

Big Becomes Beautiful for Hedge Funds

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NEW YORK (HedgeWorld.com)—Several factors have converged to boost the advantage of being part of a large organization, pushing hedge funds further into consolidation. Many now look to sell equity in their firm or find another way to join forces with other businesses.

Structural advantages such as economies of scale and scope will become increasingly important, a recent report from Citigroup Alternative Investments concluded. Growing reliance on expensive technology is among the forces that fuel this trend but is only one of the elements that favor greater size.

Tens of millions of dollars were invested in infrastructure to provide traders in Citigroup's Tribeca group with up-to-date trading analytics, data capability and technology, said Neil Brown, a Citigroup managing director.

Only firms with deep pockets can provide such capability, and small hedge funds are at a disadvantage, he said. Moreover, the larger the scale of the operation, the lower the cost of the infrastructure per dollar managed.

Then there are network and access advantages, as Mr. Brown pointed out. If you're large enough, you have multiple prime brokers, do business with big entities and speak to many people, so you're more likely to hear good ideas. You also have the resources to act on information.

A benefit of wider scope is stability: An operation that contains diverse strategies can protect against cyclical fluctuations by moving the capital around, while one that has a single investment approach doesn't have that option.

Hence the hefty business with multiple strategies is more likely to survive over the long haul. Since that inspires greater confidence in that ever more important constituency—institutional investors—it's no surprise that money is flowing to large funds, making them even larger.

However, another factor that encouraged consolidation is now in abeyance. With the U.S. Securities and Exchange Commission's decision not to appeal the *Goldstein v. SEC* ruling, managers no longer have to be registered. That means a substantial reduction in the cost of doing business.

Since most hedge funds are small firms, the money costs and time requirements of the now-overturned registration rule were proving to be crippling, argued James Hedges IV, president and chief investment officer of LJH Global Investments LLC, a Naples, Fla., fund of funds manager. He said he expects that a large number of managers will de-register.

Lower costs will make it easier for small hedge funds to stay in business. Nevertheless, Mr. Hedges also noted a strong current toward consolidation on other grounds.

In his experience, managers are concerned about being stuck at \$100 million or less in assets and want to expand the business. They're more cognizant than ever that better infrastructure and marketing require scale.

Small firms are very receptive to the idea of working with larger, broader institutions, said Russ Gerson, whose firm Gerson Group helps with acquisitions and recruits whole teams. Hedge funds seek greater resources for raising money and trading and want to be part of a diverse portfolio with synergy, he has found.

The desire to own a successful fund business and have your name on the door, long a dream for managers starting up a firm, is less significant now than it was, he said.

On the other side of this marriage market are large institutions desirous of hitching up with alternative investment managers. Mr. Gerson has in recent months worked with an asset manager that is part of a big investment bank, a large traditional manager that is part of a commercial bank and a \$10 billion-plus private investment group.

These three were looking to acquire hedge funds or lift out teams capable of pursuing hedge fund strategies. They were particularly interested in multi-strategy shops. There's also demand for distressed debt strategies, credit opportunities managers and less common investment programs.

Strong performers with special knowledge and skills and those with structural advantages will survive, said Mr. Brown. As he sees it, the industry is in a transition that has just started.

This transition appears to be global, taking place in Asia and Europe as well as America. There's a lot of action in China, Korea and Japan such as team lift-outs and acquisitions, said Mr. Gerson. He said he expects to open an office in London later this year and is considering one in Asia.

While many believe that a hedge fund's returns tend to diminish as the amount of assets under management grows beyond a certain level, the multi-strategy setup deals with this capacity issue by allocating capital to other portfolios when returns from a strategy become disappointing.