Hedge fund managers move cautiously in an uncertain world

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While the crisis that afflicted the hedge fund sector in 2008 and early 2009 may be essentially over, with market conditions remaining volatile and investors still cautious, there is no prospect of an immediate return to the buoyant growth conditions that prevailed through the mid-2000s, according to industry professionals. And continuing economic uncertainty, especially in Europe, continues to weigh on prospects for the next 12 months – although some hedge fund managers have been relishing the return of volatility to the markets over the past couple of years.

An average performance loss of around 20 per cent in 2008 was matched by a virtually equal rebound last year, and while hedge fund returns over the first couple of months of this year were patchy, March saw a fresh uplift of as much as 3 per cent – albeit helped by a surge of more than 5 per cent in US equity prices – according to index providers such as hedge fund advisory firm Hennessee Group, whose main index increased by 3.05 per cent. The Barclay Hedge Fund Index gained 3.08 per cent and Hedge Fund Research's HFRI index 2.70 per cent, while the Lyxor Hedge Fund Index rose by 2.12 per cent and the Credit Suisse/Tremont Hedge Fund Index by 2.22 per cent.

"The financial markets seem to have quickly forgotten about sovereign risk and concerns about central bank exit strategies," says Hennessee co-founder Charles Gradante. "Investors remain willing to assume greater levels of risk, and equity markets rallied sharply in March. During the month, the focus of hedge fund managers was on Greece and its debt level, as well as potential problems in Spain, Portugal and Italy."

The firm's managing principal Lee Hennessee adds: "Hedge funds posted a strong, positive month in March, but underperformed the sharply rising equity markets due to conservative positioning and difficulty shorting. Top performing strategies included emerging markets, financial equities, and distressed. All underlying hedge fund strategies were positive in March, with the exception of short biased. Despite lagging in February, most hedge funds are positive for the year due to their ability to limit losses during the sell-off in January."

HFR points to evidence that the market turbulence has starkly highlighted the difference between the most skilled hedge fund managers and the rest, noting that both 2008 and 2009 saw increased dispersion between the best- and worst-performing funds. The firm says the top performing decile of hedge funds returned an average of 100 per cent in 2009, a year when 80 per cent of funds posted positive performance, while the bottom decile lost an average of 16.5 per cent. In 2008, when just 30 per cent of funds were in positive territory, the top decile gained 40.9 per cent, while the bottom decile lost 62.4 per cent.

Good performers are being rewarded with fresh capital from investors, especially institutions, as the capital outflows from hedge funds in 2008 and the first half of 2009 went into reverse toward the end of last year. The industry appears well on the way to making good the capital it lost during the crisis, although how close that point might be is hard to determine with great certainty, given the colossal divergence between different analysts' assessments of total hedge fund assets.

According to TrimTabs Investment Research and index provider BarclayHedge, hedge funds posted an estimated inflow of USD16.6bn in February, equivalent to 1.1 per cent of the industry's total assets, which reached a 16-month high of USD1.5trn. "Hedge funds sport a stellar win streak, and the average fund outperformed the S&P 500 last year," says BarclayHedge president Sol Waksman. "Money is chasing performance."

Distressed securities funds saw February's biggest inflow, equivalent to 4.2 per cent of assets, according to TrimTabs and BarclayHedge, while emerging markets funds lost 0.1 per cent of assets despite having returned 65.6 per cent over the previous year. In addition, funds of hedge funds continued to perform poorly, suffering outflows of USD17.4bn over the three months to the end of February after having underperformed the industry by 13.9 per cent in the past year.

According to HFR, USD13.7bn of new capital was allocated to hedge funds in the first quarter of this year. Combined with the increase in assets due to performance, this amounted to a boost of USD54bn, bringing aggregate hedge fund industry net assets to USD1.67trn. During the final three months of 2009 funds enjoyed net inflows of USD13.8bn, the firm says, but over the year as a whole, net redemptions totalled USD131bn. Strong performance helped global hedge fund assets grow by nearly USD260bn over the final nine months of 2009, but they are still some USD260bn below the peak of USD1.93trn set in the second quarter of 2008.

It should be said that some estimates of the total size of the industry give substantially lower or higher figures for total assets. According to the 2009 PerTrac Hedge Fund Database Study, based on a survey of 10 hedge fund databases, total assets rose by 5.5 per cent last year to USD1.41trn, down from a peak of more than USD2trn at the end of 2007.

