Plenary 4

The Rapidly Evolving Activities of Hedge Funds

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Perspectives on Hedge Fund Growth and Regulation

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Overview

- Hedge funds have become a widely accepted, and valuable, investment option for investors
- Bewildering array of hedge fund types - dramatically more heterogeneous than other asset classes, and therefore requires more 'homework' for the investor
- Vast majority of hedge fund investment has come from wealthy individuals or institutions capable of oversight
- Large hedge fund investors are very concentrated and have significant 'clout' and resources
- Given the size and growth of the hedge fund industry, the number of problems has been remarkably small
- As growth continues, responsible industry participants have a significant interest in ensuring that bad practices do not infiltrate the industry.
- Increased oversight and regulation is viewed as sensible and inevitable, but should be well-informed and focused on key potential risks <u>that do not have market solutions</u>

Key Factors That Cause Hedge Funds to be 'Different'

- Direct linkage between performance and fees
- Wider array of instruments and trading options than traditional investment firms
- Size – even the largest hedge funds are small in assets and number of people
- High concentration of investments
- Opportunistic – focus changes rapidly with market opportunities

...these factors are precisely what cause hedge funds to be valuable to investors, yet are also what may cause them to be problematic to regulators

The Hedge Fund Model

- Typical fees:
  - 1 – 2% of Assets under Management (AUM)
  - 20% of profits (Carry)
  - Investment related expenses typically borne by the fund
- Higher quality funds often have restricted investor liquidity
  - Lockups: 1 – 2 year lockups (in some cases as long as 5 years)
  - Gates: Maximum amount permitted to be withdrawn in a given quarter
  - Redemption Fees: Penalty for withdrawal in early years of a fund
- Relatively few number of people
  - Generally very centralized, with one/few key investors driving the portfolio
  - Even the largest hedge funds do not have more than a few dozen key investment professionals
- Largest hedge funds are now clustered in the $10 – 15 billion AUM range
- As hedge fund capital has increased, high quality funds have generally raised management fees (from 1 to 2%) and lengthened lockups
- More stable capital base is now allowing many hedge funds to invest in illiquid / long term investments that would not have been possible previously

Differing incentives depending on stage of evolution...

- Large hedge funds have significant incentive to maximize/preserve ‘brand name’ and franchise value since AUM and the management fee is as important to many as the Carry

- Smaller hedge funds, that do not have scale, may have greater incentives to:
  - Pursue smaller, less sophisticated investors
  - Use improper means to boost returns, in hope of attracting future capital

Categories of hedge funds

- Macro / Commodities
  - Directional views on interest rates, currencies, market indices, commodities, etc
- Arbitrage
  - Merger Arbitrage: assessing probabilities / expected value of transactions in merger situations
  - Convertible Arbitrage: capturing differences in value of credit and options between convertibles and pure debt and equity
  - Statistical Arbitrage: program driven arbitrage of stock/option deviations from historical trading patterns
- Credit / Distressed
  - Origination or purchase of unusual / distressed loans
  - Trading of high yield/distressed publicly traded securities
- Equities
  - Trading funds: short term trades based on news and market moves
  - Longer term (Long / Short): long and short positions in stocks based on expected changes in company performance and valuation
- Multi-strategy funds
  - Funds that pursue some or all of the above strategies under one roof

Sources of return

- Exploiting inefficiencies
  - Merger arbitrage
  - Convertible Arbitrage
  - Credit Arbitrage
- Out-performance
  - Equity hedge funds (‘Long / Short’)
  - Macro hedge funds
- Unique asset class exposure
  - Distressed / Credit hedge funds
  - Commodities hedge funds

Sources of Funding

- Internal funding by financial firms
- Wealthy Individuals
- Endowments/Foundations
- Institutions
- Pension Funds
- Hedge ‘Fund of Funds’

- ***Overall, most large hedge funds have significant overlap of investors***

Evolution of Hedge Fund Investment

- Early hedge fund investors were wealthy individuals and college endowments
- At this point, allocations from endowments/foundations are at mature levels – many endowment/foundations have hedge fund allocations ranging from 10 – 50% of total assets
- Recent growth fueled by entry of large institutional investors:
  - Hedge 'Fund of Funds' (FoF)
  - Corporate pension plans
  - Public pension plans
  - Other large institutions
- % Allocations to hedge funds from large institutions is still relatively low (0 – 10%)
- Early investors were much more interested in high return investments, even if accompanied by higher volatility
- Large institutional investors / FoF are much more focused on **low volatility and low correlation** to other asset classes

