Current Trends Affecting Flows to Hedge Funds

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Chapter Six:

Current Trends Affecting Flows to Hedge Funds

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The world's geopolitical and economic environment of the last five years has resulted in a substantial increase in the allocations made by institutional investors to the alternative investment industry. In the last few years of the high-tech bubble, many hedge funds concentrated in technology produced spectacular returns, usually outperforming most market indices. Such performance increased the allocations to alternative investments. However, even in the more turbulent markets of the last three years, alternative investments have continued to see increased allocations as investors now view market-neutral and other non-correlated strategies as a way to hedge themselves against overall market risk. Institutional investors have also perceived that many of the best managers are in the alternative investment area where they can be more highly compensated for successful performance.

The increase in allocations to alternative investments has created a demand for new funds. Estimates for the number of funds range from 5,000 to 7,000 with assets under management between US$500 billion and US$600 billion globally. Both the number of funds and capital flows to the sector have continued to increase at unprecedented rates. The year 2001 saw an unprecedented growth both in the number of funds and dollars invested and it is likely that 2002 has seen continued growth. In some selected stocks, notably in the technology area, trading by hedge funds now constitutes at least one third of the average daily volume. Some studies conducted as recently as a year ago were predicting a trillion dollars would be allocated to hedge funds by 2003.

However, 2003 may prove to be a much different environment than the one anticipated. By the end of this year we may well see a major shakeout in the industry with substantial closings of funds. Although investors flocked to the market-neutral and non-correlated funds, many are reporting less than sanguine results for the past two years. The ones that have had superior performance are often closed to new investment. With volume down this year in the overall markets, many of the funds have capped out at maximums designed to give them the needed flexibility to enter and exit positions quickly without having an impact on the overall market and their positions. With top-performing funds closed to new investment and a large number of other funds not meeting investors' expectations, it is expected that investors will become more cautious and will demand much more from managers in return for allocations of their investment capital.

To some extent the industry may be falling victim to its own success. Interestingly enough, the enormous increase in allocations of funds that flowed to popular strategies in the alternative investment class over the last two years has contributed to the overall downturn in performance. The huge allocations to the strategies in vogue have caused profit margins to narrow in even the most successful strategies.

Chasing the current successful strategy has resulted in a homogeneity in the market which, in turn, has clearly hurt overall performance. Huge allocations were made to distressed debt funds and value funds over the last year. Some estimates are that distressed debt funds have received approximately 15% to 20% of all new money invested in funds over the past year. A comparable amount pursued value managers who had experienced an excellent 2001. The result has been an increasingly competitive environment for both such strategies, and the lacklustre performance of those strategies in 2002 reflects the over allocation to this market.

For the most part, performance of hedge funds in Europe and Asia has not matched those in the US. Some of this is due to the fact that over the past two years there have been many more new funds, especially in Europe than in the US, and those funds have had a more difficult time maintaining a stable capital base.

For a number of reasons, relationships in Europe and Asia between the investor and the manager have been more fleeting. Investors in Europe and Asia have normally been adverse to lock-ups so, there has really been no 'honeymoon' period for a new fund. Also the structured products favoured by European and Asian investors have been a destabilising force in the marketplace. These products often consist of a guaranty portion which is invested in a zero-coupon bond strategy and a component which is often invested with a number of hedge fund managers. The component invested with the managers, however, usually has a defeasance mechanism which calls for the hedge fund component to be

withdrawn if there is a percentage loss exceeding a certain amount. If there is a loss in the hedge fund component, the defeasance mechanism will trigger the withdrawal of capital from all the managers even if the manager's own performance has nothing to do with the loss. Therefore, managers are at risk of having their capital called away as a result of an event unrelated to their own performance. One result of this risk of defeasance has been that the quality of managers for hedge funds in Europe is less than it is in the United States, since many potential managers do not want to operate in that environment.

Strategies and Funds Currently Favoured by Investors

Investors are becoming increasingly fickle about both the types of funds as well as the strategies in which they invest. High fees are one concern which has caused investors to lose some of their fondness for funds of funds over the past year. While funds of funds were perceived as an attractive way to allocate risk, the reduced yields seen last year and in 2002 have the investor more concerned about layering the funds of funds' fees over those of the underlying fund. And perhaps more importantly, funds of funds are now perceived to lack the flexibility which an investor wants in today's markets. In volatile markets, investors want to be nimble and to be in a position to switch allocations quickly. For these reasons, funds with multi-manager strategies have seen increased capital flows since these funds can change allocations between managers quickly without waiting for the withdrawal dates, which is necessary with fund of funds investments.

