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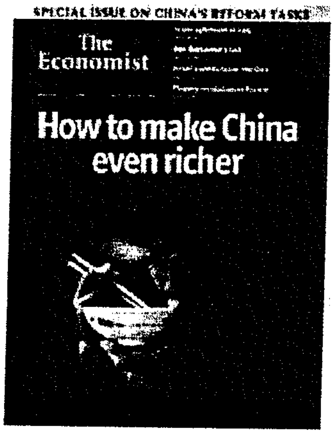

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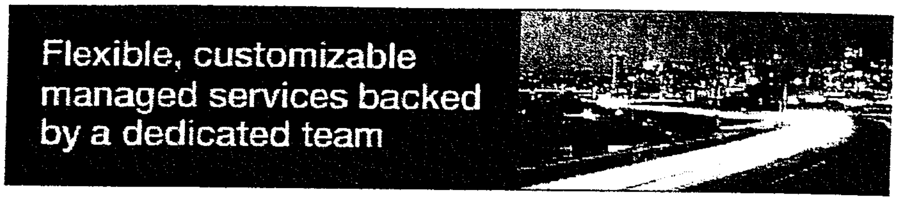


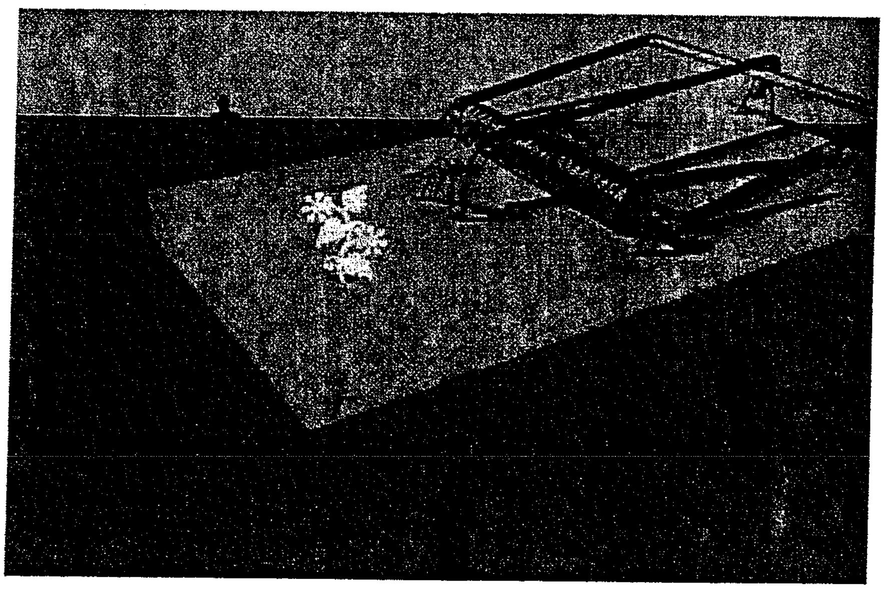
Special Report

Hedge funds

Growing pains

Mar 2nd 2006
From *The Economist* print edition

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



IN QUIET moments veteran hedge-fund managers sound a little wistful the Being a "hedgie", they reflect, isn't as much fun as it used to be. This may to believe, since many hedge-fund managers are very rich indeed. Steven hedge-fund star in Greenwich, Connecticut (the industry's main cluster in took home more than $500m last year. Plenty of others have pocketed $1 more.

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

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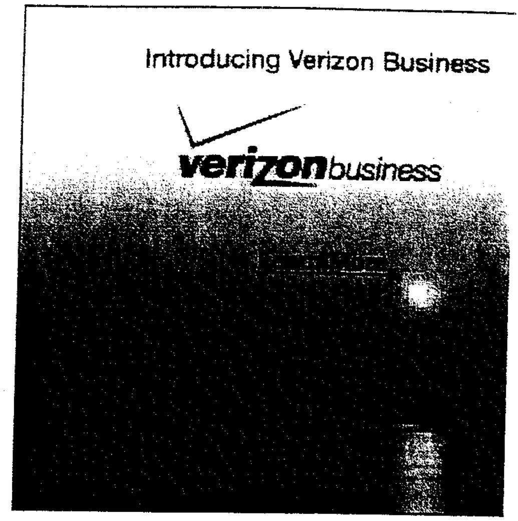
That has raised a paradox: can the industry be big and yet retain the innovative, risk-taking culture that produced the returns which, in turn, encouraged more conservative investors to invest in it? There are signs that some leading fund managers are limiting the size of their funds because they think 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 fund: crowd the market, making it harder to distinguish a genuine hedge fund fr souped-up traditional fund.



