Industry Outlook

Hedge Funds 2.0
Evolution in Action

Sixth Annual Survey

April 2012

Rothstein Kass

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April 2012

Rothstein Kass

2011 was certainly a year of contrasts for the hedge fund industry. On one hand, the industry as a whole underperformed the indices, while simultaneously being faced with more regulation, oversight and operational costs. During the same period, however, hedge funds found increased favor with a growing number of public and private pension plans, much as we predicted they would at the height of the crisis. All of these phenomena have had a significant impact on hedge funds, leading them further and further away from their "cottage industry" roots and closer to true institutionalization. Even now, hedge funds are experiencing industry evolution on almost every level, from transparency to operations, from risk management to investor relations.

Rothstein Kass has been among a few strong voices that predicted hedge funds would welcome thoughtful reform that supported investor confidence and industry best practices. Because of our close ties to the hedge fund community, we also recognized that the true catalyst for change would be primarily driven by investor demand. In fact, our very first survey of hedge fund industry leaders, conducted in 2007, confirmed that the shift toward the institutionalization of the alternative investment space was already under way as institutional investors began to increase allocations to hedge funds.

Now in 2012, the drive toward institutionalization continues. In our conversations with industry leaders, we have become aware of a wave of new mandates for the hedge fund industry, as many institutional investors increase allocations, and others consider their initial investments. Still others have taken even greater steps toward embracing the hedge fund industry and have bought stakes in individual hedge fund firms. It is now up to hedge fund managers to keep this momentum going. At the most basic level, the industry must begin to generate alpha.

Our annual research reveals an industry that is well aware of the market and performance struggles they face. It chronicles a continuing hedge fund evolution and sheds light on the issues and concerns that keep managers awake at night. Certainly, significant challenges still lie ahead for the hedge fund community, from ongoing political and economic uncertainty to compliance with SEC registration requirements. Hedge funds with less than $1 billion under management continue to struggle in the current capital-raising environment, which has overwhelmingly favored larger firms. Barriers to entry for new managers have increased, and, as a result, industry consolidation will inevitably play a role as we move forward. The way that hedge funds address these challenges will ultimately determine to what heights the industry can soar in the coming years.

Over the past year, we have seen a wave of new funds launched by portfolio managers who "came of age" within a hedge fund complex, as opposed to hailing from an institutional background or trading floor as they have in the past. We believe that these hedge funds, "Version 2.0," will continue to drive progress and innovation within the hedge fund space. Their near-term impact, as well as the long-term impact of the challenges described above, has yet to be uncovered. At Rothstein Kass, we look forward to watching these developments and reporting the resultant trends and themes to you in the years to come.

In the meantime, we are pleased to share with you the results of our 2012 research into a dynamic and evolving industry. We think that you will find this report both insightful and thought-provoking, and encourage you to contact us directly with questions or for a more in-depth discussion of our findings.

Sincerely,

Howard Altman
Co-CEO and Principal-in-Charge of the Financial Services Group
Rothstein Kass

2011 was, by at least some measures, a 'better' year for the hedge fund industry.

According to Hedge Fund Research, the industry saw $70.6 billion in net asset inflows, while total hedge fund industry assets under management soared to new heights. Heading into 2012, HFR reported that the industry had eclipsed the $2 trillion mark for the first time in its history.

Since the end of 2008, the hedge fund industry has been embroiled in an almost constant state of flux. Even though the changes that have affected the industry have been generally more evolutionary than revolutionary, the industry still looks different today than it did only three years ago. With regulation poised to transform the industry in 2012, the metamorphosis of the hedge fund industry seems far from complete. Industry participants continue to be undecided about how the future of the industry will look, although certain key themes have emerged. This annual Rothstein Kass Industry Outlook explores the issues that will impact the hedge fund industry in 2012 and beyond.

Key Findings

- While limited partnerships and offshore LLCs remain the dominant vehicles for the U.S. managers in our survey, separate accounts and funds of one are gaining ground and now nearly equal the number of offshore products.

- UCITS vehicles, despite their popularity in Europe, have yet to infiltrate the U.S. marketplace. Of the 400 hedge fund firms and more than 770 funds polled, only 17 firms reported managing UCITS products.

- Despite reported upticks in fund launches in 2010 and 2011, the number of emerging hedge funds remains lower than it was prior to 2008.

- The overall percentages of women- and minority-owned firms remain low at 5.8 percent and 10.3 percent, respectively.

- Firms launched in the last three years are three times more likely than firms founded earlier to report 50 percent or more women and minority ownership.

- Forty-seven and a half percent of those polled believe 2012 will be a difficult year for the hedge fund industry. However, they also believe that 2012 will see more fund launches than 2011.

- Seeding is a key theme in 2012, with 79 percent of respondents believing it is critical to a successful launch this year.

- Marketing/asset raising are the biggest concerns facing hedge fund firms in 2012. Firms with less than $100 million under management are more concerned than firms with more than $1 billion under management.

- While the majority of respondents are not worried about a double-dip recession in the United States, most believe that the hedge fund industry will use less leverage in 2012 due to market concerns and risk aversion.

- Nearly one-third of funds polled do not plan to use leverage in 2012, while another 52.3 percent intend to use less than 2-to-1 leverage this year.

- Slightly more than 66 percent of those polled intend to raise assets by 25 percent or more in 2012.

- Family offices remain the most important source of investor capital to our respondents overall. However, pension plans and consultants were listed as the top sources for assets by large funds, and consultants were listed as a priority for women- and minority-owned funds.

- Nearly one-third of those polled believe that investor due diligence will take six months or longer to complete.

- Almost 43 percent of the funds polled would consider lowering fees in exchange for early-stage or seed capital.

- Just under 52.5 percent of the funds polled would consider creating a separate account in exchange for a $50 million investment.

- Regulatory burdens are weighing heavily on managers — 51.5 percent are concerned about the scope and frequency of reporting requirements. Another 43.4 percent are concerned about staffing and resources required for reporting.

