

## Hedge funds

## Capitals of capital

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**In the booming world of hedge funds, London is a growing rival to New York**

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FIND a table at Nobu on a Friday night (if you can) and you will notice the sleek, Michelin-starred restaurant buzzing with a snazzy crowd. The cocktail lounge is overflowing and the sushi bar is packed. Often, those dining on yellowtail tuna with jalapeño or black cod with miso include young hedge-fund managers acting as if they are at the top of their game. Which side of the Atlantic are you on? Both.

Whether in the New York area, or London's Mayfair, it is hard to miss the stamp of the hedge-fund manager, or "hedgies" as they like to be known in the trade. They are clever, well-travelled and mostly rich. They fill up restaurants and drive up the prices of everything from apartments to art wherever they cluster.

Across the world there are more than 8,000 hedge-fund managers with over \$1.1 trillion in assets under management. Attracting them to any financial centre means big business. Moreover, thanks to their complex, rapid-fire trading strategies, hedge funds are increasingly punching above their considerable financial weight—some financial experts reckon they account for half the trading volume on the world's biggest exchanges.

Since the late 1940s, when an American journalist, Alfred Winslow Jones, began taking off-setting positions in shares to hedge market risk, New York City and (more recently) a swathe of leafy suburbs radiating from Greenwich, Connecticut, have been the centre of what became the hedge-fund world. This unusual in-crowd (they often seem more inclined mathematically than socially) is keeping the money flowing in Manhattan and southern Connecticut.

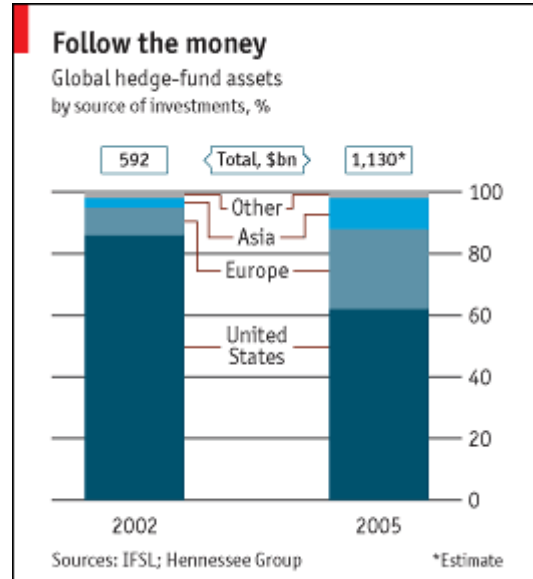
Hedge funds arrived in Britain much more recently, in the early 1990s. Since then London has emerged as the centre of Europe's hedge-fund management industry, handling about two-thirds of a total \$325 billion in funds under management (the funds themselves are held offshore, in tax havens like the Cayman Islands).

New York City remains home to roughly double the number of hedge-fund managers as London, but the two centres increasingly stand head and shoulders above the rest of the world. In 2005 Britain had the edge in performance, returning an average of 16.15%, almost twice the return of American funds. That may be one reason why London is attracting money—and talent—at an accelerating pace. Estimates vary, but by one count Britain has about 700 hedge-fund managers today. In 2002 the Alternative Investment Management Association (AIMA), a trade group, counted only 400.

In both cities, hedge funds are contributing to a trend that is changing the face of financial services. Increasingly, talented financial professionals are abandoning big investment banks for small firms. Tim Spangler, a London-based lawyer with hedge-fund clients around the world, says banks are "fighting to keep talent in the building." The rewards are a large part of the attraction of hedge funds, as is the lightly regulated environment. Funds like to play up the difference by offering nicer digs, too. Greenwich is a lot greener than Manhattan. In London many small hedge funds cluster in Mayfair, far west of the City and Canary Wharf where the big banks camp out.

American fund managers say they are attracted to London as a less-crowded place where they can try different trading strategies. Data from Hedge Fund Research, a consultancy, show that in the second quarter, a share-hedging strategy involving both long and short sales was the most popular in America and Britain. But American-based managers were more likely also to trade "event-driven" strategies, based on unexpected occurrences such as takeovers. British-based funds, meanwhile, were more likely to trade in emerging markets and fixed-income.

Despite the growing clout of hedge funds in Britain (at least 100 new funds have started there this year, the AIMA reckons), many of its fund managers still rely heavily on American investors for much of their funding—as they do elsewhere in the world (see chart). “The US investor side is the broadest, the deepest and the most willing to back new managers and strategies, wherever they may be”, says Mr Spangler. A recent change in America's pension laws makes it even easier for pension fund managers to go into hedge funds; already they are far more comfortable with such investments than are their British counterparts, who invest only 3% of their funds in alternative assets, such as hedge funds.



One of the more striking differences between America and Britain is regulation. In America hedge funds are not required to register; an effort by the Securities and Exchange Commission (SEC) to impose registration by February has been struck down by a federal court.

From the British perspective, America's approach looks “bipolar”, as one London fund-manager puts it. The optimistic attitude to starting up funds—virtually anyone can create a hedge fund in America almost overnight—is followed by a legal sledgehammer when things go wrong. And they have sometimes gone wrong in spectacular fashion, as at Long-Term Capital Management in 1998 and Bayou Hedge Fund Group last year. Since June 1999 the SEC has brought 97 enforcement cases against investment advisers for defrauding hedge-fund investors or using funds to defraud others.

Contrast this with the approach in Britain, where a surprising number of big hedge-fund managers criticise the American system for being too lax. In London, one says, requirements by the Financial Services Authority (FSA), the regulator, to start a hedge fund “are sufficiently burdensome to be useful”. In addition to requiring details on everything from the firm's compliance systems to its risk controls, there is an annual report on each firm (this applies to other financial firms, not just hedge funds). A group of the largest hedge funds receive closer scrutiny, including monitoring visits, from the authorities.

Yet once hedge funds are established in Britain, the regulator uses a relatively light touch based on broad principles, including protecting consumers and promoting competition. Amazingly, the FSA has fined only one hedge-fund manager thus far—and that was for just £750,000 (\$1.4m). As London catches up with New York, though, this will surely change.