HEDGE FUNDS

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The hedge fund industry continues to experience remarkable growth in assets under management and in the number and type of institutions that are investing in hedge funds. This report is an update of IFSL's previous overview of the global hedge fund industry which gives particular emphasis to London's role as the predominant European centre.

THE GLOBAL HEDGE FUND INDUSTRY

Assets under management of the hedge fund industry totalled $1,130bn at end-2005 (Chart 1). This was up 13% on the previous year and nearly twice the total three years earlier. Because hedge funds typically use leverage, the positions that they can take in the financial markets are larger than their assets under management. The number of hedge funds increased 6% in 2005 to reach around 8,500. Research conducted by TowerGroup predicts that hedge fund assets will grow at an annualised rate of 15% between 2006 and 2008 while the actual number of hedge funds is likely to remain relatively flat.

Estimates of the size of the hedge fund industry vary widely due to restrictions imposed on advertising and reporting of performance by hedge funds. New SEC regulations from February 2006 should bring more transparency to the industry. As there are no authoritative estimates we have relied in this report on commercial databases and index providers which rely on information provided voluntarily.

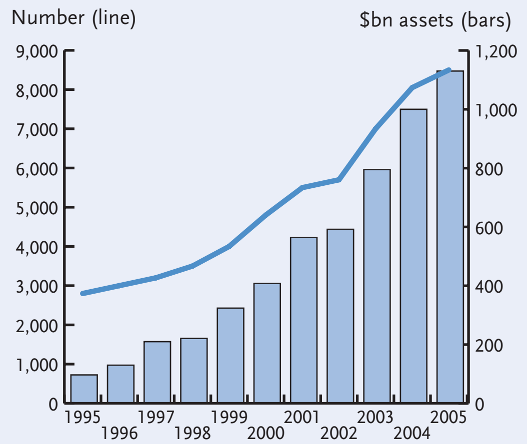
Net asset flow into hedge funds gradually decreased between the 2002 peak and 2005 partly due to lower returns in 2004 and 2005. Hedge funds' net asset inflow fell 36% in 2005 to $47bn, with most of the funds' inflow occurring in the earlier part of the year. Inflow into fund of funds declined 71% in 2005 to $10bn (Chart 2). This was partly due to the trend over the past few years of investors moving away from fund of funds into single manager multi-strategy funds.

Geographical distribution of hedge funds

Domicile of fund Hedge funds can be registered in onshore or offshore locations. At the end of 2004, 55% of the number of hedge funds, managing nearly two-thirds of total hedge fund assets, were registered offshore. The most popular offshore location was the Cayman Islands followed by British Virgin Islands and Bermuda. The US was the most popular onshore location accounting for 34% of the number of funds and 24% of assets. EU countries were the next most popular location with 9% of the number of funds and 11% of assets (Chart 3). Asia accounted for most of the remainder.

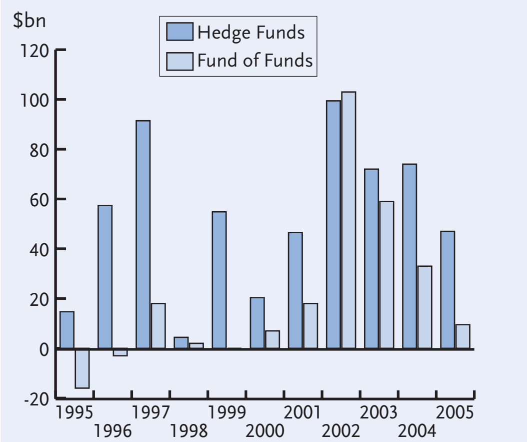
Location of hedge fund manager Onshore locations are far more important in terms of the location of hedge fund managers. New York is the world's leading location for hedge fund managers with about twice as many hedge fund managers as the next largest centre, London. This is not surprising considering that the US is the source of the bulk of hedge fund investments.