To create the 2012 Rothstein Kass Hedge Fund Survey Report, we relied on the following information:

- A survey conducted by Rothstein Kass over a four-week period in January 2012, which captured the sentiments of 400 hedge fund firms, representing more than 770 vehicles
- Survey respondents were based primarily in the United States (395 of 400 firms)
- Responses from the survey were analyzed and aggregated to create summary results
- In addition to survey questions, survey participants were asked to provide thoughts and color. Their comments have been reflected throughout this report
- Rothstein Kass partners were asked to weigh in on subjects on which they are experts
- Publications, articles, studies and white papers
- Ongoing conversations with clients and other industry participants
- Responses were also organized based on a number of key demographic groups. These results were then compared to provide additional granularity. Demographic groups that were considered separately included:

By Size:

- Hedge funds with less than $100 million under management (“Small funds")
- Hedge funds with more than $1 billion under management (“Large funds”)

By Tenure:

- Hedge funds that have been in operation for less than three years (“Emerging funds”)
- Hedge funds that have been in operation for more than five years (“Mature funds”)

By Ownership:

- Hedge funds predominantly owned/operated by women
- Hedge funds predominantly owned/operated by minorities

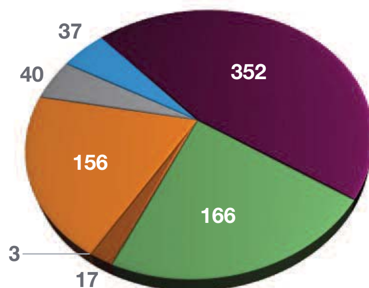
Demographic Information

The 2012 Rothstein Kass Hedge Fund survey was conducted over a period of four weeks and includes the responses and insights of 400 primarily U.S.-based hedge fund firms. As a result, we believe this study is a comprehensive representation of the U.S. hedge fund industry. In fact, most studies conclude that the U.S. represents a large portion of the global hedge fund industry (up to 68 percent according to *TheCityUK* May 2011 Hedge Funds report). Because of this, and the fact that more than 166 offshore vehicles are represented by the managers surveyed, this report also provides global industry perspective.

In addition to representing the feedback from 400 hedge fund firms, our survey also represents the interests of more than 770 investment vehicles (Exhibit 1). Based on the information we gathered, limited partnership vehicles continue to dominate the marketplace, with offshore limited liability companies a strong second. Despite the activity around Undertakings for Collective Investment in Transferable Securities (UCITS) products in Europe, they remain a rare vehicle for U.S. firms. Only 17 of our sampled firms reported managing UCITS products. Separate accounts, however, appear to be gaining ground on commingled vehicles: more than 156 separate accounts or funds of one were reported by our sampled firms, putting them almost on par with offshore LLCs.

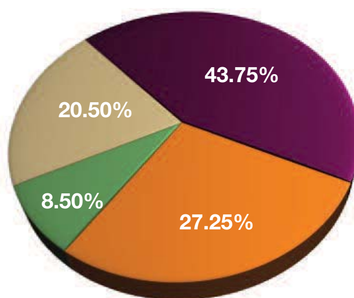
In addition to representing a variety of fund vehicles, survey respondents also provided insight into a large cross section of fund sizes (Exhibit 2). Much like the industry as a whole, the respondents in our survey were skewed toward managers with less than $100 million under management (“small funds”). Almost 44 percent of those surveyed represented firms of this size. Another 35.8 percent of respondents were from firms with between $100 million and $1 billion under management. More than 20 percent of survey respondents represented firms with more than $1 billion under management (“large funds”).

Exhibit 1
Investment Vehicles Managed by Survey Respondents



- Limited Partnership
- Offshore LLC
- UCITS product
- ETF
- Separate Accounts/Funds of One
- Other registered entities
- Other nonregistered entities

Exhibit 2
Survey Respondents by Fund Size



- Under $100 million
- $100 to $500 million
- $500 million to $1 billion
- More than $1 billion

> “We expect to see the number of women- and minority-owned firms continue to increase in 2012 and beyond,” said Kelly Easterling, principal-in-charge of Rothstein Kass’ Walnut Creek office and a sponsor of the firm's November 2011 report "Women in Alternative Investments: Industry Outlook and Trends."
>
> “Certainly, there is an increasing appetite, based on our monitoring of the Request for Proposal (RFP) universe, for investment managers that more closely mirror the constituent base of pension plans and other institutional investors. In addition, the percentage of ownership by women and minorities at larger firms bodes well for future launches and spin-outs. The first step toward changing the demographic landscape is for more women and minorities to have opportunities within hedge funds in which they can learn the business.”

Likewise, we were able to obtain responses across the firm tenure spectrum (Exhibit 3). Much like the hedge fund industry as a whole, which has seen fewer startups since the difficulties of 2008, our sample is weighted toward funds with longer track records. In fact, 56.5 percent of respondents surveyed have been in business more than five years ("mature funds"), while only 26.8 percent of respondents represented “emerging funds” with a track record of less than three years.

Perhaps not surprisingly, the emerging funds in our sample represented a greater proportion of the small funds as well. Of the emerging funds surveyed, more than 70 percent had less than $100 million in assets under management (AUM), while only 3.7 percent managed more than $1 billion.

Also not surprising is the fact that emerging funds, along with small funds, are less likely to be registered with the SEC than mature funds or large funds (Exhibit 4). Certainly large funds lead the pack in SEC registration, with 86.5 percent stating that they were already registered at the time of our survey, and another 7.3 percent stating they plan to register. Meanwhile, 69 percent of small funds were not registered with the SEC, and only 10.3 percent of those polled planned to register.

A higher percentage of emerging funds, 22.1 percent, planned to register but 56.7 percent of our respondents were not registered at the time of the survey.

Exhibit 3
Firm Tenure

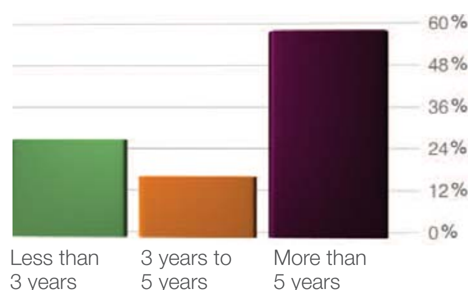
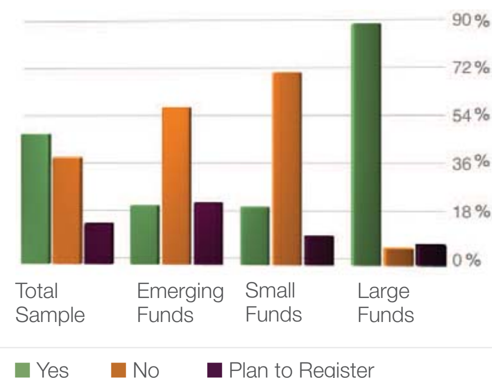


Exhibit 4
SEC Registration



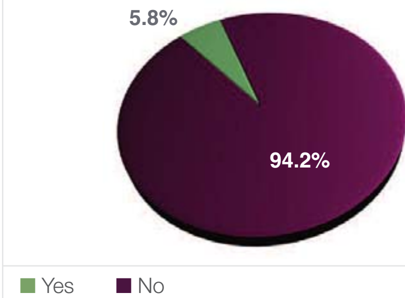
Finally, we asked our survey participants to disclose whether their firms were predominantly women- or minority-owned or managed. Our findings show only a small percentage of the overall hedge fund universe is controlled by women- and minority-owned firms (Exhibit 5 and Exhibit 6).

