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By John Mauldin

At precisely what point can we say that there are too many hedge funds? Are too many funds the reason hedge fund returns were down in 2004? What does the answer say about the potential for future returns? And how large might the industry grow in the next ten years? We deal with this and more in this week's E-Letter.

This letter was originally sent to those who have subscribed to my free Accredited Investor Letter a few months ago. The Financial Times recently ran an edited version as my first article with them. It has had a lot of positive responses, so I thought I would put it out to a larger audience. There is information on the Accredited Investor E-Letter, at the end of the letter.

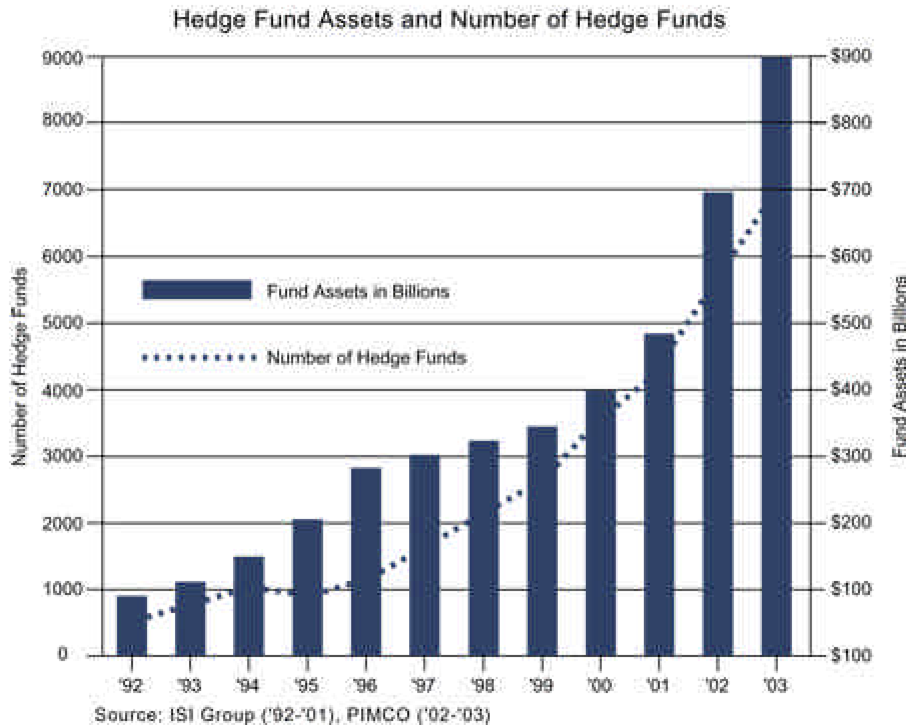
365,000 Too Many Hedge Funds

Go to Google. Type in "too many hedge funds." I get within about 0.37 seconds 365,000 references. It is the hedge fund topic du jour. "Are Hedge Funds Ready to Blow?" asked Kiplinger.com last summer (July, 2004).

My good friend, and normally sober-minded Brit, James Montier worries in a recent essay that the growth in hedge funds is another bubble on its way to meeting a pin. Bill Gross of Pimco wrote last year:

"But it's not just the competition and costs that should spell the eventual demise of the hedge fund craze. It's the realization – advanced here perhaps – that hedge funds can be manufactured in everyone's backyard like a gallon of Kentucky moonshine with revenue stamps attached, no less. You can start your own 'hedge fund' and do almost all of the things the hedgies do without the '2 and 20.' Steven Galbraith, principal at Maverick Capital, a leading hedge fund, recently was quoted as saying that, 'The barriers to entry in this business are nonexistent. It's roughly equivalent to creating a lemonade stand.' He may not have known how right he really was. The chart below confirms the sale of a lot of lemonade in the last few years, but it neglects the potential for a do-it-yourself home brew."

Are There Too Many Hedge Funds?



Now the numbers, as we shall see below, look more like a possible 7,700 funds and almost $2 trillion. Is this not a bubble? Look at that curve, it's going almost straight up. It looks like the NASDAQ in 1999!

So, with that as our starting point, we look into the question of the day, "Are there too many hedge funds?" Most of the recent articles in the public press seem to give the answer as a resounding "yes." Those already firmly entrenched in the hedge fund business would also answer yes, as who wants to see more competition in the hunt for profits in their private game reserves? But I think a more reasoned view would suggest otherwise. Not only are there not too many hedge funds, a strong case can be made that there are not enough! We (investors) actually need more!

