2010 Hedge Fund Outlook: Back to the Future?

The hedge fund industry anticipates ongoing challenges as it continues its remarkable recovery from a period of unprecedented uncertainty. For many hedge funds, the crisis reinforced the importance of maintaining institutional-quality practices while responding to a new era of transparency.

June 2010

Rothstein Kass

June 2010

Rothstein Kass

Valuing the privacy that affords protection of proprietary strategies, hedge fund managers have often been content to let performance speak for itself, as the industry indices delivered decades of superior risk-adjusted returns. Prior to the recent global market upheaval, this formula proved successful, paving the way for dramatic expansion and a steadily increasing flow of institutional assets to hedge fund products. The findings of “2010 Hedge Fund Outlook: Back to the Future?” our latest annual survey report on hedge fund sector trends, suggest an industry in transition. Much like Wall Street and governments around the globe, the industry is working diligently to restore trust shaken by unprecedented market volatility.

Whether the general public realizes it or not, “Main Street” is now an indirect investor in hedge funds and other alternative investment vehicles through corporate and government defined benefit and pension plans. In a relatively short period, an industry that had been comfortable with its reputation for privacy and confidentiality has been compelled to reassess how it communicates not only with its investors, but with legislators and regulators as well.

The industry’s enhanced institutional focus has led to widespread implementation of institutional-quality policies, practices and procedures at many hedge funds. However, a lack of clarity regarding the role of hedge funds helped to perpetuate negative and unfounded misconceptions before, during and after the crisis. At the height of the crisis, this lack of clarity made it convenient to direct blame at an industry that has often been characterized as secretive.

As we write to you today, many have acknowledged that much of the ire aimed at the alternative investment industry was misdirected, as academic analysis proved that private pools of capital did not give rise to “systemic risk.” This has only slightly diminished the fervor for reform. Recognizing the market demand for greater transparency, hedge fund industry advocates have been actively involved in educating legislators in order to promote fair and equitable regulatory reform. Stronger industry advocacy and educational initiatives have emerged to promote informed discourse.

Our latest survey draws on the experience and insight of Rothstein Kass, its diverse clientele and other industry experts to provide context for the statistical results. We are excited to share the findings with our clients and friends and encourage you to contact us. We hope you enjoy reading “2010 Hedge Fund Outlook: Back to the Future?” and appreciate your continued support of our firm.

Sincerely,

Howard Altman
Co-CEO and Co-Managing Principal
Rothstein Kass

Key Themes

- Most hedge fund investment management firms expect the difficult environment to continue, resulting in increased competition for new investors and a greater reliance on seed capital for emerging managers.

- Many hedge fund professionals feel that 2010 will bring some relative stability as the redemption rate and fund closings begin to decline. Most also expect more launches of new products.

- Despite a pervasively tempered view of the industry, two-thirds of hedge fund firms expect to raise new capital during 2010, which may signal the return of a more ambitious and growth-oriented mindset.

- Institutional investors, high-net-worth individuals and family offices are seen as the most promising sources of new investment capital for hedge funds.

- Though most anticipate a certain degree of change, hedge fund executives remain divided on exactly how fee structures and lock-up periods will be altered in the coming year.

- Closer scrutiny from regulators is expected as the industry attempts to deliver the transparency demanded by high-end investors.

Demographics

This marks the fourth consecutive year that Rothstein Kass has conducted research with the hedge fund community about their plans and expectations for the coming year. Given the relative unrest in the broader financial services industry and the specific challenges experienced by established and emerging hedge fund firms, it's no surprise that the outlook for 2010 echoes the concerns of 2009 rather than the unbridled optimism of years past and reflects a more conservative approach for the future.

Our survey explored a range of relevant topics for hedge fund professionals, including efforts to raise new capital, the changing operational and regulatory environment, and the resulting impact on personal philanthropy. It's worth noting that in nearly all cases, firms with more than US$500 million and firms with less than US$500 million expressed similar views, indicating that the gap in perspectives between smaller and larger firms that was more apparent in past years is beginning to close as market conditions have stabilized.

About the Research

In the first and second quarters of 2010 we conducted a survey of 381 hedge fund firms. The respondents were senior professionals including portfolio managers, directors of research, chief operating officers, chief financial officers and other executives of the fund management company.

The firms in the study represented a cross section of size and experience levels. Three-quarters of firms had total assets under management below US$500 million, and the remaining one-quarter had more than US$500 million in assets (Exhibit 1). More than 80% of firms had been in business more than a year, and 60% of firms had been in business for more than three years (Exhibit 2). Less than 20% had less than one year of experience, and about 30% had more than five years in operation.

