



## BOOM TIMES MASK TROUBLE AHEAD

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The hedge fund industry, never boring to start with, promises to become electric in 2006.

For a start, all US hedge funds accepting money for periods of two years or less will, from next month, be required to register with the US Securities and Exchange Commission. Other global regulators are considering similar moves.

This is not expected to staunch the flood of new money - much of it from professional money managers such as pension funds and banks - pouring into alternative assets.

Research from Britain shows the proportion of hedge fund assets belonging to families and wealthy individuals has fallen from 60 per cent in 1996 to 44 per cent in 2004.

The difference is even more telling when looking at inflows into hedge funds: institutions contributed roughly 30 per cent of inflows in 2004, and this is expected to reach 50 per cent by 2008.

By 2010, according to Tanya Styblo Beder, who runs the \$US1.5 billion (\$2 billion) Tribeca hedge fund for Citigroup, some 80 per cent of the assets under hedge fund management will come from institutions.

George Van, who has been researching and advising on hedge funds since 1992, also believes influx of institutional funds is transforming the hedge fund industry and predicts assets will double to \$US2 trillion by 2009, and double again by 2013.

Leading the way is UBS, the world's biggest wealth management company, which has seeded a new hedge fund called Dillon Read Capital Management with \$US2 billion of its own money, as well as 120 bond and fixed-income traders from the bank's proprietary trading business. UBS also threw in its commercial property trading business. Dillon Read opened its doors this month.

Hedge fund returns are likely to remain volatile month-to-month, and to keep using a range of styles. In the 11 months to November 30, 2005, only seven out of 24 constituent members (representing different hedge fund management styles) of the Greenwich-Van Global Hedge Fund Index actually outperformed it - emerging markets, opportunistic, value, specialty strategies, long/short equities, distressed securities and global macro. One, convertible arbitrage, actually had negative performance.

Yet the performance of the benchmark hedge index is not unimpressive compared with other barometers, says Wade McKnight, a vice-president of Greenwich-Van.

"The Greenwich-Van Global Hedge Fund Index has returned 7 per cent on a year-to-date basis compared to 5.3 per cent for the MSCI World Equity Index, 4.9 per cent for the S&P 500, 3.9 per cent for the Russell 2000 and 2.6 per cent for the Nasdaq," McKnight says.

That's a long way, however, from the double-digit returns associated with hedge funds during the bear

market, and used to justify their hefty 20 per cent performance fees.

To try to generate the superior performance their fee structure requires, hedge fund managers are increasingly resorting to more aggressive techniques. These include seeking exotic new avenues for investment - in areas as diverse as reinsurance, aircraft finance, and credit and weather derivatives.

They are also embracing investor activism, seeking out situations where they feel companies have lazy assets or management and aggressively lobbying for change.

Early last year, for example, Germany's Deutsche Borse cast a lascivious eye over the London Stock Exchange, making a \$1.35 billion bid. But its plans were scuppered by a group of British and US hedge funds led by TCI Fund Management and Atticus Capital, which rebelled and in effect forced the resignations of DB's chief executive and chairman.

In essence, the hedge funds thought it would be far better for DB to return funds to investors rather than splurge them on the LSE. The actions of DB and the hedge funds put the spotlight on the LSE, setting up an opportunity for Macquarie Bank, which is now leading a \$1.5 billion (\$3.5 billion) consortium bid. Expect to see increasing hedge fund activity in LSE shares if Macquarie's bid looks like gaining traction.

It was the start of a trend. Hedge funds have subsequently demonstrated a willingness to wage proxy battles and force boards to pay more attention to shareholder returns, and to do so with an aggression not normally associated with professionally managed money.

Other household names to feel the heat from hedge funds' blowtorch in 2005 included Time Warner, McDonald's and Morgan Stanley.

Not all this activity should be construed as altruistic. Some of it is purely opportunistic, in a manner reminiscent of the greenmail activities of 1980s corporate raiders. But it has served notice to company boards and management that they need to focus as much on share price and dividends as they do on corporate strategy and performance. And that they shouldn't let their own remuneration get out of kilter with that going to investors.

In many ways it is just an extension of the arbitrage tactics that have proved pivotal in determining the outcome of many takeovers, including Australian Leisure & Hospitality, Portman Mining and WMC Resources.

One of the reasons hedge funds are embracing activism is because it is getting tougher to show top-notch returns; as more and more hedge funds pursue similar investment ideas and overall market volatility drops, the double-digit returns once associated with hedge funds generally are now much harder to achieve. The funds are becoming victims of their own explosive growth.

By adopting an in-your-face approach, hedge funds are following a path forged by a small number of maverick long-only fund managers, including Australia's Peter Morgan of 452 Capital, John Sevier and Mat Williams of Perpetual, Paul Moore of PM Capital and Anton Tagliaferro of Investors Mutual.

"A lot of bigger companies have never been pressured [before], because they were perceived as being too big to be influenced," says William Ackman, whose \$US1 billion Pershing Square hedge fund is pushing McDonald's to sell units, and earlier last year pressured Wendy's International into divesting a doughnut chain.

Other activists are searching for companies that continue to grant executives excessive pay packages, or engage in wasteful spending.

"A lot of companies are poorly managed and bloated, with too many layers at the top," says veteran corporate investor Carl Icahn, who is urging Time Warner to slash its overhead and increase a share buyback, among other things.

The trend is spreading. Traditional long-only investment funds, frequently critical in private meetings with directors and managers, are publicly commenting on corporate governance issues, excessive pay and cronyism on boards. One example is the recent battles with News Corp over poison pills and executive options.

Today, activists are having more impact because they are more willing to engage in proxy fights to replace executives or take other steps, something superannuation and pension funds previously shied away from.

Finally, and ironically, the hedge funds themselves are likely to be forced to perform to survive.

Citigroup's Beder predicts diminishing returns and rising cost structures will force consolidation in the hedge fund industry.

"There are 8000 funds today and these will go down dramatically to 5000 or fewer over the next five years," Beder told a Monaco conference.

"Such a decrease will stem from rising cost structures, as you will need a lot of scale to survive. This is a talent business. Past returns won't show you where the returns are going to be, and you're going to have to look for them."