

# The future of hedge funds: I must have lost my presence of mind

by Dermot Butler, Custom House Fund Services Limited

WHEN I WOKE UP EARLY IN FEBRUARY TO REALISE THAT I HAD AGREED TO WRITE AN ARTICLE ON “THE FUTURE OF HEDGE FUNDS”, I INSTANTLY REMEMBERED AN EXTREMELY AMUSING LETTER WRITTEN BY GERARD HOFFNUNG, IN WHICH THE FUNNIEST LINE WAS “AT THAT MOMENT, I MUST HAVE LOST MY PRESENCE OF MIND”, BECAUSE SURELY NO ONE IN THEIR RIGHT MIND WOULD AGREE TO PREDICT THE FUTURE OF HEDGE FUNDS FOLLOWING 2008? NEVERTHELESS, I HAD AGREED TO SO AND SO HERE GOES.

I think that before one can try and assess what the future of hedge funds is, a brief glance at their history would be useful.

As everybody knows, the ‘hedge fund’ was created by Arthur Winslow Jones in 1948. Mr. Jones was a journalist who developed the relatively simple, but nevertheless, innovative concept that, if you select companies that you believe are going to outperform the market and buy their shares and also identify companies that are going to underperform the market and sell their shares, then you have two opportunities for making a profit, but also you hedge your position. The hedging aspect comes about because, if the market rises, your profit on those shares that are expected to increase – lets call the company ‘BullCo’ - will exceed the losses that will occur on the shares that you expect to decline (‘BearCo’), even though they will rise with the market. On the other hand, if the whole market was to decline, then the BullCo shares should decline by less than the BearCo shares and, therefore, you should still make a

profit, but albeit a smaller one, because, the BearCo shares have hedged the BullCo position and the BullCo shares have hedged the BearCo position. This, time has proven, was an excellent method of reducing risk in a portfolio.



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Unfortunately, hedging also means that you reduce the profit potential.

Mr. Jones recognised this and, therefore, introduced leverage. That meant that he borrowed sufficient money to enable him to double both his long and short positions, in the hope that the profits would double without increasing the risk, except to the tune of the interest involved. And, hey presto, A.W. Jones had thus created the long/short equity fund. In the subsequent 60 years, many variations of the long/short equity funds – the ubiquitous hedge fund - have been created, all of which, if they are true hedge funds, will involve a short element in some disguise or other. They will also involve – and this is important – another core component of all hedge funds - leverage.

So, with a few blips on the way, the hedge fund has progressed to become a very much more sophisticated animal than it was in 1948 and to have numerous strategies that are largely based on the same simple concept – a long position hedged by a short position with the profitability enhanced by leverage.

Another characteristic of the hedge fund, which certainly contributed to its substantial growth in the last 15 or 20 years, was the fee structure, which usually included a management fee of 1% or 2% of the NAV *per annum*, plus an incentive or profit sharing fee, which averaged 20% across the industry – that is 20% of profits generated by the fund. This was paid to the manager of the fund, who would usually have a substantial part of his own net worth invested in the fund.

The popularity of the hedge fund grew because the hedge fund managers identified inefficiencies in the market and exploited those inefficiencies, whether they were as simple as overpricing dodgy companies (BearCo) or mispricing between two legs of a potential arbitrage transaction, such as buying and selling government securities with different delivery dates. As a result, during the heyday of the hedge fund, hedge funds generated substantial performance, often over 30% *per annum*, net of all fees. Moreover hedge funds would return their substantial profits when the stock market was becalmed, or in a decline. Thus, it became generally expected that hedge funds offered two advantages to investors:

- Firstly, they would produce alpha. The simplistic definition of alpha is any return in excess of beta and beta is the standard return that you make out of the market.
- The second and, possibly, the major attraction of hedge funds was that, in addition to the potential for outperforming traditional investments, hedge funds would also protect the investor's capital by providing an absolute return, which means that the hedge funds would not lose money, even in a declining market. They might not make much, but they wouldn't lose it and, of course, even if they had made nothing and the rest of the market lost 20%, then they had produced 20% alpha, as well as protecting the capital.

There were several occasions when hedge funds demonstrated their ability to achieve these two objectives, the last being the Tech Bubble at the beginning of this century, which sounds an awful long time ago, but it was only eight years. Some hedge funds lost money because they were not proper hedge funds. They were basically long-only tech funds. Other hedge funds lost money because their analysis of what was a BullCo and what was a BearCo was just plain wrong, but, assuming you had picked a good manager, hedge funds, on the whole, did what it said on the box.