Exhibit 1: AUM (millions)

$500M +	23.4%
< $500M	76.6%

Exhibit 2: Years in operation

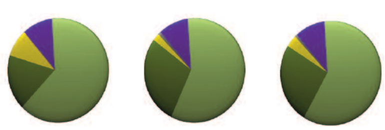
	$500M+	<$500M	Weighted Average
<1 year	6.7%	22.6%	18.9%
1-3 years	27.0%	18.5%	20.5%
3-5 years	31.5%	31.5%	31.5%
5+ years	34.8%	27.4%	29.1%

Industry Outlook

There is general agreement among respondents that difficult conditions will persist through the end of the year. Approximately 70% of firms indicated that they anticipate a trying year, while the remaining 30% have a more hopeful and optimistic outlook (Exhibit 3).

"Many of the hedge fund community's most pressing issues, including redemptions, liquidity concerns and fund closures, have subsided, allowing the industry to refocus greater energy on its core investment functions and put a greater emphasis on investor relations and raising capital," said Howard Altman, Co-CEO and Co-Managing Principal of Rothstein Kass. "Nevertheless, hedge funds are acutely aware that there are still short-term challenges to a sustained recovery. The scope and focus of regulatory action remains in question, as hedge funds and their service providers work to restore investor confidence by providing the enhanced transparency the market demands."

Exhibit 3: 2010 will be a difficult year for hedge funds



	$500M+	<$500M	Weighted Average
Strongly agree	10.1%	9.9%	10.0%
Agree	62.9%	57.9%	59.1%
Disagree	18.0%	28.8%	26.2%
Strongly disagree	9.0%	2.4%	3.9%
No opinion	0.0%	1.0%	0.8%

The introduction of new funds was all but dormant in 2009, so it's not surprising that more than 80% of firms expect there will be more new offerings in 2010 (Exhibit 4) and 75% of them expect the average launches to be smaller than they were before the credit and economic crisis began in earnest in late 2008 (Exhibit 5).

"One clear indication that the hedge fund community has rebounded is the active market for new fund launches. Many managers sense opportunity to invest in undervalued assets to deliver the superior returns on which the sector has built its reputation. Both start-ups and existing fund complexes are introducing an array of new products across a wide range of strategies to capitalize on these opportunities," said Vincent Calcagno, Principal-in-Charge of Rothstein Kass' Southern California offices.

Exhibit 4: There will be more hedge fund launches in 2010 than in 2009

	$500M+	<$500M	Weighted Average
Strongly agree	12.4%	14.4%	13.9%
Agree	68.5%	68.2%	68.2%
Disagree	13.5%	13.4%	13.4%
Strongly disagree	3.4%	3.4%	3.4%
No opinion	2.2%	0.6%	1.1%

Exhibit 5: Hedge fund launches in 2010 will be smaller (AUM) than before the credit crisis

	$500M+	<$500M	Weighted Average
Strongly agree	67.4%	31.2%	39.6%
Agree	10.1%	40.1%	33.1%
Disagree	19.1%	21.9%	21.3%
Strongly disagree	3.4%	6.1%	5.5%
No opinion	0.0%	0.7%	0.5%

A similarly large percentage of hedge fund launches, about 80%, anticipate having to rely more heavily on seed capital as a way to achieve profitable operations than gathering assets from institutional or high-net-worth investors (Exhibit 6).

"While the number of hedge fund launches is on the rise, new funds are launching with less capital than in years past. Start-up funds are often compelled to launch with primarily personal capital and capital derived from family and friends while they work to establish the track record and controls that will enable them to expand their investor base. At the same time, fierce competition for investment allocations has compelled many funds to be more reliant on seed capital investment for asset gathering efforts," said Chris Mears, Principal-in-Charge of the Rothstein Kass New York Metro Financial Services Group.

Exhibit 6: Hedge funds launching in 2010 will be more reliant on seed capital investment than before the credit crisis

	$500M+	<$500M	Weighted Average
Strongly agree	24.7%	17.1%	18.9%
Agree	46.1%	54.1%	52.2%
Disagree	29.2%	26.7%	27.3%
Strongly disagree	0.0%	2.1%	1.6%
No opinion	0.0%	0.0%	0.0%

The large majority of firms, regardless of size, say they will use less leverage than they did before the 2008 credit crisis, which is not unexpected as both investors and regulators take a closer look at risks and exposures (Exhibit 7).

"For all of its success, the hedge fund community continued to suffer from widely held but mistaken conceptions regarding its practices. For example, though hedge funds typically use less leverage than their private equity counterparts and even many established financial institutions, the industry has been overwhelmed with calls for greater restriction, with some regulatory proposals even calling for regular disclosure of leverage ratios. While the sector seems to oppose such requirements, it is apparent that hedge funds are taking steps to address investor concerns," said Mr. Calcagno. "In reality, appropriate use of leverage varies greatly from fund to fund, depending on specific risk tolerances and investment objectives of its investors."

