In years past, hedge fund firms were seemingly immune to the challenges faced by mainstream financial organizations as they continued to gather new assets, deliver strong performance results and realize impressive growth.

New World Order

Confronted with an undeniable recession and a full-scale global economic crisis, the once optimistic view of the hedge fund community has been tempered and replaced with expectations for disorderly markets and difficult business conditions in 2009. Hedge fund managers are recalibrating their investment strategies and operations to capitalize on the opportunities that will emerge from uncertainty. As they do so, many fund managers express the view that the industry will return to its roots as a niche investment class for sophisticated family and high-net-worth investors seeking to create balanced and diversified portfolios.

2009 Hedge Fund Outlook

Rothstein Kass

February 23, 2009

Rothstein Kass

For nearly two decades, hedge fund managers have come to be viewed as clairvoyant because of the consistently positive returns the industry was able to generate for its investors, and the fact that they held up extremely well during the stock market tech crash earlier this decade. The first eight months of 2008 clearly tested the industry, but very few in or out of the investment world were ready for the seismic jolt that took place during the remainder of the year. This was not just a global equity market crash, but also a global credit instrument crash. There was little place to hide. Regulators were quick to blame the hedge fund industry for creating systemic financial risk by shorting financial institutions, but in hindsight, seem to have only made matters worse. Investors announced their exit, and many funds, in an effort to protect their remaining investors, put up gates in order to create a more orderly process. Although the hedge fund indices “outperformed” in relation to equity benchmarks, the negative performance undermined the belief that hedge funds will generate positive returns in all market conditions.

As it stands, many hedge funds can be counted among the casualties of the global market meltdown. Some observers have been so bold as to predict the demise of the industry, pointing to the broad array of challenges that lie ahead, from regulatory oversight to high-water marks. As a leader in accounting firm services to the hedge fund community, we do not believe this to be the case. The industry will continue to breed talented investment managers with vision and entrepreneurial spirit. Top portfolio managers will continue to leave institutions to form their own firms. Although 2009 is only a short way towards the finish line, many funds are outperforming the indices in a significant way.

“New World Order,” our latest research report on industry trends, finds that while a clear majority of hedge fund managers are predicting a tough year ahead, an even greater percentage intend to raise additional capital in 2009. Capital will come from a variety of sources, with the bulk of new assets expected to originate directly and indirectly from financial intermediaries and independent wealth advisors on behalf of family offices and individual investors. As the industry returns to its roots, our findings show that nearly 80 percent believe that hedge funds will revert to being the niche investment it was many years ago.

Because of the current negative outlook, many observers continue to overlook signs that the industry could rebound quickly. For example, there is broad acknowledgement that an enhanced regulatory regime will increase operating costs associated with compliance functions. However, little attention has been given to how a new regulatory and business environment focused on transparency will reassure investors, thereby supporting renewed asset flows.

As the industry recalibrates, it is imperative to retain focus on the importance of investor relationships and marketing functions. By contrasting the findings of our “New World Order,” against our 2008 report “Onward and Upward,” we discovered that in both surveys, a majority of managers expressed the belief that marketing will become more important to success (64 percent in 2009 versus 85 percent in 2008). The decline suggests that demands on organizational resources are preventing some firms from taking steps to develop a cohesive marketing strategy. However, those firms that remain committed to increasing the framework for greater transparency, investor services and marketing will most likely be the firms that will be able to raise new capital. Regardless of recent setbacks, hedge funds still possess the greatest array of investment tools to help investors meet long-term goals.

“New World Order” draws on the experience and expertise of Rothstein Kass principals across practice areas to provide the context for our findings. We hope that this research will offer a new perspective on the current state of the industry, and we encourage you to contact us if you would like to discuss any of the findings of this study.

We thank you for your interest and support.

Howard Altman
Co-Managing Principal
Rothstein Kass

Key Themes

■ For the first time in three years, hedge fund professionals display gloomy attitudes about the near-term future of the sector.

■ Broadly speaking, the hedge fund industry is expected to face numerous obstacles, including higher operational costs, lawsuits from investors, fewer growth opportunities and closer scrutiny from regulators.

■ The competition for new assets will be fierce, as most hedge funds are hoping to offset losses from underperformance and liquidations.

■ Affluent investors have been identified as the most likely source of future hedge fund growth and are in a position to demand higher levels of service than in past years.

■ Due to the close relationship between fund performance and manager compensation, the large majority of the hedge fund executives surveyed saw their personal wealth decrease during 2008.

