THE SHIFTING HEDGE FUND LANDSCAPE: PART I OF II

Institutions Put Fund Managers to the Test

THE FIFTH ANNUAL GLOBAL SURVEY OF INSTITUTIONAL HEDGE FUND INVESTORS

SEI Knowledge Partnership
Insights for Investment Managers

GREENWICH ASSOCIATES
SEI’s fifth annual survey of institutional hedge fund investors was conducted in September and October of 2011 by the SEI Knowledge Partnership in collaboration with Greenwich Associates. Online questionnaires were completed by senior investment professionals at 105 institutions.

Endowments account for more than a third of all survey respondents while foundations represent just over 17%. Family offices, corporate funds, and public pension funds each account for another 12%. The remaining responses came from consultants, union plans, and non-profit organizations.

Participating organizations range in size from less than $500 million to more than $20 billion in assets [Figure 1]. The distribution of respondents by size is very similar to the universe for the 2010 edition of our survey. Approximately 85% of respondents are based in the United States with the rest based in the United Kingdom, Canada, and Scandinavia.

Survey results are being presented in two parts:

**PART I** focuses on current trends affecting the hedge fund industry, including institutional hedge fund allocations, objectives, performance, and preferences in investment strategies and vehicles.

**PART II** explores investors’ chief concerns regarding hedge fund investing, as well as the continuing evolution of institutional standards for hedge fund evaluation, selection and monitoring.
Hedge Funds in Flux

Sweeping changes in the global environment and heightened market uncertainty are challenging hedge fund investors—including seasoned and sophisticated institutions—as never before. Some long-held assumptions, like hedge funds’ non-correlation with other asset types, have been shaken. Familiar paradigms are being questioned while new ones are still taking shape. Hard experience is also leading investors to broaden their definitions of risk and sharpen their methods of managing it.

Still, institutional investors are putting their money in hedge funds in the quest for returns, continuing to deepen their commitment and increase allocations. At the same time, institutions keep ratcheting up the challenges and requirements they pose to hedge fund managers. In this new landscape, investors are pushing the industry to de-risk, to improve operations and governance, to enhance liquidity and to provide more windows into investment processes and decision-making. Even as hedge funds evolve to meet institutional standards, those standards continue to be advanced and refined.

The year 2011 was an uncommonly rough one for hedge funds, and yet they have continued to grow with institutional assets as their mainstay. In this first report and in Part II, our survey highlights what hedge funds will need to do in order to maintain investor confidence and stay on a growth track going forward.
Key Findings

Institutional allocations are continuing to rise, though more slowly than in the past. Nearly 38% of investors said they plan to increase their allocations to hedge funds over the next 12 months (vs. 54% a year earlier), while 15% expect to lower them (vs. 11% a year ago). As of October 2011, our respondents’ hedge fund allocations represented an average of 16.7% of their portfolios, up from 12% during the 2008 financial crisis.

Absolute return has emerged as the top goal of hedge fund investing. In a year of record volatility and lower returns in many asset classes, absolute return was named the #1 objective by nearly one-third of respondents—up from about 21% last year, when “non-correlated investment strategies” was the primary goal.

Investors’ stated goals also reflect a strong concern with risk management. Three of the top four goals named by respondents—accessing non-correlated strategies, diversification, and lowering volatility—address investment risks. This suggests that institutions today use hedge funds to help them lower portfolio risks as well as to boost returns.

Direct investing continues to gain momentum. Four out of ten institutions surveyed said they invest solely via single-manager funds, up from 24% a year earlier and about double the percentage who responded that way in 2008. Not surprisingly, reliance on direct investing is greatest among large investors; 56% of respondents with more than $5 billion in assets said they use single-manager funds exclusively.

Long/short equity strategies are currently most in favor. Nearly 82% of respondents name long/short equity among the top three strategies they presently employ, followed by event-driven and credit, named by 53% and 42%, respectively.

Institutions show limited interest in shifting hedge fund assets to registered products. Only 15% said they plan to divert some share of hedge fund allocations to mutual funds or UCITS in the coming year—although this may reflect obstacles to exiting existing hedge fund investments as much as attitudes toward registered products.

