Hedge funds

Strategies to last the course

Private investors are warming to the attractions of hedge funds of funds. **Mark King** asks whether they are in danger of becoming fashion victims in a crowded market

Hedge funds have long been perceived as elite vehicles run by secretive, maverick managers on behalf of the ultra-rich. But the hedge fund industry is changing. The world of hedge funds is slowly demystifying itself: typified by steadily falling costs, more transparent literature, lower minimum investments and managers who are prepared to reveal how and why they expect their vehicles to outperform.

Mark Cooper of C2i International, a hedge fund risk management consultancy, acknowledges that the vehicles are becoming more popular, but he also warns novice investors that sizeable risks remain. 'It can't have escaped anyone's notice that hedge funds are in vogue,' he says. 'There were 6,700 at the last count with $750 billion in assets. But as with any fashion, there are always victims.'

Cooper believes a stampede for the high returns they promise can cause both independent financial advisers and investors to forget they should be taking extra precautions. 'Particular risks stem from hedge funds' unregulated nature,' he continues. 'Anyone can set one up and they can be an ideal way to launder money, because the uneven returns are good for hiding suspect transactions. Moreover, their location offshore can make dealings even less transparent. The worst outcome is to find your money has been entrusted to fraudsters.'

If locating offshore is such a problem, why do hedge fund operators not locate their vehicles onshore? The answer is that the Financial Services Authority does not regulate them. Marc Gordon, managing director of Close Fund Management, says it is time for the UK's regulator to look into hedge funds. 'I'm always in favour of the regulation of hedge funds in this country,' he says.

Despite their popularity, hedge funds are still unregulated and thus come with significant risks

'The onus is on the industry itself to act with integrity, but we would welcome being policed by the FSA.'

This seems unlikely, because higher levels of compliance would seriously curtail hedge funds' activities. They would not be able to pursue an absolute return mandate using a variety of different strategies, nor would they be able to switch strategies so quickly. Moreover, most hedge fund managers would find corporate governance rules extremely difficult to follow, given that they are accustomed to making instant far-ranging decisions without consulting investors or shareholders. What's more they generally have no say in how hedge fund managers are remunerated.

The upshot of not being regulated means hedge funds cannot be marketed in the UK; instead they rely on recommendations from financial advisers, private banks and private client firms as well as a small number of wealthy investors. But Graham Gordon of advisers Moore & Smalley says interest remains flat. 'We cater for high-net-worth clients and in the last two or three years not one of them has even enquired about hedge funds. I would say there is more interest in hedge funds from the industry itself than from private investors.'

This could change if the hedge fund

Hedge funds explained

A hedge fund is a vehicle that can take both long and short positions, use complex strategies such as 'arbitrage' and 'equity hedge', trade options or bonds, and invest in almost any opportunity in any market to produce a positive return in any market conditions. A hedge fund aims to produce an absolute return, rather than trying to outperform a particular index or benchmark. Strategies can involve currency plays and derivatives trading as well as equity-related activities, and will vary enormously from fund to fund. Most use the following major strategies:

- **Arbitrage** Attempts to exploit pricing differences between related securities. By establishing long positions in undervalued assets and short positions in overvalued assets, an arbitrage strategy aims to capture profit opportunities that arise from the changing price relationship between the assets concerned.
- **Equity hedge** Aims to profit from identifying equities deemed to be under- or overvalued in relation to their peers.
- **Managed futures** Uses derivative instruments such as futures contracts and options. They are used across a range of markets, including bonds, foreign exchange and commodities markets.
- **Directional** This essentially scans the global macro-economic landscape, looking for bargains that arise as a result of political or economic changes. Emerging markets therefore feature heavily, as do sudden opportunities that arise when managers are seeking to benefit from sudden political flare-ups and economic booms and crashes.
- **Long/short equities** The simplest strategy of the lot. The manager trades equities either long or short to reap the rewards when they move up or down.

Hedge funds

of funds formula continues to attract interest. An increasingly popular choice, they work in a similar way to typical unit trust/Oeic funds of funds by investing in a range of single hedge funds, spreading risk across the bunch while increasing returns from picking the best available funds in the business – in theory.

While they are more accessible for ordinary investors, with minimum investment levels of around £10,000 rather than the £250,000 plus demanded by traditional individual hedge funds, funds of funds have been criticised for having high fees, which can ultimately eat into returns.

