Hedge Fund Capital Group

Global Markets

A Passion to Perform.

Deutsche Bank

Hedge Fund Capital Group

July 2005

Global Markets

2005 Alternative Investment Survey

Deutsche Bank's 2005 Alternative Investment Survey is the largest comprehensive hedge fund investor survey in the industry. This year we polled over 1000 representatives from 650 different investment firms. These 650 investors represent $645 billion dollars in direct hedge fund assets which we estimate is nearly two-thirds of the trillion dollars invested in the hedge fund industry.

This report was prepared by Deutsche Bank's Hedge Fund Capital Group. For addtional copies of this survey, please send a request to:

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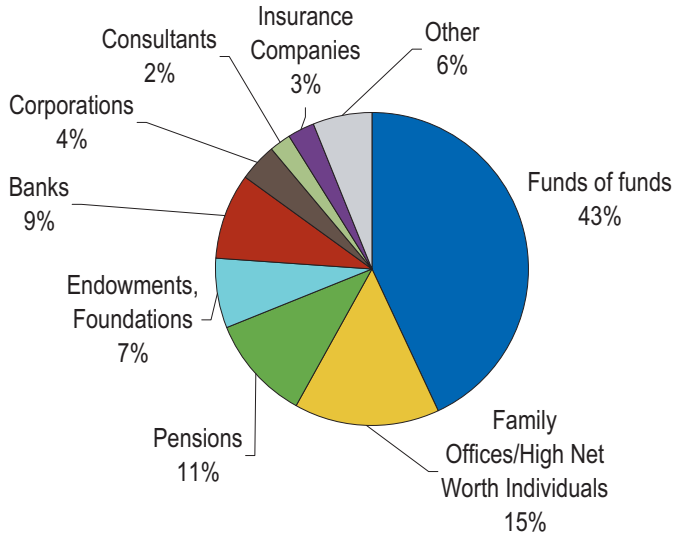
Investor Characteristics

Introduction

Over 1,000 representatives from 650 firms completed the 2005 Deutsche Bank Alternative Investment Survey. These 650 investors represent $645 billion dollars in direct hedge fund assets, which we estimate is nearly two-thirds of all assets in the hedge fund industry.

We asked each respondent to categorize themselves as a fund of funds, bank, corporation, consultant, insurance company, pension, endowment, foundation, family office or high net worth individual. We received responses from all these investor types, with a particularly strong showing from pensions, endowments and foundations, comprising 18% of respondents. Family offices and high net worth individuals are also well represented, at 15%. Funds of funds represent the largest group, with 43% of all responses [see Chart 1].

Chart 1. Respondents by Type



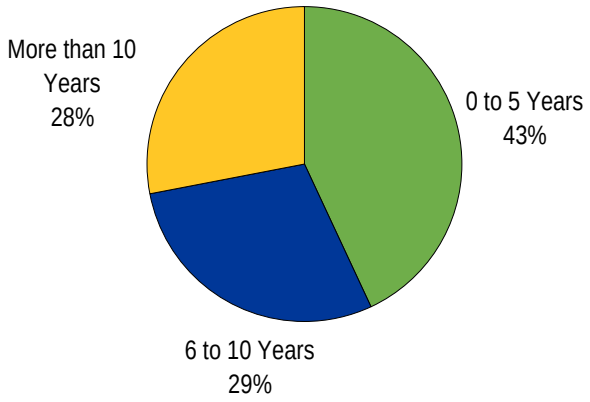
Source: 2005 Deutsche Bank Alternative Investment Survey

We polled investors from all over the world, with roughly half from the United States and more than a third from Europe [not shown in chart].

Experience

Most of our respondents have significant experience investing in hedge funds. Over the last two surveys close to 60% of our respondents reported having over 5 years of experience [Chart 2].

Chart 2. Years In Hedge Fund Investing 2005

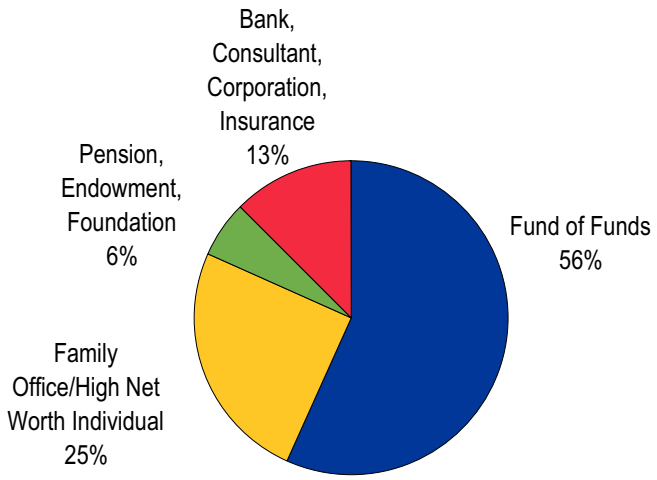


Source: 2005 Deutsche Bank Alternative Investment Survey

Most Experienced

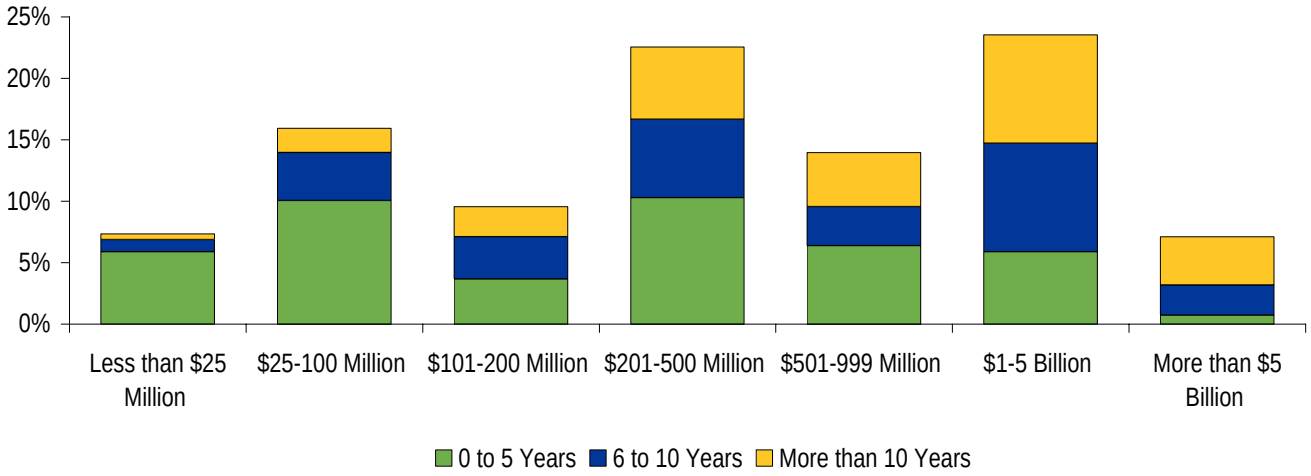
The most experienced investor firms tend to be funds of funds and firms with more assets under management [as shown in Charts 3 and 4].

Chart 3. Where Are the Most Experienced Hedge Fund Investors? (more than 10 years in HF investing)



Source: 2005 Deutsche Bank Alternative Investment Survey

Chart 4. Investor Assets Arrayed by Years of Experience in Hedge Fund Investing

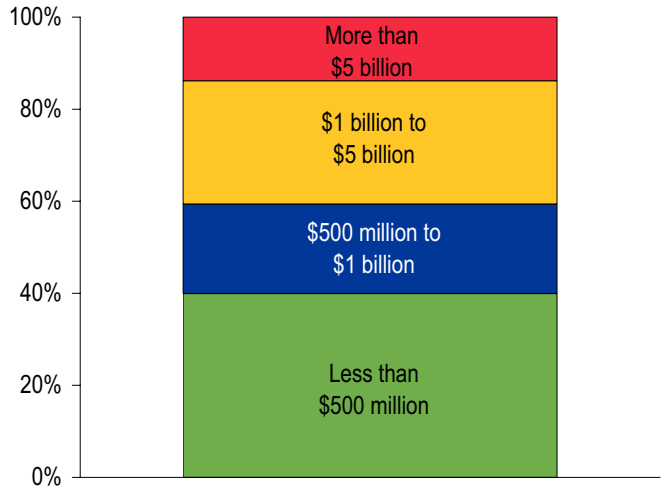


Source: 2005 Deutsche Bank Alternative Investment Survey

We also collected responses from firms who do not currently invest in hedge funds. Our non-hedge fund investors include pensions, endowments, foundations, corporations, insurance companies, banks and consultants. Respondents indicate that lack of personnel, knowledge and experience in hedge fund strategies are their primary reasons for avoiding hedge funds as opposed to perceived risk [not shown in chart].

Size

Chart 5. Assets Under Management of Investors Interested in Hedge Funds

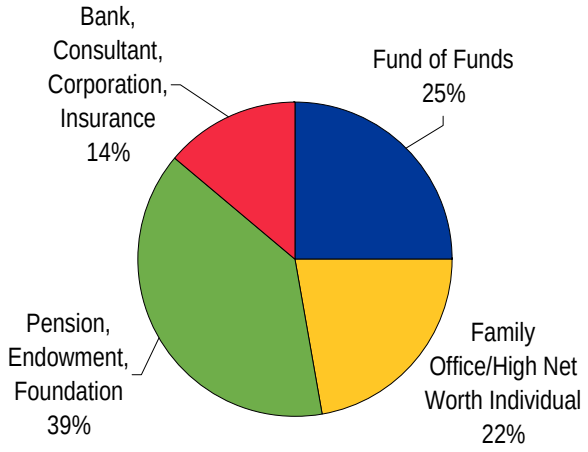


Source: 2005 Deutsche Bank Alternative Investment Survey

Size of Investors

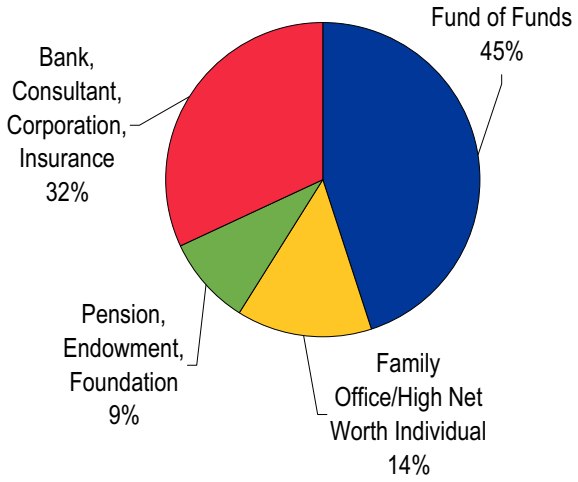
This year's 2005 respondents are well distributed in all size classes. Among those investors revealing their total assets under management, 14% manage more than $5 billion in assets, 46% manage between $500 million and $5 billion and 40% manage less than $500 million in assets [see Chart 5].

