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IFSL Research

Hedge Funds 2009

April 2009 WWW.IFSL.ORG.UK

After a decade of robust growth, global hedge fund assets under management declined sharply in 2008 due to conditions brought about by the global economic downturn. This report is an update of IFSL's previous overview of the global hedge fund industry and gives particular emphasis on London's role as the second largest global centre for hedge funds.

THE GLOBAL HEDGE FUNDS INDUSTRY

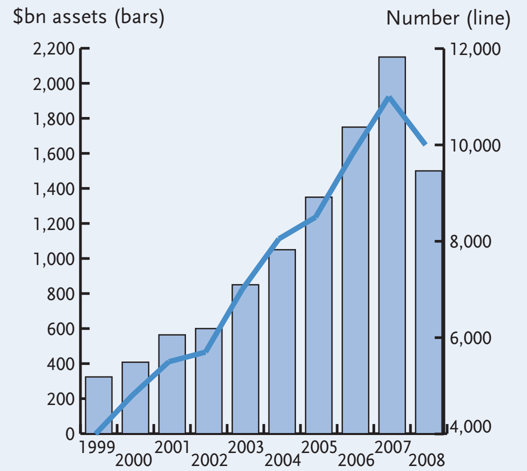
Assets under management of the hedge fund industry fell by nearly 30% in 2008 to $1,500bn[1] (Chart 1). The decline, the biggest on record, was due to a combination of negative performance, surge in redemptions and liquidations of funds. A further fall in assets under management of over 20% is possible in 2009 as some hedge funds, particularly in the US, had suspended redemptions late in 2008. The decline in assets during 2008 was split relatively equally between negative performance and asset outflows (Chart 2). On a regional level, redemptions were more responsible for a fall in assets in Europe and emerging markets, while in the US and Japan, losses on investments accounted for a bigger proportion of the decline. Asia saw the highest rate of liquidations.

The average hedge fund lost 15.7% in 2008, the worst performance on record (Chart 3). Hedge fund losses were widespread, with nearly three-quarters of funds making losses. Among fund of hedge funds, 85% lost money. Nevertheless hedge funds outperformed many of the underlying markets, such as the S&P index which saw a 38% drop. The bulk of losses came between September and November 2008. Main contributors to these losses included the collapse of banks in the US and Europe, many of which were service providers to the hedge fund industry; falls in equity markets; a ban on short-selling; and pressure to liquidate positions to meet margin and redemption calls.

Flow of funds Hedge funds returned 13.2% of investors' assets in 2008. The surge in redemptions was due to losses, risk aversion and the reputational damage inflicted by the Madoff fraud. This is only the second time over the past two decades that the industry has suffered an annual net outflow of funds. The positive inflows during the first half of the year were more than offset by outflows in the second half. Q3 and Q4 of 2008 set consecutive records in the value of quarterly redemptions. Data for the first two months of 2009 shows that investors have continued to pull money out of hedge funds with a further $115bn returned during this period. Firms more oriented towards institutional investors have fared better in this environment. Withdrawal requests were widespread across fund strategies, regions and asset sizes. Some hedge funds were forced to suspend redemptions towards the end of 2008 because selling illiquid assets would have exposed remaining investors to even biggerpotential losses.

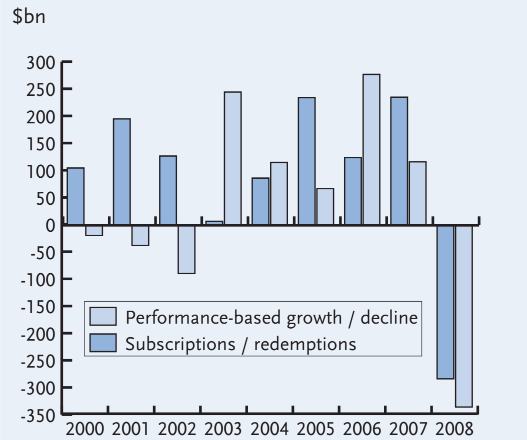
Number of hedge funds: The number of hedge funds fell by 10% in 2008 to around 10,000 with most closures coming in the latter part of the year (Chart 1). The fall was caused by funds closing due to losses, lack of liquidity and redemptions as investors looked for safer investments. Around three-

