

HEDGE FUND RESEARCH STUDY

March 2007



STATE STREET®

2007 State Street Hedge Fund Research Study

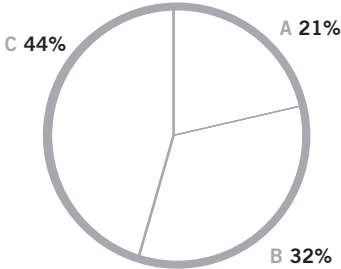
Background

State Street, in conjunction with the Global Absolute Return Congress (Global ARC), conducted a study among institutional investors at the 2006 Global ARC event, held in Boston on October 23-25, 2006. The study results reflect the role of alternative investments, including hedge funds and private equity, in institutional investors' portfolios and their general views on these investment strategies.

Institutional investors are represented by a cross section of global conference attendees including corporations, public and government pension plans, endowments and foundations. According to Global ARC, the responding institutions collectively manage more than \$1 trillion total assets in their investment portfolios. Other conference attendees, including hedge fund managers, fund of hedge fund managers, consultants and service providers, were not eligible to participate in the study.

Respondent Breakdown

- A Corporate Pensions
- B Public Pensions
- C Endowments/Foundations



Methodology

The information contained in this report is derived from a Web-based study conducted during the event. One delegate from each participating organization anonymously and confidentially recorded his or her organization's views on hedge funds and private equity funds. Results for each question reflect the views of the entire pool of respondents.

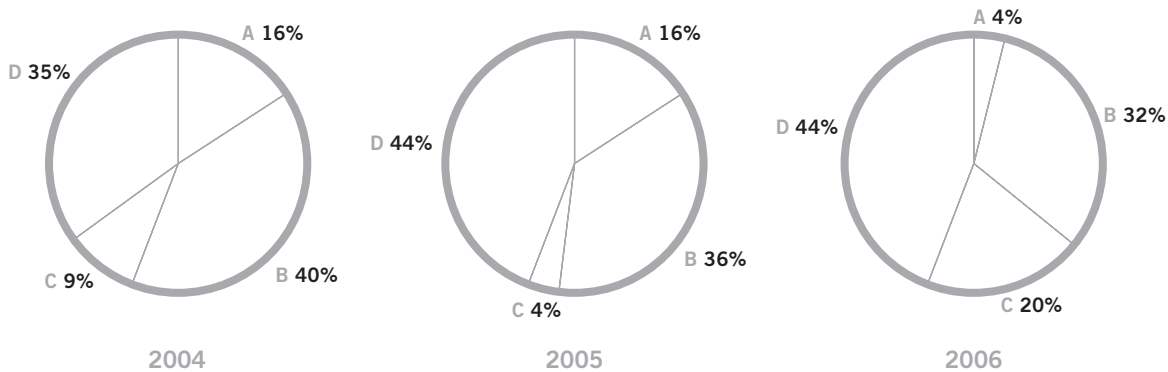
Key Findings

1. Institutions continue to increase allocations to alternative investment vehicles.

HEDGE FUND PROGRAMS COMPRISE A LARGER SHARE OF INSTITUTIONAL INVESTORS' OVERALL PORTFOLIO ALLOCATION. Nearly two-thirds (64%) of institutions reported having more than 5% of their portfolio allocated to hedge funds. This represents a marked increase over 2005, when only about half (48%) of plans had this level of allocation to hedge funds. Also in 2006, more plans began investing in hedge funds, as demonstrated by a drop in the number of plans not invested in hedge funds from 16% to only 4% today.

Percent of Portfolio Allocated to Hedge Funds

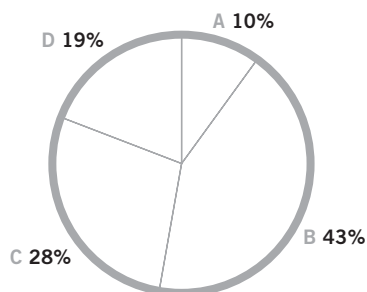
- A 0%
- B Between 1% and 5%
- C Between 5% and 10%
- D 10% or more



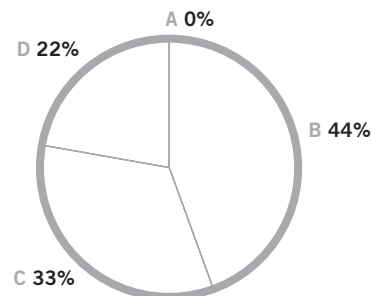
ON THE PRIVATE EQUITY SIDE, ALLOCATIONS HAVE REMAINED MORE OR LESS STABLE YEAR-OVER-YEAR, INCHING UP ONLY SLIGHTLY. However, all responding institutions now have an allocation to private equity. By contrast, 10% of respondents in last year's study reported they had no private equity allocation.

