Hedge funds in trouble

# The incredible shrinking funds

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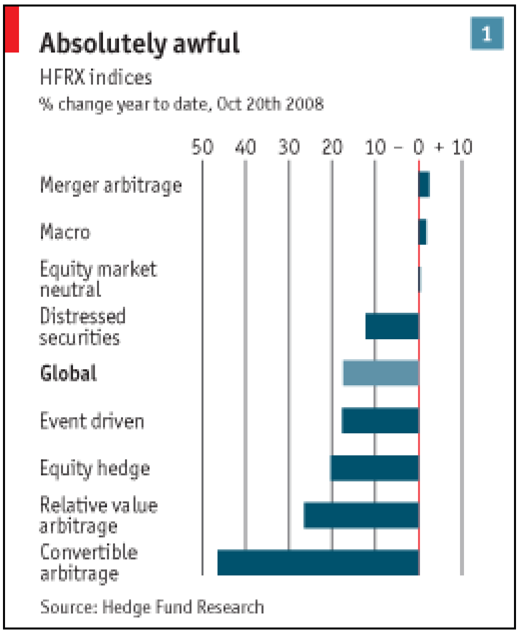
High borrowing and the credit crisis are bad enough for hedge funds. Panicky clients are worse

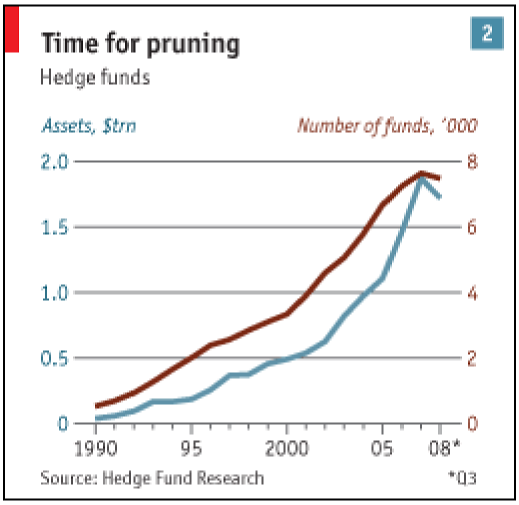
ON THE trading floor of one of London's big hedge funds, the banks of Bloomberg screens still flicker with life but the traders are almost silent. "None of us can quite believe what we are seeing," says a senior manager. A year ago hedge funds were the omnipotent vanguard of financial capitalism. They were uncompromising in their search for returns, and they dominated trading activity in most securities. But the industry has been humbled.




The typical fund has fallen by almost a fifth so far this year, according to Hedge Fund Research (HFR), an analysis firm (see chart 1). "Convertible arbitrage" funds—which try to exploit price anomalies among corporate bonds—have lost a staggering 46%. By some margin 2008 has been hedge funds' worst year since HFR began compiling records in 1990.

The carnage is indiscriminate. In Asia as well as London and America, hedge funds are closing some or even all of their operations. Few strategies have worked well. Ken Griffin, the boss of Citadel, a fund based in Chicago and known for its quantitative trading techniques, told investors that September was "the single worst month, by far" in its history. Even David Einhorn, an American short-seller who bet successfully on Lehman Brothers' demise, has lost plenty.

Over the next few quarters the fallout is likely to be brutal. Between 1990 and last year the industry's assets under management grew almost 50-fold, to nearly $2 trillion (see chart 2). Now industry executives predict that assets could fall by 30-40%, as clients stampede for the exit. The number of funds, which climbed to over 7,000 as a generation of financiers headed for the gold-paved streets of Mayfair in London and Greenwich, Connecticut, could fall by half.




It wasn't supposed to be like this. After all, most hedge funds pride themselves on providing clients with positive "absolute returns"—ie, on turning a profit whatever the financial weather. Until now that promise had been largely met. In 1998, the year that Long-Term Capital Management (LTCM), a giant hedge fund, collapsed, the industry still managed a small positive return. During the previous big financial bust of 2001 and 2002, when American shares fell by over one-third, the average hedge fund was roughly flat.

This time, however, it really is different. Bans on short-selling have made many strategies unworkable. Poor management by hedge funds may be partly to blame: the industry has more than its fair share of illiquid assets that have been hammered during the crisis. But it also appears that forced sales of assets by hedge funds have driven prices lower, in turn hurting performance—a typical case of contagion. The 30 core American equity holdings of the biggest hedge funds, tracked by analysts at Merrill Lynch, have underperformed the stockmarket since the end of August.

