MeesPierson Reads

Groundhog Day

Frank Moon argues that hedge funds are here to stay but naive investors are likely to be sorely disappointed at some point.

"Savvy hedge fund managers realise that they need to enter new terrain to outperform in a low volatility market with too many players."

Memories are short. It was little more then six years ago that John Meriwether and his posse of "quants," including two Nobel laureates watched their hedge fund, Long-Term Capital Management (LCTM), implode. When Russia devalued the rouble and defaulted on its debt in August 1998, LCTM lost 44 per cent of its net assets in that month alone. After sustaining US $4 billion in losses, LTCM was rescued by a consortium of Wall Street investment banks that decided they had potentially far more to lose than the US $3.6 billion required to bail out LTCM and prevent forced liquidation of its assets.

Loosely regulated

Hedge funds are loosely regulated partnerships catering to wealthy individuals and institutions. They can refuse to answer investor questions about their positions, their strategy and their risk management.

Both the number of hedge funds and assets under management soared following the bursting of the stock market bubble in 2000. The estimated £900 billion invested in hedge funds through the third quarter of 2004 is almost double that at the end of 2000.

The chief executive of Standard Life Investments has said that the hedge fund success story of recent years has been a "fad" and investors should be wary of their high "death rate."

Easy money

So here we are, a little more than six years after the near collapse of LTCM, on the heels of an extended period of easy money, seeing an explosion in the number of hedge funds and the assets under management. The Federal Reserve has already warned that there are "signs of potentially excessive risk-taking in financial markets."

Hedge fund investors can diversify their exposure, often by using a fund of funds to allocate money to managers using different strategies. The hope is that if macro funds or those specialising in fixed income relative value have a bad year, their performance will be offset by managers of equity long/short or convertible arbitrage.

Inefficiencies

However, hedge funds aim to capitalise on inefficiencies in markets, often making big bets. The more people chasing the same inefficiencies, the fewer opportunities for profit.

Hedge funds as a group did not outperform the S&P 100 Index last year, returning an 9.6 per cent Dollar return for 2004. The total return for the S&P 500 was 10.9 per cent.

Indices tend to flatter the performance of the hedge fund industry, according to academics who monitor performance. A substantial proportion of hedge funds, perhaps a majority, are wound up without ever growing large enough or building up sufficient track records to feature in an index, they say.

Savvy hedge fund managers realise that they need to enter new terrain to outperform in a low volatility market with too many players.

Accordingly, hedge funds have even started to reinvent themselves as takeover titans. Highfields Capital, a Boston based hedge fund, has recently bid US $3.25 billion for Circuit City, a struggling US consumer electronics chain. The move follows the $11 billion marriage of retailers K Mart and Sears, Roebuck orchestrated last November by hedge fund manager Edward S Lampert.

Human nature

History repeats itself primarily because human nature does not change. In markets human nature is circumscribed by fear and greed. Judging from the recent success of the hedge fund industry, fear is a rare commodity amongst investors these days. Hedge funds are here to stay but naive investors are likely to be sorely disappointed at some point.

We believe that MeesPierson Reads has the expertise to guide you through these difficult choices and help avoid disappointment.

FORTIS

MeesPierson Reads is part of Fortis

The information contained in this page is intended for general guidance only and should not be applied to individual circumstances without detailed professional advice. No responsibility for loss to any person acting or refraining from acting as a result of any material contained in this publication can be accepted by MeesPierson Reads, the authors or the printer.

MPR Asset Management Limited
PO Box 119, Commerce House, St Peter Port, Guernsey GY1 3HB
Tel: 44 1481 714161 Fax: 44 1481 724723
Email: investment@meespiersonreads.com www.meespiersonreads.com

MPR Asset Management Limited is licensed in Guernsey under The Protection of Investors (Bailiwick of Guernsey) Law, 1982.