Percent of Portfolio Allocated to Private Equity

- A 0%
- B Between 1% and 5%
- C Between 5% and 10%
- D 10% or more



2005



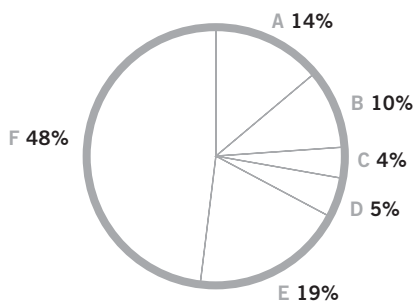
2006

THE NUMBER OF DIRECT HEDGE FUND MANAGERS HIRED ON A PER-INSTITUTION BASIS HAS RISEN. Today, over half of institutions invest with more than 10 direct hedge fund managers and 44% invest with more than 20. This implies that portfolio construction of at least half of institutional investors is in line with current empirical evidence that supports a properly diversified portfolio of hedge funds to mitigate systemic risk.

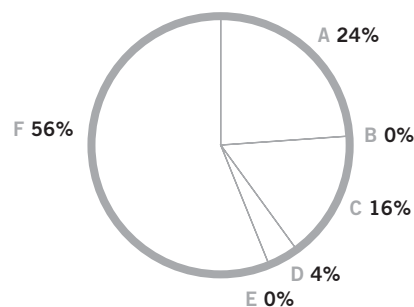
WHILE DIRECT INVESTMENT HAS GAINED MOMENTUM AMONG INSTITUTIONAL INVESTORS, THERE HAS ALSO BEEN AN INCREASE IN PLANS THAT CHOOSE TO INVEST VIA NON-DIRECT VEHICLES. That figure rose from 14% last year to 24% this year. This may be due to the influx of new investors into hedge fund investing. Study results from the 12 months earlier study indicated that new investors prefer the fund of funds route overwhelmingly.

How many direct hedge fund managers does your organization utilize?

- A None
- B 1 to 3
- C 4 to 5
- D 6 to 8
- E 8 to 10
- F More than 10



2005

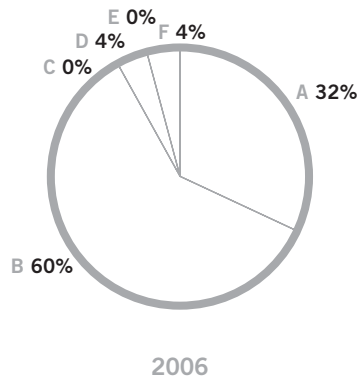
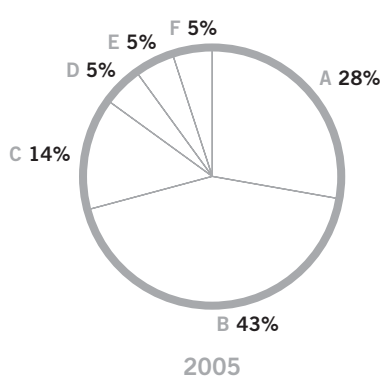


2006

INVESTMENT IN FUND OF HEDGE FUNDS IS CONCENTRATED AMONG FEWER OF SUCH MANAGERS AND MORE INSTITUTIONS ARE NOT INVESTING VIA FUND OF FUNDS. Sixty percent of institutions say they invest with between 1 and 3 fund of hedge fund managers (up from 43% last year). Nearly a third (32%) of institutions do not use the services of a fund of fund manager, up from 28% last year. Only 8% invest with more than 5 such managers, representing a drop from 15% last year. Two trends appear to be underway: new investors to hedge funds are hiring fund of fund managers, but fewer of them. Investors who have been investing longer using this approach are looking to reduce fees and in the process are leaving (or have already left) fund of funds entirely in favor of investing directly in hedge funds.

How many fund of hedge fund managers does your organization utilize?

