Convergence in the funds industry – from mutual funds to private equity

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The funds industry is in the middle of a quiet revolution in the way that investments are structured and managed. The traditional battle lines of relative return versus absolute return are being eroded daily and the players are reinventing themselves with new offerings for the more dynamic world we live in.

This paper explores the shift to absolute return focused funds, the merger of long only hedge funds with 130/30 funds and the acceptance of longer term less liquid strategies as a way of delivering alpha. It will also look to the future and the role of synthetic hedge fund of funds and what portable alpha may look like.

Before addressing the history of the investment management business it is worth taking a step back to reflect on "what is it we really do?" In short, this industry aims to make money for our clients and the impacts of technology, globalisation and the human desire to innovate naturally make this a very dynamic and changing landscape. At this moment in time we, the industry, are at a significant stage in the final evolution of the market place and the next 10 years will see this process complete with funds management being offered based on return expectations and liquidity, rather than on predefined asset categories. The reason for this fundamental change is the convergence that is happening daily across all segments of the investment community. It has accelerated as a result of the bear market of 2000 to 2002 when institutional and private investors alike came to the conclusion that absolute return was the only meaningful measure of performance. A further catalyst has been the talent drain away from traditional investment houses to hedge funds, where the personal incentives are a multiple of those in a traditional firm, especially one in the institutional space.

The changes that are examined in this research paper have all been driven by investor behavior that over time has become more sophisticated in its demands. Risk management has been a primary beneficiary of the advances in technology along with the creation of more efficient instruments to manage risk. However, against this increase in sophistication, the basic needs of the investor remain reasonably constant, the best returns for the least amount of risk. The major change we have experienced has been the move away from relative return objectives (index benchmarks) to absolute return objectives, as the world tries to find ways to deal with aging populations, social insurance fund shortfalls and greater overall volatility, in financial markets.

Industry background

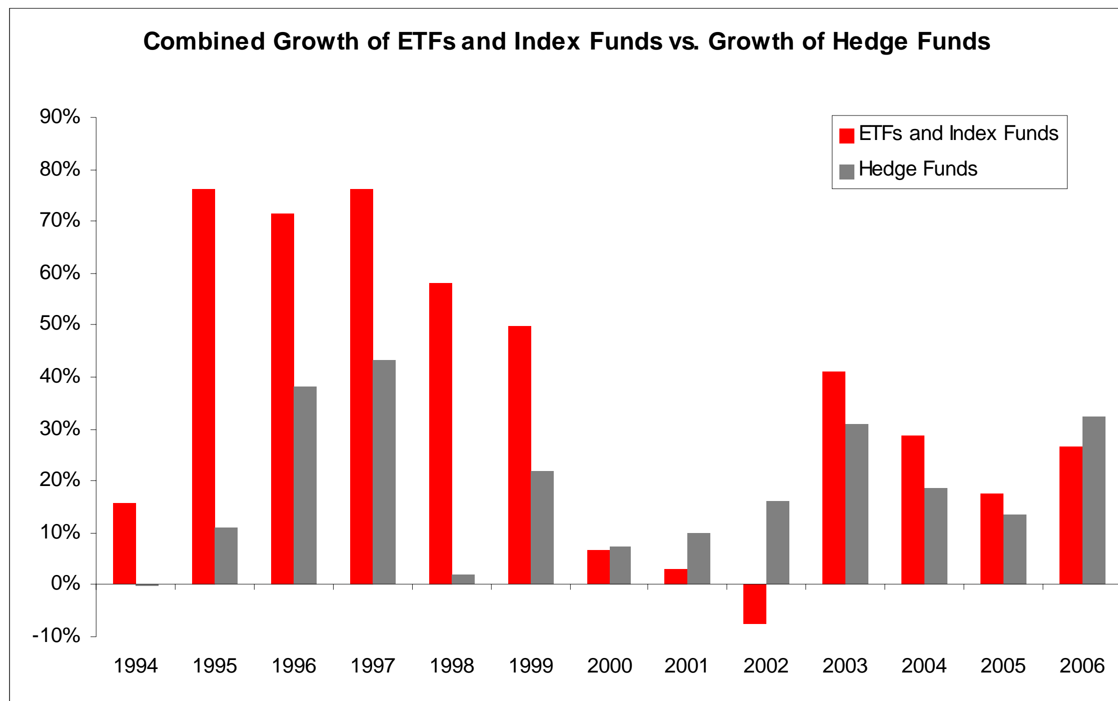
25 years ago, the investment industry was almost exclusively dominated by long only funds that were run against index benchmarks. Benchmarking itself was considered an innovation as was the earlier work of Harry Markowitz in the field of portfolio construction and portfolio diversification. However, as more investors began to subscribe to the view that a reducing number of managers were able to consistently

