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GENERAL OVERVIEW OF THE HEDGE FUND MARKET – REVIEW AND OUTLOOK 2003

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THE HEDGE FUND INDUSTRY

The market size was estimated in 2002 at USD 500 billion. Hedge funds currently account for less than 1% of global equity and bond markets and for about 5% of the worldwide mutual fund market. At the moment, hedge funds account for around 1.5% of investable global assets, but expectations are that assets should grow over the next five years to 3-5%, which at today's level would be around USD 2 trillion. Putnam Lovell NBF says global hedge fund assets will quadruple by 2010 to USD 2 trillion. This implies either a dramatic increase in the number of hedge funds (replicate scenario) or growth in the average size of funds (concentration scenario). Concentration will become the more apparent growth model in the next years as the industry matures, because larger firms with deeper infrastructure will be better able to meet the standards that institutional demand will impress upon the industry.

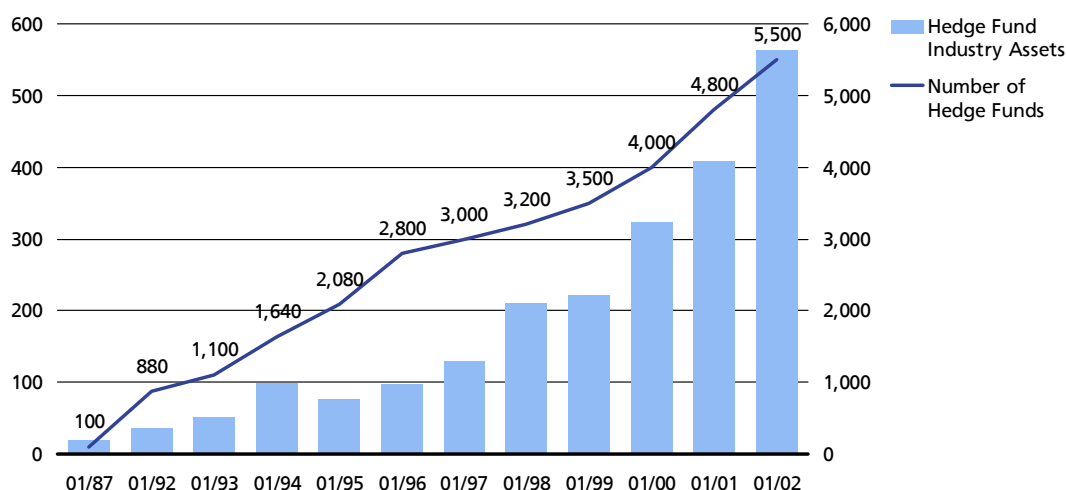
According to InvestHedge, 60 fund of funds (FoFs) have more than USD 1 billion of assets under management. The 20 largest fund of funds account for USD 93 billion. There are two types of hedge fund investors: those who see hedge funds as a separate asset class (diversification, e.g. Swiss pension fund law) and others who use hedge funds as an active overlay to a passive portfolio (passive index + hedge funds = active). The industry will be embracing fund of hedge funds which enable an investor to diversify his/her exposure with a range of hedging styles. Registered FoFs will permit sponsors to distribute hedge funds to a wider group of retail and institutional investors.

After reaching a peak in the last quarter of 2001, there has been a decline of new market entrants in 2002. Given general rapid growth, new players may have significant problems reaching a position in the top 10 or top 20 without engaging in a partnership with an existing firm.

The critical size level for a FoF is regarded to be USD 1 billion (Freeman&Co). Most companies below this level will face difficulties to gain access to institutional investors. This is due to the approach of consultants who focus on infrastructure, risk management systems, reporting capability, management depth and financial stability. In these areas, small companies sometimes are vulnerable. Freeman&Co also believes that the next critical size point is at USD 2 billion, but that investors will probably not start to reference this level until late 2003. Many of the smaller companies will continue to act as innovators in product creation and structuring as the market will continue to increase its variety of products.

Generally speaking, hedge funds preserve capital in bad times and perform similar to stocks in good times. The returns are a function of equity market returns, interest and bond rates, market liquidity and strategy alpha (= market inefficiencies as well as supply/demand imbalances).

NUMBER OF HEDGE FUNDS AND HEDGE FUND ASSETS



Source: Hennessee Group LLC

SINGLE HEDGE FUNDS (HF) VERSUS FUND OF FUNDS (FOF)

	HF Products*	FoF Products*
1 st quarter	33	16
2 nd quarter	27	8
3 rd quarter	9	12

* Issuances of new products during 2002 (data collected from financial news sources)

More products lead to more marketing, increased investor education and more investments in infrastructure. Most new products will struggle to be widely distributed; smaller firms will experience the biggest impact.

