



Overview of 2008 Key Trends in Fund of Hedge Funds

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Introduction

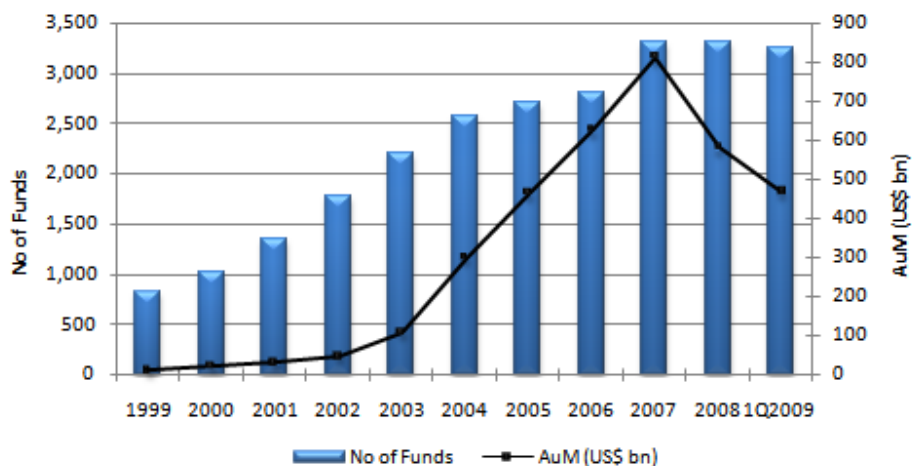
Funds of hedge funds started 2009 on a positive note, outperforming (albeit marginally) their single manager counterparts, who faced high volatility in the underlying markets, amid widespread uncertainty regarding the health of the global financial sector and persistent recessionary concerns across the board. However, this outperformance was seen after a year of notable underperformance in 2008 – when funds suffered losses amid steep market downturns and unprecedented redemption pressures; the Eurekahedge Hedge Fund Index shed 11.6% during the year, while the Eurekahedge Fund of Funds Index lost 19.6%.

Although one mostly heard and read about record redemptions out of hedge funds in the news and media throughout 2008, it is worth noting that funds of hedge funds also faced notable cash withdrawals from investors during the year, which in fact accounted for over half of the net outflows that were seen from the single manager space – net redemptions out of funds of hedge funds stood at US\$116 billion (or 14.4%) in 2008, while those out of hedge funds amounted to US\$219 billion (or 11.6%).

However, despite a rough year and a marked decline in assets, the industry has seen robust growth over the past decade. This was mainly because investors such as pension funds, among others, turned to multi-managers over past years for their expertise in fund selection and asset allocation, and to seek diversification away from traditional equity and mutual fund investments. Furthermore, funds of funds helped investors maintain a well geographically diversified portfolio without having to personally conduct due diligences on single managers, and also to benefit from consistent returns and downside protection.

The fund of funds industry currently comprises 3,260 funds (down 1.8% from 3,316 as at end-2007) that collectively manage assets to the tune of US\$468 billion (down 42.2% from US\$809 billion as at end-2007). Despite the shrinkage through 2008 and 1Q2009, the present industry size denotes a 50% increase in the number of funds and an over 4-fold increase in assets since end-2003. The figure below shows the growth of the fund of hedge funds industry over the past decade.

Figure 1: Industry Growth over the Years



Source: Eurekahedge

The notable difference between the decline in the number of funds and assets in 2008 and 1Q2009 can be explained by the fact that most of the industry's assets were eroded by losses and redemptions, rather than only by widespread closures across the industry. Furthermore, nearly 230 new fund launches over the past 15 months partly made up for close to 290 fund closures, resulting in a notably smaller decrease in the number of funds. However, going forward, we expect to see an increasing number of closures across the



fund of funds space, given that last year's losses and this year's underperformance has resulted in a spate of outflows from the industry, leaving managers squeezed for performance fees and making it more difficult for them to meet operational expenses.

We believe that going forward funds of hedge funds will need...