



The Hedge Fund Industry 2009 and Beyond: A Roadmap

Christophe Grünig and Marcel Herbst
Harcourt AG

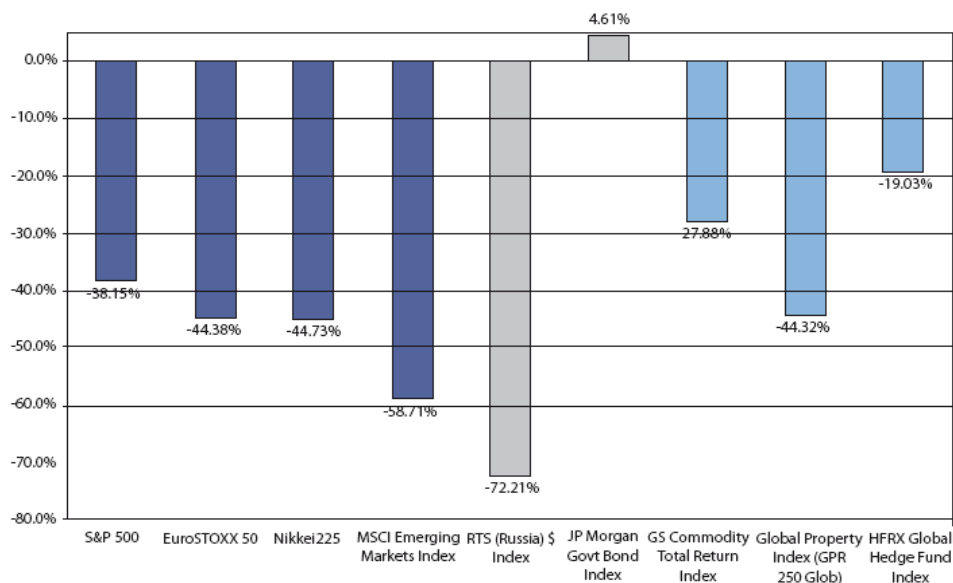
2008 will be long remembered as the year of the liquidity crisis. Within a few months, the competitive landscape of global financial intermediaries was reshuffled. With credit markets frozen, the main equity markets suffered decline of 40% or more and continue to display staggering volatility not seen in generations. The most visible early casualties of the crisis were the large independent investment banks. With governments in Europe and the US now being shareholders in a wide array of financial institutions, the financial world has changed for good. And it is reasonable to expect that more changes are on the way. These tumultuous times have a profound and lasting impact on the hedge fund industry.

With this article, we aim to provide guidance on the following: What are the prospects for the hedge fund industry; to what extent has the opportunity set for hedge funds changed; and what will our industry look like going forward?

2008: Diversification is NOT a Free Lunch

It is often said that “diversification is the only free lunch” on Wall Street. Well, the lunch tab in 2008 so far is staggering. With the exception of cash and perhaps government bonds, the year offered investors no place to hide. Traditional and non-traditional asset classes in both emerging markets as well as developed economies suffered greatly and across the board. The correlation displayed between sectors, styles, asset classes and geographies was almost complete. The liquidity crisis hit the core pillars of economic activity, namely credit and confidence, hard.

Graph 1 | Surveying the damage (YTD)



Source: S&P, Eurostoxx, MSCI, JP Morgan, HFR. Per October 23, 2008



As seen from the table above, especially the most talked about, flow-driven, and best performing investment themes from recent years (emerging markets and commodities) have corrected heavily. Investors in traditional/established parts of the world struggle to remember a period with similar drawdowns. Most of the losses this year stem from a few violent weeks in September and October, which saw markets (including hedge funds) provide bad results as well.

Indeed, hedge funds have clearly failed to deliver absolute, uncorrelated returns. In fact, the industry is on track to complete its worst year ever. Historical analysis shows that this is not surprising given the size of market dislocations and the depth of the systemic crisis. The performance of hedge funds is mostly attributable to the unique characteristics of the current liquidity crisis:

- An increase in counterparty risk and ensuing defaults;
- unexpected and arbitrary regulatory changes that curtailed hedge fund investing; and
- the (forced) deleveraging that was witnessed throughout the entire year.

