KEY ASSET MANAGEMENT

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Hedge Funds Past, Present and Future

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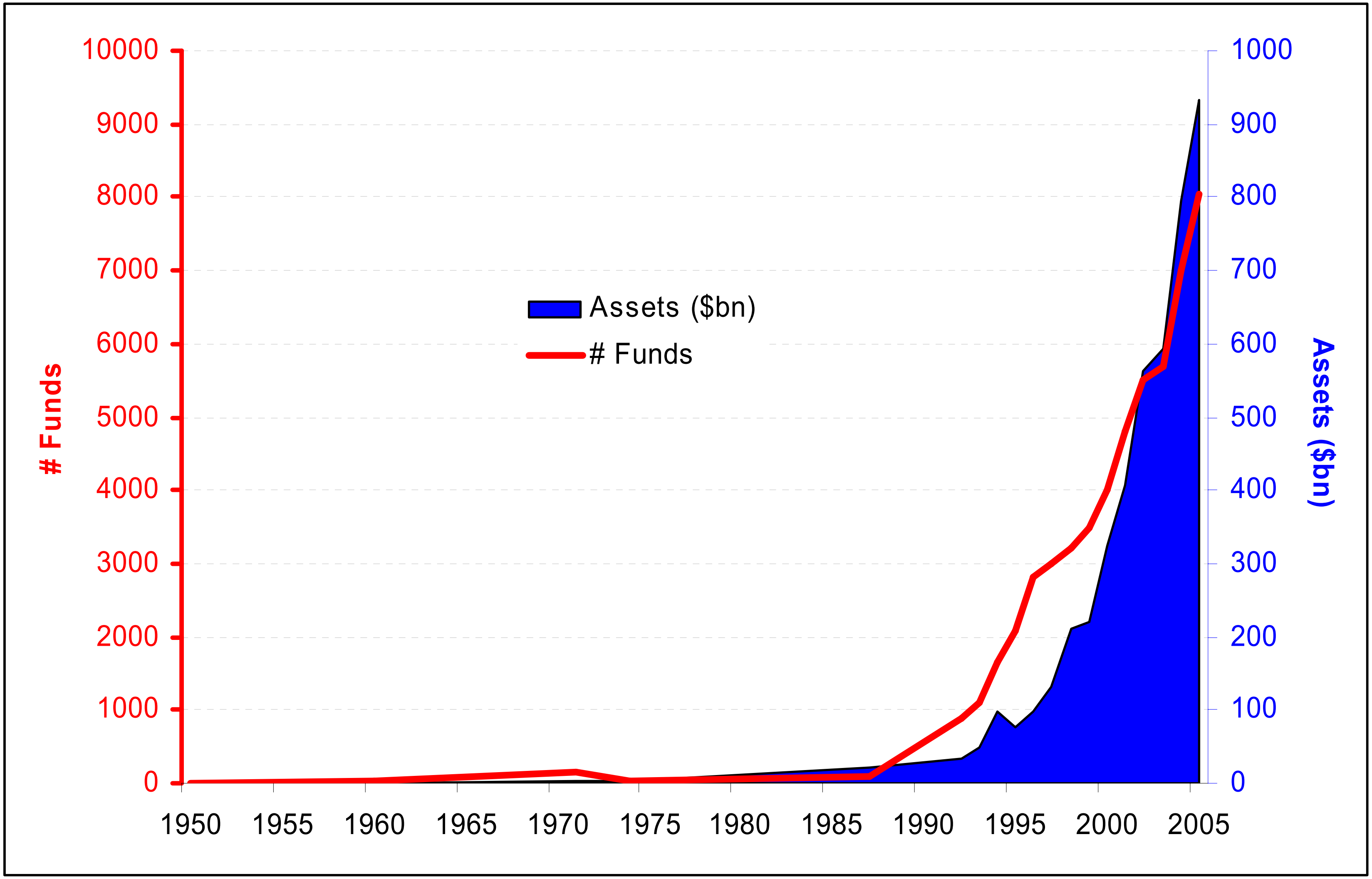
Key Asset Management