The difficulty of meeting performance expectations now overshadows all other challenges. Twenty-six percent of investors this year named performance as their top challenge in hedge fund investing—more than double the percentage who named it #1 in 2009. The issue of transparency had headed the list of top challenges in 2009 and 2010, but this year performance outranked it by a wide margin.

Returns are down, and investors register varying degrees of satisfaction with their results. Based on returns in the first half of 2011, respondents reported earning an average annualized return of 6.2% vs. 9.2% in 2010, and a median annualized return of 5.0% vs. 8.1% in the previous year. Better than six in ten said they are satisfied with their returns in the first six months of 2011; only about 7% reported any level of dissatisfaction. But, hinting at growing performance concerns, the percentage of respondents who are noncommittal rose from 22% in 2010 to nearly one-third in 2011.
Takeaways for Hedge Fund Managers

**KEEP ARTICULATING AND REINFORCING THE VALUE PROPOSITION.** While those surveyed generally show a strong, ongoing commitment to hedge funds, responses reveal heightened concern with hedge funds’ ability to deliver the kind of performance investors are seeking. Investors were also split, by a 41%-to-25% margin, on the question of whether they would be able to meet return objectives without having hedge funds in their toolkits. In a challenging climate with rising competition for investor allocations, it behooves hedge funds to demonstrate exactly how their strategies and methods are enhancing their clients’ risk-adjusted portfolio returns.

**GO THE EXTRA MILE TO MAKE STRATEGIES UNDERSTANDABLE.** While strategies go in and out of favor, it may be no coincidence that in this time of heightened market uncertainty, investors favored three relatively straightforward strategies—long/short equity, event-driven, and credit—rather than complex strategies that may pose hidden risks. Investors’ heightened concern with performance gives fund managers a compelling reason to thoroughly explain the strategies and processes they are using to generate returns.

**CONTINUE INVESTING TO IMPROVE RISK MANAGEMENT METHODS AND INFRASTRUCTURE.** All four of investors’ top-ranked objectives for hedge fund investing speak to their desire to avoid losses and manage risk. Respondents also named “understanding risk” among the top challenges of hedge fund investing.

**CLARIFY PERFORMANCE EXPECTATIONS.** Survey respondents said they now seek absolute return above all. But does this mean they will not tolerate investment losses, or simply that they expect hedge funds overall to lose less than long-only managers in downturns? With institutions more focused on performance than they have been since 2008, fund managers need to probe for a deep understanding of clients’ true return objectives and tolerance for risk. They should also work to help clients understand the tradeoffs between risk and reward, and how strategies can be expected to perform under varying market conditions.

All four of investors’ top-ranked objectives for hedge fund investing speak to their desire to avoid losses and manage risk.
Consistent with our last four annual investor surveys, institutions have not only maintained, but also incrementally increased, their commitment to hedge funds over the past year. Responses to attitudinal questions help illuminate the reasons why. Focused on meeting long-term liabilities and continuing income needs, institutions recognize the advantages to be gained by accessing the high-level investment talent and unique strategies that reside in the hedge fund sphere. Those surveyed agree, by a better than five-to-one margin, that hedge funds are where the industry’s top investment talent can be found. Four in ten also agree that they would not be able to meet their return objectives without having hedge funds in their investment toolkit.

While many institutions have come to depend on hedge funds as a source of portfolio return and diversification, the industry has also become increasingly reliant on institutional assets as its lifeblood. According to a recent Preqin study, institutions now provide more than 60% of hedge fund capital—up from 45% before the financial crisis—and hedge fund managers overwhelmingly expect to increase their reliance on institutional assets in the next 12 months.¹

Allocations are continuing to rise, albeit more slowly than in the past

Thirty-eight percent of investors say they plan to increase their allocations to hedge funds over the next 12 months, a dip from the 54% who responded that way a year earlier. The share of those who plan to lower their hedge fund allocations in the coming 12 months has risen to 15%, up from about 11% in last year’s survey and 7% two years ago [Figure 2].

