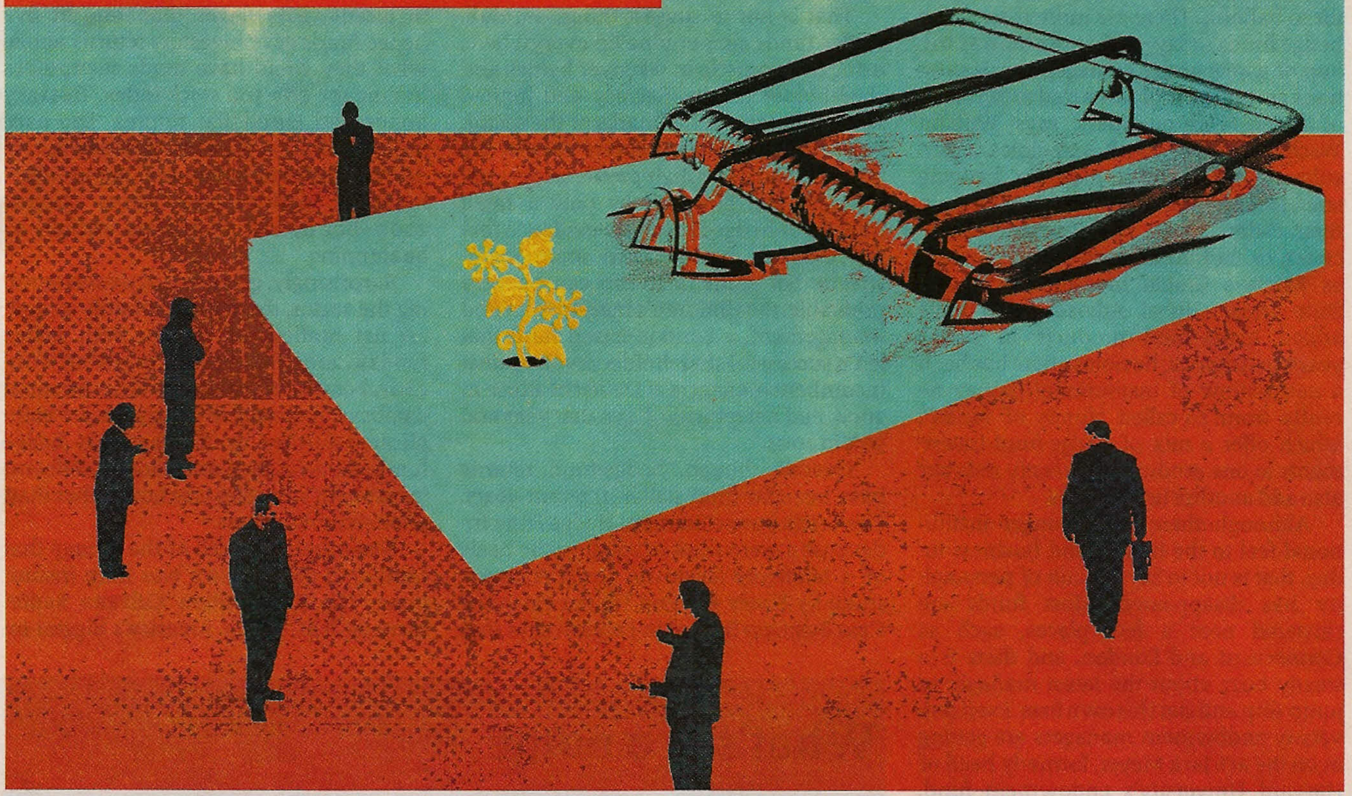


Growing pains

As institutional investors move in, hedge funds are losing some of their rough edges—and their spectacular returns

IN QUIET moments veteran hedge-fund managers sound a little wistful these days. Being a "hedgie", they reflect, isn't as much fun as it used to be. This may seem hard to believe, since many hedge-fund managers are very rich indeed. Steven Cohen, a hedge-fund star in Greenwich, Connecticut (the industry's main cluster in America) took home more than $500m last year. Plenty of others have pocketed $100m or more.

Much of the nostalgia is for an era of spectacular returns. Last year, overall returns in hedge funds were modest at best (although 2006 is off to a stronger start). But something more profound is going on: hedge funds are growing up. What once was a cottage industry is being institutionalised. The mix of investors has changed dramatically in the past five years, and that has led to big shifts in everything from fund size to competition, risk profiles, transparency and—horrors!—regulation.

