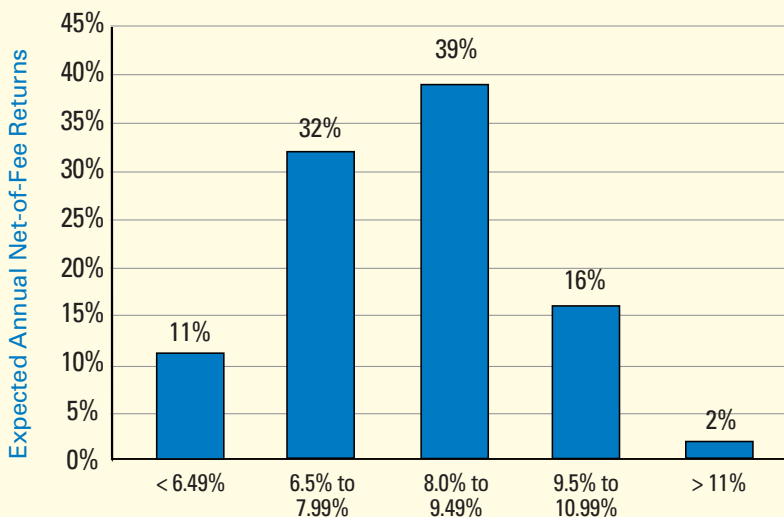
RETURN EXPECTATIONS

Institutions have an average net-of-fee return expectation from hedge funds of about 8 percent. As *Exhibit 2* indicates, nearly three quarters have expectations between 6.5 and 9.5 percent. This result was interesting to us, given that similar research done three years ago indicated that expectations were about 400 basis points higher. (Whether weaker returns to date in 2004 will further dampen expectations, remains to be seen.)

What accounts for this resetting of expectations? First, many of the newer entrants to hedge fund investing (especially defined benefit plans) prefer to do so through a lower volatility aggregate hedge fund portfolio than was typical among earlier adopters. Second, many institutions are setting target returns on a risk-free-rate-plus basis, rather than as a static absolute number; therefore, expectations have come down with rates. Third, most institutions are placing a higher premium on hedge fund strategies’ ability to diversify their portfolio—outsized returns are no longer the primary justification for making a hedge fund allocation. Finally, many institutions are anticipating a decline in returns as more capital pours into hedge fund strategies (discussed in greater detail in the next chapter).

Exhibit 2: Return Expectations

What is your current expected net-of-fee return for a diversified portfolio of hedge fund strategies?



Net return expectations are a modest 8%

SOURCE: Casey, Quirk & Acito and The Bank of New York analysis. Based on survey of Institutional Investor conference attendees (June 2004) and individual CQA/BNY interviewees.

FUND OF FUNDS VERSUS DIRECT INVESTING

Currently about one-half of all institutional investing is done through a fund of funds structure. (In “fund of funds” we include both literal fund structures and customized separate accounts structured and maintained by third parties.) Defined benefit plans have been more likely to use a fund of funds format; as newer entrants, they require greater support in gaining access, diversification, and education. Endowments and foundations with longer experience in hedge funds have had a greater propensity to make direct investments.

Institutional investing is not, however, proving to be as black and white as described above. As indicated in *Exhibit 3*, about 25 percent of institutions are employing a *dual investment model* in which both direct investing and fund of funds are employed. Most typically, a dual investor adds individual direct investments to an initial allocation to one or more fund of funds. This is done both to achieve a total hedge fund portfolio with the specific risk attributes the investor desires and to avoid additional double layers of fees. As they move into their “second stage” of investing, current dual investors have

Exhibit 3: Current Hedge Fund Investing Model

Investment Model	Number of Institutional Investors	Percent of Total Institutional Capital in Hedge Funds
Direct Only	40%	40%
Fund of Funds Only	35%	30%
Dual	25%	30%

SOURCE: Casey, Quirk & Acito and The Bank of New York analysis. Based on survey of Institutional Investor conference attendees (June 2004) and individual CQA/BNY interviewees.

on average greater capital allocated to hedge funds than investors following the direct only or fund of funds only models.

However, we find little evidence of institutions abandoning their fund of funds relationships as they develop experience with hedge funds. Most institutions are recognizing that the depth of resources required to effectively source, select, and monitor hedge fund investments are significant and expensive. At most, institutions are taking it upon themselves to begin to select managers in certain

Fund of funds are becoming the *de facto* consultant for hedge fund allocations

investment strategies, presumably where they believe they have some expertise (such as long-short equity or distressed debt). Even with these direct investments, however, institutions are reliant on their fund of funds partners to be a sounding board.