To gain a little perspective, let's go to an excellent study done by Strategic Financial Solutions, who provides investment analysis software (called PerTrac) for most of the hedge fund databases around the world. Because the study was so comprehensive, I am inclined to think that it is more reliable than other studies analyzing fewer databases. What it suggests is that the hedge fund world is bigger (at least in terms of money under management) than most previous studies have found.

They analyzed 12 major hedge fund databases, coming up with a total of 24,627 funds. But after eliminating duplicate funds in the new database, they found there were approximately 8,100 "distinct" hedge funds and funds of funds. However, 2,600 of these were funds of hedge funds (FOFs), leaving only 5,500 single-manager hedge funds.

Approximately 2,500 were US-based funds, with another 3,000 residing outside the US. Approximately 1,500 of these offshore funds appear to be "clones," or basically duplicates of domestic funds trading "pari passu." So the actual number of single-manager hedge funds is closer to 4,000. They note:

"Single-manager funds account for nearly $1.5 trillion under management, and nearly 175 funds have surpassed the one-billion-dollar mark. However, the vast majority of funds continue to manage less than $25 million." The data shows that 75% of the single-manager funds have less than $100 million under management.

The pattern is similar for funds of funds. There were 600 US-based FOFs, with another 2,000 offshore. But 900 of these were clones, leaving about 1700 distinct funds of funds. Again, almost 1500 of these FOFs managed less than $250 million.

In addition to the single-manager funds and funds of hedge funds included, there are additional 650 commodity trading advisors (CTAs) that were found within the databases, managing approximately $81 billion, with over 40% managing less than $25 million.

They note, however, that their survey does not accurately reflect the true number of hedge funds. In the summary, they write: "… a more accurate estimate might be that the databases cover approximately 75% to 85% of the commercial hedge fund universe -- or those funds interested in acquiring outside capital. In addition, simply from the Institutional Investor list of funds (which were not included in the study) we can add an additional $150 billion to the total assets under management. Smaller 'missing' funds, while numerous, would likely have little impact on the overall assets under management."

So combining hedge funds and CTAs, and assuming the database was only 80% complete, that would leave us with approximately 6,000 funds managing almost $2 trillion. Add in the 1700 fund of funds and you get somewhere north of 7,700 funds. Remember, I am counting clone funds (around 4,000 of them) as single funds, and there are likely some CTAs being counted twice because they also manage hedge funds.

Considering the fact that in 1994 there were approximately 1000 hedge funds managing $150 billion, we're left with the fact that this has been nothing less than explosive growth in the last 10 years. If this was all the data you considered, you might well conclude there was a bubble in hedge funds. But there is more to the tale than this one story.

Those of us who lived through the late '80s and early '90s might remember a similar fear that was often written in the popular press. We were told that there were too many mutual funds, and that the explosive growth in mutual funds was a clear sign of a bubble top. In addition to charts showing the growth of mutual funds, we were constantly offered the fact that we were on the verge of having more mutual funds than actual stocks.

What was the number of mutual funds that was so threatening? In the US alone, the number of mutual funds had grown from 361 managing less than $50 billion in 1970 to 3,079 managing over $1 trillion in 1990. Today there are over 8,000 US-based mutual funds managing almost $8 trillion.[1] Evidently what was threatening to some in the financial world in the late '80s did not turn out as bad as the prognosticators feared.

Worldwide the growth was even more explosive. There are now 54,446 mutual funds worldwide managing $14.47 trillion.[2] I would suggest to you that is explosive growth which has mostly been a benefit to investors, offering them diversification and access to professional management.

However large the amount of money in mutual funds and hedge funds, it is dwarfed by total world market capitalization. As of February, there was a total of $36 trillion of equity on world stock exchanges.[3] The world bond market is larger than equity markets, with a US-dollar market value of $49 trillion.[4] Almost $2 trillion a day is traded on the world currency exchanges.

Approximately two-thirds of all hedge funds are engaged in some form of equity trading, as measured by the percentage of total dollars invested. The back of the napkin calculation then suggests that $1.4 trillion in hedge funds is focused on the equity markets. That is about 4% of total world equity. Of course, that can be deceiving, as much of the hedge fund equity trading is focused on the US markets. Even if one assumes that $1 trillion is being traded by hedge funds on the US markets, that is less than 6% of US total market capitalization. And it is only 20% of the $5 trillion that is in US equity mutual funds.