Chart 6. Average Hedge Fund Held Over $1 billion



Source: 2005 Deutsche Bank Alternative Investment Survey

Chart 7. Average Hedge Fund Held Under $100 million



Source: 2005 Deutsche Bank Alternative Investment Survey

Size of Managers

We asked investors to tell us the average size of the hedge funds in which they are invested, and 39% of pensions, endowments and foundations indicate their hedge fund managers have over $1 billion in assets. Only 25% of funds of funds indicate their average hedge fund has over $1 billion [see chart 6]. Of all investor types, funds of funds dominate investments in hedge funds under $100 million, comprising 45% of the investors in this category [see chart 7].

Number and Size of Investments

The largest size investments come from banks, insurance companies, corporations and consultants [see Table 1]. An increasing number of corporations are making significant hedge fund investments as part of their treasury management operations.

The average size investment made directly into hedge fund managers is $19 million [not shown in chart], continuing a trend of year-over-year increases. Banks, consultants, corporations and insurance companies make the largest allocations, averaging more than $26 million per manager. Family offices and high net worth individuals make the smallest allocations, averaging just $11 million per manager [see Table 1].

Table 1. Average Allocation Size

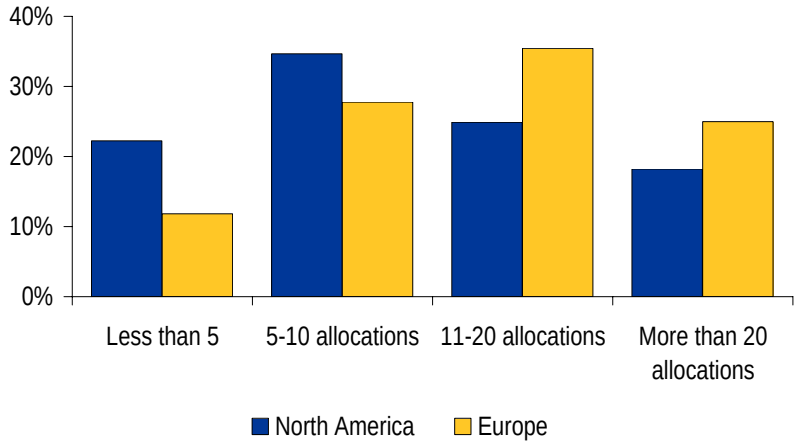
Investor Type	Average Size of Allocations in Millions of $
Bank, Consultant, Corporation, Insurance	$26
Pension, Endowment, Foundation	$25
Fund of Funds	$19
Family Office/High Net Worth Individual	$11

Pensions, endowments and foundations make fewer allocations annually than other investor types and have fewer hedge funds in their portfolio [see Table 2]. As more hedge fund managers turn toward pensions, endowments and foundations, the competition for these selected few allocations will become more demanding.

Table 2. Number of Annual Allocations

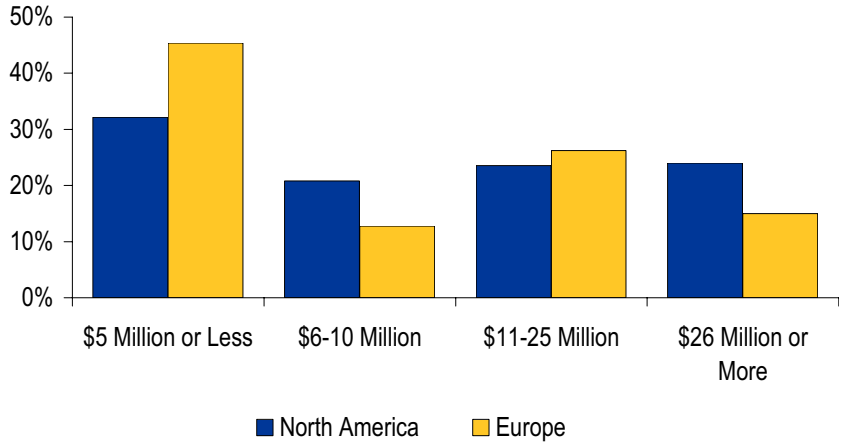
Investor Type	Median Number of Annual Allocations
Fund of Funds	15
Bank, Consultant, Corporation, Insurance	12
Family Office/High Net Worth Individual	10
Pension, Endowment, Foundation	4

Chart 8. Number of Annual Allocations (Investor Location)



Source: 2005 Deutsche Bank Alternative Investment Survey

Chart 9. Average Size of Allocations (Investor Location)



Source: 2005 Deutsche Bank Alternative Investment Survey

Investor Location

European investors typically make more allocations each year than North American investors [Chart 8]. We note, however, that the average size of European initial investments is smaller than those of North American's [Chart 9].

Funds of funds hold the largest number of investments, with 80% invested in more than twenty hedge funds. Pensions, endowments and foundations generally hold the least number of investments, with almost half (46%) invested in five or fewer funds [see Table 3].

Table 3. Investment Holdings: Number of Direct Hedge Fund Investments

Investor Type	Less than 6 Hedge Funds	6 to 20 Hedge Funds	21 to 100 Hedge Funds	More than 100 Hedge Funds
Fund of Funds	6%	15%	69%	11%
Family Office/High Net Worth Individual	14%	34%	49%	2%
Pension, Endowment, Foundation	46%	33%	21%	0%
Bank, Consultant, Corporation, Insurance	26%	24%	34%	15%

Source: 2005 Deutsche Bank Alternative Investment Survey

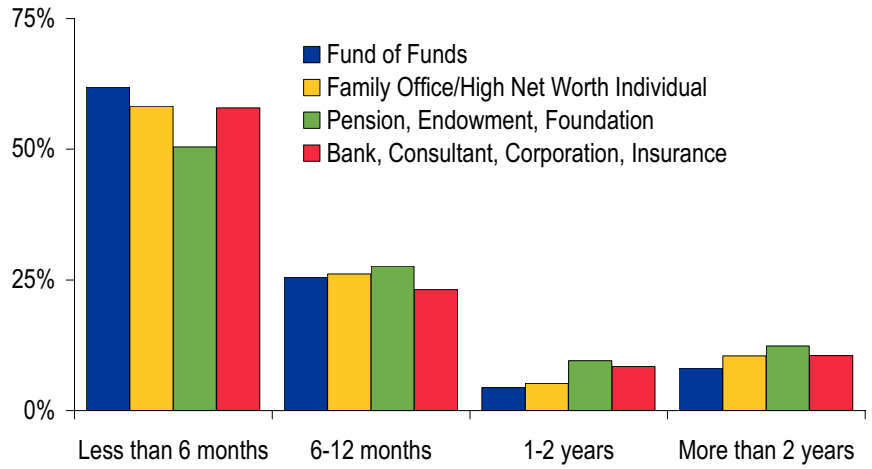
Due Diligence Period

The majority of investors report they take less than 6 months to make an investment decision. Even among pensions, which have a reputation for being slower than other investors, 78% claim that after an initial meeting with a manager, they can make an investment in less than 12 months [Chart 10].

Due Diligence

Surprisingly, 50% of all pensions, foundations and endowments say they can deploy assets to a new manager in under 6 months, the same as the average time a fund of funds says it needs to reach an investment decision and deploy assets [Chart 10].

Chart 10. Duration of the Investment Process

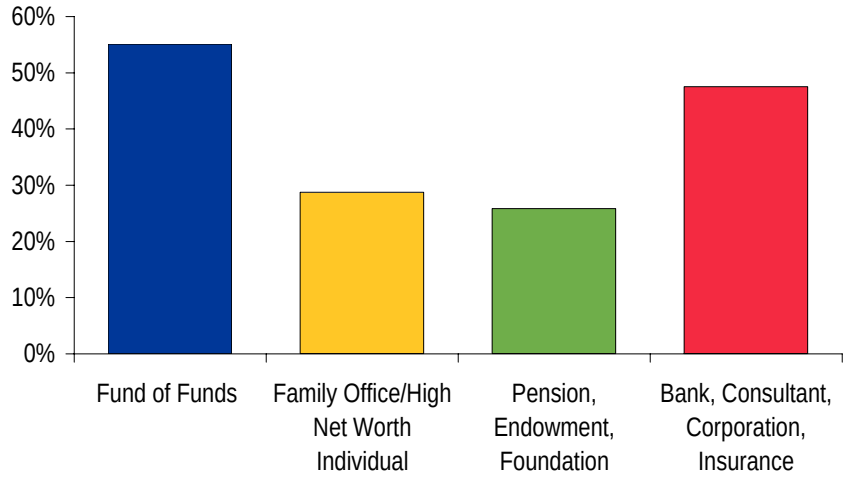


Source: 2005 Deutsche Bank Alternative Investment Survey

Manager Selection Criteria

For the fourth year, the three "P's" remain the leading selection criteria for hedge fund managers: Performance, Pedigree, and Philosophy. An emerging criterion for 2005 is Risk Management, with 20% of investors listing this criterion as their second or third selection. Investors indicate Fund Registration is the least important criterion [not shown in chart].

