The Pioneering Role of Hedge Funds

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Hedge funds are being vilified for poor performance and are threatened with heavy regulation. Amidst all this negative comment, it is salutary to remember the hedge funds' pioneering and dynamic contribution to the investment management industry, as well as their substantial positive social contribution. It will be a pity if the heavy hand of regulation destroys the benefits they bring to asset management, the wider economy and society.

The hedge fund industry is undergoing a traumatic phase, with many funds suffering from poor performance and redemptions, and large numbers are expected to close. According to some extreme estimates, 50-80% of the hedge funds are expected to disappear this year, with assets under management shrinking from US$2 trillion-plus at the peak, to a small rump of just US$300 billion.

Much of the attention is focused on disappointing performance, whereby hedge funds are accused of not delivering what they promised.

There are, however, some highly positive features of hedge funds that tend to be overlooked in this general analysis of a likely cull. Amidst all the criticism, there are many aspects in which hedge funds deserve praise. Their strongly pioneering role in venturing into new investment areas, and in the process bringing them to the attention of other investors, is one major aspect. In other ways, they make a strong social contribution, as argued below.

The main hedge fund strategies, listed in Appendix 1, which are widely analysed, do not include many of the new areas pioneered by hedge funds. This is understandable, as individually they do not yet amount to a substantial proportion of assets under management in the industry. Many of these new areas are listed and outlined in Appendix 2, which draws upon extracts from Investment Management Review in the last four years, reviewing and briefly outlining the pioneering activities of hedge funds.

Some hedge funds specialise in a few of these areas, while others will just include them as part of their overall tool kit of strategies. Many players would not even call themselves hedge funds, but in essence they are subscribing to the hedge fund-type *modus operandi* and in the wider sense, can be referred to as hedge funds.

Data on how they have performed is not available in any systematic form, but several features emerge. Many of these sectors would have been high risk and suffered from low liquidity at the outset.

Hedge fund involvement has strongly contributed to establishing two-way markets in these new areas, increasing liquidity and possibly paving the way for main stream investors to take an interest. Some of these sectors such as catastrophe (CAT) bonds and shipping are already growing fast and are potentially significant asset classes in their own right.

Overall hedge funds do deserve some criticism for not delivering on promised performance. Many of them do not add value for the fees they charge and are run by mediocre individuals who have climbed on the bandwagon in recent years. The hedge fund sector has also been oversold to private individuals and institutions, many of whom have suspended judgement and been drawn into risks they did not understand. The Madoff saga is just an extreme example, but unfortunate occurrences are much more widespread. For instance, many prestigious universities have been badly hit by excessive exposure. Investment into a single hedge fund has always been inadvisable for risk-averse individuals and institutions who did not have the resources to conduct the appropriate due diligence. Many, of course, invested through fund of hedge funds, which is a separate topic altogether.

Hedge funds' positive activities are not confined to innovative techniques. As outlined in Appendix 3, some of the better hedge fund activists are making a strong contribution to improving corporate governance in the US and probably worldwide.

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Even the long-established hedge fund techniques listed in Appendix 1 represent a positive contribution to the investment industry's armoury of tools. So much so that some of them have now crept into the mainstream fund management industry. The latter owes much to the hedge fund industry, for providing the impetus for change and becoming more results-oriented. There is also the point that the hedge fund industry has produced some outstanding individuals with superlative performance – individuals who would not have fitted in within the restrictive structures of mainstream organisations.

Conclusion

By venturing into new areas, hedge funds have widened the potential investment universe and they deserve substantial credit for this. This is a strong reason why the hedge fund industry does not deserve to disappear in its entirety, or to be completely regulated as many would argue. There should be always room for brave risk takers to establish new frontiers of investment. The above positive contributions by such individuals translated into a strong contribution by the hedge fund sector in enhancing the dynamism of asset management as a whole, and therefore make an indirect contribution to the economy and society. These pluses should not be regulated out of existence.

APPENDIX 1

The Main Hedge Fund Strategies

List of strategies analysed by EDHEC in "Hedge Fund Performance in 2008", Véronique Le Sourd, EDHEC Risk and Management Research Centre, February 2009:

Convertible Arbitrage, CTA Global, Distressed Securities, Emerging Markets, Equity Market Neutral, Event Driven, Fixed Income Arbitrage, Global Macro, Long/Short Equity, Merger Arbitrage, Relative Value, Short Selling, Funds of Funds.

A widely used index, the CSFB-Tremont index, is sub-divided into many standard sub-strategies, which are widely referred to and are as follows:

Convertible Arbitrage, Dedicated Short Bias, Emerging Markets, Equity Market Neutral, Event Driven, Fixed Income Arbitrage, Global Macro, Long/Short Equity, Managed Futures, Multi-Strategy, Global Growth Opportunities Basket, Markets Defender Basket.

APPENDIX 2

Pioneering Activities of Hedge Funds (Extracts from *Investment Management Review* 2005-2009):

Reinsurance
What can a hedge fund see in reinsurance? This is an industry with a chequered past. It is clearly cyclical and has for the most part produced returns well below what hedge funds have come to expect.