Chart 1 Global hedge funds



Source: Hennessee Group LLC; IFSL estimates for 2005

Chart 2 Hedge funds' asset flow

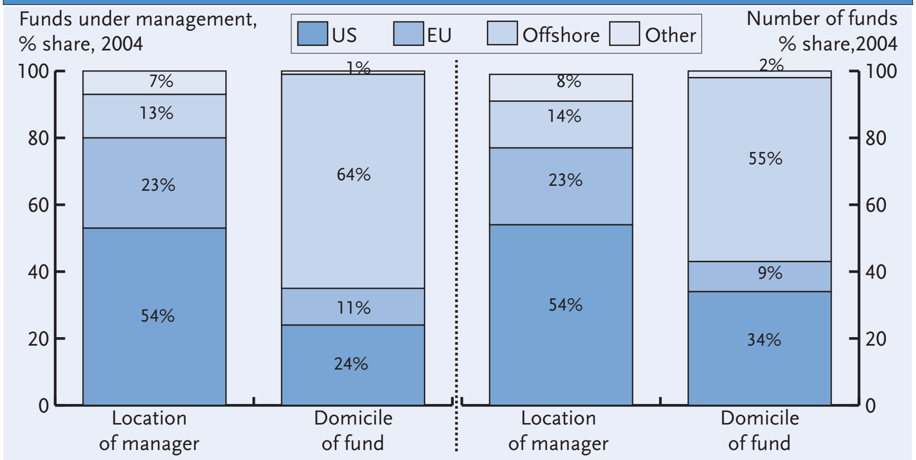


Source: Hedge fund research

Other important centres in the US for hedge fund managers include California and Connecticut. Overall, 54% of hedge fund managers were located in the US at end-2004 managing 54% of global hedge fund assets.

London is Europe's leading centre for the management of hedge funds. At end-2005, three-quarters of European hedge fund investments totalling $300bn were managed out of the UK, the vast majority from London (Chart 4). Assets managed out of London grew more than four-fold between 2002 and 2005 from $61bn to $225bn. These figures, do not include fund of funds and investments from the US managed in Europe. If these are taken into account, London probably accounts for more than 90% of hedge funds assets managed in Europe.

Chart 3 Global hedge funds by location of manager and domicile of fund



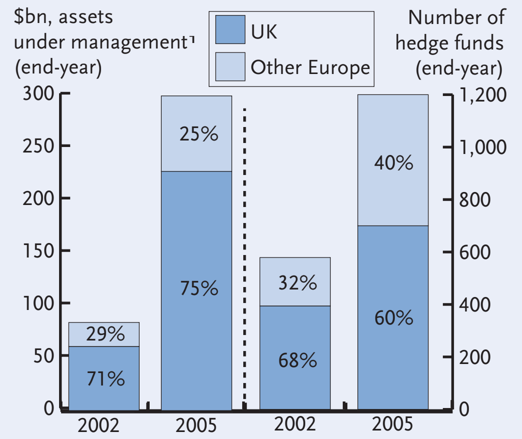
Source: TASS

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 around 1,200 European-based hedge funds at end-2005, of which nearly two-thirds were located in London. Other important locations for hedge funds in Europe include France, Spain 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.

Australia was the most important centre for the management of Asia-Pacific hedge funds. Managers located there accounted for around a quarter of the $115bn in Asia-Pacific hedge funds' assets in 2005. Other important locations in this region included Japan with a fifth and Hong Kong with 14% of the total. The US (with 23%) and UK (16%) were also important locations for managing Asian hedge fund investments.

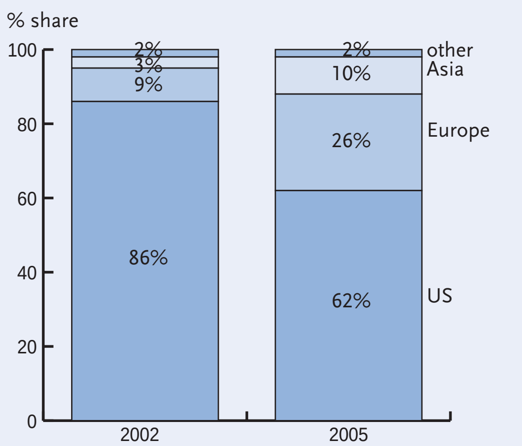
Chart 4 The UK's share of European based hedge funds market



[1] figures include European based hedge funds or those hedge funds investing exclusively in Europe

Source: IFSL estimates based on EuroHedge June 2005 data

Chart 5 Global hedge funds by source of investments - regional breakdown



Source: IFSL estimates based on EuroHedge and Hennessee Group data

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.

