The Hedge Fund Industry. State of the Craft Feb 2009.

Its going to be harder to make money. Equity long short is correlated to equity markets.
Equity long short managers in aggregate tend to have chronic long biases which introduce positive correlation to equity markets. In aggregate. Particular managers, however, will have particular styles which may offer diversification and downside control. Its all in the skill of selecting the right managers. In aggregate, however, equity markets are likely to be highly uncertain and make it both easier to make and lose money.

Its going to be easier to make money. The markets are dislocated and relative value and arbitrage opportunities exist.
It is going to be easier to make money. Provided there is the skill to identify the arbitrage opportunities, the capital to take advantage of the dislocations, the stability of capital to take a longer term view, or at least a fixed term view, the risk appetite to take on more complexity, the psychological independence to break from a herd stampeding in fear. It will be easier to make money in 2009, but the psychological barriers to investing will be high, perhaps insurmountable.

Leverage will be expensive and hard to get. Markets and investors will continue to deleverage.
True. Financing, as always, is provided to those who need and want it least. The events of 2008 do nothing to change this dynamic, only to make it far far worse. But. The Fed, however, is of course leveraging its own balance sheet mightily and lending to banks in the hope that banks will lend on to consumers and businesses. Alas, the distribution mechanism for credit is broken and this liquidity is not getting through. The Fed will likely eventually have to become a direct lender to businesses. Its already done that in the short term

commercial paper market but as credit remains tight, it will likely have to start buying corporate bonds as well. There is a threat that credit suddenly becomes massively cheap and the Fed has to reverse course. But what do we need leverage for? Leverage is only good for relatively stable businesses where fluctuations in the asset value don’t wipe out the equity. Currently asset values are so volatile that a) you shouldn’t be using leverage, but b) you don’t need leverage to make a good return. See above, its going to be easier to make money anyway.

Hedge fund assets will shrink significantly.
They have already. Estimates of the shrinkage over the last 12 months have ranged from 30% to 50%. I am inclined to believe the 50%. But here is the thing. As the hedge fund industry’s growth accelerated in the last 5 years, the average quality of the hedge fund manager has diminished. Why? Barriers to entry were low. A rising market made it easy to make money, luck masqueraded as skill and investors were not too discerning since everything was making money anyway. A great proportion of hedge funds were not high quality in the first place. The current wash out forces the poorer managers out of the industry leaving the better managers to survive. Of course, the scale of the damage is so great that unfortunately, some high quality managers will be forced out as well. Hedge fund assets will likely stabilize this year as investors come to realize that in 2008, the average hedge fund lost 18% whereas the long only mutual fund lost over 40%.

The number of hedge funds will shrink significantly.
They have already. They will likely stop shrinking this year. Some further shrinkage will occur because of consolidation in the industry as investors seek brand names and size as signals of stability and operational strength. However, noting that the super sized funds lost more money in 2008 than the mid sized hedge funds, this dynamic will find a counter balance as more astute investors whose quality of due diligence allows

them to get comfortable with smaller managers.

The fund of funds model is dead.
Funds of funds are nothing more than an intermediary. In the process they provide an important service:
1. They make sense of the complexity of certain hedge fund strategies.
2. They provide diversification over a number of funds and strategies. Being aggregators they also provide access to smaller investors who themselves would not be able to gain diversification. Most hedge funds require a minimum investment of 1 million USD.
3. They provide risk management, or more generally, active management.
4. They provide expertise in strategy and manager selection.
But:
5. They got too big and started to behave as a group so that their decisions were no longer independent on one another. If each fund of funds has the same funds in it, the demise of a single fund affects them all. If a large fund of funds faces a problem, for example if investors leave en masse due to poor performance from a bad investment, the liquidation of the fund of funds in question will lead to them redeeming out of their underlying funds en masse, which will lead to some of those underlying funds facing liquidity crises which will cause a problem for other funds of funds investing in them…and so on. One underlying manager has the potential to create a problem in a fund of funds leading to a problem for other hedge funds and thus other funds of funds.
6. In their quest to grow assets under management they took on a liquidity mismatch. They would invest in funds which offered quarterly or annual liquidity or had lock ups but they themselves offered monthly or quarterly liquidity.