What is the cause of the fire sales that seem to be at the root of the industry's problems? The obvious answer is a withdrawal of credit, which has in turn forced hedge funds to offload assets. Sceptics have long argued that for all the skill they claim to possess, hedge funds just use cheap money to amplify mediocre returns. By this account they are simply another part of a vast, debt-dependent ecosystem that is now being starved of oxygen. Yet the role leverage has played in bringing the industry to its knees is subtler than this. And there is another prime suspect for hedge funds' suffering: their own clients.

Sweeping generalisations about the degree of leverage among hedge funds are misleading, because funds come in many different types. The term "hedged fund" was coined by Alfred Winslow Jones, who in 1949 launched a vehicle that simultaneously bought and sold short shares, thus reducing sensitivity to overall movements in the market. Since then many varieties have sprung up, from the global macro funds most fashionable in the 1980s and 1990s, which bet on the fortunes of countries and currencies, to funds which try to exploit tiny differences in the prices of bonds and derivatives.

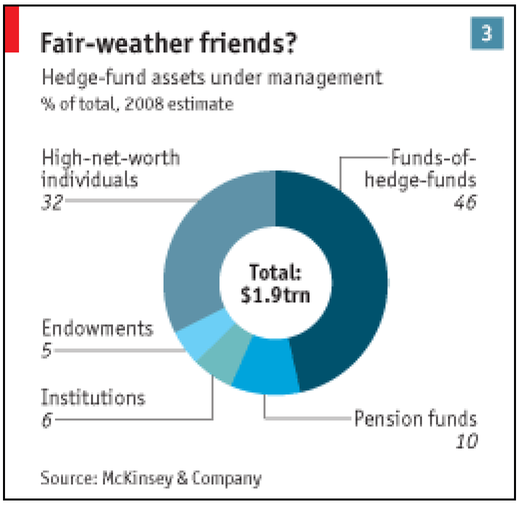
## Leverage: the long and the short of it

Hedge funds today do have some things in common: performance-related fees; light regulation; client lists replete with institutions and rich individuals; and a symbiotic relationship with prime brokers at investment banks, who provide them with credit, execute trades and help administer their funds (see article). But high leverage is not the unifying factor many believe it to be.

According to one prime broker's estimate, the industry as a whole has a ratio of assets to equity of about 1.3, against 1.8 a year ago. The assets themselves often contain further embedded leverage, through, for example, derivatives. A study by McKinsey, a consultancy, suggests that this might take the industry's leverage today to two or three times equity. By the supercharged standards of contemporary finance, that is not high: most investment banks have been running with ratios of more than 20. Regulators used to worry about the danger hedge funds might pose to their prime brokers. After the failures of Bear Stearns and Lehman Brothers the risk turned out to be the other way round.

The industry's aggregate leverage has undoubtedly caused it trouble. As asset prices have fallen, margin calls have increased, and these may have been met by selling assets. But there does not appear to have been a systematic withdrawal of bank credit from hedge funds. Most prime brokers say they have not tightened lending terms overall. They have got tougher with funds using higher leverage of, say, over five times, to pursue arbitrage strategies, in convertible bonds for example. This selective withdrawal of credit helps explain why such funds have done so badly. But because these funds account for less than a quarter of total assets, it cannot explain the woe of the industry overall.

A fuller explanation must include the increasingly jittery nature of hedge funds' clients. As the industry has grown, its customer base has widened beyond the original core of very wealthy and (reputedly) loyal individuals. Institutions have put money into hedge funds in the hope of improving risk-adjusted returns. And funds-of-hedge-funds, which act as intermediaries for private banks, some institutions and individuals who are merely affluent, have become hugely important. They supply more than 40% of industry assets under management, compared with only 5% in 1990 (see chart 3).




Even if institutions want to buy and hold their positions, some are being forced to raise cash. One hedge-fund manager says that pension funds have onerous commitments to private equity, which they are meeting by selling out of hedge funds. And there is a widespread feeling that money originated through funds-of-hedge-funds is liable to get jumpy at any hint of trouble and skedaddle if losses are made. One fund-of-funds manager says he rushes to be the first out if he suspects that others may desert a hedge fund. Some also argue that the behaviour of the individuals who invest through funds-of-funds most closely resembles that of mutual-fund investors, traditionally viewed as finance's headless chickens.

Despite the fidgetiness of their new clients, few hedge funds have locked in their money for long periods. Most funds allow redemptions each quarter: only those with the strongest records, such as TCI, an activist firm in London, can lock money in for several years. Funds-of-hedge-funds have marketed themselves as providing monthly liquidity, a claim that holds true only if clients don't all test it at once. The result is eerily similar to the plight of those banks that relied too much on fickle wholesale funding. If investors ask for their money back, funds often have to sell out of illiquid positions to raise cash, which may force prices down. In September clients withdrew a record $40 billion from hedge funds, according to analysis by TrimTabs, a research firm.