INVESTORS IN HEDGE FUNDS

Source of capital - regional breakdown The US is by far the leading source of hedge fund investments with 62% of the total stock of hedge fund assets under management at end-2005. Its share was however well below its 86% share in 2002. Europe and Asia gained in importance during this period as shown in Chart 4. Europe was the source of 26% of assets in 2005, up from 9% in 2002, while Asian investments increased from 3% to 10% of the global total.

Source of capital - sector breakdown In the 1990s most hedge fund investments came from high net worth individuals. Recent years have however been characterised by increased investment from institutional investors such as pension funds, universities, endowments and charitable organisations. These accounted for 26% of the stock of single hedge fund manager investments at end-2005, up from 22% in 1996 and 19% in 1992 (Chart 6). Fund of funds also increased their share, from 16% to 30% of investments. Although high net worth individuals increased their allocation to hedge funds over the past decade their share of the total declined from 62% in 1996 to 44% in 2005 due to the rise in institutional capital.

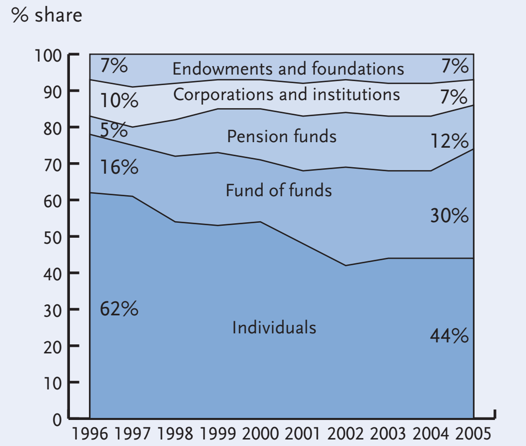
The rise of institutional allocation to hedge funds is even more evident from capital flows data, which shows that in the US institutional assets generated 28% of hedge fund capital flows in 2004, up from just 2% in 2000. This is forecast to rise to 50% by 2008 (Chart 7). In recent years some institutional investors in the UK such as pension funds, local authorities and charities have shown an increased interest in hedge fund investments, primarily through fund of funds. 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. Invesco's 2005 European Institutional Asset Management Survey shows that even though alternative investments are growing in European portfolios, hedge funds only make up around 1.2% of the overall average asset allocation. Another similar study by the Russell Investment Group estimated that average at 5.3%. The wide-ranging differences are usually due to various definitions of hedge funds or alternative assets.

The rise in 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. The greater 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

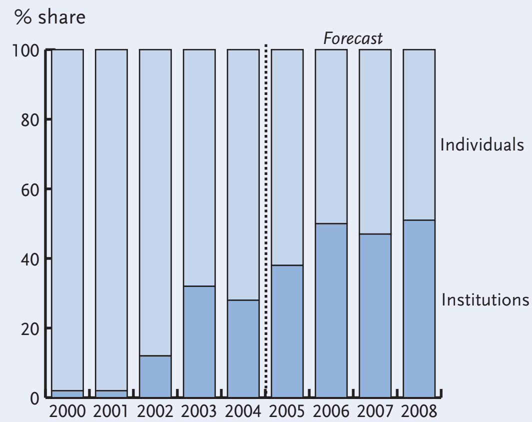
The hedge funds industry is relatively fragmented with around 8,500 hedge funds in existence at end-2005. Growth in the number of hedge funds has slowed and is expected to stabilise at the current level. As Chart 8 shows, at end-2004, hedge funds holding less than $100m accounted for 63% of the number of funds and 12% of assets. The bulk of funds (65%) was managed by funds holding between $100m and $1bn. Funds managing more than $1bn accounted for 2% of the number of funds and 23% of assets.

Chart 6 Global hedge funds by sources of capital



Source: Hennessee Group LLC, IFSL estimates

Chart 7 US institutional share of hedge fund capital flows



Source: The Bank of New York and Casey

Table 1 Largest hedge funds

Largest hedge funds (end-2004)	**$bn**
1. Farallon Capital Management	12.5
2. Bridgewater Associates	11.5
3. Goldman Sachs Asset Management	11.2
4. GLG Partners	11.1
5. Man Investments	9.7
Largest European hedge funds (Sep-2004)	
1. GLG Partners	11.1
2. Vega Asset Management	11.1
3. Man Investments	9.7
4. Barclays Global Investors	8.0
5. Brevan Howard Asset Management	7.4
Largest global fund of funds (end-2005)	
1. Man Investments	39.0
2. UBS Global Asset Management A&Q	30.7
3. GAM Multi-Manager	25.0
4. Permal Group	23.1
5. HSBC Republic	18.8

Source: Institutional Investor

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 typically remunerate managers based on percent of assets under management. Hedge funds remunerate managers with fees that are highly geered to performance. Hedge fund managers typically charge a 1-2% basic fee plus a 15-25% performance fee.
- 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.