Merely 5.8 percent of the respondents in our survey reported that their firms were owned or managed predominantly by women, while slightly more firms, 10.3 percent, reported that they were predominantly owned or managed by minorities.

Interestingly, although perhaps not surprisingly, a much higher percentage of small funds reported women and minority ownership of 50 percent or more (Exhibit 7). Of funds with less than $100 million under management, more than 14 percent reported women or minority ownership of 50 percent or more, while only 3.6 percent of funds with $1 billion or more under management reported the same statistic. Large funds were more likely to have smaller percentages of women and minority ownership than small funds, probably due to concentrated ownership structures at smaller shops.

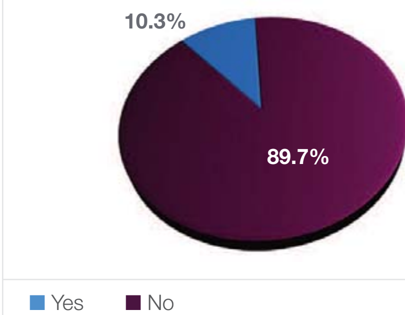
Likewise, the momentum for women- and minority-owned funds seems to be increasing, as 17.7 percent of emerging funds reported 50 percent or more women or minority ownership, compared to 4.4 percent of mature funds (Exhibit 8). Like the larger funds, mature funds were, however, more likely to provide women and minority fund ownership than emerging funds at levels less than 50 percent.

Exhibit 5
Women-Owned or Managed Hedge Fund Firms



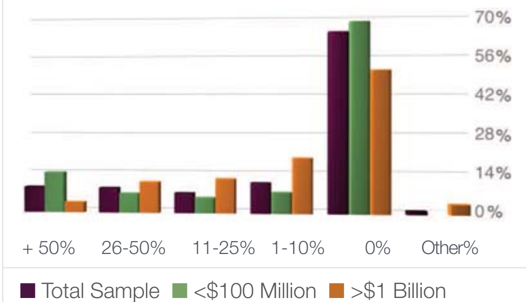
Yes No

Exhibit 6
Minority-Owned or Managed Hedge Fund Firms



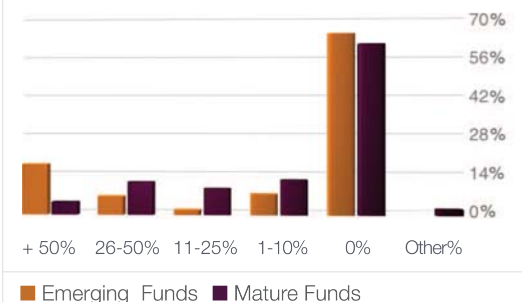
Yes No

Exhibit 7
Women and Minority Ownership/Control



Total Sample <$100 Million >$1 Billion

Exhibit 8
Emerging vs. Mature Funds with Women and Minority Ownership



Emerging Funds Mature Funds

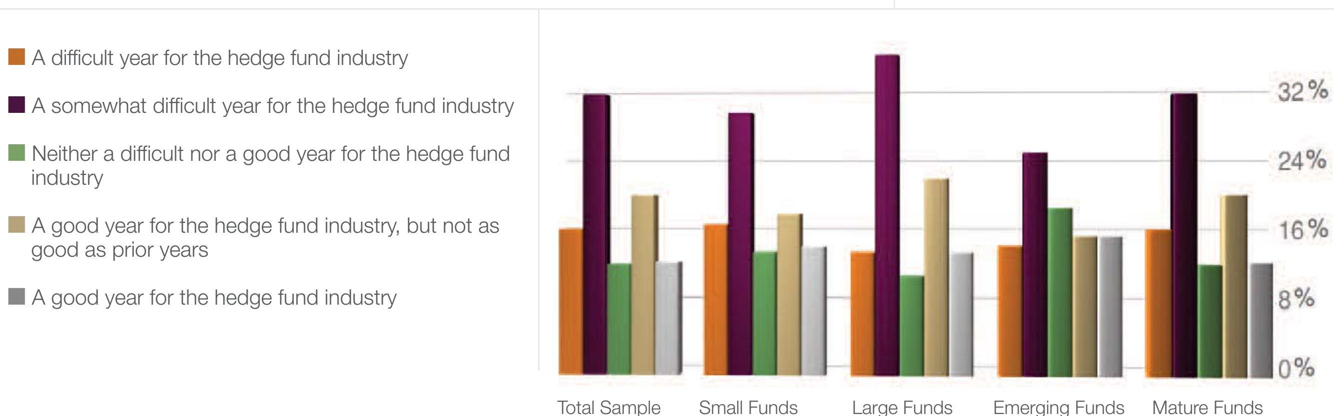
Industry and Market Outlook for 2012

Given all of the change in the industry, not to mention the challenges hedge funds have faced post 2008, we asked managers to try to quantify their industry outlook for 2012 (Exhibit 9). While the results are a mixed bag, the industry doesn't seem to believe that 2012 will be a walk in the park. Of those polled, 47.5 percent believe that 2012 will be either a difficult or somewhat difficult year for the hedge fund industry. In comparison, in the 2011 survey, only 32.3 percent of the survey respondents believed that 2011 would be a difficult year for the hedge fund industry. Certainly, market and performance woes seem to be taking a toll. "A lot of larger funds will fail to meet the performance expectation of their investors, which may dampen overall investor interest in hedge funds as a significant set of strategies," predicted one survey respondent. "Many funds had negative returns in 2011 despite a flat stock market. The pressure is really on in 2012!" echoed another manager.

"The very nature of a hedge fund manager is to face adversity head-on and overcome a changing landscape," stated one respondent. Echoing the sentiment that the industry needs to pull itself up by its own bootstraps...