That has raised a paradox: can the industry be big and yet retain the innovative, risk-taking culture that produced the returns which, in turn, encouraged more conservative investors to invest in it? There are signs that some leading fund managers are limiting the size of their funds because they think big money is incompatible with their way of doing business. Meanwhile, hedge funds face other pressures. New investors are more demanding and, curiously, risk-averse, which is forcing some hedge funds to change their investment style. And competition is growing, as more traditional fund managers introduce products that mimic hedge funds and crowd the market, making it harder to distinguish a genuine hedge fund from a souped-up traditional fund.

Amid all the change, regulators are looking more closely at the sector than in the past. This week Britain's Financial Services Authority (FSA) levied a £1.5m ($2.6m) fine against GLG Partners, a hedge fund based in London, and one of its traders, for improper securities trading. French regulators are reportedly also investigating GLG and its co-founder Pierre Lagrange, along with other big London-based hedge funds, for alleged insider trading. Such scrutiny is yet another restraint on hedge funds' buccaneering culture.

The changing investor mix is one reason why regulators are watching the sector more closely. Until recently, hedge funds were the exclusive preserve of rich Texans, Arab sheikhs and family offices of the super-wealthy. These investors put their millions in the hands of entrepreneurial fund managers who promised—and often delivered—stellar returns whilst offering almost no explanation of how they did it.

Today's hedge funds are increasingly monitored by professional managers at pension funds, endowments, foundations and even central banks—a much less colourful and vastly more demanding bunch. This new group of investors controls sums huge enough to make the assets of most hedge funds look like rounding errors. In short, they are investors with clout.

Today 50-60% of hedge-fund assets come from institutions, reckons Oliver Schupp, president of the Credit Suisse/Tremont Index, an indicator of fund performance. This trend is most pronounced in Japan and, to a lesser extent, pockets of continental Europe. In America, where the bulk of hedge funds are based, endowments and foundations embraced the sector early on, whereas other institutions were more tentative. Britain has the smallest take-up by institutional investors, although London is a big base for hedge-fund managers. "There's been much more cynicism among UK investors, due to the lack of transparency," says Dominic Rossi of Threadneedle Asset Management, an investment firm that manages traditional as well as hedge funds.

Institutional money has helped the sec- ▸▸

tor to balloon. There are more than 8,000 hedge funds today, with more than $1 trillion of assets under management. Institutions are increasingly attracted to two sorts of hedge-fund providers, says William Wechsler of Greenwich Associates, a consultancy: firms with multiple hedging strategies on offer and research to back up their claims, such as Bridgewater Associates; or traditional fund managers such as Barclays Global Investors (BGI) and State Street Global Advisors that have added hedge-fund products in recent years. In America, he notes, there has been a net outflow of institutional money recently from so-called "funds of funds", which offer a mix of hedge-fund investments in one product to diversify risk, but also add another layer of fees.

Although there is a stronger institutional feel to the hedge-fund business today, that is not to say the cult of personality has disappeared. Most funds are clustered near a few places, such as Connecticut and London, and there is a steady buzz about the latest manager to jump ship and start his own firm. Even university-endowment managers are getting in on the act: Jack Meyer, formerly head of Harvard University's endowment fund, recently raised a record $6 billion for his start-up hedge fund. Paul Allen, a co-founder of Microsoft, has reportedly put $1 billion of his own money into a new firm being launched by Mike McCaffrey, who as chief investment officer at Stanford University helped that entity's $14.3 billion endowment to earn double-digit annual returns for a decade. Other hedge funds have launched with "star" power from investment banks. Eton Park Capital is run by Eric Mindich, formerly of Goldman Sachs, and Cantillon Capital was started by William von Mueffling, previously a successful portfolio manager at Lazard.

Indeed, the industry is still largely driven by personalities and reputations. Investors are backing the managers they believe can find and exploit inefficiencies or wrinkles in the market better than anyone else. How to reconcile the reality of this large and increasingly conservative sector with its swash-buckling and secretive image? "Perception always takes a while to catch up with reality," says Stanley Fink, chief executive of Man Group, a global asset-management firm with a big stable of hedge funds. "The days of 30%-plus returns for hedge funds are long gone," he says. "The Wild West is over."

Expectations of annual returns have certainly changed: ten or 15 years ago, investors "wanted 30-50% returns and could handle the down years," says Jerry del Missier of Barclays Capital, an investment bank. Now pension funds will settle for 8-10% returns, but want less volatility. In general, he says, "people have stopped looking for the drama."

