Switzerland: Searching an Edge On Hedge Funds

Switzerland unquestionably stands out as Europe's wealth management capital. Decades of private banking expertise and total amount of wealth managed testify the Swiss leadership in the field. Concentrating $ xxx (**add exact amount**) trillion of offshore wealth, the country boasts some of the most respected private banks and investment management firms. All of that does not come as a surprise considering that over 16% of the country's GDP is made up by the financial services industry[1].

With private banking margins shrinking and performances declining, the industry is increasingly turning its focus to alternative assets. Investment in hedge funds and funds-of-hedge-funds is becoming a key component of local private banks' strategy in recent years, with some estimates indicating that between $100 and $130 billion of their assets under management are now in alternative investments. That would suggest that the Swiss private banking industry concentrates close to 20% of the assets of the global hedge fund industry.

Hedge funds made a remarkable rise on a global scale, with assets growing five-fold in the past eight years[2] to $750 billion[3] by the end of 2003. Only last year, inflows amounted to $60 billion[4], nearly four times the $16.3 billion raised in all of 2002.

The dramatic growth in hedge fund investment was provoked by a first wave of inflows that came mostly from fixed-income assets, as a result of the past years' volatility in financial markets and lower returns from traditional investment options. Analysts anticipate further growth, particularly from assets deriving from pension funds and insurance. Swiss institutions have taken the lead in hedge fund investment in Europe long ago. Most of the largest insurers such as Winterthur, Helvetia Patria, Zurich Insurance and Swiss Life, have ventured early into hedge funds. They were joined by many of the pension funds, including Nestle and Swiss Airlines. This surprising reliability on hedge funds stems mainly from the fact that hedge funds have been popular among the Swiss for over two decades.

Today, Geneva is one of the main and biggest hedge fund investor centers in Europe, as well as a fund of hedge funds center. As opposed to Zurich, which had an active stock market that concentrated much of institutions' dealings and developed a stock-investment expertise, Geneva pioneered in hedge funds, counting today on highly-experienced funds of hedge funds managers. The large amounts of capital available to invest from private banks and family offices pushed financiers to look for alternative investments to obtain more attractive returns.

Meanwhile, some industry insiders argue that the growth and expertise in hedge funds had been forged by the large private banks alone, but also by investment management boutiques and family offices looking for absolute returns, which had the flexibility to explore other asset classes and investment vehicles. The core competency of private banks has forever been client relationship, as opposed to fund management, so their

[1] Swiss Federal Department of Finance
[2] Financial Times, June 13, 2003
[3] Tass Research
[4] Tass Research

focus was on the advisory and relationship management side, rather than on the investment side.

Pressure for profits is mounting on the private banking sector, as clients seem to be less concerned about capital preservation and tax advantages than about higher returns. As a result, private banking customers are starting to benefit from onshore services, repatriating assets to Belgium or Italy as Swiss banks open offices abroad to capture new markets, offering foreign clients the option of an off-shore or on-shore service.

In an attempt to offer more appealing returns and boost their profits, Swiss private banks have gradually integrated hedge funds into traditional portfolio management, managing their own funds of hedge funds or using third parties to manage them. Most institutions are getting their exposure through funds of hedge funds, which provide them with immediate diversification and eliminate the risk of monitoring single managers. As a result, a host of Swiss exchange listed funds of funds have been launched in the past few years, starting in 1996 with Julius Baer's Creinvest, 40% of which is said to be held by institutions.

As hedge funds become more popular, "the question is: can they consistently outperform the market?", Frederic Martel, Head of UBS' Alternative Investment Solutions team states: "To achieve that, investment management houses and banks need to focus on selecting the right managers via a due diligence that ensures they have the capacity to scale up their business, manage the additional in-flows, the investment opportunities and have the right risk management processes in place. When investing a large pool of assets, investment advisors need to make sure that the investment is safe for investors and perform due diligence both on the quantitative and qualitative side. The value the bank adds is in the capacity to select the right managers in line with the risk/return profile of their investors".

Interest among retail investors is on the rise and so is the need for comprehensive investor education and accurate reporting. According to Mr. Martel, "Due to Hedge Funds' attractive historical return and lower volatility, there is a new breed of investors attracted to hedge funds that need to be educated on the implications of investing in this asset class. They need to be made aware of the advantages and the potential returns but also the risks they may be exposed to".

Meanwhile, increased demand and inflows are heating the discussion on the scalability of the business. "We do not feel very comfortable with the assumption that this is a scalable business", states Luc Estenne, Chief Executive of Partners Advisers, a Geneva-based family office and Funds of Hedge Funds Advisors running over half a billion dollars. "Hedge funds strategies are at the fringe of markets, exploiting pockets of inefficiency that can be best implemented by highly-specialized managers. If those inefficiencies are the target of large assets, opportunities will disappear and return will sooner or later decline".

Whilst growth will inevitably happen, it may bring along reduced returns. Mr. Estenne fears that as hedge funds are in fashion "part of the industry may become an asset gathering business, as opposed to a performance business, which is the very essence of hedge funds".

Until 1997, when the Swiss Federal Banking Commission approved the first Hedge Funds for public sale, legislation had refrained the development of hedge fund investing in Switzerland. Flexible regulation of hedge funds is luring fund managers and investment houses to distribute their products within Swiss borders. Switzerland has many competitive advantages to position itself as a main investor center for hedge funds: location, credibility, expertise, regulatory and fiscal advantages. Legislation is particularly convenient for advisory boutiques that benefit from the lack of minimums and limited licenses required to operate. Yet, it may take several years to catch up with London or the Caribbean, if so.

The regulatory framework comes at a crossroads with authorities' efforts to protect investors. The Swiss Funds Association together with the SWX Swiss Exchange, recently launched an initiative to satisfy demand for increased market transparency called TIF – Transparency in the Fund Market. The project is aimed at creating an information system for the over 3800 investment funds approved for distribution in the country, of which only 500 are Swiss origin, including hedge funds.

As the industry receives extra assets, observers wonder which players are best positioned to capture growth from the second wave of money coming from pension funds. According to Luc Estenne, "big players with brand recognition will attract a significant portion of assets but will fail to deliver top risk-adjusted performance. Given the fact that most pension funds tend to be risk-averse, process focused and that their decision-making process is highly structured, they will trust on a well-respected name".

Despite emerging consolidation in the banking sector and its potential impact on hedge funds, managers see more consolidation happening on the funds of hedge funds side. Mr. Estenne continues: "The industry landscape is shaped by three major groups of players; at one end, large institutions that will continue to hold the lion's share but will be under pressure for selecting the best managers and allocating investments. At the other end of the spectrum, we find a number of boutiques, like Partners Advisers, which are niche players and focus on performance, obtaining outstanding results. The remaining mid-sized group will further live or die by either being successful on their own, consolidating or downsizing".

Overall, managers fear that as hedge funds continue growing in size and assets, they risk disappointing investors. With the prospect of increased assets and funds, hedge fund managers will need to be incredibly creative in their strategies in order to continue delivering good-looking returns. Let us not forget that as Mr. Estenne puts it: "Hedge funds are about the exception, not about the rule".