Investors are also increasingly concerned with the discipline of the manager and the strategy, as much as performance. Therefore, performance above the fund's comparative index in these tough markets will not necessarily result in new allocations from the institutional investment community. Investors will look through the performance of the manager and focus on whether or not the manager has been true to his strategy, rather than having secured better performance by deviations from his articulated investment strategy. It therefore becomes critical for the manager to show the investment community a well-defined and clearly articulated investment strategy in addition to robust performance.

Among the funds considered trend setters, the more esoteric the strategy, the better. Investors realise that a fund with a popular strategy which is seeing substantial capital inflows is likely to have a more difficult time meeting its performance objectives. Attempting to find the fund that doesn't have hundreds of competitors in its chosen strategy is one of the challenges facing today's institutional investor wishing to invest in alternative investments.

The New Seed Investors

Other funds are probably the largest seed investors in hedge funds at the present time. Universities have also been increasing their allocations to alternative investments and seed investments in particular. Some notable universities have increased their endowment allocation to alternative investments to as much as 50%, and a healthy percentage of that has gone to seed new funds. A number of single-manager hedge funds are also significant participants in seeding new funds.

The institutional investor who is drawn to seeding new funds does so for a number of reasons. First, with the lower performance of the fund industry in 2001 and 2002 and the growth in the number of funds, the seed investor can demand a more lucrative deal for his money than he could previously, and certainly a considerably better deal than if he would invest in an established fund. Additionally, the seed investor may perceive an opportunity to find a new and more esoteric strategy that may not be as overcrowded with investment dollars. Also, since many of the top-performing hedge funds are closed to new money, investors have been forced in some respects into becoming seed investors.

Currently, seed investing in hedge funds is somewhat reminiscent of what occurred with respect to venture investing from 1997 to 2000. During this period, traditional later- stage investors began investing earlier and earlier due to the increasing competitiveness of the marketplace and the difficulty in finding acceptable terms given the perceived risk. Also, there was a perceived lowering of risk for early-stage investing and an increased prospect of reward in investing in early rounds. When traditional later-stage investors began investing in early rounds, it spelled the beginning of the end for the fabulous run venture capital had experienced in the 1990s. Hopefully, the alternative investment industry will not experience a similar meltdown.

Some managers who are starting new funds but have recently shut down their prior fund may find that they can retain some of their existing investors as seed investors in their new fund. However, special deals usually have to be made with the existing limited partners. These deals may include waiving the management fees, lowering performance fees or offering them part ownership of the management company in return for helping to seed the new fund.

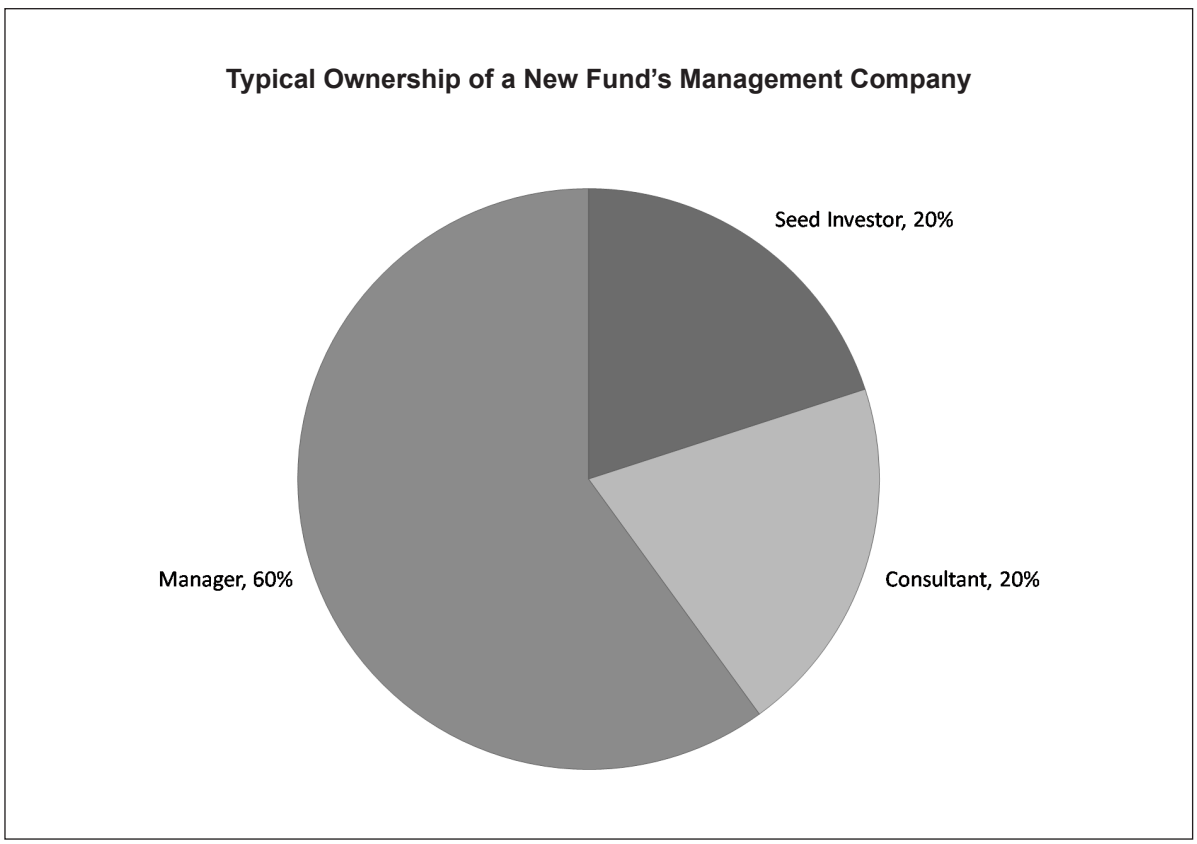
A well-structured seed investment which would properly position the fund to access the institutional marketplace should represent a commitment of at least US$25 million. Below this amount, a fund is going to have a much more difficult time accessing the institutional investor. In return for seeding the fund and helping position it for institutional capital, the seed investor is usually looking to own a percentage of the management company, often as much as