And then came 2008.

We have seen some substantial ranges of performance from exceedingly profitable at 30% and 40% up, to horrific losses – even worse than the stock market. My belief is that the majority of those that lost huge sums of money were probably not true hedge funds and I base this on the fact that the average hedge fund lost somewhere between 15% and 20%, depending upon the survey you read. What some people have taken a long time to appreciate is that means that, given that the stock markets of the world declined between 25% and 50%, the average hedge fund did meet its objective by providing around 20% or 25% alpha – the return in excess of 'the market'. However, the majority made losses and so they failed in the second objective of protecting capital and providing an absolute return and many hedge fund investors (and, I suggest, more commentators) have decried their performance.

It goes without saying that hedge fund managers quite understand that hedge fund investors are not happy that they have lost money, but few people have sat down and thought about why they had lost money until this year. Again, I am going to be somewhat simplistic, but if one of the core elements of a hedge fund is leverage and if the banks, without warning, eliminate liquidity and withdraw leverage (i.e., borrowings and credit lines) from all hedge funds, including those that are conservative and well managed, then those hedge funds are left with no option but to liquidate their positions. In my simplistic example of a hedge fund, this means that the manager has to sell not only the BearCos but also the BullCos and, in that fire sale market situation, which was largely driven by panic, both BullCos and BearCos were decimated and the 'quality arbitrage', if you like, which distinguished the BullCo from the BearCo, was eliminated at a stroke.

Those hedge funds which made profits and, in some cases, substantial profits, were funds that had, perhaps, superior analysis or funds that were short-bias and had identified the financial services sector and several of the major companies within that sector as BearCos and, indeed, any company that was involved in sub-prime debt. I have not seen the portfolios of these very successful companies and so am not able to confirm whether they were, in fact, themselves, effectively short-only funds and not really hedge funds – but those questions are rarely asked of somebody who has returned 40% or more.

Be that as it may, as we enter the second quarter of 2009, there has been some anecdotal evidence that would support both a bullish and bearish argument for hedge funds themselves. I am more in favour of the bullish argument, which is based on the fact that many investors, including both professional investors including some pension funds, have recognised that hedge funds did substantially outperform the rest of the market and would have protected the investor's capital if the credit crunch had not been so vicious. Accordingly, it appears that many pension funds that had not previously invested in hedge funds are now actively considering it and I understand, from one of the leading pension fund consultants, that

they expect many of these 'virgin' pension funds to enter the hedge fund market at the end of the second or during the third quarter of 2009. In fact, we have seen evidence of this already happening with the Universities Superannuation Scheme and there was a rumour reported in a widely read weekly newsletter that a large UK-based institution has recently placed US\$1bn in a new hedge fund managed account – but managed accounts do seem to be the flavour of the month.

Unfortunately, it is likely that many of those pension funds that had been invested in hedge funds would still have to liquidate part of their hedge fund holdings, despite the fact that the managers of the pension funds would prefer to increase their allocation to hedge funds. This is because those pension funds have a mandate which limits the exposure to hedge funds to, say, 10% of their portfolio and, ironically, the fact that hedge funds outperformed the rest of the portfolio, means that their weighting in the portfolio now exceeded the mandate and so they will have to liquidate the hedge funds to bring them down proportionately – a classic example of 'throwing the baby out with the bath water'.

Another reason that I feel reasonably bullish for hedge funds is my belief that 2008 and the knock-on effect in 2009 will bring a sense of realism back into the market. The extraordinary performance of hedge funds during 2007 and the beginning of 2008 had resulted in lurid press stories of huge sums of money being earned by some managers, to the extent that footballers looked impoverished. A general impression of obscene excess and 'Geckoism' pervaded every story about hedge funds and the inevitable jealousy and backlash from those of more moderate tastes occurred. I believe that those days have passed and that, although a successful hedge fund manager will still earn more than 99.9% of the population, including footballers, the hundred million and billion dollar bonuses are probably a thing of the past.

Nevertheless, that doesn't mean that a competent hedge fund manager can't make a decent living and build up a business, if he starts from scratch today. And we must

remember that there are a large quantity of very competent traders and money managers who have been thrown out onto the street, either by the closure of proprietary desks at banks, or by the closure of hedge funds which were decimated by the credit crunch. These traders are talented and many of them will have a loyal following of investors, or potential investors, who would back them. Two years ago, a US\$100m fund was considered petty cash and inadequate. Ten or 15 years ago, membership of the US\$100m club was a sign of achievement and those who enter the club were the elite of the industry.