outperform their target index or benchmark, index tracking funds began to gather traction and the concept of passive investment was born. Its creation was a result of the same investor demands we see today, if returns are not in excess of predefined measures (benchmarks) investors would rather pay lower fees for a systematic approach to investing in the chosen asset. Fees are of much greater importance to investors when they feel they are not getting value for money.

Current landscape

Today one of the largest growth areas in the investment industry is exchange traded funds, the second generation index product. As can be seen in Chart 1 below, ETFs have grown from USD 2Bn ten years ago to USD 423Bn today, roughly equal to 4%[i] of the global mutual fund market. When added to index funds they represent an investment subset close to the size of the hedge fund industry. Over the past decade, assets in these indexed products have increased more than tenfold.[ii] Their offering of liquidity, low fees, transparency and low tracking error make them a corner stone for those seeking either short term tactical exposure to a specific index or asset, or those not concerned about out performance of the long term returns from markets.

Chart 1



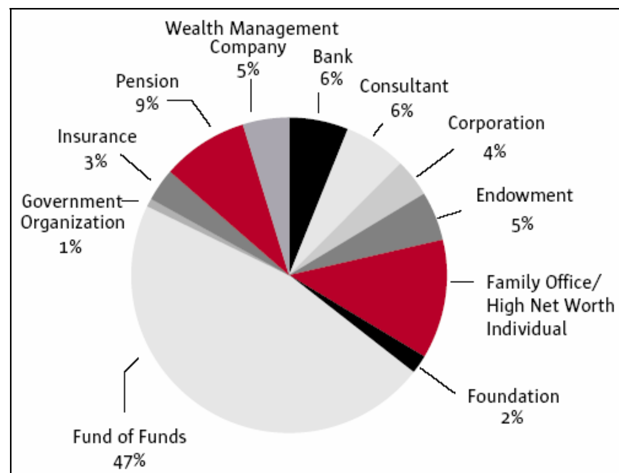
Sources: 2007 Investment Company Institute Fact Book; HFR Q12007 Industry Report

The growth of the passive investment industry has had an inevitable knock on effect to the active world and has lead many talented managers to either focus on less efficient assets that offer the opportunity to deliver above market returns (emerging markets, high yield) or to join the hedge fund community where index benchmarking does not exist. In both cases the investor has supported these managers with capital (hedge fund assets today stand at USD 1.6 trillion) and has accepted higher fees in return for higher returns and higher alpha, Based on the latest Russell Survey on Alternative Investing, investors have

increasing reliance on hedge funds to boost returns and increase portfolio diversification, as they "believe in the active money management and the ability of hedge fund managers to extract alpha from the inefficient markets around the world."[iii] . In addition the investor has accepted a lower level of liquidity ranging from weekly, on specialist emerging market funds, to monthly on equity hedge funds. The motivations of the managers are also easy to work out; they have more flexibility in their investment approach (being unconstrained by a bench mark or a limitation on the financial instruments they can trade) and stand to make more money through performance fees.

Whilst traditional "active" managers continue to exist they are not presently thriving. Investor appetite at both institutional and private client level is for alpha generation. The concept of core and satellite is well ingrained in investors thinking and this is best reflected in the changing composition of the investor base in hedge funds, which is no longer dominated by high net worth individuals and foundations. Pension funds, insurance companies and private investors have all participated in the growth of the hedge fund industry, which in turn has launched long only absolute return funds to enable a wider audience to participate (Refer Chart 2). In most cases the hedge funds have offered the long side of their portfolio and used cash to manage exposure rather than shorts. This has made the transition much easier for investors who were uncomfortable with the level of derivatives, leverage and short exposure common in a long short equity fund.