Many of the managers polled, however, seem cautiously optimistic about the state of things to come. "The very nature of a hedge fund manager is to face adversity head-on and overcome a changing landscape," stated one respondent. Echoing the sentiment that the industry needs to pull itself up by its own bootstraps was another respondent who said, "From an allocator perspective, [I] get a sense there is a lot of dry powder on the sidelines. Given global macro concerns, managers really need to give allocators a reason to allocate."

Exhibit 9
Hedge Fund Industry Outlook for 2012



"It is not surprising to hear that hedge funds are slightly more pessimistic than in recent years, given difficulties with the markets, fee pressure, capital allocations and increased regulatory demands," said Howard Altman, co-CEO of Rothstein Kass.

"Our sense is that the tidal wave of pressure that has been negatively impacting managers will begin to ease in 2012. While the regulatory burdens are real, they are now also concrete, so managers can begin to address them and move on to the other facets of their business. In addition, if the economic picture continues to improve, more money will move off the sidelines, which will be positive for existing funds and startups alike. We believe that 2012 is the beginning of a more virtuous cycle for the hedge fund industry."

Perhaps counter-intuitively, funds with more than $1 billion under management or with more than five years in operation are more pessimistic about 2012. Both large funds (43.9 percent) and mature funds (50.3 percent) expect 2012 to be difficult or somewhat difficult. Emerging and small funds have the best outlook for 2012, with 15.5 percent of emerging fund managers and 14.3 percent of small managers stating it will be a good year for the hedge fund industry. However, many in those categories remain concerned about raising capital. One survey respondent said: "Assets will return and be added. The question is whether the smaller funds will ever begin to see capital from the pension funds, large endowments and the big institutional investors."

Despite general pessimism about 2012, many of the survey respondents are united in thinking some things will improve (Exhibit 10). For example, 52 percent of those polled believe that the pace of fund launches will continue to increase over 2011 levels. To put that into context, HFR reported that there were 1,113 fund launches in 2011, the most since 2005, while 775 funds liquidated during the same period.

Sixty percent of our respondents feel that the pace of investor redemptions will slow in 2012, while another 58 percent believe that hedge funds will be the beneficiaries of an inflow of talent from other segments of the financial services industry.

One overwhelming point of agreement is on the issue of fund seeding: 79 percent of the survey respondents believe that hedge funds launched in 2012 will be more dependent on seed capital than in prior years. Those polled generally agree that institutional investors will become more active in seeding in 2012.

One area of concern, and a topic on which respondents are clearly split, is the prospects for hedge fund closures. Forty-five percent of those polled believe there will be more hedge fund closures in 2012, compared with 41 percent who believe fewer funds will be closing their doors.

Exhibit 10
Hedge Fund Industry Outlook for 2012

	Uncertain	Strongly Disagree	Disagree	Agree	Strongly Agree
Hedge funds will benefit from an inflow of talent from other segments of the financial services industry in the next 18 months.	**21%**	**3%**	**18%**	**52%**	**6%**
According to some sources, there were more hedge fund launches in 2011 than since 2007. In 2012 the pace of launches will increase.	**13%**	**3%**	**33%**	**48%**	**4%**
There will be fewer hedge fund closures in 2012 than in 2011.	**14%**	**6%**	**39%**	**38%**	**3%**
The pace of investor redemptions will slow in 2012.	**14%**	**2%**	**24%**	**56%**	**4%**
Hedge funds that launch in 2012 will be more dependent on seed capital than in prior years.	**13%**	**0%**	**8%**	**58%**	**21%**
Pension plans, endowments and foundations will increasingly provide seed capital.	**24%**	**3%**	**29%**	**39%**	**4%**
U.S.-based hedge funds will increasingly launch UCITS-compliant hedge funds to access European investors.	**35%**	**5%**	**16%**	**37%**	**7%**
Consolidation in the asset management space will intensify in 2012.	**16%**	**1%**	**14%**	**59%**	**10%**

> "There is certainly a growing dichotomy in the hedge fund industry between large and small funds," according to Chris Mears, principal-in-charge of Rothstein Kass' New York Metro Financial Services Group.
>
> "Large funds, while comprising a relatively small number of the funds within the industry, have become the dominant force within it. Large funds will certainly be a driver in the consolidation movement, as they look to expand capacity as well as the strategies within their firms. They will also be the leaders in developing technological solutions to the regulatory issues facing all funds. In many ways, their burdens are the greatest, and certainly they engender more scrutiny, so it will be up to the large-fund community to set the stage in 2012."

One of the survey respondents hypothesized a fairly Machiavellian reason for hedge fund closures, rife with political and conspiracy-theory intrigue. However, other respondents were more sanguine, believing that consolidation would drive a number of individual firm and fund closures.

Indeed, consolidation is a key theme in this year's survey. "Many hedge funds remain below their high-water marks, and closures and consolidation will continue," wrote one respondent. Many of the comments pointed to cost and marketing difficulties that could drive consolidation, especially for those managers with below $1 billion under management. Overwhelmingly, marketing and asset raising, as well as regulatory and compliance costs, were the two reasons most often cited for future consolidation in the hedge fund industry (Exhibit 11). Increasing the range of product offerings was a distant third reason.

In some ways, the biggest concerns for funds in the coming year mirror the drivers for consolidation. Certainly, asset raising and marketing are far and away the top issues for funds in 2012, with 53.1 percent of respondents stating those are their biggest concerns (Exhibit 12). There is, however, a definite split between large and small managers on this issue. For the small firms in our survey, marketing and asset raising are of enormous concern, being cited by more than 60 percent of the small-firm respondents. More than one firm in our survey expressed extreme frustration with the allocation biases toward funds with more assets under management, while others wondered when, if ever, this trend would end.

For larger firms, marketing and asset raising are less of a concern, with only 33 percent of those polled listing these as their biggest issues in 2012. Still, asset raising and marketing are the top concerns for large firms, followed closely by performance, which is ranked by 30 percent of the respondents in that category.