Chart 1 Global hedge funds



Source: IFSL estimates

Chart 2 Net asset flow and returns



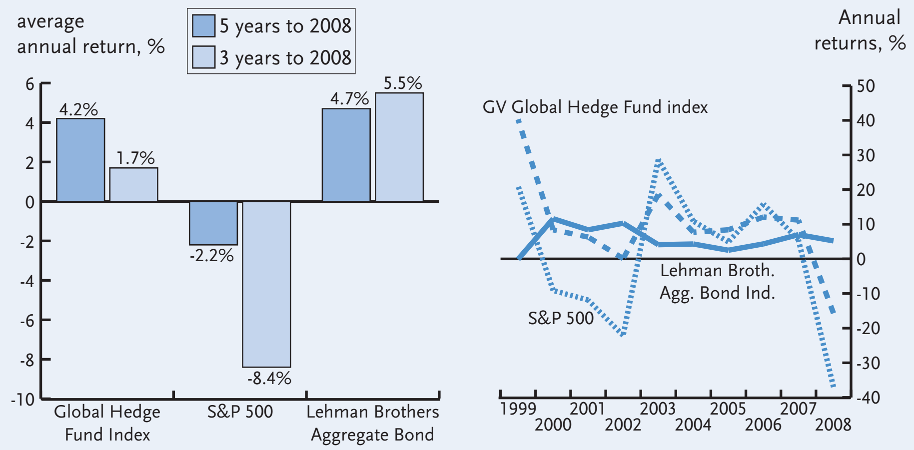
Source: IFSL estimates

[1] Estimates of the size of the hedge fund industry vary due to restrictions imposed on advertising and reporting of performance by hedge funds. As there are no authoritative estimates we have relied in this report on commercial databases and index providers which rely on information provided voluntarily.

quarters of funds in the hedge fund industry are single manager hedge funds and the remainder fund of hedge funds.

Employment: According to the Alternative Investment Management Association (AIMA), the UK hedge fund industry employs around 40,000 people. Around 10,000 of these are directly employed by hedge funds and the remainder among the industry's advisers and service providers. The industry employed some 150,000 people worldwide at the end of 2008, about 6% down on the previous year. Further falls in employment are likely in 2009.

Chart 3 Global hedge fund returns



Source: Greenwich Alternative Investments

Geographical distribution of hedge funds

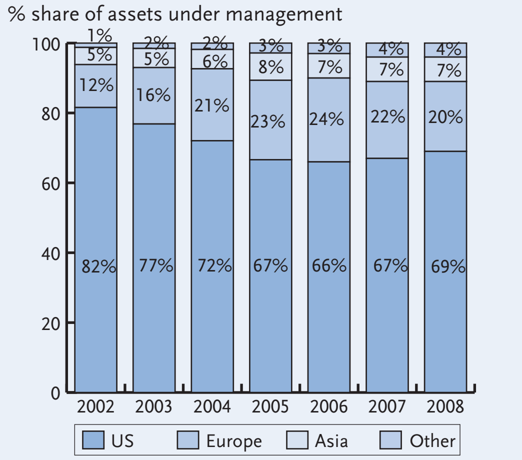
Domicile of fund Hedge funds can be registered in onshore or offshore locations. At the end of 2008 around a half of the number of hedge funds were registered offshore. Offshore funds saw asset reductions at a faster rate during 2008 than onshore funds. The most popular offshore location was the Cayman Islands (67% of number of offshore funds), followed by British Virgin Islands (11%) and Bermuda (7%). The US was the most popular onshore location in 2008 accounting for nearly two-thirds of the number of onshore funds, with European countries accounting for most of the remainder.

Location of management Hedge funds are predominantly managed from onshore locations. The US is by far the leading location for management of hedge fund assets with over two-thirds of the global total having increased its share slightly in 2008 due to bigger redemptions in Europe. Its share, however, was still well below its 82% share six years earlier. Europe and Asia gained in importance in the six years up to 2008 as shown in Chart 4.

New York is the world's leading centre for hedge fund management, followed by London. Around 60% of US domiciled hedge assets are managed from New York. Other important centres in the US include California with 15%, and Connecticut, Illinois and Florida with around 6% each. IFSL estimates that around 42% of global hedge fund assets were managed in New York in 2008, down from 50% in 2002 but slightly up on 2007 (Chart 5).

