

# HEDGE FUNDS

## City Business Series



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The global hedge fund industry has experienced remarkable growth over the past decade. This brief gives an overview of this industry with particular emphasis on London as the predominant European centre. Hedge funds have featured briefly in other IFSL reports such as Fund Management, Derivatives and International Private Wealth Management.

Hedge funds are private pooled investment limited partnerships which fall outside many of the rules and regulations governing mutual funds. Hedge funds therefore can invest in a variety of securities on a leveraged basis. Today, the term hedge fund refers not so much to the hedging techniques hedge funds may employ as it does to their status as private investment partnerships. There are other unregistered pools of investments that are similar to hedge funds such as venture capital funds, private equity funds and commodity pools which are not categorised as hedge funds.

### THE GLOBAL HEDGE FUND INDUSTRY

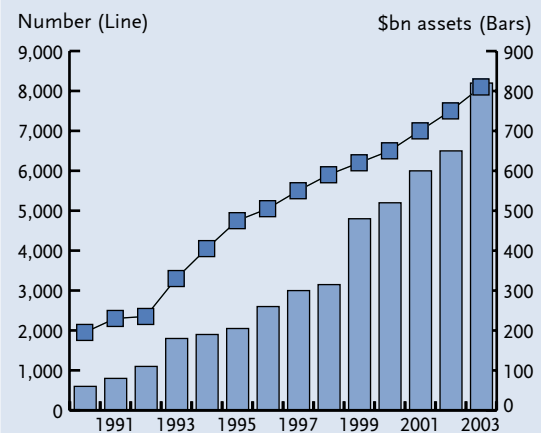
*Assets under management* The number of hedge funds increased from less than 2,000 in 1990 to over 8,100 in 2003 (Chart 1). During this period assets under management grew from \$50bn to \$820bn. In the first quarter of 2004 they increased further to over \$860bn. Growth was very strong in the late 1990s due to the significant increase in the value of the overall equities market. Because these funds typically use leverage, the positions that they can take in the financial markets are larger than their assets under management.

It should be noted however, that estimates of the size of the hedge fund industry vary as there is a lack of transparency in the industry due to restrictions imposed on the advertising and reporting of performance by hedge funds. As there are no authoritative estimates we have relied in this report on commercial services which are provided with information voluntarily. Various commercial services may define hedge funds differently which may account for the varying estimates of the size and structure of this industry.

*Investors in hedge funds* Institutional funds account for an increasing proportion of hedge fund assets under management: 52% in 2002, nearly three times their 19% share in 1992. Although high-net worth individuals increased their allocation to hedge funds during this period, their share of the total declined. Pension funds accounted for a quarter of funds under management in 2002, fund of funds 22% and endowments and foundations 5% (Chart 2).

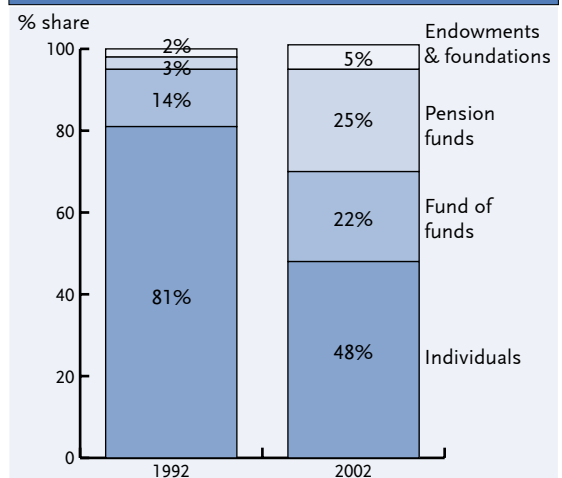
*Location of fund managers* Although the US is still by far the most important location for hedge fund managers with around three-quarters of hedge fund assets under management, over the past few years Europe has gained in importance. As shown in Chart 3, European-based

**Chart 1 Number and assets under management of hedge funds**



Source: Van Hedge Fund Advisors International Inc., Morgan Stanley, Hedge Fund Research

**Chart 2 Hedge funds by investor type**



Source: Hennessee Group and CQA analysis

hedge funds' assets more than doubled between 2002 and 2003 to reach \$170bn at the end of 2003. The number of European-based hedge funds grew from 579 to 814 during this period. Growth in hedge funds in Europe has primarily been driven by increased investment from institutional investors, attracted by risk diversification, the flexibility of investment options and the ability to deliver non-market correlated returns.