Chart 2: Composition of Investor Universe in Alternatives.



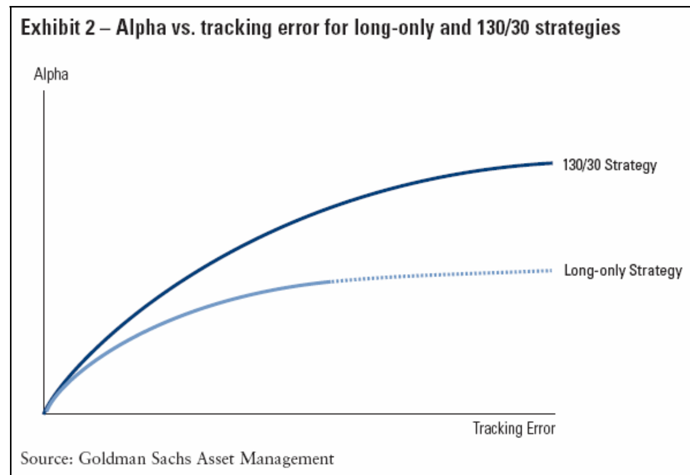
Source: 2006 Deutsche Alternatives Survey,

Development of 130/30 Funds

Where traditional managers are beginning to fight back to capture some of the "active equity" portion of investors' portfolios is through the introduction of 130/30 funds. The name comes from the managers' approach of holding 130% of his fund long and 30% short. This has a number of advantages over a traditional long only portfolio but most importantly maintains the investors' exposure to the market at 100%. The managers' ability to go short the market allows him to express negative views he may have on individual companies, or the market as a whole and thus protect himself from down turns. It also enables him to take more active positions on stocks where he has a positive view whilst hedging his exposure by shorting similar market cap companies where his view is less positive. The 130/30 funds are now providing

a satisfactory middle ground for many managers who have struggled to generate alpha from their existing long only fund but do not want to make the move to an unconstrained, non benchmarked approach, as can be seen in Chart 3 below.

Chart 3 – Alpha vs tracking error for long-only and 130/30 strategies



It is highly likely that the development of 130/30 funds will lead to the cannibalization of many traditional funds. At present the market is seeing both traditional benchmarked managers and quantitative equity long short funds launch products. This is a significant blurring of the old demarcation lines and could ultimately lead to a battle for supremacy. In their favour traditional managers are likely to charge lower fees but they also acknowledge the risk that shorting stock is not simply a reversal of being long. In many cases they will need to hire new portfolio managers, skilled in this discipline or spend time reskilling their existing teams. Investors may well be prepared to pay the higher fees hedge funds will charge to be sure their manager is properly equipped to deal with this new dimension to his process.

