

Don't Write the Obit for Hedge Funds Yet

by Benjamin N. Alpert, CFA | 05-19-09 | 06:00 AM

Lots of ink has been spilled about the demise of hedge funds since turmoil in the financial markets accelerated in last year's third quarter. Some pundits have predicted that hedge fund assets would shrink by as much as 75% and that half of those in existence would close up shop. There's no denying that many are closing. So far, nearly 30% of hedge funds in our database have either told us that they've closed or have stopped reporting performance to us for at least six months (a sign that they have likely ended up in the hedge fund graveyard). Many more are suffering large asset declines, but it's premature to say that hedge funds are history.

The (Alternative) Resistance Lives On

It's true that the pace of new fund launches in the first quarter of 2009 was roughly half that of the past five years, causing a decline in the number of funds for the first time in memory. Expecting the hedge fund industry to shrink further is not outlandish following the Bernie Madoff and Alan Stanford scandals and the fact that hedge funds experienced their worst year on record in 2008. But even during the market's darkest days of late 2008 and early 2009, new hedge funds were opening. A search of Morningstar's hedge fund database recently revealed nearly 100 inception in the fourth quarter of 2008 and 75 launches in the first quarter of 2009.

New hedge funds continue to come to life, and one might expect them to look different now. After such a tumultuous year, it seems reasonable to expect new funds to assume less risk, but that does not appear to be the case. Emerging-markets equity funds account for 15% of the new funds, for example, despite having been in one of the market's toughest corners (the Morningstar Emerging Market Equity Hedge Fund Index was the worst-performing and most volatile hedge fund category index in 2008). And while the fact that some new hedge funds are not yet reporting to our database makes them difficult to quantify, we've seen news reports announcing the launch of many distressed-debt, currency, and futures funds.

Best of Both Worlds?

Two of the knocks against hedge funds have been their lack of transparency and hefty fees, which are clear disadvantages versus more-transparent and inexpensive mutual funds. Yet, mutual funds don't offer the same flexibility; they are limited to having less than 15% in illiquid securities and have strict limitations on their use of investment leverage. Hedge funds have no restrictions on their concentrations in illiquid securities, and some strategies boost their

returns significantly by borrowing and investing many times the amount of their net assets. One case in point is the Treasury's plan to have money managers purchase distressed assets from banks. The limits on illiquid securities and leverage make it nearly impossible to create stand-alone mutual funds dedicated to benefiting from the proposed Public-Private Investment Program, or PPIP. Although re-establishment of a market for those assets is a stated goal of the program, it's a stretch to call them anything but illiquid at this point.

The noted liquidity and leverage restrictions prevent many alternative strategies from being offered to nonqualified investors in mutual fund form. But there are a significant and growing number of alternative style mutual funds working within these limits. Morningstar tracks more than 100 mutual funds that use an alternative strategy or asset class. These funds offer individual investors access to investment styles, such as managed futures, currencies, merger arbitrage, long/short equity, and market-neutral equity that have historically been dominated by hedge funds. As long as these funds exist, it's too soon to write off alternative asset classes, either.

Take, for example, the following three mutual funds that were recently launched. Each offers a hedge-fund-like flavor:

AQR Diversified Arbitrage I ADAIX

The first mutual fund offering from a long-standing alternative manager combines various arbitrage strategies not typically found in mutual funds. Arbitrage strategies identify groups of securities trading at prices that don't agree with their expected relationships. For example, merger arbitrage investors seek to exploit price discrepancies that occur when one company is buying another one. Open since January 2009, this fund combines merger arbitrage, convertible bond arbitrage, capital structure arbitrage, and other arbitrage techniques aiming to generate investment returns with low correlations to the stock market.

Legg Mason Partners Permal Tactical Allocation LPTAX

Legg Mason is making the services of its alternative asset-management team, Permal, available to mutual fund investors. Although tactical allocation is not on its own an alternative concept, Permal has a long history of success operating strategic and tactical asset management within funds of hedge funds. Open for about a month, this fund allocates among various asset classes aiming to outpace a traditional asset mix.

Turner Spectrum Fund TSPEX

The newest entry, just opened on May 7, combines six long/short

equity strategies managed by Turner Investment Partners that are not otherwise available as mutual funds. Previously, the underlying portfolios were only available to institutional investors through separate accounts.

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