Further, the image that all hedge funds are swashbuckling traders turning over their portfolios every few days simply does not square with reality. Many equity hedge funds have relatively stable portfolios, looking for value (or the lack of it) and not frenetic trading to be the driver of their profits. And yes, some equity hedge funds are leveraged. But my research suggests that would at most increase the actual money traded by 50%, which would still not be a large portion of the US equity markets.

In fact, the great majority of equity hedge funds have exactly the same purpose and goals as most equity mutual funds: finding value in the equity world. Hedge funds simply have more tools at their disposal in their quest for value, and most attempt to do so while at the same time dampening the volatility of the market. While one could argue that a continued proliferation of long/short US equity hedge funds would mean that the opportunities for finding value will be more difficult, and thus returns would be

[1] Source: Investment Company Institute 2004 Fact Book.
[2] Source: Investment Company Institute www.ici.org/stats/mf third-quarter 2004 summary, latest available data.
[3] Source: World Federation of Exchanges, Focus Report, March 2005.
[4] Source: PWL Capital, fall 2004, www.pwlcapital.com

depressed, that does not mean that hedge funds are a bubble, any more than 50,000 mutual funds constitute a bubble.

What I believe will happen is that over time, as profits are harder to come by, fewer and fewer hedge funds will be formed (or survive) to trade in the US equity markets. Entrepreneurial managers will start looking for opportunities in other markets where the space is less crowded.

This will be driven by the economics of the hedge fund business. According to various estimates, somewhere between 500 and 700 hedge funds went out of business last year. Much of the time they went out of business for a very prosaic reason: it's not that they were not profitable for their clients, but they were not profitable for the fund managers. Of course, some went out of business because they did lose money for their clients (or didn't make enough to warrant interest) and were unable to attract new money or at least enough to stay in business.

As noted above, the SFS study shows that there are 2000 hedge fund managers with assets under $25 million. Let's look at the economics of running a hedge fund with $15 million that charges a 1% management fee and an incentive fee of 20% of the profits. If the fund makes 10% or $1.5 million, that would mean they would have an incentive fee of $300,000. Add a $150,000 management fee and you get total income of $450,000.

Sound like a lot? Not after you pay overhead, research, salaries for staff, legal, and salaries for what is generally at least two partners. If you are in New York, that doesn't go a long way. And that would be for the average fund. Funds which only returned 3-5%, or even lost money, would be sucking gas. After a few years of such returns, it is difficult to attract new investors, and the spouses of the fund managers are beginning to encourage them to get real jobs.

The reality is that a hedge fund is a small business. Yes, I know there are the spectacular billion-dollar startups, but they are the exception, not the rule. Most hedge funds start up with money from friends and family. Managers cut back on their lifestyles and go through their savings, while hoping to catch lightning in a bottle and be one of those rare funds that grows to capacity.

Eighty percent of all new small businesses fail within the first five years. While there has been no definitive study done on the survivability of hedge funds, my bet is hedge funds are no different than any other small business in their survivability rate.

And let's say that our intrepid managers are lucky enough to acquire $25 million under management. For achieving that goal they are now required to register with the Securities and Exchange Commission. At a minimum, the regulatory cost will likely be $100,000. Many industry sources think the figure will be closer to $250-300,000. Of course, they could do compliance on the cheap and take the risk, and I expect many of the smaller funds will do so. They simply will not be able to stay in business with the

potential cost of regulatory compliance eating up 50% or more in a year when performance is off, and thus incentive fees are meager.

Future Growth of the Hedge Fund Industry

If the hedge fund industry averages only 7% net a year for the next 10 years, then assets under management will double from internal growth. Given the relative performance of hedge funds to mutual funds and other styles of management, is it not reasonable to think that a significant amount of money will also come into hedge funds in addition to internal growth? Is it unreasonable to think that we can see hedge funds managing $5 trillion within 10 years? Will that amount of money be managed by the same 7000 funds that exist today? I don't think so. That would mean an average of about $700 million per fund. That is not realistic.

My bet is that a large percentage of the hedge funds in existence today (and over half of the funds which are new) will be out of business within five years, and a significant portion of the remainder in five years after that, either through consolidation or outright closing of the doors. It is a rough world out there.