Chart 11. Investors Requesting Future Capacity Rights



Source: 2005 Deutsche Bank Alternative Investment Survey

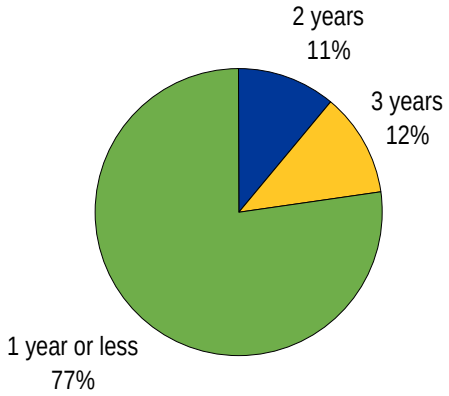
Future Capacity

In 2004, 38% of investors indicated they required future capacity rights in their hedge funds. This year we saw an increase: 45% of all investors indicate they require future capacity rights [not shown in chart] and 55% of funds of funds report they require future capacity rights as terms set when investing [see Chart 11]. We feel this is due to the massive amounts of capital we have seen flow into the industry over the last two years.

Lock-ups

Investors are becoming increasingly resistant to lock-up periods. In 2004, 68% of investors would only invest in managers with lock-ups of one year or less, but in 2005, the number rose to 77% [see Chart 12].

Chart 12. What Lock-up is Acceptable?

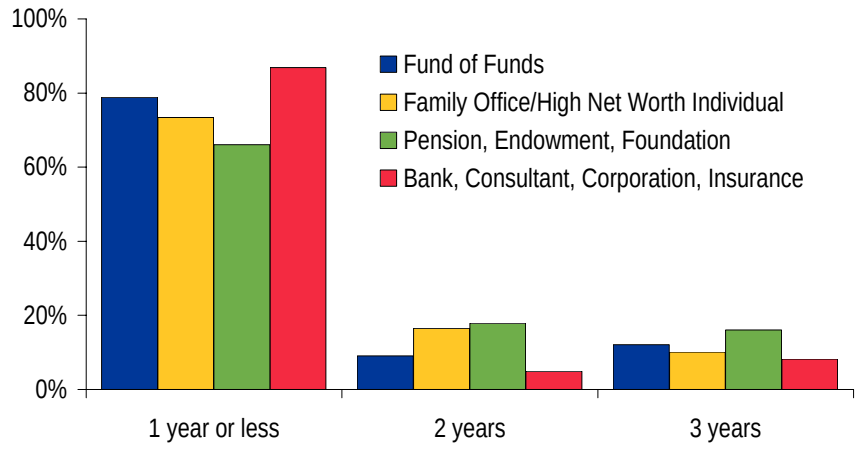


Source: 2005 Deutsche Bank Alternative Investment Survey

Maximum Lock-up

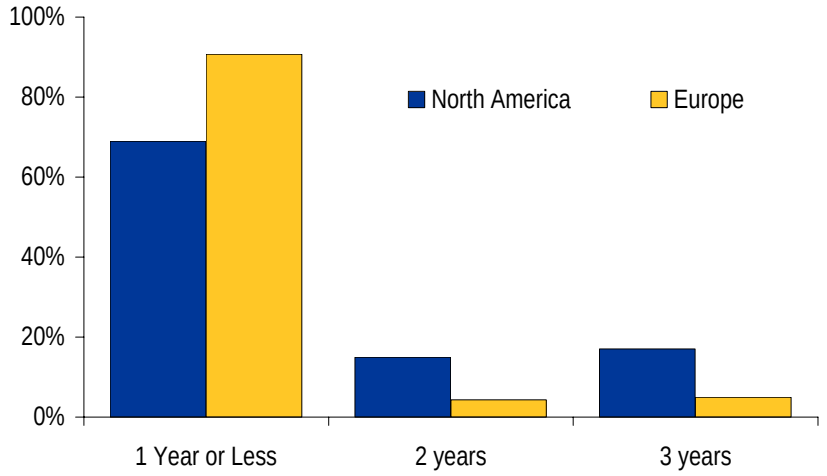
While some pensions, foundations and endowments are willing to accept longer term lock-ups, all investor groups overwhelmingly prefer lock-up periods of a year or less [as shown in Chart 13].

Chart 13. Maximum Lock-up Period



Source: 2005 Deutsche Bank Alternative Investment Survey

Chart 14. Maximum Lock-up Period (North America and Europe)



Source: 2005 Deutsche Bank Alternative Investment Survey

Lock-up and Locations

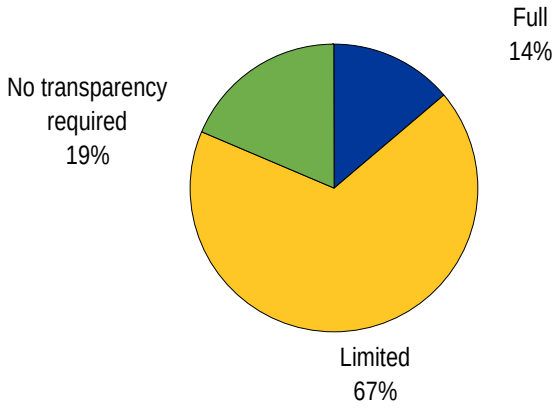
European investors are more resistant to lock-ups of over a year than North American investors. More than 90% of investors in Europe require a lock-up of a year or less, as opposed to 68% of those in North America [see Chart 14].

We note that some managers who invest in illiquid securities as well as some prominent managers, managers with limited capacity, and managers with extraordinarily high and consistent returns can and do impose longer lock-ups. Funds of funds are particularly concerned, however, that they might have a mis-match of liquidity between the lock-up terms their managers impose versus those they give their own investors. To mitigate this concern, some hedge fund managers offer terms that release investors in under a year with a penalty fee.

Transparency

14% of all investors require full transparency of position level data, and 19% of investors do not require any transparency at all. The remaining investors want some degree of transparency from their managers [as shown in Chart 15].

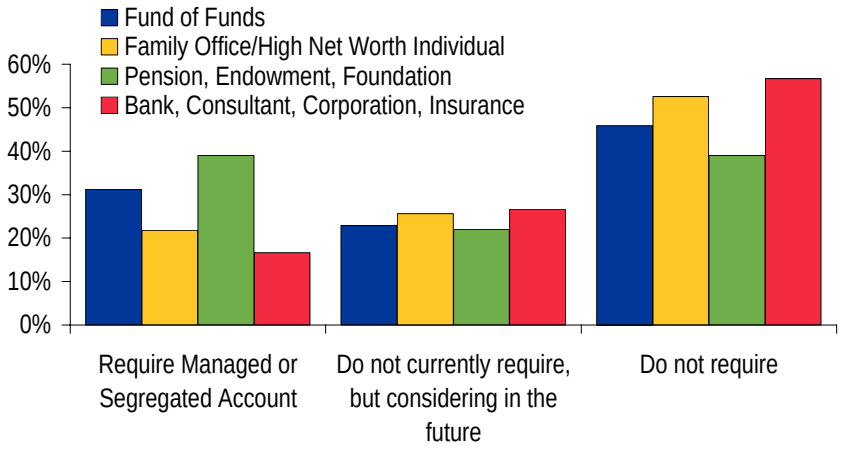
Chart 15. Degree of Transparency Requested



Source: 2005 Deutsche Bank Alternative Investment Survey

Transparency may take the form of sector breakdowns, geographic concentrations, top long positions, asset class and security type weightings. This is especially true for investments in Multi-Strategy managers where investors want to know what percentage of the manager's portfolio is invested in various trading strategies so they can properly understand their overall exposure to these strategies across their entire investment holdings.

Chart 16. Who Needs Managed or Segregated Accounts?



Source: 2005 Deutsche Bank Alternative Investment Survey

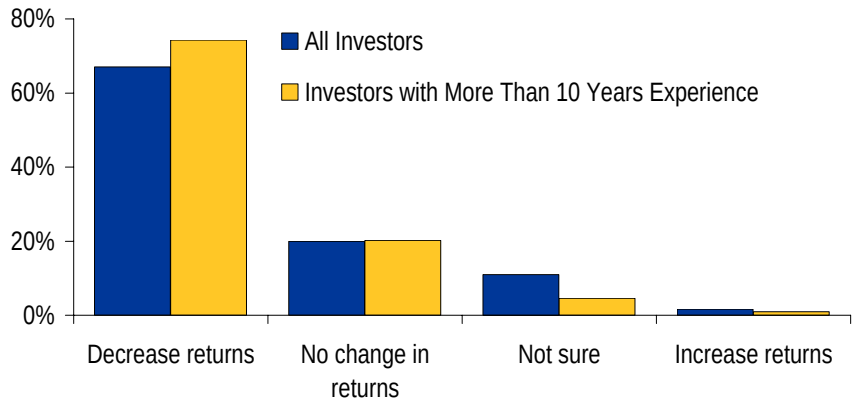
Managed Accounts

In 2004, only 20% of investors indicated they used managed accounts when investing in hedge funds. For those unfamiliar with this term, we refer to a hedge fund's management of a separate pool of capital for an investor. Managed accounts often have different terms and conditions than the main fund. This year, we see an increase to 29% of investors using managed accounts [not shown in chart]. The use of managed accounts is highest among foundations (50%) and lowest with insurance companies (10%) [not shown in a chart].

Allocations

Allocations in 2005

Chart 17. Effect of Large Capital Inflows on Performance



Source: 2005 Deutsche Bank Alternative Investment Survey

Inflows

67% of investors feel large inflows of capital adversely effect returns. Respondents who have been investing in hedge funds for more than ten years are even more likely to believe large inflows will cause a negative impact on hedge fund returns [as shown in Chart 17].

Investors plan to increase their allocations to hedge funds again this year. Smaller investors, such as those with assets under $500 million, plan to increase their investments to hedge funds more than larger investors as a percentage of their total investment holdings [see Table 4].