But tallies based on surveys of hedge fund administrators yield much higher numbers than reporting by managers. Two such surveys toward the end of last year put single-manager fund assets at between USD2.3trn and USD2.4trn, in each case down from a peak of more than USD3trn, while assets under management in funds of hedge funds were reckoned at between USD900bn and USD1.1trn. Other types of investment in hedge fund strategies, such as managed accounts and Ucits III structures, may swell the total even further.

Not all managers have shared equally in the recovery, according to HFR, which says that 52.2 per cent of all funds returned to their respective high water mark levels over the 12 months to the end of March. In the first quarter of last year, investors continued to allocate new capital primarily to larger funds, with firms with more than USD5bn in assets under management experiencing net inflows of USD14.9bn. These managers account for just 5.1 per cent of all funds in the industry but more than 62 per cent of its total net assets. Meanwhile firms managing between USD500m and USD5bn experienced net outflows totalling USD3.7bn. All four main strategy areas identified by HFR enjoyed asset growth, led by USD5.6bn in new capital for event-driven strategies.

There are other indications that the industry is gradually returning to health, such as a decline in the number of hedge fund liquidations, which had reached a total of some 2,000 between the beginning of the crisis and the end of last year. The number of new hedge fund launches increased in the fourth quarter of 2009 while the pace of liquidations continued to decline, according to HFR.

The firm estimates that 230 funds were launched and 165 liquidated in the final three months of the year, after launches outnumbered liquidations in the third quarter for the first time since the start of the crisis. Over 2009 as a whole, more than 1,000 funds were liquidated compared with 800 new launches, while the previous year a record 1,471 funds were liquidated and just 659 were launched.

One question that continues to intrigue industry analysts is whether the traumas of the past three years have had any permanent impact on the level of management and performance fees charged by hedge fund managers, or whether the established model, of an annual 2 per cent management fee plus a 20 per cent performance fee for gains exceeding the manager’s high water mark, has come through the dislocation intact.

The figures produced by industry data providers are not conclusive but do tend to point toward some degree of movement away from the ‘2-and-20’ standard. According to HFR, management and performance fees averaged 1.6 and 19.2 per cent respectively at the end of last year, although the firm says that in some cases managers agreed lower fees with investors in return for agreeing longer lock-ups on their capital.

The move toward lower fees, if it is indeed a trend, appears to be more pronounced for funds of hedge funds. HFR says performance fees for single manager funds fell from 19.34 per cent in the first quarter of 2008 to 19.2 per cent in the fourth quarter of last year, while performance fees for funds of funds declined from 8.05 per cent to 6.9 per cent over the same period. The average performance fee for funds launched last year was 17.6 per cent, 1.6 per cent below the broader industry average.

Alternative investment research firm Preqin, which conducted two surveys of 900 hedge fund and fund of hedge funds managers in the second and fourth quarters of last year, goes even further. Its report, The Fee Debate – An End to 2 & 20?, says that just 38 per cent of single manager funds now charge according to the standard fee structure, with performance fees for funds currently averaging 18.89 per cent and management fees averaging 1.65 per cent.

However, fund of funds managers are charging an average management fee of 1.44 per cent and performance fee of 11.54 per cent (Preqin found that some funds that were launched toward the end of 2009 were coming to market with management fees higher than those of funds launched in the middle of the crisis). The firm also says that on average, European managers charge lower management and performance fees than their US counterparts.

“The issue of fees continues to be much debated within the industry,” says Preqin hedge fund data manager Amy Bensted. “Investor calls for more appropriate alignment of interests, coupled with a difficult fundraising environment, have led to shifts in the fee structures charged by managers. Single-manager funds have cut management fees but performance fees have been less affected by the market crisis. Investors that access hedge funds directly are happy to reward good performance, and are willing to pay high performance fees. This has paid off for most investors as the funds that charged the highest performance fees have produced the strongest returns during the difficult markets of the past two years.”

For the rest of the industry, though, the optimism is more measured. “The process of recovery is still ongoing in the hedge fund industry,” says HFR president Ken Heinz. “A number of firms were able to achieve outstanding results in 2009 amid a very complex economic environment, but the landscape in terms of capital, strategies, service providers, fees, regulation, liquidity and transparency has evolved significantly. These trends are likely to define the growth of the hedge fund industry in the next decade.”

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