London is Europe's leading centre for managers of hedge funds. In 2003, 70% of European-based hedge funds' assets were managed out of the UK, the vast majority from London. Assets managed out of London nearly doubled between 2002 and 2003 from \$61bn to \$119bn (Chart 3). The number of European-based hedge funds located in the UK totalled 513 in 2003, up a quarter on the previous year. These figures, which are compiled by EuroHedge, do not include fund of funds and US hedge funds with a trading desk in London that primarily invest outside of Europe. If these are taken into account, London probably accounts for more than 90% of Europe's hedge funds assets under management.

London's predominance is due to many factors including its local expertise, the proximity of clients and markets, a strong asset management industry and a favourable regulatory environment. The UK was followed by Switzerland and Luxembourg. More recently funds have been established in France, Germany, Sweden, Ireland and Italy.

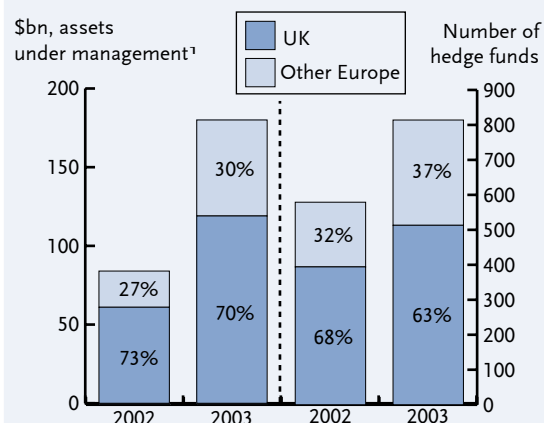
London is also a leading centre for hedge fund services such as legal services, accounting and consultancy services, administration and in particular prime brokerage services. The financial barriers to entry into prime brokerage are high and business is principally conducted by large investment banks. With around a half of European investment banking activity conducted through London, it is a natural location for prime brokerage services.

*Domicile of funds* Hedge funds can be domiciled in onshore or offshore locations. Onshore locations are typically in the US although some countries in Europe have also recognised onshore hedge funds. In most European countries hedge funds operate under the same regulations as fund managers. The regulatory environment for hedge funds is summarised on pages 6 and 7.

The vast majority of offshore funds are registered in tax neutral jurisdictions such as the Cayman Islands, British Virgin Islands, the Bahamas and Bermuda. In 2003, offshore locations accounted for 40% of the number of funds and 49% of assets under management (Chart 4).

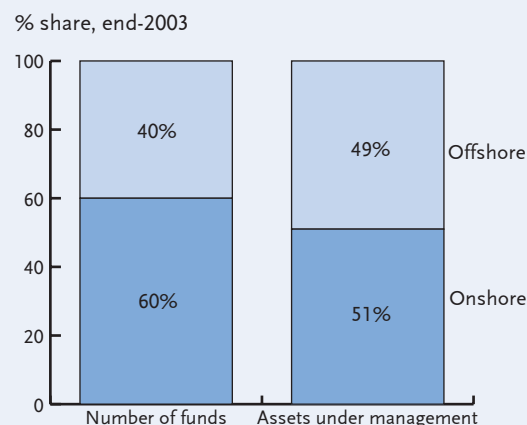
*Largest hedge funds* Most hedge funds are relatively small, but the largest hedge funds are well known and manage the bulk of the money in the hedge fund industry. As Chart 5 shows, in 2002 nearly half the hedge funds managed less than \$25m. A third of funds held between \$25m and \$100m and 19% held between \$100m and \$500m. The largest proportion of funds under management was, however, managed by 4% of funds, each with more than \$500m under management.

**Chart 3 The UK's share of European based hedge funds market**



<sup>1</sup> figures include European based hedge funds or those hedge funds investing exclusively in Europe  
Source: EuroHedge

**Chart 4 Hedge funds by domicile**



Source: Van Hedge Fund Advisors International Inc.