Top Predictions for 2009

This report marks our third-annual survey of senior hedge fund professionals to gauge their perspectives on the business and their expectations for the year ahead. It is the first, however, in which the majority of respondents expressed a less than enthusiastic point of view.

For the first time in recent years, hedge fund professionals take a guarded stance toward the operating environment, sourcing new capital and the business implications in the coming year.

88.7% 2009 will be a very difficult year for the hedge fund industry

79.5% Hedge funds will revert to being a niche investment

62.8% M&A and restructuring activity among hedge funds will boom

97.5% Desire to source additional capital

83.7% Competition for hedge fund investors will dramatically increase

74.7% New investors will be the primary source of new capital

98.7% There will be increased regulation of hedge funds

82.4% Hedge funds will be much more costly to operate

54.8% It will be significantly harder to attract and retain talent

64.0% Marketing will become much more important to hedge fund success

The Research

In January 2009, we conducted telephone interviews with 239 senior hedge fund professionals from companies meeting the following criteria:

– No less than five years in operation
– At least US$100 million under management

Approximately two-thirds of the executives represented funds with assets between US$100 million-US$500 million and the remaining one-third had assets in excess of US$500 million. The sampling process provided an early indication that industry fundamentals had shifted. Like most other investment advisory businesses, many of the firms in our study reported that average year-over-year assets had declined substantially due to performance and investor withdrawals. As we expected, in some more extreme cases, firms had also ceased operations entirely. As we approached the community for their outlook for 2009, it was apparent that the industry is somewhat smaller in terms of total assets under management and firms in existence.

Figure 1: Firms by AUM

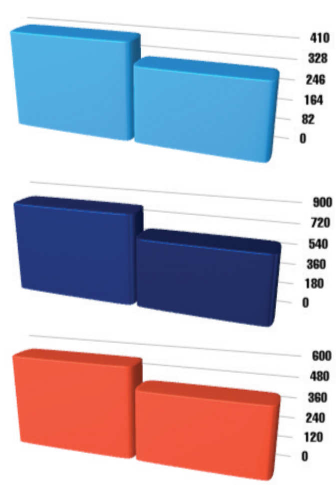
$100M to $500M	64.4%
$500M+	35.6%

Figure 2: Mean & Median AUM

$100M to $500M
Mean $402.1M
Median $311.2M

$500M+
Mean $814.3M
Median $610.6M

Weighted Average
Mean $548.7M
Median $417.7M



2009 Industry Predictions

In some cases all firms responded similarly, but in more than half of scenarios there was a marked difference between firms by size.

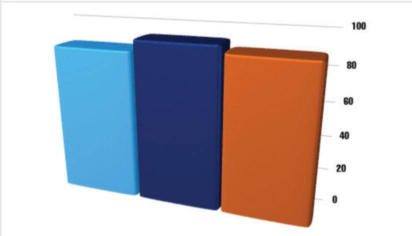
The Operating Environment

The following scenarios are specific to the economic climate and its impact on the business environment for emerging and established hedge funds.

Challenging Year Ahead

Nearly nine in 10 hedge fund executives expect 2009 to be difficult, a far cry from the perspectives shared in our 2007 and 2008 surveys. This viewpoint is fairly constant across firms of all sizes.

2009 will be a very difficult year for the hedge fund industry



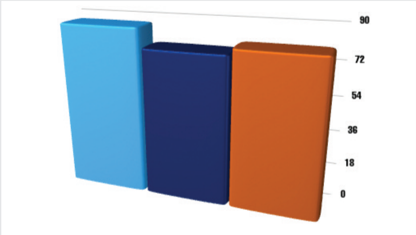
$100M to $500M	86.4%
$500M+	92.9%
Weighted average	88.7%

"After a period of consistently outstanding performance that led to a proliferation of funds across a limitless spectrum of strategies and styles, the hedge fund industry was battered by a series of events in 2008. Though hedge funds still outperformed in relation to equity benchmarks, the theory that hedge funds could generate strong returns independent of market conditions was put to rest in the last four months of 2008 when all asset classes were simultaneously decimated," said Howard Altman, Co-Managing Principal and head of the Financial Services Group at Rothstein Kass. "As the global liquidity crisis conspired to undermine investor confidence, the sector has also experienced an upswing in the pace of redemptions and even fund closures. The consensus is that investor demand for transparency and increased regulation will continue to increase the barriers to entry. However, we're already witnessing growing interest from talented managers looking to introduce products that will target undervalued assets."

