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= FOCUS: Hedge Fund Consolidation Picks Up In Choppy Markets

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LONDON (Dow Jones)--To survive in turbulent markets, hedge funds are teaming up with bigger rivals, moving an industry founded on the skill of individual traders into the hands of several dozen big firms.

Recent buyers of smaller funds include U.K. hedge fund giant Man Group PLC (EMG.LN) and New York's Millennium Capital Management. GLG Partners Inc. (GLG), another industry mammoth, has said it is looking for purchases, while banks including Goldman Sachs Group Inc. (GS) and Morgan Stanley (MS) are amassing stables of hedge fund managers by taking minority stakes.

Analysts say the timing is right for more deals - though it's not clear yet if the consolidation trend could result in longer-term negatives for the industry, such as lower returns as fewer independent managers compete to attract investor cash.

The benefits of being part of a larger organization have become obvious to hedge fund managers in current markets. Even $1 billion-plus firms have seen their assets quickly shrink from market losses or investor redemptions. Being acquired is also a way to reach new investors, and to put a value on businesses that may be owned by just a few founders and traders.

"These deals show investors that a firm is stable and doing well. It can also be a way for a manager to get to the next level in terms of critical mass and improving their brand recognition," said Steven Nadel, a partner in law firm Seward & Kissel's investment management group, which advised New York-based Claren Road Asset Management on its sale of a minority stake to Goldman Sachs last week.

While the difficult markets have stepped up the pace of deals, the consolidation trend has come about because of the continued growth of the $2 trillion hedge-fund industry. By buying full or partial stakes in managers, banks and asset managers can offer more funds to their institutional clients and wealthy individuals. They also get a share of the high fees hedge funds earn.

"By partnering with these companies, we participate in the growth of the businesses to benefit Morgan Stanley's shareholders, while providing our clients access to their proven investment expertise," said Stu Bohart, co-head of Morgan Stanley Investment Management, which last week took a minority stake in London commodities managers Hawker Capital, adding to holdings that include full-ownership of FrontPoint Partners LLC and a partial stake in Lansdowne Partners.

Being large or backed by a high-profile partner gives firms an edge with investors new to the hedge-fund industry, since initial investments are frequently allocated to the biggest operators and their "institutional-strength" risk systems and infrastructure.

A recent report from SEI Investments Co. found that infrastructure has become the number one factor for U.S. institutional investors in choosing a hedge fund manager, with performance ranking a distant second.

Jacob Schmidt, chief executive officer of investment consultant Schmidt Research Partners, said consolidation comes with its own issues, though, such as the challenges of integrating teams.

"If you are used to running your own show for two or three years and then you have to report to someone, it can be not that pleasant," he said.

Examples of acquisitions that will be folded into broader businesses include Man Group's 50% purchase last week of New York credit specialist Ore Hill Partners LLC and Millennium Management's March buy of London's Castlegrove Capital Management Ltd.

Banks taking minority stakes typically leave hedge funds to operate independently.

Another possible drawback of consolidation could prove to be lower returns, if investment processes become too standardized within firms, or managers are discouraged from taking sufficient risk. Several academic papers have found that younger hedge funds perform better than established operators, probably because they are often putting new ideas into practice and because partners have much of their own net worth on the line.

Yet GLG Partners and Man Group - two of the world's largest hedge fund operators with $24.6 billion and $75 billion, respectively, under management - have continued to post strong performance as they've grown larger.

"Where consolidation really helps funds is with their bankers, who are more likely to keep doing business in tough times with the largest funds," said Patrick Brennan, portfolio manager on NewFinance Capital's Opus Credit fund of hedge funds.

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