In this context, we find it interesting that, for many institutions, fund of funds are becoming the *de facto* investment consultant for hedge fund allocations. They are counted on as trusted overall advisors, providing manager search, strategic and tactical asset allocation guidance, as well as risk monitoring. In our survey, traditional institutional investment consultants were rarely mentioned as being influential in selecting individual hedge funds for their clients; most have been relegated to selecting fund of funds.

BARRIERS TO HEDGE FUND INVESTING

No summary of current institutional interest in hedge funds would be complete without a fair representation of a contrary view. After all, most institutions still do not allocate to hedge fund strategies. Why?

As *Exhibit 4* supports, the primary reason for not investing remains Headline Risk. Headline Risk is the (not irrational) view that poor performance (let alone malfeasance) among hedge fund investments will bring outsized criticism relative to the same performance from more traditional managers. For public and corporate officials, whose careers are in the balance, this asymmetric risk is often perceived as simply not worth taking. One of the reasons endowments and foundations have been earlier hedge fund adopters is that their trustees generally face less retribution.

Among non-investors, the next most important concern is that hedge funds will fail to deliver the promised goods. In particular, these institutions expect that, especially with greater flows of capital to hedge funds, returns will be reduced and/or that correlations will

Exhibit 4: Primary Impediments to Hedge Fund Investing

Impediment	Percentage of Respondents
Headline risk	34%
Returns will come down (and correlation up) as more money enters the market (capacity)	31%
Lack of investment process transparency	14%
Can't get comfortable with the fees (both the underlying managers and FoHF)	12%
Too large to put enough capital to work to get the benefits of diversification	9%

SOURCE: *Casey, Quirk & Acito and The Bank of New York analysis. Based on survey of Institutional Investor conference attendees (June 2004) and individual CQA/BNY interviewees.*

increase. Any remaining perceived benefits do not outweigh the additional headaches associated with hedge fund investments.

For a few particularly large institutions (say, over \$30 billion in assets), one additional reason for not investing was their inability to effectively put enough capital to work in hedge funds to receive the full benefits of diversification. While this is a small number of institutions, they represent a large pool of potential capital.

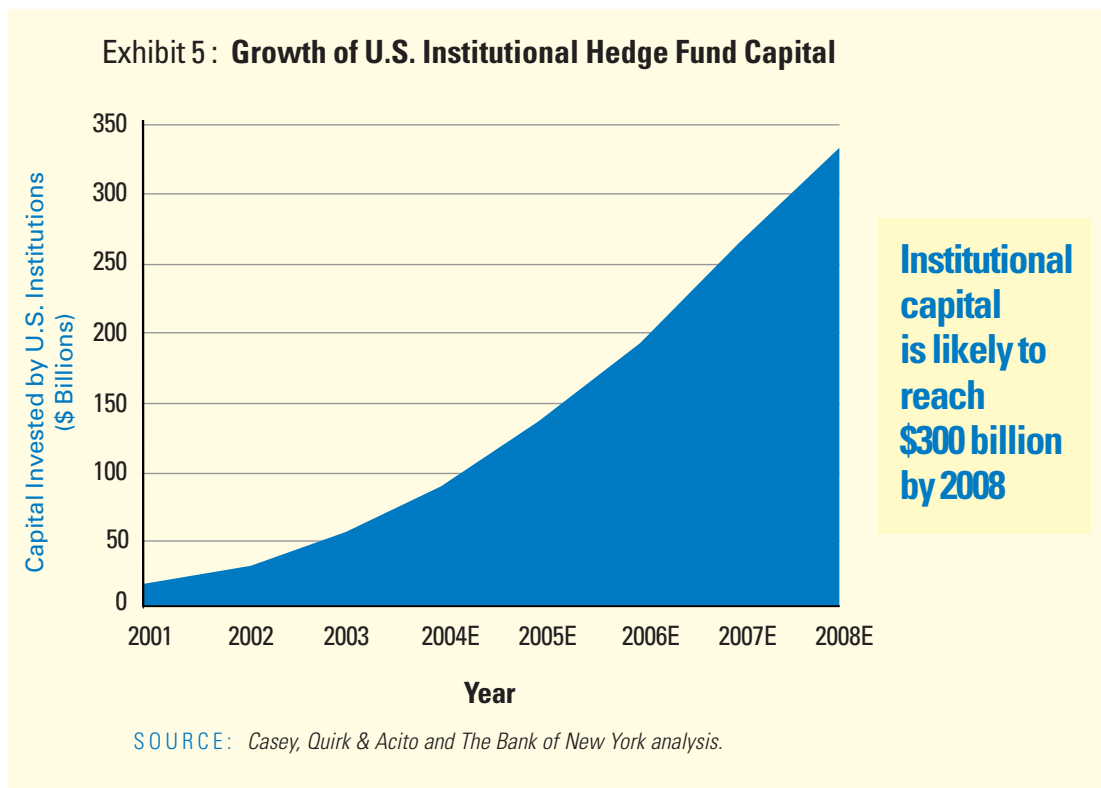
Finally, our survey work indicates that lack of sophistication is not necessarily an important factor among most non-investors. Many have begun or continue to study alternatives in general and hedge funds specifically. *Exhibit 4* also indicates that most do not overly weight lack of transparency or high fees as considerations.