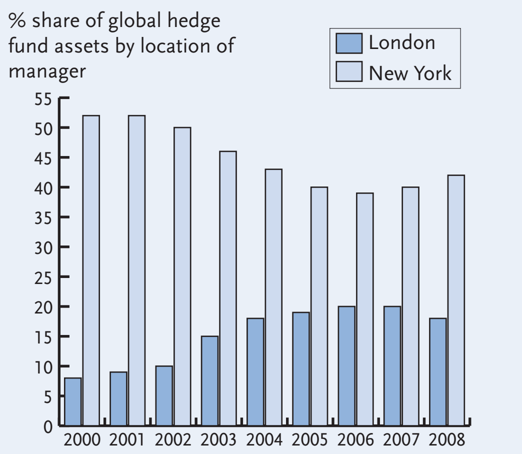
London was the second largest global centre for hedge fund managers with 18% of global hedge fund assets managed there in 2008. Its share was slightly down on the previous year due to a bigger fall in hedge fund assets in Europe than in the US. London is much the largest centre in Europe for the management of hedge funds. At the end of 2008, four-fifths of European hedge fund assets totalling around $300bn were managed out of the UK, the vast majority from London (Chart 6). These figures, do not include fund of funds and investments from the US managed in Europe. If these are taken into account, London probably accounts for more than 90% of hedge funds assets managed in Europe. There were around 1,300 European-based hedge funds in 2008, of which two-thirds were located in London. Other important locations for hedge fund managers in Europe include France, Spain and Switzerland.

Chart 4 Management location of global hedge fund assets



Source: IFSL estimates

Chart 5 Share of global hedge fund industry, London vs. New York



Source: IFSL estimates

Hedge funds

Hedge funds are private pooled investment limited partnerships which currently fall outside many of the rules and regulations governing mutual funds. Hedge funds therefore can invest in a variety of securities on a leveraged basis. Today, the term hedge fund refers not so much to the hedging techniques hedge funds may employ as it does to their status as private investment partnerships.

Fund of funds

Fund of Hedge Funds are closed-end registered investment companies that invest in hedge funds and other pooled investment vehicles. Their holdings consist of shares in hedge funds and private-equity funds. Fund of funds seek diversification of their assets in terms of geographic mandate and investment style. Investing in funds of hedge funds typically allows for a more stable investment return than when investing in any individual strategy. They also offer investors and the mass affluent a means of broadening exposure to a wider range of hedge funds.

Despite the global economic slowdown, London retains its structural advantages which make it an attractive location for hedge fund management. These include its local expertise, the proximity of clients and markets and a strong asset management industry. London is also a leading centre for hedge fund services such as administration, prime brokerage, custody and auditing. With around a half of European investment banking activity conducted through London, it is a natural location for prime brokerage services.

Asia, and more particularly China, is taking on a more important role in the global hedge fund industry more as a source of funds than a location for management. The UK and the US are leading locations for management of Asian hedge funds' assets with around a quarter of the total each. Other important centres include Hong Kong, Australia, Singapore and Japan.

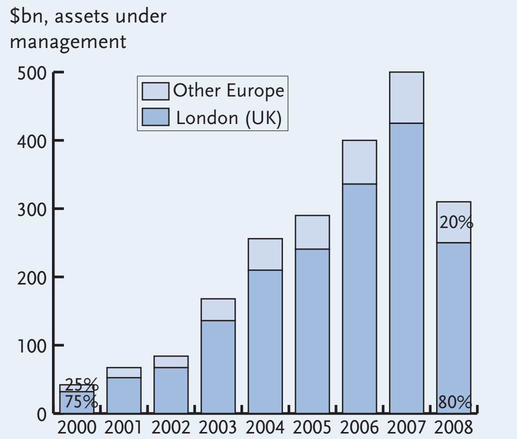
SOURCE OF HEDGE FUNDS' INVESTMENTS

Hedge funds faced unprecedented pressure for redemptions in the latter part of 2008, with investors withdrawing funds due to dissatisfaction with the performance or to cover for even greater losses or cash calls elsewhere. This in turn led to forced selling and closures of positions by hedge funds causing a cycle of further losses and redemptions. Some funds were not able to meet withdrawal requests so were forced to suspend redemptions, as selling illiquid assets would have damaged the investors that remained. Hedge funds could see further withdrawals of 10-20% in early 2009 as restrictions on redemptions are lifted, particularly in some US based hedge funds.