**Table 1 Largest hedge funds**

end-2003	\$bn
Caxton Associates	12.1
Farallon Capital Management	10.6
Angelo, Gordon & Co.	10.0
Citadel Investment Group	9.3
Cerberus Capital Management	8.7
Andor Capital Management	8.3
Soros Fund Management	8.3
Vega	8.2
Bridgewater Associates	8.1
Man/AHL	8.1

Source: Absolute Return / EuroHedge

As Table 1 shows, eight of the largest ten hedge funds in 2003 were from the US. Caxton Associates topped the list with \$12bn under management. It was followed by Farallon Capital Management, Angelo Gordon & Co. and Citadel Investment Group. Vega (8th with \$8.2bn), and Man/AHL (10th with \$8.1bn) were the highest ranked European funds. As shown in Table 2, GAM Multi-Manager was the largest hedge fund of funds at the end of 2003, followed by RMF and Permal Group.

**KEY CHARACTERISTICS OF HEDGE FUNDS**

Some of the key characteristics of hedge funds include:

- Being exempt from many of the rules and regulations governing mutual funds. Because of this hedge funds are not required to meet disclosure requirements but are prohibited from public advertising and soliciting investors directly or through a registered broker-dealer;
- Flexibility in their investment options. For example hedge funds can use short selling, leverage and derivatives. This enables them to deliver non-market correlated returns. Van Hedge Fund Advisors estimates that 27% of hedge funds did not use leverage in December 2002, 45% used less than 2:1 leverage and the remainder were above 2:1 (Chart 6);
- Wide dispersion in investment returns, volatility and risk;
- Linking compensation to performance with compensation of managers based on a percentage of the hedge fund’s capital gains and capital appreciation. In addition, hedge fund managers often have their own money invested in their fund.

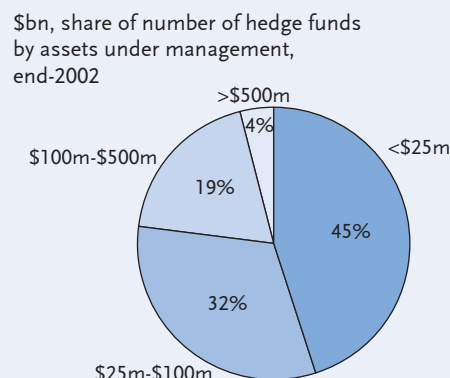
**Difference between hedge funds and mutual funds**

Hedge funds have a structure similar to mutual funds in that they are both pooled investment vehicles that accept investors’ money and invest it on a collective basis in publicly traded securities.

There are, however, many important distinctions:

- Mutual funds are highly regulated and restricted in the variety of investment options. Hedge funds are less regulated and therefore have a wider range of investment options;
- Mutual funds are measured on relative performance such as a market index or other mutual funds. Hedge funds are expected to deliver absolute returns;
- Hedge funds are often specialised and operate within an industry or speciality that requires a particular expertise;
- Mutual funds remunerate managers based on percent of assets

**Chart 5 Size distribution of hedge funds**



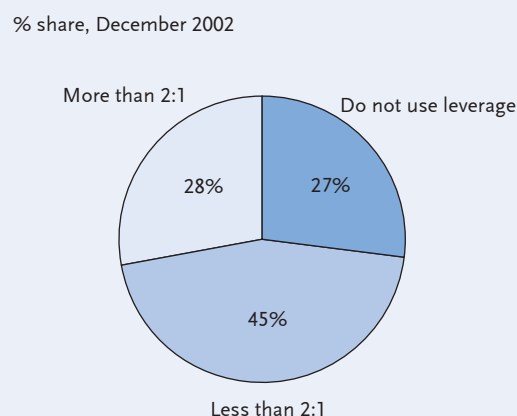
Source: Van Hedge Fund Advisors International Inc.

**Table 2 Largest hedge fund of funds**

end-2003	\$bn
GAM Multi-Manager	17.9
RMF <sup>1</sup>	13.3
Permal Group	11.1
Union Bancaire Privee	10.9
Quellos Capital Management	10.3
Ivy Asset Management Corp.	9.5
UBS Global AM <sup>2</sup>	9.4
Financial Risk Management	8.6
Goldman Sachs AM	8.3
Grovenor Capital Management	7.9

<sup>1</sup> assets as at 31.10.2003; <sup>2</sup> assets as at 30.09.03  
Source: InvestHedge

**Chart 6 Hedge funds use of leverage**



Source: Van Hedge Fund Advisors International Inc.

under management. Hedge funds remunerate managers with performance related investment fees. Hedge fund managers typically charge a 2% basic fee plus a 20% performance fee. Fund of hedge funds operators typically charge an additional 1.5% in basic fees and up to 10% in performance fees;

- The future performance of mutual funds is dependent to a greater extent than that of hedge funds on the direction of equity markets;
- Hedge funds have much larger minimum investments (average \$1m) than mutual funds. Usually very little of the investment manager's own money is invested in mutual funds;
- While mutual funds are available to the general public, hedge funds usually face many restrictions in selling their product. In the US, for example, an individual needs to be an accredited investor (annual income over \$200,000 or net worth over \$1m) in order to invest in a hedge fund.