Chapter 2: Impact of Increasing Demand

Whereas the previous chapter discussed the current state of institutional investment in hedge funds, this chapter attempts to discuss the future potential. We believe that as total hedge fund capital grows beyond the \$1 trillion mark, the nature of the industry will change as well. These changes can be expected to range from the institutionalization of capital flows, to the lowering of expected future returns, to the waning of traditional long-only management.

FUTURE CAPITAL FLOWS

We expect that by 2008 U.S. institutions will have over \$300 billion in capital invested in hedge funds. Assuming a market return of 7 percent per annum, this implies a net growth rate of over 35 percent per year. *Exhibit 5* illustrates our projection.

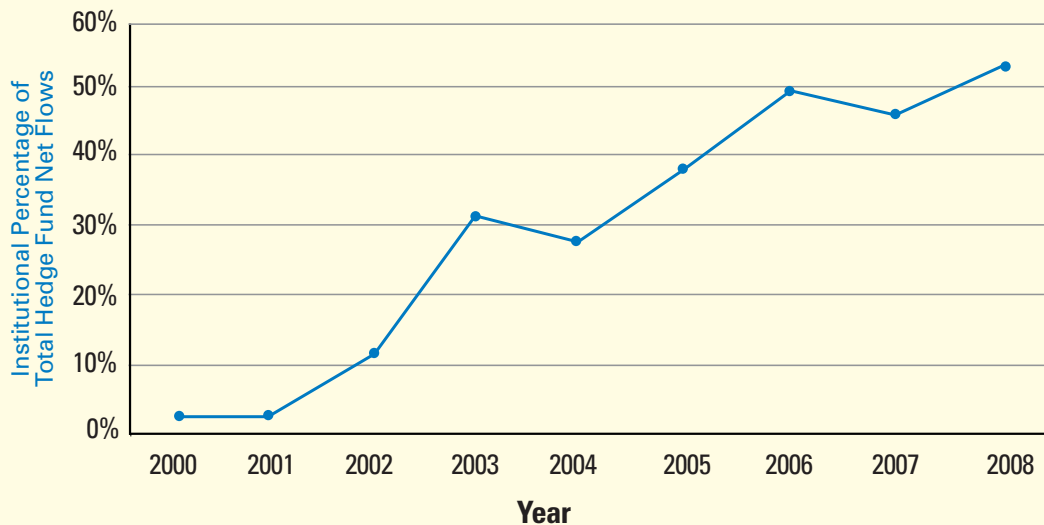


This increased capital flow will be driven disproportionately by defined benefit plans, as endowments and foundations have already made larger percentage allocations. We expect pensions' proportion of institutional capital to move from 40 percent to over 65 percent by 2008. Defined benefit plan capital contributions will come from both first time investors as well as current investors fulfilling their investment policy objectives.

We anticipate that fund of funds will maintain roughly a 50 percent share of the capital allocated from institutions. While direct investing will continue to grow, the dual investment model (described in Chapter 1) will preserve a base for fund of funds that will also grow with new investors (who will more likely choose the fund of funds vehicle over direct investing).

Perhaps more interesting and important than the absolute level of institutional hedge fund investing, will be the changes in net new flows. As illustrated in *Exhibit 6*, U.S. institutions will likely increase to a 50 percent of net new capital flowing to hedge funds globally. Add European and Asian institutions, and the percentage likely rises even higher. This transition is dramatic—institutional share was less than 10 percent through 2001.

Exhibit 6 : Institutional Share of Total Hedge Fund Capital Flows



SOURCE: Casey, Quirk & Acito and The Bank of New York analysis.