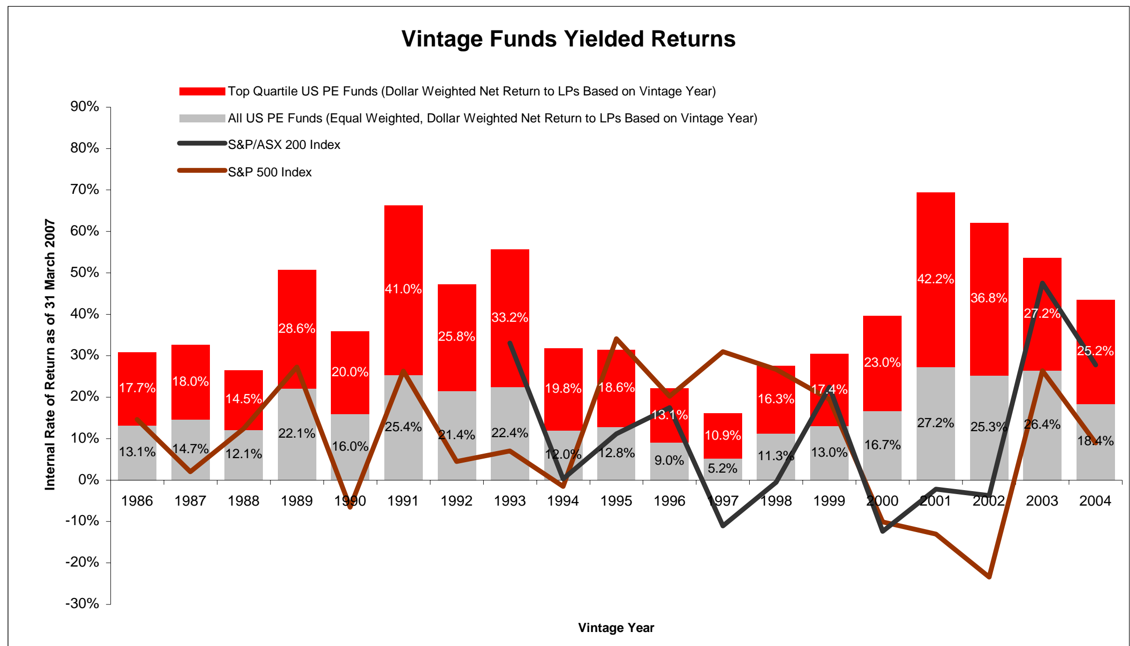
Evolution of Hedge Funds

The move towards a more “main stream” activity by Hedge Funds is also part of the convergence story and is very much where the two worlds of traditional and alternative asset management meet. Many market neutral managers will find the move towards running a fund with net exposure of 100%, more comfortable than their long only colleagues coming to terms with the risks of shorting. The Bear market of 2000 to 2002 was one of the key catalysts that has brought the hedge fund community into the institutional arena at an accelerated pace. Similarly private clients have learnt that contrary to popular belief, hedge funds aren’t high octane investment options but rather a logical core allocation in a well diversified portfolio.

One of the challenges when two “cultures” meet is to agree the terms on which they are to be compared. Hedge funds have traditionally been less liquid than stocks or mutual funds and this has been one of the hardest concepts for investors to grasp. A significant portion of the alpha that hedge funds generate is through a more active approach to shareholding and investing. Many funds specialize in corporate events such as mergers or restructurings and as such need to know that their capital will remain in place until the transactions complete. The best example of a less liquid strategy rewarding investors is Private Equity.

The return from the top firms over the past 15 years has exceeded the return from public market by a multiple of 10[iv]. As illustrated in Chart 4, private equity funds, especially the top quartile performers had not only consistently achieved positive returns, but also generally outperformed the equity markets over the span of 18 years. In an attempt to become more main stream (hedge funds today still only represent a little over 10% of the traditional funds industry) the industry has bifurcated, with one segment striving to provide more liquid solutions and the other moving further down the liquidity curve, nearer to private equity.

Chart 4



Source: Cambridge Associates LLC U.S. Private Equity Index and Benchmark Statistics, 31 March 2007; Bloomberg

Note1: 2005 and 2006 returns are not material as results are premature and capital continues to be deployed

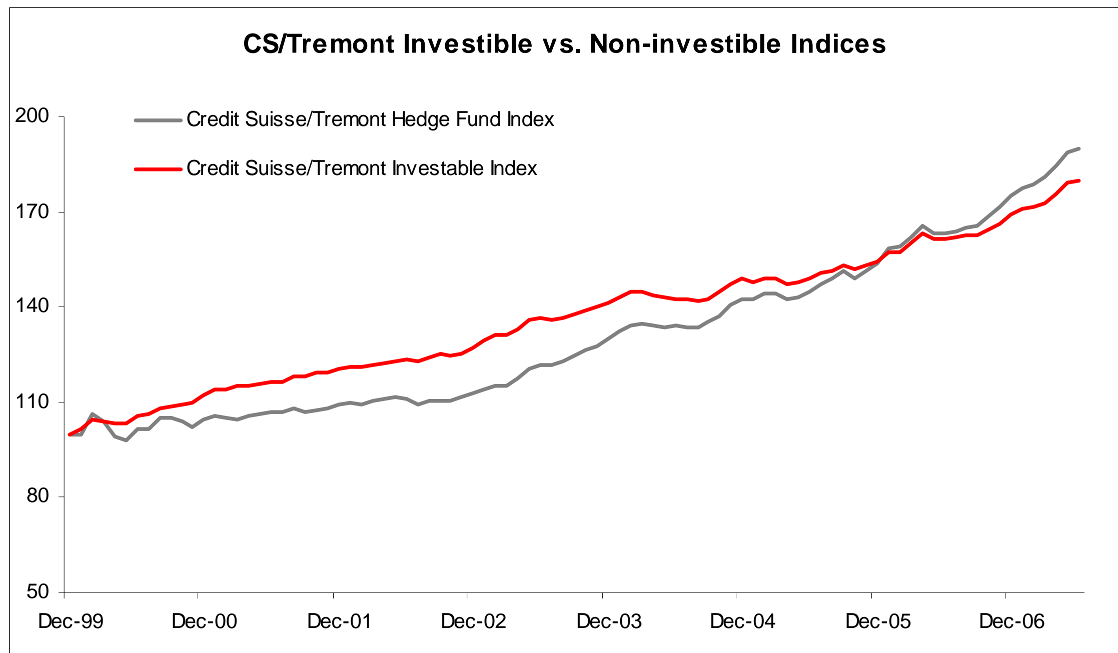
Note2: Based on data compiled from 630 U.S. private equity funds, including fully liquidated partnerships. Returns are net of fees, expenses and carried interest.

