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High-flying funds assume a more modest role : Trimmed hedges

By Barbara Wall International Herald Tribune
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Most hedge fund managers have had little to crow about this year: Returns have been disappointing and pressure has been mounting on practitioners to cut fees and improve transparency. On top of that, the nascent market rally is leading many investors to conclude that hedge funds have served their purpose ã namely, to help weather a bear market ã and can be dispensed with.

To some, that might be good riddance.

"They are all too often opaque," said John Sandwick, managing director of Encore Management, an asset manager in Geneva and one of the most vocal critics of hedge funds. "Many fund managers act like gods. They consider it beneath them to talk to investors, let alone defend their investment decisions."

Not to mention, Sandwick added, that "annual performance can be terrible."

"Few people want to remember what happened to hedge funds in 1999," he said, "when the hedge-fund index returned minus 9 percent and scores of funds went bust."

Then there are fees to consider. Funds of hedge funds, in particular, have come under attack.

"Investors could end up paying four or five times more than a traditional no-load fund," said an investment adviser in London.

Given all the criticism, it is difficult to see why, given the recent rally in equities, there has not been a mass sell-off in hedge funds. And now that economic prospects have brightened, surely the smart money is on equities.

Well, yes and no.

There is little doubt that there will be an economic recovery, but the rate of economic growth is likely to be slower than the 2.75 percent a year forecast recently by the chairman of the Federal Reserve, Alan Greenspan. In a slow-growth environment, individuals may be more interested in preserving their gains than in seeking yield, and that makes the case for hedge funds worth listening to.

The average hedge fund in Europe returned 5 percent in the second quarter, not as good as the 18 percent returned by the average offshore equity fund. But if investors are more interested in protecting their investment against losses than chasing performance, the tradeoff might be considered worth it. David Smith, who runs a multimanager hedge fund for Global Asset Management in London, said that in a low-risk, low-reward environment, a hedge fund manager who can protect an investor's capital and make modest incremental returns every year is doing a good job.

"Funds that aim for returns of 15 percent are bound to disappoint," Smith said. "Without wanting to bore my investors to death, I would consider an annual return of 8 percent net of fees a respectable achievement."

Smith is one of the few European hedge fund managers who do not charge a performance fee. Since Global Asset Management introduced the Diversity fund in 1998, funds under management have risen tenfold, to §10 billion, or about $11.07 billion. The fund is such a solid, low-risk producer that the average investor views a holding in the fund as a quasi-bond allocation, Smith said.

With single-manager hedge funds having minimum subscription levels of around §1 million, it makes sense for private investors to opt for a multimanager hedge fund, where entry levels are lower. Finding one to suit might prove tricky. Sandwick, a difficult sell if ever there was one, said he was fortunate this year in discovering two European funds of hedge funds to invest in: the Harcourt family of Belmont funds and the Arias funds from Absolute Return Investment Managers, in Lisbon.

Sandwick said he had been drawn to the Belmont and Arias funds because of their "openness, modest fees and stable pricing during periods of high volatility."

Exchange-listed multimanager hedge funds, which are traded like any other share, provide investors with an additional level of transparency and access. The main criticism of these funds is that shares often trade at a sizable discount to net asset value. Investors could end up being hit twice: by a fall in the share price and a widening of the discount.

Funds like HSBC Republic's European Absolute include a mechanism to control the development of large discounts. HSBC tends to trade on small discount of around 0.3 percent.

According to a report by ABN AMRO, the best performing London-listed multimanager fund during the first half of the year was Dexion Absolute, which gained 7.5 percent. The best performing Swiss-listed multimanager fund over the same time frame was Absolute Europe, up 9 percent.