

HEDGE FUNDS

City Business Series



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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 second largest global centre for hedge funds.

THE GLOBAL HEDGE FUND INDUSTRY

Assets under management of the hedge fund industry totalled around \$1,500bn at end-2006 (Chart 1). This was up a third 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 reached over 9,000 in 2006, up around 5% on the previous year. The rapid growth in the number and assets of hedge funds was helped by a rise in institutional portfolio allocation into hedge funds in recent years.

Estimates of the size of the hedge fund industry vary due to restrictions imposed on advertising and reporting of performance by hedge funds. As there are no authoritative estimates we have relied in this report on commercial databases and index providers which rely on information provided voluntarily.

Geographical distribution of hedge funds

Domicile of fund Hedge funds can be registered in onshore or offshore locations. In January 2006, 55% of the number of hedge funds were registered offshore. The most popular offshore location was the Cayman Islands (63% of number of offshore funds), followed by British Virgin Islands (13%) and Bermuda (11%). The US was the most popular onshore location (with funds mostly registered in Delaware) accounting for 48% of the number of onshore funds, followed by Ireland with 7%.

Location of hedge fund manager Hedge fund managers tend to be based onshore. The US is by far the leading location for hedge fund managers with nearly two-thirds of global assets managed in 2006. This is not surprising considering that the US is the source of the bulk of hedge fund investments. Its share, however, was well below its 82% share in 2002. Europe and Asia gained in importance during this period as shown in Chart 2. Europe's share doubled to 24% of assets, while Asian managers' share increased from 5% to 8% of the global total.

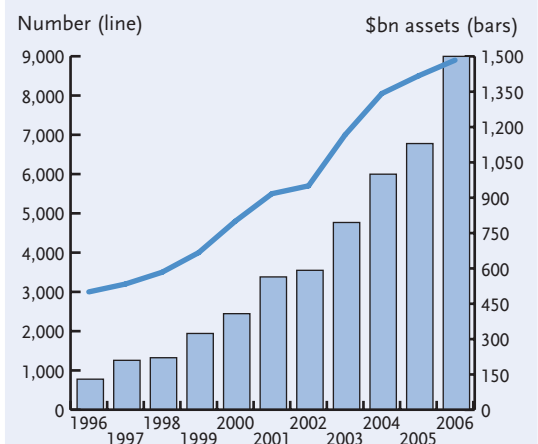
New York is the world's leading location for hedge fund managers, followed by London. Nearly half of US domiciled hedge fund managers are based in New York. Other important centres in the US include California with 15% of the number of US domiciled managers, and Connecticut, Illinois and Florida with around 6% each. IFSL estimates that around 36% of global hedge fund assets were managed in New York in 2006, down from 45% in 2002 (Chart 3).

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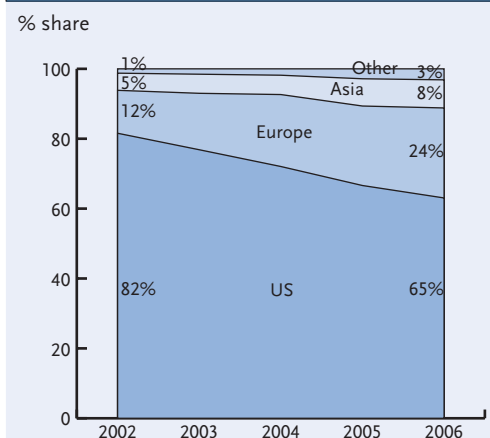
www.ifsl.org.uk

Chart 1 Global hedge funds



Source: IFSL estimates based on various sources

Chart 2 Regional breakdown of global hedge fund assets



Source: IFSL estimates based on various sources

London is the second largest global centre for hedge funds managers after New York. Its share of global hedge fund industry more than doubled between 2002 and 2006 to 21%. London is much the largest European centre for the management of hedge funds. At end-2006, four-fifths of European hedge fund investments totalling \$460bn were managed out of the UK, the vast majority from London (Chart 4). Assets managed out of London grew more than five-fold between 2002 and 2006 to around \$360bn. 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.

Growth of the UK and 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. There were around 1,400 European-based hedge funds in 2006, of which two-thirds were located in London. Other important locations for hedge fund managers in Europe include France, Spain and Switzerland.

