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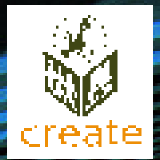

FINANCIAL SERVICES

Hedge funds:
a catalyst reshaping global investment

ADVISORY

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Acknowledgments

This is the fourth in a series of research reports produced by the think-tank CREATE and KPMG International.

The first three reports focused on how the global investment management industry coped with the worst bear market in living memory.

This latest version aims to identify the means by which the investment value-chain is being impacted by the rising importance and influence of hedge funds.

Our foremost thanks go to some 550 companies in 35 countries in all the regions who have participated in the four different surveys that make up the report this year.

We would also like to offer our special thanks to those 100 CEOs, CIOs and Board Directors who participated in our face-to-face structured interviews. Their insights and foresights have helped us to produce a most comprehensive picture of the impact of hedge funds on the investment industry as it faces an increasingly challenging environment.

We would also like to thank members of the editorial board and other colleagues around the world who have helped us in carrying out this research: in particular, Liz Pratt at CREATE; and Jonathan Jesty and Nick Hopwood at KPMG LLP (U.K.).

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The anonymous interview quotes throughout this document were obtained during the face-to-face interview stage of the research project. The information reflected in the graphs and charts was obtained during both the face-to-face interview stage and questionnaire stage.

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1 Hedge funds: a catalyst reshaping global investment

"Things that count, often can't be counted. Things that can be counted, often don't count".

Albert Einstein

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Background to this study

This is the fourth in the annual series of reports on global fund management, produced jointly by CREATE and KPMG. The previous ones were:

- *Building Capability for the Twenty First Century: 2002*
- *Revolutionary Shifts, Evolutionary Responses: 2003*
- *Raising the Performance Bar: 2004.*

Against the background of burgeoning interest in hedge funds worldwide, CEOs and CIOs participating in our series suggested that our 2005 report should turn the spotlight on to *hedge funds*; covering issues that are pertinent to their future on the one hand and assessing their knock-on effect on the rest of the fund management industry on the other.

They were also interested in the impact of new regulations, implemented in Europe and the U.S. in the last two years. While seeking to provide investor protection, the rules do not establish a common approach on a global basis but pressures may build up for one. This may not be easy; arguably because hedge funds defy definition. Being amorphous, they deploy a variety of approaches to capitalize on arbitrage opportunities in financial, physical and intangible assets. They mutate as opportunities arise.

Since the onset of the bear market, their growth has been nothing short of spectacular; with over 8,000 hedge funds now controlling assets in excess of US$1 trillion and amounting to two percent of global investment assets. They have become a formidable force; but their lackluster performance since the latter half of 2004 has sparked a debate about their long term future.

In the light of these developments, this report presents the analysis and conclusions emerging from the most comprehensive and broadly based research study ever carried out on the future of hedge funds. Its assessment is based on a cross-sectional global survey and interviews.

Our survey has involved four sets of key players in the value chain of hedge funds:

- *Managers of hedge funds and fund of hedge funds,* with US$250 billion FUM
- *Mainstream fund managers,* with US$18 trillion FUM
- *Administrators of hedge funds,* with US$950 billion FUA
- *Pension funds,* with US$3.5 trillion of investments.

Over 550 top executives from 35 countries participated in the survey (see below). A cross-section of 100 of them went on to participate in the follow-up program of structured interviews, which also involved prime brokers and pension consultants. Their views form the basis of this report.

Geographical spread of survey participants

Australia	Cayman Islands	Hong Kong	Japan	Singapore
Austria	Curaçao	Hungary	Luxembourg	South Africa
Bahamas	Denmark	Iceland	Netherlands	Spain
Belgium	Finland	India	New Zealand	Sweden
Bermuda	France	Ireland	Norway	Switzerland
Brazil	Germany	Isle of Man	Poland	U.K.
Canada	Guernsey	Italy	Portugal	U.S.

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Executive Summary

The headline messages are:

- Worldwide growth of hedge funds will slow down from its all-time high
- Significant head winds will drive down their returns
- Hedge funds will still remain one of the ways to achieve absolute returns
- Mainstream fund managers are emulating hedge fund type strategies and structures
- Hedge funds are diversifying into long only and private equity, using their own tools
- More pension funds will dip their toes in the water with relatively small allocations
- Hedge funds will commoditize under the weight of new money
- Overcrowding, poor returns and mis-pricing will remain the key risks
- Caveat emptor: regulation will not prevent blow ups
- Like its physical counterpart, the hedge funds' universe is expanding
- The sector has a few *stars* and a long fat tail of *wannabes* and *has-beens*
- *Stars* thrive in lifestyle boutiques that aspire to grow revenue, not FUM
- Most *wannabes* cannot, as yet, deliver clients' risk-return expectations
- Bottlenecks in administration prevail in valuation and risk services
- Like long only alpha funds, most hedge funds are not scalable
- The holy grail of absolute returns is a zero sum game, producing winners and losers
- The flow of talent into hedge funds will slow down
- The hedge funds industry cannot invent new strategies at the required rate
- Consolidation will happen: more through Darwinian than traditional routes

These points are developed in detail in Sections 2, 3, 4 and 5, which outline the views expressed by each set of players in the value chain of hedge funds. The 13 key themes emerging from their assessment are given in the rest of this executive summary.

However, if there is one overarching message from our research, it is this: what cell phones did to land lines, what low budget airlines did to flag carriers, hedge funds are doing to the global fund managers; but, notably, without destroying their traditional revenue streams.

Gaining huge prominence in the last bear market, hedge funds will outlast it, as will their star managers. As a disruptive catalyst, they have started a chain reaction that extends well beyond their immediate universe. Unwittingly, they have forced mainstream fund managers to go back to their time-honored *raison d'être*: to provide absolute returns.

Prevailing investor caution and legacy products will help ensure that the resulting shifts are incremental, not seismic. Cumulatively, though, these shifts may well transform the face of global fund management by 2010.

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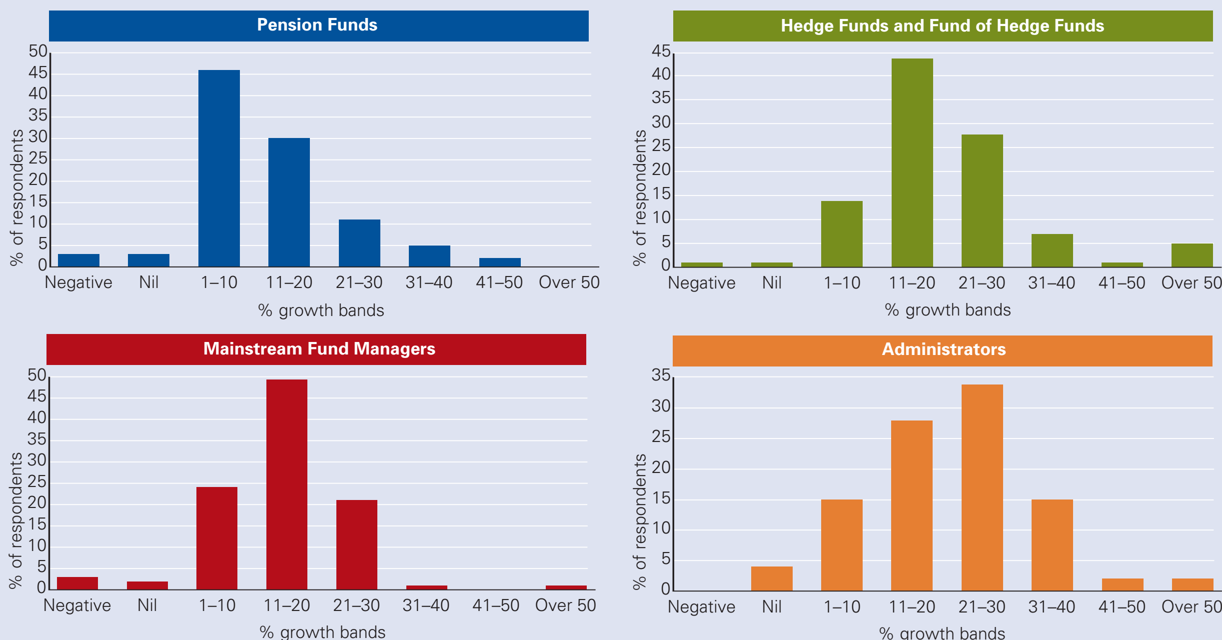
Theme 1: Relative returns are dead and absolute returns have many sources

What do you anticipate will be the average annual growth in FUM in the hedge funds industry worldwide over the next three years?



Source: CREATE and KPMG International, 2005

Interview quotes:

"Hedge funds really took off with the bear market"

"Hedge funds have jolted the twin pillars of old thinking: relative returns and equity premium"

"Money always chases good returns, not asset classes"

"Supply can create its own demand up to a certain point. That threshold has been probably crossed in the U.S."

In the last three years, the worldwide growth in hedge funds – net new money plus investment returns – has been driven by a congruence of three mutually reinforcing factors: the equity bear market; heightened investor interest in absolute returns as millions lost billions; and the flow of top talent into those hedge funds notching up absolute returns.

Over the next three years, however, neither the bear market nor high returns are expected to drive growth. Even the flow of talent is expected to ease. But as the charts show, significant growth is still expected: hedge funds are perceived as a part of the holistic solution to achieve absolute returns, aided by rising awareness of their benefits by pension consultants, especially in Europe. The benefits of uncorrelated returns in a diversified portfolio are widely recognized.

Accordingly, all the players in the value chain expect double digit growth, albeit from a relatively small base with managers and administrators of hedge funds being distinctly more bullish than pension funds or mainstream fund managers. The bullishness is highest in the U.S., followed by Asia Pacific and then Europe, reflecting the influence of a number of local factors.

However, as we shall see under Theme 2, there are caveats attached to this assessment.

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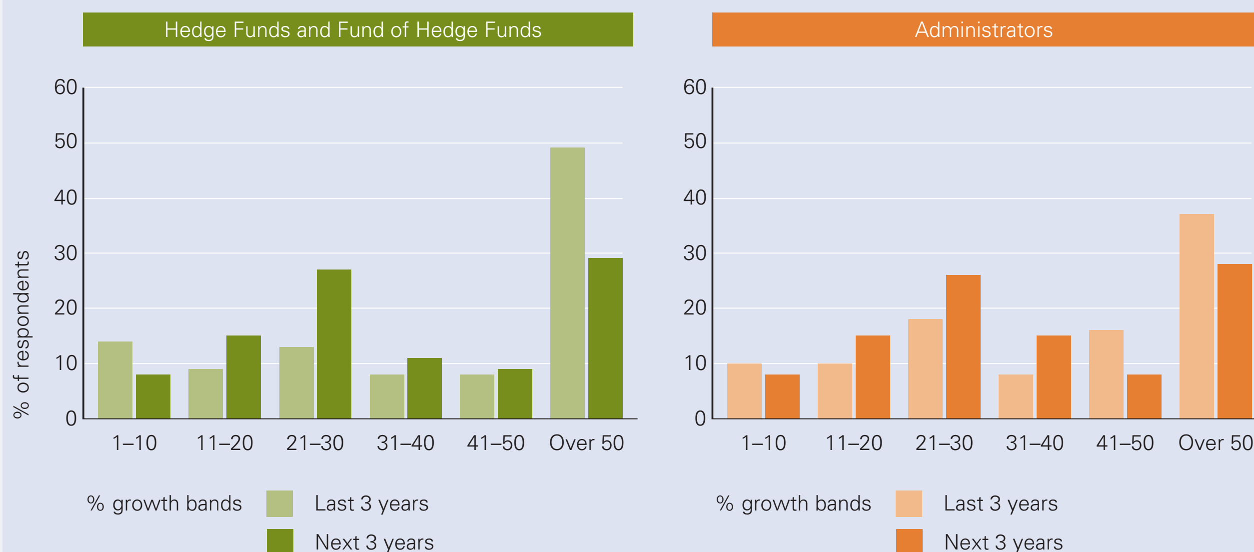
Theme 2: Growth in hedge funds will slow down

What has been the average annual growth in hedge funds under your management/administration in the last three years and what is it likely to be in the next three years?



Source: CREATE and KPMG International, 2005

"The honeymoon will soon be over"

"You can't just create capacity. You also need an opportunity set: 80 percent of fees come from velocity and volatility"

"For something so ill-defined as hedge funds, projecting the past growth into the future requires luck as well as judgement."

"Like Formula One racing, hedge funds will evolve continuously, remain a zero sum game, and have their own limits"

"The media is a pack of wolves; if we fail, we will be torn to pieces"

Against the background of a buoyant environment for their industry, managers of hedge funds and fund of hedge funds expect the growth in their own FUM to ease over the next three years and, yet, still remain very impressive by the standards of the wider funds industry. This bullish assessment is duly repeated by their administrators. However, both key players recognize that success creates its *own* problems. A unique congruence of forces catapulted their industry to the forefront in the past five years. This has changed; so, their optimism is based on five assumptions: some plausible, others questionable.

First, it assumes that as today's prime capacity is fully utilized, new capacity of equal quality will be created at the front-end, with the corresponding infrastructure support at the back end. There are major doubts about the front-end, as we shall see under Theme 6.

Second, it assumes that the losses notched up so far by mediocre managers – publicized or not – will not tarnish the image of others to the extent that would deter a new generation of institutional and retail investors. This is plausible. Third, it assumes that risks associated with strategy concentration and mis-pricing can be managed effectively. This is plausible. Fourth, it assumes that the current low inflation/low interest rate environment will persist and remain favorable to hedge fund strategies. This is questionable, since equity markets will eventually recover: the question is when, not if. Finally, it assumes that mainstream fund managers will not strike back. This is already happening: they are creating strategies that separate alpha and beta, with a range of assembled solutions in-between. This has not been painless.

But at least, they are far from inactive in the face of emerging challenges from hedge fund managers, (see Theme 11). Hedge funds are at an inflection point: their future will be different from the past, as the new market dynamics unfold.

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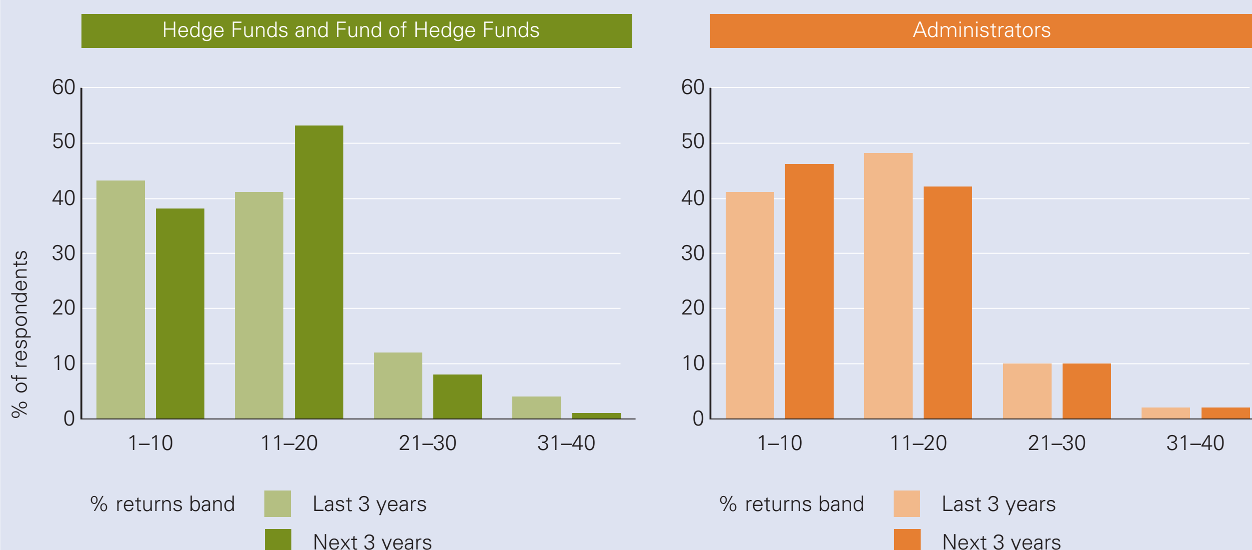
Theme 3: Hedge funds will suffer from the curse of success

What has been the approximate average annual return on the hedge funds under your management/administration in the last three years and what is it likely to be over the next three years?



Source: CREATE and KPMG International, 2005

"As hedge fund managers, our biggest risk is the risk we don't know. The second one is hubris"

"Markets are self equilibrating. No single asset class can dominate over a whole cycle: all opportunities get arbitraged away before long"

"If the value of your long only funds drops by 20 percent, nothing happens; if that of hedge funds drops by 5 percent, the manager is fired. The hype of hedge funds has made investors hugely unforgiving"

"Paradoxically, hedge funds will never be mainstream; their initial success has galvanized traditional fund managers to jettison their baggage and deliver what they should have always delivered: absolute returns"

Over the next three years, managers of hedge funds expect their *average* returns to be somewhat lower compared to the past, with the majority still expecting them in the impressive 11-20 percent per annum band, with a narrower dispersion. The managers of fund of hedge funds that were interviewed, in marked contrast, expect the returns to be far lower.

Once again, this assessment is duly repeated by their administrators. While appearing very bullish, both sets of players increasingly realize that their clients perceive hedge funds as but one of the many sources of alpha. All managers will have a real struggle generating high alpha in today's low volatility low returns environment.

In all probability, the returns will be far lower than the ones implied by the numbers here because of a new dilemma, arising from the *premature maturity* in the wake of over rapid growth in the 1990s: namely, the hedge funds industry needs a new generation of investors – especially pension funds – to sustain its headlong growth; but these very people will change the craft nature of the industry beyond recognition, by forcing greater transparency and different governance structures. Worse still, regulators in the U.K. and the U.S. are unlikely to allow retail investors into hedge funds, without further controls.

Things that made the hedge funds industry great – talent, individualism, enterprise – are the very things that will be diluted.

Industrializing a craft carries its own cost.

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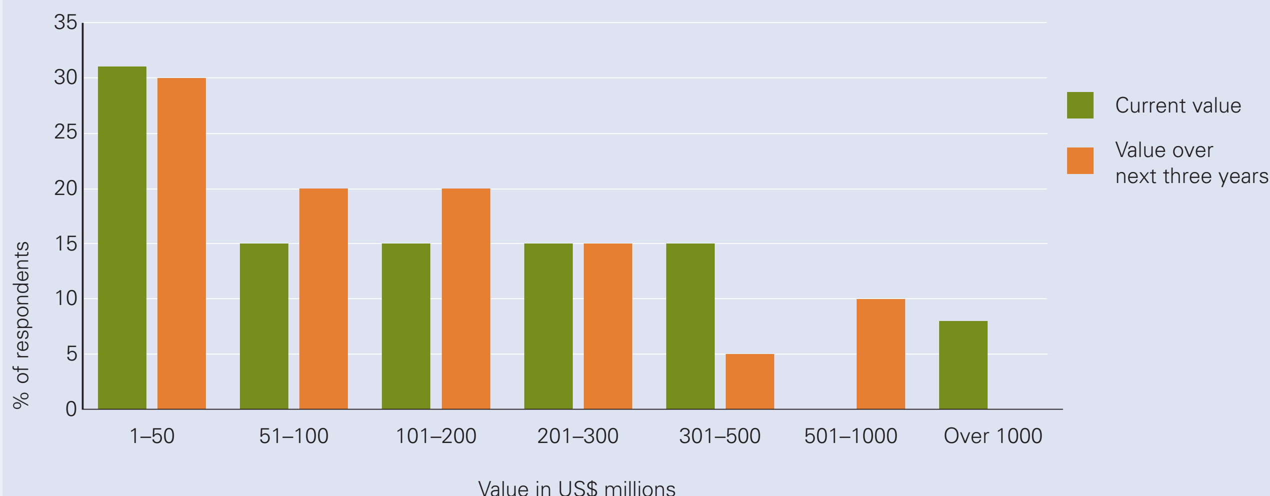
Theme 4: Pension funds' investment in hedge funds will be a matter of more haste, less speed. But their impact will be no less powerful

Pension Funds: What is the size of your current investment in hedge funds or funds of hedge funds, and what is it likely to be over the next three years?



Source: CREATE and KPMG International, 2005

"The issue is whether you can deliver alpha in the long only space or do you need sexed-up leverage?"

"Trustees want to know the nuts and bolts of what they do. They also want what it says on the tin."

"Conservatism of pension trustees and their consultants is a minus and a plus; minus because it will retard future growth: plus because it will ensure that it is a more controlled growth"

"The hedge fund industry is weighed down by money and hype in equal proportions. Elsewhere, returns are beginning to look more attractive"

"Institutionalization will change the hedge funds industry beyond recognition"

"Trustees need an intuitive leap; their appetite and understanding are critical"

Worldwide – and especially in the U.S. – pension funds have shown a keen interest in hedge funds. Contrary to recent media headlines, their allocations will be less than three percent of assets. In cash terms, however, the sums involved may double the size of the hedge funds industry over the next three to five years. Like fund managers, pension funds fall into two groups: *pragmatists* and *fundamentalists*.

The first group perceive hedge funds as but one of many credible strategies for generating alpha. The last bear market has created major discontinuities: the current interest in absolute returns is nothing short of the revival of the investment mentality of the 1960s and 1970s, before the rhetoric of relative returns and benchmark hugging blinded so many investors, so many times, for so long. On this argument, it's better to swim with the tide of absolute returns than swim against it. That said, the allocations made by the first group are small. But collectively, the weight of new money can potentially industrialize the hedge funds industry on a scale that can make the majority indistinguishable from mainstream funds. That is already evident, with ever more hedge funds venturing into the long only space and private equity.

In contrast, the second group believe that investor appetite for hedge funds will evaporate as markets recover; after all, investors chase returns, not asset classes. Furthermore, there are other ways to achieve absolute returns. They believe that long short strategies can be self-defeating for those pursuing shareholder activism. Finally, for the majority of pension funds, hedge funds carry huge reputational risk: the charges are high, as are the prospects for low returns. Their resistance boils down to investment basics: opaqueness, fees, and performance.

Both groups, however, recognize an interesting paradox: those who can afford to invest in hedge funds, don't need to; those who need to, can't afford to.

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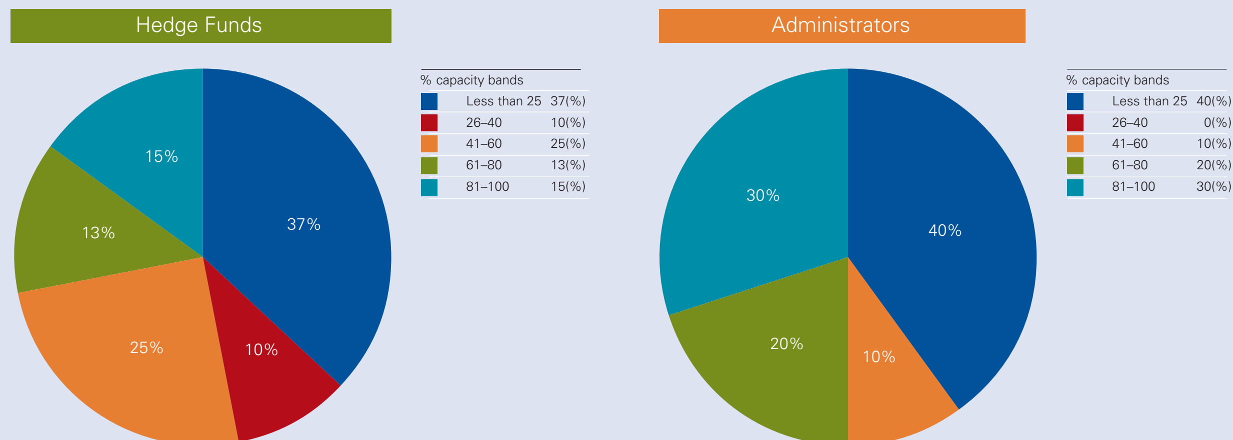
Theme 5: The size of the investable hedge funds universe is far smaller than the headline capacity figures imply

What percentage of your company's core capacity for hedge fund management or administration is currently being used?



Source: CREATE and KPMG International, 2005

"Hedge funds are the flavour du jour!"

"The real challenge is to spot off the beaten track, off the radar screen opportunities"

"There's a lot of differential pricing, as clients scramble to get ahead in the queue"

"There is a real shortage of top talent in the hedge fund industry. Birth and death rates are equally high"

"Our clients are ultra rich Wall Street managers who can afford to bet their shirts. That will change with the new generation of clients"

One of the most striking results of this study is that only around 15 percent of managers of hedge funds or fund of hedge funds are operating at their full capacity level. The corresponding figure for their administrators is 30 percent.

On the upside, this means that future growth could be mopped up by surplus capacity.

On the downside, however, it is clear that the prevailing capacity is highly variable in quality. We encountered numerous incidences where funds of hedge funds had closed to new money because they could not find prime capacity.

Reportedly, much of the reported surplus capacity is not capable of generating risk-return characteristics in line with client expectations.

Clearly, the investable universe is far smaller than these numbers imply.

At the administration end, the picture is one of surpluses and constraints.

Surpluses are evident in low value added services, like registrar and transfer agency.

Constraints are more evident at the high value end, like valuation, risk and compliance: being skills intensive and knowledge based, these are the areas that don't scale easily. Indeed, the high value end is already witnessing upward fee pressures.

Not surprisingly, many administrators now have satellite offices in close proximity to the hedge fund managers.

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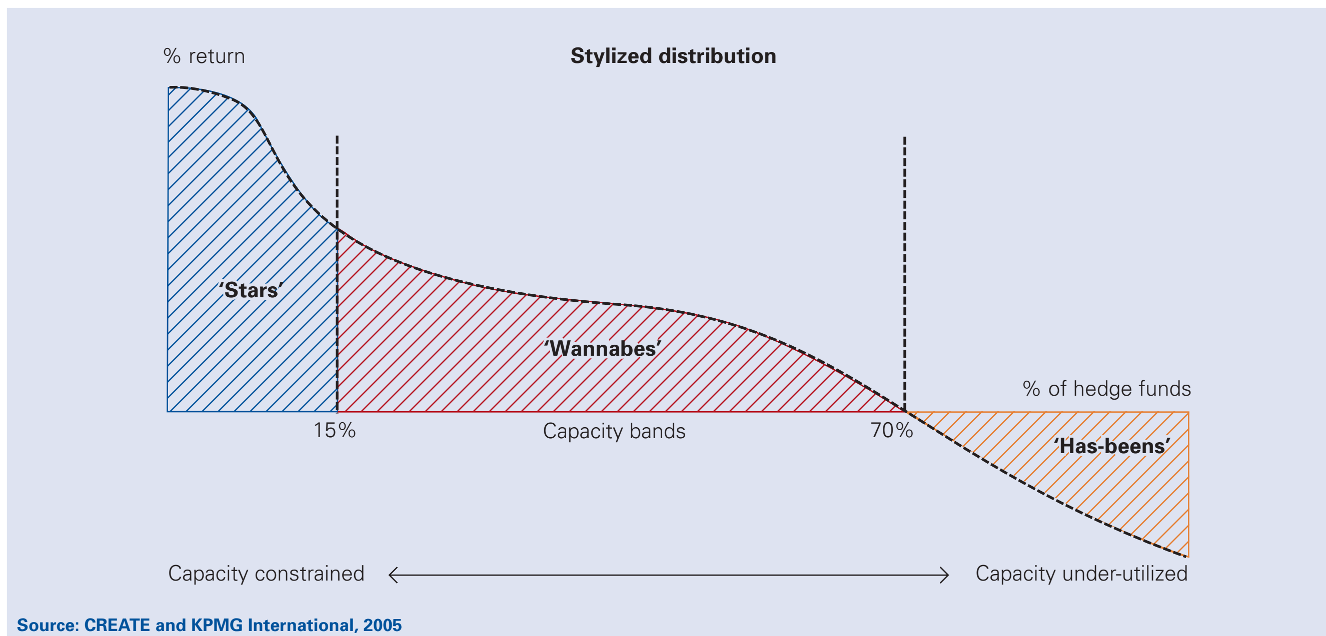
Theme 6: The quality of hedge funds capacity is markedly variable



Source: CREATE and KPMG International, 2005

"20 percent of hedge funds close each year due to business, not investment, failure"

"The biggest risk is the career risk for hedge funds managers"

"Long only managers have no instinct for trading; the vultures of Wall Street will eat them alive"

"It's a fallacy that traditional long only managers can't run hedge funds: those who are used to a tracking error of 10 percent have no problems here"

"Worldwide, a few insurance companies have in-house hedge funds to manage their general funds. Commercial banks have them, too, to manage credit risks. They may well be the next sources of new talent into hedge funds"

The hedge funds universe is perceived as having three distinct groups of managers, according to our interviews:

- Around 15 percent of managers are clear *stars*: they provide the prime capacity that is capable of generating risk-return characteristics in line with client expectations. Most of them are ex-prop traders from investment banks; with the majority based in the U.S.
- A further 55 percent are *wannabes*: many are second generation long only managers with the right pedigree. All aspire to be *stars* before long; with the majority based in Europe and, to a lesser extent, Asia Pacific
- The remaining 30 percent are *has-beens*: they are victims of the brutal churn and burn that characterize their universe.

Thus, the reported surplus capacity is sub-prime, at best; and uneconomic, at worst.

Most of it is neither tested nor stretched. Only time will tell how many *wannabes* will turn into *stars* and meet client expectations. The prevailing view is that when you have seen one successful hedge fund manager, you've seen one. They are a rare breed and typically only retain their stardom for three years.

The implication is that for their universe to remain viable, it needs ever faster infusion of new talent, capable of innovating new strategies as markets evolve, and scaling their business in order to meet the new demands. On present reckoning, this is unlikely to happen, since the inflow of talent is expected to ease. Nor does the existing talent pool particularly want to scale its business, as we shall see in Theme 8.

Currently, the universe remains young and atomized. Unless it evolves rapidly around new talent, it will stagnate and lose its uniqueness and *raison d'être*.

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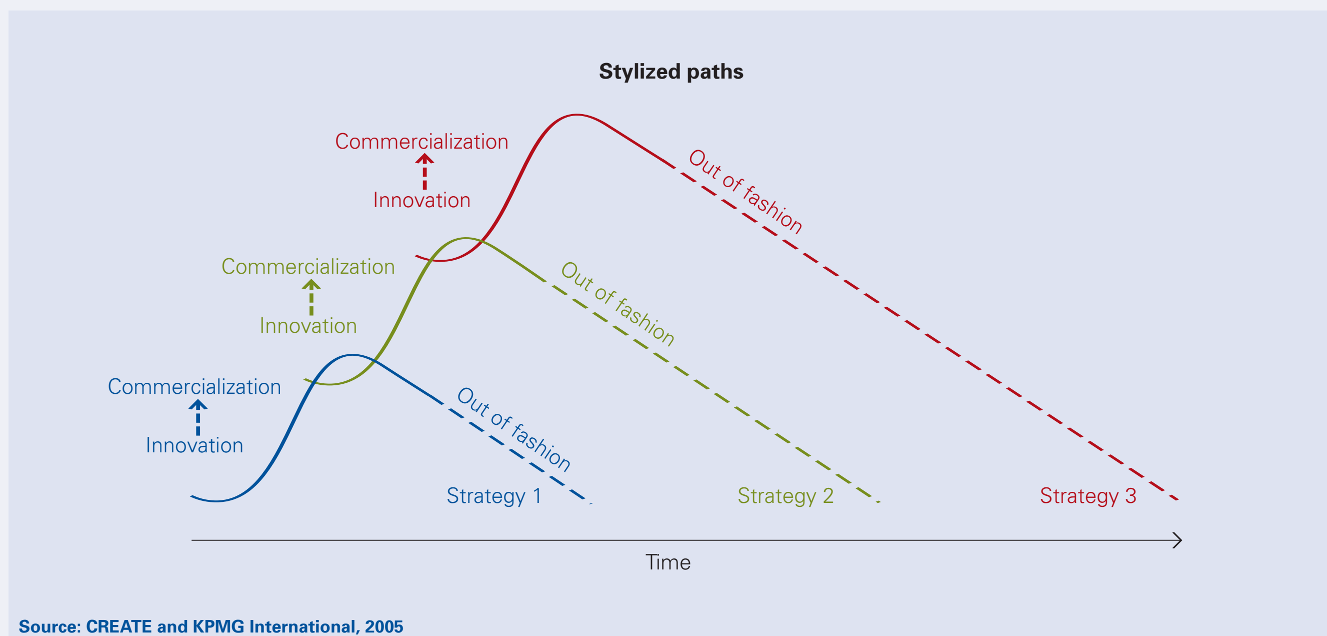
Theme 7: Success requires getting on the innovation treadmill



Source: CREATE and KPMG International, 2005

"It's difficult to redeploy hedge fund managers if styles change"

"Style drift doesn't work. You can't let a heart surgeon do a brain operation"

"Shorting is not the new alchemy of this age; just a different mindset"

"Pure alpha needs insights and intuition – the unteachable factors"

"Innovate or liquidate: that's the choice. Today's return characteristics are too difficult to achieve otherwise"

Hedge funds defy definition, since they involve exploiting price inefficiencies in a range of markets via complex customized vehicles.

On the downside, they hit capacity ceilings long before other investment vehicles: new strategies soon go out of fashion, as opportunities get arbitraged away with newcomers. Convertible bond arbitrage is an extreme case in point currently.