Madoff investment fraud

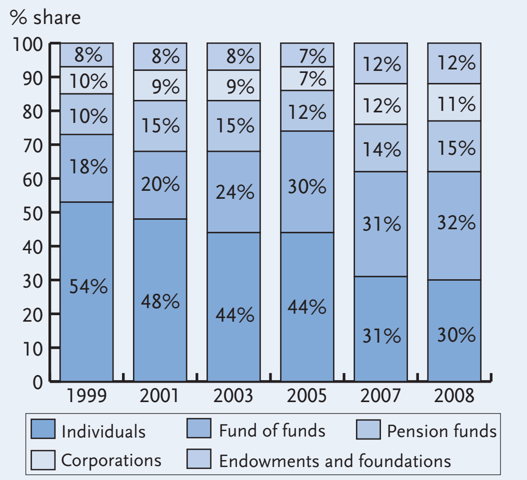
The Madoff investment scandal occurred after the discovery that the asset management business of former NASDAQ chairman Bernard Madoff was actually a giant "Ponzi" scheme. Alerted by his sons, federal authorities arrested Madoff on December 11, 2008. On March 12, 2009 Madoff pled guilty to 11 felonies and admitted to operating the largest investor fraud ever committed by an individual. According to a federal criminal complaint, client statements showing $65 billion in stock holdings were fictitious, and there is no indication that any stocks were purchased since the mid-1990s. Although Madoff did not operate as a hedge fund, he operated through various funds of hedge funds. This has inflicted great reputational damage and reduced investor confidence in the hedge fund industry, particularly fund of funds which are the source of around 40% of hedge fund assets.

Chart 6 London's share of European based hedge funds market



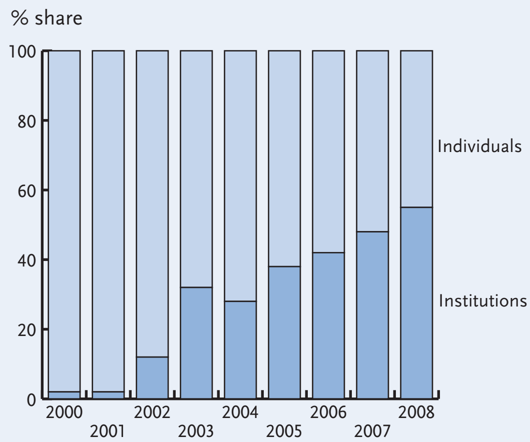
Source: IFSL estimates

Chart 7 Global hedge funds by source of capital



Source: Hennessee Group LLC

Chart 8 Institutional share of hedge fund capital flows



Source: Bank of New York, Casey, Quirk & Associates

Institutional investors have overtaken high net worth individuals for the first time to become the biggest source of assets for hedge funds in 2008 (Chart 8). Around a third of assets from institutional investors come from pension funds. Most institutional investors invest in hedge funds through fund of hedge funds and more recently through multi-strategy managers. Close to 90% of institutional investors either use fund of hedge funds exclusively or the dual approach, a combination of fund of hedge funds and single manager hedge funds. The rise in institutional capital invested in hedge funds and increased regulation are likely to have a significant impact on the hedge fund industry. This may lead to more formal procedures and controls, and increased transparency.

Fund of hedge funds' assets fell by nearly a third in 2008 to around $600bn or some 40% of global hedge fund assets. This follows a decade of consistent growth (Chart 9). The breakdown by manager location shows that 24% of fund of hedge fund assets were managed in the UK. The US was the most popular location with a 28% market share. Switzerland, France and Hong Kong were also important centres (Chart 10). To deal with falling liquidity and redemptions, many fund of funds were forced to reduce management and performance fees in order to attract new investments and retain existing customers.

The number of publicly quoted hedge fund of funds has increased rapidly over the past decade. These funds are listed primarily on London and Zurich exchanges. The London Stock Exchange overtook Zurich in 2006 as the location of choice for listing funds of hedge funds. The net asset value and share prices of the vast majority of listed funds fell during 2008. The sell-off in the listed sector has been driven by concerns over reduced liquidity and losses in the industry.

LARGEST HEDGE FUNDS

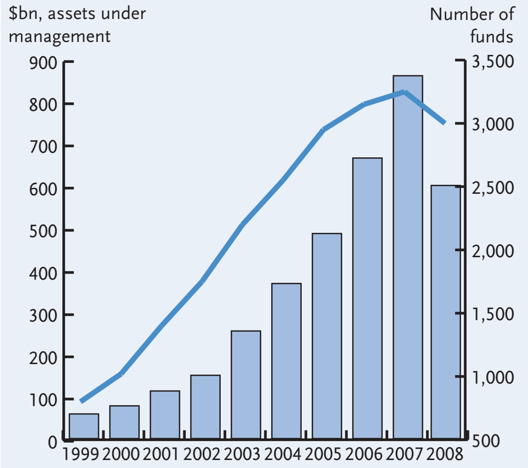
The hedge fund industry has become more concentrated at the top end over the past decade. With fund closures on the rise and new launches on the decline, consolidation intensified in 2008. The industry that emerges from the global economic slowdown will probably be characterised by a greater concentration of assets in the large funds. The top 100 hedge funds accounted for around three-quarters of total industry assets in 2008, up from 54% in 2003 (Chart 12).