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 administration, prime brokerage, custody and auditing. 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.

Asia, and more particularly China, is taking on a more important role in the global hedge fund industry. Australia was the most important centre for the management of Asia-Pacific hedge funds in 2006. Managers located there accounted for around a quarter of the \$140bn in Asia-Pacific hedge funds' assets in 2006. Other important locations in this region included Japan with a fifth and Hong Kong with 14% of the Asia total. The US (with 23%) and UK (16%) were also important locations for managing Asian hedge fund investments.

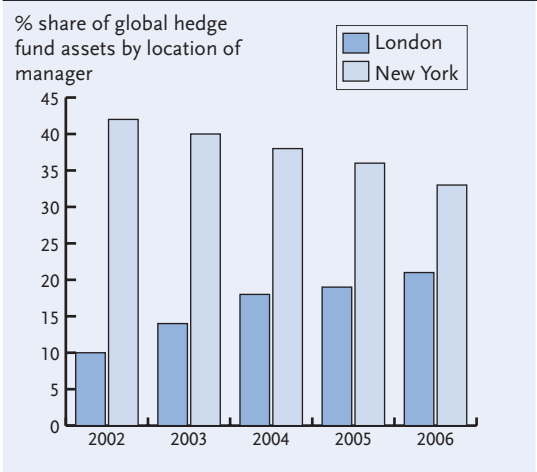
SOURCE OF INVESTMENTS

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 37% of the stock of single hedge fund manager investments at end-2006, up from 25%

Definition of a hedge fund

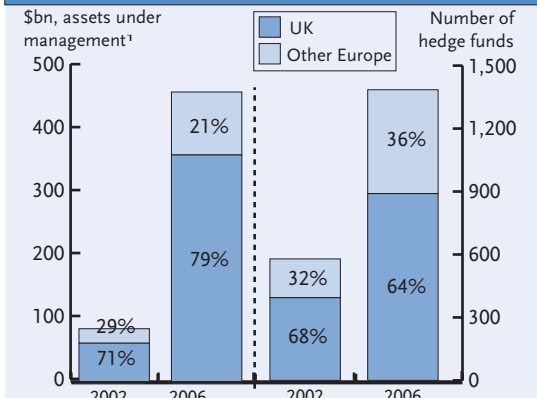
Hedge funds are private pooled investment limited partnerships which fall outside many of the rules and regulations governing mutual funds. Hedge funds therefore can invest in a variety of securities on a leveraged basis. Today, the term hedge fund refers not so much to the hedging techniques hedge funds may employ as it does to their status as private investment partnerships.

Chart 3 Share of global hedge fund industry, London vs. New York



Source: IFSL estimates based on various sources

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; ² figures in this chart are not entirely consistent with Charts 1 & 3 as IFSL's estimates for the size of the global industry are based on a number of sources
Source: EuroHedge, IFSL estimates

in 1997 (Chart 5). Although high net worth individuals increased their allocation to hedge funds over the past decade their share of the total declined from 61% in 1997 to 40% in 2006 due to the rise in institutional capital.

The rise of institutional allocation to hedge funds is even more evident from net investments data. US institutional investors generated around 40% of hedge funds' net investments in 2005, up from just 2% in 2000 (Chart 6). At the end of 2005, institutional investors accounted for around a third of the stock of hedge fund assets. Around 2% of global institutional portfolio assets were invested in hedge funds in 2005. According to a Bank of New York survey, institutions will represent more than a half of total projected investment flows into hedge funds in the next few years. Around two-thirds of new institutional asset flows is expected to come from pension funds. The survey estimates that the percentage of institutions investing in hedge funds will increase to around a quarter in 2010 from 15% in 2005.

Institutional investors from the US accounted for 41% of global institutional hedge fund investments in 2005, with European and Japanese investors accounting for 44% (Chart 7). Most institutional investors invest in hedge funds through fund of hedge funds and more recently through multi-strategy managers. According to a Greenwich Associates survey, in 2006 13% of UK pension funds invested in hedge funds. As a result, 1.1% of UK pension funds' assets are invested in hedge funds, with 24% of pension funds planning to increase their exposure to hedge funds by 2008. UK institutional investors invest less into alternative investments than some other European countries (Chart 8).