On the upside, however, the hedge funds universe is boundless, like its physical counterpart. As markets in financial, physical and intangible assets evolve, the scope for price inefficiencies will always be there. Even strategies based on weather derivatives are now available.

The key to success is having talented individuals – mini Einsteins – who can devise new trading strategies and commercialize them at an ever faster rate, akin to a treadmill. Prime capacity equates with hugely creative people with strong instinct for spotting opportunities and trading them profitably before competitors arrive on the scene.

Over the next three years, a large majority of hedge funds are likely to focus on: long short, macro, and emerging markets.

With such concentration, the opportunity sets will be limited; the returns will be much lower; and the systemic risk ever present. Only the exceptionally innovative managers will thrive under this scenario. This is not the only challenge looming on the horizon, however.

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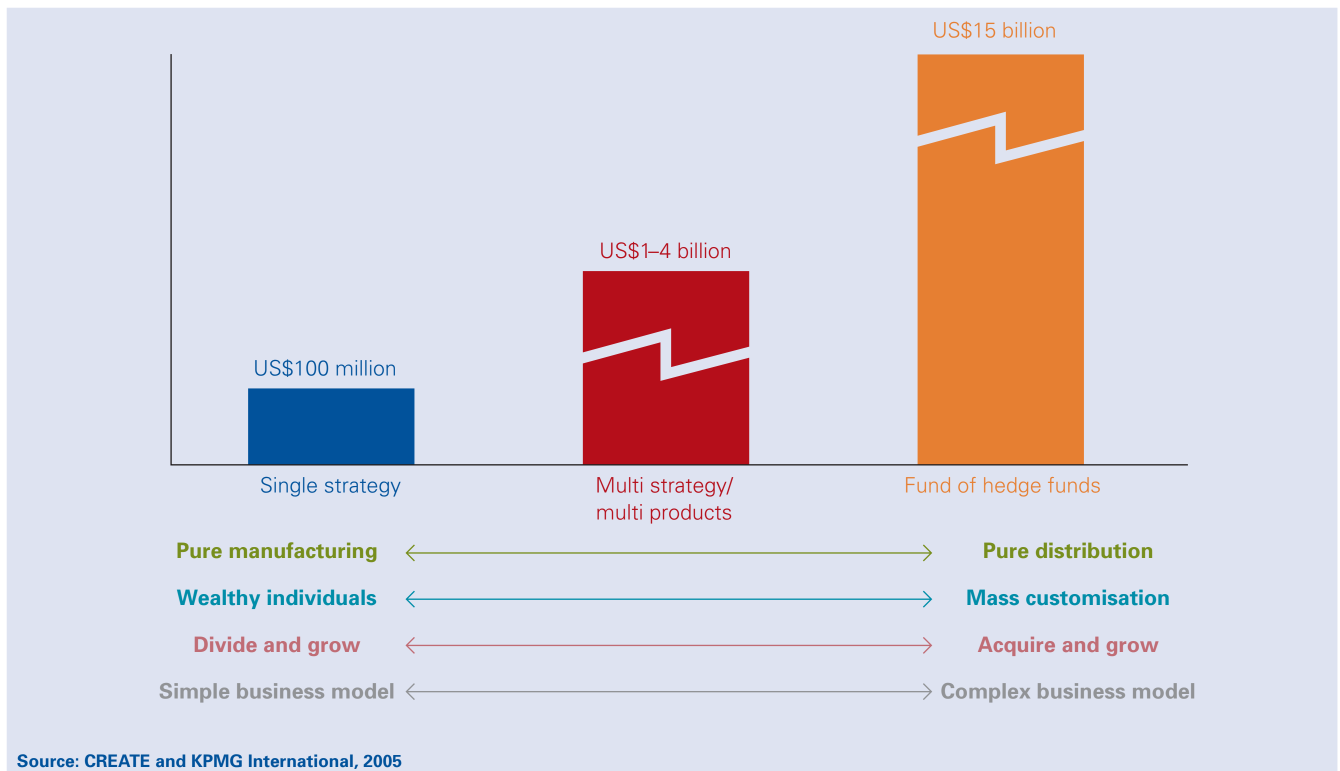
Theme 8: Hedge funds are a cottage industry with low scale points



Source: CREATE and KPMG International, 2005

"For a prime broker, this is a brutal business. We've helped to launch hundreds of funds in the last four years; only a handful have succeeded. This despite the fact that we only back the ones with the greatest potential"

"Like rock stars, hedge fund managers can only work in small bands"

"We want investors who can align their interests with our own; and accept that this is a lifestyle business"

"Transition management is hard for most of the managers because they left their old employers just to get away from running the business"

The other challenge concerns the scalability of hedge funds. Currently, there are three approximate scale points, expressed in FUM:

- Single strategy managers need a critical mass of US$100 million to break even
- They prefer to go multi-product or multi-strategy in the US$1– 4 billion range to avoid style drift
- Most fund of hedge funds can be scaled up to US$15 billion.

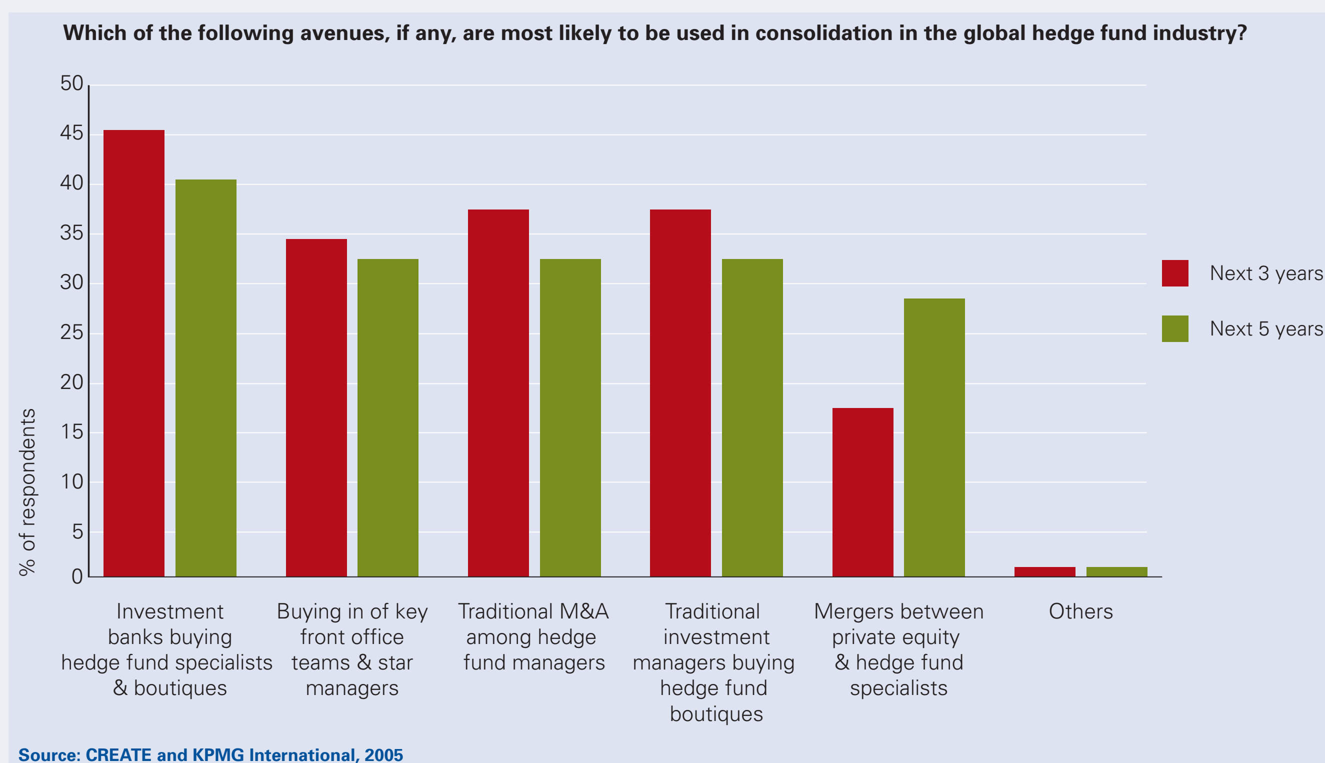
These are orders of magnitude and clearly vary between strategies. But they serve to emphasize an important point: namely, growing the business in response to rising demand involves transitions that the majority of boutique hedge fund managers are unwilling to accept, because of the resulting dilution of their craft. Furthermore, they see theirs as lifestyle businesses where profit matters more than growth, scope more than scale, performance more than size, autonomy more than ownership.

Migrating to a more complex business model has its own downsides. Most of the current generation of pure manufacturers are very cautious about going multi-strategy because it changes the ownership structure and invites bureaucracy. They accept that multi strategies are essential for dynamic switching; but they are unhappy about their side effects. Indeed, many large fund of hedge funds have found it exceedingly difficult to retain their pioneering spirit within a more complex business model.

In any event, they all have to grapple with three other paradoxes. Start-ups require a critical mass to attract money; but without money, they can't build that mass. A sustainable business requires scale; but scale is the enemy of alpha. Pension funds require discipline; but discipline stifles creativity.

Each choice carries unpalatable risks.

Theme 9: Consolidation is inevitable… mainly through Darwinism



Source: CREATE and KPMG International, 2005

"IPO is not an option for a vast majority; they don't have the necessary governance structure as a deliberate policy to sustain the incubator environment"

"Valuing a hedge fund business is damn hard as most of them are lifestyle businesses"

"There are over 1,000 fund of hedge funds currently; the large majority are suffering from fee compression"

"Only the best of hedge funds boutiques will be around five years from now, if pension funds drive the trend from here on"

A large majority of hedge funds managers do not expect to change their ownership structure, at this point in time.

However, a small minority are not averse to giving a non-majority equity stake to large investment houses to acquire distribution channels and release equity.

But they are all agreed on one point: continued independence is vital to the survival of their craft and performance alike.

Yet, they are realistic that consolidation is inevitable, in response to overcapacity. But given the extreme problems involved in valuing hedge funds businesses, especially the sub-prime ones, many are unclear about how consolidation will occur.

A number of avenues were mentioned in our research – notably investment banks or mainstream fund managers acquiring majority or minority stakes, in line with what has been happening over the past two years in the U.S. and Europe.

In some notable examples, such arrangements have worked well. But, in a universe of around 8,000 hedge funds, their numbers so far are minuscule.

Over time, mergers with private equity houses, too, cannot be ruled out, as more and more hedge funds adopt long term investment strategies.

High burn rate is expected to be by far the most powerful driver of consolidation. As returns come down, we shall witness Darwinism compressed in time.

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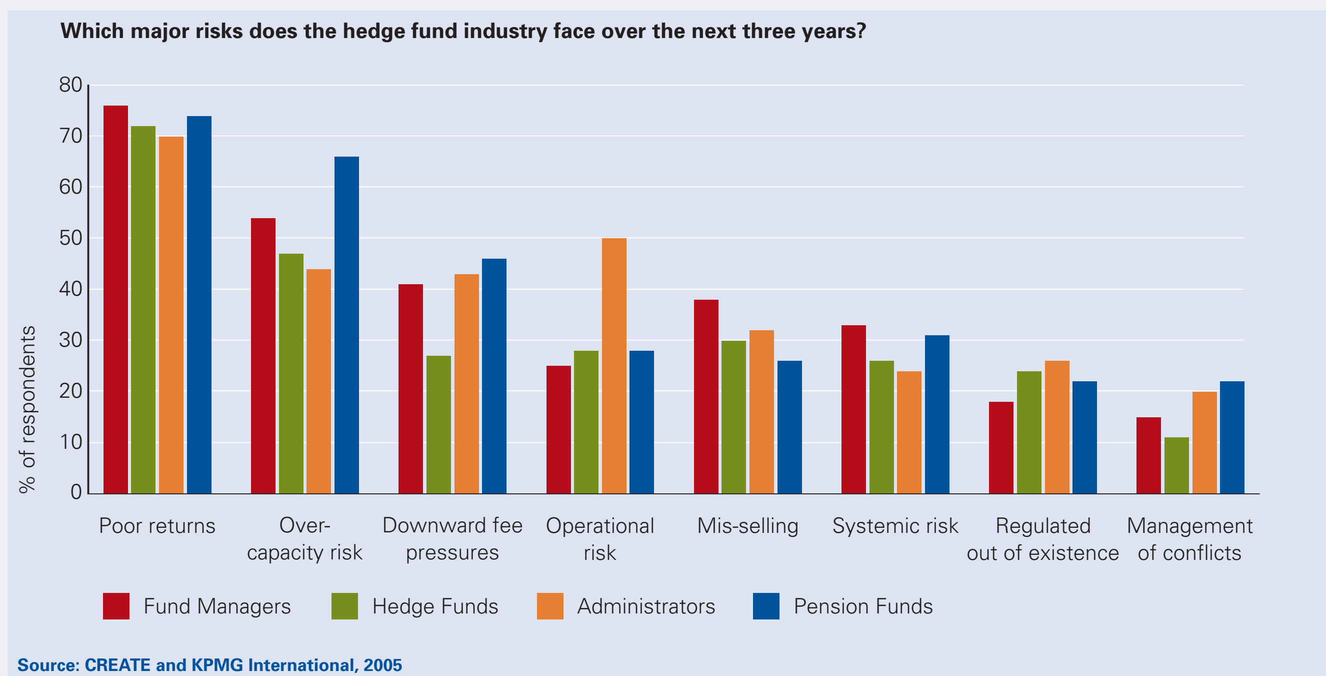
Theme 10: The key risks are the ones that no regulator can control



Source: CREATE and KPMG International, 2005

"Regulation is not a problem, so long as regulators do not reinterpret the rules"

"The mis-pricing of derivatives is a big risk"

"Regulation can not mitigate systemic risks"

"Prime broking is an almost risk free business: leverage is low. Yes, assets are more risky, but we can't conceive of a hedge fund event which can damage the viability of this bank"

Regulation within most major hedge fund markets bar all but the wealthiest and sophisticated private investors from buying hedge funds, although some European countries are to some extent liberalizing, or consulting on liberalizing, regulation prohibiting hedge funds from distributing their products to retail clients. UCITS III, too, while not intended to be a mechanism for the establishment of hedge funds or funds of funds for retail distribution, is expanding the list of allowable investments to include certain types of derivatives which could enable some hedge fund strategies to be employed in UCITS III retail funds. Overall, these changes have been welcomed worldwide, though there are concerns that the registration requirements may slow down the rate of start-ups in the U.S.; and the recent reinterpretation of tax laws in the U.K. may cause a *brain drain*. It is also recognized that the next wave of growth in hedge funds still carries two sets of risks which no regulator can control.

The first of these is the performance risk, arising from poor returns, overcapacity and inadequate talent inflow. Pension funds are especially concerned about overcapacity. The second one is the intrinsic risk, arising from price valuation of complex instruments and copycat strategies forced by market conditions. Administrators are especially concerned about operational risk arising from valuation challenges.

There is recognition that the ability to generate high and consistent returns is influenced by many factors. Some, like innovation, velocity and leverage, are controlable. Others, like style concentration, market evolution, and high volatility, are not. Indeed, in today's low volatility environment, style concentration is a major concern as unexpected events can potentially cause havoc. This much is clear from the well publicized problems faced by some hedge funds managers due to the severe downgrades of corporate bonds of major auto companies in the U.S. in May 2005.

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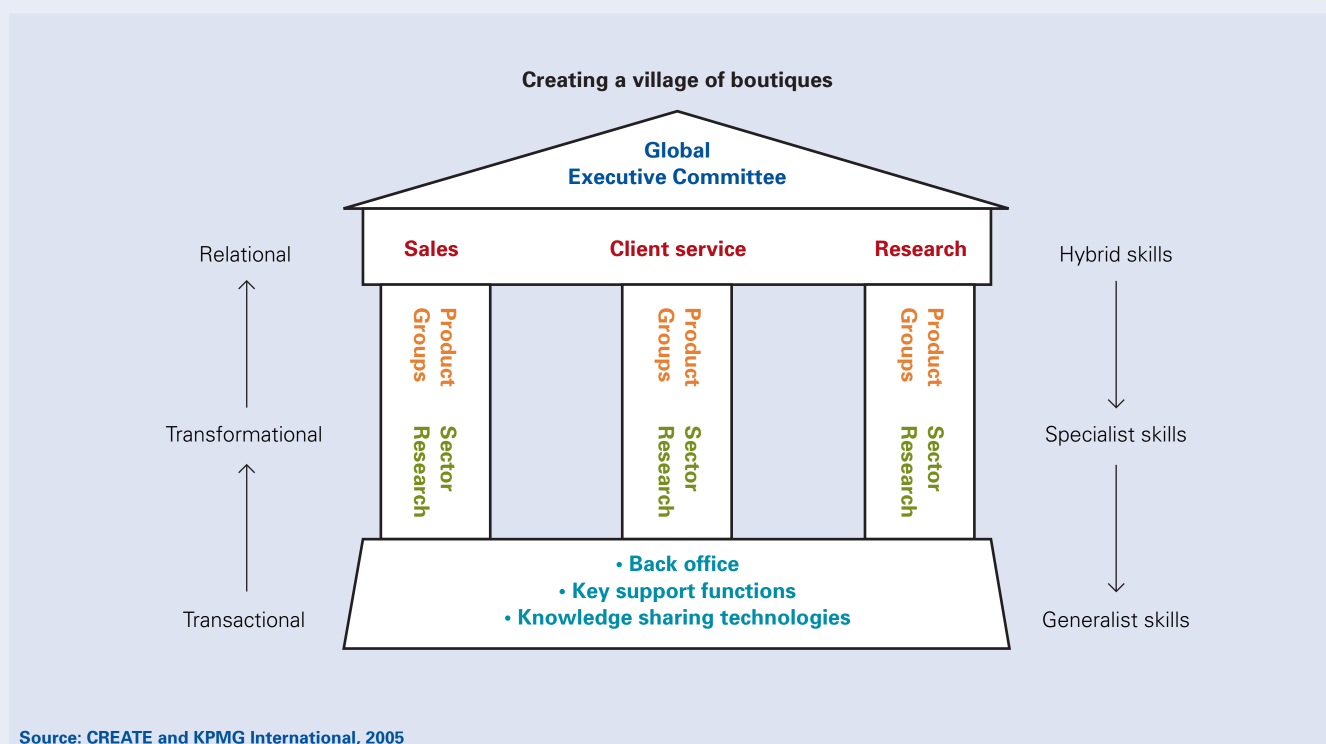
Theme 11: Mainstream fund managers are striking back



Source: CREATE and KPMG International, 2005

"Investment banks are trying to get closer to pension trustees. But fund managers have an edge in execution and relationships"

"We've got a series of unconnected alpha engines: a matter of lots of bricks and no mortar. Creation of internal boutiques is a top priority. Within it, there is a strong tail wind behind the incubator platform for hedge funds and fund of hedge funds, backed by strong analytics. The whole thing is a huge cultural challenge"

"We aim to produce decent but consistent returns, not 'home runs'"

"We're repackaging our traditional products – quants, fundamental equities – into hedge funds by ramping up fundamental research"

"Only time will tell whether our re-engineering is real or rhetorical"

In response to the growth in hedge funds, a majority of mainstream investment managers are implementing defensive changes, as trailed in our 2004 report. Some have adopted long short or derivatives-based strategies; others aim to generate alpha in the long only space. Some have separated alpha and beta production; others have long only and long short on the same floor. Some have gone into hedge funds via fund of fund routes; others via proprietary platforms.

Three in five managers are revamping their investment engines by sharpening the investment process, adopting unconstrained benchmarks, and streamlining the platforms in fewer locations. Nearly one in two are enhancing the research capability by bringing in new recruits, focusing on insights rather than information, and reducing sell-side dependency.

These and other actions are being implemented within one of three boutique-based structures: one creating internal product-based teams, backed by mid and back office support (see the figure above); one by taking minority equity stakes in alpha shops, securing preferential treatment on charges and capacity; one by creating separate fiduciary units that are also centers of product excellence in their own rights. All aim to promote high conviction investment ideas in an environment of personal autonomy, reduced hassle and meritocratic rewards.

The success of these initiatives critically depend upon various cultural and mindset shifts, as our 2004 report argued. These are slow to evolve: the strategic orientation and business leadership are still mired in the old world of relative returns. With some notable exceptions, transition to a new business model has proved very hard due to the lack of necessary strategic processes and leadership skills.

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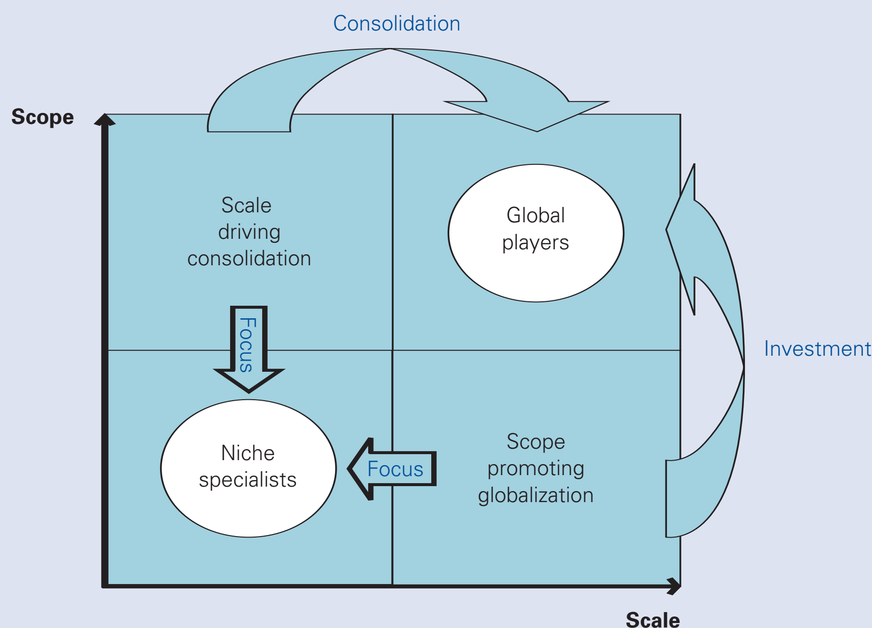
Theme 12: As more global banks enter into the administration industry, it will become polarized



Source: CREATE and KPMG International, 2005

"Investment banks have historically been the largest financiers of hedge funds. Now universal banks are becoming more attractive, thanks to a brain drain from investment banks. They can provide all the services, including administration"

"Administrators are starting to automate more, but the industry is not scalable across all the service lines"

"Capacity is the number one issue for administrators. No two funds are the same, so scaling is hard"

"For all practical purposes, tier one administrators are becoming an extension of the hedge fund"

As some hedge fund strategies become more complex and as pension funds increase their investment in them, the knock on effect on their administrators will be considerable. Pension funds want fair valuations based on transparent pricing models. They also want to receive valuation reports directly from administrators, not via hedge fund managers. Over time, the industry structure will change: niche specialists will co-exist alongside global players.

Niche players are expected to focus on single strategies and the associated product range related with them. Neither scale nor scope are credible options for them because they do not have the resources or the management inclination that go with either option. Their niche will be defined in terms of expertise, client size and client proximity.

In contrast, global players will seek to cover the whole waterfront of strategies and their associated product range; involving large scale investment in skills and technology.

Such players are likely to be global banks, who are already providing prime brokerage services or aspiring to do so. They, too, will aim to develop a seamless overlap with their clients in a range of services, starting with prime brokerage and extending to the whole range of administration services.

Thus hedge funds administrators and global banks will converge; yet, each will retain a distinct focus.

In part, this polarization will be driven by rising levels of fees. The prevailing low fees in general have encouraged administrators to focus on strategies that are easier to value. However, over time, as new strategies evolve and as pension funds demand a variety of back-up services, fees will rise, as will the pace of consolidation.

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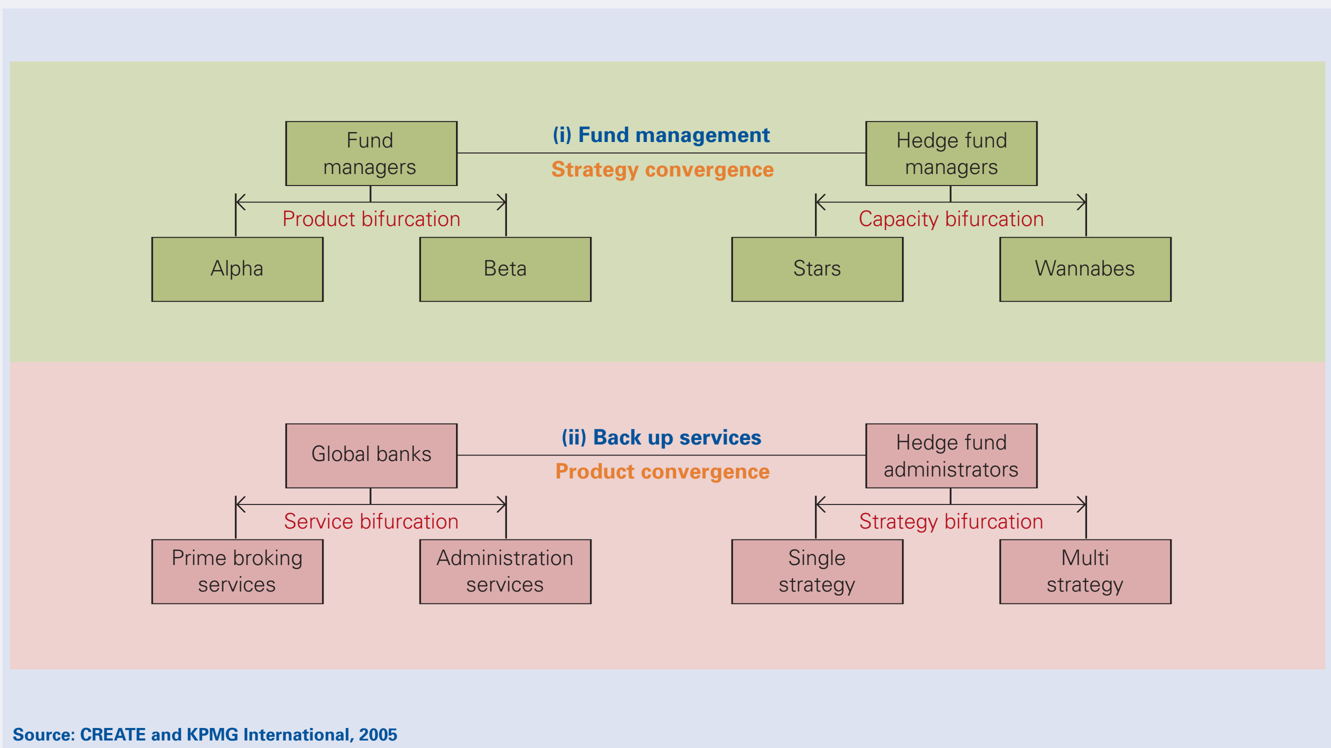
Theme 13: Global fund management is at an inflection point



Source: CREATE and KPMG International, 2005

"The media will always write about plane crashes rather than successful landings"

"By the end of this decade, a series of small steps will add up to a giant leap: little things will make a big difference"

"Like physical sciences, hedge funds have no impossible frontiers"

"The future belongs to stars"

The investment industry is in a state of flux to the extent that its future looks distinctly different from the past in two respects:

- Strategy: investment strategies used by fund managers and hedge funds managers are converging; at the same time, there is a marked separation of alpha and beta; quality and quantity
- Products: the mix of products offered by funds administrators and global banks are converging; at the same time, there is a marked separation in service variety and investment strategies.

So far, the convergence and bifurcation is most evident in the area of strategy. Be that as it may, a new business model is emerging in tune with the needs of the new age. *More for less* is its mantra; *horses for courses* its orientation.

Hedge funds will have a place in it under different guises. To retain their current uniqueness, however, hedge fund managers have to invent new strategies at a rate that is commensurate with the inflow of new money.

Those who do not, may either pale into the emerging mosaic; or become the victims of the creative destruction, which they sparked off in the first place.

Only the fittest will survive and retain their uniqueness in the investment universe.

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2 Managers of hedge funds and fund of hedge funds

"Discovery consists of seeing what everybody has seen and thinking what nobody has thought"

Albert Szent-Gyorgyl

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Hedge funds managers

This section presents the results from our survey and interviews, involving managers of hedge funds and fund of hedge funds around the world. Its key points are:

- **Realism:** While recognizing that investors will not desert other asset classes, hedge fund managers are very optimistic about their own prospects and those of their industry worldwide. However, the future is not expected to be as bright as the recent past because of capacity shortages, low market volatility and lower returns. The next wave of growth will be driven by pensions funds and retail clients who will join the two groups who drove the last wave: high net worth individuals and family offices. New regulation will attract new clients and vice versa. The honeymoon may be over.

- **Capacity:** Currently, only 15 percent of all managers of hedge funds or fund of hedge funds operate at above 80 percent of their capacity. Reportedly, 20 percent of boutiques and around 30 percent of funds close each year due to lackluster performance. Headline data on FUM discount neither the survivor bias nor the leverage. The bifurcation between quality capacity and mediocre capacity is evident; as is the inevitability of consolidation. The latter will occur more via brute Darwinism than traditional routes, since many of these talent-centred boutiques are hard to value.

- **Innovation:** As investment strategies peak or go out of fashion, hedge fund managers need to innovate and commercialize constantly. It means recruiting new talent from outside; and changing the ownership structure within a small boutique. Being craft-oriented shops, most single strategy managers are disinclined to manage this transition – typically occurring at US$1 billion FUM. Kindred spirits are few and far between. Those who want to scale are finding it hard to recruit the *crème-de-la-crème*.

- **Non-Scalability:** Indeed a large majority of hedge fund managers see theirs as lifestyle businesses in which profits matter more than growth, scope more than scale, performance more than size, personal autonomy more than ownership structure. They are quick to close funds that max out. They neither want to scale the business, nor be owned by a large house for fear of bureaucracy. They went independent to escape from it in the first place.

- **Scalability:** Currently, a majority fund of hedge funds businesses are sub-scale, despite rapid growth and a clear edge over mainstream fund managers and pensions consultants. Reportedly, nearly 50 percent have 'for sale' signs. The cost of spotting, retaining and deploying top talent in far flung corners of the world is escalating. So, M&A are inevitable, lifting the upper scale point from its current level of US$15 billion in FUM.

- **Bifurcation:** The hedge funds industry will polarize in two ways: externally, between craft shops at the manufacturing end and mass customization at the distribution end; internally, between stars and others, with the latter having high burn and churn rates. Yet, the industry has a great future. It belongs to a finite group of *stars*, adept at innovating new strategies and creating new opportunity sets. It also belongs to those mainstream fund managers who have wised up to the virtues of absolute returns.

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Thinking aloud…

"We set up this business in the belief that markets are efficient only in principle, not in practice. At the same time, we believed that the quants approach amounts to a game of roulette. Hedge funds are different. OK, so big blow ups have occurred in the late 1990s, particularly in the U.S., creating systemic risks. But they were under capitalized, and over leveraged: they failed to price in liquidity.

We believe that the easiest way to make money in the stock market is if 99 percent of people are doing the same thing: that is, indexing or pitching for relative returns. This leads to huge over-valuation. Institutions are risk averse: they have hitherto mis-priced risk and liquidity. This is changing as they wise up. There is still ample scope for talented managers to exploit price inefficiencies.

Our business model aims for the highest alignment of performance and bonus. It also recognizes that some strategies are more scalable than others (e.g. long short; macro). But, so far, no single strategy hedge fund manager has ventured beyond US$12 billion; nor should one. Opportunities can diminish exponentially as you scale.

Regulation will have a zero impact on us. As an company, we have always been regulated. Our funds are not regulated but business growth has required greater transparency and sound business basics. This industry is demand driven: we get attractive fees because our performance is stellar. The penalty for failure is huge.

We specialize in arbitrage strategies that suit insurance companies with sizeable general funds. We run their money market accounts and provide pure alpha, with no lock-ins. However, we realize that we are an arbitrage fund; so we have to evolve new techniques as markets evolve; otherwise we are kaput!

We don't see prime brokers as potential competitors; they've run hedge funds for the best part of 25 years. They make a ton of money providing services. They don't want to risk their proprietary capital.

On our part, we have sophisticated risk models. We place bets on the risks that we understand and hedge out the ones we don't. For us, risk management and innovation are the two sides of the same coin.

It's a racing certainty that within five years most of the main investment managers will have a presence in the hedge funds space; that's the way their market is going. If they don't have single strategy offerings, then fund of funds will be the second best alternative."

A European hedge fund boutique

Source: CREATE and KPMG International, 2005 – Interview quotes

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Thinking aloud…

"Hedge funds are not a bear market phenomenon; in fact, they prospered most in the bull market that was full of volatility and imperfections, as traditional asset managers thrived on benchmark hugging. Indeed, indexation permitted huge shorting opportunities.

Since then, high net worth individuals have preferred to speculate like old style merchant banks, as the overall investor sentiment has favored absolute returns. What they reflect is a convergence between old style investing and new style trading. Most fund managers have failed to recognize this new paradigm. The smart ones, however, are diversifying into long short; or non benchmark unconstrained strategies.

As a fund of funds house, we have attracted massive net inflows; perhaps more than is prudent for us to manage. For the benefit of the existing investors, we have set a cap. Our problem is two-fold: the dwindling arbitrage opportunities; and lack of really skilled individuals who are capable of inventing yet new strategies, as financial markets evolve. On the upside, in this business, you don't have to grow to make money: scarcity has generated handsome fees for us. We shall remain a low volume business.