George Soros, the financier who brought hedge funds into the global limelight through his successful speculation against sterling, clearly hopes to exploit a great opportunity through his hedge fund, Glacier Re, which specialises in reinsurance.

Pulp derivatives
A market in pulp futures has become another playground for hedge funds. This instrument is somewhat closer to commodities, a popular hunting ground for hedge fund investors. It is expected that trading will expand in pulp-related derivatives, as pulp buyers look for ways of laying off risk in paper prices for the printing of their magazines. The cyclical and volatile nature of pulp prices, as well as some clearly identifiable opportunities, such as demand for paper shooting up ahead of US election campaigns, is ideal territory for hedge fund forays.

Profit opportunities in global warming

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The launch in January 2005 of the new European emissions trading scheme is providing yet another opportunity for enterprising hedge fund managers. Trading in EU carbon dioxide (CO2) emissions credits started experimentally in mid-2004 and officially opened in January 2005. Liquidity and volume have increased in this market.

Hedge funds in real estate
GEM does not deal in just REITs. It invests in a number of other securities connected to real estate. These include shares in homebuilders and real estate operating companies. GEM also looks at preferred stocks, bonds and derivatives, and invests internationally as well.

Profit and protection from the weather
Trading in weather derivatives has become another hunting ground for hedge funds. This market has grown very rapidly since the first trade was carried out in 1997, and trading volume now exceeds US$5 billion. Though tiny compared with the trillions in interest rate derivatives, this is impressive. Trading started to pick up in September 2004 and over the last few months has been spurting. The increased interest is attributed to hedge funds.

Though hedge funds have a wide expertise in this area, most are sticking with temperature-based futures and options, rather than less typical contracts based on, for example, precipitation (rain, snowfall and snow depth and wind). The reason for this is that temperature-related contracts are the most liquid and will remain the most traded. Hedge funds also prefer straightforward to more complex deals.

Specialist funds are starting up in this field, focusing solely on weather. An example is Tawney and Windle's new venture, Takara.

Weather derivatives more widely used
Increasing volatility in the weather is leading to corresponding increases in related derivatives trading. Before the advent of hedge funds, the market was limping along at US$4 billion, but their arrival has led to this figure multiplying ten times. Peter Brewer, fund manager for the Cumulus Weather Fund, points out that weather is uncorrelated with all other asset classes.

Dealing in credit cards
Purchase of credit card portfolios has become another area of activity for hedge fund managers. Banks seek to sell them for various reasons, including the need for capital. The capital adequacy requirements of Basel II provide the motivation in many cases.

Hedge funds rush in where banks fear to tread
Banks are increasingly withdrawing from riskier lending and their place is being filled by the more intrepid hedge funds. They see profit in businesses which are seen as either too risky or too small for the big banks.

Socially responsible hedge funds
Hedge funds are not known for promoting socially responsible investments, but this is what they are in effect doing in Asia.

They are short-selling companies that look likely to suffer from more rigorous environmental and social restrictions. Though social responsibility is not their motivation, their short-selling promotes the cause of socially responsible investing in the region.

Hedge funds make movies
The financing of films by hedge funds is now reaching the UK. It has already taken off in the US in recent years and 'Capote', which won a best-actor Oscar, was financed by private equity. In the UK, Gregory Mackenzie, a writer-director, and Brett Walsh, formerly of Morgan Stanley, are hoping to raise up to £3 million though the Lexington Film Fund for supporting films at an early stage.

Film finance with low risk
Providing finance for films is widely believed to be high-risk and only for the more intrepid investors. This idea is refuted by the fund management company, Pacific Continental Fund Management (PCFM), which was founded in 2002 and has an innovative approach to investments. They have pioneered a low-risk alternative to backing films, by launching their Film Opportunities fund in February 2005.

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Catastrophe bonds and reinsurance
This is where the hedge fund pioneer, Nephila, comes in. It was the first to offer catastrophe investing in 1998 and has several funds that invest in the risks related to catastrophes and weather. Co-owner Frank Majors began his career as a reinsurance broker and is credited with some of the earliest work in structuring catastrophe bonds.

CAT bonds catching on
Catastrophe (CAT) bonds are catching on and over the past ten years have exploded from zero to a figure approaching US$10 billion, according to Tom Keatinge, head of insurance debt capital markets at JPMorgan. Considering the size of the underlying risks, he suggests that CAT bonds could easily become a US$100 billion market.

Freight carries profits for hedge funds
Freight derivatives are now seen as hot, and it is not surprising that adventurous hedge funds are sniffing opportunities in this rapidly growing market.

There are two types of shipping derivatives: forward freight agreements and sale-purchase agreements. The latter divide ships into tranches, allowing investors to have exposure to several ships or parts of ships. These derivatives are expected to be used by investors as well as ship owners.

The market was not very liquid until three years ago, but volumes are up by more than 400% since 2001, with a corresponding increase in liquidity.