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 formal procedures and controls.

LARGEST HEDGE FUNDS

The hedge funds industry is relatively fragmented with around 9,000 hedge funds in existence at end-2006. Growth in the number of hedge funds has slowed and is expected to stabilise at the current level. The industry has become more concentrated at the top end. The largest 100 hedge funds accounted for 65% of total industry assets in 2005, up from 58% in 2004 and 54% in 2003.

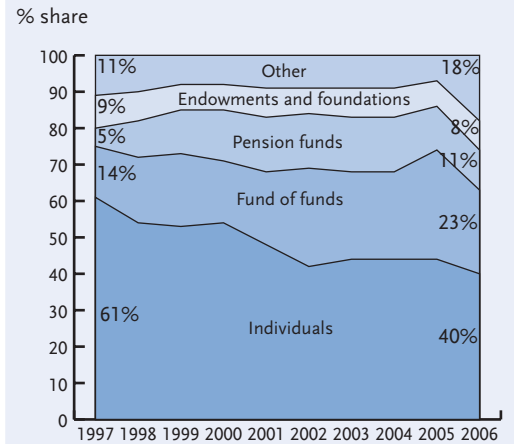
JPMorgan Asset Management was the largest hedge fund with \$34bn under management at end-2006. It was followed by Goldman Sachs Asset Management with \$32bn. Man Investments limited was the largest hedge fund based in Europe with \$19bn.

KEY CHARACTERISTICS OF HEDGE FUNDS

Some of the key characteristics of hedge funds include:

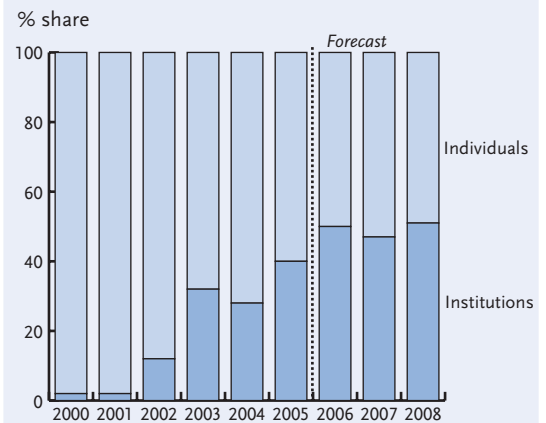
- Exemption from many investment protection and disclosure requirements as the majority of hedge funds are domiciled offshore or

Chart 5 Global hedge funds by source of capital



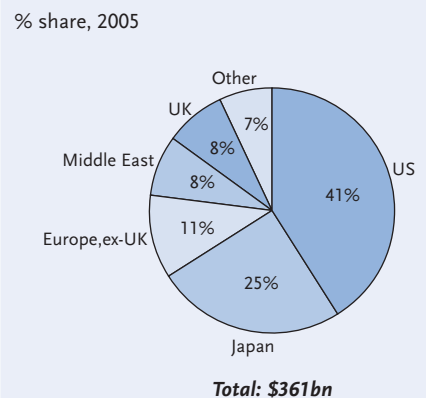
Source: Hennessee Group LLC

Chart 6 US institutional share of hedge fund capital flows



Source: The Bank of New York and Casey, Northern Trust

Chart 7 Institutional hedge fund assets by country/region



Source: The Bank of New York and Casey, Quirk & Associates analysis

subject to limited regulation by onshore regulators.

- Flexibility in 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 leverage to some extent. As Chart 9 shows, leverage averaged between 125% and 165% of assets between 1997 and 2006;
- 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. 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. 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 10). 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 ranged a year between 3.8% and 5.1% between 1999 and 2006 (Chart 14). In 2006, Amaranth Advisors collapsed, losing about \$6.6 billion in two weeks, the largest hedge-fund collapse ever.

