Morgan Stanley Hedge Fund Forum

The Morgan Stanley Hedge Fund Forum 2009 was very interesting this year.

Normally, this is held somewhere cool and luxurious where there are expensive and time consuming distractions like golf courses or beaches in case investors tire of talking to hedge fund managers or hedge fund managers tire of explaining themselves to investors. This year, Morgan Stanley decided to focus everyone's attention and hold it in Rye, New York state. Its a lovely place, don't get me wrong, with golf courses nearby, but is a place where the golfers are, well, golfers and not jaded hedgies trying to hide from one another. It is a lovely place.

107 managers were presenting, I was told by the friendly Morgan Stanley conference team member. And over 500 investors. At the outset MS had expected and provided for 350 investors. The event had been oversubscribed. Initially the thinking was:

-its was a tough year last year for hedge funds. There was a risk that turnout would be poor.

-lets not be extravagant, let's hold it somewhere modest, which from a public relations point of view was the right thing to do.

-lets hold it somewhere near where we live, in case nobody shows up, its a short drive home.

These were not my conclusions but what was half jokingly offered by way of explanation at the lunch speech

In any case:

-the event became oversubscribed. MS initially closed at 350 investors but later relented and took in the full 500+.

-additional managers were added to the initial roster. Including one which was not a client of MS.

So, a successful if rather chaotic book build, an over subscribed offering, the overflow option completely exercised without cheapening the issue, and 100% demand satisfied. Morgan Stanley did it again and you could only call the event a success. The coaching that Morgan Stanley staff provided to managers in terms of the presentation, the pitch, the relevance and context to the investor type was very professional and effective. Here was a cap intro team earning their keep.

The managers presenting were higher quality, survivors of 2008, and the majority of which trading liquid strategies.

An increasing number changed their liquidity terms to provide better liquidity, without mismatch, and there was some evidence of fee compression at least at the management fee level, as well. Performance fees remain sticky.

Many of the managers were established and of critical size by assets and were either previously closed and reopening to replace capital lost to redemptions last year, or had previously not marketed actively having never had to since capital went in search of them.

There were a handful of start ups, which is always refreshing and encouraging. I like start ups for the challenge they present of trying to assess quality without the luxury of a track record from which to naively extrapolate as so many investors do when faced with a fund with a 20 year track record, with 19 negative months and a volatility under 2% trading some complex split strike conversion thingamabob. New people with new ideas, often experienced, emerging from the shadows of their established brand name bosses.

Then there are the investors. Bruised and battered from 2008 and the opening quarter of 2009 they were back in the hunt. In the first half of 2009 these capital introduction events were poorly attended and attended by investors more interested in what was for lunch than who they would meet. What a difference

6 months makes. What a difference a rising equity market makes, even to interest in absolute return and uncorrelated investment strategies. If investors are cynical about the claims of low correlation to traditional asset markets they need only look in the mirror. Back to the point: investor appetite. Funds were reporting small inflows and in some cases net inflows of capital. The line of questioning during the manager investor roundtables was more urgent and purposeful.

I am and have been optimistic about the returns potential of hedge funds but had been long skeptical that investors would reallocate capital to the industry. I am officially changing my mind. I believe that the track record of hedge funds before, during and after the financial crisis of 2008 is proof of the pudding and that investors recognize that and will allocate once again.

What has changed? The amount of capital available has changed. The losses in traditional strategies has swamped the losses in hedge funds but still equates to less capital to allocate. The quality of hedge funds has improved simply by attrition – lower quality managers simply closed shop. Some high quality ones did too but we are talking about averages. The quality of investors has also improved. Lower quality investors also closed shop, on average.

Investors should analyse the industry as much as the strategies and managers. What are the crowded strategies? Has the liquidity mismatch issue been addressed? Am I the investor creating the next adverse selection problem?

Managers too need to change their thinking. Is improving my liquidity terms simply setting myself up to be an ATM in the next crisis? Many of the funds that offered liquidity were writing cheques their portfolios could never encash. Why did they do it? To raise capital. Investors take note of what you are driving managers to do. Managers take note the quality of investors you are trying to woo.

If I ran hedge fund, I would manage the portfolio in an additional dimension: assets, liabilities and shareholder equity. When a manager of an operating company manages, they do so to a fixed and permanent equity base. They have to manage their assets and liabilities to that equity base. The liabilities are often fixed and the assets volatile and it is this volatility that is amplified through operational leverage and can erode partially or totally the equity of a firm.

Fund managers should take the same approach managing a balance sheet. That the equity base is variable makes the job much much harder. One has a volatile asset portfolio (longs), a volatile liability portfolio (shorts, short term credit lines,) and variable equity (investors who can subscribe or redeem.)
Managers need to choose their investors as carefully as they choose their longs, shorts, prime brokers, and derivative counterparties.

Its been a good conference with much food for thought. Thanks and kudos to Morgan Stanley for hosting and arranging a useful and interesting forum.