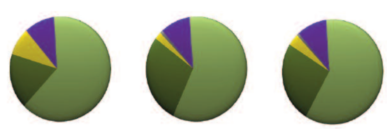
Exhibit 7: Hedge funds will use significantly less leverage now than prior to the 2008 credit crisis

	$500M+	<$500M	Weighted Average
Strongly agree	56.2%	52.1%	53.0%
Agree	21.3%	28.8%	27.0%
Disagree	12.4%	8.9%	9.7%
Strongly disagree	4.5%	5.5%	5.3%
No opinion	5.6%	4.7%	5.0%

Almost three-quarters expect the pace of redemptions to slow this year, which is an encouraging sign and may indicate the beginning of a much needed period of stability for the hedge fund industry (Exhibit 8).

"As the global economy has recovered, hedge fund managers have exhibited a renewed focus on performance and are again delivering results consistent with expectations. Meanwhile, the immediate liquidity requirements that provoked many investors to withdraw assets from alternative investment vehicles have subsided. In many cases, investors who were able to maintain allocations to hedge funds have been rewarded for their long-term approach," said Mr. Mears. "Though the pace of redemption has slowed dramatically, liquidity remains a concern among many investors, particularly those that encountered gates as they sought to withdraw capital during the credit crisis."

Exhibit 8: The pace of redemption will continue to slow in 2010



	$500M+	<$500M	Weighted Average
Strongly agree	14.6%	18.8%	17.8%
Agree	62.9%	53.1%	55.4%
Disagree	13.5%	15.7%	15.3%
Strongly disagree	6.7%	10.3%	9.4%
No opinion	2.3%	2.1%	2.1%

The majority, or about 80%, of firms surveyed feel that fund closures are likely to drop off in 2010 when compared to the higher rate of closures in 2008 and 2009, as most of the troubled funds have been liquidated or merged away (Exhibit 9).

"There's little question that the hedge fund industry experienced a major consolidation in 2009, in a process resembling survival of the fittest. By and large, the strongest funds – those with established brands that remained true to their investment philosophies and with a track record of success – persevered through economic uncertainty. These companies are now poised to benefit from renewed asset flows," said Mr. Altman. "Even though a large number of firms closed, there was not much of a ripple through the financial system. This supports the notion that hedge funds do not cause systemic risk. In fact, the industry neither requested nor received taxpayer funds associated with Federal bailout efforts."

Exhibit 9: More funds will close in 2010 than in 2009

	$500M+	<$500M	Weighted Average
Strongly agree	1.1%	3.4%	2.9%
Agree	14.6%	15.4%	15.2%
Disagree	67.4%	60.6%	62.2%
Strongly disagree	12.4%	19.2%	17.6%
No opinion	4.5%	1.4%	2.1%

Despite a drop-off in the number of fund closures, about 60% of firms still believe that consolidation among asset managers will continue and increase throughout the remainder of 2010 as a way to shore up resources and stabilize investors (Exhibit 10).

"Consolidation in the hedge fund space is expected to accelerate this year and beyond as hedge fund companies seek to offset rising compliance costs by creating economies of scale. The outlook for consolidation could shift quickly and dramatically in response to a number of factors, including proposed regulatory initiatives that, if enacted, could limit some financial institutions from operating and managing proprietary hedge fund products," said Mr. Altman.

Exhibit 10: Consolidation in the asset management space will intensify in 2010

	$500M+	<$500M	Weighted Average
Strongly agree	9.0%	15.8%	14.2%
Agree	37.1%	46.6%	44.4%
Disagree	31.5%	27.1%	28.1%
Strongly disagree	12.3%	8.8%	9.7%
No opinion	10.1%	1.7%	3.6%

Capital-Raising Environment

About two-thirds of firms surveyed plan to raise new investment capital during 2010, with about half targeting an increase of more than 25% and the balance targeting an increase of less than 25% of total assets under management (Exhibit 11).

Exhibit 11: Plans to raise new investment capital in 2010

	$500M+	<$500M	Weighted Average
Yes, plan to increase AUM by 25% or more	22.5%	34.9%	32.0%
Yes, plan to increase AUM by under 25%	49.4%	31.2%	35.4%
Not actively seeking investment capital	13.5%	18.5%	17.3%
Expect AUM to decline in 2010	5.6%	10.6%	9.5%
Undecided	9.0%	4.8%	5.8%

More than 90% of hedge fund firms expect that competition for qualified investors will be fierce, as declining private wealth has reduced investor tolerance for risk (Exhibit 12).

"Since we published our first annual hedge fund industry trends report in 2007, the hedge fund community has been unwavering in its desire to raise additional investment capital. As they engage in capital-sourcing activities, hedge fund managers face greater competition from a variety of sources, including ETFs and mutual funds that purport to replicate hedge fund strategies," said Mr. Altman. "Educational initiatives to better explain the advantages and practices of the hedge fund community will help the industry overcome intense competition for assets."