Exhibit 11
Catalysts for Consolidation

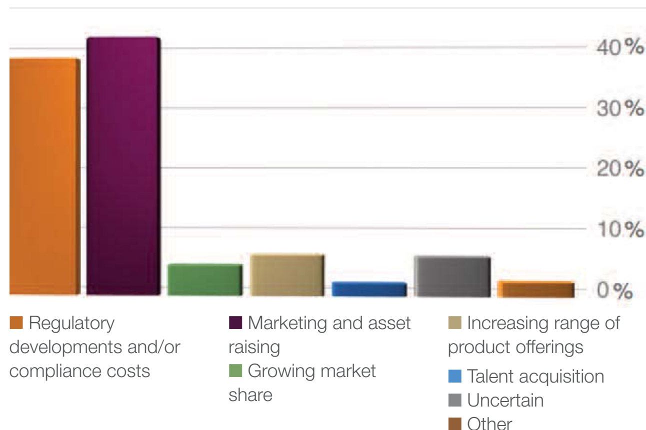
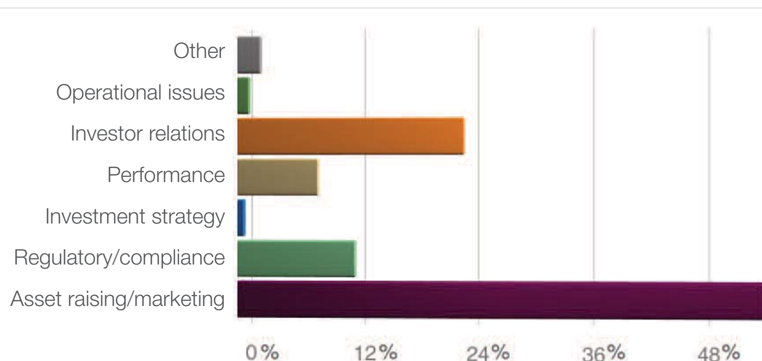


Exhibit 12
Single Biggest Concern in 2012



Performance is also a key concern for many managers, which is perhaps not surprising given relative industry performance post-crisis, as well as lingering market uncertainty. However, 61.7 percent of those polled do not believe that the United States is in danger of entering a double-dip recession in the next 18 months. "Ex-housing and government, which are both in contraction, the economy is growing at over 4 percent," stated one respondent. "The chances of a double-dip with zero interest rates are less than 10 percent and only that high because of the potential of an oil shock if Iran does something stupid. Those who think China is collapsing and will take down developed markets are misinformed at best." Another respondent put it even more bluntly, writing "Fearmongers state this [that the United States will enter a double-dip] and don't necessarily believe it, as well as people in a permanent paranoid state ... " Of course, Europe was mentioned consistently in our respondents' comments as a lingering potential spoiler, but overall, the outlook on the market was fairly positive.

Despite this optimism, the majority of the survey respondents (51.9 percent) indicated they believe that the hedge fund industry will use less leverage in 2012. When asked why hedge funds would employ less leverage, most stated that it was due to risk aversion and/or market uncertainty (Exhibit 13). So beneath their market confidence, hedge funds look to remain cautious.

"What the financial crisis proved is that leverage in the hedge fund industry as a whole was not the cause of any systemic risk," said Altman. "Our 2012 survey results further indicate that leverage remains low in the industry."

In fact, managers are so cautious in their 2012 outlook that nearly one-third plan to use no leverage at all this year (Exhibit 14). Another 52.3 percent of the firms polled stated that while they intend to use leverage, they plan to employ less than 2-to-1. Given that many people continue to assume hedge funds are always highly leveraged, the fact that nearly 85 percent of the firms polled plan to use less than 2-to-1 leverage is probably surprising.

"Unrelated business taxable income, or UBTI, can be of concern to tax-exempt investors in hedge funds," according to Joseph Pacello, a tax principal at Rothstein Kass.

"A reduction of leverage within the hedge fund community at large bodes well for endowments, foundations and pensions that may have wanted to invest in the past but were put off by the specter of UBTI. It may also mean that capital that was difficult to allocate offshore for certain tax-exempt entities can now stay within domestic limited partnership vehicles."

Exhibit 13
Why Hedge Funds Will Use Less Leverage in 2012

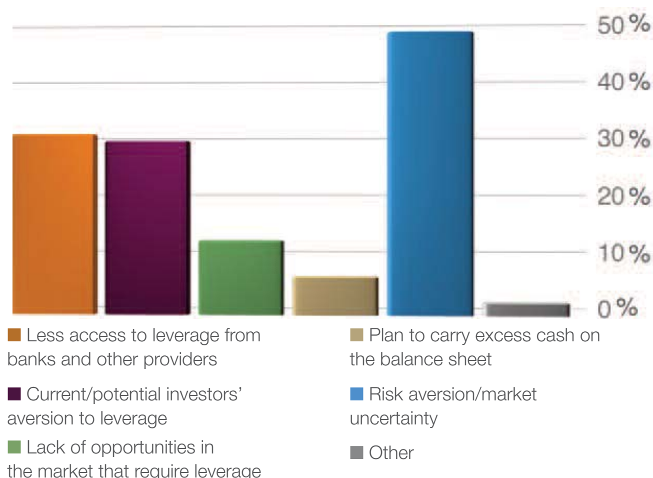
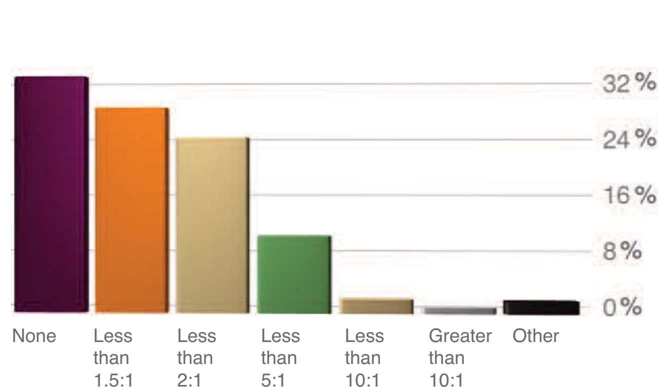


Exhibit 14
Use of Leverage in 2012



> “We have seen a proliferation of seeders and early-stage allocators within the last 12 to 18 months,” said Meredith Jones, director at Rothstein Kass.
>
> “Given the current environment, and the research that has consistently shown that smaller and emerging funds can and do outperform larger and mature funds, we expect that this trend will continue. The economics, both for managers that are increasingly dependent on seed capital at launch and for investors who need to seek out every drop of alpha, make too much sense for this trend to diminish. In fact, we expect the industry to find more ways to get institutional capital to emerging funds, perhaps through separate account platforms or through dedicated funds of hedge funds vehicles.”

