# THE CHANGING FACE OF HEDGE FUND INVESTING[1]

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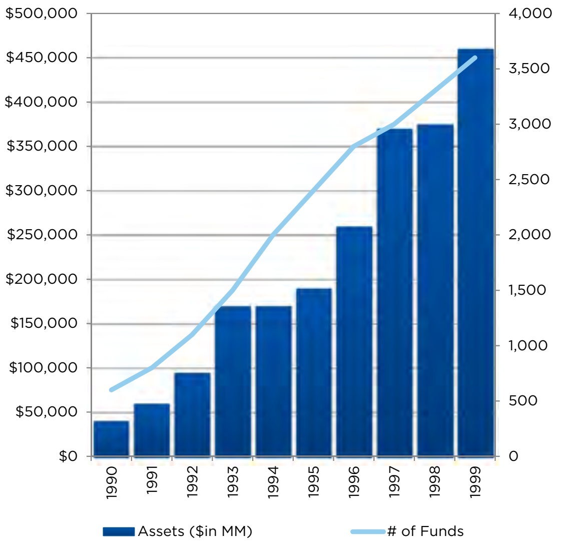
The objective of this article is to show how the hedge fund industry has grown from a small, opaque, niche sector directed towards high net worth investors into a large, transparent, and institutional-quality fund management business. It also describes how smaller investors are no longer limited to investing in hedge funds through fund of funds and how more of them are choosing to invest directly.

## A brief history

Despite having its start as early as 1949 (see side bar), the hedge fund industry remained largely a niche sector until the 1990s when real growth emerged. (See Chart 1)

**Chart 1: Growth of the hedge fund industry during the 1990s**




In 1990, the total size of the hedge fund industry was $38 billion, with fewer than 500 funds. Over the next 10 years, AUM grew more than 10 times to just over $450 billion. The number of funds grew dramatically to over 3,500.

### Who is credited with starting the first hedge fund?

In 1949, Alfred Jones wanted to find a way of investing where the value of his portfolio would be driven by the quality of his stock picking and not by the ups and downs of the broad market. He embraced the concepts of leverage and shorting, using these to construct a market-neutral portfolio where he was short by the same dollar amount as he was long. Over the next two decades Jones's hedge fund enjoyed strong success, significantly outperforming long only funds and other market benchmarks. His success began to get the attention from some in the investment world and a number of launches ensued, including the legendary George Soros in 1969.

The investor base during this period was largely comprised of high-net-worth individuals and family offices, and the fund of hedge fund business began its development to service this growing demand from private investors. Fees were high, transparency was poor and operational infrastructure was limited.

Another important feature of the 1990's was that new or previously niche strategies began to gain traction. This included more quantitative strategies that were able to take advantage of greater computing power and new financial instruments. With the development of these more complex strategies came more sophisticated hedge fund managers.

At the end of the decade, some fund of hedge funds were delivering annualized returns of over 15% with a volatility of just over 6% – numbers most investors would be thrilled

1 - In January, Mr. Da Costa was a session presenter at the 11th Annual Foundation, Endowment and Not for Profit Investment Summit held in Toronto, Canada. This article summarizes a portion of his presentation.

with today. However, the irony is that, back in 1999, not all investors were satisfied with 15% net returns as dot.com fever had taken hold. As the bubble popped in early 2000 and the stock market crashed, fund of hedge fund returns once again started to look very attractive, particularly on a risk-adjusted basis.