Exhibit 12: Competition for hedge fund investors will dramatically increase in 2010

	$500M+	<$500M	Weighted Average
Strongly agree	67.4%	79.1%	76.4%
Agree	23.6%	14.4%	16.5%
Disagree	6.7%	4.8%	5.2%
Strongly disagree	2.3%	1.0%	1.4%
No opinion	0.0%	0.7%	0.5%

About two-thirds of hedge fund firms do not feel that they will be forced to lower investment minimums in 2010 in order to attract new investors, while one-third expect a need to do so in order to raise meaningful assets (Exhibit 13).

"Hedge funds were created to help sophisticated and accredited investors to manage risk while pursuing superior returns. The industry's success in achieving this goal led to its rapid growth and the proliferation of funds and strategies to meet a broad range of investment objectives. Though competition for assets has always been fierce, the industry has long understood that having aligned investors is the key to long-term stability," said Mr. Altman. "This lesson was reinforced – harshly – for some managers during the still recent market upheaval. Lowering investment minimums might encourage investors to move in and out of funds based on short-term market forces, inadvertently denying them of the benefits of long-term hedge fund investment and undercutting the stability of the fund."

Exhibit 13: Hedge funds will lower investment minimums in 2010

	$500M+	<$500M	Weighted Average
Strongly agree	1.1%	3.1%	2.6%
Agree	25.8%	31.8%	30.4%
Disagree	59.6%	45.6%	48.8%
Strongly disagree	13.5%	16.8%	16.0%
No opinion	0.0%	2.7%	2.2%

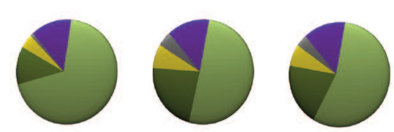
Sourcing Capital

Almost 70% of firms say that institutional investors will be a critical source of new investment assets, though larger firms are more likely to target these sophisticated and demanding clients (Exhibit 14). A similarly high percentage of firms expect to find growth in the high-net-worth markets, a strategy favored by smaller firms (Exhibit 15). Firms of both sizes share interest in the opportunities to be found in family offices, with roughly 70% of all respondents citing them as an important source of new investment dollars (Exhibit 16).

"Institutional assets have flowed steadily into alternative investments for years and have increased again following a brief pullback in response to the credit crisis. The result is that many Americans have indirectly benefited from exposure to the sector through strong returns in their pension plans. As the United States faces a monumental pension shortfall, the hedge fund industry offers a spectrum of tools that can help to deliver strong returns consistent with an institutional risk profile," said Mr. Altman. "In order to attract institutional assets, hedge funds must be institutional in their operations, behaviors and attitudes. This includes alignment with reputable third-party service providers, including brokers, consultants and administrators, and a sharp focus on operational due diligence."

"Hedge funds remain a preferred investment option for ultra-high-net-worth individuals and families, and our research suggests that smaller funds in particular are still depending on allocations from these investors. For many, however, market volatility contributed to a decline in overall net worth and demanded reexamination of goals and priorities. Though many high-net-worth families have seen some recovery, their experiences have obviated the need for a unified approach to wealth management," said Rick Flynn, a Principal in the Rothstein Kass Family Office Group. "Many wealthy individuals and families are indeed expressing renewed interest in alternative investments but are more commonly considering allocations alongside broader estate planning, wealth preservation, philanthropic and lifestyle management concerns."

Exhibit 14: Institutional investors will be an important source of new investment capital in 2010



	$500M+	<$500M	Weighted Average
Strongly agree	13.5%	14.0%	13.9%
Agree	68.5%	50.7%	54.9%
Disagree	12.4%	22.6%	20.2%
Strongly disagree	4.5%	7.9%	7.1%
No opinion	1.1%	4.8%	3.9%

Exhibit 15: High-net-worth investors will be an important source of new investment capital in 2010

	$500M+	<$500M	Weighted Average
Strongly agree	13.5%	38.7%	32.8%
Agree	40.4%	35.6%	36.7%
Disagree	30.3%	17.5%	20.5%
Strongly disagree	13.5%	6.8%	8.4%
No opinion	2.3%	1.4%	1.6%

Exhibit 16: Family offices will be an important source of new investment capital in 2010

	$500M+	<$500M	Weighted Average
Strongly agree	24.7%	27.7%	27.0%
Agree	41.6%	44.9%	44.1%
Disagree	16.9%	15.1%	15.5%
Strongly disagree	13.5%	8.9%	10.0%
No opinion	3.3%	3.4%	3.4%

Opinions on private equity firms as a source of new assets was divided, with about half agreeing on their importance, another 40% disagreeing and 10% remaining undecided (Exhibit 17).