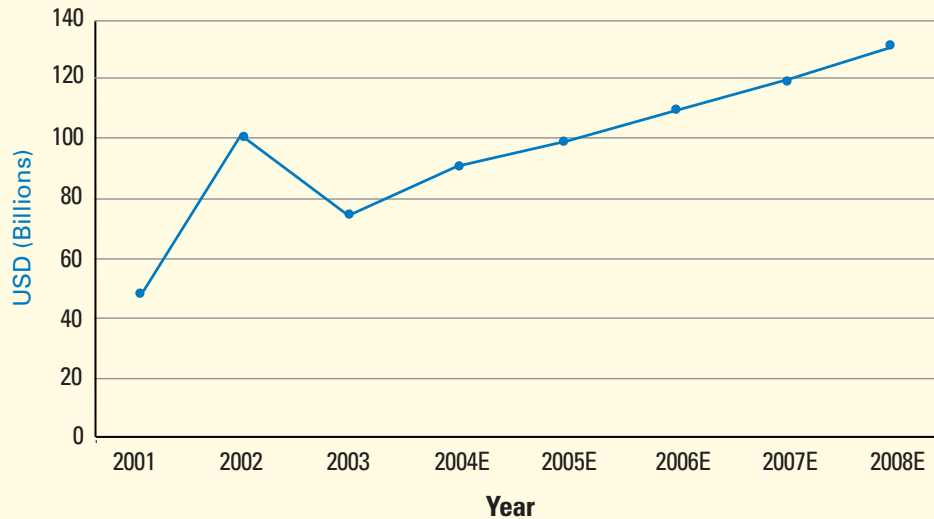
Why won't individual investment keep pace with institutions? First, the high net worth individual market is already very large at about \$800 billion. At this size, it is unlikely to sustain as high a percentage growth rate. Second, we believe it not unlikely that a reduction in average hedge fund returns will temper individuals' enthusiasm for hedge funds, as individual investors will continue to have higher return expectations than institutions.

By 2008, institutions may account for half of the net flows of capital into hedge funds

WHERE WILL THE CAPACITY COME FROM?

Can the hedge fund industry sustain its rapid growth? As illustrated in *Exhibit 7*, net new flows will begin to exceed \$100 billion per year—a figure larger than the entire industry in 1998.

Exhibit 7 : Global Net Capital Flows to Hedge Funds



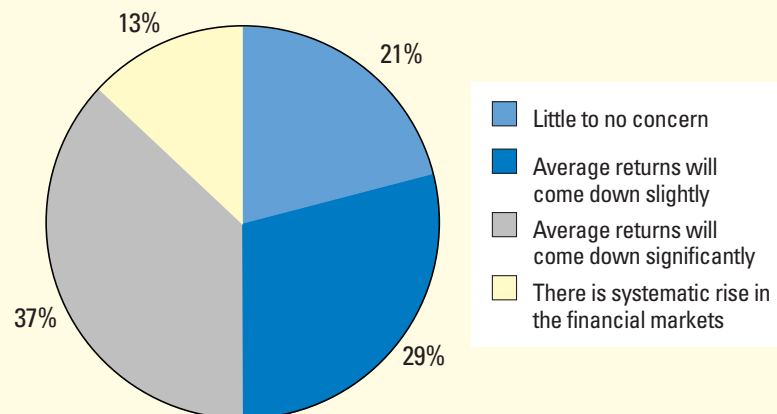
SOURCE: Casey, Quirk & Acito and The Bank of New York analysis.

To put this into perspective, \$100 billion of capital can provide \$2 billion in new capital to 30 firms while seeding 400 new funds with \$100 million each. Does the math work? Is there really enough talent? Are there enough strategies?

Lower Returns. One mechanism for avoiding future disappointment is for investors to lower their expectations. In Chapter 1, we established evidence that institutions have already dropped their return expectations relative to three years ago. *Exhibit 8* presents evidence that continued reductions in expectations are likely. Thirty-seven percent of surveyed investors believe that increased capital flows

Exhibit 8 : Anticipated Impact of Capital Flow on Returns

Are you concerned about the rate at which capital is flowing into hedge funds (in aggregate)?



SOURCE: Casey, Quirk & Acito and The Bank of New York analysis. Based on survey of Institutional Investor conference attendees (June 2004) and individual CQA/BNY interviewees.

will “significantly” reduce average returns in the future; another 29 percent believe that they will fall “slightly.”