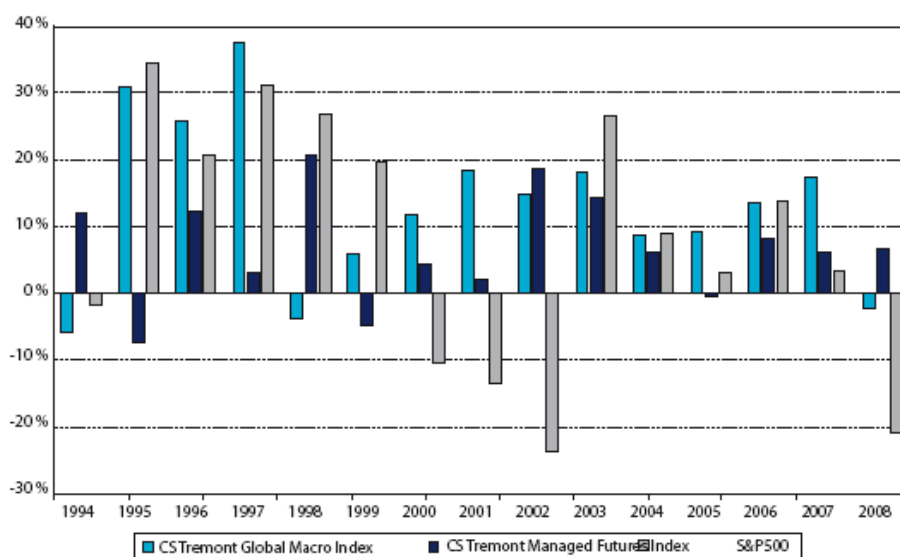
Amongst this backdrop, the sharply lowered appetite for risk increased financing costs and credit lines were cut. Given these adverse circumstances, hedge funds provided less than promised, but the magnitude of the losses is comprehensible.

Therefore, what is notable about the current drawdown is not necessarily its size, but rather the duration: The drawdown is now entering its 11th month. This demonstrates primarily the depth of the systemic crisis and its impact on the functioning of markets. Not surprisingly, strategies which are more directional were hurt by the vicious market correction in the third quarter. Equally, strategies applying leverage (fixed income arbitrage, convertible arbitrage, statistical equity arbitrage) were hit by the skyrocketing cost of funding and margin calls. In times of crisis, complex and leveraged strategies tend to fare worst.

So, what 'worked' for hedge funds in the crisis of 2008, and why?

The strategies that stood out were primarily those that do well in times of self-enforcing trends (CTA, especially short-term), or in times of global macroeconomic shifts (global macro). These two strategies also showed significant resilience during all the crises over the last 20 years (namely, at the end of the '90s and beginning of this decade).

Graph 2 | Global macro & CTA performance compared



Source: CS, S&P. Sept 30, 2008



Global macro & CTA funds invest mainly in very liquid instruments, have relatively simple underlying models and can exploit irrational and sudden market drawdowns. Also, they are 'long volatility', which means that their returns tend to increase during market turbulences. Most other hedge funds strategies are 'short volatility', ie their returns are decreasing during market stress. The 'cost' for the very attractive performance of CTAs and macros during difficult market periods is that those strategies go through prolonged periods of lackluster returns regularly.

The Big Picture: Factors Shaping the Quest for Alpha Going Forward

The financial world order has changed. Banks are partly government-owned; the liquidity crisis is not over yet; the effect of government bailouts and the regulatory environment remain uncertain; a global recession is very likely; and market participants expect a period of continued heightened volatility until credit markets have regained at least some semblance of normalcy.

Regardless of the timing of the resolution of the crisis, we believe that the future of the hedge fund industry, and its potential to generate absolute risk-adjusted returns, will structurally be dominated by three main themes:

- Less active risk takers, both in number as well as assets;
- lower assets for the hedge fund industry in the near term;
- and a changing regulatory environment and unforeseeable impact of governmental actions on markets.

The pie will be shared by fewer.

The key outcome of the liquidity crisis so far is the demise of the large, global independent investment banks. They have either ceased to exist (Lehman Brothers), reorganised as bank holding companies (Goldman Sachs), or have been acquired by regulated banks (most everybody else). As newly regulated entities, these banks now have access to favourable treasury financing. At the same time, the regulated nature forces banks to decrease leverage ratios significantly. Most independent investment banks had leverage ratios of 20-30 pre-crisis; regulated banks have leverage ratios of 10-12.

The impact for hedge funds is two-fold.

