

Offshore hedge fund landscape is set to change forever – an evolution into a more mature and approachable industry

Opportunity for hedge funds to become mainstream

Over the past decade, the hedge fund industry has been one of the fastest growing segments in the asset management industry with asset growth in excess of 20% per annum. Then came the third quarter of 2008, which saw the industry “suffering” from large redemptions due to poor absolute performance numbers, the need for liquidity and subsequent impact of deleveraging in the face of a systemic financial crisis. These factors contributed towards a substantial drop in industry assets. According to Hedge Fund Research Inc. (Opalesque.com), assets had fallen almost 40% by the end of March 2009.

Following the events of the past year, it is clear that the hedge funds industry has come to realise that the industry landscape will change forever and that the future of the hedge fund industry will largely depend on correcting the “wrongs” of the past. Rectifying “mistakes” of the past will bring with it a unique opportunity for the hedge fund industry to mature. In order for this to happen, it is crucial for the industry to ensure their business models are appropriate and that their business interests are aligned with that of their investors.

This scenario will only emerge if investors remain committed towards hedge funds and will depend on the new regulations having a positive impact on the industry going forward, as well as the willingness of hedge fund businesses to adapt their business models accordingly.

Institutional investors not backing off from long-term commitment - case for hedge funds remains compelling

SEI in partnership with Greenwich Associates earlier this year published a survey titled “Hedge Funds Under The Microscope”. The survey found that institutional investors continue to view hedge funds as important vehicles for portfolio diversification and absolute return potential. 44% of all those interviewed said they plan to increase their target hedge fund allocations significantly over the next three years.

A study conducted by The Bank of New York Mellon and Casey, Quirk & Associates in 2009, entitled “The Hedge Fund of Tomorrow: Building an Enduring Firm” found that despite the setbacks the industry experienced during 2008, the hedge fund industry is expected to recover from its oversights of the past and expected to reach almost \$2.6 trillion by the end of the year 2013. Their reasoning is two-fold - the fact that investors broadly still believe in the rationale behind hedge fund investing and the manner in which investors are rethinking the hedge fund strategies’ role within their overall investment portfolios.

Many educated investors no longer view hedge funds as a separate asset class, mainly due to some of the hedge fund strategies offering a wide range of investments with differing risk and liquidity profiles. This has resulted in many investors including some hedge fund strategies in other parts of their portfolio such as equity or fixed income allocations, rather than simply a distinct allocation to hedge funds as a separate asset class. This evolution in the application of hedge funds represents a major paradigm shift for most investors and is expected to become key in portfolio construction under the new landscape.

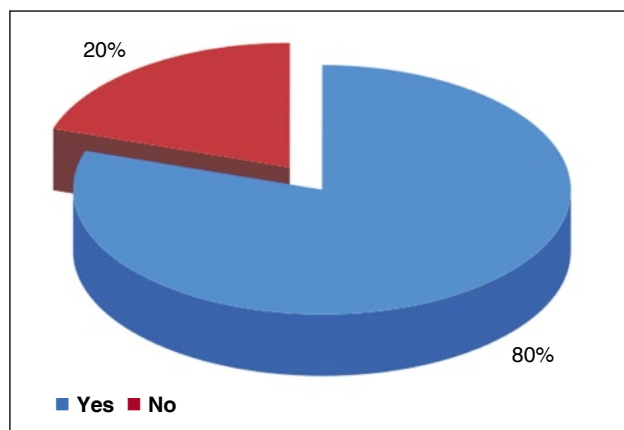
Regulatory reform – adds greater credibility to the industry

It is increasingly likely that going forward, hedge funds will be subject to greater levels of

oversight and regulation. The ongoing financial meltdown has resulted in intense scrutiny of the existing financial regulatory scheme around the world – including hedge funds.

It is somewhat misleading to characterise hedge funds as operating “outside” the existing regulatory structure since all hedge fund managers, whether registered or not, must comply with all existing securities laws and regulations. However, the perception may stem from the fact that there is no single agency that has mandatory regulatory authority over the activities of hedge funds. As such, there is no complete review of the activities and trading strategies within the hedge fund industry to assess whether such dealings collectively pose any systemic risk and provide sufficient investor protection.

A recent study conducted by KPMG in the UK, “The Current State of Play”, revealed that 80% of the hedge fund managers that participated in the survey support the idea of further regulation or supervision of the industry. Most managers support targeted measures that will improve market efficiency and reduce the ability of any participant to abuse the markets in any way.



Source: KPMG – “The Current State of Play”

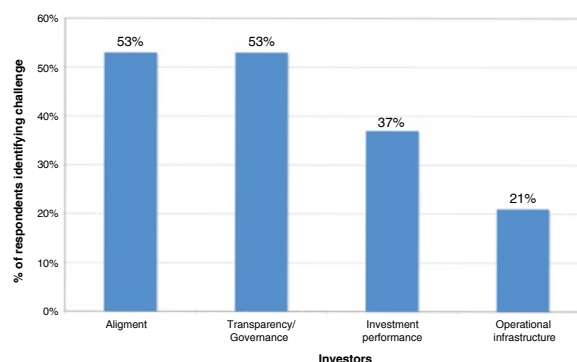
The overwhelming response in support of formal regulation is not unexpected, since this will add greater legitimacy to the industry and if properly regulated, then more assets will be able to flow into the industry. Hedge funds are considered an unregulated industry and therefore not allowed to “defend themselves in public” or advertise / solicit any new business. Therefore, as long as the hedge fund industry is not formally regulated, in some form or another, the public will continue to assume that there is something sinister about the industry and that the industry is “concealing” something from them.

The only concern the hedge fund industry expressed with regards to the looming changes in hedge fund regulation is the issue of “over-regulation”. This may result in hedge funds being constrained and raised the concern as to whether the regulator will have sufficient well-trained people to interpret the data or put another way, will they understand what they are looking at.

Hedge funds of tomorrow – adapt or die

With substantial changes expected in the regulation of hedge

funds, it should come as no surprise that the activities of hedge fund managers will be under increased scrutiny going forward. It is therefore essential for hedge fund managers to design a robust governance and control environment with active risk management, liquidity management and comprehensive investor disclosure. However, the most important challenge for the hedge fund industry is the alignment of interests. The legacy alignment structure resulted in many unstable businesses and continued investor frustration. The Bank of New York Mellon and Casey, Quirk & Associates study revealed that investors considered alignment on par with that of transparency / governance when it came to the challenges hedge fund managers will face going forward.



Source: The Bank of New York Mellon and Casey Quirk Analysis 2009

Accordingly, those hedge funds that become accustomed to the above challenges will be those that will prosper under the “new” hedge fund landscape. In addition, the ability of hedge funds to take a consultative approach to clients together with the realisation of their educational role, will continue to be key factors in their ability to attract new asset flows in the future.

Earning their rightful place within the investment fraternity

After a period of strong growth, hedge funds have experienced a severe contraction in assets. The hedge fund industry’s “most prized” asset today is remaining investors and their ongoing commitment towards hedge funds as a complementary form of investing than traditional, benchmark-oriented strategies. Regulating the industry will not only improve the ongoing poor image perceived by the public, but also give hedge funds under the new landscape the opportunity to educate the press and demonstrate that it can make a positive contribution to the overall financial system and have something meaningful to offer investors.

Hedge funds are able to make use of a much wider “toolset” than traditional asset managers and investors should not be discouraged to partake in the investment opportunities that hedge fund strategies offer them as a result of a lack of understanding of the industry or the unfavourable image that the media portrays of the “old” hedge fund industry.

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