



Bermuda International Business Association

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Collateral damage of hedge funds.

The extraordinary events in the global financial markets of the recent weeks, and months, have tested the mettle of hedge fund managers, investors and service providers to the limit in Bermuda and further afield within the alternative investment space. Hysteria has been gripping the market with the doom lords suggesting that anything between 15-75% of all hedge funds will go out of business within the next twelve months. And we have seen research suggest that, "hedge-fund assets may fall to about \$1 trillion by the middle of next year".

There is also a general sense of retribution in the air. Over the last few years, hedge funds have performed well, relatively speaking, in comparison with traditional managers. It certainly feels like payback time, with the old institutional world taking hedge funds down a few pegs. When markets were stable, it was possible to sell hedge funds based on sound arguments such as providing liquidity; cooling overheated markets; exposing corporate frauds and generally enhancing efficiency of capital flows. However, in the markets such as those seen in the 2H08, investors attitude have been about salvaging the global financial system and the benefits of hedge funds have turned to being one of part of the problem. Sentiment that, in my opinion, is quite unfair.

Those managers who had been business-savvy have been restructuring their funds in an effort to retain long-term capital. Many, however, have left it too late and are now just trying to find ways out of the inevitable problems. Some have raised "gates", introduced "side pockets" or suspended redemptions altogether. The latter, it could be argued, is hedge fund suicide for managers, as investors have always believed that such approaches are looking after the interests of the manager ahead of their investor base. In such scenarios, a crisis of confidence will prevail.

Many investors have been disgusted by the management fees paid to abet poor performance, the lavish offices, huge back office staff, not to mention salaries and bonuses. The days of 2% management fees and 20% performance fees could be a thing of the past for hedge funds as the attitude of investors begins to change significantly.

With massive redemptions, fund closures and poor performance, those acting as non-executive directors of hedge funds have had some late nights recently and have been faced with a spectrum of heightened liabilities and risks. Managing their fiduciary responsibility to protect the assets that remain has had to be of paramount importance together with protecting shareholder interests. Gone are the days of name-plate

or rubber stamping directors. Today, Bermuda resident directors of hedge funds have to demonstrate their independence or suffer the consequences from shareholders if their interests have not been protected.

In the new world of free-falling global markets, fearful counterparty relationships and much more expensive leverage, it seems certain many hedge funds will go out of business. In Bermuda, the number the new start-ups have been limited as a result of the global financial crisis. However, the general consensus of the hedge fund industry based in Bermuda is that there remains a real threat of hedge fund closures in the coming months and, after months such as September, October and November 2008, the numbers could be multiplied. This trend is not confined to Bermuda, as the attrition rate in Europe, Asia and North America has been increasing.

The destruction of the hedge fund space which is being witnessed does create opportunities for managers. That being said, the alternative funds industry will need to adapt – to increased competition; to a difficult investing environment; to new compliance and regulation; and to increased, more demanding, investors. Furthermore, managers will have to be far more disciplined with their investment mandates and approaches, maybe focusing less on searching for alpha in unfamiliar investment instruments. However, those funds that have good managers and direction, have the foresight for change, have prudent infrastructure and embrace corporate governance will be the funds that will survive this trend of volatility.

Equally, the service provider communities that assist managers in the deployment of their strategies will experience wins and losses. The industry is conserving cost and managing expansion appropriately in this environment and as is the case with managers, there will be some third party casualties in the aftermath of significant asset erosion.

Bermuda continues to be an offshore jurisdiction of choice and arguably one of the world's leading financial centres for insurance and reinsurance, captive insurance, fund administration and management and myriad of other financial services based businesses. It remains widely respected for its regulatory approach and strong legal system, but for hedge funds, a tangible benefit is the collaborative approach of all third party service providers and the experience, knowledge and guidance which they each offer to a changing alternative investment industry. And with the requirement that all Fund Administrators operating in Bermuda must be licensed by the Bermuda Monetary Authority, further adds credibility that Bermuda should remain the jurisdiction of choice.

Yes there will be fewer hedge funds, and maybe there should be. I would suggest that, it is up to the industry to prove it has talent and has not just been coasting on the cheap credit available or transacting business without proper due diligence. The emerging survivors are already telling potential investors they are gearing up for a wave of renewed buying opportunity or starting new funds that will invest in the bottom of the market in about any type of investment. These are the managers that are thinking ahead.

Opportunities are presenting themselves with greater regularity in the traditional, OTC and convergence spaces. Hedge funds, it could be argued have been part of the problem, but they are certainly going to be part of the solution in the future. With Bermuda's infrastructure, skilled workforce and collaborative approach we will be standing shoulder to shoulder with the hedge fund community in an effort to provide the right solution for the future.