

NEW MINERVA REPORT

Hedge Fund Warning

Two of our largest pension funds have decided to put money into hedge funds. The BT Pension fund is investing £500mn and the Railways Pension fund is investing £600mn. Whilst these amounts are small beer to these huge funds, they do demonstrate a growing trend towards hedge funds by pension funds and also other institutions. At the same time the Financial Services Authority (FSA) are looking at the regulations concerning hedge funds to see if they can enable them to become available to investors in the UK.

The hedge fund industry is huge. Because so many of them are based in offshore locations like Bermuda, it is not that easy to get a perfect picture, but estimates suggest that there are about \$450bn invested in about 7,000 hedge funds.

The term 'hedge' covers a multitude of investment strategies. In fact it is probably true to say that if a fund is based in an offshore tax haven, away from the prying eyes of regulatory bodies, and is not trying to outperform any particular index, then it is now termed a hedge fund.

We have reported on various different investment strategies employed by hedge funds. The first hedge fund was set up by Alfred Jones in 1940. He borrowed money to gear up the returns from the fund, and sold stocks short at the same time to limit the risk of the fund. The term hedge really suggests that a fund ought to be doing something to reduce the risk of some, or part, of its portfolio, (i.e. hedging). The majority of new funds coming to the market do just that, they have portfolios that buy stocks long, and sell stocks short. Many try to get a balance that is market neutral. All try to produce an absolute return.

We have three concerns about the growing enthusiasm for these new investment vehicles. Firstly, they need top fund managers to manage them. A mediocre fund manager could doubly muck up a fund, by going long and short in all the wrong stocks. The attractions of running hedge funds for good fund managers is that they can make more money for the investment manager: so this effectively creams off all the top fund managers away from conventional funds.

Secondly, when the authorities like the FSA get excited about a particular asset class, it probably means that it's the wrong thing in which to be investing: remember index tracking funds. We wrote in April 2000 that these were at the "End of a Trend". The authorities thought they were the best thing going, and they were 'cheap'. How many investors wish they hadn't followed that philosophy!

Finally, what does this new interest say about people's

views on future markets? It demonstrates that after the death of the ever rising index, investors are looking for other ways of making capital gains. But the bigger hedge funds become, the more they will worry about absolute returns, and the more they will fail to meet investors' expectations, especially in a rising market.

FUND OF HEDGE FUNDS

The safest and easiest way for smaller investors to invest into hedge funds is through funds that invest in a number of hedge funds. This way they can invest in a number of different strategies, and also the fund manager will know how the underlying funds are investing: for example Close Fund Management are launching a fund managed by Man Investments. Man are a FTSE company, and manage over \$38bn in over 400 hedge funds. A nice touch is that Close have arranged capital guarantee from the Royal Bank of Scotland. Their literature says that they are targeting annual returns of between 13 to 15%. Admittedly Man have managed to create those sort of returns over the past three years, but that sort of target return must be open to question. In theory to get investment returns greater than those available elsewhere means increasing risk. If you increase risk that means that you are increasing the possibility of making a loss. If you try to reduce that risk by buying more funds, you then reduce the potential for greater returns.

We think trying to make absolute returns is essential when markets, as we expect they will, continue to trade sideways for a long period. However, as they grow as an asset class, hedge funds will probably become increasingly unable to out-perform.

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