First, the large proprietary trading desks of investment banks have turned from aggressive risk takers to meek participants in the investing game. In the quest for Alpha, hedge funds will no longer have to compete against these once powerful counterparties which deployed multi-billion dollar, often leveraged, proprietary trading strategies. At the same time, the decreased risk appetite of investment banks means that leverage for hedge funds will be more difficult to obtain, and pricier. However, with risk premiums being at historically high levels and the abundance of distressed assets, hedge funds will (going forward) be far less dependent on leverage to generate attractive returns (much less are they inclined to do so!).

Therefore, all else being equal, the net effect of the above is positive for the hedge fund industry.

Assets of the hedge fund industry will decline in the short term.

At the time of this writing, fund closures have surpassed fund launches; many funds are enforcing gates or suspending redemptions altogether; and the performance weakness of many brand-name funds (Citadel, SAC, etc) is well documented. We are also anecdotally seeing consultants and institutional investors postpone their searches for managers.

So, our estimation is that, within the next two redemption cycles, hedge funds will lose approximately 30% of assets as a result of:

- 1) Closures due to underperformance;
- 2) obsolete (high leverage) strategies;
- 3) redemptions primarily from private investors and structured products; and
- 4) a general reluctance of the investing community to invest in any low-liquidity vehicle at the present time.

Part of these redemptions is pre-emptive in nature (meaning that investors place redemption orders to have the option to redeem, knowing that they can withdraw these redemptions later).



We also predict that the number of hedge funds will decrease more than the assets, since it will be more difficult for small funds to exist (and small funds make up a significant majority of the hedge fund universe). We believe that this “cleansing by fire” is ultimately positive for the hedge fund industry. It reduces the competition for Alpha for those who remain in business.

Regulation and governmental actions

For years, hedge fund regulation has been a contentious and much discussed issue. Initial attempts in the US to regulate the industry have largely failed. Yet, today more than ever, politicians view the unregulated risk-taking by hedge funds as a dangerous and possibly contributing factor to the malaise of financial markets today. The practice of short-selling in particular has been the scapegoat for the significant stress on the equity prices of banks. Consequently, shorting financial stocks has been briefly suspended during part of September and October¹.

The heightened involvement of government in financial markets is unlikely to abate anytime soon. If anything, regulation of the hedge fund industry will increase rather than decrease. At the very least, we believe that regulators will work in a more coordinated fashion to oversee hedge funds. Funds are likely to face more stringent registration requirements and closer monitoring by international regulators, and also face greater distribution restrictions on what sort of clients their products can be sold to.

While hedge funds tend to thrive in inefficient markets, they are as dependent on any financial firm on a solid underpinning of financial integrity, transparency and confidence in counterparties. To the extent that regulation provides just that, we welcome it and believe it is good for hedge funds.

Despite the current highly politicised nature of the debate, we do not expect an over-regulation of the industry (banning shorting being a point in case). We trust that regulators will ultimately recognise that it is precisely the freedom with which hedge funds invest that allows them to warehouse assets that will no longer be maintained on the balance sheets of banks (in which governments now own equity stakes), and to provide liquidity when other sources of (regulated) capital are not available. Hedge funds will remain as the ultimate takers of financial risk because it is in the interest of the (regulated) financial marketplace to have buyers for troubled assets.

In conclusion, the indiscriminate selling of assets will continue; the deleveraging cycle of the financial system is far from over. This creates mis-pricings and inefficiencies, most notably in the area of stressed/distressed assets. In addition to the systemic crisis, markets continue to be faced with the sceptre of a global recession. At the same time, assets invested “hedge fund-style” are decreasing, as is the number of competitors.

This combination is beneficial to the nimble proactive style of hedge fund investing, and structurally supports the quest for Alpha.

The Attributes of the Future Single Hedge Fund

Clearly, the industry is currently in a “wait-and-see” mode. Due to an expectation of redemptions, but also due to a lack of investment opportunities in the current environment, hedge funds continue to accumulate large amounts of cash, perhaps as much as 20% on an industry-wide average². In the short term, this allows them to handle potential margin calls and redemptions, and enables them to put money at work once attractive investment opportunities mature. Also, since they are mainly positioned neutrally, any short-term market rebounds will only partially be reflected in short-term hedge fund performance. Meanwhile, it is inevitable that more funds will enforce gates.

Looking beyond this immediate horizon, what will the single hedge fund industry look like in the future?

Fees will become less generous for *most*.

