Shooting for the stars

While recognising that investors will not desert other asset classes, hedge fund managers are very optimistic about their own prospects and those of their industry. Their assessment is corroborated by mainstream fund managers, prime brokers, pension funds and administrators who participated in the recent KPMG/CREATE global survey. However, capacity shortages, low volatility, low returns and the possibility of greater regulation remain major challenges for the sector.

The next wave of growth will be driven by institutional investors taking their place alongside the three groups who drove the last wave – namely, ultra-high-net-worth individuals, foundations and family offices.

The majority of boutique hedge fund managers see theirs as a lifestyle business in which profits matter more than growth, scope more than scale, performance more than size, and personal autonomy more than ownership structure. They are quick to close funds that reach capacity. They neither want to scale the business, nor be owned by a large financial conglomerate for fear of being stifled by bureaucracy.

Accordingly, the hedge fund industry will polarise in two ways: externally, between specialist boutiques at the manufacturing end and customisation at the distribution end; and internally, between 'stars' and others, with the latter having high burn and churn rates.

The hedge fund industry has an attractive future. It represents a finite group of stars, who are adept at innovating new strategies and creating new opportunities. It belongs to those mainstream fund managers who have wised up to the virtues of absolute returns and have strong institutional brands. They recognise that, on the one hand, a unique congruence of market conditions, new risk tools and investor disillusionment with the traditional asset classes has caused a significant shift in the global asset management industry, and that these have, in the process, created a powerful momentum behind absolute return strategies.

But they also recognise that success creates its own challenges. Past achievements are not a good guide to future performance, especially because of the powerful head winds emanating from capacity shortages, low volatility and perhaps increased regulation.

Hedge fund investment is an industry in transition. But its future depends on the availability of a band of innovative and entrepreneurial managers. Mediocrity has no place in it, as witnessed by the closure of 500 funds in 2005.

CAPACITY: THE ACHILLES HEEL The study shows that fewer than one in six managers of hedge funds or funds of hedge funds are operating at their full capacity. Against the background of rapid growth in recent years and future demand for hedge funds, there should be no capacity constraints – certainly not on paper. Yet the biggest inhibitor of growth, as reported by pension funds, managers of hedge funds and funds of hedge funds, is the shortage of high-quality capacity.

The implication is clear: much of the existing capacity cannot necessarily generate risk-return characteristics that clients have been led to expect. Indeed, in our interviews with industry leaders, it was clear that the gulf between the average and the best managers is not only big, it is also widening.

In particular, pension funds perceive the hedge fund universe as possessing three distinct groups of managers:

15% of managers are clear stars. They provide the prime capacity that can generate different risk-return characteristics in line with client expectations. Many have an investment banking pedigree; the majority are based in North America.

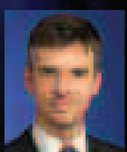
A further 55% are wannabes. These are second-generation long-only managers with the right pedigree. All aspire to be stars before long; the majority are based in Europe and, to a lesser extent, Asia Pacific.

The remaining 30% are has-beens. They are the victims of the brutal churn-and-burn that characterises this sector.

Thus, the reported surplus capacity is sub-prime at best, and uneconomic at worst.

The implication is that for the hedge fund universe to remain viable, it needs a faster infusion of new talent, capable of pioneering new strategies as markets evolve, and scaling their business to meet the

HEDGE FUNDS ARE SQUARING UP TO THE FACT THAT CAPACITY SHORTAGES AND LOW RETURNS WILL MAKE THE NEXT PHASE OF THEIR DEVELOPMENT MORE DIFFICULT. **TOM BROWN** AND **NEIL FATHARLY** EXAMINE THE PROSPECTS, BASED ON THE LATEST GLOBAL RESEARCH STUDY CARRIED OUT BY KPMG AND THINK-TANK CREATE.



Executive summary

- While hedge fund managers are optimistic, there are major challenges for the sector.
- Global research suggests that most hedge fund managers are operating below full capacity.
- Over the next three years, hedge funds are likely to focus on long/short, macro, multi-strategies and emerging markets.
- While the industry will continue to grow, most new money will flow to those with proven track records.

new demands. At present, this is unlikely to happen, since the inflow of talent is expected to ease. Nor does the existing talent pool particularly want to scale its business.

QUALITY VERSUS QUANTITY: A HARD CHOICE? Hedge funds defy definition since they involve exploiting price inefficiencies in an ever-increasing range of markets via complex customised instruments. That means they hit capacity ceilings long before other investment vehicles. It also means that new strategies soon go out of fashion, as opportunities get arbitraged away with new entrants – in 2005, convertible arbitrage was an extreme example.

However, the hedge fund universe is boundless. As markets in financial, physical and intangible assets evolve, so the scope for price inefficiencies will always be there. Over the next three years, we believe that a large majority of hedge funds are likely to focus on long/short, macro and multi-strategies and emerging markets. With such concentration, the opportunity sets will be limited, returns are likely to be much lower, and the systemic risk ever present. Only the exceptionally innovative star managers will thrive in this scenario.

The other challenge concerns the scalability of hedge funds. Currently, there are three approximate scale points, expressed in assets under management:

- single-strategy hedge fund managers need to reach a critical mass of at least $100m to break even and start attracting assets, and this figure will only rise with expected increased regulatory costs;
- managers prefer to go multi-product or multi-strategy in the $2bn-$4bn range to avoid style drift; and
- most funds of hedge funds appear scalable up to around $15bn.

This demonstrates that growing the business in response to rising demand involves transitions that the majority of boutique hedge fund managers are unwilling to accept, because of the resulting dilution of their craft.

Migrating to a more complex business model has its own downside. Most of the current generation of pure manufacturers are very cautious about going multi-strategy because it changes the ownership structure and invites increased bureaucracy. They accept that multi-strategies are essential for dynamic switching but are unhappy about their side effects. Indeed, many large funds of hedge funds have found it exceedingly difficult to retain their pioneering spirit within a more complex business and ownership model. The concentration within this sector is notable, with 14 funds over $10bn controlling more than $200bn (close to one-fifth) of the overall sector.

A CAVEAT The above assessment is based on the views expressed by the five groups who participated in the study: hedge fund managers, mainstream fund managers, pension funds, administrators and prime brokers. One aspect of their assessment is debatable for two reasons.

First, some industry analysts suggest ‘pure alpha’ – linked to skills of hedge fund managers – accounts for around 5% of return on hedge fund strategies. The remainder comes from market movements and three kinds of risks that hedge funds are exposed to – volatility, default and liquidity. On this argument, skills are not a major factor, as identified by the respondents to our research. According to our respondents, if managing these risks is not a skill, then what is? The differences in their respective view thus boils down to what the term ‘skills’ means.

Second, some believe that the high returns of the recent past can be sustained into the future so long as the average quality of hedge fund managers remains the same. The respondents to the global study believe that as the number of players in the hedge fund universe increases, so the quality will decline. Even hedge fund managers argue that quantity will jeopardise quality.

We believe the industry will continue to grow, but that most new money will flow to those managers with a demonstrable track record, a strong brand, and high-quality business operations. Managers who fail to deliver will disappear, as happened in 2005. Innovation will continue, as hedge funds push the boundaries of the capital markets and continue to produce new types of strategies. The industry will continue to institutionalise as pension funds and, eventually, retail investors become more comfortable with these new offerings. Convergence with the traditional sector is, regulation permitting, a highly probable outcome as each sector encroaches on the other, seeking opportunities for growth and enhanced profitability.

Hedge Funds: A Catalyst Changing Global Investment *is available from neil.fatharly@kpmg.co.uk.*

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