Agenda

- A Brief History of Hedge Funds
- The Current Hedge Fund Environment
- Recent Developments
- The Future for Hedge Funds
- Hedge Fund Risk
- Some Controversy

A Brief history of Hedge Funds: Growth



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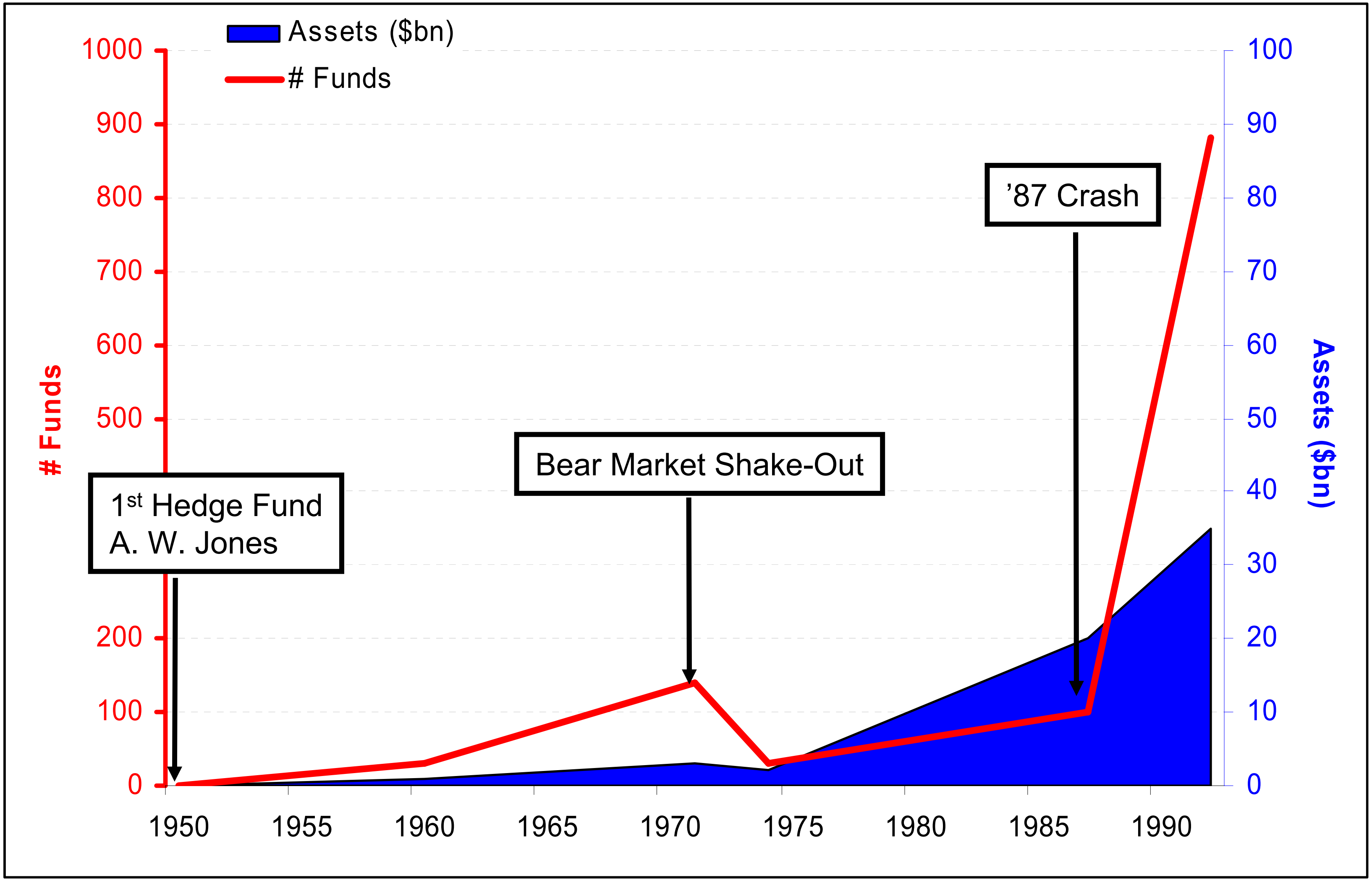