That is not to suggest things are dull. Hedge funds are popping up everywhere, using their muscle in takeover battles and shareholder revolts. Secrecy and limited regulation remain hallmarks of the sector. But some industry observers suggest the activism and other high-profile tactics—admittedly, still practised by only a small fraction of hedge funds—are evidence that the industry has become more mainstream. For some, activism can be very profitable: the Children's Investment Fund Management, a London-based fund that led a successful shareholder revolt against incumbent managers at Deutsche Börse in 2004, had net returns of 43% that year and 50% in 2005.

Overall, though, hedge-fund returns have been far from stellar in recent years. The Credit Suisse/Tremont Hedge Fund Index rose a mere 7.61% in 2005, on the heels of a relatively lacklustre 2004. A recent study by Harry Kat and Helder Palaro of Cass Business School in London says that in recent years fewer than one in five hedge funds gave investors returns above what they could have made themselves trading the S&P 500 stock index, Treasury bonds and Eurodollar futures. The pace has picked up at the start of 2006—the index was up 3.23% in January, the strongest monthly performance since August 2000—but overall returns are unlikely to be stunning.

Surprisingly, given the hype surrounding the sector, there was probably a modest net outflow of money from hedge funds in 2005. Exactly how much left is unclear, because the industry lacks a central database. Attempts to generalise are complicated further by the fact that hedge funds are actually a collection of different investment strategies (see box) rather than a coherent asset class.

Nevertheless, much of the money that came into the industry was from institutions. The $200 billion CalPERS Retirement system, one of America's biggest in-

Hedging terminology

What's in a name

The label "hedge fund" is getting fuzzier by the day

WHAT exactly is a "hedge fund"? In essence, it is a managed pool of capital for institutional or wealthy individual investors that employs one of various trading strategies in equities, bonds or derivatives, attempting to gain from market inefficiencies and, to some extent, hedge underlying risks.

Hedge funds are often loosely regulated and usually are much less transparent than traditional investment funds. That helps them to trade more stealthily. Funds typically have minimum investment periods, and charge fees based both on funds under management and on performance.

Many experts contend it is a mistake to talk about hedge funds as an asset class; rather, the industry embraces a collection of trading strategies. The appropriate choice of hedging strategy for a particular investor depends largely on its existing portfolio; if, for example, it is heavily invested in equities, it might seek a hedging strategy to offset equity risk. Because of this, discussion of relative returns between hedge-fund strategies can be misleading.

Hedge funds use investment techniques that are usually forbidden for more traditional funds, including "short selling" stock—that is, borrowing shares to sell them in the hope of buying them back later at a lower price—and using big leverage through borrowing.

The favoured strategies tend to change. "Previously the hedge-fund industry was equity driven, but now there is less long/short," says Oliver Schupp of Credit Suisse/Tremont Index. "Now it's a much more diverse picture with less concentrated exposure." Some of the most common strategies include:

- **Convertible arbitrage**—This involves going long in convertible securities (usually shares or bonds) that are exchangeable for a certain number of another form (usually common shares) at a preset price, and simultaneously shorting the underlying equities. This strategy did very well for several years, but has been less effective recently.
- **Emerging markets**—Investing in securities of companies in emerging economies through the purchase of sovereign or corporate debt and/or shares.
- **Fund of funds**—Investing in a basket of hedge funds. Some funds of funds focus on single strategies and others pursue multiple strategies. These funds have an added layer of fees.
- **Global macro**—Investing in shifts between global economies, often using derivatives to speculate on interest-rate or currency moves.
- **Market neutral**—Typically, equal amounts of capital are invested long and short in the market, attempting to neutralise risk by purchasing undervalued securities and taking short positions in overvalued securities.

vestors, recently doubled the size of its hedge-fund investments to $2 billion. Also in California, the San Diego County employees' retirement association, America's top-performing big public-retirement fund over the past decade, has about one-fifth of its total assets ($1.3 billion) in various hedge funds, roughly the same share as in the big university endowments.

Given the mediocre returns, why are institutions investing? Partly because of poor returns in other asset classes and the herd's sense that others have made a lot of money from hedge funds. But their belated arrival also signals slow decision-making processes—changing the strategy of a big institutional investor takes time.