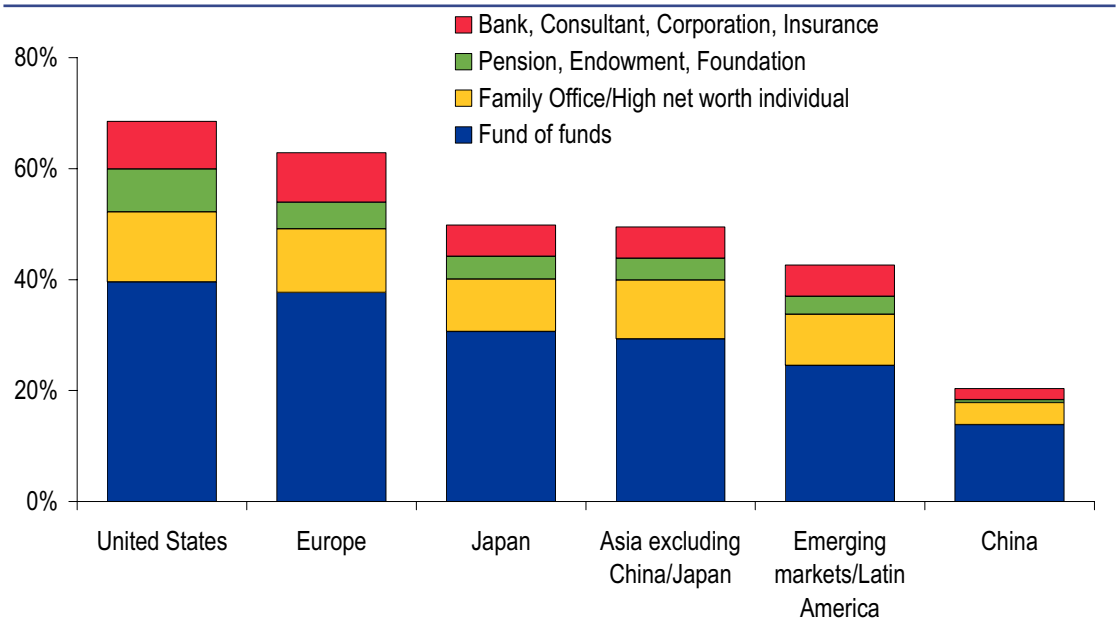
Table 4. Allocation Growth in 2005

Investor Assets	Allocation Increase
Greater than $5 billion AUM	+2.17%
$1 billion to $5 billion AUM	+2.52%
$500 million to $1 billion AUM	+3.90%
Under $500 million	+6.26%

Source: 2005 Deutsche Bank Alternative Investment Survey

Allocations in 2005: Regions

Chart 18. Current Regional Exposure in Portfolio*



** Columns will not add up to 100% as multiple selections were allowed.*
Source: 2005 Deutsche Bank Alternative Investment Survey

Holdings

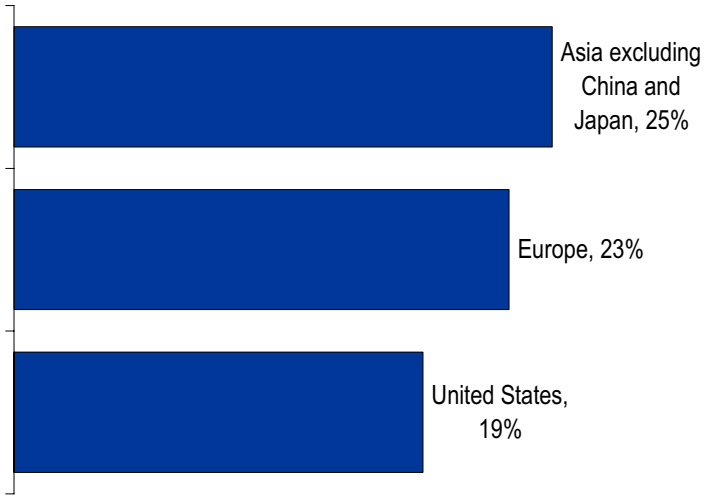
We asked investors to which regions they currently have exposure. Approximately 68% of investors polled currently have holdings in managers investing in the US market and 63% in the European market [see Chart 18].

For the last two years investors have told us that they would be increasing their exposure to European and global managers. This year we see exposure to Europe reaching levels comparable to those of the United States [as shown in Chart 18]. The exception is American pensions, endowments and foundations who favor hedge funds trading in United States securities more than other markets.

Performance Predictions

Investors predict Asia, excluding China and Japan, will be the top performing region this year. With investment focus on China over the last few years, investors feel the surrounding countries, including India, Korea, and Singapore, will offer greater opportunities in 2005. Europe comes in a close second [see Chart 19].

Chart 19. Top Predicted Regions in 2005 with Percent of Investors Selecting*



** Columns will not add up to 100% as multiple selections were allowed.*
Source: 2005 Deutsche Bank Alternative Investment Survey

Investors are acting on their predictions with 73% increasing allocation to Asia excluding China and Japan. 55% of investors will increase allocations to Europe and 26% will increase allocations to the United States [as shown in charts 20, 22 and 24].

Japan ranks high in new investments, even though investors believe the US will outperform Japan in 2005. This may be explained by the relative lack of exposure investors have to the Japanese market. Only 50% of investors have any Japanese hedge fund holdings in their portfolio [as noted in Chart 18]. The following diagram is a snapshot of allocation changes discussed in greater depth over the next few pages.

Diagram 1. Expected Asset Flow Over the Next Six Months Ranked by Investor Response

↑↑ Asia excluding China and Japan

↑↑ Europe

↑↑ Japan

↑↑ Emerging Markets/Latin America

↑ China

↑↓ United States

KEY

↑↑ 20% or more respondents will increase allocations

↑ Between 10% and 20% of respondents will increase allocations

↓↑ Responses included balanced numbers of increases and decreases of allocation

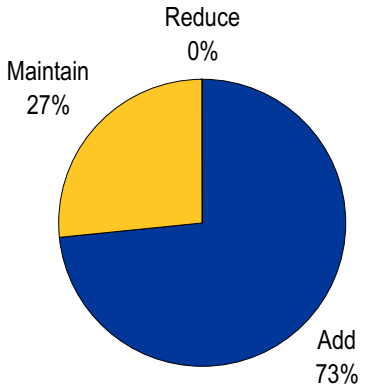
↓ Between 10% and 20% of respondents will decrease allocations

↓↓ 20% or more respondents will decrease allocations

Asia excluding China/ Japan

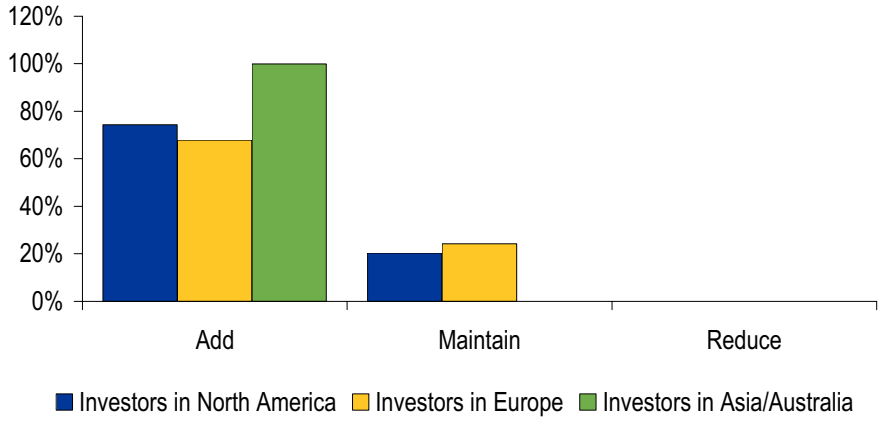
As noted earlier in the survey, Asia excluding China and Japan is predicted to be the best performing region in 2005. Three-quarters of current investors across all investor types express interest in adding to their exposure and none indicate they will reduce exposure [as shown in Chart 20]. In addition, 100% of Asian investors responding to the survey indicate they will increase their Asian allocations [see Chart 21 on next page].

Chart 20. Portfolio Allocation to Asia Excluding China and Japan



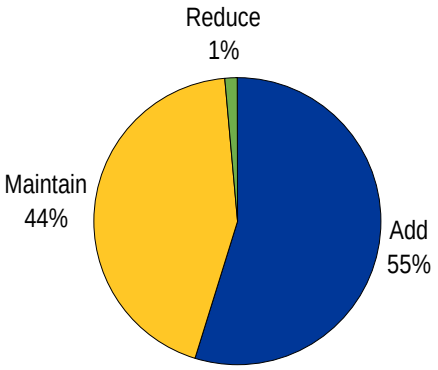
Source: 2005 Deutsche Bank Alternative Investment Survey

Chart 21. Portfolio Allocation to Asia Excluding China and Japan by Investor Location



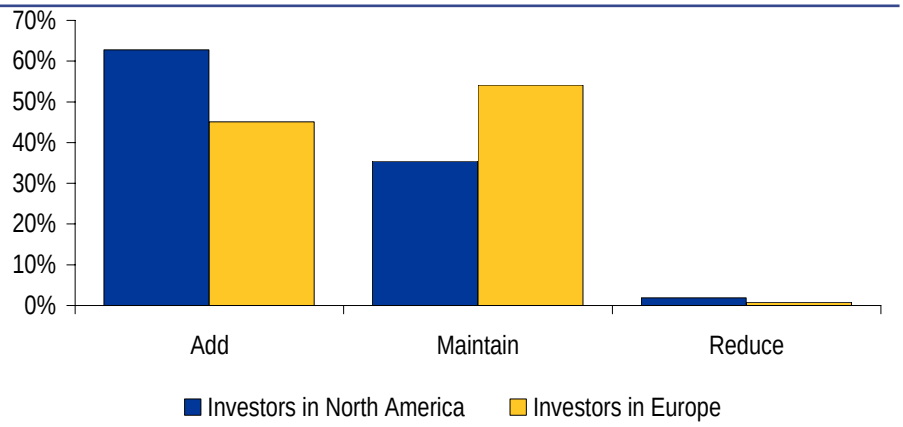
Source: 2005 Deutsche Bank Alternative Investment Survey