"In 2009 and into this year, there has been a good deal of speculation that the credit crisis would force private equity firms and hedge funds to more commonly compete for solid investment opportunities. In fact, roughly half of hedge fund managers surveyed said that they are expecting to attract assets from the private equity sector," said Mr. Mears. "An important challenge for both private equity and hedge fund companies is the fair value practices for Level 3 holdings, as firms which can provide sufficient transparency will have much greater success in sourcing capital."

Exhibit 17: Private equity firms will be an important source of new investment capital in 2010

	$500M+	<$500M	Weighted Average
Strongly agree	12.4%	24.3%	21.5%
Agree	24.7%	30.8%	29.4%
Disagree	33.7%	26.4%	28.1%
Strongly disagree	12.4%	11.3%	11.5%
No opinion	16.8%	7.2%	9.5%

Fees

Fees are another area about which there are varying perspectives among hedge fund professionals. Though roughly 55% of all firms surveyed believe that fee levels will come under scrutiny in 2010, nearly the same percentage of larger firms disagreed (Exhibit 18). At the same time, slightly more than half of all firms expect closer alignment between fees and long-term investment performance, but almost 45% of firms say that will not be the case (Exhibit 19).

"Larger, established hedge funds are less likely to face downward pressure on fees, and in fact, there have been reports that some firms have actually been able to command a premium for access to their funds. Many emerging managers are becoming more creative with their fee structures by adding hurdles and multi-year incentive terms," said Jeff Kollin, a Principal in the Financial Services Advisory practice of Rothstein Kass Business Advisory Services, LLC. "When hedge funds are willing to negotiate fee arrangements, they have consistently received concessions from investors in return for this flexibility."

Exhibit 18: There will be downward pressure on hedge fund fees in 2010

	$500M+	<$500M	Weighted Average
Strongly agree	12.4%	18.5%	17.0%
Agree	34.8%	43.2%	41.2%
Disagree	47.2%	27.0%	31.8%
Strongly disagree	5.6%	7.5%	7.1%
No opinion	0.0%	3.8%	2.9%

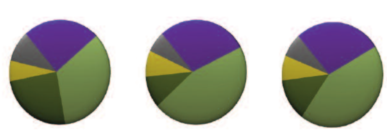
Exhibit 19: Fee structures will be more closely linked to long-term performance

	$500M+	<$500M	Weighted Average
Strongly agree	10.1%	12.0%	11.5%
Agree	43.8%	40.8%	41.6%
Disagree	33.7%	35.2%	34.9%
Strongly disagree	9.0%	8.9%	8.9%
No opinion	3.4%	3.1%	3.1%

There is greater agreement about the incentive of lower fees in exchange for longer lock-up periods, with nearly 70% expecting to see such arrangements in place during 2010 (Exhibit 20). Though it's worth noting that a considerable percentage of firms, nearly 10%, remain undecided on the issue.

"Though smaller firms may encounter some scrutiny of their fee structures, they are also more dependent on these resources to cover operating and compliance expenses. They may be more likely to consider negotiating lower fees in exchange for longer lock-up periods," said Mr. Calcagno.

Exhibit 20: Hedge funds will increasingly consider lower fees for longer lock-up periods



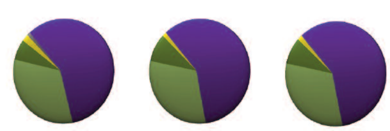
	$500M+	<$500M	Weighted Average
Strongly agree	24.7%	28.8%	27.8%
Agree	33.7%	45.5%	42.8%
Disagree	24.7%	10.3%	13.6%
Strongly disagree	6.8%	8.6%	8.2%
No opinion	10.1%	6.8%	7.6%

Operational Environment

The need for transparency and liquidity that surfaced in late 2008 has prompted investors to take a closer look at the due diligence processes employed by the hedge funds they own or are considering. Nearly 90% of firms expect that this heightened concern will continue unabated in 2010 (Exhibit 21).

"Traditional approaches to due diligence processes have sought to align risk exposures with potential rewards. Perhaps because they offer no direct compensating rewards, operational risks have often been overlooked. However, ignoring relatively small risks allows issues to intensify," said Mr. Kollin. "In response to demand for greater transparency, hedge funds are developing more comprehensive strategies for implementing thorough institutional best practices over valuation methods, trading, clearance and financial reporting."

Exhibit 21: Investors are more concerned than ever with due diligence processes in hedge funds



	$500M+	<$500M	Weighted Average
Strongly agree	57.3%	58.2%	58.0%
Agree	32.6%	31.2%	31.5%
Disagree	6.7%	9.2%	8.7%
Strongly disagree	2.3%	1.4%	1.6%
No opinion	1.1%	0.0%	0.2%

Almost three-quarters of hedge fund professionals say they will outsource more of their non-investment functions during 2010 in order to renew their focus on investment functions and deliver results for their investors (Exhibit 22).