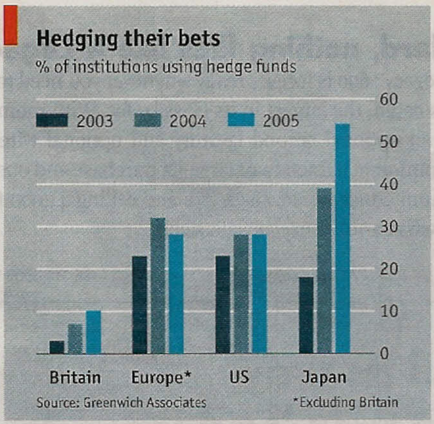
According to a recent report on European investors by the Centre for Risk and Asset Management at EDHEC, a French business school, diversification is another powerful reason why institutions think they should invest in hedge funds. The study found that hedge funds had low correlations with other investments. Other advantages cited by institutions included hedge funds' low volatility, lack of correlation with economic cycles, and the extreme risks they can afford—presumably in the hope of making big returns.

Well matched

Pension funds have been particularly keen to diversify as they struggle to address a longstanding mismatch between their assets and long-duration liabilities. Mark Tapley, a pension-fund adviser and administrator at the hedge-fund centre run by London Business School (LBS), notes that consulting actuaries are searching for liability-matching strategies. He says there is a more intense search for what is known as "alpha" (returns above those of the relevant market index).

Some investors remain sceptical. "We're very nervous whether we have the skills to identify the hedge-fund managers with the right strategies, as opposed to those who are lucky or have a good story to tell," Penny Green, a trustee with a British university employees' pension scheme, told an industry conference recently. Other institutional investors complain about a lack of understanding about investment techniques, a shortage of staff to investigate alternatives and worries about corporate governance (including potential lawsuits). "People want to know exactly how you're making your money," says Fred Dopfel of BGI. He says institutional investors need to know exactly how hedge-fund strategies fit with the rest of their portfolios. They also seek a clear separation of returns: "Market exposures are cheap," he says. "Alpha is expensive." In other words, hedge-fund managers charge a lot to beat the market average.

A typical fund's compensation structure involves a 1% or 2% management fee (a



few have stretched the limits with 3%, but investors balked), plus fees paying out 20% of performance. In Europe an estimated 75% of institutional investors with hedge-fund assets are in funds of funds. Increasingly, though, multi-strategy funds are attracting more interest.

The size of individual hedge funds is a growing concern for fund managers. "Once you become large it starts hurting, for a variety of reasons," says Narayan Naik, director of the hedge fund centre at the LBS: "No market is anonymous when you need quantity." Automated trading programs have proliferated, as funds increasingly flood exchanges with multiple small orders, in order to camouflage their trading strategies.

Several studies last year were pessimistic about the industry's ability to generate long-term returns as it grows larger. More

and more retail investment funds are capping their sizes in an effort to protect their agility and performance. Mr Meyer's fund, Convexity Capital Management, has reportedly decided to accept no more than $1 billion per year in new investments over the next three years.

As hedge funds get bigger, the worry is that managers will also become more cautious. For a growing number of managers, the main goal is "not to make mistakes," says Matthew Ridley of Consulta, a family office and investment firm. He notes that managers of large funds can live nicely on management fees alone. For retail investors and those institutions seeking edgier strategies or a personalised approach, he recommends smaller funds.

Mr Fink says he, too, worries about managers becoming too risk-averse. A shift into "asset-retention mode", he says, is "the kiss of death". Man Group has dealt with the difficulty by offering two sorts of hedge funds, he says: those that provide more transparency and lower returns, and those that are more opaque, focused and likely to give higher returns—for example Man Group's AHL Fund, a managed-futures fund that uses automated "black box" trading to invest in more than 100 futures markets across the world. It returned 14.3% in 2005, and has had average returns of 18.1% since it started.

Time to trim

Regulatory oversight of hedge funds remains relatively light, but there are signs that it, too, may grow more burdensome. Although hedge funds can set up almost anywhere, fund managers still like the marketing value of the imprimatur of America's Securities and Exchange Commission (SEC) or Britain's FSA. The SEC's fund-registration deadline on February 1st, which also affected large foreign funds with numerous American investors, was resisted by the industry, but stricter regulations are probably inevitable when retail investors' money is at stake.

Many observers predict consolidation among hedge funds in years to come. The liquidation rate of funds surged last year. Others have been bought out in whole or part by bigger businesses: Legg Mason, a big mutual-fund firm, bought Permal Group, a hedge-fund firm, for about $1 billion last year; ABN Amro, the banking group, bought out International Asset Management, one of London's oldest fund-of-fund managers, in January; and the derivatives unit of American International Group, an insurance giant that already has a fund-of-funds unit, bought a 4.3% stake in Aspect Capital earlier this month. The trend makes sense to those who watch the industry closely. "There are too many managers chasing too few opportunities," says Mr Naik. "Everyone is using the same models." ■