Institutions expect returns to fall

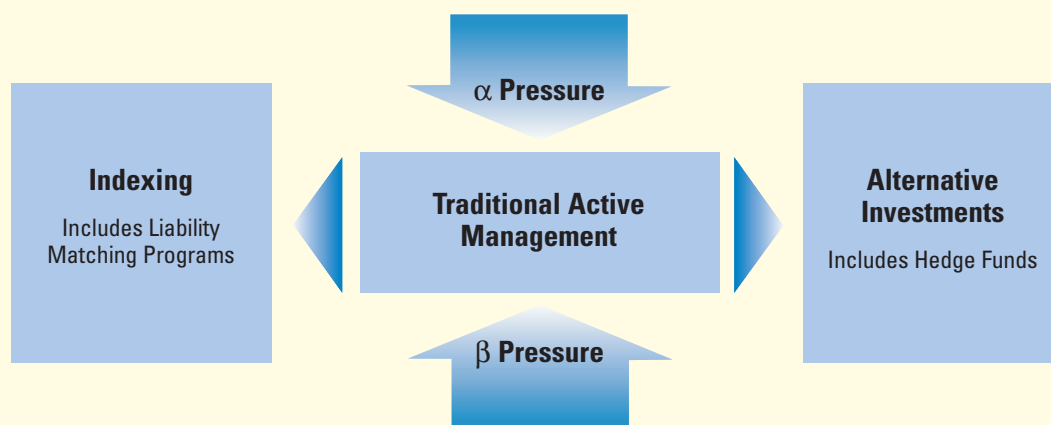
New Strategies. A second moderating factor is the ability to create more investment capacity. We are likely at a current point in time where rapid increases in demand for quality hedge fund capacity is temporarily outpacing the market’s supply. Yes, some hedge fund strategies will continue to be plagued by a surfeit of capital. However, fertile minds will advance ever more esoteric strategies into existence. (Several interviewees made remarks akin to: “Any activity within an investment bank with an IRR of 15 percent is ripe to become a hedge fund.”)

Unfortunately, traditional arbitrage and new exotic strategies may not be able to effectively absorb the majority of new capital. Therefore, we expect the continued expansion of high capacity strategies such as some Macro and CTA strategies and, especially, public equity-based strategies. In particular, a majority of our survey participants indicated a growing demand for non-traditional, generally long-only portfolios (e.g., those with an absolute return orientation, the potential for modest shorting, and commanding high fees, usually including a carried interest). We refer to these strategies as hybrid strategies, neither traditional long-only nor the usual long-short equity or fixed income strategy.

CHALLENGES TO TRADITIONAL ACTIVE MANAGEMENT

The significant movement of institutional capital to hedge fund strategies will create business challenges for traditional active money management firms, both in equity and fixed income management. First, there is the direct effect of capital redeployed from traditional² long-only active managers to fund hedge fund allocations. Second, a more important indirect effect is that the hedge fund phenomenon reflects a growing desire to *separate alpha from beta*, taking market exposure through low cost vehicles such as index funds, exchange traded funds, or derivatives while directing advisory fees to those managers who deliver high alpha for their level of risk.

Exhibit 9: The Alpha Beta Squeeze on Traditional Long-Only Management



SOURCE: Casey, Quirk & Acito and The Bank of New York analysis.

² We define “traditional” investment management to be fully-invested, non-leveraged, long-only portfolios of liquid securities managed for a flat asset-based fee with performance measured relative to a benchmark.

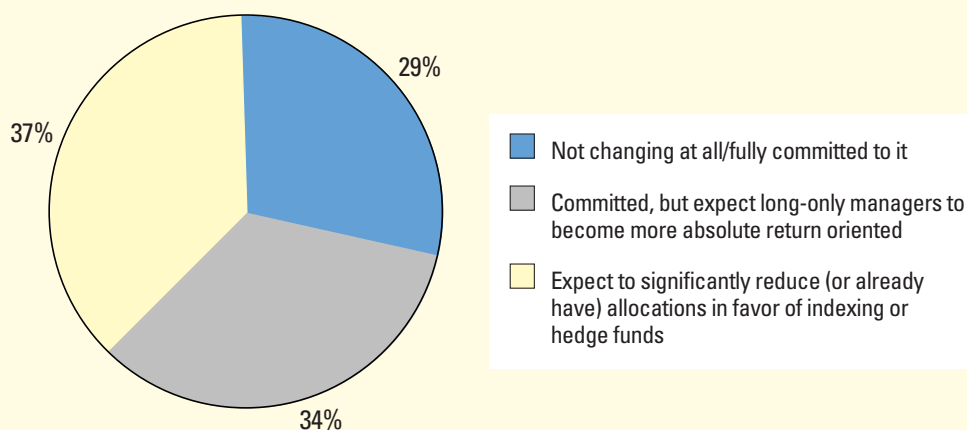
Thus, traditional active managers are currently caught in an *alpha-beta squeeze*. As illustrated in *Exhibit 9*, “ α pressure” represents institutions’ willingness to search and pay for pure alpha; “ β pressure” represents institutions’ unwillingness to pay much for broad market exposure. The pressure from both sides is squeezing asset allocation out of traditional active management and into index-like and alternative investing strategies. Over the next several years, we are likely to witness a diminution of active management for institutional investors—both as a percentage of the overall portfolio and, barring high market returns, on an absolute basis as well.