The biggest value of a fund of funds is that of a risk diversifier. Hedge funds manage capacity better than investment banks because of low leverage levels, earlier closing of large funds, more diversified funding/borrowing, and longer lock-in periods of investors.

Fund of funds beat average performance and play an important role as risk diversifiers. The business has more revenue stability, diversified products and only a minimal risk of massive losses.

Pricing, profitability and performance are important topics within the industry. The hedge fund industry is a people-intensive, customized, »tail-risk« business. Performance is subject to »realistic structures«, i.e. costs, risk management strategy, risk/return profile of underlying titles, etc.

Portfolio construction and active management are key issues within fund of funds. They may also have access to funds which are closed to new investors.

Fund of funds are becoming more professional. Increasing competition puts some pressure on them. More transparency will make performance comparison much easier.

Investors are defining the objectives concerning more aggressive or more conservative fund of funds. Within portfolios we can see an increasing turnover of funds, as well as an increasing proportion of younger managers.

EXCURSION: THE FUTURE FOR STRUCTURED ALTERNATIVE INVESTMENTS

In the near future, we will see a more supportive regulatory environment in Europe. The hedge fund industry and regulators are currently on a convergence path. An increasing number of hedge funds are becoming regulated and are adopting »best practice«.

There are risks inherent to these products for both investors and the industry, e.g. potential conflicts of interest, complex fee structures, implied volatility & duration risk, return risk for investors, and reputation risk for the industry. Principal guarantee structures on FoFs can be a »low risk« entry for new investors.

WHAT CHANGES ARE LIKELY TO OCCUR OVER THE NEXT 12 MONTHS?

Greater deregulation of retail hedge fund offerings in Europe as well as greater institutional interest. Consultants are receptive and increasingly recommend structured products. Increased use of CFO (Collateralized Fund Obligation) structures will contribute to adding more liquidity to fund-linked products and to increasing investor appeal.

- Increased usage of structured products, e.g.
- Coupon bearing and guaranteed structured notes
- Guaranteed MTN notes
- Zero bond cum option is out – dynamic hedging is in
- More complex structures, with »bells and whistles«
- Index certificates
- Total return swaps
- Convertible and call options
- Insurance and reinsurance-linked notes
- CFOs
- Participating Certificates
- Other tax-efficient structures

HEDGE FUND INDUSTRY – OUTLOOK 2003

Hedge funds will become mainstream within the financial services industry, because they introduce a compelling new money management paradigm. The traditional and alternative asset management industries might merge.

The whole hedge fund industry could be divided into two groups – fund of funds generating a strong alpha with higher volatility, and fund of funds with stable, but relatively low Libor plus returns.

Investors have the choice of allocating their assets across strategy specialists or of directly investing with multi strategy hedge funds. Institutions all over Europe (except for the UK) are actively looking at FoFs as either direct investment or as a product to distribute throughout their network.

A NEW TREND: ALTERNATIVE PRODUCTS REGISTERED WITH THE SEC (SECURITIES AND EXCHANGE COMMISSION).

Generally, these products have higher management fees than institutional products (often by 75 – 100 basis points), placement fees of up to 3.5% and minimum investment levels of USD 25.000 to 50.000. It will be interesting to see how the SEC will balance these new products and their disclosures with the data collected recently about the hedge fund industry.

GLOBAL TRENDS ON THE SUPPLY SIDE

We are seeing an increasing number of traders/portfolio managers leaving their employers to start a hedge fund. Another possibility are spin-offs from existing hedge funds. On the other hand, established managers are evolving from boutiques to businesses (diversification of products, number of staff, branding). More and more institutional suppliers (investment banks, traditional asset managers) offer hedge funds in order to retain staff and earn higher fees. There is also an increasing share of European and Asian managers as well as increasing transparency.

There will be more regulation, and regulation will become more favorable for hedge funds. The industry will face possible capacity problems, depending on the adopted strategy. Therefore, innovative investment models will emerge. As it is a seller's market, fees will remain constant.

Large firms with smaller product know-how will continue to explore the competitive landscape and will also educate themselves about fund of funds in order to proceed with more significant acquisitions to fill both the product manufacturing and the critical size criteria.

GLOBAL TRENDS ON THE DEMAND SIDE

Institutional investors are increasingly ready to invest in absolute return investment approaches; therefore the high demand growth from institutions may outweigh private investors within five years. Investors are becoming more sophisticated and professional. They want more transparency and more risk management. Large financial institutions are making the investments necessary to develop and distribute hedge fund-based products.