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Behind the Money

Hedge Funds Face New Market Realities

By Susan L. Barreto, Senior Financial Correspondent
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CHICAGO (HedgeWorld.com)—A new day is dawning in the hedge fund industry, and this time it has nothing to do with the Securities and Exchange Commission or pension funds.

Hedge funds themselves are looking to reinvent the way they operate. Strategies that were the hardest hit in 2005, such as long/short equity, equity market neutral and convertible arbitrage, could ultimately be replaced by activist investing, special situations investing and capital structure arbitrage in the coming years.

"Traditional strategies have been arbitraged to death," said Izzy Nelken, president of Super Computer Consulting Inc., Northbrook, Ill.

Comparing the rise of hedge fund strategies to the frontier spirit of the Wild West, Mr. Nelken said those who went west first were the ones who struck gold. Those managers that made it early on now need to move farther "west"—i.e., to new strategies or to new locations, such as emerging markets of Eastern Europe and Asia, as a stream of pioneer wagons rolls along behind.

Some of those exploring the hinterlands are looking at opportunities in capital structure arbitrage as a way to take on more measured levels of risk and profit and loss. Capital structure arbitrage involves taking long and short positions across the credit, stock and volatility spectrum, typically in instruments of the same issuer.

David E. Kuenzi, head of risk management and quantitative research at Glenwood Capital Investments LLC, Chicago, has observed a move by some managers to take on more market exposure coupled with a trend of long-time hedge fund strategies evolving into new strategies.

"Our analysis shows that both equity hedge and equity market neutral managers are taking on more market risk to combat low volatility," Mr. Kuenzi said.

Fewer Superstars?

Price movement in the stock market hit an all-time low in 2005, so it makes sense that taking more long positions may be a profitable place to be in the near term. Some point to the increased market efficiency hedge funds have added as a cause for this condition.

In a recent research paper, "Superstars or Average Joes," Harry M. Kat and Helder P. Palaro of London's Cass Business School found that only 17.7% of 1,917 hedge funds were able to beat their benchmark.

"Over time, we observe a substantial deterioration in overall hedge fund performance," the researchers wrote. "In addition, we find a tendency for the performance of successful funds to deteriorate over time."

Managers' dwindling returns have been blamed on the influx in recent years of hedge fund capital and overcrowding in certain strategies.

Long/short equity and equity market neutral strategies are the most overcrowded; they are where the preponderance of traditional long-only managers who have gravitated to hedge funds can now be found, according to Mr. Kuenzi.

This is because the common approach to short selling has become less lucrative in the last couple years as more managers seek to short the same stocks. In some cases, savvy prime brokers have been charging more interest for the borrowing of more popular stocks, forcing some to pay more to be allowed to short than what they would hope to make from the bet.

Less-profitable short selling has forced a number of hedge funds to manage value equity portfolios.

But then a surplus of value equity players led some in the hedge fund industry to more fully embrace activist investing techniques used by corporate raiders like Carl Icahn and firms like Third Point, Crescendo and Chapman Capital Previous HedgeWorld Story.

Mr. Kuenzi sees activist hedge funds as offering "free consulting" of sorts to companies, which in turn could provide profits to shareholders based on the hedge funds insight. In many instances, complacency in shareholder proxy voting has allowed company management to persist in value-destroying activities and therefore to lower stock prices. Hedge fund activism has pushed these management teams to make difficult yet, in some cases, profitable decisions, which has in turn led to higher prices for these companies' shares, he said.

Merger Arb and Commodity Funds Move On

Merger arbitrage is another hedge fund strategy that is being forced to evolve. When the number of mergers seemed to be falling in 2002, many wrote off the strategy Previous HedgeWorld Story. Now, though, it is making a comeback under the label "special situations," whereby managers invest by watching a variety of market events and not just mergers. For example, they may make bets during spin-offs or in times of litigation.

Another growth area for hedge funds lies in commodity-related funds, Mr. Kuenzi said. With increased demand for commodities in China and India, trading in metals, soft commodities, electricity, weather, freight and emissions tend to be ideal markets for hedge funds.

The focus is specifically on discretionary trading in commodities as opposed to traditional trend following. Discretionary allows for hedge funds to trade from a global macro perspective looking at supply and demand issues.

Messrs. Nelken and Kuenzi will be speaking about their views on alternative investing at the Graham School of Business's Wheel of Finance seminar at the University of Chicago on Feb. 23 and 24.

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