Traditional active management will decline in importance

Exhibit 10 reflects how the *alpha-beta squeeze* is affecting institutions’ behavior towards long-only active management. Over one-third of respondents indicated that they expect (or already have) significantly reduced long-only allocations in favor of beta (index-like) products and alpha products (hedge funds and other alternative strategies). Additionally, another one-third of respondents indicated that they expect their long-only managers to become more absolute return oriented.

Exhibit 10: Perceptions of Traditional Long-Only Management

How are your perceptions of traditional long-only management changing?



SOURCE: Casey, Quirk & Acito and The Bank of New York analysis. Based on survey of Institutional Investor conference attendees (June 2004) and individual CQA/BNY interviewees.

Current long-only managers will need to turn their attention to the hybrid product area previously discussed to tap into this growing market. Unfortunately for them, these hybrid approaches have not gone unnoticed by hedge fund firms. Many are having discussions with clients to run long-only like strategies. Hedge fund firms may have an advantage here—institutions seem more confident in their ability to focus on absolute returns than with managers who have historically been rewarded for being down 25 percent when the market is down 30 percent.

Chapter 3: Attracting Institutional Capital

Which hedge fund firms will be successful in attracting institutional capital? This chapter introduces the seven attributes that we believe will characterize successful firms. These factors were the most often mentioned during our extensive interviews. This checklist can serve as a benchmark for evaluating a firm's current and future competitive position.

Taken in their entirety, these attributes define a much more mature business model than has heretofore been required in the hedge fund industry. It is more resource-intensive and will require overall higher professional standards. And, while institutions believe large and small hedge fund firms alike will be viable in the future, meeting these institutional standards will require greater scale than before.

The Checklist

We begin with the assumption that the primary driver of hedge fund success will be the investment professionals' perceived ability to deliver returns in line with clients' expectations. Given managers of equal skills and the proper alignment of financial interests, which are the hedge fund firm attributes that will most appeal to institutional investors?

Exhibit 11: Requirements for Institutional Success

- ✓ **1. Business Management**
- ✓ **2. Culture of Integrity**
- ✓ **3. Operational Excellence**
- ✓ **4. Disciplined Investment Process**
- ✓ **5. Investment Strategy Innovation**
- ✓ **6. Comprehensive Risk Oversight**
- ✓ **7. Sophisticated Client Interface**

SOURCE: Casey, Quirk & Acito and The Bank of New York analysis.

Based on our interviews, we have settled on seven primary requirements for institutions' success, listed in *Exhibit 11*, and described throughout this chapter.

1. BUSINESS MANAGEMENT

As this paper argues, the growing "institutionalization" of hedge fund demand will require greater resources and higher professional standards than heretofore required for success. Organizing these resources and instilling professionalism require strong tactical business management skills. Just as venture investors pair business leaders with inventors, institutional investors are expecting CFO's and COO's to complement investment professionals. The larger and more complex the hedge fund firm, the higher the premium put on business acumen.

The attention to business management is rational. Institutions want to be assured that their hedge fund advisor is a viable long-term business and that investment professionals are not distracted from making good decisions about their portfolios. They want to minimize potential disruption due to over-dependence on any one individual for the effective operation of the firm.

Putting into place the appropriate business management talent will be a challenge for the hedge fund industry. First, the current supply of experienced talent is limited. Second, the investment

professionals who dominate most hedge fund firms are often still reluctant to recognize the importance of such skills. Quite possibly, the institutionalization of hedge fund demand may require consolidation around the short commodity of business leadership.

2. CULTURE OF INTEGRITY

Leading institutional investors rightfully require very high standards for professional conduct throughout an entire investment management firm. They want to be assured that their advisors are acting in the best interests of their clients at all times.