In my opinion, if two good quality managers set up a hedge fund today and were able to raise US\$100m, they could run that hedge fund, subject to the complexity of their trading strategy, with a staff of four people. On the current fee basis of 2% and 20%, a US\$100m fund generates US\$2m a year, which should cover the basic operational costs of the office and reasonable salaries for six people, remembering that even today the culture of a hedge fund is that your success is measured by the incentive or profit fee. In today's distressed market, a competent hedge fund manager should be able to generate 20% return and we are already seeing hedge funds achieving that sort of level in the first quarter. A 20% incentive fee on 20% growth would equate to a further US\$4m revenue, which equates to a very respectable bonus for the two traders with an equally acceptable bonus for the back-up staff. This is more attractive than working for any bank in today's environment.

And, inevitably, that brings us along to the subject of regulation. Although one must ask first, do hedge funds actually need more regulation?

Charlie McCreavy, the ex-Irish Finance Minister and current EU Commissioner commented about a year ago, at the end of a strong speech commenting on the SocGen trading debacle, with words to the effect that he thought it was unfortunate that sovereign wealth funds and hedge funds had been 'demonised', because neither of them had caused the problems and, if it wasn't for the sovereign wealth funds, at that time, several financial institutions would have folded (as they subsequently did). And there

would have been no liquidity in the market, had it not been for hedge funds. It is arguable that the knee-jerk reaction in the markets that resulted in the nationalisation of Northern Rock, the collapse and government-assisted rescue of Bear Stearns, the rescue of AIG, the total collapse of Lehmans and, in fact, the 'financial holocaust' that has all but destroyed the US, English and Irish banking industry, as well as major banks in other jurisdictions, caused the sovereign wealth funds to lose a substantial proportion of the investments they made and the hedge funds to lose the ability to provide the liquidity to the market because their liquidity was erased. The irony is that (in my opinion, largely due to the popular press) several senior politicians and the press in general have decided that hedge funds are going to be the scapegoat, and I mean that in the biblical sense of the word. The Oxford Dictionary defines a scapegoat as "One who is blamed or punished for the sins of others" and, as such, I think the word absolutely applies to hedge funds in today's market and regulatory environment.

One of the stalwarts of the UK hedge fund industry recently commented at, I believe, a Parliamentary hearing that blaming hedge funds for the financial maelstrom was like blaming the passengers in an aircraft.

I should make it clear that I am not a Luddite in the context of regulation. I believe in regulation, but, to be effective, it has to be well thought out regulation and the regulators have to be effective. I do not see any benefit in regulating hedge funds any further than they are currently regulated. Sensible regulation with regard to the structure of hedge funds and the requirement that they have audits, for example, is, of course, important and, indeed, essential, but regulation with regard to the day-to-day operation of the hedge fund, including leverage, valuations, etc., is regulation that should, for the most part, be imposed upon the manager and other service providers. I believe that it is the service providers that should be regulated and, in most competent offshore jurisdictions, such as the UK, Ireland, Luxembourg, Malta and the Channel Islands, this is the case. It is extraordinary to me (and I have said this often) that hedge fund managers in the US are not regulated and,

indeed, to date, have not been required to register, notwithstanding an abortive attempt by the SEC five years or so ago. That was an example of incompetent, badly thought out regulation, which wasted a huge amount of money and achieved nothing.

The whole discussion of regulation, of course, leads straight back to what went wrong in the first place and it seems difficult to argue with the fact that the regulations relating to the sales of financial products to the retail market are ineffectual in the US and that led to the growth of the sub-prime disaster. However, the biggest irony of all is that the US banking industry is probably one of the most regulated industries in the world and yet, despite the threat of a near meltdown following the long-term capital debacle 10 years or so ago, the regulators, having clearly identified the problem, subsequently failed to carry out appropriate and effective oversight of the banks.