Figure 2. Planned changes to target allocation over coming 12 months

Source: SEI Hedge Fund Investor Survey
Still, hedge funds continue to attract a growing share of institutional portfolios. The average allocation across all investors surveyed rose from 12% during the depths of the 2008 financial crisis to 13% in 2009 and 14% in 2010. As of October 2011, the average allocation stood at 16.7% and was projected to climb to 17.8% over the following 12 months [Figure 3]. The data also show that increases in allocations were widespread among those surveyed, in that the median allocation jumped significantly after hovering at about the same level for the prior three years.

Endowments, among the earliest to demonstrate a commitment to hedge funds, plan the sharpest jump in allocations, with the average expected to rise from 21.6% to 25.1% in the coming year [Figure 4]. On average, family offices and foundations expect to keep their allocations steady, while corporate investors project a drop from 15.9% to 14.3%. Meanwhile, public and government pension plans, consistently the most conservative hedge fund investors, also expect an increase in allocations, albeit from a smaller base, with the average rising from 8.1% to 9.3%.
Despite the challenges and uncertainties, institutional hedge fund allocations have climbed steadily since the depths of the 2008 financial crisis—and are expected to keep rising.
Over the long term, hedge funds have succeeded in outperforming mainstream markets as well as helping investors to manage portfolio risk. From January 1, 2000 through the third quarter of 2011, the HFRI Fund Weighted Composite Index doubled in value while the S&P 500 Total Return (TR) Index declined slightly. During this period, the HFRI index had only two monthly losses exceeding 5% and the largest monthly drawdown was 6.8%. Meanwhile, the S&P had 23 months with losses greater than 5%, with a maximum monthly drawdown of 16.8%.

Since 2008 the industry has encountered some rough patches in performance, undercutting its reputation for generating above-average returns. While hedge funds overall did not lose quite as much value as the S&P 500 TR Index during the global downturn of 2008 and 2009, they have failed to keep pace with the market’s recovery since then. As the S&P 500 TR Index rose more than 50% between April 1, 2009 and September 30, 2011, the HFRI Fund Weighted Composite Index gained only 29%. In fact, in the third quarter of 2011 the HFRI Index experienced its fourth worst quarter on record, declining 5.5%.

Hedge funds as a group nevertheless outperformed both the S&P 500 and the MSCI World Index, which lost 13.8% and 16.4%, respectively, in the third quarter. Since the financial crisis, hedge funds have also experienced considerably less volatility than the S&P—an important factor for hedge fund investors who are seeking to reduce portfolio risk [Figure 5].

Figure 5. Relative performance of HFRI Fund Weighted Composite Index (Indexed to 100)
Investors are intent on earning absolute returns and reducing portfolio risk

Almost a third of all survey participants identified absolute return as their primary objective for investing in hedge funds, up from just under 21% last year, when “non-correlated investment strategies” was named the primary goal [Figure 6]. The emphasis on earning positive returns is no surprise in a volatile year that saw global markets slide in the third quarter. Investors responded similarly in 2009, when “absolute return” was named the top goal by 30% of investors, ranking second, just behind “diversification.”

The goal of “absolute return” addresses both the opportunity (positive returns) and risk (avoiding losses) of hedge fund investing. The question is, how do investors understand and use the phrase? Does it mean “never losing money,” or does it mean “losing less than long-only managers”? In order to clarify and better align expectations, fund managers should discuss this point with clients from the outset and revisit it regularly.

It is also worth noting that all three of the other four top objectives named this year have to do with aspects of managing downside portfolio risk. Together, “non-correlated investment strategies,” “diversification,” and “decreased volatility” were cited by 56% of respondents. Only the fifth- and sixth-ranked objectives speak purely to the quest for returns. This response pattern has generally been consistent since our first survey in 2007. However, it reflects a marked cultural shift from the early days of hedge funds, when many investors focused on their potential to produce outsized returns.

Figure 6. Primary objective when investing in hedge funds

Source: SEI Hedge Fund Investor Survey
Use of Investment Vehicles and Strategies Has Shifted with the Markets

Direct investing continues to gain popularity and momentum

As the industry matures and investors gain expertise with hedge funds, single-manager funds are growing in popularity while funds of hedge funds (FOFs) are losing market share. Four out of ten institutions surveyed said they use single-manager funds exclusively, up from about 24% a year earlier, and about double the percentage who responded that way in 2008 (Figure 7). Among large investors (those with more than $5 billion in assets), 56% said they use single-manager funds exclusively.