Exciting bets on ships
Ships have become exciting vehicles, attracting investment from pioneer hedge funds and derivatives players. The market is expected to have reached a record US$150 billion in 2007, treble the figure of the previous year. There was some worry in 2007 as to whether shipping would suffer from the general subprime malaise, but it continued to be much more responsive to the economic strength of China.

Third-party backing of court cases
Third-party funding of lawsuits is seen as an investment opportunity and interest has exploded. The risk of losing and having to pay the costs of both sides is a massive deterrent from going to court. Capital markets are offering a remedy.

Exploiting directors' transactions
Brothers Patrick and Robert Hable, together with Ruven Oberlander, have come up with the idea of a fund and a database to systematically exploit directors' dealings in the shares of their own company.

Inside Analytics have nearly 20 clients, drawn from hedge funds and investment banks with between €100 million and €5 billion each. In the universe they use, each company is scored according to various criteria, including directors' deals, and the top 10% of the companies are rated as buys and the bottom 10% as sells.

Singing to profit
An innovative fund has acquired the copyright to more than 26,000 songs, from artists such as John Denver and the Ramones, for which they will get royalties from every commercial performance. Investors have backed it to the tune of US$130 million. The fund, First State Investments' Media Works fund, with leverage up to 50% expects to generate returns of over 15% a year after fees, and pay a dividend of 8-10%.

Hedge funds get into trade finance
Trade finance provides the money in advance for trade deals to be carried out. Traditionally this has been the province of banks supplying overdrafts, factoring and other schemes such as letters of credit. Now that banks are finding the going difficult and funds scarce, some enterprising hedge funds have not been slow to step in.

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APPENDIX 3

A Strong Positive Social Contribution from Hedge Funds

The following is extracted from *Investment Management Review*, vol 4, issue 2, Winter 2008/09, and is based on the following paper in the *Journal of Finance*, August 2008: "*Hedge Fund Activism, Corporate Governance and Firm Performance*", Alon Brav (Duke University), Wei Jiang (Columbia University), Frank Partnoy (San Diago University) and Randall Thomas (Vanderbilt University).

Hedge fund activists do harm or good?
When hedge funds undertake shareholder activism, are the results positive or negative for companies? This is an important question that carries important implications for asset management and corporate governance. The subject of hedge fund activism has attracted substantial controversy in recent years.

Hedge fund activism is tough on CEOs of target companies. In the year following the activism announcement, the average CEO's pay declined by US$1 million and the CEO turnover rate was 10% higher than that of other firms of similar size in the same industry.

Hedge funds are the best activists
Hedge fund activists represent a new type of shareholder intervention and their monitoring is fundamentally different from that of previous activism. Earlier studies are quoted, saying that mutual funds and pension funds in particular did not achieve significant shareholder benefits by activism, unlike the very positive results achieved by hedge funds outlined above. It is suggested that hedge funds are able to influence company management, unlike mutual funds and pension funds, because they employ highly incentivised managers not subjected to regulation. They can hold concentrated positions in a few companies, with their fire-power enhanced through leverage and derivatives. They also suffer fewer conflicts of interest, as they are less beholden to the management of the companies they target. The companies responsible for mutual funds and hedge funds often have other relationships with the companies they invest in.

The evidence suggests that activist hedge funds occupy an important middle ground between internal monitoring by other large shareholders and external monitoring by corporate raiders. They do better than other large shareholders because of their flexibility and independence, while they score over external corporate raiders because of their smaller stakes and frequent support from management and other shareholders.

Policymakers should take note
Many prominent commentators, including some European regulators, have called for regulation of hedge fund activism on the grounds of their alleged short-termism. The authors refute the case for this and challenge the basis for increased hedge fund regulation.

The presence of hedge fund activism exerts a disciplinary pressure on the management of public firms to make shareholders value a priority. Overall hedge fund activism should remain a positive force in corporate governance.

It is interesting that mutual funds and pension funds have a much more mixed record of activism than the positive benefits achieved by the hedge funds. One possible cause not mentioned in the paper is that many mutual funds and pension funds might not be putting the same will into activism, especially if they are being pressurised to be activist.

Particularly in the current climate, hedge funds are being viewed with suspicion and this paper deserves attention. That hedge funds are a positive force for good in the field of corporate behaviour is likely to be a startling conclusion for many who vilify the industry as just filling their own pockets at the expense of everyone else.

Dr Arjuna Sittampalam's experience encompasses the banking, insurance and specialist fund management fields, with a particular interest in derivatives and other innovative portfolio management techniques. Dr Sittampalam is the managing director of investment company Sage & Hermes Ltd, which he founded in 1994 to advise leading financial institutions in the

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USA and Europe on investment management business strategy and operations. Dr Sittampalam is the author of several books on the industry, and is the editor of Investment Management Review magazine. Dr Sittampalam is a Fellow of the Institute of Actuaries in the UK, and holds a PhD in Sub-Nuclear Theoretical Physics from Imperial College, London.

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