Fund of Funds

- Aggregate money from other sources to invest purely in hedge funds
- Have become the dominant source of hedge fund investment
- Generally charge asset management fee + incentive fee: 1% of AUM, and 5 – 10% of profits
- Size has exploded, and a significant number have reached 5 – 20+ billion in assets
- Given their size, will often invest $25 - $500 million per hedge fund
- FoF generally conduct the most extensive due diligence:
  - Extensive background checks
  - Reference checks
  - Assessment of risk and other controls
- Have played a significant role in institutionalizing the business
  - Provide smaller investors with access and oversight capability they would not otherwise have had
  - Much more methodical examination / assessment process than other investors
  - Significant preference for lower volatility / higher quality hedge funds
- Concerns:
  - Lack of clarity on FoF funding sources
  - Asset / Liability mismatches – most FoF have short term liabilities, but are increasingly investing in hedge funds with long term lockups
  - Leverage? Unclear how much leverage exists at the FoF level

Growth in Large Institutional Investors

- Individuals/Endowments/Foundations were early adopters of hedge funds, but are now at mature allocation levels
- Corporate pension funds and large institutions are dramatically larger, and their entry into the hedge fund sector has driven the recent growth...still likely to see growth in allocations
- Large public pension funds have generally not yet allocated significant amounts to hedge funds, and if they do, will likely create a significant additional flood of capital
- Institutions /pension funds have generally been investing through FoF (fueling their growth), or establishing similar infrastructure to invest in hedge funds
- As with FoF, institutions have brought a much more methodical and rigorous approach to hedge fund selection/investment

What are Hedge Fund investors looking for?

- 'Alpha'
- Low correlation to other asset classes

And...

- Early investors (individuals/endowments) sought high returns from creative, opportunistic investments
- Large recent investors are focused on ensuring low volatility
- Obvious tension in goals

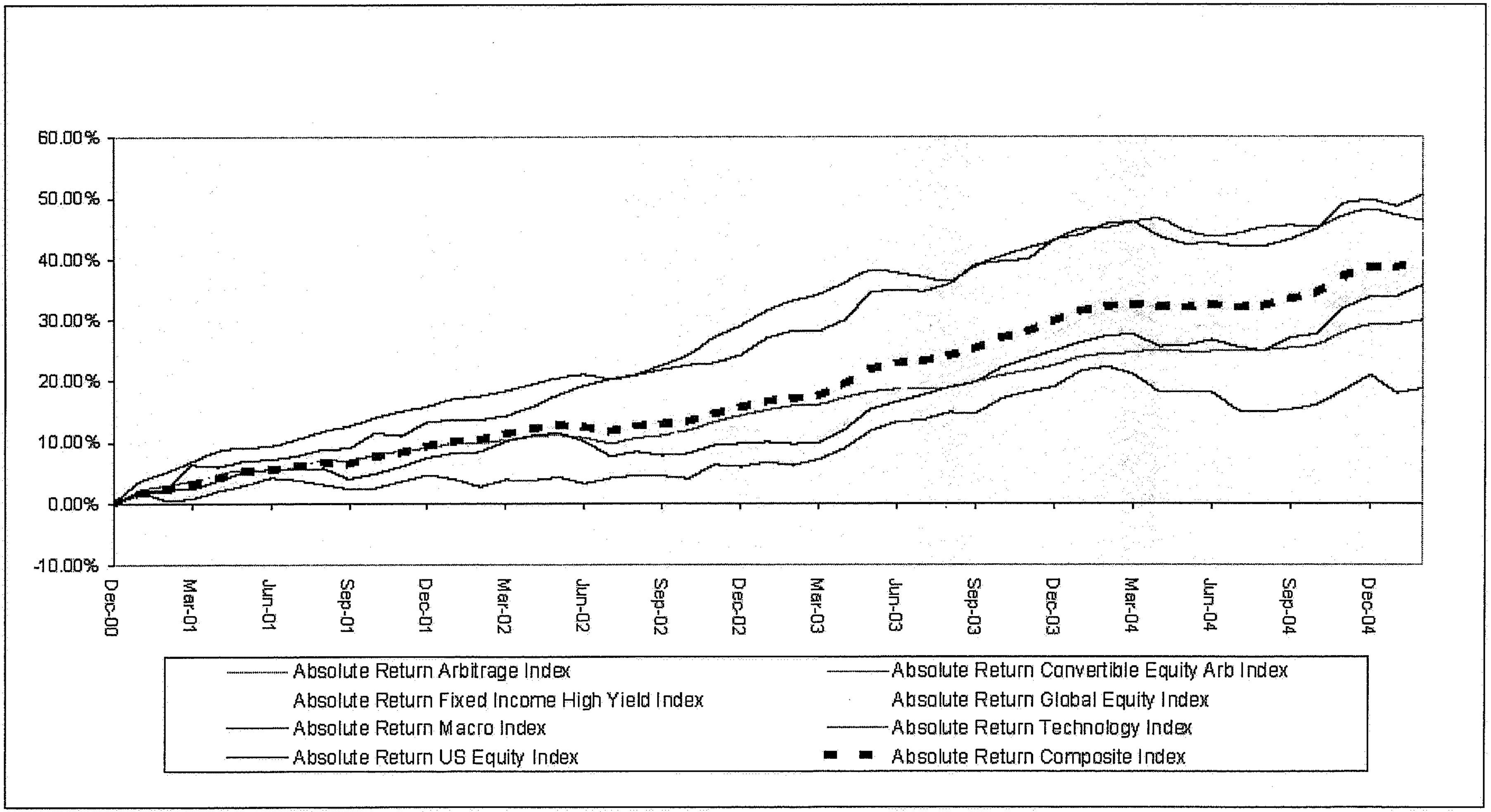
Composite Hedge Fund returns have been generally been stable...

