Hedge Funds 2.0

As the internet has evolved from its early incarnations to 'web 2.0', so hedge funds are moving into a second generation of development. Prof. **Amin Rajan**, CEO, CREATE-Research explains what that means for managers and product developers

Contrasting headlines appeared in two papers recently. "Why today's hedge fund industry may not survive" argued one. "Waiting for the flood" declared the other. Which one is right? Today, in the US alone, at least $52 billion in unallocated hedge fund cash is waiting for a green light. This sounds perverse when hedge fund implosion is a daily occurrence.

The latest and most visible story involves Carlyle Capital. Its $31 of debt for each dollar of equity exposes the true extent to which hedge funds have relied on leverage to amplify their returns. Now that banks are forced to beef up their depleted capital bases, deleveraging is gathering pace. So, where do hedge funds go from here?

On the surface, the contradictory headlines mirror nothing more than mutual antipathy. Long-only managers see hedge funds' activities as equivalent to running onto a motorway to pick up pennies. Hedge fund managers perceive their rivals as dinosaurs in the brave new world of absolute returns, relying on gimmicks like 130/30 funds.

The success of hedge funds in the 2000-3 bear market sparked a worldwide interest in uncorrelated absolute returns. This resulted in a notable shift from long-only to alternatives. In response, long-only managers have diversified in order to attract additional capital and deliver better returns. A recent CREATE-KPMG study, Convergence and Divergence: New Forces Shaping the Investment Universe, shows that in the last three years around 40 per cent of them have entered into hedge fund type strategies, using shorting, leverage and derivatives.

The study also shows that hedge fund managers who have done IPOs, or are planning one, have gone into the long-only space in order to secure the stable revenue streams demanded by external shareholders. Worldwide, over 20% of hedge fund managers have also diversified into long-only strategies. As a result, the two camps have been converging, as have their returns, net of fees. However, the current financial tsunami is exposing some fault lines developing under the surface.

HEDGE FUNDS DEFY DEFINITION SINCE THEY INVOLVE EXPLOITING PRICE INEFFICIENCIES

SHAPE UP...

For hedge funds, it was not enough that long-only funds failed their clients at the end of the 1990s raging bull market. As clients subsequently diversified into alternatives, hedge funds had to succeed in their own right by delivering absolute returns in good times and bad.

However, this is not currently happening. Many new hedge funds have been registered recently to capitalize on distressed situations and some are attracting capital. The data on returns over the past nine months look respectable, until one allows for their survivorship bias. A tiny minority of hedge fund managers are shouting from the roof top and grabbing extensive media headlines. For the rest, uncorrelated returns remain a mirage.

Internal research done by a major prime broker shows that in the past three years, we have entered the "3/97 world" where 3% of hedge fund managers delivered 97% of value. Undoubtedly, there are stars out there. For the remaining 97% of managers, the choice is shape up or ship out.

Currently, the hedge funds universe is perceived as having three distinct groups of managers:

- around 5% of managers are clear stars: they provide the prime capacity that is capable of generating different risk-return characteristics in line with client expectations.
- 60% are wannabes: many are second generation long-only managers with the right pedigree, who aspire to stardom.
- the remaining 35% are has-beens: they are victims of the brutal churn and burn that characterise their universe.

Time will tell how many wannabes will turn into stars. They are a rare breed and the current crisis has severely tested them. For their universe to remain viable, it needs an ever faster infusion of new talent, capable of innovating new strategies as markets evolve, and able to scale their business in order to meet new demands. At present, this is not happening, since the inflow of new talent has eased lately. Nor is the existing talent keen to scale its business beyond a certain point.

Hedge funds defy definition, since they involve exploiting price inefficiencies in a range of markets. On the down side, they hit capacity ceilings long before other investment vehicles: new strategies soon go out of fashion, as opportunities get arbitraged away with newcomers. On the upside, however, the hedge fund universe is boundless.

The key to success is having talented individuals who can devise new trading strategies and commercialise them at an ever faster rate. Only the most innovative managers can thrive in this environment.

Scaling the business in response to rising demand has involved transitions that the majority of boutique hedge fund managers have been unwilling to accept due to the resulting dilution of their craft. They see theirs as lifestyle businesses where profit matters more than growth, scope more than scale, performance more than size, autonomy more than ownership.

Hedge fund managers all have to grapple with three other paradoxes. Start-ups require a critical mass to attract money, but without money, they can't build that mass. A sustainable business requires scale, but scale is the enemy of alpha. Pension funds require discipline, but discipline stifles creativity. Each choice carries unpalatable risks, which are inherent to hedge funds.

... OR SHIP OUT

A growing proportion of hedge fund managers are venturing into the long-only space, for reasons that go well beyond providing stable revenue streams for their external shareholders.

Hedge funds are being institutionalized. On the demand side, pension funds are making allocations. On the supply side, their managers are creating an infrastructure of governance, systems and controls that meet their clients' fiduciary obligations.

This development not only makes them credible players in the long-only space. It is also changing the cottage industry nature of hedge funds, as it increasingly recognises that 'sticking to the knitting' is the new mantra for pension funds.

- pension funds worldwide need average annual returns of around 9% to meet their future liabilities from existing levels of funding. The majority of them are sourcing these costs effectively from the best-of-breed mainstream asset managers without recourse to extra risk and high charges.
- pension funds' pursuit of high returns is no longer couched in terms of product alpha, defined here as excess returns over a benchmark. Increasingly, solutions alpha is being sought, too, which involves delivering targeted returns at lower risk, lower volatility, and lower charges. This view of alpha is based on the belief that beta will remain the overwhelming source of wealth creation in future until there are more alpha managers with credible track records.
- the growing correlation between major asset classes is forcing pension funds to look further afield by exploiting the advantage inherent in their status as long term investors and the associated illiquidity premium via 'exotic' beta strategies. For example, in Denmark, the emphasis has been on infrastructure; in the Netherlands on forestry.
- The long-only world is evolving its own version of alternatives and deploying the tools that have hitherto been stock in trade for pure hedge fund managers.

Current realignments in the investment universe support both the headlines cited at the start. The purist hedge fund model can't bear the weight of the new institutional money. Much of it will end up in "hedge funds" that don't hedge!

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AMIN'S ADVICE

Tips and checklists for CEOs, CIOs and COOs:

Convergence between long-only and hedge funds is elegant in principle, but messy in practice. A transitional phase is always rich in the law of unintended consequences, which jack up the cost-income ratio and weaken the operating leverage. In particular, attracting institutional clients means getting a number of business basics in place. They are:

1. GOVERNANCE
Does your business have a clearly defined board structure and practices?

2. INVESTMENT PROCESS
Do you have a replicable investment process?

3. PRODUCT SUITE
Are the risk- returns features of your products clearly defined?

4. RISK & COMPLIANCE
Do you have the necessary systems and controls in place?

5. TRANSPARENCY
Do your investment strategies make sense to your clients?

6. LIQUIDITY & COMPLEXITY
Do your clients understand that they can't cash out easily with some products?

7. VALUATION
Do you offer independent valuation of non marked-to-market strategies?

8. PERFORMANCE
Do you offer regular, timely and accurate reporting?

9. ATTRIBUTION ANALYSIS
Do you breakdown performance between manager skills and market movements?

10. CLIENT SEGMENTATION
Do you have a clear service proposition for different client groups?