

The Outlook for Institutional Investment in Hedge Funds in the UK

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Summary

This brief document sets out to demonstrate that a case exists for an individual to market single manager hedge funds, and fund of hedge funds (FoHF), directly to the investment community in the UK. The document will show that the environment for this activity is very favourable.

A brief description of the investment backdrop is given plus confirmation that the UK is a major centre for investment. *A marketing plan is also shown towards the end of the document.*

Hedge fund marketing in the UK has to be broad based. It is essential that contacts be made with all links of the investment chain, from third party advisers to professional investment firms, private bankers, and individual investors. Although traditional fund management firms have suffered in the past two years or so, there has not been a stampede away from long only investing. It would appear that the main beneficiary from the equity market malaise, at private investor level, is residential property. Alternative investments have yet to make their mark.

The private investor is becoming more important as a marketing target in the UK. Professional fund managers, through competition and regulatory structure, are being forced to pass more of the investment allocation decisions over to the individual. Individuals will only make investments in when they *think* they understand the investment.

Background

Investment management in the UK has evolved beyond recognition from the early days when investment trusts were considered exotic. Wealth in the UK is now broadly spread. Fund managers, banks, and insurance companies compete directly with each other for the attention of the high street, and high wealth, investor.

The evolution and competition in the traditional investment community has come at a price. The cost of developing and marketing new products, implementing systems, and at the same time satisfying regulators, is both substantial and time consuming. Many fund managers made far too optimistic predictions for the take up of their products, and now nurse high fixed costs without the revenue to justify the initial investment.

The past two years have been extremely difficult for the equity markets. Significant drops in the global indices have had a direct impact on revenues and margins. It has been estimated that traditional fund managers in the UK saw their revenues drop by

approximately 6% between 2000 and 2001. The consultants PWC see little on the horizon to change the downward pressure on profits for fund managers in 2002 even after severe bouts of cost cutting.

The general downward movement in share prices is not the only problem. The increased market volatility and the relatively low level of interest rates, has encouraged large companies like Boots (the UK Chemist chain) to increase its bond holdings at the expense of equities.

Globally assets under management (as judged by the 100 largest fund managers) has ceased to grow and at the end of 2001 stood at \$34,000 billion.

The UK as a Fund Management Centre

The UK is the largest centre for fund management in Europe, and is split roughly in two parts. London accounts for 85% of the assets under management with Scotland accounting for almost all of the balance (as shown on the FMA fund management survey in 2000). Funds managed globally by FMA members and their international associates in June 2000 were \$10,500 billion, of which \$3,150 billion was managed in the UK. Interestingly, of the internationally managed money, roughly 30% was sourced from the UK.

In terms of institutional ownership, 81% of assets managed by a UK firm were either managed by an insurance company or a bank, 14% by fund management groups, and 5% by occupational pension schemes.

Independent research has also shown that wealth management firms marketing to wealthy individuals in the UK manage approximately \$750 billion of discretionary funds, with the growth in business expecting to take that to \$2,000 billion by 2005.

Successive governments in the UK have encouraged retirement provision through a number of tax friendly vehicles, which include private and company pension schemes, personal equity plans (PEPs), investment bonds, and independent savings accounts (ISAs). Only a small percentage of the adult population in the UK *does not* make regular investment decisions.

The growth in personal savings has not been achieved without a regulatory infrastructure. Regulators are powerful bodies in the UK. Pension mis-selling from a decade ago cost insurance companies billions of pounds in compensation and dented the confidence of the private investor. Although regulators are rigorous, they are sensitive to issues, both economic, and political, which may drive investment business elsewhere.

The Good News

The poor performance of traditional and index tracking funds in the past two years and the success of many individual hedge funds of varying strategies, has shown that hedge

funds are a plausible means to invest. The returns of many hedge funds have been impressive enough to attract new money with little marketing effort.

Research from TASS has shown that over \$32 billion of new money was invested in hedge funds in 2001 compared with just \$8 billion in 2000. Cynics would argue that hedge funds have only benefited because of the downturn in the equity markets in particular TMT shares. However the highest levels of investment came just before the highs of the stock markets roughly two years ago; new investment doubling almost every two years after 1992.

Robert Sloan, CEO of Credit Suisse First Boston Tremont Index said: “Absolute return strategies continue to provide risk diversification during this remarkably volatile time in the markets.” This of course is true. The best performing hedge funds not only generate good absolute returns but also do so with a low standard deviation.

The accounting standard FRS17 came into partial force in March 2002. It will eventually require companies to mark to market their pension liabilities and to have them added to the balance sheet. This will have a direct effect on the way many pension funds invest. The relatively high level of volatility in equity markets means that the liability associated with many pension funds could increase too. The ability to spread this volatility over a number of years is also to be removed. This may not affect well managed, fully funded schemes, but thinly spread schemes will not be able to take specific risks that may have produced much better returns.

FRS17 will make it less attractive for companies to offer traditional pension schemes to employees in favour of defined contribution plans. This inevitably means that employees will take a more active role in deciding how their money is invested.

The low volatility approach of the absolute return hedge fund or FoHF is clearly attractive to institutional investors as they can achieve diversification simply by choosing a hedge fund manager. By choosing the FoHF route, they do not even have to decide upon the best hedge fund strategy for a given moment in time themselves.

Institutions such as Royal Skandia and Royal & Sun Alliance have already placed money with Momentum Asset Management’s FoHF. The drug company Astra Zeneca appointed Goldman Sachs Asset Management to manage its fund of hedge fund investing. Private banks too have shown a keen interest in absolute return investing. The head of investment products at Coutts Private Bank disclosed that approximately 21% of discretionary money is already allocated to a variety of hedge funds, with Leopold Joseph, another private bank, a little more conservative at 15%.