Bridgewater Associates was the largest hedge fund with $38bn under management at the end of 2008 slightly up on the previous year (Table 1). It was followed by JP Morgan which saw a 26% fall in assets to $33bn and Paulson & Co $29bn. The 10% hedge fund attrition rate in 2008 was much higher than the 3% to 5% range of the previous 10 years (Chart 13).

HEDGE FUND INVESTMENT STRATEGIES

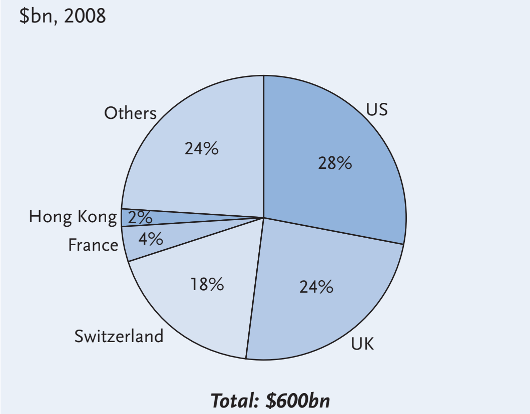
Hedge funds investment strategies vary enormously. Strategies may be designed to be *directional* (which try to anticipate market movements) or *market-neutral* (which have low correlation to the overall market movement).

Chart 9 Global Fund of Hedge Funds industry



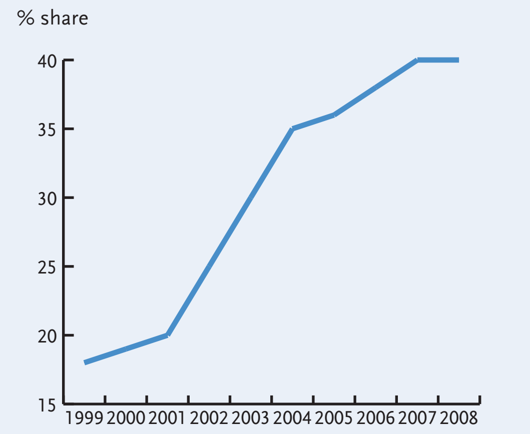
Sources: IFSL estimates

Chart 10 Fund of hedge fund assets by manager location



Sources: Eurekahedge, IFSL estimates

Chart 11 Single-manager hedge fund capital provided by funds of hedge funds



Sources: IFSL estimates

Key characteristics of hedge funds

Exemption from many investment protection and disclosure requirements as the majority of hedge funds are domiciled offshore or subject to limited regulation by onshore regulators. This may however change over the next year as regulations are tightened.

Flexibility in investment options. Hedge funds can use short selling, leverage and derivatives. This enables them to deliver non-market correlated returns. Hedge funds cut leverage by around a half during 2008 to 1.10 times the assets (Chart 14) in market conditions of falling liquidity. Research by the Financial Services Authority shows that hedge funds had cut leverage during 2008 more quickly than they were required to by the lenders.

Wide dispersion in investment returns, volatility and risk. Hedge funds are expected to deliver positive absolute returns in all market conditions.

Linking compensation to performance with compensation of managers based on a percentage of the hedge fund's capital gains and capital appreciation. In addition, hedge fund managers often invest their own money in their fund. Due to the sizeable redemptions during 2008, hedge funds may be forced to reduce their fees in order to attract new investments.

Although equity long/short strategies accounted for the leading share of strategies with a third in 2008, this was significantly down on their 41% share in the previous year (Table 3). Multi-strategy and event driven strategies were the only ones that saw positive asset flows in 2008.

Following sustained heavy equity market losses in September and October 2008, regulatory agencies in many jurisdictions instigated restrictions on the short selling of stocks. This further hampered the hedge fund industry and many funds were forced to close positions. Investment losses of hedge funds averaged 15.7% during 2008 with the bulk of losses coming in the second half of the year. Although returns may vary significantly in different years, hedge funds have typically outperformed the S&P 500 in recent years (Chart 3). There is however a survivorship bias, whereby hedge funds' returns for a particular year do not take account of hedge funds that closed during that year. The hedge fund industry may see a change towards more diversified strategies with less leverage in the coming years.