Farallon Capital Management was the largest hedge fund with $12.5bn under management at the end of 2004. It was followed by Bridgewater Associates and Goldman Sachs Asset Management (Table 1). GLG Partners was the largest European hedge fund manager in September 2004, followed by Vega Asset Management. UBS was the largest hedge fund of funds in June 2005, followed by Man Investments and Union Bancaire Privée.

KEY CHARACTERISTICS OF HEDGE FUNDS

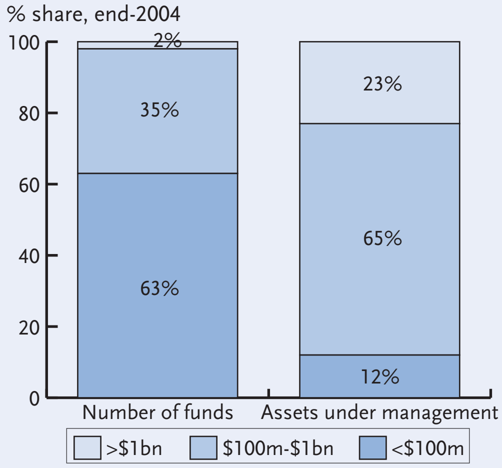
Some of the key characteristics of hedge funds include:

- Exemption from many of investment protection and disclosure requirements as many hedge funds are domiciled offshore or subject to a limited regulation by onshore regulators.
- Flexibility in their investment options. Hedge funds can use short selling, leverage and derivatives. This enables them to deliver non-market correlated returns. Around two-thirds of hedge funds use

Difference between hedge funds and private equity funds

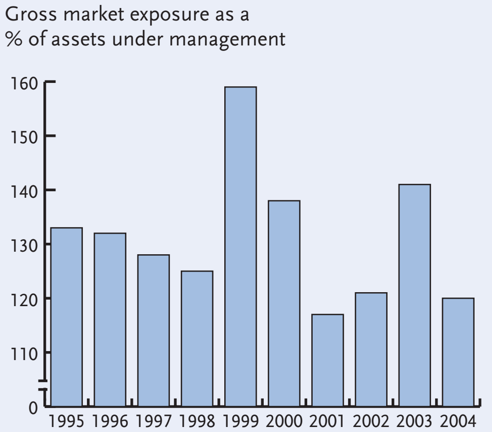
	Hedge funds	Private Equity funds
Term	Unlimited	Usually 10-12 years
Type of investment	Fairly liquid	Illiquid
Investors liquidity	Open-ended fund, periodic withdrawls possible	Closed-end funds
Capital contributions	100% contribution at subscription date	Based on capital commitment
Management Fees	Based on net asset value	Based on capital commitment
Performance-based compensation	Incentive fee taken annually on realised and unrealised gains	Carried interest on realised investments

