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Plenty of alternatives

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But hedge funds and private equity have their limits

THE stockmarket is a hard taskmaster. Beating the indices on a regular basis is difficult, and low-fee rivals are competing ever more vigorously. But the fund-management industry has found a new wonder weapon: alternative assets. What makes these special, the industry claims, is that they are not correlated with the stockmarket. They are also difficult to understand, so they require greater skills to manage—which have to be properly rewarded.

That explains why, even as ETFs are driving fees on big stockmarket funds down to a few basis points a year, the managers of the main alternative-asset categories—hedge funds and private equity—are able to charge two percentage points a year, with a performance fee on top. And clients are queuing up to pay them.

Why are they so enthusiastic? The reason goes back to mistakes made in the 1990s. The long bull market encouraged the belief that share prices could move only upwards, and investors who did not have a big allocation to equities looked foolish. Corporate-pension sponsors were able to put 80-90% of their portfolios into shares and then stop making contributions to the fund, on the assumption that juicy returns would continue.

The 2000-02 bear market revealed what an unwise bet that had been. To compound the problems of pension funds as their assets fell with the stockmarket, their liabilities rose because of the drop in bond yields, which made it much more expensive to purchase the income needed to pay pensioners. So the pension funds (and their advisers) decided to broaden their bets and reduce their risks.

One big change was to put more emphasis on alpha, the skill of the manager (see article). But funds also started to widen their range of assets, in the hope of earning a more stable return. The models for this were the university endowments of Yale and Harvard, which started moving into alternative assets in the 1970s and 1980s and have enjoyed considerable success with them. Morse's Mr Connor sees this as an extension of his music analogy: “The industry has expanded from having a limited number of genres into a wide range, from hip hop to garage, thrash metal and the rest.”

However, the move has not been without controversy. It seems plausible that emerging-market debt, property and commodities are genuine alternatives to the traditional staples of developed-market equities and government bonds. But are private equity and hedge funds really in the same category?

Private equity and its close cousin, venture capital (which concentrates on start-ups), invest in businesses that are not quoted on the stockmarket. The idea is that companies will be able to produce better returns if they are protected from the glare of constant public scrutiny and if the managers are given suitable incentives. This usually means offering them share options and loading the company up with debt, forcing managers to pay meticulous attention to their cashflow. These takeovers, also known as leveraged buy-outs, have become a big influence on stockmarkets. But is private equity really an alternative source of return? After all, most of the factors that affect quoted companies—the health of the economy, interest rates—affect private companies as well.

This is also true of hedge funds. These private pools of capital may be run in a different way from traditional funds—for example, they can go short (bet on falling prices) and use borrowed money to enhance returns. But hedge funds still mostly invest in the same types of assets—equities and bonds—as traditional fund managers.

Most hedge funds are alternative only in the way they are managed, rather than where they invest. Because of their methods, they claim to produce "absolute return"—in other words, a nominal gain regardless of market conditions. By contrast, traditional fund managers might think they have done well if they lose 17% when the index has dropped by 20%.

The short answer

Hedge funds can pull off this trick thanks to their greater flexibility, in particular their ability to go short. The worst year for the industry was 2002, when the Hedge Fund Research Index lost just 1.5% (although these indices may flatter, thanks to survivorship bias). Enthusiasts would also argue that if you believe in managers' skill, you should give them as much freedom as possible. Most companies have a tiny weighting in the index. A traditional manager who takes a dislike to a stock can only give it a zero weighting, which will make virtually no difference to performance. But a hedge-fund manager can make a much bigger bet by selling the stock short.

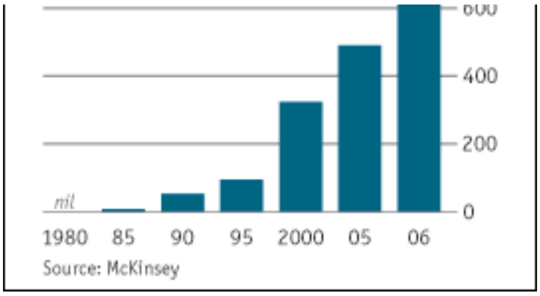
It sounds good in theory, but in practice shorting is very difficult. A long position that goes wrong becomes a smaller part of the portfolio; a short position becomes larger. And where hedge-fund managers use borrowed money, bad bets can be disastrous, as shown by the closure of Amaranth, an energy-trading fund, in 2006 and two Bear Stearns credit funds in 2007.

Even if some hedge-fund managers have special skills, can the industry continue to deliver exceptional returns as it gets bigger? Its assets increased from $39 billion in 1990 to $1.9 trillion by the end of last year (see chart 5). Allowing for the use of borrowed money, McKinsey estimates that total assets under management may be $6 trillion. If the skill of hedge-fund managers consists of exploiting market anomalies, there must surely be fewer anomalies to go around now. The result may be high fees for hedge-fund managers but modest returns for clients, or worse. "Hedge funds are rapidly deteriorating in quality. There is a nasty accident waiting to happen," says Jeremy Grantham of GMO, a fund-management group.

The same arguments can be applied to private equity. If lots of people are competing to do private deals, that is likely to force up the price of deals and cut the level of future returns. According to McKinsey, the amount of private-equity capital increased by 120% between 2000 and the end of 2006 (see chart 6); including venture capital, the sector's total assets add up to over $1 trillion. "So much money has flowed into private equity, venture capital and hedge funds that it has swamped the available talent," says Mr Grantham.

McKinsey reckons that 62% of American private-equity assets in 2006 were in the hands of the top 20 firms. This is not surprising: the top 25% of funds seem consistently to beat the rest. If anything, it is surprising there has not been more consolidation, given the lacklustre performance of the rest of the industry. The average investor in private equity has not seen particularly attractive returns compared with those available in the public market.

And those returns may be about to deteriorate. The most recent leveraged-buy-out boom ended with many firms collapsing in the early 1990s recession. Mr Grantham fears history may repeat itself. "Private equity has a long tradition of adding value, but there is one issue they have all missed," he says. "Not a single firm has in its spreadsheet the expectation that profit margins have to come down."



The move into both hedge funds and private equity involves a paradox. For an asset class to be a true diversifier, it needs to be small; but if it is small, then few investors can be exposed to it. When lots of capital flows into an asset class, it starts to behave like other markets. The recent problems in the British commercial-property market are a good example. Retail investors flocked into the sector as a diversifier from equities, and in the ten years to 2006 it performed brilliantly. But property is an illiquid asset. When prices started to fall last year, investors rushed to redeem their holdings. But it was impossible for the funds to realise on their properties in such short order, so many of them have been forced to suspend dealings in their shares and units. The asset class was simply not liquid enough to be a real diversifier for so many investors.

That has not stopped investors from looking for diversified returns elsewhere. In the second half of 2007 the truly hot areas were “frontier markets”, or what might be called the “emerging emerging markets”. The hope is that countries such as Kazakhstan and Vietnam will eventually achieve the same sort of growth rates as India and China.

Fund managers are also offering even more esoteric bets, known as “exotic beta”. Assets in this class include weather derivatives, distressed power stations and even footballers' contracts. The attraction is twofold. First, these asset classes are so remote from the forces that drive the S&P 500 index that any correlation is unlikely. Second, prices in this market may be set inefficiently, offering scope for astute fund managers to make money. At least that is what exotic-beta fund managers tell their clients to justify their fees.