HEDGE FUND SERVICE PROVIDERS

Prime brokers offer brokerage and other professional services to hedge funds and other large institutional customers. Rather than providing particular niche services, prime brokers offer a diverse range of services including: financing, clearing and settlement of trades, custodial services, risk management and operational support facilities (Chart 16). The bulk of prime brokers' income comes from cash lending to support leverage and stock lending to facilitate short selling, both areas that have been affected to a large extent in 2008. London is Europe's leading centre for prime brokerage services and accounts for more than 90% of its activity, as the largest investment banks are either headquartered or have a major office there.

The increase in liquidations, decline in assets of hedge funds and deleveraging since the start of the credit crisis has had a negative impact on prime brokerage revenues. According to Morgan Stanley, investment banking revenues from hedge funds' business could drop by 45-55% in 2009 from the 2007 peak of around $60bn (or 21% of investment banks' revenues in that year). In order to

Table 1 Hedge funds by fund sizes

$ million	% share 2003	2007	2008
> 1000	2	4	3
501 to 1000	2	5	3
201 to 500	10	14	9
101 to 200	13	13	12
51 to 100	13	16	15
21 to 50	21	20	23
<20	39	28	35

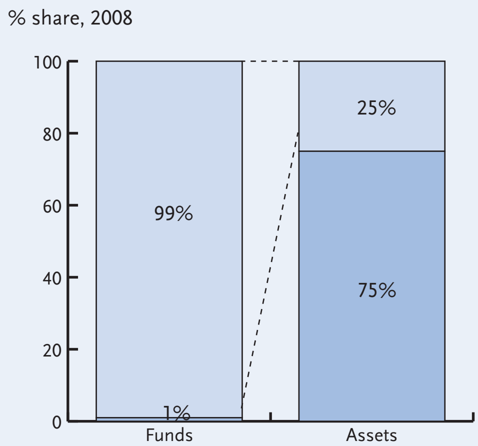
Source: Eurekahedge

Table 2 Largest hedge funds

Largest hedge funds (January 2009)	**$bn**
1. Bridgewater Associates	38.6
2. JPMorgan	32.9
3. Paulson & Co.	29.0
4. D.E. Shaw Group	28.6
5. Brevan Howard	26.8
6. Och-Ziff Capital Management	22.1
7. Man AHL	22.0
8. Soros Fund Management	21.0
9. Goldman Sachs Asset Management	20.6
10. Farallon Capital Management	20.0
10. Renaissance Technologies	20.0

Source: Institutional Investor

Chart 12 Concentration of hedge fund assets



Source: IFSL estimates

Table 3 Strategic mix of the hedge fund industry

% share	2007	2008
Long/short equities	41	33
Multi-strategy	14	17
CTA/Managed futures	9	13
Event driven	8	11
Arbitrage	10	9
Macro	6	6
Fixed income	5	5
Distressed debt	5	4
Relative value	2	2

Source: Eurekahedge

deal with the slowdown in business, some prime brokers are seeking to extend prime-brokerage to non-hedge fund clients such as sovereign wealth funds and pension funds.

Major restructuring occurred amongst prime brokers during 2008 including the acquisition of Bear Stearns by JP Morgan, the takeover of Lehman Brothers by Barclays Capital and the acquisition of Merrill Lynch by Bank of America. This resulted in a shift of market share from former investment banks to commercial banks. According to Eurekahedge, JP Morgan, Morgan Stanley and Goldman Sachs were the largest prime brokers in 2008 in terms of the number of clients, each accounting for around 10% of the market. Once 2008 figures for ranking of prime brokers by revenue are published, it is likely they will show that there are five or six key players with roughly equal market share. Morgan Stanley, Bear Sterns and Merrill Lynch dominated the market prior to the credit crisis. The global economic slowdown and closures of a number of prime brokers over the past year may intensify the trend of recent years, in hedge funds using more than one prime broker.

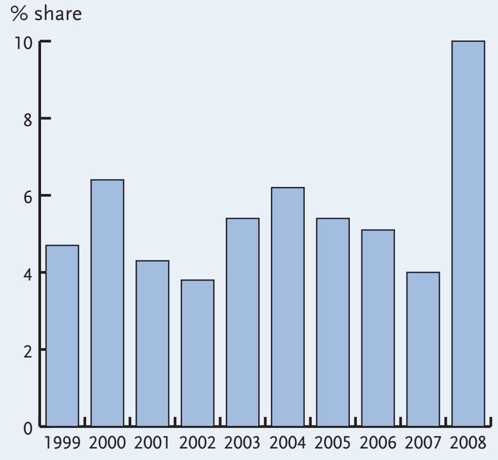
Fund administrators The extent to which hedge fund managers outsource administrative functions such as accounting, investor services or risk analysis varies widely. Assets under administration by third-party hedge fund administrators fell by around 30% in 2008 after increasing steadily for over a decade. Nine out of ten third party asset managers reported a fall in assets under administration during the year. Citco Fund Services retained its position as the largest hedge fund administrator despite a 24% fall in assets under management in the second half of 2008 to $375bn. It was followed by State Street Alternative Investment Solutions and Goldman Sachs Administration Services (Table 2).

