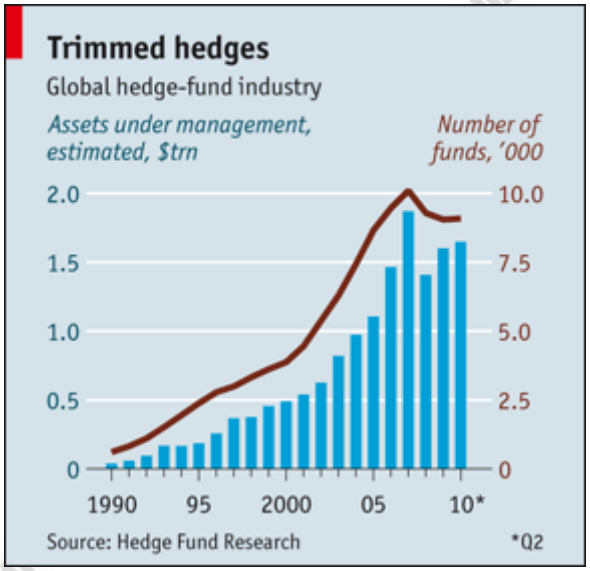
Bigger, safer but duller

A secretive industry opens up to meet the demands of investors and regulators.

FOR much of the past two years hedge-fund managers have tried to convince queasy investors not to give up on them. Now it seems that some of the industry's biggest names have given up on themselves. Stanley Druckenmiller, a celebrated hedge-fund manager and protégé of George Soros, announced on August 18th that he would close his fund, Duquesne Capital Management, because he was "dissatisfied" with its performance. Two days later it emerged that another well-known manager, Paolo Pellegrini, plans to hand back investors their remaining money by the end of September, after making losses.

Messrs Druckenmiller and Pellegrini are not the only hedge-fund managers to have been humbled. Hedge funds used to boast of their ability to deliver "absolute returns"—to make money regardless of the ups and downs in financial markets. That illusion was shattered in 2008 when the funds' average returns were -19%, according to data from Hedge Fund Research, which tracks the industry. Funds clawed back some of the losses last year but have struggled to build on that recovery. Returns were -0.2% in the first half of 2010 (although stockmarkets fell by much more). Capital losses and withdrawals by investors have left hedge-fund assets at around $1.6 trillion, down from a 2007 peak of almost $1.9 trillion (see chart).



An industry that had run almost unchecked because of the returns it once produced and the mystique of its billionaire managers may never again get the same latitude from investors. "It's almost as if you're a car dealer and there was a devastating crash", says one executive at a fund of hedge funds. "Now people for the first time want to know what's under the hood." It is not only poor performance that has given investors whiplash. Bernie Madoff's Ponzi scheme, which came to light in 2008, made clear the risks of handing over capital without close oversight.

To retain investors, hedge funds have had to shed their cloak of secrecy. Some managers have started to meet their investors regularly and provide them with more frequent reports about performance. Other firms give investors greater access, via their websites, to up-to-date information about returns, leverage and liquidity. "We are so much more transparent than we used to be, and more transparent to our investors than a lot of public institutions", says Simon Lorne of Millennium Partners.

There has been a similar rethink about day-to-day business operations. For instance, funds can reduce the risk that a big chunk of investors' assets become trapped in a bankrupt bank (as

happened when Lehman Brothers went bust in 2008), by using several prime brokers to carry out their trades and to provide them with secured lending. Many are also beefing up back-office operations, such as risk management and compliance. These sorts of changes appeal to institutional investors, such as pensions and endowment funds, which can write big cheques but require high standards of their investment firms.

To further broaden their appeal, hedge funds are offering a wider range of investment products. Managed account platforms, which allow an investor's assets to be held separately from the main fund, are popular because clients can keep track of their positions. Other products are tailored to fit the rules for retail investments. The market for hedge-fund vehicles that comply with UCITS III, the European Union regulations governing pooled investments, has almost doubled to around $110 billion in the past year, according to Eurekahedge, a research group. That rapid growth has attracted the attention of some American big names. For instance, John Paulson, a hedge-fund boss known for his lucrative bet against the housing market, will soon offer a UCITS III product.

The creep of regulation is one reason why hedge funds increasingly resemble more traditional investment managers. America's financial-reform bill, passed in July, will require hedge funds with assets over $150m—a low threshold—to register with the Securities and Exchange Commission, to hire or designate a compliance officer and to maintain records on trading positions and leverage. Proposals for new EU regulations would, if adopted, lead to increased oversight of hedge funds by regulators and put limits on funds' leverage.

The increased cost of meeting the demands of institutional investors and regulators is tilting the industry towards ever-bigger firms. Investors already favour the larger, older funds, which they perceive to be safer bets. Most of the new money allocated to hedge funds in the second quarter went to those with assets over $5 billion.

The smallest hedge funds will struggle under these conditions. Some may seek to share back-office costs with larger funds in return for a cut of their profits. Others will liquidate or put themselves up for sale. The industry is already consolidating. On August 3rd, TPG-Axon, a New York fund, announced a merger with Montrica, a London outfit.

Whether this bulking-up will be good for the industry as a whole is unclear. The most glittering returns have often come from smaller, younger outfits, which are now being sidelined. Giant funds often struggle to find ways to produce outsize returns, because they are too big to move nimbly in and out of markets. Mr Druckenmiller said one reason he decided to close Duquesne was its burdensome size.

Yet investors who have been scarred by the volatility of the past two years may now care more about stable performance than big returns. "If you can convince investors that you can consistently generate 10% returns, that is a huge market", says one hedge-fund manager. But if "10 is the new 15" when it comes to returns, as some in the industry claim, then 15 may be the new 20 when it comes to fees. Investors may be less willing to pay the typical boom-era fees of 2% of assets and 20% of returns, if those returns are subdued. Should fees come down, many other hedge fund bosses may soon join Mr Druckenmiller in retirement.

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