In an evolution very similar to the traditional world, hedge funds have turned towards passive indexing as a way meet investors needs. Here the experience has been a little different reflecting the nuances of the hedge fund world. In the 90s, those investors who were not set up to carry out due diligence on individual hedge funds, or simply wished to diversify their risk through a multi manager approach, invested in Fund of Funds. These funds delivered low to mid teen returns in an environment where inflation and interest rates were much higher than they are today and manager capacity was not an issue. As the percentage of institutional investors owning Fund of Hedge Funds increased, the risk return objectives altered with the focus shifting more to diversification of return (away from traditional assets) and management of volatility. This increase in capital into hedge funds started to create capacity constraints in some strategies and a number of the premier managers were forced to close their doors to capital. Finally the increase in popularity lead to an increase in indices as the new generation of investors wanted hedge funds to look more like traditional funds and have “benchmarks” against which to be judged. In many respects this single development changed the ethos of hedge funds which had always been for unconstrained absolute return based managers, many of which had escaped from the index focused world of traditional investing. The

indices did help some investors in their section process, although they had limited qualitative dimension, a key ingredient in successful hedge fund investing.

Investors who wanted to avoid many of these qualitative requirements such as on site due diligence visits turned to the index providers as a potential asset management solution. The key challenge for the indexers was how to run a portfolio of hedge funds where many of the managers were no longer accepting capital. This lead to the birth of the investible index which was created to satisfy this need by only including those managers who were open for investment and, in many cases, were prepared to open a managed account with the index's platform. The significance of this is often missed and leads to a potential selection bias towards those managers seeking to raise capital against those managers closed to new investors. The obvious conclusion is that successful funds have limited difficulty in attracting capital and are ultimately likely to close. On the other hand, newer, less successful, funds seeking to raise money do not have the same following. As can be seen in Chart 5, this bias is reflected in the performance of the investible indices versus the non investible indices where the out performance of the latter has been some 24% over the past 5 years[v]. Unlike the experience in the traditional investment management space the investible index funds have not delivered superior performance with most funds of funds consistently outperforming them due to their positions in closed "premium" managers plus a more active approach to asset allocation. The Investible Indices have raised assets, mainly from investors whose key requirement is liquidity or in some cases ease of execution.