Back To Basics

As hedge funds delivered consistently strong performance, increased allocations and a higher media profile helped these products become part of mainstream investing. An emphasis on risk management and renewed conservatism are expected to drive hedge funds back to their original and specialized role.

Hedge funds will revert to being a niche investment



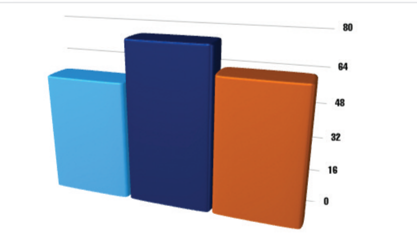
$100M to $500M	81.2%
$500M+	76.5%
Weighted average	79.5%

"When we commissioned our first survey on industry trends in 2007, our inaugural research found that a sizable portion of hedge fund managers believed that the sector would become increasingly institutional in its focus as managers sought to capitalize on growing interest from foundations, endowments and other sources. Our latest findings suggest that hedge funds are getting back to basics and will more aggressively compete for family office and high-net-worth assets," said Mr. Altman. "However, the industry's recent concerted efforts to penetrate institutional segments will continue to pay dividends. Because of their stricter reporting requirements, institutional investors have compelled hedge funds to improve transparency and compliance functions. These initiatives will ultimately help to restore investor confidence. As hedge funds reposition, those that maintain an institutional level of professionalism enjoy a competitive advantage in raising capital."

M&A

Many executives anticipate more acquisitions and consolidations among hedge funds, although that view is more prevalent among firms with more than $500 million under management.

M&A and restructuring activity among hedge funds will boom



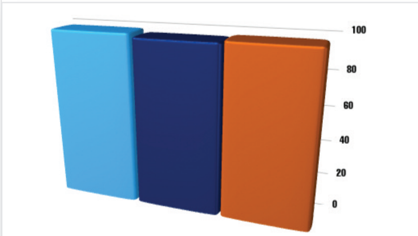
$100M to $500M	55.8%
$500M+	75.3%
Weighted average	62.8%

"In light of the challenges it faces, the expectation is that the industry will continue to contract during 2009. Our research suggests the trend toward consolidation observed in our 2007 research will also persist. Further examination shows that the underlying forces have clearly shifted," said Todd Goldman, principal-in-charge of Rothstein Kass' northern California offices. "The next wave of industry consolidation will not be driven by larger institutions looking to buy hedge fund assets. Instead, hedge fund combinations are now pursued out of necessity as smaller players seek to streamline back office and administrative functions through strategic business combinations and pursue alliances that address these concerns."

Raising Capital

Despite the dour outlook for 2009, nearly all of the professionals in our survey expressed interest in finding new assets for their funds.

Desire to source additional capital



$100M to $500M	98.1%
$500M+	96.5%
Weighted average	97.5%

"Because of the full arsenal of investment tools at their disposal, many hedge funds see opportunity in crisis. Therefore, we were not surprised to learn that nearly all respondents hope to raise additional capital during the balance of the year," said Mr. Altman. "With so many funds competing for a diminished pool of assets, successful managers will become much more thorough in their marketing approach to stand out from the crowd."

2009 Industry Predictions

In some cases all firms responded similarly, but in more than half of scenarios there was a marked difference between firms by size.

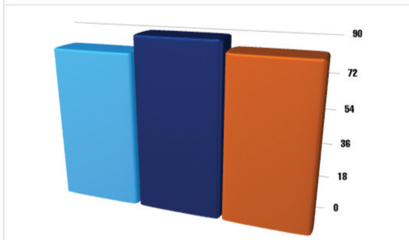
Sourcing New Capital

The following scenarios relate to the ongoing quest by hedge fund firms for new capital and the efforts required to secure new clients and new assets in a difficult economy.

Competition

Given the billions of dollars lost in personal wealth during 2008, there are fewer candidates for hedge funds and fewer overall assets to invest. As a result, the large majority of hedge fund executives surveyed expect it will become harder to find and attract accredited investors to their firms.