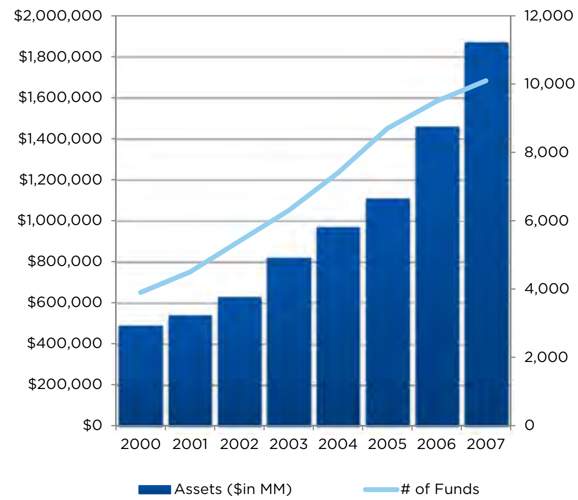
Hedge funds performed relatively well during the dot.com crash (See Table 1). The HFRI Equity Hedge Index suffered a maximum drawdown of only 10.3% while the S&P 500 was down almost 45% and the NASDAQ was down a whopping 80%. Looking at the longer term, hedge funds as a group delivered equity-like returns term but with significantly lower volatility. For example the HFRI Fund Weighted Composite delivered returns of 14.5% with a volatility of 7.3% versus the S&P 500, which had delivered a return of only 9.7% but with more than double the volatility.

Heading into the new millennium, the hedge fund industry saw its next important growth phase. (See Chart 2)

Asset growth went from under $500 billion in 2000 to over $1.8 trillion by 2007. During the same period, the number of funds grew from 3,500 to over 11,000. This asset growth was driven in part by institutions becoming increasingly interested in the space. As many were unfamiliar with hedge funds, they chose to invest via fund of hedge funds, fueling rapid growth of that sector. This period marked the beginning of the institutionalization of the hedge fund industry.

The next major milestone in the industry came with the market crash of 2008. The severity of the crash had knock-on effects that very few people foresaw. The losses across some parts of the hedge fund industry were beyond what most had expected and exposed serious flaws in some business models. Many funds suffered liquidity "mis-matches" and were unable to pay out redemptions promptly.

**Chart 2: Growth of the hedge fund industry during the 2000s**




Performance-wise the main hedge fund indices were down around 20%. Many fund of hedge funds suffered similar losses as correlations spiked and few strategies other than macro and systematic provided any diversification. However these losses, despite being large, were once again less than half of what long only equity investors experienced.

## Sowing the seeds of change

The global financial crisis actually sowed the seeds for the next major evolution of the hedge fund industry. Weaker managers shut down while the stronger ones survived and built more robust businesses. Institutional investors once again saw how hedge funds performed relative to other investments. These investors started increasing their

**Table 1: Hedge fund returns vs. market benchmarks 1990-2002)**

| | Return | Standard Deviation | Return/ Risk | Maximum Drawdown | Peak | Valley | Maximum Drawdown Dot.Com Crash Mar-00 - Sep-02 |
|---|---|---|---|---|---|---|---|
| HFRI Fund Weighted Composite Index | 14.50% | 7.30% | 2 | -11.40% | Apr-98 | Aug-98 | -6.40% |
| HFRI Equity Hedge (Total) Index | 18.20% | 9.30% | 2 | -10.30% | Aug-00 | 2-Sep | -10.30% |
| HFRI EH: Equity Market Neutral Index | 10.30% | 3.30% | 3.1 | -2.70% | Jan-99 | Apr-99 | -1.60% |
| HFRI Event-Driven (Total) Index | 14.20% | 6.80% | 2.1 | -10.80% | Apr-98 | Sep-98 | -9.30% |
| HFRI ED: Distressed/Restructuring Index | 14.30% | 6.30% | 2.3 | -12.80% | Jun-98 | Oct-98 | -4.00% |
| HFRI Macro (Total) Index | 16.80% | 8.70% | 1.9 | -10.70% | Jan-94 | Apr-94 | -7.30% |
| HFRI Relative Value (Total) Index | 13.10% | 3.80% | 3.4 | -6.60% | Jun-98 | Oct-98 | -0.50% |
| HFRI RV: Multi-Strategy Index | 10.90% | 3.60% | 3 | -8.30% | May-98 | Oct-98 | -2.00% |
| S&P 500 | 9.70% | 15.20% | 0.6 | -44.70% | Aug-00 | 2-Sep | -44.70% |
| MSCI AC World Index | 4.50% | 15.10% | 0.3 | -46.30% | Mar-00 | 2-Sep | -46.30% |
| NASDAQ 100 Stock Index | 9.10% | 27.80% | 0.3 | -80.70% | Mar-00 | 2-Sep | -80.70% |
| Barclays Aggregate | 7.70% | 5.00% | 1.5 | -7.40% | Jan-94 | Jun-94 | -2.00% |

allocations to hedge funds as a way of reducing portfolio volatility without giving up meaningful upside. As large institutions became the dominant source of new capital, they were able to effect significant changes into how hedge funds conduct their business. Hedge funds were forced to lower fees, and improve transparency and governance particularly with respect to areas such as pricing.