Chart 8 Size distribution of global hedge funds



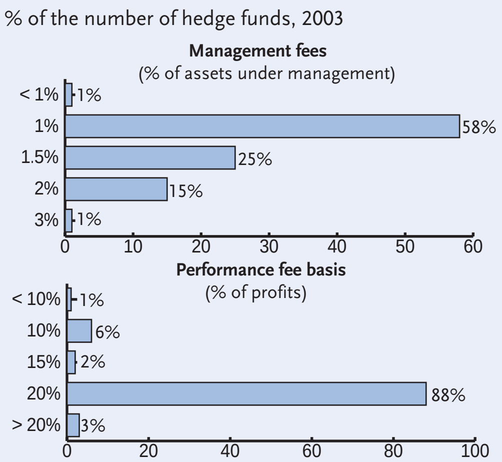
Source: TASS

Chart 9 Hedge funds use of leverage



Source: Hennessee Group LLC

Chart 10 Management and performance fees



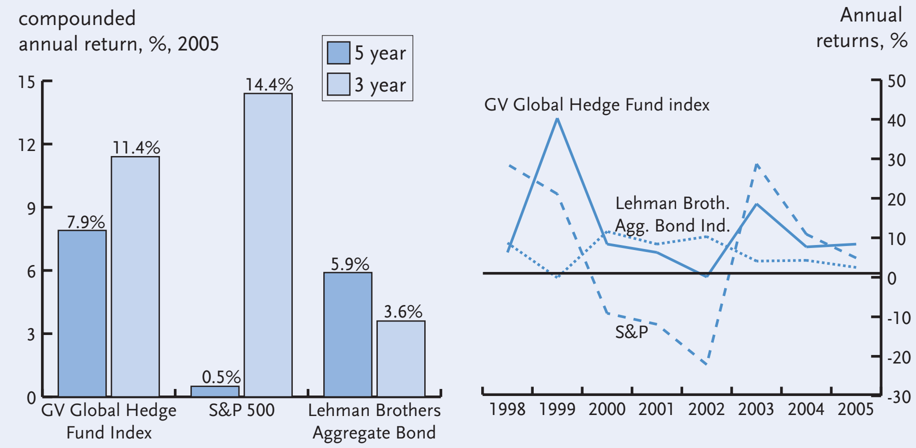
Source: Hennessee Group

leverage to some extent. As Chart 9 shows, leverage averaged between 115% and 160% of assets between 1995 and 2004;

- Wide dispersion in investment returns, volatility and risk. Hedge funds are expected to deliver positive absolute returns in all market conditions;

- Linking compensation to performance with compensation of managers based on a percentage of the hedge fund's capital gains and capital appreciation (Chart 10). In addition, hedge fund managers often invest their own money in their fund.

Chart 11 Global hedge fund returns



Source: Greenwich-Van, S&P, Lehman Brothers

HEDGE FUND INVESTMENT STRATEGIES

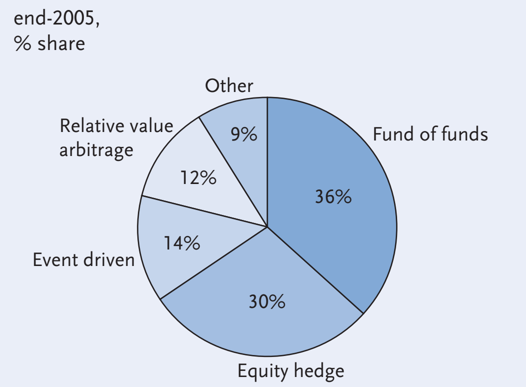
Hedge funds differ in the amount of investment risk they are willing to undertake. Investment strategies vary enormously, some use leverage and derivatives while others are more conservative and employ little or no leverage. Strategies may be designed to be *directional* (which try to anticipate market 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.

Although returns may vary significantly in different years, hedge funds have outperformed both the S&P 500 and Lehman Brothers Aggregate Bond index over the past 5 years (Chart 11). There is however a survivorship bias, whereby published results for hedge funds for a particular year do not include returns of hedge funds that closed during that year. Hedge funds' attrition rates averaged between 3.8% and 5.9% between 1999 and 2005 (Chart 14).

Fund of 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. Fund of funds seek diversification of their assets in terms of geographic mandate and investment style. Investing in funds of funds typically allows for a more stable investment return than when investing in any individual strategy. They also offer a means of increased availability of hedge funds to institutional investors and the mass affluent. Fund of funds account for around a third of hedge fund investments (Chart 12). However about a half of all institutional investment into hedge funds comes through the fund of funds route.

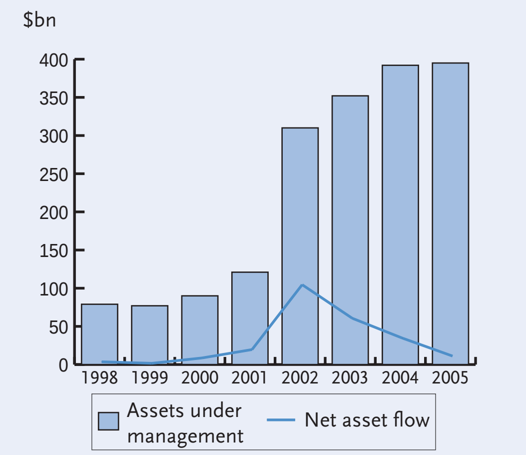
Assets under management of fund of funds grew four-fold between 2001 and 2005 to reach nearly $400bn (Chart 13). Around a third of fund of funds are located in the US, a quarter in the UK and 15% in Switzerland. US fund of funds managed around a half of global fund of funds assets as they are typically larger then their European counterparts.