"With the enhanced focus on operational due diligence and compliance processes, hedge fund managers risk becoming distracted from what they do best – raising capital and managing assets. As a result, we are seeing a trend toward outsourcing of non-investment functions to reliable third parties. In an industry that is still sometimes viewed as secretive, the quality of service provider relationships can actually be a critical consideration for investors with a wide range of options available," said Mr. Kollin.

Exhibit 22: Hedge funds will increasingly outsource non-investment functions in 2010

	$500M+	<$500M	Weighted Average
Strongly agree	18.0%	20.2%	19.7%
Agree	47.2%	53.4%	52.0%
Disagree	21.3%	20.9%	21.0%
Strongly disagree	9.0%	3.8%	5.0%
No opinion	4.5%	1.7%	2.3%

While three-quarters of all firms expect that marketing will play a bigger role in success, smaller firms are more likely to believe this to be the case. About 80% of firms with less than US$500 million in assets agree that marketing will assume greater importance, compared to just two-thirds of larger firms, many of which may have experienced meaningful growth in the past through word of mouth and capital introductions specialists (Exhibit 23).

"The alternative investment community has seen its reputation suffer along with the financial services industry as critics have cast a wide net in their search of those to blame for recent economic woes. Most of this condemnation is unwarranted but arises from fundamental misunderstandings regarding hedge funds and their objectives," said Mr. Altman. "The industry shares responsibility for this confusion. Many hedge funds have neglected marketing and public relations initiatives, wary of regulatory prohibitions. As an increasing portion of the population gains access to the sector through retirement accounts, hedge funds are placing a greater emphasis on educational and advocacy efforts to clear up misconceptions."

Exhibit 23: Marketing will become much more important to hedge fund success

	$500M+	<$500M	Weighted Average
Strongly agree	20.2%	62.0%	52.2%
Agree	38.2%	18.5%	23.1%
Disagree	23.6%	11.3%	14.2%
Strongly disagree	13.5%	5.5%	7.3%
No opinion	4.5%	2.7%	3.2%

Despite the mandated changes regarding the use of independent research by investment banking firms, hedge funds still perceive their in-house research and analysis capabilities to be an intrinsic part of their proprietary formula for success. As such, nearly 70% say that access to third-party research is not necessary to delivering above-average investment results (Exhibit 24).

Exhibit 24: Access to third-party, independent research is critical to hedge fund performance

	$500M+	<$500M	Weighted Average
Strongly agree	12.4%	15.4%	14.7%
Agree	15.7%	15.1%	15.2%
Disagree	67.4%	38.4%	45.1%
Strongly disagree	4.5%	30.8%	24.8%
No opinion	0.0%	0.3%	0.2%

Regulatory Changes

Three-quarters of firms surveyed expect to face increased regulatory requirements in the future (Exhibit 25). About half envision new regulations during the second half of 2010, while the other half believe changes will be delayed until the first half of 2011 (Exhibit 26).

"Since late 2008, the hedge fund industry has been anticipating increased regulation, with almost universal agreement in our initial survey on the subject. The disparate proposals will need to be reconciled before enactment, making it difficult to predict the ultimate outcome and impact," said Mr. Altman. "It is interesting to note that roughly a quarter of respondents now disagree that increased regulation of the sector is pending, suggesting that advocacy efforts to differentiate hedge funds from the actual causes of financial turmoil are having some effect."

Exhibit 25: There will be increased regulation of hedge funds

	$500M+	<$500M	Weighted Average
Strongly agree	13.5%	21.9%	19.9%
Agree	68.5%	53.1%	56.7%
Disagree	18.0%	24.3%	22.8%
Strongly disagree	0.0%	0.7%	0.6%
No opinion	0.0%	0.0%	0.0%

Exhibit 26: When do you anticipate the bulk of regulatory changes will take effect?

	$500M+	<$500M	Weighted Average
First-half 2010	1.1%	2.1%	1.8%
Second-half 2010	43.8%	45.5%	45.1%
First-half 2011	46.1%	44.2%	44.6%
Second-half 2011	6.7%	7.2%	7.1%
Beyond 2011	2.3%	1.0%	1.4%

Nearly 85% of firms anticipate having to register as investment advisors with the Securities and Exchange Commission as part of the new regulatory landscape (Exhibit 27). On a related note, most hedge fund executives believe they will be responsible for footing the cost associated with annual SEC inspections (Exhibit 28).

"Hedge fund registration with the SEC has been an accepted fact for the hedge fund industry that has reached the conclusion that for most funds, the costs associated with offering greater transparency will be mitigated by increased asset flows resulting from greater investor confidence," said Mr. Altman. "The appropriate threshold for registration remains a contentiously debated issue. Driving these funds from the marketplace would both eliminate a source of healthy competition and undercut an overlooked community of entrepreneurs that provides jobs to the economy and valuable services to its clients."

