

HEDGE FUNDS

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The hedge fund industry has experienced remarkable growth over the past decade both in assets under management and in the number and type of institutions that are investing in hedge funds. The aim of this report is to give an overview of the global hedge fund industry with particular emphasis on London as the predominant European centre.

International Financial Services, London
29-30 Cornhill
London, EC3V 3NF

Tel: +44 (0)20 7213 9100
Fax: +44 (0)20 7213 9133
E-mail: enquiries@ifsl.org.uk

www.ifsl.org.uk

THE GLOBAL HEDGE FUND INDUSTRY

Assets under management The number of hedge funds increased from less than 1,000 in 1990 to over 8,000 in 2004 (Chart 1). During this period assets under management grew from \$25bn to \$934bn. In 2004 alone, hedge funds assets increased by \$139bn, \$75bn from net inflows and \$64bn from positive performance. Recent years have been characterised by increased investment from institutional investors such as pension funds, universities, endowments and charitable organisations. Because hedge 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 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. These commercial services may define hedge funds differently which may account for the varying estimates of the size and structure of this industry.

Geographical distribution of hedge funds

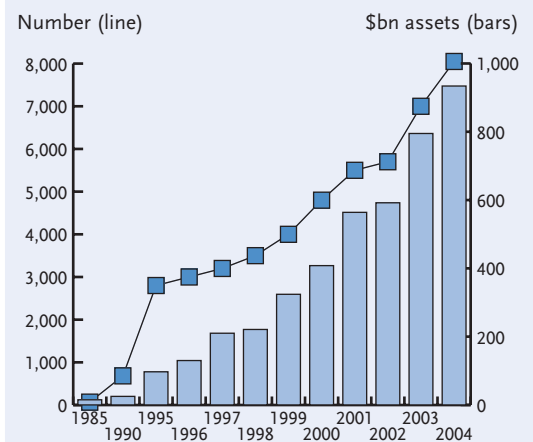
Source of investments According to IFSL estimates based on Eurohedge and Hennessee Group data, the US was by far the leading source of hedge fund investments accounting for 69% of the total stock of hedge fund assets under management at the end of 2004. Europe was the source of 23% of assets and Asia 5%. Europe and Asia however have gained in importance in recent years as shown in Chart 2.

Location of hedge fund manager New York is the world's leading location for hedge fund managers with about twice as many hedge fund managers as the next largest centre, London. This is not surprising considering that the US is the source of the bulk of hedge fund investments. Other important centres in the US for hedge fund managers include California and Connecticut.

Japan was the most important centre for Asia-Pacific hedge fund managers. Managers located there accounted for nearly a quarter of the \$47.4bn in Asia-Pacific hedge funds' assets in June 2004. Other important locations in this region included Australia (managers accounted for 18% Asia-Pacific assets) Hong Kong (17%) and Singapore (3%).

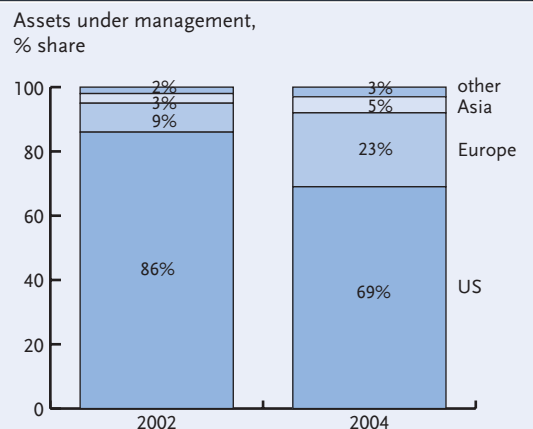
London is Europe's leading centre for the management of hedge funds. At the

Chart 1 Global hedge funds



Source: Hennessee Group LLC; Hedge Fund Research

Chart 2 Global hedge funds by source of funds - regional breakdown



Source: IFSL estimates based on EuroHedge and Hennessee Group data

end of 2004, nearly three-quarters of European-based hedge funds' assets totalling \$256bn were managed out of the UK, the vast majority from London (Chart 3). Assets managed out of London more than tripled between 2002 and 2004 from \$61bn to \$190bn. These figures, which are compiled by EuroHedge, do not include fund of funds and US hedge funds which have trading desks in London and primarily invest outside Europe. If these are taken into account, hedge fund managers located in London probably accounted for more than 90% of European hedge funds assets.