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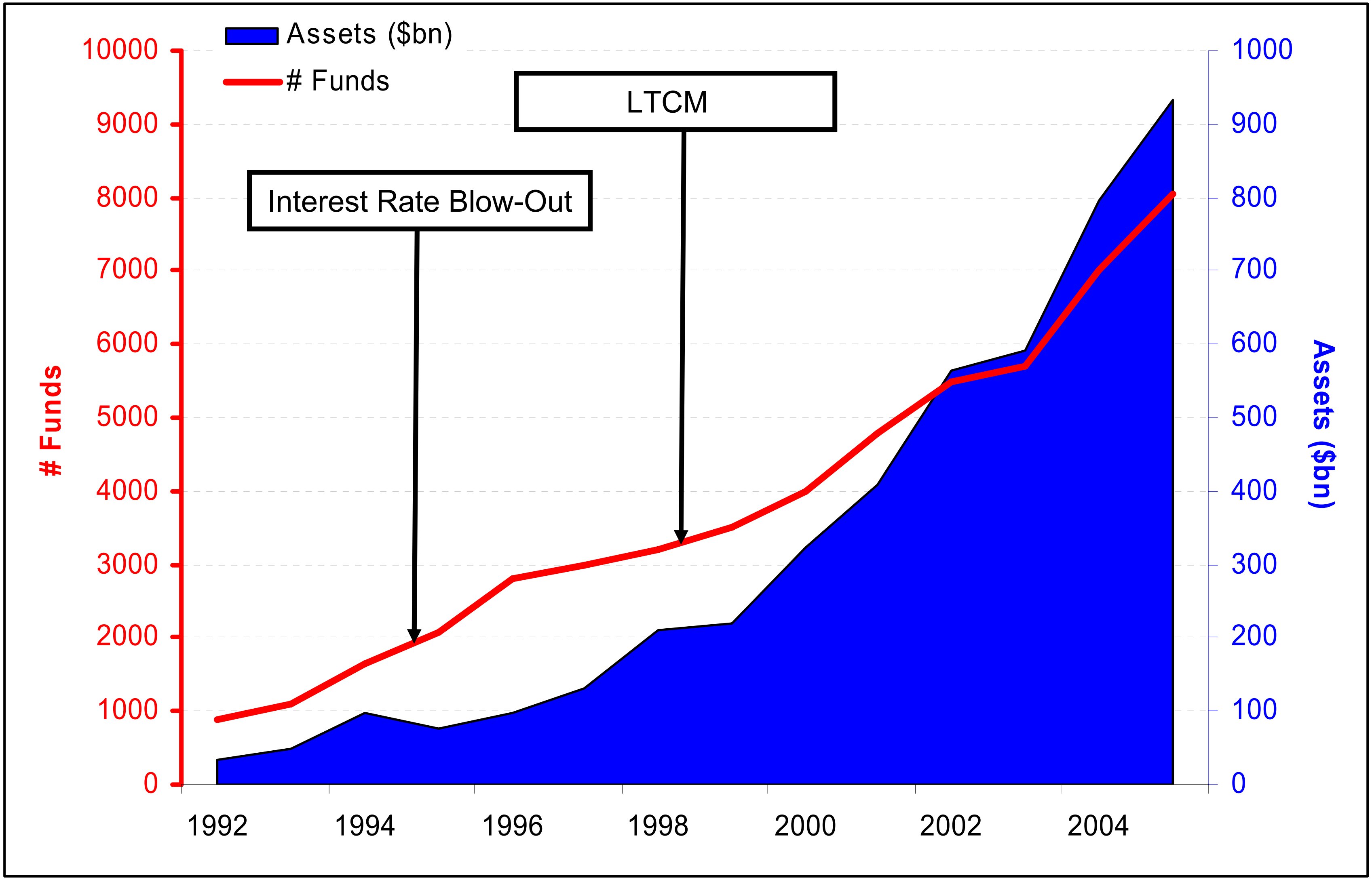