FEES AND THEN MORE FEES

Graham Gordon agrees. 'There will be a doubling up of fees, because the hedge fund of funds manager has to pay for all the other funds – and that's without counting performance fees,' he says. Hedge fund managers generally command a performance fee of up to 25 per cent on returns above a certain level, say, 6 per cent a year. 'For every 1 per cent you make on your investment above 6 per cent you are only getting 0.75 per cent, which is going to hurt,' he explains, 'although in certain cases, if there is a good absolute return, it can be worth paying for.'

Jamie Stewart, head of institutional marketing and independent research at Eden Group, a private client broking and portfolio management firm, is not a huge fan of these new-style vehicles, although he is less concerned about fees than the ability of hedge fund of fund managers to generate genuinely decent outperformance. He believes they will inevitably pick some funds or managers that underperform, as much as they pick those that do well – the net result being a rather flat return. 'I liken them to someone planting a garden with every feasible variety of flower,' he explains. 'It should produce a stunning garden, but it ends up looking like a bowl of sick.'

Stewart is more positive, however, about the kind of structured hedge fund of fund products that are being launched, such as the Woolwich Protected FTSE Hedge Plan and the Close Man Guaranteed Hedge Funds. Both are clearly designed to pique the interest of Joe Investor by offering a 'no lose' product in which capital is 'guaranteed', with the added benefit of potentially high returns.

The first of the Close Man products raised £70 million earlier this year, while the second is open for investment at least until the end of October 2004. The current fund is a manager of manager-style vehicle (it chooses the best individual managers in the market place and asks them to run mini-bespoke portfolios which all come under the parent umbrella fund). Stewart explains: 'These vehicles at least mean investors cannot lose money, but I believe outperformance is unlikely.'

Graham Gordon has similar fears, although he does rate some of the newer vehicles. 'I can see there being a place for these products as a small percentage of an investor's overall portfolio, but I wonder whether, once the charges are taken out, there will be much of a return left.'

It is also questionable whether private

OFFSHORE AND INTERNATIONAL HEDGE FUND OF FUNDS

	After 1 year % Chg	Rank	After 3 years % Chg	Rank	After 5 years % Chg	Rank	Domicile Name	Manager Name
Top 20 (ranked over three years)								
Galileo Emerging Markets	5.7	9	60.09	1	69.87	8	GU	GL Fund Mgmt (Guernsey)
Orbis Leveraged (Euro)	-2.46	63	56.66	2	226.99	1	BER	Orbis Inv Mgmt
Primeo Select Euro Fund	6.29	8	40.25	3	–	–	CAY	BA Worldwide Fund Mgmt
BrunnerInvest Ciran EM	10.69	1	34.93	4	51.14	14	IRE	Brunnerinvest AG (Zurich)
Kallista CB Arbitrage EUR	-0.02	39	33.02	5	–	–	CAY	ADI - Alternative Invs
UEB Altern Arbitrage Ptfl Euro	3.45	24	29.47	6	56.5	11	LUX	United European Bank
Estrategias de Bajo Riesgo A	4.16	20	28.23	7	53.63	12	IRE	FG Asset Mgmt EIRE
Auriga Int Swiss Franc	3.97	22	25.33	8	51.51	13	BVI	Auriga Intl Advisers
Fairfax Fund Class A	5.06	15	24.17	9	–	–	ANG	Alexander Inv & RTR
Hermes Sterling	7.52	5	23.83	10	43.39	17	BER	Hermes Intl Fd (Bermuda)
UEB Altern Arbitrage Ptfl GBP	6.93	7	23.76	11	56.74	10	LUX	United European Bank
Nucleus Fund	4.97	17	22.31	12	–	–	ANG	Alexander Inv & RTR
Liberty Ermitage Eur Absol B	9.56	2	20.51	13	–	–	LUX	Liberty Ermitage A Mgmt Jer
La Fayette Europe	5.66	10	19.75	14	166.55	3	BVI	La Fayette Mgmt
Key Delta Fund Inc €	1.01	34	18.36	15	–	–	BVI	Key
Equalt Selection	1.67	28	18.27	16	38.4	20	IRE	CPRIM Ireland
Dexia Publimix Mid	-0.05	42	16.3	17	–	–	LUX	Dexia Asset Mgmt
Dexia Publimix Mid 2	-0.02	40	16.29	18	–	–	LUX	Dexia Asset Mgmt
Quest Trading Managers A	5.45	13	15.3	19	117.4	4	ANG	Quest Global Investing
Multiadvisers Euro Eq Hedge	2.63	25	14.77	20	–	–	LUX	Lombard Odier Dar Hen
Bottom 10								
Galileo Vision 2100	-7.03	108	-19.64	79	–	–	GU	GL Fund Mgmt (Guernsey)
Hasenbichler Multi Sty Fd	-19.73	134	-20.13	80	-16.94	50	BAH	Austrian Finc. & Fut. Trust
Platinum Cap Protect Eq Plus	-4.42	87	-20.37	81	–	–	CAY	Platinum Capital Mgmt
VAM Zodiac Sterling	-2.87	69	-22.26	82	–	–	IoM	VAM
FMG Hi-Tech Hedge USD Fd	-10.27	127	-23.78	83	–	–	BER	FMG Fund Managers
Platinum Cap Protect Inc Plus	-7.3	110	-24.43	84	–	–	CAY	Platinum Capital Mgmt
Man-Glenwood Select	-11.26	129	-26.11	86	–	–	BER	Man Invs
BrunnerInvest Star MM BIAG Gl	-7.18	109	-26.51	87	–	–	IRE	Brunnerinvest AG (Zurich)
VAM Zodiac Dollar	-8.52	121	-30.6	88	–	–	IoM	VAM
FMG US Hedge USD Fund	-7.45	112	-33.29	89	-12.27	48	BER	FMG Fund Managers
Average/number of funds	**-2.46**	**134**	**0.24**	**89**	**42.86**	**50**		

