US$2 trillion industry by 2010

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The White Paper on the hedge fund industry prepared jointly by Putnam Lovell NBF and New River provides a neat footnote to a year in which the hedge fund industry defied all expectations and continued to show overall growth in assets under management, despite a number of closures.

The White Paper headlined "Institutional or Institutionalised - Are Hedge Funds Crazy; says that hedge fund assets will hit US$2 trillion in assets under management by 2010 on "the back of middling returns of 9 per cent" per annum.

The report correctly notes that the industry is becoming more "institutional"; successful hedge funds and funds of hedge funds are becoming established, institutional investors are ready to allocate to absolute return strategies and institutions employing a full line of products are gearing up to distribute hedge fund-based products to all their clients - sophisticated as well as mass market.

The report notes that for industry assets to reach US$2 trillion in eight years implies either a dramatic increase in the number of hedge funds (replication scenario) or growth in the average size of funds (concentration scenario). Concentration will become the more apparent growth mode in the years ahead.

Concentration should occur as the industry matures because larger firms with deeper business infrastructure will be better able to meet the standards that institutional demand will impress upon the industry.

The report says that underperformance of traditional managers is helping drive the inflows, but more important is the erosion of barriers to entry for supposedly "benchmark" investors. Despite the complexities and surprises, absolute return strategies with asymmetric fees should more and more be seen as profoundly in the interests of investors.

With more investors will come more scrutiny, forcing transparency and coherence on the 'secretive' hedge fund world. This is vital to institutionalising the quest for absolute return - a key regulatory thesis is that disclosure facilitates consistent performance, and risk measurement brings lower risk.

And, performance measurement agencies should take note - the report says "an entire industry will be created out of the anticipation, identification and measurement of the hedge fund process and performance."

The report notes that by 2010 the adoption rate for hedge funds will rise from 1.2 per cent to 3 per cent of global HNWI and institutional assets, but who will dominate the industry?

The reports authors say: "We nominate those that rigorously control process and risk - they will attract the most sophisticated intermediaries and in turn the largest share of assets - and those that source new talent for new products to ruthlessly replace tired strategies and personnel."

The report concludes with a clear hint of the pruning of product and people that hedge funds must conduct in order to succeed: "It ain't pretty and often it will not be fun, but absolute returns are enhanced by absolute Darwinism: the sell discipline is replaced by the kill discipline".

- Structured Products

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