The evolution of hedge funds

Jamie Stewart, head of institutional marketing and research at Eden Financial, has some useful comments about the UK's FSA and the world of hedge funds

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As with most phenomena of human and the natural world, evolution is never finite: it spawns further development calling for refining, regulating and redesigning. This is also the case in the financial arena: it's unlikely the UK's Financial Services Authority (FSA) ever saw itself as an example of evolutionary theory, but undeniably it is.

The FSA's recent discussion papers, *Hedge funds: A Discussion of Risk and Regulatory Engagement* and *Wider-range Retail Investment Products,* share a financial 'DNA' in terms of the evolutionary developments which they address.

The Regulator has long recognised that the advent of hedge funds and sophisticated retail investment products is not only unstoppable, but ultimately welcome and constructive. Newfangled as they were ten years ago, these unfamiliar formations, like platypuses, have developed relentlessly and largely creatively.

The discussion paper shows it is time to discuss compromise in hedge fund investment: not giving in but having a constructive means of permitting and encouraging access for retail investors, while ensuring adequate protection.

Both these papers have diligent detail, definition and distinction. Their essence, however, is not so much about 'leverage', 'volatility' and 'operational risk', as about the judicious balance between the permissive and the restrictive, and about where to position responsibilities.

The FSA's style has become more consultative, less dictatorial; these discussion papers are paradigms of emergent rule by reason and referral rather than by rod.

The FSA, in these two papers, as well as other recent consultation papers and policy statements, is pursuing a plan of quietly transferring responsibility for vigilance and verification to the institutions. Its approach is part of a general tendency towards self-certification and self-assessment.

The FSA is not able to treat retail investors like institutions. Whilst institutions must comply, investors are free spirits and continue to run wild. Although they are the FSA's key protégé, they are not easy to control and the FSA increasingly carries the can.

Depending always on definition, there are 9,000 worldwide hedge funds managing US$1.2trn, close to total assets managed by Fidelity Investments, and also close to the UK's aggregate personal debt.

What do managers think about these developments? Multi-managers spawned funds to meet differing needs. Hedge funds managers prefer expert investors with lots of money or clients of family offices, private banks and the personal pension, SIPPs.

Hedge fund asset inflows come from pension funds, tranches of corporate, local authority and corporate funds, as well as fund of fund managers such as Man Group and GAM. Managers are ambivalent about retail, because every new punter through the door will give the FSA more reasons to check and monitor.

The expert investor, the high net worth individual, and a few others understand the survival and selection processes of hedge funds. When the chips are down, he can name, shame, blame and claim.

There is nothing novel about this: Nell Gwyn, mistress of Charles II, discovered a long time ago that it is much more fun to have all the power and none of the responsibility than the other way round.

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