

Hedge Funds:

Will they survive?

The way hedge funds wield power and influence in global capital markets is not widely understood but recent events have left us in little doubt about their growing importance:

- In early March The Children's Investment fund led the successful revolt over Deutsche Borse's £1.4bn bid for the London Stock Exchange. One institution said "the hedge funds have done a marvellous job. No matter how we feel about companies, traditional managers cannot move as fast to achieve our aims". Perhaps their influence was initially not understood by the Deutsche Borse. The Borse will now have a different but less enamoured view of the power funds can now wield.
- Lansdowne Partners have recently snapped up 1% of Tesco. Overtaking some of the most familiar names in the city on the share register, this relatively unknown hedge fund now owns 1% of Britain's largest supermarket group. This is not just another hedge fund located in Mayfair. With assets of £1.4bn it is one of the largest in the city. Consequently more and more corporates are now seeing hedge funds as viable investors.
- Very recently one of the world's largest hedge funds Och-Ziff Capital Management has entered the £1.2bn auction for Yellow Brick Road, the Pan European directories business.
- There has been growing speculation amongst the City's merger and acquisitions specialists that hedge funds would lead a bid for a FTSE 100 company with J Sainsbury, MFI and Unilever being mentioned as takeover targets.

In terms of the level of money now invested with hedge funds, since 1998 global assets managed by hedge funds have tripled from USD 300bn to over USD 900bn. London manages around 70% of the European market. The London Market is expected to grow to £400bn by 2010.

Can the industry maintain quality while continuing its rapid pace of growth? If returns fall when will this form of investing become unattractive? Successful investment in hedge funds is about accessing highly skilled managers. But is there a capacity issue? The more money flowing into the funds, the more congested will be the strategies that funds rely on for their returns. It is logical that certain funds will suffer in a crowded environment. The poor overall performance of the sector in 2004 may give some indication this trend is already happening.

So what does the future hold for hedge funds? Two clear issues are future trading returns and regulation.

Future Returns

In a crowded market do attractive opportunities still exist? New trading commodities like carbon dioxide trading emissions or emerging markets like China may only provide some alternate trading opportunities. Do good managers have enough spare capacity to take on more money or are they closed to new investment. In addition as most institutions invest through Fund of Hedge Fund structures, can these funds also access high quality managers? In future the opportunities for high returns for new money may be significantly reduced and only available in new markets.

Regulation

The FSA has stated that it is examining the potential risks prime brokers face from hedge funds, after the spectacular collapse of the US Long term Capital Fund. Will we follow the approach of the SEC.? In 2005 any US fund with over USD 25M under management will be obliged to post fund results through the SEC for public viewing.

This secretive market is maturing. In a crowded market we are now seeing some shake out with analysts now estimating that 2/3 of new funds will now fail within the first year. However the sector's influence is now becoming more evident in the city. How long will it be before the first headline grabbing FTSE 100 acquisition arises? Will increased regulation and the request for more fund transparency effect future trading returns?



Gerry Collins provides a wide range of services to the financial markets sector ranging from FSA application sign off, providing a totally outsourced back office support function for such entities, acting as FSA auditor and also, providing tax and financial planning advice on a proactive basis. If you would like to speak to Gerry, you can email him at gcollins@wingrave.co.uk or phone him on 020 7495 2244.