Growth of the European hedge fund industry has primarily been driven by increased investment from institutional investors, attracted by risk diversification, flexibility of investment options and ability to deliver non-market correlated returns. IFSL estimates that there were over 900 European-based hedge funds at the end of 2004, of which around two-thirds were located in London. Other locations for hedge fund managers in Europe include Spain, France and Switzerland. More recently funds have been established in Sweden, Ireland, Netherlands and Germany.

London's strong position 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. 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.

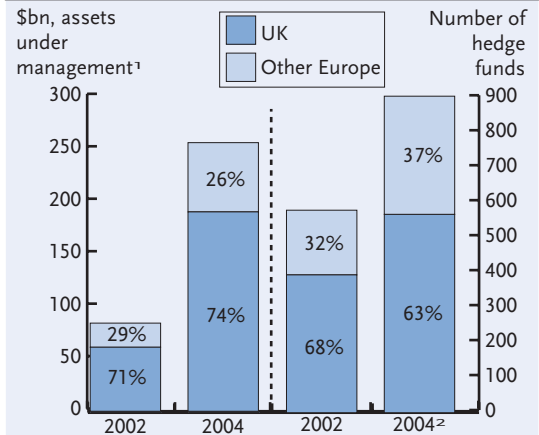
INVESTORS IN HEDGE FUNDS

In the 1990s most hedge fund investments came from high net worth individuals. In recent years however, institutional clients such as pension plans and endowments are generating an increasing proportion of capital flows. They accounted for 32% of hedge fund assets under management in 2004, up from 22% in 1996 and 19% in 1992 (Chart 4). Although high net worth individuals have increased their allocation to hedge funds over the past decade their share of the total declined.

In the UK, some pension funds looking for new strategies to increase returns are investing in hedge funds and other alternative investments. According to a 2005 JP Morgan Fleming Asset Management survey, 12% of UK pension funds allocated on average 4.8% of their portfolios to hedge funds. About 40% of the pension funds surveyed said they were considering investing in hedge funds.

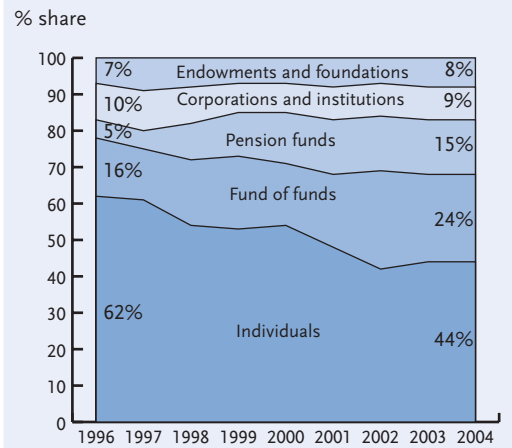
A 2004 survey by Prospera Research showed that 30% of European institutions surveyed invest in hedge funds. There are however significant regional differences. In Switzerland for example 58% of institutions have hedge fund investments whereas in the UK the figure is 15%. Across Europe, 61% of the institutions surveyed plan to hire hedge fund managers over the next two years.

