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Fund Spotlight

Top Five Hedge Fund Trends For 2007

Lauren Keyson 01.18.07, 11:30 AM ET

Investors have always been fascinated by hedge funds--the vast amounts of money involved, the secrecy, the lax regulation and the promise of wealth. But that may all be changing for individuals as hedge fund investor profiles change, as the Securities and Exchange Commission institutes new rules, and as mergers and acquisitions abound.

Here is a look at the top five hedge fund trends for 2007:

1. The changing hedge fund investor profile from individual to institutional will drive fund managers to have more formal procedures and controls.

The hedge fund investor profile has been changing for years. Once foundations and endowments like Harvard and Yale began to get involved, the news got out that these types of organizations were starting to invest. Public pension funds followed suit, including such nonprofits as the California Public Employees' Retirement System.

Now, a significant number of public pension funds and institutions allocate a significant part of their assets into alternative assets. Largely because of this, hedge funds are savvier in the way they present their product to these large-scale institutional investors. Prime brokers have capital introductions teams that are there to assist hedge funds in presenting themselves to these sources of institutional capital.

“The result of this interest from institutional investors is that fund manager presentations have to be formal and well thought out, they have to articulate the hedge fund manager's competitive edge in the market place, spell out how they make their investment decisions, and show how they manage risk,” says Mark Rice, CEO of Tamale, which provides research management solution software for 65 hedge and alternative funds. “This is pushing hedge fund managers to think clearly about, and formalize, their investment decision-making processes.”

2. The new definition of a "qualified investor" will knock some people out of the game who might otherwise have entered it.

The newly proposed accredited investor rule, No. 501(a), is actually an amendment to the old private offering rules in the Securities Act of 1933, which said that hedge funds were not allowed to offer their services to anybody with less than $200,000 in individual income or $300,000 in joint spousal income in the two most recent years, along with a million dollars in investable assets (excluding personal residences).

Then, late in 2006, the SEC proposed a change raising the minimum requirement for hedge fund investors to $2.5 million of investable assets, in addition to having to meet the previous minimum income requirement. And that's really what the new rule is about--investors just have to be wealthier before they can invest in hedge funds.

The proposed rule is meant to keep up with inflation. “A million dollars was a lot more than it is now,” says Eric Fitzwater, senior analyst for SNL Financial, a company that keeps data on hedge funds. “When the qualifying rule was originally written, a million dollars was a hell of a lot of money. Now it's not quite so much, so the SEC is making it 250% higher. It's there to protect people with less than that from getting into something they probably shouldn't be investing in. A million dollars' worth of investable assets is not what it used to be."

When the new rule takes effect, it will knock out a significant number of people who could have invested. But Fitzwater believes that will be just fine with hedge fund managers. "These less-qualified investors can cause trouble for hedge funds, because they are people who are getting in over their heads. And this is what causes lawsuits," he says.

3. There will be continued argument and confusion over the level of hedge fund oversight.

Confusion over government oversight abounds with the shifting rules and arguments. For instance, in 2004 the SEC passed Rule 203 B3-2, which was created to require hedge funds to register with the SEC, something that they didn't have to do before. Basically, any asset manager registered with a financial adviser with over $20 million in assets under management and over 15 clients had to file. That meant that if hedge funds met those requirements, they would have to register as well. But hedge funds are really two parts--the fund and the fund manager, two separate companies. So the question was, Is the fund a single entity or many investors?

Last year the U.S. Court of Appeals overturned its original ruling, and hedge funds are no longer required to register. They do not have to file Form ADV, even if they meet the minimum requirement. In essence, the U.S. is now saying that hedge funds cannot be legislated but pension funds can, mainly because they always have been.

It gets confusing. The government says that pension funds can't invest in a hedge fund unless that hedge fund is registered. "So instead of directly legislating a hedge fund, they go through the backdoor and say you're a potential investor in a hedge fund but we're not going to allow you to invest in one--unless the hedge fund you invest in follows our rules," says Fitzwater.

It may come down to each hedge fund: whether it is willing to register so that pension funds will invest in it, or whether it's just not worth having those types of funds as clients if it has to register.

So there is some increased oversight and some lessened oversight. "Basically, nobody knows where the level of oversight is going," says Fitzwater. "A Democratic Congress is probably going to lean towards more oversight, and the chairman of the SEC wants the SEC to have full oversight over the hedge funds. But then there are lots of people in Congress and many industry groups who think that these are private by nature, they are free marketers, and they believe that no oversight is necessary. They think investors should just beware."