Chart 5



Source: Credit Suisse Tremont Index, 2007

The development of Exchange Traded Fund of Hedge Funds

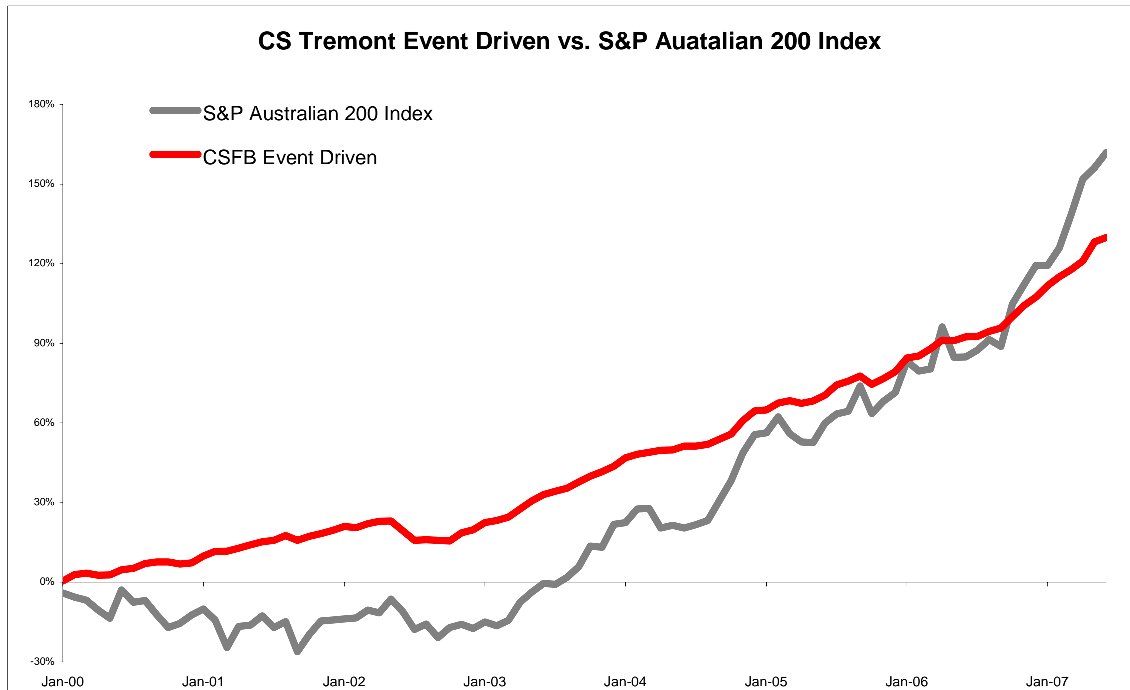
In a similar vein to the traditional world's experience, the next phase of development for the industry was the launch of exchange traded fund of hedge funds. This development overcame the manager selection bias that is the key weakness in the investible index products. As these funds of funds were launched as closed ended companies, they were unconstrained in what managers they selected (subject to their capacity) and provided investors with the outperformance of actively managed funds. The challenge they

faced was that their daily price was generated by the exchange they were listed on (as opposed to the NAV of the underlying managers) and the market price could often go to a discount in periods of redemptions. To overcome this the second generation of ETF fund of hedge funds has offered investors a facility to sell shares back to the manager, at NAV, as they would in an open ended fund. This hybrid redemption facility of either daily liquidity at market price or quarterly / half yearly liquidity at NAV, has successfully limited the discount that these funds traded at. Presently many are now trading at a premium as more investors see the merit of fixed capital fund of funds with little dilution to their star holdings. London and Zurich dominate the market for these products and the London market is about to introduce new rules that will make it easier for funds to list and will add to the growing popularity of these products.

The other branch of the hedge fund world have moved towards offering less liquidity and generating returns from strategies that are less trading oriented. The event driven sub set of the hedge fund universe has always made money from corporate restructurings be they mergers, bankruptcies or restructurings. As such one can argue that this is one of the true “alpha” generating strategies with managers less concerned with the direction of markets and more focused on the successful completion of transactions. As illustrated by the CSFB Tremont Event Driven Index in Chart 6, this strategy has consistently performed over the years with low volatility and low correlation to the market. Historically this focus on deal completion has meant that this group of managers offered less liquidity in their funds to ensure the stable capital needed to see a transaction through to completion. This situation was clouded in 2005 when the SEC, in the US, attempted to regulate all hedge funds over USD 100m UNLESS they offered liquidity terms of 2 years lock up or greater. The rationale being that only professional investors would consider these types of funds and they were not in need of regulator protection. Many funds took the opportunity to avoid the burden of regulation by extending their liquidity terms to a two year lock up and even though the SEC were later defeated on appeal, many have retained these liquidity terms and have chosen to pursue longer term investment opportunities which have consistently been more rewarding. Based on the Deutsche Alternative Investment Survey, 2006 has seen a surge in investors in hedge funds willing to accept longer lock-ups of their capital, investors willing to accept a lock-up of two years or more has more than doubled since the previous year.[vi]

