A Renaissance For The Hedge Fund Industry

The month of June is replete with hedge fund conferences. Conferences earlier this year were either poorly attended, or else investors attended them for the free breakfast or lunch, a chance to commiserate with fellow sufferers of the global financial crisis/hedge fund witch hunt. What a difference a couple of months of rising markets make. A palpable optimism is creeping back into the industry.

I recently attended the Goldman Sachs European Hedge Fund conference held in London a couple of days ago. **Over 50 hedge fund managers** attended to present their funds and a rough count of what must have been **over 300 investor groups** showed up, if not to allocate soon then at the very least to window shop.

The quality of managers was in general very high. Perhaps the weaker managers had been washed out or were facing legacy issues and thus not investable, there was clearly a Darwinian dynamic at work. The organizers would have been very selective as well so as not to waste investors' time. Or maybe it was just that Goldman Sachs simply had a bigger client base and could move further into the right tail of quality. Or, dare I say it, Goldman's clients were of a better quality. I don't know, all I know is what I saw. 5o over managers, all to a greater degree, of investable quality if one was so inclined to their strategies.

Many established managers previously closed to new investment, or usually reluctant to be presenting at capital introduction events were present. Only recently, Israel Englander's much vaunted Millennium was out looking for new capital at a number of conferences around the globe. These managers have experienced outflows of capital, redemptions which may be uncorrelated to the quality of their performance in 2008, and find that they have capacity to replace this exiting capital, as well as are faced with rich opportunity sets upon which to capitalize and thus have improved capacity.

Panel upon panel of strategy specific discussions were held and all well attended. **Investors were clearly looking for new ideas**, a sign of **recovering risk appetite** and the need to put capital to work. In every discussion, the macro landscape was an issue of great importance. At each panel, regardless of the uncorrelated or non-directional nature of the strategy from event driven to market neutral strategies, moderators and panel members were clearly focusing on the macro landscape, on regulation, on government intervention, and how these would impact the functioning of markets in which they invested. One thing was clear, **there was no consensus as to the health of the global economy**. Goldman Sach's Head of Global Economic Research Jim O'Neill was of the opinion that the worst was over and that a V shaped recovery was underway. His team forecasts better than expected growth from economies like the BRICs driving global growth. Hedge fund manager's, however, were almost evenly split 50:50 between bulls and bears, with the bears with the slight edge in extra time. Student's of Murphy's Law and other dynamic system theories will tell you that this is a healthy balance and likely to prolong current trends whether rising or falling and that reversals occur when the balance is jeopardized one way or the other.

What was really interesting for this observer, was that **despite the lack of consensus** over economic growth and market direction, each manager saw **immense investment opportunities** in their own particular strategies and markets. This would appear to be an inconsistency at best and more cynically, disingenuity at worst. Not so, in my view.

Of all the strategies represented at the conference, **there was consensus** among the respective manager groups, that the **opportunities for profit generation were great**. Equity long short, Distressed Debt, Merger Arbitrage, Volatility, Multi Strats. They all saw ways that they could make money, yet none of them could agree on whether the economy had stabilized, whether growth would resume or falter, whether inflation would rise or sink into deflation, whether markets would rise or fall. There is a larger lesson for students of economics, but that is not our aim here.

One can argue that macro leads micro, I'm not quite sure how yet, but in the narrower context of this discussion, **micro leads macro**. What these managers are individually telling us is that there are micro strategies that can be profitable. A macro analysis of the strategies that these managers employ will simply not be granular enough to capture the opportunities they talk about. And yet, when sufficient numbers of them make money, when sufficient capital is put to work in these opportunities, when sufficient time has elapsed, the macro structure of the trades becomes evident. This is the natural evolution of strategy.

Fees and Terms:

The industry has been debating if there has been any fee compression in the wake of the financial crisis of 2008, and hedge funds' apparently failure to perform as advertised. I have defended the performance of hedge funds through the initial stages of the crisis, but that is the subject of another discussion. At the Goldman conference, there was definitely **a growing number of managers charging less than the usual 2 and 20.** 1.5 and 15, and even 1 and 10, fees were seen. Encouragingly, I met a handful of managers who were going beyond reducing headline numbers and either considering or in the process of establishing a holdback provision with a vesting period, on performance fees, whereby a portion (say 50%) of a year's performance fees are held in escrow and a negative performance fee was applicable to the amount held back.

Liquidity terms were also a lot more logical. Illiquid strategies did not shy away from lock ups, while well performing or big name hedge funds with liquid portfolios and strategies, passed on that liquidity to investors. Some managers went as far as to formally exclude so-called gates, restrict suspension of NAV rights to specific circumstances, and specify side pocket provisions more explicitly. It appears that the events of 2008 have precipitated a much welcome self regulatory campaign.