Fund of Hedge Funds are closed-end registered investment companies that

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

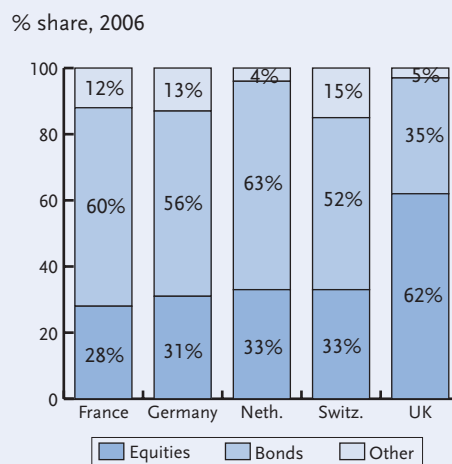
Table 1 Largest hedge funds

| <i>Largest hedge funds (end-2006)</i> | \$bn |
|---------------------------------------|-------------|
| 1. JPMorgan Asset Management | 34.0 |
| 2. Goldman Sachs Asset Management | 32.5 |
| 3. Bridgewater Associates | 30.2 |
| 4. D.E. Shaw Group | 26.3 |
| 5. Farallon Capital Management | 26.2 |
| 6. Renaissance Technologies Corp. | 24.0 |
| 7. Och-Ziff Capital Management | 21.0 |
| 8. Cerberus Capital Management | 19.2 |
| 9. Barclays Global Investors | 18.9 |
| 10. Man Investments Limited | 18.8 |

| <i>Largest global fund of hedge funds (end-2005)</i> | |
|--|------|
| 1. UBS Global Asset Management | 45.0 |
| 2. Man Investments | 35.6 |
| 3. Oaktree Capital Management | 35.6 |
| 4. Union Bancaire Privee | 20.8 |
| 5. HSBC Private Bank | 20.2 |

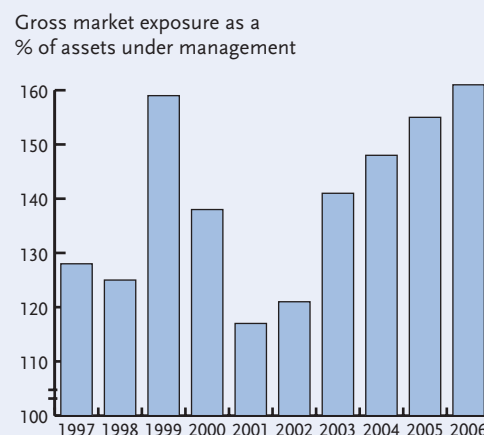
Source: HedgeFund Intelligence, Institutional Investor

Chart 8 European pension fund asset allocation



Source: Mercer Investment Consulting

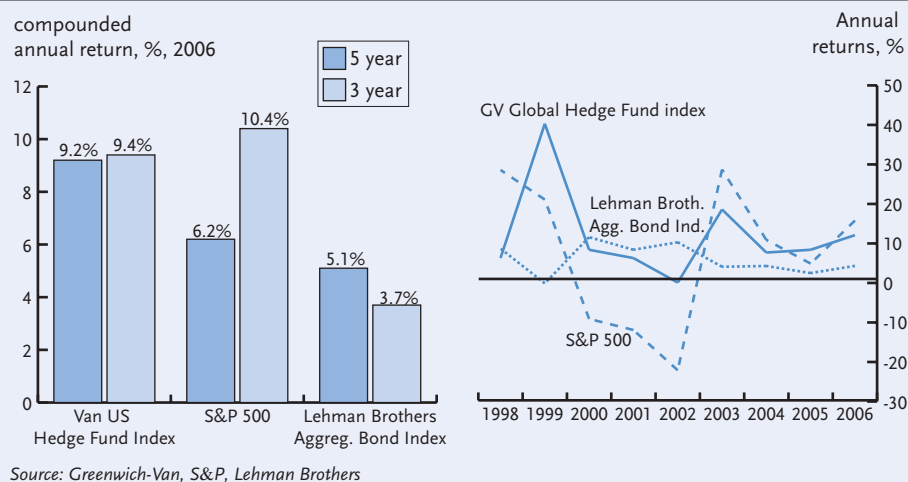
Chart 9 Hedge funds use of leverage



Source: Hennessee Group LLC, IFSL estimates

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 hedge funds typically allows for a more stable investment return than when investing in any individual strategy. They also offer investors and the mass affluent a means of broadening exposure to a wider range of hedge funds. Fund of hedge funds account for around a third of hedge fund investments. However about a half of all institutional investment into hedge funds comes through the fund of hedge funds route.