Chart 22. Portfolio Allocation to Europe



Source: 2005 Deutsche Bank Alternative Investment Survey

Chart 23. Portfolio Allocation to Europe by Investor Location

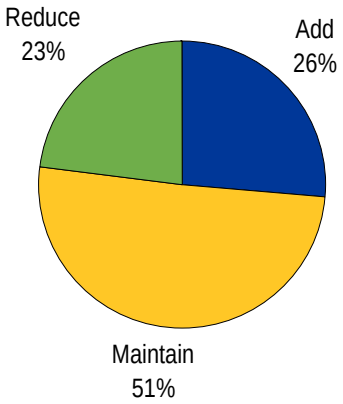


Source: 2005 Deutsche Bank Alternative Investment Survey

Europe

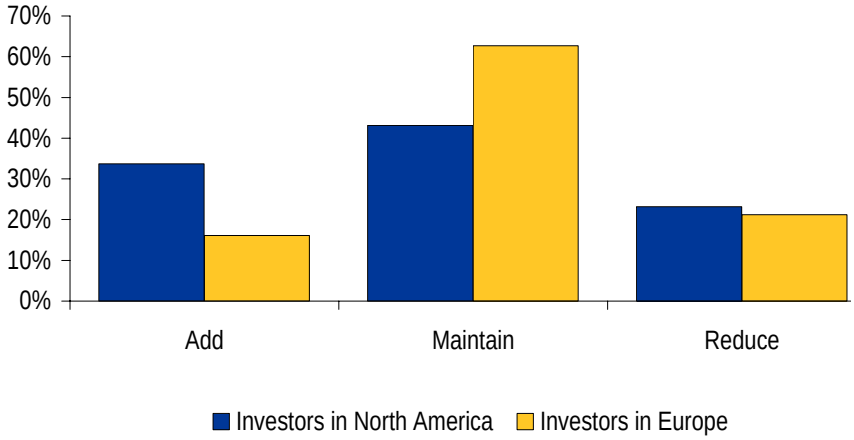
For the third consecutive year, investors express interest in increasing European exposure. 23% of investors rank Europe as a top performer in 2005 [Chart 19] and 55% indicate they will be increasing their exposure to this region [Chart 22]. Investors across all categories are interested in Europe, but there is particularly strong interest from North American investors [see Chart 23].

Chart 24. Portfolio Allocation to United States



Source: 2005 Deutsche Bank Alternative Investment Survey

Chart 25. Portfolio Allocation to United States by Investor Location



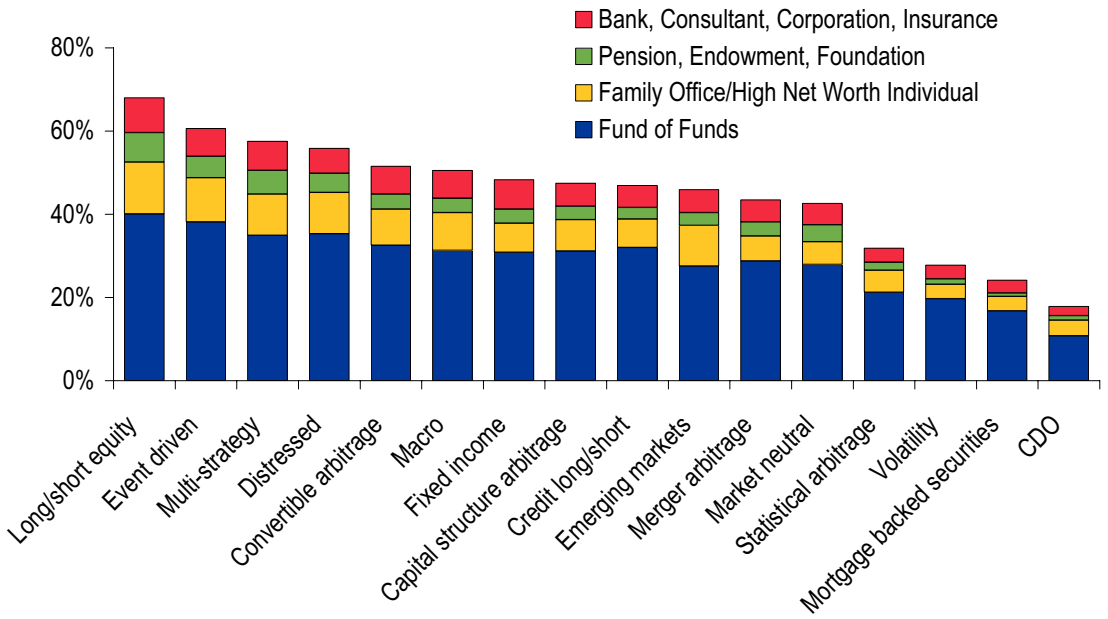
Source: 2005 Deutsche Bank Alternative Investment Survey

United States

51% of investors indicate they will maintain their present weighting in the United States [as shown in Chart 24]. There is more than twice as much interest from North American investors to increase their United States allocations (34%) than from European investors (16%) [Chart 25]. But overall, those increasing and those decreasing their exposure are fairly evenly balanced, resulting in no material change in the number of investors allocating to this region [Chart 24].

Allocations in 2005: Strategies

Chart 26. Current Strategies in Portfolio*



** Columns will not add up to 100% as multiple selections were allowed.*
Source: 2005 Deutsche Bank Alternative Investment Survey

Holdings

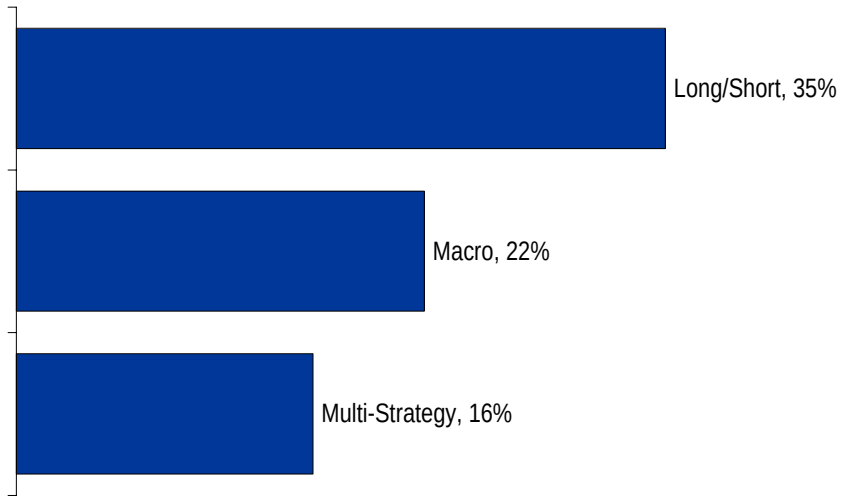
We asked investors which strategies they currently hold in their portfolios [as shown in Chart 26]. Approximately 68% of investors polled currently have allocations to Long/Short equity managers.

Respondents report current investments in a wide variety of hedge fund strategies. The strategies with the deepest penetration from investors are Long/Short Equity, Event Driven and Multi-strategy.

Performance Predictions

Each year we ask which strategies investors predict will perform best: 35% of investors rank Long/Short Equity as the top performing strategy for 2005. This is the second year Long/Short Equity is among the top three predicted best performers. Macro makes its third appearance in the top three with 22% of investors selecting it as a top performer. Rounding out the top three is Multi-strategy, making its first appearance in the top tier this year with 16% of investors selecting it as a top performer [see Chart 27].

Chart 27. Top Predicted Strategies in 2005 With Percent of Investors Selecting*

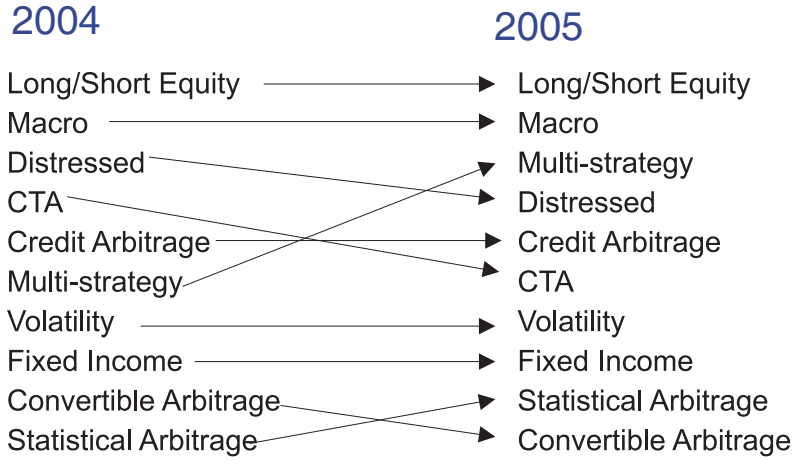


** Columns will not add up to 100% as multiple selections were allowed.*
Source: 2005 Deutsche Bank Alternative Investment Survey

Predictions

In prior surveys we also asked investors to indicate strategies they believed would perform well. Diagram 2 illustrates the movement of some of the strategies since last year. Note that most strategies retain their relative position on the list, while a few, like Multi-strategy have taken large leaps.

Diagram 2. Top Predicted Performing Strategies



Source: 2005 Deutsche Bank Alternative Investment Survey

In 2005, as in previous surveys, allocations will tend to follow predictions of best strategy. As an example, very few investors believe Convertible Arbitrage will be a top performer in 2005, and thus 44% indicate they will reduce their Convertible Arbitrage holdings this year [as shown in Chart 43 later in this report].

Sometimes, however, investors do not follow their predictions. This year Multi-strategy was a predicted top performer, but more investors indicated they would increase their allocations to Long/Short Equity, Event Driven, Macro and Emerging Markets, than to Multi-strategy. [See Diagram 3].

The following diagram is a snapshot of investor allocation changes discussed in greater depth on the following pages.