20%. Usually, the seed investor will be given its 20% interest in the general partner or management company on a going forward basis regardless of performance of the fund. In this case, the seed investor's 20% can result in substantial gains given good performance by the fund. However, deals are often struck with the seed investor where the manager is granted the right to buy back the seed investor's ownership interest in the management company after a three- to five-year period if the fund hits agreed-upon performance benchmarks over that time.

Positioning the New Fund for Capital

Funds continue to employ a variety of methods to raise capital, including in-house marketing staffs, prime brokers and outside consultants. Each of these methods has its own strengths and weaknesses. If the fund utilises the services of an outside consultant, the manager essentially has another partner in his management company along with the seed investor. However, since it is paramount that a fund wishing to access the institutional market be positioned professionally from start-up, the new fund may well look to utilise the services of a consultant to raise the seed capital and present it to the institutional marketplace. The leading consultants prefer to enter into an exclusive arrangement with the fund manager. Although such an arrangement usually means structuring an arrangement whereby the consultant will be allocated up to 20% of the incentive fee earned on new monies in the fund, the alternative, going it alone and raising the capital by oneself or with a myriad of non-exclusive relationships with finders, may prove to be much more difficult, albeit less expensive.

The institutional investor may in fact prefer dealing with a consultant who has an exclusive arrangement with the manager. Institutions would much rather deal with a consultant they know and can trust, and the consultant, in turn, will know how to position the fund and what information the institutional investor is seeking. A fund's in-house marketing staff, if it has one, may lack the in-depth knowledge necessary to access the institutional investor database and may not be sufficiently experienced to position the fund appropriately to the institutional market.



Introductions through the prime brokers are another source to access capital. Although many prime brokers offer to assist funds in introducing them to investors, this is an ancillary service which they will usually provide at no cost and therefore the incentive to assist the fund in its capital raising efforts may not be on par with that of an outside consultant. Also, the understanding of the fund which the prime broker has would usually not be as deep as the consultant and therefore the prime broker's role in this regard will be more of an introducer than a true advocate who is promoting the fund. The prime broker will invite the funds to present at investor conferences, however institutional investors normally do not send their more senior people to such conferences and therefore the opportunity to present to a truly interested party may be more haphazard than when utilising an experienced consultant who is regularly in touch with decision makers among the institutional investors.

Although the arrangement normally struck with the consultant may appear expensive at first, the consultant will have a great understanding of the various strategies and an expertise on investing styles that will normally prove valuable in the long run. Once the initial capital has been secured, the consultant's job is only half done. The consultant will continue to service the manager and will position the fund for maximum capital inflows, often recommending terms that will make the investment more attractive to the institutional investor.

Conclusion

The markets of 2001 and 2002 have changed the nature of investors' allocations to hedge funds. Seed investors are becoming increasingly desirous of finding the next successful strategy while at the same time attempting to lower fees and attribute more value to their invested capital. These concerns have changed the relationship between the manager and the seed investor, often resulting in partnerships between the seed investor and the manager whereby more value is attributed to the seed capital. If the services of outside consultants are utilised, they too can be part of this partnership with the manager and the seed investor, all designed to properly position the fund for the institutional market.

Mr. Zimmermann's practice is concentrated in the areas of investment management and regulatory proceedings. Donough McDonough and Barry Hines of Boomerang Capital LLC assisted in the preparation of this chapter.