

Hedge Funds – Things You Should Know

Over the last decade, hedge Funds have become an increasingly popular investment vehicle and an integral part of financial markets. Their diversified investment strategies and low correlation to traditional asset classes allowed them to be marketed as an “alternative” asset class for retail and institutional investors. The hedge fund industry has become big business in terms of assets under management and its influence on financial markets. It is estimated that industry assets under management “were” approaching U\$1.7 trillion globally.

Recently, hedge funds have generated a lot of negative press and redemptions as a result. At the beginning of August two high profile Bear Stearns funds that were exposed to subprime mortgages filed for bankruptcy protection. In another instance, Sowood Capital Management LP wound up its \$3 billion dollar fund after failing to meet lenders’ demand for collateral with client losses totalling \$1.4 billion. Last week, Goldman Sachs announced they would inject \$3 billion into one of Goldman’s own hedge funds days before the end of its quarterly redemption period.

Given the opportunity, jittery investors are headed for the exits leading to potentially massive redemptions and liquidation of levered portfolios. Large financial institutions which have loaned money to these funds are also placing pressure on them as banks scramble to reduce risk.

Over the last few years hedge funds have benefited immensely from attractive financing terms and substantial leverage. However, the party appears to be over and the unwinding of their leveraged positions into what is an illiquid market is contributing to volatility. Does a collapse of the hedge fund industry have the potential to create systemic risk in financial markets? Before we answer that question, let’s take a step back and look at:

- What exactly is a hedge fund?
- What strategies do they employ?
- What benefits and risks do they provide to financial markets?

What are hedge funds?

- Hedge funds are aggressively managed portfolios of investments that use advanced investment strategies.
- Hedge funds can take both long and short positions in stocks, bonds, commodities, futures, swaps and other derivative instruments.
- They are similar to mutual funds in that investments are pooled and professionally managed, however they employ more diversified investment strategies and offer even less transparency.
- Unlike mutual funds, hedge funds are not required to register with the Securities and Exchange Commission (SEC). Hedge funds typically issue securities in “private offerings” that are not registered with the SEC under the Securities Act of 1933. In addition, hedge funds are not required to make periodic reports under the Securities Exchange Act of 1934.
- Legally they are set up as private investment partnerships with a limited number of investors that typically include sophisticated wealthy individuals and financial institutions such as pension funds and insurance companies.

Equity Report

- They use leverage or debt to invest, and the positions they take in the financial markets is often much larger than their assets under management.
- Compensation packages for fund managers are largely tied to the funds performance and can be very lucrative often leading managers to take extraordinary risks.

Investment Strategies

Strategies employed by hedge funds vary enormously. Here are a few of them:

- **Distressed securities:** a fund buys equity or debt at deep discounts of companies in or facing bankruptcy or reorganization. Many institutional investors can not own non-investment grade debt and the selling pressure causes the price to overshoot on the downside creating an investment opportunity for hedge funds.
- **Market Neutral Arbitrage:** a fund attempts to hedge away most market risk by taking offsetting positions, often in different securities of the same issuer. By way of example, going long convertible bonds and shorting the underlying equity of the same issuer.
- **Short Selling:** a fund sells securities short in anticipation of being able to repurchase them at a future date at a lower price. The hedge fund manager believes the securities or the market are overvalued.
- **Quant Fund:** a fund selects securities based on quantitative analysis. Computer-based models determine whether or not an investment is attractive and make the final decision to buy or sell.
- There are many other strategies.

Hedge Funds are Big Business

- Globally hedge funds manage an estimated US\$1.7 trillion with market exposure being multiples of that with the use of leverage.
- In the U.S., they account for approximately 5% of investable assets.
- According to Greenwich Associates, "In several individual products, hedge funds provide so much liquidity that one could say that certain markets could not function efficiently without them."
- Hedge funds accounted for 30% of all stock trading volume in the U.S in 2006 and 25% of all U.S. fixed income trading.
- Hedge funds now generate 45% of annual trading volume in emerging market bonds, 47% of annual volume in distressed debt, about one-third in leveraged loans.
- Hedge funds accounted for more than 55% of all credit derivatives trading volume in 2006.
- Credit Suisse estimates that investment banks made \$25 billion in revenue from hedge funds in 2004, \$19 billion of which came from sales and trading and the rest from prime brokerage. Those numbers have grown over the past two years.

Hedge funds provide benefits to financial markets including:

- Improved liquidity
- Price discovery via arbitrage
- Diversity of opinion
- Diversification opportunities for investors.

Risks to Financial Markets

- The U.S. hedge fund industry is not regulated by the SEC. The discipline provided by creditors, counterparties, and investors is the primary mechanism for regulating excessive leverage.
- As noted above, hedge funds are major players in global financial markets often employing significant leverage. Leverage has the potential to create systemic risk in financial markets as leveraged investors are more vulnerable to market shocks. Forced liquidation by large hedge funds due to portfolio losses, redemptions, or funding issues has the potential to cause heavy losses for counterparties that could ultimately threaten important financial institutions.
- The U.S. Federal Reserve has concerns about counterparty risk management. Hedge funds have greatly expanded their activities and strategies and interactions with counterparties and creditors have also become increasingly complex. Specific concerns: 1) the hedge fund business is big business for financial institutions and increasing competition for hedge funds has eroded initial margin levels; 2) have counterparty exposures to increasingly complex transactions been accurately measured by counterparties; 3) the lack of transparency offered by hedge funds. Information about what exactly is in their portfolios and how much leverage is being used is limited.

So in the eyes of the U.S. Federal Reserve, massive liquidation by hedge funds into what are illiquid markets has the potential to create shocks within the financial system. We believe that it is fair to assume, given the hedge fund industry's significant involvement in credit markets, they are playing a role in the current credit crunch. Our expectations for ongoing liquidation suggests volatility in credit and equity markets will likely persist in the weeks ahead, get ready for it.

- Paul Danesi, CIM - Director, Portfolio Advisory Group