Capital-Raising Environment

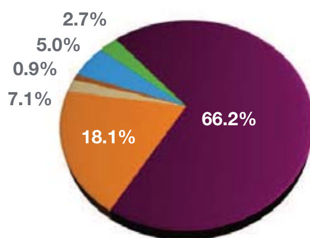
Amid the backdrop of a cautiously optimistic market environment and a more measured industry outlook, most funds plan to raise assets in 2012 (Exhibit 15). In fact, 66.2 percent of those funds polled indicated they plan to increase assets by 25 percent or more in 2012, while another 18.1 percent stated they plan to raise up to 25 percent in new assets. Only 0.9 percent of the respondents foresee capital decreases in 2012. Several of those polled added that they had recently hired marketers or increased their budgets, while one firm stated that they “… hope to get back on track. We increased AUM from late January 2009 to May 2011 by more than $350 million. Late 2011 was not a good time to raise assets.”

Certainly that was the experience for the majority of managers in late 2011. According to HFR data, less than $7 billion in net new capital was added to hedge fund industry assets in the fourth quarter of 2011, and all of that went to managers with $5 billion or more under management. The rest of the industry saw net outflows of capital, according to HFR. That explains a lot of the frustration expressed in survey comments by respondents. One established fund manager said, “As a fund that has been around for a long time with AUM under $400 million, it will be tough to get back over the $500 million level.” An emerging manager added, “Investors are hesitant to deploy capital into an emerging hedge fund.”

So clearly there are frustrations on both sides of the asset-raising fence. However, as one might expect, emerging and smaller managers have higher goals for capital raising in 2012. Roughly 77 percent of the respondents with $100 million or less under management plan to raise 25 percent or more in assets in 2012, while 79 percent of those with a less-than-three-year track record plan the same. In comparison, only 46 percent of the large managers in our survey have plans to raise more than 25 percent in new assets, and 57 percent of managers with more than a five-year track record shared that goal.

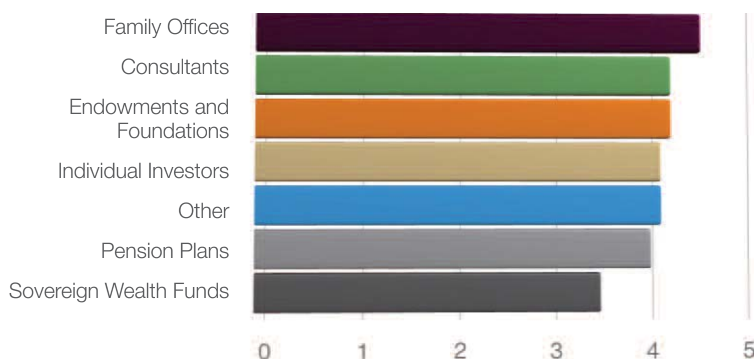
Where these capital inflows will come from seems to be a source of debate within our sampled funds. Family offices ranked first as an important source of assets, but the race was fairly tight across all investor types. Endowments and foundations and consultants ranked second, narrowly edging high-net-worth investors and “other,” which often included funds of hedge funds and also included separate account platforms and RIAs. Pension plans and sovereign wealth funds took the last spots on the list.

Exhibit 15
Capital-Raising Expectations in 2012



> “Family offices have always been an important source of capital for the hedge fund industry,” according to Rick Flynn, principal and head of Rothstein Kass’ Family Office Group.
>
> “Back in the mid-to-late ’90s, family offices were some of the earliest movers into the hedge fund space. The fact that they remain a force in the industry, particularly in the startup and emerging stages of a manager’s evolution, is not a shock. Many of the families with whom we work not only have maintained their interest in hedge funds, but have increased their efforts to include seeding and outside investment advisory services.”

Exhibit 16
Important Sources of Capital



(Note: Weighted averages ranked on a scale of 1 to 5.)

As one might expect, depending on the size and type of organization, the entities listed as important sources of capital varied (Exhibit 16). For example, small funds listed individual investors and family offices as their most important sources of capital, while large funds named consultants and pension plans. Interestingly, both the women- and minority-owned categories named consultants as their most important source of capital, likely due to a recent increase in RFP searches and consulting mandates for these groups in recent years.

We also asked survey participants to tell us what they thought about specific capital-raising issues (Exhibit 17). In general, we saw a few areas of strong agreement. For example, more than 90 percent of those polled believed that competition for assets would increase, which makes sense in light of the asset-raising plans previously detailed. It was also widely acknowledged that institutional investors would shy away from illiquid investments, with 81 percent either agreeing or strongly agreeing with that statement.

On the flip side, most respondents disagreed with the statement that more hedge funds would be closing to new investment during the next 18 months. Managers were fairly split on whether the industry would reduce risk to attract capital, and whether traditional investments in the form of ETFs and mutual funds would become marketing competition.

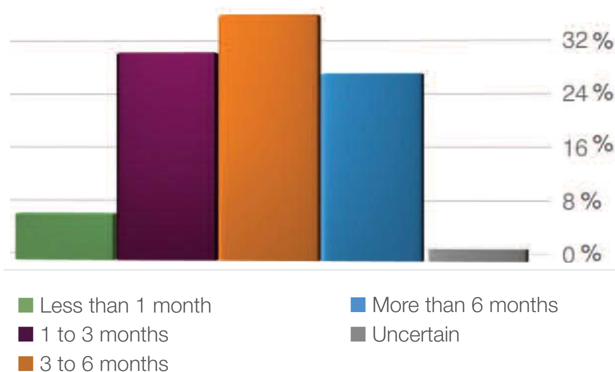
Exhibit 17
What do survey respondents think?

	Strongly Agree or Agree
Competition for assets will increase in 2012.	**90%**
In the next 18 months, more hedge funds will close to new capital than in 2011.	**29%**
Institutional investors will prefer to allocate assets to larger hedge funds ($1 billion AUM or more) in 2012.	**73%**
Institutional investors will be more averse to high concentrations of illiquid portfolio assets in 2012.	**81%**
Hedge funds will commonly reduce portfolio risk to attract capital from institutional sources in 2012.	**56%**
Hedge funds will increasingly offer special terms to pension plans and sovereign wealth funds in 2012.	**72%**
Hedge funds will face increased competition from mutual funds/ETFs purporting to offer alternative investment strategies and returns in 2012.	**55%**
Hedge fund companies will more frequently introduce mutual fund products to access retail markets in 2012.	**49%**

"As a fund that has been around for a long time with AUM under $400 million, it will be tough to get back over the $500 million level." An emerging manager added, "Investors are hesitant to deploy capital into an emerging hedge fund."