Despite being an industry-wide discussion topic for years, fees so far have remained at the typical “two and

¹ Interestingly, financial stocks suffered their biggest decline during the shorting ban, providing an indication that shorting in itself was not the main cause of stress on financials.

² Hedge funds have put a total of as much as US\$400 billion into cash equivalents in October, according to David Kostin, an analyst at Goldman Sachs Group Inc.



20". We believe this will now finally change for all but the most established and successful Alpha providers, as they are competing with more cost effective 130/30 funds, alternative beta products or very active long-only products. Today, we are seeing hedge funds offering performance fees above a certain hurdle rate. The fee concessions will largely stem from two groups: start-ups, and larger hedge funds offering lower fees in turn for longer lock-ups. The rest will follow.

Less liquidity

Performance of most hedge fund strategies is a function of several alternative risk premia, one of which is the illiquidity premium. As we have started to witness in the current market environment, forced selling hurts both hedge funds as well as their investors. As the industry matures, and as the client base for hedge fund is dominated by long-term thinking institutional investors, liquidity will very likely decline. It is in the interest of hedge funds, as well as their investors, to have mechanisms that prevent the figurative run on the bank. Of course, this will not be applicable for hedge funds dealing with highly liquid instruments, such as CTAs or global macro funds.

Less is more: Consolidation

Analogous to the mutual fund industry, consolidation in the hedge fund industry is unavoidable and already occurring. Today, the top 50 hedge funds control approximately 75% of industry assets. There are two drivers for hedge fund consolidation.

First, the prominence of the institutional investor requires deep infrastructure, which in turn necessitates size and scale. Back office, risk management, compliance, reporting and so forth increase fixed costs, which means a large asset base is needed to pay for it (especially during times of low or non-existent performance fees). And going forward, performance fees will likely be lower due to a de-leveraging of hedge fund returns.

So, lower fees + higher costs = economies of scale. Size allows funds to project more stability; to better manage redemptions; to retain employees in difficult times; to innovate and seed new business lines. This does not mean that mid-sized or even small players will altogether cease to exist. But we believe that the attrition rate among them will increase and that the barrier to entry into the industry will become much higher. For small funds to survive: they will have to either be very specialised and be leaders in their (capacity-constrained) niche; or need to provide truly stellar performance, in order to provide compensation for the operational risk associated with investing in them.

New business models

For quite some time, several brand-name hedge funds have looked to further diversify their revenue streams. For example, DE Shaw is offering a suite of 130/30 products; Citadel provides hedge fund administration services; Avenue Capital is even promoting its own fund of funds product. The demise of the independent investment banks offers further interesting opportunity for hedge funds to move into the vacuum and move into typical investment banking services such as M&A advice. We could also see hedge funds move more into the traditional private equity space.

Funds of Hedge Funds; the End of the Beginning or the Beginning of the End?

What does the future hold for funds of hedge funds? Today, they account for approximately 40-50% of all hedge fund assets; their growth over the past few years has surpassed the growth of single hedge funds. As is the case for single hedge funds, the top firms control the majority of the industry. In many ways, the development of the funds of funds industry over the past few years can be a guide to what is in store for hedge funds. Namely: consolidation and fee pressure.

Here are the key changes we expect:

More diverse landscape, bifurcation

Funds of funds compete viciously amongst themselves, but also with 130/30 funds, alternative beta replication indices, as well as increasingly with multi-strategy hedge funds and consultants. Yet, the classic fund of funds product (the broadly diversified, plain vanilla flagship fund) offers few if any distinguishing characteristics. They have become simply a proxy to industry performance and therefore primarily compete on price and scale.

As such, we believe the landscape will be bifurcated into two main groups:



On the one hand, there will be those who are content to be paid to avoid risk. These are the large, globally diversified multi-strategy flagships procured by the household names of the industry, with assets in excess of US\$15 billion. To an extent, consultants and 130/30 funds fall into this category as well. They will be re-compensated either by means of a low (and lower) flat fee, or a management fee. Recent large-scale mandates in the US or in Asia featured no component of performance fee.

On the other hand, there will be the smaller providers who will be paid to take risks and generate performance. To qualify: these are the firms who are large enough to be institutionally viable, which means in excess of US\$3-4 billion of AUM (depending on strategy); but still small enough to innovate and/or generate nimble risk/return profiles superior to the plain vanilla funds. Their incremental fees will be higher which will allow them to operate from a smaller base yet still provide institutional-quality operations. They provide high-octane funds in geographical or strategic niche-areas, and procure portfolio management and hedge fund capacity in areas off-the-beaten track.

