Funds become specialized to meet needs of funds of funds, pensions

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It should be obvious by now that the term "hedge fund" is antiquated, if not totally inaccurate. As the name suggests, the whole point of hedge funds in the olden days was hedging market risk. Today, with more and more investors plowing cash into the sector, running a successful hedge fund is more about finding an obscure strategy or "niche" and milking it -- before someone else does. Enterprising money managers are cooking up all kinds of funky ideas, making it clear why many funds prefer to be called "alternative investments." J.C. Clark Ltd. recently created a kind of private-equity fund that will invest in the death-care industry, meaning funeral homes, cemeteries and the like.

Earlier this year, Guggenheim Capital LLC raised nearly US$300-million to buy and rent aircraft. Last October, Donald Trump enticed three hedge funds to invest in a 90-storyChicago skyscraper. There are so many "niche" funds coming out of the woodwork, it's tough for them find names that haven't already been taken. "The financial markets are always looking for inefficiencies, and creativity drives the industry," says Chris Holt, head of investor relations and business development at J.C. Clark. "["Niche" funds] are exactly what hedge funds have become. That's really the only common characteristic, that they are all "niche" funds.

The objective of all of these funds is to produce uncorrelated returns. "The biggest reason is that many traditional hedge-fund strategies aren't working as well as they used to. When loads of money chases after a limited number of trading ideas, it is tougher to produce market-beating returns" according to Alex Jurshevski. Exhibit A is the steep decline in alpha generated by hedge funds, that is, the excess return above the overall market. Over the last10 years, alpha has been roughly sliced in half to 29 basis points from 65 basis points, according to a forthcoming research paper by William Fung at London Business School.

Finding un-exploited strategies might only get more difficult. By2009, hedge fund assets under management will expand toUS$2-trillion from about US$1-trillion today, predicts George Van, Chairman of Van Hedge Fund Advisors International LLC in Nashville, Tenn. Spurred by institutional and retail investors, this figure will double to $4-trillion by 2013 and US$6-trillion by 2015, he estimated in a recent paper on hedge fund demand and capacity.

By moving into new markets, hedge funds are adding more capacity. While it might take the industry another year to fully digest the new money flowing into them, their growth will accelerate, Mr. Van noted. He is bullish on hedge funds and their ability to handle an influx of new investment dollars, but others believe the sector is ripe for rationalization. Tanya Styblo Beder, chief executive of Tribeca, Citigroup Inc.'s single-manager proprietary hedge fund unit, predicts the industry will split into two camps, with large players pursuing several strategies and boutique players focusing on "niche" ideas. Overall, she expects the number of hedge funds to shrink from 8,000today to about 5,000 over the next five years. The impetus: Trading strategies will be exploited quickly, making it far more difficult for hedge funds to sustain their edge and make money. "The nature of market trends is changing and it will become increasingly difficult to survive. Three years ago, [market and trading] trends were months long and slow moving. Now the top 10 to20 trends tend to be less than four weeks and most of the money is made in the first 72 hours -- how do you trade that?" she said at a conference last month, Reuters reported.

KPMG LLP also predicts that consolidation is in the cards. KPMG reported in a recent survey that excess cash is chasing limited opportunities. In addition, KPMG concluded that the performance of hedge funds "has been petering out at the time when the number of startups has increased considerably. "Hedge funds are increasingly becoming specialized, so that they fit into hedge fund of funds strategies and meet the needs of institutional investors.

Larger investors such as pension funds findit difficult to choose a hedge fund with a generalist strategy. It is more difficult to track the risk of these general funds and to guard against style drift and other pitfalls. It is also harder to determine how these multi-strategy funds fit in with a pension fund's broad portfolio. Instead, these investors prefer putting their money in a group of hedge funds, each with a specific sector focus. For example, they may put money in a hedge fund focused on paper and forest products. They may choose another manager for oil and gas, and so on. That way, investors are able to rotate among sectors as needed and better manage their risk.

There is also growth in the strategy of pairing exchange-traded funds and hedge funds. For instance, you might passively invest 90%of your portfolio in the S&P/TSX composite index, and put 10% with along/short manager. The low cost of ETF’s makes in an attractively cheap option, even with the performance fees charged by hedge funds. Earlier this year, McFall Lamm, chief investment strategist for the global investment management unit of Deutsche Bank, noted in a Toronto speech how hedge fund returns were declining, as new money flowing into the sector caused "capacity exhaustion." Strategies like merger arbitrage, convertible arbitrage and statistical arbitrage had lost their lustre, he said. For most traditional strategies, he forecasted returns in the single digits for 2005.

Alex Jurshevski, head of Recovery Partners LLP, a turnaround specialist and buyer of distressed debt, figures plenty of hedge funds are promising alpha to investors -- along with high fees --but what they are actually offering is more beta or market returns. So the questions is, are new “niche” strategies causing fund managers to reach, perhaps dangerously so, for returns that will beat the market. "This is a key observation to make. There is more risk out there, "he says. When markets reach inflection points, as many are now, there is greater potential for extreme events. And that could bring down some hedge funds that are overexposed. "My prediction is that there will be significant fallout in the hedge fund world in the next six to 18 months," he warns. What could save many hedge funds, though, is the market.

While hedge fund performance has generally been ho-hum over the past couple of years, that could change as volatility creeps into equity markets. Between April, 2000, and September, 2002, for example, hedge funds produced a 2.1% return, while the S&P 500 lost 43.8%, Mr. Van notes. That set off huge demand for hedge funds, which reached a record high in 2004. More hedge funds turned away investors in 2004 than in2003 or 2002, he found. True to their habit of chasing performance, about 50% of these were first-quartile funds, he added. Overall, assets under management doubled to about US$950-billion over1999-2004.Hedge funds can pursue any strategy they want. But they won't coast to double-digit returns any more. The competitive field is only getting larger and tougher. And with hedge funds battling for assets, there is the temptation to take big, big swings. While there will be plenty of winning hedge funds profiting from volatility in the markets, 20% to 30% of hedge funds fail already. In other words, much of the easy money has been made. If hedge funds were investing in the hedge funds market, they might have moved on by now.