That tells something about whether hedge funds are really a scalable business. We are constantly scouting for talented managers and then building long-term relationships. The process is slow, judicious and thorough. Pension consultants can't do it. They are not our natural competitors: they lack the necessary financial, trading, and legal expertise.

Regulation will have little effect. Successful hedge fund managers are already registered; for them, the cost of regulation pales into insignificance when compared to returns. Also the new start-ups are attracting far more money now than five years ago. The more mature ones are also peaking at US$4 billion compared to US$1 billion five years ago. This means that there is a lot of churn around a small successful core.

We have a big team of front line talent scouts, backed by the best IT and research resources. We usually spot the best hedge fund talent before they meet any of our competitors; our success has also prompted them to treat us as their first port of call. We typically charge 100 bps as a flat fee plus 10 percent for out performance. The latter accrues periodically, not regularly: few managers can produce out performance year after year. Our churn rate is 20 percent so we have to look out for the best constantly, like premier football clubs. We also provide a top notch service, and do regular client perceptions studies.

Our key challenge is to grow the institutional client base without sacrificing the high returns that we have notched up so far. This is not an inherently scalable business: there is a trade off between size and performance."

A global fund of hedge funds manager

Source: CREATE and KPMG International, 2005 – Interview quotes

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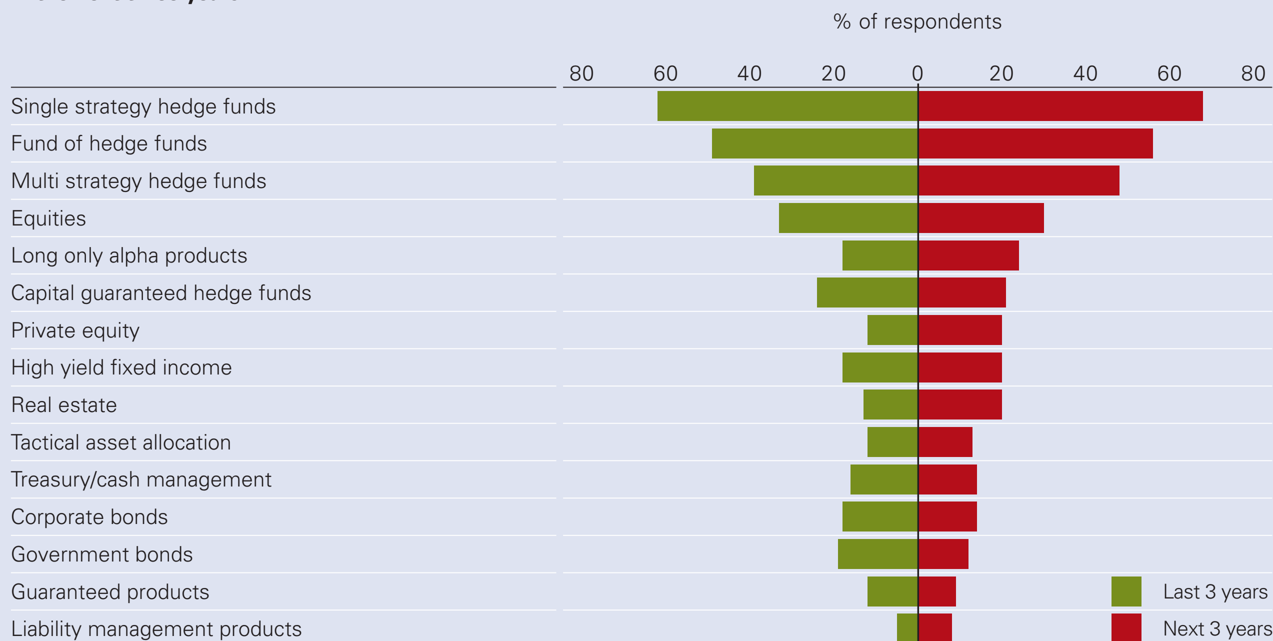
Hedge fund managers realize that their clients won't desert other asset classes



Source: CREATE and KPMG International, 2005

Interview quotes:

"Our success is based entirely on trading talent, risk instincts and mental agility"

"Fund of hedge funds are the reincarnation of the old style balanced mandates"

"Pedigree, track record, investment process, and risk tools are what really matter to our pensions clients"

"No pension fund in its right mind would want to invest more than five percent into hedge funds"

"A sound track record is the golden key that will unlock institutional doors, unless you are a former investment bank trader with wealthy contacts and friends"

Some 70 percent of hedge funds and fund of hedge fund managers participating in this study are partnerships or independent boutiques.

The rest are partly or wholly owned subsidiaries of a parent company – invariably an investment bank or a large asset manager.

Given their business mix, it is not surprising that their clients' key dealings with them has focused on single strategy funds, or fund of funds or multi strategy funds in the last three years. This trend, if anything, will continue over the next three years.

In each of these areas, growth in the recent past has been driven by high net worth individuals, family offices, endowments and proprietary money. However, the next wave of growth will increasingly feature institutional investors.

As a result, the North American managers are becoming more specialized in their offerings compared to their peers in Europe and Asia Pacific. They expect that the next wave of growth will be driven by specialist mandates from the North American pension funds.

Two other points are worthy of note here.

First, managers of fund of hedge funds have also developed specialist capability to provide a suite of products, especially targeted at their high net worth clients and family offices. They are expanding their manufacturing as well as distribution capabilities in hedge funds and other funds alike.

Second, all hedge funds managers are realistic enough to realize that their clients perceive them as but one of many sources of alpha performance.

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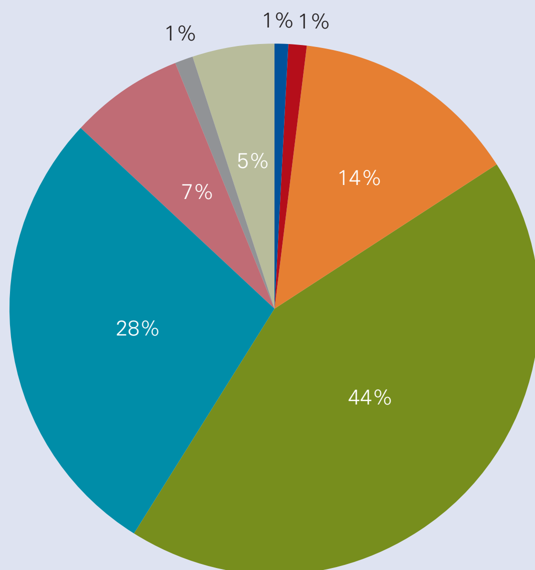
Hedge fund managers are very bullish about the future growth in their industry

What do you anticipate will be the average annual growth in FUM in the hedge funds industry worldwide over the next three years?



% growth bands	
Negative	1(%)
Nil	1(%)
1–10	14(%)
11–20	44(%)
21–30	28(%)
31–40	7(%)
41–50	1(%)
Over 50	5(%)

Source: CREATE and KPMG International, 2005

"Hedge fund managers are not geniuses with sixth sense; they are merely good at spotting mis-pricings. Even a monkey could make money in convertible arbs: they were priced too low"

Managers of hedge funds and fund of hedge funds are very bullish about the growth in their industry over the next three years. Those based in North America are the most bullish, followed by Europe and Asia Pacific.

The large majority in each region expect a double digit growth in FUM: only 1 percent of respondents expect the rate to be negative.

That said, Asia Pacific anticipates most extremes of high and low rates; and North America the least; reflecting the differing levels of maturity in the two regions.

A number of further points were made in our post survey interviews.

"Thanks to hedge funds, our FUM grew last year by 60 percent and profits by 100 percent"

First, these projected rates are only impressive when compared to non hedge fund strategies. Compared to the past five years, however, they imply a slow-down.

Second, around 30 percent of hedge funds reportedly fail each year; so the survivor bias in any published estimates of performance is significant.

Third, some published estimates include leverage; so the estimates of industry FUM are often over-stated.

"Institutional investors will create a large degree of commoditization and standardisation"

Fourth, there is also significant double counting when fund of hedge funds are included, as they are in the estimates of many firms.

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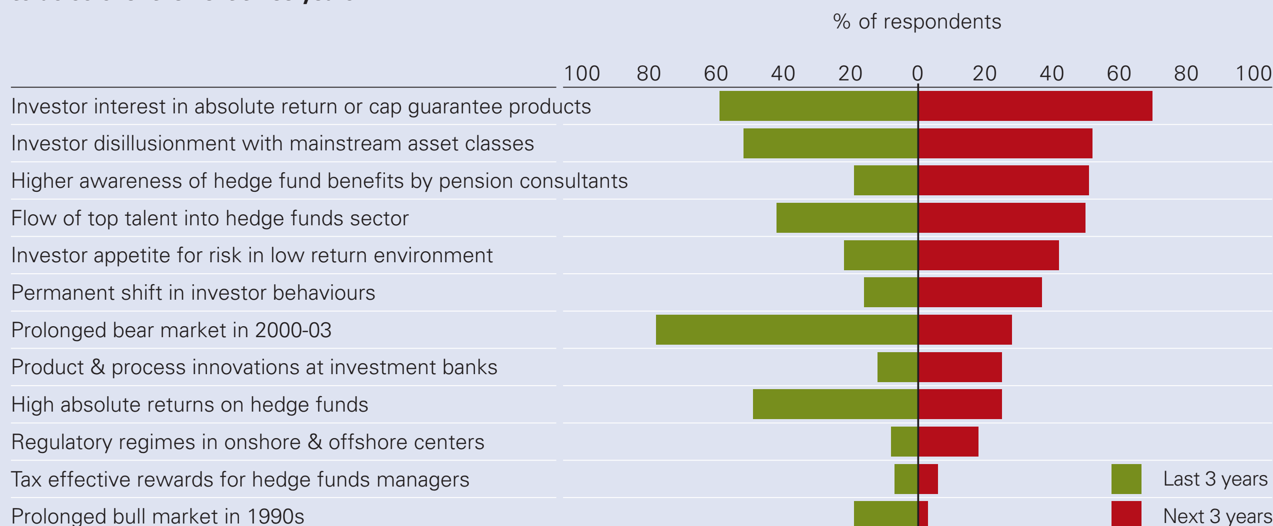
Their bullishness is based on growing investor appetite for absolute returns…



Source: CREATE and KPMG International, 2005

"As we grow, we create new companies around new strategies and give a piece of the action to newcomers. If we don't ring-fence the Newco, we are accused of style drift"

Notwithstanding some of the identified distortions in the growth data, it is clear that the industry is set to attract significant net inflows, albeit from a small base.

From the perspective of managers of hedge funds and fund of hedge funds, the factors driving growth are not very different from the ones identified by pension funds. More than two in five of them attribute the growth of the last three years to:

- A prolonged bear market (four in five)
- Interest in absolute or capital guaranteed products (three in five)
- Investor disillusionment with other asset classes (one in two)
- High absolute returns associated with hedge funds (one in two)
- Flow of talent into the hedge funds sector (two in five).

"In the U.S. alone, hedge fund managers reportedly earned over US$40 billion in 2004. Worryingly, they have invoked the same excitement as dotcom; yet the two are miles apart"

Over the next three years, these factors will prevail, except in two very notable respects: the impact of the bear market will fade, as will high absolute returns associated with hedge funds. In each region, the percentage of respondents expecting high returns is nearly halved.

The implication is that the rate of growth in FUM, as well as the returns on it, is set to slowdown.

The industry dynamics are set to change, especially with pensions consultants becoming more familiar with hedge funds and their benefits.

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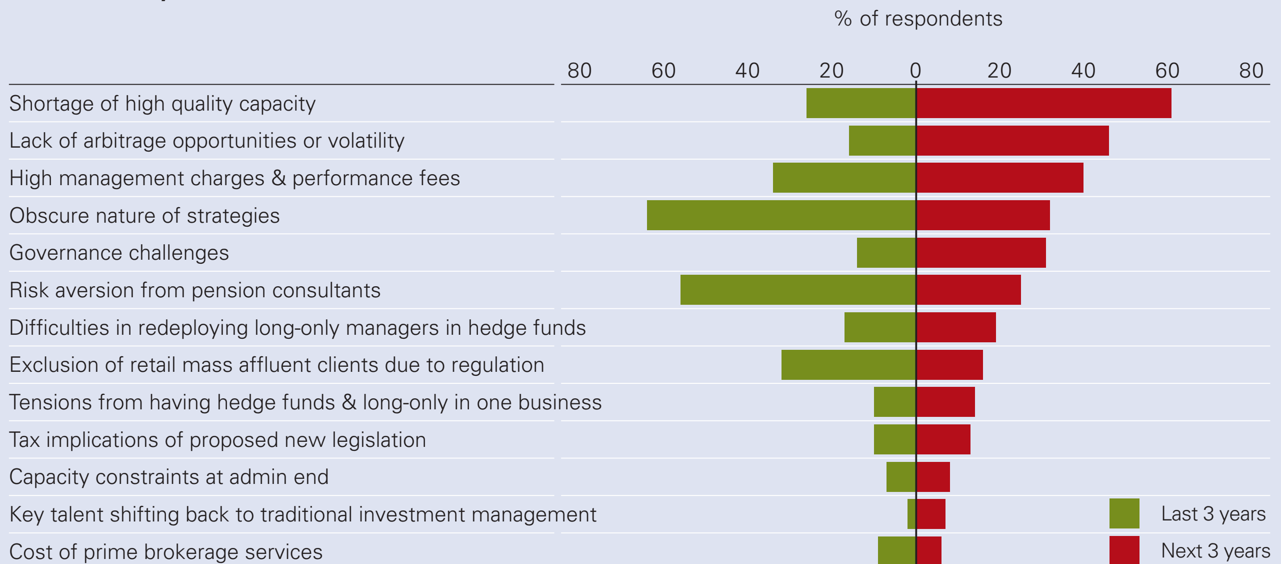
…but it is tempered by the recognition that shortages of quality capacity, lack of volatility and high fees may spoil the party



Source: CREATE and KPMG International, 2005

"Hedge funds are suffering from the curse of success"

Three major factors that constrained the expansion in the recent past are likely to ease notably: the obscure nature of strategies; risk aversion on the part of pensions consultants; and the exclusion of retail clients.

The growing interest in hedge funds by pension funds have eased the first two and the new regulation, especially in Continental Europe, has eased the last one.

Five factors are likely to constrain the growth from here on:

- Shortage of high quality capacity (three in five)
- Lack of arbitrage opportunities or volatility (one in two)
- High management charges and performance fees (two in five)
- Obscure nature of strategies (one in three)
- Governance challenges (one in three).

"Only innovative hedge funds will grow over time; the prime mover advantage matters because returns soon vanish as others pile in"

The capacity challenges are more acute in Asia Pacific and less acute in North America; reflecting the relative differences in the rates of new start-ups and the talent migration into hedge funds in these two regions.

It is clear that as the hedge funds industry has grown rapidly, old challenges have been replaced by the new ones. The new breed of clients has different expectations on returns, charges and modus operandi.

"Style drift doesn't work with most pension funds"

Most of all, the available capacity cannot readily accommodate new demands, without diluting the returns.

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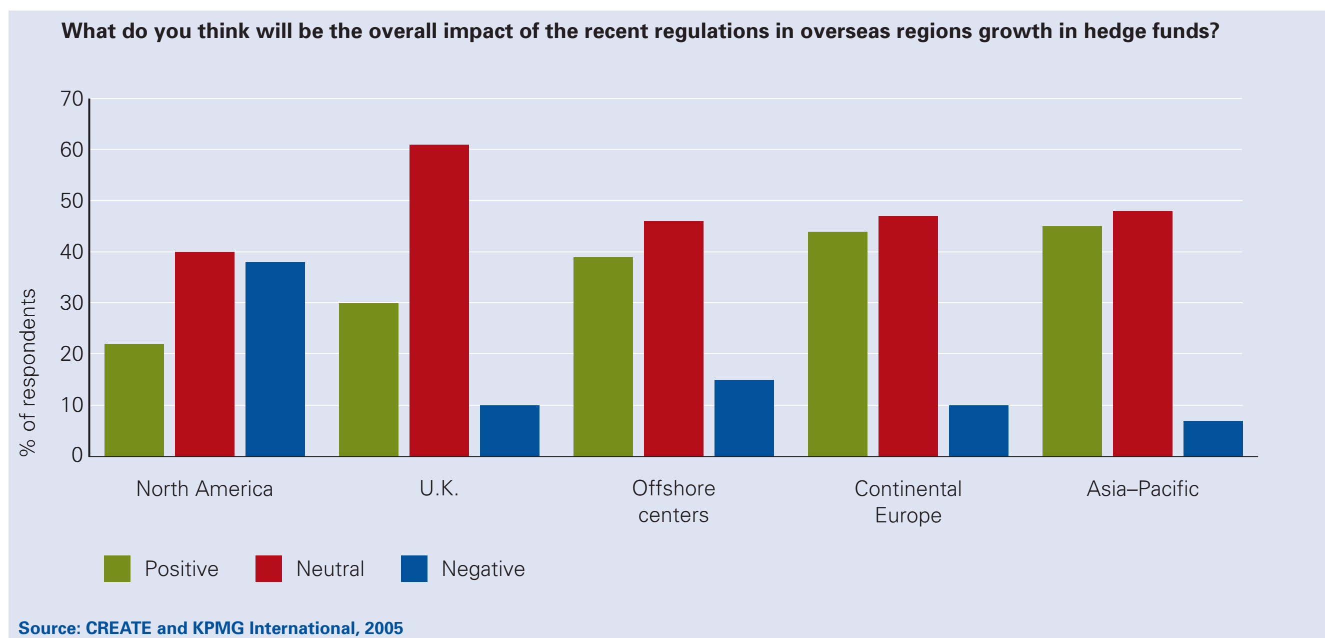
On balance, there is less concern about new regulation and more about…



Source: CREATE and KPMG International, 2005

"There are always howls of anguish when consultative papers come out; then nothing happens – regulation is not a deterrent"

"Caveat emptor: regulation will not prevent blow ups"

"Regulation is not crushing: in the U.S., it's a bit of a pain; in the U.K., it's more form filling"

"Hedge funds want flexibility; not lawlessness. Regulators don't get this"

"Success is a matter of high level thinking, ground level doing"

"Regulation in the U.S. and Europe is a red herring"

As mentioned in Section 1, new regulation is being, or has been, implemented in order to balance two emerging needs: open the market and protect the investors. The most important developments concern registration with the regulators in the U.S..

Outside North America, more than two in three hedge funds or fund of hedge fund managers believe that the impact will be *a net positive* at best, or neutral at worst.

In North America, however, a small minority believe that it will harm the rate of new start-ups that is so vital to innovation on the one hand and net capacity enhancement on the other. The high churn rate in the industry requires a faster infusion of new blood.

On the whole, managers of hedge funds and fund of hedge funds do not oppose new regulation. But they expressed two concerns.

First, because of the complexity of some of the vehicles used, regulators do not readily understand them. So, a significant amount of time during the routine visits by regulators has involved education rather than inspection.

Second, regulation is desirable if the industry is to professionalize. However, the transition to the new regime is full of hassle. In a steady state, regulation is not a problem; so long as regulators do not reinterpret the rules or create new ones.

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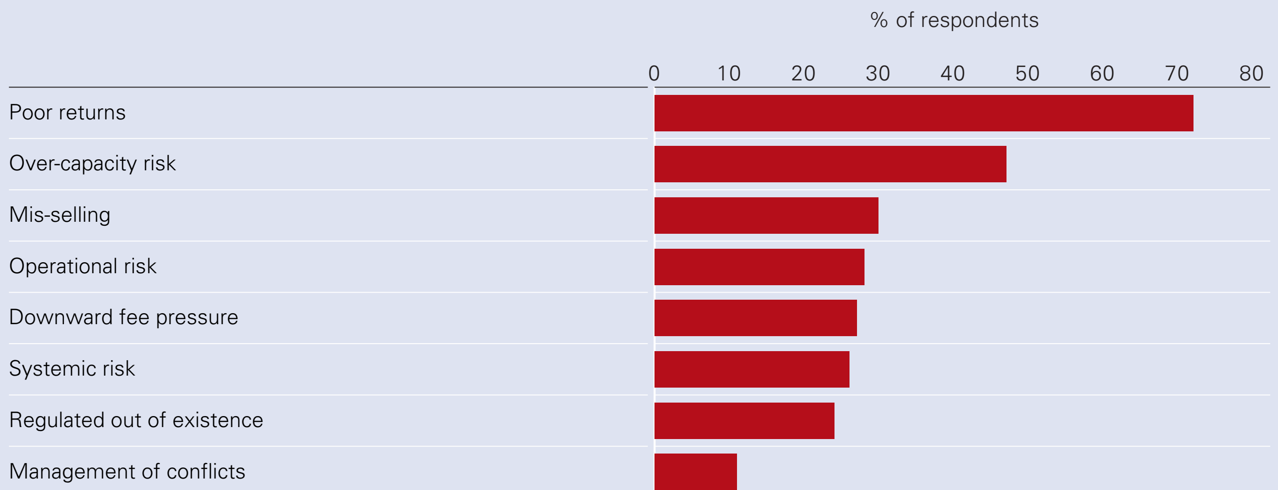
…poor investment returns and the challenges created by overcapacity



Source: CREATE and KPMG International, 2005

"When you have seen a successful hedge fund manager, you have seen one; they are a rare breed"

Managers of hedge funds and fund of hedge funds duly recognize the risks to which they are exposed. The two most widely recognized risks are inter-related:

- Poor returns (seven in ten)
- Over capacity (one in two).

"The biggest drag on growth is the lack of good suppliers"

Managers recognize that their ability to generate high and consistent returns is based on many factors.

Some, like innovation and velocity, are within their control. Others, like volatility, information inefficiencies and style concentration, are not.

Producing uncorrelated returns is first and foremost a matter of skills and a bit of luck.

"Most newcomers are exposed to operational as well as investment risks; they've never managed a business before"

They also recognize two other concerns. One is the mis-selling risk that may apply particularly to retail clients in markets that are newly opening to such clients; like France, Italy and Germany.

The other is operational risk primarily associated with the valuation of complex derivatives, often designed by hedge fund managers themselves. Many of them are neither liquid nor have clear benchmarks in the financial universe.

"The key barriers are scarce talent and high charges"

As a result, the fear of downward fee pressures is always there; as is the possibility of further regulation that could gradually drive the industry out of existence.

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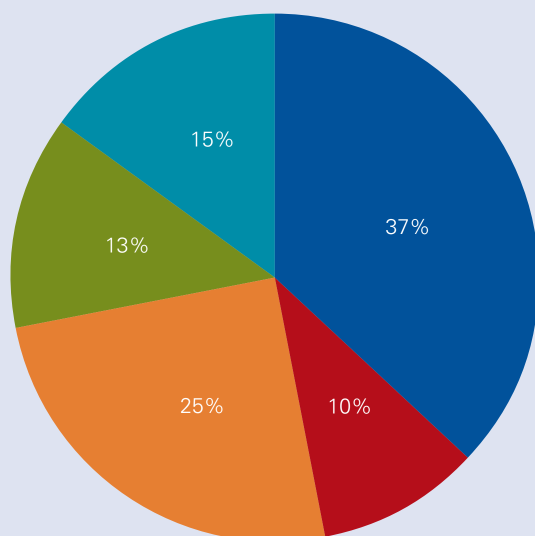
The margin of unused capacity is very wide; much of it is sub-prime

How much of your company's core capacity for hedge fund management is currently being used?



% capacity usage bands	
Less than 25	37(%)
26–40	10(%)
41–60	25(%)
61–80	13(%)
81–100	15(%)

Source: CREATE and KPMG International, 2005

"Hedge funds have to grapple with three paradoxes. You need to have a critical mass to attract money; but without money you can't build that mass. You need to build the scale to build a sustainable business; but scale is the enemy of alpha. You need a rigorous process to attract institutional investors; but such a process stifles creativity"

"Yes, innovative managers will always push the opportunity frontiers; but only if they can attract new punters"

"Single strategy carries the talent-loss risk"

One of the most striking results of this research study is that fewer than one in six managers of hedge funds or fund of hedge funds are operating at their full capacity.

In particular:

- 13 percent of managers operate at between 61–80 percent of capacity
- 25 percent at 41–60 percent
- 10 percent at 26–40 percent
- 37 percent at below 25 percent.

Against the background of rapid growth in recent and future demand for hedge funds, there should be no capacity constraints – certainly not on paper.

Yet, the biggest inhibitor of growth, as reported by pension funds, and managers of hedge funds and fund of hedge funds, is the shortage of high quality capacity. The implication is clear: much of the existing capacity cannot necessarily generate risk return characteristics that clients have been led to expect.

Indeed, in our interviews, one thing was clear: the gulf between the average and the best managers was not only big; it was also widening.

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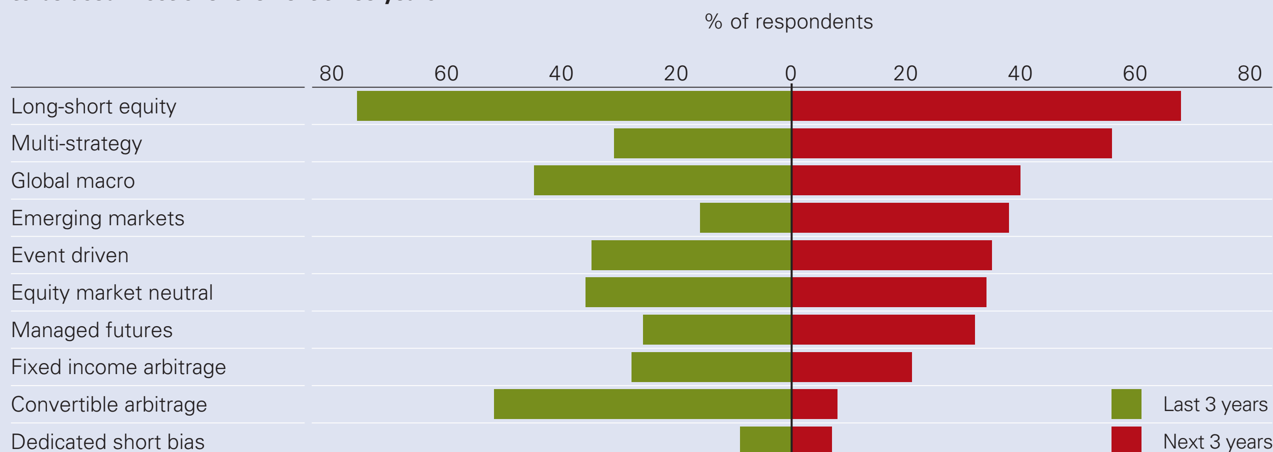
Most favorite strategies will continue to be long short, macro and hybrid

Which hedge fund strategies have been used most in the industry in the last three years and which ones are likely to be used most over the next three years?



Source: CREATE and KPMG International, 2005

"Capacity to short exceeds capacity to leverage"

"Unless they constantly reinvent themselves, hedge funds are like a new religion: here today, gone tomorrow"

"For the foreseeable future, long short and macro strategies will prevail; thereafter who knows?"

"Regulation may make it harder to deliver arbitrage based strategies, since you have to be more open on your positions"

"New strategies necessarily rely on new people: they're too specialized"

A critical factor affecting the quality of the capacity is the skills of the manager. But it is not the only one: there are two others worthy of note.

One of them is timing. Strategies are born and go out of fashion, as opportunities get arbitraged away by newcomers. Convertible bond arbitrage is a case in point. For the foreseeable future, other strategies will prevail, with long short, multi-strategies and macro trading being more popular than others.

The second factor is innovation. We repeatedly encountered the view that the hedge funds universe is endless, like its physical counterpart. As markets in physical, financial and intangible assets evolve, the scope for price inefficiencies will always be there. Even strategies based on weather derivatives are appearing!

The key challenge, on this argument, is having talented individuals – mini Einsteins – who can devise new trading strategies and commercialize them. Thus, product innovation and opportunity sets are the key preconditions for the future growth and prosperity of the hedge funds industry. Capacity is nothing more than hugely creative people with a strong instinct for spotting opportunities and trading them profitably.

The flip-side of this argument is unsettling, however: hedge funds are far from scalable; they are complex customized vehicles with the potential to peak long before other investment vehicles.

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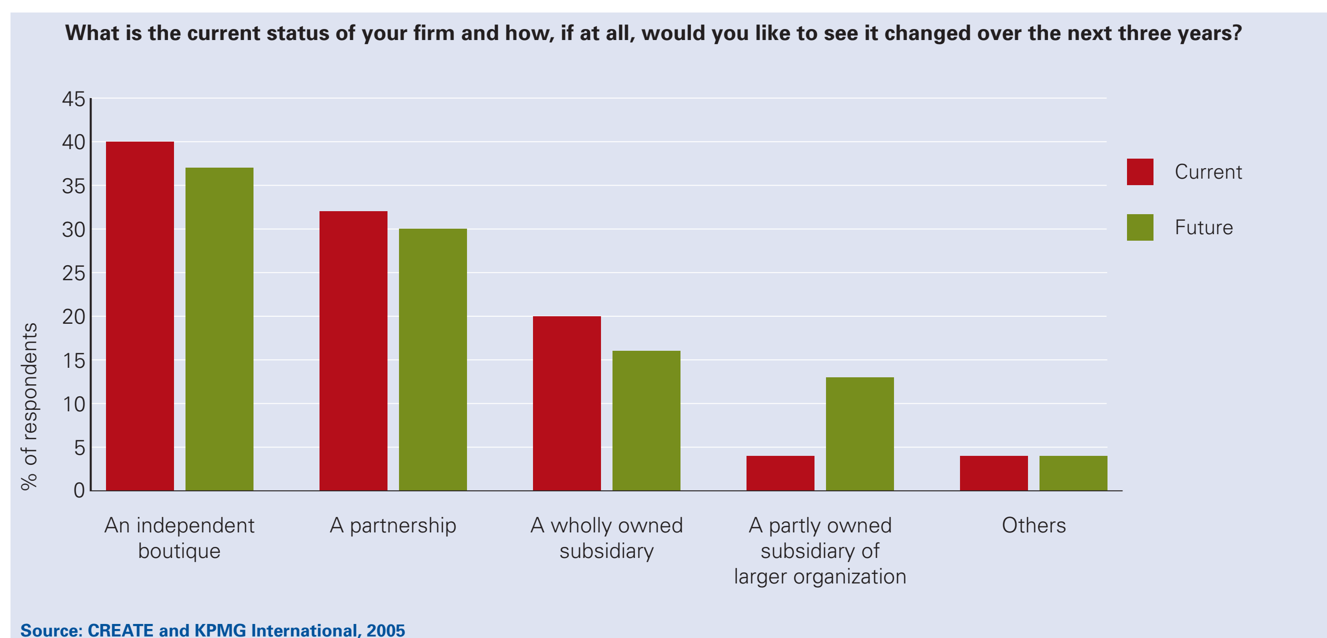
Boutiques and partnerships will continue to dominate the hedge fund universe…

What is the current status of your firm and how, if at all, would you like to see it changed over the next three years?



Source: CREATE and KPMG International, 2005

"An ideal model should have more than one gifted manager working in an entrepreneurial set up, with minimum hassle. Then, as growth occurs, take on more managers who have different specialism. You have to avoid cloning at all costs"

"Successful hedge fund managers don't need to get into bed with large houses or scale their business. But the prospect of huge riches will prove very seductive"

"Pension consultants will replace fund of hedge funds; but at a glacial pace"

"Fund of hedge funds will have global footprints because talent will have to come from far-flung corners. In this office, we now have so many names that are hard to pronounce!"

First and foremost, the hedge fund industry is craft-oriented: it thrives on the talent of individuals who are great at innovation and just as great at commercializing it via new opportunity sets. Not surprisingly, therefore, it has been more supply-driven than demand driven, so far.

An overwhelming majority of its managers rate craft loyalty higher than business loyalty. They also perceive their craft as a lifestyle business: where work and pleasure overlap in an environment of total autonomy and space in which they can generate their high conviction ideas and back them.

Many start-ups of the past five years have involved the ex-prop desk dealers from the main U.S.-owned investment banks; with strong instincts for asset mis-pricings and equally strong aversions to corporate bureaucracy. Their trading track record has inspired their former employers or ultra high net worth ex-colleagues to back them with seed money. They do not want to scale the business as a deliberate choice; partly because their chosen investment strategies themselves are not inherently scalable; and partly because scale involves the very thing that they have tried to escape from in the first place: corporate bureaucracy.

Not surprisingly, therefore, a large majority do not expect to change their ownership status, at this point in time. About the only significant change they expect is giving a minority stake to larger finance houses, mainly in pursuit of distribution channels and/or partial equity release. This assessment, however, is based on two provisos:

- overtures from larger houses will be resisted because of the prospects of continuing high returns that underpin current independence
- growth in demand from pension funds will not depress the current lucrative management charges and performance fees alike.

