US hedge funds move towards united front

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Beset by a rash of federal regulatory scrutiny, a born-again securities cop, and politicians eager to rein-in excesses of the financial sector, the hedge fund industry is assembling a united front. The Managed Funds Association, the Washington, D.C., group mostly seen as the voice of the industry's crème de la crème, is attempting to sew up affiliations with at least a dozen of its smaller, lesser-known cousins.

What's driving this unity train? For starters, President Barack Obama's administration has shoveled heaps of attention on hedge funds as contributors to the recent financial crisis. Politicians across party lines are proposing to hem-in systemic risk by controlling their activities in areas such as credit default swaps, dark pools and short sales.

What shape regulations will eventually take remains to be seen, but this campaign to bring together historically fragmented groups reflects what's at stake: Regulations proposals are far-reaching and if implemented could arguably alter the business forever. Understandably, an attempt at pooling financial resources would embolden the industry's overall lobbying clout on Capitol Hill. The real catalyst, however, is that together it can steer "sensible" regulations that would govern everything from reporting and disclosures to taxation.

That managers would soon embrace U.S. Securities and Exchange Commission registration is a given. This conciliatory move hasn't been enough, however. On the heels of the groundbreaking insider-trading indictment of Galleon Group founder Raj Rajaratnam and others on December 15, Robert Khuzami, the SEC's enforcement czar is doing the "the biggest re-organization" in over three decades with the goal of sharpening its focus on hedge funds.

The unit's been armed with new processes to improve the way it collects, mines, records, investigates and tracks tips and complaints on errant trading, fraud and the like. With this comes a new reality for would-be wrongdoers – there's no place to hide, warns Mr. Khuzami, a former federal prosecutor.

The SEC has set up a new asset management unit to police hedge funds, investment advisers and private equity under co-heads Robert Kaplan and Bruce Karpati. Thanks to the agency's newly empowered resources, including a proposed 10% bump in its latest budget to USD1.3b, it's expected to give top dollar for industry talent. It's also enhancing training for insiders in the nuanced workings of hedge funds. Sources expect a jump in examinations and sweeps notably around areas of asset-custody, fund-performance and risk management. What's even more revolutionary is that the agency's staff for the first time has free reins to issue subpoenas, sources say.

"Clearly, the era of deregulation has ended," says Walter Zebrowski, Chairman of Regulatory Compliance Association, a non-profit group, and chief operating officer of Hedgemony Partners, "We're witnessing a regulatory renaissance."

Whatever the net outcome of this regulatory spotlight, the industry has begun lifting the veil of secrecy of its own workings. For instance, its use of independent fund administration agents has risen, as has third-party valuation of hard-to-price inventory, beyond mere external validation of inputs or prices, says Umit Alptuna, a vice president at Goldman Sachs Asset Management. He sees this as a sign that "funds are striving to become more institutionalized."

Attempting to take charge of their assets, some investors are also focusing on managed accounts. Take the case of the USD5bn fund-of-funds operator Lighthouse Investment Partners, which increasingly is employing separately managed accounts to deploy capital in underlying funds. Last year, 50% of its assets were in such structures; during 2010, that number could rise to 80%.

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"We started down this path five years ago," says CIO Sean McGould. "We were tired of not knowing what we owned in commingled funds. We wanted a better way of having control over our clients' assets." Its resource commitment is huge. In addition to its internal administrative, legal and audit resources, a dedicated 70-strong team works on its account at fund-administrator GlobeOp.

Not all investors can afford or chose to make such resource-commitments required to navigate the complexities of managed accounts, though. This has fueled the rise in assets on managed-account platforms, notably bank-supported ones that altogether drew in over USD10b last year.

Capital Flows

Such efforts have quelled some of the investor-anxiety surrounding the industry's opaqueness. Last year's stellar gains of nearly 19% have helped erase 77% of record 2008 losses, according to Credit Suisse/Tremont Hedge Fund Index. Indeed, capital began to flow in again during the second half of 2009, staunching the cataclysmic USD99b outflows during 2008. Still, investors redeemed USD74b in 2009 even as USD72b of assets remained impaired. Overall industry assets rose to USD1.5trn as of December 31, 2009, from USD1.3trn at mid-year. Investment consultant Casey Quirk expects industry assets to reach USD2.6trn by 2013.