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



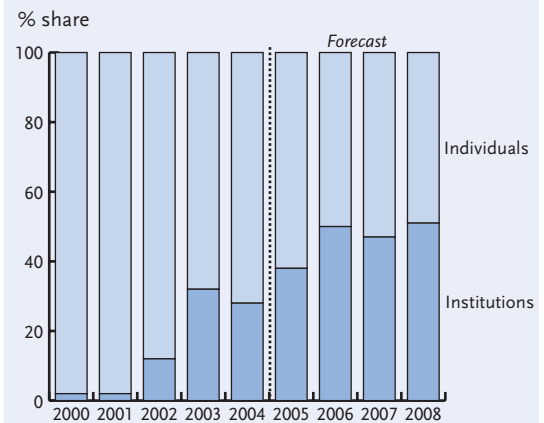
¹ figures include European based hedge funds or those hedge funds investing exclusively in Europe; ² July 2004
Source: EuroHedge

Chart 4 Global hedge funds by sources of capital



Source: Hennessee Group LLC

Chart 5 US institutional share of hedge fund capital flows



Source: The Bank of New York and Casey

Definition of a hedge fund

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 rise of institutional allocation to hedge funds is even more evident from capital flows data, which shows that in the US institutional assets generated 28% of hedge fund capital flows in 2004, up from just 2% in 2000. This is forecast to rise to 50% by 2008 (Chart 5).

The rise of institutional capital invested in hedge funds is likely to have a significant impact on the hedge fund industry. Institutions are typically more demanding than individual investors in requiring more robust business models and a reduction in risk. About a half of institutional investments in hedge funds are in fund of funds which are registered investment companies that have more formalised and transparent business models and invest in a series of hedge funds. The increased indirect exposure of smaller investors to hedge funds through for example pension funds may accelerate changes in the regulation of hedge funds.

LARGEST HEDGE FUNDS

Compared to the fund management industry where a majority of assets are concentrated amongst a few funds, the hedge funds industry is relatively fragmented with over 8,000 hedge funds in existence at the end of 2004. As Chart 6 shows, in 2003, hedge funds holding less than \$25m managed 40% of hedge funds assets. A third was managed by hedge funds holding between \$25m and \$100m and a quarter by hedge funds holding more than \$100m.

Caxton Associates topped the list of the largest hedge fund managers with \$11.5bn under management at the end of 2003. It was followed by GLG Partners and Citigroup Alternative Investments. GLG Partners was the largest European hedge fund manager in September 2004, followed by Vega Asset Management (Table 1). UBS was the largest hedge fund of funds, followed by Man Investments and Union Bancaire Privée.

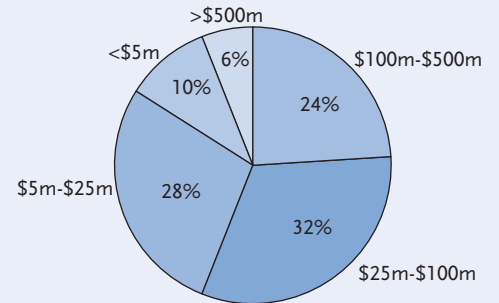
KEY CHARACTERISTICS OF HEDGE FUNDS

Some of the key characteristics of hedge funds include:

- Exemption from many of the rules and regulations governing mutual funds. Hedge funds therefore are not required to meet disclosure requirements and are prohibited from public advertising and soliciting investors directly or through a registered broker-dealer;
- Flexibility in their investment options. Hedge funds can use short selling, leverage and derivatives. This enables them to deliver non-market correlated returns. Van Hedge Fund Advisors estimates that 29% of hedge funds did not use leverage in December 2003, 41%

Chart 6 Size distribution of global hedge funds

% share of the number of hedge funds by assets under management, end-2003



Source: Van Hedge Fund Advisors International Inc.