**Fees** - At the hedge fund level, fees for top managers have been pretty sticky at 2% management and 20% performance fee. But for the average fund, management fees have come down to about 1.6% management and 18% for performance. Where fees have come down dramatically is at the fund of fund level. Back in the 1990s fund of fund fees were a fairly standard at 1.5% management and 15% performance. That has now come down to an average of 1% management with no performance fee. The largest investors will see fees even lower than that.

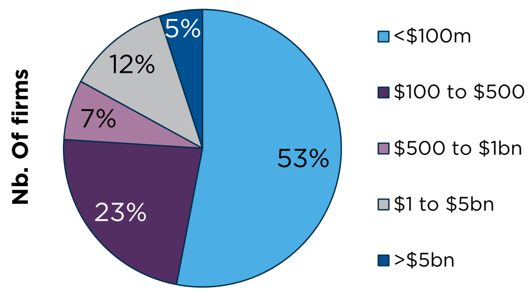
**Transparency** - Managers have improved the quality of their reporting, with many providing investors with the full portfolio (albeit usually on a lagged basis). Most managers are willing to review the live portfolio with an investor during an onsite meeting; if they are not, an investor should question why not. Not only has transparency through the managers themselves improved tremendously, but there are now other ways investors can gain heightened visibility. Third-party providers like Risk Metrics are able to provide investors with independent risk and transparency reporting. This is a powerful tool that some larger investors and consultants have implemented.

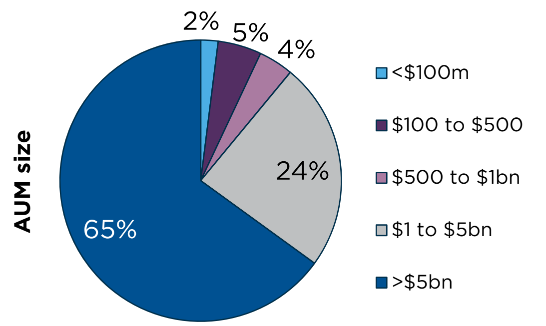
**Governance** - Several industry scandals have brought poor governance practices to the forefront of investors' attention and have forced changes across even the smallest managers. Hedge funds are now almost all priced independently by third-party administrators using independent pricing sources. Boards of directors are now typically more independent and play a more active role in overseeing the fund's management.

## Big getting bigger

Large, institutional-quality hedge funds continue to attract the lion's share of industry assets. From Chart 3, we see that 17% of managers with AUM over $1billion control nearly 85% of total industry assets. What's more, only 5% of managers have AUM over $5 billion and they alone control more than 65% of total industry assets. This raises concerns that some managers are becoming asset gatherers. However, some of these large funds have become extremely sophisticated and are helping to redefine the role hedge funds play in the capital markets. These large hedge funds are using their investment capital to engage in traditional investment banking activities such as business financing, and market making. Hedge funds are gaining an increasing share of these activities as regulatory changes such as the Volker rule force banks to reduce their proprietary activity.

**Chart 3: Largest managers attract the most assets**




## Risk management

Another change, which in part has been driven by the institutionalization of the business, is a greater focus on risk management. Institutions have a different risk appetite compared to high net worth investors and tend to be looking for steady returns, downside protection and preservation of capital. Hedge funds have succeeded in delivering this, and the risk management functions at the top firms are market leading.