- A None
- B 1 to 3
- C 4 to 5
- D 6 to 8
- E 8 to 10
- F More than 10

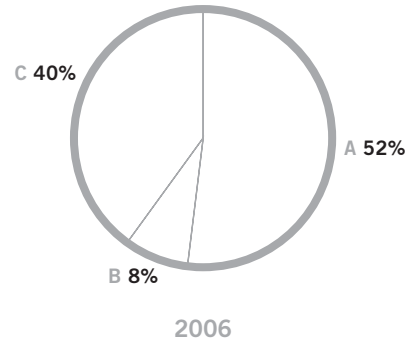
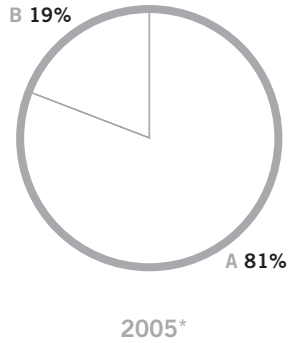


2. Investment boards and trustees continue to gain comfort with hedge funds as a component of their portfolio allocation and more dedicate a greater percentage of time discussing them.

OVER HALF OF SURVEY RESPONDENTS SAID THAT THEIR GOVERNING BODIES WERE MORE COMFORTABLE INVESTING WITH HEDGE FUNDS, AS COMPARED WITH THE RESULTS OF LAST YEAR'S STUDY WHEN 81% EXPRESSED THIS VIEW. On the other hand, 40% described their comfort level as remaining the same, and only 8% said they were not more comfortable. This represents an improvement over last year, when 19% said their comfort level had not increased.

My governing body is more comfortable with investing in hedge funds now as opposed to 12 months ago (select one).

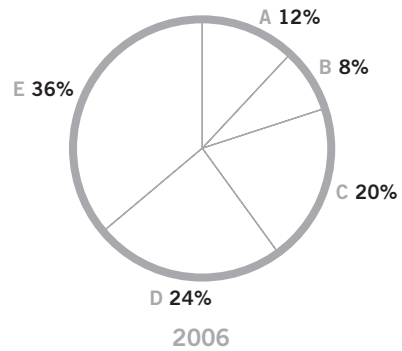
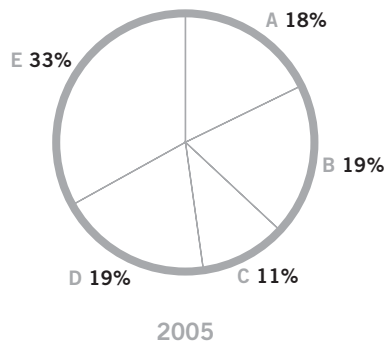
- A Yes
- B No
- C Their comfort level has remained the same



EIGHTY PERCENT OF GOVERNING BOARDS SPEND MORE THAN 10% OF THEIR TIME DISCUSSING ALTERNATIVE INVESTMENTS. Well over half (60%) spend 15% or more of their time on these investments. This represents a substantial increase over last year, when less than two-thirds (63%) said they spent more than 10% of their time and only about half (52%) spent 15% or more of their time discussing alternative strategies.

What percentage of your governing body's time do you estimate is spent discussing alternative investments?

- A Between 1% and 5%
- B Between 5% and 10%
- C Between 10% and 15%
- D Between 15% and 20%
- E More than 20%



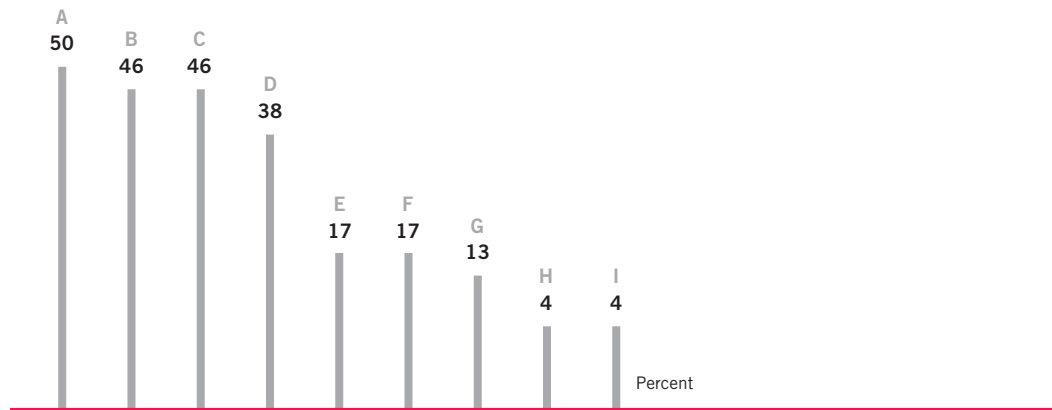
*Data for answer 'C' not applicable in 2005.