Exhibit 27: Hedge funds will be compelled to register with the SEC as investment advisors

	$500M+	<$500M	Weighted Average
Strongly agree	70.8%	47.9%	53.3%
Agree	18.0%	32.5%	29.1%
Disagree	10.1%	14.1%	13.1%
Strongly disagree	1.1%	5.5%	4.5%
No opinion	0.0%	0.0%	0.0%

Exhibit 28: Hedge fund managers will be compelled to pay for the cost of annual SEC inspections

	$500M+	<$500M	Weighted Average
Strongly agree	6.7%	2.1%	3.2%
Agree	71.9%	78.4%	76.9%
Disagree	16.9%	15.4%	15.8%
Strongly disagree	1.1%	1.0%	1.0%
No opinion	3.4%	3.1%	3.1%

Slightly more than half of all firms foresee a requirement for independent custody arrangements, though larger firms are proportionately more likely to expect this change when compared to their smaller counterparts (Exhibit 29).

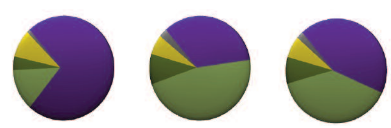
Exhibit 29: Hedge funds will be required to maintain independent custody of assets

	$500M+	<$500M	Weighted Average
Strongly agree	50.6%	20.9%	27.8%
Agree	24.7%	30.1%	28.9%
Disagree	12.4%	37.3%	31.5%
Strongly disagree	7.9%	7.5%	7.6%
No opinion	4.4%	4.2%	4.2%

Nearly 85% of firms envision a full-scale SEC investigation into allegations of hedge fund insider trading, though larger firms feel more strongly than smaller firms on the subject (Exhibit 30).

"The SEC has made no secret of its intent to crack down on insider trading, dedicating substantial resources and ramping up staffing to bolster enforcement efforts. The agency is employing a greater range of investigative tactics to build their cases," said Gary Arrick, a Principal in the Litigation and Forensic Accounting division of Rothstein Kass Business Advisory Services. "Instances of inappropriate behavior are rare but, when uncovered, often cause irreparable harm. Many investment firms are reassessing their trading practices and overall capacity to monitor for and identify suspicious activity."

Exhibit 30: The SEC will dedicate significant resources to investigations of insider trading



	$500M+	<$500M	Weighted Average
Strongly agree	71.9%	33.9%	42.8%
Agree	13.5%	46.9%	39.1%
Disagree	4.5%	9.9%	8.7%
Strongly disagree	9.0%	6.5%	7.1%
No opinion	1.1%	2.8%	2.3%

Charitable Behavior

In years past, wealthy and successful hedge fund professionals made significant contributions of time and money to the charitable causes that were important to them. Understandably, many of these professionals have adjusted their philanthropic activities in response to the decrease in assets and fees that occurred over the past 18 months that, in turn, had a negative impact on their personal wealth. We did, however, note some interesting disparities between larger and smaller firms when it came to charitable support.

About 65% of the representatives of larger firms said they maintained or increased their financial gestures in 2009, whereas almost 50% of their counterparts at smaller firms said they reduced their contributions for the same timeframe (Exhibit 31).

"If, as some suggest, the hedge fund community has been guarded in its practices and strategies, the industry's charitable involvement is perhaps a better-kept secret," said Mr. Altman. "The good news is that despite well-documented industry hardships, slightly more than half of survey respondents were able to maintain or increase monetary contributions last year."

Exhibit 31: How have economic conditions impacted your personal financial contributions to charitable causes in 2009?

Charitable Giving

	$500M+	<$500M	Weighted Average
Reduced	29.2%	47.3%	43.0%
Maintained	41.6%	36.3%	37.5%
Increased	24.7%	9.9%	13.4%
Not sure	4.5%	6.5%	6.1%

Time and personal expertise can be as valuable to charitable organizations as money and provides a way for hedge fund professionals to still make a difference when or if they cannot do so financially. Almost 80% of representatives at larger firms say they increased or maintained the amount of time they dedicated to charitable causes, compared to 62% of small-firm executives (Exhibit 32).

Exhibit 32: How have economic conditions impacted the amount of time you previously spent on charitable causes?