Diagram 3. Expected Asset Flow Over the Next Six Months Ranked by Investor Response

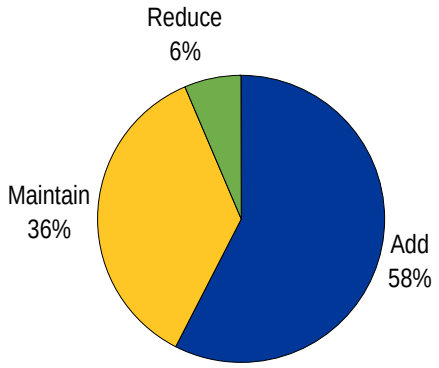
↑↑ Long/Short Equity
↑↑ Event Driven
↑↑ Macro
↑↑ Emerging Markets
↑↑ Multi-strategy
↑↑ Credit Long/Short
↑↑ Fixed Income
↑ Volatility
↑ Market Neutral
↑↓ Merger Arbitrage
↑↓ Statistical Arbitrage
↑↓ Short Sellers
↓ Distressed
↓↓ Convertible Arbitrage

Source: 2005 Deutsche Bank Alternative Investment Survey

KEY

↑↑ 20% or more respondents will increase allocations
↑ Between 10% and 20% of respondents will increase allocations
↓↑ Responses included balanced numbers of increases and decreases of allocation
↓ Between 10% and 20% of respondents will decrease allocations
↓↓ 20% or more respondents will decrease allocations

Chart 28. Portfolio Allocation to Long/Short Equity

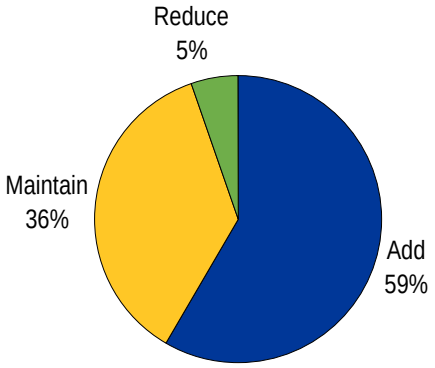


Source: 2005 Deutsche Bank Alternative Investment Survey

Long/Short Equity

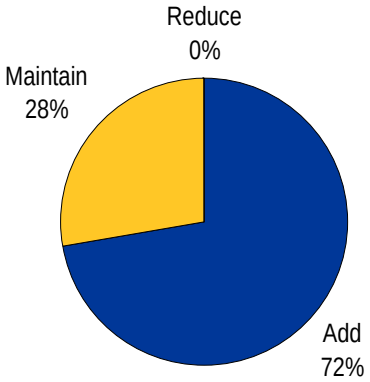
Investors predict Long/Short Equity will have the best returns for 2005. 58% of investors indicate they will add to the strategy. We note that all categories of investors are universally interested in increasing their allocations to Long/Short Equity managers.

Chart 29. Portfolio Allocation to Macro



Source: 2005 Deutsche Bank Alternative Investment Survey

Chart 30. Portfolio Allocation to Macro (Pensions, Endowments, Foundations)



Source: 2005 Deutsche Bank Alternative Investment Survey

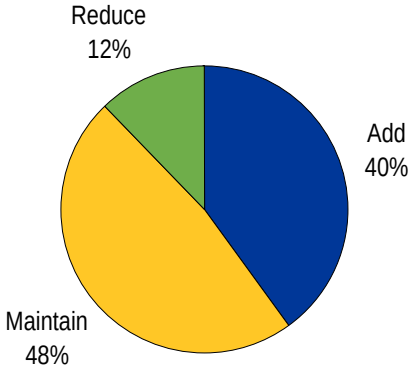
Macro

Investors predict Macro managers will be some of the top performers in 2005. 59% of investors plan to increase allocations to Macro managers [as shown in Chart 29]. In addition, 24% of pensions, endowments and foundations have current Macro allocations [as shown previously in Chart 26], and nearly three quarters plan to increase their allocations [see Chart 30]. None of the pensions, endowments and foundations surveyed indicated that they would reduce their exposure to Macro managers [Chart 30].

Multi-strategy

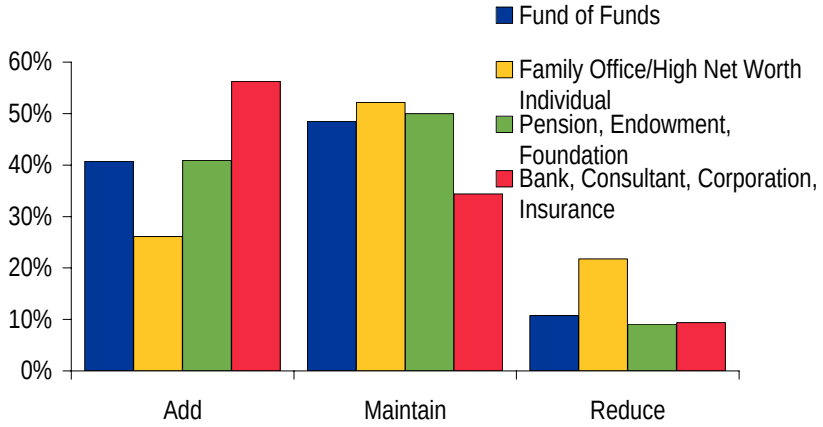
Multi-strategy managers are predicted to perform well in 2005. 40% of investors indicate they will add to managers in this category while 12% will reduce their allocations [Chart 31]. 56% of banks, consultants, corporations and insurance companies seek to increase allocations to Multi-strategy. Only 26% of family offices and high net worth individuals will be increasing exposure while 22% of investors in this category will be reducing exposure [see Chart 32]. Many investors told us they prefer Multi-strategy managers over single strategy managers because they can more nimbly allocate capital across different strategies in the current dynamic market environment.

Chart 31. Portfolio Allocation to Multi-Strategy



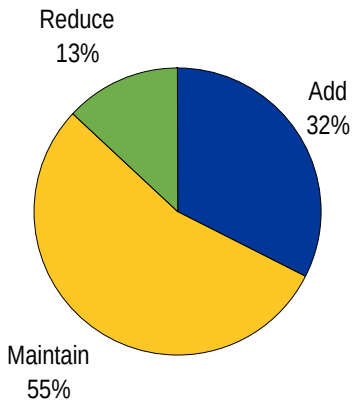
Source: 2005 Deutsche Bank Alternative Investment Survey

Chart 32. Portfolio Allocation to Multi-Strategy



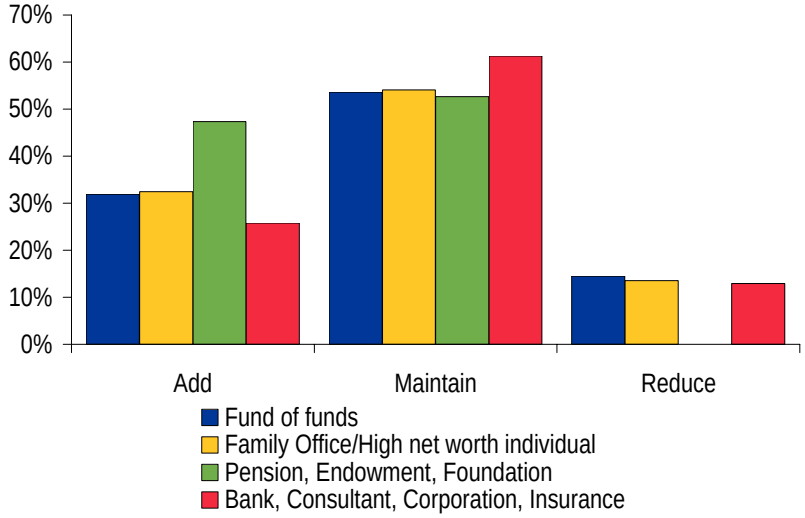
Source: 2005 Deutsche Bank Alternative Investment Survey

Chart 33. Portfolio Allocation to Credit Long/Short



Source: 2005 Deutsche Bank Alternative Investment Survey

Chart 34. Portfolio Allocation to Credit Long/Short



Source: 2005 Deutsche Bank Alternative Investment Survey

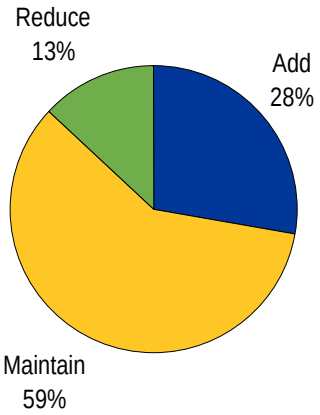
Credit Long/Short

32% of investors indicate an interest in increasing allocations to Credit Long/Short [Chart 33] even though the strategy was not selected as one of the top predicted performers. 47% of pensions, endowments and foundations plan to increase their Credit Long/Short exposure. About one third of funds of funds, family offices and high net worth individuals will also be adding to this strategy. Banks, corporations, consultants, and insurance companies are taking a more conservative view with 61% retaining their current exposure and only 26% making additions. There will be no reduction in exposure to credit managers from the pensions, endowments and foundations surveyed [Chart 34].

Fixed Income

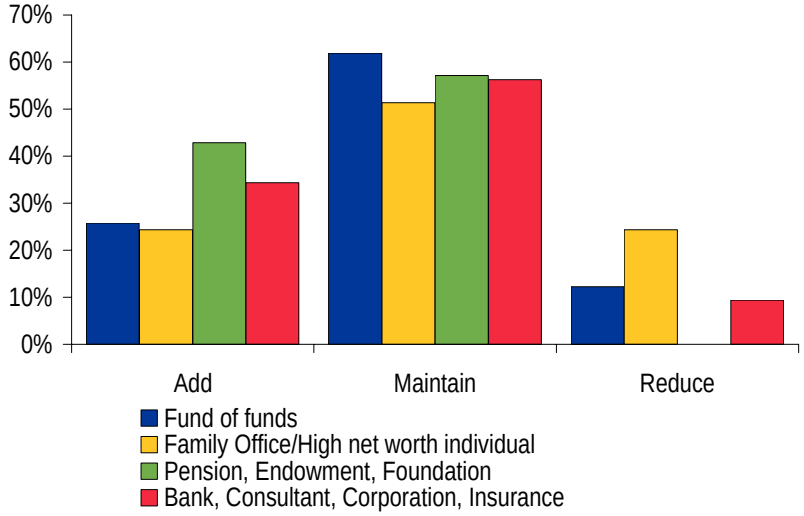
59% of investors indicate they will stay invested in Fixed Income and 28% will increase allocations [see Chart 35]. Fixed Income is particularly attractive to pensions, endowments and foundations as well as banks, corporations, consultants, and insurance companies. 43% of pensions, endowments and foundations will be adding and none will be reducing their Fixed Income investments [Chart 36].

