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Hedge funds hiding

Cash piles up as high-priced managers fiddle

By **Jeff Benjamin**
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Hedge fund investors who thought they were buying top-drawer investment advice may be getting nothing more than high priced cash management instead.

Cash is piling up in hedge funds at a growing rate, suggesting that managers who typically promise absolute returns regardless of the market are being stymied or scared off by the investment climate.

Hedge funds held about 33% of their assets in cash on average at the end of the first quarter, up from 23% at the end of 2002 and 17% at the end of 2001, according to a recent survey of managers.

"We have probably not seen a time when cash has been this high for hedge funds," says Annette Cazenave, vice president of marketing at Horizon Cash Management LLC in Chicago. "And as the cash balances are increasing, more attention is being paid to how that money is being managed."

The reason for the unprecedented cash pileup may be a matter simply of limited opportunities combined with a sort of industrywide caution, according to some analysts.

By sitting on a lot of cash, hedge fund managers aren't doing what they are paid big bucks to do, says Bruce Terry, president of Weston Financial Services LLC in Westport, Conn.

"In a hedge fund, we're looking for the manager to add alpha. Increasing the cash position as a defensive strategy is not what we're looking for," he says.

Lack of ideas?

While the hedge fund industry saw total assets under management climb by nearly 5% last year to $592 billion, the evidence suggests that a good chunk of that money is sitting on the sidelines.

At Horizon, which specializes in managing the cash portion of hedge fund portfolios, business is booming. That probably isn't the best news for hedge fund investors, who expect hedge fund managers to follow a more aggressive investing strategy.

Ms. Cazenave says she has seen funds with cash positions in the 70% range that essentially take money in and pass it through to Horizon, which has about $1 billion under management.

As cash management goes, turning to a firm such as Horizon to get bang for the buck may be practical, but it still raises questions about the value of a hedge fund that is mostly out of the market.

Mr. Terry, who allocates $1.2 billion in investor assets through the firm's funds of hedge funds, says the pursuit of absolute returns has driven investors over the past few years to alternative strategies.

"In some strategies, I could see why holding cash wouldn't be such a bad idea," he says. "But at the same time, if a hedge fund doesn't have any good ideas, that's probably not a fund you want to invest in."

Sometimes, however, sitting on the sidelines is the best strategy, hedge fund managers say.

Ian Fraley, managing principal at a small hedge fund operating out of Financia Capital LLC in San Francisco, says he recently moved his $10 million fund to fully invested status.

As recently as last month Mr. Fraley was holding a 40% cash position, but he has been putting all that money back into the market during the past few weeks because of a more bullish outlook.

Considering that his 11-month-old fund is down 10% net of fees since inception, keeping cash on the sidelines was probably a blessing.

"Sometimes cash is not such a bad place to be," Mr. Fraley admits.

On the sidelines

Charles Gradante, managing director of Hennessee Group LLC in New York, says this is the lowest level of exposure to the markets he has seen among hedge funds.

On a net basis - subtracting hedge fund short positions from long positions - hedge funds in the Hennessee database averaged a 23% long exposure to the markets at the end of March.

That exposure is down from a 33% net long exposure at the end of 2002 and a 49% net long exposure at the end of 2001.

The Hennessee survey, which included responses from 793 hedge fund management companies responsible for more than $137 billion, also showed that assets in the average hedge fund figure to fall 22% this year to $693 million.

"The thing that surprised me the most is that managers are looking to manage less money," Mr. Gradante says. However, he adds, even with a quick end to the war in Iraq, there are many domestic economic issues that don't bode well for the markets, which will keep hedge fund assets on the sidelines.

Although hedge fund assets rose 5% last year, and the number of hedge funds grew nearly 4% to 5,700, Mr. Gradante says managers are starting to refuse to take in new money, even from existing investors.

"We're seeing a more difficult market," he says. "Right now, the investment opportunities are perceived to be average to below average."

For hedge fund investors and those charged with allocating investor assets to hedge funds, that could represent a sign of caution.

Amy Hirsch, chief executive of Paradigm Consulting Services LLC in Clifton, N.J., says she has seen hedge funds with cash positions as high as 65%.

"Particularly the long-short equity managers are not finding enough on the long side, and they're getting smacked on the short side," she says. "Investors are starting to take the managers to task for holding so much cash, saying: `I don't need a hedge fund to manage my cash.'"

Ms. Hirsch, whose firm has more than $1 billion in hedge fund assets under advisement, says she has limited patience for hedge funds that sit on large cash positions for an extended period of time.

"What the hedge fund managers should do when they hold cash is return it to the investors - what a concept," she says.