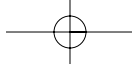
It was encouraging to see Lord Turner, Chairman of the FSA, in his recent report confirm that hedge funds were not the cause of the problems but, nevertheless, he believed that a change in the regulatory environment was required. The main problem in assessing how regulation was going to affect hedge funds and, therefore, the future of hedge funds is that, as yet, we do not know if that regulation is actually going to come into place and what it is going to be. If profit in hedge funds is going to be taxed on income, as suggested by some socialist tendency politicians in the US, then investors are going to take that into account when assessing the attractiveness of a particular hedge fund.

One of the problems with bad regulation is the so-called 'Law of Unintended Consequences'. It must be remembered that hedge fund managers are smart and they will remain smart and find new ways to make money - not initially billions, but more than the common-or-garden banker or stockbroker. As I implied before, many existing and potential managers will come out of the shrinking bank and investment bank industry and enter the hedge fund arena. We are already seeing a backlash to the populist anti-bankers tax in the US, which is the new proposal that anyone who earns more than US\$250,000 will pay 90% tax

on that excess, if he works for an institution that had received state (US taxpayers) aid. It does not take a rocket scientist to work out that anyone capable of making substantial sums for their institution will expect (and with some justification) that they get a reasonable percentage of the money they make for that institution, but not if they are going to be taxed at pre-Margaret Thatcher socialist tax rates. It seems so obvious that this is badly thought out because, if that 90% 'bonus' tax is imposed, then any institution that has not received state aid will be free to pay their staff performance-related compensation, subject to current tax rates and that means that the talent will emigrate from what are, effectively, nationalised banks to free market banks. This is the 'United Consequence'. And if further fiscal attacks are made, you can be sure that those free market banks will up roots and transfer all their entrepreneurial and speculative businesses to a more welcoming and amenable offshore centre.

Of course, there are no hedge funds that have yet required or requested such aid and, indeed, it appears that there are moves afoot to try and persuade hedge funds to purchase the 'toxic debt' and/or collateral that many of these institutions hold in order to get it off their balance sheets and, thus, strengthen the banks. It is an irony that we should have Messrs. Brown, Merkel, Sarkozy and Obama lashing out at hedge funds on the one hand and then trying to persuade them to fund banks' distressed portfolios on the other.

In the middle of all this mess, there will be many opportunities for talented people to make money and many of those talented people will be hedge fund managers and they will make their money through hedge funds. You may ask where they are going to get the leverage, which I have stated is one of the core components of the classic hedge fund. Some hedge funds will provide that leverage or, indeed, investors will – it just may be more expensive. Indeed, the demon sovereign wealth funds may provide the leverage, especially if it can be structured as a senior equity interest, rather than debt, so it is Shari'ah-compliant.



In conclusion, it is my belief that, despite the disasters of 2008 and the efforts of the press and the politicians and, particularly, the socialist politicians, hedge funds will thrive. In many cases, they are going to have to, as it says in the song, “pick themselves up, dust themselves off and start all over again”, but they will find that a lot easier than many of the banks. There are many strategies which qualify as hedge fund strategies and those strategies go in and out of fashion. Furthermore, new strategies come into play all the time, so that we are seeing a growth in asset-backed security, carbon, green, sustainable assets, distressed equity, distressed bonds and Shari’ah funds – and that is not an exhaustive list.

It should also be remembered that, although the value of invested assets has shrunk substantially, as a result of the 2008 collapse, and, indeed, this contraction may not have ended, there are still huge sectors of the world’s society who have a lot of money ‘under the bed’ which needs to be invested, because, as I believe it was Warren Buffet who said “saving cash is like saving sex for your old age”.

Furthermore, even if unemployment continues to increase – and it will – there will still be a large percentage of the population that is working and generating money, a proportion of which will be invested in pension funds. Thus, although the value of many pension funds’ assets has, and may, continue to shrink, the cash element – new subscriptions – continues to grow, albeit at a slower rate than before. And if hedge funds perform, pension funds will invest.

I started this article by saying that I must have lost my presence of mind when I agreed to write about the future of hedge funds and I meant that it was an impossible task because nobody knows what the future is. I am, obviously, reasonably optimistic, but it has to be said that, if we get another Lehmans or another Iceland, and we’ve all heard that joke about Ireland and Iceland, then there is no knowing how far the market could fall and what chaos that would bring with it.

Finally, the governments of those countries worst affected are doing what they deem to be the best they can to reignite the economies, but if they fail and have to hand out even more money, then inflation is inevitable. That will, of course, have its own serious consequences, but it will provide opportunities for managers and investors to make money over and above inflation. So, if all else fails, make sure you have a direct line to your CTA.

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