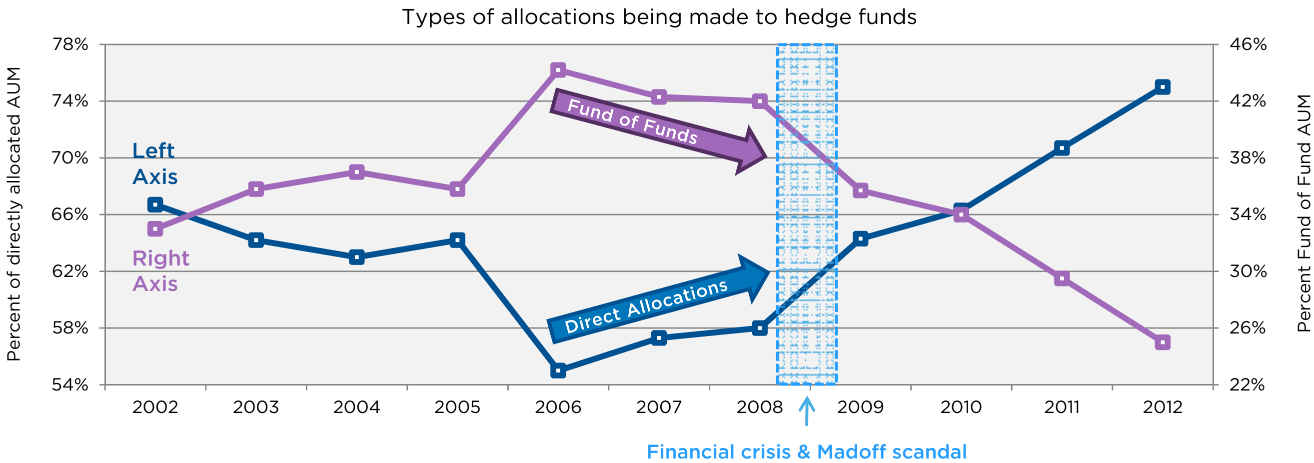
## To invest directly or via fund of funds – that is the question

Finally, let's take a look at one of the largest trends within the industry; that of larger investors increasingly investing in hedge funds directly rather than through fund of funds.

Since 2006, of the allocations to hedge funds, those made to direct investments have jumped from 55% to 75%. By comparison, those made to fund of funds have shrunk from 45% to 25%.

The primary reason for an investor to use a fund of hedge fund manager is to access instantly a diversified portfolio of

**Chart 4: Major trend – move from fund of hedge funds to direct**




fully vetted hedge funds. Fund of hedge funds are ideally suited for smaller investors who cannot meet the high minimum allocations associated with most hedge funds.

For many large institutions, investing in fund of funds was a first step that allowed them to become comfortable with investing in hedge funds. Many fund of funds hold well over 30 different hedge funds with some holding as many as 50. In some instances, this may lead to over-diversification and muted returns as good performance by some managers may be "zeroed out" by others. Going direct allows an investor to gain a more targeted, concentrated exposure to high conviction managers, with the goal of generating higher returns.

Fee savings are a primary driver for large investors considering a direct investment. We estimate a fee savings of around 75 basis points is achievable by from moving from fund of hedge funds to direct investments.

Other advantages of a direct investment:

- **Customization:** direct investors can drive the asset allocation and fund selection to suit their needs.
- **Control and liquidity:** by holding units of the individual hedge funds directly, the investor is not subject to fund of funds gating or side-pocketing investments.
- **Transparency:** by holding the hedge funds directly, investors can gain enhanced transparency.

Investing directly typically requires that the institutional investor have the internal resources to design, implement and manage a program. Investors without such capabilities will typically hire a consultant to help. (Note that it still may be worthwhile for smaller investors to hire a consultant to select high quality fund of funds.)

Of course, these are not the only options available. There are a number of different alternatives an investor can consider to access hedge fund strategies and new ones are continually being developed. 40 Act registered hedge funds are starting to gain some traction in the US and have some attractive features. UCITS in Europe and Closed Ended Investment Trusts in the UK have been around for some time but have had only mixed success. Specialised ETFs are also gaining traction and offer interesting alternatives. Investible Indices, hedge fund replication and alternative beta strategies will also be interesting for some and there are many products to choose from.

As a group, many of these alternatives to traditional hedge funds have attractive features, such as daily liquidity and lower fees. However the price of this is that many of them are more restricted in investment scope which can lead to potentially disappointing returns.

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