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## DIY SOLUTIONS

**THE EVOLUTION OF** the hedge fund industry continues apace. The rapid growth is spurred on by concern over equity returns, a low correlation to other asset classes, and the perceived ability of hedge funds to generate the absolute returns more suited to achieving investors' objective-based benchmarks.

These factors have all contributed to the creation of an industry that is increasingly attractive to institutional and individual investors alike.

The actual size of the hedge fund market, however, is difficult to quantify. In 1990, there was around \$39bn (€34bn) invested in hedge funds, and this figure has grown to a current value of around \$900bn spread across 8,000 to 9,000 funds. These figures vary considerably depending on the group providing the research, but this industry is growing at around 20% per annum and shows little sign of deceleration.

This astonishing growth rate is marred, however, by the demise of a significant number of funds. Although there are few concrete figures to support the fatality rate, it is generally accepted that around 40% close within five years of inception.

### 'Hall of shame'

The worrying effect of these statistics on potential investors is reinforced by the stark reality of some of the more prominent cases. The pronunciation of the infamous Eifuku (translated as 'good luck' or 'prosperity') fund should perhaps have been a warning for the many wealthy US individuals who saw the bulk of the fund's \$300m evaporate in the space of just a week in early 2003.

The reason for this demise was the fact that the manager in question was highly geared and, unbeknown to the fund's investors at the time, a few highly leveraged positions were sufficient to cripple the fund.

This, and other anecdotal nightmares, such as Long-Term Capital Management

(LTCM) in 1998 and Fountainhead last year, are all well documented in the hedge fund 'hall of shame'.

Surely the recent combination of poor prospective returns and performance-related fees could provide less transparent managers with the required incentive for increasing leverage in search of the requisite returns to achieve hurdle rates?

But while the hedge fund highway may be littered with casualties and a few fatalities, there are still many Porsche

## GIPS PROVIDE THE OFF-THE-PEG SOLUTION REQUIRED TO ENHANCE UNDERSTANDING OF HEDGE FUNDS

drivers with impressive track records. Clearly, the challenge is to pick out these star managers – but the hedge fund industry has traditionally been veiled by a lack of transparency and disclosure, making an informed choice difficult.

The SEC (Securities and Exchange Commission) has stepped in. Because of the increase in hedge fund fraud, the SEC last year announced a ruling that will require all but the smallest hedge funds to register with the SEC as investment advisers by 1 February 2006.

While closer regulatory scrutiny should provide some level of protection against fraud, this registration is certainly not a panacea. How can the industry take

control? Enter GIPS® (Global Investment Performance Standards). GIPS are ethical standards introduced in 1999 by what was then the AIMR (Association for Investment Management Research), now the CFA Institute.

GIPS focus on the presentation of investment performance. More importantly, they cover a number of reporting requirements intended to provide the investor with sufficient information on the investment style and objectives of hedge funds to make an informed investment decision.

### Getting a grip

The continuing evolution of GIPS has attracted global support, and more recent developments are designed to address the more exotic funds offered by the alternative investment industry.

GIPS are by no means mandatory, but they have been embraced by the vast majority of the larger money managers worldwide. They could certainly prove to be the way for hedge funds to avoid restrictive legislation. Voluntary adoption of industry best practice can only be viewed in a favourable light by both investors and the various industry bodies.

For managers of institutional business, a GIPS kite-mark has almost become a prerequisite for attracting new capital. GIPS in no way impose restrictions on a manager's investment strategy; they simply ensure that potential investors are aware of the facts.

There is no question that hedge funds will continue their impressive growth rate into the foreseeable future and, as with any investment class, it is imperative that fund objectives and risks are understood by investor and manager alike.

GIPS provide the 'off-the-peg' solution required to enhance this understanding, and should significantly help to allay the concerns of the regulatory bodies. **fe**

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