THE BUSINESS OF HEDGE FUNDS

Results of the Alpha Search Advisory Partners 2008 Manager Survey

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As 2008 drew to a close, we took a pulse on the hedge fund industry to discover how the past year impacted the business and to find out how the investment landscape is shaping up for 2009. Our survey was sent to roughly 1,000 hedge fund managers who invest globally, and the responses we received were many and varied. While 2008 presented the industry with unprecedented challenges, there are many unique opportunities to be captured and the mood going into 2009 is cautiously optimistic.

Over 75% of those surveyed felt that we were entering the greatest period of investment opportunity in our lifetime.

RESPONDENT PROFILE

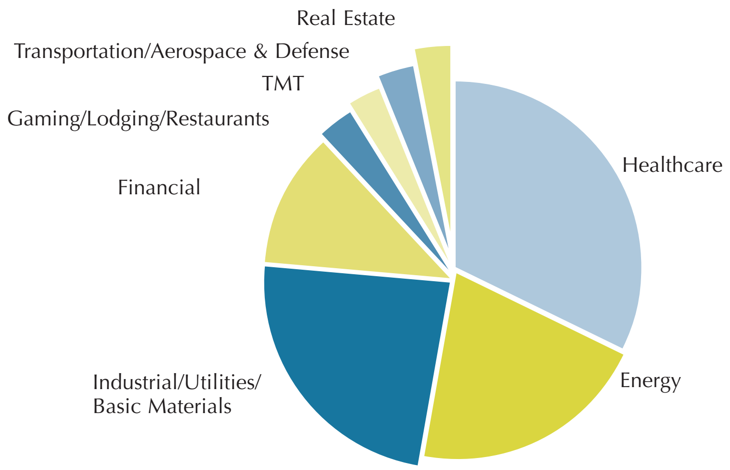
The majority of our survey respondents are founders or partners of firms that have been in business for more than six years. Interestingly, just over half of the firms represented had less than $1 billion in AUM and nearly a quarter had an AUM in excess of $8 billion, with the remainder spread equally in the mid range. Over 55% of firms indicated that they ran multi-strategy funds invested broadly across asset classes.

We also heard from a broad range of Portfolio Managers, Risk Managers, Marketers and others C-level executives who shared their unique insights and perspectives with us. The results speak for themselves –market dynamics have changed the playing field for those running a hedge fund business.

LOOKING AHEAD TO CONTINUED VOLATILITY AND TRICKY MARKETS

The respondent's views vary according to their investment strategy and role within their firm, but the majority feel that we are entering possibly the greatest period of investment opportunity in our lifetime, albeit one where regulation may reduce the opportunities for some of the highly lucrative complex investments that fuelled returns through the first half of the decade. Also, given the beating the overall stock market took in 2008, we asked what sectors were most strongly positioned for growth or a solid rebound in 2009. Healthcare, industrials and energy led the pack.

MANAGER PICKS: TOP SECTORS FOR GROWTH IN 2009



In a true bell curve, 40.5% predicted the Credit Suisse / Tremont HF Index would be between 8% and 14% by the end of 2009, with 35% believing the index would be below 7% and 19% believing it would be between 15-22%. A small number of true optimists (5.5%) forecast returns in excess of 22% by year end.

In terms of the impact to their particular portfolio construction, we'll let the data speak for itself:

2008 CORE INVESTMENT STRATEGIES

2009-2010 CAPITAL ALLOCATION GROWTH

In addition, due to the highly volatile conditions, market uncertainty and investor redemptions, we see that the percentage of illiquid investments in portfolios will continue to decline, as will leverage. Nearly 90% of respondents said that they held less than 25% of their holdings in illiquid securities, regardless of strategy. There has been a move toward cash with a third of respondents holding between 25-50% of their assets in cash… awaiting opportunities?... protecting against further redemptions?

INVESTMENT APPETITES AND OPPORTUNITIES

Concern remains among more than two-thirds of respondents that institutional investors perceive hedge funds as having missed the mark in terms of protecting them from market volatility and hostile markets. Fewer than 25% feel that institutional investors will be staying on the sidelines, while 27% felt that high net worth investors would be more reluctant to invest (or reinvest) over the next 12 months. Our respondents felt that the greatest source for raising capital in 2009 would be from the endowment category.