Hedge fund managers must instill in their firms unimpeachable ethical standards with little to no tolerance for infractions. Adequate resources must be dedicated to compliance.

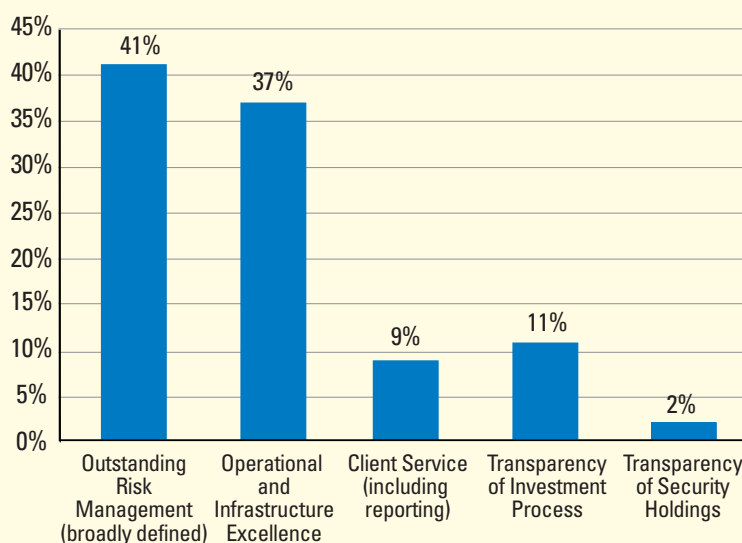
Best practices will include a series of independent checks and balances that reinforce the culture of integrity, especially with regard to valuation, risk management, trade settlement, cash movements, and custody. These duties should be segregated, and potentially performed by third-parties (especially with regard to valuation). A culture of integrity must be reinforced by policies in the spirit of “trust but verify.”

3. OPERATIONAL EXCELLENCE

Institutions are placing greater emphasis on hedge fund firms’ business infrastructure. As indicated in *Exhibit 12*, “operational and infrastructure excellence” and “outstanding risk management” are clearly the most important non-investment characteristics to institutional investors. (At this point in time, investors are placing much greater emphasis on these attributes than on client service and investment process or security-holding transparency.)

Exhibit 12: Distinguishing Characteristics

Apart from perceived investment skill, what makes for an attractive hedge fund firm?



SOURCE: Casey, Quirk & Acito and The Bank of New York analysis. Based on survey of Institutional Investor conference attendees (June 2004) and individual CQA/BNY interviewees.

During our interviews, institutions most often specifically mentioned the following operational concerns:

- **Third-party verification of pricing.**
- **Documented policies and procedures.** Institutions require documentation; leading firms have and make available written details of all key operations.
- **Well-designed trading infrastructure** that links trade-order management, portfolio accounting, and risk management.
- **Robust disaster recovery.**
- **Senior professional operational leadership** independent of the investment team.

Meeting the increased standards for operational excellence will be a significant challenge for many firms. As a result, we are likely to see the continued growth of outsourcing options for hedge fund firms.

In addition, we believe that institutions will also expect hedge fund managers to systematically address Embedded Alpha or the less apparent “frictional” costs of managing an investment portfolio. These costs include portfolio financing; the opportunity cost of failing to execute trades efficiently; ineffective cash and collateral management; and the negative market impact of trading. Embedded Alpha costs have been estimated to be 100 to 200 basis points or more per annum. To date, most hedge fund managers have not explicitly managed Embedded Alpha. However, with lower expected returns, these embedded alpha costs become even more relevant.

4. DISCIPLINED INVESTMENT PROCESS

Institutional investors realize that great investment management is a blend of art and science. That said, to appeal to institutions, hedge funds must demonstrate how they make clear investment decisions. Hedge funds must have investment processes that are understandable (even if complex), consistent, risk-aware, and perceived to be repeatable. A clearly-defined investment process establishes credibility among buyers and intermediaries. It establishes confidence in the consistent delivery of performance, within the agreed-upon risk parameters.

To appeal to institutions, hedge funds must also be able to articulate in a clear and concise manner the true competitive advantage that they possess—i.e., how they will deliver alpha in a manner that is unique and compelling.

Sophisticated evaluators are also assessing whether hedge funds have the appropriate quantity and quality of investment professionals to credibly implement their investment process. This is particularly true of fund of hedge fund firms, where the staffing requirements have increased substantially over the past few years.