An interesting consideration for hedge funds in 2012 is the length of time it will take investors to complete due diligence. After all, the due diligence process must occur before an investment can be made. According to the firms we polled, it could take a while to raise the assets desired above. Of our survey respondents, 26.7 percent believe that investor due diligence will take more than six months to complete in 2012, while another 35.1 percent believe the process will last between three and six months (Exhibit 18). Large funds are more likely to believe investor due diligence will be drawn out, with 24.3 percent stating it will take six months or longer. Small funds and mature funds are more likely to believe the process will be shorter, with only 19.4 percent believing the process will be that lengthy.

Exhibit 18
How Long Will Investor Due Diligence Take in 2012?

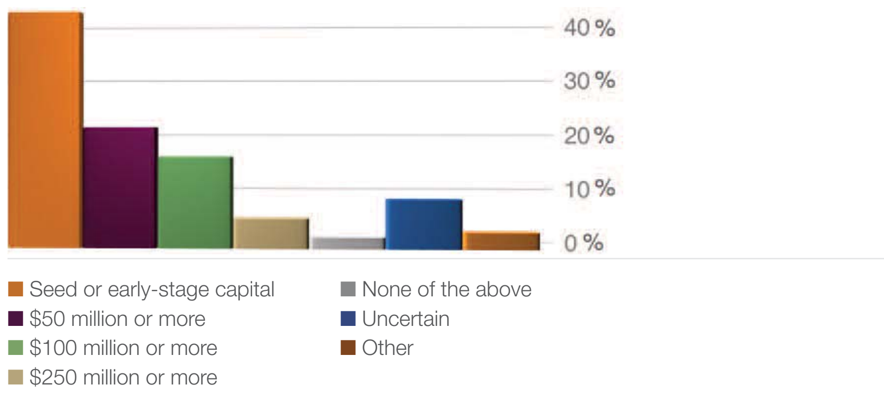


- Less than 1 month
- 1 to 3 months
- 3 to 6 months
- More than 6 months
- Uncertain

In order to attract assets, managers do seem willing to make some concessions. For example, 42.9 percent of managers polled would lower fees for seed or early-stage capital, while only 2.1 percent stated that none of the amounts listed below would be tempting for a fee reduction (Exhibit 19). Further, 52.4 percent of the survey respondents indicated they would consider creating a separate account/fund of one in exchange for as little as a $50 million commitment (Exhibit 20). Only 3.3 percent stated that the promise of as much as $250 million would not tempt them to create an investor-specific vehicle.

Exhibit 19

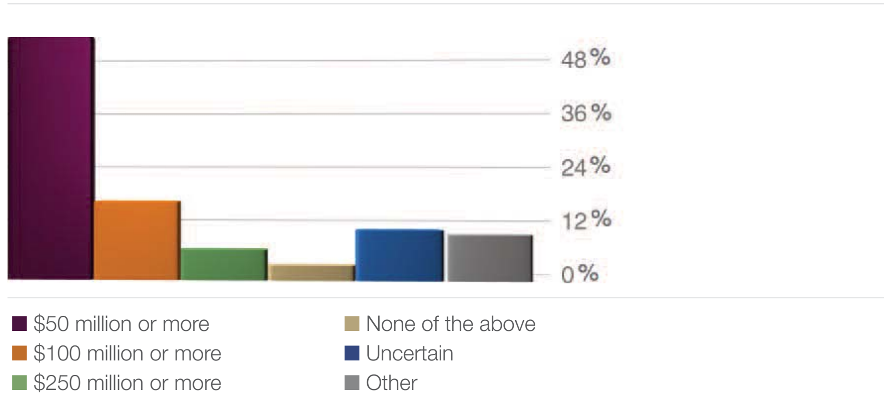
At What Level of Commitment Would You Consider Lowering Fees?



- Seed or early-stage capital
- $50 million or more
- $100 million or more
- $250 million or more
- None of the above
- Uncertain
- Other

Exhibit 20

Level of Commitment to Consider Separate Account



- $50 million or more
- $100 million or more
- $250 million or more
- None of the above
- Uncertain
- Other

"While it is very tempting to provide concessions to investors promising large investments, managers should always weigh the positives and the potential negatives," said Altman.

"In some cases the allocation will pay off in achieving critical mass and attracting additional investors, but the decision must still be weighed. How much, if any, will a fee reduction impact a manager's ability to make key hires? How will a separate account work in practice within the firm as far as allocating trades and impacting the performance of commingled products? Will future investors require a 'Most Favored Nation' clause? These questions should be answered to avoid unpleasant surprises down the road."

“Over the past few years, we have seen increasing operational development on the part of hedge fund managers,” said Vince Calcagno, principal-in-charge of Rothstein Kass’ Beverly Hills office.

“Even with our startup clients, we see more focus on operational considerations. We believe that this is part of the maturation of the hedge fund industry. It remains to be seen how well the industry can balance its forced regulatory maturation with continued innovation, and transparency with increased competition for investors' assets. People forget that 40 years ago mutual funds were the shadow investment vehicle on the street with less than 400 funds in operation and the industry AUM at roughly $50 billion. We all know how that story turned out.”

Fees, Operations and Compliance

We also looked further into each firm at emerging trends in fees, operations and compliance (Exhibit 21). Most of those polled believe that investor relations and technology will play a bigger role within hedge fund firms in 2012. Sixty-five percent of those polled believe that hedge funds will consider lower fees in exchange for longer fund lockups, while 62 percent believe that outsourcing noninvestment functions will grow in importance. In what is probably good news for investors, only 19 percent of the funds polled believe hedge funds will increasingly charge fees on redemptions in 2012, and 30 percent think investor-level gates will become more common.

Also on the operations front, chief compliance officers are now common fixtures at the hedge funds in our poll (Exhibit 22). Seventy-three percent of respondents indicated that there is a CCO at their firm. Chief financial officers are slightly less common, with 57.4 percent of those polled indicating that their organization employs a CFO (Exhibit 23). In contrast, only 21 percent of firms indicated they employ a chief technology officer (Exhibit 24). Not surprisingly, large firms are more likely to have all three positions.

Exhibit 21
What do survey respondents think?

	Agree or Strongly Agree
There will be a greater focus on technology at hedge funds in 2012.	**61%**
Hedge funds will increasingly consider lower fees in exchange for longer lockup periods.	**65%**
Hedge funds will more commonly charge fees on redemptions in 2012.	**19%**
Hedge funds will increasingly establish investor-level gates instead of fund-level gates.	**30%**
Hedge funds will increasingly outsource noninvestment functions in 2012.	**62%**
Investor relations will be more important to hedge fund success in 2012.	**76%**
Hedge funds will more frequently retain outside marketing/public relations consultants.	**47%**

Of firms with more than $1 billion under management, 82.5% reported they had a CFO, 93.5% employ a COO and another 42.6% have a resident CTO. Based on our experience, we do suspect these numbers may be higher than reported in the survey results, perhaps due to shared titles (COO/CFO, COO/CTO) within a firm. On the hiring front, approximately 3.3 percent of firms indicated they planned to hire a CFO or CCO in 2012, while 1.2 percent indicated they would employ a CTO before year-end. None of these hires were targeted within the large-fund category.

