

January 12, 2004

## Bargains Lurk Outside Hedge Fund Elite

By Tom Stabile

Investors primed to enter the hedge fund arena often hunger for the managers with star reputations. They'll find that getting access to those elite firms takes considerable effort. But hedge fund industry observers say slick reputations don't always equal value -- and that investors might benefit from expanding their sights.

There's no question that the big-name funds are a class apart. While there is no single industry top list, observers generally put the elite firms in the dozens, with a second tier of about 200 that have solid reputations, and then a sheer drop to the rest. "There is not a lot of alpha in the hedge fund industry," says Mark Casa, director of investments at Miami-based PRS Group, which runs more than \$1 billion through hedge funds-of-funds and other funds. "There is a concentration of alpha in a handful of managers. If there are 6,000 hedge funds, there are 200 or maybe 300 alpha generators."

Most personal lists might have overlap of a bigger crop like the top 50 names, says Jim Graves, director of HFN/Access, which tracks the hedge fund industry. But he doubts many would agree on a top 10, for instance. Likewise, Jeffrey Yager, product manager for Ascendant Capital Partners, a fund-of-funds firm in Berwyn, Pa., sees little agreement. "It comes down to what the investors want to do with their portfolios," he says

Names that repeatedly cropped up in an informal survey to define the elites include SAC Capital Advisors, Soros Fund Management, Pequot Capital, Caxton Associates, Tudor Investment, Lone Pine Capital, Everest Capital, and Farallon Capital Management.

The star phenomenon is most evident when a hotshot portfolio manager leaves to start a new fund. "They get oversubscribed on day one," says Mike Hennessy, v.p. in charge of hedge fund investing for UNC Management Company. The firm runs the \$1 billion endowment -- more than half invested in hedge funds -- for the University of North Carolina at Chapel Hill and several other campuses.

Prominent examples of big names that quickly generated big assets include: Jeffrey Vinik, a former high-profile manager of Fidelity's Magellan fund, who lured big dollars when he opened Vinik Asset Management; Dwight Anderson, who took his fast-growing Ospraie Fund out of Tudor and went solo; and William von Mueffling, who left Lazard Asset Management, and reportedly garnered close to \$1 billion in assets to manage right off the bat at his firm, Cantillon Capital Management.

The biggest names are understandably the hardest to access. In some cases, the funds are "hard closed" -- not even taking new money from existing investors, says Graves. More firms would be "soft closed" -- only not taking on new investors. But Graves says that a closed fund is still relatively rare. "I wouldn't say that all the star funds are closed," he says.

"For the most part, there are sporadic liquidity windows for current investors and little chance for new investors," PRS's Casa adds. Still, opportunities crop up. Casa cites the high-profile Moore Capital Management, which has open fixed income and global strategies.

Meanwhile, UNC's Hennessy says even oversubscribed hedge fund managers may be willing to look at new investors if they bring strategic advantage. One scenario is a high-profile manager preferring the more stable investment of an institution that expects to place its money for several years to a fund-of-funds that wants quarterly liquidity.

Endowments are particularly attractive, he says, because managers view them as more educated investors, less skittish, and willing to "pull the trigger" on investment decisions. "If these guys know you as a sophisticated investor, then I think the capacity is there," Hennessy says.

But while some struggle to get into top funds, sometimes selecting a specific consultant or fund-of-funds for that end, going elite may not always be the most strategic move, says Hennessy. "We would like to look different from our peers all things equal," he says. "We certainly wouldn't feel compelled to chase every big guy." With that in mind, UNC Management has a mix of big names, emerging managers, and several in between. It's a strategy that requires considerable due diligence and effort, but Hennessy says it pays off.

Likewise, Graves says the biggest-name managers may not be the best place to find the most vibrant returns, given that those shops tend to have more assets under management. "These big guys that manage \$7 billion or \$8 billion -- are they the guys that you really want to put your money in," Graves asks, "or should you be looking to these new and emerging managers who are able to produce returns more effectively with \$150 million in assets?"

Graves says there is a niche market of searching for emerging managers before they become too big and close. That sometimes requires fast decision-making by investors. Some managers close quickly, he says. "If you wait to see the guy's five-year track record, you may miss it."

The key in any manager choice is looking at the bigger picture beyond reputation and recent performance. "There are certain names that would come to mind as the consistent performers," says Graves. "Some of them deserve it, some of them do not. It's a space that is relatively opaque, because a very high proportion of the top funds don't report to the databases."

One element to consider is longevity. There is considerable churning in the hedge fund world, with hundreds of startups and failures annually. Looking back even four years considerably weeds out the market, Graves says. "So the number of firms that have consistent returns, it's not a big universe," he adds.

Another factor is evaluating whether a manager did well because it was in the right market. "A bull market can do a lot to obfuscate alpha," says Casa. "It wasn't difficult to make to make high risk-adjusted returns in some strategies. But it'll take years like 1997 and 1998 and 1999, where the macro space really didn't do too well, to demonstrate who are the true alpha generators."