THE LONG VIEW

JOEL PRESS

explains how consolidation in fund of hedge funds could boost convergence between the hedge fund and mutual fund industries

"THE CHEAP DEALS IN THE FOHF WORLD HAVE BEEN NOTED BY MUTUAL FUNDS – WHO COULD BECOME KEY TO THE SECTOR'S RECOVERY"

While the long-rumoured sale of fund of hedge funds (FoHF) firm K2 Advisors last week surprised few in the industry, the identity of the buyer was more predictable still. Franklin Resources is parent company of the Franklin Templeton mutual fund range, meaning the deal marks the latest leap by an institutional-grade acquirer into the FoHF sector. And it certainly won't be the last.

The struggle faced by FoHFs since the financial crisis has made them ripe targets for acquisition. K2 Partners, an 18-year-old FoHF running $9.3bn, joins fellow groups FRM Holdings and Prisma Capital Partners as firms bought out by bigger companies this year. The reasons have varied. Purchasing FRM made Man Group the largest FoHF provider outside of the US, while buying Prisma gave private equity firm Kohlberg Kravis Roberts a foothold in hedge funds.

The Franklin/K2 deal, however, is the most interesting yet. In my view, it signals the arrival of mutual fund players on the takeover scene. Some mutual fund providers, like BlackRock and Blackstone, have been around the FoHF scene for a while but this convergence of sectors is about to mushroom given the consolidation trend.

Here's why. Mutual fund providers have history in the hedge fund world – many started up funds in 1990s, and were successful for a time. However, it didn't work out for a number of good reasons. Mutual fund managers were often jealous of the returns and pay of their hedge fund colleagues. There were burdensome compliance aspects at play and difficult questions to consider – should a hedge fund short stock that is being backed by others within the same mutual fund company?

But FoHFs offer mutual fund providers an ideal route back into the alternatives market. FoHFs have received some tough press of late, but they deserve great respect for their research expertise and operational capabilities. These are the skill-sets lacked by many mutual fund firms and acquisitions offer a quicker way for them to build expertise in the space.

The deals on offer make this even more likely to happen. FRM was picked up by Man Group for no up-front consideration and the K2 deal appears to be fairly priced. For mutual funds looking to enter the alternatives space, good deals abound at reasonable prices.

Questions surrounding the future of many established and well-regarded FoHFs hang over these firms for a reason – since 2008, poor performance, investor redemptions, Madoff and the rise of the investment consultant has eaten into confidence in the sector. Why would installing a FoHF within a mutual fund house reverse the trend? First, placing the products and services offered by these firms within a mutual fund offering would instantly help them build more trust. Houses like Franklin Templeton are well-regarded globally and marketing under such a respected brand name would increase their appeal. Linked to this is a more important factor – access to a wholly different segment of the investor market.

Retail investors have shown more appetite for less conventional investment products in recent years and would be ideal candidates for FoHF products if marketed by mutual funds. This could prove a rich source of new money for the sector, badly needed if it is to spark a long-hoped-for recovery for mutual companies.

While sophisticated investors have increasingly shunned FoHFs for direct hedge fund investments, it will be a different scenario for retail investors. For them, a FoHF investment via a mutual house could be their first route into the sector.

Nothing is guaranteed and unless FoHFs can start generating attractive returns the decline may continue. But the cheap deals in the FoHF world have been noted by mutual funds – who could become key to the sector's recovery. ■

JOEL PRESS is the founder of Press Management