Managers of offshore hedge funds typically rely on offshore administrators for various types of services and operational support. In addition to helping set up the offshore fund, offshore administrators may also provide accounting and reporting services; offer advice on an ongoing basis with reference to complying with applicable laws; or offer independent pricing of a fund's portfolio of securities. Some offshore locations may subject the administrators to licensing and auditing requirements.

Custody Hedge fund assets are generally held with a custodian, including cash in the fund as well as the actual securities. Custodians may also control flow of capital to meet margin calls.

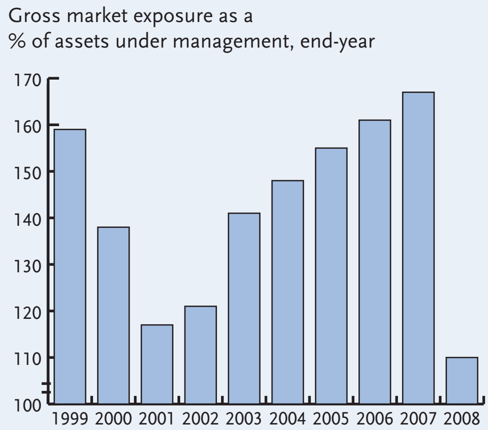
Auditing Most hedge funds are set up in a way that does not require them to have their financial statements audited. Some hedge funds however, may undergo annual audits if this is a part of the contract between the hedge fund and its investors. This may however change if regulation of hedge funds is tightened over the next year. Some offshore locations such as Bahamas and the Cayman Islands require hedge funds to have their accounts audited.

Chart 13 Hedge fund attrition rates



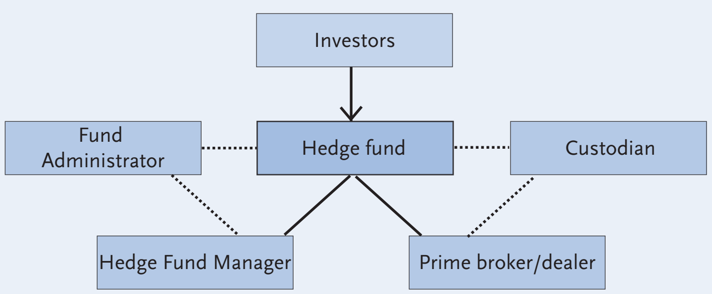
Sources: Hennessee Group; IFSL estimates

Chart 14 Hedge funds use of leverage



Source: Hennessee Group LLC, Financial Services Authority, IFSL estimates

Chart 15 Structure of a typical hedge fund



[1] Dashed lines indicate optional relationships
Sources: AIMA and ASSIRT Hedge Fund Booklet

REGULATION OF HEDGE FUNDS

The hedge fund industry has faced increased calls for regulation since the start of the global economic downturn. Although hedge funds did not play a major role in the emergence of the credit crisis, as only around 5% of their assets were invested in mortgage-backed securities in September 2007, it is alleged that they contributed to volatility in 2008 through short-selling transactions and massive selling of shares due to deleveraging and redemptions. The image of the hedge funds industry was further tarnished in 2008 by the Bernard Madoff's fraud, which has lent further support to calls for greater regulation.

In April 2009, G20 finance ministers, announced proposals for extending the oversight to all financial institutions important to global financial stability including for the first time large hedge funds. The industry would be regulated by a proposed Financial Stability Board made up of members of the G20 and European Commission. Three major European and US hedge fund groups - the Alternative Investment Management Association, the President's Working Group and the Managed Funds Association - have announced that they are working towards worldwide best practice standards. The organisations are discussing a global standard on issues such as disclosure, risk management, dealing with conflicts of interest within an organisation and statements about operational and business controls.