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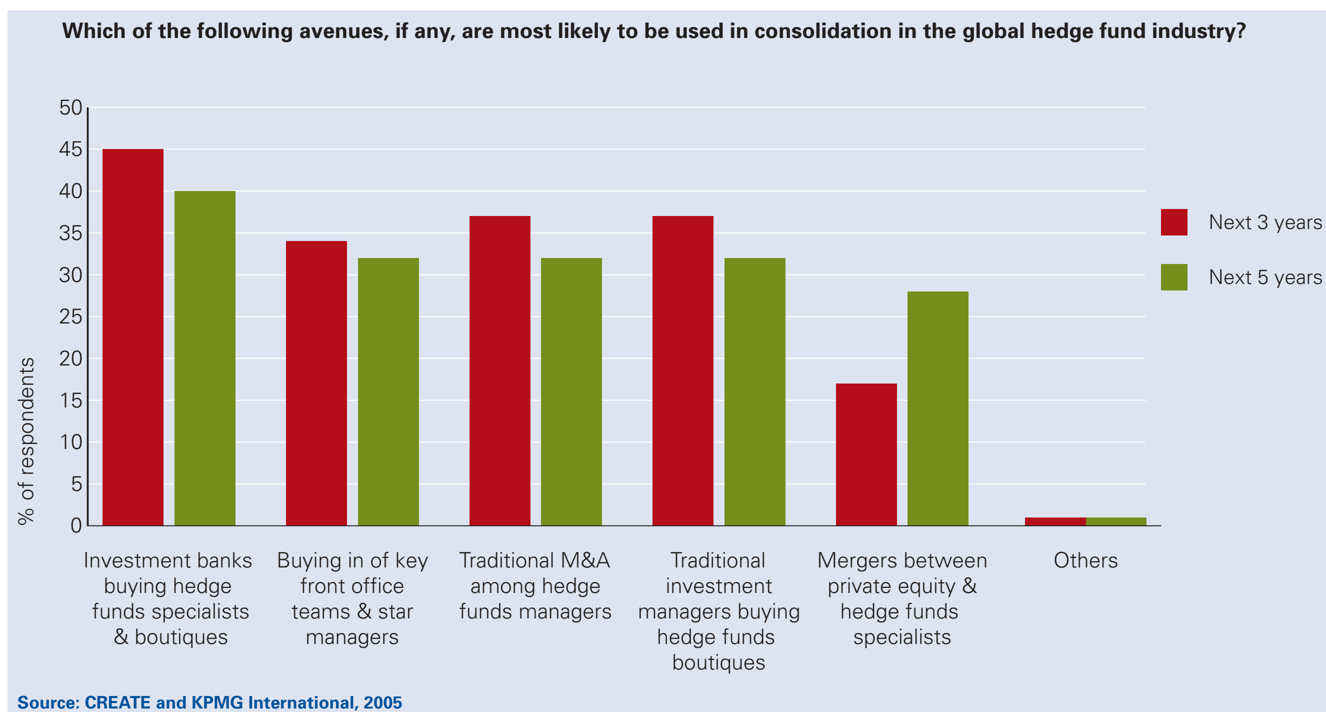
…such that Darwinism will drive the next wave of consolidation

Which of the following avenues, if any, are most likely to be used in consolidation in the global hedge fund industry?



Source: CREATE and KPMG International, 2005

"As early stars face a burn-out, the big boys will muscle in, as in the dotcom industry"

"For a start-up, the break even point was US$100 million FUM. Now it has quadrupled"

"It's difficult to sell hedge funds outfits because they're hard to value: most of them are lifestyle businesses"

"Mergers will occur amongst fund of hedge funds because at least 50 percent of them are sub-scale. As fees tumble, their cost base will be unsustainable"

"Transitions are rarely easy. I shudder to think how a recent start up with US$1 billion will manage the transitions"

Given the state of overcapacity in the global hedge funds industry, consolidation is inevitable, principally via:

- Investment banks acquiring strategic stakes (cited by two in five)
- Lift outs of teams and star managers (one in three)
- M&A amongst the existing players (one in three)
- Acquisitions by mainstream fund managers (one in three)
- Mergers with private equity houses are also likely (one in six)

In our post survey interviews, two points were made. First, it is hard to value the end-hedge funds managers: their only asset is a bunch of self-driven *stars*, with a high sense of self-worth and individualizm. They are hard to manage and motivate: their previous employers couldn't retain them for long. Second, ironically, hedge funds managers do not scale; but fund of hedge funds managers do. Currently, in FUM, their scale points are:

- US$100 million: when start-up businesses can breakeven
- US$1–4 billion: when most single strategy managers begin to max out and go multi product or multi strategy, by attracting new specialists and creating new equity structures around them
- US$15 billion: when managers of fund of hedge funds max out, when it becomes ever more difficult to maintain close relationships with end-managers around the globe. There are a few notable exceptions, however, on both sides of the Atlantic.

Many managers of fund of hedge funds are currently sub-scale; so they will see more rapid consolidation. As for hedge funds managers, many are hesitant to scale beyond US$1 billion for fear of bureaucracy associated with more complex equity arrangements. They want to run money, not businesses. For them, consolidation is more about Darwinian survival than defensive mergers.

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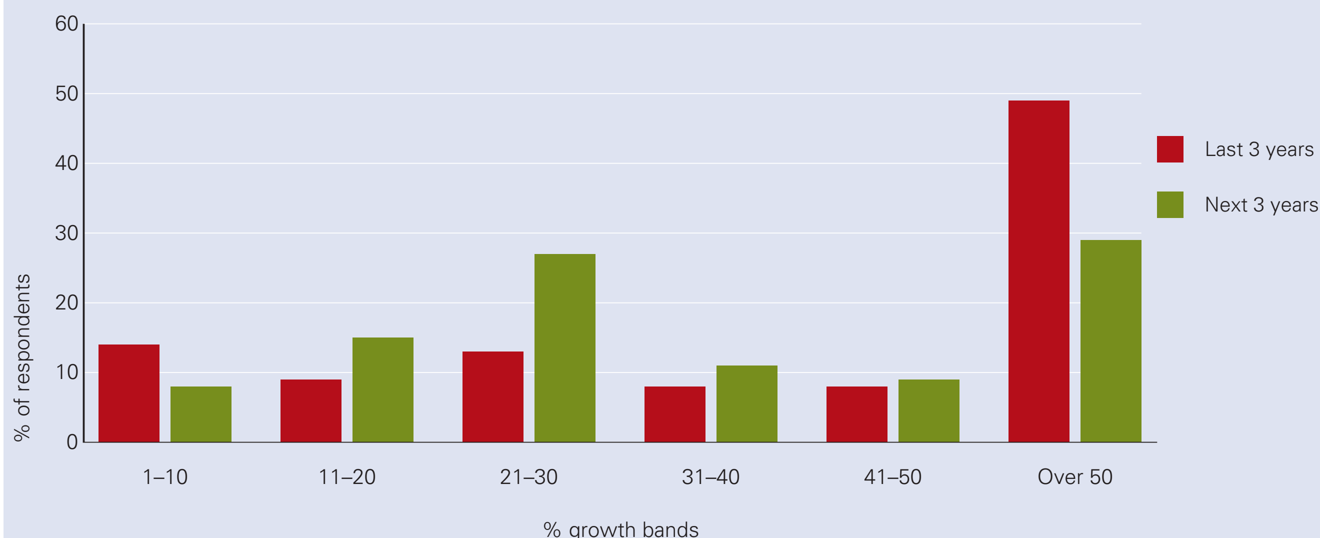
Growth in hedge funds will slow down somewhat…

What has been the average annual growth in hedge funds under your management in the last three years and what is it likely to be in the next three years?



Source: CREATE and KPMG International, 2005

"Growth since the bear market is too good to last"

In the light of the constraints identified earlier, managers of hedge funds and fund of hedge funds themselves are anticipating a moderate slow down in the growth of their own FUM.

Asia Pacific will have the biggest deceleration, followed by North America, then Europe.

"Fund of hedge funds will remain a popular avenue for the pension funds: they reduce the headline risk, whilst doing the due diligence that pension consultants are not equipped to do"

In the absence of rapid expansion in prime capacity, the next wave of expansion is expected to be more modest in scope and size.

This does not detract from the overall bullishness of these managers of hedge funds and fund of hedge funds.

But it is indicative of their recognition of triple-logic:

- The new wave will be driven by institutional investors
- This has the potential to industrialise hedge funds
- Unless new strategies are created and commercialized rapidly.

Above all, the slow-down is the reflection of the fact that hedge funds are difficult to scale.

"People know that hedge funds is not a scalable business; yet they still try"

Herein lies another paradox: quantity displacing quality. Superior performance invites a flood of new money, which serves to drive down performance.

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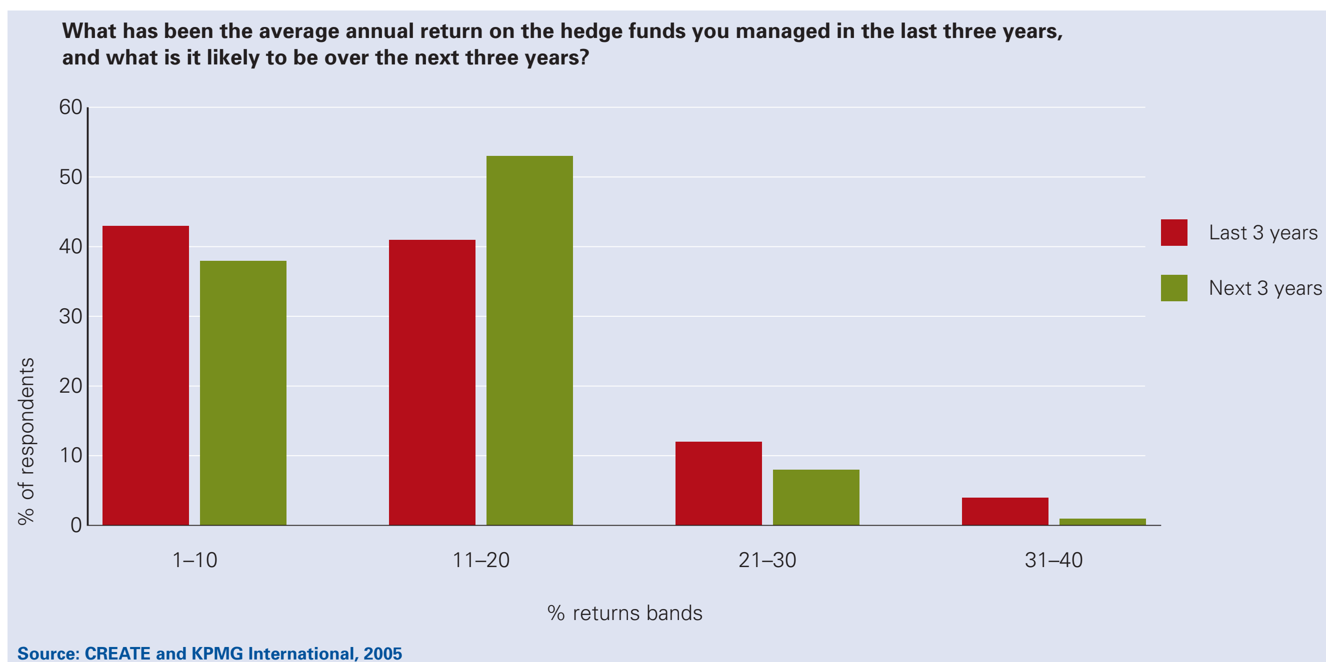
…and the returns will decline from their stellar levels of the recent past



Source: CREATE and KPMG International, 2005

"The hedge funds industry is polarized and atomized at the same time; there is a small bunch of hugely talented managers at one end, followed by a long fat tail of mediocrity. Few will survive: some will sell, others just fade away"

"Prime broking and hedge funds feed off each other"

"We aim for long lock-ins so that we don't need to rely on other large distributors"

"Teams are organized around each product area and operate like a shop within a shop. Many have closed funds because they've capped out"

The marginal slow down in the rate of net new money, in turn, is a symptom of moderate falls expected in the rate of returns on hedge funds, although the average is likely to remain in double digits over the next three years or so; not allowing for the survivor bias. This assessment is based on a number of caveats that are open to challenge.

First, it assumes that as today's prime capacity maxes out, new capacity of similar quality will be created, with the corresponding infrastructure support at the administration end.

Second, it assumes that the losses notched up by the '*has-beens*' – the losers – are not significant enough to tarnish the image of the industry and deter new generations of institutional and retail investors.

Third, it assumes that the systemic risks, associated with strategy concentration, and operational risks, associated with incorrect valuation of complex financial instruments, are effectively managed in the next wave.

Fourth, it assumes that the current low nominal return environment remains favorable to uncorrelated investment strategies and unfavorable to correlated strategies. If markets recover unexpectedly, investors may switch to investment products they understand better.

Finally, it assumes that the mainstream fund managers will not strike back. As we shall see in Section 3, this is an untenable assumption.

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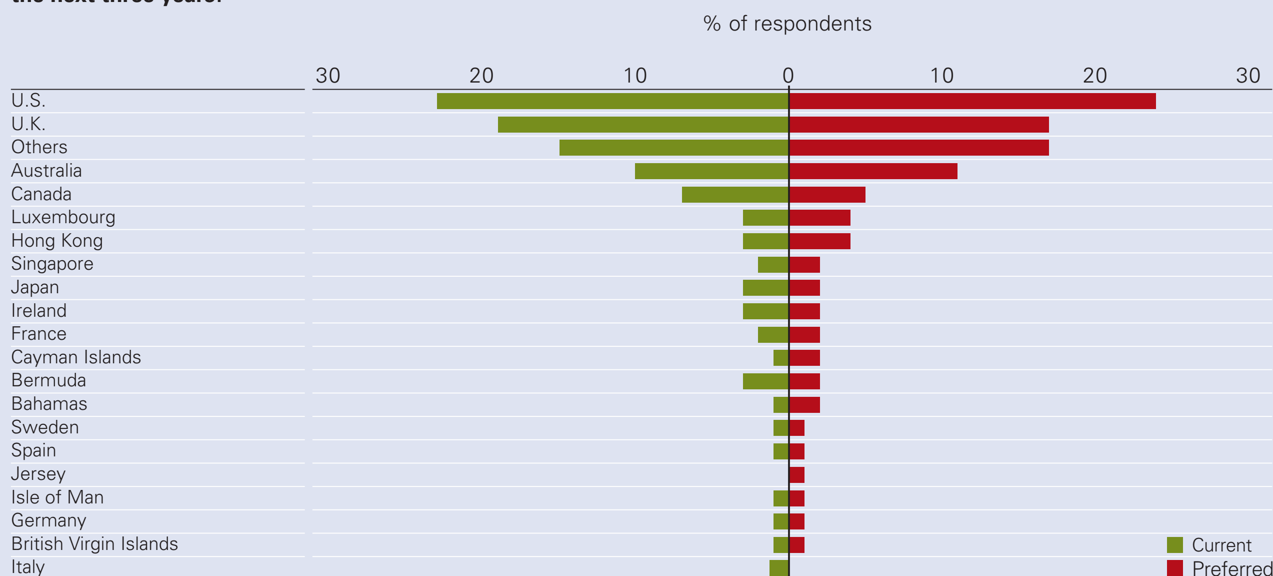
No major relocations are likely; U.S. and U.K. will remain the epi-centers



Source: CREATE and KPMG International, 2005

"In the U.K., gains on hedge funds are taxed as income not capital; this is a disincentive"

"This is a nice place to work"

"Client proximity matters a lot: offshore centers are losing their allure"

Despite the fact that the regulatory landscape is becoming more even across the world, the industry's core locations are in the English speaking world; and are unlikely to change much over the next three years.

Access to capital markets, prime brokerage and high net worth investors have contributed to the choice of locations; especially the pre-eminence of the U.S..

Availability of talent has been another contributory factor.

Over time, however, there is little doubt some of the young centers will grow, especially Luxembourg and Hong Kong.

Each of them are rapidly developing an infrastructure that can either become a satellite or flourish in its own right.

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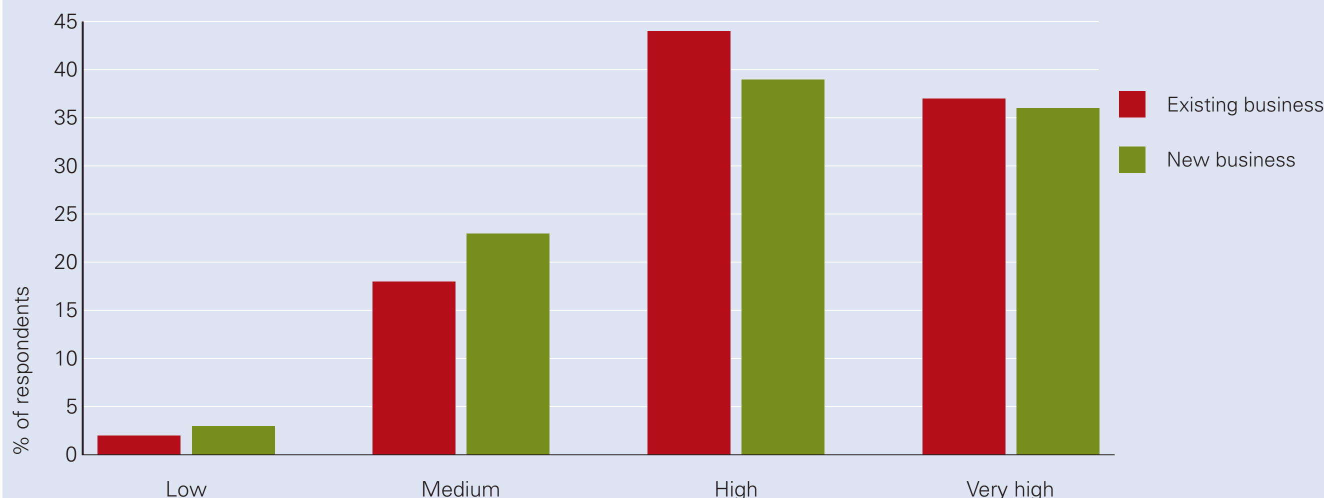
Hedge fund managers still remain bullish about their prospects, despite all the caveats



Source: CREATE and KPMG International, 2005

"As a boutique, we've grown and diluted the ownership; the founder partner is now a minority shareholder"

"To get investment at the level of large endowments in the U.S. will take time. They were also helped by top academics on their board"

"The challenge for us is to retain our entrepreneurial spirit that has so far underpinned our success. Investment banks failed to do that. Can we succeed where others have failed?"

Notwithstanding the earlier caveats, a large majority of managers of hedge funds and fund of hedge funds are optimistic about their own prospects, both in terms of retaining their existing business and attracting the new business.

The picture they have painted in this Section is one of optimism, tempered by the recognition that they face major challenges.

On the one hand, they recognize that a unique congruence of market conditions, new risk tools and investor disillusionment with the traditional asset classes have caused a seismic shift in the global fund management industry.

These have, in the process, created a powerful tail wind behind absolute returns strategies.

On the other hand, they recognize that success creates its own challenges. Past achievements are not a good guide to future performance, especially because of the powerful head winds emanating from the sources listed previously.

The hedge fund industry is truly in transition. First and foremost, its future veritably depends upon the availability of a band of truly innovative and entrepreneurial managers.

Mediocrity has no place in it.

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3 Mainstream fund managers

"We are apt to think that our ideas are the creation of our own wisdom. But the truth is that they are the result of the experience through outside contact"

Konosuke Matsushita

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Mainstream fund managers

This section presents the results of the survey and interviews, involving fund managers around the world. The key points emerging from it are:

- **Catalyst:** By popularizing the rise of absolute returns, hedge funds have forced other fund managers to revamp their business models in order to create clear focal points for the separation and generation of alpha and beta.

- **Risks:** There is remarkable similarity in the views expressed by fund managers and those in the other three sections: namely hedge funds have been aided and assisted by a prolonged bear market that sparked interest in absolute returns and the separation of alpha and beta management. That does not detract from the view that although interest in hedge funds will grow worldwide, their returns are bound to fall, due to over-crowding, which may also drive down the fees. At the same time, queues will develop at the prime end. The industry will bifurcate.

- **Diversification:** Be that as it may, some fund managers have overtly adopted defensive strategies, especially long short or derivative-based; others have sought to generate alpha in the long only space. Some have separated the alpha and beta production into separate boutiques with their own governance structures; others have long only and long short on the same floor without any Chinese walls.

- **Avenues:** Some are providing hedge funds via the external fund of fund routes; others creating proprietary platforms. Some are taking equity stakes in fund of hedge funds managers; others taking stakes in hedge fund boutiques.

- **Involvement:** Around two in five fund managers are now involved in fund of hedge funds and the number will rise to one in two over the next three years, via three principal routes: first, acquiring minority stakes in hedge funds boutiques that offer privileged access to capacity and preferential charges; second, forming alliances with boutiques and having preferential distribution rights; third, creating arms-length distribution relationships with independent boutiques on a transactional basis. One in five are also involved in creating in-house capability. These managers – and especially those in North America – rate their chances of success highly.

- **Exclusion:** Those one in two fund managers who have deliberately chosen to stay away from hedge funds rate their chances of success equally highly because they are using their core capability to provide absolute returns via other routes. They include some of the most prestigious houses on both sides of the Atlantic who believe that: investor appetite for hedge funds will evaporate before long; besides, there are other ways of scoring absolute returns; and, in any event, long short strategy has its own drawbacks.

- **Convergence:** Either way, mainstream managers are becoming more diverse in terms of investment strategies and operating models; in the process, some of them are becoming more like hedge funds. The bifurcation between alpha and beta is as real as the emergence of hybrid products born out of customized assembly in between the two extremes. Hedge funds have thus started a chain reaction whose impact extends well beyond their own immediate universe.

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Thinking aloud…

"Today's mantra is: skills-based absolute returns. No more fluffing around; what matters are convictions, decisions and results. Equally, we can't kid ourselves that we can run every type of strategy.

A major institutional client wanted to go into hedge funds via the fund of funds route, with no fat fees. So we have created a dedicated capability that engages former hedge funds managers and long only people with the potential to run long short strategies. Fund of hedge funds is not an easy option: there aren't many truly independent managers around without conflicts of interest.

We also found that most of the independents were ex-investment bank prop dealers who were looking for their last hurrahs: fast buck and instant fame mattered more to them than the creation of sustainable businesses. Indeed, many of them had 'for sale' signs on a scale hitherto unforeseen.

Our dedicated team regularly screens 8,000 hedge funds, working closely with an external research firm who are constantly screening the universe and doing due diligence on worthy candidates. Our team then goes in and does second level assessment before our CIO goes in to kick yet more tyres before the final thirty are selected. We also get a side letter from each of them about their credentials. We don't have lock-ins with anyone.

It all looks like checkers checking the checkers; and even then having clear escape hatches. But it will be terrible if we fail: the reputation risk for our clients is huge. They were skewered by the media when they revealed the size of their pension black hole three years ago. They face a difficult dilemma: either raise sponsors' contribution or go into absolute returns. They have chosen a bit of both. Currently, 5 percent of assets are in alternatives. But the figure could rise to 20 percent and also include private equity, commodities and property.

But I have to admit that this has not been an easy decision. It's one thing talking about the glory of absolute returns; but quite another delivering it. The risks are huge. Many hedge fund managers are wet behind the ears. They are refugees from reality. They have neither the skills to deliver alpha nor the acumen to run their businesses. Most of them are mediocre, like their counterparts in the dotcom era. The biggest risk is systemic; arising from most of them pursuing identical strategies. Funds of hedge funds are not as fail safe as you think.

We favor a multi-strategy approach, which enables us to develop a clear manager of manager status. If our incursion is a success, we would like to develop an alliance with a large number of reputable independent boutiques, who would also benefit from a symbiotic branding with us. This manager of manager platform will not jeopardize our long only capability because our clients want a clear separation of alpha and beta. Two things can frustrate our plans: if markets recover strongly; or hedge funds blow up visibly."

A European specialist fund manager

Source: CREATE and KPMG International, 2005 – Interview quotes

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Thinking aloud…

"We are not a hedge fund; but we act like one in the long only space.

There's no doubt that the investor mindset has shifted irrevocably towards real absolute returns. Even our retail clients are demanding products with risk-return characteristics like hedge funds. They want alpha products with large tracking errors in their traditional space. This is a sea change for us. Although, the opportunities for arbitrage are rapidly evaporating, the attitudes underlying hedge funds are here to stay. Accordingly, we have introduced a number of changes.

To start with, we now accept that investment talent is more important than the process and philosophy. So, we give our long only managers a lot of autonomy and space within a boutique environment, in which they can generate fresh ideas and convictions. We have also adopted a philosophy of 'management by exception': our professionals only come to us if they have a problem which they can't fix themselves. This hands-off approach has required a different leadership style from the top team. However, in order to discourage 'laissez faire' attitudes, we have also created a portfolio advisory group where the professionals bounce ideas and seek suggestions.

All these changes are based on the belief that long only will remain a fertile area for alpha generation. The scope of our research engine has been widened to include all industries, size and geography; and deepened to cultivate special insights through ever closer proximity to companies in whom we invest.

Finally, we're linking 70 percent of the annual bonus to alpha performance and the rest to soft factors. We've withdrawn the old long-term incentives that were linked to the share price of our parent company and replaced them with phantom shares linked to our performance and profitability. We've replicated the boutique structure in line with the craft nature of asset management; you can't scale it without a 'divide and grow' approach, if our past experience is any guide.

Sure, we are having teething problems. First, guys here don't take enough risks; their mindset is mired in the old ways of thinking. Second, as our performance has improved markedly, people feel that they have reached the pinnacle of their success: we risk cruising because the numbers are great. The curse of success has kicked in far too early: people feel neither hungry nor ambitious. Third, our boutique model risks promoting the cult of individualizm: it's hard to promote organizational loyalty in the age of individual empowerment. We are trying to promote a common understanding of these issues."

Fund management arm of a global insurance company

Source: CREATE and KPMG International, 2005 – Interview quotes

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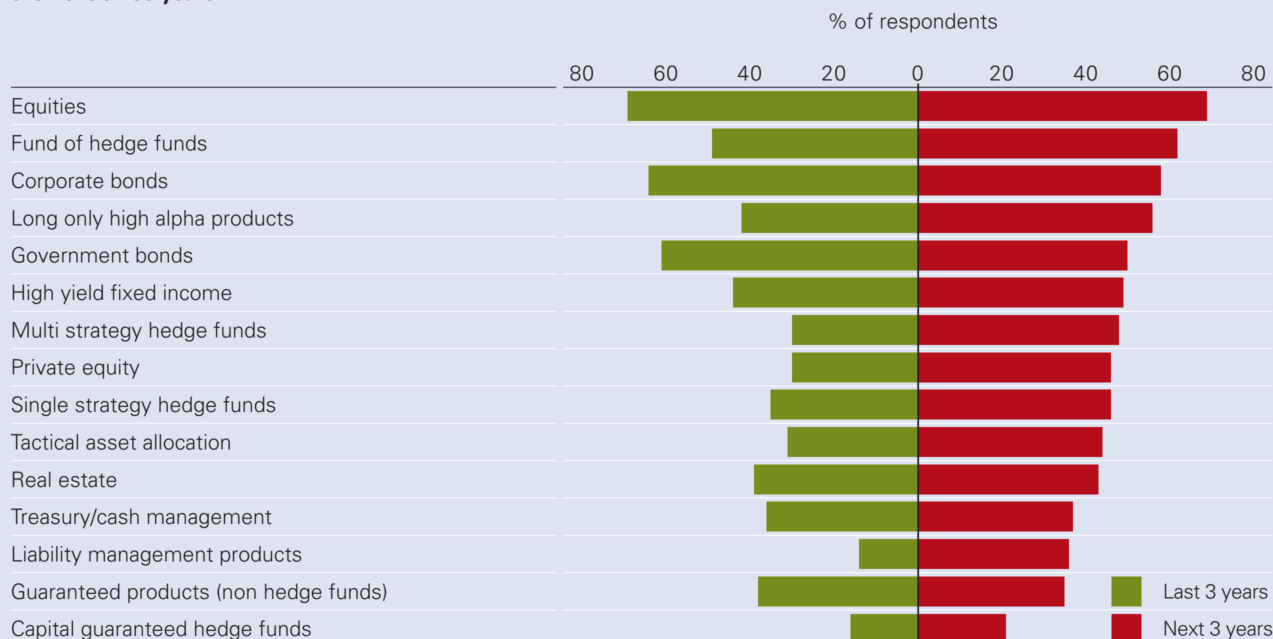
Clients of mainstream fund managers want a clear separation of alpha and beta



Source: CREATE and KPMG International, 2005

Interview quotes:

"The last bull market was like crack-cocaine to pension trustees; the bear market was a rude shock"

"We've benefited a lot from our private bank diverting its discretionary portfolio into hedge funds"

Mainstream asset managers worldwide have experienced seismic changes since the onset of the bear market.

With millions losing billions, the twin pillars of the equity culture have come under sharp scrutiny: relative returns and equity premium.

For defined benefits clients, neither has delivered the returns commensurate with their obligations, opening up big funding gaps. For defined contribution clients, large chunks of contributions made over a decade were simply wiped out: likewise, for retail clients investing in mutual funds.

These clients now want to see the separation of alpha and beta that also accommodates a number of other requirements.

The first of these is higher alpha generation in the long only space, using hedge fund style strategies, without the attendant high charges and fees.

They also want access to overt hedge funds or fund of hedge funds, either directly or via their mainstream managers.

Finally, they want liabilities-driven products that use long-term liabilities as benchmarks. These may involve structured products as well as customized ones, assembled from a variety of investment strategies.

Thus, the whole value chain of investment is being recalibrated by each of its distinct elements, in order to redefine risk-reward characteristics and the associated charging structure.

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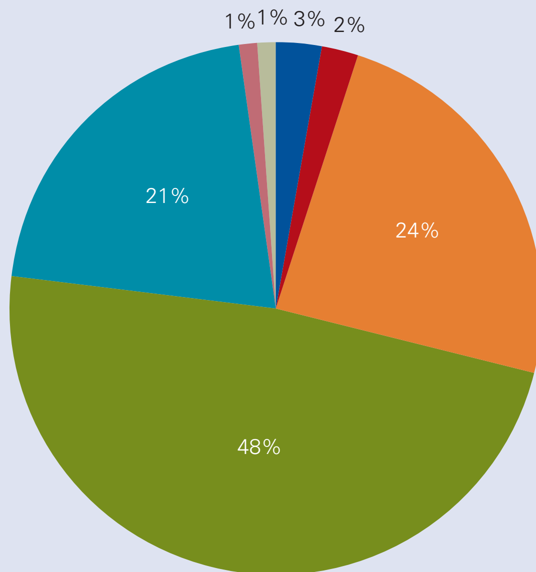
Fund managers are reasonably bullish on the growth of hedge funds worldwide

What do you anticipate will be the average annual growth in FUM in the hedge funds industry worldwide over the next three years?



% growth bands		
	Negative	3(%)
	Nil	2(%)
	1–10	24(%)
	11–20	48(%)
	21–30	21(%)
	31–40	1(%)
	41–50	0(%)
	Over 50	1(%)

Source: CREATE and KPMG International, 2005

"Investors get nervous of shorting; yet they don't mind if you are net long in pursuit of alpha. It's a matter of language!"

One thing is for sure: whether they are in hedge funds or not, all mainstream fund managers are also bullish about the growth in the hedge funds industry worldwide, with seven in every ten managers expecting double digit rates, over the next three years.

Only three percent expect the industry to contract. A further two percent expect it to remain static.

Managers in Asia Pacific are the most bullish on industry growth, followed by those in North America, and then Europe.

"For large traditional houses, hedge funds are a huge distraction; for hedge fund managers, size is a distraction"

Not surprisingly, managers who have dipped their toes into hedge funds are more optimistic than those who have chosen to stay out. Also managers who run scale business have been more optimistic, given the diversification opportunities bestowed by their size.

Their overall assessment is based on the belief that absolute returns will be the name of the game, at least while the current low return environment persists.

The majority expect it to last for the next three years; a significant minority also see it extending it into the next decade.

"Hedge funds are here to stay: they provide yet another investment strategy"

It is also based on the recognition that hedge funds are not so much an asset class but just another investment strategy in pursuit of high alpha returns.

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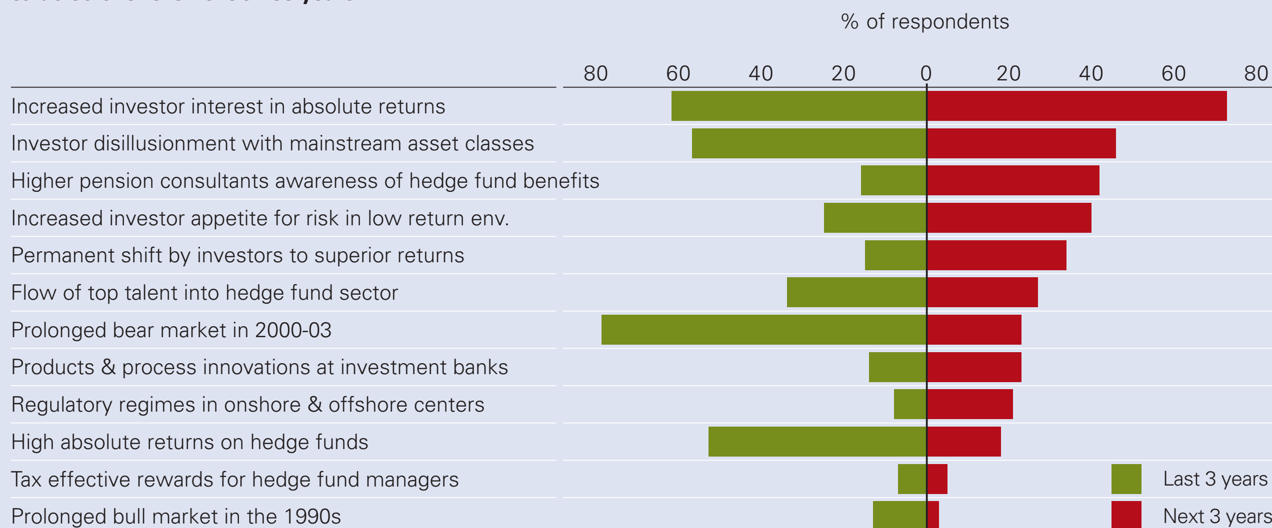
The bear market fuelled demand for hedge funds in the past; now it's the chase for absolute returns driving the growth…



Source: CREATE and KPMG International, 2005

"Without transparency, hedge funds are nothing more than financial alchemy"

"Hedge funds have recently entered the long only world due to its mediocrity"

"We rely on our parents' life funds to underpin the hedge funds business. The impact on the long only business has been nil because we're migrating hedge fund strategies into long only for flexible mandates where shorting and derivatives are second nature"

As this report has unfolded, many common themes have emerged from different players in the value chain of hedge funds.