The percentage using FOFs exclusively dropped from 61% in 2008 to just under 30% in 2011. This trend is reflected in FOFs’ asset levels, which have declined from their 2007 peak (Figure 8, page 12). As identified in a recent survey of pension and sovereign wealth investors by Citi Prime Finance, several factors are driving the trend toward direct investing, including resistance to paying an added layer of fees, access to investment talent, concern with over-diversification of FOFs, concerns with FOF incentives, and the desire to control portfolio selection.²

Still, funds of hedge funds are far from obsolete, with more than half of respondents using them exclusively or in tandem with single-manager funds. FOFs retain an important role in the industry, especially among investors lacking the resources to evaluate and monitor complex strategies. Smaller investors (those with less than $500 million in assets) report the greatest use of FOFs; 64% of them allocate some or all of their hedge fund allocations to FOFs. None of the largest investors (more than $5 billion in assets) uses FOFs exclusively. The FOF model may also get a shot in the arm from a new generation of FOFs with the expertise to identify promising start-ups. This approach could have considerable appeal to investors who need sources of above-average return to help them meet performance goals.

² Citi Prime Finance, Global Pension and Sovereign Wealth Investment in Hedge Funds: The Growth and Impact of Direct Investing, June 2011

Four out of ten institutions use single-manager funds exclusively, about double the percentage who responded that way in 2008.
Figure 7. Use of single-manager hedge funds vs. funds of hedge funds

Source: SEI Hedge Fund Investor Survey
As of September 30, 2011, total hedge fund assets stood at approximately $2 trillion, about 5.3% above their peak before the financial crisis [Figure 8]. Hedge fund assets doubled in just seven years, despite huge outflows and market losses in 2008 and 2009. The industry as a whole has seen modest, but steady inflows since 2009 [Figure 9].

The exception has been funds of hedge funds, which have become less popular as the industry has matured and investors have gained resources and sophistication. At their peak in 2007, funds of funds accounted for 45% of all hedge fund assets, but now represent about a third. Still, they remain important to some investor segments and may broaden their appeal as they evolve to address specific investor needs and expand the portfolio-level insights they provide.
Long/short equity strategies are currently most in favor

When institutions were asked to name the top three strategies (based on asset levels) in which they presently invest, more than four out of five had long/short equity on their lists—no surprise in a year when market volatility hit record levels. More than half identified event-driven as one of their top three strategies and four out of ten named credit strategies [Figure 10].

Investors’ strategy choices typically reflect their assessments of the market environment more than any enduring commitment to one strategy over another. Still, all three of the top strategies named are relatively easy to understand and to analyze from a risk perspective—a potentially important advantage at a time when investors have become wary of overly complex or opaque strategies that make it difficult to ferret out potential risks. Long/short equity also has the advantage of being the longest-running hedge strategy of all, with a track record that dates back to the first hedge fund in 1949.

Figure 10. Top three categories currently employed, by assets

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Percentage of Investors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long/short equity</td>
<td>81.7%</td>
</tr>
<tr>
<td>Event-driven</td>
<td>53.3%</td>
</tr>
<tr>
<td>Credit</td>
<td>41.7%</td>
</tr>
<tr>
<td>Macro</td>
<td>33.3%</td>
</tr>
<tr>
<td>Distressed securities</td>
<td>26.7%</td>
</tr>
<tr>
<td>Special situations</td>
<td>15.0%</td>
</tr>
<tr>
<td>Market neutral</td>
<td>13.3%</td>
</tr>
<tr>
<td>Fixed income arbitrage</td>
<td>10.0%</td>
</tr>
<tr>
<td>Commodities/CTA</td>
<td>8.3%</td>
</tr>
<tr>
<td>Relative value</td>
<td>5.0%</td>
</tr>
</tbody>
</table>

Multiple responses allowed. Source: SEI Hedge Fund Investor Survey
Institutions show moderate interest in regulated alternative products

Ever since the financial crisis, retail investors and their advisors have shown a keen appetite for alternative strategies. In response, the industry has increasingly packaged hedge-style strategies in the form of mutual funds, ETFs, or UCITS (often dubbed “Newcits”). Registered alternative funds are also being used by some institutional investors, reflecting the convergence of investor segments and products that has been one of the most sweeping investment industry trends of the past decade.