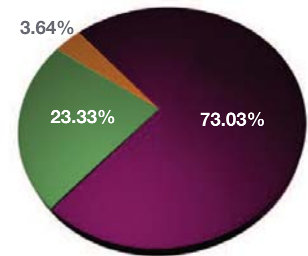
Looking ahead to the U.S. regulatory agenda, it seems clear that there will be a significant impact on hedge funds in 2012. Seventy percent of those polled indicated they believe that hedge funds will more frequently hire former regulatory officials to assist in compliance requirements (Exhibit 25). Another 43 percent believe that hedge funds will more frequently turn to a family office structure rather than register with the SEC. Forty-five percent believe that the SEC will increase qualified investor thresholds, making asset gathering potentially more difficult. Looking back at the results of our survey, a change in investor qualifications would most impact smaller hedge funds, which depend on high-net-worth individuals for a larger part of their asset-raising activities.

One of the recurring themes post 2008 is that hedge funds will increasingly relocate to find more favorable regulatory and tax regimes. While this sounds attractive in theory, we believe the practice will be fairly limited. Indeed, our survey respondents were uncertain about this phenomenon as well, with nearly half of those polled believing relocation remains a possibility.

Exhibit 25
What do survey respondents think?

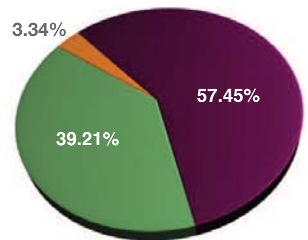
	Agree or Strongly Agree
Hedge funds will more frequently hire former regulatory officials to assist in understanding and managing compliance requirements and processes.	70%
An SEC increase in qualified investor thresholds will make it more difficult to raise capital from high-net-worth individuals.	45%
Hedge funds will more frequently relocate to countries with more favorable regulatory regimes/tax liabilities.	48%
Funding and staffing challenges will compel regulatory agencies to increase the technological focus of enforcement efforts.	70%
Hedge funds will more frequently convert to family office operations rather than register as investment advisors with the SEC under the provisions of Dodd-Frank.	43%

Exhibit 22
Does Your Organization Employ a CCO?



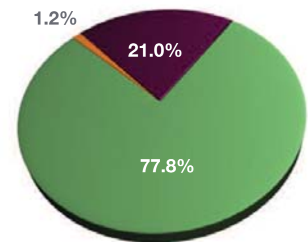
- Yes
- No
- We plan to make this hire in 2012.

Exhibit 23
Does Your Organization Employ a CFO?



- Yes
- No
- We plan to make this hire in 2012.

Exhibit 24
Does Your Organization Employ a CTO?



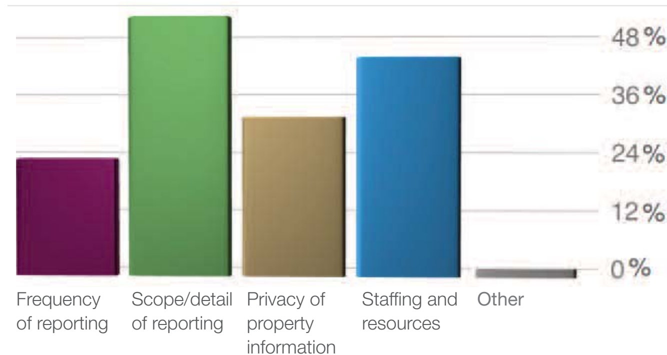
- Yes
- No
- We plan to make this hire in 2012.

The Impact of Dodd-Frank: Form PF

Finally, across all sizes and ages of managers polled, the scope and detail of reporting for Dodd-Frank is weighing heavily on managers (Exhibit 26). Of those polled, 51.5 percent think that reporting set to be implemented in the next 18 months, most notably Form PF, is a significant concern. One respondent pointed to reporting as a significant driver for increased IT within the hedge fund industry, saying "From an operational perspective, hedge funds need to think of themselves as an IT company. [The] scope and detail of reporting requires access to data in scalable manner." Staffing is also a concern for small, emerging and mature managers, while it ties with privacy issues at large funds as a significant concern.

"The issues surrounding regulatory changes that are slated to go into effect this year are overwhelming for many funds," said Gary S. Kaminsky, principal in Rothstein Kass' Regulatory Enterprise Risk Group. "Certainly, the cost of additional personnel, IT solutions and other third-party resources necessary to comply present formidable challenges for managers. This will require a renewed commitment to regulatory infrastructure and institutional enterprise risk management if an alternative investment company is to succeed."

Exhibit 26
Significant Concerns About Legislative Guidelines



Conclusion

Certainly, 2012 is set to be yet another year of change for the hedge fund industry. It will be interesting to see where the industry emerges in 2013 as we see the impact of consolidation and regulation. Over the next 12 months, hedge funds will not only have to implement new processes and expend more effort for marketing, but they must assess the cost of these efforts and whether it makes sense to remain independent or seek consolidation. We look for the hedge fund landscape to continue its evolution and we will follow these trends carefully in 2012.

"Form PF is clearly the biggest regulatory challenge our clients face in 2012," according to Jeff Kollin, principal and head of the Financial Services Advisory practice at Rothstein Kass Business Advisory Services LLC.

"The sheer volume of information that is required on Form PF can be staggering. What's more, the information is generally housed in disparate locations within a hedge fund's operations, making it time-consuming to gather. Some of our hedge fund clients have begun the process of implementing a comprehensive enterprise risk management solution, which we believe will be the only effective way to collect, parse and report the amount of data required by the form. The stakes with Form PF are simply too high to risk populating the document with the wrong data."

About the Author

Meredith Jones is a director at Rothstein Kass responsible for generating research and content on the alternative investment industry by and on behalf of the firm. She also provides business advisory services to the firm's clients. Meredith has more than 14 years of experience in the alternative investment industry, with extensive expertise in research, writing, consulting, marketing, business development, due diligence, index construction and asset allocation. Her research has been published in a number of books and journals and in the international press.

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