Strategies:

Equity long short managers were in abundance, naturally, given their market share of the hedge fund industry. The diversity of styles withi
n what many consider a relatively simple strategy makes it a very interesting area to analyse and invest. There are managers who are driven by the philosophy that fundamentals, that is earnings, cash flow generation, financial strength, matter most in determining valuations. There are those who are traders, for which fundamentals are secondary, and what matters most is how a stock's price has behaved and is behaving, and who owns what. Still others, have a macro or thematic approach, and apply these to equity investing. The **trading style managers were bullish**, arguing that increased volatility and dispersion in equity returns represented opportunity for profit. It also represents opportunity for loss as well of course. Alpha can be negative. Some of them were bullish on the market, some were bearish on the market, but there was general enthusiasm for the opportunity to trade. **Fundamentally driven stock pickers** were similarly upbeat about their strategy, arguing that the last 6 months have seen a wholesale disposal of risk followed by, in the last 6 weeks, a reversal of this risk aversion, and that such large systemic moves create mispricings in individual companies which they seek to exploit. As always there were some very clever approaches to equity long short. There was a manager who had a very strong macro view, and invested a lot of time in macro research, then researched company fundamentals in an attempt to understand the impact of macro developments on company fundamentals. There was another manager which analysed only audited financials and ignored all street and interim data, and then built sophisticated models to obtain their own more granular interim numbers. All these various managers had credible reasons why their approaches would work. In 2005, I would not have believed them; today I am a lot less skeptical.

Convertible Arbitrage managers were conspicuously absent from the conferences. The best performing strategy in 2009, albeit the worst performing strategy in 2008, convertible arbitrageurs were too busy making money from the market to attend a capital introductions event. Moreover, who would listen, they would argue, most investors having being burnt in 2005 and then again in 2008? There are good reasons why the strategy is working and is likely to work further, but the managers were too busy working it than selling it. Good for them.

Distressed Debt has been a preferred strategy since late 2007. That, however, was an expensive false start. By the end of 2008, with insufficient defaults and a catastrophic dislocation in credit markets ranging from LIBOR to swaps, from ABS to corporates, from cash to synthetics, distressed debt managers had suffered considerable losses. Rational, no memory investing would have suggested getting back into distressed investing in 2009 and to their credit, investors have been bullish on distressed investing once again. A number of surveys taken in 1Q 2009 ranked **distressed investing as one of the top 3 hedge fund strategies** among investors for 2009.

One of the least favored strategies, if investor survey's are to be believed, is merger arbitrage. It may surprise one to learn that on a rolling 12 month basis, **merger arbitrage has been one of the best performing hedge fund strategies**, behind global macro and CTAs. Merger arbitrage, or risk arb, was well represented at the Goldman conference and it was clear that **risk arbitrageurs were very much excited about the opportunities before them**.

Since July 2008, M&A transactions numbered over 5000 representing over 1 trillion USD in value, and deal flow continues on the back of cashed up corporate buyers seeking strategic assets, distressed sales from corporate restructurings, distressed sellers and government interventions. Company's are happier to do deals in rising stock markets and easing financing conditions. Also, BRICs and other EM markets outbound transactions have been strong and remain an area of considerable potential growth.

Deal spreads have been volatile. The dislocation of markets in 2008 represent a stepwise repricing of an over arbitraged space. Deal spreads of circa 10-11% blew out to 50 – 60% before settling at current levels of 15 – 20% IRR.

The financial crisis of 2008 has also reduced the number of participants **leading to a much less crowded space**.

Bank prop desks have exited or significantly reduced their books and hedge fund capital dedicated to risk arb has shrunk more than proportionately to the industry. Many risk arb funds drifted into a much too early play in distressed credit as quite often the resources if not the skill sets are the same. M&A very often wanders into litigation and distressed investing is very much about litigation. While a pure risk arb strategy would have done relatively well in the last 12 months, provided one avoided the obvious mega LBOs, the contamination from a catastrophic credit strategy has hurt many multi strategy funds with large risk arb books resulting in poor performance and redemptions. The reduced capital employed in risk arb not only results in wider deal spreads but allows more time for analysis and deal selection leading to more selective participation.

A renaissance for hedge funds:

Since hedge fund indices have been compiled, that is 1990, until the present, with the exception of 1998 and 2008, hedge funds have steadily generated positive absolute returns. These returns have seen varying correlations to the returns of other traditional asset classes such as equities and bonds, as well as varying information ratios over time. From 2005 to 2007 hedge funds’ returns exhibited increasing correlation to traditional asset classes, decreasing returns to invested capital, increasing inter strategy correlations and increasing leverage. These features are interrelated and are directly related to the amount of capital dedicated to hedge fund strategies.

With more capital deployed in arbitrage and relative value strategies, continuous risk was more evenly distributed, volatility was dampened, volatility of volatility and correlations was also dampened, credit spreads converged, other arbitrage and relative value spreads also converged. The only way to maintain return on equity was to increase the level of leverage, a practice eminently feasible in an environment of cheap credit. Return on capital at risk, however, compressed to unsustainably low levels.

Such periods of calm accumulate imbalances for discontinuities. It would seem that a protracted reduction in continuous risk results in an accumulation of gap risk. In 2008, that gap risk was crystallized resulting in a discontinuous reduction in systemic leverage and thus capital employed in arbitrage and a concomitant system wide widening of arbitrage and relative value spreads.

This is one of the more plausible explanations for why, in an economy clearly in decline, with recovery highly uncertain and non-robust, with differing opinions and outlook for financial markets, arbitrageurs are optimistic about their profit generation potential across almost all, if not all, hedge fund strategies.

Arbitrageurs will be required once again to police arbitrage and relative value spreads to bring convergence to no-arbitrage pricing, to bring relative value valuations in line and to aid in the efficient allocation of capital. In a sense, and to a certain extent, the real economy is reliant on the arbitrageur in the healing process, and therefore, one factor for the rate of recovery, or repair, of the real economy, will be the rate at which capital is redeployed to take advantage of mispricings and other arbitrage opportunities.