To throw more argument into the mix, in 2006 the Connecticut Department of Banking created a unit to oversee hedge funds based in the state. (Greenwich, Conn., is home to several hedge funds.) That state has been pushing for more rules governing the growing industry in the wake of high-profile collapses, which included Bayou Management and Amaranth Advisers.

4. In order to steer away from deception, hedge funds will no longer be as covert.

Another SEC amendment to the original anti-fraud provision under the Investment Advisers Act says that it is against the law for hedge funds to deceive their clients. The proposal would make it deceptive and manipulative for investment advisers to pool investment vehicles to make misleading statements in the course of business. The rule would apply to all these advisers, whether or not the adviser is registered under the Advisers Act.

Under the proposed rule, a pooled investment vehicle would include any investment company. The Advisers Act gives the SEC broad authority to protect against fraud by these investment advisers. Section 206(1) of the Advisers Act makes it unlawful for any adviser to "employ any device, scheme or artifice to defraud any client or prospective client.

Hedge funds advisers may employ covert tactics for their investments, but this doesn't necessarily mean they are deceptive. "The covertness was in their attempt to gain some information for investing," says Fitzwater. "They may have been trying to deceive other people, not their clients, to get information that they may not otherwise be able to obtain."

Part of the drive to end hedge fund covertness may be the secrecy involved around fees. This month Massachusetts Secretary of State William Galvin announced that investment bank UBS is cooperating with his requests for documents that he hopes will show if hedge funds are paying higher than normal brokerage fees to compensate for office space. He said it was about fairness to average investors and openness in the financial services industry.

5. There will be more M&A activity in hedge funds, with bigger-name companies getting involved.

In the last year, more institutional investors are getting into the game, compared with individual investors. Historically, we don't necessarily know what the level of M&A activity has been in the hedge fund world because of private targets. It's possible there were some deals going on and nobody knew about them, or they just weren't prominent in the market, because nobody really knew what was going on.

SNL Financial recorded 14 deals where a hedge fund was the target of an M&A transaction. Two deals already took place this month: Wachovia with European Credit Management and EFG International with PRS Group.

And there are some trends within the M&A space itself. One of these is that the buyers are bigger names, such as Wachovia, ABN AMRO, Bank of New York and Key. Morgan Stanley made three deals last year.

There are big names out there trying to get in the hedge fund game. Two years ago, Legg Mason bought Citigroup's asset management business on the same day it announced an $800 million deal for a hedge fund manager.

Most recently, EFG International announced the acquisition of PRS Group, which has $2.5 billion under management, and Wachovia announced the purchase of European Credit Management, with $26 billion under management.

Hedge Fund Deals Announced Since Jan. 1, 2006*

Buyer	Target	Announce Date	Deal Status	Assets Under Management ($000)
Wachovia	European Credit Management	01/09/2007	Pending	26,000,000
EFG International	PRS Group	01/08/2007	Pending	2,500,000
Mickey Harley	Mellon HBV Alternative Strategies	12/05/2006	Completed	969,000
Morgan Stanley	Brookville Capital Management	12/04/2006	Completed	221,000
NewAlliance Bancshares	Connecticut Investment Management	12/01/2006	Pending	318,607
Fortis	Cadogan Management	11/10/2006	Pending	1,724,986
Morgan Stanley	FrontPoint Partners	10/31/2006	Pending	5,500,000
DKM Asset Management	Illington Fund Management	08/22/2006	Completed	65,938
Southridge Capital Management	Double Alpha Group,	07/10/2006	Completed	82,153
SAS Rue La Boetie	Ursa Capital	06/12/2006	Completed	NA
Morgan Stanley	Oxhead Capital Management	06/01/2006	Completed	168,000
ABN AMRO	International Asset Management	01/20/2006	Completed	2,600,000
Bank of New York	Urdang Capital Management	01/17/2006	Completed	3,000,000
KeyCorp	Austin Capital Management	01/13/2006	Completed	900,000

Source: SNL Financial
**As of Jan. 10, 2007*
Note: Deal value is the price the buyer paid for the seller. Most are not available. For these private company deals, making deal value available to the public isn't necessary.

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