**HEDGE FUND INVESTMENT STRATEGIES**

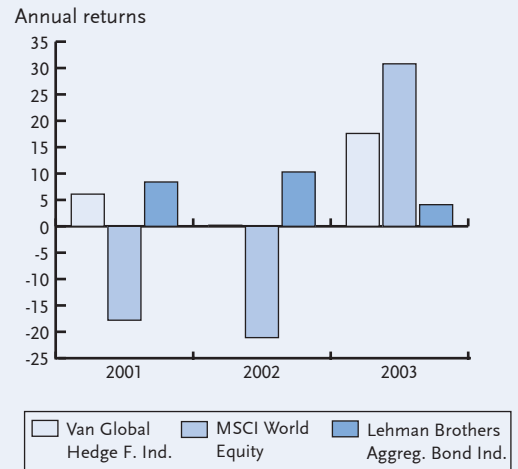
Hedge funds differ in the amount of investment risk they are willing to undertake. Investment strategies vary enormously, some use leverage and derivatives while others are more conservative and employ little or no leverage. Hedge funds are typically highly specialised and trade within their area of expertise. Strategies may be designed to be *directional* (which try to anticipate market movements) or *market-neutral* which have low correlation to the overall market movement). Generally, the more 'directional' a fund, the more volatile and a higher potential return or loss. Hedge funds may allocate their assets across several strategies at the same time. Although returns may vary significantly in different years (Charts 7 and 8), hedge funds have outperformed both the MSCI World Equity index and Lehman Brothers Aggregate Bond Index over the past 16 years. There is however a survivorship bias, whereby published results for hedge funds don't include the returns of hedge funds that don't exist anymore.

There are various hedging strategies available to hedge funds including selling short (selling securities without owning them), using arbitrage, trading options and derivatives or investing in anticipation of a specific event (merger, takeover, etc.). Generally, the predictability of future results is strongly correlated with the volatility of a strategy. The broad types of investment strategies include:

*Non-directional or market-neutral strategies* tend to involve less risk than directional strategies due to a lower degree of exposure to the broad movements of a market. Typical strategies include:

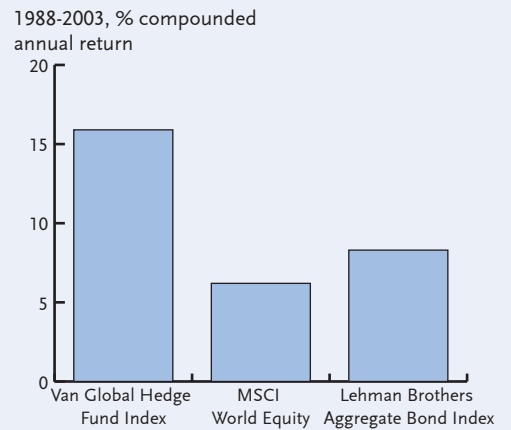
*Arbitrage* is the exploitation of the relative mispricing of securities. This is facilitated by the use of derivatives, trading software and trading on different exchanges. Because price inefficiencies tend to be very small, arbitrage

**Chart 7 Hedge fund returns**



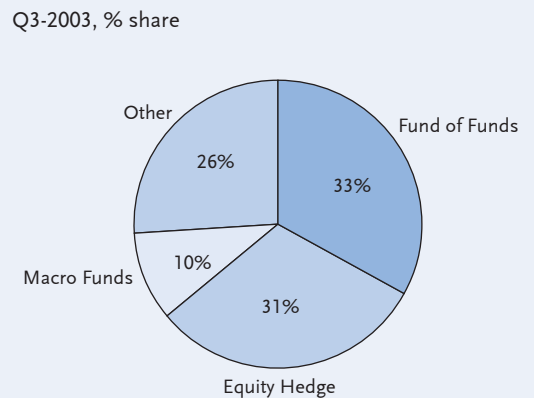
Source: Van Hedge Fund Advisors International Inc.