Fear of redemptions is just as damaging as the fact of them: if managers worry that clients will bail out, they may try to raise cash in anticipation. Merrill Lynch estimates that between July and August alone, the industry's cash holdings rose from $156 billion to a record $184 billion, equivalent to 11% of assets under management. Since then the vicious cycle of forced sales to fund anticipated or actual redemptions has only intensified.

## Survival of the biggest

Admittedly, hedge funds have been through difficult times before. The last full year of net redemptions in recent memory was 1994, when 1% of clients' money was pulled out of hedge funds. By the following year the industry was growing again. But last month alone 2% of money was withdrawn. And the omens from the last real bear market for hedge funds, 40 years ago, are far less encouraging. Between the end of 1968 and September 1970, the assets of America's top 28 hedge funds dropped by two-thirds, according to Sebastian Mallaby, an author (and a former *Economist* journalist). Eventually luminaries such as George Soros and Michael Steinhardt emerged from the ruins, but for the industry it was a long, hard slog.

That is exactly what is in prospect again. Unless performance recovers sharply and soon, clients will continue to walk away. And even if returns do pick up, it will be a while before managers make much money, because most funds have "high-water mark" structures. These demand that big losses be recovered before performance fees can be charged again. That will be hardest for smaller funds, which have higher fixed costs relative to their assets, and which some clients already worry have poor risk controls. Firms with less than $500m under management account for about three-quarters of the world's 7,000-odd hedge funds, although they manage less than a tenth of the industry's assets. The outlook for start-ups without records is particularly bleak.

The death of many of the industry's tiddlers will compound a trend that started in 2006, of clients consolidating their hedge-fund holdings with a few big managers. Those firms are working hard to strip down their cost bases by shedding employees and minimising the risk of trading blow-ups over the next year. Their main ambition for the time being is to be still standing when the dust settles.

What kind of world the survivors will face depends to some extent on politics and regulation. As lightly regulated private entities with lots of rich clients, hedge funds make easy political targets, and a direct attack on them remains possible: Italy's finance minister has called them "absolutely crazy bodies" which "have nothing to do with capitalism".

Still, by any sober assessment hedge funds rank fairly low on the list of institutions that have posed a threat to the system in the past year. Nevertheless, the indirect effects of government action could make life difficult. Even if short-sale bans go, hedge funds will now think twice before betting against the shares of important industries. And if, as seems likely, bank-solvency rules are redesigned, capital charges for prime-broking operations could yet rise, causing a contraction in lending to hedge funds. At the very least, financing the most leveraged arbitrage strategies will be much harder.

Yet an even greater unknown for the industry is its customers' reaction to a year of abysmal performance. Certainly hedge funds have, just, outperformed a weighted basket of stocks, bonds and commodities—which has fallen by 22%, according to Gavyn Davies, the co-founder of Fulcrum, an asset-management firm. But relative outperformance was never the stated objective of the industry.

Instead it made clients a different promise. The simple version of this was that hedge funds would produce consistent absolute returns whatever the condition of financial markets. That claim has been sunk. The more sophisticated expression of the promise was that hedge funds could produce "alpha" or returns that were attributable to skill rather than market risk. Alpha has always been a slippery concept: in theory there should not be much of it about and academics have struggled to find evidence that the industry consistently realises it for clients. That is one reason why fees were under pressure even before the crisis. Having compared actual industry performance with models that "clone" the risk profile of leading funds-of-funds, Narayan Naik, a professor at the London Business School, thinks the industry has failed to create alpha since the subprime crisis began in August 2007, despite outperforming many asset classes.

That could change, says Mr Naik. After the collapse of LTCM, and amid the chaos and opportunities that it created, hedge funds did clearly produce alpha for two years. The dislocation this time round, particularly for the prices of less liquid assets, is far more severe. The dramatic reduction in the number of hedge funds should make trades less "crowded". Other market participants, such as the proprietary trading desks of banks, may withdraw, further thinning the ranks of the competition. Some of the hot money that poured out of hedge funds could easily return at the first sign of stability.

Yet if the surviving firms are to prosper in the long term, and maintain their lucrative fees, the industry will have to address the structural inadequacies exposed so cruelly by the crisis. These have made its performance highly vulnerable to financial contagion. It will have to diversify its funding away from short-term loans from investment banks. Most important, it will have to wean its clients off the notion that they can both enjoy excess returns and be free to withdraw their money at will. Hedge funds have not proven to be the systemic threat that many feared, but they have not had a good credit crisis. After all, about the most hollow achievement in finance is this: to provide absolute returns—but only when markets are going up.