The emergence of these funds has been coincident with the largest volume of corporate transactions in history, in terms of mergers, share buy backs and buy outs. The driving force has been the huge cash surpluses that sat and continue to sit on company balance sheets combined with a significant increase in shareholder rights driven by the Sarbanes Oxley legislation, in the US, in the aftermath of Enron, WorldCom and other corporate scandals. Today value investors are no longer waiting for the market to recognize what they have worked out about a company’s price; they are taking charge of the situation and driving the share price higher in many cases by going head to head with the incumbent management. This ability to extract value is the essence of alpha and whilst the bull market we are currently in makes it difficult to determine alpha from beta, the next down leg for equities will highlight the talent of this group of investors who manage public equity in a similar fashion to their cousins in Private Equity.

Chart 6



Source: Bloomberg. Date: Jan 2000 to Jun 2007

Private Equity

And so to Private Equity and the "Barbarians at the gates". Currently not a day goes by without some mega deal being announced or some further hint of a move to take away their wealth for "being too successful". As has been previously stated there are no other asset classes or styles of investing that have outperformed the returns from the top tier Private Equity funds. This industry is proof that less liquidity leads to consistently higher returns. They also illustrate that fees are much less of an issue when investors are making 20% to 30% per annum net. Despite their position as the premier money managers on the planet, there have also been interesting developments that have made the asset more reachable to a wider audience and have satisfied some of the concerns investors have traditionally held.

Not surprisingly one of the key developments has been the growth in exchange traded funds and the further development of exchange traded funds of funds. The latter has also developed some interesting features with the growth of secondary funds. Outside of the longer term nature of private equity funds the second biggest reason for investors to avoid the asset class has been the "J curve". This is the industry term used for the effect that fees have in the early years when investments are being made. The investor knows with a high degree of certainty he will lose money for the first 2 to 3 years before the initial investments are realized and cashflow becomes positive. A secondary fund purchases the interests of an existing investor and as such limits or in many cases, avoids the J curve and sees immediate growth on the investment. This more "instant return", added to the daily liquidity provided by the exchange, makes the listed secondary more like a traditional fund of funds, in structure, with a different source of return; one that has traditionally outpaced most other investment choices.

Where are we headed?

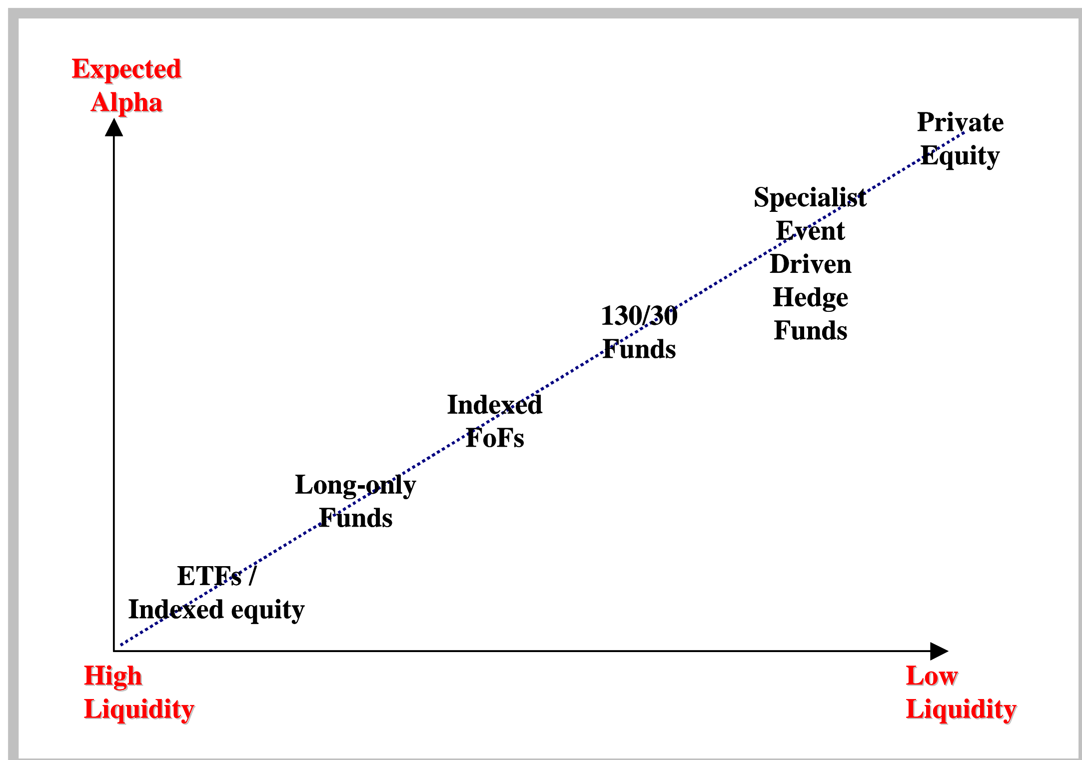
So where does this all end up? The strategic acquisitions of traditional managers of alternative boutiques and the investment banks moving into minority or complete ownership of hedge funds is all part of the consolidation the industry entered into after the last bull market ended. The bear market that ensued was one of the longest most investment professionals advising today had ever experienced. It sounded the death knoll for relative value benchmarking and removed the bizarre situation where award winning managers over 1 and 3 year periods had lost their clients money. Many people have come to recognize that hedge funds are not a different asset class; they are just a different style or approach to making money. Their flexibility has been one of the main reasons for the scores of highly rated long only managers moving over the road and setting up or joining a hedge fund, where their superior stock picking can be aligned with modern risk management to deliver more stable returns. The growth of the 130 / 30 market will stem this flow of talent as the traditional world acknowledges that long short is a more efficient way to run a portfolio. This new product will compete with the more directional hedge funds and may lead to some becoming more liquid to protect their franchises.