A recurring one is that the worldwide interest in hedge funds in the recent past has been driven primarily by a combination of a prolonged bear market, heightened investor interest in absolute returns in the face of disillusionment with the traditional asset classes, and high absolute returns notched up by hedge funds. More than one in two fund managers cite this congruence of drivers.

Over the next three years, however, neither the bear market nor the high returns in hedge funds are cited as widely; nor, for that matter, is the flow of top talent into hedge funds.

Instead, it's the interest in absolute returns and their associated strategies that is likely to drive the next wave of growth; aided, on this occasion by rising awareness on the part of pension consultants and increased investor appetite for risks in a low return environment. Most importantly, the large majority of fund managers believe that, even though high returns from hedge funds will no longer be sustainable, investor appetite for absolute return strategies – once whetted – will prevail for the foreseeable future. Hedge funds are thus seen as a catalyst whose real significance extends beyond their status as either an asset class or an investment strategy. A small spark has created a strong and cumulative self-sustaining chain reaction.

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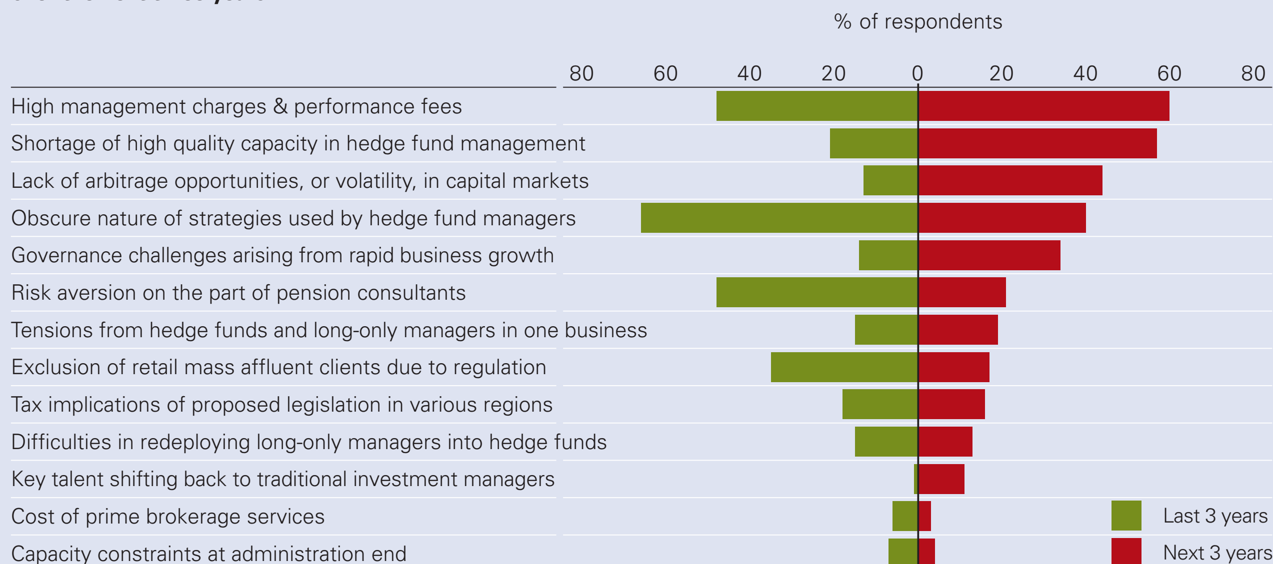
…however, concerns about opaqueness, high charges and lack of arbitrage opportunities will moderate further growth



Source: CREATE and KPMG International, 2005

"Even if our performance was bad, we would not go into hedge funds because of the potential for tension in other teams"

Three factors that were perceived as a drag on the growth in hedge funds in the last three years are no longer perceived in the same light. They are:

- The opaque nature of strategies used (two in three)
- Risk aversion on the part of pensions consultants (one in two)
- Exclusion of mass retail clients (one in three).

However, concerns about charges and fees remain. In addition, other inhibitors are also cited when it comes to growth over the next three years. They are the same as the ones identified in the previous three sections:

- Shortage of high quality capacity (two in three)
- Lack of arbitrage opportunities and volatility (two in five)
- Governance challenges as hedge funds grow (one in three)

"Our long only pot is too lucrative for us to be seduced by anything else. Our good managers are attracting new assets through strong returns and we build their wealth through a stock options programme"

Clearly over-rapid growth has created its own challenges:

- How much of the existing capacity in the hedge funds universe has the potential to generate alpha on a sustainable basis?
- What if the low-volatility low-arbitrage environment persists beyond the next three years?
- Do hedge fund managers have business instincts and the personal will to scale their activities and become normal fiduciary entities?

Individual hedge funds managers can't do much about the first two issues. The last one, however, is paradoxical: as a craft-based cottage industry, things that made hedge funds great in the past – e.g. personal autonomy, trading instincts, originality, innovation – are the very things that have to change. Industrializing a craft is daunting.

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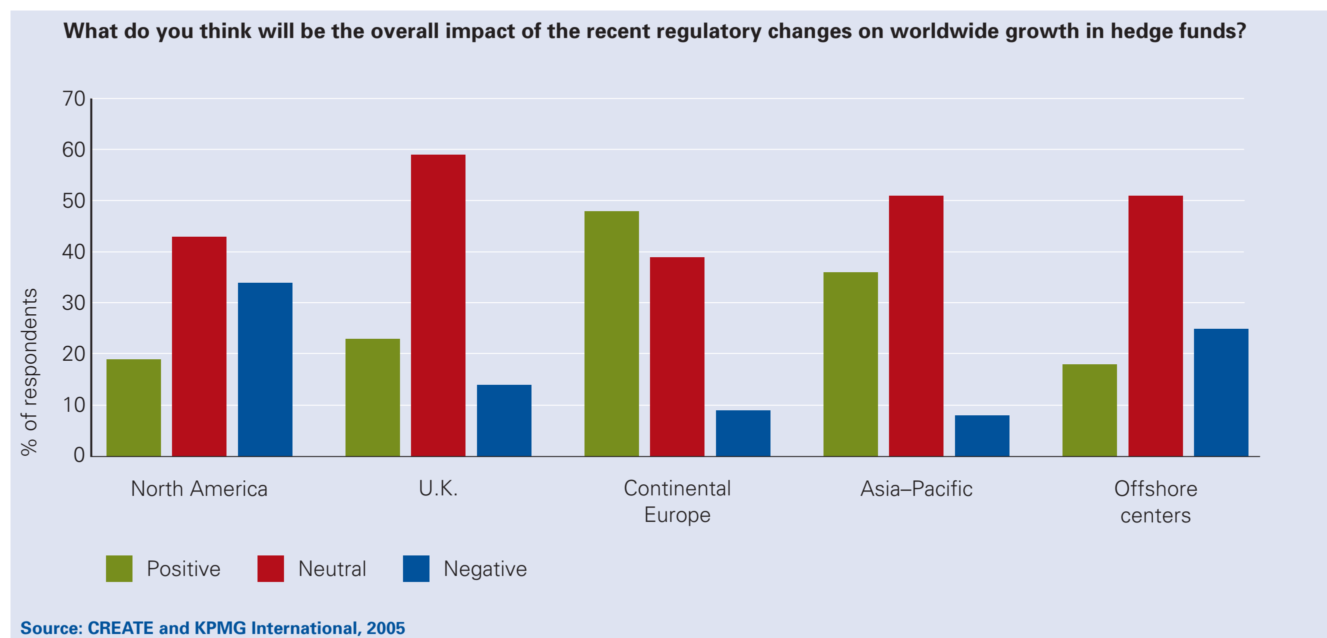
Fund managers welcome the regulation of hedge funds while recognizing its adverse impact on start-ups...



Source: CREATE and KPMG International, 2005

"New regulation is much ado about nothing"

Fund managers do not believe regulation will have a big impact, one way or the other, on the hedge fund industry. However, they recognize that the places that thrived in the past – e.g., North America, the U.K. and offshore centers – may find it hard to sustain the high rate of start-ups (U.S.), skills retention (U.K.) and domicile status (offshore centers) due to recent regulation. The recent retrospective application of tax laws in the U.K. was cited as a retrograde step for the industry. In other regions, regulation has been welcomed largely because of its minimal local impact.

On the other hand, fund managers also recognize that a benign regulatory climate may not attract the next generation of investors. The challenge for regulators is to strike the familiar balance between efficiency and fairness, client protection and enterprise culture. Experiences in large houses have shown that this is not easy: from time to time, regulators have reinterpreted their original intent in the implementation process in ways that can potentially, damage reputations.

"Compliance cost is not a big deal; in any case, we pass it on to clients"

This is one of the prime reasons behind the more evident caution towards hedge funds, especially on the part of large investment houses in Europe and North America alike.

For them, the biggest risk associated with hedge funds is the one that nobody knows.

As a result, in the event of a major mishap, regulators may take a stance whose ramifications are felt well outside hedge funds and affect the whole investment industry business model. This is, admittedly, a minority view. But it is held by some of the most prominent investment houses in Europe, and, to a lesser extent, the U.S..

"Retrospective interpretation is a major concern"

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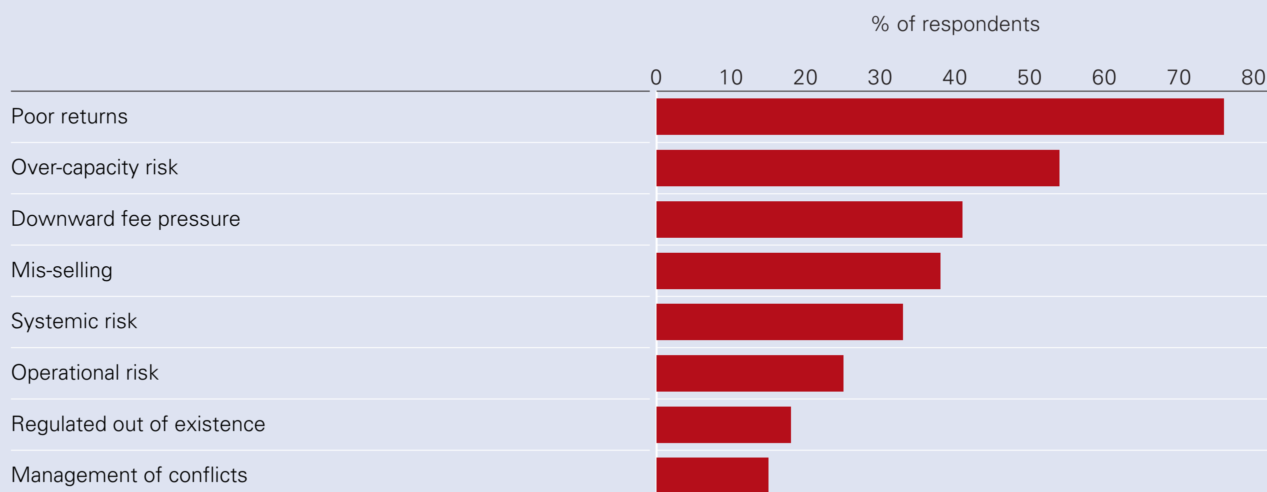
…but they also recognize the risks associated with poor returns, overcapacity and fee pressures that regulators cannot control



Source: CREATE and KPMG International, 2005

"Our management culture is very cautious. We once lost an analyst to hedge funds. Three months later, he wanted to return because the job was still vacant. We wouldn't have him"

"Our foray into hedge funds was disastrous, causing a huge brain drain. Now, it's more co-ordinated and considered"

"Our biggest worry is reputational risk: given our prominence, we are an easy target for the media. We have to keep our name off the front page"

"We went into hedge funds because we wanted to retain a couple of bright sparks here"

Fund managers perceive the risks associated with hedge funds in the same way as hedge funds managers.

The risks are connected more with business challenges than with the inherent features of these funds:

- Seven in ten fund managers cite poor returns
- One in two cite overcapacity
- Two in five cite downward fee pressures
- Two in five cite mis-selling risks.

A much lower proportion cite systemic risks because fund managers tend to rely on a variety of strategies to generate alpha; or operational risk, for that matter, because their equity-based strategies are less exposed to valuation problems.

In any event, fund managers perceive hedge funds mostly as an investment strategy, with their own risk-reward characteristics. The amount of leverage they use is nothing like the ones used in the large blow ups of the past ten years.

Nor are the conflicts of interest arising from having long only and hedge fund managers together widely felt.

Hence, at this point in time, the threat of hedge funds being regulated out of existence is minuscule.

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Fund managers are diversifying into hedge fund type strategies…

Source: CREATE and KPMG International, 2005

"Long short strategies will prevail; there will always be periodic down drafts in markets"

Currently, around one in five fund managers are not involved in either hedge funds or fund of hedge funds; nor are they planning to be involved in the near future. A further one in six is not involved but planning to be involved. So, around one in three managers are not involved at present; the biggest proportion is in North America and the smallest in Asia Pacific.

At the other end, one in six is already involved, but do not anticipate major growth. A further two in five are in and expect major growth. So, around one in two are in; with the majority anticipating significant growth.

"Our in-house alpha products are well suited to hedge fund strategies, so we are into single, multi and fund of hedge fund strategies"

That said, their approaches are highly eclectic, to say the least.

For some, hedge funds defy definition to the extent that many of their recently adopted strategies are hedge fund type, without inviting that label. They use structured products; or have equity products with high tracking errors that permit shorting; or use strategies that seek to generate high alpha in the long only space.

Some have even created separate boutiques around alpha-based products in order to give more autonomy and space to their portfolio managers, as identified in our 2004 report and the *Executive Summary* of this report.

"We are deploying aggressive strategies in the long only space. Three percent of our assets rely on shorting and another five percent on derivates trading; these numbers can rise rapidly without capacity constraints. It's all about giving your managers more latitude"

At the other extreme, some managers have created overt hedge funds strategies or set up fund of hedge funds. Some have Chinese walls between long only and long short; some have none. For the majority, their incursion into hedge funds started in the last three years or so.

This variety in approaches underlines another recurring theme in this report: investors are interested in absolute returns, not hedge funds *per se* and hedge funds are seen as a part of holistic solution, not a panacea.

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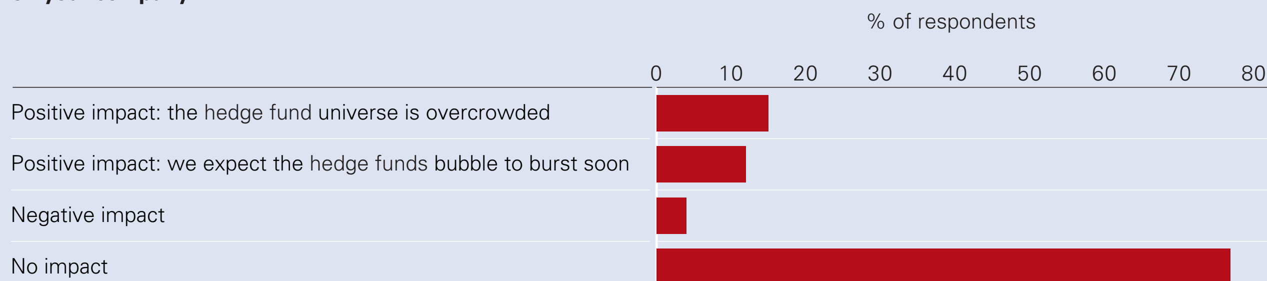
…however, those fund managers who are staying out do not anticipate a backlash

By excluding yourselves from entering the market for hedge funds or fund of hedge funds, what will be the impact on your company?



Source: CREATE and KPMG International, 2005

"Hedge funds are not the only way of separating alpha and beta"

"Prime brokers are making a lot of money out of hedge funds and jeopardizing our business; we are reappraizing our relationship with them"

"Our success rests on the fact that we've beaten the index over an extended period by selling products with low correlation, low volatility, low draw-downs and little leverage. We're an alpha shop with a hedge fund image"

"It's not easy to develop a hedge fund business inside a traditional house; you need different controls and incentives"

A big majority of fund managers who are staying out of hedge funds or funds of hedge funds believe that their exclusion will have no impact on their company. On the contrary: there are concerns on the part of a small minority that overcrowding may well cause the hedge funds bubble to burst before long. For them, the price of going in exceeds the price of not going in. This assessment, once again, underscores a wider point about how fund managers perceive hedge funds:

- They are simply another way of investing
- They are one of many ways to achieve high performance
- Like other strategies, they have downside risks
- These risks are driven by over supply and strategy concentration.

For sure, their attitude to hedge funds is characterized more by hard calculus than benign neglect. For they include some of the most successful fund managers especially in the U.S. and, to a lesser extent, in Europe. They believe that:

- Investor appetite for hedge funds will evaporate: as markets recover, as they will eventually, high charges and fees will vastly reduce their appeal. After all, investors chase returns, not asset classes

- There are alternative ways to deliver absolute return aspirations: hedge funds are not the only one, even if one ignores their unique capacity and opaqueness challenges

- Long short strategy can be self defeating: it is hard to engage in stock lending and at the same time build relationships with the same companies in the name of 'shareholder activism'.

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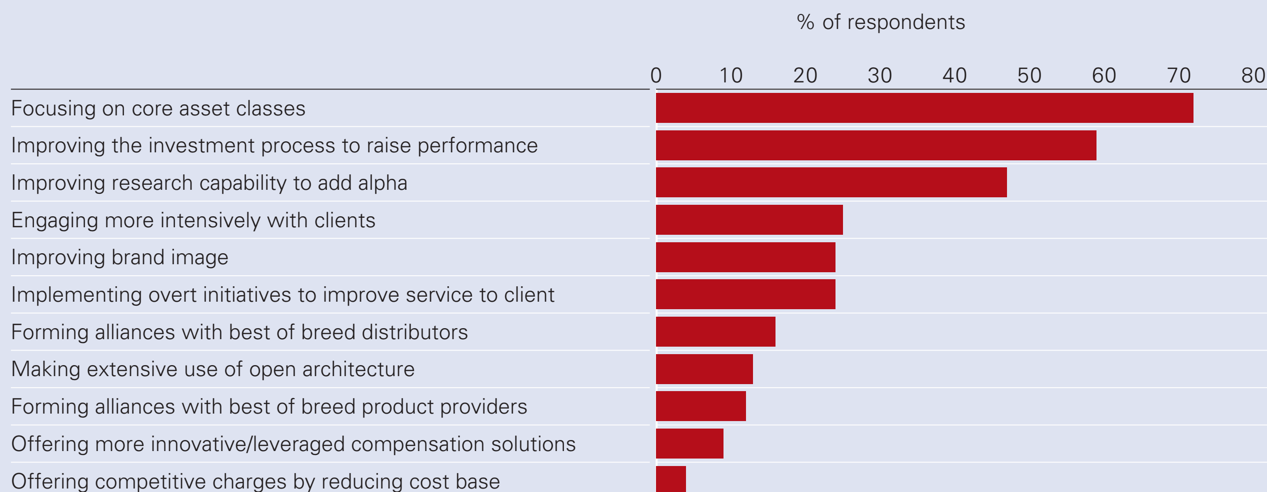
They don't anticipate a backlash because they are pursuing other ways of delivering alpha within a boutique environment…



Source: CREATE and KPMG International, 2005

"We make money by compounding: it doesn't make people rich, but it keeps them rich"

Those staying out of hedge funds have implemented a number of defensive actions. Three are adopted more widely than others, with the first more popular in Europe, and the second in North America.

First, seven in every ten are adding sharper focus to their core asset classes. This has involved separation of alpha and beta in manufacturing; and creation of new competencies in assembly, blending core products with overlays that provide alpha or meet liability benchmarks within a boutique environment, as explained in the *Executive Summary*.

Second, three in five are revamping their investment engine by sharpening the investment process, accommodating unconstrained benchmarks and streamlining the platforms into fewer locations.

"Hedge fund managers are driven by fear of failure and greed for money"

Third, nearly one in two are improving research capability by bringing in new recruits; focusing on insights, not information; and reducing dependency on the sell side.

These and other actions are being implemented within one of three boutique structures: one involving internal product-based teams, backed by mid and back office support; one by taking minority equity stakes in independent alpha shops and having preferential treatment on capacity and charges; one by creating separate fiduciary units that are centers of excellence in their own right. All aim to promote high conviction ideas in an environment of personal autonomy and meritocratic rewards.

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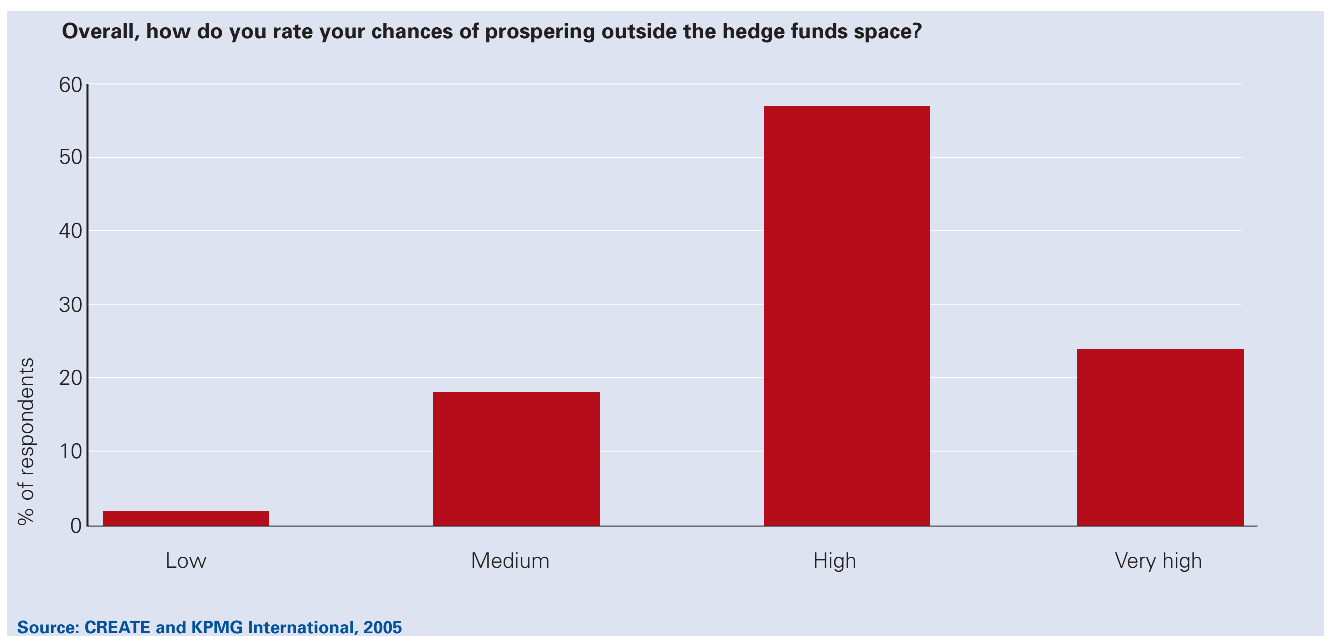
…and they think that they will succeed outside the hedge funds space



Source: CREATE and KPMG International, 2005

"Hedge funds will soon become a non-issue"

Those fund managers staying out of overt hedge funds and fund of hedge funds are very optimistic about their chances of success. Optimism is highest in North America, followed by Asia Pacific, then Europe.

Apart from their previously cited reservations, their assessment is based on the fact that hedge funds are not the best way to redeem the sins of the past.

On this argument, hedge funds are not the cause of widespread interest in absolute returns. Rather, they are a symptom of what was wrong with fund managers' old business model.

"The choice is not between hedge funds and other funds; it's between leverage and non leverage"

There is ample recognition that a model that only worked in a bull market is a recipe for disaster in today's low nominal return environment.

Worst of all, its failure to separate active management from closet tracking did untold harm to the credibility of fund managers.

Not surprisingly, bringing back the long-term buy and hold investors into the market is difficult, considering the perceived lack of trust from some client groups.

"Investors also don't like paying double fees. They would rather go to multi-strategy shops with a good track record and a trusted brand."

Thus, the delivery of absolute returns is not just a matter of adopting holistic investment strategies. It also requires holistic actions in order to produce a business model that works in good times and bad.

Hedge funds have merely served to remind fund managers what their *raison d'être* is; no more no less, so the argument runs.

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However, those fund managers providing hedge funds see them as a credible diversification route into a new asset class

If your company already manages or plans to manage hedge funds, or fund of hedge funds, what are your principal reasons for doing so?

Source: CREATE and KPMG International, 2005

"Hedge funds account for five percent of our assets and contribute 15 percent of profits"

"Outlook for bog standard equity products is dim and equity prices are trading in narrow ranges"

"Ever since we started a new hedge fund business, many single strategy boutiques have shown interest in merging with us; they don't see a future outside an established fund management firm"

Amongst fund managers, there is a marked contrast in the views of those who have stayed out of hedge funds and those who have gone in: the first are fundamentalists, the second pragmatists.

Amongst the pragmatists, more than one in four see them as:

- A credible diversification opportunity (seven in ten)
- A more established asset class (two in three)
- A way of meeting client needs (one in two)
- A way of earning high charges and fees (two in five)
- A means of retaining top talent (one in four).

Their pragmatism is based on the belief that the worst bear market in living memory has pushed the global fund management industry to a new inflection point. Major discontinuities will necessarily render the future very different from the recent past. So, it's better to swim with the tide and cope with the unfolding reality en route than swim against it.

On this argument, markets will recover and interest in hedge funds may wane; but clients have wised up. Their interest in absolute returns is no more than a revival of how things were in the 1960s and the 1970s before the hype about relative returns and benchmark hugging managed to blind so many investors, so many times, for so long.

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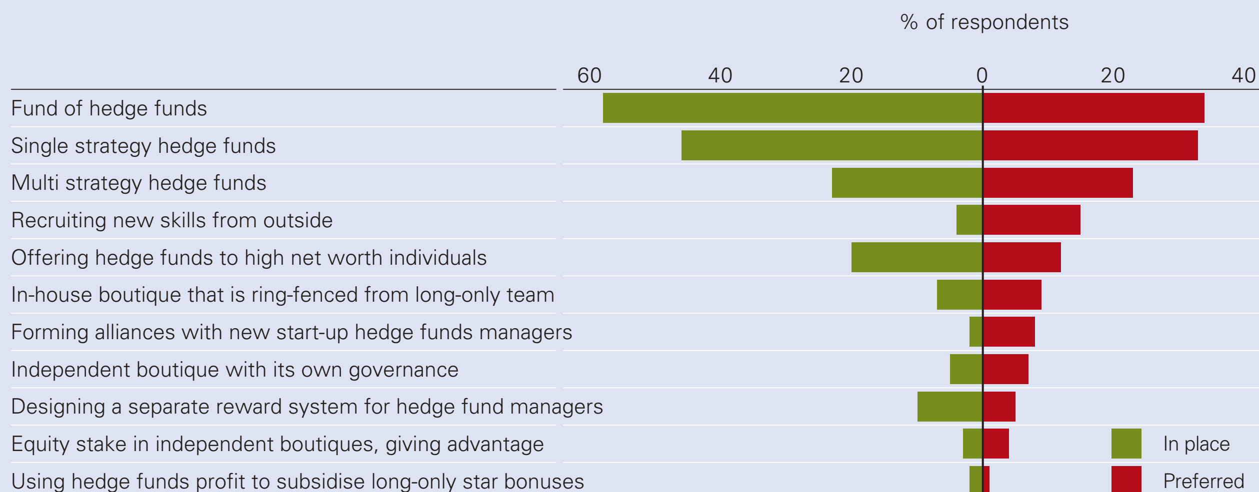
The most preferred route for diversification is fund of hedge funds…



Source: CREATE and KPMG International, 2005

"We provide single strategy hedge funds through a ring-fenced private company; and fund of hedge funds in a separate more public vehicle because of potential reputational risk if hedge funds blow up."

"Ten out of our twelve hedge fund managers are home grown and picked through a meritocratic process"

Those 50 percent of fund managers, who have ventured into hedge funds, have used one of the four routes.

Around three in five of them have used the fund of hedge funds route that has involved one or more of the following:

- Buying minority equity stakes in independent hedge funds boutiques that offered the most favored nation clause: namely, a seat on the board, privileged access to capacity, and favorable charges and fees
- Forming alliances with these boutiques that gives distribution rights and privileged access to capacity
- Having arms-length relationships on a transaction basis.

Around two in four fund managers have started their own single strategy funds by creating a specialist internal capability; in some cases, it is ring-fenced from the long only business; in others, it is not.

Around one in five has gone into multi strategies hedge funds, as an extension of their single strategy offerings.

Around one in five have seeded their early ventures with investments from high net worth clients – a phenomenon very strong in the U.S..

Over the next three years, this form of diversification will continue, with fund of hedge funds or single strategy hedge funds being the most preferred routes.

The popularity of the fund of hedge funds route reflects two considerations: managing headline risks and accessing prime capacity.

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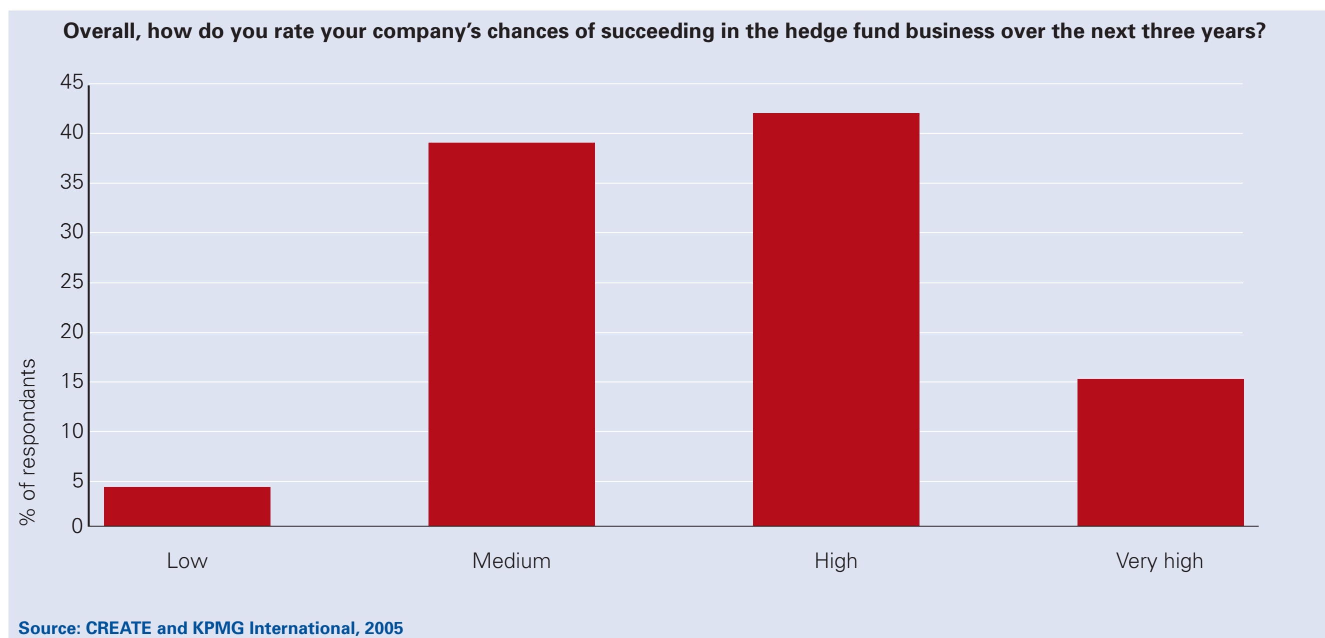
…and, as a result, fund managers are fairly confident about their chances of success



Source: CREATE and KPMG International, 2005

"We went through a Darwinian exercise collapsed in time"

Those 50 percent of fund managers who have ventured into hedge funds rate their chances of success fairly highly: noticeably more so in North America, than elsewhere. Notably, their bullishness is equally matched by their compatriots who are out of hedge funds.

This confidence with hedge funds, in turn, is based on a number of factors.

To start with, the amount of funds involved have been relatively small, varying from 0.5 percent to 12 percent of their total FUM. However, hedge funds often represent a disproportionately larger proportion of net revenue.

"A third of our assets are in hedge funds; they produce 80 percent profits. Size is a killer of profits"

The incursion has been a controlled process, starting with a paper portfolio, followed by a small seed investment, prior to cash allocation.