A recent SEI study found that assets in regulated U.S. and European alternative products have grown at a torrid pace since 2008, rising to $644 billion in August 2011. Assets in such funds are projected to double by 2016, with the emergence of new non-UCITS products such as Qualifying Investor Funds (QIFs) and Specialized Investment Funds (SIFs) expanding the market even further.3

This survey shows, however, that institutional investors are less engaged in this trend than retail investors. Only 15% of respondents said they plan to direct part of their current hedge fund allocations to a registered product such as a mutual fund or UCITS. That sub-sample cited liquidity, regulatory oversight, and transparency as the top three reasons for investing in a registered product [Figure 11]. Unsurprisingly, those most likely to do so are smaller institutions that have less clout to demand greater transparency and liquidity and may not qualify for the minimum investment required by an unregistered hedge fund product. Only one institution with assets greater than $5 billion reported plans to shift hedge fund assets to registered products.

The results suggest that even though institutional investors strongly desire the kind of transparency and liquidity that registered products can provide, they may be unwilling to give up the advantages that hedge fund limited partnerships offer—namely a greater range of unique strategies and the incentive that performance fees provide. The cost or constraints associated with redemption of existing hedge fund investments, as well as the potentially higher asset-based fees for regulated products, may also have influenced investors’ responses.

3 SEI Knowledge Partnership, Regulated Alternative Funds: The New Conventional, December 2011
Figure 11. Reasons for investing in a registered product*

- Liquidity of product: 90.9%
- Regulatory oversight of product: 63.6%
- Transparency of product: 54.5%
- Independent custody: 36.4%
- Other: 9.1%

Source: SEI Hedge Fund Investor Survey

*Based on the 15% of respondents who plan to invest in a registered product. Multiple responses were allowed.

Registered investment funds are being used by some institutional investors, although they are not as engaged in that trend as retail investors.
In 2011, investors found themselves faced with record levels of global volatility, low yields, and lower-than-historical returns for many asset classes—a market environment in which hedge funds’ potential for generating above-average returns became more important than ever. Meanwhile, hedge funds collectively earned tepid returns in the first half of the year and sustained losses in the third quarter. In this context, the question of whether hedge funds can meet performance expectations takes on new urgency.

Performance now tops the perceived challenges of hedge fund investing

In the 2011 survey, “meeting performance expectations” was named the top challenge by 26% of respondents, eclipsing transparency, which had been in the #1 spot for the previous two years [Figure 12]. The percentage of survey respondents listing performance among the greatest challenges of hedge fund investing has more than doubled since the 2009 survey, when investors were reeling from the breakdown of non-correlation and focused on penetrating the inner workings of their hedge fund investments.

Institutional investors’ focus on performance has fluctuated substantially through the years of our survey. Not surprisingly, investors surveyed right after the shockwaves of 2008 named “poor performance” their top worry by a wide margin.

As hedge fund returns rebounded in 2009, investors were most concerned with transparency and liquidity; performance dropped to #5 on the worry list and “meeting performance expectations” was the #4 challenge. In 2010, a year when hedge funds did not rebound as strongly as the S&P 500, “meeting performance expectations” was named the #2 challenge for hedge fund investors. In 2011, another year of high volatility, very low interest rates, and rising asset class correlations, the risk management measures employed by investors and managers may have dampened returns, further compounding the difficulty of meeting performance targets.

With investors’ increased emphasis on hedge fund returns, it is all the more important that fund managers clearly outline their investment philosophy and the strategies being employed in the effort to reach return targets. Risk factors and uncertainties that could affect performance should certainly be part of that discussion.
Figure 12. Single most important challenge faced

Source: SEI Hedge Fund Investor Survey
Investors are realistic in gauging their portfolio returns

As the most sophisticated of investors, institutions have high expectations but understand that the ebb and flow of markets and strategies are intrinsic to investing. Asked about their own hedge fund portfolio returns in the first half of 2011, those surveyed reported average and median returns for the first half of 2011 that, when annualized, were about one-third lower than 2010 returns [Figure 13].