Chart 35. Portfolio Allocation to Fixed Income



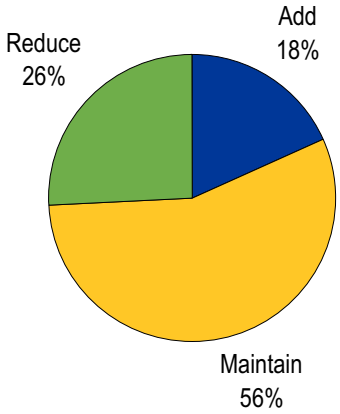
Source: 2005 Deutsche Bank Alternative Investment Survey

Chart 36. Portfolio Allocation to Fixed Income



Source: 2005 Deutsche Bank Alternative Investment Survey

Chart 37. Portfolio Allocation to Distressed



Source: 2005 Deutsche Bank Alternative Investment Survey

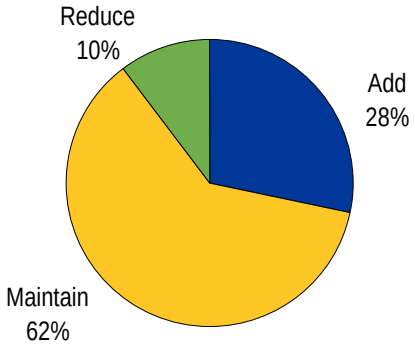
Distressed

Investors do not believe Distressed will be a top performer in 2005. 26% of investors indicate they will reduce exposure, while only 18% will add. While we see some inflows and outflows, the majority, 56%, will maintain their current allocation level in Distressed funds [Chart 39].

Market Neutral

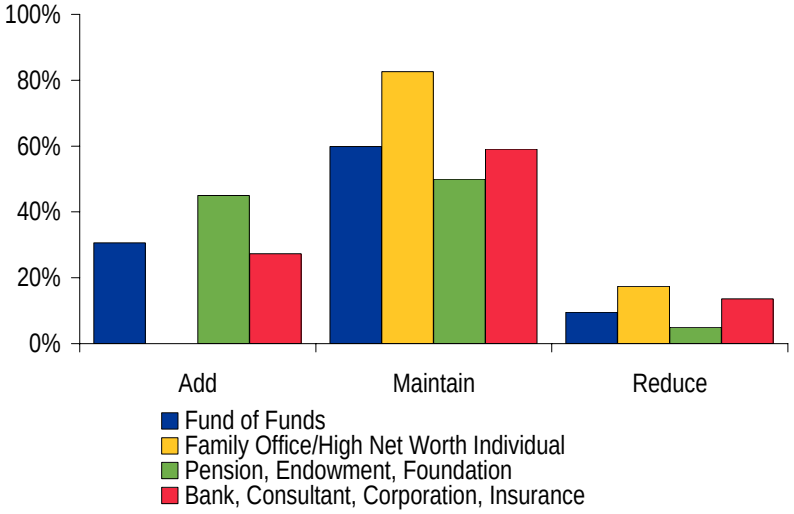
Market Neutral will see some inflows, with 28% of investors adding holdings and only 10% reducing [Chart 38]. Family offices and high net worth individuals will not be adding to Market Neutral. Instead they will maintain or reduce their holdings [Chart 39].

Chart 38. Portfolio Allocation to Market Neutral



Source: 2005 Deutsche Bank Alternative Investment Survey

Chart 39. Portfolio Allocation to Market Neutral

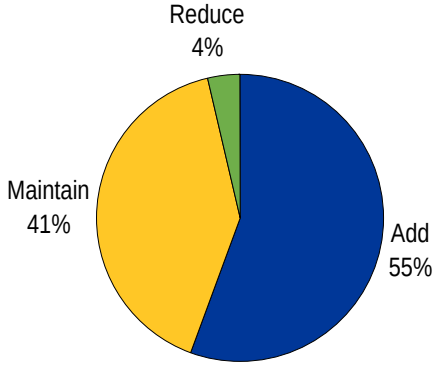


Source: 2005 Deutsche Bank Alternative Investment Survey

Event Driven

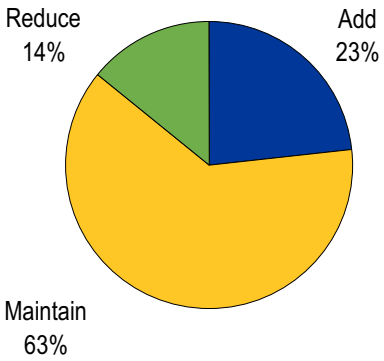
Investors indicate a strong interest in the Event Driven strategy, the second most popular strategy in 2005. 55% of investors across all categories plan to increase their allocations to Event Driven funds [Chart 40].

Chart 40. Portfolio Allocation to Event Driven



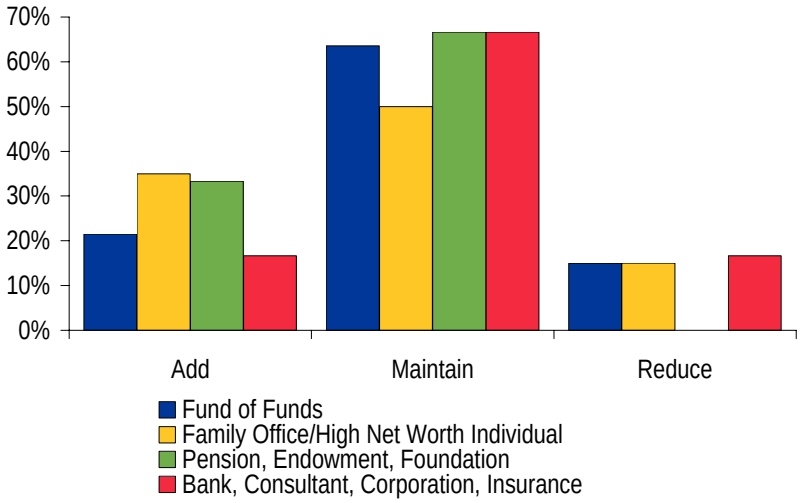
Source: 2005 Deutsche Bank Alternative Investment Survey

Chart 41. Portfolio Allocation to Statistical Arbitrage



Source: 2005 Deutsche Bank Alternative Investment Survey

Chart 42. Portfolio Allocation to Statistical Arbitrage



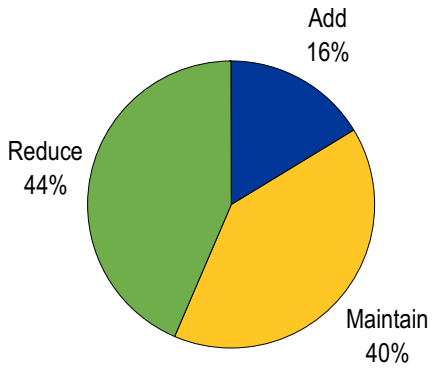
Source: 2005 Deutsche Bank Alternative Investment Survey

Statistical Arbitrage

Although investors do not expect Statistical Arbitrage to be one of the top performing strategies for 2005, more than 23% of respondents plan to increase their allocations [Chart 41].

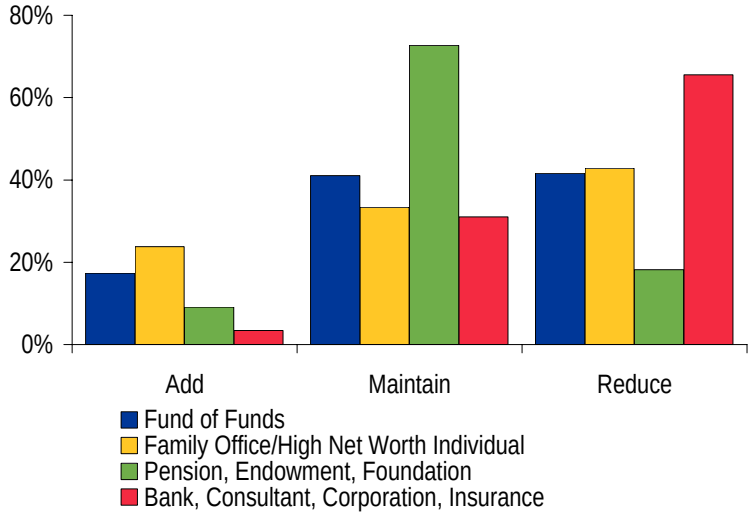
In addition, we see disproportionate interest from family offices, high net worth individuals, pensions, endowments and foundations in adding Statistical Arbitrage investments. In fact, no pension, endowment or foundation surveyed plans to reduce their Statistical Arbitrage exposure [Chart 42].

Chart 43. Portfolio Allocation to Convertible Arbitrage



Source: 2005 Deutsche Bank Alternative Investment Survey

Chart 44. Portfolio Allocation to Convertible Arbitrage



Source: 2005 Deutsche Bank Alternative Investment Survey

Convertible Arbitrage

At the time of the survey, investors had already begun downsizing their investments in dedicated Convertible Arbitrage funds and they indicate they will continue to downsize for at least the next two quarters, June and September.

Over the past several months, we have seen many of the funds of funds reduce their exposure to Convertible Arbitrage managers. Many funds of funds indicate they will keep a minimum exposure through Multi-strategy managers.