If the spectacular growth of the mutual fund industry is any indicator, it is likely that we will see the number of hedge funds at least double or triple from here. And as investors we need them to do so. Not only do a significant number of funds go out of business every year, there are also a number of funds that simply reach their investment capacity and stop taking new money. For investors to find quality hedge funds into which they can put their money, we need to see multiple hundreds of new funds started each year, in the hope that some will survive long enough for us to find them before they too close to new money.

Further, the percentage of new hedge fund managers who truly bring a significant value-added skill set to the table is sadly small. Even if a very (!) optimistic 25% of hedge fund managers had significant value-added skills, that means we would need 20,000 hedge funds in 10 years to find 5,000 such mangers to parse out the large bulk of the potential $5 trillion that is coming.

That is enough for this month. In the future, I will comment on some of the regulatory issues facing the hedge fund world, and why the far greater problem for investors is not the “highly secretive, lightly regulated” nature of hedge funds, but the lack of any coherent organization in the process of finding the funds. The SFS study analyzed 12 databases. No fund was on all 12, and no database had 50% of the funds which are out there. As a professional in the industry, I have trouble finding funds I like for clients. In light of the obstacles, what’s an “average” millionaire to do these days? Stay tuned.

If you are an Accredited Investor (basically $1,000,000 net worth- see the web site for a complete description) and would like to get my Accredited Investor E-Letter, you can go to www.accreditedinvestor.ws and sign up, as well as seeIn closing, let me

remind you I work closely with Altegris Investments (and my international partners) to try and find managers with the value-added skills I mentioned. We work quite hard at helping investors find hedge funds and alternative investments which make sense for them in this economic climate. You should make us part of your "research team." We have recently added a number of new funds to our list, and my firm is producing 1-2 new research reports on specific hedge funds and other alternative investments a month, which are only available through Altegris or my international partners.

Moving, London and Hectic Schedules

OK, small confession. I have been saving this week's letter for a month or so, knowing that this weekend I am moving and am running in circles. In fact, I am finishing this up from my kitchen as the movers are packing. Nothing like waiting to the last minute! But moving is an opportunity to shed a lot of stuff accumulated over the years. If I can just keep myself from stopping to read all those important things I saved! And the pictures of the kids! Can't stop to look. Well, maybe just a minute or so. But we are only taking two days to pack and move, so we have to move fast. I predict long days, but I have lots of help.

The terrorist attack in London is yet another appalling act by a form of evil as perverted in their actions as any deviant group ever formed. Our thoughts and prayers go to the victims and their families. For what its worth, I am taking my seven kids and one daughter-in-law to London and Paris this summer, and will ride those same subways and buses.

Between moving and finishing a major writing project (coming to a bookstore near you this fall), plus the "normal" pressure of business, keeping up on my reading and writing, staying on top of new hedge funds, research reports on funds, talking with clients (very important!), I have been way behind on my "other important" projects, like re-doing my web sites, getting yet another regulatory license (this time an 86 – it seems like there is no end to new regulatory tests), reorganizing my files, etc. But I see the light at the end of the tunnel. I have sworn not to put any more projects into my queue until I get everyone that is already on my list done.

Enjoy your week

Your literally moving fast this week analyst,

John Mauldin

PAST RESULTS ARE NOT INDICATIVE OF FUTURE RESULTS. THERE IS RISK OF LOSS AS WELL AS THE OPPORTUNITY FOR GAIN WHEN INVESTING IN MANAGED FUNDS OR ANY ALTERNATIVE INVESTMENT PRODUCT.

WHEN CONSIDERING ALTERNATIVE INVESTMENTS, INCLUDING HEDGE FUNDS, YOU SHOULD CONSIDER VARIOUS RISKS INCLUDING THE FACT

THAT SOME PRODUCTS: OFTEN ENGAGE IN LEVERAGING AND OTHER SPECULATIVE INVESTMENT PRACTICES THAT MAY INCREASE THE RISK OF INVESTMENT LOSS, CAN BE ILLIQUID, ARE NOT REQUIRED TO PROVIDE PERIODIC PRICING OR VALUATION INFORMATION TO INVESTORS, MAY INVOLVE COMPLEX TAX STRUCTURES AND DELAYS IN DISTRIBUTING IMPORTANT TAX INFORMATION, ARE NOT SUBJECT TO THE SAME REGULATORY REQUIREMENTS AS MUTUAL FUNDS, OFTEN CHARGE HIGH FEES, AND IN MANY CASES THE UNDERLYING INVESTMENTS ARE NOT TRANSPARENT AND ARE KNOWN ONLY TO THE INVESTMENT MANAGER.

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