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SEI White Paper: Maturing Hedge Fund Industry Must Shift Gears to Grow Institutional Business

Paper Identifies Five Challenges for Hedge Funds Trying to Attract Institutional Assets

OAKS, Pa., Feb. 11 /PRNewswire-FirstCall/ -- As hedge funds increasingly look to the institutional market for asset growth, they must equip themselves to fit the high expectations and conservative attitudes characterizing institutional investors, concludes a white paper released today by SEI (Nasdaq: SEIC), titled "Five Critical Challenges for Hedge Funds Taking Aim at the Institutional Market."

Hedge fund assets under management have been growing at a compound annual rate of 26% since 1990, reports the SEI analysis, with much of that growth coming from the institutional market. "To maintain that growth trajectory, the hedge fund industry will need to branch out from its traditional high-net- worth, foundation, and endowment clientele to serve the broader institutional market," said Paul Schaeffer, Managing Director of Strategy and Innovation for SEI's Investment Manager Services division. "But to compete for those assets, the industry must recognize that large institutions have a distinct set of demands concerning issues such as the quality of infrastructure, transparency, and risk."

Based partly on a survey of more than 100 institutional investors by SEI and the research firm of Infovest21, the SEI analysis details growing institutional acceptance of hedge fund investing. Forty-seven percent of the institutions surveyed said they already invest in hedge funds. Within that group, 73% of pension plans and 55% of institutions overall said they had increased hedge fund allocations over the last several years. Portfolio allocations to hedge funds averaged 30% for endowments, 13% for pension funds, and 24% for institutions.

At the same time, institutions expressed continued concerns with hedge fund investing. "Headline risk" was named by 37% of survey respondents as their biggest worry, followed by lack of transparency (19%) and poor performance (15%). Institutions also remain cautious in selecting hedge funds, the survey found, devoting an average of seven months to due diligence and 12 additional weeks to approval.

In the paper, SEI identifies five challenges hedge funds should address in order to attract more institutional assets:

1) Demonstrate institutional-quality infrastructure and operations. Infrastructure was ranked the number-one criterion in hedge fund selection, with 46% of those surveyed naming it most important. Of those who responded this way, 54% said it was because "better managed firms produce better returns." The quality of fund administration was a prime concern. Of those respondents most concerned with infrastructure, two-thirds said it is unacceptable for funds to handle their own administration internally, and half demand a "big-name" administrator; 81% said they take steps to verify that hedge fund investments are valued independently.

2) Meet investor demands for reporting and transparency. The lack of transparency was the second most commonly cited worry with hedge fund investing, with 19% of institutions ranking it number one. This concern was greatest at the strategy level, with 85% of respondents saying they would not invest in a strategy they do not fully understand. More than half said they seek portfolio transparency at the industry or sector level, and one-third were most concerned with transparency of the investment process. Only 11% said they seek transparency of specific investment positions.

3) Build stable management teams with a full range of skill sets. Interviewees ranked "people at the firm" as the third most important factor in hedge fund selection, surpassed only by "firm infrastructure" and "performance." Other survey responses revealed that investor concerns with hedge funds' organizational stability and staffing are not confined to those making investment decisions, but cut across all key management and support positions.

4) Shift focus from performance to investment disciplines. Institutions are as concerned with investment process and risk profile as they are with the level of absolute returns, the survey revealed. Interviewees ranked "consistent, stable returns," "uncorrelated returns," and "high risk-adjusted returns" as more important objectives than "high absolute returns." Seventy-two percent of interviewees said the investment strategy, rather than performance, is their starting point for hedge fund selection.

5) Keep abreast of public policy and regulatory trends. Citing ongoing deliberations over hedge-fund-related regulation, tax policies, and accounting rules and investor concerns with "headline risk," the paper urges the industry to "commit whatever resources are needed to ensure that hedge fund managers meet the highest possible standards for their overall compliance and general business practices."

"The take-away message is that institutions clearly prefer to do business with institutional-style organizations," concluded Schaeffer. "For hedge funds, the challenge will be to fit the profile of an institutional-quality fund while preserving the performance attributes that attracted major investors in the first place."

The white paper is published by the SEI Knowledge Partnership, which provides ongoing business intelligence to SEI's investment manager clients. To request a copy of the white paper, please visit www.seic.com/ims/General_5challenges.asp.

About SEI's Investment Manager Services Division

SEI's Investment Manager Services division provides total operations outsourcing solutions to global investment managers focused on mutual funds, hedge and private equity funds, separately managed accounts and institutional 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.

About SEI

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