Table 1 Largest hedge funds

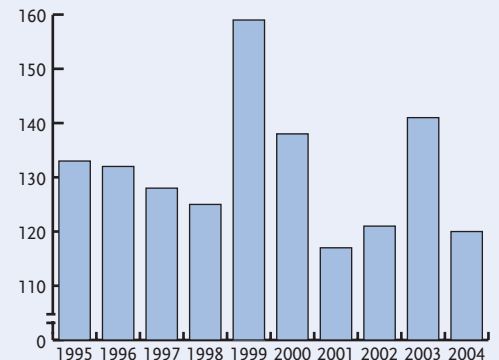
Largest European hedge funds (September 2004)	\$bn
GLG Partners	11.1
Vega Asset Management	11.1
Man Investments	9.7
Barclays Global Investors	8.0
Brevan Howard Asset Management	7.4

Largest global fund of funds (June 2004)	\$bn
UBS	38.4
Man Investments	18.6
Union Bancaire Privée	15.9
Permal Asset Management	15.1
Ivy Asset Management Corporation	14.1

Source: Institutional Investor

Chart 7 Hedge funds use of leverage

Gross market exposure as a % of assets under management



¹ IFSL estimates based on BIS data
Source: Hennessee Group LLC

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 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.

used less than 200% leverage and the remainder were above 200%. As Chart 7 shows, leverage averaged between 115% and 160% of assets between 1995 and 2004;

- 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 (Chart 8). In addition, hedge fund managers often invest their own money in their 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). Due to an increase in institutional demand, some hedge funds restrict their investments to long positions in stocks like ordinary mutual funds.

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

Chart 8 Management and performance fees

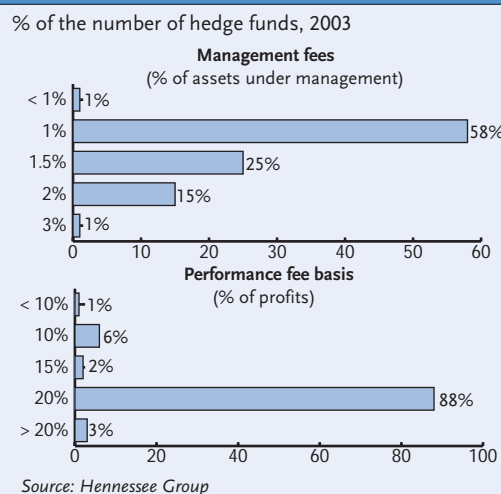


Chart 9 Global hedge fund returns

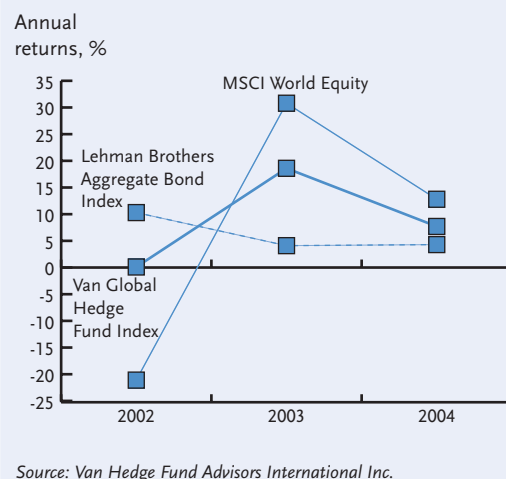
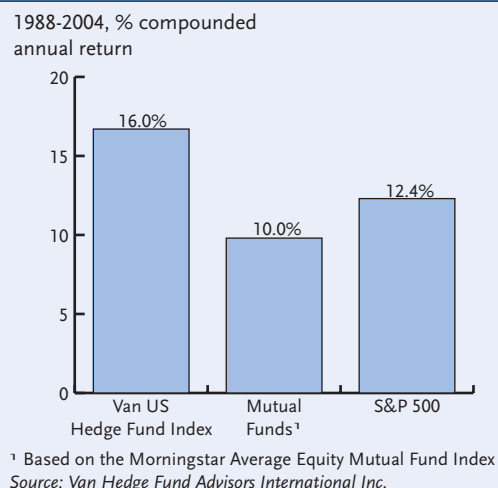


Chart 10 Global hedge fund long-term returns



different years (Charts 9 and 10), hedge funds have outperformed both the Average Equity Mutual Fund Index and S&P 500 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. According to Hennessee Group, the proportion of hedge funds closed averaged around 5% a year between 1999 and 2004.

