Equity long/short mutual funds “could easily grow twenty-fold over the next five years:” Report

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Readers of the FT over the weekend learned that “a new breed of hedged mutuals grows apace.” The paper reports that investor demands for liquidity and transparency in hedge funds have forced managers to “try something different.”

But as regular AAA readers are aware, the convergence of hedge funds and mutual funds have been occurring for several years (see end of this post). In fact, we covered a seminal paper on this subject 3 years ago. In “Hedge funds for retail investors? An examination of hedged mutual funds” Vikas Agarwal, Nicole Boyson, and Narayan Naik wrote:

“Recently a number of mutual fund companies have begun offering mutual funds that emulate hedge fund strategies, with assets tripling since 2002...over half of the Registered Investment Advisers who do not currently use hedge funds for their clients would add hedged mutual funds to their portfolios.”

The trio concluded that hedge fund managers seemed to be more adept at, well, managing hedge funds:

“...using hedge fund strategies, even within the constraints of the mutual fund environment, can significantly improve performance.”

While “hedged mutual funds” may not be that new, the Madoff Affair may have certainly made them more interesting to retail investors.

A new report by BNY Mellon’s Pershing Prime Services unit and consultancy Finadium (“Competition and Convergence: The Evolving Landscape for Hedge Funds” – available here with free registration) finds that traditional asset managers are adding long/short funds to their line-ups at an astonishing rate.

The companies forecast that the amount of long/short assets managed by traditional money managers will increase by a whopping 75% to $345 billion by 2012. Meanwhile the amount managed by actual long/short equity hedge fund managers will increase by only 25% to $580 billion. (Those of you who contend that long-only managers have no business shorting may find this to be further evidence that 2012 will indeed herald the end of the world.)

Back in 2004, Agarwal, Boyson and Nail found that their 39 “hedged mutual funds” (Table 7 of their report) represented about 2% of all hedge funds. BNY and Finadium find that today, there are 157 such funds managing $27 billion or about 4% of all hedge fund assets (see chart from report below):
But while $27 billion may represent a significant portion of the hedge fund industry, it’s a 0.1% drop in the bucket for the greater mutual fund industry. In part this seems to have fueled BNY Mellon’s and Finadium’s apparent optimism about the future of long/short mutual funds. Says the report:

“Soon, long/short mutual funds may very well be a recommended piece of every retail client's portfolio. Presuming that financial advisors eventually recommend that even 2% of their clients’ assets should be in market-neutral strategies, the equity long/short space could easily grow twenty-fold over the next five years. Given the need for investors to recoup losses sustained in the last year, this recommendation could well make sense.”

Other Similarities

As hedge funds and mutual funds begin to eat each other’s lunch, their leverage levels are also converging. According to the report (and backed up by several studies we’ve covered here[^9]), hedge fund leverage is now almost non-existent – i.e. the same as mutual fund leverage.

Mirroring the industry concentration of the hedge fund sector itself, the top 10 hedged mutual funds manage around two-thirds of all hedged mutual fund assets. By contrast, the bottom 122 (of 157) funds manages only 10% of all hedged mutual fund assets.

Hedge fund regulation has the potential to increase the speed of convergence. According to the report, traditional managers felt that "few, if any differences" would remain between hedge funds and traditional managers if hedge funds were to be regulated as investment managers.

Oddly, however, nearly half of traditional managers thought hedge funds were eating their lunch by "institutionalizing" their offerings but hedge fund managers didn't feel all that threatened by traditional investment managers – citing the usual reasoning that they lack the necessary short selling skills.

So What?

Although long/short funds managed by traditional managers are forecast to grow faster than those actually managed by hedge funds, there remains a significant opportunity for hedgies. According to the report, hedge funds could partner with traditional managers to launch new products on a sub-advisory basis, and, in effect, leverage the traditional managers’ distribution channels.
Considerable risks remain for hedge funds, however. Chief among them, according to the report is the fact that retail offerings may lead institutional and high net worth investors to believe that hedge funds “...are no longer exclusive enough...”

This is a topic of critical importance to both hedge funds and mutual funds. As this report and others like it illustrate, it’s not about hedge funds or mutual funds, it’s all about alpha.

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- [Financial crisis to slow convergence of hedge funds and private equity, but not for long, says academic](http://www.ft.com/cms/s/0/16cdf3b6-0001-44fe-abdc-000000000000.html) [11]

2008
- [Hedge Funds and Mutual Funds: Not such an odd couple – as long as conflicts of interest are managed](http://www.london.edu/facultyandresearch/research/docs/HMF.pdf) [13]
- ["Convergence" gets another shot in the arm from recent calamities](http://www.pershing.com/prime/index.html) [14]
- [January turmoil has "sharpened the argument for the convergence of traditional and alternative asset management": Report](https://www.pershing.com/assets/whitepapers/Competition_and_Convergence_The_Evolvi) [15]
- [130/30 "not monolithic" but does represent a "convergence" in money management](http://allaboutalpha.com/blog/2009/11/09/equity-longshort-mutual-funds-could-easily-grow-twenty-fold-over-the-next-five-years-report/) [16]

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- [Convergence at The Rockefeller Center](http://www.pershing.com/prime/index.html) [17]
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- [Hedge funds for retail investors? An examination of hedged mutual funds](http://www.london.edu/facultyandresearch/research/docs/HMF.pdf) [19]

2006
- [BGI CEO tells FT about "artificial distinction" between hedge and long-only](https://www.pershing.com/assets/whitepapers/Competition_and_Convergence_The_Evolvi) [21]


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