CHAPTER 3

How Large Is the Market?

It seems that everyone on Wall Street wants to work for or run a hedge fund. It seems that everyone on Main Street wants to invest in a hedge fund, and then there are some of us who just want to know how many hedge funds there are and how much money these capitalists are managing. While the two statements are true—it is impossible for us to get an answer to the last question.

HEDGE FUND DATA IS WEAK

Comprehensive hedge fund data is exceedingly deficient. Since there is no consolidated database and individual investment managers voluntarily report results to various databases, it is truly impossible to arrive at a true count of the industry. Unlike mutual funds, which are required by an act of Congress to report their returns and assets under management to FINRA (Financial Industry Regulatory Authority) on a daily basis, there is no such rule for hedge funds. This is a serious problem that Congress and the powers that be need to fix if they ever really want to get their hands around the hedge fund industry.

There are at least 10 recognized hedge fund databases that collect and report hedge fund data with some regularity. The most noteworthy include but are not limited to Credit Suisse/Tremont, Hedgefund.net, Morningstar, and Barclay Group. Many managers that are closed to new investment dollars or those that do not want to share performance results with the database simply don't list the existence of the fund and choose not to provide returns to the database companies. Because there is no reporting requirement and for the most part the databases operate on a catch-as-can basis, many firms with good performance histories report numbers and demand inclusion, whereas those with bad numbers simply don't. It is really ridiculous that the industry operates this way. It makes little or no sense, yet it is accepted.

Many service providers, including prime brokers and information sources such as Infovest21 and Lipper HedgeWorld, conduct surveys that allege to provide results that point to the size of the hedge fund industry, but the data is questionable. As recently as the summer of 2008 it was estimated that approximately $2 trillion dollars in assets was under management at hedge funds around the globe.[1]

Technology Is Helpful

One of the best indicators of the size of the hedge fund industry is an annual study done by PerTrac. Founded in 1996, PerTrac provides an analytical software solution for hedge fund investors to compile a range of statistical measures for portfolio construction and to generate reports to track performance for individual managers as well as universes of all hedge fund strategies. PerTrac aggregates 11 databases, including Barclay's, CogentHedge, CISDM, Eureka, Hedgefund.net, Hedge Fund Research, Lipper/Tass, Morningstar/Altvest, and MSCI Hedge Fund Indices, and has issued an annual study since 2003 that defines the size of the hedge fund industry. This study, which is generally issued in the first quarter of each year, has become a widely followed industry indicator. The results of the 2008 study are included in the Appendix.

In the report for the year ending 2007, PerTrac found that despite the overlap between the databases and the widespread growth among them, relatively few hedge funds report to more than two or three databases, and only one fund reports to all 11 databases. In fact, a significant number of hedge funds and fund of funds, about 12,000 in the 11-database sample, appeared only in a single database.

In 2007, the study found that new fund launches declined; although that information is interesting, it is unclear how many funds actually do not participate in the survey. Meredith Jones, a PerTrac employee, said that given the extraordinary growth rates of new fund launches in earlier years of the industry, the slowdown in launch rates was probably inevitable as the industry has matured.

"The decrease in new fund launches reflects the asset flow trends in the industry to well-known established large hedge funds and fund of funds," she said. "This acts as a deterrent for new entrants into the marketplace."

REPORTING IS WEAK

In addition to the reporting issues in the hedge fund industry, there is a second flaw to gauging the size of the marketplace, which is what the popular and trade press use when estimating the asset size of the industry. In short, leverage is not taken into account, and therefore the numbers could be off by a factor of ten.

The "total assets" number is, in reality, the total equity of the funds' equity, not total assets of the investments. Applying the actual total leverage used increases gross exposure of the manager and really represents total assets at risk. Hedge fund managers publish and notify investors of the "equity" in each respective fund.

Leverage

Long/short equity leverage generally employed by managers ranges from none to one-and-a-half times partner capital, resulting in .50 percent leverage. In other words, a manager with $1.00 of capital (or equity) invests $1.50 in assets, with many equity strategies employing higher levels of leverage, in some cases greater than 200–250 percent.

As an example, a long/short equity hedge fund that has $100 million in limited partner equity may be long $100 million in securities and short $80 million. Total gross exposure is $180 million, while net market exposure is low at only $20 million.

How does the total capital get counted and reported to investors and databases? The manager reports $100 million in partner capital, but available trading assets are really $180 million. Risk capital is actually $180 million. In reality, the manager actually has $180 million of market risk against which portfolio volatility must be evaluated, not the equity of $100 million. For every $1 price move, there will be a $1.80 move in portfolio price. In 2008 there were record levels of redemptions as investors witnessed the impact of leverage.