There are various hedging strategies available to hedge funds including selling short, using arbitrage, trading options and derivatives or investing in anticipation of a specific event (merger, takeover, etc.). 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 (Chart 11):

Arbitrage is the exploitation of the relative mispricing of securities. It is facilitated by the use of derivatives, technology and trading on different exchanges and requires large, usually leveraged investments.

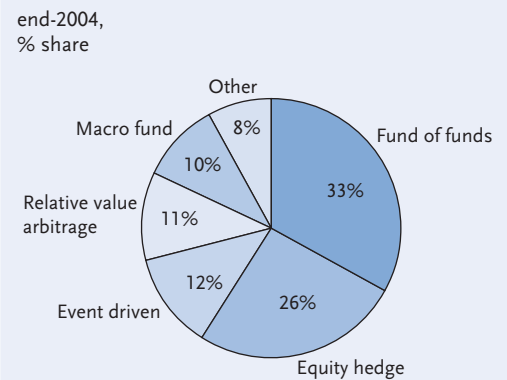
Event-driven strategies take advantage of the perceived mispricing of securities by anticipating events such as corporate mergers or bankruptcies and their effects. A 'Distressed Securities' strategy involves investing in companies undergoing some form of reorganisation. 'Risk/Merger arbitrage' strategies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

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;
- **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. 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 often does not involve shorting or hedging due to restrictions that may be in place in many emerging markets on short sales.

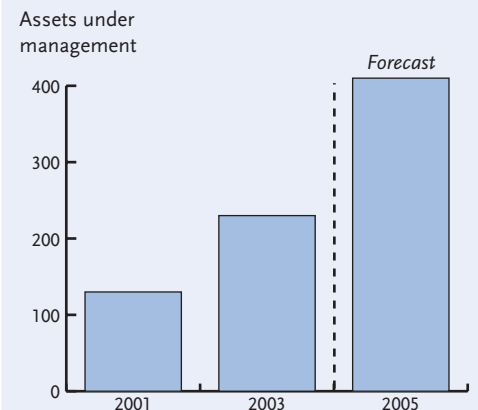
Funds of Hedge Funds are closed-end registered investment companies that invest in private hedge funds and other pooled investment vehicles. Their holdings consist of shares in hedge funds and private-equity funds.

Chart 11 Global hedge fund strategy composition



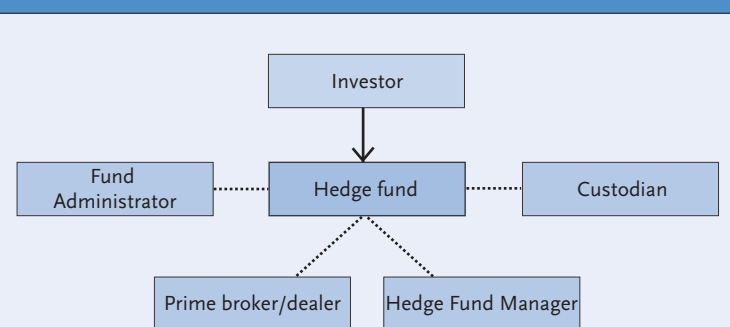
Source: Hedge Fund Research

Chart 12 Global Hedge Fund of Funds industry



Sources: Van Hedge Fund Advisors, Institutional Investor, Freeman & Co, BCG Analysis

Chart 13 Structure of a typical hedge fund



Sources: AIMA and ASSIRT Hedge Fund Booklet

Investing in funds of hedge funds allows for a more stable investment return than when investing in any individual fund or strategy. They also offer a means of increased availability of hedge funds to institutional investors and the mass affluent. In recent years investing in funds of hedge funds has been the fastest growing strategy. It is estimated that the global hedge funds of funds industry will grow to over \$400bn in 2005 (Chart 12). About half of all institutional investment into hedge fund comes through hedge fund of funds.