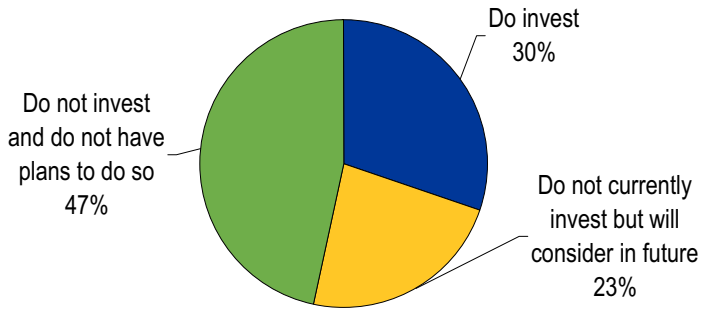
16% of investors indicate they will add to their Convertible exposure [see Chart 44] when the market bottoms and the massive redemption cycle ends (which they estimate will be later this summer). Retail oriented funds of funds show the highest reductions in this category, while pensions, endowments and foundations are the most tenacious investors with Convertible managers. The vast majority of pensions, endowments and foundations (73%) will maintain their allocations in this sector [Chart 44].

Structured Products

Strong investor interest in structured products continues [Chart 45]. More than half of investors surveyed are either using structured products or are considering them. The greatest concentration of investors is in enhanced leverage products, followed closely by guaranteed or principally protected products and swaps [Chart 46].

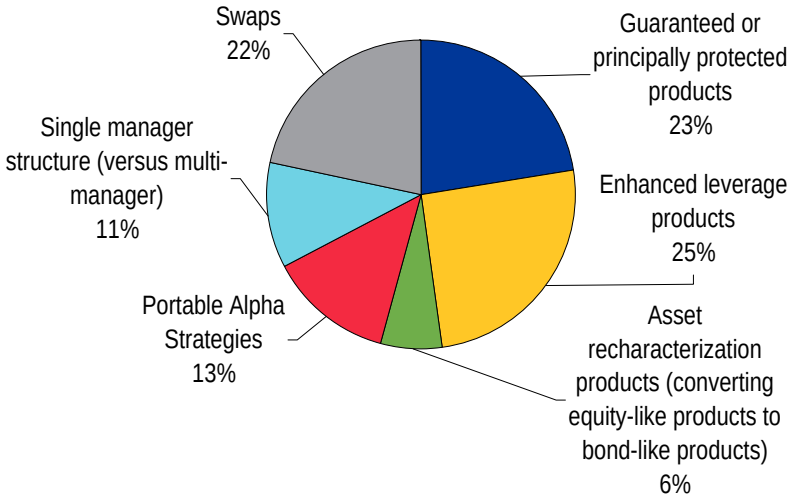
We found funds of funds are almost evenly split between those who use leverage and those who have no plans to employ leverage (41% each). But with 18% of funds of funds interested in applying leverage in the future, this balance may soon change [see Chart 47].

Chart 45. Portfolio Allocation to Structured Products



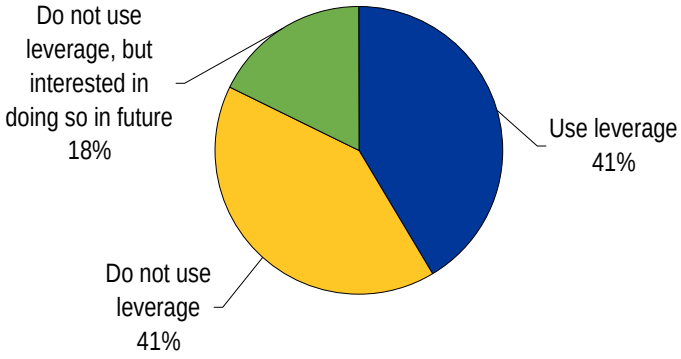
Source: 2005 Deutsche Bank Alternative Investment Survey

Chart 46. Structured Products Presently Used by Hedge Fund Investors



Source: 2005 Deutsche Bank Alternative Investment Survey

Chart 47. Leveraged Used by Fund of Funds



Source: 2005 Deutsche Bank Alternative Investment Survey

Conclusions

General Conclusions

The overall health and enthusiasm of the hedge fund industry is not a concern for most investors who took this year's survey. Many investors are still receiving inflows of capital and allocating this capital to new and existing hedge fund managers.

We note, however, that this year's investor asset growth has slowed considerably from the record levels we saw in early 2004. Also, some manager strategies (such as Convertible Arbitrage) have experienced significant investor redemptions due to challenging conditions in the first half of 2005.

Allocation trends

This year investors report the average size of an investment into a hedge fund was $19 million, consistent with last year's survey.

Smaller investors, such as those with assets under $500 million plan to increase their investments to hedge funds more than larger investors as a percentage of their total investments. Investors who have assets greater than $5 billion under management will increase their allocations this year by 2%. Many of these large investors have hundreds of billions of dollars under management and small changes in their asset allocations to hedge funds will continue to have a large effect on overall industry growth.

- 58% of investors indicate they will increase their allocations to Long/Short Equity managers. 55% of investors plan to increase their allocations to Event Driven funds, and 59% of investors plan to increase allocations to Macro managers.
- Multi-strategy funds continue to gain popularity with most categories of investors this year, largely due to their ability to dynamically allocate capital across investment strategies in changing market environments.
- European investors typically make more allocations each year to hedge fund managers than do North American investors. The average size of allocations from European investors tends to be smaller than those of North American investors.
- 55% of investors will increase their exposure to managers who trade European securities. A higher proportion of North American investors will increase their European holdings than European investors.
- Asia is a big focus in 2005, with 73% of investors indicating they will increase their allocations to Asia excluding China and Japan. However, many found it difficult to find hedge funds in the region who meet their investment requirements.

Performance Predictions

68% of investors believe the hedge fund industry will return 6% to 8%. Investors feel that record asset inflows depress returns.

Investors predict Long/Short Equity managers will be the best performing managers in 2005. This is the second year Long/Short Equity is among the top three predicted best performers, with 35% of investors selecting the strategy. Macro makes its third appearance in the top three strategies with 22% of investors selecting it as a top performer. Rounding out the top three is Multi-strategy, making its first appearance in the top tier this year with 16% of investors selecting it as a top performer.

Trends in investment terms

Investors will continue to resist longer lock-ups of their capital by managers, and those managers who require lock-ups of over a year will need to focus on the quarter of the investor marketplace willing to accept them, mostly in North America. Pensions, endowments, and foundations as well as some of the largest funds of funds are typically the investor groups willing to accept lock-ups of longer than one year.

Pensions, Endowments and Foundations

Pensions, endowments and foundations hold the smallest number of hedge funds within their portfolios. 58% invest in less than 10 individual managers and 80% have portfolios with fewer than 20 managers. We continue to observe that this group tends to be "sticky money" meaning that once invested, they are very loyal investors and hold their positions longer than any other group of investors.

Pensions, Endowments and Foundations do not necessarily require a longer time to make investment decisions than other investors. 50% of them can make allocation decisions in under six months while 78% can reach a decision in under one year.

Allocation trends

Pensions, endowments and foundations make fewer allocations each year than other investor types. This group will make, on average, 4 allocations to hedge funds annually, compared to funds of funds with 15 allocations annually.

- 39% of pensions, endowments and foundations indicate their managers average over $1 billion in assets under management.
- 43% of pensions, endowments and foundations plan to increase their exposure to Fixed Income managers.
- 47% will increase their exposure to managers specifically focused on Credit analysis and none of those surveyed will decrease their exposure.
- 24% of pensions, endowments and foundations will increase their holdings in Macro strategies and none of those surveyed will decrease their holdings.

Family Offices and High Net Worth Individuals

Family offices and high net worth individuals are investing in a growing number of hedge funds, with 49% having between 21 and 100 managers in their portfolios. Very few (2%) invest in over 100 managers each.

Allocation trends

Family offices and high net worth individuals make, on average, 10 new allocations to managers each year. Family offices and high net worth individuals make the smallest size allocations of all investor types, averaging just $11 million per manager.

- 58% of family offices can make new allocation decisions in fewer than 6 months.
- 35% of family offices indicated they would add to Statistical Arbitrage strategies and none surveyed indicate they would be adding to Market Neutral funds.

Trends in investment terms

Future investment capacity rights are not as important to family offices as for fund of funds, banks, consultants, corporations and insurance companies. Only 29% of family offices ask for this option when investing in a manager.

- 73% of family offices prefer managers with a year or less lock-up provision.
- 22% of family offices invest in managers through managed or separate accounts.

Funds of Funds

Funds of funds are generally the most experienced investors in the hedge fund market, with 56% having over ten years of direct investing experience.

Funds of funds make, on average, 15 new investments in managers each year, making them the most frequent source of capital.

69% of funds of funds hold between 21 and 100 direct investments in different managers and 11% of them have over 100 managers in their portfolios.

Over half of funds of funds either have existing leverage products or will consider applying leverage sometime in the future to enhance their returns.

More funds of funds (62%) can reach an investment decision in less than 6 months than any other investor group.

Allocation trends

- On average, a fund of funds makes allocations of $19 million to each of its managers.
- Funds of funds are the primary investors in hedge funds under $100 million.

Trends in investment terms

- As many fund of funds offer their own investors flexible liquidity terms, 79% indicated that they will only invest in a manager who has a lock-up of one year or less.
- 55% of funds of funds ask for future capacity rights when investing in new managers.

Banks, Consultants, Corporations and Insurance Companies

Banks, consultants, corporations, and insurance companies are providing the largest individual allocations to hedge funds, averaging $26 million, larger than other investor types. They make the second largest number of investments into hedge funds each year, on average 12 new hedge fund investments a year.

Allocation trends

- 56% of this group plan on increasing their allocations to Multi-strategy managers.
- 66% of banks, consultants, corporations and insurance companies indicate they will reduce their exposure to Convertible managers and only 3% said they will add Convertible Arbitrage holdings.

Trends in investment terms

Banks, consultants and insurance companies prefer to lock-up their capital for no more than a year. 87% will not invest with a manager who has terms requiring investors to lock-up their capital longer than one year.

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