On the leverage scale of low to high, long/short equity managers' use of leverage is moderate. Fixed-income arbitrage and derivative strategies typically use higher levels of leverage, often exceeding 10 times the actual equity investments. Mortgage-backed securities managers often use higher levels of leverage, whereas many other arbitrage strategies, including convertible arbitrage and corporate bond arbitrage, use leverage ranging from two to four times. Leverage is used to enhance returns, period.

If we use the 2007 PerTrac results for the size of the hedge fund industry, equity capital is $2 trillion, and the total actual assets of the hedge fund industry are dramatically understated. When total assets invested are considered, the figure probably exceeds $10 trillion, closely approaching total mutual fund assets of $11.5 trillion[2] before the deleveraging of 2008 began.

Risk Management

Risk managers are concerned about systemic risk and volatility as well as leverage and always work to evaluate the portfolio exposure on both gross and net exposures of the assets. With $10 trillion in hedge fund assets and adding off–balance sheet items, including derivatives, swaps, special purpose entities, which in turn include collateralized debt obligations (CDOs) and collateralized loan obligations (CLOs), market exposure and volatility are certainly greater than the ''accepted'' industry asset estimates of $1.5 to $2 trillion.

In looking at the total size of the hedge fund industry, the correct benchmark must be to consider total market exposure, not total equity or total assets invested in funds. In other words, while the equity of the hedge fund industry may have been $2 trillion in 2007, the industry commanded control of assets in excess of $10 trillion at year end 2007. This represents the capital at risk for on–balance sheet positions, not including off–balance sheet derivatives or credit default swaps of other leverage vehicles. In short, hedge fund assets are becoming very cumbersome, and hedge funds no longer can be called a ''cottage industry.''

Based on the 2007 results of the report,

- 15,250 single-manager hedge funds were identified, along with 7,400 fund of funds in 2007, compared with 13,675 single managers and 6,100 fund of funds in 2006.
- 4,600 distinct general partners were identified, compared with 4,900 in 2006.
- 35 percent of the single-manager hedge funds were U.S.–based funds, with 66 percent offshore, essentially unchanged from 2006.
- 13 percent of the fund of funds were U.S. based, and 87 percent were offshore.

According to the data, fund of funds assets were about $980 billion, and one-third of the fund of funds manage less than $25 million.

Single-manager funds had $1.41 trillion in assets, with 250 having assets greater than $1 billion. One-third of single-manager funds manage less than $25 million.

INSTITUTIONALIZATION OF HEDGE FUNDS

As the industry has grown and the acceptance of hedge fund investing has spread, many have said the industry is becoming institutionalized. This has resulted in large hedge funds continuing to grow and expand, with more then 350 having assets of greater than $1 billion.

In reviewing the fund of funds industry, the story is a bit skewed. Assets in fund of funds have grown from $84 billion at year end 2000 to nearly $1 trillion in 2008. According to data provided by Freeman & Co LLC, a New York–based advisor to the financial services industry that provides M&A advisory services and strategic management consulting, the compounded annual growth rate of assets under management since 2000 has been 44.1 percent for fund of funds compared with 21.3 percent for hedge funds.

Freeman's data shows that 2,000 hedge fund and fund of funds assets were $491 billion in 2000 with 17 percent in fund of funds, and Q3 2007 results totaled $1.81 billion with fund of funds assets making up 55 percent of total hedge fund assets. Clearly, as investors gain access to hedge funds, fund of funds have gained the greatest share.[3]

One of the questions that is often raised about starting a hedge fund or fund of funds is: what is the barrier to entry? We have posed a different question that many investors have raised: what is the barrier to investing in fund of funds?

The existence of high fees or a second level of fees is the most often cited barrier to investing. This comment continues to be made quite vociferously in light of the Madoff mess. However, fraud aside, longer-term fund of funds investors generally seem to be more satisfied than new investors. We believe that criticism of the extra layer of fees, while based on reality, is unfounded given that seasoned, committed fund of funds organizations play a vital role in portfolio management for a diversified pool of hedge fund strategies. Of course the Madoff situation has caused many to question whether and how managers allocate assets. While fees are always a sticky subject, we say once again that the only people complaining about fees are those who cannot charge them. In short, you get what you pay for; therefore, make sure you pay for what you are buying and vice versa.

Even if the fee issue is not enough to deal with, the other major concern is transparency. There are too many views on this subject to comment completely about it in this chapter. We will deal with transparency later on; however, it must be said that transparency is important and cannot be overlooked. Therefore, you should ask questions, get answers, and make sure you understand what is being said. If not, you could end up in a Madoff situation, a Tremont situation, or a Fairfield Greenwich situation. And while the jury is still out on the last, everyone knows, unfortunately, what happened with the first.