THE BUSINESS OF HEDGE FUNDS – DRAMATIC CHANGES FOR 2009

The second part of our survey focused on how the actual business of hedge fund management would change in terms of: investor acquisition, fee structures, liquidity provisions and organizational structures.

As expected, there are no simple answers as most hedge funds are caught between the need to provide investors greater transparency and flexibility and their own capital requirements to effectively manage their strategies. They must navigate a very tight passage.

Many respondents expect the current level of redemptions to abate as things begin to stabilize. However, respondents were split down the middle as to whether or not hedge funds would recapture the AUM and market share in the portfolios of investors that they had in previous years.

THE REGULATORY LANDSCAPE

Many of our respondents are concerned that lawmakers have a negative perception of the industry, which may create a difficult environment to operate in going forward.

There is a clear trend towards regulation, with compliance and risk management taking on ever greater importance. Over half the respondents believe that there will be mandatory disclosure of holdings and mandatory registration to a regulatory body. While most (69%) did not foresee a ban on short-selling going forward, 65% felt that if such a ban were to be imposed, their strategy would be negatively impacted.

Here's what they're saying:

Fees will need to be reduced to attract new investors, with most of the downward pressure on management fees and minimal downward pressure on performance fees. Also over 50% of respondents felt that if funds remain below their high water marks, they will shut down, with nearly 30% feeling that funds would restructure high water marks with investors and roughly 20% expecting little if any impact.

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There is concern that redemptions will continue through at least the first two quarters of 2009 (58%) and possibly throughout the year (29%) before fully stabilizing. Ten percent of respondents were more optimistic, feeling that redemptions are largely done and that re-investment is likely.

Regarding lock-ups and liquidity provision changes, there were no clear answers with solid teams on both sides of the "Will lock-ups be increased or decreased?" question. Only one-third of respondents indicated that they had enacted a gate provision in 2008.

The number of prime brokers used by firm's in 2008 remained the same for half of the respondents, while a third decreased the number.

CONSOLIDATION

Roughly half of our respondents are considering joint ventures or mergers with other asset management firms in 2009. Although we were not able to effectively gauge the conviction level to actually pursue such, the 'build or buy' question is certainly on the table at many firms.

Despite impending changes in the regulatory environment, over 80% felt that their current back office staff is adequate.

HUMAN CAPITAL CONSIDERATIONS

Managing staff through turbulent times is at best a challenge. Our survey covered staffing questions for both investment professionals and back office personnel. Despite impending changes in the regulatory environment, over 80% felt that their current back office staff was adequate, with the remainder indicating an intention to add staff. In terms of investment professionals, nearly 36% planned some staff reduction and/or a delay in hiring, with the majority considering delaying new hires until the second quarter, and 23% filling in with consultant or contract employees.

Compensation is another tricky area to manage, especially with downward pressure on fees, high water marks and a tough performance environment. Moving into 2009, over half of managers felt that their current compensation structure would remain intact. For those who plan to change compensation packages, one way is through deferred compensation, and here managers are split equally between those having programs in place and those without. When determining bonuses, more respondents plan to increase the weighting of overall fund performance over individual performance, possibly to create a greater sense of teamwork than that which currently exists at their funds. Respondents also indicated that bonuses would be increasingly discretionary versus formulaic.

WHO IS ALPHA SEARCH?

Alpha Search Advisory Partners (ASAP) is an executive search and management consulting firm specializing in sourcing and recruiting investment professionals for the alternative investment community. Our client base is comprised primarily of hedge funds and proprietary trading areas of investment banks and other financial institutions. For over 25 years, the firm has successfully performed capital markets searches; with a focus over the last eight years on recruiting for absolute return strategies.

BEYOND RECRUITING

Our services extend to contract consulting (per diem and project work), Joint Venture and M&A origination. Our database of 36,000 alternative investment professionals is global, comprehensively covering all strategies, sectors and asset classes.