Competition for hedge funds investors will dramatically increase



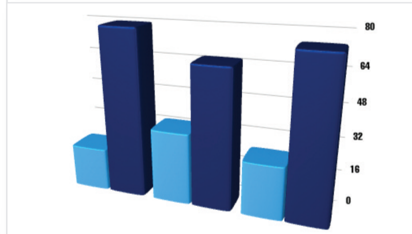
$100M to $500M	80.5%
$500M+	89.4%
Weighted average	83.7%

"The fierce competition for hedge funds assets we've observed in recent years will only be intensified by current economic conditions. For the first time in recent memory, demand for new assets could very well outpace supply, as many investors have retreated from the space," said Mr. Altman. "Some firms, it seems, are predicting that fund closures and redemptions will help to thin the herd, allowing the remaining players to continue to grow. It's more realistic to expect that the industry will grow at a slower pace than in years past. Funds with specialized strategies designed to outperform in down markets and launches by talented managers leaving besieged institutions will account for most of the new entrants."

New Capital

By and large, most firms expect new capital to come from new investor relationships rather than existing clients.

Primary source of new capital



	$100M to $500M	$500M+	Weighted average
Current investors	20.5%	34.1%	25.3%
New investors	79.5%	65.9%	74.7%

N = 233 senior hedge fund managers

"The relentless quest for capital amid less favorable economic conditions will cause hedge fund managers to look to a broad range of sources in the year ahead. Notable in our findings is the stated desire to attract new investors to hedge fund ventures," said Mr. Altman. "Part of this certainly stems from the understanding that existing hedge fund investors have absorbed significant losses in recent months."

Sourcing New Capital

Although the number and type of hedge fund investors is vast, most firms agree that the two best sources of additional monies in the coming year will be wealthy individuals and the single-family office space. It's worth noting that larger firms, those with more than $500 million in assets, also expect to source new assets from wealthy investors through independent financial advisors.

Very important sources of new capital

Source	$100M to $500M	$500M+	Weighted average
Pension funds	20.5%	25.6%	22.3%
Endowments	29.8%	31.7%	30.5%
Fund-of-funds	6.0%	13.4%	8.6%
Affluent investors directly	76.8%	65.9%	73.0%
Single-family offices	46.4%	56.1%	49.8%
Financial intermediaries	20.5%	59.8%	34.3%
Private equity firms	12.6%	36.6%	21.0%
Other	4.0%	4.9%	4.3%

N = 233 senior hedge fund managers

"If further evidence is needed that the hedge fund industry is getting back to its roots, it can be found by sourcing anticipated new capital inflows. Survey respondents over-whelmingly reported that affluent investors represent a very important source of new capital. Larger firms are also much more likely to target intermediaries and family office sources," said Mr. Altman. "Having access to a full spectrum of invest-ment populations was a critical factor in the growth of the industry, but also played a role in recent hardships. Historically, hedge fund investors have taken a long-term approach to achieving objectives and are well-prepared financially and emotionally to weather a down market. As the investor base broad-ened many funds were opened to investors that were not aligned for the long-term. These investors were among the first to exit when the market dropped, vastly increasing the pace of redemptions while pres-suring funds to liquidate positions."

2009 Industry Predictions

In some cases all firms responded similarly, but in more than half of scenarios there was a marked difference between firms by size.

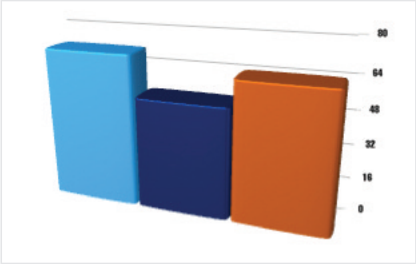
Business Implications

The following scenarios explore a potential shift in power between hedge fund managers and hedge fund investors as new money becomes harder to source and the affluent market demands greater flexibility and protection when it comes to their assets.

Role of Marketing

About two-thirds of hedge fund professionals say marketing will play a bigger role in future success. This view is more prevalent among smaller firms than their larger counterparts.

Marketing will become much more important to hedge fund success



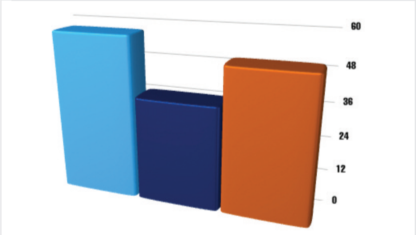
$100M to $500M	70.8%
$500M+	51.8%
Weighted average	64.0%

"For the past several years, consistently strong investment returns drew interest from high-net-worth and a growing roster of institutional investors. Marketing functions were marginalized as most firms relied on performance figures to sell their services," said Mr. Altman. "This model just doesn't work anymore. Investor preoccupation with absolute return has been replaced by questions regarding strategy, transparency and valuations. Firms that can combine performance with a cohesive and concisely stated strategy will have an advantage in targeting definable constituencies."

