Hedge fund redemptions show market is maturing

Interview with Prasana & James Melen

The third quarter of 2016 saw an estimated USD28 billion of hedge fund net outflows – the highest since 2009. This brought year-to-date redemptions to USD51.5 billion. Those suffering significant outflows included high-profile stalwarts of the industry such as Brevan Howard, which saw USD3 billion in redemptions in the first six months of 2016.

"There seems to be a significant trend of institutional investors looking at the hedge fund space carefully and making assessments with a view of repositioning capital to address internal requirements and investment mandates. Institutional investors have numerous options available to them such that they can redeem with a manager if they are dissatisfied with current performance and/or fees and move to another manager," comments Prasana, Senior Counsel, Walkers (Cayman Islands).

Even though hedge fund redemptions were significant in 1H16, the bigger picture reveals that overall net assets rose 2.5 per cent to USD2.979 trillion through Q3 2016 according to Hedge Fund Research, marking a new high.

James Melen is a Partner at Walkers (Cayman Islands). In his view, redemption levels should not always be viewed as a negative, but rather can indicate a positive reflection of the marketplace.

"In a maturing market, investor confidence rises and investors are willing to shut down investments in an underperforming fund. As hedge funds have matured over the last 15 to 20 years, investors are themselves more discerning and less inclined incur fees that are paid when the performance is not up to benchmark standards with respect to the S&P, for example.

"One has to question to what extent outflows can be attributed to hedge fund managers that are not able to deliver the kind of performance that investors want," says Melen.

Prasana, Senior Counsel at Walkers

James Melen, Partner at Walkers

In recent years, the power balance has moved to some extent from the managers to the large institutional allocators. Pension plans, SWFs and endowments have gravitated towards billion dollar hedge funds that are better equipped to devise more creative fee structures.

But as 2016 has shown, institutions are more willing to redeem when managers fail to live up to expectations. According to Hedge Fund Research, firms with USD5 billion or more in AUM incurred USD22 billion of the USD28 billion of net inflows in Q3 2016.

This, though, should be welcomed and viewed as a proper functioning industry.

"I think it is important to draw out the positives and consider that last year's redemptions are indicative to some extent of a maturing market," adds Melen.

Prasana believes that the current market paradigm is driving investment managers to further innovate and find new investment opportunities. "This could be by adopting hybrid vehicles or structuring direct lending funds and CLOs for finance-driven opportunities to generate returns away from traditional equity long/short strategies," she says, adding that a key consideration for today's hedge fund manager is to stay close to their institutional investor base, listen effectively to market feedback, and react in a nimble fashion as required.

Manager's responses include changing fee terms, offering innovation on how the manager receives performance fees to match up with liquidity terms, revisiting investment terms and/or market strategy, etc.

"Getting the fund terms right from the outset to match investor expectation is critical," says Prasana.

Another sign of market maturity is the emphasis on partnership between managers and their loyal investor base.

"There is a good deal of effort put in to arriving at a mutually agreeable arrangement pre-launch or pre-closing with respect to a fund that already has an initial track record than used to be the case. We see that with the frequent use of side letter arrangements or new share classes: techniques that illustrate how managers are trying to align a closer partnership with their investors," says Melen.

This willingness to build closer ties with investors is encouraging and tends to be overlooked in the media where large redemptions and reports of double-digit fund losses take on a degree of Schadenfreude.

"If you take a step back and look at the industry as a whole – rather than specific redemption requests – there are just as many stories and reports on net growth and creative forward-thinking managers succeeding in this space.

"Those with the greatest talent and flair are always going to make it in this industry because they are driven and committed to do so. The maturity of the market being what it is, and the harder job that new entrants have to break in to the market, is to my mind yet another sign of increasing quality," comments Melen.

It can often be assumed that the impact of increased regulation and the higher barriers to entry are wholly detrimental to the industry. But it should not necessarily be easy to become a hedge fund manager. It should be a challenge.

"We've seen several examples of very successful managers being supported by the hedge fund they are leaving to set up their own vehicle. Those managers will often tend to break through, even if it takes longer. It simply makes the most committed individuals work even harder at creating a business model and fund product that can succeed."

"It is not a market to enter without the appetite for it supported by the commitment and drive to achieve success. Managers with those elements will be successful," adds Melen.

As with any successful investment market, however, there will be times when issues of wrongdoing are unveiled. The hedge fund industry is not immune to this. Recent alleged insider trading cases have negatively impacted the industry.

"Transparency with an ethos of sound corporate governance is very important. Furthermore, the enforcement actions by the regulators, bolstered by investor disapproval, exhibited effectively with swift withdrawals, sends a strong message to the industry," comments Prasana.

Along with redemptions, higher barriers to entry and closer investor partnerships, such investigations and enforcements are, in Melen's view, another sign of a properly regulated and maturing hedge fund market.

"What would be more concerning to me would be a multi-trillion dollar industry quietly getting on with its business where no one can be perfect and a bubble develops; in that environment, problems would come out in the form of some catastrophic event that leads to a permanent impairment of the industry.

"It is far healthier to have a regulated industry, as we do today, where the regulators function as they should to identify potential wrongdoing. There will evidently be moments where those who are engaged in insider trading are found out and dealt with accordingly. You have to see the industry being assessed and regulated in the right way; that gives confidence to institutional investors," remarks Melen.

Looking ahead, Prasana sees continued opportunities for hedge funds and is confident they will innovate and move into new markets. Opportunistic credit, special situations, direct lending, hybrid vehicles and CLOs will be particular areas of expansion.

Indeed, Melen observes that some larger managers have gone from offering a traditional hedge fund to offering new platforms to operate hybrid structures. This, he says, is helping managers create entirely new business models whilst at the same time continue to run their flagship hedge funds.

"The CLO space is one we are genuinely excited about. Our funds group is working more closely with the finance lending and securities team at Walkers and that is going to increase more and more as hedge funds continue to move further into the CLO and direct lending space," concludes Melen. ■