Absolute Return Indices				
Absolute Return Composite Index				
	2002	2003	2004	**2005**
Jan	0.80%	0.88%	1.26%	-0.05%
Feb	0.14%	0.39%	0.62%	0.96%
Mar	0.88%	0.34%	0.25%	
Apr	0.79%	1.54%	-0.24%	
May	0.54%	2.18%	-0.16%	
Jun	-0.21%	0.79%	0.35%	
Jul	-0.68%	0.24%	-0.30%	
Aug	0.72%	0.70%	0.16%	
Sep	0.29%	0.93%	0.84%	
Oct	0.37%	1.43%	0.71%	
Nov	1.06%	0.84%	2.10%	
Dec	0.93%	1.30%	1.02%	
YTD	**5.76%**	**12.17%**	**6.79%**	**0.91%**

Source: Absolute Return Magazine

...though there have been significant fluctuations among different types of hedge funds over time

* YTD= Annual Compound Return



Evolution of Hedge Fund Models

- Blurring of hedge fund categories
- Globalization of many hedge funds
- Decline in traditional arbitrage asset classes
- Higher asset management fees and institutional investor preferences have resulted in increased incentive for hedge funds to avoid risk
- Increased focus on maximizing AUM, rather than IRR
- Longer term capital base has allowed migration towards illiquid / ‘private equity’ type investments
- ‘Churn’ of personnel has increased as key employees are increasingly able to raise capital themselves...resulted in ‘spawning’ of hedge funds

Key Industry Concerns

- Will returns be diluted as capital floods into the business?
- Flood of capital has collapsed returns in arbitrage type investments
- Equity markets are highly liquid, but outperformance does not 'grow on trees'
- Significant risk of return compression / anemic performance
- Will small / new hedge funds damage reputation and business for more established players?

The Hedge Fund start-up process

- Select service providers and advisors
  - Prime brokerage
  - Legal
  - Accounting
- Prepare business plan and marketing documents
- In parallel...
  - Meet with potential investors
  - Build infrastructure
  - Recruit team, as necessary
- Typical timeframe: 6 – 12 months

Remarkable degree of overlap in the Hedge Fund world

- Prime brokerage
  - Small number of firms dominate prime brokerage relationships (Goldman Sachs; Morgan Stanley)
  - Often provide one stop shopping: capital introduction; fund administration; technology/systems
- Lawyers: several law firms have dominant share (esp. Schulte Roth; Steward Kissell)
- Accountants: E&Y and PWC have dominant market shares
- Investors - Most large hedge funds have significant overlap of investors

Hedge Funds have become the most significant trading client of Wall St.

- Prime brokerage has emerged as one of the significant sources of profitability at leading securities firms
  - At some firms, prime brokerage generates far more profitability than all other equity commission business
  - Profitability driven by the financing of short positions held by hedge funds
- Hedge funds are far more profitable (per dollar of assets) than other clients
  - $1 of equity will usually represent a much larger 'balance sheet'
    - Some funds may have low risk securities that are leveraged to provide higher ROE
    - Many equity hedge funds will be short securities to hedge or offset long positions
    - Most hedge funds have portfolio turnover (velocity) that is several times greater than mutual funds
- In aggregate, hedge fund clients are now a dominant source of equities/commission related profits at securities firms
- Worth noting that in investment banking/advisory business, there exists a similar parallel –private equity firms are among the most significant generator of advisory fees for investment banks

Potential Areas for Regulator Concern

- Fundraising
- Inappropriate / overly aggressive trading
- Internal controls
  - Financial controls
  - Front-running
  - Insider trading issues
- Securities firm relationships
- Position marks
- Position manipulation
- Market destabilization

Potential Areas of Hedge Fund Concern from Regulation

- Confidentiality
- Complexity of positions
- Government / regulator dislike of short-selling
- Retroactive changes in regulation / policy
- Cost / bureaucracy

Takeaway Observations: Market Solutions vs. Regulatory Solutions

- Hedge fund investors are generally large and sophisticated
  - Increasingly focused on risk and controls
  - Increased focus from institutional investors has resulted in higher levels of due diligence
- Critical to ensure that hedge funds are not directly marketed to unsophisticated investors
- Key issue: should smaller investors be allowed to invest in hedge funds through intermediaries?
- Greatest risk comes from small to mid-size hedge fund in early days of their evolution
  - Greatest incentives to behave inappropriately
  - Often do not have the economy of scale for strong internal controls
- Suggested focus for regulation / oversight:
  - Marketing / fundraising during launch
  - Internal controls
- As for any market participant, should ensure that trading is appropriate and not creating collateral damage to other market participants