For starters, most of new capital went to marquee funds such as Tudor Investment and Millennium Partners that for the first time in years opened their doors for replacement capital. Managers, who didn't gate, didn't drift up the capital structure to less liquid instruments and adhered to robust compliance procedures saw inflows in 2009 – a trend expected to intensify this year, according to a recent Morgan Stanley survey. Still, only a handful of spin-offs from large firms drew in dollops of cash. Now with some established funds near or at capacity already, investors are on the prowl for emerging talent once again.

"Marketing's a huge focus right now," says Michael Hennessy, a managing director at Morgan Creek Capital in Chapel Hill, N.C. Things were slow for most of 2009 following a terrible 2008 but are opening up again, he says. Managers are offering more "investor-friendly" terms, such as fee discounts in return for longer lock-ups or shorter lock-ups with investor-level gates. There's no wholesale change of terms, however, he adds.

So, who's writing the checks? Contrary to dire predictions of a pension fund exodus in 2009, they have stayed committed to hedge funds while a few have even raised their allocations to compensate for large losses on their long-only portfolios, says Emma Sugarman, global capital-introductions head at BNP Paribas in New York. Family offices, seeders and some institutions also returned to the market in the last six months.

Last year, strategies that attracted the most investor-attention were equity long/short, global macro and managed futures, says Boris Arabadjiev, a managing director of Credit Suisse's asset management group in New York. Particularly appealing was the inherent liquidity and fairly strong performance for macro and managed futures strategies in 2007-08.

2009 was a different story, though. Managed futures, and to a lesser extent global macro, had difficulty delivering returns as some market aspects they exploit had already peaked. On the other hand, directional bets buoyed equity long/short funds nearly 20% higher. And emerging markets strategy also delivered handsome 30% gains on the back of rising risk appetite and turbo-powered equities performance. "Risk seeking appetite is fairly healthy at this point," he notes.

Going forward, Arabadjiev, who is investment chief of the bank's fund-of-funds group and is global head of its Alpha Strategies business, believes discretionary macro managers will outperform quantitative-based ones. That's because discretionary managers can better exploit opportunities created by catalysts such as government intervention, changes in interest rates, and the like. Driven by data-scrubbing, quantitative managers to the contrary employ a more non-fluid approach. Additionally, he expects certain areas of the credit markets to stay profitable in 2010. Nonetheless, "security selection will be a more relevant driver of performance and risk than directional exposure across many strategies," he adds.

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To attract investors, managers are trying new tacks. Case in point: some established hedge fund managers are launching retail products, including UCITS-compliant versions for the U.K. market. This strategy is a calculated gamble, though, as it helps in asset-gathering but limits both performance and stratospheric payouts, their holy grail. It remains possible that in time more hedge fund outfits would offer retail funds, but it's probably too soon to call this one. For the time being, the approach's short-term rewards are obvious: Scores of hedge fund managers raised billions of dollars for long-only funds, exchange traded funds and replication products in the U.S. last year alone.

Newer entrants are vying for investors' attention, too. IndexIQ has launched five exchange traded funds that mimic hedge fund performance. Its replication strategies aren't designed to replace hedge funds, which have "a role especially in our current economic environment," says Anthony Davidow, head of distribution. But it is pitching itself as a cheaper and transparent alternative for pension funds and the like that have concerns about liquidity and alpha-generating capability of hedge funds. Founded in October 2008, it now runs USD250m in five funds.

For now, all eyes are on managers as market opportunities become more elusive. "The easy money's been made," says Karim Leguel, the New York-based investment chief of Swiss advisory Rasini. "Some tough calls will be made in 2010." Even as the overall investment environment has improved in 18 months, everything's not back to normal yet as side-pockets, gates and/or high water mark issues linger on. The ultimate wild card: The political angle remains difficult to read, he notes.

Meanwhile, the drive to unify the US hedge funds industry is gathering steam. Mike Corcelli, president of South Florida Hedge Fund Managers, a trade group representing some 100 funds, notes, "This alignment of the group, driven by the MFA, is a once-in-a-lifetime event. The hedge funds industry needs a national voice."

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