**Chart 8 Hedge fund long-term returns**



Source: Van Hedge Fund Advisors International Inc.

**Chart 9 Hedge fund strategy composition**



Source: Hedge Fund Research

requires large, usually leveraged, investments and high turnover.

*Event-driven strategies* take advantage of the perceived mispricing of securities by anticipating events such as corporate mergers or bankruptcies and their effects. A 'Distressed Securities' strategy involves investing in companies undergoing some form of reorganisation. 'Risk/Merger arbitrage' strategies attempt to profit from pending merger transactions by purchasing stock of a company to be acquired in the merger and selling the stock of the acquiring company.

*Market Trend or Directional strategies* are used by the majority of hedge funds. These strategies have a large degree of exposure to the broad movements of the market. Such strategies include:

- *Macro funds* This type of strategy involves looking at global trends and placing large directional bets on for example currencies, interest rates, or commodities. The method and degree of hedging can vary significantly;
- *Long/Short strategies* try to exploit perceived anomalies in the prices of securities. 'Equity hedge' strategies involve holding a portfolio of long and short stock positions in order to negate the impact of general market movements. The net exposure (gross long minus gross short) is generally low. 'Equity non-hedge' strategies are similar but with larger net exposure. In this way the funds may have positive performance irrespective of the direction of the market;
- *Emerging market strategies* involve investing in emerging markets which tend to have higher inflation and volatile growth. This strategy typically does not involve shorting or hedging due to restrictions that may be in place in many emerging markets on short sales.

*Funds of Hedge Funds* combine various hedge funds and other pooled investment vehicles. Their holdings consist of shares in hedge funds and private-equity funds. Investors in funds of funds are willing to pay two sets of fees, one to the Fund of Hedge Funds manager and another to the managers of the underlying funds. Investing in Funds of Hedge Funds allows for a more stable investment return than when investing in any individual fund or strategy. These also sometimes offer access to individuals with smaller amounts of money to invest. In recent years investing in Funds of Hedge Funds has been the fastest growing strategy. In Q3-2003 it accounted for a third of the stock of hedge fund assets under management (Chart 9).

### **HEDGE FUND SERVICE PROVIDERS**

*Prime brokers* are firms offering brokerage and other professional services to hedge funds and other large institutional customers. Most hedge funds use more than one prime broker in order to diversify risk (Chart 10). Prime brokerage is a system developed by broker-dealers to

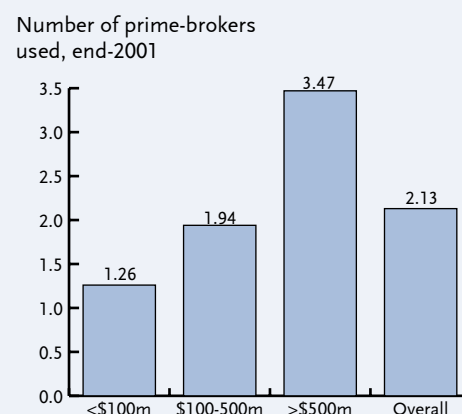
### **The history of hedge funds**

Alfred Winslow Jones is often credited with having started the first hedge fund in 1949. Jones combined shorting and leverage and used them to hedge against market movements. In 1952 he converted his general partnership fund into a limited partnership investing with several independent portfolio managers. The fund was structured so that it was exempt from SEC regulations which enabled it to use a wider variety of investment techniques.

It wasn't until the mid-1960s that hedge funds became more popular. In 1968 there were 140 hedge funds in existence. Many funds suffered significant losses during the bear markets of 1969-1970 and 1973-1974. The number of live hedge funds more than halved during this period. It wasn't until 1986 when an article in Institutional Investor documented the superior performance of Julian Robertson's Tiger fund that hedge funds began to come into fashion again.

In the early 1990s the hedge fund industry attracted negative publicity. Profits made by hedge funds from the British pound's exit in 1992 from the European Exchange Mechanism and the 1997 fall of the Thai Baht contributed to their reputation of benefiting from financial market chaos. In the late 1990s hedge funds again attracted headlines but this time for large losses following the Russian debt crisis and collapse of Long Term Capital Management (page 7) and losses incurred following the fall in the value of technology related stocks.