3. Investment boards plan to focus on enhancing risk management programs.

HALF OF INSTITUTIONAL INVESTORS SAID THAT THE NEGATIVE FINANCIAL EFFECTS THAT RECENT HIGHLY PUBLICIZED HEDGE FUND MANAGER DEBACLES HAVE HAD ON INSTITUTIONAL PORTFOLIOS HAVE PROMPTED THEM TO CALL FOR A MORE ROBUST RISK MANAGEMENT PROGRAM. Nearly half (46%) said they will require additional analysis and reporting from hedge fund managers. The same number said they will increase the rigor of their ongoing due diligence practices. Over a third (38%) said they will require greater transparency of information from hedge fund managers.

Overall, increased focus will be placed on risk and reporting, but few institutions (4%) plan to add to staff to address these concerns. More (17%) will increase use of third-party resources for due diligence, fund screening and/or investment recommendations.

Despite their concerns, only 4% of respondents indicate that they will reconsider their plans for greater allocations to hedge fund strategies.



A number of pensions, foundations, endowments, insurance companies and fund of hedge fund managers have been financially impacted by recent highly publicized hedge fund manager debacles. How will this affect the way your governing body and portfolio managers view and manage your hedge fund portfolio? (select all that apply)

- A They will call for a more robust risk management program
- B They will require additional analysis and reporting from their hedge fund managers
- C They will increase the rigor of their ongoing due diligence practices
- D They will call for greater transparency from their hedge fund managers
- E They will increase their use of third-party sources for due diligence, fund screening and/or investment recommendations
- F They will be leery of investing in multi-strategy funds
- G They will be more apt to invest in funds of hedge funds vs. multi-strategy funds
- H They will reconsider targets for increased allocation
- I They will add more individuals to their in-house staff dedicated to hedge funds

4. Risk management approach and framework are investment boards' primary concerns in terms of the tools and talent dedicated to alternative investment portfolios.

NEARLY HALF (48%) OF INSTITUTIONS INDICATED THEIR IN-HOUSE RISK MANAGEMENT TOOLS/ANALYSIS COULD BE MORE ROBUST. Some acknowledged that their governing body doesn't understand alternative investments well enough (22%) and that staff dedicated to managing and monitoring the portfolio is either too small (17%) or lacks experience (9%).



What is your governing body's primary concern regarding your in-house team/tools dedicated to your alternative investment portfolio?

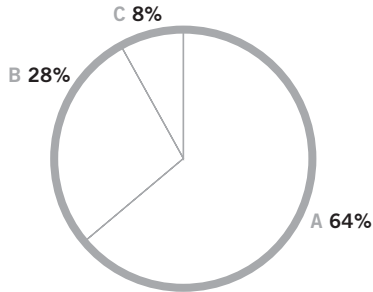
- A Risk management tools/analysis could be more robust
- B Our governing body doesn't understand alternative investments well enough
- C Staff dedicated to managing and monitoring the portfolio is too small
- D Staff dedicated to managing and monitoring the portfolio lacks enough experience
- E Staff hasn't dedicated enough time to managing and monitoring the portfolio in the past
- F Other

A MAJORITY OF INSTITUTIONS FIND IT DIFFICULT TO GAIN A COMPREHENSIVE VIEW OF RISK AMONG THEIR HEDGE FUND PORTFOLIOS. Nearly two-thirds (64%) agreed they found it problematic to aggregate risk statistics provided by all of their hedge fund holdings. Slightly more than a quarter (28%) said they didn't consider it problematic and 8% were unsure.

Improvements to the ways hedge funds account for risk are being demanded by their investors. Tools, methods, and best practices will develop over time as hedge fund products become a tried-and-true staple of pension portfolios. Asset owners will push hedge fund managers and third-party service providers, such as administrators, to develop and deliver solutions.

Each hedge fund has a unique way of measuring, managing and reporting risk. Does your organization find it problematic to aggregate the risk statistics provided by all of the hedge funds in your portfolio?

