Seventh Annual Survey
April 2013

Hedge Fund Outlook: **Water, Water, Everywhere**

The vast majority of hedge funds continue to thirst for assets, even as flows to the industry overall reach new heights.

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When we released our annual Hedge Fund Outlook survey report, "New World Order," in February 2009 — a short five months after the Lehman Brothers' demise — we found that over two-thirds of the hedge fund managers polled believed that building an effective asset raising engine would be critical to running a successful hedge fund business. As we reviewed the findings of our seventh annual Hedge Fund Outlook, "Water, Water, Everywhere," it's clear how prophetic those managers were.

The hedge fund industry has experienced increased asset flows in recent years, including 2012, with an ever-larger percentage of assets coming from the institutional investor community. In most cases, however, those institutional capital flows have pooled into funds with more than $1 billion of assets under management (AUM). In fact, less than 9 percent of asset flows in 4Q 2012 went to funds with under $1 billion AUM.[1] As a result of these wildly uneven allocations, many managers of smaller hedge funds with whom we speak feel much like the "Ancient Mariner,"[2] surrounded by water — in this case, assets — but lacking a drop to sustain their own funds.

The concentration of assets into large funds comes at a time when both the barriers to entry and the costs of doing business have increased for hedge funds across the AUM spectrum. Investors continue to demand more transparency, intensive due diligence, separately managed accounts, and robust operational infrastructure and controls. There is just no denying that successful asset raising is crucial for hedge funds to quickly build the economies of scale needed today.

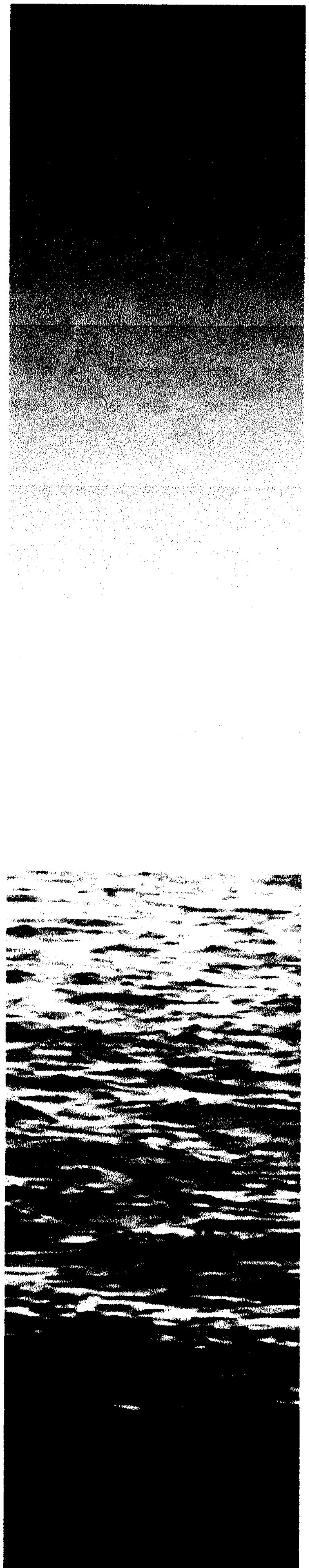
Based principally on the flow of assets, larger funds are remarkably upbeat about the prospects for a strong 2013. Funds with less than $1 billion, however, are markedly more subdued. Many of these smaller funds are thirsting for seed and acceleration capital in 2013 to provide a new wave of liquidity, substantially move the AUM dial, and create some much-needed breathing room. However, we do expect the demand for seed and acceleration capital infusions to outstrip supply, at least in the near term. It is also possible that the Jumpstart Our Business Startups (JOBS) Act, when implemented, could open alternative methods of raising capital, which may provide a much-needed asset surge. It will be interesting to see how managers use those and other tools to ramp up their fundraising efforts as the year progresses.

Of course, hedge funds must generate more consistent alpha. However, the volume of asset flows, and the manner in which they are distributed, will undoubtedly continue to impact industry trends in 2013 and beyond, including consolidation, launches, attrition and "retailization." In the meantime, we hope you will find the somewhat divergent outlooks and themes revealed in this year's research to be both interesting and thought provoking. The Rothstein Kass Institute is proud of its role as a thought leader in the alternative investments space and, as always, we invite you to contact us directly to discuss your thoughts and opinions on issues concerning our industry.

Sincerely,

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

[1]Sources: 2013 Credit Suisse *Global Survey of Hedge Fund Investor Appetite and Activity* and Hedge Fund Research data
[2]This refers to the famous poem "The Rime of the Ancient Mariner" by Samuel Coleridge, in which a sailor relates the tale of his long and arduous sea voyage.



Key Findings

- Roughly 61 percent of those surveyed disagree or strongly disagree that the United States will enter a recession in 2013, compared with almost 22 percent who agree or strongly agree that it will.
- Long/short equity is predicted to be the best-performing strategy in 2013, followed by special situations, emerging markets and macro strategies.
- Approximately 34 percent of those polled are targeting returns of 15 percent or higher in 2013.
- More than 30 percent of those polled plan to seek either seed or acceleration capital in 2013.
- More than half of the respondents believe hedge fund returns will be much better or somewhat better in 2013 than they were in 2012.
- Approximately 50 percent of the managers polled report they will employ the same levels of leverage in 2013 as they did in 2012.
- More than a third of survey respondents plan to use no leverage in 2013.
- Two-thirds of those polled believe hedge funds will continue to consolidate in 2013.
  - Marketing and asset-raising challenges were cited as the number one potential catalyst for consolidation.
  - Regulatory and compliance costs were ranked second.
- Over 75 percent of the survey respondents anticipate that institutional investors will continue to allocate to larger managers in 2013.
- More than 60 percent of those polled indicate their capital-raising cycle, from introduction to allocation, takes six months or longer.
- About 40 percent of those polled say they have no dedicated marketing or capital-raising staff.
- The scope and detail of SEC-required reporting was listed as burdensome by more than two-thirds of the survey respondents.