Chart 10 Global hedge fund returns



Assets under management of fund of hedge funds grew more than three-fold between 2000 and 2006 to reach around \$600bn (Chart 11). Around a third of fund of hedge funds are located in the US, a quarter in the UK and 15% in Switzerland. US fund of hedge funds managed around a half of global fund of hedge funds' assets as they are typically larger than their European counterparts. Research by ABN Amro shows that London overtook Zurich in 2006 as the location of choice for listing funds of hedge funds. London accounted for more than £3bn in listed fund of hedge funds in 2006, more than double Zurich after passing Switzerland in size of funds for the first time in January.

HEDGE FUND SERVICE PROVIDERS

Typical services provided for hedge funds include prime brokerage, fund administration and custody:

Prime brokers offer 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 13).

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 January 2005, Morgan Stanley and Goldman Sachs were by

Chart 11 Global Fund of Hedge Funds industry



Hedge funds' investment strategies

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

- *Arbitrage* (fixed income and convertible) 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.

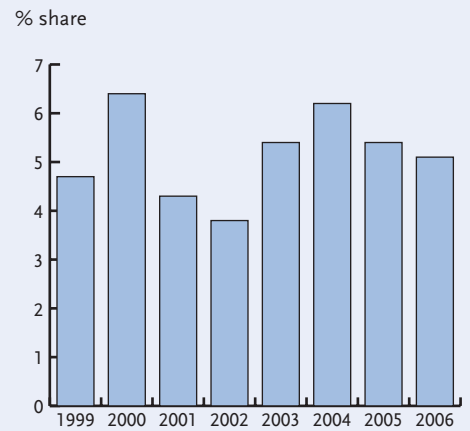
Multi-strategy funds are characterised by their ability to allocate capital dynamically among strategies that fall within several traditional hedge fund disciplines. This type of strategy has gained in importance in recent years.

far the largest prime brokers with 26% and 16% of the market. They were followed by CSFB, Deutsche Bank and Lehman Brothers. According to Tremont Tass the largest global providers of prime brokerage services in 2006 included Morgan Stanley, Bear Stearns and Goldman Sachs (Table 2).

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 accounting, investor services or risk analysis 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.

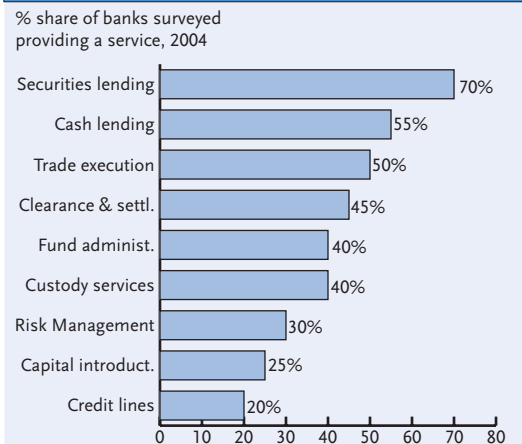
Custody Hedge fund assets are generally held with a custodian, including cash in the fund as well as the actual securities. Custodians may also control flow of capital to meet margin calls.

Chart 12 Hedge fund attrition rates



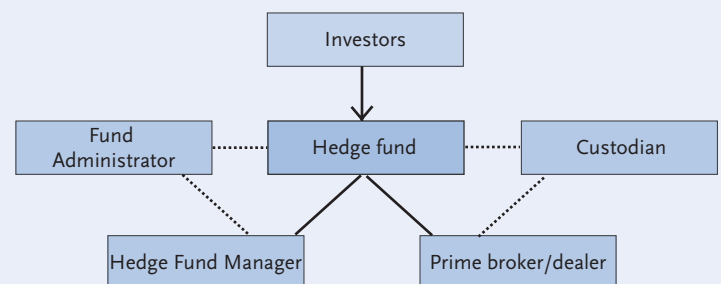
Sources: Hennessee Group

Chart 13 Types of services provided to hedge funds



Source: Banking Supervision Committee, ECB

Chart 14 Structure of a typical hedge fund



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

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. Around 45% of hedge funds are registered onshore, mainly in the US and Ireland:

US Historically, hedge fund managers in the US have not been subject to regular SEC (Securities and Exchange Commission) oversight. Rule changes introduced by the SEC in February 2006 that required hedge fund advisers to register under the Investment Advisers Act were overturned by the US Court of Appeals in June 2006. Despite this only about 10% of hedge fund advisers that signed up with the SEC have opted to withdraw due to advantages that registration brings, such as more credibility for institutional investors. The SEC unveiled proposals in December 2006 that will tighten anti-fraud regulations for hedge fund advisers and will create a new category of accredited investor in order to restrict retail investor access to hedge funds. These proposals will be subject to a further vote of the SEC commissioners before coming into force.

Europe Growing interest from retail and institutional investors in more regulated diversified products has resulted in an increasing number of EU domiciled hedge funds. One of the most important regulatory reforms will be the Markets in Financial Instruments Directive (MiFID) which will replace the Investment Services Directive and regulate the authorisation and conduct of securities firms and markets. Its intended implementation date is 1 November 2007. Some of the changes MiFID will probably bring to the European hedge fund industry include: more formality to the organisation of hedge fund managers; more detailed rules on risk management; and compliance and management of conflicts. Although domestic regulation varies across 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.

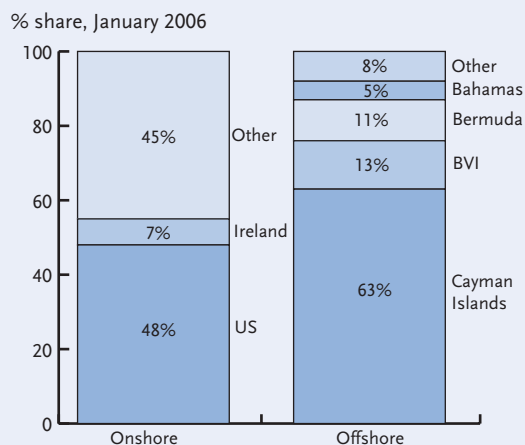
The UK is the most popular location in Europe for managers of hedge funds. Their services to hedge funds include consulting services such as advice on investment strategy which is regulated by the Financial Services Authority (FSA). The regime for hedge fund managers in the UK is similar to that which applies to other investment managers. They are able to take advantage of the Investment Services Directive which allows them to offer their investment services to clients in other countries within the EEA. The FSA specifies restrictions on sales and marketing of hedge fund products. Hedge fund products for example, cannot be marketed to the general public but UK investors can deal directly with offshore funds. The FSA set up a centre of

Table 2 Largest global prime brokers

| 2006 | Total client assets (%) |
|-----------------|-------------------------|
| Morgan Stanley | 22 |
| Bear Stearns | 19 |
| Goldman Sachs | 17 |
| UBS | 7 |
| Credit Suisse | 5 |
| Clitigroup | 4 |
| Merrill Lynch | 3 |
| Deutsche Bank | 3 |
| Lehman Brothers | 2 |
| JP Morgan | 2 |

Source: Institutional Investor

Chart 15 Global hedge funds by domicile



Sources: Alternative Asset Center

hedge fund expertise in October 2005. A priority of this team has been to enhance the FSA's oversight of the largest hedge fund managers in the UK by appointing dedicated supervisors in regular contact with the firms and undertaking periodic risk assessments. Lower impact firms are subject to baseline monitoring through regulatory returns and other types of alerts and market intelligence.

Offshore hedge funds are registered in tax neutral jurisdictions allowing investors to minimise their tax liabilities. 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. The vast majority of offshore funds are registered in the Cayman Islands followed by the British Virgin Islands, Bermuda and Bahamas (Chart 15).

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.institutionalinvestor.com

www.investhedge.com

www.mfainfo.org

www.thehfa.org

www.hedgefunds.net

www.hedgefundsreview.com

www.hedgefundsworld.com

www.hedgeweek.com

www.hedgeworld.com

www.hfmanager.com

www.hedgefundcenter.com

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This report was compiled by IFSL Senior Economist Marko Maslakovic.

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