Long live the fund of funds model.
See items 1, 2, 3, 4 above. They still all hold true.
Point 5 is hard to address. Greater transparency will allow

investors to measure overlaps in portfolios and make more discerning choices when investing in funds of funds. Hedge funds themselves, post the experience of 2008 will manage their investor base more carefully.
Point 6 is likely to be addressed fairly quickly and diligently. Funds of funds will likely match their liquidity from their underlying managers through to their funds of funds. They will of course go as far as checking that the underlying portfolios of the underlying managers can support the advertised liquidity terms.

There will be increase regulation of the hedge fund industry. This is a good thing.
Yes. There will definitely be increased regulation of the hedge fund industry. The call for greater transparency is a good thing. More information can only improve the investment decisions of investors seeking to invest in hedge funds. Standards of transparency and reporting are areas where regulation will do much good.

There will be increase regulation of the hedge fund industry. This is a bad thing.
Regulation is very hard to get right. Too little and the industry descends into chaos, too much and it is stifled. The objectives behind regulation need to be clear and disinterested. Market efficiency and investor protection should be the guiding principles. Punitive regulation, although it is never deliberately motivated as such, is a very destructive force. It often begins with misguided good intentions. Often but not always. There is always the populist mob, that ever reliable source of illogic, emotion and vengeance. Beware. In a time of great financial and economic stress, we need cool heads and rational thinking.

Investors will favour liquid strategies.
Yes, but. The great crisis of 2008 highlighted the importance of liquidity. Some strategies need it, and some strategies absolutely must not offer it. Investors, however, were

promised liquidity by a great many hedge funds, who at the end of the day were not in a position to provide liquidity. They promised liquidity because it helped in the marketing and enticed investors who sought liquidity to the exclusion or relegation of other considerations. In 2009, the majority of investors will indeed favor more liquid strategies. An investor should demand liquidity (or illiquidity) based on their needs, not greed or fear. The extension of this principle means that the liquidity of a strategy or portfolio will be passed on down the line starting from the securities in the portfolio, to the portfolio as a whole, to the fund, to the investors in the fund, to their investors and so on. Be that as it may, I expect there to be a psychological preference for more liquid strategies. This will create some lucrative opportunities in less liquid strategies for investors who can take a longer term view. Very often they will be able to achieve higher returns at lower risk, simply by giving up their thirst for liquidity.

Fees will fall
For the weaker managers or for simpler products this will certainly be the case. The signaling issues will be quite a lot of fun to analyze. Is cutting fees a negative signal or should one seize upon the opportunity of employing talent at a discount? Along another track, the market dislocations are creating some passive strategies or simpler strategies which will generate superior returns. If the strategy and not the manager is generating the returns, should investors not demand lower fees?

Fees will rise or stay the same.
Fees are high enough. It makes no sense to invite the wrath of Congress or the general public (doesn’t one represent the other?) Will fees stay the same? Apart from simpler products such as long only closed ended opportunity funds, I think actively managed funds fees will stay the same and that they will represent better value since the aggregate quality of

hedge fund managers would have increased through the natural cull.

Investors will continue to reduce risk.
It is very hard to continuously reduce risk monotonically. The actions of a herd of investors reducing risk, usually herds them into the same reserve asset, which pushes up the price of the asset to bubble proportions, representing an increase in risk. Try it, its really fun. Step 1, sell equities, sell them everywhere and sell them hard. Step 2, sell corporate bonds and other risky assets, sell them everywhere and sell them hard. Step 3, all cashed up, where do you keep the cash, exposed to bank default risk, seek sovereign risk, start buying government bonds. Step 4, for a given level of default risk the price of even a government security represents the risk of loss in default. The more you pay for a given risk of default the higher the loss if there is a default. Step 5 is still being written in the markets. Apparently risk free assets like gold and government bonds have been driven up as investors fled risky assets in terror. But there are no risk free assets. Everything is risky or not depending on your point of view. Except cash, except where do you keep it, and presto you are back to Step 3.

Investors will stop reducing risk and start investing once again.
We know that this will happen, just not when. A lot will depend on the motivation of investors. One motivation is the rate of inflation. If inflation picks up, and I believe it will sooner than people think, then investors are likely to overcome their fear, and see the logic of being a part of the price increases. And that means investing in risky assets once again. Or they can always stay in low risk assets until the risk in those asset classes increases.