

## US hedge funds industry: Experts predict growth by fourth quarter

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Following a dismal 2008, when will the US hedge funds industry show signs of recovery?

This question has steadily made the rounds among fund managers, institutions, endowments, pension plans, and other quarters, especially during the October-December time-frame as things got extremely dire. Losses escalated and market exits were jammed with investors stampeding to redeem their capital. Some funds have already closed doors and additional casualties are likely this year. Total asset contraction of around USD1trn -USD1.2trn could occur this year.

Bernard Madoff dealt the industry another major blow. The once-famed investor allegedly wiped out some USD50bn of assets he managed for funds of hedge funds, endowments and others, leaving many wondering if limited partners would return to hedge funds, without which hope for the industry's survival tanked. Some funds are decimated and additional casualties are likely this year.

Investors, meanwhile, fear other Ponzi schemes could be revealed this year amid the continued spate of redemptions. While there's still a fair amount of pessimism to go around, hedge fund practitioners are clear of one thing: what hasn't killed them will make them stronger.

Given the magnitude of market movements caused by hedge funds in 2007 and 2008, whether as a result of deleveraging or investor redemptions, it is now known that hedge funds are no longer a little niche industry for sophisticated investors and have come of age, says Professor Andrew Lo, director of the laboratory for financial engineering at MIT Sloan School of Management, Cambridge, Massachusetts. 'The investor backlash against hedge funds has largely been an emotional one. In three-six months, I suspect there will be a backlash against this backlash. I expect spectacular growth of hedge fund assets to start during the fourth quarter.'

His optimism is based on the view that the latest wave of deleveraging, asset firesales and corporate restructuring will present once in a lifetime investment opportunities. And those plays will create the biggest hedge funds of the future, provided regulatory oversight does not get too heavy-handed. "The industry will rise from its ashes this year," adds Lo.

But the turnaround will be bumpy. As a year of continued deleveraging, 2009 will be more complicated than 2008, as managers now begin to sell illiquid positions, especially in credit, convertible arbitrage and fixed income, having already offloaded what they could sell easily. Even a single forced sale could trigger major market dislocation, which will then pose serious repercussions for hedge funds as a whole. 'All you need is one burning match and the whole forest can go up in flames. That may not happen, but you never know what may happen when people panic,' reckons Lo.

Yet, early signs of revival are emerging. Following last year's financial bust, 'a restaging of talent cycle' is now taking place, says Anthony Scaramucci, managing partner of fund-incubator Skybridge Capital, New York. Many portfolio managers and proprietary traders with unblemished records are looking to strike out on their own. Yet, it is taking longer to get things off the ground. Fund-raising is subdued partly because hedge funds are wrongfully being seen as social pariahs, which will take time to burn off. Says Scaramucci: '2008 was a very humbling experience. Everybody ate crow. Everyone was set back. But that doesn't mean the industry can be written off in its entirety. It has a bunch of people determined to succeed.'

Moore Capital alumnus Stanley Shopkorn is one such example. Via his newly established Hilltop Park Associates, he launched his fund on 1 October with roughly USD100m. It took grit to set sail amid a raging storm: markets had gone awry following the collapse of Lehman Brothers and the near-brink

condition of a few others. Banks, desperate to apply a tourniquet on their wounded balance sheets, were calling back financing lines they'd sold to hedge funds. Managers had to sell assets at fire sale prices to pay back money, further pushing down asset values. In the interim, investors started fleeing in droves, forcing more bargain asset sales.

'We knew going in unless we had significant commitment and confidence to build our business over time, it was not worth the brain damage,' says Jason Siegel, Hilltop Park's partner and chief operating officer. In the current financial climate, hedge funds have become a 'high conviction' business. Barriers to entry have 'rightfully' skyrocketed and some other changes are afoot.

For example, it's no longer sufficient for a manager to possess a performance history; prospective investors now want to dig deeper to verify what percentage of those is directly attributable to the manager. Additionally, prime brokerage is no longer the main way to raise capital; a start-up should either have a large network of prospective clients or be willing to launch with a smaller purse. And be prepared for more operational due diligence from investors, who are now rolling up their sleeves to peer under the hood, says Siegel.