Yet, recognizing the headwinds that asset managers of all types faced in the past year, only 7% of respondents express dissatisfaction with overall returns from their hedge fund portfolios, down from 12% in the 2010 survey. However, the percentage who said they are “satisfied” or “very satisfied with returns” also fell, dropping to 62% in 2011 from 67% the previous year [Figure 14]. The share of investors who are on the fence jumped from 22% in 2010 to nearly one-third in the 2011 survey, a marked rise in investors’ feelings of ambivalence about performance of their hedge fund portfolios.

Figure 13. Total return on hedge fund portfolio in 2010 vs. 2011* (%)  

<table>
<thead>
<tr>
<th></th>
<th>2010</th>
<th>2011*</th>
</tr>
</thead>
<tbody>
<tr>
<td>25th Percentile</td>
<td>11.0</td>
<td>8.2</td>
</tr>
<tr>
<td>Median</td>
<td>8.1</td>
<td>5.0</td>
</tr>
<tr>
<td>75th Percentile</td>
<td>6.2</td>
<td>2.4</td>
</tr>
<tr>
<td>Average</td>
<td>9.2</td>
<td>6.2</td>
</tr>
</tbody>
</table>

*2011 total returns are annualized based on first-half 2011 performance.  
Source: SEI Hedge Fund Investor Survey

Figure 14. Satisfaction with overall hedge fund portfolio return

<table>
<thead>
<tr>
<th>Satisfaction Level</th>
<th>Percentage of Investors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Very Satisfied</td>
<td>6.7</td>
</tr>
<tr>
<td>Satisfied</td>
<td>55.0</td>
</tr>
<tr>
<td>Neither Satisfied Nor Dissatisfied</td>
<td>31.7</td>
</tr>
<tr>
<td>Dissatisfied</td>
<td>5.0</td>
</tr>
<tr>
<td>Very Dissatisfied</td>
<td>1.7</td>
</tr>
</tbody>
</table>
Conclusion

Over the past few years, the hedge fund industry has been busy remaking itself in the image of the institutional investors who have become its dominant constituents. Evolving from a performance-focused culture that thrived on secrecy, unique strategies, and huge rewards for stellar returns, the industry has itself become more institutionalized. As hedge funds have responded to investor demands for better risk management, more transparency, greater liquidity, and higher-quality operations, institutions have rewarded them with a deepening commitment and steadily rising allocations.

Now the industry finds itself at an interesting juncture—a point at which institutional investors themselves appear to be somewhat conflicted. As evidenced by their stated objectives, investors have come to view hedge funds more as a vehicle for managing portfolio risks than as a way to earn outsized returns. Yet, in a climate in which investment returns are harder to come by across the board, institutions now exhibit growing unease with hedge fund performance levels. By a wide margin, those surveyed this year named “meeting performance expectations” as the greatest challenge of hedge fund investing, a marked shift from their prior focus on transparency. With their reported portfolio returns down by about 50% from the previous year’s levels, respondents have also become more ambivalent about their levels of satisfaction with hedge fund returns, with nearly a third saying they are on the fence.

In short, institutional investors are seeking the best of all worlds—better returns, as well as lower correlations, more diversification, and better overall management of risk. This thrust is not confined to hedge funds; it was also a prominent finding of SEI’s 2011 series on institutional private equity investing. But with their promise of outperformance, their disparate risk exposures, and some high-profile blow-ups in recent memory, hedge funds have become a lightning rod for investors’ hopes and fears.

The industry will need to work closely with investors in finding ways to keep advancing toward institutional standards of risk management and operational quality while also preserving the industry’s enterprising and creative spirit. This may spur a collaborative process of clarifying, fine-tuning and perhaps even recalibrating the balance of risk and reward being sought. Herein lie both the challenges and the opportunities ahead for the hedge fund industry and institutional investors alike.

See Part II of SEI’s 2011 survey report for detailed results on more key issues:

- What worries institutional investors most about hedge fund investing?
- How are institutional hedge fund standards evolving?
- What are investors’ new top criteria for hedge fund evaluation and selection?
- How receptive are institutions to small and emerging managers?
- How important are consultants in the investment process?
- What can hedge fund managers do to enhance their competitiveness?

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