Listing a fund on an exchange is a growing solution to the dilemma of manufacturing liquidity for strategies that need time to deliver maximum returns. The ability to transform Private Equity into a daily marked and traded asset class is something that would have been difficult to imagine 10 years ago. The dominance of the derivatives market and the ability to synthetically create any investment opportunity has lead to one of the most exciting development if the multi manager hedge fund, for many years. The introduction of the fund of fund replicator products is seen by some as a liquidity alternative to a traditional hedge fund of funds. The fact that all have been launched during a stress free time frame for hedge funds makes them somewhat untested. They do add another dimension to the liquidity conundrum and like index funds are targeting broad hedge fund market returns.

The fact of the matter is the managers that are capable of delivering higher returns from a more active investment style, be it event driven hedge funds or private equity funds, will continue to be the less liquid. There will be some that will use the exchange traded route to manufacture liquidity but most are already significant established businesses not seeking new money and relying on existing investors when they see more opportunities to invest more capital.

The future

And so the landscape will be set, on one hand long funds that can short and as such improve the efficiency and ultimate return from their funds and as such will deserve a place alongside the ETFs and indexed funds that have made traditional long only investing a commoditised industry. On the other will be the alpha generators who demand stability of capital and will only entertain clients who can commit to investment horizons of years rather than months. Investors will balance their portfolios based on target returns and liquidity needs; those with longer horizons will have the luxury of higher returns and those requiring greater liquidity will need to decide between the level of beta they wish to take on and how much market exposure they are comfortable with.



Finally the question of "portable alpha". The debate still rages on whether or not it truly exists and I believe the consensus is that in order to exist, we must first find true alpha generating strategies. If the less liquid event driven managers and the longer time frame private equity funds are the closest to the source, then portable alpha will involve their management style and expertise wrapped in a more liquid instrument. The development of an exchange traded derivative that gives full participation to their strategy and at the same time neutralizes all beta in their funds, may seen as unlikely today as exchange traded private equity did 10 years ago. For now, investors will have to use the longer term strategies in tandem with their more liquid holdings and manage the cash flow needs accordingly. A challenge but not an insurmountable one and certainly one that gives planners a key role to play in adding value to clients.

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[i] Source: 2007 Investment Company Institute Fact Book
[ii] Source: 2007 Investment Company Institute Fact Book
[iii] Source: The 2005-2006 Russell Survey on Alternative Investing
[iv] Source: Bloomberg – S&P 500 vs. Upper Quartile US PE Funds from 1989 to 2004.
[v] Source: CS Tremont Index. June 2002 – June 2007.
[vi] Source: Deutsche Bank 2006 Alternative Investment Survey