

## Hedge fund capacity constraints could stifle growth

06 February 2006

Insurance Gateway

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Warren Brown

Increasing demand is moving hedge funds closer to their capacity limits, which is likely to result in the negative consequences of manager concentration and a lack of strategy diversification.

This is one of the findings of an opinion survey conducted amongst hedge fund managers by SYmmETRY Multi-Manager. "A greater number of different strategies in the SA hedge fund market will alleviate the pressure on capacity constraints becoming an obstacle to investing," said Warren Brown, Head of Alternative Investments and Fixed Interest at SYmmETRY.

"There is a sense of urgency around the timing of anticipated growth since about 90% of survey respondents believe that they will cap their existing funds within the next three years. Low levels of capping and a limited number of funds, particularly among superior performing funds, can create concern among investors who want to place sizable assets with top performing funds."

Hedge fund managers have a preference to cap, or close their funds based on the availability of investment opportunities that will sustain gains in terms of the investment strategy used in the fund.

Some 46% of respondents indicated that they would like to cap their fund at a level of between R250 million and R500 million. This, along with the remaining preferences for lower capping levels, indicates a collective potential maximum industry capacity of slightly more than R25 billion, two-and-a-half times the estimated current R10 billion invested in hedge funds.

While these figures suggest that investor concern about capacity constraints in the near future are unfounded, Brown points out that almost 85% of total hedge fund assets are concentrated in two categories: the long/short equity and market neutral strategies.

“There is greater potential for individual funds’ capacity constraints being reached in these two categories and becoming an obstacle to investors wishing to invest,” he said.

The estimated R10 billion invested in South African hedge funds equates to less than 1% of investable institutional assets, a percentage similar to what’s applicable in Europe. In the US, however, the average hedge fund allocation was 5% in 2003 and is expected to have grown to over 7.5% last year.

“This suggests that there is potential for increased demand and growth in the local hedge fund industry,” said Brown. “While it is hoped that the number of different local strategies will grow in line with what has occurred in other markets - where there are at least three times as many different strategies than in South Africa - at this stage local managers seem unenthusiastic about growing the number of funds that they run

“About three quarters said that they would focus on managing their existing assets after capping the fund. As a result, we’ll need new managers to support growth in the number of hedge funds and the number of different strategies. New investment talent may, however, prove a constraint.”

Looking ahead, more than a third of the respondents believe that the major factor driving growth over the next three years will be greater investor awareness. A further quarter believe that superior performance from hedge funds relative to traditional asset classes will spur demand for their funds.