

Commentary: The Hedge Fund Industry as 2009 draws to a close.

Turbulent times

2008 and 2009 have undoubtedly been painful times for the Hedge Fund Industry. The much discussed news of Bernard Madoff confessing to running a record breaking multi billion dollar Ponzi scheme; and Raj Rajaratnam, the billionaire founder of the Hedge Fund firm Galleon Group, being arrested after the SEC alleged he had been involved in insider trading activity that generated over \$20million of illegal gains, illustrate why anxieties exist over the perceived risks posed by Hedge Fund activity.

In the broader economy the 'Credit Crunch' of late 2008 is well documented. The repercussions for Hedge Funds and Funds of Hedge Funds were that investors withdrew their capital and reallocated to cash hoping to avoid risk and the worst of the stock market fall. In practice, however, lack of liquidity to meet these redemption requests meant that many Funds had to "drop gates" and "side pocket" illiquid investments, thereby managing an orderly distribution of cash as assets were liquidated.

This management of illiquidity is still a visible issue for many managers and investors, with current estimates suggesting that 10% of Hedge Funds are impaired in some way. Certainly the first half of 2009 can be viewed as a time of consolidation.

Performance

Whilst the first half of 2009 continued to see net outflows from Hedge Funds, the industry, estimated to be around \$1.3trillion in size at the end of June 2009, has this year shown positive returns in excess of benchmark indices in many sectors - numerous managers posting double digit returns - some in excess of 50% year to date.



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Current challenges

Focus on Hedge Funds' role in the market crash at the end of 2008 and the Madoff scandal have added pressure in Europe and the US for more regulation of Hedge Funds and Hedge Fund Managers to manage and mitigate perceived systemic risks. Possibilities include the supervision of Prime Brokers, registration requirements, operational guidelines, increased transparency and disclosure to investors. In Europe options being evaluated include restricting investment by EU members to Investment Funds originating in the EU.

Whilst the current financial markets offer many opportunities for Hedge Fund Managers wishing to launch new products and offer returns currently not available, investors' appetite for risk remains somewhat diminished and, with a few high profile exceptions, 2009 new Fund launches tend to be smaller with longer lead times.

For Hedge Fund service providers stiff competition for business, smaller launches and shrinking client asset bases have all had an impact on fees whilst at the same time many of the issues discussed above, such as increased reporting and disclosure, have

added to the potential cost base of operation. The same is true for Hedge Fund managers themselves who will have to compete on levels of more transparent fees to attract available capital.

Emerging trends

Sizeable investors, requiring better access to information about how their money is being managed, have turned to managed accounts rather than Funds an approach which adds headaches for managers dealing with multiple accounts.

Successful current strategies such as Convertible and Fixed Income Arbitrage have seen renewed interest and there exist opportunities for Funds focused on property.

Enquiries for new funds point to an increasing desire by seed capital providers for EU onshore or UK offshore products where possible rather than traditional Caribbean structures that have historically dominated the Hedge Fund market, and will continue to do so for the foreseeable future.

The future

No doubt, investors' appetite for risk will return and Hedge Funds can look forward to a recovery of capital inflows. However, we might speculate that over the medium term the Funds into which investment is made will offer greater transparency, lower fees and some measure of enhanced control from the manager's or investor's regulator.

For specialist service providers operating in this industry, the ability to focus technology on providing the accuracy and transparency demanded by fund investors and other stake-holders, and to offer flexible, high quality added value services to clients will become increasingly important in competing for business.