**Chart 10 Average number of prime brokers used by hedge funds**



Source: Global Custodian

facilitate the clearance and settlement of securities trades and to provide other services for high net worth retail customers, institutional customers and hedge funds. Rather than providing particular niche services prime brokers try to offer a diverse range of services in order to attract large customers.

Services offered by prime brokers typically entail providing operational support such as the clearing and settlement of trades, keeping custody of and lending against assets and maintaining books and records (Chart 11). Many prime brokers also provide other services such as access to research, on-line reporting and consulting. Prime brokers may also offer new hedge fund advisers with introductions or referrals to lawyers, accountants and other service providers. The bulk of prime brokers' income comes from cash lending to support leverage and stock lending to facilitate short selling.

London is Europe's leading centre for prime brokerage and accounts for more than 90% of its activity, as the largest investment banks are either headquartered or have a major office in London. Research by EuroHedge shows that in Europe in 2003, Morgan Stanley and Goldman Sachs were by far the largest prime brokers with 30% and 16% of the market. They were followed by CSFB, UBS and JP Morgan (Chart 12). According to Tremont Tass the largest global providers of prime brokerage services include Morgan Stanley, Goldman Sachs and Bear Stearns.

*Offshore administrators* Managers of offshore hedge funds usually rely on offshore administrators for various types of services and operational support. In addition to helping set up the offshore fund, offshore administrators may also, for example, provide accounting and reporting services; offer advice on an ongoing basis with reference to complying with applicable laws; or offer independent pricing of a fund's portfolio of securities. Some offshore locations may subject the administrators to licensing and auditing requirements.

*Custody* Hedge fund assets are generally held with a custodian, including cash in the fund as well as the actual securities. Hedge funds may make sub-custodian arrangements to ensure assets are held by a custodian of their choice.

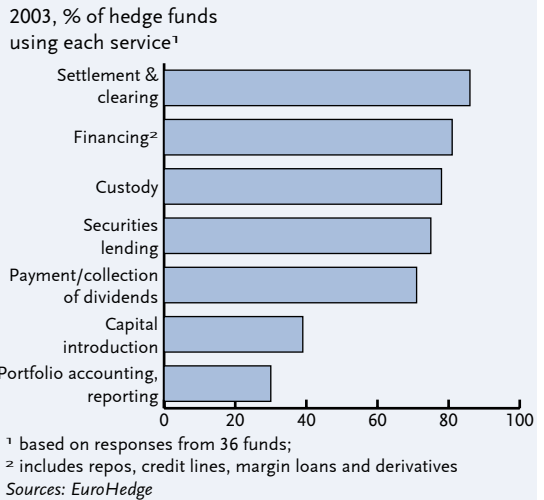
*Auditing* Most hedge funds are set up in a way that does not require them to have their financial statements audited. Some hedge funds however, may undergo annual audits if this is a part of the contract between the hedge fund and its investors. Some offshore locations such as Bahamas and the Cayman Islands require hedge funds to have their accounts audited.

**REGULATORY ENVIRONMENT FOR HEDGE FUNDS**

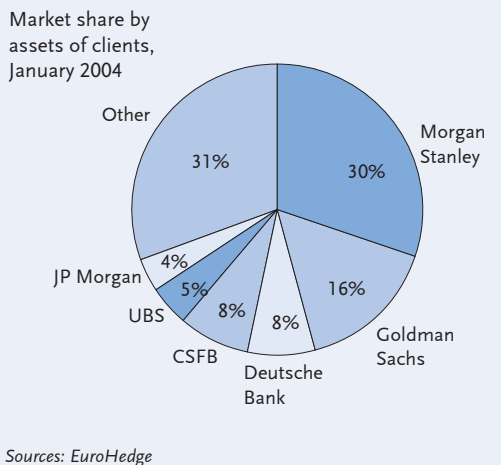
Most hedge funds are organised as limited partnerships or limited liability companies. Based on domicile, hedge funds can be classified into onshore and offshore:

*Onshore or domestic hedge funds* are investment companies registered in an onshore location:

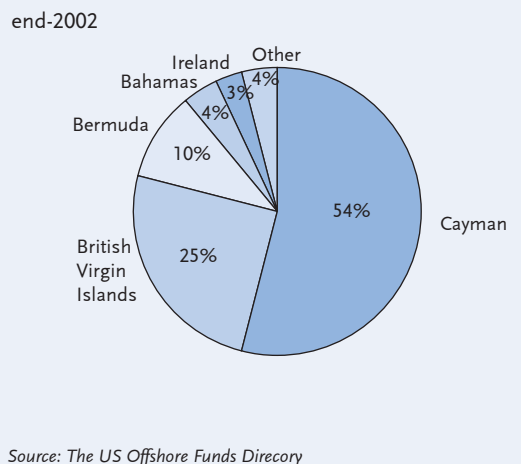
**Chart 11 Prime brokerage services**



**Chart 12 European hedge fund prime brokers**



**Chart 13 Offshore assets by destination**



*US hedge funds* In the US, hedge funds are structured to take advantage of exemptions in a number of SEC (Securities and Exchange Commission) regulations. This allows them to trade in securities and apply strategies that would not be available to registered funds. Due to their deregulated status hedge funds are subject to limited disclosure requirements. US hedge funds maintain their exemption from securities and mutual fund registration by limiting the number of investors. The Investment Company Act which applies to US mutual funds exempts funds with less than 100 investors. In 1996 it was amended to allow more investors to participate but required that investors be 'Accredited Investors' with significant high net worth or institutional investors with over \$25m.

*European hedge funds* Growing interest from retail and institutional investors such as pension funds and life insurance companies in more regulated diversified products has resulted in an increasing number of EU domiciled hedge funds. Switzerland, Ireland and Luxemburg have more liberal regulatory systems for hedge funds than other European countries although this does not always extend to distribution. It is expected that European regulation will move towards US style regulation with fewer restrictions.

The UK is the most popular location in Europe for managers of hedge funds. These fund managers provide services to hedge funds, including consulting services such as advice on investment strategy and are therefore regulated by the Financial Services Authority (FSA). FSA authorised fund managers are able to take advantage of the Investment Services Directive which allows them to offer their investment services to other countries within the EEA. The FSA also specifies the restrictions on sales and marketing of hedge fund products. Hedge fund products cannot be, for example, marketed to the general public but UK investors can deal directly with offshore funds. Some types of investors can invest through UK intermediaries.

*Offshore hedge funds* are registered in tax neutral jurisdictions such as the Cayman Islands, British Virgin Islands, the Bahamas and Bermuda (Chart 13) allowing the investors to minimise their tax liabilities by investing outside their country. Offshore hedge funds are usually structured as corporations although may sometimes be limited partnerships. Generally the number of investors is not restricted. Onshore hedge funds often set up a complementary offshore fund to attract additional capital without exceeding limits on the number of investors.

**Table 4 Offshore hedge funds by size of fund**

end-2002	<\$100m	>\$100m and <\$1bn	>\$1bn
% of number	64	33	3
% of capital	9	48	43
average size \$m	32	304	2687

Source: The US Offshore Funds Directory

### Long Term Capital Management

The reputation of hedge funds was damaged five years ago by the collapse of LTCM which was a quantitative-strategy managed hedge fund that invested primarily in the US, Japanese and European markets. Its positions were primarily in global fixed income arbitrage and equity index futures arbitrage. Because they were structured for consistent small returns, they were highly leveraged. In 1998, on capital of \$4.8bn, LTCM managed positions worth around \$120bn. The leverage ratio of LTCM was therefore over 25, higher than the vast majority of hedge funds (Chart 6).

The Russian debt crisis in 1998 caused global interest rate anomalies. LTCM lost 90% of its real value and could not maintain its open positions which were mostly in debt securities interest rate spreads between countries within the European Monetary System. In September 1998, the Federal Reserve Bank of New York helped to coordinate a \$3.6bn private rescue of LTCM by a consortium of 14 major international financial institutions. This was to facilitate an orderly closure of its positions and avoid the possible destabilisation of global financial markets. This event had an adverse impact on the hedge fund industry. As shown in Chart 1, the growth in the number of funds and assets under management temporarily stalled in 1998. Since then there has been a reduction in the average leverage ratio of hedge funds.

**LINKS TO OTHER SOURCES OF INFORMATION:**

[www.absolutereturn.net](http://www.absolutereturn.net)  
[www.aima.org](http://www.aima.org)  
[www.eurohedge.co.uk](http://www.eurohedge.co.uk)  
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This Brief was compiled by IFSL Economist Marko Maslakovic with advice from IFSL's Director of Economics Duncan McKenzie.

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