Risk Management

Although public awareness of the scandals, bail-outs, and failures in the financial industry is extraordinarily high, opinion is split regarding whether contingency plans will be required in order to secure new hedge fund assets.

"Catastrophic contingency strategies" will become more important when sourcing new monies



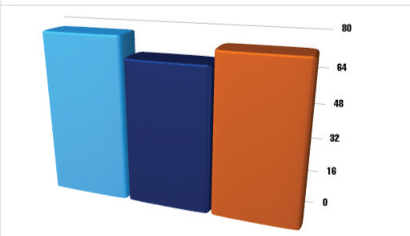
$100M to $500M	57.1%
$500M+	36.5%
Weighted average	49.8%

"The recent 'market meltdown' illustrated the shortcomings of risk management tools that don't model for the catastrophic scenarios, such as the residential mortgage crisis," said Mr. Goldman. "Firms of all sizes are re-evaluating their risk management criteria to understand the repercussions of the 'less-than-one-percent' event."

Lock-ups

Another consequence of the competitive environment—and the increased desire for liquidity among investors—is that about three-quarters of hedge fund executives think there will be less use of lock-up periods for new investment capital.

For new money, "lock-ups" will be significantly less likely



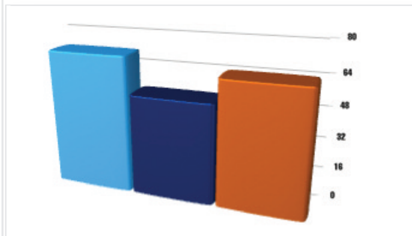
$100M to $500M	76.8%
$500M+	67.1%
Weighted average	73.4%

"Hedge fund investors tend to be among the brightest and best-informed. They are acutely aware of the shifting dynamics in the investment industry. Investors are more conscious that the process can be a negotiation and hedge funds are adjusting their strategies accordingly," said Mr. Goldman. "Hedge fund investors may not be inclined to sacrifice liquidity for exclusivity, especially with so many firms actively seeking new investment."

Cultivating Relationships

Hedge funds are more aware than ever of the need to cultivate long-term investor relationships, a marked change from years past when most firms emphasized performance and new business development.

Maintaining investor relationships will become a very important function



$100M to $500M	77.3%
$500M+	62.4%
Weighted average	72.0%

"A monthly or quarterly investor statement once might have passed for client service, but more transparency will be demanded by investors going forward. Part of an effective marketing approach is clear, consistent and direct communication with investors. Ongoing market volatility can warrant a more visible role for portfolio managers through investor calls and meetings," said Mr. Altman. "Many hedge fund managers were drawn to the industry because of its entrepreneurial culture and may feel like their efforts are best spent on investment related functions. In today's environment, it's not an either /or proposition."

2009 Industry Predictions

In some cases all firms responded similarly, but in more than half of scenarios there was a marked difference between firms by size.

Increased Regulation

Nearly all hedge fund professionals believe hedge funds will be subject to closer regulation and oversight than in past years, a probable byproduct of the collapse of the financial sector.

There will be increased regulation of hedge funds

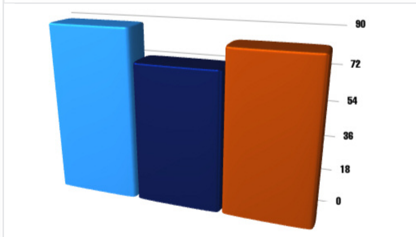
$100M to $500M	98.7%
$500M+	98.8%
Weighted average	98.7%

"The findings of our latest research are consistent with the data we tracked in "A New Regime," our 2008 survey on the outlook for regulatory change under the new president. The introduction of the 2009 Hedge Fund Transparency Act, just weeks after President Obama took office, emphasizes this position," said Mr. Altman. "However, the nearly universal agreement represents a huge shift from our initial industry research in 2007. Even at the beginning of 2008, fewer than eight percent of hedge fund managers we surveyed thought that there would be an increase in regulation. Broadly, hedge fund managers are now generally supportive of legislative efforts to promote transparency provided such measures do not undermine proprietary information."

Cost of Operations

The majority of senior hedge fund managers feel that day-to-day operations will be more costly due to more onerous compliance processes, though smaller firms were more likely to agree than larger firms.