Notes: Bid-to-bid, gross income reinvested. IoM = IoM, Guernsey = GU, Bermuda = BER, Ireland (Eire) = IRE, Cayman Islands = CAY, LUX = LUX, BVI = British Virgin Islands, Anguilla = ANG, Bahamas = BAH Source: Standard and Poors investors really understand the more technical aspects of hedge funds. Terms such as 'arbitrage' and 'high-hedge' do not roll off the tongue in quite the same way as 'share price' and 'earnings per share'. Most hedge fund managers like to operate without having to explain to the man on the street exactly how they are achieving their returns. This is partly why C2i International's Cooper warns investors to be wary. 'Hedge funds may be the new black,' he quips, 'but unfortunately they can be just as obscure.'

The simplest way to assess hedge funds is as vehicles that need markets to be volatile in order to make money, because they often benefit when prices plummet as well as rise. They essentially aim to reduce volatility and risk while attempting to preserve capital and deliver positive returns under all market conditions. This is one reason that the hedge fund sector has underperformed in recent months – global markets have been relatively stable.

HOW THE HEDGE FUND INDICES HAVE PERFORMED

Index	% return over 1 yr	% return over 3 yrs	% return over 5 yrs
S&P Hedge Fund	0.43	18.45	49.45
S&P Arbitrage	1.89	12.61	47.41
S&P Directional/Tactical	-2.52	18.23	48.11
S&P Event-Driven	1.93	23.99	51.5
S&P Managed Futures	-5.01	19.21	52.1
S&P Equity Long/Short	–	15.07	57.66
S&P US Equity Long/Short	–	21.1	65.03
S&P Global (exUS) Equity Long/Short	–	9.22	49.28
S&P 500	**0.24**	**7.07**	**13.11**

As at 1 October 2004. Source S&P

'It is a transitory thing for hedge funds and generally settles down,' says Close Fund Management's Marc Gordon. 'We do have difficult times that coincide with other assets such as equity markets, but we do not in general correlate with any other area. That is why it seems strange to me that people say hedge funds have had a problem when they have dropped by 3-4 per cent rather than, say, 30 per cent, which is what happens in equity markets.'

NO TIME FOR PLAYING IT SAFE

However, Victoria Owen of Man Global Strategies, the company responsible for selecting the hedge fund managers who will operate the tailored portfolios for Close Man Guaranteed Hedge Fund 2, admits that in the current environment she often has to demand that managers take on more risk. 'We look for managers to take on a significant amount of risk and, even though it sounds strange, we often have to ask them to take on even more. It is not possible to get a 20 per cent return while taking on only 4 per cent risk. That is why we are currently looking for 8-12 per cent risk in our portfolio.'

Could it be that a lack of volatility in the markets, following three of the most bearish years in stock market history, means hedge funds are vehicles to be sold rather than bought at present? 'By the time your taxi driver is talking to you about hedge funds, you have missed the boat,' agrees Graham Gordon. 'Those three bear years were great for hedge funds, but it is possible they have had their day.'

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Stewart is not so sure. 'It is true hedge funds thrive on volatility, but instances of volatility exist even when the market looks flat. There are huge movements within dull markets and the hedge funds that will do well are those that take a more cerebral, esoteric, long-term approach rather than those that get sucked into the equity day-trader mindset.

'To that end, private investors could benefit from seeing if funds run by respected groups such as Park Place Capital, Odey Asset Management or Lansdowne Partners are among those being held in hedge fund of funds vehicles that investors are interested in.'