The rush into hedge funds is pushing down returns

A GENTLE stroll around St James's, the nice part of London in which The Economist is based, and Mayfair, a little to the north-west, reveals to those with an eye for such things the changing face of the world’s financial-services industry. Almost every doorway, it seems, has a clutch of brass nameplates which, apart from the occasional word “capital”, reveal little about the occupation of those within.

In fact, though much of the money managed by hedge funds is in America, St James's is the international capital of the industry: within a short walk of our offices are at least 100 such funds. And the sums they manage are growing at a giddy pace—too giddy, say some.

You can see what they are driving at. Brevan Howard, a fund that was set up last year in London’s docklands, moved to St James's this year. It has $4.6 billion under management, according to Hedge Fund Intelligence, a research firm. William von Mueffling, who ran a clutch of funds at Lazard, set up on his own last year. His fund, Cantillon Capital, has already attracted $4 billion. But perhaps the most dramatic grower has been Vega, based in New York and Madrid, which had $2 billion under management at the beginning of last year. It now has $12 billion.

Depending on whose figures you believe, there are 6,000-8,000 hedge funds around the world, which together manage $1 trillion or so. In the first quarter of this year, some $38 billion
flowed into hedge funds, according to Tremont TASS, a research firm—over half of the total for the whole of last year. Small wonder that hedge funds, hitherto lightly regulated, should be attracting the attentions of financial-industry watchdogs (see article). Yet hedge funds still control less than 2% of all investible assets.

It used to be that most of this money came directly from rich people. Now much of it comes via private banks, which these days advise clients to invest in hedge funds as a matter of course. Increasingly, however, a lot of the money comes from pension funds and insurance companies, which once viewed hedge funds with the utmost suspicion, but after the dismal stockmarket of 2000-02, cannot now invest quickly enough. Mickey St Aldwyn of International Fund Marketing, a hedge-fund marketing company, reckons that such is the weight and momentum of institutional money flowing into the market, hedge funds will be managing a colossal $3 trillion within three years.

But therein lies a problem. Traders flock to set up hedge funds because they can earn a lot: typically, funds charge a 1% management fee and 20% of profits. Good, or at least popular, managers can charge what they like. Renaissance Technologies charges a 5% management fee and takes 35% of the profits. SAC takes no fee but half the profits. But whether investors should fork out such sums is debatable: the large amounts pouring into hedge funds are driving down the returns that attracted that money in the first place.

**Alpha males**

Chat to just about any hedge-fund manager and he (few are women) will at some point talk of “alpha”—the extra return that active fund managers claim to earn above the market rate. The trouble is, as one manager says, “It is not a victimless crime. To make money, you have to make it from someone else.” The losers have mostly been traditional, slow institutions. “To make money you need a lot of them willing to lose 1% a year from indolence,” he says. And institutions are starting to stir.

Most hedge-fund strategies are broadly market-neutral. That is, rather than bet on a market moving one way or the other, they play the difference— arbitrage, in the argot—between markets or individual securities. Thus they buy a cheap share and sell an expensive one; or they anticipate the effect of news on the prices of an array of companies. The need for speed helps explain why hedge funds pay up to one-third of all stockbroking commissions, and account for 10-30% of trading on the London stockmarket, depending on the day.

Such strategies might make money when there are few players and lots of inefficiencies, but they are much less lucrative when there are many funds doing the same thing. Now that there are, for example, some 600 hedge funds specialising in credit (loans and corporate bonds), the inefficiencies on which they feed are much reduced, leaving the managers scratching around for other strategies or taking more risk. Generally, this means leveraging returns by borrowing more.

Nor are hedge funds the only ones pursuing these strategies. If hedge funds look like banks’ trading operations, that is because they are indeed all but identical: many hedge funds started life when a bank's traders decided that they could make more working for themselves than punting the bank’s capital. And lately, banks have decided that trading is such a wonderful business that they have devoted even more capital to it.
For many trading strategies, however, there is a limit to the amount of money that can be moved around cheaply and briskly. While punting large amounts on the highly liquid foreign-exchange or government-bond markets is easy, betting on illiquid corporate bonds or shares is far harder. And the larger the amounts, the more expensive the bets are.

It is for this reason that many of the oldest and best-known hedge funds will not accept any new money. Some have even been handing capital back to investors. Vega itself had told some in the industry that it did not want to grow above $2 billion, though it now clearly has more confidence in its abilities.

Whether this is justified remains to be seen. Performance in general seems to be deteriorating. In the late 1990s, says Mr St Aldwyn, no one would touch a fund that did not claim to be able to make 15% a year. Now investors seem happy with a promise of high single-digit returns.

Even this seems beyond many. In the first six months of this year, most funds were flat or slightly positive: the CSFB/Tremont investible hedge-fund index is up a touch over 1% so far this year. April and May were two of the worst months for years. Many in the industry find that disturbing, given that almost nothing nasty happened in the markets. “It's all doomed in one way or another,” says one hedge-fund manager. From alpha to omega in a few short years?