He reckons the hedge fund marketplace will become stronger as a result of the ongoing upheaval. It posted positive 'absolute return' in January, versus a loss of over 8% for the S&P500 benchmark index. More months like January will remind investors of the main rationale behind hedge funds being an integral component of a diversified asset allocation program.

Siegel notes that the faucet of fresh capital could get turned back on this year just as quickly as it was turned off last year, provided funds stay in the black even if overall markets stay bad. And leverage will eventually return to the market, albeit at conservative levels for now. Even so, he thinks those managers who produced unleveraged returns during 2008 will be among the top beneficiaries of future capital inflows.

But foremost, all managers have to prove their business model still works. They must demonstrate an ability to generate uncorrelated returns in down markets and with diminished asset bases, says Karim Leguel, investment chief at advisory firm Rasini in New York. He expects most managers will lower fees and give more concessions on capital they've frozen. Even so, a handful of high calibre managers may still be able to draw in longer-term capital for particular investment opportunities and charge premium terms, Leguel adds.

In 2008, the HFRI Fund Weighted Composite, which contains around 2,200 constituent funds, declined 18.7%. Historically, research on the industry's five worst declines shows that funds post average gains of 16% during the 12 months following the bottom of the decline, says Kenneth Heinz, president of Chicago data provider Hedge Fund Research. By extension, the losses in 2008, the worst in the history of the industry, could be followed by improved performance this year. But for now, even the best performing strategies, namely global macro and managed futures, continue to see capital outflows, notes Heinz.

Most hedge funds seem to have raised sufficient liquidity to meet redemptions. For example, Daniel Och's Och-Ziff Capital Management is holding as much as 40%-50% cash in some of its funds to capitalize on new investments and meet future redemptions. Och-Ziff's AuM of USD22.1 billion as of 1 January 2009 reflects USD5.7 billion in performance-related depreciation and USD5.4 billion in net outflows during 2008.

'Most hedge funds seem to have raised sufficient liquidity to meet redemptions,' says Michael Hennessy, managing director of Morgan Creek Capital Management, a fund of funds firm based in Chapel Hill, North Carolina. 'While investors are still a bit skittish, it seems that the worst is behind us. Likewise for funds of funds for the most part.'

Madoff and other failed managers have proved that the true fund of hedge funds model is needed more than ever - to provide the identification and access to top managers, to conduct rigorous due diligence, to provide intelligent and sufficient diversification, and to have strong risk management embedded throughout the process. 'This is difficult, time consuming and expensive - not to be tried at home by the average investor,' Hennessy says.

Congress is also taking action. Prompted by last year's financial meltdown and Madoff's fraud accusation, senators Charles Grassley of Iowa and Carl Levin from Michigan proposed the Hedge Fund Transparency Act, which calls for, among other things, for funds larger than USD50m of assets to register with the Securities and Exchange Commission and annually provide key data such as current valuation of assets.

Treasury secretary Timothy Geithner and Mary Schapiro, the new SEC Chair, also want hedge funds to be regulated. This is the lawmakers' third attempt to police the industry since 2006. The proposed bill transforms certain exclusions in the Investment Company Act of 1940 into exemptions and imposes filing and other requirements. "The Bill's theory is that the SEC will have more information about managers to detect and perhaps prevent fraudulent activity," says Mitchell Nichter, a partner in the Investment Management practice at international law firm Paul Hastings.

But some large managers aren't convinced about the possible benefits of opening their books in front of the SEC, says Matt Simon of research firm Tabb Group. They are concerned about how the SEC would safeguard their trade secrets. Moreover, things could fall through the cracks despite additional regulation because that's how fraud works. And the fact remains Madoff could operate all these years before getting caught not because of lack of information at the SEC. As evidenced by whistleblower Harry Marcopoulos in recent Congressional testimony, the SEC didn't take any action even after being repeatedly told that Madoff's operation was a fraud. 'The SEC is taking it on the chin with the Madoff case. To protect themselves from foul play, investors must be their own lifeguards,' Simon says.

So far, regulatory proposals have addressed the issue of investor protection, which was easier for politicians to push for, but have left a lot to be desired on the side of systematic risk, says MIT's Lo. 'The Federal Reserve may have to be given oversight of liquidity issues of hedge funds. With proper safeguards and regulatory oversight, hedge fund growth anticipated later this year would be positive for the global economy.'

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