Based on domicile, hedge funds can be registered in onshore or offshore locations:

Onshore hedge funds account for around a half of the total number of hedge funds, although they have probably increased their share in 2008. Nearly two-thirds of onshore hedge funds are registered in the US (Chart 17):

US Historically, hedge fund managers in the US have not been subject to regular SEC (Securities and Exchange Commission) oversight. For an investment fund to be exempt from direct regulation in the US, it must be open to a limited number of accredited investors only. Rule changes introduced by the SEC in February 2006 that required hedge fund advisers to register under the Investment Advisers Act were overturned by the federal court in the same year. Early in 2009, the US Congress, proposed a number of bills on new financial regulations, including a variety of rules to govern hedge funds. If passed, the bills may impose a registration requirement for hedge funds, which would subject funds to annual financial audits and disclosure of fees.

Europe Although domestic regulation varies across European countries, fund managers are generally allowed to manage hedge fund products, and both hedge fund and conventional fund managers operate under the same regulatory regime. Closer direct regulatory and supervisory oversight of hedge funds is likely and legislative proposals may be put in by the end of April 2009. This may be in a number of areas such as short selling, capital requirements and use of derivatives to leverage. The greatest likelihood of regulatory action is probably in capital requirement rules. The European parliament's economic and monetary committee has passed a resolution calling on the European Commission to make all financial market participants including hedge funds, subject to mandatory capital requirements.

Table 4 Largest hedge fund administrators

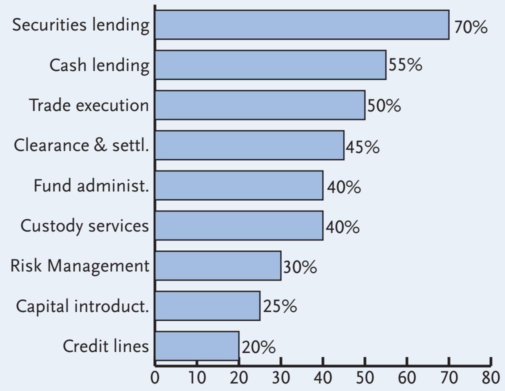
2008

	$bn
Citco Fund Services	375
State Street Alternative Investment Solutions	243
Goldman Sachs Administration Services	182
Citi	151
The Bank of New York Mellon	148
HSBC Securities Services	146
Fortis Prime Fund Solutions	110
SS&C Fund Services	100
GlobeOp Financial Services	95
CACEIS Investor Services	92

Source: HFN - Hedge Fund Administrator Survey

Chart 16 Types of services provided to hedge funds

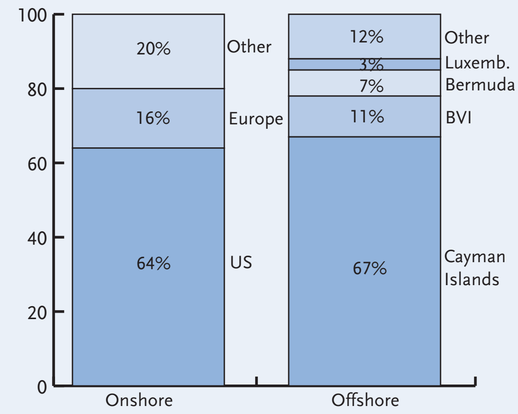
% share of banks surveyed providing a service, 2004



Source: Banking Supervision Comittee, ECB

Chart 17 Global hedge funds by domicile

% share, 2008, by number



Sources: Eurekahedge

UK hedge fund managers and advisors are typically required to seek authorisation from the Financial Services Authority (FSA). The regime for hedge fund managers in the UK is similar to that which applies to other investment managers. They are able to take advantage of the Investment Services Directive which allows them to offer their investment services to clients in other countries within the EEA. The FSA oversees a group of around 35 of the largest hedge fund managers from within a specialist supervisory team. The FSA also specifies restrictions on sales and marketing of hedge fund products. Hedge fund products for example, cannot be marketed to the general public but UK investors can deal directly with offshore funds.

Offshore hedge funds are registered in tax neutral jurisdictions allowing investors to minimise their tax liabilities. Offshore hedge funds are usually structured as corporations although may sometimes be limited partnerships. Generally the number of investors is not restricted. Onshore hedge funds often set up a complementary offshore fund to attract additional capital without exceeding limits on the number of investors. The vast majority of offshore funds are registered in the Cayman Islands followed by the British Virgin Islands and Bermuda (Chart 17).

LINKS TO OTHER SOURCES OF INFORMATION:

www.absolutereturn.net
www.aima.org
www.eurohedge.co.uk
www.hedgeweek.com
www.hedgeworld.com
www.hfmanager.com
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