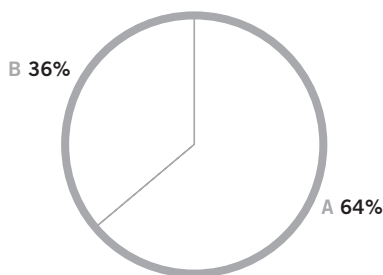
- A Yes
- B No
- C I am not sure



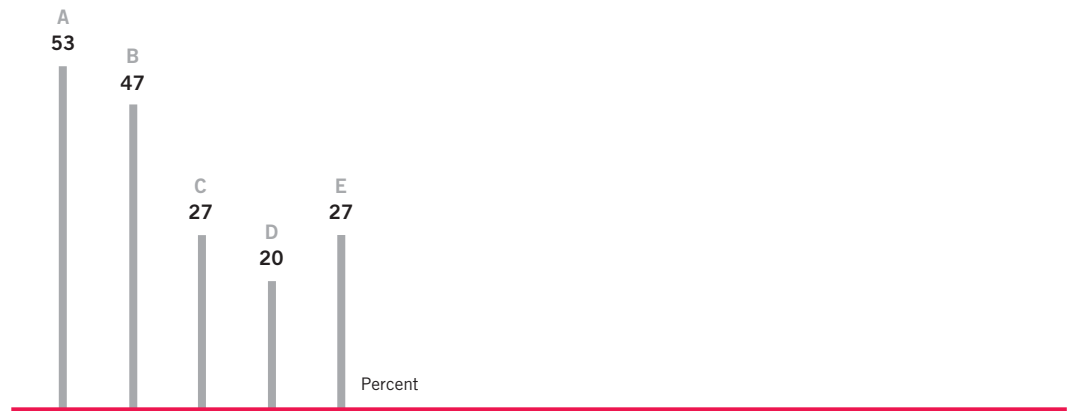
A MAJORITY ALSO AGREE THAT OBTAINING AN ACCURATE VALUATION OF HEDGE FUND HOLDINGS IS CHALLENGING. Nearly two-thirds (64%) of responding institutions said that accurately valuing their hedge fund holdings is problematic. More than a third (36%) didn't think so. For those who have concerns about pricing of hedge fund investments, however, more than half (53%) were concerned that the reason holdings may not be accurately valued is because the general partner is solely responsible for the valuation. Nearly half (47%) said their concern was that their hedge fund managers did not employ an independent administrator. Other concerns included lack of external audits (27%) and lack of SEC registration (20%).

We believe that accurately valuing our hedge fund holdings can be problematic.

- A Yes
- B No



For those who concurred that accuracy of hedge fund valuations can be problematic, the following rationales were stated:



The holdings may not be accurately valued because (select all that apply):

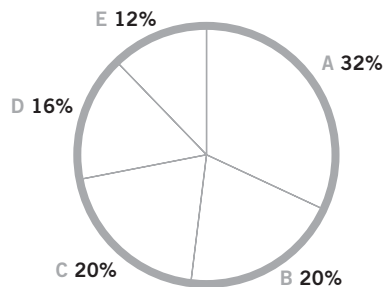
- A The general partner is solely responsible for the valuation
- B There is not an independent administrator
- C There is no external audit performed
- D The advisor is not SEC registered
- E Other

HIGH FEES OFFSETTING RETURNS WERE DEEMED THE SINGLE GREATEST THREAT TO HEDGE FUND INVESTING, WITH 32% OF RESPONDING INSTITUTIONS INDICATING THIS VIEW. Asset owners will likely begin to force fee compression for all but the most successful funds.

Among other threats, headline risk (20%) and investment loss (20%) go hand in hand, as losses from hedge funds often lead to media coverage. Too high a correlation with traditional markets was also among the threats cited (16%), reflecting rising concerns about paying “alpha” fees for “beta” returns.

My organization views the single greatest threat to hedge fund investing as:

- A Fees are so high they offset investment gains disproportionately
- B Headline risk
- C Investment loss
- D Too high a correlation with traditional markets
- E Flat fund return
- F Too much volatility*



*No respondents selected 'F'.

5. Several recurring themes were echoed in institutional investors' views on the results of hedge fund allocations and the greatest challenges they may face in the coming year with regard to those allocations.

THREE-QUARTERS (74%) OF INSTITUTIONAL INVESTORS SAY THAT THEIR HEDGE FUND RESULTS HAVE MATCHED THEIR EXPECTATIONS REGARDING PORTFOLIO DIVERSIFICATION BENEFITS. That's down from a full 100% who expressed this view last year. Matching investors' expectations in the area of volatility management was also more challenging this year with 65% of investors saying they were satisfied with hedge funds' role in reducing their portfolio's overall volatility.

On the other hand, hedge funds got higher marks for increasing absolute portfolio returns this year—the ultimate test—with 65% saying their hedge fund investments matched their expectations with regard to raising the absolute return of their portfolios (versus 57% last year).



Our actual historical hedge fund results have matched our expectations with respect to (select all that apply):

- A** Achieving portfolio diversification
- B** Raising my portfolio's absolute return
- C** Lowering my overall portfolio's volatility

Respondents noted the two greatest challenges they believed they faced in the coming year with respect to their alternative investments. Most cited challenges include:

- Returns and finding “alpha”
- Acceptable fees
- Risk measurement and analysis
- Transparency and disclosure
- Maintaining comfort level
- Finding “good” managers to invest with when increasing hedge fund allocations

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