HEDGE FUND SERVICE PROVIDERS

Latest available statistics show that in 2003 hedge funds generated around \$60bn in revenue and \$22bn in profits (Chart 14). According to CSFB, investment banks earned \$25bn or around 12.5% of total fee revenue from hedge funds in 2004. Around \$19bn of this was from commissions on hedge fund trading and the remaining \$6bn from fees for prime brokerage services.

Typical services provided for hedge funds include prime brokerage, fund administration and custody (Chart 13):

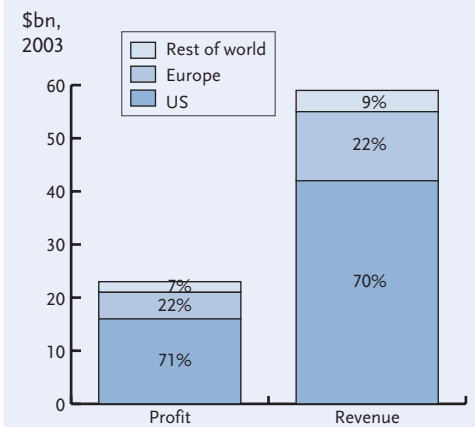
Prime brokers are firms offering brokerage and other professional services to hedge funds and other large institutional customers. This is a major growth area for investment banks which are typical providers of such services. Most hedge funds use more than one prime broker in order to diversify risk. Prime brokerage is a system developed by broker-dealers to 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. Boston Consulting Group forecasts that in 2005 prime brokerage will generate \$6.7bn in revenue, up from \$5.1bn in 2003.

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 15). A rise in competition has led to prime brokers increasing their range of services. Many prime brokers now provide access to research, on-line reporting and consulting. Some prime brokers also offer new hedge fund advisers with introductions or referrals to lawyers, accountants and other service providers. The bulk of prime brokers' income however comes from cash lending to support leverage and stock lending to facilitate short selling.

London is Europe's leading centre for prime brokerage services and accounts for more than 90% of its activity, as the largest investment banks are either headquartered or have a major office there. Research by EuroHedge shows that in Europe in 2004, Morgan Stanley and Goldman Sachs were by far the largest prime brokers with 26% and 16% of the market. They were followed by CSFB, Deutsche Bank and Lehman Brothers (Chart 16). According to Tremont Tass the largest global providers of prime brokerage services include Morgan Stanley, Bear Stearns and Goldman Sachs.

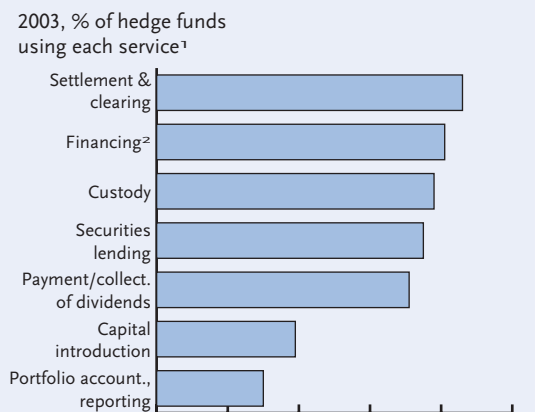
Fund administrators The extent to which hedge fund managers outsource administrative functions varies widely. Some conduct all administration

Chart 14 Revenue and profits from hedge funds



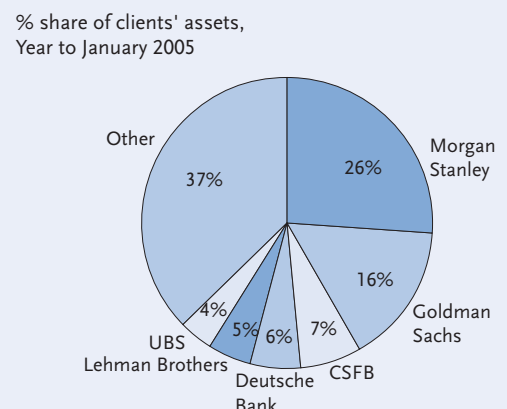
Source: The Boston Consulting Group

Chart 15 Prime brokerage services



¹ based on responses from 36 funds;
² includes repos, credit lines, margin loans and derivatives
 Sources: EuroHedge