Some traditional fund managers have taken to setting up their own in house FoHF. Jupiter Asset Management, one such fund manager, has been marketing the concept to pension funds encouraging them to look at alternative investments, and to invest in their small but growing fund. They offer their product under competitive terms with a 1.5% annual administration fee and a 7.5% annual performance fee.

Some Pitfalls

By its very nature a fund of funds means that an investor has to pay two sets of fees. The FoHF manager has to pay the fees of each constituent hedge fund, which are varied but almost always larger than their own. Fixed annual charges can be as high as 5% of the sum invested with anything up to $\frac{1}{4}$ of the annual return being charged as a performance fee. Potential overcharging by individual funds is a problem for fund of hedge funds as it has a direct impact on the bottom line and will simply prohibit many institutions that may instead invest directly in a portfolio of hedge funds themselves. Pricing is clearly an important issue. Charging the FoHF investor too little perhaps gives the wrong message regarding the quality of the investments and the skills of the investment managers, plus little in the way of revenue for the FoHF manager.

Choosing a single hedge fund manager, in many ways, is no different to buying an individual equity. At last count there were over 6000 hedge funds globally, a pool of both winners and losers. The disparity in performance between the top and the bottom quartile is growing. Statistical research has shown that hedge fund performance tends to the greatest quite soon after the inception of the fund, typically outperforming their more established cousins.

Many institutions and high wealth individuals will not have the expertise to choose the winners. However, like equity investment, seeking the winners is a worthwhile task. The ability of the fund manager, his track record, and the type of fund, become very important.

Research was undertaken last year at Reading University regarding baskets of hedge funds and how different combinations and sizes performed. The data was drawn between June 1994 and June 2001; each basket contained a minimum of one hedge fund and a maximum of twenty.

The results showed that increasing the number of funds in the basket reduced the standard deviation of performance, with fifteen funds achieving full diversification. The larger the number of funds used the better correlated the performance of the basket became with the equity markets. In addition, increasing the number of funds did not reduce hedge fund kurtosis (the risk of a large loss). A FoHF with too many investments is simply synthesising stock market indices but at a much greater cost without significantly reducing the probability of a large loss!

Hedge funds have been justifiably criticised because of the lack of transparency in investment methods. For hedge fund investing to become more widespread, the issue of transparency has to be approached. A fine balance has to be achieved between risk exposure information for investors without position level transparency, which may be detrimental to a funds performance. This is important, as without the correct balance pension fund trustees are unlikely to invest money.

Marketing Hedge Funds in the UK

The prime targets for individuals marketing on behalf of hedge funds are as follows:

- a) Fund managers (90).
- b) Pension companies (80).
- c) Private banks (50).
- d) Investment consultants (12).
- e) Insurance companies (25).

The first stage for a marketer is to target these institutions directly, and clearly some like the consultants can lead not only to pension funds but also to charities and family trusts. Research has already highlighted over 250 companies that occupy this list in the UK. Direct targeting of investors and lead creation should be achievable in quite a short period of time.

Much of the information required to make professional contact is public knowledge, but various directories and bodies exist such as the FMA, Association of British Insurers, Centre for Pensions and Social Insurance, and the Banker's Almanac, amongst others.

The pool of funds controlled by the above list is vast. The private banks alone, identified above, have funds under management of between £250 million and £17 billion.

I recently attended a seminar given by a partner of a wealth management company that outsourced £5 billion of funds to traditional fund managers. Not one penny was invested in hedge funds or a fund of hedge funds. Companies like these are looking for partners in the hedge fund world to create and manage products to sell to their own client base.

As well as lead creation a program of education and profile building will be essential. Attending wealth management and alternative investing seminars, giving presentations on the most up to date topics. In the UK, marketing the concept of investing in a hedge fund will be a first essential step.

The benefits of investing in hedge funds is clear, the following are obvious inclusions in any marketing campaign:

- 1) A hedge fund or a FoHF offers instant portfolio diversification.
- 2) Products can be created and structured quickly to meet the demands of a client.
- 3) The costs of investing are transparent.
- 4) The best managers have the best in house risk management processes.
- 5) Fund managers can offer the product with only a small increase in cost.
- 6) Accounting standard changes will force funds into low volatility investing.
- 7) Hedge funds can already be placed in a tax free ISA.
- 8) Investment selection is both quantitative and qualitative.

Conclusion

The UK is one of the world's largest investment management centers offering institutional and private investors competitive investment products in a regulated, legal, and tax friendly framework.

In response to the poor performance of the global stock markets fund managers have expanded their retail presence and emphasised multi manager products and fund of funds, which globally now stand at \$430 billion. Growing, but still *only 1.26% of all managed assets*.

This general malaise has served the profile of hedge funds well, which for the most part have only produced modest returns in the past year (estimated at an average 4%). They still comfortably outperformed most managed funds and indices, the S&P dropping by just over 11% during the same period.

Institutions have already recognised the potential of hedge funds as they hold approximately 20% of hedge fund assets. Some have gone further and have bought the entire fund. Unicredito is soon to complete the purchase of Momentum Asset Management.

As with all investing the ability to continually attract new money will be based on performance and security. Branding of individual hedge funds as a process in the UK has barely begun, but will be essential if the long term potential of this sector of alternative investing is to succeed. Given the room for business expansion in the UK the revenue potential for successful hedge funds that tap into this growth, is almost unlimited.