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The attractiveness of many hedge funds to high-net-worth investors is declining as excess returns made in their early years disappear amid stiffening competition and a growing reluctance to take risk. Increasing numbers of hedge fund managers are changing. They are no longer interested in just the performance fee but are equally interested in growing the business, establishing a broad and stable investor base and in the possibility of floating at some stage.

Many hedge funds started to reduce their risk and volatility as pension funds and other institutions, invested money. These institutions who need to manage their retirement assets on a cautious basis, usually only invest when the hedge fund has a successful track record of at least three years. With secure annual management fees of typically 2 per cent, this growing inflow of money incentivised managers to play it safe, keeping risk and returns low in order to ensure retention of their growing but more cautious institutional client base. Institutional investors, including pension funds, are willing to accept returns of just a few percentage points above cash unlike the original high-net-worth investors.

Hedge fund returns are also being hampered by crowding of strategies. The sector's profile has changed as institutions have poured money in and driven worldwide hedge fund assets to more than $1,000bn. To differentiate themselves hedge funds need an intellectual or technical edge or to have greater experience in a particular area.

However, there is not much prospect of fee structures changing, even in a low risk/low return hedge fund environment. As a result some pension fund trustees are now beginning to wonder if hedge funds are worth the higher fees and all the hassle involved in due diligence.

Furthermore, many boutique fund management houses have similar structures to hedge funds but only a fraction of the costs. They can also have an absolute return bias across their portfolios, which increase their attractiveness to the more cautious institutional investors.

Ultimately, a more integrated hedge fund sector could deter new blood, arguably the producer of high returns and innovation. The cost of back office systems and compliance with increasing regulation has raised barriers to entry. The result - turbo charged fees but saloon performance.

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