Chart 12 Global hedge fund strategy composition



Source: Hedge Fund Research

Chart 13 Global Hedge Fund of Funds industry



Sources: Hedge Fund Research, Greenwich-Van

Hedge funds' investment strategies

Market neutral strategies usually involve less risk than directional strategies and include:

- *Arbitrage* (fixed income and convertable) is the exploitation of the relative mispricing of securities.
- *Equity Market Neutral* strategies exploit equity market inefficiencies and involve having simultaneously long and short matched equity portfolios of the same size within a country.

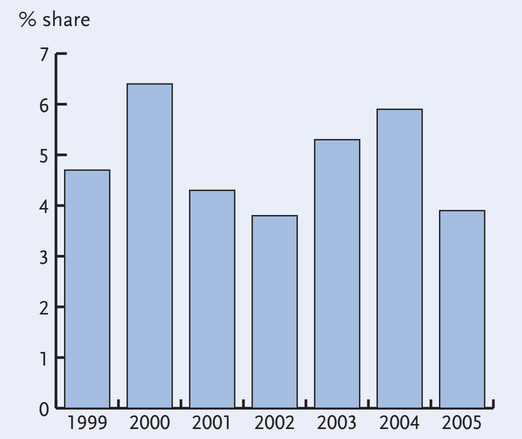
Event-driven strategies are designed to capture price movements generated by a significant pending corporate event such as a merger, corporate restructuring, liquidation, bankruptcy or reorganisation.

Directional strategies have a large degree of exposure to the broad movements of the market and include:

- *Macro funds* This type of strategy involves looking at global trends and placing directional bets on capital or derivative markets.
- *Long/Short Equity Hedge* strategies involve equity-oriented investing on both the long and short sides of the market. The objective is not to be market neutral.
- *Dedicated Short Bias* strategies are to remain net short rather than pure short in equities or derivatives.
- *Emerging markets* 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.
- *Managed futures* strategies invest in listed financial and commodity futures markets and currency markets.

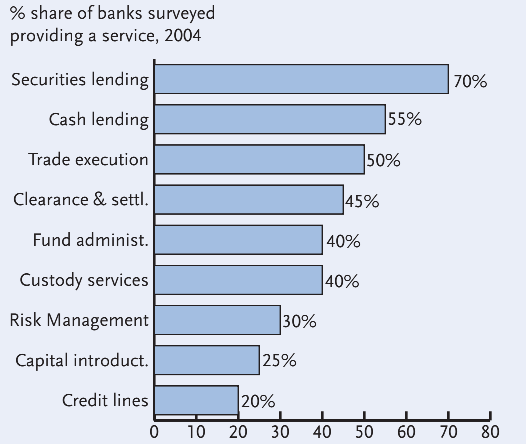
Multi-strategy funds are characterised by their ability to allocate capital dynamically among strategies that fall within several traditional hedge fund disciplines. This type of strategy has gained in importance in recent years.

Chart 14 Hedge fund attrition rates



Sources: Hennessee Group, Hedge Fund Research

Chart 15 Types of services provided to hedge funds



Source: Banking Supervision Comittee, ECB

HEDGE FUND SERVICE PROVIDERS

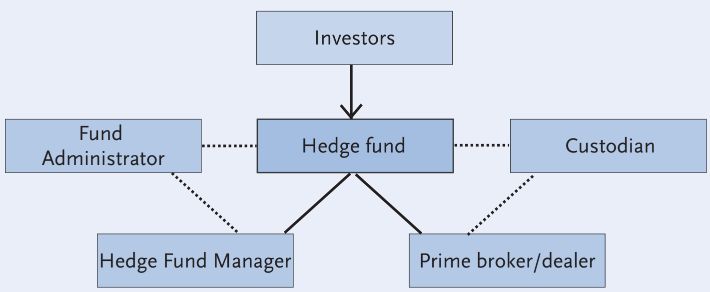
Typical services provided for hedge funds include prime brokerage, fund administration and custody (Chart 16):

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. Rather than providing particular niche services prime brokers try to offer a diverse range of services including: financing, clearing and settlement of trades, custodial services, risk management and operational support facilities (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