They have also implemented a series of other changes to their business models, such that the diversification into hedge funds is part of a larger package of measures.

Last, but not least, for many it's been a matter of triumph of hope over the uncertainties unleashed by the bear market.

In the unpredictable environment since 2000, they feel that the price of going into hedge funds is only exceeded by the price of staying out of them; in marked contrast to those who have gone in.

"Hedge funds are not the answer for us. But their underlying philosophy is"

For them, as market dynamics have changed, so has the aversion to try something new and different.

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Thinking aloud…

"Many of our top quality managers deserted us in the 1990s because they wanted to manage money in an unconstrained manner with total incentive alignment. Some went in at the arbitrage end; some at the skills end. Most of them ended up delivering terrific returns. In the meantime, our long only managers struggled to add value especially in our unwieldy structure. We had to do something at a time when our clients wanted a hefty equity premium.

The answer: separation of alpha and beta. At the outset we recognized that hedge funds were a fad: they are yesterday's answer to today's problems. Excess market volatility and big ego-centric M&A deals helped them in the late 1990s. Today, that impetus has gone even after ignoring the fact that a lot of mediocrity has joined the fray in the meantime. The easy trades are just not there anymore. Markets, too, have become more efficient, as more players are arriving.

Regulation will have little effect. Institutional investors are being seduced by prospects of uncorrelated excess returns, nothing else. The fund of hedge funds route which they are adopting is expensive. Prime brokers take huge fees for little risk; their role is to bring buyers and sellers together.

Yet, we recognize that our old model no longer works. So we have divided the business into two. Beta products are separately manufactured and sold on our parent bank's global open architecture platform, alongside the best of breed competitor products. Alpha products are consolidated into a new ring-fenced boutique, which blends single strategy hedge funds with the best of long only products. This alpha shop has its own dedicated research capability which it shares with the in house beta producers. It manages style-free non benchmark equity funds on skills and skills alone.

This unbundling was relatively easy. Asset managers wanted to migrate to their natural space and focus on what they are good at; clients are no longer so indulgent. Our sales-driven culture in the 1990s is no longer tenable in today's environment where performance is the product. That culture can only survive in the beta space.

In the alpha space, managers need to spend every second of their waking hours on adding value. They need the maximum degree of freedom to create their own strategy and process, without turning into lone guns. We have a peer group review process which regularly provides a reality check and detects disasters long before they happen. Perversely, our problem is that our most talented managers' behaviors still resonate with old style bureaucracy: latitude creates fear of failure, as an unintended outcome.

Fund management arm of a global bank

Source: CREATE and KPMG International, 2005 – Interview quotes

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4 Administrators of hedge funds

"Change is the law of life. And those who look only to the past or to the present are certain to miss the future"

President John F. Kennedy

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Administrators of hedge funds

This section presents the results from the survey and interviews, involving administrators of hedge funds in all the key regions. It also presents the views of prime brokers involved in our interviews. The main points emerging are:

- **Complexity:** Each hedge fund is unique: it has its strategy, financial instruments, risk reporting, performance measurement and regulatory compliance. This has required a big investment in IT and people alike, especially in anticipation of ever more demand for independent valuation. But the prevailing low fees have ensured that the focus is on strategies that are easier to value.

- **Scale:** Some administrators cover the whole spectrum of front-back activities. Their bespoke services don't scale easily until a critical mass is reached. The challenge for them is to specialize and differentiate in order to meet the demands of new investors and new strategies.

- **Bullishness:** Unsurprisingly, like hedge fund managers, their administrators are also bullish about the prospects for their industry and for themselves; notwithstanding a slow down in the growth of new money and lower returns on them. Like hedge funds managers, they, too, qualify their bullishness.

- **Risks:** The key risks that they perceive at the client-end are associated with poor returns, mis-pricing and over crowding. But these front-end risks offer huge back-end opportunities. Their concerns about mis-pricing are worrying, however, given their proximity to the operations. There is also real concern that the sheer weight of new money from pension funds will drive down the returns unless hedge funds attract top talent that can innovate and commercialize at the rate commensurate with returns expectations.

- **Regulation:** They also welcome the new regulation because it will be yet another way of professionalizing the industry. Also, it will enhance the scope of their compliance and reporting services.

- **Capacity:** What is true at the client end also holds at their end: there is a shortage of capacity at the complex end of administration and a huge surplus at the commoditized end. The bifurcation is evident. It is hard to scale at the former end because it is dominated by skills-intensive knowledge-based activities requiring a range of financial expertise. There is a worldwide shortage of experienced staff in middle to back office operations; alongside an acute shortage of expertise in complex services.

- **Satellites:** There is a drive to centralize in lower cost operations (e.g. India and Canada); or dedicated skills centers (e.g. Ireland , Luxembourg and the U.S.). The front value added end is being moved closer to hedge fund managers in London and New York, raising a challenge for the traditional offshore centers. A new convergence is evident, as administrators blend seamlessly with hedge fund managers in range of front and middle office services.

- **Consolidation:** This is anticipated through two routes: mergers that will bring more global universal banks into the fray; and diversification by prime brokers into ever more bespoke services as a part of their offerings. In addition, prominent software houses are starting to enter the administration market.

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Thinking aloud...

"As part of a global bank, we provide a range of services like accounting, valuation, credit, forex, distribution and back-end risk management.

This is a very profitable business, with minimum fees of around 15 bps plus sliding scale with no caps. Additionally, investors borrow 2 days in advance, so we make money on floats as well.

Capacity is our number one challenge because of acute shortage of skills in places like Bermuda, the Cayman Islands and the U.S., where some of our key operations are located.

Besides, our business is not readily scalable because every hedge fund is different, requiring a lot of time with hedge fund managers.

The penal tax regime in the U.S. – the so-called 10 commandments from the IRS – initially drove a large chunk of administration to the Caribbean.

Now that the regime has changed, more and more of the new admin work is done closer to key clients in the U.S..

Be that as it may, we have tried to standardize our reporting tools but this has been hampered by the growing demand for independent pricing and valuations, both of which are skills intensive, knowledge-based activities that are traditionally associated with the consultancy world.

Our clients view us as long-term partners because no one changes their administrators; there's too much work and hassle involved. In any event, the values of new assets that we handle are doubling each year.

The biggest growth area for us currently is fund of hedge funds. Paradoxically, their clients want to diversify risks: but they don't really know where their funds are invested and what strategies are adopted. They only get valuation once a month.

People say that single strategy funds are maxing out. But I don't know any manager who has turned away a celebrity investor; very few funds are genuinely closed. Greed and egos always override reason.

The key challenge for our clients is whether they can develop a multi-product or multi-strategy capability. Pension funds don't like style drift. That means they need specialism across the whole water-front. This is a very expensive proposition for them because one manager can't cover more than one strategy. Besides, hedge fund managers like to manage money, not business."

A hedge funds administrator from a global bank

Source: CREATE and KPMG International, 2005 – Interview quotes

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Thinking aloud...

"We provide administration, custody, cash management, forex, electronic and commission management services.

Our biggest challenge is what is a hedge fund? Because they are so amorphous, where do you draw the line? In the past, they covered long short strategies; now they cover arbitrage, asset securitization, loan book, macro development and many others. Like the universe, they are expanding in different directions and covering everything around them.

On the one hand, they are converging towards traditional asset classes like equities and private equity.

On the other hand, they are becoming hybrid in nature. This has two implications. First, they have to be customized to client needs to the extent that you can't pile them high and sell them cheap.

Second, some of them pose huge pricing challenges to the extent that they do not scale easily in the back office. For example, plain vanilla funds can be scaled but as the strategies become more hybrid, their complex valuation makes scale economies ever more illusory.

Hence, most of the back office activities attract a basic fixed basis point fee until a critical mass develops when the ad valorem fee kicks in. The problem is rendered difficult by the size of every transaction.

Given the relative newness of the industry, most of our transactions start out at around US$50 million and take two to four years to build up to a level where the scale benefits kick in. The attrition rate is high so we have to be very selective on whom we take on. In the meantime, you have to carry unused capacity: both IT and people.

Our biggest challenge is in recruiting bright accountants who can do the complicated price valuations. There is a shortage of them and the ones who are interested want to work with hedge funds or fund of hedge funds. Administration does not have a glamour image, I'm afraid. We draw a distinction between outsource (low value end) and smart source (high value end). Much of what we do is at the latter end. But it's not easy to get that across to talented accountants.

Our clients recognize that administration is not a body shop activity. Yet they are unwilling to recognize the challenges we face as a result of the high scale threshold.

We shall doubtless see consolidation in the administration business. On our part, as opportunities arise, we shall be buying geographical capacity or expertise; not the book."

A global bank in hedge fund administration

Source: CREATE and KPMG International, 2005 – Interview quotes

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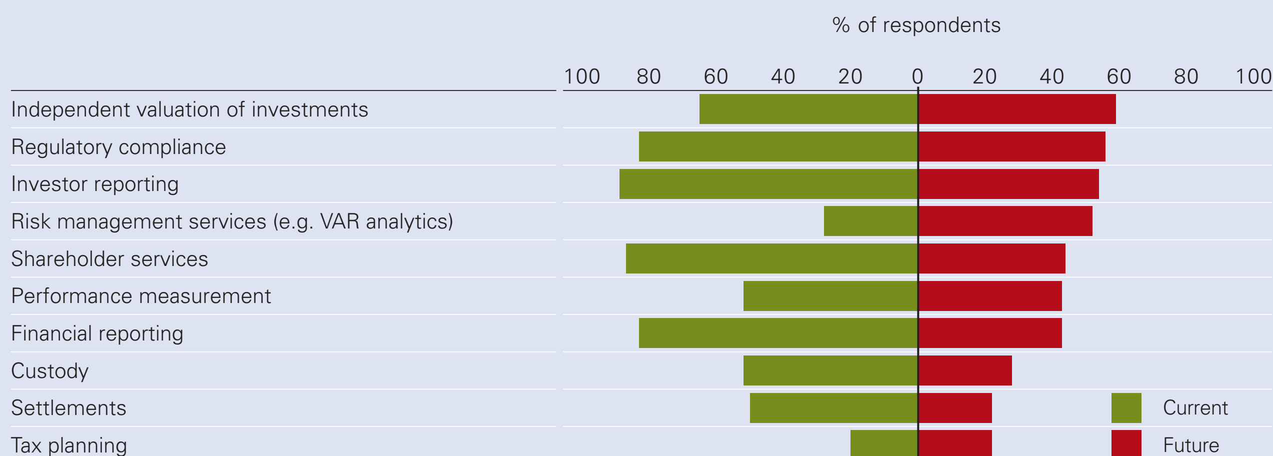
Growth will focus on high value added administration services

What hedge funds administration services does your company currently provide and which are likely to grow markedly in the next three years?



Source: CREATE and KPMG International, 2005

Interview quotes:

"Pricing is a big issue. Some managers make up their own derivatives. OTC models are increasingly used but there are time lags on pricing and different methods. There's a need for standardized modeling techniques"

"There is likely to be a move to fund of managed accounts where the underlying investments are transparent"

The value chain of administrators of hedge funds is long and varied. It covers a blend of low, medium and high value added services. All administrators aim to straddle the whole chain. However, shades of specialisms are evident.

For example, *tier one* administrators provide all of them, while also specializing at the mid and high end: e.g. valuation, compliance, and risk assessment. At the other end, *tier three* administrators focus on routine services, like investor reporting, shareholder services and settlements.

It is clear that while demand for most of these services will rise in line with the worldwide growth of hedge funds, it will be focused mainly at the complex end, involving:

- Independent valuation
- Regulatory compliance
- Investor reporting
- Risk reporting
- Performance management.

In large part, this growth is indicative of the shift in the mix of end-clients, as more and more pension funds invest in hedge funds over time. In particular, they want fair valuations based on transparent pricing methodology. They also want administrators to send valuation reports directly to them, rather than via hedge funds managers.

While they recognize that some vehicles are harder to value than others – e.g. emerging markets, distressed securities – they want to be satisfied that the methodology and reporting is fair and robust.

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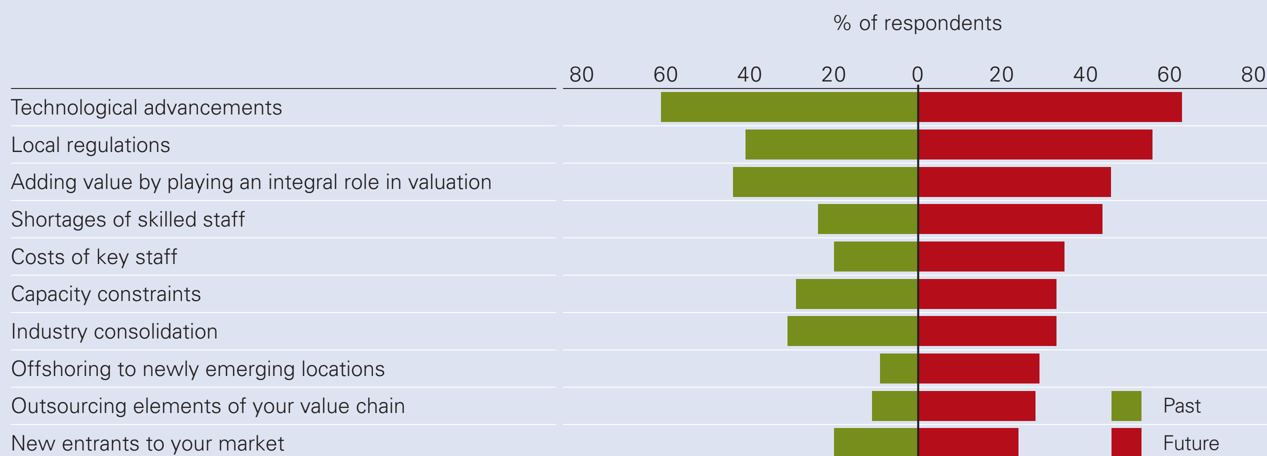
The complexity of administration business limits its scalability…

Which factors, if any, have had most impact on your business over the last three years, and which ones will have the most impact over the next three years?



Source: CREATE and KPMG International, 2005

"Most hedge fund managers are exposed to operational as well as investment risks; they've never managed a business"

"Prime brokers should do the valuation because if you want to regulate credit, start at the giving end, not the receiving end"

"Hedge funds under management worldwide will hit US$4 trillion. Behemoths will go for them and dilute the returns"

"Usually scale benefits kick in after three years' growth; with the risk that the earmarked capacity is under-utilized in the event of a failure"

Worldwide, a new infrastructure – of systems and skills – is being created on the back of the headlong growth in hedge funds.

In the last three years, demand for valuation and reporting services has led to significant investment in technology. In part, this has led to bifurcation between tier one administrators and the rest. Over time, as hedge fund strategies become more complex, the key differentiator will be the ability to scale the processes with new technology. Many software firms are likely to enter the industry.

Many global banks have already entered the fray – through organic and acquisitional routes – in the belief that they cannot only provide administration services; but also those currently offered by prime brokers. One can be used as an entry point for the other.

Indeed, some universal banks see a convergence between prime broking and administration as part of one-stop solutions for hedge funds managers. In any event, huge investments have been made in order to create scalable businesses. But this has not been easy.

To start with, the high value added services do not scale easily due to their complexity and the way capacity is allocated. Second, it is unclear what conflicts of interest may arise out of this convergence. Third, the complex end requires a growing army of experts with accountancy, legal and trading skills. It has proved hard to attract them because administration does not have the same glamorous image as hedge funds or prime broking. Skills shortages have been acute in a range of financial disciplines, especially in Ireland, the U.S. and the Caribbean. Third, at the mid and low value end, it is hard to ramp up capacity usage because each new hedge fund manager is allocated a certain amount of capacity which takes into account the potential growth in their business.

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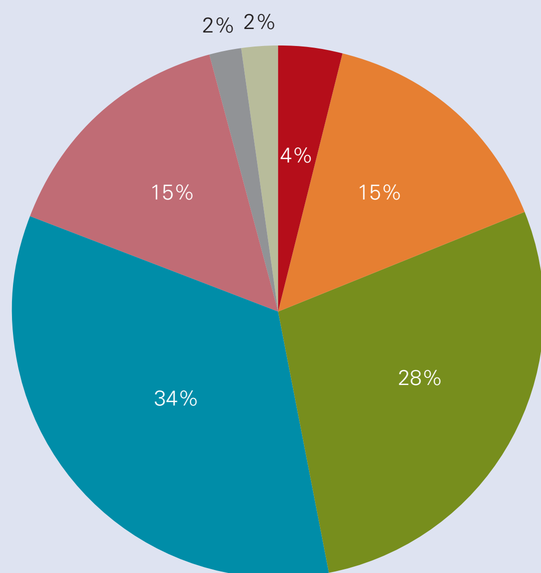
…even so, administrators are even more bullish about the growth of hedge funds worldwide

What do you anticipate will be the average annual growth in FUM in the hedge funds industry worldwide over the next three years?



% growth bands	
Negative	0(%)
Nil	4(%)
1–10	15(%)
11–20	28(%)
21–30	34(%)
31–40	15(%)
41–50	2(%)
Over 50	2(%)

Source: CREATE and KPMG International, 2005

"With valuation of investments, there is much duplication of effort between administrators and prime brokers. Regulation may cause automatic separation"

"Administrators need to understand financial instruments and not just book them – we risk not knowing what we have on the books"

Not surprisingly, for the next three years, the expected growth in the demand for hedge funds is likely to grow substantially. Administrators are even more bullish on this point than managers of hedge funds or fund of hedge funds. However, behind this seemingly bullish assessment, there are a number of divergent tendencies.

First, in the regional context, the fastest growth is likely in North America, then the Caribbean region, then Asia Pacific and finally Europe. In particular, the U.S. will remain the epicenter of front, middle and back offices alike.

Second, growth will be concentrated at the high value added end, as discussed previously. As hedge funds vehicles become more complex, administration and investment will increasingly overlap. Proximity through physical or technological presence becomes vital. Some administrators are moving the hub of their back office systems to lower cost centers or to satellite offices nearer to clients.

Third, having started from a small base, administration businesses in Europe and Asia Pacific are developing rapidly. However, they have yet to develop the scale of technological and skills infrastructure that can match North America and the Caribbean. Their fortunes critically depend upon:

- The rate of growth of the domestic hedge funds industry
- The ability to spot future winners at the screening stage
- The amount of surplus capacity in North America and the Caribbean
- The extent of their linkages with tier one administration houses.

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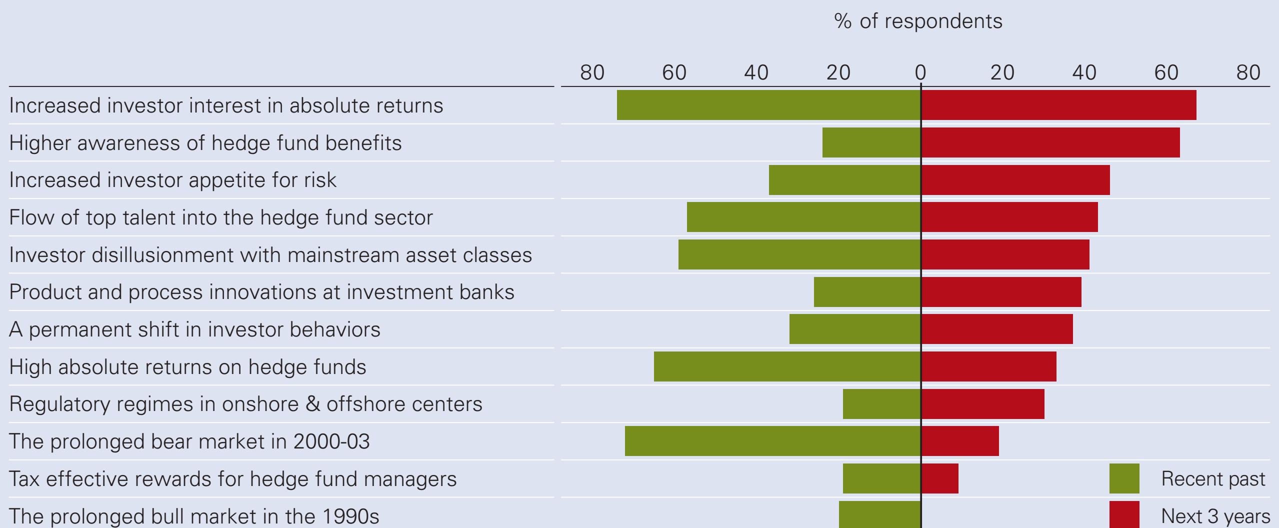
Interest in absolute returns will remain the key driver of future growth

Which factors have fuelled the worldwide growth in hedge funds in the recent past, and which ones are likely to do so over the next three years?



Source: CREATE and KPMG International, 2005

"A large amount of hedge funds capital has no independent administration. That's good news for us, but bad news for their image"

Taking a broader view of the hedge funds industry, administrators attribute its recent growth to five critical drivers:

- The bear market (cited by seven in ten)
- Increased investor interest in absolute returns (seven in ten)
- High absolute returns on hedge funds (two in three)
- Investor disillusionment with other asset classes (three in five)
- Flow of top talent into hedge funds space (three in five).

Looking to the next three years, the key drivers are likely to be:

- Interest in absolute returns (two in three)
- Higher awareness of the benefits of hedge funds (two in three).

A number of inter-related aspects of this shift are worthy of note.

"There's enough capital in the systems at present for hedge funds to survive – they don't need retail money as much as retail investors need them!"

First, high returns on hedge funds are no longer taken for granted. It is arguable whether these returns were, in fact, a bear market phenomenon.

Second, increased awareness of the benefits of hedge funds does not translate into higher returns on them. The implications are that the next wave of growth will not see spectacular returns, as the last one did.

Third, the flow of talent into the hedge funds space is likely to ease; with all that it implies for creating high quality capacity by attracting new blood into the industry.

Fourth, the competitive landscape will become tighter for hedge funds, as investor disillusionment with other asset classes diminishes. As we argued in Section 3, hedge funds are one of many ways to access alpha.

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However, lack of arbitrage opportunities and premier capacity will dampen this growth

Which factors have hindered growth in hedge funds in the recent past, and which ones are likely to do so over the next three years?

Source: CREATE and KPMG International, 2005

"There is a shortage of accountants and operational people with the required skill sets and understanding of the industry. Not enough people understand hedge funds"

"Valuation is a key issue for the industry. At present, many administrators are glorified 'Yes' people; they are not paid to look at risk analysis or complex derivatives. Fees need to be increased – this is a no-brainer"

As with its drivers, so with its inhibitors, very subtle shifts are evident in administrators' assessment of the nature and scale of factors that will slow down growth in hedge funds worldwide.

Two significant inhibitors of the recent past are likely to have less relevance: namely, the obscure nature of strategies used by hedge funds and risk aversion on the part of pension consultants.

Success of hedge funds has created its own challenges. Factors that will slow down growth include:

- Lack of arbitrage opportunities or volatility (one in two)
- Shortage of high quality capacity (one in two)
- Governance challenges (two in five).

This shift is symptomatic of the growing maturity of the hedge funds industry, as perceived by administrators.

It means that, as competition for alpha performance intensifies, it will no longer be enough to be a good manager to run hedge funds.

Investors also want in place all the necessary fiduciary and governance structures that are the hallmark of a sound business. The transition from a cottage industry to mass customization is one that not many hedge fund managers relish.

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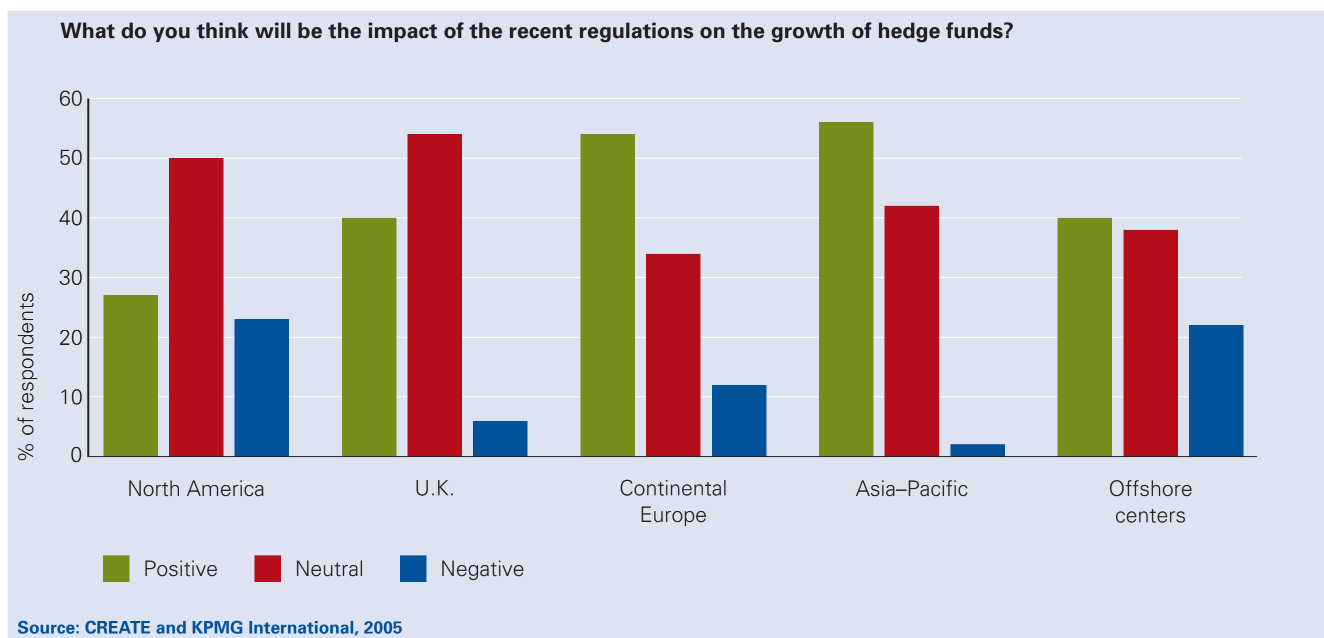
Administrators welcome the new regulation…



Source: CREATE and KPMG International, 2005

"Regulation is good for the industry – contrary to some, we don't believe it will provide a rubber stamp to smaller players"

Administrators' assessment of the impact of the new regulation in the U.S., and Europe is positive at best, and neutral at worst.

Regulation has been welcomed for three reasons.

To start with, it adds greater transparency to some hedge funds activities and raises the comfort level of the new generation of clients.

In Europe, for example, it is seen as instrumental in bringing in institutional and retail clients.

"Regulation means more business for us"

In Asia Pacific and offshore centers, it is seen as raising the comfort level of fund of hedge funds managers, whose end-managers are based in London or New York. Regulation is seen as a method of improving due diligence.

Furthermore, administrators earmark capacity to their clients in the belief that their business will grow. They do the necessary due diligence on their clients in order to spot the winners.

"Regulation will ensure the survival of the fittest"

Regulation is seen as a minor way of driving out those hedge fund managers who lack the necessary basic fiduciary and compliance structures that are essential for success.

Finally, regulation will undoubtedly create more work for administrators in the area of reporting and compliance, thereby enhancing some of the existing service lines.

"Regulation will drive out the cowboys"

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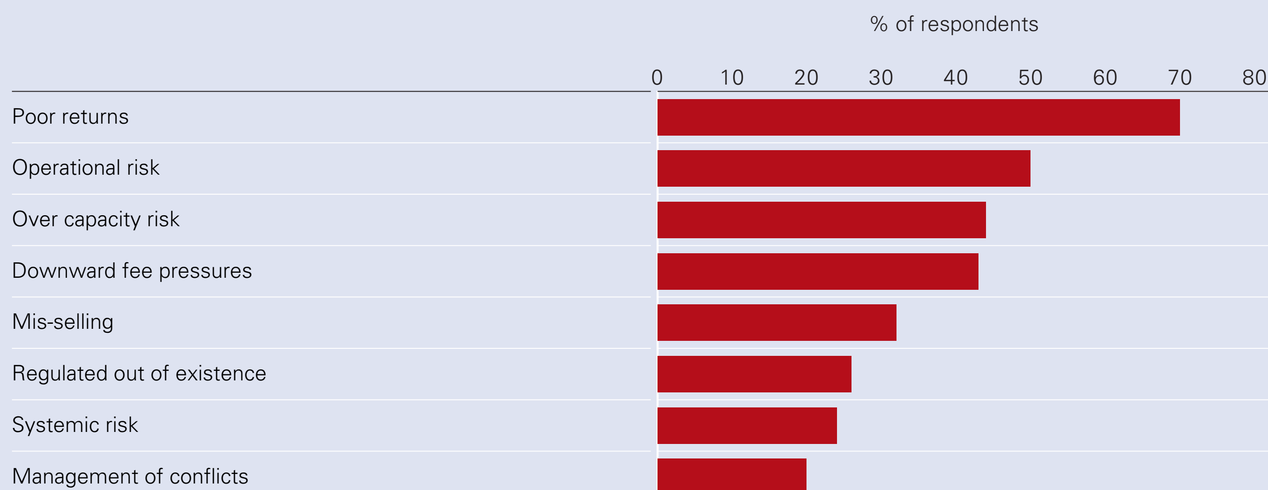
…but are concerned about risks associated with poor returns, mis-pricing and overcapacity



Source: CREATE and KPMG International, 2005

"Key-man risk is the greatest risk facing the boutique model"

Looking over the next thee years, the risks facing the hedge fund industry emanate largely from the supply-side, according to administrators of hedge funds.

Four key risks identified by respondents are:

- Poor returns (seven in ten)
- Operational risk (one in two)
- Overcapacity (two in five)
- Downward fee pressures (two in five).

"Investors want independent pricing. Many tier two and three firms are not tooled up for it yet"

Operational risk largely relates to price valuations. At present there are no industry-wide standards on fair valuations for some of the more complex securities. The accessibility, availability, timeliness and quality of price sources are variable. Reportedly, some 50 percent of hedge funds do their own valuation. This may be acceptable for equity-based strategies; but not derivatives and arbitrage-based ones. Not surprisingly, therefore, administrators regard operational risk as important.

The other risks which they perceive have two origins: immediate and basic.

The immediate risk is associated with a large amount of money chasing limited prime capacity, and ending up mainly with many of the reportedly mediocre managers.

"We don't think or worry about things we can't control"

The basic risk is associated with the fundamental fact that the industry can only grow effectively at the rate at which it attracts new talent, promotes innovation and commercializes new ideas. For sure, new money has attracted talent into the industry; but has not ensured innovation and its commercialization at the required rate.

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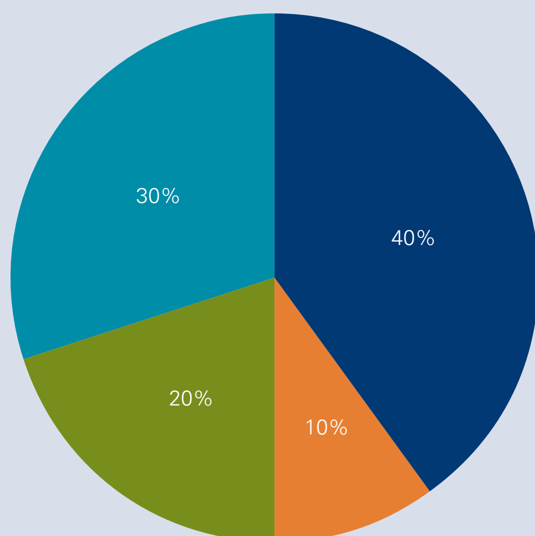
There is unused capacity in low value-added administration services and shortages in high value-added ones

How much of your company's capacity for hedge funds administration is currently being used?



% capacity usage	
Less than 25	40(%)
26–40	0(%)
41–60	10(%)
61–80	20(%)
81–100	30(%)

Source: CREATE and KPMG International, 2005

"There are capacity issues, especially with fund of hedge funds – the due diligence requirements are increasing as more specialized funds are being incorporated"

"Fund of hedge funds are the largest growth area. Problems are double layering of fees and lack of transparency on underlying positions"

Overall, there is little doubt that there is a wide margin in the global administration industry. Large banks and specialist institutions alike have invested upward of $5 billion in the IT infrastructure alone; all this in anticipation of a massive growth in demand.

At a more detailed level, however, the picture is more complex.

First, the margin of under-utilized capacity is highest in Europe, then Asia Pacific, then the Caribbean and then North America. In Europe, the industry is still in its early phase. In Asia Pacific, it is in its early phase, too; except that the size of infrastructure has been more modest.

Second, the surplus capacity has been mainly at the commodity end; at the value added end, in contrast, there are acute shortages of accountants with trading knowledge who can handle complex valuation and VAR analytics. These shortages are more acute in the U.S., Ireland and parts of the Caribbean. There will be a global redistribution of commodity services to places like Canada and India, offering the necessary skills and service levels. Adapting to changing client needs will remain a key differentiator.

In order to justify skills transfer, retention of staff is a key risk for administrators. While significant concern has been raised relating to work permit limits for expatriates in some Caribbean countries, the retention period for staff in the U.S. and Ireland is worryingly even lower. Some of the Caribbean countries have begun to recognize that they do not have a big enough reservoir of young people who can be trained in large enough numbers to ease the shortages and have increased work permit terms to up to five years for key employees.

