

The hedge fund industry: Evolving in volatile times

BY JOSEPH MORGART, SENIOR VICE-PRESIDENT, ALTERNATIVE INVESTMENT STRATEGIES, PYRAMIS GLOBAL ADVISORS

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Equity markets have both declined sharply and exhibited extreme volatility over the past year and a half. The S&P 500 Index declined 38.5% during 2008, while the Chicago Board Options Exchange Volatility Index (VIX) was recently at an all-time high of 80.86.¹ In recent months, correlations have also shot up dramatically, indicating that the market is not discriminating between good and bad companies. Basically, the market is treating everybody equally, and unfortunately, it's treating them poorly.

In this unprecedented market context, the hedge fund industry is evolving rapidly. It is consolidating and becoming more institutionalized, while being put under the microscope by investors, regulatory bodies and the media in the midst of an economic crisis.

Changing for the better

Beneath these changes and disruptions, there are signs the hedge fund industry is undergoing a longer-term evolution, one that may result in stronger managers and better operations, serving better-informed investors.

In general, managers have been de-leveraging and "de-risking" their portfolios over the past 12 months. According to several leading prime broker studies, hedge funds had a average net exposure (the average difference between their long and short investments) of 47% toward the end of 2007. One year later, that percentage had dropped dramatically to 17%,² after hedge fund managers pursued more traditional hedging strategies, as opposed to strategies intended to generate higher returns. Managers will not be able to rely on market direction to assist in returns; this will differentiate the strategies that rely on good security selection ability from the highly leveraged strategies that are no longer feasible.

A stable of prime brokers

Another change is the emergence of the concept of "multi-prime." Investment managers need to evolve from having a relationship with a single prime broker to having relationships with a group of prime brokers who compete on price, availability and sustainability. At the same time, prime brokers are taking a harder look at the hedge funds they deal with, and asking managers more difficult questions. In some cases, prime brokers are telling managers they may not wish to provide the services managers require because of the nature of the strategy the manager is pursuing or the stability of their investor base.

Investors, now routinely faced with gates and lock-ups, are asking managers tougher questions, seeking guidance about how those managers will behave in times of crisis. Investors are looking for more transparency and proof of disciplined compliance and risk management practices. While investors cite performance as the number one reason for selecting a manager, they also cite poor compliance and risk management controls as the number one reason for firing a manager.³

A smaller investable universe

Large proprietary trading desks seem to be taking leveraged capital out of the market. For example, Morgan Stanley and Goldman Sachs have become, in effect, bank holding companies. At the same time, some industry analysts are predicting between 30% and 50% of the hedge fund industry to disappear over the next year. As a result, the remaining hedge fund managers may have much richer investing opportunities going forward.

Funds-of-hedge funds managers will also be affected. Their investable universe is shrinking, redemption patterns are

¹ Chicago Board Options Exchange, November 20, 2008.

² Goldman Sachs Hedge Fund Trend Monitor, November 2008.

³ PriceWaterhouseCoopers, March 2008.

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changing, high-volatility strategies are disappearing, and their fees are being scrutinized. Simultaneously, hedge fund managers are reviewing their investor base. Managers want a diversified investor base that will remain during both good and bad markets, possibly creating a two-way street in terms of manager selection.

Tomorrow's winners need to evolve

Tomorrow's successful hedge funds will work hard to appeal to investors. Managers can no longer rely solely on prime brokers' risk management systems. Managers may need to develop proprietary applications run by talented individuals who have proven operational and investment capabilities. Compliance practices will likely become stronger. Client reporting will likely become more transparent and robust, covering both long and short positions, attributions and risk management. Larger fund managers will probably benefit the most from these developments, because they will have the necessary size and infrastructure to implement effective processes.

While investors may be better served in this smaller, opportunity-rich market, there will still be a great need for due diligence. For example, investors should consider holding separate meetings with a hedge fund's risk manager and its portfolio manager, to make sure they get consistent responses. They should also consider evaluating the fund's compliance and trading policies and strategies, as well as checking to see whether the fund is subject to oversight. A more responsive and transparent hedge fund industry is a welcome development, but investors must also continue to play their part.

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