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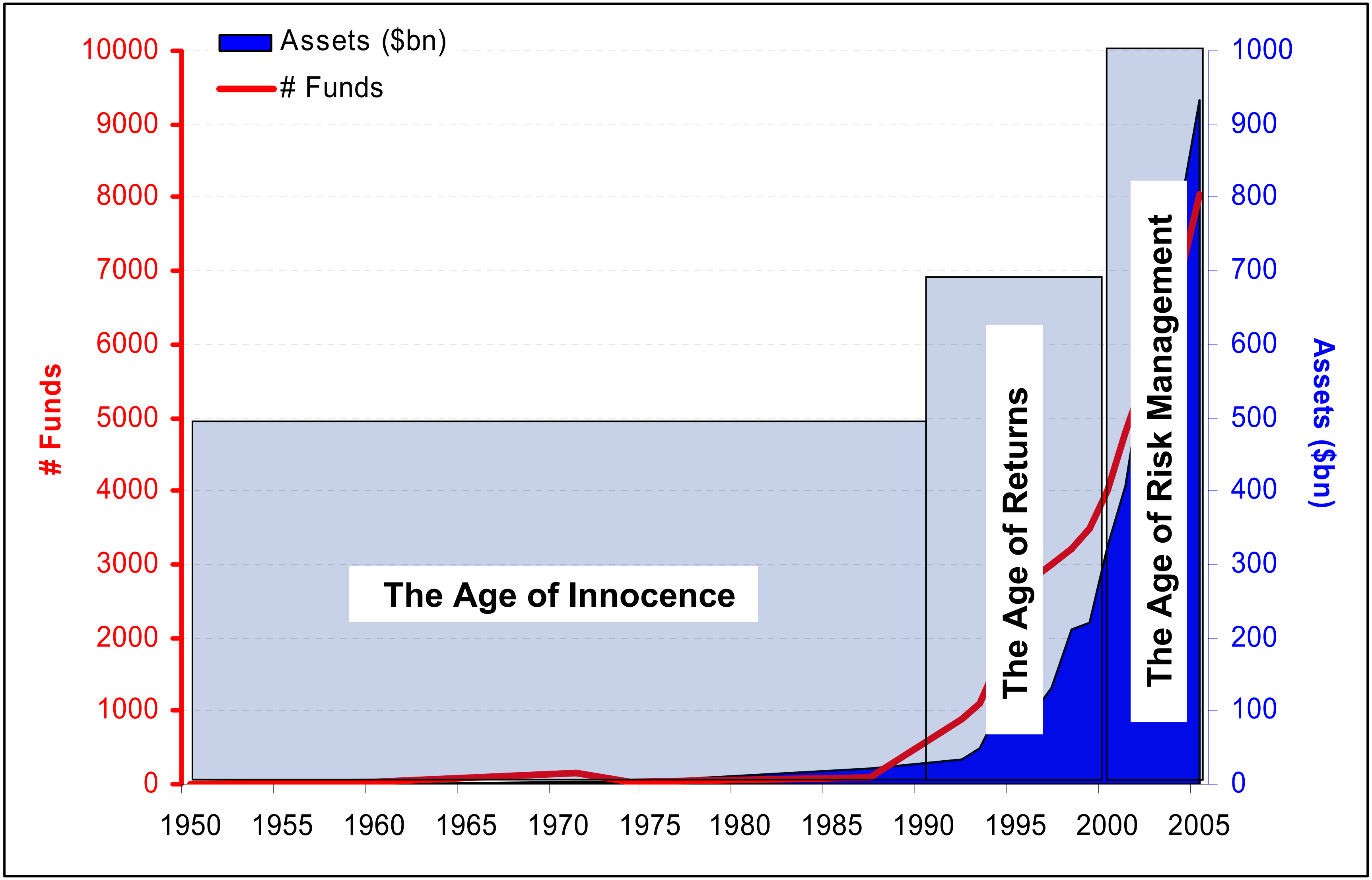