Chart 16 Structure of a typical hedge fund



[1] Dashed lines indicate optional relationships
Sources: AIMA and ASSIRT Hedge Fund Booklet

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 January 2005, 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 17). 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 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

The domestic regulation of hedge funds takes place at three levels: the fund manager; the fund itself; and the distribution of fund. Based on domicile, hedge funds can be registered in onshore or offshore locations:

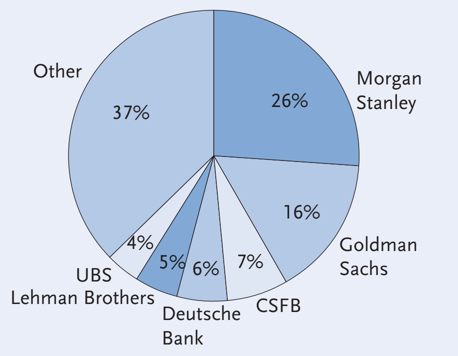
Onshore or domestic hedge funds are investment companies registered in an onshore location:

US Historically, hedge fund managers in the US have not been subject to regular SEC (Securities and Exchange Commission) oversight. In October 2004, the SEC approved a rule change implemented on February 1st 2006, that requires hedge fund advisers with more than 14 clients and $30 million in assets to register with the SEC as investment advisers under the Investment Advisers Act. Nearly 1,000 hedge fund managers had registered before February 2006. The measure, which requires hedge fund managers to dislose certain information about their operations, aims to protect investors and stabilise securities markets by creating better tracking mechanisms for the hedge fund sector.

Europe Growing interest from retail and institutional investors such as

Chart 17 European hedge fund prime brokers

% share of clients' assets, Year to January 2005

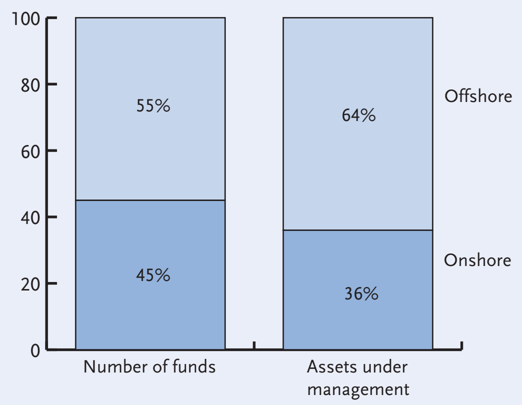


European clients' assets total: $255.8bn

Sources: EuroHedge

Chart 18 Global hedge funds by domicile

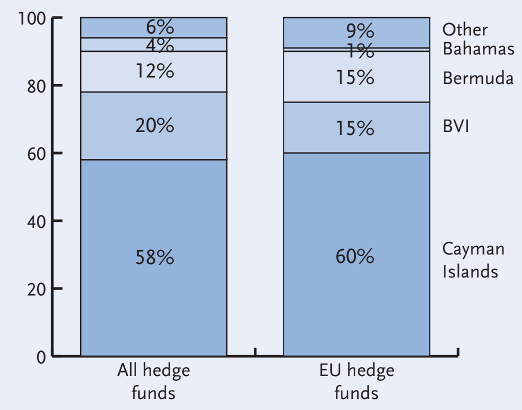
% share, end-2004



Sources: TASS, ECB

Chart 19 Destination of global hedge funds' offshore assets

end-2004, % share



Source: TASS, ECB

pension funds and life insurance companies in more regulated diversified products has resulted in an increasing number of EU domiciled hedge funds. In most European countries, fund managers are generally allowed to manage hedge fund products and both hedge fund and conventional fund managers operate under the same regulatory regime.

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). The regulatory regime for hedge fund managers in the UK is similar to the one that applies to other investment managers. 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. In June 2005, the FSA published two discussion papers about hedge funds, one concerning systemic risks, the other on consumer protection. Towards the end of 2005 the FSA created an internal team to supervise the management of 25 particularly high-impact hedge funds doing business within the UK.

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. As Chart 19 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
www.hedgefundcenter.com
www.hedgefund-index.com
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This Brief was compiled by IFSL Economist Marko Maslakovic.

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Data files

Datafiles in excel format for all charts and tables published in this report can be downloaded from the Research section of IFSL's website **www.ifsl.org.uk**