Hedge funds will be much more costly to operate



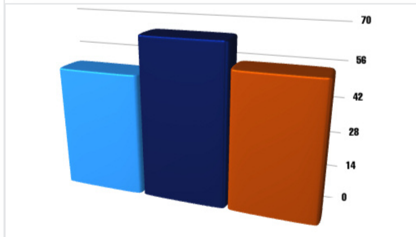
$100M to $500M	88.3%
$500M+	71.8%
Weighted average	82.4%

"There's little debate that hedge fund compliance will become more cumbersome, making funds more costly to operate. However, hedge funds should look at these expenditures as long-term investments in the future. Short-term costs can be recouped over time through a streamlining of processes. If these functions lead to increased transparency, the firm's ability to attract and retain a long-term investor base is also bolstered," said Mr. Goldman.

Personnel Retention

Slightly more than half of the executives surveyed felt the current conditions would have a residual effect on recruiting and keeping top-notch personnel, with larger firms more liable to agree.

It will be significantly harder to attract and retain talent



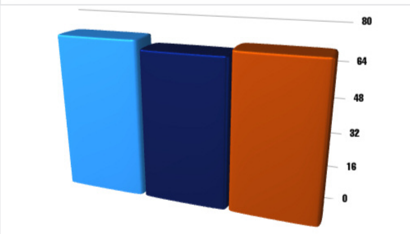
$100M to $500M	49.4%
$500M+	64.7%
Weighted average	54.8%

"Opinion is fairly evenly split among respondents regarding the current competition for talent. On the one hand, across-the-board job cuts at financial institutions have created a deep pool of available talent. At the same time, rising costs and shifting fee structures can limit total compensation packages. However, the industry will continue to breed talented investment managers," said Mr. Altman.

Litigation

About seven in 10 professionals expect the industry will see more lawsuits from investors.

Hedge funds will be subject to significantly more lawsuits



$100M to $500M	72.1%
$500M+	68.2%
Weighted average	70.7%

"The financial crisis has fueled the outlook for litigation across all subsets of the investment community. Though the threshold for establishing misconduct or breach of fiduciary duty is high, this will not deter claims by investors stung by poor performance," said Mr. Altman.

Personal Wealth

We also asked the hedge fund executives about the toll the past year has taken on their personal wealth. Like all investment strategies, hedge funds posted a variety of returns. To a much greater degree than in other asset management disciplines, the fortunes of hedge fund managers are closely linked to the performance of their funds in part because they invest heavily in their own funds and in part because they are paid on the results of their efforts. On the heels of what has been called the worst year for hedge fund performance and with one of the largest scandals to rock the hedge fund world since the LTCM crisis, 88 percent of the professionals surveyed said their net worth had declined in 2008. More telling, perhaps, is that nearly 58 percent experienced losses in excess of 30 percent. The responses were fairly similar across all firms, although smaller firms posted the larger group of increases at 10 percent.

Change in Personal Net Worth in 2008

Change	$100M to $500M	$500M+	Weighted average
Increased by 30% or more	10.4%	3.5%	7.9%
Increased as much as 30%	2.6%	2.4%	2.5%
No change	1.9%	1.2%	1.7%
Decreased as much as 30%	27.3%	25.8%	26.8%
Decreased by 30% or more	57.8%	67.1%	61.1%

"Hedge fund managers have been impacted by market conditions, as evidenced by the large percentage who report a decline in personal worth of 30% or more. This is largely because these individuals are usually heavily invested in their own funds, which demonstrates an alignment of interest with the constituencies they serve," said Rick Flynn, principal-in-charge of the Family Office Group at Rothstein Kass. "They also tend to be younger than other portions of the high-net-worth community and are therefore more aggressive in their own personal investment strategies away from their funds."

About the Authors

Russ Alan Prince is the world's leading authority on private wealth, the author of more than three dozen books on the topic, and a highly-sought counselor to families with significant global resources, and their advisers. He is co-author of *Fortune's Fortress: A Primer on Wealth Preservation for Hedge Fund Professionals* and *Beyond Performance*: *How Hedge Funds Can Strengthen and Build Their Affluent Client Base.*

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Rothstein Kass Publications

Beyond Performance: How Hedge Funds Can Strengthen and Build Their Affluent Client Base

As competition in the hedge fund sector intensifies, it will be more important than ever for hedge fund professionals to zero in on the priorities and expectations of their client base. Authors Russ Alan Prince and Hannah Shaw Grove share the research they have conducted with wealthy individuals and families that invest regularly, and significantly, in hedge funds and funds-of-funds. Their findings will help hedge fund firms understand the most effective ways to reach, cultivate and retain high-net-worth investors.

Copies of publications are available upon request via **www.rkco.com**

About Rothstein Kass

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

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