Chart 16 European hedge fund prime brokers



European clients' assets total: \$255.8bn
 Sources: EuroHedge

internally while others choose to outsource certain functions such as their accounting, investor services, risk analysis or performance measurement functions to third party administrators. Managers of offshore hedge funds typically 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. Custodians may also control flow of capital to meet margin calls.

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 registered in onshore or offshore locations:

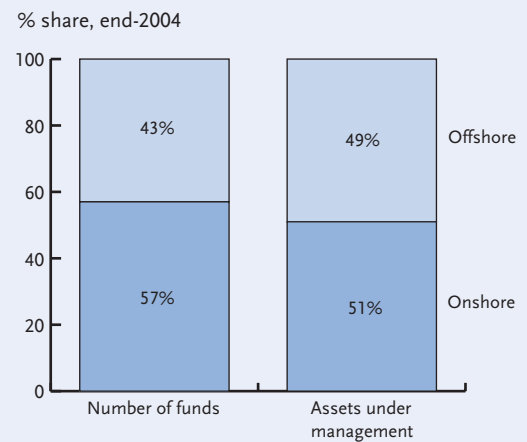
Onshore or domestic hedge funds are investment companies registered in an onshore location:

US In the US, hedge funds are currently 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.

In October 2004 the SEC adopted rules that will require many hedge fund managers in the US and abroad to register with the SEC. The rules will be effective in February 2006. The new rules will require managers to register if they act as investment adviser to a fund or funds that has 15 or more investors, has in aggregate at least \$30 million in assets and allows withdrawals within 2 years of investment. Non-US investment advisors will only have to count their US clients.

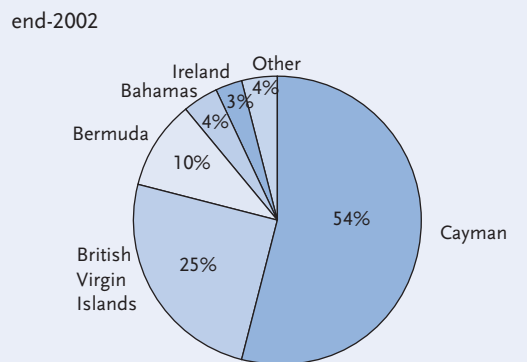
Europe Growing interest from retail and institutional investors such as pension funds and life insurance companies in more regulated diversified products has resulted in an increasing number of EU domiciled hedge funds. Switzerland, Ireland and Luxemburg have more liberal regulatory systems for hedge funds than other European countries. It is expected that as European regulation is liberalised institutional use of hedge funds will grow.

Chart 17 Global hedge funds by domicile



Sources: Van Hedge Fund Advisors International Inc.

Chart 18 Destination of global hedge funds' offshore assets



Source: The US Offshore Funds Directory

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 allowing 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. Latest available data shows that at the end of 2004, offshore locations accounted for 43% of the number of funds and 49% of assets under management (Chart 17). As Chart 18 shows, the vast majority of offshore funds are registered in the Cayman Islands followed by the British Virgin Islands, Bermuda and Bahamas.

LINKS TO OTHER SOURCES OF INFORMATION:

www.absolutereturn.net
www.aima.org
www.eurohedge.co.uk
www.hedgeco.net
www.hedgefund.net
www.hedgefund.com
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www.hedgefund-index.com
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This Brief was compiled by IFSL Economist Marko Maslakovic.

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Duncan McKenzie, Director of Economics
+44 (0)20 7213 9124
d.mckenzie@ifsl.org.uk

Marko Maslakovic, Economist
+44 (0)20 7213 9123
m.maslakovic@ifsl.org.uk

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