

THE ROLE OF HEDGE FUNDS IN THE UK ECONOMY

Trends and policy implications

UK hedge fund industry at a glance



40,000*

HIGHLY SKILLED JOBS

£3.9 Billion

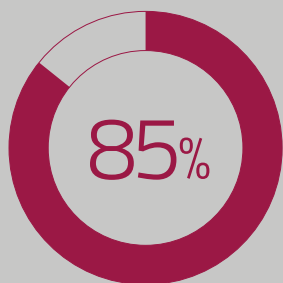
CONTRIBUTED TO TAX RECEIPTS

500 firms

HEDGE FUND FIRMS IN THE UK

£335 Billion

ASSETS UNDER MANAGEMENT



85%
OF EUROPE'S
HEDGE FUND
ASSETS ARE
MANAGED
WITHIN THE UK

Hedge funds are a valuable part of the UK economy and deliver value to:

1. Investors, by aiming to reduce volatility, preserve capital and deliver positive returns
2. Markets, by providing liquidity and enhancing efficiency and transparency
3. Key business sectors, through investment in and lending to UK companies

* This figure includes both those employed directly within the hedge fund sector and those jobs generated by the industry among service providers including legal services, administrators, prime brokers and accountants. The ratio of direct jobs to indirect jobs was found by AIMA to be generally 1:3, so the number of direct jobs within the industry in the UK is 10,000 with a further 30,000 indirect jobs generated by the industry.

Introduction

Hedge funds make an integral contribution to deep, diverse and accessible capital markets and the financing of the UK economy. They do this by providing liquidity, improving corporate governance, and undertaking investments which other investors may be reluctant to hold.

This comprises of investing in and lending to UK companies, including small and medium enterprises (SMEs), firms in difficulties, firms which carry out significant R&D expenditure, as well as infrastructure and real estate projects.

With institutional investors like pension funds and charitable foundations now accounting for the majority of funds invested in the industry, hedge fund investment strategies have become mainstream. The existing levels of transparency and regulation of the industry render the old stereotype of hedge funds as opaque to investors and regulators as inaccurate.

Our industry also has a long history of contributing to policy debates in order to shape effective regulation. AIMA's latest offering is an in-depth report entitled *Capital Markets and Economic Growth*. The findings and key implications for UK policymakers are summarised opposite.



Jack Inglis,
AIMA CEO

The study's key findings at a glance

1. Deeper capital markets enhance economic growth

The balance between market finance and bank lending matters, with over-reliance on banks coming at a cost in terms of reduced economic growth. The study estimates that growing capital markets by one-third could fuel a long-term real growth rate in per capita GDP by around 20 percent.

2. Asset managers support capital market growth

The regulatory environment for funded pension schemes is an extremely important driver for capital market size. The report's authors estimate that increasing the size of pension funds by 10 percentage points of GDP could lead to an increase in stock market size of 7 percentage points of GDP. A broad spectrum of asset managers – from passive investors through to dynamic and active investors such as hedge funds – complements the effectiveness of capital markets by enhancing market liquidity and providing capital for potentially riskier business investments.

3. Active investors can effect positive governance changes, improving the allocation of resources in the economy

Hedge funds play a vital role in capital markets using their expertise and willingness to engage with, and create positive governance changes in, the firms in which they invest. Good governance practices make for better performing firms over the long-term and ultimately protect and enhance the value of people's savings and pensions.

4. Capital markets are good for Research and Development (R&D)

Firms' R&D intensity is positively correlated with the level of equity financing. The study provides evidence that firms in bank-based economies have less flexibility in their financing decisions and therefore follow a more conservative financing strategy. This might lead to underinvestment in R&D.

Implications for UK policymakers

The central role of UK hedge funds in Europe and their significant contribution to British economic growth are largely thanks to UK's financial expertise, its strong asset management industry, the breadth and depth of the local financial services skills base, and an effective regulatory environment. However, more could be done to support the industry's contribution to long-term economic growth. To achieve this, the UK should have a supportive capital markets policy which:

1. Preserves basic legislative, regulatory and tax stability

Long-term predictability of the general framework in which capital markets operate is key to attracting investment and economic activity.

2. Maintains a diversity of key market participants and their business models.

A range of participants increases the ability of capital markets to meet the financing needs of businesses. The asset management model, in particular, enhances the stability of the financial system through the loss-bearing capacity of end-investors which avoids tax-payer funded bail-outs.

3. Promotes good corporate governance by firms through better shareholder rights

Improving minority shareholder protection rights attracts investors. Institutional investors and asset managers who are particularly good at improving corporate governance practices in investee companies are reluctant to invest in firms in countries with weak shareholder protection laws.

4. Provides a strong, consistent framework for non-bank lending

As the banking sector is constrained by the obligation to increase capital ratios, an alternative source of finance is required which can meet the shortfall in lending without affecting financial stability.

5. Creates a healthy savings environment

Tax and retirement savings rules which incentivise people to invest more savings in the capital market help pension schemes provide for an ageing population. Such a policy addresses two imperatives – to support retirement provision effectively and to provide an additional source of finance for business.

Industry facts

Hedge funds are regulated

Hedge funds must be authorised and supervised in all major financial jurisdictions, including the UK and Europe. They are subject to strict operational standards and organisational requirements such as conflicts of interest and conduct rules, protection of client assets as well as prudential regulations on liquidity and risk management.

The hedge fund industry is transparent

The hedge fund industry reports information about its positions and risk exposures to the regulatory authorities in the interests of financial stability. The needs of a now largely institutional investor base also include substantial disclosure to hedge fund clients.

Hedge funds do not pose systemic risk

By co-investing alongside their clients, hedge fund managers have skin in the game which further aligns their interests and incentivises prudent risk management practices. Hedge funds are small in size compared to participants in the broader finance industry, are not highly leveraged and are not susceptible to runs. Investors in funds bear losses themselves, unlike depositors in banks, making asset management – including hedge fund investment – a safer financing model for the economy.

Hedge fund managers reside onshore and pay UK tax

Hedge fund managers are based onshore and pay corporation and payroll taxes to their national authorities. On a conservative estimate, we consider that hedge fund management firms contribute close to £4bn a year to the UK budget.

About AIMA

The Alternative Investment Management Association (AIMA) is the global representative of the hedge fund industry. We represent all practitioners in the alternative investment management industry, from hedge fund managers to legal and accounting firms. AIMA is committed to developing industry transparency, industry skills and sound practice, and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA).

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