Quantitative research skills and tools have taken on a significant role in the investment industry, and hedge funds should be able to master and leverage these tools, even if their core processes are fundamental in nature. They are not a panacea but can provide support for the research and decision-making processes. They can also provide significant leverage to an investment team. Leading hedge

fund managers are integrating quantitative tools into several parts of the investment process such as: screening and idea generation, portfolio construction, attribution analysis, and performance monitoring.

5. INVESTMENT STRATEGY INNOVATION

Many institutions recognize that hedge fund investment strategies face cycles and secular trends with regard to their effectiveness. As a result, they expect that hedge fund firms will dedicate resources to constantly evaluating the effectiveness of their investment process. Appropriately augmenting their investment capabilities will be a core competence of successful hedge fund firms—whether this is hiring a new trading desk or constantly developing new quantitative models.

In some ways, institutions seem much more tolerant of such investment process reinvigoration among hedge funds than among traditional managers (where it is perceived as “style drift”). Many institutionally accepted hedge fund firms have migrated, for example, from merger arbitrage specialists to broader event-driven managers, or from convertible bond specialists to capital structure arbitrageurs.

6. COMPREHENSIVE RISK OVERSIGHT

Institutions have high expectations for their hedge fund managers with regard to risk controls. Most obviously, they expect a strong handle on all market risk factors to which a portfolio (not just an individual security) is exposed. Proprietary tools are encouraged, though thoughtful application of third-party packages is also satisfactory.

However, institutional caliber firms will approach risk as being broader than simply market movements. As Chapter 2 described, institutions view “Headline Risk” as the most significant impediment to hedge fund investing. They also believe that operational breakdowns are the most prevalent source of hedge fund failures. As a result, hedge fund managers should also have a compelling approach to operational, regulatory, and counterparty risks if they are to appeal to institutional investors.

Institutions perceive risk oversight best practices to include having senior risk professionals who are independent of the investment team.

7. SOPHISTICATED CLIENT INTERFACE

Historically, investment firms have been product-driven, focusing on clients only after the products have been created and are ready for sale. To be fully successful in the institutional market segments, hedge fund firms will require a broader set of distribution skills, among them:

- **Dedicated Client Service.** Institutional clients expect hedge fund managers to provide professional interaction. Institutions do, however, respect the fact that senior investment professionals should spend the majority of their time managing capital. Leading hedge fund firms are beginning to employ senior individuals to act as intermediaries between the manager and client.
- **Quality Communications.** Institutions require that information and insight, not just data, be provided to them at regular intervals.

- **Solutions Resources.** Institutions often look to their investment managers not only as a provider of product, but also as a sounding board for their investment issues. Leveraging proprietary intellectual capital as a means of influencing the institutional market can, therefore, provide an enormous competitive advantage. A well-structured thought leadership effort can play an important role in establishing such a market reputation and can create a most effective “dialogue-generation tool” to reach the firm’s target audience.
- **Willingness to Provide Transparency.** Most institutions do not (yet) want hedge funds to provide them with full transparency on their holdings—most have little ability to process and assess this information. However, institutions are interested in the willingness to provide this information to their fund of funds or third-party risk vendor (on a detailed level). Institutions will increasingly negatively view complete intransigence on this issue.

Sophisticated client interaction generates a more stable capital base for existing products and will provide greater opportunity to raise future funds.

Conclusion

As documented in our report, the hedge fund industry is midway through an important transition with regard to the sources of its capital. Five years ago, hedge funds derived nearly all of their assets from wealthy individuals. Institutional interest was limited to a small number of endowments and foundations. Over the next five years, institutions (driven by defined benefit plans) are likely to provide an additional \$250 billion of hedge fund capital, accounting for 35 percent of net new flows in this period. Coupled with the increasing influence of the fund of hedge fund industry, new hedge funds will be dependent on “professional” sources of capital for on average 70 percent of their capital.

The good news is that the next several years will provide hedge funds with an opportunity to raise significant capital from institutional investors, a desired client base for most hedge fund managers.

However, capturing this opportunity will not be easy. Institutional investors are much different than the traditional individual investor base for hedge funds. Relative to individual investors, institutions have significantly different product demands and return expectations. They also require hedge funds to have business models that are more robust and resource-intensive than has been heretofore acceptable, including higher standards for overall business management and operations and greater demands for client service. Given that serving institutions will be a business necessity for the average hedge fund, we expect that this transition will have a dramatic impact on the hedge fund industry, resulting in more mature business models than are typical today. Though many hedge funds are making the appropriate adjustments, the great majority of today’s hedge fund managers are unlikely to meet the new stringent requirements. Likely, the next great generation of hedge fund firms are only beginning to be built today.

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