	$500M+	<$500M	Weighted Average
Spent more time on charitable causes	20.2%	12.3%	14.2%
Maintained time dedicated to charitable causes	58.4%	49.7%	51.7%
Spent less time on charitable causes	18.0%	32.5%	29.1%
Not sure	3.4%	5.5%	5.0%

About the Authors

Russ Alan Prince is the world's leading authority on private wealth, the author of more than three dozen books on the topic, and a highly-sought counselor to families with significant global resources and their advisors. He is co-author of *The Family Office: Advising the Financial Elite.*

www.RussAlanPrince.com

Hannah Shaw Grove is a widely recognized author, columnist and speaker, and an expert on the mindset, behaviors, concerns, preferences and finances of high-net-worth individuals. She is co-author of *Inside the Family Office: Managing the Fortunes of the Exceptionally Wealthy.*

www.HSGrove.com

About the Contributors

Howard Altman is Co-CEO and the Principal-in-Charge of financial services at Rothstein Kass. He has extensive experience in the financial services arena, with particular emphasis on investment partnerships, offshore funds and broker-dealers. Mr. Altman's experience includes advice on initial hedge fund and broker-dealer organizational structure, supervision of audits, ongoing consultation with management regarding many diverse operational and tax matters, and involvement in investigative matters, including expert witness testimony. He is frequently called upon to provide input on current issues affecting the financial services community.

Howard Altman can be contacted at:
973.577.2400 or haltman@rkco.com

Gary M. Arrick is the Principal-in-Charge of the Litigation & Forensic Accounting practice in the Eastern Region at Rothstein Kass Business Advisory Services, LLC. Mr. Arrick specializes in complex financial investigations, compliance matters, and disputes consulting. His extensive investigative experience includes matters of financial misconduct and regulatory issues in domestic and international jurisdictions. Mr. Arrick has experience in both criminal and civil matters and has worked in coordination with law enforcement and presented results to regulatory authorities.

Gary M. Arrick can be contacted at:
917.438.3910 or garrick@rkco.com

Vincent Calcagno is the Principal-in-Charge of Rothstein Kass' Southern California offices. In addition to his management responsibilities, Mr. Calcagno specializes in audit, tax and consulting engagements for hedge funds, fund of funds, private equity funds, venture capital funds, mutual funds, management companies and broker-dealers. He has extensive operational experience in the financial services industry and is also a member of the Firm's Financial Services Best Practices Committee.

Vincent Calcagno can be contacted at:
310.887.5250 or vcalcagno@rkco.com

About the Contributors

Richard J. Flynn is a Principal and the head of Rothstein Kass' Family Office Group. A lawyer and advanced planning specialist, he advises high-net-worth clients on wealth enhancement, wealth transfer and asset protection planning. His clients include hedge fund managers, business owners and other executives, professional athletes, and entertainers. He is co-author of *Fame & Fortune: Maximizing Celebrity Wealth* and *The Family Office: Advising the Financial Elite.*

Rick Flynn can be contacted at:
917.438.3956 or rflynn@rkco.com

Jeffrey Kollin is a Principal in the Financial Services Advisory practice of Rothstein Kass Business Advisory Services, LLC. Mr. Kollin advises clients, including hedge funds, private equity fund managers, institutional investors, mutual funds and broker-dealers, on all matters, such as capital formation, infrastructure valuation, operational, technology and risk assessments, service provider evaluation, implementation of best practices, and project management.

Jeffrey Kollin can be contacted at:
917.438.3946 or jkollin@rkco.com

Christopher Mears is the Principal-in-Charge of Rothstein Kass' New York Metro Financial Services Group. Mr. Mears has over 17 years of experience in financial services, with a particular emphasis on investment partnerships, offshore funds and private equity funds. He advises alternative investment clients at the initial organizational phase to address the accounting and tax matters that may have an impact on the fund, and he subsequently oversees all services provided to the fund by the Firm, including the audit and ongoing consultation regarding many diverse operational, transactional and tax matters.

Christopher Mears can be contacted at:
973.577.2304 or cmears@rkco.com

Rothstein Kass provides audit, tax, accounting and advisory services to hedge funds, fund of funds, private equity funds, broker-dealers and registered investment advisors. The Firm is recognized nationally as a top service provider to the industry through its Financial Services Group. The Financial Services Group consults on a wide range of organizational, operational and regulatory issues. The Firm also advises on fund structure, both inside and outside the US, compliance and financial reporting, as well as tax issues from a federal, state, local and international compliance perspective.

Rothstein Kass also provides a full array of integrated services, including strategic business counseling, regulatory compliance and SEC advisory services, insurance and risk management consulting and family office services, through its Commercial Services Group. The Firm advises organizations looking for financing/investment opportunities, as well as those looking to restructure as a business strategy. Rothstein Kass has offices in California, Colorado, New Jersey, New York, Texas and the Cayman Islands.

Rothstein Kass Business Advisory Services, LLC professionals provide value-added and result-oriented consulting services to clients across industries in the areas of strategy, operations, technology, risk, compliance, dispute resolution and investigations. Rothstein Kass Business Advisory Services, LLC is an affiliate of Rothstein, Kass & Company, P.C., a premier international professional services firm serving clients for more than 50 years.

Rothstein Kass

1350 Avenue of the Americas
New York, NY 10019
212.997.0500
www.rkco.com

California • Colorado • New Jersey • New York • Texas • The Cayman Islands