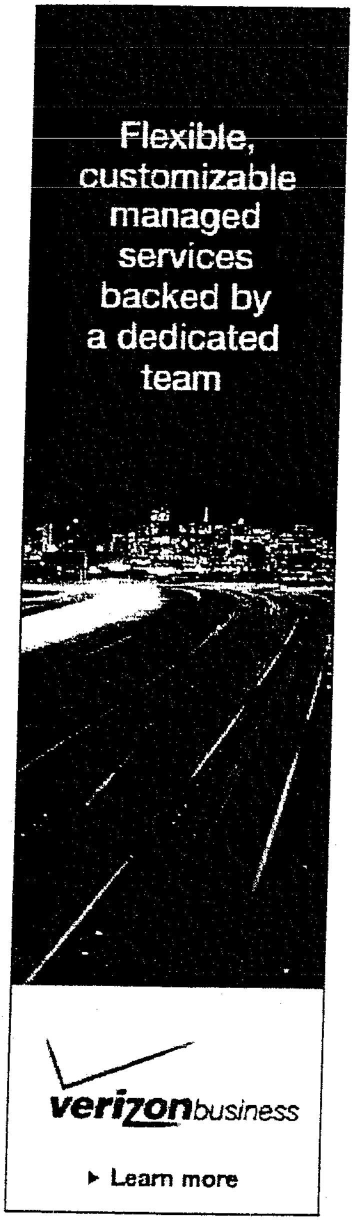
Amid all the change, regulators are looking more closely at the sector thar past. This week Britain's Financial Services Authority (FSA) levied a £1.5m fine against GLG Partners, a hedge fund based in London, and one of its tr improper securities trading. French regulators are reportedly also investiga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

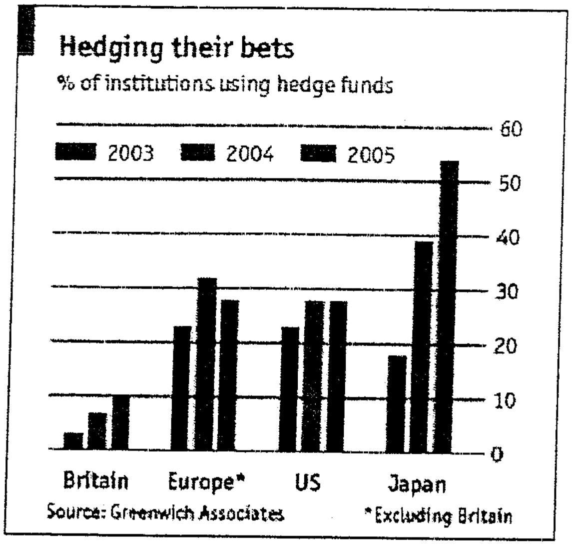
The changing investor mix is one reason why regulators are watching the s more closely. Until recently, hedge funds were the exclusive preserve of ri Arab sheikhs and family offices of the super-wealthy. These investors put t millions in the hands of entrepreneurial fund managers who promised—anc delivered—stellar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

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

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

Institutional money has helped to balloon. There are more than 8,000 hedge funds today, with more than of assets under management. Institutions are increasingly attracted to twc





firms with multiple hedging str offer and research to back up t claims, such as Bridgewater As or traditional fund managers su Barclays Global Investors (BGI Street Global Advisors that hav hedge-fund products in recent America, he notes, there has b outflow of institutional money i from so-called "funds of funds' offer a mix of hedge-fund inve: one product to diversify risk, b another layer of fees.

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

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

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

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

Overall, though, hedge-fund returns have been far from stellar in recent y Credit Suisse/Tremont Hedge Fund Index rose a mere 7.61% in 2005, on t a relatively lacklustre 2004. A recent study by Harry Kat and Helder Palarc funds gave investors returns above what they could have made themselve the S&P 500 stock index, Treasury bonds and Eurodollar futures. The pace up at the start of 2006—the index was up 3.23% in January, the strongest performance since August 2000—but overall returns are unlikely to be stur

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

Nevertheless, much of the money that came into the industry was from ins The $200 billion CalPERS Retirement system, one of America's biggest inv recently doubled the size of its hedge-fund investments to $2 billion. Also California, the San Diego County employees' retirement association, Ameri performing big public-retirement fund over the past decade, has about one total assets ($1.3 billion) in various hedge funds, roughly the same share a big university endowments.

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

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

Well matched

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

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

A typical fund's compensation structure involves a 1% or 2% managemen have stretched the limits with 3%, but investors balked), plus fees paying performance. In Europe an estimated 75% of institutional investors with h assets are in funds of funds. Increasingly, though, multi-strategy funds are more interest.

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

Several studies last year were pessimistic about the industry's ability to ge long-term returns as it grows larger. More and more retail investment func capping their sizes in an effort to protect their agility and performance. Mr fund, Convexity Capital Management, has reportedly decided to accept no $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 m cautious. For a growing number of managers, the main goal is "not to mak mistakes," says Matthew Ridley of Consulta, a family office and investmen notes that managers of large funds can live nicely on management fees al retail investors and those institutions seeking edgier strategies or a persor approach, he recommends smaller funds.

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

Time to trim

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

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

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