Client base as a competitive advantage

The value of an institutional client base (non-bank platforms) has clearly been demonstrated by 2008. Most funds of funds exposed to concentrated private banking distribution channels have lost high percentages of their assets so far this year, and therefore credibility with clients and hedge funds alike. All else being equal, a stable asset base is preferable to a large asset base. Why? Stability is required to obtain capacity with high-quality funds, even if the amounts are smaller; necessary to be able to invest in funds with longer lock-ups; and important in times of distress, such as the one we are currently witnessing. Forced selling of liquid hedge fund positions leaves a portfolio which is difficult to manage and exposed to gating.

Innovation within the hedge fund industry

Clearly, fund of funds will have to work harder and be more innovative to justify their fees. As such, we believe the geographically or strategically focused funds will proliferate going forward. Emerging economies and new strategies are areas where most hedge fund investors will not go direct, yet they are rich in informational asymmetries and structural inefficiencies. This makes them ideal for hedge funds to generate attractive, non-correlated risk-adjusted returns. Another area of innovation is large and rapidly growing socially responsible investment (SRI) universe, where funds of funds provide solutions to market that has so far largely been absent from investing in hedge funds (faith-based organisations, not-for-profit governmental institutions). By default, those investors are mostly first-entrants and therefore prefer fund of funds over investing directly in hedge funds.

Funds of alternatives

The fund of funds model is scalable vertically as well as horizontally. We believe that the skills of funds of funds can and will be transported into other alternative investing areas. Real estate, private equity and commodities are areas where some funds of hedge funds are already active. We expect this trend to continue not only because it makes good business sense to broaden business lines and revenue streams, but also because there are strong synergies in analysis, portfolio management and client servicing/distribution.

Other business models

There is a plethora of businesses which can conceivably be added to the classic fund of funds business model. Examples are:

- **Hedge fund seeding models.** The advantages of selectively investing in early-stage hedge funds, despite high and increasing attrition rates, are well documented. However, since we expect that it will become more difficult for newly established hedge funds to grow and proliferate going forward; seed capital, in addition to the stamp of approval of a highly reputed early-stage investor, becomes more valuable than ever. This puts funds of funds in a strong position to negotiate revenue shares and/or equity stakes in return for their money, thereby adding re-compensation of operational and early-stage risk to the return stream.
- **Single fund distribution.** Institutional investors will move from traditional fund of funds investing to either focused fund of funds, or go direct. Therefore, fund of funds can create value by using their selection and distribution skills to create value both for hedge funds as well as investors.
- **Customisation/advisory.** Many funds of funds are already active in this area. Yet, few have the skills or proper setup to move into the realm of advisory, both within hedge funds as an asset class



(advising on the construction and distribution of portfolios of hedge funds) and also between asset classes (construction multi-alternative portfolios). We believe that there is a growing market for white-labelling funds of funds for banks and other institutions that look to distribute proprietary solutions to their clients.

We are often asked whether the competitive forces within the funds of funds industry, and from the outside, will ultimately render the fund of funds model obsolete. We do not think so. Rather, we expect the funds of funds industry to change and adapt to the challenges, and to continue playing an important role in our industry.

Conclusion

The hedge fund industry today manages approximately US\$2 trillion of assets. This compares with global equities (currently US\$35 trillion in assets) and global bonds (US\$30 trillion). Hedge funds manage less money than the market capitalisation of the world's seven largest companies. So, the hedge fund industry is still very small. And we think it has a long way to go. Once the current crisis is over, the outlook for hedge funds is positive, both in terms of assets and also in terms of performance. This is not only because there are no alternatives to alternatives. It is also not only a function of risk-free being more expensive than ever.

Rather, we are optimistic because we believe that markets are inefficient, and will stay inefficient. The fee model of hedge funds aligns incentives with investors, and results in capital preservation and absolute returns as the ultimate goals.

The hedge fund industry will ultimately emerge from the current crisis stronger and healthier, leaner and meaner. Fewer players with less capital will employ less leverage, and generate returns from an opportunity set that is large and growing.

So, to paraphrase Churchill: This is not end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning.

This article first appeared in SwissHEDGE in its fourth quarter 2008 issue on www.swisshedgemagazine.ch.