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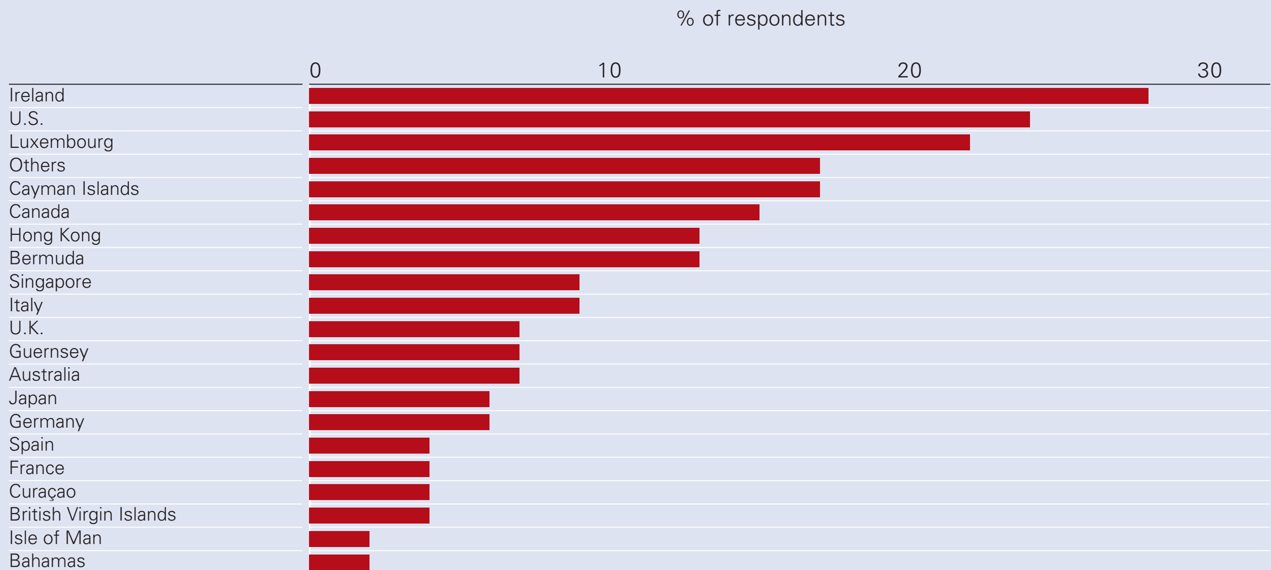
Administration will become more concentrated in fewer centers



Source: CREATE and KPMG International, 2005

"Front to back end services are being offered onshore, with some offshore locations being increasingly used for investor relations, monthly returns and RTA work"

The redistribution of high value added work does not detract from two points:

- Established centers of administration – e.g. Ireland, U.S. and Luxembourg – will evolve in close proximity to clients
- New centers will evolve slowly, as new players enter the industry.

Within these changes, another key trend is likely: it concerns the key offshore jurisdictions who were at the forefront in the last wave of growth. They will continue to remain at the forefront of the next wave as well, as far as physical operations are concerned, although the depth of service offerings may reduce as new entrants look to standardization and specialization. So, the challenge for centers like Bermuda and the Cayman Islands is how to differentiate themselves through lower cost or higher service levels in order to develop a fresh competitive edge.

"For the Caribbean countries, the real challenge is to create a sustainable competitive advantage that is not related just to their tax regime"

There needs to be a clear recognition by the hedge fund managers that independent high end services carry a risk premium which should be rewarded accordingly. As regulators increase their presence in all of the key jurisdictions above, administration is likely to become an increasingly important service.

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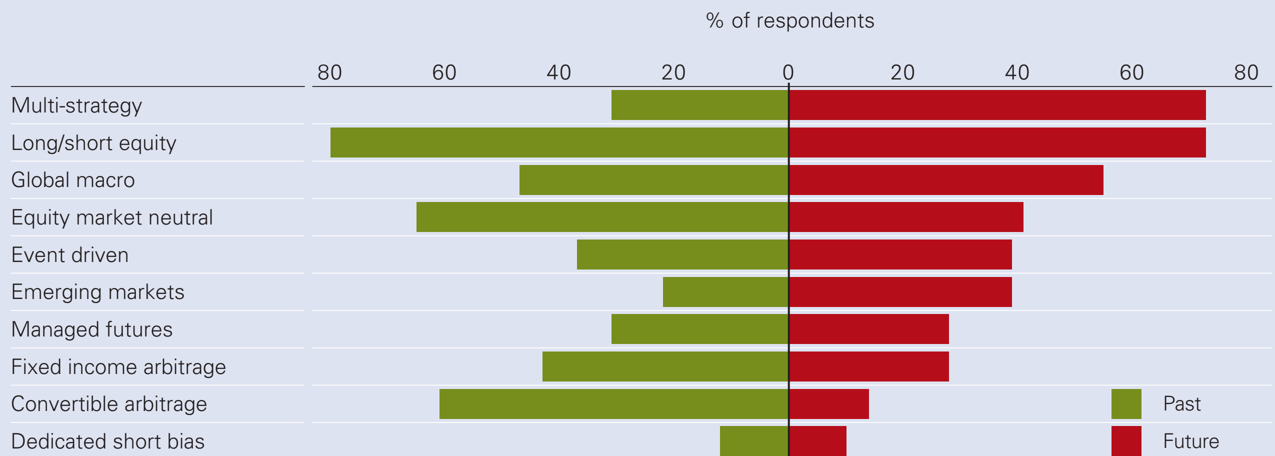
Significant shifts in strategies will ensure that multi-strategy, long short, and global macro will predominate

Which hedge fund strategies have been used most in the industry in the last three years and which ones are likely to be used most over the next three years?



Source: CREATE and KPMG International, 2005

"Most hedge funds are now starting as multi strategy funds. The biggest challenge facing the industry is that long short strategies will not survive – they must branch out into other strategies as more players move in"

The assessment presented by managers of hedge funds and fund of hedge funds is duly corroborated by their administrators, when it comes to identifying the shifts in the popularity of investment strategies between the recent past and the recent future.

Convertible arbitrage is out for the time being, especially amongst administrators in the Caribbean and Asia Pacific. Fixed income arbitrage and equity market neutral are also going out of fashion.

In contrast, most single strategy managers are creating multi-strategies as they hit capacity ceilings; or creating multiple products under single strategy. This trend will continue.

Alongside, three other strategies will retain their popularity in today's environment: long short equity, global macro and, to a lesser extent, event driven.

"We don't see a convergence between private equity and hedge funds. Private equity don't offer illiquidity premium"

The likely growth in multi-strategies will benefit the administrators especially. This is because the underlying hedge fund managers typically appoint more than one prime broker to multi-strategy vehicles; making their administrator the focal point of valuation and risk analytics.

By the same token administrators are also aware of the critical role of innovation and commercialization at the front end. In the final analysis, their fortunes are intricately tied to those of underlying managers.

However, as we saw in Section 2, multi-strategies are not without a paradox: managers need them when there is a need for dynamic switching between different hedge fund disciplines: but they don't like the business transitions that accompany them.

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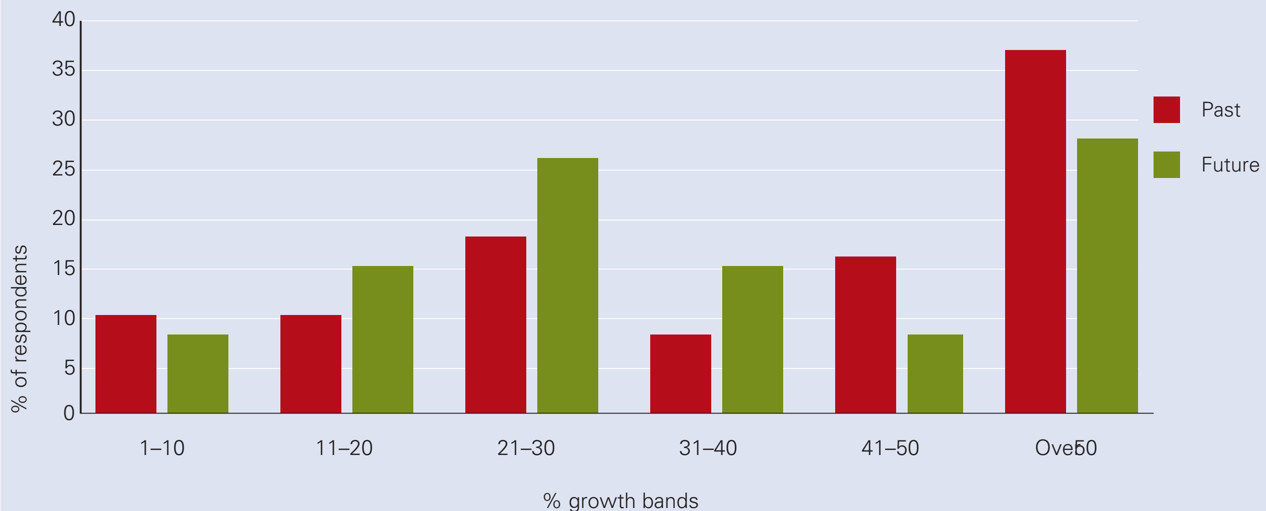
Demand for administration services will slow down, after an explosive growth…

What has been the average annual growth in hedge funds under your administration in the last three years and what is it likely to be in the next three years?



Source: CREATE and KPMG International, 2005

"There are not many administrators who offer valuation of complex derivatives. They go after the low hanging fruits, which are easier to value (long short blue chip equity funds)"

"Investors are deluding themselves if they believe independent administration is key to their problems. They need to ensure that third party administrators have the requisite knowledge of the products: especially in the lower tiers"

"Like hedge funds, the days of heady growth for administrators are probably over"

Administrators covered in our study anticipate a slowdown in the average rate of new administration money they themselves expect to attract over the next three years.

The geographical pattern of their growth will follow the overall industry pattern, identified on the previous graph, except in two senses.

First, administrators in the U.S. expect more fierce competition from the growing centers in Europe to the extent that they may not be able to match the industry average. Likewise, their peers in Europe are more bullish.

Second, tier one administrators are more bullish than their peers: they see prospects of diversifying into some of the prime broking services; leveraging the parent banks' influence and brand.

The overall pattern of slowdown duly reflects the assessment from managers of hedge funds and fund of hedge funds alike.

The pattern still remains very alluring for universal banks to contemplate further acquisitions. However, specialist firms will thrive, so long as they are tier one or tier two.

The administration industry may end up polarized between high-volume, low-value scale players and boutiques who work seamlessly with front office professionals.

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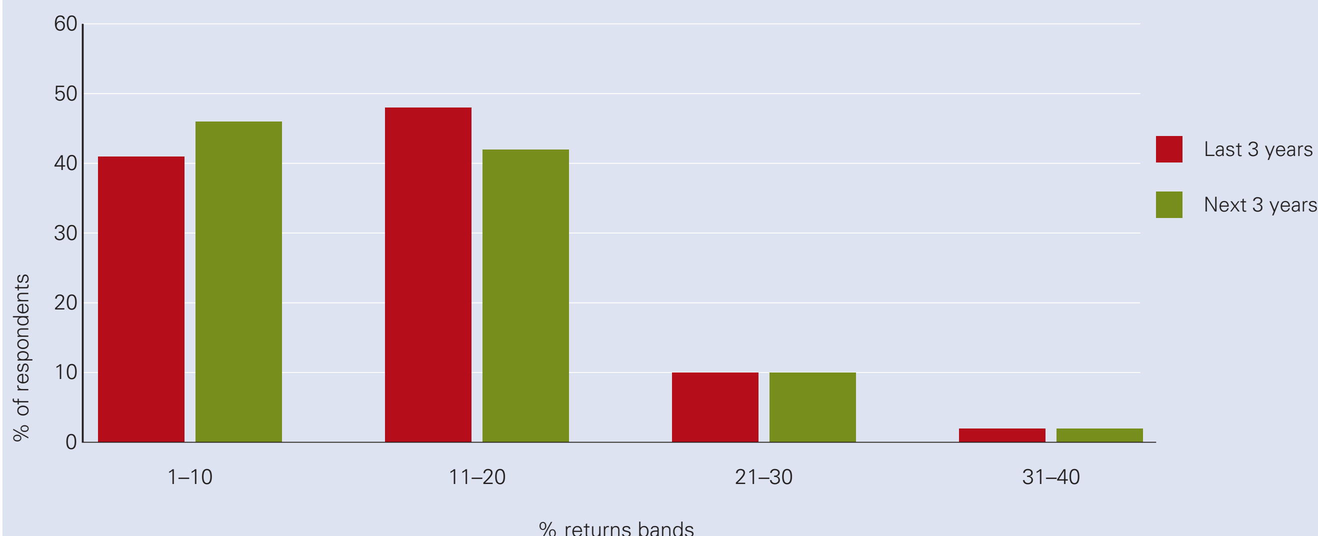
…as will the returns on hedge funds



Source: CREATE and KPMG International, 2005

"As institutionalization accelerates, the boutique players will lose out as they don't fit the necessary due diligence requirements and risk criteria"

As with asset growth, so with returns, they are likely to see a moderate decline, with a clear regional difference.

Funds administered in North America and the Caribbean expect a bigger – though not too significant – decline than those administered in Europe and Asia Pacific.

Everywhere, however, double digit returns are expected. For administrators they have twin significance.

The expected level of returns has justified huge infrastructure investment in its own right. It has turned tier one administrators into veritable global players – in size, reach and ownership; with more to come as universal banks are increasingly drawn into the industry.

"Hedge funds are a craft business. How can you make them sustainable?"

For example, a number of administrators in this study make significantly more money from non administration services – e.g. lending, forex – marking a distinct convergence in the sector.

The other point to note is that in the mainstream fund management sector, the outsourcing of the back office functions has yet to happen on a scale long predicted. So far, the main focus has been custody, settlement and client-end administration.

"We like hedge funds: we grow with them. There are no legacy challenges as in traditional fund management"

To that extent, it is hardly surprising that administrators see hedge funds as a more attractive option. Its impressive growth apart, it has fewer legacy issues to contend with. A majority of new start-ups and established players alike have little appetite for anything other than managing money.

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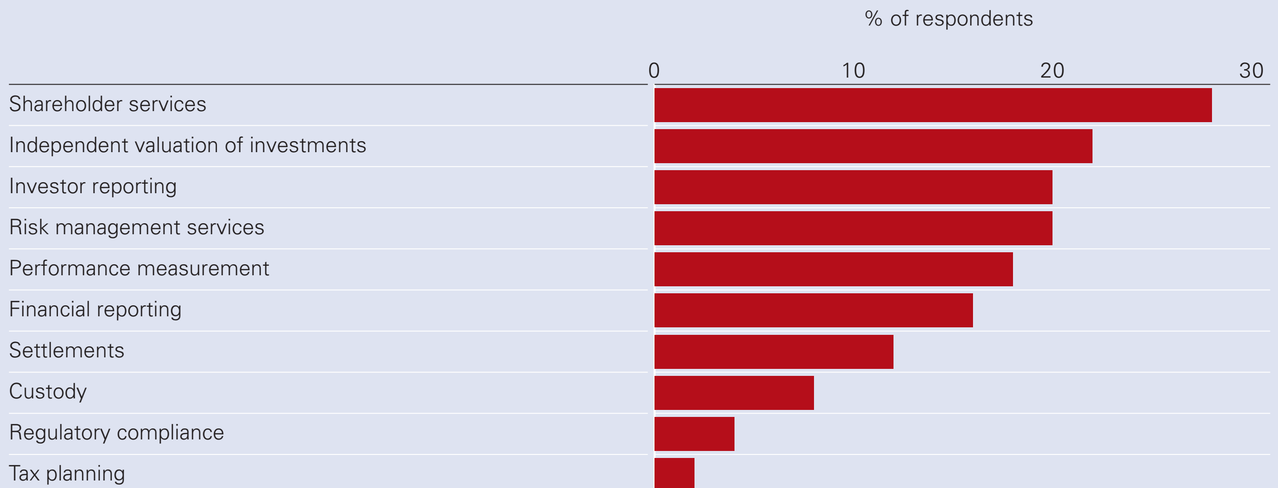
As some hedge funds become more complex, offshoring of administration services to brand new centers will be limited



Source: CREATE and KPMG International, 2005

"Administrators are starting to automate more, but the industry is not scalable because of the skills intensity of many services"

"Unfortunately, administration is perceived as the bottom of the food chain, in terms of quality of work"

"Automation is the key to administration in the future. Demands for daily P & Ls are increasing as are requests for live information. Investors no longer want to wait 15 days for the NAV"

Much has been talked about the importance of brand new centers for administration work in the global asset management industry.

However, when it comes to hedge funds, this has not been seen as an attractive option by a large majority for a number of reasons.

The existing administration infrastructure has evolved around the hedge funds industry in the U.S.. It started in offshore locations – first Bermuda and the Cayman Islands, then Ireland, and latterly Canada.

This infrastructure has yet to be utilized fully, especially in the mid and low value added services. The infrastructure is also integrated by service lines to the extent that it is not easy to detach a few of them and migrate them elsewhere.

Besides, proximity to hedge fund managers is becoming increasingly important for complex instruments that require frequent client inter-face.

Finally, few administrators are willing to risk their reputations going to newly emerging locations which lack the necessary skills infrastructure.

Hence, the pace of offshoring to brand new centers will be very modest; focused on commodity services; and led by the new entrants to the industry.

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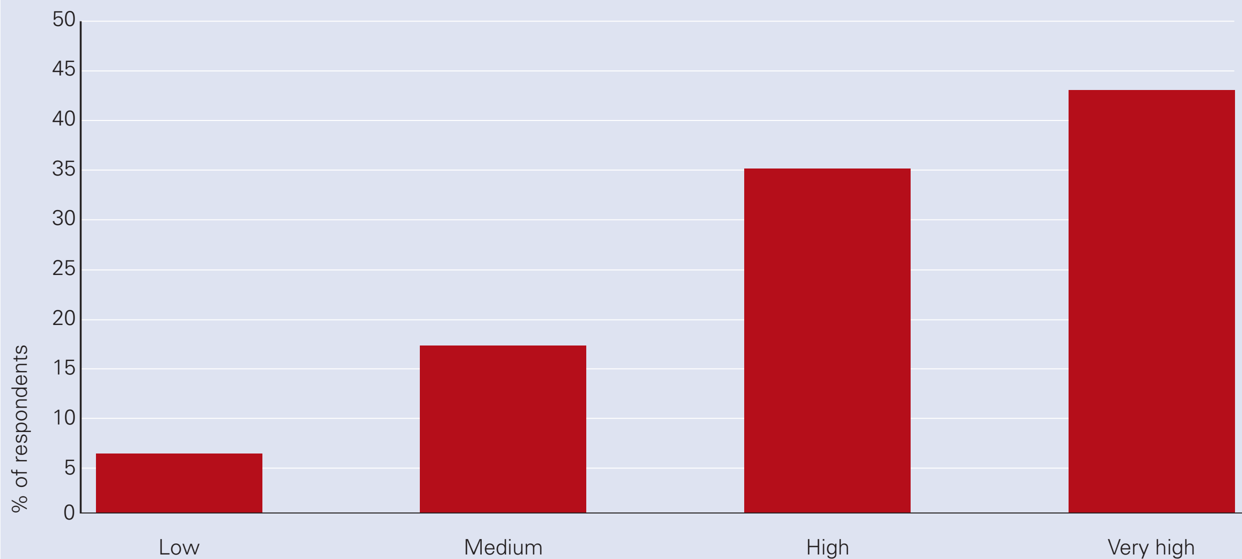
Administrators remain very bullish about their own business prospects

Overall, how do you rate your chances of attracting and retaining the hedge fund administration business over the next three years?



Source: CREATE and KPMG International, 2005

"Many large independents will be gobbled up by global banks, who can cross sell and up sell other services"

Like their business partners in hedge funds, administrators are very bullish about their own prospects.

Most of them see themselves at the dawn of a new industry, with huge potential for growth.

However, to their credit, they also realize that having potential is one thing; recognizing it quite another.

In any case, there may well be bumpy rides en route, as strategies go in and out of fashion; blow-outs occur from time to time; or hedge funds fail to satisfy the appetite of the new generation of investors – e.g., pension funds and retail clients.

"Hedge funds have their contradiction: they want new clients; but can't accept the disciplines that come with them"

They also recognize that the current wave of regulation is not designed to mitigate all the risks that hedge funds are exposed to. Nor will the regulators stop here.

Over the next five years, much can happen – if markets remain subdued and strategy concentration produces systemic risks; or if the retrospective changes in the tax rules – like that in the U.K. in 2004 – can slow down the pace of start-ups and innovation.

In summary, the hedge funds industry faces a clear dilemma: it needs a new generation of investors; but they can change it beyond recognition. There is a trade off between professionalism and innovation; systematization and commercialization. The future belongs to those who can manage these seemingly inconsistent ends.

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5 Pension funds

"Necessity is the mother of invention, it is true – but its father is creativity, and knowledge is the midwife"

Jonathan Schattke

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Pension funds

This section presents the views of pension funds around the world participating in our survey and the follow-up interviews. The key summary points emerging from it are:

- **Legacy:** The bear market has savagely exposed the scale of the funding crisis and increased pension fund deficits. *'Sticking to the knitting'* is the new mantra.

- **Interest:** Around one in two pension funds surveyed are not in hedge funds; a big proportion of them intend to stay out. Around one in two has invested; and do not expect to increase their allocations substantially. So far, the size of their allocation is typically less than 3 percent, being higher in the U.S. and Japan than Europe. The U.K. pension funds are the most cautious.

- **Rationale:** however, worldwide, demand for hedge funds will grow as a part of a holistic solution to achieve absolute returns; they are perceived to complement, not compete with, other asset classes. That said, there are widespread concerns about high charges, opaque strategies and absence of governance structures.

- **Capacity:** Furthermore, two in three pension funds believe that worldwide overcapacity will drive down the returns: the quality of the capacity is hugely variable; and the churn rate high. Success depends upon: a high and rising inflow of new talent; rapid innovation; and ability to commercialize the new strategies. Doubts persist on each of these requirements. Hence, a majority prefer no lock-ins when they invest.

- **Risks:** Nor are pension funds convinced that hedge funds managers can scale their business without sacrificing performance; or that regulation can prevent periodic blow ups. It is more acceptable for a pension fund to lose money in other asset classes; but there is a significant 'headline risk' when alternatives are involved.

- **Requirements:** Many pension funds also do not have internal governance structures to monitor complex investments. Besides, for them, there are other – more intelligible – sources of alpha. Nine in ten pension funds staying out claim they can meet their liabilities without hedge funds. Market improvements from the punishing lows of 2002-03 have helped, too. These pension funds put credence on pedigree, track record, transparency and sustainability. On current reckoning, they remain doubtful that hedge funds can deliver high returns with due governance.

- **Benefits:** Those one in two pension funds who have invested in hedge funds, or planning to, see them as a credible diversification strategy, since as returns from traditional asset classes have been unattractive. They also believe that hedge funds will become an established asset class.

- **Differences:** However, pension funds in North America are more optimistic than their peers in Europe and Asia Pacific because some of them went in much earlier and enjoyed the prime mover advantages; and many also have all the necessary oversight structures in place.

- **Softly-softly:** Outside North America, pension funds' investment in hedge funds so far is less strategic and more opportunistic. More a matter of dipping the toe in the water than diving in deep. Education, history and risks are the contributory factors.

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Thinking aloud…

"Currently, two percent of our assets are in hedge funds and the rate will grow. Like all our other assets, we manage them ourselves. Risk budgeting is what we are good at; asset proximity is our philosophy; and our large size justifies an in-house capability.

The external fund of hedge funds managers are too far removed from end managers. The closer you are, the lower the cost and higher the returns, according to our experience.

We have a rigorous screening process when we go to external single strategy managers. We seek out partners for sticky long-term money, without lock-ins. We work on low risk budget of LIBOR plus 500: it's enough to justify up-front effort and back-end liabilities. We have leverage (between two to four), especially in global fixed income portfolios.

Hedge funds are not a magical solution. We are investors, not speculators; our reputation is everything. So, our trustees instinctively perceive them as too sexy, trendy, and fancy; something open to high fatigue. But their perception is changing, as we form alliances with the best of breed.

Regulation in North America is not a big deal: unwittingly, it is promoting a false sense of security. On either side of the Atlantic, the biggest blow ups have occurred under the very noses of regulators.

We only deal with the best and know the risks. When there is an air crash, there's a full investigation into the causes by the authorities followed by a report. How many hedge fund blow ups have been investigated and reported on? Only public scrutiny will ensure a large measure of self regulation.

There are two systemic risks that need to be managed: one from business concentration, one from strategy concentration.

At present, the first one is negligible: the industry is too fragmented for a single player to abuse its market position or dominate trades. The second one is real: many players acting independently are in identical hedge fund strategies in vogue.

This over-crowding can be just as catastrophic as a single major blow up. We may see the re-run of the dotcom period when two guys operating on a card-table in their garage, using a laptop, managed to lose billions of dollars for millions of people.

Few pension funds like to be prime movers in this area. However as more pension funds move in, the fear of failure may ease."

A large North American pension fund

Source: CREATE and KPMG International, 2005 – Interview quotes

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Thinking aloud…

"We were one of the earliest in a long short fund, investing over US$100 million in the mid nineties. It hasn't performed too badly. But our experience suggests that it will be a long time before hedge funds become mainstream, if ever.

To start with, there aren't enough talented people going into hedge funds. Yes, there are a lot of start-ups, but many crash and burn without trace. Most don't have a track record which deserves a second look. All have an appetite to run money, but not business. Yet, they attract attention because the bear market has stimulated interest in absolute returns. When equities recover, these people will be seen as victims of an over hyped revolution.

Worldwide, the 2000 market crash has made trustees more cautious. We advised our trustees to switch into bonds then. Even that was hard for them. Yes, they see the need to diversify into alternatives to alleviate the funding problems; but fear that the cure can prove worse than the disease. Reputation risk is the biggest deterrent. They got slammed for piling into equities in the 1990s. What if they have another screw up with hedge funds?

The other inhibitor is governance structure. Currently, all the investment decisions are made jointly by all the trustees. We don't have an investment sub committee that can get us in and out of positions quickly. To be in hedge funds, we need to be much more nimble. Yes, the alpha opportunities are there but only for those who are fleet of foot in their decision process. Our culture involves doing a lot of due diligence through our consultants; key decisions sometimes take as long as eighteen months to implement!

Fees are not an issue: if you pay peanuts, you get monkeys. These guys have to be rewarded for above watermark returns. However, we have invested through fund of hedge funds into over 50 managers; that degree of spread has yet to produce something better than what you can get from alpha managers in long only space. In fact, we're now seeing long only managers gunning for mandates with tracking errors of 10 percent.

Well above 35 percent of fund of hedge fund managers have a 'for sale' sign. Only the smartest ones will survive the transition to the absolute return world. The demands of institutional investors are sorting out the wheat from the chaff. The survivors will have the proven expertise to spot the talent and produce returns commensurate with investor expectations. They will also have to be clever at anticipating favorite strategies. They will have to be smart at asset allocation based on sophisticated risk modeling. Above all, they will have to be strong on reasoning and strong on gut instincts.

Does five percent allocation to hedge funds make for credible diversification? No. We may raise it to ten percent not because that will ease our funding problems; but because we need to diversify into strategies that are ahead of their time and put us ahead of the crowd. We do our ALM every year and constantly review it: matching liabilities is what investment is all about now."

A large European pension fund

Source: CREATE and KPMG International, 2005 – Interview quotes

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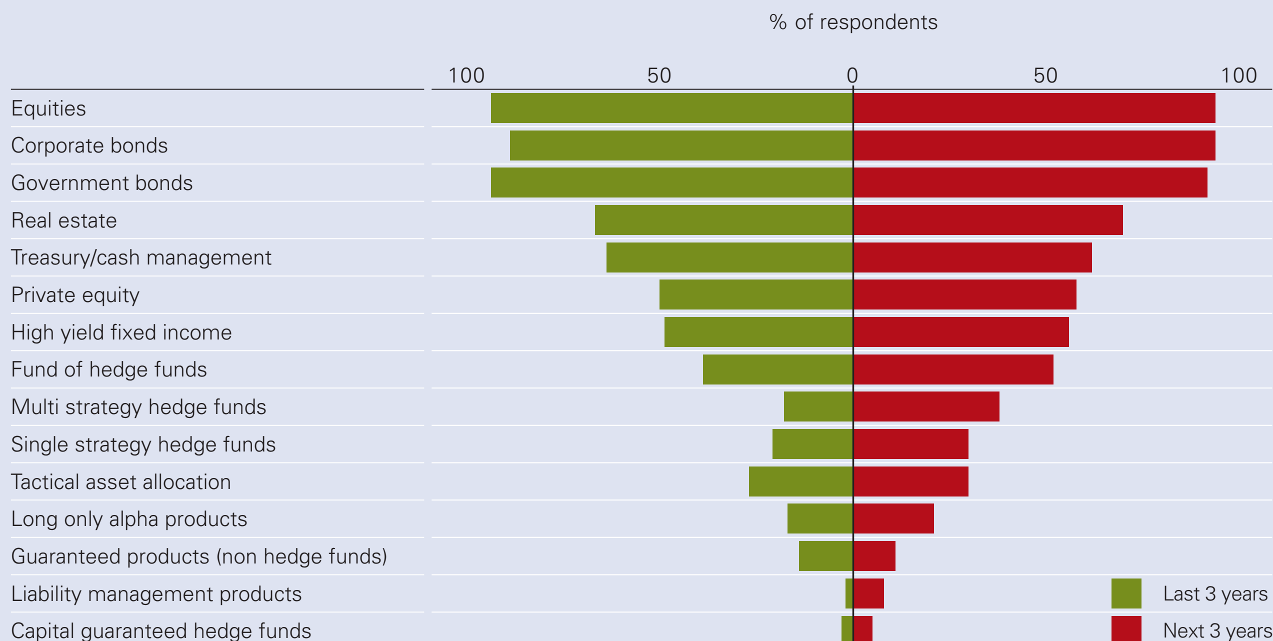
Overall, pension funds will stick to the knitting, investing in products they know



Source: CREATE and KPMG International, 2005

Interview quotes:

"Old money, like old thinking, will remain locked into old asset classes"

"Our trustees won't go into anything that seems unintelligible"

"In the U.K., pension funds are very cautious about hedge funds"

"In five years, alpha and assembled products will be the norm: beta will be cheap and commoditized"

Worldwide, pension funds interest in hedge funds or fund of hedge funds is growing: over the next three years, for example:

- One in every three pension funds are likely to invest in single strategy funds – up from one in five in the past three years
- Two in five will invest in multi strategy funds – up from one in five in the past three years
- One in two will invest in fund of hedge funds – up from two in five in the past three years.

Regionally, the strongest interest is in North America, followed by Asia Pacific, and then Europe. However, in relative terms, the amounts involved are very modest indeed: less than three percent of the assets, on average; two percent in North America, two percent Asia Pacific and one percent in Europe. However, in cash terms, the sums involved are huge.

This is partly because with improvements from the market lows of 2002-03, the funding crisis has eased. Beyond that, pension funds prefer to have a more balanced portfolio to iron out risks at the different phases of the market cycle.

Above all, given their fiduciary responsibilities, pension trustees prefer to invest in asset classes which they readily understand. Not surprisingly, therefore, their interest will remain focused on the traditional classes: equities, bonds, real estate and private equity.

Having burnt their fingers in the last bear market and been lambasted by the media, pension fund trustees are understandably cautious; for them, the reputational risk is too high.

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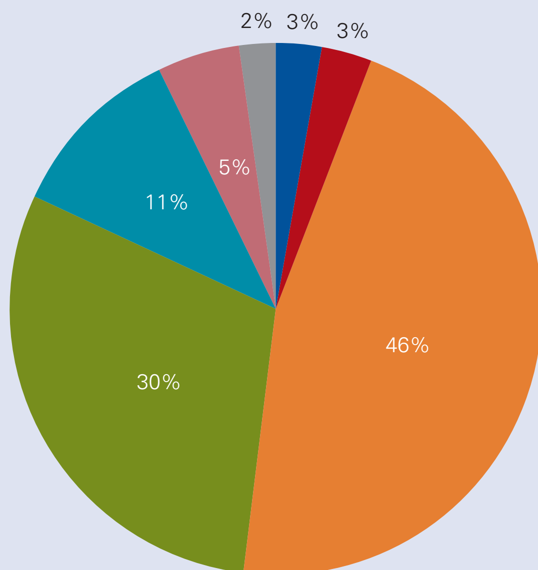
Pension funds expect hedge funds to grow worldwide

What do you anticipate will be the average annual growth in the hedge fund industry worldwide over the next three years?



% growth bands	
Negative	3(%)
Nil	3(%)
1–10	46(%)
11–20	30(%)
21–30	11(%)
31–40	5(%)
41–50	2(%)

Source: CREATE and KPMG International, 2005

"Hedge funds are the new 'promised land', if you are smart enough to invest aggressively in markets full of inefficiencies"

Notwithstanding regional differences in levels of interest in hedge funds, pension funds everywhere expect a significant growth in total assets going into hedge funds over the next three years:

- One in two pension funds expect an average growth of 1–10 percent
- One in three expect it to be 11–20 percent
- One in ten expects it to be 21–30 percent.

"Neither pension trustees nor their consultants are incentivized to take risks"

No one expects the industry to implode or contract: periodic blow outs will occur but they will be offset by new money and new entrants.