The Current Hedge Fund Environment

HEDGE FUNDS THEN	HEDGE FUNDS NOW
• No assets	• Vast inflows of assets
• Strong performance	• Varying performance
• No risk management	• Improved risk management
• 'Under the radar'	• Liquidity issues
• Entirely trade based	• Deal based and trade based
• Cottage industry	• Big business
• No specific third party support	• Substantial third party support
• Rarely (if ever) in the press	• Always in the press

The Current Hedge Fund Environment

- Where did all the money come from?
  - The rich
  - US endowments, charities and pension plans
  - European institutions and pension plans (underinvested)
  - Investment banks

The Current Hedge Fund Environment

- Where did all the hedge funds come from?
  - Investment banks
  - Traditional investment managers

Recent Developments

- Single strategy to multi-strategy
- Autocracies to partnerships
- Independent to subsidiary
- Open to ‘closed’
- Under-reported to over-reported
- Liquid to lock-up
- Rich to very rich (and powerful)
- Secretive to slightly less secretive

Recent Developments

- UK Institutional take-up
- Fund-of-funds consolidation
- Investment consultants recommending single manager funds
- Acquisitions of funds and fund–of-funds
- Retail availability

The Future

- The Age of Institutionalisation?
    - Why not short?

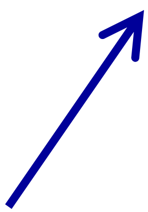
- The golden goose gets killed?

- Hedge funds as the new investment banks?

- Bigger emphasis on individual strategies and return streams thereof

- Three secenarios:

1.



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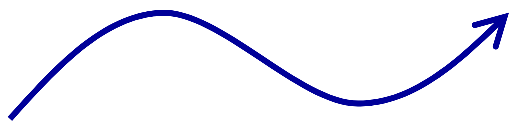

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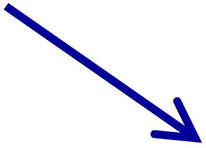

Hedge Fund Risk: Disasters

- LTCM
- Manhattan
- Beacon Hill
- Clinton
- Bayou
- Bailey Coates

Hedge Fund Risk: Lessons

- VaR = CRaP
    - Funny tails
    - Correlation shifts
    - Hidden risk
    - Path dependencies & depth of pockets
    - The death spiral

- So maybe hedge funds take more risk than we estimate from volatility of returns
    - Volatility is not a good estimator of hedge fund risk
    - Esoteric markets = ‘new frontier’ inefficiencies, nice returns
    - Esoteric markets = liquidity risk, valuation risk, financing risk

Concluding (Potentially Controversial) Remarks

- ‘Hedge Funds’: a collection of investment styles, not an asset class
- To talk about the hedge fund ‘bubble’ is a bit thick
- Hedge fund indices tell you very little
- The majority of academic work on hedge funds is lazy, formulaic and of minimal use to anybody
  - Need to look under the hood rather than generalise
  - There Is some good stuff around, however
  - Of interest to the industry is
    - Measurement of operational risk and other difficult to measure risk
    - Weird shaped distributions and tail estimation
    - Replication

Concluding (Potentially Controversial) Remarks

- Hedge funds take a whole load of beta
    - To the naïve, beta to something other than equities = alpha
- All the same, hedge funds give investors something they can’t get anywhere else
    - ‘Different shaped’ returns
    - Harvesting returns from true market inefficiencies across all markets
    - Most efficient exploitation of alpha generating capabilities