GREEN SHOOTS IN THE HEDGE FUND INDUSTRY?

ASHLEY GUNNING AND ED PEARSON, OF WALKERS, REFLECT ON THE CURRENT CONDITION OF THE HEDGE FUND INDUSTRY

Ashley Gunning is a partner in Walkers' Global Investment Funds and Corporate Groups. He specialises in the formation of hedge funds and private equity funds, and all aspects of corporate work, restructuring and mergers and acquisitions.

Ed Pearson is an associate in the Walkers' Global Investment Funds Group. He advises on all aspects of funds work and has experience in a broad range of funds transactions. Pearson advises investment managers, private equity houses and their onshore counsel.

For financial journalists, there has been an easy formula for writing an article about hedge funds in the last few years. Draw a graph of an aggregated hedge fund index against the S&P 500 over the last decade or so, and point out the gap. Note the overall industry outflows in the last couple of years. Add a paragraph about how investors are resentful of management and performance fees. Find a large institutional investor, a Calpers or a Nycers, for example, who has made a high-profile decision to downsize its hedge fund portfolio. Finally, you'll need a picture: a yacht, a stressed-looking trader, Warren Buffett smiling.

As with all of the best clichés, there is some basis in fact for each of these points. However, recent data and commentary have provided clear signs of 'green shoots' for the industry. So in the spirit of spring, at least for those of us in the northern hemisphere, we will explore them in this article.

The health of the hedge fund industry is often marked against three metrics: performance, investor flows, and investor sentiment. In April, Preqin released their *Preqin Quarterly Update: Hedge Funds* for the first quarter of 2017. In this update, they noted that hedge funds as an industry had enjoyed a run of strong returns going back to March 2016. Aggregated across all strategies that Preqin cover, the net returns over the prior 12 months averaged almost 11%. While some strategies had performed particularly well (activist and event-driven funds returning over 15%), returns were positive across all strategies other than CTAs.

While the S&P 500 was up nearly 18% in the same period, comparisons with the S&P (or indeed any other equity index) can be misleading. Investors in hedge funds are not looking for exposure to the broad equity markets; they can obtain those exposures themselves without paying hedge fund manager fees.

Hedge fund investors use hedge funds to seek risk-adjusted returns, often filling a niche identified in their portfolio that cannot be replicated in a cost-effective manner by their own investment teams. A simple read across to the equities indices ignores the risk-adjusted nature of hedge fund returns: while an investor might have enjoyed higher returns with full equity market exposure, many institutions' risk tolerance and portfolio limitations do not permit such a high exposure to equity markets.

As most hedge funds are used by investors to fill a need that is bespoke to their portfolio, it is difficult to assess whether any given strategy's aggregated returns are 'strong' in any objective sense, other than by comparison to prior years. However, surveys of investor sentiment provide some useful guidance. Simply, if investors, who know more than anyone about why they invested in the first place, are happy with returns, it's likely a safe assumption that the fund is fulfilling its role in their portfolio.

Fortunately, there are early signs of spring here as well. In June 2016, early in the recent run of positive performance, Preqin's survey of investor sentiment suggested 41% of investors had reduced confidence in hedge funds' ability to achieve their portfolio objectives. By the end of 2016, two-thirds of surveyed investors reported that their hedge fund portfolios had failed to meet expectations. However, Preqin noted that the recent performance of the hedge fund industry has been "comfortably above" the return expectations of most institutional investors.

Positive returns and improving sentiment should logically be followed by improved flows into the industry, so it was encouraging to see net inflows of almost $20bn in the first quarter of 2017. These inflows were primarily into macro and event-driven strategies, and mostly into mid-sized (between $500m and $1bn) funds. In May, a veteran of the private equity industry even predicted that, as investors struggle to find yields in their other investments, they would increasingly turn to alternative investments, including hedge funds, to achieve returns. He suggested this would lead to record inflows over the next decade.

On fees, a broad consensus has emerged as to what fee structures should aim to achieve. If hedge funds can produce true active returns (alpha), then investors are comfortable rewarding them accordingly. Fees should reward genuine outperformance of the relevant benchmark, they should not incentivise excessive risks, and they should be subject to appropriate watermarks or other safeguards

against rewarding performance.

At Walkers we have seen a clear trend towards more complex fee arrangements in recent years, as managers and investors agree to depart from the simple two-and-twenty in favour of a more bespoke balance. The conventional narrative focuses on the aggregate lowering of fees (which is supported by our own internal data, particularly with respect to management fees), but often overlooks that most investors will be willing to trade lower fees for an increased commitment: either a conventional lock-up, or a minimum-AuM threshold below which their special deal will not apply.

Even the high-profile investors who have scaled back their commitments are only part of the story. Despite all the coverage of the Calpers decision in 2014, there was less coverage of Calstrs' decision to double its hedge fund allocation from $3.6bn to $8.7bn by 2019, or the increase in the University of California's target allocation to hedge funds announced in March. According to the Calstrs' chief investment officer, reported by Bloomberg at the time, the pension fund's allocation to hedge funds is not intended to supplement market returns from the portfolio's equity portfolio, but rather to hedge against risks in the fund's much larger equities portfolio. As we noted above, context is everything.

> "INVESTORS IN HEDGE FUNDS ARE NOT LOOKING FOR EXPOSURE TO THE BROAD EQUITY MARKETS; THEY CAN OBTAIN THOSE EXPOSURES THEMSELVES WITHOUT PAYING HEDGE FUND MANAGER FEES"

Speaking of context, the conclusion of the $1m charitable wager between Warren Buffett and Protégé Partners attracted much commentary last month. There's no getting around the fact that Buffett will win handsomely when the ten year period of the bet expires next year: his S&P tracker managed by Vanguard is up by 85%, while the basket of hedge funds picked by Protégé is up 22%. As the *Financial Times* pointed out, over the course of the decade the hammer price of Buffett's annual charity auction to have lunch with him has increased from $250,000 to $3.5m, so in that context, the $1m that Protégé Partners stand to lose has bought them ten years of access to, and friendly competition with, Mr Buffett.

Here in the Cayman Islands, the seasons are not quite as pronounced as they are further north. And so it is in our industry; the trends observed above filter through to activity in the Cayman Islands fund industry in a complex way that simple metrics, such as the gentle decline in the aggregate number of Cima-registered funds, cannot fully capture.

The green shoots identified in this article are already seeing an increased level of activity for fund managers looking to launch new offshore fund products or revisit the terms of their existing ones. The inherent flexibility of the Cayman Islands legal structures and the continued supportive regulatory environment are perhaps not as exciting a topic as billion dollar withdrawals or million dollar bets, but they will provide a solid foundation if the optimism is well founded. ■