Moreover, these impressive rates will be driven, in large measure, by high net worth individuals, endowments, and, to a lesser extent, pension funds.

"Hedge funds are a mystical way of redeeming the sins of the past"

Pension funds in North America are more bullish than their peers in Asia Pacific or Europe. Many of them have developed an in-house capability to manage hedge funds. Some went into hedge funds in the last bull market. This has raised their trustees' knowledge and comfort level. Appropriate governance structures have also been created in order to enable the trustees to monitor their hedge funds investment on a weekly or monthly basis.

"If you take the whole funds universe, average returns after fees are near enough zero. So, why take on the risk?"

At the other extreme, in the U.K., trustees are dipping their toes in the water, but with extreme caution. They prefer to invest in assets that are intelligible to them. Besides, few have the resources for research, due diligence or frequent monitoring.

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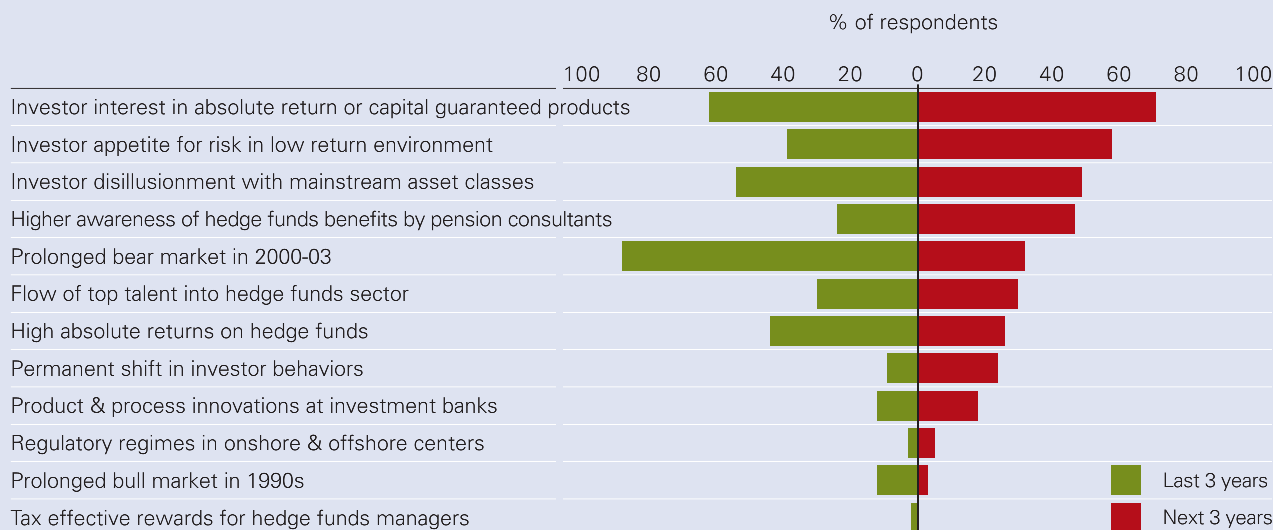
Hedge funds are perceived as part of a holistic strategy on absolute returns…



Source: CREATE and KPMG International, 2005

"We are dipping a toe in the water: four percent will be our maximum allocation. But the queue for premier capacity is endless in every corner of this planet. The returns so far are a pittance"

Hedge funds have been around for decades. A combination of market volatility and new trading strategies promoted their take-off after the mid-1990s. Up to now, the main investors have been ultra high net worth individuals and endowments.

However, it was the prolonged bear market that sparked off pension funds' interest in hedge funds. The equity culture came under severe scrutiny, as pension funds notched up heavy deficits – in some notable cases greater than the market capital of the sponsoring organizations.

Since then 'absolute returns' has become the new mantra.

"CEOs of sponsoring organizations are nervous about putting their pension assets into hedge funds"

Hedge funds are seen by pension trustees as one of the possible investment strategies to achieve absolute returns that are essential to reduce deficits but not the only one, or the main one.

This interest has been aided and abetted by a number of other factors: including the more sophisticated appetite for risk in today's low nominal return environment, disillusionment with the traditional asset classes and rising understanding of hedge funds on the part of consultants who advise the trustees.

"Relative returns are dead; and absolute returns have many mothers"

Apart from hedge funds, pension funds are using other routes to absolute returns; including alpha products in the long only space; structured products; and liability driven products assembled from a number of other solutions.

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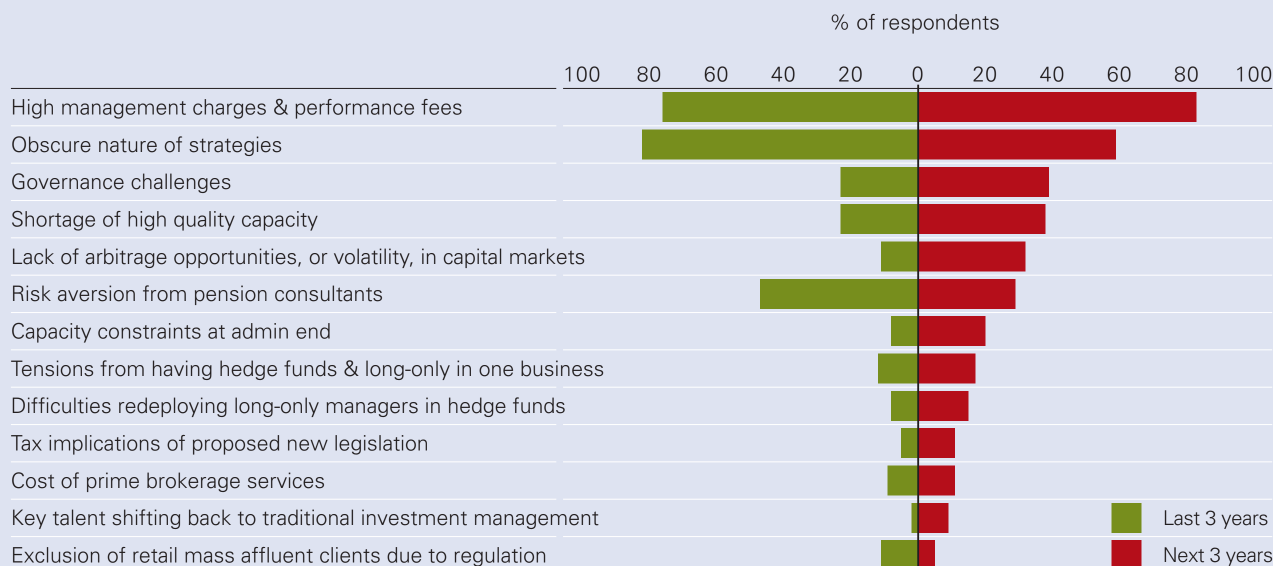
…but there are concerns about their charges, opaqueness, governance and capacity

Which factors have hindered growth in hedge funds worldwide in the recent past and which, if any, are likely to do so over the next three years?



Source: CREATE and KPMG International, 2005

"Hedge funds are suffering from the curse of success; their higher returns can only be followed by lower ones, thanks to over-crowded strategies and scarce talent"

"Hedge funds have worked only as long as they have excluded mainstream investors. Most of them are one trick ponies"

"Pension funds want alpha. Today, they think that hedge funds are an answer; tomorrow it may be different. Investment business is so cyclical"

"Our chairman wants all the trustees to be involved in every decision; that means lowest common factor in all our decisions"

According to pension funds, hedge funds are neither the main avenue nor the only one to absolute returns. Furthermore they are perceived as a strategy, not an asset class.

Be that as it may, pension funds' interest in them has remained subdued in the last three years due to three factors:

- Four in five of them are deterred by higher charges and fees
- Four in five also cite the obscure nature of the strategies used
- One in two cites risk aversion on the part of their consultants.

The last two inhibitors will ease somewhat over the next three years. But charges and fees will remain a major concern, alongside three newly emerging ones, as cited by more than one in three pension funds. They are:

- Quality of the governance of hedge funds, or fund of hedge funds
- Shortage of high quality capacity amongst the end-managers
- The lack of necessary market volatility and arbitrage opportunities.

Looking at the hedge fund industry in its totality, pension funds perceive a capacity structure with three distinct entities:

- A small percentage (around 15 percent) of *stars* at one end, producing alpha or high alpha returns
- Followed by a long fat tail of *wannabes* (55 percent) producing low returns
- Followed by *has-beens* (30 percent), producing losses and exiting the business each year.

It's a structure that argues for caution.

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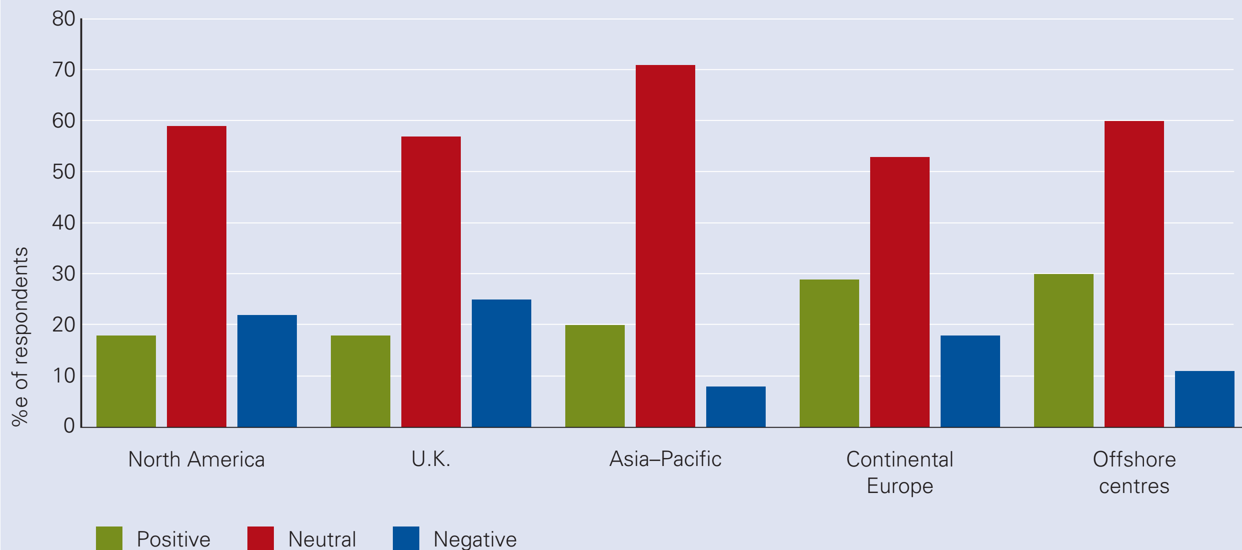
Regulation will professionalize the industry and attract a new breed of investors…

What do you think will be the overall impact of the recent regulatory changes in worldwide growth in hedge funds?



Source: CREATE and KPMG International, 2005

"Regulation will sort out the 'fly by night' outfits. Good ones will not be hurt by it"

In the past two years, many countries – including Germany, France, Ireland, Italy, Luxembourg, the U.S. and the major offshore centers – have introduced new measures that are designed to regulate the conduct of the hedge funds business or relax the rules for attracting different types of clients, as argued in the *Executive Summary*.

"Regulation is your entry ticket: if you can't accept the rules, stay out of the game"

The aim of the regulators has been to balance the pressure from the industry to open up the markets against the need to provide investor protection. Pension funds worldwide welcome these moves. However, they also believe that their impact will be neutral, on the whole.

This is because they realize clearly that regulation will not, in any way, reduce the inherent risks that are associated with hedge funds.

"Lock-ups don't make sense: hedge funds are very liquid and volatile"

There are minor regional variations on the overall impact that are worthy of note, however.

In the U.K. and the U.S. – the two dominant centers of hedge funds business – it is believed that the net impact may be a small negative one. It remains to be seen what the precise nature of these changes will be.

"Regulation in North America is not a big deal: unwittingly, however, it is promoting a false sense of security"

In contrast, the net impact of regulation will be positive in the other three regional markets: Asia Pacific, Continental Europe and offshore centers. Pension funds in these regions increasingly look to hedge fund managers in the U.S. and the U.K. when implementing their allocations. So, regulation has raised their comfort level, somewhat.

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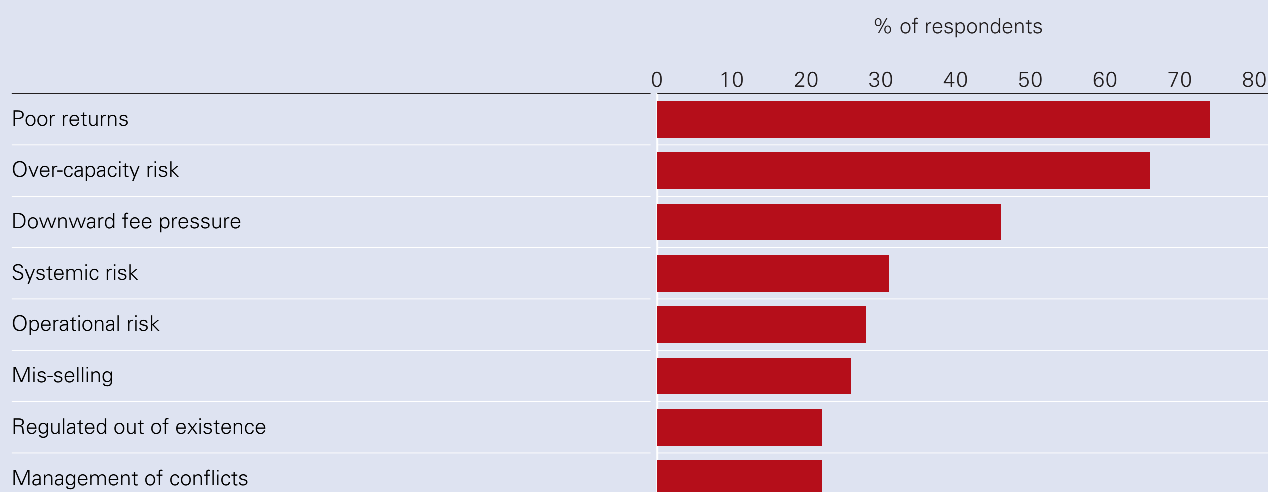
…but it will not eliminate the various risks associated with hedge funds



Source: CREATE and KPMG International, 2005

"We accept that every investment carries a risk; but we would rather that somebody else starts the ball rolling"

"What galvanizes us is when somebody noteworthy takes a plunge; we're too slow to move otherwise"

"New money is going through fund of hedge funds route; most of it ends up with managers who have maxed out"

"Every greedy person I know is in hedge funds; that means a hard landing"

"The uncorrelated returns argument does not wash here: we hold assets for the long-term"

Pension funds believe that the hedge funds are exposed to three sets of inter-related risks, despite their widespread prominence.

First, more than two in three of them believe that there is overcapacity risk. The resulting over crowding exposes the risks of low returns in certain strategies, especially since juicy capacity is restricted to no more than 15 percent of hedge fund managers. For the rest, the downward fee pressure could be intense.

Second, around one in three believe that as hedge funds strategies chase the limited arbitrage opportunities, the systemic risk is real. The potential risk of failure is the same as a large single hedge fund manager using huge leverage.

Third, around one in four believe that as managers invent ever new strategies, or venture into multi strategies, the resulting vehicles become difficult to value for accounting purposes. Prime brokers can help in this context; but hedge fund managers may use more than one broker for multi strategies. Hence, the biggest operational risk centers on valuation at the administration end. This is an area where there are capacity constraints, as we saw in Section 4.

Fourth, if and when more retail clients enter the industry, there are risks of mis-selling to the extent that regulators may step in with restrictions that constrain the hedge funds industry.

A minority of pension funds perceive these as teething problems. But a majority feel that they argue for greater caution and vigilance. For them, hedge funds are seductive in logic but complex in practice.

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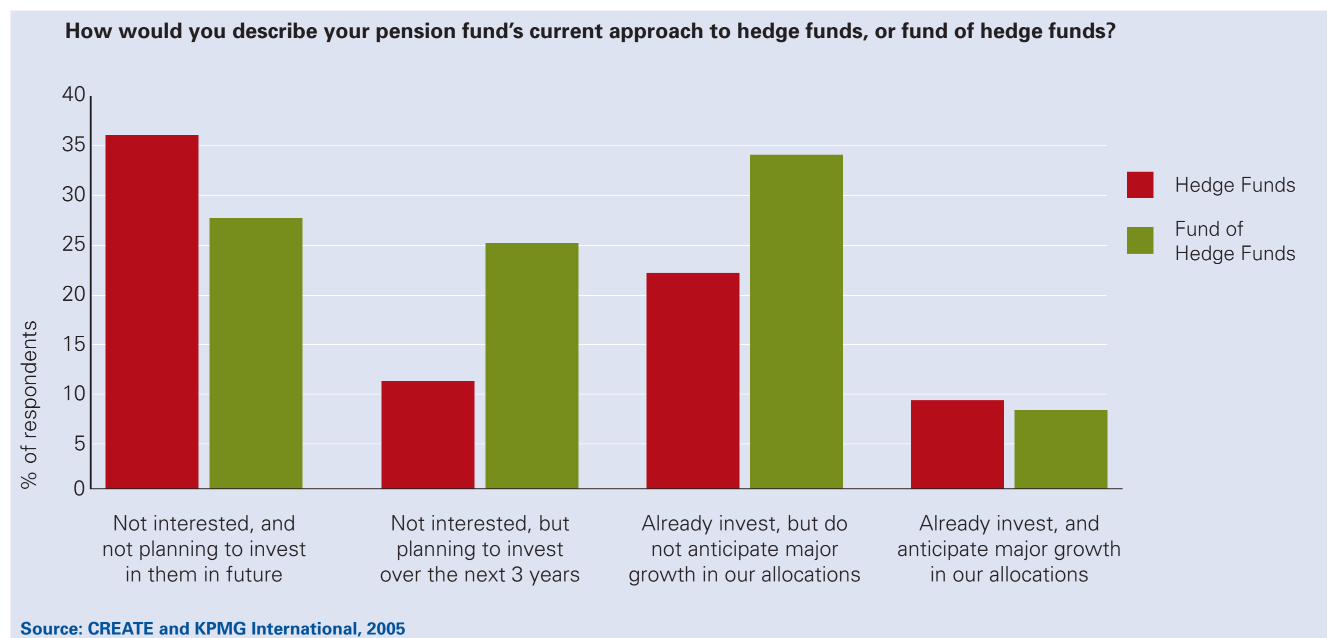
So for pension funds, investment in hedge funds will be a matter of more haste, less speed



Source: CREATE and KPMG International, 2005

"Fund of hedge funds exist because pension funds are too worried about reputational risk. It's hard to justify their added value otherwise"

"Fund of hedge funds are the reincarnation of the old style balanced mandate"

"80 percent of boutiques are life style businesses; their owners want profits, not assets. They are quick to close funds when opportunities dry up"

"Everybody is chasing alpha outside the benchmark driven assets, without recognizing that alpha is a zero sum game"

Accordingly, pension funds fall into one of four groups, when it comes to investing in hedge funds or fund of hedge funds – currently or in the next three years.

The first group is neither investing currently nor planning to invest in the near future. One in three have adopted this approach towards hedge funds and one in four towards fund of hedge funds.

The second group is not investing currently, but planning to do so over the next three years. One in ten will go directly into hedge funds and one in four will go via fund of hedge funds.

The third group already invest and do not anticipate a major growth in allocation. One in four are in hedge funds and one in three in fund of hedge funds.

The fourth group are already in hedge funds and anticipate major growth. They amount to one in ten.

Pension funds in North America are the most sanguine, followed by those in Asia Pacific, and then Europe (especially the U.K.). It partly reflects the different levels of influence exercised by consultants and partly the prime mover advantage enjoyed by some U.S. pension funds.

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Opaqueness, fees and leverage are the key show-stoppers for those pension funds who intend to stay out

Source: CREATE and KPMG International, 2005

"The key barriers are scarce talent and high charges"

Those pension funds who have stayed out and will continue to stay out of hedge funds have been deterred by a variety of factors.

Some of these focus on the nature of hedge funds. For example:

- Three in four cite their opaque nature
- Two in five cite their reliance on leverage.

Some factors focus on fees and performance. For example:

"Hedge fund managers will continue to atomize and re-atomize; without entry of new talent at the front end, there will be no industry"

- Two in three cite high management charges and performance fees
- One in three cite the unproven track record
- One in five cite volatile performance
- One in five cite their riskiness.

Equally significant perhaps, the role of pension consultants or the dearth of advice from them are cited by fewer than one in six.

Nor are the statutory rules or governance structure of a pension fund a notable barrier.

"The real issue is whether hedge funds can deliver"

It all boils down to investment basics: opaqueness, fees and performance.

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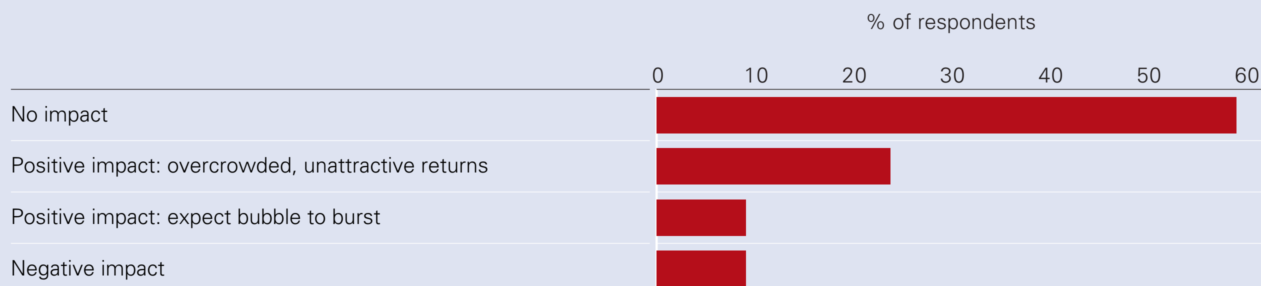
For them, staying out of hedge funds will have no adverse effects: on the contrary

By not investing in hedge funds or fund of hedge funds, what will be the impact on your pension fund?



Source: CREATE and KPMG International, 2005

"We are investors, not speculators; our reputation is everything"

A majority of the pension funds who are staying out of hedge funds believe that this decision will have no impact on the value of their fund.

On the contrary, a significant minority believe that this is the right thing to do due to the risk of low returns from overcrowding.

"We can raise the funding levels without ramping up the risk"

In their view, the overcrowded hedge funds universe will dilute returns or create periodic blow ups; both of which can jeopardize assets and reputations alike.

However, this is only part of the story.

First, as we saw earlier, pension funds are using a variety of approaches towards improving and meeting their funding levels during the bear market.

"We are a late entrant; all the upsides have vanished"

Second, in so far as they are relying on specific approaches that are more intelligible to the trustees, it is clear that some of the fear expressed here is more apparent than real.

"For every successful hedge funds boutique, there are at least a hundred who have failed. This is a brutal business"

In our interviews with pension funds and their consultants, one message came through clearly: trustees need more education and information than they currently have.

This applies not only to hedge funds; but also to other strategies that drive liability-matched investment and structured products.

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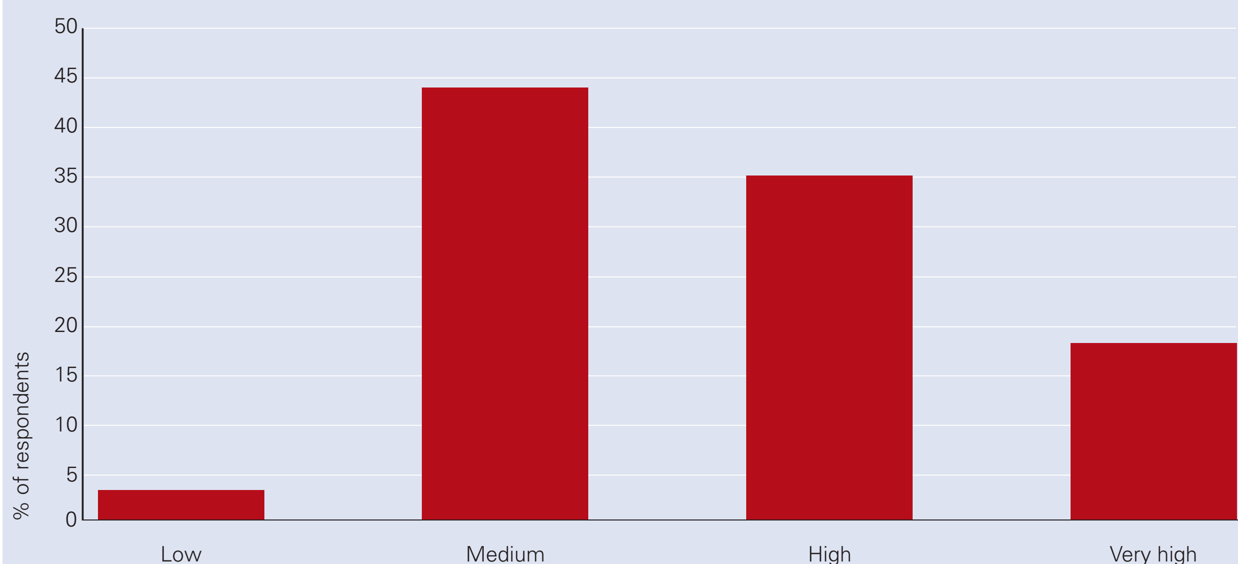
Nine in ten pension funds staying out will still be able to meet their liabilities



Source: CREATE and KPMG International, 2005

"We have neither the expertise nor the appetite for anything out of the ordinary"

"The funding level is rising so there is no pressure to go into alternatives"

"We don't slavishly follow consultants' advice; we often ignore it"

"Pension consultants have the same monopoly of wisdom as the communist party in the former Soviet Union"

"A combination of luck and prudence will see us through our funding problems"

As far as reducing deficits is concerned, those pension funds staying away are confident that they can do so without recourse to hedge funds.

In turn, this message is entirely consistent with the previous analysis. It corroborates other views.

First, hedge funds are amongst one of many avenues to achieve absolute returns. A lot is happening in the traditional investment space as the direct response to the challenge from hedge funds.

Second, some of their inherent features – leverage, opaqueness – give rise to extreme unease on the part of trustees, long used to the traditions of transparency in investment strategies, philosophy and process.

Third, pension trustees have been widely criticized around the world for their over exposure to equities in the last bull market. So, one of their biggest concerns is reputational risk.

Fourth, even if these funds made allocations to hedge funds, the prevailing view is that it would be too small to have a material impact improving deficits.

Finally, however, as more and more pension funds venture into hedge funds over time, the innate resistance towards them may well weaken across the pensions community.

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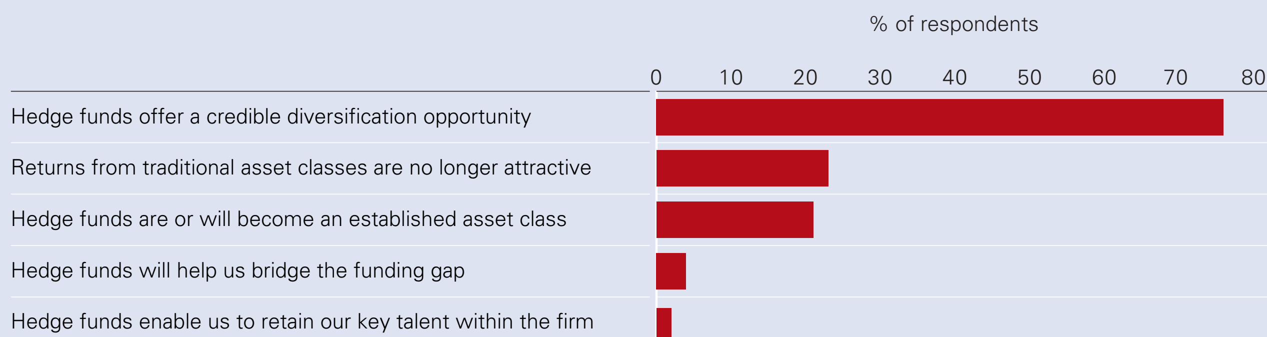
Those pension funds investing in hedge funds are looking for a credible diversification opportunity for their new money…

If you already invest or plan to invest in hedge funds, or fund of hedge funds, what are your principal reasons for doing so?



Source: CREATE and KPMG International, 2005

"Those with funding crises need to invest into hedge funds, but can't afford to; those who can afford to, don't need to"

"Currently, two percent of our assets are in hedge funds and the rate will grow. Like all our other assets, we manage them ourselves"

"Yes, pension funds want to see a track record; but in practice, they are not so choosy, since the size of their punt amounts to a flea bite"

"In the U.S., pension funds don't use consultants much"

For those one in two pension funds who are already investing in hedge funds, or planning to do so, the single most important reason is the diversification opportunities which they offer: hedge funds clearly have a long-term future.

Pension funds in all regions are virtually unanimous on this point. However, beyond that, there are very distinct regional variations.

In North America, far more pension funds also perceive hedge funds in three distinctively favorable roles:

- As an established asset class
- As an effective instrument of bridging the funding gap
- As a smart way of retaining key talent.

In contrast, in Europe and Asia Pacific, pension funds are far less inclined to ascribe these roles to hedge funds.

In a large measure, the difference is a reflection of the fact that pension funds in the U.S.:

- Went in far earlier than their peers elsewhere and enjoyed the earlier fruits of high returns
- Manage a large chunk of their money in-house and thus have a superior familiarity of hedge funds that enables them to manage their investments in line with their medium and long term goals.

As mentioned previously, over the next three years, the biggest chunk of large allocations to hedge funds or fund of hedge funds will be made in the U.S..

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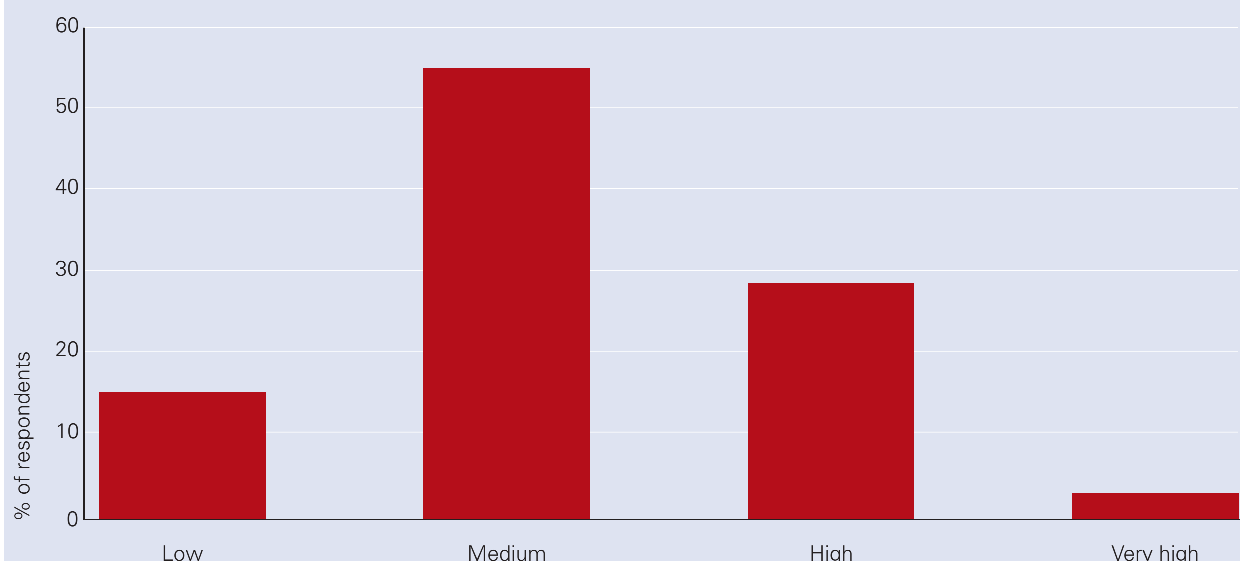
…and a way of improving their funding levels

Overall, how do you rate the chances of meeting your long-term funding requirements with the use of hedge funds over the next three years?



Source: CREATE and KPMG International, 2005

"Hedge funds are a part of a holistic liabilities solution"

On the whole, those pension funds investing in hedge funds believe that they will be able to meet their long-term funding needs. Hedge funds are seen more as help than hindrance.

In our face to face interviews, two points emerged clearly.

First, behind this confident result is a simple paradox, namely:

- Those who can afford to invest in hedge funds don't need to; their high returns from other asset classes have narrowed their funding gaps
- Those who need to invest in hedge funds can't afford to; their low returns from other asset classes have widened their funding gaps.

"We have 40 percent of assets in alternatives, targeting LIBOR plus 300 bps"

Second, in Europe and Asia Pacific, many pension funds favor hedge funds but they are used to a fee rate of 50 basis points in traditional asset classes, with no style drift. Anything outside that regime is viewed as pure greed.

In contrast, in the U.S., for reasons mentioned earlier, pension funds tend to have a more flexible approach to investment. Not surprisingly, therefore, their assessment fall in 'high' or 'very high' categories in the figure above.

The implications are two-fold:

"More pension funds would be in the fray, if they can unbundle their governance structure: you need to move at the speed of light. TAA is the name of the game"

- Pension funds' investment in hedge funds may be less strategic than the pure numbers indicate
- But those in North America have a more strategic perspective than Europe and Asia Pacific.

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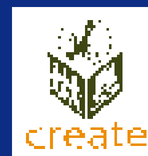

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